

UBS Investment Research

Brazil Economic Comment

2Q09 Inflation Report: How much more room for rate cuts?

Last Friday, the Central Bank of Brazil released its 2Q09 *Inflation Report*. As usual, the report contains a broad assessment of the state of the economy, puts new numbers on the BCB's inflation forecasts (conditioned on different scenarios for the Selic rate and for the FX rate), and unveils the latest estimate for GDP growth. The release of the report was followed by a press conference by the Deputy Governor for Economic Policy, Mr. Mario Mesquita.

On growth, the BCB believes that, after two consecutive quarters of decline, leading and coincident indicators already point to a gradual recovery of GDP beginning in the 2Q09. While analysts that had become most pessimistic saw grounds for considerable relief in 1Q09 GDP figures and in more recent high frequency activity indicators, the BCB revised its full year GDP forecast downwards. The BCB's 2009 GDP growth forecast now stands at 0.8%, down from 1.2% previously, reflecting weaker performance from industrial activity on the supply side, and poorer results from investment on the demand side. Manufacturing is now forecasted to contract by 4.2% this year versus an estimate of -1.6% previously, while investment will decline by 5.1% from a marginal expansion of 0.7%. The report reiterated the BCB's confidence in the resilience of domestic consumption demand as a key factor supporting economic growth this year. In fact, the BCB maintained its earlier assessment that domestic consumption will expand by 1.8% in 2009.

However, the highlight of the 2Q09 *Inflation Report* came with its relatively benign conditional inflation forecasts, particularly for 2010. The BCB's "reference scenario" (which assumes the Selic rate flat at 9.25%pa and the FX rate flat at BRL1.95/USD throughout the forecast horizon) now points to inflation of 4.1% in 2009 and 3.9% in 2010 (versus a forecast of 4% for both 2009 and 2010 in the previous report). The "market scenario" (with the Selic rate assumed to decline to 9% and the FX rate closing 2009 and 2010, respectively, at BRL2.00/USD and BRL2.09/USD) points to inflation at 4.2% in both 2009 and 2010 (the corresponding forecasts in the previous report were 4.1% for 2009 and 4.4% for 2010). In both scenarios, IPCA inflation remains below the 4% mark in both 2Q10 and 3Q10, actually reaching as low as 3.6% in the "reference scenario" for both periods and 3.7% in the market scenario for 2Q10. With conditional inflation forecasts that far below the 4.5% target midpoint for both this and next year, the natural interpretation is that there would still be considerable room for monetary easing, if the BCB wanted to explore to the utmost the room for rate cuts implied by the conditional inflation forecasts. In particular, the additional room for easing implied by the conditional forecasts seems greater than the latest Copom minutes were understood to mean when they referred to possible additional cuts as "residual".

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Since, like the minutes, the *Inflation Report* continues to refer to the additional room for easing as being “residual”, the question is how to reconcile that terminology with the conditional inflation forecasts. The first possibility is that one should interpret the term “residual” in a less stringent manner than initially thought, allowing for the Selic rate to fall by a more significant amount when compared to the total cuts already implemented – considerably more than already embedded in the market scenario rate assumptions, for instance, yet delivering inflation forecasts that still do not exceed the target midpoint. The second possibility is that, even if the conditional forecasts point to tame inflation, the BCB might be working with an unfavorable balance of risks for inflation around the conditional forecasts, and taking into account such balance of risks the monetary authority might wish to keep a sufficient compensating buffer between its conditional forecasts and the target midpoint. As a third possibility, even if the balance of risks for inflation is approximately symmetric, the BCB might be especially averse to the risk of overshooting the appropriate budget of rate cuts, being wary of the need for an early reversal of course in the monetary policy instrument. It would then, for the sake of caution, avoid taking the rate cuts all the way to the limit implied by current (and still quite uncertain) forecasts, preferring instead to let monetary conditions adjust at the margin, as needed, through changes in the expected persistence of lower rates.

We consider that there may be a little bit of truth in each one of the three possibilities just contemplated. As recently as October 2007, for instance, the Copom halted a cycle of rate cuts when conditional forecasts below the target midpoint and the accompanying description of the balance of risks were interpreted as suggesting that there was still room to ease policy further. The balance of risks described by last Friday’s Inflation Report, in turn, did contemplate both upside and downside risks, but, if anything, it seemed slightly tilted towards a cautionary tone. Indeed, the BCB called attention to disinflationary risks arising from a slower-than-expected recovery of domestic economic activity, but mentioned on the other hand: (i) a relevant risk arising from the institutional mechanisms that tend to prevent a stronger reaction of inflation in Brazil to increased slack in activity; (ii) the effects of a recovery of commodity prices on domestic inflation; (iii) that cumulative and lagged monetary policy effects could reach full impact in a moment when economic slack is already significantly reduced. Interestingly, in spite of the recent strengthening of the FX rate and no signs of inflationary repercussion from the weakening of the BRL since mid-2008, the BCB still called attention to risks associated with the FX passthrough to consumer prices. Finally, the BCB also remarked that, by containing the effects of disinflationary forces, institutional sources of inflation persistence could set an already elevated point of departure for inflation at the exit from the period of economic contraction. The latter element would stand in contrast with the preceding easing cycle, as in that case inflation started reaccelerating from 3%. Finally, we also find it natural for the term “residual” not to be interpreted any longer as possibly meaning that the additional cuts would be limited to 25 bps, and possibly meaning that, after the 50 bps cut we expect for July, the Copom could even make an additional cut up to the same size.

For now, although we acknowledge the possibility of an additional rate cut in September, we are keeping our call for a final 50 bps cut in the July Copom meeting, bringing the Selic rate to 8.75% pa. Nevertheless, even more importantly, we believe last Friday's communication piece clearly signals that the monetary authority, on the basis of the information set available now, does not envisage the need for an early reversal of the ongoing easing cycle with a view at keeping inflation contained for horizons such as late 2010 and early 2011, let alone hiking scenarios that would be consistent, for instance, with recently observed interest rate premia for terms like 12 or 18 months. On the other hand, despite rates being assumed to climb back slightly by mid-2011 (by 50 bps), the market scenario points to inflation also on a moderate rise at that horizon, to 4.4% – being likely destined to cross above the target midpoint soon afterwards if the uptrend is not somehow arrested. That generates a presumption, under the market scenario hypothesis for the FX rate, that interest rates would need to be adjusted upwards no later than 2011.

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