256th

Minutes of the Meeting of the

Monetary Policy Committee — Copom

August 1-2, 2023

BANCO CENTRAL DO BRASIL

Date: August 1-2, 2023

Place: BCB Headquarters' meeting rooms on the 8th floor (8/1 and 8/2 on the morning) and 20th floor (8/2 on the afternoon) – Brasilia – DF – Brazil

Starting and ending times: August 1: 10:08 am – 12:21 pm; 2:13 pm – 6:23 pm
August 2: 11:07 am – 12:41 pm; 2:25 pm – 6:45 pm

In attendance:

Copom Members

Roberto de Oliveira Campos Neto – *Governor*
Ailton de Aquino Santos
Carolina de Assis Barros
Diogo Abry Guillen
Fernanda Magalhães Rumenos Guardado
Gabriel Muricca Galípolo
Maurício Costa de Moura
Otávio Ribeiro Damaso
Renato Dias de Brito Gomes

Department Heads in charge of technical presentations (attending on 8/1 and on the morning of 8/2):

Alan da Silva Andrade Mendes – *Department of Foreign Reserves*
André Minella – *Research Department* (also present on the afternoon of 8/2)
André de Oliveira Amante – *Open Market Operations Department*
Fabia Aparecida de Carvalho – *Department of International Affairs*
Ricardo Sabbadini – *Department of Economics*
Rogério Antônio Lucca – *Department of Banking Operations and Payments System* (present on the mornings of 8/1 and 8/2)

Other participants (attending on 8/1 and on the morning of 8/2):

Arnildo da Silva Correa – *Head of the Office of Economic Advisor*
Edson Broxado de França Teixeira – *Head of Office of the Deputy Governor for Supervision*
Eduardo José Araújo Lima – *Head of Office of the Deputy Governor for Economic Policy*
Euler Pereira Gonçalves de Mello – *Deputy Head of the Research Department*
Gilneu Francisco Astolfi Vivan – *Head of the Financial System Monitoring Department*
Isabela Ribeiro Damaso Maia – *Head of the Sustainability and International Portfolio Investors Unit*
Julio Cesar Costa Pinto – *Head of Office of the Deputy Governor for Monetary Policy*
Laura Soledad Cutruffo Comparini – *Deputy Head of the Department of Economics*
Leonardo Martins Nogueira – *Executive Secretary*
Mariane Santiago de Souza – *Head of the Governor's Office*
Mauro Zanatta – *Press Office Advisor*
Olavo Lins Romano Pereira – *Deputy Head of the Department of International Affairs*
Renato Baldini Junior – *Head of the Department of Statistics*
Ricardo Eyer Harris – *Head of Office of the Deputy Governor for Regulation*
Ricardo Franco Moura – *Head of the Prudential and Foreign Exchange Regulation Department* (present on 8/1)

The Copom members 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 scenario[1]

1. The global environment remains uncertain, with some disinflation at the margin but with still high core inflation, gradual slowdown in economic activity, and resilience in the labor market of many countries. At the same time, the central banks of major economies remain committed to bringing inflation back to its targets, either by continuing their monetary tightening cycles or by signaling a prolonged period of high interest rates to fight inflationary pressures. This stance continues to call for greater caution in the conduct of economic policies, particularly by emerging countries.

2. Regarding the domestic scenario, the recent set of indicators suggests a scenario of gradual deceleration of activity. Apart from the strong performance of agriculture, concentrated in the first quarter, the pace of activity growth continues to corroborate the scenario anticipated by the Committee. In general, there is some retraction in the trade sector, stability in industry and some accommodation in the services sector, after a stronger growth pace in previous quarters. The labor market remains resilient but with some moderation at the margin.

3. Consumer inflation continues to show more benign current dynamics, particularly in industrial goods and food components. Although the inflation of the components more sensitive to the economic cycle and the monetary policy, which have greater inflationary inertia, declined, they remain above the inflation target. Inflation expectations for 2023, 2024, and 2025 collected by the Focus survey have reduced and are around 4.8%, 3.9%, and 3.5%, respectively.

B) Scenarios and risk analysis

4. In the reference scenario, the interest rate path is extracted from the Focus survey, and the exchange rate starts at USD/BRL 4.75[2] and evolves according to the purchasing power parity (PPP). The Committee assumes that oil prices follow approximately the futures market curve for the following six months and then start increasing 2% per year onwards. Moreover, the energy flag is assumed to be "green" in December 2023, 2024, and 2025. In this scenario, Copom's inflation projections stand at 4.9% for 2023, 3.4% for 2024, and 3.0% for 2025. Inflation projections for administered prices are 9.4% for 2023, 4.6% for 2024, and 3.5% for 2025.

5. The Committee evaluates that the international outlook is uncertain. The Committee noted the resilience of activity and the labor market in advanced economies, even if some moderation is observed at the margin, as well as lower growth projection for the Chinese economy. In this context some members see a mild moderation in activity in major economies as more likely, although a sharper slowdown is not ruled out. A disinflation process at the margin is observed, reflecting the slowdown of commodity pressures after the initial impacts of the war in Ukraine and the normalization of productive sectors, but with a slow decline in core inflation. Looking ahead, uncertainties remain about the global inflation dynamics. The downward movement in commodity prices has stalled in the recent period, and risks related to weather phenomena, the war in Ukraine, and international oil pricing policy suggest the possibility of renewed supply-side inflationary pressures. Furthermore, it is observed resilience of the labor market and tight output gap in advanced economies, in an environment of still pressured services inflation in several economies. Thus, central banks remain committed to control inflation by maintaining tighter monetary policy for a longer period. Such determination, albeit with a likely impact upon domestic asset prices in the short term, coupled with a credit slowdown in major economies, contributes to a more credible and lasting global disinflationary process. Moreover, the

[1] Unless explicitly stated otherwise, this update takes into account changes that occurred since the June Copom meeting (255th meeting).
[2] Value obtained according to the usual procedure of rounding the average USD/BRL exchange rate observed on the five business days ending on the last day of the week before the Copom meeting.

Committee considered that the synchronization of contractionary monetary policy may have a larger-than-expected impact on the global output gap and on the disinflation process. The larger-than-expected upward impact on inflation of the synchronization of expansionary fiscal and monetary policies across countries during the pandemic was mentioned again.

6. Growth data for Brazil remain consistent with the reference scenario of moderating activity anticipated by the Committee. The process of rebalancing the consumption basket, and, consequently, relative prices, between goods and services continues, with moderation in the consumption of goods in favor of greater demand in the services segment. However, the services sector has been moderating in recent months. In addition, more timely data continue to suggest that the pace of economic growth is in line with the Committee's expectations. Again, an in-depth discussion of developments in the labor market took place. Some members still consider that there is a recent moderation in the labor market, which points to the slowdown in the pace of hirings in the formal market and the decline in the participation rate. Other members emphasized the drop in the unemployment rate and the still high pace of hirings in formal employment. The Committee agreed that there is no evidence of high wage pressures in labor negotiations. Some members noted that the recent process towards a partial recomposition of previous losses in real wages moves forward. This movement is expected and has been accompanied by a deceleration in nominal gains, which is expected to intensify ahead.

7. The Committee analyzed different output gap metrics and assumptions, comparing not only the estimate of the current gap level under different methods, but also their impacts on the inflation projection. It was noted that the speed with which the gap is assumed to close over the projection horizon is as important as the initial level assumed for the gap. It was then discussed the risk that the output gap is tighter than assumed in the reference scenario, in particular in the labor market, and assessed the impacts of this alternative assumption on inflation projections. The Committee emphasizes that the output gap is an unobservable variable, subject to uncertainty in its measurement and with even greater uncertainty after the pandemic period.

8. The Committee believes that the disinflation dynamics continues to be characterized by a process with two distinct stages. The first-stage movement proved deeper than expected, given the more benign dynamics of food and industrial prices and the behavior of wholesale prices. In this regard, the recent dynamics of the exchange rate and international commodity prices, although with greater volatility, has contributed to slow down international pressures on inflation in Brazil. On the one hand, this phenomenon improves the dynamics of the second stage of disinflation, with lower inertia on core inflation and services inflation. On the other hand, the inherent volatility of food and industrial goods components suggests the possibility of abrupt reversals, recommending caution. In this debate, the risks related to *El Niño*, which were partially incorporated into the reference scenario, were mentioned, as were those related to international oil price developments, which followed the Committee's usual governance in its assumptions. In the end, it was unanimously concluded that a contractionary and cautious monetary policy was needed to reinforce the disinflationary dynamics.

9. Also in the discussion on inflationary behavior, the current stage of the disinflationary process and the recent behavior of services inflation were discussed in depth. It was noted that the indicators of this segment point to continuity in the trajectory of disinflation in the recent period, despite some oscillation at levels still above the value compatible with the target. In such a discussion, it was emphasized that it is more relevant to focus on its underlying fundamentals – in particular, possible changes in the labor market and in the dynamics of activity – than on punctual movements in services inflation, relative to some component or some period.

10. Inflation expectations have shown partial reanchoring since the previous Copom

meeting. The Committee emphasized the credibility gain produced by the June meeting of the National Monetary Council (CMN), which established the inflation target for 2026, as well as its tolerance range, at the same values as those for 2024 and 2025 and without revising the targets and ranges previously established for 2023, 2024, and 2025. In addition, the announcement of a change to a continuous target system, with rules yet to be set out, has reduced uncertainty about the targets for subsequent years, also contributing to further reanchoring. Therefore, there was a positive impact on inflation expectations immediately after the CMN's decision, reinforcing the interpretation that the inflation targeting regime has gained credibility.

11. However, the reanchoring is still partial and the Committee discussed again the reasons for such deanchoring. Members raised several possibilities. The Committee removed residual uncertainty about the approval of the fiscal framework from its balance of risks but noted in its discussion that fiscal dynamics remained relevant in its reference scenario. In particular, some members assessed that some uncertainty persists among agents about overcoming fiscal challenges, evidenced in primary balance expectations that diverge from the targets set by the government, and that this may also be reflected in unanchored inflation expectations for longer maturities. In this case, anchoring expectations around the targets set out in the new fiscal framework, with the maintenance of the fiscal commitment in addition to a reduction in uncertainties about the tax measures that underpin the implementation of this objective, would contribute to a faster disinflationary process. Others evaluated that a global scenario with higher inflation also makes it difficult to reanchor expectations, since there is a possibility of external inflation at higher levels for a longer period. Finally, the hypothesis of the agents' perception that, over time, the Banco Central do Brasil (BCB) would become more lenient in fighting inflation was mentioned. Copom members unanimously understand that, regardless of the BCB's board composition, the Institution's credibility and reputation should be ensured.

12. Copom reminds that structural reforms and the predictability of public accounts are essential to increase the economy's productivity, raise the potential growth, and improve the confidence of business, investors, and households. The lack of commitment with structural reforms, the increase of earmarked credit granting, and the uncertainties about the stabilization of the public debt have the potential to raise the neutral interest rate of the economy, with harmful impacts on the monetary policy power and, consequently, on its cost to the economy.

13. The Committee emphasizes that risks to its scenarios remain in both directions. Among the upside risks for the inflationary scenario and inflation expectations, it should be emphasized (i) a greater persistence of global inflationary pressures; and (ii) a stronger than expected resiliency on services inflation due to a tighter output gap. Among the downside risks, it should be noted (i) a greater than projected deceleration of global economic activity, particularly due to adverse conditions in the global financial system; and (ii) an impact on global disinflation larger than expected from synchronized monetary policy tightening.

C) Discussion about the conduct of monetary policy

14. Copom discussed the conduct of monetary policy, considering the set of projections evaluated, as well as the balance of risks for inflation.

15. The Committee unanimously evaluated that the evolution of the scenario since the previous meeting has given the necessary confidence to start a gradual cycle of monetary easing. This evaluation involved different dimensions. Firstly, it was emphasized the positive behavior of inflation expectations following the setting of the target by the CMN and the announcement of the change to a continuous target system. The reduction of inflation expectations, as well as of break-even inflation rates, reduces the cost of disinflation and impacts the ex-ante real interest rate of the economy, as

previously alerted by Copom. Secondly, headline inflation measures registered a clear improvement, while services inflation continues decelerating at the margin. Some members emphasized the recent dynamics, while others emphasized that the underlying fundamentals for the dynamics of services inflation do not allow yet to convincingly extrapolate the recent benign behavior. Regarding the output gap, some members noted the upward revision in its estimate, and the Committee discussed the implications of alternative output gap measures from other models and their respective impacts on projections. Finally, it was observed that the partial reanchoring of expectations contributed to reducing projections in the reference scenario. However, this movement was counterbalanced by updating some variables in the reference scenario that affect estimates and projections of the output gap, so that inflation projections did not differ significantly from those of the previous meeting. After the scenario evaluation, all members agreed that it was appropriate to reduce the Selic rate in this meeting.

16. During the debate, the Committee judged that both the options of reducing the Selic rate by 0.25 percentage point or 0.50 percentage point had merit, reinforcing that, whatever the decision, there was a consensus that a scenario with inflation expectations with only a partial reanchoring, core inflation still above the target, services inflation still above the level compatible with the inflation target, and resilient economic activity requires a more conservative stance throughout the cycle of monetary policy easing. Moreover, both options, depending on the cycle undertaken, would be consistent with the convergence of inflation to the target in the Copom's reference scenario and in other scenarios discussed in the meeting.

17. One group was in favor of a more parsimonious interest rate reduction. For this group, the Committee's signaling itself already emphasized the caution and parsimony inherent to this scenario and, according to these members, no relevant changes had been observed either in the scenario or in Copom's projections that justified the re-evaluation of this signaling. Other group considered that the monetary policy stance at a significantly contractionary degree allows the start of the cycle already at the moderate pace considered for the next meetings, without compromising the commitment to achieve the target and the credibility of monetary policy. This group emphasized that some events observed since the previous meeting, as the recent inflation dynamics more benign than expected, the partial reanchoring relatively fast after the CMN's target setting, and the adequacy of recalibrating the real interest rate in view of the inflation expectations movements.

18. Regarding the next steps, Copom members unanimously anticipated cuts of 0.50 percentage point in the next meetings and judged that this pace is appropriate to keep the necessary contractionary monetary policy for the disinflationary process. This pace brings together, on the one hand, the firm commitment with the reanchoring of expectations and the disinflationary dynamics and, on the other hand, the adjustment in the level of monetary tightening in real terms in face of the more benign dynamics of the anticipated inflation in the reference scenario projections. Copom also evaluated that there is no evidence of an ongoing monetary tightening beyond that necessary for the inflation convergence to the target, and the scenario still calls for caution, reinforcing the view of serenity and moderation that Copom has expressed. The Committee judges that there is low probability of an additional intensification in the pace of adjustment, since this would require substantial positive surprises that would raise even further the confidence in the prospective disinflationary dynamics. Such confidence would arise only with a significant change in the fundamentals of inflation dynamics, such as a much more solid reanchoring of expectations, a sharp widening of the output gap, or a services inflation dynamics substantially more benign than the expected.

19. Finally, the Committee debated the extension of the monetary policy adjustments cycle. Copom analyzed the projections in the reference scenario, in a scenario of an

interest rate reduction of 0.50 percentage point in this meeting, and in alternative scenarios that reflected the balance of risks. It was emphasized, in this analysis, the need to maintain a still contractionary monetary policy in the relevant horizon to consolidate the inflation convergence to the target and the anchoring of expectations. Copom emphasized that the extension of the cycle over time will depend on the inflationary dynamics, especially the components that are more sensitive to monetary policy and economic activity, on inflation expectations, in particular the longer-term ones, on its inflation projections, on the output gap, and on the balance of risks. The Committee maintains its firm commitment to the convergence of inflation to the target in the relevant horizon and reinforces that the extension of the cycle will reflect the BCB's legal mandate.

D) Monetary policy decision

20. Considering the assessed scenarios, the balance of risks, and the broad array of available information, Copom decided to reduce the Selic rate by 0.50 percentage point, to 13.25% p.a., and judges that this decision is consistent with the strategy for inflation convergence to a level around its target throughout the relevant horizon for monetary policy, which includes the year of 2024 and, to a lesser extent, 2025. Without compromising its fundamental objective of ensuring price stability, this decision also implies smoothing economic fluctuations and fostering full employment.

21. The Committee reinforces the need to persist on a contractionary monetary policy until the disinflationary process consolidates and inflation expectations anchor around its targets.

22. Copom considered the alternative option to reduce the Selic rate to 13.50%, but it concluded that it was appropriate to adopt a 0.50 percentage point pace in this meeting due to an improvement in the inflation dynamics, reinforcing however the firm objective of keeping a contractionary monetary policy to reanchor expectations and bring inflation to the target in the relevant horizon. The current context, characterized by a stage in which the disinflationary process tends to be slower and with partial reanchoring of inflation expectations, requires serenity and moderation in the conduct of monetary policy. If the scenario evolves as expected, the Committee members unanimously anticipate further reductions of the same magnitude in the next meetings, and it judges that this pace is appropriate to keep the necessary contractionary monetary policy for the disinflationary process. The Committee emphasizes that the total magnitude of the easing cycle throughout time will depend on the inflation dynamics, especially the components that are more sensitive to monetary policy and economic activity, on inflation expectations, in particular the longer-term ones, on its inflation projections, on the output gap, and on the balance of risks.

23. The following members of the Committee voted a reduction of 0.50 percentage point: Roberto de Oliveira Campos Neto (Governor), Ailton de Aquino Santos, Carolina de Assis Barros, Gabriel Muricca Galípolo, and Otávio Ribeiro Damaso. The following members voted for a reduction of 0.25 percentage point: Diogo Abry Guillen, Fernanda Magalhães Rumenos Guardado, Maurício Costa de Moura, and Renato Dias de Brito Gomes.