Minutes of the 204th Meeting of the Monetary Policy Committee ("Copom")* of the Central Bank of Brazil

January 10th and 11th, 2017

BANCO CENTRAL DO BRASIL

* 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: January 10th and 11th, 2017

Place: BCB Headquarters' meeting rooms 21st floor – Brasília – DF
Starting time: 10:37 am (January 10th), 2:31 pm (January 10th) and 2:00 pm (January 11th)
Ending time: 12:30 pm (January 10th), 5:49pm (January 10th) and 6:20 pm (January 11th)

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 January 10th)
Ariosto Revoredo de Carvalho - Department of Foreign Reserves
Eduardo José Araújo Lima – Research Department (also present on January 11th)
Flávio Túlio Vilela – Department of Banking Operations and Payments System
Geraldo Pereira Júnior – International Affairs Department
Gilneu Francisco Astolfi Vivan – Financial System Monitoring Department
Luiz Donizete Felício – Open Market Operations Department
Renato Jansson Rosek – Investor Relations and Special Studies Department
Tulio José Lenti Maciel – Department of Economics

Other participants (present on January 10th)
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
Lucio Rodrigues Capelletto – Secretary to the Financial Stability Committee and Consultant to the Board
Luis Gustavo Mansur Siqueira – Senior Advisor to the Deputy Governor for Institutional Relations and Citizenship (present only in the afternoon of January 10th)
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 Central Bank of Brazil's webpage (**http://www.bcb.gov.br/?MINSUP2017204th**).

A) Update of economic outlook and Copom's baseline scenario[1]

1. The set of indicators released recently suggests weaker-than-expected economic activity, including in the last quarter of 2016, and that the economic recovery should be delayed even further, and be more gradual than previously anticipated.

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

3. The global outlook remains quite uncertain. This uncertainty arises, among other factors, from possible changes in the course of economic policy in the United States, and from the resumption of the process of normalization of monetary conditions by the FOMC[2]. Nevertheless, the end of the benign environment for emerging economies has had a limited impact so far.

4. Returning to the domestic economy, recent inflation figures came in more favorably than expected, with signs of more widespread disinflation. There is evidence that the more widespread disinflation process has reached IPCA components that are most sensitive to the business cycle and monetary policy. As a result, IPCA[3] inflation for 2016 ended at 6.3%, well below expectations held a few months ago, and within the tolerance limits set for the inflation target for last year. Inflation expectations collected by the Focus survey for 2017 have declined to around 4.8% and expectations for 2018 and more distant horizons remained anchored at around 4.5%.

5. The path of regulated prices, which enters the conditional forecasts in the inflation scenarios produced by the Committee, assumes increases of 6.0% in 2017, and 5.2% in 2018.

6. The reference scenario maintains, among other assumptions, that the interest rate and exchange rate remain unchanged throughout the forecast horizon at, respectively, 13.75% per annum (p.a.) and R$3.25/US$. 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$3.45/US$ and R$3.50/US$ at the end of 2017, and 2018, respectively, and interest rates of 10.25% p.a., and 9.63% p.a. at the end of the same periods.

7. The Committee's conditional inflation forecasts retreated relative to those in the latest Inflation Report, which were based on information available until December 9, 2016. Among other factors, changes in forecasts were influenced by inflation and economic activity data released since then. In the reference scenario, forecasts for 2017 and 2018 are around 4.0% and 3.4%, respectively. The market scenario for 2017 and 2018 shows inflation around 4.4% and 4.5%, respectively. The incorporation of the latest data on economic activity into the Copom's information set contributed significantly to the decline in conditional inflation forecasts.

B) Risks around baseline inflation scenario

8. Short-run inflation behavior has been more favorable, which may signal lower inflation persistence. However, the process of disinflation of some IPCA components that are most sensitive to the business cycle and monetary policy requires continuous attention.

9. The continuous softening of the labor market and the significant deceleration of economic activity tend to produce disinflation that can be more intense than the one reflected in inflation expectations measured by the Focus survey and in the conditional projections produced by the Copom. The more favorable inflation dynamics in the recent period show signs of more widespread disinflation. Weaker-than-expected economic activity and the prospect of a further delayed and more gradual recovery tend to reinforce this process.

10. The steps toward approval of fiscal reforms have been positive so far, which suggests greater timeliness and higher probability of approval. On the other hand, the process is lengthy and carries uncertainty.

11. The end of the benign period for emerging economies might produce effects that make disinflation more difficult.

[1] Unless explicitly stated otherwise, this update takes into account the changes that have occurred since the previous Inflation Report (December 9, 2016).

[2] Federal Open Market Committee.

[3] Extended Consumer Price Index.

C) Discussion about the conduct of monetary policy

12. The Committee members discussed the evolution of economic activity, in light of the most recent releases. They all agreed that the evidence points to weaker-than-expected economic activity in the last months. In face of challenges for the resumption of economic activity, this contributed to consolidate the assessment that the recovery of the economy may be further delayed, and be more gradual than previously anticipated.

13. Regarding the global outlook, the Committee members pointed out the uncertainties associated with possible changes in economic policy in the United States and also with the end of the benign period that prevailed during most of last year, considering that the process of normalization of monetary conditions in that country resumed. These uncertainties have fueled an increase in long-term interest rates in major developed economies, with impact on emerging economies' financing costs. Nevertheless, the effects on asset prices of the end of the benign environment for emerging economies have been limited so far – in particular for commodity-exporting countries, which have been experiencing improvements in their terms of trade. This context reinforces the assessment of Committee members, that there is no mechanical relationship between the global outlook and monetary policy.

14. All members of the Committee agreed that the conditions set out at the November Copom meeting (203rd meeting) for speeding up the pace of monetary easing were present. Inflation evolved favorably in the recent period, coming below expectations. With the evidence of resumption of the disinflation process, at the margin, of components that are most sensitive to the economic cycle and monetary policy, the broad set of core measures of inflation followed by the Copom points to inflation at levels compatible with the target of 4.5% for 2017 and 2018. Furthermore, available evidence reinforces the reading that expectations remain anchored. These factors contribute to greater confidence in the projections that the disinflation process towards the target will continue. The economy has been operating at a weaker pace relative to what was expected a few months ago, and recent releases continued to point to weaker-than-expected economic activity at the margin, even after the latest revisions for the end of 2016. The steps in the process of consideration of additional fiscal reforms and other necessary adjustments in the economy remain positive.

15. Copom members also agreed that, with anchored inflation expectations and inflation projections at the target for 2018 and marginally below the target for 2017, the evolution of economic activity recommends frontloading the monetary policy easing cycle. This strategy contributes to the stabilization process and subsequent resumption of economic activity, without deviating from the goals of bringing inflation to the 4.5% target in 2017 and 2018. The Committee then moved to the assessment of options for the frontloading of the monetary easing cycle.

16. The Copom entertained reducing the Selic rate to 13.25 percent per year and signaling a larger cut at the next meeting, if conditions allowed. In favor of this option weighted the benefit of accumulating more evidence of the consolidation of Copom's baseline scenario. Another benefit would be a greater smoothing of the trajectory of the monetary policy instrument, which increases its predictability in the long run.

17. However, the Committee assessed that conditions for reducing the policy rate to 13% at the current meeting were already present due to the more widespread disinflation and weaker-than-expected economic activity, in an environment with anchored inflation expectations. This decision would already contribute to the stabilization process and later resumption of economic activity, without requiring a departure from the objective of bringing inflation to the 4.5% target in 2017 and 2018. The Committee members also judged that this decision was compatible with its communication, which favors spelling out economic conditionalities for the evolution of monetary policy, as this can better transmit the economic rationality that guides the Committee's decisions. In the Committee's assessment, the evolution of the outlook for inflation and the evidence on the evolution of economic activity gathered since the November Copom meeting and the December Inflation Report (whose reference date for the conditional inflation projections was December 9) allow for a reduction in the interest rate at a higher pace than the one discussed by the Committee at its November meeting. The conditional nature of Copom´s communication on the conduct of monetary policy allows economic agents to update their expectations based on such evidence.

18. The Committee members once again emphasized that the environment with anchored inflation expectations would enable the Copom to focus on preventing second-round effects of relative price adjustments that may occur over time.

19. All Committee members reiterated that the approval of the constitutional amendment that limits the real expansion of public expenses is an

important contribution to the Brazilian economy. They also emphasized the importance of other fiscal reforms for the continuation of the ongoing disinflationary process and for the prospects of maintaining inflation around target, with benefits for society.

20. Finally, the Committee members highlighted the importance of other reforms and investments in infrastructure aimed at increasing productivity, efficiency gains, greater flexibility of the economy, and improvement of the business environment. These efforts are fundamental for the stabilization and resumption of the economic activity and for the development of the Brazilian economy.

D) Monetary Policy Decision

21. Taking into account the baseline scenario, the current balance of risks, and the wide array of available information, the Copom unanimously decided to reduce the Selic rate to 13.00 percent per year, without bias. The Committee judges that convergence of inflation to the 4.5% target over the relevant horizon for the conduct of monetary policy, which includes 2017 and, with a gradually increasing weight, 2018, is compatible with an intensification of the ongoing monetary easing process.

22. The Copom entertained reducing the Selic rate to 13.25 percent per year and signaling a larger cut at the next meeting. However, in face of the environment with anchored inflation expectations, the Committee judges that the current scenario with more widespread disinflation and weaker-than-expected economic activity makes it already appropriate to frontload the monetary easing cycle, and allows the new pace of easing. The extension of the cycle and possible revisions of the pace of easing will continue to depend on inflation forecasts and expectations, and on the evolution of the aforementioned risk factors.

23. 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.