CURRENCY DEVALUATION, LIMITED EFFECT

A worsening external environment and the perception that the economy is deteriorating should keep the Brazilian real undervalued, but the recovery of industry will take much more than a devalued currency.

Solange Monteiro

FOR TWO YEARS, THE BRAZILIAN CURRENCY has been steadily weakening. Last year, the currency dropped 10.5% against the dollar, for a total plunge of 46% since mid-2011. In part, the devaluation of the Brazilian real and several other currencies was due to the tightening of the extraordinarily loose U.S. monetary policy and the resultant lessening of external financing. But the devaluation of the Brazilian real reflects the perception that the economy is deteriorating. In February, the U.S. Federal Reserve positioned Brazil among the countries most vulnerable to changes in U.S. monetary policy, which cemented the international market’s view of the economic outlook for Brazil.

This scenario that today penalizes Brazil, along with Turkey, Indonesia, and South Africa, reflects in part a stampede out of foreign investors ignoring the country’s positive points. Nevertheless, Brazil’s economic fundamentals have
indeed deteriorated, which in an election year intensifies expectations and uncertainties about the Brazilian situation. “Figuring out the course of the exchange rate this year is no easy task,” says Pedro Cavalcanti, professor, Graduate School of Economics of the Getulio Vargas Foundation (EPGE). With rising gross public debt-to-GDP and external debt-to-exports ratios and a deteriorating external current account (3.7% of GDP in 2013), the real is likely to devalue more.

Regis Bonelli, researcher, the Brazilian Institute of Economics (IBRE), points out that the Central Bank’s commitment to controlling inflation will in part slow the pace of devaluation this year, but “Even so, I think the real will be devalued further against the U.S. dollar. Predictability is difficult at this point because the exchange market is mixed-up,” says Bonelli. Nelson Barbosa, IBRE associate researcher, also believes the real will continue to adjust in 2014. He estimates that the exchange rate adjusted by price changes in Brazil and trading partners increased by 20% in 2012 and 2013 and the adjustment is expected to continue.

In this context, the important question is whether a devalued currency benefits Brazilian industry. So far, the numbers do not suggest that: in 2013, manufacturing posted a record trade deficit of US$54 billion—US$12 billion more than in 2012. According to the Brazilian Institute of Geography and Statistics (IBGE), industry output plunged in December 2013 by 3.5%, though it was up slightly for the year as a whole.

Some businesspeople say it takes more predictability to ensure that exchange rate devaluation will have a consistent effect on industry. “Our concern is that the correction that begins to take shape now [in industry] will take time,” says Thomaz Zanotto, head of the Department of International Relations and Foreign Trade, Federation of Industries of São Paulo (Fiesp). José Augusto de Castro, president of the Association of Foreign Trade of Brazil (AEB), explains that “manufacturing exports are not like commodities, for which there are spot sales. They require contracts that have to be met and recalculated when they are renewed.” Other businesspeople admit that a devalued exchange rate alone is not enough to make up for the lost competitiveness of manufactures; becoming competitive again requires structural changes both to reduce the “Brazil cost” and to ensure that the country’s economic fundamentals improve. “Industrial policy based on exchange rate devaluation alone does not work. We need efficiency,” Cavalcanti says.

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Silvia Matos
**RELATIVE PRICES**

José Luis Oreiro, professor at the Institute of Economics of the Federal University of Rio de Janeiro (UFRJ), argues that there is room for further correction of the exchange rate: “I have no doubt that the Brazilian real is overvalued in terms of industry competitiveness as well as the external current account deficit, which is approaching an unsustainable 4% of GDP.”

Silvia Matos, IBRE researcher, stresses the imbalances associated with the current account deficit. “A country with low domestic savings like Brazil is expected to have a higher current account deficit and require external funding,” she explains. In the Brazilian case, however, the expanding external current account deficit is accompanied by low growth, high inflation, and a fiscal deficit: “It would be acceptable for Brazil to have a large current account deficit if fixed investment was high, the government had a balanced budget, and public debt was not growing. Then the country would be on a path of sustainable growth. But that is not the case.”

What is holding up the adjustment of the balance of payments are economic policies that slow the pass-through of currency devaluation to prices. The adjustment of the current account requires a healthy increase in the price of goods traded internationally, such as oil products, relative to goods traded only in the domestic market, such as services. Unless there is a change in relative prices, Brazil will continue to import more than it can afford and export less than it could. Between June 2011 and November 2013, the

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**Most emerging market countries had their currencies devalued.**

(Effective exchange rate adjusted for inflation; above 100 indicates appreciation)

<table>
<thead>
<tr>
<th>Country</th>
<th>Dec 2010</th>
<th>Dec 2012</th>
<th>Jan 2014</th>
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<tbody>
<tr>
<td>South Africa</td>
<td>98.7</td>
<td>96.0</td>
<td>75.6</td>
</tr>
<tr>
<td>Argentina</td>
<td>105.3</td>
<td>88.4</td>
<td>74.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>103.6</td>
<td>90.0</td>
<td>85.4</td>
</tr>
<tr>
<td>China</td>
<td>101.5</td>
<td>110.1</td>
<td>121.2</td>
</tr>
<tr>
<td>Mexico</td>
<td>102.0</td>
<td>99.7</td>
<td>101.4</td>
</tr>
<tr>
<td>Russia</td>
<td>99.8</td>
<td>106.9</td>
<td>103.2</td>
</tr>
<tr>
<td>Turkey</td>
<td>98.1</td>
<td>92.8</td>
<td>80.0</td>
</tr>
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Source: Bank of International Settlements (BIS).
nominal exchange rate was devalued by 46%, but the prices of goods traded internationally fell by 6% relative to prices of goods traded domestically. Matos says that the main reason is the policy of controlling fuel prices, which prevents the pass-through of devaluation to the prices of gasoline and other petroleum products.

Price controls were largely responsible for the problems of the energy sector in Argentina, Zanotto warns. “Today this is contributing to the worsening of this country’s economic situation,” he says. With wages rising and prices of goods traded internationally not growing much, consumption and imports have been stimulated to a pace the economy can no longer maintain.

INTEREST RATES AND CURRENCY VALUE
Continuation of the exchange rate correction is arousing optimism among Brazilian manufacturers who were penalized by its appreciation in 2010 and 2011. Zanotto explains that, in addition to improving the terms of trade for Brazil’s commodities exports, the country’s high interest rate caused an undue appreciation of the Brazilian real against dollar, which attracted foreign capital. “The previous government liked the formula,” he says, “because it created a wealth effect, in which people consumed imported goods for artificially low prices, while helping fight inflation. But that was wearing down the entire domestic production chain.” Carlos Pastoriza, director of the Brazilian Association of Machinery and Equipment (Abimaq), agrees that the effect was significantly more toxic in longer production chains. He says the gradual loss of profit margins and market share resulted in

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the substitution of imported for local goods. “The vehicle industry, which in the past had 95% of its parts supplied domestically, now has less than 40%. This is what we call silent de-industrialization,” he says.

Guilherme Mercês, manager of Economics and Statistics of the Federation of Industries of Rio de Janeiro (Firjan), is another who argues that a devalued exchange rate cannot compensate for industry’s lack of competitiveness: “There is no ideal exchange rate for industry. A devalued exchange rate can help in the short term insofar as it increases the profitability of exports, but in the long run, devaluation cannot overcome all the problems related to the Brazil cost, which makes our products more expensive than those of our competitors in the international market.”
AEB’s de Castro reinforces the point, noting, “Today I advocate less concern about the exchange rate and more about production costs. The exchange rate varies according to the wishes of the market. But the cost is within a company’s control.”

**STRUCTURAL REFORMS**

There is consensus that, in an election year, little will change. “This year, the outline has already been given by the government and the Central Bank … to prioritize the fight against inflation and monitor exchange rate devaluation,” Zanotto says. José Julio Senna, head of the IBRE Center for Monetary Studies, points out that the best way for Brazil to take advantage of the recovery in developed economies is to improve international perceptions of its own economy: “The best way to protect the economy is to strengthen it, demonstrating that it is less vulnerable to inflation and the current account balance.”

To adjust the exchange rate and the external balance, according to analysts, the next government will have a long list of tasks to resume structural reforms, starting with a more robust public budget and adjustment of controlled prices. “Today inflation limits our room for maneuver, but in 2015 we must correct fuel prices,” Matos says. She also recommends reducing subsidized National Development Bank loans. Cavalcanti argues for pension reform to increase domestic savings.
Speaking for industry, Firjan’s Mercês sees three broad priorities: “We have a heavy and complex tax system. In infrastructure, we have the most expensive energy in the world, and there are deficiencies in telecommunications, such as the low quality of broadband.”

Fiesp’s Zanotto underscores the difficulty Brazil faces from having the highest interest rates in the world, adding, “We have to fight high interest rates that bring about an undue appreciation of the exchange rate.” Although managing interest rates is a classic and effective remedy against inflation, Senna points out that applying it requires skill: “The interest rate alone is not enough; it must be complemented with fiscal adjustment, in the right dosage, in order not to impact public accounts and be counterproductive,” he explains. Cavalcanti adds that attracting foreign capital is important for a country that saves little. As long as there are no reforms to increase domestic savings, he says, “we cannot afford to stop attracting capital.” Matos notes that Brazil is still dependent on imported technology to improve its productivity, and external financing, if well used, would bring positive results to the productive sector.

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