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New developmentalism, economic growth and macroeconomic policy regimes

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Introduction

NEW DEVELOPMENTALISM, a concept developed in Brazil from the studies of Bresser-Pereira (2006, 2007, 2009), is defined as a set of proposals for institutional and economic policy reforms, whereby medium-development countries seek to reach the per capita income level of developed nations. This "catching-up" strategy is explicitly based on the adoption of an export-led growth regime, in which the promotion of manufactured exports accelerates the pace of capital accumulation and introduction of technological progress in the economy. The implementation of this strategy requires adopting an *active exchange rate policy* that keeps the real exchange rate at a competitive level in the medium and long term, combined with a *responsible fiscal policy* that eliminates public deficit while allowing a sustainable increase in public investment. Maintaining the real exchange rate at a competitive level in the medium and long term requires not only an active exchange rate policy, but also a wage policy that promotes wage moderation by linking the increase in real wages to the growth of labor productivity, thus ensuring the *long run stability of the functional income distribution*. The combination of responsible fiscal policy and wage moderation would work to keep inflation at a low and stable level, thus allowing the monetary policy to be used for stabilizing the level of economic activity while enabling a strong and permanent reduction in real interest rate.

In the "new developmental model", therefore, economic growth is "pulled" by exports and sustained by private and public investment in the expansion of productive capacity and basic infrastructure. The public deficit plays no relevant role in inducing and/or sustaining growth. Finally, the stability of functional income distribution ensures that consumer spending will grow at a rate approximately equal to real GDP in the medium and long term, thus ensuring a sustainable growth rate on the side of domestic demand.

That said, this article aims to examine the theoretical foundations of new

developmentalism, in particular the underlying concept of the nature of long-term economic growth and the role of macroeconomic policy is the promotion of this "catching-up" strategy. In this context, we will present the theory of growth driven by aggregate demand, according to which, for countries without convertible currency, long-term growth is led by the growth rate of manufactured exports. Based on this theory we will argue that a growth trajectory led by wages and/or government spending is unsustainable in the long term, and therefore incompatible with the "catching-up" strategy underlying new developmentalism. Next we will argue that the adoption of a consistent macroeconomic policy regime is crucial for the success of a "catching-up" strategy, insofar as it ensures the sustainability of the long-term growth trajectory.

Effective demand, income distribution and growth regimes

The growth engine of capitalist economies is aggregate demand, given that the availability of "production factors" and technological progress are variables that adjust in the long run to the level of effective demand (Kaldor, 1988; Oreiro et al 2010). Capital stock is the result of investment decisions made in the past, which are mainly based on the expectations of entrepreneurs in relation to the growth rate of the demand for their products. This means that, within certain limits,[1] investment is an endogenous variable that adjusts to the expected growth of aggregate demand. The labor force, in turn, also adjusts to the growing demand, since the number of hours worked, the participation rate and the size of the work force itself are very elastic with respect to the production level. Finally, the existence of static and dynamic economies of scale causes labor productivity to be a function of the companies' level and rate of production growth. Thus, a *structural relationship* is established between the growth rate of labor productivity and the growth rate of production level, which is known in economic literature as "Kaldor-Verdoorn law" (Ledesma, 2002).

Aggregate demand consists of two components, namely autonomous demand and induced demand. *Autonomous demand* corresponds to that portion of aggregate demand that is independent of the level and/or variation of income and production; unlike *induced demand*, which is a function of the income and production level and/ or of its variation. In the long run, the growth rate of the product is determined by the growth rate of the autonomous aggregate demand, since induced demand adjusts to the expansion of both the income and production level.

In open economies, autonomous demand consists of government spending and exports. Investment expenditures are not part of autonomous demand, since the decision to invest in fixed capital is determined essentially by the business expectations towards the future expansion of the level of production and sales based on the investment accelerator assumption (Harrod, 1939). Assuming that workers' access to bank credit is limited, consumer spending will depend primarily on the salary mass, which is a function of the production and

employment level of the economy. Under these conditions, the growth rate of consumer spending is determined by the growth rate of the income and production level. As a result of that, the long-term growth rate of the income and production level will be a weighted average of the growth rate of exports and the growth rate of government spending.

Given the functional distribution of income, the long-term growth rate in a developing economy that lacks a currency accepted as international value reserve is determined by the growth rate of exports. This is because if the growth rate of government spending is greater than the growth rate of exports, then the product and domestic income will grow faster than exports. If the elasticity of imports income is greater than one (as is usual the case in developing economies), then imports will grow more than exports, generating a growing trade deficit that will probably become unsustainable in the long run. Therefore, sustainable growth from the standpoint of the balance of payments has to be necessarily driven by exports. If that occurs, we will have an export-led growth regime.

This long-term relationship between economic growth and autonomous demand may be *temporarily* affected by variations in the functional distribution of income. Indeed, an increase in the share of wages in income will induce a temporary increase in the growth rate of consumer spending, since the propensity to consume out of wage income outweighs the propensity to consume out of profit income. An increase in the share of wages in income also generates an appreciation of the real exchange rate, which will result in a reduction in the growth rate of exports. If the positive effect of the increased share of wages in income on consumption exceeds the negative effect of this increase on exports, then the economy will display a wage-led growth regime, i.e., a growth regime in which the increased share of wages in income boosts the expansion of the income and employment level. Otherwise, the economy will display a profit-led growth regime, i.e., a growth regime in which the increased share of profits in income is the factor that boosts the growth of the income and production level.

It should be pointed out, however, that a wage-led growth regime is unsustainable in the long run. This is because, firstly, a *cumulative increase* in the share of wages in income, which is a necessary condition for an autonomous growth in consumer spending to occur, is economically and politically unfeasible. From an economic standpoint, a cumulative increase in the share of wages in income will result, at some point, in a tendency towards a decrease in the profit rate. When the profit rate falls below the minimum level required for continued capital accumulation, then private investment will cease, thus interrupting the growth of the income and production level. From the political point of view, the capitalist class will react strongly to the continued decline of the profit rate, thereby increasing the political instability prevailing in the economy. Under these conditions, the continuity of a wage-led growth regime can be disrupted by exogenous events (e.g. coups) originating in the political sphere of society.

Secondly, a cumulative increase in the share of wages in income is associated with a trend towards an appreciation of the real exchange rate, which can impact the degree of productive specialization of the economy, thus inducing a transfer of productive activities abroad, i.e., leading to a process of *deindustrialization*. As a result of deindustrialization, the income elasticity of exports will decrease and the income elasticity of imports will increase, leading to a reduction in the growth rate that is consistent with the balance of payments equilibrium. Thus, the continuity of the wage-led regime will, sooner or later, lead to external strangulation and to a balance of payments crisis.

As a result, in the case of developing economies without a convertible currency, the only growth regime sustainable in the long term is the export-led regime. As the existence of this regime is compatible with the stability of functional income distribution, the adoption of this growth regime does not preclude the adoption of a wage policy in which the real wage growth is tied to the growth of labor productivity.

The ideal macroeconomic policy regime

A macroeconomic policy regime is deemed ideal when it meets two basic conditions, namely: (a) consistency between the operational targets of the various macroeconomic policies; and (b) long-term sustainability of the economic growth pattern. Consistency between the targets of economic policy should be understood as a situation in which the simultaneous achievement of all policy targets based on the use of the instruments available to policy makers is feasible. If this condition is not met, policy makers will, in the daily operation of the macroeconomic policy regime, prioritize the achievement of some targets over others. Depending on the targets whose attainment has been prioritized, the growth pattern resulting from these choices may not be sustainable. In the case of developing economies, an extremely important operational target for the sustainability of the growth pattern in the long term is the actual real exchange rate target. If the macroeconomic policy regime is inconsistent and policy-makers decide to sacrifice that target for the sake of achieving another target (e.g., stability of the inflation rate or an increase in the share of wages in income), then the long-term sustainability of growth may be threatened by external strangulation and the balance of payments crisis.

An ideal macroeconomic policy regime for developing countries should be able to reconcile a relatively low and stable inflation rate (although higher than that of developed countries) with a relatively stable and competitive real exchange rate over time, a real interest rate significantly lower than the capital return rate, a cyclically adjusted public deficit (relative to GDP) close to zero, and a robust real wage growth, approximately at the same rate as that of labor productivity growth. If the operational targets for inflation, real exchange rate, real interest rate, fiscal deficit and real wages are mutually consistent, then the country will be able to enjoy an export-led growth regime, in which the robust

growth of manufactured exports enables a high rate of real output expansion, which in turn induces a strong growth of labor productivity, thus enabling the non-inflationary growth of real wages and maintaining a low interest rate in both nominal and real terms. The accelerated expansion of aggregate demand in a context of low and stable real interest rates induces entrepreneurs to make large investments in the expansion and modernization of the production capacity, thus allowing aggregate supply to adjust to the expansion pace of aggregate demand, which helps to keep inflation under control.

Achieving these operational targets requires not only an adequate management of economic policy instruments, but also the development of an institutional framework conducive to this task (Herr & Kasandziska 2011, p.5). Next we will detail the modus operandi of the monetary, fiscal, wage and exchange rate policies that enables attaining mutually consistent macroeconomic policy goals.

With regard to the monetary policy, this should be conducted in a discretionary manner, with the operational goals of obtaining a stable inflation rate in the medium and long term and a sustainable growth rate for real output.[2] To obtain these operational targets the monetary authority should use not only the basic interest rate but also regulatory or prudential instruments, such as reserve requirements, capital controls and requirements for equity on the active assets held by commercial banks. The use of these prudential instruments aims to give the monetary authority some degree of control over the growth rate of credit operations by the banking sector, in order to prevent the emergence and spread of speculative bubbles and foreign capital inflows, with a view to maintaining the stability of the nominal exchange rate and control the financial system's foreign debt.

The inflation target to be pursued by the monetary authority should be high enough to avoid the risk of deflation in cases in which the economy is affected by a deflationary shock; but not so high as to adversely affect economic growth, due to the increased uncertainty about the future evolution of relative prices. Recent empirical studies on the relationship between inflation and growth may provide an indication of the inflation target to be pursued in the medium and long term. Based on these studies, the presence of a nonlinear ratio between inflation and economic growth is identified, in which the ratio is considered positive for inflation rates below a certain critical level and negative for values above that level. However, there is no convergence between these studies as to what this critical level would be. Some studies indicate a critical level between 5% and 10% p.a., while others point to a level between 10% and 12% p.a., and some even consider a critical level of 20% p.a. (Pollin & Zhu, 2009, p.118-20). Excluding the extreme values obtained in these studies, an inflation target below 10% p.a. seems to be particularly suitable for developing countries.

It should be emphasized that the convergence of the inflation rate with re-

spect to the target should occur only in the medium and long term (two to three years), thus allowing the monetary authority some leeway to accommodate demand or supply shocks that involve a deviation of the growth rate with respect to the real output growth target. Therefore, the monetary authority can smooth out fluctuations at the level of economic activity, thus allowing greater inflation variability in the short term. This lower variability in the level of economic activity also contributes positively to the decision to invest in fixed capital by reducing uncertainty about the expansion pace of aggregate demand (Herr & Kasandziska 2011, p.68).

The role of fiscal policy, in turn, should be limited to stabilizing economic activity, thus minimizing fluctuations in the growth rate of real output around the sustainable level in the long term, which is defined by the long-term growth rate of exports in the case of developing countries without a convertible currency. The use of fiscal policy as a long-term growth engine is not compatible with the inter-temporal equilibrium of the balance of payments, and therefore is not sustainable.

The function of stabilizing the level of economic activity should be compatible with the maintenance of the public debt/GDP ratio at relatively low levels in the long term. That's because a high public/debt GDP ratio generates a series of negative effects on the economic system, namely (Herr & Kasandziska 2011, p.96):

- Deterioration in income distribution, as the holders of government securities are, in general, the richest individuals in society, while taxes are paid by the entire community.
- Cumulative increase in debt interest payments, thus reducing the space in public budget to finance investment in infrastructure or implement social policies.
- Possibility of loss of public confidence in the government's ability to pay the debt's interest and principal, which will lead to an increase in the risk premium and therefore in the cost of the debt rollover.

The operational goal of fiscal policy framework that allows the stabilization of economic activity in the short term and the stability of public debt as a proportion of GDP in the long term should be *to obtain a cyclically adjusted fiscal deficit close to zero*. Thus, when the economy is hit by a negative demand shock that causes the growth rate of real output to fall below the growth rate of the balance of payments equilibrium, the so-called "automatic stabilizers" will act to increase the public deficit, thus reducing the recessive impact of the shocks in questions. When the economy resumes a growth path consistent with in the balance of payments equilibrium, the concomitant rise in the economic growth rate will take care of eliminating the public deficit, thus ensuring the stability of the public debt/GDP ratio in the long run. Mutatis mutandis, when the economy is hit by positive demand shocks that raise the real output growth rate above the growth rate of the balance of payments equilibrium, the action of the "automatic stabilizers" will cause the public sector to operate with a nominal

surplus, which will act to moderate the pace of aggregate demand expansion and lead to a reduction in the public debt/GDP ratio.

Eventually, the economy may be affected by a negative aggregate demand shock so great that the simple action of the "automatic stabilizers" will be insufficient to permit the stabilization of economic activity. In this case, the tax authority should promote a *discretionary fiscal expansion* geared to the implementation of a comprehensive public infrastructure investment program. These additional expenditures can be financed by public debt issuance, as long as they provide minimally reliable expectations of cash flow generation for the government in the future (Herr & Kasandziska 2011, p.96). Thus, the fiscal countercyclical policy should be underpinned in the action of the automatic stabilizers and in the implementation of discretionary investment spending by the government, when necessary, insofar as these are minimally "productive". The generation of permanent fiscal deficits in the government current account should be avoided.

Another important element of the macroeconomic policy regime is the wage policy. This policy plays a key role for both price stability and economic competitiveness in the long run. Indeed, a strong correlation between the evolution of unit labor costs and the implicit GDP deflator is observed in developed countries (Herr Kasandziska 2011, p.71). Thus, the dynamics of nominal wages is particularly relevant to the evolution of inflation.

The wage policy should be compatible with the stability of income distribution in the long run. This is because the stability of functional income distribution is necessary for maintaining a competitive real exchange rate over time and therefore for the robust growth of exports. If the real wage growth rate exceeds the growth rate of labor productivity, the share of wages in income will increase cumulatively over time, generating a trend towards the appreciation of the real exchange rate. In turn, if real wages grow less than labor productivity, there will be a redistribution of workers' income to capitalists, which will result in a reduction in the growth rate of consumer spending. In this case, the growth rate of the effective demand will be lower than the growth rate of the autonomous aggregate demand, thus imposing a reduction in the pace of real output growth in the long run.

Inflation rate stability is another objective of the wage policy. Given the strong correlation observed between the unit labor cost and the implicit GDP deflator, the control of the variation rate of nominal wages is variable and of fundamental importance to price stability in the medium and long term. Thus, the operational target of the wage policy should be to obtain a unit labor cost growth rate that is compatible with the inflation target set by the monetary authority.

One way to reconcile the objectives set out here is to adopt, through labor laws, a rule or standard for nominal wage adjustment, in which the variation rate of nominal wages is equal to the inflation target set by the monetary authority plus the trend rate of labor productivity growth (Herr & Kasandziska 2011, p.74). If the

monetary authority succeeds in its task of ensuring the stability of the inflation rate in the medium and long term, the implementation of this rule will allow real wages to grow at a rate equivalent to the growth of labor productivity, thus ensuring the long-term stability of functional income distribution, which is a necessary condition both for maintaining the competitiveness of the economy over time and sustaining the growth pace of consumer spending. The adoption of this wage rule, in turn, will make it easier for the monetary authority to meet the inflation target, thus allowing a more moderate use of the interest rate as an instrument for an inflation control policy. In this context, there is a situation in which the monetary policy and the wage policy are mutually reinforcing, generating positive externalities over one another.

The last but not least element to be considered in the macroeconomic policy regime is the exchange rate policy. The sustainability of an export-led growth regime critically depends on the ability of the exchange rate policy to generate a competitive real exchange rate in the medium and long term. If foreign capital inflows impose a trend towards the appreciation of the real exchange rate, the resulting deterioration of the external competitiveness of the economy will result in a progressive reduction in the exports growth rate, which may be permanent if it induces a transfer of productive activities abroad, i.e., if it is the cause of the deindustrialization process. As a result, capital inflows should be strictly controlled so as to ensure the relative stability of the nominal and real exchange rate in the context of an economy operating in a floating exchange rate regime.

The exchange rate policy should be implemented by the monetary authority based on the use of regulatory instruments, among which are capital controls. These controls can be in the form of a tax on foreign capital inflow or else in the form of administrative restrictions on the inflow of specific types of foreign capital. It is important to point out that capital controls should be comprehensive and dynamic in order to reduce the possibility of capital flight through the financial system. The monetary policy will have only an indirect role in the task of managing the nominal exchange rate. Indeed, the great contribution of the monetary policy to obtaining a stable and competitive exchange rate in the medium and long term is the simultaneous achievement of the objectives of inflation stability and smooth growth rate fluctuations around the long-term growth target through a relatively low nominal interest rate in the international comparison.

In a context in which the horizon of inflation convergence with respect to the target is relatively long (two to three years), the monetary authority has not only an inflation target, but also a (sustainable) real output growth target, and the wage policy plays an important role in stabilizing the inflation rate, inflationary pressures are expected to be relatively low, so that the nominal (and real) interest rate can be maintained at very low levels. Therefore, the arbitrage gains between the domestic interest rate and the international interest rate will be small, making the task of capital controls easier, in the sense of reducing foreign capital inflows to the economy.

The monetary authority should use capital controls on a discretionary basis in order to obtain an *effective real exchange rate target*, which should be able to provide a satisfactory level of external competitiveness for the economy in question.

Table 1 summarizes the objectives, operational targets and instruments used by the monetary, fiscal, wage and exchange rate policies in the context of an ideal macroeconomic regime. It should be noted that the operational targets have been designed in such a way that obtaining one contributes to obtaining the others. It is, therefore, a consistent macroeconomic policy regime. Furthermore, the operational targets of the macroeconomic policy regime are consistent with an export-led growth regime, which ensures its sustainability in the medium and long term.

Table 1 – Description of the components of an ideal macroeconomic policy regime

Type of policy	Objectives	Operational targets	Instruments
Monetary policy	Low and stable inflation in the medium and long term. Robust and sustainable growth of real output.	Inflation target. Real output growth target compatible with balance of payments equilibrium.	Short-term interest rate. Reserve requirement. Equity requirement.
Fiscal policy	Stabilization of economic activity. Public debt as a proportion of GDP low and stable in the medium and long term.	Fiscal deficit target cyclically adjusted to zero of close to zero. Real output growth target compatible with balance of payments equilibrium.	Automatic stabilizers. Discretionary spending on public investment in infrastructure works.
Wage policy	Stability of wage share in national income. Low and stable inflation in the medium and long term.	Target variation of the unit cost of labor equal to inflation target.	Variation of nominal wage rate set at a level equal to the sum between inflation target and labor productivity growth rate.
Exchange rate policy	Competitiveness of manufactured exports in international markets.	Real exchange rate target competitive in the medium and long term.	Controls of capital inflows.

Source: Prepared by the author.

Conclusion

Throughout this article we have presented the theoretical foundations of "new developmentalism", in particular its concept of the nature of long-term economic growth and the design of the macroeconomic policy regime that enables middle-income countries to adopt the "catching- up" strategy.

In this context, we argue that new developmentalism is based on the theory of growth led by aggregate demand, according to which, in the case of countries without a convertible currency, long-term growth is determined by the growth rate of manufactured exports. The adoption of an export-led model requires, however, implementing a macroeconomic policy regime that is consistent and sustainable in the long term, i.e., a macroeconomic policy regime capable of reconciling the achievement of a competitive and relatively stable inflation rate with a real exchange rate that is competitive and relatively stable over time, a real interest rate significantly lower than capital return rate, a public deficit (as a proportion of GDP) cyclically adjusted close to zero, and an increase in real wages roughly at the same rate as the growth pace of labor productivity.

If the operational targets for inflation, real exchange rate, real interest rate, fiscal deficit and real wages are mutually consistent, then the country will enjoy an export-led growth regime, in which the robust growth of manufactured exports ensures a high real output growth rate, which in turn induces a strong growth of labor productivity, thus enabling a non-inflationary growth of real wages and therefore the maintenance of a low interest rate in nominal and real terms. The accelerated expansion of aggregate demand in a context of low and stable real interest rates induces entrepreneurs to investment heavily in the expansion and modernization of the production capacity, thus allowing aggregate supply to adjust to the expansion pace of aggregate demand, which helps to keep inflation under control.

Notes

1 In particular, the expected capital return rate must outweigh the opportunity cost of capital.

2 Sustainable growth rate is understood here as the real GDP growth rate compatible with the balance of payments equilibrium. The concept of «potential output» should play no role in defining the targets of monetary policy, since it is endogenous and therefore depends on the historical growth recorded by the economy (Barbosa-Filho, 2009, p.154) .

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Abstract – The objective of the present article is to analyze the theoretical foundations of new developmentalism, in particular its conception about the nature of long-run growth and the role of macroeconomic policy in the promotion of this catching-up strategy.

Keywords: Growth regimes, Macroeconomic policies, New developmentalism.

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