

FINANCIAL LIBERALIZATION IN BRAZIL

Luiz Fernando de Paula

University of the State of Rio de Janeiro

Email: luizfpaula@terra.com.br

Webpage: www.ie.ufrj.br/moeda

Tokyo, Hosei University, December 2005



OBJECTIVES:

- . To analyze the determinants and effects of financial liberalization in Brazil, particularly the opening up of capital account's balance of payment.
- . My key point is that financial liberalization has contributed to define an unstable macroeconomic environment for economic growth in Brazil.



POTENTIAL BENEFITS OF FINANCIAL LIBERALIZATION FOR EMERGING COUNTRIES

International Financial Integration

```
graph TD; A[International Financial Integration] --> B[Direct Channels]; A --> C[Indirect Channels]; B --> D[Higher Economic Growth]; C --> D;
```

Direct Channels

- . Greater access to external finance markets (efficiency of savings allocation)
- . Lower cost of capital due to better risk allocation
- . Transference of technology
- . Development of financial sector

Indirect Channels

- . Inducement for better policies
- . Enhancement of capital inflows by signaling better policies

Higher Economic Growth



EMPIRICAL WORKS ARE NOT CONCLUSIVE...

- There is no robust relationship between financial liberalization and economic growth (Rodrik, 1998; Prasad et al, 2003).
- Eichengreen and Legland (2002) suggest that developed countries first developed their domestic financial market, followed by partial capital account convertibility, and only after they have developed their domestic financial market they liberalized their capital account.



BUT FLOATING EXCHANGE REGIME DOES NOT SOLVE THE PROBLEM...

- Does floating overcome the ‘impossible trinity’?
- Problems of floating: effects of exchange rate devaluation on debts denominated in foreign currency (currency mismatching), on public bonds denominated or indexed to foreign currency, on domestic prices (pass-through effect) etc.
- Predominance of ‘fear of floating’ behaviour: limitation of exchange rate volatility



ORIGINS OF FINANCIAL LIBERALIZATION IN BRAZIL...

- Until the end of the 1980s there were a lot of restriction on capital account in Brazil on both capital inflows (portfolio capital) and capital outflows (remittance of dollars).
- Law 4,131 of 1962 was very restrictive. The two main capital account items permitted were external loans and foreign direct investment.
- After the 1982 emerging countries' debt crises international financial markets stopped to finance voluntarily emerging countries.
- At the end of the 1980s and beginning of the 1990s, Brazil and other Latin American countries, such as Argentina and Mexico, began gradually but continually to liberalize their capital account.
- In 1993 Brady Plan renegotiated external debt of Latin American countries and reduced their debt service.
- Since 1992 Latin America was 're-integrated' to international financial market



THE EVOLUTION OF CAPITAL LIBERALIZATION IN BRAZIL

- In 1991 National Monetary Council permitted the acquisition by institutional investors of equities of the Brazilian firms.
- In 1992 Central Bank of Brazil allowed a broader liberalization of exchange rate market as it permitted that an special banking account called CC5, that was created during the 1960s to allow non-residents to convert dollars to domestic currency, could be operated more freely by foreign financial institutions as a result of acquisition or sale of foreign currencies. This exception in practice created a privileged way to short-term capital flight that was used during periods of contagious of currency crises, as any agent with access to a foreign bank could send dollars abroad.
- In 1994 Central Bank of Brazil implemented a tax on capital inflows (from 5% to 9% on Foreign Funds on Securities) in order to lengthen maturities of capital flows and to give some freedom degree for monetary policy as Brazil had adopted a pegged exchange rate.
- After the 1999 Brazilian currency crisis and the adoption of a floating exchange regime, economic authorities implemented a lot of norms that resulted in greater flexibility in exchange rate market, including the unification of the exchange rate market, simplification of the procedures related to the capital remittance to other countries, lengthen of maturities for exchange rate coverage related to export operations, and so on.



INDEX OF CAPITAL CONTROLS

- In order to evaluate the changes in the norms related to capital flows in Brazil we use a *Index of Capital Controls* based on Cardoso e Goldfajn (1998). We use two indexes to measure capital controls, defined as linear combinations of changes in the restrictions on capital inflows and capital outflows:
- $\Delta CC1 = \Delta RI - 0.5 \Delta RO$
- $\Delta CC2 = \Delta RI + 0.5 \Delta RO$

Where

ΔRI is a measure for any capital controls legislation change related to *capital inflows*, so that a restrictive change is given a value equal to +1 and for a liberalizing change that stimulates capital inflows is given a value equal to -1.

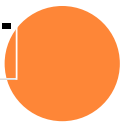
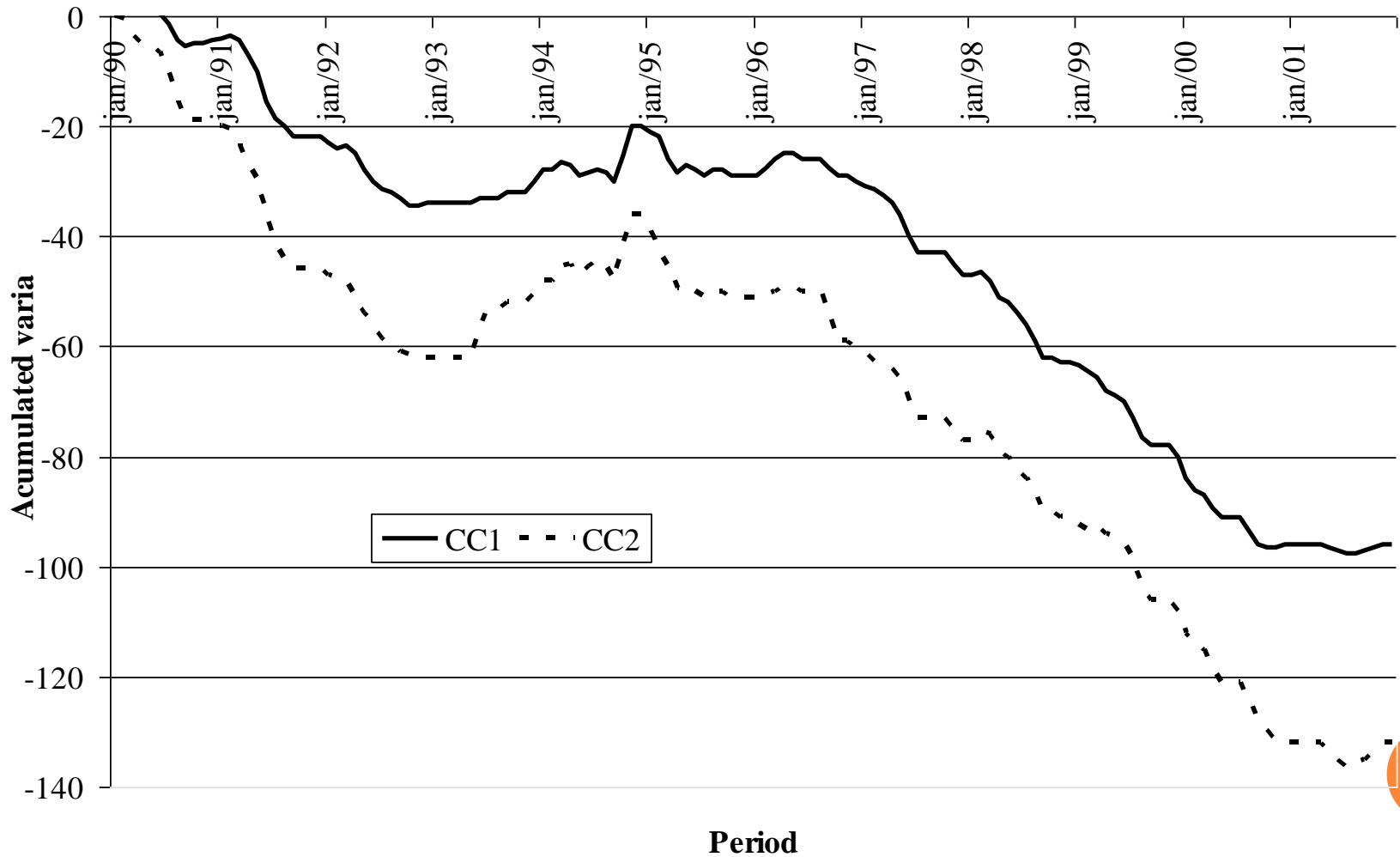
ΔRO is a measure for any capital controls legislation change related to *capital outflows*, so that a restrictive change is given a value equal to +1 and for a liberalizing change that stimulates capital outflows is given a value equal to -1.

$\Delta CC1$ assume that restrictions on capital outflows have a bigger impact on capital outflows than on capital inflows, while $\Delta CC2$ assume that restrictions on capital outflows have a bigger impact on capital inflows than on capital outflows.



FIGURE 2 INDEX OF CAPITAL CONTROLS, 1990-2001

(RESTRICTION ON CAPITAL FLOWS +1; LIBERALIZATION ON CAPITAL FLOWS -1)

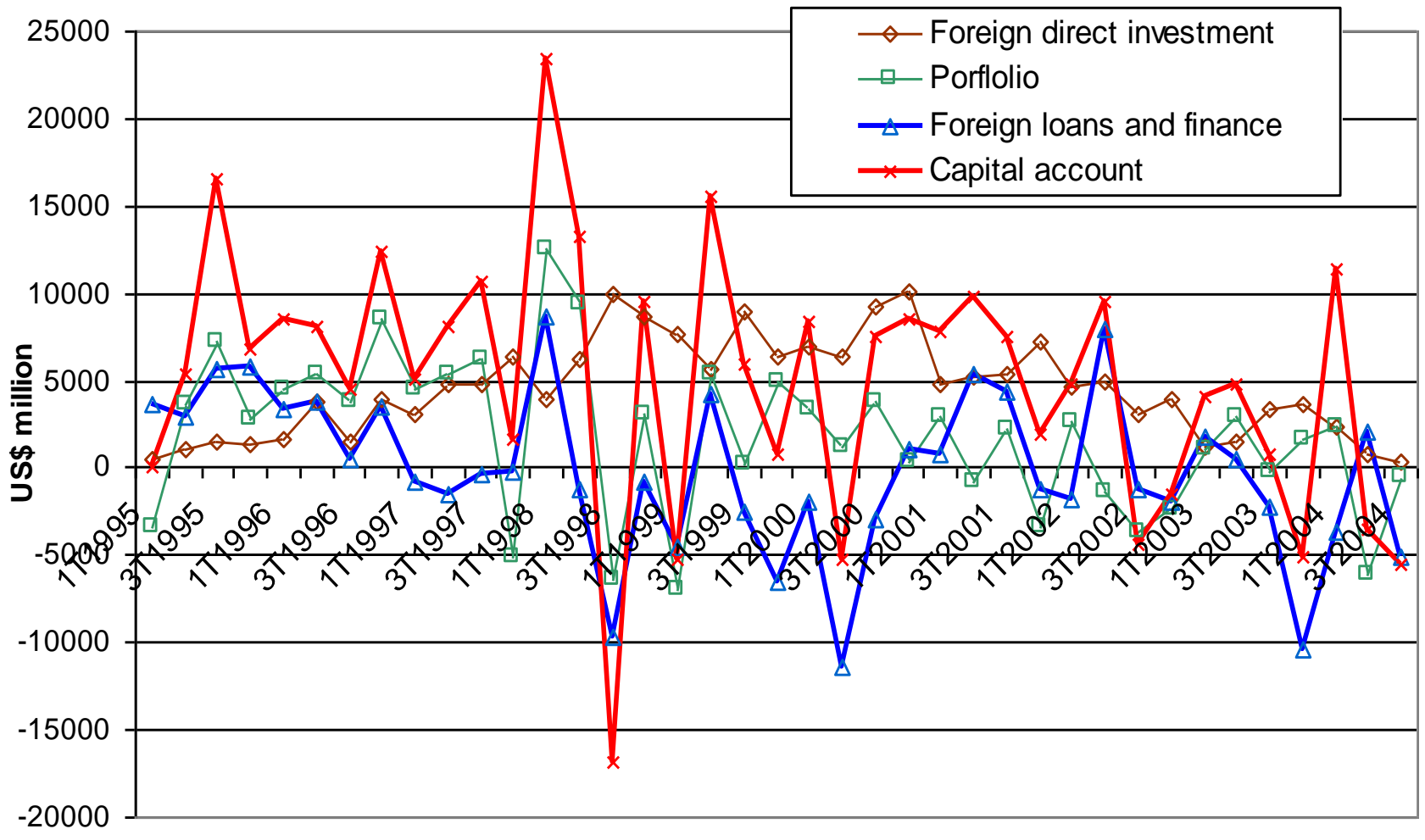


CAPITAL FLOWS IN BRAZIL...

- From 1994 to 2004 there was a huge oscillation of capital flows in Brazil, reflecting its external vulnerability (external indebtedness and capital account liberalization).
- Capital account balance in Brazil is very determined by the behaviour of 'foreign loans and finance' and 'foreign direct investment'. During periods of instability, capital flows are commanded by 'foreign loans and finance' (rollover of debt) and 'portfolio capitals'.
- FDI has had a more stable behaviour: it increases from 1997 to 2000 (privatization, foreign banks entry) and decreases after 2000.



Figure 3 Brazil - Capital account, 1994-2004



CONSEQUENCES OF CAPITAL LIBERALIZATION...

- a) 1994-1999: nominal anchor (pegged exchange rate) + trade liberalization
 - > the main defence against speculative attack on the Brazilian currency was a huge increase in the rate of interest + issue of public indexed bonds (to overnight interest rate and to exchange rate)

- b) 1999-....: floating exchange regime + inflation targeting regime
 - > capital outflows -> exchange rate devaluation -> ↑ rate of interest -> negative effects on output and employment

- c) Succession of crises: Mexico (1995), Asia (1997), Russia (1998), Argentina (2001-02), Brazil (1999, 2002)



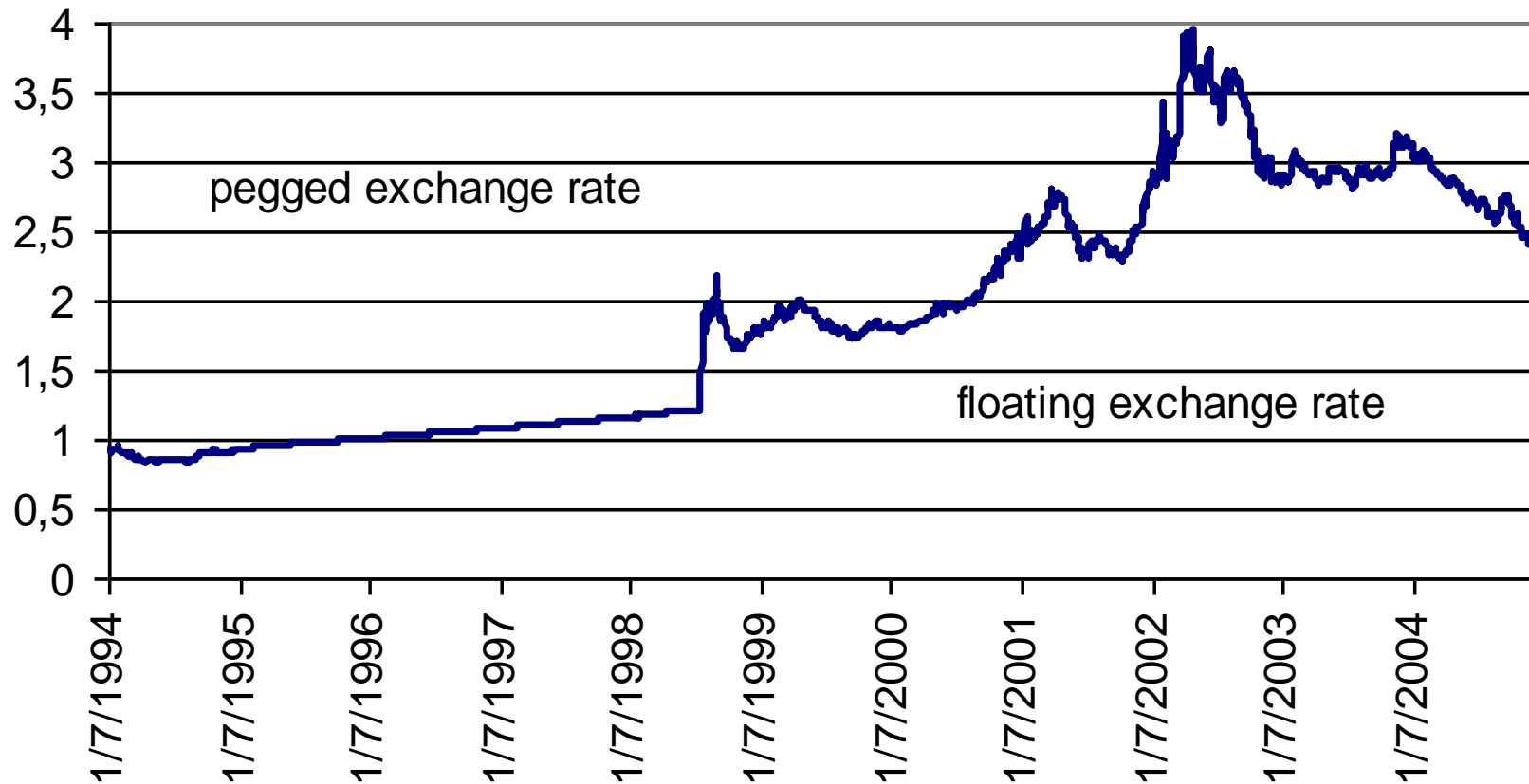
CONSEQUENCES OF CAPITAL LIBERALIZATION...

- Asymmetries in macroeconomic management in Brazil since 1997:
 - a) In spite of succession of crises, banking sector performs very well with portfolio allocation to public bonds.
 - b) State pays the 'bill' of the macroeconomic adjustment: ↑ financial costs of public debt ↑ fiscal deficit ↑ primary fiscal surplus
 - c) Mix of fiscal and monetary policies cause a economic semi-stagnation



CONSEQUENCES OF CAPITAL LIBERALIZATION...

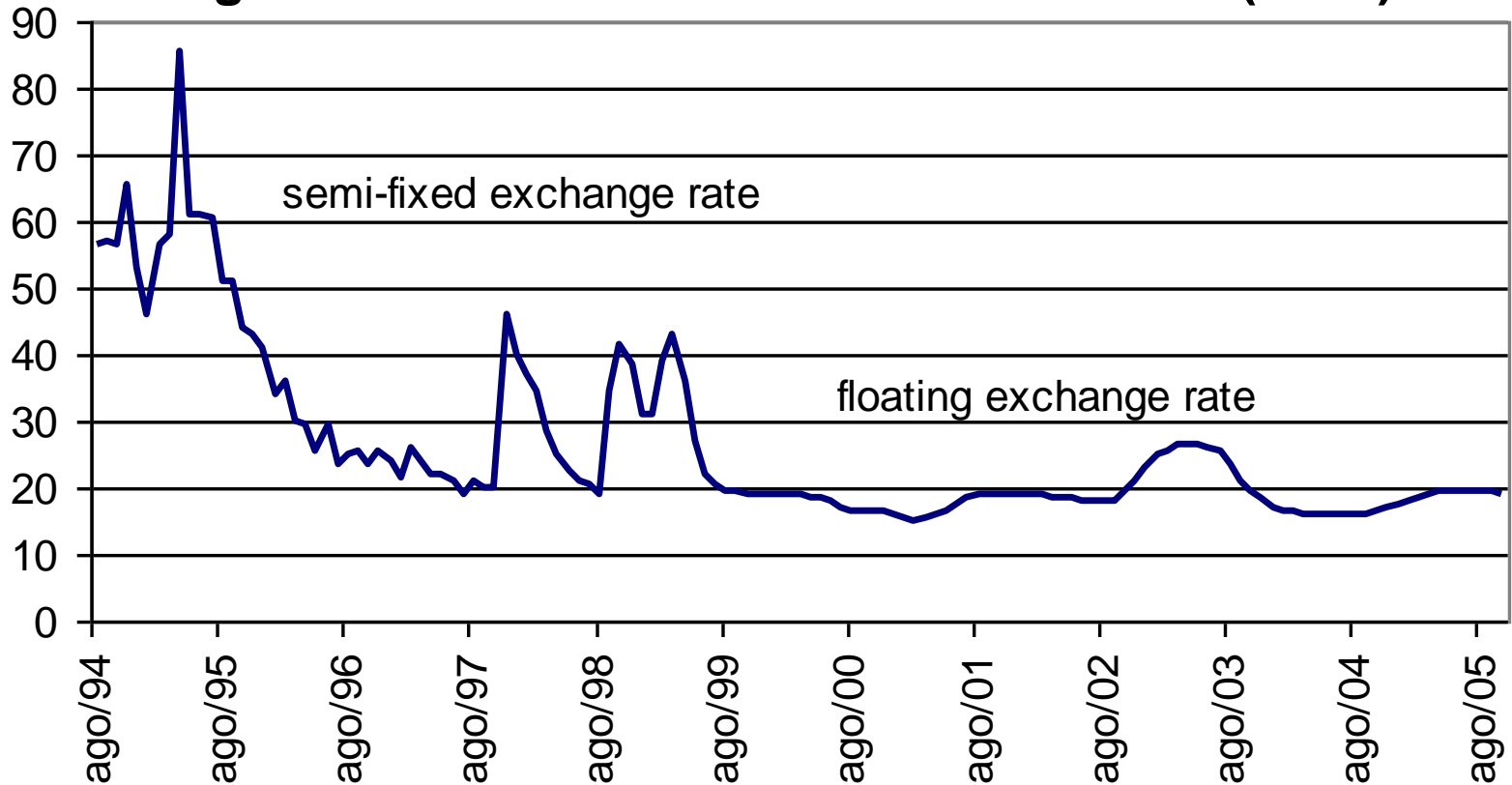
Figure 5. Nominal exchange rate



Source: IPEADATA

CONSEQUENCES OF CAPITAL LIBERALIZATION...

Figure 4: Brasil - short-term rate of interest (Selic)



Source: IPEADATA

POOR ECONOMIC PERFORMANCE OF 'LIBERAL PATTERN' OF POLITICAL ECONOMY... GDP GROWTH WAS ONLY 2.0% ON AVERAGE IN 1990-2004

Table 1. Brazil - some macroeconomic data - 1991/2004

Year	Consumer Index Price (IPCA)	GDP growth - annual %	Investment rate (percentage of GDP)	Trade balance - US\$ million	Current account - US\$ million	Net public debt-over-GDP	Real average income - Sao Paulo urban region (1985 = 100)	Formal unemployment rate* - Sao Paulo urban region (%)
1991	472.5	1.03	18.11	10,580	-1,408	38.1	58.5	6.7
1992	1,119.1	-0.54	18.42	15,239	6,109	37.1	61.3	8.0
1993	2,477.1	4.92	19.28	13,299	-676	32.6	68.4	7.6
1994	916.5	5.85	20.75	10,467	-1,811	30.0	65.9	7.8
1995	22.4	4.22	20.54	-3,466	-18,384	30.6	69.9	8.7
1996	9.6	2.66	19.26	-5,599	-23,502	33.3	71.5	9.2
1997	5.2	3.27	19.86	-6,753	-30,452	34.4	72.4	10.2
1998	1.7	0.13	19.69	-6,575	-33,416	41.7	71.5	10.8
1999	8.9	0.79	18.90	-1,199	-25,335	48.7	65.9	10.5
2000	6.0	4.36	19.29	-698	-24,225	48.8	62.3	10.0
2001	7.7	1.31	19.47	2,651	-23,215	52.6	56.9	11.6
2002	12.5	1.93	18.32	13,121	-7,637	55.5	51.6	11.4
2003	9.3	0.54	17.78	24,794	4,177	57.2	53.5	12.0
2004	7.6	5.18	19.58	33,693	11,669	51.8	52.3	10.0

Source:IPEADATA

Note: (*) Formal unemployment rate does not include informal unemployment



CONCLUSIONS

- a) Financial liberalization can be very harmful for emerging countries. The pace and nature of the process of liberalization matter.
- b) Brazil is an example that it is necessary to be very careful about the financial liberalization.

