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 December 2012. The chapter also presents the analysis of the inflation prospects up to the first quarter of 2015 and of the Gross Domestic Product (GDP) growth up to the fourth quarter of 2013. Inflation projections are presented in two major scenarios. The first scenario, called the baseline scenario, assumes that the Selic rate will remain unchanged at 7.25% per year over the forecasting horizon, the level set by Copom at its most recent meeting on March 5 and 6, and the exchange rate will remain at R$1.95 per US dollar. The second scenario, named the market scenario, is based on the expected paths for the policy interest rate and for the exchange rate drawn from the survey carried out by the Banco Central do Brasil's Investor Relations and Special Studies Department (Gerin) among independent analysts. It is important to stress that these scenarios are used only as support for monetary policy decisions and their assumptions should not be viewed as Copom forecasts of the future behavior of interest and exchange rates. The projections released here are based on the information set available up to the cutoff date of March 8, 2013.

The projections for inflation and of 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 6.31% in February, 0.46 percentage points (p.p.) higher than the value recorded in the same month of 2012. Market prices increased 7.86% in the twelve months to February (1.89 p.p. higher than the February 2012 rate) and the administered and monitored prices 1.53% (3.95 p.p. lower than the February 2012 rate). Within the set of market prices, the increase of non-tradable goods reached 9.13% in twelve months – highest value since June 2003 – and tradable goods amounted to 6.43%. The food and beverage group, still influenced by weather factors, increased 12.49% in twelve months (6.83% until February 2012). Meanwhile, inflation in the service sector, which has remained at a level consistently higher than the overall market prices, reached 8.66% in the twelve months to February. In summary, services inflation still remains at high levels, and there are pressures in the food and beverage segment.

Measures of underlying inflation calculated by the Central Bank have shown similar behavior to that of headline inflation. The average monthly change reduced from 0.73% in January to 0.59% in February and, in twelve months, reached 5.97% in February (6.10% in February 2012). More specifically, the non-smoothed trimmed mean core changed from 0.77% in January to 0.61% in February, and the smoothed trimmed mean core decreased from 0.73% to 0.53%. The double weighted core changed from 0.65% to 0.55%. The exclusion core – which excludes ten items from the groups food at home and fuels – changed from 0.63% to 0.28%; whereas the measure that excludes the prices of monitored goods and food at home changed from 0.87% to 1.00%.

The IPCA diffusion index reached 72.33% in February, higher than that of February 2012 (59.11%) and above the median of the sample started in July 1999, 61.68%. The quarterly average rose to 72.69% in February, 6.76 p.p. and 10.01 p.p. higher than the value recorded in November and February 2012, respectively, on the same comparison basis.

Broader inflation – measured by the General Price Index (IGP-DI) – which is characterized by higher volatility when compared to consumer inflation, reached 0.20% in February, after 0.31% in January. Therefore, the index cumulates 8.24% in twelve months (3.38% up to February 2012). The major component of the IGP-DI, the IPA, changed 9.24% in the twelve months to February, influenced by the agricultural sector (15.45%), which was negatively affected by supply shocks. The twelve months variation in the IPC – the second most important component of the IGP-DI – reached 6.04% in February (0.42 p.p. higher than in February 2012). The INCC – the smallest weight component in the IGP-DI – increased 7.18% in twelve months (8.02% in February 2012), which was the result of changes of 9.34% in the labor cost and of 4.99% in the cost of materials, equipment and services.

The high frequency coincident indicator of economic activity, IBC-Br, which provides monthly production estimates for the three sectors of the economy, increased 0.3% in December, after 0.6% in November, considering seasonally adjusted data. Therefore, the quarterly growth rate of the index reached 0.6% in the fourth quarter and the yearly change in 2012 reached 1.6%, compared to 2.7% in 2011 and to 7.6% in 2010.

The Consumer Confidence Index (ICC), from FGV, decreased for the fifth consecutive month in February, considering seasonally adjusted data, but remained above its historical average. The quarterly moving average of the Commerce Confidence Index (ICOM), from FGV, decreased for the third consecutive time in the quarter finished in February. In turn, the Services Confidence Index (ICS) decreased in February, in the monthly comparison, after recording an increase in January. At the same time, business confidence in the industry is still gradually recovering. According to FGV, the seasonally adjusted Industry Confidence Index (ICI) recorded an increase in February, due to an improvement in expectations, and reached the highest level since June 2011.

Industrial production increased 5.7% in January, compared to the same month of 2012. Compared to the previous month, manufacturing activity increased 2.5% in January, after increasing 0.2% in December, according to the seasonally adjusted industrial production data from IBGE. The January increase was widespread, and achieved all categories of use. In particular, capital goods production increased by 17.3%, compared to January 2012, partly due to an atypical increase in the group of capital goods for transportation equipment. The increase in the production of capital goods interrupted a sequence of sixteen negative results in the same basis of comparison. In turn, the production of durable consumer goods increased 10.3% in this basis of comparison; intermediate goods, 4.0%; while semi and non-durable consumer goods production increased 3.0%. In twelve months, industrial production accumulates a 1.9% loss, with negative variation in the groups of capital goods (-9.7%); durable goods (-2.1%); intermediate goods (-1.0%); and stability in the production of semi and non-durable consumer goods (0.1%). With regard to the real sales of the manufacturing industry, they declined 1.2% in December, compared to the same month in the previous year, while the number of hours worked decreased 2.4%. Compared to 2011, real sales increased 2.4% in 2012, while the number of hours worked declined 1.5%, according to National Confederation of Industry (CNI).

The seasonally adjusted Installed Capacity Utilization Level (Nuci) in the manufacturing sector, computed by FGV, decreased from 84.4% in January to 84.1% in February (0.4 p.p. higher than in February 2012). Still according to seasonally adjusted data, capacity utilization in the consumer goods sector decreased to 84.4%. In the capital goods, intermediate goods and materials for construction sectors, Nuci stood at 82.4%, 84.9% and 89.5%, respectively. According to CNI data, seasonally adjusted by the Central Bank, Nuci decreased from 81.4% in November to 81.2% in December. Regarding inventories in the manufacturing sector, the levels are still low in the consumer goods sector, adjusted in the materials for construction sector, and high in the capital goods sector, according to the seasonally adjusted indicator from the Manufacturing Industry Conjuncture Survey, conducted by FGV.

The retail sector is dynamic, with moderation at the margin. In fact, the retail volume increased 5.0% in December, compared to December 2011, for both restricted and broader retail trade. Thus, the twelve-month growth rate of the broader retail stood in 8.0% in 2012, with expansion in all ten segments researched by IBGE. In turn, real sales of retail trade grew by 8.4% in 2012 – highlighting sales in the sectors of furniture and house appliances (12.3%) and of pharmaceutical, medical, orthopedic articles and toiletries (10.2%). In the next months, sales will continue to be influenced by government transfers, by the real payroll growth and by moderate credit expansion.

The Brazilian economy grew 0.6% in the fourth quarter of 2012 compared to the previous quarter, when it had grown 0.4%, according to seasonally adjusted IBGE data. Compared to the same quarter of 2011, growth in the fourth quarter reached 1.4%, against 0.9% in the third. Therefore, the four-quarter growth rate of GDP in 2012 was 0.9%, after 2.7% in 2011 and 7.5% in 2010. Agricultural and industrial production decreased 2.3% and 0.8%, respectively, while the value added by the services sector was 1.7%.

From a demand side perspective, household consumption – the largest component of aggregate demand – remains robust and, at the margin, increased 1.2% in the fourth quarter of 2012 and 3.9% over the same quarter of 2011 – the thirty-seventh consecutive increase in this basis of comparison. Government consumption increased by 0.8% at the margin and 3.1% over the same quarter of 2011. Additionally, a recovery of the Gross Fixed Capital Formation (GFCF) was observed, with an increase of 0.5% when comparing quarter over quarter, after decreasing for four quarters. The investment rate in 2012 reached 18.1% of the GDP. With regard to foreign trade, at the margin, exports increased 4.5% (2.1% over the fourth quarter of 2011) and imports increased 8.1% (0.4% over the same quarter of previous year).

The IBGE reported an estimate of the unemployment rate, in January, for six metropolitan areas covered by the Monthly Labor Survey (PME). According to this data, seasonally adjusted by the Banco Central do Brasil, the unemployment rate remained in 5.5% – close to the minimum of the historical series, started in 2002 (5.3% in August 2012). It should be noted that the lower growth rate of the working-age population (PIA) in the recent years has contributed to the reduction of unemployment rates. Also according to the PME, the proportion of formal workers reached 50.1% in the private sector – new record of the historical series. In turn, the average real income rose 2.4% in January, related to the same month of 2012, and real payroll, considering the average earnings of occupied population over the six metropolitan areas, increased 5.3% in this period. Formal employment remains growing, albeit at a moderate pace. According to the data released by the Ministry of Labor and Employment (MTE), 778 thousand jobs were created between February 2012 and January 2013 compared to 1.53 million in the twelve months to January 2012.

In addition to rising payrolls, credit availability to households – largely determined by macroeconomic stability and institutional reforms in recent years – was an important driving force behind growth of household consumption. So, it should be noted that, in general, the credit market expansion is occurring in an environment where a downward trend in borrowers' interest rate and granting for longer terms prevail. Total credit to households reached R$1,088.2 billion in January, a 16.6% growth when compared to the same period of the previous year. In particular, housing loans, whose operations are mainly based on earmarked resources, grew by 34.5% in the same period, reaching R$261.4 billion. Delinquency rates have been showing some reduction, at the margin, at levels consistent with the phase of the cycle, given perspectives of continued recovery of economic activity.

The volume of credit to corporations totaled R$1,278.8 billion in January, volume 16.3% higher than in January 2012. It should be noted that average interest rate in credit to corporations was 4.5 p.p. lower than the average rate 12 months ago, reaching 13.9%. In particular, loans and financing with resources from the National Bank of Economic and Social Development (BNDES) reached R$448 billion, an increase of 15.3% in 12 months to January. Regarding the capital market, the volume of primary issues of shares registered in the Securities and Exchange Commission (CVM) reached R$12.7 billion in the twelve months to January 2013. In turn, debenture issues totaled R$79.2 billion in the same period, excluding the issuance of US$15 billion by leasing companies. From total debenture issues (excluding the issuance by leasing companies), R$64.1 billion were issued with restricted efforts, using CVM 476/09 Instruction.

With regard to the trade balance, the twelve-month result decreased to US$13.7 billion in February (US$28.6 billion in February 2012). This result stemmed from US$239.9 billion in exports and US$226.2 billion in imports, which represented variations of -7.1% and -1.5%, respectively, compared to the twelve months period ended in February 2012. The exported volume registered a decrease of 0.3% while the average price of exports decreased by 5.3%, considering the twelve months ended in January 2013. In the same period, the imported volume decreased 1.7% and the average price of imports rose by 0.2%.

The twelve-month current account deficit reached US$58.6 billion in January, equivalent to 2.6% of GDP. An important component of this deficit has been remittances of profits and dividends, which totaled US$25.2 billion. Note that foreign direct investment has been the main financing source of the balance of payments totaling US$63.6 billion in the twelve months to January, equivalent to 2.8% of GDP.

In international financial markets, some moderation in indicators of volatility and of risk aversion was observed since the release of the previous *Report*, despite risks associated to the future path of monetary and fiscal policies in the USA. Unconventional policy action implemented by important mature economies tend to increase liquidity in their respective markets and to contribute to the decrease in the probability of extreme events and long deflation

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

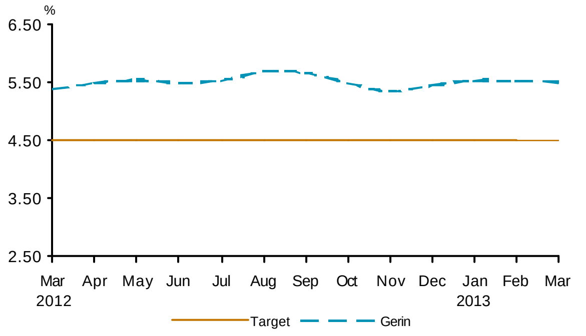


Figure 6.2 – Dispersion of inflation expectations for 2013

Relative frequency

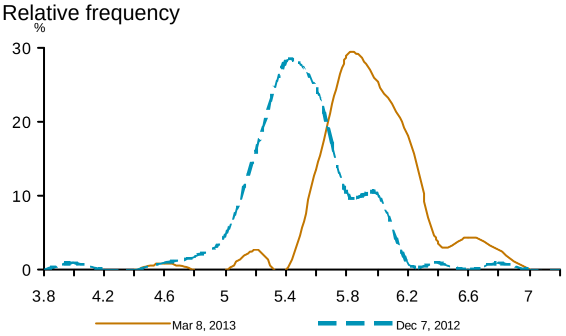


Figure 6.3 – Median market expectations by segment for 2013 IPCA-inflation

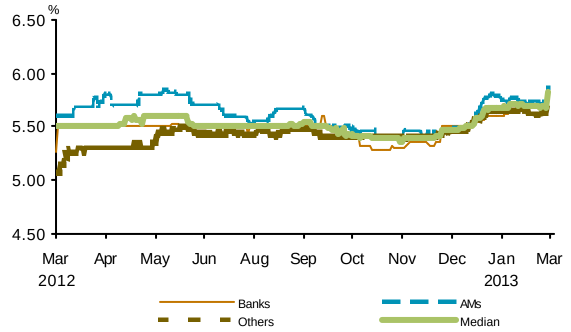
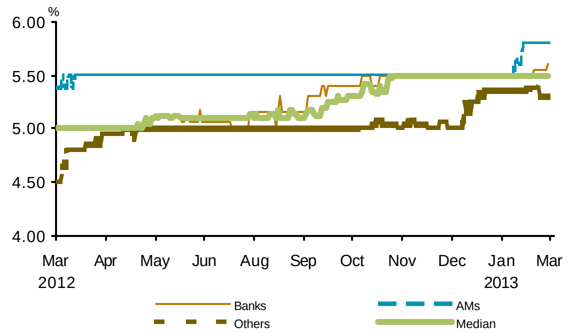


Figure 6.4 – Median market expectations by segment for 2014 IPCA-inflation



periods. Since last *Report*, leading indicators point to moderate global activity with some recovery at the margin, including in the manufacturing sector, in the United States, in Japan and in main emerging economies. In the Euro area, a stabilization sentiment prevails. Despite the accommodation of risk indicators and signals of activity recuperation in certain regions, global economy still faces more than usual uncertainty, with persistent fiscal imbalances and perspectives for slow growth for a prolonged period.

Brent oil prices have remained above US$110. It is worth noting that the geopolitical complexity which surrounds the oil sector tends to boost the volatile behavior of prices, which also reflects the low predictability of some global demand components and the fact that the supply growth depends on highly risky long-term maturity investments. Regarding other commodities, the behavior since last *Report* was heterogeneous, with a decrease of 7.5% in agricultural commodities prices and an increase of 2.4% in metal prices. At the cutoff date of March 8, the price index based on twenty two commodities, published by the CRB, accumulated a decrease of 0.7% since December 7 – the cutoff date of December 2012 *Inflation Report.*

The median of market expectations for the 2013 GDP growth rate has declined from 3.50% on the cutoff date of the last *Report* to 3.10% in March 8. For 2014, the projected growth rate decreased from 3.82% to 3.50%. During this period, the median expectation for inflation, measured by IPCA, moved from 5.40% to 5.82% for 2013, remained in 5.50% for 2014, and shifted from 5.00% to 5.20% for 2015. Twelve-month ahead inflation expectations moved from 5.44% to 5.50%, as shown in Figure 6.1. Since the release of the previous *Report*, there was a reduction in the dispersion around the central tendency measures of inflation expectations for 2013, as illustrated in Figure 6.2. The standard deviation of these projections moved from 0.36% to 0.34%. In the specific case of banks, asset managers (AMs) and other institutions (nonfinancial companies, brokers, consulting companies and others), the median inflation expectations for 2013 (Figure 6.3), at the cutoff date of March 8, were 5.78%, 5.87% and 5.74%, respectively, compared to 5.34%, 5.45% and 5.40% in the last *Report.* For 2014, as Figure 6.4 shows, they were at 5.60%, 5.80% and 5.30%, in the same order, versus 5.50%, 5.50% and 5.02% in the December 2012 *Report.*

6.2 Associated risks and monetary policy implementation

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

On the external side, in general, since last *Report*, the prospects for global activity have remained unchanged. In fact, evidence point to low growth rates in mature economies – lower than the potential growth – despite signals of acceleration in the pace of activity in important emerging economies. Prospects firmed for a moderation of localized price pressures in agricultural commodities segment, which had arisen between the second and third quarters of 2012 and were a consequence of unfavorable supply shocks. On the domestic side, the prospective scenario envisages a more intense pace of economic activity than the observed in 2012. The greater dispersion recently observed in increases in consumer prices and the resistance of inflation are also important aspects of the domestic scenario.

On the external front, the slow growth prospects for mature economies, for a prolonged period of time, still prevail. In the United States, there are positive signs in the pace of activity, as suggest recent improvements in the real estate and labor markets. However, in the United States, there are still risks associated with the fiscal tightening scenario and the European crisis. In the euro area, the political uncertainty and social stress add to the depressed economic climate – despite the recent improvement recorded in the last published data – and to the skepticism regarding the strength of the banking system in some countries. In important mature economies, restrictions in the scope for countercyclical policies, fragile labor markets, wealth destruction and constrained credit markets contribute to the maintenance of low growth prospects.

In main emerging markets, the pace of activity has grown, supported by the resilience of domestic demand, although the Copom evaluates that the developments in mature economies are transmitted to emerging economies' aggregate demand in intensity proportional to, among other factors, the importance of trade and investment flows. The Committee 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. Regarding the Chinese economy, since last *Report*, despite the marginal deceleration of the GDP, signs of stabilization in the pace of growth have been established, and growth rates tend to consolidate in a lower level than observed in former years. Prospects are favorable for other Asian emerging economies, as well as in Latin American countries, in general.

The Copom assesses that there are still significant risks for global financial stability, in particular due to the ongoing deleveraging process in the main economic blocks and to the exposure of international banks to the sovereign debt of countries with fiscal unbalances. Since last *Report*, insurance prices against default (CDS) of banks and sovereigns have been stable, but in high levels, especially in the euro area. There is still evidence of displacements of private liquidity among countries in the euro area towards economies with strong fundaments. In the relevant horizon, the Committee considers that the volatility of financial markets tends to react to the beginning (or imminent) normalization process of the monetary conditions in the United States. In this context, despite the understanding that the probability of occurring extreme events in international financial markets is low, the Committee assesses that the external environment remains complex.

In international markets, there has been a moderation of localized price pressures in agricultural commodities segment, which had arisen between the second and third quarters of 2012 and were a consequence of unfavorable supply shocks. In fact, since last *Report*, the Commodities Brazil Index (IC-Br) measured in national currency has decreased, with the increase in the prices of metal being compensated by the decrease in the prices of agriculture and energy.

The price of Brent oil barrel has kept its typical volatility since last *Report*, remaining above US$110. It is worth noting that international oil prices affect domestic inflation not only through the local price of gasoline, but also via the petrochemical production chain and the expectations channel of consumers and entrepreneurs.

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

In sum, despite recent positive evidence, the still fragile global economy remains as an important factor of containment of aggregate demand. The Committee stresses that the central scenario envisages an accommodation for commodities prices in international markets.

On the domestic side, the pace of activity was boosted in the fourth quarter of 2012. According to Quarterly National Accounts data reported by IBGE, domestic demand has continued to be the main support of the economy, with consumption being stimulated by the moderate expansion of credit, by labor and income creation. The demand growth was still positively affected by investment. On the supply side, evidence signals that the industry is starting to react to the stimulus introduced in the economy.

The Copom evaluates that domestic demand tends to remain robust, especially household consumption, mostly due to the effects of stimulus, such as income gains and moderate credit expansion. This environment tends to prevail in this and following semesters, when domestic demand will be affected by the effects of recent policy action, which are lagged and cumulative. For the Committee, these effects, added to programs for public services concessions, the inventories at adjusted levels and gradual recovery of businessman's confidence generate good perspectives for investment growth. The Committee considers that recent action points to an expansionist public sector balance. On the other hand, the Committee assesses that the still fragile international scenario is a factor of containment of demand.

In terms of factor markets, the Copom assesses that an important source of risk to inflation comes from the labor market, which on the one hand shows signs of moderation, especially regarding wage growth, and on the other hand low idle capacity. The Committee reassesses that a crucial aspect under these circumstances is the possibility that the overheating in the labor market leads to real wage increases at rates that are not compatible with productivity growth, with negative impacts on the inflation dynamics. At this point, it is worth noting that, according to the theory, which is endorsed by the international experience, wage moderation is a key element to the achievement of price stability.

Still on the labor market, the Copom understands that there are risks due to the presence of mechanisms that favor the persistence of inflation in the Brazilian economy, derived from the possibility that wage bargaining gives excessive weight to past inflation at the expense of future inflation. Nonetheless, the Committee assesses that the risks due to formal and informal mechanisms of wage indexation have lowered. This is supported by the fact, among others, that the raise in the minimum wage in the following years will be markedly lower than the one granted in 2012. This change in the pace of minimum wage tends to smooth the wage dynamics in general, with consequences to production costs, especially in labor intensive segments. Also, it should be noted that in the public sector there were gains in what concerns wage dynamics, as closed negotiations with public employees' point to moderation in wage gains for this and the next two years. Thus, for the economy as a whole, wage gains are expected to be more compatible with productivity gains.

Regarding the capital factor, available indicators point to relatively stable capacity utilization level in the last 12 months. Nevertheless, the Copom highlights that, after four reductions, the GFCF grew, in the last quarter, 0.5% compared to the previous quarter, and the investment rate reached 18.1% of the GDP in 2012, considering the accumulated amount along four quarters. However, for the Committee, the effects of the recently implemented policy actions, the programs of public services concession – especially in infrastructure and logistic segments – and the gradual businessman's confidence recovery suggest intensification of investment in this and upcoming semesters.

The Copom evaluates that joint dynamics of the factor markets – regarding the output gap – tends to be slightly disinflationary, in the short run.

The Committee assesses that there are important mechanisms making the Brazilian inflation rigid downwards. The presence of regular and almost automatic mechanisms of price adjustment, either de jure and/or de facto, has contributed to the persistence of inflationary pressures coming from the past. It is well known by literature and international experience that the existence, even informally, of price indexation mechanisms reduces the sensitivity of inflation to demand conditions. Overall, by restraining the disinflation process, indexation mechanisms contribute to increasing the "starting point" of the inflation rate during economic slowdowns, thus raising the inflation risks for the prospective scenario and increasing the costs of disinflation.

Regarding fiscal policy, the Copom reaffirms that its prospective scenario for inflation is conditioned on the materialization of the trajectories regarding fiscal variables, even though recent initiatives point to an expansionary balance of public sector. The Copom notes that the generation of primary surpluses in line with the working hypotheses considered for inflation projections presented in the next section, in addition to contributing to reduce the mismatch between supply and demand growth rates, will strengthen the reduction trend of the public debt-to-GDP ratio and the positive perception regarding the macroeconomic environment in the medium and long terms. Therefore, its financing cost tends to decrease, with favorable implications for the cost of capital in general, which stimulates private investment in the medium and long run.

The Copom highlights the recently observed moderation in certain real and financial assets' prices that, if remained at actual levels, will be an important disinflationary force.

The Copom considers that a source of risk lies on the behavior of inflation expectations that, in the actual situation, tend to be negatively impacted not only by the level of inflation but also by the great dispersion of price increases. The Committee argues that, in a broad perspective, inflation perception is increasing. In part, this worsening in agents' sentiment is due to the price increases in segments with great visibility, such as food and fuels.

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

The Copom highlights that the main scenario envisages evidences of a downward shift of the natural interest rate in the last years. This is supported by the projection models of the Banco Central do Brasil and, also, by the dynamics of the bond yields – private and public – negotiated in domestic and external markets. Additionally, the Copom evaluates that, in the vast majority of cases, indicators identified in the literature as determinants of the decrease in the natural interest rate also point in the same direction.

The Copom understands that the Brazilian economy has experienced significant structural changes, which determined retreat in interest rates in general and, in particular, in the neutral rate. Supports this view, among other factors, the reduction of risk premia, a direct consequence of the accomplishment of the inflation target for the ninth consecutive year, of the macroeconomic stability and of institutional improvements. Moreover, the process of interest rates reduction was favored by changes in the structure of the financial and capital markets, by the credit market deepening, as well as by the generation of primary surpluses consistent with the maintenance of decreasing trend for the public debt-to-GDP ratio. For the Committee, all these changes are characterized by a high degree of persistence – although, due to the economic cycles themselves, specific and temporary reversions may occur – and contribute for the Brazilian economy's current solid indicators of solvency and liquidity.

The Copom also considers that the increase in the supply of external savings and the reduction of its funding cost have contributed to the reduction of the domestic interest rates, including the neutral rate, which, according to the Committee's assessment, are largely permanent developments.

The Copom evaluates that the greater dispersion of consumer price increases recently observed, seasonal pressures and pressures localized in the transportation segment, among other factors, contribute for inflation to show resistance. Although this unfavorable dynamics may not represent a temporary phenomenon, but a possible accommodation of inflation at a higher level, the Committee considers that remaining uncertainties – stemming from foreign and domestic fronts – surround the prospective scenario and recommend that monetary policy should be administered with caution.

In this context, considering macroeconomic outlook and the inflation prospects, the Copom unanimously decided to maintain the Selic target at 7.25% p.a., without bias, in the January and in the March meetings.

The following members of the Committee voted for the decision of maintaining the Selic rate at 7.25% p.a., in January and March: 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 and Sidnei Corrêa Marques.

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, businesses and governments, as well as in the deterioration of the businessman'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.

In light of the above, the Copom will track the evolution of the macroeconomic scenario until the next meeting, and then will define the following steps of the monetary policy strategy.

6.3 Inflation forecasts

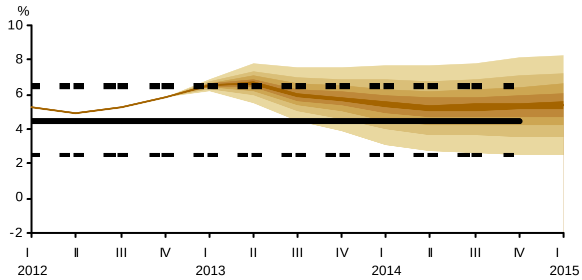
According to traditional procedures, and taking into account the available information up to the cutoff date of March 8, 2013, the baseline scenario assumes that the exchange rate remains unchanged over the forecast horizon at R$1.95/US$, and the target for the Selic rate stays at 7.25% p.a. – the level set by the March 2013 Copom meeting – against R$2.05/US$ and 7.25% p.a. considered in the December 2012 *Inflation Report*.

The market scenario, in turn, incorporates data from the expectations survey carried out by Gerin with a representative group of institutions up to the cutoff date. In this scenario, average exchange rate expectations decreased for 2013 and increased for 2014, compared to the values released in the December 2012 *Inflation Report*. For the last quarter of 2013, the average rate moved from R$2.08/US$ to R$2.00/US$. For the fourth quarter of 2014, market participants project an average exchange rate of R$2.05/US$, compared to R$2.02/US$ considered in the last *Report*. For the first quarter of 2015, market participants project an average exchange rate of R$2.07/US$.

In what regards the evolution of the average Selic rate, the expectations for 2013 and 2014 increased in comparison to the values presented in the last *Report*. For the last quarter of 2013, the expected average Selic rate moved

Figure 6.5 – Projected IPCA-inflation with interest rate constant at 7.25% 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 7.25% p.a.
(Baseline scenario)

Year	Q	Probability Interval 50%	30%	10%		30%	50%	Central projection
2013	1	6.4	6.5	6.5	6.6	6.6	6.7	6.5
2013	2	6.2	6.4	6.6	6.8	6.9	7.1	6.7
2013	3	5.3	5.6	5.9	6.1	6.3	6.6	6.0
2013	4	5.0	5.3	5.6	5.9	6.2	6.5	5.7
2014	1	4.5	4.9	5.2	5.6	5.9	6.3	5.4
2014	2	4.2	4.7	5.0	5.4	5.8	6.2	5.2
2014	3	4.2	4.6	5.1	5.5	5.9	6.3	5.3
2014	4	4.2	4.7	5.1	5.5	6.0	6.5	5.3
2015	1	4.2	4.7	5.2	5.6	6.1	6.6	5.4

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

from 7.25% p.a. to 7.79% p.a., and for the last quarter of 2014, from 8.29% p.a. to 8.33% p.a. For the first quarter of 2015, the expected average Selic rate is 8.29% p.a. This trajectory of the Selic rate is consistent with twelve-month pre-DI swap spreads of 109 basis points (b.p.) and of 119 b.p., with respect to the current target for the Selic rate (7.25% p.a.), in the fourth quarter of 2013 and 2014, respectively.

The projection for the change in the set of regulated and monitored prices, in both scenarios, is 2.7%, against to 2.4% considered in the last *Report*. This projection is based on the assumptions, for the accumulated over 2013, of 5.0% increase in prices of gasoline; price stability for bottled gas; -2.0% change in landline telephone rates; and decrease of around 15% in electricity rates, which takes into account the direct effects of the recently announced reductions in sector tariffs, as well as adjustments and ordinary tariff revisions programmed for this year. 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 projection for the change in the set of regulated and monitored prices in both scenarios is 4.5% in 2014 – the same value considered in the last *Report* – and in 2015.

With regard to fiscal policy, a primary surplus of R$155.9 billion in 2013 is considered as working hypothesis, following parameters included in the Budget Guidelines Law (LDO) – 2013. For 2014, a primary surplus of around 3.10% of GDP is considered as working hypothesis.

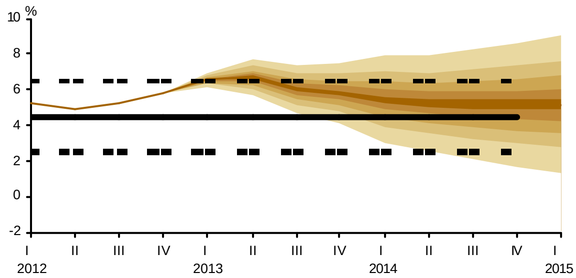
The projections presented in this *Report* incorporate the estimated reduction of the neutral interest rate registered in the last years, as well as the estimated impact of fiscal measures adopted by the government with the objective of reducing the cost of the food basket.

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

The central projection associated with the baseline scenario indicates inflation of 5.7% in 2013, 0.9 p.p. higher than the projection presented in the December 2012 *Report*. As can

Figure 6.6 – 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
2013 1	6.4	6.5	6.5	6.6	6.6	6.7	6.5
2013 2	6.3	6.4	6.6	6.8	6.9	7.1	6.7
2013 3	5.5	5.7	5.9	6.1	6.3	6.6	6.0
2013 4	5.1	5.4	5.7	5.9	6.2	6.5	5.8
2014 1	4.4	4.9	5.3	5.6	6.0	6.4	5.4
2014 2	4.2	4.6	5.0	5.5	5.9	6.3	5.3
2014 3	3.9	4.5	5.0	5.4	5.9	6.4	5.2
2014 4	3.7	4.3	4.9	5.4	6.0	6.6	5.1
2015 1	3.6	4.3	4.9	5.5	6.1	6.8	5.2

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

1/ According to Gerin.

Table 6.3 – December 2012 *Inflation Report* projections

Period	Baseline scenario	Market scenario
2012 IV	5.7	5.7
2013 I	5.7	5.7
2013 II	5.5	5.6
2013 III	4.9	4.9
2013 IV	4.8	4.9
2014 I	5.1	5.2
2014 II	5.1	5.1
2014 III	5.0	5.0
2014 IV	4.9	4.8

be seen in Figure 6.5, in the baseline scenario, the projection for twelve-month inflation ends 2013 above the central target level of 4.5% determined by the National Monetary Council (CMN). According to data shown in Table 6.1, the projection declines after the third quarter of 2013. Specifically, the projection starts at 6.5% in the first quarter of 2013, moves toward 6.7% in the second quarter, declining to 6.0% and 5.7% in the third and fourth quarters, respectively. The projection also declines along 2014, reaching 5.2% in the second quarter and stays around 5.3% and 5.4% from then on, until the end of the projection horizon.

Still in the baseline scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2013 stays in 25% and, in 2014, around 24%.

In the market scenario, the inflation projection for 2013 stays in 5.8%, 0.1 p.p. higher than the baseline scenario and 0.9 p.p. higher than value presented in the last *Report*. As it can be seen in Figure 6.6 and Table 6.2, as in the baseline scenario, the projection for twelve-month inflation declines after the third quarter of 2013 but it ends the year above the central target. Specifically, the projection starts at 6.5% in the first quarter of 2013, moves toward 6.7% in the second quarter, declining to 6.0% and 5.8% in the third and fourth quarters, respectively. In 2014, projection starts at 5.4% in the first quarter and moves to 5.1% in the last quarter of the year. In the first quarter of 2015, projection reaches 5.2%.

Still in the market scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2013 stays in 25% and, in 2014, around 26%.

The comparison of the trajectories shown 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 inflation projections for 2013 and 2014, reflecting inflation rates in recent months higher than the corresponding projections presented in the last *Report*. In the market scenario, the projections stay above values presented in the last *Report* in the entire forecast horizon, essentially due to the same reasons.

Figure 6.7 shows the path of the twelve-month inflation, according to the baseline and market scenarios, up to the first quarter of 2015, as well as the inflation target path. The figures are actual twelve-month inflation until February 2013 and, from then on, projections corresponding to the respective scenarios are used to compose the twelve-month

Figure 6.7 – Projections and target path for twelve-month acummulated inflation

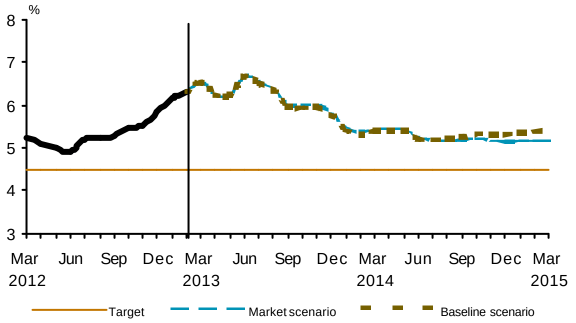
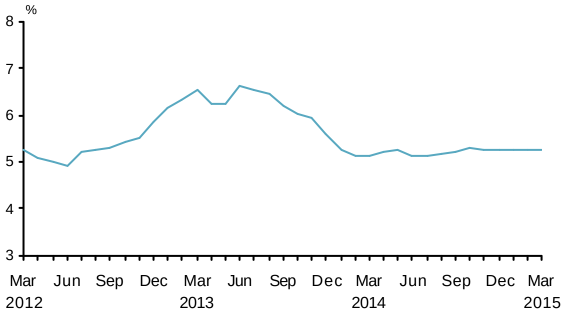


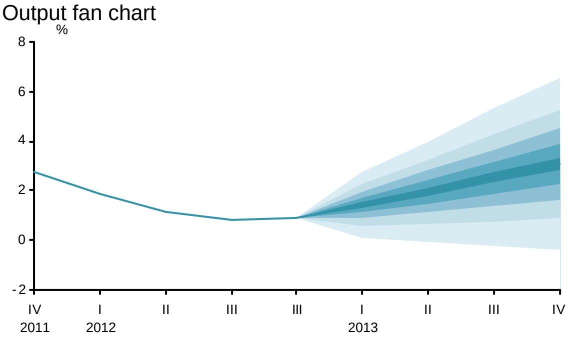
Figure 6.8 – Inflation forecast: VAR models



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

Figure 6.9 – Projected GDP growth with interest rate constant at 7.25% p.a. (baseline scenario)

Output fan chart



values. In both scenarios, projections indicate twelve-month inflation starting above the central target level, but showing a declining trend after the third quarter of 2013. Despite this decline, projections stay above the central target in 2014 and at the end of the forecast horizon, in both scenarios.

The average forecast generated by the Vector Autoregressive (VAR) models, for the twelve-month inflation, is presented in Figure 6.8. Up to February 2013, the values refer to actual twelve-month inflation and, from then on, to forecasts. According to these models, the inflation projection also presents a declining trend from July 2013 on and converges to the unconditional mean at the end of the forecast horizon.

Figure 6.9 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 of 3.1% for 2013, above the 0.9% growth rate observed in 2012. This projection considers a more intense pace in domestic economic activity in this year, consistent with investment recovery, and a growth trajectory more aligned with potential output growth.