Executive summary

The outlook for the global economy continues to indicate low economic growth for a prolonged period of time. In the United States, despite the recent signs of recovery in the real estate market, the risk associated to fiscal restraint, sluggish labor market, and the European crisis, continues to affect the pace of economic activity. In the Euro Area, although recent initiatives have contributed to reduce the likelihood of tail events in the international financial markets, political uncertainties and skepticism about the soundness of the banking system in some countries persist, sustaining an unfavorable outlook for activity. In this context, narrow room for the use of counter cyclical policies, weak labor market, wealth destruction and a still restrictive credit market, all point to a scenario of low economic growth in mature economies.

Growth expectations for emerging market economies still point to a moderate pace of activity in Latin American and Asia, partly echoing the low growth rates in developed economies. In some cases, changes have been observed in growth patterns – towards less concentration in exports – which tend to be permanent. It should also be noted that the outlook for the Chinese and Indian economies seems to be more challenging than anticipated. In this context, despite the resilient domestic demand in emerging economies, activity has been expanding at a moderate pace.

In general, international commodity prices have increased since the release of the last Inflation Report. In the specific case of agricultural commodities, this upward price trajectory was mostly due to adverse supply shocks, whose effects may be heightened by the recent unconventional monetary policy measures. On the other hand, upward pressures on commodity prices tend to be contained by a more moderate growth in China and by the weakness of the world economy. Moreover, it is plausible to anticipate a reversal, albeit partial, of these supply shocks. Thus, the baseline scenario envisages a somewhat benign momentum for food prices in the medium term, although price instability of perishable foodstuffs and grains represents a risk factor.

The economic recovery in Brazil has been gradual, although the pace of activity tends to gain momentum in the second-half of 2012 and in 2013, though with asymmetries across different sectors. On one hand, external developments affect the Brazilian economy through business confidence, foreign trade and investment flows, among other channels. On the other, the baseline scenario takes into account the effects of easing financial conditions, particularly on household consumption and investments. In this regard, it should be noted the importance of monetary policy measures carried out since August 2011, whose effects on activity and inflation are lagged and cumulative.

The recent expansion of the credit market has been moderate for operations involving both individuals and corporations. Regarding fiscal policy, recent measures point to a shift in the balance of the public sector from neutral to slightly expansionary. The Copom evaluates that the generation of primary surpluses consistent with the hypotheses underlying the inflation forecasts should contribute to consolidate the downward public debt trajectory. As a result, the public sector debt burden tends to decrease, thus positively affecting the cost of capital and stimulating private investments in the medium and long run. The Copom emphasizes that its prospective scenario for inflation depends on the materialization of the trajectories assumed for the fiscal variables.

Regarding the current account, the cumulative 12-month deficit reached US$52.0 billion in July, equivalent to 2.2% of GDP. An important component of this deficit has been the remittance of profits and dividends, totaling US$29.3 billion. It should be noted that foreign direct investments continue to be the major source of the balance of payments financing, amounting to US$66.3 billion in the 12-month period up to July, equivalent to 2.8% of GDP.

As for inflation, the 12-month IPCA closed at 5.24% in August, 1.98 percentage point (p.p.) lower than the rate recorded in August 2011. Market prices increased 5.75% in the 12-month period up to August (down 2.11 p.p. against August 2011 inflation), while regulated prices rose 3.77% (down 1.94 p.p.). The trajectory of market prices was impacted by the 8.86% price increase observed in the group of food and beverages – partly due to domestic and foreign weather conditions.

The Copom reaffirms its view that the 12-month inflation, which started to retreat in the last quarter of 2011, tends to move non-linearly towards the inflation target.

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of September 6, 2012, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R$2.05/US$ and target for the Selic interest rate at 7.50% p.a. – projects inflation of 5.2% in 2012, 4.9% in 2013 and 5.1% in the third quarter of 2014. In the market scenario – which uses data from the expectations survey undertaken by Banco Central's Investor Relations and Special Studies Department (Gerin) with a significant group of institutions – the projections indicate inflation of 5.2% in 2012, 4.8% in 2013 and 5.0% in the third quarter of 2014.

With reference to the balance of risks, the Copom assesses that the bias from the international scenario is inflationary in the short run and disinflationary in the medium run. For the Committee, since the last *Report*, domestic developments on the whole indicate a neutral balance of risks for the relevant horizon.

Regarding the transmission of monetary policy, the Copom highlights that the central scenario takes into account evidence pointing to a fall in the neutral interest rate over the last years. This consideration finds support in the Banco Central's projection models and in the behavior of the returns on public and private bonds traded in domestic and international capital markets. Additionally, the Committee evaluates that, in most cases, the variables mentioned by the literature as determinants of the decline in the neutral rate also support the above evidence.

In light of the above and considering the cumulative and lagged effects of policy actions implemented so far, which in part are reflected in the ongoing recovery of the economic activity, the Copom understands that if the prospective scenario justifies an additional adjustment in monetary conditions, this movement should be conducted with maximum parsimony.

According to the baseline scenario, the 4-quarter GDP growth rate projected for 2012 is 1.6% (0.9 p.p. lower that the estimate considered in the previous *Inflation Report*). The 4-quarter GDP growth rate projected for the second quarter of 2013 is 3.3%.