



BANCO CENTRAL DO BRASIL

Minutes of the 85th Meeting of the Monetary Policy Committee (Copom)

Date: June 17th, from 3:30PM to 6:30PM, and 18th, from 11:30AM to 1:30PM

Place: Central Bank's Headquarters meeting room of the 8th floor (on June 17th) and 20th floor (on June 18th) – Brasília – DF

In attendance:

Members of the Committee

Henrique de Campos Meirelles – Governor

Antônio Gustavo Matos do Vale

Beny Parnes

Ilan Goldfajn

João Antônio Fleury Teixeira

Luiz Augusto de Oliveira Candiota

Paulo Sérgio Cavalheiro

Sérgio Darcy da Silva Alves

Department Heads (all present on June 17th)

Altamir Lopes – Economic Department

Daso Maranhão Coimbra – International Reserve Operations Department

José Antonio Marciano – Department of Banking Operations and Payment System

José Pedro Ramos Fachada Martins da Silva – Investor Relations Group

Marcelo Kfoury Muinhos – Research Department (also present on June 18th)

Sérgio Goldenstein – Open Market Operations Department

Other participants (present on June 17th)

Antônio Carlos Monteiro – Executive Secretary

Alexandre Pundek Rocha – Advisor to the Board

Flávio Pinheiro de Melo – Advisor to the Board

João Batista do Nascimento Magalhães – Special Advisor to the Governor

Jocimar Nastari – Press Secretary

Katherine Hennings – Advisor to the Board

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

Recent Evolution of Inflation

1. In May, most measures of inflation continued their downward trend. Wholesale prices fell, mainly due to the effects of the recent exchange rate appreciation, especially on the prices of tradable goods. Consumer prices on average are also decelerating, although at a slower rate than at the wholesale level, reflecting pressures on specific items.
2. The IPCA increased 0.61% in May, in comparison to 0.97% in the previous month, accumulating 6.80% in 2003 and 17.24% in 12 months. The IGP-DI decreased 0.67% in May, compared to a 0.41% increase in April. The IPA-DI fell by 1.68% in May, in comparison to 0.07% in the previous month. The 12-month IGP-DI and IPA-DI fell for the second consecutive month, totaling 30.05% and 38.5%, respectively in comparison to 32.37% and 42.65% in April.
3. Regarding the evolution of the IPCA, the average increase of 6.45% in electricity due to both increases in household electricity tariffs and public lighting taxes in some capitals made the largest single contribution



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(0.27 p.p.) to the increase of the IPCA in May. The 14.46% increase in the price of rice also contributed significantly to IPCA inflation in May.

4. Inflation of both market and regulated prices in the IPCA slowed in May. The increase in market prices fell to 0.53% in May from 0.87% in April due to the deceleration of inflation in non-tradable goods prices, which remained stable – mainly due to declines in the prices of perishable foods and a 0.3% increase in service prices. The slowdown of inflation in tradable goods prices was less intense, with these prices rising 0.95% in May compared to 1.11% in April, with continuing upward pressures from the prices of rice, milk and dairy products and clothing. Among tradable goods, there was a deceleration in the price increases of medicine, cleaning and personal hygiene products, furniture and utensils and electronics.
5. Regulated prices increased 0.81% in May, compared to 1.21% in April, contributing 0.23 p.p. to the increase of the IPCA. In addition to electricity tariff hikes in 9 regions, urban bus and water and sewage tariffs contributed 0.08 p.p. and 0.03 p.p., respectively, to the increase in the May IPCA. Gasoline prices at gas stations decreased 3.38% due to a 6.5% decline in refinery prices that began on April 30th. The price of alcohol-based auto fuel decreased 3.88% in May. Together gasoline and alcohol-based fuel contributed – 0.20 p.p. to the change in the IPCA last month.
6. It is important to highlight that even after the most recent reductions in petroleum products, domestic prices are still higher than international prices. Considering the international dollar prices of these products and the exchange rate on June 15th, these margins stood at 8.5% for gasoline prices and bottled gas, 24% for diesel fuel and 13.8% for jet fuel.
7. Regarding the evolution of wholesale prices, one should highlight the effects of the exchange rate appreciation on both agricultural and industrial prices. Following a 0.99% decrease in April, the agricultural component of the IPA fell a further 3.08% in May. The industrial component of the IPA decreased 1.15% in May, compared to a 0.48% increase in the previous month. However, the behavior of industrial prices at the wholesale level was not uniform, with a deceleration of price increases in some sectors, outright price declines in others - mainly chemicals, paper and cardboard and power lines - and higher pressures in sectors such as machinery, transportation, fabric, clothes and footwear, beverages and food products.
8. Core IPCA inflation calculated by excluding household food items and regulated prices was 0.56% in May, compared to 0.81% in April. The accumulated change in 12 months was 10.58%.
9. Core IPCA inflation calculated under the trimmed-mean method registered 1% in May, compared to 1.1% in April. In the last 12 months, trimmed-mean core inflation accumulated an increase of 11.98%. It is worth mentioning that because of the methodology used in this measure - in particular, smoothing the changes of certain items - the results are influenced by the higher inflation resulting from the exchange rate depreciation in the second half of 2002.
10. Core IPC-BR inflation calculated under the symmetric trimmed-mean method registered a 1.05% increase in May. In 12 months, core IPC-BR inflation accumulated a 12.14% increase. Core measures of inflation with this index are also being influenced by the exchange rate shock last year.
11. In June, wholesale prices will continue to reflect the exchange rate appreciation, registering additional declines as already signaled in the partial results for June inflation. Consumer price indices will come under some upward pressure from the prices of rice, milk and dairy products and clothing prices. However, this pressure will be lower than observed in May. Also, expected declines in the prices of fresh food, beef and fuel will facilitate a further deceleration of monthly inflation.

Assessment of Inflation Trends



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12. The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypotheses.
- a. The price of gasoline is estimated to increase 5.3% in 2003, compared to 6% at the last Copom meeting. Re-estimates of the price adjustments for bottled cooking gas for 2003 resulted in a 2.1 p.p. fall compared to last month, with cooking gas now forecasted to increase 2.4% in 2003. These forecasts include price readjustments that have occurred up to the current date.
 - b. As a result of the exchange rate appreciation and the new estimate for the General Price Indices, the readjustments of electricity and telephones tariffs are estimated at 23% and 19%, respectively, including the readjustments that have occurred up to the current date.
 - c. Regulated prices, which had a 28.65% weight in the May IPCA, are forecast to increase 14.1% in 2003. The exchange rate appreciation and the decrease in the estimate of electricity and telephone price readjustments resulted in a 0.8 p.p. fall from the May projections. Regulated prices are forecast to increase 8.9% in 2004.
 - d. The projection for the 6-month spread over the Selic rate, following the specification of the VAR model using the Selic and swap rates on the eve of the Copom meeting, was -100 b.p. for 3Q03, gradually rising to 50 b.p. at the end of 2004.
13. Regarding fiscal policy, it is assumed that the public sector will accomplish the primary surplus target for this year and the following two years (4.25% of the GDP). The other related assumptions established in the May Copom meeting were maintained.
14. Considering the baseline scenario hypotheses, including maintenance of the Selic interest rate at 26.5% p.a. and the exchange rate at the level prevailing on the eve of the Copom meeting, inflation is projected above the adjusted target of 8.5% for 2003 and below the target of 5.5% for 2004.

Monetary Policy Decision

15. Monthly Inflation has been falling this year. There are three basic factors explaining this recent behavior. First, the high inflation rates observed at the beginning of the year resulted from the delayed effects on prices of the strong exchange rate depreciation observed last year and the increase of inflation persistence, with more agents adjusting prices and wages based on past inflation. Second, the recent exchange rate appreciation has reduced pressures on companies' costs and wholesale prices. Although there is still some resistance among the retail prices of tradable goods to pass-through from the recent exchange rate appreciation, consumer prices have tended to stabilize without additional readjustment pressures. Third, monetary policy has been successful in reducing inflation expectations and inflation pressures by controlling aggregate demand.
16. Inflation persistence contributed to the continuation of high inflation in the initial months of the year. Higher inflation persistence was caused by an increase in the practice of backward-looking prices readjustment, and a corresponding decline in price readjustments based on future inflation. This behavior, aimed at improving profit margins in the initial months of the year, led to a significant decrease in sales in an environment of lower demand and a monetary policy committed to preventing price readjustments from perpetuating high inflation.
17. As a consequence of higher inflation persistence, the velocity of the fall of monthly inflation has been lower than expected since inflation peaked at 3% in November. IPCA inflation only dropped below 1% in April, falling again in May to 0.61%. Similar behavior has been observed when analyzing the trend of market prices. The inflation of these items has decreased gradually, to 0.5% in May from 2.5% in November.



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18. On the other hand, the exchange rate appreciation has contributed to a reduction of cost pressures on inflation. The maintenance of appropriate fiscal and monetary policies, as well as the recent increase in international liquidity, contributed to the continuation of the exchange rate appreciation. The rollover rates for private securities and direct loans continue to increase. Country risk, measured by the Embi+, continued its decline, falling to 696 b.p. on the eve of the June Copom meeting from 833 b.p. on the eve of the May Copom meeting, demonstrating the recovery of international confidence in the conduct of economic policy in Brazil.
19. Economic activity continues to decelerate. The intensity and duration of this deceleration are similar to those observed in other recent periods of Brazilian history. However, due to the change in relative prices, especially regarding the prices of tradable goods compared to the prices of non-tradables, the deceleration of activity is not uniform. The sectors related to exports, including agribusiness, and the mineral extraction industry are expanding. On the other hand, the durable goods sector for internal consumers, which depends on domestic credit conditions, is the most depressed compared to the same month of last year.
20. According to the factors explained above, monthly inflation remains on a downward trend. The decrease of 0.4 p.p. in IPCA inflation in May was strongly influenced by the 0.6 p.p. reduction in non-tradable goods prices, which resulted mainly from the normalization of the supply of perishable foods. Nevertheless, other groups also showed a reduction of inflation pressures. The decrease of the prices of gasoline and alcohol-based auto fuel was the main factor contributing to the reduction in regulated price inflation. Excluding the increases in electricity, urban bus, water and sewage tariffs, the IPCA would have increased by 0.23% instead of the 0.61% observed in May. The decline of consumer price inflation was followed by deflation in wholesale prices, both agricultural and industrial.
21. Also in May, fewer prices in the IPCA were adjusted upward: 66.0% compared to 75.8% in April. This value is much lower than the maximum value of the series since 1995, observed in January, when the prices of 85.9% of the items in the IPCA increased.
22. Core inflation is also declining. Free prices (which is equivalent to a core inflation calculated by excluding regulated prices) increased 0.53% in May, compared to 0.87% in April, pointing to annualized inflation of 6.9%. The behavior of core inflation calculated by excluding regulated prices and household food items was similar, decreasing to 0.56% in May from 0.81% in April.
23. Trimmed-mean core inflation increased 1%, compared to 1.1% in April. Under this methodology, the readjustments of some items, which are concentrated in a few short periods of the year, are smoothed to avoid their exclusion from the core. When inflationary shocks occur, the core tends to be affected by past pressures and shows some resistance to falling. Excluding the effects produced by this smoothing process, the downward trend of core inflation is clear, falling from 0.86% in April to 0.64% in May. Another way to measure trimmed-mean core inflation, which avoids the influence of exchange rate shocks, is to substitute the current period's smoothed values with the corresponding values observed in the past 12 months. Based on this criterion, the core would be 0.88% and 0.79% in April and May respectively.
24. Both the Central Bank's inflation forecasts and market inflation expectations have been converging to the inflation targets. The Central Bank's inflation forecasts for 2003 point to inflation above the adjusted target of 8.5%. Nonetheless, inflation in the second quarter of the year registered results compatible with those presented in the Open Letter sent by the Central Bank's Governor to the Ministry of Finance on January 21.
25. Market inflation expectations surveyed by Gerin have also been converging to the 12-month ahead inflation targets. The most recent data regarding inflation expectations for the next 12 months is 7.4%, close to the 12-month ahead target path in May (7.2%).
26. In June 2003, the 12 month-ahead inflation consistent with the 2003 and 2004 targets corresponds to 7%. The Copom inflation forecast for the same period is below this figure.



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27. However, there are still risks to setting inflation on a path consistent with the target trajectory, especially with respect to the speed of disinflation. The Copom has continuously evaluated the degree of inflation persistence in recent months. One of the analytic methods consists of comparing the models that are currently used with other specifications that adopt a higher degree of persistence. It was observed that the current models forecasted May inflation with more accuracy, which may be the first hint that the degree of inflation persistence is returning to the historical average. The asymmetrical impact on prices of the exchange rate's appreciation and depreciation was analyzed in the same way. The conclusion was that the models that incorporate less impact due to exchange rate appreciations, compared to exchange rate depreciations, signaled market price inflation above the one that was effective in May.
28. Due to the recent slowdown in inflation, the Copom believes that the stance of monetary policy should ensure that the recent disinflation trend is sustained.
29. As a result, the Copom decided, unanimously, to set the target for the Over-Selic rate at 26% p.a.
30. At the close of the meeting, it was announced that the Copom would meet again on July 22, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in the Communiqué 10,187, of October 2, 2002.



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SUMMARY OF DATA ANALYZED BY THE COPOM

Economic Activity

31. The national retail sales index fell 3.82% in April and 5.45% in the first four-month period of 2003, when compared to the same period of 2002, according to the IBGE's monthly survey. The negative performance was generalized, and hit all the retail sectors and 24 out of Brazil's 27 states.
32. Seasonally adjusted data from Fecomércio-SP also show a fall of 1.45% in real retail sales in the metropolitan area of São Paulo in April, compared to March, and a fall of 15.2% compared to April 2002. Accumulated sales in the first four-months of the year showed a decrease of 9.27% year-on-year. Durable and semi-durable consumer goods posted the largest year-on-year declines of 19.9% and 20.9%, respectively. After consecutive falls in recent months, data on sales with checks and credit purchases, released by the ACSP, stabilized in May, although at a low level.
33. Despite the negative retail sales results, the monthly Fecomércio-SP survey showed a recovery in consumer confidence for the third consecutive month in June, signaling better prospects for the sector. The IIC reached 109.8, compared to 104.3 in May (out of a 0-200 range).
34. The main investment indices showed weak performance in April, still highlighting that the difficult economic scenario and the government transition postponed investment decisions, both in the public and the private sectors. Considering s.a. data, construction input production decreased 3.2% in April compared to March, accumulating a year-on-year decline of 5.2% in the January-April period. Although capital goods production increased 1.4% in April, domestic demand for these products decreased, considering that the export volume index increased 13.5% and the import volume index decreased 4.2% in the month. Medium and long term financing provided by the BNDES, another indicator of the evolution investment expenditures, was below the level observed in the same period last year. The year-on-year decline stood at roughly 9.4% in the first quarter of 2003 and increased to 10.2% for the January-April period.
35. Industrial production was relatively stable in April compared to March, with a seasonally adjusted change of -0.1%. Compared to April 2002, industrial production declined 4.2% according to the IBGE's monthly data. Both the month-on-month and year-on-year results for April should be judged with caution however. The number of working days in March 2003 was lower than normal due to the Carnival holidays. Additionally, in 2003 the month of April had two less working days than April 2002.



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36. Looking at the recent behavior of industrial output, it should be noted that the stability of overall production in April resulted from an increase in mineral extraction (1%), and an offsetting decrease in manufacturing (-0.2%). By categories of use, output of intermediate goods declined 1.5%, while output of semi-durable and non-durable consumer goods declined 0.8%. The output of capital goods increased 1.4%, while output of durable consumer goods increased 12%. It should be noted, however, that the large increase in the output of durable consumer goods in April took place after a 20.5% fall in March.
37. Manufacturing output in the January-April period was roughly stable year-on-year (increasing 0.1%), while output in the mineral extraction sector in the same period increased 4.5% compared to the first four months of 2002. Total industrial output in the first four months of the year grew 0.6% relative to the same period in 2002, a deceleration from the 2.5% year-on-year growth registered in the first quarter of 2003. By categories of use, the positive influence of the agricultural industry and exports on industrial performance in the current year is notable, reflected in a 2.7% increase in the output of intermediate goods. The remaining categories registered declines: 1.5% in capital goods, 4.6% in durable consumer goods and 5.3% in semi-durable and non-durable consumer goods.
38. Data on manufacturing and real industrial sales released by the CNI showed a reduction in industrial activity in the first four months of the year. Although the accumulated year-on-year growth rates in the four-months of 2003 were positive (1.96% and 0.26% respectively) they were lower than the growth rates observed in the first quarter, indicating deceleration at the margin. Installed capacity utilization reached 79.63% in April (s.a.), compared to 81.59% registered in October of 2002. The average of the first four-months of 2003 was 0.6% below the average level observed in the same period of last year.
39. In the auto sector, production and internal sales recovered in May, with growth of 4.46%(s.a.) and 1.87% (s.a.), respectively, compared to the previous month, while external sales fell 0.03%. In the January-April period, auto output increased 3.94% year-on-year, driven exclusively by a 39.5% expansion in external sales, as domestic sales fell 6.63% during this period.

Labor Market

40. Legally registered employment increased 0.2% in April s.a., compared to March, and 3.1% compared to April 2002, according to the Ministry of Labor and Employment. According to the new methodology for the IBGE's employment survey, the unemployment rate in the six main metropolitan areas reached 12.4% in April, compared to 12.1% in March.
41. According to the survey, the number of occupied people remained roughly stable in April (with an increase of 0.1% compared to March). While formal employment increased 3.5% between April 2002 and April 2003, the informal employment grew 9.1%. The average real wage of employed workers fell by 6.3% compared to the same month of 2002.

Credit and Delinquency Rates

42. Total non-earmarked bank credit in May remained roughly stable relative to April (R\$214.8 billion), as a 2% fall in dollar-indexed credit due to higher repayments offset growth in domestically-funded credit to companies (0.6%) and individuals (0.9%). Regarding credit to individuals, personal credit increased 2.3% and financing for purchases of autos and goods increased 0.8%. In the domestically-funded credit to companies, working capital loans increased 2.6%.
43. The delinquency rate on non-earmarked bank credits remained at 8.8% in May. For individuals, the rate fell to 15.4% in May from 15.7% in April, while for companies it increased 0.1 p.p. to 4.7%. The average interest rate on bank loans fell 0.1 p.p. to 57.8% p.a. in May. The fall in interest rates charged by financial institutions was driven mainly by a decline in rates on fixed-income credits, which was partially offset by an increase in rates for dollar-indexed credits.



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44. Regarding defaults on retail credit, ACSP statistics show that the number of new delinquency registrations fell by 2.66% and the amount of cancelled registrations increased 11.13%, compared to the previous month, reducing the net delinquency rate to 5.2%, compared to 7% in April and 8.8% in May 2002.

External Environment

45. The rapid conclusion of the war conflict in Iraq has not yet translated into a strong impulse to global economic activity. Projections for economic growth in 2003 continue to be reduced.
46. In the US, the latest indicators reinforce the hypothesis of a slow economic recovery, and there are risks that the recovery may not be sustainable. In Japan and Germany, the recessionary scenario continues, with zero growth and disinflation. Labor markets in the industrialized economies continue to weaken with unemployment rates at high levels.
47. The lack of dynamism in the labor market is negatively influencing consumer confidence, mainly in Europe. In the US, although economic indicators have improved, consumer confidence showed signs of falling, according to the University of Michigan. Business expectations are recovering in the US, but not in the other industrialized countries.
48. Inflation continues to fall in the main economies. In the US, the producer price index registered a decline of 0.3% in May, after falling 1.9% in April. However, according to the Federal Reserve Bank, the risk of deflation is very low. Oil prices registered new increases in mid-April, signaling an upward trend due to the adjustment of the market to the new conditions of supply and demand.
49. The ECB reduced its benchmark interest rate by 50 b.p. at its last meeting, to 2% p.a. In the UK, the Bank of England maintained its rate at 3.75% p.a. International financial markets are less volatile and less risk averse, as shown by the reductions in the EMBI+ and in the spreads of sovereign and private securities. Stock exchanges registered significant recoveries, not only in the developed economies but also in the emerging countries.

Foreign Sector

50. The trade surplus reached US\$2.5 billion in May, accumulating US\$8 billion in the first five months of 2003, basically due to the performance of exports which have grown sharply, while imports decreased slightly.
51. Exports reached US\$6.4 billion in May and US\$27.1 billion year-to-date, increasing 43.5% year-on-year in the month and 29.3% in the first five months compared to 2002. Imports decreased 4.9% in May, reaching US\$3.9 billion, and were stable in the first five months of the year, reaching US\$19.1 billion, both compared to 2002.
52. The current account posted a surplus of US\$882 million in May, compared to the US\$1.9 billion deficit in the same month of 2002. The deficit in the services and income account reached US\$1.8 billion and unilateral transfers posted a US\$212 million surplus. The 12-month current account deficit reached US\$512 million, or 0.13% of GDP in May. The financial account of the BoP registered a net inflow of FDI totaling US\$541 million and an inflow of US\$1 billion from the sovereign bond issued by the Republic.

Monetary Market and Open Market Operations



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53. After the last Copom meeting, the yield curve shifted downwards and inverted further. More favorable indicators of inflation, the appreciation of the exchange rate, a decline in sovereign country risk, and the approval of the social security reform project by the specific commission of the Lower House contributed to this movement.
54. Securities and swaps maturing since the previous meeting have been rolled over through swaps with terms ranging from 5 to 55 months (12 months on average). Lower placement rates, as compared to the previous period, were due to the fall in the dollar-linked interest rate curve as a result of a better perception of sovereign risk and new bond issues abroad.
55. Since the May Copom meeting, the Treasury has offered LTNs five times, for an amount totaling R\$8.7 billion. The significant demand for these securities and the movement in the domestic yield curve allowed the offer of longer average tenors and lower rates than in the previous period. Four issues of LFTs were also made at longer terms and lower rates, totaling R\$19.5 billion. It should be highlighted that in June the Treasury issued R\$1.3 billion of LFTs maturing in June 2007.
56. The settlement of securities between May 22nd and June 18th caused a contractionary monetary impact of R\$3.5 billion, as a result of net placements of R\$8.7 billion in LTNs, partially offset by net redemptions of R\$2.9 billion of dollar-indexed securities and R\$1.6 billion in LFTs.
57. The domestic securitized public increased by R\$16.4 billion (2.5%) in May, mainly due to net placements of R\$3.2 billion in securities and to interest payments.



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Acronyms

ACSP	São Paulo Trade Association
b.p.	basis points
CNI	National Confederation of Industry
Fecomércio-SP	São Paulo State's Federation of Commerce
ECB	European Central Bank
GDP	Gross Domestic Product
Gerin	Investor Relations Group
IBGE	Brazilian Institute of Geography and Statistics
IGP-DI	General Price Index – Domestic Supply
IGP-M	General Price Index – Market
IIC	Consumer Intentions Index
INCC	National Index of Civil Construction
IPA	Wholesale Price Index
IPC-BR	Consumer Price Index – Brazil
IPCA	Consumer Price Index - Extended
LFT	National Treasury Bills (floating)
LTN	National Treasury Bills (fixed rate)
p.a.	per annum
p.p.	percentage point
s.a.	seasonally adjusted
VAR	Vector AutoRegressive