



# BANCO CENTRAL DO BRASIL

## Minutes of the 84<sup>th</sup> Meeting of the Monetary Policy Committee (Copom)

**Date:** May 20<sup>th</sup>, from 3:30PM to 6:30PM, and 21<sup>st</sup>, from 10:30AM to 1:30PM

**Place:** Central Bank's Headquarters meeting room of the 8<sup>th</sup> floor (on May 20<sup>th</sup>) and 20<sup>th</sup> floor (on May 21<sup>st</sup>) – 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 May 20<sup>th</sup>)

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 May 21<sup>st</sup>)

Sérgio Goldenstein – Open Market Operations Department

#### Other participants (present on May 20<sup>th</sup>)

Antônio Carlos Monteiro – Executive Secretary

Alexandre Pundek Rocha – Advisor to the Board

Flávio Pinheiro de Melo – Advisor to the Board

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, designed to comply with the inflation targets established by the government.

### Recent Evolution of Inflation

1. In April, most measures of inflation registered their smallest monthly increases since September of 2002. This development was most pronounced in wholesale price indices, mainly due to the effects of the recent exchange rate appreciation and seasonal contribution of agricultural goods prices. The decline in consumer price inflation was smaller, reflecting a modest deceleration in market price inflation and increases in regulated prices.
2. The IPCA increased 0.97% in April, in comparison to 1.23% in the previous month, accumulating 6.15% in the first four months of 2003 and 16.77% in 12 months. The IGP-DI increased 0.41% in April, compared to 1.66% in March. The IPA-DI rose by 0.07% in April, in comparison to 1.93% in the previous month. The 12-month increase of the IGP-DI and IPA-DI fell after having increased for eleven consecutive months, totaling 32.37% and 42.65%, respectively.
3. The deceleration of IPCA inflation resulted exclusively from the evolution of market prices, which increased 0.87% in April, compared to 1.29% in March. Among market prices, the main contribution to the slowdown



## BANCO CENTRAL DO BRASIL

came from food prices, thanks particularly to the normalization of the supply of perishable foods, reflecting more favorable weather conditions. As a consequence, prices of perishable food increased 1.78% in April, in comparison to 7.17% in March. Among tradable goods apart from food items, the smaller increase of the IPCA was due to the behavior of the prices of medicines, household goods and cleaning and personal hygiene products, which increased less than in the previous month. However, due to seasonal effects, clothing items posted a higher increase in April (1.03%) than in March (0.6%).

4. Regulated prices increased 1.21% in April, up from 1.08% in March, contributing 0.35 p.p. to the IPCA result in the month. An increase in the price of electricity made the largest single contribution to the increase in the IPCA (0.13 p.p), reflecting tariff hikes in six metropolitan regions. Additionally, urban bus tariffs, bottled cooking gas (whose price remained stable at the refinery level), water and sewage tariffs and the price of airplane tickets all registered increases.
5. Regarding the evolution of wholesale prices, one should highlight the effects of the exchange rate appreciation and the normalization of the supply of perishable foods. The agricultural component of the IPA decreased 0.99% in April, after a 0.3% increase in March, mainly due to declines in the prices of fruits and legumes (7.05%) and export crops (5.49%). The industrial component of the IPA increased 0.48%, compared to 2.56% in March, reflecting the deceleration of price increases in most of the industrial sectors.
6. Core IPCA inflation calculated by excluding household food items and regulated prices was 0.81% in April, compared to 1.13% in March, but still above the levels observed in the first three quarters of 2002. The accumulated change in 12 months was 10.53%.
7. Core IPCA inflation calculated under the trimmed-mean method registered a 1.10% increase in April, higher than the headline index. In the last 12 months, trimmed-mean core inflation accumulated an increase of 11.43%, as compared to 10.8% in March.
8. Core IPC-Br inflation calculated under the symmetric trimmed-mean method registered a 1.2% increase in April. In 12 months, core IPC-Br inflation accumulated a 11.37% increase.
9. In May, the positive effects of the exchange rate appreciation on inflation are likely to increase, particularly on wholesale prices, as signaled by recent previews of the IGP-M. With respect to consumer prices, tradable goods will also benefit from the exchange rate appreciation, and in conjunction with the fall of perishable food and fuel prices will contribute to the downward trend of inflation. However, upward pressures from clothing prices and electricity tariffs (due to both increase of household electricity and implementation of public light tariffs) will prevent this effect from being more pronounced.

### Assessment of Inflation Trends

10. The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypothesis:
  - a. Estimated price adjustments for gasoline in 2003 are around 6%, including the reduction at the beginning of May. The projection for the readjustment of the price of bottled cooking gas for 2003 increased to 4.5%, due to the 4.13% increase in April.
  - b. With respect to household electricity tariffs, estimated readjustments decreased again as a result of the exchange rate appreciation, reaching 23.7% for 2003. This rate could be lower, were it not for the charges of public lighting in several capitals, including Curitiba, São Paulo, Fortaleza, Recife, Belo Horizonte, Goiânia and some municipalities of greater Rio de Janeiro.
  - c. Regulated prices, which had a 28.6% weight in the April IPCA, are forecast to increase 14.9% in 2003. Despite the increase of in the projection for bottled cooking gas, the decrease of gasoline



## BANCO CENTRAL DO BRASIL

prices, the exchange rate appreciation and the consequent reassessment of electricity price readjustment resulted in a 0.4 p.p. fall from the April projections for regulated prices.

- 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 80 b.p. for 4Q03, gradually rising to 150 b.p. at the end of 2004.
11. 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 April Copom meeting were maintained.
12. Considering the baseline scenario hypotheses, including a steady 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.

### Monetary Policy Decision

13. Inflation remains on a downward trend. Wholesale price inflation has been decreasing more than consumer price inflation. There is evidence that the dynamics of the two groups of prices have been different. At the wholesale level, the exchange rate appreciation and the normalization of the supply of perishable food have been the main factors underlying the decrease in inflation.
14. However, the deceleration of consumer price inflation has not been as significant. Regulated prices increased by 0.34 p.p. more than market prices, due to items such as water and sewage, bottled cooking gas, electricity, urban bus fares, airplane tickets, motor oil and cellular phones. Market price inflation declined, largely due to smaller price increases in services and items linked to the exchange rate.
15. GDP may close the first quarter of 2003 roughly stable in comparison to the previous quarter. On the one hand, manufacturing output fell. On the other hand, the mineral extraction industry, the agricultural sector and the tradable goods sector registered positive performance.
16. The resistance to a more rapid decline in consumer price inflation points to the existence of increased inflation persistence in the economy. The prices of important groups in the consumption basket have increased significantly, although at a decelerating rate, including beverages, canned products, cleaning and personal hygiene products and furniture and utensils. Consequently, core inflation still remains at a high level.
17. This persistence is due to wage and price readjustments that have occurred since the beginning of the year and that have been based on the high inflation rate accumulated in the last twelve months, rather than assessments of future inflation. Also, businesses have made an effort to regain profit margins in a scenario of falling aggregated demand. This behavior resulted in a significant decrease in sales. Retail sales decreased 6% in the first quarter of the year compared to the same period of the previous year.
18. The Copom believes that monetary policy should not ratify price and wage readjustments based on past inflation, due to the risk of perpetuating higher inflation.
19. There are initial signs that monetary policy is curbing inflation. The Copom as well as market participants expect inflation to maintain a declining trend towards its target. These favorable expectations regarding inflation are based on the following assumptions: (i) inflation persistence is temporary; (ii) the recent exchange rate appreciation positively affects price dynamics (in the same way that the exchange rate depreciation affected inflation).



## **BANCO CENTRAL DO BRASIL**

20. Since inflation remains relatively high, it is still premature to conclude that inflation persistence is definitively decreasing and that the effect of the exchange rate appreciation on prices is significant. Thus, the Copom concludes that the decrease of inflation depends on the maintenance of its current effort.
21. As a result, the Copom decided, unanimously, to maintain the target for the Over-Selic rate at 26.5% p.a.
22. At the closing of the meeting, it was announced that the Copom would meet again on June 17, 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.



## **BANCO CENTRAL DO BRASIL**

### **Summary of Data Analyzed by the Copom**

#### **Economic Activity**

23. Carnival holidays in March reduced the number of working days to 19, compared to 20 days in the previous month and in March 2002. As a result, the comparisons of production and sales data contain statistical distortions that have not been eliminated by the usual seasonal adjustment. The March 2003 results are underestimated the same way that data in February was overestimated.
24. Having eliminated the working day effect by using the quarterly moving average, it is clear that the growth rates of industrial production and industrial and retail sales decreased in 1Q2003, compared to the same period last year and the last quarter of 2002.
25. According to the IBGE, the national retail sales index fell 11.3% in March and 6% in the 1Q2003, when compared to the same period of 2002. The negative performance hit all the retail sectors and states in Brazil. Data from Fecomércio-SP also show a fall of 4.7% in real retail sales in the metropolitan area of São Paulo in March, compared to the same month in 2002. However, accumulated sales in the first quarter showed an increase of 7.3%.
26. Data on sales with checks and credit purchases, released by the ACSP, confirmed the downward trend of the retail market in March and in the first quarter of this year.
27. The monthly Fecomércio-SP survey showed an improvement in consumer confidence in May. The IIC reached 104.3, compared to 100.3 in April (out of a 0-200 range). Both components of the IIC increased: current consumer intentions rose by 0.4 p.p. while future intentions increased by 5.7 p.p.
28. The main investment indices declined in 1Q2003. The difficult economic scenario and the governmental transition period contributed to a postponement of investment decisions, both in the public and the private sectors. Civil construction, which is responsible for more than 60% of gross fixed capital formation, decreased 2.1%, compared to the first quarter of 2002. Considering s.a. data, the fall in the first quarter this year reached 5.7%, in relation to the last quarter of 2002.
29. Although capital goods production was roughly stable in the first quarter compared to the same period of 2002 (increase of 0.5%), it fell 3.5% in relation to the last quarter of 2002, s.a. By sector, it is important to note the continuous expansion in the production of machinery and agricultural equipment, due to the increase in the income of the agricultural sector and the significant decrease in energy generating equipment. This decrease was a consequence of the high figures registered last year, when investment in this area was stimulated by the energy crisis.
30. Industrial production decreased 3.4% in March compared to the previous month, s.a., according to the IBGE. Discounting the working days effect, industrial production recorded an increase of 0.1% in the month.
31. The data shows that the behavior of the industrial sector in March was consistent with developments that have been observed since mid-2002, with the best performance in the intermediate goods sector, relating to the expansion of exports, and the agricultural and oil extraction sectors. The consumer goods sector showed significant declines.
32. Considering 1Q2003, the manufacturing and mineral extraction industries increased 2.1% and 4.8%, respectively, compared to 1Q2002. Industry grew 2.5% year-on-year, but fell 1.1% in relation to the performance observed in 4Q2002.



## **BANCO CENTRAL DO BRASIL**

33. Data on real sales and hours worked in the manufacturing sector released by the CNI also indicated a decrease of industrial activity during the first quarter. Although the accumulated data in the quarter posted positive growth compared to the same period last year (7,4% and 2,4%, respectively), they were lower by 2.5% and 1% in relation to the data observed in the last quarter of 2003. Installed capacity utilization reached 79.8% in March, s.a., compared to 80.2% recorded in the same month of 2002.
34. Other indicators related to industrial performance showed positive results in April. Production of corrugated paperboard grew 11.3% month-on-month, s.a., according to the data released by the ABPO. Gross steel production increased 2.5% month-on-month, according to data released by the IBS.

### **Labor Market**

35. Legally registered employment increased 0.2% month-on-month in April, s.a., and 3.3% in the first four-months compared to the same period of 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 12.1% in March, compared to 11.6% in February, despite the increase of 0.1% in the number of employed workers in the same period.
36. The IBGE also verified an increase in informal work in the last twelve months. While the number of formal employees increased 3.3% between March of 2002 and March of 2003, the number of informal employees grew 9.3%. In addition, according to the PME, the average real wage of employed workers fell by 4.9% compared to the same month of 2002. In the industrial sector, according to the CNI, the real payroll in March was 7.7% lower than in March 2002.

### **Credit and Delinquency Rates**

37. Total non-earmarked bank credit decreased 0.4% in April, with the largest decline in the corporate portfolio as a result of the effects of the 13.8% exchange rate appreciation on dollar-indexed loans. Domestically funded credit to companies grew 1%, driven mostly by the increase of corporate overdraft accounts and working capital loans. The results indicate that companies have been choosing short-term debt in order to recompose cash flows. ACC operations grew 1.7%, mirroring the robust performance of the export sector and the progressive normalization of external commercial lines. Credit to individuals increased 2.2%, highlighting larger demand for short-term credits.
38. The average interest rate on credit operations in April increased 0.6 p.p., reaching 58.4% p.a. In the month, fixed rate loans fell in some segments, mirroring the reduction in the slope of the yield curve as a result of the improvement in the sovereign-risk premium and the expectations of falling inflation.
39. The delinquency rate on non-earmarked bank credits increase to 8.8% in April from 8.7% in March. For individuals the rate remained at 15.7% while for companies it increased 0.1 p.p. to 4.6%.
40. Regarding default rates on retail credit, there was a slight improvement in April. ACSP data showed that the number of new delinquency registrations and the amount of cancelled registrations fell 13.2% and 8.1%, respectively, compared to the previous month, reducing the net delinquency rate to 7%, compared to 7.2% in March. The volume of returned checks fell from 5.9% of the total settled in March to 5.6% in April.

### **External Environment**

41. GDP in the Euro Area and Japan remained stable in 1Q2003 compared to the previous quarter, while in the US GDP growth (1.6% annualized) was lower than expected.



## BANCO CENTRAL DO BRASIL

42. The recovery of the global economy continues to depend on a stronger recovery of growth in the US, which is still showing evidence of macroeconomic fragilities: industrial production fell 0.5% in April; capacity utilization stands at 74.4%, the lowest level since 1983; retail sales declined; and the trade deficit increased.
43. The unemployment rate in the Euro area increased in April, reaching 8.7%, while in the US it stood at 6%. Business confidence in industrialized countries points to a contraction in economic activity. Regarding consumers, pessimism persists in Europe. However, there was a slight improvement in the US.
44. In addition to the weak performance of industrialized economies, the spread of SARS is a new concern for the world economy, and growth in China and the countries of Southeast Asia may be significantly damaged. The volatility of oil prices remains high, and the downward trend in prices was partially reversed after the approval of the cut in production by OPEC countries, and the disturbance caused by a new wave of terrorist attacks.
45. The inflation shows signs of falling in the main economies. In the US, consumer price indices in April registered the largest fall in nineteen months, fostering the perception that deflation risks are increasing. The weakening of the dollar may decrease this perception, and contribute to an improvement in the activity and a reduction of the US trade deficit. However, the appreciation of the euro increases the risks of deflation and recession in Europe.
46. Central banks decided to keep interest rates unaltered in their last meetings. Official interest rates remain at their lowest levels of the last four decades in the US (1.25%), the Euro area (2.5%), and the UK (3.75%). In Japan, they have been zero since 1999.

### Foreign Sector

47. The trade surplus reached US\$1.7 billion in April, accumulating US\$5.5 billion in the first four months of 2003, basically due to the performance of exports which have grown sharply, while imports remained stable.
48. Exports reached US\$5.7 billion in April and US\$20.8 billion year-to-date, increasing 23.1% in the month and 25.6% in the first four months compared to 2002. Imports decreased 3.6% in April, reaching US\$4 billion, and increased 1.8% in the first four months of the year, reaching US\$15.3 billion, compared to 2002.
49. Current account showed a deficit of US\$966 million in April, 50.9% less than in the same month of 2002. The deficit in the services and income account reached US\$2.9 billion, not completely compensated by the positive results of the trade balance (US\$1.7 billion) and unilateral transfers (US\$205 million). The 12-month current account deficit reached 0.74% of GDP in April.

### Monetary Market and Open Market Operations

50. After the last Copom meeting, the yield curve shifted downwards, mainly for maturities over 6 months, increasing the negative slope of the curve. A decline in sovereign country risk, appreciation of the exchange rate, deceleration of inflation and market expectations of a larger reduction of inflation in the second half of the year contributed to this movement. On May 20<sup>th</sup>, the spreads of 6-month and 1-year rates were -204 b.p. and -293 b.p. respectively, compared to -166 b.p. and -179 b.p. on April 23<sup>rd</sup>.
51. Securities and swaps maturing since the previous meeting have been rolled over through swaps with terms ranging from 4 to 56 months (11 months on average). Lower placement rates, as compared to the previous period, were due to the overall reduction in the dollar-linked interest rate curve.
52. Since the March Copom meeting, the Treasury has offered LTNs five times, for an amount totaling R\$9.9 billion. The significant demand for these securities and the movement in the domestic yield curve allowed





## **BANCO CENTRAL DO BRASIL**

the offer of increasing amounts, longer average tenures, and lower rates than in the previous period. Four issues of LFTs were also made at longer terms and lower rates, totaling US\$23.7 billion.

53. The settlement of securities between April 24<sup>th</sup> and May 21<sup>st</sup> caused a contractionary monetary impact of R\$8.2 billion, as a result of net placements of R\$9.9 billion in LTNs and US\$3.3 billion in LFTs, partially offset by net redemptions of R\$5.2 billion of dollar indexed securities.
54. In the same period, the Central Bank intervened weekly in the open market through 1-week, 2-week, and 1-month repo operations, and conducted daily liquidity management operations with maturities of 2 working days. These operations withdrew excess liquidity of R\$52.8 billion on average.
55. As a result of the appreciation of the real, domestic securitized public debt fell by R\$5.3 billion (-0.8%) in April, while the share linked to the dollar decreased to 30.4% from 34.7%.





## BANCO CENTRAL DO BRASIL

### Acronyms

ABPO	Brazilian Corrugated Board Association
ACSP	São Paulo Trade Association
b.p.	basis points
CNI	National Confederation of Industry
Fecomércio-SP	São Paulo State's Federation of Commerce
GDP	Gross Domestic Product
IBGE	Brazilian Institute of Geography and Statistics
IBS	Brazilian Steel Institute
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)
OPEC	Organization of the Petroleum Exporting Countries
p.a.	per annum
p.p.	percentage point
PME	Monthly Employment Survey
s.a.	seasonally adjusted
SARS	Severe Acute Respiratory Syndrome
VAR	Vector AutoRegressive