

Brazil is getting into increasingly difficult challenges for policy management, which should ultimately result in substantial currency depreciation and lower real interest rates.

Consider a first paradox for the Brazilian situation: Brazil has initiated a visible monetary policy tightening since the first quarter of 2010, bringing the Selic rate from 8.75% in April 2010 to 12% after the latest 25 bp increase on April 20th 2011. Among large emerging economies, Brazil has by far the highest real interest rates. This is weighing down on investment spending, but not so much on money supply and credit expansion and inflation is still accelerating: at 6.5% year-on-year in April, it is just a shade above the central bank's targeted ceiling. Conversely, the very large interest rate differential with US rates induces large capital inflows attracted by the positive carry, notwithstanding the taxes on short-term capital put in place by the authorities. Such capital inflows push the exchange rate at a level that is a major handicap for non-commodity exporters, while market interventions by the central bank of Brazil to limit such appreciation pressures feed the domestic money supply and run against the initial objective of high interest rates. The bottom line of this paradox is that the currency appreciation progressively becomes the only substantial tool to fight against inflationary pressures.

Natural consequences of this policy mix are growing external imbalances and substantial impediments to long-term growth. Indeed, Brazil is expected to register a current account deficit of USD 65 bn this year, after USD 47.5 bn in 2010 despite the slowdown in economic activity (GDP growth slowing from 7.5% in 2010 to around 4.5% this year) and favorable international circumstances. Considering the potential for commodity price reversal and the expected slowdown in Chinese growth, there are clear downside risks on the external accounts. Simultaneously, anecdotal evidence clearly suggests that the current valuation of the currency is becoming a major hindrance for Brazilian manufacturers. The currency overvaluation also explains that supply is slowing down earlier and on a larger scale than demand, with a growing share of demand satisfied by cheap imports. In parallel, the high real interest rates act as a permanent break on investment spending, with the overall investment to GDP ratio in Brazil below 19%, a level clearly insufficient to ensure an economic growth above 4% per year and therefore to meet Brazilian social challenges over the next years.

TAC quantitative models show that the Real is currently overvalued by about 25%-30%. The IMF index for the BRL real effective exchange rate suggests a 50% overvaluation. With a combination of slower growth, higher external deficits, large speculative inflows and difficulty in cyclical management, the question is now more about timing and triggers for a currency depreciation. Clearly the central bank will aim at ensuring that its anti-inflation credibility is not threatened, and we should expect at least one or two 25 bp hikes in the Selic rate between now and the end of the summer. By then, inflation may have peaked and could move back rapidly within the central bank's target (4.5% +/-2%). If the announced fiscal rectitude is maintained, the slowdown in headline inflation should be enough to induce a rapid reversal in the interest rate policy, possibly associated with some quantitative measures on credit expansion. If this happens at a time of progressive change in the Fed's policy and a reversal in commodity prices, it will immediately create strong downward pressures on the BRL. Brazil has however accumulated very large foreign currency reserves (USD 315 bn at the end of March 2011), which would be useful to ensure that such currency pressures do not translate into a run and that liquidity issues do not become significant.

Overall, a return of the BRL to a more competitive level of 2.10-2.30 against the USD, associated with slightly lower real interest rates, would create a far better environment for both cyclical and structural development of the country. As always, the challenge is to move from now to then in a context of highly volatile capital movements.

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