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THE PROJECT: Financial Instability and Overvaluation of the Exchange Rate in Latin America: Analysis and Policy Recommendations

PROJECT PROPOSAL TO THE FORD FOUNDATION BY THE CENTER FOR DEVELOPMENT MACROECONOMICS OF THE SCHOOL OF ECONOMICS OF SÃO PAULO OF GETULIO VARGAS FOUNDATION, COORDINATED BY LUIZ CARLOS BRESSER-PEREIRA AND NELSON MARCONI

The present Global Crisis began as a banking crisis that turned into a major economic crisis. It took the world by surprise, because politicians, businessmen and economists believed that they had learned with 1930s Great Depression. The Keynesian revolution, the strengthening of central banks, the development of full regulatory system, and the creation of the Breton Woods institutions proved such learning. They had a definite objective: to avoid new major financial crises. Yet, since the 1970s, economists engaged in de-learning or forgetting what they have learned. They relegated Keynesian macroeconomics to the margin and deregulated financial markets. In consequence, since the early 1980s financial crises multiplied in the central and in the developing economies, but only in the later they were disastrous as, for instance, the 1980s Latin American debt crisis, or the 2001 Argentinean crisis. In the central countries they happened but were relatively mild. But suddenly a banking crisis that began in the United States with the default of subprime mortgages in 2007 turned into bank failures and into panic in October 2009. A consensus was established very soon that this was the worst economic crisis since the 1930s. It will be a crisis that probably will live with us for many years despite the strong and reasonably competent economic policies with which governments responded to it.

In this crisis, developing countries suffered less. All of them saw their growth rates to be reduced and, in several cases, turned negative, but while all rich countries were strongly hit by the crisis, major losses among middle income countries only occurred in the ones that had become highly indebted recently like some East European countries, or, being industrial economies, depended too much on oil

exports like Russia, or had their economy too much dependent on the American economy like Mexico. This lighter impact is not surprising in relation to Asia, but it is in relation to Latin America that has a long history of recurrent financial crises.

Objectives

The most general target of this project is to study financial instability in Latin America and particularly the impacts in Brazilian economy. In order to be more specific, this project will involve two conferences, and our two main objectives will be to discuss in the first conference: (1) how will change the world economy and Latin America in consequence of the global financial crisis; and (2) the nature of financial crises that haunted Latin America in the recent past and search for the policies that should be adopted to avoid them. A third objective that will be the subject of the second conference is to study the relations between financial instability, the exchange rate and deindustrialization in Brazil.

Financial crises in Latin America

The first objective is relevant. The world economy will change; the economic center of the world will change to the East; the dollar will lose relative power as reserve money; nationalism will increase; regulation of financial markets will increase; financial flows will most likely be reduced. Yet, although these facts will have strong impact on Latin-American economies and we will discuss them, the main focus of the project will not be in these themes because they are not specific to Latin America. Our main concern will be to offer responses to the second objective. The assumption or hypothesis is that usually financial crises in Latin America are not banking crises as the present one is, but are balance of payment or exchange rate crises — crises that happen in countries that are not indebted in their own money, but in other countries' money. Thus, when a developing country follows the growth with foreign savings policy, it incurs in overvaluation of the exchange rate and in recurrent and high current account deficits; it becomes heavily indebted; creditors eventually lose confidence, suspend the rolling over of the foreign debt, and the country defaults — what will cause a sudden stop in capital inflows and sharp devaluation of the currency.

In this project, our assumption is that there is a tendency to the overvaluation of the exchange rate — and that this tendency or the overvalued currency is a major factor not only in causing balance of payment crisis but also artificially high real wages, artificially high consumption, low domestic savings, and low growth rates.

In this project, we will, first, verify if this is really so: if financial crises in Latin America are not mainly or originally banking crises (crises that originate in poor lending on the part of domestic banks), but are balance of payment crises that also originate in poor lending — lending made by banks of the rich countries, in their own currencies, to firms and governments in the developing countries. These crises

break up when the foreign banks (that are not yet threatened of going bankrupt) feel uneasy on continue lending to the developing country, lose confidence, and suspend the rolling over of a debt often when the country is already involved in Ponzi finance: it does not generate hard currency even to pay current interests on the foreign debt.

Second, given that financial crises are recurrent in Latin America, we will see if there is certain regularity in the balance of payment crises. Or, in other words, if developing countries, and, among them, Latin-American countries tend systematically to incur in high foreign indebtedness, following a cycle. Our hypothesis is that they do.

Third, we will discuss the reasons for this. Is it true that this foreign indebtedness and recurrent balance of payment crises derive from the recurrent public deficits or fiscal largess or fiscal populism, as the dominant economic literature asserts, or, alternatively, it derives from recurrent current account deficits, or from the growth with foreign savings policy? For sure, we can escape from this question by assuming the twin deficits hypothesis. But, do twin deficits (public and current account) always happen? Or may national economies have current account deficits without incurring in public deficits because an overvalued exchange rate causes excess foreign demand and increasing private indebtedness?

Fourth, we will discuss a key hypothesis: that there is a tendency to the overvaluation of the exchange rate in developing countries. The exchange rate does not fluctuate nicely around the line of intertemporal equilibrium of the current account, as orthodox economists would predict; nor is just volatile, as less orthodox economists widely recognize; but this volatility has a sense: it tends to appreciation or overvaluation. Thus, unless economic policy neutralizes such tendency, the economy will face increasing current account deficits, foreign indebtedness, and eventually crisis or default on the foreign debt. In this moment the exchange rate sharply depreciates, and a new cycle begins.

Fifth, if this hypothesis makes sense, we should look for its causes, but before discussing the causes of the tendency, we must discuss what an equilibrium exchange rate is. In principle, it should be the exchange rate that equilibrates intertemporally the current account. Yet, if the country faces the Dutch disease, the real equilibrium exchange rate will be the one that makes competitive industries utilizing technology in the state of the art or in production efficient frontier: the industrial equilibrium exchange rate.

Sixth, we should discuss the causes of the overvaluation of the exchange rate in developing countries. The Dutch disease is a structural cause that explains part of the overvaluation, the one that implies the transition from the industrial to the current equilibrium exchange rate. At this level the exchange rate makes unviable economically tradable industries utilizing technology in the state of the art, but do not cause current account deficit. Thus, we need a second structural cause to explain why the exchange rate tends to get more appreciated than the one corresponding to the current equilibrium. This cause is the fact that higher profit and interest rates usually existing in developing countries attract capital inflows that addition-

ally appreciate the national currency. More important than this second structural cause, however, are the policy causes that additionally attract foreign capitals: the growth with foreign savings policy, the adoption of nominal (exchange rate) anchors to fight inflation, the use of exchange rate appreciation in capital targeting policies to meet the target, capital deepening policy (to increase the interest rate) policies, and, finally, "exchange rate populism": the practice often adopted by politicians of appreciating the exchange rate to lower inflation, increase real wages and consumption, and get reelected if the ensuing balance of payment crisis does not take place before the election date.

Seventh, once we reasonably agree on the previous hypothesis, we must ask for evidence. First, to survey the existing evidence — the previous econometric studies that did not have behind the tendency to the overvaluation of the exchange rate hypothesis but sustain it; second, new evidence, out of new research.

Eight, we will ask for policy recommendations. Recommendations at national level related to the neutralization of the Dutch disease and the administration of the exchange rate; recommendations at the international level, as, for instance, an international agreed cap on current account deficits, and an international institution (possibly the IMF) monitoring the current account deficits and signaling when the country surpasses the cap.

This is essentially an economic theory and economic policy project, but, besides economists, we will ask political scientists to participate because, for instance, in the discussion of the causes of overvaluation and crises related either to excessive lending-borrowing or to exchange rate populism, we are interested also in the political questions involved. Second, when we discuss policy recommendations, we also need political scientists and international relations specialists to participate in the discussion.

Deindustrialization in Brazil?

Latin America is our object of study, but we will provide a special attention to Brazil because it is the greatest country of the region and because the majority of the researchers that will participate are Brazilians. Brazil is a middle income country counting with a large manufacturing industry that since the early 1990s is being threatened by deindustrialization. First, we have to confirm this fact, because, besides the existence of data showing the fact, there is still discussion on the theme. Would it be a premature deindustrialization, or a normal one, as it is happening in developed countries? Second, which is the relation of it with financial instability, and, particularly, with the opening of foreign accounts in the early 1990s and the overvaluation of the exchange rate?

Although the Brazilian economy is often presented as one of the BRICs and as an example of success, we are persuaded that this view is mistaken. In the last ten years Brazil's growth was one third of the other BRIC countries' growth, and not considering the present global crisis, it fell in two balance of payment crisis, Russia in one, and China and India, in none. Why it happened? Is it reasonable to think

that the destiny of China is to be the world's factory whereas Brazil will be the world's farm? What is the relation of this possibility to the higher financial instability and considerably lower rates of growth when compared to China? The answer will not be very different from the more general one given in relation to financial instability in Latin America and its relation to the high leverage not only of the public but mainly of the private sector. Yet, we will have to be more specific in this case.

The Center of Structuralist Development Macroeconomics

The Center of Structuralist Development Macroeconomics of the São Paulo School of Economics of Getulio Vargas Foundation is a small research center that aims to study the relation between macroeconomics and development economics and to recommend economic policies seeking for higher life standards, full employment and stability. Their researchers concentrate efforts in the definition of the "new developmentalism" and the search for empirical evidences of the well-succeeded catching-up reached by countries that follow a national development strategy, like the Asian ones. The workshops and the conference included in this project, as much as the book we intend to publish with the papers presented and discussed on them, will decisively help to disseminate this view and to formulate a proposal of global financial governance and a consistent national development strategy in Latin-American countries in the post-crisis scenery.

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THE FIRST WORKSHOP: New Developmentalism

In the first workshop held in São Paulo, in May 24-25, 2010, the Ten Theses on New Developmentalism were originally discussed. Following, is the document that accompanied the invitation of the participants.

With the support of Ford Foundation, the Center for Development Macroeconomics of the School of Economics of São Paulo of Getulio Vargas Foundation will held, on May 24-25 2010, a workshop and in March next year a broader conference on "Growth with financial stability and new developmentalism". In the workshop, the 20 Brazilian and foreign economists that will be invited will be asked to define a list of 10 short theses or policy recommendations that should characterize "new developmentalism" — the national development strategy that middle income countries are supposed to adopt to grow with financial stability. New developmentalism is an expression that several of the participants of the workshop have been using since the early 2000s as a responsible and feasible alternative to the Washington consensus or to conventional orthodoxy. To limit the theses or policy recommendations to 10 is important because the objective is to get out of these project with some reasonably agreed and simple to remember ideas. Personally, I have been using a tripod — exchange rate responsibility or growth with domestic savings, fiscal responsibility, and strategic role for the state — to define new developmentalism, but this approach is oriented to public opinion or to the national agenda that is unable to assume more than three elements of a given theme. In order to be understood to a more restricted number of economists and politicians or of policymakers, I believe that 10 is a reasonable number.

The organizers will propose a provisory list of 10 theses to be discussed. In the workshop we will, first, discuss and define the theses, amending and substituting what is agreed. Second, we will distribute them among ourselves so that each theme will be under the responsibility of two participants. Third, the other participants will offer suggestions to the two participants responsible for the theme. After this, each group of two participants will have a 10 months period to write a small policy paper

(15 to 20 double space pages). In the second workshop to be held in March 2011 these policy papers will be discussed with a larger group of invited people including Brazilian politicians and policymakers, and with the presence of the media.

Adopting this somewhat heterodox method we are not aiming full agreement, nor writing anything similar to a plan. We are just asking for some agreement on a list of key theses or policy recommendations that characterize a competent national development strategy. We would like to have agreement on the expression "new developmentalism", but this will not be required from anybody. Below we offer a short reference to papers and books that used the expression, and we attach a recent paper by Bresser-Pereira to be published in the *Handbook of Latin America Economics* that José Antonio Ocampo is editing for Oxford University Press that, in some way, summarize the ideas. We just make reference to articles that used the expression. Without using it, there are a large number of heterodox economists — certainly all the invited to this workshop — that wrote on the subject.

This project has as background, on one hand, the 2008 Global Financial Crisis and, on the other, fast growth in several dynamic Asian countries that, in some way, adopt a new developmentalist national strategy. The most general objective of these two conferences is to discuss how to achieve economic growth in a global framework of financial instability. As most participants are Brazilians and Latin-Americans, the economy of these countries will get more attention. In order to be more specific, the three main concerns will be: (1) to analyze the global financial crisis and its consequences in developing countries; (2) to identify the main characteristics of the repeated financial crises in Latin America in the recent past; and (3) to discuss the policy recommendations that will assure growth with stability.

Financial instability

The 2008 crisis took the world by surprise, because politicians, businessmen and economists believed that they had learned with 1930s Great Depression. The Keynesian revolution, the strengthening of central banks, the development of full regulatory system, and the creation of the Breton Woods institutions proved such learning. They had a definite objective: to avoid new major financial crises. Yet, since the 1970s, economists engaged in de-learning or forgetting what they have learned. They relegated Keynesian macroeconomics to the margin and deregulated financial markets. In consequence, since the early 1980s financial crises multiplied in the central and in the developing economies, but only in the latter they were disastrous as, for instance, the 1980s Latin-American debt crisis, or the 2001 Argentinean crisis. In the central countries they happened but were relatively mild. But suddenly a banking crisis that began in the United States with the default of subprime mortgages in 2007 turned into bank failures and into panic in October 2009. A consensus was established very soon that this was the worst economic crisis since the 1930s. It will be a crisis that probably will live with us for many years despite the strong and reasonably competent economic policies with which governments responded to it.

In this crisis, developing countries suffered less. All of them saw their growth rates reduced and, in several cases, turned negative, but while all rich countries

were strongly hit by the crisis, major losses among middle income countries only occurred in the ones that had become highly indebted recently like some East European countries, or, being industrial economies, depended too much on oil exports like Russia, or had their economy too much dependent on the American economy like Mexico. This lighter impact is not surprising in relation to Asia, but it is in relation to Latin America that has a long history of recurrent financial crises. Of particular interest is the fact that banking and financial systems appear to have weathered the crisis without major difficulties.

The global financial crisis as well as the continued and high growth of several Asian countries are having and will have major impacts in Latin America. The continued expansion of developing countries in the East will provide both opportunities and challenges; the instability of the dollar will lead to a search for a more stable international monetary standard; declining global trade flows will make national policies and priorities more important; new regulation for financial markets will be proposed; global financial flows will relatively shrinkas financial institutions become more risk averse and reduce leverage. While all of these changes will have strong impact on Latin-American economies, none of them will be dominated by the response by Latin-American economies to the crisis. The main focus of the project will thus be on the second objective. The assumption or hypothesis is that while financial crises in Latin America have usually involved a crisis in the banking system, problems usually originate in the balance of payments or in borrowing on foreign currency that leads to currency crises. The present crisis differs because it did not start in a developing country, and it seems to have been initiated by the banking system in developed countries. Indeed, financial systems in developing countries appear to have been isolated from the worst effects of the subprime lending bubble. Many Latin-American countries, including Brazil, appear to be recovering from the crisis more rapidly than the developed countries. This raises the question of the impact of the crisis on the banking system in Latin America and whether it has played a major role in the rapid recovery in countries such as Brazil. Indeed, some have suggested that developing countries were unable to decouple from the developed countries in the propagation of the crisis, but that they have been able to do so in the recovery. This will thus be a major focus of the project.

Since most developing countries have followed policies of financing domestic growth by borrowing foreign savings, they have suffered overvaluation of the exchange rate that has supported recurrent and large current account deficits. As debt increases foreign creditors eventually lose confidence, refuse to roll over their loans and the resulting sharp reversal in capital inflows leads to a sharp devaluation of the currency and sovereign and domestic defaults that spread to the domestic financial system. It is this tendency to the overvaluation of the exchange rate that has been a major factor not only in causing balance of payment crisis but also artificially high real wages, artificially high consumption, low domestic savings, and low growth rates and have provided the background for fragility of the domestic financial system.

The project will seek to verify this explanation of recurrent financial crises in Latin America, that is, that they are the result of balance of payment crises that originate in poor lending decisions made by banks of the rich countries, in their

own currencies, to firms and governments in the developing countries, rather than by the bad lending decisions of domestic banks to lend to domestic borrowers.

Given that financial crises are recurrent in Latin America it will be necessary to ascertain whether there is accompanying regularity in the balance of payment crises. Or, in other words, if developing countries, and, among them, Latin--American countries tend systematically to incur in high foreign indebtedness, following a cycle.

The question is whether this foreign indebtedness and recurrent balance of payment crises derive from the recurrent public deficits or fiscal largess or fiscal populism, as the dominant economic literature asserts, or, alternatively, whether it is the result of repeated current account deficits financed by lending by foreign financial institutions in foreign currency.

It is also necessary to investigate whether the foreign financing of balance of payments imbalances leads to a tendency to the overvaluation of the exchange rate in developing countries. The exchange rate does not fluctuate nicely around the line of intertemporal equilibrium of the current account, as orthodox economists would predict; nor is just volatile, as less orthodox economists widely recognize; but this volatility has a sense: it tends to appreciation or overvaluation.

The use of overvaluation raises the question of the definition of the equilibrium exchange rate. In principle, it should be the exchange rate that produces intertemporal equilibrium in the current account. However, in the presence of the Dutch disease, the real equilibrium exchange rate will be the one that makes competitive industries utilizing state of the art technology or that are on the production efficiency frontier in equilibrium. It is thus necessary to determine the causes of the overvaluation of the exchange rate in developing countries. The project will thus seek explanations of the overvaluation by historical evidence, previous econometric studies and new evidence based on our research.

Given the reversal in the role of the banking system in the current crisis, it will be necessary to identify how domestic banks and financial systems were involved in this process of overvaluation. In addition, it will be necessary to identify if this role has changed in the current response to the crisis. For example, after the crisis of the 1980s the Brazilian financial system underwent a major crisis and government intervention. In the mid 1990s the crisis was not yet solved, and required additional government intervention: the PROER initiative. Since that time it has been extremely stable, withstanding all the crises of the 1990s as well as the recent one with no bank panic or insolvencies. However, in the period of the crisis of 2007-2008, Brazilian and foreign banks were involved in foreign currency speculation that may have contributed to the overvaluation of the exchange rate and to large subsequent losses for domestic businesses.

In this period domestic firms were also offered complex speculative contracts that used out of the money options predicated on the assumption of continued appreciation and overvaluation of the Real. After the Lehman collapse the exchange rate unexpectedly started to depreciate. In two months, from August to October, the exchange rate moves from around 1.60 to 2.30 and eventually to around 2.50 two months later. This is a move of between 40% and 50%. For an out of the money option that had been written at a strike of 1.70 would have produced a loss

of Real 3.5 million on a notional contract of R10 million. Or if written at 2X leverage 7 million. The estimates are that companies that bought these contracts such as Aracruz lost $2,130 million, Grupo Votorantim Diversificado -$1,040 million and Sadia -$360 million.

The existence of these contracts not only created solvency problems for businesses, which is important to the impact of the Dutch disease, but more importantly for the project, the existence of such contracts acted in a pro cyclical manner in the foreign exchange market. Thus, it exacerbates the overvaluation of the currency when it is appreciating and increases the demand for dollars in the domestic money market, creating a sharp increase in demand for dollar liquidity, exacerbating the volatility of the exchange rate.

Since this project involves economic theory and economic policy project, it will involve political scientists as well as international trade, macro and financial market economists to participate because, for instance, in the discussion of the causes of overvaluation and crises related either to excessive lending-borrowing or to exchange rate populism, we are interested also in the political questions involved. Second, when we discuss policy recommendations, we also need political scientists and international relations specialists to participate in the discussion.

New developmentalism

The extraordinary growth rates of several Asian countries since the 1980s contrast with substantially smaller rates in Latin America. In the 2000s there was some improvement in growth rates in Latin America, but this outcome was not explained by endogenous factors, but by the increase in commodity prices. From the 1930s or, at least, from the 1950s, Latin-American countries adopted a successful national development strategy, namely, national developmentalism, based on development economics and in the Latin-American structuralist economic theory. In the late 1980s, after ten years of foreign debt crisis combined with high rates of inflation, this strategy was replaced by the Washington Consensus or conventional orthodoxy — an imported strategy based on the deregulation of markets, growth with foreign savings, high interest rates and overvalued exchange rates. Ten years later, after the 1994 Mexican, the 1998 Brazilian and the 2001 Argentinean financial crises, the failure of this strategy became evident, as it caused repetitive balance of payment crises and failed to improve living standards. On the other hand, I assume that middle-income developing countries are supposed to grow faster than rich countries and catch up. Financial globalization is a threat to that, but commercial globalization is as opportunity as the Asian experience shows.

Since the early 2000s, Latin-American countries have been once again seeking a national development strategy. In the political realm, this search has been expressed by the successive elections of center-left and nationalist political leaders. Yet the success of this search is not assured, because, on one hand, most of these countries are poor, lack a capable state and very difficult to be governed, and, on the other, because we cannot see national development strategies behind this political change. The poorer a country is, the more unequal and poorly educated will be its people, and more difficult it will be to govern and to formulate appropriate economic policies.

New developmentalism is a set of values, ideas, institutions, and economic policies through which, in the early 21st century, middle-income countries seek to catch up with developed countries. It is not an economic theory but a strategy; it is a national development strategy, based mainly on Keynesian macroeconomics and structuralist development macroeconomics. It is the set of ideas that enables developing nations to reject rich nations' proposals and pressures for reform and economic policy, like capital account liberalization and growth with foreign savings. It is the means by which businessmen, government officials, workers and intellectuals can stand together as a true nation to promote economic development. New developmentalism is suitable for middle-income countries rather than for poor countries, not because poor countries do not require a national development strategy, but because their strategies involve accomplishing primitive accumulation and industrial revolution, or, in other words, because the challenges they face are different from those faced by middle-income countries.

The basic propositions behind new developmentalism are macroeconomic; they derive from a structuralist development macroeconomics that is being defined by critical Latin-American economists having as parameter the Asian experience. The supply aspects of economic growth including industrial policy are naturally considered in this approach, but, given its Keynesian and Kaleckian foundation, two tendencies that press down demand — the tendency of wages to increase below the productivity rate and the tendency to the overvaluation of the exchange rate — are crucial to the new ideas. The first derives from the definition of a developing country as a dual economy and from the classic work of Arthur Lewis (1954) showing that developing countries face an unlimited supply of labor — and represents a major impediment to the creation of mass consumption economies in the region. This fact implies a rise in wages when the worker migrates from the traditional sector to the modern sector, but thereafter it presses down wages in the modern sector — which causes increasing inequality and a chronic insufficiency of demand. In the 1970s, in Latin America, this problem was classically "solved" by the production of luxury goods to be consumed by the middle class and the rich, or by exporting wage goods and importing luxury goods and capital goods.

The second structural tendency — the tendency to the overvaluation of the exchange rate — explains why the exchange rate is not eventually controlled by the market, but by balance of payment crises instead or by sudden stops. As conventional economics presupposes that wages are well equilibrated by the labor market, it supposes that the same happens with the exchange rate. Yet, if the exchange rate is left fully free in a developing country, a series of structural and policy factors will lead it to appreciate, the country will incur in current account deficit, will get indebted, will suffer from chronic financial fragility, and, finally, when foreign creditors lose confidence, will face a "sudden stop" — a balance of payment or currency crisis and a sharp devaluation.

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THE DOCUMENT:
Ten Theses on New Developmentalism

In May 24 and 25 of 2010, a group of economists sharing a Keynesian and structuralist development macroeconomics approach got together in São Paulo to discuss ten theses on New Developmentalism — the name that some of them have been using for some years to design the national development strategy that middle income countries are today using or are supposed to adopt for catching up. They summarize a theoretical and policy alternative to conventional orthodoxy. The New Developmentalism Project, financed by the Ford Foundation, has as background the failure of the Washington Consensus to promote growth in Latin America and the 2008 Global Financial Crisis that showed the limits and dangers involved in financial globalization and financial deregulation. The general objective of the workshop was to analyze the repeated financial crises in middle income developing countries and 2008 global financial crisis, and to evaluate how effective can be the new developmentalist strategy to assure growth with stability; the specific one was to discuss the ten theses on new developmentalism previously presented to the participants: theses that supposedly avoid financial crises and bolster growth rates.

After two days of vivid discussion, the local organizers of the workshop were charged of editing the theses to reflect the views of the participants expressed in the debates and in the following e-mail discussion. This is the final document that the original participants subscribed and immediately after invited a number of other economists and social scientists committed with the idea of economic growth with stability and social equity.

Economic development is a structural process of capital accumulation with incorporation of technical progress that involves not only the increase of productivity in each industry but also the continuous transference of labor to industries producing goods and services with higher value added *per-capita* and paying higher wages and salaries. In the case of developing countries this is particularly true because they are characterized by structural heterogeneity.

Although markets play a major role, **the state is supposed to have a strategic role** on the **macro** level assuring investment opportunities (satisfactory expected rates of profit), keeping inflation and public debt under control and the financial system stable, and, on the **micro** level, implementing a strategic industrial policy. State intervention should be primarily counter-cyclical at the macro-level.

In the framework of globalization, economic development requires a **national**

development strategy, i.e., an informal cluster of objectives, understandings and policies that increase profit expectations, stimulate investment, and achieve growth and full employment with price, financial stability and income distribution.

Although the supply side of economic development and a strategic industrial policy are relevant, **the demand side is where the major growth bottlenecks are**. Besides the fact well established since Keynes that the supply does not automatically create demand, there are two structural tendencies that limit demand and, so, investment opportunities: the cyclical tendency of wages to increase below the growth of the productivity, and the tendency to the overvaluation of the exchange rate.

The **tendency of wages to increase below the growth of productivity** is due to the existence of an unlimited supply of labor. The definition of a minimum wage and a system of cash and benefits transfers to the poor should be part of the policies neutralizing this tendency that undervalues labor. The alternative — chronic overvaluation of the national currency — is not a sustainable alternative.

The **tendency to the cyclical overvaluation of the exchange rate** in developing countries is mainly due to the Dutch disease and the attempt to grow with foreign savings (current account deficits financed by capital inflows) and national indebtedness. This tendency implies that the exchange rate in developing countries is not just volatile around the current market equilibrium, but checked by currency crisis or sudden stops. It also implies that export oriented investment opportunities are chronically insufficient in these countries in so far that efficient business enterprises turn uncompetitive internationally.

The **Dutch disease** is a **permanent overvaluation** of the national currency due to Ricardian rents originated by the export of commodities based on natural resources (or cheap labor combined with a large salary-wage dispersion) that impede that other tradable industries utilizing technology in the world state of the art are competitive in so far as it creates a divergence between the "current equilibrium exchange rate" (the one that balances intertemporally the current account) and the "industrial equilibrium exchange rate" — the one that allows tradable industries to be competitive utilizing technology in the world state-of-art.

Economic development is supposed to be financed essentially with **domestic savings**; the creation of public financial institutions to finance investment is recommended. The attempt to use foreign savings or to recur to current account deficits usually does not increase the investment rate (as it is supposed to do), but domestic consumption; it usually implies a high rate of substitution of foreign for domestic savings. The growth with foreign savings policy, first, causes this substitution; second, causes financial fragility and the constraint to get involved in the "confidence building" game; and, eventually, ends into a balance of payment or currency crisis.

In order to achieve financial and price stability (low inflation), government is supposed to prove **fiscal responsibility** (long term budget deficit that keep the relation between public debt and GDP in a satisfactory level) and **exchange rate responsibility** (a real exchange rate that is supposed to correspond to the industrial equilibrium level).

To achieve growth with stability, **fiscal and monetary policies** should pursue clear employment, inflation and exchange rate **targets** that are compatible with

growth with domestic savings and the neutralization of the tendencies to the increase of wages below the productivity rate of growth and to the overvaluation of the exchange rate. With these three objectives in mind, policymakers should adopt a large collection of policy instruments that should include the management of the interest rate around a moderate level, increase in foreign reserves, capital controls, and exports taxes on Dutch disease commodities. And society as a whole should develop a welfare system that reduces inequality and is anti-cyclical.

São Paulo, September 29, 2010

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THE SECOND WORKSHOP: Financial Stability and Financial Governance in Brazil

MARCH 24-25, 2011

This project granted by the Ford Foundation has as background, on one hand, the 2008 Global Financial Crisis and, on the other, the fast growth in several dynamic Asian countries that, in some way, adopt a new developmentalist national strategy. In order to be more specific, the three main concerns are: (1) to analyze the global financial crisis; (2) to identify the main characteristics of the repeated financial crises in Latin America in the recent past; and (3) to discuss the policy recommendations linked to a national development strategy that will assure growth with stability.

Objective

The Phase 1 of this project produced the *Ten Theses on New Developmentalism*. Three of these theses (6, 7 and 8) dealt with financial problems. Given the central role of financial governance in the discussion, the content of Phase 2 evolved towards a second workshop to be held in São Paulo (March 10-11, 2011), that will focus primarily on the role of financial governance in promoting a competitive exchange rate to support development strategies in Brazil.

The role of financial institutions and financial governance in supporting a competitive exchange rate and development strategies in Brazil.

Themes

1. To what extent financial regulation in Brazil was effective in neutralizing the tendency to the overvaluation of the exchange rate (Theses 6 on new developmentalism) in that country since the 1994 Real Plan?
2. How did financial regulation influence Brazil's response to the 2008 financial crisis? Did it have a role in the emergence of Brazil as a Global Financial Player?
3. What revisions of financial regulation and financial governance in Brazil are necessary to support Brazilian development? What's in place and what's missing?
4. Financial governance and the *Ten Theses*: Brazil's long term economic development in the context of the changing financial landscape: What's in place and what's missing?