BANCO CENTRAL DO BRASIL

Minutes of the 188th Meeting of the Monetary Policy Committee (Copom)

Summary
Recent Economic Developments
Assessment of Inflation Trends
Monetary Policy Decision

Date: January 20th, 2015, from 4:12PM to 7:59PM, and January 21st from 4:14PM to 7:19PM

Place: BCB Headquarters meeting rooms – 8th floor on January 20th and 20th floor on January 21st – 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 January 20th)
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 January 21st)
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 January 20th)
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 0.78% in December, 0.27 percentage points (p.p.) above the one recorded in the previous month. As a consequence, inflation accumulated in 2014 reached 6.41% (5.91% in 2013). Market prices changed 6.72% in 2014 (7.29% in 2013), and regulated prices, 5.32% (1.54% in 2013). Among market prices, the prices of tradable goods increased 5.95% in 2014 (6.01% in 2013) and the prices of non-tradable goods, 7.43% (8.43% in 2013). It should also be noted that the prices of the food and beverages group increased 8.03% in 2014 (8.48% in 2013), and the prices of services rose 8.33% (8.75% in 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 0.34% in November to 0.66% in December. As a consequence, on a twelve-month trailing basis, average core inflation reached 6.32% (0.04 p.p. above the one registered in December 2013). Specifically, the double weight core inflation changed from 0.38% in November to 0.68% in December; the core inflation by exclusion of regulated prices and household food, from 0.31% to 0.87%; the core by exclusion, which excludes ten household food

items and fuels, from 0.33% to 0.73%; the non-smoothed trimmed means IPCA core inflation changed from 0.32% to 0.53%; and the smoothed trimmed means IPCA core inflation, from 0.38% to 0.49%. The diffusion index stood at 68.4% in December (1.0 p.p. below the one recorded in December 2013).

3. The General Price Index (IGP-DI), increased 1.14% in November and 0.38% in December, reaching 3.78% on a twelve-month trailing basis (5.52% in December 2013). The main component of this indicator, the Wholesale Price Index (IPA), changed 2.15% in twelve months (5.07% in December 2013), with increase of 4.40% 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 6.86% in twelve months through December (5.64% in December 2013). The Civil Construction National Index (INCC), component with the lowest weight in the IGP-DI, changed 6.94% (8.09% in December 2013), partially driven by pressures stemming from the labor cost, which increased 8.49% 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 1.16% in November, changing 4.56% 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 November 2014, the IBC-Br decreased 1.30% year-over-year and, seasonally adjusted, 0.04% month-on-month. The composite Purchasing Managers' Index (PMI) regarding Brazil changed from 48.1 in November to 49.2 in December, suggesting contraction in activity. On its turn, the Consumer Confidence Index (ICC), from the Getúlio Vargas Foundation (FGV), increased 0.9% in December. Despite the favorable development at the margin, the index remains at historically low levels. The Services Confidence Index (ICS) increased 1.3% in December month on month, while the Industry Confidence Index (ICI) decreased 1.5% in December, influenced by the deterioration in the current situation assessments. Regarding agriculture, the Agricultural Production Systematic Assessment (LSPA), carried out by the IBGE in December 2014, indicates that grains production is expected to grow by 5.2% in 2015, relative to the 2014 harvest.

5. The industrial activity decreased 0.7% in November, after increasing 0.1% in October, according to the seasonally adjusted series released by the IBGE. As a consequence, the industrial production accumulates a 3.2% fall up to November 2014. According to the observed series, year-over-year, the industrial production decreased 5.8% in November. The result was negative in the four use categories and in 22 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 decreased 4.9% between October and November 2014, according to the seasonally adjusted series, and is 4.8% lower than the one observed in November 2013. The PMI of the industrial sector, on its turn, increased to 50.2 in December, resuming growth.

6. Among the use categories, according to the November month-over-month and seasonally adjusted data series, the production of durable consumer goods (-2.1%) and semidurable and non-durable consumer goods (-1.3%) recorded more significant decreases. The capital goods sector decreased 0.2%, while the intermediate goods sector remained stable. Regarding year-over-year growth, there was a decrease in production in the four categories: durable consumer goods (-11.0%), capital goods (-9.7%), intermediate goods (-5.8%) and semidurable and non-durable consumer goods (-3.1%).

7. According to the Monthly Employment Survey (PME), covering six metropolitan areas, the unemployment rate reached 4.8% in November. The figure represents increases of 0.1 p.p. compared to October 2014 and of 0.2 p.p. compared to November 2013. Data released by the Ministry of Labor and Employment (MTE) show that 8.4 thousand formal jobs were created in November, the worst figure for November since 2008. In short, the set of available data indicates narrow idleness margin in the labor market, although some data point to an accommodation process.

8. According to the retail monthly survey (PMC), released by the IBGE, the retail sales volume increased 1.0% in November, compared to November 2013. On its turn, broad retail sales volume, which includes vehicles and

construction inputs, fell 2.7% in November, according to the same comparison basis. The month-on-month changes were 0.9% and 1.2%, respectively, according to the seasonally adjusted series. In twelve months, the retail sales growth rate was 2.6% and the broad retail sales growth was -1.2%, with expansion in seven out of the ten surveyed segments. The Trade Confidence Index (ICOM), measured by the FGV, decreased 1.5% in December, reflecting dissatisfaction with the performance of this end of year. 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.

9. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by the FGV, without seasonal adjustment, reached 81.9% in December and, according to the seasonally adjusted series, 81.3%. Among the industry use categories, according to the seasonally adjusted series, the ones showing the highest Nuci are construction material (88.2%) and intermediate goods (82.6%), followed by durable consumer goods (81.6%), capital goods (78.3%) and non-durable consumer goods (76.3%). On its turn, the absorption of capital goods decreased 9.4% in the last twelve months through November.

10. The twelve-month trailing trade balance result reached US$3.9 billion in December. This result stemmed from US$225.1 billion in exports and US$229.0 billion in imports, with retreats of 7.0% and 4.4%, respectively, year-over-year. On its turn, the current account deficit accumulated in twelve months reached US$88.7 billion in November, equivalent to 4.0% of the GDP. Foreign direct investment totaled US$62.3 billion, according to the same comparison basis, equivalent to 2.8% of the GDP.

11. Regarding the global economy, leading indicators signal, in the horizon relevant for monetary policy, growth prospects in line with the trend in important advanced and emerging economies. Particularly about Europe, despite recent monetary policy actions, high unemployment rates, coupled with the fiscal consolidation and political uncertainties, constitute elements constraining investments and growth. Regarding the monetary policy, in general, accommodative stances prevail in advanced and emerging economies. The inflation rates remain at low levels in the advanced economies; and, in the emerging ones, they stand at relatively high levels.

12. The price of the Brent oil barrel decreased to levels below US$50 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 8.63% and 5.04%, respectively. On its turn, the Food Price Index, calculated by the Food and Agriculture Organization of the United Nations (FAO), fell 8.5% in the twelve months through December 2014.

Assessment of Inflation Trends

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

14. For the set of regulated prices inflation, the projected adjustment is 9.3% in 2015, up from 6.0% considered at the December Copom meeting. Among other factors, this projection considers the assumption of increases of 8% in the price of gasoline, to a great extent as a consequence of the Contribution for Intervention on the Economic Domain (Cide) and of the PIS/COFINS (Profit Participation Program Contribution and Social Security Financing Contribution, respectively); of 3.0% in the price of bottled gas; of 0.6% in fixed telephone tariffs; and of 27.6% in electricity prices, due to the passthrough to the tariffs of the costs stemming from the financing operations of the Energetic Development Account (CDE), contracted in 2014. The items for which there are more information available 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 is 5.1% for 2016, down from 5.2% considered in the December meeting.

15. The estimate path for the spreads over the Selic rate, based on the 360-day swap rates, on the baseline scenario, projects 9 basis points (bps) and 19 bps for the fourth quarters of 2015 and 2016, respectively.

16. The structural primary surplus is considered as the fiscal indicator. It derives from the primary surplus trajectories set at 1.2% and 2% of the GDP for 2015 and 2016, respectively. It also bears emphasizing that, in a given period, the fiscal impulse corresponds to the variation of the structural surplus in comparison to the observed in the previous period.

17. Since the last Copom meeting, the median of the projections compiled by the Investor Relations and Special Studies Department (Gerin) for the 2015 IPCA changed from 6.49% to 6.72% and, for 2016, from 5.70% to 5.60%.

18. The baseline scenario assumes the maintenance of the exchange rate at R$2.65/US$1.00 and the Selic rate at 11.75% p.a. during the forecast period. Under this scenario, the projection for the 2015 inflation increased, 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 2015 IPCA inflation forecast also increased relative to the value considered at the December meeting and remains above the inflation target. For 2016, according to both the baseline and the market scenarios, the inflation forecast remained relatively stable above the 4.5% inflation target set by the CMN.

Monetary Policy Decision

19. 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.

20. 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.

21. 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, although in 2014 growth rates in important economies were lower than expected, a more intense global activity trend prevails throughout the monetary policy relevant horizon. In this respect, the prospects indicate activity recovery in some advanced economies 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. Important emerging economies experience a transition period, and therefore, of moderation in the activity pace, despite the resilience of the domestic demand.

22. Still regarding international financial markets, the Committee highlights evidence of volatility sources in the currency markets and moderation in the dynamics of commodities prices in the international markets. Regarding oil, the Committee highlights that, regardless of the behavior of the domestic prices of gasoline, the evolution of international prices tends to be transmitted to the domestic economy both through productive chains, such as the petrochemical, and through inflation expectations.

23. The Copom considers that the expansion rates of domestic absorption and GDP have converged and that the domestic activity expansion pace this year will be lower than the potential growth. For the Committee, the activity expansion pace tends to intensify as companies' and households' confidence strengthen. 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 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. Regarding 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.

24. The Copom observes that the main inflation scenario considers the materialization of the assumed trajectories regarding fiscal variables. The Committee argues that, during the relevant horizon for the monetary policy, the balance of the public sector tends to shift to the neutral zone, and does not rule out the hypothesis of 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 highlights that this primary surpluses' path will strengthen the perception of sustainability of the public sector balance. Thus, this sustainability contributes to reduce the public debt financing cost, with favorable impact on the cost of capital in general, stimulating private investment in the medium and long terms. Specifically regarding inflation control, the Committee highlights that the literature and the best international practices recommend a consistent and sustainable fiscal policy, in order to allow monetary policy actions to be fully transmitted to prices.

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, as illustrated by the recently implemented actions, the Committee considers opportune initiatives with the aim of moderating concessions of subsidies through credit operations.

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 Committee 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 a scenario that includes inflation

increase in the short term, anticipates that inflation tends to remain high in 2015, but will enter already this year a long period of decline. 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, assessing the macroeconomic scenario and the inflation prospects, the Committee unanimously decided to raise the Selic rate by 0.50 pp, to 12.25% 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 Corrêa 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 follow a moderate expansion pace, due to factors such as income growth and moderate credit expansion; on the other hand, relatively favorable financial conditions, especially in the case of real estate financing, the concession of public services, the broadening of oil exploration areas, among other factors, tend to benefit 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. For the Committee, 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 target of 4.5% established by CMN for the next year.

31. Accordingly, the Copom believes that the convergence scenario of inflation to 4.5% in 2016 has strengthened. For the Committee, however, the progress made in the fight against inflation - like benign signals stemming from the medium and long-term expectations indicators – has not yet been sufficient.

32. At the end of the meeting, it was announced that the Committee will reconvene on March 3rd 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.