

# A Monetary Tsunami? Brazil in the Cross-Fire of New Style Currency Wars

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At the beginning of the last decade (2001-03), the major economies were growing below their perceived potential. Central banks reacted by lowering interest rates and pursuing an accommodating monetary policy. The U.S. Federal Reserve Board was possibly the most aggressive: between 2000 and 2003 rates fell from 6.5 to 1 percent. At the same time, the key economies embarked in expansionary fiscal policies, with Japan in the lead; the latter caught in an apparent liquidity trap, for which low interest rates had limited impact. Although voices were heard that bubbles in commodity and real estate markets were forming as a result, the difficulty of asserting unambiguously that growth was not on solid ground postponed any policy action. Moreover, in the context of rising incomes and employment, and subdued price inflation, what were the incentives for politicians to cut the party short?

At the time, financial liberalization and intense competition led to growing private sector indebtedness. Families took on debt to acquire their first or second homes, to refinance existing mortgages and expand their levels of consumption. Firms responded with greater output and investment financed from retained earnings, and increasingly from equity and debt raised in capital markets. New, complex instruments reallocated risk, often hiding its magnitude from regulators, which on their turn were not then imbued with a sense of caution. The finance industry was having its day, or better, its decade, with managers being remunerated on account of returns unadjusted to the extent of risk being taken. If the age of “irrational exuberance” was coming to an end, most people were simply unaware that the “good times” would soon be over.

The year 2007 marks the onset of the crisis. It began in the mortgage market with New Century Financial unable to honor commitments, followed by Bear Sterns being effectively shielded by the U.S. Treasury before being taken over (by J.P. Morgan) in early 2008. Trouble moved to the U.K., which was forced to nationalize Northern Rock. Then on both sides of the Atlantic a quick sequence of major disasters followed, culminating with the collapse of Lehman Brothers on September 15. By then, the crisis had become systemic.

With credit markets paralyzed and the real sector seeing its demand collapse, there was no other option except for central banks and governments to act decisively. In addition to taking on quasi bankrupt institutions, injecting equity and providing extraordinary guarantees, governments used spending and tax cuts to act as fiscal stabilizers. Between 2007 and 2010, fiscal balances (at the start already negative) quickly deteriorated, with net borrowing increasing by 5.3 percent of GDP in the euro area, 6.8 percent in Japan, 6.9 percent in the U.S. and 7.5 percent in the U.K. Yet, after this initial attempt of a classical Keynesian fix, debt dynamics and political constraints have since forced an inflection; monetary policy became the “least cost” alternative.

Indeed, as the crisis loomed and the danger of the economies spiraling out of control became apparent, central banks began to push reference rates down to unprecedented low levels. Arguably, the Fed was the most aggressive, while the European Central Bank (ECB) was the slowest to act and certainly the most conservative (if interest rate differentials are an indication), possibly due to the influence of the Bundesbank, well known for overweigh-

ing the risk of inflation. But the overcautious nature of the ECB's policies prior to Mr. Draghi's accession were not immaterial to the current crisis in Europe. Be that as it may, by February 2009, ECB interest rates were still 175 points above the Fed and the Bank of Japan (BoJ), and 100 points above the Bank of England (BoE); as of April 2012, all such rates are effectively close to zero.

Yet the policy toolkit was not yet exhausted. Between August and December 2008, the Fed's balance sheet expanded by 148 percent, the BoE 156 percent, while the ECB was somewhat the "odd man out" with 41 percent. After a contraction in early 2009 (respectively 8.7 percent for the Fed and 10.8 percent for the ECB, though more significant for the BoE at 24 percent), when it appeared that the worst was over, other rounds of quantitative easing (QE) in its various shades followed, and since then the asset base of major central banks continued to grow in reaction to the lingering crisis. In fact, new rounds of monetary easing further expanded the Fed's balance sheet, which as of the end of March 2012 stood 40 percent above early 2009 levels, while for the BoE the increase was in the order of 84 percent. Yet the most relevant shift was undertaken by the ECB under Mario Draghi. Already in the transition—between being named its new head in June 2011 and taking over on November 1—the European Central Bank expanded its asset base by 17.3 percent and, after Draghi's accession, by another 29 percent by the end of March 2012. In sum, since mid 2011, the ECB added a whopping trillion euros in assets, one-third of its total.

Although the Fed and more recently the ECB were the main players in the limelight, the Swiss National Bank (SNB) and the People's Bank of China (PBC) have also been fast adding assets to their balance sheet, which have grown by close to 80 and 51 percent respectively since September 2008. Putting it all together, those six major central banks—namely, the Fed, ECB, BoE, BoJ, SNB and PBC—added nearly \$6.6 trillion in liquidity, slightly doubling their asset base in just three and half years. Combined with quasi zero interest rates

in Europe and the U.S., one has a monetary tsunami in the making. And such a cash wave should not have immaterial consequences for countries on the receiving end, Brazil among them.

Here opinions split (at least) two ways on the actual effect of such major monetary movements on exchange rates (and asset prices): for some, they explain to a great degree exchange rate appreciation in countries which attempt only to accommodate—but effectively do not control—exchange rate movements; others, without denying their impact, see the infusion of liquidity of secondary importance. The debate is further complicated by the proposition that the worst is still to come, as a good chunk of liquid assets is dammed for the moment in a few central banks, the ECB primarily. Once commercial banks and other financial institutions tire of earning negative interest rates for their voluntary central bank deposits and overcome their aversion to the risk entailed in reallocating their portfolio to financially more attractive alternatives (such as private and government bonds in commodity exporting emerging and other economies) the "currency war" might be more than an image grabbing expression.

Not that there have been no casualties. Hard pressed countries are having second thoughts on the importance of freer trade, a less intrusive industrial policy, a more open capital account or even an inflation targeting regime, if this means accepting passively growing exchange rate volatility and its adverse impact on the real economy. Governments are beginning to realize there may be sharply adverse trade-offs in taking as given WTO tariff commitments in the face of an exchange rate driven fall in levels of protection. As a result, they can ill afford to avoid industrial targeting and other discriminatory policies when major industries, including some in labor-intensive sectors, are under threat from perceived "nonstructural" factors emanating from the political imperative of pump-priming recoveries. If other countries revive their economies on a new type of beggar-thy-neighbor policy, why should they stick to a policy course which translates into loss of income and jobs?

Maybe even more worrisome, for economies with a history of hyperinflation, adding exchange rate policy to the menu of active instruments and as a means of containing appreciation to defend local industry, may potentially undermine carefully built inflation targeting systems, while accumulating reserves in excess of what is prudent brings significant fiscal costs. For countries which have to finance current account deficits with private capital inflows, slapping capital controls seems not only contradictory but also adds an additional layer of uncertainty and corresponding economic costs.

This in a nutshell describes the current policy conundrum Brazil faces. A combination of steady, inclusive growth, a booming domestic market with the *aggiornamento* of a new middle class, a fairly solid fiscal regime and a significant resource base, has made the country an attractive lot to park capital. As a commodity currency, the Brazilian real has become a good bet, with a positive twist: interest rate arbitrage (“carry trade”) has in the last few years brought significant gains to investors. As of early April 2012, real interest rates (nominal reference rates minus projected 12-month inflation) in Brazil stood in percentage terms at 4.3, significantly above Australia (1.3), Mexico (1.2), Chile (1.0), India (0.5), Indonesia (0.25), South Korea (zero), Thailand (-0.6) and Canada (-1.0), while in Japan (-0.1), the eurozone (-0.7), the U.K. (-1.5) and the U.S. (-2.0), nominal rates were very close to zero, and real rates negative (as noted).

In this context, the real has appreciated with force, with the government caught in an uncomfortable dilemma: should it simply let the domestic currency appreciate, compress inflation in the tradable sector, and try to compensate by other means the loss in competitiveness (at least while a new exchange rate equilibrium is reached as interest rates lower)? Or should it intervene, have the central bank purchase foreign currency and institute capital controls, taxing the entry of “speculative capital” and/or imposing quarantine, at the risk of higher inflation? While in the beginning the Lula government used currency appreciation as an additional support to maintain inflation in check, it

later leaned the other way. The new government strengthened the policy shift, mopping up excess dollars, adding to a burgeoning exchange reserves (\$365 billion in early April), while imposing a relatively stiff tax rate (6 percent of the principal) in an attempt to take away excess returns from foreign financing operations with less than a five-year term. Although this dilemma is not unique to Brazil, the pressures it faces are arguably more intense, in view of the size of the economy, the depth of financial markets (particularly in government bonds), the tradition of domestic and international companies to access credit markets abroad, and the economic incentives for interest rate arbitrage.

Yet managing the exchange rate, however justifiable, is not done without a penalty. There is of course a fiscal cost (the difference between borrowing rates and the average remuneration of reserves) as the purchase of foreign currency is systematically sterilized. Further, corporate financing costs also go up, as border taxes on incoming financial flows are passed on to borrowers and eventually consumers. And at the end of the day the current account deficit (estimated at 2.9 percent of GDP or approximately \$70 billion in 2012) needs to be financed, with attractive interest rates playing a key part. The larger the obstacles for incoming capital, the higher effective interest rates need to be.

However, the key policy paradox comes from the fact that to defend the currency, the government and the central bank are forced to accept a higher rate of inflation than most of Brazil’s trading partners, with the result that real exchange rates tend to increase while nominal rates stand put at best. On the other hand, if the central bank decides to pursue its inflation target, it will need to lean against the wind with a more conservative stance. If it uses interest rates as the instrument of choice, it will be acting at cross purpose with the stated aim of moderating capital inflows; if it resorts to regulatory measures to compress domestic credit, it will need to do a good amount of guesswork regarding its impact on inflation, complicating further the imperative of steering agents’ inflation expectations to the center of the target.

As a political entity, the government cannot simply stand on the sidelines. Well organized interest groups—unions and industrialists—cry foul to the relentless pressure on cost competitiveness as the real appreciates (which disallows increasing costs to be passed on automatically to consumers), while the price of non-tradables faces no such constraints.

Brazil is fast becoming a high-cost platform, but not only due to exchange rate distortions. There are macroeconomic impediments to the modernization of the productive apparatus related to low savings and investments rates; and there are structural obstacles ranging from poor infrastructure, low levels of education and technical training, insufficient innovation, and a complex tax regime (and accompanying high rates), which combined weaken Brazil's competitive standing. The bottom line is that firms are unable to counter higher costs with significant enough productivity gains. And they complain loudly.

The government's response has gone well beyond managing the exchange rate with support from the central bank. On the external front, it denounces the ongoing "currency war" and attempts to elevate the discussions to the G-20 and like meetings. There it looks for friends in the same predicament, looks for support to change WTO rules, allowing for currency appreciation countermeasures, while trying to argue for a redressing of the balance between fiscal and monetary stimuli, with a renewed emphasis on the former.

Domestically, it is the mirror image: it pushes the central bank toward an accommodating monetary policy and lower interest rates, combined with mopping up operations of excess foreign exchange to contain currency appreciation; it acts to protect automotive, capital goods and other sectors such as textiles and shoes from foreign competition, pushing existing WTO rules to the limit while risking retaliation; and it provides for highly targeted tax relief and subsidized finance, the latter through the National Development Bank (BNDES, which received loans from the Brazilian Treasury of over \$150 billion since the onset of the crisis), tilting the

playing field toward dominant firms, strengthening their market position, not only abroad but also domestically. The benefits of this policy in terms of output and employment (industrial) growth appear limited at best, although one could always argue the counterfactual. Be that as it may and to put it succinctly, it is an inglorious fight for the government: dammed if you do (which they are doing!); dammed if you don't.

Not that structural reforms are out of consideration. The Brazilian government is clearly aware that it needs to announce a credible reform agenda sometime soon and move beyond ad hoc "packages", with déjà vu characteristics: targeted subsidies and protection to well-placed incumbents, without much being asked from them. President Dilma Rousseff is hard working and well intentioned, and arguably has not committed any major blunders in the domestic or foreign affairs arena. Moreover, she was able to jettison the ministerial-level deadwood inherited from the previous government without major trauma (and in the process remain untainted by corruption scandals) and in parallel make a political statement of independence from Congressional threats. As a result, she is now more popular than her predecessor, Lula!

But something is amiss. Unlike Fernando Henrique Cardoso or Lula, she rides along without a strategy—in one case, centered on consolidating post-hyperinflation macroeconomic stability by reforming the state; in the other, making growth more inclusive by a combination of microeconomic reforms and a substantial expansion of transfers and well targeted social safety nets. Their place in history is assured. Hers, a big question mark: will she be able to devise a reform agenda and political strategy which moves it forward, or are we going to observe only well-intentioned patchwork?

With markets in the beginning of the second quarter providing a respite—temporary maybe—and the American economy on the way to sustained recovery, it may now be a good time for Brazil to be more ambitious and propose a comprehensive and intelligible reform agenda. The premise is simple:

over the next couple of years, the U.S., Europe and other economies will not budge in any significant way on their accommodating monetary policies for the simple fact that there is nothing else to put in place. This is even more so if the Chinese economy and Asia decelerate and cannot be counted on as sources of autonomous demand.

In 2012, Brazil has been crying wolf. For in fact there is not a deluge of dollars prying open the doors of the bond market. Arguably, a combination of a stronger dollar as the U.S. economy gained traction with respect to the rest of the world, and domestic capital controls, appears to have been effective in containing the influx. While the Brazilian Central Bank bought \$24 billion in 2009, \$41.4 billion in 2010 and \$47.9 billion last year, so far this year purchases amounted to less than \$2.8 billion, with the real actually devaluing 6.35 percent since February. It appears that the government would like to maintain the nominal real-dollar exchange rate in the 1.8 to 1.9 band. For the moment, and under current circumstances, the defense mechanisms seem to be working. Yet what might happen if resources deposited with the Fed, the ECB and other central banks leave their safety vaults and start aggressively looking for higher returns?

If and when countries leave the arena of a phony currency war and the true tsunami comes (which no analyst can be certain of), it is highly unlikely that current remedies will do the trick, unless policymakers would be willing to deny domestic firms access to foreign finance, slapping

prohibitively high border taxes on capital inflows. Of course, that would make life for firms far more difficult, increase policy uncertainty and put a lid on growth. Why instead not prepare the country for more intense competition—including from such spurious forces—on the basis of a productivity-centered strategy? If a balanced global recovery actually takes place, so much the better. As is often the case, a constructive approach depends far more on domestic factors: political will and the ability to put forward a coherent set of initiatives.

In sum, for an economy with significant resources and endogenous sources of dynamism—both in terms of entrepreneurial capacity and a domestic market which is proving to be a boom to most producers—only self-inflicting policy mistakes can be the real hindrance to growth, short a global economic catastrophe. At the end of the day, and if one had to weigh the pros and cons of the aggressive monetary policies being pursued by major central banks, they have possibly done more good than harm by ensuring that none of the major countries and economic jurisdictions slipped into deep recessions. Not that the forces that are at work bringing a misalignment of exchange rates are immaterial to the competitive standing of domestic industry and its share in trade and output. But this cannot be used as a smokescreen to hide the need to move forward with a reform agenda that will thrust the Brazilian economy in a trajectory retaining its virtuous inclusive features, but combining it with a more efficient, innovative and resilient productive base.