

ECONOMICS: LATIN AMERICA PERSPECTIVES—JANUARY 20, 2012

Brazil Cuts Rates, but How Much Further Will They Fall?

■ **Lars Pedersen**
 Senior Economist—Latin America Research

Brazil has been reducing its short-term rate as global commodity inflation eases and the Brazilian economy slows. The market expects additional cuts, and we think rates could fall further than expected—if the right political choices are made.

Brazil, which has the highest policy rates among nations with comparably sized domestic financial markets, recently cut its overnight SELIC rate to 10.5%, continuing a cycle of cuts that's brought rates down from 12.5%. Among the reasons for the easier money policy: relief from global commodity inflation and slower economic growth in Brazil. The central bank also feels that, with developed nations reluctant to borrow more in 2012, slower growth should reduce global inflation.

How low can Brazil's short-term rate go? That's the question investors are pondering right now. Based on sentiment in the futures markets, the low for this cycle is expected to be about 10%, with interest-rate hikes resuming once again by 2013. In our view, policy rates could actually end up much lower than that—given the right conditions.

Motivation to Normalize Rates

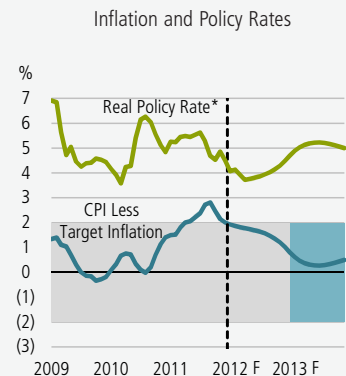
In our view, policymakers have strong motivation to lower Brazil's exceptionally high rates and bring them into alignment with world rates. This action would reduce

the glaring distortions created by the great excess of Brazilian rates over world rates. These imbalances have required increasingly draconian capital controls to rein in an increasingly overvalued currency, and have created a huge gap between subsidized interest rates for public-interest projects and rates for everyone else in Brazil.

The success of the effort to cut interest rates to new lows depends on maintaining a convincing anti-inflation stance, given Brazil's recent history of hyperinflation. Central bank governor Alexandre Tombini rattled markets when he began cutting rates in mid-2011, with the inflation rate at nearly 7.5%.

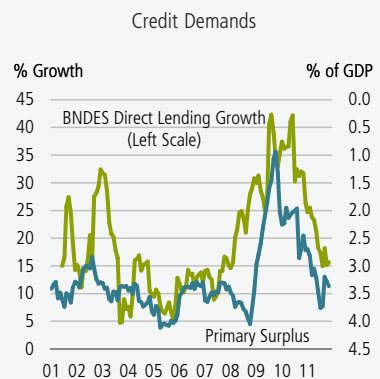
Since then, Tombini and his staff have argued that a key driver of higher inflation will be removed by mid-2012, as one-time price adjustments from a year earlier fall out of the calculations. Tombini's judgment seems to have been accurate so far: by the end of 2011, inflation had declined to 6.5%, the upper edge of the targeted inflation range.

Display 1
Market Expects High Real Rates



*If 10% rates are the low
 As of January 15, 2012
 Source: Banco Central do Brasil and Haver Analytics

Display 2
Can the Public Sector Back Off?



As of December 31, 2011
 Source: Banco Central do Brasil and Haver Analytics

Expectations for Falling Inflation

Based on several surveys, the Brazilian inflation rate is expected to fall further by 2013, approaching the middle of the targeted range. The central bank's latest inflation report is even more optimistic, noting that its models project that inflation will fall below the targeted range over the same time period, assuming no change in interest rates.

No matter which forecast turns out to be more accurate, inflation should cool further with the redefining of Brazil's consumer price basket at the beginning of this year, which would increase the bias toward lower inflation figures. The inflation path isn't completely clear, though. Brazil saw a very large hike in its minimum wage as 2012 started; this will almost certainly increase the costs of local services as it restarts the economy's halting recovery.

As the central bank has noted repeatedly, real, or inflation-adjusted, interest rates should slide downward over time, moving closer in line with world standards. After all, it's unusual to have marginal money-market rates at 5% to 6% above the inflation target, and these ample real rates

(**Display 1, previous page**) have clearly been a magnet for global carry trades over the past few years. This development has made policymakers increasingly uncomfortable. But what would be a reasonable landing point for real interest rates? In our view, real rates could be reduced to 2%—as they have been everywhere else.

Progress in Taming Public Credit Demand

To get real interest rates to that level, the central bank has to deliver low inflation, which means reducing overall demand. The key to taming demand is for the government to stop tapping Brazilian credit markets directly, and to rein in the redirection of those funds to "approved" sectors of the economy through subsidized lending by development banks. If public-sector demand were to take a step back in these two ways, it would allow rates to be brought down and open the door for private-sector borrowers to step in.

There's been progress on both fronts so far. The annualized growth of direct lending by the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) and other development

institutions has fallen to 15%. That's down from over 40% during the recovery year of 2009 and into the election year of 2010. The slowdown was probably overdue, but better late than never.

Similarly, Brazil's public-sector primary surplus (excluding interest costs) has also risen, which is an indication that, to some extent, the government is stepping away from credit markets. The primary surplus had dropped to 1% of GDP during 2009 as the government made greater use of credit, but since then it's gradually risen, and is currently running near 3.5% (**Display 2, previous page**).

In the end, the ultimate success of this effort boils down to a central political decision. Brazil can bring its financial markets toward normalcy if the public sector and political-interest groups can bear to give up their pet projects and sources of cheap, subsidized financing. If they're unwilling to do so, normalcy may be beyond reach. ■

The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

Note to Canadian Readers: AllianceBernstein provides its investment management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc.

Note to UK Readers: UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: 50 Berkeley Street, London W1J 8HA.

Note to Australian Readers: This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is only intended for persons that qualify as "wholesale clients," as defined in the Corporations Act 2001 (Cth of Australia), and should not be construed as advice.

Note to New Zealand Readers: This document has been issued by AllianceBernstein New Zealand Limited (AK 980088, FSP17141). Information in this document is only intended for persons who qualify as "wholesale clients," as defined by the Financial Advisers Act 2008 (New Zealand), and should not be construed as advice.

Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia, China, Taiwan and India: This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

Note to Readers in Malaysia: Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial planning services in Malaysia.

Note to Singapore Readers: This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C). The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Taiwan Readers: This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (100) FSC SICE no. 012. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and independently operated business.

Note to Hong Kong Readers: The document has not been reviewed by the Hong Kong Securities and Futures Commission. The issuer of this document is AllianceBernstein Hong Kong Limited.