Exchange rate appreciation again on the agenda

Recently, the notion has gained weight that Brazil and other emerging economies are once again experiencing some degree of decoupling from the bleak prospects of the developed countries. To be sure, this does not mean that emerging economies will emerge unscathed from the global economic slowdown. But this view, suggested in IBRE's last letter — and taken up in a leader in *The Economist* shortly thereafter[1] — is based on the fact that some of the more prominent emerging countries have not suffered the real estate bubble or the excessive financial leverage of banks and households that set off the crisis in the developed world. Moreover, in some of the BRIC countries (Brazil, Russia, India, and China — all emerging economies) there is room for stimulating domestic demand to offset decreasing foreign demand. And in some cases, recovery in one BRIC country entails recovery in another: the best example is the resumption of demand and the evolution of the prices of commodities exported by Brazil early this year after China's performance exceeded expectations.

Brazil's partial recovery from the deepest point in the crisis must be celebrated. But it has a spin-off: renewed debate on some issues that had temporarily been "resolved" by the wave of turbulence. Without doubt one of the major controversies is about exchange rate appreciation, once again under debate after the severe depreciation caused by the outflow of capital toward the safe haven offered by US Treasury bills. If a certain degree of decoupling is correct, a stronger Brazilian currency might be here to stay. Since January projections of the 2009 trade balance have improved

significantly, from US$14.5 billion to US$20 billion (the median of market projections collected by the Central Bank of Brazil). The median projection of the external current account deficit for the year has been cut almost in half since the beginning of December: from US$30 billion to US$17.5 billion, just above 1% of GDP.

On the financial side there are clear signs that Brazil has benefited from the gradual restoration of normal financial conditions in world markets. Brazil's country risk measured by EMBI (the Emerging Markets Bond Index) has fallen below the average for emerging economies, after having been above it. This suggests that the country has moved forward relatively faster than its peers to reduce risk perception. A factor that may have contributed to this improved risk perception is the stability and soundness the national financial sector demonstrated even in the worst of the turbulence. For the first time, at the most severe point in the crisis foreign investors witnessed a decline in the debt-to-GDP ratio — because the Brazilian public sector is a creditor in terms of US dollar position. This has definitely helped crystallize the view that the country has attained a new high point in terms of economic stability. This development contrasts sharply with the debacle in many countries in Eastern Europe that had been considered emerging stars until last September.

The good side of this improved risk profile is that Brazil will be able to live with lower interest rates for a given deficit on current transactions, because domestic rates are determined by internal supply and demand and by the willingness of the rest of the world to finance the country. This is excellent news. It suggests that, when the recovery of economic activity accelerates in 2010, monetary policy need not be as tight as it would have to be if Brazil had a less favorable foreign scenario.

Today, therefore, the situation could be considered satisfactory — were it not for the fact that the exchange rate is starting to appreciate, which many economists believe has negative implications for economic growth.

Brazil and other emerging economies are once again experiencing some degree of decoupling because they have not suffered the real estate bubble or the excessive financial leverage of banks and households that set off the crisis in the developed world

This is a long and complex debate. The view of most critics of appreciation of the national currency is that it hinders growth in industrial production that would bring about positive externalities — the most frequently cited is the introduction of new technology, particularly in export industries, and the generation of dynamic comparative advantages.

With regard to the exchange rate debate, it is important to recognize the seduction

that the "Asian model" exerts on economists in Brazil and other developing countries. They believe the formula for the success of the Eastern Asian countries incorporates one or all of the following elements: export-based growth to a great extent supported by exchange rate depreciation; high savings and investment rates; considerable investment in education and human capital; adoption of industrial policies; emphasis on the absorption of foreign technology; and economic stability.

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Much as the Asian model rests on factors associated with the liberal recipe book, such as emphasizing education and economic stability, it is also undeniable that it enhances the role played by the state. The debate to determine just which elements of the model account for the exceptional performance in those countries is far from over. But it happens that a large number of developing countries — including Brazil, some countries in Latin America, the Middle East, and India — in the post-war period also adopted measures that foster specific economic sectors and dirigisme. Those attempts for the most part resulted in partial or total failure.

Previous IBRE Letters have discussed the incompatibility of the Asian model with some of the deep determinants of what we might call the "Brazilian model," which has well-defined political, social, and economic roots. Thus, one of the key elements of the depreciated exchange rate in the Eastern Asian countries is their remarkably high savings. This in turn implies an intertemporal choice to trade present for future income. This choice may be translated into many institutional formulas in societies where there are significant incentives for saving, investment, education, and work. A typical example is public social security, which is extremely limited in Asian countries compared with Brazil.

Despite institutional differences, some economists seem to believe that there is room for Brazil to adopt an economic model similar to the Asian model. Some of those countries, with China in the lead, have in the past few decades combined extremely low interest rates with an aggressive policy of reserve accumulation; this has allowed them to keep their real exchange rate relatively depreciated.

It would, however, be unwise to disregard one element that is deeply linked with political, social, and economic choices. This fundamental element is the distribution of income between capital — by means of retention of company profits — and labor. In fact, the balance deteriorates in favor of capital as intervention in the exchange rate market leads to a rise in savings and, as a

consequence, in investment, which are the goals pursued by advocates of the Asian model. This process is linked to the rise in the share of capital in revenue, which broadens retained profits and consequently company savings and investment. The mechanism of regressive revenue distribution stems from the higher relative increase in the prices of goods traded internationally ("tradables") as the national currency depreciates. Relative to salaries, tradables become more expensive, which increases the profitability of capital.

Eduardo Levy-Yeyati and Federico Sturzenegger have suggested that a policy of reserve accumulation may produce a more depreciated exchange rate, which in turn produces a permanent positive impact on growth.[2] An interesting aspect of their article is that the transmission channel between the devalued exchange rate and growth is not foreign trade and industrial activity but rather the higher savings and investment resulting from intervention in the foreign exchange market and reserve accumulation. Thus, the depreciated exchange rate would raise internal savings by increasing the retention of business profits.

The issue of adapting the Asian exchange rate model to Brazil, therefore, might be summed up in a simple question: How is it possible to make a depreciated exchange rate — regressive in terms of income distribution — compatible with a trend of real growth in salaries?

The relationship between the exchange rate and the distribution of revenue assumes further importance when the political perspective is introduced. Dani Rodrik, a supporter of the Asian model, pointed out in 1999 that democracies tend — in relative terms — to pay much higher real salaries than authoritarian regimes.[3] Brazil's appreciating exchange rate is thus a macroeconomic byproduct of its sociopolitical choice to reduce inequality, which has been absolutely consistent throughout the 25 years since the country's redemocratization. The fate of the Asian model in Brazil must therefore depend on an unlikely change in the priorities of our democratic institutions. ■

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[1] *The Economist*, "Decoupling 2.0," May 23–29, 2009, page 14.

[2] Eduardo Levi-Yeyati and Federico Sturzenegger, 2007, "Fear of Appreciation," World Bank Policy Research Working Paper n. 4387.

[3] Dani Rodrik, 1999, "Democracies Pay Higher Wages," *Quarterly Journal of Economics*, 114(3): 707–738.