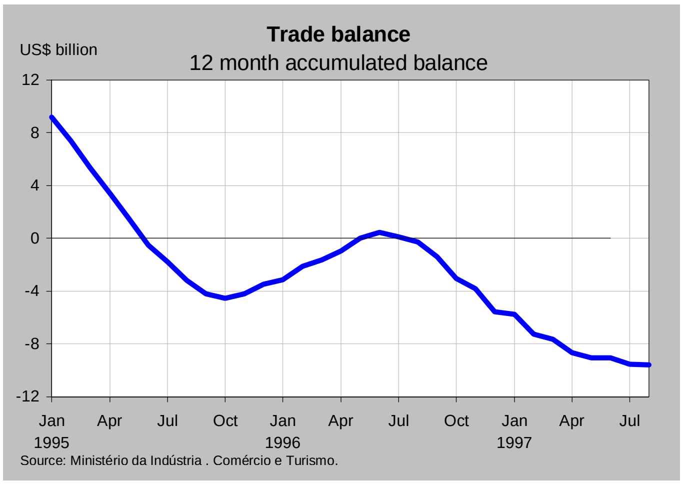
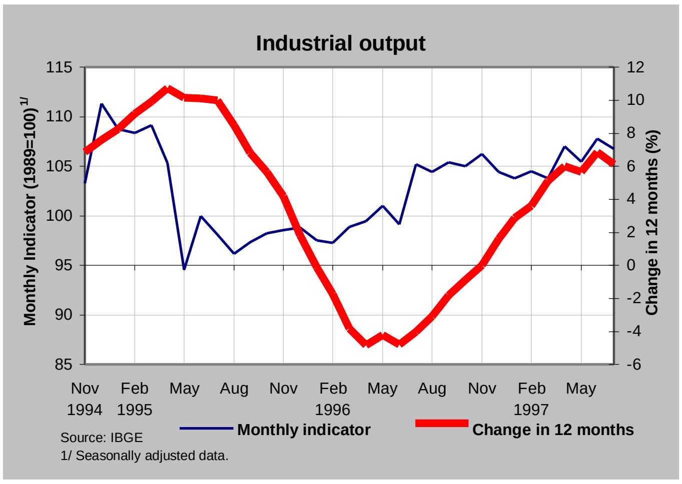
# Monetary programming for the fourth quarter of 1997

## A. The economy in the third quarter of 1997

1. Following a decline of 0.7% in the first quarter of the year, Gross Domestic Product (GDP) expanded by 3.3% in the second quarter in the seasonally adjusted series. When one considers the average of the last four quarters —corresponding to the third year of the Real Plan—GDP growth closed at 5.1%, with expansion of 7.3% in industry, 5.8% in crop and livestock farming and 3.1% under services.

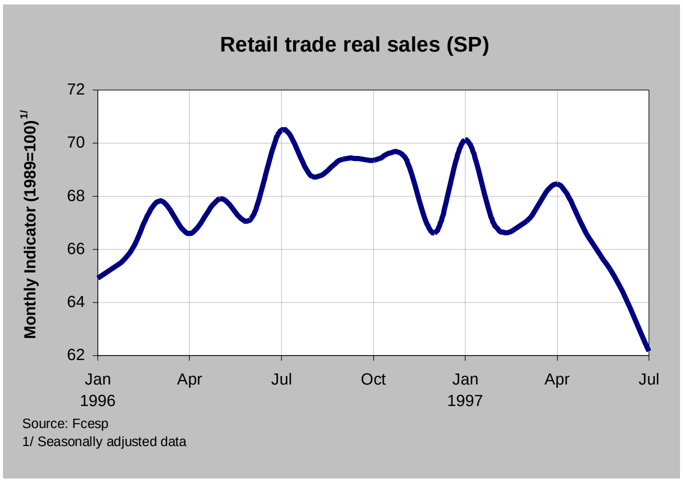



2. Seasonally adjusted industrial production was stable in July, when compared to the second quarter average. The latter period had registered an increase of 3% in comparison to the immediately previous quarter. In the first seven months of 1997, industry expanded by 5.2% led by production of durable consumer goods and intermediate goods.

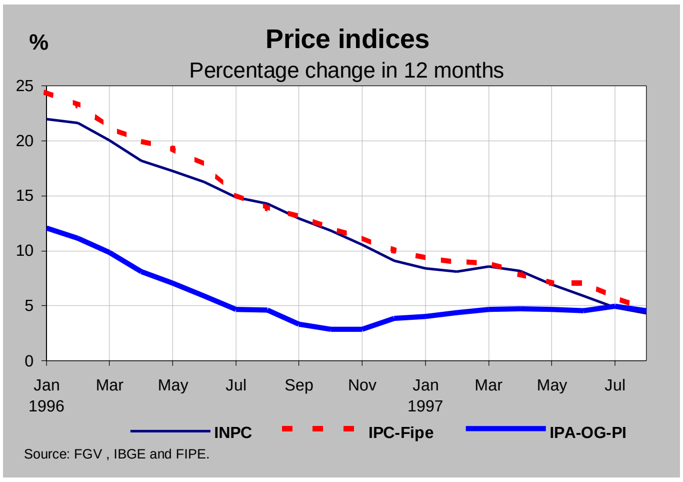



3. In terms of real billings, the retail trade sector of the Metropolitan Region of São Paulo turned in a performance that was precisely the opposite of July industrial output, with a drop of 6.6% in relation to the second quarter average. For the year as a whole, the drop in billings came

to 1.4%, with a 9.1% slide under durable goods.

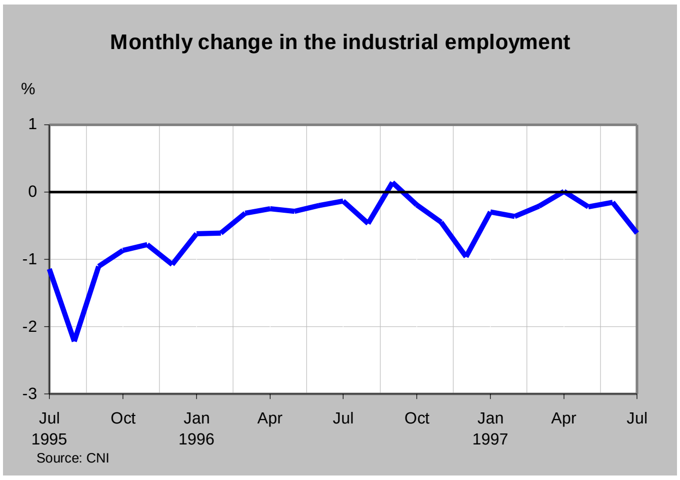



4. In July and August, price indices continued downward in terms of annualized results. In the 12 month period ended in August, the INPC and IPC-Fipe accumulated levels of 4.3% and 4.6%, respectively, as compared to 5.9% and 7.1% up to June. The annual growth rate under wholesale industrial prices remained stable, with the IPA-OG-industrial products closing at 4.6% in both June and August. The price index results pointed to even greater convergence between the prices of tradables and nontradables.

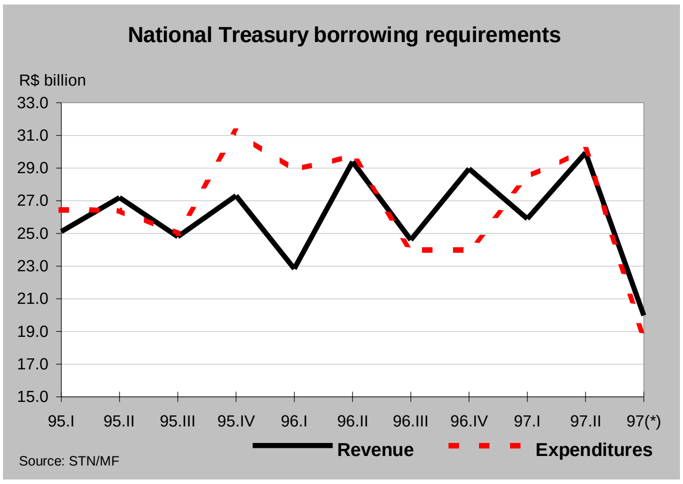



5. Industrial production recovery has not been accompanied by job growth, indicating that the industrial sector is still immersed in a wide-ranging adjustment program aimed at achieving a more solid position on the international market. In this framework, the level of Brazilian industrial employment in July was 1.8% below that of December 1996, according to data released by the

National Confederation of Industry. Ministry of Labor data on formal employment indicate growth of 1.1% up to June, led by the construction industry with 2.3% employment expansion.

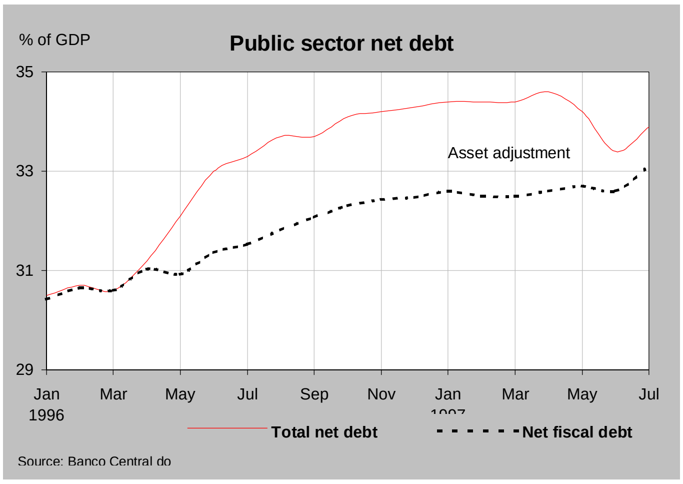



6. National Treasury budget operations closed with an August surplus of R$ 1.2 billion, based on the difference between revenues of R$ 10.1 billion and expenditures of R$ 8.9 billion. Accumulated revenues in the period totaled R$ 75.8 billion, while outlays added up to R$ 77.2 billion, for a final deficit of R$ 1.4 billion. With respect to the January-August/96 period, revenues closed with 9.8% nominal growth, while expenditures expanded by 3.8%. Here, one should stress that Treasury revenues in the current year encompass R$ 4.3 billion in CPMF inflow, for which there was no corresponding heading last year, aside from R$ 1.5 billion generated by telecommunications service concessions.



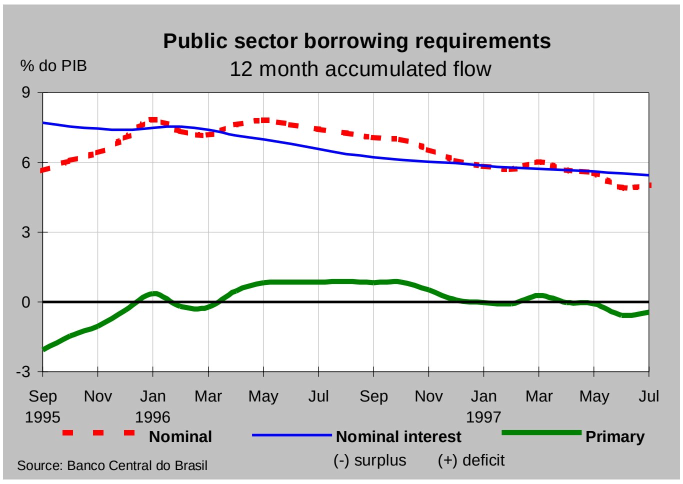

7. The consolidated net public sector debt, which includes the indebtedness of the federal government and Banco Central, states and municipalities and state enterprises, totaled R$282.2 billion in July, equivalent to 33.9% of GDP, or less than the final 1996 position. In June, the net debt trajectory registered a curve deviation generated by inclusion of the resources granted to the private sector by the north, northeast and central-west constitutionally mandated financing funds. Net assets of these operations reached R$ 6.3 billion. In July, the net fiscal debt — net public sector debt less asset adjustment — came to R$

276 billion (33.1% of GDP).



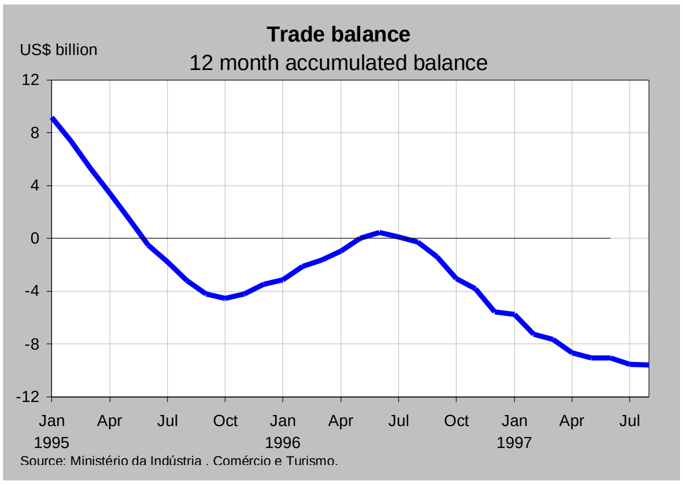

8. Public sector borrowing requirements (NFSP) continued on a downward trajectory, as the nominal deficit came to 5.02% of GDP in the accumulated flow for the 12 month period ended in July, as compared to 7.42% in the same period of the previous year. This result was generated by growth in the primary surplus to 0.43% of GDP in the accumulated 12 month total up to July, as compared to a deficit of 0.84% in the same 1996 period, and by a drop in nominal interest outlays from 6.58% of GDP to 5.46%.

9. Physical exports in the July-August period totaled US$ 10.3 billion, while imports came to US$ 11.4 billion in the same period, generating a negative trade balance result of US$ 1.1 billion. Considering the trade balance performance from January to August, exports closed at US$ 35.1 billion and imports totaled US$ 40.1 billion. These two figures were 10.6% and 22.6% higher than in the same period of the previous year, respectively. In the first eight months of the year, the trade balance deficit reached a mark of US$ 5 billion.

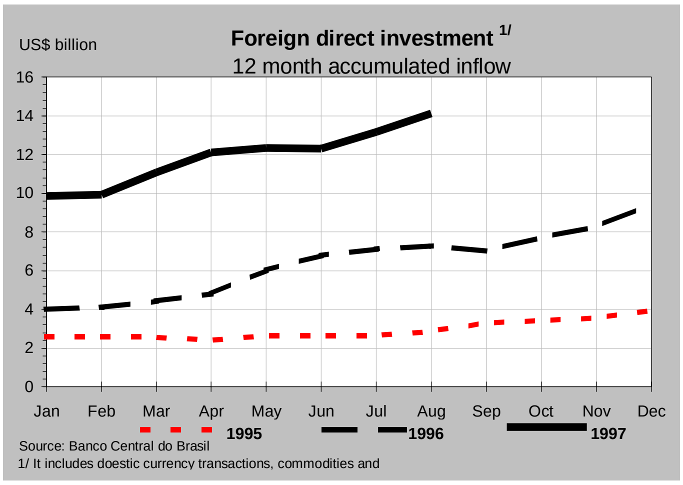



10. The current account balance registered an accumulated deficit of US$ 19.9 billion in the first eight months of the year, corresponding to 3.9% of GDP. Aside from the negative trade balan-

ce result, some items in the area of services contributed importantly to this result, such as net interest payments (US$ 5.8 billion), net profit and dividend remittances (US$ 3.5 billion), net outlays on international travel (US$ 2.9 billion) and transportation (US$ 2.8 billion). Up to August, 51.2% of the current account deficit was financed by net inflows of direct foreign investment. Net inflows of these resources in the period totaled US$ 10.2 billion, while the investment inflow to the capital market closed at US$ 7.9 billion. Net inflows of medium and long-term loans totaled US$ 22.4 billion between January and August.



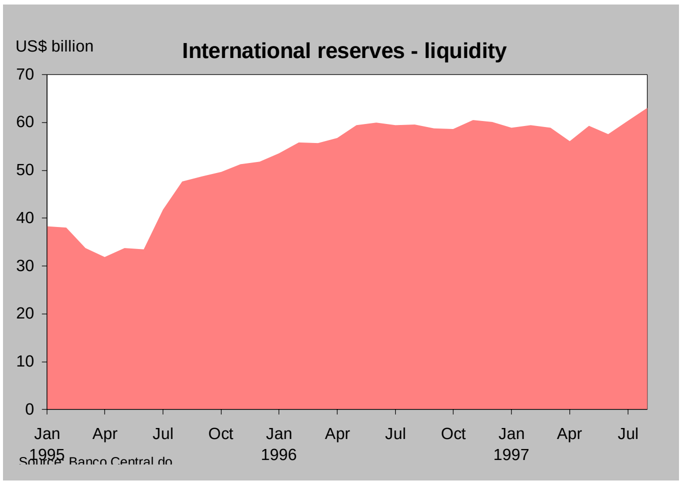

11. These capital movements contributed to growth in international reserves in comparison to the final 1996 level. In August, in the international liquidity concept, reserves reached a level of US$ 63.1 billion, corresponding to 12 months of imports.




12. Exchange contracting in the free rate segment from January to August registered a net accumulated inflow of US$ 14.7 billion, based on a surplus of US$ 17.1 billion in financial transactions and a US$ 2.5 billion deficit in trade-related operations.

13. In July and August, accumulated exchange devaluation in the free rate segment

came to 1.365%, raising the total for the first eight months of the year to 5.022%. The exchange rate float interval remained stable in February at R$ 1.05/US$ for purchase and R$ 1.14/US$ for sale.




**B. Monetary policy in the July-August 1997 period**

14. In August, average daily balances for the restricted monetary base came to R$ 25 billion, for growth of 24.3% in the year and 48.3% in 12 months. At the component level, banking reserves turned in growth of 115.9% while currency issued expanded by 25.7% in relation to August 1996. Strong growth in banking reserves reflects the behavior of demand deposits.

15. The expanded monetary base — restricted monetary base plus compulsory cash deposits and federal public securities outside Banco Central — totaled R$ 213.1 billion in August. The expanded base grew by 15.8% in the first eight months of the year and 31% in the 12 month period ended in August.

16. Viewed under the prism of average daily balances, the money supply (M1) reached R$ 37.9 billion in August. M1 growth in the year and in 12 months came to levels of 30.7% and 61.1%, respectively. At the component level, currency held by the public expanded by 26.2% over 12 months and demand deposits increased by 91.8% over the same period. In the current year, the performance of demand deposits has been strongly impacted by levying of the CPMF and, more recently, by the requirement that demand deposit funds may no longer be transferred automatically to investment funds without the prior authorization of the holder of the account.

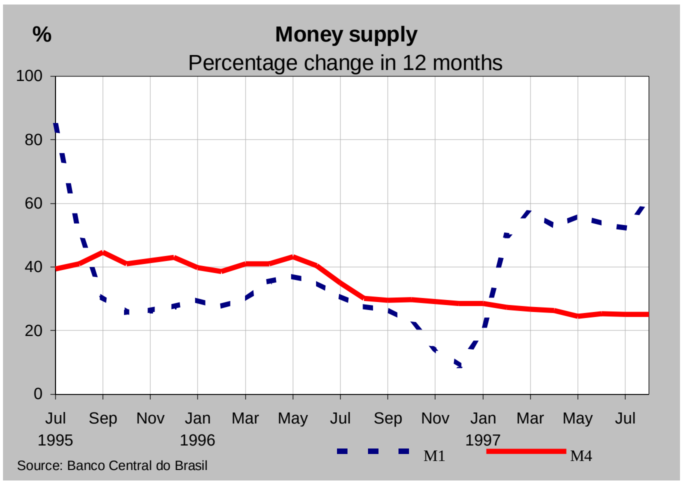
17. In the broader concept of economic liquidity, M4 added up to R$ 363.3 billion in August, equivalent to growth of 12.8% and 25.2% in the year and 12 months, respectively.

18. In the July-August period, the TBC and TBAN remained unaltered at 1.58% and 1.78% per month, or precisely where they have been since April of this year. The effective average Over-Selic rate, however, turned in a slight downward tendency, moving from 1.61% per month in June to 1.60% and 1.59% in July and August, respectively.

**Table 1. Observed August and forecast monetary program for the third quarter of 1997** [1/]

| Itemization | Forecast | | Observed | |
|---|---|---|---|---|
| | R$ billion | Percentage change in 12 months [2/] | R$ billion | Percentage change in 12 months |
| M1 [2/] | 33.8 - 39.7 | 51.3 | 37.9 | 61.1 |
| Restricted base [2/] | 22.7 - 26.7 | 43.2 | 25.0 | 48.3 |
| Expanded base [3/] | 225.8 - 265.1 | 48.7 | 213.1 | 31.0 |
| M4 [3/] | 340.4 - 399.6 | 24.4 | 363.3 | 25.2 |

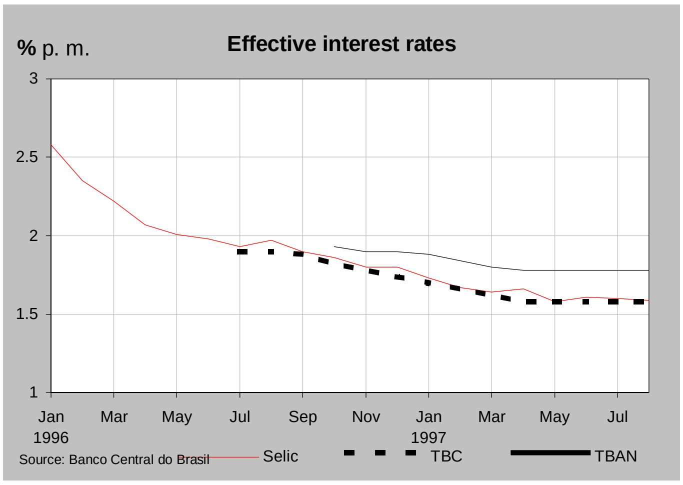
**Source:** Banco Central do Brasil
[1/] Refers to the final month in the period.
[2/] Percentage changes are based on the medium point of forecast.
[2/] Working-day balance average of last month in the period.
[3/] End-of-period balances.




## C. Outlook for the fourth quarter of 1997

19. In the first seven months of 1997, economic performance was marked by upward growth in productive activities without, however, jeopardizing the downward trajectory of inflation. Any evaluation of the possibility of sustaining this process must be based on an analysis of trade and credit indicators, which suggest that families are nearing their debt ceilings, and of the positive performance registered under capital goods which, leveraged by new investments, would seem to point to a reorientation of the dynamics of industrial production.

20. The two factors that are at the roots of expectations of a course change by the productive sector and, consequently, of sharp growth in internal demand are the potential investments that should result from privatization of basic sectors of the economy, such as electric energy, communications and transportation, and those associated to the growing inflow of foreign resources, mostly through direct investments.




21. Despite these expectations, the growth indices expected for the third and fourth quarters of this year are lower than those registered in the first two quarters, a fact that can be ascribed to the high basis of comparison. Furthermore, 1997 production is expected to outpace that of 1996.

22. In a framework of downward movement in the price trajectory, the configuration of this scenario, demand for foreign resources to finance the balance of payments current account balance and a lack of definition with respect to international interest rate levels were the factors underlying monetary policy formulation.

23. Among the determining factors of monetary policy, one should also include a reduced level of freedom in defining fiscal policy, despite the positive results achieved in public accounts. In this regard, one should also mention the probable extension of the Fiscal Stabilization Fund, an important element in controlling public accounts, coupled with developments in the Privatization Program. In this sense, one should underscore the advances made at the federal level in terms of cellular telephone concessions and, at the state level, through privatization of electrical energy and financial companies.

24. Even though the Privatization Program will be a very important source of public sector funding over the next several years, effective fiscal balance will still depend on the proposed structural changes. Consequently, it is essential that the administrative and social security reforms be completed.

25. As of the second quarter of the year, the performance of the trade balance

points to lesser acceleration in import growth and increased exports, principally involving manufactured goods. The balance of trade results are expected to continue at the average position of the current year, while the services balance comes under increased current account pressure, basically as a consequence of interest outlays, international travel and profit and dividend remittances.

26. No difficulties have been encountered in financing the current account deficit. This is evident in the fact that, despite this deficit, it has still been possible to raise international reserves to an August level of US$ 63.1 billion, in the international liquidity concept. The consistency of monetary and exchange policies, as well as the factors underlying economic performance, ensure continuity of the movement of international reserves into the country, with increasing participation of foreign direct investment.

## D. Growth targets for the monetary aggregates

27. Programming of the monetary aggregates for the fourth quarter of 1997 gave due consideration both to the probable scenario and government goals for inflation, GDP, interest rates, monetary impact generated by National Treasury operations, Banco Central interventions in the exchange market and financial system and rediscount and open market operations. Table 2 presents projections for the monetary aggregates up to the end of the fourth quarter of 1997.

28. Following the migration of resources after introduction of the CPMF, which had an expansionary impact on the restricted aggregates, in the month of August the government forbid banking institutions to transfer funds in demand deposits automatically into investment funds. This has had a strong impact on the trajectory of these monetary aggregates and is expected to generate significant growth in the money supply and, consequently, the monetary base.

29. As a result of this prohibition, it is now expected that the projection of the average balance of the M1 aggregate (currency held by the public plus demand deposits) will expand at a rate higher than expected due to the seasonal influence of the end-of-year festivities. These factors resulted in an upward revision of the 12 month projection to 82.2% in December 1997.

30. Based on forecast demand for M1 and in light of the currency held by the public, in a framework of stability in reserve requirement rates on demand resources, 12 month growth for the average monetary base balance (currency issued plus banking reserves) is placed at 71.2% in December 1997.

**Table 2. Monetary program for 1997 [1/]**

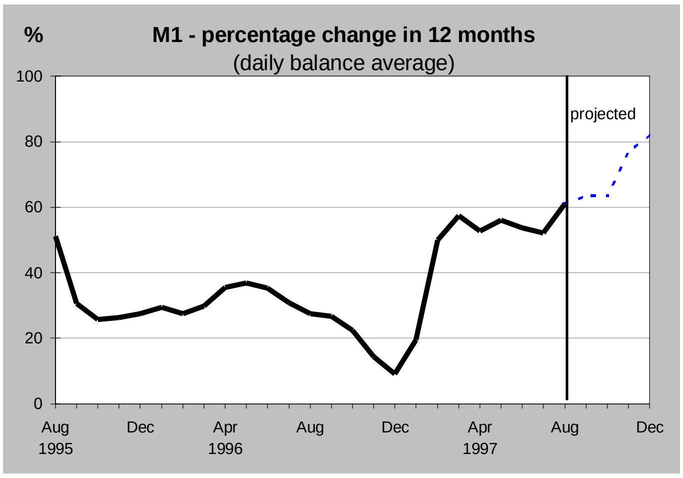
R$ billion

| Itemization | Third quarter | Percentage change in 12 months |
|---|---|---|
| M1 [2/] | 48.6 - 57.1 | 82.2 |
| Restricted base [2/] | 31.7 - 37.2 | 71.2 |
| Expanded base [3/] | 257.7 - 302.5 | 52.2 |
| M4 [3/] | 371.4 - 436.0 | 25.3 |

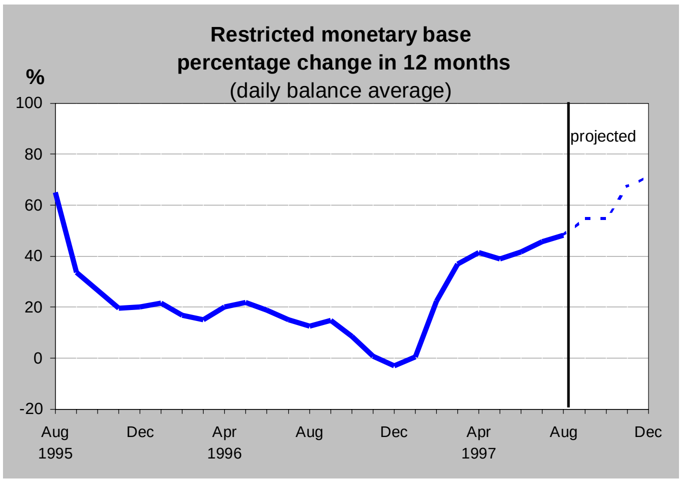
**Source:** Banco Central do Brasil
[1/] Refers to the final month in the period.
[2/] Working-day balance average in month.
[3/] End-of-period balances.

31. The projection of the expanded base (a measurement of the federal internal debt in currency and in securities), which presupposes the neutrality of the factors conditioning the restricted monetary base, shows that the major sources of expansionary pressures in coming months will be state debt restructuring operations and substitution of National Treasury securities received in privatization auctions. As a result of this, it is now expected that the expanded base will grow by 52.2% in the 12 month period ended in December 1997.

32. In much the same way, and consistent with the standard performance of the other aggregates, it is estimated that M4 will expand by 25.3% over the 12 month period ended in December 1997.

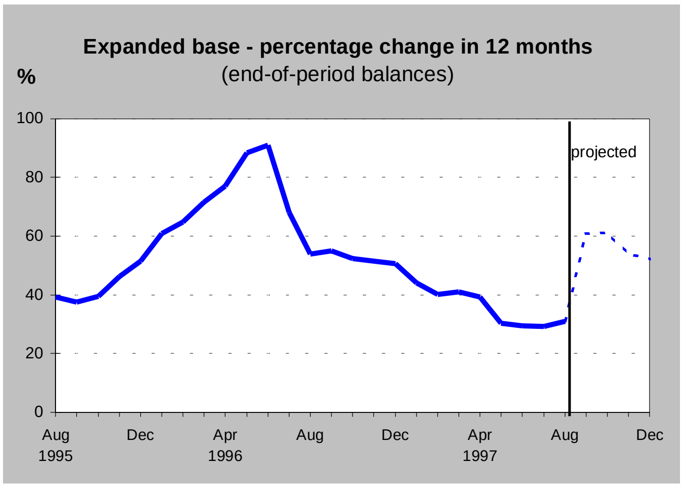


33. Monetary aggregate growth is summarized in the following table, which also shows the results for 1996 and in the July-August 1997 period, together with the projection for the fourth quarter of 1997. The data that have not yet been registered were calculated on the basis of average forecasts.

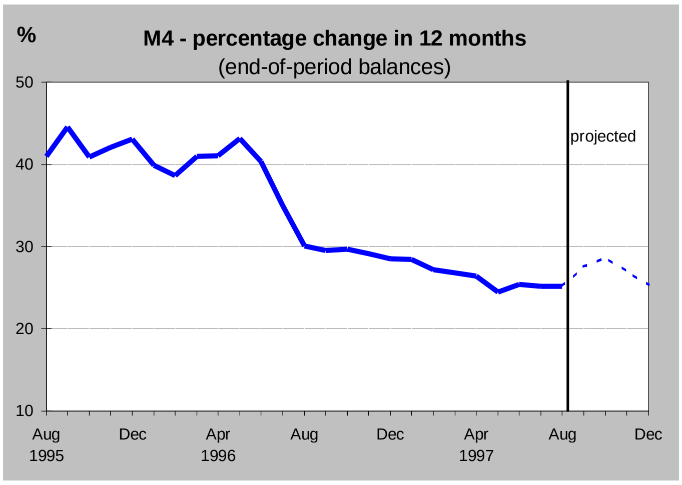



34. Growth of the different multipliers implicit in monetary programming is summarized in the following table:

35. As a result of a significant period of price stability, one should not expect excessive volatility in future values of the restricted monetary base multiplier, even though the monetization process has not yet fully run its course.



36. In coming months, the expanded monetary base multiplier is expected to close with a reduction in its current levels, mirroring the operations related to restructuring of state debts and substitution of securities received in privatization auctions since, despite their impact on the expanded base, a share of these operations should not have an impact on M4.




**Summary of Projections:**

### Table 3. Evolution of monetary aggregates [1/]

| Itemization | 1996 | | 1997 | | | |
|---|---|---|---|---|---|---|
| | Year | | Two month period (July - August) | | Fourth quarter [2/] | |
| | R$ billion | % change in 12 months | R$ billion | % change in 12 months | R$ billion [3/] | % change in 12 months |
| M1 [4/] | 29.0 | 9.1 | 37.9 | 61.1 | 52.8 | 82.2 |
| Restricted base [4/] | 20.1 | -3.1 | 25.0 | 48.3 | 34.4 | 71.2 |
| Expanded base [5/] | 184.1 | 50.5 | 213.1 | 31.0 | 280.1 | 52.2 |
| M4 [5/] | 322.1 | 28.5 | 363.3 | 25.2 | 403.7 | 25.3 |

**Source:** Banco Central do Brasil
[1/] Refers to the final month in the period.
[2/] Projected.
[3/] Medium point of forecasts.
[4/] Working-day balance average in month.
[5/] End-of-period balances.

## Table 4. Monetary multiplier [1/]

| Itemization | 1996 | | 1997 | | | |
|---|---|---|---|---|---|---|
| | Year | | Bimestre July - August | | Fourth quarter [2/] | |
| | Multiplier | % change in 12 months | Multiplier | % change in 12 months | Multiplier | % change in 12 months |
| M1 / Restricted base [3/] | 1.442 | 12.6 | 1.517 | 8.7 | 1.535 | 6.4 |
| Banking reserves / Demand deposits [3/] | 0.232 | -53.4 | 0.380 | 12.4 | 0.376 | 62.1 |
| Currency / M1 [3/] | 0.505 | 18.5 | 0.367 | -21.6 | 0.355 | -29.7 |
| M4 / Expanded base [4/] | 1.750 | -14.6 | 1.705 | -4.4 | 1.442 | -17.6 |

**Source:** Banco Central do Brasil
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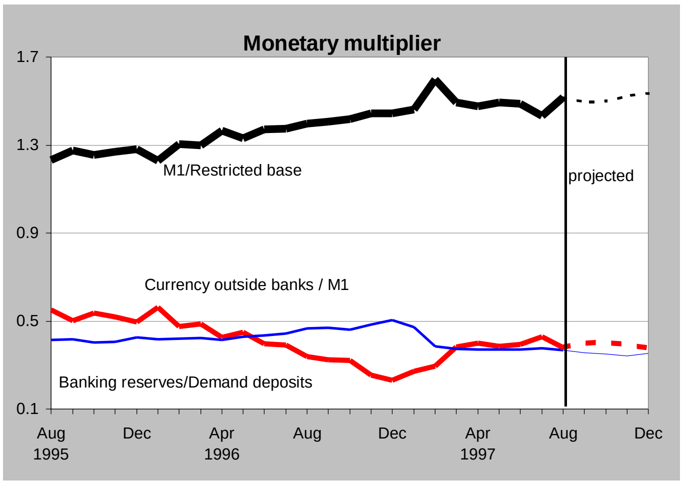


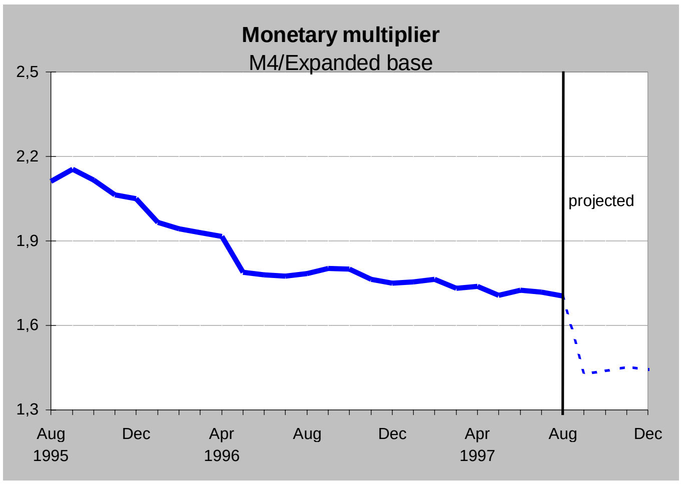

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## Table 2. Monetary program for 1997 [1/]

R$ billion

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