

Inflation Outlook

Carlos Hamilton Araújo

September 2014

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IV. Activity

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I. Introduction

BCB's Mission

- Ensuring the stability of the purchasing power of the currency and a solid and efficient financial system

Importance of this Mission

- The international experience and the economic theory set low and stable inflation as a precondition to sustainable growth
 - **High inflation:**
 - It increases risk premiums, diminishes confidence, shortens the planning horizon and depresses investment
 - Reduces employment, income and consumption
 - Increases the income concentration, diminishes the economic growth and the society welfare

The Brazilian Experience

Period	Annual Average (%)	
	Real GDP Growth	Inflation
1980-1985	2.6	147.1
1986-1994	2.3	842.5
1995-2003	2.2	9.1
2004-2013	3.7	5.5

Retrospective - Abroad

Since the last Report release :

- The risks to global financial stability remained high, although, in general, an environment of low volatility has prevailed, despite geopolitical events:
 - In the US, the process of normalization of monetary conditions has continued
- The scenario of more intense global activity has consolidated, despite the heterogeneity of the expansion pace in the main economies
- In the international markets, there was retreat in the prices of agriculture and energy commodities, and increase in the prices of metal commodities
- In general terms, accommodative monetary policy stance remained, in the emerging and mature economies

Retrospective - Brazil

Since the last Report release:

- The national accounts relative to the second quarter of 2014 pointed to alignment of the domestic absorption and GDP growth rates; and that, at the margin, GDP growth decreased 0.6%
- In the market of factors: ICU in slight decline and narrow idleness margin in the labor market
- The prices dynamics in the wholesale markets – both in the industrial and in the agricultural segment – were benign
- Two important relative prices (Domestic/External and Regulated/Market) correction processes have advanced; the monthly consumer inflation was moderate, but, on a twelve-month basis, it remained high
- The Selic rate remained at 11%

Prospects – Abroad 2014-2016

- Risks for the global financial stability tend to remain high:
 - Highlights for the risks stemming from changes in the interest rate slope in important mature economies
- Prospects for more intense global activity pace throughout the relevant horizon for the monetary policy, with growth around the trend:
 - Highlights for the heterogeneity of the main blocks
- New tension and volatility focuses in the currency markets are likely to be observed, as well as decompression in the risk premiums
- In the relevant horizon for the monetary policy, prospects for the gradual increase of the global inflation

Prospects – Brazil 2014-2016

- Activity expansion pace tends to be less intense this year, compared to 2013:
 - In the upcoming quarters, annual GDP growth rates tend to be low and below potential growth
- In the relevant horizon for the monetary policy, changes in the composition of aggregate supply and demand are anticipated:
 - Composition of medium-term growth tends to be more favorable to the long-term growth (potential growth)
- Current accounts' deficit tends to continue to be essentially financed by FDI flows
- Moderate credit expansion:
 - Credit to consumption tends to grow at a pace in line with the growth of households available income

Prospects – Brazil 2014-2016

- In the next quarters, inflation tends to remain high:
 - Two important prices realignment processes - domestic *versus* external prices and regulated *versus* market prices – tend to intensify
 - Wage pressures
 - High inflation expectations
- But, considering the maintenance of the monetary conditions, the inflation tends to enter a trajectory of convergence to the target in the final quarters of the forecast period:
 - The output gap tends to remain disinflationary in the next quarters
 - The wage pressures and the ones stemming from the two above mentioned prices realignment processes tend to moderate
 - Effects of the Selic rate increase over inflation will, in part, still materialize
 - Inflation expectations are more favorable at the end of the forecast period
 - The composition of inflation tends to be sustainable

Prospects – Forecasts - 2014-2015

GDP Forecast:

- 2014 GDP growth estimate at 0.7%
- GDP growth estimate in four quarters up to June 2015 at 1.2%

Inflation Forecasts:

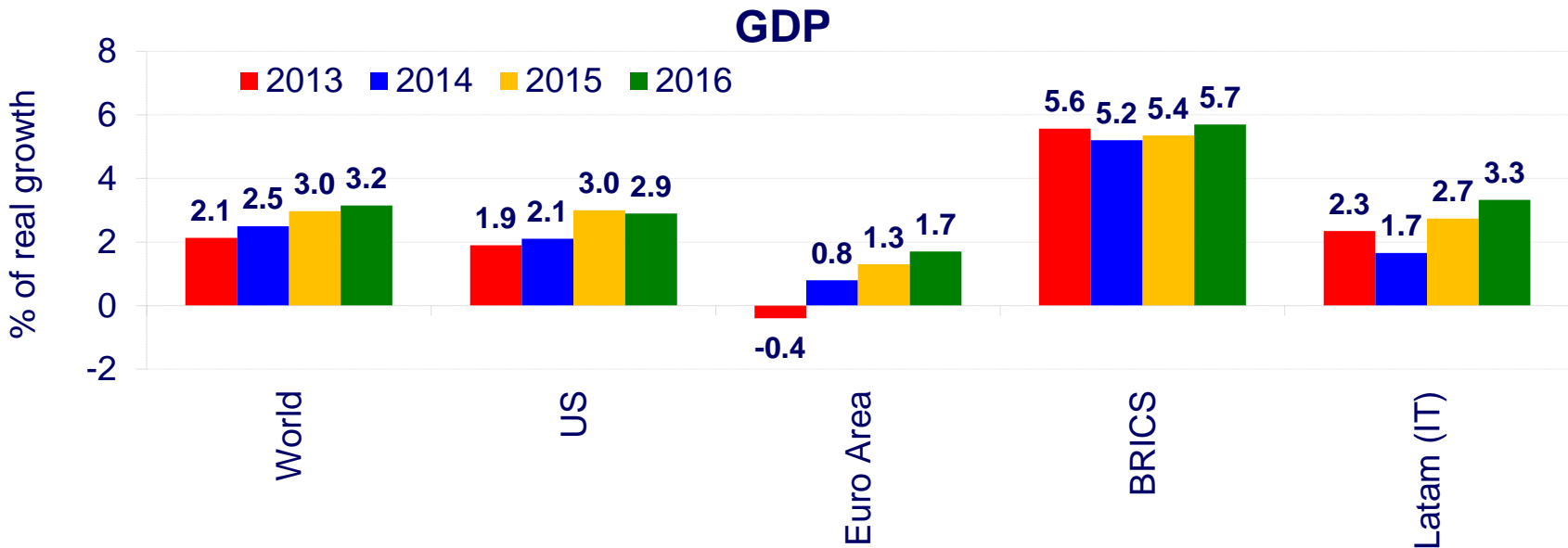
- Baseline scenario: 6.3% for 2014; 5.8% for 2015; and 5.0% in twelve months up to the third quarter of 2016
- Market scenario: 6.3% for 2014; 6.1% for 2015; and 5.2% in twelve months up to the third quarter of 2016

Prospective Scenario – Monetary Policy

- The Copom highlights that, in moments such as the current one, the monetary policy should remain vigilant, in order to minimize risks that high inflation levels, such as the one observed in the last twelve months, persist in the relevant horizon for the monetary policy

II. International Environment

Activity – Expectations



2014 GDP (%)

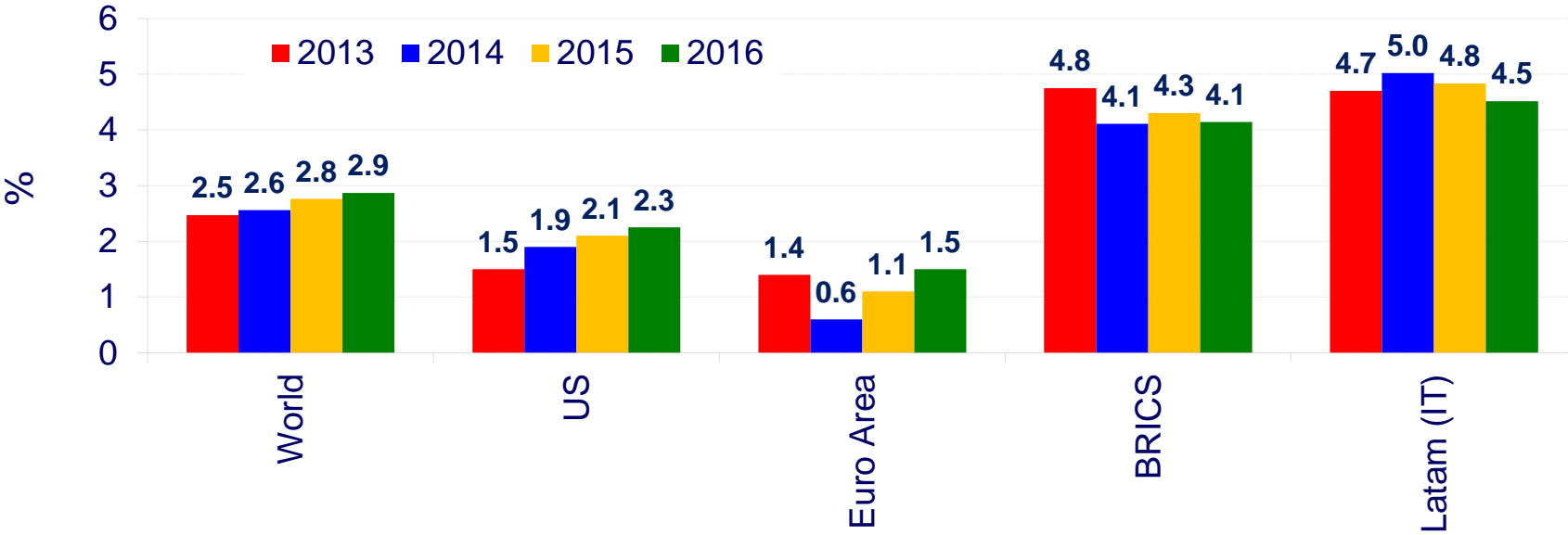
	2013		2014	
	Dec	Mar	Jun	Sep
US	2.6	2.7	2.2	2.1
Euro Area	1.0	1.1	1.1	0.8
Japan	1.6	1.4	1.5	1.1
UK	2.4	2.7	3.0	3.1
China	7.5	7.4	7.3	7.4
India	4.8	4.7	4.7	5.4
Brazil	2.0	1.7	1.2	0.3

2015 GDP (%)

	2013		2014	
	Dec	Mar	Jun	Sep
US	3.0	3.0	3.0	3.0
Euro Area	1.4	1.5	1.5	1.3
Japan	1.2	1.2	1.2	1.2
UK	2.4	2.5	2.5	2.6
China	7.2	7.2	7.2	7.1
India	5.5	5.4	5.4	5.4
Brazil	2.5	2.0	1.6	1.0

Sources: Bloomberg and Focus – last available day of each month

Inflation – Expectations



2014 Inflation (%)

	2013		2014	
	Dec	Mar	Jun	Sep
US	1.7	1.7	1.8	1.9
Euro Area	1.2	1.0	0.7	0.6
Japan	2.4	2.6	2.7	2.8
UK	2.2	2.0	1.8	1.7
China	3.1	2.7	2.5	2.3
India	9.2	9.5	9.5	7.2
Brazil	6.0	6.3	6.5	6.3

2015 Inflation (%)

	2013		2014	
	Dec	Mar	Jun	Sep
US	2.0	2.0	2.1	2.1
Euro Area	1.5	1.4	1.3	1.1
Japan	1.8	1.8	1.8	1.8
UK	2.2	2.0	2.0	1.9
China	3.2	3.2	3.0	2.8
India	8.0	8.1	7.8	7.8
Brazil	5.5	5.8	6.1	6.3

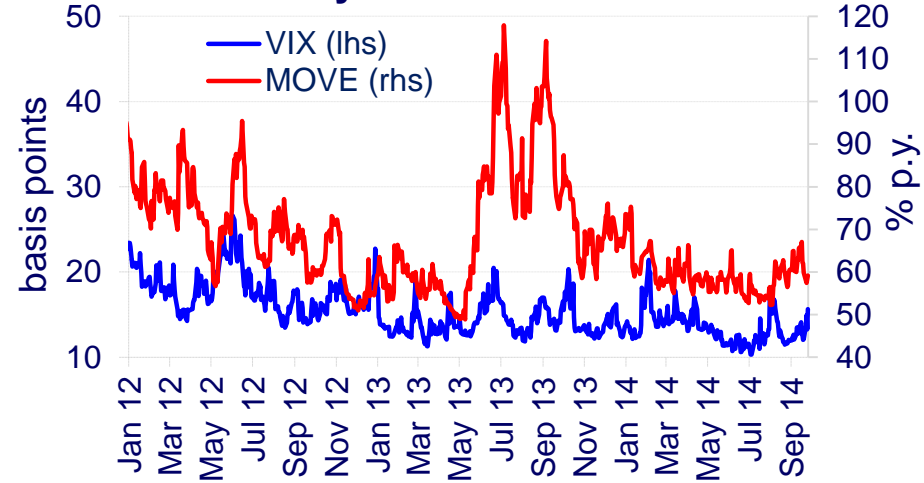
Sources: Bloomberg and Focus – last available day of each month

Commodities and Volatility

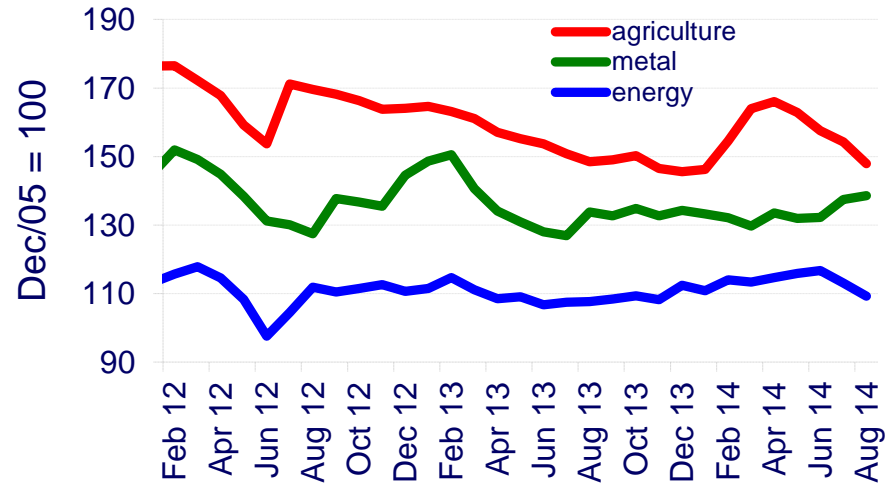
CRB



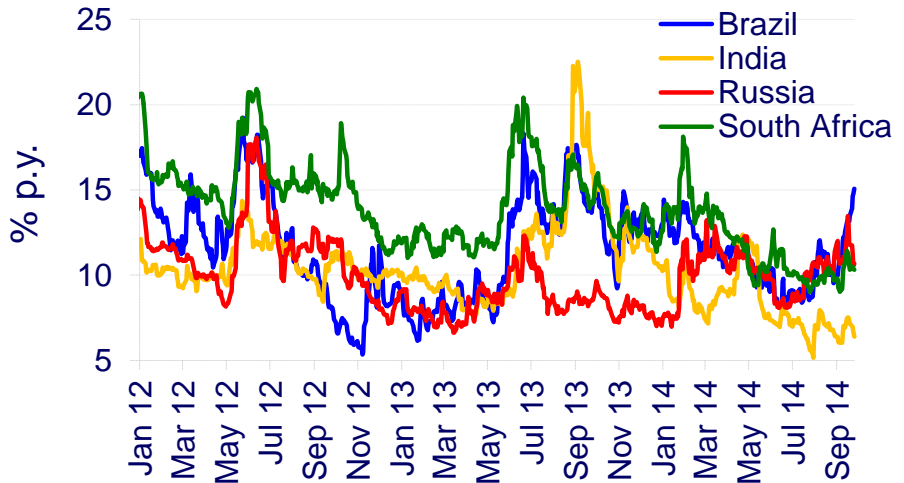
VIX and Volatility in the Securities' Markets



IC-Br (R\$)



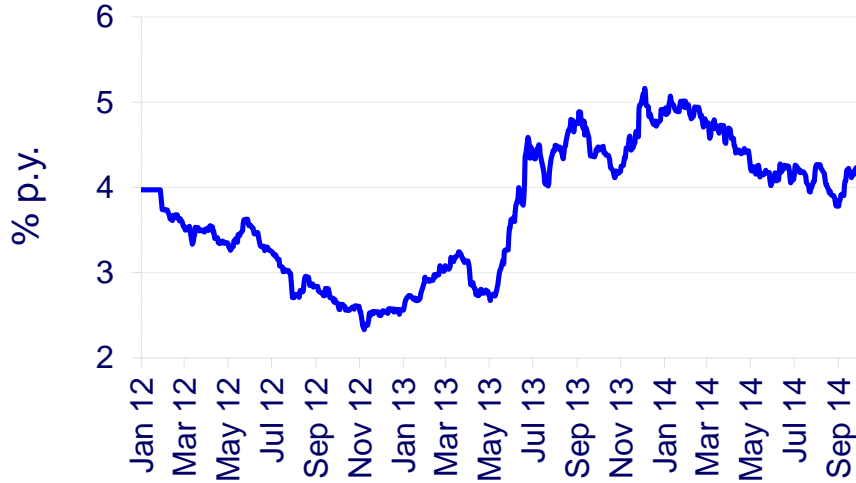
Currency Volatility



data up to 9/25

Interest Rate and Risk Premium

Brazil – 10-Year Interest Rate

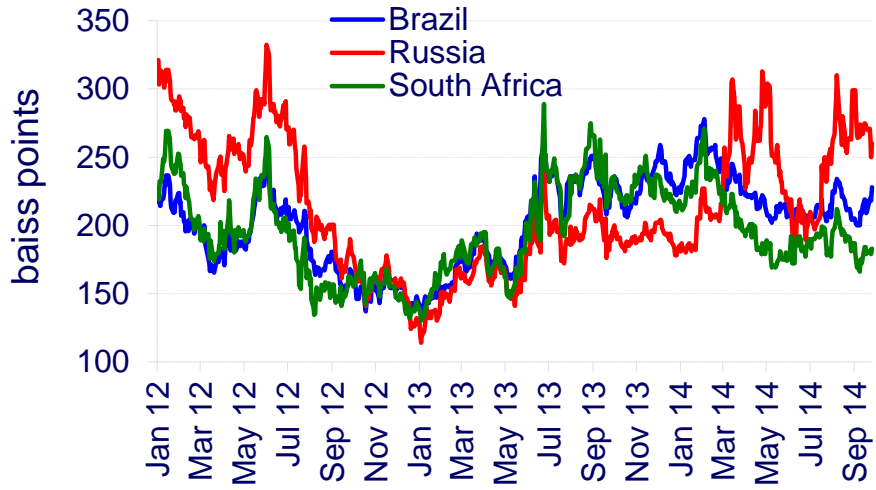


Ratings

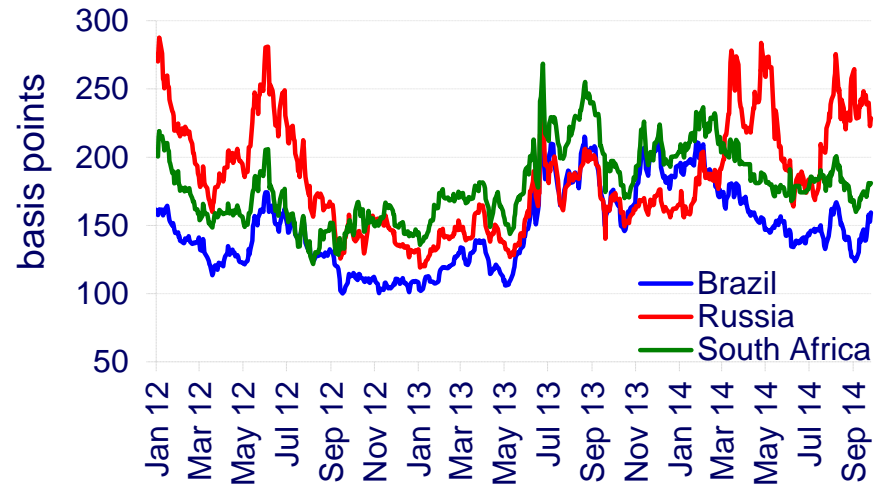
	Moody's	S&P	Fitch
Brazil	Baa2 (-)	BBB- (=)	BBB (=)
Russia	Baa1 (-)	BBB- (-)	BBB (-)
India	Baa3 (=)	BBB- (-)	BBB- (=)
South Africa	Baa1 (-)	BBB- (=)	BBB (-)

= estable; - negative; r review

EMBI+



CDS

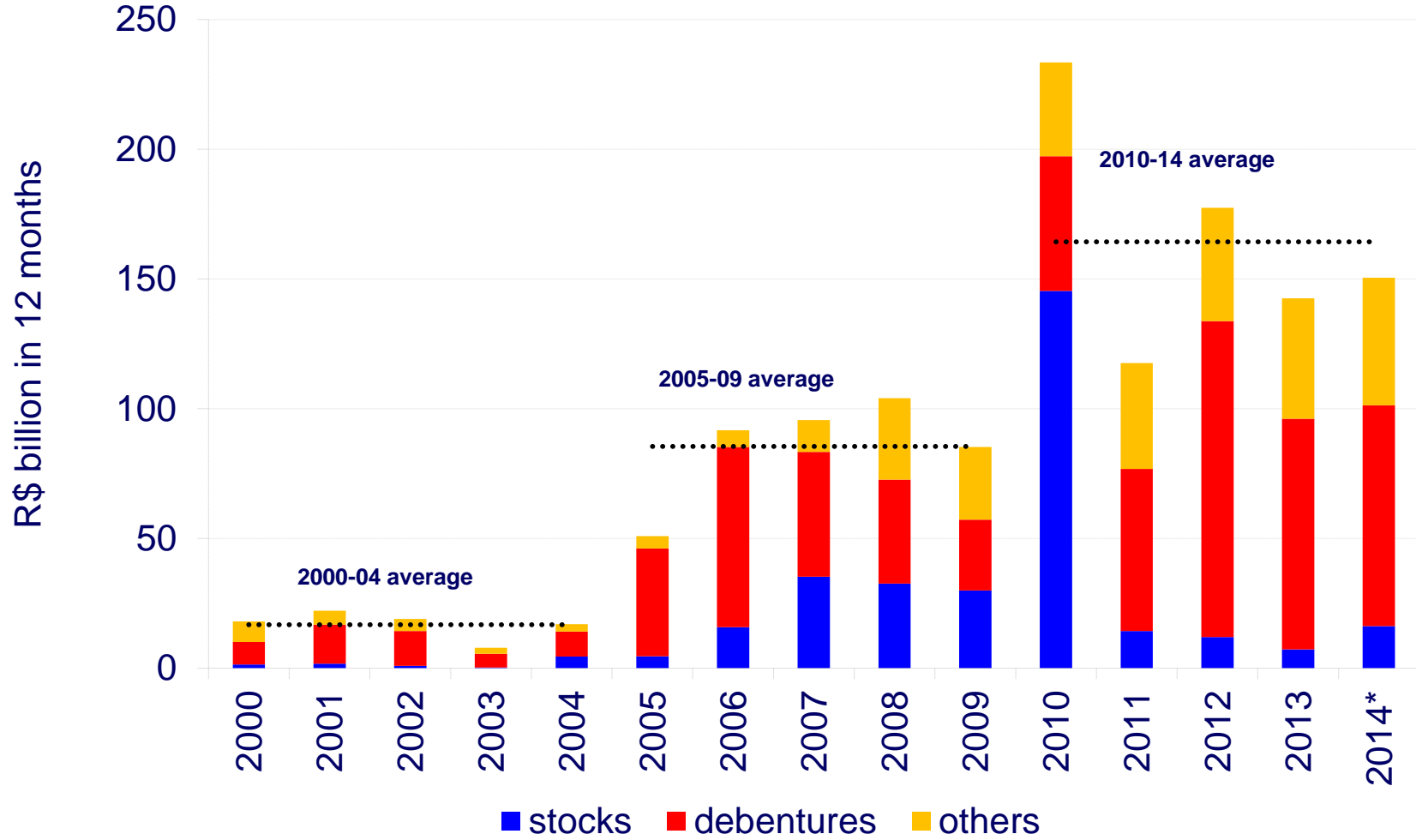


data up to 9/25

III. Financial Conditions

Capital Market Domestic Operations

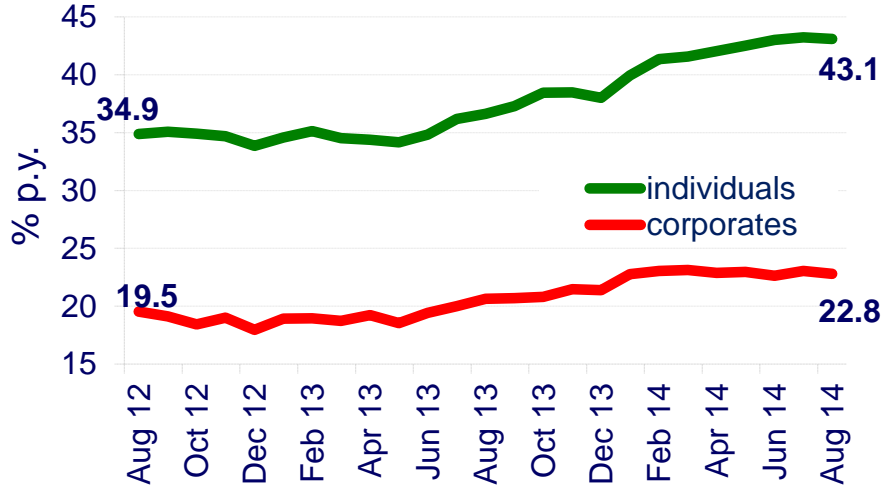
Primary Issues



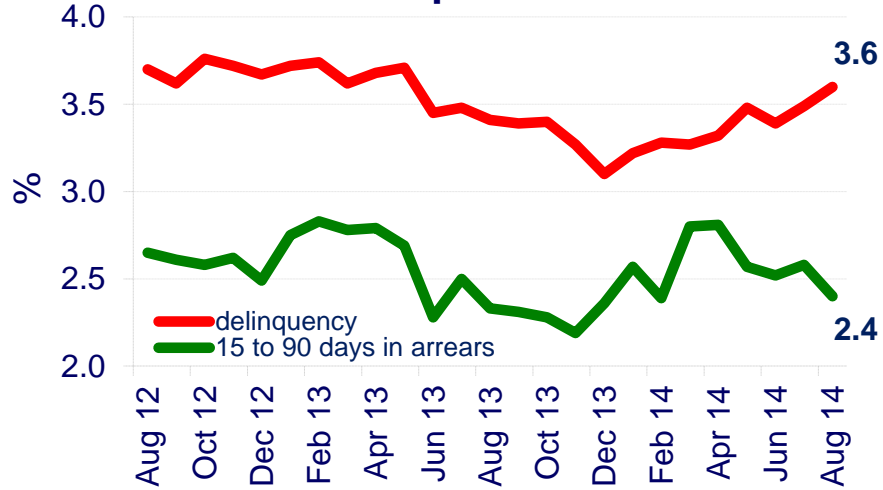
*12 months through Jul/14

Non-Earmarked Credit: Cost, Delinquency and Arrears

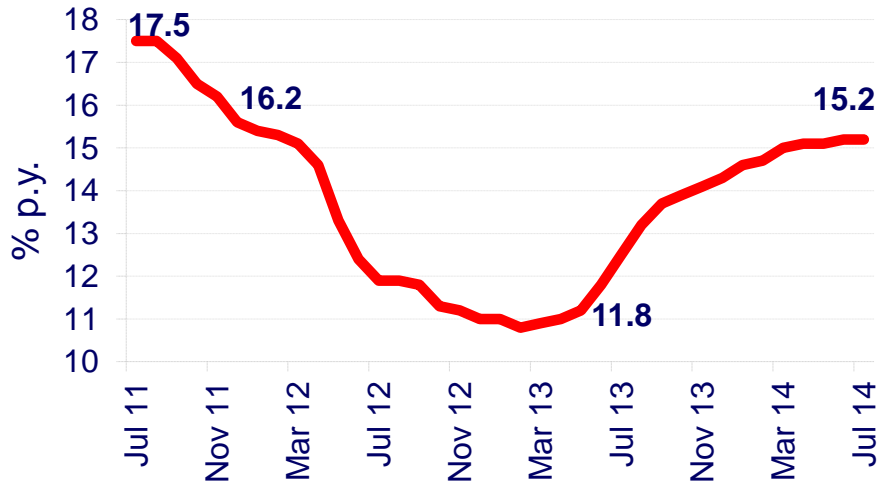
Interest Rate



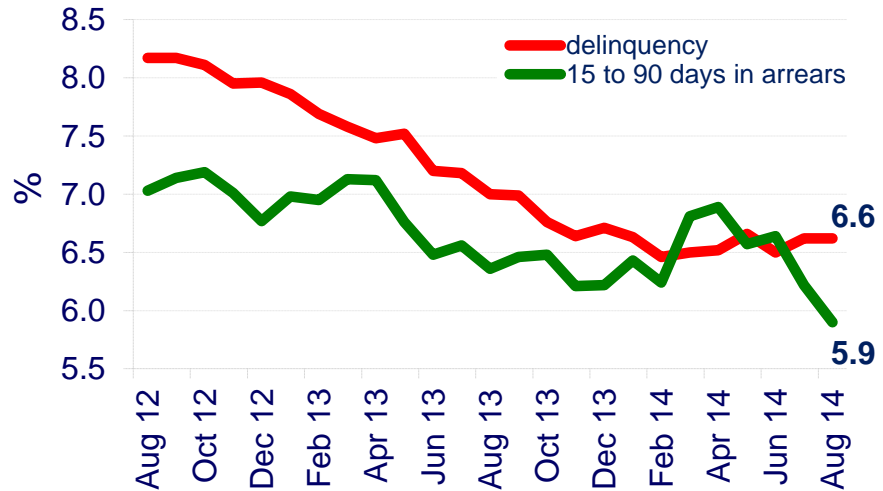
Corporates



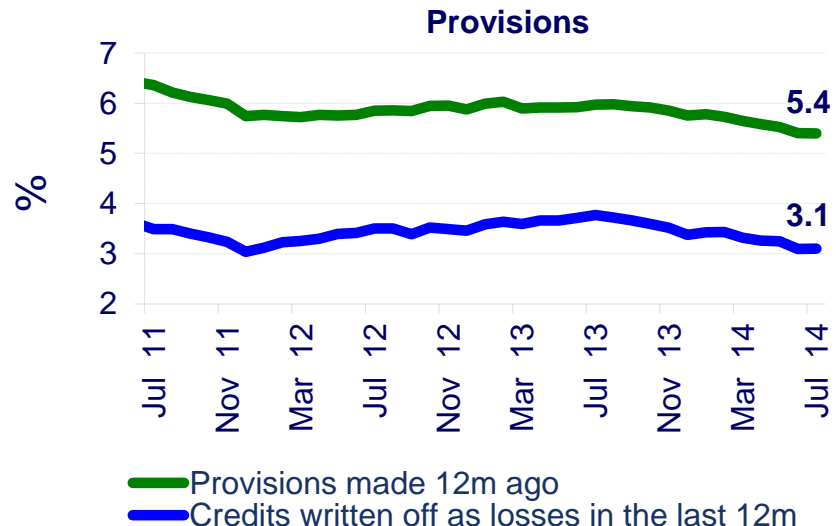
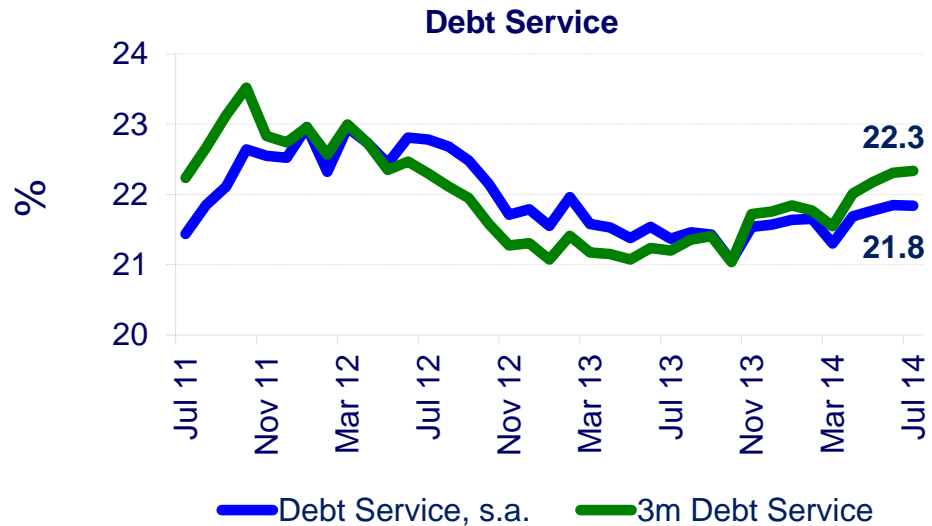
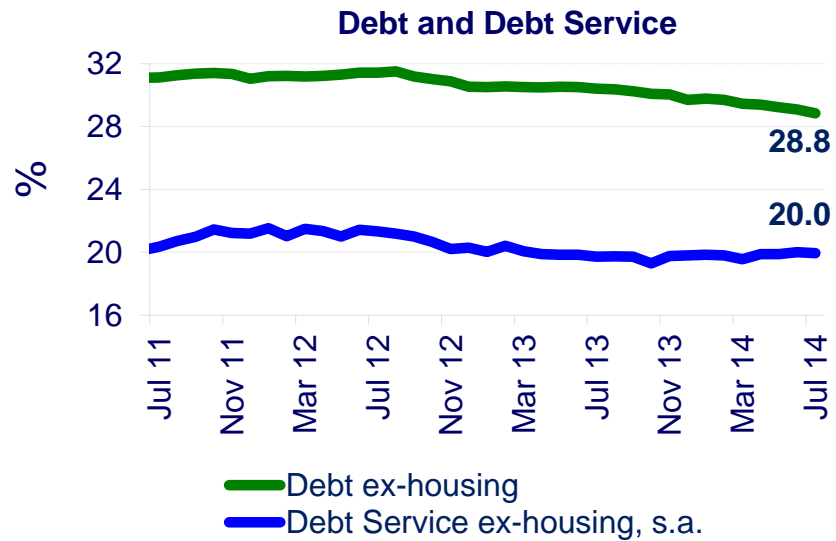
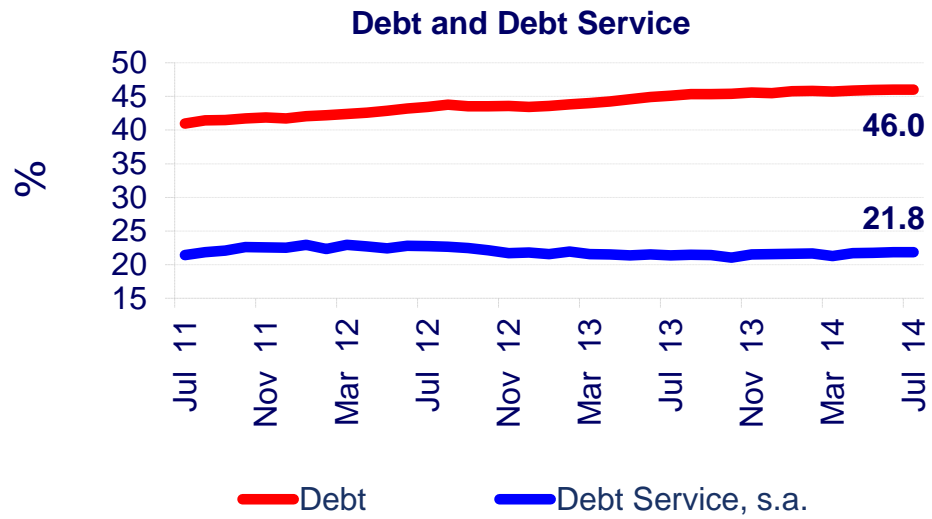
Prime Rate



Individuals



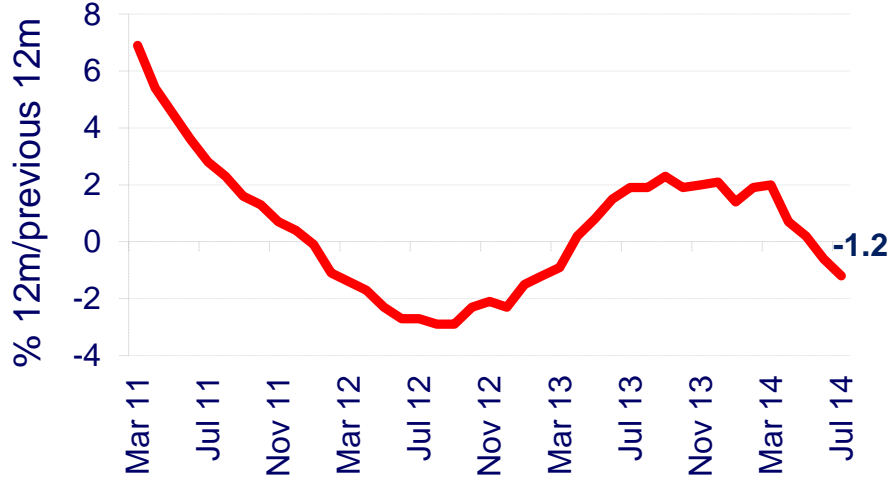
Household Debt and Provisions of the System



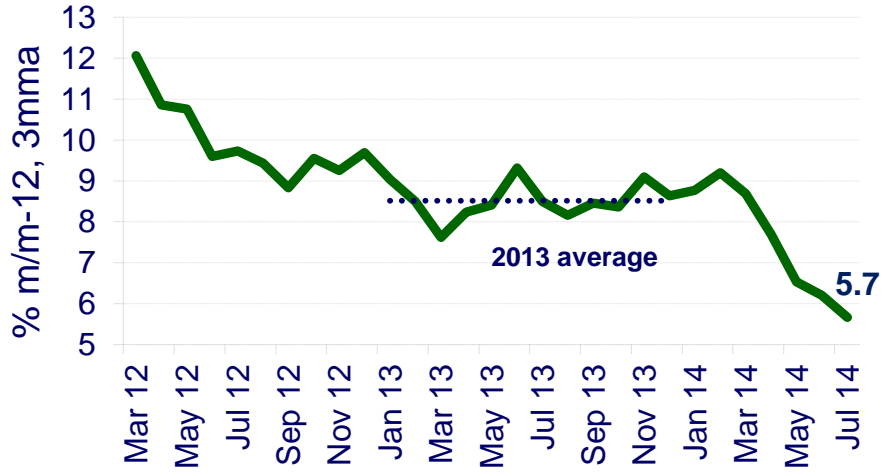
IV. Activity

Supply

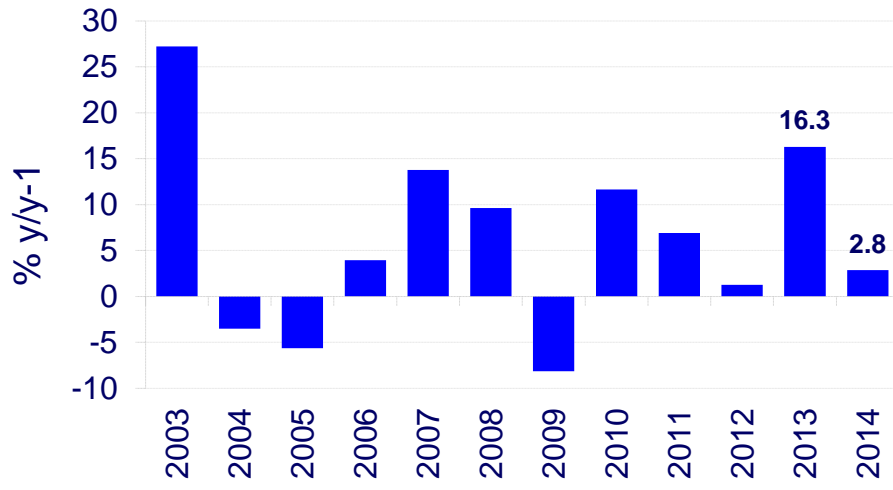
Industrial Production



Services Nominal Income

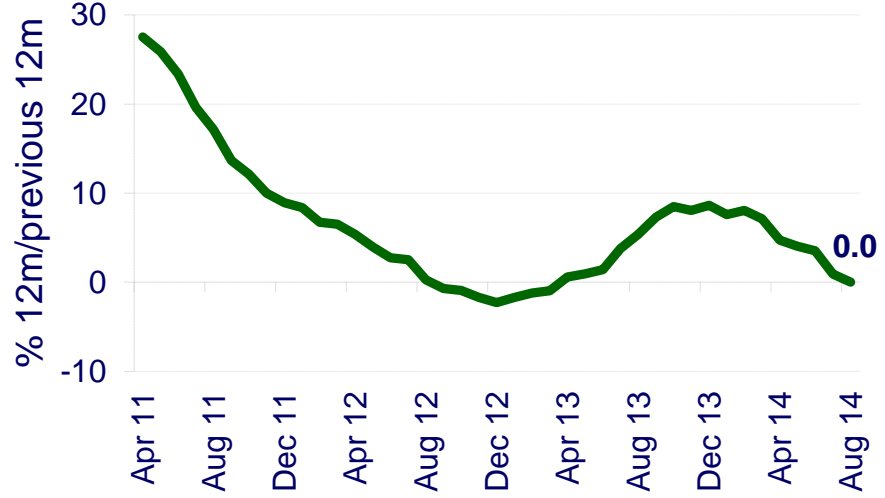


Crop Harvest



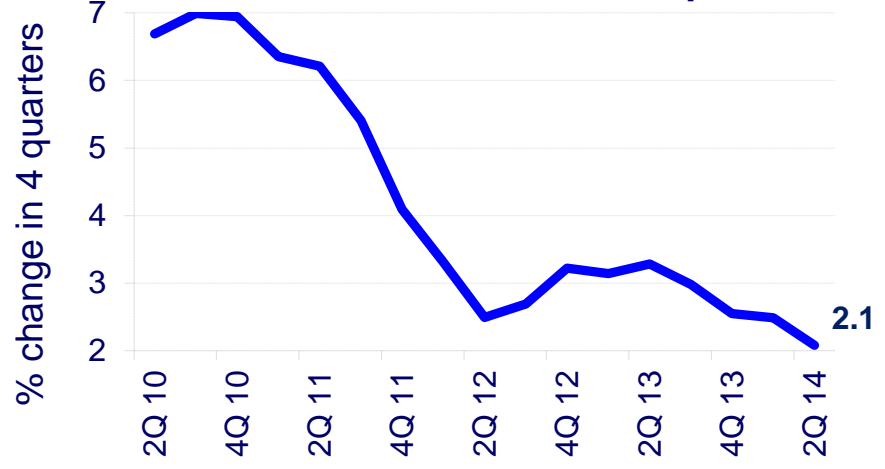
2013: IBGE estimates in Aug/14

Imports Quantum

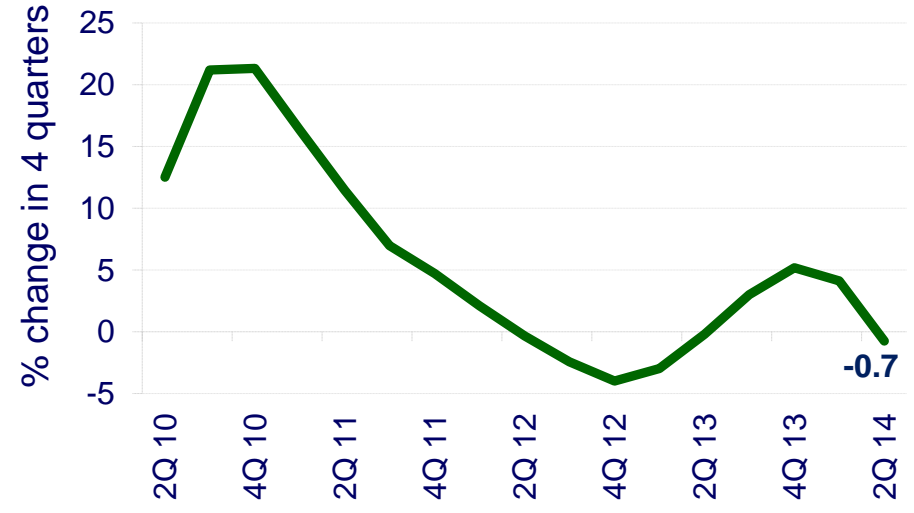


Demand

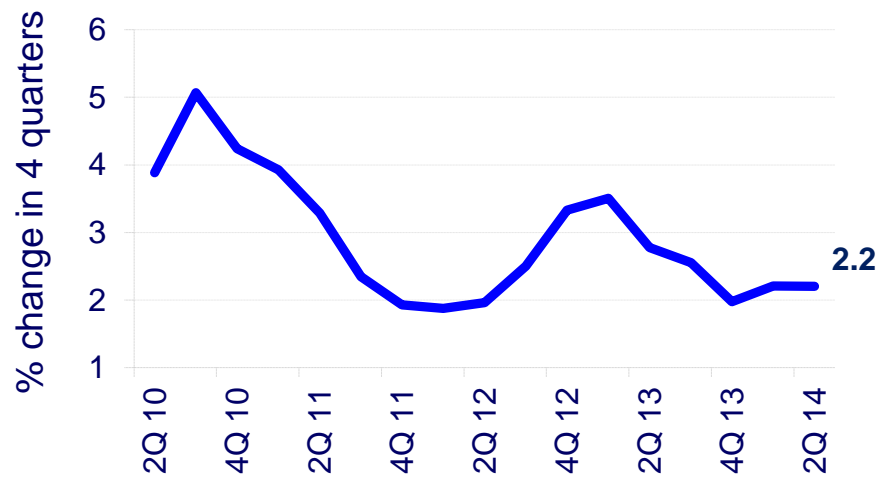
Household Consumption



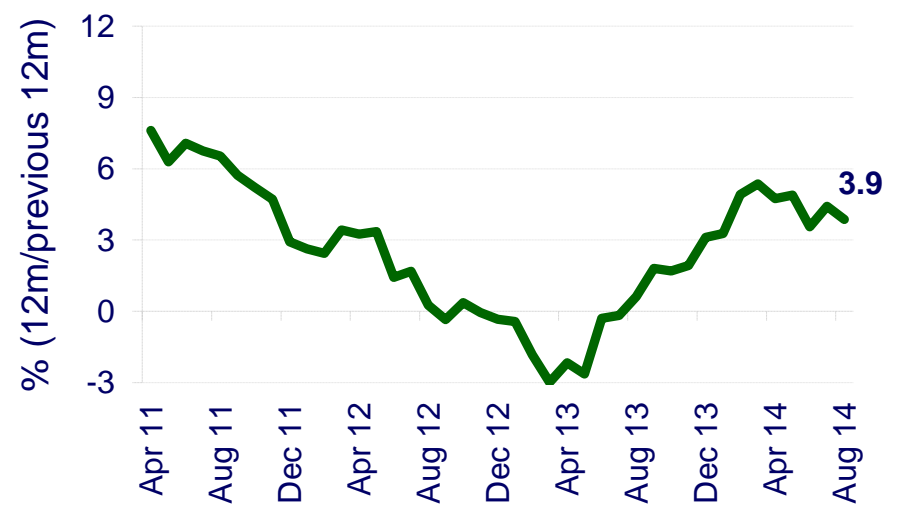
FCGF



Government Consumption



Exports Quantum



Diffusion Index of the Brazilian Economic Activity (IDAE-Br)

- It presents a synthetic measure of the activity diffusion, tool that complements others that are used by the BCB
- The evidences suggest that the indicator provides information regarding the economic activity with small time lag (it anticipates information).

Confidence Indices and Macroeconomic Variables

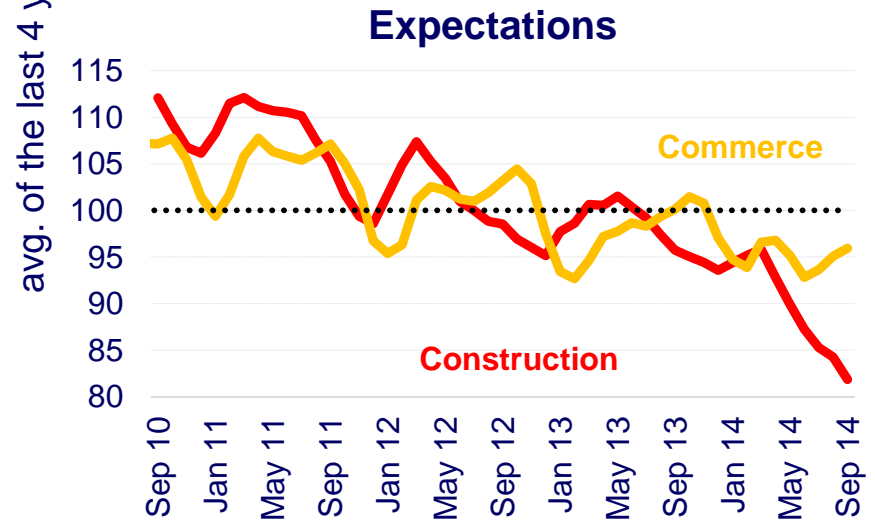
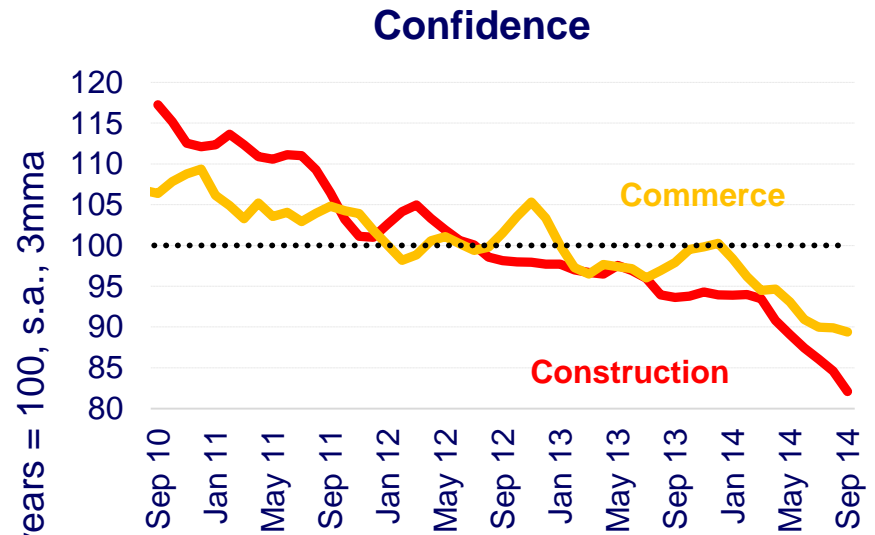
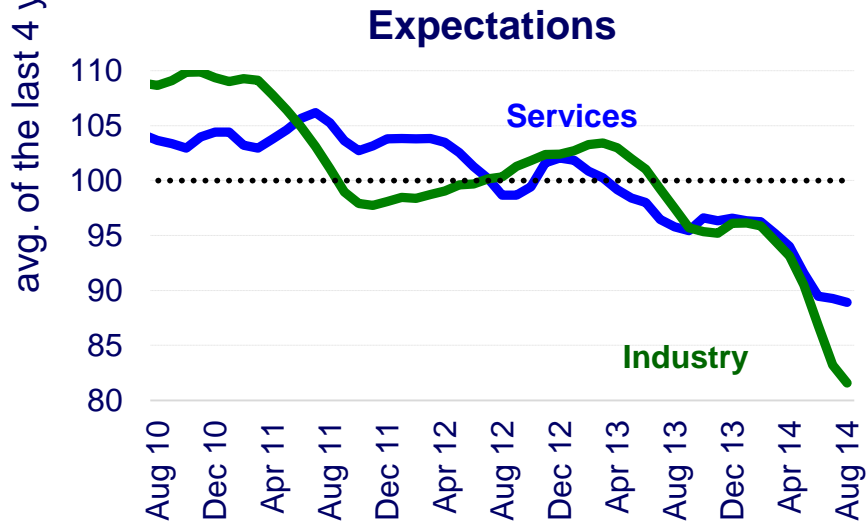
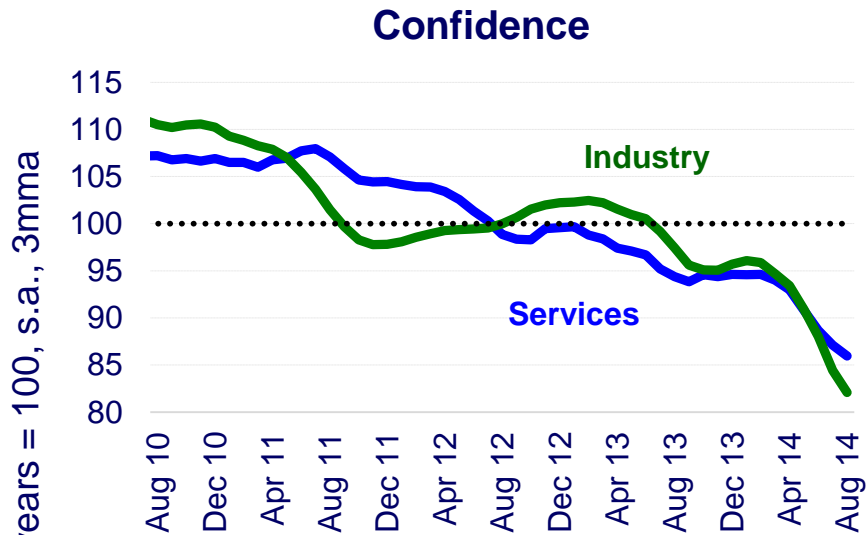
- It identifies relations among three confidence indices and of them with economic activity and inflation;
- The results suggest existence of circular time leadership among the confidence indices for the industry, services and consumers, as follows: ICI → ICS → ICC → ICI.
- The exercises suggest that shocks in the industry confidence have direct effects over inflation and economic activity (in the case of shocks in the confidence of consumers and of businessmen in the services sector, only indirect effects)

Box: Projections for the Balance of Payments

Revised Forecast for 2014:

- Estimate for the current account deficit remains at US\$80 billion (3.5% of the GDP)
- Estimate for the trade surplus reduced from US\$5 billion to US\$3 billion
- Forecast for FDI inflows remain at US\$63 billion (approximately, 80% of the current account deficit).

Confidence



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

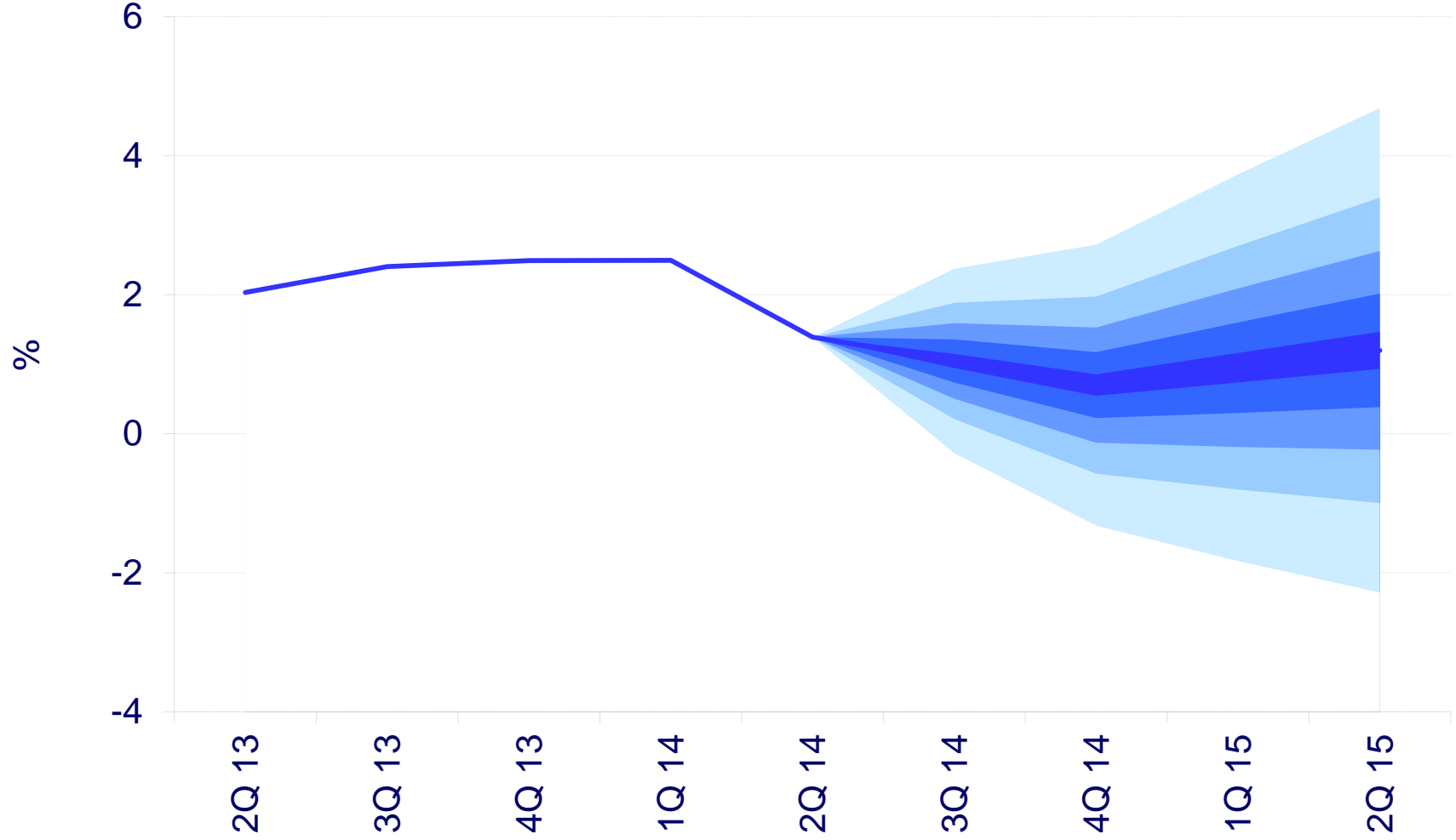
Box: GDP Forecasts

- **Growth revision for 2014, from 1.6% to 0.7% (domestic demand, 0.4 p.p.; and net exports, 0.3 p.p.);**
 - **Supply**
 - Agriculture and livestock: 3.1% (1.1% in Q2/2014)
 - Industry: -0.1% (0.5% in Q2/2014)
 - Services: 1.5% (1.6% in Q2/2014)
 - **Demand**
 - Investments: -2.4% (-0.7% in Q2/2014)
 - Household Consumption: 1.6% (2.1% in Q2/2014)
 - Government Consumption: 1.2% (2.2% in Q2/2014)

- **Growth of 1.2% in the four quarters ended in June 2015**

GDP Forecast

Baseline Scenario*



* Interest rate constant at 11.00% p.y.

V. Inflation Developments

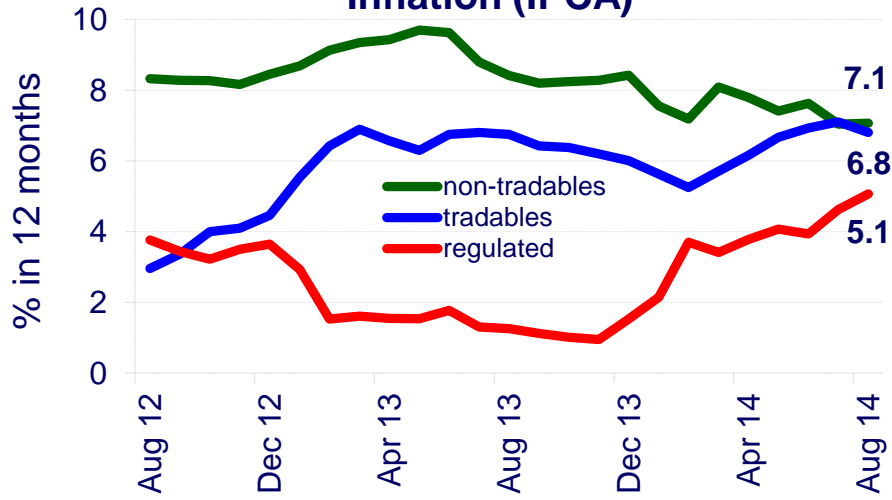
Inflation Developments

Prices Indices

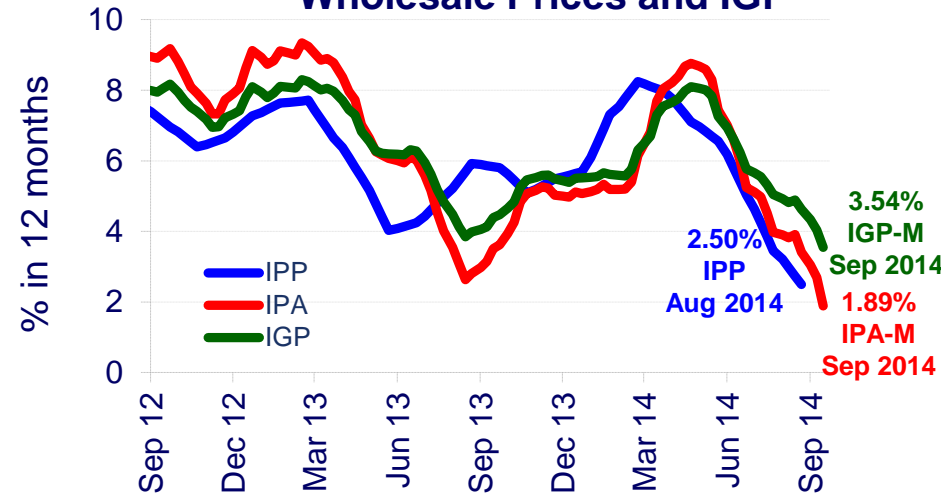
	Change in 12 months (%)		
	Aug/13	Aug/14	
IPCA	6.09	6.51	▲
Market Prices	7.64	6.95	▼
Regulated	1.27	5.07	▲
Tradables	6.75	6.81	▲
Non-Tradables	8.42	7.07	▼
INPC	6.07	6.35	▲
IPC-C1	5.36	6.22	▲
IGP-DI	3.98	4.63	▲
IPA-DI	2.81	3.41	▲
Agricultural	-2.41	1.91	▲
Industrial	4.93	3.97	▼
IPC-DI	5.54	6.76	▲
INCC-DI	7.86	7.26	▼

Prices

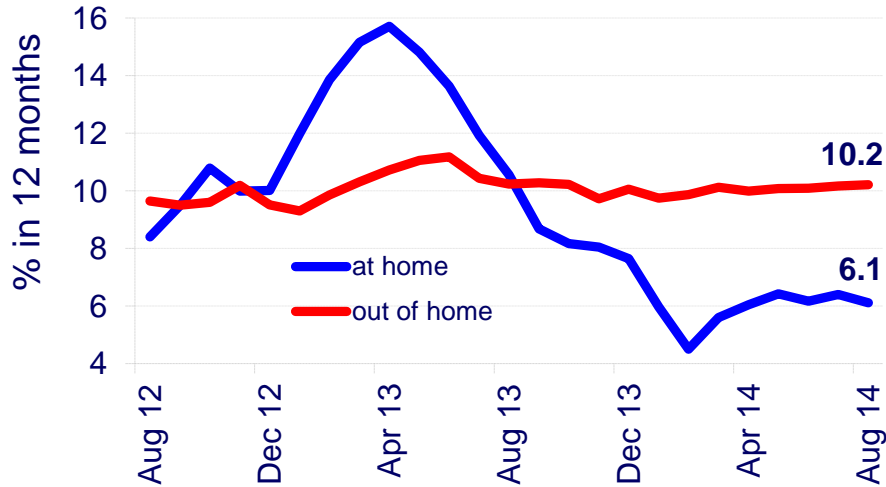
Inflation (IPCA)



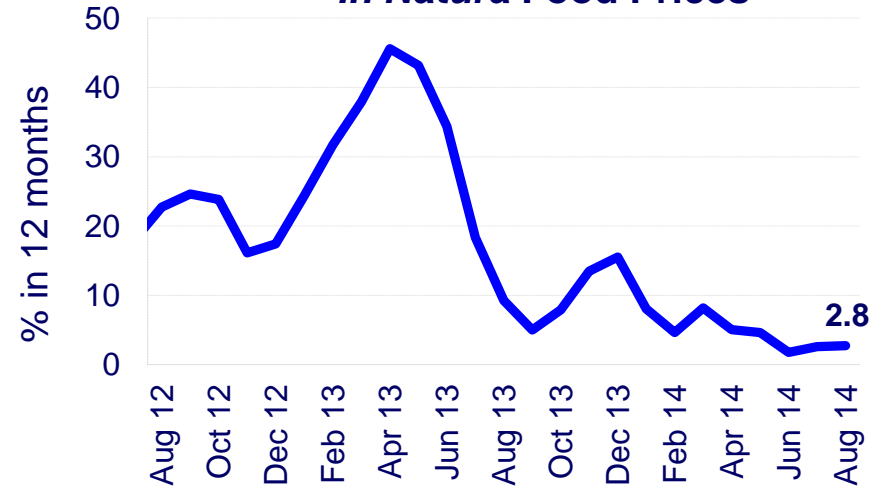
Wholesale Prices and IGP



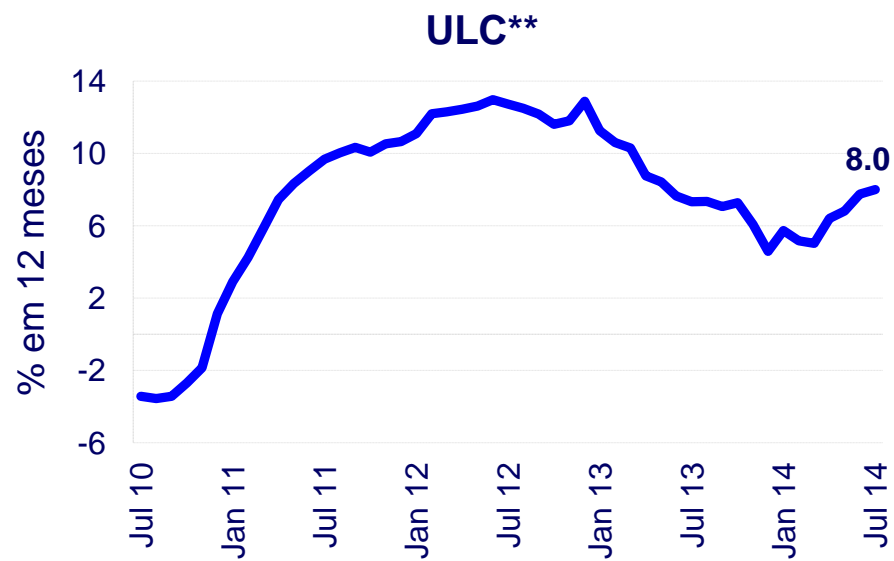
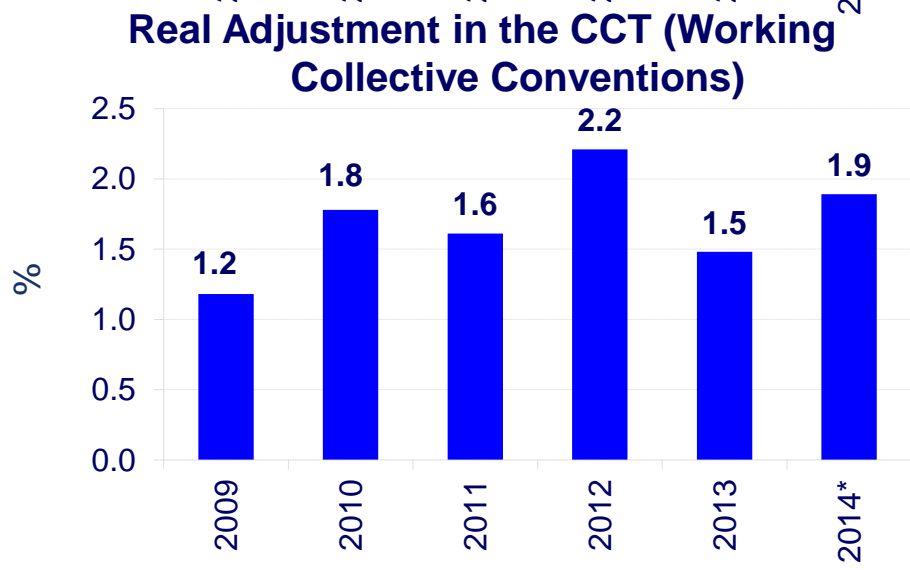
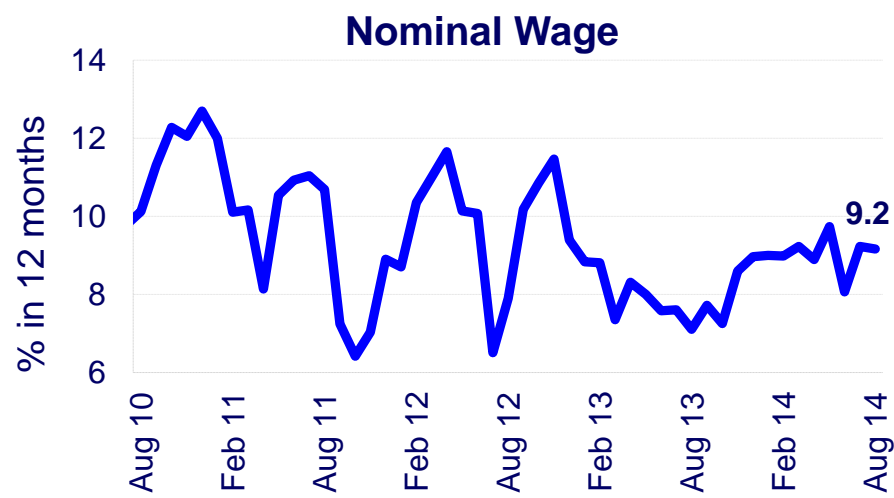
Inflation (Food)



In Natura Food Prices



Wages



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

Labor Market Conditions Indicator

- It presents a synthetic measure of changes in the conditions of labor market – Labor Market Conditions Indicator (ICMT) -, which aggregates information of a diversified set of variables
- The exercises suggest that, in addition to the unemployment rate, factors such as qualification and composition of the labor force, as well as turnover and earnings, among others, are relevant sources of information about the labor market condition

Decomposition of the Unemployment Rate (2002/2014)

- It decomposes the unemployment rate (TD) change in three parts: occupied population effect (EPO), Working Age Population effect (EPIA) and Activity Rate effect (ETA)
- In all sample period, the EPIA contributed to increase the TD; on the other hand, the EPO contributed to reduce from 2002 to 2012, and the ETA, to increase
- The exercises indicate that, in the last quarters, the reduction of the TD was due to the retreat of the Activity Rate and not to the effective increase of the occupied population

Physical Fundamentals of the Prices of Soy, Corn and Wheat

- It focuses on the connections among the dynamics of prices, inventories and the consumption
- The evidences point to the existence of negative correlations among prices and the ratio inventories expectations /consumption;
- If this correlation persists in the near future, the international prices of soy and of corn would tend to retreat; whereas the prices of wheat would tend to increase

BCB Inflation Forecasts

Baseline Scenario* and Market Scenario

Period		Baseline	Market
2014	3	6.6	6.6
2014	4	6.3	6.3
2015	1	6.0	6.1
2015	2	5.6	5.8
2015	3	5.8	6.1
2015	4	5.8	6.1
2016	1	5.6	5.9
2016	2	5.3	5.5
2016	3	5.0	5.2

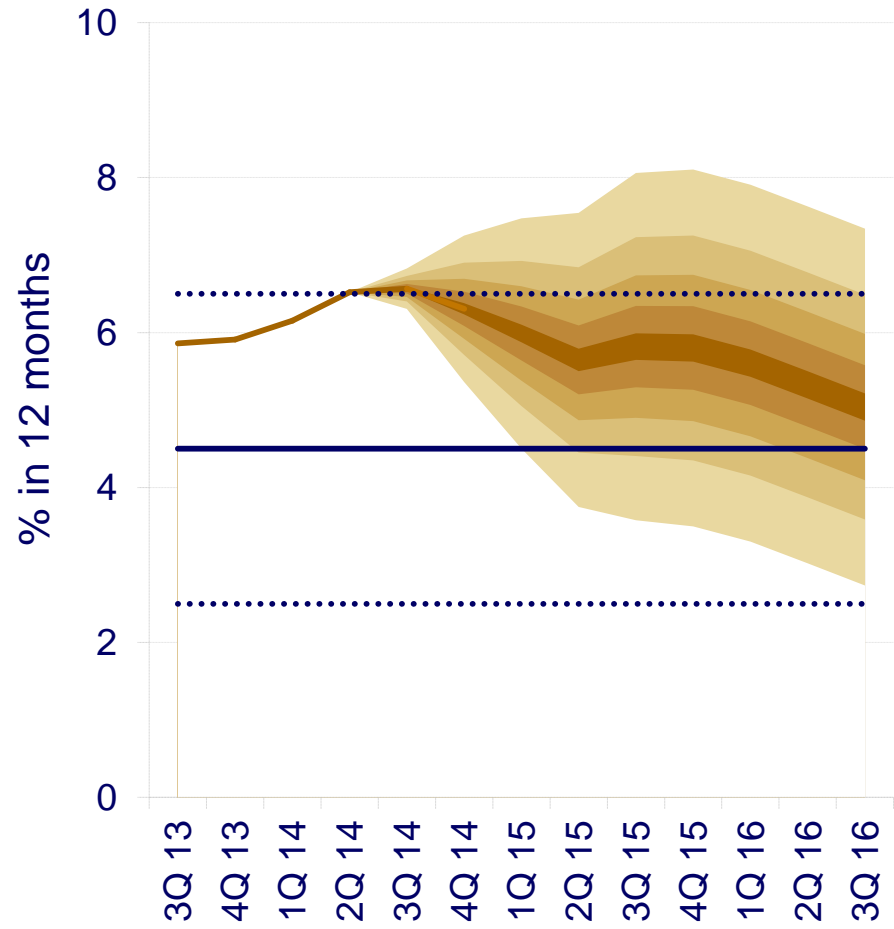
Obs.: 12-month accumulated inflation (%)

* Interest rate constant at 11.00% p.y.

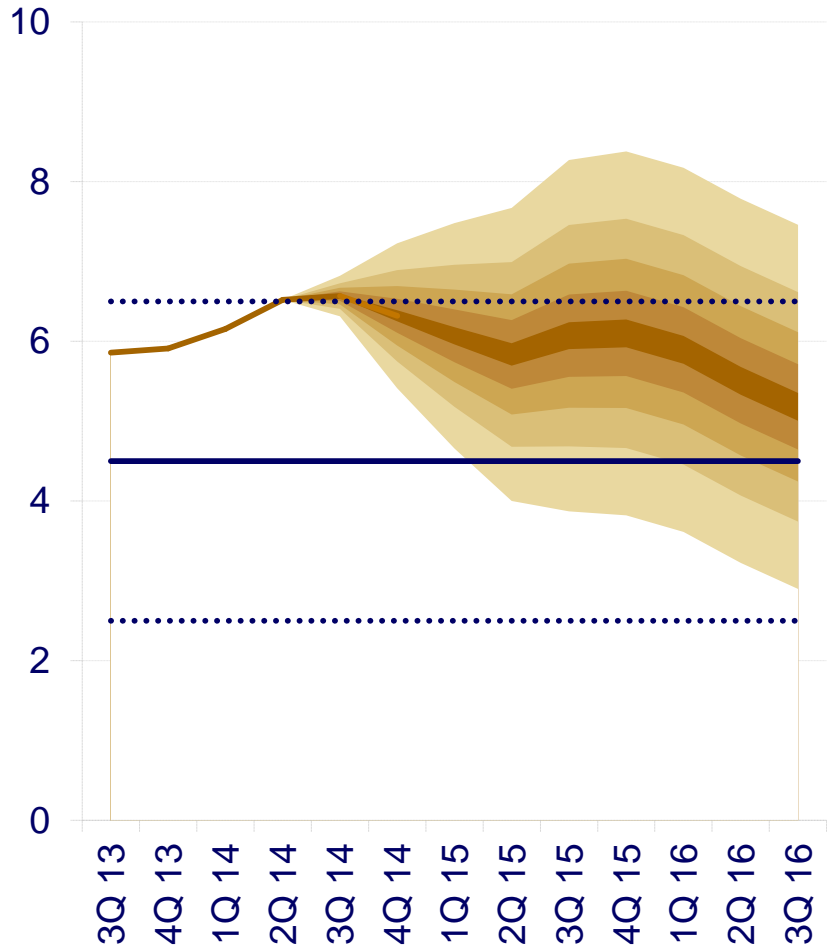
BCB Inflation Forecasts

Baseline Scenario

(interest rate constant at 11.00% p.y.)



Market Scenario



Market Expectations – Summary

	2014			2015		2016			
	30/6/14		26/9/14	30/6/14		26/9/14	30/6/14		26/9/14
IPCA	6.45	▼	6.31	6.10	▲	6.30	5.50	=	5.50
Regulated Prices	5.00	▲	5.10	7.00	=	7.00	5.50	=	5.50
Market Prices	7.08	▼	6.84	5.71	▲	5.99	5.50	=	5.50
IGP-M	5.39	▼	3.66	5.50	=	5.50	5.30	▲	5.50
IPA-DI	5.55	▼	2.10	6.00	▼	5.40	5.50	▼	5.10
Selic (end-of-period)	11.00	=	11.00	12.00	▼	11.38	11.00	▼	10.75
Exchange rate (end-of-period)	2.40	▼	2.35	2.50	▼	2.45	2.55	=	2.55
GDP	1.07	▼	0.29	1.50	▼	1.01	2.50	▼	2.30
Industrial Production	-0.50	▼	-1.95	2.20	▼	1.50	3.00	▼	2.50
Trade Balance	2.50	▼	2.40	9.90	▼	9.00	12.93	▼	11.00
FDI	60.00	=	60.00	55.60	▲	57.00	57.50	▲	60.00
Primary Result	1.40	▼	1.10	1.90	▼	1.80	2.00	=	2.00



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