Lower inflation, higher interest rates

As monthly rates of inflation continue to fall, the temptation will be to shorten the monetary tightening cycle. Nothing would be more imprudent. The Central Bank should keep interest rates high for longer than it envisaged at the beginning of the year.

Salomão Quadros

Inflation is falling every month. The May results show that the most acute price pressures have subsided. Prices of alcohol, gasoline, and fresh food are declining significantly and will help reduce inflation next month. This will bring relief especially for lower-income families — but it would not prevent 12-month inflation from breaching the government target for at least one quarter, jacking up inflation expectations.

Neither declining monthly inflation nor the still-increasing 12-month inflation are reliable indicators of future inflation. Even if inflation rates fall substantially next quarter, it is legitimate to...
ask what the rate will be at year-end. If inflation levels off at about 0.3%, the convergence to the center of the inflation target will be relatively quick and can be verified before year-end. But if it is higher, 0.5% to 0.6%, 12-month inflation may exceed the 6.5% top bound of the inflation target at year-end.

**Food and Services**

There is a possibility that food prices will decline because of better supply and less demand — unlike 2010, when prices rose over 10%. With the strong production response, stimulated in Brazil and in most producing countries by compensating levels of pay, prices of agricultural raw materials are falling, which has not happened since early 2010. Moreover, with competition from imports and an appreciating exchange rate, prices of durable consumer goods are barely moving. For the 12 months ending in April, new cars were only 0.22% more expensive.

The main obstacles to deceleration of inflation are services and administered prices: 12-month services inflation reached 8.6% in April. Services are not subject to competition from imports and respond primarily to increases in domestic demand, which mainly reflects an overheated labor market. As for prices administered by the government, little can be done in the short term because they are defined without direct relation to domestic demand.

Given the inflation crossroads envisaged for the end of the year, the Central Bank should do what it announced in the minutes of the last meeting of the Monetary Policy Committee: keep interest rates high for longer than was expected at the beginning of the year. With monthly rates of inflation falling, there is a great temptation to shorten the monetary tightening cycle. Nothing would be more imprudent than premature relaxation of monetary policy.