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BRAZIL: THE WEAKENING OF THE BRL

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Key changes in the external environment have weakened EM currencies

- Following a period of steady appreciation post-2008/09 global financial crisis, emerging market currencies have experienced weakening pressures since May amid key changes in the global environment that have implications on liquidity conditions and commodity prices. Among emerging market and Latin American inflation-targeting countries that operate under floating exchange rates, currencies are now experiencing nominal depreciation pressures. (Figure 1.)
- Two developments in the global environment are placing downward pressure on Latin American currencies: 1) the prospect of tighter financial conditions upon the expectation of QE tapering by the US Fed, and 2) slower growth in China, which is weighing on commodity prices.
- Latin American economies are able to handle weakened currencies. Inflation is low, balance sheets do not expose large mismatches with foreign currencies, and international reserve accumulation is high—all of which support policy flexibility. In this context, Latin America's Central Banks can allow the floating FX rates to absorb external shocks, with the focus of intervention being to minimize volatility and control the pace of depreciation.
- Brazil has relatively less flexibility to manage a weaker FX. Inflation is elevated, with high core readings, so the challenge is to abate the pass-through from a weaker BRL to prices.

BRL: External and domestic factors call for weakness

- Recent depreciation of the BRL has been more marked than that of other currencies, though we note that the BRL experienced stronger appreciation pressures since late 2009 from persistently large capital inflows and high commodity prices, and that the real exchange rate remains appreciated by around 4% relative to its 10-year average. (Figures 1 and 2.)
- At BRL2.4:USD1, the BRL is down 20% from its May average of 2.0. This compares to weakening of 17% for India's rupee and 11% for Indonesia's rupiah over the same period.
- External changes have combined with deteriorated fundamentals—low growth, high inflation, and a wider current account deficit—to weaken the BRL. The BRL has not yet stabilized, with volatility stemming from ongoing global risk uncertainty. We expect external and domestic factors to maintain a depreciated BRL, trading near BRL2.4:USD1, in the next few quarters.

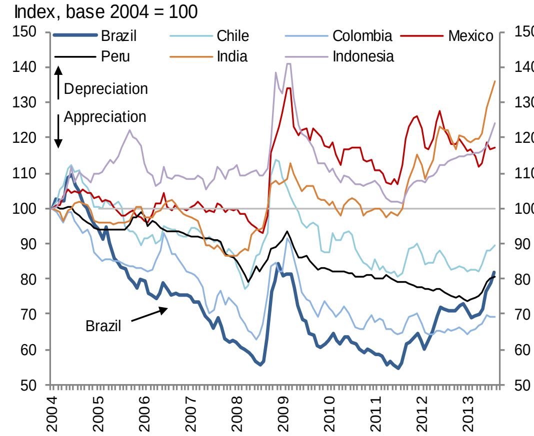
Weak BRL to help exports and external accounts, but will pressure inflation

- A weaker BRL should provide a competitive boost to exports and begin to narrow the current account deficit. Yet, it will also pressure inflation, which persists above the target mid-point.
- To sustain the desirable recovery of Brazilian competitiveness, the nominal BRL depreciation must be accompanied by depreciation of the real exchange rate (which adjusts for price levels relative to trading partners).
- This means that controlling inflation should be the government's policy priority. It will serve to curb expectations of inflation and nominal depreciation, while supporting real depreciation. (Figure 2.) The real exchange rate has weakened since tradables inflation has eased upon lower commodity prices and terms of trade, but non-tradables inflation remains high. (Figure 3.)

Extent of BCB's concern over inflation will determine monetary and FX policy

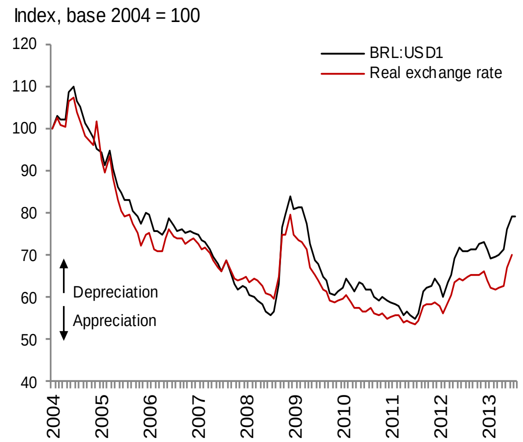
- The Central Bank's USD54bn currency swap program through end-2013—announced on August 22nd—will assist to contain inflation. The BCB will offer USD500m in daily swap auctions on Mondays – Thursdays. On Fridays, USD1bn will be offered in spot repo funding. The BCB's move to offer USD liquidity to the market should ease volatility and the pace of BRL weakening; yet, it is not likely to tame the trend for a depreciated exchange rate.
- With fiscal policy remaining expansionary, the responsibility to contain inflation still rests with the BCB, which has been tightening monetary policy since April despite the lackluster pace of GDP growth. We expect the BCB will hike the SELIC by 50bp at this Wednesday's meeting.
- Tighter monetary policy may come at the expense of a softer labor market, which is operating at near record low unemployment despite a third year of underperforming growth. Labor market adjustment would be unpopular for President Rousseff, who is running for re-election. Even so, the industrial and export sectors would benefit from lower unit labor costs. Lower prices for such non-tradables, in turn, would encourage real depreciation and firmer competitive gains.

Figure 1 - Local currency unit : USD1



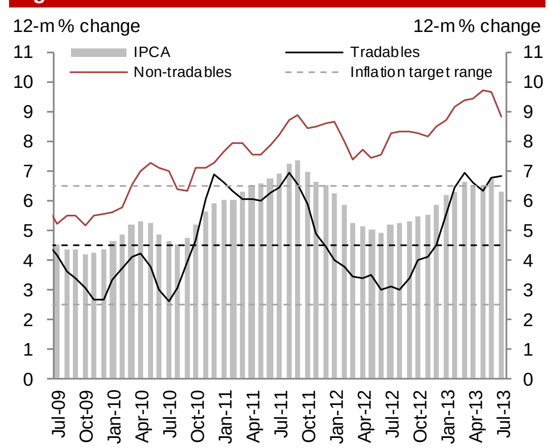
Source: Central Bank; BTMU Economic Research (NY).

Figure 2 - Nominal and real exchange rate



Source: Central Bank; BTMU Economic Research (NY).

Figure 3 - Inflation



Source: Central Bank; IBGE; BTMU Economic Research.

For historical data and commentary following BTMU's Economic News Releases, see our website at: https://reports.us.bk.mufg.jp/portal/site.