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Guest post: Brazil’s expansionary sterilisation

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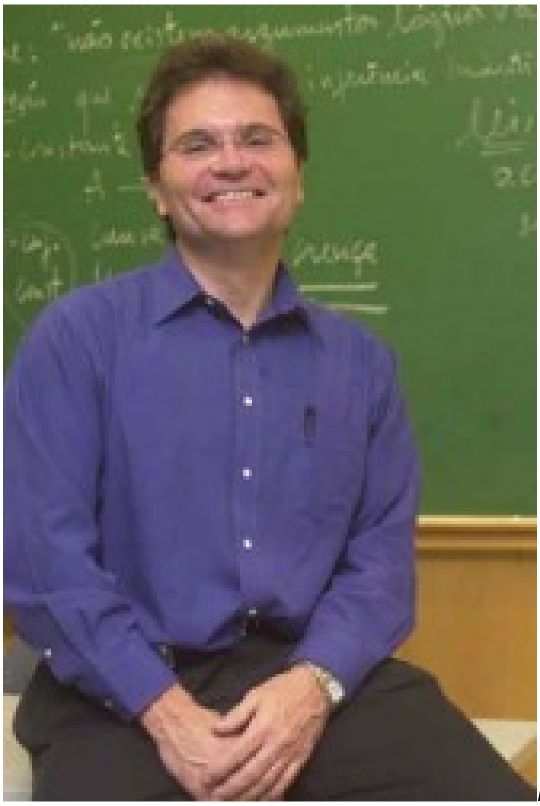
By Márcio Garcia of PUC-Rio

Yesterday’s beyondbrics post “Quantitative easing, Brazilian style” argues that, with massive sterilised foreign exchange (FX) purchases, Brazil is performing a sort of quantitative easing. Is this argument valid?
Quantitative easing (QE) is a monetary policy tool conceived to revive moribund economies. Central banks resort to QE when the nominal interest rate attains its possible minimum: zero. Neither the motivation (a very weak economy), nor the attainement of the zero lower bound (ZLB) characterize the Brazilian recent past.

Sterilized interventions were very sizeable in 2010, when GDP grew 7.5 per cent and the basic interest rate (Selic) ended the year in double digits. Sterilized FX purchases are smaller today, since capital inflows are no longer as strong, and commodity prices have come down. Currently, the economy is at a soft patch, growing less then 2 per cent, and the Selic is at a historical low of 7.5 per cent, still quite far from the ZLB.

The massive sterilized interventions conducted by the Brazilian Central Bank (BCB) have probably contributed to mitigate the exchange rate appreciation. Good for Brazilian exports, but bad for imports and inflation. Furthermore, given the still high interest rate differential, keeping $380bn (and rising) in low-yielding foreing reserves constitutes a major fiscal burden.

Nevertheless, the post calls attention to an effect that I have also identified in my academic work: sterilized FX purchases contribute to credit growth, which increases aggregate demand. This effect holds true even if sterilized interventions do not affect the exchange rate. However, the channel of transmission I identify is not quite the same.

Here is why I think FX sterilized purchases are expansionary even if the exchange rate is not affected. Suppose capital inflows take the form of a foreign loan to a Brazilian bank. When the foreign loan is received, the bank's liabilities increase. The sterilized FX purchase by the BCB is aimed at making the bank hold all the increase in liabilities in the form of very liquid short-term government bonds. However, with increased liabilities, and with the same Selic rate, the Brazilian bank wants to diversify its assets and channel part of the new funds into loans.

This pressure to reallocate the bank's portfolio increases loan supply and lowers the loan rate, thereby expanding aggregate demand. With higher aggregate demand, money demand expands, and the BCB, bound to hold the Selic rate at the predetermined level set by the Copom (the Brazilian monetary policy committee), has to accommodate it by issuing money.

In 2010, for example, despite the increase of the Selic from 8.75 per cent to 10.75 per cent, the monetary base expanded 25 per cent. Credit was expanding at a similar rate and inflation, at 6 per cent, was getting out of control, prompting the government to adopt macroprudential measures to contain credit growth, aggregate demand and inflation.

In other words, when a central bank follows an interest rate rule, such as inflation targeting, and conducts large sterilized FX purchases, it does not mop up all the liquidity it created – that is, it does not fully sterilize its FX purchases. If the central bank wants to fully sterilize the massive capital flows, it has to increase the interest rate above the level prevailing when capital flows started.

In the previous explanation, I used the example of capital flows taking the form of a foreign loan to a Brazilian bank. But any exchange rate inflow, be it a capital or a commercial flow, that ends up as a Brazilian bank liability would have a similar effect. The explanation hinges on the portfolio effect within banks when the central bank keeps interest rates constant.

Therefore, if and when the world economy (hopefully) recovers, and capital flows strengthen, emerging market central banks should not count too much on sterilized FX purchases. Besides having a dubious effect on the exchange rate, and generating large fiscal burdens, they tend to heat up the economy, stoking inflation.

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