

Executive summary

In the international environment, the Copom considers that, since the previous report, the external outlook remains especially complex. However, in spite of the occurrence of events of higher volatility affecting important emerging markets, the Copom still identifies low probability of occurrence of extreme events in the international financial markets.

Global activity has shown a trend for greater moderation through the relevant horizon for monetary policy. In this regard, evidence points to minor growth rates, below to the potential growth in mature economies. It also should be highlighted the uncertainties related to the loss of momentum of China and its implications to the global economy. In international markets, prospects point to the moderation in the dynamics of commodities prices.

Prices of domestic assets evolved in line with changes in the perception of risk of the Brazilian economy. Even in a scenario of increasing global risk aversion that reflects uncertainties associated to changes in the Chinese exchange rate policy and to the pace of the global economic activity, the domestic risk premium fluctuated mainly in line with domestic developments. In the relevant horizon for monetary policy, the Committee points out that uncertainties related to the recovery process of fiscal balances and to the development of noneconomic events influence and will continue to influence the prices of financial assets. As such, it is important to emphasize, once again, that eventual rises in the volatility and risk aversion in international markets tend to be transmitted to domestic assets, in a discrete and incremental fashion, but can possibly be amplified as a result from the perception of domestic macroeconomic and financial soundness. Especially on the dynamic of this transmission, it is noteworthy to highlight that the effects from the recent exchange rate appreciation over the domestic prices depend, fundamentally, on the perception of how permanent is such appreciation.

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 the GDP continued to

line up, indicating that the pace of expansion of the domestic activity this year will be below than previously projected. This process has been intensified by the uncertainties related to non-economic events. However, for the Committee, after a necessary period of adjustments, which has been more intense and longer than anticipated, the pace of activity tends to intensify, to the extent that the confidence of firms and households strengthens. Regarding the external component of the aggregate demand, the depreciation of the Real tends to favor the Brazilian economic growth.

The impact on asset prices due to uncertainties regarding the recovery process of fiscal results and their composition, especially after a new downgrading, in February, of the country's sovereign rating by a rating agency is also a relevant aspect on the domestic front.

Still regarding internal activity, the Copom assesses that, in the medium-term, important changes should occur in the composition of the 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, summed up to other changes at place, anticipate a composition of the aggregate demand growth in the medium run that is more favorable to the potential growth. Committee highlights, however, that the pace and the gains of these changes depend, chiefly, on a path of primary surpluses that strengthen the perception of public sector balance sustainability, besides on the reduction of the uncertainties from domestic and international scenarios. It is highlighted the importance of persevering the progression of structural reforms to assure the fiscal consolidation in longer terms.

The Copom highlights that the central scenario envisages a 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 evolution of the credit operations in the quarter ended in February of 2016 was consistent with the trajectory of the economic activity and with the

monetary conditions. Noteworthy, still, the impacts on the borrowing decisions resulting from the effects associated to the downturn in the activity and its consequences over the employment and the income indicators, and over the maintenance of the confidence indicators of both consumers and entrepreneurs at a reduced level.

Regarding the public accounts, the primary deficit growth for the public sector in 2015 reflected, especially, the impacts of the deceleration of the economic activity on the level of public revenues and the adjustment of the liabilities with the federal banks and with the FGTS. Thus, become relevant the prospects that long-term fiscal adjustment measures are submitted and approved, contributing to the debt indicators resume the trajectory that is consistent with macroeconomic stability.

External sector indicators continue to reflect the effects of the macroeconomic adjustment process underway in the country. The path of the exchange rate and the slowdown in domestic activity are favoring trade balance, with a significant decline in the imports and a decrease in the net outflow of services and income. Show up in this process, the significant declines in the international travel expenses and in the net remittances of profits and dividends. Direct investment in the country remained at an appropriate level to finance the current account deficit.

Concerning prices, the inflation measured by Broad National Consumer Price Index (IPCA) reached 1.27% in January and 0.90% in February. Thus, the twelve-month accumulated inflation reached 10.36% in February, 2.65 p.p. higher than the rate recorded until February 2015. On the one hand, market prices accumulated variation of 8.97% in twelve months (7.12% up to February 2015); on the other hand, the regulated prices increased 14.94% (9.66% up to February 2015).

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of March 18, 2016, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R\$3.70/US\$ and the target for the Selic interest rate at 14.25% p.a. – projects inflation of 6.6% in 2016, 4.9% in 2017 and 4.5% in the first quarter of 2018. 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 6.9% in 2016, 5.4% in 2017 and 5.0% in the first quarter of 2018.

Concerning GDP growth, the projection for 2016, according to the baseline scenario, is -3.5% (1.6 p.p. lower than the estimate considered in the previous Inflation Report).

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.

In this context, as indicate the projections presented in this report, the Committee considers, as anticipated, the still high inflation level reflects the processes of relative price adjustments that occurred in 2015, and the process of tax revenues recovery observed at the federal and the state level in the beginning of this year, making inflation resilient. At the same time that recognizes that these processes have direct impact on inflation, the Committee reaffirms its view that the monetary policy can, should, and it is curbing the resulting second-round effects from these processes.

Assessing the macroeconomic scenario and the outlook for inflation, the Copom considers that uncertainties associated with the balance of risks remain, mainly, regarding the process of fiscal results recovery and their composition, the behavior of current inflation, and of inflation expectations. In addition, uncertainties about the external scenario also remain, especially regarding the concerns on the Chinese economy performance and its developments, and the evolution of the oil market prices.

The Copom reaffirms that the aggregate demand will remain moderate over the relevant term for the monetary policy. On the one hand, household consumption tends to be influenced by factors as employment, income and credit; on the other hand, the concession of public services and the expansion of agricultural income tend to favor investments. In their turn, the net exports presented better results, either by the increasing exports benefited from the depreciation of the local currency, or by the ongoing import substitution process. For the Committee, the combined effects of these elements, plus the development on fiscal, para-fiscal, and asset market dimensions, and, this year, the dynamic of the administered

prices and an output gap more disinflationary than originally foreseen, are all important factors of the context in which the future monetary policy decisions will be taken, in order to ensure the convergence of inflation to the 4.5% target established by the CMN, in 2017.

The Committee highlights that there are uncertainties related to the balance of risks, mainly, regarding the recent behavior of the expected inflation and of the observed actual inflation, combined with the presence of indexation mechanisms in the Brazilian economy, and regarding the process of fiscal results recovery and their composition. Moreover, the relative price adjustment process has taken longer and has been more intense than the anticipated. Additionally, uncertainties regarding the behavior of the global economy remain. In this context, the Committee reiterates that these conditions do not allow to consider the hypothesis of monetary easing, and the Committee will adopt the necessary actions to ensure the compliance with 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.