The exchange rate dominates the economic debate

Klaus Kleber, São Paulo

The economic debate in Brazil today is primarily about the exchange rate and its impact on national development, as was demonstrated in September at the seminar on “The role of industry in Brazil’s growth” sponsored by the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV) at the Federation of Industries of São Paulo (FIESP).

Luiz Guilherme Schymura de Oliveira, IBRE director, emphasized the importance of the debate, given factors that have affected Brazilian industry. In his view, the declining share of industry in gross domestic product (GDP), from 36% in 1985, measured at current prices, to 17% in 2008, should not be cause for surprise, since it follows an international trend. As a country’s income increases, demand for services rises, so the share of industry in GDP decreases. Brazil is no exception.

In recent years, however, the “China effect” has become worrisome, Schymura said. Chinese manufacturing is competing more intensely with Brazilian manufacturing, especially in South America, Brazil’s main export market. Within Brazil cheaper Chinese products are also competing with products made domestically. However, there is no evidence of deindustrialization. Employment in Brazilian industry grew from 13% of total employment in 1992 to 14% in 2008, according to the National Household Survey (PNAD). In the same period, the share of manufacturing in total gross fixed capital formation (GFCF) increased from 14% to 18%.

Price

Highlighting the importance of the seminar’s subject, Benjamin Steinbruch, acting president of FIESP, said that Brazil is paying the price for its success. In recent years, the country managed to add 50 million consumers to its domestic market, 30 million people having risen into the middle class and 20 million having been assisted by government social programs. This was done by controlling inflation, an organized production system, and a sound financial system. The services and agribusiness sectors are also doing well. But there is a lack of synchronization between growth in Brazil and in other countries whose economies still have not overcome the effects of the global credit crisis and still have much of their industrial capability idle. There is thus a serious imbalance between supply and demand in international markets.
“China and Brazil are now major targets of the world,” said Steinbruch. In his view, because of the peculiarities of its economy China is able to protect itself. That makes Brazil the biggest target for countries trying by every means to increase their exports. “Besides the low price of imported goods,” he said, “nine Brazilian states are subsidizing imports by deferring the VAT. Normally, imported goods would pay 12% VAT but they end up paying 3%.”

The fall in industry’s share in GDP is occurring prematurely because of the overvalued exchange rate, Steinbruch observed. He also cited the “Brazil cost” as another major problem. He explained that to build a steel plant in Brazil with annual capacity of five million metric tons requires an investment of US$5 billion. In China it is possible to build the same plant for US$3 billion. In addition, a steel plant of this size would take five years to build in Brazil and only three years in China.

Steinbruch called the adjustment of salaries of 10% or more obtained by some categories of workers a “time bomb.” Besides increasing the cost of domestic production, increases of about 4.5% above inflation that have been granted to some categories where there is a shortage of trained and skilled workers affect consumption and increase imports.

Exchange rate disorder
Finance Minister Guido Mantega, citing the August cover story of The Brazilian Economy, agreed that there is no deindustrialization in Brazil but also was very concerned about the evolution of the exchange rate. He said the capitalization of Petrobras attracted estimated foreign capital of more than US$15 billion, but the government has the means to prevent currency appreciation. Mantega mentioned its successive purchases of dollars to support the exchange rate against the U.S. currency that had increased foreign reserves to over US$275 billion by October 1.

The minister assured participants that government has a battery of measures available to avoid further appreciation of the real. Besides action by the Central Bank, the government may apply to Brazil’s Sovereign Fund or use fiscal instruments, as it did in early October, when it increased from 2% to 4% the tax on financial operations related to fixed-income securities and investment funds.

Mantega said he plans to take the exchange rate issue to the G20 for discussion. In his view, there is an ongoing “currency war” prompted by China, which remains adamant in its decision not to let the yuan appreciate. Thus, each country seeks to devalue its own currency, as did Japan and other Asian countries; the United States let the dollar slide down. The managing director of the International Monetary Fund, Dominique Strauss-Kahn, said he would not rule out the possibility of a global currency war, but he believes that is unlikely.

Minister Mantega promised a realignment of the VAT rate but did not specify how it would be done, since decisions on the tax must be

There is an ongoing “currency war” prompted by China, which remains adamant in its decision not to let the yuan appreciate.

Guido Mantega, Minister of Finance
approved unanimously by the Council on Tax Policy (Confaz), which is composed of the 27 state Secretaries of the Treasury. Naturally, states that consider themselves worse off will claim compensation from federal authorities even though federal finances are precarious and the government has used fiscal gimmicks to keep the public sector primary surplus at 3.3% of GDP this year.

**Primary products**

Businesspeople participating in the meeting emphasized the increasing share of primary products in Brazilian exports at the expense of industrial products. For exporters of primary products, rising commodity prices offset the exchange rate appreciation, which does not happen for the industries that have been forced to give ground in foreign markets. According to data presented by Roberto Giannetti da Fonseca, director of the FIESP Department of International Relations, the share of manufactured goods in Brazilian exports fell from 61% in 1994 to 44% in 2008. Exports of commodities rose from 20% of total exports in 2004 to 41% in 2009.

Giannetti admitted that good prices have strengthened commodity exports, which would tend anyway to have greater participation. However, it seems unacceptable that industrial products have been losing competitiveness against other countries not only because of the “Brazil cost” but also because of the decision to maintain an exchange rate policy contrary to that of other countries. Between 2004 and the first half of 2010, the Brazilian real appreciated by 41%, the most in the world (the Colombian peso was in second place, having appreciated by 33.6%). In the same period, among other emerging countries Turkey devalued its currency by 7.6% and Mexico by 16.3%.

Industry also suffers the effects of increasing imports of consumables. Among the reasons that Brazilian industry has lost competitiveness Giannetti cited not only the overvalued exchange rate but also tax rebates, failure to negotiate trade agreements, Chinese competition, and lack of adequate financing for exports.

On the importance of industrial policy and technological innovation, José Ricardo Roriz Coelho, director of the FIESP Department of Competitiveness and Technology, pointed out that it is difficult to find countries that have made productivity leaps without putting in place policies to foster productive development. He said that such policies “should be seen by society as part of a growth strategy that aims to expand opportunities for everyone, not just for the privileged sectors.”

Brazil must therefore fund the instruments of the Innovation Law, increasing investments in research and development (R & D), which are very low in Brazil compared to GDP but may improve as a result of the Policy for Production Development (PDP). Coelho noted that the PDP does not include subsidies or tax breaks, or anything else that would violate

---

As incomes increase, demand for services rises, so the share of industry in GDP decreases. Brazil is no exception.

*Luiz Guilherme Schymura*
World Trade Organization (WTO) rules. What is provided is tax relief for investments in equipment and R&D.

**Vulnerability**

Lia Valls Pereira, chief economist at the IBRE Center for Foreign Trade, said that the fiscal crisis in the 1990s put an end to the policy adopted in 1970 that aimed to increase exports of manufactured goods through tax subsidies and credits. Due to commitments in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), predecessor of the WTO, the Brazilian government had financed export companies using public funds, the National Bank for Economic and Social development (BNDES), and drawback operations (tax exemptions for the import of raw materials and parts for products intended for export).

Since 1991 there has also been a major liberalization of imports. The average tariff on imports fell from 57.5% in 1987 to 30.5% in 1990 and 11.2% in 1994, though there has been some recent increase in the average, which rose to 13.6% in 2008. Most protected are industry, with an average tariff of 14.1%, and agriculture, with 10.2%. The maximum rate permitted by the WTO is 35%, applicable to automobiles, garments, and textiles, imports of which, despite the high tariff and other charges, have been increasing in recent years.

In recent decades, said Valls, Brazil has made little progress on its agenda for trade agreements. Mercosur has failed to realize the goal of becoming a common market, but Brazil has signed free trade agreements with all the other countries of South America, seeking closer political dialogue with its neighbors through the Union of South American Nations (UNASUR). As negotiations with the European Union (EU) are proving increasingly problematic, Brazil has failed to consolidate any agreements with developed countries.

At the same time, Chinese goods have been crowding out Brazilian exports because of the exchange rate and competition, especially from China, as a new study presented by Valls found. The study identifies products that both China and Brazil export to certain markets that accounted for 70% of total exports by Brazil in 2005 and 64% in 2008.

Brazilian exports fell 40% to the United States and 18% to the EU. This can be explained partly by the increase in the export value of Brazilian commodities. The decline is more pronounced in South America, to which Brazil exports virtually no basic commodities. In 2008, Brazilian export earnings losses reached 41% in Argentina, 52% in Uruguay, and 37% in Chile.

**Opposite situations**

For the economist Samuel Pessoa, head of the IBRE Center for Economic Growth, disparities in economic policies between Brazil and China may not be limited to interest rates and exchange rate policy. While the Brazilian real appreciates, the yuan remains undervalued against the main convertible currencies. “Actually,” he said, “we are the opposite of China. Our savings are low, consumption is increasing, and we have a lot of natural resources. In China, savings are 50% of

The adjustment of salaries of 10% or more obtained by some categories of workers is like a “time bomb.”

*Benjamin Steinbruch*
Brazilian exports have fallen 40% to the United States and 18% to the EU.

Lia Valls

GDP, investment is 40%, and 10% of savings are exported, which lowers domestic consumption. In addition, China is poor in natural resources.”

Moreover, he noted, the Chinese social contract and the nature of its people produce an economy that stimulates the production of manufactures, since in general services are not tradable. The social contract in Brazil is quite different. As a percentage of GDP, income growth was channeled to social security spending (80%) and social programs (10%), including the Family Allowance Program, Bolsa Familia. In recent years, the Brazilian government has spent 13% of GDP on pensions in the public and private sectors and about 3.5% of GDP on real interest payments.

“Building up a great network of social welfare causes private consumption to be strongly procyclical,” Pessoa said. “When the economy goes well, consumption and investment also grow. The low average level of savings means that we have to live with high current account deficits as investment rises.”

He commented that “the Keynesian mechanism has not worked in Brazil: the growth of autonomous spending leads to an elevation of output growth but does not increase savings. Consequently, foreign savings have to fill the gap.” As an example he mentioned that from 2004 through the third quarter of 2008, investment rose from 14% to 19% of GDP but the savings rate was unchanged.

For the country to live with an external current account deficit and not be exposed to an external crisis, Pessoa believes, it should keep a sound fiscal position, adhere to its exchange rate policy, and avoid currency mismatches. He stressed that with regard to foreign direct investment and portfolio investment (investments in stocks and fixed-income securities) the country has to be a creditor in foreign currency and a debtor in domestic currency or equity. In his view, the public sector must also signal that it will not provide the private sector with a hedge against exchange rate variations, leaving it to private companies to hedge their own risks.

Disparities in economic policy between Brazil and China may not be limited to interest rates and exchange rate policy.

Samuel Pessoa, IBRE