Minutes of the 205th Meeting of the Monetary Policy Committee (“Copom”)* of the Central Bank of Brazil

February 21st and 22nd, 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: February 21st and 22nd, 2017

Place: BCB Headquarters' meeting rooms 21st floor – Brasília – DF
Starting time: 10:02 am (February 21st), 2:34 pm (February 21st) and 2:00 pm (February 22nd)
Ending time: 11:39 am (February 21st), 5:39pm (February 21st) and 6:20 pm (February 22nd)

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 February 21st)
André Minella - Research Department (also present on February 22nd)
Ariosto Revoredo de Carvalho - Department of Foreign Reserves
Flávio Túlio Vilela – Department of Banking Operations and Payments System
Gilneu Francisco Astolfi Vivan – Financial System Monitoring Department
João Barata Ribeiro Blanco Barroso – International Affairs 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 February 21st)
Gustavo Ênio Falcão Freire – Press Officer
Eugênio Pacceli Ribeiro – Chief to the Deputy Governor for Economic Policy
Leonardo Martins Nogueira – Chief to the Deputy Governor for Monetary Policy
Enrico Bezerra Ximenes de Vasconcelos – Secretary to the Financial Stability Committee and Consultant to the Board
Luis Gustavo Mansur Siqueira – Chief to the Deputy Governor for Institutional Relations and Citizenship (present only in the afternoon of February 21st)
Adalberto Felinto da Cruz Junior – Executive Secretary
Arnildo da Silva Correa – Deputy Head of the Economic Advisory to the Presidency
Ricardo Eyer Harris – Chief to the Deputy Governor for Regulation
Wagner Thomaz de Aquino Guerra Junior – Chief to the Deputy Governor for International Affairs and Corporate Risk Management

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/?MINSUP2017205th).

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

1. The set of indicators of economic activity released since the last Copom meeting shows some mixed signals, which are, however, consistent with stabilization of the economy in the short run. Available evidence suggests a gradual recovery of economic activity during the course of 2017.

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. Nevertheless, stronger global economic activity and its positive impact on commodity prices have so far mitigated the effects on the Brazilian economy of revisions of economic policy in some large economies, notably in the United States. There is also uncertainty regarding the outlook for the Chinese economy.

4. Returning to the domestic economy, inflation presents favorable dynamics, with signs of lower persistence in the inflationary process. The disinflation process is more widespread and includes IPCA components that are most sensitive to the business cycle and monetary policy, increasing confidence in its continuation. Furthermore, food price disinflation resumed, which constitutes a favorable supply shock. Inflation expectations collected by the Focus survey for 2017 fell to around 4.4% and expectations for 2018 and longer horizons remained anchored 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 5.8% in 2017, and 5.3% in 2018.

6. The market scenario considers, among other hypotheses, the paths for the policy rate and the exchange rate extracted from the Focus survey. In particular, this scenario assumes exchange rates of R$3.30/US$ and R$3.40/US$ at the end of 2017, and 2018, respectively, and interest rates of 9.50% per annum (p.a.), and 9.00% p.a. at the end of the same periods.

7. Under these hypotheses, the Committee's inflation forecast for 2017 retreated relative to the one reported in the January Copom Minutes (204th meeting), to around 4.2%. The forecast for 2018 in this scenario remained around 4.5%.

8. The Committee's inflation forecasts in the scenario in which the interest rate and exchange rate remain unchanged throughout the forecast horizon at, respectively, 13.00% p.a., and R$3.10/US$, are around 3.8% for 2017 and 3.3% for 2018[2].

B) Risks around baseline inflation scenario

9. Food price disinflation resumed, which constitutes a favorable supply shock and might produce second-round effects on inflation and, thus, contribute to additional reductions of inflation expectations and of inflation itself in other economic sectors.

10. The process of approval of fiscal reforms has been positive. The next steps involve the consideration of reforms that are fundamental to the sustainability of the public accounts, such as the social security reform. This process may be lengthy and involves uncertainties.

11. The economic activity signals stabilization in the short run, but its recovery might be more (or less) gradual and delayed than currently anticipated.

12. The highly uncertain global outlook might make disinflation more difficult.

C) Discussion about the conduct of monetary policy

13. The Committee members discussed the evolution of economic activity, in light of available data. They all agreed that there are mixed signals, which are, however, consistent with stabilization of

[1] Unless explicitly stated otherwise, this update takes into account the changes that have occurred since the January Copom meeting (204th meeting).

[2] The Committee understands that, in the context of the ongoing monetary easing process, these projections with constant interest rates are not very informative. From now on, the Copom will disclose in the Statements and Minutes of its meetings only the conditional inflation forecasts under scenarios that it considers to be informative of its views on the conduct of monetary policy. Nevertheless, with the aim of maintaining a high level of transparency, the Copom will continue to report, in the Inflation Reports, conditional forecasts in the four scenarios that have been released since the 3Q 2016 Inflation Report.

the economy in the short run. The prospective assessment of the Committee is that risks seem more balanced now than in the last months of 2016. However, the challenges for the resumption of economic activity remain, and the Committee expects the economic recovery during the course of 2017 to be gradual.

14. Regarding the global outlook, the Committee members pointed out the continuation of uncertainties associated with possible changes in economic policy in the United States and also with the outlook for the Chinese economy. Nevertheless, they believe that the Brazilian economy nowadays shows greater capacity to absorb occasional negative developments in the global economy, due to the progress in the disinflationary process and in the anchoring of expectations.

15. All Committee members agreed that the prospects for inflation have evolved in a favorable way since the last Copom in January (204th meeting) and, to a large extent, in line with expectations. The broad set of core inflation measures followed by the Copom points to inflation at levels compatible with the target of 4.5% for 2017 and 2018. Inflation expectations remain anchored.

16. The Committee members reaffirmed the understanding that, with anchored inflation expectations, with inflation forecasts at the target for 2018 and marginally below the target for 2017, and in light of the high level of economic slack, the Copom's baseline scenario prescribes frontloading the monetary easing cycle.

17. Regarding the extension of the cycle, i.e., the accumulated reduction in the Selic rate at the end of the monetary easing process, the discussion focused on two different dimensions, both relevant for its determination. The first dimension pertains to the structural interest rate of the economy. This rate depends on factors such as the economy's productivity growth, the perspectives for fiscal policy, the quality of the business and contractual environment, the efficiency of resource allocation through the financial system, and the quality of economic policy. Measurement of the structural interest rate involves a high level of uncertainty, and necessarily requires judgment. The Committee judges that the change of economic policy by the government, with approval and implementation of fiscal reforms - notably the social security reform - besides others reforms and necessary adjustments in economy, can reduce the structural interest rate of the Brazilian economy. In this context, the Committee will continue to reassess its estimates of the structural interest rate of the economy over time. This dimension generates changes for monetary policy that are less frequent and more structural.

18. The second dimension refers to conjunctural aspects. The Committee understands that its estimates of the extension of the ongoing monetary easing cycle depend not only on the structural interest rate trajectory envisaged for the economy, but also on the evolution of economic activity, on the other risk factors mentioned above, and on inflation forecasts and expectations.

19. Regarding the pace of monetary easing over the cycle, the Committee understands that, for a given estimate of its extension, a possible acceleration of the pace is equivalent to greater frontloading of the cycle. Some members of the Committee pointed out that the estimated extension may also be itself revised, depending on the degree of frontloading of the cycle.

20. All members of the Copom agreed that the evolution of the economy since the January Copom meeting was compatible with the reduction of the Selic rate to 12.25 percent p.a.

21. Hence, the members of the Committee discussed the next steps for monetary policy and expressed preference for keeping more leeway for future decisions, which will depend on the evolution of the Copom's baseline scenario and on the aforementioned risk factors. They emphasized the fundamental condition that any future decision should be compatible with the maintenance of inflation projections at the target over the relevant horizon for the conduct of monetary policy, and with anchored inflation expectations. They also debated, on the one hand, how monetary policy could contribute to the stabilization process and subsequent resumption of economic activity and, on the other hand, the lagged effects that monetary policy could have on 2018 inflation, which is now forecast around the 4.5% target - both in Focus survey and in the Copom’s conditional projection in the market scenario.

22. The Committee members once again emphasized that the environment with anchored inflation expectations would allow the Copom to focus on preventing second-round effects of relative price adjustments that may occur over time. This applies to the favorable food supply shock. The Copom understands that the primary effects of this supply shock, to which monetary policy should not react, should be estimated taking into account demand conditions in that sector. Monetary policy should, then, focus on possible second-round effects of this shock, which might contribute to additional reductions of inflation expectations and of inflation in other sectors of the economy.

23. All members of the Committee emphasized that the approval and implementation of reforms,

notably those of a fiscal nature, and of adjustments in the Brazilian economy are fundamental to the sustainability of disinflation and to the reduction of its structural interest rate, with widespread benefits for society.

24. 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

25. 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 12.25 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 the ongoing monetary easing process.

26. The Copom judges that the extension of the monetary easing cycle will depend on estimates of the structural interest rate of the Brazilian economy, which the Committee will continue to reassess over time.

27. The Copom emphasizes that a possible acceleration of the pace of monetary easing will depend not only on the estimated extension of the cycle, but also on the evolution of economic activity, on the other risk factors, and on inflation forecasts and expectations.

28. 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.