BANCO CENTRAL DO BRASIL

Translation of the Open Letter sent by Banco Central do Brasil's Governor, Henrique de Campos Meirelles, to the Minister of Finance, Antonio Palocci Filho.

Presi-2004/264 Brasília, February 19, 2004

Dear Minister,

1. This Open Letter is addressed to you as required by the Decree n. 3,088, of June 21, 1999, which formally instituted the inflation-targeting regime in Brazil. As you are aware, the sole paragraph of the 4^{th} article of the Decree mentioned above establishes that if the target set by the National Monetary Council (CMN) is not fulfilled:

" Banco Central do Brazil's Governor will publicly release through an open letter addressed to the Minister of Finance the reasons for the nonfulfillment of the target. This letter should include:

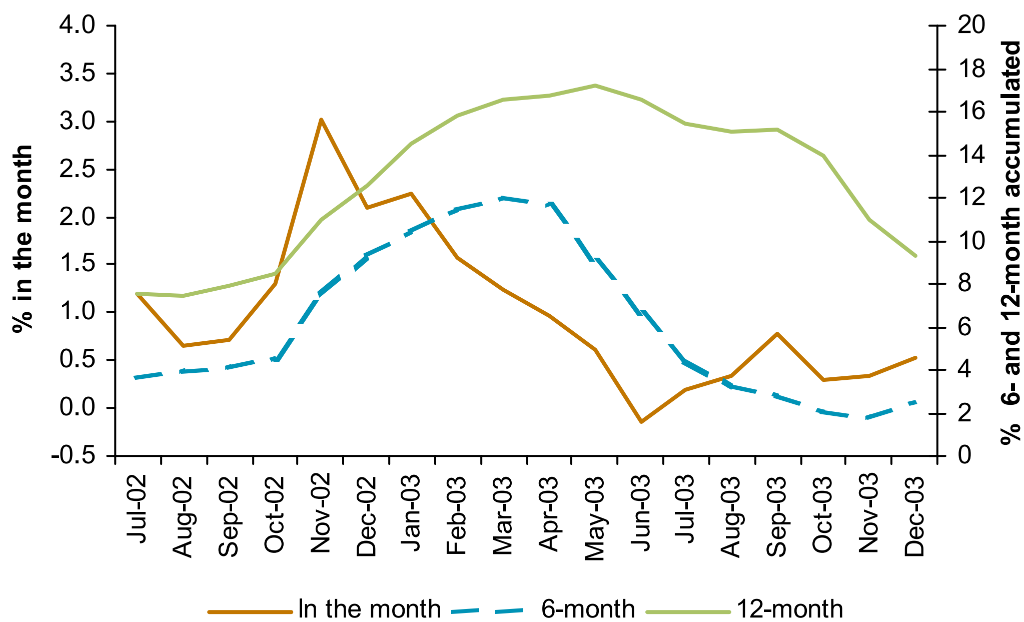
I - detailed description of the causes for the nonfulfillment;
II - measures to ensure the convergence of inflation to the established targets;
III - time span in which the measures are expected to have effect."

2. In 2003, the inflation rate measured by the variation in the Broad National Consumer Price Index (IPCA) was 9.30%, surpassing the upper limit of the tolerance interval of 2.5 percentage points above and below the 4.0% central target set by the CMN for the year. I remind you that the 8.5% adjusted target for 2003 was not determined by the CMN, but proposed by the Banco Central do Brasil (BCB) on the Open Letter accepted by you on January 21, 2003. Therefore, this Open Letter would be necessary regardless of how close actual inflation was to its adjusted target.

Causes for the Nonfulfillment of the Target

3. The major part of the inflation in 2003 occurred in the first months of the year, reflecting the same factors that caused the inflation acceleration at the end of 2002. In the first quarter, the IPCA change reached 5.1%, representing 55% of the total inflation in 2003. Considering the first five months of the year, the IPCA variation totaled 6.8%, or 73% of the annual inflation. Graph 1 shows the monthly and the six- and twelve-month accumulated inflation between July 2002 and December 2003.

Graph 1 – Monthly and six- and twelve-month accumulated consumer inflation (IPCA)
(2002:07 – 2003:12)

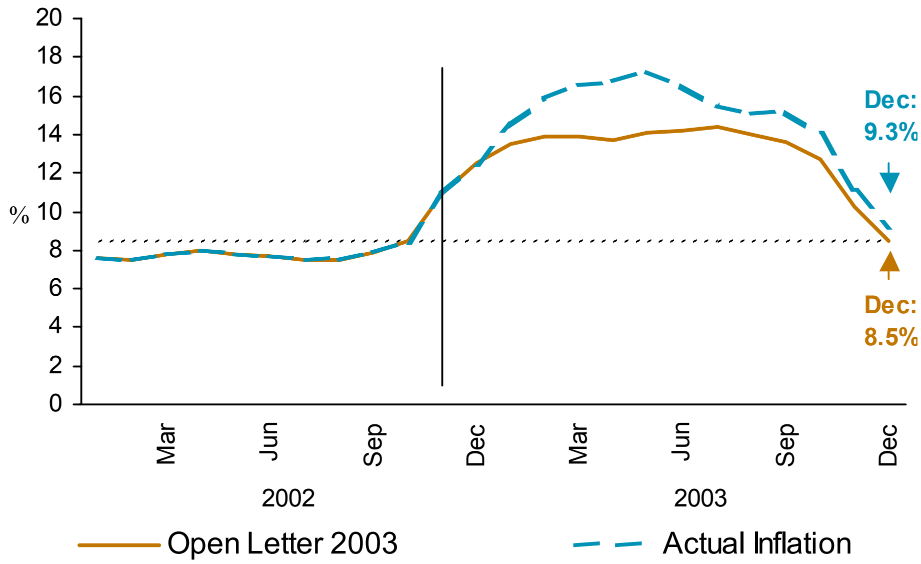


4. Despite the high rates of the first quarter, the accumulated inflation in 2003 was very close to the adjusted target established in January. Although tolerance intervals, like those of the targets set by the CMN, do not apply to the adjusted targets, the 9.3% inflation rate—which surpassed the adjusted target by just 0.8 percentage point—remained within an acceptable error margin, considering the uncertainties inherent to the initial phases of a disinflation process, which are greater than those that usually accompany the monetary policy effects in stable scenarios.

5. The Open Letter released last year presented a projected inflation path compatible with the adjusted targets. Graph 2 compares that twelve-month accumulated inflation projection to actual inflation. The inflation path during 2003 followed basically the trend projected in the

Open Letter. Actual inflation was higher in the first quarter, when the magnitude of the inflationary inertia was above the initially estimated. This difference was greatly compensated by the better-than-expected behavior of the inflation rate in the following quarters, as can be noted by the approximation of the actual inflation to the inflation path compatible with the adjusted target.

Graph 2 – Inflation Path compatible with the Adjusted Target (Open Letter of 2003) and Actual Inflation in 2003 – 12-month accumulated values

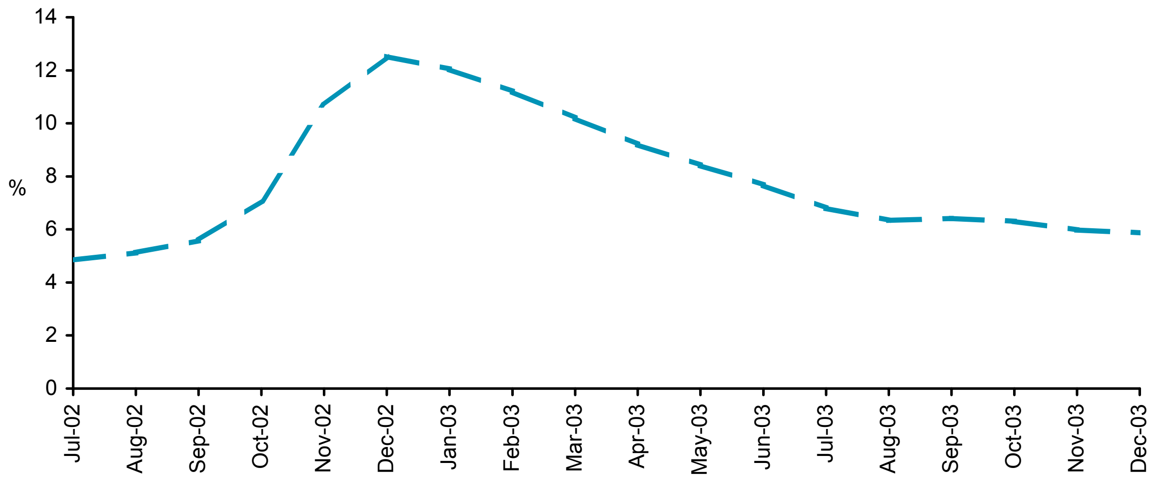


6. The first quarter deviation can be mainly attributed to a temporary increase in inflationary persistence throughout the period, augmented by the expectations deterioration that had been observed since the fourth quarter of 2002. In fact, studies carried by the BCB and released in the *Inflation Report* of September 2003 show that, after the successful implementation of the inflation-targeting regime, the degree of inflationary inertia dropped to around 35% in mid-2000. Yet, because of the inflation acceleration that took place at the end of 2002 and the uncertainties regarding the future conduct of monetary policy, the degree of inflationary inertia increased significantly, reaching the highest levels since the adoption of the inflation-targeting regime. With the firm conduction of both monetary and fiscal policies, consistent with macroeconomic equilibrium, the estimates show that, at the end of the first half of 2003, the degree of inflationary inertia had returned to the low levels existing before the inflation rise observed in the last quarter of 2002.

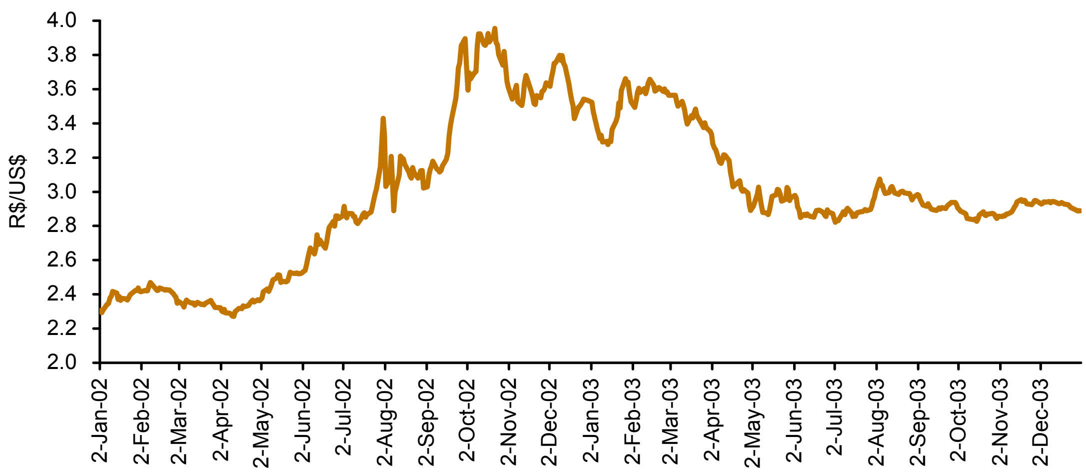
7. The second half of 2002 was marked by sharp deterioration of expectations, deep exchange rate depreciation and high inflation, with the latter reaching 6.6% in the last quarter,

or 29% in annual terms, the highest level since 1995. Graph 3 shows the behavior of the median of market expectations collected by the BCB's Investor Relations Group for the 12-month-ahead inflation since 2002. Graph 4 shows the behavior of the exchange rate during 2002 and 2003.

Graph 3 – Market expectations for the 12-month-ahead inflation
(monthly average)

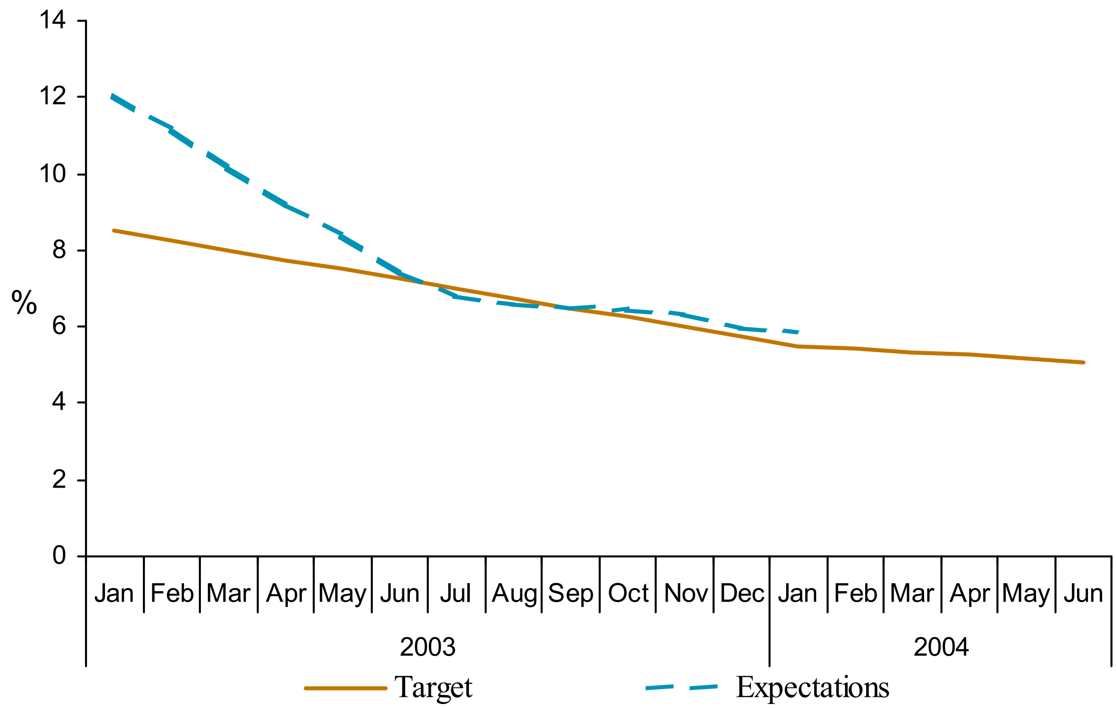


Graph 4 – Exchange rate (2002-2003) – R$/US$



8. In the first months of 2003, the confidence crisis scenario was reverted as a consequence of the authorities commitment to the inflation-targeting regime, along with a fiscal stance aimed at generating public sector's primary surpluses compatible with the sustainability of the public debt. Since May, as we can see in Graph 5, the 12-month-ahead inflation expectations have shown a close convergence to the adjusted inflation targets, calculated by the interpolation of the targets for each year. The *real* appreciation deepened, especially in March and April. However, inflation was still high in this period. As mentioned before, a large share of the inflation in the last quarter of 2002 contaminated prices in the following quarter through inertia mechanisms. Similarly, the high inflation expectations, though in a downward path, continued to pressure prices up. In addition, inflation in the first quarter of 2003 was also impacted by the exchange rate depreciation that took place in 2002 because of the existing lags in the pass-through of the exchange rate to prices, which are higher for the regulated prices.

Graph 5 – Target and market expectations for the 12-month-ahead inflation
(monthly average)

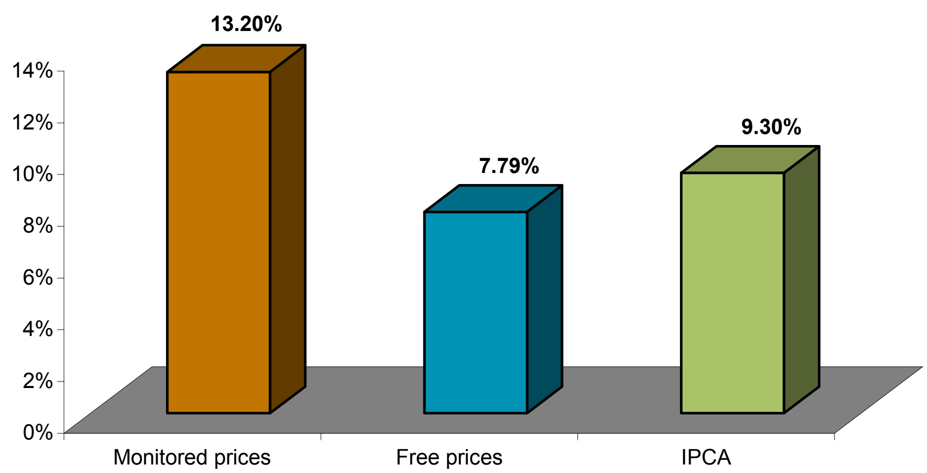


9. Since mid-2003, a quite different scenario has prevailed, marked by restored confidence and the return to macroeconomic normality. The outcomes of the macroeconomic policy have become more evident, the sharp uncertainties have been dissipated and inflation has returned to relatively low and stable levels. After a unusual deflation of 0.15% in June, inflation in the second half accumulated 2.49%, equivalent to an annual 5.04% rate, the second lowest 6-month

rate since the adoption of the inflation-targeting regime. At the end of December 2003, inflation expectations for 2004 and 2005 stood at 6.0% and 5.0%, respectively, while the inflation targets established by the CMN for these years were 5.5% and 4.5%, respectively.

10. The uncertainties scenario, capital outflows and the increase in interest rates since the second half of 2002 led to a contraction in economic activity. A 0.3% GDP growth is estimated for 2003. The contraction, however, was concentrated in the first two quarters of the year, when seasonally adjusted GDP fell 0.8% and 1.2%, in comparison to the previous quarter. In the second half, economic activity started to recover, with a 0.4% GDP growth in the third quarter and a 2.5% estimated growth in the last quarter. Monetary easing and the strengthening in confidence enable the BCB to forecast a 3.5% GDP growth for 2004. It should be noted that the performance of the Brazilian economy in 2003 is clearly superior to that of other emergent economies that faced similar confidence crises.

Graph 6 – Contributions to the IPCA in 2003, by groups

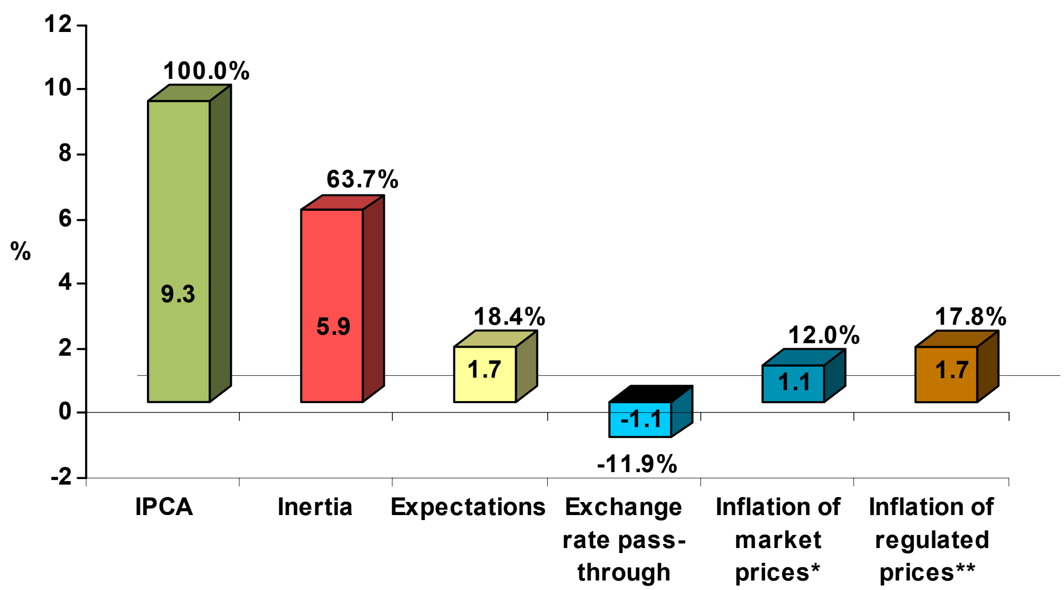


11. Similarly to the observed in previous years, regulated prices pressured inflation more than market prices did. The former increased 13.20%, while the latter grew 7.79% (Graph 6). Regulated prices contributed with 3.76 percentage points to the variation of the IPCA, and market prices, whose weight in the IPCA basket is higher, were responsible for 5.54 percentage points. The most important individual contributions to consumer inflation among regulated prices were bus fares and electricity and telephone tariffs. These items contributed 1.23, 0.91 and 0.64 percentage points, respectively, to the overall index, corresponding to around 74% of the total contribution of the regulated prices to the IPCA change. Oil by-products, in turn, did

not pressure inflation, differently from what occurred in 2002. Gasoline and bottled gas presented 1.24% and 2.93% increases, respectively.

12. Following the methodology already adopted in previous Open Letters, the BCB's structural model allows decomposing inflation into different inflationary factors. Graph 7 breaks down inflation into five components: i) the exchange rate depreciation; ii) the inertia associated with the share of inflation that outstripped the target in 2002; iii) the inflation expectations above the target; iv) the inflation of market prices, excluded the effects of the previous items; and v) the inflation of regulated prices, excluded the effects of items “i” and “ii”.

Graph 7 – Contributions to inflation in 2003
(in percentage points and as a percentage contribution)



* Excluding exchange rate pass-through, inertia and expectations.
** Excluding exchange rate pass-through and inertia.

13. The high inflation recorded in the last quarter of 2002 strongly influenced the following quarter’s inflation due to inertial mechanisms. The component of inertia of the previous year above the inflation target contributed with 5.9 percentage points to inflation in 2003. Responsible for 63.7% of inflation, this inertial component was the main inflationary factor in

2003, differently from what occurred in 2002, when the exchange rate depreciation was the most important individual factor.

14. The exchange rate appreciated during 2003, when compared to the last quarter of 2002. As can be seen in Graph 7, the exchange rate had an overall deflationary impact in 2003.

15. Inflation expectations also influenced prices significantly because of the registered high values at the beginning of the year. In the first half of 2003, the average 12-months-ahead inflation expectation was 9.8%, whereas in the second half of the year it stood at 6.3%. The above-the-target inflation expectations contributed with 1.7 percentage point to inflation.

Central Bank Policy in 2003: Measures taken to ensure the convergence of inflation to the established targets

16. Committed to the inflation-targeting regime, the BCB policymaking is based on the assessment of future inflation behavior and its convergence to the established targets. In 2003, specifically, monetary policy was focused on reverting the confidence crisis and bringing inflation expectations to the targets, also considering the costs involved in terms of output losses.

17. Regarding the targets, the January 2003 Open Letter mentioned that monetary policy in 2003 and 2004 would be directed so that inflation would converge to the adjusted targets. The adjusted targets, 8.5% in 2003 and 5.5% in 2004, were obtained by summing up three components: i) the inflation target established by the CMN; ii) part of the inflationary inertia from the previous year; and iii) the primary effect of the shocks to regulated prices. Considering the magnitude of the shocks that affected the Brazilian economy, the BCB decided to seek an inflation path that would lead to a significant disinflation in 2003 and would bring inflation down to the tolerance intervals of the inflation target two years ahead. It is important to highlight that sharper disinflation paths would result in significant output losses. Therefore, Banco Central do Brasil surely took into account the economic activity perspectives when determining the disinflation strategy.

18. The inflationary acceleration, however, was neither a result of an external shock alone, nor a temporary deviation from the long run inflation path that could be autonomously reverted. It was a phenomenon that had a direct relation with the deterioration of private sector expectations. Therefore, it demanded a firm action of the monetary authority, as the success in reverting expectations deterioration would be crucial to minimize the output loss required to stabilization. In addition, a failure in the disinflation process would put at risk the long-term stability gains for growth and would threaten to restore the institutionalized mechanism of indexation. Therefore, a loose monetary stance would not entail better perspectives to the economic activity neither in the short run nor in the long run.

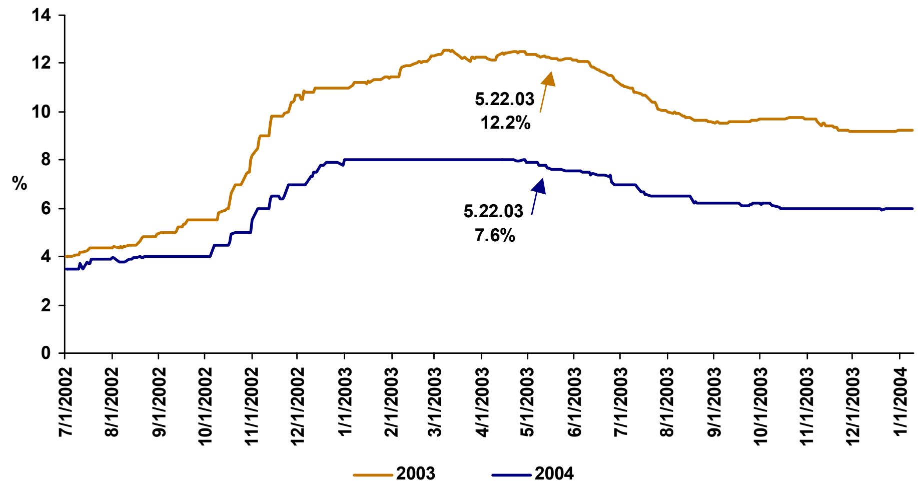
19. Considering the scenario mentioned above, the Monetary Policy Committee (Copom) decided to increase the Over-Selic rate to 25.5% and to 26.5% in January and February 2003, respectively, from 25.0% in December 2002, keeping this rate unchanged until June (Table 1). In February, the reserve requirement ratio on demand deposits was increased as well. It is important to highlight that, at that point, there were still doubts about the speed rate at which inflation would decrease and about the magnitude of the inflationary inertia. As a matter of fact, the initial inflation in 2003 had been above expectations, mainly as a consequence of the pressure of regulated prices. As a result, the benchmark scenario inflation forecast for 2003 presented in the quarterly *Inflation Report* increased to 10.8% in March 2003, from 9.5% in December 2002, despite the fact that the latter forecast had already incorporated the 1.5 percentage point increase in the Over-Selic rate in that period.

20. The first positive outcomes of the restrictive monetary and fiscal policies began to show up in the first half of 2003. Following the decisions to increase the Over-Selic interest rate, the exchange rate presented sharp appreciation in March and April. From R$/US$ 3.59 in February, the exchange rate reached R$/US$ 3.00 two months later. Market inflation expectations, however, remained flat at 12.5% and 8.0% for 2003 and 2004, respectively, still significantly above the adjusted targets of 8.5% and 5.5%. The maintenance of the inflation expectations in this level would not only damage the accomplishment of the targets, but it would also create a favorable environment for the return of indexation. Only in May, with the maintenance of the tight monetary policy, did the expectations start to revert.

Table 1 - Copom Decisions in 2003

Meeting Date		Selic Rate Target
N.	Date	% a.a.
80th	Jan 22	25.5
81st	Feb 19	26.5
82nd	Mar 19	26.5
83rd	Apr 23	26.5
84th	May 21	26.5
85th	Jun 18	26.0
86th	Jul 23	24.5
87th	Aug 20	22.0
88th	Sep 17	20.0
89th	Oct 22	19.0
90th	Nov 19	17.5
91st	Dec 17	16.5

Graph 8 – Accumulated Inflation Expectations for 2003 and 2004



21. At the end of June, the CMN set the inflation target at 5.5% and 4.5% for 2004 and 2005, respectively, both with a tolerance interval of 2.5 percentage points above and below the target. The decision taken by the CMN confirmed the BCB's adjusted target as the central target for 2004.

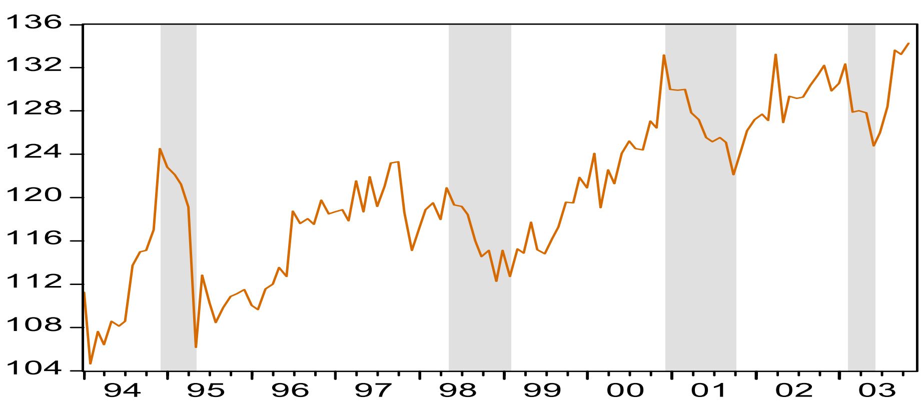
22. Monetary policy could be eased only when inflation expectations started to converge to the targets and uncertainties were dissipated. This favorable environment was accomplished in the middle of the year, when the results of the monetary policy became more evident. As published in the *Inflation Report* in June 2003, 12-month-ahead market inflation expectations stood at 7.4%, which was close to the target path rate (7.2%). The inflation rate began to fall as a result of the restrain in aggregate demand, of the reversion in inflation expectations, and of the exchange rate appreciation. From June on, the Copom began a process of gradual reduction of the Over-Selic rate, which reached 16.5% in December. In August, the reserve requirement ratio on demand deposits was reduced.

23. The monetary policy easing has been conducted without surprises, in order to ensure a safe path to the accomplishment of the inflation targets and the return to a sustainable long run economic growth. In fact, the policy implemented in 2003, despite the restrictive effects in the short run, was favorable to a sustainable economic growth as it has restored confidence and led inflation to the targets path.

24. Economic activity began to recover earlier than market consensus, benefiting from the re-establishment of confidence, the exports growth and, more recently, the flexibilization of

monetary policy. Graph 9 shows seasonally adjusted data for industrial output since 1994, highlighting four successive episodes of contraction in the industrial activity. Besides the most recent one, in 2003, the contraction episodes are associated to: i) the Mexican crisis (1994/1995); ii) the Russian crisis and the exchange rate devaluation (1998/1999); iii) the Argentine crisis and the electric energy rationing (2000/2001). Comparing the most recent episode with the previous ones, it is evident that the 2003 contraction was the shortest and the weakest. While the other episodes lasted from 10 to 11 months (in the case of the first crisis, although production had ceased to fall in the sixth month, output remained around the same level for several months) and output fell from 7% to 15% when compared to the previous peak, the most recent lasted only five months and resulted in a maximum fall of 6%. Moreover, the previous peak had already been surpassed after only three months of recovery.

Graph 9 – Industrial Production (1994:1 –2003:11)



25. Therefore, the BCB adopted the necessary policies during 2003 to avoid inflation running out of control and make projected inflation return to the targets trajectory. Throughout 2004, the BCB will continue to carry out monetary policy consistent with the inflation-targeting regime.

Respectfully,

Henrique de Campos Meirelles
Governor