Dilemmas raised by the external deficit

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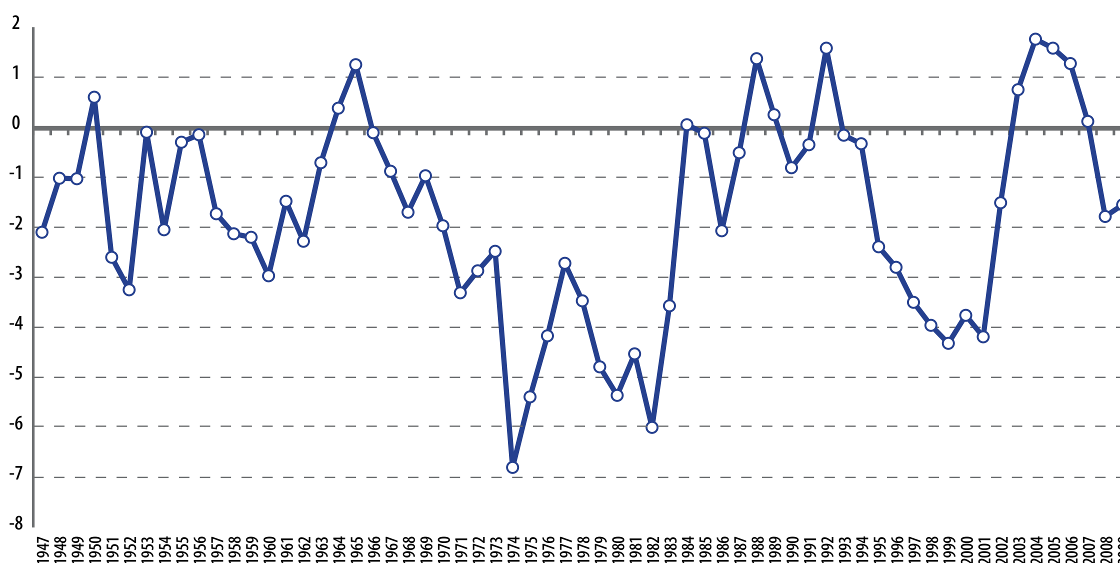
The return of external current account deficits is a reality Brazil must live with, but there are concerns about the possible effects of these continuous and high negative balances on the Brazilian economy. During a seminar on "Current Account Deficits: Opportunity or Threat?" presented by the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV), panelists Affonso Celso Pastore, Marcio Holland, Pedro Cavalcante, and Samuel de Abreu Pessoa demonstrated how the issue divides analysts.

On one side are those who see no danger in using foreign savings to finance consumption and investment as long as Brazil continues to have sound economic policies, as in the last two decades, and the composition of external liabilities is favorable, with low foreign currency debt and high foreign direct investment. In that case, foreign savings simply complement domestic savings, which probably will remain low. Proponents of this position admit, however, that there are uncertainties that can affect their favorable scenario.

The opposite view is that, in the long term, the strategy represents a threat to continued growth and calls for intervention in the foreign exchange and capital controls areas to prevent excessive appreciation of the real against the dollar and thus reduce Brazil's external vulnerability.

External current balance (% of GDP)



Source: Central Bank of Brazil.

Despite their differences, all agree on two points: Brazil is returning to its historical pattern of external current account deficits, a structural problem whose root is the low level of domestic savings. In February the balance of external transactions was the worst since 1947, leading the Central Bank to revise its projection for the 2010 current account deficit from US$40 billion (2.5% of GDP) to US$49 billion (4%). For the first time in nine years, the inflow of direct investment was not enough to counterbalance outflows, so the country had to depend on short-term loans to fill the external current account gap. That has not happened since 2001.

Multiplier effect — Sound economic policies and sustained growth reduce the risk of using foreign savings to finance excess domestic absorption (private and public consumption and investment). According to this reasoning, which takes into account the preferences of Brazilian society and the political system, foreign savings represent an opportunity to accelerate growth by increasing the investment rate. "The inflow of foreign capital causes the real exchange rate to appreciate, leading to increased investment, and the multiplier effect of that causes an expansion in income and consumption and a reduction in net exports. Thus there appears the current account deficit," explained former Central Bank governor Affonso Celso Pastore.

Brazil has low domestic savings, so investments require foreign savings, imported through current account deficits. According to Pastore, national accounts data show that whenever external current account deficits grow, so does investment. "The conclusion is that foreign savings are predominantly used to raise production capacity, not consumption, which contributes to economic growth," he emphasized.

To give up external resources, Brazil would have to radically change its economic policy and aim to increase domestic savings — starting with the public sector, cutting current expenditures and income transfers that stimulate private consumption. As the government is not contemplating any such strategy, it is unlikely that Brazil will follow the Chinese way: domestic savings of almost 50% of GDP, low public spending on social security, and high private savings. Brazil's domestic savings fell last year to 14.6% of GDP, the lowest level since 2001.

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Samuel de Abreu Pessoa, head of the IBRE Center for Economic Development, believes that economic policy should not be directed against current account deficits but should clarify the limits, consequences, and risks of this option. He believes that economic policy should induce a structure of external liabilities that do not cause problems for the country. For example, for a long time Australia has survived high external current account deficits due to an economic model that has protected the country from external shocks, despite high foreign currency debt.

"If we do our homework, we are not likely to go through a balance of payments crisis because there will be no shortage of external financing," Pessoa said. In his view, Brazil today can sustain economic growth even with high current account deficits:

"The question is whether the world will continue financing Brazil's current account deficit."

Luiz Guilherme Schymura

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"Unlike the past, when external liabilities were predominantly in US dollars, the proportion of external liabilities denominated in the real has increased, and this creates favorable momentum for Brazil. It is helped by robust foreign exchange reserves and the fact that the country is a net external creditor."

The structure of Brazil's external liabilities in the last 14 years has changed: the share of loans and debt financing fell while foreign direct investment and equity investments increased. At the end of 2009, together investments and the purchase of shares accounted for 72% of total external liabilities, compared to only 29% in 1995.

The economic and institutional mechanisms to operate safely on the path of external financing, Pessoa said, should include, beyond control of inflation, fiscal balance, and the floating exchange rate, government action to discourage companies borrowing in foreign currency without hedging, to make it clear that the public sector does not offer hedging protection. "This is all you can do," he said, "because policy choices that will lead us to a long period of external current account deficits have already been made." Among those choices are the expansion of programs of income redistribution and the population's preference for consuming in the present rather than saving for the future.

For Pedro Cavalcanti Ferreira, professor in the FGV School of Graduate Studies in Economics, there is no doubt that the safest policy would be to increase domestic savings, thus eliminating the risk of not being able to finance the external deficit and creating the conditions for devaluation of the exchange rate. But, he added, "This is neither feasible nor likely in the short and medium term, as there are in place none of the conditions necessary to reverse the external current account deficit except in the long term." Moreover, the evidence that exchange rate overvaluation has a negative impact on economic growth is not robust. Exchange rate revaluations in 2002–08 did not have a big impact on industry and advanced technology sectors, he said, so he has no concerns about future current account deficits affecting growth in the long term.

However, Cavalcanti warned, external financing leaves Brazil vulnerable to shocks that can disrupt capital inflows. In this sense, the large foreign exchange reserves and a floating exchange rate, combined with an appropriate composition of external liabilities where there is little mismatch between assets and liabilities in dollars, could help the economy to make the necessary adjustments.

Threats and vulnerabilities — On the other side of the debate are those who see current account deficits as a threat, due to the potential vulnerabilities they carry and their negative implications for economic growth in the long term. The main concern here is that the deficits make it more likely that there will be balance of payments crises similar to those experienced in the past. This view holds that even assuming the continuity of sound economic policy, capital inflows could reverse abruptly due to changes in the international economy beyond Brazil's control, making it difficult to finance current account deficits. An external crisis could

quickly contaminate the country's economy, and exchange rate flexibility would be insufficient to accommodate the shock — or might even aggravate it, because a sharp devaluation could disrupt the domestic economy.

"All the projections for the external current account deficit are being revised up. Soon it will affect growth, and the familiar history will repeat itself," said Márcio Holland, professor of economics at FGV São Paulo. He advocates more policy intervention in the exchange rate in the short run to prevent excessive appreciation of the real. Among the fears raised by the overvaluation of the real — one of the most volatile currencies in the world — are the possibility of de-industrialization, which would make the economy less dynamic, push up remittances of profits and dividends, and worsen trade deficits.

Holland, too, argues for an increase in domestic savings. While agreeing that low domestic savings are a result of the expansion of social rights in the Constitution of 1988, he thinks the situation can be reversed with a strong fiscal adjustment in government spending and some constitutional changes. For example, the public sector invests around 2.5% of GDP, but spends 3% on death benefits. In the countries of the Organization for Economic Cooperation and Development, average death benefits are only 0.5% of GDP.

Parallel discussions — Other risks are the inevitable rise in international interest rates on capital flows to Brazil, the effects of developments in world trade on Brazilian exports, and increased competition from Chinese products in markets traditionally supplied by Brazilian industry. "Perhaps the question should be whether it's worth letting the situation reach a threatening deficit," said IBRE economist and seminar coordinator Regis Bonelli. He suggested that "Since it is impossible to know in advance if exchange rate flexibility will be sufficient to cushion the effects of negative changes in the external scenario without harmful consequences for the domestic economy, it would be wise to adopt policies that avoid the unnecessary exchange rate volatility that would arise from excessive capital inflows today, followed by disorganized capital outflows tomorrow."

IBRE director Luiz Guilherme Schymura, raised one more problem: huge institutional advances are occurred in Brazil, facilitating production and changing the economic structure, yet the state of the post-crisis world remains unclear. Recovery is slow in developed countries and is especially bad in Greece, Portugal, and Spain, which are fighting high debt as well as slow economic growth. "The question is whether the world will continue financing Brazil's current account deficit," he said. "What is clear so far is that we have low domestic savings and excess consumption in addition to increasing social spending and the current spending of government. One scenario is continuing foreign capital inflows; the other is that the worsening global situation will interrupt them."

Pastore is not so concerned that the foreign resources now being invested in Brazil will leave any time soon to migrate to other countries. "Investment opportunities in the rest of the world do not seem plentiful," he said, "so there is a lot of money to put in Brazil."

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