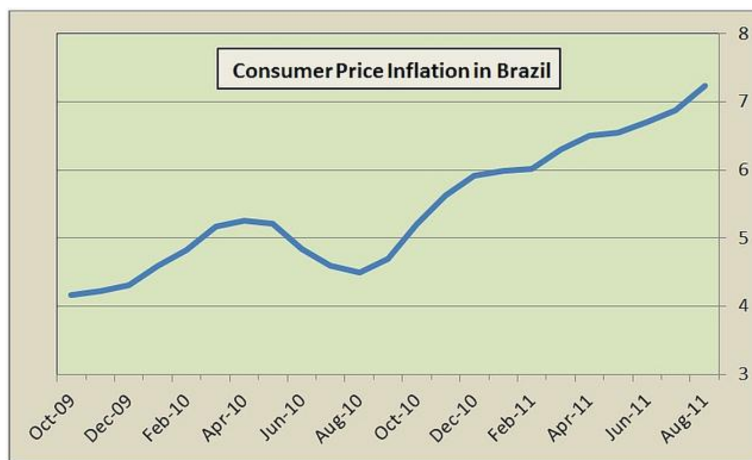
CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES
Published on *Center for Strategic and International Studies* (http://csis.org)

Brazil's Betting on a Global Recession

Sep 8, 2011

By Arturo C. Porzecanski, PhD



Brazil's central bank president Alexandre Tombini has been in office only since the start of this year, but he has already managed to surprise the international financial markets on two occasions. The first was on April 20, when Tombini led the Copom (like the Federal Open Market Committee of the U.S. Federal Reserve System) to raise the Selic interest rate (Brazil's equivalent of the Fed funds rate) by a quarter point to 12 percent rather than by a half point to 12.25 percent, as expected by 41 of the 58 analysts surveyed by Bloomberg News days before.   In subsequent months, the Selic target rate was raised further to 12.5 percent.

The second Tombini surprise was on August 31, when the central bank voted to cut the benchmark rate a half point to 12 percent, when all 62 analysts surveyed by Bloomberg had previously forecast that rates would be left on hold. The reason given by Tombini in the Copom's press release was that the policymaking committee had reassessed the international scenario, and found that "there was a substantial deterioration, materialized, for instance, in a generalized and significant reduction in growth projections for the main economic blocks." Given the likely deflationary ramifications in Brazil of slower world growth or even a global recession, "in the relevant forecast period, the balance of risks for [domestic] inflation becomes more favorable." Thus, Brazil's central bank became only the second G-20 monetary authority to cut interest

rates, following Turkey's pioneering move on August 4 to lower its benchmark interest rate to 5.75 percent from 6.25 percent.

The problem is that inflation in Brazil has been running substantially above the government's (relatively high) objective of 4.5 percent for this year and next. Year-on-year inflation as measured by consumer prices (the so-called IPCA) has steadily accelerated from 4.5 percent in August 2010 to 7.2 percent as of August of this year. Market expectations as of early September, captured by a weekly central bank survey, are that 2011 will close with inflation of 6.4 percent. Of greater concern is that the market forecast of inflation even for next year has remained above the official target since March, and on the heels of the surprise rate cut has edged up to 5.3 percent. And there are reasonable grounds for market skepticism: the 2008-09 experience confirmed that core inflation in Brazil is not impacted much by drops in commodity prices or by a temporary economic slowdown. Indeed, the current driver of high inflation in Brazil is the prices of domestic services rather than goods: in August, services were costing nearly 9 percent more than one year ago – and they are unrelated to what is going on in Europe or the United States.

To be sure, market expectations and not only central bank forecasts of future inflation in Brazil have been wrong in the past, most notably in 2002-03. But since a major intended outcome of every inflation-targeting regime is to manage expected and not simply actual inflation, it would be correct to characterize President Tombini's reputation as definitely being on the line right now. It is not a proper conservative posture for the Banco Central do Brasil to cut rates ahead of Europe and other front-line economies when inflation in Brazil is mainly determined by domestic dynamics, such as rock-bottom unemployment (a mere 6 percent), overly rapid growth in bank credit, an inappropriately loose fiscal policy—and now also the expectation of monetary easing.

Arturo C. Porzecanski is a professor of international economics at American University in Washington, DC.

CSIS Center for Strategic and International Studies
1800 K Street, NW
Washington, DC 20006
Tel: 202-887-0200 Fax: 202-775-3199
All content © copyright 2010 All rights reserved.

Source URL: http://csis.org/blog/brazils-betting-global-recession