BBVA Research Flash

Brazil

…and still inflation does not converge

The just-released Inflation Report presents "less benign" inflation forecasts than before. Inflation does not converge to the target anytime soon in any of the scenarios presented. Still, the CB sees a "more favorable" balance of risks due to a "substantial deterioration" of the external environment and suggests extra "moderate adjustments" in the SELIC.

- **Focus on the external sector**

  The Inflation Report released today show the monetary authority is mainly focused on the deterioration of the global scenario which will have, according to the CB, a deflationary impact on the domestic economy. The CB's base scenario for the external environment shows "low growth in developed economies for a prolonged period, with no occurrence of extreme events". Regarding the domestic environment, the CB revised 2011 GDP down to 3.5% from 4.0% and highlighted the risk that the recent increase of 12-month inflation drive future inflation up, especially considering the current labor market tightness.

- **The CB's models show inflation will not meet the 4.5% anytime soon**

  In the base scenario presented by the CB where the SELIC rate and the exchange rate are kept constant at, respectively, 12.0% and 1.65, inflation reaches 6.4% and 4.7% by the end of 2011 of 2012 (BBVA forecasts for these periods are respectively 6.4% and 5.4%). In the market scenario where the CB incorporates market forecasts for both SELIC and exchange rate (more precisely, SELIC at 11.4% in Q4 2011 11 and at 11.0% in Q4 2012 and exchange rate at 1.60 and 1.65, respectively, at Q4 2011 and Q4 2012), inflation is estimated to reach 6.4% and 5.0% by the end of 2011 and 2012. Finally, in an alternative scenario where a DSGE model is used and the hypothesis that the negative impact of the global environment will be equal to one quarter of the impact of the 2008/09 crisis, inflation reaches 6.4% and 4.7% in the end of 2011 and 2012. In any scenario, therefore, inflation converges to the 4.5% target before the end of 2012 even tough the assumptions about the SELIC and the exchange rate are, at this moment, too optimist as a more depreciated exchange rate and lower interest rates are very likely to be observed. Nonetheless, in a clear sign of dovishness, the CB concludes that "moderate adjustments in the interest rate are consistent with a scenario where inflation converges to the target in 2012".

- **We expect the SELIC to be at 11.0% by the end of this year**

  The Inflation Report released today support the view that the CB will continue adjusting the SELIC rate down in the next few months. We expect two additional 50bps cuts in the two final monetary policy meetings this year. The implementation of a laxer monetary policy can lose some steam at the beginning of the next, but we expect the monetary policy to create room for additional cuts along the year so that the SELIC reaches 10.0% by the end of 2012. However, as suggested by the just-released Inflation Report, if by any chance we see a materialization of an "extreme event" in developed economies, the CB would then implement an even laxer monetary policy.

For more on Brazil, click here

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