



Inflation Outlook

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Inflation Report

June 2015

I. Main Message

II. International Environment

III. Financial Conditions

IV. Activity

V. Inflation Developments

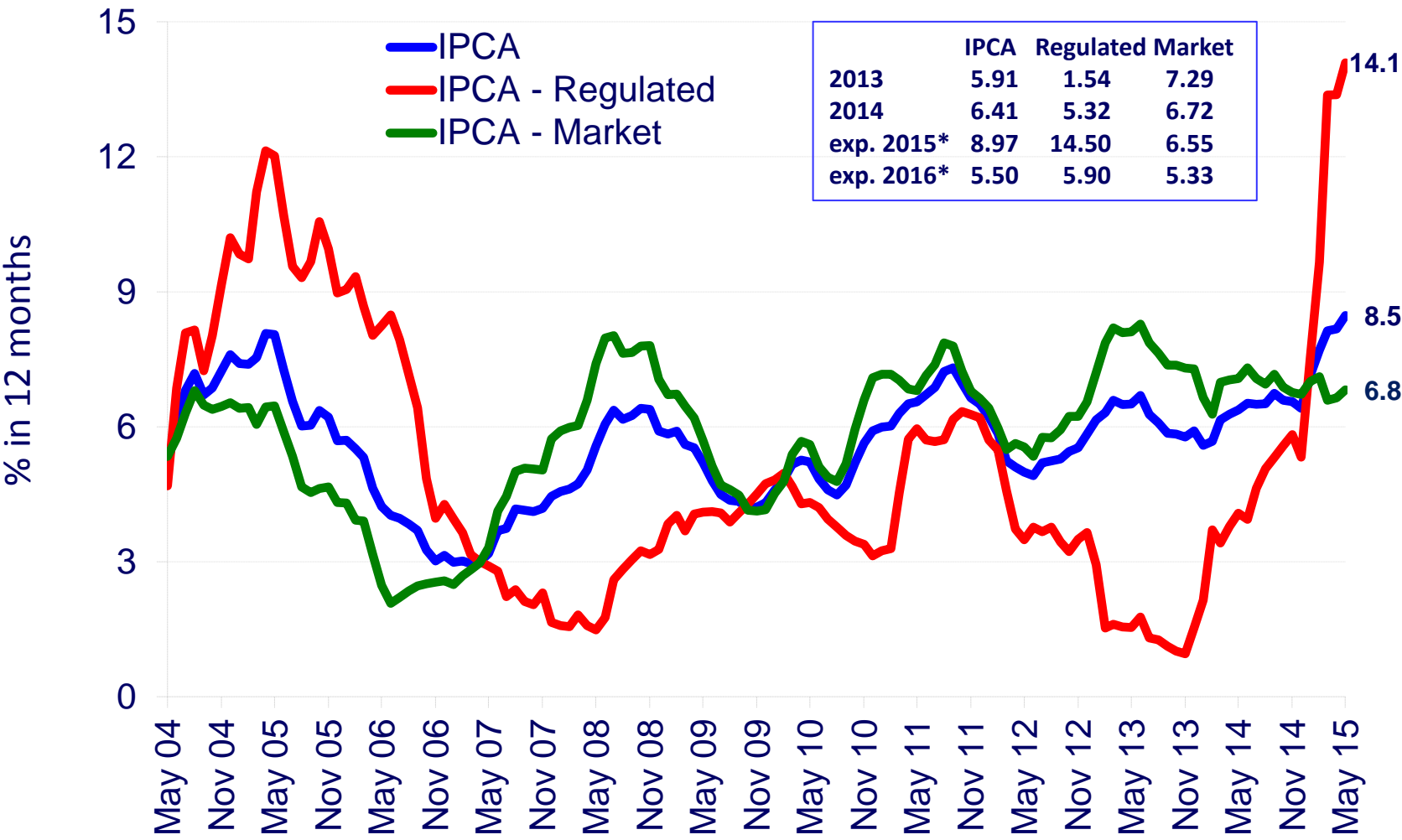
I. Main Message

- **Monetary Policy is and will remain vigilant to ensure the convergence of inflation to the 4.5% target at the end of 2016**
- **Inflation is high in 2015; the Monetary Policy Committee (Copom) reiterates the need for determination and perseverance in the fight against inflation in the short, medium and long term**

First Results in 2015 Show Transition

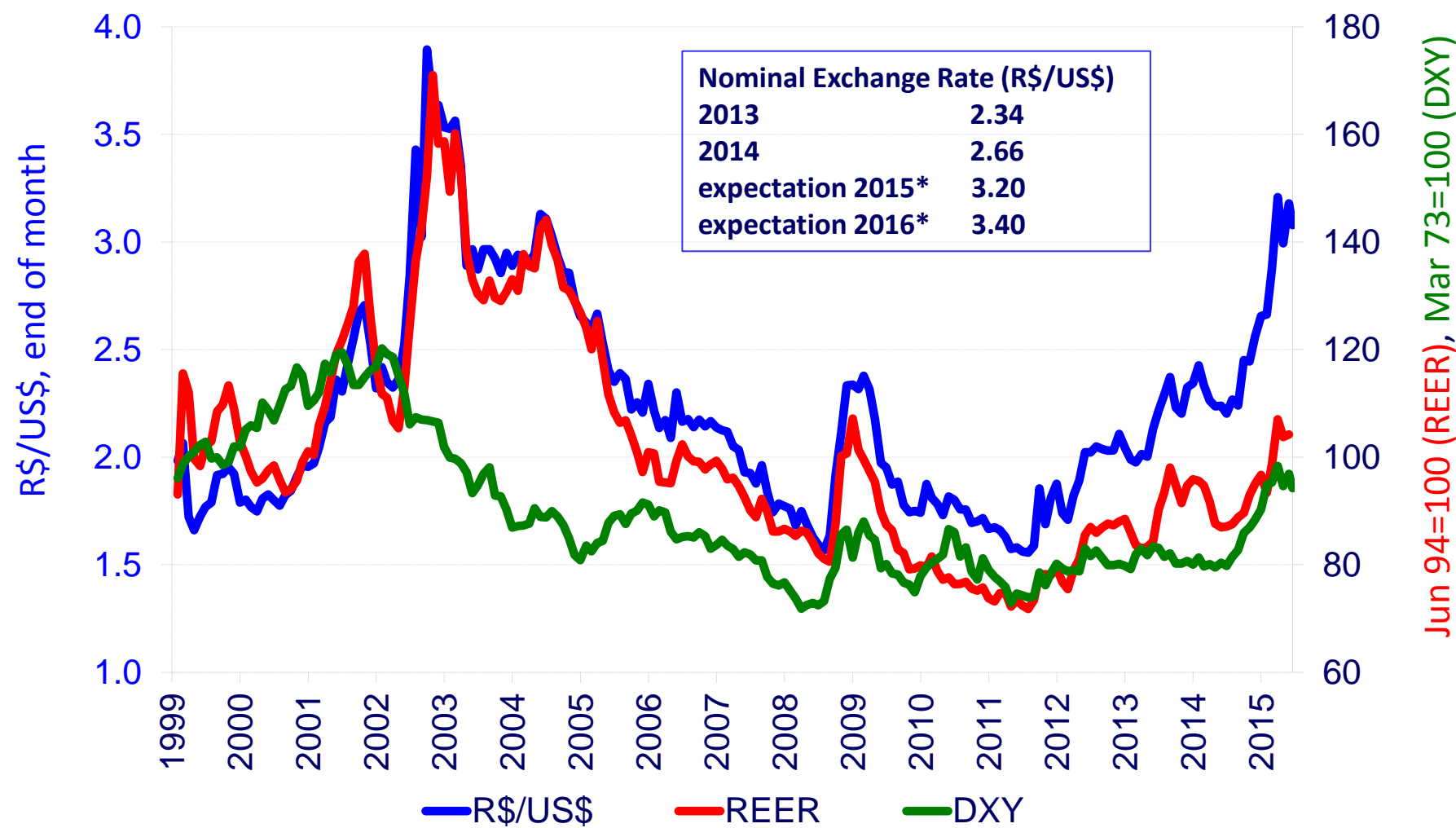
- Macroeconomic adjustment is standard and necessary: it is important to persevere with fiscal and monetary policies in progress
- Initial reduction of unbalances with double adjustment of relative prices (regulated and external); improvement in current account
- Efforts to strengthen fundamentals should continue, to prepare for the external monetary normalization; and to build a solid base for a new cycle of sustainable growth

Relative Price Adjustment: Regulated vs. Market



*median of market expectations on 6/19

Relative Prices Adjustment: Exchange Rate



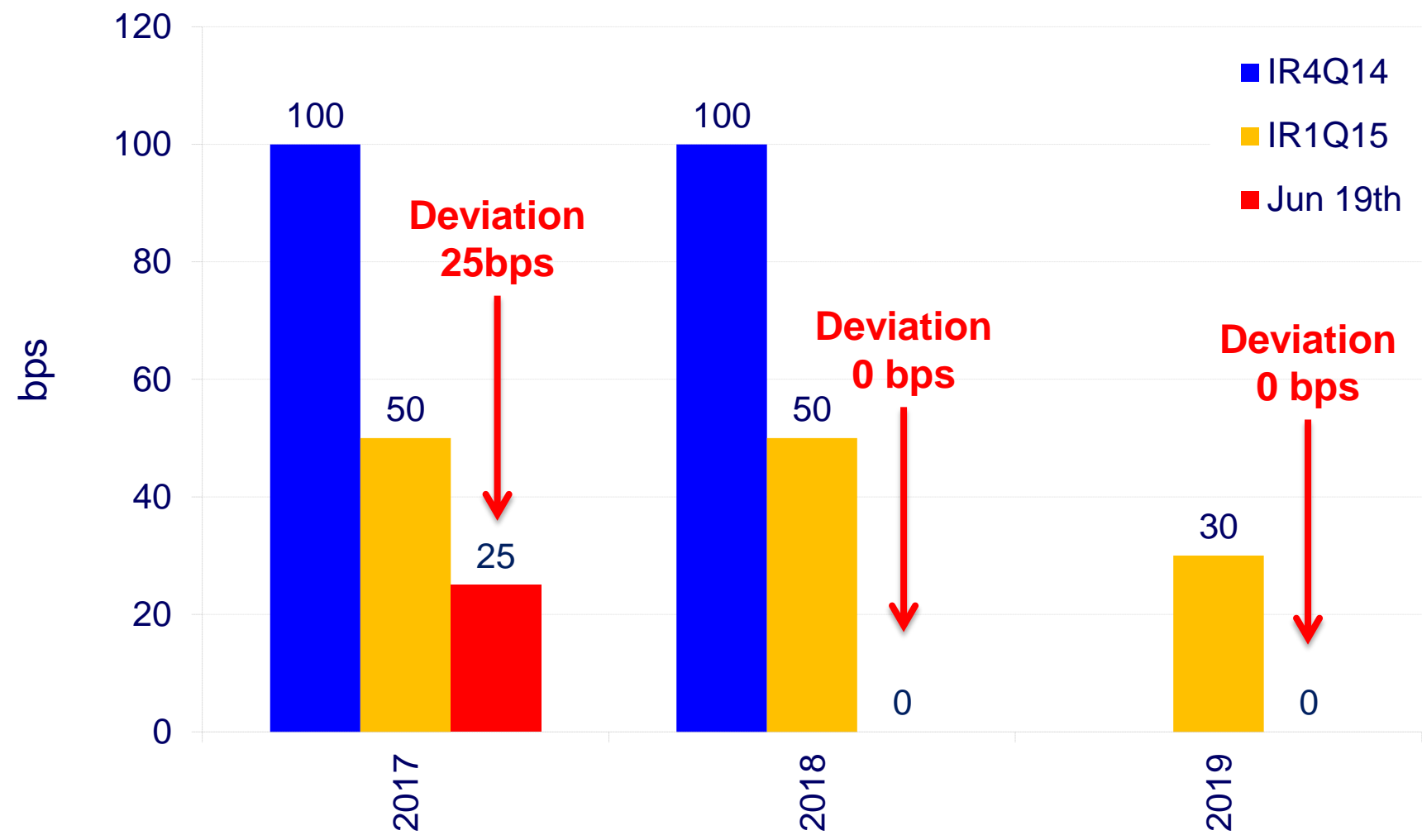
R\$/US\$ and DXY through June (6/19), REER through May *median of expectations on 6/19 (end of period)

Price Adjustments Impact 2015 Inflation

- The double relative prices adjustment (regulated and external) impacted inflation in 1Q 2015, increasing 12-month accumulated inflation
- The objective of monetary policy is to avoid this impact to be transmitted to 2016 and beyond
- Monetary policy can and should contain the second-round effects, to circumscribe them to 2015
- For this reason, monetary policy should remain vigilant to ensure the convergence of inflation to the 4.5% target at the end of 2016

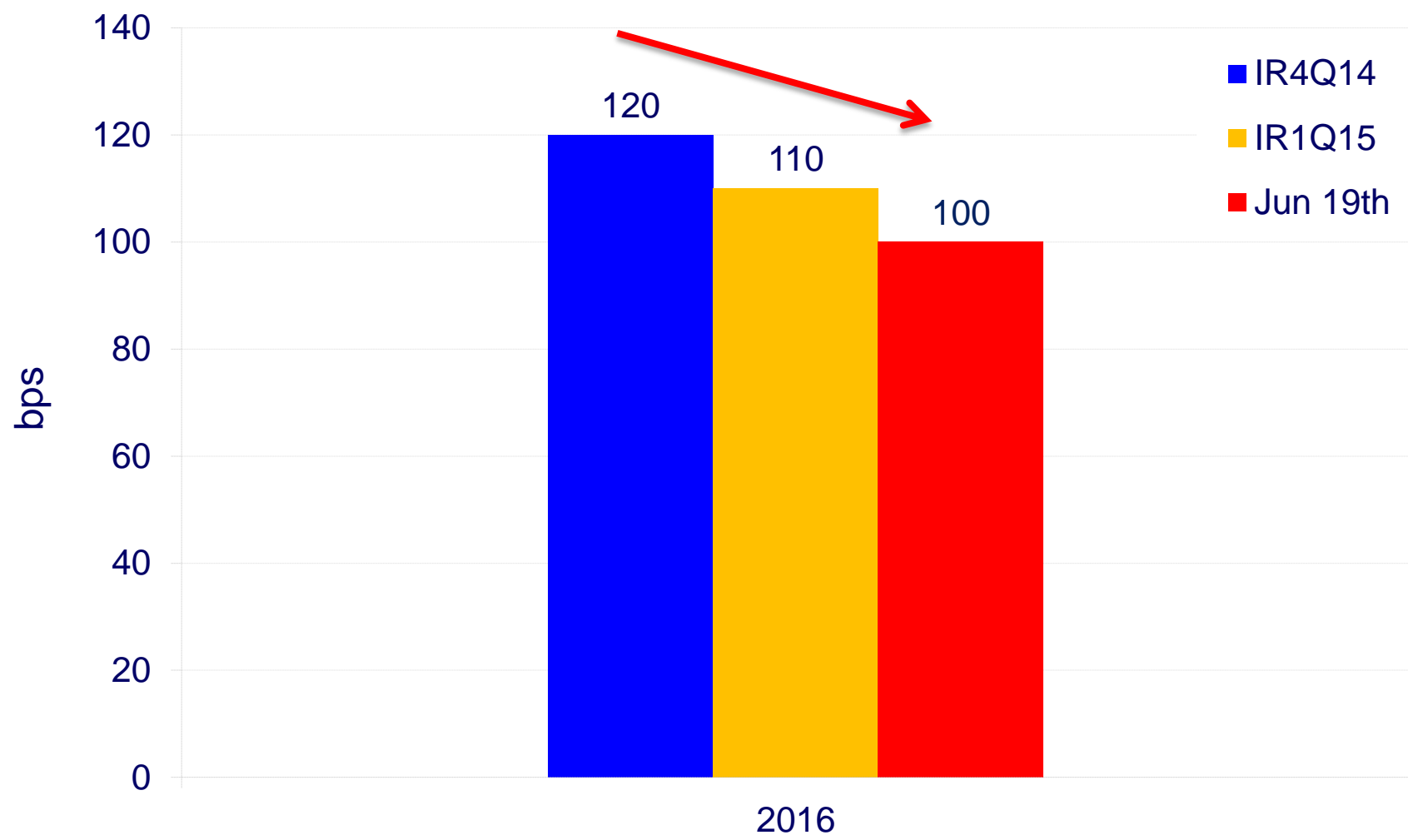
Market Expectations Deviation in Relation to 4.5%

In the Medium-Long Term (2017,2018 and 2019): Anchorage



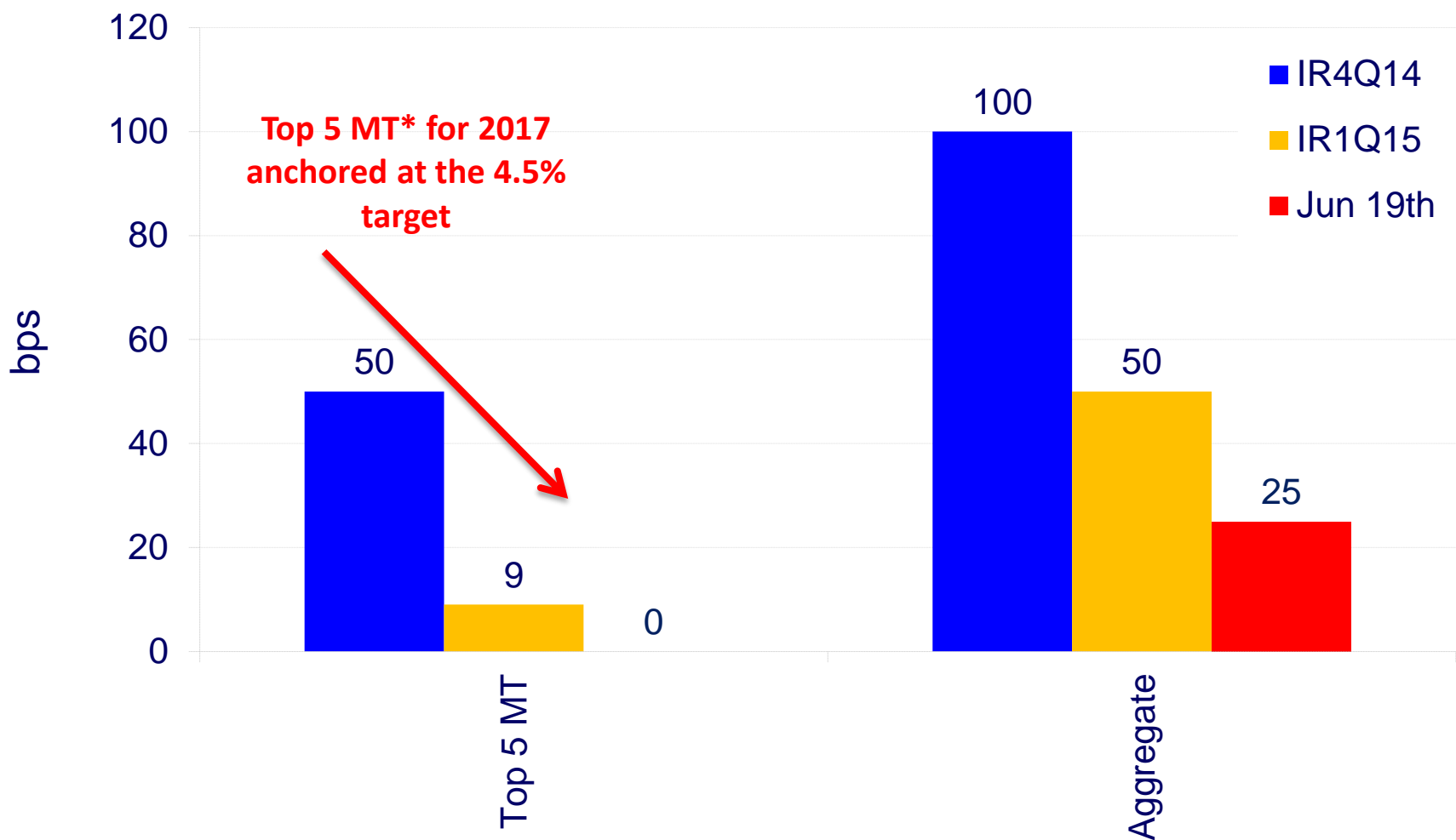
Market Expectations Deviation in Relation to the Target

In the Short Term (2016): Progress has not been enough yet



Market Expectations Deviation in Relation to 4.5%

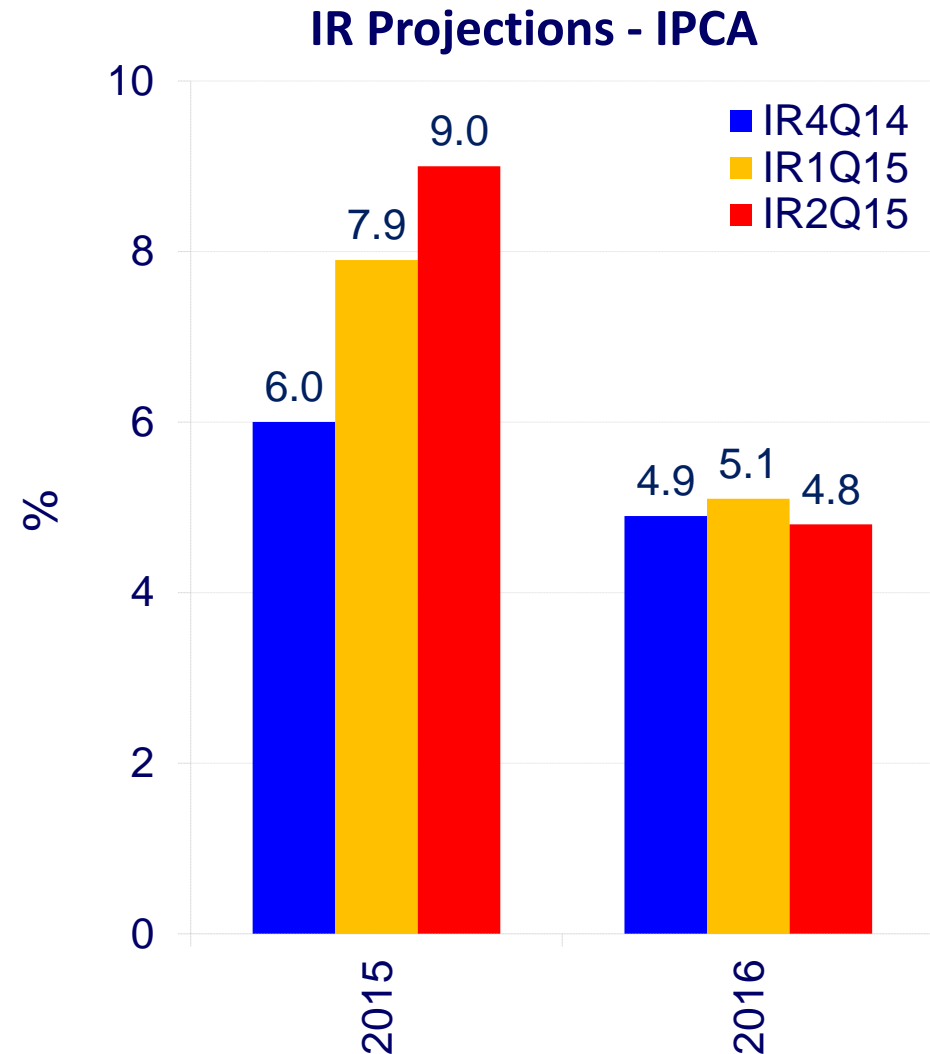
Inflation Expectation for 2017: Top 5 x Aggregate



*Median of expectations of the Top 5 institutions (Medium Term ranking)

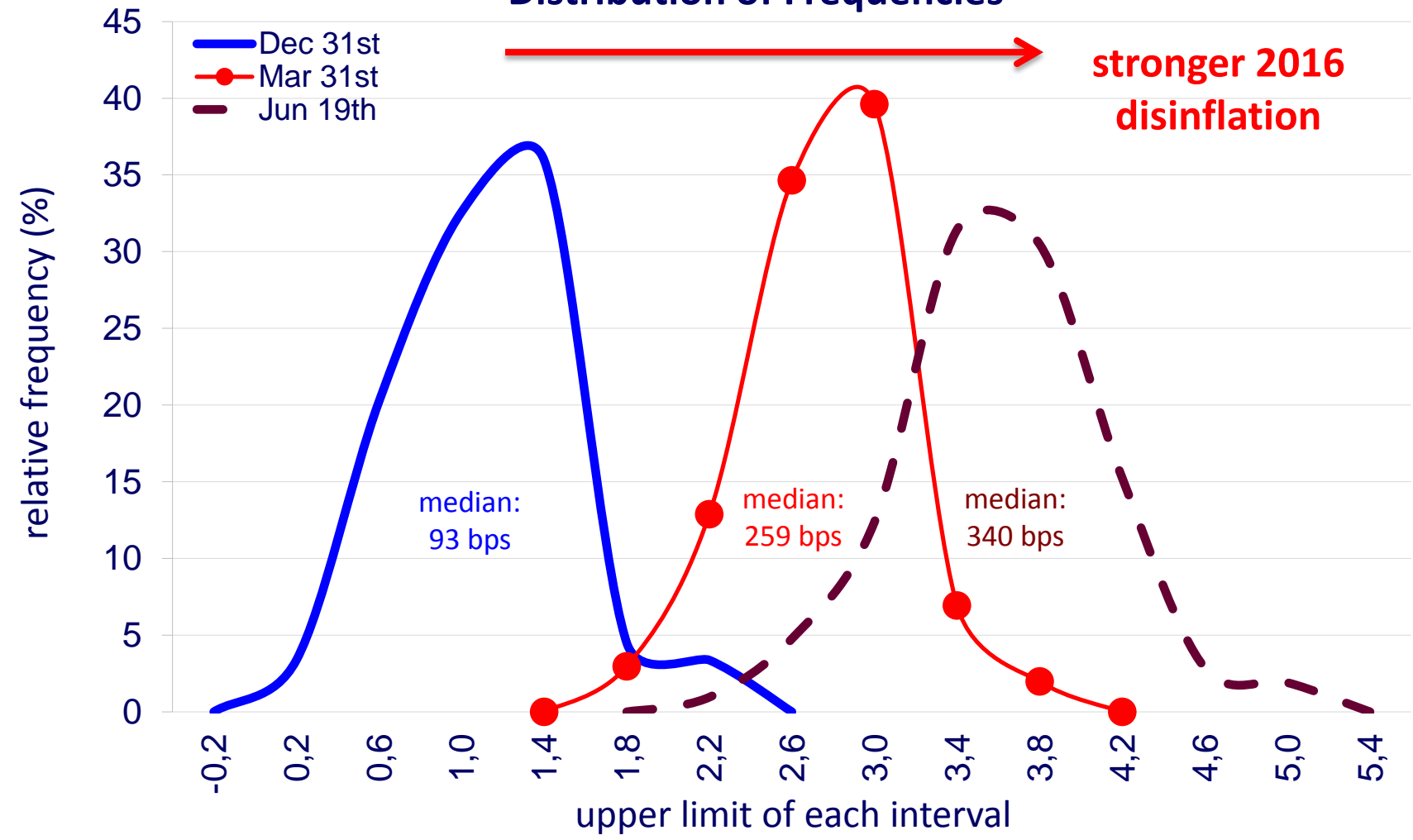
Inflation Report Projections for Inflation

- Inflation projections show stability for 2016, despite the increase for 2015



Distribution of 2016 vs. 2015 Disinflation

Differences between 2015 and 2016 IPCA Expectations (Focus)
Distribution of Frequencies



Convergence to the Short and Medium-Long Terms

Annual IPCA inflation expectations (Focus median)

	2015	2016	2017	2018	2019
Jan 2nd	6.56	5.70	5.50	5.50	5.00*
Jun 19th	8.97	5.50	4.75	4.50	4.50
change	2.41 p.p.	-0.20 p.p.	-0.75 p.p.	-1.00 p.p.	-1.00 p.p.

Intensification of the relative prices adjustment

Macroeconomic policy acting in the medium and long term expectations

*on Jan 12th, first available data

Risk Balance for 2016 Inflation (1)

- Impact of price realignments to be circumscribed to 2015; the path of 12-month accumulated inflation will have significant reduction in the 1Q 2016
- Transmission of relative prices adjustment happens with the beginning of labor market distension
- Decrease of intensity of the adjustment passthrough in the current cycle phase
- Fiscal Policy contributes for containing demand
- Moderation of credit and reduction of subsidies

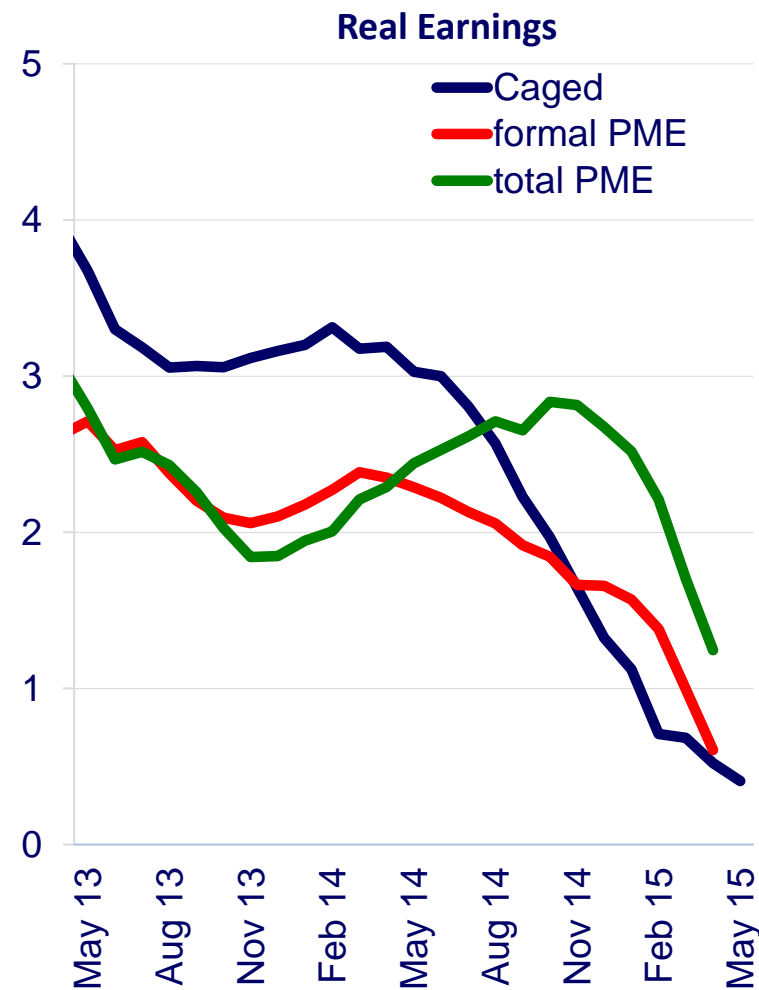
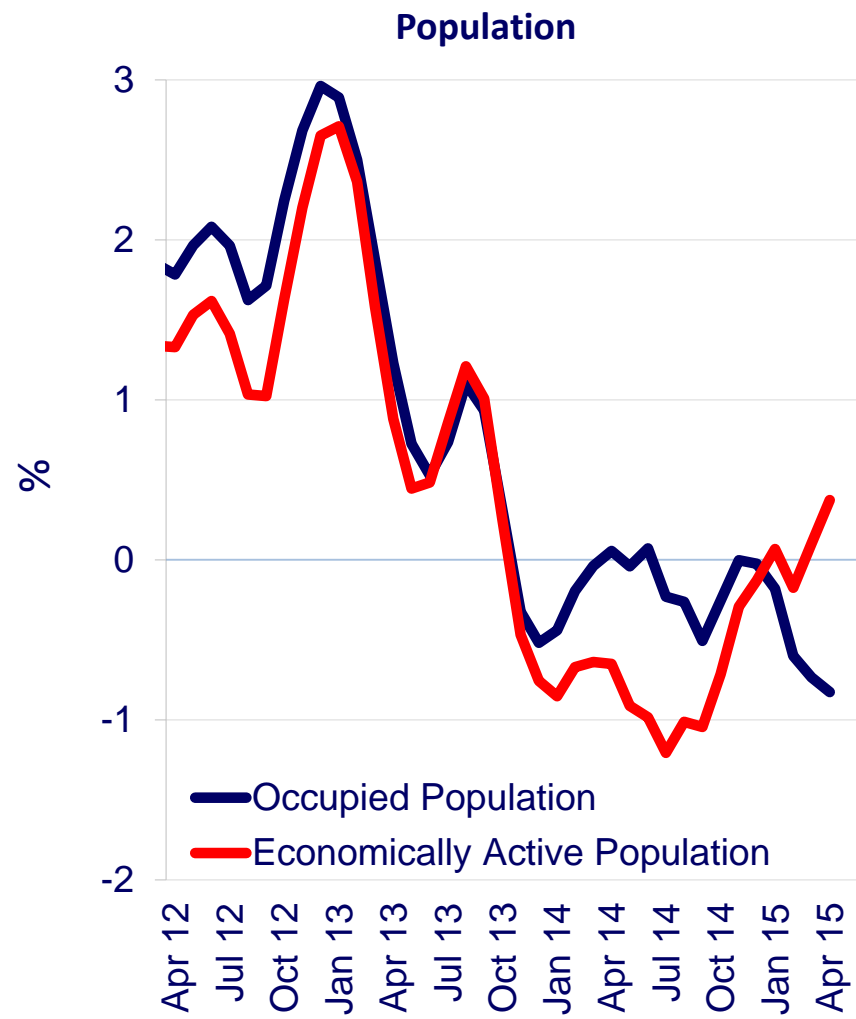
Risk Balance for 2016 Inflation (2)

Beginning of Labor Market Distension

- Process in progress is normal; adjustments may occur as a combination of quantity and price
- Return of young and aged people tends to contribute for increasing productivity in the services sector
- Higher competition may favor adequation of wages and productivity; higher return on “years of education” creates incentives to improve human capital and productivity

Labor Market: Signs of Distension

Internannual change of the 3-month moving average



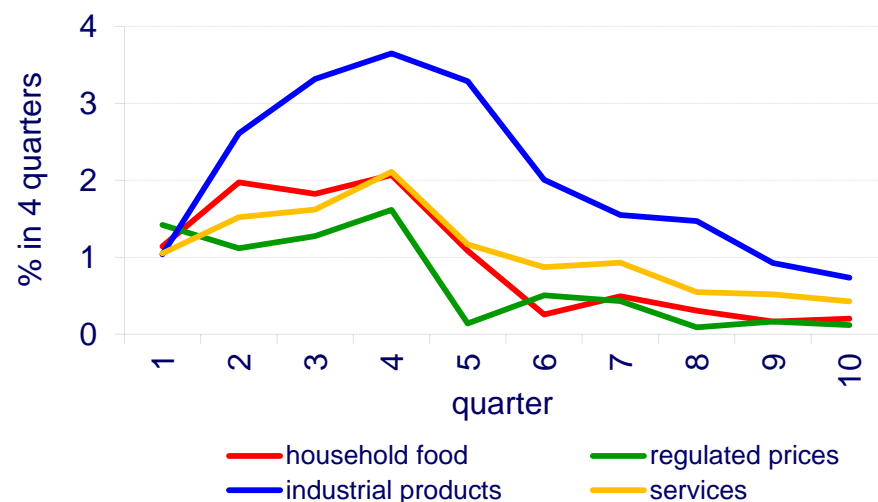
Caged: through May 2015; PME: through April 2015

Boxes: Inflation Persistence and Models Revision

Inflation Persistence from Sectoral Shocks

- Seeks to identify the existence of differentiated behavior in the inflation propagation stemming from specific sectors
- The results indicate differences in inflation dynamics, with higher inflation spillover in the industrial products and lower for regulated prices, suggesting lesser degree of persistence for headline inflation this year

Response of Headline Inflation to Shocks in Different Sectors*



* Shocks with 1 p.p. effect in headline IPCA

2015 is a Year of Standard Macroeconomic Adjustment

- 1st phase: adjustment impacts quantities (e.g., activity); non-economics events are overlapping in the process; strong fall in investment attenuated output gap widening
- 2nd phase: adjustment impacts prices (e.g., inflation); recent inflation resilience is overlapping in the process
- 3rd phase: better results signal a horizon of stability for the agents (inflation at the 4.5% target, anchored in the short, medium and long terms)
- Consolidation of adjustment process requires determination and perseverance

Situation in 2016 Should Be of Resumption

- After the 3rd phase, the reduction of imbalances improves fundamentals and perception: increases agents confidence, favors their planning and “animal spirit” of investors
- Adjustments contribute to change demand composition and to favor investment, which increases potential output and productivity
- Strong domestic market with “low hanging fruits”, and investment opportunities still present

Situation in 2016 Should Be of Resumption

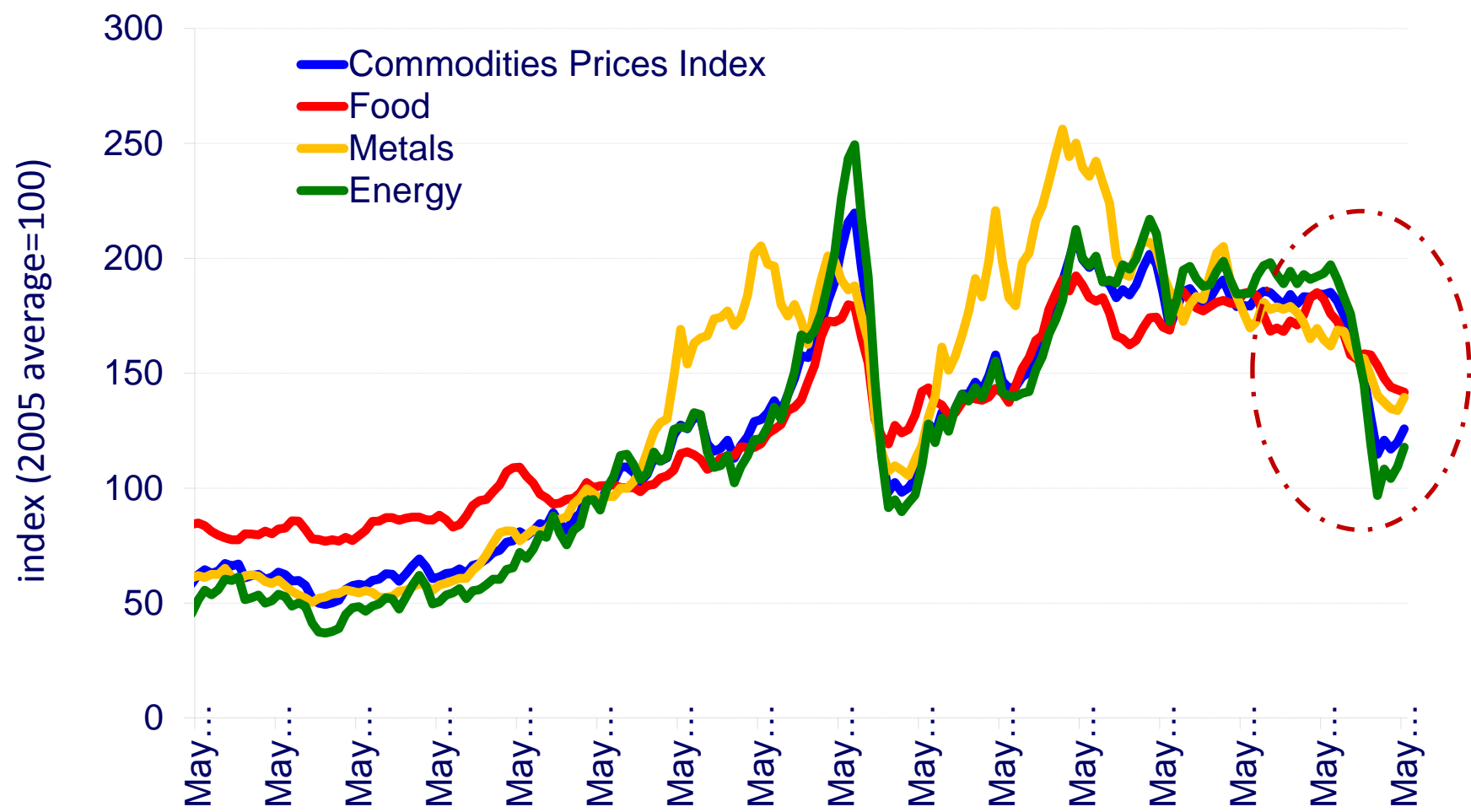
- Better contribution of monetary policy to this virtuous cycle and more growth is to bring inflation to the 4.5% target at the end of 2016 and to anchor expectations in the medium-long terms

II. International Environment

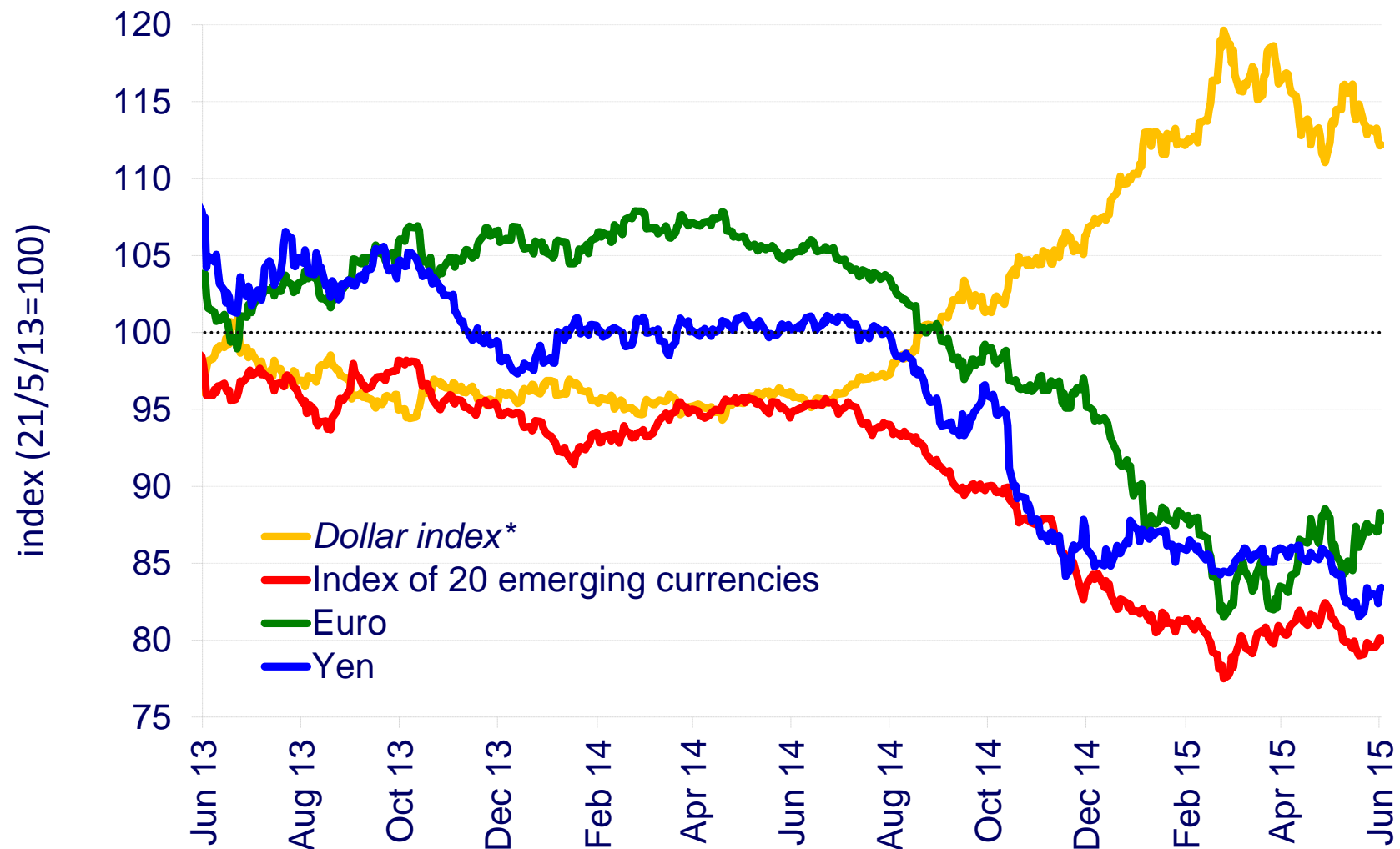
- Waiting for the interest rate normalization by the Fed; in this context, global strengthening of the dollar with improvement in the US; even with better preparation, volatility is possible**
- Process of commodities prices moderation; better environment and reduction of our current account deficit**

Falling Commodities Prices

Commodities Index and subindices calculated by the IMF



US Dollar Appreciation is a Trend (but there is Vol)



Data through June 19th; *dollar index: measures the international value of the dollar against basket of the six main reserve currencies in the world (Swiss franc, Canadian dollar, Japanese yen, pound sterling, euro and Swedish kron)

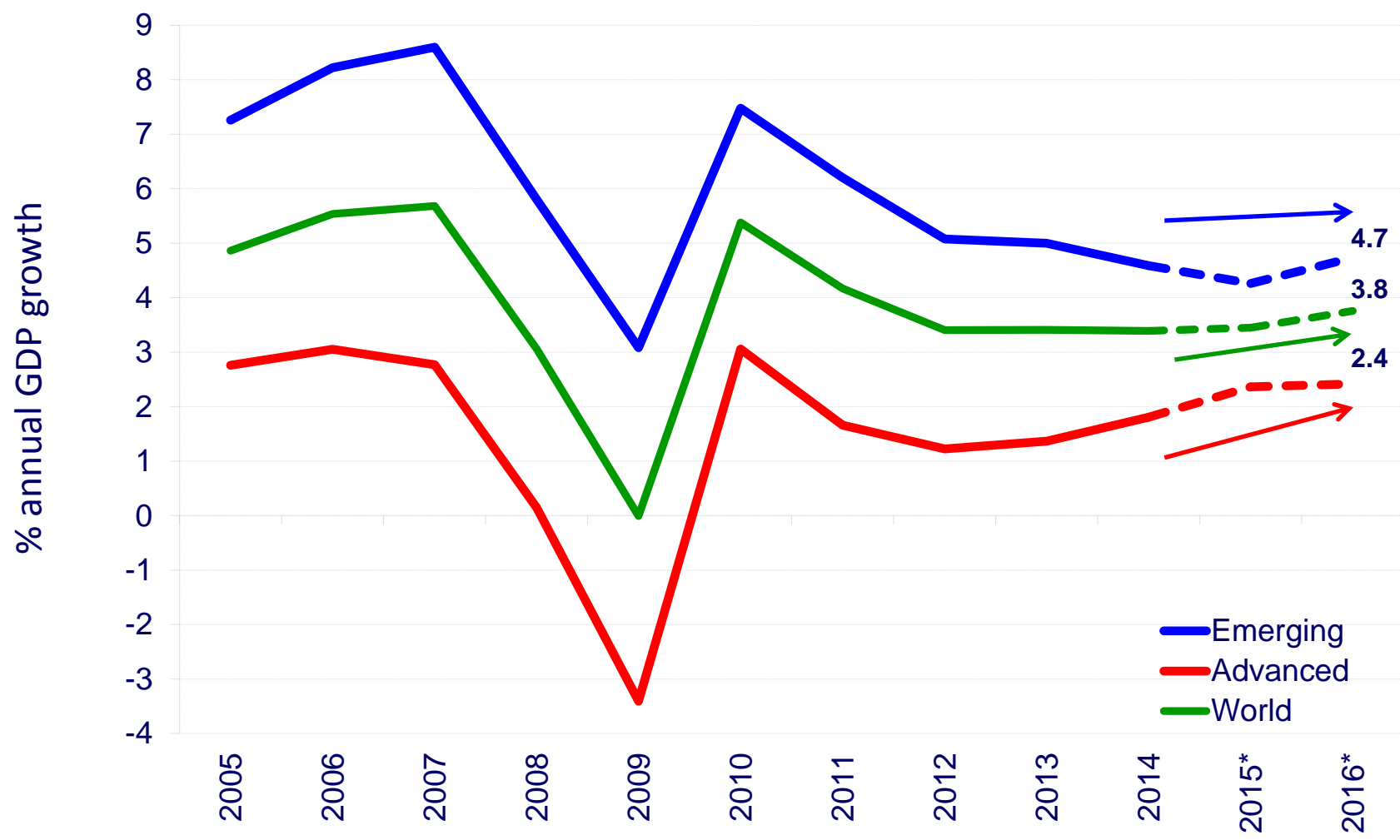
Retrospective – Abroad (since 1Q 2015)

- Risk aversion at low level, with episodes of volatility, (e.g., sovereign bonds of mature economies); possible currency volatility (e.g., dollar strengthening)
- With the uneven recovery process of the G3 economies, respective central banks undertook asymmetrical monetary policy actions
- Risks for global financial stability still tend to remain high

Prospects – Abroad 2015-2016

- Throughout the relevant horizon for the monetary policy, prospects for more intense global activity pace (e.g., improvement in the US, QE in Europe and in Japan)
- Tendency to reduction of oil and commodities prices suggests contained global inflation in 2015 and 2016; in spite of a recent advance of metal and energy commodities prices, reduction in the segment of agricultural products

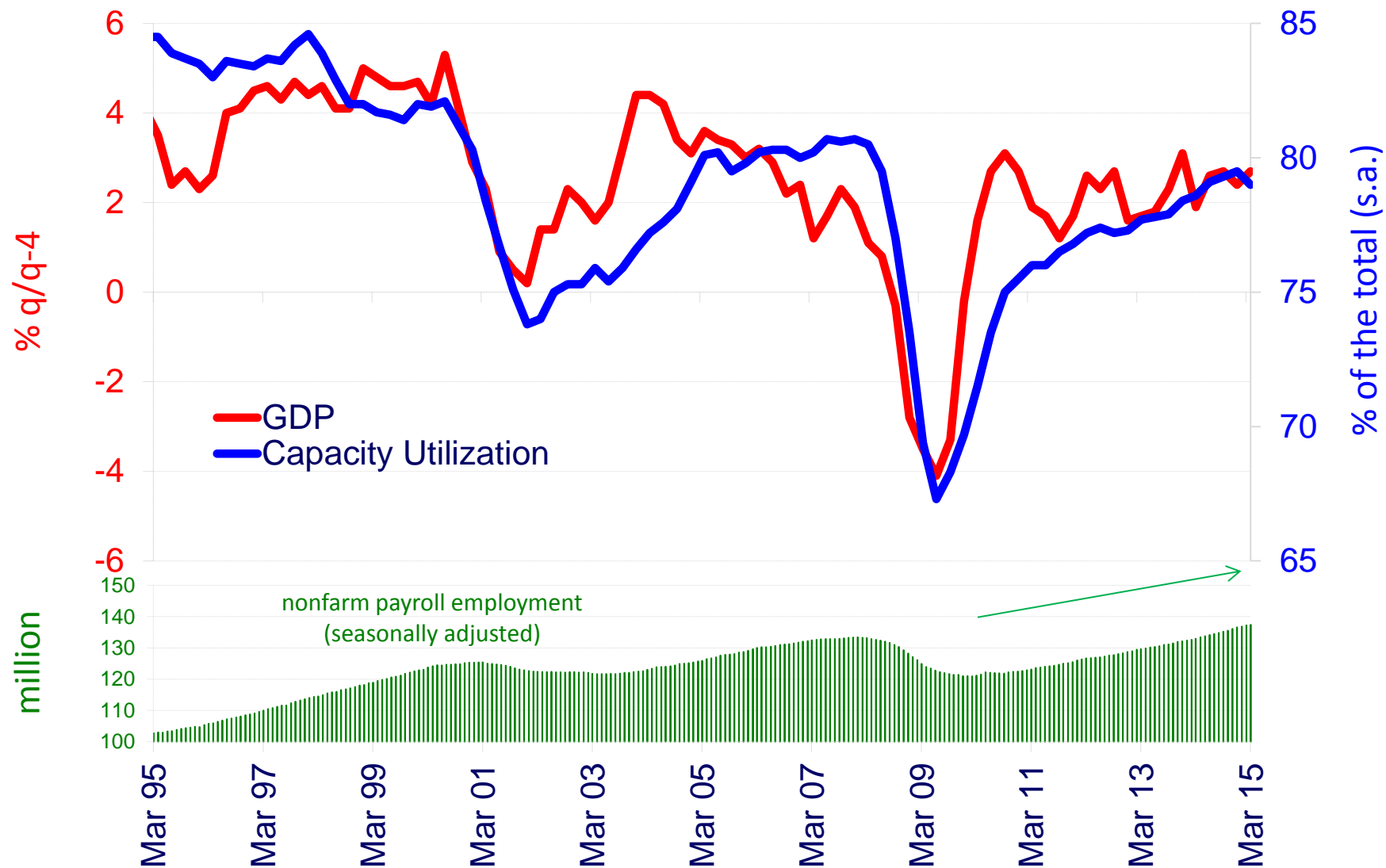
Global Economy in Gradual Recovery



*estimates

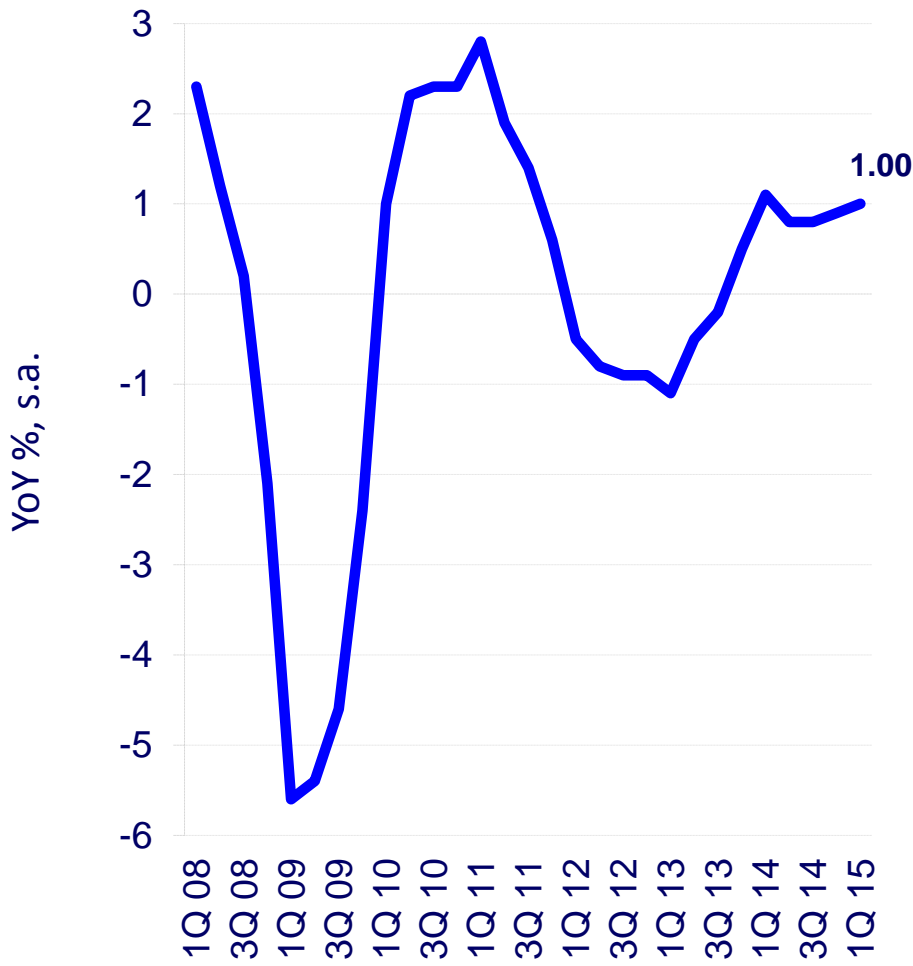
Source: IMF (WEO Update, April 2015)

Economic Recovery in the US

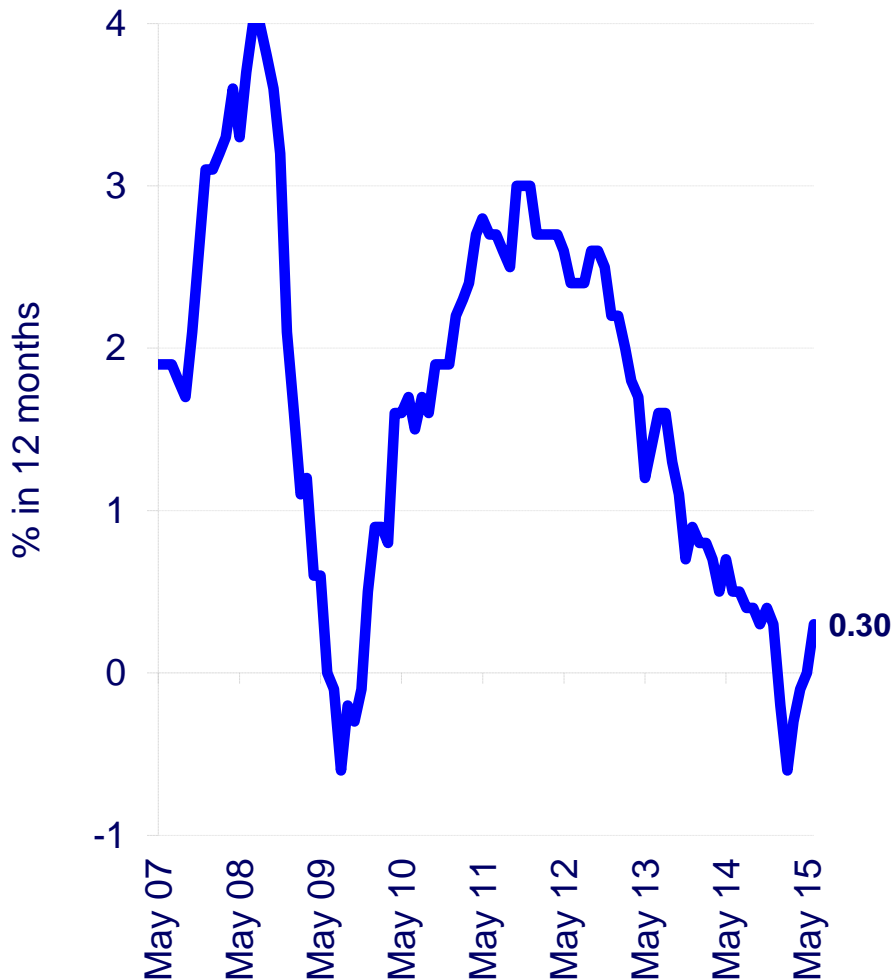


Europe – Growth and Inflation

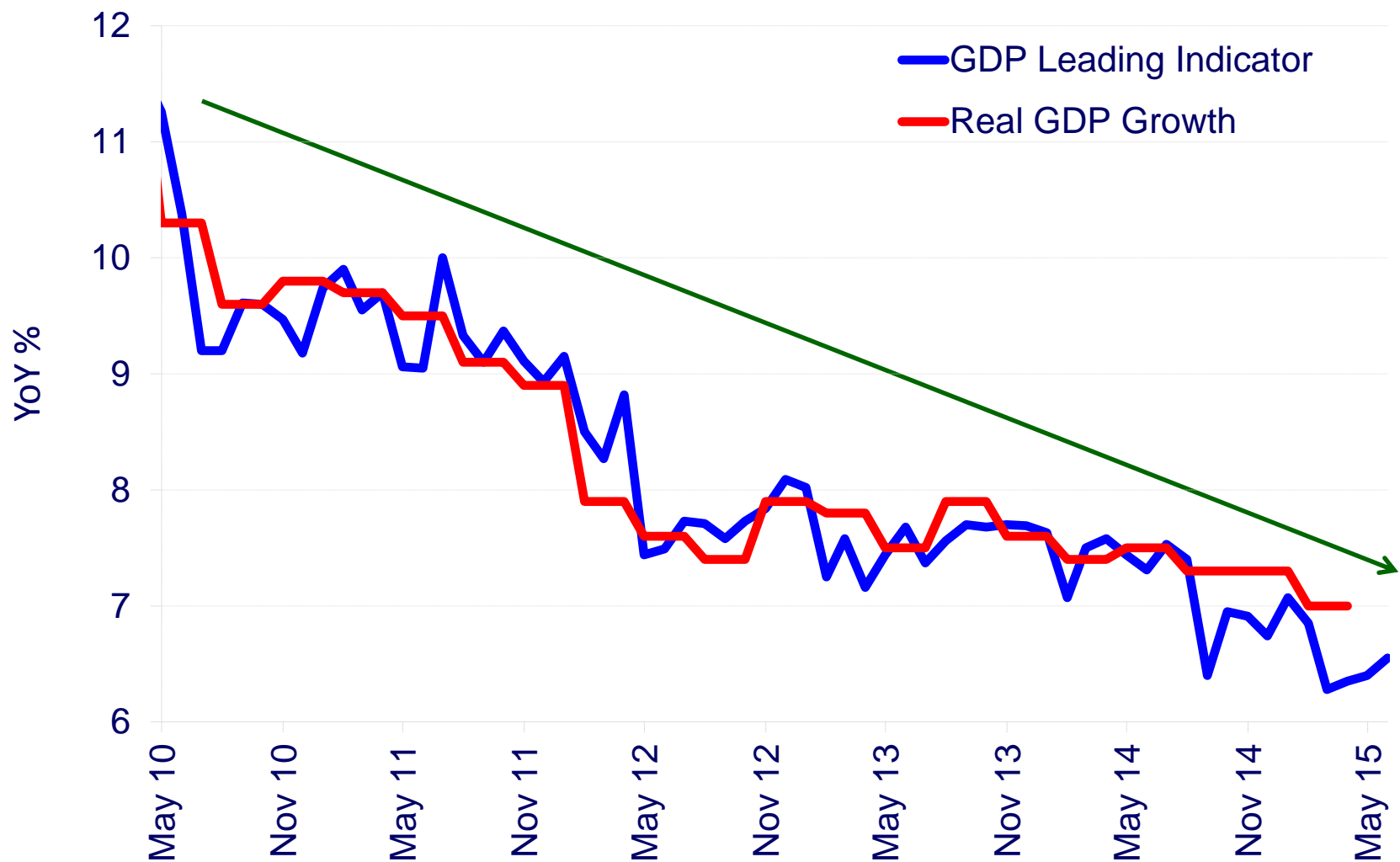
GDP Growth – Euro Area



Consumer Inflation – Euro Area



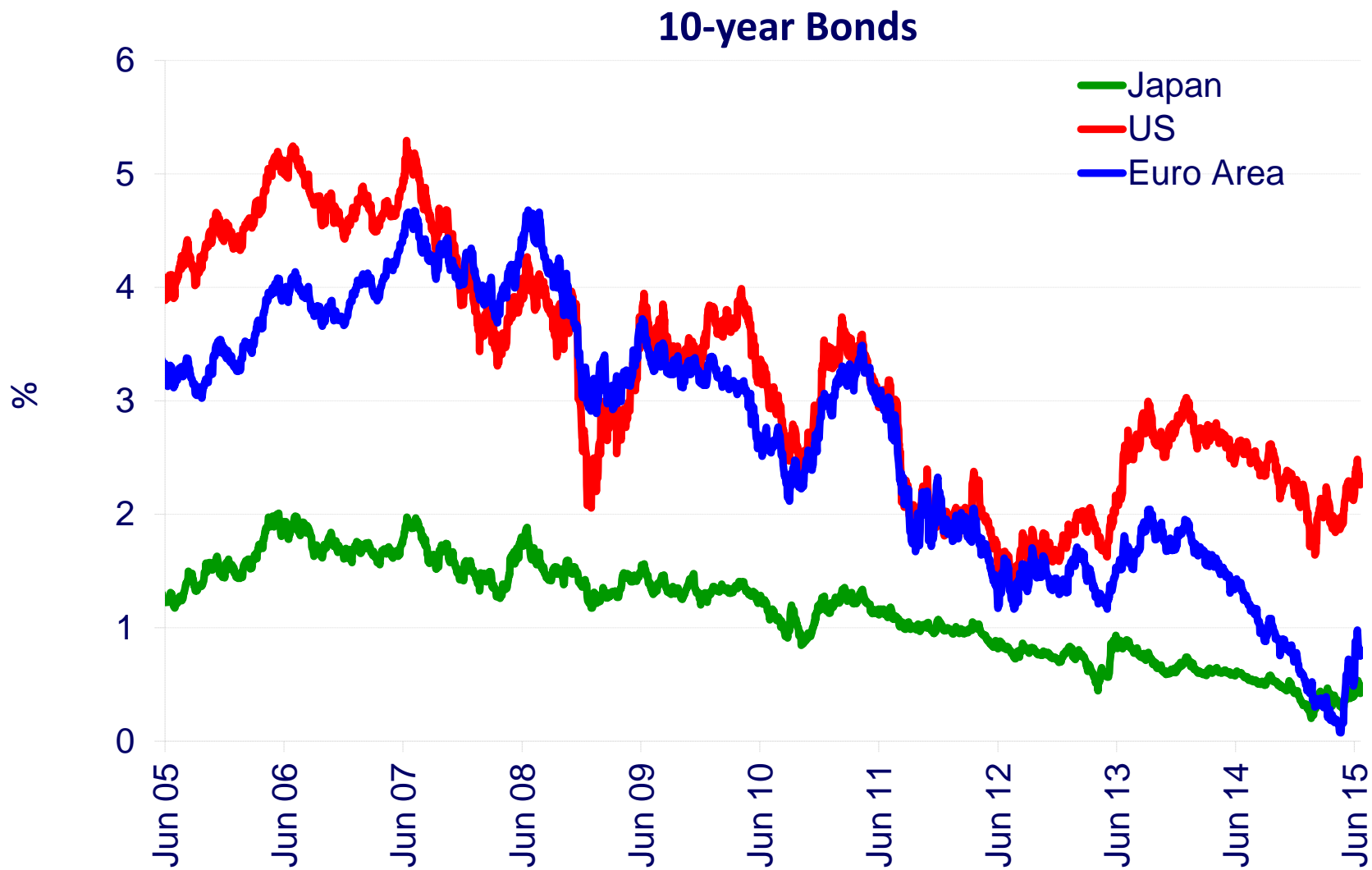
China – Gradual Deceleration



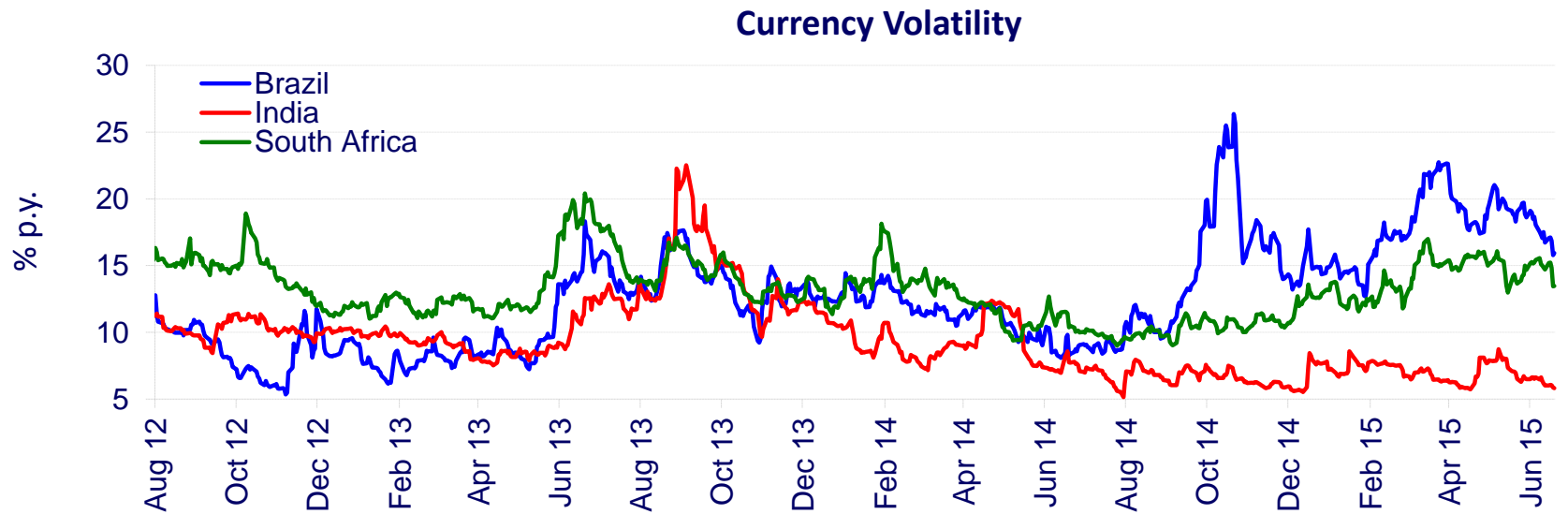
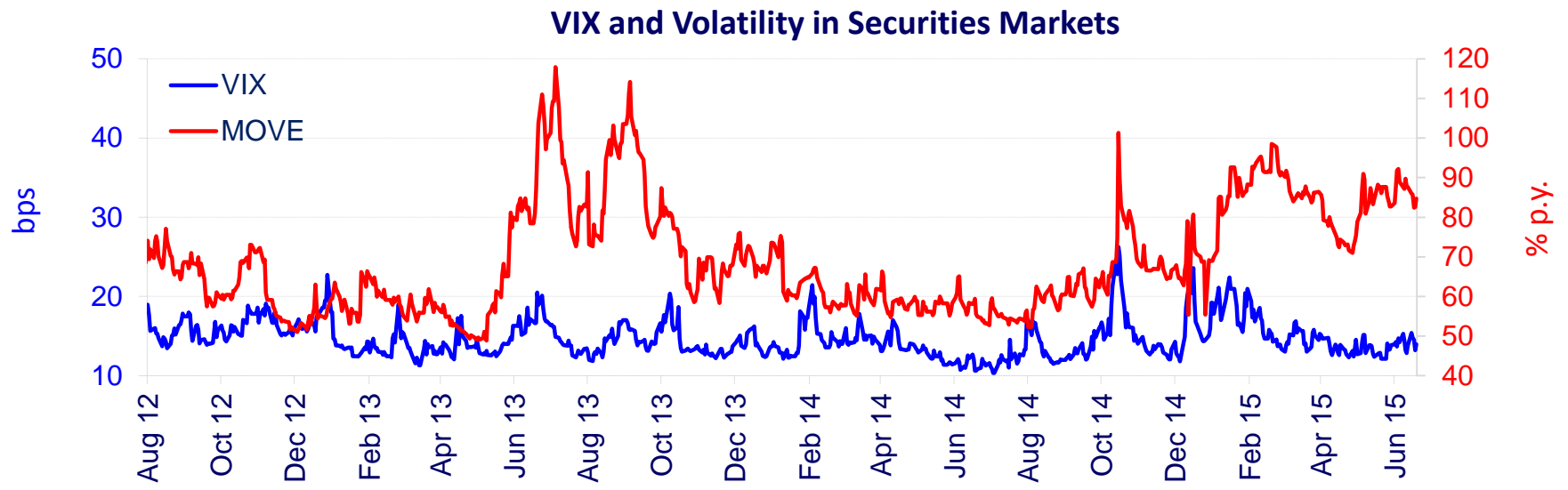
Box: G3 Monetary Policy

- Advanced economies in different positions in the economic cycle. US already consolidating the resumption of economic growth
- Deflation risks have increased since the 2nd half of 2014, particularly in the Euro Area and Japan; at the margin, this risk has decreased
- Monetary policies at distinct moments: Fed has already ended the Asset Purchase Program, ECB and BoJ in the midst of this process. Fed signals the likely beginning of tightening cycle in its benchmark rate
- Stronger growth in the US and prospects of higher fed fund rates favor the appreciation of the dollar. Dollar Index appreciated 18.4% between July 2014 and July 10, 2015
- Recent increases in 10-year bond yields in the US and Germany. But current stance of monetary policy in Europe and Japan tends to be a downward bias to the slope of the yield curve in the US

Divergence in Monetary Policy



Volatility



data up to June 19th

Box: Projections for the Balance of Payments

Revision for 2015 shows signs of ongoing improvement:

- The macroeconomic adjustment in progress allowed the current account deficit estimate reduction, from \$84 billion to \$81 billion (4.2% of GDP). In 2014, the current account deficit reached US\$ 104.8 billion (4.5% of GDP)
- The estimate maintains a US\$3 billion trade surplus, accompanied by further contraction in trade flows. Estimates for exports and imports were reduced in \$10 billion each to \$200 billion and \$197 billion respectively
- The decrease in the projected services account deficit was mainly due to lower expected expenses on trips (US\$ 1.5 billion reduction) and transport (US\$ 1 billion reduction)
- The profits and dividends projection was reduced by \$1.5 billion to \$21 billion, against \$31.2 billion in 2014
- In the financial account liabilities, direct investment estimates (\$80 billion) and rollover rate (100%) have been maintained, while the net inflow of stocks and investment funds was increased from \$13 billion to \$15 billion

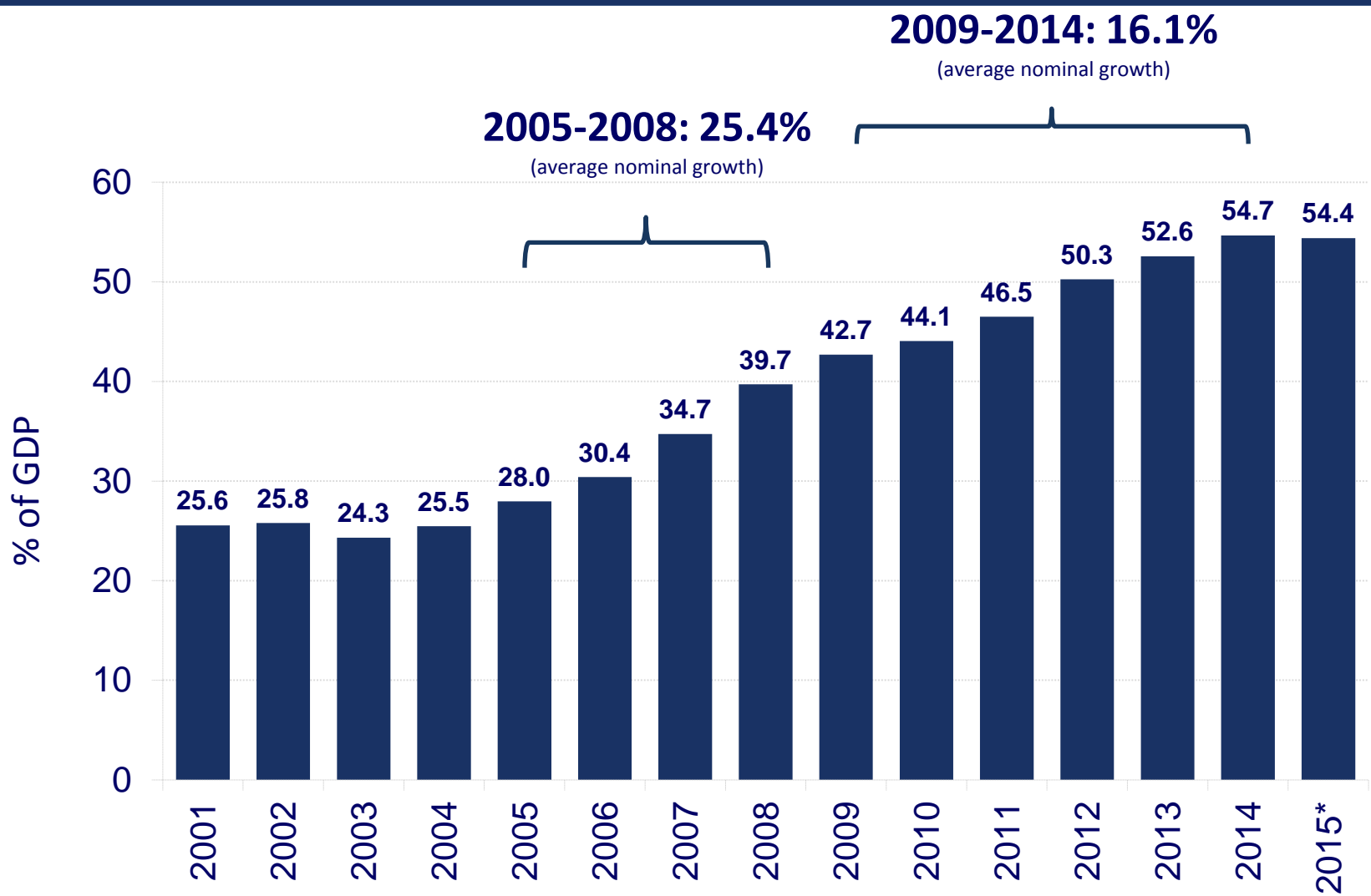
External Summary: Preparation for Fed Lift-Off

- Normalization is complex; Fed lift-off after tapering is the most expected, well announced and prepared event
- Perceptions about Brazil are evolving; positive effect of macroeconomic adjustment; no “perfect storm”; but, despite perception improvement, it is fundamental to continue the adjustment process
- We have to keep macroeconomics in order and stabilized for the lift-off; using standard receipt: reinforce monetary policy stance, keeping solid fundamentals

III. Financial Conditions

- **Moderation in the pace of credit concession consistent with adjustment and cycle**
- **Robustness and liquidity of the National Financial System remain and ensure financial stability**

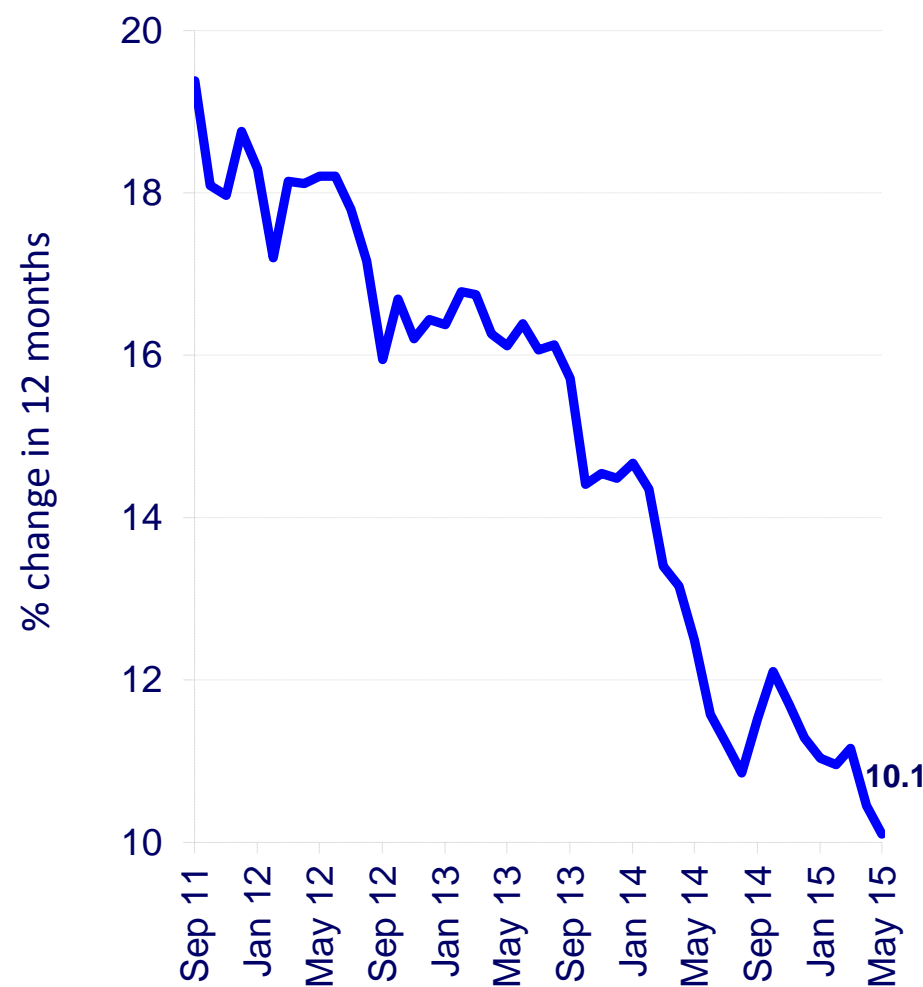
Credit/GDP Ratio



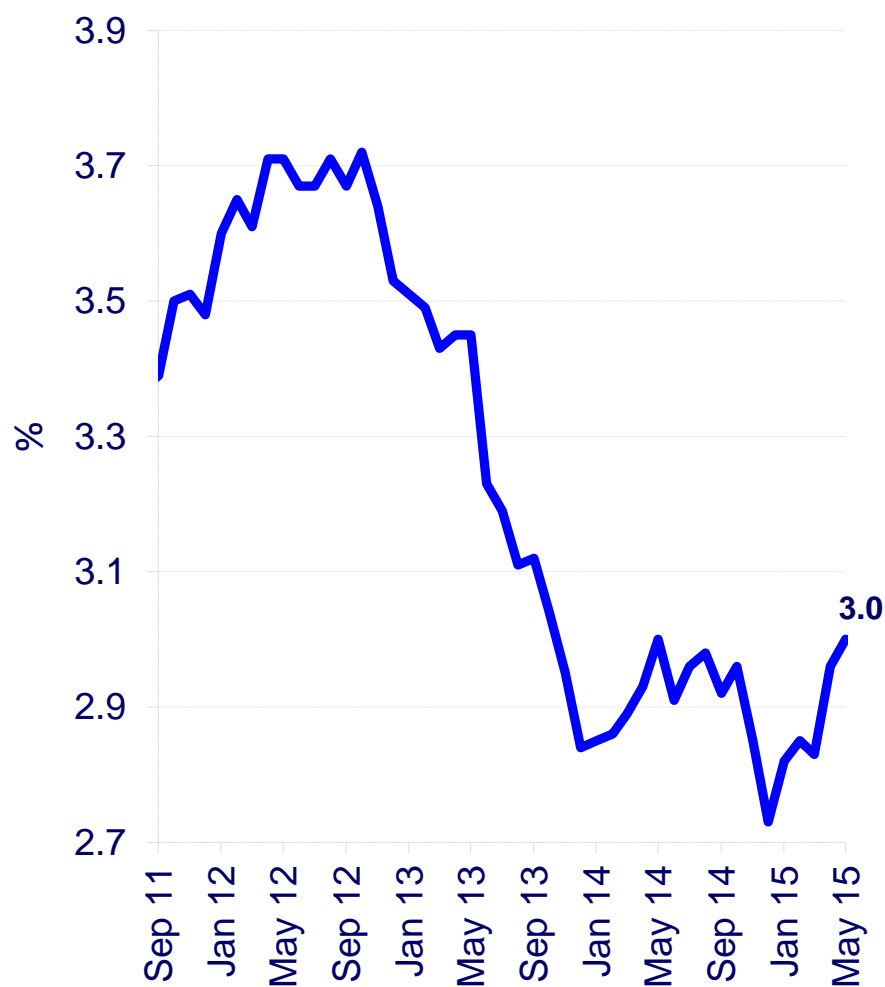
new methodology as of 2011; *May 15

Credit and Delinquency

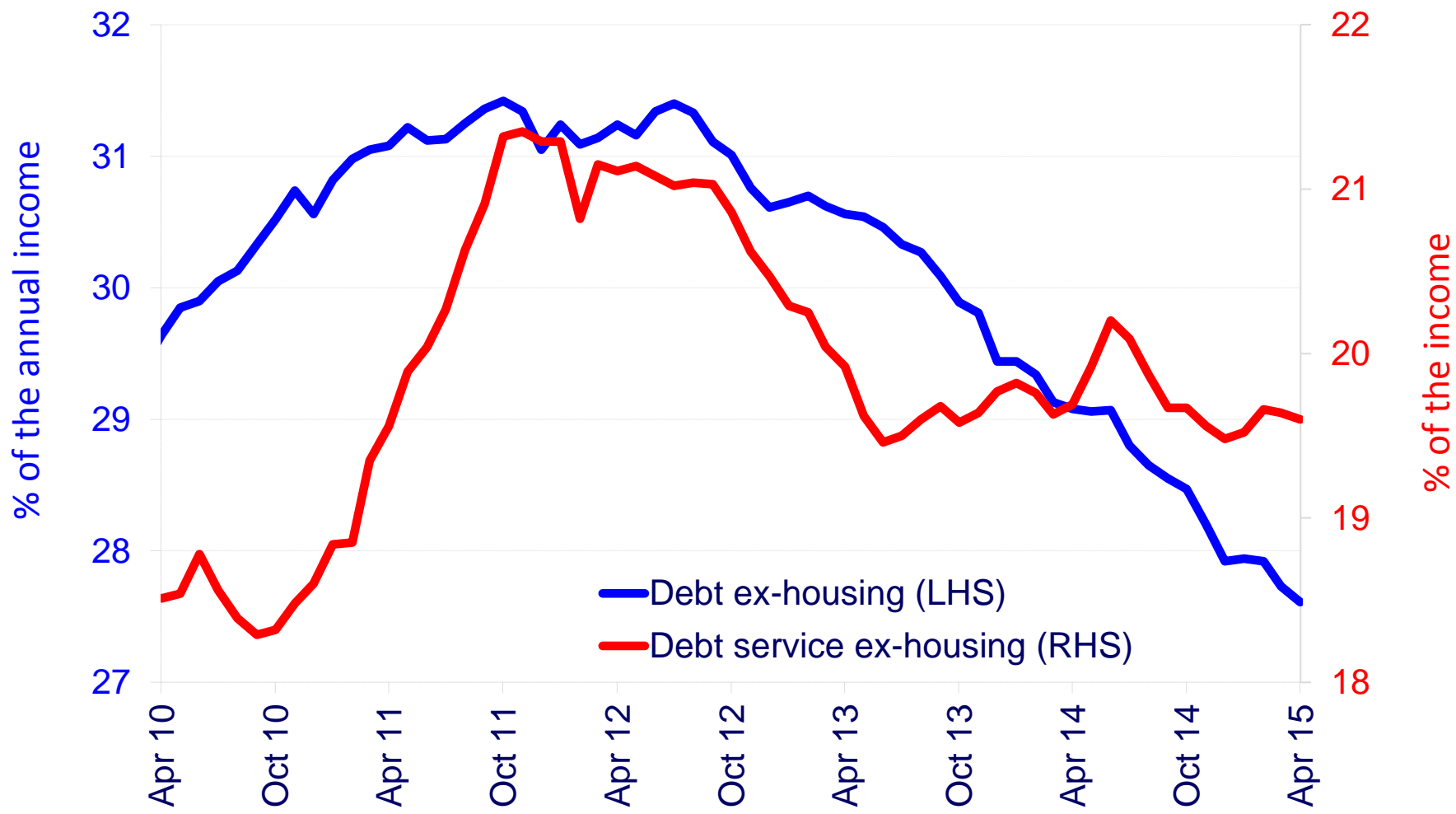
Expansion of Credit Outstanding



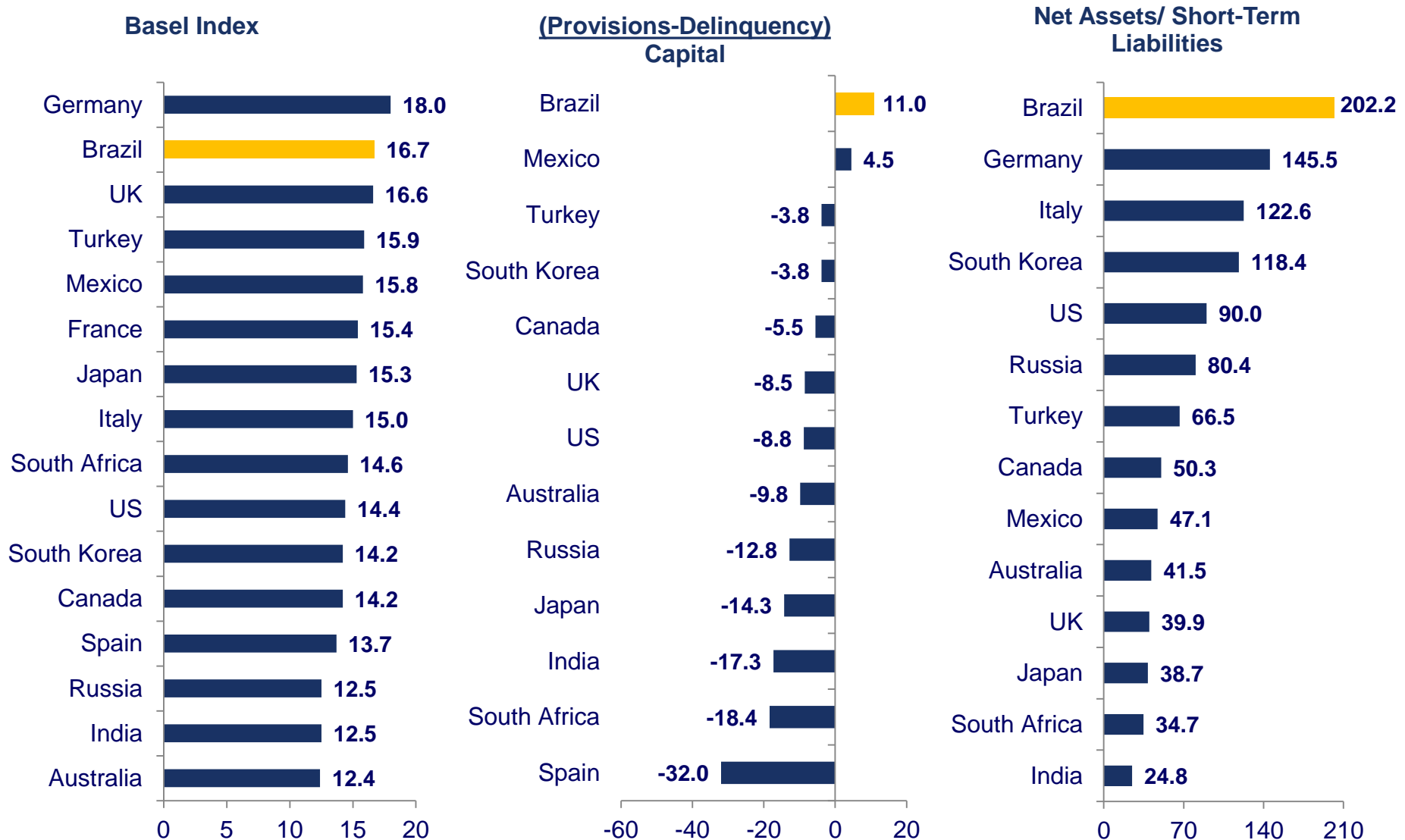
Delinquency



Declining Household's Debt



Financial Soundness Indicators

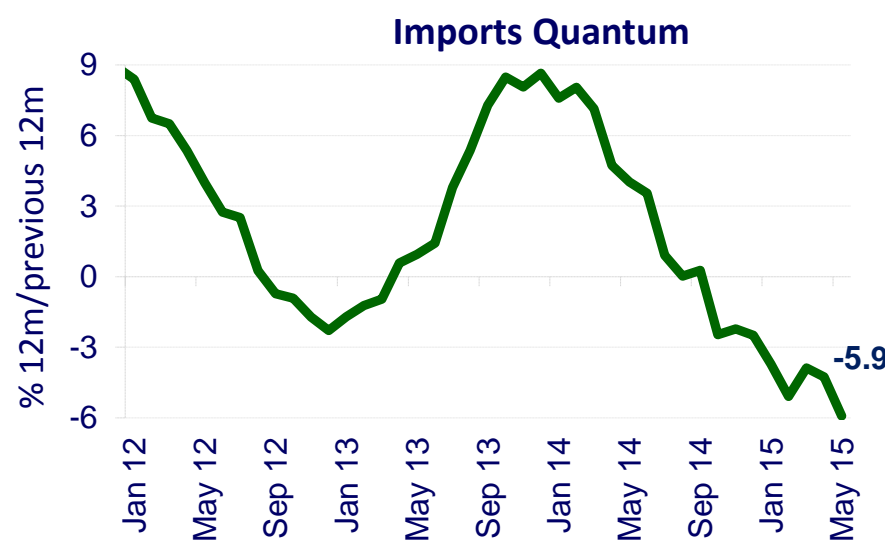
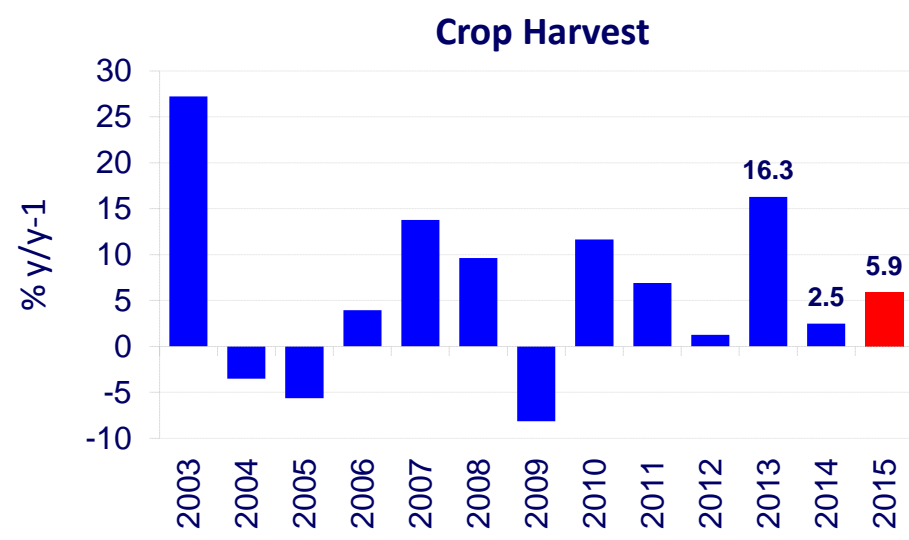
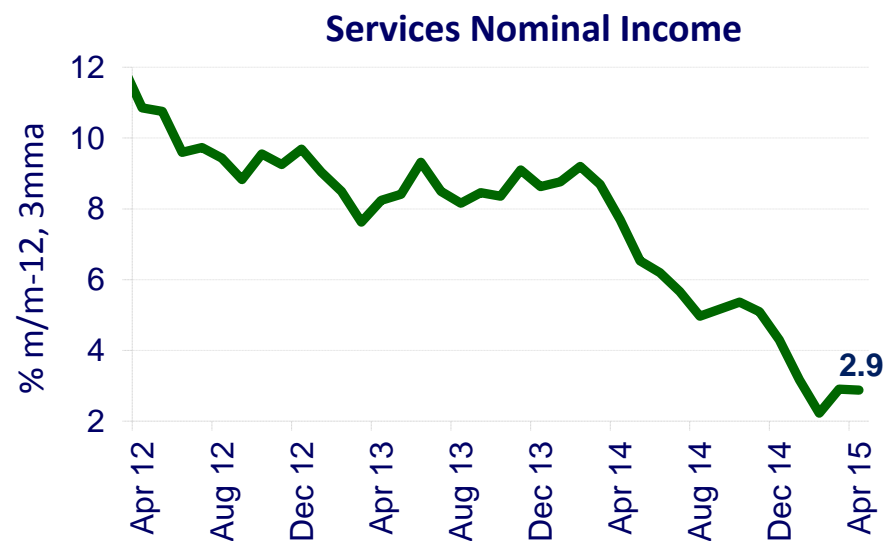
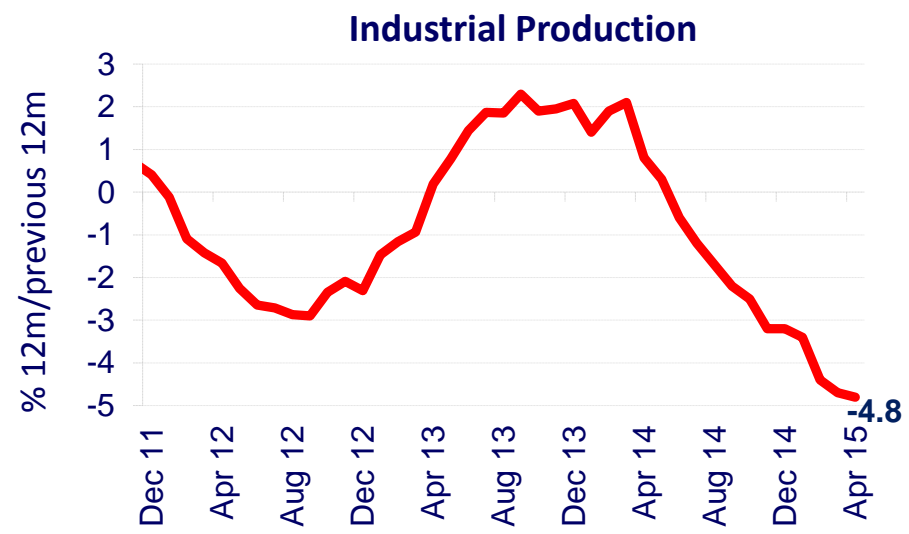


Source: IMF (FSI – last available data)

IV. Activity

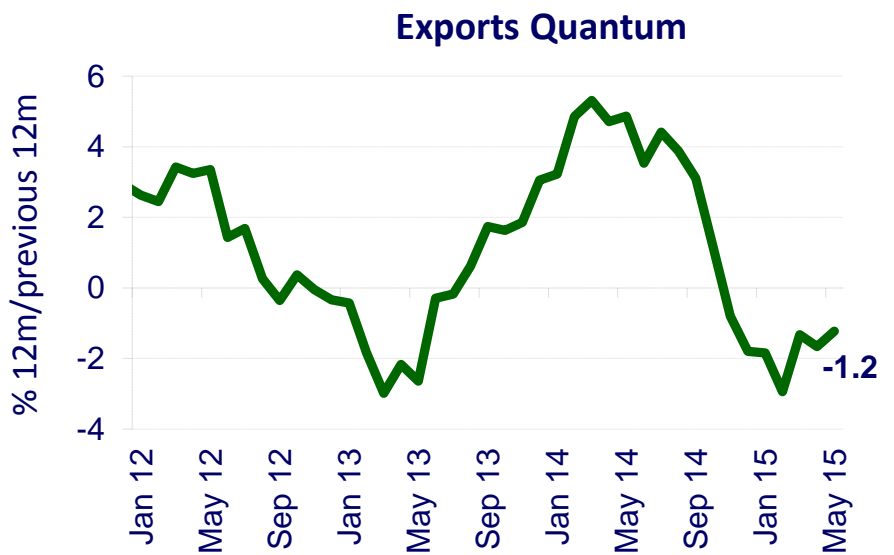
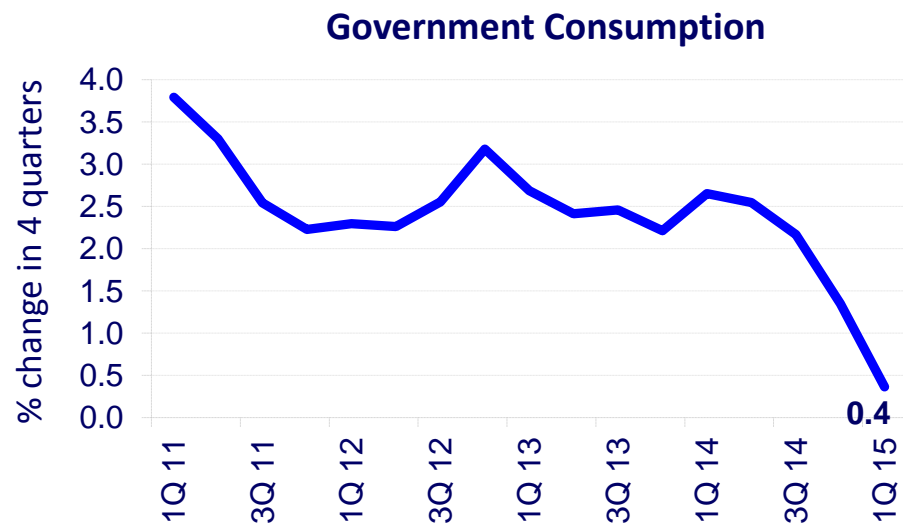
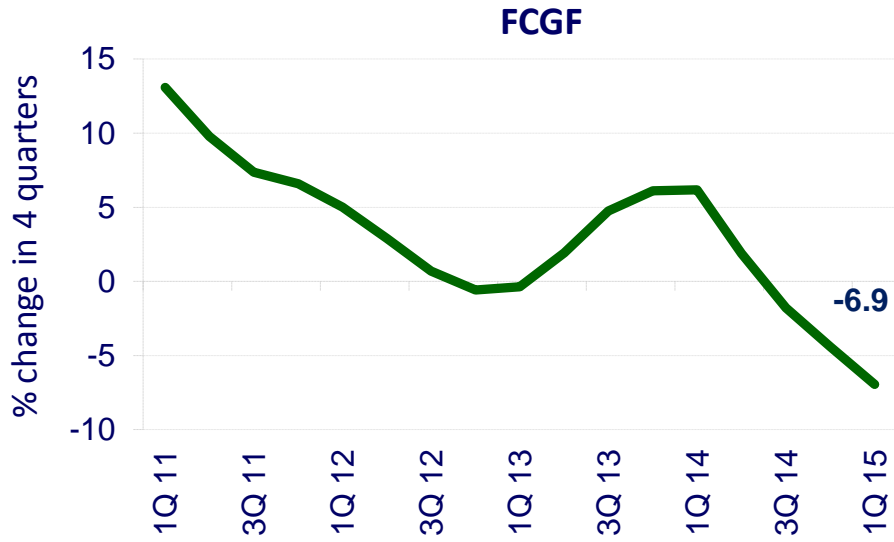
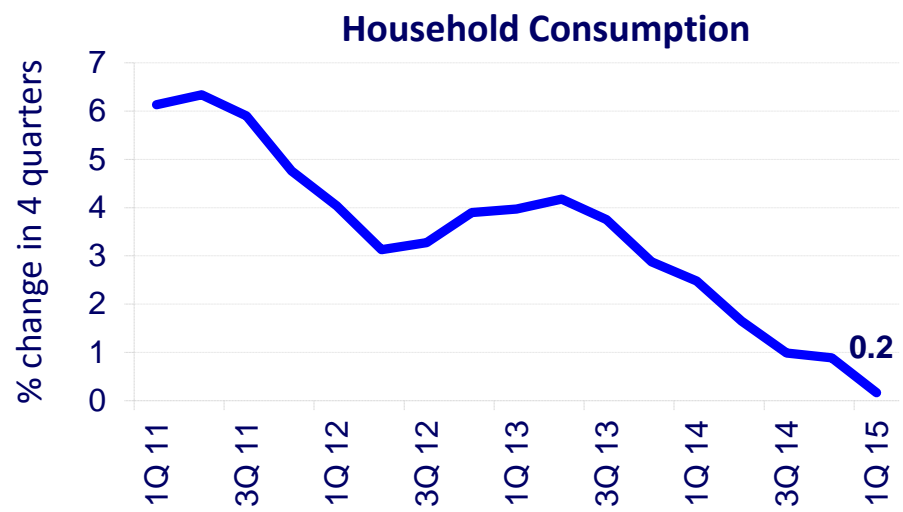
- **2015: a year of adjustment; impact on the activity and lower growth rates (below potential) are expected; non-economic events overlap the cycle**
- **Resumption after confidence improvement**

Supply: Lower Dynamism



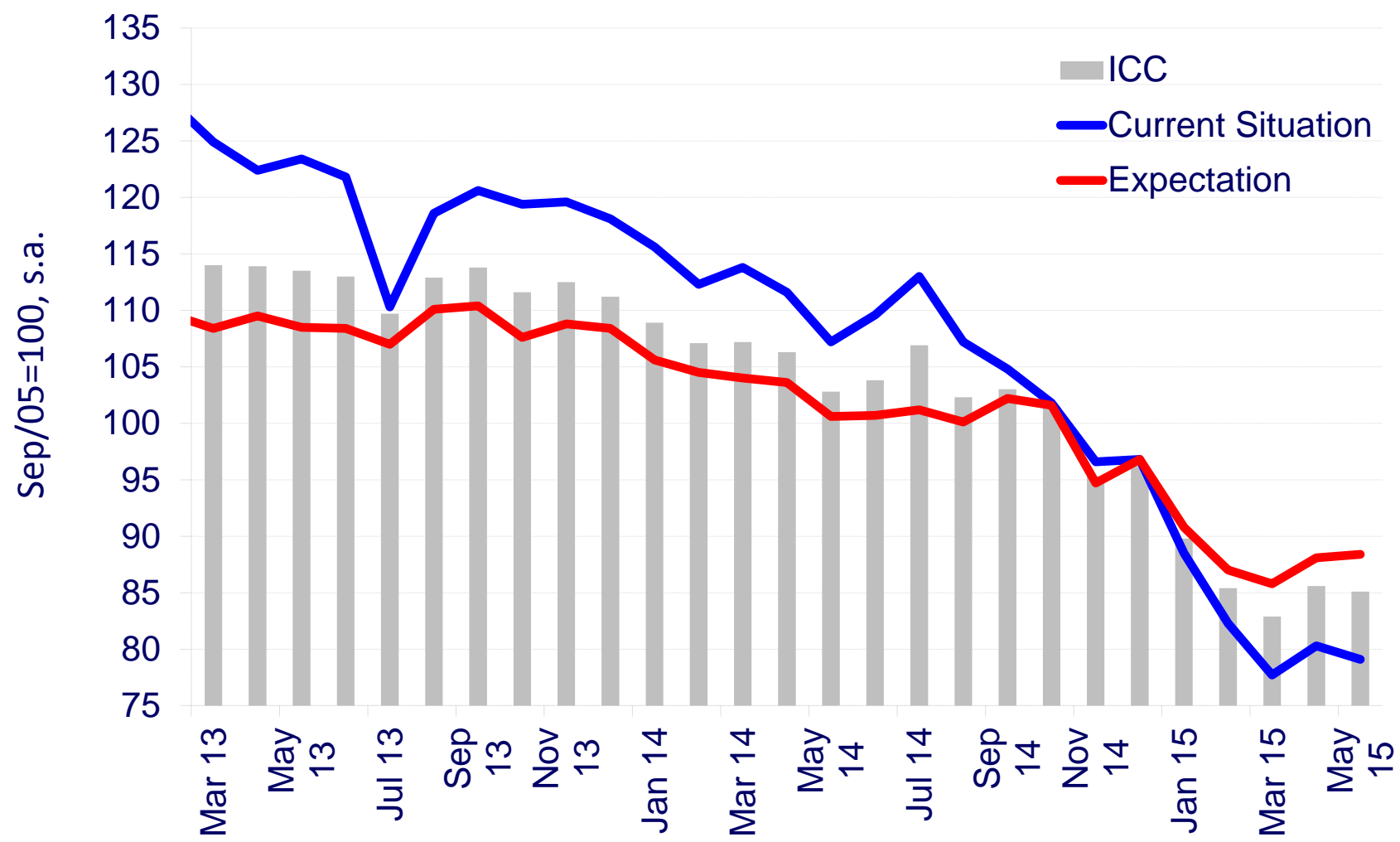
2015: IBGE estimates in May/15

Demand: Moderation in Line with Adjustment



Consumer Confidence: Stabilization of Decrease

Consumer Confidence Index



Note: Proportion of favorable answers – proportion of unfavorable answers + 100 (100=neutral)

Box: GDP Projection

- **Revision of the 2015 growth rate, from -0.5% to -1.1% (domestic demand, -2.6 p.p.; and net exports, +1.5 p.p.):**
- **Supply:**
 - Agriculture and livestock: 1.9% (0.6% in 1Q2015)
 - Industry: -3.0% (-2.5% in 1Q2015)
 - Services: -0.8% (-0.2% in 1Q2015)
- **Demand:**
 - Investments: -7.0% (-6.9% in 1Q2015)
 - Households' Consumption: -0.5% (0.2% in 1Q2015)
 - Government Consumption: -1.6% (0.4% in 1Q2015)
- **A 0.8% decrease in the four quarters ending in March 2016**

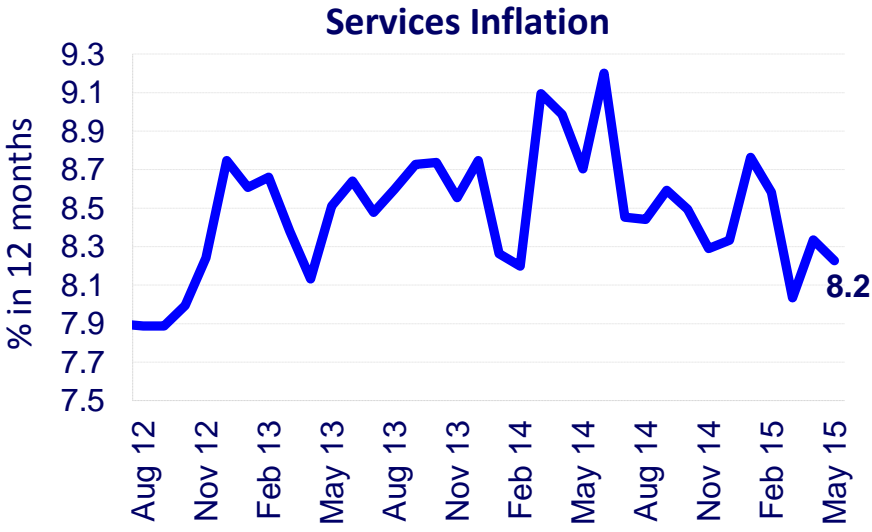
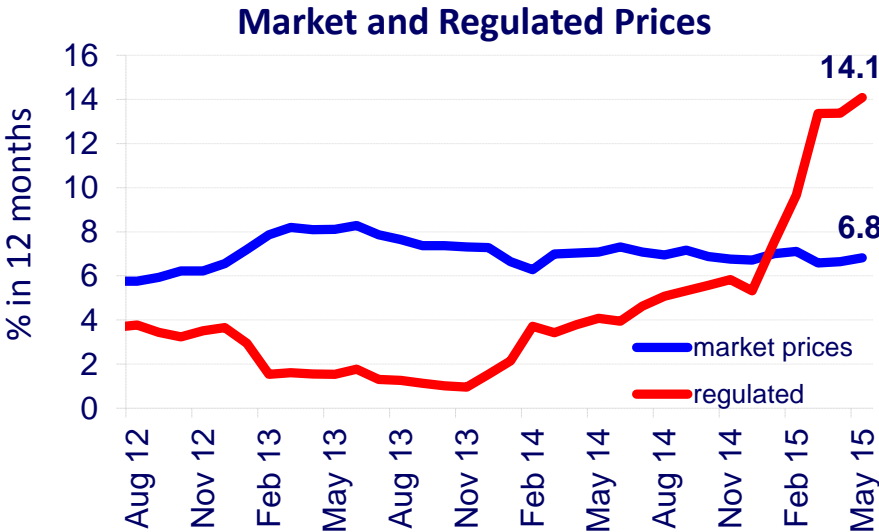
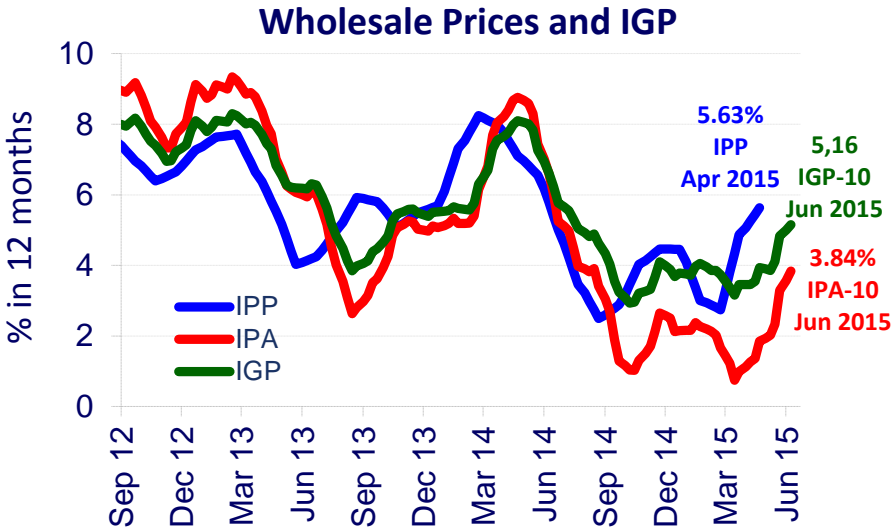
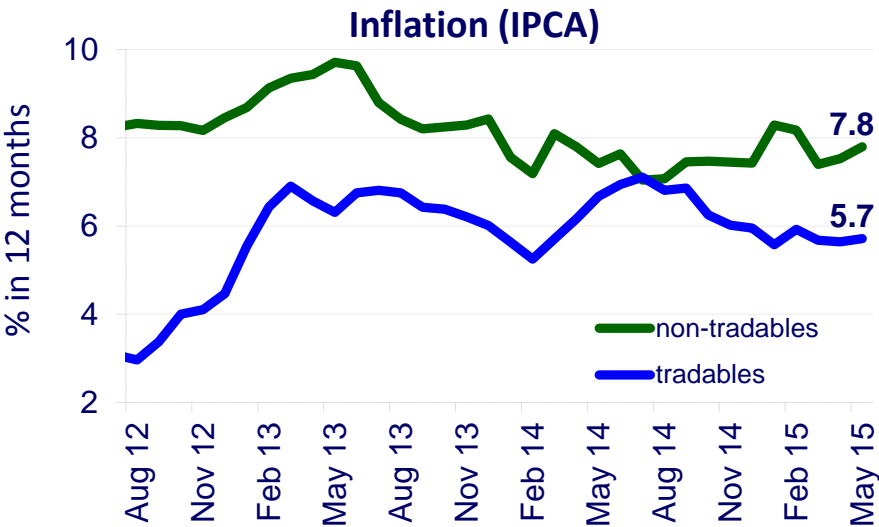
V. Inflation Developments

- The double relative prices adjustment (regulated and external) impacted inflation in the first half of 2015, increasing the 12-month accumulated inflation; the target is to avoid its transmission to 2016 and beyond
- Monetary policy can and should contain the second-round effects, to circumscribe them to 2015; so it must remain vigilant to ensure the convergence of inflation to the target of 4.5% at the end of 2016

Inflation Developments: Led by Regulated Prices

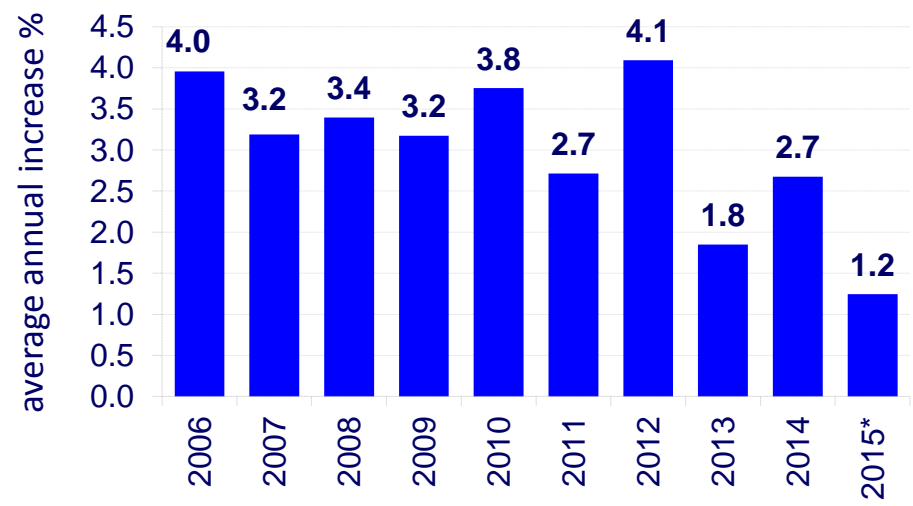
	change in 12 months (%)		
	May/14	May/15	
IPCA	6.37	8.47	▲
Market Prices	7.07	6.82	▼
Regulated	4.08	14.09	▲
Tradables	6.67	5.71	▼
Non-Tradables	7.42	7.79	▲
INPC	6.08	8.34	▲
IPC-C1	6.00	8.97	▲
IGP-DI	7.26	4.83	▼
IPA-DI	7.43	3.29	▼
Agricultural	9.32	2.75	▼
Industrial	6.73	3.50	▼
IPC-DI	6.57	8.63	▲
INCC-DI	7.75	5.74	▼

Prices: Slow Adjustment in Non-Tradables

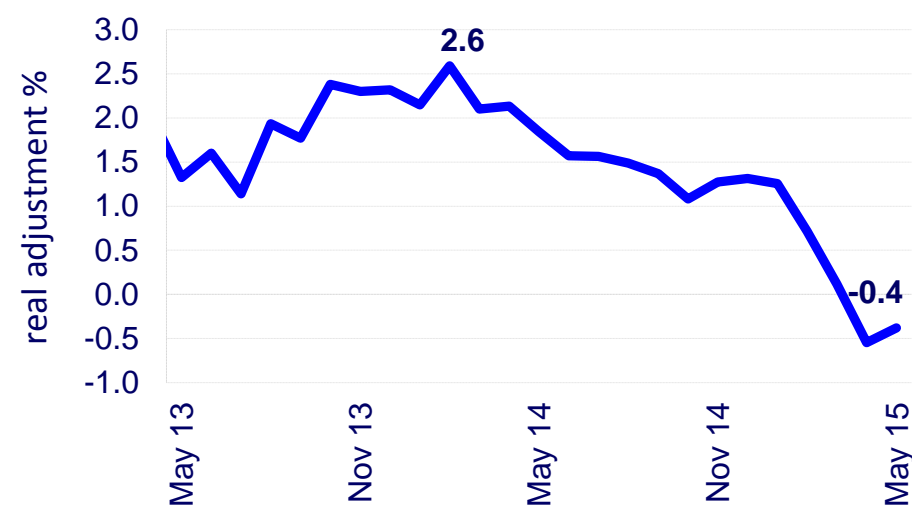


Wages: Adjustments in Progress, but still Risks

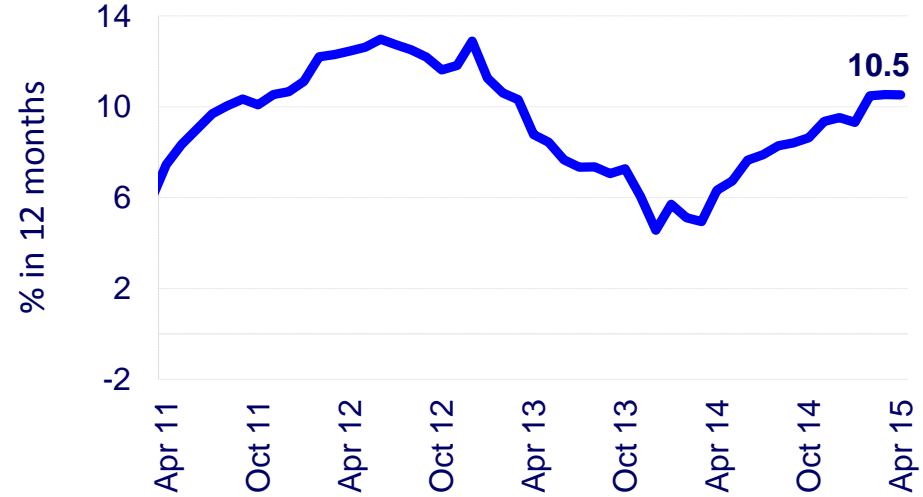
Real Wages



Labor Collective Conventions



ULC**



* 12m through Apr; ** Unit Labor Cost in the Manufacturing Industry: Nominal Payroll/Physical Output

BCB Inflation Forecasts

Baseline Scenario: Interest rate constant at 13.75% p.y. and exchange rate of R\$3.10/US\$

Period	Probability Interval						Central projection
	50%						
		30%					
			10%				
2015 2	8.9	8.9	8.9	9.0	9.0	9.1	9.0
2015 3	9.0	9.1	9.3	9.4	9.6	9.7	9.3
2015 4	8.4	8.7	8.9	9.1	9.4	9.6	9.0
2016 1	5.9	6.3	6.6	6.8	7.1	7.5	6.7
2016 2	4.5	4.9	5.3	5.6	6.0	6.3	5.4
2016 3	4.0	4.4	4.8	5.1	5.5	5.9	5.0
2016 4	3.8	4.2	4.6	4.9	5.3	5.7	4.8
2017 1	3.8	4.2	4.5	4.9	5.2	5.6	4.7
2017 2	3.5	3.9	4.3	4.6	5.0	5.4	4.5

Obs.: 12-month accumulated inflation (% p.y.)

BCB Inflation Forecasts

Market Scenario*: 2015 Interest rate at 14.00% p.y. and avg. exchange rate of R\$3.19/US\$
 2016 Interest rate at 12.00% p.y. and avg. exchange rate of R\$3.30/US\$

Period	Probability interval						Central projection
	50%						
		30%					
			10%				
2015 2	8.9	8.9	8.9	9.0	9.0	9.1	9.0
2015 3	9.0	9.1	9.3	9.4	9.6	9.7	9.3
2015 4	8.5	8.7	9.0	9.2	9.4	9.6	9.1
2016 1	6.0	6.3	6.6	6.9	7.2	7.5	6.8
2016 2	4.6	5.0	5.4	5.7	6.0	6.4	5.5
2016 3	4.2	4.6	5.0	5.3	5.7	6.1	5.2
2016 4	4.1	4.5	4.9	5.2	5.6	6.0	5.1
2017 1	4.0	4.4	4.8	5.1	5.5	5.9	5.0
2017 2	3.9	4.3	4.7	5.0	5.4	5.8	4.8

Obs.: 12-month accumulated inflation (% p.y.); *data as of June 12th

Prospective Scenario – Monetary Policy

The Copom evaluates that the monetary policy should contribute to the consolidation of a favorable macroeconomic scenario in longer term horizons. In this sense, it reassures that, under the inflation targeting regime, it guides its decisions according to the values projected for inflation by the Central Bank and based on the analysis of alternative scenarios for the evolution of the main variables that determine prices dynamics.

The Copom evaluates that the scenario of inflation convergence to 4.5% in 2016 has strengthened. However, the advances pursued in inflation control – as shown by benign signs stemming from medium and long term expectations indicators – have not been sufficient yet.

Inflation Outlook

Thank you!

Inflation Report

June 2015