Devaluation policies: a viable option to boost economic growth through exports?

Bachelor degree thesis

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Contents

Introduction ....................................................................................................................................................... 5

1. A theoretical outlook on policy-making within open economies ............................................................. 6

1.1 Do devaluation policies improve a country’s trade balance? ................................................................. 6

1.1.1 Devaluation policies benefit the trade balance: the Marshall-Lerner condition .................................. 6

1.1.2 The J-curve effect, a dynamic perspective on devaluations and trade balance ................................. 8

1.2 Exchange rates and policy-making in the short-run ............................................................................. 9

1.2.1 Small open economies facing external constraints: the Mundell-Fleming model ............................ 9

1.2.2 Relative freedom of policy-making in floating exchange rate regimes ........................................... 10

1.2.3 Policy-making in fixed exchange rates regimes: commercial stability or loss of sovereignty on monetary policies? ................................................................. 12

1.3 Do exchange rates affect the trade balance in the medium-run? ........................................................... 14

1.3.1 Aggregate demand and supply: reaching the natural level of production ..................................... 14

1.3.2 Further limits to devaluations under fixed exchange rate regimes ................................................. 16

1.3.3 Excessive uncertainty under floating exchange rates ...................................................................... 17

2. The role of devaluation policies in export-led growth strategies ......................................................... 18

2.1 Export-led growth: a general framework ............................................................................................... 19

2.1.1 Export-led growth fundamentals and the importance of exports diversification ............................ 19

2.1.2 Developing countries between catching-up and unfair trade practices .......................................... 21

2.2 Milestones in export-led growth: case studies among developing countries .................................. 22

2.2.1 Japan and Asian Tigers, the pioneers in export-led growth ............................................................ 22

2.2.2 China and the power of currency undervaluation ........................................................................... 23

2.3 The western approach to international trade and devaluation policies ............................................ 25

2.3.1 Beyond export-led growth strategies: developed countries as global actors of international trade liberalization ................................................................. 25

2.3.2 Devaluation policies as a necessity: the case of the United States ................................................. 26

3. Italian exports: the evolution from lira competitive devaluations to the sole currency ............................ 28

3.1: Italian exports before adopting euro ..................................................................................................... 28

3.1.1: The vulnerability of Italian lira and competitive devaluations in the 1970s ..................................... 28

3.1.2: 1992’s lira devaluation: the latest demonstration of Italian weakness within the European Economic Community .................................................................................. 28

3.2: Italy and European integration: gradual constraints on freedom to devaluate ................................ 31

3.2.1: Brief history of European limits to lira exchange rate fluctuations ........................................... 31

3.2.2: The shift to the sole currency: the final stop to lira’s “whirling dance” ........................................... 33

3.3: Italian exports under fixed exchange rate regime .............................................................................. 35

3.3.1: Has euro benefitted Italian exports? ............................................................................................... 35

3.3.2: If economic stagnation is the question, can exports be the answer? ............................................. 36

Conclusion ...................................................................................................................................................... 38

References ..................................................................................................................................................... 40
Introduction

Trade is one of the most dynamic elements within a country’s development pattern – regardless of its economic size. The idea of trade has certainly changed throughout the centuries; depending on different ideological frameworks, commercial relationships have been identified as the reflection of a country’s ability to dominate its partners or, opposite, as a means to spur cooperation, innovation, knowledge and technological spillover. One traditional issue with trade is competitiveness; the globalization process has weakened national barriers while empowering the international commercial network over the last three decades. Consequently, the necessity to foster grip on the global market is currently challenging both developed and developing countries.

Also, increasing integration has been amplifying international economic shocks effect at national level: policy-makers are currently forced to take into account both national and international issues when elaborating development strategies. After World War II, regional cooperation models have become quite popular in order to elaborate common solutions to common economic problems.

Policy-makers have paid increasing attention to the exchange rate: weaker currencies are generally associated to exports competitiveness, and consequently to economic growth. Moreover, after World War II it was clear that exchange rates between the most powerful currencies should be stabilized one way or another, in order to secure international trade and spur economic recovery. Meanwhile, exchange rate was increasingly perceived as the external representation of a country’s economic stability and prosperity: a weak and obsessively floating exchange rate would reflect internal instability from both economic and political point of view. Thus, a trade-off gradually emerged between manipulating national currency’s exchange rate in order to spur exports competitiveness and maintaining it as the country’s trademark on the global market.

The aim of this dissertation is to analyze the relationship between devaluation policies, exports competitiveness and economic growth. After World War II, currency devaluation was quite popular as it was perceived as a shortcut to wealth; but its implication were frequently ignored – from both political and economic perspective. We want to understand here if a devaluation revival could help western countries to give new impulse to exports and to overcome economic stagnation.

In the first part of this dissertation, we will provide a theoretical framework for the relationship between devaluation policies, exports and economic growth. We will see that exchange rate reductions actually have a positive influence on exports as long as the Marshall-Lerner condition holds. But the Mundell-Fleming model will explain how such policies should not be encouraged within a small open economy; we will analyze the implications of devaluation policies under both fixed and floating exchange rate regimes.

In the second part we will check whether theoretical assumptions fit empirical evidence or not. We will focus on export-led growth strategies, which appeared to be the ultimate path to economic growth in the 1960s and 1970s and were largely based on devaluation policies. We will describe the typical features of such strategies and see that successful ones include a wide range of elements, since exchange rate manipulation is solely insufficient to explain a brilliant economic performance. Empirical evidence from the Asian Tigers will support such assumptions; we will also analyze the specific features of Chinese exports pattern, which is currently the most relevant example of currency undervaluation supporting the country’s global leadership in trade. Moreover, devaluation policies will be considered from the western point of view: we will try to understand
the reasons why such policies are more or less officially unpopular among developed countries – which have stepped forward and tried to elaborate other strategies to face international trade strategies.

Finally, we will focus on a particular case study: the third part will entirely rely on Italy, on its different monetary experiences that influenced the exports pattern. The main point of interest is the adoption of the sole currency, which has put an end to Italian lira competitive devaluations that frequently occurred until the 1990s. Euro has been sharply criticized, as Italy had to make a huge economic effort to meet the adoption criteria; one frequent argument is that the sole currency overvaluation has destroyed Italian exports competitiveness. We will try to understand if such assumption is supported by empirical evidence, and see if devaluation policies could have any influence on the loss of competitiveness—if Italy ever decided to exit the Eurozone. Conclusions will follow.

1. A theoretical outlook on policy-making within open economies

In the first part of this dissertation we will provide a theoretical framework to understand how open economies deal with external constraints. We are interested in understanding the consequences of devaluation—a reduction in national currency value as measured in terms of foreign currency. Policy-makers are tempted to undergo such a measure to increase exports competitiveness and to stimulate GDP growth; we will see that its positive effects have to be balanced with those from fiscal, monetary and commercial policies. Furthermore, some countries prefer keeping freedom of decision-making and opt for floating exchange rate regimes; some others pay more attention to limiting uncertainty that might worsen commercial relationships, and choose fixed exchange rates. We will see the different implications of this choice on devaluation in the short- and medium-run.

In order to have a full theoretical perspective, we will first focus on the relationship between devaluations and net exports as described by the Marshall-Lerner condition; then, we will analyse the difference between short-run policy-making under fixed and floating exchange rate regimes through the Mundell-Fleming model. Finally, we will have a look at medium-run exchange rate trends under both fixed and floating exchange rate regimes; their difference on production almost disappears in a longer time lag, since prices are no more “sticky”.

1.1 Do devaluation policies improve a country’s trade balance?

1.1.1 Devaluation policies benefit the trade balance: the Marshall-Lerner condition

Net exports can be defined as the difference between exports and imports; or, in more precise economic terms:
\[ NX \equiv X - \frac{IM}{\epsilon} \]

Exports (X) positively depend on foreign production (Y*) and negatively on national exchange rate (\(\epsilon\)); imports (IM) positively depend on national production (Y) and exchange rate (\(\epsilon\)). Alfred Marshall and Abba Lerner were the first to derive the equation resuming all of these relationships—the basis for all the following literature on this subject:

\[ NX \equiv X(Y*, \epsilon) - \frac{IM(Y, \epsilon)}{\epsilon} \]

As long as the so-called Marshall-Lerner condition is satisfied, devaluations can have a positive effect on a country’s trade balance. Since the exchange rate (\(\epsilon\)) enters three times the equation, Blanchard et al (2010: 455) underline it influences net exports in a triple way. First of all, exports (X) increase because the nominal devaluation of the exchange rate corresponds to a real one: national goods are now more competitive, thus it follows an augmentation in other countries’ demand for them (Y*). Secondly, imports (IM) decrease because the national currency’s loss of value implies an augmentation in foreign currency’s value: foreign goods become more expensive, depressing national demand for them (Y). Thirdly, foreign goods’ price in terms of national goods \((1/\epsilon)\) is higher: it is evident that now it takes a larger quantity of national goods to equal the same amount of foreign ones; imports are undoubtedly discouraged. The total direct effect of devaluations on trade balance is clear: exports have to increase and imports have to decrease enough to balance the augmentation of foreign goods’ price in order to improve a country’s net exports. Shirvani and Wilbratte (1997: 44) have shown the consistency of the Marshall-Lerner condition with empirical data in main industrialized countries, highlighting a cointegration relationship between real exchange rate and trade balance.

But devaluations can also have indirect effects on production and net exports (Blanchard et al, 2010: 455). Any modification in national exchange rate can be identified as a change in foreign production—or, equally, in foreign demand for national goods. This corresponds to the ZZ schedule in figure 1.1a, shifting to ZZ’ after the devaluation: a reduction in national exchange rate brings to an augmentation in foreign demand for national goods. Notice that DD schedule (representing national demand for goods) is steeper than ZZ’ in A’: exports are now higher than imports. Similarly, the NX schedule benefits from this devaluation shifting to NX’ in figure 1.1b. Higher exports lead to an increase in national production and demand for goods: Y shifts to Y’ in figure 1.1a. Imports are stimulated by this growth in national productions; but they can not overcome the exports augmentation—the general conclusion is that devaluations improve a country’s economic growth.

Devaluation is not neutral to production: manipulating the exchange rate could mislead output from its natural level. Thus, exchange rate policies are usually combined to fiscal ones in order to control both trade balance and production. For instance, if a country has to deal with low production and commercial deficit, the government will probably associate a devaluation to fiscal policies that can help reaching the natural level of production—i.e. increase or decrease in public spending.
1.1.2 The J-curve effect, a dynamic perspective on devaluations and trade balance

The Marshall-Lerner condition takes a static picture of the relationship between exchange rate and trade balance; a further step is the analyse of its development through time. Devaluations have a positive influence on exports, but only after a certain lag: any modification in a country’s exchange rate immediately affects prices, but not quantities.

Going back to equation 1.1, we notice that a devaluation results in a reduction of $\varepsilon$; but import and export quantities do not vary immediately: $IM/\varepsilon$ increases, and consequently net exports $(X - IM/\varepsilon)$ decrease. The gradual adjustment of quantities to prices only successively leads to the well known condition of augmentation in foreign demand for national goods and reduction of national demand for foreign goods.

Figure 1.2 shows this adjustment through time -the J curve effect. Exchange rate reduction worsens the country’s initial commercial deficit, which shifts from OA to OB. As national goods become cheaper than the foreign ones, exports gradually increase while imports decrease: net
exports not only get back to their previous level and reach again point C, but also they improve and the commercial deficit is reduced.

The delay in the short-run adjustment is not negligible, as it might take years for devaluations to benefit the country’s trade balance: for instance, the US have continuously reduced the dollar’s exchange rate from 1985 on, but this produced its positive influence on net exports only from 1987 on (Blanchard et al, 2010: 459). However, it is estimated that the adjustment generally takes places within 6 to 12 months from the devaluation. In some cases Shirvani and Wilbratte (1997: 47) have shown a reversed L-curve effect lasting 24 months: the trade balance is flat during the first six months and recovers during the following 18 ones. The first conclusion to draw is that certainly devaluations benefit net exports, as long as the Marshall-Lerner condition holds; but this positive influence has to be balanced with other factors involved—among which we can include the slow short-run adjustment of quantities to prices.

1.2 Exchange rates and policy-making in the short-run

1.2.1 Small open economies facing external constraints: the Mundell-Fleming model

Small open economy means that the country’s commercial activities volume is not big enough to have a deep influence on the world’s trade balance. This means the country’s real interest rate (r) is equal to the world’s one (r*): assumed that the perfect capital mobility condition holds, any modification in national real interest rate will be balanced by foreign investments that will take it back to r* level. For instance, a reduction in national saving will produce an augmentation in r; this will lead foreign investors to buy national bonds, now providing more income than r*. But this flow of capital from abroad will gradually reduce national bonds price, and take r back to its r* level.

Robert Mundell and Marcus Fleming have translated the small open economy’s behaviour into a formal model—an expansion of the notorious IS-LM model. Provided that r = r*, the Mundell-Fleming model includes two schedules: IS*, representing the internal goods market; LM*, explaining what happens within the monetary market. The model’s aim is to analyse the impact of external flows of capital on IS* and LM* -and to compare them to their “sisters” IS and LM.

IS* curve equation can be written as:

\[ Y = C(Y - T) + I(r^*) + G + NX(e) \]

1.3

Its similarity to IS schedule is evident; but some changes need to be noticed. First of all, as we have seen above a small open economy has to deal with foreign real interest rate: since r = r*,

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1 This is a simplification: political uncertainty (especially within developing countries) and future expectations about exchange rate modification influence present real interest rate. θ is the prize risk, an exogenously determined variable resuming all these factor; real interest rate in the Mundell-Fleming model should be written more precisely as \( r = r^* + \theta \) -r value is higher because the country’s bonds are more risky. Future expectations on exchange rate fluctuations tend to become reality: the higher θ is, the more real interest rate will increase and the exchange rate will diminish.
investment (I) does not depend on r anymore, rather it is negatively related to r*. Foreign real exchange rate is exogenously determined, thus the IS* curve corresponds to a given r* value. Then, since \( e = \frac{e_P}{p^*} \), nominal exchange rate (e) is assumed to be equal to the real one (ε); our analyse is set in the short-run, consequently both internal (P) and foreign (P*) price levels should be constant; therefore, any modification in ε proportionally affects e. Provided that the Marshall-Lerner condition holds, nominal exchange rate changes will influence NX—which is not even included in a basic IS-LM model. It is clear that the IS* curve represents the negative relationship between national exchange rate, net exports and production: any increase in e will result in a reduction of NX and, consequently, of Y. This is the reason why the IS* schedule is negatively sloped in figure 1.3.

![Figure 1.3](image)

The other fundamental element in figure 3 is the LM* schedule, whose equation is:

\[
\frac{M}{P} = L(r^*, Y)
\]  

The LM* curve is not sloped because money supply (M) is exogenously determined by the central bank’s decisions, while price level (P) is assumed not to be varying in the short-run. Unlike the traditional IS-LM model, demand for money is here influenced by income (Y) and foreign real interest rate (r*) instead of r: any increase in Y positively affects money demand in close economic systems and results in an augmentation of r value, while open economies have to deal with a pre-determined real interest rate. On the opposite, exchange rate has no influence on Y -indeed LM* is not sloped.

A quick glance to the Mundell-Fleming model is sufficient to suggest that there is not much room for governmental decisions to influence the overall trends within a small open economy; many variables are here exogenously determined –real interest rate, money supply, price levels... Concerning our main point of interest, it is also evident that freedom to choose devaluation policies is limited: we have seen above that they can eventually affect net exports within the IS* schedule, but the fact that LM* remains unvaried strongly limits the possibility to influence the overall outcome in terms of production. Nonetheless, it is still possible for governments to use traditional tools of policy-making –monetary and fiscal policies.

### 1.2.2 Relative freedom of policy-making in floating exchange rate regimes
Not only have small open economies to deal with an exogenously determined real interest rate, also can external constraints include exchange rates. Sovereignty on policy-making can be deeply influenced by different exchange rate regimes. We will focus here on the hypothesis that exchange rate is an endogenous variable: whenever policy-makers produce a shift for the IS* or LM* schedule, the exchange rate will vary in order to re-establish balance between them (Mankiw and Taylor, 2009: 274). We refer to this situation as a floating exchange rate regime; in the third part of this dissertation we will see that lira exchange rate manipulations have been frequently used as a “safety valve” until the 1990s.

First of all, we can check the previous assumption implications on fiscal policies; for instance, the government can produce an expansion through public spending augmentation or tax reduction. As we can see from figure 1.4 below, this has immediate consequences on the IS* curve—a shift to the right; but no impact on the LM* curve.

The Mundell-Fleming model here represents the balance adjustment through the exchange rate. The government-decided fiscal expansion would lead to an increase in production; in a traditional IS-LM model this would result in an income, money demand and interest rate augmentation—therefore, in an overall increase in Y. But in our small open economy the real interest rate is exogenously determined: as soon as national real interest rate grows higher than r* level, foreign investors start buying the country’s bonds and take r back to its previous level. Also, the augmentation in r leads foreign investors to buy more national currency, determining an increase in national exchange rate; as we can see from figure 1.4, the appreciation of e has a depressing effect on net exports, resulting in a reduction of the overall production. Fiscal expansive policies in a floating exchange rate regime only increase national exchange rate, with no variation in Y.
Unlike fiscal policies, figure 1.5 shows that monetary policies can influence production when the exchange rate is floating. Our hypothesis here is a monetary expansion—the central bank decides to increase money supply. Provided that in the short-run prices do not vary, this expansion will result in a shift to right for the LM* schedule. In a closed economic system the increasing money quantity would lead to reduction in its price—real interest rate; investment would be stimulated, as well as production. A lower real interest rate is not attractive to foreign investors, that will sell national bonds; their price will increase until r = r*. Meanwhile, the increase in money quantity leads to a reduction in exchange rate: as long as the Marshall-Lerner condition holds, we know that net exports will improve. Monetary expansions coincide with a devaluation and stimulate the country’s economic growth (figure 1.5).

Finally, we must pay attention to the implications of the floating exchange rate regime on commercial policies—which is fundamental to the purpose of this dissertation. Governments often declare the intention to reduce imports in order to improve countries’ trade balances; but is this true? When looking at figure 1.6 below, we notice that this kind of restrictions to commercial activities do not benefit the overall production.

Indeed, a reduction in imports benefits net exports and results in a shift to the right for the IS* schedule; but as long as income increases, there will be an augmentation in demand for money and real interest rate. The flows of capital from abroad push r down to the r* level, while increasing money demand leads to an exchange rate appreciation: net exports are depressed, which is exactly the opposite result the government wanted to pursue. A restriction on national demand for foreign goods only initially benefits the trade balance, but successively it will increase the exchange rate without spurring economic growth.

1.2.3 Policy-making in fixed exchange rates regimes: commercial stability or loss of sovereignty on monetary policies?

We have seen that in a floating exchange rate regime policy-makers have to deal with external constraints that can be clashing with fiscal and commercial policies declared purposes; but still, they can boost the country’s economic growth through monetary policies. Conditions completely change within a fixed exchange rate regime: here the central bank determines the value of the national currency in terms of foreign ones, and it is forced to sell or buy reserves in order to maintain the exchange rate at this specific level. Such a system further limits policy-makers;
nonetheless, after World War II fixed exchange rate regimes have been created in order to stop exchange rates excessive fluctuations –i.e. Bretton Woods, European Monetary System\(^2\) (EMS)...

Mankiw and Taylor (2009: 277-278) describe the mechanism of a fixed exchange rate regime: the central bank is endowed with reserves of both national and foreign currency, which decides whether to sell or buy in order to maintain a certain exchange rate level. For instance, if a reduction in national exchange rate is required, the central bank will buy foreign currency in order to increase national currency supply and diminish its price –the exchange rate. Similarly, the central bank will buy national currency whenever an appreciation is necessary, because selling foreign currency will lead to its devaluation.

Fixed exchange rates regimes have different implications on short-run policy-making if compared to floating ones. Figure 1.7 shows that fiscal policies produce an impact on production; in particular, a fiscal expansion can stimulate the country’s economic growth. This happens because the augmentation in public expenditure (or tax reduction) provokes a shift to the right for the IS* schedule and an exchange rate increase. The central bank is forced to contrast this appreciation, and sells national currency to induce a devaluation. The increase in money supply makes the LM* schedule shift to the right, and aggregate income (Y) increases.

On the opposite, monetary policies lose their influence on aggregate production –and this is the main reason why fixed exchange rate regimes are strongly criticised. For instance, if the central bank decides to increase money supply by buying national bonds, the LM* schedule should shift to the right because of this monetary expansion. But when looking at figure 1.8 we might think that no modification in LM* position has occurred. What really happens is that the central bank is forced to buy national currency to stop the exchange rate reduction: this leads the LM* to shift to left, back to its initial position.

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\(^2\) See 3.2.1.
Monetary policies in fixed exchange rates regimes are extremely important to us: indeed, the central bank can decide to modify national exchange rate consequently to considerations on the economic trends within the country. For instance, it might be necessary to reduce the previously fixed exchange rate in order to improve the country’s net exports –and this is exactly what we call a devaluation.

Fixed exchange rates also modify the effect of commercial policies on production. While we have seen above that restrictions on imports are ineffective under floating exchange rates, figure 1.9 shows that the overall result is different. If policy-makers impose restrictions on national demand for foreign goods, this has a positive effect on net exports and makes the IS* curve shift to right. The exchange rate increase is contrasted by the central bank with a monetary expansion. The augmentation in money supply boosts aggregate income and has a positive effect on production. Moreover, Mahmud et al (2004: 236) have shown that the Marshall-Lerner condition is more likely to be satisfied within fixed exchange rate regimes

1.3 Do exchange rates affect the trade balance in the medium-run?

1.3.1 Aggregate demand and supply: reaching the natural level of production

In the medium-run we can not refer to the Mundell-Fleming model anymore: we will be using here a traditional AS-AD model. Prices are not “sticky” in the longer run, so we need to describe their role in gradual adjustment to the natural level of production. The crucial short-run issue of exchange rate manipulation almost disappears in a longer lag of time: the natural level of production can be reached under both floating and fixed exchange rates (Blanchard et al, 2010: 478). Provided that \( \varepsilon = EP / P^* \), not only is the real exchange rate affected by variations in the nominal one (as it happened in the short-run), but also prices medium-run variations have an influence on it –in both exchange rate regimes.

Medium-run demand for goods negatively depends on real interest rate and taxation, and is positively related to public expenditure; or, in a more formal way:

\[
Y = Y \left( \frac{EP}{P^*}, G, T \right)
\]
The aggregate demand (AD) equation slightly differs from closed to open economy: notice that here M/P is not mentioned, because we have seen that capital flows from abroad deprive central banks of their control over money supply. Instead, they can boost overall production through \( \frac{EP}{P^*} \) modifications, thanks to the Marshall-Lerner condition. Moreover, in closed economies prices fluctuations influence M/P and consequently interest rates, while in open economies this is not possible: since \( r = r^* \), prices can only affect \( \frac{EP}{P^*} \). For instance, an increase in \( P \) would result in a real exchange rate appreciation and reduce production –this is the reason why the AD curve is negatively inclined in figure 1.10.

Since money supply and exchange rates are not included in it, aggregate supply (AS) remains unvaried in open and closed economies:

\[
P = P^e (1 + \mu)F\left(1 - \frac{Y}{L}, z\right)
\]

The higher future prices \( (P^e) \) are expected to be, the higher nominal wages value will be; and this augmentation in workers’ purchasing power will lead corporations to increase present prices. Meanwhile, more production means higher wages, that will result in increasing prices as well. This positive relationship between prices and production explains AS curve’s positive inclination in figure 1.10.

Short-run balance is reached where AS and AD are crossing (A); notice that here production is under its natural level. The AD-AS models helps understanding the gradual medium-run adjustment to \( Y_n \): in the short-run effective prices are lower than their expected level, and this will lead to reduction in nominal wages. Nonetheless, low prices result in low exchange rate: provided that the Marshall-Lerner condition holds, improving net exports spur economic growth until the natural level of production is reached (B). We have seen that in the short-run it is not possible to think separately of fixed nominal and real exchange rate; the fundamental implication here is that in the medium-run fixed real exchange rate might vary from nominal level because of prices adjustment.

Blanchard et al (2010: 482) underline that governments might be tempted to proceed to devaluation in order to reach the natural level of production: figure 1.11 shows that both reductions in exchange rate and gradual AS shifts lead to \( Y_n \).
Prices are considerably higher after a devaluation (C) than they naturally were (B): an exchange rate reduction is just a shortcut to improve a country’s economic performance, and has relevant negative consequences. Firstly, we know that the J curve effect might be perverse: import and export quantities adjust to varied prices only after a lag of time, during which an economic recession is possible. Secondly, increasing prices lead to higher nominal wages, and this will make corporations determine higher selling prices for their goods: consumers’ purchasing power will be undermined after a devaluation.

### 1.3.2 Further limits to devaluations under fixed exchange rate regimes

Even under fixed exchange rate regime a devaluation might be necessary; this is a typical hypothesis for a country whose exchange rate is determined towards a low-inflation one: if domestic prices are constantly higher, this kind of monetary policy is required in order to improve commercial activities. Or it might be that internal political and economic reasons require a reduction in the interest rate to boost production. Whenever investors are persuaded that these hypothesis are likely to become truth, an exchange rate crisis will occur.

We have assumed that in small open economies $r = r^*$, and consequently $i = i^*$. But this was a simplification; now we need to re-write the interest rate equation in order to include expected exchange rate effects on it:

$$i_t = i^* - \frac{E_{t+1}^e - E_t}{E_t} \tag{1.7}$$

Under fixed exchange rate regime it should be normally that $E_t = E_{t+1}^e = \bar{E}$, so that parity between domestic and foreign interest rate is maintained. But when investors expect a devaluation, this condition obviously does not hold; in order to maintain parity the central bank will be forced to operate an interest rate augmentation including the expected devaluation amount—which is represented by $\frac{E_{t+1}^e - E_t}{E_t}$. If the interest rate is not modified in order to take into account a future exchange rate reduction, investors will not be attracted by national bonds anymore—they will be too risky with regards to the possible earning.
Blanchard et al (2010: 485) explain that before proceeding to a devaluation, the central bank initially tries to reassure investors and convince them not to rely on expectations about the exchange rate. Since often this is not enough, the following step is an interest rate augmentation that does not include the whole risk of an expected devaluation; investors prefer to get rid of national bonds and currency, thus the central bank is massively deprived in its foreign currency reserves. It makes sense to have such a high interest rate if it is only for a short lag of time, or a small exchange rate reduction is necessary. When it is not possible to maintain the determined exchange rate anymore, the only viable option is devaluation: investors expectation effectively become truth; this is the reason why many economists are persuaded that freedom to proceed to such policies should be limited under fixed exchange rate regimes.

1.3.3 Excessive uncertainty under floating exchange rates

We have simplified the relationship between exchange rate and interest rate, assuming that any variation in the first one positively influences the second one; countries under fixed exchange rate regimes complain about the loss of control over both factors. So why would a government decide to agree to such a constraint? Actually the relationship between exchange rate and interest rate complex: when the first one’s fluctuations are uncontrolled, their effect on the second one are difficult to determine.

We can express the exchange rate equation as:

\[ E_t = \frac{1+i_t}{1+i_t^*} + E_{t+1}^e \quad (1.8) \]

In the considered lag of time (from \( t \) to \( t+1 \)) exchange rate is expected to depend on present domestic interest rate (\( i_t \)), present foreign interest rate (\( i_t^* \)) and expected exchange rate in one year (\( E_{t+1}^e \)). We have assumed that \( E_{t+1}^e \) is constant; but \( E_t \) depends on expected exchange rate in one year, as well as this one depends on domestic and foreign interest rate in one year, and expected exchange rate for the following year. It is clear that any expected variation in foreign or domestic interest rate, as well as exchange rate, will influence \( E_t \). We can not show all the mathematical steps for space reasons; but we can re-write the exchange rate equation in order to include the effects of future expected variations in domestic and foreign interest rate and exchange rate on \( E_t \) (1.8). In particular, the equation shows that \( E_t \) depends on domestic and foreign interest rate variations for every year (\( t, t+1 \ldots t+n \)) as well as expected exchange rate in \( t+n \) years.

\[ E_t = \frac{(1+i_t)(1+i_{t+1}^*) \ldots (1+i_{t+n}^*)}{(1+i_t^*)(1+i_{t+1}^*) \ldots (1+i_{t+n}^*)} E_{t+n}^e \quad (1.9) \]

Blanchard et al (2010: 489-490) have interpreted equation 1.9 in different ways. First of all, \( E_{t+n}^e \) can be considered as the required exchange rate in order to eliminate trade balance deficit by year \( t+n \). For instance, investors might expect a future devaluation to improve a country’s net exports: a reduction in \( E_{t+n}^e \) will result in a parallel decrease in \( E_t \).
Secondly, policy-making can affect both short- and medium-run domestic interest rate: \( E_t \) will vary if investors are persuaded that \( t_t \) or \( t_{t+1} \) will be affected by fiscal and monetary policies – for instance, a money supply reduction associated to fiscal expansion can result in an exchange rate augmentation because of the increase in present and future interest rate.

Finally, the central bank might have different reasons to reduce the interest rate; investors will make expectations about how long this reduction will last – this is typically linked to considerations about the depth of political, economic and structural crises within a country that undermine its accountability on financial markets. We can assume that the longer these reductions are expected to last, the more \( E_t \) will decrease; if the interest rate diminution lasts less than expected, investors will modify their expectation and \( E_t \) will probably increase. But the truth is that investors’ expectations have become more and more irrational speculations on interest and exchange rates (Blanchard et al, 2010: 491).

2. The role of devaluation policies in export-led growth strategies

In the first part of this dissertation we have analyzed the theoretical reasons why devaluation policies should not be encouraged – in both fixed and floating exchange rate regimes. Nonetheless, empirical evidence from developing countries (East Asia, Latin America…) seems to show a relationship between currency undervaluation, exports competitiveness and economic growth: such a pattern spurs foreign capital inflows and increases their share within the international market. Thus, in this second part we will try to assess whether the theoretical framework on devaluation policies and open economies contrasts with empirical evidence of export-led growth; we will have a glance at relevant concrete examples of countries following such a development pattern.

In the first section, we will provide a general framework of export-led growth strategies, trying to outline their main features and to show how close to unfair commercial practices they can be while allowing developing countries to catch up industrialized ones; also, we will analyze whether export-led growth can be a path to economic recovery after 2008’s global financial crisis. Then, the second section focuses on typical examples of countries enacting export-led growth strategies – Japan, the Asian Tigers, China; moreover, we will give an overview of a relatively recent trend in export-led growth – the so-called South-South trade. In this section we will try to understand the effective impact of devaluation policies on this development model: we will see that exchange rate manipulation cannot solely explain such brilliant economic performances. Finally, in our third section we will highlight the main features of developed countries’ approach to international trade and devaluation policies: we will briefly describe the evolution from the GATT signature to the WTO creation; we will also focus on the United States as a concrete example of how western countries perceive exchange rate manipulation as a necessity rather than an instrument to spur economic growth.
2.1 Export-led growth: a general framework

2.1.1 Export-led growth fundamentals and the importance of exports diversification

By “export-led growth (ELG) strategy” we mean a development model that mainly relies on manufactured goods and services selling on the international market. In the second half of the 20th century many developing countries, such as China or the Asian Tigers (Singapore, Hong Kong, Taiwan, South Korea), have experienced an economic boom that was partly due to their competitive advantage in exports. As a consequence of the economic models we have seen in the first part of this dissertation, we expect that devaluation policies play a key role in ELG strategies; indeed, low exchange rates certainly have a propelling effect on exports. But this is only one, eventual feature of a successful ELG strategy; so, which are the other ones?

Commenting on examples of ELG strategies that occurred in the 80s, Gray (1991: 1) summarizes their “vital characteristics” as “quality manufacturing, quantity manufacturing, and export-led growth in quality manufacturing”. These conditions are essential yet not universal: other particular circumstances have allowed these countries to experience such a brilliant economic growth –which might be difficult to repeat in those exact terms. In particular, the success of past ELG strategies was strongly linked to two elements: due the openness of the US market and the small cumulative pressure that those strategies created on industrialized markets.

In fact, in the 80s developing countries that were poor in resources ran ELG strategies when dealing with the three main blocks of importing countries -North America; European Community; Japan and Asian Tigers (Gray, 1991: 3). Not only was this possible because of their comparative advantage in production costs, but also thanks to the US dollar overvaluation under Reagan administration and market openness. Big exports demanders are fundamental for an ELG strategy to succeed; and it is likely to fail if one of them decides to undergo deficit-reducing policies –i.e. limiting imports, like the United States did to overcome 1981-82 crisis (Gray, 1991: 4).

Also, the development of ELG countries was related to a cumulative change imposed on industries in developed countries: the latter experienced a reallocation of resources from declining to booming sectors (Gray, 1991: 4). Of course, reallocation is but a cost-free process: on the economic point of view, foreign firms “push disturbance” on domestic ones; and the “loss of industry-specific capital on the part of a local community”, as well as the internal development of technologies that can displace low-productivity workers, have deep social consequences. Unsurprisingly, all of these elements create an hostile environment for imports and can easily lead to protectionist measures –which were avoided in 1980s because, as we have seen above, ELG strategies created little cumulative pressure on industries in developed countries.

Even if expressing doubts about the possibility to repeat such a development model, Gray claimed (1991: 2) that a successful ELG strategy should allow the foreign market to find “its own level” and the equilibrium with internal ones, where reallocation of resources should occur. Also, a good ELG strategy should “capitalize on the availability of intelligent, conscientious, easily trainable, well-trained and relatively cheap labor”, while exploiting “(imported) technology and modern capital goods” (Gray, 1991: 5). Opposite, being a “labor-rich” country is not necessary to develop a winning ELG strategy: increasing workers migration, especially in regional labor markets
Gray’s assumptions are in general still valid, but empirical evidence has proved that ELG strategies can work even in current situation—eventually under different circumstances. One feature that emerged in recent years is exports diversification, which is necessary to better counterbalance international shocks that result in output volatility—especially for developing countries (Haddad and Shepherd, 2011: 6). Exports diversification can be promoted through trade facilitations and market barriers lowering (Haddad and Shepherd, 2011: 6).

Each country has its “pattern of specialization” (Hausmann et al., 2006: 1) and costs of production, resulting from the “endowments of physical and human capital, labor, and natural resources along with the overall quality of its institutions”: these “fundamentals” are clearly very difficult to change. Nonetheless, not all goods have the same effect on the overall productivity: “specializing in some products will bring higher growth than specializing in others” (Hausmann et al., 2006: 2) so policy-makers should orientate patterns of specialization towards higher-productivity sectors.

The “cost discovery process” (Hausmann et al., 2006: 3) is fundamental to this aim. A pioneer entrepreneur exploring a new sector has to face “considerable cost uncertainty”; but as long as the business proves successful, other entrepreneurs will join in. This “blueprint” will result in a gradual adaptation of the country’s patterns—in terms of both institutions and domestic endowments of capital and labor. A successful business will produce positive externalities, so that “returns to the pioneer investor’s cost discovery become socialized”; if not, only the incumbent entrepreneur will have to bear its costs—without other significant negative externalities. Policy-makers should subsidize “cost discovery” in order to encourage exports sophistication: trading what rich countries trade accelerates economic growth (Hausmann et al., 2006: 17).

ELG strategies were popular among developing countries between the 1960s and the 1980s; but could “export-led growth version 2.0” be a path to get out of current economic crisis? are persuaded that new impulse should be given to this development model—featuring “technology transfer, learning-by-exporting, increased competitive pressure that reduces markups and improves efficiency, and economies of scale” (Haddad and Shepherd, 2011: 8). Also, measures should be taken to build “sound macroeconomic fundamentals”: reserves accumulation; foreign investment regulation; deficit reduction (Haddad and Shepherd, 2011: 6). The importance of exchange rate manipulation would be more and more marginal in an “export-led growth version 2.0”: devaluation policies would not contribute to world economy stabilization and recovery after 2008’s brutal financial shock.

The ultimate framework of ELG is South-South trade: instead of developed countries, middle-income countries (and not only the BRICs) are the new exports demanders for middle- and low-income countries—they represented 12% of world importers in 1996 and 31% in 2008 (Hanson, 2011: 100). Low-income countries were traditionally not specialized in high-technological sectors - agricultural products, extractive activity and textiles (Hanson, 2011: 103); but they are currently shifting in global value chain thanks to increasing exports diversification—they are expanding in sectors such as electronics, iron and steel, machinery, transports (Hanson, 2011: 107). Also, exports have been diversifying on a regional pattern: East Asian and Pacific countries mainly export apparel and electronics, while Middle East and Sub-Saharan Africa are more specialized in petroleum.

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3 Haddad and Shepherd (2011: 6).
extraction and agriculture (Hanson, 2011: 108). Once again, we can notice that other factors rather than devaluation policies have helped developing countries to improve their exports competitiveness.

2.1.2 Developing countries between catching-up and unfair trade practices

Opening to international markets spurred economic growth to “unprecedented levels” in some developing countries – for instance Brazil, China, Malaysia (Haddad and Shepherd, 2011: 1). The neoclassical economic theory has established a link between increasing competitiveness due to trade liberalization and efficiency, innovation and productivity (Chandra et al., 2009: 28).

Only some developing countries enacting ELG strategies have succeeded the so-called “catching-up” – which is the country’s ability to reduce the gap between labor productivity within a given industrial sector and the technological frontier established by another country (Chandra et al., 2009: 28). Catching-up has proved to be following an inverted-U trend: the farther is the industrial sector from technological frontier, the less likely innovation policy will occur to shorten the distance. Competitiveness in catching-up analysis results under three different profiles: revealed comparable advantage (RCA) in producing a certain type of goods, labor productivity and ability to export high-technology goods similar to those produced in OECD countries.

As highlighted in a 2012 OECD report, South Korea has been successfully catching up OECD countries in less than three decades; figure 2.1 shows how the typical 1950s low-income country ranked among middle-income ones in the 1980s and continued growing despite 1997-98 Asian financial crisis (Chandra et al., 2009: 27).

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP per capita in constant 2005 USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>5000</td>
</tr>
<tr>
<td>1973</td>
<td>10000</td>
</tr>
<tr>
<td>1976</td>
<td>15000</td>
</tr>
<tr>
<td>1979</td>
<td>20000</td>
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<tr>
<td>1982</td>
<td>25000</td>
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<td>1985</td>
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<td>1988</td>
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<td>2003</td>
<td>60000</td>
</tr>
<tr>
<td>2006</td>
<td>65000</td>
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</tbody>
</table>

The OECD report underlines how South Korea’s catching-up has been possible thanks to a government-led ELG strategy that combined exports promotion, imports control and exchange rate

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4 The technological frontier is a “rapidly moving target”, rather than a fixed standard: the catching-up country’s growth rate has to be higher than the frontier country’s one in order to close the gap (Chandra et al., 2009: 41).
depreciations. Also, an improvement in educational system, as well as an impressive shift from agricultural to industrial economy—in particular heavy and chemical industry, and electrical machinery (Chandra et al., 2009: 37). These measures were contained in consequential Five-years Economic Plans adopted between 1962 and 1992; once again, we notice that devaluation policies alone would probably not allow South Korea’s brilliant economic performance.

South Korean experience is based on unique factors; but it might be a useful example for countries dealing with development challenges and catching-up—even if we have seen above that each of them has to develop its patterns specialization. On one hand, international trade offers big opportunities in terms of technological progress and productivity; on the other hand, direct implication is that while pursuing ELG strategies governments might be tempted to undergo unfair trade policies in order to accelerate economic growth.

One of these practices is dumping, which Penrose (1990: 1) qualifies as the “situation in which prices are charged in exports markets that are lower than those charged in the exporters’ domestic markets”; such difference in prices is not justified by a variation in production costs. Dumping policies might “drive out competition”: high-technology industries in developing countries can displace lower-technology ones in developed countries thanks to trade barriers reduction; thus, governments might adopt protectionist measures to protect domestic industries. Also, GATT includes anti-dumping measures addressing WTO members (Penrose, 1990: 1).

According to Penrose, dumping is not necessarily to be included among uncompetitive trade practices (1990: 2). Multinational firms have the “same research base, similar technology, or common managerial resources”, even if their output is diversified: intrafirm trade within a group of countries justifies prices discrimination in order to share production and distribution costs. Both developing countries and the EU have been adopting dumping-style measures (Penrose, 1990: 4). On one hand, a successful ELG strategy should not undergo dumping policies that are toxic to international firms competitiveness; on the other hand, governments should not take advantage of anti-dumping measures to hide protectionism and facilitate domestic industries (Penrose, 1990: 4).

### 2.2 Milestones in export-led growth: case studies among developing countries

#### 2.2.1 Japan and Asian Tigers, the pioneers in export-led growth

In 1955 the four Asian tigers (Hong Kong, Singapore, South Korea and Taiwan) were as poor as African countries and “hopelessly overpopulated” (Paldam, 2002: 457). They were affected by an “anti-developmental culture”, yet they were excluded from LDCs group: they were not socialist and escaping non-alignment paradigm in Cold War. Japan’s economy was in turn devastated by World War II experience. These five countries chose a different path of development from the state-controlled import-substitution industrialization model prevailing at that time among LDCs; export-led growth is what determined their impressive economic performance between the 1960s and the 1990s.

Klein defines quality manufacturing, quantity manufacturing and export-led growth in quality manufacturing as the three main features of Japan’s and Asian Tiger’s development strategy (1990: 1). They were raw materials importers rather than exporters: the shift from basic materials to high-technology exporting represented the turning point of their development.
Japan’s economic boom started in the 1960s because of the “manufacturing production of textiles, apparel, optical goods, electronic goods, transportation equipment, finished steel, and many other, widely varying products” (Klein, 1990: 2); the country was previously known for rather low-quality manufacturing goods –for instance, inexpensive toys (Klein, 1990: 4). Western countries largely supported Japanese reconstruction after World War II –and the consequent technological spillover played a key role in the country’s shift from “mainstream large-scale manufacturing to large-scale, high quality manufacturing”. When such a transformation occurred, the Asian Tigers closed the gap by producing low-to-moderate technologies (Klein, 1990: 2); nowadays, the “Japanese-style” Tigers (Taiwan and South Korea) are world leaders in information technologies (Paldam, 2002: 456).

The Asian Tigers had small public sectors, which accounted for 30% of GDP against 40-50% in developed countries -in Hong Kong it was only 9%; also, they had unusually high savings rates, which were probably as twice as rich countries (Paldam, 2002: 456) and huge endowments in human capital (Klein, 1990: 3). These particular features, as well as an ELG strategy relying on exchange rate reforms and imports liberalization (Bradford and Chakwin, 1993: 9) justify the “hyper-successful” Asian Tigers’ outstanding position from the other LDCs group (Bradford, 1993: 14). Only Hong Kong had a relatively different pattern of growth from the other Tigers, with lower indices of structural change between 1965 and 1990 –industries remained specialized in textiles and apparel rather than shifting to high-quality manufacturing (Bradford, 1993: 20); nonetheless, Hong Kong is one of current leading financial centers.

Until now we have dealt with the Asian Tigers’ economic boom from an “export push”, neoclassical approach (Bradford, 1993: 17). But what if exports were not the exogenous variable? An alternative approach suggests that exports are an endogenous variable depending on both foreign and domestic investment, rather than trade liberalization (Bradford and Chakwin, 1993: 10). However, both approaches show that exchange rate policies are solely insufficient to stimulate economic growth through exports.

2.2.2 China and the power of currency undervaluation

It is not possible to deal with ELG strategies without mentioning China, whose impressing economic growth in the last three decades has been relying on opening up commercial relationships with the rest of the world. Indeed, until the 1970s Chinese economy had been closed, with negative effects on technological progress and capital accumulation (He et al., 2009: 88). Then, the Asian Tigers’ economic boom proved that ELG strategies could benefit the economy more than self-imposed isolation. Thus, Chinese governments started undergoing fiscal facilitations to foreign invested enterprises, as well as reforming external trade -control reduction on imports; tariff and non-tariff barriers lowering; export licenses increasing; exchange rate reforms. Opening-up culminated with WTO membership in the second half of the 1990s.

Exports played a major role in this economic performance: Goldstein highlights they accounted for 23.3% of Chinese GDP in 2000 and for 36.6% in 2008 –notice that global net exports accounted for 44.2% of GDP in 2000 and for 65.1% in 2008 (2011: 69). In 2009 China outpaced Germany for the first time and became the top exporting country at global level thanks to its multinational firms assembling parts imported from other Asian countries (Goldstein, 2011: 72). In
2011 China ranked among the first three goods suppliers for 96 countries out of 140, and was the first one for the US and Japan (Goldstein, 2011: 74).

Chinese exports mainly consist in low value-added goods that have to be processed in other countries, such as Hong Kong (Goldstein, 2011: 68). China is a key player in global value chains, especially in textiles and electronics: BRICs exports in the latter sector almost doubled between 2002 and 2007 mainly thanks to China (Goldstein, 2011: 77). Branding and final products distribution compete to western corporations (Goldstein, 2011: 74): apparently, China has only marginal profits in terms of value-added. Nonetheless, Chinese firms are highly specialized in their parts of production chain, so that they minimize costs and have economies of scale that explain why China is the “firm of the world” (Goldstein 2011: 75).

One crucial aspect to this dissertation is that Chinese ELG strategy strongly relies on an artificially low exchange rate: Chinese yuan is under a sort of fixed exchange rate regime to US dollar, which is justified by the government as the only way to boost exports and raise the country from poverty (Goldstein, 2011: 143). The Economist’s Big Mac Index, which is based on purchasing power parity, gives a clear outlook on such a permanent yuan undervaluation to US dollar.

Yuan undervaluation has crucial political implications: “the emergence of china and the imbalances of its trade with the United states are shaking the stability of the global system” (Haddad and Shepherd,2011: 1); G20 countries have been calling for a yuan revaluation to reduce global imbalances (Goldstein, 2011: 142). All countries are interested in maintaining yuan fixed exchange rate because of its stabilizing effect on international trade and foreign investment. Nonetheless, such an undervaluation has toxic effects on goods competitiveness on international market –for both developed and developing countries. The debate over yuan revaluation is paralyzed at the moment because the two main actors have opposing interests: since the dollar is still the reference currency, only the US could eventually pressure China for an exchange rate appreciation; but since Chinese investors hold a significant share of US bonds, the government is not likely to submit to such a self-damaging engagement (Goldstein, 2011: 143).

Despite increasing imports, yuan undervaluation plays a key role in supporting Chinese enormous commercial surplus because of the expectations mechanism operating under fixed
exchange rate regimes—which we have analyzed in the first part of this dissertation. Whenever investors are persuaded that a revaluation might occur, further appreciations in exchange rate are expected and foreign capitals flow in. But yuan underestimation alone is not sufficient to explain China’s surplus—which resisted despite an exchange rate appreciation by 20% between 2005 and 2008; indeed, we have seen above that another key factor is Chinese centrality in global value chains (Goldstein, 2011: 143).

Also, yuan possible revaluation is an issue for developing countries: some economists believe Chinese huge growth damages them—the difficulty in gaining market shares is leading to their gradual de-industrialization; others are persuaded that China is a sort of engine for the whole Far East: an eventual yuan appreciation would not only damage Chinese exports, but also would have negative consequences on other developing countries (Goldstein, 2011: 143).

Even if yuan revaluation is not likely to occur, the Chinese government seems to start perceiving the necessity of modifying the traditional development pattern by diversifying production, as well as paying more attention to the domestic market and introducing social services and assistance (Goldstein, 2011: 143). However, this is rather a unique case of undervaluation representing the commercial strength of a country rather than its weakness; certainly it is a key factor in Chinese ELG strategy, but not the only one. China’s development pattern has highly specific features; and countries considering devaluation policies as a viable option to spur economic growth through exports cannot ignore it.

2.3 The western approach to international trade and devaluation policies

2.3.1 Beyond export-led growth strategies: developed countries as global actors of international trade liberalization

We have discussed how the concept of export-led growth is more often associated to developing rather than developed countries: apparently it has been a more individual story, whenever a non-industrialized country (Japan, China, the Asian Tigers…) has managed to combine exchange rate reforms, technological progress and specialization of goods production in order to empower economic performance through exports. Of course, this has been a key factor in developed countries’ commercial pattern too; but after earlier stages where they were often playing singularly against each other, developed countries have given impulse to international trade liberalization by building up economic regimes—which have been reproduced at regional level by developing countries (i.e. ASEAN, MERCOSUR…).

Western countries’ individualism brutally decreased after World War II: protectionism was reputed to be ideologically linked to the strong nationalism that poisoned international relations after World War I. The new idea of a “positive correlation between trade and peace” (Hoekman and Kostecki, 2001: 25) gave impulse to the creation of international organizations, such as the International Monetary Fund or the World Bank. Between 1947 and 1948, 23 countries signed a temporary treaty—the General Agreement on Trade and Tariffs (Hoekman and Kostecki, 2000: 38).
The necessity to contrast “beggar-thy-neighbor protectionism\(^5\), competitive devaluation, and capital controls\(^6\)” justified the gradual emergence of the institutional structure that became one of international trade’s pillars (Hoekman and Mavroidis, 2007: 7). Even if sharply criticized in following years, the GATT played a crucial role in stabilizing postwar international relations, exchange rates and monetary flows; while (some) developing countries were experiencing mainly at individual level the benefits of export-led growth, developed countries stepped forward in fostering such a complex economic regime at global level. Clearly, devaluation and depreciation policies were not seen among developed countries as a path to postwar economic recovery through trade.

Since the 1960s GATT members have addressed different aspects of trade liberalization: non-tariff barriers; technical barriers; intellectual property rights; (Hoekman and Mavroidis, 2007: 12). Some members (in particular the United States) have criticized the gradual expansion of GATT measures as it appeared not to improve domestic industries competitiveness and (paradoxically) to further limit trade liberalization.

In 1994 the WTO was created and international trade liberalization did not only concern OECD countries anymore (Hoekman and Kostecki, 2000: 40). The new institution embodied the General Agreement on Trade and Services (GATS), the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs) and the GATT (Hoekman and Kostecki, 2000: 37). The WTO can currently be qualified as the “regulator of regulatory actions taken by governments that affect trade” (Hoekman and Kostecki, 2000: 41); it is the pulsating core of an economic regime, a set of rules and procedures (Hoekman and Kostecki, 2000: 25).

Some of the principles underlying the WTO functioning can help understanding in what economic cooperation overcomes simple ELG strategies. First of all, there shall be no discrimination between national and foreign goods (Hoekman and Kostecki, 2001: 29). Then, levels of protection among different members’ markets should gradually converge in order to fight against free-riding in international trade, as well as to reduce reciprocally externalities resulting from commercial policies implementation (Hoekman and Kostecki, 2001: 32). Also, dispute settlement procedures are established to ensure the enforcement of members’ commitment—a fundamental guarantee for developing countries (Hoekman and Kostecki, 2001: 34). Transparent access to information and accountability to other members should reduce potential conflict (Hoekman and Kostecki, 2001: 34); the regime’s legitimacy is enforced as long as members actively participate to multilateral surveillance of trade policies.

### 2.3.2 Devaluation policies as a necessity: the case of the United States

We have seen that newly industrialized economies undergo currency undervaluation to boost exports more frequently than western countries (Di Gaspare, 2011: 359); such a reluctant approach to exchange rate adjustment is a typical feature of economic organizations trying to discipline international trade. For instance, art. IV section I of the IMF charter clearly states that members should:

\(^5\) Measures to contrast devaluation and depreciation policies’ domino effect: if trading partners are persuaded that a country’s reduction in exchange rate might negatively affect their industries, in turn they might undergo depreciation or devaluation policies to preserve competitiveness.  
\(^6\) Developing countries were often reluctant to open domestic markets to foreign access, as financial speculation could have destabilizing effects on raw materials price and exchange rate (Di Gaspare, 2011: 359).
“iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members”.

Developed countries are generally not persuaded of devaluation policies’ viability because they know what are their premises and consequences; in the first chapter of this dissertation we have mentioned how a devaluation is the extreme solution when bad economic conditions result in a country’s impossibility to maintain an excessively high exchange rate. Posner claims that “devaluation is a traditional response to depression”; indeed, historical cases where developed countries adopted such measures were typically related to deep economic crisis: just to mention one, in 1985 devaluation was the United States’ response to the deep recession enhanced by a strong increase in oil prices; as it gradually had a positive effect on exports competitiveness, Klein defines such a measure as a “crutch” for US economic recovery (1990: 4).

What about now? 2008’s financial crisis seems to have paralyzed economic growth among western countries; we have mentioned in the first part of this chapter how an “export-led growth version 2.0” could be the path to economic recovery; but we did not specifically deal with the role that devaluation could play in such a strategy. In particular, current debate focuses on dollar depreciation, as long as the US is reputed to be one of key actors of economic global imbalances. While the “equilibrium approach” depicts such imbalances as a consequence of structural weaknesses, the “disequilibrium approach” claims they result from the opposition between China surplus and United States deficit7 (Haddad and Shepherd, 2011: 2). From this latter point of view, dollar depreciation is a necessity to gain commercial competitiveness and to boost economic growth –even if we have mentioned before the international political implications of such a decision.

The mechanism can be simplified like this: US public deficit has to be reduced, but investors seem not to be attracted by bonds; the Department of Economy is forced to increase their interest rate to attract foreign investors; higher are interest rates are not sustainable; the Federal Reserve ends up buying exceeding bonds to lower interest rate (Di Gaspare, 2011: 353) and stabilize US dollar exchange rate (Di Gaspare 2011: 355). Nonetheless, we have seen in the first chapter of this dissertation that the monetary expansion caused by central bank’s purchase results in turn in a depreciation: and this has been the case for US dollar after FED’s operations (Di Gaspare 2011: 354).

On one hand, it is clear that public deficit and dollar depreciation are fostering “dollar-centric mechanism” vulnerability (Di Gaspare 2011: 354). On the other hand, the US have interest in maintaining a low exchange rate because their foreign debt is expressed in dollars: between 2007 and 2011 a depreciation by 40% resulted in a parallel reduction of debt value- even if deficit has been increasing (Di Gaspare, 2011: 355). Also, such reduction in dollar exchange rate had a vital importance in currency war against global exports leaders –above all China (Di Gaspare, 2011: 355). Consequently, many economists claim dollar depreciation is a necessity; but we are more persuaded that devaluation is not answer to the question posed by financial crisis. As explained by Posner, a devaluation has certainly a positive effect on domestic labor demand, as it boosts exports while reducing foreign goods competitiveness; nonetheless, a substantial reduction in dollar exchange rate could damage the US accountability on financial markets as it is the “major

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7 This deficit results from a combination of fiscal expansions leading to excessive public expenditure and financial innovations fostering private one (Haddad and Shepherd, 2011: 2).
international reserve currency”. Dollar is a source of wealth for the US, as developing countries buy them to increase their reserves; thus, it needs stability rather than a floating exchange rate.

3. Italian exports: the evolution from lira competitive devaluations to the sole currency

In the third section of this dissertation we will discuss the complex relationship between euro, exports and economic growth within a specific framework –the Italian one. We will try to understand how current dissatisfaction with the sole currency originated since its adoption at the end of the 1990s; we will focus on the claim that the shift to the sole currency has undermined Italian exports competitiveness, and have a quick glance at our exports pattern before euro adoption. First of all, we will address the question of competitive devaluations, and we will pay particular attention to 1992’s dramatic episode; we will see how such exchange rate manipulations were the external manifestation of our country’s political and economic fragility, rather than a method to encourage exports and economic growth. Secondly, we will analyze Italian gradual commitment to exchange rate stabilization within the European framework: despite heavy socio-economic costs, the monetary integration that started with the EMS and culminated with euro adoption represented the path to escape lira exchange rate obsessive fluctuations. Finally, we will discuss euro impact on Italian exports: we will see that our loss of competitiveness is due to structural productivity problems rather than sole currency overvaluation; we will conclude by analyzing reasons why refusing EU membership would worsen rather than improve our commercial performance.

3.1: Italian exports before adopting euro

3.1.1: The vulnerability of Italian lira and competitive devaluations in the 1970s

In the early 1960s Italy had a very dynamic position within the international market: the increasing industrial specialization was leading to the development of quantity and quality manufacturing; commercial relationships with other European countries and the US further spurred innovation and competitiveness of Italian exports (Carli, 1962: 41). The increase in industrial productivity resulted in higher wages and, of course, in higher prices (Carli, 1963: 76): the fight against high and floating inflation rate (figure 3.1) has been the leit-motiv of Italian monetary policies throughout the following decades.

In particular, the Italian Central Bank started to perceive the necessity of inflation-targeting policies from 1964 on: New York Federal Reserve was selling dollars to finance the United States commercial deficit, so that inflation was running in Italy and other European countries as a consequence of such dollar “invasion” (Carli, 1965: 154). We must notice that in that period Italian lira was under Bretton Woods regime, whose specific aim was to stop post-war exchange rate excessive fluctuations. It would have been easier to just let lira exchange rate adjust to increasing prices: but Italy could not give up the commitment to international trade stabilization, which was pursued through fixed exchange rate regime (Carli, 1965: 156).
Adjustments in parity condition (i.e. deflation policies and restriction on imports) were often required, since under Bretton Woods every country could give “inflationist or deflationist impulse resulting from imbalances in balance of payments and ability to maintain or lose currency reserves” (Carli, 1969: 316). Many economists thought that the fixed exchange rate regime was not sustainable anymore because of global economic imbalances (Carli, 1969: 314); nonetheless skepticism towards floating exchange rates persisted because of the related risks of financial speculation on weaker currencies (Carli, 1969: 315) and social costs of resources reallocation – especially within the industrial sector8. Anyway, in 1971 the bad conditions of US economy led to failure of the dollar-centric Bretton Woods regime; a relentless effort from Bank of Italy and Italian Exchange Rate Office was necessary to avoid shocks and speculation on Italian lira after the shift from the “old” to the “new” exchange rate regime (Carli, 1972: 452).

Such intervention often coincided with monetary expansions that produced exchange rate reductions; as a result, Italian exports were the only dynamic element of growth within a rather still economic framework (Carli 1973: 494). The international economic crisis due to the shock in oil prices fostered expectations on British pound and Italian lira devaluation (Carli, 1973: 496): this forced the Bank of Italy to sell around 850 billion lira of reserves between 1972 and 1973 –in a desperate rush to protect currency quality rather than quantity (Carli, 1973: 498). Further changes on lira exchange rate were made to stop massive capital exports encouraged by expectations on devaluation, yet the Bank of Italy was reluctant to undergo monetary restrictions that would “suffocate” economic recovery (Carli 1973: 499).

The crucial point to our dissertation is the sharp criticism against Bank of Italy, which was accused to be masking a lira devaluation and enhancing Italian exit from European Economic Community: despite spurring Italian exports competitiveness, such modification in our currency exchange rate was rather an external signal of the then-weakness from both political and economic point of view. Carli, who was governing the Bank of Italy at that time, justified the monetary policy as the only way to defend currency reserves and avoid an effective devaluation (1973: 502).

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8 Under fixed exchange rates it would have been possible to support such “long and painful” process of rebalancing through reserves withdrawal (Carli, 1969: 315).
1973’s oil price shock worsened Italian and other European countries commercial deficit (Carli, 1974: 545): thus, they agreed to limit exchange rate fluctuations against non-European currencies (Carli, 1974: 542). The Bank of Italy was forced to make loans with the United States, the European Economic Community and the International Monetary Fund to finance the intervention on lira exchange rate—which was worth 8850 million dollars in 1974 (Carli, 1974: 545); nevertheless such a struggle was not sufficient to avoid lira massive depreciation by 16-17% and further reserves reduction (Carli, 1973: 543). Thus, Italy could not afford the agreement on European currencies fluctuations, that would limit lira exchange rate against dollar between 459.55 and 576.30 -instead of 561.9 and 672.5 (Carli, 1973: 543). Not only lira devaluation undermined Italian accountability at international level, also such a “bad reputation” affected exports (Carli, 1973: 548).

The situation gradually recovered, until in 1975 lira exchange rate was strong enough to allow reserves purchase—which was necessary for Bank of Italy to refund loans (Baffi, 1976: 630). But a sudden dollar appreciation enhanced expectations of lira and pound devaluation (Baffi, 1976: 631): once again, Bank of Italy’s intervention was required, but the balance of payment situation did not justify it (Baffi, 1976: 632). Exporters tried to find alternative solutions to the hundredth devaluation that would empower inflation -i.e. facilitation on credit access for exporting firms; but avoiding official exchange rate manipulation would not improve its vulnerability. Political instability, worsening balance of payments and insufficient reserves led the central bank to proceed to a devaluation (Baffi, 1976: 633) and further reserves reduction. The Bank of Italy and the Italian Exchange rate Office acted like the economy was under “state of emergency” (Baffi 1976: 635).

In January 1976 lira exchange rate against dollar reached 947 –its minimum level until then (Baffi, 1977: 668); despite successive exchange rate stabilization and commercial debt pay off with main creditors (United States, Germany, United Kingdom), the Bank of Italy still needed massive loans from the EEC (Baffi, 1977: 669). Long-term negative effects of devaluation policies are crucial to our dissertation. We have seen in the second chapter that dollar undervaluation could work for the United States to cut foreign debt quotation; since Italy was not playing a similar key role in world economy, we could not afford such a strategy to reduce interests on our foreign debt – which increased indeed after each devaluation (Baffi, 1977: 670). Also, “after an initial little advantage, the internal prices adjustment to exchange rate” determined inflation10 (Baffi, 1978: 710): proceeding on such a path would mean destroying Italian consumers’ purchasing power.

Inflation-targeting almost obsessed Italian governments and Bank of Italy governors until the 1980s: despite commercial surplus, internal political tensions had a negative impact on lira exchange rate—in 1977 it had lost nearly 40% of its 1973 value against dollar (Baffi, 1978: 712). It was fundamental to enhance positive expectations on lira exchange rate recovery in order to slowdown inflation, increase reserves and preserve exports competitiveness (Baffi, 1978: 713).

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9 This percentage refers to February 1973 levels (Carli, 1974: 543).
10 As we have seen in chapter 1, \( \varepsilon = \frac{EP}{P^*} \); this means that when nominal exchange rate (E) decreases domestic prices (P) increase.
3.1.2: 1992’s lira devaluation: the latest demonstration of Italian weakness within the European Economic Community

It is true that consequential exchange rate reduction partially benefitted Italian exports: for instance, in 1981 lira devaluation by 13% against US dollar and by 9% against other European currencies resulted in a 3% increase in exports competitiveness (Ciampi, 1982: 881). Nonetheless, we have seen that devaluation policies constantly undermined Italian accountability on the international market, as they symbolized the structural weakness of both our economy and politics. Also, the fact of entering the European Monetary System at the end of the 1970s further constrained Italian economy: exchange rate manipulation would have even deeper consequences on our country’s external reputation. This is the reason why 1992’s devaluation probably represented the darkest hour in lira exchange rate history.

At the beginning of the 1990s Tangentopoli scandals shook Italian political system and had negative reflections on economy; also, the Gulf War I had a crucial impact at both international and national level (Castronovo, 2006: 546). Subsequent lira devaluations in previous years had undermined Italian reputation at international level and enhanced sharp speculation; particularly, in 1992 the fear that Denmark could reject Maastricht Treaty empowered the generalized euro-skepticism wave that further spurred speculation on weak European currencies (Italian lira, Spanish peseta). On one hand, it was necessary to reduce interests on massive public debt and stop speculation on lira; on the other hand, although European standards were hard to fit, it was impossible for Italy to simply exit the EEC –the then-PM Giuliano Amato defined such an option as an “impossible autarchy”, as European loans were vital to our economy in such a difficult moment (Castronovo, 2006: 547). On July 10th the government decided an economic operation worth 30 billion lira, while the Bank of Italy was leading operations on currency reserves worth 48 billion US dollars. Such measures were not sufficient to overcome the crisis, and a reduction in lira exchange rate seemed to be the only path to exit: in 1992 the then-MP Amato announced the last devaluation of the 1990s (Figure 3.2). On September 4th lira exchange rate against German mark reached 765,5 and finally on September 13th lira lost 20-25% of its value.

Such a decision benefitted Italian firms competitiveness –in 1992 exports increased by 10%. But Italy had entered the European Monetary System in 1979, which imposed limits on exchange rate manipulations: Italian lira and British pound were forced to abandon the EMS in autumn 1992, and foreign investors were betting on extraordinary “war economy” measures –such as partial stop in interest repayment on national bonds or forced withdrawal. This was certainly not our first devaluation, yet it had the worst impact on Italian international (and European) accountability.

Drastic cuts in public expenditure helped Italy to gain back at least part of its international reputation (Castronovo, 2006: 549). The commercial surplus scored in 1992 was certainly due to devaluation but also to imports steadiness, as internal demand and consumption were depressed by austerity measures (Castronovo, 2006:548): this highlighted the urgency to find alternative and less painful solutions to boost exports –such as “Made in Italy” diversification, for instance by

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13 Ibid.
14 Ibid.
expanding heavy industry. The 1992 episode definitely proved how devaluation represented the “concentration of all dysfunctions and anomalies within our economy and our public institutions” (Castronovo, 2006: 558).

### 3.2: Italy and European integration: gradual constraints on freedom to devaluate

#### 3.2.1: Brief history of European limits to lira exchange rate fluctuations

European integration benefitted Italian exports, which played a key role in post-war economic recovery – they almost doubled between 1958 and 1966 (Carli, 1967: 267). Nonetheless, Italian firms’ competitiveness was seriously undermined by debts, whose level was sensibly higher than European average: for instance, between 1963 and 1965 debt accounted for 57% of overall activities in Italian firms against 32% in Benelux (Carli, 1967: 268). Also, 1971’s Bretton Woods breakdown could further threaten European currencies (and particularly Italian lira) grip on international markets: thus, EEC members agreed to limit exchange rate fluctuations.

The first step was the creation of the so-called “snake in the tunnel” in 1972: a variation by ±2.25% of a given exchange rate value was allowed between European currencies and against US dollar. (Carli, 1973: 446). After shocks in oil price destroyed the “snake in the tunnel”, in 1979 the European Monetary System was created. The EMS was based on a special currency, the ECU, which represented a basket of European currencies; EEC members limited to ± 2.25% their currencies exchange rate fluctuations against ECU – once again, Italian lira was an exception, as variations by ±6% were allowed. Also, each member agreed to transfer 20% of currency and gold reserves to a shared fund.

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15 L’Unione Economica e Monetaria (UEM) e l’euro.
When Italy entered the EMS in 1978 (Baffi 1979: 757), the then-PM Giulio Andreotti claimed that “a revolution without revolution” was enacted (Gualtieri, 2004:185). Indeed, the EMS represented the earlier stage of an economic and monetary integration process that would permanently change our development pattern. Italy was forced to reduce lira exchange rate by 4% against other European currencies in order to meet the EMS standards: more competitive exports helped fighting against unemployment and resulted in a “satisfying combination of stability and growth” (Baffi 1979: 758). EEC members (and particularly Germany) strongly agreed to Italian participation to the EMS, as they perceived lira competitive devaluations as a threat to their industrial development and exports (Gualtieri, 2004: 187).

The EMS had a crucial importance in stopping speculation on lira, but negative expectations on our currency stability forced the Bank of Italy to a relentless intervention (Ciampi, 1980: 848); the effort to meet EMS standards had a deep political and social impact (Gualtieri, 2004: 187). As we have seen above, devaluation had deep socio-economic consequences as well; but its negative impact on Italian accountability at international level proves that it is but a viable option to boost economic growth. European integration could rather be the way for our small economy to gain global market shares, even though it is certainly not easy to bear its costs—and it was particularly hard after economic imbalances resulting from Germany reunification. Italy had even managed to fit the 2.25% exchange rate limit in the early 1990s; but we have seen above that 1992’s massive devaluation caused Italian exit from the EMS. The British pound similar condition finally made EEC members enlarge exchange rate parameters to 15% in 1993.

The ultimate stage of economic stabilization was a three-step process of monetary integration: it started with the shift from the EMS to the European Monetary Union, that was successively embodied in 1992’s Maastricht treaty. The first step (since July 1st 1990) included the creation of structural funds to reduce regional imbalances between EEC members and encourage economic convergence, as well as the gradual reduction of exchange rate control to spur capital flows. Then, since January 1st 1994 the European Monetary Institution should be created while fostering national central banks independence and establishing criteria for public debt reduction. Finally, since January 1st 1999 the European Central Bank should be the European monetary policy-maker instead of the European Monetary Institution, and the sole currency should be created.

3.2.2: The shift to the sole currency: the final stop to lira’s “whirling dance”

At the end of the 1990s, 12 of the then-15 EU members agreed to establish euro as their sole currency; in particular, since 1999 it was used in not-cash transactions and since 2002 in all payments. Denmark, Sweden and United Kingdom have refused to enter the Eurozone, yet the EMS II was created in order to stabilize the exchange rate of their currencies against euro. The 12 adopting countries necessarily had to fit five convergence criteria: the respect of exchange rate parameters for at least two years; public debt under 60% of GDP; inflation rate under 1,5% of the

17 L’Unione Economica e Monetaria (UEM) e l’euro.
19 L’Unione Economica e Monetaria (UEM) e l’euro.
average three lowest inflation rates among EU members; interest rate under 2% of the average three lowest interest rates among EU members; deficit under 3% of GDP.

Also, the adopting countries committed to transfer reserves to the European Central Bank - 15% of which consisted in gold and 85% in non-EU currencies, mainly dollars. The sole monetary policy was clearly inflation-targeting oriented, and the permanent stabilization of exchange rates within the Eurozone was a fundamental step of such a strategy. On one hand, it is not difficult to guess that Italy has made an impressive economic effort in order to meet European conditions; on the other hand, adopting euro has stopped that vicious circle of speculation and devaluation that lira apparently could not exit on its own. Permanent exchange rate stabilization has had a positive effect on Italian public debt and import costs –raw materials have become cheaper thanks to this stronger currency (Castronovo, 2006: 580).

Nonetheless, euro was (and still is) but a miraculous solution to Italian structural problems: high unemployment rate (especially in the South); welfare state and public administration huge costs; low-quality infrastructures; firms loss in competitiveness (Castronovo, 2006: 580). Opposite, entering the Eurozone required a stark economic effort and had heavy socio-economic costs. Firms size was one crucial issue: 90% of Italian firms were small or eventually medium and traditionally family-driven; they represented the core of Italian exports, yet they were not competitive at international level -especially when facing export leaders from East Asia (Castronovo, 2006: 582). Also, the Asian currencies devaluation consequential to 1997-98 financial crisis seriously undermined “made in Italy” exports pattern (Castronovo, 2006: 583): in that period Italian imports from East Asia increased while exports decreased by 0.8% in 1998 second semester.

One year later Italian adoption of euro, Ciampi still defined it a “technical success”, as it was gradually becoming an international reserve currency. Nonetheless, prices sensibly increased over expectations even because of the economic stagnation in Europe persisting in the early 2000s; in Italy, such increase was 1% higher than the average among other EU members. The then-PM Romano Prodi successively claimed that the heavy consequences on consumers’ purchasing power resulted from the lack of governmental control on prices conversion and from speculation during the transition from lira to euro.

Ten years later, in Italy purchasing power reduction was estimated around -39.7% and prices increased by +53.7%23. A typical, popular (and eventually populist) claim is that “it was right to enter euro but we made it under wrong conditions”: this massive, unexpected increase in prices would be the consequence of an excessively low lira exchange rate against euro - Italy’s “original sin”24. Indeed, in this perspective the exchange rate should have been 1500 lira against 1 euro – instead of 1936.27; this would help fighting inflation25, yet a “super-lira” would not facilitate Italian exports. Such a strong exchange rate would require even bigger sacrifices for our economy to enter Eurozone and rebuild Italian accountability.

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20 La congiuntura e le politiche economiche. Bollettino economico n.31 (1998).
21 Ciampi: “L’euro, un successo ma ha fatto salire i prezzi” (2002).
22 Mille lire pari a 1 euro, il grande imbroglio che ci ha impoverito (2012).
23 Ibid.
25 See note 3.
3.3: Italian exports under fixed exchange rate regime

3.3.1: Has euro benefitted Italian exports?

The shift to the sole currency has had a deep, unexpected influence on purchasing power; we shall focus now on the impact on exports. On one hand, we might expect a stronger currency to damage our commercial position; on the other hand, the fact of joining a permanent partnership with other European countries should have a positive influence on Italian status as international trader. The truth is that “since euro was adopted, Italian competitiveness has been constantly worsening, mainly because of productivity stagnation and exports unfavorable pattern”\textsuperscript{26} (see figure 3.3).

2008’s financial crisis has worsened and deepened the effects of stagnant productivity; this results from a combination of various elements: lack of industrial and technological innovation; weak human capital accumulation; labor market deep fragmentation and inefficient organization; highly centralized wages contracting\textsuperscript{27}.

Costs and structural dysfunctions have caused a relentless loss of international competitiveness: Italy has been shifting from a 2% commercial surplus in the early 1990s to deficit around 3.2% in 2011\textsuperscript{28}. It is true that some kind of “currency overvaluation” was estimated by the IMF between 5 and 8% in 2005; but eventual exchange rate adjustment would not be sufficient to recover Italian exports competitiveness without structural reforms. Stagnant productivity pre-existed the sole currency adoption, which has dramatically highlighted the urgency to find effective solutions.

One typical issue within Italian productive pattern is the coexistence of high costs per output unit and heavy taxation, which paralyzes the labor market. Indeed, in both Northern and Southern Italy wages increased by 2.3% between 2009 and 2011 against a European average of 1.6%. At the same time, labor taxation in Italy reached 42.6% in 2010, while in other EU countries it is estimated around 36%. Also, Italian prices grow at the same rate of European ones, yet profits increase is

\textsuperscript{26} Documento di lavoro dei servizi della Commissione. Esame approfondito per l’Italia (2012).
\textsuperscript{27} Ibid.
\textsuperscript{28} Ibid.
slower: this generates further market inefficiency. All of these elements summed up result in a loss of competitiveness in both tradable and non-tradable sector\textsuperscript{29}.

Small to medium, family-driven firms represent another traditional feature of Italian development pattern. These have proved not be competitive enough at global level: it is true that bigger firms are usually more exposed to international economic shocks, but also they have suffered less from recent global crisis effects. Production on higher scale means costs reduction, output diversification, distribution to further markets; if Italian firms managed to enlarge their production scale, it is estimated that output would increase by 37\%. Also, Italian exports should be geographically re-targeted in order to exploit demand for imports in East Asia rather than other EU countries. Finally, a tradable sector re-organization is required, as Italian exports are currently specialized in low technology sectors (textiles, heavy industry, extracting activities) where they suffer from developing countries competition\textsuperscript{30}.

To sum up, it is not deniable that while stabilizing exchange rate and (partially) encouraging Italian accountability in international trade, euro has contributed to worsen Italian commercial position. But we have underlined above that it would be unfair to charge euro with responsibilities on our loss in competitiveness; this is rather related to pre-existing issues: excessive taxation on firms and capital accumulation; market barriers for small and medium firms; expensive contracts execution; persistence of family-driven entrepreneurial model\textsuperscript{31}. Unless Italy manages to overcome these obstacles to innovation, it will not gain back its grip on global trade –with or without euro.

\textbf{3.3.2: If economic stagnation is the question, can exports be the answer?}

\textit{“Toward the beginning of the decade, the main complaint was that the euro was too weak for booming economies like Ireland. Now the complaint is that it is too strong for growth-challenged countries like Italy.”}\textsuperscript{32}

Since the earlier stages of monetary integration, the debate over the sole currency covered several issues –from both economic and political point of view. Persisting dissatisfaction with euro even worsened after 2008, when the Eurozone was particularly affected by international economic shocks. The mix of global financial crisis, dollar depreciation and yuan undervaluation has led more and more European countries to consider the opportunity to exit the monetary union, as the imposed economic standards appear not to fit real economy anymore. In particular, Italy, Greece and Spain were often expected to return to their former national currencies; even before the crisis explosion, in 2005 the then-PM Silvio Berlusconi and Minister Roberto Maroni sharply criticized euro overvaluation and its negative effects on Italian economy\textsuperscript{33}.

Leaving the Eurozone: is this the solution to our economic problems? Eichengreen claims that if lira was re-introduced, its devaluation would be expected: consequent increase in domestic wages value would neutralize any positive external effect in terms of exports competitiveness; also, the value of foreign debt and debt cost services would increase, as we experienced during the 1980s. It is true that such negative effects could be avoided through labor market and institutional reforms

\textsuperscript{29} Ibid.
\textsuperscript{30} Ibid.
\textsuperscript{31} Ibid.
\textsuperscript{32} Eichengreen B., (2010) The euro: love it or leave it?.
\textsuperscript{33} Ibid.
—such as the improvement of fiscal system to reduce deficit; but ordinary evidence suggests how “long and painful” this re-adaptation process would be.

Also, if Italy decided to leave the Eurozone, commercial relationships with EU members would be permanently damaged: Eichengreen underlines how any leaving country would be “treated as a second class member of the EU”. Of course, wealthy countries like Denmark or Sweden have not adopted euro, yet they are first class EU members; but we have seen in this section that several elements have been undermining our country’s international reputation in the last decades. Italy has been frequently accused to be one of Europe’s “bad pupils”: such a fragility is a serious counterargument to any “single-player” hypothesis.

One more issue with lira revival concerns procedural costs: firms, banks, households, as well as the government would be implied in a massive contracts redenomination from euro back to national currency—and it is not necessary to explain how slow and complicated this implementation would be. As highlighted by Eichengreen, when euro was adopted in 1998 EU members agreed to a fixed exchange rate regime in order not to produce a national currency depression in the transition time lag; but any leaving member could not currently undergo such a pre-commitment. This would lead to a “system-wide bank run”: firms and households would move their redenominated deposits to Eurozone banks instead of Italian ones, while foreign investors would not be attracted by Italian bonds redenominated in lira. Also, “it would be unlikely that the ECB would provide extensive lender-of-last-resort support”; and it would be almost impossible for the government to slowdown deficit through banks resources. To sum up, in Eichengreen’s words “this would be the mother of all financial crises”.

Italy is a small but dynamic economy: in this dissertation we have tried to explain why we can afford neither currency massive undervaluation (as global trade leaders do, i.e. China or the US) nor exchange rate fluctuation to empower our commercial relationships. Despite crucial socio-economic issues, euro is fundamental to build up the international accountability we need to spur exports and economic growth.

![Italian exports increase, 1990-2012](image)

*Figure 3.4. Personal elaboration on World Bank data.*
Exports share of GDP was not deeply affected by the adoption of the sole currency: it dramatically decreased in 2008-2009 as a consequence of global financial crisis and its reflection on the Eurozone; but it has been gradually recovering since then (figure 3.4). Italian exports could represent the path to economic recovery: in 2012 they increased by 3.7%, worth 473 billion euro in goods and services\(^\text{34}\); also, exports prices competitiveness improved relative to 2011 (+2.3%) and 2009 (+6.3%) levels. Despite negative effects of 2008’s financial crisis, during the last three years Italy has been more competitive than European partners on global markets. Italian firms are increasingly diversifying output, in order to give new impulse to Made in Italy while competing with global trade leaders such as China or Germany\(^\text{35}\); in such a perspective, EU membership is fundamental to strengthen our reputation within global commercial networks. Some measures have been recently adopted to face this crucial challenge to our economy: for instance, the ICE was created as a special agency to promote Italian commercial relationships and to assist Italian entrepreneurs in US, Asia, Africa. Also, the “Desk Italia” has been introduced to improve the relationship between public administration and foreign investors\(^\text{36}\).

**Conclusion**

This dissertation aimed to analyze the relationship between exchange rate reductions, exports and economic growth, in order to understand if devaluation policies could actually be the starting point of a brilliant economic performance. Our overall conclusion is negative: both theoretical and empirical evidence show that exchange rate manipulations positively influence exports, but their deep implications suggest another path to economic growth should be found – especially in current highly globalized economic context.

The Marshall-Lerner condition assesses that devaluation policies improve exports competitiveness after an initial adjustment stage. Unfortunately, such a theoretical assumption is only part of the story: both small and big economies currently deal in an open, globalized context – where the choice of the exchange rate regime is not neutral. On one hand, undergoing floating exchange rates means keeping sovereignty on monetary policy and freedom to devaluate national currency in order to adjust to both external and internal economic shocks; yet such a regime undermines exchange rates stability and facilitates speculation on weaker currencies. On the other hand, opting for a fixed exchange rate regime helps overcoming this monetary uncertainty; here, devaluation policies are more or less strictly banned –a country is forced to manipulate the exchange rate only when the required economic standards are not sustainable anymore. Thus, a trade-off between accountability on global market and freedom to devaluate is suggested at theoretical level; however, exchange rate manipulation is not encouraged as a solid basis for economic growth.

When shifting to empirical analysis, we might expect to find evidence against such theoretical assumption: low exchange rate is reputed to be the key of exports competitiveness in developing countries. Surprisingly, a closer look to the Asian Tigers case suggests that exports diversification and technological sophistication could explain their impressive economic boom more than low exchange rates –these have certainly helped it, but not entirely enhanced it. One

\(^{34}\) Monti R. (2013) *Valorizzare le esportazioni per ridare slancio al sistema Italia.*

\(^{35}\) Ibid.

\(^{36}\) Ibid.
typical, current argument is that Chinese commercial surplus is mainly due to currency undervaluation; we have seen that yuan low exchange rate certainly improves exports competitiveness, yet this cannot solely explain why China is currently one of global trade leaders. China is an exception rather than a model because of the extremely specific features of its exports pattern; yuan undervaluation is a rare case of low exchange rate representing the economic strength of a country –rather than its weakness. Any other country would probably sink in international commercial competition when choosing to permanently reduce its currency exchange rate by 40%.

Also, the export-led growth analysis highlighted developed and developing countries different position towards devaluation policies. While developing countries apparently conceive exchange rate manipulation as a tool to improve exports competitiveness, in western paradigm this has rather a negative meaning. Developed countries have traditionally opted for devaluation policies when bad economic conditions forced them to do that; thus, they have tried to foster cooperation through economic organizations and fixed exchange rate regimes as an alternative solution to crisis and uncertainty. Unsurprisingly, the only western country which can currently afford devaluation policies is the US –thanks to the fact that dollar is basically the main international reserve currency. Once again, any other country could hardly maintain its credibility on the global market with such a low currency exchange rate –yet it is quite difficult for the United States.

This is particularly true for Italy: we have chosen to focus the third part of our dissertation on this small open economy whose economic history has been featuring the so-called competitive devaluations; we were particularly interested in understanding the impact of European integration on Italian monetary policy –which is often perceived as a “sovereignty theft” at national level. One current, populist claim is that euro has destroyed Italian exports competitiveness. Despite the name, we have found that competitive devaluations had little positive influence on exports in comparison to the impact on overall Italian economy. Before adopting euro, Italy was the typical example of a small, western country which was forced to relentless devaluation because of sharp speculation on lira; such a measure exactly reflected the country’s both political and economic weakness and undermined its accountability at international level. Of course, euro has not magically solved Italian economic issues –opposite, it has worsened them under certain circumstances; but its stabilizing effect on exchange rate cannot be denied. Italian exports have lost competitiveness because of pre-existing structural problems; if Italy ever decided to renounce to its EU membership and take back sovereignty on monetary policies, devaluation policies would not be sufficient to solve such crucial issues.
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