

Henrique Meirelles: Ten years of floating exchange rates in Brazil

Speech by Mr Henrique Meirelles, Governor of the Central Bank of Brazil, to celebrate 10 years of floating exchange rates in Brazil, Central Bank of Brazil, Brasília, 19 January 2009.

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It is an honor for me to speak to you today, which marks a special date in Brazilian economic history. That is because ten years ago yesterday, January 18, Brazil floated the *Real* (BRL), breaking with decades of exchange rate manipulation and repression by the government. I will start with some facts and then offer an assessment of the regime so far.

First, let me address the global context. Since its inception the floating exchange rate regime has weathered many storms, starting with the bursting of the high tech bubble in 2000, the Argentine crisis in 2001, the September 11th attacks and, recently, the effects of the 2008 global financial crisis. On the other hand, the global environment was on the whole favorable between 2003 and 2007. So, it is fair to say that in its first ten years the floating BRL has faced a pretty diverse external environment, neither persistently challenging nor consistently favorable.

Now, let us consider the behavior of the exchange rate itself. The floating BRL has averaged \$2.34 against the USD, within a range of \$1.32 on the outset, to \$3.96 on 22 October 2002. It is nothing but a sheer coincidence that the nominal exchange rate currently stands very close to its 10-year average. The real effective exchange rate has also oscillated substantially, reacting to shifts in fundamentals such as the terms of trade, risk aversion and underlying capital flows. Compared with a long-term average of 100, the real effective exchange rate (measured in terms of BRL) has moved within 58, on October 2002, when the BRL was particularly weak, to 125 in August 2008, when it was stronger than the medium-term norm.

Regarding the balance of payments, the current account balance has averaged -1.0% of GDP, compared with a long-term average (since 1970) of -2.1%. Net FDI inflows have also performed relatively well, with an average of 3.0% of GDP, compared with 1.5% since 1970. Thanks to the improvement in the balance of payments the Central Bank has been able to accumulate sizeable foreign exchange reserves, which stand at about \$205 billion currently. The process of reserve accumulation did not impinge on the functioning of the floating exchange rate regime, as the Central Bank strove to buy foreign currency always through publicly announced auctions at the going market price.

At inception of the floating exchange rate regime, the foreign sovereign credit rating was B+ (according to S&P) and Brazil had an active stand-by program with the IMF. Brazil is now investment grade, the sovereign credit rating stands at BBB- and the Central Bank has a currency swap agreement, as yet not drawn, with the US Federal Reserve.

Of course, a floating exchange rate regime is a pre-condition for inflation targeting. After struggling to reach the targets in the early years, the Central Bank has managed to keep inflation within the targeted range (since 2005 at 4.5% plus or minus two percentage points) for 5 years in a row. In fact, last year, when global inflationary pressures were quite strong (at least until the third quarter), the BCB was one of the few monetary authorities, within the set of those formally targeting inflation, not to miss its target, even though economic activity, until the end of the third quarter, remained quite strong.

Thus, from a narrow balance of payments viewpoint, as well as from a macroeconomic stance, the floating BRL has been remarkably successful.

That has not meant that the regime has counted with unqualified support. Time and again criticism of the floating BRL has mounted, be it because the currency is seen as not floating enough, or floating too much, or being too weak, or too strong, or helping some sectors of the economy or regions of the country at the expense of others.

More fundamental is the criticism that the exchange rate is too important to be left to the markets. The recent financial crisis and misdemeanors have made this position fashionable again in mature economies. In Brazil, with a long tradition of heavy state intervention in the economy, which was characterized by close linkages between a few privileged segments and the government, this position has always had, and still has, its vocal advocates in all sorts of media.

The first point to acknowledge, which the opponents of the floating BRL often seem to forget, is that regardless of the exchange rate regime, the real effective exchange rate always floats. Or, putting another way, the relative price of tradeables to nontradeables changes continually. Thus, the relative prices that are relevant for production and consumption decisions for exporters, importers, households and enterprises always adjust, whether the *nominal* exchange rate is fixed by a group of, hopefully enlightened, civil servants, or set by the markets. But when the exchange rate is allowed to float, relative price adjustment tends to be faster, and the impact of external shocks on quantities, that is to say on income and employment, tends to be smaller than when the nominal exchange rate is fixed.

The second point to highlight is that even controlling the nominal exchange rate can be a challenge, and comes at the cost of either the ability to pursue an independent monetary policy or of free capital flows. Countries cannot elude this constraint: nominal exchange rate management requires either severing linkages between the home economy and international capital markets, or shadowing some other country's monetary policy. In sum, adopting a workable nominal exchange rate target (be it explicit or hidden, for the level or the path) imposes macroeconomic choices that fewer and fewer countries have been willing to make.

It is somewhat heroic to assume that the State would be extremely competent at setting the nominal exchange rate. At least in the Brazilian case, there is very little empirical evidence of that. Under managed exchange rates Brazil suffered recurrent balance of payments difficulties in the 1950s and 1960s, the 1980s debt crisis, which contributed to a dramatic deterioration in macroeconomic performance in the following years, and the slowdown and crisis of the 1990s, before its final collapse in January 1999.

Letting the market set the exchange rate does not mean remaining inactive when markets become dysfunctional. Thus, the Central Bank has used its reserves, during the current period of global financial turmoil, to ensure that Brazilian exporters and importers retain access to trade finance, to help Brazilian corporates rollover their debts and to provide liquidity to the spot market. Throughout this difficult period our focus has been on contributing to improve the way markets function, not to replace them. This approach is, and will remain, the cornerstone of our action in the foreign exchange market.

There is no doubt that the world is currently experiencing an extremely difficult time. But it is also true that Brazil is among the countries that are better prepared to cope with the effects of the global financial crisis – a fact pointed out by several organizations in many occasions, such as the last issue of the OECD composite leading indicators, a survey encompassing 35 countries.¹ Brazilian fundamentals not only enable us to face the current environment in better conditions than most countries, but also in a much better shape than in the past.

One of the distinguishing features of the Brazilian economy is its prudential regulatory framework. The vigilant stance of the Central Bank prevented the development of

¹ See http://www.oecd.org/document/59/0,3343,en_2649_34349_41966331_1_1_1_1,00.html, January 12, 2009.

disequilibria and excesses that emerged in several other economies. We did not let the markets adopt risk taking attitudes that led to the losses and problems that many countries are facing today. In fact, the Brazilian framework is considered a model for prudential regulation and regarded as an example to be followed by other regulatory authorities.

That does not mean that Brazil is not being hit or suffering the impacts of the financial turmoil. But the Brazilian government is prepared to react and take all the necessary measures to tackle the crisis.

In conclusion, a floating exchange rate is no cure-all remedy for all economic ills. But it is certainly the best regime for a large, relatively closed, economy like ours. If Brazil had not floated the BRL in 1999, it would surely have done so since then, and possibly in more adverse conditions. For all the above, this 10th anniversary is worth celebrating.

Thank you very much.