Executive summary

The global economic recovery over 2021 should be more robust, reflecting the new fiscal stimuli in some developed countries and the progress in the implementation of Covid-19 immunization programs. The communication of several central banks indicates that the monetary stimulus will be long-lasting, in a scenario of global economic slack. However, some markets show an increased volatility in an environment of greater inflationary risk in major economies. This repricing of important financial assets could result in a more challenging environment for emerging economies.

Regarding the domestic economic activity, the recent evolution of indicators, particularly the 2020Q4 GDP release, corroborates the scenario of a consistent economic recovery despite the unwinding of the emergency transfer programs. Higher frequency information suggests that the upward movement probably continued in January and February. However, these data do not capture the effects of the sharp and recent increase in the number of Covid-19 cases. Uncertainty about economic growth remains high, especially for the first and second quarters of this year. A possible setback in economic activity due to the worsening of the pandemic tends to be less extreme than in 2020 and would likely be followed by a fast recovery, especially in the second half of 2021, as the effects of vaccination are felt more broadly.

The central projection for GDP growth in 2021, still under above-usual uncertainty about the pace of economic growth, was revised to 3.6% from 3.8% in the previous Report. It should be emphasized that this prospect is conditioned to the continuity of the process of reforms and necessary adjustments in the Brazilian economy, an essential condition to allow a sustainable economic recovery.

Consumer inflation was higher than expected in the quarter ended in February, mainly explained by the increase in commodity prices in local currency, especially through its effects on fuel prices. Additionally, the various measures of underlying inflation are in levels above the range compatible with meeting the inflation target.

Inflation expectations for 2021, 2022, and 2023 collected by the Focus survey are around 4.6%, 3.5%, and 3.25%, respectively.

Copom's conditional projections for inflation in the baseline scenario stand around 5.0% for 2021 and 3.5% for 2022, with the interest rate path extracted from the Focus survey and the exchange rate starting from R$5.70/US$ and evolving according to the purchasing power parity (PPP). This scenario assumes a path for the Selic rate that ends 2021 at 4.50% p.a. and rises to 5.50% p.a. in 2022.

The projections presented use data available up to the 237th Meeting of the Monetary Policy Committee (Copom), held on March 16-17, 2021. As for the conditioning information used in the projections, especially those from the Focus survey carried out by the Banco Central do Brasil (BCB), the cut-off date is 3/12/2021, unless otherwise stated.

In its most recent meeting (237th meeting), the Copom unanimously decided to increase the Selic rate by 0.75 percentage point (p.p.) to 2.75% 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 it is consistent with convergence of inflation to its target over the relevant horizon for monetary policy, which includes 2021 and, mainly, 2022.

At the time, the Committee communicated that its baseline scenario for inflation encompasses risk factors in both directions. On the one hand, the worsening of the pandemic may delay the economic recovery, producing a lower-than-expected prospective inflation trajectory. On the other hand, an extension of fiscal policy responses to the pandemic that aggravates the fiscal path or a frustration with the continuation of the reform agenda may increase the risk premium. The relative increase in the risks of these events implies an upward asymmetry to the balance of risks, *i.e.*, in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy.

The Committee believes that persevering in the process of reforms and necessary adjustments in the Brazilian economy is essential for a sustainable economic recovery. The Copom also stresses that uncertainty regarding the continuation of the reform agenda and permanent changes to the fiscal consolidation process could result in an increase in the structural interest rate.

The Copom members consider that the current conditions ceased to prescribe an extraordinary stimulus. GDP ended 2020 growing strongly at the margin, recovering most of its first half-year decline, and inflation expectations rose above target at the relevant horizon for monetary policy. Additionally, inflation projections increased to levels close to the upper bound of the target for 2021.

Therefore, the Copom decided to start a process of partial normalization by reducing the extraordinary degree of monetary stimulus. For all the aforementioned reasons, the Committee considered appropriate an adjustment of 0.75 p.p. in the Selic rate. In the Committee's evaluation, a swifter adjustment has the benefit of reducing the probability of not meeting the inflation target in 2021, as well as of keeping longer horizon expectations well anchored. Additionally, the broad set of information available to the Committee suggests that this strategy is consistent with meeting the 2022 inflation target, even if social distancing increases temporarily.

For the next meeting, unless there is a significant change in inflation projections or in the balance of risks, the Committee foresees the continuation of the partial normalization process with another adjustment, of the same magnitude, in the degree of monetary stimulus. The Copom emphasizes that its view for the next meeting will continue to depend on the evolution of economic activity, the balance of risks, and inflation projections and expectations.