Finding the right balance for financing the economy

Brazil’s current account deficit is narrowing—but how much longer will the world be willing to finance it?

Solange Monteiro

ONE OF THE FEW ITEMS OF good news for the Brazilian economy so far this year was that the external current account balance improved in the first half. It had been deteriorating since 2010, and at the end of 2014 had a deficit of 4.4% of GDP. For an economy that is barely moving, the 2014 current account deficit of US$104.9 billion was alarming, raising questions about Brazil’s external vulnerability in 2015. Now a worse than expected downturn in economic activity is helping to narrow the deficit. In the first half of 2015, the current account had a deficit lower by 23.4% than in the same period of 2014, and the trade balance recorded a small surplus. “I am much more optimistic than I was earlier this year,” says IBRE research associate Samuel Pessôa. “I think the external
imbalance is declining, and today assessment of Brazil’s sovereign risk is more focused on the dynamics of public debt and fiscal policy.”

IBRE is projecting that by the end of 2015 the current account deficit will fall to 3.7% of GDP, US$69 billion, down from 4.4% in 2014. For 2016, the estimate is for a further narrowing to 3.1%, US$61 billion. However, IBRE researchers Lia Valls and Livio Ribeiro point out that many factors may affect this outlook. “Trade balance risks continue with the prospect of low commodity prices and China’s slower growth scenario, which makes Brazil more dependent on manufactured exports recovering,” Valls says. “The exchange rate devaluation may help, but it does not transform into exports immediately, because we still have to address our structural problem of low productivity. … Nor should we forget that the higher foreign savings, the higher are salaries, interest income, and dividends; people happily consume but it is a disaster for the country.”

Luiz Carlos Bresser-Pereira

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The central bank is expected to hold its policy interest rate at 14.25% for an extended period, which will help to attract foreign investors.

**Cyclical versus structural**

Pessôa sees it as positive that the current external adjustment has a clear structural component. “At first, [the ongoing adjustment of the economy] seems all cyclical, since the decline in economic activity implies a lower current account deficit. But there has been an important structural change in the policy regime. When Brazil resumes growth, the external deficit will not grow to the same extent because fiscal and monetary policy has changed.”

Alexandre Barros, president of Datamétrica Consulting, agrees: “It was a policy mistake to prioritize inflation control by preventing the exchange rate from depreciating with foreign exchange swap operations, which resulted in a large external current account deficit. But the government realized it would not be able to continue to intervene in the exchange rate, and now we have a structural correction.”

Afonso Celso Pastore, former president of the Central Bank, says that the exchange rate has depreciated because the external current deficit.

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**Brazil: Balance of payments projections**

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<td>Reserve assets</td>
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Sources: IBRE estimates using the new Balance of payments manual, 6th edition (BPM6).

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travel and lower profit remittances. He expects that the average exchange rate for 2015 will be R$3.21 to the US dollar, up 36% from R$2.35 in 2014. As for sources of financing, he sees a trend for direct investment in Brazil to drop: “Inflows of portfolio investments should be no problem, but foreign investors will ask for higher yields,” he says, noting that the
account was too large, but such factors as the appreciation of the U.S dollar, the fall in commodity prices, a major slowdown in world exports, and an increase in the perception of Brazil risk have also contributed. “Devaluation was the only solution,” he says. Braulio Borges, chief economist at LCA Consultancy, points out that the current exchange rate is about 40% higher than it was five years ago and it is likely to hold at that level for several years. However, he estimates that it would take two years for the exchange rate devaluation to have its full positive impact on the external current account.

Pessôa and Borges recognize that Brazil’s structurally low savings rate requires foreign savings to finance growth and the external current account deficit. The external current account is the difference between national savings and investment, and a current account deficit may therefore reflect a low level of national savings relative to investment. “We have to accept that our economy is more like that of Australia or Chile, countries whose current account deficits are consistently in the range of 2.5% to 3% of GDP,” Borges says. But what would be an acceptable external current account deficit for Brazil? The appropriate limit, Borges thinks, would be below the long-term average of foreign direct investment in Brazil: “Since foreign direct investment has been running close to 3% of GDP, in our case the ideal would be to maintain a safe level of 2% to 2.5% of GDP.”

**Exchange rate and external surplus**

Borges estimates that an exchange rate of R$3.20 to the US dollar would be sufficient

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**The soaring of the US dollar**

Exchange rate R$1 per US dollar, monthly average

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Source: Central Bank of Brazil.

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“Growth feeds the world’s willingness to finance us.”

Livio Ribeiro
“The idea that we need to attract foreign savings to finance our development is gibberish. In fact, what ends up happening is that by attracting foreign savings, the exchange rate appreciates, and in that way it reduces domestic savings. We have to do the opposite.”

José Luis Oreiro

to keep the external current account deficit within a safety margin of 2–2.5% of GDP. He sees several indications that the competitiveness of the Brazilian real is improving. One example is the popular Big Mac Index: in the mid-July edition of The Economist, for the first time since 2007 the index showed that a Big Mac hamburger in Brazil was 10.6% cheaper in U.S. dollars than in the United States. Another indicator is Brazilian industry unit labor costs measured in dollars, a statistic compiled monthly by the Central Bank; in June it reached the lowest level since 2009. “In the last two years, there has been an important correction [in the unit labor cost] because either the Brazilian currency has depreciated against the dollar or wages in local currency have declined due to the recession,” Borges says. “This indicates that the competitiveness of industry has improved. The exchange rate is already showing signs of having reached equilibrium.”

Would further exchange rate devaluation be advisable in order to zero the current account deficit? José Luis Oreiro of the Federal University of Rio de Janeiro challenges the argument that the structure of the Brazilian economy makes it impossible to have external current account surpluses. “We had a positive current account balance from 2003 to 2007,” he points out, “and before 1994 we also had surpluses.” Oreiro believes that only with current account surpluses will the exchange rate reach the level necessary—close to R$4 per US dollar, he estimates—to induce more robust long-term growth. He argues that domestic savings are reduced when Brazilian policy emphasizes attracting external financial sources. In Oreiro’s opinion, “The idea that we need to attract foreign savings to finance our development is gibberish. In fact, what ends up happening is that by attracting foreign savings, the exchange rate appreciates, and in that way it reduces domestic savings. We have to do the opposite.”

Luiz Carlos Bresser-Pereira, former finance minister and FGV emeritus professor, considers the external current account to be a synonym for immediate consumption. He says, “I agree with Pessôa that we save little. In Brazil we have a high propensity for consumption. But while Pessôa says that there’s no way to change this, I say maybe there is.” He believes the key is to recognize that the deficit reflects imbalance,
not investment. “The higher foreign savings, the higher are salaries, interest income, and dividends; people happily consume but it is a disaster for the country.” Alexandre Barros of the Federal University of Pernambuco state (UFPE) reinforces this point: “Brazil’s savings are not fixed … companies also save, and save more when they have to pay for investments made previously. With more investment, savings will increase.”

For Oeiro, Barros, and Bresser-Pereira, the formula for increasing savings and building the external surplus is more intervention to devalue the exchange rate and more tax increases. Oeiro argues that structural adjustment of the external current account implies a permanent change in the real exchange rate to bring it closer to R$4 per US dollar than R$3. To devalue the exchange rate, he advocates tighter fiscal policy and more expansionary monetary policy, arguing that “A stronger fiscal adjustment would allow a reduction in interest rates and a more sustainable debt-to-GDP ratio.” He notes that “The first Cardoso administration [1995–98] operated with a fiscal primary deficit; early in the second Cardoso administration the primary surplus rose to 3.75% of GDP, primarily through tax increases. Today this cannot happen because the Rousseff administration lacks a cohesive base of support in Congress to make this kind of adjustment.” Barros believes that Brazil should tax foreign currency flows, which would make it possible to raise the domestic interest rate to control inflation without forcing an appreciation of the exchange rate.

For his part Bresser-Pereira supports taxation of commodity exports. That could make up for the difference between an exchange rate for the current account equilibrium that is close to R$3.20 per US dollar, and a rate for industrial competitiveness of about R$3.65, which would make exports of sophisticated goods and services profitable. With such a tax, the cost to produce and export commodities rises and the exchange rate depreciates until the two exchange rates coincide, ensuring the competitiveness of industry.

Pessôa acknowledges that the main difference between these policy recommendations has to do with how Brazilian capacity to save is evaluated. “Many economists agree that to have a devalued and competitive exchange rate requires higher public savings, and a high primary fiscal surplus of 5% of GDP. I think if we reach a surplus of that size, interest rates will fall and the exchange rate will depreciate naturally,” he says. “The question, however, is

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How to achieve a large enough primary fiscal surplus, and how much intervention will be necessary to ensure a competitive exchange rate.” Pessôa is against raising taxes because the tax burden is already high. In his opinion a middle-income country like Brazil cannot have a tax burden of 40% of GDP.

Borges believes that at this point, “Monetary policy should seek to preserve the recent real exchange rate depreciation.” He argues that if the Central Bank targets inflation of about 4.5%, Brazil’s inflation would not be far from average global inflation, which according to the International Monetary Fund is about 4% a year. “The closer we stick to it, the less inflation will erode the depreciation of the exchange rate attained so far,” he says. Borges also advocates that the Central Bank reduce its foreign currency swaps to signal that it will let the exchange rate float.

IBRE’s Ribeiro points out that the external balance also depends on Brazil’s success in adjusting the fiscal balance and on growth resuming. “Growth feeds the world’s willingness to finance us,” he says. He cites the case of Australia: even though it has had a high external current account deficit for decades, it has never suffered a severe balance of payments crisis because it has continuously managed to attract external financing. Another critical factor, in Ribeiro’s opinion, is whether Brazil will retain its investment grade rating, which may affect foreign direct investment less then portfolio investment. “That’s another door of external financing that can close if we cannot maintain our investment grade rating,” he says.