

# Policy constraints, current account deficits, and competitiveness-oriented macroeconomics

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**Summary:** Orthodox (neoclassical and Austrian) economics is in crisis since 2008. It is failing to offer the responses to the question that the secular stagnation of rich countries poses. In this paper that follows the New-Developmental approach, the author tries to offer some clues to the macroeconomics of our time, which should be from the start an open development macroeconomics. Following this line, the paper discusses the macroeconomic prices that the market is unable to keep right or balanced, particularly the exchange rate, and the macroeconomic policy constraints, emphasizing the role of the current account or competitiveness constraint. Having in mind this constraint, the paper distinguishes a production-oriented or competitiveness-oriented from a consumption-oriented policy regime, and shortly compares Germany with France, and China with the U.S.

**Key words:** macroeconomics, policy constraints, current account, competitiveness

**JEL Classification:** E00, F00, O57

In the 1970s, Keynesian macroeconomics was in crisis; today is mainstream neoclassical economics that is not offering answers to the economic problems. Since 2008 rich and developing economies, except a few East and South Asian countries, are quasi-stagnant, but Keynesian as well as orthodox (neoclassical and Austrian) economics fail to offer a remedy to the problem, the later because it assigns to the market a regulatory capability that it does not have, the former because was born a closed model and finds difficulty in overcoming this original problem, both because they remain relatively closed models that don't take into account the current account or competitiveness constraint. To remain meaningful and propose policies that guarantee growth and financial stability in a globalized world, macroeconomics must be a development macroeconomics. In this paper, I offer some clues to overcome this crisis on the macroeconomic side; I start from the new-developmental approach to economics and focus on the five macroeconomic prices, the macroeconomic policy constraints, and the concept of competitiveness to offer these clues.<sup>1</sup>

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Economics is a science that was born with the formation of the nation-state and the rise of capitalism. After the mercantilist phase, the classical political economists had as objective to explain how markets coordinate the national economic systems and international trade. As to the practical objective, it was limited to a critique of mercantilism and to a form of legitimizing the market coordinated economic system that was then rising – capitalism. It didn't propose other policies besides the defense of competition. "Political economy" (the original name of economics) was not born "liberal" but "developmental"; it was born in the framework of mercantilism, which, historically, was the *first* developmentalism. Political economists recognized that the market is a wonderful institution to coordinate competitive economic systems, but they knew it does not dispense some intervention by the state. In the last quarter of the nineteenth century, when the first countries to industrialize had become relatively rich, economics made a liberal-conservative turn. It adopted a hypothetic-deductive instead of a historical-deductive method, replaced the labor theory of value by the marginal utility theory, understood that the general equilibrium model represented well the working of economic systems, and, instead of classical, came to be called "neoclassical".<sup>2</sup> Economic theories are either developmental or liberal, it either defends a moderate intervention of the state in the economy, or limits the state to the economic role of guaranteeing property rights and contracts. The German Historical School and the American Institutional School, which were an alternative to Neoclassical Economics, were developmental schools of thought that oriented respectively the development of Germany and the U.S. in the late nineteenth and early twentieth century. After the 1929 crash and the 1930s Great Depression, Keynesian Macroeconomics and, a little later, Development Economics (which I call Classical Structuralist Developmentalism) turned dominant. The last theories were behind the New Deal and the post-war Golden Age – the time of a developmental social democracy. Since the 1980s, liberal Neoclassical Economics became again mainstream, while Post-Keynesian Macroeconomics, the French Regulationist School, and, more recently, New Developmentalism, defend a developmental approach to economics.

In the history of economics two major geniuses, Marx and Keynes, made the critique of orthodox economics, the first, of the classical political economy, the second, of neoclassical economics. With the difference that Marx was not concerned with reforming capitalism but change it to socialism, while Keynes showed why the market is unable to assure economic stability or full employment, invented macroeconomics, turned it operational – it made fiscal and monetary policy a tool for the state assuring stability and full employment. In the 1980s, after a relative economic crisis in the previous decade, notwithstanding the step ahead that post-Keynesian macroeconomics had

represented, rich countries were back to economic liberalism and economics, back to neoclassical economics, while capitalism, which had been a developmental social-democracy in the Golden Age, turned neoliberal. But, predictably, this regressive form of economic organization of capitalism produced poor results. Since the 2008 global financial crisis, neoclassical economics and the neoliberal ideology are in economic crisis, and since 2016, with the election of Donald Trump in the United States and the Brexit in the UK, they are also in political crisis.

However, although neoclassical economics is in crisis and the rich economies face secular stagnation since 2008, orthodox policymaking remains dominant. In the neoliberal time (1980-2008), it was so dominant that when, in Europe, social-democratic, and in the U.S., “liberal” (progressive) political parties or political coalitions were elected, the administrations adopted neoliberal policies. This is so because heterodox development macroeconomics remains underdeveloped and requires an overhaul. Post-Keynesian macroeconomics remains the more solid tool to face it, but it has an original sin – it was born a *closed* model – a problem that up to now was not satisfactorily overcome. Since the 1970s, the French Regulationist School, based in Marxist and post-Keynesian economics, contributed to our understanding of contemporary capitalism and its financial character, but it was unable to develop an abstract macroeconomic framework policy and growth oriented. The same applies to institutionalist or evolutionary economics.

Today, it seems clear that we need a new macroeconomic approach, which is, from the start, an *open* and *development* macroeconomics, which takes into consideration the globalization and financialization of contemporary capitalism. Since the early 2000s, New Developmentalism is a theoretical framework that searches responses to these new and old realities. It was, originally, oriented to the understanding of middle-income countries, but I already used it to analyze the Euro Crisis.<sup>3</sup> In this paper, starting from the new-developmental models, I will try to define the basic features of the development macroeconomics that countries require to resume growth with stability. With this objective in mind, I will, first, consider the five macroeconomic prices; second, the basic macroeconomic policy constraints that countries face, emphasizing the current account or competitiveness constraint; and, third, I will distinguish a consumption from a production or competitiveness-oriented macroeconomic policy regime.

### **The five prices and the exchange rate cycle**

Let's begin with the investment function and usual existence of *exchange rate cycles* that involve the expected profit rate and the interest rate. According

to simple growth function, growth depends on the rate of capital accumulation and the productivity of capital. To change the variables on the supply side that affect the output-capital relation is a long-term problem involving institutions and the microeconomic variables like education, technology and industrial policy. On the other hand, all countries usually do, day-to-day, their best to improve these variables. Thus, in this paper, I will limit myself to the macroeconomic problem of increasing the rate of investment.

On what depends the investment rate? On the supply side, it depends on the economic and cultural *disposition* of economic agents to save; depends on the support they give to policies limiting immediate consumption - variables very difficult to change. On the demand side, following Keynes, investment depends on expected rate of the entrepreneur's profit, i.e., on the expected rate of profit less the interest rate. The relation between the expected profit rate and investment is direct – the greater the expected profit, the higher the investment – but is not linear. There is a given threshold or edge in which the expected profit rate is conventionally *satisfying*, and the companies will invest. Given the interest rate, companies will invest if the expected profit rate is satisfying, i.e., if companies, conventionally, view as attractive the existing alternative opportunities. Before this edge, companies will invest little, beyond it, they will invest just a little more than in the conventional satisfying threshold.

The expected rate of profit, on its turn, again following Keynes, depends, essentially, on the aggregate demand. If the economy is growing, if demand is increasing, companies will be optimistic, their expected profit rate will be high, and they will invest. That is why a competent macroeconomic policymaking means keeping a sustained demand, which encourages investment and assures full employment. Yet, a satisfying rate of profit may materialize despite a feeble demand. This happens when profits are not the fruit of competition but of monopoly power, which corporations achieve by involving into an incessant process of mergers and acquisitions. In this case, the corporations don't invest to expand production, but just to keep updated the technology. They distribute dividends, and/or buy back their own stocks so as to keep the company's market price high as rentier capitalists or "investors" request, and to keep the bonuses of the top executives equally high. This is, essentially, what is happening in rich countries from the 1980s, and is one of the explanations for their low growth rates.

A relative alternative to achieve a sustained demand and a satisfying rate of profit, now following Schumpeter, is by making innovations. In this case, the profit rate depends also on demand, but not on aggregate demand; it depends on the demand that the company creates for itself by achieving a competitive advantage. This is a relative alternative because Schumpeterian innovations imply assuring to the company a monopoly. Innovations make all the difference

for a company, while, at the macroeconomic level, they will only make a difference to the country's economy when there is a chain of them, each innovation opening investment opportunity for several others. Thus, the policymaker cannot count on them to encourage investment in the short-term, and we must go back to the demand-oriented macroeconomics and ask on what the investment depends.

To say, again following Keynes, that it depends on the “entrepreneurs’ animal spirits” it is a good response, but it leaves things indeterminate. A more specific response is to say that the investment rate depends on the interest rate, the expected profit rate, and the exchange rate, which gives or denies *access* to the existing demand. The inclusion of the exchange rate among the determinants of investment, which is a central trait of New Developmentalism, requires that we abandon the common assumption that the exchange rate is always floating in the short-term around the equilibrium. Instead, we must acknowledge that in certain countries the national money may remain overvalued for several years. For several reasons: because the country's central bank sets a consistently high interest rate, either to attract foreign capitals or to respond to the pressure of rentiers and financiers, because the country has Dutch disease but does not neutralize it, either because it is not aware of this fact, or because it does not see how to neutralize this major competitive disadvantage. The country's currency may be also overvalued because other relevant competing countries either adopt a depreciate currency as a growth strategy or press down wages to become more competitive. No currency is always overvalued, but often it is cyclically overvalued, depreciating in the moments of financial crises. When the companies evaluate their investment projects in the countries whose national currency tends to be overvalued, they will take as reference the long period of overvaluation rather than the short period of devaluation and will not invest even if they dispose of the best technology available.

We may be tempted to discard this possibility of a long-term overvaluation of the exchange rate in rich countries because since 2008 the interest rate is very low and does not attract capitals. But the other causes of overvaluation just referred are present, including the Dutch disease when the country is an exporter of commodities. And there is an additional one: the euro. In the Euro Region, the “internal exchange rate” or the “internal euros” of France, Italy, Spain, Portugal and Ireland tend to be overvalued in relation to the internal euros of Germany and the other northern countries because the later ones are more willing to restrict consumption and accept more austere macroeconomic policies than the others. Before the euro, normal devaluations resolved the disequilibrium; now, a costly internal adjustment is required.

In this short analysis the relation between growth and the investment rate, three macroeconomic prices were expressly considered. To assure a satisfying

profit rate to the tradable companies (the ones that require a competitive exchange rate), the macroeconomic policy must keep the interest rate low and the exchange rate, competitive. The interest rate must be low not only because it is a deduction in the expected profit rate of the entrepreneur, but also because a high interest rate in the long-term causes an equally long-term overvalued currency as they attract undesirable capital inflows.

A fourth macro price is inflation, which is an evil by itself, but which rich countries search to control differently. In the Euro Region, for instance, the same northern countries tend to be radical in their repulse to inflation when compared with the southern ones. In consequence, their economies are usually more constrained by short-term adjustment policies, but, as a trade-off, their exchange rate is more competitive and, in the long-term, they may present best economic results than the southern ones. Note that this is a non-Keynesian conclusion or possibility, which derives from the fact that the traditional Keynesian models are closed or being closed, while we are reasoning from the start with an open economy where the exchange rate – the real as well as the internal exchange rate – plays a crucial role. If, due to the fear of inflation, the relatively restrictive macroeconomic policy adopted does not encourage private investment as much as it could while keeping prices stable, the country will not grow as faster as it potentially could. In contrast, if the country is able to keep its exchange rate competitive, it will avoid financial crises, and the final or long-term growth will be better than in the more easy-expending countries. I will be back to this problem below.

Finally, our fifth macroeconomic price: wages. They are the only republican or public interest reason for economic development, but they must be kept reasonably balanced. Within each country, in the short-term, the profit rate depends obviously on the wage rate, but we cannot simplify saying that the higher the wage, the lower will be the profit, because there is the demand problem to be considered. This is well-known and there is little to be added. But we must also take into account international competition – the one originated from the low wages in developing countries and their capability of exporting manufactured goods.

### **The macro constraints**

In the previous section, we have discussed possible clues for macroeconomics on the point of view of the macroeconomic prices. The second approach I propose in this paper is considering the macroeconomic policy constraints. There is a simplified view of economics that opposes the neoclassical economics “of scarcity” to the Keynesian economics “of consumptions”. This is poor economics. Keynes criticized the neoclassical

“common sense” tenet that savings precede investment, that to increase investments the country must, first, increase savings. The critique represented a major theoretical achievement in economics because it is at the same time right and counterintuitive. But we cannot conclude from that finding that scarcity was chased from economics. In this section I will discuss shortly six macroeconomic constraints: the profit rate constraint, the fiscal deficit constraint, the monetary constraint, the interest rate constraint, and the wage constraint. In the next section, I will discuss the current account constraint, where there is, perhaps, some novelty in what I will say.

**The profit rate constraint.** I propose that the profit rate constraint is the core constraint in capitalism. The profit rate does not need to be “high” or “low” but *satisfying*. I take this concept or this expression from Herbert Simon. If we had to define capitalism very shortly, we would say that it is the mode of production where business entrepreneurs accumulate capital, aiming to achieve a profit. The maximum profit? In principle, always, but this is a meaningless concept in business terms; the companies know the constraints of the market and don’t aim a vague maximum profit, but the possible profit that they project in their budgets. Which is a satisfying profit rate if it falls in the rate of profit interval that the companies in that given country and time consider sufficient to continue to invest and expand production. In other words, it is the minimum rate of profit that the companies that continue to invest and grow expect. The satisfying profit rate is a convention or, more broadly, an institution historically localized. It is higher than microeconomics’ “normal” rate of profit; it is higher than the profit rate of a company producing goods and services whose demand ceased to expand. It is a “reasonable” rate of profit.

Again, in other words, we can say that a satisfying profit rate is the rate that makes *competitive* the companies utilizing the best technology available. Competitive domestically and internationally. When a company utilizes the best technology available, it is *technically* competitive. It will only be *economically* competitive (endowed of productivity) if, in addition, the exchange rate is intertemporally competitive and the “country-cost”, i.e., the tax and infrastructure costs, are small in comparison with competing countries. The idea that the policymaker can ignore these external costs because the companies are supposed to compensate them makes little sense.

Some could argue that the rate of profit constraint is so obvious to policymakers that there is no reason to ask them to have it always in mind, but this is not true. I heard many times that “OK, the national currency may be overvalued, but this will encourage the companies to increase their productivity.” Actually, what encourages productivity is market competition, not market disadvantages. On the other hand, policymakers quite often ignore that, in a given industry or in a given moment, if the profit rate ceased to be

satisfying, that is possibly because the investment rate is falling and they do not adopt the policies that may fix or lessen the problem.

**The fiscal constraint.** The fiscal constraint is the more well-known and the more discussed macroeconomic policy constraint. For orthodox economics is the only constraint. Since liberal economists believe that the market is self-regulated, the only reason for macroeconomic policymaking is keeping the fiscal accounts balanced (the rest the market provides). Which are the explanations for the fiscal constraint? A first explanation is because fiscal deficits would cause inflation, but we know well that this is true only under the condition of full employment and a closed economy. A second reason is that public investment will crowd out private investment, but this depends on the type of good or service that the state provides. If the state invests in the same competitive sectors that the private sector does, crowding out will be inevitable. Contrarily, if it invests in infrastructure and monopolistic basic inputs companies, public investment will create demand and promote private investment. Third, “because the state may go bankrupted”, because it may eventually default its debt, but this explanation makes no sense. A nation-state is not a company; if it is indebted in its own currency, it will never go bankrupted because it always can issue money and pay its debts. Japan is the best confirmation of this. Its public debt is 260 per cent of GDP, but all its debt is in the national money, the yen, and pays a very little if not negative interest rate.

**Monetary interest rate constraint.** For neoclassical monetarist economics, the money constraint is central because it is associated to the fiscal constraint. The state issues money essentially to finance public deficits. The argument is that the increase in the money supply will cause inflation. This is an article of faith for orthodox economists, who transformed the “equation of exchanges” into a theory, the “quantitative theory of money”. The identity or equation of exchanges is very simple –  $MV=Yp$  – where M is the money supply, V, the velocity of circulation of money, Y is the GDP and p, the price level. As it is an identity which derives from the definition of the velocity of money ( $V=Yp/M$ ) it is not a theory, it does not involve any prediction. It *becomes* a theory if one establishes a causal relation as does the quantitative theory of money, which says that “inflation is a rise in the general price level *caused* by an imbalance between the quantity of money and trade needs”. With David Hume, Irving Fisher, and Milton Friedman, the relation between the quantity of money and inflation changed into a monetarist theory of inflation – a theory that is so simple as it is wrong: that inflation is determined by the increase of the supply of money. It is wrong because it supposes that the velocity of money is constant – what definitely is not true – and that the government has the control of such supply, what is only partially true. Actually, the quantity of money is an endogenous variable, which increases when the state increases its expenditures or when the



banks increase their credit or decreases when the inverse happens. As to the velocity of money (is the rate at which money is exchanged in an economy), it is extremely variable, which changes with the economic cycle. In the United States, in the Great Depression, it bottomed out at 1.15 times; from 1959 through the end of 2007, the velocity of the money stock averaged 1.86 times with a maximum of 2.21 times in 1997 and a minimum of 1.66 times in 1964. Since 2007, the velocity of money has fallen dramatically as the Federal Reserve greatly expanded its balance sheet, i.e., engaged in quantitative easing; in the first quarter of 2016, M2 velocity was just 1.46 times.

The exchange equation only turned into a sensible (and more modest) theory with the Keynesian theory of inflation - the demand theory of inflation where  $Y$ , aggregate demand, is the independent variable; inflation rises when aggregate demand increases above the aggregate supply. Why, then, does the quantitative theory of money have such a long history? First, because it is apparently true, because there is a close correlation between the quantity of money and inflation. All studies show that. The problem is to identify the independent variable. For Keynes, the independent variable is demand; for the theory of inertial inflation, the relevant variable is the same  $p$ : it is autonomous of demand, depending on the degree of formal (in the contracts) and informal indexation of the economy.<sup>4</sup> Second, the increase of the money supply is determinant of inflation for an etymological reason: originally the word “inflation” meant simply the increase of the amount of money in circulation.<sup>5</sup> The power of an etymological tradition is strong.

The fact that the supply of money is endogenous was reasonably clear to Keynes and became core claim of post-Keynesian economics with the contribution of Basil Moore (1979). Not aware of this work, Bresser and Nakano (1983) argued that the money supply was the “sanctioning factor” of inflation (the accelerating factor were shocks, the maintaining factor, indexation). Nevertheless, in the 1980s, when neoclassical economics turned mainstream, the monetarist view became dominant, and most central banks adopted it. Yet, they soon verified that the theory made no sense, and replaced it by a more sensible policy, inflation targeting. Yet, the final blow on monetarism was the “quantitative easing” policy adopted by the central banks of the United States, Japan, United Kingdom, and the Euro Zone after the 2008 global financial crisis. In the condition of the liquidity trap, when the interest rate inundated their economies with new money, and the inflation did not budge. Monetarism was dead, neoclassical economics was deeply wounded.

**No monetary constraint.** Does this analysis mean that there is not a monetary constraint? That central banks are free to increase as much as they want the money supply. In the present condition, when the core capitalist countries face a profusion of capitals or an excess of liquidity never seen before,

the response is yes. The quantitative easing is the empirical corroboration. But this is happening in a determined historical condition: after the 2008 Great Crisis, when capitalism faces secular stagnation characterized by very low interest rates. In this condition, the positive impact of quantitative easing on demand and economic recovery is doubtful, but one thing is certain: there was a substantial reduction of the public debt, which is not recognized by the public accounts, although a large part of the public debt of the rich countries is not to the private sector, but to the central banks.

In this historical framework, the ideas of the Monetary Theory of Money, an off-spring of post-Keynesian economics, prospered. It assumes the endogenous character of money, the fact that the quantity of money in the economic system is rather a consequence than a cause of inflation and concludes that the state can always issue money to finance countercyclical public investments. Thus, the theory rejects either a monetary or a fiscal constraint. The only one is the supply-demand constraint; there is only a demand-supply constraint, which happens when the increase of public expenditures financed by new money causes the excess of demand over supply and results in inflation.

I have two objections to this view. First, the fact that the supply of money is endogenous does not mean that the government does not have control over it. It does not have much control on the sources of money creation, the loans by the financial system, but it can control the other: the expansion of its expenditures. Second, the increase of the money supply through the quantitative easing mechanism (the central bank purchasing public and private securities) is not automatic, because the new money so created may disappear or fade away as the private sector does expend it. Then what to say if, giving a recession, the government increases its expenditures but immediately "pays" them with quantitative easing finance? In this case, the government will be making countercyclical policy – which is for sure the right policy – but the state is not getting more indebted.<sup>6</sup>

It is obvious that we should not double count the public debt, but it is what the public authorities in each country and the international financial agencies do as they do not deduct from the state's debt its bonds in the hands of the central bank. Why? For the reasonable resistance of economists and, more generally, the economic elites with the government issuing money. "This is fiscal indiscipline that causes inflation", they say. What is not true if there is not excess demand over the supply. By the unemployment rate? This is the right criterion, but how much employment is "natural"? When it reaches the natural rate of unemployment beyond which inflation increases? OK, but in this case, we are defining this rate by the outcome that we want to avoid. Another explanation is that such a policy would open a way to progressive statization of the economy.

But here again the problem for the economic authorities is to act prudently, and this will not happen.

**The wage constraint.** The wage constraint is so important as the profit constraint. In the time of classical political economists, the wage constraint was “physical” because the assumption was that the cost of reproduction of labor, which was defined as subsistence level, defined the wage rate. Today, it is a relative constraint, because wages continue to be basically determined by the cost of reproduction of labor, but this cost is socially defined, and increases as the level of education and acquisition of professional capabilities increase. Thus, policymaking may reduce real wages if the government is politically strong enough. Eventually, the constraint is rather political than economic.

The competitiveness of a country depends on the level of the real direct and indirect wages. That is why the neoliberal reforms adopted from the 1980s have had as their main objective to reduce wages by making the labor contracts more “flexible”, and by dismantling the welfare state. The competition of developing countries in the exports of manufactured goods began in the 1970s with a few countries competing in the global arena and was extended to others in a series of “waves”: the first wave was formed by six original countries (South Korea, Taiwan, Singapore, Hong Kong, Brazil and Mexico); the second comprised Malaysia, Thailand and Indonesia; the third and bigger wave of competition came from China; more recently we are seeing another giant, India, and also Vietnam benefiting from globalization to sophisticate their economies with the exports of goods and services, while rich countries, despite their superior management and technology, fall behind.

This competition began while the departments of economics of the major universities in the West were abandoning Keynesian macroeconomics because it didn't have all the responses for the problems that were emerging from globalization and the ensuing new competition originated in developing countries. The explanation offered for this change was that Keynesian macroeconomics and the Philips curve were failing to elucidate the stagflation that appeared in the U.S. in the late 1970s. It was a poor explanation for the change, because the responses offered by neoclassical economics and its “new macroeconomics” that the departments of economics adopted (originally Milton Friedman's “monetarism”, later on, Robert Lucas' “rational expectations macroeconomics”) were much more defective. In fact, the neoliberal turn was the consequence of a huge intellectual investment of liberal-conservative capitalists in the U.S. They generously financed university departments and think-tanks with the objective of legitimizing the rise of a new class coalition of rentier capitalists and financiers and its neoclassical-neoliberal ideology, profiting from the crisis of the developmental and social democratic class coalition that presided capitalism from the New Deal to the mid 1970s.

At the same time that a neoliberal turn was happening in the rich countries, the U.S., counting with the support of the international organizations (mainly the World Bank, the WTO and the IMF), pressed/persuaded developing countries to follow the same course. They failed in relation to the East and South Asian countries but were successful in relation to the rest of the world: Latin America and Africa, which (a) are exporters of commodities that originate the Dutch disease, and (b) believe that is possible to grow with current account deficits by attracting capitals with high interest rates - the two causes of the long-term overvaluation of the exchange rate that make non-competitive economically companies that are technically competitive. In this framework, Brazil deindustrialized radically, while the whole Mexican manufacturing industry was transformed into a “maquila system” where only the less sophisticated and more poorly paid parts of the manufacturing production process are realized.<sup>7</sup>

In synthesis, the main explanations for the stagnation of wages of the low-skilled labor in rich countries since the 1970s was the adoption of the neoliberal reforms searching to reduce real wages and, so, neutralize the new competing capacity of developing countries. A second and well-known cause is the relative reduction of the demand for non-skilled labor caused by the information and communication technology revolution. Macroeconomic policy does not have tools to counteract this distribution problem except by searching to keep full employment while avoiding financial crises.

### **Current account or competitiveness constraint**

If a satisfying rate of profit is the main and the more general constraint that capitalist economies face, because all the other constraints are directly or indirectly related to it, the current account constraint, that we also may call the competitiveness constraint, is the more strategic or dangerous that macroeconomic policymakers face. It is also competitiveness constraint because in the time of globalization companies and nation-states compete at world level more actively than they used to do. Macroeconomists are concerned about current account deficits because of the balance of payments crises they can cause. This is a right concern, but if the country adopts a prudent economic policy, the deficits are not either high or chronic, and the foreign debt to GDP ratio is under control, balance of payments crises will not happen. But there is second consequence of current account deficits which are negative even if the policymakers are prudent and avoid fiscal crises.

There is an inversion relation between the current account balance and the exchange rate, and, considering only the deficits, an “equilibrium” to each level of current account deficit; the exchange rate that balances a current account deficit is necessarily more appreciated than the one that keeps the current account

zeroed, because the deficit requires additional capital inflows – an additional supply of hard currency – which will keep the national currency overvalued while the deficit is in place. Policymakers usually ignore this fact. Giving that the current account deficit is equal to the foreign savings that the country must receive to finance it, they believe that by incurring in current account deficits the country is benefiting from “foreign savings” that will add to domestic savings and increase total savings and the investment rate. This is mistaken because disregards that the capital inflows that finance the deficit will finance rather consumption than investment. The long-term current account deficits imply necessarily a long-term appreciation of the national currency, for a logical reason (the correspondence between the current account deficit and the exchange rate just mentioned) and for an economic reason: because the country involved into current account deficit will have an extra demand for foreign money for its exports and other international revenues. In other words, a current account deficit and the ensuing appreciated national currency will encourage consumption because it will increase the acquisitive power of the workers’ wages, the managers’ and employees’ salaries, and capitalist rentiers’ (“investors”) dividends, interests and real-estate rents. It will discourage investment because the long-term appreciation of a national currency means that companies that are technically competitive cease to be economically competitive. Instead of adding to domestic savings, the foreign savings will replace them. For that reason, we may also say that this is competitiveness constraint. Only in special moments when the economy is growing very fast and the marginal propensity to consume fell as the expected rate of profit increased, the substitution of foreign savings for domestic savings falls, and the investment rate will increase despite the negative current account.

The current account policy constraint should *not* be confused with the “balance of payments constraint” which post-Keynesian economists have been studying since Anthony Thirlwall has formalized the model of the two perverse income-elasticities originally proposed by Raúl Prebisch in the framework of his defense of industrialization or structural change. While the Prebisch-Thirlwall’s constraint is a limitation to growth, which only may be solved by industrialization, in this paper I am dealing mostly with policy constraints. Some economists wrongly “solved” the balance of payments constraint by identifying it with a shortage of dollars and proposing that the country engages into additional foreign indebtedness. With the hypothesis of the two perverse income-elasticities, Prebisch was just adding an argument favoring industrialization; not proposing that the developing countries resorted to foreign savings. While the balance of payment constraint is a structural obstacle to industrialization, the current account constraint is rather a warning against the adoption of the growth with foreign savings policy.<sup>8</sup> The assumption besides this constraint is that the

current account deficit is not a fatality but the outcome of a policy that governments usually adopt - the growth with foreign savings policy. Governments everywhere are anxious to receive more foreign direct investment which, in their view, would have a double function: to finance the deficit and to increase the investment rate, as if foreign savings would simply be added to domestic savings. They disregard that the additional capital inflows rather finance consumption than investment - that foreign savings replace domestic savings. They believe in the liberal orthodoxy's claim that growth is a competition between countries to see which one receives more direct foreign investments because the more the country receives direct investment the more it will grow. They don't understand that the dependent variable is the inverse. The more the country grows, the more its domestic market increases, and the bigger will be the foreign direct investments. Second, they don't realize that the problem is not with the foreign direct investment but with the current account deficit. Countries should welcome foreign direct investments not because they involve additional capital inflows, but because they contribute to technological progress and/or to the opening of new markets. What the country should not do is to incur in current account deficit and finance them with capital inflows. To incur in current account deficit is only positive to a country in the rare moments the country is growing very fast, the marginal propensity to consume has fallen, and the rate of substitution of foreign for domestic savings has therefore fallen. Current account deficits, not foreign direct investments, are usually negative to the growth of a country. The Chinese understood well that. Since China opened its economy, it had a systematic current account surplus but, nevertheless, receives willingly foreign direct investments that bring new technology or open new markets while it uses the capital inflows to increase reserves or to finance their foreign direct investments.

Instead of referring to a current account constraint, I could refer to an exchange rate constraint. They are similar but not exactly the same thing, because the overvaluation of the exchange rate may have other reasons besides current account deficits and the capital inflows to finance them.

### **The fiscal and the current account constraint**

Which is the relation between the current account constraint and the fiscal constraint? We saw that the usual arguments in favor of fiscal discipline are not very strong. They don't necessarily cause inflation, nor crowd out private investment. They will only cause inflation if the expansionary fiscal policy causes an excess of aggregate demand over supply. Second, the simple issue of money may finance fiscal deficits. This is not a "nice" thing, but the issue of money does not necessarily cause inflation because the quantity of money in a

national economy is endogenous. Does this mean that governments are wrong in defending fiscal discipline? They are not. The fiscal history of the countries that developed consistently and became developed is also a history of fiscal discipline. Not because fiscal largess causes inflation or leads the country to fiscal crisis, but because it usually leads its currency to become overvalued in the long-term and its economy, to loss of competitiveness, low growth and, possibly, financial crisis. Actually, fiscal and current account discipline go together. If the increase of fiscal expenditures increases effective demand above the domestic supply, this does not lead to inflation unless the economy is in full employment, but causes a current account deficit that, as I am arguing, is a negative factor in the growth process. And they usually lead to the “twin deficits” condition while the exchange rate do not turn overvalued. Once this happens and the country presents a high current account deficit, but the government engages in fiscal adjustment, the fiscal deficit will fall, but, as the national currency remains overvalued, the current account will continue to exist.

Thus, the final constraint is the current account constraint, the chronic current account deficits and the corresponding overvalued in the long-term exchange rate. The fiscal constraint is a reality, not so much because fiscal deficits cause inflation (they only have this consequence when the country is in full employment), but because the country must be internationally competitive - because the country must respect the current account constraint. In the *General Theory* (1936), which was the more important economic book of the twentieth century, Keynes built a closed macroeconomics model because he needed to simplify a theory and because at that time the national economies were relatively closed. Thus, at that time, the *competitiveness* problem was not a central problem; today, with globalization, it is. There is a technical and a macroeconomic or exchange rate competitiveness. Microeconomics takes care of the technical competitiveness; macroeconomics must take care of the exchange rate competitiveness. Both are necessary conditions for economic development but are not always together. Technical competitiveness is a long-term economic problem, exchange rate competitiveness a relatively short-term problem. Good institutions, well-functioning markets, education, investment in infrastructure, technological policy, industrial policy are means to technical competitiveness. A capable macroeconomic policymaking that sees the current account constraint as fundamental is the only means to guarantee exchange rate competitiveness. To try to achieve macroeconomic competitiveness by acting in the microeconomic variables, by making markets more competitive, as orthodox economists defend, or by engaging in industrial policy, as many heterodox economists propose is a big mistake. There is a relationship between the two competitiveness, but they are relatively autonomous, and require independent policies.

By defending the fiscal and the current account constraints, I am not defending “fiscal austerity” – a rightwing orthodox policy that heterodox economists strongly criticize. My definition of austerity is narrower than a very spread definition of a certain vulgar Keynesianism. Austerity, for me, is not to engage in fiscal discipline; this is sound policymaking. Austerity is to do two things: first, to reject the policy of countercyclical fiscal deficits, and, second, when the economy faces not only inflation but also foreign disequilibrium, to engage only in fiscal adjustment as if the country was a closed economy, instead of using the macroeconomic tools to depreciate the national currency as capital control, the interest rate policy, and policies to neutralize the Dutch disease. The difference between the two forms of adjustment is that when the depreciation complements the fiscal adjustment not only the salaried people but also the rentier capitalist society pay for it, while in the case of the “internal adjustment” all the cost fall on the salaried.

In synthesis, the fundamental reason why countries must keep its fiscal account balanced is the current account constraint – is to keep the country competitive internationally. Companies in each country are supposed to be competitive technically, but, in addition, the country must assure an exchange rate that is competitive. Current account deficits mean that the exchange rate is overvalued in the long term and the country is rather consumption than production oriented. Current account surpluses mean that people valorize savings and medium-term growth rather than immediate consumption.

## **Two comparisons**

From this concept of current account constraint and its relation to the fiscal constraint we may derive an additional distinction. Countries may adopt either a consumption-oriented or a competitiveness-oriented policy regime; it may be constantly involved in current account deficits and increase their short-term consumption, or in current account surpluses and oriented to production and international competition. On the other hand, in the framework of New Developmentalism, I understand that there are two basic forms or economic organization of capitalism, the developmental and the liberal.<sup>9</sup> Capitalism was born developmental everywhere. Considering England and France, which underwent all the phases of capitalist development, capitalism was born liberal in the sixteenth century, changed to liberal around the 1840s; moved to social democratic and developmental after the Second World War; and changed to neoliberalism in 1980-2008/16. In this period, neoliberal capitalism proved to be regressive socially, inefficient economically, and instable financially.<sup>10</sup>

Considering all this, let us compare, for instance, France and Germany since the 2000.<sup>11</sup> Around 1980, both countries, following the lead of the U.S., had



changed from a developmental and social democratic to a neoliberal form of organizing capitalism. They did not involve into the neoliberal reforms as deeply the as the U.S. or the U.K. did instead – this explaining why the literature on the models of capitalism and, specifically, the Hall and Soskice’s varieties of capitalism distinguishes the Anglo-Saxon “market economies” from the European “market coordinated economies”.<sup>12</sup>

<b>2000-2018</b>	<b>France</b>	<b>Germany</b>
Yearly growth rate	1.4	1.4
Average investment rate (% GDP)	22.1	20.1
Average fiscal account (% GDP)	-1.3	0.8
Average current account (% GDP)	0.2	4.2

**Table 1: France and Germany Compared. Source: OECD.**

When we compare France and Germany since 2000 using the theoretical framework that this paper proposes, Germany adopts a competitiveness-oriented, while France a consumption-oriented macroeconomic policy regime. The superior rate of growth of Germany from 2000 to 2018 is due, basically, to this fact – which it follows the competitiveness constraint which is associated to fiscal discipline and the current account surpluses. This policy regime created more investment opportunities to the companies producing tradable goods, and, so, the average investment rate was greater. For sure, this is a simplification. Other variables interfere in the determination of the investment and the growth rates of countries, but here we have similar and comparable countries, and it will not be easy to find other variables that diverge so clearly as the fiscal and current accounts of these two countries. There is, however, a problem with the German model. Germany’s *big* current account surpluses represent a major problem for the other countries; they were a core cause for the Euro Crisis (2010-16).

<b>2000-2018</b>	<b>US</b>	<b>China</b>
Yearly growth rate	2.1%	9.1%
Average investment rate (% GDP)	21.2%	43.0%
Average fiscal account (% GDP)	-3.4%	-1.2%
Average current account (% GDP)	-3.5%	3.6%

**Table 2: United States and China Compared. Source: OECD.**

The second example comparing competitiveness vs consumption oriented macroeconomic regimes involves two very different countries - the U.S. and

China, the former, consumption oriented, the later production-oriented. But in this case, while the U.S. is a liberal market economy, China is a developmental market economy. China is more open than the U.S., but given the role of the state-owned enterprises, the industrial policies adopted, and the firm management of the macroeconomic prices, particularly the exchange rate, China is clearly a case of developmental capitalism, nor of liberal capitalism.

The economic outcomes are very different. The fact that the two countries are in different stages of growth certainly explains part of this difference. We must also consider that the U.S. is a democracy, while China, an authoritarian regime. But, essentially, what we have is the competition between a country adopting a developmental strategy and a country that insists in a liberal strategy. Americans usually believe that this liberal strategy made the U.S. the richest country of the world, but this is false. The U.S. only opened its economy in 1939, and its form of capitalism remained rather developmental than liberal up to 1980. Not by coincidence, since this year the U.S. is losing ground to China. China counts with a national development project, its elites and its people are associated to it, fiscal discipline and current account surplus are part of this project, while the American society is today a divided society; the last time it counted with a real project - the time inaugurated with the Franklin Delano Roosevelt and ended with James Carter - is today a distant past. Considering that we can distinguish a technical from an economic competitiveness, the later one depending on the exchange rate, China is reducing everyday its technical competitiveness gap in relation to the U.S., while having as policy the current account surpluses that is cause and consequence of a competitive exchange rate. The U.S., instead, since the late 1960s adopted a consumption-oriented strategy characterized by large current account deficits which do not result in currency crises because the debt is in dollars. In this way, it benefits from this “exorbitant privilege”, the famous expression of De Gaulle - exorbitant in financial but not in economic terms, because the current account deficits are necessarily associated to a long-term overvalued currency and loss of competitiveness.

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<sup>1</sup> For New Developmentalism see Bresser-Pereira, Oreiro, and Marconi (2014). Showing that this is a work in progress, there is a Portuguese 2016 version of this book (*Macroeconomia Desenvolvimentista*) published by Elsevier Brazil, where the theory is better developed; Bresser-Pereira (2018).

<sup>2</sup> This took a long time. Keynes, in the *General Theory* (1936), does not distinguish the classical from the neoclassical school of thought, calling both “classical”.

<sup>3</sup> Bresser-Pereira and Rossi (2015).

<sup>4</sup> This is why, in their basic paper on this theory, Bresser and Nakano (1984 [1987]) called the money supply “the sanctioning factor of inflation”.

<sup>5</sup> Inflation is originated from the Latin, “inflation”, which meant “blowing”, “flatulence”, “inflammation”. According to the Online Etymological Dictionary, “inflation meaning ‘action of inflating with air or gas’ is from the seventeenth century; the monetary sense of ‘enlargement of prices’ (originally by an increase in the amount of money in circulation) was first recorded in 1838 in American English”. <https://www.etymonline.com/word/inflation>, June 6, 2019.

<sup>6</sup> Unless you include in the public debt the debts of the state to the central bank which is part of the state apparatus. This is absurd, but is what countries do in their fiscal accounts.

<sup>7</sup> With the exception of the automotive industry.

<sup>8</sup> See the “two hiatus model” of Chenery and Bruno (1962) and the defense of the growth with foreign savings policy in Thirlwall and Hussain (1982).

<sup>9</sup> Bresser-Pereira (2017).

<sup>10</sup> Bresser-Pereira, Oreiro, Marconi (2014); Bresser-Pereira (2019).

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<sup>11</sup> I choose this year because it was when the negative short-term effects of the unification of Germany (an exogenous variable) had been reasonably overcome.

<sup>12</sup> Soskice and Hall (2001).