SPIDER WEB Inaugural Workshop
(School for Policies, Innovation and Development Research Web)

Building Conceptual Bridges for Innovative, More Socially Effective and Politically Responsible Proposals

Dates: February 27 to March 1rst 2013

Organizers: Graduate Program in Public Policies, Strategies and Development (**PPED/ IE/UFRJ**); National Institute for Science and Technology in Public Policies, Strategies and Development (**INCT-PPED**)
Sponsors: **CAPES** (Coordenação de Aperfeiçoamento de Pessoal de Nível Superior); **CAF** (Banco Latino-Americano de Desenvolvimento); **BNDES; INCT-PPED; IBRACH** (Instituto de Estudos Brasil – China).
Local: BNDES - Edifício Ventura Oeste, Av. Chile 300, salas 901-903 – Rio de Janeiro

Day 1 – February 27

9h15 – 13h00 – Session 1

Global Challenges, Restrictions and Conventions/ Macro Finance:

New historical circumstances, as globalization, the reassurance of the role of the state, and the recent economic crisis, had created unique opportunities to reopen the debate on diverse development models *vis a vis* the inexorable process of globalization. The macro finance and financing development in a new era are main issues to deserve a renewal economic thinking.

Chair: Fernando Cardim de Carvalho (Professor, UFRJ)

9h15 – 10h15 - Introducing themes and proposals for the debate
Jan Kregel (Levy Institute and MINDS)

The debate on the reregulation and reform of the financial regulation is currently framed by a number of unquestioned presumptions. The first is that national financial institutions must be big enough to compete in global financial markets and that national regulation should not constrain their international competitiveness. This presumption negates any realistic measures to resolve the problem of banks being too big to fail. The second is that there should be a move towards a global

regulatory authority or institution to impose standards of operation on global financial institutions that will insure international financial stability. The feasibility of implementation is limited by the aphorism of Mervyn King that large, too big to fail, banks are "global in life, but national in death". And this is even more true for the shadow banking systems that are supported by national banks.

A global authority is never likely to command the resources required to prevent the failure of a large bank. As long as this responsibility and cost remains at the national level, regulation will remain a national prerogative. It was considerations such as these that led to the recommendation in the President of the General Assembly's Report on Reform of the International Financial System for "host country regulation," that is, subjecting all foreign financial institutions to regulation and supervision on the same basis as national financial institutions.

Nonetheless, the movement towards a global regulator continues through the suspices of the BCBS of the BIS, the G-20, the Financial Stability Board, and the International Monetary Fund. The lack of developing country representation on these bodies in well known, although measures have been taken to remedy the problem. The BIS has co-opted some emerging market economies such as Argentina, Brazil, Canada, Hong Kong SAR, India, Indonesia, Mexico, South Africa, and Turkey and issues invitations to attend particular meetings on an ad hoc basis. The same countries have been coopted as members of the Group of Twenty. Not surprisingly, the FSB, created by the G-20 also counts these same middle income emerging market developing countries in its membership. It is thus not surprising that these bodies place more emphasis on the financial stability of developed financial systems than on the questions of the appropriate financial system and regulation in support of the development process.

Among the multilateral institutions the IMF and the IBRD not only have fuller representation of developing countries, they also have mandates to deal with the problems facing developing countries. And the IMF does have the potential resources to provide the kind of support that might be required to support large globally regulated financial institutions. Indeed, the IMF has increasingly lent in excess of quota or managed consortia of lenders to provide indirect support to failing financial institutions in member countries via direct support to governments.

Thus the focus of the discussions around reform of the multilateral institutions has concentrated on increasing the size of overall quotas to bring them into step with the rise of globalisation, on increasing the relative size of developing country quotas and on increasing their influence on the Executive Boards. In addition, the proposal for additional SDR creation has resurfaced, on the one hand as a way of supplementing liquidity for lender of last resort operations in the absence of rapid movement on quota increases, and on the other hand as a means to provide an alternative to the US dollar as the global reserve currency.

But, all of these measures accept the original framework and intentions of the Bretton Woods Institutions and the theoretical principles that underly their operations. But these institutions were designed for a global economy dominated by developed countries that had already attained a certain level of industrialisation, or in the case of the IBRD to insure that the IMF funds would not be used for the capital reconstruction of the industrial sectors of the European economies. Virtually none of the former colonies of the European powers that were created as independent countries in the aftermath of the Second Word War and now compose the majority of the list of least developed countries did not yet exist at the time of the 1944 New Hampshire UN Conference.

Thus, rather than seeking marginal changes in the structure of these global institutions as momentum increases in support of making them truly global governance and regulatory institutions, we might rather seek to propose more radical reforms.

It is now generally forgotten that the financial stability mandate of the IMF was as structural support for the restoration of the free international trading system. As a result, financial stability came to be expressed as a fixed exchange rate system in which member countries were to intervene to preserve the parity of their currency with respect to the US dollar through the management of their foreign exchange reserves. As Keynes had already pointed out with respect to the formal gold standard, this system implies asymmetric adjustment with deficit countries bearing the burden of support of stable exchange rates. But, more importantly, it meant that the size of surpluses and deficit were strictly limited by the size of national reserve balances and the automatic and conditional quotas in the IMF.

While this stabilisation fund system, preferred by the US, technically provided a stable exchange rate system, it was also in direct contradiction to the interests of developing countries. Indeed, this can be seen by the fact that as Europe was attempting its reconstruction the IMF was bypassed and the European deficits were funded direct by the US through the Marshall Plan. But, more importantly, as UN agencies and development economists continued to recommend the net transfer of resources from developed to developing countries, apparently no one noticed that this would imply large current account surpluses in the developed countries and deficits in developing countries. Since developing countries did not have the foreign exchange resources to combine a large “developmental” deficit with a fixed exchange rate, there were faced with the choice between sacrificing development and introducing domestic austerity, or facing a devaluation that often led to a rise in inflation and no improvement in the external account.

A return to stability would then require the elimination of the deficit and the import of the manufactured goods from developed countries that were required to build up a domestic manufacturing sector. Indeed, the IMF’s insistence on a definition of stability linked to equilibrium in the balance of payments created an

inherent impediment to attempts by developing countries to escape from the trap of the declining terms of trade by creating a domestic manufacturing sector that was efficient and capable of competing in international markets.

But the presumption of external equilibrium was not the only incompatibility between development policies and international financial stability. When internal adjustment policies supported by IMF conditionality were unable to produce a reversal of external disequilibrium, countries were required to introduce a currency realignment. While Keynes argued that the new international system would require substantial exchange rate flexibility his concerns were rejected, aside from granting countries the ability to adjust exchange rates within 10 per cent of parity without reference to the IMF and the ability to introduce restrictions on trade under the scarce currency clause.

However the efficacy of devaluation to produce external balance was already known to require very precise elasticity conditions summarised in the Marshall-Lerner conditions. While it was not obvious that these conditions applied to developed countries -- indeed it was generally believed that the UK on the one hand, and the reconstructing economies on the other did not satisfy the conditions -- whether they would be satisfied in developing countries was never considered. It seems reasonable a priori that they would not have been met, and much of Prebisch's arguments concerning the negative impact of the declining terms of trade are couched in terms of the impossibility for developing countries to meet those elasticity conditions.

The post-war international financial system was thus designed on the presumption of external equilibrium across countries, in which deficit countries would be primarily responsible for external adjustment through internal demand policies, and when that was not sufficient, to use of exchange rate depreciation to reinforce the impact of contractionary fiscal policies. On the other hand, international development policy was formulated on the assumption of sustained surpluses and deficits between developed and developing countries in support of sustained expansion and the inapplicability of exchange rate adjustment as a measure to influence external balances.

That these two visions of the post war financial system were inconsistent does not appear to have occurred to either the IMF nor the IBRD and the UN, responsible respectively for exchange rate stability and economic development. In this context, Prebisch's concerns can be seen as a recognition of this inconsistency, while the emergence of the Washington Consensus can be seen as a resolution of this cognitive dissonance in official policy by rejecting the need for any special conditions and policies for developing countries.

This internal inconsistency represented a major obstacle to developing countries. But they also ignored a major problem for developing countries: international debt. Since foreign exchange would be required to pay for the excess

of imports of necessary consumption goods and capital goods over exports required for the development plans these plans required positive net resource flows encouraged by early UN development policy. But over time these flows generate debt service outflows that increase the current account deficit to increase unless the trade deficit is reduced to accommodate a fixed level of capital inflows and lead to a reduced impact on development. Alternatively, foreign capital inflows would have to rise to accommodate the rising current account deficit caused by the increased debt service payments on capital factor services account for any given level of the goods account deficit, leading to an ever increasing level of external debt. Neither solution would be compatible with the stability of the international system conceived at Bretton Woods.

As Domar (1950) had already shown before the rise of net transfer of resources development strategies based on net imports financed by foreign capital inflows can only exist with a stable ratio of debt to GDP if the interest rates paid for foreign capital are equal or less than the rate of increase of lending by foreigners. If interest rates are higher than the rate of increase of inflows, the policy will eventually and automatically become self-reversing as the current account becomes dominated by interest and profit remittances that exceed capital inflows.

In the context of the cognitive dissonance between stability of the international financial system and development, it is interesting to note that the Domar conditions for a sustained long-term development strategy based on sustained external financing are equivalent to the conditions required for a successful Ponzi financing scheme. As long as the rate of increase in inflows from new investors in a pyramid or Ponzi scheme is equal or greater than the rate of interest paid to existing investors in the scheme there is no difficulty in maintaining the scheme. But, such schemes are eventually condemned to failure because of the increasing absolute size of the net debt stock. Domar's condition only refers to the ratio of debt to GDP, not its absolute size.

External financing cannot provide developing countries with a permanent development strategy unless the rate of increase of export earnings is equal to the rate of interest on the outstanding debt. However, if the foreign borrowing is not used for expenditures that create net foreign exchange earnings (it makes little difference if this is domestic infrastructure investment, or purchase of basic or luxury consumption goods, or military equipment) it means that the country's development planning is subject to maintaining the steady rate of increase in capital inflows and becomes hostage to international financial markets. But even if it is used to expand export potential, any external event which causes the rate of increase in inflows to fall off will create domestic instability and require domestic adjustments to reduce dependence on external resources, usually leading to financial crisis through failure to meet financial commitments. At the same time, in order to make foreign lenders confident in the country's ability to meet foreign

commitments, policies that enhance the short-term ability to pay, such as building up foreign exchange reserves or reducing external dependence by reducing domestic growth to produce a stronger export performance and fiscal balance must be implemented. But, these policies are also self-defeating from the point of view of positive development, since they either reduce the capital inflows that can be maintained on a permanent basis, or reduce the growth of per capita incomes. External financing as a source of a long-term development strategy is thus a two-edged sword that must be managed judiciously if it is to contribute to development rather than becoming a source of persistent financial instability and crisis. But, the international financial system's prejudice in favour of limited external imbalances is as much of an impediment.

An associated issue is that the presumption in favour of external financing for development also means a presumption in favour of a uniform, equilibrium exchange rate. As Kaldor has noted, the basic problem facing developing countries is not an inability of produce manufactured goods, but an inability to produce them at levels of productivity that allow them to be competitive in international markets. That is, the same problem identified by Diamand (1978) as a bottleneck. And this is a problem of relative prices. For a primary commodity producing developing country "The first measure should thus consist in restructuring the industrial exchange rates for exports. The starting point must be an exchange rate adequate for the primary sector. But there is no reason why this primary exchange rate for exports should coincide with the nominal exchange rate. The nominal exchange rate can be based on a more expensive dollar, reconstructing the primary exchange rate for exports which had been set as a starting point by means of the application of adequate export duties. Thus, we would have two basic exchange rates. On the one hand, the nominal rate which would be used for financial transactions, industrial exports and, with the corresponding import duties (much lower than in the conventional system), also for imports. On the other hand, we would have the primary exchange rate for exports, determined by the nominal rate less export duties. This reform would bring the nominal exchange rate substantially closer to the structure of industrial costs and would improve the possibility to export manufactured goods." (1978, p. 31)

Kaldor makes a similar point, "When import requirements exceed the capacity to export on account of high domestic costs, this is generally taken as evidence of over-valuation of the currency. … but it is essential to understand that that it is not the kind of over-valaution that could be "cured" by any uniform adjustment of the exchange rate. This is because the exchange rate which would make it possible for an under-developed country to develop export markets in manufactured products would mean a considerable under-valuation of its currency in terms or primary commodities which form the great bulk of its exports; and the rise in export proceeds in the primary sector which follows a devaluation tends to

generate an inflation in domestic costs and prices that soon neutralises any initially beneficial effects on the export costs of manufacturers. … the rise in the domestic price of export crops is bound, sooner or later, to lead to a corresponding rise in the local prices of food. And since, at the levels of income characteristic of under-developed countries, money wages in industry will be closely correlated to the price of food, a rise in earnings from primary exports will tend to bring about a corresponding advance in the level of money costs in manufacturing production." (1964, p. 186-7). As a consequence, "there is no single rate of exchange which is capable"…" of securing equilibrium between domestic costs of production and the prices, or the level of costs, in foreign markets" and, in agreement with Diamand "There is no way out of this dilemma except by some system of dual exchange rates, or some system of combined taxes and subsidies which produce the same effect as dual exchange rates" (p. 188)

But, if dual exchange rates are a necessary condition, it also follows that the use of exchange depreciation to provide stability and eliminate imbalances will not only be ineffective but prevent successful development. As Kaldor notes, "the periodic efforts of … the I.M.F. to secure an alleviation of the balance of payments problems of particular under-developed countries by the introduction of more "realistic" exchange rates, … have proved so misguided. In most of these cases … devaluation has been followed by a new wave of inflation which has swallowed up the stimulus to exports afforded by the devaluation, within a relative short period. The diagnosis that has led to such recommendations has been based on the false analogy from the situation of industrialised countries whose export prices are cost-determined to that of primary producers whose export costs are price-determined." (p. 187-8)

The result is the imposition of exchange rate policy that prevents a country from earning its way out of the payments imbalance and imposes "the return to a single exchange rate aim[ed] at stimulating efficiency; finally, exchange freedom is aimed at restoring confidence and at promoting loans and investments from abroad."

From the point of view of Diamand's "corrected conceptual prism, devaluation means greater incentives for the traditional primary exporting sector to the detriment of wages and other urban incomes. Monetary restriction is aimed at inducing recession.

The plan is called a 'stabilization' plan but its first visible effect is a heavy inflationary impact as a result of devaIuation with which the word 'stablization' gets a somewhat ironic undertone. … On the other hand, the 'efficientist' measures, consisting of lower tariff protection and a unified exchange structure, not only block the way for all the rational solutions outlined before but also contribute to increase the proportion of imports in the GNP and to discourage

even those industrial exports which could have opened their way to foreign markets, The result is a further aggravation of the external bottleneck."

Here the basic problem is not only the presumption of price effects producing current account equilibrium but the presumption that these adjustments take place from a position of equilibrium. However, as Diamand insists, if the economy is already in a position of external imbalance there is no guarantee that the adjustment will be effective. Indeed, this reflects Myrdal's insistence that the most appropriate analogy would be that of cumulative causation with backwash effects overwhelming spread effects, or the forward and backward linkages of Hirschman.

Thus, if there is to be a radical reform of the global regulator it will be important to recognise that the current approach to global financial stability is in direct contradiction with the needs of developing countries and would involve the express introduction of exchange rate and capital flow management, the possibility of multiple exchnage rates and the recognition that development will always involve international imbalances.