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BTMU LATIN AMERICA TOPICS

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BRAZIL: INFLATION RESULTS AND COPOM MEETING

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Slow decline of inflation and elevated inflation expectations for 2014

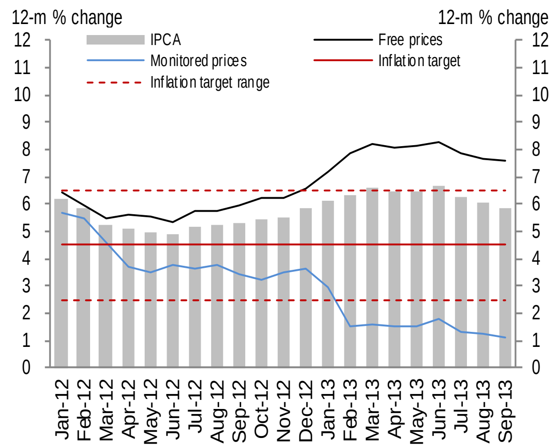
Brazil's 12-month consumer price inflation (IPCA) rate, released this morning, lowered to 5.86% in September. The result marks deceleration from 6.09% in August and readings above the target ceiling earlier this year upon lower food prices and base effects. Gradual labor market weakening and near-term relief for BRL depreciation have also eased inflation pressures.

Even so, inflation remains in the upper range of the 4.5% +/- 2% target and masks important differences among index components. To begin, there is a sizeable gap between free and monitored price inflation. (Figure 1.) Annual inflation of prices regulated by the government—electricity tariffs, gasoline and public transportation—is suppressed to just 1.1%. Conversely, core inflation remains uncomfortably high at around 6%. Services inflation quickened to 8.7% in September from 8.58% in August.

In its 3Q13 Inflation Report, the BCB presented its forecast for the slow deceleration of inflation. Its 2013 reference scenario projects an inflation rate of 5.8%, down from 6% in the June report.

Inflation expectations have stabilized for 2013 at 5.8%, yet they remain de-anchored from the target. Moreover, expectations for 2014 have risen on account of above-target readings, the possibility of rising of gas prices, and a depreciated BRL that is required by weaker balance of payments fundamentals and the prospect of less favorable global liquidity conditions. The BCB elevated its inflation forecast for 2014 to 5.7% from 5.4%. Meanwhile, the market's expectations for 2014 have risen to 5.95% from 5.8% in August. (Figure 2.)

Figure 1: Free vs. monitored consumer price inflation



Source: Central Bank; IBGE: BTMU Economic Research.

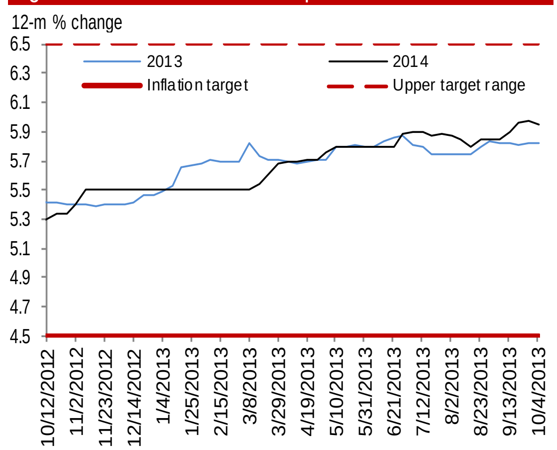
COPOM will announce its policy rate decision today

The Central Bank's Monetary Policy Committee (COPOM) will announce this afternoon its decision on the policy interest rate (SELIC). We expect a 50bp increase—unchanged from the previous meeting—which will raise the SELIC to 9.5% per year.

Since COPOM's unanimous 50bp hike on August 29th, it has signaled in its meeting minutes and 3Q13 Inflation Report released on September 30th that the tightening cycle continues to be underway, stating that monetary policy remains vigilant to assure the downward inflation trend.

The focus will be on today's accompanying statement and forthcoming meeting minutes. A change in the statement or mention of data-dependent moves may signal that a smaller rate hike of 25bp is likely and that the BCB is nearing the end of its tightening cycle. If the accompanying statement is unchanged from the previous meeting, the BCB could be keeping the door open for another 50bp hike in November.

Figure 2: Consensus inflation expectations



Source: BCB Focus Survey; BTMU Economic Research.

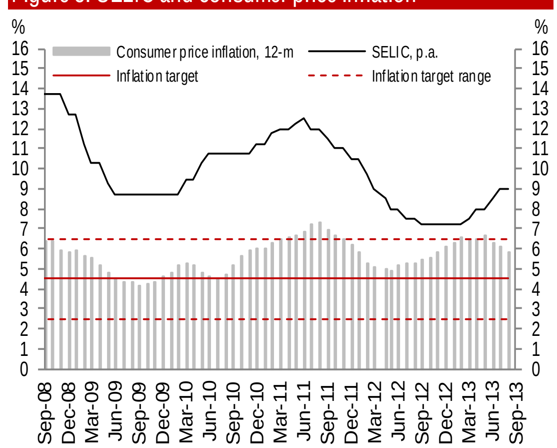
Monetary tightening remains opposed by loose fiscal policy

We maintain our view of a 50bp increase today and a final 25bp increase at COPOM's next meeting on November 27th, ending the tightening cycle with the SELIC at single digits at 9.75%. The combination of slowly declining inflation, eased BRL depreciation pressure, and weak growth are likely to curtail the length and magnitude of the hiking cycle. Speaking to investors in London last week, Chairman Tombini stated that the BCB is making progress in containing inflation and that easing pressures are expected to continue.

The BCB's effort to tighten monetary policy is still opposed by the government's high spending on recurring consumption expenditures. (See *Loose Fiscal Stance Remains Part of Policy Mix*, July 2013.) The public sector's primary surplus was 1.8% of GDP in the 12-months through August, below this year's target of 2.3% of GDP and the official target of 3.1% of GDP. Interestingly, the BCB's 3Q13 Inflation Report views fiscal policy moving towards neutrality as the fiscal impulse—the change in the structural fiscal balance—lessens. However, we note that this overlooks the fact that the overall stance remains expansionary, and it contradicts with signals from the Finance Ministry that public spending is unlikely to be constrained as the October 2014 approaches.

This scenario of a concluding monetary tightening cycle and expansionary fiscal policy suggests that inflation should remain in the upper target range, and that above-target inflation is unlikely to be addressed by policy improvements until at least 2015.

Figure 3: SELIC and consumer price inflation



Source: Central Bank; IBGE: BTMU Economic Research.

For historical data and commentary following BTMU's Economic News Releases, see our website at: http://www.bk.mufg.jp/report/ecolatin2013/index.htm