Dec | 2012

Monthly Economic Outlook

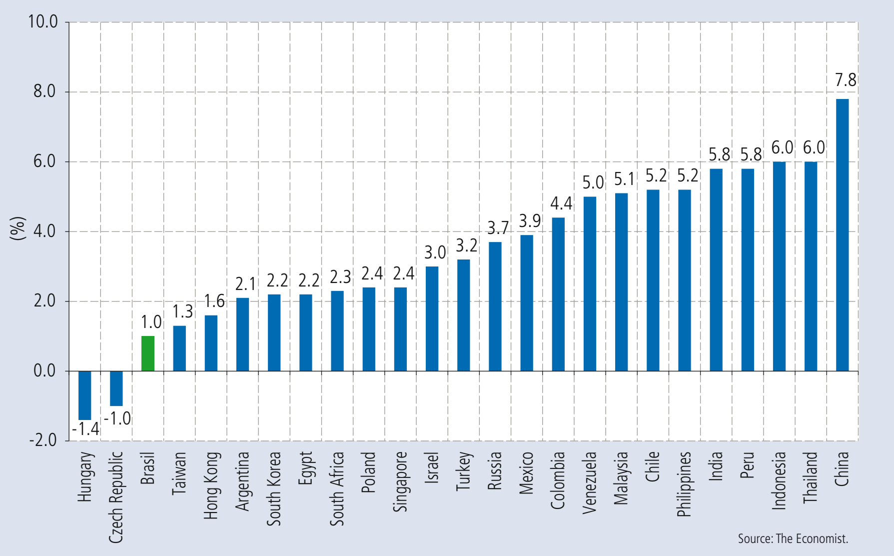
VotorantimAsset

What are the expectations for the Selic benchmark interest rate in 2013?

> Clearly the adverse international economic scenarios, especially the uncertainties surrounding the European crisis, have disrupted the environment for productive investment

In early December, during her opening remarks at the 7th edition of the National Conference of Industry, President Rousseff herself acknowledged that the performance of Brazil's industrial sector had unfortunately been "very precarious" in 2012. Indeed, even with the timid recovery that started to take hold in the second half of this year, Brazil is on course to register a contraction in GDP of around 2.3%, with negative industrial performance limiting the nation's GDP growth in 2012 to somewhere around a modest 1.0%. Clearly the adverse international economic scenarios, especially the uncertainties surrounding the European crisis, have disrupted the environment for productive investment. Nevertheless, when viewed from the global perspective, Brazil's recent economic performance has been quite frustrating, as can be seen in this first graph which puts Brazil in 23rd place among the world's 25 most relevant emerging economies in 2012. This is a drop of two positions from last year when Brazil was ranked 21st on the same list.

GDP Emerging Economies – Growth Expectations (2012)
Survey - The Economist



As recent statements from Brazilian authorities clearly denote, this weak economic growth will continue to trouble the country over the next few months. The IBGE will not release the official figure for the 2012 GDP until March 1, 2013, and it is our assessment that during the first half of next year the primary orientation of economic policy will be to continue stimulating growth. As for the benchmark interest rate, if the Central Bank of Brazil were to present any change to its official plans of maintaining the Selic rate stable for a "prolonged period" at its current level of 7.25%, then the only possible change we envision would be a resumption of the downward cycle. However, further reductions in the Selic rate are not part of the basic scenario that we are projecting, due to the inflationary pressures that still exist, even in this current context of low GDP growth. The graph below illustrates the strong inflationary pressures that are still arising from the service sector, in professions such as (doctors, dentists, hairdressers, domestic workers, and others). The graph also shows that when the inflation from these traditional services is combined with the food-away-from-home service sector they account for more than 34% of the IPCA (Extended National Consumer Price Index). The main problem is that inflation among these important groups is rising at a level which is almost

Furthermore, it appears that inflationary expectations themselves have begun to dangerously crystallize above Brazil's official target range.

twice that of the government's official IPCA target of 4.5%. This is happening even though GDP growth is low, because the labor market continues to be tight with the unemployment rate hovering around its historic low. Furthermore, it appears that inflationary expectations themselves have begun to dangerously crystallize above Brazil's official target range. The use of the word "dangerously" here is valid, because the inflationary process unfortunately incorporates the components of a "self-fulfilling prophecy". When economic agents declare that they expect high inflation, the expectation in itself ends up pressuring future inflation because wage and price negotiations will preemptively incorporate these inflationary expectations into the process. That is, with inflation under structural pressure following the 5.25% drop in the benchmark interest rate, we believe that any additional cuts to the Selic rate in 2013 will only occur if the international scenario produces another negative shock to the Brazilian economy. On the other hand, if by the end of 2013 the economy has shown a strong response to the economic stimuli already introduced by the government, then the Central Bank might have to once again apply moderate increases to the Selic rate. However, we believe that if this upward adjustment becomes necessary it is highly unlikely that the Selic rate will move above the threshold of 8.0% per annum. One explicit goal of current economic policy is to consolidate the long-term interest rate at lower levels. Regarding the return to a more accelerated rate of economic growth, it is our assessment that in addition to monetary and fiscal stimulus to aggregate demand, it is also essential that the country continues to move forward with political reforms that will improve the competitiveness of domestic production.

Annual Inflation IPCA

Variation decomposition between administered prices and prices of goods and services

	Weight*	2005	2006	2007	2008	2009	2010	2011	2012	2013
IPCA - Total	100.0%	5.69%	3.14%	4.46%	5.91%	4.31%	5.91%	**6.50%**	**5.52%**	**5.51%**
IPCA - Administered	24.2%	8.98%	4.28%	1.65%	3.28%	4.74%	3.13%	**6.20%**	**3.55%**	**3.68%**
IPCA - Services not counting food away from home	26.2%	6.77%	5.49%	5.17%	6.38%	6.37%	7.62%	**9.01%**	**7.85%**	**7.95%**
IPCA - Goods not counting durable goods and food	16.1%	5.79%	4.33%	3.93%	7.25%	6.20%	5.24%	**6.87%**	**5.28%**	**5.39%**
IPCA - Food at home	15.6%	0.59%	-0.13%	12.36%	10.67%	0.88%	10.69%	**5.41%**	**9.42%**	**4.86%**
IPCA - Food away from home	8.1%	6.90%	5.92%	7.68%	12.00%	7.75%	9.82%	**10.47%**	**9.61%**	**8.11%**
IPCA - Durable goods	9.8%	3.06%	-1.75%	-0.05%	-0.01%	-1.87%	0.93%	**-1.56%**	**-3.85%**	**2.20%**

* These weights incorporate the new Household Budget Survey (POF) (2008/09) calculated by the IBGE, and they will go into effect for the IPCA of January of this year.

Source: IBGE. Data in bold print are projections from VWM&S.