BANCO CENTRAL DO BRASIL – FOCUS

January 10, 2000

MINUTES OF THE 42nd MEETING OF THE BANCO CENTRAL DO BRASIL MONETARY POLICY COMMITTEE (COPOM)

Date: 12.15.1999

Place: 8th floor meeting room Banco Central Headquarters – Brasília – DF

Called to order: 5:50 PM

Adjourned: 10:10 PM

In attendance:

Members of the Board

Daniel Luiz Gleizer – **Acting Governor**

Carlos Eduardo de Freitas

Edison Bernardes dos Santos

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Sérgio Ribeiro da Costa Werlang

Department Heads

Fernando Antônio de Moraes Rego Caldas – Department of Economics **(Depec)**

Daso Maranhão Coimbra – International Reserve Operations Department **(Depin)**

José Antônio Marciano – Department of Banking Operations **(Deban)**

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

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

Other participants:

Alexandre Pundek Rocha – Senior Advisor to the Board and Executive Secretary of Copom
Claudia Safatle – 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 supply and demand

Aggregate demand indicators for October and November point to moderate recovery, with slight growth in consumption and investment levels. The volume of credit has been expanding in a framework of declining default levels and more favorable credit conditions offered by the trade sector.

Up to October, real revenues of the retail trade sector in five metropolitan regions accumulated a reduction of 4.63%. However, when one excludes the performance of factory authorized vehicle sales outlets from this calculation, the overall result is one of stability. In the same period, revenues on consumer goods remained stable, while vehicle sales dropped by 29.75%, followed by a reduction of 5.47% under building materials.

The upward movement under private sector credits that began in the second quarter of 1999 continued. The October default rate in the private financial system (4.6%) followed a downward trajectory, while the rate for the public financial system also dropped, albeit at a lesser pace.

Notwithstanding expectations of lesser primary surpluses in the final months of the year, 1999 fiscal performance has been quite satisfactory and easily surpassed the targets defined in the economic program agreed upon with the IMF. Not only has this aided in attenuating the "Brazil risk", it has also increased confidence that the 2000 targets will be achieved.

In the month of October, the consolidated public sector primary surplus (performance criterion) came to R$ 1.4 billion. The primary surplus for the year totaled R$ 32 billion or R$ 6 billion more than the fiscal target worked out with the International Monetary Fund (IMF) for the period. In the nominal concept, public sector borrowing requirements totaled R$ 7.9 billion. When the impact of the exchange devaluation is excluded from the public debt indexed to exchange, the nominal deficit closed in the range of R$ 6.2 billion.

Exports expanded in both October and November. The accumulated trade balance up to November registered a deficit of US$ 1.5 billion, as compared to US$ 6.1 billion in the same period of the previous year. Foreign sales came to US$ 43.3 billion or 8% less than in the previous year. Here, one should note that export volumes have been expanding since July, while the price indices for these goods – expressed in data purged of seasonal factors - have been improving since September. In comparison to the same period of the previous year, imports up to November declined by 15.9%. Average prices for imports rose sharply, mostly as a consequence of oil price hikes.

The service account accumulated a deficit of US$ 21.8 billion up to November, as compared to US$ 25.5 billion in the same period of the preceding year. The 31% rise in interest payments was more than offset by a 45.6% reduction in net outlays under other headings, particularly profits and dividends, transportation and international travel.

According to IBGE statistics, GDP remained stable in the third quarter of the year. In October, industrial output expanded in all use categories. November figures are expected to reveal a similar result with no significant pressures on production costs. In the series purged of seasonal factors, industrial output expanded by an estimated 0.52% in October, bringing the result for the year to an accumulated drop of 2.2%. Output of capital goods expanded by 3.1% in the same month.

Average nominal labor earnings remained stable in September, closing the first nine months of the year with an accumulated loss of 4.52%. According to IBGE figures, open unemployment in October came to 7.92%, as against 7.64% in September.

Prices

The November broad consumer price index (IPCA) registered growth of 0.95%, as against 1.19% in October, mirroring lesser expansion under food and transportation. These items closed at 1.35% and 2.15%, as against 1.77% and 3.24%, respectively, in the previous month. The prices of tradable goods, which had previously been responsible for considerable pressure on the index, increased by 0.96%, as compared to 2.16% in October. In contrast to this performance, government managed prices increased by 1.90%, compared to 0.76% in October, while the prices of nontradables remained practically stable.

In the same month, the consumer price index-Fipe (IPC-Fipe) expanded by 1.48%, mostly as a result of price increases under food (2.46%) and transportation (4.89%). In the last twelve months, the IPCA and IPC-Fipe registered growth of 8.65% and 7.98%, respectively.

According to a Banco Central survey, expectations of economic analysts for the major price indices were revised upward during the course of November. Insofar as December is concerned, observers expect a lesser rate of inflation as the effects of the off-season harvest period wane. Forecasts for 2000 point to IPCA growth in the range of 6.2% to 7%.

External Environment

Despite predictions of a growth slowdown in 1999, the United States economy has continued thriving. The impact of recent interest rate increases has yet to be felt. Based on revised data purged of seasonal factors, GDP expanded at an annualized rate of 5.5% in the third quarter, when compared to the previous quarter. In October, consumer credit expanded by 3.7%, as compared to 3.1% in September. In November, retail sales increased by 0.9%, thus surpassing the 0.3% growth level registered in October.

Following a period of stability in September, industrial output moved upward (0.6%) once again in the month of October. For the second consecutive month, unemployment remained stable in November (4.1%), while average hourly labor earnings increased by 0.15%, raising accumulated positive growth in comparison to November 1998 to 3.9%. In the twelve month period ended in November, the raw material producer price index expanded by 16.2%, while the index for intermediate goods rose by 3%. Measured by the consumer price index, inflation remained stable. The National Association of Purchase Managers' November index (NAPM) came to 56.2 in November, as compared to 56.6 in October.

In Japan, GDP dropped by 3.8% in the third quarter when compared to the previous quarter. The first quarter, it should be recalled, registered strong growth. The third quarter falloff was caused by a decline in consumption in all sectors of activity, including the public sector. However, one should also note that, when compared to the third quarter of 1998, the Japanese GDP expanded by 0.9%. The trade balance dropped by 1.3% in October as a result of greater demand for imports and valuation of the yen. In much the same way, seasonally adjusted industrial output declined by 2.3% following a September drop of 0.8%. Unemployment held steady at 4.6%. The Tankan indicator of expectations – manufacturing industry - moved from –22 to –17, thus pointing to a sense of confidence in the continuity of the recovery process, albeit at a less accelerated pace.

In the case of the Euro Zone, the outlook was bright, particularly with regard to the expected performance of the German and French economies. In the month of October, industrial output expanded by 0.8% in relation to the same period of the previous year, while unemployment dropped from 10% in September to 9.9%. The most relevant monetary aggregate, M3, expanded by 6% in October, as against 6.4% in September. The harmonized consumer price index rose by 0.1% and closed with an accumulated twelve month total of 1.4%, while the producer price index increased by 0.5% in September and 1.3% in twelve months.

Growth in the United Kingdom was steady as industrial production expanded by 0.2% in October, with a drop under exports. In accumulated twelve month terms up to November, the purged consumer price index closed at 2.2%.

Argentine industrial output increased by 0.1% in October, as compared to 1.9% in September and 4.8% in August. With the impact of the recession in that country, tax revenues shrank by 4.7% in the period from January to October. The fiscal situation deteriorated in 1999 and the deficit for the year was estimated at US$ 5.8 billion. Among other measures, the fiscal adjustment now being negotiated with the Argentine congress depends on approval of the budget for 2000, redistribution of revenues and expenditures among the central government and provinces and increases in already existent taxes coupled with creation of new levies.

Prospective assessment of inflation trends

In relation to the 41st Copom Meeting, the forecast trajectory for the federal funds rate was altered. Based on an analysis of futures market operations, quarterly increases of 0.25 percentage points are expected as of the first quarter of 2000, until reaching a level of 6.25% per year. With regard to international petroleum prices, expectations of an increase during the winter season in the industrialized nations were maintained, with a subsequent downturn followed by stabilization in the range of US$ 20 to US$ 22 per barrel for Brent type crude.

The major identified risk is that of growth in government managed prices, a question already cited in the minutes of the 41st Copom Meeting. The basic scenario uses a conservative estimate of an average 9.2% increase in 2000, which would generate a direct impact of 2.3 percentage points on inflation in that year.

Inflation trends were simulated according to the available models and respective confidence bands and were based on the central scenario, which includes the hypothesis of maintenance of the Selic rate at 19% per year. These simulations led to the conclusion that there is a probability of almost 50% that inflation in the second and third quarters of 2000 will close at a level 1 percentage point above the central trend stated in the fourth review of the Program negotiated with the IMF. However, the same simulations indicate that maintenance of interest rates at the current level will make it possible to achieve the 1999, 2000 and 2001 inflation targets.

Money market and open market operations

At its November 10 meeting, Copom decided to maintain the Selic rate target at 19% per year and eliminate the downward bias.

From November 11 to December 14, the National Treasury carried out eleven LTN auctions and five LFT auctions. Preset papers were readily absorbed by the market in operations marked by longer maturities, thus indicating improvement in the overall economic environment. In six auctions, LTNs were sold with terms of 6 months.

On December 1, the National Treasury carried out two NTN-C auctions at uniform prices, with terms of three and seven years. Though buyers were allowed to effect payment to the Treasury with securitized credits for which they were liable, there was a general preference for liquidation in cash.

Definitive operations with Banco Central securities were limited to sales of NBCE and had the sole objective of offsetting redemptions of debt updated according to exchange rate variations.

Following its strategy of allowing the Selic rate to float more freely, Banco Central reduced its open market interventions. Consequently, in the period between November 11 and December 14, the institution limited its interventions aimed at bringing financial system liquidity into line to just seven, with five being effected through overnight operations.

Monetary policy guidelines

Now that the wave of seasonal shocks and increases in government managed prices that had generated upward pressure on price levels has been largely absorbed, inflation is expected to turn downward in coming months. Recovery in demand has been slow and the exchange value of the nation's currency has risen (as a result of the broadening of exchange market intervention limits, Banco Central market interventions, the decision taken at the 41st Copom Meeting and combined auctions on the forward dollar market).

Fiscal policy has aided in maintaining price stability and recent results indicate that the targets for the primary surplus in 1999 and 2000 will be met. Exports, which were impacted by a generally unfavorable international market scenario in 1999, have already begun reacting. On the external scenario, market expectations point to a rise of 0.5% in the federal fund rate in the first half of 2000.

Based on its analysis of current data and the outlook for 2000, Copom opted not to alter the Selic rate target of 19% per year and refrained from indicating a bias. This position is justified by the need to:

1. confirm the diagnosis regarding inflation trends. More recent wholesale and consumer price indices point to some degree of deceleration, though the drop in inflation measured by the IPCA from October to November was at best modest;

2. give due consideration to uncertainties regarding the behavior of government managed prices in the coming year. This is still the major source of concern in light not only of the direct impact of these prices on inflation in 2000 but also their indirect effects on the other prices of the economy.

At the close of the meeting, the members were reminded that the Committee will meet once again on January 19, 2000, at 4:30 PM, as called for in the Schedule of Ordinary COPOM Meetings, released by Banco Central Communiqué no. 7,065, dated 11.18.1999.

Alexandre Pundek Rocha

Executive Secretary of COPOM

Information for unrestricted disclosure. It is not intended to bind Banco Central do Brasil in its monetary or foreign exchange policy actions.