

July 26<sup>th</sup>, 2002

**MINUTES OF THE 73<sup>rd</sup> 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

Acronyms

**Date:** July 16<sup>th</sup> and 17<sup>th</sup>, 2002

**Place:** Central Bank's Headquarters 8th floor Meeting room (on July 16<sup>th</sup>) and 20th floor (on July 17<sup>th</sup>) -Brasília - DF

**Called to Order:** 3:35 PM on July 16<sup>th</sup> and 11:28 AM on July 17<sup>th</sup>

**Adjourned:** 7:52 PM on July 16<sup>th</sup> and 2:21 PM on July 17<sup>th</sup>

**In attendance:**

**Members of the Board**

Armínio Fraga Neto - **Governor**

Beny Parnes

Carlos Eduardo de Freitas

Ilan Goldfajn

Luiz Fernando Figueiredo

Sérgio Darcy da Silva Alves

Tereza Cristina Grossi Togni

**Department Heads (all present on June 18<sup>th</sup>)**

Altamir Lopes – Economic Department (DEPEC)

Daso Maranhão Coimbra - International Reserve Operations Department (DEPIN)

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

Paulo Springer de Freitas - Research Department (DEPEP)

Sérgio Goldenstein - Open Market Operations Department (DEMAB)

**Other participants (all present on June 18<sup>th</sup>)**

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)

Tarsila Segalla Afanasieff - 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 has been showing deceleration in the last few months, as a consequence of the recent instability and its impact on the aggregated demand. Some indicators show that the favorable results of industry and commerce, observed in previous months, were associated with circumstantial facts such as the statistical effect of the Easter holidays in March, and events like

the Mother's Day and the World Cup. Recent information indicates relative economic stability, due to the modest growth of payroll and of credit demand. Further circumstantial factors, such as the payment of the balances of Time in Service Guarantee Fund (FGTS), in a context of financial uncertainty, may marginally affect the evolution of the activity level indicators in the following months.

Industrial production fell by 5.1% in May (seasonally adjusted data), due to the 6.4% reduction in the manufacturing industry, compensated in part by the 2.8% growth in the mining industry. The contraction of production of manufacture in the month was predictable - as the result was partly due to the statistical effect compared with the steep growth registered in April - albeit the decline was sharper than expected. All the categories of use showed decline, especially the durable consumer goods (-12.9%) and capital goods (-9.7%). Regarding the performance of the industrial sectors surveyed, one can observe that most sectors registered declines (16 out of the 22), especially electrical material and communications (-8.9%), mechanical (-8.8%), transport material (-7.6%), food products (-5.7%) and metallurgical (-4.6%). Indicators related to the production of corrugated paper and machinery for agricultural activities registered another fall in industrial production in June, however far less steeper than the one observed in May.

The Continuous Survey of Agricultural Production, carried out by IBGE in May, continued to indicate an increase in the total grain production between 2001 and 2002, however lower than the one registered last month. Total grain production would reach 98.8 million tons in 2002, representing 0.3% increase in relation to 2001. Besides grain production, other important farming products should show higher production levels, such as sugar cane (4.5%), oranges (10.2%) and coffee (12.4%).

In the last months, demand indicators have been showing an unstable behavior with no defined trend. The real turnover of the retail commerce in São Paulo's Metropolitan Region decreased by 2.1% in June (seasonally adjusted data), maintaining the pattern of ups and downs throughout the year, according to data from the São Paulo State's Federation of Commerce (Fecomércio). The analysis by segments shows that the automobile commerce and the non-durable goods sales

maintained a favorable performance during the month, growing 1.3% and 0.9%, respectively. The environment of economic instability apparent in June contributed to the negative performance of the remaining segments.

According to the São Paulo Trade Association (ACSP), the enquiries to the Credit Protection Service (SPC) and to the Usecheque expanded 1.5% in June, in relation to May (seasonally adjusted series). However, according to the same institution, the default rate rose to 8.3% in June from 7% in May (seasonally adjusted data).

The Index of Consumer Intentions (IIC), released by Fecomércio, registered steep recovery (12.8%), according to seasonally adjusted data, after two consecutive months of decline. The fact that Brazil won the World Cup together with the payment of the balances of the FGTS reflected positively on consumer expectations in July. Both actual and future intentions registered growth in their indexes.

The demand for credit remains retracted, influenced by the economic instability observed in the last few months, while the financial institutions continue to be selective with their lending policies. Nevertheless, in June, there was an expansion of 2.4% in bank credit stock - that reached R\$ 351.8 billion - basically due to the accounting effect of the exchange rate depreciation over the portfolios funded by external resources and the incentive to operations using the Advance on Export Contracts (ACC).

Among the operations with freely allocated resources, responsible for 59% of the total balance, the stock of credit to companies increased 4.2% in June, totaling R\$ 130.5 billion. This expansion was concentrated, for the second consecutive month, in modalities contracted with foreign resources, which increased by 8.5% in the month. Noteworthy are the expansions of 8.7% in the balance of loans with external funding and 8.2% of the ACC operations. The stock of credit contracted by private individuals remained practically stable at R\$ 76.5 billion, with a variation of 0.1% in the month.

The banking spread of prefixed credit operations reached 37.1 pp, the smallest value in the last 12 months, mainly due to the increase in the medium and long term funding cost and to the stability of lending rates. This stability resulted from a 0.7 pp decline of credit to companies, especially short term operations, in relation to May, while the credit to private individuals increased 0.4 pp, as several credit lines to individuals increased, especially credit to finance automobile purchases. The credit operations default with freely allocated resources declined by 0.4 pp, reaching 8.5%. The default levels on credit operations with freely allocated resources declined by 0.4 p.p., reaching 8.5%. This performance is a result of debt renegotiation, mainly related to personal credit lines, lent by large financial institutions.

In the labor market, the average rate of unemployment, measured by IBGE, remained almost stable in May, 7.7% compared to 7.6% in April. However, both the employed workers, according to IBGE, and the formal employment, according to the Ministry of Labor and Employment, maintained an upward trend in May. The seasonally adjusted series of formal employment showed an increase of 0.2% in May, while the number of employed workers, according to the Monthly Employment Survey carried out by IBGE, increased 0.5% in the same period.

Regarding the external transactions of the Brazilian economy, the trade balance accumulated a US\$ 2.6 billion surplus in the first semester, in comparison to the US\$ 72 million deficit registered in the same period of 2001. This result was caused by a 22.6% reduction in imports, mainly of raw materials and capital goods, motivated by the gradual and continuous import substitution, by the drop of exports of manufactured goods, by the slower pace of industrial production and by the reshaping of investment projects. Exports dropped by 13.4% in the first semester as a result of the decline in exports to Argentina. In the first two weeks of July, the trade surplus reached US\$ 764 million, due to the sharp increase in exports of basic and semi-manufactured goods. Daily average of exports, which were showing successive drops in the previous months, registered a 28.5% growth in the first fifteen days of July, in comparison to the same period in 2001, while the imports registered a decline of 3.3%. The result of July is in part a consequence of the normalization of shipments after the delays of May and June, due to the strike of the customs authorities.

The improvement in the trade balance has contributed to the reduction in the current account deficit that is taking place simultaneously with the reduction of the resources available to finance the balance of payments, mainly the issuance of securities abroad and long term foreign loans. In June, the current account deficit reached US\$ 1.3 billion, in comparison to the US\$ 2.1 billion in the same month of 2001, totally financed by the US\$ 1.6 billion inflow of foreign direct investment.

In summary, the second quarter was a period of downturn in economic activity from the recovery initiated at the end of 2001, especially towards the end of the period due to deteriorating expectations. The deterioration of the environment of uncertainties due to the elections in October and unfavorable events in the international scenario have influenced the decisions of the economic agents who have postponed expenditure on consumption and investment.

### **External environment**

The uncertainty in capital markets, caused by the accounting frauds, is causing an increase of risk aversion by investors and reducing international liquidity. This fact has asymmetrically impacted on emerging market countries, especially those with largest balance of payments borrowing requirement. This scenario worsened by the lack of recovery in economic activity of developed countries and to the decline in international trade.

In the United States, the scenario of a possible economic recovery continues to be undefined. In the last revision, real GDP grew 6.1% p.a. in the first trimester of 2002. In May, personal consumption expenditures remained stable for the third consecutive month. The sales of industry and commerce declined 0.4% in May, with inventories showing a variation of 0.2%. The inventory-to-sales ratio reached 1.36, slightly superior to the previous level. Retail sales increased by 1.1% in June, above market expectations. In spite of the 0.14% growth, in June, producer price index declined by 2.04% in the year. The core index registered 0.2% in the month, accumulating 0.27% in the year. The entrepreneurs confidence indicators, surveyed by the *Institute for Supply Management*, stayed positive, however, showing some variations - PMI-manufacture ratio rose to

56.2% in June from 55.7% in May, while BAI-Services ratio declined to 57.2% from 60.1%, in the same period. The latest forecasts of the index of consumer confidence have shown retraction. The index measured by the Conference Board fell to 106.4 in June, while that measured by the University of Michigan declined to 86.5 in July, the lowest level since November 2001. The trade quantum continued retracting in April and the trade deficit registered slight growth, due to the reduction in exports. In the first quarter, the current account deficit increased and the net financial flow declined.

The expectations regarding the behavior of the Japanese economy improved with more optimism over the prospects of the future recovery in the levels of economic activity. Retail sales have not reacted yet, with the growth rate staying stable at 0.1%, over the 12 months, up to April. However, factory orders increased by 2.5%, in May, compared to April, increasing for the third time in the year. Industrial production, in May, expanded by 4.1%, reflecting gains of electrical machinery and of the transport equipment sectors. The confidence index Tankan which expresses the expectations of the larger entrepreneurs, reached -18 points in the second trimester, in comparison to -38 points in the previous period, the first positive variation since the second quarter of 2000. The trade balance reverted its downward trend, in spite of the appreciation of the yen. The performance of trade balance in May was mainly due to the decline in imports. Exports totaled US\$ 36.6 billion in May, a 6.9% increase in relation to May 2001, while imports fell 8.2%, in the same period, reaching US\$ 29.3 billion.

In the Euro Area, the domestic demand remained depressed, with a 0.1% growth in retail sales, in 12 the months up to April. The rate of unemployment remained stable at 8.3%. Regarding inflation, the annual variation of the Consumer Price Index - Harmonized declined to 2% in May, from 2.4% in April. In addition, the producer price index registered a higher deflation of 0.9%, in comparison to the deflation of 0.7% in April. The evolution of the main confidence indicators show a reversion in the recovery trend of the expectations of entrepreneurs and consumers. In spite of the euro appreciation, the trade balance accumulated in 12 months continues to grow, although export sales are growing at a slower rate.

In Argentina, the economic activity continues to slowdown, although some demand indicators have increased in May, in relation to April, such as supermarket sales (4.7%), shopping center sales (7.1%) and civil construction (2.5%). Industrial production in May declined by 13.5% in relation to May 2001 and increased by 0.9% in relation to the previous month. Preliminary data shows that 23% of the Economically Active Population is unemployed and 22% are sub-employed. The recession and the demand contraction have been responsible for the restraints on prices, resulting in the decline in inflation in the last two months. The trade balance registered a US\$ 6.6 billion surplus in the first five months of the year, in comparison to a US\$ 1.1 billion surplus in the same period of last year. The result reflects contractions of 6% in exports and 64% in imports.

## **Prices**

The main price indices registered increases of inflation in June compared to May, reflecting the rise in food prices, the impact of exchange rate depreciation, mainly in the wholesale prices, and the readjustments of the administered and monitored prices in the period. The IPCA increased by 0.42% in comparison to 0.21% in May, and the IGP-DI increased by 1.74%, in comparison to 1.11% in May.

Amongst the items that most pressured the IPCA in June, noteworthy are the increase in bottled gas (9.02%), urban bus fares (2.44%) and clothing (1.39%) - due to the launch of the Autumn/Winter collection. It is important to stress that the free prices maintained relative stability in the month varying 0.12% in June and 0.11% in May, contributing to the maintenance of the IPCA close to the threshold of the market expectations interval, in June.

Regarding the IGP-DI results, the evolution of the wholesale prices, mainly the agricultural prices should be highlighted. The Agricultural Wholesale Price Index showed a 4.57% rise, reinforcing the recovery of prices initiated in May, when the index showed a 0.85% variation. It is worth mentioning that the agricultural prices reflect, to a large extent, the recent behavior of the exchange rate – much of the impacts observed in the month came from items whose prices were highly



influenced by the exchange rate, such as soy, wheat and soy bean oil. The wholesale industrial prices registered rises of 1.74% in June, compared to 1.42% in May, reflecting, among others, the exchange rate depreciation. The Consumer Price index (IPC) did not follow, to the same extent, the increase in the wholesale prices, reaching 0.55% in June, compared to 0.28% in May.

For July, a larger impact of administered by contracts and monitored prices is expected on the inflation indices, due to the concentration of readjustments of public services tariffs in the period, namely, electricity (in São Paulo and Curitiba) and fixed-line telephone (in the whole country), and the readjustments of fuel prices at the beginning of the month. This factor should increase the rates of consumer price indices in July, when the highest inflation of the year may be registered. However, free prices should go on showing favorable behavior, going slightly above the level registered in June, due to the recovery of food prices.

It is worth highlighting that from August onwards the administered by contracts and monitored prices tend to show expressively smaller variations, since the main readjustments expected for the year have already occurred. Moreover, the effects of exchange rate depreciation over the prices – although meaningful for the wholesale prices – mainly due to the absence of items of services and by the presence of commodities in their composition - tend to be significantly smaller compared to the consumer prices indices, mainly due to the limited growth of the activity level.

### **Money market and open market operations**

The deterioration in the risk perception and the movement of some market participants that unwound contracted positions in the interest rate future market, contributed to the interest rate yield curve reaching the highest level of slope within the period, and the spread between the 1-year rate and Selic rate target reaching 1280 b.p., on June 21<sup>st</sup>. After that, there was a gradual reduction of interest rate practiced in the interest rate futures market. On July 16<sup>th</sup>, the spread between the 1-year rate and the Selic target rate reached 878 b.p, compared to 833 b.p. on June 18<sup>th</sup>.

In the period between June 19<sup>th</sup> and July 16<sup>th</sup>, the Banco Central do Brasil (BCB) carried out three auctions to rollover the NBCEs. Exchange rate swap auctions were carried out in two stages in order to rollover R\$ 5.5 billion maturing on July 11<sup>th</sup>. In the first, the value corresponded to R\$ 2.8 billion, and contracts were offered with maturity in 2005, 2007 and 2008; in the second rollover, amounting to R\$ 2.7 billion, contracts were placed for redemption in 2 and 7 months. Regarding the R\$ 2.9 billion rollover of NBCE maturing on July 18<sup>th</sup>, only the equivalent of R\$ 1.2 billion in Fx swap contracts were auctioned, with maturity in 2, 7 and 17 months. The partial rollover was due to the weak demand observed.

At the same time, the National Treasury auctioned on three occasions, LTN and LFT maturing in September 2002, limiting the total offer to 500 thousand securities per auction. The financial volume was R\$ 1.6 billion, of which R\$ 1,2 billion in LTN.

Considering the financial settlements between June 20<sup>th</sup> and July 16<sup>th</sup>, there was an expansionary monetary impact of R\$ 14.2 billion, resulting mainly from the net redemptions of LTN and dollar-indexed securities.

During the 19 working day period between June 20<sup>th</sup> and July 16<sup>th</sup>, the BCB 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\$ 10.5 billion and R\$ 2.1 billion, respectively. The BCB also carried out an auction of LTN with a repurchase agreement totaling R\$ 0.6 billion with tenure of 29 working days.

Moreover, Banco Central carried out three operations to exchange LFT. The operations intended to reduce the duration of the securities in the market in order to reduce the market's exposure to the volatility of these assets' price. R\$ 3.0 billion in LFT was exchanged maturing in 2003 for LFT maturing in 2002.

The BCB carried out two auctions of exchange Fx swap aiming at reducing distortions in the slope of the Fx coupon and at reducing the average tenure. In the first, the BCB assumed short position

in contracts maturing in July 2003, amounting to US\$ 1.1 billion and assumed a long position in contracts maturing in January 2003 and January 2005, to the sum of US\$ 0,8 billion e US\$ 0,3 billion, respectively. In the second, assumed long position in contracts maturing in October 2002, amounting to US\$ 1.5 billion and a short position maturing in April and July 2003, of US\$ 0.5 and US\$ 1.0 billion, respectively.

The BCB and the National Treasury carried out on July 12<sup>th</sup> a joint operation to exchange NBCE by LFT with Fx swap. The selling auction of LFT by National Treasury amounted to R\$ 9.9 billion, a sum equivalent to the NBCE purchased by the BCB. The operation intended to generate less volatility to the quotas of investment funds that were the holders of securities and Fx swaps (due to the asymmetric evolution of the Fx coupon slopes of the two instruments) and the decline in the volume of the collateral maintained in the BM&F.

In June, the domestic federal securitized debt increased by R\$ 14.4 billion (2.3%). The increase in the share of the exchange rate indexed debt by R\$ 23.4 billion was due to the depreciation of the Real of 12.8% occurred in June.

### **Assessment of inflation trends**

The identified shocks and their impact were reassessed in the light of newly available information. The scenario considered in the simulation considers the followings assumptions:

1. The inflation rate in June, measured by the IPCA, reached 0.42%, in comparison to 0.21% observed in May;
2. For 2002 as a whole, a reduction of 2% is forecast for gasoline prices due to the fall in January and February, a lower reduction than the projected in the last Copom meeting (-4.5%). For bottled gas, a 42% increase is forecasted for 2002, of which 32% has already

occurred from January to June. In the Copom meeting of June 2002 an increase close to 28% was projected, characterizing a substantial increase in the forecasts.

3. Regarding electricity tariffs, an increase of 19.2% for 2002 is projected, compared to a 19.4% forecast in June. For 2003, the forecast for the readjustment of electricity tariffs increased to 14.4% in July from 12.3% in June, due to exchange rate depreciation and the expected increase of inflation for 2003;
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 8.9%, compared to 8.1% forecasted in the Copom meeting of June. The increase in the forecast was basically due to the exchange rate depreciation that occurred between the Copom meetings of June and July. For 2003, the inflation forecast for the prices administered by contracts and monitored is 6.6%. There was thus an increase of 0.5 p.p. since the Copom Meeting of June. The increase in the inflation forecast for 2003 is also due to the effects of the exchange rate depreciation, besides the increase of expected inflation for 2003, which is used in forecasts of some specific items as water and sewage tax, electricity and fixed-line telephones.
5. The projection of the 6-months spread over the Selic rate, applying a specification based on a error correction estimation model and maintaining constant the Selic rate at 18.5%p.a., starts from 460 b.p. at the third quarter of 2002, declining to -80 b.p. in the last quarter of 2003;
6. The path of the U.S. Fed Funds rate, based on the futures contracts maturities, was revised to reflect a 1.75% rate at the third and fourth quarters of 2002, increasing to 1.8% in the first quarter of 2003 and remaining unchanged at 2.0% after the second quarter of 2003;

7. The sovereign risk premium, based on the spread over treasury of Brazil's Global 08, is forecasted to decline gradually to 700 b.p. in 2003 from the average plateau of 1.800 b.p. in this quarter;

The core inflation of the IPCA, calculated under the symmetric trimmed-mean method, declined to 0.40% in June from 0.51% in May. In the last 12 months, this core registered a 7.23% variation. In its turn, the IPC-BR core inflation, calculated under the symmetric trimmed-mean method, increased to 0.41% in June from 0.36% in May. In the last 12 months, this core registered a 6.94% variation. Core inflation calculated by excluding the prices administered by contracts and monitored plus household food prices registered a 0.13% variation in June, accumulating 6.22% in the 12 months.

The accumulated variation of the IPCA in 12 months registered 7.66% in June, below the rate observed in May (7.77%) and in April (7.98%). The free market prices contributed with 4.02p.p. to inflation and the prices administered by contracts and monitored with 3.65 p.p.. The inflation expectations surveyed by the BCB's Investor Relations Group (Gerin) for 2002 and 2003, increased to 5.8% and 4.2% respectively.

Regarding the fiscal policy, the hypothesis assumed is to achieve the primary surplus of 3.75% for the consolidated public sector. All the others assumptions considered 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 indicates an inflation rate slightly over 5.5% in 2002 and well below the target in 2003.

## Monetary policy guidelines

The economic activity has lost dynamism in the last few months, reflecting the recent instability and its impact on aggregate demand. Most of the data related to industry showed decrease in May in comparison to April, in the seasonally adjusted series. According to the IBGE, production declined by 5.1% and, in accordance to the CNI, there was a decline in employment (0.1%), in hours worked in production (4.1%), in the payroll (0.6%) and in the utilization of installed capacity (1.2%). Preliminary indicators, such as the reduction of shipments of corrugated paper and in the production of agricultural machinery, indicate a new decline of industrial production in June. There is also a prospect of fall in the Industrial Entrepreneur Confidence Index.

In spite of the negative results of the industrial sector, there are factors that have softened the deceleration of the activity level. Agricultural production in 2002 should be higher than in 2001, with some items growing more than 10%, like soy, wheat, coffee and oranges. Besides, demand has been sustained by the increase of agricultural income, the liberation of balances of the Time in Service Guarantee Fund (FGTS) and the social programs expenditures. The Consumer Intentions Index increased by almost 10 p.p. between June and July, although this figure only partially offsets the 12 p.p. fall registered between May and June.

The interest rates set by the market showed an considerable increase in the last two months, constraining the activity level. The 6-month fixed interest rate swap increased to 23.0% from 18.5% between the meetings of May and July, and the 12-month fixed interest rate swap reached 26.4% from 20.2%. It is understood that the aggregate demand is not a factor of inflationary pressure in the economy.

The foreign sector has registered positive results in the last twelve months. The trade balance shows a US\$ 5.3 billion surplus in the twelve months up to June, which represents an increase of approximately US\$ 0.4 billion since May. The current account deficit, in the twelve months result, has continuously declined since August 2001 and reached US\$ 18.2 billion in June. This deficit

was entirely financed by the net inflows of foreign direct investment, which reached US\$ 22.2 billion in the twelve months up to June.

However, the adverse situation observed since mid-April, characterized by an increase of the uncertainty in relation to the future of the country and, aggravated, in the last month, by the increase of the risk perception in relation to the world economy, has negatively influenced the asset prices denominated in foreign and local currencies. The risk measured by the Embi+ reached 1572 b.p. and the thirty-day volatility of the exchange rate increased by 20.3%, despite the fall to 12.8% of the five-day volatility. The volatility of the markets also affected other assets. The one-year FX coupon reached 16.6%.

The inflation measured by the IPCA was 0.42% in June, above the 0.21% registered in May, due to the behavior of administered by contracts and monitored prices, which increased 1,09% in June. The inflation of these prices was pressured mainly by the readjustments of bottled gas (9.02% in June and 32.4% year-to-date) and urban bus fares in Salvador and Rio de Janeiro (10.0% and 9.09%, respectively). The prices administered by contracts and monitored should also impact significantly on inflation in July. In this respect it is worth highlighting the readjustments of 6.75% and 6.2% for gasoline and bottled gas in the refineries, the 8.07% average increase in the tariffs of fixed-line telephones and the 14.24% and 10.96% increase in electricity tariffs in São Paulo and Curitiba.

Recent data confirm the declining inflation of free market prices in the economy. After reaching a 0.64% variation in February, the inflation of free market prices declined to 0.45%, 0.24%, 0.11% and 0.12% in the following months. It should be emphasized that, unlike in May, inflation in June was not benefited by the harvest season. When household food items are excluded from the free market prices, corresponding to core inflation measured with the exclusion of administered by contracts and monitored prices and of household food items, inflation declines to 0.13% in June, from 0.46% in May. The variation of the core inflation measured by the symmetric trimmed-mean method also decreased, reaching 0.40% in June from 0.51% in May.

The shock of administered by contracts and monitored prices declined to a figure close to 0.35 p.p., as the projection for the inflation of administered by contracts and monitored prices was smaller than that forecasted by the pass-through coefficient, as occurred in June. The projection for the 2002 inflation is above the center of the target adjusted by the impact of the shock of administered by contracts and monitored prices and by the impact of part of the inflationary inertia of 2001 in 2002, resulting in the 4.0%-4.5% interval for the adjusted target. However, the difference between the projection for 2002 and this interval reflects the recent depreciation of the exchange rate, which tends to be temporary (at least partially) and, due to its magnitude, recommends a more gradual correction of its inflationary effects.

The inflation expectations surveyed by the Investor Relations Group (Gerin) of the BCB increased since the Copom's meeting of June. For 2002, the expectations changed to 5,8% from around 5,5%, probably due to the depreciation of the exchange rate observed in the period. For 2003, the inflation expectations were revised in 0.2 p.p., rising to 4.2% from 4.0%.

The inflation caused by free market prices may rise in the coming months due to the pass-through of the exchange rate depreciation to prices. However, this impact may be limited, as firms may have difficulties to pass-through the increase in costs linked to the exchange rate variation, due to the slower pace of economic growth.

The exchange rate depreciation and the increases in the several risk premiums in the markets are due to the uncertainties in relation to the international scenario and the future macroeconomic policy in Brazil. This combination of the increase in risk aversion by enterprises and global banks and the perception of fragility in Brazil requires a response that is beyond monetary policy.

The Copom has worked with a basic scenario for the next 18 months that assumes the maintenance of an economic policy in 2003 committed to the fiscal and monetary responsibility and to the fulfillment of contractual obligations. These policies are not related to ideologies or political parties, and represent an essential condition to ensure economic security, growth and development. It is therefore reasonable that one awaits their maintenance in the next administration, which has



been indicated by the main Presidential candidates. This commitment may make possible, if necessary, stronger financial support from the international community.

In this basic scenario, the decreasing trend of the inflation of free market prices observed in this year should continue through the following eighteen-month period. For 2003, the basic scenario forecasts inflation significantly below than the new target of 4%. In addition, the change of the target for 2003 and the definition of 3.75% as the target for 2004 offer more leeway to accommodate fortuitous upward revisions of the projections, if alternative scenarios are confirmed. Consequently, the members of the Copom agreed that there is room for a loosening of the monetary policy.

However, there was no consensus about the adequate timing for the returning to the process of reducing the basic interest rate. Five members considered that the forecast of inflation for 2003 significantly below the target and the confidence in the maintenance, in the future, of a responsible macroeconomic framework, recommend immediate reduction of the current basic interest rate. Two members of the Copom considered, however, that, as the turbulence in the financial market causes uncertainties on the inflation projections, recommend the loosening of the monetary policy when the situation in the financial market stabilizes, voting for the maintenance of the interest rate with a downward bias.

In the light of these facts, the Copom decided, by a majority of 5 to 2, to reduce the target for the Selic interest rate to 18.0% p.a..

At the close of the meeting, it was announced that the Committee would meet again on August 20<sup>th</sup>, 2002, at 3:00 pm, for technical presentations and, on the following day, at 11:00 am, in order to discuss the monetary policy guidelines, as set in the Communiqué no. 8911, of Oct.3.2001, and in Communiqué 9586, of Jun.6.2002.

## 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