Flash

Brazil

CB changes the thermometer as the fever does not recede

In the minutes of last week's monetary policy meeting in which the SELIC was cut by 50bps to 11.50% the CB presented its new central scenario in which the impact of the current crisis is around ¼ of the impact of the 2008-2009 crisis and where inflation converges to the target in 2012. "Traditional" models continue showing inflation will not meet the 4.5% before 2013. We see in this change and in the continued focus on the external environment a support to more "moderate" downward adjustments of the SELIC in the coming months.

- **Inflation does not converge to the target according to CB's traditional models…**
  According to CB's traditional "reference" and "market" scenarios inflation will not converge to the target anytime before 2013. In the reference scenario, where the CB takes as input a constant SELIC at 12.0% and a constant exchange rate at 1.75 (values observed right before the meeting), inflation forecasts for 2011 and 2012 increased in comparison to August and remain higher than the 4.5% target. In the market scenario, where the monetary authority uses market estimations for both the exchange rate and the SELIC, the inflation also moved up in comparison to the previous meeting and continued not converging to the target anytime soon.

- **… but it does converge according to CB's new model.**
  However, according to a new model used by the CB "to more comprehensively" identify the effects of the new external environment on Brazil, and in which the impact of the crisis is calibrated to be around ¼ of the impact of the Lehman Brothers crisis, inflation will converge to the 4.5% target in 2012. This convergence occurs even if a "moderate adjustment" of the SELIC rate is implemented. This new model was for the first presented in the minutes of the previous monetary policy meeting. At that moment this model was behind CB's "alternative" scenario. It has now become the key piece of the CB's "central" scenario.

- **The focus is on the external environment**
  The minutes show that the main focus of the monetary authority is on the global environment. Secondarily, the CB refers to domestic risks (inertia, the strength of the demand vis-à-vis the supply, labor market tightness).The CB suggested the introduction of measures to moderate the concession of subsidized credit (a clear reference to credit supplied by the BNDES, the development public bank) as the public credit expansion can reduce the room for further SELIC cuts.

- **Moderate adjustments ahead**
  We see the reliance on a new inflation model, the focus on the external environment, and the explicit reference to "moderate" adjustments as a support to our call for a SELIC at 11.0% by the end of this year (which means and additional 50bps cut in the last monetary policy meeting of this year in November) and at 10.0% by the end of 2012.

For more on Brazil, click here.

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