

September 28<sup>th</sup>, 2001

**MINUTES OF THE 63<sup>rd</sup> MEETING OF THE BANCO CENTRAL DO BRASIL  
MONETARY POLICY COMMITTEE (COPOM)**

**Summary**

Economic activity

Prices

External Environment

Money market and open market operations

Prospective assessment of inflation

Monetary policy guidelines

**Date:** September 18 and 19, 2001

**Place:** Central Bank's Headquarters 8<sup>th</sup> floor meeting room (on 09.18) and 20<sup>th</sup> floor (on 09.19) -  
Brasília - DF

**Called to Order:** 4:17 PM on 09.18 and 5:41 PM on 09.19

**Adjourned:** 8:01 PM on 09.18 and 7:58 PM on 09.19

**In attendance:**

**Members of the Board**

Arminio Fraga Neto - **President**

Carlos Eduardo de Freitas

Daniel Luiz Gleizer

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

Tereza Cristina Grossi Togni

**Department Heads (all present on 09.18)**

Altamir Lopes - Economics Department (DEPEC)

Daso Maranhão Coimbra - International Reserve Operations Department (DEPIN)

Gustavo Bussinger - Research Department (DEPEP)

José Antônio Marciano - Department of Banking Operations and Payments System (DEBAN)

Sérgio Goldenstein - Open Market Operations Department (DEMAB)

**Other participants (all present on 09.18)**

José Pedro Ramos Fachada Martins da Silva - Senior Advisor to the Board

Alexandre Pundek Rocha - Senior Advisor to the Board

Antônio Carlos Monteiro - Executive Secretary

João Borges - Press Secretary (ASIMP)

Fabia Aparecida de Carvalho - Coordinator of the Investor Relations Group

The Board 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 determined by the government.

**Economic activity**

Domestic economic activity continues to indicate deceleration, following the trend observed since the end of the first quarter. This has been reflecting the deterioration in the external economic situation and the energy crisis and, the resulting impact on expectations and on the behavior of interest and exchange rates.

The demand indicators exhibited relative stability in August and September, partly due to their prompt and stronger response to the changes in the economic environment. Nevertheless, the signs are still incipient to affirm that the deceleration process is near the end. In addition, the repercussion of the attacks to the U.S.A. has not yet reflected in the economic indicators released so far. It shall be stressed, however, that the likely unraveling of this crisis creates new uncertainties regarding the external economic environment, which is unfavorable for recovery in the domestic economic activity in the current circumstances.

Preliminary data released by the Trade Federation of the State of São Paulo (FCESP), showed that the retailers' turnover in the Metropolitan Region of São Paulo increased by 1% in August compared to July, but accumulated a 3% drop year-to-date compared to the same period of 2000. The outcome in August was affected by the 7.2% increase in the sales of construction material, which offset the 1.3% decline in the sales of consumer goods and 8.3% in the auto-vehicle sales.

The Consumer Intentions Index (IIC), also measured by FCESP, partially recovered in September to reach 94.9, still within the pessimistic range – below 100, in a 0 to 200 scale. This recovery featured the positive evolution of both components, current and future intentions, mirroring a less negative perception of domestic economic and political environment at the end of August, when the survey was carried out. Therefore, the result in September still does not reflect the repercussion of the attacks to the U.S.A. on the formation of domestic expectations.

The overall investment indicators in the country exhibited signs of cooling in July, mainly regarding imports and exports of capital goods, whereas domestic production of capital goods still showed some dynamism, geared by the effects of the energy rationing, which bolstered the production of energy generation equipments. The production of raw material for the building industry leveled off in the month, after plunging in the previous bimester.

The industrial production decelerated for the fifth consecutive month in July, with a 1.2% decline in the seasonally adjusted series. In the year, the industrial production grew by 4.3%, with the accumulated change reaching 5.1% in the twelve months to July, from 5.7% in June. In the month, negative growth was observed in 13 of a total of 20 industrial sectors and 3 of the 4 usage categories. Positive growth was observed solely in the production of capital goods. Noteworthy, in the two first months under the energy rationing program, the industrial production diminished by 0.1% compared to the same months last year, as a result of the 4.7% reduction in the production of durable consumer goods and 1.6% in intermediate goods. Considering the intensity of electrical energy expenditures, highly intensive sectors cut down on production by 10.1% in the June-July period, whereas medium and low intensive sectors expanded by 4.4% and 4%, respectively, compared to the same period of 2000.

The weaker performance in industrial production resulted in a new reduction of productive capacity, as surveyed by the National Confederation of Industries (CNI), reaching 79.7% in July in the seasonally adjusted basis. It was the fifth consecutive drop since the recent 82% peak observed in February 2001. Working hours in the production reduced by 1.5% in July, in the seasonally adjusted basis, as reported by CNI, revealing that the overtime cuts and the collective vacation have constituted the preferred alternative as compared to job cuts to adjust to deceleration in the industrial activity. Notwithstanding, industrial surveys indicate reduction in employment in this sector. The unemployment rate reached 6.19% in July, versus 6.38% in June, though as a result of reduction of 49 thousand positions and of 91 thousand people in the employable population (PEA).

Regarding credit operations, the outstanding stock of free resources increased by 2.4% in August, due to a 2.6% increase in the operations with corporations and 2.1% with households. This performance, however, continued to reflect a positive flow resulting from transactions settled previously, as new loans fell for the second consecutive month, a response to the environment of uncertainties together with the maintenance of lending rates on an upward trend. The daily average of credit concession to corporations and households dropped by 6.1% and 1.3% in August, respectively, compared to the previous month.

On the fiscal front, the increase of the primary surplus to R\$ 34.4 billion up to September confirms the maintenance of austerity. In August, collection of taxes and contributions remained at a growing pace, mainly due to the effects of tax collection on capital income and financial turnover, as tax collection on corporate revenue has been growing at a lower pace, reflecting the deceleration of the economic activity.

As to the external transactions of the Brazilian economy, the trade balance recorded a US\$ 663 million surplus in August and a US\$ 120 million surplus on the first two weeks of September, accumulating a positive result of US\$ 779 million year to date. Noteworthy, after May, exports and imports started to grow at lower rates, reflecting, simultaneously, but at a different intensity, the effects of deceleration in the Brazilian and global economies.

In August, exports was improved by aircraft re-exports, similarly to August 2000, although growth in sales of basic products continued to be remarkable, mainly poultry, beef and pork, together with

the recovery in exports of semi-manufactured products, resulting from the recovery in sales of iron and steel products and the continuing sugar export growth. Shipment of manufactured products fell once again compared to the same month of 2000. As to market destination, the best results were achieved with countries holding a smaller share of Brazilian exports, confirming the diversification of destination of Brazilian sales in 2001, at the same time as the sales to the main markets, United States and Mercosur, slowed.

Regarding total import volumes, purchases of capital goods were the sole segment to increase comparing to August 2000. In terms of daily average volumes, only the acquisition of fuel and oil surpassed August 2000 results. The reduction in purchases of consumption and intermediate goods reflects the slower industrial output growth in the country and the recent depreciation of the exchange rate.

To conclude, the deterioration in the external front and the adjustment of the economy to the energy crisis triggered a process deceleration in economic activity, which is still on. As a result, the observed and projected growth rates for the Brazilian economy for 2001 is lower. The labor market is starting to adjust, albeit gradually, to this environment, which shall exert additional pressure to the real wage bill, already affected by the impact from administered price adjustments. The deterioration of credit conditions, with more selectivity, shorter maturities and higher interest rates, does not favor demand recovery. The fiscal position remains favorable, yet with prospect for continued decelerating revenue growth. The recent trend in trade suggests recovery of surpluses, mainly reflecting the downward trend of imports inasmuch as the international environment, even prior to the attacks to the United States, was unfavorable for exports.

## **External environment**

To evaluate the world economic outlook after the attacks to the United States on September 11 is more difficult as it tends to be tightly linked to the impact of such actions upon the North American economy. Although premature, the analysis is based on the acute expectation of unfavorable influence on consumer confidence and the prospects for deepening the slowing in the short run. This led the Federal Reserve to reduce basic interest rates by 50 bp, for the eighth time in the year, on September 17, currently standing at 3%. Alongside monetary loosening, the government signals the adoption of expansionary fiscal policy, partially using the primary surplus, which tends to

produce positive impacts over the medium term, fostering the recovery stimulated by an easier monetary policy.

Until early September, U.S. economy remained on a decelerating process and statistics released did not signal recovery in the short run. The consumption remained as the main pillar of demand, albeit on a downward trend, as investments decreased significantly since the end of 2000. The accentuated drop in investments has been recorded in the levels of inventory and fixed assets, such as facilities, machinery and software. It shall be stressed that this adjustment is considered relevant for the correction of imbalances impelled by the high growth period. The positive fiscal results have been inferior to initially expected, reflecting tax reduction, the change in collecting dates and the lower activity level. Trade has also been influenced by the deceleration growth, resulting in lower rates of import growth. Additionally, global repercussion of the fall in U.S. economic activity has translated into lower export growth rates. The evolution of price indices does not evidence existence of inflation pressures, enabling interest rate reduction. It shall be stressed that the expectations of manager's purchases (NAPM) in the manufacturing sector had improved substantially in July, differently from the expectations of the managers in the services sector and consumers.

In the Euro Area, statistics point to the contagion from the deceleration process in the United States. The Gross Domestic Product in the second quarter expanded by 1.7% relatively to the same period in the previous year, after a 2.4% rise in the first quarter. Country specific indicators relative to July and August and entrepreneurs' perception, translated into the fall in confidence indicators of the three major economies in the region – Germany, Italy and France-, suggest the maintenance of this trend in the next quarter. It shall be emphasized that, in coordination with the Federal Reserve, the European Central Bank reduced basic interest rates by 50 basis points on September 17<sup>th</sup>, after which the main rediscount rate stood at 3.75% p.a.

The Japanese economy remains with no signs of recovery in the activity level although the yen has been showing appreciation trend. Eastern Asian economies, which tend to present high dependence on both American and Japanese demand, are searching for measures to countervail external sector retraction, with China and South Korea featuring as the most successful.

Latin American economies are undergoing the unfavorable impacts from the international markets via trade and tighter liquidity in financial markets, resulting in higher uncertainty and risk aversion

from investors. The Argentine economy remains in recession, despite internal efforts and financial support programs by international financial institutions.

In synthesis, the trend of cooling in economic activity is observed at a global level, led by the United States. This scenario tends to become deeper in the short run, as a function of the recrudescence of American consumer and corporate spending contraction, in response to the attacks on September 11. Nonetheless, the easing, already in progress, of monetary and fiscal policies in the United States should contribute to mitigate the contracting output trend in the medium term, with positive impacts for the world economy.

## **Prices**

In August, the adjustment of the administered prices continued to exert pressure on the main inflation indices, albeit at a lower intensity, thus contributing to lower monthly changes as compared to July. Considering consumer prices, electricity price adjustments in São Paulo, Curitiba and Belém, together with the rise of fuel prices at a national level put forth the most significant impact on the monthly outcome. As to wholesale prices, in addition to the impact from fuel prices, it shall be stressed the pressure from the increase in cereals and grains and crops for exports, among agricultural products, reflecting, in part, the effects of the exchange rate variation.

The IPCA rose by 0.70% in August, compared to 1.33% in July, accumulating 5.06% in the year and 6.41% in the last twelve months. The retreat in the monthly outcome was due to the lesser impact of administered price adjustments, which concentrated in July. Food prices increased by 0.83%, geared by the 21% hike in soy oil prices, mostly led by the rise in international prices which had impacted wholesale prices in July. The impressive hikes in wheat flour, bread and pasta prices reflected both wheat price increases and the exchange rate variation. Still in the food sector, price increases were associated with off-season effects. The item domestic employee, which incremented by 2.38%, featured as the main individual contribution for the monthly variation (0,08 pp). This percentage reflects the variations in the labor market after the minimum wage adjustment in May. Regarding the item electricity, the 1.21% variation was a consequence of a 10.79% increase recorded in Belém, where the tariffs were readjusted by 14%, after August 7.

The IGP-DI rose by 0.9% in August, compared to 1.62% in July, accumulating 7.4% in the year and 9.8% in the last twelve months. The 1.13% variation in IPA was the main determinant of the IGP-DI result, whereas the IPC rose by 0.54%, still reflecting the hike in administered prices. The INCC increased by 0.62%, exclusively as a result of the hikes in civil construction prices inasmuch as labor costs remained stable.

Based on the analysis of July and August indices, a conclusion may be drawn that the hikes observed stemmed from pressures arising from specific groups. A generalized rise among sectors is not evident, nor are continuous upward movements, which evinces the absence of indexation mechanisms in the economy. Taking into account this fact, together with the waning of pressures derived from administered price adjustments, a prospect for significant reduction in inflation rates is expected for the coming months.

### **Money market and open market operations**

The trend of reduction in the slope of the interest rate yield curve continued some weeks after last Copom meeting, motivated by the interpretation that the 19% Over-Selic target would be an interest rate ceiling and by the favorable news on the external front—increase in the Purchasing Manager's Index (NAPM) in August, indicating smaller retraction in the activity level, and tax collection in Argentina at a level higher than expected. Between August 22 and September 9, the spread between the Over-Selic rate and the Futures DI to January reduced to 190 bp from 340 bp. Nonetheless, after the attacks to the U.S. on September 11, this trajectory reverted, with the spread increasing to 320 bp on September 17. On that date, a higher slope was observed in the whole extension of the curve.

In September, the strategy of rolling over integrally the principal and final interest payments of exchange rate indexed securities, preferably with placements of NTN-D, has started. As a means to roll over the R\$5.8 billion in NBCE redeeming on September 6, three auctions of 3-year NTND were carried out, at a financial volume equivalent to 67% of the total redeemed, in addition to an 11-month placement, matching the demand for long term securities. The yield for the three-year securities reduced to 10.38% p.a. in the last auction from 10.87% p.a. in the two first ones. For shorter maturity securities, the average yield was of 5.54% p.a..



The rollover of the R\$3.7 billion redemption on September 17 was carried out with two auctions of three-year NTND (totaling 69% of the redemption), at rates of 11.50% and 11.95%, and an 8-month security offer at an average yield of 5.81%. On August 29, there was still a 3-year NBCE auction to rollover R\$1.1 billion in NTND maturing on September 3. The average yield was of 10.29% p.a.. On September 13 and 14, a total of three placements of five-month NBCE was realized to meet the demand for hedge. The resulting financial volume transacted was of R\$6.7 billion and the average yields were of 9.69%, 9.96% and 10.26%. The large quantities offered and the yields accepted sanctioned an increase of the exchange rate coupon.

On August 29, a five-month LTN auction was settled. The financial volume transacted was of R\$0.9 billion at an average yield of 22.6%, which presented reduction relatively to similar auction carried out in the previous week, under the expectation that the Selic target would not be elevated. In this scenario, on September 4, the National Treasury placed R\$1.3 billion in 7-month LTN, at the average yield of 22.86%.

On September 5, a five-year LFT auction was settled, totaling a financial volume of R\$1.2 billion. Demand outstripped the offer (2.2), due to the lower volumes offered and investment funds' needs to recompose their portfolios, which led to a halt in the upward movement of average discounts over face values, reducing to 0.34% from 0.40%.

Stemming from the effects of the terrorist attack on September 11 in the market, the National Treasury decided to cancel the LFT and LTN auctions scheduled for that day. The auction was resumed on September 18, with the sale of R\$1.2 billion five-year LFT, at an average discount slightly below the previous auction (0.33%) and with a demand again superior to the offer (1.6 ratio). Considering the financial settlements between August 22 and September 18, a R\$142 million expansionary monetary impact was observed in the period. The additional placements of NBCE offset the net redemption of National Treasury securities.

Within a 19 working day period, the Central Bank intervened for ten times in the open market, aiming at administering the short-term interest rate. In all interventions, the Central Bank carried out purchases of federal securities with resale agreements, at a minimum yield of 19.06% p.a.. The average volume of the interventions reached R\$5.3 billion.

## Prospective assessment of inflation

The identified shocks and their impacts were reassessed in light of newly available information. The scenario considered in the simulations encompasses the following assumptions:

1. August inflation rate, measured by the IPCA, reached 0.70%, near the expected results for the month;
2. the forecasts for the prices of oil products was calculated based on the price structure implied by Brent crude oil futures contracts. The expectation for the average price of the barrel was raised to US\$ 26.2 on the third quarter and to US\$ 28.1 on the fourth quarter of 2001. For 2002, it was assumed that the prices of oil by-products in the domestic market would be adjusted based on the structure of costs determined by the average prices effective on the last quarter of 2001. From the second quarter on, these prices would follow market inflation.
3. for a wider set of administered prices, weighting 30.4% of the IPCA in August, the expected inflation in 2001 remained relatively stable at 11.0%, from 10.0% in August. Price variation from January to August accumulates 7.9% with further 3.0% being expected for the remainder of the year. The evolution of these prices is expected to directly contribute with 3.2% for the year inflation, compared to the 2.9% estimated in August.
4. the forecast for the adjustment of electricity tariffs in 2001 remained at 20%. For 2002, the expected readjustment is of 20%, considering residential and non-residential consumers;
5. the slope of the domestic yield curve - defined as the difference between the 180 day swap rate and the one day Selic rate - is projected at an average of nearly 500 basis points on the third quarter of 2001, linearly declining to an average of 300 basis points at the end of 2002;
6. the path for the Fed funds interest rates was projected based on the maturity of forward contracts that indicate a decrease in the rate until the end of the second quarter of 2002 and a slight increase in the remainder of the year;

7. on the external front, the assumption for the average risk premium – measured as the difference between the yield of Brazil's Global Bonds and the United States Treasury Bonds with equivalent duration calculated by linear interpolation – was revised to incorporate a declining path from current levels to a plateau near 700 basis points from the second quarter of 2002 on.

It was assumed a stable exchange rate, in 2001 and 2002, around the levels observed on the eve of the Copom meeting.

The core inflation of the IPCA, calculated under the symmetric trimmed-mean method, declined in August to 0.56%, from 0.65% in July. Accumulated in 12 months, the core index increased by 6.25%. The core inflation of the IPC-BR, calculated under the symmetric trimmed-mean method, declined to 0.59% in August. Accumulated in 12 months, this core increased by 3.73%. The inflation core calculated with the exclusion of administered prices – considering the wide set weighting 30.4% of the IPCA in August - and of household food prices increased by 0.40% in August, with accumulated variation of 4.04% in 12 months.

The median of market expectations for the IPCA variation, as surveyed by the Central Bank on a daily basis, was revised to 6.5% from 6.3% for 2001 and remained stable at 4.5% for 2002.

In relation to the fiscal policy, it was assumed that the primary surplus targets for the consolidated public sector would be met, as stated in the Economic Program of the Government.

The remaining assumptions established in the previous meeting were maintained.

Simulation exercises with several specifications of the structural model allowed for the conclusion that the maintenance of the interest rate at the current level of 19.0% p.a. would result in inflation above the upper limit of the target for 2001. For 2002, the projected inflation is slightly above the 3.5% central target for the year.

## **Monetary Policy Guidelines**

Recently released indicators confirm the slowdown trend in demand as a result of the set of shocks that affected the Brazilian economy. The drop in demand may be explained by the worsening in the external scenario, by effects of the energy crisis on expectations and by the recent tightening in monetary policy, yet enough for GDP to grow moderately this year. As addressed in the last Copom meeting, the balance between aggregate supply and demand has been exerting downward pressure on inflation, since the slowdown in demand has outstripped the effect of the energy rationing on the aggregate supply. After an expected increase in inflation in July and August, basically due to the hike in administered prices, the IPCA and other indices already show marginal decrease, with reduced variation in market prices.

Notwithstanding the downward pressure on inflation stemming from the activity slowdown, the exchange rate remains under pressure. In the international scenario, adverse expectations prevail. The recovery of the U.S. economy had been postponed as indicated by recent released data. With the recent attacks on September 11th, the probability that this recovery will be delayed for the third quarter of next year is higher. In Europe, following the developments in the U.S. economy, the reduction trend in the pace of economic activity will be accentuated. The Japanese economy will not present signals of recovery in the short run.

It is still premature to predict the effects of U.S. crisis in the world economy and in Brazil. Nonetheless, it is possible that the recent international scenario has two consequences in the short run: i) doubts about the world economic situation, aggravated by the attacks to the U.S., may weaken consumers' confidence, increase the volatility in stock markets and oil prices, and reduce capital flows; and ii) the level of global economic activity shall retract, global trade flows.

The improvement in the result of the trade balance, as a result of weaker aggregate domestic demand and depreciation of the real, and the recovery of economic growth on the second half of next year will intensify the ongoing narrowing of current account deficit and improve the quality of its financing. In the meantime, the new agreement between the IMF and Brazil will provide support for the financing of the Balance of Payments.

The IPCA core inflation registered the second consecutive monthly reduction. Nonetheless, August outcome remains high (+0.56%). Inflation expectations, as surveyed daily by the Central Bank with the participation of a number of institutions, exhibited small marginal increase for 2001 and

indicate a downward trend for inflation in 2002. In 2001, the IPCA accumulated a 5.06% variation until August, led by the evolution of administered prices (7.86%), with a contribution of 2.30% for the IPCA. The remaining prices, weighting 69.6% of IPCA, increased by 3.86% in the period, with a contribution of 2.76%.

For 2002, the forecasts derived from Central Bank's structural model, built upon the assumption of a constant interest rate trajectory, indicate an inflation rate above 3.5%. The increase in the projected inflation for the next year results exclusively from the path of exchange rate and energy and oil products prices. In this sense, the shocks that affected the Brazilian economy this year will still have reflexes on next year inflation. The forecast for market price inflation, upon which monetary policy has the major impact, remains significantly below 3.5%.

Copom recognizes that there are risks of a passthrough of the recent exchange rate devaluation on domestic prices next year, as long as the exchange rate remains under pressure. However, Copom understands that the monetary policy is currently adequate to maintain market prices under control and to neutralize secondary effects of the supply shocks.

Accordingly, Copom unanimously decided to maintain the Selic rate target in 19% p.a. .

At the close of the meeting, it was announced that the Committee would meet again on October 16, 2001, at 3:00 PM, for technical presentations and, on the following day, at 4:30 PM, in order to discuss monetary policy guidelines, as set in the Calendar of Copom's Ordinary Meetings, published in the Central Bank Communiqué n. 8,018, of 11.22.2000.