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BRAZIL: NEW YEAR, HARDER CHOICES

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GROWTH: GRADUAL ACCELERATION, YET STILL MEDIOCRE

After two years of disappointing growth, the Brazilian economy will see accelerated, though unexceptional, expansion this year. The latest consensus forecasts place growth at 0.98% in 2012 and 3.3% in 2013. This is below the annual average of 3.6% over the last 10 years. The slower pace of expansion lies in a combination of cyclical and structural forces; the Brazilian economy has been held back by the weaker external environment, as well as by its own unbalanced growth model. Growth dynamics are led by consumption and are deficient in investment. (See *Brazil: More of the Same Does Not Lead to a Different Outcome*, December 7th 2012.)

POLICY CHOICES ARE GETTING MORE DIFFICULT

The two main instruments chosen by the government to stimulate the economy in 2011/12—a weak BRL and low interest rates—have not spurred a sustained acceleration in economic activity. The current policy mix has been popular and easy; but, to the government's disappointment, it has not generated coveted growth. Stimulus policies have targeted private consumption and industry; they still have not addressed a main problem, which is that stronger growth cannot come without fixed investment and capital accumulation.
Underinvestment has continued resulting in supply-side constraints that have combined with robust consumption and a weaker BRL to pressure inflation even as GDP growth has been lackluster. This situation of weak growth and lingering inflationary pressures will contest the government's ability to maintain a weaker BRL and keep low interest rates—the primary stimulus tools it has relied on so far.

Exchange rate: Tightly managed BRL weakness

To support the industrial sector, the government has stepped in to contain BRL appreciation pressures coming from overall still-favorable terms of trade and capital inflows. Room for further BRL weakening in 2013 will be limited by the persistent upward pressures on prices, however, since a weaker currency would pass-through to generate inflationary effects.
The Central Bank (BCB) has been tightly managing the BRL within the de-facto fixed exchange rate range of BRL2.0-2.1:USD1 since May 2012 and has more recently allowed the currency to weaken within this range closer to BRL2.1:USD1. Yet, the government is unlikely to actively maneuver a weakening of the currency beyond BRL2.1:USD1. On this account, the BCB intervened in December to curb the BRL from weakening past this point. (Figure 1.)

Inflation: Above target mid-point

The 12-month consumer price inflation (IPCA) rate accelerated to 5.53% in November, up 0.6% over the previous month. Inflation has remained in the upper range of the target (4.5% +/- 2%) despite the slow growth pace. (Figure 2.) Higher food prices contributed to the uptick in inflation from mid-2012 and should fall in 2013. But structural factors are still the reason for Brazil's inflation challenges.
While consumption remains robust, supply-side constraints resulting from underinvestment are also placing persistent upward pressures on prices (especially for non-tradables). Low unemployment and gains in real wages have continued supporting consumption and, thus, kept services inflation hovering above 8%. With inflation already above the target mid-point, inflationary pressures will become a headache as the pace of economic activity gradually picks up.

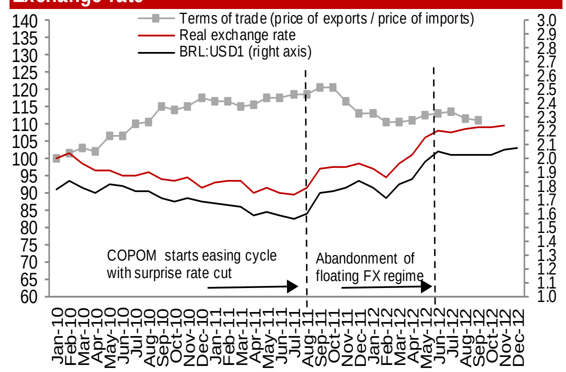
Monetary policy: Inflation vs growth

A key theme to watch is if, and to what extent, the BCB will worry about higher inflation vs stronger growth in 2013. The BCB wants to support growth through lower rates, but it also wants to preserve its credibility as an inflation targeter.
Since undertaking the easing cycle that reduced the SELIC by 525bp from August 2011-October 2012, the BCB has signaled its comfort with a higher rate of inflation in exchange for stronger growth. The BCB may want to undertake further rate cuts, especially if the recovery continues to disappoint. But this would come at the risk of inflation down the road. On the other hand, given rising inflation, some rate hikes are looking more necessary for end-2013 or early-2014. Still, this may be an unlikely choice for the Central Bank, which has explicitly stated in its latest monetary policy statements that it intends to keep the SELIC low for an extended period.
Until the recovery solidifies, it is probable that the government will postpone raising rates, choosing in the short term to counter inflation first through macroprudential tools and efforts to cut prices via lower taxes and price controls on electricity and gasoline.

THE SOONER, THE BETTER

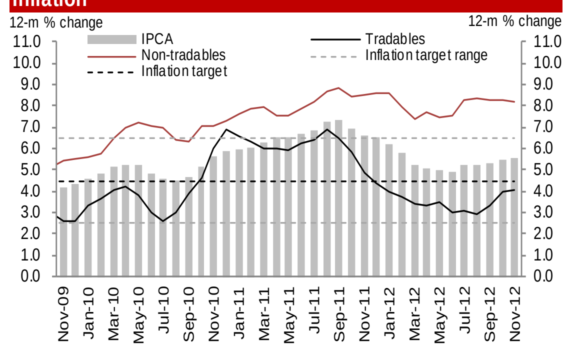
Longer-term solutions to reducing the inflationary pressures accompanying growth require serious efforts to boost investment and productivity, and reduce the government's recurring expenditures. The government has announced concessions for infrastructure projects, but the choice to shift towards a more balanced growth model requires a commitment that it has yet to fully embrace. Perhaps preparations for hosting the World Cup in 2014 will introduce a greater sense of urgency to address the growth imbalance. The sooner, the better.

Exchange rate



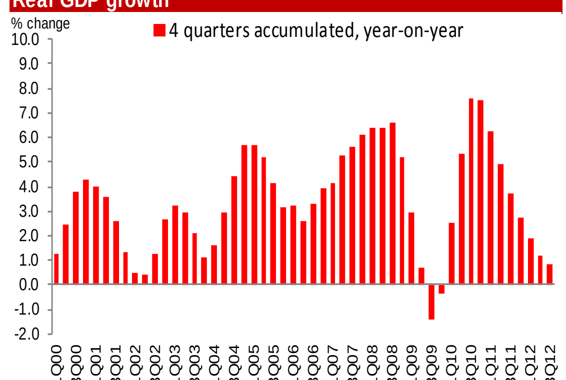
Source: Central Bank; Funcex; BTMU Economic Research.

Inflation



Source: Central Bank; IBGE; BTMU Economic Research.

Real GDP growth



Source: 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.