Inflation, which in 1994 and 1998 decided presidential elections in Brazil, will probably not be at the center of the debate in this year’s campaign, but it could be jolted into prominence by natural uncertainties surrounding the change in command of economic policy. After 16 years of successful economic management based on inflation targets, fiscal adjustment, and floating exchange rate — by both tucano (Brazilian Social Democratic Party, PDSB) and workers’ party (PT) administrations — the “beast” might continue its undisturbed slumber were it not for the special context of an intensely overheated economy and certain tensions in the air. On the market side, there is the fear that economic policy will change in January 2011, regardless of whether the winning candidate is Dilma Rousseff (PT) or José Serra (PDSB). On the government side, the context includes the adoption of a more intensive short-term adjustment lest the higher central bank policy rate taint the electoral debate.

For alert observers, for some time now there have been clear signs that inflation will miss the center of the 2010 target,
In addition to seasonal pressures, there were adjustments resulting from the overheating of the domestic market. Although by less than in 2008, when consumer inflation rose to 6.4%. The new cycle of interest rate hikes started in late April, when the monetary authority validated market expectations and raised the annual policy rate from 8.75% to 9.5%, continuing the monetary squeeze initiated by the increase in commercial bank reserve requirements at the Central Bank to mop up excess liquidity and the end of tax incentives for certain industrial segments. “All seems to indicate that a number of the meetings of Copom [the Monetary Policy Committee] this year will result in a rise in interest rates; the cumulative increase could total 3 percentage points,” says economist Salomão Quadros, coordinator of the General Price Index of the Getúlio Vargas Foundation.

The monetary authority changed course after 18 months of an unchanged policy rate — 8.75% a year, the lowest in history — and increased the rate by 0.75 percentage points because of signs of upward pressure on price indexes early in the year that led the markets to successive revisions of projected inflation. According to the latest estimates by market analysts in a Focus survey, which is a source of information for Copom, the IPCA, the official broad consumer price index calculated by the Brazilian Statistics Institute, is expected to reach 5.5% in 2010. If it does, we would be at least 1 percentage point over the center of the target (4.5%), though still within the two-point tolerance band (6.5%). In the 12-month period through March the IPCA reached 5.17%, which annualized would be 8%. The 2011 forecast incorporates those changes, and the projection is for 4.8% — also above the 4.5% center of the target.

Inflation in the aftermath of a global financial crisis is a problem afflicting other emerging countries as well. Brazil, China, and India, which dealt very well with the scarcity of credit brought about by the Lehman Brothers bankruptcy in 2008, boosted domestic demand using expansionary fiscal policies. Now they are countering inflationary pressure by raising interest rates and introducing other measures to contain consumption.

At this juncture, inflation is generated in two areas: the prices of tradables (commodities, food items, electro-electronic appliances), which are influenced by increases in international markets; and the higher domestic prices of services, pushed up by domestic demand. “Although the CPI has missed the center of the target, by December accumulated inflation should not exceed 6% because the influence of tradables is more subdued.
than in 2008. The US, Japan, and Europe, which make up 70% of the global economy, are still dragging,” Quadros explains. This is not what happened two years ago, when the world was in expansion, commodity prices soared, and stocks became scarce, which triggered inflation in food prices. Inflation of domestic prices, however, should be comparable to that in 2008 because the domestic market is speeding ahead.

**Overheating**

This has been a different year from the start. In addition to seasonal pressures — some of them expected, such as higher school fees; and others unforeseen, such as higher bus fares in São Paulo and Rio — there were adjustments resulting from the overheating of the domestic market, IBRE economist André Braz points out. “Seasonality coupled with price hikes deriving from increased domestic consumption resulted in a higher price level than in previous years,” he adds.

According to the IPCA, the prices of services, which went up during the crisis, continued to do so at the beginning of 2010. Braz comments, “As growth picked up, became clear the strength of service prices became clear. The adjustments were kept at around 7% over 12 months, as in early 2009, a trend that is starting to spill over to durable goods. It is all the effect of an increasing wage bill and of the expansion of demand.”

Price pressure in early 2010 was quite obvious in durable goods, especially cars: in the 12-month period through January 2010 their prices had declined by 0.57%, but in the 12-month period through March, they grew by 0.34%, having declined by 1.48% in March of 2009. “Government incentives until the end of March this year, consisting of a reduction in the tax on manufactured goods, helped the recovery,” Braz notes. Prices of nondurable goods, another component of the IPCA, rose less than in the first quarter of 2009. In the 12 months through March, they rose by 5.8% compared to 8.7% in 2009.

Prices of raw materials for industry have also shot up. Manufacturing materials, a thermometer for industrial raw materials, increased by 2.8% last February compared to January, according to the IPA, the broad producer prices index. “That is quite a lot for a single month,” Quadros points out. From January to April this year, the accumulated increases amount to 6.4%. In this case, the pressure on prices originates not in Brazil but elsewhere. For instance, prices of petrochemical products were pushed upward by higher demand in China. The same happened with other raw materials: according to the IPA, in the first four months in 2010 fertilizers soared by 22.4%, aluminum by 28.3%, and polystyrene by 17.5%. “So far, those price hikes are contained within the industrial sector, but they may soon be passed on to the final consumers,” Quadros says.

There is still anxiety about the evolution of the prices of services.
Keeping policy interest rates high will contain the inflationary process, but inflation rates will only begin to decline and return to the center of the inflation target toward the end of the year.

Because the price indexes used to calculate utility prices were lower in 2009, prices of water, electric power, and telephones are expected to fall in the second quarter. Those services, which increased by 4.8% in the 12 months through January 2010, increased by 4.6% through March, a contraction of 0.2 percentage points in two months, according to the IPCA. Those prices account for about 30% of a household budget. “Reduced pressure from those prices is welcome news,” Braz says.

But there is still anxiety about the evolution of the prices of services. By mid-2010, the costs of car repairs, visits to the doctor, entertainment, and vacations during the July recess are bound to increase. Quadros says, “We are experiencing a period of expansion of credit and wages, and positive consumer expectations regarding the future of the economy. This combination will generate heightened anxiety about consumption, and this will feed inflation during 2010.”

Quadros believes that keeping policy interest rates high will contain inflation, but inflation rates will only begin to decline and return to the center of the inflation target toward the end of the year and, more clearly, in 2011. There is a time lag between a hike in interest rates that renders credit more expensive for both consumers and businesses and the effects on domestic demand and prices.

What is significant is that the monetary authority has acted firmly and promptly to prevent the first wave of inflation from sparking second-round price hikes caused by salary increases and inflationary expectations. “The market will perceive that this first wave of acceleration of prices is temporary,” Quadros concludes. What is essential is not to let this process contaminate the next few years in a snowballing effect. Braz adds that “A certain degree of inflation is quite normal as employment, the wage bill, and consumption are growing. Nevertheless, we should not allow those increases to become entrenched and generalized.”