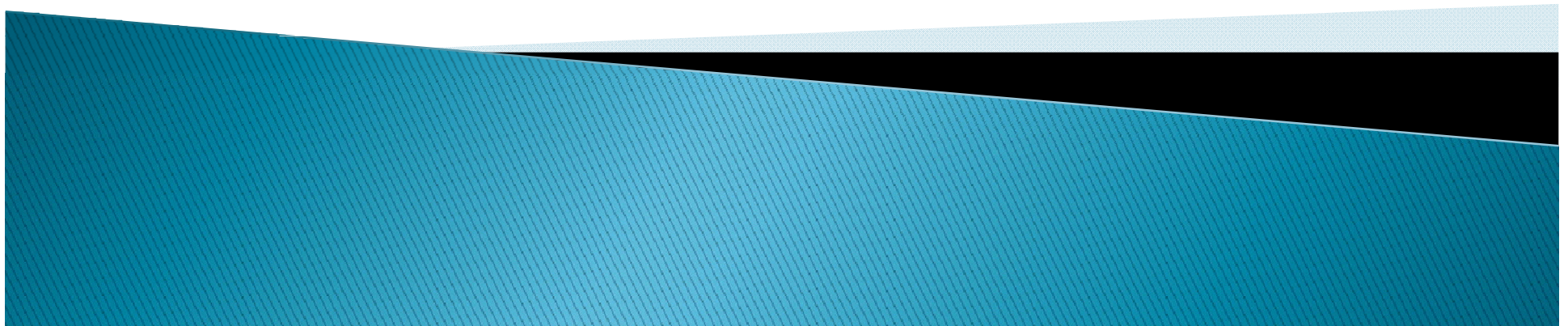


Capital flows and the changing balance in the world economy

Luiz Carlos Bresser-Pereira

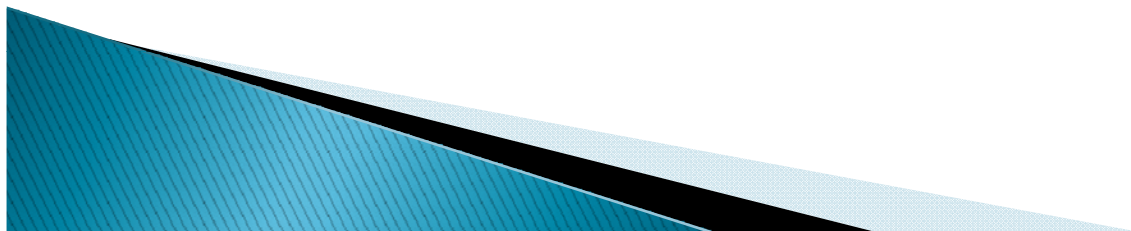
“After the crisis: planning a new financial structure”
Levy Institute, New York, April 14–16, 2010



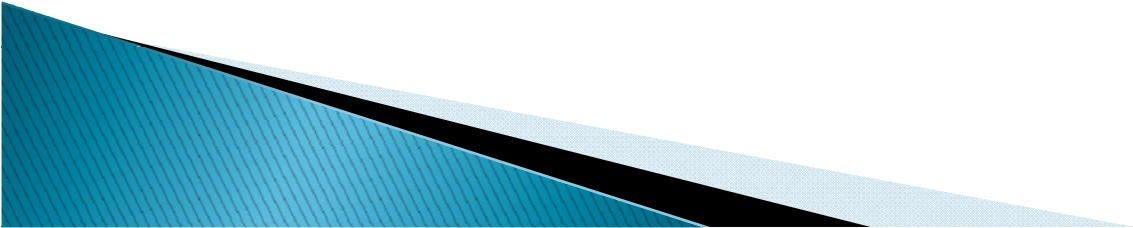
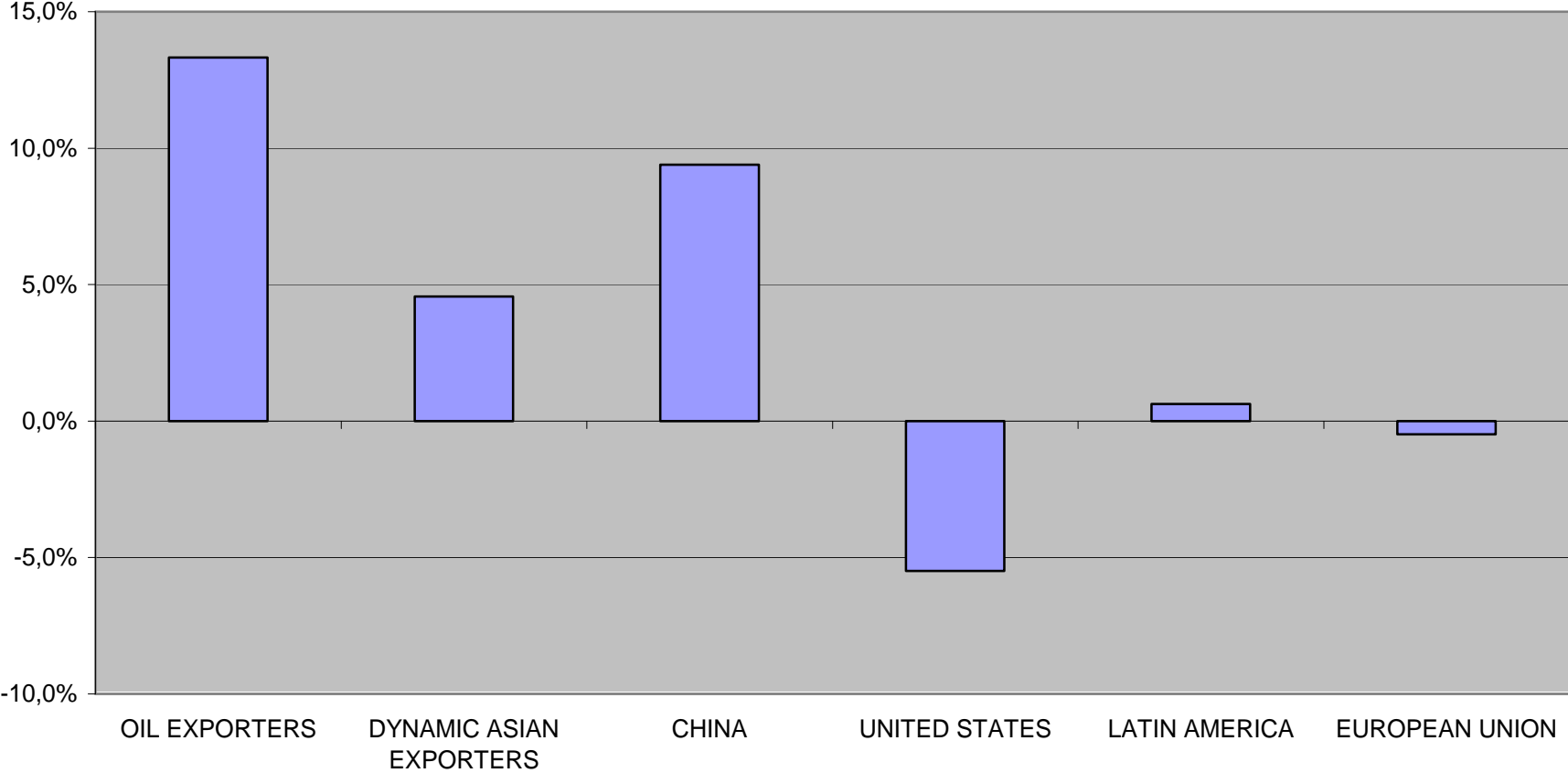
The world economic balance is changing

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

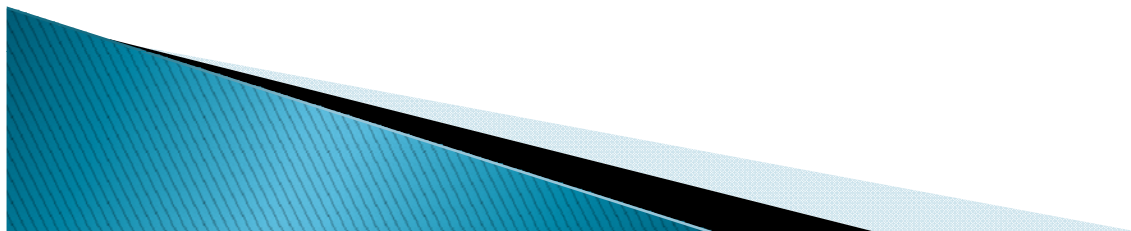


**Current account / GDP
2005/08 average**



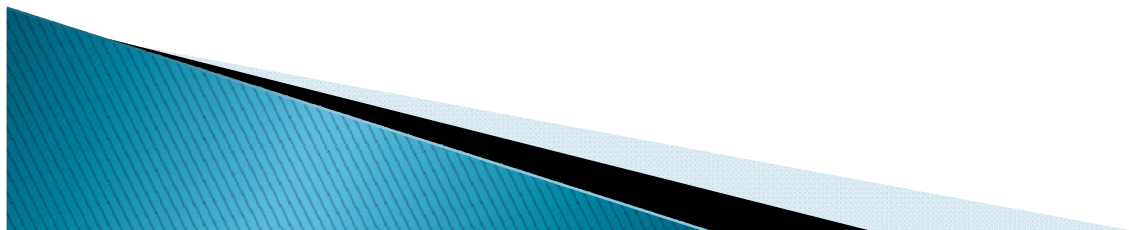
Middle income countries and oil exporters were supposed to catch up

- ▶ 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) have grown faster.



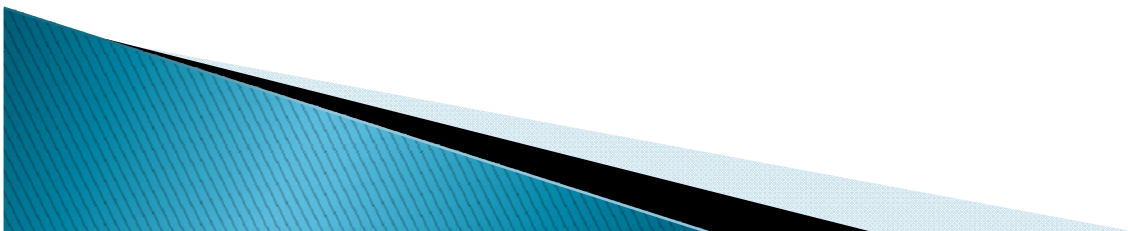
Rich country's logic was simple:

- ▶ Market and financial 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.



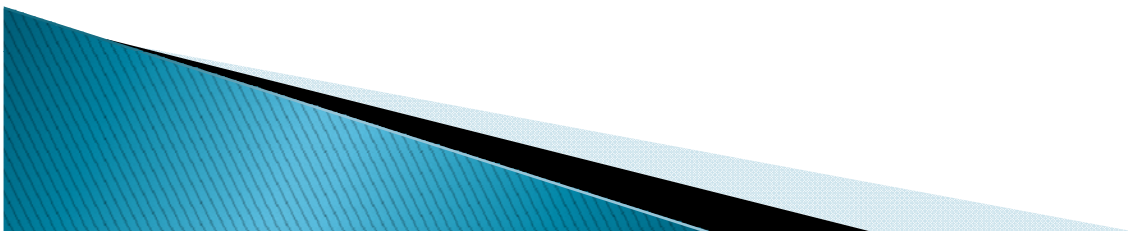
Catching was successful in the countries that resisted

- ▶ that adopted a industrializing 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 bifurcation:
 1. Group 1: most countries, certainly Latin American countries)
 2. Group 2: fast growing Asian countries



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

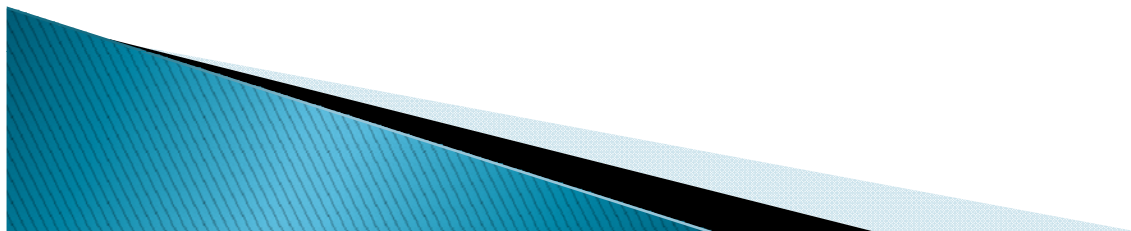
- ▶ 1. Growth in some fast growing middle income countries (chiefly China and India) accelerated still more.
- ▶ 2. Oil exporting (and other commodity exporters) benefited from the rise of commodity prices
- ▶ 3. Both groups of countries achieved high current account surpluses that allowed them to increase 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

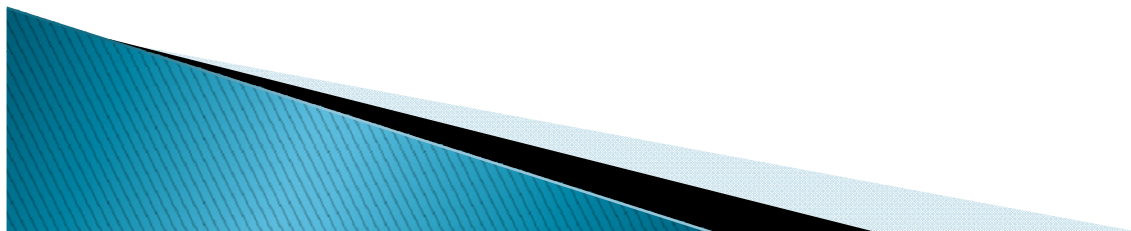
Because it boomeranged: the rich countries adopted the deregulation reforms that they recommended do developing countries.



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:

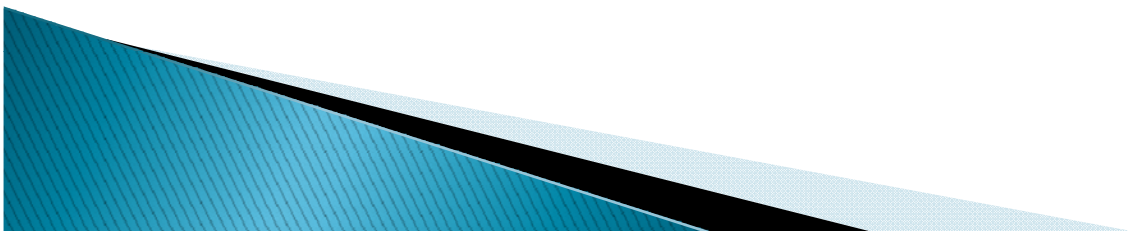
Because they learned that a “competitive” exchange rate is a crucial demand side variable in economic growth



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.

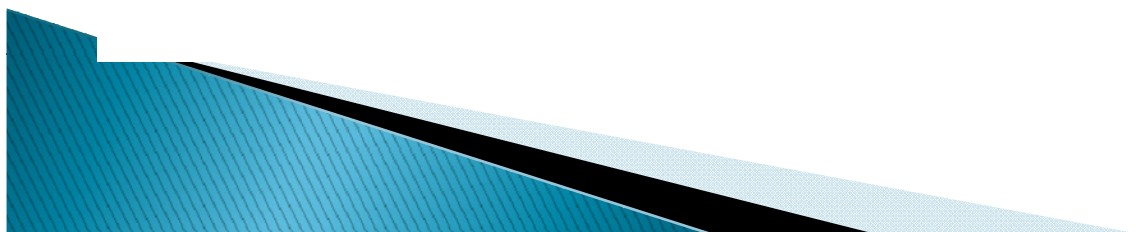
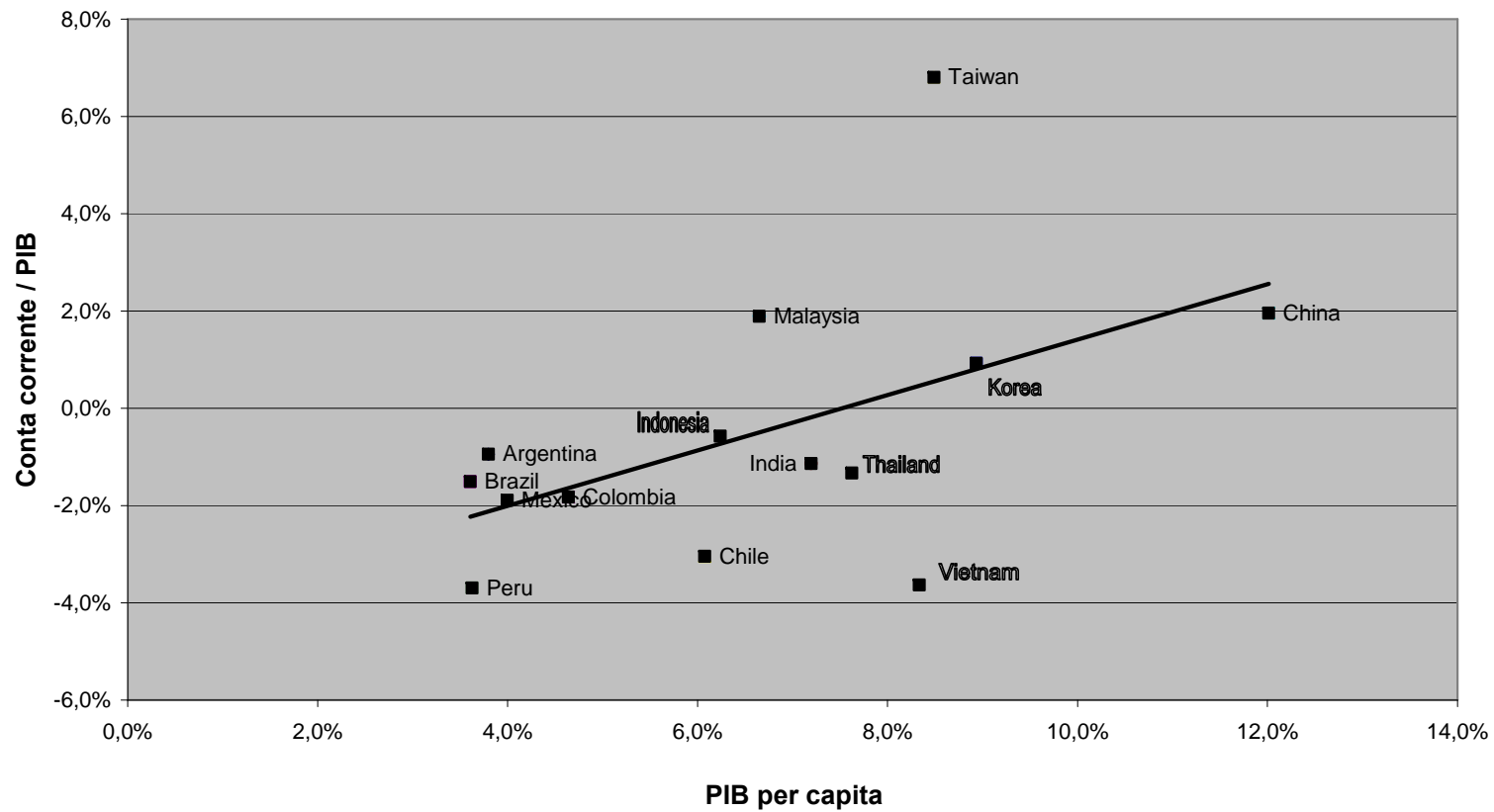
Usually there is a high rate of substitution of foreign for domestic savings (or a high rating of savings displacement)

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)

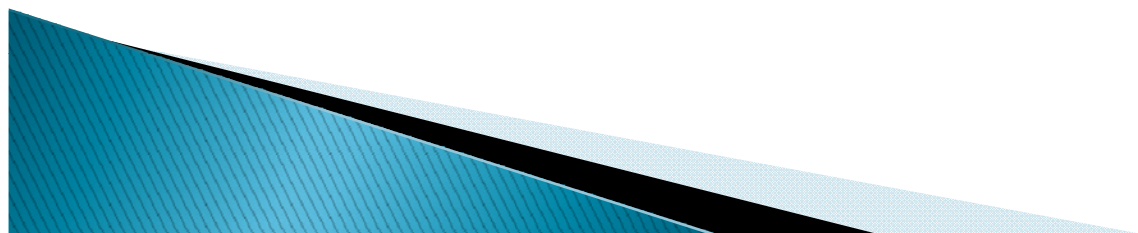


**PIB per capita (PPP, var %) X Saldo em conta corrente (em % do PIB)
variação média entre 1981 e 2007**



(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

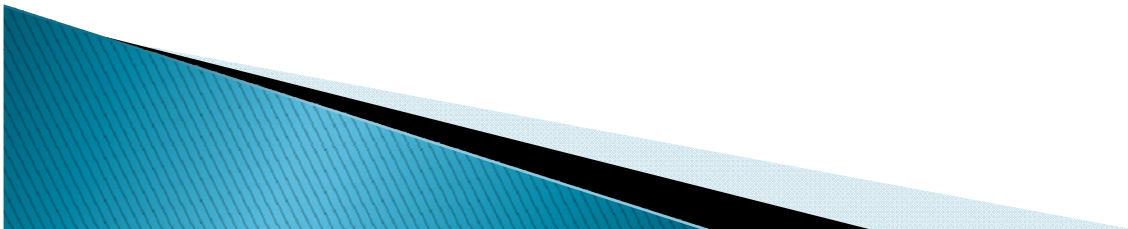
- ▶ Is a major market failure because it is consistent with the long term equilibrium of the exchange rate in the “current” equilibrium.
- ▶ The competitive exchange rate is the one corresponding to the industrial equilibrium
- ▶ Cheap labor countries like China also face the Dutch disease because, additionally, they 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.

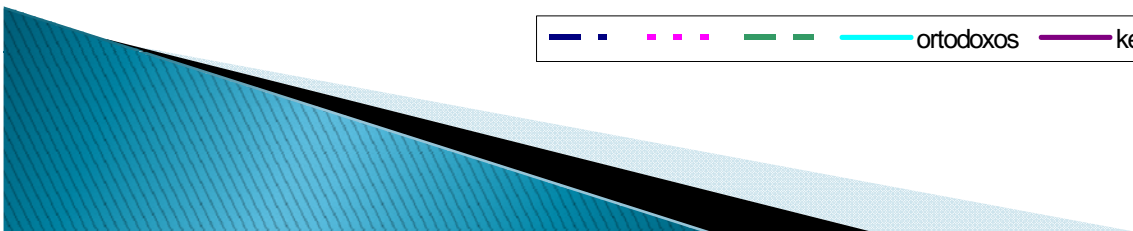
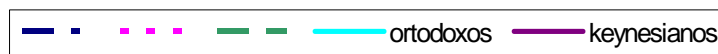
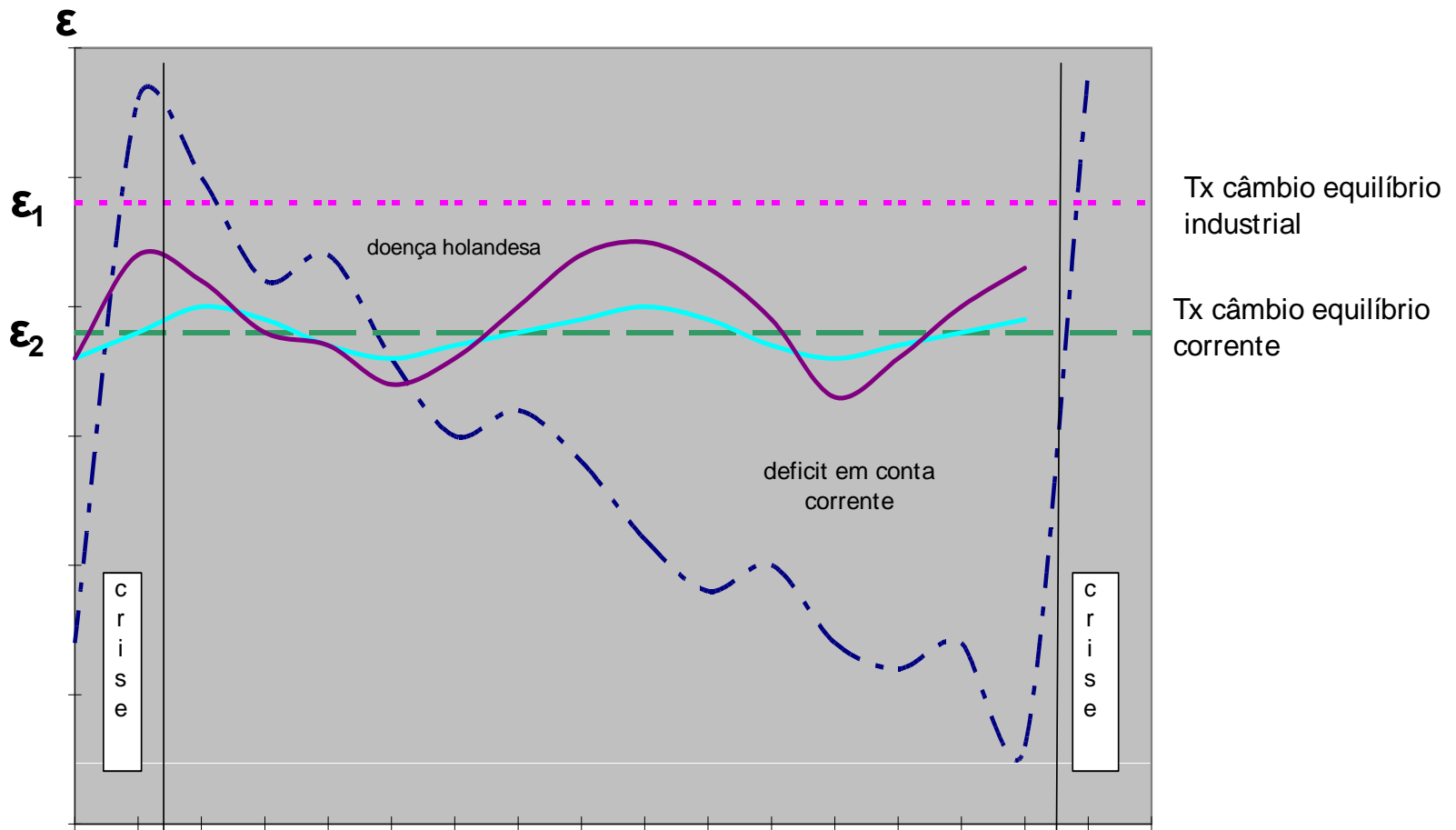
- ▶ Thus, MICs will have to make investments abroad
- ▶ (Instead of capital rich countries to finance capital poor countries we will see the inverse)



(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





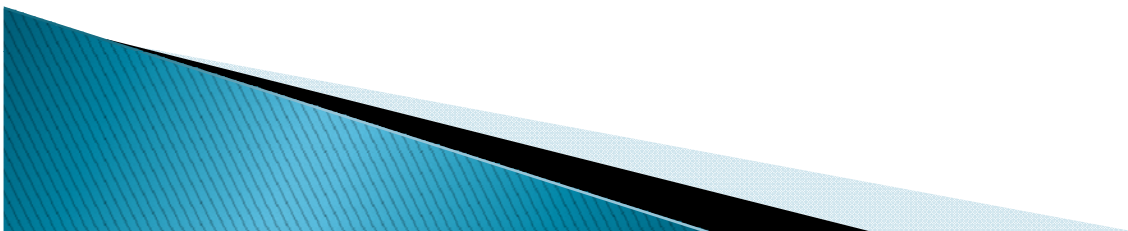
Summing up, middle income countries are learning

- ▶ (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 conclusion, 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) it is based on a demand based theory that I propose to call “Structuralist Development Macroeconomics”

