Monthly Economic Outlook

March | 2015

Realignment of administered prices set to pressure inflation strongly in 2015

Consumer price inflation measured by the official IPCA index remained high in the first two months of the year. Administered prices were the main source of upside pressure, owing especially to resets of: (i) electricity prices with the advent of a "red flag" tariff, (ii) mass transit and taxi fares, and (iii) fuel prices on the back of a tax hike. Other contributions to higher inflation came from seasonal factors typical of the start of the year, such as rises in a wide range of service prices (including school fees, rents and domestic servants), as well as upside pressure from fresh produce. Reflecting all these factors in aggregate, the IPCA rose more in January and February than in the same period of any year since 2003, and we expect new administered price resets to keep inflation high in March and April. In addition, we have revised our forecast for the year-end BRL/USD exchange rate to 2.90 (from 2.70 previously). Rapid and intense local currency depreciation associated with cost pressure will tend to favor pass-through to consumers, fueling upside pressure on free-market prices. In response to these shocks, we have revised up our forecast for inflation in 2015 to 7.9%, with free-market prices rising 6.3% and administered prices 13.7%.

Most of the projected rise in administered prices will occur in March-April, keeping inflation high – roughly at the same level as in January-February. The main driver of this movement will again be electricity prices, given the "tariff realism" to which the government is now committed. In accordance with recent indications from ANEEL, the electricity industry regulator, the cost of the Energy Development Account (CDE) (hitherto subsidized by the Treasury) and higher prices of power generated by Itaipu (due to local currency depreciation) were transferred to consumers in the form of a special tariff review validated on March 2, and the average impact of this increase will be 23.6%. ANEEL also announced a hike in the "red flag" tariff to R$0.055 per kWh (from R$0.030 previously). Taking all these factors together and adding in the distributors' regular tariff resets, we project a rise of 31% in electricity prices in March-April, contributing more than 95 basis points to inflation in the period. For calendar 2015 we project a rise of more than 50% in electricity prices.

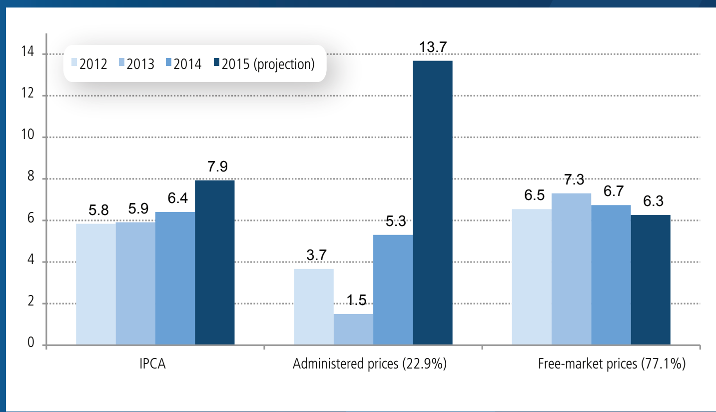
Besides the prospect of rising electricity prices, it is also important to mention that administered prices usually rise sharply in April because this is when prices of pharmaceuticals are reset. The charts below illustrate the distribution of projected administered and free-market price pressures in the coming months and compare them with the actual changes seen in 2014.

Another reason to revise projections for administered prices is the possibility of an additional increase in taxes on motor fuels, given the difficulties Finance Minister Joaquim Levy may face in winning approval for spending cuts from a more independent Congress, and/or a more intense fall in tax collection due to weak economic activity. The impact on annual inflation of additional taxes required to help achieve the 2015 fiscal target is estimated at 15 basis points.

Analogously to administered prices, we have also revised up our projection for free-market prices. The exchange rate rose rapidly in February in response to growing aversion to Brazil risk due to fiscal deterioration, the problems experienced by Petrobras (including the rating downgrade) and the risk of electricity rationing. Reflecting these factors, Brazil's five-year CDS spread rose from an average of 210 bps in January to 240 bps in February. Local currency depreciation drives up corporate costs, pressuring free-market prices via pass-through. It is also important to mention that the sharp rise in electricity prices also contributes to upside pressure on corporate costs. On the other hand, we have also taken into consideration the possibility that the weakness of economic activity (we have revised down our forecast for GDP growth in 2015 to -1%) may partially mitigate price rises in some sectors. Generally speaking, however, pass-through will happen, pressuring free-market prices.

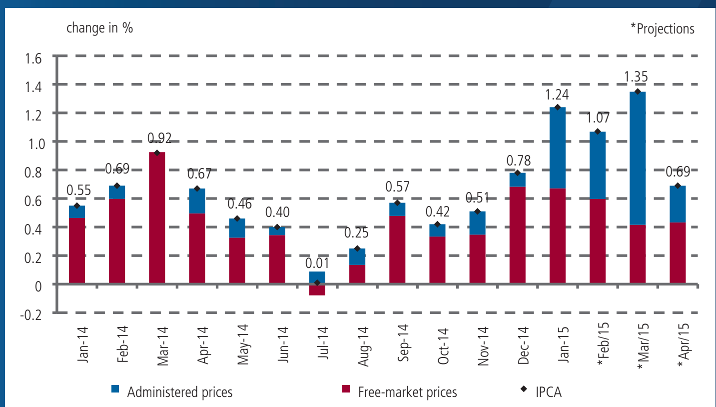
Strong upside pressure in the next two months will push up trailing 12-month inflation from 7.14% at end-January to around 8.0% by end-April. This more adverse outlook may lead the Central Bank to extend the monetary tightening cycle in an attempt to contain inflation expectations and engineer convergence to the annual target in the years ahead. For now we maintain our forecast of 13.00% for the Selic at end-2015, although the risks point to an additional rate hike.

IPCA and main price groups, actual and projected monthly change



Sources: IBGE and Banco Votorantim.

IPCA: actual and projected monthly change



Sources: IBGE and Banco Votorantim.