THE INTEREST RATE
The pursuit of sustainability

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THE ECONOMIC VARIABLE that most attracted the attention of specialists in the current year—the central bank policy interest rate—declined 525 basis points from July 2011 to December 2012, from 12.5% to 7.25%. Samuel Pessôa, associate IBRE researcher, notes that the real interest rate differential, net of inflation expectations and sovereign risk,[1] has held at about 5% a year since 2003, for reasons that vary according to the period examined but usually because of movements in exchange rates.

The real interest rate differential has been high since 2006 as a result of the policies of supporting domestic industry, maintaining a more depreciated exchange rate, and lower absorption of foreign savings; the recent decline in interest rates is due mainly to the significant drop in Brazilian domestic demand, particularly the fall in investment in the last five quarters. “If investment grows back stronger, which is desirable, interest rates would increase. Is the country then condemned to have high interest rates?” Pessôa asks.

He argues that a high policy interest rate should not be viewed as by definition a nega-

[1] The real interest rate differential was calculated by subtracting from the interest rate the expected inflation given by the central bank’s Focus Bulletin, the U.S. real interest rate, and the Brazil risk.

tive indicator of the economy's health. "In Brazil, we tend to think that is so because high rates were generally the result of errors in economic policy or crises of confidence. In those situations we paid an exorbitant interest rate differential to keep investors from withdrawing their money from the country. But it must be clear that, in a normal world where there is no risk of capital flight or solvency problems, a high interest rate is a positive sign, because it is the variable that balances savings and investment," Pessoa explains adding that such was the case for the Brazilian economy between 2004 and 2008.

Pessôa draws three scenarios in which interest rates might stay low even after investment growth resumes. The first would be stagnation in total factor productivity. "That's more or less what has been occurring since 2008. When it ceased to grow, productivity knocked down investment, growth, and interest rates," he says. The second would be a resumption of investment growth, but accompanied by policies to ensure that domestic savings grow at the same speed so that there is a natural balance between savings and investment, which would eliminate the need to manage the interest rate. The third scenario assumes that, even before economic activity picks up again, the government does not interfere with the foreign exchange rate to protect industry. As Pessôa explains, "The interest rate does not necessarily have to rise. But if we keep everything as it is and productivity and investment growth come back, interest rates will surely rise."