

Minutes of the 201st Meeting of the Banco Central do Brasil Monetary Policy Committee (Copom)*

August 30th and 31st, 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: August 30th and 31st, 2016

Place: BCB Headquarters' meeting rooms – 8th floor (August 30th) and 20th floor (August 31st) – Brasília – DF

Starting time: 10:04 am (August 30th), 2:34 pm (August 30th) and 2:01 pm (August 31st)

Ending time: 11:57 am (August 30th), 5:16 pm (August 30th) and 6:00 pm (August 31st)

In attendance:

Members of the Copom

Ilán 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 August 30th)

André Minella – International Affairs Department
Ariosto Revoredo de Carvalho – Department of Foreign Reserves
Eduardo José Araújo Lima – Research Department (also present on August 31st)
Flávio Túlio Vilela – Department of Banking Operations and Payments System
Gilneu Francisco Astolfi Vivan – Financial System Monitoring Department
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 August 30th)

Edric Martins Ueda – Senior Advisor to the Deputy Governor for Administration
Gustavo Paul Kurrle – Press Officer
João André Calvino Marques Pereira – Chief to the Deputy Governor for Regulation
Leonardo Martins Nogueira – Chief to the Deputy Governor for Monetary Policy
Márcio Barreira de Ayrosa Moreira – Executive Secretary
Maurício Costa de Moura – Chief of Governor's Staff

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 at the Banco Central do Brasil's webpage (<http://www.bcb.gov.br/?MINSUP2016201st>).

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

1. The indicators released since the last Copom meeting presented additional evidence that economic activity has stabilized recently. In particular, the measure of investment in the national accounts showed the first increase after ten consecutive quarters of decline. There are signs of a possible gradual recovery in economic activity, such as the expectations components of confidence indexes, expectations for 2017 GDP² growth compiled in the Focus survey, and expansion of industrial activity.

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

3. Regarding the external outlook, the scenario still presents a benign period for emerging economies, reflected in the behavior of asset prices. However, the dynamics of the global economic recovery remain fragile, with uncertainty regarding growth and deflationary risks in major developed economies. Moreover, recent manifestations of FOMC³ members signaled the possibility of further interest rate increases in the short term, generating uncertainties about the effects of a possible resumption of the normalization process of monetary conditions in the United States.

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 additional increase in expectations for 2016 IPCA⁴ inflation measured by the Focus survey, which stood at around 7.35%. As for 2017, IPCA inflation expectations reported in the same survey have declined by approximately 0.15 percentage point (p.p.) since the last Copom meeting, to around 5.15%.

5. The conditional forecasts⁵ in the scenarios for inflation produced by the Committee remained

relatively stable or retreated over the relevant horizons⁶ for monetary policy.

6. For regulated prices, the Committee forecasts an increase of 6.3% in 2016, 0.3 p.p. lower than the forecast in the July Copom meeting. For 2017, the current forecast of a 5.8% increase in regulated prices is 0.5 p.p. higher than the forecast in the last Copom meeting. The revision for 2017 is primarily due to the forecasts for increases in electricity tariffs (7.7%) and urban bus fares (6.8%).

7. The reference 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\$3.20/US\$. The market scenario considers the paths for the policy rate and the exchange rate extracted from the Focus survey. In particular, this scenario assumes exchange rates of R\$3.29/US\$ and R\$3.45/US\$ at the end of 2016 and 2017, respectively, and interest rates of 13.75% p.a. and 11.25% p.a. at the end of the same periods.

8. For 2016, the projections under the reference and market scenarios were revised from approximately 6.75% to around 7.3%. Despite this revision, the Committee's baseline scenario continues to contemplate disinflation in the Brazilian economy in the upcoming years. For 2017, disinflation towards the 4.5% target occurs under the assumptions of the reference scenario. In the market scenario, the projection stands around 5.1%. Although disinflation in this scenario occurs at slower pace than the one pursued by the Committee, this forecast decreased 0.2 p.p. relative to forecast at the July Copom meeting. One of the factors that contributed for this reduction was the favorable evolution of inflation expectations compiled by the Focus survey.

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 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. Given the uncertainties involved in these estimates, this expression should not be perceived as referring to a rigid horizon.

B) Risks around baseline inflation scenario

9. There are short-term risks to inflation in Brazil. The increase in food prices persists. However, wholesale prices already show some signs of fading. With the transmission of wholesale into retail prices, it is possible that a reversion of these prices at the consumer level occurs, decreasing risks of second-round effects of this shock on other prices in the economy.

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.

C) Discussion about the conduct of monetary policy

12. The Committee members agreed that there was improvement in the macroeconomic scenario and that recent indicators show somewhat clearer evidence of economic activity stabilization. Moreover, there are signs of possible gradual pick-up in economic activity. This perspective is corroborated by the improvement in forward-looking indicators of economic activity, and by industrial production and investment data.

13. Regarding inflation, the Committee members mentioned results that printed above expectations in the short term, and the increase in projections for 2016. In this sense, they reasoned that the ongoing disinflation process has been evolving at a speed that is below the one pursued by the Committee. Nevertheless, all agreed that there was progress with regards to expectations and projections over longer horizons. The fall in measures of inflation expectations collected by the Focus survey for 2017 and more distant horizons, which are already around the 4.5% target, and the fall of projections for 2017 under the assumptions of the market scenario were highlighted.

14. Regarding the international context, some Committee members pointed out that the period since the last Copom's meeting in fact offered a relatively benign environment for emerging assets, which may continue. However, the recent increase in uncertainty regarding the process of normalization of monetary policy in the United States increases the risk of interruption of this benign period. In this context, all Committee members agreed on the need to monitor the pace of monetary policy normalization in the United States and its possible implications for the speed of inflation convergence. There was also consensus on the continuation of the medium and long term risks in the external environment, associated with the fragility of the global economic recovery. In some major developed economies, non-economic factors may still constitute unlikely events, but with significant adverse impacts (i.e., "tail risks").

15. 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 the development of the Brazilian economy. The Committee should monitor these efforts closely, since they have important implications for the disinflation process. There was no consensus on the speed of these adjustments, which suggests that they constitute, at the same time, 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, which is a risk to be monitored.

16. 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 higher-than-expected

inflation in the short term, and on the increase in conditional forecasts for the current year produced by the Copom. For longer horizons, the Committee members discussed the effects of the level of spare capacity in the economy. In particular, they highlighted the possible implications of the current scenario for the sensitivity of services inflation to the economic activity.

17. The Committee also discussed the implications of specifying economic conditionalities for monetary policy going forward, in contrast to the communication currently in place, which might be understood as involving a time dimension. The Committee concluded that, for a given monetary policy stance, conditioning the future evolution of monetary policy on factors that matter for inflation can better transmit the economic rationality that guides the Committee's decisions. This contributes to increase transparency and to improve Copom communication.

18. All Committee members showed satisfaction with the progress in the prospects for disinflation in the Brazilian economy in the relevant horizons for monetary policy. At the same time, they expressed concern with inflation expectations for 2017 as measured by the Focus survey, and with the forecast for 2017 inflation in market scenario - both of which are above the target of 4.5%.

D) Monetary policy decision

19. Taking into account the baseline scenario, the balance of risks and the wide array of available information, the Copom unanimously decided to maintain the Selic rate at 14.25% p.a., without bias.

20. The Committee judges that a loosening of monetary conditions will depend on factors that allow greater confidence on meeting the inflation targets at the relevant horizons for the conduct of monetary policy, in particular the 4.5% target for 2017. The Committee emphasizes the following domestic factors: (i) that the persistence of the impacts of the food price shock on inflation be limited; (ii) that IPCA components that are most sensitive to monetary policy and economic slack show disinflation at an appropriate pace; (iii) that the uncertainty regarding the approval and implementation of the necessary economic adjustments be reduced, including the composition of fiscal measures, and their effects on inflation. The Committee will assess the evolution of the combination of such factors.

21. The Committee anticipates that the assessment of the impacts stemming from the evolution of these factors on the prospects for inflation will involve judgement based on available evidence. There is no factor that is by itself determinant for monetary policy decisions. In other words, neither of these factors is a necessary nor sufficient condition for an easing of monetary conditions.

22. 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.