BTMU LATIN AMERICA TOPICS

Economic Research Group (New York)

Magalí E. Solimano
Latin America Economist
TEL: (212) 782-5708
msolimano@us.mufg.jp

BRAZIL: COPOM CONTINUES TIGHTENING AT UNCHANGED PACE

July 11th 2013

Decision: Inflation pressures COPOM to continue hiking SELIC

- The Central Bank's Monetary Policy Committee (COPOM) raised the policy interest rate (SELIC) by 50bp to 8.50% per year on Wednesday, July 10th 2013. The decision was unanimous and followed the 50bp hike delivered on May 29th.
- The accompanying statement was left unchanged from the previous meeting: "Following the process of adjusting the interest rate, COPOM decided, unanimously, to raise the SELIC to 8.5% per year, without bias. The Committee evaluates that this decision will contribute to bring inflation downward and assure that the trend persists next year."
- High inflation is forcing the Central Bank to raise interest rates. The inflation-targeting Central Bank (BCB)'s concern over high inflation—despite weak GDP growth—prompted the tightening cycle that began in April. With the latest move, COPOM has now increased the SELIC by a combined 125bp since then. The real (inflation-adjusted) rate now stands closer to 2% per year, up from 0.6% back in March. (Figure 1.)

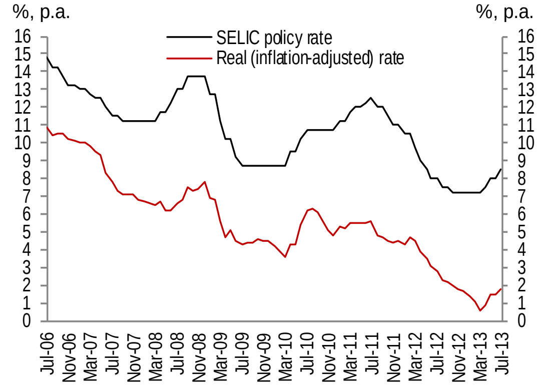
Inflation: Above ceiling of target range again in June

- Consumer price inflation (IPCA) rose by 0.26% month-on-month in June, slowing from 0.37% mom in May. Even so, the 12-month IPCA rate accelerated to 6.7% in June, surpassing the ceiling of the BCB's target range of 4.5% +/- 2%. (Figure 2.)
- While above-target headline inflation readings are likely to be temporary since agricultural prices are falling and regulated prices remain tightly controlled, inflation will remain in the upper range of the target. Despite below-potential GDP growth, inflation is pressured by elevated core inflation, a weaker BRL, and a de-anchoring of inflation expectations.
- Core inflation remains high. The 12-month increase accelerated to an average of 6.31% for all core measures in June, versus 6.09% in May. At 8.64%, the pace of services inflation is persistently lingering well-above the inflation target. On the other hand, regulated prices—those monitored by the government via price controls on electricity, gasoline, and public transport—rose 1.8% in the 12 months through June.
- Inflation expectations for 2013 lowered last week to 5.81% from 5.87%. However, expectations for 2014 rose for the second straight week, to 5.9%. (Figure 3.)

Challenges in containing inflation: Will the BCB get any help from the fiscal side?

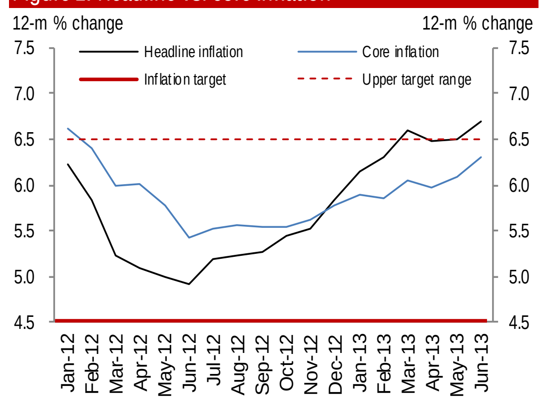
- The language in the accompanying statement suggests that monetary tightening is still underway. High inflation is forcing the BCB to raise the SELIC in order to preserve credibility. We expect another 50bp hike to the SELIC in August, followed by a final 50bp increase in October. This would raise the SELIC to 9.5%. Yet, we note that there are uncertainties in the outlook. The forthcoming minutes from the meeting should provide additional guidance, and it will be important to see how the BCB assesses the growth performance and FX pressures.
- The BCB faces challenges in carrying out its inflation-targeting mandate. GDP growth is low and tighter monetary conditions will constrain stronger growth. Consensus forecasts have been revised downwards and are now placing growth at 2.3% this year and 2.8% next year.
- Importantly, this dynamic of high inflation and low GDP growth is now occurring in the midst of key changes in the external environment. The Chinese economy is displaying slower growth, thus weighing on the outlook for commodity prices and the BRL. Moreover, the expectation that the US Federal Reserve will eventually begin to taper QE has tightening implications on global liquidity conditions and capital flows.
- What is still needed, in terms of containing inflation, is clearer support from fiscal policy. The government's expansionary spending, mainly on recurring consumption expenditures, is opposing the BCB's efforts to tighten monetary conditions. (See *Loose Fiscal Stance Remains Part of Policy Mix*, July 3rd 2013.) The government has said that some budget cuts are on the way. However, fiscal credibility still needs to be re-earned through improved clarity of policy-making and a longer-term commitment to build space for counter-cyclical spending.

Figure 1: SELIC policy rate



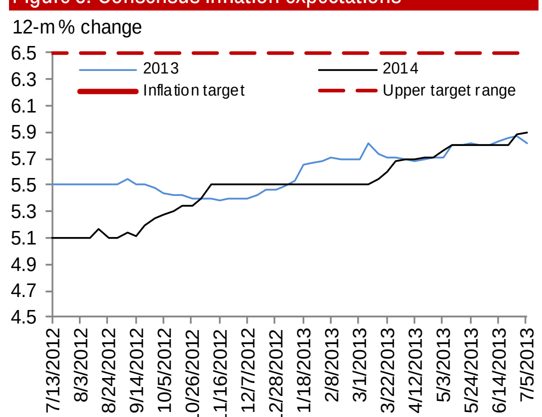
Source: Central Bank; IBGE: BTMU Economic Research.

Figure 2: Headline vs. core inflation



Source: Central Bank; IBGE: BTMU Economic Research.

Figure 3: Consensus inflation expectations



Source: BCB Focus Survey; 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.