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Daily Dollar Sales and Beyond

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... Data unknown.
- Null data or an indication that the corresponding item does not exist.
0 ou **0,0** figure smaller than half the value of the last digit to the right.
***** preliminary data.

An hyphen (-) between years (1970-1975) indicates the total of years, including the first and the last. A slash (/) between years indicates the yearly average of such years, including the first and the last, or harvest-year or agreement-year, according to the text.

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Foreword

The institutionalization of the Banco Central do Brasil Technical Notes, conducted by the Department of Economics, promotes the dissemination of works featuring economic content, attracting both theoretical and methodological interest, giving a view of the short-term developments of the economy and reflecting the work of the Bank's employees in all areas of action. Besides, other works, though external to the Banco Central, may be included in this series provided the Bank has afforded institutional support to their preparation.

Summary

Daily Dollar Sales and Beyond

PETER B. KENEN[1]

1. The new strategy

Intervention is usually large and episodic, and can have two overlapping objectives: filling a gap between demand and supply in the foreign-exchange market with the explicit aim of stabilizing the exchange rate, or changing the path of the rate to influence expectations and induce market participants to reduce their short positions. The new strategy adopted by the BCB is therefore unusual in three respects. The BCB is now firmly committed to make small dollar sales continuously, amounting to $50 million per day or roughly $1 billion per month for the next six months, without regard for the short-run effect on the exchange rate or the effect on exchange-rate expectations. Furthermore, it, plans to continue those sales in 2002.

As I understand it, this strategy is predicated on three suppositions:

1) domestic and foreign developments are apt to depress the dollar value of the *real* over the next few months, prolonging the depreciation that occurred during the last several months;
2) this process may feed on itself by encouraging the private sector to hedge more of its large dollar debts;
3) a further, substantial depreciation of the *real* could prevent the BCB from reducing the inflation rate to the BCB's 6 percent ceiling in 2001 (i.e., to the upper end of the 2 percent band around the BCB's 4 percent target).

The new strategy has one clear advantage over conventional intervention. As the dollar sales will occur every day, even on days when the *real is* appreciating, the BCB can credibly insist that it does not have an exchange-rate target (ix., that the *real is* floating). Therefore, the success of its policy should not be judged in the way that one judges ordinary intervention-by "matching" short-term movements in the value of the *real* with contemporaneous intervention. Presumably, the policy will cause the *real* to be stronger on average than it would have been in the absence of daily sales by the BCB, but no one, not even the BCB, will be able to say what the "counterfactual" exchange rate would have been. The new strategy, however, poses potentially serious problems. Some of the large immediately others may crop up later.

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2. Immediate issues

The BCB has not yet succeeded in getting its message across. The financial press has judged the policy to be inadequate because the daily dollar sales are deemed to be too small to affect the exchange rate significantly. Some observers have therefore predicted that the BCB will have to raise interest rates in order to "defend" the *real* it would thus seem that the BCB's unconventional strategy is being judged in the same way as conventional intervention, by asking if it will suffice to stabilize the *real.* That, of course, would be the most satisfactory outcome, but it is not the main objective, which is instead to reduce but not necessarily eliminate the ongoing imbalance between demand and supply in the forex market and thus reduce the size of the depreciation that is still likely to occur in the months ahead. (The metaphor used to explain the policy, that it aims; at "irrigating" the forex market, may have been unhelpful from this standpoint; "irrigation" brings to mind a need for "liquidity" and may thus suggest that the BCB's strategy is designed to deal, with a thin or one-way market in which the *real* would depreciate sharply. In other words, the metaphor may actually invite a comparison between the new policy and the more aggressive policy followed a few weeks ago).

Concerns have also been expressed about the reserve-reducing effect of the new policy. Taken by itself, it would reduce Brazilian reserves by $6 billion during the rest of 2001 – by almost half the difference between Brazil's current reserves and the $25 billion floor set by its IMF agreement. The BCB may be confident of its ability to offset this loss of reserves by additional foreign borrowing. But markets may not be equally confident of Brazil's ability to borrow that much. The cost of such borrowing, moreover, may rise steeply and abruptly if Argentina goes belly up. Although an Argentine default would not come as a total surprise, its effects on emerging-market spreads, especially Brazilian spreads, could still be quite large.

It is tempting to suggest that the BCB explain more fully how Brazilian reserves are expected evolve between now and the end of 2001 under the joint influence of daily dollar sales and new foreign borrowing. That option is risky, however, unless it can also be shown that Brazil's ability to borrow the required amounts would not be impaired by an Argentine default. Otherwise, a default or some other shock right impair the credibility of the commitment to daily dollar sales.

Most important, the firm commitment to daily dollar sales may tie the hands of the BCB and limit its policy option. If, for example, the *real* depreciates sharply in the wake of an Argentine default or a sudden deterioration in the economic outlook for the United States and Europe, the BCB may want to intervene more heavily to support the *real.* It could not do that, however, even if had enough reserves to do that safely, without appearing to abandon its current strategy, and it would be hard to revert to that strategy after departing abruptly from it.

The opposite case should also be considered. What should the BCB do if the *real* appreciates strongly later this year or in early 2002? Should it continue its daily sales? The BCB might not do itself damage by reducing or suspending its daily sales if it could safely declare that they were no longer needed and could then readily resume them if the outlook turned sour again. But if it decides to discontinue its daily sales or reduce their size, it should justify the change by citing relevant "news" about trends in trade or FDI. It would be wrong to explain a change in either direction by citing exchange-rate developments *per se.* Linking a change in its strategy to the strength or weakness of the *real* would strengthen the market's belief that BCB really has an exchange-rate target.

Here is a suggestion that might be helpful in this regard. A paragraph might be attached to the minutes of each **Copom meeting** saying **that Copom** has, reviewed the ongoing policy of daily dollar sales in the light of the most recent information about prospective trends in trade, **FDI**, **and other key components** of the balance of payments. In light of that review, it was decided that the volume of sales should not be changed (or, when appropriate, that it should be raised or reduced). It might be best, however, to delay the introduction of any such paragraph into the Copom minutes until the new policy has been in place for two or three months, so as to avoid any suggestion that the BCB has doubts about the medium-term viability of its new strategy.

3. Looking ahead

Some of the problems and options listed above may take on more importance if the daily dollar sales are continued throughout 2002. By the start of next year, of course, market participants should be accustomed to those sales and should come to understand the basic reason for them. It will have seen that the BCB sells dollars on days when the real is appreciating and that its dollar sales have not reduced Brazilian reserves to any significant extent. By that time, then, market participants and financial columnists may cease to judge the success of the policy in the same way that they judge conventional intervention.

Nevertheless, market participants and financial journalists may need to be told how the BCB proposes to finance its daily dollar sales for 12 more months without reducing Brazilian reserves to a level that ties the hands of the BCB. In other words, a new borrowing plan must be outlined and explained. That plan, moreover, must be robust – the amounts must be seen to be feasible and the cost must be seen to be moderate. Otherwise, the viability of the policy itself may be called into question.

Furthermore, the BCB may want to build some flexibility into its strategy, along lines suggested above, before commiting itself to continue its dollar sales for another year. It need not display flexibility before the end of 2001, by raising or reducing its dollar sales before the end of the year. But it must decide for itself the way in which it might do so thereafter. It must not be seen to do so in response to short-term movements in the actual exchange rate or in the stock of reserves. That is why, later this year, it might be wise to begin including in the Copom minutes a regular assessment of the new policy. A routine review framed in terms of the outlook for the balance of payments could then provide an appropriate vehicle for announcing a change in the volume of sales should that become desirable.

4. Another option

I conclude by suggesting a different approach to daily intervention that should perhaps be contemplated if the BCB decides to adhere to that techniques over the medium team. In his recent writings on exchange-rate policy, John Williamson has favored a loose form of managed floating which was proposed initially by the Tarapore Comission, appointed to consider the liberalization of India's foreign-exchange regime. It involves the use of a "monitoring band" to govern intervention. Under Williamson's variant of that scheme, the central bank does not intervene when the exchange rate remains within the monitoring band. But when the rate crosses the edge of the monitoring band, the central bank *may* intervene (or take other policy measures) to move the rate back toward the band.

How might that scheme be adapted to the Brazilian situation? Suppose that the BCB adopted a monitoring band for the *real,* setting the upper edge of the band at, say, R$2.35 and the lower edge at R$2.15. (I have deliberately chosen limits that put the current exchange rate out of the band and thus "instructs" the BCB to go on selling dollars daily.) Whenever the *real* was above the band, the BCB would sell a fixed number of dollars, say $50 million, and would go on doing that until the *real* had moved back within the band. Whenever the *real* was below the band, the BCB would buy that same number of dollars. The strategy would not involve a confrontation with the market. Although the duration of daily sales or purchases would depend on the exchange rate, their volume would be predetermined, just as it is today. Furthermore, the position of the band itself might be adjusted frequently; it could be raised or lowered by an amount no larger than the percentage change in the actual exchange rate over the previous month or quarter.

The use of a monitoring band would, of course, represent a significant change in the announced stance of the BCB, which currently disavows any explicit connection between its foreign-exchange transactions and short-run exchange-rate behavior. But if the BCB decides to continue its current policy beyond next year and has therefore to build into that policy a way to avoid a gradual reduction in Brazilian reserves or an imprudent dependence on large foreign borrowing, the use of a monitoring bank might be a sensible and transparent way to trigger, halt, or reverse fixed daily amounts of interventions in the forex market without inviting market participants to judge the success or failure of the BCB's policy by the sufficiency or duration of its daily sales or purchases.

I would want to think long and hard before adopting a monitoring band, even as 1 would want to think long and hard about continuing the present one-way policy of daily dollar sales for another full year. But if the current strategy is deemed to be a good way of proceeding over the medium term, a monitoring band could perhaps serve as a viable framework to govern a future permutation involving two-way transactions.