LatinSource BRAZIL SPECIAL REPORT

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Current Accounts, Capital Flows and an Appreciating Exchange Rate

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EXECUTIVE SUMMARY

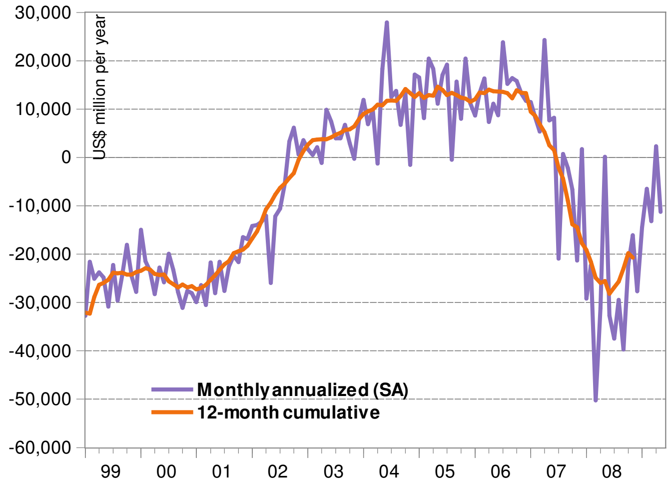
The fact that domestic demand (and absorption) is falling faster than GDP is contracting explains the sharp fall in the current account deficits since the end of 2008. The predominant factor has been the drop in gross fixed capital formation. The initial sharp decline in household consumption is already reversing. Counter-cyclical measures are slowly expanding consumption. The recovery of investments will be slower. For this reason Brazil will run small current account deficits for some time to come. The recovery of investments will eventually increase the deficits, but this will only happen starting in 2010.

The return of capital inflows is one of the main forces behind the appreciation of the nominal exchange rate, which is carrying over to the real rate. The main channels have been foreign direct investments and stock market investments, but the interest rate differential is very high, stimulating flows to the bond market as well by investors willing to run the exchange rate risk. In reaction to the stronger real exchange rate, pressures are growing – still expressed more as grumbling rather than a general outcry – for the government to introduce some form of controls on capital inflows. We expect the government to resist these pressures, but they will probably grow.

CURRENT ACCOUNT AND DOMESTIC DEMAND TRENDS

The current account deficit in May rose slightly in comparison with April. But this does not indicate a reversal of the declining trend that began in the third quarter last year (Graph 1). The international crisis unleashed effects that led to a strong and rapid fall in the current account deficits. What's behind this reversal of behavior? What are the perspectives for the evolution of this deficit in the coming quarters?

Graph 1
Current Account Balances



To answer these questions it's best to look at the evolution of GDP and total domestic absorption (household and government consumption plus gross fixed capital formation)[1]. In Graph 2 we show the behavior of absorption and GPD, expressed in constant 2000 prices in *reais*, and in Graph 3 we compare the excess of GDP over absorption with net exports in *reais*, which reproduce the behavior of the current accounts[2]. Starting in 2002, GDP growth outpaced that of absorption, leading to surpluses that lasted until the end of 2005. But in 2008, absorption fell below GDP, causing the current account deficits to shrink. The contagion from the international crisis has cause GDP in Brazil to contract, but it has also produced a decline in total domestic absorption. The fall of domestic demand due to the crisis has been more intense than the fall of GDP, triggering a reduction of the current account deficits.

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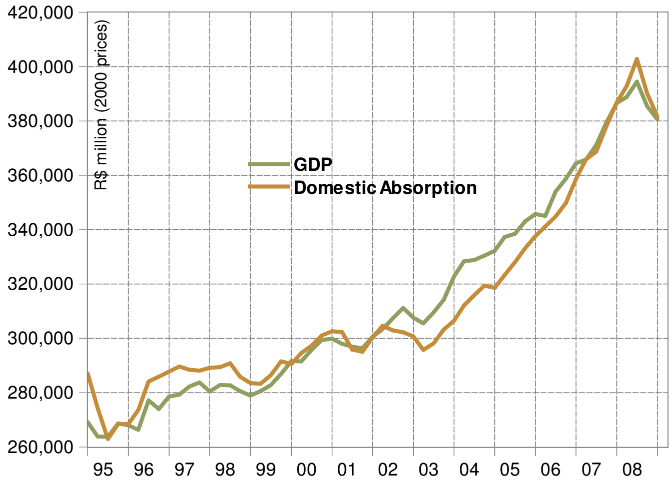
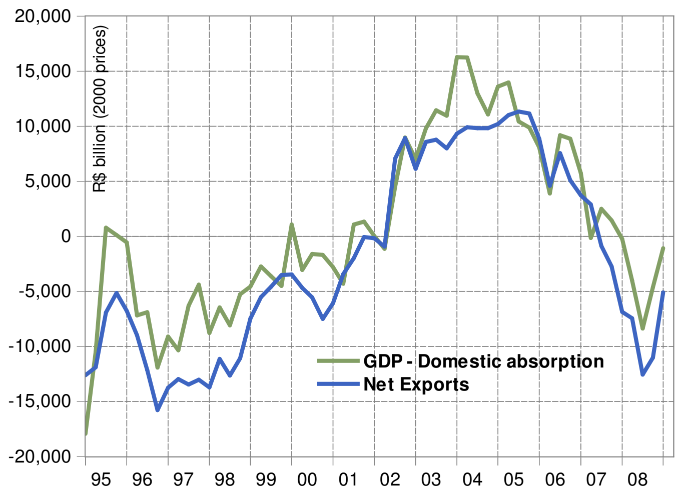
[1] An examination of the components of the current accounts in dollars shows that the greatest contribution to this fall has come from the reduction of profit and dividend remittances. In this respect, the change in the composition of the external liability (the growth of risk investments and the fall of the external debt) plays an important role. Another factor has been the reaction of the trade surpluses, which after falling during the more severe phase of the crisis, have started to recover, due mainly to the decline of imports. These factors are useful to describe this fall, but insufficient to explain its causes.

[2] The data are from the quarterly national accounts.

Graph 2
Domestic Absorption and GDP



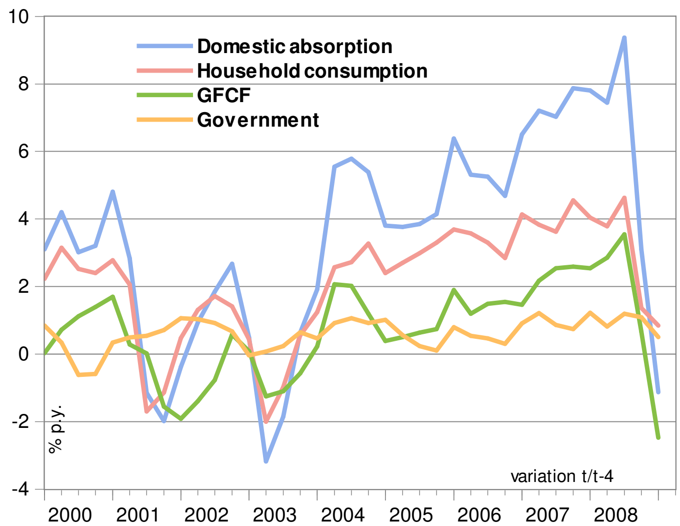
Graph 3
GDP less Absorption and Net Exports



Where has this decline of absorption been concentrated? Has it been mainly in investments or household consumption? In Graph 4 we show the decomposition of the annual variations of absorption[3].

[3] Based on the definition of absorption, given by $A_t = C_t + I_t + G_t$, that decomposition is given by the expression $\left(\frac{A_t}{A_{t-4}} - 1\right) = \left(\frac{C_t}{C_{t-4}} - 1\right)\frac{C_{t-4}}{A_{t-4}} + \left(\frac{I_t}{I_{t-4}} - 1\right)\frac{I_{t-4}}{A_{t-4}} + \left(\frac{G_t}{G_{t-4}} - 1\right)\frac{G_{t-4}}{A_{t-4}}$. In these expressions, C is household consumption, G is government consumption, and I is gross fixed capital formation.

Graph 4
Decomposition of Absorption Variations



The current global crisis has a clear "demand shock" characteristic, represented by leftward shift of the aggregate demand curve[4]. Economic recovery in this case is a synonym for higher aggregate demand. The fall in the real interest rate, the gradual rebound of consumer credit and the fiscal stimulus measures, materialized in the form of increased public payroll spending and income transfers, are behind the slow recovery of consumption. Investments will recover even more slowly because business profits have fallen, there are still high levels of idle capacity and the decline of exports inhibits the appetite to invest to boost the capacity of industries mainly serving the export market.

To the extent that spare capacity will decline over the coming quarters, and the counter-cyclical stimulus policies will continue, fixed capital investments will tend to rise, increasing absorption faster than GDP. When this occurs, the current account deficits will resume growing[5]. But this is very unlikely to happen in the next few months. The more likely horizon is during 2010.

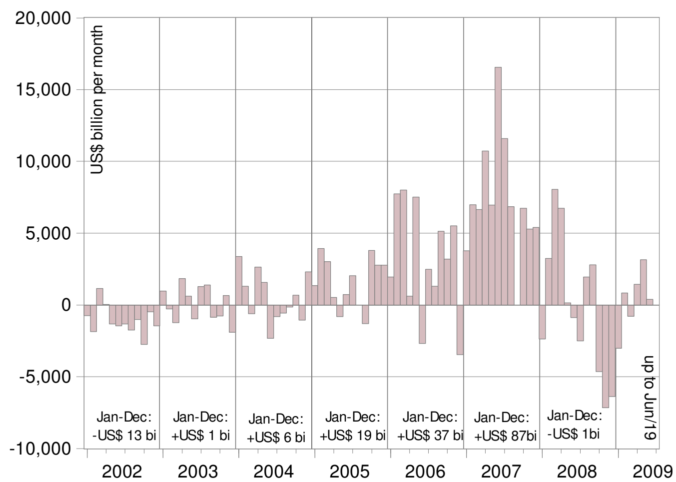
[4] For instance, in the United States inflation rates, GDP, industrial output and the level of employment have all fallen. The contagion that has affected Brazil also has contracted demand: the biggest decline has been in gross fixed capital formation, which has fallen by more than 3% of GDP. The drop in external demand has also been a decisive factor in this shock. The difference is that in the Brazilian case prices have fallen less.

[5] Another way to gauge the behavior of the current account deficits is to remember they are equal to the excess of domestic investments over savings (public and private). Savings in Brazil are small and do not react quickly and intensely to an increase in investments, meaning that acceleration of investments will lead to higher current account deficits. But the slow recovery of investments will tend to produce slow current account movements as well.

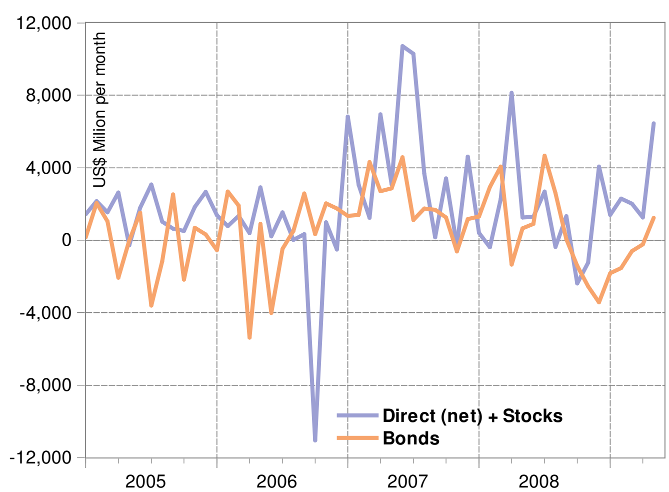
CAPITAL FLOWS

The international crisis caused a temporary halt in capital inflows, cutting short a cycle of strong inflows that was particularly strong in 2007. That year these flows ran at well over US$ 5 billion a month, and topped US$ 10 billion in some months. The flows shown in Graph 5 refer to net commercial and financial flows taken together. These monthly flows had already declined before the more acute phase of the present crisis, and for the worst four months there were net outflows greater than US$ 5 billion per month. But recently these flows have started to return, and although they are small in relation to the levels from 2006 until the middle of 2008, the perspectives are that they will pick up in the coming quarters.

Graph 5
Capital Flows



Graph 6
Capital Flows: Direct, stock and bond investments



The rise of the trade surpluses only partly explains the improvement in these flows. The main component has been the flows for direct investments and to the stock market (Graph 6). Together these have been growing and were nearly US$ 6 billion last month. The same graph shows that recently there has also been a rise in net flows to the fixed-income market.

Brazil is already emerging from the recession. Although the renewed growth is still modest, it exceeds the average of industrialized countries. This acts as a stimulus to foreign direct and stock market investments. There is a parallel reduction of risks, as shown by the evolution of the EMBI and CDS. These are forces that should maintain the capital inflows. This behavior, along with the low current account deficits, means there is a good probability for continuing, though moderate, appreciation of the exchange rate.

PRESSURES TO CONTROL CAPITAL INFLOWS

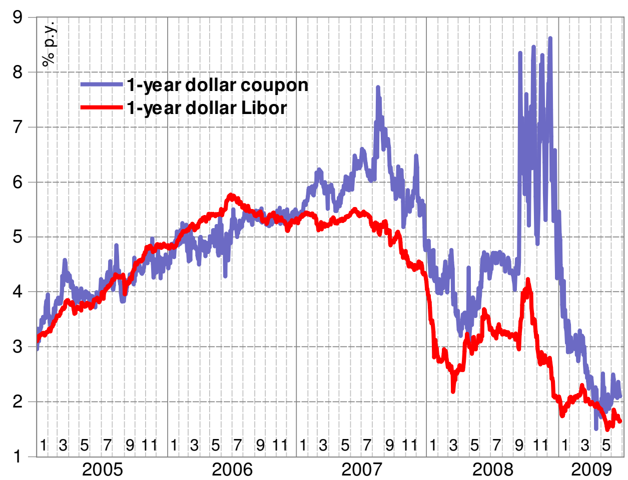
There is a high positive correlation between the nominal and real exchange rate (Graph 7). The renewed foreign capital flows are causing the nominal exchange rate to appreciate, which is propagating to the real exchange rate as well.

Graph 7
Nominal and Real Exchange Rate

Exporters are reacting by increasing their calls for the government to do something to inhibit this appreciation, by introducing measures to control capital inflows. So far these pressures have been mainly expressed in private, only occasionally cropping up in the press. But even without any knowledge of their details, it is obvious measures will not be proposed to limit direct investments or investments in the stock and long-term bond markets. After all, these are the source to finance fixed capital investments, and reducing these flows would hurt gross fixed capital formation and undermine GDP growth itself. The target of these measures will surely be short-term fixed-income investments, attracted by the interest rate differential.

Here we have to distinguish between two cases: investors who want to cover their exchange rate risk and investors who accept this risk. We first examine a carry-trade operation for one year, with an investor who does not want to run an exchange rate risk. In this case, the investor will obtain funds abroad at the one-year Libor and put the funds in a one-year fixed-income investment in Brazil tied to the dollar (*cupom cambial*), earning the difference between the two rates. The comparison between these two rates is shown in Graph 6. During 2007 and into 2008, before the sharpest phase of the crisis hit, this dollar investment in Brazil for one year yielded an average of more than one percentage point above the Libor[6]. Hence, there were significant gains to be made, which attracted resources. But this is no longer the case: currently the differential between these two rates is too small to act as a strong inducement to capital flows.

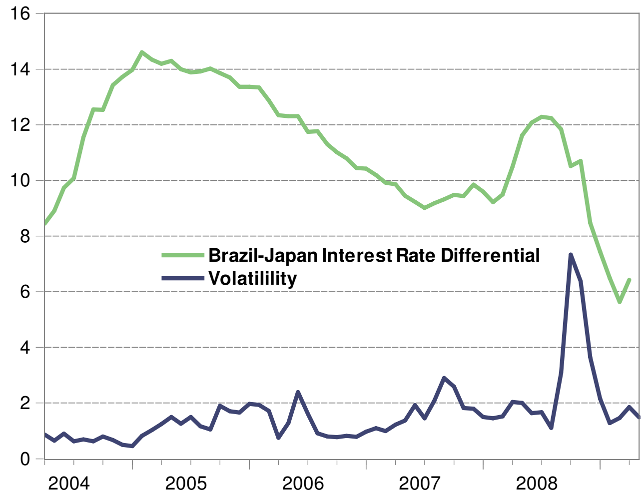
Graph 8
Libor and the Rate on Dollar Investments in Brazil for One Year



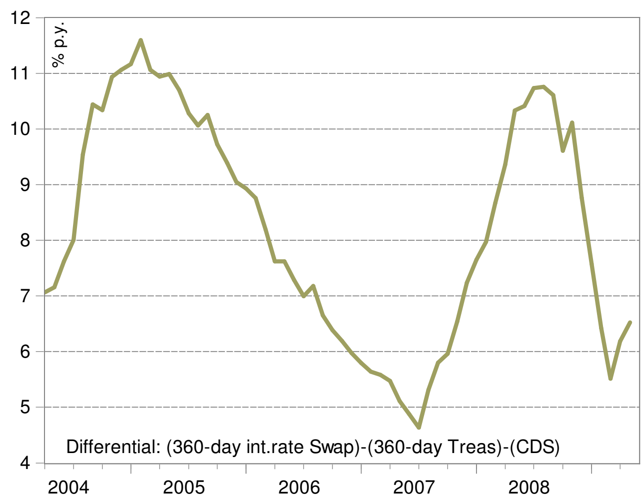
This is not the case for investors who accept the exchange rate risk. We first look at the difference between the one-year interest rates in Brazil and Japan. Since the Brazil risk is higher and more volatile, this differential must be adjusted by the risk premiums. We chose the CDS for this adjustment[7]. The recent fall in the interest rate in Brazil has tightened this differential (Graph 9), but it is clear it is still very high. In the graph we also show a measure of the exchange rate volatility, which is a measure of the exchange rate risk. It's easy to see that has not risen enough to inhibit the stimulus to this type of operation. In Graph 8 we repeat this exercise for the one-year rates between Brazil and the United States, also adjusted by the CDS. In this graph we omit the exchange rate volatility, which was already shown in the previous graph. Just as in the comparison with Japan, the difference has remained high, even after the recent fall in the Brazilian interest rate.

[6] During the worst of the crisis, the excess was much larger, but the risks that grew "in the midst of the storm" inhibited the operation.
[7] Unfortunately we only have CDS data for 10 years, which makes the correction imperfect. But we have a notion of the intensity of the differential, and the direction it is headed.

Graph 9
Brazil-Japan Interest Rate Differential and Exchange Rate Volatility

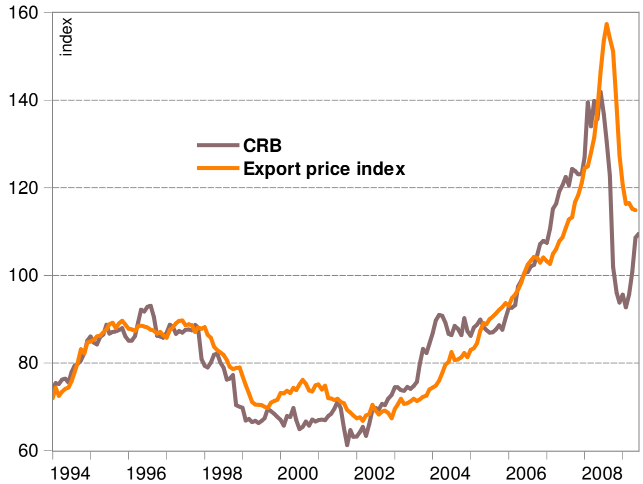


Graph 10
Brazil-USA Interest Rate Differential

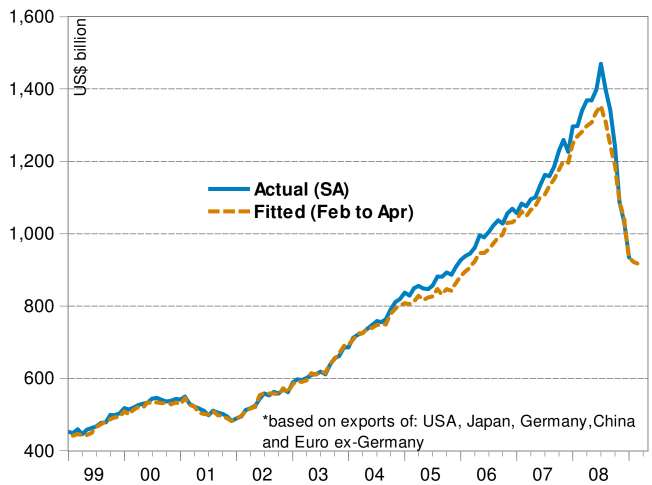


The pressures for capital controls will tend to grow if exports recover more slowly. The dollar prices of Brazilian exports follow international commodity prices, which have already shown some recovery in recent months (Graph 11). This movement is helping to stabilize monthly exports in dollars, which have stopped falling. But it's hard for us to imagine a strong rise in Brazilian exports when our estimate of total global exports still is for a decline (Graph 12), although not as accentuated as in recent months, and when the global recession still inhibits stronger recovery of commodity prices.

Graph 11
Dollar Prices of Brazilian Exports and CRB Commodity Price Index



Graph 12
Dollar Value of Global Exports



There are three arguments against these pressures. The first comes from the Brazilian experience with capital controls in the past. In a country with a sophisticated financial market like Brazil, these controls are only temporarily effective, as abundant empirical evidence shows. The second is that the biggest victim of a tax on fixed-income investments would be the Treasury itself, which would have to bear a higher cost to service its debt. And third, as economic recovery picks up in 2010, the current account deficits will grow, and Brazil will need capital inflows to finance higher current account deficits without putting greater pressure on the exchange rate, which would raise inflation and push up the interest rate.

The best economic policy reaction in a situation like this is: a) to continue reducing the interest rate to the limit permitted by the effects on inflation from the narrowing output gap and strengthening exchange rate, and b) to resume accumulating reserves at a moderate pace. We expect this to be the government's reaction. But the probability that the government will yield to these pressures is by no means nil.

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