

Exchange rate pegs and unemployment: a model of the Brazilian currency crisis of 1999

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The paper examines the vicious circle into which the Brazilian economy fell after the stabilization of the currency of July 1994 as a result of the excessive rigidity of the nominal exchange rate. The exchange rate based stabilization, while successful in reducing inflation, led after 1996 to increasing unemployment, worsening exchange rate expectations and higher nominal and real interest rates. In turn higher interest rates led to higher unemployment. The paper presents estimates of a three equation model explaining exchange rate expectations (the credibility of the peg), the rate of unemployment and the short term interest rate. The model is estimated with monthly data from mid-1995 to mid-1999. The effects of the Asian (1997) and Russian (1998) crises and of the world business cycle are taken into account.
