Executive summary

The outlook for the world economy remains pointing to low growth for a prolonged period. In fact, several developed economies already face a recessive economic environment. In the United States, if, on the one hand, a more positive perception prevails regarding the economic activity, although for the short term, on the other, concerns arise about the associated risks, for instance, from the recent rise in oil prices and the scenario of fiscal consolidation for this and subsequent years. In the euro area, recent events demonstrate that a definitive solution for the fiscal and financial crisis will be postponed, thus indicating an outlook of low or negative economic growth for the region. Economic growth expectations for major emerging economies have also been reduced and, in some specific cases, the new levels reflect a permanent change.

The Brazilian economy decelerated in 2011, expanding below its potential growth rate during the latest quarters. To a certain extent, the more moderate pace of economic growth was consequent upon policy measures implemented in late 2010 and early 2011, intensified by a deteriorating global economic outlook in the second half of 2011. Against this backdrop, the domestic economy slowed down in the first half of 2011 in comparison to the previous period, and this decelerating trend became more intense during the second half of the year. The impact of a deteriorating international outlook has passed on to the Brazilian economy, among other transmission channels, through business and consumer expectations, external trade flows and investments. In addition, it should be highlighted the process of inventory adjustments implemented by major industrial sectors in the second half of the year.

The slower pace of overall credit expansion in recent months arises from, among other factors, slightly more restrictive credit supply conditions to households, in the context of a delinquency rate level consistent with the current phase of the economic cycle and relatively stable recently. Housing credit operations continue its strong expansion trend, partly due to improved institutional arrangements. Insofar as corporate credit operations are concerned, more moderate economic growth rates have helped curtail demand in the segment of non-earmarked credit.

Expansion of government revenues in 2011 partly contributed to the full compliance with the primary surplus target set for the year.

Concerning the foreign sector, the 12-month trade balance closed at US$28.6 billion in February, as compared to US$21.5 billion in February 2011. External demand, weakened by the complex international outlook, has given a moderate contribution to growth in the volume of exports. In fact, in the 12-month period up to January 2012, export volume rose by 2.6% as against the previous 12-month period, whereas the average price of exports increased by 21.2%. The volume of imports, in turn, grew by 8.5% in the same period, partly reflecting the trajectory of domestic demand, in spite of its more moderate growth rates in the last months, which can be seen in the gradual decelerating trend since the beginning of 2011.

The current account deficit was fully financed by foreign direct investments (FDI). Net portfolio investments in equities added up US$5.1 billion in the first two months of the year, as compared to US$6.2 billion in entire 2011. This performance is consistent with the exemption, as of December 2011, of the IOF levied on this investment modality.

Inflation measured by the 12-month IPCA change, has been slowing down since October 2011, and closed February 2012 at 5.85%, 0.16 p.p. lower than in the same period of 2011. Inflation deceleration was basically consequent upon lower free price increases in the period. Core inflation indicators measured by the Banco Central do Brasil followed, in general, a path similar to that of the headline inflation index.

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of March 9, 2012, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R$1.75/US$ and target for the Selic interest rate at 9.75% p.a. – projects inflation of 4.4% in 2012, 0.3 percentage point (p.p.) lower than that of the December 2011 *Inflation Report*, 5.2% in 2013, and 5.1% in the first quarter of 2014.

In the market scenario – which uses data from the expectations survey undertaken by Banco Central's Investor Relations and Special Studies Department (Gerin) with a significant group of institutions – the inflation projections are of 4.5% for 2012, 0.3 p.p. lower than that of the latest *Report*, 5.3% for 2013, and 5.2% for the first quarter of 2014.

With reference to the balance of risks, the Copom assesses that the international scenario continues to show disinflationary bias for the relevant horizon, which makes the balance of risks for domestic inflation more favorable. For the Committee, since the last *Report*, domestic developments on the whole have indicated a favorable balance of risks for the relevant horizon.

The Copom understands that the Brazilian economy has experienced significant structural changes over the past years, which have led to a fall in interest rates in general and, in particular, in the neutral rate. Some factors that support this view include the reduction of risk premia, which is directly related to the accomplishment of the inflation target for the eighth consecutive year, macroeconomic stability and improvements in the institutional environment. Moreover, the reduction in interest rates has been favored by changes in the structure of the financial and capital markets, credit market deepening, as well as the generation of primary surpluses consistent with a decreasing trend for the public debt-to-GDP ratio. For the Committee, all these changes have a high degree of persistence – although specific and temporary reversions can occur due to business cycle fluctuations – and contribute to the solid solvency and liquidity indicators that the Brazilian economy currently displays.

The Copom also considers that the increase in the supply of external savings and the fall in its financing cost have contributed to the reduction of the domestic interest rates, including the neutral rate. According to the Committee's view, these developments are largely permanent.

Considering the values projected for inflation and the associated balance of risks, the Copom attributes high probability for the materialization of a scenario that considers the Selic rate moving to slightly above the historic low levels, and stabilizing at these levels.

According to the baseline scenario, the GDP growth rate projected for 2012 is 3.5%, same value considered in the December 2012 *Inflation Report*. This projection contemplates acceleration of activity between the first and second halves of the current year, is compatible with the domestic and external equilibrium, and is consistent with the convergence of inflation to the target in 2012.