

## Brazilian central bank looks to 'macro-prudential' measures to rein in inflation

**"Inflation increased in March to 6.3% year on year"**

The coming week sees the release of unemployment data (March) on Tuesday 19<sup>th</sup> with the Central Bank of Brazil (BCB) meeting the next day to decide the key base rate (SELIC). The BCB signalled in its latest minutes that it will rely more on credit curbs (macro-prudential measures) to fight inflation, as it wants to avoid hiking interest rates too aggressively. This should

minimise the damage to economic growth and the upward pressure on an already strong currency. Indeed, although the BCB has already hiked the base rate 100 basis points this year (to 11.75%), inflation has continued to climb and stands at 6.3% in the latest March data.

The BCB is hoping the 'macro-prudential' measures it started to put in place from December 2010 will dampen the credit boom (that has fuelled the high inflation rate) from the current 21% year on year growth to a more acceptable level of 10-15%. The new measures include higher reserve requirement ratios for banks, higher capital requirements on consumer loans and an increased financial operations tax (IOF). A recent BCB survey showed that these new measures are expected to have the same affect as a 75bp interest rate rise. Also, with the unemployment rate increasing from its record low of 5.3% in December to 6.4% in March, the pressure to hike rates drastically will ease, with the markets now looking at a 25bp rather than the 50bp hike in the coming meeting. This new emphasis on macro-prudential measures bodes well for the housing sector, as the less than anticipated hikes in the SELIC rate will reduce further appreciation of the exchange rate which in turn will make it more

attractive for foreign investors. Additionally, mortgage rates in Brazil (which has have increasing of late) should benefit from fewer rate hikes (see chart below).

That said, the BCB has urged patience with regards to inflation, and their own forecasts predict inflation will be well above target for the rest of 2011 before coming back to the target range of 4.5% in 2012. The governor has indicated that additional credit dampening measures could be enacted should inflation accelerate further.

**"Unemployment also rose in February from 6.1% to 6.3%"**

### Mortgage rates have been increasing on the back of rate hikes



## German economy is booming, but rising interest rates pose risks to property

**"Survey indicators are close to all-time highs"**

Two key German business surveys are due next week. The April manufacturing PMI survey is due Tuesday 19<sup>th</sup> and the April Ifo survey is due Thursday 21<sup>st</sup>. The former measures past activity (just in the manufacturing sector as the name suggests) whereas the latter is a broader gauge of sentiment in the manufacturing, retail, wholesale and construction sectors. The key messages

from both surveys are that manufacturing activity is growing at close to a record pace (the headline PMI reading came in at 60.9) and general business sentiment is also near record highs (the Ifo headline reading

came in at 111.1).

Although the main factor behind the strength in the survey indicators is the external climate, which the German manufacturing sector is heavily exposed to, the domestic sphere is being stimulated indirectly. One of the channels through which this is occurring is the labour market; as manufacturers increase production they need to hire more labour, which in turn boosts confidence and generates more domestic spending. Indeed, the unemployment rate has fallen to 6.3% presently, the lowest since June 1992, whilst consumer confidence is only slightly below last November's all time high. The evidence on consumer spending growth is less clear cut, because the data is volatile, but the overall message is positive nonetheless.

### German house price growth gas picked up



One of the side effects of a stronger labour market has also been a pickup in house prices. According to the Hypoport index, existing home prices in March were up by 6.7% on the year, while new home prices were up by 3.6%. Our view is that house price growth may increase further during 2011, due to the lagged impact of a stronger labour market, but the medium term risks are already shifting to the downside. Probably the single biggest risk to the German housing market is tighter monetary policy now that the ECB has begun raising interest rates. We expect the key refinancing rate to reach around 1.75% by year end, which is likely to weigh on housing demand.

**"House price growth has picked up"**



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## Japanese economy lurches down following earthquake

**“Housing starts will fall sharply in the wake of the earthquake”**

The Bank of Japan Senior Loan Officer survey is due for release on Thursday 21<sup>st</sup>, and housing starts for March are published the following week on Thursday 28<sup>th</sup>. Building activity picked up in the final half of 2010, with starts in December reaching the highest level in two years. However, softer data in January and February is likely to be

followed by a sharp decline in March following the Japanese earthquake. We have previously estimated the cost of the quake to be in the region of Yen 16 to 25tn, with many homes destroyed in eastern regions of the country. The monthly fall in starts at the height of the latest recession was 32%, and it is conceivable that the forthcoming number will be equally dramatic.

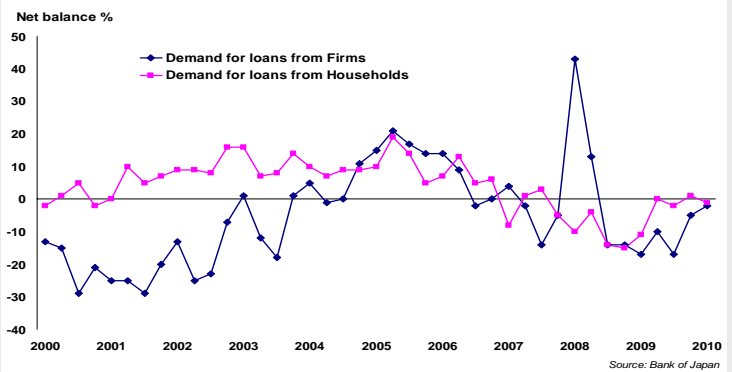
Indeed, business and household surveys released in the past week have suggested that, understandably, sentiment has been significantly hit by the disaster; the Cabinet Office's monthly Economy Watchers Survey posted its largest drop on record, plunging to 27.7 in March, from 48.4 in February. The survey revealed that confidence for the economy over the coming quarter also tumbled. Moreover, the composite PMI fell to 36.1 from 51 in February (a reading below 50 marks contraction in the economy). This, alongside the extremely weak March manufacturing PMI report, underscores the severity of the immediate impact of the recent natural disaster on corporate activity in Japan.

The loan officers' survey, which measures lending activity to

households, firms and local governments, is also likely to be heavily influenced by the earthquake. The last survey (Q4 2010) showed that demand for loans from both households and firms had broadly stabilised and showed little change from the previous quarter; the index settled around zero where a positive reading marks greater demand and a negative signals weaker demand. Interestingly, the forward looking index suggested the outlook for households demand was weaker than for firms, but this divergence may narrow in the light of recent events.

**“Business sentiment has already plunged”**

### Demand for loans from borrowers had broadly stabilised



## Will the Bank of England follow the ECB?

**“News flow over the past few weeks has contributed to the uncertainty”**

While the ECB has taken the plunge and begun to row back on the hugely accommodating monetary stance put in place in the wake of the credit crunch, it remains unclear as to whether at this stage, the Bank of England will follow suit. News flow over the past few weeks has contributed to the uncertainty with hard data on industrial production and retail sales disappointing but business

sentiment and employment numbers showing more encouraging signs. On top of this, the March inflation data undershot expectations with the headline rate slipping from 4.4 to 4% but the prospect of

higher utility bills in the months to come suggest that the peak has yet to be seen.

The volatility in the one year overnight index swap (shown in the chart) is indicative of the shifting mood music on base rates. It is still suggesting that interest rates will be half a point higher twelve months down the road (with the average rate over this period around 0.75%) but the market is clearly very sensitive to fresh data. Amongst the releases over the next fortnight that could influence the MPC when it meets in May are (official) retail sales on Thursday 21<sup>st</sup>, the CBI Industrial Trends Survey on Tuesday 26<sup>th</sup> and, most significantly, the first stab at Q1 GDP on Wednesday 27<sup>th</sup>. Our suspicion is that the latter could record a quarter-on-quarter gain of 0.8%. In other circumstances, this might be viewed as a reasonable outcome. However, following the 0.5% drop on the final three months of 2010, it would point to a pretty flat underlying trend in the economy.

### 1 year overnight index swap highlights volatility on base rates



Before any of these numbers are published, the minutes of the last MPC meeting will be released (Wednesday 20<sup>th</sup>). They will be interesting if only to see whether any more members of the Committee shifted sides in April. In recent meetings, Andrew Sentance, Spencer Dale and Martin Weale have supported a tightening in policy but have been outvoted by the other six members. We would not be surprised if the voting pattern is similar in May.

**“Volatility in the one year overnight index swap is indicative of the shifting mood music on base rates”**

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