

# **BANCO CENTRAL DO BRASIL – *FOCUS***

**March 29, 2001**

## **MINUTES OF THE 57<sup>th</sup>**

### **MEETING OF THE BANCO CENTRAL DO BRASIL MONETARY POLICY**

### **COMMITTEE (COPOM)**

#### **Summary**

Aggregate demand and supply. External environment. Prices. Money market and open market operations. Prospective assessment of inflation trends. Monetary policy guidelines

**Date:** 03.20 and 03.21.2001

**Place:** 8<sup>th</sup> floor (03.20) and 20<sup>th</sup> floor (03.21) meeting rooms. Central Bank Headquarters – Brasília – DF

**Called to order:** 4:45 PM on 03.20 and 5:09PM on 03.21

**Adjourned:** 7:05 PM on 03.20 and 8:12 PM on 03.21

#### **In attendance:**

##### **Members of the Board**

Armínio Fraga Neto – Governor

Carlos Eduardo de Freitas

Daniel Luiz Gleizer

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Tereza Cristina Grossi Togni

##### **Department Heads (all present on 03.20)**

Altamir Lopes – Department of Economics (DEPEC)

Daso Maranhão Coimbra – International Reserve Operations Department (DEPIN)

José Antonio Marciano – Department of Banking Operations (DEBAN)

Alexandre Antonio Tombini – Research Department (DEPEP)

Eduardo Hitiro Nakao – Open Market Operations Department (DEMAB)

**Other participants (all present on 03.20)**

Alexandre Pundek Rocha – Advisor to the Board

Gustavo Bussinger – Advisor to DEPEC

João Borges – Press Advisor (ASIMP)

Sérgio Goldenstein – Advisor to the Monetary Policy Directorate

The Board analyzed the recent performance 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**

In the beginning of 2001, indicators of the level of economic activity continued signaling robust expansion. Demand for consumption expanded both at wholesale and at retail levels, as evidenced by industry sales, including specific segments as auto vehicles, and by retail sales in the metropolitan region of São Paulo. Pointing in the same direction, the expansion of 9.6% in the number of credit card transactions, in the first two months of the year, compared to the same period in 2000, and the expansion related to the growth of the number of cleared checks, 1.5% in the same period.

Contributed to the growth in consumption, the reduction in interest rates, stimulated by cuts in the Selic rate, as well as the growth in the level of employment, evidenced by the reduction in the open unemployment rate and by the growth in rates of formal employment. Noteworthy, however, that although that movement favors the increase of the total wage bill, it occurs in a moderate pace.

The reduction in interest rates, combined with better conditions in employment and income, has contributed to the maintenance of the growth path of credit operations, of the financial system, expressed by the growth of 5.2% in credit volume carried out with free resources, in the first two months of the year. Of note, the increase of 9.7% in credit directed to individuals, while funds borrowed by companies registered an increase of 2.9%, responding to lower seasonal demand. Credit expansion has been followed incipiently by an increase in arrears in operations with individuals, which increased from 3.5% in January to 3.6% in February, considering credits in arrears for over 90 days.

The credit expansion has stimulated, above all, sales of durable goods, segment in which the unitary value of goods is relatively higher, which makes their sales more susceptible to financing operations.

The industrial production grew 6.5% in 2000, the best result since 1994, signaling a recovery in the sector, after two years of decline. In this context, the mining industry reached variation of 11.9%, resulting, mainly, from the growth of crude oil drilling and natural gas, and of the transformation industry, which responds for around 90% of total production, of 5.9%.

The analysis of seasonally adjusted statistics reveals greater dynamics in the evolution of investment indicators, comparatively to those related to consumption. That behavior, to the extent that it reflects decisions towards augmenting productive capacity, indicates that economic agents expect sustainable and prolonged growth.

Investment in January, exhibited positive overall evolution. With data released from seasonal influence, capital goods production grew 0.5% in January, and the production of inputs to construction, 2.1%, pushing these indicators to remain in a level significantly higher than the one registered in January 2000.

The analysis of production of selected capital goods items indicates an accumulated variation of 19.2% in 12 months up to January, in production of capital goods for industrial use, significantly superior to the rate of expansion of industrial production as a whole, 6.9%, and to the rate of expansion of capital goods, 14.6%, indicating a growth path of the sector's installed capacity, as well as of other productive segments, like transportation and agriculture.

The main impact of the demand warming is observed in the trade balance. The deficit registered in the year, up to the third week of March, reached US\$ 689 million. Despite growth of 13.8% in the first two months in exports compared to the last year, imports have expanded at a higher speed (18.4%) in the period. The effect of the economic growth becomes transparent in the disaggregated data of imports: increase of 25.9% in the imported *quantum* of intermediate goods, and of 9% for capital goods in the last 12 months. Part of this increment, however, reflects not only growth in domestic demand, but also expansion of the exported quantity of manufactured goods, with a net positive effect, although lagged, over the trade balance.

The increases of the trade deficit and of the current account deficit have contributed to affect the level of the exchange rate, which has increased from an average of R\$1.81 in the third quarter of last year, to an average of R\$2.02 in the year, up to March 20. Nonetheless, since February, the evolution of the exchange rate has started to reflect the deterioration of the external scenario. In particular, it can be cited, greater uncertainties as to the pace of deceleration of the US economy, reflected in part in the rapid decline in stock prices traded in its stock exchanges, and the confidence crisis in important emerging markets like Argentina and, in a minor degree, Turkey.

### **External environment**

The world economy has been marked by the deceleration in the United States and by stagnation of the Japanese economy, whereas European countries have sustained a moderate growth path. The international scene has also been influenced by volatility in oil prices. This volatility is not expected to be reduced in the short run, given uncertainties over the world

demand and the possibility of new cuts in OPEC's production, in addition to the cuts already announced in January and March.

Monetary policy in the US was marked by three consecutive cuts this year of 0.5 percentage point each in the fed funds rate. The US economy is going through a rapid deterioration in private confidence and an increase yet moderated in the unemployment rate, while the inflation rate remains stable. The monetary easing may affect positively the economy's performance in the second half, although the magnitude and duration of the current deceleration are proving greater than expected by the majority of analysts few weeks ago.

The emerging economies, although yet in a recovery cycle after the 1997 crisis and 1998, tend to suffer the impacts of a loss of dynamism in world trade and of the higher risk aversion of investors, associated with a larger degree of world uncertainty.

In relation to Argentina, the economy experienced a period of growing uncertainty about the growth capacity in the short run, and about the political support for the fiscal adjustment proposed by the government. The recent instability led to a dual change in command in the Ministry of Economy in March, and to an ample ministerial reform, facts which did not contributed to maintain the levels of external confidence and sovereign risk perception.

## **Prices**

The behavior of prices in the first two months of the year was influenced by seasonal factors as readjustments of enrolment fees and tuitions, as well as by increases in raw food products. Also important were increases in urban bus fares and electricity, as well as water and sewage service fees in certain state capitals. The IPCA accumulated an increase of 1.03% in the first two months, compared to 0.75% in the same period of the year before. The sum of the accumulated inflation up to February plus the expected increase in administered prices over the year is to reach 2.4%, which represents 60% of the target for the year.

In February, the groups transportation and education contributed with 0.31 percentage point for the variation of 0.46% in the IPCA.

The general price index – IGP-DI - grew 0.83% in the first two months of the year, being 0.49% in January and 0.34% in February. In equal period of 2000, they registered 1.22%. In the first month of the year, the increase in the index was favored by a decline in the price of agricultural products, which was reverted in February, having grown 0.3%. It is to be observed that the IPA, IPC and INCC registered lower variation rates, compared to January. In the case of IPA, rates reached 0.40% in January and 0.31% in February. This behavior was caused basically by smaller increases of industrial products prices (0.31% anti 0.78%). In the IPC, the deceleration was more pronounced, passing from 0.64%, in January to 0.4% in February. The INCC presented rates of 0.58% and of 0.34% respectively. This reduction was mainly caused by lower labor costs.

It is to be observed that supply of certain products, as meat and milk, will contribute in a less intense degree to contention of prices, in relation to the pattern registered in 2000, given the occurrence of specially favorable meteorological conditions this year. Yet, it is to be considered the readjustments already predicted in contracts, in certain administered prices, to become effective from June, and the recent evolution of the exchange rate, reflecting the deterioration in the international scene.

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

In the period between February 14 and March 20, the Central Bank maintained the strategy of rolling over entirely the updated principal of NBC-Es and NTN-Ds. However, to satisfy greater demand for foreign exchange hedge arising from aggravation of the external crisis, two extra auctions were carried out of NBC-Es of six months on March 19. Computing all definitive placements of NBC-Es and interest payments of such Notes in the market, the monetary result registered contraction of R\$1.0 billion.

Competitive operations with securities of responsibility of the National Treasury, by its turn, determined an expansion of R\$2.9 billion in the monetary market, in particular, due to net redemption of R\$1.0 billion of NTN-Ds.

The National Treasury carried out eight auctions of LTNs, with the financial value of the sales reaching R\$6.9 billion, in counter part to total redemptions of R\$9.1 billion, in which it is included R\$1.7 billion relative to three buy auctions of securities before maturity. In the period, it was carried out only one public offer of LFTs, of five-year tenure. This sale totaled R\$1.1 billion, with an average discount of 0.03% per year. Redemptions of such securities summed R\$1.3 billion.

Ratifying the consolidation trend of the NTN-C market, it was carried out the first public offer of securities with tenure of ten years, as well as the re-offer of securities maturing in 2005. The sales reached R\$0.5 billion, being 5% settled with the use of securitized credits of National Treasury's responsibility.

### **Prospective assessment of inflation trends**

The identified shocks and their impacts were reassessed in accordance to the new information available. The scenario considered in the simulations contemplates the hypothesis listed as following:

- a. observed inflation in February (0.46%) exceeded the expected value (0.20%);
- b. international spot and futures oil prices receded around US\$ 1.50 since February. Therefore, in spite of the depreciation of the *real* that took place over the first quarter, it is estimated a decline of 4.5% in the gasoline prices at gas stations in April (equivalent to an estimated decline of less than 6% at the refinery), and small additional reductions in July and September;
- c. the average readjustment estimated for administered prices in 2001 was revised downwards from 8.5% to 6.1%, with direct impact on the IPCA of 1.39 percentage point. That revision was motivated by three factors, beyond the already mentioned gasoline price. First, the adoption by IBGE of the usual methodology for the calculation of the item

“Domestic Employee” from April. That might reduce the variation of that item from 19.2% (readjustment of the minimum wage) to something around 11% in the year, with effects distributed along the year instead of fully concentrated in April. Second, the estimated increase in urban bus fares in 2001 was reviewed upwards, since in some cities there were no adjustments last year. And third, the average readjustment of electricity was re-estimated from 15.8% to 12.8%;

d. following the future contracts’ projections, the hypothesis for the path of the fed funds rate includes an additional reduction of 25 basis points in the third quarter of 2001. Therefore, this rate would be reduced from the current 5.0%p.a. to 4.75%p.a., next stabilizing at this level;

e. in the external scenario, the baseline assumes a deceleration of the US economy, with growth reduction concentrated in the first half, followed by a recovery starting in the second half. The baseline considers that the recent increase in Brazil’s risk premium shall be reverted over the year. In relation to the last meeting, however, it is projected a small upward shift in Brazil’s risk curve.

The other hypotheses considered in the previous meeting were maintained, in particular the realization of primary fiscal surpluses that meet the established fiscal policy targets.

The IPCA core inflation calculated by the trimmed-mean method has increased from 0.42% in January to 0.54% in February. The same behavior was presented by the IPCA core calculated by exclusion. Excluding the influence of administered prices, the accumulated variation of the IPCA in the last 12 months increased from 3.2% in January to 3.8% in February, interrupting the declining trend initiated in September. Yet core inflation measured by the IPC-BR, released by Fundação Getúlio Vargas, fell from 0.44% to 0.36%.

The median of the expectation for IPCA variation collected through the daily survey of the Central Bank remained at 4.20% for 2001, but was reduced from 3.82% to 3.75% for 2002.



The magnitude of the recent exchange rate variation, given the acceleration in the pace of economic activity, may increase the degree of passthrough to domestic prices. In this case, the inflationary pressure originated from the exchange rate channel could elevate the inflation rate this year. From the simulation exercises with the scenario considered in the basic (structural) model, the conclusion is that the maintenance of the interest rate at the current level of 15.25%p.a. represents non-negligible risks for meeting the 4% inflation target in 2001.

### **Monetary policy guidelines**

The strong growth of the economy in the end of 2000 continued in the first months of 2001. This trend, nonetheless, has not yet resulted in imbalances between supply and demand, which would directly affect the inflation indices.

The main impact of aggregate demand expansion has been on the trade balance. Although imports partially respond to the increase in manufactured exports, it is undeniable that the demand pressure has affected the imported quantum. The net effect in the first two months of the year was a US\$ 360 million increase in the trade deficit when compared to the same period of 2000. However, the prospects for the second and third quarters of this year are of improvement in foreign trade, due to the beginning of shipments of agricultural products. For the whole year, the trade balance will essentially depend on the growth differentials between Brazil and its main trade partners, and on the path of the real exchange rate.

The reduction in the trade balance and the corresponding increase in the current account deficit have contributed to weaken the exchange rate, despite the fact that external financing needs have increased only moderately. More recently, the exchange rate has been affected by the uncertainty in the external conjuncture, particularly in relation to the magnitude of the downturn in the United States' economy and to the political crisis in Argentina. The recent behavior of the exchange rate, therefore, results from a combination of temporary as well as more persistent factors.

The recent currency depreciation raises the important issue of the passthrough from the exchange rate to domestic prices. Since the floating of the *real* in 1999, the degree of passthrough has been declining steadily, given that only the part of the exchange rate variation perceived as permanent is transmitted to prices, without changing significantly inflation expectations. However, sharp exchange rate depreciations, albeit reflecting mainly the uncertainty in the markets, can increase the degree of passthrough, to the extent that part of the depreciation can be perceived as long-lasting.

The increase in core inflation in the last months, observed inflation above expectations, and the uncertainties related to the degree of passthrough from the recent exchange rate depreciation, given the accelerating pace of economic activity, when taken all together, indicate that there are risks for the achievement of the 4%- target for inflation in 2001.

Hence, COPOM decided to increase the target for the SELIC rate to 15.75% per year.

At the close of the meeting, it was announced that the Committee would meet again on April 17, 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 no. 8,018, of 11.22.2000.

Alexandre Antonio Tombini

Minutes revised by the Board of Directors.