

## **New developmentalism: Macroeconomics and political economy for developing countries**

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After showing remarkable development, the Brazilian economy was quasi-stagnant in the 1980s, having gotten caught in the web of high inflation and a massive foreign debt crisis. Since 1994, although these two obstacles have been conquered, the country's growth per capita has been one percent per year, from 4.5 % between 1950 and 1980 – a semi-stagnant situation.

I realized this in the 2000s and wrote a book, *Macroeconomics of Stagnation* (2007), in which I attempted at once to understand the Brazilian economy's poor performance and develop a new theory to explain it. This article is about that theory and how it applies to Brazil.

The 2007 book didn't garner much attention at publication because a commodities boom intervened and the Brazilian economy skyrocketed. But the following years confirmed my diagnosis. I persisted in the construction of the theory and its application to Brazil, and published two books – *Globalization and Competition* (2010) and, together with Nelson Marconi and José Luiz Oreiro, *Developmental Macroeconomics* (2016).

The theory gradually gained shape and a name: new developmentalism. It includes a development macroeconomics and a political economy of developmental capitalism as opposed to two extremes: liberal capitalism and statism.

The macroeconomics innovates in how it addressed the foreign exchange rate and the current-account balance, and because it focuses on the five macroeconomic prices – the interest rate, the exchange rate, the wage rate, the rate of profit, and the inflation rate.

The capitalist state is supposed to guarantee the general conditions of capital investment. For long, they were education, institutions, infrastructure investments, a financial system able to finance investment, and a stable national currency. Keynes, in the 1930s, added sustained demand are essential to the economic development process. I argue that the exchange rate and the current-account balance are a seventh essential condition, and, together with sustained demand, its outcomes are short-term.

Out of all macroeconomic prices, the exchange rate has deserved the least interest from economics. In his *General Theory* (1936), Keynes creates a "closed" economy model with no foreign trade and posits a fixed exchange rate, thereby excluding exchange rate policy from his book. Liberal or neo-classical economists believe that the exchange rate is satisfactorily determined by the market and their only proposal in this regard is free currency exchange.

Classical developmental economists like Arthur Lewis, Albert Hirschman, Raúl Prebisch and Celso Furtado understood the importance of the exchange rate, but instead of arguing for a competitive rate, they proposed a problematic substitute to foster industrialization: high tariffs in manufactured goods imports.

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Many still hold that the exchange rate is only important in determining imports and exports, but it is crucial for inflation as well and, according to new developmentalism, it also determines investment and savings and, therefore, economic development.

An exchange rate appreciated in the long run makes a country's manufacturing firms uncompetitive, discourages investments and thereby becomes an obstacle to growth. In addition, the corresponding current-account deficit ends up leading the country to a balance-of-payments crisis.

Notwithstanding, the overwhelming majority of economists fails to assign due importance to current-account deficits. They are concerned – and rightly so – with the state's fiscal indiscipline as expressed in chronic and high public deficits, but are deeply mistaken to not argue for foreign exchange discipline as well – that is, refraining from high and chronic current-account deficits.

### **Against current-account deficits**

A theory is good when, in addition to being true, it is also counter-intuitive.

To replicate common wisdom is not good science. The new developmental macroeconomics starts out from a counter-intuitive principle: middle-income countries like Brazil do not need foreign capital. Current-account deficits, which are necessarily financed by foreign funds, hamper economic development rather than fostering it. The notion that capital-poor countries must attract capital from rich ones appears true, but is misguided.

The argument for taking on foreign debt is that a current-account deficit represents “foreign savings”, which add to domestic savings and increase the investment rate. This, however, is an accountant's reasoning, not an economist's. An economist thinks in terms of cause and effect, not in terms of identities.

When a country moves from equilibrium to a current-account deficit, its exchange rate will correspondingly appreciate; second, the revenues of laborers (wages) and of rentiers (interests, rents and dividends) will increase in real terms; thirdly, the profits of businessmen will drop and business firms will thereby be discouraged from investing, while workers and rentiers are encouraged to consume.

Therefore, incoming foreign funds leads to a substitution of domestic for foreign savings whose elasticity that is usually high. The only situation in which it will not be high is when a country is already experiencing very marked growth, investment opportunities multiply, and propensity to invest increases. This was seen for the last time in Brazil during the 1968-1973 “miracle”.

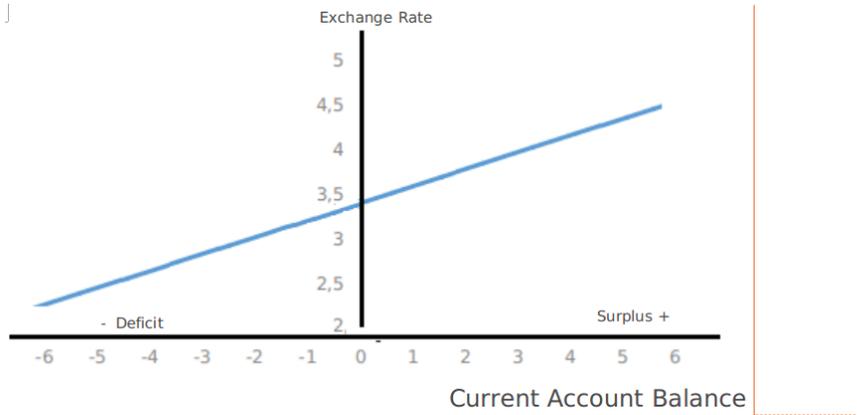
As figure 1 shows, there is a direct link between the balance of the current account (horizontal axis) and the exchange rate (vertical axis). A current-account deficit corresponds to a more appreciated exchange rate than that required for a balanced current account.

To illustrate, assume a country similar to Brazil; it has already industrialized. But shows very slow growth, low investment and savings rates, high public and current-account deficits. In such a country, the exchange rate that would hold the current-account at zero is R\$ 3.30 to the US Dollar, whereas the exchange rate that would make its competent manufacturing companies competitive is R\$ 4.00 to the US Dollar, and corresponds to a current-account surplus equal to one percent of GDP. In the same country, a current-account deficit at 3 % of GDP corresponds to a more appreciated exchange rate of R\$ 2.80 to the US Dollar. Figure 1 shows this correlation.

When this country's government decides to achieve growth with foreign savings, it therefore decides to incur a current-account deficit; the decision is self-defeating because the increased current-account deficit implies an exchange rate that is appreciated in the long run, making companies that are competitive from the technological point of view (using the best technology available) uncompetitive in monetary terms.

By making this decision, or accommodating a current-account deficit, the country's government incurs in exchange rate populism – the country incurs current-account deficit that makes artificially high wages, interests, real-state rents and dividends, instead of increasing investment and growth.

**Figure 1: Current-account balance and exchange rate**



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Therefore, for Brazilian business firms (be they local or multinational) to enjoy equal competitiveness with companies located elsewhere, the government must embrace a policy causing the exchange rate to hover around R\$ 4.00 to the US Dollar, corresponding to a current-account surplus of just over one percent of GDP.

The notion is counter-intuitive because it means that such a country does not need foreign funds. In fact, and surprisingly, it will show added growth by incurring into a current-account surplus, while reducing its foreign debt or increasing its international reserves, or financing the local companies investing abroad.

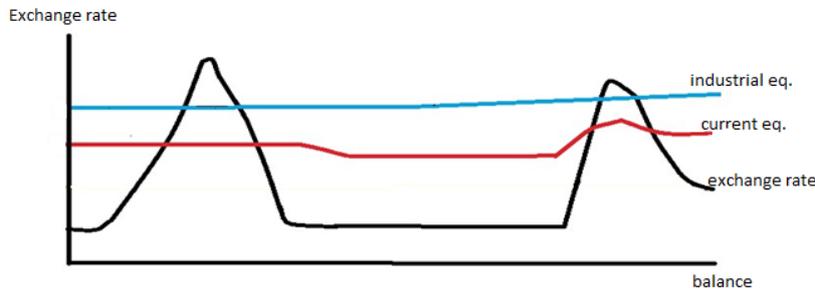
**Dutch disease**

The Dutch disease is a long-term overappreciation of a country's exchange rate caused by commodities exports that, be it because of a momentary prices boom, be it because of differential or Ricardian rents, can be exported at a profit at an exchange rate significantly more appreciated than that which make manufacturing companies using world state-of-the-art technology competitive.

In the example above, the exchange rate that balances the current account, or holds it at zero (R\$ 3.30 to the US Dollar) is the "current equilibrium" exchange rate. Why is the competitive, or "industrial equilibrium", exchange rate different, at around R\$ 4.00 to the US

Dollar? Simply because the country is afflicted by the Dutch disease, which, in this country and at this time, is of R\$ .70 to the US Dollar (the difference between industrial equilibrium and current equilibrium). It may be far greater, particularly in oil-exporting countries where the cost of extraction is very low. The severity of this competitive disadvantage will increase or decrease as international commodities prices vary.

**Figure 2: Current and industrial equilibria and exchange rate**



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We showed in the previous section that a country afflicted with the Dutch disease must show a current-account surplus. In figure 2, with the exchange rate on the vertical axis and time on the horizontal, the two equilibria are the near-parallel lines: the current equilibrium is the lower line, and industrial equilibrium is the upper one. In a commodities-exporting country, commodities will determine the current equilibrium because this equilibrium corresponds to a satisfactory rate of profit for local producers.

Neutralizing the Dutch disease means raising the current equilibrium to the level of industrial equilibrium. Because the latter is higher than the former, this means that, to neutralize the Dutch disease and thereby ensure the competitiveness of competent business firms, the country must necessarily show a current-account surplus.

The two equilibria vary over time. For the purposes of this article, suffice it to say that industrial equilibrium varies mainly with increased productivity and rising manufacturing wages, whereas current equilibrium varies mainly with changes in commodity prices.

How does one neutralize the Dutch disease? Before it was properly known, it was already intuitively neutralized with high customs tariffs. Governments justified this using the argument of the nascent industry, while critics accused the governments of protectionism. But in many cases the main cause for this was neutralizing the Dutch disease for the purposes of the foreign market.

The United States, for example, endured the Dutch disease from oil exports, and thereby kept tariffs high until 1939. To speak of a nascent industry at that point was absurd, and nor does it make sense to mention protectionism. In fact, the high tariffs were a necessary condition for the United States' industrialization. It stopped neutralizing the Dutch disease in 1939 because it was already very rich by then and lacked competitors as a result of the war.

Ordinarily, however, a country will neutralize the Dutch disease relative to the foreign market starting from a certain development stage, following an import substitution industrialization. To this end the country adds to its high import tariffs on manufactured good, subsidies to manufactured goods exports. This is what Brazil did, and very successfully,

between 1967 and 1990: in 1965, manufactured goods exports were just 6 % of the total; the share had risen to 62 % by 1990!

The WTO now forbids subsidies. The alternative (which in fact is far more elegant than tariffs and subsidies) is to enact tax on commodities exports with a variable rate based on commodity prices.

In our example, for every US Dollar in exports, the exported of a certain commodity will pay .70 per US Dollar of exports. As a consequence of the reduced supply that the tax causes, the exchange rate will depreciate, thereby reestablishing the supply, while the manufacturing industry turned competitive. Therefore, given the tax, the market will automatically equal the current and industrial equilibria.

This is a very interesting way to neutralize the Dutch disease, because, after all, exporters pay nothing: what they do pay, they get back in full as depreciation.

### **Overappreciation trend**

Figure 2 also shows a third curve with a cyclical behavior expressed as two peaks; this is the real exchange rate curve. If the market operated as liberal economists assume that it does, the curve would float slightly around the current equilibrium. We know, however, that this is not the case.

According to new developmental macroeconomics, in developing countries, particularly those afflicted with the Dutch disease, a trend exists of cyclical and chronic exchange rate overappreciation, so that the economy goes from one financial crisis to another, through lengthy periods of foreign exchange overappreciation. The peaks correspond to financial crises, where the exchange depreciates sharply.

In our example, this was the case in 2002 and 2014, when the exchange rate briefly became higher (more depreciated) than industrial equilibrium. The exchange rate then resumes appreciation, crosses through the industrial equilibrium, then through the current equilibrium, to enter the current-account deficit area (that between the exchange rate and current equilibrium), to finally stabilize for a few years at a bottom level that is not good for commodities, but enough to keep producers exporting.

Two causes lead the exchange rate to resume appreciation after a crisis: the Dutch disease and very high interest rates. The Dutch disease “pulls” the exchange rate only as far as the current equilibrium because, for a commodities-exporting country, it is commodities that determine the current equilibrium. But the exchange rate continues to drop below the current equilibrium. This is due to the fact that such a country adopts substantially higher interest rates than rich countries do. Finally, the exchange rate reaches bottom, which, in our example, was around R\$ 2.80 to the US Dollar (at today’s prices) from 2007 to 2017, with sharp deindustrialization and quasi-stagnation.

While the exchange rate continues to hover near the bottom, the current-account deficits incurred year after year will gradually increase the foreign currency-denominated debt of business firms and, therefore, of the country.

Because the exchange regime is floating-rate, the deficits should cause the country’s currency to depreciate, but this does not occur because a credit bubble forms. Foreign creditors are happy with the high interest rates that they receive, their economists tell them that the deficits are foreign savings and beneficial for the country, and they gladly continue to extend

credit. In consequence, the local manufacturing companies turn uncompetitive and accumulate debt.

Usually the portion of the foreign deficit's financing (more than half) is made through foreign investment, which only extends the overappreciation period. But creditors eventually realize that they are facing the risk of sovereign default and suspend foreign debt refinancing. Or multinational companies, fearful of not being able to repatriate their profits, stop investing. Or local business firms (manufacturers in particular) forced to take on debt because they have ceased to be competitive, conclude that they must stop accumulating debt. In any case, business firms suspend investments and a financial crisis is triggered, while the exchange rate once again appreciates sharply.

Why are interest rates in developing countries? They are usually justified by two "needs": that of attracting foreign capitals, and that of making the exchange rate an anchor against inflation.

By now, it should be clear that the policy of attracting foreign capitals is self-defeating.

As for inflation, the central bank must use interest rates to fight it, not the exchange rate. The use of the foreign exchange anchor to hit inflation targets is an absurd policy; proper economists are outraged when a government holds back the prices of state-owned companies (such as Petrobras, for example) to keep inflation under control; they should be similarly outraged when a country's central bank holds back the "price of the country" – the foreign exchange rate.

Besides the rate we have to consider the level of the real interest rate around which the central bank performs its policy. It is OK that this level is a little higher than the one of rich countries, but nothing justifies a much higher level.

There is a third cause for high interest rates: this is highly beneficial for rentiers and financiers. This is also a perverse cause. In a healthy economy and a democratic country, interest rates are low. To justify the high rates through foreign savings is, as we have seen, a mistake: the resulting foreign exchange appreciation leads to higher consumption instead of investment.

### **Financial crises**

Every country is subject to financial crises, which are mainly banking crises in rich countries and balance-of-payment or foreign-exchange crises in developing ones.

Conventional economics explains them away using the thesis of fiscal irresponsibility. Indeed, financial crises may stem from this: excessive government spending may cause an increase in demand, in imports and, ultimately, to fiscal and current-account deficits. When these occur together, they are referred to as the "twin deficits".

Still, crises may emerge in the absence of fiscal indiscipline, simply as a consequence of the policy of growth with foreign savings.

These days, governments' fiscal accounts are increasingly scrutinized by ratings agencies, the financial system's economists, and the press, so that fiscal imbalances such as seen in the Dilma administration are more an exception than a rule in middle-income countries.

On the other hand, the indebtedness of business firms and the current-account deficits associated with them do not deserve the same level of attention from conventional economists, be they liberal or developmental, because they mistakenly assume that the market will provide

proper controls. It is therefore understandable that these deficits are the main causes of developing countries' financial crises.

### **Exchange rate and development**

Investment is the key variable in the development process. The state's economic role in modern societies is to provide equitable income distribution and ensure the overall conditions for capital accumulation. In this latter role, it must provide education, institutions to ensure the proper working of the markets, infrastructure investments, long-term financing and the stability of the national currency.

Keynes realized that a tendency exists in capitalism to insufficient demand, and added a sixth condition: demand for investments. New developmentalists added a seventh general condition: an exchange rate capable of ensuring business firms' access to demand. The exchange rate is like a switch that will turn on or off business firms from the foreign and domestic markets.

Economic development programs and textbooks do not discuss the exchange rate because it is seen as a short-term problem, and only the long run is of interest to economic development. They acknowledge that it is volatile, but this volatility does not occur around an average point assumed to be the current equilibrium. If that were the case, its negative effect on investments would be relatively small because businessmen would not take an appreciated interest rate for reference when making their investment calculations.

The new developmental theory views the problem differently, because it is the only theory that claims a real fact – that in developing countries there is a tendency to the cyclical appreciation of the exchange rate, and, so, the exchange rate tends to be appreciated in the long run, in-between financial crises.

For example, in Brazil's latest foreign-exchange cycle, the exchange rate remained appreciated for seven years, from 2007 to 2014, during which it hovered around R\$ 2.80 to the US Dollar. In this case, a businessman making investment calculations will take this exchange rate into account and find that, given this, no investment will be competitive, even if the best technology available is used; and will choose not to invest.

### **What economic policy?**

To make sure that investments are made and savings increase, macroeconomic policy must be responsible not only on the fiscal level, but on the exchange-rate level as well. And mostly in it, because current-account deficits are less justifiable than public deficits.

It is paramount that the five prices are kept at proper levels: low interest rates, competitive exchange rate; a wage rate compatible with a satisfactory rate of profit so that business firms will invest; and a low inflation rate.

Out of these five prices, the exchange rate is the most important, requiring a foreign exchange policy that will keep it hovering near the industrial, or competitive, equilibrium. In other words, the trend to cyclical and chronic exchange rate overappreciation must be neutralized to ensure business firms' access to both foreign and domestic demand. There must also be an industrial policy in pace, but as a supplement, never a substitute for macroeconomic policy.

How to achieve and maintain a competitive exchange rate? Through a foreign exchange policy that neutralizes the Dutch disease through a variable tax on commodities exports. Second, through the decision to reject the three policies habitually embraced in developing countries that cause additional exchange rate appreciation: the policy of growth with foreign debt, the use of the exchange rate as an anchor against inflation, and the high interest rates policy used to enable the former two. Third, by capital controls, particularly by limiting the capital inflows, including direct investment capital inflows as does China.

Central banks should certainly use interest-rate policy to fight inflation, but keep it around a low level, just slightly above rich countries' interest rates. Because they are responsible for keeping inflation in check, they are constantly tempted to keep interest rates high and the exchange rate appreciated. This is why central banks should also be responsible for growth, in addition to inflation; and thus, as is already the case in certain countries, each country should have an exchange rate policy committee similar to the existing monetary policies committees, leaving only the execution of the foreign exchange policy to the central bank. And, naturally, the government should be able to control capital flows.

### **Where the difficulty lies**

The theory is therefore quite simple, and so is the foreign exchange policy that stems from it. It explains why so many developing countries face the great competitive disadvantage that lies in a long-term appreciated exchange rate and are therefore unable to industrialize, or why countries that were intuitively able to neutralize the trend to cyclical and chronic exchange rate but later took apart the neutralization mechanisms then deindustrialized, as has been the case in Brazil.

Why did they do it? Because with pressure from the North since the 1980s, developing countries surrendered to economic liberalism and opened up their economies, thereby tearing down the mechanism that prevented overappreciation (essentially, high import tariffs and subsidies for manufactured goods production), on whose purpose their economists were not clear.

New developmentalism emerges to explain all of this and offer the policies to address the problem. Now that the theory is available, why don't developing countries, Brazil included, embrace the required policies?

Firstly, because trained economists have enormous trouble learning and internalizing new things. I and a small group of economists have been writing books, papers, newspaper articles and conferences in an effort to discuss and disseminate the new theory and policy, but the new ideas are very slow to understand and incorporate. It is the young that show the most interest.

Secondly because, in the short run, there is a cost involved in shifting the economy from current-account deficit to a surplus, or, from a different angle but with the same outcome, in adjusting the exchange rate and keeping it competitive thereafter. The necessary one-time devaluation reduces the income of both workers and rentier capitalists.

No-one, therefore, likes devaluation. This is why developmental economists, who defend the short-term interests of wage-earners, and liberal economists, who basically represent the interests of rentiers and financiers, stand opposed to devaluation.

Rentiers do so with better reason than workers. For the latter, a depreciation will cause wages to lose purchasing power in the short run, but they will soon be rewarded with additional jobs and, further ahead, with increased productivity and the consequent higher wages. For

rentiers, the picture is different. A devaluation will similarly reduce the purchasing power of their revenues (interests, dividends and real-state rents), but also the worth of their wealth and, finally, devaluation will only take place if the interest rate is reduced – which duns definitely counter to rent seekers’ interests. This is why liberal economists won’t even hear of a competitive exchange rate. For this reason, and also for the neo-liberal education that they receive in American and British universities, they inevitably “forget” the exchange rate when discussing developing countries’ economic problems.

Faced with the macroeconomic maladjustment caused by high current-account and public deficits, liberal economists propose merely fiscal adjustment, which, by causing a recession and unemployment, will reduce the interest rate and make the domestic currency more competitive without devaluing the national currency. In this way, only the wage and salary people will pay for the adjustment, because wages will drop.

The new developmental proposal also includes a fiscal adjustment, but simultaneously reduce the interest rate and depreciates the currency. The outcome will be a fuller adjustment of the country’s fiscal and foreign accounts, and a more equitable distribution of the cost of the adjustment.

Under the liberal adjustment, the cost is entirely borne by wage and salary earners, who lose their jobs and see their wages and salaries reduced, whereas the bill for the new developmentalist adjustment is distributed between wage earners and rentiers as far as the interest rate is reduced and the national currency, depreciated.