

Exchange rate war and Dutch disease

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The economists should abandon the assumption that the market has good control of the exchange rates

After the collapse of the Bretton Woods regime, the battle cry was floating exchange rate. The result was a huge increase in the frequency and intensity of financial crises. After 2008, the battle cry is “currency war” that the United States would have started when they tried to devalue the dollar, but that only got that name when Japan recently intervened on the yen market to halt its appreciation. Now G7 finance ministers want the IMF to formulate new regulations to prevent the currency war. Therefore, its economists should abandon the assumption that the market has good control of the exchange rates, and admit that they must be managed again, but in the framework of an agreement aiming at balancing the countries' current accounts, that should hover around zero.

If this is a difficult agreement between rich countries, it is a virtually impossible one among them and developing countries. Few see clearly the reason for this difficulty, but the governments of the developing countries are already inferring it. These countries are interested in welcoming multinational corporations that would bring them technology, but, as it happens with China, for receiving direct investment they do not need nor should incur current account deficits. The true balance of their economies is not consistent with such deficits, as it was always assumed, not even with a zero current account, but rather with a current account surplus. They do not need “foreign savings” to grow. Current account deficits only lead to exchange rate overvaluation, to more consumption, and usually to a small increase in investment.

The explanation for this counterintuitive assertion lies in the fact that practically all developing countries suffer, although in varying degrees, from the Dutch disease. Their

exchange rate is defined by commodities using abundant and cheap natural resources whose exports are lucrative with a more appreciated exchange rate than the one that is necessary for the other tradable industries using state-of-the-art technology. This is also true for the dynamic Asian countries that, instead of abundant natural resources, have cheap labor and a much higher wage differential than rich countries. If those countries fail to manage their exchange rate, the exchange rate will be defined by low-technology manufacturing industries that use unskilled labor; consequently, the more sophisticated industrial sectors, using more engineers and skilled workers, become internationally non-competitive, even if they use the most modern technology.

For those countries to diversify their economies and industrialize, they must neutralize this major market failure. They need to move the exchange rate from the “current” equilibrium to the “industrial” equilibrium – to a level that makes for industries using the best technology competitive. This neutralization is made either through the complete control of the exchange rate, as does China, or through a tax on the export of the good giving rise to the Dutch disease. For the oil-producing countries, whose cost of exploitation is very low, the required tax may be over 95% in relation to the export value. For countries with a less severe Dutch disease, as it is the case with Brazil (on account of natural resources) or China, on account of cheap labor and the big wage span, the required tax should be around 20 to 25%.

Considering as constant the international price of the commodity, a tax proportional to the severity of the Dutch disease neutralizes this overvaluation, because it shifts upwards the supply curve of the good as compared to the exchange rate, and, as a result, it moves it from the current equilibrium towards the industrial equilibrium. For example, let's assume that the *current* equilibrium exchange rate in Brazil (the one that balances intertemporally the country's current account) is R\$ 2.00 per dollar, and that the exchange rate is in this point. In this case, should the government conclude that the *industrial* equilibrium exchange rate is R\$ 2.60 per dollar (the one that would make competitive industries using the best world technology available without any other support or protection), and would soybean be the only good generating the Dutch disease, an export tax of R\$ 0.60 per exported dollar would neutralize the Dutch disease. First, it would make soybean exporters refuse to continue producing and exporting at this exchange rate, because it would not be profitable. Their refusal would

go on until the exchange rate would reach R\$ 2.60. In this way, they would be shifting upwards their supply curve. Consequently, the exchange rate would move towards the industrial equilibrium, and the Dutch disease would be neutralized.

When a country moves its exchange rate from the current equilibrium towards the industrial equilibrium, this means, necessarily, that he will be achieving a current account surplus. Now, if all the countries facing the Dutch disease understand this fact (as they have started to do), and decide to neutralize the disease (what is not easy), all of them will have a current account surplus, and, consequently, rich countries will face a current account deficit. A deficit they will have to be paid by transferring the property of assets (securities, stock, real property) to the residents in the developing countries that were able to neutralize the Dutch disease.

Therefore, it is likely that developing countries transfer capital to rich countries, and not the other way round, as seems more natural. The big surpluses that several developing countries are experiencing and the sovereign funds they are creating already reflect this fact. It is necessary to have a world agreement on the exchange rates, and this agreement will only be reached with mutual concessions. But it is not probable that developing countries will adhere to agreements to eliminate their current account surpluses.

Concerns about Dutch disease may also derive from the view that real exchange rate overvaluation lowers growth, a result that appears to be supported by the empirical evidence. Evidence on the positive effects that an undervalued real exchange rate may exert growth is mixed, with some studies suggesting that undervaluation actually hurts growth. In any case, the real exchange rate appreciation associated with Dutch disease is in principle an equilibrium phenomenon that reflects a change in underlying fundamentals and not necessarily implies overvaluation, so it is not clear why lower growth should be an unavoidable outcome. Real vs. nominal exchange rates. Exchange rate policy, welfare, and growth. Dutch disease, overvaluation, and volatility. Exchange rate regimes. To float or not to float. "Other people's money". Social strife and conflict (e.g., "diamond wars"). False sense of security. Risk of rusting foundations of growth. The term Dutch Disease refers to the adverse effects on manufacturing of natural resource "discoveries". Specifically, when a country experiences a resource boom due to a tradable resource discovery and/or to an increase in a resource price, it normally undergoes a real appreciation of its exchange rate and, as a result of rising wages, a relocation of some of the labour force to the resource sector. A real appreciation reduces the international competitiveness of other tradable sectors because resource-based exports crowd out commodity exports produced by those sectors (Krugman, 1987). The co...