

# **BANCO CENTRAL DO BRASIL – *FOCUS***

**June 1<sup>st</sup>, 2001**

## **MINUTES OF THE 59<sup>th</sup> MEETING OF THE BANCO CENTRAL DO BRASIL MONETARY POLICY COMMITTEE (Copom)**

### **Summary**

Economic activity. External environment. Prices. Money market and open market operations. Prospective assessment of inflation . Monetary policy guidelines

**Date:** 05.22 and 05.23.2001

**Place:** 8<sup>th</sup> floor meeting room (on 05.22) and 20<sup>th</sup> floor (on 05.23). Central Bank Headquarters – Brasília – DF

**Called to order:** 3:59 PM on 05.22 and 5:00PM on 05.23

**Adjourned:** 7:38 PM on 05.22 and 7:06 PM on 05.23

### **In attendance:**

#### **Members of the Board**

Arminio Fraga Neto – Governor

Carlos Eduardo de Freitas

Daniel Luiz Gleizer

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Tereza Cristina Grossi Togni

#### **Department Heads (all present on 05.22)**

Altamir Lopes –Economics Department (DEPEC)

Daso Maranhão Coimbra – International Reserve Operations Department (DEPIN)

José Antonio Marciano – Department of Banking Operations and Payments System (DEBAN)

Gustavo Bussinger – Research Department (DEPEP)

Sérgio Goldenstein – Open Market Operations Department (DEMAB)

#### **Other participants (all present on 05.22)**

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

Alexandre Pundek Rocha - Advisor to the Board

Antônio Carlos Monteiro - Executive Secretary of Banco Central do Brasil

João Borges - Press Secretary (ASIMP)

The Board analyzed the recent performance and outlook for the Brazilian and International economies in the framework of the country's new monetary policy regime, which is designed to ensure compliance with government defined inflation targets.

### **Economic activity**

The indicators of the level of economic activity have shown signs of cooling, evidenced by, mainly, the evolution of consumption indicators for the last two months. This trend shall be accentuated in the next months as a result of the impacts of electrical energy rationing. Initial effects, as the deterioration of expectations and the new planning of future expenditures, as much on the part of consumers as of companies, should be reflected in the next results of economic indicators. In the productive sector, the restrictions of electrical energy shall be reflected, among others, in the reduction of the growth rhythm that has been observed, mainly in the industrial sector.

Among the demand components, consumption is the one that has revealed the stronger loss of dynamism. Data related to total sales in commerce and consumer expectations indicate this behavior. In the retail segment, survey from IBGE, at national level, showed fall of 0.1% of the real invoicing of the commerce in the year up to March, after registering growth of 3% in January, comparatively to equal periods of the previous year. Data of the Trade Federation of the State of São Paulo (FCESP) showed growth of 6.2% up to April, against 8.1% in January. The consultations to the Credit Protection Service (SPC) and the Telecheque in the city of São Paulo also presented waning signs. The number of consultations to these services fell 2.1% in April, after seasonally adjustments, reducing accumulated growth in the year to 8.77% up to April from 10.42% up to March.

The performance of retail activity reflects consumer perceptions. Consumer Intentions Index in the Metropolitan Region of São Paulo, released by the FCESP, dropped to 101 in May from 106.3 in April. This drop is attributed to the internal political crisis and to the deterioration of the external scenario. Since the survey encompasses expectations from the beginning of May, the index had not yet reflected the negative impacts caused by the energy crisis.

Regarding default rates, information from the Trade Association of São Paulo (ACSP) showed that the net rate (discounting the cancellations of new registers in the records of SPC) reached 9.4% in April of 2001, against 9.3% registered in same month of the previous year. Up to April, there was growth of 22.6% in average net rate of defaults and of 27.9% in the relation between the number of checks returned for insufficiency of funds and the number of cleared checks.

Financial system credit indicators still do not clearly suggest cooling in activity level. Credit operations in the free segment registered growth of 3.5% in April (as opposed to 5.1% in March). This performance is associated, to a large extent, to the behavior of the credit destined to companies whose activities are related to the exchange rate, that showed growth of 3.8% in the balance of the operations with companies. When the referred modalities are excluded, these operations presented an evolution of 2.2% in the month, as opposed to 3.3% in March.

In the same way, the growth of 2.9% in April (as opposed to 5.5% in March) in the operations with individuals suggests a still high growth in the demand for personal credit and for acquisition of goods, despite the deceleration in response to the increase in lending rates. In April, daily averages of concessions of new credits in the categories of “personal credit” and “acquisition of goods” registered falls of 0.7% and 3.9%, respectively.

On the supply side, the most encompassing data refers to March, reflecting, up to that period, the strong expansion of the economic activity. The GDP registered growth of 3.77% in the first quarter, encouraged, mainly, by the performance of the industrial sector, largely influenced by mining industry (+10.5%) and by the transformation industry (+6.4%). It shall be highlighted that in the manufacturing segment the use of installed capacity, according to survey of Fundação Getulio Vargas, reached 84% in April of this year, as opposed to 83% in April 2000. This result, compared to the growth of the sector observed in the last year, reveals, in part, the expansion of investments.

This dynamism in the first months of the year reflects, in part, the good performance of exports and explains the high level of imports. Up to April, the trade balance presented significant growth of exports by increased shipments of beef and soy in grain and soy bran, due to plant health measures in European countries. The manufactured goods performance remained similar to that of the last months of 2000, mainly exporting products linked to the automobile industry. Deserve special mention fuel exports, item that gained importance since the end of 2000, as a result of the strategy that aims at swapping oil by products in surplus in the Country.

Imports also kept the performance of the last months, largely due to the maintenance of industrial growth, responsible for the rise of the expenses with acquisition of important items of capital goods, raw materials and intermediate goods. The increase of auto imports was equally significant, resulting from trade agreements and from the rise in imports originated from Asian countries.

The signs of gradual accommodation of economic indicators, mainly demand ones, would not jeopardize the desired expansion of economic activity this year. To the contrary, this slowdown would be beneficial to the economic environment by improving price performance – excessively impacted by agricultural prices - and the trade balance. However, one has to consider the future perspectives given now the energy crisis.

The implications, at this first moment, refer to the deterioration of the expectations and its unfolding on the flows of expenses and credit. The perspectives are of intensification of the process of consumption deceleration since May, mainly in relation to the goods whose sales involve future income commitments. Considering a longer horizon, the

cooling of consumption will be conditional to the magnitude of the effect of the crisis on incomes and job levels.

Regarding credit, a slowdown in the volume of new concessions is expected in the short term and a fall in the medium term. This behavior will be conditional on the increase in lending rates and bank spreads, in the imminence of an augmented risk of default. Additionally, the demand for credit, as much for consumption as for investments, might be affected by the evolution of the income.

For the industrial segment, which has operated in a higher level when compared to the previous year, the energy crisis implies the reduction in the pace of expansion. However, the possibility of transferring energy consumption between sectors tends to reduce the impacts of the rationing on manufacturing. Moreover, processes of rationalization, substitution of energy sources and intensification of self-generation of electric energy shall contribute to the same objective. It must be observed that these processes, as well as the absence of accurate sectoral coefficients of energy-output relations in the various segments, make it difficult to precisely quantify the impacts of rationing on industrial production.

In light of the above, even if the manufacturing is not strongly affected, the rationing of electric energy might cause contraction in exports as well as in imports. Exports of basic products shall not be significantly affected, as much for using relatively less electricity than industrialized ones, as for the fact that a substantial part of the exportable production occurs outside the rationing area. Among the main semi-manufactured products exported, there are the metallurgical products which intensively use electric energy. Nevertheless, some companies are self-sufficient in energy generation. It is likely, however, that exportable surplus be reduced. The manufacture production might suffer the direct impact of lower energy supply and also of reduced supply of raw materials and intermediate goods domestically produced, which might be replaced by imported inputs.

Regarding imports, a fall in acquisitions of raw materials and intermediate goods is expected. This reduction, however, can be attenuated by the substitution of domestic supply by imported goods. In a similar way, the reduction in capital goods imports might be offset, in part, by the necessity to substitute energy generating equipment and to speed up the required investments to overcome the energy crisis. For fuels and lubricant, the import reduction, due to the contraction in economic growth, might be mitigated by the necessity to substitute electric energy for energy generated from oil by products. Therefore, both, exports and imports shall be impacted from cuts due to rationing and to the reduction in the activity level.

Finally, regarding prices behavior, the immediate effect refers to the impact of surcharges on energy bills of “households”, already estimated to be around 0.15 percentage point in June’s IPCA. It shall be highlighted that this effect will be the opposite at the end of the process. As to the indirect impact of rationing, it shall be considered, on the one hand, the restrictive perspectives on supply and the consequent rise of costs. On the other hand, the further contraction of consumption flows and of investments tend to minimize prices pressures.

## Prices

In April, the price indices continued to be affected by the same factors observed in March. The main responsible for inflation in the period were food products, especially those of animal origin. The indices were also pressured by the exchange rate movement in the last months.

The inflation increase in April was due mainly to the food price behavior. The latter was a consequence of the draught and the losses of bean crops, as well as of the domestic effects of expanded meat exports, along with the impacts on the wheat by-products from exchange rate depreciation.

The IPCA accumulated 2% in the year and 6.61% in 12 months, with variation of 0.58% in April. The result was influenced by the contribution of 0.23 percentage point of the tradable goods, as milk, bean, poultry and bread. Among the non-tradable products, *in natura* foods were responsible for 0.11 percentage point and the domestic employees contributed with 0.08 percentage point. In the case of administered prices, the increase in energy costs and in water and sewer charges were compensated by the reduction in alcohol and gasoline prices.

IGP-DI recorded variation of 1.13% in April, accumulating an increase of 2.79% in the year and 11.16% in 12 months. The breakdown of April's IGP-DI was the following: 1.39% IPA increase, 0.86% IPC and 0.36% INCC. Regarding IPA, it shall be stressed that the acceleration of farm prices, contributed with 3.8% of the expansion in agricultural product prices and with 0.48% of the industrial products. These items also pressured the item food in the IPC, that registered an increase of 2.26% in April. The IPC core was raised to 0.64% in April, accumulating 6.07% in 12 months.

For the near future, a drop in agricultural prices is expected. The behavior of administered prices will impact inflation results, given, among other factors, the surcharge on electric energy bills and the previously expected increase in electricity tariffs, the increase of bus fares in the city of São Paulo, and the increase in telephone tariffs, in June.

## External environment

The international economy remains in deceleration, due to the performance of the United States and the stagnation of Japan, while the rise in spot and future prices of oil remains as a key concern regarding the inflation path. In this context, the International Monetary Fund (IMF), on its May report, reduced the growth forecast for world output in 2001 from 4.2% to 3.2% in October of 2000. In Latin America and Brazil, uncertainties regarding economic and financial difficulties in Argentina should be added to this economic deceleration process.

In the United States, the deceleration of economic activity growth lead the monetary authority to promote successive reductions of the basic interest rate in 2001, totaling 250 basis points until May 15, when rates reached 4% p.a.. Consumer credit whose twelve-month variation was above 10% until February, was lowered to 9.9% in March. The industrial production registered a contraction for the seventh consecutive month, recording - 0.3% variation in April. Hence, the accumulated variation in twelve months was reduced from 4.4% in March, to 3.7% in April. Deceleration signs are also

remarkable in the labor market, with unemployment rate reaching 4,5% in April, and the amount of job openings dropping by 223.000 units in the same month. The first official estimate indicates GDP annualized growth of 2% in the first quarter of 2001, compared to an expansion of 1% in the last quarter of 2000 (in seasonally adjusted series). Output growth decelerated in relation to the same quarter of the previous year, reaching 2.7% in the 1° quarter of 2001, compared to 3.4% in the last quarter of 2000. The annual inflation rates for consumers and producers recorded a moderate increase in April, reaching 3.3% and 3.7%, respectively.

The European Central Bank (BCE) reduced the minimum reference interest rate by 0.25 percentage point to 4.5% p.a., on May 11<sup>th</sup>, in response to lower activity growth in the Euro Area and to the downward trend of inflation towards 2%. Nevertheless, the harmonized price index (IPCH) has been registering monthly variations of 0.6%, 0.4% and 0.5%, respectively, between February and April, raising the annual rate from 2.6% to 2.9% in the last two months.

In Argentina, the government has seek to revert negative expectations regarding the overall economy, while the country's aggregate demand and industrial output has remained at low levels. Supermarket and shopping center sales in March grew 2.6% and 0.15%, respectively, compared to the same period of the previous year. The Monthly Industrial Estimator in March recorded a contraction of 1.1%, seasonally adjusted, implying an accumulated variation in twelve months of -1.5%. The fiscal results in the first quarter totaled a deficit of US\$ 3 billion, 48% higher than in the same period of 2000. In spite of substantial increase in March and April, interest rates gradually decreased in May, as a result of news about the debt swap. The interest rate was at 15.10% p.a. on May 23<sup>rd</sup> for 30-day transactions in pesos and 11.80% p.a. for dollar transactions. On April 27<sup>th</sup>, in order to revert less than favorable financial markets expectations, the government implemented fiscal measures to reduce the deficit by US\$ 4 billion. Among these measures were: the increase of the tax rate on financial transactions, from 0.25% to 0.4%; and a US\$ 900 million cut in public expenditures. The third revision of the agreement with the IMF was concluded, with the increase by US\$ 1 billion in the fiscal deficit target for the 1<sup>st</sup> half of 2001, in order to correct for the deviation from the original target for the 1<sup>st</sup> quarter of the year. The conclusion of the third revision allows the disbursement of US\$ 1.2 billion of the financial package agreed in December. Additionally, the Argentine government is committed to complete debt swap process to lengthen the maturity of both internal and external debts

### **Monetary market and open market operations**

In the weeks following last Copom meeting the term structure of interest rates remained volatile. In the day before the May 23<sup>rd</sup> meeting, the slope of the curve increased for tenures above five months. This movement was mainly caused by the uncertainty regarding both economic and political impacts, in the medium term, of the energy crisis and the election process next year. Fixed-income instruments, therefore, continued to yield losses until the day before of the May 23<sup>rd</sup> meeting.

Between April 19 and May 22, there were four public selling auctions of dollar-indexed securities (NBCE), with tenures of 5, 7 and 10 months. These auctions were used to

fully rollover principal and interest payments. Securities with tenure of 7 months were partially placed (53%) and the average rate of placement stood at 13.60% p.a.. The other securities were fully placed. The shortest tenure reached 8.9% yield to maturity and the longest one reached 8.75% and 8.84% in two auctions, totaling R\$ 5.1 billion.

The National Treasury offered fixed income securities at only two instances given that both Selic rate and volatility remained high. The Treasury succeeded in placing R\$ 0.9 billion in two tranches of five month securities at 20.39% p.a. average yield to maturity in the first auction and 21.65% in the second one. Five year tenure LFN's were offered in four instances. The total nominal value was R\$ 8.9 billion, with average discounts of 0.05%, 0.07%, 0.09% and 0.14% p.a., respectively. Twenty year tenure NTN-C totaling R\$ 1.4 billion were offered in two tranches, yielding 10.78% p.a. with the simultaneous redemption of 52% of LFT-B and securitized credits of the National Treasury.

Regarding the monetary impact, considering the financial redemption between April 19 and May 22, the National Treasury transactions caused an expansion of R\$ 9.7 billion, due basically, to the net redemption of R\$ 7.5 billion of LTN. The Central Bank operations generated a R\$ 2.1 billion contraction.

The increase in the Selic target rate decided in the last two COPOM meetings and the net redemption of LTN can explain the reduction in the fixed income instruments observed since March 2001. This drop totaled R\$ 12.4 billion between February 28 and May 18 and the ratio to total domestic debt was reduced to 12% from 15% in the same period. On the other hand, the Selic indexed debt was raised by R\$ 12.2 billion during the same period, which is strictly associated to the net placement of LFT and the net redemption of LTN. The dollar-indexed debt also showed an increase of R\$ 19.4 billion, due to both the exchange rate devaluation and the net placements of NBC-E, in response to the demand for hedge.

In April, the average daily volume of final transaction was R\$ 5.2 billion, against R\$ 5.9 billion in the previous month. This difference can be explained by the low volume of public offerings and also the interest rate variation in the month. The reduction of 43.5% in the daily volume of LTN transactions was the main responsible for the reduction in the average daily volume of final transactions, since the remaining groups of securities showed increased trading volumes. The average daily volume of LTN's in April was R\$ 1.3 billion, after an impressive drop to an average of R\$ 2.3 billion in March. As a result, the relative share of those securities was reduced to 25% in April from 39.6% in March.

Along with the public securities market, the future interest rate contracts showed less liquidity. The daily average of future DI decreased to 194 thousand contracts from 235 thousand in March. The October future DI remained the focus of the transactions. The turnover of term DI contracts was also reduced to 2 thousand contracts from 3.3 thousand, with no new transactions.

### **Prospective assessment of inflation**

Identified shocks and their impacts were reassessed in light of newly available information. The scenario considered in the simulations is based on the following hypotheses:

1. April's inflation rate (0.58%) stayed on the upper limit of expectations due to the increase in the following items: Food and Beverage (1.8%), Domestic Employee (2.6%) and Electrical Energy (1.9%). The variation of these three components accounted for 0.55%, almost equivalent to the full change in the monthly headline index;
2. The international price of oil increased since last meeting, maintaining high volatility of daily prices. Considering the implicit price schedule from futures type-Brent petroleum contracts, the average for the year should be around US\$ 27.5 per barrel;
3. The projection for electric energy price adjustments for the remaining of the year was raised from 15.8% to 20%, including the surcharge to be levied on households' energy bills, to be effective in June; adjustment in public transportation was also reassessed, taking into consideration the 21.7% increase in bus fares in the city of São Paulo, whose weight in the index is substantial. For the group of administered prices, including fuel, energy, public transportation and telecommunication, the total expected adjustment is 13.3%, which represents a direct contribution of 2.4 percentage points to this year's inflation;
4. The observed reductions in agricultural prices in the initial weeks of May justified the change in the underlying hypothesis for food price behavior: no variation in this group of prices is expected in the second quarter, reverting the strong increases observed until April;
5. It is expected that fed funds rates remain at the current 4.0% p.a. level until the end of 2002;
6. In the external scenario, it is assumed that after the recent elevation, Brazil's risk premium tends to remain stable in the following quarters. This assumption is equivalent to an upward shift in the Brazil risk curve when compared to last meeting's projected trajectory.

The electrical energy shock was initially modeled as a typical supply shock, reducing the growth rate and pressuring domestic prices. It was also considered as a temporary shock, i.e. its impacts are to be reverted in 2002.



Other hypothesis considered in the previous meeting were maintained, particularly the one of attaining primary fiscal surplus targets. First quarter GDP growth was adjusted according to data released by the IBGE.

From simulations using the basic structural model, it was concluded that keeping interest rate at the current level of 16.25% p.a. yields inflation projections considerably above 4% in 2001. In 2002, however, inflation projections are very close to the 3.5% target.

The IPCA inflation core, calculated by the trimmed-mean method, was reduced from 0.59% in March to 0.46% in April. In twelve months, core inflation reached 5.63%. The assessment of IPCA inflation cores, calculated by exclusion of items, leads to the conclusion that by leaving out the influence of administered and food prices, the twelve-month variation of IPCA remains around 3.5%. The inflation core of IPC-BR, released by Fundação Getulio Vargas, increased from 0.53% to 0.64% between March and April.

The median of market expectations for IPCA inflation, surveyed by the Central Bank on a daily basis, presented the following evolution: for 2001, it was revised upwards from 4.5% to 5.0%, and for 2002, from 3.68% to 3.8%.

### **Monetary Policy Guidelines**

The strong economic activity at the beginning of 2001, in the context of growth deceleration observed in the economies of our trading partners, has influenced the level of imports, that grew at a faster pace than our exports. Hence, more pressure has been exerted on the current account balance and on financing requirements of the balance of payments, with a negative impact on the exchange rate. A series of particularly unfavorable events in both domestic and external scenarios are added to this environment. Among them, the Argentine crisis, domestic political instability and more recently the announcement of energy supply limitations in three out of the five of the country's geographical regions. These events have contributed to maintain the exchange rate under pressure, since this variable immediately responds to risk perceptions of economic agents. The magnitude of recent exchange rate depreciation makes it more difficult, at least potentially, to keep consumer price inflation at low rates.

The heating of aggregate demand observed in 2001 was accompanied by domestic credit expansion in the last months. Although some economic indicators suggests a contraction in aggregate demand at the margin, it is not yet the case with credit operations. In fact, credit volumes loaned out by the banking system increased 3.5% in April, suggesting that the more positively sloped term-structure of interest rates has not yet produced, in full, the expected reduction in loans. Despite the moderate increase in default levels and returned checks, the overall quality of financial institutions' assets has not been affected.

The increasing uncertainties since last meeting were, to a large extent, the result of announced restrictions in energy consumption, whose consequences can not yet be assessed with the desired accuracy. It is clear, however, that the impacts on aggregate

supply will be severe, given the initially expected magnitude and duration of the reduction in energy consumption. This characterizes a supply shock.

In principle, this shock shall reduce more rapidly the quantity supplied of goods and services than the quantity demanded, which tends to lead to inflationary pressures and lower GDP growth rates. However, it is not a trivial task to adequately quantify these effects and their repercussions. For instance, the fall in supply will depend upon the capacity of the economy to adjust to the new environment by means of energy substitution, self-generation of electricity and rationalization of usage. Besides, should domestic demand not fall at the same pace of supply, which is probable, then the exceeding demand could be matched by imports or lead to price increases. The inevitable initial reduction in output growth tends to countervail the inflationary pressures over time by restoring supply and demand equilibrium. On the other hand, if aggregate demand is strongly affected by deteriorated expectations, then inflation and the trade balance would be less affected than output.

Monetary policy shall seek to neutralize the secondary effects of energy rationing on inflation, particularly those whose impacts are to be felt in 2002. The primary consequences of this shock are not limited to the direct impact on price indices from higher energy costs. They also encompass the expected change in relative prices of goods and services due to the downward shift in supply, that tends to raise the indices. The secondary effects include eventual propagation movements generated by the initial price increases and have to be fought to avoid the offsetting of relative price changes, which would, by its turn, lead to additional price adjustments.

Besides the energy shock, other relevant changes in the economic scenario since last Copom meeting shall be taken into account. In the external scenario, uncertainties remain, despite signs of improvement. In the case of Argentina, the attentions remain focused on the swap of short term debt for longer term instruments, and this situation should change only in June, after the settlement details are made public. In the United States, the new reduction of 50 basis points in the basic interest rate tends to improve global liquidity conditions and growth outlook for the world economy. This favors the continuity of adequate external financing of the current account balance, even in the context of lower direct investment flows.

In the internal scenario, April's inflation was higher than expected, again as a consequence of food price increases. Some agricultural products had substantial price increases explained by the currency depreciation. This was the case of beef and poultry, whose exports were raised by strong external demand, and also the case of wheat and its by products. In the initial weeks of May, however, improvement on weather conditions and crops made available at market place have led to a substantial reduction in food prices.

The trajectory of core inflation, calculated by the trimmed-mean method, showed a reduction in April, although its level is still high. Estimates for administered price changes were revised upwards, mainly due to the adverse evolution of international prices of oil. Moreover, other relevant factors underlying this revision are the temporary surcharge to be levied on household energy bills and the increase in public transportation (bus fares) in the city of São Paulo. Taking all together, administered prices shall have a 2.4 percentage point impact on 2001 inflation.

In sum, the Brazilian economy is facing several simultaneous adverse shocks, whose net effects on inflation need to be identified. Signs of demand slowdown are being observed since the increase in interest rates and the deterioration of expectations. In the opposite direction, there are the potential inflationary impacts of the continued exchange rate depreciation and of the energy shock, yet to occur.

Copom concluded that the persistence of existing pressures on inflation and the probable secondary effects of the energy crisis recommend a reinforcement of monetary policy so as to realign the expected inflation trajectory with the established targets for 2001, and, mainly, for 2002.

Consequently, Copom unanimously decided to increase the Selic rate target to 16.75% p.a.

At the close of the meeting, it was announced that the Committee would meet again on June 19, 2001, at 3:00 PM, for technical presentations and, on the following day, at 4:30 PM, in order to discuss monetary policy guidelines as set in the Calendar of Copom's Ordinary Meetings, published in the Central Bank Communiqué no. 8,018, of 11.22.2000.

Gustavo Bussinger  
Notes Revised by the Board