December 27, 2002

BANCO CENTRAL DO BRASIL (BCB)
MINUTES OF THE 79th MEETING OF
THE MONETARY POLICY COMMITTEE (COPOM)

Summary

Date: December 17 and 18, 2002

Place: Central Bank's Headquarters meeting room of the 8th floor (on December 17) and 20th floor (on December 18) -Brasília - DF

Called to Order: 3:30 PM on December 17 and 11:30 AM on December 18

Adjourned: 7:00 PM on December 17 and 1:00 PM on December 18

In attendance:

Members of the Board

Arminio Fraga Neto **-** Governor

Beny Parnes

Carlos Eduardo de Freitas

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

Sergio Darcy da Silva Alves

Tereza Cristina Grossi Togni

Department Heads (all present on December 17)

Altamir Lopes – Economic Department (DEPEC)

Daso Maranhão Coimbra – International Reserve Operations Department (DEPIN)

José Antonio Marciano - Department of Banking Operations and Payment System (DEBAN)

Marcelo Kfoury Muinhos - Research Department (DEPEP)

Sérgio Goldenstein - Open Market Operations Department (DEMAB)

Other participants (all present on December 17)

Antônio Carlos Monteiro - Executive Secretary

Alexandre Pundek Rocha - Advisor to the Board

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

João dos Reis Borges Muniz - Press Secretary (ASIMP)

Fabia Aparecida de Carvalho – Manager of the Investor Relations Group

The Board analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, designed to comply with the inflation targets established by the government.

Economic Activity

In the beginning of the fourth quarter, the evolution of the level of activity followed the trend of gradual growth that has been outlined in the last months. The increase in exports, the favorable results in retail commerce, mainly boosted by the disbursements from the FGTS, and the demand for inputs associated with the expansion of agricultural production are factors that continue to give more dynamism to the economy in the second half of this year.

According to seasonally adjusted data from Fecomércio, the retail sector's real revenues in September and October were essentially stable in relation to August, when there was a significant increase in sales in the metropolitan region of São Paulo. Year to date figures point to a 3.8% growth relative to the same period of 2001, with a notable expansion in sales of consumption goods, particularly non-durable goods. The national survey carried out by the IBGE showed a 0.14% fall in the volume of retail sales in the year to October figures, confirming the gradual recovery of the retail sector over the year.

After posting a sharp increase in October, car sales fell in November, according to seasonally adjusted data from the Fenabrave. The increase in sales in October was driven by a high number of promotions in that month and the prospect of price increases in the following months (since confirmed), and therefore was not repeated. The auto sector was negatively affected this year by the evolution of expectations and credit conditions, and declined by 7.7% in the year to November. The recent recovery observed in consumer expectations is one of the factors that tend to favor sales in the medium term.

In December, the IIC increased by 5% to reach 106.8 points on a scale ranging from 0 to 200, according to the survey by Fecomércio. The increase in the IIC resulted from an improvement in consumers' intentions, current and future, and it should be highlighted that the future intentions index reached 120.3, the highest level since the beginning of the series in March 1999. The perception of improvement in the political scenario was the factor that most influenced this result, together with a decline in concerns over a higher unemployment rate.

Regarding defaults, data from the ACSP show that the number of new default registrations was stable in November as compared to October. The number of cancelled default registrations fell by 7.4% in the same period, but it should be highlighted that this number had been growing significantly between July and October, reflecting liquidation of debts using extraordinary disbursements from the FGTS.

The default rate on financial institutions' credit portfolio of freely allocated resources remained steady in November at 8%. The percentage of arrears on credits to individuals fell by 0.2 p.p., repeating the performance of the previous month. With respect to credits to corporations, the 0.2 p.p. increase in the percentage of arrears resulted from a few new occurrences with high volumes, and to the fall in the relative participation of on-lending of external resources, with smaller default rates.

Outstanding credit operations with freely established rates declined by 0.2% in November, the same behavior of the segment of credit lines to corporations. The volume of credit to private individuals remained stable, indicating households' caution because of the adverse conditions for indebtedness, which have stimulated borrowers to repay liabilities with resources from the FGTS, income tax refunds and the 13th wage. The fall in credit operations to corporations was due to the 4.9% reduction in operations with external funding, since the end-of-month balances of operations funded domestically expanded by 3.7%.

Investment indicators remain on a downward trend, reflecting the effects of the political transition on business decisions. However, there was an improvement in the production of inputs for civil construction for the third consecutive month, reflecting the recent increase in the demand for construction materials for small renovations and residential enlargements. It should be noted that the recent improvement in the real estate market, reflected in the expansion of the number of new residential and commercial units, will have a positive effect on the production of inputs and on the labor market in the coming months.

Regarding industrial activity, production registered a 1.7% expansion in October as compared to the previous month on a seasonally adjusted basis. With this latest result, data from the PIM carried out by the IBGE showed industrial growth for the fifth consecutive month on a seasonally adjusted basis. In October, 16 of the 20 groups surveyed posted an expansion, with the highest growth in transportation material, which increased by 19.8% in the last two months on a seasonally adjusted basis. By categories of use, the increase of 4.9% in the production of durable consumption goods and of 4.3% in capital goods should be highlighted. The production of intermediate goods, which has a heavy weighting in the composition of industrial output, maintained the recent trend of gradual growth in the month, registering an increase of 0.8%. With these results, industrial production in the year to October expanded by 1.9%.

The increased dynamism in industrial activity has been reflected in indicators of installed capacity utilization. Data from the Conjunctural Survey carried out by the Getulio Vargas Foundation show that utilization reached 80.4% in October, as compared to 79% in July and 79.8% in the same month of 2001. This reading, however, is relatively far from the peak of the series, 86%, registered in April 1995.

In the labor market, the average open unemployment rate measured by the IBGE remained stable in October, at 7.4%, as compared to 7.5% in September. This result was due to a 0.2% fall in the PEA, while the number of employed workers remained stable. According to the Ministry of Labor, in October legally registered employment grew by 0.2% from the previous month on a seasonally adjusted basis, and by 3.6% over the past 12 months.

With respect to the external accounts, the trade balance continued to show good performance in December, registering a US$662 million surplus up to the second week of the month. Average daily exports reached US$251 million, in comparison to US$238 million for the year. Average daily imports reached US$185 million, 1.9% lower than the figure observed from January to December 15. As a result, the accumulated trade surplus in the year-to-date reached US$11.9 billion, in comparison to the US$1.9 billion in the same period of 2001. Exports reached US$57.6 billion, 2.8% higher than in the same period of 2001, while imports reached US$45.7 billion, 15.6% below the corresponding figure last year.

The current account of the BoP adjusted strongly in 2002, more sharply in the second half, not only due to the performance of the trade balance, but also because of a reduction in net expenditures on services and income.

In summary, the observed growth in the level of activity has been a result of the relatively strong performance of retail activity and the significant expansion of the trade balance. Reflecting these factors, industrial activity has been gradually expanding over the second half of this year. For the upcoming months, it is possible to outline a favorable scenario for the continuity of this expansion. The inventory adjustment observed in the industrial sector, the relatively low level of defaults, the prospect for lower commitments of the 13th wage as a result of the disbursements from the FGTS, and the recovery of expectations are contributing factors in this process.

External Environment

The international scenario continues to point to a fragile recovery of the world economy, with investment expenditures too low to foster an increase in production. The prospect of moderate growth for the world economy remains in place for 2003, supported by consumption, low inflation and loose monetary and fiscal policies. The confirmation of this view is still subject to potential risks in the short run, including the possibility of an armed conflict between the United States and Iraq, which would destabilize the petroleum market, already affected by the political crisis in Venezuela. The financial markets also remain unstable, with the possibility of further declines due to increased risk perceptions or to the frustration of expectations for corporate profits.

In the United States of America, the 4% annualized GDP growth in the third quarter was confirmed, supported mainly by private consumption, which increased by 4.2%. Retail sales increased by 0.4% in November, in comparison to October, and excluding automobiles rose by 0.6%. Industrial and commercial inventories and industrial orders increased in October. The labor market remained depressed, with the unemployment rate reaching 6% in November. On the other hand, the productivity of the non-agricultural sector grew 5.1% in the third quarter, keeping unit labor costs unchanged. As of now, inflation remains under control and the Federal Reserve kept the target for the Fed Funds rate at 1.25% p.a.. Confidence indicators show improved business and consumer expectations in November.

In Japan, revised data show a 3.2% annualized GDP growth in the third quarter, sustained mainly by domestic consumption. Even so, the Bank of Japan recently revised downward the evaluation of the economy for the first time in eleven months, due to external uncertainties and the global deceleration. Export growth has been slowing due to insufficient external demand, mainly on items related to information technology. In October the unemployment rate once again reached 5.5%, repeating the level of December 2001, the highest since the start of the survey in 1953. Annual inflation measured by the IPC was –0.9% in October, while the wholesale price index registered an increase of 0.3%. The Tankan industrial confidence index increased for the third consecutive quarter.

In the countries of the euro area, the economic stagnation continues, unchanged by the announcement of the 0.8% growth of GDP in the third quarter, in comparison to the same period of the previous year. The recessionary scenario is particularly intense in Germany, the most important economy of the region. The 0.5 p.p. reduction of the basic interest rate by the ECB revealed its concern with this scenario, although the annual rate of inflation increased to 2.3% in October, above the ECB's target of 2% since August. Confidence indicators remained without a discernible trend in November. Regarding the business sector, confidence indicators in the euro area and of the main economies of the region registered increases, except in Germany. As for indices of consumer expectations, there were positive results in France and Italy, and drops in Germany and in the other regions' indicators.

Prices

Price indices showed large increases in November, mainly reflecting the effects of the supply shocks - exchange rate depreciation and restriction in the supply of agricultural products - occurring in the second half of 2002. The IPCA increased by 3.02% in November, accumulating a 10.22% increase in the year and a 10.93% increase in 12 months. In the IGP-DI, the effects of these shocks were stronger in wholesale prices, both agricultural and industrial. The monthly increase in the IGP-DI reached 5.84% in November, compared to the 4.21% increase in October, accumulating a 23.09% increase in the year and a 23.31% increase in 12 months.

Products with monitored prices contributed 1.19 percentage points (a 4.29% increase), while products with free prices contributed 1.83 percentage points (a 2.53% increase) to the 3.02% monthly increase of the IPCA. Among the products with monitored prices, increases in airline tickets and fuel prices should be highlighted. The latter encompasses a pass-through of more than 70% of the refinery price adjustment to consumer prices. Among the products with free prices, tradable goods contributed 1.42 percentage points and non-tradable goods contributed 0.42 percentage points.

In the IGP-DI, the IPA-DI rose by 7.45% in November mainly due to the acceleration of the increase in industrial prices, which reached 7.05% in the month compared to 4.96% in October. The increase in agricultural prices, although still high at 8.42%, compared to 8.65% in October, showed signs of deceleration and provided prospects for a reversion in the next months' results. The IPC-BR, the retail price segment of the IGP-DI, rose by 3.14% in the month, compared to 1.14% in October, mainly as a consequence of increases in the prices of food, transport and housing items. The INCC rose by 2.45% in November, compared to a 1.13% rise in October, due mainly to the increase in the prices of construction materials.

In December, inflation may slow down as a result of smaller pressures due to the evolution of the exchange rate and the exhaustion of the process of food price increases. However, the indices may still show relatively high rates of increase. The rise of monitored prices, although on a decelerating trend, may significantly impact the IPCA in the last month of the year, as a consequence of the residue of the readjustments allowed in November, of the increase of urban bus tariffs (in Curitiba, Brasilia, Goiania and Belem) and of the last correction in fuel prices.

Monetary Market and Open Market Operations

On the eve of the Copom meeting in November, the spread between the Over-Selic target and the 1-month interest rate was 192 b.p., in line with the expectation of an increase in the target. On the same date, the spread of the 1-year interest rate was 1045 b.p. After the release of the high inflation indices in November, short-term interest rates increased again, while the 1-year interest rate declined as a consequence of the perception of a lower country risk. At the end of the period, on December 17, the short-term and the1-year spreads stood at 253 b.p. and 717 b.p., respectively.

A total of US$5.9 billion in securities and exchange rate swaps matured from November 20 to December 18. The rollover rate reached 76%, through swap contracts with terms ranging from 2 months to 2 years. The slope of the exchange rate coupon curve declined significantly in the period, although it remains negative. In addition, the curve shifted down across all maturities. This movement was due to increased external funding by financial institutions and to the reduction of uncertainties, allowing significantly lower interest rates in the rollover of exchange rate indexed debt.

In the same period, the National Treasury carried out four auctions that resulted in the sale of R$25.1 billion in LFTs with an average tenure of 210 days. Both the continuous reduction in these securities' discount rates and the high liquidity in the market for bank reserves explain the increasing demand for LFTs observed since October.

Due to the lower demand for IGP-M indexed securities, since the last Copom meeting there was just one 3-year NTN-C auction totaling R$0.7 billion, compared to the total of R$3.8 billion in two auctions in the previous period. In the traditional monthly auction, a total of R$0.9 billion in 5- and 15-year securities was placed.

Banco Central do Brasil intervened in the open market from November 21 and December 17 on a daily basis, in order to withdraw and provide liquidity. The rates were 22.00% and 21.90% respectively, and the average daily volumes were R$60.6 billion and R$3.4 billion, respectively.

Considering the financial settlements from November 21 to December 17, there was an expansionary monetary impact of R$8.0 billion, basically due to net redemptions of R$14.5 billion of LTNs, of R$7.8 billion in FX-indexed securities and of R$3.1 billion in NTN-Cs, partially offset by net placements of R$17.9 billion in LFTs.

In November, the domestic federal securitized debt remained practically stable at R$631.5 billion, compared to R$632.1 billion in October, due to the net redemption of securities totaling R$10.4 billion.

Assessment of Inflation Trends

The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypotheses:

1. The projections for the prices of petroleum by-products assumed the hypothesis that the rise in international petroleum prices and the exchange rate change observed since the last readjustment would be passed through to domestic prices.. In the case of bottled gas, an increase of 2.0% for the final impact on consumer prices was forecast. For gasoline, a 3.8% decrease is projected for the coming year. It is worth emphasizing that these projections were based on the current values of Cide. In December, the House of Representatives approved an authorization for a maximum readjustment of the Cide charged on gasoline to R$0.86 per liter, from R$0.50, and to R$250.00 per ton, from R$136.70, for bottled gas. The basic scenario does not compute these readjustments, whose direct impact on the IPCA would be around 1 p.p..

2. The projections for household electricity tariffs include a 30.3% elevation in 2003. This projection increased by 3.3 p.p. since the last Copom meeting, as a consequence of the revision of the expectations for the IGP-M, an important component in the readjustment criterion for electricity tariffs. For 2002, there was no alteration in relation to the projection released in the Minutes of the Copom meeting of November.

3. For the set of prices administered by contracts and monitored, which has a 27.7% weight in the November IPCA, increases of 15.4% and 13.04% were projected for 2002 and 2003, respectively. In relation to November projections, there was an increase of 2.0 p.p. for 2002 and of 0.9 p.p. for 2003. For 2004, a 7.6% inflation of prices administered by contracts and monitored was projected, assuming that all these items would follow the variation of the IGP-M in that year.

4. The projection for the 6-month spread over the Selic rate, which utilizes an error correction based-model specification, starts at 320 b.p. in the first quarter of 2003, and reaches -120 b.p. at the end of that year.

Core inflation calculated with the exclusion of household food items and administered prices – considering the broadened set of these items and their new definition, which had a 27.7% weight in the November IPCA – registered a 1.17% increase in the month, a significant elevation in comparison to the variations of 0.74% and of 0.61% observed in October and September, respectively. The 12-month accumulated increase in November was 7.35%. Core inflation of the IPC-BR, calculated under the symmetric trimmed-mean method, reached 1.46% in November. In twelve months, this core registered an 8.04% increase.

The 12-month accumulated increase of the IPCA, which showed a declining trend from May to August, registered increases in September (7.93%), October (8.44%) and November (10.93%). In these last twelve months, free market prices contributed 6.70 p.p. to inflation, while prices administered by contracts and monitored contributed 4.23 p.p..

Regarding fiscal policy, it is assumed that the consolidated public sector will achieve the target of a primary surplus of 3.88% of the GDP this year, and of 3.75% for the coming years. The other related assumptions established in the previous meeting were maintained.

From the simulation exercises with several specifications of the structural model, it has been concluded that the maintenance of the interest rate at 22.0% p.a. and of the exchange rate at a level close to the level on the eve of the Copom meeting (R$3.55) indicates an inflation rate significantly above the upper limit of the tolerance interval in 2003.

Monetary Policy Guidelines

Economic activity shows signs of recovery, with industrial activity showing moderate growth and the retail sector stabilizing at a higher level than usual at the beginning of the year. The maintenance of consumption is mainly due to several conjunctural factors, such as disbursements from the FGTS, the payment of the 13th wage and the improvement of expectations for the future. Industrial production, which increased for the fifth consecutive month in October, is being supported by exports and the mineral extraction industry.

The remaining disbursements from the FGTS in 2003 will support consumption growth next year. It is worth noting that the disbursements from the FGTS impact aggregate demand. These disbursements produce a reallocation of expenditure to the population with lower purchasing power and, consequently, greater willingness to consume, especially on lower value items.

The exchange rate remained more stable in the period between the Copom meetings of November and December, but at a depreciated level, which has been helping the rapid adjustment in the balance of payments. Also, there was an improvement in the capital account, with growth in net foreign investment, external funding and commercial financing lines. There was also an improvement in risk perceptions, as suggested by the decline in the domestic interest rate (e.g. FX Coupon) and in the EMBI+ spread.

However, inflation rates increased significantly in November. The monthly inflation rate measured by the IPCA reached 3.02% in November, higher than in October (1.31%), September (0.72%), and the forecast at the November Copom. Core IPCA inflation, calculated with the symmetric trimmed-mean method, increased to 1.32% in November from 0.78% in September and October. In 12 months to November, this measure of core inflation registered an increase of 8.21%.

Inflation expectations for 2003 surveyed by the Banco Central do Brasil's Investor Relations Group (Gerin) increased in the period between the last two Copom meetings, to 11.0% in December from 9.8% in November. Since September, the median of inflation expectations doubled. In the Copom's view, the factors that could have driven the market to significantly increase inflation expectations for 2003 include: i) the view that there are some economic sectors with repressed exchange rate pass-through, which could lead to pressure on free price inflation in 2003; ii) uncertainties regarding the future conduct of monetary policy; iii) inflation inertia associated with the high inflation registered in the last quarter of 2002.

The Copom's inflation forecast for 2003 was also adjusted upward, as a consequence of the inertial effects of the high inflation in the last quarter of 2002, the deterioration of inflation expectations, and the impacts of exchange rate depreciation on administered prices in 2002.

The Copom considered an alternative scenario in which inflation expectations for 2003 and the exchange rate decline faster. This scenario is based on the recovery of confidence in the Brazilian economy and also on the fact that inflation in the last quarter of 2002 had a strong temporary component. The agricultural off-season, higher prices for some international commodities and preventive price increases are temporary factors that are unlikely to pressure inflation again in the coming months. There are signs, albeit still incipient, such as the Fipe four-week index and the survey of food prices, which show a decline in the speed of price readjustments in the first weeks of December. Moreover, based on the historical average of exchange rate pass-through in Brazil, and the level of inflation in October and November, there is no evidence of restrained exchange rate pass-through still to be realized.

Nevertheless, in a scenario of deteriorating expectations, rising inflation, and a recovery of economic activity, the probability of price readjustments increases, making the convergence of expectations to a level more consistent with the inflation targets more difficult.

With this in mind, the Copom believes that an increase in interest rates may inhibit price readjustments, help to coordinate expectations and hinder the deterioration of self-fulfilling inflation expectations. This decision to increase the interest rate will allow the reduction of inflation expectations for 2003.

As a result, the Copom decided, unanimously, to increase the target for the Selic rate to 25% p.a.

At the close of the meeting, it was announced that the Committee would meet again on January 21, 2003, for technical presentations and, on the following day, in order to discuss the monetary policy guidelines, as set in Communiqué 10187, of October 2, 2002.

Acronyms

ac 12m accumulated in 12 months
ACC Anticipated Exchange Rate Contracts
ACSP São Paulo Trade Association
BM&F Mercantile and Futures Exchange
bp basis points
CDI Interbank Futures Contract
CETIP Center for Financial Custody and Settlement of Private Securities
Cide Contribution on Intervention on the Economic Domain
CNI National Confederation of Industries
CPMF Provisory Contribution on Financial Transactions
CSLL Social Contribution on Net Profit
DI Interbank Deposit
ECB European Central Bank
Fecomércio São Paulo State's Federation of Commerce
Fenabrave National Federation of Auto Distributors
FED Federal Reserve System

FGTS Time in Service Guarantee Fund

FOMC Federal Open Market Committee

FRA Forward Rate Agreement

GDP Gross Domestic Product

IBGE Brazilian Institute of Geography and Statistics

IF Financial Institution

IGP-DI General Price Index – Domestic Supply

IIC Consumer Intentions Index

INCC National Index of Civil Construction

IPA Wholesale Price Index

IPA-DI Wholesale Price Index – Domestic Supply

IPC Consumer Price Index

IPC-BR Consumer Price Index - Brazil

IPCA Consumer Price Index – Extended

IPCH Consumer Price Index – Harmonized

IPP Producer Price Index

IR Income Tax

IRF-M Market Fixed Income Index

IRRF Withholding Income Tax

LFT National Treasury Letters (floating)

LFT-B National Treasury Letters - B series (selic rate)

LTN National Treasury Letters (fixed rate)

NAPM National Association of Purchasing Managers

NBCE Central Bank Note - E Series (exchange rate variation)

NTN-C National Treasury Note - C Series (price index)

NTN-D National Treasury Note – D Series (exchange rate)

p.a. per annum

PEA Economically Active Population

PIM Monthly Industrial Survey

p.m. per month

pp percentage point

Selic Central Bank's Custody and Settlement Center

SPC Credit Protection Service

STN National Treasury Secretariat

ytd year-to-date

