2015 note summing up of New Developmentalism

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New developmentalism is a research program in progress. Here is a summary of its basic ideas, which are more completely developed in the Portuguese version my book with Nelson Marconi and José Luis Oreiro, *Developmental Macroeconomics* (2014), to be published in Brazil by Campus-Elsevier.

1. New developmentalism is a comprehensive theoretical approach to development economics and to the political economy of growth and distribution that was born in the early 2000s from the critique of classical developmentalism or structuralist development theory and from post-Keynesian macroeconomics, with which it shares the rejection to neoclassical economics.

2. New developmentalism encompasses an open development macroeconomics, a development microeconomics, and a political economy of growth and distribution.

3. New developmentalism adopts the historical-deductive methods – the method of Smith, Marx and Keynes . It uses some economic concepts and economic syllogisms, but it in its core are open models formed of tendencies and behavior regularities.

4. New developmentalism should not be confused with really existing forms of developmentalism, as were in the past mercantilism, Bismarckism, Fordism and national-developmentalism, and, more recently, social-developmentalism or neodevelopmentalism in Brazil.

5. New developmentalism draws its models and policies from the successful experience of Brazil and other Latin American countries between 1930 and 1980, and from the still more successful experience of East Asian countries after World War II to now.

6. New developmentalism starts from the assumption that markets are an excellent institution to coordinate the competitive sector of the economy, not the non-competitive ones; they don't assure the right microeconomic prices particularly in strategic sectors as is the infrastructure industry

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and the financial industry, and they definitely don't assure the right macroeconomic prices.

7. New developmentalism works with five macroeconomic prices: the profit rate, the exchange rate, the interest rate, the wage rate, and the inflation rate, and understands that they must be kept *right*.

8. "Right" prices do not mean prices defined by full competition, but prices that make sense economically and politically: (a) the profit rate must be high enough to support investment by business; (b) the exchange rate must make the business enterprises competitive; (c) the level of the interest rate should be as low as possible; (d) the wage rate should increase with productivity, and be consistent with a satisfactory profit rate; (e) the inflation rate should be low.

9. The basic difference between rich and middle-income countries – b besides the level of income – is the fact that while rich countries get indebted in their own money and are only subject to banking and financial crises, middle-income countries get indebted in foreign money (which they cannot either issue, or depreciate), being additionally subject to currency or balance of payment crises.

10. Economic development is the main element of progress or human development, which also involves the increase in security, the increase of individual liberties, the reduction of inequalities, and the protection of the environment.

Growth and the investment rate

11. Economic development is a process of capital accumulation with the incorporation of technical progress that increases wages and standards of living in the long term; it supposes an increasingly well-educated population; it involves industrialization or, more precisely, increasing productive sophistication combined with the transference of labor from low to high income per capita industries.

12. As is well known, the growth rate depends on the investment rate, which depends on the difference between the expected rate of profit and the interest rate. The expected rate of profit depends on the existence of effective demand.

13. But what is not usually known is that the expected profit rate depends on the *level* of the exchange rate, because the exchange is not just volatile around the equilibrium, but in developing countries, given the tendency to the cyclical and chronic overvaluation of the exchange rate, it is usually overvalued in the *long-term* – something that neoclassical and Keynesian macroeconomics don't acknowledge.

14. When the exchange rate is overvalued in the long-term, the business enterprises that use state of the art technology are *disconnected* from

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effective demand, as the average expected rate of profit falls and possibly turns negative, what leads them to reduce or stop investment.

15. When the investment rate is low, the rate of private savings will also be low, because, as Keynes showed, it depends on investment.

16. Private savings rate depends additionally on the national culture, and on the existence (or lack thereof) of a social security system, which is supposed to create savings on behalf of individuals.

17. Instead, given the budget deficit that keeps the public debt under control, public investment depends on public savings (taxes minus current expenditures) and on the profits of state-owned enterprises.[i]

The determinants of the exchange rate

18. The determinants of the exchange rate are its value *and* the supply and demand for foreign money.

19. The *value* of the exchange rate, or, more precisely, of the foreign money, is the value that covers the cost plus a reasonable profit of the business enterprises that participate in foreign trade and ensure the equilibrium of the current account of the country.

20. The value of the exchange rate depends on the country's comparative unit labor cost (wage rate divided by productivity of the country compared with other countries).

21. The *price* of the exchange rate floats around its value according to the demand and supply of foreign money.

22. The supply and demand for foreign money (1) depends on the textbook determinants, particularly on the interest rate (which attracts capital when increases) and on the purchase or selling of foreign reserves by the central bank, (2) on the speculative capital flows, and (3) on the three habitual populist policies that developing countries adopt: the growth with current account deficits ("foreign savings") policy, the policy of a high level of the basic interest, well above the international rate, and the use of an exchange rate anchor to control inflation.

Dutch disease

23. When the country faces the Dutch disease, there are two values and corresponding equilibriums for the exchange rate: the current equilibrium, which is the exchange rate that balances intertemporally the country's current account, and the industrial equilibrium, the exchange rate that makes competitive the business enterprises utilizing technology in the world state of the art.

24. The Dutch disease is the permanent overvaluation of the exchange rate caused by the fact that the country has abundant and cheap natural

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resources, which benefit from Ricardian rents, and, so, may be exported with a satisfactory profit at an exchange rate floating around the current equilibrium, what makes the non-commodity tradable industries non-competitive because they require that the exchange rate floats around the industrial equilibrium to be competitive.

25. Another way of defining the Dutch disease is to say that it is a long-term competitive disadvantage for the non-commodity tradable industries of a country that results from the fact that the technically competitive business enterprises are not economically competitive, because the former are profitable with a more appreciated exchange rate than the one required by the later, which benefit from Ricardian rents.

26. When the country does not face Dutch disease, the current and the industrial equilibriums are the same, or, in other words, there is only one when value, around which floats the exchange rate price.

27. When there is Dutch disease, the exchange rate price floats around the current equilibrium, which is dominant because it is lower (more appreciated) than the industrial equilibrium.

28. The distance between the industrial and the current equilibrium gives the severity of the Dutch disease.

29. The current equilibrium (1) depends on the international price of the commodities in an inverse way; when the prices increase, the current equilibrium increases and, so, the price of the exchange rate increases (making the Dutch disease less severe), (2) depends on the export tax that the country uses to neutralize the Dutch disease, and (3) depends, on the domestic side, on the tariffs on imports.

30. The industrial equilibrium depends on the value of the exchange rate relative to the manufacturing or non-commodity tradable industries, which depend on the comparative unit labor cost of the country in relation to its main trade competitors.

The tendency toward overvaluation

31. In developing countries there is a tendency to the cyclical and chronic overvaluation of the exchange rate, which means that, contrary to Keynesian and neoclassical macroeconomics, the exchange rate tends to be overvalued in the long run. In Figure 1, the market exchange rate behaves accordingly, and we have two real (the current and the industrial equilibrium), besides one false exchange rate equilibrium (the foreign debt equilibrium).

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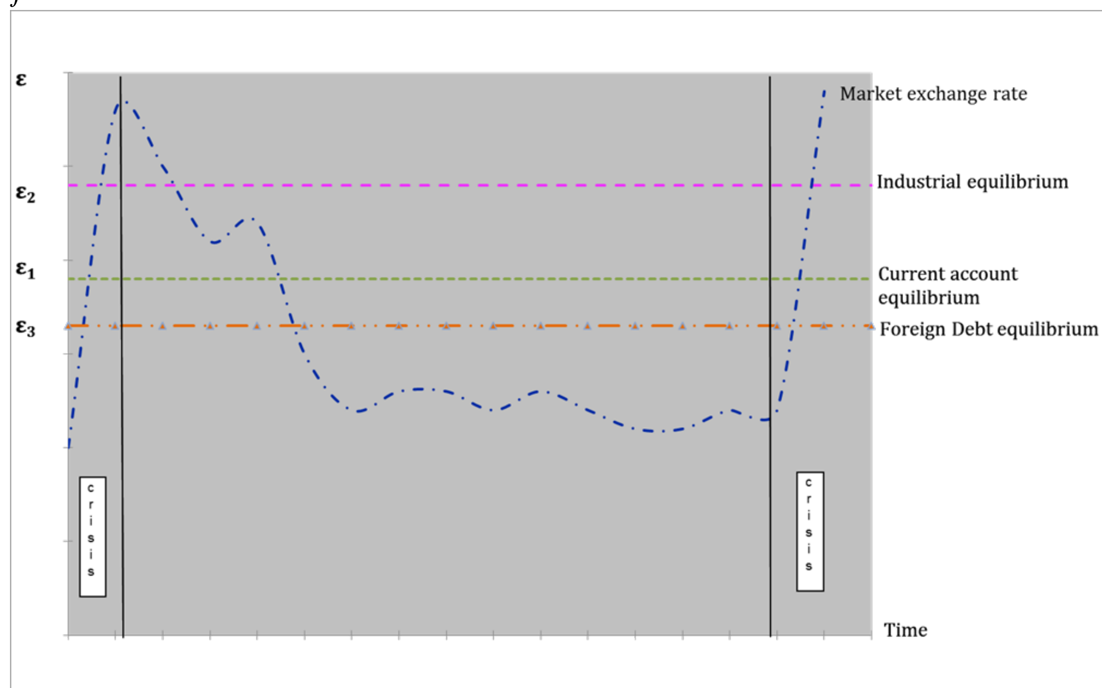
32. Figure 1: Tendency to the cyclical and chronic overvaluation of the exchange rate

33. *f*



34. There is a direct but not linear relation between the exchange rate and the current account;

35. The current equilibrium is the value of the exchange rate that balances intertemporally the current account; it is the effective equilibrium around which the exchange rate floats; the industrial equilibrium, the value of the exchange rate that is required to make competitive the tradable business enterprises using the best technology available; it is the competitive equilibrium; the foreign debt equilibrium is the exchange rate that corresponds to a current account deficit which keeps the foreign debt growing at the same rate as the GDP.

36. As a consequence of this tendency, besides investing too little, developing countries will go from one currency or balance of payment crisis to another, from one sudden stop to another sudden stop.

37. The tendency toward cyclical and chronic overvaluation of the exchange rate has a structural cause (the Dutch disease), and three habitual policy causes: (1) the growth *cum* current account deficits (foreign savings) policy ignoring the high rate of substitution of foreign for domestic savings, complemented by the policy of keeping the interest rate at a *level* high enough (around which monetary policy is practiced) to attract capital, (2) the adoption by the central bank of a high level basic interest rate, well above the international rate, to control inflation and to attract capital flows, and (3) the adoption of an exchange rate anchor to control inflation.

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38. The Dutch disease is a long-term competitive overvaluation or disadvantage originating from the fact that the country benefits from Ricardian rents derived from abundant and cheap natural resources; such rents enables business enterprises to export commodities at a profit at an exchange rate that floats around the current equilibrium, which is substantially more appreciated than the exchange rate required by other businesses enterprises producing tradable goods that use the best technology available in the world.

39. A non-neutralized Dutch disease means that, with the exception of the commodities that cause it, all existing and potential business enterprises producing tradable goods and services will not be able to invest and innovate because the expected profit rate will be small or negative. If the country neutralized the Dutch disease in the past, but later on ceases to do that (as was the case with Brazil), it will deindustrialize.[ii]

40. In most cases these often-adopted policies are forms of exchange rate populism because they lead the nation-state to spend irresponsibly more than it gets and to increase its foreign debt. And we have fiscal populism when the state spends irresponsibly more than it takes in and the public debt increases.

Balance of payment crises

41. The continuous appreciation caused by these three factors (the Dutch disease and the three habitual and, essentially, populist policies) will, first, involve a high rate of substitution of foreign for domestic savings. Second, it will increase the foreign debt and cause financial fragility, compelling the country to engage in the pathetic practice of "confidence building" policy (to adopt policies not according to the interests of the country but according to the conditions demanded by the IMF and of the international financial system), and, third, it will trigger a balance of payment crisis, which completes the cycle.

42. If the Dutch disease is not duly neutralized, it will keep the exchange rate overvalued in the long-term. But as it only pushes the exchange rate from the industrial to the current equilibrium, it will not cause a balance of payment crisis. What push the exchange rate down to the current account deficit are the three habitual and populist policies.

43. If the three habitual policies (growth *cum* current account deficits and the exchange anchor) are not rejected, the exchange rate will sooner or later cross the foreign debt equilibrium. Then a balance of payment or currency crisis will necessarily materialize.

44. The floating exchange rate regime does not prevent the financial crisis, because a bubble credit will keep the exchange rate overvalued for a long time, allowing the foreign debt to increase beyond a secure line.

Policies

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45. New developmentalism does not have a special contribution in relation to monetary and fiscal policy. Monetary policy should make the interest rate vary around a reasonable level—just a little bit higher than the average level of the real international interest rate.[iii]

46. Fiscal deficits are recommended only when there is a clear insufficiency of demand making the expenditures counter-cyclical. A loose definition of insufficiency of demand and the adoption of chronic budget deficits don't lead to growth and full employment; they are just an excuse for fiscal populism. To adopt a lax concept of insufficiency of demand and to propose chronic budget deficits is not Keynesian thinking, but vulgar Keynesianism.

47. As there is a monetary policy to determine the interest rate, an exchange rate policy is essential to determine the exchange rate, which should not be thought to be just an endogenous variable and, so, reduced to monetary policy, i.e., to change of the interest rate.

48. Besides no being reduced to monetary policy, exchange rate policy (a) should not be limited to the adoption or not of capital controls; (b) involves the rejection of two habitual policies: the growth cum foreign indebtedness policy; and, (c) when there is Dutch disease, requires a once for all policy to neutralize it: an export tax on the commodities that originate the disease.

49. The policy of growth *cum* indebtedness or foreign savings is self-defeating; even if the current account deficit is financed by direct foreign investments, the resulting capital inflow will appreciate the national currency, reduce the incentive for investment, and the usual outcome will be a high rate of substitution of foreign for domestic savings. This means that most of the foreign savings will finance consumption, not additional investment, even if the financing is made by direct investments.

50. This does not mean that the country should reject foreign direct investments. These investments are welcome if they bring technology or open new markets, and not because they finance current account deficits – something that middle-income countries definitely should not have. Given that, foreign direct investments will increase reserves and finance foreign direct investments, as does China and the fast growing Asian countries.

51. The use of the exchange rate as a nominal anchor against inflation is a major policy mistake; inflation may be controlled in this way, but at an absurd cost. If inflation is not inertial, the way to control it is through fiscal and monetary policy, besides macroprudential policies. The fact that a temporary rise of the interest rate to control inflation attracts capitals is true, but this effect will be small.

52. The growth cum foreign indebtedness policy and the policy of controlling inflation with the appreciation of the national currency involve exchange

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rate populism: the artificially increases wages and lowers inflation. In doing so they facilitate the re-election of politicians, but at the country's expenses.

53. It makes no sense to keep the exchange rate overvalued in the long term and justify the policy with the argument that the depreciation required to make the exchange rate competitive will cause real wage reduction; it will also cause the reduction of other revenues, and, so, will not have a truly distributive outcome, except in favoring the expected profit rate; but this is the objective of the devaluation: to ensure a satisfactory profit rate, which motivates business enterprises to invest.

54. The reduction of inequality should be achieved through both a minimum wage policy, which reduces wage and salary differentials, and the restoration of a progressive tax system.

55. The neutralization of the Dutch disease is done by the imposition of an export tax on the commodities equal to its severity (the difference between the industrial and the current equilibrium). This tax will increase the cost of the commodity, their exporters will reduce their supply at the existing exchange rate, and the market will take charge of depreciating it.

56. A second best way of neutralizing the Dutch disease is a linear (equal for all goods) increase in import tariffs by adding to it an "exchange rate-tariff"; it will neutralize the Dutch disease in the domestic market, but will continue to block competent firms seeking to export.

57. Although the twin deficits hypothesis does not hold when the exchange rate is either overvalued or undervalues, it holds when the exchange rate is competitive. Given that in the countries that neutralize the Dutch disease the exchange rate will be competitive and the current account will show a surplus, it should also if not a fiscal surplus, for sure, a budget deficit consistent with a small and controlled public debt.

58. The cost involved in neutralizing the Dutch disease and, more broadly, in neutralizing the tendency to the cyclical and chronic overvaluation of the exchange rate is a temporary one and relatively small; it will amount to a rise of inflation and a reduction of all revenues in real terms (the wages and salaries, and the interests, the real state rents, and dividends), except the profits of the business enterprises—precisely what is required to increase the investments opportunities that an overvalued currency depresses.

59. The outcome of these policies will be an increase in the profit opportunities, an increase in the investment rate, and in the export rate of manufactured goods, and, last but not least, the achievement of a current account surplus. This will, necessarily, derive from the neutralization of the Dutch disease—from the shift from the current equilibrium to the industrial equilibrium, which, by definition, corresponds to a current account surplus.

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60. Thus, new developmentalism claims, counterintuitively but logically, that middle-income countries do not need foreign capital to grow; they will grow faster if they present current account surpluses most of the time.

Development strategy

61. A growth strategy may be wage-led, neutral, or export-led, depending on the openness coefficient of the country be falling, constant, or increasing.

62. New developmentalism rejects a wage-led strategy, because such strategy supposes protectionist tariffs, or, in other words, which are legitimate for countries that are beginning their industrialization, not for middle-income countries, which must compete in the international markets.

63. New developmentalism favors an export-led strategy after the once and for all depreciation required to move the value of the national currency from the current to the industrial equilibrium had its short-term effect, and up to the moment that low wages represent a competitive advantage in relation to rich countries. After that, the strategy should be neutral or balanced in so far as the openness coefficient achieve its appropriate level, given mainly the size of the country

Microeconomics and distribution

64. Prices vary according to the demand and supply around the value of the good or service, which is defined by the social labor required. Or, more simply, defined as the cost plus reasonable profit involved in its production.

65. The allocation of factors in the competitive sector is made by the market through the tendency toward the equalization of the rates of profit, whereas in the non-competitive sector, particularly in infrastructure, planning or state coordination is required.

66. Industrial policy is part of the competitive game among nations, but it should be adopted strategically, as an addition to the right macroeconomic prices, particularly the profit and the exchange rate, never as a substitute.

67. The once and for all depreciation of the exchange rate required to make the shift from the current to the industrial equilibrium implies an increase in the profit rate and a reduction of all revenues (wages, salaries, interest, dividend and rent revenues); this is necessary to make the competent business enterprises competitive and assure full employment.

68. Minimum wage policy, a progressive tax structure and a low level of interest rates—not an overvalued currency—are the three legitimate and indispensable means to reduce economic inequality, which is inherent in capitalism.

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69. The protection of the environment and a reasonable growth rate require a permanent compromise and a persistent search of win-win solutions.

Political Economy

70. Capitalism is either market and state coordinated, or almost exclusively market coordinated; in the first case the state will be developmental, in the second, economically liberal.

71. The first historical form of capitalism in each country—the one where the formation of the nation-state and the industrial revolution occurs—is always developmental and authoritarian. Considering only the countries that first industrialize, the first historical form of developmentalism was characterized by a mercantilist class coalition. Considering the latecomer or developing countries, the class coalitions had as models the Meiji Restoration and the Bismarckian class coalitions.

72. Economic liberalism was just a 19th century attempt never fulfilled to make the coordination of capitalist economies depend only on self-regulated markets.

73. It was followed by a second developmentalism—the Fordist or social-democratic developmentalism. Neoliberal capitalism was a second and short-lived attempt to go back to the past.

74. A developmental class coalition associates business entrepreneurs, the public bureaucracy and the workers, whereas a liberal class coalition associates rentier capitalists, the financiers who manage the wealth of the former and the foreign interests.

75. Developmentalism was historically authoritarian and conservative. It only became democratic and progressive with social democracy or Fordism in the New Deal and the Golden Years of Capitalism.

76. New developmentalism, which focuses on middle-income countries that are supposed to be democracies, searches to be progressive alternative not only to neoliberalism, but also to conservative developmentalism. In democratic middle-income countries, developmentalism is consistent with social democracy, not with socialist policies that underestimate the fact that a satisfactory profit rate is a condition for capitalist growth.

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[i] Public savings equal total revenue less consumption or current expenditures including interest on the pubic debt.

[ii] Between 1967 and 1990 the "confisco cambial" [exchange confiscation] was embodied in the country's trade policy: an average tariff on the import of manufactured goods of 45% and an average subsidy of the same 45% on the exports of manufactured goods implied a tax of 30% on the export of commodities. Policymakers adopted this policy without knowing that a large part of the tariff was not protectionism, but the necessary neutralization of the Dutch disease, which fluctuates around 20% in Brazil, becoming more or less serious as the price of commodities increases or decreases.

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[iii] It should not be substantially higher because it should not be willing to attract foreign capital.

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