

The President of Banco Central do Brasil, Arminio Fraga, wrote an open letter to the Minister of Finance explaining the reasons for the non fulfillment of the 4.00% inflation target established for 2001. Please find below the translation of the letter.

“ Dear Minister:

As you are aware, the inflation target regime was formally instituted in Brazil through the Decree 3088 of June 21, 1999. The Decree established that the National Monetary Council (CMN) would initially set, until June 30th of that year, the inflation targets for 1999, 2000 and 2001, and every year, thereafter, it would set the target for the third subsequent year. In addition, the sole paragraph of article 4 of the aforementioned Decree established that in the event of the non fulfillment of the target:

“The President of the Banco Central do Brasil will publicly release the reasons for the non fulfillment of the target through an open letter to the Minister of Finance, which must contain”:

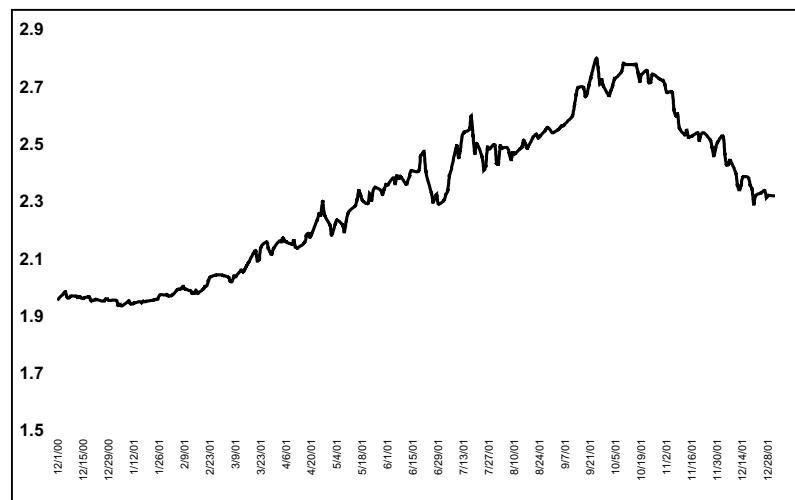
- I - a detailed description of the causes for the non fulfillment;*
- II - the measures to assure the return of inflation to the established limits; and*
- III - the time period in which the measures are expected to have effect”*

2. On June 30th 1999, the National Monetary Council set the targets of 8.0%, 6.0% and 4.0% for the IPCA variation for the years 1999, 2000 and 2001, respectively, as well as the tolerance intervals of two percentage points above and below the central target. In the two first years of the program, the target was achieved, with inflation, as measured by the IPCA, reaching 8.9% and 6.0% in 1999 and 2000, respectively. In 2001 the inflation reached 7.7%, hence above 6%, which corresponds to the upper limit of the inflation target for that year. I am therefore sending this open letter to you with the explanation for the reasons that led to the non fulfillment of the target, the measures to be taken to assure that inflation returns to the established limits, and the time period in which these measures are expected to take effect.

Reasons for not achieving the target

3. The inflation in the year was above the established target as a consequence of the external and domestic shocks that hit the Brazilian economy in 2001. On the external front, the deceleration of the world economy, the negative factors stemming from the Argentine crisis, and the terrorist attacks to the United States generated strong pressure for the depreciation of the Real in 2001. In October, the Real peaked at R\$ 2.84 to the US dollar, accumulating in a depreciation of 42.6% (Graph 1). The appreciation of the exchange rate in the last two months of the year reduced the accumulated average depreciation in 12 months up to December to 20.9%. This depreciation of the Real markedly pressured domestic prices.

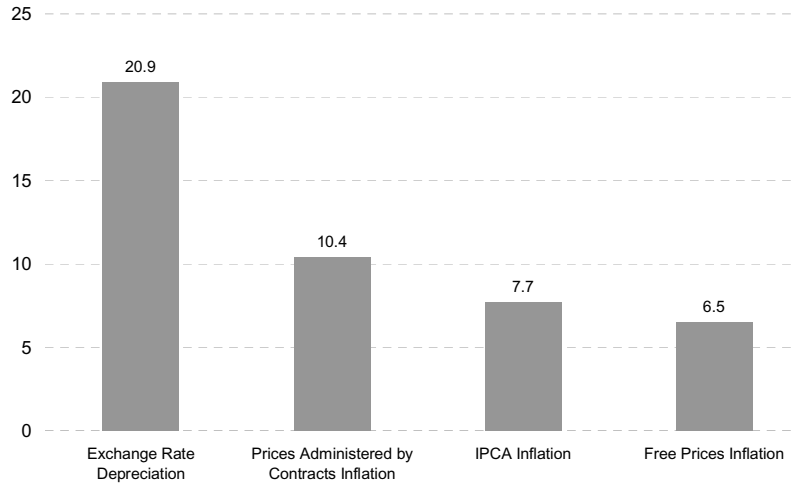
Graph 1
Exchange Rate (R\$/US\$) in 2001



4. On the domestic front, it is noticeable the accentuated hike in prices administered by contracts, mainly the tariffs for electricity. The inflation of these prices reached 10.4%, above the 6.5% inflation of free prices and 7.7% IPCA inflation (Graph 2). Prices administered by contracts should be understood as those whose sensitivity to demand and supply factors is lower, and not necessarily those prices that are directly regulated by the government¹.

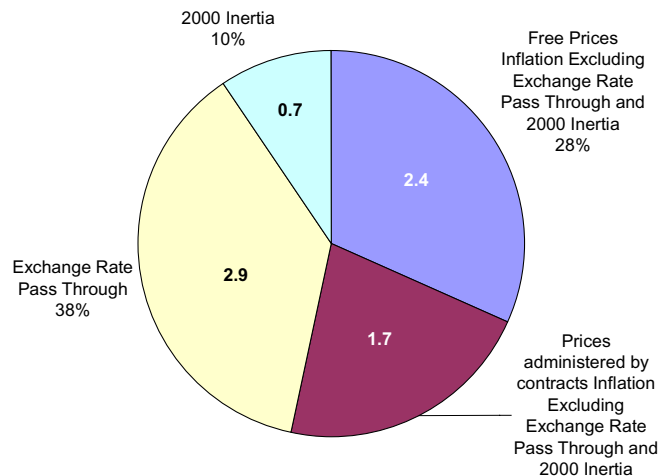
¹ The definition of prices administered by contracts was altered by the Copom in July 2001, in order to include a wider set of items weighing 30.7% in the IPCA (December 2001). This set includes items such as electricity (3.87% in the IPCA), gasoline (4.43% in the IPCA), fixed telephone (3.02% in the IPCA), urban bus (4.61% in the IPCA), health plan (2.55% in the IPCA), water and sewage (1.64% in the IPCA) and cooking gas (1.35% in the IPCA), among others.

Graph 2
Exchange Rate Depreciation and Inflation in 2001
Percentage in the Year



5. The 2001 inflation may be broken down so as to detach the effects of the exchange rate depreciation (even indirectly through its effects on certain prices administered by contracts, such as fuel and energy), from the inflation of prices administered by contracts and the inflationary inertia carried over from 2000 (Graph 3).

Graph 3
Contributions to the Inflation in 2001
 Percentage of the Total and Percentage Variation in the Year (values within the chart)



6. It is estimated that the pass through of the exchange rate depreciation to inflation in 2001 represented 2.9 percentage points. This calculation was based on Central Bank's structural model, which considers that the pass through to free prices inflation, as a percentage of the observed depreciation, is 7% in the quarter and 12% for the year. The pass through to free prices contributed with 1.7 percentage points of the inflation and the exchange rate pass through to prices administered by contracts with 1.2 percentage points of the inflation in 2001. The exchange rate pass through to prices administered by contracts incorporates the increase in oil-by-products and in prices whose contracts are indexed to the general price index (IGPs).
7. The contribution of prices administered by contracts to the inflation was of 1.7 percentage points, once deducted the pass through of the exchange rate and the inflation inertia in 2000. The inflationary inertia inherited from 2000 contributed with 0.7 percentage point for the IPCA in 2001.
8. Considering that both the exchange depreciation and the magnitude of the increase in prices administered by contracts in 2001 may be interpreted as non recurrent events, it is conceivable to evaluate what the inflation would be if: (i) the exchange rate depreciation in 2001 had not occurred to the extent observed, and (ii) the inflation of prices administered by contracts had been restricted to 4%, the center of the inflation target for 2001.
9. Had the exchange rate remained at the level of R\$ 1.96, as observed in the fourth quarter of 2000 (hence assuming zero depreciation), the inflation would have been of 4.8%. The exercise clearly shows that solely the effect of the exchange rate depreciation on inflation in 2001 explains nearly 2.9 percentage points of the inflation.
10. Had the inflation of prices administered by contracts, once deducted the pass through of the exchange rate and the inertia on these prices, been restricted to 4%, the center of the inflation target for 2001, the IPCA inflation would have been 0.5 percentage point lower. This value is considered to be the effect of the shock coming exclusively from prices administered by contracts. Therefore, in the absence of this shock, the inflation in 2001 would have been of 7.2% (7.7% minus 0.5%).
11. Removing the effect of both the exchange rate variation and the shock on prices administered by contracts from the IPCA inflation in 2001, the inflation would have been of 4.3%, near the center of the target.

Central Bank actions in 2001

12. In 2001, the Central Bank acted in a preemptive manner aiming at reducing the potential inflationary effects of the depreciation of the exchange rate and increase in the prices administered by contracts - especially, in order to avoid the propagation of the shocks. Had the Central Bank not acted in such a preemptive fashion, the inflation would have been higher than the observed and the adjustment in the real exchange rate---dominant element in the improvement of the external accounts---would have occurred in an environment of great uncertainty. In this context, the reversal of the expectations that created the conditions for the exchange rate appreciation, the reduction in the risk premium and the improvement in the perspectives of the Brazilian economy would not have been materialized in 2001.
13. The set of shocks that hit the Brazilian economy in 2001 generated trends for the exchange rate and prices administered by contracts different from the ones projected at the end of 2000. In the *Inflation Report* of December 2000, prices administered by contracts were expected to be readjusted by 6.2% in 2001 and, based on an average exchange rate of R\$2.02, an inflation of 3.9% was forecast for the year. Central Bank's forecasts were then supported by private sector market analysts. According to information collected by the Investor Relations Group (GCI) upon the last survey of the year 2000, the forecast for the exchange rate was of R\$2.00 at the end of 2001, and, for inflation, 4.3% in 2001.
14. The unexpected evolution of the exchange rate trend in 2001 - average values in Reais of 2.01, 2.29, 2.54, and 2.56 from the first to the fourth quarters and of 2.35 in the year - may be attributed to a perception of a worsening profile of Brazil's balance of payments. The aggravation of the Argentine situation and the perspective of a more intense world slowdown pressured the exchange rate, given the need for a higher adjustment in Brazil's external accounts. The energy crisis exerted additional pressure on the exchange rate to the extent that it increased the uncertainties in the future evolution of the Brazilian economy. Finally, the uncertainties in the world economy following the terrorist attacks in the United States led to a new round of exchange rate depreciation in Brazil
15. The increase in prices administered by contracts was also higher than the expected. Among the main surprises, the hikes in electricity (18% increase compared to a forecast of 9%) and in gas (a 7.2% increase compared to a forecast of a 8% fall)



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should be noticed. These higher than expected hikes stemmed from the above-the-inflation administered readjustments for electricity and, in the case of the gasoline, the high prices of the oil in Reais prevailing for the most of the year.

16. Acting in a preemptive manner and anticipating to the effects of the shocks, the Copom, in March, promoted the first 50 basis points increase in the Selic interest rate. In the subsequent months, the Copom promoted four new hikes in the basic interest rate, which increased from 15.75% p.y. in March to 19% p.y. in July, and this remained unchanged until the end of the year (Table 1).
17. The exchange rate market showed instability at some moments, especially after the September attacks. As a response, the Central Bank chose to complement the interest rate policy by increasing the reserve requirement ratio on time deposits and by temporarily intervening in the exchange rate market, with satisfactory results.
18. In mid 2001, the Copom concluded that the monetary policy was adequate to restrain the spread of the shocks and to assure the accomplishment of the inflation target in 2002. Based on this new assessment, Copom maintained the interest rate stable at 19% p.y. throughout the second half of 2001. This is an important feature of the inflation target system: the Central Bank must seek to conduct the monetary policy always pursuing the target 12 to 18 months ahead. These preemptive actions avoid the propagation of second round effects or the inertialization of the supply shocks or other temporary ones.
19. Because of the intensity and the comprehensiveness of the set of shocks that hit the Brazilian economy, the cost---in terms of reduction in the level of economic activity---of avoiding the direct impacts from increasing inflation in 2001 to a level above the tolerance interval of the target would have been significantly higher. An effort of monetary policy to keep inflation within the target in 2001 could have driven the inflation to a level considerably lower than the target in 2002, given the lags existing in the transmission channel of the monetary policy.

Table 1



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Copom Decisions and Target for the Over Selic Rate

Annual Rates

month/year	rate
Dec 00	15.75
Jan 01	15.25
Feb 01	15.25
Mar 01	15.75
Apr 01	16.25
May 01	16.75
Jun 01	18.25
Jul 01	19.00
Aug 01	19.00
Sep 01	19.00
Oct 01	19.00
Nov 01	19.00
Dec 01	19.00

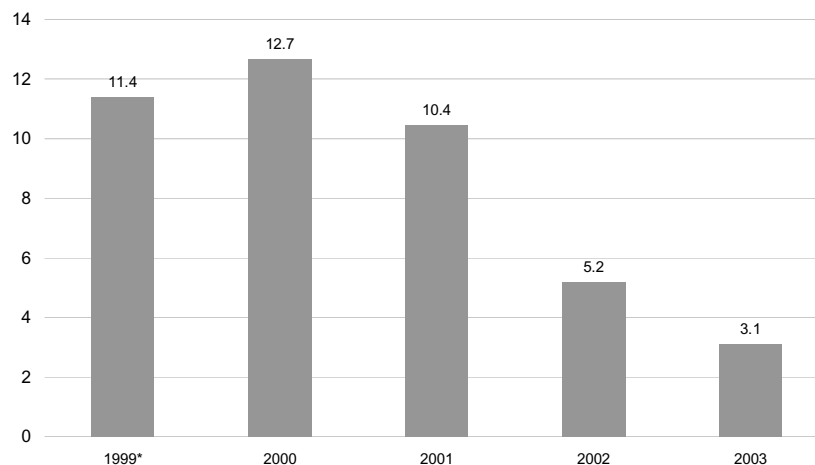
Prospects for inflation and monetary policy

20. The economic policy measures in 2001 were implemented taking into account the magnitude and the effects of the shocks that hit the Brazilian economy. For 2002, the likelihood that these shocks might occur again in the same magnitude is unlikely. On the contrary, a reduction in the inflation of prices administered by contracts and an exchange rate trajectory that reflects the combination of the reduction in Brazil's risk premium and lower international interest rates is expected.
21. We project a 5.2% increase (direct contribution of 1.6 percentage points for the inflation) for prices administered by contracts in 2002, influenced by the 19% hike in electricity for households (Graph 4). The projected inflation for prices administered by contracts in 2002 is above the 3.5% center of the inflation target for this year.

Graph 4

Inflation of Prices administered by contracts in 1999-2003


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Percentage in the Year



*Definition and weight of the set of prices administered by contracts differ from those used in the following years

22. The forecast of lower inflation for prices administered by contracts this year is partially due to the readjustment in oil-by-products. Their prices should fall significantly as a result of the exchange rate appreciation and the reduction in oil prices in the international market. Contrary to price setting based on the moving average criteria, established under the parametric rule in place in 2001, at the beginning of this year will be established by market forces. As the competition in the retail commerce of oil-by-products is assured, consumer prices should fall reflecting the price reductions in the wholesale market.

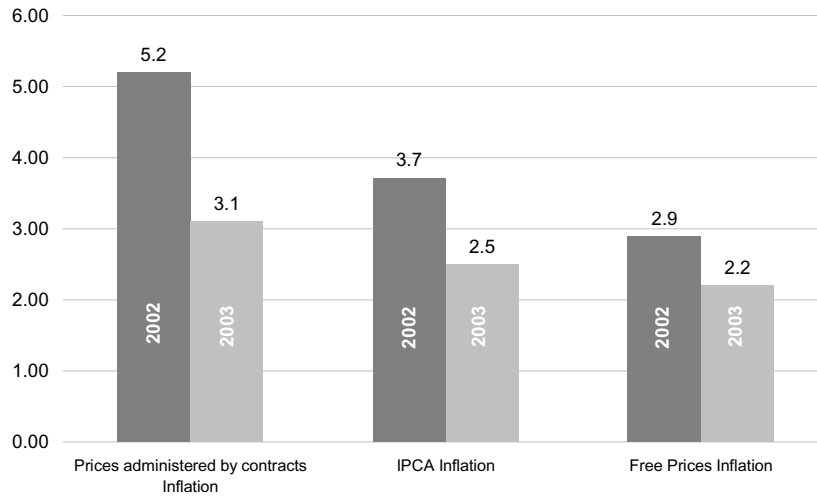
23. As a result of the expected trend of the exchange rate and prices administered by contracts, more favorably than the observed in the past year, the projection for inflation in 2002 is of 3.7%, near the 3.5% center of the target, assuming interest rates at the level of 19% p.y. and a stable exchange rate as prevailing on the day prior to the last Copom meeting. For 2003, the projection is of 2.5%, below the 3.25% center of the target (Graph 5).

Graph 5



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Projections for Inflation in 2002 e 2003



24. It should be noted, in accordance to what was indicated in the *Inflation Reports*, that the inflation forecasts are not totally reliable, and, therefore, are better represented by confidence intervals. The confidence intervals calculated in Central Bank's model for the IPCA inflation projections convey a dispersion of the projected values around the central value of the forecast. The 3.7% estimate for the year in comparison to the market's expectation of 4.7%, is in the center of these intervals.

Table 2
Confidence Intervals for the Inflation Projections in 2002 and 2003

Period	Confidence Intervals						Central Projection
	50%						
	30%						
	10%						
2002:1	6.1	6.4	6.6	6.9	7.2	7.5	6.8
2002:2	5.1	5.5	6.0	6.3	6.8	7.2	6.1
2002:3	3.4	4.0	4.6	5.1	5.6	6.3	4.8
2002:4	2.0	2.7	3.3	4.0	4.6	5.4	3.7
2003:1	1.4	2.2	3.0	3.7	4.4	5.2	3.3
2003:2	0.9	1.7	2.5	3.3	4.0	4.9	2.9
2003:3	0.5	1.4	2.2	3.0	3.8	4.7	2.6
2003:4	0.3	1.3	2.1	2.9	3.7	4.7	2.5

25. The inflation projection for the IPCA in 2002 incorporates two effects on inflation:

- i) an inflation of prices administered by contracts projected for 2002 of 5.2% (1.6 percentage points contribution to the IPCA), corresponding to 1.7 percentage points above the 3.5% center of the inflation target for 2002. This part of the inflation which exceeds the target represents a shock of prices administered by contracts that, after the exclusion of the effect of the exchange rate and the inflation inertia upon these prices, represents an impact of 0.2 percentage point.
- ii) due to the fact that the 2001 inflation was 3.7 percentage points above the center of the target, the inflation in 2002 tends to be higher. This part of the inertia of the 2001 inflation---relative to the part of the IPCA inflation that exceeded the target in 2001--is estimated at 0.7 percentage point.²

The absence of these shocks would correspond to a situation in which: i) the inflation of prices administered by contracts would equal the 3.5% center of the target in 2002; ii) the inflation in 2001 would have equalled the 4% center target.

The rise in prices administered by contracts, once excluded the effects from the exchange rate and the inertia, should be considered as a new shock for the inflation in 2002. The inflationary inertia

2. It is important to stress that Brazil is in a deflation process, where the targets for inflation, as defined by the National Monetary Council (CMN) until 2003, are decreasing. As a result, each year it is necessary to act upon the inflationary inertia, even if the target has been achieved in the previous year.



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inherited from 2001 is the propagation of the shocks hitting the economy in 2001, typically constituting a secondary effect of the shocks.

27. The monetary policy must be oriented towards eliminating the secondary effect of the shocks on inflation, fighting against the eventual movements of the propagation of the initial increases in these prices and, simultaneously, preserving the initial realignment of relative prices. The monetary policy must also seek the adequate timing for inflation to return to the target forecast, which depends on the magnitude and the degree of persistence of the shocks, maybe extrapolating the calendar year. In this manner, an excessive volatility in the activity level is avoided.

28. In summary, supply shocks or the ones of a temporary nature determined the increase in inflation to a level above the upper range of the target. The cost in terms of level of activity of avoiding that the direct impacts increased inflation to a level above the upper limit of the inflation target in the calendar year of 2001 would have been high. As those shocks are not expected to reoccur with the same magnitude as observed in the previous year, the inflation trend is downwards. The projections generated by the several specifications of the structural model point to the convergence of inflation to its target path. As usual, the Central bank will be diligent to any unexpected occurrences of the international and national economic environment. The macroeconomic regime of inflation targets, floating exchange rate and fiscal responsibility proved to be effective to deal with a perverse sequence of strong shocks in the economy, keeping the inflation and the expectations under control, and preserving an economic growth rate near the world average.

With all due deference,

Arminio Fraga Neto
President

To the honorable
Pedro Sampaio Malan
Minister of Finance “