

ECONOMIC DEVELOPMENT AND EXCHANGE RATE POLICIES

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THE TWO MAJOR ISSUES

- ❖ **Dynamic efficiency:** scaling up towards activities with higher technological contents is the key to dynamic growth. Difficulties faced by natural-resource dependent economies in doing so.

Exchange rate policy plays an essential role in facilitating or hindering economic diversification.

- ❖ **Balance of payments dominance:** cyclical fluctuations in external financing and the terms of trade limit the space to adopt countercyclical macroeconomic policies.

Active exchange rate management and capital account regulations help manage these cyclical swings without affecting long-term growth.

DYNAMIC EFFICENCY

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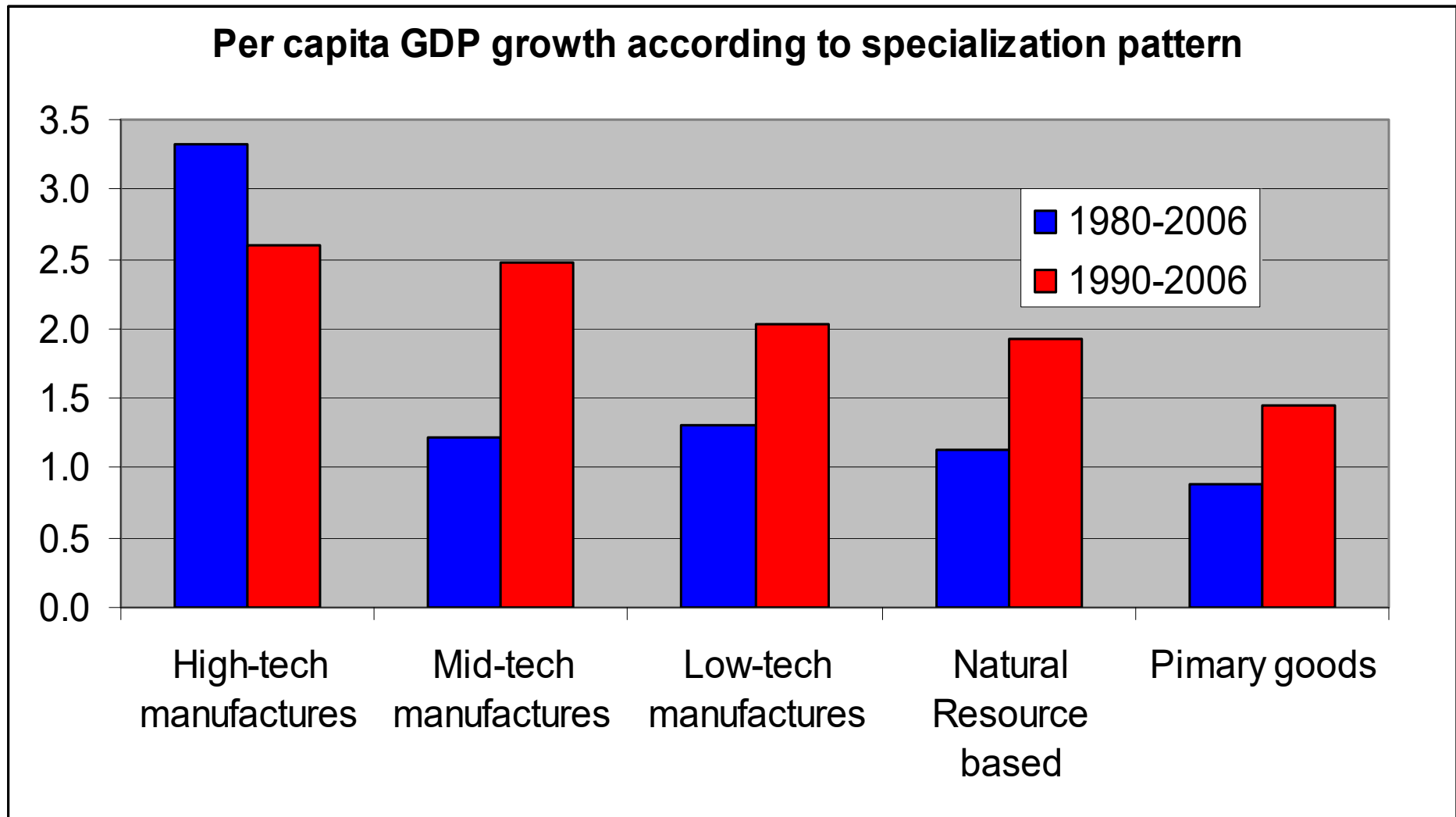
- ❖ Successful development is essentially a process of structural change. It depends on dynamics of production structures and related policies and institutions.
- ❖ Basic issue: there may be a conflict between static (resource allocation) and dynamic efficiency (changes in the structure of production).
- ❖ Analytical contributions of classical development economics, neo-Schumpeterian, structuralist and evolutionary economics: critical role of learning, externalities and economies of scale/agglomeration.
- ❖ Disappointment with effects of more open economic policies on growth (e.g., Latin America).

SPECIALIZATION PATTERNS MATTER

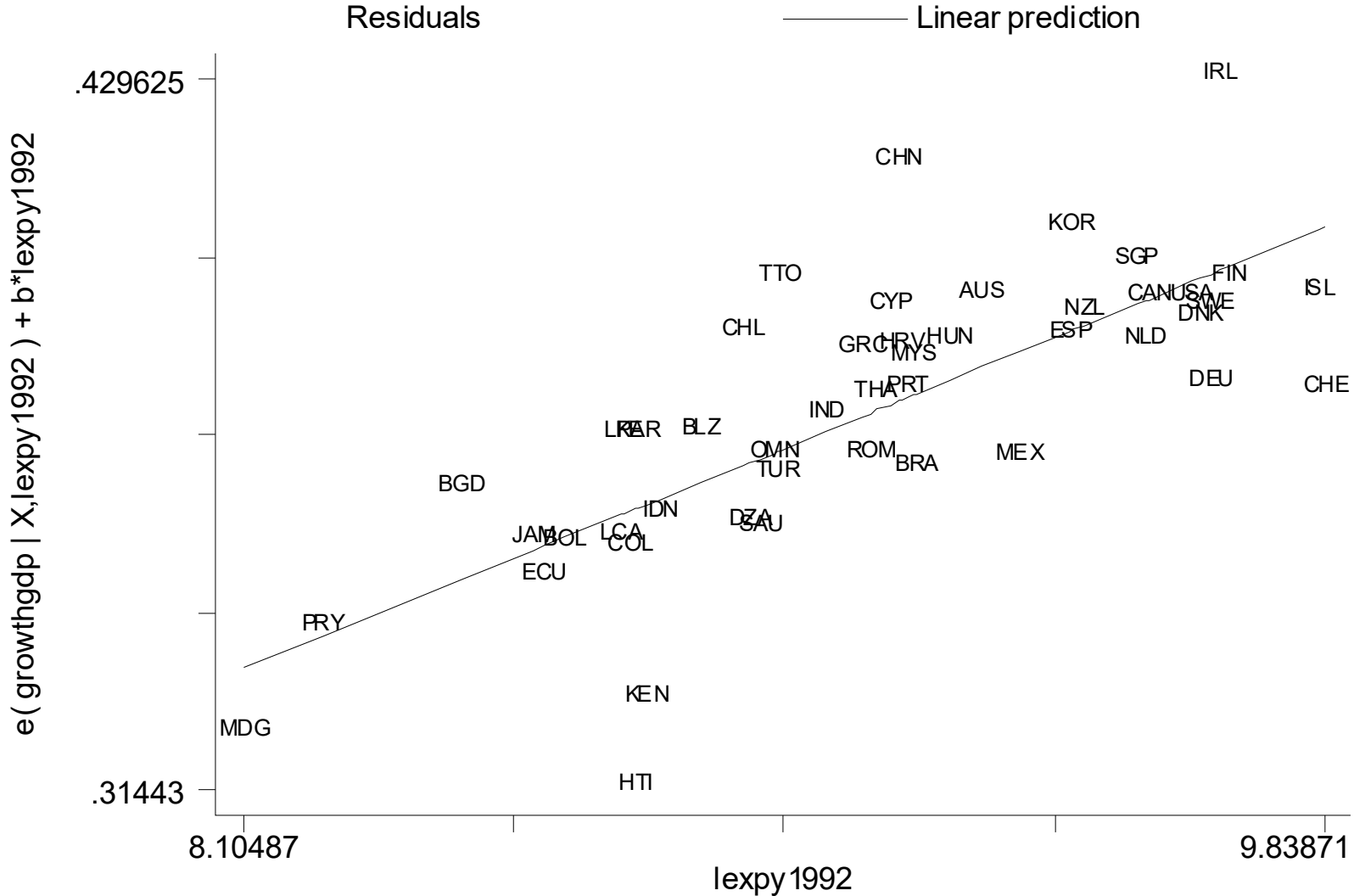
- ❖ Most countries that have failed in increasing market shares are exporters of primary goods and natural resource-intensive manufactures.
- ❖ Non-dynamic markets face “fallacy of composition” effects (typical of commodity markets).
- ❖ There are countries that have extracted fair growth out of a specialization pattern based on natural-resources or low-tech manufactures.
- ❖ But most developing countries that have grown fast have been increasing market shares in mid or high-technology exports
- ❖ The East Asian regional cluster has an effect on top of those captured by the patterns of export diversification (huge contrast with Latin America).

SPECIALIZATION PATTERNS MATTER

(Ocampo-Parra)

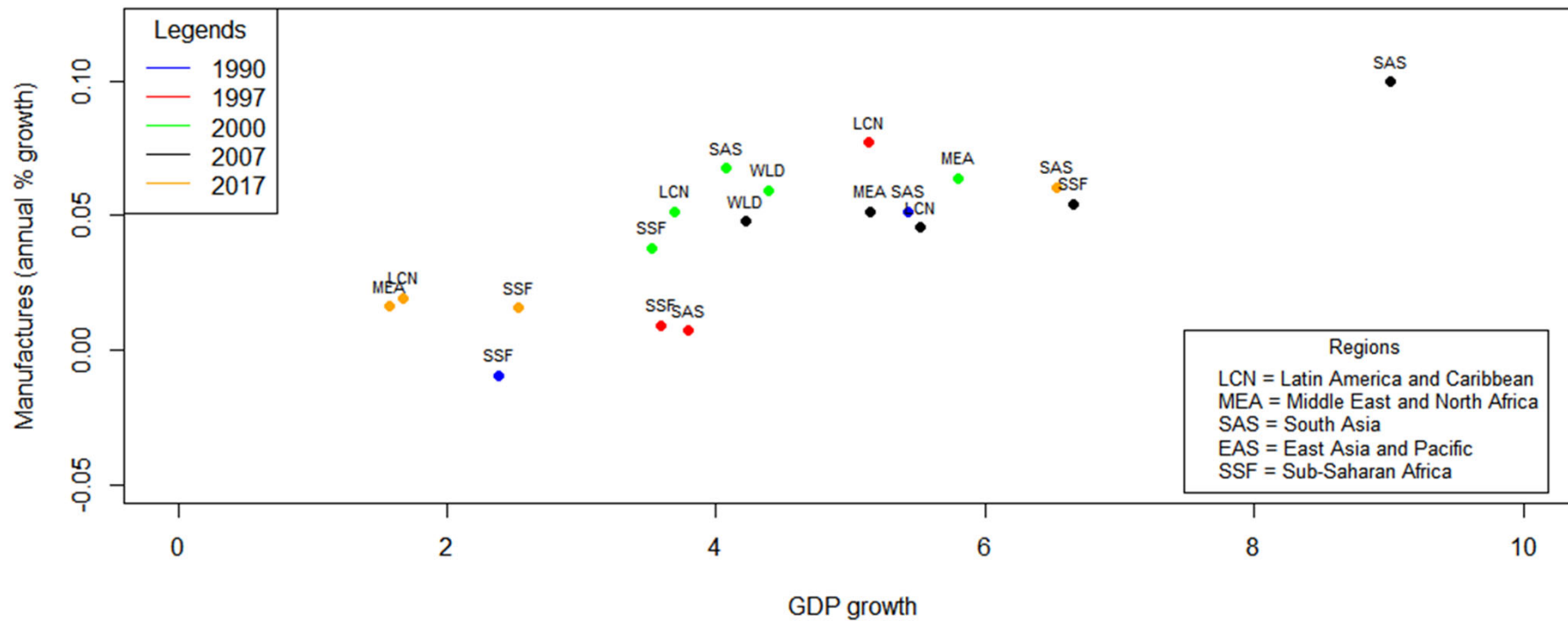


SPECIALIZATION PATTERNS MATTER (Hausmann-Hwang-Rodrik)



MANUFACTURING IS CRUCIAL FOR RAPID GDP GROWTH

Manufactures growth vs GDP growth



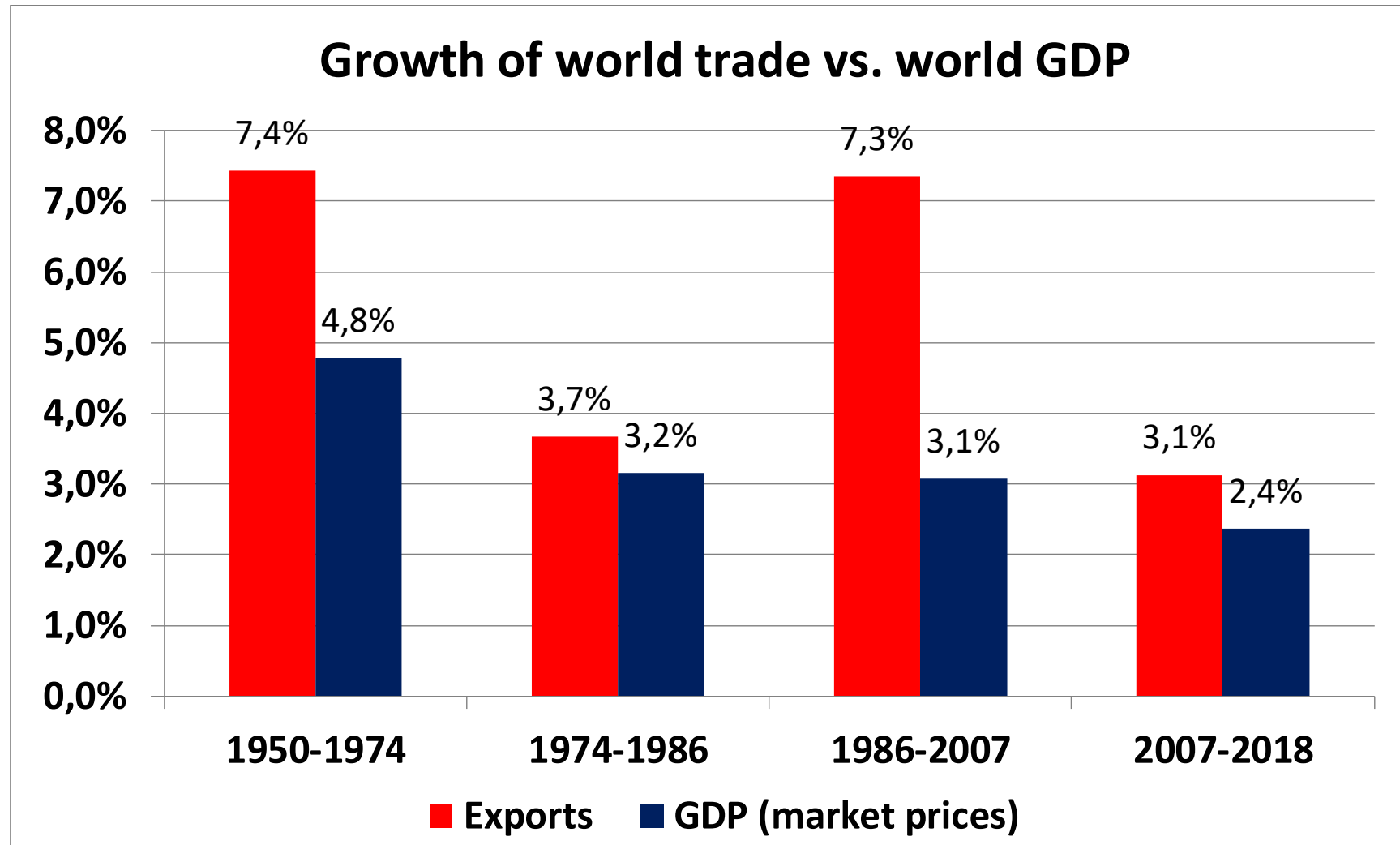
STRUCTURAL TRANSFORMATION POLICIES

- ❖ High quality infrastructure and education systems serve as basic “framework conditions”
- ❖ Support for structural transformation of production
 - ✓ Support for new industries and production clusters
 - ✓ Diversification of the export base
 - ✓ Domestic production linkages of exports and activities with FDI presence
- ❖ Innovation systems that accelerate the development of technological capacities
- ❖ And appropriate international rules / “policy space”

EXPORT STRATEGIES

- ❖ Increasing market shares in sectors where a specific country has an established position.
- ❖ Diversifying into higher technology products.
- ❖ The first strategy is widely available. The second will be available only to a limited number of developing countries
- ❖ Individual countries can succeed in any of these strategies, but as a group developing countries can only succeed if the demand is elastic (it may require developed countries losing market shares).
- ❖ Different markets provide different opportunities (N-S, S-S with China at the center, intraregional).
- ❖ Domestic markets may still be attractive!

STRONG SLOWDOWN OF INTERNATIONAL TRADE MAKES DOMESTIC/REGIONAL MARKETS MORE ATTRACTIVE



ANCHORED VS. SHALLOW INDUSTRIES

- ❖ The development impact of the strategy of a given country depends on the capacity to capture a high or small share of the value added.
- ❖ This is in a sense obvious and even tautological, as GDP is nothing else but “value added”
- ❖ But can have broader implications, as those activities with limited value added (e.g., maquila) are likely to be footloose.
- ❖ Unless the industries are firmly “anchored” in the domestic economy, their growth-enhancing capacity evaporates: “shallow” specialization.

A CRITICAL INSTRUMENT: NATIONAL DEVELOPMENT BANKS

- ❖ Private finance unwilling to fund activities with uncertain returns, strong learning effects and externalities key for structural transformation and sustainable development.
- ❖ Basic functions:
 - ✓ Provide counter-cyclical finance.
 - ✓ Support activities that lead structural transformation.
 - ✓ Deepen and improve financial markets for development-friendly instruments.
 - ✓ Support greater inclusion of small firms.
 - ✓ Finance global public goods (climate change).
- ❖ NDBs should work very closely with private sector.

THE ROLE OF EXCHANGE RATES

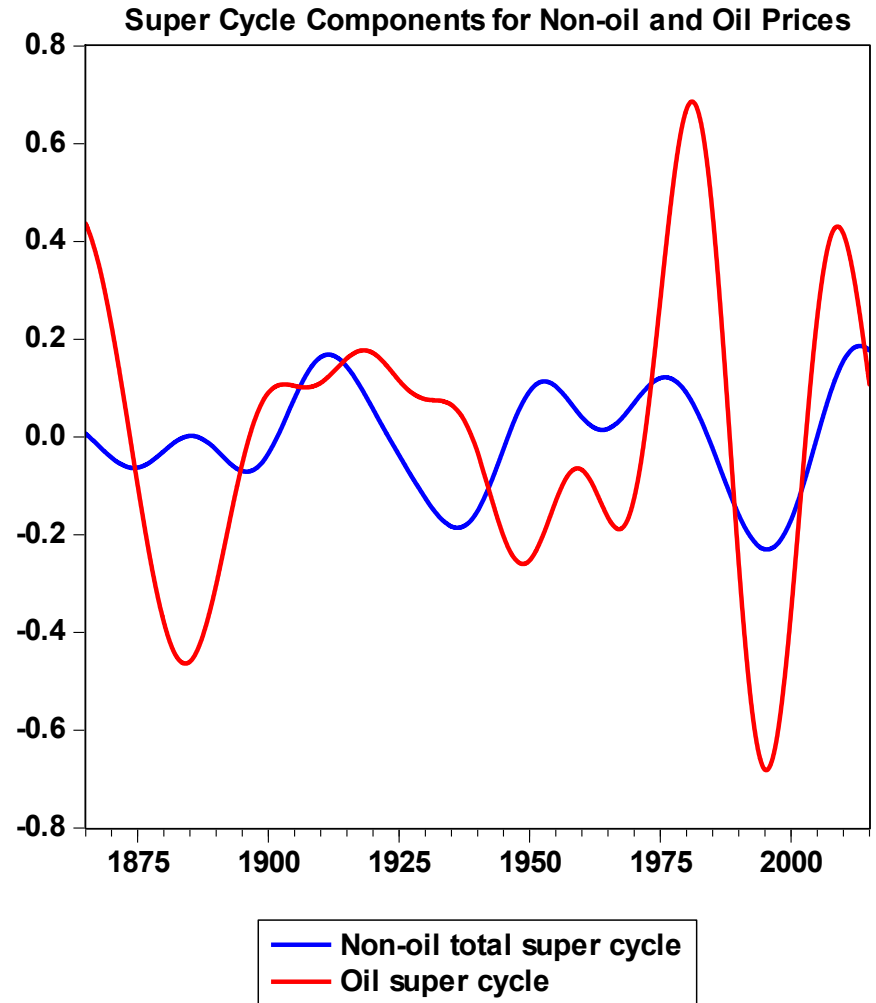
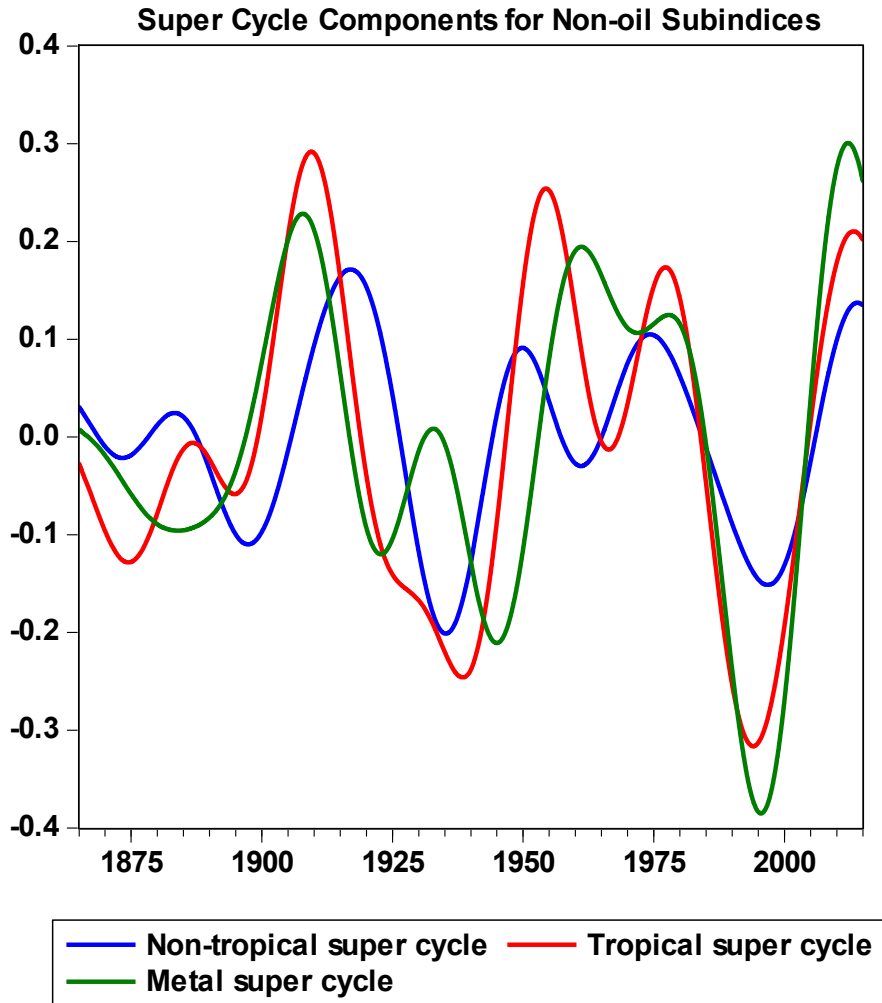
- ❖ Competitive and stable real exchange rates always play an essential role in the development of new production sectors. Large empirical evidence in this regard.
- ❖ This role is stronger if we want to overcome two constraints: the possible rent-seeking effects of industrial policy, and limits imposed by international rules (lack of sufficient policy space).
- ❖ At the same time, tax sectors with no learning spillovers or externalities.
- ❖ This leads to *effectively multiple real exchange rates*: different real exchange rates for sectors with diverse spillovers, while maintaining the commitment of IMF members to avoid multiple exchange rates.

BALANCE OF PAYMENTS DOMINANCE

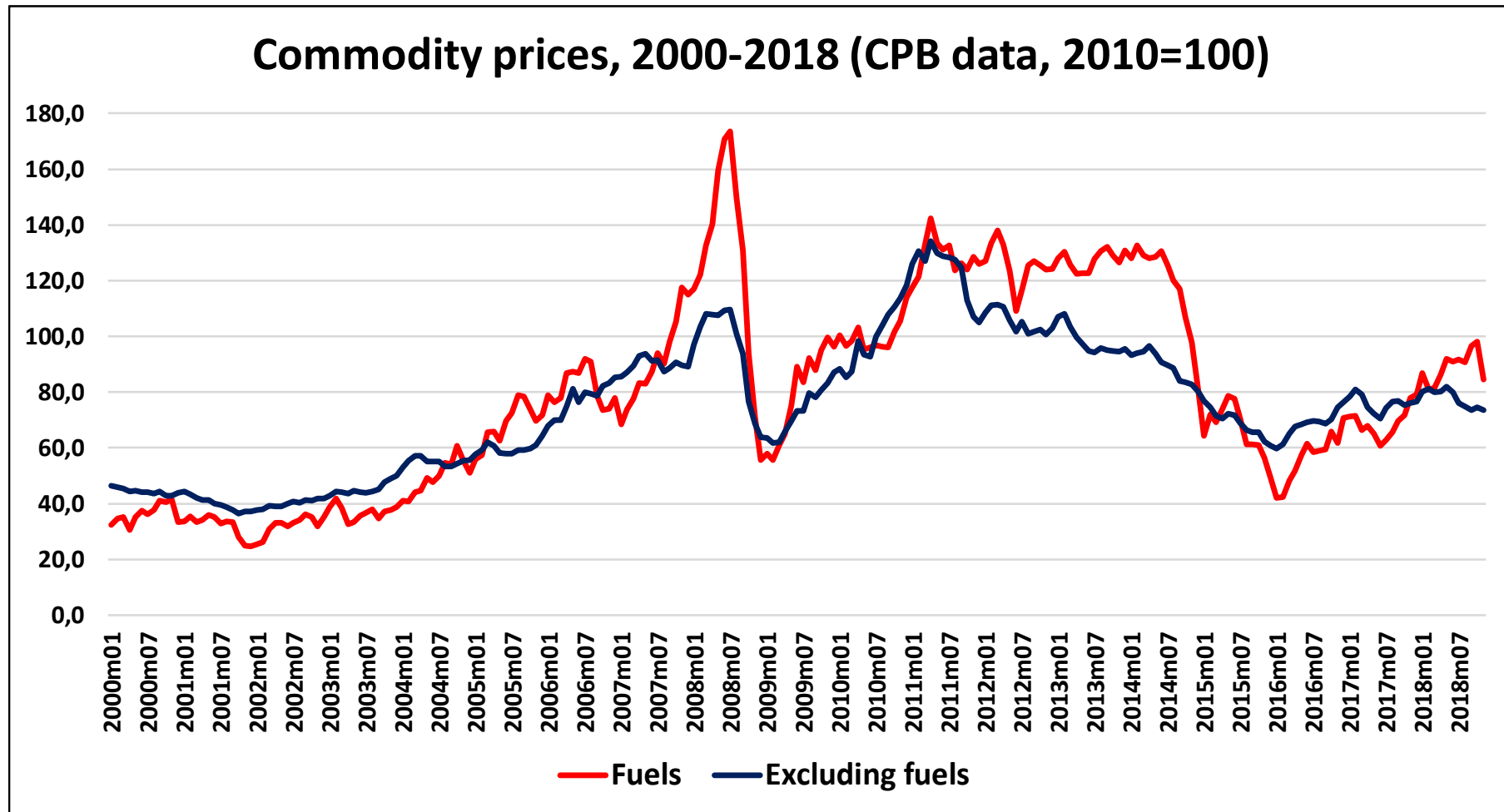
BALANCE OF PAYMENTS DOMINANCE (1)

- ❖ “Balance of payments dominance” refers to a macroeconomic regime in which short-term dynamics is determined by external shocks, positive or negative.
- ❖ In developing economies, the major sources of commodity price cycles and procyclical external financing (including, possibly, sudden stops). Changes in export volumes may also play a role, but are generally less important.
- ❖ The most important, and more difficult to manage are **medium-term cycles**, more than short-term volatility.

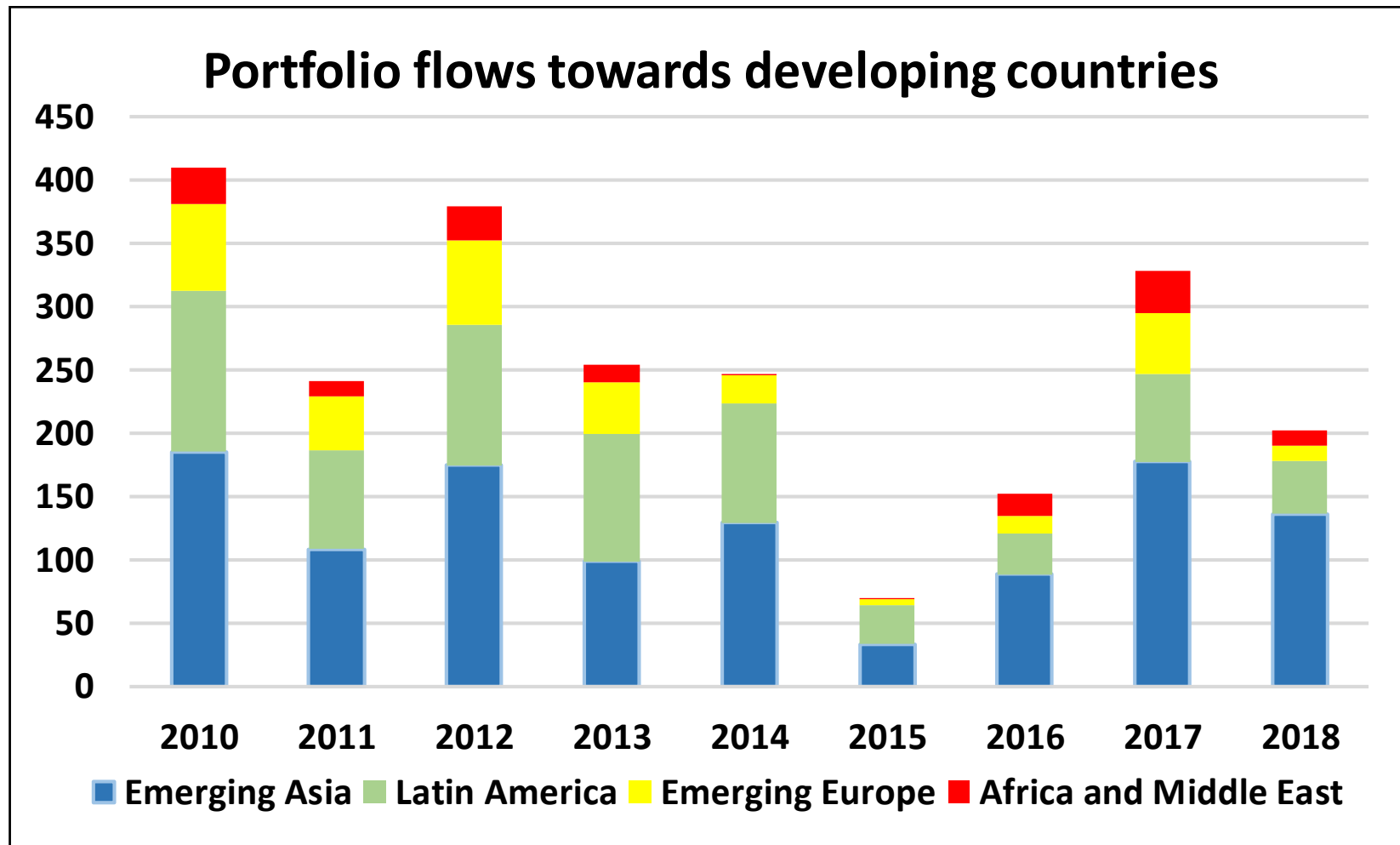
THERE IS STRONG EVIDENCE OF LONG-TERM COMMODITY PRICE CYCLES



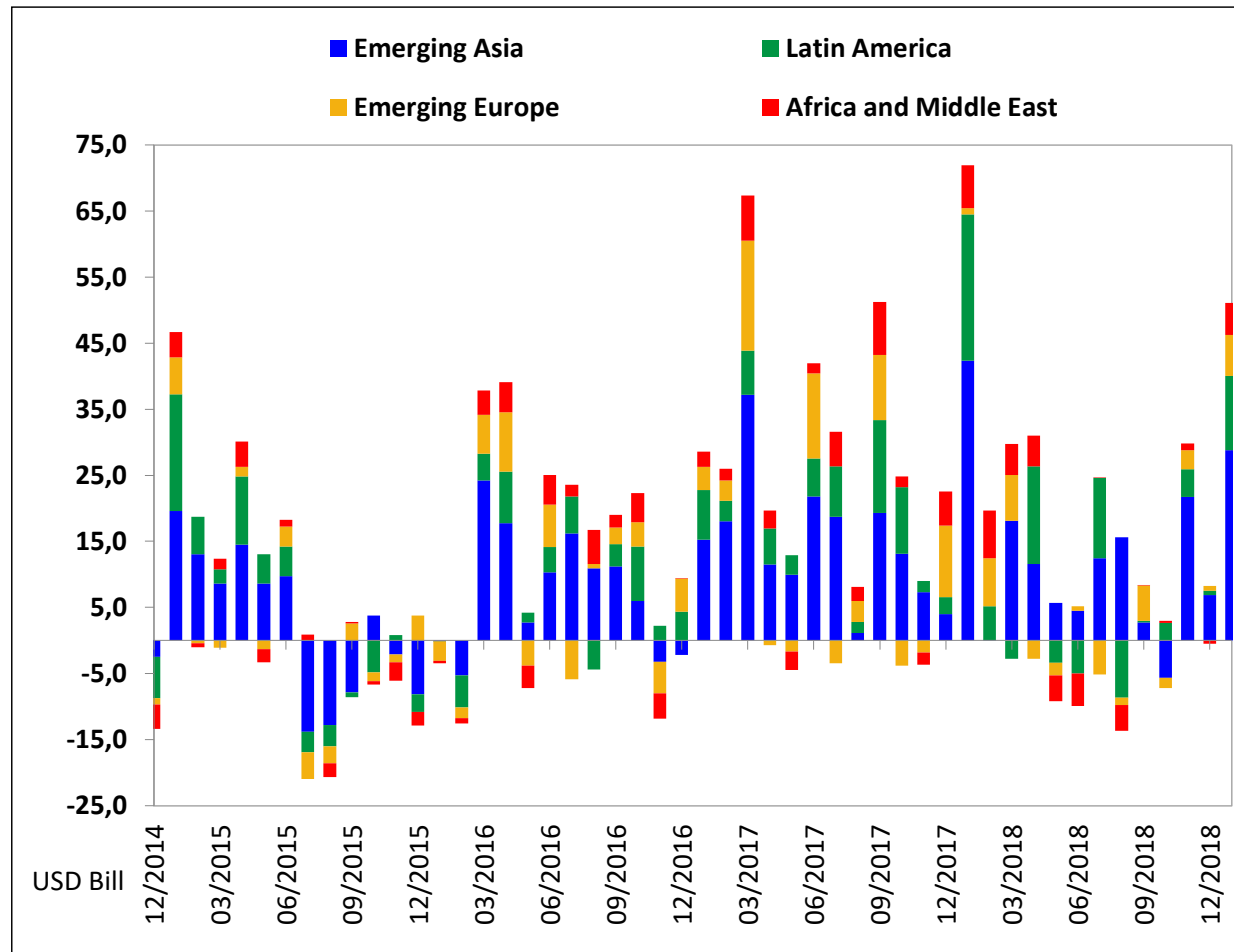
STRONG COMMODITY PRICE FLUCTUATIONS HAVE CONTINUED IN THE EARLY TWENTY-FIRST CENTURY



VOLATILITY OF PORTFOLIO FLOWS HAS PERSISTED....



... BUT THERE IS NO EVIDENCE OF A SUDDEN STOP ... SO FAR



BALANCE OF PAYMENTS DOMINANCE (2)

- ❖ These cycles directly affect domestic spending, the growth of credit and asset prices...
- ❖ ... but they also reduce the margin for countercyclical macroeconomic policies, and even generate incentives to adopt procyclical policies.
- ❖ Fiscal policies can always play a countercyclical role, but face strong economic and political economy pressures to turn procyclical.
- ❖ With capital mobility, economic policy faces a strong undesirable trade-off between a procyclical monetary policy and a procyclical exchange rate policy.
- ❖ The latter has strongly negative effects on economic diversification, both because of uncompetitive rates during booms (“Dutch disease” effects) and volatility.

THE DEBATE ON FISCAL RULES

- ❖ Several rules are procyclical in their design (including the Maastricht rules), but others have the desirable countercyclical elements (Chile 2000, Colombia 2011)
- ❖ In commodity-exporting countries, stabilization funds must be one of its instruments
- ❖ In any case, there are strong procyclical pressures:
 - ✓ Financing is procyclical (somewhat less in the case of domestic bond markets)
 - ✓ Political economy: austerity during crisis generates strong pressures to spend during booms.
 - ✓ Countercyclical policies can generate high deficits
- ❖ In any case, since the work by Kaminsky, Reinhart and Végh, strong evidence that fiscal policies tend to be procyclical in the developing world.

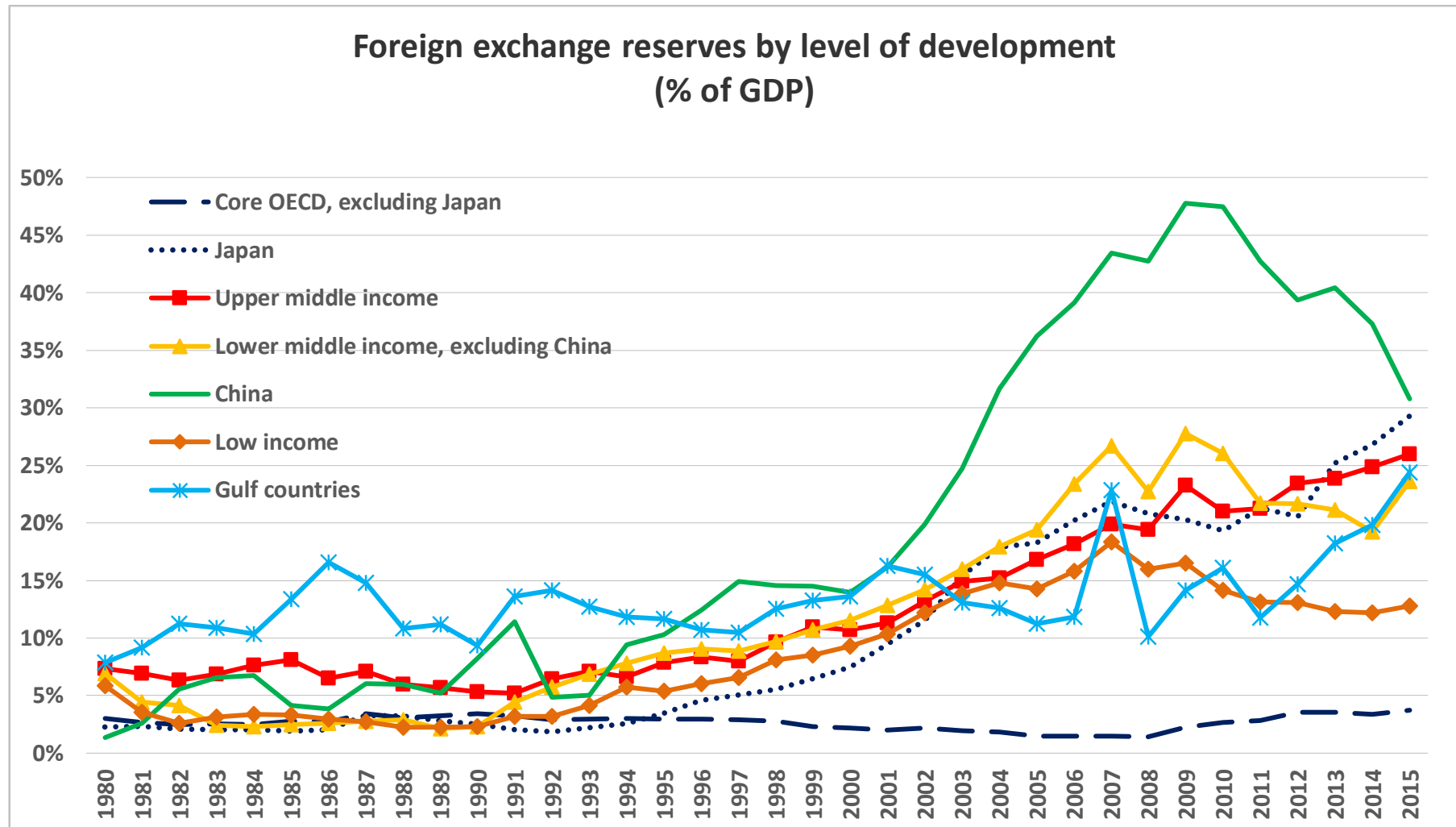
THE DEBATE ON MONETARY AND FOREIGN EXCHANGE POLICIES (1)

- ❖ The dominant vision: the optimal policy is inflation targeting with flexible exchange rates and free capital movements.
- ❖ Fundamental problems with this view:
 - ✓ Portfolio flows towards developing countries tend to be procyclical.
 - ✓ In this context, countercyclical monetary policies may enhance the cyclical pattern of capital flows.
 - ✓ The domestic effects of exchange rate on domestic prices have the opposite sign to those generated by demand, generating an incentive to adopt procyclical monetary policies.
 - ✓ Through the effect on the domestic cost of foreign debts, exchange rate fluctuations also generate procyclical wealth effects.

THE DEBATE ON MONETARY AND FOREIGN EXCHANGE POLICIES (2)

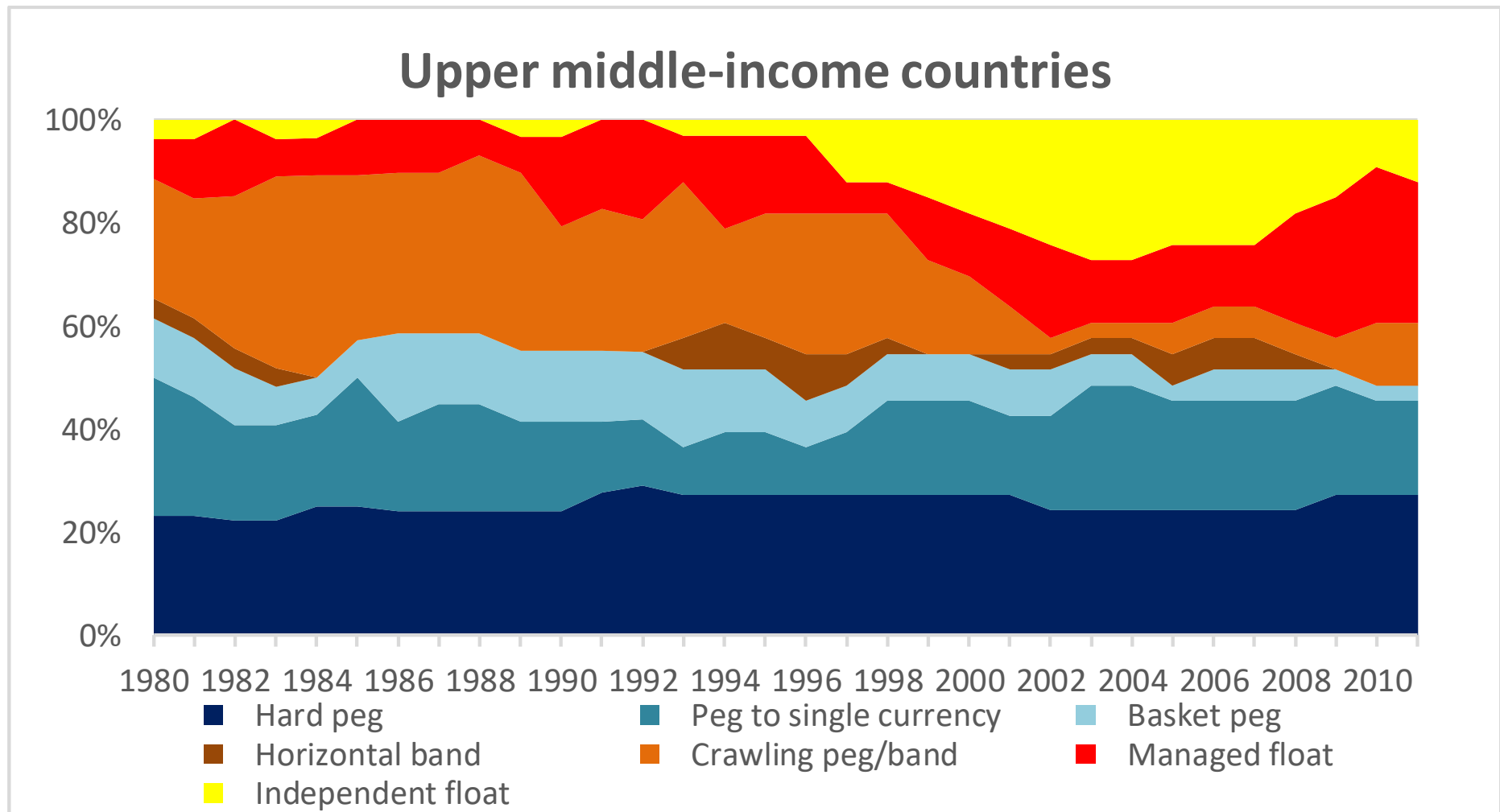
- ❖ Fundamental problems (cont.)
 - ✓ For all these reasons, a countercyclical monetary policy may not avoid overheating during booms and strong contractionary pressures during crises...
 - ✓ ... together with procyclical exchange rate variations, that have negative effects on structural diversification (again, overvaluation during booms, volatility through the business cycle).
- ❖ The policy response:
 - ✓ Interventions in foreign exchange markets and reserve accumulation = **intermediate foreign exchange regimes.**
 - ✓ **Manage the capital account** through regulation on capital flows and other “macroprudential” policies
 - ✓ In a sense, all desirable choices are in the interior of the Mundell triangle.

STRONG RESERVE ACCUMULATION HAS BEEN THE RULE SINCE THE ASIAN CRISIS (Ocampo, 2017)



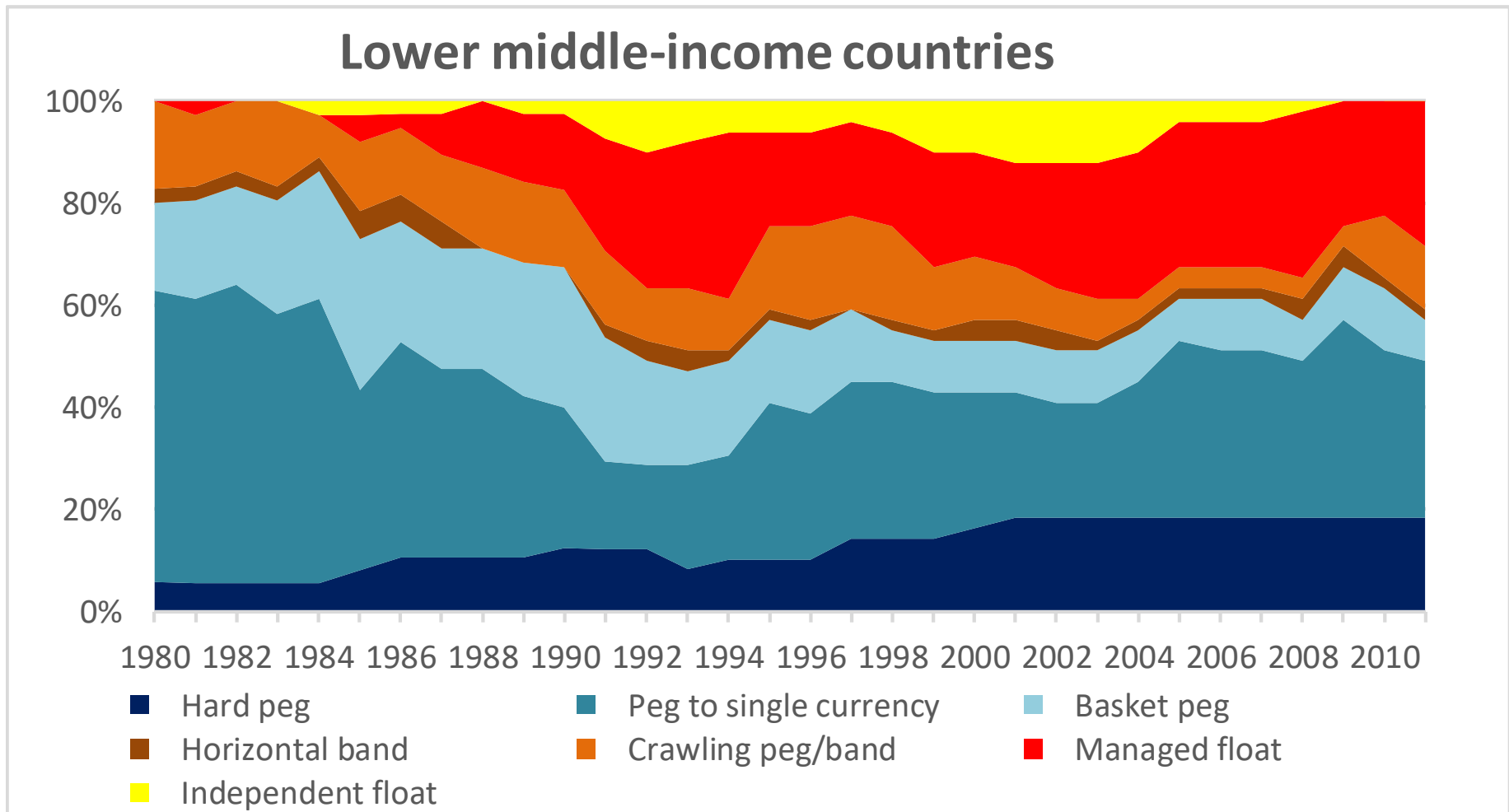
INTERMEDIATE FOREIGN EXCHANGE REGIMES HAVE BECOME MORE COMMON (1)

(Ghosh, Ostry y Qureshi, 2015)



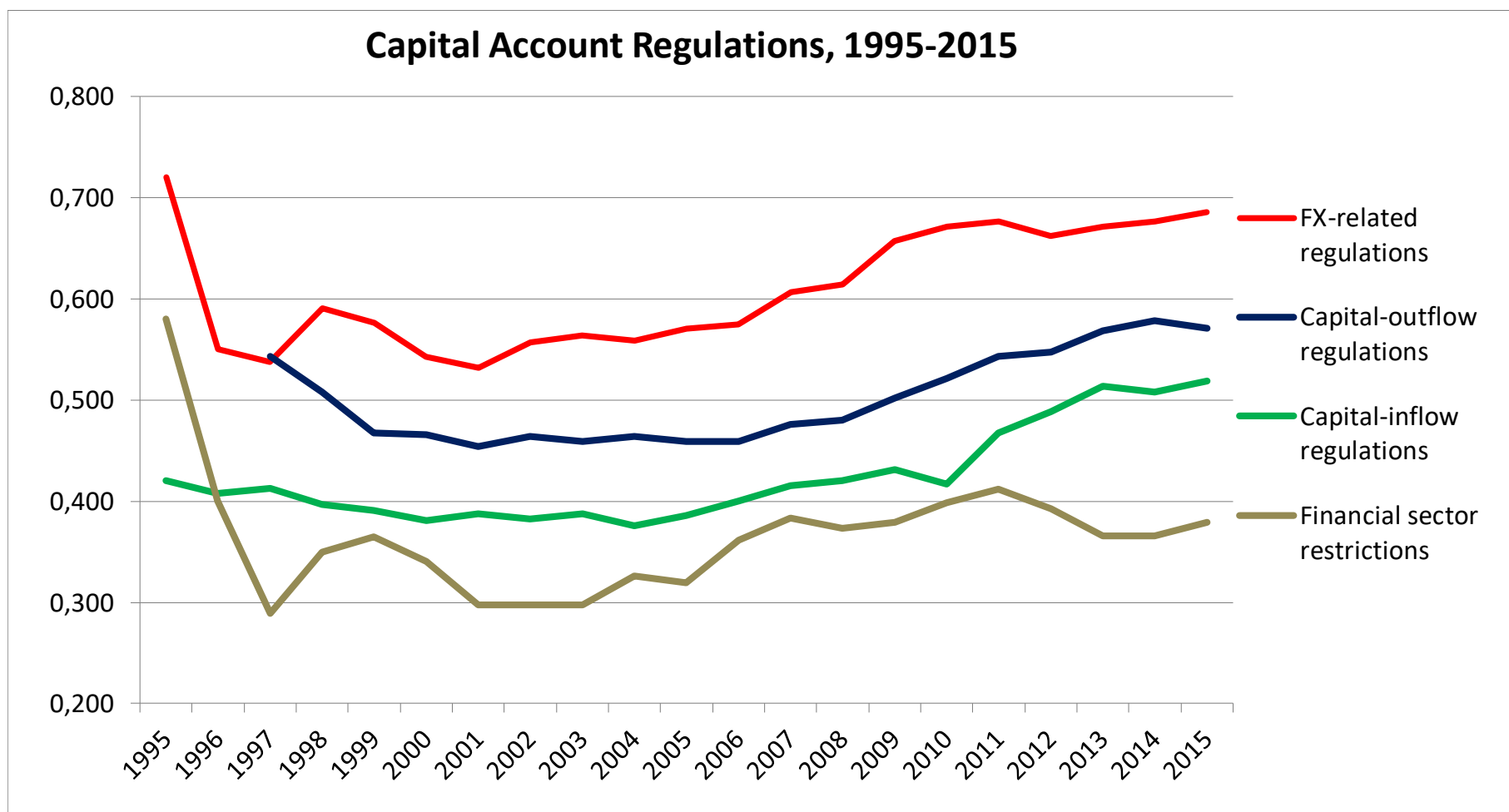
INTERMEDIATE FOREIGN EXCHANGE REGIMES HAVE BECOME MORE COMMON (2)

(Ghosh, Ostry y Qureshi, 2015)



THERE IS ALSO A MORE FREQUENT USE OF CAPITAL ACCOUNT REGULATIONS

(Erten and Ocampo, 2017)



IMPLICATIONS FOR THE ROLE OF CAPITAL ACCOUNT REGULATIONS IN THE INTERNATIONAL MONETARY SYSTEM

- ❖ Regulation of cross-border capital flows is an essential ingredient of global financial regulation, but it has not been recognized by G-20/FSB and OECD, partly by IMF.
- ❖ It should be seen as an essential element of macroeconomic management in emerging economies, not as an “intervention of last resort”.
- ❖ The major problems today are the management of the asymmetric monetary policies that the world economy may require, and the limitations on the use of the instrument in some free trade agreements.
- ❖ So long as source countries are not active participants, capital account regulations will remain weak.

HOW DO WE MANAGE BALANCE OF PAYMENTS DOMINANCE?

- ❖ Countercyclical macroeconomic policies during booms are essential in all dimensions: fiscal, monetary and foreign exchange policy.
- ❖ The latter means avoiding overvaluation and strong exchange rate volatility.
- ❖ This can only be made consistent with countercyclical monetary policy with intermediate foreign exchange regimes and capital account management.
- ❖ If countercyclical policies have not been adopted during booms, procyclical policies are unavoidable during crises.

**SUMMARY:
POLICY IMPLICATIONS**

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- ❖ Combine strategies of structural transformation with countercyclical macroeconomic policies that help manage balance of payments dominance.
- ❖ An essential element of both is an active exchange rate policy aimed at guaranteeing competitive and relative stable real rates.
- ❖ Strategy of structural transformation may require effectively multiple real exchange rates, which implies taxing sectors that do not generate learning externalities.
- ❖ Avoiding overvaluation and exchange rate volatility through the business cycle requires intermediate foreign exchange regimes and active capital account management

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