IPCA forecast for 2022 rises from 7.4% to 9.2%. For 2023, expectations rise from 4.0% to 4.5%.

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The materialization of inflationary risks drives the upward revision

- Risks that we had been monitoring (see the monthly macro report for May) became part of the base scenario, and we raised the IPCA forecast for 2022 to 9.2% (from 7.4%);

- The "covid zero" policy in China raises and prolongs bottlenecks in the supply chain, and the prices of industrial goods should suffer a new shock. Group inflation went from 7.5% to 10.0% in 2022;

- International gasoline price parity remains high, and fuel price readjustment seems to be a matter of time. We incorporated a 10% increase for gasoline into the scenario;

- Stronger economic activity at the margin, especially in the service sector, should contribute to the price level being above the pre-pandemic trend;

- Food inflation also rose due to the secondary effects of the shocks listed above and more pressured prices at the margin;

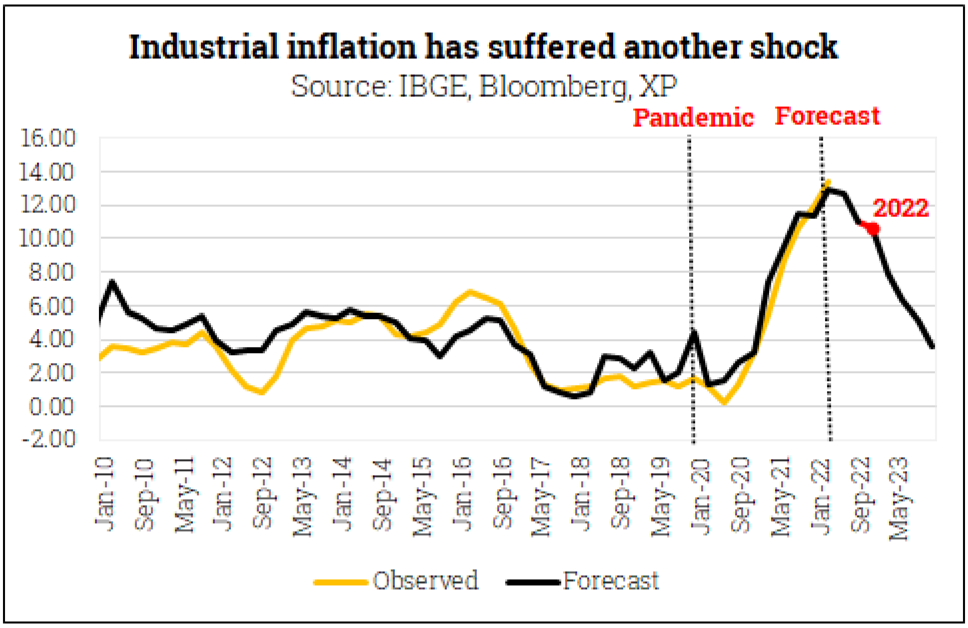
- The projection for the 2023 IPCA rose from 4.0% to 4.5% due to the higher inertial coefficient.

In our latest monthly report, we discussed and quantified the upward bias of our inflation forecast. Since then, most of these risks have materialized or their probability of occurrence increased considerably – worsening disruptions to global supply chains due to Chinese lockdowns, pressure on fuel prices, and services accelerating as the economy reopens.

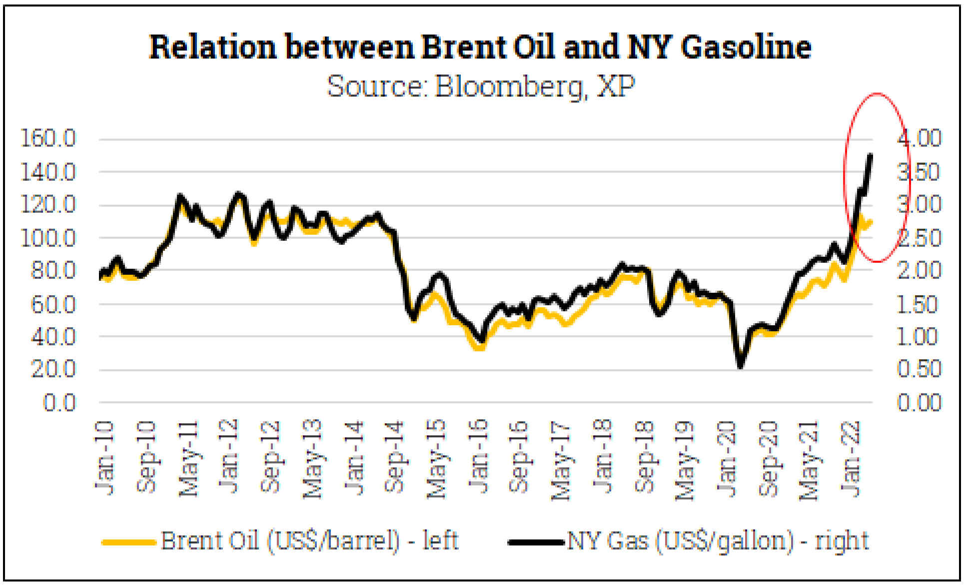
Accordingly, we revised our IPCA forecasts for 2022 and 2023 to 9.2% and 4.5%, up from 7.4% and 4.0%, respectively.

In Chinese cities, persisting severe mobility restrictions raised inflationary pressures, especially for industrial goods. Import delays at the ports of Shanghai have risen sharply, cargo transport within the country has also suffered many interruptions, and factories have reduced production. Several multinational companies have already reported that their production has been suffering from the effects of China's zero covid policy. This new supply shock adds to ongoing problems seen since the beginning of the pandemic and will put even more pressure on the prices of industrial goods.

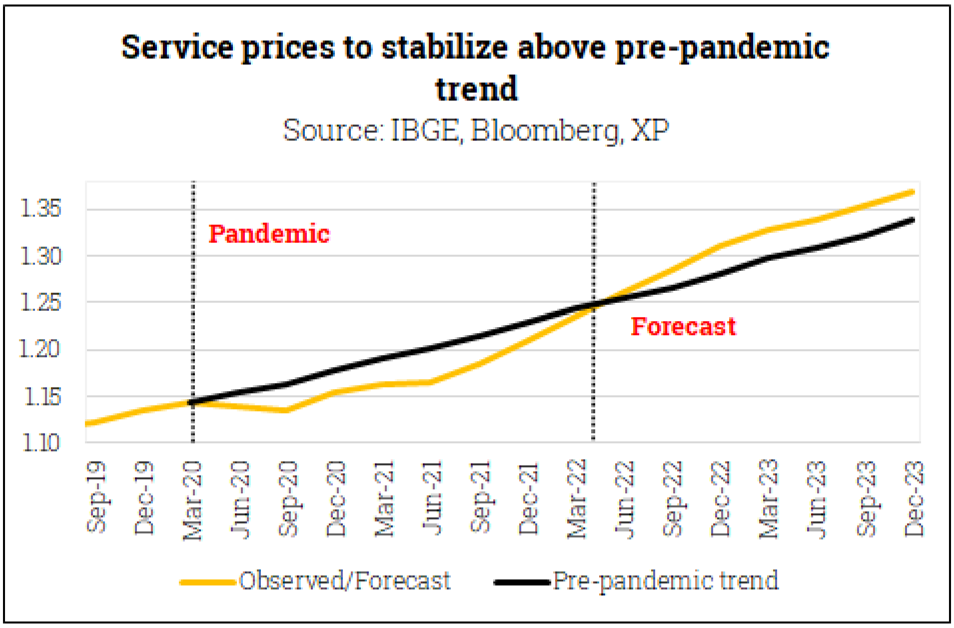
In a study carried out by the IMF (*Supply Bottlenecks: Where, Why, How Much, and What Next?*, *February 2022*), half of the rise in prices in the manufacturing sector would not have occurred without supply bottlenecks. And production stoppages during the pandemic could explain up to 40% of the global supply shock. Late last year, industry experts had expected supply shortages to mostly dissipate by mid-2022, and completely by the end of 2022. Still, given new waves of covid, especially in Asia, disruptions will last more, possibly until 2023. Thus, we incorporated the industrial inflation into our scenario that resulted from the estimate we made for our monthly report in May. The same shock suffered at the worst moment of the pandemic is repeated this year. The projection for the industrial group has risen from 7.5% to 10%.



Another risk scenario that has gained much more probability is the increase in fuel prices, given that the readjustment seems to be a matter of time. Despite the stability of oil prices around our base case hypothesis (US$ 105 barrel) and the exchange rate orbiting R$ 5.00 per dollar, gasoline and diesel prices in the global market soared due to the sharp rise in refinery margins (see chart). At international price parity, the lag for gasoline is already close to 20%. In our scenario, we incorporated a 10% fuel price readjustment in June, raising the expected inflation for the administered group from 6.6% to 8.6%.



Service inflation is also expected to be higher, in line with the sector's stronger-than-expected performance at the margin. The persisting repressed demand, and the very high current inflation and high expectations will drive stronger price adjustments in this group, surpassing the pre-pandemic trend. In our simulations, service prices, which are already at the same level as the pre-pandemic trend, should continue to rise, heavily influenced by higher expectations and a slightly narrower output gap. Therefore, we revised services inflation forecast from 7.4% to 8.3%.



Finally, as discussed in the last monthly report, our forecast for food prices already considered the inflationary effects of the war in Ukraine. We have raised our forecast to include the secondary round effects of higher fuel and other costs across the group and updated our price surveys and models. Our projections for food at home inflation increased from 9.5% to 11.1%

For 2023, the inflation forecast rose to 4.5%, previously at 4.0%. We did not change assumptions for the next year, such as the exchange rate, interest rates, or commodities prices. Therefore, the change was due to greater inflationary inertia. We estimate that the inertial coefficient is 0.27, higher than we estimated a year ago, at around 0.2.

IPCA Forecast: main groups	2021	2022 (P)	2023 (P)
IPCA (CPI) %YoY	10.1	9.2	4.5
Market-set prices	7.7	9.4	3.9
Food at home	8.2	11.1	3.5
Services	4.7	8.3	5.4
Industrials	12.1	10.0	2.0
Regulated prices	17.3	8.6	6.4

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