BANCO CENTRAL DO BRASIL

Minutes of the 187th Meeting of the Monetary Policy Committee (Copom)

Summary
Recent Economic Developments
Assessment of Inflation Trends
Monetary Policy Decision

Date: December 2nd, 2014, from 4:12PM to 7:57PM, and December 3rd from 4:50PM to 8:14PM

Place: BCB Headquarters meeting rooms – 8th floor on December 2nd and 20th floor on December 3rd – Brasília – DF

In attendance:
Members of the Committee
Alexandre Antonio Tombini – Governor
Aldo Luiz Mendes
Altamir Lopes
Anthero de Moraes Meirelles
Carlos Hamilton Vasconcelos Araújo
Luiz Awazu Pereira da Silva
Luiz Edson Feltrim
Sidnei Corrêa Marques

Department Heads (present on December 2nd)
Bruno Walter Coelho Saraiva - International Affairs Department
Daso Maranhão Coimbra - Department of Banking Operations and Payments System
Eduardo José Araújo Lima - Research Department (also present on December 3rd)
João Henrique de Paula Freitas Simão - Open Market Operations Department
Márcio Barreira de Ayrosa Moreira - Department of Foreign Reserves
Renato Jansson Rosek – Investor Relations and Special Studies Department
Tulio José Lenti Maciel – Economic Department

Other participants (present on December 2nd)
Fernando de Aquino Fonseca Neto – Coordinator at the Economic Department
Gustavo Paul Kurrle – Press Officer
Otávio Ribeiro Damaso – Chief of Governor's Staff

The members of the Copom analyzed the recent performance and the prospects for the Brazilian economy and for the international economy, under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

Recent Economic Developments

1. Monthly inflation measured by the Extended Consumer Price Index (IPCA) reached 0.42% in October, 0.15 percentage points (p.p.) below the one recorded in the previous month. As a consequence, inflation in twelve months decreased to 6.59% (5.84% in October 2013). Market prices changed 6.88% in twelve months (7.37% in October 2013), and regulated prices, 5.57% (1.01% in October 2013). Among market prices, the prices of tradable goods increased 6.25% in twelve months (6.38% in October 2013) and the prices of non-tradable goods, 7.47% (8.24% in October 2013). It should also be noted that the prices of the food and beverages group increased 7.60% in the same period (8.88% in October 2013), and the prices of services rose 8.50% (8.74% until October 2013). In short, available information suggests some persistence of inflation, which partially reflects the dynamics of prices in the services sector.

2. The average of the underlying monthly inflation measures, calculated by the BCB, changed from 0.55% in September to 0.44% in October. As a consequence, on a twelve-month trailing basis, average core inflation

reached 6.63% (0.35 p.p. above the one registered in October 2013). Specifically, the double weight core inflation changed from 0.57% in September to 0.44% in October; the core inflation by exclusion of regulated prices and household food, from 0.58% to 0.42%; the core by exclusion, which excludes ten household food items and fuels, from 0.55% to 0.41%; the non-smoothed trimmed means IPCA core inflation changed from 0.51% to 0.41%; and the smoothed trimmed means IPCA core inflation, from 0.54% to 0.51%. The diffusion index stood at 64.9% in October (2.8 p.p. below the one recorded in October 2013).

3. The General Price Index (IGP-DI), increased 0.02% in September and 0.59% in October, reaching 3.21% on a twelve-month trailing basis (5.46% in October 2013). The main component of this indicator, the Wholesale Price Index (IPA), changed 1.32% in twelve months (5.07% in October 2013), with increase of 1.29% in the prices of agricultural products and 1.32% in the prices of industrial products. Inflation measured by the Consumer Price Index (IPC), the second most important component of the IGP-DI, changed 6.84% in twelve months through October (5.36% in October 2013). The Civil Construction National Index (INCC), component with the lowest weight in the IGP-DI, changed 6.87% (8.14% in October 2013), partially driven by pressures stemming from the labor cost, which increased 8.48% in the period. On its turn, the Producer/Manufacturing Industry Price Index (IPP/IT), calculated by the Brazilian Institute of Geography and Statistics (IBGE), increased 0.94% in September, changing 2.87% in twelve months. The Copom considers that the effects of the behavior of wholesale prices on consumer inflation will depend on the current and prospective demand conditions and on the price setters' expectations regarding the future inflation path.

4. The Economic Activity Index of the BCB (IBC-Br) incorporates estimates for the monthly production of the three sectors of the economy, as well as for taxes on products, and constitutes important coincident indicator of the economic activity. In September 2014, the IBC-Br changed 0.92% year-over-year and, seasonally adjusted, 0.40% month-on-month. The composite Purchasing Managers' Index (PMI) regarding Brazil changed from 48.2 in October to 48.5 in November, suggesting a moderate contraction in activity. On its turn, the Consumer Confidence Index (ICC), from the Getúlio Vargas Foundation (FGV), decreased 6.1% in November, reaching the lowest level since December 2008. The Services Confidence Index (ICS) reached the lowest level of its historical series, with a decrease of 2.1% in November. On the other hand, the Industry Confidence Index (ICI) increased 3.6% in November, influenced by the improvement in business perception. Regarding agriculture, the Agricultural Production Systematic Assessment (LSPA), carried out by the IBGE in October 2014, indicates that grains production is expected to grow by 2.5% in 2015, relative to the 2014 harvest.

5. The GDP at market prices increased 0.1% in the third quarter of 2014, after decreasing 0.6% in the previous quarter, according to data seasonally adjusted by the IBGE. Year-over-year, it reached -0.2% (compared to -0.9% in the second quarter). From the aggregate demand perspective, household consumption decreased 0.3% in the third quarter, quarter-over-quarter, according to seasonally adjusted data, and increased 0.1% compared to the same quarter of 2013. On its turn, the government consumption increased 1.3% at the margin and 1.9% compared to the same quarter of 2013. Fixed capital gross formation (FBCF) increased 1.3% compared to the previous quarter and decreased 8.5% compared to the third quarter of 2013.

6. The industrial activity remained stable in October, after falling 0.2% in September, according to the seasonally adjusted series released by the IBGE. As a consequence, the industrial production accumulates a 3.0% fall in 2014. According to the observed series, year-over-year, the industrial production decreased 3.6% in October. The result was negative in the four economic categories and in 23 out of the 26 surveyed activities, according to the same comparison basis. According to data released by the National Confederation of Industry (CNI), real revenue in the manufacturing industry increased 3.1% between September and October 2014, according to the seasonally adjusted series, and is 1.3% larger than the one observed in October 2013. The PMI of the industrial sector, on its turn, fell again in November.

7. Among the use categories, according to the October month-over-month and seasonally adjusted data series, the production of intermediate goods (0.0%) and capital goods (0.0%) registered stabilitly. On the other hand, the production of durable consumer goods and semidurable and non-durable consumer goods decreased 0.8%, and 0.6%, respectively. Regarding year-over-year growth, the production of capital goods and durable consumer goods registered the sharpest falls among the major economic categories, -11.4% and -9.4%,

respectively, followed by retreats in the segments of intermediate goods and semidurable and non-durable consumer goods, -2.8% and -0.1%, respectively.

8. According to the Monthly Employment Survey (PME), covering six metropolitan areas, the unemployment rate reached 4.7%, a record low for October since 2002. The figure represents reductions of 0.2 p.p. compared to September 2014 and of 0.5 p.p. compared to October 2013. Data released by the Ministry of Labor and Employment (MTE) show that 30.3 thousand formal jobs were destroyed in October, the worst figure for October since the beginning of the historical series. In short, the set of available data indicates narrow idleness margin in the labor market, although some data point to an accommodation process.

9. According to the retail monthly survey (PMC), released by the IBGE, the retail sales volume increased 0.5% in September, compared to September 2013. On its turn, broad retail sales volume, which includes vehicles and construction inputs, fell 1.2% in September, according to the same comparison basis. The month-on-month changes were 0.4% and 0.5%, respectively, according to the seasonally adjusted series. In twelve months, the retail sales growth rate was 3.4% and the broad retail sales growth was -0.1%, with expansion in five out of the ten surveyed segments. The Trade Confidence Index (ICOM), measured by the FGV, decreased 1.0% in November, despite the favorable developments in the Current Situation Index (ISA-COM). The Copom evaluates that the retail sales trajectory will continue to be influenced by governmental transfers, by the pace of real payroll growth and by the moderate credit expansion.

10. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by the FGV, without seasonal adjustment, reached 83.9% in November and, according to the seasonally adjusted series, 82.7%. Among the industry use categories, the ones showing the highest Nuci, according to the seasonally adjusted series, are construction material (87.1%) and durable consumer goods (85.4%), followed by intermediate goods (84.4%), capital goods (80.4%) and non-durable consumer goods (77.8%). On its turn, the absorption of capital goods decreased 5.4% in the last twelve months through September.

11. The twelve-month trailing trade balance result reached US$1.6 billion in November. This result stemmed from US$228.4 billion in exports and US$230.0 billion in imports, with retreats of 5.2% and 3.7%, respectively, year-over-year. On its turn, the current account deficit accumulated in twelve months reached US$84.4 billion in October, equivalent to 3.7% of the GDP. Foreign direct investment totaled US$66.0 billion, according to the same comparison basis, equivalent to 2.9% of the GDP.

12. Regarding the global economy, leading indicators signal growth prospects in line with the trend in important advanced and emerging economies. Particularly about Europe, despite recent improvements, high unemployment rates, coupled with the fiscal consolidation and political uncertainties, constitute elements constraining investments and growth. Regarding the monetary policy, the Federal Reserve has confirmed the end of the assets' purchase program and, in general, accommodative stances prevail in advanced and emerging economies. The Bank of Japan expanded its program of monetary stimulus and signaled the possibility of new extensions. The inflation rates remain at low levels in the advanced economies; and, in the emerging ones, they stand at relatively high levels.

13. The price of the Brent oil barrel decreased to a level near US$70 since the previous Copom meeting. It bears highlighting that the geopolitical complexity that involves the oil sector tends to heighten the volatile behavior of prices. This volatile behavior also reflects the low predictability of some global demand and supply components. Since the last Copom meeting, the international prices of agricultural and metal commodities have fallen 3.13% and 2.68%, respectively. On its turn, the Food Price Index, calculated by the Food and Agriculture Organization of the United Nations (FAO), fell 6.9% in the twelve months through October 2014.

Assessment of Inflation Trends

14. The identified shocks, and their impacts, were reassessed according to the new set of available information.

15. For the set of regulated prices inflation, the projected adjustment is 5.3% in 2014, unchanged relative to the October Copom meeting. Among other factors, this projection considers gasoline and bottled gas price changes until October (0.3% and 3.8%, respectively), as well as assumptions of a 6.4% reduction in fixed telephone tariffs and the increase of 17.6% in electricity prices. The items for which there are more information were projected individually, and for the others, the projections are based on endogenous determination models for regulated prices, which compute, among other factors, seasonal components, market prices inflation and the IGP (General Price Index) change. Based on these models, the projected regulated prices change are 6% for 2015, the same value considered at the October Copom Meeting, and 5.2% for 2016, up from 4.9% considered at the previous meeting.

16. The estimate path for the spreads over the Selic rate, based on the 360-day swap rates, on the baseline scenario, projects 66 basis points (bps) and 7 bps for the fourth quarters of 2014 and 2015, respectively.

17. The structural primary surplus is considered as the fiscal indicator. It derives from the primary surplus trajectories, both for 2014 and 2015, according to the parameters set out in the Budget Guidelines Law (LDO)/2014 and in the Budget Guidelines Law Project (PLDO)/2015, respectively. Therefore, in a given period, the fiscal impulse corresponds to the variation of the structural surplus in comparison to the observed in the previous period.

18. Since the last Copom meeting, the median of the projections compiled by the Investor Relations and Special Studies Department (Gerin) for the 2014 IPCA fell from 6.45% to 6.43% and, for 2015, it increased from 6.30% to 6.49%.

19. The baseline scenario assumes the maintenance of the exchange rate at R$2.55/US$1.00 and the Selic rate at 11.25% p.a. during the forecast period. Under this scenario, the projection for the 2014 inflation fell, compared to the value considered at the previous Copom meeting and remains above the 4.5% midpoint target established by the National Monetary Council (CMN). According to the market scenario, which incorporates the market expectations for the exchange and Selic rates trajectories collected by Gerin, in the period immediately prior to the Copom meeting, the 2014 IPCA inflation forecast also fell relative to the value considered at the October meeting and remains above the inflation target. For 2015, according to both the baseline and the market scenarios, the inflation forecast remained relatively stable above the 4.5% inflation target. For the first three quarters of 2016, although the forecasts indicate that inflation enters a convergence path towards the 4.5% target established by the CMN, the forecasts also point to inflation above this level, both in the baseline and in the market scenarios.

Monetary Policy Decision

20. The Copom emphasizes that the international evidence, which is ratified by the Brazilian experience, indicates that high inflation rates generate distortions that lead to higher risks and depress investments. These distortions are manifested, for example, in the shortening of the planning horizons of households, companies and governments, as well as in the deterioration of the businessmen confidence. The Committee also emphasizes that high inflation rates reduce the purchasing power of wages and transfers, with negative repercussions over households' confidence and consumption. As a consequence, high inflation rates reduce the potential of economic growth, as well as of jobs and income generation.

21. In view of this, the Copom evaluates that the monetary policy should contribute to the consolidation of a favorable longer-term macroeconomic environment. In this respect, the Copom reassures that, under the inflation targeting regime, it guides its decisions according to BCB projected inflation and based on the analysis of alternative scenarios for the evolution of the main variables that determine prices dynamics. The Committee also understands that low risks for the underlying inflation in the short run tend to reduce uncertainties regarding the future behavior of headline inflation, facilitate the assessment of scenarios by the monetary authority, as well as help the process of coordination of economic agents' expectations, particularly prices setters'. Additionally, it is noteworthy that low risks for the underlying inflation in the short run tend to intensify the effects of monetary policy actions, enabling them to affect in a more long-lasting manner the dynamics of headline inflation in the future. Although the Copom recognizes that other macroeconomic policy

actions may influence the prices trajectory, it reaffirms its view that it is particularly under the responsibility of the monetary policy to remain especially vigilant, to guarantee that pressures detected in shorter horizons do not spread to longer horizons.

22. The Copom considers that, since its last meeting, the risks to global financial stability have remained high, such as those derived from changes in the yield curve slope of major advanced economies. Despite identifying low probability of occurrence of extreme events in the international financial markets, the Committee considers that the external environment remains complex. For the Committee, despite recently released data have been less positive than anticipated, the prospects for more intense global activity throughout the relevant horizon for the monetary policy have remained. There are improvements in advanced economies, with recovery of activity in some countries and acceleration in the pace of growth in others, although, in general, the room to use monetary policy in these economies remains limited and a fiscal restraint scenario prevails in this and in the upcoming years. On the other hand, in important emerging economies, the activity pace has not matched the expectations, despite the resilience of the domestic demand. The Committee highlights the evidences of tension and volatility focuses in the currencies' markets, as well as the prospects of moderation in the dynamics of commodities' prices in the international markets.

23. The Copom considers that the expansion rates of domestic absorption and GDP have converged and that the domestic activity expansion pace will be less intense this year, compared to 2013. However, according to the Committee's view, the activity tends to enter in a recovery trend in the second semester of next year. Moreover, the Committee evaluates that, in the medium term, important changes should take place in the composition of aggregate supply and demand. The consumption tends to grow at a more moderate pace; and the investments tend to gain momentum. These changes, together with other currently underway, anticipate a composition for medium-term growth more favorable to potential growth. Regarding the external component of aggregate demand, the scenario of higher global growth, combined with the depreciation of the BRL, contributes to make this component more favorable to the Brazilian economy growth. Focusing on the supply side, the Committee evaluates that, in the longer term, more favorable prospects for the competitiveness of industry and agriculture have emerged; the services sector, on its turn, tends to grow at rates lower than those recorded over the recent years. For the Committee, it is plausible to claim that these developments - coupled with advances in terms of qualification of the labor force and with the program of public services concession - will be reflected in a more efficient allocation of the production factors of the economy and in productivity gains. The Committee also highlights that the speed of materialization of the aforementioned changes and their resulting gains depend on the strengthening of companies' and households' confidence.

24. The Copom observes that the main inflation scenario considers the materialization of the assumed trajectories regarding fiscal variables. Despite of identifying evidence of fiscal stimuli in the composition of aggregate demand this year, according to the Committee's view, the balance of the public sector tends to shift to the neutral zone during the relevant horizon for the monetary policy; moreover, it argues that cannot rule out migration to the fiscal restraint area. The Committee also notes that the generation of primary surpluses in line with the working hypotheses considered in the inflation projections will contribute to create a positive perception regarding the macroeconomic environment in the medium and long terms. It also bears emphasizing that the generation of primary surpluses to strengthen the perception of the public sector balance sheet sustainability will contribute to reduce the public debt financing cost, with favorable impact on the cost of capital in general, which will stimulate private investment in the medium and long terms.

25. The Copom highlights that the main scenario also considers moderate credit expansion. It´s important to highlight the fact that, after years of strong expansion - cooled with the introduction of macroprudential measures at the end of 2010 - the credit market oriented to consumption has moderated, so that, over the last quarters it was possible to observe, on the one hand, exposure reduction by banks, and, on the other hand, deleveraging of the households. In the aggregate, therefore, it can be inferred that the risks in the consumer credit segment have been mitigated. In another dimension, the Committee considers opportune initiatives with the aim of moderating concessions of subsidies through credit operations; moreover, it attributes high probability that actions in this regard be implemented in the relevant horizon for the monetary policy.

26. Regarding the factors' market, the Copom highlights the narrow idleness margin in the labor market and it considers that, under such circumstances, a significant risk stems from the possibility of concession of wages increases incompatible with productivity growth and their negative impacts over inflation. Although the projected adjustment for the minimum wage, this year, is not as significant as in the previous years, and the occurrence of real wage changes is more consistent with the gains estimated for the labor productivity, the Committee evaluates that the wages dynamics remains originating inflationary cost pressures.

27. For the Copom, the fact that inflation currently stands at high levels reflects, in part, the occurrence of two important relative prices adjustments processes underway in the economy - the realignment of domestic prices relative to international prices and the realignment of regulated prices relative to market prices. The Copom also considers that, since its last meeting, among other factors, the intensification of the aforementioned adjustments in relative prices in the economy has made the balance of risks to inflation less favorable. In this context, the Committee does not rule out the occurrence of scenario which includes increase in inflation in the short term, and anticipates that inflation tends to remain high in 2015, but will enter in a long period of decline already in the next year. While recognizing that these adjustments in relative prices have direct impacts on inflation, the Committee reaffirms its view that monetary policy can and should contain the second order effects arising from them.

28. Given the above context, the Committee unanimously decided to intensify, at this time, the adjustment of the Selic rate and raise it by 0.50 pp to 11.75% p.a., without bias.

29. The following members of the Committee voted for this decision: Alexandre Antonio Tombini (Goveror), Aldo Luiz Mendes, Altamir Lopes, Anthero de Moraes Meirelles, Carlos Hamilton Vasconcelos Araújo, Luiz Awazu Pereira da Silva, Luiz Edson Feltrim and Sidnei Correa Marques.

30. The Copom evaluates that the aggregate demand tends to be relatively robust in the relevant horizon for the monetary policy. On the one hand, household consumption tends to record a moderate expansion pace, due to the effects of stimulus factors, such as income growth and moderate credit expansion; on the other hand, relatively favorable financial conditions, the concession of public services, the broadening of oil exploration areas, among other factors, tend to benefit the expansion of investments. On its turn, exports tend to be benefited by the scenario of higher growth of major trading partners and by the depreciation of the real. These elements and the developments in the quasi fiscal framework and in the assets market are important parts of the context in which future monetary policy decisions will be taken, aiming to ensure the convergence of inflation to the targets path, which, according to the view of the Committee, tends to occur in 2016.

31. The Copom highlights that, in moments such as the current one, the monetary policy should remain especially vigilant, in order to minimize risks that high inflation levels, such as the one observed in the last twelve months, persist in the relevant horizon for the monetary policy. However, considering the cumulative and lagged effects of the monetary policy, among other factors, the Committee evaluates that the additional effort of monetary policy tends to be implemented with parsimony.

32. At the end of the meeting, it was announced that the Committee will reconvene on January 20th 2015, for the technical presentations, and on the following day, to deliberate on monetary policy, as established in the Communiqué 26,042, of June 24th, 2014.