

## Brazilian inflation: should we be worried?

April 2010 - Author: Lewis Jones, Fund Manager

The mid-March decision by Brazil's central bank to keep the SELIC rate on hold came as a surprise to the market where expectations were for a hike of as much as 75bps. Consumer and wholesale prices have been ticking up and the economy has recovered quite quickly from what has proved to be a rather modest recession last year. This has got the market asking whether or not the COPOM is behind the curve which could mean sharper hikes and greater cumulative rate increases going forward. Rexiter believes that there is no reason to panic yet and that on a balance of probabilities basis, the risk of a deflationary external shock is more of a concern than the threat of spiralling internal inflation expectations.

So where is the price pressure coming from? We would expect rising demand to account for some of the rise as the economy is expanding by a forecasted 5%+ this year which is above long run potential. However, given that there is still a positive output gap after the slight economic contraction last year, the demand side is only a marginal contributor. More significant is the recovery in commodity pricing over the past 6 months, even after adjusting for appreciation of the Brazilian real. As the chart below shows, the deflationary impact of falling commodity prices from 2008/2009 has disappeared and a relatively stable FX rate is no longer holding imported inflation down.



Source: Bloomberg (commodity price index ticker CRY, priced in BRL)

Breaking down the inflation index confirms this analysis. The most recent inflation prints show food as accounting for the majority of aggregate positive price pressure whereas the rest of the basket is rising at a rate well below the central bank's 4.5% annual inflation target. It is very possible that recent inflationary surprises have been more to do with seasonal effects coupled with a low base than a longer term trend that requires sharp monetary tightening to address.

However, with this in mind, it is still likely that the central bank will resume tightening this month with a 50bps hike. This will be necessary to anchor inflationary expectations for 2011 and beyond which have been quite subdued up to this point. Long rates have been well anchored and survey results suggest that inflation peaks this year before dropping next. With the external environment still facing significant problems, it remains to be seen what the required aggregate hikes will be, but we expect to finish this year with the SELIC rate around 11%. The most likely risk to this view would be for a negative external event that would bring global growth expectations down again, which would be very negative for commodity prices.