Economic outlook

1

This chapter of the Inflation Report analyzes the recent evolution of the economic outlook, considering the international and domestic scenarios, as well as the prospects for the evolution of the country's economy in the coming quarters.

The assessment of the international scenario comprises the status of the major advanced and emerging economies, with emphasis on aspects that tend to influence the Brazilian economy, especially the indicators for inflation, activity and performance of monetary authorities.

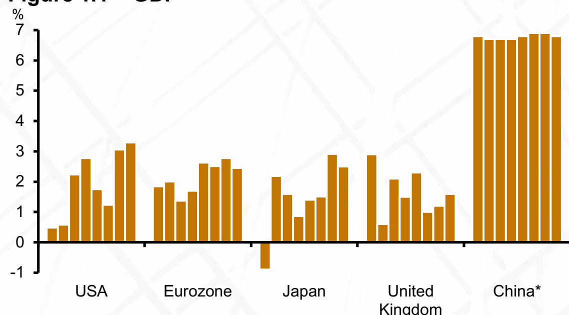
The domestic outlook analysis comprises the major drivers of economic activity, seen from the point of view of national accounts as well as from the point of view of the trajectory of the most frequent and timely sectorial indicators. Central aspects are assessed, especially those associated to the movements in the labor market, to the evolution of credit markets, and to the performance of the country's public accounts and external accounts. The final section of this chapter analyzes the behavior of inflation and market expectations, taking into account the trajectories of the main price indicators.

1.1 External scenario

The trajectory of activity indicators in major countries remains favorable, as the global economic activity has been recovering with no pressures on financial conditions of advanced economies. On one hand, this behavior ratifies the prospects for continuation of activity expansion during the next year. On the other hand, it requires a more intense monitoring of prices evolution and risks associated with an occasional reaction in inflation rates.

GDP evolution in the third quarter of the year followed distinct trajectories in major economic areas, with a quarter-on-quarter (QoQ) deceleration

Figure 1.1 – GDP[1/]



1/ QoQ saar. Last: Q3 2017.
* China: %Q/Q-4
Source: Thomson Datastream

in the Euro Area, Japan and China, and acceleration in the USA and United Kingdom.

The USA GDP increased 0.8 percent in the quarter, the sharpest QoQ expansion since the 2014Q3, reversing the expectations that climate phenomena in the Southern region would negatively affect activity in the country. It should be highlighted the performance of the Gross Fixed Capital Formation, reinforcing the optimistic expectations for the USA economy trajectory in the next year.

In the Euro Area, the expansion of the quarterly GDP reached 0.6 percent, representing the eighteenth consecutive increase in this basis of comparison, with special performances from the German and Italian economies.

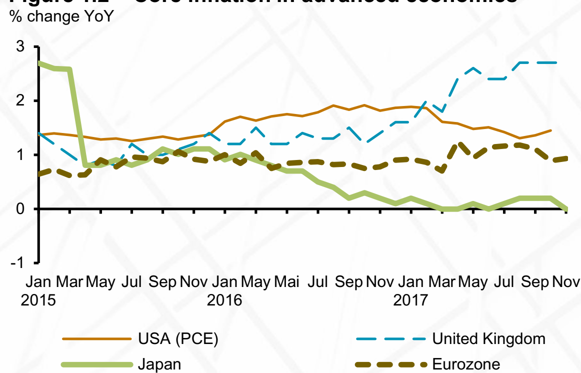
The Japanese economy grew 0.6 percent in the quarter, the seventh consecutive quarterly increase, the longest sequence of positive results since 2001. It is worth noting that the deceleration registered in the period was mostly driven by the retraction in consumer spending and public investment, in contrast with the positive contribution of the external sector, in a context of growing demand from the country's major commercial partners.

In China, GDP's inter-annual expansion remained significant in the third quarter of 2017, although in a lower level than those recorded in the two precedent quarters. In accordance with the country's process of economic restructuring, production of the secondary sector decelerated in relation to the second quarter, whereas the tertiary sector showed greater dynamism.

GDP growth in the United Kingdom showed slight acceleration in the third quarter of the year, confirming the economy's loss of momentum in 2017, in a context of depreciation of the sterling pound and decreases in real wages. Additionally, the slow evolution of negotiations related to Brexit continues to impose significant uncertainty over the business environment and to restrict investments.

Despite the continued growth of the global economy, annual rates of inflation remained at a low level in advanced economies, as in the previous quarter. The exception remained the United Kingdom, where twelve-month inflation hit 3.1percent in November. The underlying inflation measures in these economies remained subdued, with little change over the second

Figure 1.2 – Core inflation in advanced economies

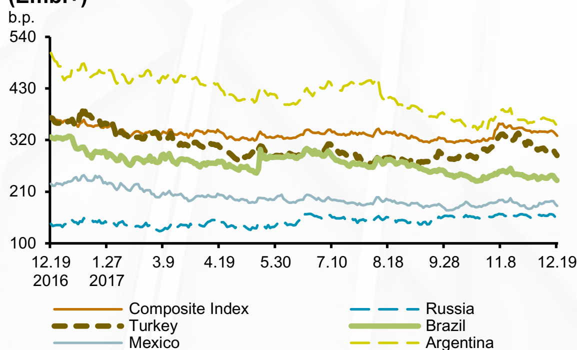


Source: Thonsom Datastream

Figure 1.3 – Implicit number of increases in Fed Funds up to December 2018

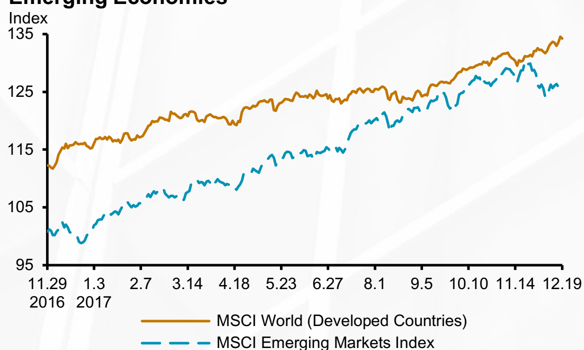
Source: Bloomberg

Figure 1.4 – Emerging Markets Bond Index Plus (Embi+)



Source: Thomson Reuters

Figure 1.5 – MSCI Equity Indices: Developed and Emerging Economies



Source: Thonsom Datastream

quarter, despite persistent tightening in the labor markets of the USA, Euro Area and Japan.

This environment of global economic growth, together with low inflation levels in advanced economies, allows the maintenance of the gradual process of monetary policy normalization in the USA, led by the Federal Open Market Committee (FOMC) of the Federal Reserve (Fed). In this regard, the slow process of reducing the Fed's balance began in October, as scheduled. In this direction, the European Central Bank announced a 50 percent reduction in the monthly acquisition of assets, to begin in January 2018, with prospects to endure up to September 2018. As of yet the Bank of Japan does not indicate a reduction in the monetary easing in force, as inflation core measures and inflation expectations remain low.

The scenario of acceleration in economic growth, low inflation, low interest rates, and the prospects that the on-going monetary tightening in the USA and Europe will gradually continue, tends to benefit the emerging economies, although the appetite for risk has been edging down in the recent months. Partially influenced by the marginal tightening of monetary policy in advanced economies, stock exchanges behaved differently in most emerging economies, in contrast with the consistent valuation occurred until mid-September. In this context, sovereign risk indicators started to show divergent variations, reversing a downward trend observed in the third quarter of the year.

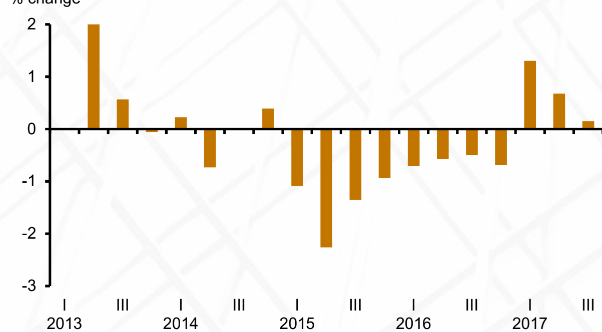
In short, since last Inflation Report the global economy sustained the positive momentum towards growth, whereas inflation rates remained low in major advanced economies. The monetary policies in these economies may continue accommodative for an additional time, as long as inflation remains low. There are, however, risks of asset prices corrections if a more robust activity expansion translates into higher inflation rates in the advanced economies.

1.2 Domestic scenario

Economic activity and the labor market

The economic activity in the country remains in a trajectory of gradual recovery, as demonstrated by the three consecutive QoQ GDP increases. Taking into account this context and the positive prospects for

Figure 1.6 – GDP[1/]
Quarter/Previous Quarter



Source: IBGE
1/ Seasonally adjusted data.

Table 1.1 – Gross Domestic Product
Quarter/previous quarter
Seasonally adjusted

% growth

	2016		2017		
	III Q	IV Q	I Q	II Q	III Q
GDP at market prices	-0.5	-0.7	1.3	0.7	0.1
Crop and livestock	1.2	2.7	12.9	-2.3	-3.0
Industry	-1.5	-1.2	1.2	-0.4	0.8
Services	-0.6	-0.7	0.3	0.8	0.6
Households consumption	-0.3	-0.4	0.2	1.2	1.2
Government consumption	-0.4	-0.1	-0.1	-0.1	-0.2
Gross fixed capital formation	-2.9	-1.7	-0.6	0.0	1.6
Exports	-3.6	-0.4	5.7	1.2	4.1
Imports	-5.1	3.8	1.9	-3.4	6.6

Source: IBGE

the continuity of this recovery, projections for GDP growth in 2017 and 2018 were updated, translating into a more favorable outlook, as described in a box herein appended.

National accounts data released in December by the Brazilian Institute of Geography and Statistics (IBGE) incorporated important revisions regarding the GDP expansion in the first quarter (from 1.0 percent to 1.3 percent) and in the second quarter (from 0.2 percent to 0.7 percent), leading to increases in the accumulated GDP for the first half of the year and in the carry-over to 2017 (from 0.5 percent to 1.0 percent).

GDP expansion reached 0.1 percent in the third quarter over the previous quarter (seasonally-adjusted data). This performance confirmed, on the supply side, the positive evolution of industrial activity, especially in manufacturing, and the third consecutive increase in the services sector – which has the greatest weight among the supply components – partially due to the expansion in trade and other services, more correlated with the industrial sector.

On the demand side, the consistent contribution of domestic demand is of major significance. Household consumption grew 1.2 percent, following an expansion of the same magnitude in the previous quarter, when it was still under the influence of the authorized withdrawals from the Employment Compensation Fund (FGTS) accounts. The quarter-over-quarter (QoQ) evolution in consumption demonstrates both the growth in household purchasing power, driven by the decline in inflation, and the effects derived from better conditions in the labor and credit markets. Of note, on the demand side, the first QoQ expansion in the Gross Fixed Capital Formation (GFCF) since the third quarter of 2013.

More recent statistics incorporating data for the fourth quarter support the view that the economic recovery shall continue in a gradual pace. In this direction, it confirms the stability of industrial output in the quarter ended in October over the quarter ended in July, in which it had already grown 1.9 percent over the previous quarter, according to seasonally-adjusted data from the Monthly Industrial Survey – Physical Production (PIM-PF) from IBGE. The deceleration reflected a decline of 0.7 percent in the extractive industry and an expansion of 0.7 percent in manufacturing, which registered growth in fifteen of the twenty-three activities surveyed. This was a performance sustained by the dynamism of durable

goods, especially automotive vehicles, trailers and bodyworks (5.9 percent) and IT equipment, electronics and optical products (3.7 percent).

As highlighted in a box herein appended[1], the resumption of the industrial sector in the year is consistent with a cyclical economic activity recovery, sustained mainly by the dynamism of the domestic market.

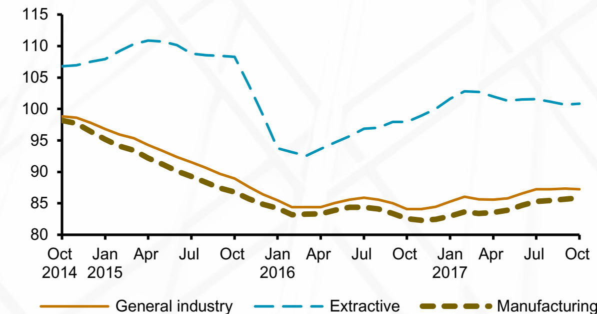
Qualitative indicators signal that stocks have been adjusted and that there is confidence in recovery, conditions that benefit the maintenance of industrial expansion. Stocks in manufacturing, as calculated by FGV declined 6.8 points in the quarter ended in November, compared to the quarter ended in August, reaching 102.2 points[2], considering seasonally-adjusted data. This trajectory reflected decreases in all categories, especially in capital goods (6.4 points) and intermediate goods (4.5 points).

The Industrial Confidence Index (ICI)[3] reached 95.5 points in the quarter ended in November, a 4.7 points increase when compared to the quarter ended in August, according to seasonally-adjusted data from IBGE. This growth in confidence in the quarter was spread in all usage categories, especially in the segments of non-durable goods (8.4 points), durable-goods (6.5 points) and capital goods (4.7 points).

The services sector showed a consistent recovery in the three first quarters of 2017, according to National Accounts data. There was a QoQ growth of 0.6 percent in the third quarter, especially reflecting expansions in trade (1.6 percent), in line with the positive performance of household consumption and real estate and rental services (0.9 percent).

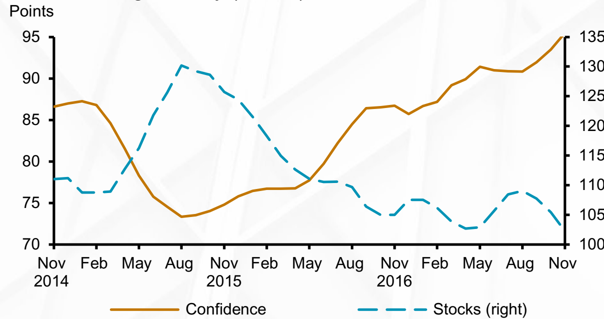
Data from the Monthly Services Survey (PMS) suggest, however, that activity indicators in this sector are still oscillating. Thus, the services sector declined 1.6 percent in the quarter ended in October over the previous quarter, when it had grown 0.9 percent in the same basis of comparison. Of note, transportation services registered a 0.9 percent expansion in the quarter[4].

Figure 1.7 – Industrial production 1/
Total (3MMA)
2012 = 100



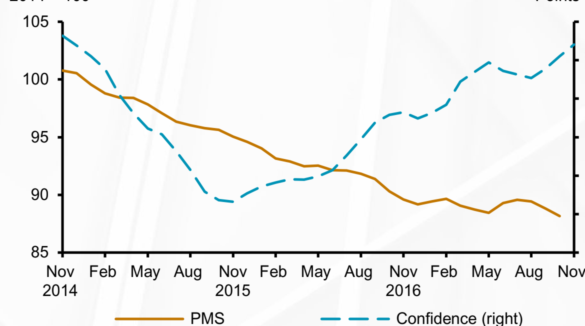
Source: IBGE
1/ Seasonally adjusted data.

Figure 1.8 – Confidence and Stocks Indexes1/
Manufacturing industry (3MMA)
Points



Source: FGV
1/ Seasonally adjusted data.
Stock index calculated from 100 to 200 – released stock index.

Figure 1.9 – Services Volume and Confidence Indexes1/
Services (3MMA)
2014 = 100



Source: IBGE, FGV
1/ Seasonally adjusted data.

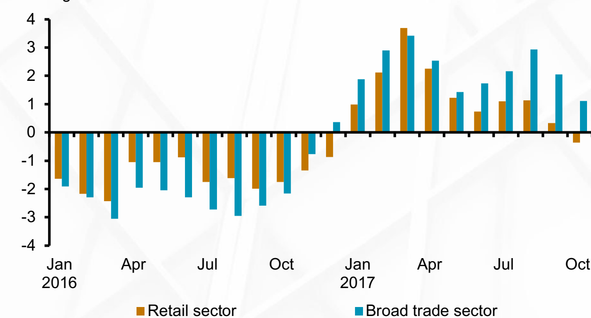
1/ Please see herein appended box “2017 industry growth analysis ”, on page 25.
2/ A 200 points complement of the original index released by FGV. Values greater than 100 points indicate stocks higher than otherwise planned.
3/ Values higher than 100 points indicate a feeling of optimism.
4/ It should be observed that, as demonstrated in the box “Comparability Analysis between Service Indicators”, appended to the March 2017 Inflation Report, activities surveyed in the PMS are equivalent to 30 percent of the value that services add to GDP, a broader measure of the sector.

Notwithstanding the divergence between indicators, the evolution of confidence suggests a favorable outlook for the services sector. In fact, the Services Confidence Index (ICS) grew 4.4 points in the quarter ended in November, compared with that ended in August, according to seasonally adjusted FGV data, reflecting growth in indicators related to the current situation (4.6 points) and expectations (4.1 points).

On the demand side, it is worth noting that growth in household consumption remains on a level similar to that registered in the second quarter of this year. This process of recovery happens in an environment of improved labor and credit markets (partially due to the interest rate cycle), lower level of household leverage and, mainly, declining inflation.

After two quarters of significant consumption expansion, a more moderate growth is expected in the fourth quarter. In this direction, broad retail sales decelerated, registering an increase of 1.1 percent in the quarter ended in July over the previous quarter, when it had previously expanded 2.2 percent in the same basis of comparison, according to seasonally-adjusted IBGE data. Notwithstanding this deceleration, sales increased in seven of the ten segments surveyed.

Figure 1.10 – Retail sales[1/]
3-Month Períod over previous 3-Month Period
% change

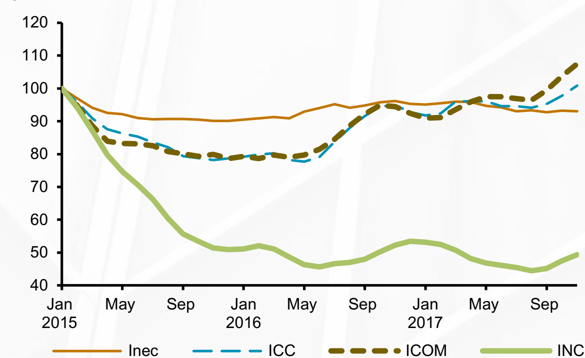


Source: IBGE
1/ Seasonally adjusted data.

Similarly, sales of automobiles and light commercials increased 2.3 percent QoQ in the quarter ended in November, according to the National Federation of Automotive Vehicles Distribution (Fenabrave). The Serasa-Experian Index for Commercial Activity, nationwide and based on the monthly consultations addressed to Serasa archives by commercial companies, grew 2.4 percent in the same period.

The trajectories of the Consumer Confidence Index (ICC) and the Commerce Confidence Index (Icom), both from FGV, indicate positive prospects for the sector in the coming months. Both indicators registered sharp QoQ growth in the quarter ended in November, surpassing the average levels of the last five years.

Figure 1.11 – Confidence indexes
3MMA



Sources: ACSP, CNI and FGV

GFCF registered a QoQ recovery in the third quarter of the year. It should be stressed that the 1.6 percent increase in comparison with the previous quarter represents the first expansion after fifteen quarters. The recovery of investments reflected the ascending movement in imports and in the production of capital goods, a trend spread among major categories. Of note, the recent evolution of the input production

for the construction sector and related capital goods. This statistics, together with the behavior of the Construction Entrepreneurs Confidence Index (Icec), suggest that the sector, which is responsible for more than half of total investments in the economy, starts to react after the significant retraction cycle observed in the previous years.

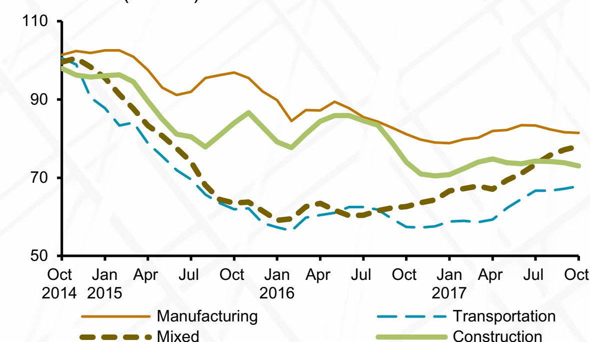
As already mentioned in other reports, the effective recovery of investment is partially driven by the pace of the deleveraging process of nonfinancial companies, a trend that may be further intensified by the cycle of decline in interest rates over the next quarters. Additionally, the consolidation of economic activity recovery and the favorable behavior of financial and risk indicators should also contribute for investment recovery.

In the short term, however, there is no forecast for a stronger reaction in investments, unlike other periods of economic recovery that followed the end of recession cycles. This perspective is partially explained by the level of uncertainties in the economy and the impact of slack in the production factors, reflected in the low utilization of industrial capacity and the high level of unemployment.

In this context, the Installed Capacity Utilization Level Index (Nuci) of the manufacturing sector reached 74.1 percent in the quarter ended in November and 74.3 percent in the previous quarter, considering seasonally-adjusted data from the Manufacturing Industry Survey of FGV. These figures reflect Nuci decreases in the segments of durable consumer goods (0.6 percentage points) and non-durable consumer goods (0.1 percentage points), as well as increases in the segments of capital goods (3.0 percentage points) and intermediate goods (0.3 percentage points)[5].

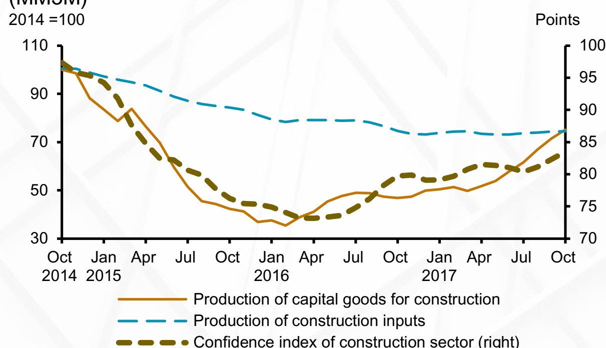
The unemployment rate, released by the Household National Sample Survey (PNAD) from IBGE reached 12.2 percent in the quarter ended in October 2017, 12.8 percent in the quarter ended in July 2017 and 11.8 percent in the quarter ended in October 2016. The QoQ decrease mostly reflected the recovery of employed population among non-registered workers and self-employed workers, segments where informal working conditions prevail.

Figure 1.12 – Capital goods production[1/]
2014 = 100 (MM3M)



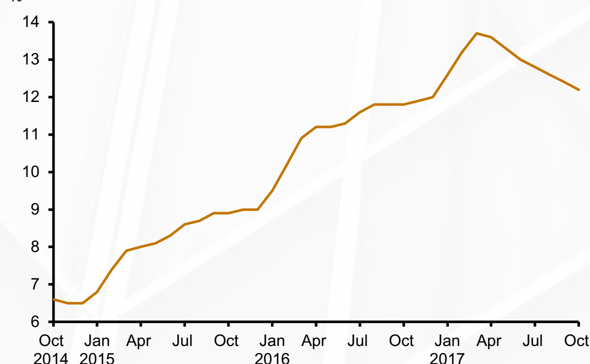
Source: IBGE-PIM
1/ Seasonally adjusted data.

Figure 1.13 – Capital goods absorption[1/]
(MM3M)



Sources: IBGE-PIM and Funcex
1/ Seasonally adjusted data.

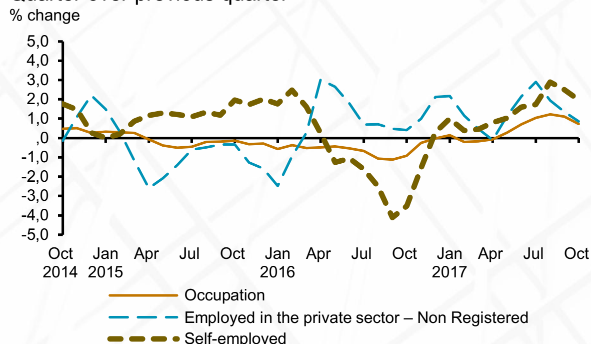
Figure 1.14 – Unemployment rate
%



Source: IBGE (Continuous National Household Survey)

5/ As discussed in box "Dynamic relations between Nuci and the Capital Goods Investment in Brazil", appended to the March 2017 Inflation Report, a low level in Nuci configures a factor of influence, but not impediment, for the gradual recovery in investments during the next quarters.

Figure 1.15 – Employed population[1/]
Quarter over previous quarter



Source: IBGE (Continuous National Household Survey)
1/ Seasonally adjusted data.

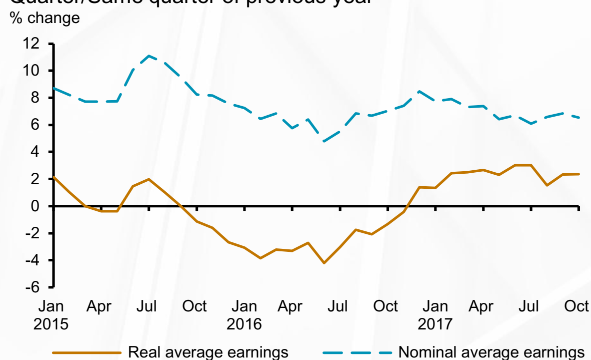
Table 1.2 – Formal employment

New jobs (thousands)

	2016		2017	
	Quarter[2/]	Year[3/]	Quarter[2/]	Year[3/]
Total	-148.0	-792.3	146.4	217.4
Manufacturing industry	10.1	-139.1	71.8	109.5
Commerce	17.3	-252.4	63.1	-50.6
Services	-48.5	-223.2	43.0	94.1
Building	-83.2	-227.8	-3.4	-40.1
Agriculture and livestock	-36.1	50.9	-24.3	93.6
Public utilities	-2.7	-7.2	-2.4	-2.8
Others[1/]	-4.9	6.5	-1.2	13.6

Source: Ministry of Labour
1/ Includes mining, public administration and others.
2/ Quarter ended in October.
3/ Accumulated in the year until October.

Figure 1.16 – Real and nominal earnings
Quarter/Same quarter of previous year



Source: IBGE (Continuous National Household Survey)

According to an analysis presented in a box appended herein[6], this increase in employed population is related to an increase in the net flow of individuals from the unemployed category to the employed category, during the second and third quarters of 2017, as well as the reduction in the net flow of individuals out of the workforce to unemployment. That is to say that even in relation to informal categories, the decline in the unemployment rate represents an improvement in the employment conditions of individuals.

Although the decrease in the unemployment rate reflects an increase in informal jobs, a significant reversal in the dynamics of job creation has been observed in the formal labor market. In this context, according to the General File of Employed and Unemployed Persons from the Ministry of Labor (MTb), 146.4 thousand formal jobs were created in the quarter ended in October, compared to a destruction of 148.0 thousand jobs in the same period of 2016. Of note, the increases in manufacturing (71.8 thousand) and commerce (63.1 thousand).

In relation to workers' income, the disinflationary process in course continues to benefit their purchasing power. According to data from the Continuous National Household Sample Survey (PNAD Contínua), the average real wage of all segments increased 2.5 percent in the quarter ended in October, in comparison to the same period of 2016. Overall wages increased 4.2 percent, in the same basis of comparison.

The consolidation of economic recovery and the recent structural changes in labor legislation tend to have positive impact on the current process of employment recovery, favoring additional reductions in the unemployment rate.

On the other hand, as discussed in recent boxes[7], there seems to be room for a cyclical recovery of labor productivity and a trend for slower growth in the employed population and, consequently, in the pace of decline of the unemployment rate.

Credit

The balance of credit operations of the National Financing System grew 0.1 percent in the quarter

6/ Please see box Transition rates and recent developments in the labor market on page 29 of this Report.
7/ In this regard, please see boxes "Considerations on the evolution of labor productivity and the level of employed population", appended to the March 2017 Inflation Report and "Recent evolution of labor productivity", appended to the September 2017 Inflation Report.

Figure 1.17 – Credit outstanding
% change YoY

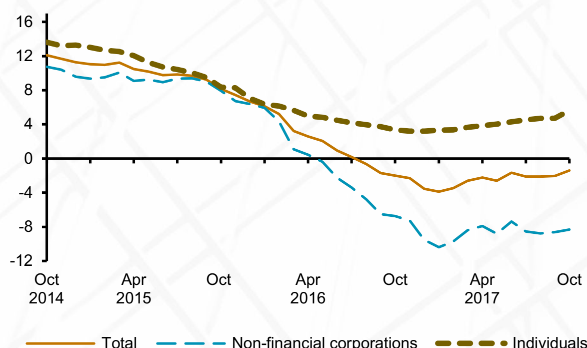


Figure 1.18 – New transactions seasonally adjusted
3 months average – R$ billions

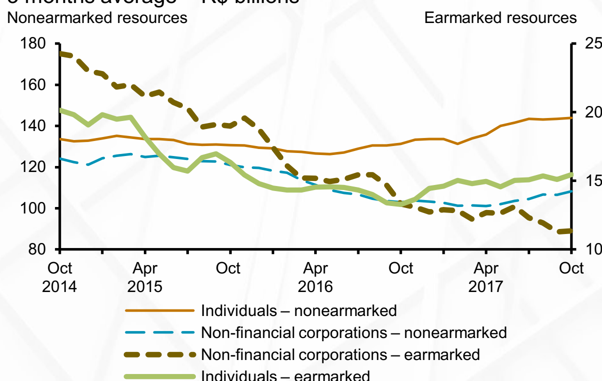


Figure 1.19 – Interest rates

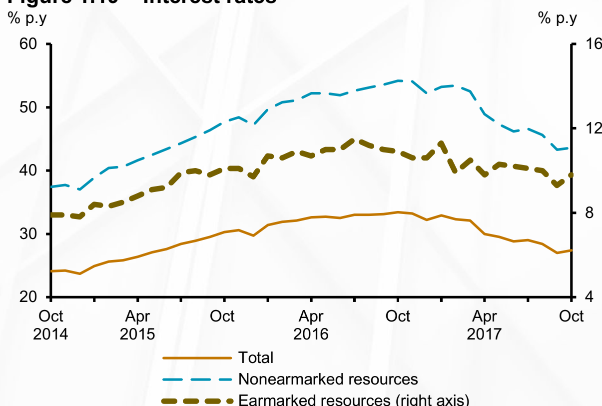
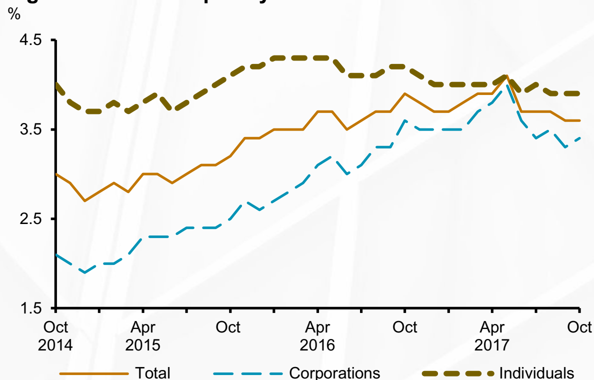


Figure 1.20 – Delinquency rates[1/]



1/ Credit operations overdue for more than 90 days.

ended in October, with changes of 1.7 percent in the credit for individuals segment and -1.7 percent in the corporate segment. In a YoY basis, credit operations for individuals continue to show greater dynamism, in a scenario of improvements in the labor market, inflation decline, household deleveraging and greater consumer optimism. Regarding the recent evolution in household credit, the highlights were the increase in the balance of loans in the segments of payroll-deducted loans, real estate loans and credit card loans. The corporate credit portfolio showed sharp declines when considered the same basis of comparison, despite the slower pace of retraction in operations with non-earmarked resources. It is worth noting that the reduction in corporate credit operations has been partially offset by the increase in funding obtained through capital markets, considering both domestic and external emissions[8].

Lending, considering seasonally-adjusted data, increased 1.5 percent in the quarter ended in October. There were increases of 0.2 percent in lending operations for individuals (non-earmarked, 0.2 percent; earmarked, 2.6 percent) and 1.9 percent in lending operations for corporations. Overall, there was a 3.6 percent increase in lending with non-earmarked resources. It is worth noting that the QoQ trajectory of corporate lending is compatible with the gradual economic recovery registered during the year.

The average interest rate of credit operations reached 27.4 percent per year in October, decreasing 1.6 percentage points in the quarter, in line with the monetary policy cycle. The decrease reached 3.0 percentage points in the segment of non-earmarked resources – reflecting alterations in the charging of interest and fines relative to overdue installments, valid from September 2017 onwards[9] – and 0.3 percentage points in the segment of earmarked resources, with a contraction in credit for individuals.

The delinquency rate of the financial system's credit portfolio showed relative stability, reaching 3.6 percent in the quarter ended in October. The indicator stood at 3.9 percent in the in the segment of credit for individuals and 3.4 percent in the corporate credit segment, observed the respective declines of 0.1 percentage points and 0.3 percentage points in operations with non-earmarked resources.

8/ Regarding the trajectory of credit for companies, please see box "Recent Evolution of Corporate Credit" on page 40 of this Report, where this segment's concentration and replacement of funding sources are identified.

9/ Resolution nr. 4,558 from the National Monetary Council on February 23rd 2017.

Table 1.3 – Public sector borrowing requirements – Primary result

Twelve-month accumulated

	2015		2016		Oct 2017	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central Government	116.7	1.9	159.5	2.5	200.0	3.1
Sub-national governments	-9.7	-0.2	-4.7	-0.1	-12.3	-0.2
State companies	4.3	0.1	1.0	0.0	-0.5	-0.0
Total	111.2	1.9	155.8	2.5	187.2	2.9

Table 1.4 – Balance of Payments

US$ billion

Itemization	2016			2017	
	Nov	Jan-Nov	Year	Nov	Jan-Nov
Current account	-0.7	-17.6	-23.5	-2.4	-5.4
Balance on goods	4.5	40.8	45.0	3.2	59.4
Exports	16.1	168.6	184.5	16.6	199.7
Imports	11.6	127.7	139.4	13.4	140.3
Services	-2.3	-27.1	-30.4	-3.1	-30.2
Primary income	-3.2	-34.1	-41.1	-2.6	-36.7
Secondary income	0.3	2.7	2.9	0.1	2.1
Financial account	-0.2	-10.4	-16.4	-1.8	-0.6
Direct investments	-7.8	-55.0	-65.4	-5.6	-62.2
Abroad	0.2	7.9	12.8	-0.6	2.9
In Brazil	8.0	62.9	78.2	5.0	65.0
Portfolio investments	0.0	18.0	19.2	3.2	10.0
Derivatives	0.3	-1.1	-1.0	0.0	0.1
Other investments	6.2	18.7	21.5	0.0	38.9
Reserve assets	1.0	8.9	9.2	0.6	12.5
Memo:					
Current account / GDP		-1.1	-1.3		-0.3

Fiscal

The consolidated public sector registered a primary deficit of R$77.4 billion in the first ten months of 2017 (R$45.9 billion in the same period of 2016), result of a deficit of R$95.9 billion from the Central Government and a surplus of R$18.0 billion from the subnational entities. Law 13.480 from September 13th 2017 established a primary deficit of R$159.0 billion as a fiscal target for the Central Government in 2017 and the same target for 2018, with an indication for gradual recovery of the public accounts' balance in the following years.

The Public Sector Net Debt (DLSP) reached R$3,298.6 billion (50.7 Percent of GDP) in October, an increase of 4.6 percentage points of GDP in comparison to December 2016, notably due to the contributions of the Public Sector Borrowing Requirements (6.2 percentage points) and the growth of GDP (-1.7 percentage points). The Gross General Government Debt, which includes Federal Government, National Social Security Institute (INSS), state and municipal governments, reached R$4,837.2 billion in October (74.4 percent of GDP), increasing 4.5 percentage points in the same basis of comparison, with emphasis to the impact of the accruement of interests over the debt stock (5.7 percentage points).

The advancement in the process of reforms and other necessary adjustments in fiscal management remain crucial for the reversion of the ascending trajectory of public debt.

External demand and Balance of Payments

Current transactions registered a deficit of US$5.4 billion (0.3 percent of GDP) up to November 2017, in comparison with US$17.6 billion (1.1 percent of GDP) in the same interval of 2016. It is worth noting in the period a US$18.6 billion increase in the surplus of the trade balance, reflecting the expansion of 9.8 percent in imports, especially due to the acquisition of intermediate goods, fuel and lubricants and, in the last months, capital goods; and the expansion of 18.5 percent in exports, driven by the sale of basic products, notably soybeans, iron ore and oil, in line with the favorable external scenario and record agricultural harvest. Also of note the exports of some manufactured goods, especially passenger cars. Regarding the financial account, from January to November of this year net investment inflows in

the country surpassed net outflows of investments abroad by US$13.3 billion. Net inflows of direct investment totaled US$62.2 billion in the period, with growth in direct investment abroad from July on. In the context of portfolio investments, as of July the increase in net outflows of investment funds was also a highlight.

The conditions for access to credit, as offered by the international market to companies resident in Brazil, improved in 2017. The total rollovers rate, considering long term-term securities operations and direct loans in the international market reached 100 percent in the first eleven months of the year (65 percent in the same period of 2016).

The estimated stock of foreign debt reached US$317.2 billion in November, in comparison to US$326.3 billion at the end of 2016. The ratio between the international reserves stock in the liquidity concept and the 12-month external debt maturities reached 371 percent in November 2017 compared to 335 percent in December 2016. The stock of international reserves in the liquidity concept corresponded to 18.8 percent of GDP in November, equivalent to 30 months of imports of goods.

1.3 Inflation and market expectations

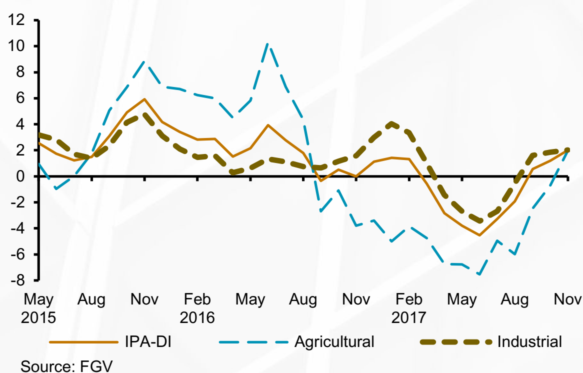
Consumer inflation behavior remained favorable in the quarter ended in November, staying, for the fifth consecutive quarter, in a level lower than expected[10]. The indicator evolution was sustained, especially, by the benign behavior of food prices, in contrast with the evolution of general prices, which unexpectedly started to increase again, mitigating the deflationary surprise of this quarter.

The several underlying inflation measures remain in comfortable or low levels, including the components most sensitive to the business cycle and monetary policy.

Price indexes

After registering deflation for two consecutive quarters, the Broad Producer Price index (IPA) increased by 2.02 percent in the quarter ended in

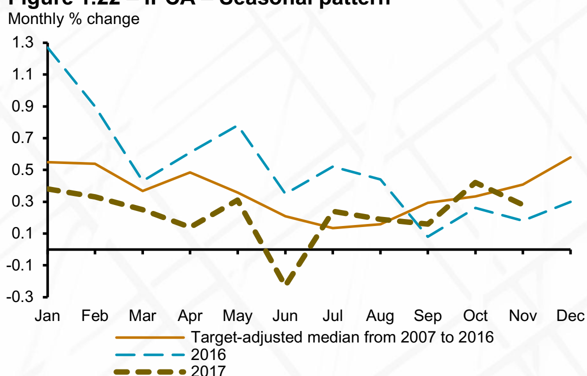
Figure 1.21 – IPA-DI
% change in 3 months



Source: FGV

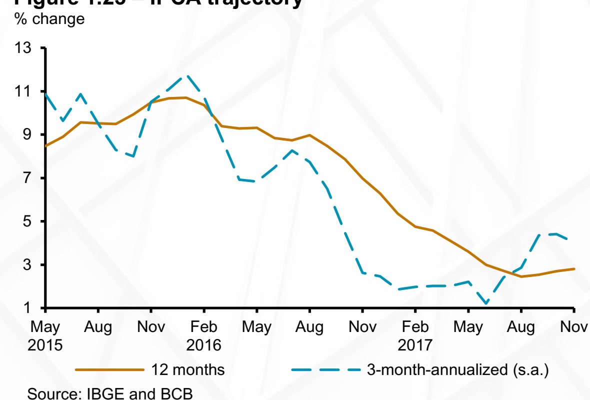
10/ According to estimates released in the previous Inflation Report.

Figure 1.22 – IPCA – Seasonal pattern



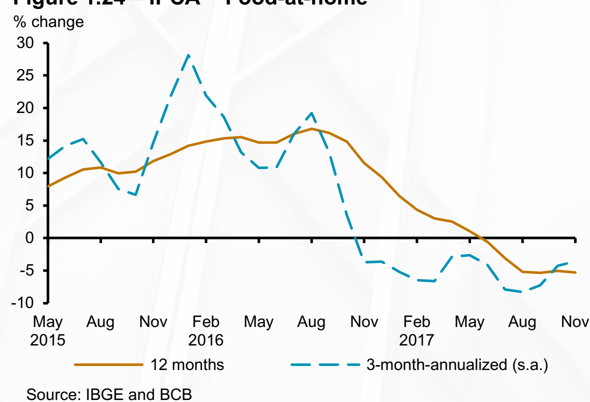
Source: IBGE and BCB

Figure 1.23 – IPCA trajectory



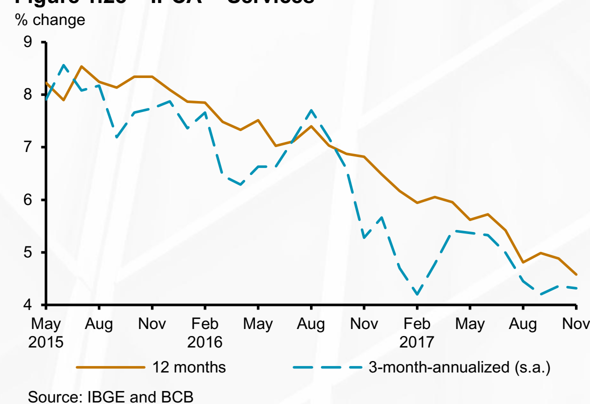
Source: IBGE and BCB

Figure 1.24 – IPCA – Food-at-home



Source: IBGE and BCB

Figure 1.25 – IPCA – Services



Source: IBGE and BCB

November, an evolution that, although spread among its components, was particularly influenced by the behavior of the most volatile prices, such as corn (23.66 percent), oil derived products (17.19 percent) and soybeans (8.67 percent). In general, the recent dynamics of producer prices is consistent with the prospects of gradual increase of inflation in consumer prices for food and industrial goods, in the coming quarters.

The Extended National Consumer Price Index (IPCA) grew 0.86 percent in the quarter ended in November, reflecting increases of 2.56 percent in administered prices and 0.29 percent in free market prices. The IPCA variation in the quarter was slightly below than the historic median compatible with the center of the target (1.04 percent)[11], but higher than that registered in the same period of the previous year (0.52 percent), which resulted in the increase of the twelve month rate, from 2.46 percent in August, to 2.80 percent in November.

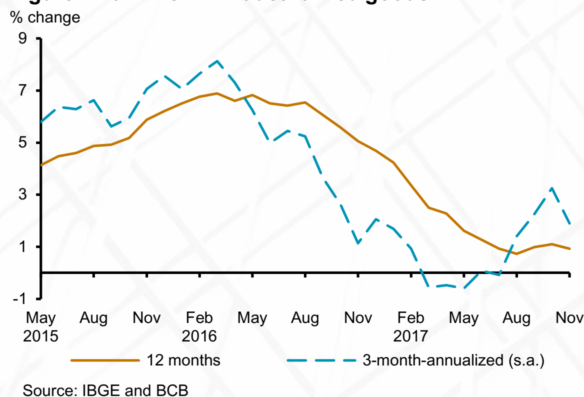
Despite the deceleration in the pace of falling prices, the food-at-home subgroup registered, for the fifth consecutive quarter, a variation lower than the seasonal pattern, expanding the deflationary surprise coming from this segment. Twelve months food inflation reached -5.30 percent in November, after reaching 5.20 percent in August 2017, in comparison to 11.56 percent in November 2016. Despite the still widespread deflation, the recent evolution of agricultural and livestock prices and the prospect of the La Niña climatic event suggest a less benign scenario for food inflation in the following months.

The slack in production factors and the dissemination of the current low inflation level continue to benefit the reduction of inflation of services, which registered 4.58 percent in November 2017, 4.81 percent in August 2017 and 6.82 percent in November 2016. Considering seasonally-adjusted quarterly variations, inflation of services showed a relative stability in November, amidst the slowing of the underlying components (notably food away from home and condominium fees) and acceleration in tourism and communications prices.

Despite occasional price pressures from ethanol and cigarettes in recent months, twelve-month inflation in the industrial goods segments remains low, reaching 0.92 percent in November, down from 0.73 percent

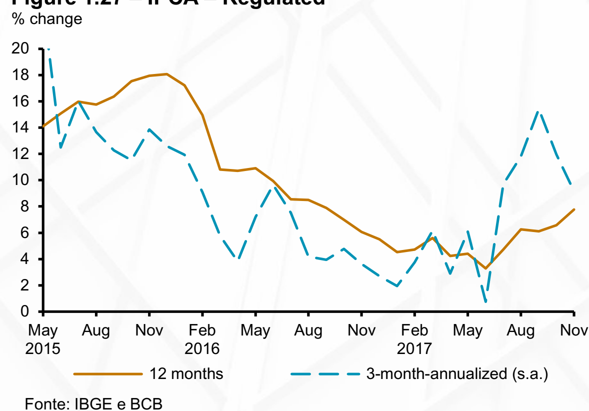
11/ Seasonal pattern obtained from monthly medians for the period from 2007 to 2016, adjusted so the twelve month total is around 4.5 percent.

Figure 1.26 – IPCA – Industrialized goods



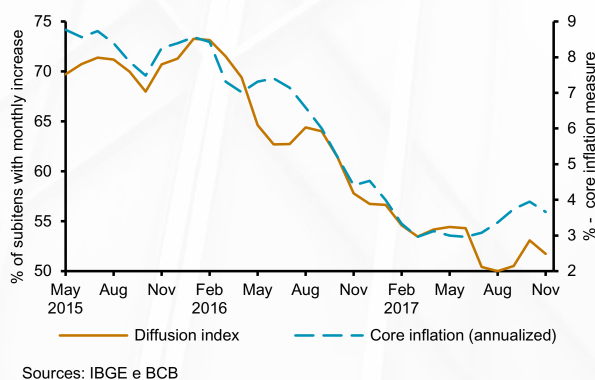
Source: IBGE and BCB

Figure 1.27 – IPCA – Regulated



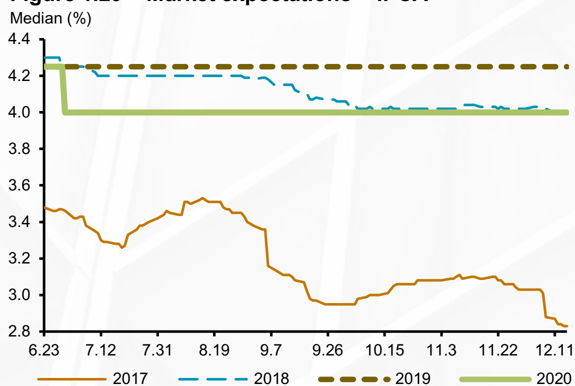
Fonte: IBGE e BCB

Figure 1.28 – Diffusion index and core inflation



Sources: IBGE e BCB

Figure 1.29 – Market expectations – IPCA



in August and 5.06 percent in November 2016. In this context, it is worth noting the favorable evolution of durable goods inflation, which registered -1.68 percent in the last twelve months.

Differently from other segments and inducing great volatility in the monthly IPCA rates, administered prices registered acceleration for the second consecutive quarter, reflecting the increase in electric power tariffs[12] and the effects of the raise in international oil prices over domestic gasoline and bottled gas prices. In the opposite direction, there was a deceleration in the prices of water and sewage services and urban transportation tariffs. Twelve-month inflation for administered prices was 6.26 percent in August and reached 7.76 percent in November.

Diffusion index and core inflation measures

The diffusion index, which measures the proportion of IPCA components with positive price variations, registered an average of 51.7 percent in the quarter ended in November, 45.1 in the quarter ended in August and 57.6 percent in the same period of the previous year. Considering seasonally-adjusted data, the recent evolution of the diffusion index suggests the exhaustion of the deflationary process in course.

The twelve month core inflation measures continued to decelerate, but showed some acceleration in the seasonally-adjusted series, a behavior consistent with the inflexion of the inflationary process. The average variation of five core measures reached 3.34 percent in the period of twelve month up to November, remaining in the interval of the inflation target.

Market expectations

According to the Focus survey, the median projections for the annual IPCA variation in 2017 declined from 2.95 percent on September 29th to 2.83 on December 15th. The median of projections for 2018 declined form 4.06 percent to 4.00 percent in the same period. The median of projections for 2019 and 2020 remained in 4.25 percent and 4.00, respectively. The median of expectations for the twelve-month inflation ahead – smoothed – declined from 3.97 percent to 3.91 percent, in the same period.

12/ Change from yellow to red flag (level 2) in October and, in November, revision of the respective additional value of R$3.50 to R$5.00 for each 100kWh consumed.

Table 1.5 – Summary of market expectations

	30.6.2017		29.9.2017		15.12.2017	
	2017	2018	2017	2018	2017	2018
In percentage						
IPCA	3.46	4.25	2.95	4.06	2.83	4.00
IGP-M	0.58	4.50	-0.80	4.44	-0.80	4.39
IPA-DI	-0.95	5.00	-3.61	4.56	-3.16	4.47
Administered Prices	5.10	4.70	6.50	4.70	7.90	4.90
Selic (end-of-period)	8.50	8.25	7.00	7.00	-	7.00
Selic (average)	10.22	8.25	9.84	7.00	-	6.75
GDP growth	0.39	2.00	0.70	2.38	0.96	2.64
In BRL/US$						
Exchange rate (end-of-period)	3.35	3.40	3.16	3.30	3.29	3.30
Exchange rate (average)	3.26	3.40	3.17	3.24	3.20	3.30

(continues)

Table 1.5 – Summary of market expectations
(concluded)

	30.6.2017		29.9.2017		15.12.2017	
	2019	2020	2019	2020	2019	2020
In percentage						
IPCA	4.25	4.00	4.25	4.00	4.25	4.00
IGP-M	4.50	4.50	4.25	4.00	4.30	4.00
IPA-DI	4.50	4.50	4.50	4.25	4.35	4.12
Administered Prices	4.50	4.25	4.25	4.00	4.25	4.00
Selic (end-of-period)	8.50	8.25	8.00	8.00	8.00	8.00
Selic (average)	8.50	8.33	8.00	8.00	8.00	8.00
GDP growth	2.50	2.50	2.50	2.50	2.75	2.50
In BRL/US$						
Exchange rate (end-of-period)	3.49	3.55	3.36	3.43	3.40	3.45
Exchange rate (average)	3.45	3.50	3.32	3.40	3.32	3.40

The median of expectations for the increase in administered prices in 2017 and 2018 reached, respectively, 7.90 percent and 4.90 percent on December 15th (6.5 percent and 4.7 percent on September 29th). Projections for 2019 and 2020 remained, respectively, 4.25 percent and 4.0 percent, in the period considered.

The exchange rate medians projected by the market for the end of 2017 and 2018 reached, respectively, R$3.29/US$ and 3.30/US$ on December 15th (R$3.16/US$ and R$3.30/US$ on September 29th). Medians relative to 2019 and 2020 increased, respectively, to R$3.40/US$ and R$3.45/US$ (R$3.36/US$ and R$3.43/US$ on September 29th).