

LATIN AMERICA FOCUS

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Are Brazil's critics right?

- The decision by Brazilian policymakers to start cutting interest rates while inflation is at a six-year high has led to a chorus of disapproval from both investors and market commentators. In this *Focus* we assess five of the most common criticisms and explain why at least some are wide of the mark.
- **Criticism #1: The Central Bank is making a mistake by cutting interest rates while the economy is growing strongly and consumer spending is robust.** In fact, the economy is already in the midst of a sharp slowdown. GDP appears to have stagnated in quarterly terms in Q3 and the forward looking indicators point to worse to come in Q4. Even consumer spending is showing signs of slowing. We expect the economy to expand by just 2.5% next year – below its potential rate of around 4% or so.
- **Criticism #2: The Central Bank is making a mistake by cutting interest rates when inflation is running at a six-year high.** Inflation has probably peaked. Food inflation should fall sharply over the next six months as last year's commodity price shock unwinds, while slowing growth is consistent with a negative output gap opening up by the mid-2012. Widespread indexation and a generous hike in the minimum wage will cushion the slowdown in inflation, but we still expect it to fall within its 4.5% ± 2% target range by Q1 2012, and to close to its central target by the end of next year.
- **Criticism #3: The Central Bank is pursuing a dual mandate to target growth and inflation, which will damage its credibility and undermine the improvements made to policy frameworks over the past decade.** We are less concerned that "premature" rate cuts will damage the Bank's credibility and are instead more worried about proposed legislation to dilute the current inflation targeting regime. The devil will be in the details, but this warrants close attention over the coming months.
- **Criticism #4: The Central Bank's decision to start cutting interest rates risks reigniting a credit bubble.** In the near term, lower interest rates should reduce pressure on over-stretched household finances. But we remain concerned that rapid capital inflows stoke asset price and credit bubbles over a 2-5 year horizon. Quantitative measures (and fiscal reform, of which more below) will continue to play an important role in mitigating such risks.
- **Criticism #5: The government's objective to reduce interest rates to single digits cannot be achieved without a rise in inflation.** In theory at least, this is wrong. In practice, however, the key to lower interest rates lies in fiscal policy reducing some of the pressure on monetary policy as the economy picks up speed once again next year. We estimate that a fiscal tightening worth 2% of GDP would allow the Selic rate to fall from an average of 10.5% in the last interest rate cycle to around 8% in the next cycle.

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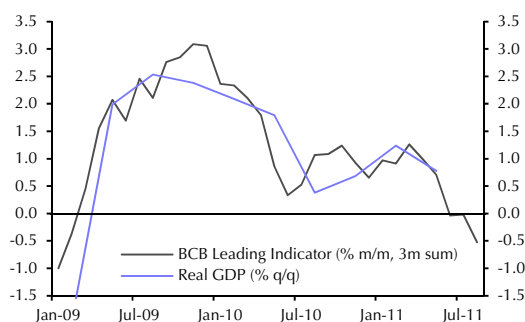
Are Brazil's critics right?

The decision by Brazilian policymakers to start cutting interest rates at a time when inflation is running at a six-year high has led to a chorus of disapproval from both investors and market commentators. But at least some of the criticisms that have been levelled at policymakers appear wide of the mark. In this *Focus* we assess five of the most common criticisms and explain why they might ultimately prove to be misplaced.

Criticism #1: The Central Bank is making a mistake by cutting interest rates while the economy is growing strongly and consumer spending is still robust.

The blunt truth is that growth is now *slowing* – and more sharply than many seem to appreciate. The Central Bank's (BCB) own monthly activity indicator suggests that the economy stagnated in the third quarter. (See Chart 1.)

CHART 1: BCB ACTIVITY INDICATOR & QUARTERLY GDP GROWTH



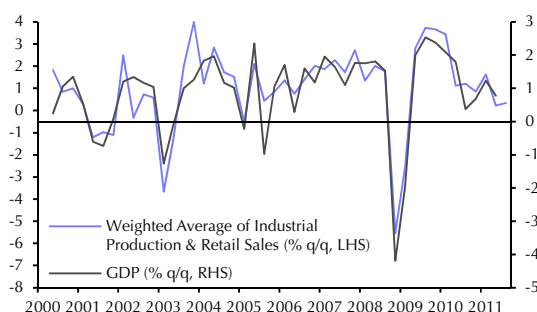
Sources – BCB, Thomson Datastream

This is supported by our own simplified leading indicator for quarterly GDP growth, based on a weighted average of the monthly data on retail sales and industrial production. (See Chart 2.)

Of course, the growth challenge facing Brazil is nowhere near as great as that facing the debt-laden economies of the developed world. But even so, regular readers will recall that we have warned for some time about the limits to “two speed” growth

in Latin America's largest economy, which has seen consumer facing sectors boom while industry has stagnated. (See for example *Latin America Update*, “Worrying signs from Brazil's current account”, 22nd June.)

CHART 2: CE SIMPLIFIED INDICATOR & GDP GROWTH



Sources – Thomson Datastream, CE

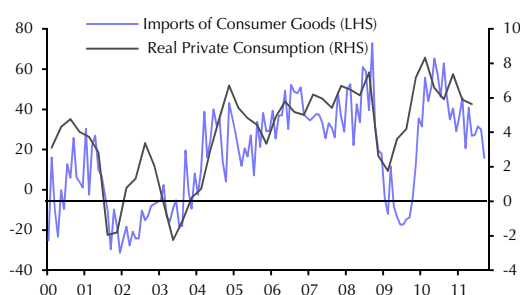
The problems facing industry are well known – a super-strong currency has squeezed exports, while at the same time diverting domestic spending to imports. To compound matters, demand in key export markets has slumped in recent months. **But at the same time, the three pillars on which Brazil's two-year boom in domestic demand has been built – namely, a continued improvement in the terms of trade, rapid capital inflows and a surge in domestic credit – are looking increasingly fragile too.**

The recent fall in commodity prices will weigh on Brazil's terms of trade, while rising investor risk aversion has slowed inflows to emerging markets. At the same time, with consumer finances starting to look stretched, the current pace of credit growth appears unsustainable. (For more on this see *Latin America Update*, “Brazil: Credit where credit due?”, 12th July.)

Admittedly, the labour market remains in rude health and the government is committed to an inflation-beating 14% rise in the minimum wage in January. (Most estimates suggest that around 45m Brazilians, equivalent to nearly one-third of the

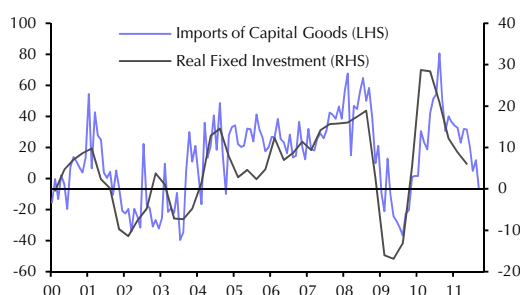
adult population, earn the minimum wage, around 22m of whom are pensioners.) But even so, the signs from the monthly trade data suggest that private consumption growth has started to slow, while fixed investment appears to have collapsed. (See Charts 3 & 4.)

CHART 3: IMPORTS & PRIVATE CONSUMPTION (% Y/Y)



Source – Thomson Datastream

CHART 4: IMPORTS & FIXED INVESTMENT (% Y/Y)

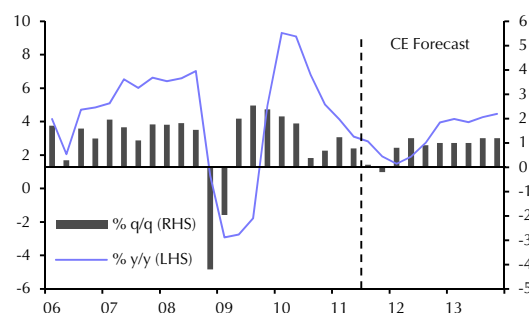


Source – Thomson Datastream

The upshot of all of this is that, despite claims to the contrary, the Brazilian economy appears to be experiencing a reasonably sharp slowdown in growth. This shouldn't necessarily come as a surprise. After all, during the 2008-09 global crisis Brazil was one of the first of the emerging economies to feel the effects of problems in the West. Back then, the economy experienced a peak-to-trough drop in output of 6.5% between Q3 2008 and Q1 2009. Fast forward to today, and much will now depend on how the crisis in the euro-zone plays out. For now, our base case is that Brazil will suffer a more moderate downturn than in 2008-09, with output falling by around 0.25% peak-to-trough, and the economy starting to recover by the middle of next year. (See Chart 5.)

This is consistent with GDP growth of 3% in 2011 and 2.5% in 2012, and is based on one quarter of negative growth in Q4 of this year. But while our forecasts are already below consensus, it would clearly be premature to rule out the possibility of a steeper downturn, encompassing a technical recession, in the event of a messy end to the euro-crisis. Of course, the scope for policy stimulus should still ensure that Brazil stages a recovery at some point next year. **Either way, however, the crucial point, from the perspective of the recent debate is that signs the economy is already slowing. This, coupled with mounting risks to future growth, supports the decision to cut interest rates.**

CHART 5: REAL GDP



Sources – Thomson Datastream, CE

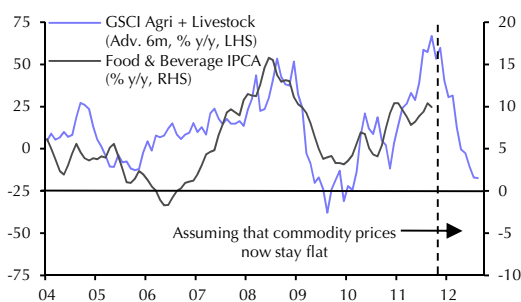
Criticism #2: The Central Bank is making a mistake by cutting interest rates when inflation is running at a six-year high.

Despite the fact that growth is slowing, some have argued (vehemently in many cases) that cutting interest rates is a mistake since, at 7.3% in September, inflation is well above its central target of 4.5% (and, indeed, the 6.5% upper bound of its target range).

But there are at least three good reasons to think that inflation has now peaked. First, movements in global agricultural prices suggest that food inflation – which has been the primary driver of the spike in inflation over the past year – is likely to fall sharply over the coming months, perhaps reaching 4% by Q4 2012 (from close to 10% currently). (See Chart 6, overleaf.) This alone would knock around 1.5%

off of the headline rate of inflation, bringing it back to within its target range (though still leaving above its central target).

CHART 6: BRAZIL FOOD INFLATION & GLOBAL AGRI. PRICES



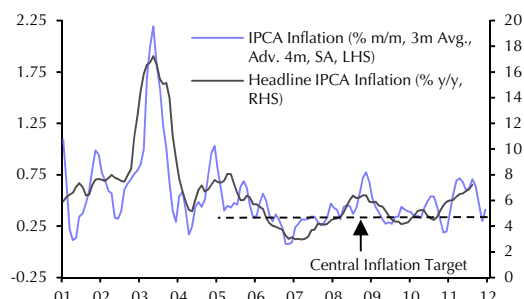
Source – Thomson Datastream

Second, our forecast for Brazilian growth to slow to 3.0% this year and just 2.5% in 2012 is consistent with a negative output gap opening up by around the middle of next year. Slower growth should start to ease capacity constraints and thus relieve underlying price pressures.

And finally, at least some of the most commonly cited upside risks to inflation appear to be overdone. Most obviously, past experience suggests that the recent drop in the real is unlikely to lead to a surge in imported inflation. (For more see “What should we make of the real’s fall from grace?”, 22nd September.)

Of course, there are still some valid causes for concern. In particular, widespread indexation – half of the CPI basket is linked to last year’s prices – means that inflation is inherently stickier in Brazil than it is elsewhere in the region. This suggests that annual inflation might not slow quite as sharply as recent monthly movements in prices imply. (See Chart 7.) **Nonetheless, the key point is that inflation has probably peaked and, although it may be a slow grind, we do expect it to fall to within its target range by Q1 next year and to its central 4.5% target by Q1 2013.** Accordingly, we suspect that some of the more vocal claims that the central bank has gone soft on inflation will soon start to fade.

CHART 7: CONSUMER PRICES

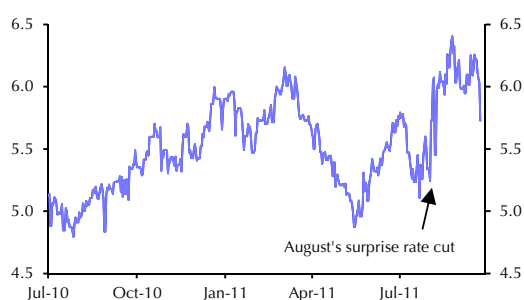


Sources – Thomson Datastream, Capital Economics

Criticism #3: The Central Bank is now pursuing a dual mandate to target growth and inflation, which will ultimately damage its credibility and undermine the improvements made to policy frameworks over the past fifteen years.

As should be clear by now, we think that the data on both growth and inflation over the next 6-9 months will ultimately justify the BCB’s decision to cut interest rates. In this sense, concerns about potential damage to the Bank’s credibility stemming from a “premature” interest rate cut seem wide of the mark. Indeed, two-year market-implied inflation expectations have already started to fall in recent weeks. (See Chart 8.) We suspect they will fall further over the coming months.

CHART 8: TWO-YEAR MARKET-IMPLIED INFLATION EXPECTATIONS (%)



Source – Bloomberg

Nonetheless, there are legitimate worries about the independence (and thus credibility) of monetary policymaking in Brazil. Of particular concern is a bill making its way through Congress that would give the BCB a dual mandate to target both

inflation and growth (at present the Bank's charter requires it to focus solely on targeting inflation and maintaining financial stability). Of course, central banks in a number of developed countries already pursue dual mandates – the US Fed has a dual mandate to maintain “maximum employment and stable prices”, while the Bank of England has a mandate to deliver price stability and “subject to that, support the Government's economic objectives including those for growth and employment”.

In the case of Brazil, it's important to bear in mind that the proposed bill has yet to be passed and, even if it is, much will depend on exactly how the BCB's charter will be changed and how these changes will be implemented in practice. Both are unclear at this stage. (An important point is that in the case of the US Fed both targets carry an equal weight of importance, whereas in the UK, the BOE's inflation target is primary to the objective of supporting other government policies.)

Even so, context is everything and, in this regard, we would make three observations. First, while the BCB operates with *de facto* independence from government, unlike other central banks in Latin America and the rest of the world, this is not enshrined in law. Second, Brazil's inflation targeting regime is relatively young, meaning that radical changes to encompass a dual mandate are perhaps more. And finally, the BCB's central inflation target (and indeed its target range) is already high relative to the rest of the region.

More broadly, the adoption of inflation targeting has been integral to the transformation of Brazil's economy over the past fifteen years or so. Hyperinflation has been conquered and long term interest rates have fallen. **Looking ahead, our view is that Brazil's best interests would be served by strengthening the current inflation targeting regime – in particular granting the BCB full independence and reducing its inflation target – rather than diluting it.** To this end, we are less worried about “premature” interest rate cuts and

will instead be keeping a close eye on the passage of proposed legislation to alter the BCB's charter.

Criticism #4: The Central Bank's decision to start cutting interest rates risks reigniting a credit bubble.

We were one of the first forecasters to warn that rapid capital inflows were stoking an unsustainable credit boom in Brazil. (See *Latin America Update* ‘Brazil: credit where credit's due?, 12th July.) Since then credit growth – especially to households – has shown little sign of abating. Lending expanded by nearly 20% y/y in September and we have some sympathy with the idea that rate cuts by the BCB might further fuel a credit bubble.

Despite this, however, we still think that monetary easing is justified by the need to support flagging economic growth. Indeed, one way in which this will help is by easing the hefty debt servicing costs faced by households. We estimate that debt servicing currently accounts for at least 17.5% of household's disposable income. Given that most consumer credit is held at short maturities and on variable interest rates, much of that debt could be rolled over onto lower rates. Indeed, we estimate that for every 1%-pt reduction in the Selic rate, household's debt servicing burden is reduced by around 0.5% of disposable income. Not only would that free up resources to be spent on other goods and services (and thus boost growth), but lower debt servicing costs could help to reduce the severity of any increase in non-performing loans as the economy slows and thus reduce any losses accruing to the banks.

Meanwhile, **we suspect that the deterioration in the macroeconomic environment will act as natural brake on bank lending.** With the economy slowing, banks are unlikely to sanction new lending at the same pace that they did when the economy was booming. At the same time, as both business and consumer confidence softens *demand* for credit is likely to weaken too.

Nevertheless, while near-term rate cuts may be justified by the worsening outlook for growth, the

threat of a credit bubble (and indeed asset price bubbles more generally) in the medium term (say 2-5 years) remains. It is becoming increasingly clear that both growth and interest rates in the developed world will remain very slow and very low for a long time. As a result, when the global economy stabilises once again, sizeable capital flows to those emerging market economies with comparatively good growth prospects are likely to resume. And Brazil's relatively bright prospects, low domestic savings rate and high interest rates mean that it will remain a favoured destination for investors. **The defining challenge for Brazilian policymakers over the next decade will therefore be to prevent these inflows from stoking bubbles and destabilising the financial system.**

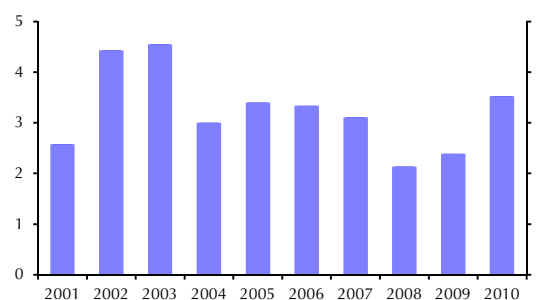
In actual fact, the experience of the past year or so suggests that interest rate hikes might not be the best response to the problems posed by rapid capital inflows. With each additional hike the interest rate differential with the West would widen, attracting more capital and ultimately exacerbating the problem. Quantitative limits on lending and restrictions on inflows are therefore likely to become increasingly important policy tools. Meanwhile, flexible and responsive demand management via fiscal policy will be crucial.

Criticism #5: The government's objective to reduce interest rates to single digits cannot be achieved without a corresponding rise in inflation.

It is well known that Brazil suffers from the highest real interest rates of any major economy. At the same time, the government's ambition to reduce interest rates (in nominal terms) to single digits is equally well known. But the idea this cannot be achieved with permitting a corresponding rise in inflation is fundamentally misplaced. Fiscal policy holds the key. In particular, if lower interest rates are counterbalanced by reductions in government spending and/or higher taxes, there would be no impact on aggregate demand and thus, all other things being equal, inflation.

As Brazil's economy started to recover from the effects of the last global downturn in 2009, fiscal policy remained comparatively loose. This was because the government was slow to unwind stimulus measures enacted in late-2008 and early-2009. Accordingly, the structural fiscal deficit (i.e. the deficit adjusted for the effects of the economic cycle) actually *widened* in 2010 as the economy returned to growth. (See Chart 9.) A failure to tighten fiscal policy meant that as growth returned, monetary policy had to tighten more quickly than otherwise would have been the case.

CHART 9: STRUCTURAL GENERAL GOVERNMENT FISCAL DEFICIT (% OF POTENTIAL GDP)



Sources – IMF

The current monetary easing cycle therefore presents an opportunity to reduce Brazil's comparatively high level of interest rates. We expect the benchmark Selic rate to fall to 10% by mid-2012 but keeping it there, and perhaps reducing it even further, will depend on fiscal reform.

To put this into context, a recent central bank study found that a fiscal tightening equivalent to 1% of GDP would have a similar impact on inflation as 125bps of interest rate hikes. Given that the Selic rate averaged 10.5% in the previous cycle (peak-to-peak), this implies that a fiscal tightening worth around 2% of GDP would be required to lower the average Selic rate in the next interest rate cycle to 8% or so. This in turn, would have the added benefit of leaving Brazil less vulnerable to speculative capital inflows (attracted by the comparatively high rates of return), which, as noted earlier, are likely to return over the

coming years. Indeed, we've long-argued that domestic fiscal reform offers the best hope of weakening the super-strong real and allowing to Brazil to prevail in its self-styled "currency war".

The problem, of course, is that this is easier said than done. Fractious local politics mean that radical reforms look unlikely for now, and the promise of a 14% hike in the minimum wage next year works against the need to trim spending (around one-fifth of government outlays are linked to the minimum wage). **Nonetheless, it is certainly possible for Brazil to reduce interest rates without permitting a corresponding increase in inflation. The key, as ever in Brazil, lies with fiscal policy.**

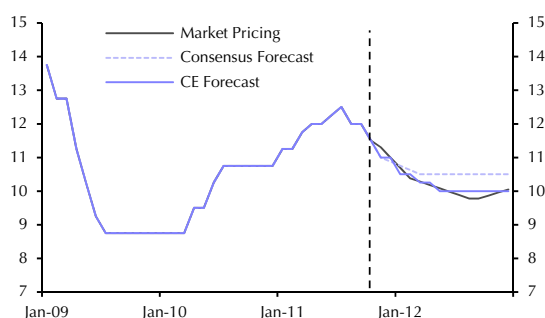
Summary

To sum up then, while the global backdrop is particularly uncertain at present, our best guess is that, contrary to the current consensus view, the BCB's decision to cut interest rates will ultimately be justified by a slowdown in both growth and inflation over the next 6-9 months. Indeed, we expect further rate cuts over the coming months and see the Selic rate reaching 10% by mid-2012 (a forecast that remains below consensus but is now priced into the market). (See Chart 10.)

years. At the same time, we expect a re-run of the past year's currency wars at some point over the next 18 months – two years.

Finally, of all the concerns that have been voiced in recent months about monetary policymaking, we think that moves to dilute the present inflation targeting regime are the most valid. To this end, we are less worried about "premature" interest rate cuts and think investors should instead keep a close eye on the plans to change to the Bank's charter.

CHART 10: SELIC INTEREST RATE (%)



Sources – Bloomberg, Capital Economics

But keeping the Selic at 10% or below will require wholesale fiscal reforms that will be politically difficult to achieve. Accordingly, we have pencilled in rate hikes in 2013. This in turn means that speculative capital inflows are likely to return and preventing asset bubbles from developing will remain the defining challenge over the next five