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Brazil: Inflation

Is It Time to Upgrade Core Inflation Measures?

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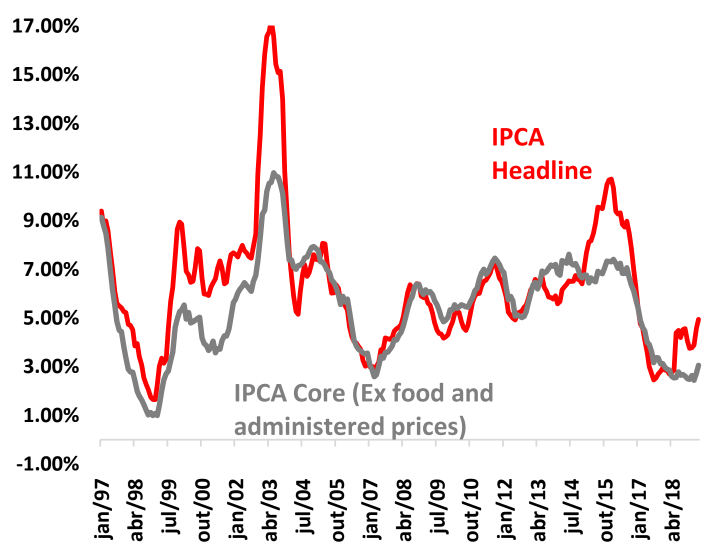
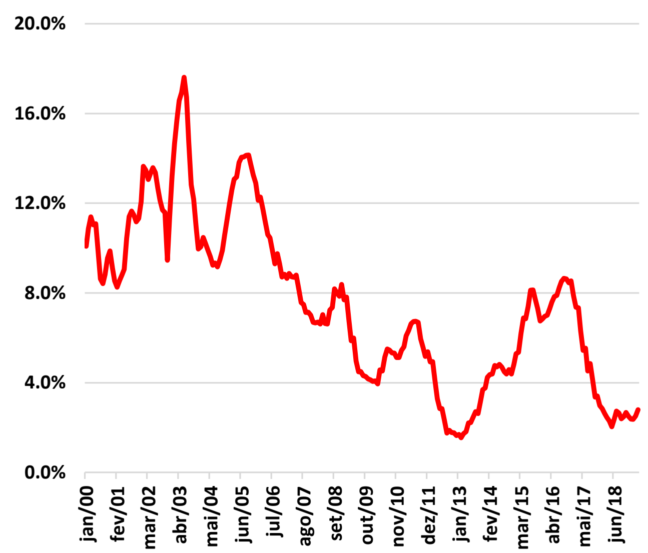
- **Although most analysts stand on common ground in the belief that the current monetary policy stance is expansionary, recent disappointing economic activity indicators have intensified the debate on whether the current monetary policy is expansionary enough.**
- **A critical component of this discussion is the neutral interest rate: significant changes in key macroeconomic conditions (most notably the pace government expenditures and public-owned banks' approach to lending) may have led to a meaningful reduction in this non-observable variable considering the recent past.**
- **In our view, the difficulties in assessing the ideal magnitude of the effects of monetary stimuli on the economy conditioned to the targets for inflation will likely intensify in 2019 and 2020, as headline and core inflation decouple.**
- **According to our forecasts, this decoupling will last longer than usual due to: (i) relative food price adjustments stemming from supply shocks; (ii) meaningful and persistent corrections in the real exchange rate; and (iii) an unusually wide output gap.**
- **In this context, we believe it could be appropriate for the monetary policy framework to assign greater importance to core inflation measures by providing consensus and official forecasts, or even implementing a migration to a formal core inflation targeting regime.**
- **We believe the current and expected dynamic of core inflation provides a better gauge of the expected impact of monetary policy on: (i) supply and demand conditions; (ii) projected distance between actual and neutral interest rates; and last but not least (iii) the risks associated with the convergence of inflation to the target in the medium to longer term.**

Figure 1. IPCA (% YoY)
(Headline and Core)



Source: IBGE.

Figure 2. Real ex Ante Selic Rate
(Selic (-) 12-month forward forecasts for the IPCA)



Sources: Santander calculations based on BCB data.

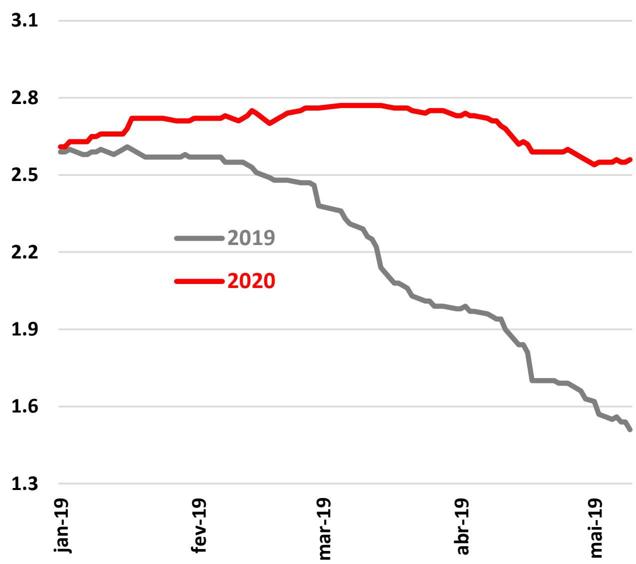
Inconsistency?

According to our forecasts, the Brazilian economy contracted ~0.3% in 1Q19 (+0.4% YoY), suggesting, in our view, that within a few weeks, consensus expectations for average 2019 GDP growth will fall behind both our 1.3% forecast as well as the psychological 1% threshold. Meanwhile, IPCA inflation has been systematically on the rise, reaching almost 5% YoY in April, 75 bps above the target for this year and 2 p.p. above the final figure observed 18 months ago.

This same dynamic can be seen in **expectations** regarding the performance of economic activity and prices in the near term, as illustrated by following charts. The uninterrupted downward revisions in 2019 and 2020 consensus forecasts for GDP growth have not prevented analysts (ourselves included) from increasing expectations for inflation in the same period.

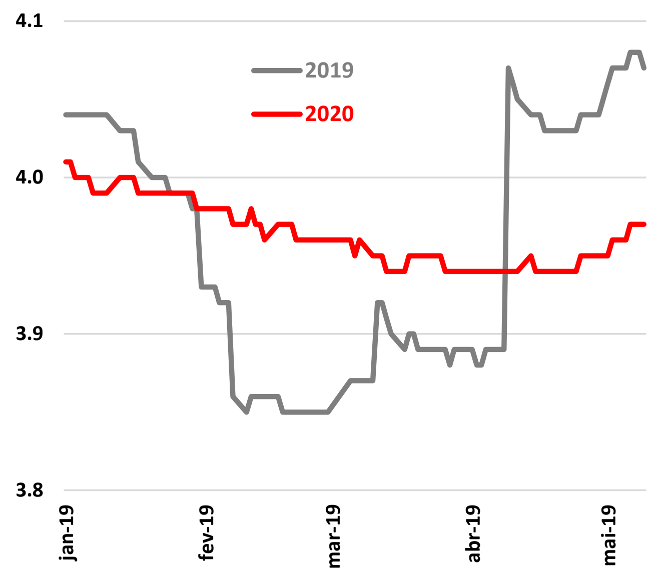
Of course, this apparent inconsistency can be easily explained by specific cases of relative price adjustments — chiefly food and energy — as a consequence of supply shocks and the pass-through from the variation of the exchange rate in recent months. Nonetheless, at the end of the day, this type of situation could signal difficulties for monetary policy.

Figure 3. Consensus Expectations for GDP Growth (% p.a.)



Source: Brazilian Central Bank.

Figure 4. Consensus Expectations for Inflation (IPCA, % p.a.)



Sources: Brazilian Central Bank.

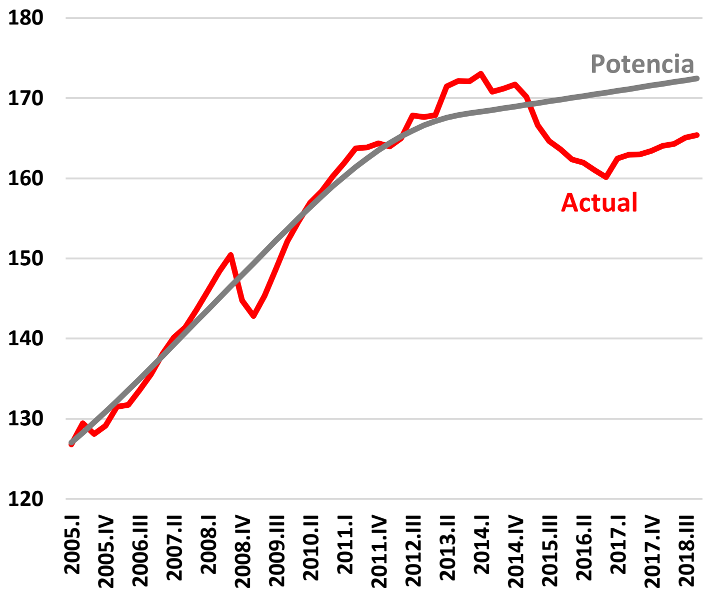
Implication

In fact, under current circumstances (and considering that the Brazilian monetary policy regime is formally based on a target for headline inflation), we believe that the BCB's approach of maintaining the base rate constant (therefore, expressing that current monetary policy stance is adequate) makes perfect sense, even in a context of an unusually wide output gap.

Although we acknowledge that the monetary authority considers a much wider set of factors, approaches, models, balances of risks, and scenarios in arriving at decisions for the Selic, markets appear convinced that ongoing supply shocks on headline inflation will play a more important role in Copom's decision rather than assessments related to a generalized inflationary process. We believe that substantial deterioration in the projected performance of domestic demand (in the context of a wide output gap and below-target core inflation — see following charts for details), without the expectation of a meaningful monetary policy response, reinforces this view.

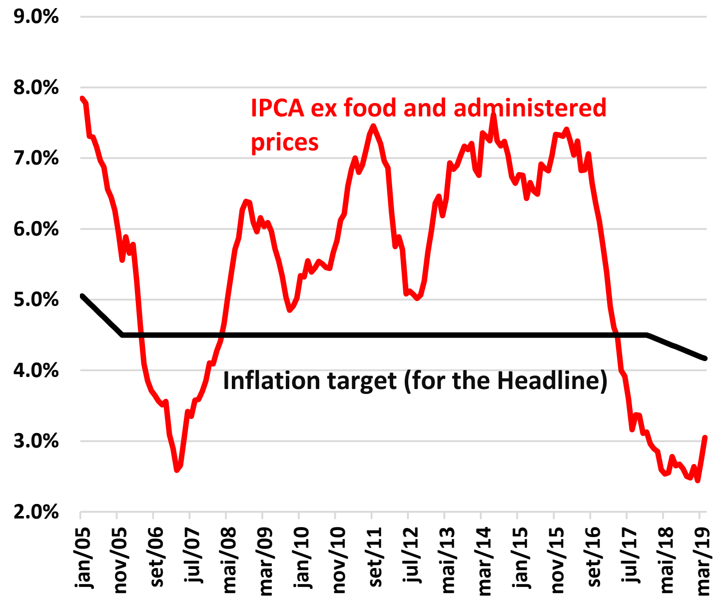
An alternative approach to would be to formally upgrade core inflation measures (particularly those that exclude food and controlled prices from the headline, as these are the most straightforward and easy to understand) within the monetary policy framework by setting a target and providing official projections for this variable.

Figure 5. Output Gap
(GDP - current and potential)
seasonally adjusted, 1995 = 100



Source: Santander estimates based on IBGE data.

Figure 6. Core Inflation and Target
(IPCA ex food and administered prices)

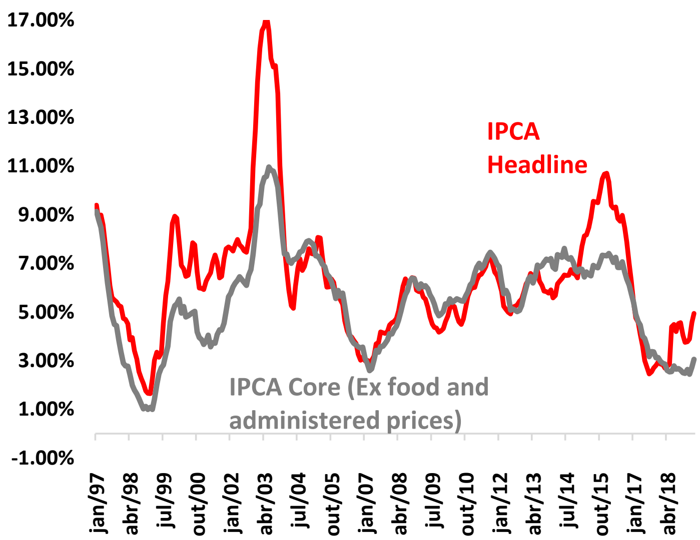


Sources: IBGE and BCB.

Is This Time Different?

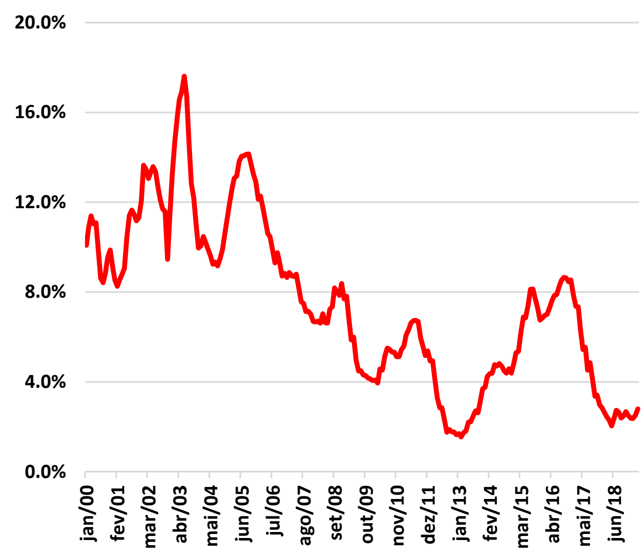
One could argue that during Brazil's relatively short history under a monetary policy regime based on inflation targets, a different emphasis on a core measure of inflation or headline would not have made much of a difference in terms of monetary policy decisions. After all, as Figure 7 illustrates, both measures have shown similar patterns, except during very short periods. Moreover, it is also true that a headline measure is a much more straightforward way of communicating with the public.

Figure 7. IPCA (% YoY)
(Headline and Core)



Source: IBGE.

Figure 8. Real Ex Ante Selic Rate
(Selic (-) 12-month forward forecasts for the IPCA)



Sources: Santander calculations based on BCB data.

However, we see a clear risk that the current decoupling of ex food, and administered core and headline inflation (that started in mid-2018) will become more pronounced and persistent — at least until the end of next year. There are three key factors that support our assessment: (i) the BRL's ongoing (and forecast) correction (down more than 20% since the beginning of 2018); (ii) the African swine fever's potential adverse impact on food prices (see our April 30 report, *The Year of the Pig: Good Fortune?*); and (iii) risks associated with international oil prices in a context of geopolitical uncertainties.

All these factors, in our view, could lead to the maintenance of consensus expectations and the Central Bank's own forecast for headline inflation not far from the target in the near future, possibly overshadowing a more benign perception about inflationary pressures and risks based on core measures and the stance of the output gap.

Although the monetary authority does not disclose its own core inflation forecasts, we believe that these could still be comfortably below the target for 2019 and 2020. According to the minutes of last meeting, a stable Selic at 6.5% and a BRL3.95/USD would result in a headline of 4.3% in 2019 and 4% in 2020. Those forecasts embed administered prices increasing 5.6% and 5.1%, respectively.

A much more credible Central Bank, the diminished importance of inertia on inflation and a contained pass-thorough from exchange rate variations are other factors that differ from the recent past, reinforcing the view that it may be time to increase the focus on core inflation.

Conclusion

Accessing the monetary policy stance. There has been intense debate on the current level of neutral interest rates and the state of monetary policy. Although Copom has stated that monetary policy is currently expansionary, some analysts argue that it may not be expansionary enough. The current fiscal policy, characterized by a more austere approach in terms of government spending growth and subsidized credit concessions from public-owned banks, may have contributed to a substantially reduced neutral interest rate. Moreover, a changing global environment has reduced the contribution of manufacturing exports to employment and production in Brazil. Those factors have led to a reduction of the non-observable neutral interest rate. Core inflation measures provide a more precise assessment of current monetary policy stance than forecasts for the headline inflation under such uncertainty, in our view.

Reduced incentives for government intervention in public prices. An additional benefit of an increased focus on core inflation and disclosing forecasts for this measure as a guide to monetary policy decisions is that such moves would reduce incentives for the government to try to influence Copom through the active management of tariffs, as was the case at the beginning of this decade.

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