An Options-Based Analysis of Emerging Market Exchange Rate Expectations: Brazil's *Real* Plan, 1994-1997

by

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ABSTRACT

This paper uses currency option data from the BMF, the Commodities and Futures exchange in Sao Paulo, Brazil, to investigate market expectations on the Brazilian Real-U.S. dollar exchange rate from October 1994 through July 1997. Using options data, we derive implied probability density functions (PDF) for expected future exchange rates and thus measures of the credibility of the "crawling peg" and target zone ("maxiband") regimes governing the exchange rate. Since we do not impose an exchange rate model, our analysis is based on either the risk-neutral PDF or arbitrage-based tests of target zones. The paper, one of the first to use options data from an emerging market, finds that target zone credibility was poor prior to February 1996, but improved afterwards. The market anticipated periodic band adjustments, but over time developed greater confidence in the Real. We also test whether devaluation intensities estimated from these option prices can be explained by standard macroeconomic factors.

JEL Codes: F31, G15, G13, F37.

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