Exchange rate, the “light switch”

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It was a pleasure to read Dani Rodrik's interview in the newspaper *Valor* (July 23, 2012) in which he saw optimistic prospects for Brazil, provided that the governmental policy of reducing the interest rate and depreciating the exchange rate is successful, that is, provided that we reach “a context in which the relative incentives to investment in the manufacturing industry and in other internationally tradable sectors will be maintained". The Turkish Harvard economist adopts, therefore, the fundamental idea of the new developmentalism according to which the trap that is preventing Brazil's sustained growth at a rate of at least 5% per annum is the trap of the high interest rate and of the chronically overvalued exchange rate.

But, my readers may ask, why would an equilibrium exchange rate – that is, an exchange rate that makes competitive manufacturing industries adopting worldwide state-of-the-art technology – be so important? After all, economic development textbooks make no reference to the exchange rate. The answer is twofold: first, because the exchange rate is a kind of “light switch” or “dimmer” that, when it appreciates, disconnects the technologically and administratively competent domestic companies from the whole global market, and, at the same time, connects possibly less competent foreign companies to our domestic market; second, because, if left to the market, this exchange rate tends to be cyclically and chronically overvalued in developing countries.

The metaphor of the light switch helps us understand one of the reasons of the drop in the country's growth rate. During the Lula administration the exchange rate did not stop appreciating, but this was compensated by the increase in the domestic market provided to industrial companies by the welcome distributive policy. But the light switch connected foreign companies to our domestic market, so that, with a nearly three-year gap (the time it takes importers to get organized), they took over the domestic market, and deindustrialization became worse.

President Dilma Rousseff is working firmly to solve this problem. And she already managed to raise the exchange rate, from R$ 1.65 to R$ 2.03 per dollar; she managed, therefore, to depreciate the exchange rate by 25%; and this without increasing inflation, because the Central Bank took advantage of the weak internal demand. But the dollar has stopped at that level for already nearly two months now, and still is very far from the “industrial equilibrium” – the exchange rate that makes internationally competitive the domestic companies using worldwide state-of-the-art technology.

To achieve a deeper devaluation and a stable exchange rate, it will be necessary to continue to lower the interest rates and also to tax commodity exports. Without this tax, a rate of R$ 2.50 per dollar, for instance, will generate high profits which will increase the supply of those commodities and will revalue the real. Therefore, it is necessary for the president to be backed up by a national debate, in which it will be clearly stated that commodity exporters will have nothing to lose from the tax, because they will be compensated by the increase in the exchange rate. In democracies, only this kind of debate will be able to solve this problem, which is the fundamental economic problem faced by Brazil – the problem of connecting competent domestic companies to the global demand.