BTMU LATIN AMERICA TOPICS

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BRAZIL: LOOSE FISCAL STANCE REMAINS PART OF POLICY MIX

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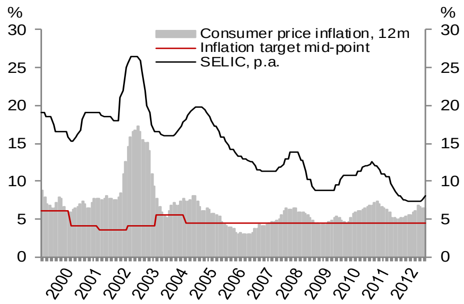
Some improvement to the policy mix in 2013

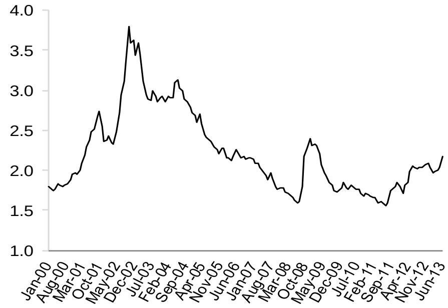
- The Central Bank of Brazil (BCB) initiated a monetary tightening cycle in April, as its concern over rising inflation took priority over low GDP growth for the first time since mid-2011. Inflation is uncomfortably high—with the consumer price inflation (IPCA) at 6.5% in the 12-months through May—and it has been lingering in the upper range of the 4.5% +/- 2% target owed to higher food prices and elevated core inflation.
- The inflation-targeting BCB's stance to tighten monetary conditions marks an improvement in policy clarity, which had deteriorated since mid-2011 amid its tolerance for higher inflation in exchange for higher GDP growth. The government has also loosened capital controls in 2013 with the aim curb BRL weakness in an environment of high inflation. This policy clarity indicates a partial return to the so-called tripod of economic fundamentals that served Brazil in securing macroeconomic stability and economic growth over the last decade: 1) targeting consumer price inflation, 2) maintaining a free floating BRL, and 3) meeting a primary fiscal surplus target. (Figures 1, 2, and 3.)
- Nonetheless, the tightening of monetary policy currently remains opposed by the expansionary stance of fiscal policy. This loose fiscal stance is placing more pressure on the BCB to contain inflation at the same time that changes in the external environment are placing downward pressure on the BRL.

Figure 1: Inflation targeting regime



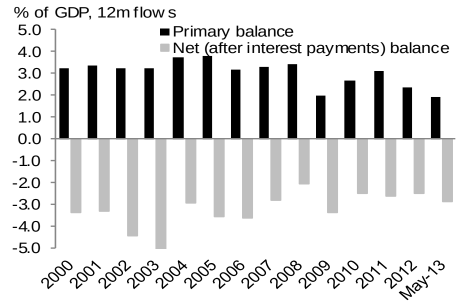
Source: Central Bank; IBGE: BTMU Economic Research.

Figure 2: BRL:USD1



Source: Central Bank; BTMU Economic Research.

Figure 3: Public sector balance



Source: Ministry of Finance; BTMU Economic Research.

Expansionary fiscal pressures continue

- The consolidated fiscal results through May 2013 were released on Monday. They point to a primary balance of 2.0% of GDP in the 12-months through May, presenting deterioration from 2.4% at end-2012. The net (after interest) balance came in at -2.9% of GDP in the 12-months through May. (Figure 3.)
- The primary balance is below both the government's official target of 3.1% of GDP and Finance Minister Mantega's informal target (established in the budget) of 2.3% of GDP. Excluding recent creative accounting practices, the primary balance—which stands closer to 1.5% of GDP—displays weaker results.
- Since 2009, fiscal policy—which is already rigidly tied up in large recurring expenditures—has been expansionary and complemented by quasi-fiscal measures that have substantially boosted the lending growth of government-controlled banks. In effect, government spending is stimulating aggregate demand at a time when the economy is at full employment, thus contributing to upward inflation dynamics in an environment of already elevated inflation.
- GDP growth will be higher this year (2.4%) than last year (0.9%), but there are two reasons why the government is unlikely to cut back on spending in the near term. The first reason is that the presidential election is in October 2014 and fiscal spending leading up to the election is expected to increase since President Dilma Rousseff is running for a second term. Second, the wave of protests in Brazil have voiced discontent over the poor quality of public services and resulted in a widespread drop in approval ratings and voting intentions for Dilma. The latest poll released by Datafolha over the weekend showed an approval rating of just 30% for the President, down from 57% at the beginning of June and 65% in March. Thus, the government's motivations to address shortfalls in public services and raise approval ratings, especially during campaign mode, are high. The President has promised five pacts to the protestors: fiscal responsibility, spending on public transport, investing 100% of future oil royalties in education, bringing in foreign doctors, and political reform.
- The government is at a crossroads, and the decline in popularity could still prompt changes to the economic policy framework. The President can adopt a more conservative fiscal stance, especially since one of the pacts is fiscal responsibility; yet, this still remains just a pledge and signals are quite mixed.

Higher burden placed on monetary policy to contain inflation

- The scenario of an expansionary fiscal stance and a weaker BRL—looking to end 2013 near BRL2.15-2.2:USD1 from an average of 1.95 in 2012, upon external developments and a widening current account deficit—places a higher burden on monetary policy to control inflation. This should prompt the BCB, which is now more focused on containing high inflation, to undertake a firmer tightening cycle (through acceleration of rate hikes or an extended hiking cycle).
- The BCB's Monetary Policy Committee (COPOM) meets next week on July 9th and 10th. The BCB has not provided clear guidance with regard to its upcoming monetary policy decision, but in its 2Q13 Inflation Report it did raise its inflation forecasts through 2Q15. It is likely that the BCB will decide on another 50bp increase to the SELIC next week. It is, nevertheless, conceivable that it may choose to increase the pace of SELIC tightening and deliver a 75bp hike to tame expectations upfront. Inflation should begin a downward trend upon lower food prices in 2H. Yet, it is important to note that expectations remain unanchored above the target midpoint. Inflation expectations for 2013 and 2014 rose last week to 5.87% and 5.88%, respectively, from 5.86% and 5.80%.
- The SELIC stands at 8.0%, and the tightening cycle could raise it to 9.25% via additional hikes in August and October. It is doubtful that the BCB will raise the SELIC to pre-2011 rates and that the tightening will be large enough to lower inflation to the midpoint, implying that inflation will stay in upper range of the target in 2013-14. To be sure, the next monetary policy decisions will indicate the extent of the BCB's commitment to fight inflation in the midst of loose fiscal policy.

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