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 MAINTAINS TIGHTENING PACE WITH ANOTHER 50BP HIKE

January 15th 2014

COPOM raises SELIC by 50bp to 10.5% per year

In a unanimous decision, the Brazilian Central Bank's Monetary Policy Committee (COPOM) raised the policy interest rate (SELIC) by 50bp on Wednesday, January 15th, to 10.5% per year.

The move maintained the 50bp tightening pace delivered at the previous five meetings. Since starting the current tightening cycle to contain inflation, COPOM has now raised the policy rate by a combined 325bp and returned the SELIC above double-digits. (Figure 1.)

The accompanying statement released with today's decision was short and did not give any signals concerning COPOM's next move: "Continuing the process of adjusting the basic interest rate, commenced at the April 2013 meeting, COPOM unanimously decided, for now, to increase the SELIC by 50bp to 10.5% per year, without bias."

With the move, the Central Bank (BCB) opted for a more data-dependent decision. Although COPOM had changed the language in its communication at the November meeting to give itself flexibility to reduce the hiking pace to 25bp and set-up for the conclusion of the tightening cycle, December's higher-than-expected inflation result increased the odds for today's 50bp hike.

Inflation ends at 5.91% in 2013, above both 2012's result and the target mid-point

Brazil's inflation challenge continues despite the current monetary tightening cycle and the government's suppression of monitored prices. Consumer price inflation (IPCA) accelerated to 0.92% month-on-month (mom) in December, from 0.54% mom in November, to raise the annual rate for 2013 to 5.91%. The result marks the fourth consecutive year that inflation has ended in the upper range of the BCB's official target of 4.5% +/- 2%. It also exceeds the BCB's implicit target, which was for inflation to fall below 2012's rate of 5.84%. (Figure 1.)

We see the persistence of upward pressures for inflation and inflation expectations in 2014—in an environment of weak GDP growth—on account of the tight labor market, a weaker BRL, partial increase of government-regulated prices, and loose fiscal policy (including public bank lending growth). Consensus expectations place end-2014 inflation at 6%.

Indeed, with record-low unemployment rates, core inflation measures are still averaging higher than 6% year-on-year (yoy). Services inflation is high and hovering above the headline reading; it was 8.75% yoy in December, accelerating from 8.55% yoy the previous month and showing no improvement from 8.74% yoy in December 2012.

Pass-through from BRL depreciation is also presenting some inflation pressures, which should continue in 2014 in the context of US Fed tapering and less favorable commodity prices compared to prior years. In terms of Brazil's fundamentals, the combination of low growth, a widened current account deficit, and possible sovereign ratings downgrade also supports a weaker BRL outlook.

The sizable and difficult-to-maintain gap remains between free prices (those determined by the market) and government-regulated prices (which include electricity, public transportation, and gasoline). Free market price inflation was 7.3% yoy and monitored price inflation was 1.6% yoy in the 12-months through December. (Figure 2.) Monitored prices accelerated 91bp mom upon the gasoline and diesel price adjustments (4% and 8%, respectively) that took effect on November 30th to support Petrobras' finances. As we've stated previously, the suppression of monitored prices is unsustainable. Pending price increases (for electricity tariffs and public transport fares) will eventually generate inflation pressures, though full adjustments are likely be delayed until after the October 2014 election. In the meantime, partial adjustments can be expected for fuel prices.

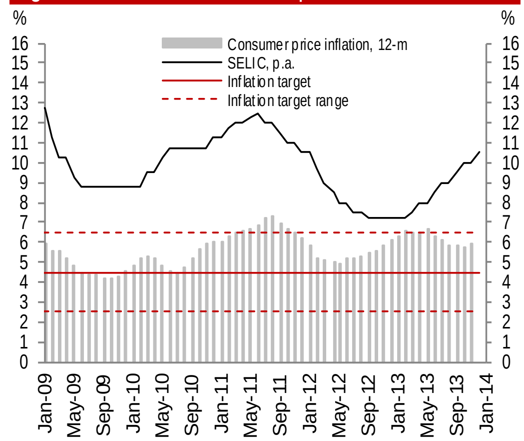
Data-dependent mode: Inflation, BRL, and inflation expectations

While the BCB would have likely preferred to slow the hiking pace and conclude the tightening cycle sooner rather than later into 2014 to support GDP growth during an election year, the latest inflation results did not permit its shift away from a tightening policy stance.

COPOM's next move pertaining to the pace and length of the monetary tightening cycle will be data-dependent on the trajectory of inflation, the BRL, and inflation expectations. If the BRL continues to weaken, COPOM may opt to extend the rate hikes and use spot market intervention to minimize volatility and limit the pass-through to inflation. Moreover, inflation expectations will be another key indicator to follow. Expectations remain de-anchored from the official target of 4.5% since a perception of uncertainty remains regarding the BCB's mandate and implicit policy goals. (Figure 3.)

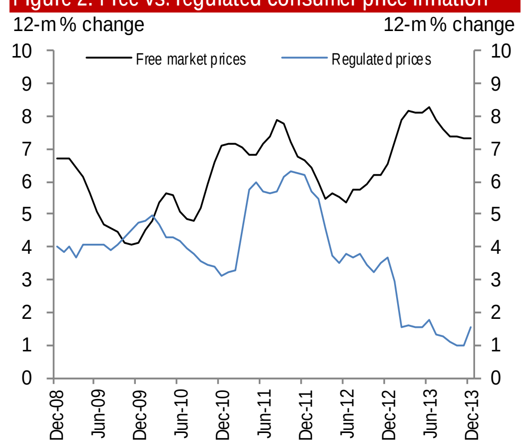
We currently expect a final 25bp increase at the next meeting on February 26th. The minutes, to be released next Thursday, should provide clarity on the BCB's decision and our outlook.

Figure 1: SELIC and consumer price inflation



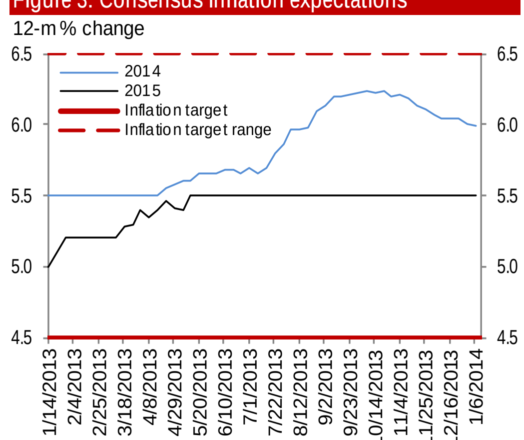
Source: Central Bank; IBGE; BTMU Economic Research.

Figure 2: Free vs. regulated consumer price inflation



Source: IBGE; BTMU Economic Research.

Figure 3: Consensus inflation expectations



Source: BCB Focus Survey; BTMU Economic Research.

For reference to our previous BTMU Latin America Topics Reports, see our website at: http://www.bk.mufg.jp/report/ecolatin2013/index.htm