Inflation outlook

6

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 March 2014. The chapter also presents the analysis of the inflation prospects up to the second quarter of 2016 and of the Gross Domestic Product (GDP) growth up to the first quarter of 2015. Inflation projections are presented in two major scenarios. The first scenario, called the baseline scenario, assumes that the Selic rate will remain unchanged at 11.00% per year over the forecasting horizon, the level set by Copom at its most recent meeting on May 27 and 28, and the exchange rate will remain at R$2.25 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 June 6, 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 6.37% in May, 0.13 percentage points (p.p.) lower than the value recorded until May 2013. The twelve-month accumulated inflation decrease reflects the lower variation in market prices, 7.07% until May (8.11% until May 2013). The regulated and monitored prices changed 4.08% (1.54% until May 2013). Within the set of market prices, the increase of non-tradable goods reached 7.42% in twelve months, and tradable goods amounted to 6.67%. Still on tradable goods, twelve-month accumulated inflation in the food and beverage group declined to 7.67% in May (13.52% until May 2013). In turn, the services sector inflation – around one-third of the consumption basket of IPCA – has reached 8.70% (8.51% until May 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.

The average monthly change of the measures of underlying inflation calculated by the Central Bank shifted from 0.51% in April to 0.54% in May, reaching 6.52% in twelve months (0.35 p.p. higher than the rate recorded in May 2013). Specifically, the core that excludes the prices of monitored goods and food at home changed from 0.41% in April to 0.42% in May; the smoothed trimmed mean core changed from 0.56% to 0.64%; the non-smoothed trimmed mean core changed from 0.50% to 0.58%; and the exclusion core – which excludes ten items from the groups food at home and fuels – changed from 0.52% to 0.54%. In turn, the double weighted core changed from 0.56% to 0.50%. The IPCA diffusion index reached 66.8% in May (3.8 p.p. higher than that of May 2013) and 69.3% on the three-month average (3.3 p.p. lower than the average observed from March to May 2013).

Broader inflation – measured by the General Price Index (IGP-DI) – which is characterized by higher volatility when compared to IPCA, decreased 0.45% in May, after a 0.45% increase in April. Therefore, the index cumulates change of 7.26% in twelve months to May (1.06 p.p. higher than the variation up to May 2013). The major component of the IGP-DI, the IPA, changed 7.43% in the twelve months to May, due to the 9.32% inflation in the agricultural sector and to the 6.73% increase in the industrial sector prices. The IPC, the second most important component of the IGP-DI, reached 6.57% in the twelve months to May (5.96% up to May 2013). The INCC, the smallest weight component of the

IGP-DI, increased 7.75% in twelve months (0.19 p.p. higher than the variation up to May 2013), due to the change of 8.68% in the labor cost and of 6.74% 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, decreased 0.1% in March, compared to the previous month, after remaining stable in February, according to the seasonally adjusted series. Therefore, the IBC-Br growth rate has shifted to 2.1% in the last twelve months. The PMI for Brazil showed a moderate growth pace in the services sector in May, while indicating contraction in the industrial sector.

The Consumer Confidence Index (ICC), the Industry Confidence Index (ICI), the Services Sector Confidence Index (ICS) and the Commerce Confidence Index (ICOM), computed by FGV, have all decreased in May. The ICC shifted to the lowest level since April 2009 and remained under its historical average. The ICI and the ICS have also moved farther away from their historical averages, recording the greatest losses since December 2008. Finally, the ICOM recorded the lowest quarter average index in the historical series beginning in March 2010. The decrease of all indicators was, in general, influenced by a worse perception with respect to the current scenario and by less optimism regarding the following months.

The industrial production decreased 0.3% in April, with unfavorable results in three of the four major categories of use and in 12 of the 24 surveyed activities, according to the seasonally adjusted industrial production data of IBGE. The overall production was 5.8% lower than April 2013, but the resulting accumulated growth in twelve months increased 0.8%. In this basis of comparison, also increased the production of capital goods (5.5%), durable consumer goods (1.2%), semi and non-durable consumer goods (1.7%), but on the other hand the production of intermediate goods (-0.3%) showed contraction. With regard to real revenue of the manufacturing industry, according to National Confederation of Industry (CNI) data, there was a 0.7% growth in twelve months up to April, compared to the same period of the previous year, but the number of hours worked decreased 1.8%.

The seasonally adjusted Installed Capacity Utilization Level (Nuci) in the manufacturing sector, computed by FGV, reached 84.3% in May (88.8% in the materials for construction sector; 81.7% in the non-durable consumer goods sector; and 81.7%

in the capital goods sector). The level of inventories in the manufacturing sector, computed and seasonally adjusted by FGV, remained stable since the last Report, released in March 2014. In May, according to the seasonally adjusted data, 9.7% of the establishments had excessive inventories and 2.9% 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 decreased 1.1% in March, compared to March 2013, after twelve months of continuous growth in yearly basis. The broader retail trade contracted 5.7% in the same basis of comparison. The growth rate for the last twelve months was, therefore, 4.5% for the restricted retail trade and 3.2% for the broader retail trade. There was expansion of retail volume in three of the ten segments researched by IBGE, considering the seasonally adjusted index. In the next months, sales will continue to be influenced by government transfers, by payroll growth and by moderate credit expansion.

The Brazilian GDP at market prices increased 0.2% in the first quarter of 2014, after increasing 0.4% in the previous quarter, according to seasonally adjusted IBGE data. Compared to the same quarter of 2013, growth reached 1.9% in the first quarter of 2014 (against 2.2% in the fourth quarter of 2013). Therefore, Brazilian economy grew 2.5% in the last four quarters, as a result of a 2.3% increase in value added and a 3.5% increase in direct taxes. The production in the agricultural sector increased 4.8%, in the industrial sector, 2.1% and in the service sector, 2.2% in four quarters.

From a demand side perspective, household consumption – the largest component of aggregate demand – contracted 0.1% in the first quarter of 2014, in comparison to previous quarter, according to seasonally adjusted data, and 2.2% compared to the same quarter of 2013. In turn, government consumption increased 0.7% at the margin and 3.4% in respect to the same quarter of 2013. The Gross Fixed Capital Formation (GFCF) decreased 2.1% when compared to the previous quarter as well as when compared to the same quarter of 2013. The foreign trade sector also contributed negatively to the GDP growth rate in the first quarter of 2014, with exports decreasing 3.3%, in comparison to previous quarter, and imports expanding 1.4%, according to seasonally adjusted data. Comparing to the first quarter of 2013, this contribution was also negative, a result of the 4.5% increase in exports and 6.8% increase in imports.

The IBGE reported the results of the Continuous National Household Sample Survey (PNADC) – which covers around 3500 municipalities – for the first quarter of 2014. According to the survey, the unemployment rate was 7.1% (8.0% in the first quarter of 2013). According to the Monthly Labor Survey (PME), that covers only six metropolitan areas, the unemployment rate, without seasonal adjustments, was 4.9% in April (5.8% in April 2013). According to the Central Bank seasonally adjusted data, the unemployment rate reached the minimum (4.6%) 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 2.6% in April, compared to the same month of 2013, and real payroll, 3.6%, in the same basis of comparison. The evolution of real labor income has shown low dispersion among regions in April, due to increase in all metropolitan areas covered in the survey, with Belo Horizonte recording the lowest rate (0.4%) and Salvador the highest rate (4.5%). Formal employment is expanding, albeit some moderation in job creation occurred. According to the data released by the Ministry of Labor and Employment (MTE), 678 thousand jobs were created in twelve months up to April 2014 (732 thousand up to April 2013).

In addition to rising payrolls, credit availability – largely determined by macroeconomic stability, improvement in financial system infrastructure and institutional reforms in recent years – was an important driving force behind growth of household consumption. Total credit to households reached R$1,294.2 billion in April, a 15.2% nominal growth relative to April 2013. In particular, housing loans for households, whose operations are mainly based on earmarked resources, grew by 30.7% in the same period, reaching R$367.6 billion, which corresponds to 7.4% of GDP. Delinquency rates have shown stability at the margin, at levels consistent with the phase of the cycle.

The volume of credit to corporations totaled R$1,482.9 billion in April (11.9% higher than in April 2013). The average interest rate of this segment reached 16.0%, 2.0 p.p. higher than the average rate observed in April 2013. In particular, loans and financing to corporations with resources provided by the National Bank of Economic and Social Development (BNDES) reached R$530.6 billion – an increase of 14.5% in twelve months up to April. Regarding the capital market, the volume of primary issues of shares registered in the Securities and Exchange Commission of Brazil (CVM) reached R$17.2 billion in twelve months up to April 2014, against R$12.4 billion up to April 2013. In turn, debenture issues, excluding the issuance of leasing companies, totaled R$61.1 billion in twelve months up to April 2014 (against R$82.5 billion in the same period of the previous year). In total, firms financing from capital markets by issues of shares, debentures, commercial papers and receivables in credit rights reached R$109.0 billion in twelve months up to April 2014, against R$120.0 billion observed in the same period of 2013.

With regard to the trade balance, the twelve-month result decreased to US$3.1 billion in May (US$7.8 billion in May 2013). This result stemmed from US$239.0 billion in exports and US$235.9 billion in imports, which represented variations of 0.4% and 2.4%, respectively, compared to the twelve-month period ended in May 2013. Considering the twelve months ended in April, the exported volume increased 4.7% and the average price of exports decreased 4.3%, while the imported volume increased 4.7% and the average price of imports diminished 1.4%.

The twelve-month current account deficit reached US$81.6 billion in April, equivalent to 3.7% of GDP. An important component of this deficit has been remittances of profits and dividends, which totaled US$25.5 billion in liquid terms (US$27.7 billion in April 2013). 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$19.9 billion in the twelve months up to April (US$18.9 billion up to April 2013). It is also worth noting that imports of oil and derivatives reached, during the same period, US$34.6 billion (US$32.9 billion in April 2013). Foreign direct investments – which have been the main financing source of the balance of payments – totaled US$64.5 billion in the twelve months up to April, equivalent to 2.9% of GDP.

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

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

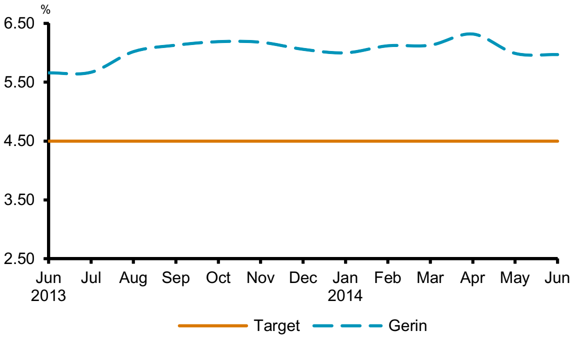
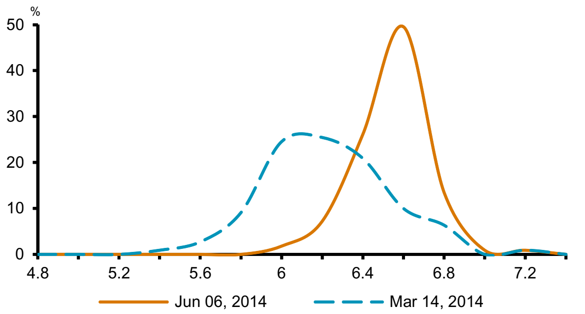


Figure 6.2 – Dispersion of inflation expectations for 2014

Relative frequency



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 an increase of 0.8% in metal commodities prices and an increase of 4.8% in agricultural prices. At the cutoff date of June 6, the price index based on twenty two commodities, published by the Commodity Research Bureau (CRB), increased 2.4% against the value registered at the cutoff date of the Report of March 2014.

The median of market expectations for the GDP growth for 2014 moved from 1.70% to 1.44%, between March 14, the cutoff date of the previous Report, and June 6. For 2015, the projected growth rate decreased from 2.00% to 1.80%. During this period, the median expectation for inflation, measured by variation in IPCA, moved from 6.11% to 6.47% for 2014; and from 5.70% to 6.03%, for 2015. The twelve-month ahead inflation expectations moved from 6.13% to 5.97%, as shown in Figure 6.1. Since the release of the Report of March 2014, there was a reduction 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 fell to 0.18%.

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 on which the Committee makes policy decisions.

On the external side, in general, since the last Report, the prospects of stronger global activity have remained unchanged in the relevant horizon for monetary policy, although evidences 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 the prices of commodities, despite localized price pressures observed at the margin, as well as the occurrence of volatility spots in the currency markets. On the domestic side, the main scenario envisages a less intense pace of economic activity this year, when compared to 2013. Other important aspects of the domestic environment are the labor market dynamics and two important ongoing processes of relative prices adjustments – the domestic prices realignment relative to the international ones and the realignment of regulated and monitored prices relative to market prices.

On the external front, despite remaining limited the space for monetary policy and prevailing, albeit with less intensity than in recent years, a scenario of fiscal restriction, the prospects indicate recovery of economic activity in some mature economies and strengthening in the pace of growth for others. In the United States, the pace of economic activity in the beginning of the year was affected by adverse climate conditions. However, there is still a trend for improvement in the labor market and for recovery in the real estate market, in an environment that combines moderate levels of inflation. In the Euro area, despite recent initiatives announced by the ECB, uncertainties about the effectiveness of these actions, combined with a certain skepticism regarding the soundness of the banking system in some economies in the area, are still reflected in the fragility of employment and of investments. Accordingly, prospects point to moderate growth this year in the Euro area, with asymmetric distribution among member countries. Regarding risks for global activity, it is worth mentioning the ones derived from the strategy of withdrawing, by the Federal Reserve, of monetary incentives introduced by conventional and unconventional policy actions in the aftermath of the 2008 crisis; as well as, the ones derived from geopolitical tensions.

The Copom evaluates that the developments in mature economies are transmitted to emerging economies' aggregate demand at an intensity that is proportional to, among other factors, trade and capital flows. In this sense, recent events – on one hand, the improvement in the pace of global activity; and, on the other hand, the change in the slope of the yield curve in important economies and the volatility spots in the 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, the Committee notices that despite improvements in the global scenario, in particular in mature economies, there has been lower than expected growth in the main emerging market economies, in spite of the resilience of domestic demand. However, recent indicators suggest that growth rates for the group of emerging economies tend to remain relatively high, though with different distribution and in lower levels than recorded in recent years.

The Copom assesses that the 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 Report of March 2014, 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. In the recent period, insurance prices against default (CDS) of banks and sovereigns – in particular, of emerging and the European periphery economies — moved to levels below respective historical averages. However, it is not clear that this movement of premia compression is reflecting appropriately economic fundamentals. An alternative hypothesis is that it is essentially a result from the implementation of unconventional monetary policy in important economic blocs. Despite identifying low probability of occurring extreme events, the Committee assesses that the international financial markets environment remains complex.

Aggregate commodity prices indexes show relative stability in international markets, but with asymmetric behavior of their major components. In this context, the Commodities Brazil Index (IC-BR), measured in United States dollars, remained at levels registered in the beginning of the year. The segments of this index indicate a fall in the IC-BR for agriculture and a rise in the IC-BR for metals and in the IC-BR for energy. In the latter case, the increase in commodity prices occurs despite the Brent oil prices having remained around US$110 per barrel. The Committee highlights that, in spite of circumscribed pressures, perspectives indicate a moderate dynamics for commodities prices. Specifically regarding oil prices, the Committee stresses 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 considers 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 international market for goods and services, in a global environment with historically high levels of spare capacity.

On the internal side, the Copom evaluates that the pace of economic activity growth tends to be less strong this year, compared to 2013, and that significant changes should occur in the in the composition of aggregate demand and supply, in the medium-term. In this context, considering twelve-month variations, the Copom acknowledges that the growth rates of domestic absorption have been higher than the growth rates of the Gross Domestic Product (GDP), but both rates are converging. Besides, notwithstanding being aware that high frequency data may eventually point to a different direction, the Committee notes that consumption tends to keep expanding, but at a more moderate pace than observed in recent years, and that investments tend to gain momentum. Regarding the external component of aggregate demand, the scenario of higher global growth, combined with a depreciation of the Real, tends to benefit the Brazilian economy growth. On the supply side, the Committee evaluates that, in longer terms, more favorable prospects emerge for the competitiveness of the industrial sector, and also of the agriculture and cattle raising sector. Meanwhile, the services sector tends to grow at lower rates than the ones registered in recent years.

According to the Copom's view, the changes mentioned in the previous paragraph anticipate a growth composition more favorable to the potential growth. Also point in this direction improvements in the workforce qualification and the program of public services concessions. In this context, in longer terms, a ground would emerge for the expansion of the investment growth rates, for a more effective allocation of the factors of production and, consequently, for GDP growth rates to return to higher levels. The Committee highlights, however, that the speed, with which the above mentioned changes and the gains derived from them will be achieved, depends on the confidence strengthening of firms and households.

In terms of factor markets, the Copom considers that an important source of risk to inflation comes from the labor market, which shows low idle margin. The Committee reaffirms that a crucial aspect under these circumstances is the possibility of real wage increases not compatible with productivity growth, causing 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 regarding 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 the 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 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, the National Accounts data related to the first quarter show that the investment rate reduced for the second consecutive quarter, moving to 17.8% of the GDP in the twelve-month rate. In turn, the capacity utilization has shown a slight falling trend and a heterogeneity degree relatively high among the sectors.

In terms of idleness indicators for the whole economy, the Copom notes that, in general, conventional measures of output gap have moved toward the disinflationary direction. In fact, at the margin, the economic activity growth rates have been smaller than the estimates of the potential economic growth. Besides, considering the growth prospects for the next quarters (according to Section 6.3), the Committee evaluates that the output gap measures tend to be disinflationary.

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 understands that a relevant source of risk for 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 mainly by the uncertainties related to the path of prices in segments with great visibility, such as gasoline, and some public services fares (for example, electricity and urban buses).

The Committee 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 Copom, the dynamics of the credit market deserves attention, be it for its potential impacts on aggregate demand or for the macroprudential risks (which, by the way, were reduced in recent years) that may be originated from it. Besides, the Committee considers opportune the initiatives that aim at moderating the concession of subsidies through credit operations.

The Copom highlights the occurrence, since the Report of March 2014, of a benign dynamics of domestic asset prices in general, which has also translated into stability gains. In the relevant horizon for monetary policy, however, the Committee evaluates that risk aversion and international financial market volatility may react to the publication of new indicators and/or to the signaling made by monetary authorities that suggest the beginning or the deepening of the normalization process of the monetary conditions in big economic blocs, particularly in the United States. Therefore, it is natural to expect that eventual rises in volatility and in risk aversion in international markets, even though partially, may be transmitted to domestic assets.

The Copom highlights that, in market economies, in the long run, prices tend to show relatively similar growth rates. In this sense, in line with projections reported in the next section, the Copom identifies a realignment process between regulated and monitored and market prices.

The Copom reminds, in turn, that the Selic rate was increased by 375 b.p. and 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. In this regard, the Committee notes that, before reaching prices, monetary policy actions interfere in the consumption and investment decision-making process of households and firms; and that, in the presence of relatively modest confidence levels as the ones currently observed, the effects of monetary policy actions on inflation tend to be magnified. Taking that into consideration, as well as the Brazilian experience during the Inflation Targeting regime, the Committee assesses 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 introduced in the economy throughout 2013 and 2014 have propagated normally through the main transmission channels and that this process will remain in the next quarters.

In summary, the Copom argues that wage costs pressures and the high change in consumer price indexes in the past twelve months contribute for inflation to show resistance. In the assessment of the Committee, two important relative price adjustment processes also contribute to this resistance – the realignment process of domestic with respect to international prices and the realignment of regulated and monitored with respect to market prices. The Committee recognizes that these relative price adjustments have a direct impact on inflation and reaffirms its view that monetary policy can and should restrain the second order effects that derive from them. In order to oppose these and other price pressures, the Copom highlights that monetary conditions have been tightened and that the effects of the increase in the Selic rate on inflation are, partly, still to materialize; as well as, in the presence of relatively modest confidence levels, the effects of monetary policy actions on inflation tend to be magnified.

In this context, the Copom decided unanimously to raise the Selic rate to 11.00% p.a., without bias, in the April meeting; and to keep it in 11.00% p.a., without bias, in the May meeting.

The following members of the Committee voted for the decision of raising the Selic rate to 11.00% p.a. in April and for keeping the same rate in May: 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.

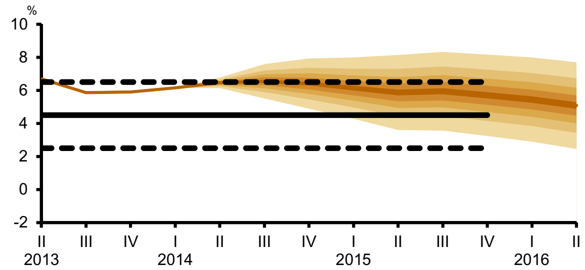
The Copom assesses that existing inflationary pressures – such as the ones derived from the process of realignment of prices mentioned earlier and from wage gains incompatible with productivity– tend to decrease, or even disappear, throughout the relevant horizon for monetary policy. In shorter horizons, this is added to the shifting of the output gap to the disinflationary side. Still, the Committee anticipates a scenario that envisages a resistant inflation in the next quarters, but which, with unchanged monetary conditions, tends to converge to the target in the final quarters of the projection horizon.

The Copom still highlights that, in moments such as the current one, the monetary policy should remain 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.

6.3 Inflation Forecasts

According to traditional procedures, and taking into account the available information up to the cutoff date of June 06, 2014, the baseline scenario assumes that the exchange rate remains unchanged over the forecast horizon at R$2.25/US$, and the target for the Selic rate stays at 11.00% p.a. – the level set by the May 2014 Copom meeting – against R$2.35/US$ and 10.75% p.a. considered in the March 2014 Inflation Report.

Figure 6.3 – Projected IPCA-inflation with interest rate constant at 11.00% 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 11.00% p.a.
(Baseline scenario)

Year	Q	Probability Interval						Central
		50%						
			30%					
				10%				projection
2014	2	6.3	6.4	6.4	6.5	6.5	6.6	6.5
2014	3	6.1	6.3	6.5	6.6	6.8	7.0	6.6
2014	4	5.8	6.1	6.3	6.5	6.8	7.0	6.4
2015	1	5.4	5.7	6.0	6.3	6.6	6.9	6.1
2015	2	4.9	5.3	5.7	6.0	6.4	6.8	5.9
2015	3	5.0	5.4	5.8	6.1	6.5	6.9	6.0
2015	4	4.7	5.1	5.5	5.9	6.3	6.7	5.7
2016	1	4.4	4.9	5.3	5.6	6.0	6.5	5.4
2016	2	4.0	4.5	4.9	5.3	5.7	6.2	5.1

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

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 decreased for 2014 and 2015, compared to the values released in the March 2014 Inflation Report. For the last quarter of 2014, the average rate moved from R$2.48/US$ to R$2.39/US$. For the fourth quarter of 2015, market participants project an average exchange rate of R$2.48/US$, against R$2.54/US$ considered in the last Report. For the second quarter of 2016, market participants project an average exchange rate of R$2.53/US$.

Regarding the evolution of the average Selic rate, the expectations for the fourth quarter of 2014 remained at 11.00% p.a. and, to the fourth quarter of 2015, shifted from 12.00% p.a. to 12.08% p.a. For the second quarter of 2016, the expected average Selic rate is 11.58% p.a. This trajectory of the Selic rate is consistent with twelve-month pre-DI swap spreads of 22 basis points (b.p.) and of 110 b.p., with respect to the current target for the Selic rate (11.00% 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, same value considered in the last Report. This projection is based on the variations occurred, up to May, in gasoline (1.4%) and bottled gas (0.7%) prices, as on the assumptions for the accumulated over 2014, of reduction of 3.8% in landline telephone rates and increase of 11.5% 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 6.0% in 2015, compared to 5.0% considered in the last Report, and 4.5% in 2016, same value considered in the last Report.

The structural primary surplus that derives from the primary surplus trajectories for 2014 and 2015 is considered as the fiscal indicator, according to the parameters set out in the Budget Guidelines Law (LDO)/2014 and the Budget Guidelines Project Law (PLDO)/2015, respectively. 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 6.4% in 2014, 0.3 p.p. above the value presented in the March 2014 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 6.5% in the second quarter of 2014; shifts to 6.6% in the third quarter; and ends the year at 6.4%. For the first quarter of 2015, the projection is 6.1%; it moves to 5.9% and 6.0% in the second and third quarters of 2015, respectively; and ends the year at 5.7%. In the first and second quarters of 2016, the projection is 5.4% and 5.1%, respectively.

Still in the baseline scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2014 stays around 46% and, in 2015, around 30%.

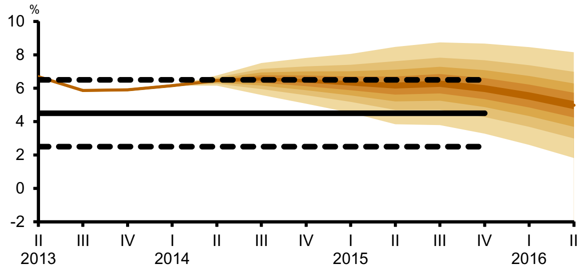
In the market scenario, the inflation projection for 2014 stays in 6.4%, same value projected in the baseline scenario and 0.2 p.p above the value presented in the last Report. As it can be seen in Figure 6.4 and Table 6.2, the projection for twelve-month inflation, as in the baseline scenario, ends the year above the central target. Specifically, the projection starts at 6.5% in the second quarter of 2014; shifts to 6.6% in the third quarter; and ends the year at 6.4%. The projection is 6.3% in the first quarter of 2015; moves to 6.2% and 6.3% in the second and third quarters of 2015, respectively; and ends the year at 6.0%. In the first and second quarters of 2016, the projection stays at 5.5% and 5.0%, respectively.

In the market scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2014 stays around 48%, and in 2015, around 38%.

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, and stability for the first quarter of 2016. The rise for 2014 and 2015 is partly due to the inflation rates in recent months, in general, above the projections that prevailed during the time of the previous Report publication; and due to higher projections for regulated and monitored prices for 2015. In the market scenario, the projection also rises, partly reflecting inflation

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 50%	30%	10%		30%	50%	Central projection
2014	2	6.3	6.4	6.4	6.5	6.5	6.6	6.5
2014	3	6.2	6.3	6.5	6.6	6.8	6.9	6.6
2014	4	5.9	6.1	6.3	6.5	6.8	7.0	6.4
2015	1	5.6	5.9	6.2	6.4	6.7	7.0	6.3
2015	2	5.2	5.6	6.0	6.3	6.7	7.1	6.2
2015	3	5.3	5.7	6.1	6.5	6.9	7.3	6.3
2015	4	4.9	5.3	5.8	6.2	6.6	7.1	6.0
2016	1	4.3	4.8	5.3	5.8	6.2	6.7	5.5
2016	2	3.7	4.2	4.7	5.2	5.7	6.3	5.0

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

1/ According to Gerin.

Table 6.3 – March 2014 Inflation Report projections

Period	Baseline scenario	Market scenario
2014 I	6.0	6.0
2014 II	6.2	6.2
2014 III	6.4	6.4
2014 IV	6.1	6.2
2015 I	6.0	6.1
2015 II	5.8	5.9
2015 III	5.8	5.8
2015 IV	5.5	5.5
2016 I	5.4	5.2

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

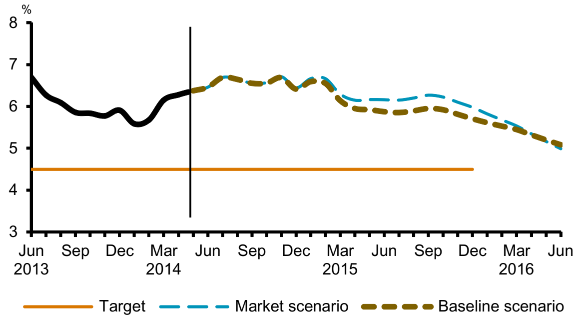
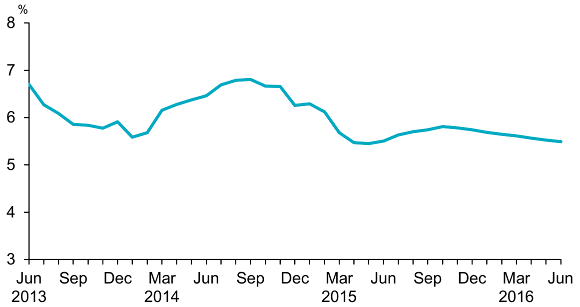
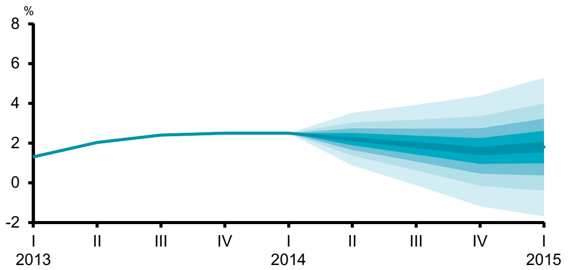


Figure 6.6 – Inflation forecast: VAR models



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 11.00% p.a. (Baseline scenario)
Output fan chart



expectations for 2014 and 2015 higher than those considered at the time of the March 2014 Report publication, added to the reasons mentioned earlier.

Figure 6.5 shows the path of the twelve-month inflation, according to the baseline and the market scenarios, up to the second quarter of 2016, as well as the inflation target path. The figures are actual twelve-month inflation until May 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, but staying above the central target throughout 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 May 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 1.6% in 2014 (0.4 p.p. lower than the one considered in the previous Report), and 1.8% in the four-quarter period ending in the first quarter of 2015.