The exchange rate and the low growth

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President Dilma has changed the way of understanding the "macroeconomic tripod" prevailing in Brazil since 1999, but, as we could see by the results of the third-quarter GDP, predicting only 1% growth in 2012, she was still unable to get rid of its consequences: high interests, overvalued exchange rate, and low growth. Those consequences do not arise from the primary surplus which, as a manifestation of fiscal responsibility, is good economic policy. They arise from the inflation targeting policy, because this policy, instead of being understood as the central bankers' autonomy to pragmatically react to the threats of increased inflation, was used in order to legitimate stratospheric interest rates and exchange rate appreciation. They also arise from the floating exchange rate policy, which was understood as a permission for the exchange rate to be determined exclusively by the market – which is an economic absurdity, given the existence in developing countries of a tendency to the cyclic and chronic overvaluation of the exchange rate.

The present administration rejected the conceptions of liberal orthodoxy, and it was thus reasonably successful in lowering the interest rate. But since it can no longer rely on explosively increasing commodity exports, and since the domestic market increase caused by the redistributive policy of the former administration was already captured by imports, the country reverted to a slow growth. The domestic market was captured by imports because only a modest exchange rate depreciation was achieved, and thus the exchange rate did not reach the "current equilibrium" (the exchange rate that balances the trade account), let alone the "industrial equilibrium" – the exchange rate required for industrial companies using world state-of-the-art technology to be competitive – which must be, respectively, around R$2.20 and R$2.70 per dollar.

The industrial equilibrium was not reached because the reduction in the interest rate, the purchases of reserves and the controls of capital inflows were insufficient to depreciate the exchange rate, and because the government lacks political conditions to impose an export tax that would neutralize the Dutch disease. Without this kind of tax, an exchange rate at the industrial equilibrium level makes so lucrative the commodity-exporting companies that if, hypothetically, the government would be able to shift the exchange rate towards this equilibrium, the increase in supply in relation to the exchange rate would lead to a revaluation of the exchange rate.

Shifting the exchange rate to the industrial equilibrium implies huge gains in growth and increased well-being in the medium term, but it implies costs and sacrifices in the short run that require society's greater political support.

The alternative pursued by the government is to gradually depreciate the exchange rate. It does that through some of the above-mentioned policies, except for the tax, and through specific industrial policies, particularly the increased protection of specific sectors.

Will president Dilma be successful in this strategy? It is not certain, because the exchange rate has too much appreciated, widening the distance towards the equilibrium. And because, since it is not viable nor desirable to go back to a system of multiple exchange rates, the export tax is the only alternative to lead the exchange rate towards the industrial equilibrium. Definitely, the economic challenges the president and Brazil face in order to grow again at high rates are not easy.