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Monthly Economic Outlook

Inflationary pressures dictate monetary policy caution

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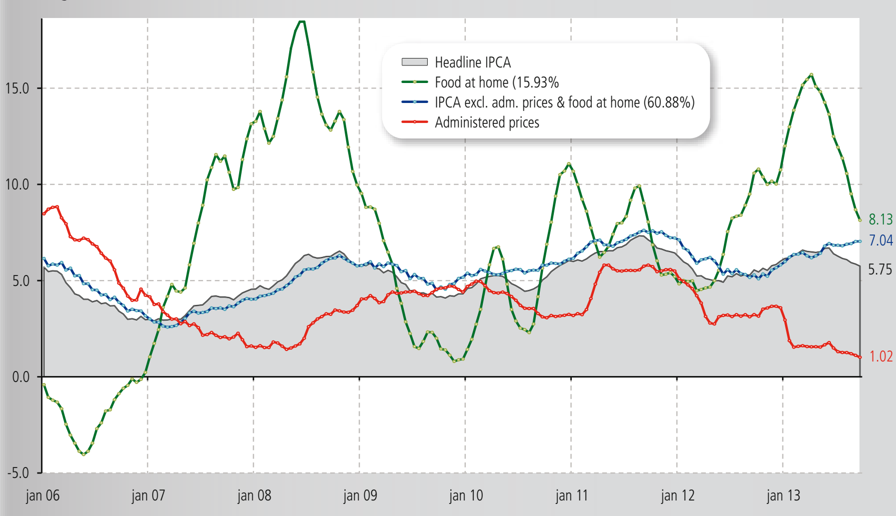
We project inflation in the range of 5.90% measured by the IPCA in 2013. This would take average inflation for the last four years to 6.03% (5.91% in 2010, 6.50% in 2011, 5.84% in 2012, and 5.90% in 2013), closer to the upper limit of the Central Bank's target range (6.50%) than to the midpoint (4.50%). Worse still, inflation would have exceeded the upper limit of the target range in 2013 if it had not been for the 20% fall in electricity prices due to Law 12.783, enacted in January (we estimate an impact of 0.8 of a percentage point on the 2013 IPCA). Indeed, the exclusion core rate has reached an alarming 7.04% in the past 12 months (see first chart).

The exclusion core rate excludes precisely those items that do not respond to macroeconomic factors relating to supply and demand, such as (i) administered prices (electricity, buses, landline telephone service etc.), set to rise less in 2013 than in any year since the Central Bank's current time series began; and (ii) food prices, up 8.13% in the last 12 months in response to pressure from fresh produce (especially fruit and vegetables) due to short-term weather problems.

In other words, after removing the distortions that have driven up inflation in the past 12 months (food) as well as the downside distortions (administered prices) we are left with 7.04% inflation deriving from macroeconomic factors. This justifies a strong dose of monetary policy caution.

The persistence of inflationary pressures is due to a number of factors. First, there are growing signs that several consecutive years of rising price levels have tended to strengthen indexation mechanisms in many sectors of the Brazilian economy. A recent study by Dieese (the Inter Union Department of Socioeconomic Studies & Statistics) shows that 97% of the pay awards negotiated across all sectors fully compensated for inflation in the previous 12 months. Wages have risen 8% on average this year in nominal terms. Demands for the recouping of past losses to purchasing power are almost inevitable in price and wage negotiations when inflation is running high, especially in a low-unemployment environment. Inflation of 6% p.a. corresponds to 26.2% in four years, whereas inflation of 3% p.a. corresponds to 12.6% in four years. The monetary policy literature points to about 3% as the optimal level of inflation for emerging economies (below the 4.5% midpoint of the Central Bank's target

Consumer inflation (IPCA): upside pressure from food and administered prices
Trailing 12-month rate (%)



Source: IBGE. | Preparation: VAM.

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range), among other things, to inhibit indexation and permit adequate variation in relative prices, as well as extending economic predictability with lower risks.

Furthermore, the exchange rate's contribution to inflation has inverted since 2012. In light of the prospect that Brazil's low industrial competitiveness will reduce its merchandise trade surplus to zero or thereabouts in 2013, while the current account is set to display a deficit equivalent to about 3.5% of GDP, we also expect local currency depreciation against the US dollar, which began last year, to continue in 2014. In these closing months of 2013, had it not been for strong intervention by the Central Bank, which is selling US$3 billion per week into the market, the inflationary pressure from local currency depreciation would certainly be even higher. Given the US economy's gradual recovery and the resulting global appreciation of the US dollar, our basic scenario points to a BRL/USD exchange rate above 2.30 for most of 2014.

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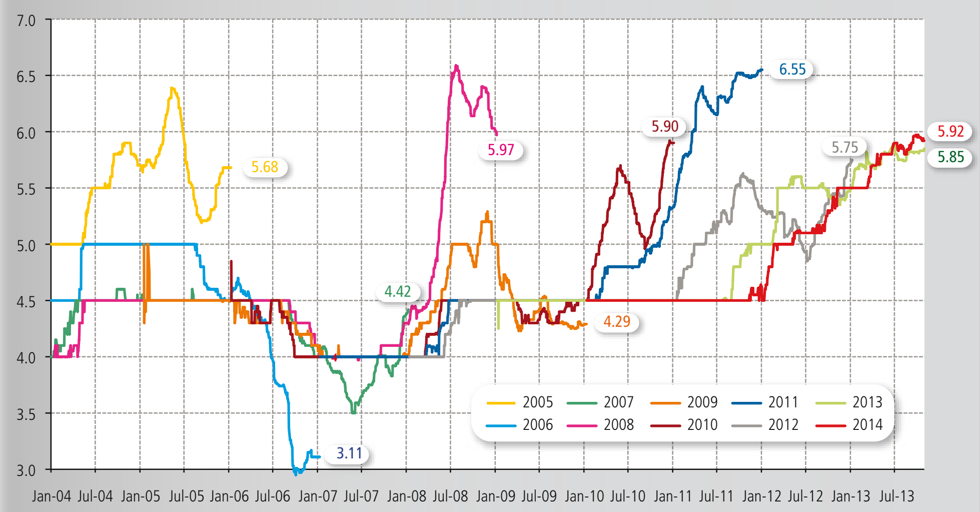
Finally, coordination of expectations plays a central role in inflation targeting regimes such as the one that governs Brazilian monetary policy. Market projections for the IPCA in 2014 remain dangerously close to 6% (see second chart).

Here again, high inflation expectations lead wage and price makers to seek preventive hikes in order to avoid major losses to purchasing power. The Central Bank has been trying since April to bolster the credibility of its commitment to reduce inflation closer to the 4.5% target in 2014. The minutes from the last monetary policy meeting suggest it will raise the Selic rate to the range of 10.25% early next year in an attempt to contain these inflationary pressures. In recent years it has become steadily clearer that the pursuit of lower inflation is a necessary condition for a cycle of higher, more sustainable growth.

Inflation expectations (IPCA)

Median consensus forecast according to Central Bank survey of analysts



Source: Banco Central. | Elaboração: VAM.