Minutes of the 232nd Meeting of the Monetary Policy Committee (Copom*) Banco Central do Brasil**

August 4-5, 2020

BANCO CENTRAL DO BRASIL

***** The Monetary Policy Committee of the Banco Central do Brasil 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 prevail

Date: August 4-5, 2020

Place: BCB Headquarters' meeting room on the 8th floor – Brasilia – DF – Brazil
Starting and ending times: August 4: 10:10 AM – 12:41 PM; 2:56 PM – 7:32 PM
August 5: 2:02 PM – 6:19 PM

In attendance:
Members of the Copom
Roberto Oliveira Campos Neto – Governor
Bruno Serra Fernandes
Carolina de Assis Barros
Fabio Kanczuk
Fernanda Feitosa Nechio
João Manoel Pinho de Mello
Maurício Costa de Moura
Otávio Ribeiro Damaso
Paulo Sérgio Neves de Souza

Department Heads in charge of technical presentations (present on August 4)
Alan da Silva Andrade Mendes – Department of Foreign Reserves
André Minella - Research Department (present on August 4-5 sessions)
André de Oliveira Amante – Department of Open Market Operations
Fabia Aparecida de Carvalho – Department of International Affairs
Flávio Túlio Vilela – Department of Banking Operations and Payments System
Ricardo Sabbadini – Department of Economics

Other participants (present on August 4)
Adalberto Felinto da Cruz Junior – Executive Secretary
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 the Economic Outlook and Copom's Baseline Scenario[1]

1. Regarding the global outlook, the Covid-19 pandemic keeps causing the largest economic downturn since the Great Depression. Against this backdrop, despite some promising signs of recovery in major economies, and some moderation in financial assets volatility, the environment for emerging economies remains challenging.

2. Turning to the Brazilian economic activity, recent indicators suggest a partial recovery. Sectors more directly affected by social distancing measures remain depressed despite the offsetting effects of the government transfer programs. Prospectively, uncertainty about economic growth remains larger than usual, especially for the period starting at the end of this year, concurrently with the expected winding up of the emergency transfer programs.

3. Various measures of underlying inflation remain below the level compatible with meeting the inflation target at the relevant horizon for monetary policy.

4. Inflation expectations for 2020, 2021, and 2022 collected by the Focus survey are around 1.6%, 3.0%, and 3.5%, respectively.

5. Short-term inflation seems to be cooling after July's sharp increase. Relative to the previous Copom Meeting, short-term projections remain relatively stable. Revisions to some components of service price inflation have offset the impact of the depreciation of the Brazilian *real* and the rise in commodity prices.

6. The Copom's inflation projections in the hybrid scenario with interest rate path extracted from the Focus survey and constant exchange rate at R$5.20/US$[2] stand around 1.9% for 2020, 3.0% for 2021 and 3.4% for 2022. This scenario assumes a path for the Selic rate that ends 2020 at 2.0% p.a., rises to 3.0% p.a. in 2021 and 5.0% p.a. in 2022. In this scenario, inflation projections for administered prices are 1.6% for 2020, 3.4% for 2021, and 3.9% for 2022.

7. The scenario with constant interest rate at 2.25% p.a. and constant exchange rate at R$5.20/US$ yields inflation projections around 1.9% for 2020, 3.0% for 2021 and 3.7% for 2022. In this scenario, inflation projections for administered prices are 1.6% for 2020, 3.4% for 2021, and 3.9% for 2022.

[1] Unless explicitly stated otherwise, this update takes into account changes occurred since the June Copom meeting (231st meeting).

B) Risks Around the Baseline Inflation Scenario

8. The Committee emphasizes that risks to its baseline scenario remain in both directions.

9. On the one hand, economic slack may continue to produce a lower-than-expected prospective inflation trajectory. This risk increases if a slower reversion of the pandemic effects lengthens the environment of high uncertainty and precautionary savings.

10. On the other hand, fiscal policy responses to the pandemic that permanently aggravate the fiscal path or frustrations regarding the continuation of the reform agenda may increase the risk premium. Additionally, the credit and transfer programs implemented in response to the pandemic may cause a smaller-than-estimated decline in aggregate demand, introducing an asymmetry to the balance of risks. This set of factors could potentially result in a higher-than-expected path for inflation over the relevant horizon for monetary policy.

C) Discussion about the conduct of monetary policy

11. Regarding the global economy, the data already available for the 2020Q2 GDP did not surprise, but it showed that the depth of the current economic downturn is only comparable to that of the Great Depression. There are some promising signs of recovery which, however, has shown to be incomplete. The strong recovery in consumption was not followed by the services sector. The Committee pondered that the main restriction to a full recovery in the major economies is the evolution of the pandemic itself, and the possibility of a second wave of the virus is a major risk.

12. The Copom members discussed the evolution of domestic economic activity in light of the available information and indicators. They evaluated that recent data suggest a partial recovery of the economic activity. Government transfer programs have allowed for a relatively strong resumption of durable goods consumption and even of investment. However, several service sector activities, especially those most directly affected by social distancing measures, remain quite depressed. Looking forward, the poor predictability associated with the evolution of the pandemic and the necessary decline in emergency aid by the end of 2020

[2] Value obtained according to the usual procedure of rounding the average R$/US$ exchange rate observed in the five business days ended in the last day of the week prior to the Copom meeting.

increase uncertainty about the speed of the economic recovery. The Committee considered that this unpredictability and the risks associated with the evolution of the pandemic may imply a domestic scenario characterized by an even more gradual recovery of the economy.

13. The Copom members debated on the level of economic slack. As with the activity, the Committee believes that the pandemic should continue to have heterogeneous effects on the economic sectors. Given the nature of the shock, the service sector should continue to have a larger economic slack than other sectors. The Committee concluded that the nature of the crisis probably implies that the disinflationary pressures from reduced demand may last longer than in previous recessions.

14. The Committee then assessed the appropriate degree of stimulus for the current environment. First, it analyzed whether the existence of an asymmetry in its balance of risks, mainly related to fiscal issues and the continuation of reforms in the Brazilian economy, would be a sufficient reason to maintain the stimulus at its current level. Given its perception of economic slack and prospective inflation, the Committee considered that, although asymmetric, its projections for inflation are below the target for the relevant horizon for monetary policy. Therefore, in line with its inflation targeting mandate, the Committee concluded that it would be appropriate to increase residually the degree of monetary stimulus.

15. The Committee then resumed discussion of a potential effective lower limit for the Brazilian policy interest rate and its connection with prudential and financial stability issues. For the majority of the members of the Copom, this limit would be significantly higher among emerging economies than among developed countries due to the existence of a risk premium. This premium is dynamic and tends to be larger in Brazil, given the country's relative fiscal fragility and the uncertainties regarding its prospective fiscal path. In this context, we would already be close to the level from which further interest rate reductions could be accompanied by asset price instability.

16. The Copom also discussed the relative importance of the main components of credit and operating costs of the financial system. Considering the long history of the Brazilian economy operating with the basic interest rate at a very high level, the unprecedented low interest rates may compromise the performance of some markets and economic sectors, with potential impact on financial intermediation. Based on results from stress test scenarios, the Committee considers that the financial system is resilient to the credit risk arising from the current pandemic. However, when analyzing the financial system in a broad way – considering its various industries, markets, products and financial services – the Committee reflected that an unprecedentedly low interest rate environment may generate increased asset price volatility. Moreover, without the necessary time to transition to a new environment, it may affect the proper functioning and dynamics of the financial system and the capital markets. Hence, the Committee concluded that possible new interest rates reductions would demand caution and additional gradualism. To this end, if necessary, further interest rate cuts would require greater clarity about prospective inflation and activity and could be spaced over time.

17. In order to provide the monetary stimulus deemed adequate to meet the inflation target, but maintaining the necessary caution for prudential reasons, the Copom considered the use of a forward guidance as an additional monetary policy tool. The Copom discussed the limitations on the use of this instrument in emerging countries. Relative to developed countries, emerging countries are more susceptible to contagion from external crises and have greater vulnerabilities in their economic fundamentals. Therefore, due this greater unpredictability and volatility, the use of such an instrument becomes more challenging. The Committee concluded that despite those limitations, the forward guidance would be the policy strategy with the best cost-benefit ratio. The forward guidance transmits the Committee's vision on its future actions and tends to adjust the expectations reflected on the intermediary part of the yield curve.

18. To adapt the forward guidance to the dynamic limits imposed by prudential issues, the Committee considered that it should have an asymmetric policy intention, in which, if the necessary conditions were met, the Copom would not raise the interest rate but could reduce it. To maximize its effectiveness, the Committee decided that this forward guidance should be conditional on inflation expectations, as well as on the inflation projections of its baseline scenario, for the relevant monetary policy horizon, which currently includes 2021 and, to a lesser extent, 2022. This information on inflation would be considered altogether and, when they were sufficiently close to the inflation target for the corresponding horizon, they would indicate the end of the intention.

19. Given the difficulties inherent in using forward guidance in emerging economies, in addition to expectations and projections of inflation in the relevant horizon, the Committee also deemed necessary to condition its interest rate policy intention on two other factors. First, it is conditional on the maintenance of the fiscal regime, since its rupture would imply significant changes to the structural interest rate of the economy. Second, it is conditional on the anchoring of long-term inflation expectations, given that an unanchoring would indicate that the costs derived from the monetary stimulus would be outweighing its benefits.

D) Monetary Policy Decision

20. Taking into account the baseline scenario, the balance of risks, and the broad array of available information, the Copom unanimously decided to lower the Selic rate by 0.25 percentage point to 2.00% p.a. The Committee judges that this decision reflects its baseline scenario for prospective inflation, a higher-than-usual variance in the balance of risks, and it is consistent with the convergence of inflation to its target over the relevant horizon for monetary policy, which includes 2021 and, to a lesser extent, 2022.

21. The Committee believes that persevering in the process of reforms and necessary adjustments in the Brazilian economy is essential for a sustainable economic recovery. The Copom also stresses that doubts regarding the continuation of the reform agenda and permanent changes to the fiscal consolidation process could result in an increase in the structural interest rate.

22. The Copom believes that the current economic conditions continue to recommend an unusually strong monetary stimulus but it recognizes that, due to prudential and financial stability reasons, the remaining space for monetary policy stimulus, if it exists, should be small. Consequently, possible future adjustments to the current degree of monetary stimulus would occur with additional gradualism and would depend on the perception of the fiscal trajectory, as well as on new information that changes the Committee's current assessment about prospective inflation.

23. Despite the asymmetry on its balance of risks, the Copom does not foresee reductions in the monetary stimulus unless inflation expectations, as well as its baseline scenario inflation projections, are sufficiently close to the inflation target at the relevant horizon for monetary policy, which currently includes 2021 and, to a lesser extent, 2022. This intention is conditional on the maintenance of the current fiscal regime and on the anchoring of long-term inflation expectations.

24. The following members of the Committee voted for this decision: Roberto Oliveira Campos Neto (Governor), Bruno Serra Fernandes, Carolina de Assis Barros, Fabio Kanczuk, Fernanda Feitosa Nechio, João Manoel Pinho de Mello, Maurício Costa de Moura, Otávio Ribeiro Damaso, and Paulo Sérgio Neves de Souza.