

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 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.

Since last Report, despite the heterogeneity of the distribution among the great economic blocs, prospects of increased global activity in the relevant horizon for the monetary policy persist.

In international markets, prospects point to moderation in the dynamics of commodities prices, as well as to tension and volatility spots in exchange markets.

Still in the external environment, the Copom evaluates that it is natural to expect that eventual increases in volatility and risk aversion in international markets are transmitted, even in part, to domestic assets.

In the domestic environment, there has been moderate recovery of economic activity in the third quarter of 2014, with a 0.1% Gross Domestic Product (GDP) growth with respect to the second quarter, according to seasonally adjusted data released by IBGE. On the supply side, the growth rate was positive in the industrial (1.7%) and services (0.5%) sector; and negative to agriculture (1.9%). From the demand side, it is worth stressing the growth of investments (1.3%) and the contraction of private consumption (0.3%).

The Copom argues that growth rates of domestic absorption and of GDP are aligned and that the pace of expansion of domestic activity will be less intense this year, compared to 2013. However, in the view of the Committee, the economy tends to enter a recovery path in the second semester of 2015.

In this regard, it notes that the scenario of global growth in the relevant horizon, 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.

Still regarding activity, in the medium-term the Copom evaluates that important changes may occur in the composition of aggregate supply and aggregate demand. For example, aggregate consumption tends to expand at a moderate pace and investments tend to gain momentum. These changes, among others, anticipate a growth composition in the medium term more favorable to potential growth.

The Copom highlights that the central scenario envisages moderate expansion of credit. In this regard, note 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. Still on the credit Market, the Committee considers timely initiatives towards moderating concessions of subsidies through credit operations. It also gives high probability that actions in this direction are implemented in the relevant horizon for monetary policy.

Regarding public accounts, moderation in economic growth and the adoption of incentive measures to specific sectors have had significant impact on tax collection this year. This fact, associated with the growth of some expenses in higher levels than initially accrued, in particular current and capital expenses, were decisive to make the consolidated public sector reach primary deficit of R\$11.6 billion in the ten first months of 2014.

Current account deficit totaled US\$80 billion in the first eleven months of the year, 10.4% higher than the same period of 2013. The trade balance deficit and the increase in remittance of profits have especially contributed to this result. The current account deficit funding conditions remain comfortable. In this sense, note that direct investment – the most significant capital inflows modality – reached US\$55.8 billion up to November. Prospectively, higher global growth, the Brazilian real depreciation and the increase of the domestic production of oil should contribute to reverse the trade balance deficit; and foreign direct investment flows tend to continue to be the most important funding source of the current account deficit.

The inflation measured by the twelve-month accumulated Broad National Consumer Price Index (IPCA) reached 6.56% in November, 0.78 p.p. higher than the rate recorded until November 2013. On the one hand, there was a slight moderation of market prices, which accumulated variation of 6.76% in twelve months (7.31% up to November 2013); on the other hand, the regulated prices significantly accelerated, increasing 5.83% (0.95% up to November 2013).

Regarding inflation projections, following the usual procedures and taking into account the information set available up to the cutoff date of December 5, 2014, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R\$2.55/US\$ and target for the Selic interest rate at 11.75% p.a. – projects inflation of 6.4% in 2014, 6.1% in 2015 and 5.0% in 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 4.9% in 2016.

Regarding GDP growth, the projection for 2014, according to the baseline scenario, is 0.2% (0.5 p.p. lower than the estimate considered in the previous Inflation Report) and 0.6% in the 4-quarter rate up to the September 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.

For the Copom, the fact that inflation currently stands in high levels reflect, in part, the occurrence of two important relative price adjustment processes in the economy – the domestic price adjustment relative to international prices and the regulated price adjustment relative to market prices.

The Copom evaluates that the recent intensification of these relative price adjustments, combined with wage cost

pressures and fiscal stimulus evidences in the composition of aggregate demand has turned the inflation risk balance less favorable, among other factors. In this context, the Committee does not discard increase of inflation in the short run and anticipates that inflation tends to remain high in 2015, but, on the other hand, anticipates that still in the next year inflation enters a long declining path.

The Copom highlights that, in moments such as the current one, the monetary policy must remain especially 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 monetary policy. In this sense, the Committee will do whatever it is needed to put inflation in a long declining path, which will take it to the target of 4.5% in 2016.