BANCO CENTRAL DO BRASIL – *FOCUS*

September 12, 2000

MINUTES OF THE 50TH MEETING OF THE BANCO CENTRAL DO BRASIL MONETARY POLICY COMMITTEE (COPOM)

Summary

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Executive Secretariat of COPOM

Date: 08.22 and 23.2000

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

Called to order: 4:00 PM on 08.22 and 4:25 PM on 08.23

Adjourned: 6:55 PM on 08.22 and 5:30 PM on 08.23

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

Fernando Antonio de M. R. Caldas – Department of Economics **(DEPEC)**

Carlos Yoshitaka Urata – 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 – Advisor to the Board

Gustavo Bussinger – Advisor to DEPEC

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

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

Joel Bogdanski – Advisor to DEPEP

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

Following second quarter deceleration, demand indicators turned upward once again at the start of the third quarter, particularly under consumption and industrial sales. Among the factors that contributed to this turnaround, one should cite more plentiful credit and lower interest rates on bank credits, coupled with rising exports and private investment.

The balance of credit operations at preset rates involving nonearmarked resources increased by 1.5% in July. Credits to individuals rose by 1.3% in the month, registering accumulated expansion of 62.3% in the year and 91.5% over 12 months. Personal credit and financing for acquisition of goods were the segments that turned in the strongest growth. Business credits increased by 1.7% in the month, 4.8% in the year and 23.3% in 12 months.

Real revenues in the retail trade sector of the metropolitan region of São Paulo rose by 11.2% in the year up to July, according to figures released by the Trade Federation of the

State of São Paulo. Growth was particularly strong under sales involving goods with high unit value as a result of a more ample supply of credit. Revenues on sales of durable consumer goods increased by 17.2%, while sales of the automotive industry registered a high of 11.6% in comparison to the same period of the previous year. Particular mention should be made of the performance of the supermarket segment in the last two months, as sales of nondurable consumer goods climbed by 13.7% in the same period of time.

The number of consultations with the Trade Association of São Paulo (ACSP) up to the month of July indicates more accentuated growth in installment sales when compared to the use of checks (10.3% and 6.1%, respectively). This movement corroborates the improvement that has occurred in consumer credit conditions, making it much easier to purchase goods over longer terms and at lesser interest rates. Parallel to this, the number of transactions effected through the use of credit cards up to July expanded by a full 23.9%.

Another factor that has contributed to a greater credit supply is the decline in the net rate of defaults. According to the ACSP, the default level in São Paulo came to 5.8% in July. This was the lowest level in the last 11 months and was caused by both a decrease in current defaults registered and an increase in cancellations of past defaults.

Up to the month of July, the automobile industry registered expansion of 21.9% in sales, with growth of 49.6% under exports and 15.7% under internal sales. Foreign sales of farm machines increased by 39.7% in the same period. Exports of motorcycles grew by 95.7% up to July, while overall sales expanded by 32.6% in the period.

Investment indicators registered growth throughout the first half of the year. According to IPEA estimates, the investment rate came to 19.3% in June, reflecting steady upward movement from a low of 18.2% in June 1999. Output of capital goods increased by 8.5%, while the volume of imports dropped by 13.6% in the same period, clearly revealing the impact that the exchange policy shift has had on the import substitution process.

The balance of trade turned in a surplus of US$ 937 million up to July, as compared to a deficit of US$ 531 million in the same period of 1999. It is important to note that this turnaround was achieved despite growth in international oil prices, a factor that partially explains the increase that has occurred under imports. In this period, foreign sales increased by 17.3% in relation to the same period of the previous year, with a particularly strong performance under sales of manufactured goods (22.9%).

The manufactured goods that registered the sharpest sales growth were transmission/reception equipment, aircraft and passenger cars, with respective revenue increases of 169.1%, 78.1% and 70.3%. Foreign sales of semimanufactured products rose by 9.9% while exports of basic goods grew by 6%. Iron ore continued as the most important export product, accumulating US$ 1.758 billion in the period, with growth of 11.3%.

Up to the month of July, imports rose by 11.5% due mostly to greater outlays on fuels and lubricants (49.9%) caused by higher international petroleum prices. Imports of raw materials and intermediate goods expanded by 21.8%, reflecting the upturn in industrial output growth and expanded exports of manufactured products. One should stress that the manufactured goods exported by Brazil contain high levels of imported components.

In the first half of 2000, GDP expanded by 3.8% in relation to the same period of 1999. The best performance was registered by the industrial sector, with growth of 6.8%. Crop and livestock output increased by 6.5% while the service sector turned in expansion of 3%, with a strong 14.1% performance under communications.

Output of consumer durables registered growth of 22.1% in the first six months of the year, in relation to the same 1999 period, and was the leader among the various industrial segments. In order of magnitude, this performance was followed by output of intermediate goods and capital goods with respective growth rates of 7.9% and 8.5%. On the other hand, production of semidurable and nondurable goods declined by 0.8% in the same period. One should note that the level of industrial production at the end of the first half of the year was the highest since the IBGE began recording this series in 1975

However, when distributed into use categories, the only sector to register successive records was output of intermediate goods. At the end of June, the output levels of durable goods, capital and semi and nondurable goods were still well below the most recent peak in this series. According to the FGV survey, the average level of utilization of installed output capacity came to 82.8% in July, indicating that the economy still has a considerable amount of idle production capacity.

The grain harvest is expected to expand by 4.3% in the 1999/2000 agricultural year, according to IBGE estimates elaborated in June. Frosts in the month of July are expected to generate adverse impacts on the output of such winter crops as wheat and the intermediate corn harvest. Despite this, however, this year's harvest should still be slightly greater than that of last year.

With regard to the labor market, figures for the first half of the year indicate that the process of employment and productivity growth begun toward the end of 1999 has moved steadily forward. In the month of June, formal employment registered positive growth (+0.7%) for the eighth consecutive month. Increased employment was registered in all sectors of the economy, with the sole exception of construction. The result was creation of 590 thousand jobs in the first half of the year. The rate of open unemployment declined to 7.41% in June, with sharp growth in the overall economically active population.

External environment

Recent indicators further strengthen the signs that the United States economic performance has begun leveling off. Notwithstanding the high level of activity, inflation has remained stable, mostly as a result of productivity gains.

The second quarter GDP increased by 6% in annualized terms, when compared to the same 1999 period. Industrial production expanded by 0.3% in July, raising growth to 4.9% in 12 months. In June, the trade deficit came to US$ 37.2 billion, raising the accumulated total to US$ 404.8 billion in the last 12 months. In the month of July, the rate of unemployment held steady at 4%. Productivity in the manufacturing sector increased by 6.9% in the second quarter, while the unit cost of labor dropped by 1.9%.

The producer price index (PPI) held steady in July and accumulated 4.1% growth in 12 months, while the core index registered rates of 0.1% and 1.5%, respectively. The consumer price index (CPI) and the CPI-core rose by 0.2% in July, raising accumulated 12 month expansion by 3.6% and 2.4%, in the same order. These figures indicate that inflation is firmly under control.

In Japan, industrial output moved upward in the first six months of the year, with accumulated 12 month growth of 4.7%. In June, housing starts rose by 12.6% and factory orders increased by 14.3%. One should note that, in the last 12 months, growth in family spending declined from 1.9% in May to 1.8% in June. In the first six months of the year, the trade surplus expanded by 7.8%, while imports expanded at a still more intense pace. Unemployment rose from 4.6% in May to 4.7% in June. For the first time in a decade, the Bank of Japan increased its basic interest rate, moving to 0.25% per year, marking the end of a period of 17 months with a nominal rate equal to zero.

In the Euro Zone countries, annual industrial production growth picked up steam in May, registering growth of 7.2%, as compared to 5.8% in April. Quarterly growth in productivity increased by 2% in the first quarter of the year, the highest level since the first quarter of 1998. Unemployment turned downward once again in June and closed at 9.1%. The harmonized consumer price index increased by 0.2% in July, as growth over the last 12 months remained steady at 2.4%. In the first five months of the year, foreign sales expanded by 2.6% and imports rose by 11.2% when compared to the same 1999 period. Consequently, the accumulated 12 month surplus dropped to US$ 37.5 billion, the lowest since the euro was first adopted.

In Argentina, industrial production rose by 3.1% in July, with accumulated 12 month expansion of 4%. The rate of unemployment increased to 15.4% in May, as compared to 13.8% in October and 14.5% in May 1999. In the first half of the year, the trade surplus totaled US$ 896 million, due mostly to 13% growth in exports, with a particularly strong performance under petroleum and soybeans. Imports increased by 2% in the same period, despite a decline in the volume index. The overall fiscal deficit accumulated in the first six months of the year came to $ 2.24 billion (excluding privatizations) and easily complied with the $ 2.69 billion target negotiated with the IMF for the period in question. In July, the

Treasury's financial result was a negative $ 1 billion. The differential between interest rates on peso and dollar deposits on the 30 day interbank market has remained practically stable at 0.5% per year since mid-June, following the decline that occurred in response to the government's announcement of public spending cuts in the second quarter of the year.

International oil market price moved upward once again at the end of July, reflecting worries generated by insufficient United States stocks, particularly in the case of such derivatives as gasoline.

Prices

In the month of July, both general price indices and consumer price indices registered the highest growth rates of the year. This result was due to the fact that the impact of three factors was concentrated in a single month: supply pressures caused by the off-season period, contractual price increases for electricity and telephone services and higher fuel prices.

In July, the general price index – domestic supply (IGP-DI) increased by 2.26%, due to expansion of 2.79% under wholesale prices, 1.91% under consumer prices and 0.30% in construction costs. Taken as a whole, farm products accounted for 1.06 percentage points of the change in the wholesale price index (IPA) and 0.53 in the consumer price index (IPC), accounting for practically 35% of the growth in the general price index (IGP). The products responsible for this high were few and included beef, milk, beans and *in natura* products. Adjustments in the prices of petroleum derivatives and alcohol accounted for 43% of the rise in the general index.

Adjustments in government managed prices were responsible for 62% of the monthly change in the broad consumer price index (IPCA). Of this total, 34% of the impact resulted from the rise in petroleum and alcohol prices and 28% from growth in the rates charged for telephone and electricity services and airline tickets. The impact of the agricultural off-season was aggravated by adverse climatic factors and accounted for 25% of the change. When these three factors are brought together, they accounted for 87% of the 1.61% growth registered by the IPCA in July.

Though these increases were no surprise to the market, their magnitude was unexpected and led the institutions included in the survey carried out by Banco Central to revise their projections upward for the year as a whole. Median expectations for IPCA growth in the year shifted from 6.0% to 6.1%.

Prospective assessment of inflation trends

In order to evaluate the inflation outlook for the year, one must first identify the shocks capable of generating impacts on future price level trends. These shocks and their impacts were reassessed in light of new information. In summarized form, the major points taken into consideration were as follows:

a. Inflation in the month of July was sharply higher than expected due to two factors. In the first place, with the drought in major meat and milk production areas, the effects of the off-season period were felt earlier than usual. Secondly, the failure of the sugarcane harvest in the southeast region generated a strong increase in sugar and alcohol prices, with indirect impacts on gasoline prices.

b. This unexpected performance had the natural impact of shifting the start of the future inflation trajectory upward. Parallel to this, since fuel increases occurred in the second half of July, part of the impact will still be felt in terms of August inflation.

c. International oil prices moved back to the range of US$ 30 and, based on the prices used in futures contracts, there are no expectations of declines in coming months.

d. Despite lesser probability of changes in fed fund interest rates up to the end of the year, the hypothesis of a small increase in the fourth quarter, which is implicit in futures contracts, was maintained.

e. Data on the evolution of GDP in the second quarter of the year are fully in line with previous estimates, as evident in the fact that inflationary pressures caused by aggregate demand over the coming months were not detected.

f. The conservative estimate of an increase in food prices was revised from just over 2% to 3% in the final quarter of 2000. This rate is higher than inflation projected for the IPCA in the period.

The other hypotheses discussed at the previous meeting were maintained, particularly that regarding a primary surplus fully in keeping with the targets defined by fiscal policy.

Based on simulations performed with the basic scenario, it was concluded that, if the interest rate is held to its current level of 16.5% per year, it will be possible to comply with inflation targets up to 2002. However, the leeway forecast at the previous meeting in relation to the target for 2000 has disappeared, while that forecast for 2001 has been sharply reduced. Exercises with alternative scenarios indicate that an adverse performance on the part of the grouping of foodstuffs could push inflation in 2000 to a level slightly above the 6% target.

Both leading indicators for inflation and short-term forecasts were presented. The leading indicators point to successive decline in inflation between August and November, with a slight upturn in December. The nonstructural short-term models point to stable monthly inflation in the range of 0.5% from September to November. On average, these models indicate accumulated inflation of just over 6% for the year as a whole.

IPCA core inflation was also presented. The method used to calculate this figure excludes items for which monthly growth is above the distribution percentile of 80 or below the percentile of 20. In this procedure, those items that register change just once per year were smoothed out or, in other words, their impact was redistributed in equal shares in the month of the effective increase and over the other eleven months of the year. The IPCA core, which held at a monthly average of 0.40% during the course of the first half of the year, climbed to 0.58% in July.

The consumer price index – Brazil (IPC-BR) core announced by the FGV increased sharply from 0.16% in June to 0.74% in July, with accumulated 12 month growth of 4.6%. Though expansion is still well below that of the full index (7.73% over twelve months), this high may suggest the start of a period in which the core will settle down to a plateau above the monthly average of 0.28% registered in the first half of the year.

Money market and open market operations

At its meeting on July 19, Copom reduced the Selic rate target from 17% to 16.5% per year, without indicating a bias.

In the period from July 19 to August 22, the monetary impact of definitive operations with Banco Central-issued securities generated expansion of R$ 1.0 billion and, in the case of operations with securities for which the National Treasury is liable, expansion came to R$ 4.9 billion. BBCE's were offered on four different occasions. In the first public offer, three year papers were offered, moving to four year securities in the remaining offers.

In the period under analysis, the National Treasury made ten LTN sales, with a financial value of R$ 11.1 billion. Redemptions came to R$ 7.5 billion, of which R$ 3.8 billion took place ahead of time and were effected through two purchase auctions. The four LFT placements in public offers came to a total of R$ 9.1 billion, while redemptions added up to R$ 17.0 billion. There were no public offers of LFT on August 15 when the National Treasury sold only preset papers. On the 28th and 31st of July, the National Treasury made a public offer of five year NTN-C, with a total of R$ 0.5 billion in securities.

Banco Central operations on the secondary market came to a total of seven, covering a period of 25 business days, and had the objective of managing very short-term interest rates in the period under consideration. One should also stress that a committed sales auction of nonearmarked LTN was held on August 21.

Monetary policy guidelines

Analysis of supply and demand indicates an absence of imbalances capable of generating inflationary pressures in the horizon relevant to the inflation targeting system. The pace of growth under consumption and investments seems to have slowed less than has been thought at the previous Copom meeting and is still within parameters fully compatible with price stability.

The expressive fiscal results obtained in the current year confirm the government's commitment to austerity and stand as a guaranty that the targets defined in the Economic Program will be met. Aside from this, announcement of the 2002 fiscal target reflects the willingness of the public administration to continue firmly on this path in the future.

As regards the external scenario, the fact that the drop-off in the United States economy is still very tenuous, coupled with reasonable growth in the Euro Zone and Asia and significantly less volatility on financial and capital markets, would seem to favor growth in net exports. At the same time, these factors tend to improve the perceptions of risk in the emerging economies. Most specifically, the successful placement of bonds of the Republic with 40 year maturities and the steady reduction in the nation's risk premium have greatly improved the outlook of Brazilian companies with respect to foreign financing.

Of the factors that have caused the greatest concern on the international scenario, petroleum is the most troublesome. The negative impact of oil prices has shown itself to be lasting while there is an increasing probability of new highs as the winter season takes hold in the northern hemisphere, at the same time in which the OPEC countries have transmitted only very vague signs of just how much oil they intend to pump. Should international prices remain where they are or move upward, it may become advisable to introduce internal adjustment measures.

The overall situation is consistent with compliance with inflation targets, though some degree of aggravation can be noted in a comparison to the previous meeting. Inflation in July as measured by the IPCA was far above the level forecast by both the market and Copom. An analysis of the components of the index point to highs under fuel prices, public services and some food products which, taken together, account for almost 90% of inflation. The conclusion drawn in this framework is that the high is transitory.

Aside from this, in the month of July, inflation measured by the IPCA core moved upward by about 0.6%, thus breaking out of the steady monthly pattern of 0.4% registered in the first half of the year. This question is pertinent since, over the medium and long terms, inflation measured by the core and observed inflation tend to converge.

Once the data contained in more recent price indicators is incorporated into the forecasting instrument available to Copom, expected inflation in 2000 was revised upward by eliminating the margin that previously existed. In this context, an unexpected shock or contamination generated by other prices could raise the year's level of inflation above the 6% target. Though this would not jeopardize compliance in 2000, it could imperil the trajectory expected for 2001. In this light, one is going to have to keep a very close eye on price evolution in order to clear up any doubts regarding the transitory nature of the shocks and their effect in the future.

With this in mind, Copom decided to maintain the Selic rte target at 16.5% for the year.

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 September 19, 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
