DEFICITS, EXCHANGE RATE, AND GROWTH

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Prof. Affonso A. Pastore and other competent ortodox economists still bileve that foreign savings cause grouth. Actually, they increase consumption and mostly replace domestic savings

There are many Brazilian orthodox economists, but none as serious and competent as prof. Affonso Celso Pastore. His macroeconomic analyses are always well structured and well reasoned, and almost always end by recommending greater fiscal austerity – something with which I agree. We are both against public deficits that make the State irresponsibly indebted. Why not to have the same position regarding current account deficits that make the nation irresponsibly indebted (households, enterprises, and the State combined)? Why such a double standard? Prof. Pastore, in an article in the newspaper *O Estado de S. Paulo* (Feb. 28, 2010), has an explanation for this contradiction – for his defense of current account deficits and for the prevailing exchange rate policy. It reproduces a theory that rich countries and their economists have always used with respect to developing countries: to propose that they should incur current account deficits in order to obtain "foreign savings", in the form of direct investments or loans, to finance such a deficit. The assumption suggested by the expression "foreign savings" is that the current account deficit would be added to the countries' domestic savings, and, as a result, their investment rate (which is a decisive factor in economic development) would increase. However, this theory, or the assertion that "capital-rich countries should transfer their capital to capital-poor countries" is as true as the assertion that the Earth is flat... It seems to be true, but it is essentially false.

When a country decides to accept this proposition of "growing with foreign savings", the first consequence is the appreciation of the exchange rate. Next, on the supply side, there is an artificial increase in wages, and, consequently, an increase in domestic consumption. Given the high marginal propensity to save existing in developing countries, there is a high increase in consumption and a corresponding reduction in domestic savings, so that domestic savings decrease, and foreign savings, instead of complementing, largely replaces domestic savings. On the demand side, the result is the same: the currency appreciation provokes a decrease in lucrative export-oriented investment opportunities; investments drop and, in Keynesian terms, domestic savings drop. More broadly, foreign indebtedness engenders three successive damages: first, we have a high rate of substitution of foreign for domestic savings, with a large portion of capital inflows financing consumption instead of investment; second, we have an increase in foreign indebtedness, which leads the country to a situation of external vulnerability and to the disastrous policy of *confidence building*, to uncritically accept the recommendations of our creditors and competitors; and, third, we have the balance-of-payment crisis.

If the investments of multinational corporations (which are desirable if they bring technology to the country) finance the current account deficit, they have the same destination as the loans. Even if the multinational corporation makes a new investment instead of simply buying an existing enterprise, a good part of the resources that entered the country will indirectly finance consumption through the exchange rate appreciation. This would not happen if the direct investment, instead of financing the current account deficit, would become resources used by the country to make its investments and financial investments abroad. This is what China does.

Pastore argues that our savings rate is insufficient – less than half of China's. There is no doubt about it. The mistake is to think linearly that the problem will be solved by resorting to foreign savings. Today we already have a significant amount of research showing that the smaller the current account deficit (or the larger the surplus), the higher the country's growth rate. This same ratio may be break down into two stages, so that the smaller the current account deficit (or the larger the surplus), the more competitive the exchange rate, and the more competitive the exchange rate, the higher the country's growth rate.

How, then, to increase Brazilian savings rate? Households must reduce their luxury consumption and the State must reduce its administrative or bureaucratic expenditure, or, in other words, must make its social services and its security services more efficient. But the most important thing in order to increase savings is to manage the exchange rate so that it remains competitive rather than chronically appreciated. It is not to increase wages artificially, but rather to guarantee that entrepreneurs have good profit expectations or, in other words, good export-oriented investment opportunities. In a country that still has a relatively cheap workforce as Brazil, if the exchange rate is competitive, the whole foreign market will be open to its competent enterprises. When the exchange rate is overvalued as Brazilian exchange rate is today, there is no use being efficient.

Prof. Pastore states that "the critics of the current Brazilian exchange rate regime" defend a "permanently more depreciated" exchange rate. This is not what I defend, but rather an *equilibrium* exchange rate, that is, a *competitive* exchange rate. How can we define it? Were we not the victims of the Dutch disease, the competitive exchange rate is the one that balances intertemporally the current account: it is the "current equilibrium" exchange rate. Today, something around R$ 2.00 per dollar. However, since we have a mild but real Dutch disease (the oil-producing countries have a serious one), the competitive exchange rate is the "industrial equilibrium" one – that is, the exchange rate that makes internationally competitive the companies producing tradable goods and services that adopt state-of-the-art technology. Today, something probably around R$ 2.40 per dollar.

In order to keep the exchange rate relatively stable at that level, we must manage it. We know that the developing countries' exchange rate is not well controlled by the market, does not float gently around the current equilibrium, as suggested by the orthodox. Nor is it simply volatile around this equilibrium, as Keynesians presume. In fact, if left completely free, it structurally tends to overvaluation, and it is "controlled" not by the market, but by the balance-of-payment crises, the sudden stops. When the crisis arise, there is a violent depreciation, but, next, the causes of appreciation start to operate. Among them, we have first the Dutch disease, that pulls the industrial equilibrium exchange rate towards the current equilibrium; later, the growth with foreign savings policy, the speculative capital inflows, and the exchange rate populism, which successively lead the country to the current account deficit, to the substitution of foreign for domestic savings, to excessive foreign indebtedness, to *confidence building*, and, finally, to a new crisis.

Prof. Pastore is aware of the dangers of the current account deficits. He states: “The very high current account deficits contain the seed of their own destruction because they require, after some time, the depreciation of the real equilibrium exchange rate to finance the charges of higher net foreign liabilities.” Why, then, the contradiction of starting the article by defending the “growth with foreign savings”? The explanation lies in the two mistaken beliefs that I have just criticized: the belief that current account deficits are worthwhile because they would significantly increase investments; and the belief that the market tends to keep the exchange rate at the desired equilibrium, and there is no need to manage it.

Actually, it is not enough to control the inflation rate, it is also necessary to manage the exchange rate so as to neutralize the tendency to its overvaluation. It is not convenient to define a target – we should rather think of the exchange rate in terms of a range – but it is essential to assure the enterprises that it will be kept at that level. Brazilian economic development critically depends on the existence of demand – of investment opportunities. On the supply side, the only short-term bottleneck is the infrastructure bottleneck – and this problem requires a strenuous effort of both government and enterprises. Once this effort is made and a competitive exchange rate is warranted – at the industrial equilibrium level – Brazil may grow over the next few years at an average rate of around 7% p.a., instead of the 3.5% on average allowed by the present exchange rate, amid recurring crises. The dynamic Asian countries grow at rates that are high above the Brazilian one because they learned to manage their exchange rate. It is time for us to do the same.