Minutes of the 214th Meeting of the Monetary Policy Committee (Copom) * of the Central Bank of Brazil **

May 15th and 16th, 2018

BANCO CENTRAL DO BRASIL

* The Monetary Policy Committee of the Central Bank of Brazil is herein referred to as the "Copom" and the "Committee".

** These minutes represent 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: May 15^{th} and 16^{th}, 2018

Place: BCB Headquarters' meeting rooms on the 8^{th} floor (May 15^{th}) and 20^{th} floor ((May 16^{th}) – Brazil – Brasília – DF

Starting and ending time: May 15^{th}: 10:08 am – 12:16 am; 2:42 pm - 4:44 pm
May 16^{th}: 2:00 pm – 6:00 pm

In attendance:
Members of the Copom
Ilan Goldfajn – Governor
Carlos Viana de Carvalho
Carolina de Assis Barros
Maurício Costa de Moura
Otávio Ribeiro Damaso
Paulo Sérgio Neves de Souza
Reinaldo Le Grazie
Sidnei Corrêa Marques
Tiago Couto Berriel

Department Heads in charge of technical presentations (present on May 15^{th})
Alan da Silva Andrade Mendes - Department of Foreign Reserves
André Minella - Research Department (*also present on May 16^{th}*)
Flávio Túlio Vilela – Department of Banking Operations and Payments System
João Barata Ribeiro Blanco Barroso – Department of International Affairs
João Henrique de Paula Freitas Simão – Department of Open Market Operations
Tulio José Lenti Maciel – Department of Economics

Other participants (present on May 15^{th})
Adalberto Felinto da Cruz Júnior – Executive Secretary
Daniela Pires Ramos de Alcântara – Head of the Deputy Governor for International Affairs and Corporate Risk Management's office
Enrico Bezerra Ximenes de Vasconcelos – Secretary of the Financial Stability Committee and Advisor to the Board
Eugênio Pacceli Ribeiro – Head of the Deputy Governor for Economic Policy's office
Fábio Araújo – Economic Advisory to the President
Fernando Alberto Sampaio Rocha – Head of the Department of Statistics
Gilneu Francisco Astolfi Vivan – Head of the Financial System Monitoring Department
Gustavo Paul Kurrle – Press Officer
Leonardo Martins Nogueira – Head of the Governor's Office
Rogério Antônio Lucca – Head of the Deputy Governor for Monetary Policy's office
Sílvia Marques de Brito e Silva – Head of the Deputy Governor for Regulation's office (*present only in the afternoon session*).

The members of Copom analyzed the recent performance and prospects for the Brazilian and international economies, under the monetary policy framework, whose objective is to comply with the inflation targets established by the National Monetary Council.

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

1. The latest indicators show softening of economic activity in the context of a consistent, albeit gradual, recovery of the Brazilian economy.

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

3. The global outlook has become more challenging and showed volatility. The evolution of risks associated, to a large extent, with normalization of interest rates in some advanced economies led to adjustments in international financial markets. As a result, risk appetite towards emerging economies has diminished.

4. Inflation developments remain favorable, with various measures of underlying inflation running still at low levels. This includes the components that are most sensitive to the business cycle and monetary policy.

5. Inflation expectations for 2018 collected by the Focus survey are around 3.5%. Expectations for 2019 and 2020 are around 4.0%.

6. The Copom's inflation projections in the scenario with interest rate and exchange rate paths extracted from the Focus survey stand around 3.6% for 2018, and 3.9% for 2019. This scenario assumes a path for the policy interest rate that ends 2018 at 6.25% p.a., and 2019 at 8.0% p.a., and a path for the exchange rate that ends both 2018 and 2019 at R$/US$ 3.40. In the same scenario, the inflation projections for administered prices for 2018 and 2019 are 5.7% and 4.2%, respectively.

7. In the scenario with a constant interest rate, at 6.50% p.a., and a constant exchange rate, at R$3.60/US$[2], the projections for both 2018 and 2019 stand around 4.0%. In the same scenario, the inflation projections for administered prices for 2018 and 2019 are 6.3% and 4.4%, respectively.

[1] Unless explicitly stated otherwise, this update takes into account changes occurred since the March Copom meeting (213th meeting).

B) Risks around baseline inflation scenario

8. The Committee emphasizes that risks around its baseline scenario remain in both directions.

9. On the one hand, (i) the possible propagation, through inertial mechanisms, of low inflation levels may lead to a lower-than-expected prospective inflation trajectory.

10. On the other hand, (ii) frustration of expectations regarding the continuation of reforms and necessary adjustments in the Brazilian economy may affect *risk premia* and increase the path for inflation over the relevant horizon for the conduct of monetary policy. This risk intensifies in the case of (iii) further changes in the global outlook for emerging economies. The latter risk has intensified since the last Copom meeting.

C) Discussion about the conduct of monetary policy

11. The Committee members discussed the evolution of the economic activity in light of available data. They agreed that the pace of the economic activity has softened, at the margin. This movement occurs amidst a process of consistent recovery, albeit at a gradual pace, of the Brazilian economy. In this context, Committee members believe that, as economic activity recovers, inflation tends to gradually return to target. They reaffirmed the view that, as a result of current levels of slack in the economy, marginal revisions in the intensity of recovery would not lead to material revisions in the expected path for inflation.

12. Regarding the global outlook, the Committee considered that the scenario has become more challenging. The risk of a faster normalization of interest rates in some advanced economies induced changes in assets prices and volatility of financial conditions in international markets. The baseline scenario comprises a gradual normalization of monetary policy in central economies, but is dependent on the prospective path of price and wage inflation in these economies. The Committee members also mentioned the geopolitical risks and the risks associated to the continued expansion of international trade, with possible impacts on global growth. In this context, the Copom members once

[2] Value obtained according to the usual procedure of rounding the average R$/US$ exchange rate observed on the five business days ending on the Friday prior to the Copom meeting.

again highlighted the Brazilian's economy capacity to withstand a setback in the international scenario, given its robust balance of payments, low inflation environment, anchored expectations and prospects of economic recovery. Nevertheless, the Copom pondered the risks derived from possible continuation of the reversal in the outlook for emerging economies, in a context of frustration of the expectations regarding the necessary reforms and adjustments in the Brazilian economy. In this context, they consider that, should the evolution of the global outlook produce relative price changes, its impact on monetary policy will be circumscribed by its second-round effects on inflation (i.e., on the prices of economy not directly affected by the shock).

13. The Copom analyzed the inflation trajectory throughout the current and subsequent years. All members agreed that inflation developments remain favorable, with several measures of underlying inflation running still at low levels. This includes the components that are most sensitive to the business cycle and monetary policy. They also discussed to what extent these trajectories are compatible with the convergence of inflation to the target, in the relevant horizon for the conduct of monetary policy. On the one hand, persistence of underlying inflation measures at low levels poses downward risks for the prospective inflation path. On the other hand, the recovery in economic activity is still expected to contribute to bring underlying inflation towards the target in the relevant horizon. Additionally, risks associated with continuation of the reversal in the outlook for emerging economies, in a context of frustration of the expectations regarding the necessary reforms and adjustments in the Brazilian economy, still remain. The Copom judges that the recent evolution of these dimensions as a whole, has mitigated the risk of delayed convergence of inflation towards the targets.

14. The Committee members also discussed the conditional projections for inflation in different scenarios. In the scenario with interest and exchange rates extracted from the Focus survey, the projections showed slight decreases when compared to the projections produced at the time of the March Copom meeting. In the scenario with constant interest and exchange rates, as detailed in paragraph 7 of these Minutes, 2018 and 2019 projections are around 4.0% - slightly above the levels observed in the aforementioned scenario. The Copom sees these levels as comfortable and, taking into account the current balance of risks, deems that the odds that inflation remains below target in the relevant horizon have diminished.

15. The Committee reaffirmed the understanding that, with anchored inflation expectations, in the face of occasional shocks that lead to changes in relative prices, monetary policy should focus on their second-round effects only. The Copom highlights that its reaction to possible changes in relative prices will be symmetrical, i.e., monetary policy will follow the same principles, whether in the face of inflationary shocks (as in the case of an external shock leading to a devaluation of the exchange rate), or in the face of disinflationary shocks (as in the case of a favorable food price shock).

16. Having established how monetary policy should react to shocks that induce changes in relative prices, Copom members discussed the extent of exchange-rate pass-through in the Brazilian economy. They concluded that the intensity of pass-through depends on several factors, such as the level of slack in the economy and the degree of anchoring of inflation expectations. The Committee decided to monitor the different measures of exchange-rate pass-through to both inflation and underlying inflation.

17. The Copom members reaffirmed their understanding that economic conditions with anchored inflation expectations, underlying inflation measures at low levels, inflation projections below target for 2018, and slightly below target for 2019, and high level of slack in the economy prescribes accommodative monetary policy, i.e., interest rates below the structural interest level. Although estimates of this rate imply a high degree of uncertainty, Committee members expressed the view that current *ex-ante* real interest rates provide stimulus to the economy. Over time, this should contribute to the convergence of inflation to its targets.

18. The Copom understands that the process of reforms and necessary adjustments in the Brazilian economy contributes to the reduction of its structural interest rate. The Committee will continue to reassess estimates of this rate over time.

19. The Committee members then discussed the evolution of the baseline scenario and the balance of risks since its March meeting (213th meeting) and the appropriate monetary policy decision in light of such evolution.

20. Firstly, they evaluated the alternative of reducing the basic interest rate by 0.25 percentage point (p.p.) to 6.25% p.a. in order to mitigate the risk of delayed convergence of inflation towards the targets. Some factors were in favor of this alternative, namely the low levels of inflation and underlying inflation and the gradual pace of recovery of the economy and its recent softening. They then assessed the alternative of keeping the Selic rate at 6.50% p.a. In favor of this option, weighed the change in the balance of risks for inflation due to the external shock, which reduced

the chances of inflation remaining below target in the relevant horizon, through possible second-round effects on inflation. This made it unnecessary to mitigate the risk of an overly slow convergence of inflation to targets. Weighing the baseline scenario and the balance of risks, the Committee concluded that the decision to keep the interest rate at the current level was the most appropriate.

21. The members also evaluated the fact that recent communication by Copom members appears to have been interpreted by the public as indicative of a decision to further reduce the interest rate. In the end, the understanding prevailed that the focus on the best possible decision, given the set of information available at the time, results, over time, in greater credibility for monetary policy.

22. The Committee discussed the possible interpretation by economic agents that monetary policy would be reacting mechanically to recent exchange rate developments. Committee members understand that there may be impacts of the external shock on the Brazilian economy, but they emphasized that it is essential to understand that monetary policy will not react to these impacts automatically, since its implications for monetary policy depend on how the shock may be transmitted to expectations, to inflation projections, and to the balance of risks.

23. In this context, the Copom stated that the focus of monetary policy will be on the second-round effects on inflation (that is, on the propagation to prices in the economy which are not directly affected by the shock) and that, in a context of anchored inflation expectations, these effects tend to be mitigated by the high level of slack in the economy.

24. The Committee also emphasized that its communication should reaffirm the conduct of monetary policy with exclusive focus on the evolution of inflation projections and expectations, of the balance of risks, and of economic activity. External shocks should be tackled only in the secondary impact they may have on prospective inflation. In this context, the Committee concluded that the absence of a mechanical relationship between the external scenario and monetary policy will be evident over time, but that this should already be made explicit by the Copom in its official communications.

25. Based on all assessments, the Copom members agreed to maintain the Selic rate at 6.50% p.a. They also decided to indicate, for the next meetings, that with comfortable inflation projections and the current balance of risks, the Committee deems it appropriate to maintain the interest rate at the current level.

26. The Committee reaffirmed its preference for communicating conditionalities on the evolution of monetary policy, which better transmits the economic rationality that guides its decisions. This contributes to increase transparency and improve Copom communication. In this context, the members reaffirmed that the next steps in the conduct of the monetary policy will continue to depend on the evolution of economic activity, the balance of risks, and on inflation projections and expectations.

27. All Committee members once again emphasized that the approval and implementation of reforms – notably those of a fiscal nature – and adjustments in the Brazilian economy are fundamental for the sustainability of the environment of low and stable inflation, for the full operation of monetary policy and for the reduction of the structural interest rate of the economy, with widespread benefits for society.

28. Finally, the Copom stressed the importance of other initiatives aimed at productivity increases, efficiency gains, greater flexibility of the economy and improvements in the business environment. These efforts are fundamental for the resumption of economic activity and for the development of the Brazilian economy.

D) Monetary Policy Decision

29. 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 6.50% p.a. The Committee judges that this decision reflects the recent change in the balance of risks to prospective inflation and is consistent with the convergence of inflation to target over the relevant horizon for the conduct of monetary policy, which includes 2018 and, to a greater extent, 2019.

30. The Committee reiterates that economic conditions prescribe accommodative monetary policy, i.e., interest rates below the structural level.

31. The Copom emphasizes that the evolution of reforms and necessary adjustments in the Brazilian economy contributes to the reduction of its structural interest rate. The Committee will continue to reassess estimates of this rate over time.

32. In the Copom's assessment, the evolution of the baseline scenario and, mainly, of the balance of risks made it unnecessary to ease monetary policy further in order to mitigate the risk of delayed convergence of inflation toward the targets. Regarding the next meetings, the Committee deems appropriate to

maintain its policy rate at its current level. The Copom emphasizes that the next steps in the conduct of monetary policy will continue to depend on the evolution of economic activity, the balance of risks, and on inflation projections and expectations.

33. The following members of the Committee voted for this decision: Ilan Goldfajn (Governor), Carlos Viana de Carvalho, Carolina de Assis Barros, Maurício Costa de Moura, Otávio Ribeiro Damaso, Paulo Sérgio Neves de Souza, Reinaldo Le Grazie, Sidnei Corrêa Marques, and Tiago Couto Berriel.