Executive summary

In the international environment, the Copom considers that, in the relevant horizon, the global growth scenario is moderate, with the depreciation of the Real against important trade partners' currencies making external demand more favorable to Brazilian economic growth.

Global activity has shown a trend for greater moderation through the relevant horizon for monetary policy. In this regard, evidence points to minor growth rates, below to the potential growth in mature economies. It also should be highlighted the continuous worries about Chinese economy and its consequences in other economies, summed up to the uncertainties about United States economy perspectives and to political movements implications in mature economies, with increase in risk aversion and adverse impact on financial assets. In international markets, prospects point to the moderation in the dynamics of commodities prices, despite its increase in the recent period. Regarding risks, the Committee considers that the external environment is still a challenge.

In the internal environment, the Copom reinforces that the growth rates of domestic absorption and of the GDP are still negative due to various uncertainties. Investment is retracting due to these uncertainties, and private consumption is retracting in line with credit, employment and income data. However, for the Committee, to the extent that the confidence of firms and households strengthen, the pace of activity tends to recover.

Still regarding internal activity, the Copom assesses that, in the medium-term, important changes should occur in the composition of the aggregate demand and supply. Consumption tends to grow at a moderate pace and the investments tend to gain momentum. In the Committee's view, these changes, summed up to other changes at place, anticipate a composition of the aggregate demand growth in the medium run that is more favorable to the potential growth. Committee highlights, however, that the pace and the gains of these changes depend, chiefly, on the implementation of structural fiscal measures that strengthen the perception of public sector balance sustainability, besides on the reduction of the uncertainties from domestic and international environments. It should be highlighted the importance of stabilizing and, later, reducing public debt to GDP, a crucial measure to reinforce the positive perspective about economic environment, to increase agents' confidence and to contribute to anchor inflation expectations.

Regarding the supply side, the Committe evaluates that, in longer horizons, more favorable perspectives to industrial and agricultural productivity will arise. Services sector tends to grow at a lower rate than observed in the recent years.

The Copom highlights that the central scenario envisages a moderate credit expansion, which had already been noticed and tends to persist. In this regard, note that, after years of strong expansion, the credit market directed toward consumption underwent a period of moderation, leading in the last quarters, on the one hand, to lesser exposure of banks and, on the other hand, to household deleveraging. Taken together, therefore, one concludes that risks have been mitigated in the consumer credit segment.

In this context, the credit operations kept slowing down in the quarter ended in May, what was consistent with the scenario of downturn in the activity, rise of new loans average cost, increase in default rate and reduced level of the confidence indicators of economic agents.

Regarding fiscal policy, the approved change in 2016 budget considered, among other factors, macroeconomic parameters similar to the market ones and, specially, the impact of economic downturn on tax revenues.

The Committee understands that efforts to change the perspective of the public sector accounts are essential to create a positive perception of the macroeconomic environment in the medium and long terms. A consistent fiscal policy will positively affect the capital cost, in general, which, in turn, will stimulate the private investment in medium and long terms.

Considering that fiscal adjustment also have its own lags between discussion and the adoption of measures and its results, the more timely is the implementation of the ongoing process, the faster will be the resumption of a favorable path for public debt and confidence of families and firms, helping the economic recovery and the inflation fight.

The literature and the best international practices indicate that a consistent and sustainable fiscal policy contributes to reduce inflation expectations so that disinflation process is faster and less costly.

Regarding the external sector, the favorable paths of the trade balance and of the services and income net expenditures led to a significant reduction of current account deficit – from 4.42% of GDP in May of 2015 to 1.70% of GDP in May of 2016, considering twelve months intervals. This performance, reflecting lagged effects of exchange rate devaluation and the observed downturn in domestic economic activity, tends to continue in the next quarters.

Net income of foreign direct investments, even in a scenario of reduction in financial account, persisted in a comfortable level to finance the current account deficit. It is noteworthy that in May the international reserves stock, in the liquidity concept, represented 30 months of imports and 3.4 times the amount of external debt payments due in the next twelve months.

Concerning prices, the inflation measured by Broad National Consumer Price Index (IPCA) reached 0.61% in April and 0.78% in May. Thus, the twelve-month accumulated inflation reached 9.32% in May, 0.85 p.p. higher than the rate recorded until May 2015. On the one hand, market prices accumulated variation of 8.82% in twelve months (6.82% up to May 2015); on the other hand, the regulated prices increased 10.90% (14.09% up to May 2015).

Regarding inflation projections, following the usual procedures, and taking into account the information set available up to the cutoff date of June 17, 2016, the baseline scenario – which assumes constant exchange rate over the forecast horizon at R$3.45/US$ and the target for the Selic interest rate at 14.25% p.a. – projects inflation of 6.9% in 2016, 4.7% in 2017 and 4.2% in the second quarter of 2018. 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 7.0% in 2016, 5.5% in 2017 and 5.5% in the second quarter of 2018.

Concerning GDP growth, the projection for 2016, according to the baseline scenario, is -3.3% (0.2 p.p. higher than the estimate considered in the previous Inflation Report).

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 businessmen'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.

In this context, as indicate the projections presented in this report, the Committee considers, as anticipated, the still high twelve months inflation level reflects the processes of relative price adjustments that occurred in 2015, and the process of tax revenues recovery observed at the federal and the state level in the beginning of this year, besides of the temporary supply-shocks in the food sector. At the same time that recognizes that these processes have direct impact on inflation, the Committee reaffirms its view that the monetary policy can, should, and it is curbing the resulting second-round effects from these processes.

The Copom reaffirms that the aggregate demand will remain moderate over the relevant term for the monetary policy. On the one hand, household consumption tends to be influenced by factors as employment, income and credit; on the other hand, the concession of public services and the expansion of agricultural income tend to favor investments. In their turn, the net exports presented better results, either by the increasing exports benefited from the depreciation of the local currency, or by the ongoing import substitution process.

For the Committee, the approve and the implementation of the Brazilian economy adjustments, including fiscal one, besides other factors as the dynamic of the administered prices, the distension process in the labor market, and the perspective of a disinflationary output gap, are important factors of the context in which future monetary policy decisions will take place, to assure the convergence of inflation to the target of 4.5% established by the CMN, in 2017.

The Committee highlights that there are progressions in the inflation fighting process, but, its continuity depends on adjustments – mainly fiscal – in the Brazilian economy. Besides that, other factors affect the inflation fight, as the inertia derived from the process of relative prices realignment, the confluence of weather events on the global food output, especially on grains output, and their effects on domestic prices, and the uncertainties regarding the behavior of the global economy. In this context, the Committee will attempt to circumscribe the inflation into the limits established by the CMN, in 2016, and will adopt the necessary measures to assure the convergence of the inflation to the target of 4.5%, in 2017. In this way, the baseline scenario does not allow to work with the hypothesis of easing monetary condition.