BTMU LATIN AMERICA TOPICS

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BRAZIL: COPOM DELIVERS EXPECTED 50bp SELIC HIKE

August 29th 2013

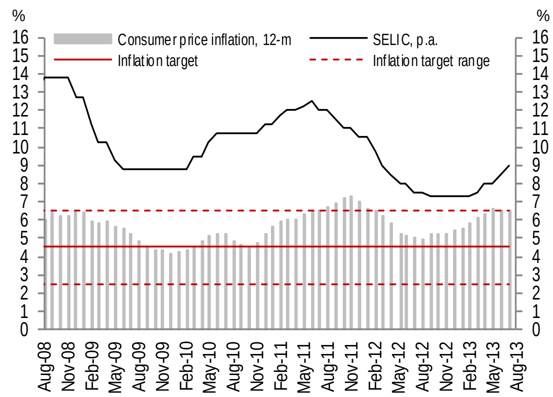
Decision: Central Bank raised SELIC by 50bp

- The Brazilian Central Bank's Monetary Policy Committee (COPOM) raised the policy interest rate (SELIC) by 50bp to 9.0% per year last night on Wednesday, August 28th 2013. The decision, which was unanimous, was expected.
- The monetary tightening cycle comes in the midst of above-target inflation and recent depreciation of the BRL. COPOM has now increased the SELIC by a combined 175bp since undertaking the tightening cycle in April. (Figure 1.)
- The statement released by COPOM was again left unchanged from the previous meeting: "Following the process of adjusting the interest rate, COPOM decided, unanimously, to raise the SELIC to 9.0% per year, without bias. The Committee evaluates that this decision will contribute to bring inflation downward and assure that the trend persists next year."
- This language suggests that the monetary tightening cycle is still underway and does not signal a change in the pace of rate increases.

Monetary tightening cycle is still underway

- We expect another 50bp increase to the SELIC at the next COPOM meeting on October 9th, followed by a 25bp increase at the final meeting of the year on November 27th. This would raise the SELIC to 9.75% this year.
- COPOM's forthcoming decisions will likely be influenced by the trajectory of the exchange rate, inflation expectations, and GDP growth. High inflation has combined with changes in the external environment that, along with weaker domestic fundamentals, are supportive of a depreciated BRL and pass-through to upward pressure on prices. (Figure 2.) The limit to rate hikes—despite the risks to inflation—is weak growth. There is the chance that, if the BCB chooses to support weak growth in exchange for leniency on inflation, the hiking cycle may be smaller and shorter if economic activity disappoints in 3Q13.
- The inflation risk is persisting due to high core inflation, a depreciated BRL, and deterioration of inflation expectations. The 12-month consumer price inflation rate eased to 6.27% in July upon lower food and regulated transportation prices; yet, average core inflation readings are at 6.16%, and non-tradables inflation is close to 9%.
- The BCB's FX intervention program—announced last week—to offer USD liquidity is providing some support to inflation in the near term by easing the pace of BRL weakening, though it will likely not change the trend for a depreciated exchange rate. The outlook in the medium term is still for a weaker BRL than we have seen in recent years. (See BTMU Latin America Topics - *The Weakening of the BRL*, August 26th 2013).
- Along with the recent depreciation of the BRL, inflation expectations for 2013 rose last week to 5.80% from 5.74%. Expectations for 2014 rose to 5.84% from 5.80%. Of note, inflation expectations remain de-anchored from the target mid-point. (Figure 3.)
- The minutes from COPOM's meeting, to be released on September 5th, should reveal how board members assess the recent BRL depreciation and the prospect of rising domestic fuel prices. Both of these developments present upward pressures to inflation. Last week, Chairman Tombini stated that the market was pricing in excessive risk premium in the yield curve, and it will be interesting to see if this was discussed at COPOM's meeting.
- We are of the view that monetary policy requires continued tightening in order to contain inflation, preserve credibility, and improve policy clarity. The task is not an easy one, since growth is recovering slowly and also because keeping the unemployment rate low will be important for President Dilma Rousseff, who is running for re-election in October 2014. Moreover, the BCB's current tightening of monetary policy is still being challenged by expansionary fiscal policy, which remains a stimulus to aggregate demand and inflation.
- With the BCB undertaking monetary tightening, a clearer commitment from the government to transparently meet a primary fiscal surplus target would provide a desired credibility boost to economic policy during a time of global risk uncertainty.

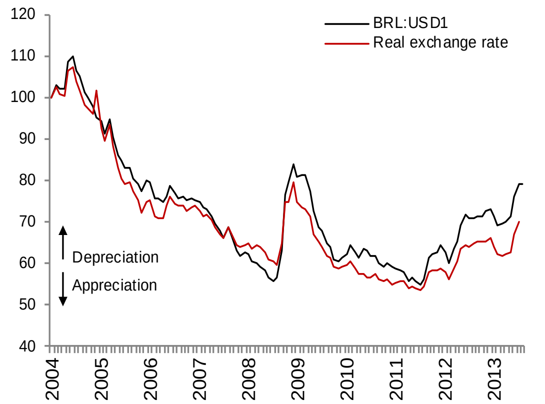
Figure 1: SELIC and consumer price inflation



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

Figure 2: Nominal and real exchange rate

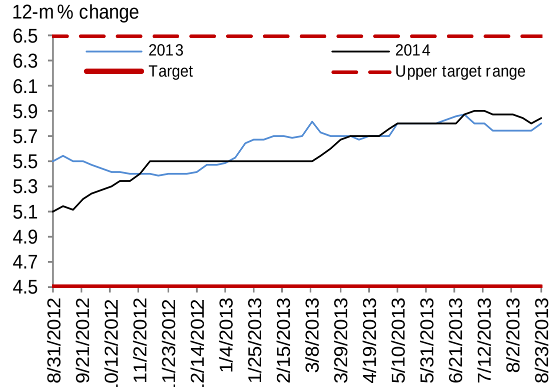
Index, base 2004 = 100



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

Figure 3: Consensus inflation expectations

12-m % change



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

For historical data and commentary following BTMU's Economic News Releases, see our website at: http://www.bk.mufg.jp/report/ecolatin2013/index.htm