



BANCO CENTRAL DO BRASIL

Translation of the Open Letter sent by the Governor of the Banco Central do Brasil, Roberto Oliveira Campos Neto, to the President of the National Monetary Council, Paulo Roberto Nunes Guedes¹

Notice 823/2022–BCB

Brasília, January 11, 2022.

Mr. Paulo Roberto Nunes Guedes
Minister of Economy
President of the National Monetary Council

Subject: Open letter explaining inflation above the upper limit of the target tolerance band in 2021

Dear Minister,

The “inflation targeting regime” was created as a monetary policy framework by means of Decree 3,088, of June 21, 1999. In its sole paragraph of article 4, the decree establishes that when year-over-year (yoy) inflation falls outside the tolerance band at the end of a given calendar year,

“the Governor of the Banco Central do Brasil will publicly disclose the reasons for the non-fulfilment of the inflation target by means of an open letter to the Minister of Finance, which must include:

- I - a detailed description of the causes for the non-fulfilment;
- II - measures to ensure the return of inflation to the established limits; and
- III - the time span in which the measures are expected to be effective.”

2. In 2021, the yoy inflation rate, measured by the Extended National Consumer Price Index (IPCA), reached 10.06%, above the upper limit of the tolerance band of 1.5 percentage points (p.p.) around the 3.75% target set by the National Monetary Council (CMN) in its Resolution 4,671, of June 26, 2018.

3. Therefore, in compliance with what is established by the sole paragraph of Article 4 of the aforementioned decree, I hereby submit this open letter.

¹ In case of any inconsistency, the original version in Portuguese prevails.



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I. Reasons for the realized inflation being above the tolerance band of the 2021 target

4. The main drivers for inflation to exceed the upper limit of the tolerance band in 2021 were the following: i. strong rise in prices of tradable goods in local currency, especially commodity prices; ii. water scarcity electricity flag; and iii. imbalances between demand and supply of inputs and bottlenecks in global production chains. The pressures on commodity prices and on global production chains reflected the change in consumption patterns caused by the pandemic, with a greater share of demand oriented towards goods and stimulated by expansionary policies. These developments, which occurred at a global level, generated excess demand over short-term supply for several goods, causing an imbalance that, in several countries and sectors, was exacerbated by labor shortages, logistical issues, and production bottlenecks. In fact, the significant acceleration of inflation in 2021 to levels above the targets was a global phenomenon, affecting most advanced and emerging countries.

5. The factors mentioned above translated into large price changes in different components of the IPCA (Table 1 and Figure 1). Administered prices inflation reached 16.90% (a contribution of 4.34 p.p. to the IPCA change), lower only than the variation in 1999 and 2015, mainly reflecting increases in fuel and electricity prices. The prices of gasoline, bottled gas, and household electricity rose 47.49%, 36.99%, and 21.21% (contributions of 2.33 p.p., 0.41 p.p., and 0.98 p.p.), respectively. Ethanol price rose 62.24%, above other fuels, also reflecting the shortfall in the sugar cane harvest. Industrial goods and food-at-home prices rose 12.00% and 8.23% (contributions of 2.75 p.p. and 1.25 p.p.) respectively, strongly affected by commodity prices and bottlenecks in global supply chains. Services prices rose 4.75% (contribution of 1.72 p.p.).

Table 1 – Selected components of IPCA in 2021

Selected components and items	Change (%)	Contribution to IPCA change (p.p)
Administered prices	16.90	4.34
Gasoline	47.49	2.33
Bottled gas	36.99	0.41
Household electricity	21.21	0.98
Market prices	7.70	5.72
Food-at-home	8.23	1.25
Industrial goods	12.00	2.75
Automotive vehicles (new or used)	15.74	0.76
Appliances and electronic devices	12.11	0.21
Ethanol	62.24	0.41
Services	4.75	1.72
Consumer Inflation (IPCA)	10.06	10.06

Source: IBGE and BCB

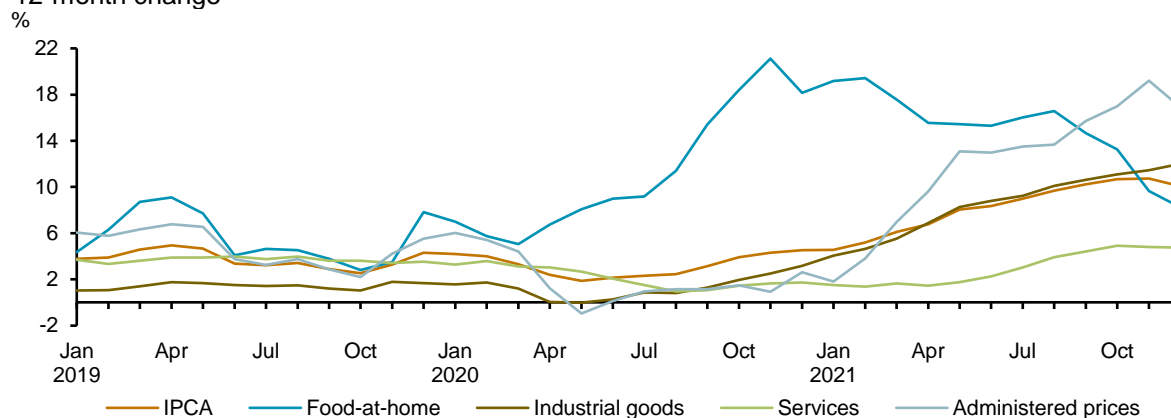
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Figure 1 – IPCA inflation and components
12-month change



Source: IBGE and BCB

6. The role of inflation drivers can be quantitatively assessed by an inflation breakdown procedure, whose results are usually presented every year in the Inflation Report². Using models from the Banco Central do Brasil (BCB)³, the contributions of the following determinants of the inflation deviation from the target are identified: (i) inertia associated with the deviation of previous year's inflation from the target; (ii) difference between agents' inflation expectations and the inflation target; (iii) imported inflation (combination of exchange rate and changes in commodity prices – including oil) as deviation from the target; (iv) output gap; (v) electricity tariffs flags; and (vi) other factors. It is worth noting that these estimates are based on models and, therefore, are subject to uncertainties inherent to the modeling and estimation processes.

7. Using the methodology mentioned above, the main factor for the deviation of 6.31 p.p. of inflation from the target came from imported inflation, with a contribution of 4.38 p.p., about 69% of the deviation (Figure 2). Looking at the item's breakdown, stands out the contributions of 2.95 p.p. from oil price, 0.71 p.p. from commodities in general as measured by the Commodities Index – Brazil (IC-Br), and 0.44 p.p. from the exchange rate⁴. The inertia of the previous year (as deviation from the target) contributed with 1.21 p.p., and the electricity flag tariff, with 0.67 p.p. in 2021, reflecting the adoption of the water scarcity flag at the end of the year. Inflation expectations, measured by the Focus survey conducted by the BCB, contributed with 0.25 p.p. to the deviation of

² See, for example, the box “Breakdown of 2020 inflation”, of the March 2021 Inflation Report. Further details on methodological procedures in the box “2017 inflation decomposition”, of the March 2018 Inflation Report, and CUSINATO, R. T., FIGUEIREDO, F. M. R., MACHADO, V. G., MELLO, E. P. G. and PEREZ, L. P. (2016), “*Decomposição de Inflação: revisão da metodologia e resultados para 2012 a 2014*”, Banco Central do Brasil, Working Paper 440.

³ See the box “Revision of the small-scale aggregate model”, of the December 2021 Inflation Report.

⁴ The contributions of external prices were calculated assuming deviations in relation to 2.0% p.a. for the change in commodity prices, coherent with long-term external inflation at the same level, and 1.75% p.a. for the exchange rate, consistent with long-term modeling conditions of the Phillips curve for market prices.

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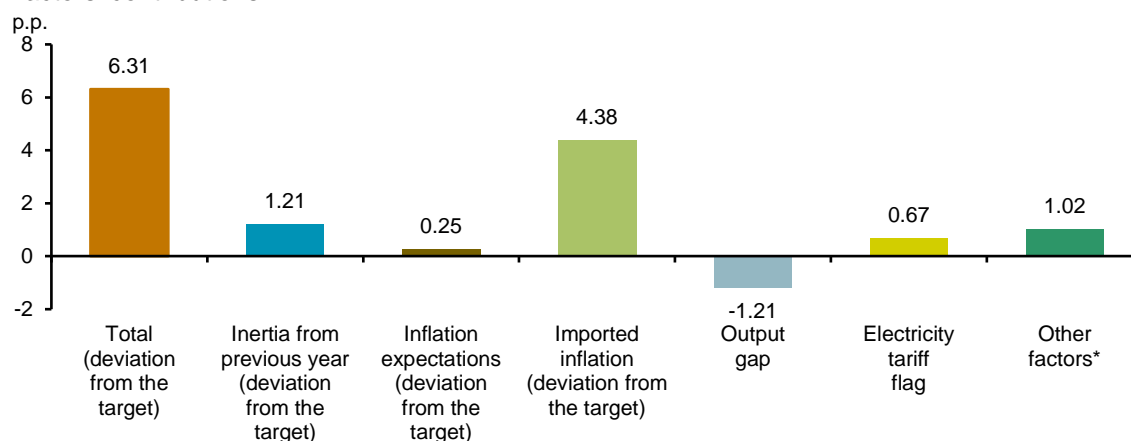


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inflation from the target. The item “other factors” includes a variety of elements, such as the effect of the General Price Index – Market (IGP-M) change, specific factors associated with medicines and health insurance, and climatic anomalies, as well as a part not explained by the model. Using the small-scale disaggregate model – which includes a specific equation for industrial goods prices inflation⁵ – for a deeper sectoral investigation, one finds that industrial price shocks contributed with 1.77 p.p. to IPCA inflation in 2021, reflecting logistical issues and global supply-demand imbalances.⁶ Conversely, the estimated output gap, alone, contributed with -1.21 p.p. for inflation remaining below the target. Therefore, according to this breakdown procedure, there was a combination of cost shocks that was partially offset by the negative output gap.

Figure 2 – Contributions to the deviation of inflation from the target in 2021

Factors' contributions



*Contribution for inflation as deviation from the target after excluding the following factors: inertia associated with the deviation of previous year's inflation from the target; inflation expectations as deviation from the target; imported inflation as deviation from the target; output gap; and electricity tariff flag.

Source: BCB

8. Commodity prices, after being negatively affected by the outbreak of the Covid-19 pandemic in the first quarter of 2020, started to rise in the third quarter of that year and continued to rise throughout 2021, significantly surpassing pre-pandemic levels. Considering the IC-Br measured in U.S. dollars, commodity prices reached, in the last quarter of 2021, average values 46.2% and 45.3% higher than those prevailing in the last quarters of 2019 and 2020, respectively (Figure 3). The rise was widespread in all commodity groups (Agriculture and Livestock, Metal, and Energy). Commodity prices were driven by several factors, such as the significant growth in global demand for goods vis-à-vis services, the rise in transportation costs, the announcement of infrastructure programs in the United States, and modest supply growth, especially in oil production. Brent oil prices reached, in the last quarter of 2021, average values 27.7% and 76.4% higher than those observed in the last quarters of 2019 and 2020, respectively (Figure 4). Therefore, in 2021, oil

⁵ See the box “New small-scale disaggregate model”, of the March 2021 Inflation Report, for the disaggregated model.

⁶ The shocks represent the entire unexplained part of the Phillips curve for industrial goods prices. Therefore, they do not capture the impact of production bottlenecks only. However, considering broad evidence about the impact of these bottlenecks, they could be assumed as the main factor.

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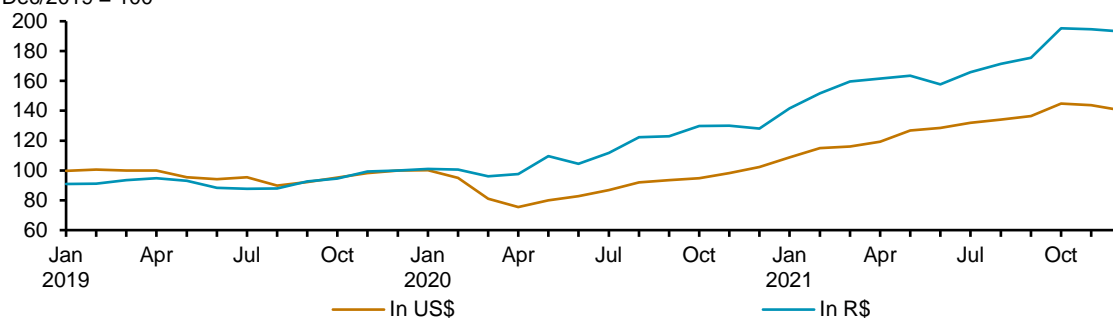
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prices rose more significantly than the agriculture and livestock and metal groups in the IC-Br, besides being the commodity with the highest pass-through to the IPCA, given the weight of oil derived products in that index.

Figure 3 – IC-Br

Monthly average

Dec/2019 = 100

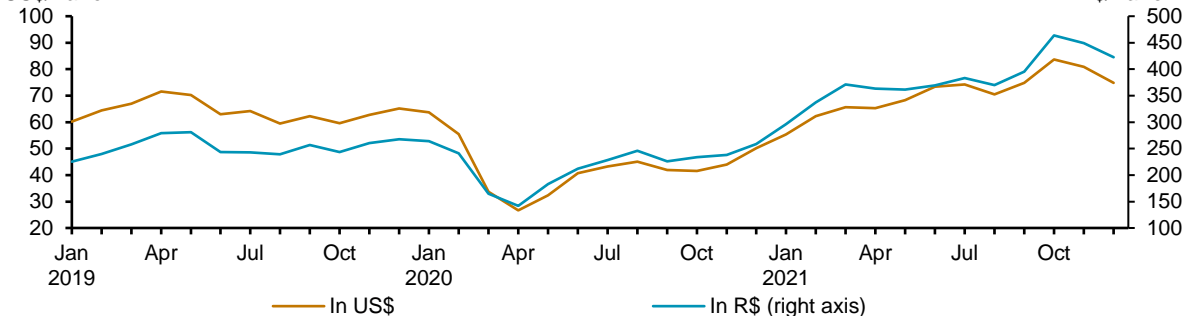


Source: BCB

Figure 4 – Brent oil price

Monthly average

US\$/Barrel



Source: Bloomberg and BCB

9. The exchange rate fluctuated throughout 2021 within the levels observed in the second half of 2020. The appreciation trend observed in the second quarter of the year was reverted throughout the second half. In December 2021, the average exchange rate was 9.83% higher than in December 2020 (Figure 5). The depreciation trend observed in the second half of 2021 mainly reflected doubts regarding the future of the country's current fiscal framework and the increased risk premia associated with Brazilian assets, given the greater uncertainty surrounding the future path of sovereign indebtedness. Despite the lower exchange rate contribution to inflation than in 2020, it is worth mentioning the break in the historical pattern of national currency appreciation during cycles of commodity price increases, such as the one that has occurred over the last 18 months. As a result, the growth of the IC-Br and the oil price measured in local currency was amplified, reaching 50.3% and 82.9% in the year, respectively, when comparing the average of the last quarter of 2021 with the same period of 2020 (Figures 3 and 4), both representing the largest variations observed since the start of the time series.

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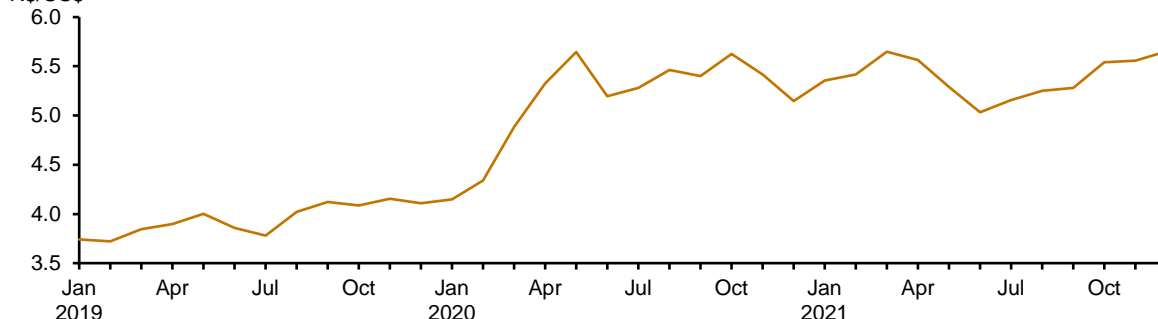


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Figure 5 – Exchange rate

Monthly average

R\$/US\$



Source: BCB

10. Poor rainfall regime led to the activation of thermoelectric power plants and other energy sources with higher costs during the second half of 2021, resulting in a significant rise in electricity tariffs. Following the adoption of the yellow flag between January and April, the red flag level 1 was activated in May. Between June and August, the red flag level 2 was adopted, with higher values as of July (Table 2). In September, the water scarcity flag was created and activated, resulting in an increase of 49.6% over the previous flag, and of 5.8% over the previous month's tariff. The water scarcity flag is scheduled to be effective until April 2022.

Table 2 – Energy flag

Month	Energy flag	Value (R\$/100kWh)
Dec-20	Red 2	6.24
Jan-21	Yellow	1.34
Feb-21	Yellow	1.34
Mar-21	Yellow	1.34
Apr-21	Yellow	1.34
Mai-21	Red 1	4.17
Jun-21	Red 2	6.24
Jul-21	Red 3	9.49
Aug-21	Red 4	9.49
Sep-21	Water Scarcity	14.20
Oct-21	Water Scarcity	14.20
Nov-21	Water Scarcity	14.20
Dec-21	Water Scarcity	14.20

Source: Aneel and BCB

11. Global production chains presented important bottlenecks throughout 2021, such as depletion of input inventories, shortages of semiconductors, and increases in delivery times and prices of international freight. Imbalances in the supply of inputs are associated with several factors. On the demand side, the significant changes in consumption patterns resulted in an increased demand for industrial goods. At the same time, supply did not react promptly at a sufficient pace

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for meeting the new demand. Mobility restrictions in several countries made it difficult to supply important inputs into international production chains. Moreover, the energy market was under pressure, with the more intensive use of energy to produce goods, in addition to difficulties in expanding the supply of some sources, partly reflecting the policies for limiting greenhouse gas emissions in several countries. Among the most affected sectors, with repercussions on prices, are the automotive, and electronics and computers. In 2021, inflation of new or used cars was 15.74%⁷ and, of appliances and electronic devices, 12.11%. The inflation of industrial goods reached the highest rate of the inflation targeting regime in a calendar year (12.00%).

12. Services inflation has been particularly affected by the Covid-19 pandemic, reflecting to a large extent the evolution of social distancing. The significant increase in social distancing due to the outbreak of the pandemic led to a strong reduction in the demand for services in 2020, resulting in five monthly deflations in a six-month period (between March and August 2020), and a historical low 12-month inflation of 0.95% in August 2020, closing the year at 1.73%. However, as the social distancing was reduced, driven by significant progress in the Covid-19 vaccination campaign, the reactivation of the services sector led to a realignment of prices, leading to an acceleration of inflation in this group, which rose 4.75% in 2021. In other words, part of the services inflation of 2021 is related to the normalization of the price level that had been depressed as a result of the specific impacts of the health crisis.⁸

13. After reaching a minimum of 2.9% in the September 2020 meeting of the Monetary Policy Committee (Copom), the BCB's conditional projections for inflation in 2021 started an upward trend, exceeding the target in the March 2021 meeting and the upper limit of the tolerance band in the June meeting (Figure 6). The revision of the projections reflected the conditioning factors and developments explained in the previous paragraphs.⁹ The Focus survey's expectations for inflation in 2021 followed a similar path.

⁷ This behavior is different from the past. In the previous ten years (2011 to 2020), cumulative inflation of new or used cars was near zero.

⁸ See box "Recent evolution of services inflation", of the December 2021 Inflation Report.

⁹ On the change in inflation projections for 2021 and the important role played by conditionals, see the box "Impact of the conditioning factors on inflation projections" of the September 2021 Inflation Report.

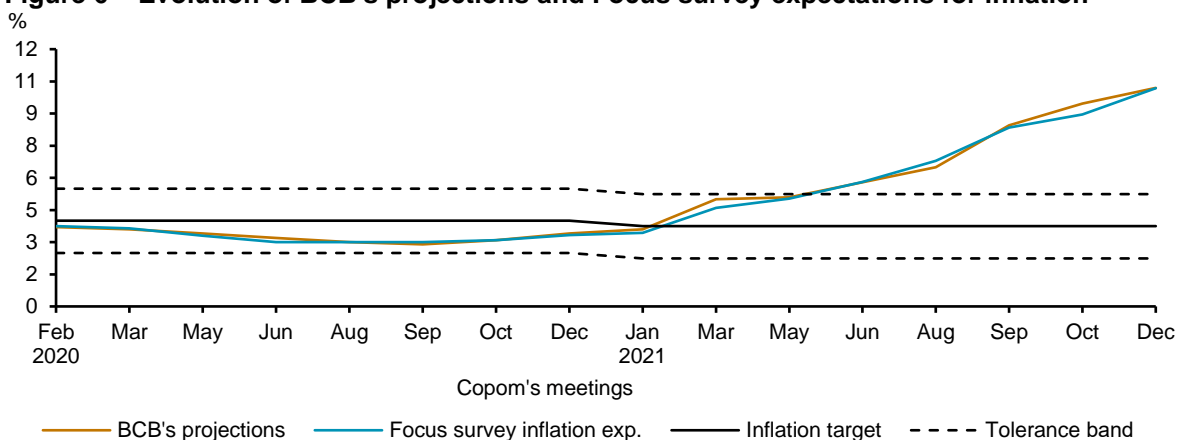
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Figure 6 – Evolution of BCB's projections and Focus survey expectations for inflation



Note: Focus' expectations are collected on the Friday prior to the Copom meeting. The lines of the inflation target and the tolerance band refer only to the calendar year, but, for better visualization, they are presented for all quarters.

Source: BCB

14. Regarding economic activity, 2021 was marked by the progress of the vaccination campaign and the normalization process of economic activity that began in the second half of 2020. In 2020, the wide range of government policies implemented allowed for a rapid economic recovery, leading the Gross Domestic Product (GDP) to reach, in the first quarter of 2021, levels close to those observed before the pandemic outbreak (Figure 7). With the extension of some fiscal aid programs launched in 2020, demand – mainly for goods – was sustained throughout 2021, reinforcing price pressures in segments with supply shortages or logistical bottlenecks. It is also noteworthy that, throughout 2021, the reduction in social distancing, coupled with the substantial progress of the Covid-19 vaccination and the health crisis relief, stimulated services activities particularly affected by the pandemic, allowing the recomposition of prices. Labor market figures, in turn, evolved favorably. Net hirings measured by the New General Registry of Employed and Unemployed Persons (Novo Caged – Ministry of Labor and Social Security) indicated 3 million net job openings in 12 months up to November 2021¹⁰ (Figure 8). Furthermore, the unemployment rate, released by the Brazilian Institute of Geography and Statistics (IBGE), started to decline since the beginning of 2021 and has already reverted most of the increase seen during the pandemic (Figure 9).

¹⁰ Data do not consider information from late submissions.

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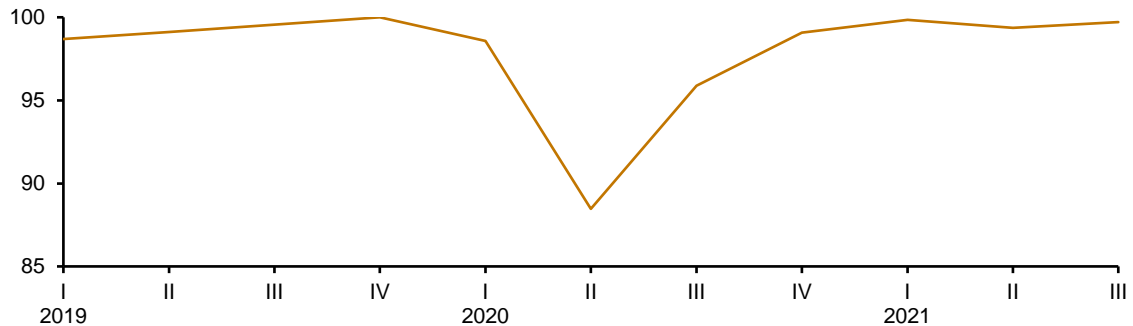
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Figure 7 – Gross Domestic Product

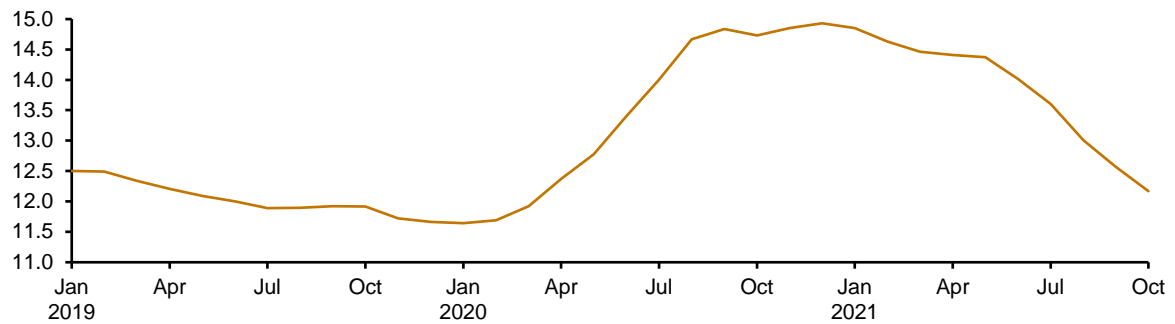
2019.IV = 100, s.a.



Source: IBGE

Figure 8 – Unemployment rate

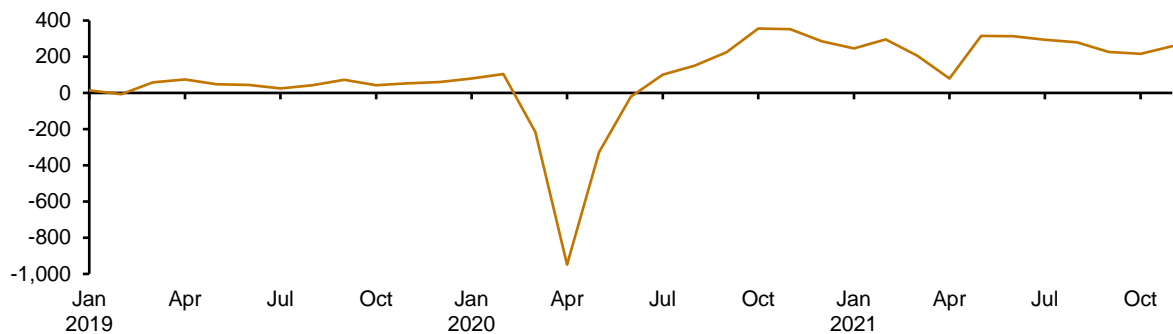
%, s.a.



Source: IBGE and BCB

Figure 9 – Formal Employment (Caged): net hirings

thousands, s.a.



Source: MTP and BCB

II Measures to ensure the return of inflation to the established limits

15. The BCB has been calibrating the policy interest rate (Selic) and will continue doing so, to comply with the inflation targets established by the National Monetary Council (CMN).

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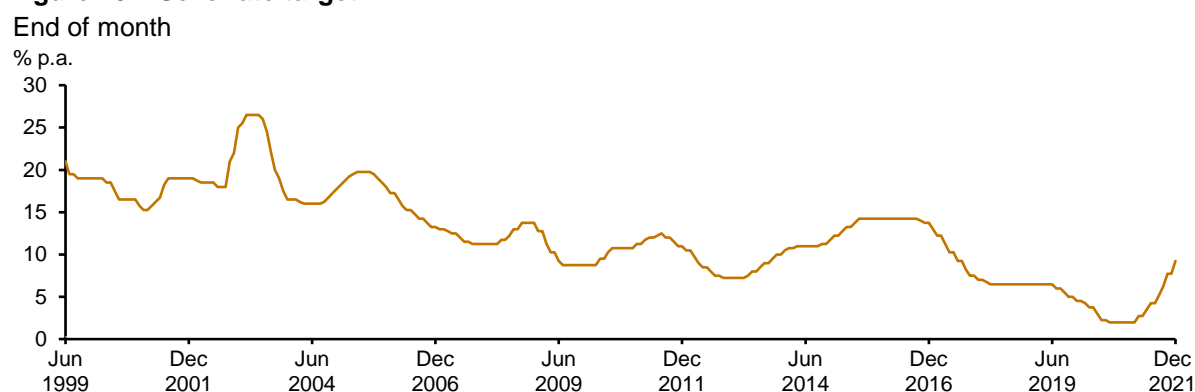
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16. In response to the outbreak of the Covid-19 pandemic and its strong disinflationary effects, the BCB reduced the Selic rate from 4.25% p.a. to a minimum of 2.00% p.a. between its March and August 2020 meetings (Figure 10). Concurrently, a series of measures involving liquidity, capital, and credit were taken to counterbalance the effects of the pandemic.¹¹ Copom emphasized that, at that moment, the economic environment prescribed unusually high monetary stimulus, justified by both Copom's projections and market expectations. The level of extraordinary stimulus went beyond the reduction of the Selic rate to 2% p.a. Forward guidance was also adopted as of August 2020, signaling that monetary policy would be extraordinarily accommodative as long as the BCB's own projections and private inflation expectations remained significantly below the target. However, there was a sequence of upward surprises in the inflation data in the last months of 2020, leading inflation to end the year at 4.52%, against the target of 4.00%. Among the surprises is the change from the green electricity tariff flag in November to the red level 2 in December, an unusual level for the end of the year, with an impact of around 0.42 p.p. on the 2020 inflation. These surprises prompted a change in Copom's communication, which culminated with the beginning of a monetary tightening cycle in the first quarter of 2021. In the December meeting, the Copom observed a reversal in the downward trend of inflation expectations relative to the targets for the relevant horizon, and warned that the maintenance of the inflation convergence scenario suggested that the conditions for maintaining forward guidance might soon no longer be valid.

Figure 10 – Selic rate target



Source: BCB

17. Throughout 2021, the current inflation data, the conditional projections for the relevant horizon, and the balance of risks deteriorated, as a result of the shocks outlined in section I of this letter. In response to the scenario change since the end of 2020, Copom started to adjust monetary policy in the first quarter of 2021. In the January 2021 meeting, the Committee announced the removal of the forward guidance as its underlying conditions were no longer held, since inflation expectations and the inflation projections under the baseline scenario, were sufficiently close to the inflation target for the relevant monetary policy horizon. In the March 2021 meeting, Copom started the process of adjusting the Selic rate, leading to a total increase of 7.25 p.p. in seven meetings (an average of 1.04 p.p. per meeting), ending the year at 9.25% p.a. (Table 3). During 2021, Copom has recalibrated its budget and pace of monetary policy adjustment in response to economic

¹¹ See, for example, the 2020 April and October Financial Stability Reports.

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developments that have negatively affected its projections and to the deterioration of inflation expectations, aiming at ensuring inflation convergence toward the targets over its relevant horizon. It is worth noting that the economic recovery scenario following the Covid-19 pandemic has been marked by unusually high uncertainty and volatility, influencing inflationary surprises around the world.

Table 3 – Copom's decisions

Meeting	Decision's date	Selic rate (% p.a.)	Change (p.p.)
232nd	8/5/2020	2.00	-0.25
233rd	9/16/2020	2.00	0.00
234th	10/28/2020	2.00	0.00
235th	12/9/2020	2.00	0.00
236th	1/20/2021	2.00	0.00
237th	3/17/2021	2.75	0.75
238th	5/5/2021	3.50	0.75
239th	6/16/2021	4.25	0.75
240th	8/4/2021	5.25	1.00
241st	9/22/2021	6.25	1.00
242nd	10/27/2021	7.75	1.50
243rd	12/8/2021	9.25	1.50

Source: BCB

18. The rise in the Selic rate and in agents' expectations about its future movements, coordinated by the monetary policy communication, led to a significant increase in the real interest rate. Considering the four-quarter-ahead Selic rate discounting inflation expectations, both taken from the Focus survey and measured in terms of quarterly averages, a substantial increase was observed throughout 2021, rising from -1.3% p.a. in the last quarter of 2020 to 4.4% p.a. in the last quarter of 2021 (Figure 11). Therefore, the increase in the path of the nominal Selic rate was sharper than the rise in inflation expectations, according to the measure considered. This movement meant the shift of monetary policy stance from accommodative to restrictive (assuming a neutral real interest rate of 3.5% p.a.). Under this path, the real interest rate increases to 6.3% and 6.4% in the first and second quarters of 2022, respectively. The increase in the real interest rate in this cycle is the largest that has occurred during the inflation targeting regime.

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Figure 11 – Four-quarter-ahead real Selic rate

Quarterly averages

% p.a.



Note: Real Selic calculated as the four-quarter-ahead Selic rate, discounted from inflation expectations for the same period, both variables extracted from the Focus survey. The values for 2022-2024 were calculated using data collected on 1/7/2022.

Source: BCB

19. However, uncertainties regarding the future of the current fiscal framework imply in increased risk premia and raise the risk of deanchoring inflation expectations. This implies assigning greater probability to alternative scenarios that consider higher neutral interest rates. The Committee reiterates that the process of reforms and necessary adjustments in the Brazilian economy remains essential for a sustainable economic growth. Weaknesses in the structural reform effort and permanent changes to the fiscal consolidation process could result in an increase in the structural interest rate.

III - The time span within which the measures are expected to yield results

20. The BCB's conditional projections are that inflation will enter a downward trajectory already at the beginning of 2022, ending the year at a level significantly lower than that of 2021. In the December 2021 Inflation Report, the conditional projections¹² pointed to inflation of 4.7% in 2022 (a drop of about 5.4 p.p. in relation to 2021), 3.2% in 2023 and 2.6% in 2024, against inflation targets of 3.50%, 3.25% and 3.00%, respectively (Figure 12). Therefore, the outlook suggests inflation converging to the targets over the relevant horizon. In this scenario, inflation should still be above the target in 2022, although within the tolerance band, due to the inertial effects that propagate from the 2021 inflation. These effects are counterbalanced by monetary policy, although not entirely, due to the time lags between the inertial impacts of the shocks, which happen in the short term, and the effects of monetary policy, which are preponderantly concentrated in the medium term. Inflation expectations from the Focus survey (January 7, 2022) also indicate a significant reduction of inflation in 2022, although to a lesser extent, reaching values around 5.0% in 2022 and 3.4% in 2023 (Figure 13).

¹² Elaborated with information available until December 8, 2021, using a trajectory for the interest rate extracted from the Focus survey (of December 3, 2021) and an exchange rate starting from R\$5.65/US\$ (rounded average of the average rate in the week prior to the Copom meeting) and evolving according to the purchasing power parity (PPP).

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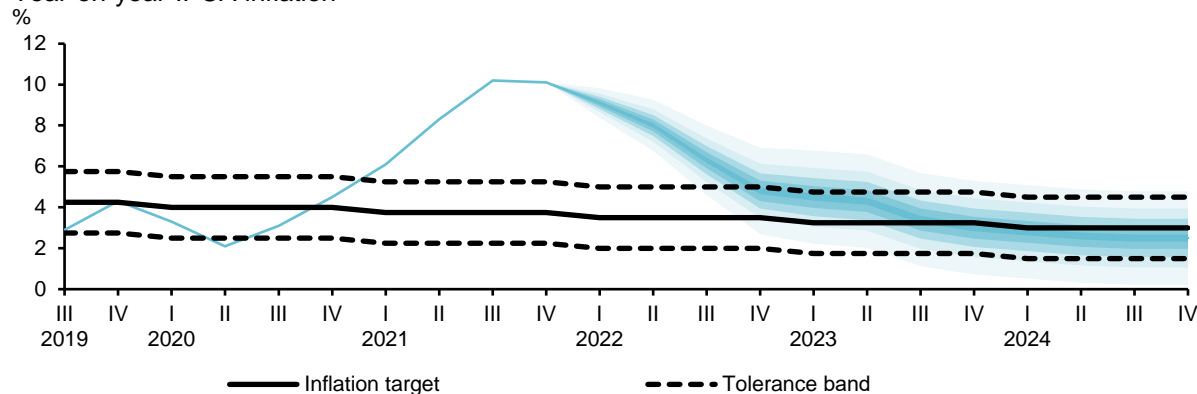
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Figure 12 – Inflation projection and fan chart – Scenario with Selic from Focus survey and PPP exchange rate

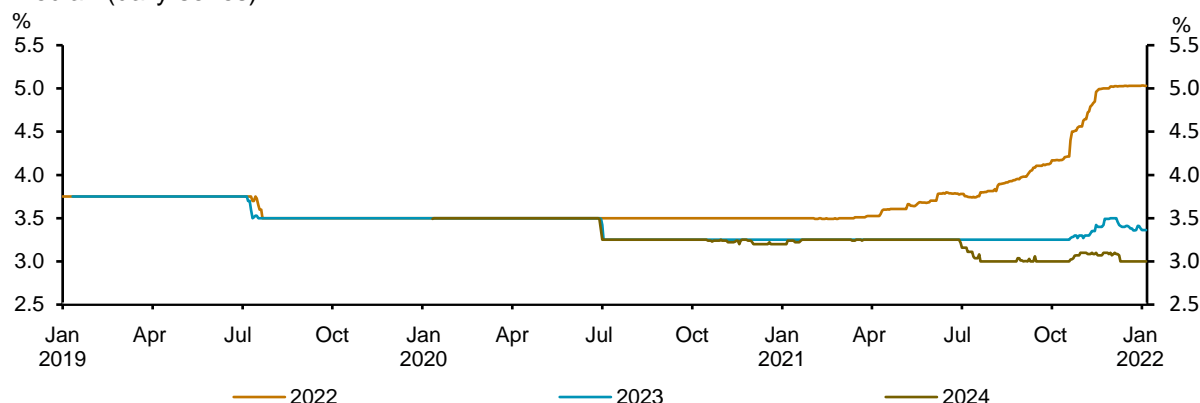
Year-on-year IPCA inflation



Note: The lines of the inflation target and the tolerance band refer only to the calendar year, but, for better visualization, they are presented for all quarters.

Figure 13 – Inflation expectations from the Focus Survey for 2022-2024

Median (daily series)



Note: Figure data range: 1/2/2019 - 1/7/2022
Source: BCB

21. Therefore, the BCB has adopted appropriate measures that will allow inflation to comply with the targets established by the CMN, of 3.50% in 2022, 3.25% in 2023, and 3.00% in 2024. In its December 2021 meeting, considering the baseline scenario, the balance of risks, and the broad array of available information, Copom unanimously decided to increase the Selic rate by 1.50 p.p. to 9.25% p.a. The Committee judges that this decision reflects its baseline scenario for prospective inflation, a higher-than-usual variance in the balance of risks and is consistent with the convergence of inflation to its target throughout the relevant horizon for monetary policy, which includes 2022 and 2023. Without compromising its fundamental objective of ensuring price stability, this decision also implies smoothing of economic fluctuations and fosters full employment, in line, therefore, with the objectives set forth in law for the BCB.

22. The Committee considers that, given the increase in its inflation projections and in the risk of longer term expectations deanchoring, it is appropriate to advance the process of

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monetary tightening significantly into the restrictive territory. The Committee will persist in its strategy until the disinflation process and the anchoring of expectations around its targets consolidate.

23. According to the Statement and Minutes of the December 2021 meeting (243rd Meeting), for its next meeting, the Committee foresees another adjustment of the same magnitude. Copom emphasizes that the future steps of the monetary policy could be adjusted to ensure the convergence of inflation towards its targets and will depend on the evolution of economic activity, on the balance of risks, and on inflation expectations and projections for the relevant horizon for monetary policy.

Sincerely,

Roberto Oliveira Campos Neto
Governor

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