

Minutes of the 216th Meeting of the Monetary Policy Committee (Copom) * of the Central Bank of Brazil **

July 31st and August 1st, 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: July 31st and August 1st, 2018

Place: BCB Headquarters' meeting rooms on the 8th floor (July 31st) and 20th floor (August 1st) – Brasília – DF – Brazil

Starting and ending time: July 31st: 10:16 am – 12:00 am; 2:34 pm - 5:36 pm
August 1st: 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 July 31st)

Alan da Silva Andrade Mendes - Department of Foreign Reserves
André Minella - Research Department (*also present on August 1st*)
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 July 31st)

Adalberto Felinto da Cruz Júnior – Executive Secretary
André Luiz Caccavo Miguel – Head of the Financial System Monitoring Department
Eugênio Pacceli Ribeiro – Head of the Deputy Governor for Economic Policy's Office
Fabia Aparecida de Carvalho – Deputy Head the Research Department
Fabio Araújo – Economic Advisory to the President
Gustavo Paul Kurrle – Press Officer
Leonardo Martins Nogueira – Head of the Governor's Office
Renato Baldini Junior – Head of the Department of Statistics
Ricardo Eyer Harris – Head of the Deputy Governor for Regulation'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 scenario¹

1. Recent indicators of economic activity reflect the effects of the temporary halt in the transportation sector, but there is evidence of subsequent recovery. The baseline scenario entertains continuation of recovery of economic activity in the Brazilian economy, at a more gradual pace than envisaged prior to the halt.

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 showed some accommodation recently, but remains more challenging. The main risks are associated with normalization of interest rates in some advanced economies and with uncertainty regarding global trade. Risk appetite towards emerging economies remained relatively stable, at a level below that observed earlier this year.

4. June inflation reflected significant upward pressure from the halt in the transportation sector and other relative price changes. Recent data corroborate the view that these effects should be temporary. Measures of underlying inflation are still running at low levels. This includes the components that are most sensitive to the business cycle and monetary policy.

5. Inflation expectations for 2018 and 2019 collected by the Focus survey are around 4.1%. Expectations for 2020 and 2021 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 4.2% for 2018, and 3.8% for 2019. This scenario assumes, among other hypotheses, a path for the policy interest rate that ends 2018 at 6.5% p.a., and 2019 at 8.0% p.a., and a path for the exchange rate that ends 2018 at R\$/US\$ 3.70 and 2019 at that same level. In this scenario projections for the administered prices inflation are 7.2% for 2018 and 4.8% for 2019.

7. In the scenario with a constant interest rate at 6.50% p.a., and a constant exchange rate at R\$3.75/US\$², Copom's inflation projections stand around 4.2% for 2018 and 4.1% for 2019. In this

scenario, the inflation projections for administered prices are 7.4% for 2018 and 5.0% for 2019

B) Risks around baseline inflation scenario

8. The Copom's baseline scenario for inflation encompasses risk factors in both directions.

9. On the one hand, (i) the possible propagation, through inertial mechanisms, of low inflation levels in the past and 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) that the global outlook for emerging economies deteriorates. The Committee judges that the latter risks remain at higher levels.

C) Discussion about the conduct of monetary policy

11. The Committee members discussed the evolution of economic activity in light of available data. May 2018 data reflect the effects of the temporary halt in the transportation sector that took place at the end of that month. Indicators available since then point to subsequent recovery, although some indicators referring to June may still be influenced by that halt. The baseline scenario entertains the continuation of recovery of economic activity in the Brazilian economy, albeit at a more gradual pace than estimated prior to the halt.

12. Regarding the global outlook, the Committee judges that financial conditions showed some accommodation, but the scenario remains more challenging. The baseline scenario comprises gradual normalization of monetary policy in central economies. There is risk of additional impact on emerging economies owing to this process, which may reinforce changes in asset prices and in the volatility of financial conditions in international markets. The Committee members also mentioned the growing risks to the

¹ Unless explicitly stated otherwise, this update takes into account changes occurred since the June Copom meeting (215th 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.

continued expansion of international trade, with possible impacts on global growth. 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 low inflation environment in the recent past, in addition to anchored expectations and prospects of economic recovery. Nevertheless, the Copom pondered the risks stemming from a possible additional deterioration in the outlook for emerging economies, in a context of frustration of expectations regarding the necessary reforms and adjustments in the Brazilian economy.

13. The Copom analyzed the inflation trajectory in the short-term. All members agreed that June inflation reflected significant upward pressure from the halt in the transportation sector and from other relative price changes. Inflation projections for July and August corroborate the view that these effects should be temporary.

14. The Committee pointed out that several measures of underlying inflation were running at low levels before those shocks and that relative price changes in a context of anchored inflation expectations may contribute to the convergence of inflation to target, without posing risks to its favorable dynamics once these price changes are over. Nevertheless, the 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 shocks – both those that have already occurred and those that may yet arise – on inflation (i.e., their second-round effects).

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 also highlighted 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 depreciation of the exchange rate) or in the face of disinflationary shocks (as in the case of a favorable food price shock). The Committee emphasizes that this prescription requires an environment with anchored expectations.

16. Having established how monetary policy should react to shocks that induce changes in relative prices, Copom members discussed the extent of the 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 will monitor the different measures of exchange-rate pass-through to both inflation and underlying inflation.

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

18. The Committee also debated 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.

19. 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 estimates of this rate over time.

20. The Committee members then discussed the evolution of the baseline scenario and the balance of risks since its June meeting (215th meeting) and the appropriate monetary policy decision in light of such evolution.

21. The Committee assessed the effects of the halt in the transportation sector. It was agreed that these effects are revealing themselves temporary. Nonetheless, they discussed possible more enduring effects of the shocks faced by the Brazilian economy. This context reinforces the importance of monitoring over time the evolution of the baseline scenario and its risks and of evaluating the duration of the effects of shocks on inflation (i.e., its second-round effects) in order to ensure that the achievement of low inflation persists, even in the face of adverse shocks.

22. Regarding the balance of risks, on the one hand, the Committee judged that downward risks for the prospective inflation path due to the low level of inflation in the recent past have decreased. However, the persistence of a high level of economic slack also poses downward risks to inflation. On the other hand, it discussed the importance of the continuation of the process of adjustments and reforms in the Brazilian economy for mitigating the risks associated with the deterioration of the scenario for emerging economies, in a context of frustration of the expectations about

these reforms and adjustments. The Copom judges that these risks remain at higher levels.

23. Based on all assessments, the Copom members agreed to maintain the Selic rate at 6.50% p.a.

24. The Copom then discussed the advisability of signaling on the future evolution of monetary policy. All members considered that, in the absence of additional shocks, the inflationary scenario should prove comfortable. However, the higher level of uncertainty of the current situation generates a need for greater flexibility in the conduct of monetary policy. This recommends refraining from providing indications on the next steps of monetary policy.

25. The Copom members reiterated the importance of reaffirming the conduct of monetary policy with exclusive focus on the evolution of inflation projections and expectations, the balance of risks, and economic activity. Relative price shocks should be tackled only in the secondary impact they may have on prospective inflation. In particular, they reiterated the importance of insisting on communicating that there is no mechanical relationship between recent shocks and the conduct of monetary policy.

26. The Committee members reiterated once again their preference for communicating conditionalities on the evolution 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.

27. 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.

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 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.

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 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.

32. 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 around the targets. Therefore, there is no mechanical relationship between recent shocks and the conduct of monetary policy.

33. The Committee judges that the effects of recent shocks on inflation are revealing themselves temporary, but it is important to follow the baseline scenario and associated risks, and to assess possible persistent effects of shocks to inflation (i.e., their second-round effects).

34. In the Copom's assessment, the evolution of the baseline scenario and 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.

35. The following members of the Committee voted for this decision: Ilan Goldfajn (Presidente), 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 e Tiago Couto Berriel.