Capital flows and the changing balance in the world economy

Luiz Carlos Bresser-Pereira

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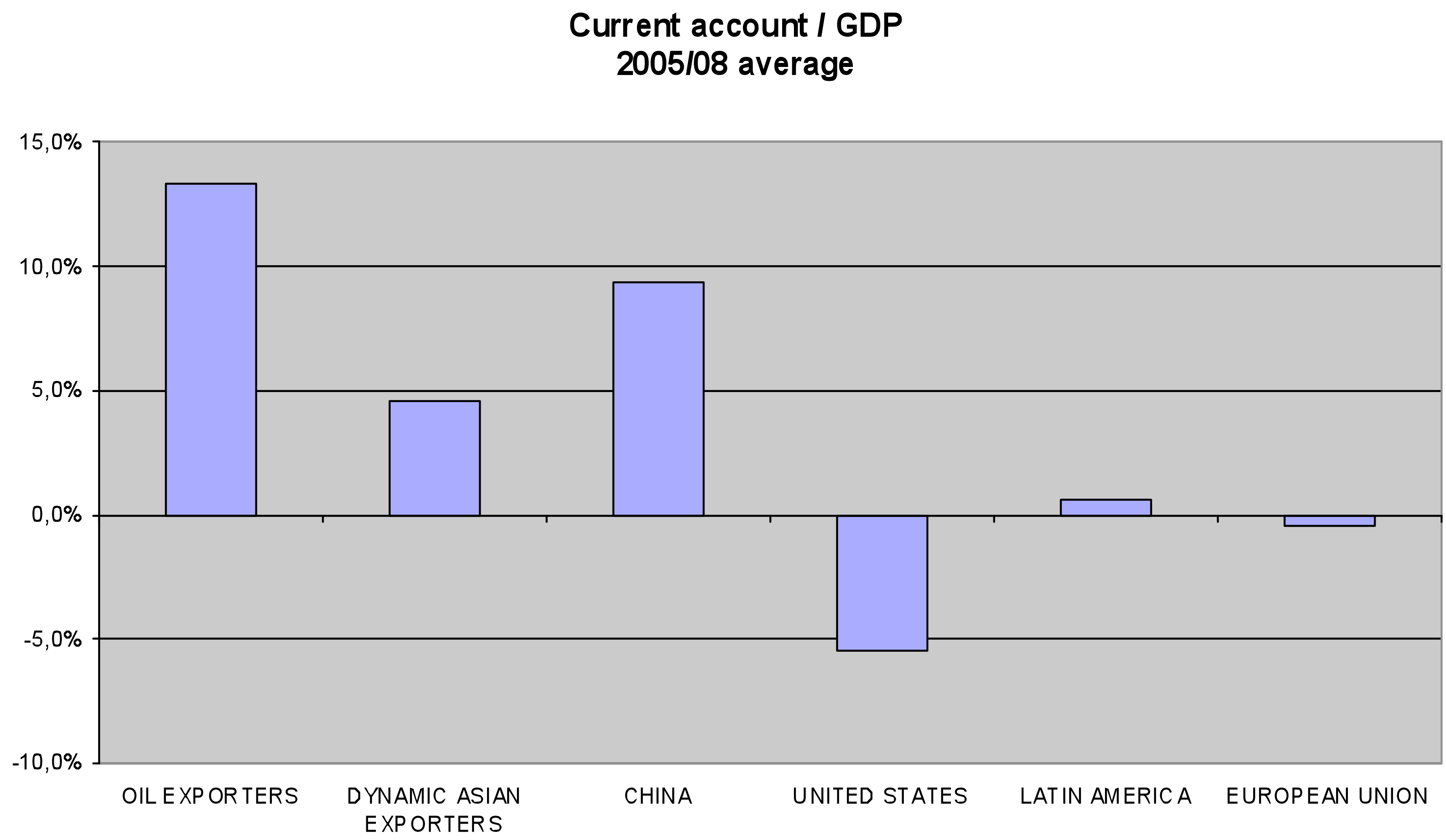
The world economic balance is changing

Several middle income countries (MICs) and oil exporter countries are:

1. growing much faster than rich country (catching up),
2. Achieving high current account surpluses
3. Making direct investments abroad


Current account / GDP
2005/08 average
15,0%
10,0%
5,0%
0,0%
-5,0%
-10,0%
OIL EXPORTERS
DYNAMIC ASIAN EXPORTERS
CHINA
UNITED STATES
LATIN AMERICA
EUROPEAN UNION

MIC (middle income country) defined

- Differently from a “poor country”, counts with the basic ingredients to catch up (because it “completed” its industrial and national revolution).
- – a capable business or capitalist class
- – a large middle professional class
- – a relatively organized working class
- – thus, a <u>nation</u>, and a reasonably effective <u>state</u> to serve of instrument of this nation to achieve its political and economic goals.

MICs and oil exporters were supposed to catch up

- For obvious reasons: cheap labor, capacity to by technology, abundant natural resources
- Yet, in the “30 golden years” (1949–78) and in the “30 neoliberal years of capitalism” (1978–2008) rich countries succeed (not deliberately) in partially neutralizing catching up.

The basic strategies neutralizing catching up were:

- Always:

– pressure for the liberalization of trade, plus
– proposal of growth with foreign savings or with foreign finance and foreign indebtedness.

- Additionally, since the yearly1990s:

– pressure to liberalize financial markets (i.e., to lose control on the exchange rate and allow for its appreciation).

Rich country's logic was simple:

- Market liberalization + growth with foreign savings
- "Given" that MICs lack domestic resources to grow,
- capital rich countries should transfer their capitals to capital poor countries.
- In other words, MICs should incur in current account deficits and in chronically high foreign debt to be financed either by loans or by direct investments.

Catching was successful in the countries that resisted

- that adopted an industrialization national strategy originally, based on a import substitution, but soon (1970s) changed into a export led strategy.
- Yet, since the 1970s/80s, there was a <u>bifurcation</u>:

  1. Group 1: most countries, certainly Latin American countries)

  2. Group 2: fast growing Asian countries

Group 1 (most countries): catching up stopped because:

(1) in the 1970s, they accepted a “growth with foreign savings policy”,
(2) in 1980s’ they faced the Great Debt Crisis, and got financially weakened,
(3) they got involved in economic populism and turned additionally fragile
(4) in the 1990s adopted neoliberal or market oriented reforms and lost control on their exchange rate

Group 2(fast growing Asian countries) growth accelerated because

- They did not get involved either in the Great 1980s Debt Crises or economic populism
- They resisted neoliberal reforms particularly on financial liberalization and kept control on their exchange rates
- Summing up, because they adopted new developmentalism's policy trypod:
  (1) fiscal responsibility,
  (2) exchange rate responsibility,
  (3) strategic role for the state.

In the 2000, the world balance began to change toward East

- 1. Growth in some fast growing middle income countries (chiefly China and India) accelerated still more.
- 2. Oil exporting (and other commodity exporters) benefited from the rise of commodity prices

3. Both groups of countries achieved high current account surpluses that allowed them to increase reserves and build large sovereign funds.

In 2008, a major financial crisis strengthened this change

The crisis hit the rich countries more severely than developing countries

Because it boomeranged: the rich countries adopted the deregulation reforms that they recommended do developing countries.

Why catching up and in the world balanced changed?

- Principally (not only) because middle income are are starting to learn how to deal with three major problems, all them related to the exchange rate:

Because they learned that a "competitive" exchange rate is a crucial demand side variable in economic growth

More specifically, because some MICs learned in relation to the exchange rate

- (1) how to finance growth without recurring to current account deficits;
- (2) what is and how to deal with the Dutch disease;
- (3) how to neutralize the tendency to the overvaluation of the exchange rate existing in developing countries.

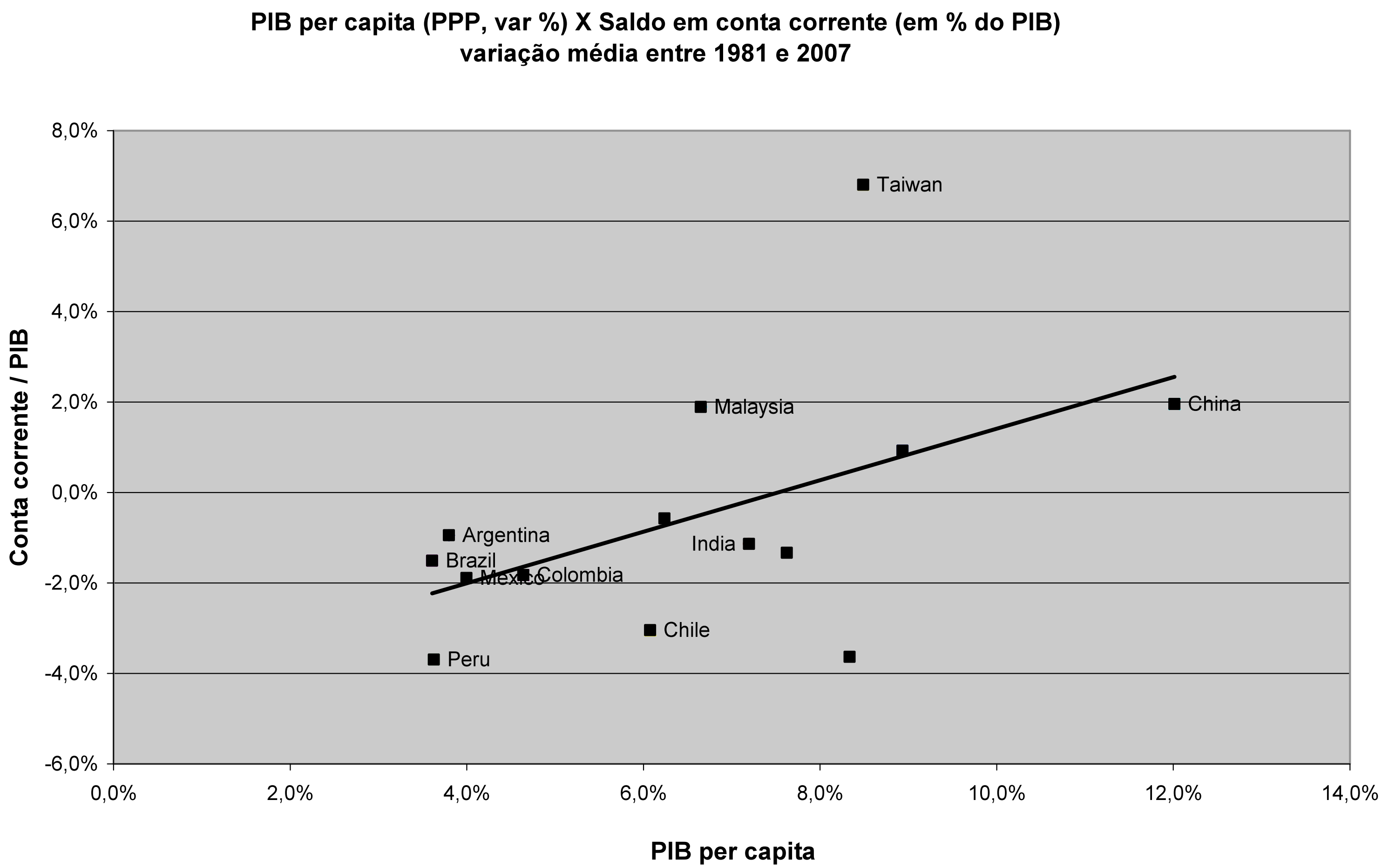
(1) To finance growth without recurring to current account deficits

or to "foreign savings", or to capital inflows.

Usually there is a high rate of substitution of foreign for domestic savings (or a high rating of savings displacement)

So that instead of increasing investment, capital inflows financing current account deficits cause

1. appreciation of the exchange rate
2. Increase in consumption
3. Increase in the foreign debt (See Graph)


PIB per capita (PPP, var %) X Saldo em conta corrente (em % do PIB)
variação média entre 1981 e 2007
Conta corrente / PIB
PIB per capita
8,0%
6,0%
4,0%
2,0%
0,0%
-2,0%
-4,0%
-6,0%
0,0%
2,0%
4,0%
6,0%
8,0%
10,0%
12,0%
14,0%
Taiwan
Malaysia
China
Argentina
India
Brazil
Mexico
Colombia
Chile
Peru

(2.1.) What is the Dutch disease

- What is: a permanent overvaluation of the currency caused by Ricardian rents deriving of one or a few commodities cheap and abundant natural resources that limits industrial growth because it leads to two exchange rate equilibriums:

1. "Current" equilibrium – the one that balances intertemporally the current account
2. "Industrial" equilibrium – the one that is required to tradable industries utilizing technology in the state-of-the-art be competitive.

The Dutch disease

- Is a major market failure because it is consistent with the long term equilibrium of the exchange rate in the “current” equilibrium.
- The competitve exchange rate is the one corresponding to the industrial equilibrium

- Cheap labor countries like China also face the Dutch disease because, additionally, the have a much higher salary-wage dispersion than rich countries.
- That is why fast growing Asian countries are so keen in managing their exchange rate

The neutralization of the Dutch disease (making it equal to the industrial equilibrium)

- requires a strong administration of the exchange rate;
- particularly a tax on exports equal to the difference between the two equilibrium prices that
- (1) shifts the supply curve of the commodity upwards,
- (2) leads to a current account surplus.

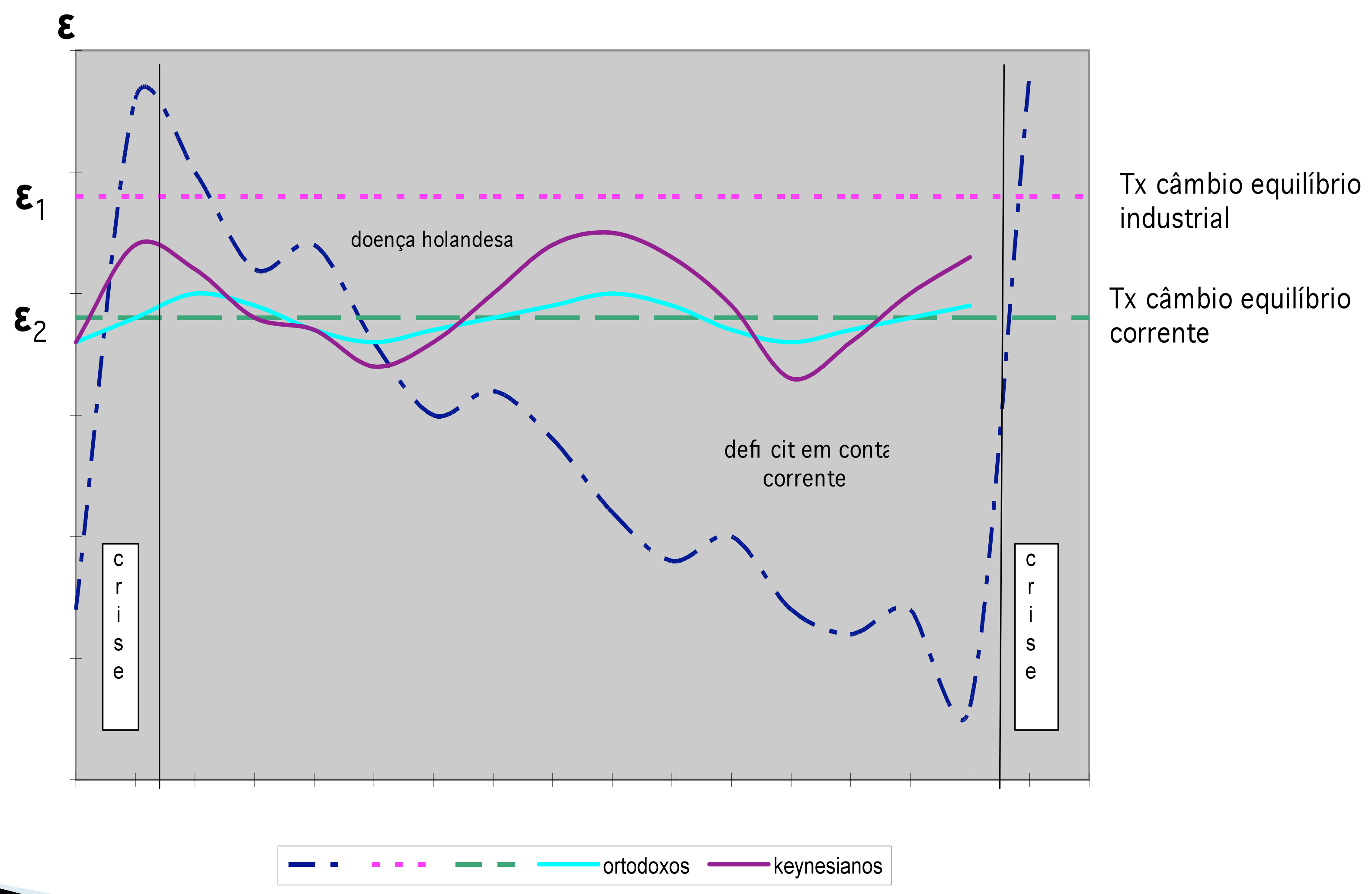
If all countries having the Dutch disease neutralize it

- (what is not easy),
- they will present high current account surpluses
- that will correspond to high current account deficits in rich countries.

- Thus, MICs will have to make investments abroad
- (Instead of capital rich countries to finance capital poor countries we will see the inverse)

(3) Cyclical tendency to the overvaluation of the exchange rate

- In developing countries the exchange rate is controlled by the market but by cyclical crises.
- The causes of the overvaluation are:
- 1. The Dutch disease that brings the exchange rate from the industrial to the current equilibrium
- 3. Capital inflows caused by the growth with foreign savings policy, inflation anchor, high interests to control inflation and "economic populism". See Figure


ε
ε1
ε2
Tx câmbio equilíbrio industrial
Tx câmbio equilíbrio corrente
doença holandesa
defi cit em conta corrente
c r i s e
c r i s e
ortodoxos
keynesianos

Summing up, middle income countries are learning

- (1) to finance growth with domestic savings;
- (2) to deal with the Dutch disease;
- (3) how to neutralize the tendency to the overvaluation of the exchange rate.
- And this learning partially explains
  (1) their high growth,
- (2) their current account surpluses and
- (3) their large sovereign funds.

This discovery process is partial – it is only beginning

- Latin American countries like Brazil still ignore that they are deindustrializing and falling behind.

- Several East European and African countries are again facing a major crisis because they believed that foreign savings caused growth.

In other words, the change in the world economic balance toward the East

is not happening by hazard,

- It the consequence of deliberate catching up policies that,
- (1) constitute a new developmentalism and
- (2) are theoretically based on a demand based theory that I propose to call “Structuralist Development Macroeconomics”