BTMU LATIN AMERICA TOPICS

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BRAZIL: COPOM MINUTES INDICATE HEIGHTENED VIGILANCE ON INFLATION

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Minutes from COPOM's May 29th meeting released

- The minutes from the Central Bank's Monetary Policy Committee (COPOM)'s May 29th meeting—in which the SELIC intervention interest rate was unanimously raised by 50bp to 8.0% following weak 1Q13 GDP data—were released today.
- COPOM's minutes highlight two points: 1) there has been deterioration in inflation expectations for 2013 and 2014, with an unfavorable balance of risks to inflation; and, 2) the Central Bank (BCB) has shifted to a clearer stance that addresses high inflation versus low GDP growth.

Inflation expectations have risen for 2013 and 2014

- Inflation continues to pressure monetary policy. The 12-month consumer price inflation rate was at 6.49% in April, in the upper range of the BCB's target of 4.5%+/-2%. (Figure 1.) The diffusion index, a measure of the share of items with prices increases, is at 65.8%.
- The minutes show COPOM's increased concerns over the upward near-term trend for inflation and its unfavorable balance of risks, which affect consumption and investment. It cited reasons for the resiliency of price pressures: the high level of inflation to begin with; dispersion of price increases; price indexation; and the market's rising inflation expectations.
- Since April's COPOM meeting, the BCB's inflation forecast for 2013 has risen to 5.81% from 5.68%. And, for 2014, it has risen to 5.80% from 5.70%.
- Market expectations have also been rising. For 2013, they have risen to 5.81% from 5.71% just one month ago. For 2014, market expectations are at 5.80%. While the expected increase for 2014 has stabilized over the last several weeks, there has been a noteworthy de-anchoring of inflation expectations above the target midpoint of 4.5%. (Figure 2.)

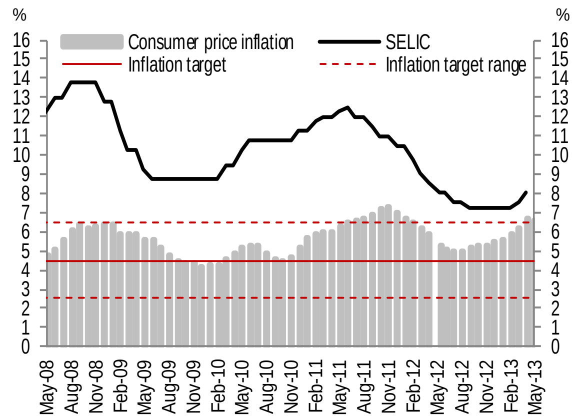
Stricter stance on inflation

- In our view, the deterioration in the market's inflation expectations has been an important motivation behind the BCB's intensified tightening of monetary policy.
- The Central Bank's move to accelerate rate hikes preserves institutional credibility, which serves to contain inflation expectations. It also sets up the BCB to keep rates unchanged in 2014, an election year. For the government, keeping unemployment low will remain the top priority. But it will also want to avoid the political cost associated with high inflation and rising interest rates in the months before the October 2014 election.

The BCB defines its course of action: Containing inflation is now a higher priority

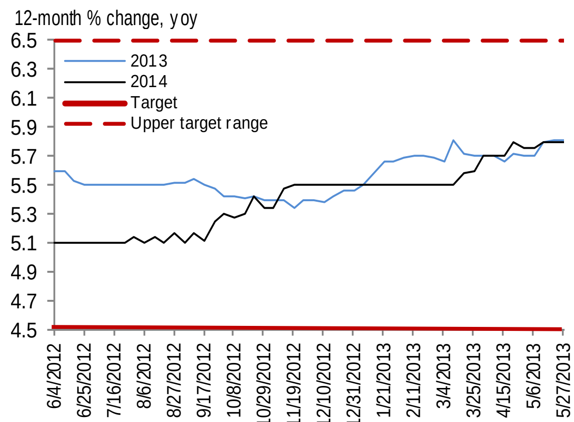
- COPOM gave no indications that the tightening cycle has ended, nor did it express concerns over the pace of GDP growth. Instead, it emphasized its vigilance on inflation.
- In this scenario where—for the first time since mid-2011—the BCB has provided a clearer signal affirming its commitment to inflation-targeting, an additional 50bp hike in July and a 25bp hike in August are expected. This would raise the SELIC by a combined 150bp, to 8.75%, by the end of the cycle. The preference is to front-load modest tightening to contain inflation expectations in the near term while continuing to support the pace of GDP growth.
- Monetary policy will still be dependent on the trajectory of inflation expectations and the exchange rate. Since Brazil is the only emerging economy raising rates, and GDP growth remains weak, the ability to maneuver policy tools with flexibility is key going forward.
- This week, the Ministry of Finance cut the financial transactions tax (IOF) on fixed income capital inflows to zero, undoing a measure that had been implemented at 6% since October 2010 to contain short-term portfolio inflows and BRL appreciation pressures (Figure 3). Alone, it is not enough to support a BRL stronger than 2.05:USD1 given weaker fundamentals and uncertain prospects for the volume and direction of global capital flows. Yet, it does make Brazilian bonds more attractive, relieving some recent BRL weakness and, thus, pass-thru to inflation. An underlying challenge for inflationary pressures remains the expansionary fiscal policy stance that it is coming from an already large government.

Figure 1: SELIC and consumer price inflation rate



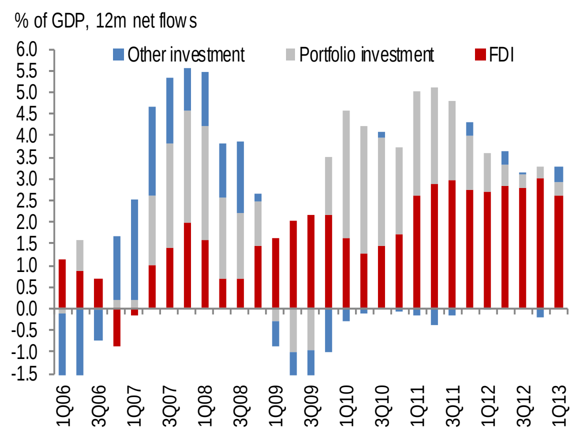
Source: Central Bank; IBGE: BTMU Economic Research.

Figure 2: Market consensus inflation expectations



Source: Central Bank Focus Survey; BTMU Economic Research.

Figure 3: Flows of the Financial Account



Source: 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.