BTMU LATIN AMERICA TOPICS

Economic Research (New York)

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

BRAZIL: UPWARD INFLATION PRESSURES PROLONG MONETARY TIGHTENING CYCLE

April 3rd 2014

Central Bank hikes SELIC by 25bp to 11.0% and sets data-dependent tone

High inflation and rising inflation expectations have prolonged the Brazilian Central Bank's current monetary tightening cycle, which has increased the SELIC by a combined 375bp since April 2013. The BCB had signaled the intention to pause the tightening cycle earlier this year. However, the resilience of free market prices, partial adjustment of regulated prices, and recent increase of food prices have combined to renew upward pressures on inflation and to delay the conclusion of rate hikes. Headline inflation is near the target ceiling and core inflation remains elevated, thus limiting the Central Bank's room to be lenient on inflation and contain supply-side shocks to food prices.

In this context, in a unanimous and expected decision on Wednesday, April 2nd 2014, the Central Bank's Monetary Policy Committee (COPOM) raised the SELIC policy rate by 25bp to 11.0% per year. The accompanying statement was changed to indicate that COPOM's next steps will be data-dependent; it did not clearly signal the end of the tightening cycle, nor the continuation of further rate hikes. The statement left out the phrase "continuing the process of adjustment of the interest rate", which COPOM has used previously to indicate the extension of the tightening cycle. It added that "the Committee will monitor the evolution of the macroeconomic scenario until its next meeting, so that it then defines the next steps in monetary policy strategy."

The BCB is emphasizing that it is in a data-dependent mode. With below-potential GDP growth and the national election approaching in October, we are of the view that the BCB is likely to pause the tightening cycle at 11.0% for the rest of the year and resume rate hikes in early 2015. This means that, in 2014, inflation will persist in the upper range of the BCB's 4.5% +/- 2% target for the fifth consecutive year. Yet, with inflation remaining pressured in the near-term by food prices, the probability of further rate hikes to contain inflation expectations is rising.

Inflation pressured by food prices and adjustment between regulated and free prices

Consumer price inflation (IPCA) increased 0.69% month-on-month (mom) and 5.68% in the 12-months through February, lingering in the upper range of the target. (Figure 1.) The IPCA-15 for mid-March rose 0.73% mom, elevating the 12-month inflation rate to 5.9%. The average core inflation measure was 6.2% in the 12-months through February, as it remains pressured by services inflation that is still above 8%.

The supply side shock to food prices is the main driver of higher inflation pressures in the short-term. A severe drought during the summer months in Brazil has reduced crop yields and increased the prices of agricultural products, which is now passing through to food prices.

The drought has also raised the risk of electricity rationing, in which case consumer price inflation pressures would ease upon slower economic activity. But if the government attempts to delay any rationing measures until after the October election and adjusts regulated electricity prices upwards, inflation pressures would persist.

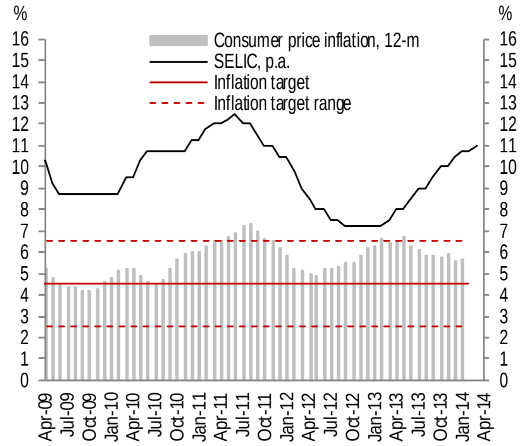
An important and pending pressure on inflation is the wide gap between regulated and free market prices, which should adjust further this year and more so in 2015 following the election (Figure 2). Suppressed prices for gasoline, transportation, and electricity all require upward adjustments.

Under these pressures, inflation expectations remain unanchored from the target midpoint. Indeed, the Central Bank's latest inflation projection—released in its 1Q14 Inflation Report—has risen to 6.1% (from 5.5% previously) for 2014. Meanwhile, the market's expectation has been drifting above 6.1% in recent weeks. (Figure 3.)

Data-dependency: Focus on inflation expectations and BRL

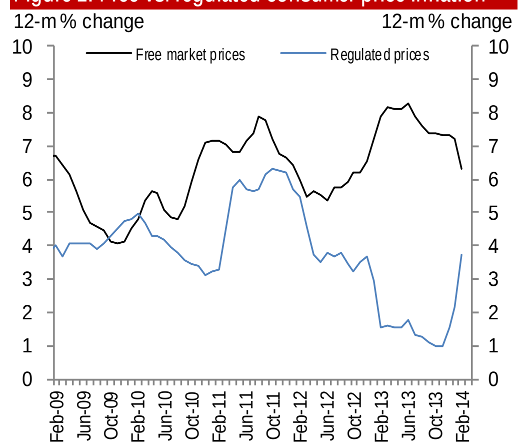
The economic recovery remains slow, and GDP growth will be below-potential again this year. The BCB has signaled that it will be in a highly data-dependent mode until its next monetary policy decision on May 28th. While the BCB would like to pause the rate hikes in May, it will be important to see how such a move is substantiated—in the context of high inflation and short-term pressures on inflation coming from food prices—so as to contain the deterioration of inflation expectations. In this sense, the evolution of both inflation expectations and the BRL will be closely monitored. The recent strengthening of the BRL serves to limit pass-through to inflation, but it will be interesting to assess the BCB's view on the BRL and GDP growth outlook in the COPOM minutes to be released next Thursday, April 10th.

Figure 1: SELIC and consumer price inflation



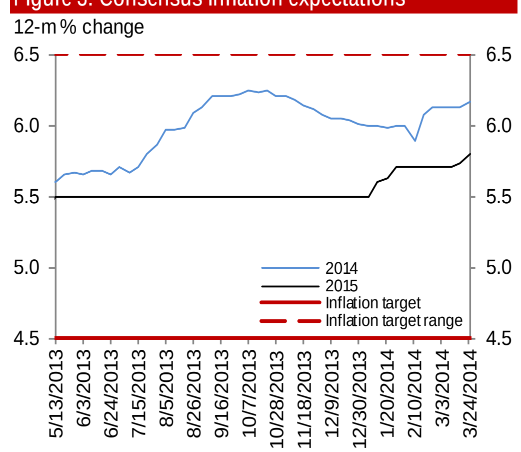
Source: Central Bank; IBGE; BTMU Economic Research.

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/ecolatin2014/index.htm
Our 2013 archives can be found at: http://www.bk.mufg.jp/report/ecolatin2013/index.htm