Monetary Policy During the Transition to a Floating Exchange Rate

Brazil's Recent Experience

The financial crisis that erupted in Asia in 1997 quickly spread to other developing regions, as international investors panicked and pulled their capital out. In this article, the governor of Brazil's central bank outlines the steps Brazil took to avert financial disaster when inflows of private foreign capital suddenly dried up.

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THE BACKGROUND to Brazil's financial crisis in early 1999 included both fiscal and balance of payments weaknesses: in mid-1998, Brazil's consolidated fiscal position was showing a primary deficit as the government's expenditures, excluding interest payments, exceeded its income. The bulk of the government's domestic debt—which amounted to 40 percent of GDP—consisted of short-term financing. The current account deficit was approaching 5 percent of GDP, even as the economy was sliding into recession. Then, as often happens to vulnerable countries, an economic crisis erupted: after Russia defaulted on its debt in August, capital flows to Brazil came to a halt.

These events forced Brazil to float the real and led to a panic in January 1999. In February, the real plummeted to 2.15 to the dollar, from 1.20 at the beginning of the year. The situation was ominous: Brazil could soon have found itself in all kinds of trouble. A panicky reaction to the devaluation could have created serious imbalances, fueling inflation while driving the economy into a deep recession. The threat of inflation was particularly relevant, given Brazil's history; observers predicted inflation rates ranging from 30 percent to 80 percent. Forecasts for GDP growth in 1999 ranged from –3 percent to –6 percent.

Curbing the panic

The first decision we faced was whether to go back to a managed peg or fixed-rate regime, or whether to float. For standard optimum currency–area reasons, we felt it made sense to allow the real to continue to float. As a result, we needed to find a new nominal anchor. A policy based on a monetary aggregate did not seem feasible, particularly considering the uncertainties inherent in the crisis sweeping through the Brazilian economy. Another possibility was the adoption of a fully discretionary policy without an explicit anchor. However, given the degree of instability expected, a stronger and more transparent commitment was essential. To address this need, we opted for a full-fledged inflation-targeting framework.

We also had to make a decision on the timing of the announcement of the inflation target. The issue was whether it made sense

to announce an inflation target immediately or whether it was better to wait until the dust had settled a bit. It was too risky for us to announce a multiyear target right away. We were afraid of quickly burning what we thought was the right long-run framework for Brazil by announcing either a target that would be too easy to meet or one that had too great a chance of being missed. We knew that, with the right policies, inflation would eventually slow, but it was unclear at that stage how high inflation would climb or how fast it would come down. We did not know how much overshooting we would have to deal with and how the economy would respond.

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So we went for a two-step solution. In March 1999, we announced (1) that our goal was to bring inflation down to a single-digit annualized rate by the last quarter of 1999 and (2) that we would have the full inflation-targeting system in place by the end of June. The year-end target served as a temporary anchor, which contributed to the effort to contain the panic.

The good news at that point was that, in the six months before the crisis, a remarkable turnaround in fiscal policy had taken place. Between October and February, quite a few policy changes had been implemented in Brazil. The path was not smooth; some important measures were defeated in congress and had to be reintroduced later. But, in the end, Brazil succeeded in moving from a primary deficit of 1 percent of GDP in 1997 to a running surplus of 3 percent of GDP in late 1998 and into 1999. That was key. Without a primary surplus, concerns about the future path of the debt-to-GDP ratio would have continued to grow.

At that time, there was little confidence in Brazil's fiscal turnaround. Interest rates were still 39 percent—the level they had reached before the float—and we needed to decide what our next interest rate move, if any, should be. The basic guideline we used was expected inflation, which, in practice, amounted to following an informal inflation-targeting program right away.

A first question was related to the degree to which the devaluation of the real was creating inflationary pressures. Solid data were not yet available because the floating rate had only recently replaced the managed exchange rate. So we used some back-of-the-envelope calculations. We assumed a pass-through coefficient (of the devaluation to inflation) of 30–40 percent (based on the estimated share of traded goods in the economy). With the exchange rate at 2.15, this could mean a very high inflation rate, so something had to be done. We raised interest rates to 45 percent.

While it is always a dangerous thing for a central banker to take a view on the market, I felt quite strongly that the exchange rate was fast moving into an overshooting or bubble range, which would have negative and unpredictable consequences. This view was predicated on reasonable balance of payments and real exchange rate calculations that seemed to imply that a 50 percent devaluation, in real terms, was more than enough. Therefore, if we could succeed in calming the panic, the overshooting would diminish and inflation expectations would come down as well. We instituted an interest-rate-bias concept (like the U.S. Federal Reserve's) and immediately announced a downward bias for the intervals between future monetary policy committee meetings. That meant the central bank could lower rates between meetings without calling for a new vote by the committee. Market reaction was positive: the yield curve inverted almost instantly, something that had not happened in Brazil in a long time.

To improve further the odds of halting the panic, a final area had to be covered—namely, international financing. Given the fragility of the government's debt situation at that time, there was a risk that a policy of high interest rates alone would be seen as pushing Brazil down the wrong path, one that led to an increasing debt-to-GDP ratio. The exchange rate was overshooting in part because markets doubted our ability to finance the balance of payments over the next few months.

The financing package led by the IMF played a key role. In parallel with formulating a policy response on the domestic front, we worked with the IMF in putting together an international financial plan that covered the months from April until June. The plan took a conservative (but then quite reasonable!) view of our ability to finance the balance of payments over this period. It assumed very low rollover rates for most payments coming due and anticipated a financing gap that would be covered by loans from multilateral and bilateral institutions.

These numbers were presented to the commercial banks to demonstrate that the balance of payments would be feasible with rollover rates of less than 100 percent for trade and interbank lines. We then asked the banks for their voluntary support. We held discussions with individual groups of banks, each representing a major geographic region. To encourage a collective rollover of trade and interbank lines, we provided each group with information not only about its own exposure to Brazil but also about the exposures of every other region. Reports on bank exposure to Brazil were to be provided frequently thereafter. This policy of using information disclosure as a coordination device worked well and, by August, the voluntary agreement was no longer necessary.

A successful response to crisis

Summing up briefly, the policy response to the crisis entailed a combination of tighter fiscal policy, tighter monetary policy with an inflation target, and external financial support. Results have, so far, been surprisingly positive. The exchange

rate stabilized and fell below 2 reais to the dollar very quickly. Inflation expectations also came down, which allowed us to use the interest-rate bias twice during March 1999; rates were first cut to 42 percent, then to 39½ percent. Synthetic onshore dollar rates fell dramatically, from the teens and even the twenties to mid-single-digit levels not much above international rates. We no longer needed short-term capital other than trade finance to finance the balance of payments.

During the months that followed, we were able gradually to lengthen the maturities of the government's domestic debt, from six months to about a year. By June 1999, the panic was behind us. At the end of the month, the inflation targets for the rest of 1999 and for the next two years were announced, as planned. A broad-based consumer price index was chosen (the IPCA). The targets are 8 percent for 1999, 6 percent for 2000, and 4 percent for 2001. The targeting mechanism will therefore play a dual role: a permanent one of nominal anchor and a temporary one of disinflation guideline. This is not unlike what has happened in other countries that adopted inflation targeting immediately after letting their currencies float.

A band of 2 percentage points around the target levels was introduced. The band is wider than that of most other countries because we do not have a core inflation index in Brazil yet, and also because there is more intrinsic uncertainty in Brazil at this stage than elsewhere. We have been careful not to focus much attention on the band in order not to distract expectations away from the targeted path. The band is there to guide the response to supply shocks and to trigger an open letter to the finance minister in case the target is missed.

The minutes of the monthly monetary policy committee meetings are released with a two-week lag, which will soon be reduced to one week. A quarterly inflation report is also being produced; since the September 1999 issue, it has been published simultaneously in Portuguese and English. Both documents can be found on the central bank's website at www.bcb.gov.br. The report, which is very detailed, is modeled on disclosure reports published by Sweden and the United Kingdom.

The Brazilian economy has weathered the crisis well. Despite a series of internal and external shocks since June, the exchange rate has floated with very limited central bank intervention. The interventions are announced at the end of the day. Inflation in 1999 reached 8.9 percent, within the tolerance interval, and inflation expectations for 2000, as measured by a broad survey, are less than 7 percent. We have also, and most surprisingly, seen growth for two consecutive quarters (thanks, in part, to the fact that Brazil's private sector was not excessively leveraged and had limited exposure to foreign exchange risk at the outset of the crisis). GDP growth is estimated at nearly 1 percent for 1999, and at 4 percent for 2000.

On the external side, the current account deficit decreased from $33 billion to $24 billion in 1999, being totally financed by record inflows of $30 billion in foreign direct investment. Despite depressed commodities prices, exports are expected to make a robust recovery in 2000, as a result of improved Brazilian competitiveness and a more favorable international scenario. Brazil's trade balance could reach a surplus of nearly $4 billion in 2000, even with an expected increase in imports.

The implementation of inflation targeting in Brazil is off to a promising start. The adoption by the IMF, for the first time, of a consultation mechanism on inflation targets, in the last revision of the program, stresses the soundness of our current monetary policy.

On the micro side, a major overhaul of the regulatory aspects of the money market and of the domestic government debt market has just been completed. Financial repression is also being greatly reduced. The plan is to reduce the volume of directed credit as well as reserve requirements so as to improve microeconomic efficiency and also to enhance the transmission mechanism of monetary policy. The capital account of the balance of payments is being liberalized. For this year, we will place a new focus on capital markets reform, including improved transparency rules and minority shareholder protection. These policies are being supplemented by the adoption of stronger prudential measures that include a revision of the payments system and improved bank supervision and regulation. These microeconomic reforms will support Brazil's inflation targeting cum flexible exchange rate system. F&D

This article is based on a talk delivered by the author in August 1999 at the Jackson Hole Conference of the U.S. Federal Reserve Bank of Kansas City.

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