BANCO CENTRAL DO BRASIL – *FOCUS*

April 27th, 2001

MINUTES OF THE 58th
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: 04.17 and 04.18.2001

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

Called to order: 4:00 PM on 04.17 and 4:50PM on 04.18

Adjourned: 7:05 PM on 04.17 and 9:20 PM on 04.18

In attendance:

Members of the Board

Arminio Fraga Neto – Governor

Carlos Eduardo de Freitas

Daniel Luiz Gleizer

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Department Heads (all present on 04.17)

Altamir Lopes –Economics Department (DEPEC)

Daso Maranhão Coimbra – International Reserve Operations Department (DEPIN)

José Antonio Marciano – Department of Banking Operations (DEBAN)

Gustavo Bussinger – Research Department (DEPEP)

Sérgio Goldenstein – Open Market Operations Department (DEMAB)

Other participants (all present on 04.17)

Alexandre Pundek Rocha – Advisor to the Board

Antônio Carlos Monteiro – Executive Secretary of Banco Central do Brasil

Alexandre Antonio Tombini – Coordinator of Investor Relations Group (GCI)

João Borges – Press Secretary (ASIMP)

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

The indicators of the level of economic activity continued signaling robust expansion in the first months of 2001, mainly in the industrial segment. In March, however, statistics referring to the retail activity were less favorable than in the previous months.

In the manufacturing sector, the industrial production surveyed by the IBGE, as well as the level of real sales, surveyed by the CNI, continued to grow in February, with increases of 1.53% and 6.32%, respectively, related to the same month of last year. The initial data released for March, referring to the vehicles segment, has indicated continuity of this expansion. In that month, 181,000 units had been sold, 33.5% above of the sales of March 2000.

The seasonally adjusted total revenue, in real terms, of retail in the Metropolitan Area of São Paulo presented positive result of 1.9% in February, according to survey of the Trade Federation of the State of São Paulo (FCESP). In the year, real sales had accumulated increase of 7.1%, mainly as a result of total revenue of consumer durable segment, 11.8%, of non-durable, 13.9%, and of construction materials, 13.5%. It shall be observed that, despite the expressive growth of retail up to February, the rate is still below of the accumulated variation in 2000, 10.4%. The preliminary result (seasonally adjusted) for March, which fell by 0.75%, indicates a slowdown in the rhythm of expansion.

Other indicators also show a downward trend in the rhythm of expansion of the retail activity. Data of the Trade Association of São Paulo (ACSP), referring to the number of consultations to the Credit Protection Service and Telecheque, show the reduction of 0.89% in March, considered the seasonally adjusted series. For the first fifteen days of April, it was registered expressive reduction in the number of consultations in relation to equal period of 2000.

In part, the recent behavior of retail indicators can be attributed to the rise in default rates and to the deterioration of agents' expectations. The Consumer Confidence Index, as tracked by FCESP, recorded 113.4 in April, 115.6 in March and 119.9 in February, in a scale that spans from zero (the most pessimistic) up to 200 (the most optimistic). The index decline in the last three months was, mainly, due to the perception of worse economic conditions. Regarding default rates, information of the ACSP had shown that the net rate (discounting the cancellations of new registers in the records of SPC) raised 32% in the first quarter of 2001 as opposed to equal period in 2000. In the same way, the relation between the number of checks returned for insufficiency of funds and the number of cleared checks reached an average of 4.47% in first quarter of 2001, compared to 3.55% in equal period in the previous year.

Financial system credit indicators reveals that the stock of credit still records high growth. The balances of new credit operations within the free segment had registered monthly growth of 5% in March, distributed in 5.4% for operations with individuals and 4.9% for funds borrowed by companies.

However, the new credit concessions, considering the daily average of the operations carried out in March, had recorded growth of 0.6% in the operations with individuals, and a reduction of 4.3% in the operations with companies, after growth of 9.2% and 7.1%, respectively, in the previous month. Growth in default rates, represented by credits in arrears for over 90 days, was moderate reaching 5.9% and 2% of the total of the credit operations of individuals and companies, respectively.

Despite growth in industrial activity, the utilization of installed capacity has presented relative stability, reaching 80.2% in February, keeping almost the same percentile of February of 2000, 80.3%, according to CNI. This behavior was due to, in part, the expansion of Gross Fixed Capital Formation in industry, trend that has being maintained in the last months, according to the numbers of investment indicators.

In this sense, it is pointed out the growth of 17.6% in the production and 39.1% in the *quantum* of imports of capital goods in the first two months of the year, performance that, along with the contraction of 3% in the *quantum* of exports of this segment provides evidences of the expansion of apparent consumption of capital goods, suggesting the enlargement of installed capacity.

In the agricultural sector, the Survey of Agricultural Production (LSPA) of February lead to a revision of the percentage growth of the grains' harvest in agricultural year 2000/2001 to 12.4%, from 10.3% in the previous survey. The record harvest should reach 93.6 million tons, highlighting the increases of 26% and 8.6% foreseen in the production of corn and soy, respectively. The expected real growth of agricultural income shall contribute for the maintenance of the current level of domestic demand.

The positive performance of economic activity has been reflected in labor markets. The open unemployment rate reached 5.72% in February, in comparison to 5.7% in January and 8.16% in February of 2000. Removing seasonal influences, the rate shows a downward trend since last October. The formal employment continued its recovery, growing, seasonally adjusted, 0.27% in the same month. Data of CNI and FIESP for industry confirmed the increasing trend of the employment level. In February, surveys performed by these entities indicated increase of 0.55% and 0.41%, respectively, in the number of job positions in Brazil and São Paulo, considering data seasonally adjusted. In February, the real wage bill in the industry grew 0.75%, according to CNI, and 1.13%, according to FIESP, reaching variations of 4.26% and 5.71% in twelve months, respectively.

In relation to the flows of foreign trade, it is highlighted the impact of the expansion of domestic investments, which has pressured the imports of capital goods and intermediate goods, contributing to the deficit of USS 677 million in the trade balance in the first quarter. Exports grew 14.4% in comparison to equal period of the previous year, with prominence to basic products and manufactured products as well.

The illnesses affecting European cattle enlarged exports of vegetal protein and Brazilian meats. The exports of soy bran and soy in grain grew significantly, benefited with price gains in the case of soy bran destined to feed animal. Exports of poultry meat, mainly to

Europe, commanded the increment of businesses with meats, followed by, in a smaller scale, the sales growth of beef and pork meat.

The sales of manufactured products, such as airplanes, shoes, mobile phones and vehicles kept the good performance, outlining, in the case of vehicles, the maintenance of the importance of the US market. Oil derivatives sector (fuel oil and gasoline) had also shown strong growth in exports within the last months.

In short, economic activity is strong and expanding in the first months of 2001. This behavior echoes, mainly, in the levels of industrial production, in more pressure on imports and in the favorable evolution of labor market indicators. Data recently disclosed, referring to March and April, signals a softening on this expansion, mainly in the activity of the retailing businesses, attributed to the expectations of a reduction in the supply of credit and to the less favorable economic conditions.

Prices

The main determinant of the inflation in March was the growth in the prices of food. The IPCA increased by 0.38%, as against 0.46% in February, showing growth in expenditures with beans, raw food products, milk and poultry meat, which contributed with 0.18 percentage of inflation. The increase in the prices of medicines, mainly observed in mid-February, but with extensive impacts to March, contributed with 0.06 percentage point of the variation for the month.
The General Price Index – Domestic Supply (IGP-DI) grew 0.80%, as against 0.34% in February, as a result of higher variation in IPC (0.56% anti 0.40%) and mainly in IPA (1.01% anti 0.31%). In the wholesale, emphasis shall be given to the price increases of animal and by-products - cattle, poultry, eggs and milk, as well as of beans and vegetables, that jointly, contributed with 0.82 percentage point of the variation of the IPA. In the IPC, the variation of these same items represented about half of the increase of the index. The IPC core grew 0.53% in March, reaching 4.43% over the past twelve months.

External environment

The international scenario continued to present deceleration signs in the growth path. The stagnation of Japan and, mainly, the deceleration of the US economy reduced the perspective for world economic growth. In Latin American countries, the difficulties regarding this scenario are more pronounced due to the uncertainty about the development of the Argentine economy.

In the United States, demand indicators support a declining in the accumulated variation in 12 months, although still positive, with the exception of consumer credit that grows at rate higher than 10%. Industrial production recorded, in March, a growth of 0.4% in seasonally adjusted series, after drops for five consecutive months, but the accumulated variation in 12 months continued to decline, recording 4.5%, anti 5% up to February. The labor market reflects this context and suggests the companies' adjustments. Hence, the unemployment rate recorded in March the highest level since July 1999, 4.3%. Confidence index in the manufacturing industry and consumers, that recorded a mild increase in March, does not suggest a deepening of deceleration of the U.S. economy. It shall be emphasized that price indices do not suggest inflationary pressures, despite the volatility in international petroleum prices, so that the cuts in the interest rates by the Federal Reserve tends to contribute suitably to the performance of the economy, with a diminished inflationary risk.

The uncertainties regarding the recovering of Argentina's economic fundamentals and the resumption of growth contributed to increase the volatility in local financial markets, with higher interest rates on government bonds placements and also increasing spreads on external placements, notwithstanding the changes proposed by the new economic team. The unfavorable GDP results of the fourth quarter of 2000, which contributed to the contraction of the annual GDP and also to fiscal deficits larger than the previously expected. This environment influenced negatively the risk assessment of international agencies leading to rating revisions.

Monetary market and open market operations

In the weeks right after the last Copom meeting, the term structure of interest rates showed strong volatility, reflecting the uncertainty in the international market environment along with the Copom's decision itself – considered a surprise to the market. As a result, losses were inflicted to fixed-income instruments.

Between March 21 and April 17 there were two public selling auctions of dollar-indexed securities (NBCE), with tenures of 4.6 and of 2 years. These auctions were used to fully rollover principal and interest payments due in maturing instruments in April19. The choice of two placements intended to meet the demand for hedge at alternative maturities. The securities with longer tenure were fully placed at 11.20% p.a. and the securities with shorter tenures were placed at 10.95% p.a., both totaling R$ 2.9 billions.

Regarding the monetary impact, considering settlements between March, 21 and April, 17, the operations with National Treasury bonds were responsible for an expansion of R$ 3.8 billion, particularly due to the net redemption of R$ 8.3 billion of LTNs. The operations with Central Bank notes generated a contraction of R$ 1.7 billion.

The increase of the basic interest rate since last Copom meeting changed in the composition of domestic federal debt. The combination between net redemption of fixed-income securities and the price declined due to the interest rate increase reduced the stock of LTNs in the market (marked to market) to R$ 66.4 billion in April, 9, from R$ 74.5 billion in January. The net placements of LFTs in substitution of LTNs increased the stock of those securities to R$ 139.7 billion from R$ 126.0 billion in the same period. The share of dollar-indexed securities increased to R$ 122 billion from R$ 108.8 billion in January. The average maturity of securitized debt decreased to 31.4 months in March from 32.2 months in February. The average maturity of the Federal Government issues reduced to 21.2 months in March from 45.5 months in February, due to the small offering of LFTs and to the shorter term of the auctioned NBCEs.

The maturity schedule indicates redemption of about R$ 21 billion of LFTs, R$ 8.3 billion of LTNs and R$ 2.3 billion of NBCEs and NTN-Ds in March.

In March, the average daily volume of final transactions, excepted repo operations totaled R$ 5.9 billion, compared to R$ 7.8 billion in the prior month. The downfall was observed in every group of securities and was due to the smaller volume of public offers and to the deterioration in expectations. The daily rollover of fixed-income securities, particularly, shrank almost 41%, reducing to R$ 2.3 billion in March from R$ 3.9 billion in February.

Prospective assessment of inflation trends

Identified shocks and their impacts were reassessed in light of newly available information. The scenario considered in the simulations is based on the following hypotheses:

a. the March inflation (0.38%) was above expectations (0.22%) due to the increase in food prices;

b. the international price of oil remains volatile. In the spot markets, prices rose since the last meeting, but futures markets still show a declining trend along the year. Considering the implicit price schedule from futures type- Brent petroleum contracts, the average for the year should be around US$ 25 per barrel;

c. the adjustments in electric energy prices for the remaining of the year was revised from 12.8% back to 15.8%, with the bulk of it occurring in the third quarter. The expected changes in telephone charges and public transportation fares were also reassessed. The timing and the size of projected changes in the item “domestic employees” was adjusted in light of the new methodology adopted, in April, by IBGE. Regarding the set of administered prices, including fuel, energy, public transportation, and telephone services, the expected average adjustments reaches 8.9%, with a direct contribution to this year’s inflation of 2 percentage points;

d. it was also included the hypothesis that food price variation stays 0.5% below the overall inflation in the second quarter. This assumption is related to the harvest period, which tends to partially revert the unusual food price increases observed in the first quarter;

e. according to projections implicit in futures markets, the hypothesis for fed funds encompasses a linear reduction from its current level of 4.5% p.a. to 4.0% p.a. at the end of the year, remaining stable thereafter;

f. regarding the external scenario, it is assumed the deceleration of the US economy should be concentrated in the first half of the year, and followed by a recovery beginning at the end of the second half. The recent deterioration of Brazil’s risk premium is expected to revert during the year. Comparing to last meeting’s scenario, however, it is introduced a small upward shift in the Brazil risk curve.

Other hypotheses considered in the previous meeting were maintained, particularly the one of attaining primary surplus targets. GDP growth was adjusted according to recent data released by IBGE.

From simulations using the basic structural model, it was concluded that keeping interest rate at the current level of 15.75% p.a., inflation projection for 2001 is above 4%, although comfortably within the tolerance interval. For 2002, inflation projection lies quite close to the 3.5% target.

The IPCA inflation core, calculated by the trimmed-mean method, was raised from 0.54% in February to 0.59% in March. In twelve months, core inflation reaches 5.62%. The assessment of IPCA inflation cores, calculated by exclusion of items, leads to the conclusion that by leaving out administered prices and food, the twelve-month variation of IPCA remains around 4%. The inflation core of IPC-BR, released by Getulio Vargas Foundation, increased from 0.36% in February to 0.53% in March.

The median of market expectations for IPCA inflation, surveyed by the Central Bank on a daily basis, presented the following evolution: for 2001, it was revised upwards from 4.20% to 4.50%, while for 2002, it was reduced from 3.75% to 3.68%.

Monetary Policy Guidelines

The strong demand in the last months has had an impact on the trade balance with imports growing at a faster pace than exports. In this context, the deepening of external uncertainties along with a more unstable domestic political scenario has contributed to maintain the exchange-rate under pressure. Due to a complex combination of factors, outlined above, the passthrough from exchange-rate variation to domestic prices is subject to considerable uncertainties.

Since last Copom meeting, the economic environment has changed. First of all, the estimates for administered price changes were revised upwards. Public services charges will likely be raised by more than previously expected. Those tariffs pegged to the general price indices should be affected by the more pronounced influence of exchange-rate variation on wholesale prices. As a whole, administered prices tend to account for 2 percentage points in this year’s inflation, which characterizes a major supply shock.

Second of all, first quarter inflation stayed above both Central Bank and market expectations. This was mainly due to unfavorable performance of food prices. A closer look at inflation, however, suggests that there is room for a partial reversion of the adverse effect of some food prices. Improvement in weather conditions as well as the crops reach the marketplace shall contribute to this reversal. Likewise, there is not yet a clear evidence of an increase in the exchange-rate passthrough. For some products like poultry meet and beef, the observed passthrough has been slightly above expectations. For other products, however, such as electronic appliances, characterized by high import content, the observed passthrough has been below expectations. Nevertheless, the deterioration of agents expectations indicates the possibility of greater pressure for passthrough in the future. To the extent that the GDP growth stabilizes at a more moderate level, this pressure should be mitigated due to greater difficulties to transfer these costs to the price of final goods.

With respect to positive changes in the scenario, it shall be underlined the broadening of the fiscal effort embodied in the budget guidelines proposal for the next two years, and the additional cut of half of a percentage point in the US basic interest rate. The latter shall mitigate the impact of the US growth deceleration on the world economy and will improve global liquidity conditions.

The domestic interest rate term structure shows a steep positive slope. As a result, a reduction in the supply of credit by financial intermediaries is expected, which in turn may lead to a moderation in the rate of economic growth. The most recent activity indicators of retail sales reinforce the prospects for stabilization of economic activity level. In case this trend is confirmed, which seems probable, there should not be additional inflationary pressures for this and next year.

Copom considered that the understanding of the basic concepts that guide its actions should be reinforced.

The main objective of the Central Bank is to control inflation according with the targets established by Government, is the Central Bank's main objective. Differently from the previous policy regime, the level of the exchange rate is not the target of the Central Bank, likewise no other specific price in the economy. Hence, exchange rate variations are only relevant to the extent that they may affect the IPCA inflation rate. Given that the relationship between inflation and exchange rate depends upon a variety of factors (whether the currency depreciation is temporary or permanent; whether or not there will be passthrough to prices) it is essential to stress that the target is the inflation rate and not the exchange rate itself.

The main policy instrument of the Central Bank is the interest rate. Other monetary policy instruments are only complementary. For instance, in case of liquidity shortage and high volatility, the sporadic intervention in the foreign exchange market can be instrumental to allow a consistent price formation. The same applies in the case of dollar-indexed bonds.

The impact of monetary policy on inflation is not instantaneous. The lag between Central Bank's policy action and its effect on the economy requires Copom to take preemptive action by anticipating inflationary pressures, instead of reacting based on lagged information. The risk is of being late in the process of controlling inflation, which leads to higher uncertainty, with damage to economic activity and potential economic growth.

The Central Bank pursues the target trajectory for inflation of 4% in 2001, and 3.5% in 2002, with a tolerance interval of 2 percentage points. The tolerance margin is large since the target is defined for headline inflation (and not for its core or for a purged index) and does not contemplate any escape clause, as usual in other inflation targeting countries. Nevertheless, the Central Bank aims at the central point of its annual targets. The relevant distinction to be made is between the rigor of the planned objective and the *a posteriori* performance assessment. This is analogous to a riffle shooter that would be content with hitting the target board, but always seeks to hit the bull's eye, and not its surroundings.

To assess when the Central Bank may use its tolerance interval requires the identification of the causes leading to the deviation. If the underlying cause is a demand shock, then the interest rate must be adjusted to bring aggregate demand back to its pre-shock trajectory. If the cause consists of a supply shock, the consensus among the majority of central banks is that second-round effects should be fought, but not the direct effect of the shock on the price level. Thus, in the case of a negative shock, action should be taken to let the deviation from target be only temporary. The reasoning is symmetric for positive shocks.

It is necessary to be careful to avoid mixing-up changes in the price level with deviations of the inflation trajectory. For example, a supply shock with a one percentage point impact on the price level would imply an increase of one point in the twelve-month inflation rate. By definition, this increase would remain embodied in the inflation rate for the next twelve months, fading out at the end of the period, provided that second-round effects were avoided. This requires that monthly inflation is brought back to levels consistent with the desired path in the months right after the shock. The tolerance interval serves the purpose of guiding Central Bank action under these circumstances, by helping to calibrate the speed of convergence to the desired trajectory for inflation. The important aspect is to have confidence in bringing inflation back to its target path.

In practice, classifying the shocks is not always an easy task. Current economic conditions encompass a combination of pressures. On one hand, one should take into account the effect of an expanding domestic demand in the last months, within a context of world economic growth contraction and increasing risk aversion. On the other hand, the overall adjustments in administered prices impact production costs and represent a supply shock to the economy, whose second-round effects need to be controlled. By its turn, the depreciation of the exchange rate has an impact on both, the production cost of goods, which use imported inputs, and also on the demand for tradable goods. The turbulent environment has reinforced the defensive nature of economic agents' reactions to events in Argentina, and, to a lesser extent, to the domestic political environment. This suggests the temporary nature of part of the current pressure on the exchange rate.

After assessing the macroeconomic scenario presented above and its indicators – the increase of the core inflation in the last months, the observed inflation above expectations, and the uncertainties regarding the degree of passthrough of the recent depreciation – it was concluded that the initial move made in the March meeting should be consolidated in order to realign the expected trajectory of inflation with the targets established for 2001 and 2002.

Consequently, Copom unanimously decided to increase the Selic rate target to 16.25% p.a.

At the close of the meeting, it was announced that the Committee would meet again on May 22, 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.

Gustavo Bussinger

Notes Revised by the Board