Inconvenient Asymmetries

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The recent events in the Middle East provide a challenging background to the discussion of economic asymmetries by G-20 leaders in the context of a framework for macroeconomic policy coordination. At the very core of recent debates on global imbalances—in addition to the usual discussion of the "exorbitant privilege" enjoyed by the U.S. and the global impact of quantitative easing —lies China.

China and its combination of demographics and democratic deficit have very concrete implications for its macroeconomic policy and in particular its exchange rate. This note is about the somewhat inconvenient thesis that the lack of democracy may enhance economic performance through an overly competitive exchange rate and cheap labor costs, which may be one obstacle in the global effort to coordinate macroeconomic policy.

A common and superficial view of the chronic weakness of the Chinese currency is that it is caused and maintained over the years by continued intervention or "manipulation" performed by monetary authorities—a claim that goes somewhat against practical experience in foreign exchange controls in developing economies and also against the skepticism of mainstream economists about the effectiveness of continued intervention and of targeting real exchange rates. There are indeed no signs of segmented markets and other indications of artificiality in the exchange rate formation despite some heavy regulation. Somehow in China, the undervalued exchange rate (in the sense of a major and sustained deviation from purchasing power parity rates) appears to be an "equilibrium" outcome, which is key to explaining how China keeps accumulating reserves without limitations and noticeable monetary impacts and inflation. The notion of "equilibrium" here requires caution; it can be interpreted as meaning that currency undervaluation *results* from a given "development model" rather than being an independent choice of strategy exercised by the authorities.

The exact nature of this blend of factors is being actively sought in many countries not only because of the flamboyant rates of growth in China which all the "peripheral" countries want to replicate, but also because many countries are experiencing undesired currency appreciation and/or inflation as a consequence of balance of payments surpluses. Developing countries with an extensive record of balance of payments deficit problems— like those in Latin America—are puzzled by the fact that "too much of a good thing", or foreign exchange abundance, can also have considerable costs and policy dilemmas. A formula to accumulate reserves indefinitely would offer a shield against external shocks without much fiscal costs and monetary consequences. This would be almost like a free lunch and even more so if it comes with high growth.

There is no doubt that the China development model is very appealing to other developing countries and there are many questions as to China's "uniqueness". Related discussions on an evolving "Beijing Consensus" are opening up debates on capital controls, intervention technologies and even tampering with inflation measurements. Yet, China appears to be the only unqualified success in dealing with chronic undervaluation and continued surpluses, challenging the notion that imbalances in international payments should produce self-equilibrating mechanisms. Indeed, China's ability to sustain surpluses through the years appears to be robust and one key ingredient behind it, beyond its demographics, is China's democratic deficit.[1]

There is no shortage of suggestive indicators in analyzing the economic consequences of authoritarian rule, a theme that is hardly novel in Latin America; the table below offers an unusual approach to the problem by sampling well-known country rankings produced by prestigious organizations focused on some key structural country attributes.

	WEF	IMD	IEF	EDB	TI-CPI	ATK-FDI	Rating
Brazil	58	38	113	127	69	4	Baa3
Russia	63	51	143	123	154	18	Baa1
India	51	31	124	134	87	3	Baa3
China	27	18	140	79	78	1	Aa3
TOTAL	**139**	**58**	**179**	**183**	**178**	**25**	

Acronyms and sources: *WEF, World Economic Forum, Competitiveness Index, 2010-11; IMD, Global Competitiveness Index 2010; IEF, Index of Economic Freedom, Heritage Foundation, WSJ, 2010. EDB, Ease of Doing Business Index, IFC & The World Bank, 2011; TI-CPI, Transparency International, Corruption Perception Index, 2010; ATK-FDI, AT Kearney Foreign Direct Investment Confidence Index, 2010; and sovereign ratings, long term debt, Moodys.*

The first two rankings refer to "competitiveness" and the other rankings in sequence refer to "economic freedom", business climate, perceived corruption, confidence to undertake foreign direct investment and sovereign ratings (the usual indicator for capacity and willingness to pay and also macroeconomic soundness). In all but the ratings column, the numbers refer to the country's position in a pool of many, as indicated in the last line. All these indexes are available in variety of decompositions, thus opening a vast world of possibilities as to the determinants of each country's position. The table does not report a "democratic governance index", a surprisingly difficult indicator to find.[2] However, one could argue that democratic values are embedded in attributes as diverse as enforcing contracts, property rights, rule of law, paying taxes, freedom from corruption and the like.

An explicit democratic governance index might not be that necessary to prevent anyone from seeing that more "business freedom" or "ease of doing business" may occur quite paradoxically in countries ranked very low in the broadly defined field of democratic practice. This is a challenging yet unsurprising finding that should not be seen as a shortcoming of any of the indexes listed in the table. If competitiveness or a good business atmosphere happens to be observable in dictatorships, one is simply forced to come to terms with the uncomfortable theory that authoritarian rule may enhance economic performance.[3]

If one closely examines the sources of competitiveness, it is clear that the factors reducing competitiveness in Brazil are mostly related to labor costs, labor laws and unions, and the limitations in increasing maximum working hours and in reducing safety standards and minimum wages—all of which adversely affect productivity. Indeed, a "social democratic" approach to labor market institutions may reduce competitiveness. In fact, the political and social institutions framing labor markets "can move wage levels up or down in any country by 40 percent or more" as put by a globalization non-enthusiast.[4]

The labor market in Brazil has many "European" features, especially when it comes to its connection to social safety nets, which makes labor more expensive or uncompetitive with respect to China, Indonesia and Guatemala. There are certainly other factors, such as demographics and infrastructure, to distinguish China as an off-shoring platform when compared to other countries with cheap labor. However, an unlimited supply of labor combined with well-crafted, export-led growth policies do make a winning combination within which competitive exchange rates reflect relative labor costs and continued balance of payments surpluses mirror a continued supply of new labor preventing wages from increasing.

The model is only reinforced when it comes to government spending and the tax system. Brazil has a large government compared to other BRIC countries and size goes along with complexity and bureaucracy. It is easy to exaggerate the negative impact of large government on growth, but in democracies there is no way out of certain social "obligations". Brazil has social safety nets that are intertwined with labor market institutions, which has large implications for public expenditure and taxation; China has no such obligations. Whereas one could say Brazil is ahead in regards to social overhead and security, China is unquestionably behind. Again, an asymmetry is associated with politics and its profound impact on competitiveness, exchange rates and economic performance.

In summary, the theory outlined here is that the competitive advantage of China has little to do with the exchange rate as such or with intervention in foreign exchange markets, but with relative wages or asymmetric labor market workings and demographics. And to the extent that labor markets are indeed tightly controlled in authoritarian regimes, we are back to the theory that authoritarian regimes do better than democracies in competitiveness and economic growth. The fact that the lack of democracy diminishes government responsibilities to provide social security, public health and education, only reinforces the theory because public resources are instead funneled into capital formation and infrastructure projects. In these conditions, growth comes along with increased inequality, which was indeed the case in much of Latin America when it was ruled by the military.

The relation between inequality and growth, as expressed by the "Kuznets Curve", was heavily debated in the 1970s in Brazil when the country was under authoritarian rule and living the so-called "economic miracle"; Brazil during this period was experiencing rates of economic growth similar to the rates of growth that China has experienced in recent years, though with rising inequality and tensions slowly translating into higher inflation. Albert Hirschman wrote about the incredible tolerance of dictatorship, inequality and inflation as long as growth remained high. Many such insights fit the recent Chinese experience quite well. Like Brazil at that particular moment, there were other examples of alleged "efficient" dictatorships in Latin America prone to some types of reforms and with good growth records. Each of these examples helps support the utilitarian argument that democracy might be a luxury good in the process of economic development.

Even more provocative, if we investigate a little further the comparison between Brazil in the 1970s and China today, is the way Brazil's authoritarian regime was phased out both for its perceived association with decreases in economic performance, supply shocks and inflation, and for the populist prone behavior following the years of authoritarian rule. The oil shocks in the 1970s produced stagflation, debt accumulation, balance of payments problems, high inflation and eventually the collapse of dictatorships in Latin America. Each country had its own trajectory, but let us take Brazil as example and avoid extending its lessons to others without serious qualifications. It is fair to say that Brazil's transfer of power to civilian rule was done in an orderly way since there was no revolution or political dislocation. Yet, the most impressive consequence of the political transition was the fiscal chaos that rapidly took form during the first civilian government starting in 1985. In five years, inflation reached 83 percent per month in March 1989 from levels slightly over 100 percent per year by the time President Jose Sarney took office. The derailing of fiscal accounts had everything to do with social demands of all types, turning Brazil's budget into complete disarray and leading to a rare case of hyperinflation during peacetime.[5] It is not difficult to see how much of a challenge this ended up becoming for Brazilian democracy. As social demands that were repressed during authoritarian rule exploded into economic chaos years later, a reversal toward strong regimes might look very feasible since "weak" governments that were paralyzed by a lack of consensus or authority were unable to respond to runaway inflation.[6]

All these Latin American stories and recollections may appear distant yet disturbing when connected to the social tensions created by inflation around the world, especially where democratic rule is lacking and most especially when combined with shock waves from the Jasmine Revolution in the Middle East. The lack of democracy is a theme with surprisingly little objective quantification and almost always absent from the discussion of economic asymmetries between countries. This note argued that the economic consequences of the lack of democracy might be very important in explaining the economic asymmetries at the very core of global imbalances. It will be hard for the G-20 process to address these issues explicitly, but it will be interesting to see whether the G-20 is able to raise awareness on the economic effects of democratic deficits.

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Endnotes

[1] Under the assumption of "unlimited supply of labor", balance of payment surpluses can last as long as it is possible to draw more labor to the countryside to prevent wages from rising. An extended discussion of the Chinese development model and its replication in other countries, and in Brazil more specifically, can be found in Franco and Vieira (2011).

[2] To judge from the survey found at UNDP, Sources for Democratic Governance Indicators.

[3] Tavares and Wacziarg (2001) and Helliwell (1994) are examples of studies that fail to establish a positive association between democracy and growth, and also define conditions under which the opposite conclusion would hold.

[4] Dani Rodrik (2011, p. 192). The original conclusion is in Rodrik (1999).

[5] For a full description of this process see Franco (1993).

[6] For a vivid description see Chapter 15 in Hirschman (1995).