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Brazil: A Soft Landing?

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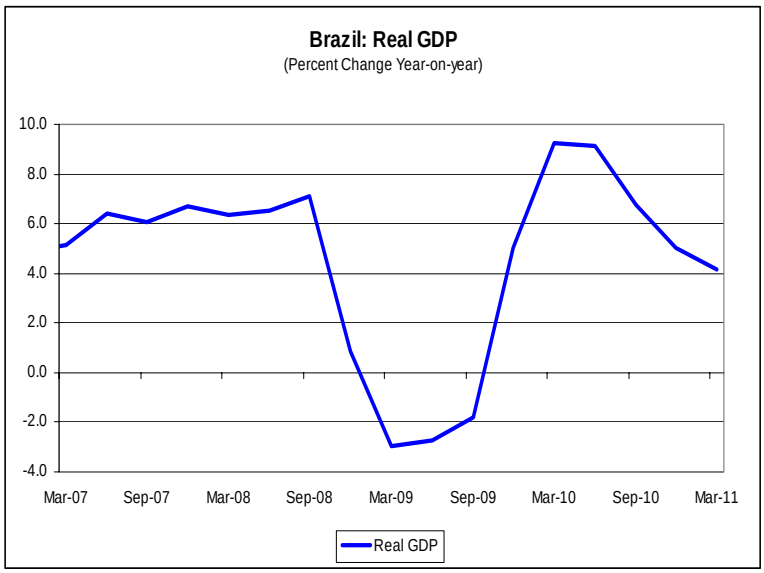
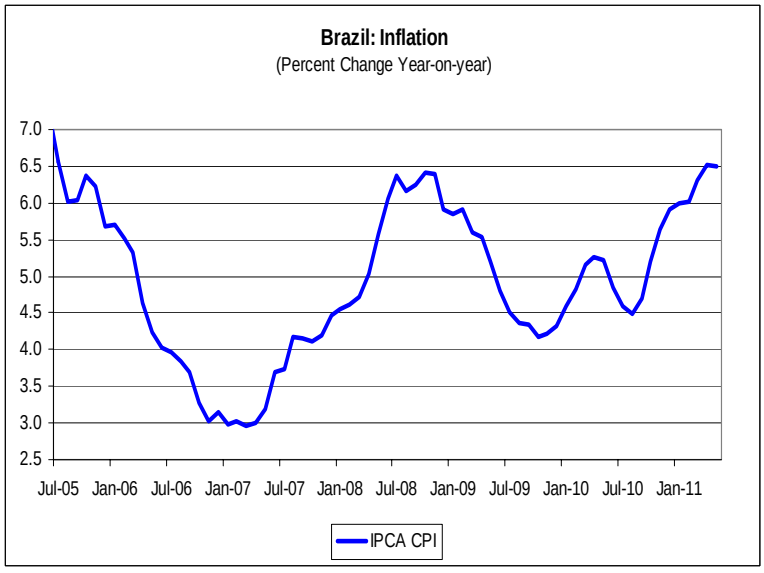
The national accounts data just released has a very pronounced soft-landing look, suggesting not only that real GDP growth (seasonally-adjusted 1.3% quarter-on-quarter; 4.2% year-on-year in January-to-March 211) could proceed over the foreseeable future in the 4%-to-4.5% range but that the central bank should be very close to a pause, possibly as early as next week.



During the most recent meeting of the monetary council (Copom), the bank hiked rates by only 25 basis points, in contrast with the 50-basis points per meeting in the earlier months of 2011.

The overnight-Selic, Brazil's key policy rate, has moved up by 325 basis points in the last year, to 12% now, which leaves inflation-adjusted rates at extremely high levels even with inflation climbing from 4.5%, the center of the target range, to around 6.5%, its ceiling.



From an objective, data and historical perspective, and considering the usual lags in monetary policy, as well as the central bank's continuing fight to prevent further real appreciation, it would seem sensible for the Banco Central do Brasil (BCB) to enter a pause at this point. Whether they will or choose to wait until later will probably depend to a significant extent on their evaluation of the expectations-impact of such a decision.

Should this be the case, since annual inflation may have (marginally) surpassed the 6.5% mark in May, the likelihood is that the majority vote, which had to

overcome a significant hawkish minority in April, will hesitate to move further in the dovish direction, hiking rates instead at the 25 basis-points pace initiated back then and waiting until the July or August meeting for more inflation-friendly data. However, that might not happen in the near-term: on an annual basis prices may continue to rise close to or above the upper-ceiling of the central banks for a few months before a descent towards the target begins.

This would not be a shocking development for the BCB, whose leaders have publicly warned that any effort to bring down inflation to the 4.5% neighborhood in 2011 would be unreasonably costly for the economy. Nonetheless, after a very aggressive tightening campaign, and facing significant opposition within their own ranks, the majority will have to be convinced that the costs of tightening further *now* could exceed the benefits, and indeed not be necessary from the standpoint of inflation-control. It's unclear that they will make that shift by June 8th, but they will in any event have to make it relatively soon to avoid rising overkill risks.

To be sure, the data suggest that policymakers are not against the wall in either direction, neither forced to tighten—domestic demand is growing at a moderate pace, which the BCB has just called *sustainable*—nor to pause and/or ease, as domestic demand seems still well supported by labor market fundamentals looking forward. Investment, in particular, accelerated from a seasonally-adjusted bottom of 0.4% quarter-on-quarter at the end of 2010 to 1.2% quarter-on-quarter in the January-to-March period. Private consumption is a greater concern, having slowed from 2.4% quarter-on-quarter to 0.6% quarter-on-quarter—although on an annual basis it should be noted that the gain is close to 6% year-on-year. It is also important to notice the record-low level of unemployment that prevails, providing a cyclical floor for consumption that seems to be under no significant risk at present. Meanwhile, real exports of goods and services declined 3.2% quarter-on-quarter, the first such drop since the recession ended, while imports also fell but by a much smaller 1.6% quarter-on-quarter.

All of these figures suggest that BCB demand-management is not needed to keep growth below inflationary rates, and that the risk of overkill is emerging as a more significant danger as the bank ponders their next move. On the basis of this logic, from a fundamental perspective it would be difficult to justify more than one interest rate increase, probably of 25 basis points.