New developmentalism and structuralist development macroeconomics

Florence, October 7, 2010

Developmentalism

- Is the ideology of economic development or of increased material well-being.
- (as liberalism is of liberty, socialism, of equality, and ambientalism, of protection of nature).
- It correspond to “structuralist development economics” – a theory that does not see growth just as consequence of free markets but of political design.

New developmentalism

- is the national development strategy that successful middle income countries are adopting today to catch up;

- is an alternative to conventional orthodoxy or the Washington consensus, based on neoclassical economics

- It is based on structuralist development macroeconomics (that is being developed)

Three types of countries
in terms of their capitalist revolutions

- –Rich countries – completed long time ago their capitalist revolution
- <u>–Middle income countries</u> – completed it recently
- –Poor countries – are in process of realizing it

A capitalist revolution may be viewed as "completed" when

-its nation-state is formed and is effectively autonomous

-its industrial revolution have been reasonably completed;

-the survival of business enterprises depend on capital accumulation and technical progress;

-the appropriation of economic surplus ceases to be done through the state and is done through the market;

-there is sizeable capitalist class, a waged working class, and a growing professional middle class

Why, in globalization, new developmentalism?

- In globalization, nation states became more interdependent and, so, less autonomous.
- But, in so far as
- this interdependence draws from increased competition among nation-states,
- and “soft power imperialism” is alive,
- nation-states became more strategic, and require a national development strategy to compete.

A national development strategy

- is a international competition strategy.
- Is a sum of laws, policies, common understandings, common objectives oriented to economic growth.
- Is a sum of institutions creating investment opportunities.

The key development institution

- is not the protection of property rights and contracts (as affirms Douglas North and the neoliberal vulgate)
- But a national development strategy.

Entrepreneurs want security, but they are ready to assume institutional risks if they have opportunity to innovate and invest.

Structuralist development macroeconomics

- – is behind new developmentalism

- Is the development macroeconomics that was lacking in
- –development economics (the economics of the “pioneers of development”)
- –and in the Latin American version of it: Eclac’s structuralist approach.

SDM is demand sided

- It acknowledges that supply side policies required for growth (as education, health care, infrastructure, and good institutions)

- but asserts that the crucial bottlenecks are in the demand side – in the investment opportunities side.

There is a simple chain behind economic growth

- Growth depends on investments
- that depend on profit opportunities (not on savings)
- that depend on the existence of domestic and international demand.

- The problem: there are structural obstacles – two structural tendencies – for a sustained demand.

Two structural tendencies

- (pushing down aggregate demand and limiting investment opportunities)
- 1rst. The tendency of wages to grow below the rate of increase of the productivity rate
- – it depress domestic demand
- It is based on the unlimited supply of labor model (Arthur Lewis' classical model).
- It is an obvious and well discussed problem that, among others, Celso Furtado analyzed. I will not discuss it.

2nd. The tendency to the cyclical appreciation of the exchange rate

- – it depress demand in so far as an overappreciated currency disconnects efficient business enterprises from world demand.

- Note that the exchange rate
- –is not just a macroeconomic price affecting imports and exports
- –it affects real wages, inflation, consumption, expected profit rates, investments, savings

- It is a "forbidden price" that rich countries and conventional economists hate to discuss.

Note that, within the Euro area,

- you may believe that you don't need to worry in relation to the exchange rate,
- but this is wrong.
- Whenever in a country wages increase more or the productivity, less, than in the other countries (in Germany, for example), the money of this country is getting overappreciated,
- and, so, its business enterprises producing tradable goods are being expelled from the market.

The evils of a chronically overappreciated exchange rate:

- First, <u>apparent</u> benefices
- -increases artificially real wages
- -increases artificially consumption
- -reduces inflation in a non sustained way.

- Second, <u>obvious</u> problems
- -reduces exports and increases imports,
- thus leading the country to foreign indebtedness, financial fragility, and, eventually, currency crisis.

Third, less obvious consequences:

- Only in the short-short term,
- it expands investments due to
- -the fall in the prices of imported machines, -and the increase in domestic consumption

- In the short and medium term,
- -reduces export opportunities,
- -reduces export oriented investments,
- -reduce savings, reduces growth.

Causes of the tendency to the cyclical overappreciation of the exchange rate (in developing countries)

- 1. large (und unnecessary) capital inflows,
-   that are perversely justified with
- a. the growth cum "<u>foreign savings</u>" policy
- b. exchange rate <u>anchors</u> to control inflation thus achieving inflation targets
- c. "capital deepening" or making interest rates higher
- 2. Exchange rate <u>populism</u> (as it reduces inflation and increases real wages).
- 3. the Dutch disease.

Critique of “foreign savings”’, and unwanted capital inflows

- “Growth with foreign savings” (current account deficits) is the key strategy that rich countries recommend.
- Most developing countries accept this recommendation as “evident truth”.
- Note that “foreign savings” is synonym of current account deficits.

In fact, growth with "foreign savings"

- does not cause increase the investment rate but in consumption.
- Thus, it does not cause growth.
- The capital inflows required to finance the current account deficits ("foreign savings"):
- -appreciate the national currency,
- -reduce export opportunities
- thus, involving a high rate of substitution of foreign for domestic savings

Conventional economics additionally supports capital inflows

- in order to control inflation .

- Inflation targeting schemes are usually “successful” in so far as they use exchange rate anchors.

Also populist politicians

- Use foreign finance and the consequent capital inflows
- to appreciate the currency,
- increase artificially wages,
- And get reelected (if the currency crisis does not happen before elections).

- Thus, conventional economics and populist politicians are hand in hand.

Dutch disesease Concept

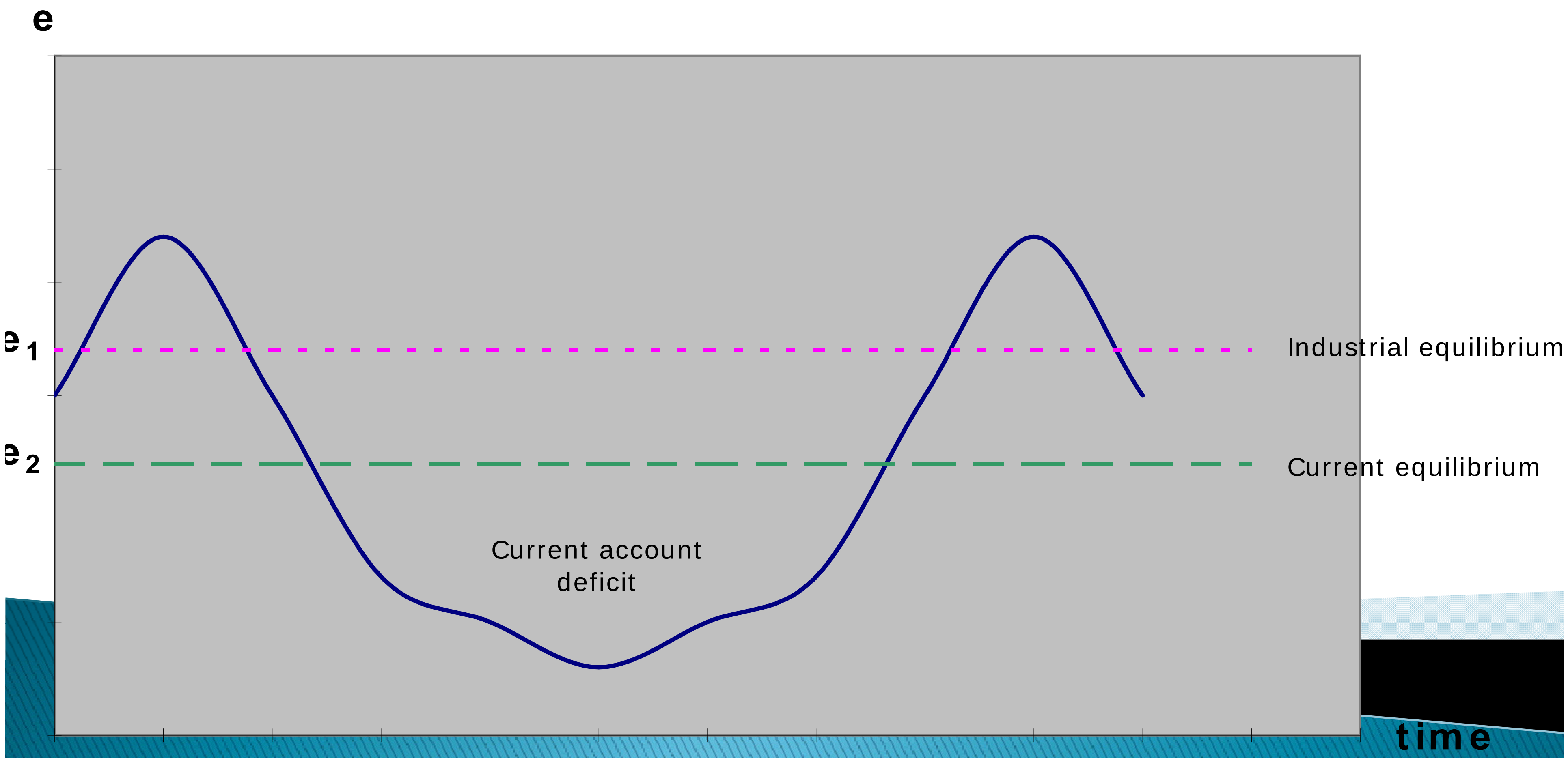
- The Dutch disease is a major market failure; in the country that suffers it there are two exchange rate equilibriums:
- 1. the "current" or market equilibrium (that balances the current account), and
- 2. the "industrial" equilibrium – the one required to tradable industries using technology in the world state of the art are competitive.

The Dutch disease is caused by Ricardian rents

- that make the commodity utilizing abundant and cheap natural resources viable with the "current equilibrium" .

- It is a major market failure because, in so far as this exchange rate is consistent with the intertemporal equilibrium of the current account, the country is permanently condemned to underdevelopment if it does not actively <u>neutralize</u> the disease.

DH-Equilíbrio Corrente e Industrial

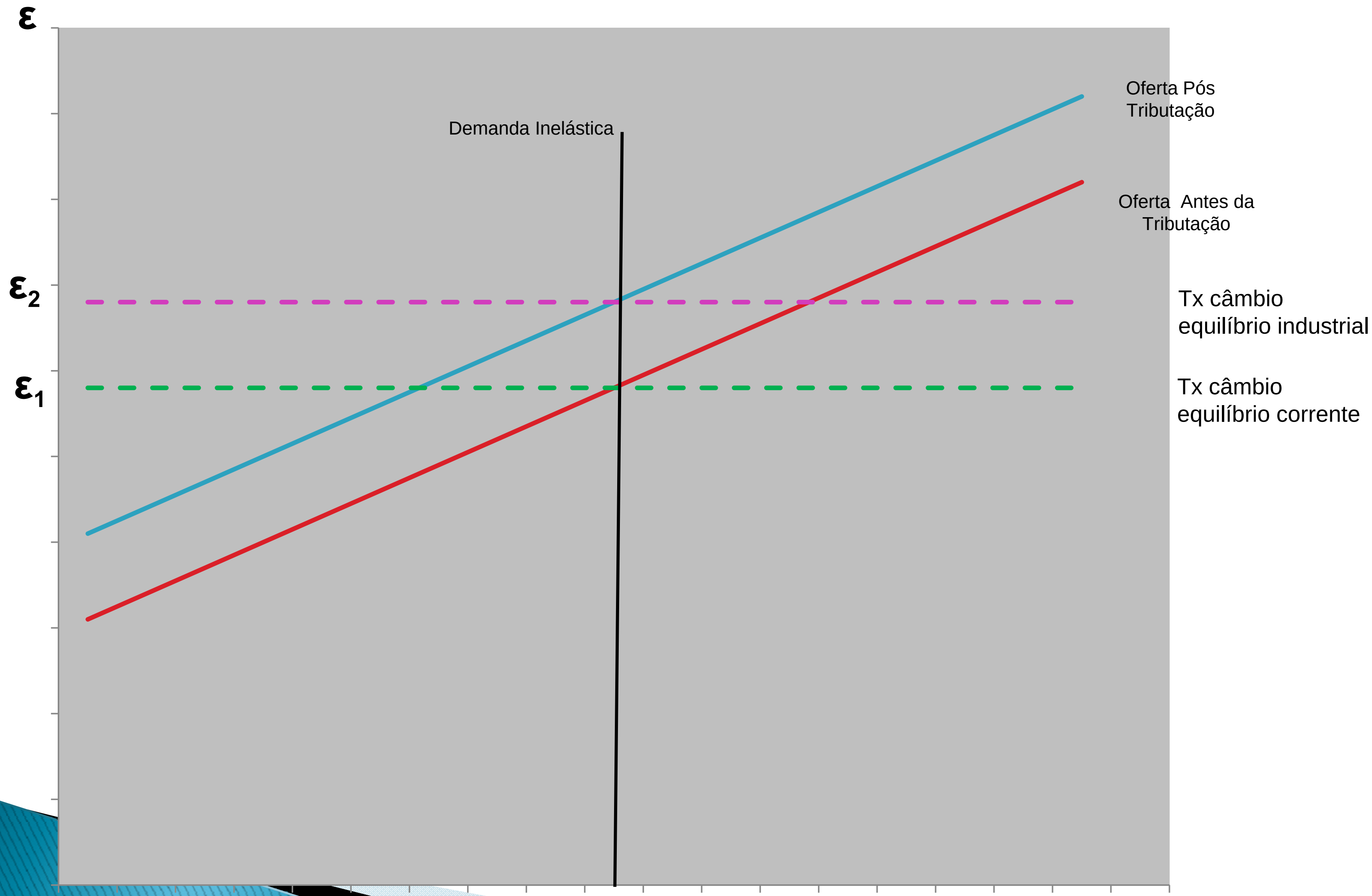


Neutralization of the Dutch disease requires

- 1. the imposition of an export tax on the commodities that originate it (because it shifts up the supply curve of the good in relation to the exchange rate)
- 2. the creation of a sovereign fund to invest the result of the tax

- Once this is done, it follows:
- 1. current account surplus;
- 2. budget surplus

Efeito de imposto de exportação sobre a taxa de câmbio

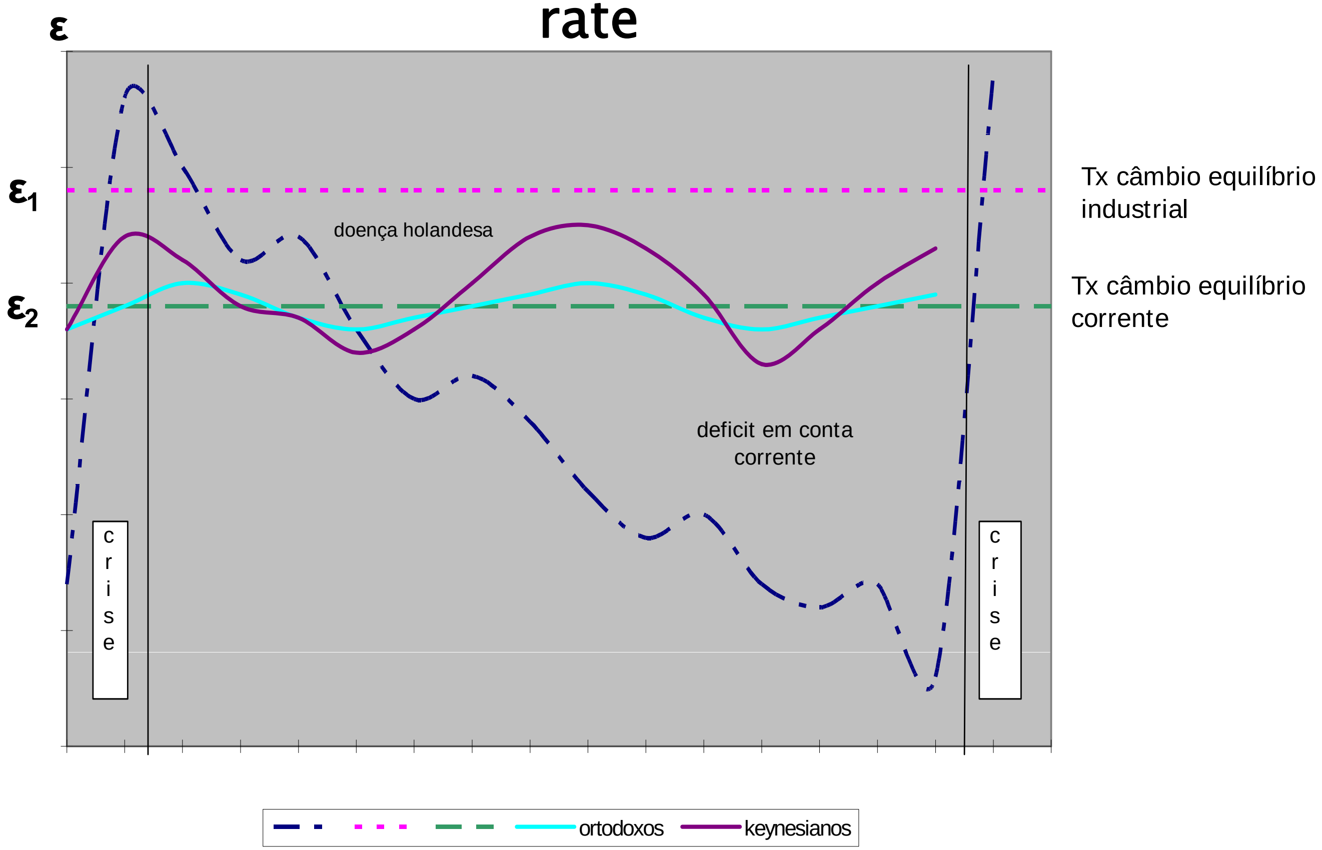


Dado o preço internacional constante e a demanda inelástica em relação à taxa de cambio

Tendency to cyclical overappreciation model in a single graph

- The exchange rate is not controlled by the market but by currency crises
- In the crisis, the currency sharply depreciates
- Then begins the appreciation:
- First, the Dutch disease brings the e.r. to the current equilibrium
- Second capital inflows bring the e.r. below the current equilibrium, into deficit.
- A currency crisis closes the cycle.

Tendency to the cyclical overvaluation of the exchange rate



Comparing new developmentalism with conventional orthodoxy

New developmentalism	Conventional economic policy
Low interest rates	High interest rates to attract foreign capitals and control inflation
Exchange rate responsibility: growth with domestic savings, control of capital inflows, and neutralization of the Dutch disease	Exchange rate populism: high current account deficits and no capital controls to control inflation ad grow with “foreign savings”.
Fiscal responsibility (to keep public debt below 1/3 of GDP)	Fiscal responsibility (although inconsistent with current account deficits)
Minimum wage policy and social expenditures to keep domestic demand.	No minimum wages policy. To reduce public expenditures and the tax burden.
Strategic role for the state in the supply and in the demand side.	No economic role for the state except controlling inflation.

Asian countries and the others

- Dynamic Asian countries adopt new developmentalism and grow fast,
- while the other countries,
- accept conventional economics' recommendations
- and fall behind.

These ideas are developed in the book

- Globalization and Competition (Cambridge University Press, 2010)
- Also in Portuguese, French and Spanish.

Dutch disease is a major failure

- Because it is consistent with current account equilibrium.
- Thus,
- -the market does not control it;
- -not even crises, because it does not cause currency or balance of payment crises.

Old and New Developmentalism,

Old developmentalism	New developmentalism
1. Industrialization is state-led and based on import substitution.	1. Export-led industrialization combined with strong domestic market.
2. Leading role for the state in obtaining forced savings and in making investments.	2. The state is supposed to create investment opportunities and reduce economic inequalities.
3. Industrial policy is central.	3. Industrial policy is subsidiary; the essential is a competitive exchange rate.
4. Mixed attitude in relation to budget deficits.	4. Rejection of fiscal deficits. If the country suffers from the Dutch disease, it should have current account and fiscal surplus.
5. Relative complacency towards inflation.	5. No complacency towards inflation.

Macroeconomic Policies Compared

Conventional Orthodoxy	New Developmentalism
7. The central bank has a single mandate target: inflation. Other objectives are to be pursued by the government.	7. The central bank and the government have three mandate targets: inflation, exchange rate, and employment.
8. The primary surplus is the central fiscal standard.	8. The budget deficit and public savings are the central fiscal standards.
9. Fully floating exchange rate; no exchange rate objective, nor related policy.	9. Floating but administered exchange rate; the competitive exchange rate corresponds to "industrial equilibrium" exchange rate.
10. The central bank uses a single instrument: the short-term interest rate; the government keeps public deficit under control.	10. The central bank may also buy reserves, and the government besides controlling the budget may impose controls on capital inflows.

Original Structuralist Theory	Structuralist development macroeconomics
Tend deteriorattion terms of trade	Kept.
Structural character of developm	Kept
Central role of the state	Strategic role of the state
Center-periphery	Kept
Infant industry argument	Superated
Tend wages grow below producty	Kept
Strucutural inflation	Superated
Foreign constraint, or two gaps m.	Abandoned
Added	Competitive exchange rate required
Added	Tendency to the overvaluation of er.
Added	Dutch disease
Added	Growth with domestic savings.
Added	Foreign + budget equilibri required