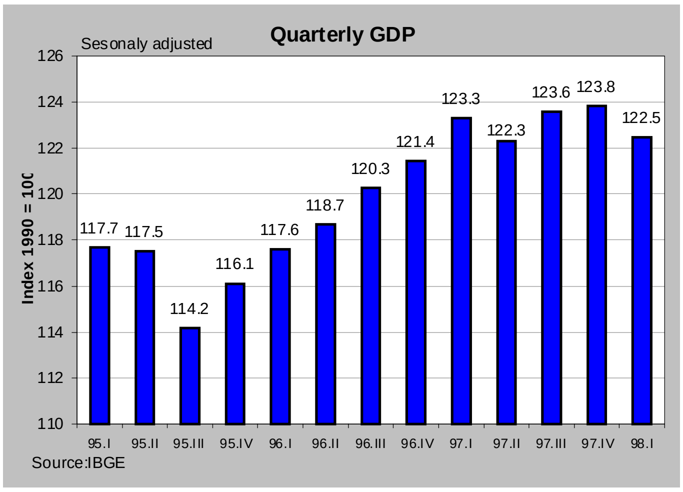
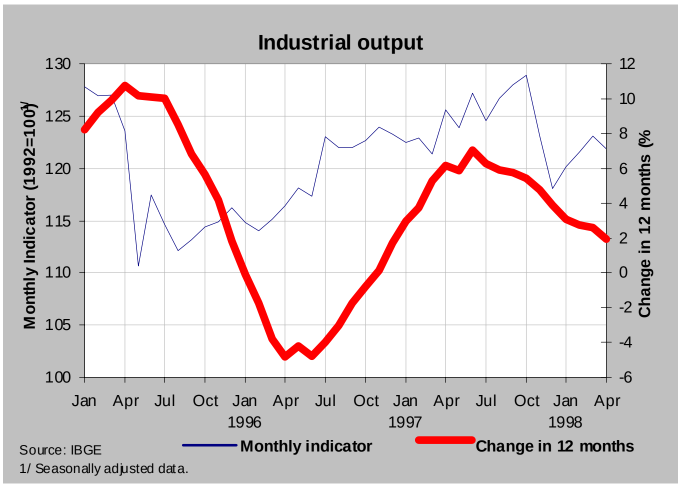
Monetary program for the third quarter of 1998

A. The economy in the second quarter of 1998

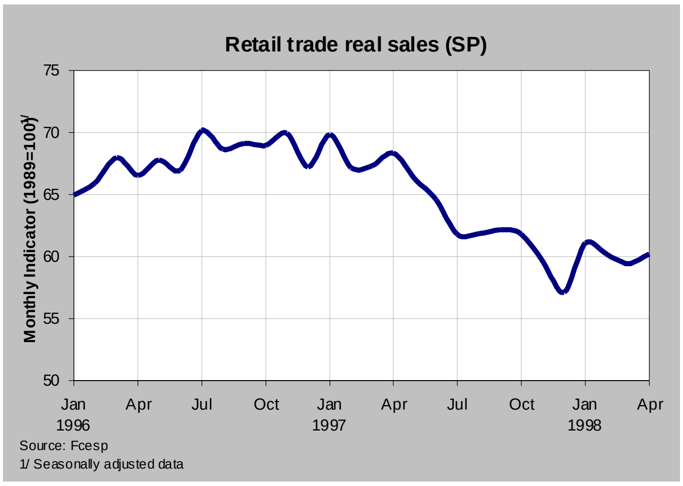
1. In the first quarter of 1998, gross domestic product (GDP) expanded by 1.1% in relation to the same 1997 period. This result was based on expansion of 1.36% and 1.25% in the industrial and service sectors, respectively, and a negative results of 1.04% for the agribusiness sector. In comparison to the first quarter of 1997, the industrial performance was generated by growth of 5.3% in the building industry and 5.72% in public utility industrial services, coupled with a drop of 1.21% under manufacturing. The result of the service sector was caused by expansion under the subsectors of transportation (8.26%) and communications (4.35%). Finally, the drop under crop and livestock production reflected a falloff of 3.91% under crops, offset to some extent by expansion of 5.16% under animal production.



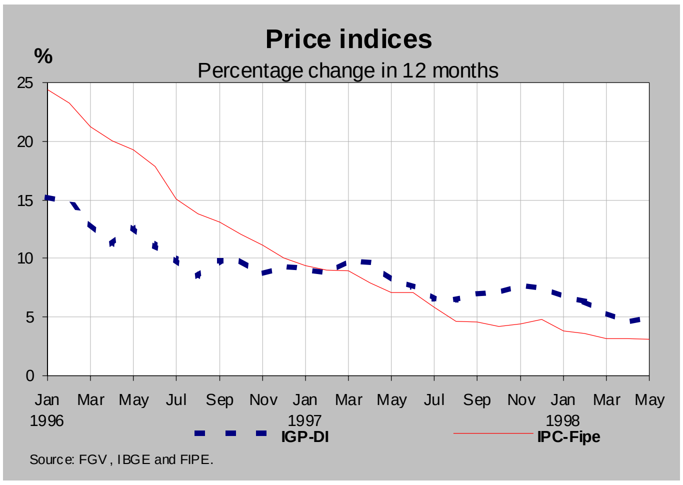
2. Based on data from which seasonal factors have been removed by Depec, the IBGE Monthly Industrial Survey pointed to a drop of 0.98% in April production, based on a drop of 0.88% in the manufacturing industry and 0.52% in the mineral extraction sector. A breakdown by categories of usage shows reductions of 0.53%, 0.84% and 0.22%, respectively, in the production of capital goods, intermediate goods and consumer products. When one considers the twelve month period ended in April, the 1.66% increase in industrial production was a consequence of favorable growth in the capital goods sector, coming to 5.6% in the period.



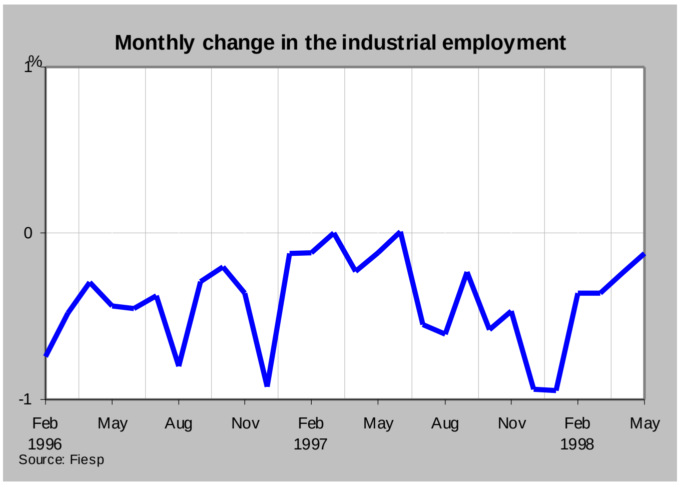
3. The performance of real billings in the retail trade sector of Metropolitan São Paulo in the month of April did not accompany the drop registered under industry and closed with expansion of 1.28% according to data purged of seasonal factors by Depec. This growth reflected the behavior of consumer goods sales (+1.63%) and compensated for the decline under the automotive industry (-2.25%) and building materials (-0.4%). In the 12 month period ended in March, real billings of the retail trade sector accumulated a reduction of 10.38%.



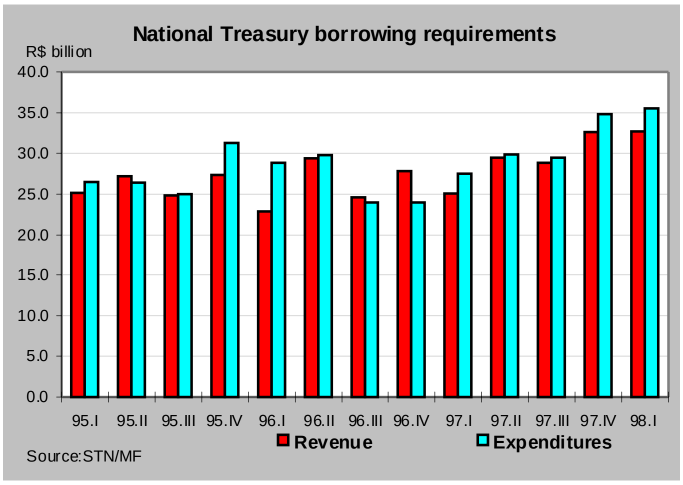
4. The trajectory of the major price indices in the second quarter of the year has confirmed the downward slide that started with introduction of the Real Plan. In the first five months of the year, accumulated growth under the IGP-M came to 1.6% while expansion under the IPC-Fipe closed at 0.99%. When one considers the twelve month period, the IGP-M closed the month of May at a level of 4.95%, as compared to 7.74% in December 1997 while the IPC-Fipe closed at rates of 3.12% and 4.82%, in the same order.



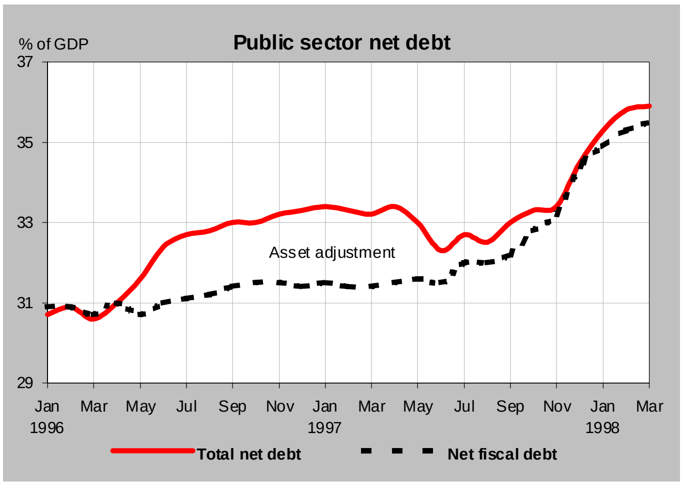
5. According to Ministry of Labor (MTb) data, the level of formal employment in the country remained stable in April. The major causes of this performance were a drop of 0.2% under manufacturing and growth of 0.13% under construction. In comparison to April 1997, formal employment dropped by 0.91%. Industrial employment in São Paulo dropped by 0.36% in May 1998, in relation to the previous month, reflecting a cutback in the pace of the downward trend. In 12 months, the level of industrial employment dropped by 5.24%, as a result of the ongoing restructuring process in the sector.



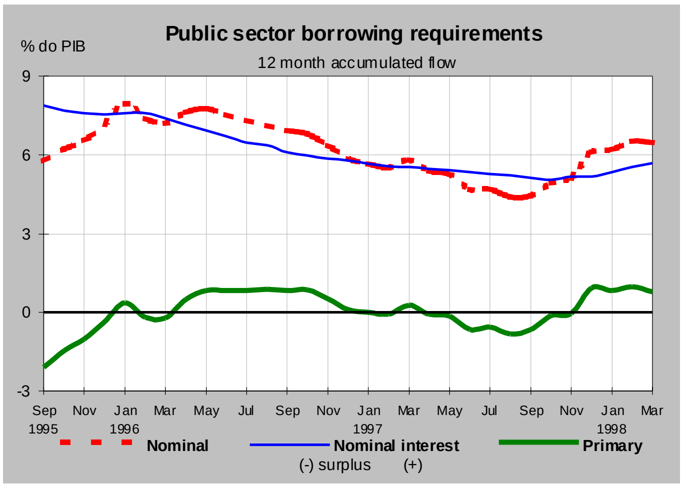
6. In the month of March, National Treasury budget operations registered a deficit of R$ 2 billion, based on revenues of R$ 11.2 billion and expenditures of R$ 13.2 billion. In the first quarter of the year, the accumulated deficit totaled R$ 2.8 billion, reflecting revenues of R$ 32.7 billion and outlays of R$ 35.5 billion. In comparison to the first quarter of 1997, real growth came to 20.9% under revenues. To some extent, this was a consequence of concentrated payments of the income tax and contribution on business profits in the month of March, to the increase in the income tax rate and alteration of the collection system for taxes on fixed yield funds in January. Expenditures increased by 19.6% in the period, for the most part due to the change in the payment date of civil service wages.



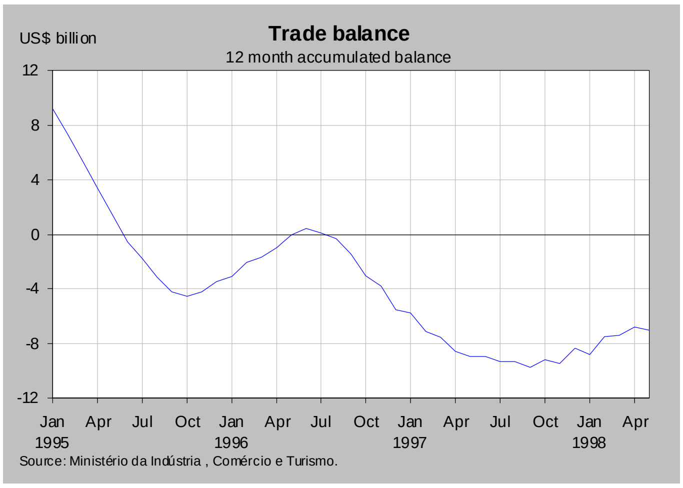
7. In March, the net public sector debt (DLSP) totaled R$ 324.2 billion, representing 36% of GDP. The net fiscal debt, which encompasses privatization resources and contingent liabilities (skeletons) came to R$ 320.2 billion, or 35.5% of GDP. In the first quarter of the year, alterations occurred in the composition of net public indebtedness due to the process of recomposition of international reserves. Internal indebtedness increased from 30.2% of GDP in December 1997 to 33.5% in March, while the net foreign debt dropped from 4.3% of product to 2.4% in the same period.



8. In terms of the accumulated flow over the 12 month period extending to March, public sector borrowing requirements (NFSP) registered a deficit of 0.8% of GDP in the primary concept. The inclusion of nominal interest, which came to 5.7% of product, resulted in a nominal deficit of 6.5% of GDP.

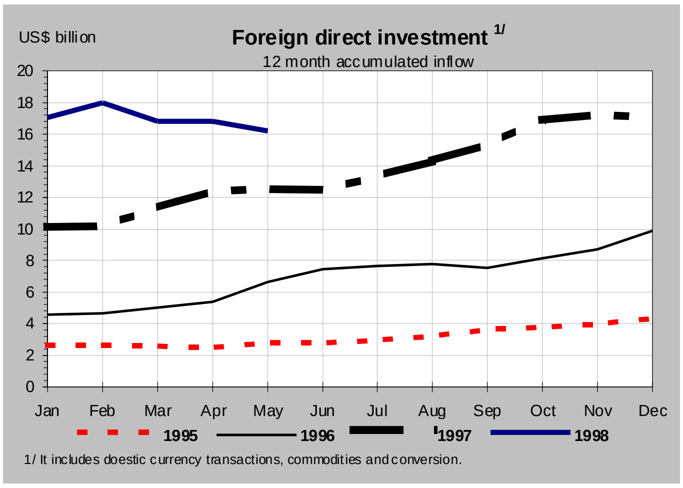


9. In the first quarter of 1998, the current account deficit totaled US$ 6 billion or 11.1% less than in the same 1997 period. The major reason for this was a greatly improved trade balance picture, since outlays on services moved slightly upward. Exports closed at US$ 11.9 billion, for growth of 11.7% in comparison to the previous year, while imports added up to US$ 13.4 billion, for growth of 2.2%. These results generated the deficit of US$ 1.5 billion. In the period from April to May 1998, foreign sales and purchases came to respective levels of US$ 9.2 billion and US$ 9.7 billion, corresponding to declines of 1.1% and 4.7%, in comparison to the same period of the previous year. The result was a reduction in the trade deficit from US$ 931 million to US$ 560 million.

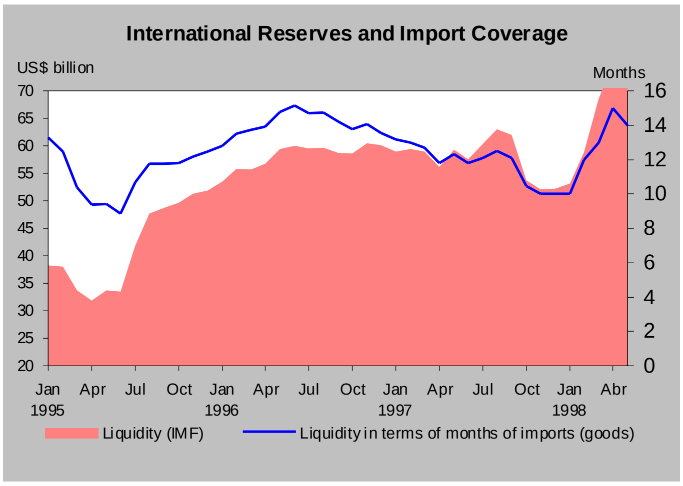


10. Insofar as the service account is concerned, the deficit for the first three months of 1998 came to US$ 4.9 billion, or 1.7% higher than in the first quarter of the previous year, party as a consequence of increased interest payments. In the April-May period, however, lesser outlays under this item contributed to the falloff in the service account deficit which, coupled with the reduction in the negative trade balance result, generated a 7.1% drop in the current account deficit in comparison to the same 1997 period.

11. The inflow of foreign capital investments was particularly strong in the January-March 1998 period, as net capital market investments added up to US$ 4.8 billion, for growth of 65.1% in comparison to the same quarter of the previous year. At the same time, net direct foreign investments moved to US$ 2.6 billion. Net inflows of financial loans came to US$ 12.8 billion. Here, the most important items were placements of notes and loans under the terms of Resolution no. 63/67.



12. In the April-May period, net direct foreign investments totaled US$ 2.9 billion, as against US$ 3.4 billion in the same period of the previous year. However, one should recall that privatization of the Vale do Rio Doce Company occurred in May 1997 and accounted for an inflow of US$ 1.2 billion in direct investments. The net inflow of portfolio investments in the period came to US$ 3.9 billion or 91.1% more than in the same two month period in 1997. With respect to financial loans, net inflows totaled US$ 4.8 billion, of which 62.8% originated in placements of notes. With the growth in foreign currency transactions, Banco Central exchange market operations, coupled with the net result of its primary operations, produced an increase of US$ 4.2 billion in the two month period in total international reserves, raising the reserve level of US$ 72.8 billion in the international liquidity concept.



13. The lower and upper limits of the exchange rate float band moved by 3.047% and 3.211% from January to May 1998, closing at R$ 1.15/US$ and R$ 1.157/US$, respectively. In the free rate exchange market, the average sale rate devalued by 3.054%.

B. Monetary policy in the first quarter of 1998

14. Viewed under the prism of average daily balances, the restricted monetary base came to R$ 30.9 billion up to the end of March, closing at a level 5.1% above the upper limit forecast in monetary programming for the first quarter (R$ 25.1 billion – R$ 29.4 billion), though still well within the extraordinary margin of 20% defined by Law no. 9,069, dated 6.29.95. For the most part, this result was due to the growth in banking reserves that occurred once Banespa's liabilities for compulsory reserves had been resolved. The March percentage change in the base was a negative 3.4%, reducing 12 month growth to 24.9%. Currency issued and banking reserves turned in reductions of 4.1% and 2.5% respectively in the month of March, closing at R$ 17.2 billion and R$ 13.6 billion, with accumulated 12 month growth rates of 8.9% and 53.6%, in the same order.

15. The expanded monetary base, which corresponds to the restricted base plus compulsory cash deposits and federal public securities outside Banco Central came to R$ 311.9 billion in March, closing at a level below the parameters forecast in monetary programming (R$ 313.9 billion – R$ 368.5 billion). The reason for this result was the fact that no state debt restructuring operations occurred in the quarter. Thus. The monthly rate of growth of the expanded base came to 6% while the accumulated 12 month rate closed at 60.6%.

Table 1. Observed results and forecast monetary program for the first quarter of 1998

Itemization	Forecast		Observed	
	R$ billion	Percentage change in 12 months 1/	R$ billion	Percentage change in 12 months
M1 2/	36,1 - 42,4	6.4	41.4	12.3
Restricted base 2/	25,1 - 29,4	10.4	30.9	24.9
Expanded base 3/	313,9 - 368,5	75.7	311.9	60.6
M4 3/	406,6 - 477,3	31.4	417.2	24

1/ Percentage changes are based on the medium point of forecast.

2/ Working-day balance average of last month in the period.

3/ End-of-period balances.

16. The money supply (M1) totaled R$ 41.4 billion in March in terms of average daily balances, with negative growth of 2.8% in the month and expansion of 12.3% over 12 months, easily within the parameters defined by monetary programming (R$ 30.1 billion – R$ 42.4 billion). The average balances of currency held by the public and demand deposits dropped by 4% and 2.1% in the month, closing at respective levels of R$ 15.1 billion and R$ 26.4 billion, with growth of 9.3% and 14.1% in the 12 month period ended in March.

17. The expanded monetary aggregate (M4) came to R$ 417.2 billion in March, well within the interval defined by monetary programming (R$ 406.6 billion and R$ 477.3 billion), for growth of 2.7% in the month and 24% in 12 months.

18. Downward movement in basic interest rates intensified in the first quarter of 1998 and was accompanied by an increase in the TBC – TBAN spread. In that period, the TBC and TBAN dropped in average terms from 37.66% per year and 42.9% per year in January to 34.5% and 42% per year in February and 28.87% and 38.54% per year in March, respectively. This movement was accompanied by the over-Selic rate which dropped from a January level of 37.19% per year in January to 34.32% per year in February and 28.32% per year in March.

C. Monetary policy in April-May 1998

19. At the end of May, the restricted monetary base closed at R$ 32.4 billion in the concept of average daily balances, with growth of 4.9% in the month and 32.3% in 12 months. Currency issued and banking reserves totaled R$ 17.4 billion and R$ 15 billion, with growth of 0.3% and 10.7% in the month and 11.8% and 68.1% in 12 months, respectively.

20. The end-of-period expanded monetary base balance came to R$ 320.4 billion in May, with growth of 1.05% in the month and 59.5% in 12 months.

Table 2. Observed May and forecast monetary program for the second quarter of 1998

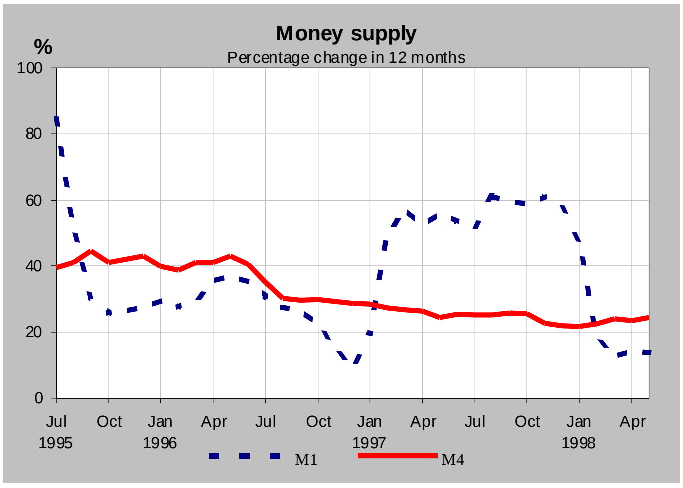
Itemization	Forecast		Observed	
	R$ billion	Percentage change in 12 months 1/	R$ billion	Percentage change in 12 months
M1 2/	37,9 - 44,5	12.1	41.6	13.8
Restricted base 2/	30,2 - 35,5	33	32.4	32.3
Expanded base 3/	320,4 - 376,1	71.4	320.4	59.5
M4 3/	405,8 - 476,3	25.5	426.8	24.3

1/ Percentage changes are based on the medium point of forecast.

2/ Working-day balance average of last month in the period.

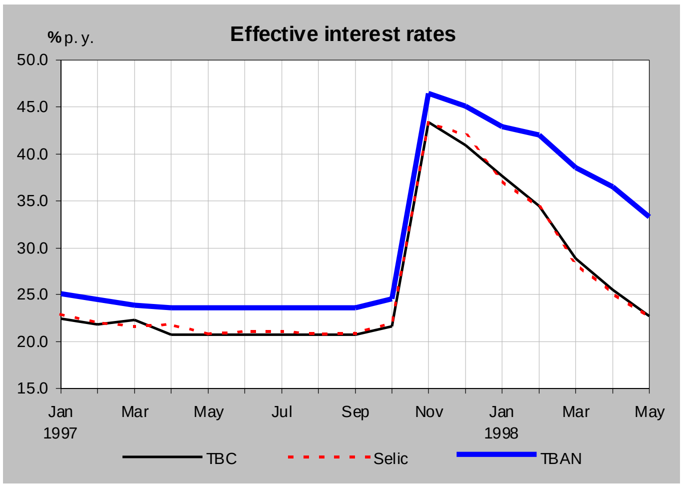
3/ End-of-period balances.

21. The average money supply balance (M1) totaled R$ 41.6 billion in May and remained stable in relation to April. In the 12 month period, the M1 growth rate came to 13.8%. Currency held by the public totaled R$ 15.2 billion, with monthly growth of 1% and accumulated 12 month expansion of 11.9%. Demand deposits came to R$ 26.4 billion, closing with an 0.6% reduction in the month and 14.9% growth in 12 months.



22. The balance of the expanded money supply (M4) came to R$ 426.8 billion in May for monthly growth of 1.7% and accumulated 12 months expansion of 24.3%.

23. The downward movement in basic interest rates continued in the April-May period. In average terms, the TBC and TBAN declined from 25.48% per year and 36.55% per year in April to 22.72% per year and 33.3% per year in May. In the same period, the over-Selic rate dropped from 25.16% per year to 22.6% per year, closing below the level of the TBC due to the improved liquidity of the interbank market.



D. Outlook for the third quarter and for 1998 as a whole

24. Since issue of the Real Plan, inflation has moved steadily downward, with a clear tendency to convergence among the major price indicators for tradable and non-tradable goods, thus evincing maturation of the stabilization process. Recently, supply has expanded more rapidly than demand, eliminating pressure on prices and making it possible to predict that the downturn will continue through the end of 1998, closing at less than 5%.

25. In the first quarter of 1998, the GDP remained at a level higher than in the same period of the previous year indicating that, despite the contractive response to the end-of-1997 interest rate hike brought about by a changing international scenario, the pessimistic forecasts made at that time did not come about. In this framework, when one takes the four quarter moveable average GDP trajectory as a tendency, it is clear that the renewed growth that started in the second half of 1996 was not repeated in the final quarter of 1997 and first quarter of 1998.

26. Industrial production in the month of April declined in the series from which Depec has purged seasonal factors. However, expectations are that growth will move upward just as occurred in the first quarter of the year. These expectations are based mainly on the strength of investment indicators, as capital goods production expanded by 5.26% in the period between January and April and on the average take-home pay of workers which, in the month of March, held at 3.4% above that of the same month of the previous year. Based on these figures, expectations are that GDP will register positive growth of about 2% in the year, as increased economic activity in the second half makes it possible for 1998 to close as the sixth consecutive year of positive product growth.

27. The production growth that occurred between 1994 and 1997 came to an annual average of 4% per year and has been achieved through improved productivity, powered by a more liberal trade policy and enhanced internal competition. In its turn, the increase in productivity has resulted in wage increases. Since wage increases no longer respond to changes in price indices, it is probable that the decline in the growth rate of wages will be reversed during the second half of the year.

28. The increase in productivity and the redefinition of wage adjustments has enhanced the competitiveness of national products on international markets. This, plus government incentives, has resulted in a sharp upturn under exports and improvement in the trade balance and current account result. In the first five months of the year, the trade deficit came to US$ 2 billion or 39.8% less than in the same 1997 period, while the current account deficit reached US$ 11.2 billion, for a 9.4% decline in relation to the January-May period of last year.

29. This result has been easily financed by the net flow of international capital, which has been so intense that international reserves have expanded considerably. The composition of these flows has improved in qualitative terms, with growth in the share of resources destined to remain in the economy for longer periods of time, such as direct foreign investments. These investments have been stimulated by stabilization and economic growth and by the privatization program, so much so that expectations for 1998 foresee a total inflow of approximately US$ 20 billion.

30. The fiscal situation stands as the economic fundamental that has registered the least favorable growth. Notwithstanding the fact that the government's determination in its efforts to reform the State, as evinced in the administrative, social security and tax reforms, coupled with the National Privatization Program, clearly demonstrates its awareness of the importance of a permanent fiscal adjustment, there is little likelihood that these efforts will lead to significant improvement in the 1998 fiscal deficit. Despite this scenario, however, one should stress the fact that the net debt/GDP ratio has remained stable, with expectations that this tendency will continue.

E. Indicative targets for the growth of monetary aggregates in the third quarter and all of 1998

31. Programming for monetary aggregates in the third quarter of 1998 and estimates for the end of the year took due account of the probable scenarios for inflation, GDP, interest rates, monetary impacts caused by National Treasury operations and restructuring of state debts, Banco Central interventions in the exchange market and financial institutions and rediscount and open market operations. Chart 3 shows the bands projected for the monetary aggregates at the end of the third quarter and for all of 1998.

Table 3. Monetary program for 1998 [1/]

R$ billion

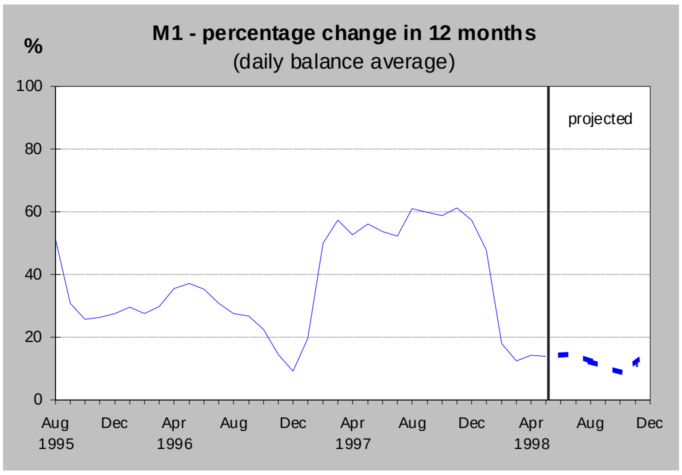
Itemization	Second quarter	Year
M1 [2/]	39.4 - 46.3	48.7 - 57.1
Restricted base [2/]	31.0 - 36.4	37.4 - 43.9
Expanded base [3/]	346.6 - 406.9	377.4 - 443.0
M4 [3/]	415.8 - 488.1	429.7 - 504.4

1/ Refers to the final month in the period.

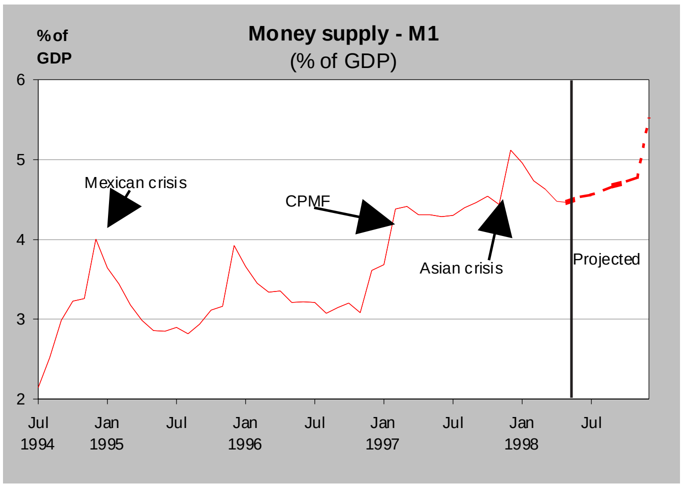
2/ Working-day balance average in month.

3/ End-of-period balances.

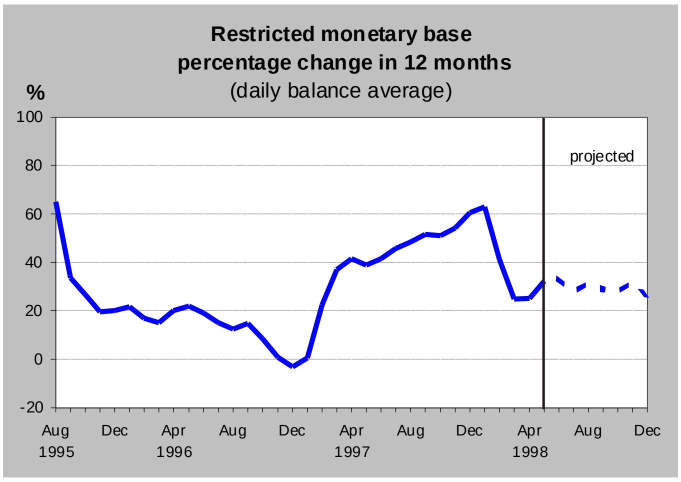
32. Expectations of relative stability for internal interest rates and moderate growth in nominal earnings for coming months, coupled with other factors that impact the money supply stock, resulted in 12 month growth projections for average daily balances of the M1 aggregate (currency held by the public plus demand deposits) of 10.4% in September and 15.9% in December 1998.



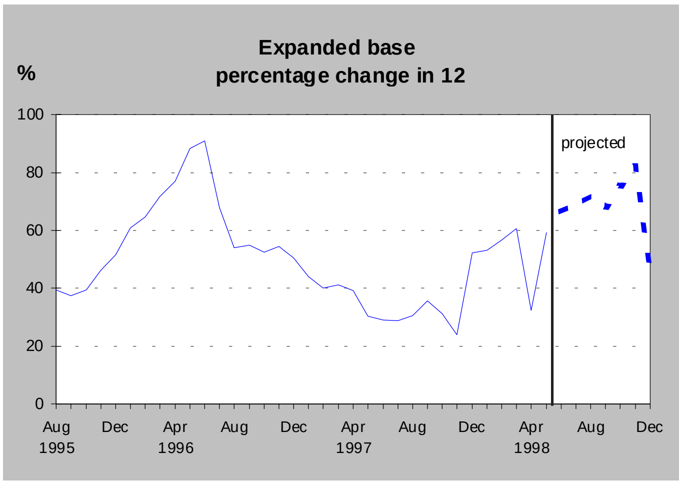
33. In the second half of the year, the M1/GDP ratio is expected to return to the upward trajectory that has characterized practically the entire period since introduction of the Real Plan. The fluctuations that have occurred in this ratio in the intervening period resulted from adoption of economic policies as a result of pressures on the domestic exchange market brought about by the crises in Mexico and Southeast Asia and introduction of the CPMF, the effects of which are not expected to last through the entire year.



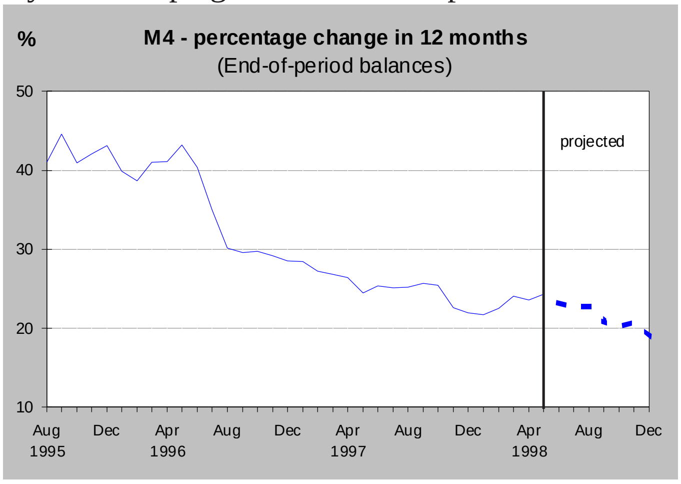
34. Based on the forecast performance of demand for M1 and currency, as well as the scenario for compulsory deposits on demand resources, 12 month growth for the average monetary base balance (currency issued plus banking reserves) is projected to grow by 28.9% in September and 26% in December 1998.



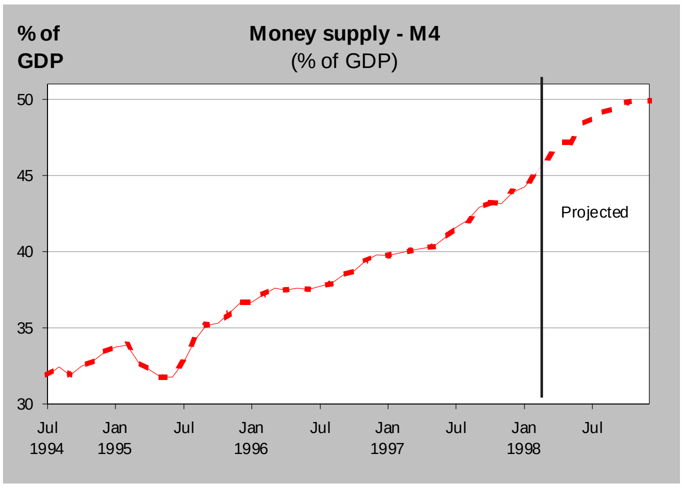
35. Projection of the expanded base (a measurement of the internal federal debt in currency and in securities), which presupposes the neutrality of the factors that condition the restricted monetary base, still must take due account of the restructuring of state debts as the major source of expansionary pressures. Thus, for this monetary aggregate, one can project 12 month growth of 68.2% in September and 46.5% in December 1998.



36. In much the same way and in keeping with the behavior pattern of the other aggregates, 12 month growth in M4 was estimated at 20.9% in September and 18.9% in December 1998.



37. The proportion between M4 and GDP is expected to continue the upward trend that began with introduction of the stabilization program in 1994. This has been a consequence of the process of remonetization, balance of payments surpluses and precise measurement of the public sector's contingent liabilities. It is forecast that this process will slow at the end of the year with conclusion of the process of state debt renegotiations. The impact of this process will be most strongly felt in the third quarter.



38. Growth in the monetary aggregates is summarized in the following chart, which presents the 1997 results together with those of the April-May 1998 period, as well as the amounts forecast for the third quarter and for all of 1998. The figures forecast for the future are based on the average point of the forecasts.

Table 4. Evolution of monetary aggregates 1/

Itemization	1997		1998		1998			
	Year		*April'May*		Third quarter 2/		Year 2/	
	R$ billion	% change in 12 months	R$ billion	% change in 12 months	R$ billion 3/	% change in 12 months	R$ billion 3/	% change in 12 months
M1 4/	45.6	57.4	41.6	13.8	42.8	10.4	52.9	15.9
Restricted base 4/	32.3	60.6	32.4	32.3	33.7	28.9	40.7	26.0
Expanded base 5/	280.1	52.2	320.4	59.5	376.8	68.2	410.2	46.4
M4 5/	392.8	21.9	426.8	24.3	451.9	20.9	467.1	18.9

1/ Refers to the final month in the period.
2/ Projected.
3/ Medium point of forecasts.
4/ Working-day balance average in month.
5/ End-of-period balances.

39. The growth of the different multipliers that is implicit in monetary programming is summarized in the following chart:

Table 5. Monetary multiplier [1/]

Itemization	1997		1998		1998			
	Year		January-February		Second quarter [2/]		Year [2/]	
	Multiplier	% change in 12 months	Multiplier	% change in 12 months	Multiplier	% change in 12 months	Multiplier	% change in 12 months
M1 / Restricted base [3/]	1.413	-2.0	1.286	-14.0	1.270	-14.4	1.300	-8.0
Banking reserves / Demand deposits [3/]	0.438	88.8	0.567	46.5	0.579	40.9	0.536	22.4
Currency / M1 [3/]	0.384	-24.0	0.365	-1.6	0.368	1.9	0.392	2.1
M4 / Expanded base [4/]	1.402	-19.9	1.332	-22.1	1.199	-28.2	1.139	(18.8)

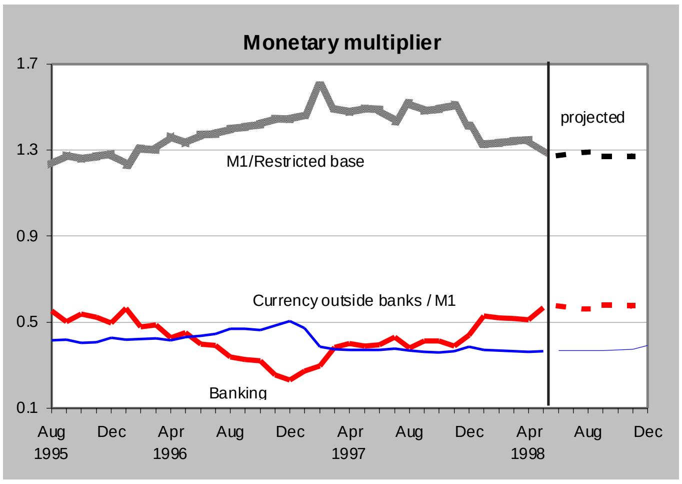
1/ Refers to the final month in the period.

2/ Projected.

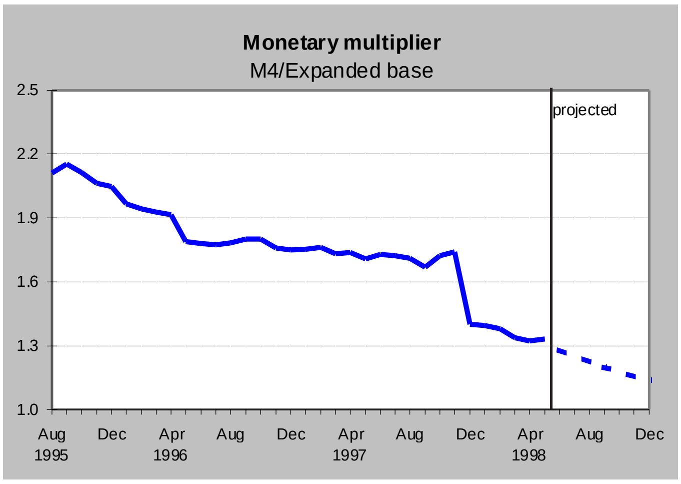
3/ Working-day balance average in month.

4/ End-of-period balances.

40. Even though the process of monetization has yet to fully run its course, the long period of price stability that has been achieved makes it possible to predict that there will not be significant volatility in the future values of the restricted monetary base multiplier.



41. The expanded base multiplier will continue registering reductions over the coming months, mirroring operations related to restructuring of state debts since, despite their influence on the expanded base, part of these operations will not impact M4.



Summary of projections

Table 1. Observed results and forecast monetary program for the first quarter of 1998

Itemization	Forecast		Observed	
	R$ billion	Percentage change in 12 months 1/	R$ billion	Percentage change in 12 months
M1 [2/]	36,1 - 42,4	6.4	41.4	12.3
Restricted base [2/]	25,1 - 29,4	10.4	30.9	24.9
Expanded base [3/]	313,9 - 368,5	75.7	311.9	60.6
M4 [3/]	406,6 - 477,3	31.4	417.2	24

1/ Percentage changes are based on the medium point of forecast.

2/ Working-day balance average of last month in the period.

3/ End-of-period balances.

Table 2. Observed May and forecast monetary program for the second quarter of 1998

Itemization	Forecast		Observed	
	R$ billion	Percentage change in 12 months 1/	R$ billion	Percentage change in 12 months
M1 [2/]	37,9 - 44,5	12.1	41.6	13.8
Restricted base [2/]	30,2 - 35,5	33	32.4	32.3
Expanded base [3/]	320,4 - 376,1	71.4	320.4	59.5
M4 [3/]	405,8 - 476,3	25.5	426.8	24.3

1/ Percentage changes are based on the medium point of forecast.

2/ Working-day balance average of last month in the period.

3/ End-of-period balances.

Table 3. Monetary program for 1998 [1/]

R$ billion

Itemization	Second quarter	Year
M1 [2/]	39.4 - 46.3	48.7 - 57.1
Restricted base [2/]	31.0 - 36.4	37.4 - 43.9
Expanded base [3/]	346.6 - 406.9	377.4 - 443.0
M4 [3/]	415.8 - 488.1	429.7 - 504.4

1/ Refers to the final month in the period.

2/ Working-day balance average in month.

3/ End-of-period balances.

Table 4. Evolution of monetary aggregates [1/]

Itemization	1997		1998		1998			
	Year		April/May		Third quarter [2/]		Year [2/]	
	R$ billion	% change in 12 months	R$ billion	% change in 12 months	R$ billion [3/]	% change in 12 months	R$ billion [3/]	% change in 12 months
M1 [4/]	45.6	57.4	41.6	13.8	42.8	10.4	52.9	15.9
Restricted base [4/]	32.3	60.6	32.4	32.3	33.7	28.9	40.7	26.0
Expanded base [5/]	280.1	52.2	320.4	59.5	376.8	68.2	410.2	46.4
M4 [5/]	392.8	21.9	426.8	24.3	451.9	20.9	467.1	18.9

1/ Refers to the final month in the period.

2/ Projected.

3/ Medium point of forecasts.

4/ Working-day balance average in month.

5/ End-of-period balances.

Table 5. Monetary multiplier [1/]

Itemization	1997		1998		1998			
	Year		January-February		Second quarter [2/]		Year [2/]	
	Multiplier	% change in 12 months	Multiplier	% change in 12 months	Multiplier	% change in 12 months	Multiplier	% change in 12 months
M1 / Restricted base [3/]	1.413	-2.0	1.286	-14.0	1.270	-14.4	1.300	-8.0
Banking reserves / Demand deposits [3/]	0.438	88.8	0.567	46.5	0.579	40.9	0.536	22.4
Currency / M1 [3/]	0.384	-24.0	0.365	-1.6	0.368	1.9	0.392	2.1
M4 / Expanded base [4/]	1.402	-19.9	1.332	-22.1	1.199	-28.2	1.139	(18.8)

1/ Refers to the final month in the period.

2/ Projected.

3/ Working-day balance average in month.

4/ End-of-period balances.