The foreign exchange regime shift

Once the currency movement was left to the markets, the ups and downs are clearly visible. With the start of the Global Financial Crisis in 2007, Brazil has suffered a great erosion in the market values of its companies. Bovespa, its currency and stock market has lost 41% value in the year 2008 The Global Context The years following the regime shift of Brazilian Exchange Rates were full of Global upheaval. In 2000, the world saw the dot-com bubble burst resulting in huge unemployment across the world. Brazil had a significant impact as the US, the source of the dot-com bubble burst, was one of the main allies of Brazil. The world had just recovered from the dot-com bubble, so there was Argentine Crisis and more importantly the September 11, 2001 attacks on the US. These attacks disturbed sentiments across the world and many close trade allies of the US were affected. Brazil could not escape from the repercussion of the crisis. The period between 2003 to 2007 was relatively stable and favorable for growth and we can notice Real (BRL) strengthening against USD in the graph above. In 2007, came the Subprime Crisis followed by the Global Credit Crunch and a steep nosedive of Global Financial Markets.

The graph shows BRL depreciating against USD after May 2008. Keeping in mind the above ups and downs, we can say that the floating BRL saw an uneven global context. Analysis of the Behavior of BRL Exchange Rate The ten year average of floating BRL against USD is $2. 34 with the lowest at $1. 32 at the time of inception of the current regime and the highest at $3. 96 in Oct 2002 (please see the graph). During late 1994 and early 1995, BRL gained value as a result of large capital inflows but slowly the depreciation process started and till 199, Brazil suffered maxi-devaluation and had to suffer from the fluctuations widely. In spite of various attempts of the Central Bank of Brazil to keep BRL low, it was not able to keep BRL away from appreciating until 2008 when the global Financial Crisis devalued BRL. As evident in Figure 2, BRL suffered depreciation until late 2002. This was the same period when Brazil witnessed a spike in inflation (see below graph). Noticeably, this was the time when there was a prospect of the election of Lula da Silva as a presidential candidate. He was considered as a populist among the financial markets. The markets considered him to be anti-industrial and feared that Brazil would once again fall prey to the non-democratic powers.

Although, the market sentiments bettered after the repeated assertion of the Central Bank and the President Lula da Silva that the ongoing financial reforms would be continued along with continuous payment of public debts (see Figure 3) and as a result, BRL continued to appreciate from 2003 to 2008 until the Global Financial Meltdown affected its performance. In October 2006, Lula da Silva announced a package of more reforms in the economy in order to reduce taxes and increase investment in infrastructure. Figure 3 Public Debts of Brazil Source: CIA Factbook Figure 3 shows us the decreasing Public Debts from 2004 to 2008. It achieved the status of Investment Grade in 2008 but the government’s strategy of achieving growth by reducing public debt put pressure on inflation. The yield to the 2015 call date on Brazil's 11 percent bonds due in 2040 fell by 21 basis points to 5 percent in New York, according to JPMorgan Chase; Co. The price rose from 1. 602 cents on the dollar to 136. 301 cents, the highest since the country issued the securities in 2000. Brazil had experienced a recurrent balance of payment difficulties which led to the poor macroeconomic performance of the country in the following years.

After the introduction of the Floating Exchange Rate regime, the current account balance of BRL has bettered to -1. 0% of Gross Domestic Product as compared to the long term average (since 1970) of -2. 1%. The improving Balance of Payments (BoP) enabled the Central Bank of Brazil to raise its forex up to $205 billion. But this rise in forex did not affect the functioning of the floating exchange rates as the government purchased the foreign currency through open auctions at the prevailing market prices. Figure 4 Current Account Balance of Brazil Source: CIA Factbook. Looking at Figure 4, we can see that Brazil has recorded a Current Account Surplus from 2003 to 2007 and has also recorded its first surplus since 1992. It is notable that the Current Account Balance has improved continually for Brazil since the introduction of the Floating Exchange Rate system in 1999. Brazil, however, incurred a Current Account Deficit in 2008, the reason being a significant drop in world demand and prices in commodities. After the currency crisis of 1999, the then President of Central Bank of Brazil, Arminio Fraga introduced the concept of Inflation Targeting.

Opting for a floating exchange rate regime and doing away with the fixed exchange rate system was an inevitable option. With the floating exchange rate regime, Brazil could better focus on inflation targeting. As shown in the graph below, it faced problems in managing the inflation in the first half of the past decade, but in the past few years, it has managed to keep inflation within the targeted range. Figure 5 Inflation Rates in Brazil (Targeted vs Actual) Source: Central Bank of Brazil We can observe inflation shooting up in 2007 and 2008. The reason for this is the government's strategy of reducing public debts in order to boost economic growth. The floating exchange rate regime in Brazil has also witnessed strong criticism on various fronts. Critics argue that exchange rates are too important to leave them to the markets. This argument gains even more credibility in this global financial turmoil. In addition, Brazil has a history of heavy governmental intervention with close linkages between some industries and the government during the times of dictatorship and military authoritarianism.

So, the critics of the floating exchange rate system will always have support in all sorts of media. The governor of the Central Bank of Brazil, Henrique Meirelles, in his speech on the occasion of the tenth year of the Floating Exchange rate regime, defended the central bank's stand. He said that regardless of the exchange rate regime, the relative prices of tradable to non-tradable change continuously hence the real effective exchange rate always floats. So the advantage of having a floating exchange rate regime is that these price adjustments happen faster and the impact of external shocks on the economy becomes relatively smaller. Although Brazil follows a floating exchange rate regime, it does not mean that it has left the exchange rate to suffer during the current financial turmoil. For the first time since 1999, the government has used its reserves to safeguard the interests of the exporters and importers of Brazil and provide liquidity to the financial markets in the times of liquidity crunch. All policies have their pros and cons. There is no doubt that the Brazilian economy has made great progression in the past ten years since 1999 and a major credit of it goes to the regime shift from Fixed to a Floating Exchange Rate System. As long as the regime favors developmental activities in Brazil, there is no reason for its government to shift to another policy.

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