Brazil’s central bank injects liquidity in financial markets

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Original post here.

In March, Brazil’s central bank (BCB) unveiled a series of liquidity measures totaling $243 billion (1.2 trillion Brazilian reals) to ensure that “financial institutions have funding to meet the market’s liquidity needs.” The measures represent about 16.7% of last year’s GDP. In addition, the BCB can now temporarily purchase government bonds directly in the primary market and purchase corporate bonds in the secondary market due to recent constitutional amendements.

Brazil, the largest Latin American economy, has been hit hard by COVID-19. It recently became the second country after the U.S. to surpass 50,000 deaths. Since March, Brazil has experienced shortages in foreign exchange liquidity; the Brazilian real has depreciated by over 25%; and Brazil’s national debt hit a record 79.7% of GDP in April. The IMF currently expects a 9.1% contraction in 2020. (For the Bank of Mexico’s liquidity measures, see this YPFS blog post.)

The BCB stated that it “will not hesitate to use its entire arsenal to ensure financial stability and smooth operation of the money and foreign exchange markets—supporting, therefore, the normal functioning of the Brazilian economy.”

On May 7, Brazil amended its constitution to temporarily allow the BCB to directly purchase government debt during the COVID-19 crisis. Previously, the BCB could only buy government debt on secondary markets. BCB’s President Roberto Campos Neto said that the newly granted powers are intended for “market stabilisation and not an alternative form of monetary policy.”

Additionally, the BCB can now purchase corporate bonds in the secondary market. In regards to these non-financial sector assets, the constitutional amendment sets limitations. Securities must have a BB- rating or higher provided by an international credit rating agency, and the reference price published by a financial market entity needs to be approved by the BCB (BCB Circular 4028).

The $243 billion in liquidity measures include fostering credit for SMEs, increase in the amount reserve requirements are taken into account in the Liquidity Coverage Ratio, reduction of the Capital Conservation Buffer, restrictions on dividends distribution and top managerial compensation, and other temporary relaxation of rules. Among those measures, this post focuses on measures aiming to support certain financial markets.

For the credit market by providing liquidity to financial institutions:

- Through the Special Temporary Liquidity Facility (LTEL-LFG), the BCB lends up to $134 billion to financial institutions backed by Guaranteed Financial Letters (LFG) collateralized by loan pools or securities. Financial letters’ primary issuance must be registered with a central depository, and the financial assets or securities pledged as collaterals must be fiduciarily assigned to the BCB (CMN Resolution 4795).
- Through the Special Temporary Liquidity Line (LTEL), the BCB lends up to $18.2 billion in domestic-currency to financial institutions backed by debentures. These operations are guaranteed by reserves that financial institutions hold at BCB (CMN Resolution 4786).

- The New Term Deposit with Special Guarantees (NDPGE) offers an alternative fundraising instrument to financial institutions members of the Credit Guarantee Fund (FGC). The FGC is one of the two private nonprofit entities in Brazil that provides deposit insurance and protects clients of financial institutions in the event of resolution. It is regulated by the National Monetary Council and the BCB. The NDPGE increases the guarantee amount for its member institutions in an amount corresponding exactly to their net worth, limited to $400 million (CMN Resolution 4785). The NDPGE was used in 2009 during the 2007-09 global financial crisis and is now expected to expand credit provision by $40 billion. FGC's guarantees do not involve public funds since they are funded by premiums paid by member institutions.

For the government bond market:

- The BCB will conduct up to $10 billion in repurchase operations (repos), with up to one-year terms, collateralized by Brazilian sovereign bonds denominated in US dollars. The repos are expected to reduce volatility in the market. A 10% haircut will apply and there is a transfer of margin during the repurchase maturity period, whenever the exposure of any counterparty is equal to or greater than $500,000 (BCB Circular 3990).

For the foreign exchange (FX) market:

The BCB has been intervening in foreign exchange markets, supported by a cushion of foreign exchange reserves. That support was as high as 20% of Brazil's GDP in March. BCB interventions may be conducted through currency swaps, operations in the spot market, and repo lines of credit.

- In March, the BCB and the U.S. Federal Reserve established a $60 billion liquidity swap line for at least six months. The swap line potentially expands U.S. dollar availability in the domestic market, and does not entail economic policy conditionalities. BCB's President Campos Neto said that "for Brazil, the swap line reassures external investors and commercial partners. But it works much more as a signal than as an effective source of U.S. dollars for the Brazilian economy, since we do not foresee the need to use the facility."

- Tax effects arising from the FX hedge operations of banks will not be deducted from their equity (CMN Resolution 4784). Banks hedge their investments on equity held abroad, in order to obtain protection against exchange-rate fluctuations. The estimated capital relief is $9.2 billion, which could allow for an additional $104 billion in credit operations.

- A legislative change eliminated the tax asymmetry between the financial impacts of exchange-rate fluctuations on banks' investments overseas and the impact of the associated foreign-exchange rate hedge of this investment (Provisional Measure 930). This asymmetry is an incentive for banks to contract excess protection—the so-called overhedge. In times of higher FX volatility, the effect of the FX variations on the overhedge increases demand for dollar liquidity by banks, reinforcing FX volatility and entailing negative effects on FX market functionality.

Table 1: Brazil's Central Bank Liquidity Measures Usage (as of June 29, 2020)

Liquidity Measures	Potential	Implemented
Special Temporary Liquidity Line (LTEL-LFG): loans backed by Guaranteed Financial Letters (LFG)	$134 billion	$5.2 billion
Special Temporary Liquidity Line (LTEL): loans backed by debentures	$18.2 billion	$0.6 billion
New Term Deposits with Special Guarantees (NDPGE)	$40 billion	$1.2 billion
One-year term repos backed by federal government bonds	$10 billion	$4.6 billion
Swap Lines with the Federal Reserve	$60 billion	Not used
Overhedge: capital relief	$104 billion	$104 billion
Source: Brazil's Central Bank, Presentations by Governor Roberto Campos Neto. June 29 and June 26.		