

Minutes of the 200th Meeting of the Banco Central do Brasil Monetary Policy Committee (Copom)

July 19th and 20th, 2016



* These minutes represent the Copom's best effort to provide an English version of the minutes of its policy meeting. In case of any inconsistency, the original version in Portuguese prevails.

Date: July 19th and 20th, 2016

Place: BCB Headquarters' meeting rooms – 8th floor (July 19th) and 20th floor (July 20th) – Brasília – DF

Starting time: 2:31 pm (July 19th) and 2:30 pm (July 20th)

Ending time: 6:04 pm (July 19th) and 6:02 pm (July 20th)

In attendance:

Members of the Copom

Ilan Goldfajn – Governor
Anthero de Moraes Meirelles
Carlos Viana de Carvalho
Isaac Sidney Menezes Ferreira
Luiz Edson Feltrim
Otávio Ribeiro Damaso
Reinaldo Le Grazie
Sidnei Corrêa Marques
Tiago Couto Berriel

Department Heads (present on July 19th)

Andre Minella – International Affairs Department
Ariosto Revoredo de Carvalho – Department of Foreign Reserves
Eduardo José Araújo Lima – Research Department (also present on July 20th)
Flávio Túlio Vilela – Department of Banking Operations and Payments System
João Henrique de Paula Freitas Simão – Open Market Operations Department
Renato Jansson Rosek – Investor Relations and Special Studies Department
Tulio José Lenti Maciel – Department of Economics

Other participants (present on July 19th)

Gustavo Paul Kurrle – Press Officer

The members of the Copom analyzed the recent performance and prospects for the Brazilian and the international economies, under the monetary policy framework, whose objective is to comply with the inflation targets established by the National Monetary Council. Supplementary material to these Minutes, with analysis of the recent economic developments, is available, only in Portuguese, at the Banco Central do Brasil's webpage (<http://www.bcb.gov.br?COPOMMATSUP200>).

A) Update of economic outlook and Copom's baseline scenario¹

1. Some indicators released since the last Copom meeting show prospects of economic activity stabilization in the short term. In particular, there are signs of interruption in the fall of investment and industrial production. This evidence is corroborated by some early signs of improvement in future prospects for economic activity, such as the expectations components of confidence indexes and expectations for GDP² growth in 2017 compiled in the Focus survey.

2. However, the economy continues to operate with a high level of idle capacity, reflected in industrial capacity utilization indexes and, mainly, in the unemployment rate.

3. Regarding the external outlook, the United Kingdom's decision to leave the European Union ("*Brexit*") was followed by a brief period of asset price volatility. Signs of additional stimulus by monetary authorities of some developed economies contributed to stabilize financial markets and to create a relatively benign environment for emerging economies in the short term. However, the dynamics of the global economic recovery remain fragile, with uncertainty regarding growth and deflationary risks in major developed economies. The possible economic consequences of *Brexit* contributed to an increase in medium- and long-term uncertainty and produced downward revisions in growth forecasts for the United Kingdom and the Euro Zone. In the United States, the FOMC³ has signaled it will proceed more gradually in the normalization of its monetary policy. Nevertheless, the paths for the interest rate under appropriate policy reported by its members remain above the path inferred from financial instruments, which might lead to corrections in the future.

4. Returning to the domestic economy, price indexes showed inflation exceeding expectations in the short term, due to food price increases and, perhaps, to more persistent inflation. These results contributed to an increase in expectations for 2016 IPCA⁴ inflation measured by the Focus survey,

which stood at around 7.25%. As for 2017, IPCA inflation expectations reported in the same survey have declined by approximately 0.20 percentage point (p.p.) since the last Copom meeting.

5. The conditional forecasts⁵ in the scenarios for inflation produced by the Committee remained relatively stable over the relevant horizons⁶ for monetary policy since the last Copom meeting, but declined relative to forecasts published in the last Inflation Report.

6. For regulated prices, the Committee forecasts an increase of 6.6% in 2016, 0.2 p.p. lower than the forecast in the June Copom meeting. For 2017, the current forecast of a 5.3% increase in regulated prices is 0.3 p.p. higher than the forecast in the last Copom meeting.

7. The reference scenario points to inflation around the target of 4.5% already in 2017. This scenario maintains, among other assumptions, that the interest rate and exchange rate remain unchanged throughout the forecast horizon at, respectively, 14.25% per annum (p.a.) and R\$3.25/US\$. It is worth noting that the same does not occur under the assumptions of the market scenario, which imposes the paths for the policy rate and the exchange rate extracted from the Focus survey. According to this scenario, inflation for 2017 stands at around 5.3%.

8. In short, the Committee's baseline scenario contemplates disinflation in the Brazilian economy in the upcoming years. For 2016, the projections under the reference and market scenarios point to inflation close to 6.75%. For 2017, disinflation towards the target occurs under the assumptions of the reference scenario. However, in the market scenario, disinflation evolves at a slower pace than the one pursued by the Committee.

¹ Unless explicitly stated otherwise, this update takes into account the changes that have occurred since the previous Copom meeting.

² Gross Domestic Product.

³ Federal Open Market Committee.

⁴ Extended Consumer Price Index.

⁵ The Copom uses the term "conditional forecast" to emphasize that the forecasts in the reference and market scenarios depend on conditioning assumptions for the future paths of the policy rate and the exchange rate, among other variables.

⁶ The Copom uses the term "relevant horizons" for the conduct of monetary policy to refer to the period of time until a change in monetary conditions implemented at a given point in time attains its maximum estimated effect on inflation.

B) Risks around baseline inflation scenario

9. There are short-term risks to inflation in Brazil. The recent increase in food prices can show persistence, given the transmission process from wholesale prices into retail prices. However, favorable seasonality may contribute to a fast reversion of these prices.

10. Additionally, on the one hand, prolonged periods of high inflation and above-target expectations, such as in the recent Brazilian experience, tend to reinforce inertial mechanisms and make the disinflation process slower and costlier. In this context, greater inflationary persistence requires greater monetary policy persistence. On the other hand, the continuous softening of the labor market and the significant deceleration of economic activity can, in principle, produce faster disinflation - for example, in the services sector - than the one reflected in the inflation expectations measured by the Focus survey and in the conditional projections produced by the Copom.

11. The implementation of the necessary adjustments in the economy, including those of fiscal nature, presents itself as both a risk and an opportunity for the ongoing disinflationary process. The risks would materialize if there were a perception that adjustments would be abandoned or postponed significantly. In this scenario, the disinflationary process would tend to be slower, increasing the costs of bringing inflation to target. On the other hand, the necessary adjustments in the economy can be approved and implemented more quickly, enabling confidence gains and falling inflation expectations. In this case, the reduction of uncertainty would boost the effects of the ongoing monetary adjustment process.

12. There are risks that are inherent to the conduct of monetary policy. The latter impacts the economy with long, variable and uncertain lags. It is thus expected that, even under appropriate policy, realized inflation will fluctuate around target. This is due to the substantial uncertainty associated with inflation projections in the relevant horizons, which arises naturally from the incidence of favorable and unfavorable shocks to the economy over time. The Committee should seek to conduct monetary policy so that inflation projections, including in the market scenario, point to the inflation target in the relevant horizon.

C) Discussion about the conduct of monetary policy

13. The Committee members agreed that there was a noticeable improvement in the macroeconomic scenario and that recent indicators show prospects for the stabilization of economic activity in the near term. This perspective is corroborated by the improvement in some forward-looking indicators of economic activity. Regarding inflation, the Committee members also agreed that progress has been made. However, the ongoing disinflation process has been evolving at a speed that is below the one pursued by the Committee. There are prospects of progress in this dimension, supported by the fall in measures of inflation expectations for 2017 and 2018.

14. Regarding the international context, some members of the Committee were relatively optimistic with respect to the environment for emerging economies' assets in the short term. Financial markets have reacted positively to the possibility of additional stimuli signaled by some central monetary authorities after Brexit. This suggests that monetary policies retain the capacity to provide stimulus, despite the levels of interest rates in major economies and the size of the balance sheets of major central banks. The possibility of additional stimuli has, in fact, created a benign period for such assets.

15. However, all members of the Committee highlighted the presence of medium- and long-term risks in the external environment, associated with the fragility of the global economic recovery. In some developed economies, non-economic factors may pose tail risks. Despite more reassuring signs by the FOMC recently, all members of the Committee agreed on the need to monitor the pace of monetary policy normalization in the United States. Finally, some members argued that the eventual end of the benign period for emerging economies can pose a risk in itself.

16. All members of the Monetary Policy Committee emphasized that the continuation of efforts for approval and implementation of adjustments in the economy, especially with regard to fiscal reforms, is essential to facilitate and reduce the cost of the disinflation process. There was no consensus on the speed of these adjustments, which suggests that they may constitute both a risk and an opportunity. All members agreed that the implications of the adjustment process in the economy for inflation dynamics depend not only on the impact of short-term measures on aggregate demand, but also on the perception of improved dynamics of public finances in the medium and long term. The members of the Committee highlighted that the fiscal

adjustment process may involve measures with unfavorable direct effects on inflation, and this is a risk to be monitored.

17. The debate on the balance of risks to inflation also focused on the degree of confidence regarding the ongoing disinflation process. For shorter horizons, the emphasis fell on recent food price increases and on the discrepancy of approximately 0.5 p.p. between inflation expectations calculated by the Focus survey and the projections produced by the Monetary Policy Committee for the current year. For longer horizons, the Committee members discussed the effects of the level of spare capacity and the current, still high, inflation rates. In particular, they highlighted possible implications of the current scenario for the sensitivity of inflation - especially in the service sector - to the level of economic slack, as well as for inflation dynamics - in particular its inertial component. Some members reasoned that, given the economic slowdown experienced so far, a greater decline in inflation was expected. Other members drew attention to the disinflation in services prices already observed. Some members of the Committee expect that the disinflationary effects stemming from the level of economic slack may yet manifest themselves more intensely.

18. In this context, all Committee members acknowledged progress on the disinflation prospects of the Brazilian economy, but expressed concern with the 2017 inflation expectations measured by the Focus survey, which stand above the target, and with the Committee's projections for inflation under the assumptions of the market scenario, which are also above the target for horizons of 18 months or more.

D) Monetary policy decision

19. The Copom concluded that, taken together, the baseline scenario and the current balance of risks indicate no room for monetary easing.

20. Therefore, the Copom unanimously decided to maintain the Selic rate at 14.25% p.a., without bias. The following members of the Committee voted for this decision: Ilan Goldfajn (Governor), Anthero de Moraes Meirelles, Carlos Viana de Carvalho, Isaac Sidney Menezes Ferreira, Luiz Edson Feltrim, Otávio Ribeiro Damaso, Reinaldo Le Grazie, Sidnei Corrêa Marques and Tiago Couto Berriel.