

June 28th, 2002

**MINUTES OF THE 72nd 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: June 18th and 19th, 2002

Place: Central Bank's Headquarters 8th floor Meeting room (on June 18th) and 20th floor (on June 19th) -Brasília - DF

Called to Order: 3:43 PM on June 18th and 11:18 AM on June 19th

Adjourned: 7:33 PM on June 18th and 1:35 PM on June 19th

In attendance:

Members of the Board

Armínio Fraga Neto - **Governor**

Beny Parnes

Edison Bernardes dos Santos

Ilan Goldfajn

Luiz Fernando Figueiredo

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Sérgio Darcy da Silva Alves

Tereza Cristina Grossi Togni

Department Heads (all present on June 18th)

Altamir Lopes – Economic Department (DEPEC)

Daso Maranhão Coimbra - International Reserve Operations Department (DEPIN)

Gustavo Alberto Bussinger - Research Department (DEPEP)

José Antônio Marciano - Department of Banking Operations and Payment System (DEBAN)

Sérgio Goldenstein - Open Market Operations Department (DEMAB)

Other participants (all present on June 18th)

Antônio Carlos Monteiro - Executive Secretary

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

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 economic activity continues to show gradual expansion, albeit at a slower pace than at the beginning of the year. The initial perception of stronger growth was partly due to a statistical seasonality effect, created by Easter holidays falling earlier this year, in March. The latter has a strengthening effect on the seasonally adjusted results in April. In fact, there are signs of economic slowdown, evident from, among other factors, the recent outcomes of both consumer and entrepreneur expectation surveys.

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The economic recovery was confirmed by the growth of 1.3% in Gross Domestic Product (GDP) in the first quarter of 2002, compared to the previous quarter, according to seasonally adjusted indexes released by the Brazilian Institute of Geography and Statistics (IBGE). Compared to the same quarter of 2001, GDP declined by 0.73%, mostly due to the sequence of shocks that occurred between the two periods rather than by an adverse result in the quarter in reference. In addition to the favorable performance of the agricultural and livestock sectors, the output of the services sector continued to increase, particularly due to the good results of the communications sub-sector, which still reflected the investment cycle initiated after the privatization of the telecommunication companies.

In April, industrial production increased by 4.1%, seasonally adjusted data, with an increase of 7.1% in the production of capital goods, 7.2% in consumer goods and 2.4% in intermediary goods. These good results, as previously mentioned, were influenced by the Easter Holiday falling in March this year. This fact is not offset in the seasonal adjustment process, and thus atypically increased the results in April and similarly reduced them in May.

The Continuous Survey of Agricultural Production, carried out by the IBGE in April, forecasted that in the primary sector, the total grain production in 2002 should reach 99.3 million tons, an expansion of 0.8% in relation to the 2001 harvest. It should be highlighted that the increase in the production of beans and rice, which are products of great importance to the basic consumer basket, caused reductions in their prices. The latter had a favorable influence on inflation in the first months of 2002. In addition, the growth in the harvested crop of soybeans and the higher production of oranges should contribute positively to the trade balance. On the other hand, the reduction in the harvested crop of corn may lead to an increase in the cost of livestock production and require imports to supply the domestic demand.

Regarding demand indicators, retail commerce has shown a roller coast pattern of monthly ups and downs throughout the year. This fact is partly explained by the seasonality effect of Easter coming in March and reflecting in April too. However, the latter trend reveals a loss of dynamism in the

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process of recovery of the sector – initiated in the second semester of 2001, attributed to the still low growth in income and credit. On the other hand, Mother's day and the proximity of the World Cup contributed to sales in May, according to the preliminary data from the São Paulo State's Federation of Commerce (Fecomércio), which shows a 3.2% growth in the monthly sales (seasonally adjusted data).

The volume of credit operations further revealed more moderate expansion. The total balance of those operations in the domestic financial system reached R\$ 343.4 billion in May, with increases of 1.3% in the month and 2.7% in the quarter ending in May. The operations with freely allocated resources totaled R\$ 201.8 billion, increasing by 1.2% in the month, particularly due to a 1.6% growth in the stock of credit granted to private individuals. Noteworthy are the increases of 2.1% in personal credit in the month and 1.4% in the financing of automobiles in the month, 9.4% accumulated in the year.

The stock of credit operations for corporations increased 0.9% in the month. With the 6.7% exchange rate depreciation in May, this expansion was concentrated in the credit lines linked to foreign resources, which grew by 4.4% in the month. On the other hand, the stock of credit lines granted with domestic resources declined by 0.8%, indicating that companies may be liquidating debts and postponing their banking credit requirements.

The average prefixed interest rate charged on credit operations increased by 0.4% p.p. in May. This trend was a result of the increase of the interest rates in the futures market, which raised the average cost of funding. The banking spread declined by 0.3%p.p. in the month. The default rate in operations with freely allocated resources increased by 0.2% to reach 8.9%. The percentage of operations with private individuals in arrears grew by 0.1 p.p., reaching 15.2%, whilst the same figure related to companies remained stable at 4.9%.

The credit conditions and the high default rate have affected consumer expectations. The Index of Consumer Intentions (IIC), released by Fecomércio declined by 12.3% in June, reflecting sharp drops both in the current and future consumer intentions. Furthermore, the index was influenced by

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concerns regarding unemployment and by the unease related to the development of the country's political scenario and the international environment.

Investment, which is another demand component, is showing a partial recovery from the deceleration observed in the last months of 2001. The shift in results is a consequence of the evolution of the production of both capital goods and basic materials for the civil construction industry, as confirmed by recently released indicators for April, bearing in mind the influence of the seasonality effect in this case too. In the month, there were increases of 2.2% in the production of civil construction materials, 6.2% in the production of machinery and equipment and 6.2% in the *quantum* of imported capital goods, seasonally adjusted data. Another indicator of business investment decisions is the financing granted by the National Bank of Economic and Social Development (BNDES), which increased by 29% in the first five months of 2002 compared to the same period of 2001. The BNDES financing requires a 40% to 50% complement from the investor.

Regarding the evolution of investment flows, it should be highlighted that despite the recovery trend observed in the last few months, the absorption of capital goods declined by 4.9% in the first quarter, in comparison to the same period of 2001. This was a result of the combination of the 0.3% growth of domestic production, an 18% decline in imports of capital goods, and to the 12.5% fall in the exports of capital goods.

In the labor market, the increase in the formal employment index is worth noting. There was a 0.4% increase in April, in the seasonally adjusted series, reflecting the creation of 175 thousand job positions, according to the Ministry of Labor and Employment. However, the IBGE's Monthly Employment Survey registered an increase in the unemployment rate to 7.6%, from 7.1% in March, mainly as a result of the 7.5% increase in the number of unemployed, since the number of employed workers declined by 0.2%. The decline in the number of active workers was mainly due to the slowdown of the civil construction industry and of commerce, whilst the manufacturing industry showed a 2.3% increase. Data released by the National Confederation of Industries (CNI) indicated a similar trend, apart from revealing an increase in the real payroll.

As for the external transactions of the Brazilian economy, the current account deficit declined to US\$ 7 billion during the January-May 2002 period, compared to US\$ 11.2 billion deficit registered in the same period of 2001. The current account deficit in the January to May 2002 period was totally financed by the net inflow of foreign direct investment, which reached US\$ 8.1 billion.

The better current account result reflected the reduction of the deficit in the services and income accounts and, principally the reversal of the trade balance, which reached a US\$ 1,933 million surplus in the first five months of 2002, in comparison to a deficit of US\$ 353 million in the same period of 2001. The shift in the trade balance result was due to the 21.4% fall in imports, as the contraction of important markets for Brazilian products led to a 12.2% decline in exports. Moreover, soybean exports have been delayed this year, in spite of the growth in the production, as the sector is well capitalized and awaits the right moment to trade an important part of the current harvest. Regarding the decline in imports, in addition to the impacts of the substitution of purchases abroad by domestic producers, the decline in exports of manufactured goods, which have a high coefficient of utilization of imported raw materials and components, all had a noteworthy influence too.

In summary, activity related to production is still growing, but shows some signs of deceleration. From the demand viewpoint, the positive effects of the increasing agricultural revenue and the beginning of the payment of the installments related to the agreement on the losses of the Time in Service Guarantee Fund (FGTS) are being, nevertheless offset by the deterioration of consumer expectations.

External environment

In the United States, the scenario of recovery of economic activity is still unclear. The GDP growth in the first quarter was revised to 5.6% from 5.8%. The result was highly influenced by isolated factors, such as the increase in defense expenditures and private investments, mainly in inventories, whilst final demand evolved more slowly than in the previous quarter. The industrial production expanded by 0.1% in May, compared to the forecast of 0.3%, showing signs of

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deceleration. The level of utilization of the installed capacity remained stable at 75.5%. Industry and commerce inventories declined by 0.2% in April, despite the upward trend of the last months. There was a marginal improvement in the labor market, with a reduction in the unemployment rate to 5.8% in May from 6% in April and stability in the number of employees and hours worked, in addition to the retraction in the real average income.

The retail commerce sales (excluding food services) declined by 0.9% in May, according to seasonally adjusted data, albeit being 1.9% above the sales of May 2001. In the same month, the producer's price index (PPI) once again registered negative variation (0.4%), with the highest fall of the last six months. The core index, which excludes food and energy price variations remained unchanged. The consumer prices continued to be stable in May, resulting in an annual variation of 1.2%, while the core index of consumer prices increased by 0.16% in the month, maintaining the 2.5% annual variation. The entrepreneur and consumer expectations remained on an upward trend, according to the indications of surveys by the *Institute for Supply Management* and the *Conference Board*.

In Japan, the statistics revealed some positive signs of economic recovery. First estimates indicated that GDP grew by 1.4% in the first quarter of 2002, in comparison with the previous quarter, and 5.7% on an annual basis, geared by the performance of the external sector. Exports totaled US\$ 32.9 billion in April, increasing by 3.8% over the same month of 2001, while the imports declined by 9.2% over the same period, reaching US\$ 26.9 billion. The growth in the exports of automobiles and electronic goods should be highlighted. Industrial production increased by 0.2% in April, whilst inventories declined for the third consecutive month, and factory orders increased by 11.3%, indicating a recovery in commercial investments. The unemployment rate reached 5.2% in March, after remaining stable at 5.3% in the first two months of the year.

In the Euro Area, after a long period of stagnation, the economy starts showing signs of moderate expansion. GDP grew by 0.2% in the first quarter of 2002, favored by export growth, despite the recent exchange rate appreciation. Domestic demand remained sluggish, with retail sales increasing only 0.3% in March, after rising by 0.5% in February. In May, the expectations of the

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entrepreneurial sector remained favorable in France and in Italy, improving in Germany, after an localized retraction in April. Consumer confidence is improving in France and in Germany and is stable in Italy. The inflation of consumer prices declined to 0.1% in May, and to 2% on an annual basis, favored by the drop in food prices, by the appreciation of the euro and even by the favorable statistical effect derived from the fact that May 2001 registered the highest rise of consumer prices in the year.

In Argentina, the fall in the level of economic activity, the liquidity crisis, and the exchange rate market volatility persist. Industrial production shrank by 16.5% in April compared to the same month of 2001. The inflation showed signs of deceleration in May, but the price variation ytd is 25.9% in the consumer index and 80.4% in the wholesale index. The trade balance maintained a surplus in the first four months, with a fall of 65% in imports, due to the reduction in the quantum, and a drop of 5% in exports, reflecting depressed prices. The overall public sector deficit reached P\$3.3 billion in the first four months of the year, exceeding the annual budgetary target of P\$3 billion.

Prices

The main price indices showed a divergent paths in May. The Consumer Price Index – Extended (IPCA) decreased to 0.21% in May from 0.8% in April, while the General Price Index – Domestic Supply (IGP-DI) increased to 1.12% in May from 0.7% in the previous month. The recent evolution of the price indices can be largely attributed to the behavior of food prices – with distinct trends in the wholesale and retail commerce - and to monitored prices, especially fuel prices.

In the IPCA, food prices fell in April (0.71%) and May (0.59%), benefiting from reductions in the prices of items with relevant weight in the basic consumer basket, such as rice, beans, meat and, recently, *in natura* products. This behavior is explained by the seasonality in the period, by favorable agricultural harvests and by favorable climatic conditions, characterizing a favorable supply shock. The group of products with prices administered by contracts and monitored was the

main reason, for the second consecutive month, for the rise in the IPCA in May, reflecting mainly the readjustments of electricity tariffs and the wages of housekeepers.

In the past months, except for food prices, the free market prices continued to show relative stability in their monthly variation (0.48% in March, 0.52% in April and 0.46% in May). Among the main groups responsible for these variations are pharmaceuticals in March, privately owned vehicles and clothing in April, and electro electronics and services of maintenance and repair in May.

Regarding the IGP-DI results, it is worth highlighting the evolution of the wholesale prices, which have a weighting of 60% in the general index. In this segment, it is worth mentioning the recovery, after consecutive falls since the beginning of February, in agricultural prices, which rose by 0.85% in May compared to a decline of 0.71% in April and to a reduction of 0.6% in the agricultural prices in the IGP-M of May. The main factors that explained the behavior of Agricultural Wholesale Price Index (IPA) were the prices of the soy (influenced by the variation of the exchange rate), corn (this product has a supply constraint this year, its price had already increased in the previous months), and meat in general (whose prices are now presenting a less intense decline). The wholesale prices of industrial products continued on an upward trend observed since the beginning of April. This trend reflected, in part, the depreciation of the exchange rate in the period, especially affecting the metallurgical and mechanics segments, in addition to paper and cardboard, chemical and food products. The civil construction workers' wage readjustment scheduled in their labor agreement in three out of the eleven surveyed capitals increased the variation of the National Index of Civil Construction (INCC) by 2.5%, impacting with 0.25 p.p. in the monthly variation of the IGP-DI. The variation of the Consumer Price Index (IPC) registered deceleration, reaching 0.28% compared to 0.71% in April, mainly due to the lower rises observed in transport and housing.

In June, the prices administered by contracts and monitored should remain as the main source of inflationary pressure, as a result of the recent readjustments in the prices of bottled gas, urban transport tariff in Rio de Janeiro and Salvador, and fixed telephone tariffs. The contribution of the

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food group should be smaller, as a result of the behavior of wholesale agricultural prices. However, these movements constitute supply pressures, thus with temporary effects on the trajectory of the indices. Trend inflation Indices (core inflation indices in twelve months or free market prices excluding food) show favorable prospects.

Money market and open market operations

The last Copom decision did not cause significant shifts in the yield curve. From the beginning of June onwards, however, a significant increase was observed in the slope of the yield curve due to the deterioration in the risk perception on the part of the economic agents. The spread between the 1-year interest rate and the Over-Selic target increased to 833 bps on June 18th, from 188 bps on May 21st. The 1-month interest rate spread increased to 38 bps from -23 bps.

In the period between May 22nd and June 18th, the National Treasury and Banco Central carried out six auctions to rollover R\$ 10.0 billion in NBCE and NTN-D maturing. For the first rollover of R\$ 3.7 billion in NBCE redeeming on June 13th, two NTN-D auctions were carried out at a five month tenure. For the second rollover of R\$ 6.3 billion in NTN-D maturing on June 19th, four exchange rate swap auctions were carried out, one at 2-year tenure, representing 45% of the total, and the others at a 6-month tenure.

Meanwhile, the National Treasury carried out three auctions of LTNs. In the first one, 6-month securities maturing in December 2002 were offered. In the second, which had demand for only 68% of the offers, 7-month securities maturing on January of 2003 were offered. Consequently, the National Treasury decided to reduce the tenure of the offers in the last auction of the period to four months. The total financial volume of the operations was R\$ 4.3 billion, of which 84% referred to the placements of securities maturing in 2002.

Considering the financial settlements that occurred between May 23rd and June 19th, there was an expansionary monetary impact of R\$ 12.5 billion, resulting mainly from the R\$ 3.7 billion net

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redemptions of LTN and the R\$ 7.9 billion redemptions of dollar-indexed securities (mainly due to the rollover of NTN-D with exchange rate swaps).

During the 18 working day period between May 23rd and June 19th, Banco Central do Brasil intervened in the open market by withdrawing and providing liquidity at one working day tenure and yields of 18.40% and 18.50% p.a., and average volumes of R\$ 6.5 billion and R\$ 0.9 billion, respectively. In the same period, Banco Central operated with daily spread auctions to level out the banking liquidity. In all operations in which Banco Central provided liquidity to the market, the yield was 18.60%. In the liquidity withdrawing interventions, the yield fell to 10% from 15%, ending the period at 18.30%. In the 18 day period, the average liquidity withdrawn and provided in the leveling operations, reached R\$ 0.7 billion and R\$ 0.2 billion, respectively. There were also two selling auctions of LTN with repurchase agreements, totaling R\$ 3.4 billion and with an average tenure of 20 working days.

Moreover, in June, Banco Central carried out several operations to exchange federal securities (LFT and dollar-indexed). The operations intended to reduce the duration of those securities in the market, in order to reduce the market's exposure to these assets' price volatility.

In the first auctions to exchange LFT, the securities repurchased were scheduled to mature in 2004, 2005 and 2006, and the ones placed will mature in 2003, totaling R\$ 24.3 billion. In the other auctions, the securities offered were scheduled to mature in 2002 and the ones repurchased will mature in 2003. The nature of these operations was due to the rise in the discount of the latter securities. Banco Central accepted, on June 14 and 17, bids to exchange securities maturing in 2004 to 2006, amounting R\$ 5.1 billion. The bids for LFT maturing in 2003 reached R\$ 14.4 billion, on June 17 and 18.

In the three auctions to exchange dollar-indexed securities, the repurchased securities were scheduled to mature in 2004 and 2005. In the first two, securities maturing in 2003 were sold (totaling R\$ 4.0 billion), and, in the last one, Banco Central sold securities maturing in 2002 (amounting to R\$ 3.0 billion).

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Three auctions to exchange FX swaps were carried out in order to reduce the duration and distortions in the slope of the exchange rate coupon. In the first two, the contracts accepted were scheduled to mature in 2004 and the ones placed will mature in 2003. The notional value of the operations reached US\$ 1.7 billion. In the third operation, Banco Central assumed a long position in contracts maturing in 2003 and 2007 and a short position in contracts maturing in 2004. The notional value of the operation was US\$ 1.9 billion.

In May, the domestic federal securitized debt increased by R\$ 6.1 billion compared to the previous month. The increase in the share of the exchange rate indexed debt to 30.3% in May from 28.8% in April was mainly due to the depreciation of the Real.

Assessment of inflation trends

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

1. May inflation rate, measured by the IPCA, declined in relation to April, reaching 0.21% in May, compared to 0.80% in the previous month;
2. For 2002 as a whole, a 4.5% decline in gasoline prices is forecast due to the fall in January and February. This forecast is higher than the -6.6% forecast in the last Copom meeting. For bottled gas, a 28.0% increase is forecast for 2002 (compared to an increase of around 29% in the last meeting), of which 21.5pp has already occurred from January to May. The increase in the forecasts of these products was partially offset by a smaller than expected readjustment of these products in the May IPCA;

3. The average increase of electricity tariffs in 2002 is estimated at 19.4%, compared to 18.0% forecast in May. For 2003, the forecast for the readjustment of electricity tariffs declined to 12.3% from 13.6% forecast in May;
4. Regarding the set of prices administered by contracts and monitored, with a weighting of 30.8% in the IPCA, the inflation forecast for 2002 is 8.1% compared to 7.6% forecast in the May Copom meeting. The increase in the forecast was basically due to the exchange rate depreciation that occurred between the Copom meetings of May and June. This depreciation was partially offset by the evolution of the international price of petroleum and its by-products. The gasoline price in the United States, which is used by Petrobras as a parameter, has declined. Likewise, the future prices of gasoline and propane gas have declined compared to the Copom meeting of May. The forecast inflation for the prices administered by contracts and monitored is 6.1% for 2003. There was thus an increase of 1.6 p.p. since the May Copom meeting. The increase in the inflation forecast for 2003 is due to the effects of the exchange rate depreciation, to the increase in the future price of petroleum by-products next year, and to the change in the hypothesis of price readjustments for specific items;
5. The inflation forecasts were based on the new specification of the structural models 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 forecast of the 6-month spread over the Selic rate is based on a model specification that is based on the new method of estimating by error correction. Maintaining the Selic rate constant, the 6-month spread forecast starts at 350 b.p. on the third quarter of 2002, presenting a declining trend afterwards to reach 50 b.p. during 2003.
6. The trend of the U.S. Fed Funds rate, based on the maturities of the future contracts, was changed to reflect a 1.75% average rate in the second quarter of 2002, increasing to 2.25% in the first quarter of 2003, and stabilizing at 2.5% from the second quarter of 2003 onwards.

7. The sovereign risk premium, based on the spread over treasury of Brazil's Global 08, is forecast to decline gradually to 700 b.p. in 2003 from the average plateau of 940 b.p. in this quarter. On the eve of the Copom meeting, it reached around 1,500 b.p.

The core inflation of the IPCA, calculated under the symmetric trimmed-mean method, declined to 0.51% in May from 0.56% in April. In the last 12 months, this core figure registered a 7.58% variation. The IPC-BR core inflation, calculated under the symmetric trimmed-mean method, declined to 0.36% in May from 0.46% in April. In the last 12 months, this core figure registered a 7.10% variation. Core inflation calculated by excluding prices administered by contracts and monitored plus household food prices registered a 0.46% variation in May, accumulating 6.39% in 12 months.

The accumulated variation of the IPCA in 12 months was 7.77% in May, below the rate observed in April (7.98%) and close to the rate observed in March (7.75%). The free market prices contributed with 4.05p.p. to inflation and the prices administered by contracts and monitored contributed with 3.72p.p. The inflation expectations surveyed by Banco Central do Brasil's Investor Relations Group (GCI) remained stable for 2002 and 2003, respectively at 5.46% and 4.00%.

Regarding the fiscal policy, the hypothesis assumed is to achieve the primary surplus target of 3.75% for the consolidated public sector. The remaining assumptions established in the previous meeting were maintained.

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 will lead to an inflation rate of approximately 5.5% in 2002 and below the target in 2003.

Monetary Policy Guidelines

The indicators of economic activity on the second quarter of 2002 seem to confirm that the economy is recovering from the low level of growth observed last year, albeit at a slower pace. In the first quarter of 2002, seasonally adjusted GDP grew by 1.34% compared to the previous quarter. The strong seasonally adjusted growth in the industrial production in April (4.07%), measured by the IBGE, was partially influenced by the anticipation of the seasonal bank holidays. In line with the growth in industrial production was the increase in the real payroll in April, both in São Paulo, according to FIESP, and throughout Brazil, according to the CNI.

For the month of May, some indicators point to a reduction in industrial production compared to the previous month. The inventory levels in the manufacturing industry of raw materials and intermediate goods declined according to CNI estimates, whilst inventories of final goods increased in the first quarter. The open unemployment rate, measured by the IBGE, interrupted the downward trajectory and started to rise again, reaching 7.6% in April, compared to 7.1% in March. The Consumer Intentions Index, measured by São Paulo's Fecomércio, significantly declined by 12.31% in June (seasonally adjusted). Likewise, the Industrial Entrepreneur Confidence Index fell slightly in the current quarter, albeit rising significantly in the first quarter of the year compared to the two previous quarters. Credit to consumers and corporations should be relatively constant in the following months due to the increase in default rates, constraining expenditures with consumption and investments.

The performance of the external sector continues to be positive. The trade balance showed a positive result of US\$ 4.9 billion in the last twelve months up to May. The current account deficit accumulated in 12 months has continuously declined since August 2001, reaching US\$ 19.4 billion in April. From January to May 2002, this deficit was fully financed by the net inflows of foreign direct investment, which totaled US\$ 22.4 billion accumulated in the last 12 months. For 2002, the

deficit is projected to reach US\$ 19 billion, and should be almost entirely financed by the US\$ 18 billion net inflow of foreign direct investment.

Nonetheless, the recent adverse economic scenario, marked by an increase in the uncertainties regarding the future of the country, has negatively influenced the price of local and foreign assets. Comparing the exchange rates quoted on the days immediately preceding the Copom meetings, the Real has depreciated by 7.5% since the meeting in May, with the country risk measured by the Embi+ rising to a level above 1,300 bps from 930 bps. The volatility in the markets also hit other assets. The one-year exchange rate coupon significantly increased in comparison with that observed at the beginning of the year, the same occurring with the discounts on the long term LFTs.

The IPCA inflation in May was 0.21%, 0.59 p.p. below April inflation. The prices administered by contracts and monitored increased by 0.43%, influenced by the readjustments in the prices of oil by-products. Free market prices increased by 0.11%, benefiting from the seasonal behavior of food prices. The variation of the free market prices has declined since February 2002, reaching 0.64%. Excluding the impact of *in natura* food prices, free market prices increased by 0.17% in May.

For the months of June and July, a higher increase is expected in free market prices compared to those registered in May. The reversal in the decline of agricultural prices is already impacting on wholesale prices, with the agricultural IPA increasing by 0.85% in May. Moreover, the recent exchange rate depreciation should exert pressures on free market prices in the following months. Nonetheless, this impact may be limited. Firstly, as a result of slower economic growth, the capacity of firms to passthrough the cost increases associated with the exchange rate variation is limited. Furthermore, during the first four months of the year, for the establishment of prices, in all likelihood, a more depreciated exchange rate than effectively occurred was being used as a parameter. Likewise, the economic agents may also be establishing prices based on an exchange rate that is more appreciated than is effectively occurring.

Prices administered by contracts and monitored should also exert pressures on inflation in June and July. Petrobras announced a 9.2% readjustment in the refinery prices of bottled gas, effective from June 1st. In that period, there will also be a concentration of readjustments in the prices of electricity and fixed-line telephones.

The impact of the exchange rate variation on prices administered by contracts and monitored is more direct than on free market prices. In the case of prices of oil by-products, the domestic prices closely follow international prices converted into Reais, though the percentage readjustment to consumers would be lower due to the existence of other cost elements and the disproportion between taxes and prices. In the case of electricity and fixed-line telephones, the contracts signed with the concessionaires usually embed readjustments based on the exchange rate variation and/or on the IGP variation, which is influenced by the exchange rate.

The shock of prices administered by contracts and monitored is defined as the value that exceeds the inflation target, after deducting the impact of the exchange rate passthrough and the inertia on these prices. As the exchange rate depreciated, the impact of its passthrough on the prices administered by contracts and monitored increased. However, the projection for the inflation of prices administered by contracts and monitored was lower than that predicted by the passthrough coefficient, mainly due to the drop of international prices of oil by-products. Thus, the primary effect of the shock of prices administered by contracts and monitored declined to around 0.5 p.p. On the other hand, the forecast for the impact of 2001 inertia on 2002 inflation increased to 0.9 p.p. from 0.7 p.p. due to the incorporation of the chain effect through 2002, as detailed in the Technical Note n. 22 (“Methodology for calculating the inflation inertia and the effects of the shock to administered prices”). The inflation target for 2002 adjusted for the impact of the primary effects of the shocks of prices administered by contracts and for part of the impact of the 2001 inertia on the 2002 inflation is between 4.5% and 5%.

The inflation expectations surveyed by the Banco Central do Brasil's Investor Relations Group (GCI) are still indicating a decline in inflation for the near future. For 2002 and 2003, the expectations are converging to a figure below 5.5% and around 4.0%, respectively.

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Copom has worked with a basic scenario for the following 18 months that assumes both the maintenance of an economic policy in 2003 that is committed to fiscal stability and the inflation target regime and a transition to the future government without exaggerated and/or prolonged moments of turbulence.

In this basic scenario, the inflation of free market prices should maintain its downward trend and the inflation measured by IPCA should be in accordance with the targets established by the government. According to the models used by the Central Bank, the projection of the variation of IPCA for 2002 increased since the May meeting and is around 5.5%. The revision was due exclusively to the exchange rate depreciation in the period. The projection for the IPCA in 2003 is below the established target of 3.25%.

In this scenario, the Copom understands that it would be advisable to reduce the interest rate due to the following factors: (i) in the current monetary conditions, the projection of inflation for 2003 is significantly below the target, (ii) the inflation expectations show confidence prevailing to a downward trend for inflation in the following 18 months, and (iii) despite the projection for inflation in 2002 being slightly over the center of the target adjusted by the impact of the shocks of prices administered by contracts and monitored and in part due to the impact of the inflationary inertia of 2001 on 2002 inflation (resulting in an interval between 4.5% and 5.0%), this difference reflects the recent increase of the market's volatility, especially in relation to the exchange rate, which tends to be a temporary factor.

However, one should evaluate the risk of the non-materialization of this basic scenario. As uncertainty in relation to the future of the country's economy and the recent adverse conjuncture, characterized by the steep depreciation of asset prices and of the exchange rate persist, the risk of an increase in the projections for inflation in 2002 and 2003 also exists. Especially, the perception of a temporary exchange rate variation and the magnitude of its passthrough to prices could be brought into question, in spite of the factors that could restrain the exchange rate passthrough described above.

Weighing up all the options, Copom considered that, although the prospects for inflation are favorable in the baseline scenario, the increase of the uncertainties regarding the economic scenario place doubts on the materialization of this scenario and recommends the maintenance of the present interest rate. However, as the financial market normalizes, with the stabilization of asset prices and of the exchange rate at levels that reflect more adequately the economic fundamentals, the prospect of declining inflation in the following 18 months will become more likely, and may in turn permit a reduction in the interest rate. As a result, taking into account that the recent instability does not reflect the current fundamentals of the Brazilian economy and thus can be considered as temporary, the Copom assessed that the situation recommends signaling of a possible reduction in the interest rate before the meeting in July.

In the light of these facts, the Copom decided, unanimously, to maintain the target for the Selic interest rate at 18.5% p.a., and signal a downward trend.

At the close of the meeting, it was announced that the Committee would meet again on July 16th, at 3:00pm, for technical presentations and, on the following day, at 11:00am, in order to discuss monetary policy guidelines, as scheduled in the Calendar of Copom's Ordinary Meetings, published in the BCB Communiqué n. 8911, of Oct 3, 2001, and in the BCB Communiqué n. 9586, of June 6, 2002.

Acronyms

ac 12m accumulated in 12 months

ACC Anticipated Exchange Rate Contracts

BM&F Mercantile and Futures Exchange

bp Base Points

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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

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PEA Economically Active Population

pp percentage point

Selic Central Bank's Custody and Settlement Center

STN National Treasury Secretariat

ytd year-to-date