

Executive summary

In the international environment, the Copom considers that, since the previous report, the external outlook remains complex, and in spite of identifying low probability of occurrence of extreme events in the international financial markets, there are events of higher volatility affecting important emerging markets.

In the relevant horizon for monetary policy, the Committee assesses that global risk aversion and the volatility of international financial markets tend to react to the continuation of the gradual normalization process of the monetary conditions in United States. On the other hand, highlights that domestic factors, especially the uncertainties regarding the process of fiscal result recovery and the development of non-economic events, are influencing and will remain influencing, if not promptly addressed, the financial asset prices. Hence, it is important to highlight, once more, that possible increases in the volatility and in the risk aversion in the international markets tend to be transmitted to domestic assets, discontinuously and incrementally, with possible amplifications, depending on the perception regarding the domestic macroeconomic and financial soundness.

In general, since the previous report, prospects of global activity have shown moderation through the relevant horizon for monetary policy. In this regard, note that evidence points to growth rates relatively more homogeneous in mature economies, though low and below potential growth, notably in the euro area. In international markets, prospects point to moderation in the dynamics of commodities prices.

In the internal environment, the Copom reinforces that, in accordance with the ongoing process of macroeconomic adjustment, the available indicators show that the growth rates of domestic absorption and of GDP continued to line up and confirm that the pace of expansion of domestic activity this year will be below potential. This process is intensified by uncertainties related to non-economic events. However, for the Committee, after a necessary period of adjustments, which seems to be more intense and longer than anticipated, the pace of activity tends to intensify,

to the extent that the confidence of firms and households strengthen. Regarding the external component of aggregate demand, the global growth scenario, though moderate, combined with the depreciation of the Real, tends to favor the rebalancing of external accounts and the sustainable growth of the Brazilian economy.

Relevant for the domestic environment, beside the adjustment of domestic prices relative to international prices and the adjustment of administered prices relative to market prices, are the impacts, on the asset prices, of uncertainties regarding the paths of fiscal variables, both in terms of the speed of recovery of results and its composition, especially after the downgrade of the credit rate of the Brazilian sovereign bonds, announced by a second credit rating agency.

Still regarding internal activity, the Copom assesses that, in the medium-term, important changes may occur in the composition of aggregate demand and supply. Consumption tends to grow at a moderate pace and the investments tend to gain momentum. In the Committee's view, these changes indicate that there is room for composition and pace of growth in the medium-term that may lead to the potential growth.

The Copom highlights that the central scenario envisages moderate credit expansion, which had already been noticed and tends to persist. In this regard, note that, after years of strong expansion, the credit market directed toward consumption underwent a period of moderation, leading in the last quarters, on the one hand, to lesser exposure of banks and, on the other hand, to household deleveraging. Taken together, therefore, one concludes that risks have been mitigated in the consumer credit segment. In another dimension, following implemented actions, the Committee considers appropriate to reinforce initiatives aiming to moderate the concession of subsidies through credit operations.

In this context, the credit transactions remain in a decelerating trend in the quarter ended in October. This result reflected increasing interest rates and the outlook of economic activity downturn, and the deterioration of both indicators of confidence and of employment and income. The reduction in the dynamism of credit markets was partially mitigated by the performance of earmarked portfolios, especially those focused on housing and farm credit.

Regarding the public accounts, the primary deficit projected for the public sector in 2015 reflects, especially, the impacts of the deceleration of the economic activity on

the level of public revenues. Such scenario - worsened by the recurrent increasing of non-economic events and by the perspective of payments of expenses cumulated from past calendar years, mainly the ones related to the programs for equalization of the rates and subsidies -, tends to be attenuated, in medium run, by the impacts of fiscal adjustment measures recently adopted.

The results of the balance of payments are still confirming the view of significant reduction of current account deficit, consistent with the scenario of depreciation of the Real, the slowdown of internal demand, and recovery, yet moderate, of the economy of important trader's partners. The continuity of the process of macroeconomic adjustment in place should still strengthen, in 2016, the path of current account. Net capital inflows from abroad have been financing properly the current account deficit, with particular reference to the net inflows of direct investment in the country. Moreover, we highlight the roll-over of bonds and loans at 106%, during the first eleven months of this year.

Concerning prices, the inflation measured by the twelve-month accumulated Broad National Consumer Price Index (IPCA) reached 10.48% in November, 3.92 p.p. higher than the rate recorded until November 2014. On the one hand, market prices accumulated variation of 8.28% in twelve months (6.76% up to November 2014); on the other hand, the regulated prices increased 17.95% (5.83% up to November 2014).

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of December 18, 2015, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R\$3.90/US\$ and target for the Selic interest rate at 14.25% p.a. – projects inflation of 10.8% in 2015, 6.2% in 2016, and 4.8% in 2017. In the market scenario – which uses consolidated information from the expectations survey undertaken by Banco Central's Investor Relations and Special Studies Department (Gerin) with a significant group of institutions – the projections indicate inflation of 10.8% in 2015, 6.3% in 2016 and 4.9% in 2017.

Concerning GDP growth, the projection for 2015, according to the baseline scenario, is -3.6% (0.9 p.p. lower than the estimate considered in the previous Inflation Report) and -1.9% for 2016.

The Copom emphasizes that the international evidence, in which it is ratified by the Brazilian experience, shows

that high inflation rates generate distortions that lead to higher risks and depress investment. These distortions are manifested, for example, in shortening the planning horizons of households, firms 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. Hence, high inflation rates reduce the growth potential of the economy, as well as of jobs and income generation.

For the Copom, the high level of the current inflation reflects, in a large part, the effects of the two important and necessary relative-price adjustment processes in the economy – the regulated price adjustment relative to market prices and the domestic price adjustment relative to international prices, as well as uncertainties regarding the speed of fiscal recovery and its composition.

In this context, according to the projections presented in this report, the Committee notes, as anticipated, that these price adjustments made inflation increase in 2015, requiring determination and perseverance to avoid its transmission to longer terms. At the same time that the Committee understands that adjustments in relative prices have direct impact on inflation, it reaffirms its view that monetary policy can, must and is containing the second-order effects of these adjustments. In the same way, although recognizing that other macroeconomic policy actions can influence the price dynamics, the Copom reaffirms its view that it is, specifically, the monetary policy that should be particularly vigilant, to assure that pressures perceived in shorter horizons do not spill over to longer horizons.

The Committee observes that the expectations for 2016 have been increasing since August, reverting its previous declining path. This increasing in inflation expectations – which happened at the same time as the increasing of the uncertainties regarding the fiscal results – is also observed, though in lower intensity, in the market forecasts for 2017 and 2018. These facts constitute a clear and important signal about the recent deterioration of the balance of risks of the economy, and demand monitoring to define the next steps of the strategy of monetary policy.

Evaluating the macroeconomic outlook and the inflation perspectives, the Copom considers that there are still uncertainties related to the balance of risks, mainly, regarding the velocity of the process of fiscal results recovery and its composition, and that the process of

relative price adjustment has been more intense and slow than anticipated.

The Copom reaffirms that the aggregate demand will remain moderate in the relevant horizon for the monetary policy. From one hand, the household consumption tends to be influenced by factors as employment, income and credit; on the other, the public services concession and the increase of the rural income, between others, tend to favor the investments. The net exports have been presenting better results, either due to the higher exports, benefited by the perspectives of higher growth of important trade partners and for the Real depreciation, or due to the process of imports substitution in place. For the committee, the joint effects of these elements, the development in the fiscal and non-fiscal environments, and in the assets market, and, in 2016, the regulated prices dynamics, are important factors of the context in which future monetary policy decisions will be taken.

The Committee highlights that there are uncertainties related to the balance of risks, mainly, regarding the speed of the process of fiscal recovery and its composition, and that the process of relative price adjustment has been more intense and slow than anticipated. In this context, regardless of the delineations of the other policies, the Committee will adopt the necessary actions to ensure the delivery of the objectives of the inflation targeting regime, i.e. to circumscribe the inflation into the limits established by the CMN, in 2016, and to make the convergence of the inflation to the target of 4.5%, in 2017.