National command on the exchange rate

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Basic claim

- The exchange rate is the more strategic of the macroeconomic prices.
- In developing countries it tends to be cyclically overvalued.
- And, for that reason, a major obstacle to economic growth with financial stability.
- Thus, developing countries and their central banks should keep command on their exchange rate.

Exchange rate: the more strategic of the macroeconomic prices

- The exchange rate does not just balances exports and imports (or the current account),
- it also determines or influences:
- 1. inflation
- 2. wages
- 3. consumption
- 4. expected profit rate
- 5. interest rate
- 6. investment rate
- 7. savings rate
- 8. growth rate

Appreciated currency is consistent with (1):

- 1. Low inflation
- –it falls with appreciation
- 2. Artificially high wages
- –they increase in real terms with appreciation as the price of tradable goods fall.
- 3. Artificially high consumption
- –it increases as wages increase

Appreciated currency is consistent with (2):

- 4. <u>Low expected profit rate</u>
- In the short run it may increase due increase in consumption,
- but, in the medium run (the one relevant for investments)
- it will fall because it will reduce exports opportunities and will represent a threat to sales in the domestic market.
- 5. <u>High level of the interest rate</u>
- – a high level that is used to attract foreign capitals, in so far as developing countries believe in the “fetich of foreign savings”.

Appreciated currency is consistent with (3)

- 6. Low investment rate
- -in so far that it depends on the expected profit rate (low) minus the interest rate (high).

- 7. Low savings rate
- -in so far as it depends on the investment rate (given the existence of domestic credit)

- 8. Low growth rate
- -in so far that it depends on the investment rate (given no bottleneck on the supply side)

In other words, an equilibrium or competitive exchange rate is required

- because
- it makes the world demand available
- to firms producing tradable goods that are efficient or utilize technology on the state of the art.

Caveat: I am not arguing that a depreciated currency is advisable

- A depreciated currency may be helpful in the short run,
- but, in the medium run, it is cause of
- 1.unduly low wages
- 2. unnecessary high current account surpluses
- 3. permanent conflict with other countries

I am arguing

- –for a competitive or balanced exchange rate;
- –against the 2nd Washington consensus that included financial liberalization among reforms and, consequently opened run for the tendency to the cyclical overvaluation of the exchange rate.

What is a balanced or competitive exchange rate

- When the country does not face the Dutch disease,
- it is the rate that balances intertemporally the current account: it is the "current equilibrium e.r."

- When the Dutch disease is in place,
- it is the rate that makes competitive tradable industries utilizing technology in the state of the art; is the "industrial equilibrium e.r.")

To get a balanced exchange rate

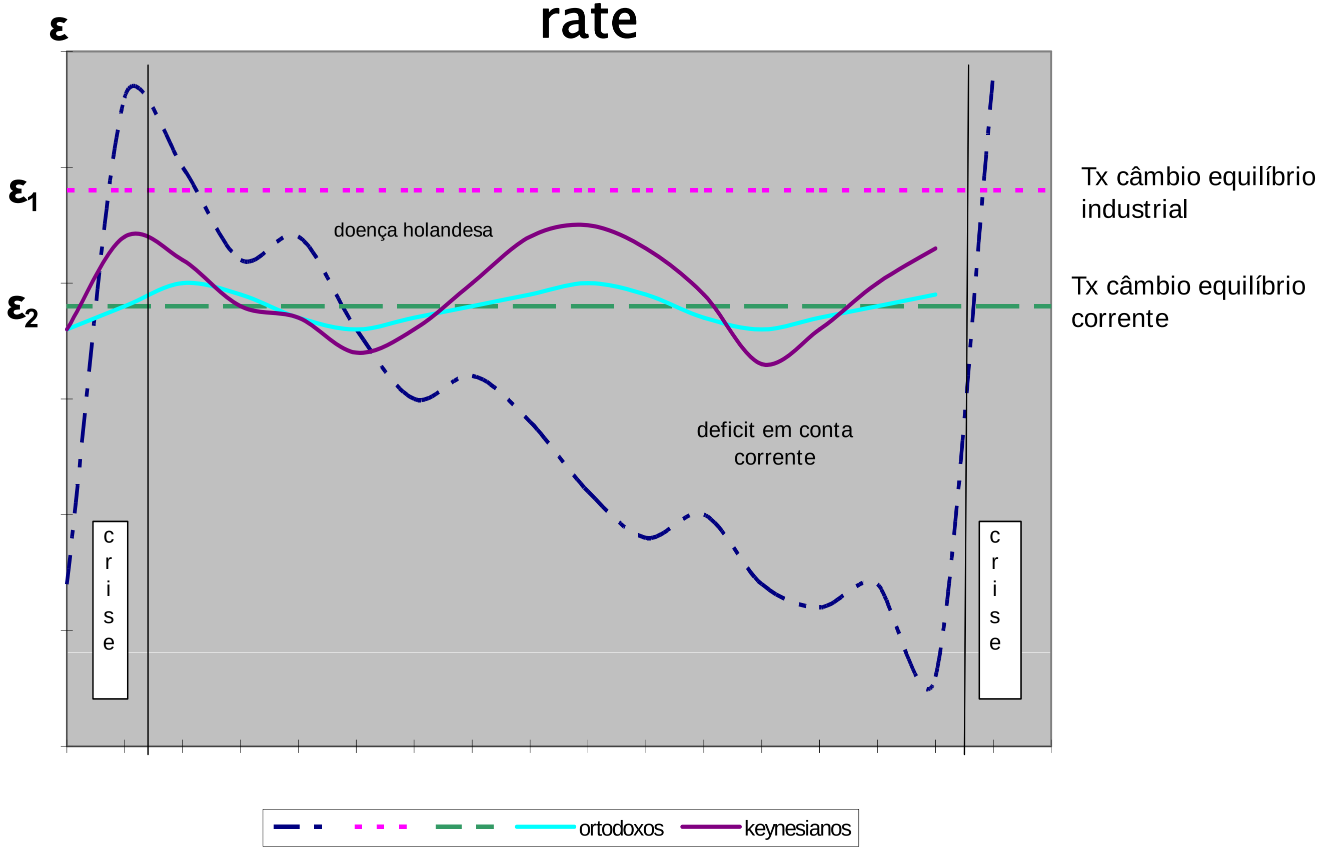
- developing countries cannot and should not depend on the market
- because, in them,
- The exchange rate is not just highly volatile (as asserted Keynesian economists), but there is a
- tendency to cyclical overvaluation of the exchange rate.

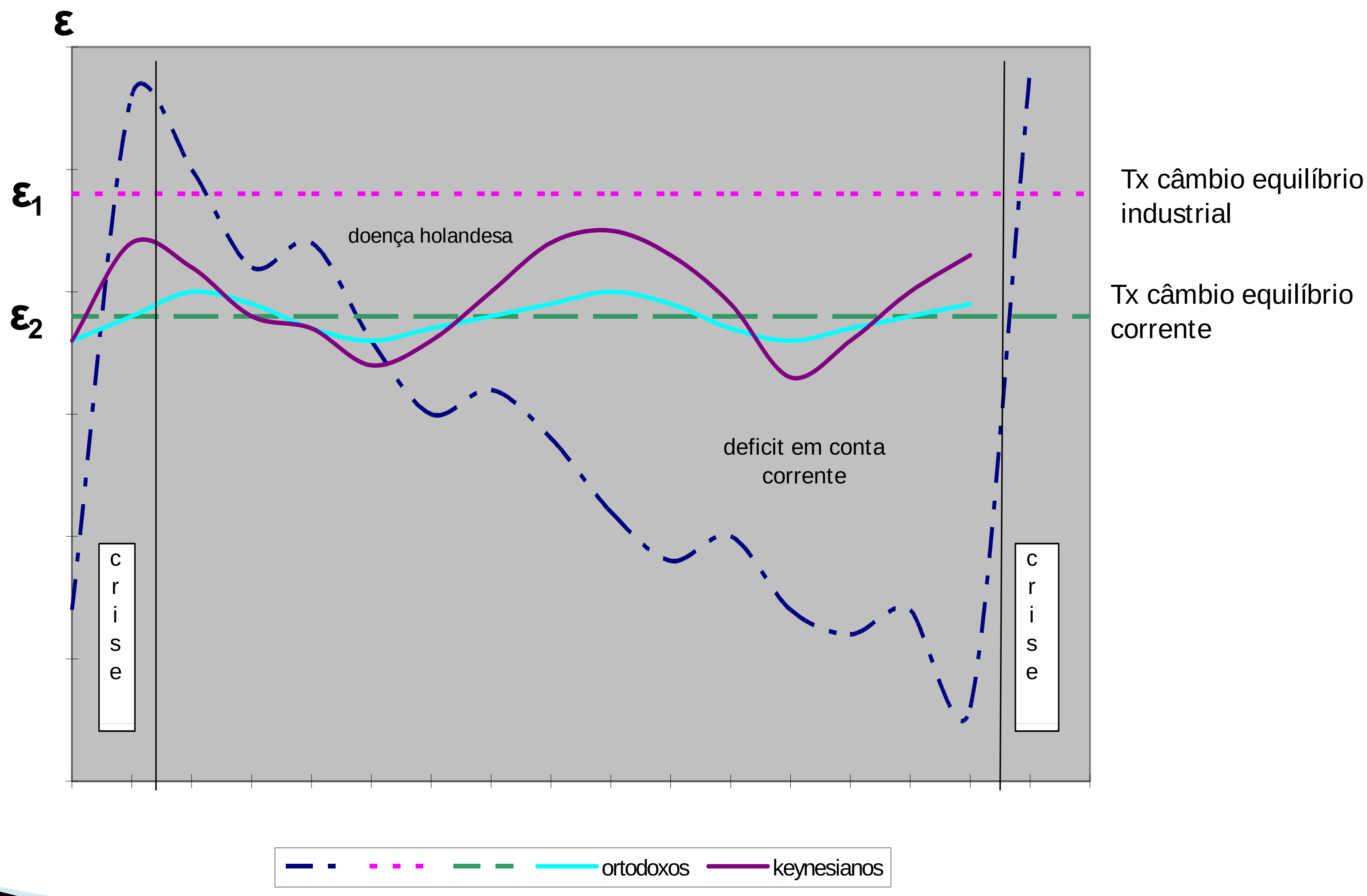
Causes of the tendency

- First, the Dutch disease
- pulls the exchange rate from the industrial to the current equilibrium.

- Second, capital inflows (caused by the foreign savings' fetish, and the populist costume of using appreciation to control inflation,make the exchange rate to fall (appreciate) below the current equilibrium, into current account deficit, increased foreign indebtedness, capital flight and currency crisis.

Tendency to the cyclical overvaluation of the exchange rate

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Capital inflows and current account deficits and are "justified"

- Developing countries would need "<u>foreign savings</u>" to grow.
- That is false, it is an common sense <u>fetish</u>.
- "Foreign savings would be <u>added</u> to the domestic ones.

Actually capital inflows that finance current account deficits

- (1) increase consumption, materializing a high rate of substitution of foreign for domestic savings;
- (2) cause financial fragility; and
- (3) cause currency crisis.
- Only marginally increase investment.

Developing countries are able to grow with domestic savings

- It is false that, due to the “foreign constraint”, they <u>need</u> foreign finance,
- and that
- their “natural condition” is one of high indebtedness: to be flooded into foreign debt.

Foreign finance and capital inflows are on the interest of

- – foreign financial investors
- that profit from high interest rates and engage in carry trade as these inflows appreciate the local currency
- – central bankers
- – that can achieve inflation targets through appreciation of the currency
- – multinational enterprises
- that, with the foreign savings argument, justify capture of dev countries domestic markets without reciprocity
- – populist politicians
- that engage in “exchange rate populism” to be reelected.

Conventional orthodoxy's argument of last resort :

"it is impossible to manage the exchange rate"

- False. There are adequate tools:
- 1. Imposing export tax that neutralize de Dutch disease
- 2. Purchasing foreign currency
- 3. Controlling capital inflows
- "But capital controls don't work!".
- False. Experience shows the opposite, provided that they are actualized as anti-virus tools are.

Summing up,

- Keeping command on the exchange and maintaining it competitive (in the industrial equilibrium) is a condition for
- financial stability
- and fast growth.

- It is condition of national sovereignty.