Should we celebrate the interest rate slide?

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A MAJOR ANOMALY in the Brazilian economy in recent decades has been Brazil's very high domestic interest rates. Yet, inexplicably, even with interest rates high, Brazil has also lived with relatively persistent high inflation since hyperinflation ended in 1994: in the last 10 years, inflation has averaged 6.4% a year.

Now, the big news is that Brazil's real interest rate (adjusted for inflation) seems to be finally approaching values that are more consistent with those in the rest of the world.

Until May 2007, domestic real interest rates mainly fell because the Brazil risk had been lowered, thanks primarily to the successful political transition in 2003 and the recognition by international markets—and Brazilians—that the elected government, though leftist, was committed to respecting contracts and being financially responsible. Accordingly, in mid-2007 Brazil risk, as measured by the Emerging Markets Bond Index spread over US treasury bonds, narrowed to less than 150 basis points (1.5 percentage points) from 960 (9.6 points) in mid-2003. Thereafter, however, the main determinant of high domestic interest rates was the excess of investment over savings. The recent change does not mean that the external sector has ceased to affect the domestic interest rate, but now it does so primarily through changes in the exchange rate and the prices of international tradable goods on the National Consumer's Price Index.

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From 2004 through 2008, prices of tradables in foreign markets were high. Thus, both domestic and international demand for Brazilian manufactured goods was buoyant. Investment, in turn, grew

faster than savings. On the other hand, the policy of transfers to the poor—family grants, increases in the minimum wage, generous social security benefits—meant that higher growth did not lead to higher savings. All these factors interacting pushed up the domestic interest rate.

The global crisis of 2008 and 2009 changed that process. Because growth in developed countries did not resume, there was a surplus of manufactured goods pressing down on the price of tradables in international markets. Brazil has thus had to absorb substantial disinflationary pressure.

Brazilian industry has stopped growing because of the increased international competition in manufactures. Today industrial output is 3.4% below what it was as recently as March 2010. Part of the recent decline in interest rates is therefore a result of the greater international supply and thus the lower prices of manufactured goods.

More importantly, the decline in investments associated with a fall in total factor productivity (TFP) may have helped bring down interest rates. For instance, the decline in TFP is reducing demand for investment; since the third quarter of 2010, investment has been falling. Savings have also fallen, but less than investment.

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Between 2004 to 2008, investment grew faster than savings; today the opposite is occurring.

Although reducing the gap between savings and investment is good news, the fact that the reduction in investment is caused by low TFP is very bad news. Brazil is now at risk of making the unpleasant discovery that the long- awaited reduction in real interest rates is at last happening, but only because economic growth is being suppressed by declining productivity. If it is falling productivity that is bringing down the real interest rate, that certainly makes celebration of this landmark event questionable.

The causes of the decline in productivity are a separate, and far more complex, issue.