May | 2013

Monthly Economic Outlook

Domestic inflationary pressures drive up the Brazilian benchmark interest rate in contrast to prevalent international monetary policy

Brazil is the only relevant country on the international scene that has had to raise its interest rate in 2013, while in contrast between March and May, Australia, Colombia, Hungary, India, Mexico, Poland and the Eurozone countries have all lowered their benchmark interest rates. In this way Brazil's current monetary policy, unlike its tightening cycle of (2010 and 2011) and its loosening cycle of (2009 and 2011/12) has now clearly dissociated itself from prevailing international monetary policy, and since it is fundamental domestic inflationary pressure that is prompting the Brazilian Central Bank to increase the Selic rate, even during this current scenario of slow global economic recovery, we believe that this paradox is likely to continue.

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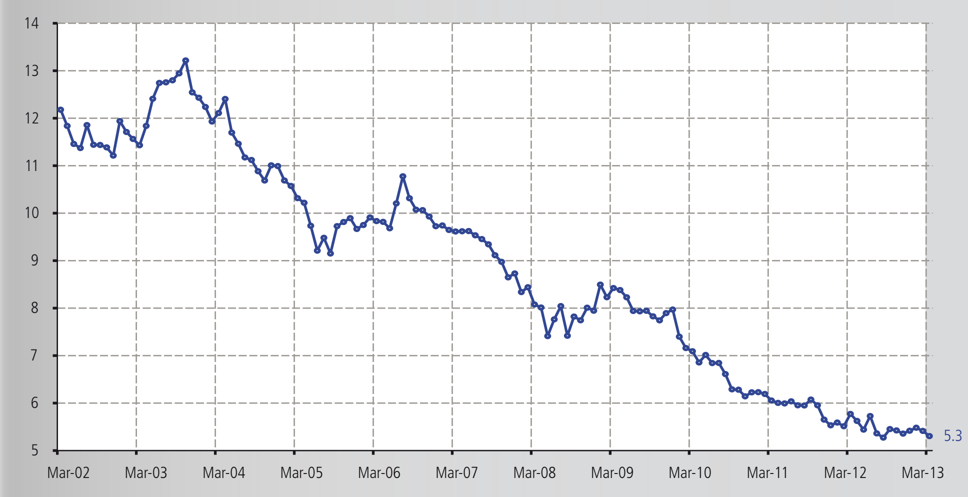
First of all, as the accompanying graph demonstrates, the current inflation expectations for 2013 and 2014 are now dangerously approaching the Central Bank's target ceiling of (6.50%). And after the 2010, 2011 and 2012 IPCA registered an average variation of 6.08%, the fundamental aspect of the tightening cycle that began in April, has been the recovery of credibility that market agents attribute to the BC, as a proactive institution that will in fact move to bring the IPCA closer to its target center of (4.50%). However, it should be noted that the initial 25bsp increase to the Selic implemented at the April meeting was still not enough to keep market projections for the 2014 inflation from surpassing the target. In this regard, the Central Bank's director of Economic Policy recently affirmed that there is a high probability that BC will have to "intensify" the Selic tightening cycle in order to contain inflationary expectations.

The second problem contributing to the persistent high levels of inflation is the tight job market. This is clearly demonstrated by the second graph that shows the unemployment rate at a historic low of 5.3%, even though GDP growth has declined significantly in 2012 and 2013. Like the rest of the global economy, Brazil's GDP growth this biennium should be significantly lower than it was in the previous biennium. The Brazilian economy is not likely to exceed an average annual growth of 2.0% during this biennium, while during this same period the overall global economy is expected to grow by an average of 3.1%. During the previous biennium of (2010 and 2011), Brazil grew at an average rate of 5.1% and the global economy that was also recovering from the great recession

Market Inflation Expectations (IPCA)

Values in US$ billions – FOB



Source: Central Bank of Brazil (BC) | Prepared by: VAM

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of 2009 grew at an average rate of 5.2%. Nevertheless, most analysts have been surprised by the fact that even amid Brazil's economic slowdown, which has been more severe than that of the global economy; the unemployment rate in Brazil has not followed the generalized elevation that has occurred internationally. As the BC recently recognized, this is one more indication of the supply constraints that have been impeding faster economic growth. Therefore it is of fundamental importance that measures are taken within the Brazilian economy to stimulate increased productivity through structural reforms and greater investment in the enhancement of the country's physical and human capital. In the short term, however, even with slow GDP growth, inflation control will continue to be a major challenge for the Brazilian monetary authority.