6 Inflation outlook

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 September 2013. The chapter also presents the analysis of the inflation prospects up to the fourth quarter of 2015 and of the Gross Domestic Product (GDP) growth up to the third quarter of 2014. Inflation projections are presented in two major scenarios. The first scenario, called the baseline scenario, assumes that the Selic rate will remain unchanged at 10.00% per year over the forecasting horizon, the level set by Copom at its most recent meeting on November 26 and 27, and the exchange rate will remain at R$2.35 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 December 6, 2013.

The projections for inflation and for GDP growth released in this Report are not point estimates. They consist of probability intervals which embody the degree of uncertainty that was present at the above mentioned cutoff date. Inflation projections depend not only on assumptions about the interest and exchange rates, but also on a set of assumptions on the behavior of exogenous variables. The most likely set of assumptions considered by the Copom is used to build the scenarios to which the Committee attaches the greatest weight on making its interest rate decisions. On setting out these assumptions, the Copom seeks to foster transparency to the monetary policy, thereby contributing to the effectiveness of policy decisions in controlling inflation, which is its primary objective.

6.1 Inflation Determinants

The twelve-month inflation measured by the change in the Broad National Consumer Price Index (IPCA) reached 5.77% in November, 0.24 percentage points (p.p.) higher than the value recorded until November 2012. Inflation growth was due to the acceleration in market prices, which changed 7.31% in the twelve months to November (1.08 p.p. higher than the one recorded until November 2012), despite some moderation at the margin. During the same period, the administered and monitored prices recorded the lowest rate of change (0.95%) of the historical series started in 1994, 2.55 p.p. lower than the November 2012 rate. Within the set of market prices, the increase of non-tradable goods reached 8.29% in twelve months, and tradable goods amounted to 6.20%. Still on tradable goods, it is worth highlighting some weakening in food and beverage group prices, which increased 8.63% in twelve months (1.45 p.p. below the change until November 2012 and 5.37 p.p. lower than that reported by April 2013). Meanwhile, inflation in the service sector reached 8.55% in the twelve months to November (8.24% until November 2012), remaining higher than the variation of market prices. In summary, services inflation remains at high levels, and there are pressures, though descending, 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 shifted from 0.56% in October to 0.54% in November, reaching 6.22% in twelve months to November (5.37% to November 2012). The non-smoothed trimmed mean core changed from 0.52% in October to 0.55% in November; the exclusion core – which excludes ten items from the groups food at home and fuels – changed from 0.51% to 0.57%. Meanwhile, the smoothed trimmed mean core has declined from 0.58% to 0.45%; the double weighted core changed from 0.61% to 0.52%. The measure that excludes the prices of monitored goods and food at home remained at 0.60%.

The IPCA diffusion index reached 68.2% in November, higher than that of November 2012 (62.7%). The quarterly average reached 64.6% (1.4 p.p. lower than the average observed from September to November 2012).

Broader inflation – measured by the General Price Index (IGP-DI) – which is characterized by higher volatility when compared to consumer inflation, reached 0.28% in November, 0.35 p.p. lower than the October rate. Therefore, the index cumulates change of 5.49% in twelve months to November (7.22% up to November 2012). The major component of the IGP-DI, the IPA, changed 5.02% in the twelve months to November, due to the change of -0.90% in the agricultural sector and of 7.44% in the industrial sector. The IPC, the second most important component of the IGP-DI, changed 5.59% in the twelve months to November (5.89% up to November 2012). The INCC, the smallest weight component of the IGP-DI, increased 8.16% in twelve months (7.06% up to November 2012), due to the change of 9.92% in the labor cost and of 6.31% 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 3.3% in September, compared to the same month of 2012 (increase of 1.3% in August in the same basis of comparison). Therefore, the activity level in the first three quarters overcame the one recorded in the first three quarters of 2012 by 2.8%. The growth rate over the twelve months up to September reached 2.5%.

The Consumer Confidence Index (ICC), from FGV, increased in November, partially reversing the drop observed in October. According to seasonally adjusted data, this recovery was mainly due to better perception towards the future, given that the perception of the current situation remained relatively stable. The Industry Confidence Index, from FGV, showed a slight recovery in November, according to seasonally adjusted data. Similarly, the Commerce Confidence Index (ICOM), also from FGV, increased for the fourth consecutive month in November, but still stands 5.2% below the level in the same month of 2012. In turn, the Services Sector Confidence Index (ICS) showed the third consecutive decrease in November.

The industrial production increased 0.6% in October, after increasing 0.5% in September, according to the seasonally adjusted industrial production data of IBGE. The increase in production in October was widespread, in that there was positive growth in 21 out of the 27 surveyed activities. The overall production in October was 0.9% higher than October 2012, resulting in an accumulated growth in twelve months of 0.9%. The production of capital goods recorded the highest growth rate among the four categories of use (9.9% in twelve months), followed by the production of durable consumer goods (1.6%). On the other hand, there was a decrease in the production of semi and non-durable consumer goods (-0.1%) and intermediate goods (-0.2%). With regard to real revenue of the manufacturing industry, according to National Confederation of Industry (CNI) data, there was a 4.6% growth in the first ten months of the year, compared to the same period of the previous year, but the number of hours worked increased only 0.1%.

The seasonally adjusted Installed Capacity Utilization Level (Nuci) in the manufacturing sector, computed by FGV, reached 84.3% in November (90.4% in the materials for construction sector; 84.8% in the intermediate goods sector; 83.6% in the consumer goods sector; and 83.5% in the capital goods sector). According to CNI data, seasonally adjusted by the Central Bank, Nuci reached 82.0% in October. In turn, the level of inventories in the manufacturing sector, computed and seasonally adjusted by FGV, remained stable since last Report. In November, according to the seasonally adjusted data, 8.4% of the establishments had excessive inventories and 1.6% had insufficient inventories. Still regarding the Manufacturing Industry Conjuncture Survey, conducted by FGV, inventories remained at high levels in the capital goods and durable consumer goods sectors. At the same time, there was a strong reduction of inventories in the materials for construction sector in last three months.

Sales in the retail sector continue to rise, despite some moderation at the margin. For the restricted retail trade, the retail volume increased 4.1% in September 2013, compared to September 2012; while the broader retail trade expanded 7.5%. In the last twelve months up to September, the broader retail trade grew 4.9% in real terms – with expansion in all ten segments researched by IBGE – while the restricted retail trade grew 4.8%. In the next months, sales will continue to be influenced by government transfers, by payroll growth and by the moderate credit expansion.

The Brazilian economy contracted 0.5% in the third quarter of 2013, after increasing 1.8% in the previous quarter, according to seasonally adjusted IBGE data. Compared to the same quarter of 2012, growth reached 2.2% (3.3% in the second quarter). Therefore, the four-quarter growth rate of GDP reached 2.3%. In great part, the decline of the production of goods and services, in the third quarter, was due to the 3.5% decrease, in respect to previous quarter, of production in the agricultural sector, according to seasonally adjusted data. In turn, the industrial and the services sectors remained stable, with growth of 0.1% in both sectors.

From a demand side perspective, household consumption – the largest component of aggregate demand – raised 1.0% in third quarter of 2013, in comparison to previous quarter, according to seasonally adjusted data, and 2.3% compared to the same quarter of 2012. This was the fortieth consecutive increase in this basis of comparison. In turn, government consumption increased 1.2% relative to the previous quarter and 2.3% in respect to the same quarter of 2012. Additionally, the Gross Fixed Capital Formation (GFCF) decreased 2.2% at the margin, but increased 7.3% when compared to the same quarter of 2012. Thus, the four-quarter growth rate of GFCF reached 3.7%, with the investment rate of the economy at 18.3%. The foreign trade sector also contributed to the negative GDP growth rate in third quarter, with exports decreasing 1.4%, in comparison to previous quarter, and imports declining 0.1%.

The IBGE reported an estimate of the unemployment rate in October for six metropolitan areas covered by the Monthly Labor Survey (PME). According to this data, seasonally adjusted by the Central Bank, the unemployment rate moved from 5.4% in September to 5.3% in October – reaching the minimum of the historical series that started in 2002. It should be noted that the lower growth rate of the working-age population (PIA) in the recent years has contributed to keep the unemployment rates at historically lower levels. Thus, the labor supply, as measured by the Economically Active Population (PEA) across the six metropolitan areas covered by the PME survey, decreased 0.5% in twelve months up to October. In turn, the average real income rose 1.8% in October, compared to the same month of 2012, and real payroll, 1.4%. The evolution of real labor income has been considerably dispersed among regions, with significant annual increases in average real income in Porto Alegre (5.6%) and Rio de Janeiro (4.6%) and, at the same time, decreases in Recife (-2.5%) and Salvador (-5.5%). Formal employment shows a slowdown trend at the margin, albeit still in expansion. According to the data released by the Ministry of Labor and Employment (MTE), 682 thousand jobs were created between November 2012 and October 2013 (954 thousand jobs in the twelve months up to October 2012).

In addition to rising payrolls, credit availability – largely determined by macroeconomic stability, improvement in infrastructure and institutional reforms in recent years – was an important driving force behind growth of household consumption. Total credit to households reached R$1,214.9 billion in October, a 16.7% nominal growth relative to October 2012. In particular, housing loans, whose operations are mainly based on earmarked resources, grew by 34.5% in the same period, reaching R$326.4 billion, which corresponds to 6.9% of GDP. Delinquency rates have been showing some moderation, at the margin, at levels consistent with the phase of the cycle, given perspectives of gradual recovery of economic activity.

The volume of credit to corporations totaled R$1,395.1 billion in October (12.9% higher than in October 2012). The average interest rate of this segment reached 14.8%, 0.8 p.p. higher than the average rate observed in October 2012. In turn, loans and financing to corporations with resources provided by the National Bank of Economic and Social Development (BNDES) reached R$487.2 billion – an increase of 15.0% in twelve months up to October. Regarding the capital market, the volume of primary issues of shares registered in the Securities and Exchange Commission of Brazil (CVM) reached R$7.2 billion in the current year and R$10.3 billion in twelve months up to October 2013. In turn, debenture issues totaled R$65.7 billion and R$82.7 billion in the same periods, respectively, excluding the issuance of leasing companies. In total, firms financing from capital markets reached R$100.6 billion from January to October 2013, against R$98.3 billion observed in the same period of 2012.

With regard to the trade balance, the twelve-month result decreased to US$2.2 billion in November (US$21.0 billion in November 2012). This result stemmed from US$241.1 billion in exports and US$238.9 billion in imports, which represented variations of -1.6% and 6.7%, respectively, compared to the twelve-month period ended in November 2012. Considering the twelve months ended in October, the exported volume increased 1.8% and the average price of exports decreased 3.7%, while the imported volume increased 8.8% and the average price of imports diminished 1.5%.

The twelve-month current account deficit reached US$82.2 billion in October, equivalent to 3.7% of GDP. An important component of this deficit has been remittances of profits and dividends, which totaled US$24.8 billion in liquid terms. Another significant component of the deficit refers to expenses under the item called “operational leasing services” which are, in a great part, meant to oil and minerals exploitation, reaching US$18.8 billion in the twelve months up to October (US$18.6 billion in October 2012). It is also worth noting that imports of oil and derivatives reached US$42.0 billion in the same period (US$34.4 billion in October 2012). Note that foreign direct investments – which have been the main financing source of the balance of payments – totaled US$59.1 billion in the twelve months up to October, equivalent to 2.6% of GDP.

In international financial markets, since the release of the previous Report, moderation of volatility and risk aversion indicators was observed. At some extent, the prospect of continuation of accommodating policies in important mature economies in the medium run contributes to the reduction of volatility and risk aversion.

Regarding global activity, since the last Report, leading indicators point to a consolidating pace of growth in mature economies, particularly in the United States, and in emerging economies. It should be noted, however, that the global economy still faces more than usual uncertainty, with persistent fiscal imbalances, especially in the Euro area.

Brent oil prices, since the release of the previous Report, were volatile and decreased to a level close to US$110. The geopolitical complexity which surrounds the oil sector tends to boost the volatile behavior of prices, which also reflects the low predictability of some global demand components and the fact that the supply growth depends on highly risky long term maturity investments. Regarding other commodities, there was an increase of 1.7% in metal commodities prices and a decrease of 6.1% in agricultural prices. At the cutoff date of December 6, the price index based on twenty two commodities, published by the Commodity Research Bureau (CRB), decreased 2.5% against the value registered at the cutoff date of the previous Report.

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

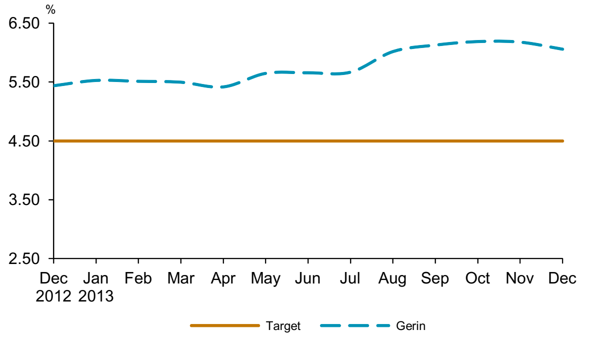
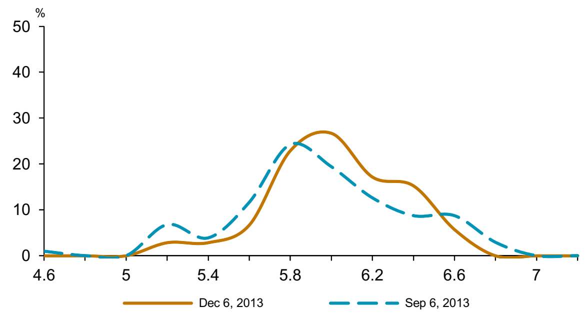


Figure 6.2 – Dispersion of inflation expectations for 2014

Relative frequency



The median of market expectations for the 2013 GDP growth rate was stable at 2.35% between September 6, the cutoff date of the previous Report, and December 6. For 2014, the projected growth rate decreased from 2.28% to 2.10%. During this period, the median expectation for inflation, measured by variation in IPCA, moved from 5.82% to 5.70% for 2013; from 5.85% to 5.92%, for 2014; and was maintained at the 5.50% level, for 2015. Twelve-month ahead inflation expectations moved from 6.13% to 6.04%, 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 2014, as illustrated in Figure 6.2. The standard deviation of these projections decreased from 0.41% to 0.31%.

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 of moderate global activity have remained unchanged for the short run. In fact, evidence still point to low and below potential growth rates in mature economies for this year. In the relevant horizon for monetary policy, however, prospects point to intensification in the pace of global activity. In international markets, there has been some accommodation in the prices of commodities, as well as more volatility and tendency of appreciation of the United States dollar. On the domestic side, the main scenario envisages a relatively stable pace of economic activity in the next year, when compared to 2013. It is worth noting that the pace of materialization of the expected gains depends on the strengthening of firms' and households' confidence. The labor market dynamics is also an important aspect of the domestic environment, as well as the natural and expected relative prices correction, due to the exchange rate depreciation and volatility observed in the last quarters, which constitutes a source of inflationary pressures in shorter horizons.

On the external front, despite the limited space for monetary policy and the scenario of fiscal restriction, the recovery prospects for mature economies are still supported by positive data about the level of activity, including for countries of the Euro area. In the United States, there are still positive signs from the real estate and, especially, from labor market, in an environment that combines moderate levels of inflation and recuperation in the pace of activity. Regarding risks for global activity, it is worth mentioning the ones derived from the strategy of withdrawing monetary incentives introduced by conventional and unconventional policy actions in the aftermath of the 2008 crisis by the Federal Reserve. In the Euro area, high unemployment rates, together with efforts for fiscal consolidation and political uncertainty, still translate into investment decrease and slow growth. In the relevant horizon, there is still risk to activity due to the skepticism regarding the soundness of the banking system in some economies in the area.

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 capital flows. In this sense, recent events – the improvement in the pace of global activity and the increased volatility in international financial markets – are opposing forces. The Committee also highlights the importance of the transmission through the expectations channel, which affects investment, in the case of entrepreneurs, and consumption, in the case of households. In this context, in main emerging market economies, despite the resilience of domestic demand, in general there has been lower than expected growth. However, recent indicators suggest the exhaustion of the process of accommodation of activity in these economies, and that growth rates tend to remain relatively high, but in lower levels than recorded in recent years, in the relevant horizon for monetary policy.

The Copom assesses that scenario of higher global growth, particularly of important trade partners of Brazil, combined with the depreciation of the Real, militates in making the dynamics of external demand more favorable to the growth of the Brazilian economy, in the relevant horizon.

The Copom considers that, since last Report, risks for global financial stability remained high, such as the ones derived from the ongoing deleveraging process in the main economic blocs and the steep interest curve in important mature economies. During this period, insurance prices against default (CDS) of banks and sovereigns of mature economies have remained in historically high levels, especially in the Euro area. Regarding emerging economies, in general, the implicit risk premia in financial assets remained in high levels. In the relevant horizon for monetary policy, the Committee assesses that financial markets volatility tends to react to the publication of new indicators and/or to signs of a starting (or imminent) process of normalization of monetary conditions in the United States by authorities. In the Euro Area, aspects that eventually may demand action from the European Central Bank as low levels of inflation and banking system evaluation have been focus of attention. In sum, despite identifying low probability of occurring extreme events in the international financial markets, the Committee assesses that the external environment remains complex.

In international markets, commodity prices have shown some accommodation, despite discrepancies between the price dynamics of the three great segments (energy, metal and agriculture). The twelve-month agricultural prices are declining and the energy ones are rising. It is worth noting that, since the last Report, both the Commodities Brazil Index (IC-Br), measured in United States dollars, and the CRB showed a slight decline. Specifically regarding oil prices, it is important to stress that their influence on domestic inflation does not materialize exclusively through the local price of gasoline, but also via the petrochemical production chain and the expectations channel of consumers and entrepreneurs.

The Copom 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, imports reduce the demand for domestic input, contributing to the weakening of cost pressures and, by consequence, of its eventual pass-through to consumer prices. In this respect, it is worth adding that factor cost pressures not offset by efficiency gains contribute to the reduction in the competitiveness of domestic firms in the goods international markets, in a global environment with historically high levels of spare capacity.

On the domestic side, following the strong growth observed during the second quarter of this year, economic activity decreased in the third quarter. Notwithstanding consumption growth and fall in investment, at the margin, the twelve-month change of these variables continues to support the view that a change in demand composition is occurring. Thus, consumption would continue to grow, but in a more moderate pace, while investments and net exports would boost. On the supply side, despite the decline in agricultural production and stabilization in industrial production, at the margin, the twelve-month variation of these variables also suggests that a change in supply composition is on the way. In this context, while more favorable prospects emerge for the industrial and agricultural competitiveness, the services sector tends to show some accommodation in the relevant horizon, with growth rates smaller than those observed in previous years.

The Copom evaluates that aggregate demand tends to remain relatively robust. On one side, household consumption tends to benefit from stimulus factors, such as income gains and moderate credit expansion. On the other, favorable financial conditions, public services concessions and rights to oil exploration, among others, generate good perspectives for investments. The Committee, however, observes that the fragile external scenario is still a factor that restrains aggregate demand, in spite of prospects of progress in the relevant horizon.

In terms of factor markets, the Copom assesses that an important source of risk to inflation comes from the labor market, which shows low idle capacity. The Committee reaffirms that a crucial aspect under these circumstances is the possibility of 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 a macroeconomic environment with price stability.

Still on the labor market, the Copom understands that there are risks, due to the presence of mechanisms in the Brazilian economy that favor the persistence of inflation, derived from the possibility that wage bargaining gives excessive weight to past inflation at the expense of future inflation. In this context, even though wage gains are near the levels consistent with estimates of productivity gains for the economy as a whole in the first semester, the Committee evaluates that the wage dynamics remains originating inflationary cost pressures. However, in the relevant horizon for the monetary policy, events that tend to contribute to lower the risks associated to the labor market are anticipated, such as lower projected raises in the minimum wage and in the public servants salaries. These developments tend to smooth the wage dynamics in general, with consequences to production costs, especially in labor intensive segments.

Regarding the capital factor, since the last Report, the capacity utilization level has remained stable and the IBGE has informed that investments decreased during the third quarter of 2013. Nonetheless, the twelve-month investment rate increased for the second consecutive quarter and reached 18.3% of the GDP. For the Committee, favorable financial conditions, the programs of public services concession – especially in infrastructure and logistic segments – and the rights to oil exploration in the pre-salt layer suggest intensification of investments in the upcoming semesters.

Regarding fiscal policy, the Copom reaffirms that its prospective scenario for inflation is conditioned on the materialization of the trajectories regarding fiscal variables. For the Committee, the generation of primary surpluses in line with the working hypotheses considered for inflation projections, on one hand, would contribute to reduce the mismatch between supply and demand growth rates; and, on the other hand, would contribute to create a positive perception regarding the macroeconomic environment in the medium and long terms. Accordingly, the fiscal indicator used in the inflation forecasts (the structural primary surplus) would, therefore, tend to maintain some stability, with fiscal impulses (the change in the structural primary surplus between two periods) being of negligible size. Regarding the impacts over aggregate demand, the Committee evaluates that the conditions are established for the public sector balance to shift to the neutrality zone in the relevant horizon for monetary policy.

The Copom considers that nowadays primary surpluses of large magnitudes are not so necessary as opposed to the time when the public sector solvency was a matter for concern. For the Committee, however, primary surpluses of magnitude close to the average levels registered in more recent years are necessary to maintain the public debt at a sustainable path. Given this condition, the Committee understands that the financing cost of the public debt would decrease, with favorable implications for the cost of capital in general that would stimulate private investment in the medium and long run.

The Copom appraises that exchange rate depreciation and volatility that occurred in the past quarters provide a natural and expected correction process in relative prices, i.e., of domestic prices relative to prices in the rest of the world. On the other hand, the realization of this process becomes more complex because administered prices, in part of non-tradable goods and services, are misaligned at low levels. The Committee believes that these movements in the domestic foreign exchange market are, to some extent, part of a global phenomenon and reflect perspectives of transition of the international financial markets towards normality in terms of liquidity and interest rates, among other dimensions. For the Committee, the aforementioned relative price adjustment process is a source of inflationary pressure in shorter terms. However, the secondary effects that result from it and that would come about in longer terms may and should be limited by the appropriate conduct of monetary policy.

The Copom considers that a source of the risk of inflation lies on the behavior of inflation expectations that were negatively impacted, in the last months, by the level of current inflation, by the dispersion of price increases and by uncertainties related to the path of prices in segments with great visibility, such as gasoline and some public services. In this regard, the Committee has acted to ensure that the high variation of price indexes observed in the last twelve months is perceived by economic agents as a short term process. In this case, the inflation persistence would tend to decrease, as well as its damages to the decision-making process on consumption and investment.

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

The Copom remembers that the transmission of monetary policy actions to inflation occurs with lags. In this process, several channels - for instance, demand, credit, exchange rate and expectations – are involved and not necessarily operate with the same intensity and in a simultaneous way. Additionally considering that, before reaching prices, monetary policy actions interfere in the consumption and investment decision-making process of households and firms, in any circumstance, there is some degree of uncertainty about the intensity of inflation reaction to policy actions. To the Committee, this uncertainty may increase – and it actually has increased - in an environment like the present one, in which financial markets volatility has been amplified by the steep interest rate curves in advanced economies, particularly in the United States. In the other hand, the Copom evaluates that the high change in the consumer price indexes in the past twelve months contributes for inflation to show resistance. In this context, the formal and informal indexation mechanisms and the economic agents' perception regarding the inflation dynamics are included. Considering the damage that the persistence of this process would cause to the consumption and investment decision-making process, it is necessary, according to the Committee's perspective, that this process be reverted with due promptness.

In this context and carrying on the adjustment process of the basic interest rate initiated this year in the April meeting, the Copom decided unanimously to increase the Selic rate to 9.50% p.a., without bias, in the October meeting; and to 10.00% p.a., without bias, in the November meeting.

The following members of the Committee voted for the decision of raising the Selic rate to 9.50% p.a. and to 10.00% p.a.: 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, which is ratified by the Brazilian experience, shows that high inflation rates generate distortions that lead to higher risks and depress investments. These distortions are manifested, for example, in shortening the planning horizons of households, businesses and governments, as well as in the deterioration of the businessmen's confidence. The

Committee also emphasizes that high inflation rates subtract the purchasing power of wages and transfers, with negative repercussions over households' confidence and consumption. Therefore, high inflation rates reduce the growth potential of the economy, as well as of jobs and income generation.

The Copom highlights that, in moments such as the current one, the monetary policy should remain especially vigilant, in order to minimize risks that high inflation rates, such as the ones observed in the last twelve months, persist in the relevant horizon for monetary policy. At the same time, the Committee considers that the transmission of the effects of monetary policy actions to inflation occurs with lags.

6.3 Inflation Forecasts

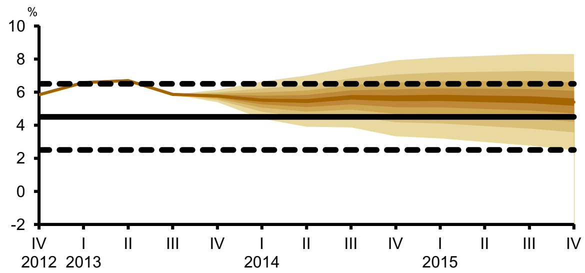
According to traditional procedures, and taking into account the available information up to the cutoff date of December 6, 2013, the baseline scenario assumes that the exchange rate remains unchanged over the forecast horizon at R$2.35/US$, and the target for the Selic rate stays at 10.00% p.a. – the level set by the November 2013 Copom meeting – against R$2.35/US$ and 9.00% p.a. considered in the September 2013 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 diminished for 2013 and remained stable for 2014, compared to the values released in the September 2013 Inflation Report. For the last quarter of 2013, the average rate moved from R$2.37/US$ to R$2.26/US$. For the fourth quarter of 2014, market participants project an average exchange rate of R$2.40/US$, the same value considered in the last Report. For the fourth quarter of 2015, market participants project an average exchange rate of R$2.43/US$.

Regarding 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 from 9.54% p.a. to 9.57% p.a., and for the last quarter of 2014, from 9.75% p.a. to 10.33% p.a. For the third quarter of 2015, the expected average Selic rate is 11.29% p.a. This trajectory of the Selic rate is consistent with twelve-month pre-DI swap spreads of 58 basis points (b.p.), of 34 b.p. and of 161 b.p., with respect to the current target for the Selic rate (10.00% p.a.), in the fourth quarter of 2013, 2014 and 2015, respectively.

Figure 6.3 – Projected IPCA-inflation with interest rate constant at 10.00% p.a. (Baseline scenario)

Inflation fan chart



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

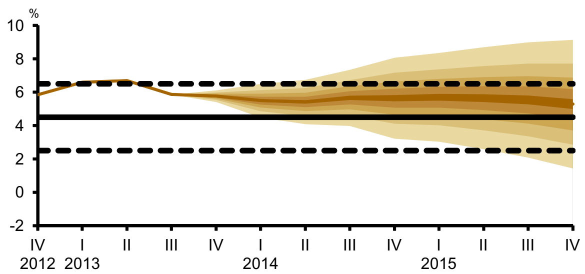
Table 6.1 – Projected IPCA-inflation with interest rate constant at 10.00% p.a.
(Baseline scenario)

Year	Q	Probability Interval 50%	30%	10%		30%	50%	Central projection
2013	4	5.6	5.7	5.7	5.8	5.9	5.9	5.8
2014	1	5.1	5.3	5.4	5.6	5.8	6.0	5.5
2014	2	4.8	5.1	5.3	5.6	5.8	6.1	5.5
2014	3	4.9	5.3	5.5	5.8	6.1	6.4	5.7
2014	4	4.7	5.1	5.5	5.8	6.2	6.6	5.6
2015	1	4.6	5.1	5.5	5.8	6.2	6.7	5.7
2015	2	4.5	5.0	5.4	5.8	6.2	6.7	5.6
2015	3	4.4	4.9	5.3	5.8	6.2	6.7	5.5
2015	4	4.2	4.7	5.2	5.6	6.1	6.6	5.4

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

Figure 6.4 – Projected IPCA-inflation with market interest and exchange rates expectations

Inflation fan chart



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

The projection for the change in the set of regulated and monitored prices, in both scenarios, is 1.3%, for 2013 and 4.5% for 2014, compared to 1.8% and 4.5% respectively, considered in the last Report. This projection is based on the assumptions, for the accumulated over 2013, of 5.4% increase in gasoline prices; 6.2% increase in prices of bottled gas; -0.9% change in landline telephone rates; and decrease of around 16% in electricity rates, which takes into account the direct effects of the announced reductions in sector tariffs, as well as adjustments and ordinary tariff revisions programmed for this year. For the accumulated for 2014, the projection considers stable prices for gasoline, bottled gas and landline telephone rates, as well as a 7.5% increase in electricity rates. Regarding items for which more information is available, price changes were estimated individually. For the remaining items, the projections are based on models of endogenous determination of regulated prices, which consider, among other variables, seasonal components, market price inflation and General Price Index (IGP) inflation. According to these models, the projected adjustment in the set of regulated and monitored prices in both scenarios is 4.5% in 2015, same values considered in the last Report.

The structural primary surplus that derives from the primary surplus trajectories for 2013 is considered as the fiscal indicator, according to the parameters set out in the Budget Guidelines Law (LDO)/2013; and, for 2014 and 2015, according to the parameters set out in the Budget Guidelines Law Project (PLDO)/2014. As highlighted in previous Reports, for a certain period of time, the fiscal impulse is equivalent to the change of structural surplus, compared to the previous period. Considering the estimated paths for effective and potential output, fiscal policy may be considered to be shifting to neutrality in the relevant horizon for monetary policy.

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 and exchange rate paths that characterize the baseline and market scenarios.

The central projection associated with the baseline scenario indicates inflation of 5.8% in 2013, same value presented in the September 2013 Report, above the central target level of 4.5% determined by the National Monetary Council (CMN). As can be seen in Figure 6.3 and in Table 6.1, the projection starts at 5.8% in the fourth quarter of 2013, decreases to 5.5% in the first and second quarters of 2014; shifts to 5.7% in the

Table 6.2 – Projected IPCA-inflation with market interest and exchange rates expectations [1/]

Year	Q	50%	30%	10%	10%	30%	50%	Central projection
2013	4	5.6	5.7	5.7	5.8	5.8	5.9	5.8
2014	1	5.1	5.3	5.4	5.6	5.7	5.9	5.5
2014	2	4.9	5.1	5.3	5.5	5.7	6.0	5.4
2014	3	5.0	5.3	5.5	5.8	6.1	6.4	5.7
2014	4	4.6	5.1	5.5	5.8	6.2	6.6	5.6
2015	1	4.6	5.1	5.5	5.9	6.3	6.8	5.7
2015	2	4.4	4.9	5.4	5.9	6.4	6.9	5.6
2015	3	4.1	4.7	5.3	5.8	6.4	7.0	5.5
2015	4	3.7	4.4	5.0	5.6	6.2	6.9	5.3

Probability Interval

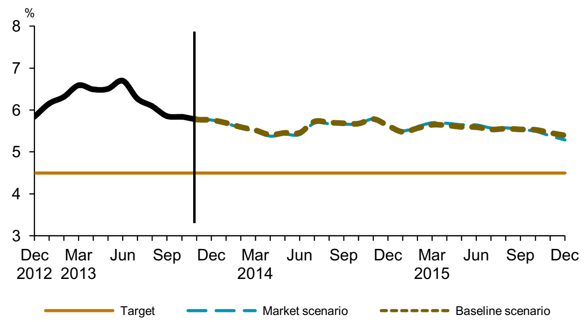
Note: accumulated inflation in 12 months (% p.a.).

1/ According to Gerin.

Table 6.3 – September 2013 Inflation Report projections

Period	Baseline scenario	Market scenario
2013 III	5.9	5.9
2013 IV	5.8	5.8
2014 I	5.8	5.8
2014 II	5.6	5.6
2014 III	5.8	5.8
2014 IV	5.7	5.7
2015 I	5.6	5.6
2015 II	5.6	5.5
2015 III	5.5	5.4

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



third quarter and ends the year at 5.6%. For the first quarter of 2015, the projection is 5.7%; and it decreases to 5.4% at 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 2014 stays around 27% and, in 2015, around 27%.

In the market scenario, the inflation projection for 2013 stays in 5.8%, same value presented in the last Report and in the baseline scenario. As it can be seen in Figure 6.4 and Table 6.2, the projection for twelve-month inflation, as in the baseline scenario, ends the year above the central target. Specifically, the projection starts at 5.8% in the fourth quarter of 2013, decreases to 5.5% and 5.4% in the first and second quarters of 2014, respectively; and ends the year at 5.6%. The projection is 5.7% in the first quarter of 2015; and decreases to 5.3% in the last quarter of 2015.

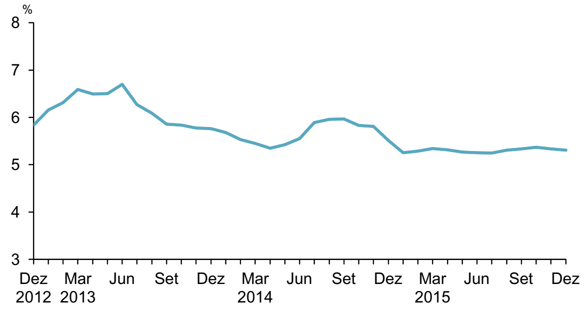
In the market scenario, the estimated probability that inflation will breach the upper tolerance level of the target in 2014 stays around 28% and, in 2015, around 30%.

The comparison of the trajectories presented in this Report with those released in the previous one – the latter shown in Table 6.3 –, in the baseline scenario, shows stability in the inflation projection for 2013 and a decrease in the projection for 2014. This decrease is partly due to the increase in the Selic rate considered in this scenario and to the pace of domestic activity – less intense than the one considered in the last Report. In the market scenario, the projection for the end of 2013 is also stable, and the projection for the end of 2014 decreases.

Figure 6.5 shows the path of the twelve-month inflation, according to the baseline and the market scenarios, up to the fourth quarter of 2015, as well as the inflation target path. The figures are actual twelve-month inflation until November 2013 and, from then on, projections corresponding to the respective scenarios are used to compose the twelve-month values. In both scenarios, projections indicate twelve-month inflation starting above the central target level, with a light declining trend and location above the central target 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 6.6. Up to November 2013, the values refer to actual twelve-month inflation and, from then on, to forecasts. According to these models, the inflation projection presents

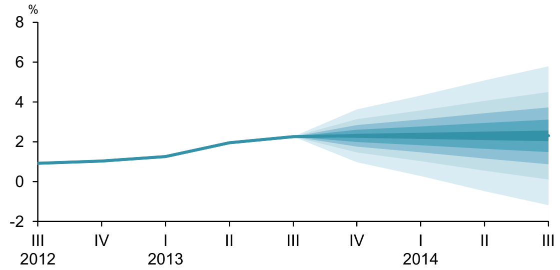
Figure 6.6 – Inflation forecast: VAR models



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

Figure 6.7 – Projected GDP growth with interest rate constant at 10.00% p.a. (Baseline scenario)

Output fan chart



a path with declining trend from December 2013, partly reverted in mid-2014 and converging to the unconditional mean at the end of the forecast horizon.

Figure 6.7 illustrates the output growth fan chart built under baseline scenario assumptions. Considering that the GDP growth projection process uses two variables that are not directly observable – potential output and output gap –, the forecast errors associated with these projections are considerably higher than the errors related to inflation projections. According to this scenario, the projected four-quarter GDP growth is 2.3% in 2013 (0.2 p.p. lower than the estimate considered in the previous Report), and 2.3% in the four-quarter rate up to the third quarter of 2014.