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BRAZIL: THE LOW GROWTH VS HIGH INFLATION DILEMMA

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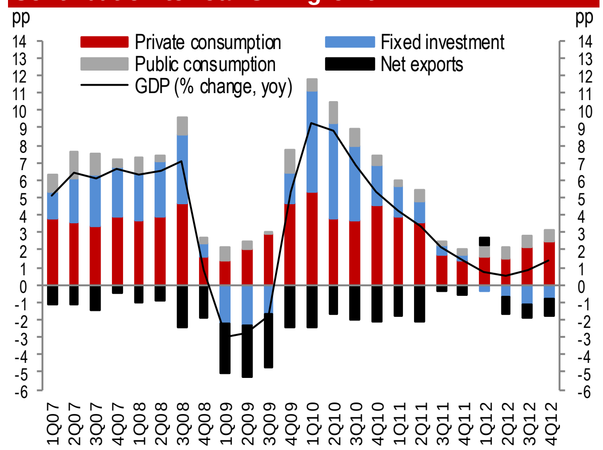
4Q12 GDP: Still a slow and unbalanced recovery that is led by consumption

- GDP results released on Friday confirm that the economy grew by 0.9% in 2012. By now, the impediments of the tired, unbalanced growth model are difficult to overlook.
- In 2012, private consumption remained the strongest growth component (+3.1%) and it is leading the recovery. But the decline in fixed investment (-4.0%) lowered the investment/GDP ratio from 19.3% in 2011 to 18.1%, back to 2009 levels. Amid the weak external sector in 2012, exports rose by 0.5% and imports grew by 0.2%.
- On the supply side, services recorded the strongest expansion in 2012 (+1.7%), while industry contracted by 0.8% and agriculture contracted by 2.3%.
- There was some modest improvement in economic activity in 4Q. Real GDP expanded by 1.4% yoy, versus 0.9% yoy in 3Q. It rose by 0.6% qoq/sa versus 0.4% qoq/sa in 3Q. Private consumption continues firm, supported by a tight labor market and tax breaks. Fixed investment rose slightly by 0.5% qoq/sa in 4Q, reversing four consecutive quarterly declines; yet, it is still underperforming in spite of government stimulus and low real rates.
- Economic activity should continue to gradually accelerate upon higher fixed investment and public consumption. The recovery will certainly require stronger fixed investment as growth drivers rebalance. Consensus forecasts place growth at 3.1% in 2013.

Contribution to real GDP growth

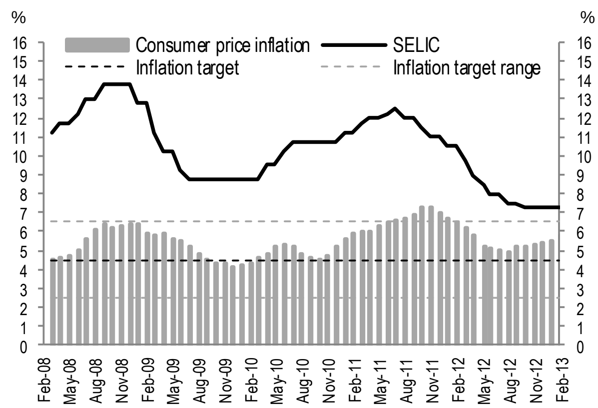


Source: IBGE; BTMU Economic Research.

Inflation: With no relief, inflation remains above target mid-point

- Inflation continues to be a challenge, despite the weak pace of the economic recovery. Consumer price inflation (IPCA) rose to 6.15% in the 12-months through January. It remains uncomfortably above the Central Bank's 4.5% target and in the upper part of the target range of 4.5% +/- 2%.
- Persistent inflationary pressures are a consequence of the unbalanced growth model, since the combination of strong demand and weak investment has led to supply-side pressures. They also, in part, reflect higher food prices since 2H12.
- Prices for tradables rose 5.5% in the 12-months through January, reflecting a more stable but still weak external sector. Non-tradables prices—including for services—rose higher, by 8.7%. A tight labor market and strong consumer demand are underpinning upward price pressures for non-tradables.
- Lower food prices and lower base effects should ease some price increase pressures in 2H13. The market expects the 12-month inflation rate to be at 5.72% by year-end, which is still above the target mid-point. Upward inflation forces—especially for services—will be especially difficult to contain as the recovery accelerates.

SELIC and 12-month consumer price inflation rate



Source: Central Bank; BTMU Economic Research.

The BCB's dilemma: Low growth vs. high inflation

- High inflation will contest the BCB's ability to keep the SELIC on hold at 7.25% this year, despite the BCB's stated intent to maintain the policy rate stable for a prolonged period. The main question is: how long can the BCB delay rate hikes amid an environment of low growth and above-target inflation?
- The BCB's Monetary Policy Committee (COPOM) will meet on Wednesday, March 6th. For now, it seems that COPOM will delay any major policy change, and it is expected to keep the SELIC on hold this week. It may signal a more clear bias towards the direction that it will steer monetary policy and, in this regard, the language of the accompanying statement and forthcoming minutes from the meeting will be closely examined by the market.
- There are indications that the BCB is less comfortable accepting a higher rate of inflation in exchange for higher GDP growth. The BCB has recently acknowledged in official statements that supply side constraints are delaying the recovery and pressuring inflation—as we've pointed out before—and it has reiterated that the SELIC is the main tool to fight inflation. COPOM stated in the minutes from January's meeting that the weaker-than-expected recovery is "essentially attributed to limitations on the supply side…that cannot be addressed by monetary policy."
- At a speech in NYC on February 25th, BCB President Alexandre Tombini did not indicate changes to the current monetary policy stance. Yet, he clearly said that the BCB is an inflation targeter and that it must work to re-anchor expectations. Tombini said that the BCB's explicit inflation target is 4.5%, and that there is no unspoken higher target. It was suggested that monetary policy decisions will remain dependent on inflation data.
- Under current policy, the BCB is likely to act to contain inflation through more ad-hoc fiscal measures (tax cuts and postponements that lower prices) and slight short-term BRL appreciation. The BCB will also be hoping for lower agricultural prices. Despite inflation risks, the BCB would buy time before hiking. If inflation does not ease upon lower food prices and lower base effects, do not rule out the BCB reluctantly undertaking mild rate hikes in 2H13. To this end, COPOM may begin to signal more flexibility in its policy stance, indicating that inflation is overtaking its worry over low growth for the first time since 2011.

Real GDP results

%variation	qoq/sa				yoy					
	1Q12	**2Q12**	**3Q12**	**4Q12**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**2011**	**2012**
Total	0.1	0.3	0.4	0.6	0.8	0.5	0.9	1.4	2.7	0.9
Supply-side										
Agriculture	-7.6	5.8	2.1	-5.2	-8.5	1.7	3.6	-7.5	3.9	-2.3
Industry	1.2	-2.2	0.8	0.4	0.1	-2.4	-0.9	0.1	1.6	-0.8
Services	0.6	0.5	0.0	1.1	1.6	1.5	1.4	2.2	2.7	1.7
Demand-side										
Private consumption	0.9	0.7	1.0	1.2	2.5	2.4	3.4	3.9	4.1	3.1
Public consumption	1.5	1.2	0.0	0.8	3.4	3.1	3.2	3.1	1.9	3.2
Fixed investment	-2.2	-0.9	-1.9	0.5	-2.1	-3.7	-5.6	-4.5	4.7	-4.0
Exports	0.8	-3.5	0.3	4.5	6.6	-2.5	-3.2	2.1	4.5	0.5
Imports	0.8	-0.3	-7.5	8.1	6.3	1.6	-6.4	0.4	9.7	0.2

Source: IBGE; BTMU Economic Research.

SELIC and 12-month consumer price inflation rate
%, end-month

	SELIC policy rate	12-month IPCA Broad index	12-month IPCA Tradables	12-month IPCA Non-tradables
Jan-11	11.25	5.99	6.61	7.65
Feb-11	11.25	6.01	6.31	7.91
Mar-11	11.75	6.30	6.04	7.93
Apr-11	12.00	6.51	6.03	7.55
May-11	12.00	6.55	5.96	7.53
Jun-11	12.25	6.71	6.26	7.89
Jul-11	12.50	6.87	6.44	8.18
Aug-11	12.00	7.23	6.90	8.68
Sep-11	12.00	7.31	6.52	8.88
Oct-11	11.50	6.97	5.87	8.41
Nov-11	11.00	6.64	4.87	8.48
Dec-11	11.00	6.50	4.41	8.59
Jan-12	10.50	6.22	3.97	8.62
Feb-12	10.50	5.84	3.77	7.97
Mar-12	9.75	5.24	3.41	7.37
Apr-12	9.00	5.10	3.36	7.69
May-12	8.50	4.99	3.49	7.45
Jun-12	8.00	4.92	2.97	7.52
Jul-12	8.00	5.20	3.08	8.24
Aug-12	7.50	5.24	2.96	8.33
Sep-12	7.50	5.28	3.37	8.28
Oct-12	7.25	5.45	4.00	8.27
Nov-12	7.25	5.53	4.10	8.17
Dec-12	7.25	5.84	4.47	8.46
Jan-13	7.25	6.15	5.54	8.69

Source: IBGE; Central Bank; 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.