The Access to Demand*

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Abstract

In this paper I argue that, in developing countries, sufficient aggregate demand is not enough to motivate investment and achieve full employment. Besides, according to the Keynesian developmental macroeconomics under construction, competent business enterprises must have *access* to that demand – access which is denied to most of them because developing countries face the tendency to the cyclical and chronic overvaluation of the exchange rate.

Keywords: exchange rate, current equilibrium, industrial equilibrium, access to demand

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1. Introduction

Keynes opened *The General Theory* with a critique of Say's Law, according to which supply creates its own demand. In his book, which transformed economic theory, he argued that that capitalist countries face a tendency to chronic insufficiency of demand, and must adopt an active macroeconomic policy (fiscal and monetary) to neutralize it and achieve full employment. In this paper I argue that in developing countries it is not enough to guarantee effective demand; policymakers must also adopt an active exchange rate policy to guarantee economic growth and full employment, because of a further tendency, that is, the tendency to the cyclical and chronic overvaluation of the exchange rate. The *cyclical* nature of this tendency explains why developing countries go from currency crisis to currency crisis, from sudden stop to sudden stop. Moreover, the *chronic* nature of this tendency indicates that the currency overvaluation is not just a "misalignment" associated with the well-known short-term volatility of the exchange rate, but a long-term problem that makes the exchange rate central to macroeconomics in general and to development macroeconomics in particular; thus it requires policymakers to ensure not only that effective demand is sufficient but also that competent business enterprises have access to existing demand.

In this paper I first discuss the investment decision in the context of an exchange rate that is chronically overvalued; second, I define the equilibrium exchange rate that serves as a parameter for the appraisal of the overvalued or undervalued condition of the market price exchange rate based on the value of foreign currency, and I distinguish the current equilibrium from the industrial equilibrium exchange rate; third, I briefly present the causes of the tendency to the cyclical and chronic overvaluation of the exchange rate; and, fourth, I conclude with the discussion of a third equilibrium, namely the foreign debt equilibrium – the equilibrium usually recommended to developing countries – which besides corroborating the tendency to over-appreciation, is a risk equilibrium because it easily generates currency crises.

2. The Investment Decision and the Exchange Rate

In a national economy full employment and economic growth depend essentially on investment, which depends on the expected rate of profit (given the cost of capital and productivity), which in turn depends on demand *and* the exchange rate, or, in other words, on the existence of effective demand for the goods and services that a country produces, and on the *access* to the domestic and the foreign markets that the exchange rate is supposed to guarantee. The interest rate is here assumed to be constant only because this is a medium-term model, while productivity is increasing at the same rate as in the rest of the world. Thus, instead of making investment depend on variations of the interest rate along the curve of the marginal efficiency of capital, as short-term macroeconomics does, in this developmental macroeconomics model it depends on the shifts of this curve, which are caused by movements of the exchange rate in and out of *equilibrium*.

Thus, the exchange rate is a variable of the utmost importance in the investment decision. In Keynes's terms, given the existence of credit, investment precedes savings, and, so, what determines the investment rate is not the savings rate but the investment opportunities that an equilibrium exchange rate assures to competent business enterprises, whereas the savings rate is the residuum. The level or equilibrium around which the exchange rate fluctuates according to the demand for and supply of foreign money affects the expected sales, the expected margins, and the consequent expected rate of profit.

This economy contains some manufacturing business enterprises or, more generally, business enterprises producing tradable goods and services, which utilize world state-of-the-art technology. Yet, if the exchange rate is chronically overvalued, these business enterprises will be *disconnected* from local and global demand. They will not be able to

export, and, what is worse, in their domestic market they will be exposed to competition from foreign firms whose technology may be on a par with, or even inferior to, their own. Thus the exchange rate, by assuring or denying investment opportunities to business enterprises, determines the extent of their access to foreign and domestic markets. If the exchange rate remains chronically overvalued, competent enterprises that use world state-of-the-art technology will be uncompetitive, not because they are inefficient, but because they face a distorted macroeconomic price.

Generally, when we discuss a country's competitiveness, we discuss business enterprises' technological and administrative capability, the wage and non-wage labor costs they incur, the quality of the economic infrastructure, and the tax burden. But these factors should not distract our attention from most important variable determining competitiveness: the exchange rate. The same applies to international trade relations. Import tariffs are extensively debated. Their presence is normally understood as "protectionism", as the implicit acknowledgement by a country that imposes them that its business enterprises are inefficient. Yet they may be just an awkward form of neutralizing the chronic overvaluation of the exchange rate that prevails in developing countries, whose causes, including the Dutch disease, I briefly discuss below.

3. What Is The Equilibrium Exchange Rate?

Why does the exchange rate tend to be chronically overvalued? To answer this question I must, first, define the equilibrium exchange rate. Economic theory does not clearly provide such a definition, but simply assumes that the exchange rate is determined by the supply of and demand for foreign money. In recent years, by studying the Dutch disease I believe that I have answered the question, in other words that I have arrived at a correct and very simple theory of the exchange rate. In this theory, the key distinction is between the *value* and the *price* of foreign money, and the central claim is that the market exchange rate fluctuates around its value or necessary price. The value of the exchange rate is, in a given country, the value in local money of a basket of foreign currencies that covers the costs plus reasonable profit of the business enterprises that participate in the country's foreign trade and assures the intertemporal equilibrium of its current account. I call the equilibrium exchange rate the "*current* equilibrium". It is an equilibrium in value, not in price, terms. Its basic determinant is the unit cost of production (wages divided by productivity) of the country compared with the unit costs of production of the main countries with which this country trades. It is a value of the foreign money (*a*) because it is determined in the real sector of the economy, (*b*) because it is equivalent to the labor value of the goods and services, which have a practical expression in the cost of production plus a satisfactory or reasonable profit margin (satisfactory in the sense of being sufficient to motivate business enterprises to invest), and (*c*) because it serves as a hub in money terms around which the true price, the exchange rate market price, turns or fluctuates. [1]

Note that, in my definition of it, the value of the exchange rate has two determinants – the cost of production and the equilibrium in the current account. In principle, one corresponds to the other, although the more important one for economic growth is the cost of production (cost plus a reasonable or satisficing profit margin). With this factor taken into account, in countries vulnerable to the Dutch disease there is a second value for foreign money and a second equilibrium for the exchange rate that I call the "industrial equilibrium".

The Dutch disease is a permanent although variable overvaluation of the exchange rate caused by exports of commodities that benefit from Ricardian rents, and, for that

[1] See Bresser-Pereira (2010, 2013).

reason, may be exported at a satisfactory profit at an exchange rate that is more appreciated than that required by other existing (or potential) business enterprises producing tradable goods using world state-of-the-art technology. In the case of the Dutch disease there are two values for the exchange rate: (1) the one around which the market price of the foreign money will float – which is defined by the commodities that cause it, and corresponds to the current equilibrium, (2) and the value of the foreign money relative to the other tradable goods which are produced or potentially produced by business enterprises utilizing technology in the world state of the art, which I call the "*industrial* equilibrium". The market price exchange rate will fluctuate around the lower value or the more appreciated equilibrium, the current equilibrium. The difference between the two equilibriums is the Dutch disease; the bigger this difference, the more severe the disease is. It is a disease because it inhibits potential business enterprises from producing more sophisticated goods and services that have a higher value added per capita, and for that reason damages the fundamental source of increase in productivity, which is the transfer of labor from low value added per capita industries to high value added per capita industries.

Given the existence of two values or two equilibriums, the one that is the *true* equilibrium – the one that makes the exchange rate the *correct* rate – is the industrial equilibrium. It is this equilibrium that is consistent with the elementary principles of economics, which makes business enterprises utilizing world state-of-the-art technology competitive.

A country relatively poor in natural resources, as many Asian countries are, will not suffer from the Dutch disease, or will do so only moderately, and its industrialization and catching-up using cheap labor will be facilitated. A poor country that has abundant natural resources and faces the Dutch disease, as most as most Latin American and African countries do, will diversify its economy and grow only if it is able to neutralize the disease by shifting the current equilibrium "upward" to the level of the industrial equilibrium.[2] Middle-income countries like Brazil, which industrialized in the past because they were able to neutralize the disease (usually by imposing a tax on the commodities that cause it, and by adopting an active exchange rate policy that includes capital controls),[3] but stopped such neutralization because they liberated trade and capital flows, will undergo a process of deindustrialization and their rates of growth will fall.

4. Tendency to Overvaluation

Thus, a non-neutralized Dutch disease is a basic cause of the chronic overvaluation of the exchange rate that exists in developing countries. In this case, the exchange rate will fluctuate around the current equilibrium, whereas the true and competitive equilibrium – the one that assures that competent business enterprises existing in the country have access to demand – is the industrial equilibrium. But my contention is that the overvaluation of exchange rate in developing countries is not only chronic; it is also cyclical: the country goes from balance of payments crisis to balance of payments crisis. However, this cyclical character is unconnected to the Dutch disease; whereas a country's cycles of indebtedness in foreign money require large and persistent current account deficits, the Dutch disease is

[2] I say "upward" because I am defining the exchange rate as the price of the national currency divided by the different reserve moneys.

[3] The tax will increase the costs plus reasonable profit margins of the business enterprises exporting the commodity and, for that reason, will increase the value of the current equilibrium. On the assumption that this tax is equal to the difference between the two values, the disease will be neutralized, but the exporters of the commodity will not suffer because what they pay in tax they receive back in the devaluation of the exchange rate.

consistent with the long-term current-account equilibrium: it only "pulls" the exchange rate from the industrial equilibrium to the current equilibrium.

What are the basic factors that usually lead developing countries to high current account deficits and to currency crisis? To answer this question I must first make clear what I mean by a *cyclic*ally overvalued exchange rate. It is an exchange rate that is so overvalued that it causes current account deficits great enough to lead the country into cyclical financial crises. A currency crisis or balance of payments crisis will materialize if the ratio of foreign debt to GDP increases, which will happen in so far as the rate of increase of the current account deficit (which is directly associated with the exchange rate) normally remains for several years above the rate of growth of GDP. The fundamental characteristic that distinguishes developing countries from rich countries is that they cannot become indebted in their own currencies to foreign creditors. If, as I am assuming, the foreign debt/GDP ratio is increasing because the current account deficit in relation to GDP is higher than the growth of GDP, the first effect is a credit bubble, in so far as creditors are happy or euphoric to finance the country independently of its capacity to honour the debt; second, the increase in the external vulnerability of the country forces it to carry out a pathetic "confidence building policy" – an attempt to retain the confidence of foreign creditors by acceding without question to their recommendations and pressures; and third, as the debt in foreign currency grows, the creditors, hitherto euphoric about their loans, suddenly, and displaying well-known herd behaviour, lose confidence in the country's ability to repay its debts and suspend the debt rollover, and the currency crisis unfolds as the domestic currency depreciates violently. This crisis or sudden stop happens because it then becomes obvious to all the creditors that they on one hand, and the government and the enterprises of the debtor country on the other hand, have together been engaged in what Hyman Minsky called "Ponzi finance", in which additional indebtedness was being used to repay not the principal but the interest on the existing debt.

Thus, the Dutch disease explains the overvaluation of the exchange rate, but does not explain the large current account deficits that characterize the tendency to the cyclical and chronic overvaluation of the exchange rate. But why are such deficits so common in developing countries? The exchange rate often depreciates and falls below the current equilibrium in response to external factors, such as a financial crisis in rich countries. But I am not interested in such cause, which is exogenous and unpredictable. To explain large and persistent current account deficits and the corresponding chronic exchange-rate overvaluation, we need to identify systematic causes – causes that, in line with the historical-deductive method adopted here, normally and regularly lead to that outcome. I suggest a single structural cause and four policy causes. All of them affect the price, not the value, of the exchange rate; all of them involve excessive or unnecessary capital inflows.

The structural cause is the fact that in developing countries the profit rate and the interest rate tend to be higher than those in rich countries, which causes capital inflows and exchange-rate appreciation. But I don't believe that this cause is important. Certainly more relevant are the four policy causes: the adoption of the policy of growth with foreign savings, the use of the exchange rate as an anchor to control inflation, the carry trade practiced by financial markets, and exchange-rate populism.

I begin with the policy of growth with foreign savings. This policy has been adopted in all developing countries except the fast-growing Asian countries, where current account surpluses are frequent. Conventional policymaking in developing countries sees current account deficits as "natural" and "necessary". Actually, they appreciate the exchange rate, and, for that reason reduce access to demand; in other words they hamper investment and stimulate consumption, thus involving an usually high rate of substitution of foreign savings

for domestic savings. This policy is usually accompanied by high interest rates deemed necessary "to attract foreign capital".

The second policy cause of large current account deficits and the cyclical overvaluation of the exchange rate is the frequent use of the exchange rate as an anchor to control inflation. Such a policy may be legitimate in the event of hyperinflation, but is definitively perverse in the case of normal inflation. It is an old practice, but it became disastrous when liberal economics became hegemonic, transformed the control of inflation into the only important objective of economic policy, and adopted inflation policy targets as a kind of religion. A policy target for inflation is reasonable for central banks if it is combined with an informal exchange rate target corresponding to the administration's estimation of the industrial equilibrium.

It is undoubtedly good for the control of inflation that the central bank gains credibility by meeting its inflation target. But there is a circular problem that the use of the exchange rate anchor perversely "solves". After all, the bank's credibility ultimately depends on the target being met. Since the ability of the interest rate to control inflation is limited and takes time to have its effect, the temptation to resort to (or profit from) an appreciation of the exchange rate in order to meet the inflation target becomes difficult to resist. Therefore, we often have an inflation target, an explicit interest rate policy to meet it, and an implicit exchange rate policy. This exchange rate policy is never avowed, because conventional economics maintains that the only legitimate instrument to be used by the central banks is the interest rate, and that the price of foreign currency is adequately defined by the market.

Models of the inflation targeting include the exchange rate, but treat exchange rate appreciation or depreciation as an endogenous variable – as the consequence of the supply of and demand for foreign money, over which the administration has little control. Thus, for instance, if the prices of the goods and services exported are increasing, the exchange rate may appreciate; if foreign demand for the goods exported by the country falls, the exchange rate will depreciate. But my general contention is that the cyclical overvaluation of the exchange rate it is an *exogenous* variable: it is the outcome of policies that developing countries usually adopt, following the prescriptions of the liberal orthodoxy or the demands of populism. When the policymaker decides on growth with foreign savings, or decides to use the exchange rate as an anchor to control inflation, he is deciding to appreciate the exchange rate, which in this case is an exogenous variable: the appreciation is *deliberate*.

The third cause that keeps the exchange rate below the current equilibrium is a market price exchange rate that still has room for appreciation combined with a high interest rate. When, after the sharp devaluation that occurs with the sudden stop, the exchange rate begins to appreciate, there is plenty of room for its appreciation. But there is also a floor to it: the point at which even the export of commodities becomes uneconomic. Whereas the country does not achieve this floor, the speculative practice of carry trading is highly profitable for its practitioners, and makes the appreciation of the national currency a self-fulfilling prophesy. Counting on the appreciation of the currency and on the high interest rate offered by government bonds, the trader buys the currency continuously, causing the exchange rate to appreciate.

The fourth cause of large current account deficits and the overvaluation of the exchange rate is the exchange rate *populism.* The appreciation of the exchange rate is attractive not only to foreign countries because it opens the way for their loans and their multinationals, and to the general public because it increases the income and the wealth of all in the short term. It is attractive also to politicians, because when the exchange rate

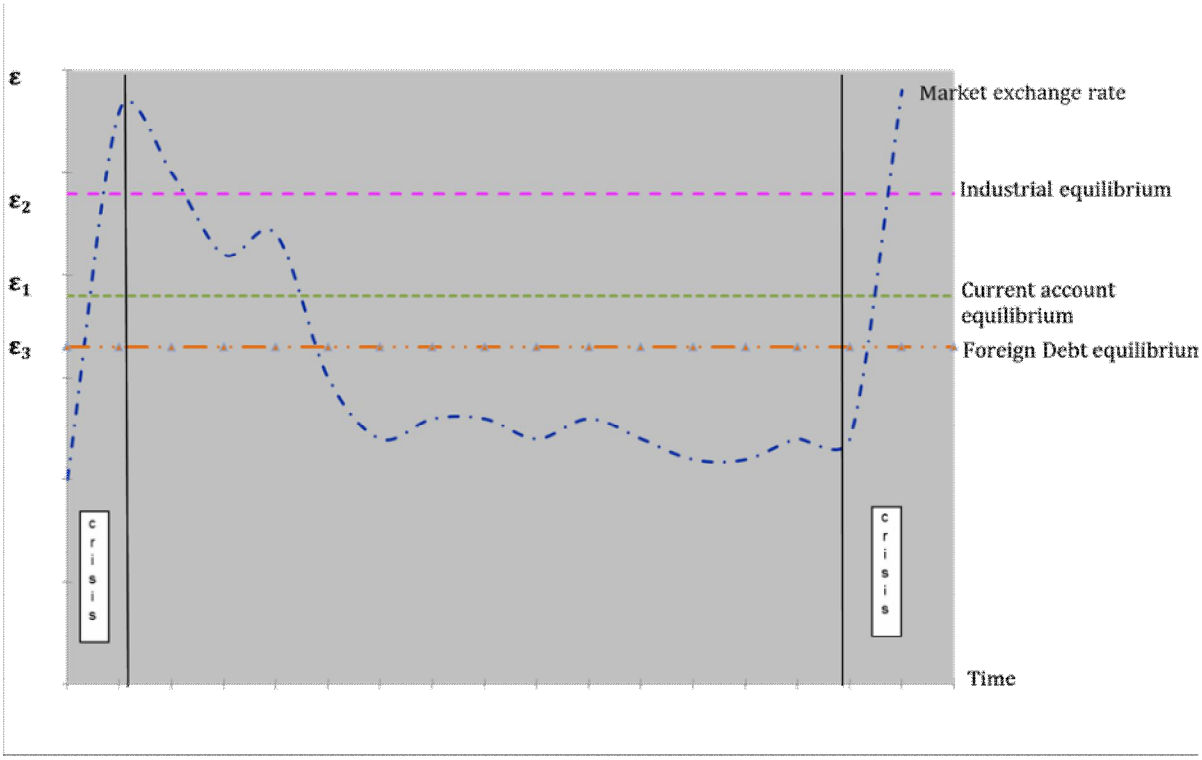
appreciates inflation goes down and real incomes go up; and, provided that the financial crisis does not break up before the election, the politicians are re-elected.

5. A Third Dangerous Equilibrium

I summarize the tendency to the cyclical and chronic overvaluation of the exchange rate and the consequent lack of access to demand in Figure 1. In this figure we have the exchange rate in the ordinate, and time in the abscissa. From the top down, the first horizontal line is the industrial equilibrium – the value of the exchange rate when there is Dutch disease; and the horizontal line below it is the current account equilibrium – the equilibrium that balances the country's current account intertemporally. The market price exchange rate is depicted by the curve with a flat bottom, having as its limits two currency crises that sharply depreciated the currency which in the preceding years had appreciated.

By examining the figure we can understand why business enterprises in developing countries that don't manage their exchange rates don't have access to demand. The figure depicts the cyclical character of the exchange rate, which is in line with the extensive literature on political cycles and with the meager literature on the role of the exchange rate in such cycles, to which the latest contribution is Adolfo Canitrot's (1976) classical paper on the subject.[4] The figure also shows that the overvaluation is chronic. We are assuming that the exchange rate cycle – a financial cycle of foreign indebtedness – lasts several years. During this period, in a brief moment, immediately after the balance of payments crisis breaks, the national currency depreciates, while for the rest of the time it appreciates – it appreciates chronically or in the long term.

Figure 1: The three equilibriums and the market exchange rate



Source: Elaborated by the author.

[4] Adolfo Canitrot, "La experiencia populista de distribución de renda" [The populist experience of income distribution], *Desarrollo Económico* 15(59) (1975): 331–51.

Note that Figure 1 contains a third horizontal line, which depicts what I propose to call the "foreign debt equilibrium". This is in my view a mistaken and dangerous equilibrium; it is the exchange rate that corresponds to a ratio of current account deficit to GDP that keeps the ratio of total foreign debt to GDP constant at a level viewed by international financial markets as "comfortable". I say that this equilibrium is mistaken because it disconnects actual and potential competent business enterprises existing in this economy from demand; it is dangerous because the exchange rate easily falls below this third level, which increases the ratio of foreign debt to GDP and enhances the likelihood that a currency crisis will materialize.

I stress this third line in Figure 1 not only to emphasize the risk involved but also to observe that this is the equilibrium that most economists believe to be correct or advisable for developing countries. According to these economists, this is the exchange rate that would maximize the growth rate of the country, given their belief that capital-rich countries should transfer their capital to capital-poor countries – a belief based on the false assumption that foreign savings add to domestic savings instead of substituting for them and increasing consumption, as is usual in developing countries.

6. Conclusion

I believe that by now the reader will understand why full employment and growth do not depend on active macroeconomic policies that neutralize the tendency to the insufficiency of effective demand; in developing countries, where the exchange rate tends to be chronically overvalued, full employment and growth depend also of an active exchange rate policy. Such a policy has a structural component and a day-to-day component. The structural component is an export tax on the commodities that cause the Dutch disease, because this tax increases the value of the exchange rate, so making the current equilibrium and the industrial equilibrium coincide and, for that reason, making the market price exchange rate fluctuate around this equilibrium. The day-to-day exchange rate component is the macroeconomic policy that manages capital inflows and outflows either administratively by the adoption of capital controls, or in price terms by the central bank buying and selling foreign reserves.

I have been sketching over the last 12 years the developmental macroeconomics models that I have summarized here. In this paper I draw on them, and add to them the problem of access to demand, which I have not previously fully discussed. Together these historical (rather than hypothetical-deductive) models constitute a developmental macroeconomics under construction. They are based on experience; they have been verified by the research of many economists – often economists who were not aware of the entire underlying theory. In order to develop they need much theoretical thought and much research, but they already add up to an instrument that developing countries may use to accelerate their growth and catching-up.[5]

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[5] These ideas will be put together in the book by Luiz Carlos Bresser-Pereira, José Luis Oreiro and Nelson Marconi, *Developmental Macroeconomics* (London: Routledge, 2014 forthcoming).

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