The floating exchange rates of brazilian real

In simple terms, exchange rate is the value of one currency as compared to another. The market for foreign exchange was developed because of lack of a common currency complicating trades between countries. In today's globalised financial markets, the significance of Exchange Rates could never be lesser. It is the basic platform through which traders of different countries value the goods and services of another party. Exchange rates are also better indicators of a country's international purchasing capability and its economic power.

Exchange rates are basically a market for currencies driven by the normal forces of supply and demand. However, each country has its own exchange rate policy and exchange rates are fixed or floating depending upon the monitory policies of the countries. A country typically chooses its exchange rate regime depending on its economic characteristics like its inflation, past economic shocks, monitory credibility etc. (Calvo & Reinhart, 2002).

With many countries opting for floating exchange rate regime, changes in the demand for a country's currency causes fluctuation in its exchange rates and it has also helped international investors to revise their investment decisions rapidly as new information emerge. As much as the exchange rates are a direct link between the prices of goods and services between the trading nations, the financial flows among nations have dwarfed the value of world trade in goods and services (Niles, Orden, Rosson, & Benson). Therefore unsurprisingly, less than 20% of all forex activities are directly linked to the needs of traders of goods and services and more than 80% of transactions involve the the purchase of foreign financial investments and currency speculation. One of the main reasons for exchange rate movements

is exchange rate expectations or speculations. The analysis done by Dornbusch and Fischer in their book " Macroeconomics" confirms that the exchange rate expectations have the power to impact the capital flows and thus actual exchange rates. Thus these expectations become the primary sources of macroeconomic disturbances (Dornbusch, Fischer, & Startz, 2007).

The flow of foreign trades between the countries is significantly shaped by the exchange rates as they affect the prices of imports and exports. The greater the demand of foreign currency or the shorter the supply of it, the greater will be its exchange rate. The principal determinants of the foreign exchange rates of a currency are corporations and persons who deal in international commerce and their lenders, currency speculators and central banks. Central bank intervention occurs for several reasons. The main reason is, as cited above, that the change in exchange rates affected by capital flows is merely a reflection of unstable expectations and causes unnecessary changes in domestic output. Secondly, central intervene to affect trade flows, hence managing exchange rates becomes necessary.

Thirdly, Central banks also intervene to manage the domestic inflationary conditions. Central banks slow inflation by intervening in exchange markets to prevent the currency from depreciating and thus preventing higher import prices (Dornbusch, Fischer, & Startz, 2007). Finally, we can say that regardless of complexities in their management and fluctuations, exchange rates are one of the primary indicators of the trade activities and economic performance of a country. Brazil is the eighth largest economy in the world with a total Gross Domestic Product (GDP) of USD 1. 9 trillion. Brazil has

hundreds of trade partners and more than 80% of its exports come from manufactured and semi manufactured goods.

The major trading partners of Brazil include EU, Asia and US. Brazil is blessed with vast natural resources that have played an important role in making it the largest economy of South America. The average economic growth rate of Brazil was 5. 7% in 2008. The service sector has the largest share of 66. 8% followed by Industrial Sector at29.

7 %. The share of agriculture is very low, 3. 5% while the sectors employs 10% of the 100 million labor force population. The 2008 figure of inflation stands at 4. 46% which quite within the range of Inflation Targeting of the Central Bank of Brazil. Along with the measures opted to balance the economy, Brazil also carried out initiatives for social security for its citizens like retirement pensions and tax systems.

It created policies to encourage exports and investments proving business friendly atmosphere for local and global investors and producers. Crises in Brazil Economy and Introduction of Floating Exchange Rate RegimeBrazil is the largest country of South American subcontinent. It got independence in 1822 from the Portugal rule has never seen a stable political and economic leadership since then. It was ruled by a number of different leaders after 1882, dictator, constitutional democracy, military authoritarianism and back to the democracy in 1985. After the fall of military authoritarianism (1964-1985), Brazil shifted to constitutional democracy in 1985 till today. Since then, Brazil has seen many ups and downs in its economy.

In1992, President Fernando Collor was impeached when a big corruption scheme was uncovered. During this period, Brazil had an inflation rate of 50% and the economy was at the brink of collapse (Weinberger, 1996). In 1993, the finance minister Fernando Cardoso introduces the famous RealPlan. He was elected President in 1994 and he introduced free market policies bringing down inflation under 2% (Weinberger, 1996). He raised interest rates to 50% to make sure the investors money was within the country (The Economist, 1999).

Brazilian economy was in deep trouble in 1999 since the high interest rates created problems with mortgages and loans. The Real Plan The Finance Minister Fernando Cardoso introduced the Real Plan for fiscal and currency reforms in 1993. “ The main element of the Real Plan included the introduction of a new currency (The Real), de-indexation of the economy, an initial freeze of public sector prices, the tightening of monetary policy, and the floating of the currency with a floor specified for its value in relation to the dollar (Clements, 1997).” Subsequent to the real plan, Brazil recorded the best recovery in the history.

The economy growth was 4-5% per annum, unemployment dropped, exports and imports enhanced, consumer goods purchase was increased and food consumption rose (Weinberger, 1996). The President, under the Real Plan, also privatized a number of state owned industries earning billions of dollars for the government from the sale. The Real Plan created confidence in the investors, both domestic and international (Forbes, 1995). The best feature of the Real Plan was that it reduced the government spending hence increasing the ray of hope for the stabilization of the economy.

The critical success factor for the real plan was that it incorporated the development of poors. Since its implementation, the distribution of income has improved significantly thereby reducing the poverty. Benedict Clements stated in his article, " The Real Plan, Poverty and Income Distribution," " Between 1994 and 1995 the income of the lowest 50% of the workers grew by around 30% whereas the income from the top group grew only 10% (Clements, 1997)". The Real Plan also saw great support from the middle class societies of Brazil. They aggressively supported the Real Plan deeming the inflationary moves as derogatory to their society (O'Dougherty, 1999). A great indicator of the Real Plan's success was that the percentage of people living below the poverty line had decreased as the minimum wage in Brazil had risen above the basic consumption basket (Vignogna, 2000).

However, the Real Plan was never the savior of Brazilian economy even though it had all the power of being so. The country faced currency crisis in 1999. The Foreign Exchange Regime Shift Since 18th January 1999, Brazil moved towards floating exchange rate regime after this crisis. The transition occurred as a result of currency crisis with expectations that the ongoing economic imbalances would be over and the economy would be protected from external shocks.

The following figure shows the exchange rate of Brazilian Real (BRL) vis a vis USD from January 1995 to May 2009.