Brazil Flash

Monetary easing to continue "with more parsimony"

After cutting the SELIC at a 75bps pace in the last meetings, the minutes of last week's monetary policy decision suggest that the Monetary Policy Committee (COPOM) will continue adjusting the SELIC down, but at a slower pace. We expect a 25bps cut to be delivered in May and the SELIC to remain constant at 8.75% for some time from then on. More cuts should, however, not be ruled out as this CB Board has already taught us.

- **COPOM refers to a deflationary external environment and to a slower than expected domestic recovery**

  In the minutes of the previous monetary policy meeting, the COPOM had guided markets by saying that it was very likely that the SELIC would move to slightly above historic lows (meaning SELIC would reach and remain stable at 9.0% as historical low is 8.75%). This reference was excluded from today's minutes. Instead, the following statement was included: "…even though the recovery of activity is occurring more slowly than expected, the COPOM considers that given the lagged and cumulative effects of actions adopted so far any additional monetary flexibility should be conducted with parsimony". In addition to highlighting the fact that domestic recovery has been slower than anticipated, the monetary authority said once again that the current external environment is deflationary and that it expects inflation to converge to the 4.5% target by the end of the year. All in all, we take today's minutes as a sign that monetary easing will continue, but at a slower pace.

- **The "saving accounts barrier"**

  After driving the SELIC down from 12.5% in August of 2011 to 9.0% last week, the space for additional cuts is very limited. This is not due to significant inflationary pressures (as the CB will continue downplaying them) but instead due to the "saving accounts barrier". Saving accounts ("contas de poupança" as they are called in Brazil) pay a fixed, tax-free rate of 6.2% per year (0.5% per month) plus a small monetary correction (around half of the IPCA, in the last years). The remuneration of saving accounts ends up setting a floor (somewhere between 8.0% and 9.0%, according to calculations) for the SELIC rate as resources would massively migrate to saving accounts from SELIC-investment funds if interest rates were to fall below this floor. Even though President Dilma has recently confirmed that the government will analyze changing the rules governing the remuneration of saving accounts, we do not expect a change to be implemented very soon because touching a politically sensitive issue ("contas de poupança" are among families' main saving mechanisms in Brazil) in an electoral year (regional elections will be held in October) could be an unnecessary risk to be faced by the government.

- **Adjusting our SELIC call: stability at 8.75% and not at 9.0%, and risks to the downside**

  Taking into account today's minutes, we adjust our SELIC call and now expect the COPOM to announce a 25bps cut in its next meeting in the end of May and to bring the SELIC to 8.75%. We expect rates to then remain constant at 8.75% (at least till the end of the year), but this CB Board has taught us that more cuts should never be ruled out even if inflation refrains from converging to the 4.5% target (we expect inflation, which is currently at 5.2%, to remain above 5.0% in the remainder of the year and to close 2012 at 5.4%).

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