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Inflation Report

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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. However, 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. Other potential sources of disturbances are geopolitical events. Thus it is expected that eventual increases in volatility and risk aversion in international markets are transmitted, at least partially, to domestic assets.

Still regarding the external environment, the prospects for more intense global activity in the relevant horizon for monetary policy have remained unchanged since the release of the previous Report. In this regard, note that evidence still point to heterogeneous growth rates in mature economies, in some cases low and below potential growth rates. In international markets, prospects point to moderation in the dynamics of commodities prices, as well as to tension and volatility spots in exchange markets.

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

In the domestic environment, the Copom acknowledges that the growth rate of domestic absorption is aligned with the growth rate of the Gross Domestic Product (GDP), and that the pace of domestic activity expansion tends to be less intense this year, when compared to 2013. In the medium-term, the Committee evaluates that important changes may occur in the composition of aggregate supply and aggregate demand. The aggregate consumption tends to keep expanding – at a more moderate pace than observed in recent years – and that investments and exports tend to gain momentum.

These changes, among others, anticipate a growth composition in the medium term more favorable to the long term growth (potential growth). Nonetheless, the Committee highlights 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 credit market follows a trend of moderate expansion in line with the cyclical position of the economy. It is important to highlight that, after years of strong expansion – slowed down by the introduction of macroprudential measures in the end of 2010 – the credit market aimed to consumption showed moderation, leading, in the last quarters, on the one hand, to lesser exposure of banks and, on the other hand, to household deleveraging.

The primary surplus generated by the public sector in the first seven months of 2014 diminished when compared to the same period of 2013, partly due to the moderation in the pace of economic activity and tax breaks.

The current account deficit reached US$54.8 billion in the first eight months of 2014. Comparing to the same period of 2013, the observed deficit reduced by 5.0%, especially due to the better trade balance performance and to the lower income transferred. By considering the same period, the foreign inflow via direct investment, stocks, international bonds and loans, and local bonds summed up US$91.2 billion (US$61.5 billion in the same period of 2013).

The inflation measured by the twelve-month accumulated Broad National Consumer Price Index (IPCA) reached 6.51% in August, 0.42 p.p. higher than the rate recorded until August 2013. On the one hand, market prices slightly decelerated, from 7.64% (twelve-month accumulated in August 2013) to 6.95% (twelve-month accumulated in August 2014). On the other hand, the regulated prices significantly accelerated from 1.27% (twelve-month accumulated in August 2013) to 5.07% (twelve-month accumulated in August 2014).

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of September 5, 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 6.3% in 2014, 5.8% in 2015 and 5.0% in the third 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 6.3% in 2014, 6.1% in 2015 and 5.2% in the third quarter of 2016.

Regarding GDP growth, the projection for 2014, according to the baseline scenario, is 0.7% (0.9 p.p. higher/lower than the estimate considered in the previous Inflation Report) and 1.2% in the 4-quarter rate up to the second 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.

Despite inflation has still been high, the Copom evaluates the current inflation pressures at place – as the ones from wage increases not compatible with productivity gains; from the domestic price adjustment relative to international prices; and from the regulated price adjustment relative to market prices – 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. In this context, the Committee reassures its view that kept monetary conditions unchanged – that is, considering a strategy with no reduction in the monetary policy instrument – inflation 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.