What should be done about the exchange rate?

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Former finance minister Antonio Delfim Netto thinks that doing the homework — adjusting the public accounts — is the way for Brazil to equalize domestic and external interest rates. In his view, this would reduce the appreciation of the real against the dollar, and President-elect President Rousseff (PT) can meet this challenge despite pressures for increased spending. But economist Raul Velloso, an expert in public finance, takes another view of the exchange rate issue: unless Brazil gets on the wrong path, he says, capital inflows will continue coming through several doors, so the country must learn to live with an appreciated real. Both agree, however, that manufacturing will decline if the new government does not adopt policies that can counter the negative effects of the exchange rates on manufactured exports.
The Brazilian Economy — Why has the exchange rate appreciated so much in Brazil?

Antonio Delfim Netto — The exchange rate today is no longer the variable that used to balance a flow of exports, goods and services, with a flow of imports, which would depend on the terms of trade. Today, the exchange rate is the price of a financial asset (currencies) that is in the portfolios of 140 countries. Stock exchanges trade currencies, chasing differences in the third decimal place of their exchange rates. Trade in goods and services now accounts for less than 5% of foreign exchange transactions worldwide. According to the Bank for International Settlements, the Brazilian real last April was the most traded currency (US$28 billion a day). In any model, the exchange rate can only reflect the relative prices of imports and exports if the domestic real interest rate is equal to the external interest rate. This is the central point. It is said that ports, transport, education, and government in Brazil are poor, and that electricity is expensive. That may be true but has it changed in the last three years? The institutions may have been equal, but not worse. What else is a factor? The exchange rate.

Raul Velloso — Brazil entered a virtuous cycle in 2003, peaked in 2006, and leveled off until late 2008 when the global crisis erupted. The flood of dollars, the gradual appreciation of the real, and the accumulation of reserves are not new. After the crisis, we again accumulated reserves as we had before, but now in a different context. The United States, Europe, and Japan are purging their excess leverage and debt. Because deleveraging is time consuming and requires more savings to pay down debt, consumption drops. Rich countries dump U.S. dollars in an attempt to revive their economies, and investors seek alternative investment opportunities. With interest rates low elsewhere and high here, it is obvious why Brazil, among the emerging countries, attracts so much capital.

Will the world continue to be willing to provide funds to Brazil?

Delfim Netto — Brazil has every reason to receive a bonus from abroad. We got rid of the external problems that persecuted us and we now have another bonus, deep sea oil, but if we do not use it properly, it will cause problems. One problem is that in 2030 we will have 240 million people and we must have good-quality employment for 140 million of them. We cannot depend only on export of agricultural and mineral products; they are not labor-intensive.

Velloso — The current world crisis will benefit us. While most other countries continue to suffer economically, foreign investors view favorably the export-oriented segments of our economy, such as commodities, and the ones directed to the domestic market, such as cars and buildings. They come here directly as business partners, lending resources, supplementing domestic savings. Attracting capital and increasing exports reinforces the natural tendency of

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currency appreciation. China, for example, is completely different: the foreign market is favored because Chinese save a lot and consume little. Naturally, they are exporting capital.

Is there a way out of the currency appreciation predicament?

Delfim Netto — It is not simple. We need to move toward equalizing domestic and international interest rates. The new government, the finance minister and the central bank governor will together have to assert that they will control spending, which will grow less than GDP, and produce a primary surplus of about 3.2% of GDP so that the debt-to-GDP ratio declines to 30% to 35% in 2014. The obligation of the central bank is to control inflation and make the real interest rate 3%. This we will do in the next 15 months. The increased financial transactions tax (IOF) is a legitimate self-defense. It’s a joke to think that if we cannot control the exchange rate, we will control the current account deficit.

Velloso — Unless Brazil heads in the wrong direction, exchange rate appreciation is inexorable, as it was to some extent before the crisis. The country has to decide whether it can continue buying U.S. dollars and paying the high cost of carrying large international reserves without messing up the public accounts, which will require increased taxes and will further reduce the competitiveness of Brazilian industry.

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Is part of the solution a fiscal adjustment?

Delfim Netto — Yes, we have to do our homework. Chilean economist Ricardo Caballero, director of the Economics Department at the Massachusetts Institute of Technology (MIT), just said, “Let’s get out of Fantasyland and return to reality if we want to do something. Because today we are only consuming”

Velloso — The big challenge is how to handle the additional tax cost of accumulating reserves, which in a few years has jumped from US$60 billion to US$280 billion. There are other ghosts, such as the cost of the expansion of the National Bank for Economic and Social Development (BNDES). Will the new government watch passively the difficult adjustment of the manufacturing industry or will it be more proactive? Will we increase public savings or will we just defend ourselves against attacks on the public purse? Increasing public savings when there are pressures from all sides to increase spending requires twice as much effort. There are people advocating radical measures: the central bank would no longer buy U.S. dollars or restrict the entry of foreign capital, letting the currency appreciate. The external deficit would grow so much that it would help to devalue the real. But imports would grow so much that it would be necessary to recreate the Provisional Contribution on Financial Transactions to subsidize domestic industry.
I do not agree with this solution, but it illustrates the dramatic choices that must be faced.

Why has the central bank not yet adopted a monetary policy that by forcing a rapid decline in interest rates promotes exchange rate depreciation?

Delfim Netto — The latest minutes and the final report of the meeting of the Monetary Policy Committee (Copom) show that the light finally went on. Both documents cast doubt on what had been central bank certainties. Any monetary policy requires three pieces of information: The first is the lag between action and result: interest rates are increased, and in nine to twelve months demand falls. But it may only take six or seven months. It has become clear that this is a variable, not a constant. The second is potential growth: There is nothing more ridiculous than this economist’s invention. Of course, there is a point above which we cannot grow. Three years ago, the central bank was sure that Brazil could not grow more than 3.5%, then it said 4.5%, now it says 5% to 6%. The third is the neutral interest rate: The central bank was absolutely convinced that rate was between 7% and 8%. Now the bank does not say what the neutral rate is; it just says it has been dropping over the years.

Monetary policy should now improve dramatically because this doubt is creative. It will make the central bank much more capable of understanding the Brazilian reality. How did the central bank attract credibility? It underestimated real output and overestimated the neutral interest rate. This hurt growth, but inflation stayed where the bank wanted it. The social cost is huge.

Velloso — We attract more money from abroad not just because we export commodities and we are the “big ticket” for international investors. Another reason is the appreciation of the exchange rate because of the interest rate differential with the rest of the world — while elsewhere nominal rates are about zero, the benchmark interest rate here is about 10%, one of the highest in the world. The first two reasons are here to stay, and the third helped justify the dollar going from R$4 in 2002 to the current R$1.80. Nobody knows how much the dollar should be due to structural issues, but it would certainly be below R$4 and over R$1.60. But in two or three years, when the world returns to normal, international interest will be 4% and our benchmark interest rate between 8% or 9%, so our opportunities will continue to exist, China will continue buying minerals and food that only Brazil has to sell. Our goal for technological development is to make Brazil the largest exporter of commodities. Although there are doubts about future oil prices, with the deep sea oil, Brazil may well become one of the largest players in oil too, as it is in minerals and agricultural products. That is, the prospect is to continue attracting more dollars. And as we save little, we depend on foreign capital.

Will a fiscal shock be necessary?

Delfim Netto — No, because there is not a lack of control. We know that we cannot continue to expand BNDES lending; we must increase domestic

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savings, improve the tax system to exempt investment from taxes, encourage savings, and return the VAT credit to exporters as guaranteed. Brazil remains the champion at taxing exports, and steps taken to alleviate the burden remain on paper only. All this can be done without changing the Constitution. Just changing the VAT will help a lot.

Veloso — The crux of this whole story is old: it’s fiscal. We have accumulated international reserves by issuing public bonds. And that creates large interest payments: 10% of US$200 billion is almost R$30 billion. If each year we accumulate US$50 billion, the annual cost will be about R$8 billion. There is also the additional expense to the Treasury of BNDES lending. It’s sad, because this huge increase in spending is not mitigating the situation of the manufacturing industry. As dollars continue to come in — for another two to three years, who knows? — how will we pay for these international reserves we are buying as we desperately try to stem appreciation of the currency? This is the great challenge of Brazil: how to handle the additional cost of international reserves in public accounts and adjust the manufacturing industry to confront this new reality.

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Can the Rousseff administration, with a strong bias for continuity, achieve fiscal adjustment?

Delfim Netto — Rousseff is an excellent administrator. She follows up. Decisions must be complied with or an explanation given why not. There is a need not for fiscal shock but for relatively calm policy rules and better management. We must ensure that government spending — everything that is not investment — grows less than GDP. This will open space to increase investment. To the extent that the policy of lowering interest rates produces results and the country continues to grow between 5% and 5.5%, the savings in interest payments will make it possible to expand investment. This is a virtuous cycle.

Veloso — José Serra would have had more technical skills to deal with such problems, though experience does not guarantee success. But before long we will know how the president-elect will deal with pressures to increase expenditure, the fiscal cost of maintaining international reserves, and how to save industry from the appreciated exchange rate. Rousseff and her team will have to command a policy that can deal with all three crucial issues early in her government.

In this context, how do we save domestic industry?

Delfim Netto — The exchange rate is destroying the sophisticated industrial system that we built. It is essential to save the manufacturing industry, for industry and services are the sectors that may give some comfort to us. There is no need for a compensatory industrial policy. The exchange rate is an endogenous variable, a relationship between internal and external prices.
If the interest rate is in place, the trend of the exchange rate would be moving in the right direction. And capital movements will be less important. We are funding the debt in domestic currency; we have international reserves and all the conditions for an adjustment. Then the exchange rate will seek equilibrium. The idea that a floating exchange rate adjustment will produce no trauma is absolutely false, because on the day that there is a doubt about the exchange rate, the adjustment will make the exchange rate overshoot, destroying government finances and businesses. We are again inducing companies to borrow abroad.

Velloso — Without an industrial policy the sector will decline. The auto industry will have to find a new role, with the help of government. But in what direction should this support go: a platform for exports to occupy the global space that Asians have not yet occupied? If we remain paralyzed, soon we will have many Asian automakers here. And the suppliers will go along. Unless we believe that high commodity prices have not come to stay, and that China is not here to stay.

Has exchange rate appreciation become a structural problem?
Delfim Netto — If the difference between domestic and foreign real interest rates is a random variable, on average constant and with little variance, the speculation disappears. The exchange rate will be whatever one has to adjust to. If the economy is less efficient, it will be a little higher; if it is more efficient, it will be lower. Our system is canonical: fiscal responsibility, declining debt, inflation targeting, and a floating exchange rate. The defect is that the exchange rate cannot float when the differential between domestic and foreign interest rates is huge and does not disappear. Suppose that the central bank got out of that business. How much would the real interest rate be today? Very close to the rate outside, because it is the central bank that keeps the interest rate where it is and brings in more capital inflows. If the central bank would leave, there would be an invasion of liquidity and the domestic interest rate would fall. The central bank is keeping the real interest rate high.

Velloso — For cyclical reasons, which will still last for two to three years, and structural ones, Brazil is being flooded with dollars. For the time being, commodity prices offset the negative effect of currency appreciation on exports, and the heating of the domestic market relieves industry from competition with imported products, but it is being squeezed by Chinese exports. We are increasingly competitive in agricultural and mineral products. China is indeed good in manufacturing.

Will Brazil have to learn to live with a higher exchange rate?
Delfim Netto — We live with the wage level, and the prices of bananas, coal, and oil. At some point, if we accept this system, which is far from ideal, the exchange rate converges to a proper level. We can say it would actually converge to produce the balance in

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current accounts. When this happens, we will not need anything else. Today, where should the exchange rate be? If we want the exchange rate to produce a balance in current accounts, it should be higher, something like R$2, R$2.05, R$2.08. It’s a guess, no one knows. But certainly there is an obvious overestimation. The dramatic point is that in the last three years all other things remained constant or improved. And the exchange rate has appreciated. So it is the exchange rate indeed. There is no other explanation.

Velloso — The greater weight of commodities in the economy is a change that is here to stay. Brazil has become more competitive in this area with the research of Embrapa (Brazilian Company of Agricultural Research), in spite of infrastructure bottlenecks. We moved from a country that produced little to one that produces a lot of commodities and technology-intensive products, contrary to what one may think. That appreciates the currency. If we had no obstacles, the country would become a star. We have come to occupy a different position in the world. At the same time, several things have matured together: the macroeconomy has been adjusted, which earned us an international investment grade rating, and we have reaped the fruits of a very long process.

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