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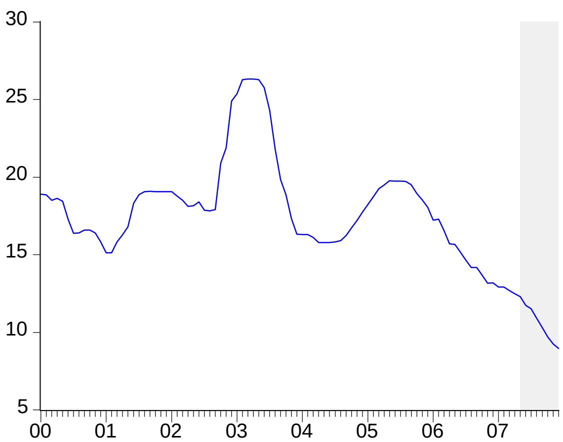
BRAZIL – Monetary Committee (COPOM) could go as far 9.50% by Year-End

Even though some of the market enthusiasm towards the speed up of rate cuts has faded out since the last divided COPOM meeting of April 18th, we continue to believe there is space for more easing than the market is pricing and expecting. As we have argued before, the additional easing would help the BCB leave the FX market improving the ability of the authority to perform monetary policy without imposing any type of capital controls. We foresee improvement of inflation expectations throughout the year, which is key variable for the conduct of monetary policy in Brazil.

The recent developments on the Brazilian FX market could work as an important trigger to change the course of the monetary policy conducted by the BCB. The appreciation of the currency and the intensive intervention on the currency market by the central bank

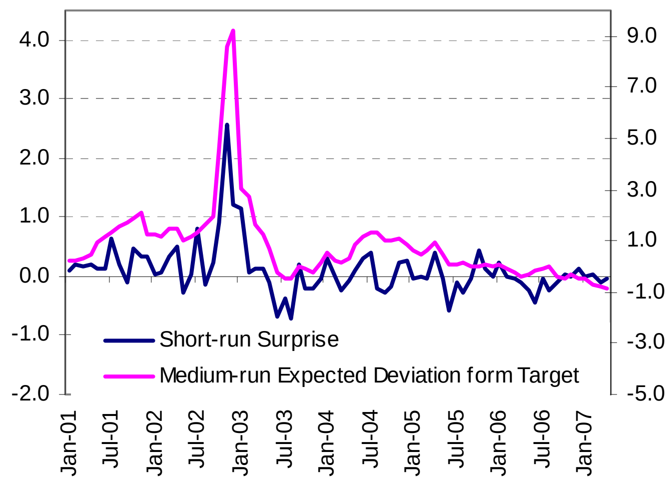
BRAZIL - Selic Rate Forecast - Taylor-Rule
Source: IDEAglobal



continues to feed a system in which more reserves accumulation end up reducing overall external risk premium, attracting more dollar inflows given the current high interest differential. It is well known the impacts of movements in the currency over inflation expectations. The direct and indirect channels of transmission guarantee that a further appreciation will lead to even lower 12-months ahead IPCA expectations, improving the BCB's ability to cut rates, endorsing an inevitable speed up of rate cuts.

More specifically, we call for a 50 bps cut on the next meeting (June 6th) followed by two 75 bps cuts in July and August and two final cuts of 50 bps in October and December. This policy path in conjunction with a less aggressive FX intervention could well be implemented with the Selic reaching a year-end rate of 9.5%. Our results are in line with our Taylor rule model of the specification below, using the Focus market expectations data.

BRAZIL - Inflation Surprise and Deviations from Target
Source: IDEAglobal, BCB



$$SL_t = C_1 + C_2SL_{t-1} + C_3(I_t - I_t^*) + C_4(H_t - H_t^*) + C_5d(FX_{t-n}) + e_t$$

Where SL_t is the effective Selic rate at time t, I_t is the 12-months ahead IPCA inflation expectations at time t, I_t^* is the 12-months ahead IPCA inflation target at time t, $H_t - H_t^*$ is the output gap at time t, $d(FX_{t-n})$ is the exchange rate change (appreciation or depreciation) at time $t-n$, and e_t are the residuals (i.i.d.).

In this case, the less active intervention by the BCB would result in more appreciation of the BRL as USD inflows are set to be very robust throughout the year. The appreciation would contribute to create negative short-run inflation surprises (when actual inflation readings are lower than market expectations one month ago) and, as argued by Garcia (2007)[1], negative short-run surprises tend to push medium term inflation expectations (12-months ahead IPCA) to lower level, reducing even more the deviation from the established target allowing a further easing of the monetary policy.

[1] Garcia, M. and Lowenkron, A. (2007) *Monetary Policy Credibility and Inflation Risk Premium: A Model with Application to Brazilian Data.*

The main argument against the speed up of rate cuts is the path of actual inflation given the level of domestic demand. In our view, the additional easing would not cause a derail of inflation and market expectations as we can identify a very positive and benign process of fixed-capital investment. The data on industrial production has been showing for at least one year a process of important increase in the production of capital goods, which will certainly expand productive capacity, avoiding the overheating of the economy. Imports are another key element to support the strong domestic demand without a rupture of the system, specially considering the downward trend in import prices.

Summing up, we believe the proposed policy is superior to the imposition of capital controls as the country clearly finds itself in a situation of impossible trinity. The proposed policy framework will add degrees of freedom to the monetary authority without the necessity of hot money capital inflexibilities or other types of USD inflow controls. Nonetheless, we agree that the implementation of this course of action needs the endorsement of market participants, as it is very unlikely that the BCB will implement such a policy in the form of a surprise.

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