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Brazil—Exchange Rate

"Lethal Weapon": How Far Can the BCB Go with Swaps?

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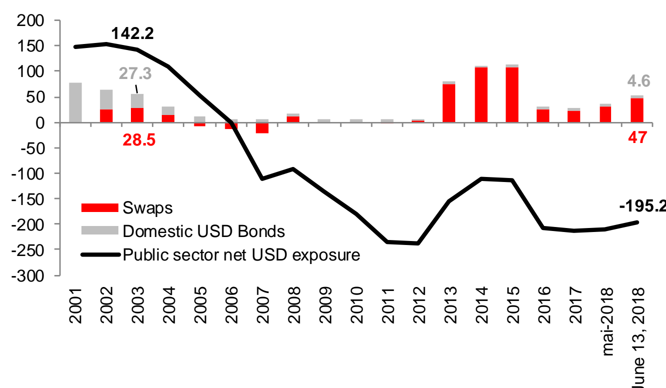
- **Brazil's public sector currently has net-long foreign currency exposure (net creditor in USD) of around USD195 billion, given the outstanding notional of FX swaps at USD47 billion, which means that 10% BRL depreciation would increase the Brazilian government's assets by roughly BRL72 billion, or around 1% of GDP. The net-creditor position acts as a countercyclical fiscal cushion.**
- **Therefore, in theory, the only constraint to what the BCB can offer in FX swaps is fiscal – how much the government thinks is necessary to reduce its net-long foreign currency exposure in order to control the volatility in FX markets.**
- **Previous episodes of crisis offer a useful guide as to the extent the private sector hedged its external exposure. In 2002 and 2015, the ratio of USD exposure of public domestic debt (swaps plus USD domestic bonds) to private external debt reached 58% and 25%, respectively. Currently, this ratio is at 10%.**
- **We believe the most likely scenario is that additional swaps will be consistent with a coverage ratio somewhere between the historical average (16%) and the 2015 level (25%), with Brazil remaining a net creditor in USD in either case, preserving the countercyclical fiscal cushion.**

Figure 1. Public Sector Net Foreign Currency Exposure



Positive net exposure = short; negative net exposure = long.
Source: Brazilian Central Bank.

What is the limit?

We often hear that Brazil's Central Bank (BCB) has a lot of ammunition to calm markets and contain BRL weakening. In addition to USD380 billion in international reserves, in theory there is no limit to what BCB can offer in FX swaps, which can be created at will and are settled in BRL. The only constraint here is fiscal – i.e., how much the government is willing to spend to defend the currency amid depreciation.

Brazil's public sector currently has a large net-long foreign currency exposure: excluding the external sovereign debt (USD133 billion) from the stock of reserves, local USD-linked bonds (USD4.6 billion), and the outstanding notional of FX swaps

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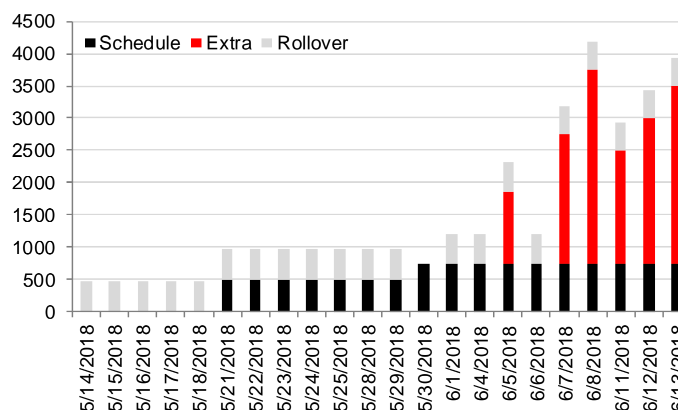
(currently at USD47 billion), the balance is around USD 195 billion. At this level, this position acts as an important countercyclical fiscal cushion: a 10% BRL depreciation would increase the Brazilian government's assets (hence decreasing net debt) by roughly BRL72 billion, or around 1% of GDP. The contrast with the turbulent election cycle in 2002 is enormous: at the end of that year, Brazil's net foreign currency exposure was USD152 billion short, and a 10% BRL weakening would add BRL54 billion, or 3.6% of GDP at that time, to net debt.

Figure 2. Daily Swaps Auctions (Less than 30 days)



Source: Brazilian Central Bank.

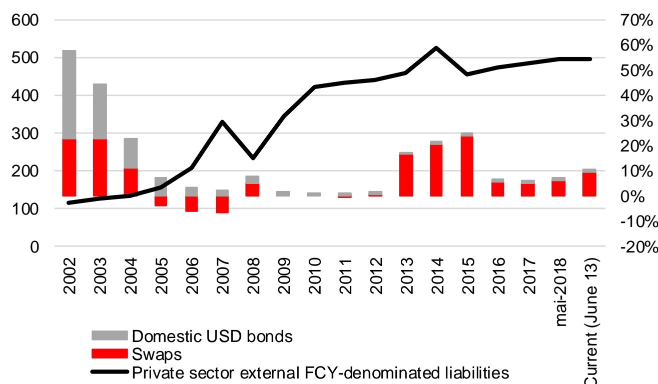
Assuming that the Central Bank keeps the daily amount of intervention at the current level of around USD3 billion/day through June 30, the outstanding notional of FX swaps would reach USD86 billion. In this case, by the end of June, the public sector would continue to have a comfortable net-long foreign currency exposure of USD156 billion, assuming that the amount of international reserves, external sovereign debt, and local USD-linked bonds remains constant. Therefore, the countercyclical fiscal cushion would remain in place, with a 10% BRL depreciation increasing the Brazilian government's assets (hence decreasing net debt) by BRL56 billion, or around 0.8% of GDP.

We believe that a potential (but still quite aggressive) limit to interventions in the FX market would be cutting that long foreign currency exposure to zero, so that the government's accounts would be immune to gyrations in the value of the domestic currency. Under this premise, we calculate that the Central Bank could still sell, from July on (assuming the aforementioned USD86 billion outstanding at the end of this month), USD156 billion in swaps, bringing the total amount of such operations to USD242 billion. That would more than double the maximum amount of intervention used in 2014-15 of around USD115 billion.

Will we get there? That would depend on a combination of continuing demand for hedging and speculation. According to the Central Bank's latest balance-of-payments data (April 2018), Brazilian companies owe around USD496 billion (25% of GDP) in foreign currency. Some of this exposure tends to be hedged by the external, foreign-currency denominated assets held by the private sector, in which case at least a portion of them is in the hands of those who hold external liabilities. In any case, a full hedge of liabilities does not seem to be the most likely scenario, in our view; rather, the private sector tends to look at some efficient level of hedging, taking into account risks and costs involved.

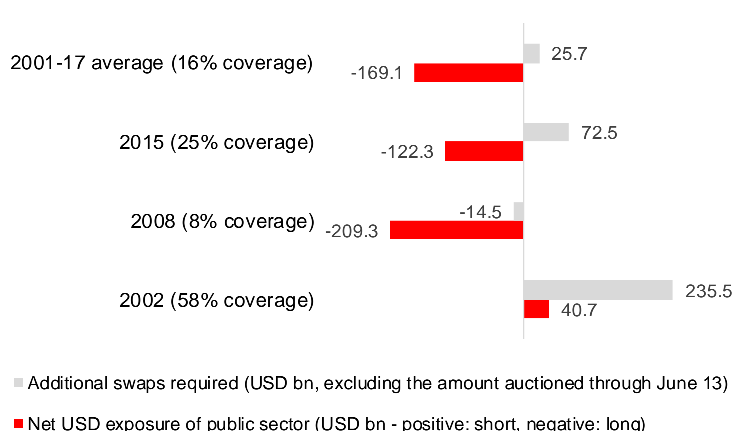
We believe that the two previous crises of confidence could provide a hint as to an efficient private external debt hedge level, and as a consequence, a potential prudent intervention level. In 2002, the outstanding USD exposure of public domestic debt (swaps plus USD-linked bonds) climbed to 58% of outstanding private sector external liabilities denominated in foreign currency; in 2015 the outstanding USD exposure of public domestic debt reached 25% after an extensive swap program. Currently, the outstanding USD exposure of public domestic debt corresponds to about 10% of outstanding private sector external liabilities denominated in foreign currency. There seems to be room for demand for further hedging, in our view, considering that at 10% the current coverage is below both the historical average (16% between 2001 and 2017) and the levels seen in previous episodes of tension in the currency markets.

Figure 3. USD Exposure of Public Domestic Debt vs. Private Sector External Debt



Sources: BCB and Santander estimate.

Figure 4. Simulation of Public Sector Net Foreign Currency Exposure



Sources: BCB and Santander estimate.

Conclusions

What is the limit, and what is the goal for BCB's swap policy? There are no clear answers to these questions, but two notions may provide a guide to potential answers. On the side of demand, past episodes of crisis offer a useful guide as to the extent the private sector hedged its external, foreign-currency-denominated liabilities. On the supply side, we observe that the key limit seems to be the USD exposure of the public sector – it is preferable for the public sector to remain a net creditor in USD, which provides a countercyclical fiscal cushion (that is, net public debt would decline in the event of currency weakening).

If the BCB wants to provide sufficient swaps to enable firms to cover their liabilities at the historical average ratio (16%), the BCB would have to auction an additional USD25.7 billion in swaps, and the public sector would remain a net creditor by USD169 billion. If the BCB wants to allow a coverage ratio similar to the one seen in the previous episodes of crisis, it would require an additional USD72.5 billion in swaps, and the public sector would still be a net creditor by USD122 billion. In a more extreme scenario, if the demand for hedging approaches that seen in 2002 (when the coverage ratio peaked at 58%), the BCB would be required to auction an enormous USD235.5 billion in new swaps, turning the public sector position to net debtor by USD41 billion.

In our view, this latter possibility seems slim, for two reasons. First, fundamentals are stronger than in 2002, and therefore we think they are less likely to drive a similar level of investor concern to that seen in that occasion. Second, should market turbulence ever reach those levels, we believe the BCB would prefer to allow the currency to depreciate, even if accompanied by severe volatility, rather than allow a shift to net debtor status in USD that would result in deteriorating debt dynamics (in which a weaker BRL leads to higher net public sector debt, and solvency concerns lead to a weaker BRL, in a vicious cycle). We believe the most likely scenario is that additional swaps will be consistent with a coverage ratio somewhere between the historical average (16%) and the 2015 level (25%).

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