Monetary Policy in a Transition to a Floating Exchange Rate: Remarks on the Recent Brazilian Experience

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We have just gone through a fairly dramatic change in our exchange rate regime, with both panicky and bubbly features appearing in many different ways. I will narrow the scope of my remarks mainly to monetary policy.

Let me begin with a bit of background. Going into the second half of 1998, Brazil was running a fiscal deficit on the primary concept and had the bulk of its domestic government debt (some 40 percent of GDP) financed in the short term. The current account deficit was widening toward 5 percent of GDP, even as the economy went into recession. Then, as it often happens when a country is vulnerable, Brazil ran into a crisis, with capital inflows grinding to a halt after Russia in August.

These events led to a forced floating of the exchange rate and a panic in January of this year (1999). In February, the exchange rate reached 2.15, after having started the year at 1.20 to the dollar. Clearly, this was a situation where Brazil could run into all kinds of trouble, and where the panic influences could push the economy into a bad equilibrium with high inflation and a deep recession. Inflation was a particularly relevant threat, given the country's history. At that point, inflation expectations ranged from 30 percent to 80 percent and forecasts for GDP growth ranged from -3 percent to -6 percent for 1999.

The first decision we faced was whether to go back to a managed peg or stronger fixed-rate regime or whether to float. For standard optimum currency area reasons, we felt it made sense for us 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 to the crisis transition the Brazilian economy was going through. Another possibility was to run policy on a fully discretionary basis without an explicit anchor. However, with unstable expectations, a stronger and more transparent commitment was essential, so we opted for a full-fledged inflation-targeting framework.

Another decision was the timing of the announcement of the inflation target. The issue was whether it made sense to announce an inflation target right away or to wait until the dust settled a bit. It was too risky for us to announce a multi-year target right away. We were afraid of quickly burning what we thought was the right long-run framework for Brazil by either announcing a target that would be "too easy" or one with too high a chance of being missed. Sure, with the right policies, inflation would eventually come down. But it was unclear at that stage how high inflation would go and 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.

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

The good news at that point was that in the six months prior to the crisis, a remarkable turnaround in fiscal policy had taken place. Between October and February, quite a few policy changes were implemented in Brazil. The path was not smooth, with some important votes being first lost and then reintroduced in Congress. In the end, the bottom line showed a swing in the primary result from a 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, any forward-looking evaluation of the Brazilian economy would not converge.

The turnaround in fiscal policy was taking place, but nobody really believed in it then. At that point, interest rates were still at the 39 percent level they had been at prior to the float and we needed to decide what, if any, our next interest rate move should be. The basic guideline used at that stage was to look at expected inflation, which, in practice, amounted to following an informal inflation-targeting program right away.

A first question was related to the degree of inflation pass-through from the devaluation. Good statistical guidance was not available because, as in all countries that floated, a managed exchange rate was in place until just recently. So, we used some back-of-the-envelope calculations in order to proceed. We assumed a pass-through coefficient of 30 to 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 from 39 to 45 percent.

Although it is always a dangerous thing for a central banker to take a view on the market, we felt quite strongly that the exchange was fast moving into an overshooting or bubble range, with unpredictably negative consequences. This view was predicated on standard balance of payments and real exchange rate calculations that seemed to imply that a 50 percent real devaluation 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. To point in that direction, we instituted an interest-rate bias concept (like the Fed's) and immediately announced a downward bias for the upcoming time interval between Monetary Policy Committee meetings. That meant the central bank could lower rates between meetings without the need to call for a new vote of the Committee. Market reaction was positive and the yield curve inverted almost instantly, something which had not been seen in Brazil in a long time.

In order to further improve the odds of halting the panic, a final area had to be covered—namely the international financing side. Given the fragility of our fiscal/government 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 with an increasing debt-to-GDP ratio. The exchange rate was overshooting, in part, because markets doubted our ability to finance the balance of payments during the next few months.

Here the financing package led by the IMF played a key role. In parallel with the 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 during this period. It assumed very low rollover rates for most payments coming due, and came up with a financing gap that was then covered by loans from multilaterals and bilaterals.

These numbers were presented to the commercial banks in order to demonstrate that the balance of payments was feasible with less than 100 percent rollover rates of trade and interbank lines. We then asked the banks for their voluntary support. The discussions took place with a group of banks, each representing a major region of the world. In order to induce and maintain a collective rollover of trade and interbank lines, we provided each regional group of banks with the exposure to Brazil of their own group, as well as that of each individual region. Exposure reports 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.

Summing up briefly here, the policy response to the crisis entailed the 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 very quickly. Inflation expectations also came down. That allowed the use of the interest-rate bias twice during the month of March, with rates being cut from 45 percent to 42 percent then to 39 ½ percent.

Synthetic on-shore dollar rates also fell dramatically, from the teens and even the twenties at times to mid single-digit levels not much above international rates. Short-term capital, other than trade finance, is no longer necessary to finance the balance of payments.

During the subsequent months, we were able to start a gradual lengthening of the maturity of the government's domestic debt, which rose from six months to around a year. By June, 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 happened in other countries that adopted inflation targeting immediately after floating the exchange rate.

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 are released with a two-week lag. A quarterly Inflation Report is also being produced, the September issue published simultaneously in Portuguese and English. Both documents can be found on the central bank's website at bcb.gov.br. The report is very detailed and tries to follow the example of disclosure of the United Kingdom and Sweden.

The economy 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. Inflation is on track to meet the 8 percent target for this year, and, what is even more encouraging, inflation expectations for next year, as measured by a broad survey, have

converged to the 6 percent target. We have also, and most surprisingly, seen two quarters of growth on a sequential basis (thanks, in part, to the fact that the private sector went into the crisis with an unlevered and unexposed balance sheet).

The possibility of good economic performance may have opened a political window of opportunity for us to nail down a few of the remaining structural reforms (such as social security reform and tax reform) that still need to be done in Brazil.

Let me finish with a few brief comments on the micro side of reforms. A major overhaul of money markets has just been completed. Next, the plan is to start reducing directed credit guidelines and reserve requirements so as to improve microeconomic efficiency, and also to improve the transmission mechanism. The capital account of the balance of payments is being deregulated. These policies are being supplemented by prudential measures which include a revision of the payments system and improved bank supervision and regulation. These micro reforms will support the inflation targeting cum flexible exchange rate system in Brazil.