

BANCO CENTRAL DO BRASIL – *FOCUS*

October 04, 2000

MINUTES OF THE 51ST MEETING OF THE BANCO CENTRAL DO BRASIL MONETARY POLICY COMMITTEE (COPOM)

Summary

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Date: 09.19 and 20.2000

Place: 20th floor meeting room Banco Central Headquarters – Brasília – DF

Called to order: 3:45 PM on 09.19 and 5:55 PM on 09.20

Adjourned: 6:20 PM on 09.19 and 6:45 PM on 09.20

In attendance:

Members of the Board

Armínio Fraga Neto – **Governor**

Carlos Eduardo de Freitas

Daniel Luiz Gleizer

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Sérgio Ribeiro da Costa Werlang

Department Heads

Altamir Lopes – Department of Economics (**DEPEC**)

daso Maranhão Coimbra – International Reserve Operations Department (**DEPIN**)

Miguel Arcanjo Neto - Department of Banking Operations (**DEBAN**)

Alexandre Antonio Tombini – Research Department (**DEPEP**)

Eduardo Hitiro Nakao – Open Market Operations Department (**DEMAB**)

Other participants:

Alexandre Pundek Rocha – Advisor to the Board and Acting Executive Secretary of COPOM

Gustavo Bussinger – Advisor to DEPEC

Thais Matos de Herédia – Press Advisor (**ASIMP**)

The Board analyzed the recent evolution and outlook for the Brazilian and international economies in the framework of the country's new monetary policy regime, which is designed to ensure compliance with government defined inflation targets.

Aggregate demand and supply

At the start of the third quarter of the year, aggregate demand indicators, stimulated by a greater supply of consumer credit and expanding exports, pointed to continuation of the growth trajectory.

According to the Trade Federation of the State of São Paulo, real revenues of the retail trade sector in the metropolitan region of São Paulo rose by 3.2% in August, with accumulated growth of 12.3% in the year. Sales of durable consumer goods and automobiles led this growth and were powered mostly by improved credit conditions.

With respect to industrial sales, data released by the National Confederation of Industry and the São Paulo Federation of Industries pointed to continued positive growth, with final figures of 10.8% and 12.7% accumulated in the year up to July, respectively. In the month of August, automotive industry sales registered growth of 21% in accumulated terms for the year, with an increase of 46.7% under exports and 15.2% under internal sales.

Investment indicators have expanded steadily. Output of capital goods increased by 9.4% in accumulated terms for the year up to July. This growth was particularly strong under typically industrialized goods and transportation equipment and capital goods for the construction industry. Production of building industry inputs closed with more moderate 1.8% growth utilizing the same basis of comparison. Imports of capital goods have continued on a downward slide, though the negative results registered in terms of imported volume have been declining throughout the year.

Fiscal results have clearly underscored the government's commitment to austerity and guaranteed compliance with the targets defined in economic programming. In the month of July, the consolidated public sector result registered a primary surplus of R\$ 1.3 billion, with an accumulated total of US\$ 25.1 billion in the year.

Up to the month of August, the balance of trade turned in a surplus of US\$ 1 billion, as compared to a deficit of US\$ 717 million in the same period of 1999. Foreign sales expanded by 18.9% in relation to the January-August 1999 figures, with particularly strong growth of 25.4% under sales of manufactured goods. Imports rose by 12.9% utilizing the same basis of comparison and were powered by outlays on fuels and lubricants and raw materials, which expanded by 57.5% and 21%, respectively.

While imports of fuels and lubricants expanded as a result of price growth, foreign purchases of raw materials were pressured by growth in the volume of imports. This performance reflects the process of growth in industrial output, particularly under foreign sales of manufactured goods. One should note that production of the latter has a high level of imported components.

Aggregate supply indicators reveal that the growth process has continued, as the average level of utilization of installed capacity has expanded, new productivity gains have been achieved and industrial employment has turned upward.

According to July IBGE estimates, the grain harvest is expected to close the 1999/2000

agricultural year with growth of 1.3% and total output of 83.4 million tons. This forecast is below those issued previously. The decline in this case has been caused by adverse climatic factors that have impacted such winter crops as wheat and what is known as the intermediate corn harvest.

Output of durable consumer goods has led the process of industrial recovery, with growth of 21.8% in accumulated terms for the year up to July. Production of intermediate goods expanded by 7.9% and capital goods by 9.4%, while output of semidurable and nondurable goods dropped by 1.2% in the same period of comparison.

The output level of durable goods, capital goods and semidurable and nondurable products is still well below the peak registered by the statistical series in July, indicating that there is still considerable idle production capacity available. The average level of utilization of installed capacity measured by the CNI pointed to a July figure of 81.1%, based on seasonally adjusted data.

With respect to the labor market, accumulated data up to July points to a growth trend under both employment and productivity, without generating pressure on production costs. In the month of July, formal employment expanded for the ninth consecutive month, with creation of 696 thousand job openings in the year. All sectors turned in expanded employment opportunities, with the sole exception of the construction industry. Open unemployment dropped to 7.17% in July.

External environment

The most recent macroeconomic indicators released in the United States further reinforced signs of lesser growth in aggregate demand at the start of the second half of the year. In this same sense, factory orders declined by 7.5% in July, following growth of 5.2% in the previous month. August expansion in retail sales closed at 0.2% in relation to the previous month, reducing the accumulated 12 month rate from 9.6% in July to 9.3% in August. Consumer credit expanded by 0.6% in July and 7.3% in 12 months. Finally, the survey carried out among procurement managers (NAPM) closed the month of August at 49.5, a clear sign that the level of activity is expected to fall in coming months.

With respect to inflation, the Producer Price Index dropped by 0.2% in August, following stability in July. The 12 month period closed with a high of 3.2%, while the core index increased by 0.1% in August and 1.5% in 12 months. The Consumer Price Index fell by 0.1% in August, while the core index increased by 0.2%, raising accumulated 12 month growth rates to 3.2% and 2.5%, respectively.

In the case of Japan, more recent economic indicators point to deceleration in the pace of economic growth in relation to the expansion registered in the first half of the year. In July, industrial production fell by 0.7%, factory orders dropped by 7.6% and new housing starts rose by 10% in relation to the previous month. The 4.7% unemployment rate remained stable in relation to June. In terms of accumulated 12 month growth, family spending dropped by 2.6% while the income of salaried workers decreased by 0.4%.

Insofar as the euro zone countries are concerned, the level of economic activity remained high in an environment marked by a gradual increase in the rate of inflation. Annualized GDP closed with expansion of 3.6% in the second quarter (data purged of seasonal factors) in relation to the previous quarter. The rate of unemployment remained stable at 9.1% in the month of July. The Producer Price Index increased by 0.5% in the month, raising accumulated growth to 5.5% in twelve months, while the harmonized Consumer Price Index remained stable in August, with accumulated twelve month expansion of 2.3%. The inflation high was caused by depreciation of the euro and increases in international petroleum prices.

Argentina has released the new Economic Policy Memorandum worked out with the IMF, raising the fiscal deficit target for 2000 from US\$ 4.7 billion to US\$ 5.3 billion. Forecast GDP growth dropped to 2%, while estimates for the current account deficit were revised downward from US\$ 12.3 billion to US\$ 10.8 billion.

High oil prices and their excessive volatility have been caused by supply restrictions imposed by the Organization of Petroleum Exporter Countries - OPEC, international economic growth, low stock levels in consumer nations and expectations of a seasonal increase in demand during the upcoming winter season in the northern hemisphere.

Even when one considers the most recent increases in export quotas agreed upon within the OPEC framework at its September meeting, oil prices are expected to remain volatile until at least the end of winter in March 2001.

Prices

The impact of farm price increases and changes in government managed prices exerted added pressures on August price indices, though these pressures were somewhat attenuated in relation to the month of July.

Growth in farm prices was generated by adverse climatic factors that not only resulted in smaller than expected sugar cane and wheat harvests, but also provoked an early start to the meat and milk off-season period. In the case of sugar cane, the harvest failure increased pressures on fuel prices as a direct result of higher alcohol prices.

In August, the General Price Index – DI expanded by 1.82%, based on growth of 2.56% in the wholesale price index, 0.86% in the consumer price index and 0.39% in the cost of construction index. The largest pressures on the wholesale price index were caused by the prices of fuels, meat products, sugarcane and milk, which account for 71% of the change in the index. In the case of the consumer price index – IPC, government managed prices, *in natura* products and meats accounted for 92% of the rate. One should note that the core IPC increased by 0.27% in the month, as against 0.75% in July, thus returning to the median level that marked the first half of the year.

The broad consumer price index registered growth of 1.31% in the month of August, as compared to 1.61% in July, raising accumulated growth for the year to 4.63%. Increases in government managed prices – gasoline, alcohol, health insurance plans, bottled gas and airline tickets – were responsible for 50% of the monthly growth registered by the index. The grouping of foodstuffs and beverages registered a high of 2.07% and accounted for 35% of the month's result.

Prospective assessment of inflation trends

Based on newly available information, both the shocks already identified and their impacts on the economy have been analyzed. The basic scenario is founded upon the following hypotheses:

- a. Once again, August inflation (1.31%) was higher than expected due, this time, to persistently high food prices. The subgrouping of Household Food Supplies registered growth of 2.38% in July and 2.58% in August. An analysis of the various components of this subgrouping indicates that this is a temporary price shock and that its effects will be dissipated as of September. Despite this, the off-season agricultural period could have a marginal impact on inflation in the final quarter of the year. Consequently, the hypothesis of an across-the-board increase in food prices in the final quarter of 2000 has been revised downward from 3% to 1%.
- b. Prices on the international oil market remain highly volatile, clearly reflecting uncertainties with respect to the real volume of production, speculation regarding demand growth in the northern hemisphere winter season and concerns regarding historically low levels of world stocks of petroleum derivatives. This shortage of both petroleum and derivatives could generate added pressures on current prices, despite the fact that the structure of futures prices indicates successive monthly declines. When one considers futures market projections for external petroleum prices and the readjustments already introduced into domestic fuel prices, the basic scenario incorporates an increase of approximately 5% in the internal prices of petroleum derivatives (to final consumer) that will be reflected in price indices for the final quarter of the year.
- c. With respect to other government managed prices, just as had been expected, the most substantial pressure on inflation occurred in July and August. For the remainder of the year, the basic scenario incorporated the impact of public transportation fares in municipalities that had not yet authorized annual increases, as well as electricity rates in Rio de Janeiro. These hypotheses reflect average increases of 12.2% for government managed prices in general in 2000, with a direct impact of 2.8 percentage points. For 2001, the hypothesis is that public service rates will follow the growth trajectory estimated for the general indices used in the respective contracts and that other government managed prices will accompany the median level of the other prices of the economy.

- d. With respect to the external environment, the trajectory of the interest rates on federal fund implicit in futures contracts indicates that the current level of 6.5% per year has been maintained, despite possible inflationary pressures caused by petroleum prices. The hypothesis of world growth in the range of 4% for the coming year is maintained, thus contributing to the continuity of improvement under the balance of trade and international liquidity conditions required for financing the current account deficit in 2001.

The other hypotheses considered at the previous meeting were maintained, particularly that regarding a primary surplus based on the targets defined for fiscal policy and GDP growth compatible with equilibrium between aggregate supply and demand.

Based on simulations performed with the basic scenario, it was concluded that the current level of interest rates at 16.5% per year would make it possible to comply with inflation targets up to 2002. For 2000, projected inflation is just slightly above the median point of the target (6%) due to adverse supply shocks (fuels and foodstuffs) that affected the economy in the second half of the year. However, the effects of these shocks dissipated rapidly and, since they are clearly temporary in nature, provoked no significant alterations. Early figures for the month of September point to downward movement under inflation and would seem to confirm the lesser degree of inertia in price formation. With this, inflation projected for 2001 is slightly below the target. At the same time, in the alternative scenario which considers no additional increase in domestic fuel prices, the target for 2001 would be met with considerable ease.

Leading indicators for inflation were presented together with short-term forecasts. Leading indicators pointed to a steady reduction in inflation rates up to November, with the possibility of a marginal increase in December of this year and January 2001. The nonstructural short-term models also point in the direction of an inflation decline as of the month of September and maintain the projection of monthly rates in the range of 0.5% up to December 2000. In accumulated terms for the year, these models point to median IPCA growth slightly above 6%.

IPCA core inflation was also presented. This figure remained at a monthly average of 0.4% in the first six months of the year before increasing to 0.58% in July and 0.6% in August. Pressures were somewhat attenuated as foodstuffs registered a lesser high, generating expectations of a downturn in the IPCA core in September. Core inflation measured by the consumer price index – Brasil, which is calculated and released by the FGV, declined to 0.27% in August, following a level of 0.75% in July. The August result was quite close to the monthly average of 0.28% registered in the first half of the year.

According to the daily Banco Central survey, median expectations for growth in the IPCA increased since the last meeting. For 2000, estimates were revised from 6.2% to 6.3%, while estimates for the following year were altered from 4.29% to 4.4%.

Money market and open market operations

At its meeting on August 23, Copom maintained the Selic rate target at 16.5% per year.

In the period from August 23 to September 19, definitive operations with papers issued by Banco Central produced a contractive monetary impact of R\$ 0.4 billion. In the case of operations with papers for which the National Treasury is liable, the result was expansion of R\$ 4.2 billion. NBC-Es were offered on two separate occasions for purposes of partially rolling maturing exchange papers for which the National Treasury is liable. The second of these placements initiated the trading of NBC-E with half-year coupons of 6% over the nominal value of the papers, as a result of the use of simple interest.

In the period analyzed, the National Treasury carried out nine sales of LTN, with a total value of R\$ 11.9 billion. Redemptions added up to R\$ 10.1 billion, of which R\$ 4.5 billion were carried out earlier than scheduled through two public purchase offers with three maturities each. In relation to LFTs, the three public offers came to R\$ 4.6 billion, while redemptions added up to R\$ 8.8 billion. On August 30 and 31, the two stages of the public offer of five year NTN-C occurred, with a total value of R\$ 0.5 billion in these papers.

In order to regulate liquidity, Banco Central operated on seven different occasions on the secondary market, involving a total of 19 business days. In the secondary market, Banco

Central carried out its second committed operation with no earmarking of the papers in question.

Monetary policy guidelines

The balance of supply and demand points to an absence of imbalances that would indicate any significant inflationary pressures on the horizon relevant to the system of inflation targeting. The pace of economic activity growth has remained solid and well within the parameters deemed compatible with price stability. Aggregate demand indicators are strong, with a greater supply of consumer credit and growth in exports.

The highly positive fiscal result obtained during the course of the year confirmed the government's commitment to austerity and stands as a guaranty of compliance with the targets set down in the Economic Program. The fiscal situation has been steadily improving, as economic expansion has made it possible to increase inflows. At the same time as the confidence of economic agents in the Brazilian economy increases, it has become possible to gradually lengthen the maturities of public debt securities.

Led by durable consumer goods and capital goods, industrial output has been expanding. One result has been an increase in average utilization of installed capacity. Labor market indicators point to growth in employment and productivity, with no significant impacts on production costs.

The external scenario has gained in relative importance in terms of risk to the growth of the Brazilian economy, particularly in light of uncertainties surrounding petroleum prices. However, other international economic conditions would seem to be generally favorable to Brazil. More recent indicators reflect greater confidence in relation to the hypothesis of a smooth slowdown in the United States economy, at the same time in which futures markets would seem to discard any possibility of changes in American interest rates in the coming months. Growth perspectives seem to have improved for Japan and remain solid for the euro zone, despite the downturn in the value of the common currency. This situation will have a positive impact on Brazilian exports and contribute to improvement in perceptions of risk in the emerging nations in general.

However, international oil prices are still climbing and their volatility is such that forecasting is a somewhat futile exercise. This highly adverse price shock has shown that it will be with us for some time to come and the probability of new highs will increase as winter in the northern hemisphere approaches. Over the medium-term, the tendency in futures markets points in the direction of a price decline, though average prices expected for 2001 remain high, just over the level forecast for this year.

The overall situation was judged consistent with compliance with inflation targets, with no significant changes in comparison to the analysis carried out at the previous meeting. Measured by the IPCA, inflation in the month of August was slightly higher than estimates formulated both by the market and by Banco Central. However, this was considered a result of temporary upturns under some foodstuffs. Here, one should stress that unexpected but transitory increases have not altered the expectations of those responsible for price formation to the point of generating significant secondary impacts on inflation. This low level of inertia was noted in the wake of the final quarter of 1999 and would now seem to be repeating itself, even though the economy as a whole is clearly in a stronger growth trajectory.

Once they had been incorporated into the diverse forecasting instruments available to Copom, the information contained in more recent indicators resulted in a new upward revision in the values expected for inflation in 2000. In light of the aforementioned supply shocks, inflation for the year will probably close at a level somewhat above 6%, but well within the tolerance band. This leeway exists precisely for the purpose of making it possible to manage this type of shock, while also taking measures aimed at avoiding its spread into other areas of the economy. Inflation should turn downward in the coming months and accumulated value in 2001 will close slightly below the 4% target. However, price performance should be very closely monitored in order to confirm the hypotheses underlying these conclusions.

In this light, Copom decided to maintain the Selic rate target at 16.5% per year.

At the close of the meeting, it was announced that, based on the Schedule of Ordinary

COPOM Meetings, released by Banco Central Communiqué no. 7,228, dated 01.19.2000, the Committee would meet again on October 17, 2000 at 3:00 PM, for technical presentations and on the following day, at 4:30 PM in order to discuss monetary policy guidelines.

Alexandre Pundek Rocha

Acting Executive Secretary of COPOM