BANCO CENTRAL DO BRASIL

## Minutes of the 82nd Meeting of the Monetary Policy Committee (Copom)

**Date:** March 18th and 19th
**Place:** Central Bank's Headquarters meeting room of the 8th floor (on Mar 18th) and 20th floor (on Mar 19th) – Brasília – DF

**Called to Order:** 4:00 PM on Mar 18th and 11:15 AM on Mar 19th
**Adjourned:** 7:00 PM on Mar 18th and 3:00 PM on Mar 19th

**In attendance:**
**Members of the Committee**
Henrique de Campos Meirelles – Governor
Beny Parnes
Ilan Goldfajn
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Luiz Fernando Figueiredo
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

**Department Heads (all present on March 18th)**
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 March 19th)
Sérgio Goldenstein – Open Market Operations Department

**Other participants (all present on March 18th)**
Antônio Carlos Monteiro – Executive Secretary
Alexandre Pundek Rocha – Advisor to the Board
João dos Reis Borges Muniz – 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, designed to comply with the inflation targets established by the government.

## Economic Activity

Recently released economic indicators showed some loss of dynamism in industrial activity and the retail sector. Export growth and import substitution continue to support aggregate demand, partially offsetting the contractionary effect of the decrease in real incomes and the worsening in credit conditions.

According to the IBGE, in January, the national retail sales index fell 4.9% compared to January of last year. With respect to the 12-month accumulated index, the decline seen in recent months worsened slightly (1% in January compared to 0.7% at the end of 2002). By sector, *supermarkets, food products, beverage and tobacco* was the segment responsible for most of the decrease in sales for the second consecutive month, reflecting the decline in workers' real incomes due to higher prices of food and cleaning and personal hygiene products.

The Fecomércio-SP survey showed a decline in consumer confidence in March, with the IIC falling to 97.8 from 102.5 in February, reflecting a decrease of 7.7% in current consumer intentions and 3% in future intentions. These declines suggest the reversal of the optimistic sentiment seen immediately after the presidential elections, due to concerns over unemployment, inflation and the international scenario.

Regarding defaults on retail credit, ACSP statistics reveal that the number of new delinquency registrations fell by 2.2% in February as compared to January, but the amount of canceled registrations decreased 7.1%, also compared to January. Thus, the net default rate increased to 6.8% in February from 6.2% in the previous month.

The delinquency rate on non-earmarked bank credits increased 0.2 p.p. in February, to 8.4%. The default rate for individuals and corporate loans reached 15.1% and 4.5%, respectively. The average interest rate on bank credits increased 2.6 p.p. in February to 56.5% p.a.

Total non-earmarked bank credits increased 0.8% in February, reflecting mainly the seasonal growth of operations with individuals, which increased 1.2%. Credits to companies increased 0.5%, with the expansion largely funded domestically. Of note in this area is the growth of ACC operations, which have been favored by the normalization of external bank-to-bank trade lines.

Investment indicators improved slightly in January, after the downward trend observed in the second half of 2002 due to the uncertainties that marked the period. The domestic output of machines and equipment, the volume of capital goods imports and the production of inputs for civil construction increased 5.1%, 16.7% and 0.6%, respectively, compared to December (s.a.).

Industrial output in Brazil increased 0.7% in January compared to the previous month, s.a., according to the IBGE. The rise was the result of a 13.7% increase in mineral extraction, as manufacturing output fell 0.2%. This behavior in the mineral extraction sector was a consequence of the normalization of activities in Brazil's oil and gas fields, after prescheduled maintenance interruptions in the last two months of 2002.

Regarding the evolution of the manufacturing sector, the January result confirms the signs of a slowdown in industrial activity, with the exception of the sectors closely linked to external trade. In fact, industrial sales fell 0.1% in January according to the CNI, the third consecutive monthly fall.

Data for the automobile sector up to February also confirm that exports are contributing strongly to the improvement in the trade balance. Seasonally adjusted data shows that wholesale domestic auto sales declined 2.4% in February and 6.9% in the quarter ended last month, while auto exports increased 0.3% and 23.6%, respectively, in the same periods.

In the labor market, legally registered employment increased 0.2% month-on-month in January, s.a., and 3.5% compared to January 2002, according to the Ministry of Labor. According to the new methodology for the Monthly Employment Survey, the unemployment rate measured by IBGE in the six main metropolitan regions reached 11.2% in January, compared to 10.5% in December. This rise repeated the normal seasonal pattern for January, when there are more unemployed workers seeking for jobs.

With respect to the external accounts, the trade balance posted a US$1.1 billion surplus in February, accumulating a US$2.3 billion surplus in the first two months of 2003. Considering daily averages, exports increased 23% in February and 22.4% in the first two months of the year, compared to the values registered in the same periods of 2002. Imports increased 2.7% in February and decreased 0.5% in the first two months of the year. In the first two weeks of March (8 working days), the trade surplus totaled US$491 million. The expansion of exports resulted mainly from the continuous growth of sales to the US and China, and the recovery of trade with Argentina, in addition to the increase in prices of important export commodities.

Summing up, economic activity lost momentum at the end of 2002 and in the beginning of this year, even though exports have continued to grow. There are signs that domestic demand has weakened due to the drop in real income as a consequence of higher inflation, a trend only partly attenuated by extraordinary disbursements from the FGTS. Additionally, consumer expectations have shown a reversal of the optimism seen during the governmental transition.

## External Environment

The uncertainty regarding the possibility of a military confrontation in Iraq was the major development in the international economic scenario. This environment contributed to volatility in the financial markets. In recent days, with the war coming closer after the US ultimatum, stock prices rose, oil prices declined and the US dollar appreciated, reversing previous trends. Notwithstanding these short-term developments, recent indicators have shown that the main economies are facing difficulties in consolidating their fundamentals, mainly with worsened fiscal accounts and less room to maneuver monetary policy.

In the US, GDP growth decelerated strongly in the last quarter of 2002, falling to 1.4% p.a., according to preliminary data. The US current account deficit increased in the fourth quarter, reaching 5% of GDP in 2002. In February, retail sales fell 1.7% and the unemployment rate rose to 5.8%, with the elimination of 308 thousand jobs. Consumer confidence indicators worsened significantly while those related to business expectations are barely above the indifference level. Inflation measured by the PPI increased 1%, accumulating a 3.5% increase in the 12 months ending in February, under the pressure of the recent increase in fuel prices.

The Euro area continues to grow slowly, led by the weak performance of the German economy. The fiscal deficit in Germany surpassed the limit set by the European Union, which may lead to fiscal tightening. The ECB reduced the basic interest rate by 0.25 p.p. in March, setting it at 2.5% p.a., the lowest level of the last three years. European consumer confidence has been hurt by expectations of war in Iraq and increasing unemployment.

## Prices

In February, inflation decelerated to its lowest rates since last October. The IPCA increased 1.57% compared to 2.25% in January, accumulating an increase of 3.86% in the first two months of the year and 15.85% in 12 months. The IGP-DI increased 1.59% in February, compared to 2.17% in the previous month, accumulating an increase of 3.8% in the first two months of the year and 30.73% in 12 months.

In the IPCA, inflation in both free market prices and regulated and monitored prices decelerated, posting increases of 1.10% and 2.71%, respectively, compared to 1.64% and 3.83% in the previous month. Among free market prices, the main increases occurred in school fees and perishable food due to seasonal reasons, with both categories rising by 6.5%. Important food products in the consumer basket—soybean oil, rice, meat and chicken—registered price declines of 0.75%, 0.73%, 0.57% and 0.49%, respectively. Among regulated prices, the largest contributions came from the 5.9% increase in urban transport, 3.3% increase in gasoline, 11.8% increase in alcohol-based fuel, and 3.5% increase in telephone fares. It should be highlighted that the price of bottled cooking gas declined by 3.7%.

With respect to the IGP, the IPA sub-index increased 1.71% in February as compared to 2.21% in January, with the deceleration due to the behavior of industrial prices, as agricultural price inflation increased slightly, from 1.16% to 1.20%. This increase reflected the unfavorable contribution of grains and exporting commodities, and higher increases in the prices of legumes and fruits. Industrial prices decelerated broadly, increasing 1.91%, as compared to 2.64% in January. Of the most heavily weighted segments, only the prices of chemical products decelerated less sharply, due to increases in the prices of fuel and lubricants, fertilizers and plastic.

In March, inflation measured by the main price indices will continue to fall although it will remain at high levels compared to the average for this month in previous years. Considering the IPCA, regulated and monitored prices will decelerate strongly, due to the end of the impacts of the recent readjustments. Regarding free market prices, increases in the prices of medicines will be the main source of pressure, while clothing will contribute favorably for seasonal reasons. With respect to wholesale prices, agricultural products will contribute to the reduction of the indices, mainly as the result of lower price increases for grains and some vegetables.

## Money Market and Open Market Operations

In the period after the Copom decision in February, the reduction of country risk, the appreciation of the exchange rate and the deceleration of inflation contributed to consecutive and significant reductions in the slope of the yield curve. On March 18, the eve of this month's Copom meeting, the spreads of the 1-month and 1-year interest rates were 5 b.p. and 57 b.p., respectively.

Securities and FX swaps maturing since the previous meeting were fully rolled over through swaps. The US$1.3 billion maturing on March 5 was rolled over with terms ranging from 3 to 67 months (12.4 months on average). The favorable bid/ask ratio allowed the rollover in a single auction. Of the US$1.9 billion rolled over on March 13, two auctions occurred, with the tenor of the swaps ranging from 2 to 49 months (8.2 months on average). The rollover of securities and FX swaps maturing on April 1 was held in advance, and through an auction on March 14 a total of US$0.8 billion was placed, about 25% of the total to mature. The improvement in country risk and capital inflows contributed to the progressive reduction of the interest rates in these auctions.

The Treasury has resumed the offer of LTNs, which had not occurred since last November. In the period between the February and March meetings, R$2.4 billion were placed, with decreasing rates following the reduction of the yield curve. LFTs were offered four times during this period, with placements totaling R$21.8 billion. The average tenor rose as a result of higher demand for longer-term LFTs, due to the significant reduction in the price discount of shorter tenor securities. A total of R$0.6 billion of NTN-Cs was placed, with tenors of 5, 14 and 18 years. Aiming at reducing the concentration of LFT maturities in upcoming months, the Treasury carried out an auction substituting longer tenor bonds for R$2.1 billion in securities with maturities in the next 1 to 2 months.

The settlement of securities between February 20 to March 19 caused a contractionary monetary impact of R$2.7 billion, due to net placements of R$4.8 billion of LFTs and R$2.4 billion of LTNs, partially offset by net redemptions of FX-indexed securities (R$4.5 billion).

In the same period, the Central Bank intervened in the money market through repo operations ranging from 7 to 30 days, and through daily liquidity management operations with maturities of 2-working days, with the aim of reducing the need for daily interventions and withdrawing excess liquidity through longer-term operations.

## Assessment of Inflation Trends

The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypotheses:

1. The projection for the increase in gasoline prices rose to 12.4% from 8.0% for 2003 since the February Copom meeting. Considering the adjustments up to February, this hypothesis assumes the price of gasoline remains stable until the end of the year. An increase of 4.2% is forecast for the price of bottled cooking gas in 2003, of which 0.7% occurred in the year to February. This forecast is 2.2 p.p. below the previous meeting.

2. As compared to the previous meeting, the forecast rise in household electricity tariffs for 2003 is roughly stable, standing at 27.5% compared to 27.1% in February.

3. For the set of regulated and monitored prices, which had a weight of 28.3% in the February IPCA, an increase of 16.8% is projected for 2003, of which 6.6% has already occurred in the first two months of the year. The increase of 0.9 p.p. compared to the forecast at the February meeting already took place. The forecast for the increase in the regulated prices from March to the end of the year remained practically stable at 9.5%. For 2004, the forecast for the increase in these prices is 9%, practically unaltered since the previous meeting (8.7%).

4. The projection for the 6-month spread over the Selic rate, following a new specification of the VAR model using the variables Selic rate and swap rate in levels, was 70 b.p. in the days before the meeting, rising gradually to 100 b.p. in the beginning of 2004.

Core inflation calculated with the exclusion of household food items and of regulated and monitored prices fell to 1.0% in February, confirming the deceleration trend observed since December, but still higher than the first three quarters of 2002. The 12-month accumulated change was 9.4%. Core inflation calculated under the trimmed-mean method registered a 0.9% increase in February, also decelerating since December (1.4%), but also higher than the first three quarters of 2002. In the last 12 months, the trimmed-mean core increased by 10.1%, as compared to 9.7% in January. Regarding core inflation of the IPC-BR, calculated under the symmetric trimmed-mean method, the rate reached 0.9% in February and 9.9% in 12 months.

The accumulated variation for the IPCA in 12 months increased to 15.8% in February, as compared to 14.5% in January, due to the exclusion of the February 2002 inflation (0.4%) and the inclusion of the February 2003 inflation (1.6%). In the last 12 months, free market prices contributed 9.4 p.p. to inflation, while regulated and monitored prices contributed 6.4 p.p.

Regarding fiscal policy, it is assumed that the primary surplus target for this year (4.25% of the GDP) will be accomplished. The other related assumptions established in the February Copom meeting were maintained.

From the simulation exercises with several specifications of the structural model, it has been concluded that the maintenance of the interest rate in 26.5% p.a. and of the exchange rate at the level prevailing on the eve of the Copom meeting indicates inflation above the adjusted target of 8.5% for 2003.

## Monetary Policy Guidelines

Economic activity continues to decelerate, as already diagnosed in the minutes of the February Copom meeting. Manufacturing production fell 0.2% in January. However, mineral extraction grew by 13.7%, due to the normalization of activities in the oil sector, offsetting the decline in manufacturing and resulting in a 0.7% growth for overall industrial production.

Results for the current account, which were roughly balanced in the first two months of the year, point to the consolidation of the external sector adjustment. There are signals of improvement in the capital account, and new issues abroad have been announced, most of which are shorter than 1 year. Rollover rates continue to recover, although they are at a reduced level, which contributed to negative FX flows in the first days of March.

The financial markets improved significantly between the February and March meetings. Sovereign risk fell to 1,067 b.p. from 1,333 b.p. The real appreciated by 5% and the 21-day dollar volatility fell sharply to 12.2% from 20.5% in the same period. Demand for public securities remained high. The Treasury resumed placements of LTNs. Discounts on short term LFTs fell.

There are signs that inflation is falling. Monthly IPCA inflation decreased from the 3.02% peak in November to 2.25% in January and 1.57% in February. The fall of inflation in free market prices is even clearer. Free market price inflation registered a peak of 2.53% in November, then declined to 2.32% in December and 1.12% in February, the lowest rate since September 2002. The trimmed-mean core, which had been stable at 1.30% since November, fell to 0.93% in February.

In February, regulated and monitored price inflation (2.7%) was 2.4 times higher than free market price inflation. Although they had a weight of 28.3% in the IPCA, these prices were responsible for 48% of the inflation in January and February, and for 41% of the inflation accumulated in the last 12 months. The four items that contributed the most in the set of regulated and monitored prices were alcohol-based fuel (11.8%), urban transport (5.9%), telephone (3.5%) and gasoline (3.3%), due to changes in the administration of the ICMS tax.

After the price adjustments in January and February, the forecast for regulated and monitored price inflation in 2003 increased 0.9 p.p., reaching 16.8%. According to this new forecast, the primary effect of the shock of regulated and monitored prices on overall inflation was revised, implying a 1 p.p. rise in the adjusted inflation target for 2003, according to the methodology described in the Open Letter of the Governor of the Banco Central do Brasil to the Ministry of Finance of January 21, 2003. However, the Copom considers it premature to modify the adjusted target at this time due to the high volatility of international oil prices, and believes it is preferable to wait for more information about the adjustments that could affect regulated prices.

The downward trend for inflation was maintained in some inflation measures that consider the first weeks of March, such as the first estimate for the IGP-M and the four-week Fipe indices. Additionally, price surveys in the first two weeks of March confirm the expectations of a decrease in inflation, especially in the food and beverage, education and transport categories, which produced the largest pressures in February. Notwithstanding these developments, there are some significant ongoing price increases, such as in the prices of perishable food in greater São Paulo, alcohol-based auto fuel, and medicines. Based on price surveys and market expectations, inflation measured by the IPCA in March is expected to be below 1%, the lowest in the last 6 months.

The median of market expectations for the IPCA interrupted the upward trajectory that had been observed for seven consecutive weeks and moved back to 12.33% on the eve of the Copom meeting. This expectation incorporates the results of the two first months of the year, both high and strongly affected by the increases in regulated prices. The median of market expectations for the IPCA accumulated in the next 12 months fell to 9.7% from 10.7% between the February and March meetings. The focus on the forward inflation rate is important, since it highlights the perception of a downward trend. Monetary policy is concerned about the future trajectory of inflation.

Even though the forecast inflation for 2003 in the baseline scenario is above the adjusted target of 8.5%, the outlook for inflation from the second quarter onward, as assessed by the Copom, is positive. First, the Copom considers that monetary policy has been able to bring inflation to a trajectory compatible with the one outlined in the Open Letter to the Ministry of Finance from the second quarter of this year on. Second, it is premature to evaluate the full effect of the monetary policy actions implemented in recent months. Alternative scenarios with inflation trajectories close to the adjusted target for 2003 were also evaluated by the Copom.

As a result, the Copom decided to maintain the target for the Selic rate at 26.5%.

Notwithstanding this decision, the Copom understands that there are considerable risks to the realization of more favorable inflation trajectories, including those associated with external uncertainties due to the war in Iraq. There are doubts about the speed of the disinflation and the degree of inflationary inertia. A slower fall of inflation has a chance of interrupting the convergence of the inflation to its target, since future readjustments of prices and wages may be based on accumulated inflation instead of on current and expected inflation. As a result, the Copom decided to adopt an upward bias.

At the close of the meeting, it was announced that the Committee would meet again on April 22, for technical presentations, and on the following day, in order to discuss the monetary policy guidelines, as established in the Communiqué 10,187, of October 2, 2002.

**Acronyms**

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| ACSP | São Paulo Trade Association |
| b.p. | basis points |
| Fecomércio-SP | São Paulo State’s Federation of Commerce |
| FGTS | Time in Service Guarantee Fund |
| GDP | Gross Domestic Product |
| IBGE | Brazilian Institute of Geography and Statistics |
| ICMS | Tax on the Circulation of Goods and Services |
| 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 |
| IPC-FIPE | Consumer Price Index of the Economic Research Institute Foundation |
| IPCA | Consumer Price Index - Extended |
| LFT | National Treasury Letters (floating) |
| LTN | National Treasury Letters (fixed rate) |
| NTN–C | National Treasury Note – C Series (price index) |
| PPI | Producer Price Index |
| p.a. | per annum |
| p.m. | per month |
| p.p. | percentage point |
| s.a. | seasonally adjusted |
| VAR | Vector auto-regressive |