

Brazil

Macro policy

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The last credible central bank

The interest rate cycle is turning as growth hits the wall

With central banks across the globe falling over themselves to ease monetary policy, Brazil's Banco Central (BC) has been standing firm. The BC's reluctance to cut interest rates to stimulate the economy reflects its concern that inflation could push through the upper limit of its inflation-targeting band. But current data show that the economy hit the wall in October and inflation appears to be peaking. We expect these trends to strengthen in the coming weeks, leading to a reversal of policy at the Copom meeting on 20-21 January.

Although the BC is likely to keep its policy unchanged at this week's Copom meeting, the rapid slowing of the economy will in our view force an easing of monetary policy in January even though IPCA inflation will still be close to 6.5 per cent, the upper limit of its inflation-targeting band. This has created an attractive entry point for investors into the local fixed income market. This conclusion is bolstered by the fact that the BC intervened aggressively in the cash market when the Real weakened last week to USD/BRL2.50. This suggests that downside currency risks are limited, given the BC's ample international reserves of US\$207 billion and its apparent willingness to support the currency at these levels.

Core Case

The negative effects of the current financial crisis spread quickly through global markets, but its nature varies from country to country. Some policymakers anticipated the fallout of the crisis and moved quickly to ease monetary and fiscal policies. In Brazil the response of the authorities was more cautious.

The fall in global commodity prices has had a substantial impact on corporate confidence, and production plans have been rolled back in many industries even before aggregate demand has shown significant weakness. This has occurred because growth data in Brazil continued to be relatively strong reaching 6.8 per cent in Q3/08, even though it is obvious that a sharp slowing of demand is imminent.

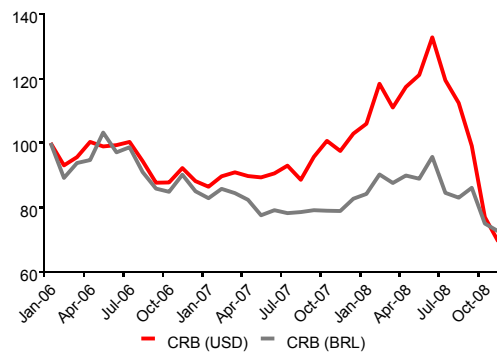
A second factor that influenced the picture conveyed by short-term data was the BC's decision to limit its FX interventions and permit a substantial decline in the Real, even though the country's US\$200 billion plus in international reserves were clearly large enough to cushion the slide in the currency. This policy appears to have been reversed last week when the BC intervened aggressively to support the Real when it hit the USD/BRL2.50 level. Since midyear the BC has spent a total of US\$41.8 billion on FX interventions, 80 per cent in the futures market and the rest in the cash market.

Whether this policy was appropriate can only be properly assessed in hindsight. It did, however, have a noticeable impact on domestic inflation, since the deflationary effect of falling global commodity prices was offset to a significant extent by a weakening Real (see Chart 1).

Brazil has not stood passively on the sidelines as the current crisis unfolded. Indeed, the authorities have reacted in a timely manner using appropriate instruments, such as cuts in banks' reserve requirements and new repo lines in reais as well as dollars and initiatives to ease the illiquidity facing smaller banks. What the BC has not done, at least so far, is to follow other central banks in lowering interest rates. Brazil's interest rate policy must be understood in terms of the BC's perception of the crisis and how it relates to its long-term objectives and the framework of its inflation-targeting monetary policy regime.

The fact that the effects of the global crisis were seen in a rise in inflation in August due to the impact of depreciation in the Brazilian currency led the BC to keep rates constant, rather than follow other countries' policy of cutting rates. Consumer price data released on 5 December indicated a welcome drop in November's food and housing inflation and year-on-year headline inflation: as measured by IPCA, Brazil's CPI was stable at 6.4 per cent, just below the 6.5 per cent upper limit of the BC's target zone (Chart 2). Reflecting this result, the BC's survey of market inflation expectations dipped this week for the first time in several months.

Chart 1: CRB index in US dollars and Brazilian reais (January 2006:100)

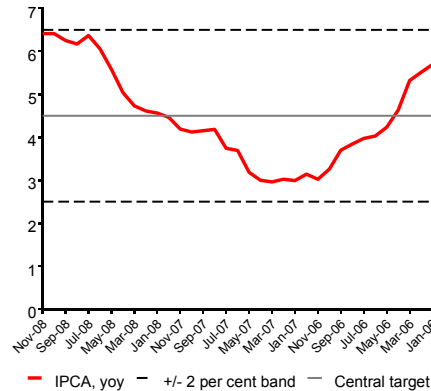


Source: CRB indices and TS based on CRB and Bloomberg data.

Despite this initial sign of a peak in the inflation cycle and the accumulating evidence of a sharp fall in economic activity, we do not expect the BC to ease rates at its 9-10 December meeting. We believe the December IPCA data - to be released a month from now - will confirm that the inflation cycle is peaking.

We expect this finding to trigger a decision to initiate an easing in the BC's Selic (overnight lending) rate even if year-on-year inflation is still running close to the upper limit of the target zone. If we are wrong and IPCA bounces back to previous levels, then we expect the BC to stick to its guns and keep the Selic rate unchanged, notwithstanding political pressure to ease in view of slowing growth in the economy.

Chart 2: Headline inflation (IPCA) and the inflation target zone (per cent)



Source: Banco Central.

Contagion and damage control: The right thing at the right time?

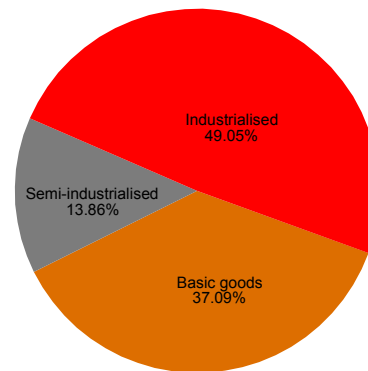
The initial effects of the global crisis arrived in Brazil through almost every possible door, via both fundamental and non-fundamental channels, given the openness of the country's trade and financial markets. Probably the most obvious route through which the crisis is permeating the Brazilian economy is trade.

Global commodity prices have fallen by 40 per cent since June and this is already denting export incomes and leading to the postponement of investments that were viable when prices were higher. Additionally, external demand has weakened and will continue to do so as recession takes hold in

the developed markets which account for over 40 per cent of Brazil's exports. A vivid illustration of the sudden impact of the crisis was provided by the iron ore exporter Vale, which was seeking ad hoc price increases from its Chinese customers this summer just as China's steel producers were hit by an unexpected drop in demand for their output. In November the volume of Brazilian iron ore exports declined by nearly 20 per cent year on year and by nearly 33 per cent month on month to 17.9 million tonnes, according to the Trade Ministry. On the other hand, at US\$1.37 billion, export revenues for the month were still 60 per cent higher than in November 2007.

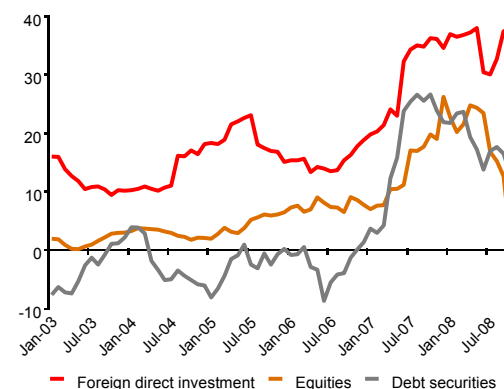
It is worth remembering that industrial goods account for the largest share of Brazil's exports, representing 49 per cent of the total (Chart 3). To put this in context, industrial export revenues fell below 50 per cent of the country's total export revenues this year for the first time since 1980, according to Brazil's Foreign Export Association, due in part to strong commodities prices. Still, the reversal of fortunes of commodity exporters clearly played a role in depressing the equity market, though, interestingly, not foreign direct investment (Chart 4).

Chart 3: Composition of Brazilian exports, January-November 2008 (per cent)



Source: Banco Central.

Chart 4: Capital flows, FDI, equity and fixed income (rolling 12 million totals, US\$ million)



Source: Banco Central.

Financial channels, which are more complex than trade channels, are illustrated in Chart 4 above. Brazil's pattern of capital outflows was very similar to that of other emerging markets, driven in part by overblown fears that Brazil would be badly affected by the crisis. Many investors wrongly, in our view, grouped Brazil with other commodity-exporting emerging markets, even though such trade accounts for only 37 per cent of total Brazilian exports.

Thus, for Brazil, the crisis has manifested itself both as a problem of real

demand (through diminished exports) and as a liquidity problem caused by the drying up of external finance and the outflow of capital from the domestic equity and fixed income markets. The shock, then, is different in nature to the problems affecting developed economies and the authorities' response to it was adapted to its specific Brazilian conditions with a clear eye on the availability of policy instruments to deal with it, mainly monetary rather than fiscal initiatives.

The initial response to the external shocks was to allow the exchange rate to adjust and to take measures to provide liquidity in both domestic and foreign currencies. The goal was to prevent liquidity problems from escalating into solvency problems in the domestic financial sector.

Brazil did not expend a large chunk of its FX reserves on defending the Real. On 4 December the Real touched USD/BRL2.51, down from BRL/USD1.55 in July, a decline of 38 per cent. This clearly reflected a policy decision that depreciation in the real would help to bridge the gap that was beginning to emerge due to declining external demand. In other words, a cheaper real would help reduce imports and shift demand towards domestic goods, while helping exporters to compete more effectively and retain market share in ailing developed markets.

It is worth noting that the substantial decline in the Real was achieved without major disruptions in domestic financial markets, though it did impose an estimated US\$30 billion in losses on a handful of corporations that entered into ill-advised short-dollar currency trades. Interestingly, the government was net long dollars vs the Real, so it gained substantially from the depreciation.

Additionally, the BC used a broad set of policies to provide liquidity support (described in the Assumptions and Evidence section below). Overall, these measures have played a key role in supporting exporters and preventing domestic liquidity from freezing up. Although several smaller banks have encountered liquidity problems, Brazil's major banks have so far weathered the crisis in strong shape.

Objectives, domestic conditions and (more) instruments

Another major objective of the BC during this crisis – other than keeping inflation under control - is to bolster the credibility of monetary policy in the face of markets liable to extreme volatility. Hard to gain and easy to lose, credibility is essential to preserving the effectiveness of monetary policy, a point that is clearly stressed in the minutes of the last Copom meeting.

Although the economic data for September and October showed continued strength in certain sectors, some of these indicators are starting to deteriorate. The latest industrial production figures revealed a larger-than-expected decline and layoffs are now making the headlines in Brazil, as they are in many other countries (see [Brazil weekly review](#)). Financing remains difficult overall, especially trade finance.

In our view, the BC is well aware of the changing underlying situation in the economy. Its goal is to bring an overheated economy with rising inflation back to a more sustainable development path. Weakening demand and already high real interest rates will serve to keep inflation under control, despite the depreciation of the Real.

This policy package carries the risk that the softening in demand now under

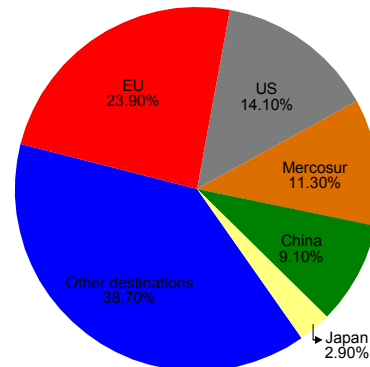
way could be substantially underestimated. Central banks across the developed and developing world appear unwilling to take that risk and have launched unprecedented monetary stimulus programmes. In Brazil the BC has taken a different approach to this crisis, stressing the credibility of its institutional goals (such as its inflation-targeting regime) and rolling out a series of other instruments to secure monetary stability.

The BC is sensitive to the risks of its strategy. If the country's economy shows continuing signs of slippage and if subsequent data confirm that inflation is peaking, a rate cut is likely at the January meeting. If not, then monetary easing will be further postponed to the March Copom session. However, we are firmly of the view that the policy shift will take place in January.

In either case, investors should position themselves for the inevitable decline in Brazilian interest rates that will come. They can do so in the confidence that the BC will have enhanced its credibility when many other central banks have apparently been willing to put their own credibility at risk.

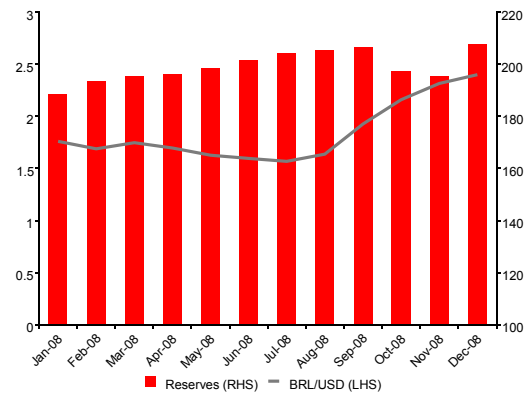
Assumptions and Evidence

Chart A-1: Export destinations, 2008 (per cent)



Source: Banco Central.

Chart A-2: Exchange rate USD/BRL and foreign reserves (US\$ billion)



Source: Bloomberg, Banco Central.

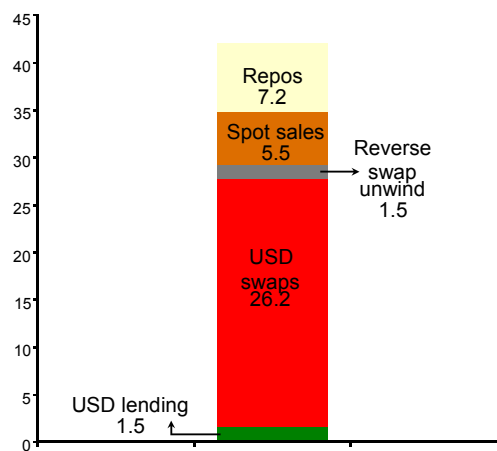
Table A-1: Summary of measures to provide liquidity

Sales of US dollars in repo auctions
Reduction of reserve requirements for banks acquiring US dollars with repos
Sales of currency swap contracts
Sales of US dollars in spot markets
Collateralised loans aimed at financing exports
Elimination of tax (IOF) on fixed-income capital inflows
Authorisation for BC to engage in currency swap transactions with other central banks
Agreement with the US Federal Reserve
Source: Banco Central.

Table A-2: Initiatives to inject liquidity into the domestic market

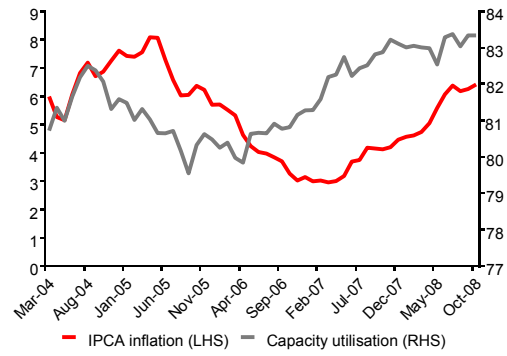
Increase of exemption limits, reduction of rates and/or postponement of reserve requirements
Commitment to eliminate reserve requirements on time deposits and on deposits by leasing companies
Reduction of reserve requirements on time deposits for banks that buy assets from other institutions
Authorisation for BC to buy certain assets from banks
Authorisation for public banks (Banco do Brazil and Caixa) to acquire stakes or control of other institutions
Increase in lending requirements to rural sector
Source: Banco Central.

Chart A-3: Foreign currency liquidity injections (US\$ billion)



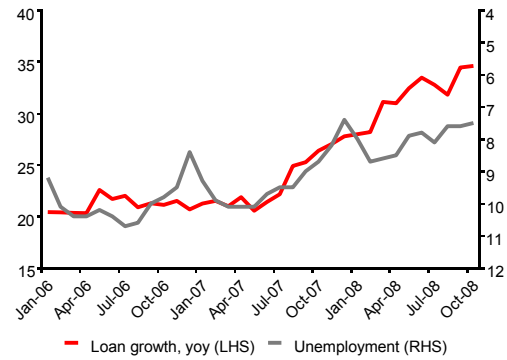
Source: Banco Central.

Chart A-4: Inflation and capacity utilisation (per cent change yoy)



Source: Bloomberg and Banco Central.

Chart A-5: Domestic monetary drivers: Loan growth and unemployment (unemployment axis is inverted)



Source: Bloomberg.

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