Prices are Clearing the Markets

Márcio Garcia[1]

The economic outlook for the whole world has been deteriorating since the beginning of the year, especially so after the terrorist attacks to the WTC and the Pentagon. Nevertheless, very few countries, if any, have been as hardly hit as Brazil. Most analysts would agree that this is due to a combination of self-inflicted injuries with a large dose of bad luck. When 2001 started, hopes were high that economic growth would resume. After all, Brazil had done a lot: hyperinflation was dead since the start of the Real plan in 1994, the fiscal stance had improved remarkably since the end of 1998, privatization had been very successful in many sectors as mining, steel, and telecom (although had stalled in a few others, noticeably energy generation), and a new and very successful inflation targeting regime had replaced the quasi-fixed exchange rate regime. Sustained economic growth, necessary to improve the poor social conditions of the country, seemed to be an inescapable reward.

Unfortunately, that was not so. A combination of bad shocks sequentially hit the economy since then: the political crisis among the parties that form the coalition supporting the President, the energy shock, the contagion from Argentina and the deterioration in world economic activity, as a consequence of the US bad economic performance. But even the pessimists would not have forecasted such nasty consequences.

As far as my own retrospect is concerned, six months ago, I wrote an article called "The Brazilian Economy in Rough World Seas" (*BBM Weekly Report*, 3/19/2001). What I then termed as world rough seas were causing a large (sic) depreciation of 10% that threatened the inflation target. At that time, I forecasted that the central bank would be forced to raise interest rates and that such measure would be ... *very deleterious to the fiscal accounts, since the majority of the domestic debt is instantly indexed to the basic interest rate. It may attract capital flows, which will help to counteract the depreciation, but this is not certain given the extremely high degree of risk aversion that currently prevails in international markets*

What a higher real interest rate will certainly do is to contain aggregate demand, and this will help the inflation target in two ways. The first is through the short run trade-off between inflation and activity. The second, and currently more important channel is through the trade balance. Imports have been rising very fast, reacting to the recent GDP expansion. A slowdown of the economy will probably forestall the import expansion (and also help exports in the short run), thereby decreasing the pressure in the exchange rate market. The ensuing appreciation of the BRL will certainly help the central bank to achieve the inflation target.

Unfortunately, all the negative components of the forecast (the interest rate raise and the recession) became reality while the positive components (the reversal of the exchange rate depreciation) failed to materialize. This happened even as the government, in a clever move, acted preventively to tap the IMF for some 15 USD billion. The accumulated depreciation since the beginning of this year has more than quadrupled, peaking over 45% in late September (it has appreciated somewhat since then). The rough sea of March would look like a placid lake in October. In mid-March, the consensus forecast for the year-

[1] Márcio Garcia, a Stanford Ph.D., is the chairman of the Economics Department at the Catholic University in Rio de Janeiro (PUC-Rio). Besides his academic activities, Prof. Garcia has served as a consultant to numerous Brazilian and international organizations and enterprises. His academic articles and op-ed pieces may be downloaded from his web page at http://www.econ.puc-rio.br/mgarcia.

end (2001) exchange rate, computed by the Central Bank, was 2.05 BRL/USD, while it is currently 2.70 BRL/USD!

Therefore, it is a good time to reassess the impacts of the exchange rate depreciation on the Brazilian economy. **First**, what is the main cause of such huge fall of the BRL? Certainly, the exchange rate depreciation was mainly caused by the perverse combination of two factors:

- the high foreign indebtedness and high current account deficits of the Brazilian economy;
- a marked increase in risk aversion on international financial markets, exacerbated after the terrorist attack to the WTC and the Pentagon, which made much more difficult to roll over the existing debt and to finance large current account deficits.

In order to understand how the BRL could fall so much, it is worthwhile to review a few features pertaining to the interaction between the two features highlighted above. To begin with, investors must perceive that debt strategies must be sustainable. That means that all debt will eventually be repaid, i.e., the present value of a country's external debt very far in the future must be zero. Nobody would lend to a country whose debt were perceived to be in a Ponzi trajectory.[2] Therefore, if an emerging market like Brazil has both a large external debt and a sizeable current account deficit, it must at some point in the future turn the deficit into a surplus in order to repay the debt.

Suppose that at the end of last year, when growth prospects of the world economy were still good, the scenarios for the future path of the Brazilian current account results indicated that the debt was sustainable. A decrease in world growth prospects, as it has happened since then, implies that world trade will grow more slowly, and that Brazilian exports will not grow as fast as previously envisaged. This undermines the sustainability of the large Brazilian external debt. A statistic usually used to ascertain the capacity of a country to repay its external debt is the external debt to exports ratio. According to the rank recently published by the magazine *The Economist*, Brazil is very bad shape, second only to the almost bankrupt Argentina. Therefore, it should not come as a complete surprise the hardships that Brazil is now facing. Similar difficulties are currently being faced by large international enterprises with large debts. As those firms, Brazil faces harsher conditions to roll over its debt, with higher risk *premia* and shorter maturities. The increase in the Brazilian external debt yields, despite the fall in world interest rates, further deteriorates the prospects of debt sustainability, forming a vicious circle. Probably the effects are exaggerated, but markets are well known for exhibiting manic-depressive behavior.

What is special about countries is that, unlike firms, most have their own currency, and many, as Brazil, have a floating exchange rate regime. Therefore, in bad times as the current ones, the result shows up at the exchange rate market, with very few sellers and numerous buyers. As more players realize that the exchange rate has no "reasonable" upper bounds, they look for hedging alternatives, which further prop up the demand for foreign currency and the exchange rate.

Second, what are the consequences of such high depreciation on the main macroeconomic variables? To avoid a very high pass through of the exchange rate depreciation to inflation, the Central Bank had to raise interest rates and may be

[2] Ponzi schemes (named after a Bostonian financier of the beginning of the century) happen when new debt is contracted to pay current interest payments, resulting in an ever-increasing debt that leads to an eventual default.

prompted to take further restrictive monetary policy measures in the future, as it did recently by raising reserve requirements to mop up liquidity and mitigate the speculative pressure in the exchange rate market. This has already weakened the economy, as well as decreased imports, thereby improving the trade and the current accounts. These movements, however, have not yet convincingly reversed the upward trend of the exchange rate.

No doubt that eventually the real exchange rate will depreciate to a level such that the current account will be in equilibrium, and that the existing supply of external finance will match Brazil's debt roll over needs. Imports will fall more, and the trade and current accounts will further improve. Exports will also increase, but it may take longer given the low world growth. Some forecasts of the current account deficit for next year have already fallen below 20 USD billion, much less than the 26 USD billion forecasted for this year, not to mention the 33.6 USD billion registered in 1998. Despite the bad economic conditions, prices are clearing the markets, as economic theory teaches us they should do.

As far as the capital account is concerned, Brazilian assets are becoming so cheap in USD that despite the increase in risk aversion, capital flows will eventually resume. Foreign Direct Investment (FDI) has fallen a lot but is still quite sizeable, and is bound to increase as the US and world economies pick up momentum. After all, at the given real exchange rate Brazilian enterprises are extremely cheap. Of course, the timing of such reversal is the big question.

The downside of the current Brazilian economic strategy is that the fall in domestic output may be very large and take a long time. Unfortunately, there is not much the government could do. Further fiscal restriction would surely help, but given that 2002 is an electoral year, such move is not likely. The same caveat applies to the currently hindered reforms (tax, labor, political) and remaining privatizations. The most likely scenario is that the *status quo* will remain until world economic conditions improve. However, if world recession becomes a reality and lasts long enough, scenarios contemplating the reversal of the reforms engineered in the nineties cannot be ruled out.