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Brazil: monetary policy

Inflation Report has reinforced Central Bank's high-risk strategy.

Commodity price shock has made Central Bank change previous strategy and tighten policy further. However, policy reaction hasn't been enough to reinforce monetary policy credibility. Our take is that de-anchoring expectations is today's most relevant risk. Nonetheless, Central Bank will probably sustain its current strategy and take high risks.

After a pause in 4Q10, Central Bank (BCB) has changed its strategy and moved toward a second tightening cycle.

Our base call in December was that rates were likely to remain unchanged all over 2011. But in our outlook BCB was also ready to change plans and tighten further if inflation started to move consistently up. Inflation dynamics could be a sign that its assumptions were incorrect.

That is what has happened. Inflation has increased over the past three months. That said, what kind of changes in assumptions may have justified BCB's new strategy?

Our core view is that most hypotheses remain the same, but fiscal policy and commodity price outlook have changed in a relevant way. Supply shock has been much higher and persistent than initially expected, increasing risks dramatically. Also, last year's fiscal policy has offset results of the monetary tightening.

In this report, we analyse (a) the main changes in hypotheses; (b) the policy response we have seen since December; and (c) the current policy capacity to re-anchor inflation expectations. The main conclusion is that BCB will probably take high risks, maintaining its wait-and-see strategy. Again, in the case assumptions prove to be wrong – mainly the commodity outlook – we do believe Central Bank will start a new tightening cycle.

What has changed?

Our base hypotheses remain the same. Monetary policy keeps coming across less conservatively than market consensus due to differences in theoretical framework. Compared with market's view, BCB's stance probably works with lower neutral real interest rates and higher policy efficiency.

Inflationary risks, however, have deteriorated further. Our reading is that inflation stems from local factors – a still heated economy – and global issues, such as commodity price shock.

Locally, fiscal policy hasn't helped Central Bank. On the contrary. After September, central government expenditures, as a GDP share, have increased 100 bps, which we estimate to be equivalent to 200 bps rate cut. Since last year's monetary tightening was a 200 bps hike, we can say last year's fiscal policy has totally offset results of the monetary efforts.

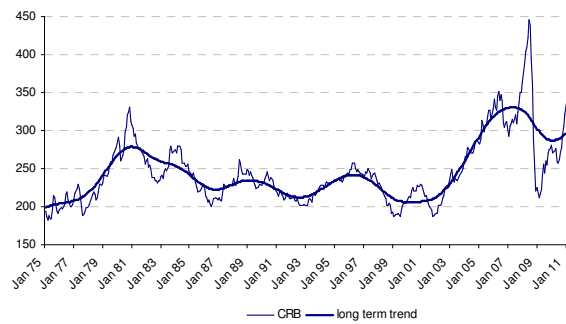
As a consequence, monetary policy hasn't produced any relevant effect. We estimate full impact on economy could have come in the 1Q11, but up to now deceleration has been weak: leading economic indicators haven't pointed to any further slowdown and core inflation is flying high.

But far from being a local issue, inflation is rising globally on the back of commodity price hike. These prices have been running above trend since September. Indeed, over the past two months, prices have gone even higher (figure 01).

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Disclosures and statements required by regulatory bodies are shown on the last page.

Figure 01: Commodity price shock (CRB)



Source: Bloomberg, WestLB Brazil.

This spike is linked to different factors: (a) increase in global liquidity; (b) confidence in world growth; and, most recently, (c) oil price upswing and weaker US dollar.

Differently from past years, however, we haven't seen a local currency appreciation brought about by commodity price increase. FX market has been increasingly risky due to noises arising from the US monetary policy, current account deficit and government's interventions. As a consequence, inflation pressure has increased: BRL has no longer been used as a channel to offset commodity price hike, as it used to be.

Commodity price hike tends to affect local inflation instantaneously. Our estimate is that wholesale and consumer prices are fully hit in the same quarter. Since pass-through tends to be higher when local growth is strong, inflation tends to quickly spread all over the economy. In fact, not only tradable but also non-tradable prices, such as services inflation, have been under pressure.

Moreover, current inflation is also a relevant driver for expectations. Since expectations in Brazil are backward looking, we have seen a clear de-anchoring process, with inflation forecasts diverging from the target (figure 02).

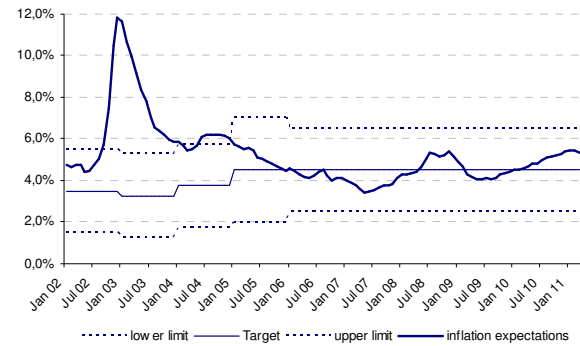
Policy response

Supply shocks are always challenging for monetary management, since volatile prices make inflation vary regardless of output gap changes.

According to academic consensus, when adverse shocks hit the economy, central bankers may use escape clauses, such

as longer convergence period and target ranges, in order to gradually eliminate temporary inflation induced by a supply shock and thus minimize a stronger-than-required economic slowdown.

Figure 02: Inflation expectations (12 months ahead)



Source: Central Bank, WestLB Brazil.

A new monetary tightening cycle is also necessary to move growth below potential, control inflationary dissemination and deal with the credibility issue. In fact, our reaction function confirms that a further tightening spell was necessary: an additional 175 bps, higher than the 150 bps total cycle suggested by Central Bank.

Newly sworn-in government has given policy response. But rather than a single monetary policy reaction, government has used different tools. We have evidence that economic policy stance as a whole has changed.

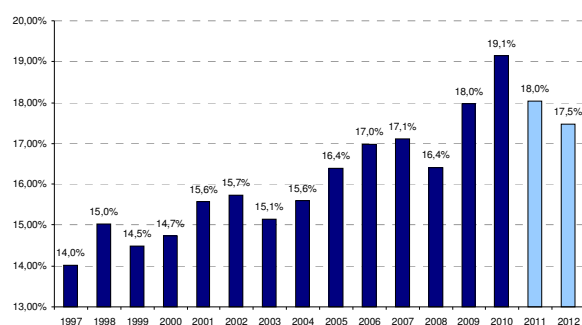
Differently from 2010, fiscal policy has been a timely help for BCB to tame inflation and anchor expectations. Not only due to straight fiscal impacts on growth and inflation, which we estimate to be low, but also by increasing confidence in the new government. As will be seen later, credibility is particularly important these days: a longer inflation convergence and past years' loose fiscal policy may tarnish it.

We sustain our call that central government's expenditure increase is likely to be controlled and reach 18% of GDP this year (figure 03). We estimate current policy is equivalent to a 75 bps hike in the interest rates.

Finally, the increase in reserve requirement and prudential measures have been adopted to move credit expansion

toward a sustainable long-term growth¹, which Central Bank estimates to be within 10% to 15%. Since our forecast point to a 16% increase in total outstanding loan this year and 18% in 2012, we don't rule out that further prudential measures are likely to be taken. We estimate that the bulk of quantitative measures already in place may be equivalent to a 125 bps rate raise.

Figure 03: Central government expenditures (% GDP)



Source: Central Bank, WestLB Brazil.

All in, this year's fiscal and monetary policy reaction may be equivalent to a 350 bps raise in the Selic rate. Higher interest rates and quantitative controls will probably shrink credit market, move growth below potential and stir inflation toward target. Note that we don't see fiscal policy offsetting the monetary tightening, as was the case last year.

De-anchored expectations

Is the policy response enough to anchor expectations? Unfortunately, we don't think so. Policy credibility has become a major issue.

But not only in Brazil. Credibility has been a common issue in so many different countries. Global recession and the current commodity price hike have made central bankers less preemptive in reacting to inflation. Caution has made them do less than their optimal policy choice.

Developed and emerging economies have faced the same problem. In Latin America, Mexico hasn't started to normalize its monetary policy, while Colombia has just

raised rates. Other countries, such as Brazil, Chile and Peru, have adopted pauses during their tightening process. Overall, investors have been increasingly criticizing central bankers' most cautious stance. Definitely, it is hard to tell apart a higher inflation tolerance from a longer inflation convergence strategy.

Brazil is not different and anchoring inflation remains challenging. The lack of formal autonomy has wrecked its damages: inflation has moved consistently up, with current uncertainties deeply affecting BCB's anti-inflation reputation.

Risks are amazingly high, indeed. Even if we assume a further local economic deceleration and a fall in commodity prices, 1Q11 inflation has already moved our call for this year's inflation from 5.5% to 6.2%. For 2012, we maintain our forecast unchanged at 4.8%. In this scenario, IPCA is very likely to run temporarily above target's upper limit in 3Q11. But if we work with a higher commodity price assumption for the year as a whole, IPCA may jump to target's upper limit (6.5%). Such a risk has to be seriously considered.

A long-standing common view is that political interferences have made BCB assume multiple targets, such as growth, FX and inflation. Moreover, markets have not shed off last year's criticism on monetary management. Having the political transition and the supply shock as a backdrop, BCB's countercurrent views on neutral real rates and policy efficiency have caused too much noises.

Prudential measures reinforce this diagnosis: investors read them as political constraints to raise rates. Also, the impacts of prudential measures on growth and inflation are unclear, hampering the capacity of the monetary policy to anchor inflation.

Finally, fiscal policy's low credibility is an additional reason for current pressures on the monetary policy and on inflation expectations. Past years' performance and the lack of an institutional design to improve transparency and accountability have increased doubts on new government's commitment to responsible policies.

¹ See Blinder, A S. "How central should the central bank be?", JEL, 2010, 48:1.

If you add it all up, it is almost a consensus in the financial market that BCB's tolerance to inflation has increased. This is a key issue for the monetary management.

Credibility does matter for the inflation target system and BCB's strategy. The use of escape clauses is deeply tied to credibility, since a longer convergence period can be easily read as a higher inflation tolerance.

In order to bolster reputation, monetary policy demands shorter convergence. BCB has to convince the public that the inflationary impact of a supply shock is only a one-off rise in the price level and not a permanent increase in inflation. In other words, communication has to be clear.

Unfortunately, BCB hasn't improved its communication channels and, therefore, has failed to convince investors that monetary policy doesn't have an inflationary bias. And this is so, mainly, because prudential measures impacts on inflation are hard to estimate and Central Bank hasn't reacted to the worsening inflation expectations.

Differences between Central Bank and markets are unusual in our inflation targeting experience. On one hand, investors have pressured BCB to abandon its plan and adopt more preemptive actions. But on the other hand, monetary policy has to be independent from the market, once investors tend to overreact to short-term information flow². At the end of the day, however, market's sentiment has to be considered. Even if we assume that seasonal factors and unusual oil price instability have largely contaminated inflation expectations, investors' forecast is a relevant channel for policy transmission. Also, it does herald overall uncertainties and can affect inflation dynamics itself.

Central Bank's strategy

The bottom line is that monetary policy strategy depends not only on the macroeconomic scenarios, but essentially on credibility. Our core view is that de-anchored expectations have become today's most relevant risk.

In our estimates, further raise rates - 50 bps in April and 50 bps June - were necessary to deal with the supply shock and the de-anchored expectations. But our take is that BCB probably will not react to the worsening inflation expectations. According to the 1Q11 Inflation Report, in the base scenario Central Bank is likely to pause after April and maintain rates unchanged for a long period.

BCB's outlook is based on lagged policy effects. We estimate current policies will hit economy within the coming quarters, fully reaching inflation only in the 1Q12. Moreover, BCB's strategy has been strongly connected to commodity price performance, as it was also pointed in the Inflation Report.

Our reading is that commodity prices may have soared too far, since we still have a sluggish global recovery outlook: unemployment rate performance, real income and credit conditions in the US, Europe and Japan are far from regaining lost ground. Also we see FED behaving very cautiously, which may prevent economy from sustaining an extremely high liquidity level. Controlled liquidity and a slightly stronger global dollar reinforce a call for commodity prices.

Most importantly, in a scenario with higher commodity prices, we do believe BCB will start a new tightening cycle, a message the Inflation Report has already conveyed.

We don't share the common reading that political influences have made BCB assume an inflationary bias. We still see monetary management committed to the target: the country has political incentives to maintain inflation under control, since real income is highly correlated with government's popularity. That said, changing strategy is always an option for BCB.

² See Blinder, A S. "The quiet revolution", Yale University Press, 2004.

Table: Forecasts

	2008	2009	2010	2011P	2012P
Real GDP (% yoy)	5.1	-0.2	7.5	3.9	3.8
Total outstanding loans (% GDP)	42.5	46.9	46.6	49.1	52.6
Retail sales (% yoy)	9.1	5.9	10.9	5.9	6.2
Industrial production (% yoy)	3.1	-7.4	10.4	3.5	3.8
Unemployment rate (% yearly average)	7.9	8.1	6.7	6.5	6.4
Consumer prices (IPCA, % yoy)	5.9	4.3	5.9	6.2	4.8
Consumer prices (INPC, % yoy)	6.5	4.3	6.5	6.1	4.7
Wholesale prices (IGP-M, % yoy)	9.8	-1.0	11.3	6.5	6.4
Short-term interest rate (% yearend)	13.75	8.75	10.75	12.25	12.25
Public Sector primary surplus (% GDP)	4.07	2.10	2.90	2.80	2.30
Public Sector nominal deficit (% GDP)	2.00	3.30	2.40	2.50	2.90
Net public sector debt (% GDP)	38.5	42.8	40.4	40.1	40.4
Gross public sector debt (% GDP)	57.4	62.0	55.0	59.1	60.3
Exchange rate units/US\$ (end-yr, monthly average)	2.39	1.75	1.69	1.65	1.60
Exchange rate units/eur (end-yr, monthly average)	3.24	2.46	2.24	2.10	2.10
Trade balance (US\$ bn)	24.8	24.7	20.3	26.5	23.0
Current account balance (US\$ bn)	-28.3	-24.3	-47.5	-50.7	-63.2
Current account balance (% GDP)	-1.8	-1.5	-2.3	-2.2	-2.7
Risk premium, CDS 5 years (bps)	345	110	112	100	85
Risk premium, EMBI (bps)	474	210	175	165	150
Net foreign direct investment (US\$ bn)	45.1	21.6	48.5	55.0	60.0
International reserves (US\$ bn)	207	235	289	325	370
US real GDP (%)	0.0	-2.6	2.9	3.3	2.5
Fed funds rate target (%)	0.25	0.25	0.25	0.25	1.50

Source: IBGE, Central Bank, WestLB Brazil.

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