*U.S. monetary policy and Brazil's current account deficit will condition what happens next year.*

AS THE YEAR NEARS ITS END, analyst perceptions that space is limited for unexpected changes to economic policy in the short term are solidifying. Attention is therefore turning to what can be expected in the 2014 election year, given the legacy of the current year and the external outlook. Here, uncertainties abound.

Inflation will continue to push at the ceiling of the inflation target (6.5%) even if there are no adjustments of some controlled prices, such as that for gas, that presently lag behind international prices. The legacy of fiscal policy also does not support optimism about 2014, given the modest pace of economic activity—and thus tax revenue—and the continuing difficulties (notably political) in containing growing public spending.

And there are obvious complicating factors. The fact that inflation is so close to its target ceiling leaves little room for the authorities to maneuver. Any adverse shock to prices could easily push inflation for the year beyond 6.5%. In the current economic situation, how the exchange rate will behave is also a major concern, especially considering two major potential problems.

The first has to do with the recent worsening of the perception of how risky it is to invest in Brazil. The recent depreciation of the real exchange rate can be partly attributed to that heightened country risk, because international investors are reacting badly to the worsening of the country's fiscal results: Needless to say, its high gross public debt makes Brazil's economy more vulnerable., There is also growing concern about the balance of payments, since the current account deficit has risen to 3.6% of GDP and there are no clear signs that the situation will improve. Correction of this imbalance will require additional depreciation and a substantial decrease in the oil imports deficit, which today accounts for over 1% of GDP. Any worsening of expected external financing of the current account deficit could push the exchange rate down further and push domestic inflation up.

The second problem has to do with how the United States is managing its monetary policy. Since last May, the long-term interest rate in the U.S. has increased considerably, while the dollar has strengthened significantly in international markets.

Thus, there are significant uncertainties about the external outlook in 2014, and in particular it is not possible to rule out further appreciation of the dollar. As a general rule, when this happens the Brazilian currency depreciates against the dollar. With little room to accommodate economic shocks, depending on the intensity of that depreciation the resulting inflationary pressure may become an important issue in the presidential election campaign.