BANCO CENTRAL DO BRASIL – *FOCUS*

July 3rd, 2001

MINUTES OF THE 60th 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: 06.19 and 06.20.2001

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

Called to order: 4:05 PM on 06.19 and 4:17PM on 06.20

Adjourned: 7:47 PM on 06.19 and 9:51 PM on 06.20

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 06.19)

Altamir Lopes –Economics Department (DEPEC)

Daso Maranhão Coimbra – International Reserve Operations Department (DEPIN)

Gustavo Bussinger – Research Department (DEPEP)

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

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

João Borges - Press Secretary (ASIMP)

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

Economic activity

Recently disclosed economic activity indicators suggested that prior to evidences on the electrical energy crisis, the pace of economic growth was already exhibiting signs of deceleration. Such behavior shall be attributed to the already high production level**,** to the increase in default and interest rates, as well as to the effects from unfavorable domestic political scenario and international economics conditions. Current expectations reinforce the perspective of cooling economic expansion in the coming months, influenced by the restrictions imposed by the energy rationing program

In the retail segment, monthly commerce real invoicing in the metropolitan region of São Paulo, disclosed by the Trade Federation of the State of São Paulo (FCESP), decreased by 3.9% in May, seasonally adjusted figures. Year-to-date variation reached 2.8% in May, relatively to 8% in March and 4.9% in April, mainly driven by the decline in sales of consumption goods and automobiles. The monthly trade survey carried out at a national stance by the Brazilian Institute of Geography and Statistics (IBGE), also points to a slowdown in the retail sector, which depressed by 0.7% in the first 4 months of the year. Adding to the indicators of retail activity, the number of cleared checks declined by 6.13% in May compared to the same month in the previous year.

Consumer Intentions Index (IIC), released by FCESP, which captures consumers' perceptions on current and future conjunctures, dropped by 19% in June, reaching 81.7, from 101.1 in May. This plummet, which confirms a downtrend commencing in March, reflects the negative impacts of the energy crisis. With such result, the IIC was displaced to the pessimistic area (below 100) from optimistic (from 100 to 200).

Statistics from the Credit Protection Service (SPC) from the Trade Association of São Paulo (ACSP) showed that the net rate of defaults, which discounts cancellations of new registries, reached 8.1% in May 2001 compared to 6.2% in May 2000. Accumulated up to May, average net default rates rose by 24.1% along with a 30.9% surge in the ratio of the number of checks returned due to insufficient funds and the number of cleared checks.

The total outstanding financial system's credit rose by 1.6% in May. Non-earmarked credit operations increased by 3%, responding to a 4.6% rise in the individuals' segment and a 1.9% augment in corporations'. Since February, new gross concessions have remained at approximately R$ 2.1 billion to corporations and R$ 1 billion to individuals, on a daily basis. However, a waning of new credit operations is expected in the short-run due to less favorable conditions materialized into higher costs to the final borrower and to higher risk aversion upon concessions, which in turn mirror the recent hikes in basic interest rates and in uncertainty.

On the labor market, the open unemployment rate, assessed by IBGE, increased to 6.51% in April, from 6.46% in March, although formal employment maintained its upward trend, which was positively impacted by the net hiring of 135 thousand workers in April. Yet, according to the monthly employment survey also carried out by IBGE, labor costs decreased in March. Average salaries, deflated by the INPC, had a negative variation of 0.28% compared to the same period of the previous year, accumulating a 0.49% loss year-to-date. As to the manufacturing sector, the unit labor cost, defined as the ratio of industry's wage bill deflated by IPA-DI and industrial production, both released by IBGE, dropped by 5.96% in the 12-month period ending in February 2001.

Regarding the manufacturing sector, April output decreased by 1.6% in the seasonally adjusted series compared to March, reflecting a decline in intermediate and consumption goods output and stability in the production of capital goods. Even though industrial output expanded by 7.1% in the first quarter, after including April outcome, expansion retreated to 6.8% in the year. The average utilization of installed capacity, as released by the National Confederation of Industry (CNI), also fell in April, reaching 81% from 81.9% in March.

The positive performance of domestic capital goods production in April, in particular the production of electrical energy equipment, was replicated in other investment indicators. The production of civil construction' inputs and the *quantum of* capital goods imports rose by 4.3% and 43.9%, respectively, in the first 4 months of 2001 compared to the same period of 2000. Up to April, BNDES disbursements had been elevated by 53%, special notice to credit concessions to the production of tradable goods.

Investment growth has been posing pressures to imports of capital goods, chiefly to electronic products, contributing to a US$ 546 million trade balance deficit accumulated in the year up to May. Imports grew by 17.4% in the same period, reflecting the accelerating pace of industrial production. Exports grew by 12.2% in the aforementioned period, basically reflecting an increase in shipments, for prices are practically unchanged when compared to the previous year. Noteworthy was the 32% soar in the sales to the North-American market, mainly composed of manufactured products such as airplanes, automobiles, fuel, footwear and transmission and reception devices.

In the first three weeks of June, the trade balance registered surplus of US$ 110 million, exports posing a reduction in daily average balances compared to May, albeit at a slower pace than imports. When compared to June 2000, both daily average exports and imports expanded by 2%. Exports of sectors with higher capacity utilization level, such as metallurgy and paper and pulp, fell compared to June 2000, offset by increased exports of meat and soybeans. As to imports, stronger reductions were recorded in the segment of raw materials to the textile industry (cotton, threads, synthetic and artificial fibers) responding to the increase in 2001's domestic production of cotton, in addition to aircrafts and parts.

It is expected that the electrical energy rationing bring about deeper impacts in exports of semi-manufactured goods, inasmuch as some of the sector's participants are electricity-intensive consumers. Exports of manufactured goods shall also be impacted, although to a smaller extent, due to the likelihood that domestically produced inputs be substituted by imported ones.

Weaker industrial activity levels are expected to reduce imports. Impacts shall be felt in all usage categories. Such trend should be lessened in the case of raw materials due to the depression in some of the domestic production and therefore its substitution by imported ones. As to capital goods, an increase in imports of alternative energy generation equipment may occur, with impacts on the imports of fuel. Nevertheless, non-related capital goods imports are expected to decline.

Even though the electric energy rationing shall induce a reduction of exports and imports, the differentiated impact of the slowdown in the industrial activity in each of those categories should allow for a better-than-expected performance of the trade balance.

The analysis of the recent evolution of the activity level reveals that the economy was already signaling a loss in dynamism in the months preceding the electrical energy crisis. Awareness of the crisis has intensified the cooling process of the economic activity, not only due to direct rationing effects but also to the deterioration of agents' expectations, as captured by consumer and entrepreneurs' surveys, which indicate cut downs in both consumption and investment. However, the intensity of the rationing impact on the activity level will depend, among others, on the rationalizing capacity of companies, on energy self-generation, energy sources substitution and inter-sectoral transfers of production. A slower pace of economic growth is expected, nevertheless. As a consequence, impacts in export and import flows may result in improvements on the trade balance in the following months.

Prices

In May, the main monthly inflation indices declined, driven by the performance of food prices, which reversed the significant ascent observed in March and April. The several readjustments of administered prices, on the other hand, contributed to the maintenance of monthly variation above the levels verified in the same month of the previous year. The passthrough of recent exchange rate depreciation to prices has been in motion, although concentrated in the retail level and in few products, such as wheat by-products, beer, steel boards and copper wires. The passthrough has also reflected in the increase of administered prices, in particular, gasoline prices.

The consumer price index IPCA rose by 0.41% in May, accumulating 2.42% in the year up to May and 7.04% in 12 months. Non-food prices directly contributed with a 0.28% variation in the month. The largest individual impact was of 0.07 percentage point from readjustments of electric energy tariffs. In the transportation segment, the most significant impact arose from the 21.7% readjustment in the urban bus tariffs in the city of São Paulo, in place after May 24th . Cooking gas prices, deregulated since May 4th, incremented by 3.68%, particularly influenced by the 29.95% hike observed in the city of Goiânia. Food prices increased by 0.58%, significantly decelerating in regard to April (1.8%). The deceleration in price growth rates was generalized due to the larger supply of products such as beans, potatoes, tomatoes, onions, fruit, poultry and eggs.

The wholesale price index IGP-DI increased by 0.44% in May, compared to 1.13% in April, accumulating 3.24% in the year and 10.9% in 12 months. The reversal observed in the monthly rate was led by the trend reversal in food prices, which drove agricultural index IPA to a decline of 0.64%, compared to a 3.8% inflation in April, and waned the expansion of the food item in the consumer price index IPC, which went up by 0.33% compared to 2.26% in April. While the full IPC index increased by 0.41%, the IPC core incremented by 0.52%, in response to the exclusion of a number of negative variations under the trimmed-mean criteria. The wholesale industrial prices elevated by 0.49% in May, a slight increment from previous month's outcome (0.48%), while the INCC accelerated, rising by 2.11%, mainly responding to wage readjustments, collective bargaining and cement prices.

Administered price readjustments are expected to strongly influence IPCA variations in June and July, in particular the inclusion of urban bus tariff readjustments in São Paulo, as well as water and sewage services also in São Paulo, fixed telephone tariffs throughout the country and electrical energy in some capitals. On the other hand, food prices shall continue on a downward trend, attenuating the increase of the general index. Finally, the effects of energy rationing on the economy's price indices tend to be diminished, as already observed, and due to the perspectives of cut-downs on consumption in the following months which will likely curb the passthrough of cost hikes to prices and price increases due to supply shortage.

External environment

More recent information have ratified the cooling trend of the international economy, especially the United States, with Japan still facing difficulties to surpass its economic recessive trajectory as external demand weakens. In the Euro Area, the recent Monetary Policy expansion aimed at stimulating inland demand as a means to offset the loss in exports dynamism, although the inflationary scenario tends to bind expansion of future credit supply. In Argentina, the deepening of the recessive scenario has been postponed by positive exports performance, while the instability in the financial markets has waned after the revision of the IMF agreement and the sovereign debt swap. New economic measures were released in mid-June, aiming at reactivating of the economy.

In the United States, the economic indicators still do not suggest a response of the expansionary monetary policy implemented since January 2001, showing deceleration of the activity level. GDP growth in the first quarter of 2001, initially estimated at 2%, was revised to 1.3% in the seasonally adjusted series, compared to a 1% expansion in the last quarter of 2000. In May, the industrial output contracted for the eighth consecutive month, declining by 0.8%, countersigning the economic slowdown. Annual inflation rates recorded growth, not detected in the core inflation. In May, the Consumer Price Index rose by 3.6% in 12 months, after a 3.3% increase up to April, while the CPI core registered annual variation of 1.6% in April and May.

The Euro Area performance indicates a loss of dynamism due to the contraction of domestic and external demands. GDP grew by 2.5% in the first quarter as to the same period in 2000, compared to 2.9% in the last quarter of the previous year. Industrial output waned, with annual expansion reducing to 3% in March, from 5.5% in January. Price trajectory evidences inflationary acceleration. The harmonized price index registered annual variation of 3.4% in May, compared to 2.6% in March, with rising monthly variations. Corporations' confidence index in Germany and France pointed to expectations of economic activity deceleration, while in Italy the indicators foresee recovery. Hence, the European Central Bank (BCE) decided to maintain the minimum basic interest rate at 4.5% pa.

In Argentina, the revised agreement with the International Monetary Fund (IMF), together with the recent debt swap and the last measures designed to stimulate the economy were recognized as attempts to reverse expectations regarding the fundamentals of the economy.

Macroeconomic indicators in Argentina persist on a less than favorable evolution, except for the commercial performance. Industrial output grew by 1.2% in April, but remains on its downward trend initiated in January 2001 as to 12-month figures. After a feeble recovery in March, demand indicators retracted in April. The most positive performance of the economy relies on the external sector, reaching a surplus of US$694 million in the accumulated series up to April, compared to US$269 million in the same period of 2000. On the other hand, National Treasury's deficit reached USS 1.1 billion in May, accumulating USS 5.1 billion year to date, which will require a surplus of US$ 200 million in June to meet the target for the first half.

The Argentine government carried out a debt swap operation at the beginning of June, which amounted to US$29.5 billion in redeemed bonds, lengthening the maturity of the sovereign bonds and reducing the public sector borrowing requirements by US$16 billion up to 2005. In June 15th, the government released a new set of measures in order to foster economic recovery. Among these measures were changes in the collection of the Value Added Tax (VAT), deductions in the income tax incident on wages ranging from US$ 1.500 to US$ 4.000, tax exemption on salary increases up to US$ 150 by the distribution of food and transportation benefits for salaries lower than US$ 1,500, increase in the social security contribution ratios, subjected to tax compensation and reduction in the Common External Tariff (TEC) on consumption goods.

In addition, the Argentine government designed a foreign trade transitory regime to be operated by means of a convergence factor. Such factor is to be calculated by the Central Bank of the Argentina Republic on a daily basis, considering the simple average of the difference between the parity of dollar and euro in London's interbank market, and it will be used to increase the import costs and create a bonus for exports.

Money market and open market operations

The interest rate curve continued to present variations after the last COPOM meeting in May. The market experienced a relief as a consequence of the announcement of the debt swap in Argentina, immediately contributing to the drop in the premium embedded in the future interest rate in Brazil. The annual interest rate of one year DI term contracts decreased to 20.30% on June 8th, from 23.05% on May 23rd. In this period, a lower impact in the movements of the exchange rate in the interest market was observed. In the week between June 11 and 15, the curve's slope presented gradual increases. The spread between the one-year term DI rate and the Selic target increased to 505 bp in June 15, from 392 bp in June 11. In June 18, the curve showed an impressive increase in the slope to tenures lower than four months and also a significant upward parallel movement for higher tenures, with the *spread* reaching 635 bp. This movement was essentially due to uncertainties that generated an adverse impact on the secondary market of sovereign debt for emerging countries. Market's fixed-income portfolio presented an increasing loss compared to the eve of last COPOM meeting.

Of the six public auctions of NBCE settled between May 23rd and June 19th, five auctions were placed with 10-month maturity and one with 16-month maturity. The strategy adopted was the full rollover of the updated principal, plus interest (three auctions totaling R$ 3.9 billion), in order to meet the additional demand for *hedge* (three auctions, totaling R$ 6.9 billion). The average rate ranged from 7.36% pa and 8.19% pa for the auctions conceived to roll de exchange rate linked debt and from 8.35% pa and 9.72% pa for the auctions designed to meet the demand for hedge. The average ratio demand/supply was of 3.9 for the auctions designed to roll the debt and 2.2 for hedge demand.

Four selling offers of fixed income securities were placed between May 23rd and June 19th. They referred to five-month tenure securities at average rates of 20.13% pa in the first auction, 20.57% pa in the second, 19.97% pa in the third and 19.34% pa in the last one. The total amount settled reached R$ 4.6 billion. The average demand/supply ratio was of 2.5. The National Treasury's decision to increase the volume of fixed securities was due to the lower volatility observed in market's interest rates.

The four auctions of LFT settled in the period totaled R$ 13.7 billion. The securities were offered with five-year tenure and average discounts of 0.16% p.a., in the two first ones and 0.15% p.a. for the outstanding.

Selling offers of four-year and ten-year NTN-C were place with yield to maturity of 10.50% and 10.60% p.a., respectively, reaching R$ 565 million, with R$ 33 million being settled through exchanges with securitized credits of the National Treasury.

Considering the settlements between May 23rd and June 19th, there was an expansionist monetary impact of R$ 2.2 billion. Operations with National Treasury's securities imposed an expansion of R$ 9.2 billion, mainly due to net redemptions of R$ 5.1 billion of LFT and R$ 3.4 billion of LTN. Operations with Central Bank's securities, on the other hand, generated a contracting monetary impact of R$ 7.0 billion.

The average tenure of the issues wase reduced to 43.8 months in May from 47.3 months in April. This reduction is associated with National Treasury's decision to offer fixed-rate securities LTN. The average tenure of the stock of debt increased to 33.6 months in May from 32.0 months in April, essentially due to the approximately 3-month increase in the average tenure of the Selic-indexed debt.

Among the owners of federal securities, Financial Investment Funds held approximately 46% of the fixed debt and 52% of Selic-indexed debt. The remaining of the debt, mostly composed of dollar-indexed and price-indexed securities, was in financial institutions portfolios. Financial Investment Funds have changed their portfolios in the past months more significantly compared to financial institutions. Since the beginning of April, the participation of LTN in those funds securities portfolios reduced to 12.6% from 18.6%, against a surge in dollar-indexed securities to 17.7% from 14.6% and Selic-indexed securities to 67.4% from 64.9%. The net redemption of LTN in April and May and the significant exchange rate devaluation observed in the last month explain such movement.

In May, the average daily volume of definitive transactions reached R$ 5.7 billion, compared to R$ 5.2 billion last month. The low volume registered in the last three months may be explained by the absence of fixed securities auctions in March added to the low offered volume of these securities in the other two months, besides the high volatility of the interest rates.

Along with the fixed-rate securities market, the future interest rate contracts presented a liquidity reduction in May. The daily average of negotiated contracts of future DI reduced to 163 thousand from 194 thousand. The DI future contract for October continued to concentrate negotiations. The daily turnover of term DI remained stable in 2.0 thousand contracts, again without new contracts' redemptions.

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. May's inflation rate (0.41%) was in line with expectations;

2. The international price of oil declined in the last few days, albeit daily prices have exhibited high volatility. Considering the price schedule implied by Brent crude oil futures contracts, the average for the year is assumed to be around US$ 26.5 per barrel;

3. The projection for electricity price increases for 2001 was changed to 20%, considering some adjustments already authorized for areas covered by the IPCA. Adjustments for public transportation were also reassessed, taking into account increases in bus fares above expectations. For the set of government managed prices, including fuel, energy, public transportation and telecommunications, the total expected adjustment is 13.1%, which represents a direct contribution of 2.9 percentage points to this year's inflation;

4. Reductions in agricultural prices in May, indicated by some price indices, were not confirmed by the IPCA. The increase in food and beverages prices reached 4.71% this year, while the IPCA as a whole rose 2.42%. Therefore, the hypothesis for the evolution of food prices was changed to incorporate some deflationary pressure in June and to follow the average of the other prices for the remaining of the year;

5. The inclusion of the term structure of domestic interest rates in the inflation forecast models, as specified in the June 2001 *Inflation Report*, demands the specification of

hypotheses as to its slope. The assumption is that the slope of the interest rate curve would remain positive, smoothly declining through time up to the end of 2002;

6. The hypothesis for the path of the Fed Funds rate, in line with the path for the rate indicated in the futures contracts, is of a reduction from the current level of 4% to 3.5% per year in the third quarter of this year, and stability thereafter;

7. In the external scenario, the persistence of uncertainties is assumed to maintain the Brazil risk premium stable over the next quarters.

Regarding the electricity shock, results yet preliminary of the modeling efforts point out to a reduction in the economic growth rate this year. Net effects on inflation, on the contrary, tend to be minor, especially when compared to the effect of other shocks such as that of government managed prices.

The IPCA inflation core, calculated by the symmetric trimmed-mean method, rose in May to 0.60%, mainly due to food prices. In April, most of the items excluded for being in the upper tail of the distribution belonged to the food group and presented very high rates, contributing to the core's value of 0.46%. In May, the IPCA captured price deceleration for these items, whose fall should be completed by June. Thus, some of those items were included in the core, raising it. Over the last twelve months, core inflation reached 5.9%. The evaluation of the IPCA exclusion core rates leads to the conclusion that, by excluding the influence of managed and food prices, the twelve-month variation of the IPCA remains around 3.7%. The IPC-BR inflation core, released by Fundação Getúlio Vargas, fell from 0.64% to 0.52% between April and May, accumulation 4.95% in twelve months.

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 5.00% to 5.50%, and for 2002, from 3.80% to 3.82%.

The remaining assumptions established in the previous meeting were kept unchanged, in particular the achievement of the primary fiscal surplus according to the fiscal policy targets.

Simulation exercises with the scenario considered in the basic (structural) model leads to the conclusion that the preservation of the interest rate at the current level of 16.75% per year would result in inflation near the upper limit of the target for 2001. However, for 2002 the projected inflation is below the 3.5% target.

Monetary Policy Guidelines

Economic activity continued to grow robustly in the first quarter, followed by an apparent moderation at the beginning, and a substantial drop at the end of the second quarter. Industry led the expansion, and the growth of capital goods production suggests an increase in the investment rate. The marginal deceleration is confirmed by the consumption indicators of April and May and by the reduced demand for credit.

The reduction in energy consumption has been well assimilated by society, although its implications may differ between individual consumers and activity sectors. The energy crisis also has different effects on each macroeconomic variable. There is no doubt that it will have negative effects on output growth this year, but the magnitude of this impact is difficult to quantify. On the other hand, there is a growing consensus that the net impact on inflation tends to be lower. Another important consequence of the energy crisis is to alter expectations, due to its contribution to domestic political instability.

Besides these domestic uncertainties, the external scenario remains troublesome. The global economy still does not shown signs of recovery in growth. The United States' and the Euro Zone's economies still lack strength, while Japan's remains stagnant. Oil prices remain high, despite the recent fall. Therefore, despite the resultant slackening of monetary policy in these economies, the environment of risk aversion remains.

Argentina's situation has improved since the last meeting. The country completed an important lengthening of part of its short-term public debt, making room for advances in the economic stimulus and fiscal reform program. A return to economic normalcy, however, depends on the confirmation of an improving fiscal outlook and consistent signs of economic recovery, which will take some time.

The exchange rate deserves a detailed discussion. In the first months of the year, part of the gradual depreciation of the exchange rate could be explained by the perception of deterioration in the balance of payments and other domestic and external uncertainties. The worsening uncertainties in this period had strong repercussions on Brazil's risk perception, lifting the costs of raising capital abroad. Moreover, the balance of payments' performance was not particularly favorable. The negative outcomes for the trade balance reflected the strength of domestic demand in opposition to the global economic deceleration, suggesting that imports would remain strong, while exports would face foreign demand constraints. As a result, the expected magnitude of the current account deficit was rising, while the expected flows of foreign direct investment were declining. Therefore, it was natural to expect that the foreign exchange market would seek a new equilibrium.

The potential pass through from exchange rate depreciation to prices was one of the reasons for the reaction of monetary policy in the period, with an increase in the interest rate to attempt to neutralize these effects. Inflation expectations, although they were revised upward, did not accompany the pace of depreciation, indicating that part of the latter was not perceived as permanent and, therefore, should not be transmitted to final prices. However, the total impact of the pass through from depreciation to prices should also include the effect on the adjustment of tariffs and other managed prices, especially of gasoline. In this more general context, the exchange rate depreciation is estimated to contribute with at least 1.5 percentage points to the expected inflation for this year.

More recently, however, the dynamics observed in the foreign exchange market changed. Over the last few weeks, the domestic price of the dollar rose considerably. This despite the fact that, in this period, the forecasts of the economic impact of the energy crisis became less pessimistic and there was some improvement in the external scenario. Basic interest rates fell in the United States and in Europe, and Argentina successfully completed a debt swap operation. The pricing process in the foreign exchange market seemed to present new dynamics, decoupled from the usual fundamental determinants: the dollar's price rises simply because a growing number of market participants believe that, since it rose in the past, it will also rise in the future. Therefore, those who otherwise would purchase foreign currency only in the future prefer to do so right away, whatever the current price might be, since they believe that procrastination may be too costly. Although this self-feeding process of exchange rate depreciation is not sustainable in the medium run, it may have nefarious consequences for the economy while it lasts, by distorting consumption and investment decisions, affecting corporate balance sheets, and, most of all, changing relative prices and threatening the inflation targets.

Copom determined that measures should be implemented so that price formation in the exchange market ceases to present the characteristics of a speculative bubble. These measures include an elevation in the cost of maintaining speculative positions and the adoption of the disposition to irrigate the market with additional resources, stemming from reinforcements to the financing of the balance of payments, in order to provide the adequate liquidity for price formation and to avoid the anticipation of future demand for defensive or precautionary reasons. These actions will be backed by the implementation of important structural measures in banking and taxation.

Inflation measured by the Broad Consumer Price Index – IPCA accumulated 2.42 percentage points up to May. This figure is above expectations as a result of (i) the increase in food prices in the first five months of the year, surprising considering the arrival of the agricultural crop, (ii) the increase in government-managed prices 4.2 percentage points above the model's projections, and (iii) the partial pass through of the exchange rate depreciation. Moreover, core inflation measures remain high and managed prices are expected to increase 13.1% in average. Copom considered that the prospect of inflation considerably above 4% in 2001 represents substantial risk for the accomplishment of the target. On the other hand, the path of inflation, in the absence of spiraling exchange rate depreciation, is at present consistent with the 3.5% target for 2002.

In sum, Copom concluded that the persistence of existing pressures on inflation and the potential effect of an unstable process of exchange rate depreciation recommend a reinforcement of monetary policy through a significant elevation in the interest rate, so as to realign the path of expected inflation with the established targets. Two proposals were considered: an increase in interest rates at the upper bound of market expectations or a larger increase, with the simultaneous indication of a downward bias. The second alternative was chosen because, although more complex, it indicates more clearly a proactive approach in seeking a reversion of the present situation. The downward bias was introduced in the understanding that the measures to be announced might contribute to a rapid reversion in inflation expectations.

Accordingly, Copom unanimously decided to increase the Selic rate target to 18.25% per year and indicate a downward bias.

At the close of the meeting, it was announced that the Committee would meet again on July 17, 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.