VotorantimAsset

Monthly Economic Outlook

April | 13

As illustrated in the accompanying table, the Brazilian inflation rate measured by the IPCA has been hovering dangerously close to the Central Bank's target ceiling of (6.50%) over the last three years. Unfortunately, our forecast for 2013 and 2014 is not much different. For 2013, we are projecting an IPCA of 5.60%, but one must keep in mind that government tax reductions on the price of electricity and on basic food products, among other tax reductions with lesser ramifications, will have significant impact on this year's IPCA. It is our estimation that those first two tax reductions alone will impact the 2013 IPCA by 0.80 % and 0.25 % respectively. Therefore, excluding the specific impact of electricity and basic food products, inflation is already likely to breakthrough the CB's target ceiling this year. For 2014, our projection models indicate that the IPCA will once again dangerously approach the target ceiling. Had there not been signals form the Central Bank that it is preparing to tighten the cycle of monetary stimulus (we expect a moderate increase of the Selic rate starting in May 2013), our forcast for the 2014 IPCA would have been considerably higher than the 5.65% we are currently projecting.

There seems to be a growing consensus of opinion among inflation analysts regarding the interpretation of the impact of tax reductions on consumer items such as household electricity and basic food products. Even if they can eventually produce a positive reduction of the tax burden, from the perspective of inflationary pressures, these tax reductions are more likely to postpone the problem than they are to solve it. Since these items carry significant weight within the inflation indices, the inflationary relief is almost instantaneous. However, over the long run these tax reductions do not act on the factors that have been pushing inflation upward in Brazil: the misalignment of inflationary expectations and inflation in the service sector, (which we believe will continue to oscillate between 7% and 9% from 2011 to 2014 - see table). Ultimately, tax reductions on consumer items may even aggravate the inflationary outlook over the longer term for the following two reasons: (i) by providing tax relief for consumer items, these measures add purchasing power to domestic demand, which in turn pushes up inflation in sectors that have less exposure to international competition - in particular services, and (ii) the tax reductions will end up unanchoring the long-term expectations even more, because the fiscal cost of these measures makes it clear to economic agents that such an

Annual Inflation IPCA

Variance decomposition between administered prices and prices of goods and services

	Weight*	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
IPCA - Total	100,0%	5,69%	3,14%	4,46%	5,91%	4,31%	5,91%	6,50%	5,84%	5,60%	5,65%
IPCA - Administered prices	23,7%	8,98%	4,28%	1,65%	3,28%	4,74%	3,13%	6,20%	3,67%	2,47%	4,63%
IPCA - Services excluding food away from home	26,4%	6,77%	5,49%	5,17%	6,38%	6,37%	7,62%	9,01%	8,50%	7,78%	7,41%
IPCA - Goods excluding durable goods and food	16,0%	5,79%	4,33%	3,93%	7,25%	6,20%	5,24%	6,87%	5,24%	5,33%	5,73%
IPCA - Food at home	16,0%	0,59%	-0,13%	12,36%	10,67%	0,88%	10,69%	5,41%	10,02%	7,21%	5,10%
IPCA - Food away from home	8,3%	6,90%	5,92%	7,68%	12,00%	7,75%	9,82%	10,47%	9,51%	9,46%	8,50%
IPCA - Durable goods	9,6%	3,06%	-1,75%	-0,05%	-0,01%	-1,87%	0,93%	-1,56%	-3,45%	1,77%	1,44%

Source: IBGE and VAM.

anti-inflationary strategy would be very difficult to replicate for many years.

As mentioned above, the inflationary outlook is likely to remain dangerously high throughout 2013 and 2014. After the Selic rate dropped from 12.50% to 7.25% over the last year, we are glad to see clear signs that the Central Bank is now seeking to contain inflationary expectations. Our baseline scenario contemplates that the Selic will increase to around 8.75% this year. As the CB itself recognized in the last minutes of the Monetary Policy Committee, the pace of the recovery of Brazil's GDP growth remains frustrating, and it seems not to have come from any weakness in aggregate demand (keep in mind that the pace of retail sales, calculated by IBGE, has grown at 7.9% over the last twelve months), but rather it has come from "limitations in the field of aggregate supply". Therefore, in addition to continuing the battle for lower inflation in the Brazilian economy, it also seems increasingly essential to advance the competitiveness agenda, with investments in physical and human capital, and to finally address the age-old challenge of needed structural reforms.

Selic Rate and Variation meeting by meeting of the Copom
History from Jan/2000 and scenario up to Dec/2014