

LATIN AMERICA CENTRAL BANK WATCH

Oct. 2011



More to follow Brazil's lead

- *Deteriorating global outlook should ultimately justify Brazilian rate cuts.*
- *But question marks over credibility likely to persist in the very near-term.*
- *Others will follow Brazil's lead and rate cuts everywhere likely in next 12m.*

Brazil's decision to continue cutting interest rates despite the fact that inflation is running at a five-year high remains as controversial as ever. Nonetheless, on balance we think that the central bank's judgement that the greatest near-term threat to the economy is slowing growth not rising inflation will ultimately prove to be correct. Indeed, we expect other central banks in the region to follow Brazil's lead and cut interest rates over the coming months and quarters. Mexico looks like the most obvious candidate to move next, although we expect cuts in every country in the region over the first half of 2012.

More generally, taking a step back from the controversy surrounding Brazil's decision to cut rates, the key point is that policymakers in the region have room to manoeuvre in the face of a renewed slump in the Western world. Growth in Latin America is likely to slow by more than most expect over the next year as global headwinds build, but the capacity for a policy response will cushion the slowdown and quicken the recovery. In this sense, we think that Brazil's pre-emptive move to cut rates is best viewed as a sign of how far the country has progressed over the past decade or so rather than a retrograde retreat to the monetary indiscipline of the past.

Brazil (30th November, CE Forecast: 50bps cut)

As expected, COPOM cut the Selic rate from 12% to 11.5% earlier this month. The accompanying statement noted that the decision was unanimous (in contrast to August's rate cut, which was passed by a 5-2 majority) and that with the global environment becoming more "restrictive" the move was "consistent with inflation converging to target in 2012". Nonetheless, with inflation now at a five-year high of 7.3%, the decision to continue easing policy remains controversial.

Indeed, we suspect that a *larger* cut may have been on the cards, but for two things. First, global financial markets have rallied over the past few weeks on hopes that European policymakers will agree a package of measures to resolve the euro crisis. Second, it seems likely that Brazilian policymakers will have been chastened somewhat by the ferocious backlash from investors to last month's surprise interest rate cut.

Two-year inflation expectations – implied by the difference in yields on nominal and inflation protected bonds – have shot to over 6% in recent weeks, and at one point neared 6.5%. (See Chart 1, overleaf.) At the same time, prominent former policymakers have voiced concerns that the government is turning is back on fiscal and

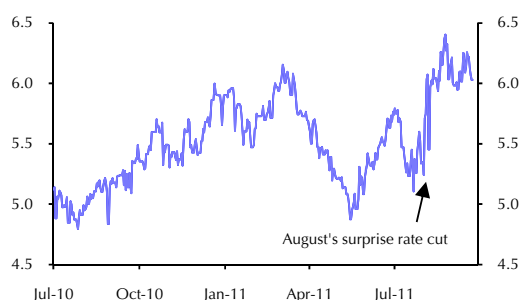
TABLE 1: LATIN AMERICA'S INTEREST RATE FORECAST

	Current interest rate (%)	Latest Inflation rate (%)	Central Bank inf. target (%)	Next meeting date	CE forecast next meeting (bps)	CE forecast end-12 rate (%)	Consensus forecast end-12 rate (%)	Market implied end-12 rate (%)
Brazil	11.50	7.3	4.5 +/-2.0	30 th Nov	50bps cut	10.00	10.50	10.25
Mexico	4.50	3.1	3.0 +/-1.0	2 nd Dec	No change	4.00	4.50	4.75
Colombia	4.50	3.7	3.0 +/- 1.0	30 th Sep	No Change	3.75	5.00	N/A
Chile	5.25	3.3	3.0 +/- 1.0	15 th Nov	No change	4.00	4.50	3.50
Peru	4.25	3.7	2.0 +/- 1.0	10 th Nov	No change	3.50	4.75	N/A

Sources – Thomson Datastream, Bloomberg, Capital Economics

monetary discipline, which has formed the backbone of the economy's success over the past decade or so.

CHART 1: BRAZIL 2-YR. MARKET IMPLIED INFLATION EXPECTATIONS (% Y/Y)



Sources – Bloomberg, CE

While we have concerns about the long-run direction of fiscal policy and would not underplay the fear of inflation locally (hyperinflation is a relatively recent memory), we believe that the BCB's judgement that the greatest near-term threat is slowing growth not rising inflation will ultimately prove to be correct.

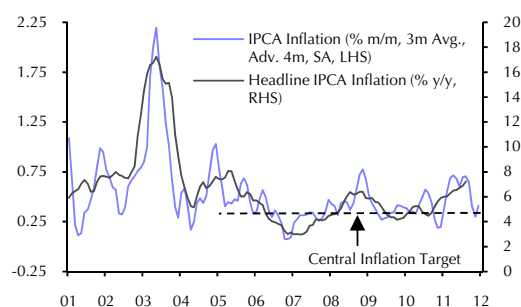
Much, of course, depends on how the debt crises in the Western world will play out. We take a sceptical view. **Indeed, we think that the eurozone will spend much of the next year or so in recession and that the current crisis will ultimately result in some form of break-up of the single currency. If we are right, Brazil will not escape the fallout.**

As we've noted before, the common assumption that Brazil is shielded from developments in the world economy by virtue of its relatively low dependence on exports is wrong. In fact, Brazil is often among the first economies to be hit by a deterioration in global conditions. Recent data show that growth is already slowing – PMI surveys suggests that industry is in recession, and retail sales contracted by 0.4% m/m in August. The BCB's own activity indicator suggests that the economy shrank by 0.5% in August – the biggest monthly contraction since January 2009 when the economy was in the midst of recession. Of course, monthly data are volatile and we would caution

against reading too much into one set of figures. But even so, **we still think that GDP growth will slow to a below-consensus 2.5% next year.**

Meanwhile, having reached a five-year high of 7.3% last month, inflation has probably peaked. Food inflation, which has been the primary driver of the latest spike in the headline rate, should start to ease as the effects of the sharp rise in global agricultural prices in the second half of 2010 and the first half of this year, starts to unwind. Moreover, monthly changes in prices point to a sharp slowdown in the headline CPI rate more generally over the coming months. (See Chart 2.)

CHART 2: BRAZIL IPCA CONSUMER PRICES



Sources – Bloomberg, CE

We would be surprised if inflation fell quite as quickly as the relationship in Chart 2 suggests, but we do expect the headline rate to slow to within its target range of 4.5% ± 2% by Q1 next year, and to near its central target by end-12. So while markets remain to be convinced, COPOM's decision to cut interest rates should ultimately be justified. Indeed, further easing is likely over the coming months and we see the Selic rate hitting 11% by the end of this year (final meeting on 30th November) and 10% by the end of 2012. This is below consensus expectations (end-12: 10.5%) and market expectations (end-12: 10.25%).

Mexico (2nd December, CE Forecast: no change)

The Central Bank of Mexico (BANXICO) stuck to its guns and held interest rates at 4.5% for the twenty-second consecutive meeting earlier this month. As we had anticipated, policymakers highlighted the threat of higher inflation stemming from the recent depreciation of the peso against

the dollar. But they also noted that they are prepared to “lower rates” if the global economy continues to deteriorate.

In actual fact, the incoming news regarding the global economy has improved a little in recent weeks. Activity data from the US have been stronger than expected and it appears that Q3 may not have been the onset of a double-dip recession as had once seemed likely. What’s more, concerns about the euro-zone have settled down for now at least, which has been reflected by a stabilisation in the financial markets. The combination of these factors bought policymakers some time to assess just how much impact the weaker peso will actually have on inflation.

As a result, **even though import prices have risen by over 10% in recent weeks, we expect firms to absorb at least some of the price increases into their margins rather than pass them onto consumers and risk a decline in sales.** We are therefore sticking to our forecast for inflation, which edged down to just 3.1% y/y in September (from 3.4% y/y in August), to remain close to the Bank’s 3% target throughout next year.

On the whole, policymakers appear to agree with this viewpoint and noted that inflation is “showing favourable trends”. But they are also wary of the threat to inflation stemming from the weaker currency and are likely to wait for official confirmation that September’s sell-off of the peso did not cause inflation to spike before turning their attention to monetary easing. Indeed, as Chart 3 shows, the average exchange rate so far this month implies that the CPI rate could reach 4.5% if price increases are fully passed on to consumers.

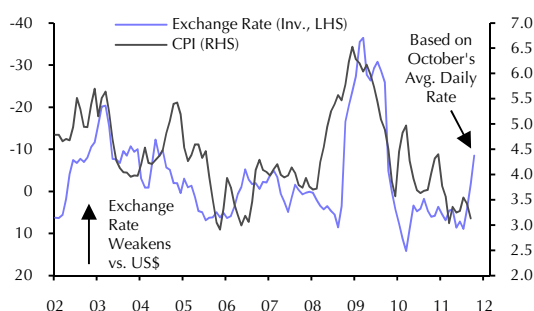
Turning our attention to December’s meeting, it is a close call. If the incoming data take a turn for the worse over the coming weeks, policymakers could commence monetary easing. But, **on balance, we think that it may well be held back until Q1 of next year. Either way, we expect 50bps of cuts to take rates to a new historic low of 4.0% in the first half of next year, and for rates to remain very low for a long time.** By contrast, the consensus is for rates to *rise* to 4.75% over the same period.

Colombia (28th October, CE Forecast: no change)

The Central Bank of Colombia (BANREP) held interest rates at 4.5% last month, as expected. In the minutes from the meeting policymakers highlighted that, while the global economy has shown signs of weakening, the domestic economy has been very strong.

Indeed, despite all of the global turmoil, activity has still been strong. The three-month average of retail sales growth ticked down only slightly to 11.2% y/y in August (from 11.7% y/y in July), while industrial production grew by 5.4% y/y (up from 3.9% y/y) over the same period. As a result, it appears that GDP growth accelerated towards

CHART 3: MEXICO INFLATION & EXCHANGE RATE



Source – Thomson Datastream

As Chart 3 shows, history suggests that there is certainly a threat to price stability, perhaps more so than elsewhere in Latin America. Nonetheless, we think that the general weakness of the economy will keep a lid on inflation this time around. The output gap remains in negative territory, unemployment is still relatively high and domestic demand is weak. In addition, even though a dreaded double-dip recession may have been avoided in Q3, there is no getting away from the fact that demand from the US is faltering and that it will remain weak for a very long time. Meanwhile, the European debt crisis is likely to intensify. Indeed, the risks to our forecast, for GDP growth of 3.5% this year, now seem to be skewed to the downside. And we expect a further slowdown to just 2.5% next year.

6.0% y/y in Q3, from 5.2% y/y in Q2 leaving the economy on track to expand by 5.5% this year.

In the first half of this year that would have stoked fears about overheating. But the debate has moved on since then and, following the recent wobble in the global economy, **the pillars that have supported growth look set to weaken.** For a start, we expect further falls in commodity prices as global growth cools, reversing some of the positive terms of trade shock. Second, we expect an increase in risk aversion to cause a moderation of capital inflows and perhaps even capital flight. Finally, we expect a turn in the credit cycle to ultimately feed through to weaker consumer spending. If we are right, then GDP growth may slow to around 3.0% next year. That would not be a disaster, especially when compared to growth in the developed world, but it would still be below Colombia's potential rate of 4-5% per year.

The good news is that the slower pace of growth should cool inflation. Prices rose by 0.5% on the month in September, which caused the annual rate of headline rate of inflation to jump to 3.7% (from 3.3% in August). The pick-up was largely driven by food inflation and, as we have long argued, that will probably push inflation to about 4.0% over the coming months. What's more, some argue there is a risk that the 7% drop in the peso against the dollar in recent weeks will cause inflation to rise. But the evidence suggests that there is not a particularly strong relationship between the exchange rate and prices and, with the commodity price shock set to pass through the inflation series and slower growth set to weigh on core inflation, we expect the CPI rate to fall next year and to remain close to the Bank's 3% target for the foreseeable future.

The upshot is that the current pattern of growth and inflation will probably prevent policymakers from cutting interest rates in the very near-term. But as the growth outlook steadily deteriorates next year, policymakers may turn their attention to monetary easing. **We have pencilled in 75bps of interest rate cuts, starting in Q1 of next year, to**

take rates down to 3.75% by mid-2012. Thereafter, rates should stay low for an extended period. By contrast, the consensus is for rates to rise to 5.0% by the end of next year.

Chile (15th November, CE Forecast: no change)

Chile's central bank (CBC) kept interest rates unchanged at 5.25% for a fourth straight meeting earlier this month. The decision to keep rates on hold was in line with most analysts' expectations. Bank officials have maintained that they are comfortable with rates at their current level and will not be rushed into making cuts.

The post-meeting statement was more long-winded than usual and noted that a "deepening of observed tendencies in the international economy" would have "consequences" for monetary policy. Nevertheless, it essentially told us nothing that we didn't already know – that is, that **the CBC stands ready to act as and when external conditions warrant a policy response.**

So how soon might this be? We would certainly not bet against a cut before year-end, especially if a coherent plan to address Europe's sovereign debt crisis is not forthcoming. Nevertheless, if we assume that foreign policymakers will continue to muddle through, we suspect that cuts are most likely to start in Q1 of next year. There are a few factors behind this.

First, authorities will want to avoid further peso volatility. Chile's currency has been on a rollercoaster ride since the start of September, falling 15% against the US\$ in the space of a month, before staging a partial recovery over the past few weeks. Admittedly, this was largely driven by a sharp sell-off and subsequent bounce in copper prices. But all the same, the central bank will not want to risk adding fuel to the fire by surprising the market with an early cut.

Second, inflation rose in September due to an acceleration of food and energy price pressures, which are still feeling the lagged effects of a commodity price spike earlier this year. Most of these effects should pass out of the system by early

2012, pushing inflation back down towards the CBC's 3% target mid-point.

Third, recent indicators have shown a slight improvement in economic activity. The monthly IMACEC index, which is a proxy for GDP, rose by 4.6% y/y in August, following a below-expectations 4.0% y/y increase in July. Although GDP growth is set to slow in Q3, strong consumer spending will prevent a collapse and any consolidation of copper prices should provide some near-term support to domestic demand.

Further ahead, Chile's openness makes it more exposed than most to a deterioration of external demand. We forecast GDP growth to slow to a below-consensus 3% in 2012, from 6% or so this year, as global growth weakens and the G7 countries flirt with recession. **We expect to see 125bps of cuts starting in Q1 2012, taking the benchmark rate to 4.00% by the end of next year. Assuming we do not witness a collapse of external demand in the intervening period, the CBC's language will prepare the markets for policy easing from next year.**

Peru (10th November, CE Forecast: no change)

Interest rates in Peru were held at 4.25% during October's central bank (BCRP) meeting. The policy rate has not been adjusted since a 25bp hike back in May, as authorities remain wary about slowing global economic activity, despite resilient domestic conditions.

Recent comments from central bank officials have made it very clear that **the board will not hesitate to set in motion various forms of policy easing if the external situation gets any worse, or on concrete signs of a domestic slowdown.** This is the clearest signal yet that rate cuts are on policymakers' agendas.

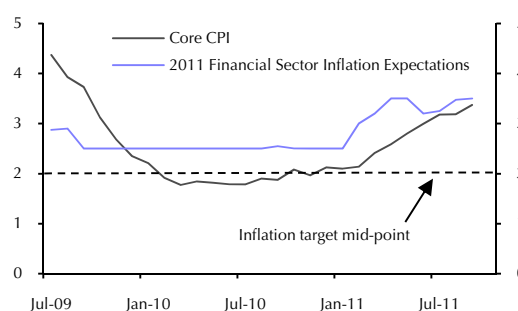
Nonetheless, it still remains to be seen whether the bank would choose to implement other forms of loosening, such as reserve requirement adjustments, before embarking on rate cuts. Furthermore, we still believe that without an external 'trigger', such as a further escalation of the

sovereign debt crisis in the eurozone, **it will probably be Q1 2012 before we see any monetary easing.**

One of the reasons for this is the recent strength of domestic economic activity. After a small post-election dip in June, GDP growth bounced back impressively in July and August, with the latter month posting a 7.5% y/y expansion (up from 6.5% y/y in July). Meanwhile, **all of the signs are of a continued recovery in business confidence and planned investment, which should help underpin near-term domestic demand strength.**

Another key factor is an acceleration of inflationary pressures. Most notably, core inflation – which strips out volatile food and energy components – rose further above the central bank's 3% upper tolerance band last month. Core CPI increased to 3.4% y/y in September, from 3.2% y/y in August, and is unlikely to fall back into its target range before Q1 of next year. To further compound policymakers' dilemmas, recent evidence suggests that inflation expectations have continued to build. (See Chart 4.)

CHART 4: PERU CORE INFLATION & INFLATION EXPECTATIONS



Source – Thomson Datastream, BCRP

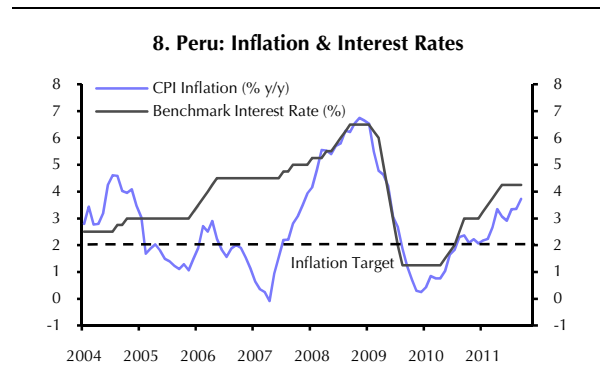
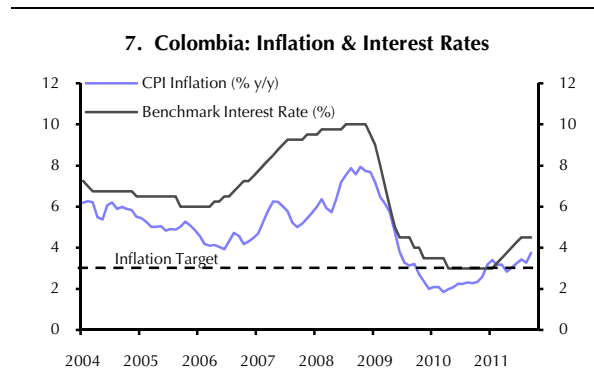
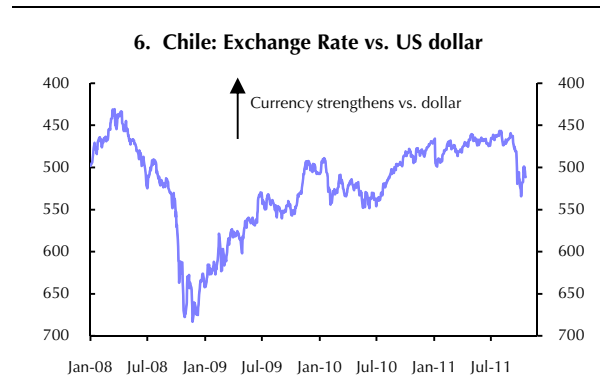
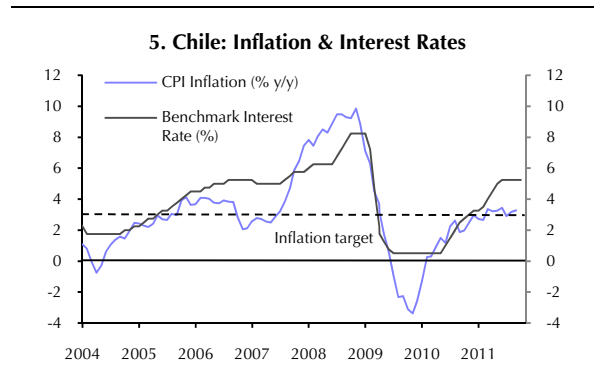
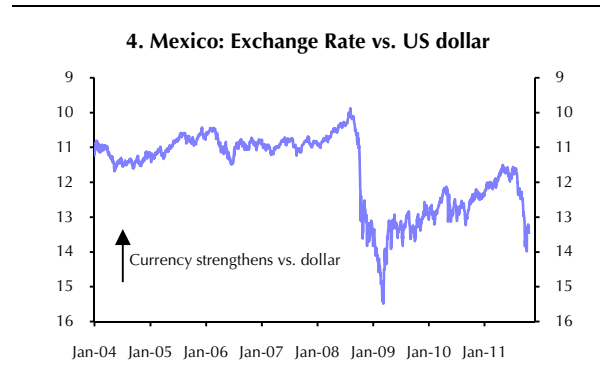
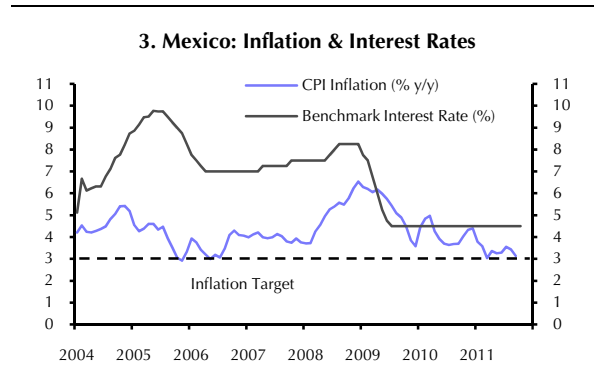
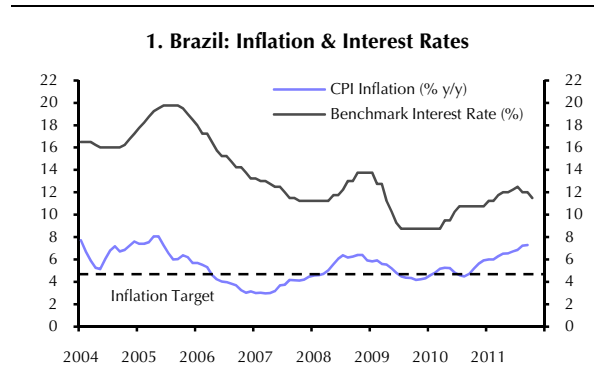
From next year, lower metals prices and weaker external industrial demand will inevitably take a toll on growth, which we believe will slow by more than most are expecting. Admittedly, Peru's healthy finances provide some scope to cushion against the slowdown and we anticipate fiscal stimulus as well as monetary easing in 2012. We expect GDP growth to cool to around 4% next

year (versus consensus 5.25%), following an expansion of 7% or thereabouts in 2011.

In summary, while rate cuts now appear to be inevitable over the next 12 months, we suspect they could be a little further off than elsewhere in Latin America. This is despite some of the bold statements of intent from Peruvian officials. We expect to see 75bps of monetary easing over 2012, most likely beginning in Q1, while of course acknowledging that much will depend on a highly uncertain external picture. Indeed, should the growth outlook in the advanced economies show signs of stabilising over the next few months, we think that the BCRP would probably be one of the last regional central banks to lower lending costs.

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Background Charts



Sources – Bloomberg, Thomson Datastream, Capital Economics

BACKGROUND INFORMATION

Brazil

Interest Rate Meetings 8 Meetings in 2011

Inflation Target 4.5%, with +/- 2% tolerance range.

Governor Alexandre Tombini

Interest Rate Meetings	Date	Outcome	Vote
	8 th December 2010	10.75%	Unanimous
	19 th January 2011	11.25%	Unanimous
	2 nd March 2011	11.75%	Unanimous
	20 th April 2011	12.00%	5 for 25bp hike, 2 for 50bp hike
	8 th June 2011	12.25%	Unanimous
	20 th July 2011	12.50%	Unanimous
	31 st August 2011	12.00%	5 for 50bp cut, 2 to stay on hold
	19 th October 2011	11.50%	Unanimous

Mexico

Interest Rate Meetings 11 Meetings in 2011

Inflation Target 3%, with +/- 1% tolerance range.

Governor Agustín Carstens

Interest Rate Meetings	Date	Outcome	Vote
	15 th October 2010	4.50%	
	26 th November 2010	4.50%	
	21 st January 2011	4.50%	
	4 th March 2011	4.50%	
	15 th April 2011	4.50%	
	27 th May 2011	4.50%	
	8 th Jul 2011	4.50%	
	26 th August 2011	4.50%	
	14 th October 2011	4.50%	

Colombia

Interest Rate Meetings Once a month

Inflation Target 5%, with +/- 0.5% tolerance range.

Governor José Darío Uribe Escobar

Interest Rate Meetings	Date	Outcome	Vote
	25 th February 2011	3.25%	
	18 th March 2011	3.50%	
	29 th April 2011	3.75%	
	30 th May 2011	4.00%	
	17 th June 2011	4.25%	
	29 th July 2011	4.50%	
	19 th August 2011	4.50%	
	30 th September 2011	4.50%	

BACKGROUND INFORMATION (CONTINUED)

Chile

Interest Rate Meetings Once a month, (on every 2nd Thursday)

Inflation Target 3%, with +/- 1% tolerance range.

Governor José De Gregorio Rebeco

Interest Rate Meetings	Date	Outcome	Vote
	13 th January 2011	3.25%	
	17 th February 2011	3.50%	
	17 th March 2011	4.00%	
	12 th April 2011	4.50%	
	12 th May 2011	5.00%	Voting breakdown unavailable
	14 th June 2011	5.25%	
	14 th July 2011	5.25%	
	18 th August 2011	5.25%	
	15 th September 2011	5.25%	
	13 th October 2011	5.25%	

Peru

Interest Rate Meetings Once a month

Inflation Target 2%, with +/- 1% tolerance range.

Governor Julio Velarde

Interest Rate Meetings	Date	Outcome	Vote
	6 th January 2011	3.25%	
	10 th February 2011	3.50%	
	10 th March 2011	3.75%	
	7 th April 2011	4.00%	
	12 th May 2011	4.25%	Voting breakdown unavailable
	9 th June 2011	4.25%	
	8 th July 2011	4.25%	
	11 th August 2011	4.25%	
	8 th September 2011	4.25%	
	6 th October 2011	4.25%	

Source – National Central Banks