

This chapter of the Inflation Report presents the Monetary Policy Committee's (Copom) assessment of the behavior of the Brazilian economy and of the international scenario since the release of the previous Report in December 2013. The chapter also presents the analysis of the inflation prospects up to the first quarter of 2016 and of the Gross Domestic Product (GDP) growth up to the fourth quarter of 2014. Inflation projections are presented in two major scenarios. The first scenario, called the baseline scenario, assumes that the Selic rate will remain unchanged at 10.75% per year over the forecasting horizon, the level set by Copom at its most recent meeting on February 25 and 26, and the exchange rate will remain at R\$2.35 per US dollar. The second scenario, named the market scenario, is based on the expected paths for the policy interest rate and for the exchange rate drawn from the survey carried out by the Banco Central do Brasil's Investor Relations and Special Studies Department (Gerin) among independent analysts. It is important to stress that these scenarios are used only as support for monetary policy decisions and their assumptions should not be viewed as Copom forecasts of the future behavior of interest and exchange rates. The projections released here are based on the information set available up to the cutoff date of March 14, 2014.

The projections for inflation and for GDP growth released in this Report are not point estimates. They consist of probability intervals which embody the degree of uncertainty that was present at the above mentioned cutoff date. Inflation projections depend not only on assumptions about the interest and exchange rates, but also on a set of assumptions on the behavior of exogenous variables. The most likely set of assumptions considered by the Copom is used to build the scenarios to which the Committee attaches the greatest weight on making its interest rate decisions. On setting out these assumptions, the Copom seeks to foster transparency to the monetary policy, thereby contributing to the effectiveness of policy decisions in controlling inflation, which is its primary objective.

6.1 Inflation determinants

The twelve-month inflation measured by the change in the Broad National Consumer Price Index (IPCA) reached 5.68% in February, 0.63 percentage points (p.p.) lower than the value recorded until February 2013. The twelve-month accumulated inflation decrease reflects the lower variation in market prices, 6.28% until February (1.58 p.p. lower than the rate up to February 2013). The regulated and monitored prices changed 3.71% (2.18 p.p. higher than the inflation accumulated up to February 2013). Within the set of market prices, the increase of non-tradable goods reached 7.19% in twelve months, and tradable goods amounted to 5.25%. Still on tradable goods, twelve-month accumulated inflation in the food and beverage group declined to 6.31% in February (6.18 p.p. lower than the variation up to February 2013). In turn, the services sector inflation – around 35% of the consumption basket of IPCA – has reached 8.20% (8.66% until February 2013), and remains in levels above the market prices inflation. In summary, available information suggests some inflation persistence, which partially reflects the price dynamics in the services sector.

Measures of underlying inflation calculated by the Central Bank have shown dissimilar behavior to that of headline inflation. The average monthly change shifted from 0.53% in January to 0.70% in February, reaching 6.18% in twelve months (0.21 p.p. higher than the rate recorded in February 2013). Specifically, the double weighted core changed from 0.55% in January to 0.69% in February; the measure that excludes the prices of monitored goods and food at home changed from 0.52% to 0.92%; the non-smoothed trimmed mean core changed from 0.54% to 0.57%; and the exclusion core – which excludes ten items from the groups food at home and fuels – changed from 0.50% to 0.79%. In turn, the smoothed trimmed mean core changed from 0.55% to 0.51%. The IPCA diffusion index reached 63.8% in February (8.5 p.p. lower than that of February 2013) and 68.4% on the three-month average (4.3 p.p. lower than the average observed from December 2012 to February 2013).

Broader inflation – measured by the General Price Index (IGP-DI) – which is characterized by higher volatility when compared to consumer inflation, reached 0.85% in February, after a 0.40% variation in January. Therefore, the index cumulates change of 6.30% in twelve months to February (1.94 p.p. lower than the variation up to February 2013). The major component of the IGP-DI, the IPA, changed 6.15% in the twelve months to February, due to the 0.47% inflation in the agricultural sector and to the 8.41% increase

in the industrial sector prices. The IPC, the second most important component of the IGP-DI, reached 5.95% in the twelve months to February (6.04% up to February 2013). The INCC, the smallest weight component of the IGP-DI, increased 8.04% in twelve months (0.86 p.p. higher than the variation up to February 2013), due to the change of 9.57% in the labor cost and of 6.43% in the cost of materials, equipment and services.

The high frequency coincident indicator of economic activity, IBC-Br, which provides monthly production estimates for the three sectors of the economy, increased 1.3% in January, compared to the previous month, after decreasing 1.4% in December, according to the seasonally adjusted series. Therefore, the IBC-Br growth rate has shifted to 2.5% in the last twelve months. In this beginning of the year, the PMI for Brazil showed expansion of the activity in the manufacturing sector, while indicating contraction in January and expansion in February in the services sector.

The Consumer Confidence Index (ICC), from FGV, decreased in February, following the trend of the two previous months, remaining under its historical average. The Industry Confidence Index (ICI) also decreased, according to seasonally adjusted data. Similarly, the Commerce Confidence Index (ICOM), also from FGV, decreased for the second consecutive month in February. In turn, the Services Sector Confidence Index (ICS) increased in February, influenced by a better businessmen's perception with respect to the current scenario.

The industrial production increased 2.9% in January, when all categories of use showed expansion, as well as 17 from 27 surveyed activities, according to the seasonally adjusted industrial production data of IBGE. The overall production was 2.4% lower than January 2013, but the resulting accumulated growth in twelve months increased 0.5%. The production of capital goods recorded significant growth rate in twelve months (12.1%). On the other hand, the production of durable consumer goods (-0.2%), semi and non-durable consumer goods (-1.0%) and intermediate goods (-0.5%) showed contraction. With regard to real revenue of the manufacturing industry, according to National Confederation of Industry (CNI) data, there was a 2.4% growth in twelve months up to January, compared to the same period of the previous year, but the number of hours worked decreased 0.9%.

The seasonally adjusted Installed Capacity Utilization Level (Nuci) in the manufacturing sector, computed by

FGV, reached 84.6% in February (88.8% in the materials for construction sector; 85.6% in the intermediate goods sector; 84.4% in the consumer goods sector; and 81.1% in the capital goods sector). In turn, the level of inventories in the manufacturing sector, computed and seasonally adjusted by FGV, remained stable since last Report. In February, according to the seasonally adjusted data, 8.7% of the establishments had excessive inventories and 1.4% had insufficient inventories. Still regarding the Manufacturing Industry Conjuncture Survey, conducted by FGV, inventories remained at high levels in the capital goods and durable consumer goods sectors.

The retail volume for the restricted retail trade increased 6.2% in January, compared to January 2013; while the broader retail trade expanded 3.5%. In the last twelve months up to January, the broader retail trade grew 3.3% in real terms – with expansion in all ten segments researched by IBGE – while the restricted retail trade grew 4.3%. In the next months, sales will continue to be influenced by government transfers, by payroll growth and by the moderate credit expansion.

The Brazilian GDP at market prices increased 0.7% in the fourth quarter of 2013, after contracting 0.5% in the previous quarter, according to seasonally adjusted IBGE data. Compared to the same quarter of 2012, growth reached 1.9% (against 2.2% in the third quarter). Therefore, Brazilian economy grew 2.3% in 2013, as a result of a 2.1% increase in added value and a 3.3% increase in direct taxes. The production in the agricultural sector increased 7.0%, in the industrial sector, 1.3% and in the service sector, 2.0% in the year.

From a demand side perspective, household consumption – the largest component of aggregate demand – raised 0.7% in fourth quarter, in comparison to previous quarter, according to seasonally adjusted data, and 1.9% compared to the same quarter of 2012, the fortieth first consecutive increase in this basis of comparison. In turn, government consumption increased 0.8% at the margin and 2.0% in respect to the same quarter of 2012. Additionally, the Gross Fixed Capital Formation (GFCF) increased 0.3% when compared to the previous quarter and 5.5% when compared to the same quarter of 2012. The foreign trade sector also positively contributed to the GDP growth rate in the fourth quarter, with exports increasing 4.1%, in comparison to previous quarter, and imports declining 0.1%, according to seasonally adjusted data. In the year, however, this contribution was negative, a result of the 2.5% increase in exports and 8.4% increase in imports.

The IBGE reported the first results of Continuous National Household Sample Survey (PNADC). According to the survey, unemployment rate in the second quarter of 2013 in Brazil was 7.4%, which represented a decrease of 0.1 p.p. when compared to the same quarter of 2012. According to the Monthly Labor Survey (PME), that covers only six metropolitan areas, the unemployment rate, without seasonal adjustments, was 4.8% in January, which represents a reduction of 0.6 p.p. against the rate observed in January 2013. According to the Central Bank seasonally adjusted data, the unemployment rate reached the minimum (4.9%) of the historical series that started in 2002. It should be noted that the lower growth rate of the working-age population (PIA) in the recent years has contributed to keep the unemployment rates at historically lower levels. Still according to the PME, the average real income rose 3.6% in January, compared to the same month of 2013, and real payroll, 3.3%, in the same basis of comparison. The evolution of real labor income has been considerably dispersed among regions, with significant annual increases in average real income in Porto Alegre (7.7%) and Rio de Janeiro (7.3%) and, at the same time, large decrease in Salvador (-7.8%). However, formal employment is expanding, albeit some moderation in job creation occurred. According to the data released by the Ministry of Labor and Employment (MTE), 731 thousand jobs were created between February 2013 and January 2014.

In addition to rising payrolls, credit availability – largely determined by macroeconomic stability, improvement in infrastructure and institutional reforms in recent years – was an important driving force behind growth of household consumption. Total credit to households reached R\$1,263.8 billion in January, a 16.2% nominal growth relative to January 2013. In particular, housing loans for households, whose operations are mainly based on earmarked resources, grew by 33.0% in the same period, reaching R\$347.7 billion, which corresponds to 7.2% of GDP. Delinquency rates have shown some decrease, at the margin, at levels consistent with the phase of the cycle, given perspectives of gradual recovery of economic activity.

The volume of credit to corporations totaled R\$1,453.4 billion in January (13.7% higher than in January 2013). The average interest rate of this segment reached 15.9%, 1.9 p.p. higher than the average rate observed in January 2013. In turn, loans and financing to corporations with resources provided by the National Bank of Economic and Social Development (BNDES) reached R\$522.4 billion – an

increase of 16.5% in twelve months up to January. Regarding the capital market, the volume of primary issues of shares registered in the Securities and Exchange Commission of Brazil (CVM) reached R\$7.2 billion in 2013 against R\$12.0 billion in 2012. In turn, debenture issues, excluding the issuance of leasing companies, totaled R\$83.2 billion in 2013 (against R\$83.1 billion in the previous year). In total, firms financing from capital markets by issues of shares, debentures, commercial papers and receivables in credit rights reached R\$116.7 billion in 2013, against R\$124.2 billion observed in 2012.

With regard to the trade balance, the twelve-month result decreased to US\$1.7 billion in February (US\$13.7 billion in February 2013). This result stemmed from US\$242.6 billion in exports and US\$240.9 billion in imports, which represented variations of 1.1% and 6.5%, respectively, compared to the twelve-month period ended in February 2013. Considering the twelve months ended in January, the exported volume increased 3.3% and the average price of exports decreased 3.2%, while the imported volume increased 7.6% and the average price of imports diminished 1.3%.

The twelve-month current account deficit reached US\$81.6 billion in January, equivalent to 3.7% of GDP. An important component of this deficit has been remittances of profits and dividends, which totaled US\$26.5 billion in liquid terms. Another significant component of the deficit refers to expenses under the item called “operational leasing services” which are, in a great part, meant to oil and minerals exploitation, reaching US\$19.4 billion in the twelve months up to January (US\$18.7 billion in January 2013). It is also worth noting that imports of oil and derivatives reached, during the same period, US\$35.4 billion (US\$32.9 billion in January 2013). Note that foreign direct investments – which have been the main financing source of the balance of payments – totaled US\$65.4 billion in the twelve months up to January, equivalent to 2.9% of GDP.

In international financial markets, since the release of the Report of December 2013, deterioration of volatility and risk aversion indicators was observed, that was followed, however, by a return to previous levels. The observed deterioration in the beginning of the year has been related, to a certain degree, to the gradual reduction of the securities purchases program by the Federal Reserve. However, in general, the prospect of continuation of accommodating policies in important mature economies in the medium run contributes to the reduction of volatility and risk aversion.

Regarding global activity, since the previous Report, leading indicators point to growth prospects compatible with trends in mature and in emerging economies. In emerging economies, however, some reduction in the economic activity pace is observed. In Europe, despite recent improvements, high unemployment rates, along with fiscal consolidation and political uncertainties still constitute elements of investments and growth restraint.

Brent oil prices, since the release of the previous Report, remained at a level close to US\$110. The geopolitical complexity which surrounds the oil sector tends to boost the volatile behavior of prices, which also reflects the low predictability of some global demand components and the fact that the supply growth depends on highly risky long term maturity investments. Regarding other commodities, there was a decrease of 0.6% in metal commodities prices and an increase of 10.7% in agricultural prices. At the cutoff date of March 14, the price index based on twenty two commodities, published by the Commodity Research Bureau (CRB), increased 5.3% against the value registered at the cutoff date of the Report of December 2013.

Figure 6.1 – Inflation target path and market expectations for twelve-month ahead inflation

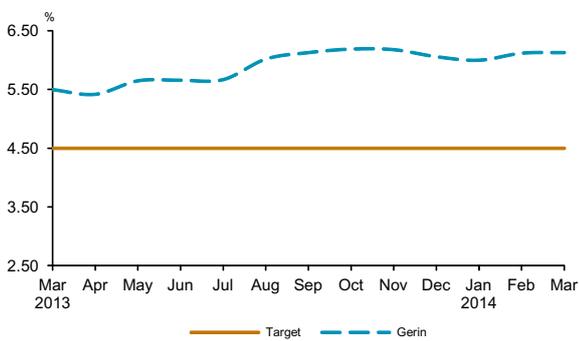
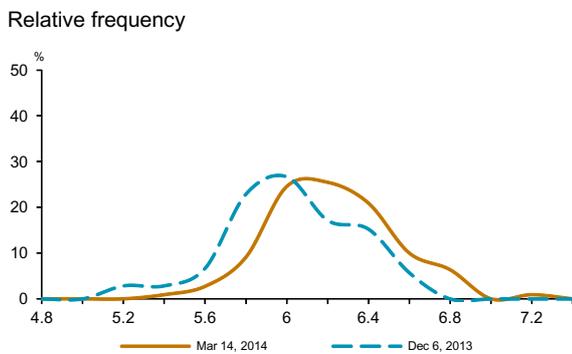


Figure 6.2 – Dispersion of inflation expectations for 2014



The median of market expectations for the 2014 GDP growth moved from 2.10% to 1.70%, between December 6, the cutoff date of the previous Report, and March 14. For 2015, the projected growth rate decreased from 2.50% to 2.00%. During this period, the median expectation for inflation, measured by variation in IPCA, moved from 5.92% to 6.06% for 2014; and from 5.50% to 5.70%, for 2015. Twelve-month ahead inflation expectations moved from 6.07% to 6.13%, as shown in Figure 6.1. Since the release of the Report of December 2013, there was stability in the dispersion around the central tendency measures of inflation expectations for 2014, as illustrated in Figure 6.2. The standard deviation of these projections remained at 0.31%.

6.2 Associated risks and monetary policy implementation

The projections used by the Copom are based on a set of assumptions about the behavior of the main macroeconomic variables. This set of assumptions, as well as the risks associated with them, make up the main prospective scenario based on which the Committee makes policy decisions.

On the external side, in general, since last Report, the prospects of more intense global activity have remained unchanged in the relevant horizon for monetary policy, although evidence still point to low and below potential growth rates in some mature economies for this year. In international markets, prospects point to moderation in the dynamics of prices of commodities, despite localized price pressures observed at the margin, and there has been more volatility and tendency of appreciation of the United States dollar. On the domestic side, the main scenario envisages a relatively stable pace of economic activity in this year, when compared to 2013. It is worth noting that additional progress in terms of the expected gains depends on the strengthening of firms' and households' confidence. The labor market dynamics is also an important aspect of the domestic environment, as well as the natural and expected relative prices correction, due to the exchange rate depreciation and volatility observed in the last quarters, which constitutes a source of inflationary pressures in shorter horizons.

On the external front, despite the limited space for monetary policy and the scenario of fiscal restriction, the prospects of recovery for some mature economies and of intensification in the pace of growth for others are still supported, among others, by recently released positive data about the level of activity. In the United States, despite adverse climate conditions recorded in the last months, there is still a tendency of improvement in the labor market and of recovery in the real estate market, in an environment that combines moderate levels of inflation. In the Euro area, high unemployment rates, together with efforts for fiscal consolidation and political uncertainty, still translate into investment decrease and slow growth. Despite the asymmetric distribution between central and peripheral countries, prospects point to moderate growth this year. Regarding risks for global activity, it is worth mentioning the ones derived from the strategy of withdrawing monetary incentives introduced by conventional and unconventional policy actions in the aftermath of the 2008 crisis by the Federal Reserve. In the Euro area, in the relevant horizon, there are still risks to activity associated with low levels of inflation and with the skepticism regarding the soundness of the banking system in some economies in the area.

The Copom evaluates that the developments in mature economies are transmitted to emerging economies' aggregate demand in intensity proportional to, among other factors, trade and capital flows. In this sense, recent events – the improvement in the pace of global activity, the steepness of

the yield curve in important economies and the high volatility in international financial markets – are opposing forces. The Committee also highlights the importance of the transmission through the expectations channel, which affects investment, in the case of entrepreneurs, and consumption, in the case of households. In this context, in main emerging market economies, despite the resilience of domestic demand, in general there has been lower than expected growth. However, recent indicators suggest the exhaustion of the process of accommodation of activity in these economies, such that growth rates would tend to remain relatively high, though in lower levels than recorded in recent years, in the relevant horizon for monetary policy.

The Copom assesses that scenario of higher global growth, combined with the depreciation of the Real, militates in making the dynamics of external demand more favorable to the growth of the Brazilian economy, in the relevant horizon.

The Copom considers that, since the December 2013 Report, risks for global financial stability remained high, in particular the ones derived from changes in the slope of the interest curve in important mature economies. During this period, insurance prices against default (CDS) of banks and sovereigns of mature economies have remained in historically high levels, especially in the Euro area. Regarding emerging economies, in general, the implicit risk premia in financial assets has also remained in high levels. In the relevant horizon for monetary policy, the Committee assesses that financial markets volatility tends to react to the release of new indicators and/or to signs that point to the deepening of the process of normalization of monetary conditions in the United States by authorities. In the Euro area, low levels of inflation and the banking system evaluation have been at focus of attention and may, eventually, demand action from the European Central Bank. In summary, despite identifying low probability of occurring extreme events, the Committee assesses that the international financial markets environment remains complex.

In international markets, commodity prices have shown strong recovery in the beginning of this year, encompassing all main segments (energy, metal and agriculture). The Commodities Brazil Index (IC-Br), measured in United States dollars, reached the highest level since February 2013. The increase in commodity prices occurs despite the relative stability in Brent oil prices. The Committee highlights, nevertheless, that in spite of the recently observed pressures, perspectives indicate a moderate dynamics for commodities prices. Specifically regarding oil prices, it is important to stress that their influence on domestic inflation does not

materialize exclusively through the local price of gasoline, but also via the petrochemical production chain and the expectations channel of consumers and entrepreneurs.

The Copom evaluates that purchases of external goods tend to contribute to the weakening of domestic inflationary pressures through two channels. Firstly, these products compete with goods that are domestically produced, imposing greater discipline to the price setting process. Secondly, imports reduce the demand for domestic input, contributing to the weakening of cost pressures and, by consequence, of its eventual pass-through to consumer prices. In this respect, it is worth adding that factor cost pressures not offset by efficiency gains contribute to the reduction in the competitiveness of domestic firms in the goods and services international markets, in a global environment with historically high levels of spare capacity.

On the domestic side, National Accounts data regarding 2013 last quarter confirm the gradual recovery of Brazilian economy. Important to note that the variations, in the margin or in a twelve-month basis, support the view that a change in demand composition is occurring. Thus, consumption would continue to grow, but in a more moderate pace, while investments and net exports would increase its shares. Despite the stabilization in agricultural and industrial production, at the margin, it is anticipated, in the relevant horizon for monetary policy, continuity in the change in supply composition. In this context, while more favorable prospects emerge for the industrial and agricultural competitiveness, the services sector tends to show some accommodation in the relevant horizon, with growth rates smaller than those observed in previous years. Evidence of changes in demand and supply strengthen perspectives of continuity for the current growth cycle in this and in the following years, in a process that tends to be supported by the robustness of the domestic market and by the intensification of global activity.

In this environment, the Copom evaluates that aggregate demand tends to remain relatively robust. On one side, household consumption tends to benefit from stimulus factors, such as income gains and moderate credit expansion. On the other, favorable financial conditions, public services concessions and rights to oil exploration, among others, generate good perspectives for investments.

In terms of factor markets, the Copom assesses that an important source of risk to inflation comes from the labor market, which shows low idle capacity. The Committee

reaffirms that a crucial aspect under these circumstances is the possibility of real wage increases at rates that are not compatible with productivity growth, with negative impacts on the inflation dynamics. At this point, it is worth noting that, according to the theory, which is endorsed by the international experience, wage moderation is a key element to the achievement of a macroeconomic environment with price stability.

Still on the labor market, the Copom understands that there are risks, due to the presence of mechanisms in the Brazilian economy that favor the persistence of inflation, derived from the possibility that wage bargaining gives excessive weight to past inflation at the expense of future inflation. In this context, despite lower raise in the minimum wage this year than in previous years, as well as real wage gains in the last quarters near to the levels consistent with estimates of productivity gains, the Committee evaluates that the wage dynamics remains originating inflationary cost pressures. However, in the relevant horizon for the monetary policy, events that tend to contribute to lower the risks associated to the labor market are anticipated, such as lower projected raises in the minimum wage and in the public servants salaries. These developments tend to smooth the wage dynamics in general, with consequences to production costs, especially in labor intensive segments.

Regarding the capital factor, investment rate increased, at the end of 2013, for the third consecutive quarter, reaching 18.4% of the GDP in the twelve-month rate. Nonetheless, together with the capacity utilization level that has a slight growth trend in the last quarters, the perspectives for capital factor use continue to be positive. For the Committee, favorable financial conditions, the programs of public services concession – especially in infrastructure and logistic segments – and the rights to oil exploration in the pre-salt layer suggest intensification of investments in the upcoming semesters.

Regarding fiscal policy, the Copom reaffirms that its prospective scenario for inflation is conditioned on the materialization of the trajectories regarding fiscal variables. For the Committee, the generation of primary surpluses in line with the working hypotheses considered for inflation projections, on one hand, would contribute to reduce the mismatch between supply and demand growth rates; and, on the other hand, would contribute to create a positive perception regarding the macroeconomic environment in the medium and long terms. Accordingly, the fiscal indicator

used in the inflation forecasts (the structural primary surplus) would, therefore, tend to maintain some stability, with fiscal impulses (the change in the structural primary surplus between two periods) being of negligible size. Regarding the impacts over aggregate demand, the Committee evaluates that the conditions are established for the public sector balance to shift to the neutrality zone in the relevant horizon for monetary policy.

The Copom considers that nowadays primary surpluses of large magnitudes are not so necessary as opposed to the time when the public sector solvency was a matter for concern. For the Committee, however, primary surpluses of magnitude close to the average levels registered in more recent years are necessary to maintain the public debt at a sustainable path. Given this condition, the Committee understands that the financing cost of the public debt would decrease, with favorable implications for the cost of capital in general that would stimulate private investment in the medium and long run.

The Copom appraises that exchange rate depreciation and volatility that occurred in the past quarters provide a natural and expected correction process in relative prices, i.e., of domestic prices relative to prices in the rest of the world. On the other hand, the realization of this process becomes more complex because administered prices, partially composed of non-tradable goods and services, are misaligned at low levels. Nonetheless, the Committee believes that these movements in the domestic foreign exchange market are, to some extent, part of a global phenomenon and reflect perspectives of transition of the international financial markets towards normality in terms of liquidity and interest rates, among other dimensions. For the Committee, the aforementioned relative price adjustment process is a source of inflationary pressure in shorter terms. Sum to that the localized pressures that sometimes occur, especially in fresh food segment, although, at first, it should be considered a temporary shock and it should tend to revert in the following months. In any case, the Committee reaffirms its understanding that the secondary effects that result from it and that would come about in longer terms may and should be limited by the appropriate conduct of monetary policy.

The Copom considers that a relevant source of the risk of inflation lies on the behavior of inflation expectations that were negatively impacted, in the last months, by the level of current inflation, by the dispersion of price increases and by uncertainties related to the path of prices in segments with

great visibility, such as gasoline and some public services, like electricity. In this regard, the Committee has acted to ensure that the high variation of price indexes observed in the last twelve months is perceived by economic agents as a short term process. In this case, the inflation persistence would tend to decrease, as well as its damages to the decision-making process on consumption and investment.

The Copom highlights that its main scenario considers moderate credit expansion, in particular, in the individuals' segment, at a pace more compatible with the growth of household disposable income. For the Committee, the dynamics of the credit market deserves attention, be it for its potential impacts on aggregate demand or for the macroprudential risks that may be originated from it. In this context, the Committee considers opportune initiatives that aim at moderating the concession of subsidies through credit operations.

The Copom reminds that the transmission of monetary policy actions to inflation occurs with lags. In this process, several channels – for instance, demand, credit, exchange rate and expectations – are involved and not necessarily operate with the same intensity and in a simultaneous way. Additionally considering that, before reaching prices, monetary policy actions interfere in the consumption and investment decision-making process of households and firms, in any circumstance, there is some degree of uncertainty about the intensity of inflation reaction to policy actions. To the Committee, this uncertainty may increase – and it actually has increased – in an environment like the present one, in which financial markets volatility has been amplified by the steep interest rate curves in advanced economies, particularly, in the United States.

Still regarding the transmission of monetary policy and considering the Brazilian experience during the Inflation Targeting, one concludes that the economy's response to the recent cycle of the Selic rate adjustment, along with the prospects for the coming quarters, is aligned with what could be anticipated. In other words, the available information suggests that the monetary impulses have propagated normally through the main channels of transmission and that this process will remain in the next quarters.

The Copom evaluates that, despite observed moderation at the margin, the high change in the consumer price indexes in the past twelve months contributes for inflation to show resistance, which, by the way, has been shown slightly above what was anticipated. In this context, the formal and informal

indexation mechanisms and the economic agents' perception regarding the inflation dynamics are included. Considering the damages that the persistence of this process would cause to the consumption and investment decision-making process, it is necessary, according to the Committee's perspective, that this process be reverted with due promptness.

In this context and carrying on the adjustment process of the basic interest rate initiated in the April 2013 meeting, the Copom decided unanimously to increase the Selic rate to 10.50% p.a., without bias, in the January meeting; and to 10.75% p.a., without bias, in the February meeting.

The following members of the Committee voted for the decision of raising the Selic rate to 10.50% p.a. and to 10.75% p.a.: Alexandre Antonio Tombini (Governor), Aldo Luiz Mendes, Altamir Lopes, Anthero de Moraes Meirelles, Carlos Hamilton Vasconcelos Araújo, Luiz Awazu Pereira da Silva, Luiz Edson Feltrim e Sidnei Corrêa Marques.

The Copom emphasizes that the international evidence, which is ratified by the Brazilian experience, shows that high inflation rates generate distortions that lead to higher risks and depress investments. These distortions are manifested, for example, in shortening the planning horizons of households, businesses and governments, as well as in the deterioration of the businessmen's confidence. The Committee also emphasizes that high inflation rates subtract the purchasing power of wages and transfers, with negative repercussions over households' confidence and consumption. Therefore, high inflation rates reduce the growth potential of the economy, as well as of jobs and income generation.

The Copom highlights that, in moments such as the current one, the monetary policy should remain especially vigilant, in order to minimize risks that high inflation rates, such as the ones observed in the last twelve months, persist in the relevant horizon for monetary policy. At the same time, the Committee considers that the effects of monetary policy actions to inflation are cumulative and occur with lags.

6.3 Inflation forecasts

According to traditional procedures, and taking into account the available information up to the cutoff date of March 14, 2014, the baseline scenario assumes that the exchange rate remains unchanged over the forecast horizon at R\$2.35/US\$, and the target for the Selic rate stays at 10.75% p.a. – the

level set by the February 2014 Copom meeting – against R\$2.35/US\$ and 10.00% p.a. considered in the December 2013 Inflation Report.

The market scenario, in turn, incorporates data from the expectations survey carried out by Gerin with a representative group of institutions up to the cutoff date. In this scenario, average exchange rate expectations increased for 2014 and 2015, compared to the values released in the December 2013 Inflation Report. For the last quarter of 2014, the average rate moved from R\$2.40/US\$ to R\$2.48/US\$. For the fourth quarter of 2015, market participants project an average exchange rate of R\$2.54/US\$, against R\$2.43/US\$ considered in the last Report. For the first quarter of 2016, market participants project an average exchange rate of R\$2.54/US\$.

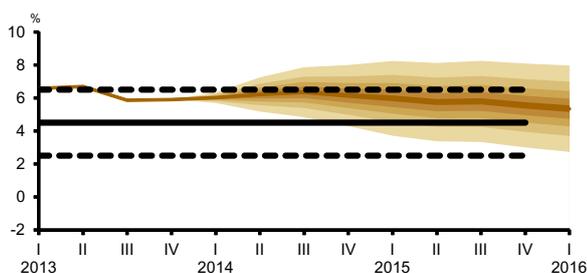
Regarding the evolution of the average Selic rate, the expectations for 2014 and 2015 increased in comparison to the values presented in the December 2013 Report. For the last quarter of 2014, the expected average Selic rate moved from 10.33% p.a. to 11.00% p.a., and for the last quarter of 2015, from 11.29% p.a. to 12.00% p.a. For the first quarter of 2016, the expected average Selic rate is 11.79% p.a. This trajectory of the Selic rate is consistent with twelve-month pre-DI swap spreads of 29 basis points (b.p.) and of 144 b.p., with respect to the current target for the Selic rate (10.75% p.a.), in the fourth quarter of 2014 and 2015, respectively.

The projection for the change in the set of regulated and monitored prices, in both scenarios, is 5.0%, for 2014, compared to 4.5% considered in the last Report. This projection is based on the variations occurred, up to February, in gasoline (0.6%) and bottled gas (0.3%) prices, as on the assumptions for the accumulated over 2014, of stability in landline telephone rates and increase of 9.5% in electricity rates. Regarding items for which more information is available, price changes were estimated individually. For the remaining items, the projections are based on models of endogenous determination of regulated prices, which consider, among other variables, seasonal components, market price inflation and General Price Index (IGP) inflation. According to these models, the projected adjustment in the set of regulated and monitored prices in both scenarios is 5.0% in 2015, compared to 4.5% considered in the last Report.

The structural primary surplus that derives from the primary surplus trajectories for 2014 and 2015 is considered as the

Figure 6.3 – Projected IPCA-inflation with interest rate constant at 10.75% p.a. (Baseline scenario)

Inflation fan chart



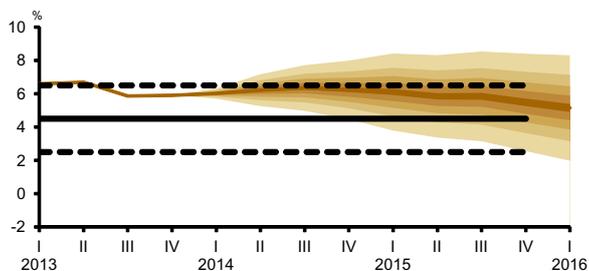
Note: accumulated inflation in 12 months (% p.a.).

Table 6.1 – Projected IPCA-inflation with interest rate constant at 10.75% p.a.
(Baseline scenario)

Year	Q	Probability Interval					Central projection	
		50%	30%	10%	50%	30%		
2014	1	5.9	5.9	6.0	6.0	6.1	6.1	6.0
2014	2	5.8	6.0	6.1	6.3	6.5	6.6	6.2
2014	3	5.7	6.0	6.2	6.5	6.7	7.0	6.4
2014	4	5.4	5.7	6.0	6.3	6.6	6.9	6.1
2015	1	5.0	5.4	5.8	6.2	6.5	6.9	6.0
2015	2	4.8	5.2	5.6	5.9	6.3	6.7	5.8
2015	3	4.8	5.2	5.6	6.0	6.4	6.8	5.8
2015	4	4.5	5.0	5.4	5.7	6.1	6.6	5.5
2016	1	4.3	4.7	5.2	5.6	6.0	6.4	5.4

Note: accumulated inflation in 12 months (% p.a.).

Figure 6.4 – Projected IPCA-inflation with market interest and exchange rates expectations
Inflation fan chart



Note: accumulated inflation in 12 months (% p.a.).

Table 6.2 – Projected IPCA-inflation with market interest and exchange rates expectations ^{1/}

Year	Q	Probability Interval					Central projection	
		50%	30%	10%	50%	30%		
2014	1	5.9	5.9	6.0	6.0	6.1	6.1	6.0
2014	2	5.8	6.0	6.1	6.3	6.4	6.6	6.2
2014	3	5.8	6.0	6.2	6.5	6.7	6.9	6.4
2014	4	5.5	5.8	6.1	6.4	6.7	7.0	6.2
2015	1	5.2	5.6	5.9	6.3	6.7	7.1	6.1
2015	2	4.8	5.3	5.7	6.0	6.4	6.9	5.9
2015	3	4.7	5.2	5.6	6.1	6.5	7.0	5.8
2015	4	4.3	4.8	5.3	5.7	6.2	6.7	5.5
2016	1	3.9	4.4	4.9	5.4	5.9	6.4	5.2

Note: accumulated inflation in 12 months (% p.a.).

1/ According to Gerin.

fiscal indicator, according to the parameters set out in the Budget Guidelines Law (LDO)/2014. As highlighted in previous Reports, for a certain period of time, the fiscal impulse is equivalent to the change of structural surplus, compared to the previous period.

Based on the above assumptions and using the information set available until the cutoff date, projections were constructed for the four-quarter IPCA inflation, consistent with the interest rate and exchange rate paths that characterize the baseline and market scenarios.

The central projection associated with the baseline scenario indicates inflation of 6.1% in 2014, 0.5 p.p. above the value presented in the December 2013 Report, above the central target level of 4.5% determined by the National Monetary Council (CMN). As can be seen in Figure 6.3 and in Table 6.1, the projection starts at 6.0% in the first quarter of 2014, shifts to 6.2% and 6.4% in the second and third quarters of 2014, respectively, and ends the year at 6.1%. For the first quarter of 2015, the projection is 6.0%; it decreases to 5.8% in the second and third quarters of 2015 and ends the year at 5.5%. In the first quarter of 2016, the projection is 5.4%.

Still in the baseline scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2014 stays around 38% and, in 2015, around 27%.

In the market scenario, the inflation projection for 2014 stays in 6.2%, 0.1 p.p. above the projection of the baseline scenario and 0.6 p.p. above the value presented in the last Report. As it can be seen in Figure 6.4 and Table 6.2, the projection for twelve-month inflation, as in the baseline scenario, ends the year above the central target. Specifically, the projection starts at 6.0% in the first quarter of 2014, shifts to 6.2% and 6.4% in the second and third quarters of 2014, respectively; and ends the year at 6.2%. The projection is 6.1% in the first quarter of 2015; and decreases to 5.5% in the last quarter of 2015. In the first quarter of 2016, the projection is 5.2%.

In the market scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2014 stays around 40%, and in 2015, around 29%.

The comparison of the trajectories presented in this Report with those released in the previous one – the latter shown in Table 6.3 –, in the baseline scenario, shows an increase in the inflation projection for 2014 and for 2015. This rise is

Table 6.3 – December 2013 Inflation Report projections

Period	Baseline scenario	Market scenario
2013 IV	5.8	5.8
2014 I	5.5	5.5
2014 II	5.5	5.4
2014 III	5.7	5.7
2014 IV	5.6	5.6
2015 I	5.7	5.7
2015 II	5.6	5.6
2015 III	5.5	5.5
2015 IV	5.4	5.3

Figure 6.5 – Projections and target path for twelve-month cumulative inflation

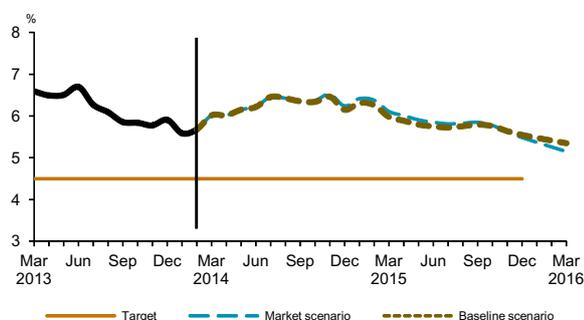
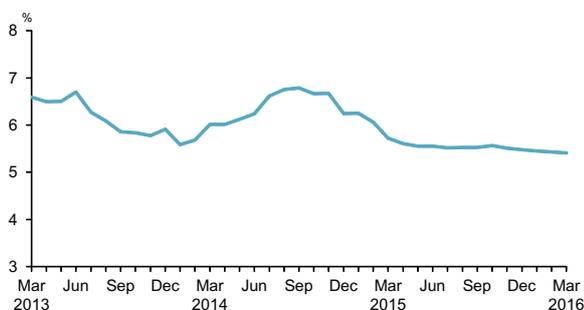


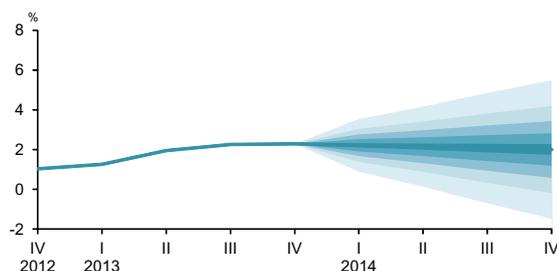
Figure 6.6 – Inflation forecast: VAR models



Note: accumulated inflation in 12 months (% p.a.).
Average forecast generated by the VAR models.

Figure 6.7 – Projected GDP growth with interest rate constant at 10.75% p.a. (Baseline scenario)

Output fan chart



partly due to the inflation rates in recent months above the projections that prevailed during the time of the previous Report publication; and also, due to higher projections for regulated and monitored prices for 2014 e 2015. In the market scenario, the projection also rises, partly reflecting exchange rates for 2014 and 2015 above the projections considered at the time of the publication of the December 2013 Report.

Figure 6.5 shows the path of the twelve-month inflation, according to the baseline and the market scenarios, up to the first quarter of 2016, as well as the inflation target path. The figures are actual twelve-month inflation until February 2014 and, from then on, projections corresponding to the respective scenarios are used to compose the twelve-month values. In both scenarios, projections indicate twelve-month inflation starting above the central target level, with a declining trend beginning in the third quarter of 2014 and location above the central target at the end of the forecast horizon.

The average forecast generated by the Vector Autoregressive (VAR) models, for the twelve-month inflation, is presented in Figure 6.6. Up to February 2014, the values refer to actual twelve-month inflation and, from then on, to forecasts. According to these models, the inflation projection presents a path with rising trend up to the third quarter of 2014, with declining trend from then on and converging to the unconditional mean at the end of the forecast horizon.

Figure 6.7 illustrates the output growth fan chart built under baseline scenario assumptions. Considering that the GDP growth projection process uses two variables that are not directly observable – potential output and output gap –, the forecast errors associated with these projections are considerably higher than the errors related to inflation projections. According to this scenario, the projected four-quarter GDP growth is 2.0% in 2014, 0.3 p.p. lower than the observed growth in 2013.