A delicate balancing act for Brazil

THE GOVERNMENT CLEARLY NEEDS to do something about the radical deterioration in Brazil's current accounts—between April 2007 and April 2013, the balance moved from a surplus of more than 1% to a deficit of 3%—mainly because of the worsened trade balance. But whatever it does has to be done carefully to avoid unbalancing other areas of the economy.

With commodity prices and China's economy (and therefore demand) both going backwards, Brazil's trade balance deteriorated, and as it did, it has exposed structural vulnerabilities in Brazil's current accounts. For the next few years, then, Brazil's main problem will be financing the deficit in external current accounts. To adjust the balance of payments Brazil will have to let the exchange rate float to encourage exports by promoting the competitiveness of our products on world markets. Ultimately, that will be the only way to pull the economy out of its current, and ever more evident, stagnation.

That means we're looking at further depreciation of the *real*. Unfortunately, that will undoubtedly lead to inflation. That calls for a careful rebalancing of monetary policy to hedge against depreciation spillover effects on wages and other prices, using those comfortable international reserves to smooth out volatility of the exchange rate.

There's also an important role for fiscal policy in this scenario. A tighter fiscal policy would allow the central bank to raise interest rates less than otherwise needed to cushion domestic prices against the exchange rate depreciation.

With monetary and fiscal policy working in tandem, the inevitable devaluation will shrink domestic demand by reducing incomes and curbing imports by making them more expensive. But monetary and fiscal policies by themselves will not be enough—even if major devaluation to relieve the external account deficit is politically feasible—and it may well not be.

Part of the balance adjustment has to be a push for higher productivity. That's the only way our exports will be able to compete. That means Brazil needs to invest more in innovation and technology, but starting at the bottom with better quality basic education and initiatives for more vocational education, so that young Brazilians learn how to think innovatively early on.

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Brazil also has to rethink its trade policy. Barring the products of other countries, protectionism, has never worked. The local content policies are killing companies that can't find components they need because they're not made here; visa restrictions for foreign workers are killing the possibilities for technology transfer because experts can't stay long enough to train Brazilians effectively.

Brazil should also pursue more vigorously bilateral trade agreements, including with traditional trading partners like the U.S., as other Latin American countries did. We may have overestimated, and overreacted to, the relative loss of US power and also overestimated the convergence of our interests with those of China. In the last decade, the lack of major trade deals signed by Brazil was overshadowed by high commodity prices and booming demand from China. Now with lower commodity prices and lower demand from China, Brazil needs more than ever to diversify its export markets and address its structural problems.