Why a competitive exchange rate is determinant of economic growth?

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Note on New Developmentalism' concept of competitive exchange rate and the theory explaining why a competitive exchange rate is a condition for growth. Written to be published in my website. EAESP / FGV, November 2019.

When in 2001 I began to develop the theoretical system that is now called New Developmentalism, my basic hypothesis was that a competitive exchange rate is a determinant of investment and therefore of economic growth. I had long said that a "relatively undervalued" exchange rate was essential for development, and my first paper on topic "Economic Growth with Foreign Savings?" (2003), which I wrote with Yoshiaki Nakano, was based on this assumption. Following this line of thought, in the same year I suggested my student Paulo Gala to make a doctoral dissertation on the exchange rate and economic growth (Gala 2006). I was certain that my hypothesis would be confirmed, as indeed it was. Concomitantly, studies were moving in the same direction, showing that a correct exchange rate was essential for development.

In 2008, when I published my basic work on Dutch disease, "The Dutch Disease and Its Neutralization: The Ricardian Approach," I also defined what I mean by a competitive or equilibrium exchange rate. It is the exchange rate that makes companies using the best technology in the world competitive. This rate is, in principle, the "current equilibrium exchange rate". In the market it makes no sense that companies of this quality are not competitive. They will be, will export or face successfully competition from imports, and the equilibrium exchange rate will be one that balances the country's current account intertemporally. However, if the country has the Dutch disease, I have called "industrial equilibrium" the competitive exchange rate - the exchange rate that makes competitive the capable companies. In this case, the country will show a current account surplus since the industrial equilibrium is, by definition, more depreciated than the current equilibrium exchange rate. In short, when there is no Dutch disease the competitive exchange rate is the current equilibrium; when there is, it is the industrial balance. The industrial equilibrium is a theoretical equilibrium defined by companies that use state-of-the-art technology. In the case of current equilibrium state-of-the technology condition is not required: the competitive exchange rate is simply the exchange rate that balances the current account.

Note that this is a new concept in economic theory. It should not be confused with John Williamson's (1994) "fundamental equilibrium exchange rate" - a concept that assumes a "sustainable" current account deficit that will keep the foreign debt / GDP ratio constant. This equilibrium considers both internal and external balance, the first relating to potential output

and inflation, the second to differences in productivity increases between tradable and non-tradable goods. New Developmentalism also has a name for this kind of balance: it calls it “external debt equilibrium”. Such balance is not the competitive equilibrium - the one that is consistent with growth. It corresponds to an appreciated exchange rate that discourage investment and stimulate consumption because, by definition, it is more appreciated than current and even more appreciated than the industrial equilibrium. This fundamental equilibrium interests central countries - the creditors of peripheral countries; it is not on the interest of these countries because current account deficits involves the increase foreign debt - something that New Developmentalism views critically. It only admits it in times of very rapid growth in which the marginal propensity to consume falls while the marginal propensity to invest increases, and thus the rate of substitution of savings. internal by external is low.

Defined what is the competitive exchange rate in these terms we have a question: why is it a determinant of investments? A question whose response may be simply because the new-developmental is the only theory that assumes that the exchange rate tends to be overvalued in the long-term. I only came to answer to this question in the 2012 paper published in *Advanced Studies* journal, "The Exchange Rate at the Center of Development Economics." In it I argued that developmental macroeconomics had placed the exchange rate at the core of development theory for the first time. Earlier the economic schools of thought did not have taken this position. Contrary to the neoclassical claim the exchange rate tended to float nicely around the current equilibrium, the post-Keynesian and the classical-developmentalist schools acknowledge that the exchange rate is volatile being often misaligned. But this volatility would be short-term and always around the equilibrium. Instead, New Developmentalism argues the exchange rate in developing countries undergoes a cycle which begins and ends with a financial crisis, while, in between, the exchange rate remains overvalued and the country will exhibit for several years a current account deficit and an overvalued currency. Given that, the companies will consider this overvalued currency in their investment calculations and will not invest. Or will invest the minimum required to maintain their plants technologically updated.

In other words, if the exchange rate was only volatile, subject to misalignment, as conventional economic theory assumes, it would not have an impact on investment - or rather, as several surveys have shown, it would have a relatively small impact on investment and growth as it would increase the uncertainty of the businessmen in relation to the decision to invest. When, however, the country tends to have current account deficits and will remain appreciated in the long run, the picture changes completely. Now companies, when considering a new investment, will find that they have become economically uncompetitive even though it is technologically and administratively competitive and will not invest.

Thus, the exchange rate is a determinant of private investment in developing countries. It would not be if developing countries did not use high interest rates to attract capitals to finance current account deficits, using as justification that they are adopting the “growth with foreign savings policy”, or that they are using the exchange rate as a nominal anchor against inflation. In this case, the national currency would not remain overvalued in the long-term, and, so, the real exchange rate would be relatively constant, thus not influencing the investment decision. Actually, we have two possibilities: the country has Dutch disease, or not. If not, its exchange

rate will remain appreciated or non-competitive as long as the growth with foreign indebtedness policy is maintained and the country will have to finance the deficit with additional capital inflows that will appreciate the national currency. If it has the disease and does not neutralize it, the exchange rate will be even less competitive, because now the exchange rate that will make competitive the companies producing tradable non-commodity goods and services is not the current equilibrium but the industrial equilibrium exchange rate.

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