BANCO CENTRAL DO BRASIL – FOCUS

May 04, 2000

MINUTES OF THE 46th MEETING OF THE BANCO CENTRAL DO BRASIL MONETARY POLICY COMMITTEE (COPOM)

Summary

Aggregate demand and supply

External environment

Prices

Prospective assessment of inflation trends

Money market and open market operations

Monetary policy guidelines

Executive Secretary of Copom

Date: 04.18-19.2000

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

Called to order: 4:15 PM on 04.18 and 5:15 PM on 04.19

Adjourned: 7:05 PM on 04.18 and 6:30 PM on 04.19

In attendance:

Members of the Board

Armínio Fraga Neto – **Governor**

Carlos Eduardo de Freitas

Daniel Luiz Gleizer

Edison Bernardes dos Santos

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Sérgio Ribeiro da Costa Werlang

Tereza Cristina Grossi Togni

Department Heads

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

Carlos Yoshitaka Urata – International Reserve Operations Department **(DEPIN)**

Luis Gustavo da Matta Machado - Department of Banking Operations **(DEBAN)**

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

Paulo Roberto Zakarewicz – Open Market Operations Department **(DEMAB)**

Other participants:

Alexandre Pundek Rocha – Advisor to the Board

João dos Reis Borges Muniz – Press Advisor **(ASIMP)**

Sérgio Goldenstein – Advisor to the Board and Executive Secretary of COPOM

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

Aggregate demand indicators point to an ongoing process of sharp recovery in the Brazilian economy dating to the end of last year. An increased supply of credit and lower rates of bank interest aided in expanding consumption and investments in the first two months of the year.

One should stress that the balance of credits granted to individuals continued expanding, with growth of 4.8% in the month, 7.7% in the first two months and 25.4% over 12 months. This growth was particularly strong under personal credit and financing for acquisitions of goods. In the private financial system, the default level remained stable at 4.3% in the month.

Investment indicators registered growth in February, continuing the recovery process that began in mid-1999. Based on the seasonally adjusted series, monthly output of construction inputs increased by 1.6% in the month and 2.6% in the first two months of the year. Production of capital goods expanded by 14.9% in the first two months of the year and benefited sharply from the change in relative prices caused by devaluation of the real. BNDES System disbursements to the manufacturing sector expanded by 4.7% in the year and 10.5% in the 12 month period ended in the month of March.

In the metropolitan region of São Paulo, real revenues of the retail trade sector expanded by 2.5% in February. This figure is based on data purged of seasonal factors and was sharply impacted by an improved performance under consumer durables which, in turn, was generated by improved credit conditions. In the first two months of the year, sales of consumer durables rose by 14% and construction materials increased by 11.6%, in relation to the same period of the previous year. One should highlight the good performance of factory authorized vehicle sales outlets, with a sales increase of 16.4% in the first two months of the year, when compared to the same period of the preceding year.

Since the change in the nation’s exchange system, the trade balance has shown consistent recovery and closed the first quarter of the year with a surplus of US$ 26 million, reducing the accumulated 12 month deficit to US$ 365 million. A fundamental factor in this growth was expansion of the nation’s export operations, particularly in volume terms. Foreign sales increased by 19.9% when compared to the first quarter of 1999 and were powered by growth of 28% under sales of manufactured goods and 17.8% in sales of semimanufactured products.

Utilizing the same basis of comparison, imports increased by 10.7%, mostly as a result of higher international oil prices. The grouping of fuels and lubricants registered an increase of 57.7% in imported value. Renewed growth in industrial production coupled with expanded exports of manufactured goods are the factors that explain the 22.5% growth under imports of raw materials and intermediate goods. Among these, the most important items were naphtha, petrochemical and pharmaceutical products, fertilizers, parts and spares for transportation equipment and mineral products. In their turn, imports of capital goods and consumer goods continued on a downward trajectory.

In the first two months of the year, the consolidated public sector result was a surplus of R$ 7.6 billion or R$ 0.3 billion above the target for the first quarter of the year, as defined in the IMF agreement. The net public sector debt came to R$ 529.6 billion in February, corresponding to 47.5% of GDP. This result was R$ 33.2 billion below the trajectory foreseen for the net adjusted debt in the month as specified in the IMF agreement.

Aggregate supply indicators point to a process of accelerating recovery since the final quarter of 1999. One should note that, for the first time, industrial production in the month of February surpassed the mark achieved immediately prior to the Asian crisis. Growth of 3.1% in February – in the seasonally adjusted series – resulted in expansion of 10.7% in the first two months of the year, in comparison to the same period of the preceding year. All of the different use categories turned in positive growth. This was particularly true under durable consumer goods, which expanded by 12.3% in the month and 28.7% in the year. Utilizing the same basis of comparison, production of capital goods rose by 7.3% and 14.9%, respectively, while output of intermediate goods rose by 1.2% and 10.4%, in the same order.

The average level of utilization of installed capacity in the manufacturing sector came to 81.6% in February. This result is based on data from which seasonal factors have been purged by the CNI and corresponded to the highest level for that month since this series was first calculated in 1992. Hours worked in the industrial sector expanded by 2.1% in February according to data from which seasonal factors have been eliminated and closed with accumulated expansion of 4.8% in the year.

The most recent IBGE estimate indicates that overall output of grains, oil-bearing crops and legumes will close at 84.3 million tons in 2000, reflecting an increase of 2.1% over the previous year’s result. The sharpest growth is expected in the north and northeast regions, with 22.4%, while production in the southeast and south, which account for about 90% of national output, will remain stable.

Insofar as the job market is concerned, available data point to upward movement. In February, based on seasonally adjusted data, formal employment expanded by 0.4%, with creation of 119.4 thousand jobs in the two month period. All sectors of activity turned in positive growth in relation to the previous month. Here, particular mention should be made of 0.61% expansion under manufacturing. In this framework, it is important note that the increase in the unemployment rate to 8.16% was caused by growth in the economically active population, at a pace higher than the employed population. This is a situation characteristic of scenarios of economic recovery when more favorable expectations convince those who had practically given up on seeking employment that it is worth their while to begin looking for a job vacancy once again.

External environment

In the United States, GDP expanded by 7.3% in the final quarter of 1999, raising growth for the year to 4.2%. Recent consumption and investment indicators show that the American economy has continued expanding vigorously in the early months of the current year. Growth in demand has been generated by expanded personal credit and higher overall labor earnings. Even though inflation is under control, there are growing uncertainties with respect to how long this trend will continue, despite high productivity gains.

One of the effects of the high rate of growth is an expanding trade deficit, which has already hit a record level. In January, the deficit came to US$ 32.4 billion, raising the accumulated total for the last 12 months to US$ 359 billion. On the other hand, fiscal policy has achieved very good results that were even better than in the previous fiscal year.

Industrial output in the month of February registered annual growth of 4.1% and made use of 81.4% of installed production capacity. In the month of March, the unemployment rate remained at 4.1%, while average hourly earnings increased by 3.7%, when compared to the same month of 1999. At the same time, one should stress that the sharp rise in price indices in that month was impacted by the oil price high. The producer price index expanded by 1%, and registered accumulated growth of 4.6% in 12 months. The consumer price index increased by 0.7%, while its core expanded by 0.4%, raising accumulated 12 month growth to 2.4%.

In Japan, economic indicators show signs of recovery in the early months of the year. In February, family spending increased by 3.8% and retail sales in large stores increased by 2.3%, as compared to the same month of the previous year. Industrial output was 8.4% higher than in February 1999, while new housing starts expanded by 2.4%, utilizing the same basis of comparison. The Tankan business confidence index, which measures supply and demand conditions, increased from –34 in the fourth quarter of 1999 to –29 in the first quarter of 2000, at the same time in which the index on output of the manufacturing sector rose from –17 to –9. The rate of unemployment increased from 4.7% in January to 4.9% in February.

The Euro Zone economy has continued expanding vigorously, based on growing internal demand and exports. In the month of January, industrial production rose by 3.9% in comparison to the same month of 1999, while exports totaled US$ 72.5 billion, or 17.1% more than in January 1999 and imports closed at US$ 69.8 billion, for growth of 12.9%. The jobless rate remained at 9.5% in February and seems to have leveled off.

Devaluation of the euro and sharp oil price increases are the factors that have created the greatest pressure on prices. The harmonized consumer price index registered growth of 2.1% in the 12 month period up to March, while the producer price index accumulated expansion of 5.7% in the 12 months up to February.

Prices

In the quarter, consumer price indices confirmed expectations of deceleration as pressures on food prices that marked the end of 1999 ran their course. Despite pressures caused by outlays on education that are typical of the early months of the year, the dynamics of price pressure were impacted downward by negative growth under apparel, mostly as a result of clearance sales.

Following the example of consumer price indices, the general price indices also decelerated over the course of the first quarter. One of the factors responsible for this performance was that of wholesale prices, which reflected the drop in the prices of farm products. In the month of March, the wholesale price index – market (IPA-M), farm products, declined by 1.8% and reflected the effects of the current harvest. It should be noted that the drop in industrial prices at the wholesale level was less intense as a consequence of the rise in the prices of the goods produced by the sectors of chemicals, plastics, paper and metallurgy.

In the month of March, the broad consumer price index – IPCA increased by 0.22% and was impacted by the pressure caused by the rise in fuel prices on the transportation sector. For the quarter, the IPCA accumulated an increase of 0.97%, with 6.92% over the past 12 months.

Prospective assessment of inflation trends

Evaluation of the outlook for inflation must begin with identification of the shocks capable of impacting future price level trends. The shocks thus identified are listed below and their impacts have been reevaluated on the basis of new information, particularly as regards growth in petroleum prices. The basic scenario involves the following hypotheses: the federal fund rate trajectories and international oil price levels implicit in the respective futures contracts; average increase of 9% in government managed prices during the remainder of the current year, with the impact of this growth concentrated in the second and third quarters; farm sector neutrality as regards price pressures in the year, though the performance of these prices will follow the normal seasonal variations; a fiscal policy that will comply with the target for the accumulated primary surplus of the consolidated public sector at a level of 3.25% of GDP in 2000, with a positive contribution to price stability; increased international market volatility; and growth perspectives at the level of the world economy, thus generating the international liquidity conditions needed to ensure financing of the balance of payments. Aside from the elements cited above, the basic scenario encompassed the uncertainties rooted in the potential impact on the debt/GDP ratio of the indexing of the Employment Compensation Fund (FGTS) balances.

Simulations performed with the central scenario concluded that if interest is maintained at the current level, it will be possible to comply with inflation targets for 2000 and, with even more leeway, for 2001. Following presentation of the central scenario, simulations of economic models were performed on the basis of alternative scenarios. The major differences in relation to the first scenario involve growth of the international economy and the so-called Brazil risk. The volatility that has marked the major asset markets of the industrial countries obviously generates repercussions that affect perceptions of country risk and, consequently, the exchange rate trajectory. Alterations in expectations are passed through the exchange rate channel and simultaneously impact inflation. However, there is little probability of an abrupt turnaround in the expected process of world economic growth as a result of market volatility. At the same time, given the basic resilience of the underpinnings of the Brazilian economy, the impact of increased international market volatility on the Brazil risk should be limited.

Short-term forecasts were presented, together with the leading indicators for inflation. The results point to upward movement in inflation in the second quarter of 2000. More specifically, the leading indicators forecast increased pressure on prices as of April, while the non-structural short-term models indicate a moderate high in comparison to first quarter inflation.

On April 17, the median expectations of inflation as measured by the IPCA and collected through the daily Banco Central survey were still above the inflation target for 2000 (6.48%, as compared to a target of 6%).

Money market and open market operations

At the meeting held on March 21 and 22, COPOM maintained the Selic rate target at 19% per year, but decided to indicate a downward bias.

In the period from March 22 to April 18, public offers of Banco Central papers were restricted to sales of four year NBCE. The strategy adopted in these placements was to issue volumes that were slightly below those maturing, given that the volume of debt being rolled by private agents had lessened.

In the same period, the National Treasury carried out eight LTN sales for a total of R$ 14.5 billion, as compared to redemptions worth R$ 7.5 billion. The average rates for six month and one year LTN came to respective levels of 18.23% and 18.21% per year on March 28, the lowest since implementation of the Real Plan. LFT placements with a total value of R$ 13.5 billion were held on four different occasions, while redemptions added up to R$ 18.5 billion. In the first two events, the operations involved two year papers, with three year securities being issued in the subsequent placements. Despite the lengthening of the debt term, average discounts held firm in the range of 0.01% per year. The third re-offer of NTN-C occurred in the period under consideration. Sales came to R$ 1.2 billion in three year papers at a rate of 11.70% per year and R$ 0.3 billion in seven year papers at the rate of 12.50% per year, aside from the change in the general price index – market (IGP-M). Approximately 58% of the revenues of the two sales were liquidated through the use of securitized credits for which the National Treasury was liable. With regard to the secondary public securities market, one should highlight growth in the daily volume of definitive operations, which moved from approximately R$ 5 billion in October 1999 to R$ 9.6 billion in March 2000, with strong participation on the part of preset papers.

Banco Central effected open market operations on thirteen different occasions for an overall total of twenty business days with the objective of bringing financial system liquidity into balance.

Monetary policy guidelines

Analysis of supply and demand points to an absence of imbalances that could generate inflationary pressures sufficient to impact the system of inflation targeting. Consumption and credit indicators confirm the outlook for strong improvement in the level of activity over the course of 2000 but do not constitute a source of inflationary pressures. The austere fiscal policy being followed by the government has contributed positively to price stability and attenuation of the Brazil risk. The foreign sector has performed satisfactorily and expectations of recovery in net exports during the year are solid. Monitoring of the farm harvest indicates no real pressures during the year.

The overall situation would seem conducive to price stability. However, the supply shock represented by international oil prices and the rise in internal government managed prices expected in the second and third quarters of the year are risk factors that will have to be closely monitored and carefully quantified. Particular attention should be given to recent upward movement in oil prices. Over the short-term, the greatest source of uncertainties is the increase in the volatility of asset market prices in the United States and the consequent – albeit low level – risk of generating a stronger impact on other markets. Based on the information discussed and analyzed by Copom, it was concluded that the level of volatility will remain high for some time into the future.

Another question that deserves the Committee’s attention is related to uncertainties related to indexing of the Employment Compensation Fund (FGTS) which, though it has no impact on current public sector spending, does have a negative effect on perception of the country risk. By raising sovereign risk, it causes an immediate impact on the rate of exchange.

However, an alternative vision considered the fact of having managed to reverse both expectations and the projected trajectory of consumer inflation in a period of approximately three months. At the present time, inflation expectations (IPCA) for 2000 have moved below the mark of 6.5%, though they are still above the target. Another important indicator to illustrate this reversal is core inflation, which registered a decline in the first quarter of 2000 when compared to the final quarter of 1999. The drop in inflation occurred in the midst of negative supply shocks, such as occurred in the cases of public sector tariffs and oil prices. The rapid reversal in the trajectory of domestic prices in the midst of negative supply shocks suggests that there is space for a reduction in the interest rate level now in effect in the country.

Copom's position is that the current real rate of interest is not neutral or, in other words, it is above the real long-term equilibrium rate for the Brazilian economy. This perception was reinforced by projections for 2001 inflation, which were recently published in the Inflation Report (March 2000). Though current inflation and its expected trajectory are compatible with the predefined targets and fiscal results have proven to be highly positive, the preponderant position at Copom identified risks that should not be ignored, with uncertainties rooted in the following factors: (i) the question of the value of the indexing of FGTS balances now being judged by the Federal Supreme Court; (ii) the recent behavior of international oil prices; and (iii) the external environment, with the increased volatility of international markets, expectations of higher interest rates in the United States and their impact on the Brazil risk premium.

In this light, Copom decided by a seven to one vote to hold the Selic rate target steady at 18.5% with no indication of a bias. The dissenting vote favored a reduction to 18% per year with no indication of a bias.

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 May 23, 2000, at 3:00 PM, for technical presentations and on the following day, at 4:30 PM in order to discuss monetary policy guidelines.

Sérgio Goldenstein

Executive Secretary of COPOM