

June | 2014

Monthly Economic Outlook

Inflation close to top of target band requires continuing monetary policy caution in 2014 and 2015

Our projections for the IPCA in 2014 and 2015 show consumer price inflation set to remain very close to the upper limit of the target band

After raising its benchmark interest rate (Selic) from 7.25% per annum in April 2013 to 11.00% p.a. in April 2014, the Central Bank of Brazil decided to interrupt the tightening cycle in May. In recent post-meeting statements the monetary authorities had already signaled the intention to put rate hikes on hold while observing the “lagging effects” of monetary policy on inflation. However, our projections for the IPCA in 2014 and 2015 show consumer price inflation set to remain very close to the upper limit of the target band, so that monetary policy will have to remain cautious and further tightening may be necessary next year.

As illustrated by the chart on the right, our projections suggest the inflation outlook does indeed remain challenging. From a trough of 5.59% in January 2014, the 12-month inflation rate has accelerated steadily and is set to rise further in the months ahead. We project 6.69% in September 2014; this is well above the upper limit of the target band (6.50%). Under our base scenario, the 12-month inflation rate is set to retreat moderately toward year-end, reaching 6.36% in December 2014. It should be noted that the risks to this inflation scenario are still on the upside. For example, if the price of gasoline were adjusted so as to eliminate the lag between the domestic and international prices, inflation would remain above the top of the target band until end-2014. Other administered prices, such as urban bus fares, also represent upside risks because they have been frozen since 2013. Rising food prices may also represent an inflationary shock to the IPCA, which has been fluctuating around 6.00% p.a. since 2010, well above the midpoint of the target band (4.50%) and dangerously close to the upper limit (6.50%).

The table below shows that although the recent food-at-home price shock was the main driver of the short-term spike in the IPCA, food prices will not be the major cause of inflation as far as the whole of calendar 2014 is concerned. We project a rise of 7.09% for food at home in 2014, down compared with the

FGV: manufacturing executive confidence index (ICI)

Seasonally adjusted

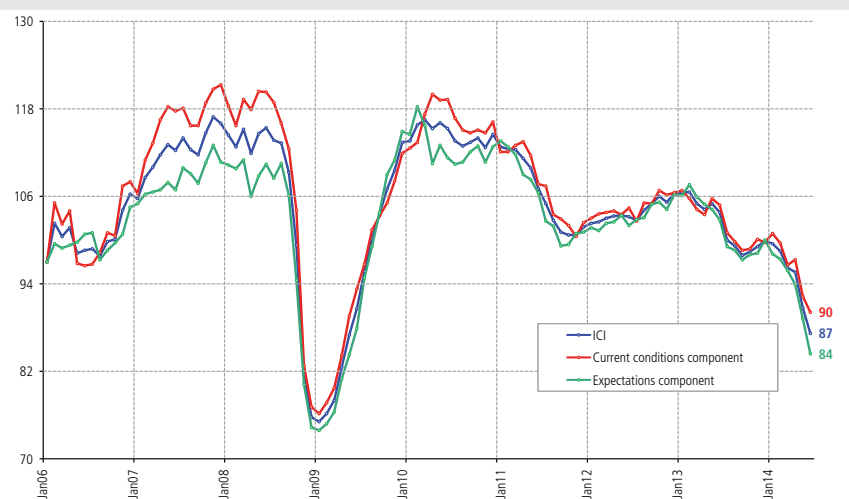


Chart: VAM

Source: IBGE

Most items in the services group have risen substantially in the last 12 months

previous year. Services continue to be the main source of upside pressure on the IPCA. Most items in this group have risen substantially in the last 12 months, including school fees (up 9.2%), domestic help (11.8%), residential rent (10.4%), physicians (11.7%), and dentists (9.3%). Food away from home, with a projected rise of 9.6% in 2014, also remains under upside pressure, sustained by the cost of both food and the services priced in by restaurants (rent and labor). In sum, services in general are still the main driver of inflation, pressured as they are by the continuing tightness of the labor market (the unemployment rate measured by IBGE remains close to the all-time low),

by problems relating to the indexation of prices to high past inflation, and by problems relating to high inflation expectations for the coming months (which motivate preventive price hikes).

The outlook for economic activity in 2014 remains one of low GDP growth (about 1.6%). Industry continues to perform weakly and manufacturing output is below the level seen in 2008. However, it is increasingly evident to economic agents that a sustainable resumption of faster economic growth going forward requires an improvement in business and consumer confidence, which in turn requires a reduction in inflationary pressures.

Breakdown of annual inflation measured by IPCA

Total, administered prices, and prices of goods and services

	Pesos*	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
IPCA - Total	100%	5.69%	3.14%	4.46%	5.91%	4.31%	5.91%	6.50%	5.84%	5.91%	6.30%	5.95%
IPCA - Administered prices	22.91%	8.98%	4.28%	1.65%	3.28%	4.74%	3.13%	6.20%	3.67%	1.52%	4.70%	5.48%
IPCA - Services ex food away from home	27.02%	6.77%	5.49%	5.17%	6.38%	6.37%	7.62%	9.01%	8.50%	8.32%	8.00%	7.23%
IPCA - Bens Goods ex durables & food	16.03%	5.79%	4.33%	3.93%	7.25%	6.20%	5.24%	6.87%	5.24%	5.94%	5.77%	5.14%
IPCA - Food at home	16.03%	0.59%	-0.13%	12.36%	10.67%	0.88%	10.69%	5.41%	10.02%	7.43%	6.23%	6.03%
IPCA - Food away from home	8.58%	6.90%	5.92%	7.68%	12.00%	7.75%	9.82%	10.47%	9.51%	9.84%	9.41%	8.64%
IPCA - Durables	9.45%	3.06%	-1.75%	-0.05%	-0.01%	-1.87%	0.93%	-1.56%	-3.45%	3.48%	3.65%	2.03%

Source: IBGE | Numbers in bold are projections by VWM&S