

Inflationary pressure requires caution from monetary authorities

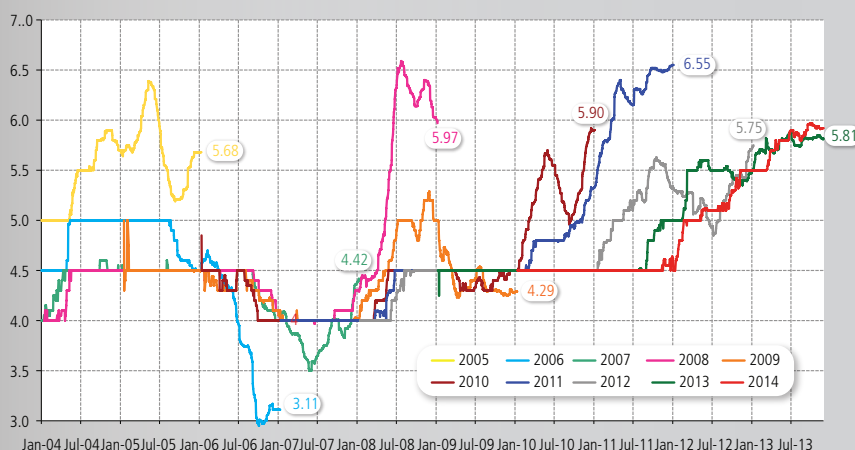
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The Brazilian economy has underperformed expectations in 2013. After two years of low GDP growth (2.7% in 2011 and 0.9% in 2012), Brazil is set to grow only about 2.4% this year, and our projections point to about 2.0% in 2014. Despite this frustratingly slow pace of growth, however, inflation remains persistently high: we project 5.78% in 2013 and 5.87% in 2014, on top of 6.50% and 5.84% in 2011 and 2012 respectively. As we have stressed in recent issues of Votorantim Asset's Monthly Outlook, reinforcing the conditions for price stability should be a top priority for policymakers. In particular, inflation should be brought back down to the midpoint of the target range, which is 4.50%, so that GDP growth can resume at a faster and more sustainable pace.

The accompanying chart shows the deterioration in inflation expectations in recent years. Between 2005 and 2009 the median consensus forecast was close to the 4.5% target. Short-term shocks triggered fluctuations in current inflation, with the official consumer price index, the IPCA, running just over 4.5% in some years (e.g. 2005 and 2008). In other years, however, such as 2006, 2007 or 2009, inflation came in under the 4.5% target, albeit always above the lower limit of the tolerance band, which is 2.5% (with 6.5% as the upper limit). The problem of de-anchoring of inflation expectations has occurred systematically since 2010, with expectations remaining persistently above target. For 2014, this de-anchoring appears to have reached the most critical level yet: no January in Brazil has ever seen inflation forecasts so high for the new year (the consensus forecast for the 2014 IPCA is now 5.92%).

The Central Bank of Brazil itself is quite clear on this. To quote the minutes from the last meeting of its Monetary Policy Committee (Copom): "The Copom stresses that the international evidence, which is ratified by the Brazilian experience, indicates that high inflation creates distortions that lead to an increase in risks and depress investment. Examples of these distortions include shorter planning horizons for households, firms and government, as well as deteriorating business confidence. The committee also stresses that high inflation erodes the purchasing power of wages and transfers, with negative repercussions for consumer confidence and spending. For all these reasons, high inflation reduces the

Inflation expectations (IPCA)



Source: Banco Central do Brasil (BC). | Preparation: VAM.

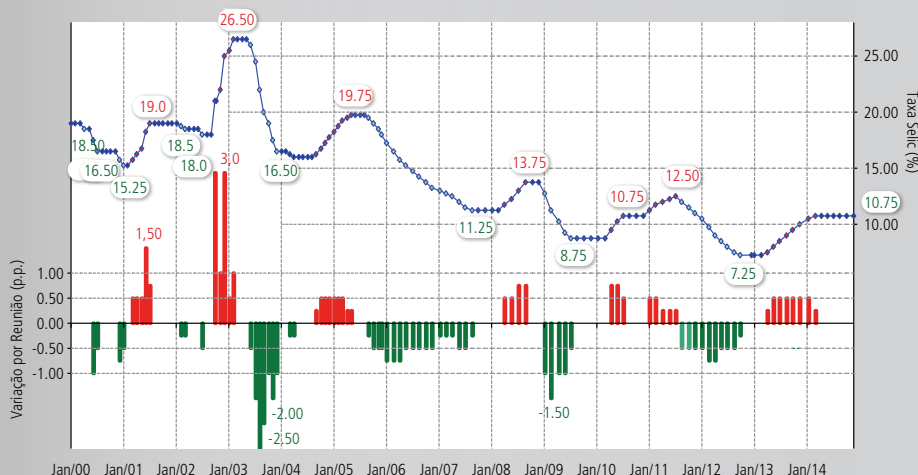
economy's growth potential, job creation and average earnings growth" (paragraph 32). Despite signs of weak economic growth in the near term, Votorantim Asset's Monthly Outlook has underscored the importance of action by the monetary authorities to combat inflation precisely in order to create the conditions for faster and more sustainable growth going forward. For exactly this reason, we expect the Selic rate to continue rising in the early months of 2014 and to reach a level close to 10.75%

p.a. In our view indicators pointing to weak economic activity at the turn of the year could shorten the tightening cycle. However, our projection models indicate that under alternative scenarios assuming a lower increase in the Selic rate from now, inflation pressure could intensify in 2014 and 2015, making another round of rate hikes inevitable in future, with negative effects on the prospects for economic growth.

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Taxa Selic e variação por reunião do Copom

Histórico desde jan/2000 e cenário até dez/2014



Source: Banco Central do Brasil (BC).