

Minutes of the 202nd Meeting of the Banco Central do Brasil Monetary Policy Committee (Copom)*

October 18th and 19th, 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: October 18th and 19th, 2016

Place: BCB Headquarters' meeting rooms – 8th floor (October 18th) and 20th floor (October 19th) – Brasília – DF

Starting time: 10:09 am (October 18th), 2:38 pm (October 18th) and 2:04 pm (October 19th)

Ending time: 12:03 pm (October 18th), 6:28 pm (October 18th) and 6:20 pm (October 19th)

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 October 18th)

Alan da Silva Andrade Mendes - Department of Foreign Reserves
André Minella – International Affairs Department
Eduardo José Araújo Lima – Research Department (also present on October 19th)
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 October 18th)

Cláudio Henrique de Araújo Coutinho – Substitute Executive Secretary
Edric Martins Ueda – Senior Advisor to the Deputy Governor for Administration
Gustavo Ênio Falcão Freire – 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
Lucio Rodrigues Capelletto – Secretary to the Financial Stability Committee and Consultant to the Board
Luis Gustavo Mansur Siqueira – Analyst to the Deputy Governor for Institutional Relations and Citizenship (present only in the afternoon of October 18th)
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/?MINSUP2016202nd>).

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

1. The indicators released since the last Copom meeting suggest economic activity slightly below expectations in the short-term. In particular, indicators for August came in below expectations.

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

3. Fluctuations at the current stage of the business cycle are common and probably explain the recent results. Overall, the available evidence is consistent with recent stabilization of the Brazilian economy. Confidence indices, expectations for 2017 GDP² growth measured by the Focus survey and the behavior of risk premiums and asset prices point to a possible gradual recovery of economic activity.

4. 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 global economy remain fragile, with uncertainty regarding its growth. Moreover, recent manifestations of FOMC³ members signaled the possibility of additional interest rate increases this year, generating uncertainty about the effects of a possible resumption of the normalization process of monetary conditions in the United States.

5. Returning to the domestic economy, recent inflation figures came in more favorable than expected, partly due to the reversal of food price increases. These results contributed to a decrease in expectations for 2016 IPCA⁴ inflation measured by the Focus survey, which stood at around 7.0%. As for 2017, IPCA inflation expectations reported in the same survey have declined to around 5.0% and remain above the inflation target of 4.5%. Expectations for 2018 and more distant horizons are already around this level.

6. The path of regulated prices, which enters the conditional forecasts in the inflation scenarios produced by the Committee, assumes increases of

6.2% in 2016, 5.8% in 2017 and 5.1% in 2018 - the same numbers of the last Inflation Report (IR).

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\$3.25/US\$, R\$3.40/US\$ and R\$3.50/US\$ at the end of 2016, 2017 and 2018, respectively, and interest rates of 13.50% p.a., 11.00% p.a. and 10.00% p.a. at the end of the same periods.

8. For 2016, the Copom's projections under the reference and market scenarios retreated since the release of the last IR, and stand around 7.0%.

9. Over the relevant horizon for the conduct of monetary policy, the behavior of inflation forecasts relative to the most recent IR changed according to the scenario. Under the assumptions of the reference scenario, the forecast for 2017 inflation fell to approximately 4.3%, while the forecast for 2018 stands around 3.9%. Under the market scenario, the forecast for 2017 remained essentially unchanged at around 4.9%, and the forecast for 2018 increased to around 4.7% - both above the inflation target for these two calendar years, of 4.5%.

B) Risks around baseline inflation scenario

10. The recent Brazilian experience, with a prolonged period of high inflation and above-target expectations, may still reinforce inertial mechanisms. There are signs of a recent pause in the disinflation process of IPCA components that are most sensitive to the business cycle and to monetary policy, which might signal slower convergence of inflation to target. In this context, greater inflationary persistence requires greater monetary policy persistence.

11. 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.

12. The process of approval and implementation of the necessary adjustments in the economy, including those of fiscal nature, presents itself as

¹ Unless explicitly stated otherwise, this update takes into account the changes that have occurred since the release date of the September 2016 Inflation Report.

² Gross Domestic Product.

³ Federal Open Market Committee.

⁴ Extended Consumer Price Index.

both a risk and an opportunity for the ongoing disinflationary process. The first steps in this process have been positive, which may suggest greater timeliness and probability of approval. On the other hand, the process is long and involves uncertainties. The reduction of uncertainty would enhance the effects of monetary policy.

C) Discussion about the conduct of monetary policy

13. The Committee members discussed the evolution of economic activity in the short term, in the light of the most recent statistics, and agreed that indicators for August came in below expectations. Nevertheless they reasoned that such fluctuations tend to take place during stabilization periods. In particular, after an economic contraction such as the one experienced in the last two years, it is likely that the stabilization process involve significant fluctuations at this stage of the business cycle. In this context, the Committee members agreed that the available evidence is consistent with recent stabilization of the Brazilian economy and a possible gradual recovery of economic activity.

14. Regarding the international context, the members of the Committee pointed out the continuation of a relatively benign environment for emerging assets. However, uncertainties regarding the process of normalization of monetary policy in the United States remain. 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 Brazilian economy. There was also consensus on the continuation of the medium- and long-term risks in the external environment, associated with the fragility of global economic activity.

15. The Committee analyzed its conditional forecasts for inflation in different scenarios. The Copom concluded that the evolution of the forecasts in the reference scenario over the relevant horizon, which covers the calendar years 2017 and 2018, indicate that there is room for a gradual and moderate easing of monetary policy. On the other hand, forecasts under the market scenario suggest that there are limits to the magnitude of easing in the same horizon.

16. The members of the Monetary Policy Committee pointed out that, besides the analysis of conditional inflation forecasts, the favorable evolution of the factors emphasized by the Copom in its August Statement (201st meeting) leaves

room for the beginning of a process of gradual and moderate easing of monetary policy.

17. Regarding current inflation, the Committee members mentioned the favorable results in the short run and the drop in forecasts for 2016. The transmission process of declining food prices from the wholesale into the retail sector seems to have continued, and there is no evidence of second-round effects of the food-price shock on other prices in the economy. Inflation forecasts for 2016, as measured by the Focus survey, have retreated in a way that is compatible with this assessment.

18. The conditional forecasts for inflation produced by the Copom assume a path for regulated prices that is close to the one used in the latest IR. A number of factors may lead to changes in these forecasts. In particular, the Committee members mentioned: (i) the recently announced change in fuel price policy; (ii) evidence of larger-than-expected reductions in electricity prices in some regions; (iii) possibility of postponement of increases in public transportation fares in some cities; (iv) risk of hikes in electricity prices above expectations for 2017, due to, among other factors, changes in base rates for electricity.

19. The Copom analyzed service price inflation and its components. The Committee members highlighted the progress obtained in the disinflation process of this IPCA component. Regarding recent results, the Committee members argued that, to some extent, the recent fall owes to the reversion of earlier movements in more volatile items, and to the evolution of components that are sensitive to the recent food price disinflation. Considering different measures with items that are more sensitive to the business cycle and to monetary policy, the Committee members concluded that there are signs of a recent pause in the disinflationary process that had been observed in these components, after accounting for seasonal effects. They also noted that this pause occurs at a level that, if maintained, would produce disinflation at a slower pace than the one assumed in the Copom's baseline scenario. This scenario assumes a gradual disinflation path going forward. As a consequence, the Committee members highlighted the need to monitor the resumption of this path.

20. All members of the Committee recognized the progress and the efforts for approval and implementation of adjustments in the economy, especially with regard to fiscal reforms. The Committee members emphasized that these efforts are crucial for the stabilization and the development of the Brazilian economy. The Committee should monitor these efforts closely, since they have important implications for the disinflation process. All Committee members

agreed that the process of consideration of the proposed reforms has been faster than expected. However, the long and uncertain nature of the process suggests that there is, at the same time, risk and 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.

21. The Committee reaffirmed its goal of conducting monetary policy in order to achieve the inflation target in the relevant horizon, which encompasses the calendar years 2017 and 2018. In this context, the Copom understands that the pace of monetary easing will be calibrated, always taking into account its inflation forecasts and its determinant factors, in order to pursue a trajectory that complies with the inflation target for 2017 and 2018. Hence, the Committee judges that currently there is no incompatibility between these two objectives.

22. The Committee believes that, in presenting its conditional forecasts for inflation and emphasizing factors that can allow greater confidence in meeting the inflation targets, it increases transparency, strengthens its communication and enhances the effects of monetary policy.

23. In this context, the Copom members also discussed the implications of spelling out economic conditionalities for the pace and magnitude of the monetary easing just initiated. The Committee concluded that 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.

D) Monetary Policy Decision

24. Taking into account the baseline scenario, the balance of risks and the wide array of available information, the Copom unanimously decided to reduce the Selic rate to 14.00% p.a., without bias.

25. The Committee judges that convergence of inflation to the 2017 and 2018 target is compatible with a moderate and gradual easing of monetary conditions. The Committee will assess the pace and magnitude of monetary easing over time, in order to ensure convergence of inflation to the 4.5% target.

26. The magnitude of monetary easing and a possible speeding up of its pace will depend on a

favorable evolution of factors that allow greater confidence in meeting the inflation targets at the relevant horizon for the conduct of monetary policy, which includes 2017 and 2018. The Committee emphasizes the following domestic factors: (i) that disinflation of IPCA components that are most sensitive to monetary policy and economic slack resumes clearly and at an appropriate pace; and (ii) that the pace of approval and implementation of the necessary economic adjustments contribute to inflation dynamics that are compatible with inflation converging to target. The Committee will assess the evolution of the combination of such factors.

27. 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.