THE POLITICAL ECONOMY OF

TRADE, FINANCE, AND THE EXCHANGE RATE

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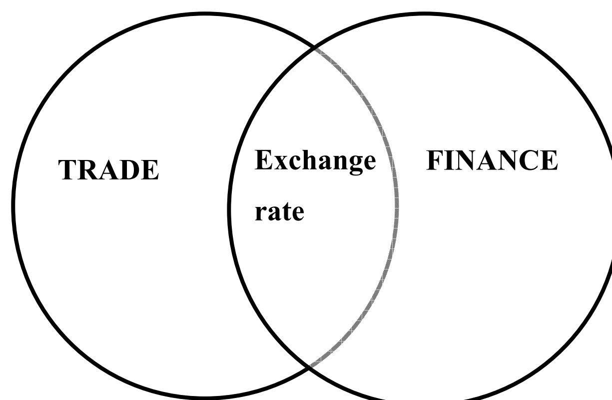
Since the Breton Woods agreements trade policy and international policy finance are separated partners. IMF and World Bank take care of finance policy; WTO, from trade negotiations. Why such separation despite the fact that trade and finance are intimately linked? The fact that finance is required to finance trade is not the only link: the central link is defined by the exchange rate. This separation is also present in the academic disciplines: Trade theory deals with tariffs, while international finance and macroeconomics take charge of exchange rates. Following the logic of the global governance system, trade is supposed to be negotiated at WTO, while the exchange rate should not be negotiated since it would be an endogenous macroeconomic price that is part of an optimum macroeconomic policy that IMF is supposed to know. Yet, as the figure illustrates, there is a major intersection between trade policy and financial policy: the exchange rate. This intersection is so important that it makes little sense to negotiate tariffs without assuming stable exchange rates. If, for instance, a country's currency depreciates 20% in relation to another, this is the same that to impose a tariff of 20% on imports.



Trade and finance

The separation between trade and finance exists essentially because the global economic architecture is defined by the rich countries, and it is not on the interest of the rich countries to include exchange rate in the trade discussions. They know how strategic this macroeconomic price is. Besides, they suspect that exists a chronic tendency to the over-appreciation of developing countries' currencies that would justify, as a trade-off, higher tariff protection. On the other hand, it is on the interest of rich countries to relate positively finance with economic development.

The interest of countries is to have a competitive or equilibrium exchange rate instead of an over-valued one, and, contrarily to conventional wisdom, a positive relation between international finance and economic growth is the exception, not the rule.

Economists usually define the equilibrium exchange rate as the one that equilibrates intertemporally the current account. Yet, an additional and necessary condition is that tradable industries using technology in the state of the art are profitable or competitive at such rate. In rich countries these two conditions are normally present. Not in developing ones, in which there is a tendency to the over-appreciation of the exchange rate. That tendency has four major causes. Three of them (the attraction that higher interests and expected rates of profit exert on foreign investors, the growth *cum* foreign savings policy recommended by rich countries and by the two international financial institutions, and exchange rate populism) are inter-related and make the exchange rate more appreciate than the one that balances intertemporally the current account. The three involve the increase of capital inflows that appreciates the exchange rate. The first is a purely economic variable, the second a policy variable, and the third, the perverse attitude of many politicians in developing countries to use an exchange rate anchor to control inflation, increase wages and consumption, and facilitate their reelection if the inevitable balance of payment crisis does not come before. The interesting thing on this is that IMF, by adopting the US Treasury's policy of growth *cum* foreign savings in the 1990s, became coalescent with exchange rate populism despite criticizing so insistently fiscal populism. The only difference between them is that in fiscal populism is the state that expends more than it gets, while in exchange rate populism is the nation that does that.

The fourth and more important cause of the tendency to the over-appreciation of the exchange rate in developing countries is the Dutch disease. The commodities benefited by

ricardian rents press down in such extent as to cause that the exchange rate that balances the current account becomes more appreciated than the one that makes viable or profitable other tradable industries using technology in the state of the art.

Given this tendency, the only way to achieve a competitive exchange rate today is by managing it –in the context of a floating exchange rate. Yet, rich countries oppose strongly such management. Since the major rich countries have their currencies as international reserve currency, they cannot manage them; if they do, they would loose trust – and trust is everything for a reserve currency. Thus, they reject that developing countries manage their own currencies to neutralize the over-appreciation tendency. First, they reject the possibility of exchange rate management: the long term exchange rate would be a fully endogenous price. Second, they charge the developing countries that do manage their currencies, of creating a "beggar-thy-neighbor" situation: exchange rate management would imply gains for the managing country at the expenses of the other countries. Third, they call depreciatively the management of floating exchange rate 'dirty' float. Finally, they do not hesitate listing the 'evils' of a devalued exchange rate: higher inflation, lower wages, increased costs of servicing the debt, etc. Among all these arguments, the only serious one is or could be beggar-thy-neighbor indictment. Yet, such charge would make sense if developing countries were involved in retaliatory devaluations. That is not the case. What they are doing is just neutralizing the over-appreciation of their currencies.

In the global economic system, commercial globalization represents a major opportunity to developing countries. What is not on their interest is financial liberalization. Yet, rich countries are permanently pressing middle and poor developing countries to practice financial and trade liberalization. Middle income countries resisting financial liberalization is understandable. Yet, given the fact that these countries don't have anymore infant industries that require protection and have cheap labor that give them an advantage in international trade, it is not so easy to comprehend why they also resist trade liberalization. The only explanation is that they react to trade liberalization because their exchange rate is over-appreciated, or, in other words, because they are unable to neutralize the tendency to its over-appreciation. When they are able to do that, as it is, for instance, the case of the Asian dynamic countries, they dispense tariff protection, and take full advantage of commercial globalization.

Development and finance

I hope that it is now clear why rich countries refuse to discuss trade and finance together. Yet, they insist in linking development and finance. According to their economists, foreign finance or external savings would be essential to economic development. Why? Rich countries and conventional economics do not bother to explain why since it would be self-evident – an assumption, a 'basic truth' not requiring further argument: "it is natural that the capital rich countries should transfer their capitals to capital poor countries".

Yet, this assumption is similar as to affirm that the land is flat.. Actually, international 'development finance' and the growth *cum* foreign savings policy are on the interest of the rich, not on the developing countries. Rich countries benefit from the interests received, and their financial agents are ready to ignore prudent lending practices. Currency appreciation reduces the competitiveness of middle income developing countries – what is welcome by its rich competitors. Finally, developing countries that accept the growth *cum* foreign savings policy turn more dependent on their creditors, whose power in this way increased.

The growth *cum* foreign savings policy is not on the interest of developing countries Actually, current account deficits (another name for foreign savings) are usually detrimental to the financed countries. The negative consequences go from the worse one – balance of payment crisis – to other two equally damaging: on one side, financial fragility, financial dependence, and confidence building policy, and, on the other, over-apreciation of the local currency, artificially increased wages and domestic consumption, and high substitution of foreign for domestic savings. The exceptional case in which foreign savings cause growth, instead of impeding it, is when the country is already growing rapidly, profit expectations are high, and increase in wages are directed toward investment instead of consumption.

Policy conclusions

Which are the policy conclusions for developing countries from this analysis?

- First, keep fiscal accounts balanced. A capable state is a non indebted state.
- Second, keep current account balanced or run surpluses. Do not engage in new debt, and gradually pay old debt if this is possible, or, in other words, if debt renegotiation is not a must. A strong nation is a non-indebted nation.

- Third, create your own national or regional banks to finance investment: business enterprises need long term finance, countries do not.
- Fourth, manage your exchange rate, resorting, if necessary, to controlling capital inflows so to avoid overvaluation of your currency. If the case is of Dutch disease, do not hesitate in taxing or charging royalties on the respective commodities: The exchange rate is not fully endogenous. The over-appreciation of the local currencies is a permanent threat that must be neutralized.
- Fifth, do not be afraid of economic nationalism. Do not accept the confusion between nationalism and populism. Be as nationalist as the rich nations are.

BRESSER-PEREIRA'S RELATED PAPERS

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