High Interest Rates and Sustained Growth in Brazil

For many investors used to the workings of the US economy, it may appear quite odd the recent decision of the COPOM,[1] the Brazilian equivalent of the US FOMC,[2] to keep the basic domestic interest rate (Selic) at 18%. After all, chairman Greenspan has been lowering interest rates since the beginning of last year trying to shorten or mitigate the US recession. Economic activity in Brazil has also been falling. At the end of last year, the GDP growth rate forecasted for 2002 was 2.4% , according to the Central Bank poll.[3] Last week's poll indicated that such (already low) rate had fallen to 1.4% .[4] The GDP growth rate forecasted for next year was 3%. Why, in face of low economic activity (recession), the Brazilian Central Bank does not lower the incredibly high interest rate, as did the FED? One possible explanation is that inflation rate is very high. That, however, is not the case. According to the same poll, inflation is forecasted to be around 6.6% for 2002 and 5.2% for 2003. Therefore, if those reported expectations are to be believed, the real interest rate will remain in the two digits in Brazil for the near future. Double-digit real interest rate is certainly hard to reconcile with the current zero or even negative real interest rate in the US.

The last month COPOM meeting minutes[5] reveal that, according to the Central Bank's simulations, such double-digit real interest rate is necessary for not missing the inflation target by too much. One can certainly take issue with the Central Bank models (or any other model), but that is not my point. Let's, for a moment, forget the (very important) credibility issue associated with badly missing the inflation target, and assume hypothetically that the Central Bank were to take the bold move of considerably lowering the Selic rate, say, from 18% to 14% . At first approximation (i.e., keeping constant the expected inflation rate), this would still provide a high real interest rate, much higher than any real interest rate the US economy has witnessed since Paul Volcker fought inflation some twenty years ago.

Unfortunately, inflation would not stay put if the interest rate were to fall as much. Such policy measure would prompt capital outflows and further currency depreciation, which would fuel inflation. In the short run, the current account would adjust mainly through the fall in imports, since exports take time to increase. Investment would not pick up, since macroeconomic uncertainty would increase, while many firms with hard currency debt would go bankrupt. Consumption could increase, but that alone would not lead to sustained growth. In summary, in this exchange-rate-led stagflation, the Brazilian economy would have more inflation without being able to resume growth.[6]

This powerful channel through the exchange rate has, so far, been of little or no relevance in the US. The fear of massive capital outflows[7] has never entered in the realm of the practical considerations that geared the FED's decisions of lowering interest rates to reflate the economy. This, however, is a luxury that emerging markets central banks cannot afford. Reflating a recessionary economy in times of high-risk aversion is a procedure that is not to be found in emerging markets monetary policy manuals.

If you happen to agree with my arguments so far, you must certainly be thinking that I am about to conclude that the Brazilian economy will likely exhibit dismal growth rates, in contrast to its bright post-war growth record

[1] Monetary Policy Committee.
[2] Federal Open Market Committee.
[3] See http://www4.bcb.gov.br/gci/Readout/MR20011228.pdf.
[4] See http://www4.bcb.gov.br/gci/Readout/MR20020913.pdf.
[5] See http://www.bcb.gov.br/mPag.asp?perfil=1&cod=131&codP=125.

[6] A few Brazilian economists have voiced a disagreeing opinion on that matter. According to their argument, the interest rate is so high because the market knows less than the Central Bank and reads between the lines of the Central Bank's actions to infer the amount of default risk. The Central Bank, according to the argument, has the power of choosing: if it signals high default risk through a high interest rate, that is what the market will believe. If, however, it signals low default risk through a low interest rate, the market will charge a low default risk premium. I do not think that asymmetric information is at the heart of the problem of the very high interest rate in Brazil, and therefore do not agree that the Central Bank has better alternative policies.
[7] The IMF's most recent *Global Financial Stability Report* raises doubts on whether or not "... the United States will continue to attract and distribute substantial shares of international capital" See http://www.imf.org/external/pubs/ft/GFSR/2002/03/index.htm.

until the eighties. If so, let me be clear that I do not think that Brazil is cursed to keep having the low and volatile growth rates that marked the last two decades, but certainly there is an important agenda to render the Brazilian economy less fragile and more prone to economic growth.

From this long agenda, I will dwell on the point of external vulnerability, which is extremely relevant to enable the Central Bank to set interest rates compatible with economic investment and sustained growth. In a recent piece,[8] Edmar Bacha, refers to three, possibly complementary, ways of making the emerging market economies less prone to exchange rate crises. The "global option" would be the institution of an international lender of last resort. However, this option would not be politically viable in the near future. The "regional option" would be "... the establishment of a free trade area in the Americas, accompanied by full dollarization." Given the reluctance of the US to let international concerns influence its monetary policy, this option would likewise be of little immediate use. Finally, there would be measures at the national level, mainly "... to deepen and further long-term domestic financial markets, thus making the investment process less dependent on foreign finance." This would require the need to improve a long-term finance market, and to increase the "exportability" of the economy.

This last point is an issue as important as it is misunderstood. For example, all the leading presidential contenders have in their economic programs "import substitution" as the main policy to deal with the external vulnerability. Although import substitution and export promotion both aim at lowering current-account deficits, the emphasis on import substitution is completely mislead. After all, the goal is have a (much) higher portion of the output that is "exportable", i.e., which meet both the quality standards and is competitively produced (without subsidies). Import substitution promotion schemes have led in the past to low quality and high prices, while requiring large subsidies. The candidates offer no clue as how this will not be repeated, except for saying that it will be a "new" industrial policy. Whatever policy mix the new president will favor to resume sustained growth, import substitution policies will only jeopardize the main goal.

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[8] See http://www.bndes.gov.br/conhecimento/publicacoes/catalogo/bacha.PDF.

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