

New developmentalism

The exchange rate at the center of development economics

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NEOCLASSICAL economics became dominant in universities in the second half of the 1970s. It was based on the general equilibrium model, rational expectations macroeconomics, and growth models. Although there is no direct link between this kind of thinking and the neoliberal policies and reforms proposed by the World Bank and, more broadly, by rich countries to developing countries, known as the Washington Consensus, it is clear that neoclassical theory served as an allegedly scientific basis for them. Correspondingly, the theoretical alternative to neoclassical economics - the associated structuralist development economics that was dominant between the 1940s and the 1960s lost influence and was no longer significantly renewed.¹ As a result of both this change in theoretical hegemony and the serious external debt crisis that weakened developing countries, particularly Latin American countries, these countries submitted, one by one, to the liberalization and deregulation policies proposed by the neoliberal consensus. As a result of this change in the ideological and theoretical hegemony and of the huge foreign debt crisis that in the 1980s debilitated the developing countries, particularly in Latin America, most of those countries submitted, one by one, to the policies of liberalization and deregulation prescribed by the neoliberal consensus. The exceptions were the fast-growing Asian countries that modernized their institutions and opened their economies to trade, but kept their capital accounts relatively closed their exchange rates under control.

It was in this context that from the early 2000s - when the inability of the Washington Consensus to promote economic development with price stability became clear - Latin America began to experience a second moment of *structuralist development macroeconomics*, which is no longer concerned with demonstrating the need to industrialize or to transfer labor to sectors with higher value-added per capita (these are taken as given) but focuses on macroeconomic prices, especially the interest rate and the exchange rate. At the same time a new national development strategy, rival both to the former national developmentalism (which had become outdated since the countries were at a more advanced stage of development) and to the Washington Consensus, started to take shape

and came to be known as “new developmentalism”. New ideas, as well as an independent political phenomenon - the victory of leftist political and economic nationalist parties in Latin America - reflected the same phenomenon: the failure of neoliberal reforms to promote development and reduce inequality.

In this paper my goal is to present a summary of new developmentalism, comparing it with the neoliberal orthodoxy, and the structuralist development macroeconomics that perhaps can be considered a second moment of the structuralist development theory that originated in a group of economists who, during the Second World War, in London, gathered within the scope of the transition of the League of Nations to the United Nations, and whose thoughts prevailed between the 1940s and 1960s.² I want to point out how and why structuralist development macroeconomics places the exchange rate in the center of the theory of economic development. Usually this macroeconomic price is not considered part of the development theory because it is presumed either that it floats gently around the current equilibrium, as in neoclassical theory, or that it floats in a volatile manner around this equilibrium, as in Keynesian theory. It would therefore be a short-term problem to be studied by macroeconomics. However, if instead of that we assume that the exchange rate tends to appreciate cyclically, it's easy to understand why it remains chronically overvalued, and therefore it is an issue of medium term also to be studied by development economics. An overvalued exchange rate prevents modern and efficient companies in developing countries have access to the international market.

Structuralist development macroeconomics starts from the Keynesian assumption that the major bottlenecks to growth and to full employment lie on the demand side. The supply side is obviously essential - particularly education, technical progress, a good infrastructure - but the chief problem lies in using the available resources through investments that also increase the supply capacity of the country. This structuralist macroeconomics that began to be defined in the first decade of the twenty-first century is characterized by two structural trends that limit investment opportunities: the tendency for wages to grow more slowly than productivity and the tendency to the cyclical overvaluation of the exchange rate. The first tendency, which has been emphasized and widely discussed by Celso Furtado and by other members of the structuralist school, limits the growth of the domestic market. Its basic cause is the unlimited labor supply existing in developing countries (Thesis 6 of the structuralist theory). Neoclassical economists argued that developing countries should grow through concentrating income and, therefore, with wages growing more slowly than productivity “because in those countries the rich save more than the poor,” but that argument does not hold empirically, first, because it is not savings that determine investment, but it is investment that (duly internally financed) determines savings; second, because in those countries the rich have a high propensity to consume and their consumption tends to be directed toward imported

goods. In turn, it should be remembered that in the long run, on the assumption of neutral technical progress, an increase in wages of the same proportion as an increase in productivity is not only necessary for ensuring entrepreneurs profitable investment opportunities, but is compatible with the maintenance of the profit rate at the level required to promote the investment provided that technical capital is neutral.

Structuralist development economics

Structuralist development macroeconomics is worthy of the name because it adopts the historical-deductive method to understand economic development, instead of formulating hypothetical-deductive growth models. Therefore, it views economic development as a complex process of structural change that is historically translated as “industrialization”, meaning the increase in productivity associated with the continuous transference of labor to sectors producing more technologically sophisticated goods and services, with higher value-added per worker, which require more educated and skilled labor and pay higher wages; that is also manifested in the continuous change in institutions and in values or ideologies; and whose primary cause is capital accumulation with the incorporation of technical progress.

Secondly, structuralist development economics maintained that the market is an excellent institution of economic coordination, but that economic development cannot rely exclusively on it. Economic development entails the formulation of a project or a national development strategy that involves government action and the regulatory power of the State. Economic development depends not only on the market but requires planning to ensure forced savings, finance private investment and take advantage of externalities derived from combined investments.

Third, it was concerned with the lack of lucrative investment opportunities because, contrary to what happens in developed countries, the first industrial enterprises to be installed do not take advantage of externalities flowing from the existence both of a group of enterprises oriented toward the same activity and of forward and backward linkages. For this reason, and also because the private sector would lack the ability to invest in economic infrastructure and in basic raw material industries, the state should promote forced savings and plan a “big push” - an extensive investment program.

Fourth, structuralist development economics presumed (erroneously, as we shall see) that developing countries including the middle income ones would not generate sufficient domestic savings to finance their development and, in addition, that they would be victims of a permanent shortage of hard currencies or dollars, and should therefore rely on foreign savings in order to grow.

Fifth, the structuralist theory denied that developing countries would enjoy permanent comparative advantage in the production of primary goods in which they should specialize, and rejected the condemnation of tariff protection

made by conventional economics. Their critique was based on the infant industry thesis, on the thesis of the tendency to the decline in the terms of trade, and on the thesis of the high income-elasticity of the demand for manufactured goods versus the low-income elasticity of the demand for primary goods.

Sixth, according to the classical model of Arthur Lewis, an unlimited supply of labor from an economy's primary and traditional sector makes industrialization possible with a small increase in wages, but, for this same reason, it creates a chronic shortage of domestic demand.

Seventh, the structuralist theory maintained that structural inflation would necessarily follow economic development, because the imperfection of markets, particularly the food production market, implied supply bottlenecks, which would be solved only through an increase in prices.

Exchange rate at the center of the theory

Structuralist macroeconomics places the exchange rate at the center of the theory of economic development. Previous schools of thought, including the Keynesian and structuralist schools, had not adopted this position because they assumed that the exchange rate would be unbalanced only in the short-term; that contrary to what neoclassical economists say, the exchange rate varies widely, is very volatile.³ However, as I stated and demonstrated theoretically that the exchange rate tends to be cyclically overvalued and therefore export-oriented companies cannot rely on the assumption that it will remain in relative equilibrium – they should rather assume that it will generally be overvalued - exchange rate becomes a critical variable in development. A competitive exchange rate is essential for economic development, because it works as a sort of light *switch* that “turns on” or “turns off” technologically and administratively competent companies to global demand. A competitive exchange rate stimulates export-oriented investments and correspondingly increases domestic savings. It is the rate located at the “industrial equilibrium” level, that is, corresponding to the exchange rate required for enterprises using worldwide state-of-the-art technology to be internationally competitive. What is a competitive exchange rate? It is not a “relatively undervalued” exchange rate as I had thought for a while, but the exchange rate of industrial “equilibrium” that I defined when developing the “Dutch disease” model based on two equilibrium exchange rates. Why does it tend to be overvalued? First, because the Dutch disease pulls the exchange rate from the industrial equilibrium level to the current equilibrium level. Second, because excessive capital inflows caused especially by erroneous policies, e.g. the growth with foreign savings policy promoted by both higher interest rates to attract capital and the irresponsible increase in government spending; the exchange rate anchor policy to fight inflation; the policy to eliminate “financial repression”; and exchange rate populism, continue to bring about the appreciation of the exchange rate, pushing the it below the current equilibrium towards a current account deficit.

The tendency towards cyclical overvaluation found in developing countries therefore neither varies around the current equilibrium rate as assumed by the economic theory, nor floats in a well-behaved manner as assumed by the conventional theory or in a volatile way as stated by Keynesian economists. It is not the market, but the balance of payments crises that determine its cycles. In the absence of an exchange-rate management policy to neutralize this tendency, the cycle starts with a financial crisis that abruptly and violently depreciates the exchange rate. The exchange rate, which when the cycle began was below the “current equilibrium” level (which inter-temporally balances the country’s current account), depreciates violently, and subsequently begins to appreciate, driven by two structural factors: first, the Dutch disease appreciates the exchange rate until it reaches the current equilibrium level; subsequently, capital inflows attracted by profit and interest rates, which tend to be higher, continue to bring about the appreciation of the exchange rate and produce the current account deficit. This structural attraction, coupled with erroneous policies that are not structural but recurrent, will continue to appreciate the exchange rate until the process is interrupted by a new balance of payments crisis. As long as the economic authorities pursue these policies while continuing to refuse to manage the exchange rate, the country will go into a current account deficit, will become indebted, and will gradually lose creditors’ confidence who, at a given moment determine the sudden stop, i.e., they cease to roll over the country’s external debt, the country plunges into a balance of payments crisis which, again, will depreciate the domestic currency and then the country’s currency once again violently depreciates.

A competitive exchange rate is essential for economic development because it makes the entire foreign market available to truly technologically and administratively competent domestic companies. Given the ongoing technical progress (the basic growth variable on the supply side), economic development is a function of the investment rate. A competitive exchange rate encourages export-oriented investments and correspondingly increases domestic savings. It encourages investment by companies that use global state-of-the-art technology, and which would not be internationally competitive if the exchange rate was chronically overvalued. When the exchange rate matches the “industrial equilibrium”, the entire foreign demand is open for really competent companies that use the best technology available in the world. An exchange rate in a country not affected by the Dutch disease (this occurs in very few countries if we use the broad concept of Dutch disease) is the exchange rate that balances the exchange rate inter-temporally: the “current equilibrium” exchange rate; in other countries it is the rate located at the “industrial equilibrium” level, that is, corresponding to the exchange rate required for enterprises using worldwide state-of-the-art technology to be internationally competitive.

Dutch disease

The Dutch disease is an old problem, inherent in monetary economies where there are Ricardian rents arising from commodity exports, but it received this name because it was identified in the Netherlands in the 1960s, when Dutch economists found that the discovery and export of natural gas were appreciating the exchange rate and threatening to destroy the country's entire manufacturing industry. It was only in the 1980s that the first theoretical model on the subject appeared: a two sectors model (Corden & Neary, 1982; Corden, 1984). The literature on the subject is still scarce and insufficient. My model, instead of assuming two sectors of the economy, assumes two equilibrium exchange rates. The Dutch disease is a market failure that permanently overvalues the exchange rate, but it is consistent with the inter-temporal equilibrium of the current account. Even though in developing countries this failure constitutes a major obstacle to industrialization, neither development economics nor Latin American structuralist theory took it into account. Yet it was intuitively perceived, and reflected in developmentalist economic policies.⁴ The import duties that structuralist theory advocated were not, after all, particularly protectionist, but were an effective way of neutralizing the Dutch disease on the import side, since the duties imply a devaluation of the currency for importers. On the other hand, those nations that subsidized the exports of industrial goods in the 1970s (such as Brazil and Mexico) were also neutralizing the Dutch disease on the export side, even if this was not clear to them. The duties on the one hand and the export subsidies on the other, from which the commodities giving rise to the Dutch disease were excluded, ended up as, in practice, the equivalent of a tax on these commodities.⁵

The Dutch disease, or “the natural resources curse”, may be defined as the chronic or permanent overvaluation of a country's exchange rate caused by Ricardian rents arising from abundant and cheap resources, whose production is compatible with a *current-equilibrium* exchange rate that is clearly more appreciated than the *industrial-equilibrium* exchange rate. The “current equilibrium” exchange rate is here understood as the rate that balances inter-temporally the country's exchange rate, and the “industrial equilibrium” exchange rate as the rate that economically favors enterprises in the tradable sector using worldwide state-of-the-art technology. On this definition, the Dutch disease is a market failure that, by damaging the prospects of efficient and technologically sophisticated enterprises, prevents the structural change - the country's industrial diversification - that characterizes economic development. Several authors draw a distinction between Dutch disease and the curse of natural resources: whereas the former would be a market failure, the latter would result from corruption or from *rent seeking* made possible by the abundance of natural resources in countries where society likes cohesion and the state is weak and often captured by private interests. Although the problem of corruption exists in every country and

is more serious in poor countries where there are Ricardian rents to be captured by corrupt individuals, we do not draw a distinction here between the two concepts, both because corruption is a criminal rather than an economic problem, and because the emphasis on corruption diverts attention from the economic phenomenon itself, namely, the permanent or chronic overvaluation of the exchange rate caused by the Dutch disease or by the curse of natural resources.

The countries affected by the Dutch disease may fall into three categories. The first category includes countries that have never industrialized (such as Venezuela). In the second category, countries that were able to industrialize for some time because, consciously or unconsciously, they neutralized the Dutch disease, but later adopted financial opening, lost control over their exchange rates, and either for that reason or because the prices of their exported commodities greatly increased engaged in a process of premature deindustrialization (such as Brazil), or because they were industrialized and then discovered natural resources that gave rise to the Dutch disease (such as the Netherlands and Norway). Gabriel Palma (2005), using the terms defined by Robert Rowthorn (1994), points out that economic development follows a U-curve regarding industrialization: it is identified first with industrialization, and later with deindustrialization. From then on, Palma classifies middle-income countries into two groups: those that have no development alternative but to generate a surplus from the export of manufactured goods (such as the fast-growing Asian countries), and those that can generate this surplus from the export of commodities (such as Latin American countries); and he defines the Dutch disease as premature deindustrialization, as an “excess” of deindustrialization existing in countries rich in natural resources that are not able to prevent premature deindustrialization.

The *severity* of the Dutch disease is determined by the difference between the industrial-equilibrium exchange rate and the current-equilibrium exchange rate. The greater the difference, the more severe is the disease. The *neutralization* of the Dutch disease, in turn, is achieved when the policy of *managing* the exchange rate makes it competitive, taking it from the current-equilibrium level to the industrial-equilibrium level. A *competitive* exchange rate, therefore, is equivalent to the industrial-equilibrium exchange rate. The neutralization of the Dutch disease is mainly effected through the imposition of a variable tax or levy on the commodity exports equal to the difference between the two rates in domestic currency. This tax shifts the supply curve of the good upwards to the industrial level, in relation to the exchange rate (not in relation to the international price, which we presume constant) because now the producers of the good will only be willing to produce the same amounts if the exchange rate is depreciated accordingly. Ideally, the government should not use resources of this tax to finance current expenditures, but rather to create and invest in a sovereign fund, so as not to put pressure on the exchange rate with government

capital inflows. If a Dutch disease country keeps the exchange rate around its industrial equilibrium, the country will have a current-account surplus, and, provided that it invests the resources in the sovereign fund, a fiscal surplus.

How to measure the severity of the Dutch disease, g , or, in other words, what is the tax on the sales value of the good that takes it from the current equilibrium to the industrial equilibrium? It will be equal to the difference between the industrial-equilibrium exchange rate, e_i , and the current equilibrium rate, e_c , divided by the export price of the commodity, x .

$$g = (e_i - e_c) / x$$

A simple example helps to explain the problem. Let's assume two countries (A and B) exporting two different commodities whose price in hard currency is equal to one monetary unit of hard currency. In country A the Dutch disease is mild, and therefore the current equilibrium exchange rate (e_c) is #2.00 and the industrial equilibrium exchange rate (e_i) is #3.00 monetary units of the country per dollar. Yet in country B the disease is severe: the current-equilibrium exchange rate is the same, but the industrial-equilibrium exchange rate is #40.00 monetary units of this country per dollar. In country A, therefore, the severity of the Dutch disease is relatively low, 33.3% with regard to the sale price of the good in local currency, whereas in country B the severity is much higher, 95%.

$$g_A = (3 - 2) / 3 = 33.3\%.$$

$$g_B = (40 - 2) / 40 = 95\%.$$

To neutralize the Dutch disease in country A a 33.3% tax will suffice, while in country B a 95% tax will be required. In a country producing agricultural goods the severity of the Dutch disease should be close to the case A; in an oil exporting country it may reach the level of case B.

Growth with foreign savings

The Dutch disease chronically appreciates the exchange rate, but does not pull it to the current account deficit because one of its key features is to be consistent with the inter-temporal current account balance. The exchange rate, however, continues to appreciate below the current equilibrium due to capital inflows, whose causes I have already mentioned. Among them the most important is the growth with foreign savings policy, i.e., with current account deficits financed by loans, direct investment and portfolio investments.

For a long time I believed that external debt was the price of development. I shared this vision with the structuralist theory and its *two-gap* model which formalized the belief that Latin American countries face a permanent foreign exchange restriction that needed to be corrected with current account deficits financed by loans or foreign investment. I failed to consider, however, that cur-

rent account deficits or foreign savings were not added to domestic savings but mainly replaced them, to the extent that foreign savings contribute to appreciating the domestic currency.

For structuralist development macroeconomics there is no truth in the “obvious” or “intuitive” argument that developing countries need foreign savings to grow. Only in some cases the current account deficit, rhetorically called foreign savings, helps the country to develop. Typically, it causes a high rate of replacement of foreign savings with domestic savings, so that it is not investment, but consumption and the external debt that grow. The exchange rate here is the endogenous variable determined by capital inflow incentive policies. The higher the capital inflow, the greater the exchange rate appreciation.⁶ The more appreciated the exchange rate, the higher the real *wages* (of workers) and salaries (of the professional middle class), because the prices of internationally tradable consumer goods will be lower in relation to the prices of non-tradable services, including wages and salaries. Consequently, the capitalists’ profits will fall either because on the income or supply side wages and salaries have increased, or because on the demand side companies will reduce their profit expectations in export-oriented investments and thus will invest less. The elasticity of real wages with regard to the exchange rate will be higher for each household the higher is its marginal propensity to consume and the higher the sensitivity of exports and imports to the exchange-rate appreciation. Profits and wages, therefore, apart from depending on the economy’s level of productivity and on its pattern of income distribution, also depend on the exchange rate.

As for the profit rate, we know that it is the reverse of the wage rate, so that an increase in wages decreases the profit rate. But both the real profit rate and the expected profit rate also depend on domestic demand and external demand. Or, in the second case, on the exchange rate allowing or denying efficient companies access to the global market. If the interest rate and exchange rate tended to remain in equilibrium dodging it within a certain limit, then investments, which depend on the expected profit rate, would not be affected. But since this is not true and the interest rate is often higher than it would be reasonable in developing countries, and since the exchange rate tends to appreciate, in the absence of a corrective economic policy the investment rate will be low, which will cause the ex-post saving rate to also be low, and, finally, the growth rate to be well below what it could be if the two rates - the interest rate and the exchange rate - were maintained at a balanced level - the first at a reasonable level without prejudice to the monetary policy and the second around the industrial equilibrium. We know that a growth with foreign savings policy, that is, growth with foreign indebtedness, implies in the medium term an increase in the country’s financial vulnerability and, later, a balance-of-payment crisis. But before this it implies a usually high substitution of foreign for domestic savings as the exchange rate appreciates. Why? On the income side, because the

appreciation of the currency artificially increases real wages, and, given a high marginal propensity to consume, increases consumption and reduces domestic savings. On the demand side, the exchange-rate appreciation reduces lucrative investment opportunities, export-oriented investments decline, and domestic savings decline. In both cases, foreign savings are not added to domestic savings but rather replace them.

In formal terms, the rate of substitution of foreign for domestic savings may be measured in a simple way. Given the marginal propensity to consume and the elasticity of investments with regard to exports, the rate of substitution of foreign for domestic savings is equal to 1 minus the variation in the rate of investment or total savings divided by the variation in the rate of foreign savings in the given period.

$$z = 1 - (I/Y_t - I/Y_{t-1}) / (S/Y_{xt} - S/Y_{xt-1})$$

If, for instance, the investment rate in a certain period varies from 20% to 21% of GDP, whereas in the same period the current-account deficit or foreign savings increased by 4% of GDP, the rate of substitution of foreign for domestic savings will have been 75%; only 25% of the funds received from abroad were actually invested, and the remaining 75% were directed toward consumption.

Fiscal responsibility

Public deficit weakens the State and causes inflation, and thus should be avoided, except in times of recession. This idea was implicit in structuralist theory, and was never challenged by its major representatives, but it was the subject of a serious distortion, as long as, particularly in Latin America in the 1980s, vulgar Keynesianism criticized orthodox economists for defending fiscal responsibility and proposed chronic fiscal deficits as a way of fighting the shortage of demand. Keynes (1980, Ch.5) distinguished between the current budget and the capital budget, and argued that the former should be in balance. To Robert Skidelsky (2009 p. XVI), Keynes was not an apostle of fiscal deficits; on the contrary, “It may surprise readers to learn that Keynes thought that government budgets should normally be in surplus.” Luiz Fernando de Paula (2008, p.225), in turn, pointed out that

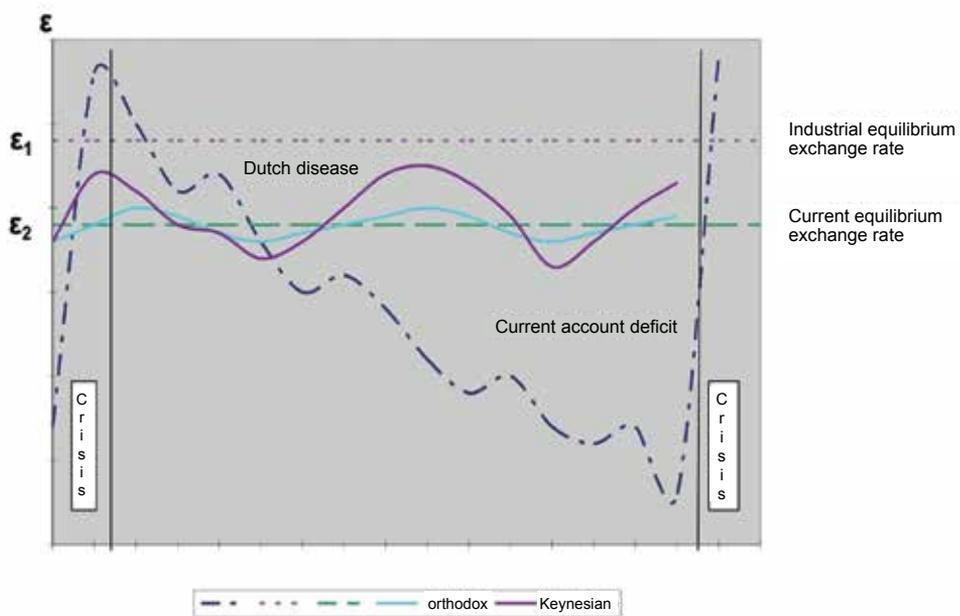
Keynes advocated that the *regular budget* should be in balance the whole time or even in surplus, that it should be transferred to the *capital budget*, whereas this latter might be temporarily unbalanced, although it should be in balance in the long run.

Structuralist development macroeconomics therefore adopts a similar attitude to public deficits as it does to current account deficits: it is against it, except in special situations. It sees in the two deficits ways to disrupt and weaken the economic system: in one case we have *fiscal irresponsibility* and in the other

exchange rate irresponsibility. For economic development with stability to occur, the economy of the Nation-State should be solvent; sometimes, current account deficits weaken it, make it dependent on foreign creditors, besides causing inflation. The State should also be capable, because this principle is the nation's main instrument of collective action, since the proper operation of markets depends on its regulation; well, all budget deficits do is weaken the State.

Summary figure

Based on the five theses concerning the exchange rate, in the framework of the *exchange-rate cycle* in Figure 1 we can see and compare three approaches to the exchange rate in developing countries. According to the conventional theory, the exchange rate floats in a controlled way around the current equilibrium exchange rate; according to the Keynesian theory, it floats in a volatile way, but still around the current equilibrium exchange rate. In contrast, the assumption of structuralist development macroeconomics is that there is a tendency to the cyclical overvaluation of the exchange rate. As it is assumed that the country suffers from the Dutch disease, we have a line for the current equilibrium exchange rate and another for the industrial equilibrium exchange rate. Whereas for the conventional and Keynesian theories it is still the market that controls the exchange rate, for structuralist development macroeconomics this role is performed by the balance-of-payment crisis. In Figure 1, the ordinate represents the exchange rate in terms of domestic currency/reserve currency, so that the lower the position in the exchange rate curve, the more appreciated is the domestic currency.



Graph 1 - Tendency to the cyclical overvaluation of the exchange rate

Given the assumption that the government *does not* manage the exchange rate, the tendency to the cyclical overvaluation of the exchange rate is manifested in a cycle that begins and ends with a currency crises or balance-of-payment crises. At the moment of the crisis – a *sudden stop* resulting from foreign creditors' loss of confidence - there is a sudden and violent devaluation that may take the exchange rate up to a more appreciated level than the industrial-equilibrium level. Subsequently, the forces that in developing countries appreciate the domestic currency begin to operate. First, on the assumption that the country has the Dutch disease, it is up to it to pull the exchange rate back to the current equilibrium level. If the disease is serious, this first movement already represents a major appreciation. But, since the Dutch disease is compatible with the inter-temporal equilibrium of the current account, the appreciation it causes stops there. Afterwards, the exchange rate continues to appreciate and enters the area of the current-account deficit. The structural cause of this second movement is the fact that market profits and interest are higher in developing countries. More significant, however, are the economic policy causes that encourage the capital inflows: the growth with foreign savings policy, the use of the exchange rate as an anchor to inflation, the inflation targeting policy that actually uses the exchange rate as a nominal anchor, and the “financial deepening”, i.e., the increase in real interest rates to “make the economic activity more rational” and attract capital. These four policies are part of the conventional prescription book. Add to these a policy of local politicians – exchange-rate populism - i.e., the practice of setting the exchange rate or allowing it to appreciate for inflation to fall, real wages to increase, and politicians to be re-elected (if the balance of payments crisis does not occur before that).

When the exchange rate crosses the line or the range of the current equilibrium, the country is in a deficit that must be financed. In addition, it probably has an external debt that still needs funding. Besides, it has an external debt that continues to require financing. For a long period, however, the rollover and the increase in foreign debt are easily financed, because foreign creditors are happy with the nice interest and commissions they are receiving. Beyond a certain point, however, whether because the debt/export ratio is becoming too high (the basic explanation of exchange-rate crises in Latin America) or because the pace of growth of the current-account deficit is too high (which occurred in four Asian countries in 1997), the creditors eventually lose confidence and halt new loans, even those involving the mere rollover of debt. It is the crisis, and we once again have an abrupt devaluation of the domestic currency.

Old and new developmentalism

Following this short presentation of structuralist development macroeconomics, we are in a position to set out, also in a condensed way, the new developmentalism. It is best presented by comparison with the old developmentalism and, later, with the conventional orthodoxy or the Washington Consensus. We

are still referring to middle-income countries. Development structuralist macroeconomics theses also apply to poor countries, but with several adjustments. For the purpose of comparison between old and new developmentalism, Table 1 is self-explanatory. Therefore, and because we have no room for more, rather than discussing each of the five pairs of policies, we shall limit ourselves to some general issues. Not all changes are a criticism of national developmentalism; they merely reflect the fact that this national development strategy is intended for poor countries, whereas the new developmentalism is intended for middle-income countries. Including poor countries requires adjustments. The first difference - between import-substitution industrialization and *export-led industrialization* — well reflects this fact. The new developmentalism defends the export-led model and views the import-substitution model as outdated. In the export model, developing countries have the opportunity to exploit two major advantages: cheap labor and the possibility of buying or copying the available technology. On the other hand, if a country adopts this strategy, the economic authorities, who are making industrial policy in favor of their enterprises, can now base their decisions on an efficiency criterion: only enterprises efficient enough to export will benefit from the industrial policy.

Table 1 – Old developmentalism and new developmentalism

Old developmentalism	New developmentalism
1. State-oriented industrialization, based on import substitution.	1. Export-oriented industrialization, combined with mass consumption in the domestic market.
2. Central role of the State in obtaining forced savings and making investment.	2. It is the State's duty to create investment opportunities and reduce economic inequality.
3. The industrial policy is a key issue.	3. The industrial policy is subsidiary but strategic.
4. Ambiguity about public and current account Deficits.	4. Rejection of the two deficits. If the country has the Dutch disease it should achieve a fiscal surplus and a current account surplus.
5. Relative complacency regarding inflation.	5. No complacency regarding inflation.

Whereas in the national developmentalism the state's task was to complete the primitive accumulation of capital and promote the industrial revolution, in the new developmentalism the *state's role* decreases and the market's role increases. For the new developmentalism, the state still can and should promote forced savings and invest in certain strategic sectors, but now the domestic private sector has the resources and the entrepreneurial capacity to implement a good part of the necessary investments. On the same lines, for the old develop-

mentalism industrial policy was central; in the new developmentalism it is still significant but strategic, and must be applied to specific sectors and to enterprises able to compete internationally.

The new developmentalism *is not protectionist*, but simply emphasizes the need for a competitive exchange rate, which it identifies as the industrial-equilibrium exchange rate. It assumes that medium-development countries have already progressed beyond the infant industry stage, but, besides the problem of excessive capital inflow, they face the problem of the Dutch disease, and therefore they need to neutralize it. Neutralizing the Dutch disease does not imply protectionism, but rather exchange-rate management, particularly, as we have seen, through the imposition of a variable export tax on the commodities giving rise to the Dutch disease. According to microeconomics teaching, a tax shifts upwards the supply curve of the good, because now the producers will only be willing to produce at a higher price. Or, in the case of exports and if the international price is provided, producers will only be inclined to maintain production if the exchange rate depreciates in an amount corresponding to the tax, thereby shifting the current equilibrium exchange to the industrial equilibrium level and maintaining the commodity profitable while enabling the rest of the industry that uses internationally competitive technology.

The fact that the strategy of the new developmentalism is not protectionist does not mean that countries should be inclined to indiscriminate trade opening. In the context of World Trade Organization (WTO) and regional agreements, they should pragmatically negotiate openings with compensation. Above all, it does not mean that a country should renounce industrial policies. The scope for these policies was limited by the highly restrictive agreements of the Uruguay Round, but there is still some room for industrial policies, which, if they are strategically conceived and if take into account future comparative advantages, they will effectively promote economic growth.

Conventional orthodoxy and new developmentalism

In order to compare new developmentalism with conventional orthodoxy, we can differentiate development strategies from of macroeconomic stability strategies, even though they are closely connected. Let us begin with the differences more directly related to economic development or to the medium term. These differences are implicit in the discussion of the 13 theses summarized in Table 2 and thus will only be discussed briefly here. Unlike the comparison with old developmentalism, the general problem here is not a change in the stage of development, but *mistaken policies*: conventional orthodoxy suggests a package of reforms and economic policies, many of them tainted with market fundamentalism, which are of interest not to developing countries but rather to their competitors in the framework of globalization - the rich countries.

Table 2 – Conventional orthodoxy and new developmentalism (growth)

Conventional orthodoxy	New developmentalism
1. There is no economic role for the nation.	1. The nation is the agent responsible for defining a national development strategy.
2. The fundamental institution for growth is the guarantee of property rights and contracts.	2. The key institution for growth is a national development strategy.
3. Reforms should reduce the size of government and deregulate markets.	3. Reforms should strengthen the state and markets – and the latter should be well regulated.
4. The state should not implement an industrial policy or a redistribution policy.	4. Industrial policy should be limited and strategic and play a major role in income distribution.
5. There are no structural trends to be neutralized.	5. The tendency to currency overvaluation and the tendency of wages to grow slower than productivity should be neutralized.
6. Growth should be financed largely by foreign savings.	6. Growth should be based on domestic savings.

Orthodoxy ignores the problem of the *nation* or else assumes that in times of globalization nation-states have lost significance, while new developmentalism states that, in the context of the widespread competition that characterizes globalization, the fundamental agent of economic development is the nation, because it is up to the nation - the social classes agreeing reasonably among themselves - to define a national development strategy or an international competition strategy. Contrary to the claims of new institutional economists and political scientists, the fundamental institution for development is not the guarantee of ownership and contracts. This guarantee is necessary, but entrepreneurs are men and women who accept the risk as long as they have an opportunity to make profits and grow. The institution or group of institutions that plays this role is the national development strategy.

Conventional orthodoxy is *market fundamentalist*, and believes that “in the beginning there was the market”, an entity that coordinates everything in an optimal way provided that it is free; whereas new developmentalism views the market as an efficient institution to coordinate economic systems, but is aware of its limitations. Good markets, efficient markets, are regulated markets. The allocation of factors is their best performed task, but even there it presents problems. Incentive to investment and innovation leaves much to be desired. Its ability to maintain financial markets stable is insufficient. And in terms of income distribution it is definitely an unsatisfactory mechanism because markets reward the strongest and most capable. Whereas conventional orthodoxy acknowledges market failures but affirms that the failures of the state in trying to compensate for them are even worse, the new developmentalism rejects this pessimism about the power of collective action and wants a capable state - strong, not at the cost

of the markets, but in order to make markets strong as well. If men are able to build institutions to regulate human actions, including the market itself, there is no reason why they should not be able to strengthen the State as an apparatus or organization, increasing the legitimacy of its government, the soundness of its finances and the efficiency of its administration while strengthening the State as law, making its institutions increasingly suitable for the social needs. Politics and democracy exist precisely for that purpose.

While the *new developmentalism* rejects the opening of the capital account, or *financial globalization* it is favorable toward *trade globalization* - a commercially open, competitive economy. But it is aware of the need to use international negotiations to obtain compensations, since world markets are far from being free. Both the new developmentalism and the conventional orthodoxy are favorable toward more flexible labor markets, but the new developmentalism, based originally on Scandinavian, but now increasingly European experience of “flexsecurity”, does not confuse flexibility with the absence of protection, while conventional orthodoxy makes the work more flexible in order to deteriorate the workforce and enable wage reductions.⁷

Switching from the medium to the short term, a fundamental difference between new developmentalism and conventional orthodoxy lies in the fact that the latter strongly preaches something that it considered obvious: developing countries would not have the resources to fund their growth and therefore should rely on *foreign savings* - i.e., they should incur current account deficit (definition of foreign savings) and finance them with loans or direct funding. We have already seen that this policy is only effective in the rare moments when the country is already growing considerably and the marginal propensity to save decreases. In most cases it is a misguided policy that does not increase investment but promotes the replacement of foreign savings with domestic savings. New developmentalism understands that it is not only possible but necessary to grow with saving of its own, as did all the countries that have already developed and are currently rich. This does not mean that new developmentalism is against foreign *direct investment*; its opposition is to current account deficits. It is perfectly possible to benefit from the technology brought by direct investments without using them to finance current account deficits. This is, for example, what China does.

The basic assumption underlying the macroeconomic policies compared in Table 3 is the need for *macroeconomic stability*, but whereas conventional orthodoxy ultimately restricts the concept of stability to the control of public expenditure and inflation, the new developmentalism applies it more broadly to include the stability of asset prices or the control of financial bubbles, balance-of-payments equilibrium, and reasonably full employment.

Table 3 – Conventional orthodoxy and new developmentalism (macro)

Conventional orthodoxy	New developmentalism
7. The Central Bank has a sole mandate: low inflation. The rest of the administration should pursue other goals.	7. The government and the Central Bank have three mandates: low inflation, balanced exchange rate and full employment – all three are essential for development.
8. The fiscal standard should be defined in terms of primary surplus.	8. The fiscal standard should be defined rigorously in terms of public deficit and savings.
9. The exchange rate should be floating: no target or policy for the exchange rate.	9. The exchange rate should be floating but managed; the target is the industrial equilibrium exchange rate.
10. The Central Bank and the government each have a sole mandate: to determine, respectively, the short-term interest rate and fiscal policy.	10. The Central Bank and the government may additionally buy reserves, impose capital controls, etc.
11. An income policy is not required or desirable.	11. Minimum wage and income policy should contribute to ensure that wages grow as much as productivity.

The conventional orthodoxy approach can be summarized as follows: to ensure macroeconomic stability the country should have a primary surplus that maintains the public debt/GDP ratio at an acceptable level for lenders; the Central Bank should have a sole mandate – to fight inflation - since it has a single instrument - the short-term interest rate; given the fiscal imbalance, this rate, despite being the only instrument, is essentially endogenous, i.e., it is defined by the market, needs to be high to fight inflation; the exchange rate is also endogenous and its balance will be ensured by the market.

New developmentalism presents substantially different proposals: fiscal adjustment aims not merely at a primary surplus but at positive public savings, and implies a decrease not only in current expenditure but also in interest rates; The Central Bank, together with the Ministry of Finance, has three mandates: to control inflation, to ensure full employment, and to keep the exchange rate at a level compatible with the stability of the balance of payments and with the necessary incentive to export-oriented investments. The Central Bank's instruments go beyond the interest rate. The interest rate is an instrument to fight inflation, but it can be much lower than assumed by conventional orthodoxy.

The exchange rate should be *floating but managed* - no exchange rate is totally free. In resource-rich countries, as is the case of virtually all Latin American countries, it must be recognized that the Dutch disease artificially appreciates the currency and undermines the industry. Its neutralization is not easy because it involves depreciating the currency - which reduces wages in the short term (and strongly increases them in the medium term) and causes transient but unwanted inflation. The correct way to neutralize the Dutch disease is to establish a negotiated variable tax on the export of these goods capable of keeping production equally profitable (producers therefore lose nothing, because the tax is

offset by depreciation). The tax should be variable, so as to be altered according to the increase or decrease in the international price of each commodity, should have the necessary value to shift the supply curve of the good from the current equilibrium to the industrial equilibrium level. The revenues should be used to establish a *sovereign fund*. Therefore, the revenues from this tax should not be used to finance current expenditures, except for a small amount (1) to finance social policies that compensate for the decrease in wages, and (2) to establish a second fund - a stabilization fund for agricultural commodities (if they rather than oil are responsible for the Dutch disease). This fund is necessary because Dutch disease resulting from agricultural goods is usually not serious; the prices of such goods are highly unstable, and sometimes their decline makes production unviable, even with a zero-rated tax and at the current-equilibrium exchange rate, and it becomes necessary to subsidize them.

Advocates of conventional orthodoxy accuse developmentalist economists of populism. If we understand economic populism as one spending more than one gets, then we have *fiscal populism* (expressed in the current account deficit) and *exchange rate populism* (in the form of current account deficit). By neutralizing the Dutch disease, new developmentalism argues in favor of a current-account surplus (derived from the shift of the exchange rate toward the industrial equilibrium) and a public surplus (derived from not using the revenues from the tax that neutralizes the disease to finance current expenditure). Conventional orthodoxy, in turn, at the fiscal level, is satisfied with a primary surplus that maintains the public debt at a level considered not dangerous for lenders, and advocates that the country incur in current account deficits, as these would ensure growth with foreign savings.

Conclusion

In this paper we presented the foundations of a structuralist development macroeconomics that might be considered a second moment of the structuralist theory of development. A structuralist view because it maintains the idea that economic development is a process of structural change – of innovation in sectors already explored and of labor transfer to sectors with value added per capita and increasingly higher average wages. A structuralist view because it presupposes two structural tendencies: the tendency of wage rates to grow slower than productivity and the tendency towards the cyclical overvaluation of the exchange rate. Finally, a structuralist theory because it sees two structural factors behind this second trend: the Dutch disease and the fact that due to the relative scarcity of capital, profit and interest rates in developing countries are higher than in rich countries.

To be successful in this fierce competition – i.e., globalization - not only between companies but also between nation-States, each country should have its national development strategy - the key institution to stimulate investment and savings. We call this strategy new developmentalism, and we have seen that

its success depends essentially on neutralizing those two trends that limit economic development on the demand side: the tendency of wage rates to grow slower than productivity restricts the demand originated in the domestic market, while the tendency towards the cyclical overvaluation of the exchange rate prevents local businesses from accessing foreign markets.

A major novelty in this study is that it places the exchange rate at the center of the economic development theory. The previous economic theory, both the neoclassical and the Keynesian, as well as the structuralist theories assumed that exchange rate imbalances were short term imbalances, and therefore discussed them within the realm macroeconomics. To the extent, however, that exchange rate appreciation tends to be chronic (due to the Dutch disease) and cyclical (because of capital inflows), it is not difficult to understand that the exchange rate works as a sort of *light switch* that «turns off» the country's competent companies to the export markets.

School of Economics of São Paulo. Version of June 9, 2011.

Notes

- 1 This theory, whose main representatives were Rosenstein-Rodan, Arthur Lewis, Ragnar Nurkse, Gunnar Myrdal, Hans Singer, Albert Hirschman, Raul Prebisch and Celso Furtado is usually called “development economics” while the adjective “structuralist” has been reserved for the thought developed within ECLAC around thoughts of the last two aforementioned economists. However, as this designation does not distinguish clearly this school of thought from the mathematical models of growth, I have decided to call it “structuralist development economics”.
- 2 The economic literature generally restricts the term “structuralist” to the Latin American thought of Prebisch and Furtado. The term “development economics” applies to the school of thought of the “pioneers of development,” among whom are the two aforementioned economists. However, all of them were structuralists, and therefore I have decided to call that school “structuralist development economics”, in order to identify it more clearly and simply.
- 3 Since 2002 I have been developing a theoretical model that places the exchange rate at the center of development economics. In recent years there has been a substantial increase in the number of empirical studies associating exchange rate with development: Razin & Collins (1997); Flassback (2001); Gala (2008); Rodrik (2007); Eichengreen (2008). But these studies do not present a theory associating exchange rate with development. The relationship developed here between exchange rate and growth is found especially in Bresser-Pereira (2001); Bresser-Pereira and Nakano (2003); Bresser-Pereira & Varela (2004); Gala (2006); Bresser-Pereira & Gala (2007); Bresser-Pereira (2009a, 2009b). Although the last study mentioned - *Mondialisation et compétition* does not claim to presents a structuralist development macroeconomics (I came to this conclusion later), it contains almost all the ideas summarized in this paper.
- 4 Celso Furtado, for example, in a 1957 report on Venezuela practically arrived to the

definition of Dutch disease. That report has been recently published by the Celso Furtado Center and Contraponto Publisher (Furtado, 2008).

5 For example, in Brazil, in the 1970s, the average import duty was 50% and the export subsidy on manufactured goods was also 50% on average. This way, the agricultural goods that did not have a subsidy paid a “disguised tax” of 33.3% on the exported price.

6 The existence of current account deficit is associated with relative currency appreciation and thus might imply a market pressure for it to depreciate and the deficit to be zeroed out. However, as we are talking here of a “strategy”, this means that the economic authorities are satisfied with the deficit and, especially, through a high interest rates policy, seek to keep the exchange rate at the relatively appreciated level consistent with it.

7 About “flexsecurity” see Robert Boyer (2006).

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ABSTRACT – This paper presents the main ideas of structuralist development macroeconomics – the theory behind new developmentalism. Its focus is on the exchange rate that is positioned for the first time in the core of development economics. Economic theory usually views the exchange rate as a short term problem to be discussed in open macroeconomics. Structuralist development macroeconomics argues that there is in developing countries a tendency to the cyclical overvaluation of the exchange rate caused by the lack of neutralization of the Dutch disease and by excessive capital inflows. In consequence it views the exchange rate as chronically overvalued, and, for that reason, a major obstacle to economic growth. In the development process, the exchange rate has the role of light switch that connects or disconnects the national business enterprises utilizing technology in the world state of the art from world markets.

KEYWORDS: Exchange rate, Development macroeconomics, New developmentalism, Dutch disease, Foreign savings.

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The author thanks Fernando Ferrari Filho, Luiz Fernando de Paula, and Nelson Marconi for their comments.

Received on 10 May, 2012 and accepted on 25 May, 2012.