



Inflation Outlook

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Inflation Report

March 2015

I. Main Message

II. International Environment

III. Financial Conditions

IV. Activity

V. Inflation Developments

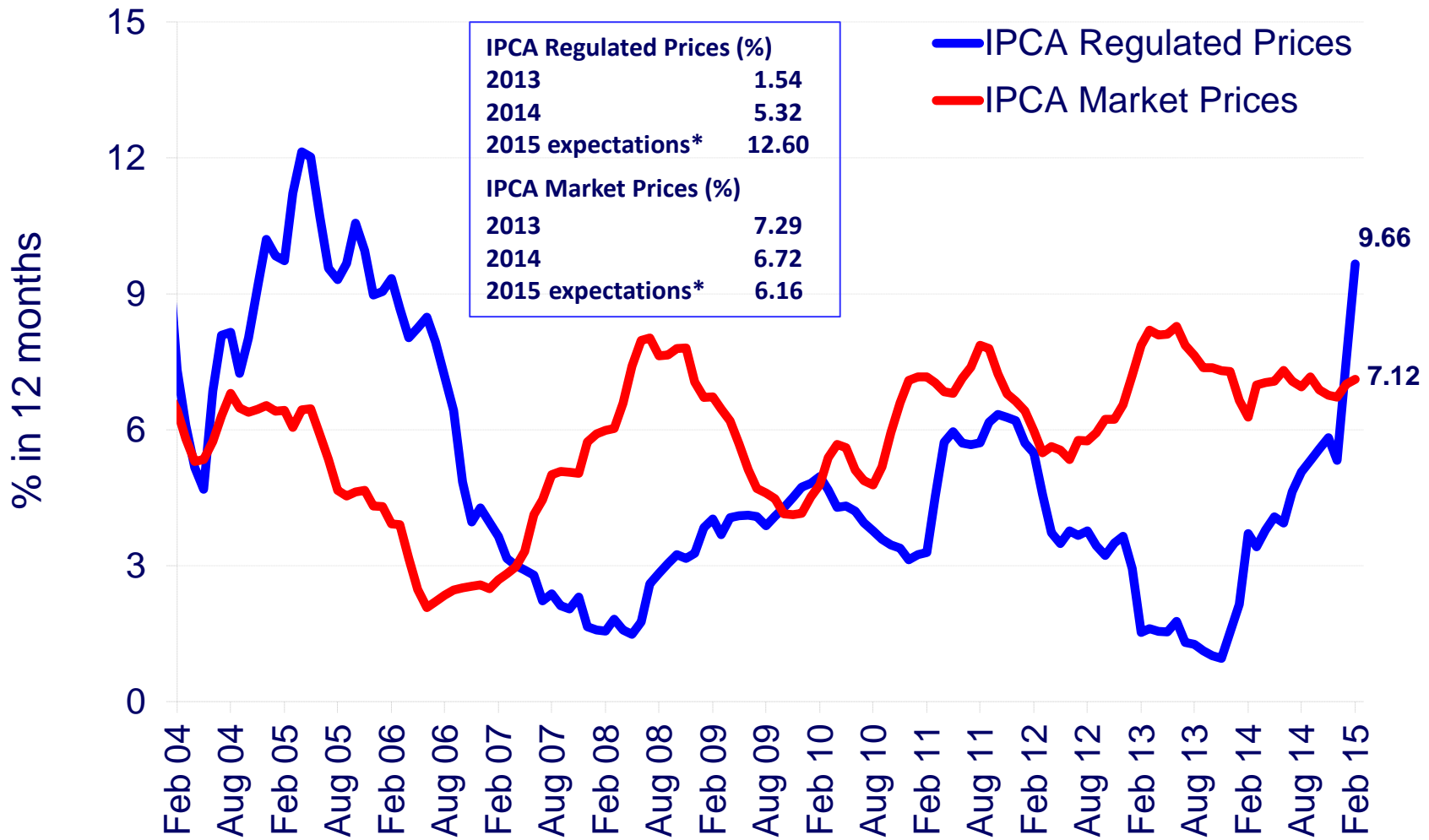
I. Main Message

- **Monetary Policy is and remains vigilant to ensure the convergence of inflation to the 4.5% target throughout 2016**

Situation in 2015 is of Transition

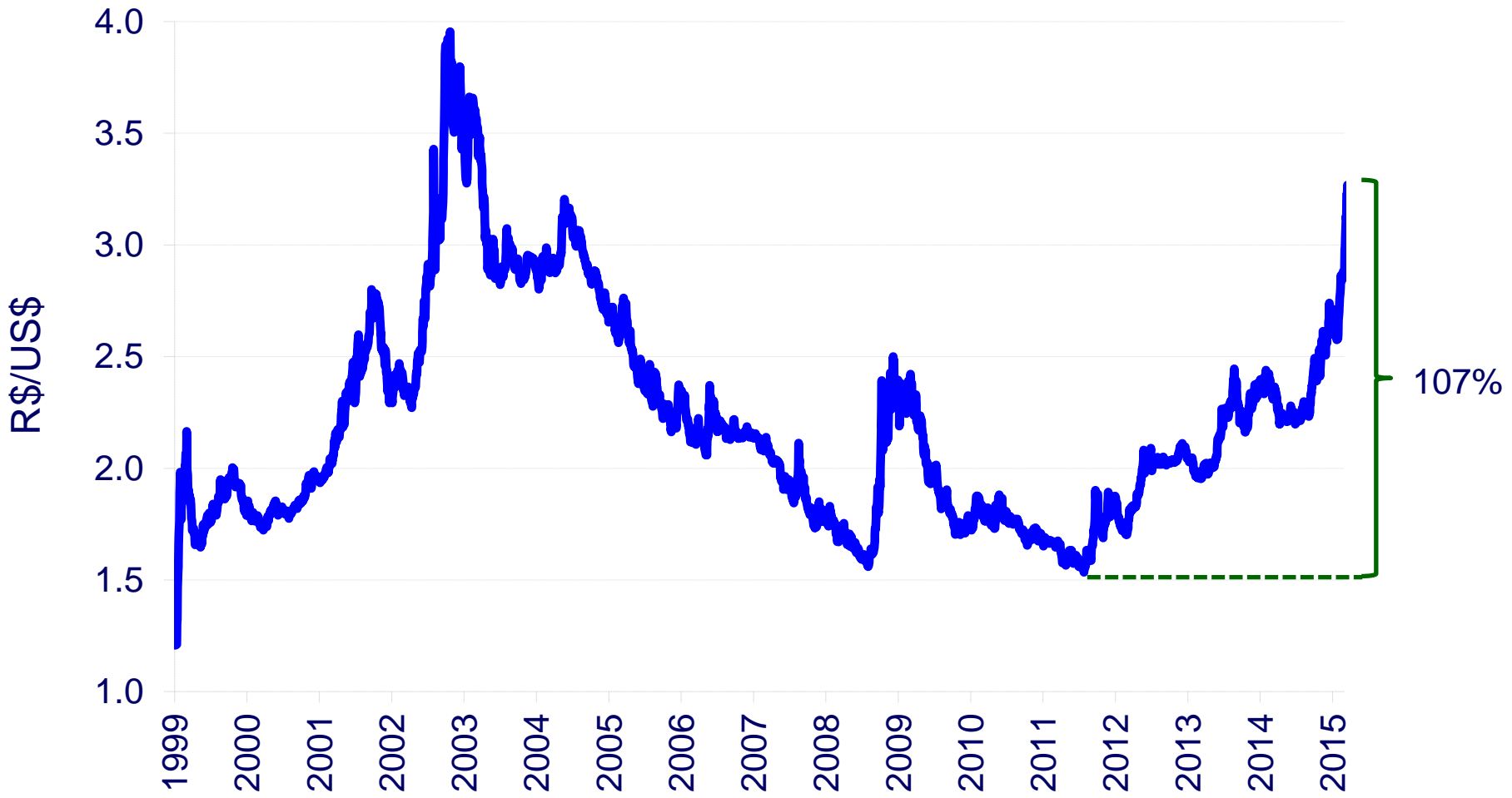
- Reduction of unbalances with double adjustment of relative prices (regulated and external) through the use of adequate fiscal and monetary policies

Ongoing Adjustment of Relative Prices



* data on March 20th

Depreciation of the Nominal Exchange Rate



data through March 23rd

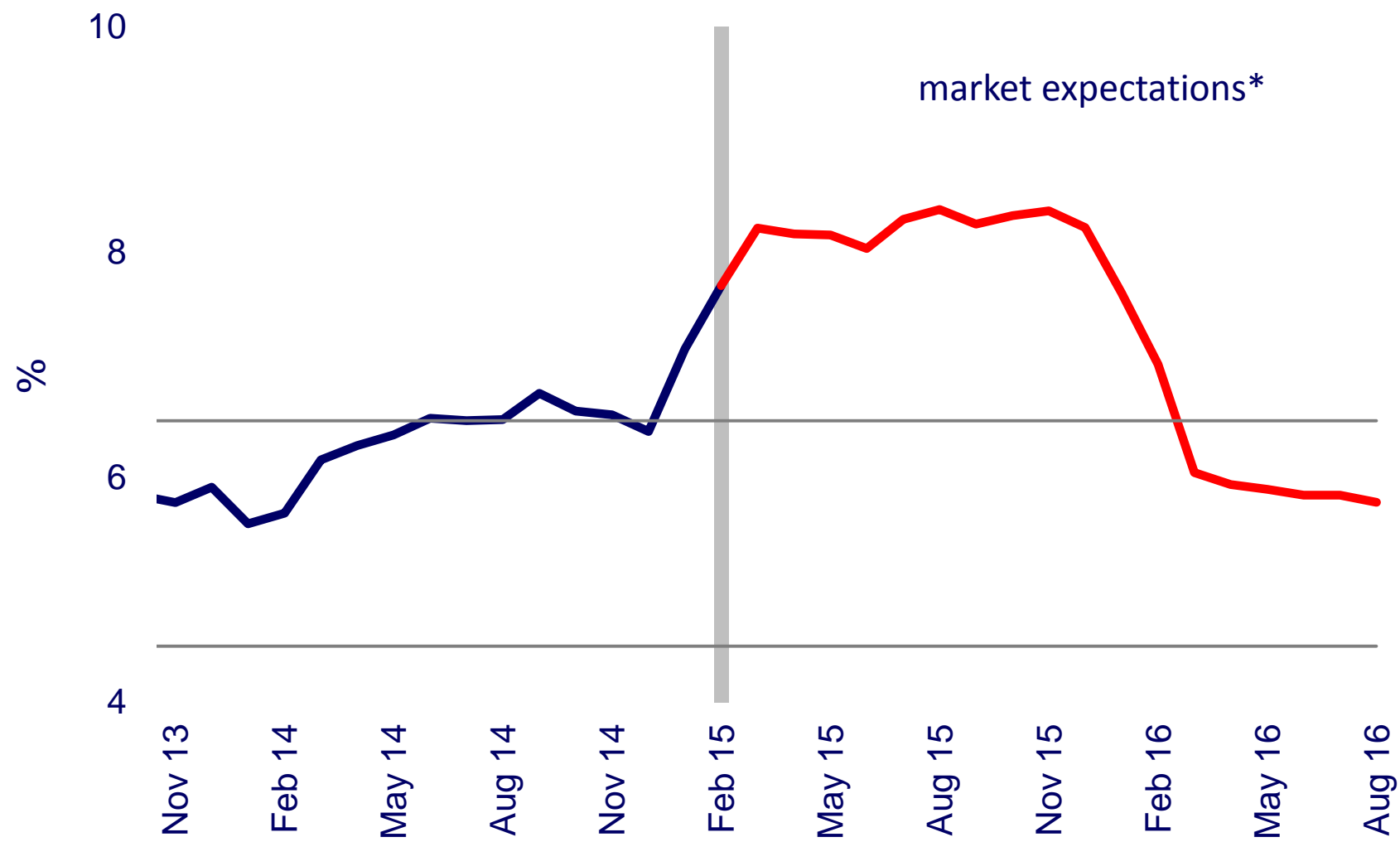
Situation in 2015 is of Transition

- The adjustment is standard, relevant and necessary
- Objective is to strengthen fundamentals and prepare for new cycle of sustainable growth
- *Maintenance of the sovereign risk grade (investment grade) by S&P*

Price Adjustments in 2015 Impact 2015 Inflation

- The double relative prices adjustment (regulated and external) increased inflation in Q1 2015
- Inflation expectations for 2015 increased relative to the last IR
- The objective is to limit this impact to 2015 and contain the second order effects through the Monetary Policy

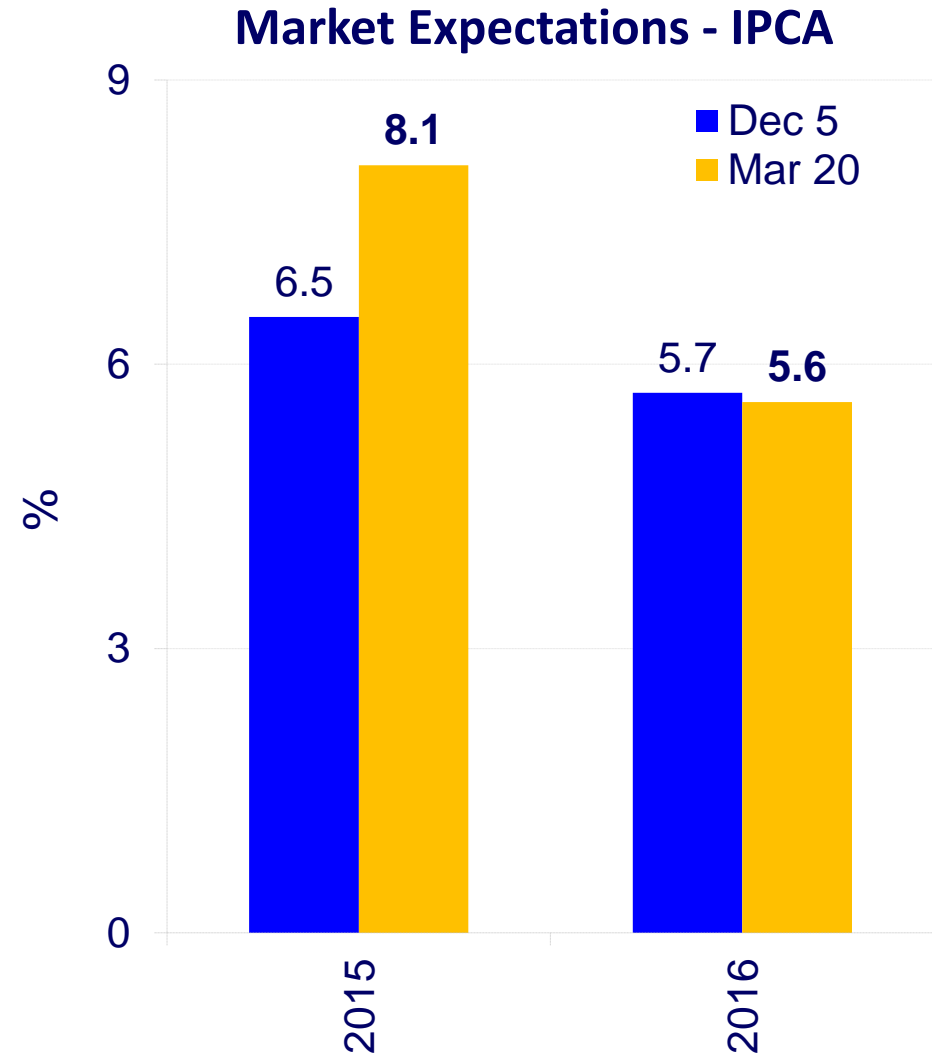
Price Adjustments in 2015 Impact 2015 Inflation



*on March 20th, data through Aug/16

... But did Not Impact 2016 Expectations

- Inflation expectations for 2016 do not show significant change (relative to the last IR)
- And they have shown stability in the last weeks



Situation in 2016 Will be of Resumption

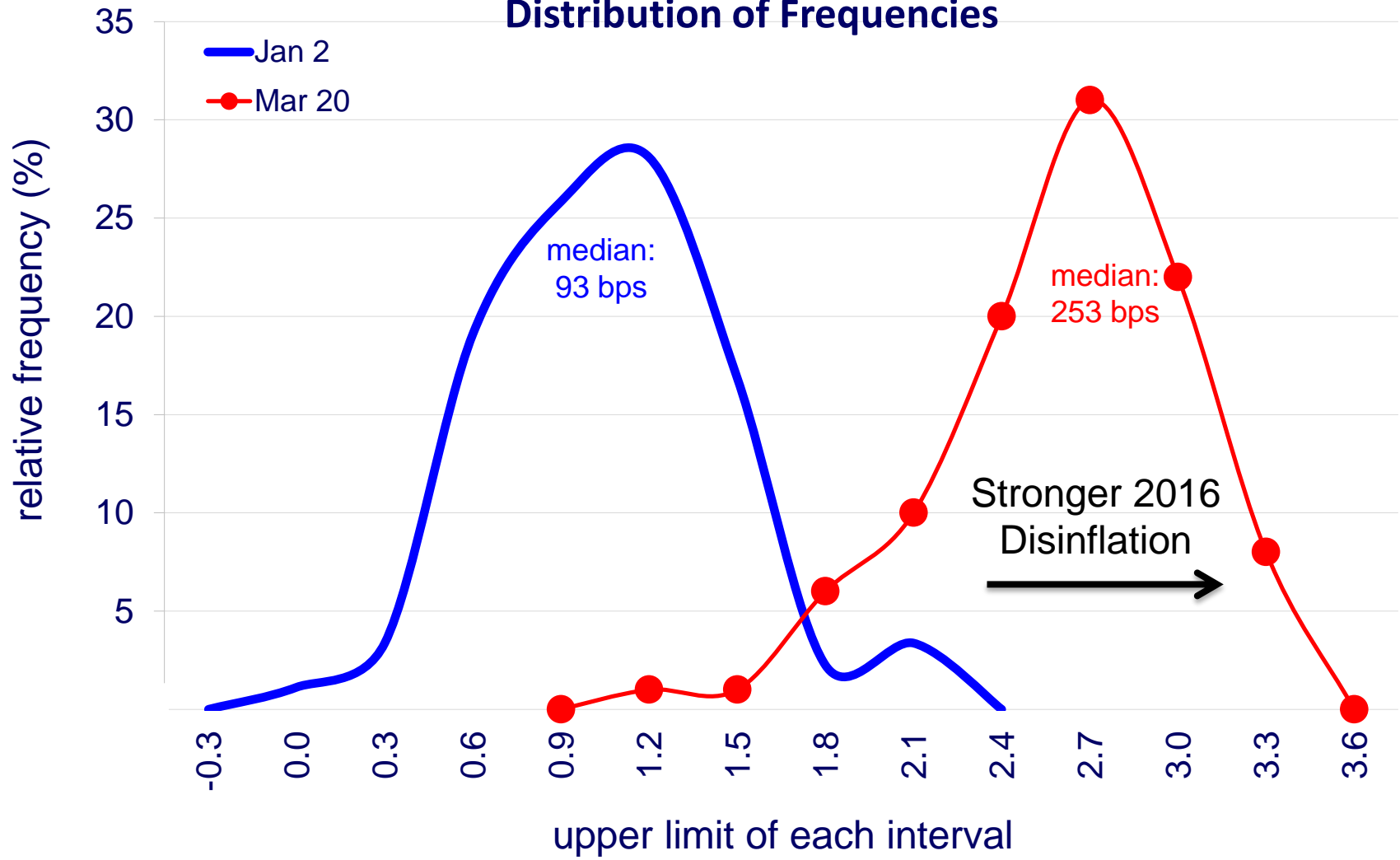
- Reduction in unbalances improves fundamentals and perception: increases the confidence of agents and favors planning
- Adjustments in 2015 contribute to change the composition of demand and favor investment and productivity
- Attractive domestic market and investment opportunities continue present

Consensus regarding More Favorable Conditions in 2016

- Prices realignments will have already occurred in 2015
- 12-month accumulated inflation trajectory includes significant discard effect in Q1 2016

Distribution of 2016 Disinflation

Differences between 2015 and 2016 IPCA Expectations Distribution of Frequencies



There are Additional Favorable Factors in 2016

- Monetary Policy is and will continue vigilant
- *Falling medium and long term IPCA expectations*

Annual IPCA inflation expectations (Focus median)

| | 2015 | 2016 | 2017 | 2018 |
|--------|-------------|--------------|--------------|--------------|
| Jan 2 | 6.56 | 5.70 | 5.50 | 5.50 |
| Mar 20 | 8.12 | 5.61 | 5.10 | 5.00 |
| change | 1.56 p.p. ↑ | -0.09 p.p. ↓ | -0.40 p.p. ↓ | -0.50 p.p. ↓ |

Intensification of the relative prices adjustment

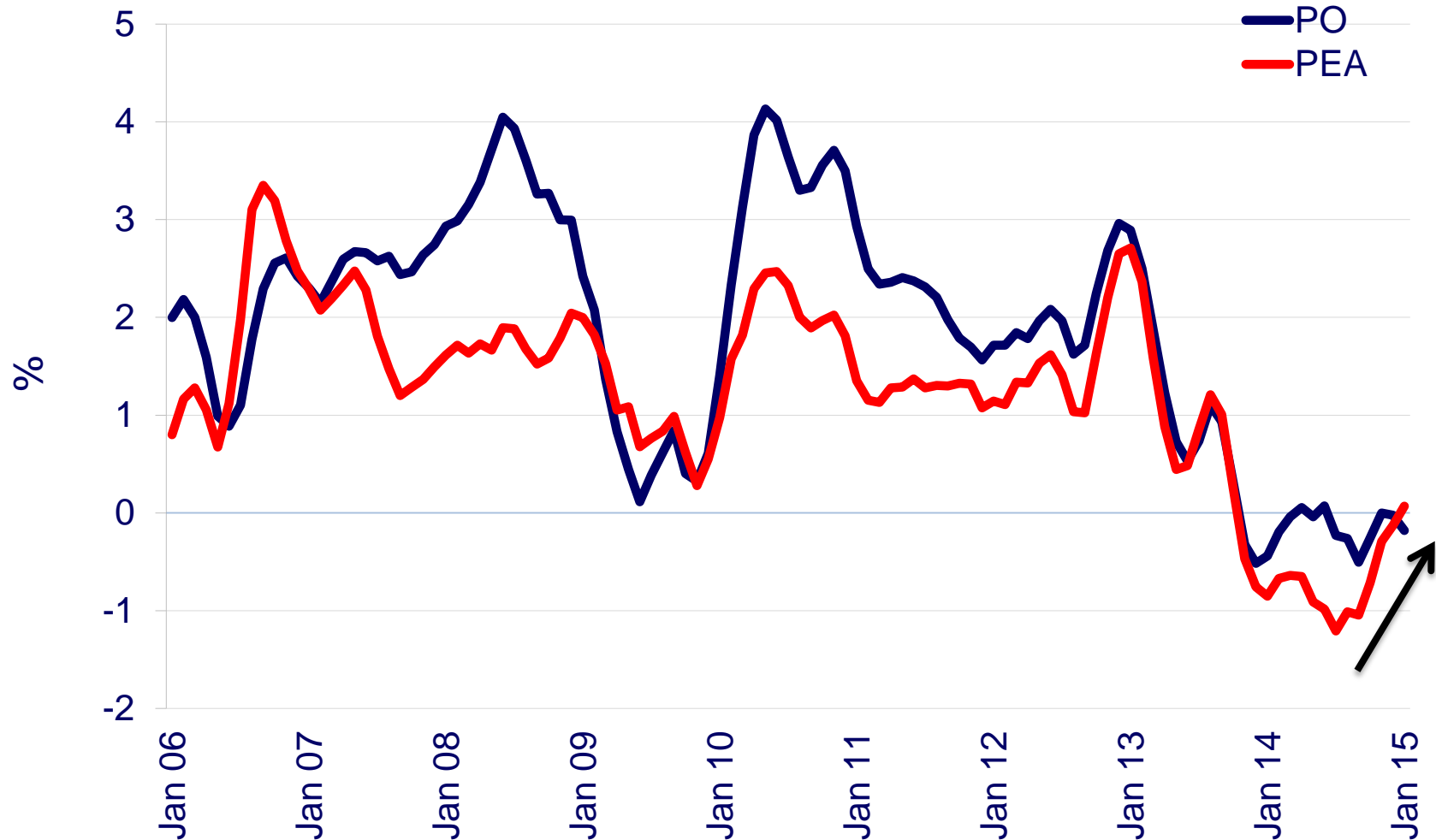
Macroeconomic policy acting in the medium and long term expectations

There are Additional Favorable Factors in 2016

- Fiscal Policy (FP) aligned, contributing to the moderation of demand
- Transmission of the relative prices adjustments occurs with perspective of less stressed labor market
- Decrease in the intensity of the adjustments' pass-through
- Moderation of credit and reduction of subsidies

Evolution of the Economically Active Population (PEA) and Occupied Population (PO)

Internannual change of the 12-month moving average

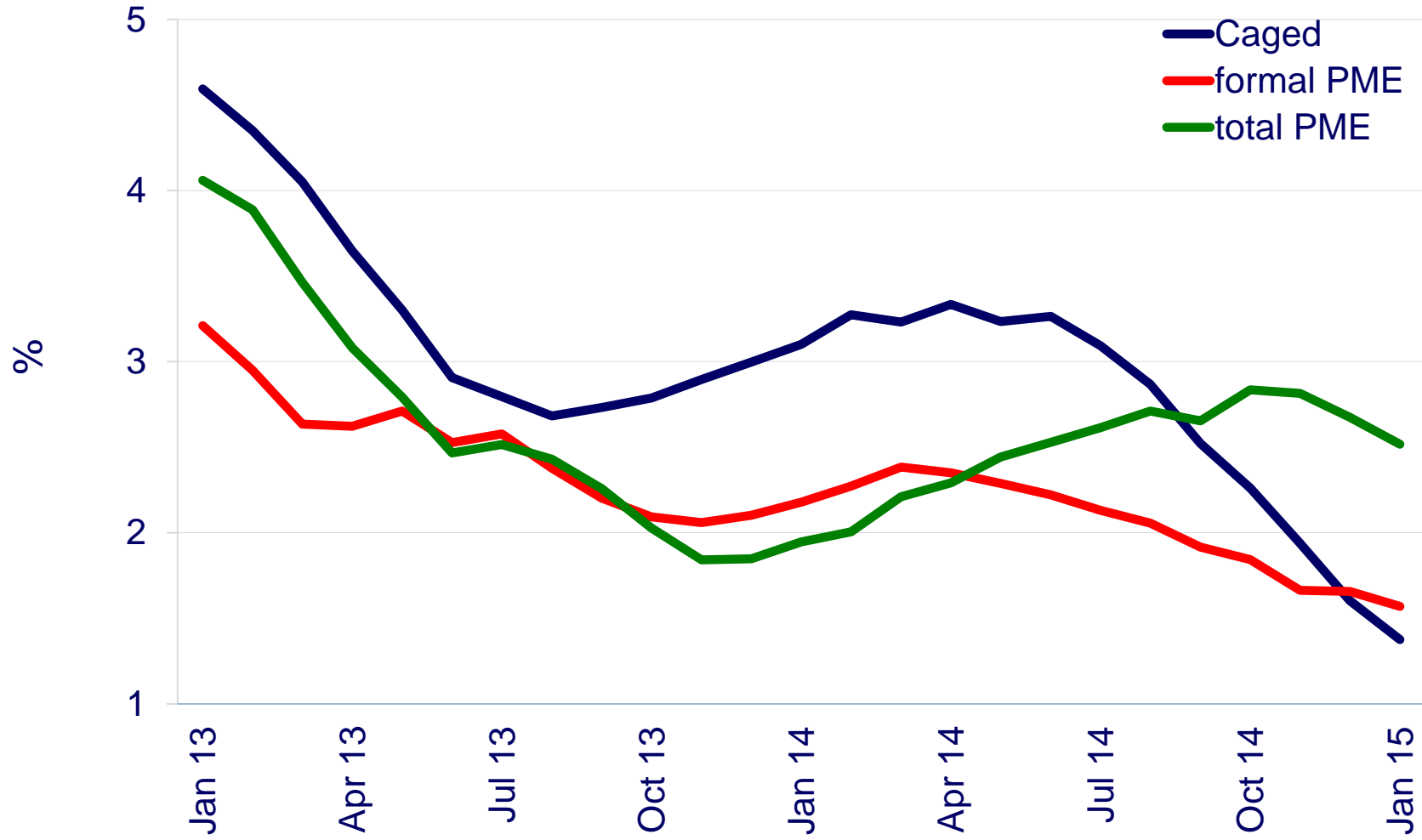


Box: Signs of Distress in the Labor Market

- Signs of recovery in the participation of labor force
- Prospective of higher convergence of evolution of salaries and productivity

Evolution of Real Earnings

Interannual change of the 12-month moving average



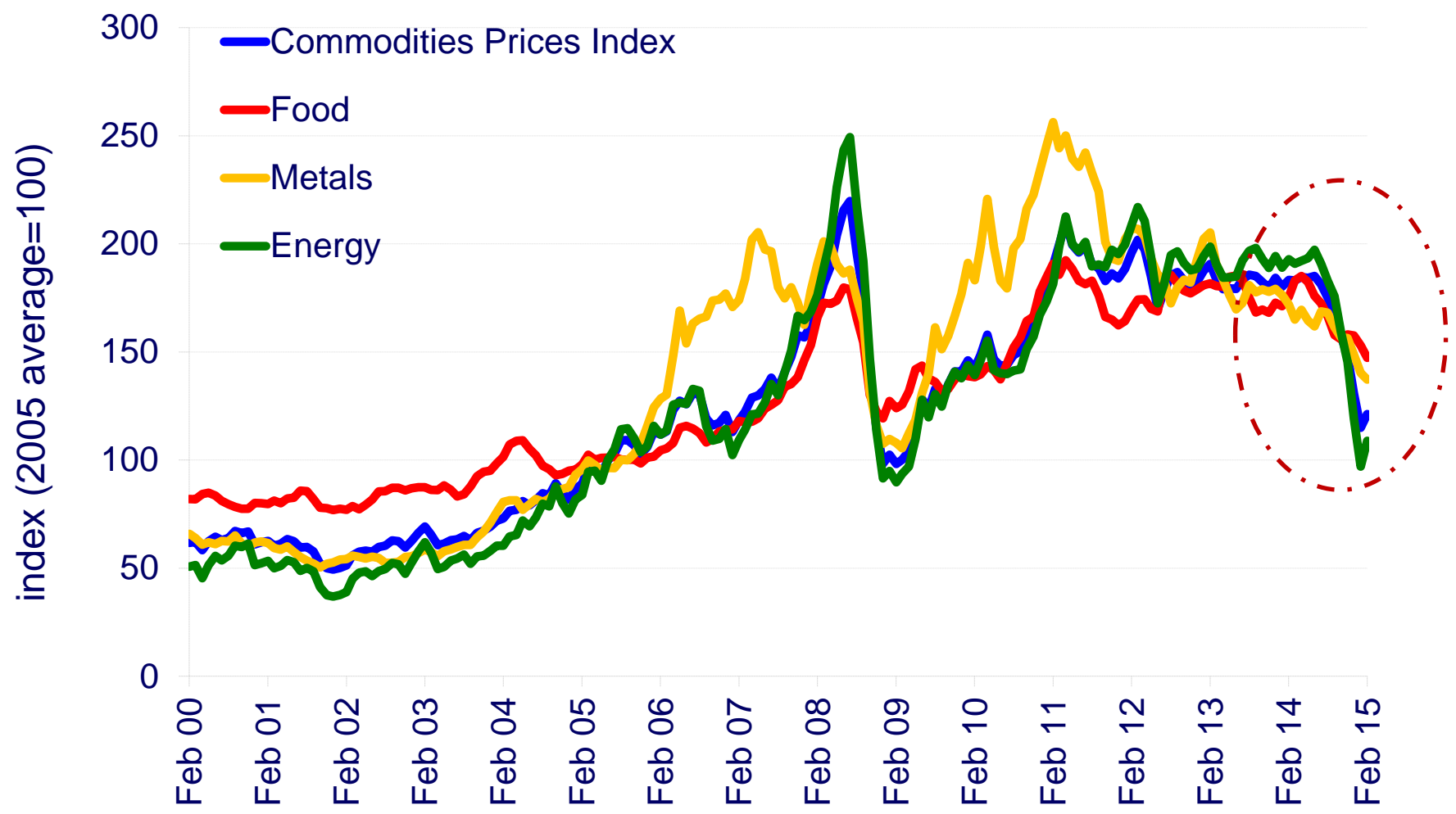
Sources: Caged and IBGE

Box: Commodities Prices and Exchange Rate Pass-Through

- Global economic scenario favors the continuity of the benign evolution of commodities prices to inflation
- Fall in the prices of commodities smoothes the effect of the US dollar strengthening over domestic inflation

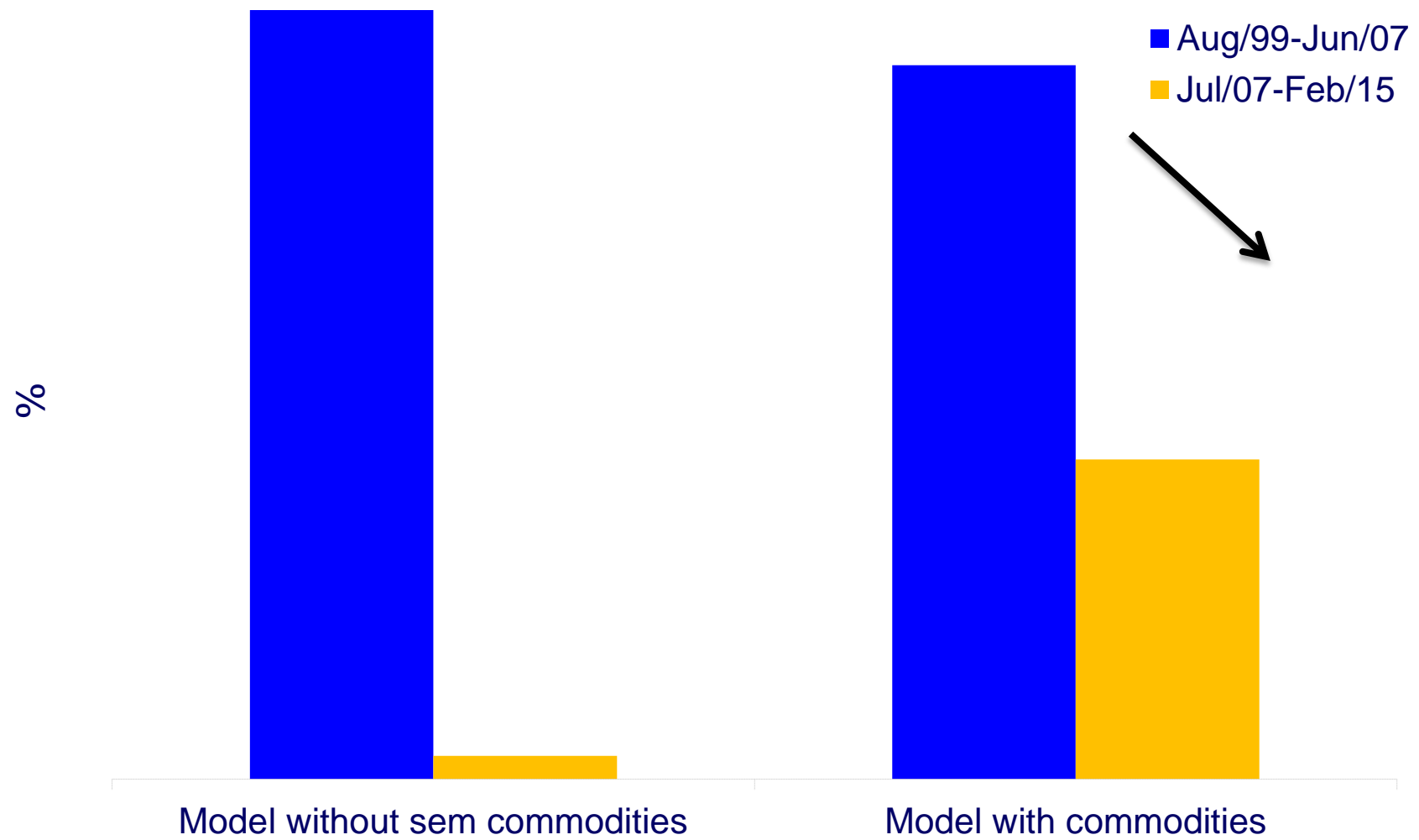
Falling Commodities Prices

Commodities Index and subindices calculated by the IMF



Exchange Rate Pass-Through to the IPCA

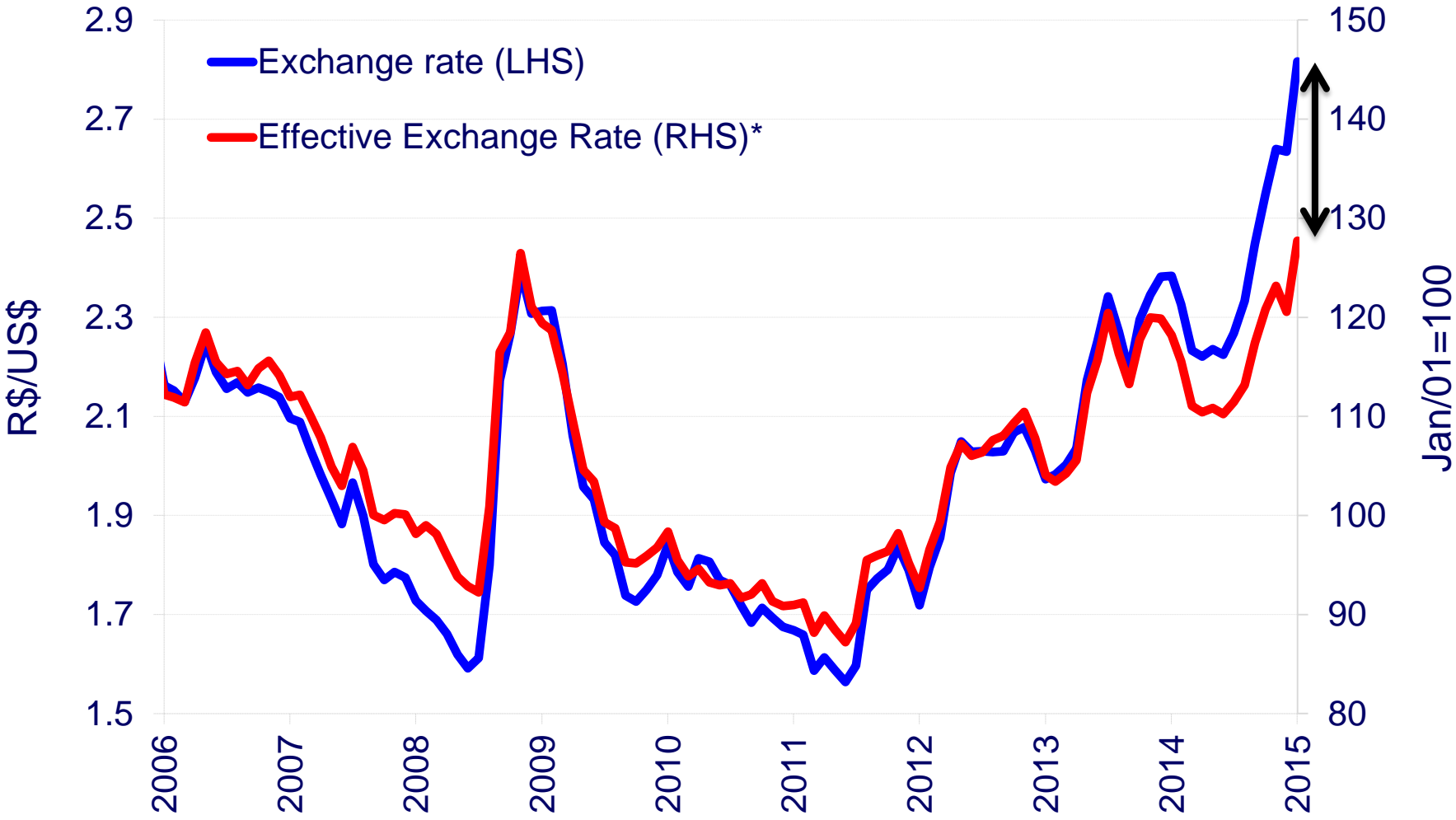
Accumulated in 12 months



Box: Exchange Rate Pass-Through to Prices

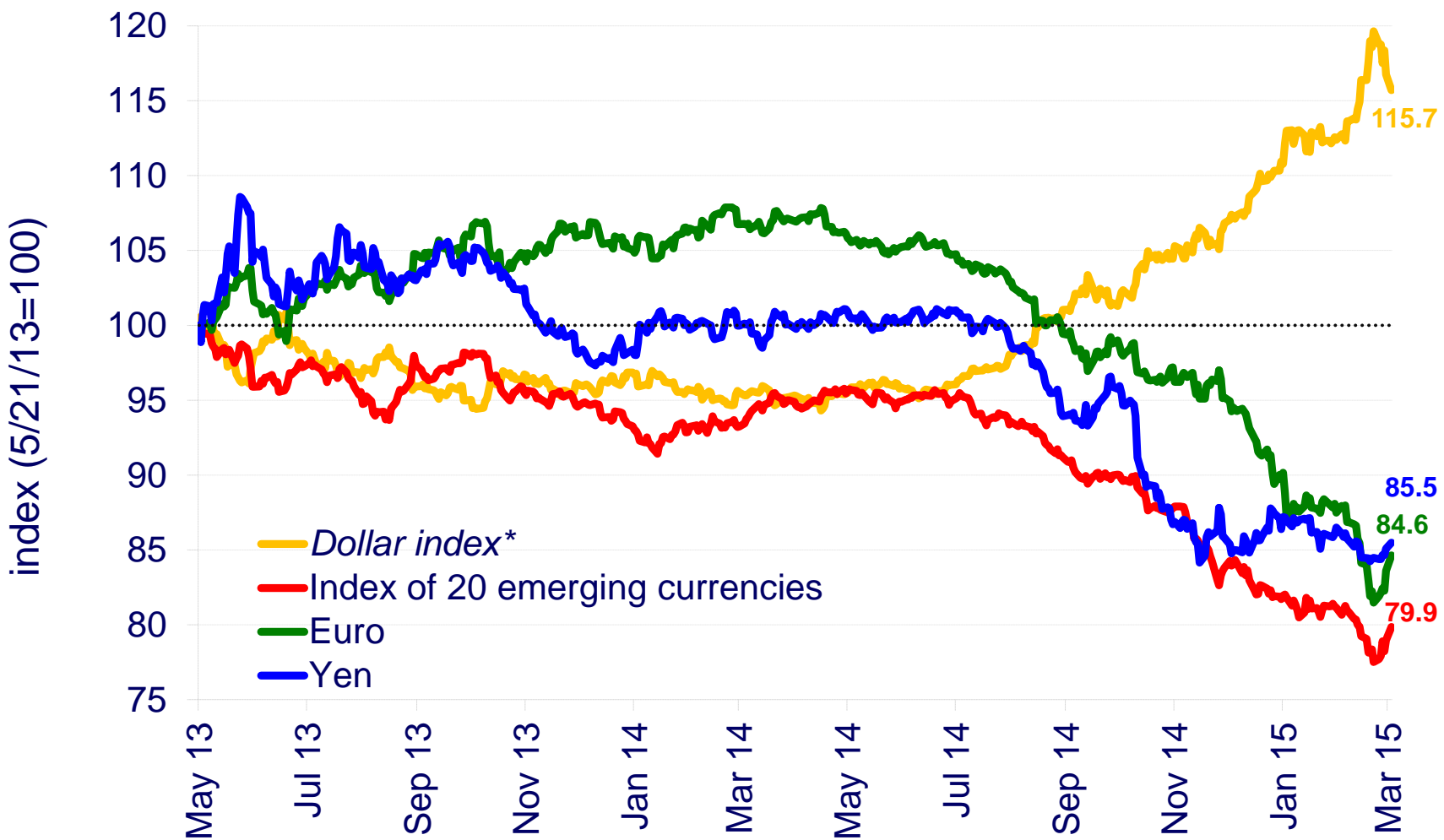
- Historical trend of decreasing exchange rate pass-through
- Measures of effective exchange rate can be more representative for the transmission of shocks to inflation than bilateral exchange rates
- Pass-through also depends on the cyclical position of the economy

Nominal R\$/US\$ and Nominal Effective Exchange Rate



*inverted index relative to the published by the BIS: its increase indicates BRL depreciation

US Dollar Appreciation is Global Trend



Data through March 23rd; *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).

II. International Environment

- Marginal improvement (US), falling commodities prices, global strengthening of the US dollar

Retrospective - Abroad

Since the last Report release :

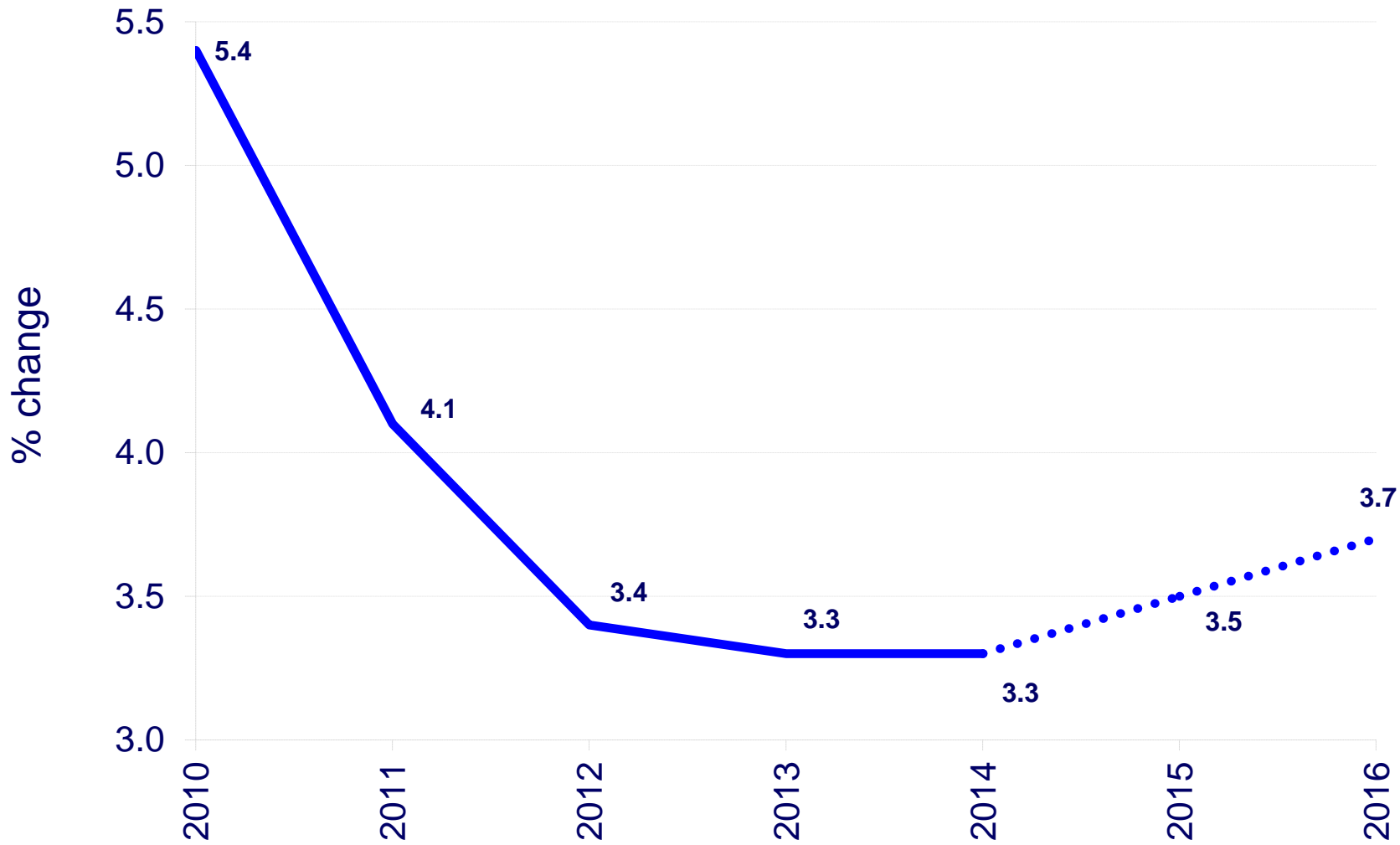
- The risks to global financial stability remained high (volatility and risk aversion increased)
- The process of global economy recovery has shown heterogeneous
- In the international markets, there was a retreat in the prices of commodities, especially in the segment of energy
- In general terms, the difference in the recovery pace among the economies and the singular inflation outlooks reflect in the monetary policy actions

Prospects – Abroad 2015-2016

- Risks for the global financial stability tend to remain high
- 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)
- New volatility rallies in the currencies' markets are likely to be observed (e.g., the strengthening of the US dollar)
- The reduction of oil and commodities prices suggests contained global inflation in 2015 and 2016

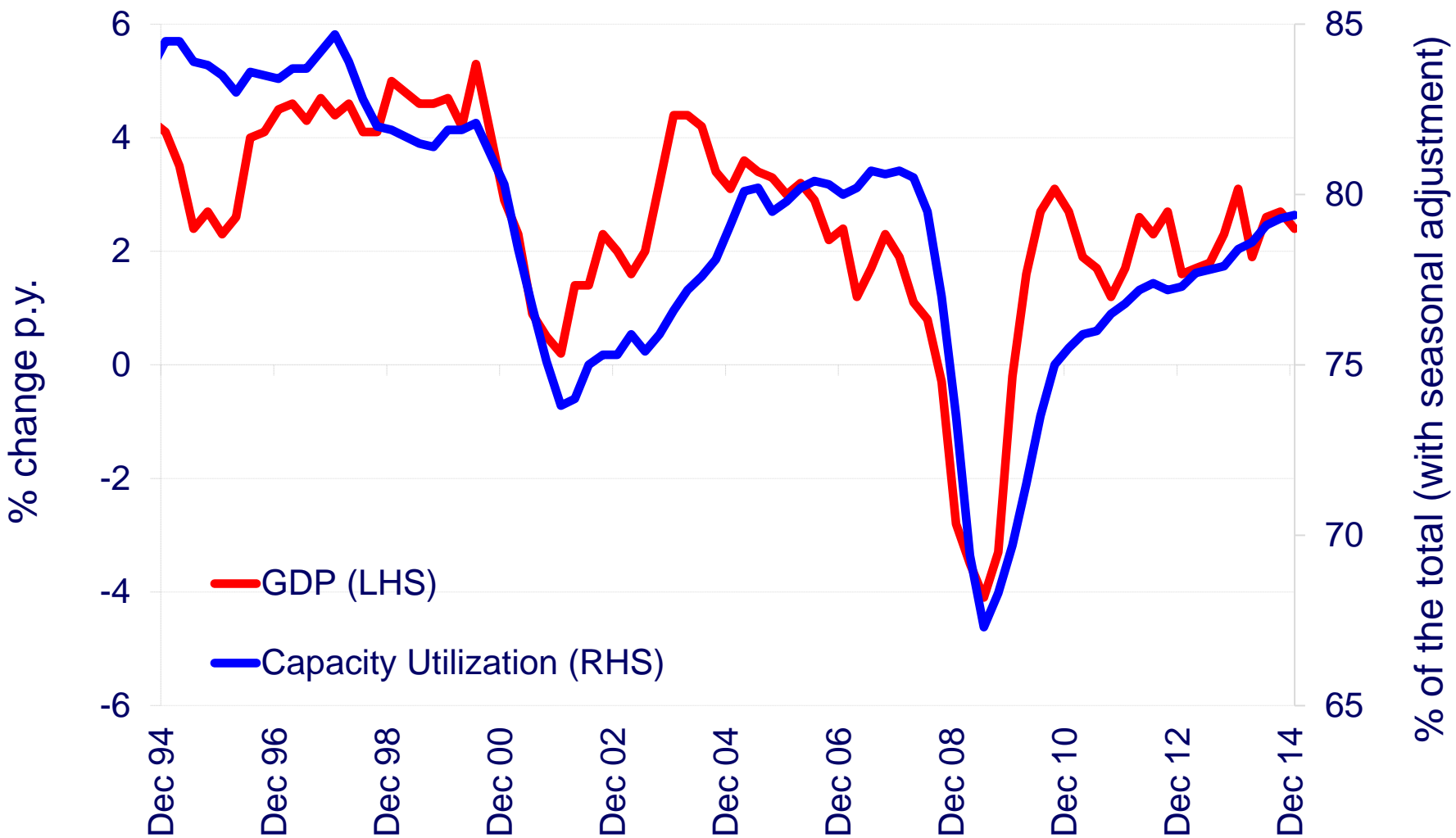
Global Economy in Gradual Recovery

Global Growth



Source: IMF (WEO Update, January 2015)

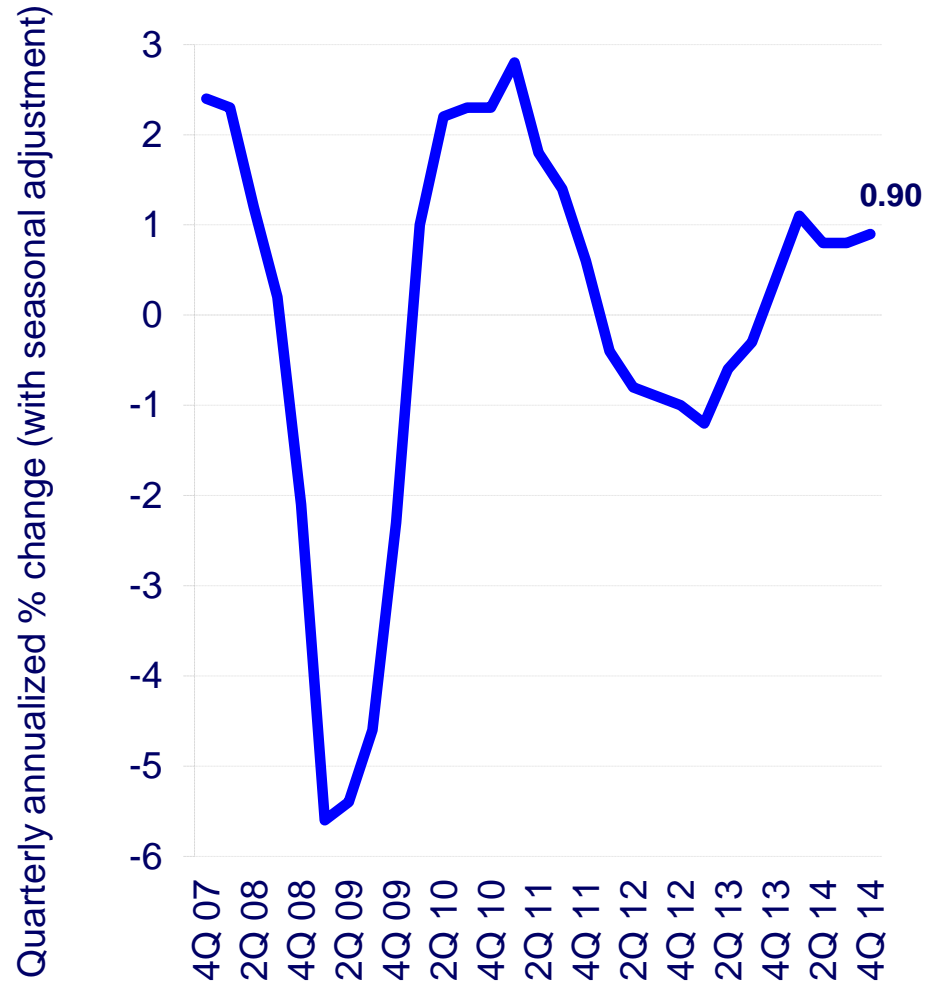
Economic Recovery in the US



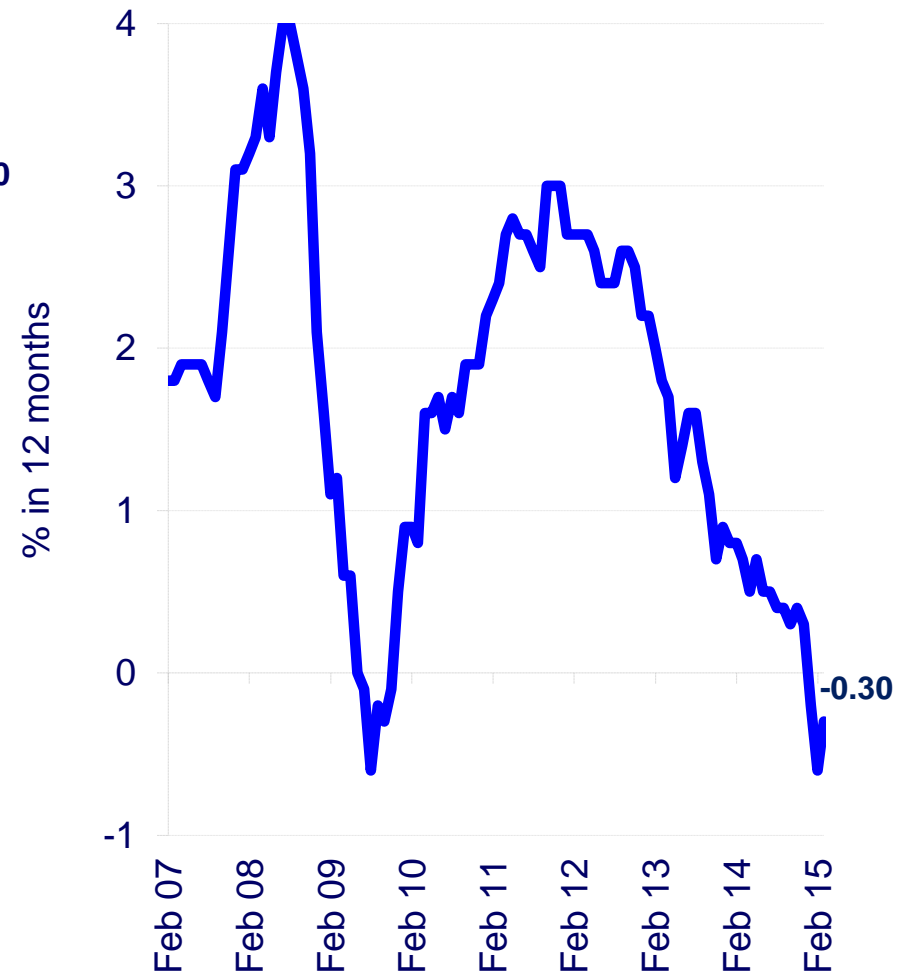
Source: U.S. Bureau of Economic Analysis / Federal Reserve

Europe – Growth and Inflation

GDP Growth – Euro Area

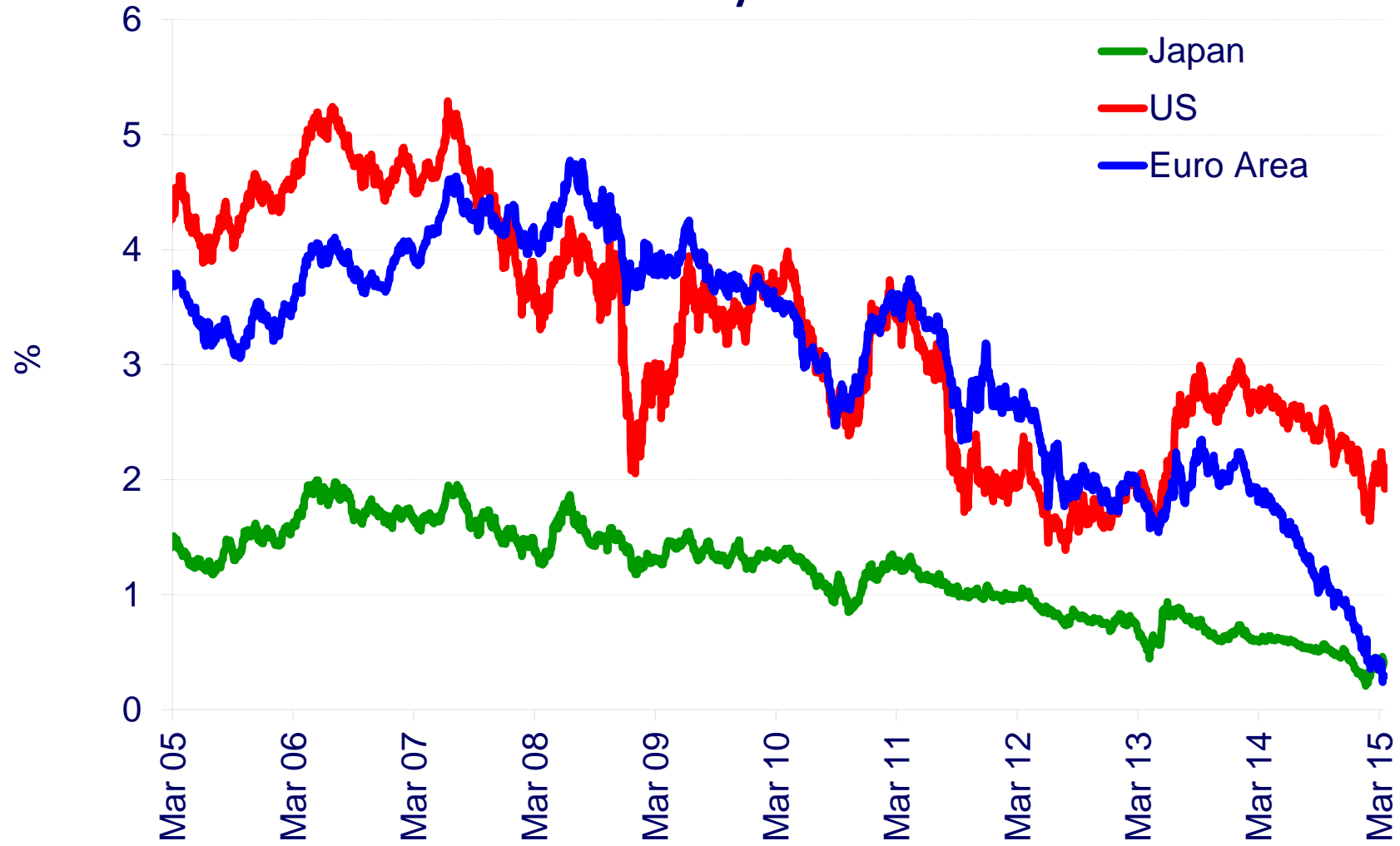


Consumer Inflation – Euro Area



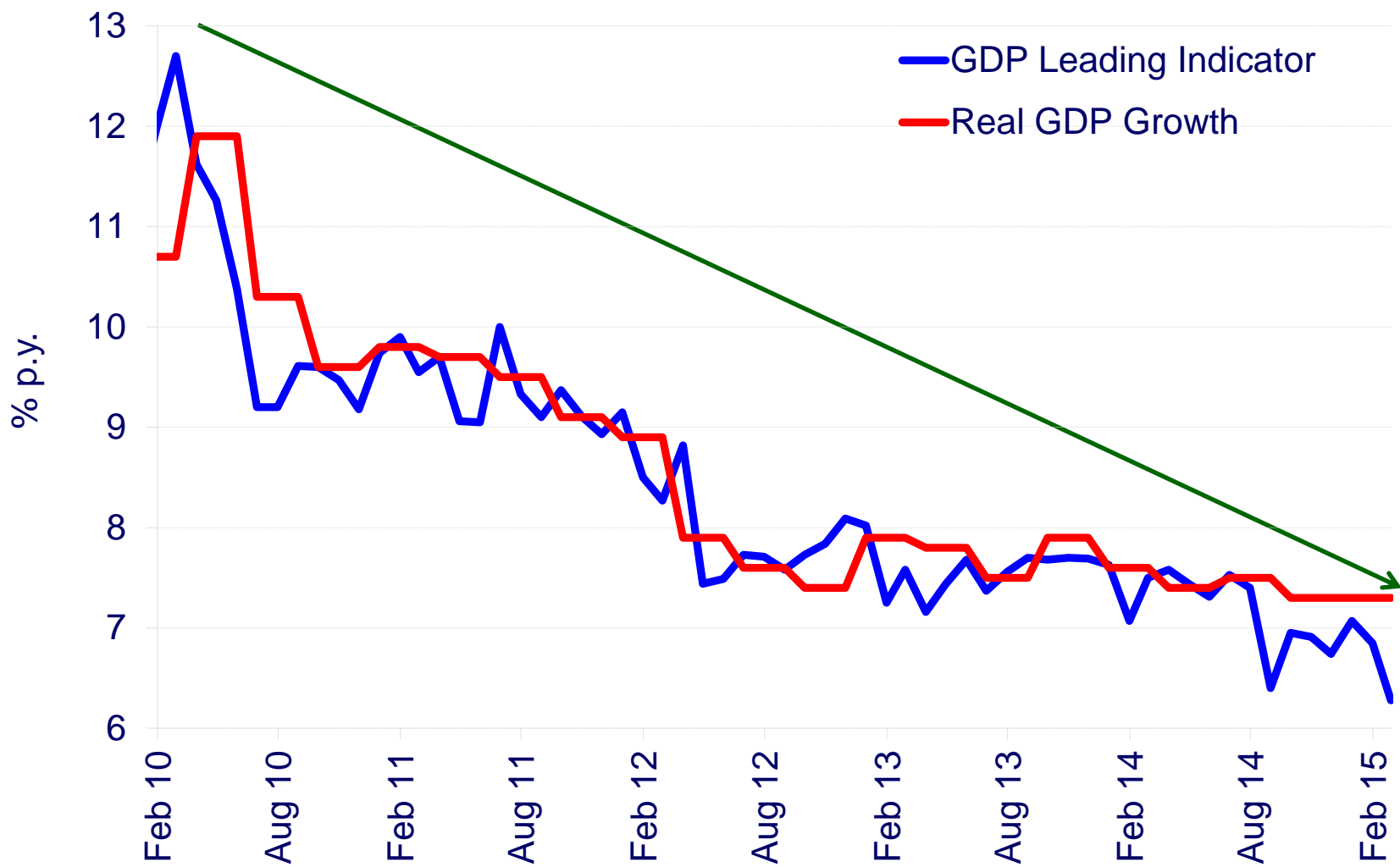
Divergence in Monetary Policy

10-year Bonds

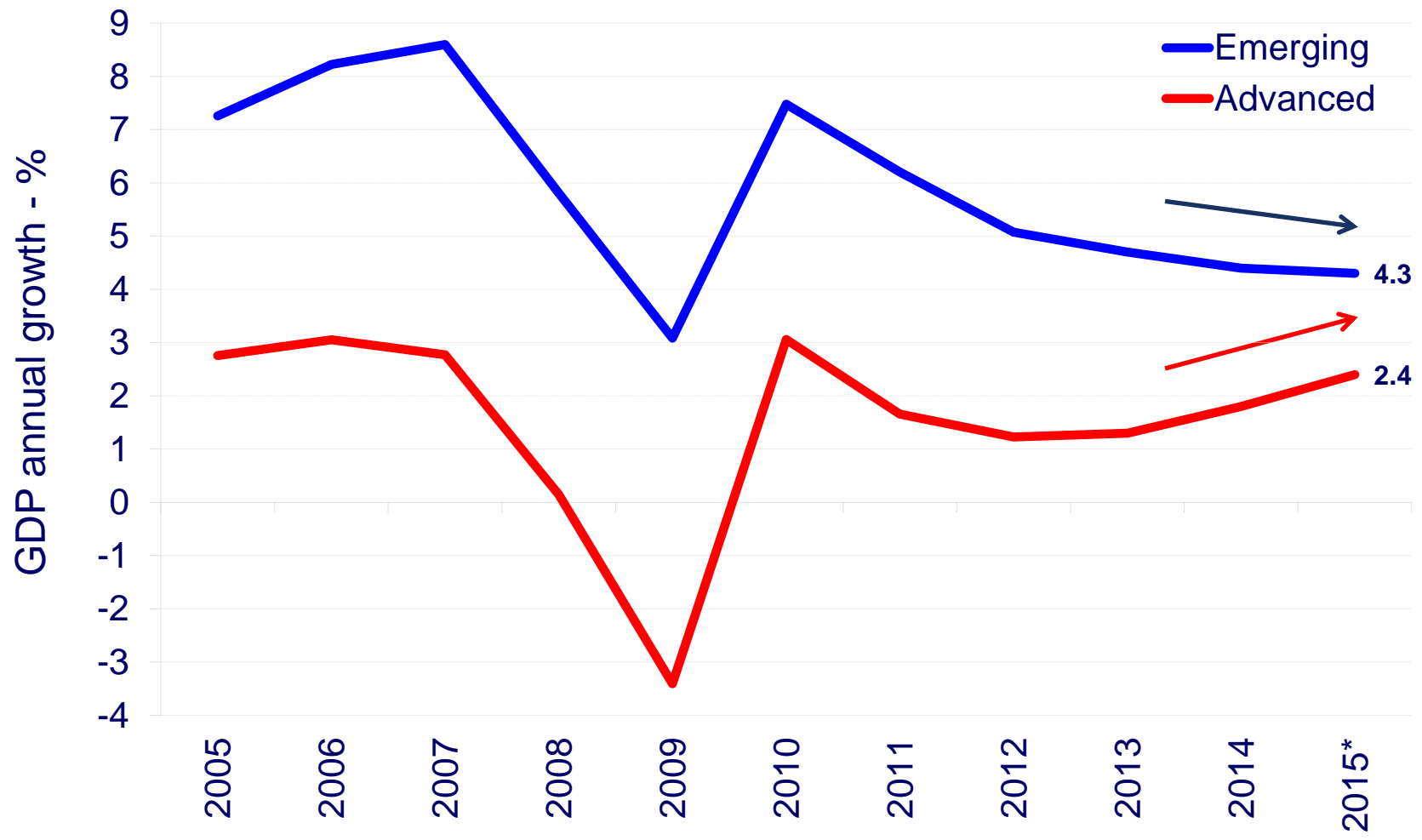


Source: Bloomberg

China – Gradual Deceleration



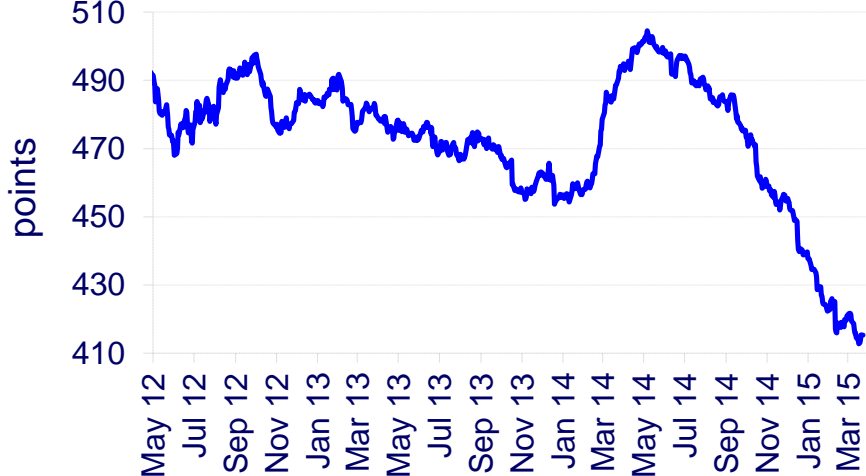
Emerging Countries – Moderation in Growth



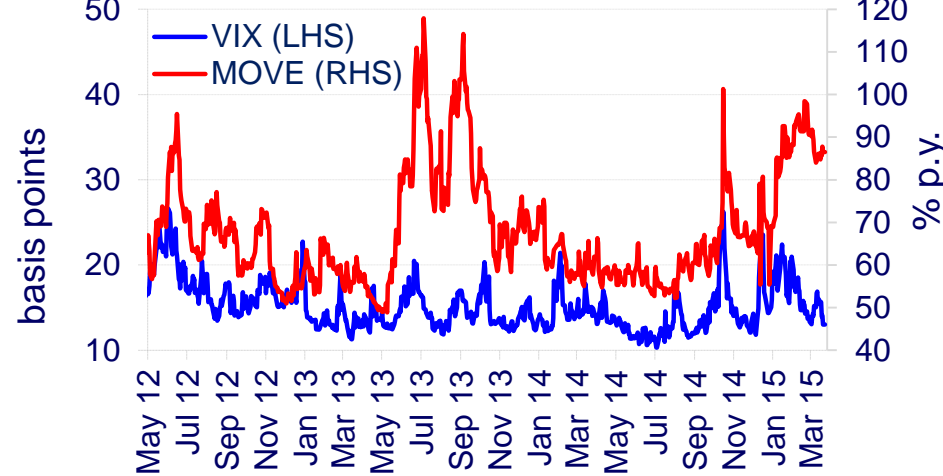
*projection for the end of 2015

Commodities and Volatility

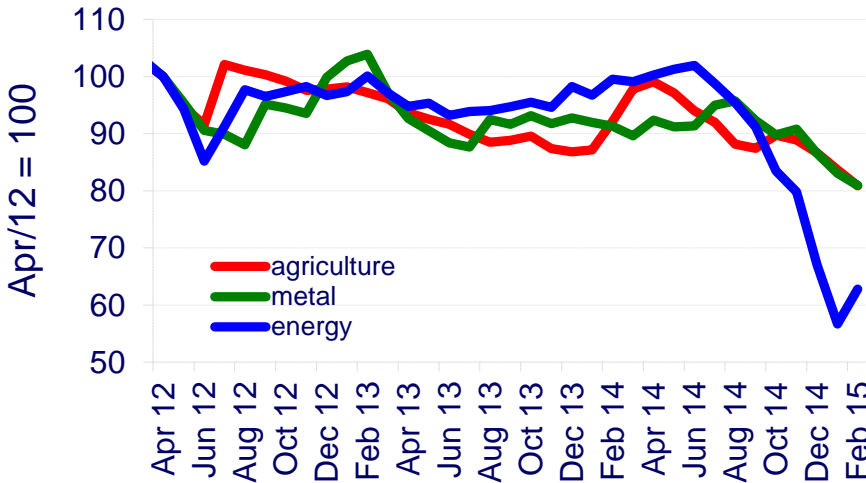
CRB



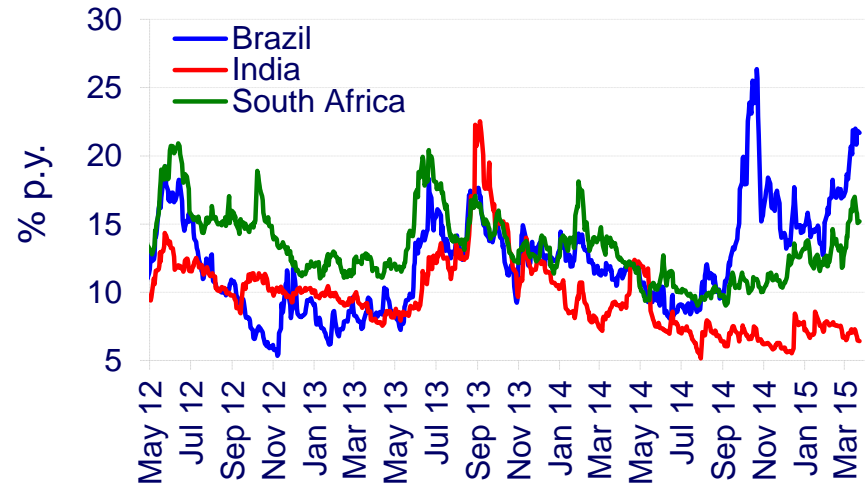
VIX and Volatility in the Bonds' Market



IC-Br (US\$)



Currencies' Volatility



Data through March 20th

Box: Projections for the Balance of Payments

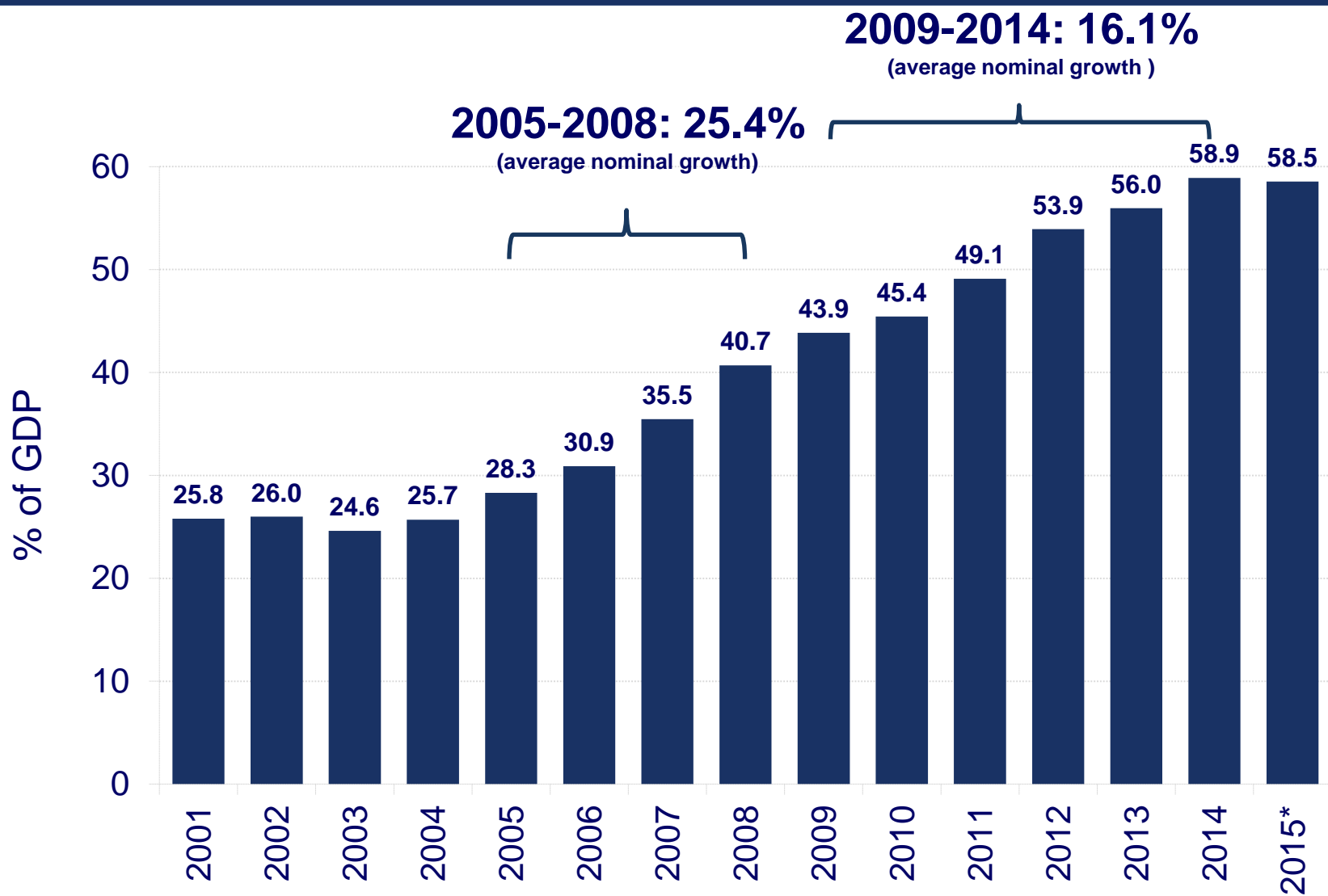
Revision for 2015:

- Estimate of current account *deficit* decreased from US\$83.5 billion to US\$80.5 bilhões (4.2% of GDP)
- For the trade balance, a reduction of US\$2 billion in the surplus is expected, from US\$6 billion to US\$4 billion
- Estimate of *deficit* in services and incomes is also reduced, by US\$5 billion, with lower net outflows in transportation, travels, equipment leasing and profits
- Estimate of FDI inflows remains at US\$65 billion (approximately, 77% of the current account *deficit*)

III. Financial Conditions

- Moderation in the pace of credit concession
- Robustness of the National Financial System ensures financial stability

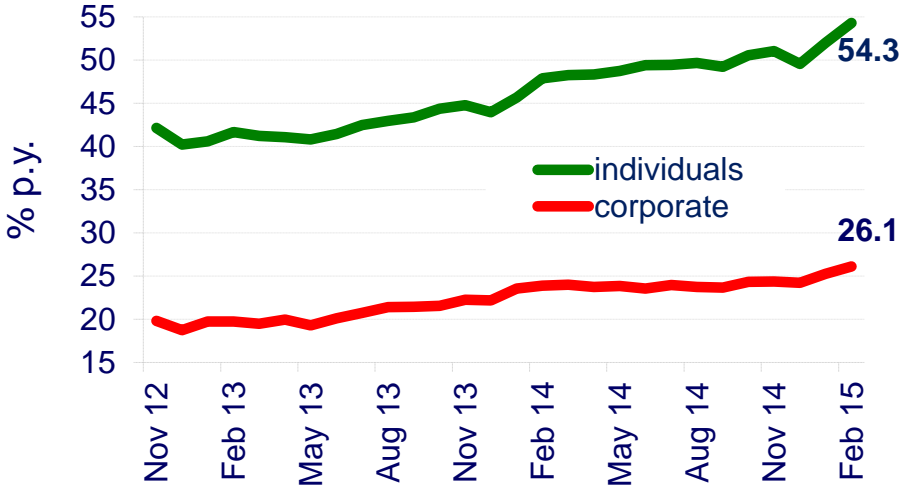
Credit/GDP Ratio



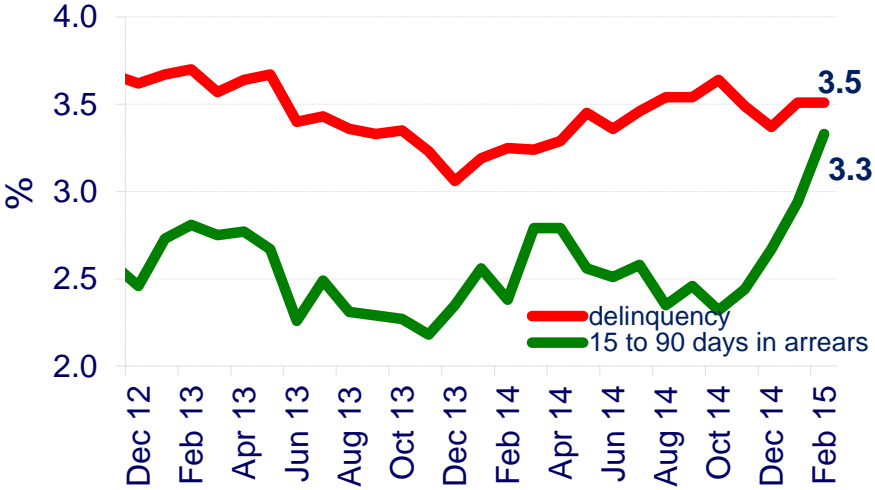
new methodology as of 2011; *Feb 15

Non-Earmarked Credit: Cost, Delinquency and Arrears

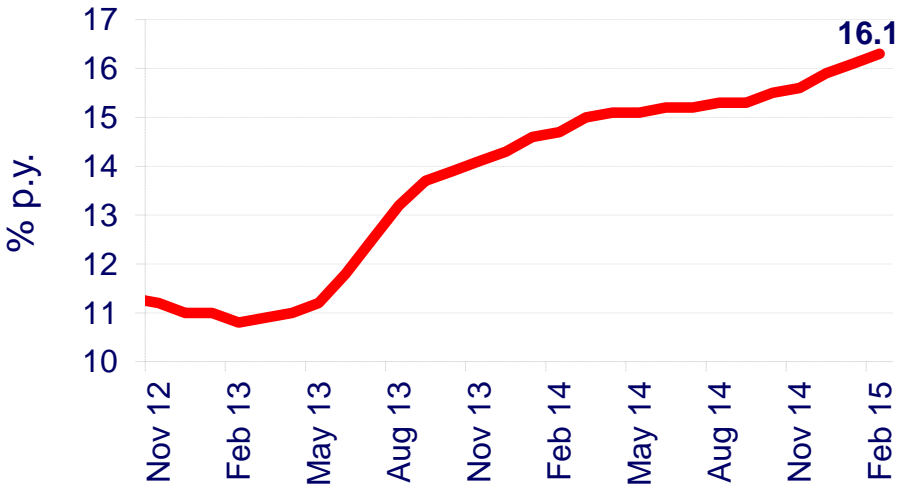
Interest Rate



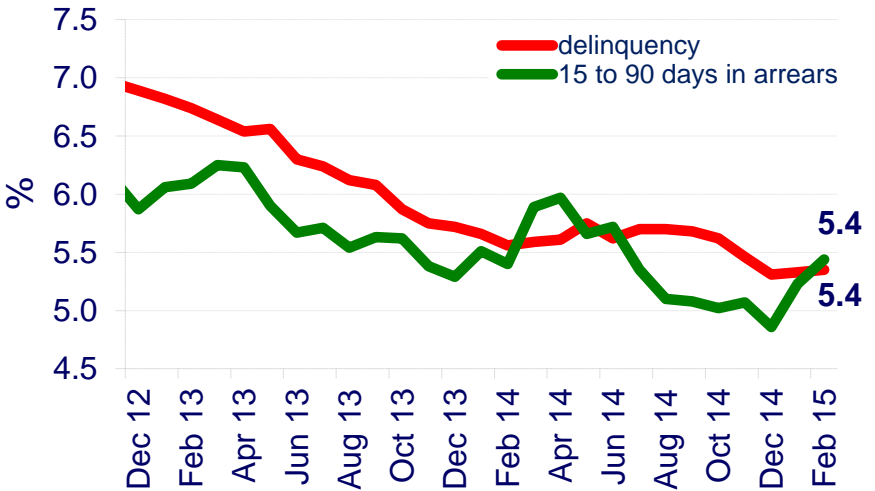
Corporates



Prime Rate

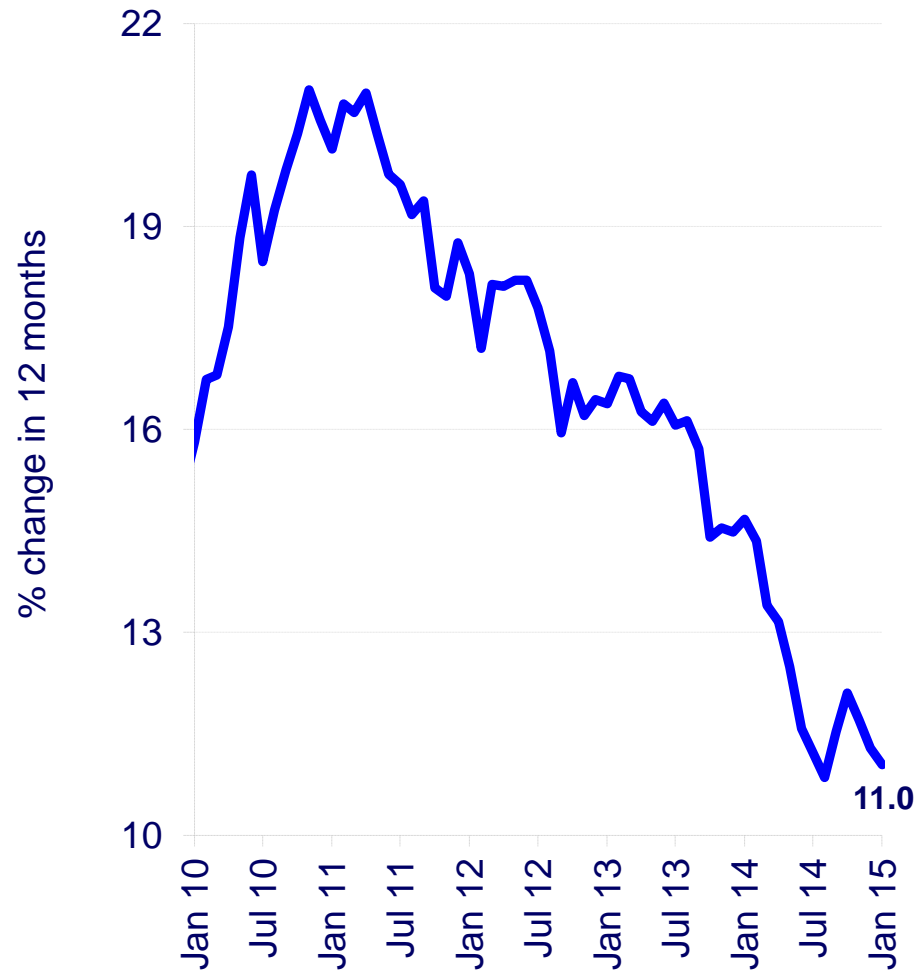


Individuals

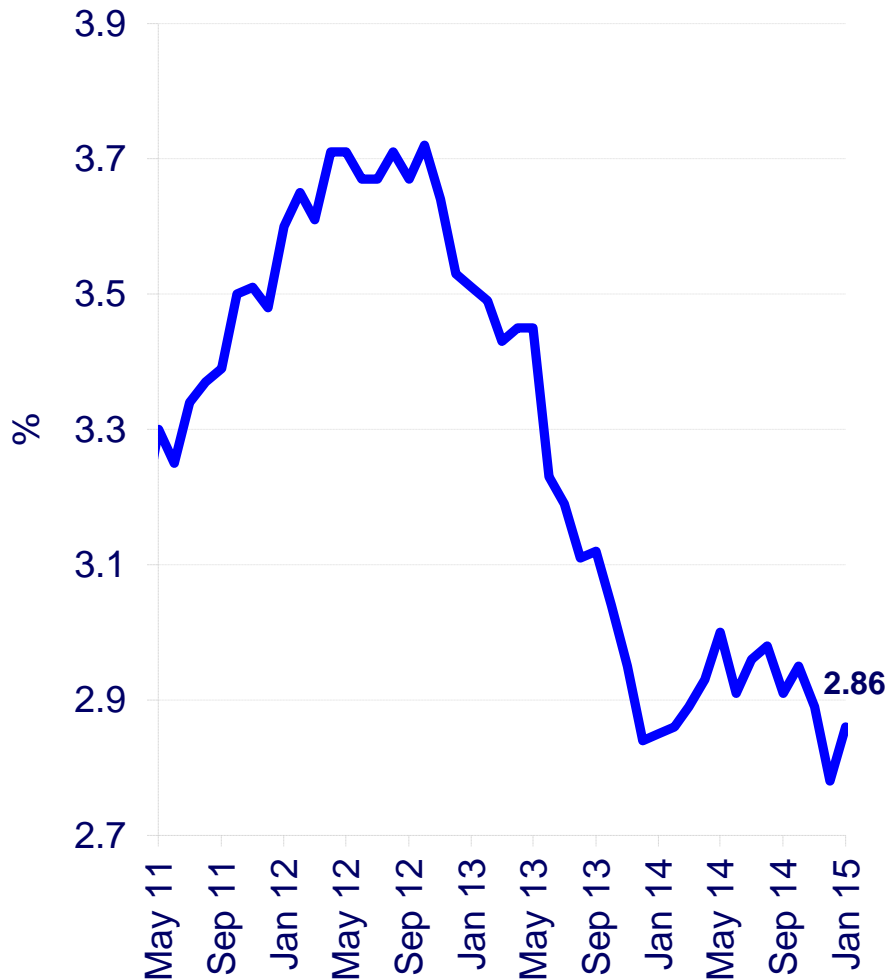


Credit and Delinquency

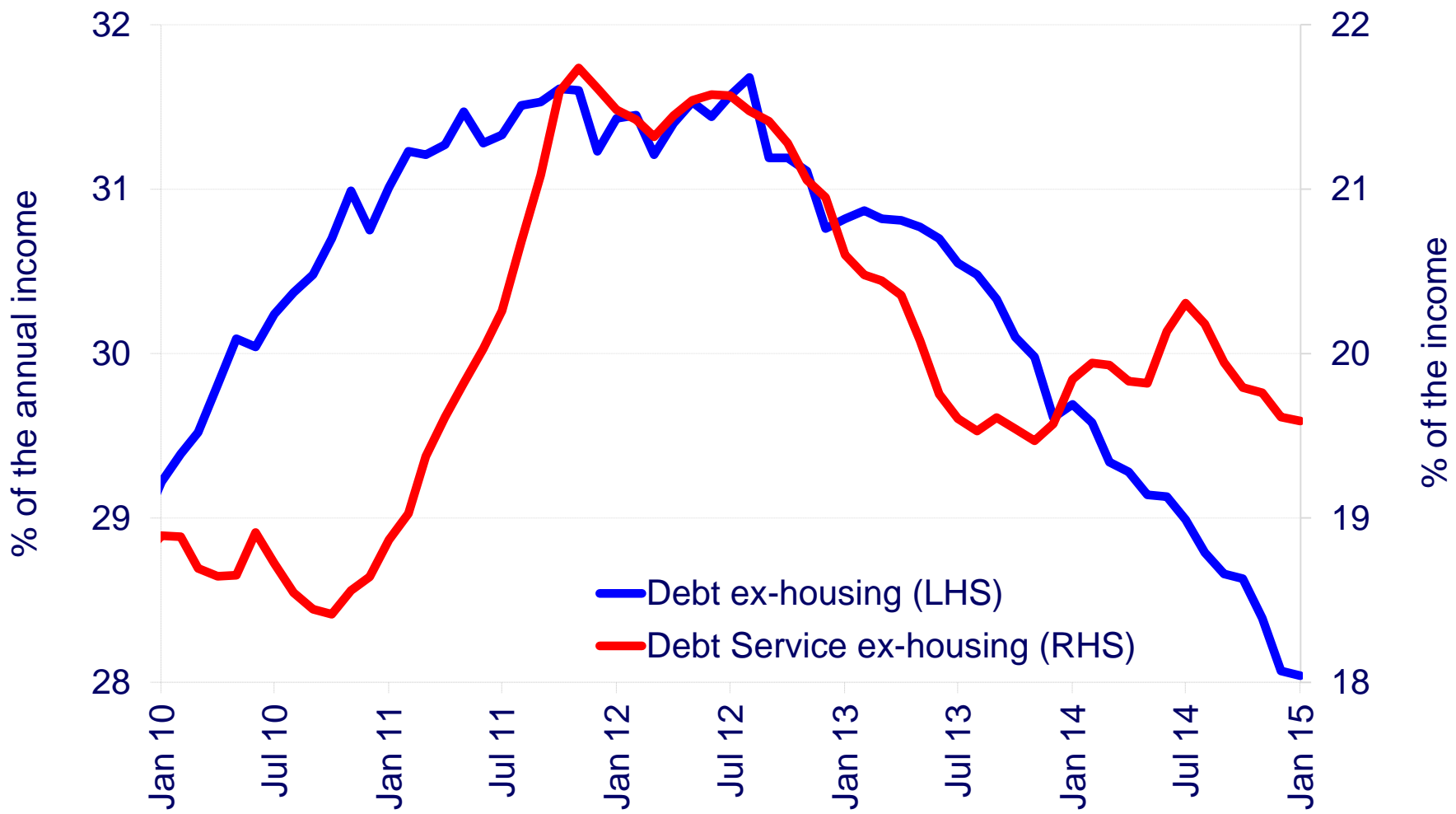
Expansion of Credit Outstanding



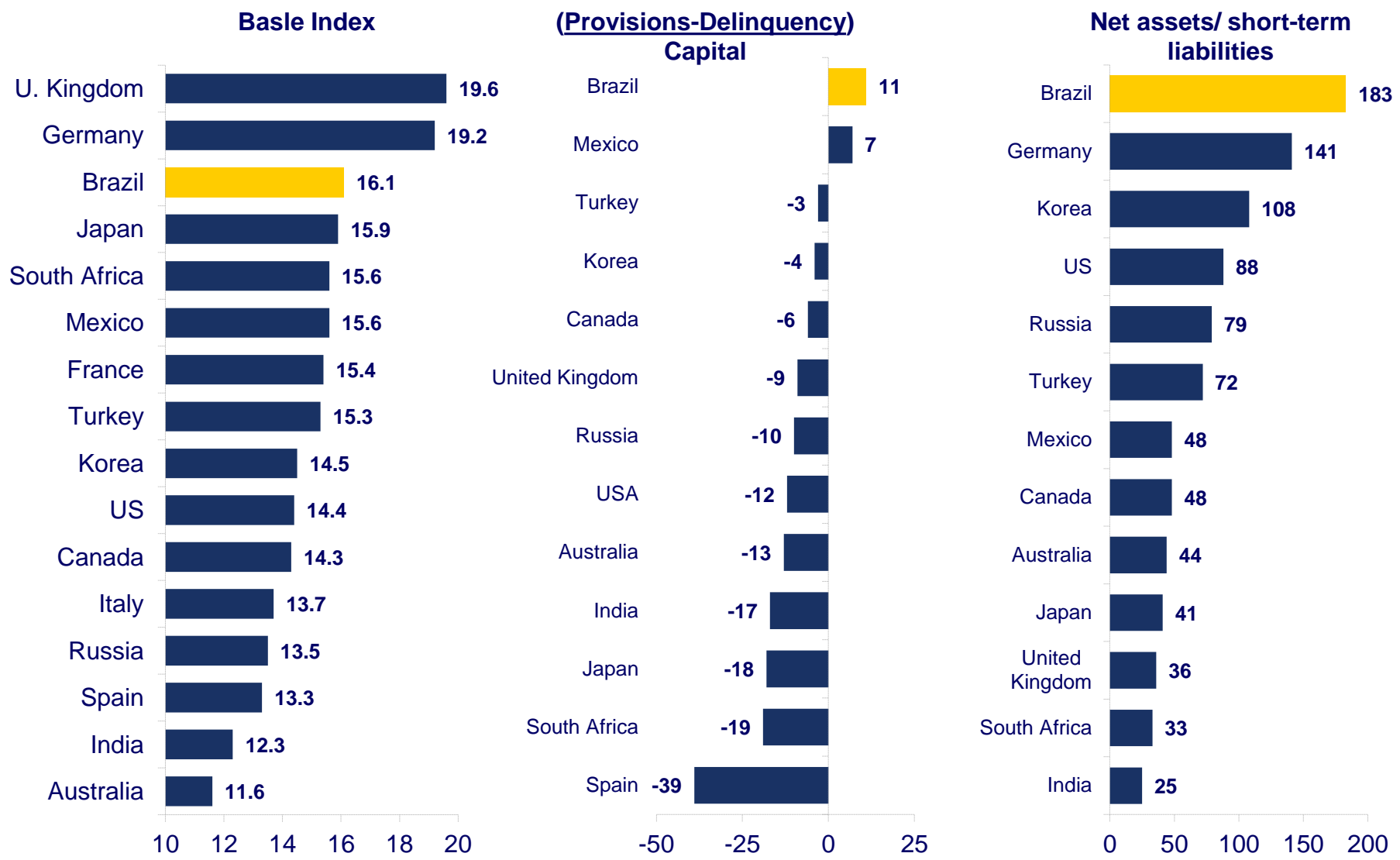
Delinquency



Declining Household's Debt



Financial Soundness Indicators



Source: IMF (FSI – last available data)

Box: Revision of the Credit Statistics

- Revision of the statistics, with improvement of the classification criteria by credit modalities. The objective is to update and complement the reformulation implemented in February 2013
- The improvement of the information systems allowed the production of new statistics:
 - Credit card interest rates (revolving credit, credit in installments and total)
 - Segmentation of the credit operations according to the borrowers' economic activity sector, based on the National Classification of Economic Activities (CNAE), adopted by the IBGE

Box: Issuance of Subsidiaries Abroad

- Brazilian companies took advantage from the international liquidity after the 2008 financial crisis to issue bonds via subsidiaries abroad
- The external debt statistics reflect the parcel of the resources that are internalized and destined to the headquarters in Brazil
- The registers of BCB foreign capital indicate that approximately 79% of the resources obtained via issuances of subsidiaries abroad are internalized
- Part of the non-internalized resources is used for the constitution of assets abroad
- There is natural protection for these liabilities as many of the Brazilian groups are exporters
- The operations are continuously monitored by the BCB

IV. Activity

- A year of adjustments (2015) and transition with growth rates that tend to be low (below potential)
- Possible recovery (confidence improvement) as of the end of the year

Retrospective - Brazil

Since the last Report release:

- Indicators from the industry, commerce and services evidenced low dynamism of activity in Q42014
- In the market of factors: UCI in relative stability and labor market with narrow iddleness, but with signs of cooling at the margin
- Continuity of the two processes of correction of relative prices; less favorable scenario for inflation in the short run
- The Selic was increased to 12.75%

Prospects – Brazil 2015-2016

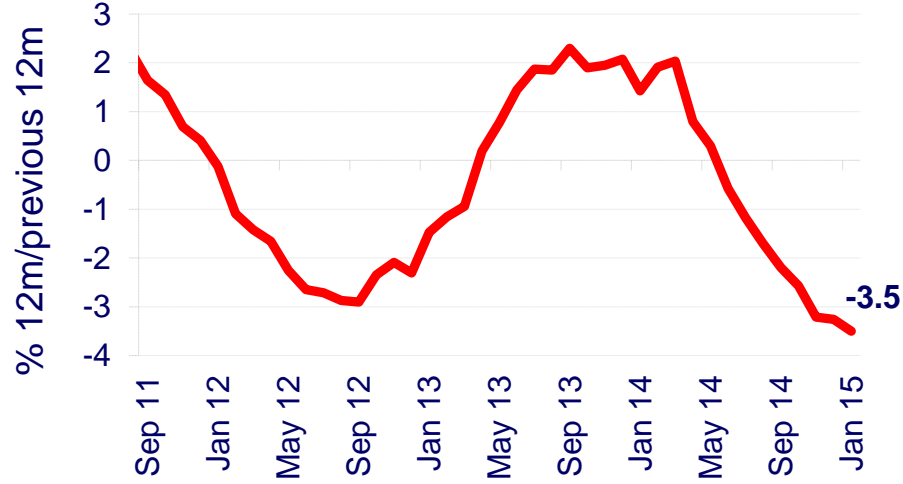
- The activity expansion pace tends to be moderated in the relevant horizon
- In the relevant horizon for the monetary policy, changes in the composition of aggregate demand and supply are anticipated
- *Deficit* in the current accounts tends to continue to be financed, essentially, with FDI inflows
- Moderate credit expansion

Prospects – Brazil 2015-2016

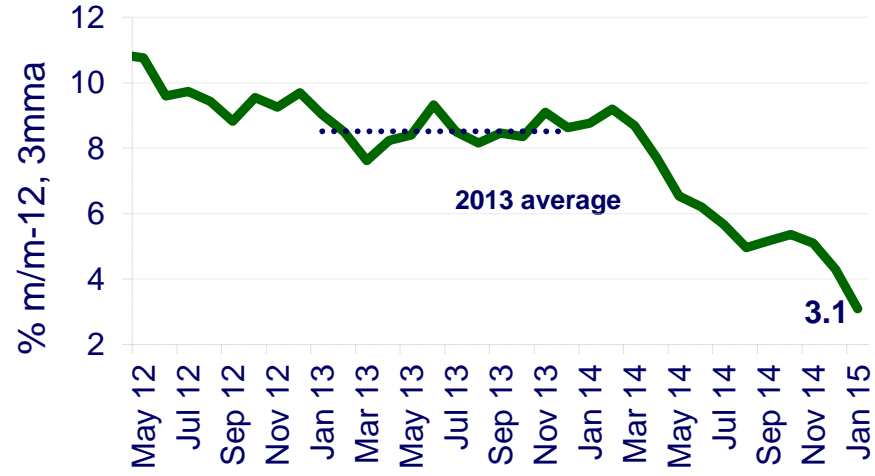
- Prices adjustments impacted Q12015 inflation
 - Prices realignments - domestic *versus* external and regulated *versus* market prices; expectations and wages costs
- But the inflation convergence scenario for the 2016 target has strengthened
 - Monetary policy acts to ensure that short term pressures do not propagate for longer term horizons:
 - Processes of prices realignment concentrated in Q12015
 - Inflation expectations more favorable at the end of the forecast horizon
 - Labor market distress
 - The public sector result tends to shift to the neutrality zone – not discarding the hypothesis of migration to the contention zone

Supply

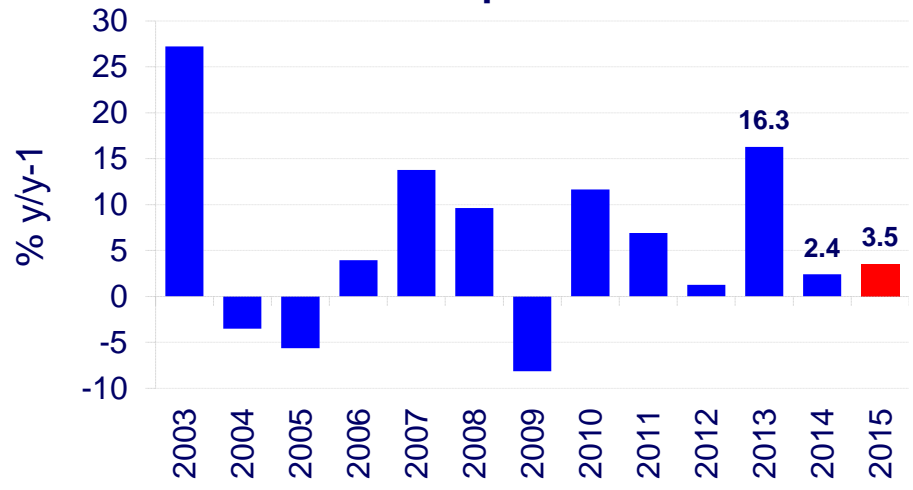
Industrial Production



Services Nominal Income

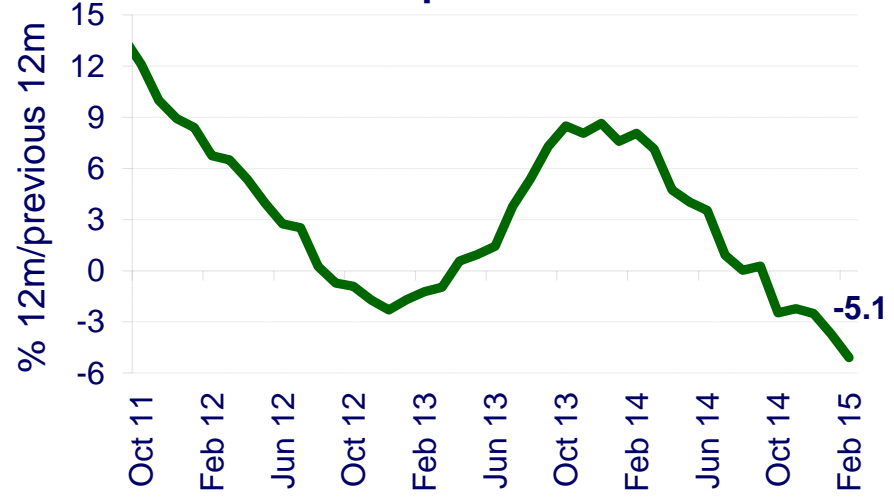


Crop Harvest



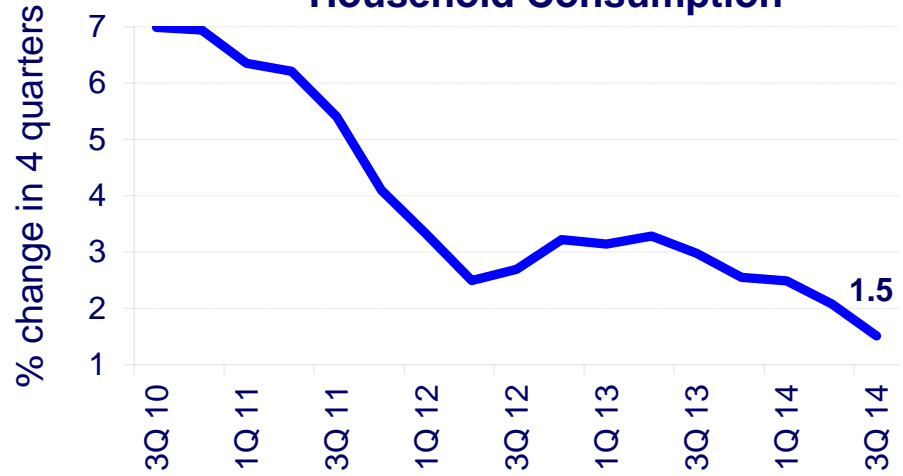
2015: IBGE estimates in Feb/15

Imports Quantum

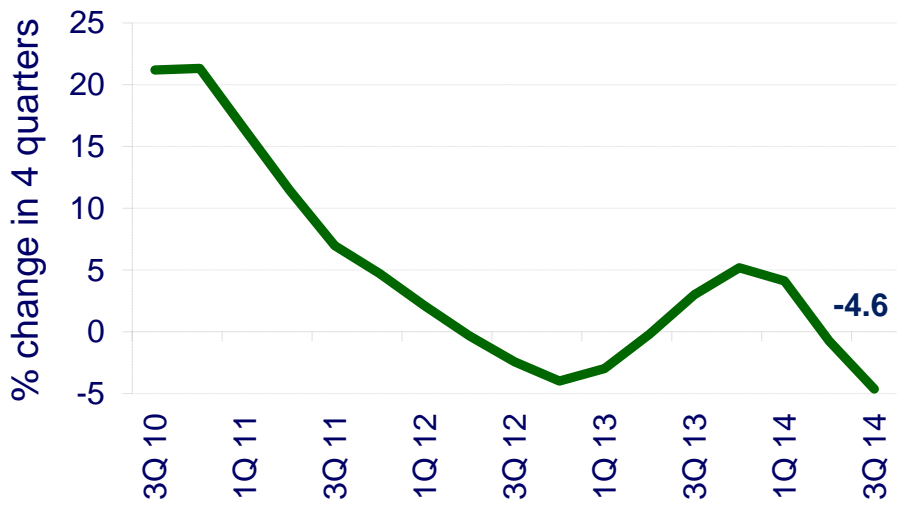


Demand

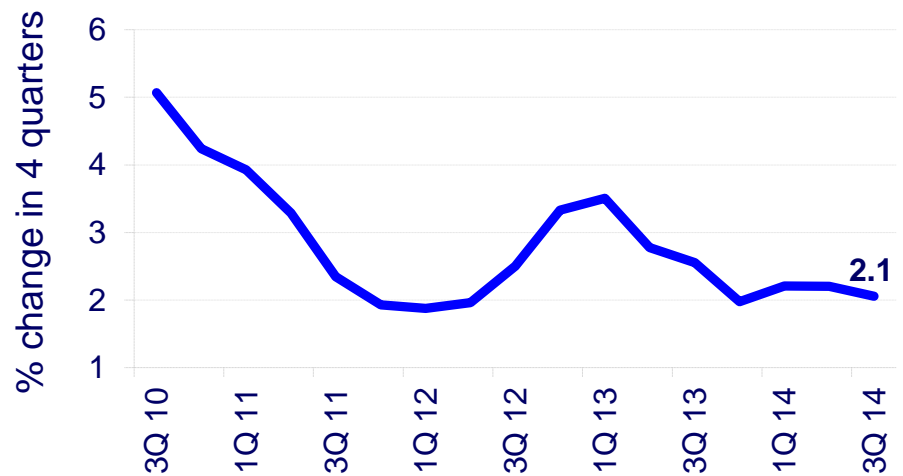
Household Consumption



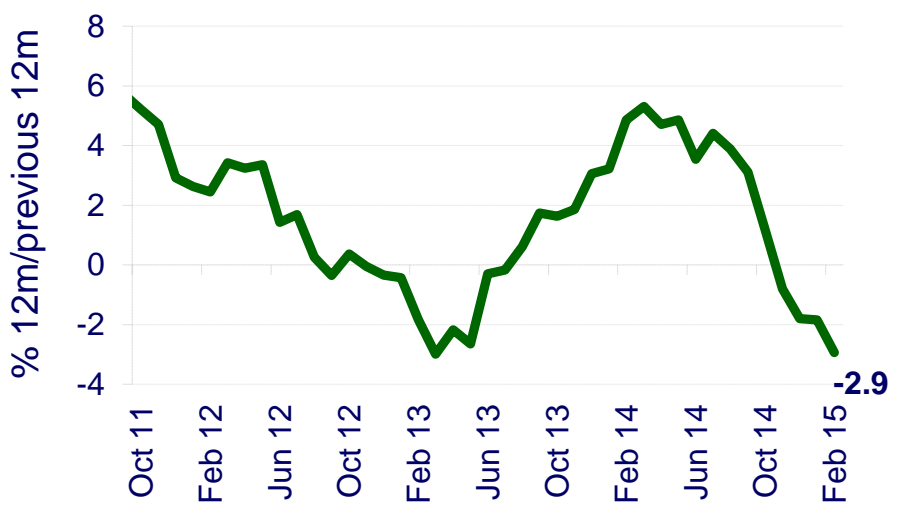
FCGF



Government Consumption

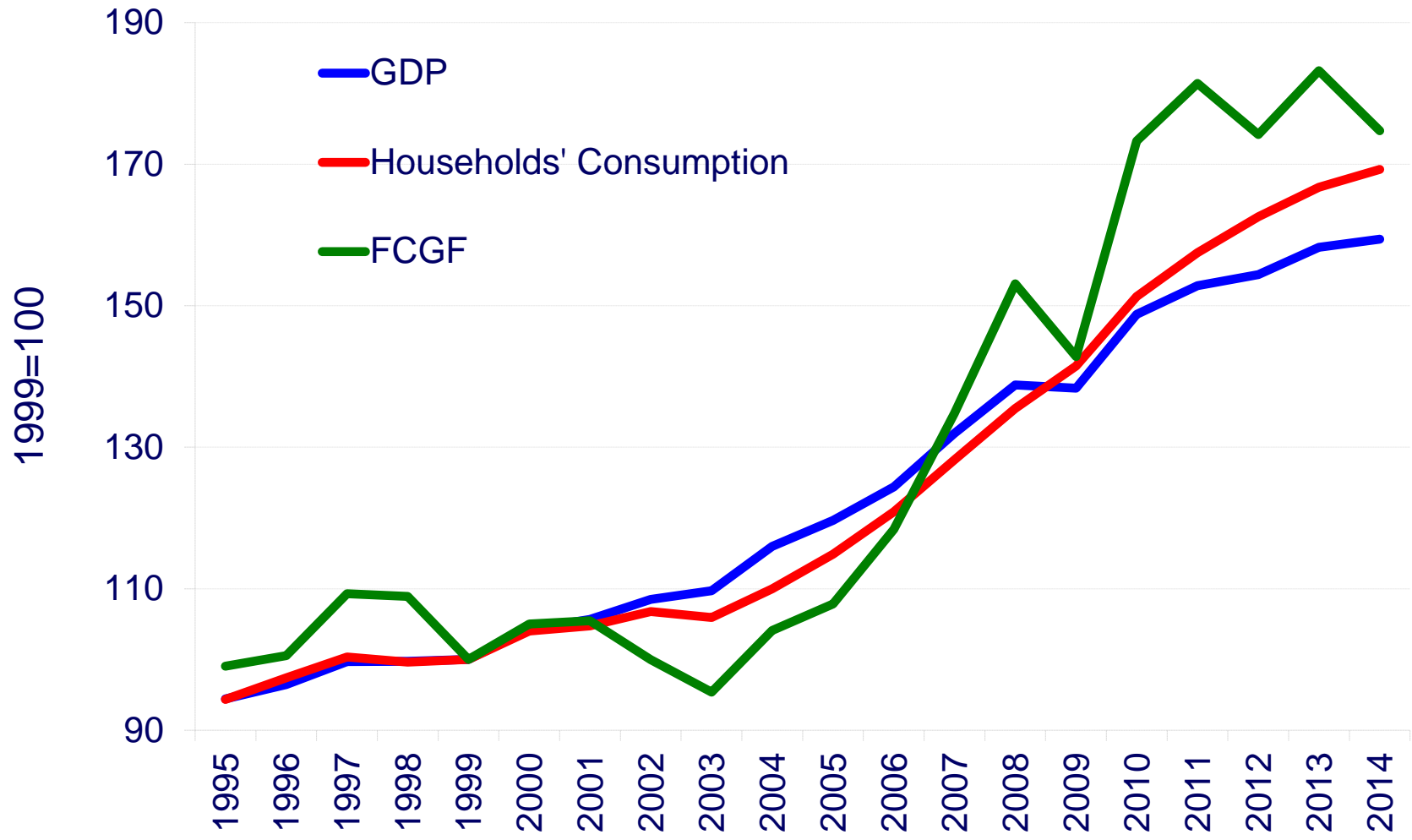


Exports Quantum



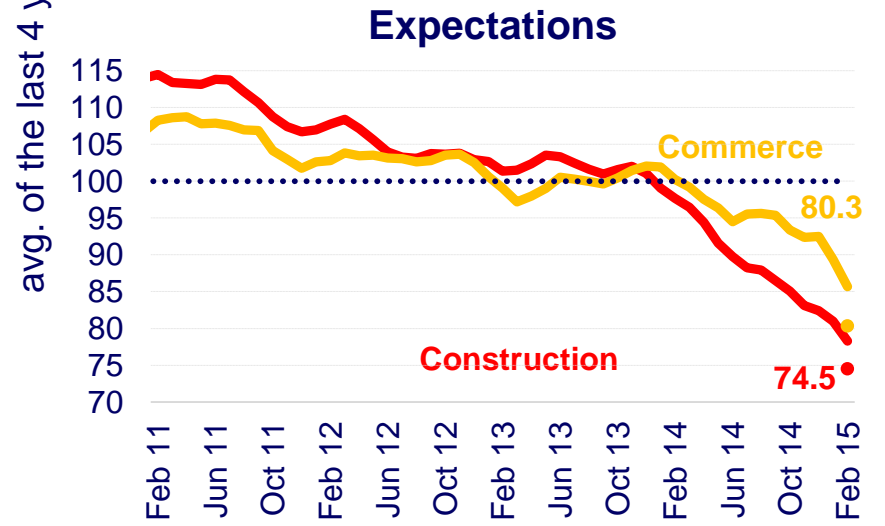
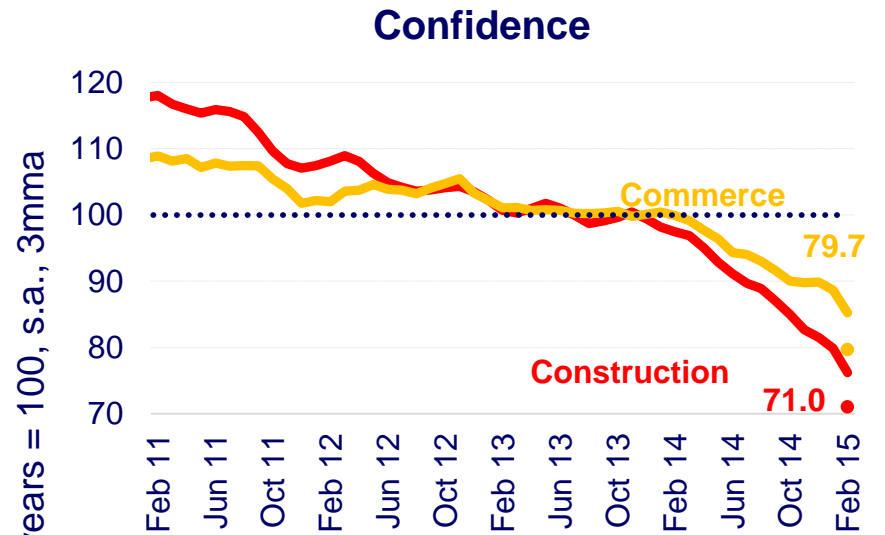
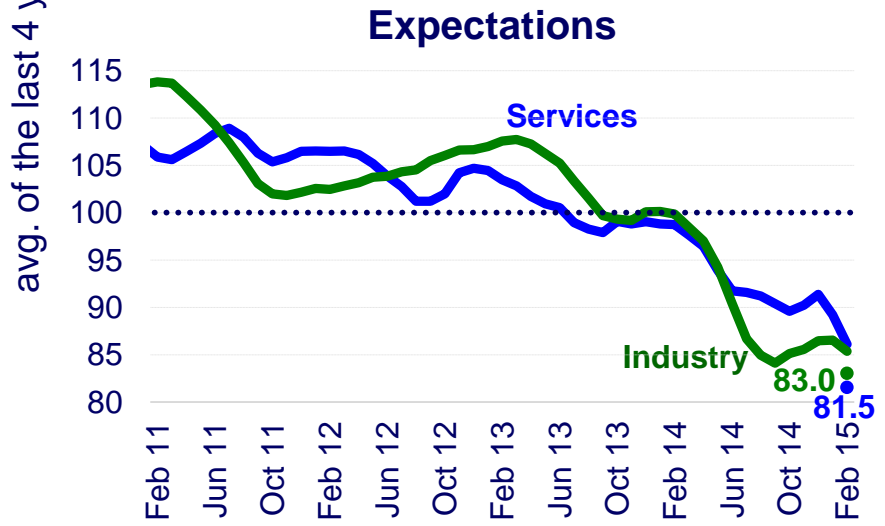
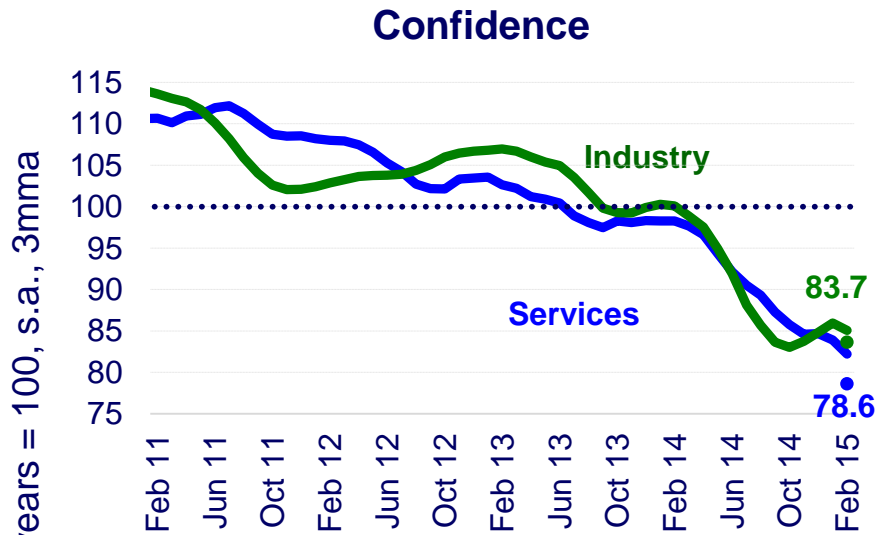
Activity (long-term perspective)

GDP, Households' Consumption and FCGF



Data through the 3rd quarter of 2014

Confidence



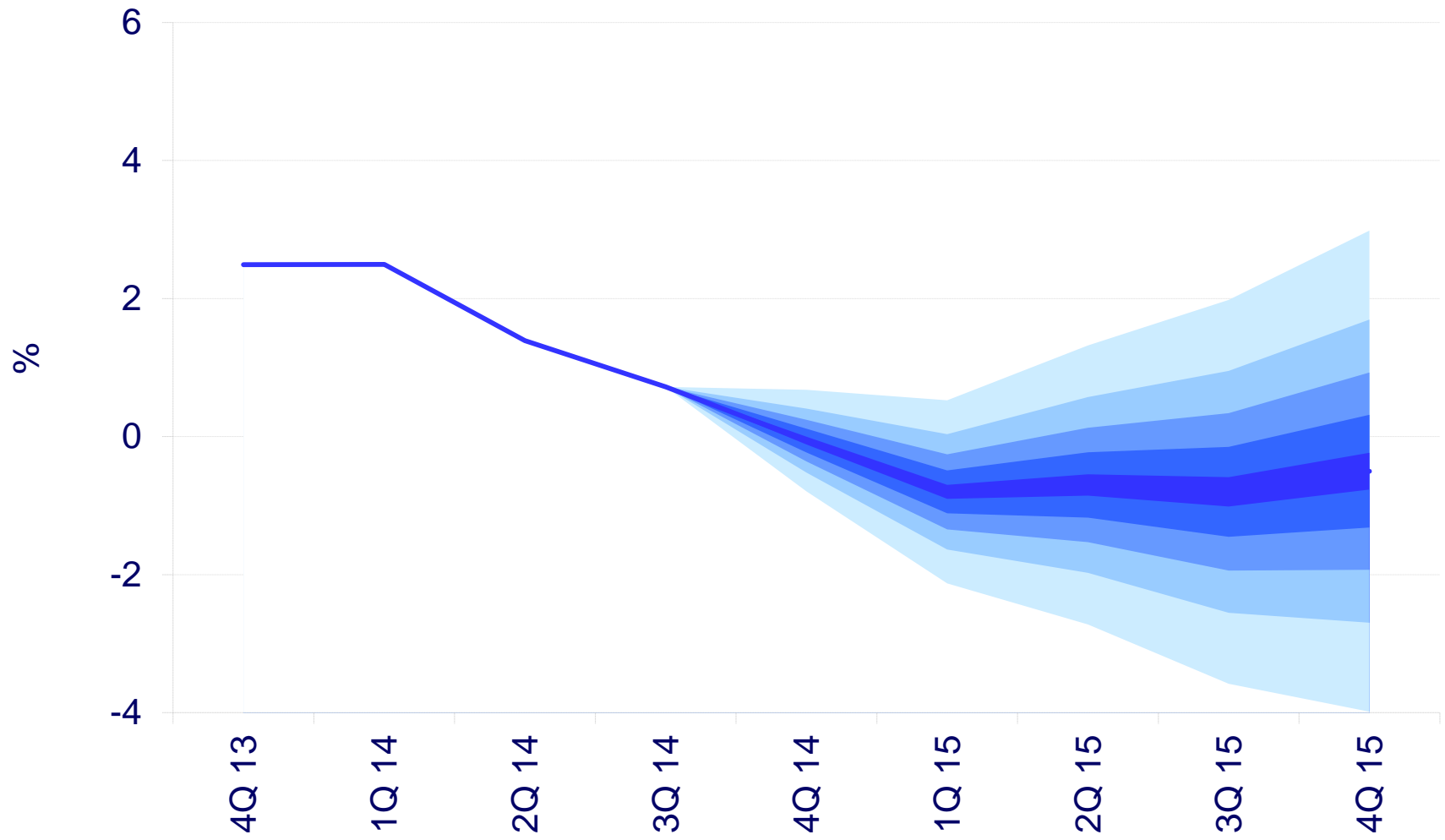
Obs.: Proportion of favorable answers – proportion of unfavorable answers + 100 (100=neutral)

Box: GDP Projection

- **Revision of the 2014 growth rate, from 0.2% to -0.1%**
- **Change of -0.5% in 2015**
- **Supply:**
 - Agriculture and livestock: 1.0% (1.3% in 2014)
 - Industry: -2.3% (-1.7% in 2014)
 - Services: 0.1% (0.6% in 2014)
- **Demand:**
 - Investments: -6.0% (-8.2% in 2014)
 - Households' Consumption: 0.2% (1.0% in 2014)
 - Government Consumption: 0.3% (1.8% in 2014)

GDP Forecast

Baseline Scenario*



* interest rate constant at 12.75% p.y.

V. Inflation Developments

- The double relative prices adjustment (regulated and external) increased Q12015 inflation and the expectations
- Improvement of the monthly inflation will already begin to be felt in April-May 2015

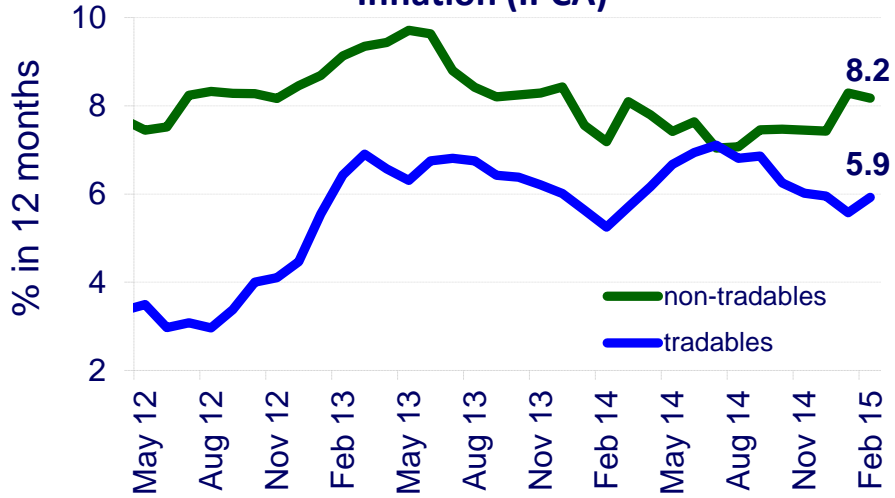
Inflation Developments

Price Indices

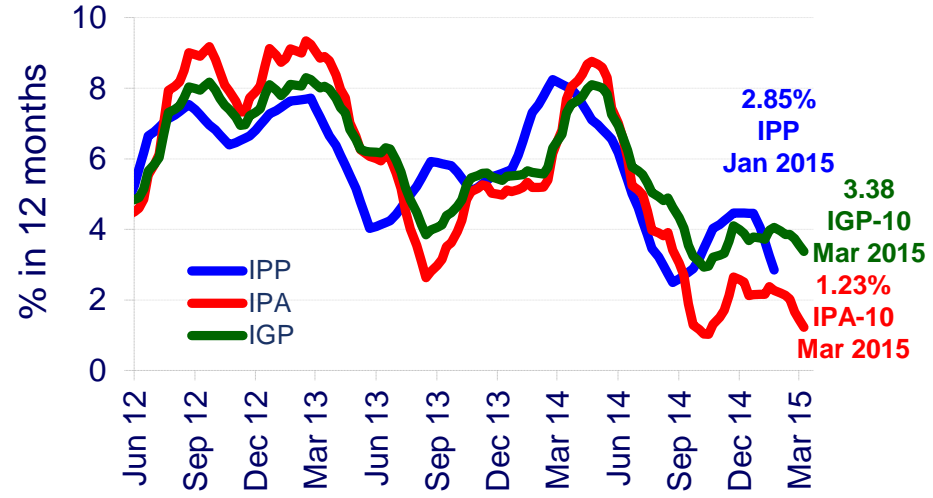
| | Change in 12 months (%) | | |
|----------------------|-------------------------|-------------|----------|
| | Feb/14 | Feb/15 | |
| IPCA | 5.68 | 7.70 | ▲ |
| Market Prices | 6.28 | 7.12 | ▲ |
| Regulated | 3.71 | 9.66 | ▲ |
| Tradables | 5.25 | 5.92 | ▲ |
| Non-Tradables | 7.19 | 8.17 | ▲ |
| INPC | 5.39 | 7.68 | ▲ |
| IPC-C1 | 5.00 | 8.06 | ▲ |
| IGP-DI | 6.30 | 3.74 | ▼ |
| IPA-DI | 6.15 | 1.67 | ▼ |
| Agricultural | 0.47 | 6.17 | ▲ |
| Industrial | 8.41 | 0.01 | ▼ |
| IPC-DI | 5.95 | 7.99 | ▲ |
| INCC-DI | 8.04 | 6.98 | ▼ |

Prices

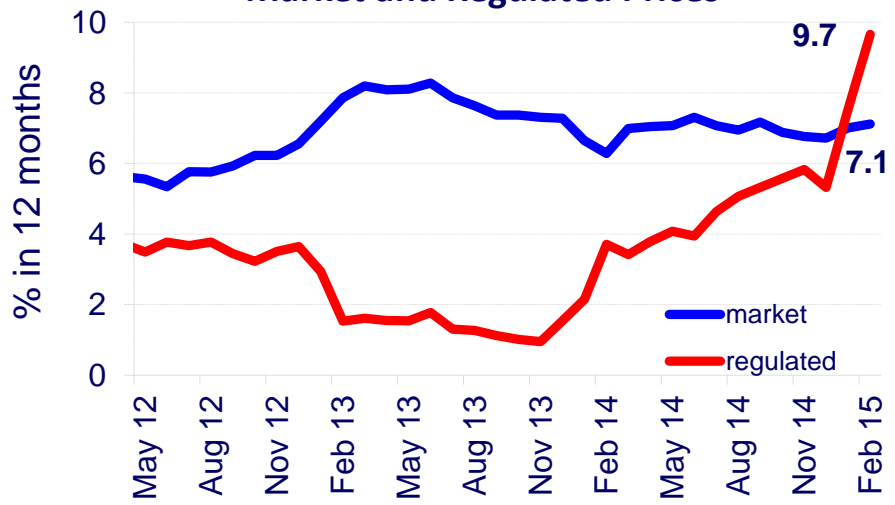
Inflation (IPCA)



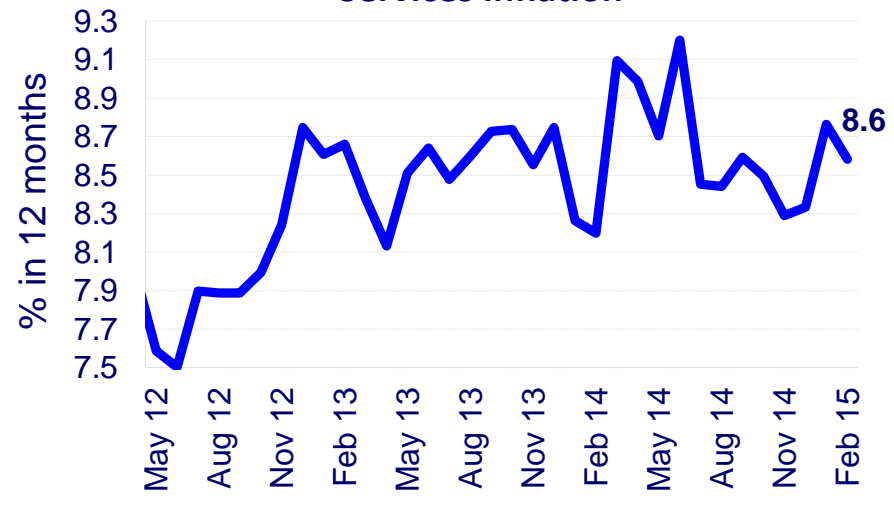
Wholesale Prices and IGP



Market and Regulated Prices

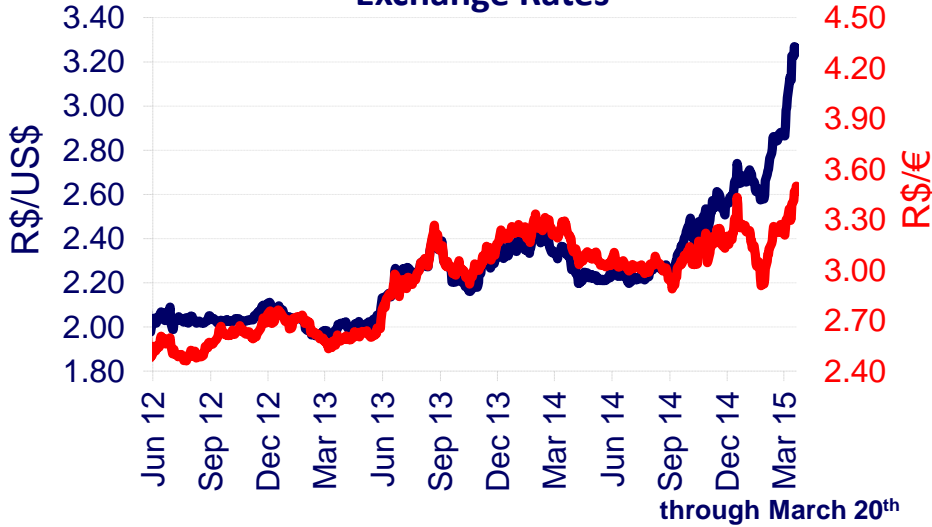


Services Inflation

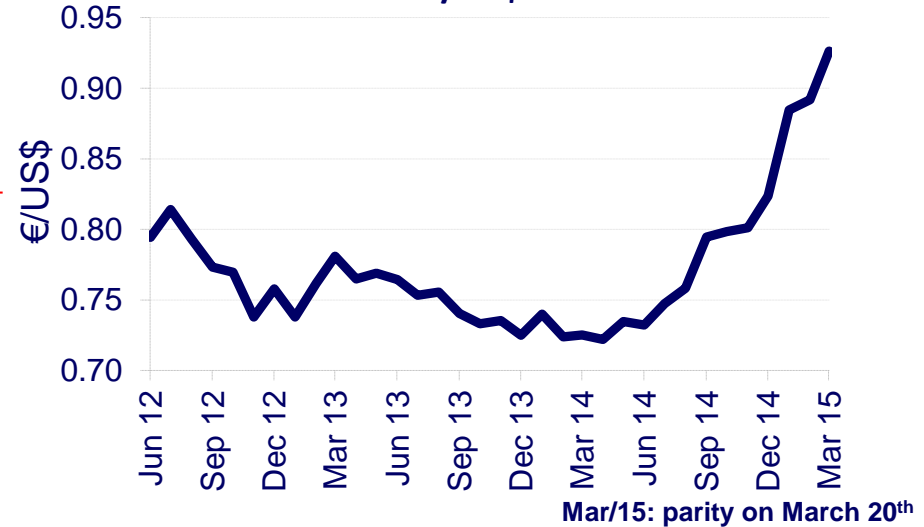


Exchange Rate

Exchange Rates



€/US\$



Real Effective Exchange Rate

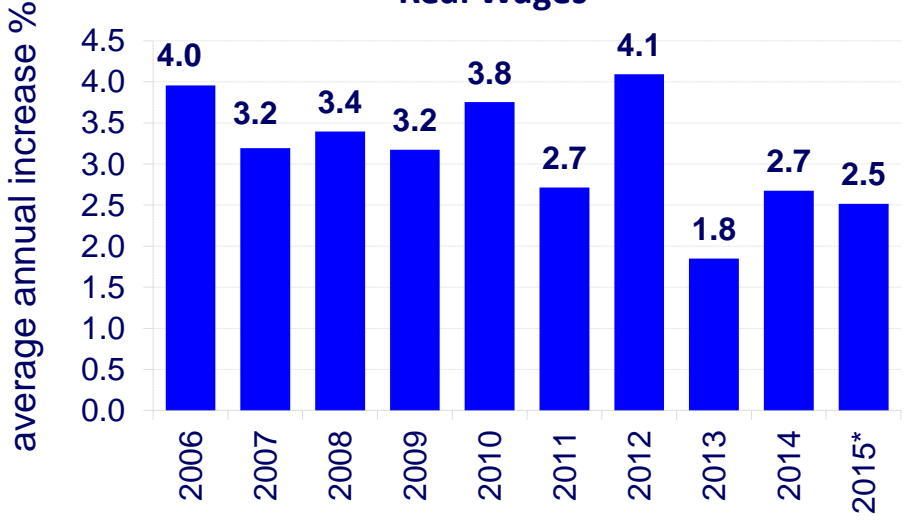


US\$ Real Exchange Rate (DXY)

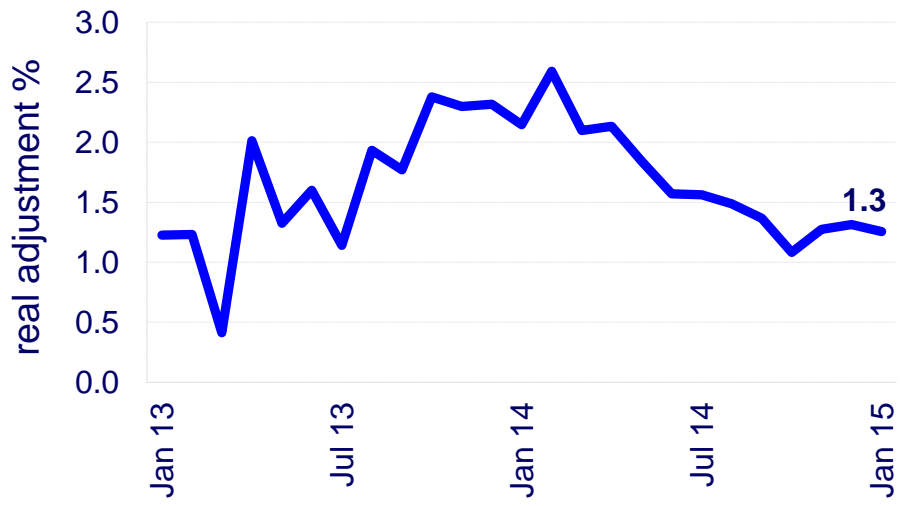


Wages

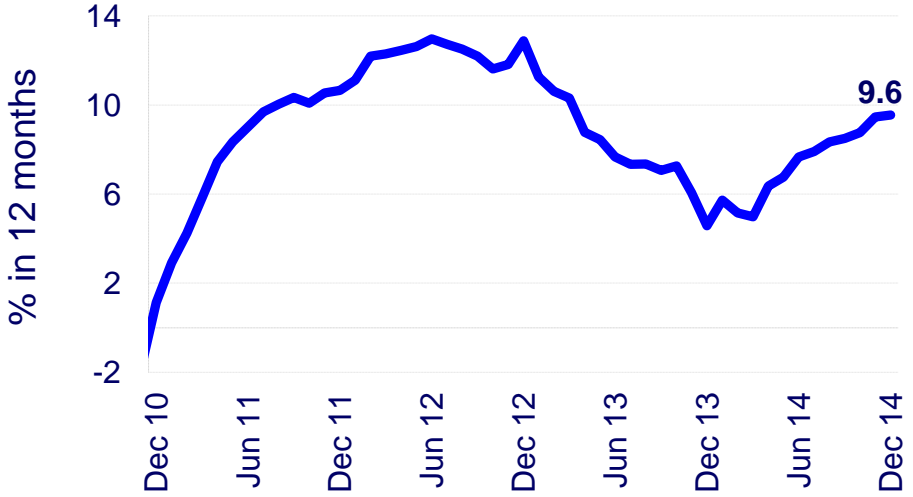
Real Wages



Labor Collective Conventions



ULC**



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

BCB Inflation Forecasts

Baseline Scenario: Interest rate constant at 12.75% p.y. and exchange rate of R\$3.15/US\$

| Period | Probability Interval | | | | | | Central projection |
|--------|----------------------|-----|-----|-----|-----|-----|--------------------|
| | 50% | | | | | | |
| | 30% | | | | 10% | | |
| | 80% | 70% | 60% | 50% | 40% | 30% | |
| 2015 1 | 8.0 | 8.0 | 8.0 | 8.1 | 8.1 | 8.2 | 8.1 |
| 2015 2 | 7.6 | 7.8 | 8.0 | 8.1 | 8.3 | 8.4 | 8.0 |
| 2015 3 | 7.6 | 7.8 | 8.1 | 8.3 | 8.5 | 8.8 | 8.2 |
| 2015 4 | 7.2 | 7.5 | 7.8 | 8.1 | 8.4 | 8.7 | 7.9 |
| 2016 1 | 4.9 | 5.3 | 5.7 | 6.0 | 6.4 | 6.8 | 5.9 |
| 2016 2 | 4.4 | 4.8 | 5.2 | 5.5 | 5.9 | 6.3 | 5.4 |
| 2016 3 | 4.0 | 4.4 | 4.8 | 5.2 | 5.5 | 5.9 | 5.0 |
| 2016 4 | 3.9 | 4.3 | 4.7 | 5.1 | 5.4 | 5.8 | 4.9 |
| 2017 1 | 3.7 | 4.1 | 4.5 | 4.8 | 5.2 | 5.6 | 4.7 |

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

*data of March 13th

BCB Inflation Forecasts

Market Scenario*: 2015 Interest rate at 13.00% p.y. and exchange rate of R\$3.06/US\$
 2016 Interest rate at 11.50% p.y. and exchange rate of R\$3.11/US\$

| Period | Probability interval | | | | | | Central projection |
|--------|----------------------|-----|-----|-----|-----|-----|--------------------|
| | 50% | | | | | | |
| | 30% | | | | 10% | | |
| | 80% | 70% | 60% | 50% | 40% | 30% | |
| 20151 | 8.0 | 8.0 | 8.0 | 8.1 | 8.1 | 8.2 | 8.1 |
| 20152 | 7.6 | 7.8 | 8.0 | 8.1 | 8.2 | 8.4 | 8.0 |
| 20153 | 7.6 | 7.8 | 8.0 | 8.3 | 8.5 | 8.7 | 8.1 |
| 20154 | 7.1 | 7.4 | 7.7 | 8.0 | 8.3 | 8.6 | 7.9 |
| 20161 | 4.9 | 5.3 | 5.6 | 5.9 | 6.3 | 6.7 | 5.8 |
| 20162 | 4.4 | 4.8 | 5.1 | 5.5 | 5.8 | 6.2 | 5.3 |
| 20163 | 4.0 | 4.5 | 4.8 | 5.2 | 5.5 | 5.9 | 5.0 |
| 20164 | 4.1 | 4.5 | 4.9 | 5.2 | 5.6 | 6.0 | 5.1 |
| 20171 | 4.0 | 4.4 | 4.8 | 5.1 | 5.5 | 5.9 | 4.9 |

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

*data of March 13th

Market Expectations – Summary

| | 2015 | | | 2016 | | |
|--------------------------------------|----------|---|---------|----------|---|---------|
| | 12/31/14 | | 3/20/15 | 12/31/14 | | 3/20/15 |
| IPCA | 6.56 | ▲ | 8.12 | 5.70 | ▼ | 5.61 |
| Regulated Prices | 7.85 | ▲ | 12.60 | 5.80 | ▼ | 5.50 |
| Market Prices | 6.00 | ▲ | 6.16 | 5.66 | = | 5.66 |
| IGP-M | 5.65 | ▲ | 6.10 | 5.50 | = | 5.50 |
| IPA-DI | 5.68 | ▲ | 6.25 | 5.10 | ▲ | 5.30 |
| Selic (end-of-period) | 12.50 | ▲ | 13.00 | 11.50 | = | 11.50 |
| Exchange rate (end-of-period) | 2.80 | ▲ | 3.15 | 2.80 | ▲ | 3.20 |
| GDP | 0.50 | ▼ | -0.83 | 1.80 | ▼ | 1.20 |
| Industrial Production | 1.04 | ▼ | -2.19 | 2.68 | ▼ | 1.68 |
| Trade Balance | 5.00 | ▼ | 3.50 | 10.00 | ▲ | 11.00 |
| FDI | 60.00 | ▼ | 56.50 | 60.00 | ▼ | 58.00 |
| Primary Result | 1.00 | ▼ | 0.80 | 1.90 | ▼ | 1.80 |

Prospects – Projections – 2014-2015-2016

- **GDP Projection:**

- 2014 GDP change estimated at -0.1%
- 2015 GDP change estimated at -0.5%

- **Inflation projections:**

- Baseline scenario: 7.9% (2015) and 4.9 % (2016)
- Market scenario: 7.9 % (2015) and 5.1 % (2016)

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 confirms 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 shown sufficient yet.



Inflation Outlook

Thank you!

Inflation Report

March 2015