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Economic activity

Prices

External Environment

Money market and open market operations

Prospective assessment of inflation

Monetary policy guidelines

' DWH July 17 and 18, 2001

30DFH Central Bank's Headquarters 8<sup>th</sup> floor meeting room (on 07.17) and 20<sup>th</sup> floor (on 07.18) -  
Brasília - DF

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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.

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The domestic economic activity continued to show cooling signs at the end of the semester, confirming the prevailing scenario at the last COPOM meeting. This performance may be related to the impacts of the energy crisis and of the instability in international markets, which fostered the deterioration of economic agents' expectations. However, more recent information related to the consumer behavior indicates that the harsh initial reaction, expressed in face of the expectations of economic activity rationing, has already been minimized, contributing to some recovery of general indicators of commerce. Nevertheless, the retraction on the sales of durable goods, specially electronics, remained, given the unfavorable evolution on the credit conditions and also energy rationing effects.

The retail activity in São Paulo, as surveyed by the Trade Federation of the State of São Paulo (FCESP), showed an increase of 0.2% in June, after a decrease of 5.2% in May, in the seasonally adjusted series, standing at a level 6.6% lower than in June 2000. With this result, the accumulated growth in the year reduced to 0.9% in the semester from 2.8% up to May. The retail sales index

calculated by the Brazilian Institute of Geography and Statistics (IBGE), with national coverage, dropped by 0.96% in the first five months of the year, compared to the same period of last year.

Default indicators remained higher than in 2000, although monthly evolution indicates stability or decline. According to the Credit Protection Service (SPC) from the São Paulo Trade Association (ACSP), the net rate of default, which discounts the cancellations of new registries, reached 7.6% in June, contributing to a 8.9% average in the first half of 2001, compared to 6.8% in the same period of the previous year. The ratio of number of checks returned due to insufficient funds and cleared checks reached 5% in June, with a 4.7% average in the first six months of the year, whereas the average of the first half of the previous year stood at 3.6%.

The Consumer Intentions Index (IIC), measured by the FCESP, indicated that, in July, consumers' behavior still reflected the deterioration of economic indicators, mostly external and energy crisis related. These factors had already significantly and negatively impacted the index in June. As a result, the IIC reached 90.87 in July, compared to 81.70 in the previous month, still in the pessimistic region, although posing recovery both in present and future intentions.

For the past three consecutive months, the industrial production, as tracked by IBGE's Monthly Industrial Survey, has showed a decline, reducing by 1.5% in May, seasonally adjusted figures. This decline reduced the growth accumulated in the year to 6.2% from 7.1% registered in the first quarter. Despite the result, the level the installed capacity usage, as calculated by the National Confederation of Industries—CNI, based on information from twelve States, remained stable between April and May. The expectation is that, in June, industrial production fell, grounded on the retreat on the production of auto-vehicles and agricultural machinery, as well as on waved cardboard dispatching.

Nonetheless, credit, investment and employment indicators still do not significantly reflect signs of deceleration.

The total outstanding credit stock reached R\$347.3 billion in May, posing a 1.8% growth. This volume is expected to reduce significantly in June, as a result of the Strengthening Program for Federal Financial Institutions, which aims at adjusting net-worth imbalances of these institutions,

impacting ear-marked outstanding credit. Consequently, the share of non-earmarked credit outstanding on the total will rise to a large extent.

The stock of non-earmarked credit outstanding rose by 2.8% in June, due to a 2.5% increase in the operations with corporations and 3.3% in the operations contracted with the individuals segment. Regarding new loans, in the same period, the daily average concession to corporations grew by 5.8% and those contracted by households increased by 3.2%. This performance, after the observed drop in concessions in the previous month, may be partially explained by the substitution of external loans for domestic ones, by the liquidity reduction in the non-banking credit market, which stimulates the demand for banking loans, and by the increased demand for overdraft account loans in both segments. Regarding corporations, credit has contributed to the adequacy of production to conditions determined by the energy crisis, and is responding to cash-flow recovery needs, given reduced demand and consequent inventory formation.

The evolution of investment remains favorable, as assessed by the domestic absorption of capital goods and production of inputs to supply civil construction. Even though capital goods and input production for civil construction in May contracted by 2.3% and 2.7% respectively, in the seasonally adjusted series, the absorption of capital goods rose by 19.1% and the civil construction by 3.6% in the first five months of the year, comparatively to the same period of the previous year. The absorption of capital goods elevated by 31.6% in the first five months of the year, in spite of a 6.7% contraction in May. This performance was responsible for a 19.4% expansion in gross fixed capital formation as a share of GDP in the twelve months ending in May 2001, from 18.6% in the same period of 2001. Noteworthy was the 8.2% growth in May in the production of capital goods for electric energy generation, seasonally adjusted series, accumulating a 37.1% expansion in the first five months of the year.

Until May, a favorable trend was in place in the labor market. Records from the Ministry of Labor and Employment pointed to a 3.1% growth in formal employment accumulated in the year, with the hiring of 465.5 thousand workers. The unemployment rate, as measured by the Brazilian Institute of Geography and Statistics—IBGE, based on a domicile survey conducted in six metropolitan regions, increased to 6.9% in May from 6.5% in April, which resulted from a 0.4% growth in the number of employed, insufficient to offset the 0.8% rise in PEA (employable population). On the

other hand, unemployment rate in all months of 2001 has been below the rates observed in the same months of 2000.

The trade balance recorded a US\$277 million surplus in June mainly driven by export growth, which registered daily average record levels (US\$252). As a result, the trade balance deficit in the first half of 2001 reduced to US\$70 million. In the same period, imports, on the other hand, increased at a faster pace than exports, which hampered the replication of the surplus observed in the same period of 2000. A medium term improvement in the trade balance is expected due to the actual decreasing growth rate observed in both export and imports, more accentuated, however, in imports.

The current conditions of world growth have negatively impacted Brazilian exports as to what demand and prices are concerned. Depressed international prices of food and raw materials commercialized by Brazil unfavorably reflected on the terms of trade in April and May, seasonally adjusted series, with direct impacts on country's receipts. In spite of that, exports have registered increased shipment volumes of some export items, such as soy, chicken, meat, and sugar.

Capital and durable consumer goods, in particular auto-vehicles, were the items leading import growth in the first half of 2001. Imports of those categories fell in June, compared to the previous month, and maintained a decreasing growth trend compared to the same months of 2000. Capital good imports increased by 25.6% in the first half and 3.9% in June. Imports of raw material and intermediate goods behaved accordingly, growing by 9.1% in the first half and contracting by 1% in June. The reduction in the domestic activity level expected to occur until the end of the year should accentuate this cooling trend in imports, contributing to a balanced result in the trade account.

The impacts of the reduction in the electricity supply on the future evolution of production are directly related to the capacity consumers have to rationalize and self-generate energy, in addition to the intersectoral transfers of excess supply and the use of alternative electricity sources. The expressive adhesion of the Brazilian population to the rationing program, with targets to residential and commercial sectors being outperformed suggest that the effects of the energy crisis may be smaller than initially expected. Yet, projections on GDP growth for 2001 have already incorporated the slowing pace of economic activity.

To conclude, the deceleration of the industrial sector, particularly the transformation segment, may be specially due to the reduction in demand as a response to lower consumer confidence, associated not only with the rise in interest rates and to the reduction of financing tenures, but also with restrictions deriving from reduced energy supply. Investment, credit demand and employment levels, however, have not been fully affected by this cooling evolution.

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In June, consumer price indices were mainly influenced by the increase in administered prices. Those pressures, however, were partially attenuated by the deceleration in food prices. The evolution of wholesale price indices, on the other hand, basically reflected the passthrough of the exchange rate.

The IGP-DI increased by 1.46% in June, as a result of the 1.96% rise in IPA, compared to 0.18% in May. Wholesale prices, both agricultural and industrial, mirrored the exchange rate depreciation. It shall be stressed the pronounced increases in iron, steel and its by-products, mechanicals, electric material, plastic substances, cereals and grains, and crops for exports.

The IPCA raised by 0.52% in June, mostly responding to the increase of 1.53% in administered prices, which represented 0.39 percentage point of the index. The main pressures in administered prices originated from the increase of urban bus tariffs in the city of São Paulo, responsible for 0.23 percentage point of the variation; water and sewage tax readjustment (0.07 p.p.); cooking gas (0.03 p.p.) and fixed telephone tariffs (0.04 p.p.). The rise of the IPCA in the month was attenuated by the reduction in prices of pharmaceuticals (-0.10 p.p.) and *LQ QDIXUD* food (-0.13 p.p.).

Increases in administered prices are expected to continue to impact price indices in July, mainly from telephone, fuel, electric energy and, to a smaller extent, urban and interstate bus tariffs. The influence of the minimum wage increase, effective after April, shall be added to these factors and is likely to especially impact the IPCA, due to the two-month lag to incorporate data from the monthly employment survey released in May. Regarding IPA, the effects of the exchange rate depreciation tend to be important, in addition to the pressure resulting from fuel price increase.

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The international economy is still on the cooling trend. The United States' economy does not exhibit recovery signs yet, although executives' expectations improved in June. Early expectations of recovery beginning in the second half of 2001 were postponed to the last quarter of 2001 and first quarter of 2002. The Euro area economies have not succeeded in the maintenance of the growth pace and also show deceleration. The Japanese economy still does not show signs of resurgence. In Latin America, the economies are suffering from the weak performance of main world economies and from the rising uncertainty towards Argentina. In this context, East Asian countries have also been strongly affected by the reduction of the level of world demand, but they are less internally imbalanced than they were in 1997 and 1998.

In the United States, the demand maintains its decelerating trend, although at a lower pace. In June retail sales recorded the sixth positive monthly variation out of the last seven months. However, the trajectory of the accumulated 12-month variation remains waning, similarly to orders to industries and commencement of housing construction. The pace of export and, mainly, import growth reduced, decreasing the trade deficit between October 2000 and April 2001.

In this context, first quarter GDP grew by 1.2%, annualized, compared to the fourth quarter of 2000, in the seasonally adjusted series. Industrial production contracted for the ninth consecutive month, showing accumulated 12-month growth of 2.1% comparatively to an expansion of 5.9% in October 2000. The inflation rate remained stable, considering the 3.62% annual variation of consumer prices in May and of the 2.53% increase in producer prices in June. This outlook drove the Federal Reserve to reduce fed funds in 0.25 percentage point in June, reaching 3.75% p.a., emphasising the weakness of the economy. Indicators of executives' expectations signal improvements in the next months, with rise in NAPM indicators for both the processing and non-processing sectors and in Conference Board Leading Indicators.

The Euro Area economic performance still points to a loss of dynamism, while consumer price inflation continued on the upward trend. Annual expansion of retail sales dropped to 1.5% in April from 2.1% in March. After a slight recovery in the first quarter, the trade balance recorded a deficit of US\$ 2.7 billion in April, with imports annual variation of 11.62% overcoming exports annual variation of 7.31%. Industrial production showed negative monthly variation in March and April,

reducing annual expansion to 1.6% in April from 2.9% in March. The annualized harmonized price index increased to 3.4% in April, from 2.6% in February and March, above the 2% reference level established by the European Central Bank (BCE) since June 2000. On its last meeting, the BCE decided to maintain the basic interest rate at 4.5% pa. Entrepreneurs' expectations in the three main countries of the region still indicate a downward trend.

In Argentina, macroeconomics fundamentals still point to a waning economic activity. Supermarket and shopping centers sales dropped in May comparatively to the same period of last year, as did civil construction. As to the external sector, the trade balance recorded a surplus of US\$ 1.2 billion up to May 2001, similarly to the last year's result. Supply indicators corroborate the recession environment. First quarter GDP fell by 0.2% compared to the previous quarter and industrial output declined by 1.3% in May compared to April. Fiscal Results still evidence difficulties in attaining the targets agreed with the International Monetary Fund (IMF). The total deficit reached US\$ 4.9 billion in May, US\$ 39 million below the target set for the first half.

The absence of recovery signs, the fiscal outlook, and the political crisis played a role in the severe worsening of the risk perception of the Argentine economy, elevating the yields on the Treasury Bills (Letes) auctioned. In this context, the government announced the fiscal policy program to reach a zero deficit. This program included measures to reduce public workers salaries and to increase the rate of the Financial Transactions Tax. However, uncertainties regarding political support to the program still have not promoted substantial changes in the path of domestic interest rates and of Argentina's sovereign risk.

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The prior COPOM meeting's decision to increase the Selic rate target by 150 points and to indicate a downward bias, conjugated with the announcement, in the day after the meeting, of measures related to the foreign exchange market and the balance of payments led, at the first moment, to a reduction of the slope of the interest rate curve for short tenures. The spread between the three-month rate and the Selic rate decreased to 190 points from 410 points. It was also observed a downward parallel movement in the curve, of approximately 80 points, for higher tenures. Due to the aggravation of the uncertainties in Argentina, the curve started to present successive upward movements. The last movement, between July 3rd and July 16th, showed a strong increase in the

curve slope of tenures lower than 90 days: the spread between the DI Future for October (most liquid maturity) and the Selic rate increased to 660 points from 340 points.

Of the six public auctions of NBCE settled between June 20th and July 17th, three of them were placed with one-year maturity, two with two-year maturity and one with five-year maturity. The average rates ranged from 8.32% p.a. and 13.20% p.a.. The average demand/supply ratios were of 1.7 for the auctions designed to rollover the debt and 1.5 for hedge demand. It should be stressed that the demand/supply ratio decreased to 1.2 in the last offer on July 12th.

Three selling offers of fixed income securities, with five-month tenure, were placed between June 20th and July 17th. The average rates were 22.02% p.a. in the first auction, 20.70% p.a. in the second and 21.88% in the last one. The total amount settled reached R\$ 5.6 billion and the average demand/supply ratio was of 1.7. At the beginning of July, the National Treasury decided to temporarily interrupt the sales of LTN due to the increase of volatility observed in the market's interest rates.

The four auctions of LFT settled in the period totaled R\$ 17.8 billion. The securities were offered with five-year tenure and increasing average discounts between 0.14% p.a. and 0.29% p.a.. In the COPOM meeting's day, July 18th, the LFTs auctioned out on the eve were settled, the five-year securities being fully sold with an average discount of 0.31% p.a., reaching a financial amount of R\$ 3.5 billion.

The average tenure of issuance of federal securities reduced to 32.4 months in June from 43.8 months in May. This reduction is related to the increase in the volume of NBCE placements, especially with one-year tenure, and of five-month LTN, in addition to the reduction of NTN-C auctions' tenure to 7 years, in average, in June, from 20 years in May.

In the same period, the average maturity of the securitized debt grew to 35.2 months from 33.6 months. This rise was due to the significant volume of LFT redeemed, which was practically entirely rolled over, through public offers with 61-month tenures and, through direct issues (Banco do Brasil and Caixa Econômica Federal) with 41-month tenures.

Among the holders of federal securities, financial institutions portfolio started to have a higher participation in the total domestic securities in the market in July, in detriment of the Financial Investment Funds (FIFs). In mid-July, financial institutions participated with 41% of the total, compared to 38% of FIFs' participation. This was due to the net redemptions in FIFs' portfolios in May, June and July and to the direct placements of LFT to Banco do Brasil and Caixa Econômica Federal in June and July.

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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:

1. June's inflation rate, measured by the IPCA, reached 0.52%, slightly above the expected (0.46%);
2. Considering the price schedule implied by Brent crude oil futures contracts, the expectation for the average price of the barrel in the third quarter of 2001 was reduced to US\$25.5 in the third quarter and US\$25.0 in the last quarter of 2001. From 2002 on, the hypothesis is that these prices shall follow market's inflation rate;
3. The projection for the electric energy tariffs' readjustment in 2001 remained at 20%. For the set of administered prices, including fuel, energy, public transportation, IPTU and domestic employment, the expected total readjustment remained practically unaltered at 13%, which represents a direct contribution of 2.9 percentage points to the 2001 inflation;
4. The hypothesis for the slope of the interest rate curve lies at 575 base points in the third quarter of 2001, linearly declining to 235 base points in the third quarter of 2002;
5. The hypothesis for the path of the Fed Funds rate is of a drop from its average level up to the end of the year, with a gradual elevation up to the second half of 2002, and stability thereafter;

6. On the external front, the increase of uncertainties is assumed to elevate the average of Brazil risk premium in the third quarter of 2001 for levels prevailing before this Copom meeting, subsequent reductions being expected in the following quarters, stabilizing in the 600 base points level.

Regarding the net effects of electricity shock on the inflation rate, modeled based on the impact on the aggregate demand and supply, the previous assumptions were maintained.

The IPCA core, calculated under the symmetric trimmed-mean method, rose in June to 0.73%, due to increases distributed among several product categories. Accumulated in 12 months, the core index increased by 6.22%. The IPC-BR core, released by Fundação Getúlio Vargas, elevated to 0.56% in May from 0.52% in April, accumulating a 4.75% increase in 12 months.

The median of market expectations for the IPCA, as surveyed by the Central Bank on a daily basis, was revised to 6.00% from 5.50% for 2001 and to 4.00% from 3.82% for 2002.

The remaining assumptions established in the previous meeting were maintained. It shall be stressed that the fiscal performance has been granting the achievement of the primary fiscal surpluses above to the established fiscal targets.

Regarding the exchange rate, a slightly upward trajectory from the day prior to the Copom meeting was considered.

Simulation exercises with the scenario considered in the basic (structural) model leads to the conclusion that the maintenance of the interest rate at the current level of 18.25% per year would result in inflation near the upper limit of the target for 2001. However, for 2002 the projected inflation is below the 3.5% target.

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The fall of pace of demand growth was accentuated at the end of the second quarter and beginning of the third quarter, revealed by recently announced commerce indicators. The real invoicing of the retailing sector of the Region Metropolitan of São Paulo declined by 6.2% in June 2001 compared

to the same month of the previous year. The National Index of Consumer's expectation decreased significantly by 7.1% in the second quarter. The deceleration in the economic activity reflects the effect of a sequence of shocks that impacted the Brazilian economy, such as the cooling of global economy growth, the Argentina crisis and the electric energy shocks.

The unraveling of these shocks along the past weeks deserves attention. The management of the use of electric energy has been successful, with companies and consumers demonstrating considerable advances in the process of rationalization of its use. There are signs that the negative effect of the rationing of energy upon the economy's supply may be less than expected. As a result, the cooling of the growth pace in the past months shall have been driven by a fall in demand and not by reduced supply, given the effects of the various shocks on consumers' expectations. In Argentina, in spite of the implementation of a set of measures aiming at improving public accounts, the profile of the public debt and the competitiveness of the economy, the risk premiums in the financial market remain high.

Bank loans are still growing, yet at a lower pace than previously observed, but still significantly. Inasmuch as the decelerating growth of the demand for goods and services has been more pronounced, continued expansion in banking loans may be reflecting credit substitution - among others, foreign or domestic non-banking loans by domestic loans extended by the banking sector. In this case, current credit growth shall not be posing additional pressures upon inflation.

The depreciation of the exchange rate since the beginning of the year may be attributed to the diverse external and domestic shocks the economy has experienced and to the perception of a worsening in the balance of payments. In this sense, although the likelihood that the formation of the exchange rate entails a parcel of proper dynamics is not rejected, the perception that the observed behavior of the exchange rate is tied to fundamentals, some being temporary, is becoming predominant. In order to strengthen balance of payments financing, the Central Bank decided to announce the sale of US\$6.0 billion, conducted uniformly until the end of the year, not violating the principles that guide the floating exchange rate regime, which are based on the continuity of the monetary and exchange policies in place.

The potential passthrough to prices is one of the reasons justifying monetary policy reaction, translated into increases in interest rates to neutralize this effect. Even though overall inflation

projections have been revised upwards, they have not been following the speed of exchange rate depreciation, what is in line with the expectation that a share of this depreciation will not be transmitted to consumer prices. In fact, the IPCA accumulated a 2.96% increase in the first half of 2001, mostly influenced by the evolution of food and administered prices, as tradables recorded smaller variations.

In spite of that, core inflation as measured under the symmetric trimmed-mean methodology, has increased in the past months. The analysis of the items composing the core inflation in June points to a generalized pressure on prices, distributed among many product categories. In this sense, it is important that the monetary policy remain vigilant so as to avoid the propagation, in 2001 and 2002, of price realignments resulting from the shocks and exchange rate devaluation.

In sum, Copom concluded that the pressures on inflation, the increase of the core inflation in the past months and the risk of passthrough to inflation, also via administered prices, recommend a tightening in monetary policy by means of an increase in interest rate, so as to ensure convergence of inflation to the targeted trajectory.

Accordingly, Copom decided unanimously to increase the Selic rate target to 19.0% p.a..

At the close of the meeting, it was announced that the Committee would meet again on August 21, 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.