

# THE TENDENCY TO THE OVERVALUATION OF THE EXCHANGE RATE

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**Summary.** In developing countries there is a tendency to the overvaluation of the exchange rate. It has two structural causes: the Dutch disease and the attraction that higher profit and interest rates usually prevailing in developing countries exert on foreign capitals, and four policy causes: the policy of growth with foreign savings, the control of inflation to exchange rate anchors, the policy of “capital deepening”, and exchange rate populism. Either the country neutralizes this tendency and grows fast, or does not and will suffer cyclical balance of payment crises.

**Key words.** Exchange rate overvaluation Dutch disease foreign savings exchange rate populism

I discussed elsewhere that the national development strategy adopted today by the fast growing Asian countries should be called “new developmentalism” and should clearly be distinguished from conventional orthodoxy of the Washington consensus (Bresser-Pereira 2006). Given that, the question is to know, among the policies forming new developmentalism, which are the strategic ones, those that will more effectively and rapidly cause fast growth. Although not playing down the importance of the main supply variables affecting the rate of growth (education, technological progress and infrastructure investments), I understand that the decision to grow with domestic savings and the macroeconomic policy variables on the demand side – a hard fiscal policy, a moderate interest rate and a competitive exchange rate – are the key ones. To come to this conclusion, on one hand I have observed what was happening in the dynamic Asian countries – which policies were strategic in their growth process – and on the other hand I submitted the hypothesis to a simple econometric test, comparing such variables (Bresser-Pereira 2008b). Sound macroeconomic variables and policies showed a strong correlation with economic growth. I excluded from the test long-term institutions because they are correlated to the *level* but not to the *rate* of economic development; the rich countries are also those with more elaborate and well-regarded

institutions, but it is impossible to relate institutional reforms with the rate of growth. Institutional reforms are always necessary, but they rarely precede economic growth: they need time to mature, to be transformed into law, and to be enforced.

To develop, a country should keep its public budget in balance, its interest rate moderate, and its exchange rate, competitive. For long I knew this, and also that among these three policy variables the most strategic was the exchange rate, as it is a powerful determinant not only of exports and imports but also of salaries, consumption, investment and saving. Yet this fact was not acknowledged by growth theory; the exchange rate was not viewed as a legitimate subject of study by economists concerned with economic development. Only a few empirical works challenged this view, but they were not sufficiently focused and clear to change the dominant opinion. Research on this matter began with a major study by Dollar (1992: 535) relating the exchange rate to growth, followed by works by Sachs and Warner (1999) and Razin and Collins (1997). Dollar assumed that Latin American and African countries tend to have more appreciated exchange rates than Asian countries, and concluded that if they had adopted Asian exchange rate standards their yearly average growth in the period 1976–85 would have been, respectively 1.5 and 2.1 percentage points higher than they effectively were. According to Dollar, “these results strongly imply that trade liberalization, devaluation of the real exchange rate, and maintenance of a stable real exchange rate could dramatically improve growth performance in many poor countries”. Other studies (Benaroya and Janci 1999; Easterly 2001; Bresser-Pereira and Nakano 2002b; Fajnzylber et al. 2004; Gala 2006; Johnson, Ostry and Subramanian 2007; Levy-Yeayti and Sturzenegger 2007; Rodrik 2007) also showed that a lower exchange rate would assure developing countries higher growth rates. Using Dollar’s data basis, Easterly studied the period 1960–99; his objective was to explain why market-oriented reforms effected in the 1980s and 1990s did not cause the expected results in growth terms. One of the explanations was that certain currencies, such as the Mexican peso, appreciated in real terms; other, like the Brazilian real and the Argentinean peso, remained constant; while some Asian currencies depreciated up to 1990, and then appreciated until the 1997 balance of payments crisis. Gala (2006) corrected Dollar’s and Easterly’s data, by considering the different rates of productivity of the countries under study and the consequence that they should have on the relative real exchange rates. The currencies of the Asian countries experiencing above-average increases in productivity, such as Korea

or Taiwan, should have appreciated in relation to the others countries where growth was slower, as the Harrod–Balassa–Samuelson rule predicts. Yet this did not happen. The conclusion from Gala’s econometric study was clear: the Asian countries clearly showed more competitive exchange rates than the Latin American ones and consequently grew faster.

Thus, a competitive exchange rate is a condition for economic growth. Yet, since the 1990s, this condition is not present in most developing countries, particularly the Latin American and African countries. They do not have the required “relatively devaluated” exchange rate, or, as I prefer to say today, a “competitive” exchange rate. Before the 1990s, Latin American countries were able to keep the exchange rate competitive in so far as the developmentalist policies that they adopted implied tightly managed currencies. To avoid overvaluation, their nominal exchange rates were modified by import taxes and export subsidies. In Brazil, for instance, in the 1970s, given that import taxes were around 50 per cent and export subsidies for almost all goods except coffee were also 50 per cent, the effective exchange rate was 33 per cent lower than the nominal rate; coffee exporters paid a 33 per cent tax.

Although compelling on the econometric aspect, the recent literature on the subject presents two problems: it ignores the difference between competitive and depreciated exchange rates, and it lacks a theory or a transmission mechanism to explain why a merely competitive exchange rate causes economic growth in middle-income countries. The confusion between a competitive and a depreciated exchange rate was a mistake for which I am to blame too. For many years, since the 1970s, I was persuaded that a “relatively depreciated currency” was a central explanation of fast economic growth. Thus, I acknowledged the central role of the exchange rate in economic development but suggested that its average level was an artificial outcome of intervention in the money market. In other words, I was saying that this relatively depreciated exchange rate was the outcome of an intervention in the market that could be indicted for being “neo-mercantilist” or for “begging thy neighbor”. Since 2007, however, after I developed the critique of the policy of growth with foreign savings<sup>1</sup> and the model on

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<sup>1</sup> I first developed the argument that in most cases foreign savings do not contribute to economic growth, but just appreciates the exchange rate and causes the substitution of foreign for domestic savings in Bresser-Pereira (2002) and Bresser-Pereira and Nakano (2003). I closed the analysis with the paper, “Foreign savings, insufficiency of demand, and low growth” (Bresser-

the Dutch disease based on two exchange rate equilibria (Bresser-Pereira 2008a), I realized, first, that this disease and also the higher profit and interest rates that tend to prevail in developing countries were two structural causes for the tendency of the exchange rate to overvaluation. Second, that neutralizing such a tendency was a condition for fast growth in middle-income countries. Third, that the resulting exchange rate was not relatively depreciated but just competitive; given the model of Dutch disease distinguishing a “current equilibrium exchange rate” that corresponds to the level that the market rate tends intertemporally because it assures current account balance, from an “industrial” equilibrium that makes competitive business enterprises using the best technology available in the world, I call competitive the exchange rate that corresponds to the later – to industrial equilibrium exchange rate. Since the Dutch disease is a major market failure, the exchange rate does not tend to this rate but to the one that equilibrates the current account.

The relation between a competitive exchange rate and economic development is clear. Given that growth depends on the rate of investment and the productivity of capital, and that the investment rate depends on the existence of profit opportunities, only a competitive exchange rate will stimulate the export oriented investments that are necessary to the middle income country to profit from its key economic advantage – low wages – and grow. It is also clear how strategic the policy of exchange rate is. But we cannot just assume that the exchange rate tends to equilibrium and, so, is competitive. If it is difficult to keep the public budget in reasonable balance and the interest rate at an overall moderate level, it is considerably more difficult to keep the exchange rate competitive because policymakers are not supposed just to behave moderately and reasonably, they must also proactively neutralize a structural tendency: the tendency to the overvaluation of the exchange rate.

Around the exchange rate there are obvious interests. We cannot escape from the political economy involved. No country accepts that its competitors artificially depreciate their currencies. This is viewed as unfair – as a nationalist form of “beggar thy neighbor”. According to conventional economic theory, Asian countries and particularly China are growing at the expenses of their competitors by artificially

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Pereira and Gala 2008). This paper and the one on the Dutch disease (Bresser-Pereira 2008a) are the two papers that complete the initial discussion of the tendency to the overvaluation of the exchange rate.

keeping their exchange rates depreciated. Yet, while these countries are just neutralizing the tendency of the exchange rate to over-appreciation, or are just neutralizing the Dutch disease and rejecting the policy of growth with foreign savings that floods their countries with foreign currency that they don't need, the neo-mercantilist argument ceases to make sense.

### **EXCHANGE RATES AND GROWTH**

When we study economic development we must always take into consideration its two sides: the supply side and the demand side. Conventional economics tends to analyze economic growth merely in terms of supply, focusing on education, on the broader improvement of human capital, on scientific and particularly on technological development, on innovation, and on investments in infrastructure and in machines that increase workers' productivity. Yet, as Keynes and Kalecki classically demonstrated, demand is not automatically created by supply, and therefore insufficiency of demand may become an essential obstacle to economic growth. Although developing countries are characterized by low levels of education, limited command of technological progress and deficient investments in energy production and transportation, the huge unemployment of human resources in low-growth medium-income countries leaves no doubt that the main problem is often on the demand side rather than on the supply side. Demand is formed by consumption, investments, public expenditure, and exports minus imports or the trade surplus. Among these components of aggregate demand exports are key. Neoclassical economists just ignore the demand side. As for the Keynesian economists who attribute a major role to demand, the problem is that they often forget the role of exports in sustained aggregate demand, for three reasons: first, because they focus the short-run macroeconomic equilibrium; second, because they often presuppose closed systems; third, because many Keynesian economists in developing countries continue to give priority to the domestic market and to mass consumption, and are distrustful of export-led growth.

These are mistaken views that ignore the central role of the exchange rate and of exports in economic development. Exports are key to developing countries in any circumstance, and there is no conflict between the development of the domestic market and the export-led growth strategy. When the country is still poor, that is, when it has not completed its

Industrial Revolution, and does not have investment capacity or a class of entrepreneurs and middle-class professionals to conduct investments, it usually escapes the poverty trap by combining two strategies: by exporting some mineral or agricultural commodity with which the country is particularly endowed, and by a systematic and planned state intervention oriented to forced savings and to increasing the country's investment rate. The combination of these two strategies will vary from country to country (Brazil and Australia on one side, Japan, Russia and China on the other), but exports are always important. It usually follows an import-substitution phase that should be short – an industrialization strategy is valid while we can assume that the manufacturing industry is still “infant” (a problem with Latin American growth was that the industrialization strategy was artificially overextended). In this phase exports apparently have been given a secondary role, but this is only partially true. Immediately after the import-substitution strategy is exhausted, the country will have to resort to exports to grow, now using its relatively low-cost labor to export manufactures.

While the country is just exporting commodities, the neutralization of the Dutch disease is not a major problem because the country does not have yet conditions to industrialize. In the moment that some entrepreneurial and technical capacity is acquired, however, the challenge will be to industrialize and export; it makes no sense to the now middle-income country to renounce diversification into high per-capita income industries; but, for that, a competitive exchange rate is a necessary condition. To be sure, we could ask two questions: first, is it really necessary to industrialize in order to grow? Second, is it necessary to increase exports in order to sustain aggregate demand? Couldn't the country sustain it just by managing the internal variables, that is, investment and consumption? I will not go over the first question. This is a problem that was resolved in the 1940s and 1950s by development economics and the Economic Commission for Latin America and the Caribbean (ECLAC), and revisited by Nicholas Kaldor in the 1970s.<sup>2</sup> Economic development is a process of increasing productivity that takes place within industries and, principally, through the transfer of labor from low valued-added industries to high value-added industries – industries that use sophisticated technology and pay high average wages and salaries. We know that primary goods industries are becoming increasingly technology-intensive, and, thus, we could imagine a developed

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<sup>2</sup> See Prebisch (1950), Kaldor (1978).

country based entirely on primary industries. But, for that, the country would have to be small, like New Zealand or Chile. And even these countries do not limit their production of tradable goods to primary goods. Economic development requires that the country that becomes technologically capable is able to transfer its labor to industries with the highest per capita value-added. It makes no sense a country structurally limited in the industries in which it could specialize because its exchange rate is overvalued. As to the question why a country shouldn't sustain aggregate domestic demand just by managing it, the answer is that this is theoretically possible, but it is evident that the possibility of also counting on external demand makes things much easier for the country. If the economy is closed – or if policymakers act as if it were – it is difficult to increase the investment and the savings rate without reducing short-term domestic consumption. Within the domestic market, the policymaker and the entrepreneur face a classic egg-and-chicken dilemma: investment opportunities depend on strong domestic demand which, in its turn, depends on investment. If the country begins by increasing demand, inflation can follow; if the idea is to start by increasing investments, what would be the incentive to invest? These problems disappear, however, if we assume that the economy is open and growth should be export-led. In this case, when the developing country enjoys technological capacity and a competitive exchange rate, it will be able to take advantage of its relatively cheap-labor export. Demand ceases to be only domestic demand and expands to become world demand. This was successfully done by the Asian Tigers, Brazil and Mexico in the 1970s. This is what the latter two Latin American countries ceased to do after the 1980s debt crisis because they agreed to open their financial accounts and ceased to neutralize the tendency of the exchange rate to overvaluation. Exports based on a competitive exchange rate not only represent demand when there is a positive balance in commercial transactions, but, in addition, they encourage demand's main variable – investments – which operates as much on the supply side as on the demand side.<sup>3</sup> Exports are therefore strategic in order to solve the problem of unemployment or of insufficient demand. In the era of globalization, export-led growth is the only sensible strategy for developing countries while they have the

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<sup>3</sup> Investment expenditure evidently also depends on other variables, besides increased exports, such as the interest rate and, particularly, profit expectations, but these latter would be substantially better should the entrepreneurs rely on an exchange rate that encourages them to export.

competitive advantage of cheap labor. The argument that an export-led growth model is inconsistent with income distribution and mass domestic consumption makes no sense. Exports increase employment, wages and domestic consumption. Often export-led growth temporarily increases inequality, but still more often import-substitution growth leads to the same outcome.

Most economists who acknowledge the positive relation between competitive exchange rate and faster growth explain it by either the financial crises or the corruption or rent-seeking that usually derive from an overvalued currency. This is correct but obvious. Recently, Rodrik (2007: 20–26) has essayed a more elaborate explanation. Since a real currency devaluation is by definition an increase in the relative prices of tradable goods in relation to non-tradable goods, he argues that a “undervalued” currency would “enhance the relative profitability of the traded-goods sectors and cause it to expand (at the expense of the non-traded sector)”. Yet he recognizes that this is not a theory, because “such theory would have to explain why tradable goods are ‘special’ on the standpoint of growth”. He resorts to two explanations for this. One is not really in the realm of economics: weak institutions and their associated corruption would impose “a higher tax on tradable goods”; the other explanation is that “market failures predominate in tradables”. These explanations are not satisfactory, and wrongly insist in the idea of an “undervalued” rather than a “competitive” exchange rate (see next section). Levy-Yeyati and Sturzenegger (2007: 22) make the same mistake, but come closer to the real explanation. They find that the mechanism that makes an “undervalued” exchange rate to cause faster growth “is associated with an increase in aggregate savings and investment, and a decline in unemployment and labor relative to capital compensation”. Yet they do not explain why a competitive exchange rate is associated with a higher savings and investment rates.

I have been arguing for some time that the transmission mechanism between a competitive exchange rate and economic growth is simple. On the demand side, given the existence of technological capacity and of idle or unemployed resources, growth depends on the rate of savings, which depends on the rate of investment, which depends on the existence of profit opportunities, which, in turn, depend on export opportunities, which, finally, will exist only if the exchange rate is not overvalued but competitive. The exchange rate is, in fact, the main variable to be studied by development macroeconomics, since it plays a strategic role in economic growth. According to the

classical or political economy model, growth depends essentially on the rate of capital accumulation, which depends on expected profits, or, more precisely, on the difference between expected profits and the interest rate, but which also depends on savings. According to the Keynesian view, however, savings depend on investments – which makes profit expectations the key economic growth variable. Although profit expectations depend on domestic demand, they depend also and more strongly on exports, and, so, on a competitive exchange rate. In other words, if conditions exist on the supply side – and we should not overlook them – a competitive exchange rate is necessary for export-oriented investments to materialize. The central mechanism that links the exchange rate to growth is on the demand side, but it also may be thought on the supply side as a factor that increases domestic savings. The exchange rate has a strong effect on real wages and salaries. When the exchange rate is overvalued, wages will be artificially high, wages and salaries will be equally high, and, given the high marginal propensity to consume, principally among workers, domestic consumption will also be artificially high. Thus, when economic policy brings the exchange rate to the competitive or equilibrium level, real wages will fall and domestic consumption will decrease, creating space for an increase of domestic savings (in so far as this change in the supply side is completed on the demand side by the increase in the investment rate).

This theory assumes that policymakers are able to manage the long-term exchange rate. Thus, it rejects the neoclassical assumption that the exchange rate is endogenous. And naturally it also rejects the neoclassical inversion that makes the exchange rate dependent on the savings rate. This is, for instance, what Pastore, Pinotti and Almeida (2008: 296) argue. They agree that a competitive exchange rate is associated with economic growth, but expressly reject my model, in which a non-neutralized Dutch disease and the policy of growth with foreign savings plus a high interest rate policy (and exchange- rate populism) determine the overvaluation of the real exchange rate, which, in turn, reduces the saving and investment rates. Instead, the authors assume that the exchange rate is “an endogenous variable” and conclude that “countries having high savings in relation to investments present current account surpluses, a more depreciated real exchange rate, and grow fast. But this is the outcome of their high savings, not of their deliberate policy of determining a more depreciated real exchange rate”. In doing so, they make the real exchange rate a short-term macroeconomic variable, dependent on the savings rate, a long-term structural variable – which makes little sense. If we

admit that the exchange rate may be systematically managed by a country in the context of a national development strategy – something for which there is strong historical evidence not only in Asia but also in Latin America between 1930 and 1980 – it makes more sense to say that a macroeconomic policy aiming at a competitive exchange rate is able to gradually bring about an increase in the savings rate, which, in turn, in so far as it increases, reinforces the competitive exchange rate policy.

Today, the policy of managing the exchange rate to prevent its appreciation is more effective in the dynamic Asian countries than in Middle Eastern, African and Latin American countries. The Latin Americans extensively used exchange rate management up to the 1980s and grew fast, but lost this capacity after the debt crisis and their submission to the North. The fast-growing Asian countries' capacity to manage their exchange rate is the central explanation of their success, which comes from their great national autonomy in relation to the North and their firm rejection of economic populism. These are two essential conditions for a national development strategy. A third explanation could be that Asian countries have relatively scarce natural resources, and therefore are less subject to the Dutch disease. Yet it is significant that the countries that do have abundant natural resources, such as Thailand and Malaysia, do not base their growth on their exploitation.<sup>4</sup>

### **THE TENDENCY TO OVERVALUATION**

The main reason why some medium-income or emerging countries grow fast and *catch up* while others fall behind is because the former neutralize, while the latter fail to neutralize the *tendency to the overvaluation of the exchange rate*. After several years studying the relation between the exchange rate and economic growth, my more general conclusion is that the fundamental obstacle that middle-income countries face in catching up is this tendency to chronic and cyclical overvaluation of the national currency. While a competitive exchange rate is associated with faster growth, its tendency to overvaluation is still a topic of scientific inquiry, and may be viewed as a hypothesis to be demonstrated. Yet, the almost permanent state of financial fragility and

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<sup>4</sup> They are subject only to the “extended” Dutch disease, derived from the existence of cheap labor, the concept of which I discuss in Bresser-Pereira (2008a).

the recurrent balance of payment crises that we observe in developing countries amount to strong evidence supporting the hypothesis. The tendency to the overvaluation of the exchange rate has two main structural causes: the Dutch disease and the attraction that the higher rates of profit and of interest existing in developing countries exert over abundant international capital as a result of the prevailing relative scarcity of capital. They are *structural* causes because they are independent of economic policies or human intervention. The second cause, however, is *augmented* by three policies, two of them recommended by conventional orthodoxy (the policy of growth with foreign savings and “capital deepening”), and the third originates within developing countries: exchange rate populism.

The role played by the Dutch disease is different from those played by the other causes because of its powerful upward pressure on the exchange rate, but does not lead a country to experience current account deficits and high foreign indebtedness. The Dutch disease is the outcome of Ricardian rents arising from abundant natural resources that produce an exchange rate consistent with long-term equilibrium of the current account, but inconsistent with the international competitiveness of tradable industries using the best technology available in the world that are not the commodities that generate the disease. Thus, a country benefiting from the existence of precious natural resources is cursed because it has not one but two exchange rate equilibria: the “current” equilibrium that intertemporally balances the exchange rate and the “industrial” equilibrium that makes tradable industries utilizing state-of-the-art technology economically viable. The larger the difference between these two equilibria, the more serious the disease will be. Thus, the Dutch disease appreciates the national currency, but this pressure stops when the exchange rate reaches the level corresponding to the current equilibrium.

The other main cause of the tendency to the overvaluation of the exchange rate is related to capital inflows. They are the outcome of the structural attraction that higher rates of profit and of interest exert on international capital. But they are also the outcome of an insistent policy of growth with foreign savings that conventional orthodoxy recommends. Since business enterprise investments require finance, conventional economists conclude that the country as a whole will also need foreign finance. Yet this is a classical situation in which microeconomic logic (the need for finance on the part of entrepreneurs) cannot be transferred to macroeconomic logic. In

some cases foreign finance may be positive, but in most cases the attempt to grow with foreign savings fails: instead of increasing investments, foreign savings increase consumption – and a high rate of substitution of foreign for domestic savings materializes. Countries that engage in the policy of growth with foreign savings pass through three perverse stages. There is no need to criticize this strategy once it has arrived at the second (international financial fragility) or the third stages (balance of payment crisis), and the damage to the country becomes obvious. Therefore, in previous works I focused my analysis to stage one (Bresser-Pereira and Gala 2008), in which the country has not yet suspended international payments, or even gotten deep enough into debt to become dependent on creditors and therefore compelled to adopt the alienating practice of confidence building. As Barbosa Lima Sobrinho (1973), following Ragnar Nurkse (1953), puts in the title of one of his books, ‘capital is made at home.’ Only at particular moments, when a country is growing at an extraordinary pace and expected profit rates are high, foreign savings or current account deficits may be positive in causing growth because at such moments the increase in real wages caused by exchange rate appreciation will flow mostly not to consumption but to investment.

While the Dutch disease stops pushing up the exchange rate when it reaches the current equilibrium, the capital inflows resulting from the policy of growth with foreign savings have a continuing effect in appreciating the currency over and above that equilibrium. The exchange rate appreciates gradually as capital inflows finance the current account deficit and increase the foreign debt. If such inflows are not stopped, sooner or later they will lead to a balance of payment crisis. The crisis will arrive as soon as the stronger the process of appreciation is and the less the local government neutralizes it.

It is easy to understand this over-appreciation if the exchange rate is fixed. It is a mistake, however, to believe that the problem will be solved if the exchange rate floats. It will not, because exchange rate markets are highly inefficient, principally in relation to developing countries. They do not react by depreciating the currency as soon as a deficit appears in the current account. In today’s financial markets, the exchange rate depends less and less on commercial flows and increasingly on capital flows. While investors continue to believe that the country is sound – and they will be tempted to believe that as long as they are being well remunerated – they will continue to pour capital into the country, and the exchange rate will remain over-appreciated.

The pressure of the Dutch disease on the overvaluation of national currencies varies according to its gravity. This major market failure exists at different levels in the countries where abundant and cheap resources generate Ricardian rents. Such rents make the economic exploitation of resources viable at a more appreciated exchange rate than is consistent with the international competitiveness of industries using state-of-the-art technology. The consequence is that the only tradable goods that the country is able to produce are those that generate the Dutch disease. A national development strategy will materialize only if the country is capable of neutralizing the effects of the Dutch disease through the imposition of an export tax on the commodities that generate it.

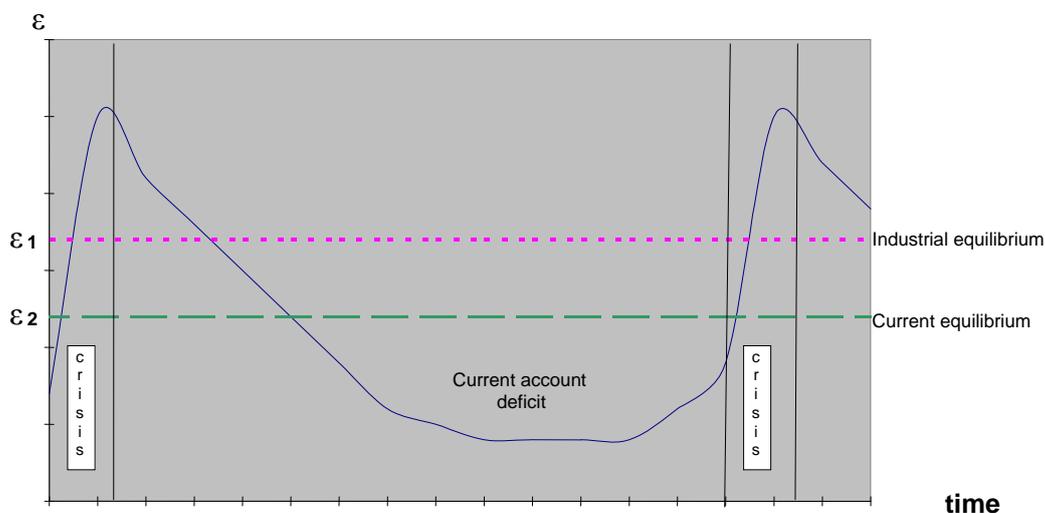
Besides the policy of growth with foreign savings, the policy of “capital deepening” and the use of the exchange rate as a nominal anchor to inflation also magnify the structural attraction exerted by higher profit and interest rates. Capital deepening is just an elegant term to justify high interest rates that will attract capital inflows; it was introduced by McKinnon (1973) and Shaw (1973), when many developing countries controlled interest rates and often kept them negative. Besides, capital deepening should also convey earnestness in terms of economic policy, while administered interest rates and economic populism suggest the opposite. Another complement to the policy of growth with foreign savings is the use of the exchange rate, and particularly of an exchange rate “anchor”, to control inflation. This policy became popular after Argentina, in 1991, controlled hyperinflation by pegging the exchange rate to the US dollar. The disastrous consequences of this policy are well known even by conventional orthodoxy, which after the late 1990s abandoned it in favor of a floating exchange rate. Yet the practice of using exchange rate appreciation to control inflation remains central to conventional orthodoxy. The success of Brazil in reducing inflation since 2002, for instance, is due to the subsequent strong appreciation of the real. On the other hand, when the exchange rate becomes over-appreciated, the acceleration of inflation that the required depreciation would entail forms a big obstacle to such depreciation. This acceleration of inflation is temporary in an open, competitive and non-indexed economy; the inflation bubble will soon subside. But the stigma of high inflation can be significant, as it is in Brazil, so that, faced with any acceleration of inflation rates, people fear the return of high inflation, which legitimizes the policy of the Central Bank to increase the interest rate, even in the absence of excessive inflation, simply to appreciate the exchange rate and to get down the inflation rate.

‘Exchange rate populism’ – one of the two forms of economic populism – is also a cause of the tendency to the overvaluation of the exchange rate. While political populism is a political practice whereby political leaders become directly connected with the people, without the intermediation of political parties and ideologies, economic populism spends irresponsibly more than one’s income. Whereas with fiscal populism the state organization or apparatus spends more than it collects in revenues, incurring chronic and irresponsible public deficits, with exchange rate populism it is the nation state or country that spends more than it collects, incurring chronic current account deficits.<sup>5</sup> An appreciated exchange rate is more attractive in the short run than a competitive rate because it implies higher real wages and higher profits.. The rich, who measure their wealth in dollars, see it grow every time the foreign exchange increases in value. The wages of the middle class, with its relatively high component of imported consumption, rises whenever the local currency gains value. Even the poorest benefit from real wage increases with non-competitive exchange rates, as a share of the products in their consumption basket becomes cheaper. Government ministers are interested in an appreciated exchange rate because it pleases voters and, as a result, they do not hesitate to practice what I have been calling foreign exchange populism. And the economists of the government who accept conventional orthodoxy’s single mandate for the Central Bank –controlling inflation – are also interested in an appreciated exchange rate because they can say – as has become common in Brazil recently – that the appreciation of the real was ‘a good thing’ because it increased wages. Conventional orthodoxy criticizes fiscal populism, but is sympathetic to exchange rate populism because exchange rate appreciation is consistent with its central proposal to developing countries: to growth with foreign savings. Let us, then, examine first this policy, and then discuss the Dutch disease – the two main factors behind the tendency to the overvaluation of the exchange rate.

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<sup>5</sup> On economic populism see Bresser-Pereira (1991) and Dornbusch and Edwards (1991). The classical studies on economic populism, including fiscal and exchange rate populism, were written by Adolfo Canitrot (1975), Carlos Diaz-Alejandro (1982), and Jeffrey Sachs (1989) and are all reproduced in the book I edited.

**Figure 1: Tendency to the overvaluation of the exchange rate**



The tendency to the overvaluation of the exchange rate may be illustrated with a simple graphic. In Figure 1 the exchange rate is defined as the price, in national currency terms, of the foreign currency or basket of currencies, so that the lower the exchange rate is, the more appreciated the national currency or the exchange rate will be. The exchange rate is in the vertical axis, and in  $\varepsilon_1$  and  $\varepsilon_2$  are, respectively, the industrial exchange rate equilibrium (the exchange rate required to make industries utilizing technology in the state-of-the-art competitive internationally) and the current exchange rate equilibrium – the rate to where tends the market rate because it is the rate that equilibrates intertemporally the current account. If we take as a starting point a financial crisis and the respective fast and big depreciation of the local currency (a vertical rise of the curve in the figure), a gradual process of appreciation of the exchange rate will follow, driven by the several factors just discussed. Although the causes act at the same time, it is easier to separate them because the Dutch disease just presses down the exchange rate to the current exchange rate equilibrium line; further appreciation will be caused by the other factors. In the overvaluation process the exchange rate, under the pressure of the Dutch disease, first crosses the horizontal line representing the industrial equilibrium exchange rate ( $\varepsilon_1$ ), continues to appreciate (that is, to fall in the graphic), and crosses the horizontal line representing the current equilibrium exchange rate ( $\varepsilon_2$ ). From this point on the current account deficit and the foreign debt will start increasing. The Dutch disease ceases to push down the exchange rate, but its appreciation continues and the country enters in the current account deficit area, now under the pressure of the policy

of growth with external saving and of exchange rate populism. Finally, as the current account deficit grows and erodes the confidence of international creditors, the balance of payment crisis materializes, and the exchange rate again depreciates vertically. How long does this cycle require to be completed? If the country does not have a policy of neutralizing the tendency to the overvaluation of its exchange rate, the gap between crises may be short (let us say, eight years). The assumption that a floating exchange rate regime will automatically correct the exchange rate is not realistic because capital flows, not commercial flows, are today the main determinants of the market exchange rate. While foreign investors remain confident and are attracted by high interest and profit rates, they will continue to finance the country. At a given moment, however, they will realize the risk, and the herd effect will lead the country to default. In so far, however, as the country is able to neutralize partially the tendency to the overvaluation of the exchange rate, the crisis may never happen – only reduced growth rates will follow.

This simple theory explains why developing countries are so subject to balance of payment crises. Contrarily to what conventional economists believe, they are not only caused by “exchange rate volatility”, nor indicate the existence of “exchange rate misalignment”, but they are a consequence of a structural tendency magnified by mistaken policies. Exchange rates are effectively volatile, and they are often misaligned, but they are not either the outcome of random shocks, or of the psychological instability of economic agents, despite the fact that some shocks are difficult to predict and economic behavior often falls short of rationality. These factors may play a role, but the essential thing is a tendency to overvaluation that has behind Ricardian rents giving origin to the Dutch disease, and the attraction that higher profit and interest rates characterizing developing countries exert on foreign capitals. Due to these structural factors and the mistaken policies that deepened it – the strategy of growth with foreign savings, the practice of using nominal anchors to control inflation, the police of capital deepening, and exchange rate populism – the local currencies in developing countries tend to become cyclically over-appreciated up to the point in which a balance of payment crisis turns up.

The theory is simple, but its consequences are big: if the country is not able to neutralize the tendency to the overvaluation of the exchange rate it will not grow, or will grow slowly. Since I am not offering empirical demonstrations, we should consider it a hypothesis – but a strong hypothesis because it explains the recurrent balance of

payment crises to which developing countries are subject. These crises are not principally the outcome of economic populism as is often said, but of a tendency that has among its causes a particular kind of economic populism – exchange rate populism. Countries are not always financially fragile because the inflow of foreign capitals in the form of loans of direct investment is a condition to their development, but because they fail to neutralize this tendency. To find econometric evidence to this tendency and to know how to neutralize it – which is the role of the decision to grow with domestic savings, of imposing taxes on the exports of goods causing the Dutch disease, and, more generally, of managing a floating exchange rate – are questions for other papers.

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