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BRAZIL: COPOM HIKES SELIC BY 25bp, BUT SETS CAUTIOUS TONE

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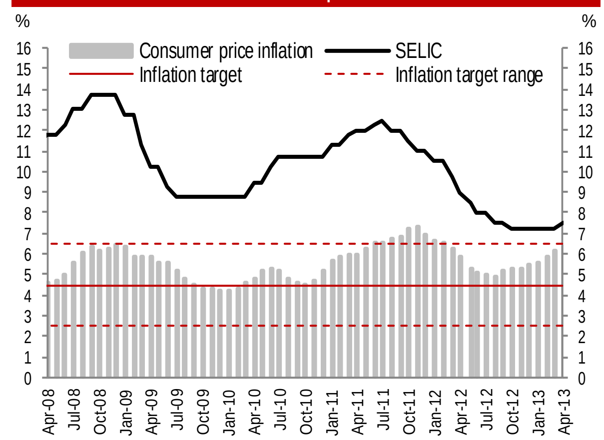
Decision: First rate increase since mid-2011 was not unanimous

- The Central Bank's Monetary Policy Committee (COPOM) raised the intervention interest rate (SELIC) by 25bp to 7.50% per year on Wednesday, April 17th 2013. The move marks the first increase to the SELIC since mid-2011, and follows an aggressive easing cycle of 525bp undertaken during August 2011-October 2012.
- The decision was split. Six committee members voted for the 25bp increase, while two members supported no change.
- The statement accompanying yesterday's decision indicated that "the committee judges that the elevated levels of inflation and dispersion of price increases, among other factors, contribute to the resilience of inflation and require a monetary policy response. On the other hand, COPOM considers that internal and, mainly, external uncertainties surround the prospective scenario for inflation and recommends that monetary policy be administered with caution."
- Inflation is indeed pressuring monetary policy, and the SELIC hike was in the making for the inflation-targeting BCB. But the timing and size of the commencement of the tightening cycle was not a clear call, owing to uncertainty regarding the BCB's policy stance. With yesterday's decision indicating that the BCB is still trying to balance the high inflation-low GDP growth dynamic, the tightening cycle may be short and marginal.

SELIC and 12-month consumer price inflation rate

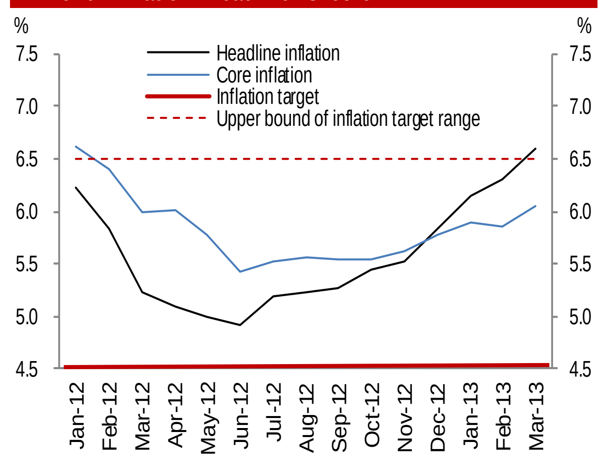


Source: Central Bank; IBGE: BTMU Economic Research.

Inflation: Surpassed the ceiling of target range in March

- The 12-month consumer price inflation (IPCA) rate came in at 6.59% for March, piercing the target range of 4.5% +/- 2%, though likely temporarily. Despite the below-potential growth pace, inflation pressures are coming from core inflation and higher food prices.
- Price increases are widespread, though there was some recent improvement in March. The diffusion index, which is a measure of the share of items in the index with price increases, came in at 69% versus 72% in February.
- Core inflation remains elevated. It reaccelerated to an average of 6% for all core measures in March, versus 5.8% in February. The pace of services inflation slowed in March. Yet, at 8.4%, it remains high and is lingering well-above the inflation target.
- The rise of headline inflation pressures in March was concentrated in food prices, which rose by 13.5%. Inflation readings of the next few months are expected to show the retreat of agricultural prices from 2H12, thus partially reducing headline inflation pressures in combination with some controls on prices.
- Regulated prices have been falling since the government has been relying on price controls. It has reduced electricity tariffs and lowered the increase in gasoline prices, helping to cut the increase in regulated prices to 1.6% in the 12-months through March. Yet, non-regulated prices (those set by the market) have been rising. Prices for tradables rose 6.9%. Non-tradables prices—including for services—rose by 9.4%.

12-month inflation: Headline vs. core



Source: Central Bank; IBGE: BTMU Economic Research.

Marginal and cautious tightening pace. What is the BCB's plan?

- In this scenario where the BCB is aiming to balance the high inflation-low GDP growth dynamic, the tightening cycle will be short and the size of rate increases will be marginal. The size of yesterday's SELIC increase (+25bp versus +50bp) and the tone of the accompanying statement continue to suggest a cautious and dovish policy stance, though the door is open for more data-dependent rate hikes. The BCB is the only central bank tightening monetary policy among emerging markets. It may raise the SELIC to 8.25% in this cycle, via additional 25bp increments over the next three meetings, though the combined size of the hike cycle may indeed be smaller. The forthcoming minutes from the COPOM meeting should provide further guidance on the BCB's position.
- The pace and scope of the tightening cycle will be largely determined by the trajectory of inflation expectations over the next several months, as well as by food prices. The market expects the 12-month inflation rate to be at 5.7% by year-end, which is within the inflation target range but still above the target mid-point. However, the latest inflation expectations for end-2014 have risen to 5.7% from 5.5% last month. The BCB is also still betting on lower food prices and base effects this year which should ease some price increase pressures in 2H13.
- Unless the BCB adopts a stricter stance on inflation—which seems unlikely—the modest tightening cycle will be aimed at containing inflation expectations and preserving institutional credibility. Inflation will remain a challenge that will not be solved soon. It will linger in the target's upper range in 2013-14 until the BCB more firmly commits to its inflation-targeting policy and the structural limitations of the economy are addressed by the government. This suggests that the BRL will continue trading near the level that the government has been targeting (BRL1.95-2.0:USD1), with slow growth testing weakness above 2.0.

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