Minutes of the 218th Meeting of the Monetary Policy Committee (Copom) * of the Central Bank of Brazil **

October 30th and 31st, 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: October 30th and 31st, 2018

Place: BCB Headquarters' meeting rooms on the 8th floor (October 30th) and 20th floor (October 31st) – Brasília – DF – Brazil

Starting and ending time: October 30th: 10:05 am–11:45 am; 2:34 pm–4:54 pm
October 31st: 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 October 30th)
Alan da Silva Andrade Mendes - Department of Foreign Reserves
André Minella - Research Department (*also present on October 31st*)
André de Oliveira Amante – Department of Open Market Operations
Flávio Túlio Vilela – Department of Banking Operations and Payments System
João Barata Ribeiro Blanco Barroso – Department of International Affairs
Tulio José Lenti Maciel – Department of Economics

Other participants (present on October 30th)
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 Senior Advisor to the Board
Eugênio Pacceli Ribeiro – Head of the Deputy Governor for Economic Policy's Office
Fabia Aparecida de Carvalho – Deputy Head of the Research Department
Fabio Araujo – Head of the Economic Advisors' Office
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
João Henrique de Paula Freitas Simão – Advisor to the Department of Open Market Operations
Kathleen Krause – Head of the Deputy Governor for Regulation's Office
Leonardo Martins Nogueira – Head of the Governor's Office
Rogério Antônio Lucca – Head of the Deputy Governor for Monetary Policy's Office

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. Recent indicators of economic activity point to the recovery of the Brazilian economy, at a more gradual pace than envisaged early this year.

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 remains challenging, with risk appetite towards emerging economies at levels below those seen early this year. The main risks continue to be associated with normalization of interest rates in some advanced economies and with uncertainty regarding global trade.

4. Various measures of underlying inflation are running at appropriate levels. This includes the components that are most sensitive to the business cycle and monetary policy.

5. Inflation expectations for 2018, 2019 and 2020 collected by the Focus survey are around 4.4%, 4.2%, and 4.0%, respectively. Expectations for 2021 remain around 3.9%.

6. The Copom's inflation projections in the scenario with Selic and exchange rate paths extracted from the Focus survey stand around 4.4% for 2018, 4.2% for 2019, and 3.7% for 2020. This scenario assumes a path for the Selic rate that ends 2018 at 6.5% p.a., increases to 8% p.a. over the course of 2019, and remains at that level until the end of 2020. It also assumes a path for the exchange rate that ends 2018 at R$/US$ 3.71, 2019 at R$/US$ 3.80, and 2020 at R$/US$ 3.75. In this scenario, the inflation projections for administered prices are 7.4% for 2018, 5.6% for 2019, and 3.9% for 2020.

7. In the scenario with a constant Selic rate at 6.50% p.a., and a constant exchange rate at R$3.70/US$[2], Copom's inflation projections stand around 4.4% for 2018, 4.2% for 2019, and 4.1% for 2020. In this scenario, the inflation projections for administered prices are 7.3% for 2018, 5.4% for 2019, and 4.1% for 2020.

B) Risks around the baseline inflation scenario

8. The Copom's baseline scenario for inflation encompasses risk factors in both directions, but with greater weight on the last two risks, listed below.

9. On the one hand, (i) the high level of economic slack 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 case (iii) the global outlook for emerging economies deteriorates. The Committee judges that the degree of asymmetry in the balance of risks has diminished since its previous meeting.

C) Discussion about the conduct of monetary policy

11. The Committee members discussed the evolution of economic activity in light of available data. They concluded that the data indicate continuation of the recovery of economic activity, at a more gradual pace than envisaged early this year.

12. Regarding the global outlook, the Committee members considered that it remains challenging for emerging economies. They evaluated that, since their previous meeting, risk appetite for assets of these economies stabilized – in contrast with the worsening trend observed in the previous months. However, the assessment was that this stabilization occurred at levels lower that those observed at the beginning of the year, which implies higher risk premia. In addition, since the previous Copom meeting, prices of risky assets in some advanced economies have shown greater volatility, which contrasts with the favorable evolution observed previously. The Copom's baseline scenario assumes gradual normalization of monetary policy in central economies. The Committee members also mentioned the risks to the continued expansion of international trade, with possible impacts on global growth, and on the Chinese economy, in particular. In this context, the Copom members once again highlighted the capacity of the Brazilian economy to withstand a setback in the international scenario, given its robust balance of payments and the environment of

[1] Unless explicitly stated otherwise, this update takes into account changes occurred since the September Copom meeting (217th meeting).

[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.

anchored inflation expectations and prospects of economic recovery.

13. The members of the Committee also highlighted the reduction of uncertainties in the domestic front, which led to a decline in risk premia embedded in Brazilian asset prices. This decline of uncertainties contributed to reduce the degree of asymmetry in the balance of risks for inflation. Despite this improvement, the Copom members concluded that upward risks to inflation continue to have a greater weight in the balance of risks.

14. The Copom analyzed the inflation trajectory for the next months. This trajectory should lead to a rise of 12-month inflation, reaching a peak around the second quarter of 2019. Thereafter, 12-month inflation is expected to decline over the remainder of 2019, towards the target.

15. With regard to underlying inflation, in recent months its various measures have risen from levels considered to be low, reaching levels that the Committee deems appropriate —i.e., generally consistent with the inflation targets. Recent changes in relative prices, in a context of anchored inflation expectations, seem to have contributed to raise inflation to levels compatible with the inflation targets, without posing risks to the maintenance of inflation at these levels once such relative price adjustments have taken place. However, the Committee members considered that the evolution of the prospective inflation path in the medium and long terms — along with the anchoring of inflation expectations — should be monitored in order to evaluate possible more enduring effects from recent shocks to inflation (i.e., their second-round effects).

16. Copom members then discussed the convenience of maintaining in their official documents the message on principles for conducting monetary policy in face of relative price shocks in an inflation targeting regime with anchored expectations. The Copom has communicated that, in this context, monetary policy should focus only on possible second-round effects of relative price changes induced by occasional shocks. It has also stressed that its reaction to possible changes in relative prices will be symmetric, i.e., monetary policy will follow the same principles, whether in face of inflationary shocks (as in the case of a shock leading to a depreciation of the exchange rate) or in face of disinflationary shocks (as in the case of a favorable food price shock). Committee members pondered that it should already be clear that there is no mechanical relationship between shocks that produce relative price adjustments and monetary policy. Hence, they agreed to exclude this message as of their next meeting, with the understanding that this should not be interpreted as a change in the conduct of monetary policy.

17. The members of the Committee also discussed the extent of the exchange rate pass-through in the Brazilian economy. They assessed that, with the exception of some administered prices, the level of pass-through has been contained. The members pondered, however, that the intensity of pass-through depends on several factors, such as the level of economic slack, and the degree of anchoring of inflation expectations. The Committee will continue to monitor different measures of exchange rate pass-through to both inflation and underlying inflation.

18. The Copom members assessed that economic conditions with anchored inflation expectations, underlying inflation measures at adequate levels, inflation projections close to the target for 2019 and 2020, and high level of slack in the economy still prescribe accommodative monetary policy, i.e., interest rates below the structural interest rate level. Although estimates of this rate involve a high degree of uncertainty, the Committee members expressed the view that the current *ex-ante* real interest rates provide stimulus to the economy.

19. The Committee also discussed the conditionalities that would prescribe accommodative monetary policy. All members agreed that the appropriate level of stimulus depends on economic conditions – in particular, on inflation expectations, the level of economic slack, the balance of risks, and inflation projections. Importantly, the provision of monetary stimulus requires an environment with anchored inflation expectations. The Committee assessed that this stimulus should be removed gradually if the prospective scenario for inflation at the relevant horizon and/or its balance of risks worsen.

20. The Copom stresses that the continuation of reforms and necessary adjustments in the Brazilian economy is essential to the reduction of its structural interest rate. The Committee will continue to reassess the estimates of this rate over time.

21. The Committee members then discussed the monetary policy decision, in light of the evolution of the baseline scenario and the balance of risks since its September meeting (217th meeting). They unanimously decided to maintain the Selic rate at 6.50% p.a.

22. The Copom then discussed the advisability of signaling the future evolution of monetary policy. Despite the reduction in the degree of asymmetry of the balance of risks, all members considered that the current environment prescribes retaining greater flexibility in the conduct of monetary policy, which requires refraining from providing indications of the next steps of monetary policy. The members of the Copom reinforced the importance of emphasizing their commitment to conducting monetary policy in order to

maintain the path for prospective inflation in line with inflation targets. This requires flexibility to gradually adjust the conduct of monetary policy when and if needed. This ability to respond to different circumstances contributes to the maintenance of the environment with anchored expectations, which is fundamental to ensure that the achievement of low inflation persists, even in face of adverse shocks.

23. The Committee members reiterated their preference for communicating the conditionalities for the conduct of monetary policy, which better transmits the economic rationality guiding their decisions. This contributes to increase transparency and enhance Copom's communications. In this context, they reasserted 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.

24. All Committee members once again emphasized that the approval and implementation of reforms — notably those of fiscal nature— and adjustments in the Brazilian economy are crucial 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. The Committee also notes that the perception of continuity in the reform agenda affects expectations and current macroeconomic projections.

25. Finally, the Copom members 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

26. 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 its baseline scenario for prospective inflation and the associated balance of risks and is consistent with convergence of inflation to target over the relevant horizon for the conduct of monetary policy, which includes 2019 and, with a smaller weight, 2020.

27. The Copom emphasizes that the evolution of reforms and necessary adjustments in the Brazilian economy is essential to maintain low inflation in the medium and long run, for the reduction of its structural interest rate, and for sustainable economic recovery. The Committee stresses that the perception of continuation of the reform agenda affects current expectations and macroeconomic projections.

28. The Copom judges that it should base its decisions on the evolution of inflation projections and expectations, of the balance of risks, and of economic activity. Shocks that produce relative price changes should only lead to a monetary policy response to their possible second-round effects (i.e., to the propagation to prices in the economy that are not directly affected by the shock). It is through such second-round effects that these shocks may affect inflation projections and expectations, and change the balance of risks. These effects may be mitigated by the level of economic slack and by inflation expectations anchored at the targets. Therefore, there is no mechanical relationship between recent shocks and the conduct of monetary policy.

29. The Copom reiterates that economic conditions still prescribe stimulative monetary policy, i.e., interest rates below the structural level. This stimulus will begin to be removed gradually if the outlook for inflation at the relevant horizon for the conduct of monetary policy and/or its balance of risks worsen.

30. In the Copom's assessment, the evolution of the baseline scenario and of the balance of risks prescribes keeping the Selic 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.

31. 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.