Executive summary

The recent path of the main economic activity indicators is consistent with a gradual recovery of the Brazilian economy.

In the third quarter of 2017, Gross Domestic Product (GDP) recorded the third consecutive quarter-on-quarter (QoQ) increase. On the supply side, the economic performance reflected the positive evolution of industrial activity, especially in manufacturing, and the third consecutive increase in the services sector – which has the greatest weight among the supply components – in part, because of the expansion of trade and transportation activities, more correlated with the industrial sector. Of note, on the demand side, were the significant expansion in household consumption and the growth of Gross Fixed Capital Formation (GFCF), representing the first QoQ expansion since 2013Q3.

The recovery in consumption continued to benefit from real income gains, with a particular impact of the reduction of inflation on wage purchasing power; from the reaction in the credit for individuals, reflecting the effect of the basic interest rate cuts and the advanced stage of the household deleveraging process; from the gradual recovery of consumer confidence; and from better labor market conditions.

In fact, signs of employment reaction remain consistent with the process of gradual activity recovery. The unemployment rate fell again QoQ in the quarter ending in November, and, during the same period, there was net creation of 146.5 thousand formal jobs, in comparison with the destruction of 148 thousand jobs in the same period of 2016.

The global outlook has been favorable, as global economic activity continues to recover, without exerting excessive pressure on financial conditions in advanced economies. This supports risk appetite towards emerging economies.

Risks remain that 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 a reversal of the current benign global outlook for emerging economies.

However, the Brazilian economy shows greater capacity to absorb occasional setbacks in the global economy given its robust balance of payments and low inflation environment, anchored expectations and prospects of economic recovery.

Indeed, the country's external transactions evolved favorably in 2017, with the current account deficit reaching 0.3% of GDP in the year to November, compared with 1.1% of GDP in the same period of 2016. In addition, it is worth noting the improvement, during this year, of the conditions of access to credit in the international market for companies in Brazil.

Inflation expectations from the Focus survey, measured by changes in the Extended National Consumer Price Index (IPCA), stand at 2.8 percent for 2017. Expectations for 2018, 2019 and 2020 remain around 4.0 percent, 4.25 percent and 4.0 percent, respectively.

The baseline inflation scenario has evolved, to a large extent, as expected. Inflation developments remain favorable, with various measures of underlying inflation running at comfortable or low levels. This includes the components that are most sensitive to the business cycle and monetary policy.

Nonetheless, there are risks that possible second-round effects from the favorable food price shock and low current levels of industrial goods inflation, and the possible propagation, through inertial mechanisms, of low inflation levels may lead to a lower-than-expected prospective inflation trajectory.

Regarding the conditional inflation projections, under a scenario with interest rate and exchange rate paths extracted from the Focus survey, projections stand around 2.8 percent for 2017 and 4.2 percent for 2018. In the same scenario, inflation projections for 2019 and 2020 stand around 4.2 percent and 4.1 percent, respectively.

The Copom judges that economic conditions prescribe accommodative monetary policy, i.e., interest rates below the structural level. The

Committee emphasizes 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.

The Copom highlights that the evolution of the baseline scenario, in line with expectations, and the stage of the monetary easing cycle made it appropriate to reduce the Selic rate by 0.5 percentage point at its December meeting. Regarding the next meeting, provided the Committee's baseline scenario evolves as expected, and taking into account the stage of the monetary easing cycle, at this time the Copom views an additional moderate reduction of the pace of easing as appropriate. The Committee views this guidance as more susceptible to changes in its baseline scenario and balance of risks than in the previous meetings. Going forward, the Committee judges that the current stage of the cycle recommends caution in conducting monetary policy. The Copom emphasizes that the monetary easing process will continue to depend on the evolution of economic activity, the balance of risks, possible reassessments of the extension of the cycle, and on inflation projections and expectations.