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Inflation Report

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BANCO CENTRAL DO BRASIL

Executive summary

In the external environment, the Copom evaluates that the risks to the global financial stability remained high since the release of the previous Inflation Report, in particular, those derived from the changes in the slope of the yield curve of relevant mature economies. The Committee considers that, in the relevant horizon for monetary policy, risk aversion and financial markets volatility tend to react to the release of new indicators and/or to the signaling made by authorities that indicate the beginning or strengthening of the restoration process of monetary conditions in great economic blocs, in particular, in the United States. Despite identifying a low probability of extreme events, the Committee considers that the environment in the international financial markets remains complex.

Still regarding the external environment, in general, the prospects for more intense global activity in the relevant horizon for monetary policy have remained unchanged, despite evidences still pointing to low and/or below potential growth rates in some mature economies for this year. It is also worth noting that prospects, on the one hand, indicate moderate dynamics of commodity prices in international markets – despite local pressures in prices at the margin –, on the other hand, envisage volatility spots in exchange markets.

The Copom evaluates that the scenario of higher global growth, combined with the depreciation of the Brazilian real, contributes to make the dynamics of external demand more favorable to the growth of the Brazilian economy.

In the domestic environment, the Copom highlights that the main scenario envisages less strong pace of domestic activity in 2014, compared to 2013. In the medium-term, the Committee evaluates that important changes may occur in the composition of aggregate demand and supply. In this context, considering the 12-month change, the Copom acknowledges that the growth rates of domestic absorption have been bigger than the growth rates of the Gross Domestic Product (GDP), but both rates are converging. Notwithstanding being aware that high frequency data may eventually indicate different direction, the Committee argues that consumption tends to keep expanding – at a more moderate pace than observed in recent years – and that investments and exports tend to gain momentum.

The Committee highlights, however, that the pace of occurrence of previously mentioned changes, as well as the consequent gains, depend on the strengthening of firms and households' confidence.

The Copom notes that the recent performance of the credit market moves in line with the monetary conditions and the cyclical position of the economy. The total credit portfolio of the financial system increased at a moderate pace in the quarter ended in May relatively to the one ended in February, with a higher share of earmarked credit operations. In the segment of nonearmarked credit operations, stand out operations for non-financial corporations and, in the segment of earmarked operations, stand out operations for households, in particular, real state and rural credit. Interest rates rose in the quarter, especially for nonearmarked operations directed to households. At the same time, nonperforming loans did not show relevant changes.

The primary surplus generated by the public sector in the first four months of 2014 was consistent with the target of 1.9% of GDP set for the year.

The twelve-month current account deficit reached 3.65% of the GDP in May 2014, the same level since August 2013, and was essentially financed by net inflows of foreign direct investment. The net expenditures of services and income tend to remain at current levels, and, under a scenario of recovery of the global economic activity and of the domestic oil production, the outlook suggests improved trade balance throughout the year.

The inflation measured by the twelve-month accumulated Broad National Consumer Price Index (IPCA) reached 6.37% in May, 0.13 percentage points (p.p.) lower than the rate recorded until May 2013. The twelve-month accumulated inflation decrease reflects the lower variation in market prices, 7.07% (compared with 8.11% until May 2013), once the regulated prices increased 4.08% (compared with 1.54% until May 2013). Headline Inflation persistence partially reflects the price dynamics in the services sector – around one third of the consumption basket of IPCA – that reached 8.70% (compared to 8.51% until May 2013).

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of June 6, 2014, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R$2.25/US$ and target for the Selic interest rate at 11.00% p.a. – projects inflation of 6.4% in 2014, 5.7% in 2015 and 5.1% in the second quarter of 2016.

In the market scenario – which uses consolidated information 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 6.4% in 2014, 6.0% in 2015 and 5.0% in the second quarter of 2016.

Regarding GDP growth, the projection for 2014, according to the baseline scenario, is 1.6% (0.4 p.p. lower than the estimate considered in the previous Inflation Report) and 1.8% in the 4-quarter rate up to the first quarter of 2015.

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, firms 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. Hence, high inflation rates reduce the growth potential of the economy, as well as of jobs and income generation.

The Copom evaluates the current inflation pressures at place – as the one from the regulated price adjustment relative to market prices; from the domestic price adjustment relative to international prices; and from wage increases not compatible with productivity gains – tend to decrease or even to vanish through the time horizon relevant for the monetary policy. In the short run, the shift of the output gap towards the disinflationary field is also relevant. Even tough, the Committee considers a scenario in which inflation remains persistent over next quarters but, kept monetary conditions unchanged, tends to converge to the target in the last quarters of the forecast horizon.

The Committee further highlights that, in moments such as the current one, the monetary policy should remain 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 the monetary policy.