



# BANCO CENTRAL DO BRASIL

## Minutes of the 97<sup>th</sup> Meeting of the Monetary Policy Committee (Copom)

**Date:** June 15<sup>th</sup>, from 4:45PM to 7:00PM, and June 16<sup>th</sup>, from 3:30PM to 6:15PM

**Place:** BCB's Headquarters meeting room of the 8<sup>th</sup> floor (on June 15<sup>th</sup>) and 20<sup>th</sup> floor (on June 16<sup>th</sup>) – Brasília – DF

### In attendance:

#### Members of the Committee

Henrique de Campos Meirelles – Governor  
Afonso Sant'Anna Bevilacqua  
Alexandre Schwartzman  
Antônio Gustavo Matos do Vale  
Eduardo Henrique de Mello Motta Loyo  
João Antônio Fleury Teixeira  
Luiz Augusto de Oliveira Candiota  
Paulo Sérgio Cavalheiro  
Sérgio Darcy da Silva Alves

#### Department Heads (present on June 15<sup>th</sup>)

Altamir Lopes – Economic Department  
Daso Maranhão Coimbra – International Reserves Operations Department  
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group  
Luiz Fernando Cardoso Maciel – Department of Banking Operations and Payments System  
Marcelo Kfoury Muinhos – Research Department (also present on June 16<sup>th</sup>)  
Sérgio Goldenstein – Open Market Operations Department

#### Other participants (present on June 15<sup>th</sup>)

Alexandre Pundek Rocha – Advisor to the Board  
Flávio Pinheiro de Melo - Advisor to the Board  
Hélio José Ferreira – Executive Secretary  
João Batista do Nascimento Magalhães – Special Advisor to the Governor  
Jocimar Nastari – Press Secretary  
Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

### Recent Evolution of Inflation

1. In May, the main inflation indicators increased, mainly due to specific pressures on fresh food prices, harshly affected by climate adversities. The Broad National Consumer Price Index (IPCA) rose 0.51%, compared to a 0.37% increase in April, accumulating a 2.75% change in the year up to May. The IPCA change in the last twelve months stood at 5.15%, the lowest variation since the adoption of the inflation-targeting regime in 1999.
2. The General Price Index (IGP-DI) rose by 1.46% in May, compared to 1.15% in April, totaling a 5.54% change in the first five months of 2004. The IGP-DI acceleration was due not only to wholesale-prices inflation (1.71%), but also to stronger pressures from consumer prices (0.71%) and construction industry costs (1.83%). The variation of the IGP-DI and of the Wholesale Price Index (IPA-DI) in the last twelve months to May stood at 7.97% and 8.76%, respectively.



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3. In May, the IPCA upsurge primarily reflected the turnaround in food prices, which increased 0.23% from a negative 0.34% in April. Climate adversities and the milk inter-harvest period explain this shift. Food-prices inflation was not generalized, as important products (manioc flour, meat, bean, rice, eggs, chicken, fish and soy oil) registered price falls.
4. For the second consecutive month, medicine was the main individual contributor to the IPCA inflation (0.10 p.p.), reflecting the readjustments authorized by the sector's Regulation Chamber. Energy and vehicles contributed each with 0.06 p.p., while pasteurized milk and clothes contributed with 0.05 p.p. each. Together, these five items accounted for 0.32 p.p. of the 0.51% IPCA change.
5. Market prices increased 0.57%, compared to 0.39% in April. Excluding food, these prices increased 0.74% as against 0.75% in April. Regulated prices rose by 0.35% (0.32% in April), impacted by the increase in energy prices in six State capitals and in fuel-alcohol prices, which recovered from a sharp reduction from January to April. Market prices accounted for 0.41 p.p. of the monthly IPCA, while regulated prices contributed with the residual 0.10 p.p.
6. The IPA-DI registered a 1.71% variation in May, from 1.57% in April. The accelerating trend resulted from the increase in the agriculture IPA, which rose to 2.71% in the month, compared to 0.8% in April, mainly influenced by the prices of fresh food products, meat and chicken. The industrial IPA decreased to 1.32%, compared to 1.86% in April.
7. Core inflation measures remained relatively stable in May, compared to April. The IPCA core inflation calculated by excluding household food items and regulated prices posted a 0.70% change (0.72% in April), accumulating 7.15% in the last twelve months. When calculated under the smoothed trimmed-mean method, the core increased to 0.59% (0.57% in April), totaling 8.46% in twelve months. Without the smoothing procedure for pre-selected items, the IPCA core recorded 0.43% in the month and 5.46% in twelve months, compared to 0.45% and 5.68%, respectively, in April.
8. The IPC-Br core inflation measure, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed-mean method, stood at 0.57% in May, accumulating 6.64% in 12 months.
9. In June, inflation should be influenced by the increase in the prices of gasoline (the readjustment to consumers, effective since June 15th, is expected to average 4.5%) and of fuel-alcohol, still recovering from the significant price decrease that took place from February to April. Food prices are also expected to continue affecting inflation, especially meat and dairy products, due to the beginning of the inter-harvest period. As to the wholesale, besides the agricultural price pressures, some deceleration in the industrial price variation is expected, apart from fuel.

### Assessment of Inflation Trends

10. The identified shocks and their impacts were reassessed according to new available information. The scenario considered in the simulations assumes the following hypotheses:
  - a. The projections for the evolution of gasoline and bottled cooking gas prices in 2004 were maintained at 9.5% and 6.9%, respectively;
  - b. The projections for household electricity prices were maintained at 11% for 2004. Yet, for fixed telephone prices, the Copom revised the adjustment estimate to 6.1% for the year, 0.6 p.p. lower than in the previous meeting;
  - c. Regarding all regulated prices, with a total weight of 28.6% in the May IPCA, a 7.7% rise is projected, the same as in the previous meeting;



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- d. The projection for the readjustment of all regulated prices for 2005, following the model of endogenous determination, which takes into account seasonal components, the exchange rate, market prices inflation and the IGP-DI change, was maintained at 6.0%;
  - e. The projection for the 6-month spread over the Selic rate, following the specification of a Vector Autoregressive model based on the Selic and the swap rates on the eve of the Copom meeting, increases from 39 basis points in the second quarter of 2004 to 60 basis points in the fourth quarter of 2005.
11. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of the GDP for 2004 and the following two years will be achieved. The related assumptions considered in the previous meeting were maintained.
12. Considering the benchmark scenario hypotheses, including the maintenance of the Over-Selic rate at 16.0% p.a. and the exchange rate at the level observed on the eve of the Copom meeting (R\$3.10), the IPCA inflation was projected above the 5.5% target for 2004 and below the 4.5% target for 2005. According to the market scenario, which takes into account the consensus exchange rate and Over-Selic rate as surveyed by the BCB's Investor Relations Group (Gerin) on the eve of the Copom meeting, inflation is projected above the central targets for both 2004 and 2005.

### Monetary Policy Decision

13. In May, the IPCA inflation edged up in comparison to April but it did not deviate from market consensus. Similar to previous months, the strongest pressure stemmed from market prices. For the second consecutive month, tradable prices presented a higher increase than non-tradable prices. An unusual feature was the unfavorable trend in food prices. Other national consumer-price indices also edged up in May, like the IPC-DI (up 0.71% from 0.31% in April). Wholesale inflation also increased but, contrary to previous months, the main pressure stemmed from agriculture prices, while industrial prices changes decelerated. The pass-through of wholesale prices to consumer prices remains below usual. Wholesale-industrial prices should continue to decelerate due to the recent trend of commodity prices. Agriculture prices, however, represent an important source of pressure over inflation in the short run, larger than the seasonal pattern at this time of the year.
14. In May, IPCA core measures remained relatively stable compared to April. Core inflation calculated under the trimmed-mean method, with and without the smoothing procedure of pre-selected items, rose by 0.59% and 0.43%, respectively. Core inflation excluding food items and regulated prices stood at 0.70%. In the year to May, the cores calculated under the trimmed-mean methods continued close to the headline inflation (with and without smoothing changed 3.19% and 2.46%, respectively), differently from the core by exclusion, which rose by 3.97%.
15. Recent economic activity indicators confirm, undoubtedly, the continuity of the economic rebound process initiated in the second quarter of 2003. The recovery trend was corroborated by the GDP figures for the first quarter of 2004. Real GDP grew 1.6% quarter-on-quarter, seasonally adjusted. In comparison with the same quarter of 2003, real GDP rose by 2.7%. In order to achieve the 3.5% estimated growth rate for the year, it is necessary for the GDP to grow on average 0.5% per quarter during the next three quarters. In an extremely unrealistic scenario in which the seasonally adjusted GDP remains flat in the next three quarters, the 2004 GDP would grow 2.8%.
16. The industrial production levels of March were maintained in April, while growth prospects remained favorable. Industrial production grew 0.1% month-on-month in April, seasonally adjusted, accumulating a 6.1% growth in the year, compared to the same period of 2003. Capital goods (up 21.4%) and durable consumer goods (up 21.1%) are the categories leading the industrial growth



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cycle. According to CNI data, seasonally adjusted by the BCB, real industrial sales grew 3.7% month-on-month in April, confirming the growth trend initiated in the second half of 2003.

17. In April, retail sales sustained the growth pace, reaching the highest levels since the IBGE initiated the retail survey in January 2000. Sales grew 1.8% compared to March, adding to a 5.4% increase in the November-April period compared to the previous six months. Consumer confidence measured by the *Federação do Comércio do Estado de São Paulo (Fecomercio SP)* fell in June, but the average index for the first semester is still 6.8% higher than the level registered in the same period of the previous year. Credit operations continued to expand for both individuals and companies, despite the fall of non-earmarked credit concessions in May. Several other coincident and leading indicators reinforce the perception of a continued economic recovery, such as packaging paper shipments, which grew 8.4% in the first five months of the year compared to the same period of 2003.
18. Even though the exports have been playing an important role to economic activity rebound, as a consequence of the significant adjustment of the external accounts, domestic demand has been increasing its relative importance to the sustained economic growth. This importance tends to broaden as the recovery of employment and real payroll lead to higher consumption. In April, employment in the manufacturing sector increased, while real payroll registered a slight decrease, although it kept in an upward trend. There are three reasons why employment growth has not yet reduced the unemployment rate. Firstly, this period of the year is usually characterized by a seasonal increase in the unemployment rate, independently on the economic cycle. Secondly, the recovery process has stimulated workers to search for jobs, even those who had not been searching for occupation for some time. As a consequence, labor force increases causing the unemployment rate to rise. Lastly, the unemployment rate is calculated in the largest urban areas, where employment growth has been not as strong as in medium and small urban areas, as well as in the rural areas. According to the Ministry of Labor and Employment, the level of formal employment in the first four months of the year increased 3.2% in the metropolitan regions and 3.8% out of those regions, both compared to the same period of 2003.
19. Brazilian external accounts have continued to register expressive positive results. Despite the increase in imports, the trade balance posted a US\$3.1 billion surplus in May, a historical record. The BCB's revised upwards its trade balance estimate for the year to US\$ 26 billion from US\$24 billion. The current account balance has remained positive, accumulating a US\$2.4 billion surplus in the year up to May, close to the estimated surplus for the whole year.
20. The external scenario has somewhat stabilized since the last Copom meeting, even though the high volatility environment has persisted. Although tension in the oil market has lessened, there are still uncertainties regarding the expected path of the fed funds rate in the U.S. The exchange rate has remained slightly above R\$3.10/US\$, and its 21-day volatility reached the highest level since May 2003. The country risk measured by the JP Morgan Chase's Embi+ decreased from 728 b.p. in the period immediately before the last Copom meeting to 670 b.p. on the eve of this meeting.
21. Since the last Copom meeting, oil prices have fallen approximately 11%, following the OPEC decision to increase output. The 10.8% wholesale readjustment in gasoline prices announced by Petrobrás on June 15 stood close to the figures expected by the Committee, and partially closed the gap between internal and external prices.
22. Market inflation expectations deserved special attention by the members of the Copom. The deterioration observed since the last meeting was not limited to 2004 IPCA expectations (the median rose to 6.71% from 6.22%), but also affected longer-terms expectations: for the next twelve months, the median projection increased to 6.03% from 5.67%, while for 2005, the median, that was anchored around 5%, moved up to 5.44%. In a scenario of temporary shocks affecting the inflation path, it would be more reasonable to observe a sharper deterioration in inflation expectations in shorter horizons, when the first order effects are concentrated and monetary policy



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effectiveness is limited. The Committee members share the conviction that the magnitude of the deterioration observed for longer horizons is not compatible with the view that, in the presence of eventual supply shocks of a more permanent nature, the monetary policy will not accommodate its secondary effects. Such deterioration is also not compatible with the inflation forecasts produced by the different models used by the Copom, even if these projections take into account particularly unfavorable scenarios to the evolution of the main determinants of the recent shocks.

23. Since the meeting in April, the Copom has assessed inflation prospects based on the assumption of a low degree of persistence of the first quarter inflation, as observed in previous years when there was a seasonal relief in market prices inflation in the second and third quarters. Considering the inflation in April and May, and the non-usual increase of market-prices inflation in May, the Copom assessed with greater emphasis the inflation projections made without the assumption of low persistence. Inflation projections in the benchmark scenario, based on an unchanged Over-Selic rate at 16.0% and the exchange rate at R\$3.10/US\$ throughout the projection horizon, point out to an inflation rate above the target of 5.5% for 2004 and below the target of 4.5% for 2005. In the market scenario, which takes into account the exchange rate and Over-Selic rate expected by the market on the eve of the Copom meeting, inflation projections remain above the targets for 2004 and 2005. Compared to May, there was a slight increase in the projections for 2004 in both scenarios, basically caused by the higher inflation expectations for 2004 and 2005.
24. As in the previous meeting, the Copom also considered the inflation projections for the next 12 months, corresponding to the second half of 2004 and the first half of 2005. This is a period when inflation outcomes will be more sensitive to monetary decisions taken in the next few months, and at the same time, it presents more reliable inflation projections than the ones already available for 2005. Projected inflation for this 12-month period, on both the benchmark and market scenarios, remains within the central targets established by the National Monetary Council for 2004 and 2005.
25. In an inflation-targeting regime, the Central Bank policy-making process is based on the assessment of different scenarios for the most important variables affecting inflation dynamics. The current uncertainties concerning the external scenario have been responsible for a short-term volatility that tends to increase inflation uncertainty. As a consequence, the coordination of private agent's inflation expectations became more difficult. The inflation rate increase in the short-term, caused by either seasonal factors or financial assets prices volatility, should not contaminate private expectations for longer periods. Like in the previous meeting, the Committee assessed that the macroeconomics perspectives for the medium-term are still favorable. In the short-term, however, inflation expectations have become a relatively more important risk factor than in the last month.
26. Even considering less favorable scenarios, the Copom is still optimistic about the achievement of economic growth with price stability. Considering the hypothesis that important external variables continue under pressure for a longer period, the flexibility of the inflation-targeting regime could judiciously absorb the primary shocks associated with this pressure. However, it would be paramount for monetary policy to fight the second order effects of these shocks. In this case, economic activity could benefit from the progressive recovery of real earnings, which depends on a price stability environment in the medium-term.
27. As a result, the Committee decided, unanimously, to maintain the target for the Over-Selic rate at 16.0% p.a., without bias.
28. At the closing of the meeting, it was announced that the Copom would meet again on July 21, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in Communiqué 11,516, of October 15, 2003.



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### **SUMMARY OF DATA ANALYZED BY THE COPOM**

#### **Economic Activity**

29. Retail sales continued to expand in April, according to the IBGE's retail survey. Sales and nominal revenues increased 9.9% and 9.2%, respectively, in comparison to April 2003. In the year up to April, sales and nominal revenues rose 8.0% and 9.6%, respectively.
30. The São Paulo Trade Association (ACSP) data for May registered a 0.5% reduction of consultations related to credit sales, while the Usecheque system consultations increased 2.2%, compared to the previous month (seasonally adjusted). In the year up to May, the same indicators increased 7.0% and 1.0%, respectively.
31. The Fecomercio-SP monthly survey indicated a decrease in the Consumer Confidence Index (ICC) in June, after a sharp increase in the previous month. In June, the ICC declined 9.1% month-on-month, standing at 113.1 points (range 0 to 200). This performance was a result of a decrease of 18% and 5% in current and future conditions, respectively. Despite the fall, the ICC still reveals consumers' optimism.
32. In the first quarter of 2004, capital goods and construction inputs production increased 21.5% and 1.6%, respectively, compared to the same period of 2003. Domestic absorption of capital goods increased 9.3% in the same period, despite the 50.5% exports increase, led by agricultural machinery. BNDES credit operations increased 59% from January to May, in comparison to the same period of 2003.
33. The IBGE's monthly industrial survey registered a 0.1% increase in industrial output in April, compared to March, seasonally adjusted, with increases of 1.0% and 0.3% in mining and in the manufacturing industry, respectively. Out of the 23 sectors surveyed, 13 registered increased output. In the first four months of the year, industrial output increased 6.1%, compared to the same period of 2003. Semi and non-durable goods production started to recover, albeit still modestly, in tandem with the gradual improvement of labor market conditions.
34. In April, the National Industry Confederation (CNI) recorded a 3.7% increase in real sales and a 1.9% increase in worked hours, in comparison to March, seasonally adjusted. Compared to the first four months of 2003, real sales and worked hours increased 13.6% and 2.8%, respectively. The level of capacity utilization declined 0.1% month-on-month in April, but increased 1.3% in the year up to April, compared to the same period of 2003.
35. The car industry produced 177,000 vehicles in May, up 3.9% compared to April and 7.7% above May 2003, seasonally adjusted. In the year up to May, output increased 12.1%, and domestic sales and exports expanded 18.7% and 4.2%, respectively, compared to the same period of the previous year.

#### **Labor Market**

36. The formal employment index increased 0.4% month-on-month in April (seasonally adjusted), and 3.9% year-on-year, according to the Ministry of Labor and Employment. In 2004, there has been an expansion of 2.3% in formal employment, compared to December 2003. The data indicate that hiring has increased at a higher pace outside large urban areas, where employment increased 2.7% in the year up to April, whereas in the main metropolitan areas the growth rate stood at 1.9%.
37. The unemployment rate measured by IBGE in 6 metropolitan areas increased to 13.1% in April, despite the 0.7% increase in the number of employed workers. In April, the labor force rose 1%,



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and the number of unemployed increased 3.2%. Also in April, IBGE recorded a 0.7% fall in average real earnings, compared to March.

38. According to CNI seasonally adjusted data, employed workers and real payroll in the industrial sector remained stable in April, compared to the previous month. For the January-April period, real payroll and employed workers increased 7.1% and 0.4%, respectively, compared to the same period of 2003.

### Credit and Delinquency Rates

39. Non-earmarked credit operations grew 3.6% in May. Corporate credit with external and domestic funding increased 2.3% and 7.6%, respectively, while individuals credit outstanding increased 2.5% in May.
40. The average interest rate on non-earmarked credit registered a decrease of 0.5 p.p. in May, reaching 44.2% p.a. The result was due to a decline of 0.9 p.p. in the average lending rates to individuals, to 62.4% p.a., while the average rate to companies presented a slight increase of 0.1p.p. to 30.0% p.a. The decrease in the average interest rate to individuals reflected mainly an increase of credit operations with payroll-deducted repayments.
41. Regarding delinquency in the retail sector, there was an increase of 11.6% in the number of cancelled files and stability in the number of new registers in May, compared to the previous month. As a consequence, the net default rate, measured by ACSP, decreased to 5.1% in May from 6.4% in April. The average default rate in the first 5 months of the year stood at 6.0%, 0.5 p.p. lower than the level observed in the same period of 2003.

### External Environment

42. World economic growth has continued to gain momentum, despite the geopolitical risks. In Japan, GDP growth was revised upwards in the last two quarters. Meanwhile, other indicators have been confirming the economic rebound, mainly boosted by the vigorous regional trade. In the U.S., the latest economic indicators have ratified economic expansion, particularly those related to the labor market. Recovery in Europe, however, has persisted sluggish.
43. Inflation concerns increased worldwide. The Bank of England has raised its basic interest rate by 0.25 p.p. for the second consecutive month, to 4.5% p.a. In the U.S., prices have been rising under control, reflecting mainly the impacts of energy prices. In China, the consumer price index increased again in May to 4.4% compared to the same month of 2003; authorities seem more worried about the effects of the vigorous economic growth over the price level.
44. Market volatility has decreased in the latest few weeks. However, adjustments in financial prices continue, anticipating the effects of the expected rise in the US fed funds and the measures adopted by the Chinese government to reduce the country growth pace. Markets have stabilized in emerging economies, giving way to a slight recovery of the stock markets and an appreciation of the currencies against the U.S. dollar. The dollar has continued to appreciate against strong currencies, in spite of the fiscal and trade deficits experienced by the U.S. economy.
45. Commodities prices fell in May, but the upward trend prevailing until the end of March has kept prices above their historical average. Oil price pressures continued up to the beginning of June, mainly as a result of political tensions in the Middle East and of high global demand. In order to+ help preventing prices from moving upwards, OPEC decided to increase production from July 1<sup>st</sup> by 2 million barrels/day, which may be supplemented by other 500 thousand barrels/day from August on.



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### **Foreign Trade and Balance of Payments**

46. The Brazilian trade balance posted a US\$3.1 billion surplus in May, when the total external trade reached US\$12.8 billion. Exports and imports increased 24.6% and 25.1%, respectively, compared to the May 2003 daily averages. In the first two weeks of June (8 working days), the trade surplus totaled US\$1.3 billion, with exports and imports increasing by 44.9% and 48.6%, respectively, compared to the average figures of June 2003.
47. In May, the current account registered a US\$1.4 billion surplus, accumulating a US\$2.4 billion surplus in the year. In the period, the trade balance posted a US\$11.2 billion surplus while the services and income account presented a US\$10.2 billion deficit. Net FDI inflows reached US\$207 million in May, accumulating US\$3.3 billion in the year, equivalent to the amount registered in the same period of last year. At the end of May, international reserves reached US\$50.5 billion, while net reserves stood at US\$22.2 billion (IMF concept).

### **Money Market and Open Market Operations**

48. Over the past weeks, there has been high volatility in the yield curves. From the last Copom meeting, the 3-month and 6-month rates have increased 0.21 p.p. and 0.11 p.p. respectively, influenced by the revision of inflation expectations. On the other hand, the 1-year and 2-year rates have decreased 0.16 p.p. and 0.62 p.p. respectively.
49. For the first time in the year, the BCB carried out an auction to rollover dollar-linked securities and swaps, maturing on June 17. In this event, US\$326.6 million in swaps were contracted (33.2% of principal coming due), with tenures of 7 and 19 months. Including interests, the net redemption of these instruments in the year up to June amounted to US\$18.4 billion.
50. Due to market volatility, the National Treasury did not carry out any selling auction of LTNs in the period. However, simultaneous buying and selling auctions were carried out on May 20 and 21, aiming at giving liquidity to these securities when prices presented more volatility. Three LFTs auctions were carried out totaling R\$9.9 billion, maturing in 2005, 2006, and 2007. The issuance of National Treasury Notes – Series B and C (NTN-Bs and NTN-Cs) amounted to R\$ 2.4 billion, R\$1.4 billion of which settled in exchange for other National Treasury's securities.
51. The BCB maintained in its open market operations the weekly post-fixed repo operations (2-week tenure) and the fixed repo operations (3-month tenure), as well as the 2-working-day liquidity management operations. The BCB also carried out in this period 13 fixed rate repos falling due between 1 and 4 working days. Due to the net redemption of securities, the excess liquidity drained from the market with operations shorter than 30 days and with 3-month tenure averaged R\$59.4 billion and R\$23.5 billion, respectively.
52. In May, the net securitized domestic public debt decreased R\$19.3 billion due to the net redemption of R\$31.1 billion of LFTs. The dollar-linked share increased 0.3 p.p. to 16.6%, as a result of the exchange rate depreciation and the net redemption of R\$11 billion in Fx securities and swaps.