BANCO CENTRAL DO BRASIL
Focus

**June 3rd, 2002**

# MINUTES OF THE 71st MEETING OF BANCO CENTRAL DO BRASIL (BCB) MONETARY POLICY COMMITTEE (COPOM)

**Summary**

Economic activity
External Environment
Prices
Money market and open market operations
Assessment of inflation trends
Monetary policy guidelines

**Date:** May 21st and 22nd , 2002
**Place:** Central Bank's Headquarters 8th floor Meeting room (on May 21st) and 20th floor (on May 22nd) -Brasília - DF
**Called to Order:** 3:30 PM on May 21st and 11:35 AM on May 22nd
**Adjourned:** 8:05 PM on May 21st and 2:08 PM on May 22nd

**In attendance:**
**Members of the Board**
Armínio Fraga Neto **- Governor**
Beny Parnes
Carlos Eduardo de Freitas
Edison Bernardes dos Santos
Ilan Goldfajn

Luiz Fernando Figueiredo
Sérgio Darcy da Silva Alves
Tereza Cristina Grossi Togni

**Department Heads (all present on May 21st)**

Altamir Lopes – Economic Department (DEPEC)
Daso Maranhão Coimbra - International Reserve Operations Department (DEPIN)
Paulo Springer de Freitas - Research Department (DEPEP)
José Antônio Marciano - Department of Banking Operations and Payment System (DEBAN)
José Henrique de Paula Freitas Simão - Open Market Operations Department (DEMAB)

**Other participants (all present on May 21st)**

Antônio Carlos Monteiro - Executive Secretary
Alexandre Pundek Rocha - Advisor to the Board
João Borges - Press Secretary (ASIMP)
Fabia Aparecida de Carvalho - Investor Relations Group

The Board analyzed the recent performance and prospects for the Brazilian and international economies under the monetary policy framework, designed to comply with the inflation targets established by the government.

**Economic activity**

The indicators of performance of the economic activity showed, at the end of the first quarter, signs of slowing of the recovery started in October 2001. This tendency is only partially explained by inventory level adjustments, mainly by industry, and to possible statistical seasonality effects that diminish March results. The loss of impetus is also attributed to the still modest growth of the payroll, the absence of a more expressive recovery in credit , plus the exhaustion of the process of recovery of consumer expectations that had been present since the end of last year.

Retail commerce was significantly influenced in the last two months by Easter holidays The recovery of business activity observed since the end of last year came to a halt in the Metropolitan Region of São Paulo, as identified by April sales figures. The latter registered a 1.9% drop in real turnover for the month, compared to a 2.3% growth in March, according to the seasonally adjusted data from São Paulo State's Federation of Commerce (Fecomércio). From the analysis by segments it is evident that the decline in supermarket sales was the main reason. The supermarket sector declined 9.3%, compared to an 8% growth in the previous month when Easter holidays boosted business. Other segments less influenced by April seasonality factors showed expansion in the month, such as durable consumer goods, which grew by 2.4%, whilst sales of cars grew 7.5%.

According to the São Paulo Trade Association (ACSP), the enquiries to the Credit Protection Service (SPC) increased by 4.6% in April in comparison with March (seasonally adjusted figures), which coincided with the sales pattern of durable goods. Likewise, the enquiries to Usecheque increased by 7%. According to the same institution, the default rate rose to 9.4% in April from 6% in the observed series and increased to 5.8% from 4.9% in the seasonally adjusted series, reaching the same levels observed in April 2001. The default rate measured by the ratio of checks returned due to insufficient funds and those cleared declined slightly to 5% in April, compared to 5.2% in March.

Year-to-date retail commerce activity declined compared to the same period of 2001. According to IBGE's survey, the accumulated decline was 0.8% up to March and, specifically for the Metropolitan Region of São Paulo, according to data from Fecomercio, the accumulated decline is 3.8% up to April. It should be noted, however, that the growth in income generated by the agriculture and livestock sector has stimulated consumption outside the metropolitan regions. The better performance in the countryside partly explains the less accentuated negative results of the national statistics compared with those of the Metropolitan Region of São Paulo.

Consumer expectations are amongst the factors that explain the current cooling down of economic activity. The Index of Consumer Intentions (IIC), released by Fecomércio, registered growth

throughout this year up to April, but at declining rates. In May, the growth sequence was interrupted and the index fell by 0.9%, showing a fall in the indicators that both reflect current conditions and that signal future conditions.

The survey of the National Confederation of Industry also showed a slight reduction in entrepreneurial confidence in April, reaching 58.9 compared to 59.9 in the January survey. The worse evaluation of the current conditions of the Brazilian economy was a reflection of the weaker levels of activity of the sector and enterprises taking part in the survey. However, the index remained above 50, indicating that entrepreneurs are still confident, mainly in regard to the expectations for the next six months, which remained practically stable at 64.5 from 64.7 in the previous survey.

Industrial production declined by 0.8% in March, according to seasonally adjusted data released by the IBGE, interrupting the sequence of four consecutive months of growth. Three out of the four categories of uses registered decline: 4% in the production of capital goods, 1.5% in intermediary goods and 1.9% in semi-durable and non-durable consumer goods. The production of durable consumer goods was the only one to grow by 1%, in comparison with the previous month. The analysis by sectors, however, shows that the deceleration in industry was not generalized, as 8 out of the 20 surveyed industrial sectors registered expansion. Of the sectors that registered negative results, the food industry showed the worst performance, possibly attributed to inventory adjustment, since the same sector had shown particularly high production in the first two months of this year. The increase in inventories may also be one of the reasons for the slower production levels of industry as a whole. The industrial survey carried out by the CNI reveals that inventory levels of final products increased in April compared to the beginning of the year. Excessive inventory levels were also detected by the Business Scenario Survey of the Processing Industry, carried out by FGV, but simultaneously revealed a reduction in the intentions of lowering inventory levels in coming months.

The weak performance of the production of electric power generating equipment in March was the main reason for the month by month decline in the production of capital goods. On an accumulated

basis, however, capital goods production still show a growth of 8.7% in the first quarter, in comparison to the same period of 2001. Year to date, the expansion rates registered in the production of agricultural machinery and industrial commissioned built goods, 9.9% and 7.2% respectively, are noteworthy, indicating an increase in the production capacity in these sectors. Although on a yearly basis the production of material for the civil construction industry still registered a decline, it has grown for the last three consecutive months, to March, thus contributing to the share increase of the Gross Capital Formation in the Gross Domestic Product (GDP) to 18.8%, according to a forecast of current values released by BCB's Economic Department (Depec).

Regarding the performance of the primary sector, the Continuous Survey of Agricultural Production, carried out by the IBGE in March, estimated that total grain production should reach 98.6 million tons in 2002, remaining stable in relation to the total harvest of 2001. It should be highlighted that the increase in the production of staple foods is of great importance to the price of the basic consumer basket. A typical example is the production of beans and rice, which has already caused declines of 15.2% and 10.5%, respectively, in the prices of these products in the first quarter of 2002, according to the Consumer Price Index – Extended (IPCA).

The formal employment index increased again in March (0.4% in the seasonally adjusted series), reflecting the creation of 90 thousand job positions during the month in the labor market, according to data released by the Ministry of Labor and Employment. IBGE's monthly employment survey also registered an increase in the number of active workers in March; even so, since the 1.3% expansion was lower than the total increase in the number of unemployed workers, the unemployment rate rose to 7.1%, from 7% in February in the non seasonally adjusted series. The IBGE survey also showed a 0.26% drop in the average real wage, considering the seasonally adjusted series. It should be emphasized, however, that only service sector workers suffered a real average wage decline of 2.3%. The earnings of the workers employed in manufacturing, in commerce, in civil construction, and in other activities increased by 1.5%, 1.3%, 0.3% and 1.2%, respectively, in relation to the previous month. By occupations, there was a 0.3% increase in the real average wage of those formally and informally hired , and reductions of , respectively, 3.0% and 2.1% in the earnings of self-employed and employers.

The total stock of credit operations of the domestic financial system increased by 1%, in April, reaching R$ 338.8 billion. The operations with freely allocated resources reached R$ 199.5 billion, maintaining the trend of moderate growth, with variations of 1.2% in April and 3.5% in the year. The stock of credit contracted by private individuals grew by 2% in the month, with expansion in all modalities of operations, especially overdraft accounts (3.6%), and acquisition of vehicles (1.6%). The 1.2% growth in personal credit may be partially explained by the use of credit lines in anticipation of tax returns from the Internal Revenue.

The stock of credit to companies increased by 0.7% in April, reaching R$ 124.2 billion. Modalities contracted with domestic resources increased by 0.4%, especially those that are typically short run, such as guaranteed overdraft accounts and hot money. In relation to the operations linked to foreign currency, the stock returned to January levels, R$ 41.5 billion, showing a 1.3% increase in the month. The 3.8% increase in foreign transfers was partially neutralized by the 1% drop in Foreign Exchange Advances (ACC), causing the total balance of operations to grow by less than the 1.7% exchange rate depreciation in April.

The average interest rates charged on credit operations dropped by 1.1 p.p. in April. This was due to the 2.2 p.p. reduction in average rates charged to private individuals, reflecting the sales promoted by institutions linked to vehicles' assemblers. On the other hand, the stability of the average rates charged on operations to companies resulted from the offsetting of the increases in the modalities of turnover capital, rediscounts and guaranteed overdraft accounts against the reductions in hot money and, mainly, in vendor lines.

Financing requirements fell, for the international transactions of the Brazilian economy, in the first four months of 2002. The current account deficit decreased to US$5.2 billion, compared to US$9 billion in the same period of 2001. Foreign direct investments, reached US$6.7 billion in the period and were more than enough to finance the entire current account deficit.

The reduction in the deficit of the services and income accounts plus the positive trade balance enabled the better current account performance. The trade balance accumulated a US$1.5 billion surplus in the first four months of 2002, compared to a US$561 million deficit in the same period in 2001. This reversion in the trade balance result came from a sharp decline in imports, 21.3%, which counterbalanced the 10.7% drop in exports, consequence of the retraction observed in important markets for Brazilian products. Part of the fall in imports was a result of lower exports of manufactured products, a group comprised of representative items and with an intensive use of imported components. Imports substitution by domestic production was another factor that restrained imports, since the decrease in imports was higher than that of the domestic industrial production.

Summarizing, the economic recovery outlined in the last quarter of 2001 onwards was partially due to overcoming of the shocks that hit the economy last year. The recent cooling off in this expansion, observed in March and April, may be interpreted as a reflex of factors that tend to interfere with growth, such as: a) the small increase in credit and income, aggravated by conjuncture factors that contributed to negatively influence domestic expectations; b) readjustments of energy and fuel prices and their impacts on inflation indices; and c) the depreciation of the exchange rate. The slower growth of the economic activity created a slight increase in inventories to above desired levels in the sectors of production, as registered in the sector's recent performance. However, production should not keep on declining. Some sector indicators in April confirm this expectation i.e. vehicle production and corrugated paper, amongst others. In regardo to demand, a number of favorable factors can be cited such as the growth in income related to agricultural activities, the labor market improvement, continued government expenditure in social programs, plus the beginning of the payment of installments related to the Time in Service Guarantee Fund (FGTS) losses agreement.

**External environment**

In the United States, the prudent optimism of economic recovery prevailed. The most recent indicators however, still presented contradictory signs, a phenomenon peculiar to phases of

economic cycle inversion. The 5.8% GDP growth in the first quarter was influenced by one off factors, such as the increase of 20% in defense expenditures and 22.6% in private investment, mainly in inventory, while final demand increased by only 3.7%, a slower pace than in the previous quarter. The 8.6% growth in productivity was accompanied by a 5.3% fall in unit labor cost and an increase in the unemployment rate to 6% in April from 5.7% in March. The increase in unemployment is associated with the return of the previously discouraged to the labor market, since the number of employed remained practically stable during the same period.

The retail commerce sales (excluding food services) increased by 1.3% in April, according to seasonally adjusted data, 3.7% above those in April 2001. Industrial production continued to rise for the fourth consecutive month, in April, by 4%, increasing the level of industrial capacity utilization to 75.5%. In the same month, the producer's prices index (PPI) declined 0.1%, maintaining a downward trend, although consumer inflation (CPI) increased, accumulating 1.6% in the 12 months up to April.

On the other hand, business and consumer expectation indicators showed signs that the recovery of the U.S. economy will not be as quick as the more optimistic forecasts make believe. In spite of remaining above the leveling off mark of 50 (activity expansion), the Purchasing Managers' Index (PMI) declined to 53.9% in April from 55.6% in March, while the services' index measured by the Business Activity Index (BAI) dropped to 55.3% in April from 57.3% in March, both surveyed by the Institute for Supply Management (ISM, former-NAPM). The Conference Board indicators show a similar trend, with a decline in the Consumer Confidence Index to 108.8 in April from 110.7 in March, and a drop of 0.4% in the Leading Indicator, the first decline in six months.

In the Euro Area, statistical information takes longer to be released, but they show a slower and still uncertain economic recovery. Retail sales grew by 0.5% in February, compared to the previous month, showing that domestic demand is providing only a small contribution to economic growth recovery. The progress of industrial production is also timid, with an increase of only 0.5% in March, but an annual decline of 2.9%, mainly due to Germany's performance, with a fall of 0.8% in the month, and 10.3% over 12 months. The behavior of the German economy affected the

country's business sector expectations, interrupting the recent recovery trend. Nonetheless, the expectations of French and Italian businessmen continued to show optimism and a trend towards recovery. The 2.2% annual inflation rate stayed over ECB's reference level. The trade balance surplus continued to increase up to February, the last month of available data, as imports have been declining more than exports, a trend that may change due to the euro appreciation observed since February.

**Prices**

The main price indices showed an increase in the rate of inflation in April, due to the rise in monitored prices of gasoline, bottled gas and electricity tariffs in some capitals. On the other hand, the inflation of the free prices showed a higher deceleration than in the previous months, influenced by the negative variation in the food prices.

The IPCA increased by 0.8% in April, accumulating a rise of 2.3% in the year and 7.98% in the last twelve months. The 8.7% rise in gasoline prices, in consequence of the readjustments of 9.39% on March 16th and 10.08% on April 6th in the refineries selling prices, contributed with 0.34 of a percentage point to the monthly variation. The price of bottled gas increased by 8.74% in consumer retail outlets. Gasoline and bottled gas together were responsible for 0.47 of a percentage point in the 0.8% IPCA variation in April.

Still amongst monitored prices, the increase of 1.31% in the residential electricity tariff, in consequence of the readjustments in five capitals, and 0.28% in urban transport, due to the increase in the transport tariff in Fortaleza, should be noted. Considering the free prices, the deceleration in price rises was due mainly to the 0.32% negative variation in food prices, a result of the good harvest and the favorable meteorological conditions.

The General Price Index – Domestic Supply (IGP-DI) varied by 0.7% in April, compared to 0.48% in the first quarter, accumulating 1.18% in the year and 8.68% in the last twelve months. The rise in the monthly variation was due equally to the effects of the readjustment of fuel prices in the

Wholesale Price Index (IPA), specially the ones of the chemical industry, and in the Consumer Price Index (IPC), in transport (gasoline) and housing (bottled gas) items. The decline of food prices maintained a negative variation in the agricultural IPA, softening the rise of the industrial IPA and of the IPC. The IPA monthly variation reached 0.75%, compared to 0.1% accumulated in the first quarter, following the 1.3% rise of the industrial prices in the month, against 0.08% in the quarter. The IPC rose by 0.71% in April, compared to 0.42% in March, accumulating 2.07% for the year.

The main pressures on the prices indices for May will come again from the increase in monitored prices, albeit at a lower level than registered in April. In addition to the residual effect of the recent readjustments in fuel and electricity, the readjustment in the transport tariff in Rio de Janeiro should affect the consumer indices. In the wholesale area, the decline of food prices should continue, although at a lower rate, since the preliminary results of the IGP-M showed some recovery in the prices of cereals and meat. In three out of the eleven surveyed capitals, the workers' wage renegotiations in the civil construction sector should significantly impact on the increase of the variation of the National Index of Civil Construction (INCC), with a consequent impact on the IGP-DI monthly variation.

**Money market and open market operations**

After the last Copom decision to keep the Over-Selic rate at 18.50%, the yield curve, which had indicated a reduction of approximately 25 b.p, shifted upwards for all maturities. For maturities of up to 1-month, the negative slope shifted to a positive one, and, for longer ones, the slope shifted upwards. Since then, the yield curve behavior was influenced, mainly, by the uncertainties stemming from the electoral process, by the unfavorable evaluations of the country risk and also by the increase in the Brazil EMBI, which rose to 968 points on May 22nd from 733 on April 17th . The spread between the 1-year interest rate and the Over-Selic target increased to 226 b.p from 49 b.p.

In the period between April 18th and May 22nd , the National Treasury and Banco Central carried out ten auctions to rollover NBCE and NTN-D totaling R$ 9.6 billion. For the first rollover of R$ 5.0 billion in NBCE and NTN-D maturing on May 8th, the following auctions were carried out: two for exchange rate swaps conjugated to LFT at two and three year tenures, two NTN-D auctions at two year tenure, and one exchange rate swap auction at three year tenure. For the second rollover of R$ 4.6 billion in NBCE, redeeming on May 16th , five exchange rate swap auctions were carried out on May 10th and May 14th. After May 7th, the rollovers were exclusively carried out with exchange rate swaps, which led to a significant reduction in the premiums.

At the same time, the National Treasury offered 7 and 12 month-tenure LTNs. The short tenure securities were offered in the five weekly sales events in the period, while the 12-month tenure LTNs were only offered in the first week. The total financial volume of the placements reached R$ 7.2 billion, of which 94% referred to the placements of securities maturing in 2002.

Considering the financial settlements that occurred between April 17th and May 21st, there was an expansionary monetary impact of R$ 14.0 billion, resulting mainly from the R$ 5.0 billion redemptions of LFT, the R$ 6.2 billion placement of LFT conjugated to exchange rate swaps, and the R$ 14.9 net redemptions of dollar-indexed securities.

On April 19th, in order to guarantee liquidity at the beginning of the Brazilian Payment System (SPB) and also to deconcentrate the return of the operations, BCB carried out eight go-arounds, providing and withdrawing liquidity at 2 to 5 working day tenures. Due to the reduction in the number of transactions in the market of bank reserves after the beginning of SPB, Banco Central modified the way it intervenes in the money market, starting to carry out go-arounds at pre-defined spreads in the morning, and leveling off liquidity at the end of the day. In nineteen intervention through go-arounds, Banco Central provided liquidity at a minimum yield of 18.43% p.a, with a R$ 2.3 billion average volume and at an average term of 2.2 days. In twenty five interventions, Banco Central withdrew liquidity at the maximum yield of 18.40% p.a, an average volume of R$ 6.7 billion and an average term of 1.2 day. Moreover, Banco Central carried out two auctions of

LFT repurchase amounting to R$ 3.1 billion, and also R$ 270 million in swap of LFT maturing in February 2003 by LFT maturing in 2006. There were three selling operations of federal securities with repurchase agreements at open unit prices of return, at two and three month tenures, with only the first one being with free transactions of securities.

In April, the domestic federal securitized debt increased by R$ 7.0 billion or 1.1% compared to the previous month. This rise was inferior to the variation of the Over-Selic rate and to the exchange rate depreciation in the period, basically due to the net redemption of R$ 5.5 billion. Due to the R$ 4.2 billion net placements of LTN, the relative share of fixed-rate securities in the total debt increased to 9.8% at the end of April, from 9.1% at the end of March. Incorporating the LFT conjugated with exchange rate swaps, the dollar-indexed debt increased by R$ 3.0 billion, although maintaining its participation in the total debt practically steady at around 28.8%. Under this same concept, the LFT debt fell by R$ 3.4 billion, reducing its relative share in the total to 50.1% from 51.2%.

**Assessment of inflation trends**

The identified shocks and their impacts were reassessed in the light of newly available information. The scenario considered in the simulations assumes the following hypotheses:

1. April inflation rate, measured by the IPCA, increased to 0.80% from 0.60% in March;

2. The forecasts for prices of petroleum by-products assumed the following parameters: the behavior of the exchange rate; the spot and future prices of gasoline in the United States for the gasoline readjustments, and the spot price of the propane gas in the United States as well as the futures prices negotiated in the New York Mercantile Exchange (NYMEX) for the readjustments of the bottled gas. For 2002 as a whole, a 6.6% decline is forecasted due to the fall in gasoline prices in January and February. This percentage figure is the same as was forecasted in the last Copom meeting. This forecast has been maintained despite the exchange rate depreciation, since the latter was offset by a lower-than-expected readjustment of gasoline consumer prices in April

and a lower than expected increase of prices in the refinery in May, as defined by Petrobrás. For bottled gas, a 29% increase is forecasted for 2002, of which 26.1% has already occurred between January and April;

3. The average increase of electricity tariffs in 2002 is estimated at 18%, compared to the projection of 15% in April. This revision was due mainly to the exchange rate depreciation. For 2003, the forecast for the readjustment of electricity tariffs was increased to 13.6% from 12.7% forecast in April. These price rises are concentrated within the period of April to July;

4. Regarding the set of prices administered by contracts and monitored, with a weighting of 30.4% in the IPCA of April, the expected readjustments are 7.6% for 2002, and 4.5% for 2003, with a direct contribution of 2.3 p.p. and 1.4 p.p. for the IPCA. In the April meeting, the expected readjustments for these prices were 7.2% and 4.3%, respectively;

5. The inflation forecasts were based on the new specification of the structural model that has the 180-days pre-fixed DI swap as its explanatory variable, replacing both the Selic rate and the slope of the term structure of the interest rate. The projection for the 6-months spread over the Selic rate is based on a new specification. An error correction model is used. This model includes the Selic rate and the swap rate. The estimated value starts from the current plateau, near zero, to reach -100 b.p. at the end of 2003. This forecast was based on the hypotheses of a constant Selic rate at 18.5% up to the end of 2003;

6. The trend of the U.S. Fed Funds rate, based on the futures contracts maturities, was changed to reflect a 1.8% average rate in the second quarter of 2002, increasing to 2.7% in the first quarter of 2003, stabilizing thereafter;

7. The sovereign risk premium, based on the spread over treasury of Brazil's Global 08 Bond is forecasted to decline to around 700 b.p. for 2003 from the current plateau of 780 b.p..

The core inflation of the IPCA, calculated under the symmetric trimmed-mean method, declined to 0.56% in April from 0.58% in March. In the last 12 months, this core registered a 7.68% variation. The IPC-BR core inflation, calculated under the symmetric trimmed-mean method, declined to 0.46% in April from 0.50% in March. In the accumulated over 12 months, this core registered a 7.27% variation. Core inflation calculated by excluding the prices administered by contracts and monitored (considering the wide set of these items weighted 30.4% in the IPCA in March) and household food prices registered a 0.46% variation in April, accumulating 6.31% in 12 months.

The accumulated variation of the IPCA in 12 months was 7.98%, above the rate observed in March (7.75%) and February (7.51%). The free prices contributed with 4.48% p.p. to inflation and the prices administered by contracts and monitored contributed with 3.70 p.p.. The inflation expectations surveyed by the BCB's Investor Relations Group (GCI) registered a slight increase for 2002, reaching 5.46%, and stablizing at 4.00% for 2003.

Regarding the fiscal policy, the hypothesis of achieving the primary surplus targets for the consolidated public sector, as stated in the Economic Program of the Government, was maintained, as well as the remaining assumptions established in the previous meeting.

From the simulation exercises with several specifications of the structural model, it has been concluded that the maintenance of the interest rate at 18.5% p.a. and the exchange rate at the same plateau as on the eve of the Copom meeting indicates an inflation rate a little over 5.0% in 2002 and below the 3.25% target in 2003.

**Monetary Policy Guidelines**

The recovery of the Brazilian economy over the last few months is showing signs of slowing down. Industrial production declined by 0.8% in March compared to the previous month (seasonally adjusted data). Regarding retail commerce, real sales in the metropolitan region of São

Paulo fell by 1.96% in April (seasonally adjusted data), according to Fecomércio. The Consumer Intentions Index fell in May, after increasing for six consecutive months.

This result was partially offset by the fact that the Easter fell in March. The loss of impetus is also attributed to, the phasing out of the recovery process in consumer expectations, to the end of the cycle of inventory re-composition, to the still modest growth of the payroll, to the lack of credit recovery, and, more recently, to the steeper slope of the yield curve.

In spite of the above scenario there are no indications that the economy is heading for recession. The consumption of durable goods would increase as a result of the end of the electricity rationing and the approach of the World Cup. It is also expected that the elections stimulate some specific sectors, such as the electro-electronics, paper and pulp, and textiles. In addition, some indicators show that the real payroll has grown since January 2002 and that the level of industrial employment has increased since December 2001, according to CNI data (seasonally adjusted). The beginning of payment of the installments related to the FGTS agreement should trigger consumption.

The performance of the external sector remains positive. The current account deficit accumulated in 12 months up to April (US$19.4 billion) was entirely financed by the net inflows of foreign direct investment, which reached US$22.4 billion in the same period. From January to April 2002, the US$5.2 billion current account deficit was also entirely financed by the net inflows of foreign direct investment, which totaled US$ 6.7 billion

Nonetheless, the country risk and the exchange rate have not reflected these good performance of the external sector. Since the Copom meeting of April, the country risk as measured by the Embi+ increased to 940 b.p. from 733 b.p., and the Real depreciated by 7.6%.

Inflation measured by the IPCA was 0.80% in April, 0.20 p.p. above March inflation. Prices administered by contracts and monitored increased by 2.07%, influenced by the price readjustments of oil by-products, and those of free prices (0.24%). The variation of free prices has

declined since February 2002. After reaching 0.64% in February, the monthly variation fell to 0.45% and 0.24% in the two following months. The downward inflationary trend of free prices is projected to continue during 2002 and 2003.

In relation to prices administered by contracts and monitored, Petrobras announced a 1.06% reduction in the price of gasoline at refineries and the maintenance of the bottled gas price. The projection for the inflation of the set of prices administered by contracts and monitored in 2002 is 7.6%, compared to 7.2% forecast in the Copom meeting of April. This projection embodies the increases of urban bus tariffs in the cities of Rio de Janeiro (9.09%) and Salvador (10.0%). The projection increase derives basically from the exchange rate depreciation that took place between the Copom meetings of April and May.

Shock of prices administered by contracts and monitored is defined as the value that exceeds the inflation target, once deducted the impact of the exchange rate pass-through and the inertia over these prices. As the exchange rate depreciated, the impact of its pass-through on the prices administered by contracts and monitored increased. However, the projection for the inflation of prices administered by contracts and monitored did not rise in the same proportion of this impact and, thus, the primary effect of the shock of prices administered by contracts and monitored declined to below 1 p.p.

According to the models used by BCB, the projection of the variation of IPCA for 2002 increased since the April meeting and is slightly over 5.0%. The revision was due almost exclusively to the exchange rate depreciation in the period.

The impact of the exchange rate variation on the inflation projection may be lower than usually predicted which was taken into account in the projection. There are two factors that may induce the recent depreciation of the real to have a relatively smaller than expected impact on inflation. Firstly, the cooling down of economic recovery should inhibit the exchange rate pass-through to the prices. Secondly, in a floating exchange rate regime, the impact of an exchange rate variation on prices should be reduced when the agents perceive this variation as temporary. Thus, in the first

quarter of 2002, the appreciation of the real did not lead to a negative readjustment of prices possibly because the economic agents set prices taking into account a more depreciated exchange rate than actually observed. Thus, the exchange rate variation that is relevant for the economic agents between the first and second quarters of this year should be less significant than actually observed, causing weaker inflationary pressure. However, this does not mean that further exchange rate depreciations will have the same reduced effect on prices.

It is worth noting that, even if the economic agents made their decisions based on the effectively observed exchange rate, which would imply in a higher pass-through of the depreciation to inflation, the projected IPCA for 2002 would still be below the upper limit of the 5.5% target.

For 2003, the projected IPCA is below the target of 3.25%, with an estimated variation in prices administered by contracts and monitored of 4.5%. The low inflation in 2003 should result not only from the lower inflation of the free prices, but also from the convergence of the general price indices, which are used as the reference for the readjustment of prices administered by contracts and monitored in the IPCA.

The inflation expectations surveyed by the Investor Relations Group (GCI) of the BCB are still pointing to a declining trend in inflation in the near future. For 2002 and 2003, the expectations are converging to a figure below 5.5% and around 4.0%, respectively.

The members of Copom considered that the projected downward trend of inflation in 2002 and 2003 forecasted by BCB, reinforced by the market expectations, would recommend a resumption in the process of monetary policy easing, specially in a context of an observed decrease in the inflation of free prices and a trend in economic activity that should not pose inflationary pressures.

However, there was not a consensus on the adequate timing to resume the process of reduction of the basic interest rate. Despite the projection of inflation for 2003 being below the target, the majority of the members considered that the balance of risks for 2002 - the worsening of the country risk, the recent exchange rate depreciation, and the proximity of inflation projections to the

ceiling of the target interval – recommends the confirmation of the downward trend of the inflation rate before the easing of monetary policy, which still has an impact on the outcome of this year's results.

In the light of these facts, Copom decided, with a majority of 5 to 3, to maintain the target for the Selic interest rate at 18.5% p.a..

At the close of the meeting, it was announced that the Committee would meet again on June 18th, at 3:30pm, for technical presentations and, on the following day, at 4:30pm, in order to discuss monetary policy guidelines, as scheduled in the Calendar of Copom's Ordinary Meetings, published in the BCB Communiqué nº 8911, of Oct.3.2001.

**Acronyms**

**ac 12m** accumulated in 12 months
**ACC** Anticipated Exchange Rate Contracts
**BM&F** Mercantile and Futures Exchange
**bp** Base Points
**CDI** Interbank Futures Contract
**CETIP** Center for Financial Custody and Settlement of Private Securities
**CNI** National Confederation of Industries
**CPMF** Provisory Contribution on Financial Transactions
**CSLL** Social Contribution on Net Profit
**DI** Interbank Deposit
**Fecomércio** Federation of Commerce of the State of São Paulo
**FED** Federal Reserve System
**FOMC** Federal Open Market Committee

**FRA** Forward Rate Agreement

**GDP** Gross Domestic Product

**IBGE** Brazilian Institute of Geography and Statistics

**IF** Financial Institution

**IGP-DI** General Price Index – Domestic Supply

**IIC** Consumer Intentions Index

**IPA** Wholesale Price Index

**IPC** Consumer Price Index

**IPCA** Consumer Price Index – Extended

**IPCH** Consumer Price Index – Harmonized

**IPP** Producer Price Index

**IR** Income Tax

**IRF-M** Market Fixed Income Index

**IRRF** Withholding Income Tax

**LFT** National Treasury Letters (floating)

**LTN** National Treasury Notes (fixed rate)

**NAPM** National Association of Purchasing Managers

**NBC-E** Central Bank Note - E Series (indexed to the exchange rate variation)

**NTN-D** National Treasury Note – D Series (indexed to the exchange rate)

**p.a.** per annum

**p.m.** per month

**PEA** Economically Active Population

**pp** percentage point

**Selic** Central Bank's Custody and Settlement Center

**STN** National Treasury Secretariat

**ytd** year-to-date