Brazil's domestic outlook has become more challenging

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THE OUTLOOK FOR THE WORLD ECONOMY is still uncertain, with recovery taking different trajectories in different countries. The U.S. economy is expanding moderately, so the Fed should begin normalizing its monetary policy by the end of the year, and the euro area economy is beginning to accelerate, driven by domestic demand.

However, the Chinese economy is still slowing, although low inflation gives it room for a more expansionary monetary policy if needed. China should grow around 6.8% this year; the new official target is 7.0%, down from 7.4% in 2014.

Capital flows to emerging countries are likely to decline and the dollar will keep strengthening. With the prospect of U.S. interest rates rising, emerging countries have little scope for countercyclical policies. A strong dollar and high interest rates will keep commodity prices low—and recovery in emerging economies sluggish.

Among emerging countries, Brazil has been a negative highlight. In 2014, its growth of 0.1% was the worst among the BRICS (Brazil, Russia, India, China, and South Africa); in the rest of Latin America, only Argentina and Venezuela are expected to have worse numbers.

Uncertainty over economic policy, the unfolding investigations of graft in the state-oil company Petrobras, and risks of electric power shortages make the growth outlook for 2015 very weak. We expect that GDP will fall by 1.8% in 2015, compared to our earlier projection of 0.6%.

Despite the weak economy, Brazil's inflation is on the rise. Exchange rate depreciation has been significant, and adjustments in controlled prices should be about 13.8% this year. IBRE staff expects inflation to reach 8.7% in 2015, well above the 6.5% government target. Thus, monetary policy is expected to continue tightening to prevent a generalized increase in prices and deterioration in inflation expectations.

Imports of goods and services have declined, which in principle could significantly improve the trade balance, but exports have also declined because prices of Brazil's commodities have fallen. We are forecasting a trade surplus of only US$3 billion in 2015 compared to the US$8 billion previously projected.

Since 2013, foreign direct investment has not been enough to finance the external deficit. Some funding comes from short-term capital flows, which makes the balance of payments more vulnerable to external shocks. Still, so far foreign investors have been willing to finance much of the growing current account deficit. However, today the much more uncertain scenario is unattractive to investors, and normalization of U.S. monetary policy will reduce global liquidity.

Brazil: IBRE baseline scenario for 2014-2016

	2013	2014	2015 Proj.	2016 Proj.
Real GDP growth (% change)	2.7	0.1	-1.8	0.5
Inflation (% change)	5.9	6.4	8.7	5.3
Central Bank policy rate (end-period, %)	10.00	11.75	14.50	12.50
Exchange rate (average, Reais per U.S. dollar)	2.2	2.4	3.2	3.5
Primary balance surplus (adjusted, % of GDP) [1]	0.5	-1.5	0.0	1.1
External current account balance (% of GDP) [2]	-3.4	-4.4	-4.5	-4.3
Trade balance (US$ billions)	2.6	-3.9	3.0	4.0
Export (US$ billions) [1]	242.0	225.0	192.0	201.0
International reserves (US$ billion)	376.0	374.0	370.0	380.0

Source: Institute of Geography and Statistics (IBGE), Central Bank of Brazil, IBRE staff projections.

[1] Recurring government primary balance surplus defined as budget balance excluding interest payments on public debt, extraordinary revenues from dividends and concessions, and some investments of the Growth Acceleration Program.

[2] Balance of payments compilation methodology changed in 2014.