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BANCO CENTRAL DO BRASIL

Inflation Report

June 2004

Volume 6 – Number 2

XX réis, 1753, with a shield-shaped
stamp increasing the value to XL réis

Portuguese Mint – Lisbon
Coinage made for Brazil and Guine

Museum of Money of
Banco Central do Brasil Collection

Shield-shaped stamps

During the reign of D. Maria I, due to the scarcity of metal and to increase the funds of the government, the diameter and the thickness of copper coins were reduced, while maintaining the facial value. In 1809, aiming to standardize the coins in circulation, D. João ordered the copper coins of XL, XX, X e V réis to be stamped with a shield coined before 1799, to double their value.

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... data not available.
- nil or non-existence of the event considered.
0 ou **0.0** less than half the final digit shown on the right.
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Hiphen between years indicates the years covered, including the first and the last year.
A bar (/) between years (1970/1975) indicates the average of the years covered, including the first and the last year or even crop or agreement year, when mentioned in the text.

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Foreword

Inflation Report is a quarterly publication of the Banco Central do Brasil with the objective of evaluating the performance of the inflation targeting system and providing a prospective scenario for inflation. The national and international economic conditions underlying decisions taken by the Monetary Policy Committee (Copom) concerning the monetary policy management are presented.

The *Report* is divided into six chapters: Activity level; Prices; Credit, monetary and fiscal policies; International economy; Foreign sector and Prospects for inflation. With regard to the activity level, growth in retail sales, inventories, output, labor market and investments are investigated. In the following chapter, price analysis focuses on the results obtained in the quarter as a consequence of monetary policy decisions and the real conditions of the economy outside the realm of government action. The chapter referring to the credit, monetary and fiscal policies, the analysis is centered on the behavior of credit, financial and budget operations. In the chapter dealing with the international economy, the *Report* presents an analysis of the world's major economies and seeks to identify those conditions capable of impacting the Brazilian balance of payments. Insofar as the foreign sector chapter is concerned, analysis is targeted at economic-financial relations with the international community, with emphasis on trade results and foreign financing conditions. Finally, prospects on inflation growth are analyzed.

Executive summary

The recent evolution of the economic activity level and the leading indicators – industrial and expectations surveys – confirmed the ongoing growth trend in the Brazilian economy. Despite the fact that the exports expansion has continued as a major factor underlying this process, it should be highlighted that the domestic demand has increased its relative importance to the growing dynamism of the economy, more markedly from the second half of 2003 on.

Real Gross Domestic Product (GDP) registered expansion of 1.6% (seasonally adjusted data) in the first quarter of 2004, compared to the previous quarter. This figure corresponds to an annual growth rate of around 6% for the second consecutive quarter. If the real GDP level should remain constant in the next three quarters, the carry-over exercise projects a total GDP growth of 2.8% for 2004. However, the momentum generated by credit and its multiplier effects throughout the economy, the growth in real wages and the sharp upturn in job creation, even not taking into consideration the seasonal factors typical of that period of the year, clearly support the expectations of growth above that level for 2004. According to the scenarios outlined in this *Report*, the growth rate for 2004 is forecasted at 3.5%, the same figures projected in the two previous *Inflation Reports*.

Recent growth in credit operations encompasses both individuals and companies. The growth in operations with individuals was sustained mainly by personal credit operations, especially those of payroll-discounted installments, benefited significantly from the successive reduction of the Over-Selic rate throughout the second half of 2003, which not only resulted in considerable cost reductions in funding, but also fuelled demand for durable consumer goods. Likewise, corporate credit operations showed an upward trajectory in the quarter ended in May, backed up by both external and domestic funding. In addition to that, the impact of the operations with the export-oriented sectors has persisted, prevailing those linked to the agribusiness activities.

Furthermore, the favorable performance of the macroeconomic fundaments, as evidenced by the consistency of the convergence of inflation to the targets and the positive fiscal and foreign trade account results, as well as the recovery of consumers and business confidence, are other important factors sustaining the current pace of the upturn in the economic activity level.

Fiscal results registered up to April signal that the primary surplus target for the first half of the year will be accomplished and are consistent with the target set for the year, particularly taking into consideration the seasonal behavior of spending and revenues. It should be stressed that tax revenues has incorporated the effects of the economic rebound, generating a situation in which revenues are moving to levels compatible with the parameters defined in the fiscal budget.

The debt/GDP ratio continues in a downward trend, which should be maintained due to the successive interest rates reductions, to the decreased vulnerability of the debt to exchange rate fluctuations, and to the favorable outlook for the economic growth.

External sector results have benefited from the positive performance of the world economy. Besides, specific geographic areas are still expected to benefit from the higher commodity prices caused by growing demand in the more dynamic economies. In the period from January to May 2004, the Brazilian trade balance registered a US$11.2 billion surplus, and the current unilateral transfers registered significant improvement in comparison with the same period of 2003. Even with the rise in the net remittances in the income account, the Country managed to obtain a US$2.4 billion current account surplus, compared to a US$43 million deficit in the same period of 2003. As far as the 12-month accumulated figures are concerned, the current account surplus totaled US$6.4 billion in May, equivalent to 1.24% of the GDP, the best result since December 1993.

The current account is expected to keep on running surpluses throughout the year, mostly because of the exports growth rate. On the other hand, the imports growth registered in the year is consistent with the economic activity rebound, and does not put at risk the projections of an annual surplus of US$26 billion, significantly above the figures obtained in the previous year.

The private sector rollover rate and the net inflow of foreign direct investment, though below the levels previously projected, have contributed to dissipate eventual uncertainties regarding the financing of the Brazilian external accounts. Adding up to this favorable outlook, the positive flow registered in the exchange market in the first five months of the year, which is particularly evident in the exchange positions of the banks, and the prospects signaled by the recent placement of sovereign bonds in a context of still sharp volatility in the international markets make it clear that there will be no difficulties in financing the 2004 balance of payment. In fact, the significant improvement in registered in the external accounts in the recent past should enable the Country to end up the year with an international reserves level equal or superior to the level observed in 2003, even in scenarios of worse financing conditions in the coming months.

In this context, despite the increased observed in May, the recent evolution of inflation indices and their core measures revealed absence of any widespread pressures over prices, in a manner that is consistent with the inflation target set for the year. It should be stressed that the recently adopted economic policy measures have played an important role to the achievement of this favorable outlook, making it possible to overcome external pressures such as the increase in commodity prices, particularly oil, as well as the exchange rate depreciation that has taken place recently.

Despite this favorable scenario, temporary pressures are still expected to influence the price indices in the coming months, as the ones observed in May. Amongst the main factors, one should highlight the concentration of regulated price readjustments of important items, such as the telephone and electricity tariffs, and adverse seasonal factors like the inter-harvest period for milk and dairy products, or even pressures in specific sectors, mostly those that perceive more influence of climatic conditions or international prices.

Since the publication of the last *Report*, the main change in the scenario with which the Copom works has been the increased volatility of the external environment, consequence of the uncertainties that still persist concerning the monetary policy dynamics in the US in the coming months, in a context of growing signs of a progressive increase in the Fed Funds rate. In addition to this main factor, other uncertainties persist, such as the ones concerning the oil prices in the near future, or China’s capacity to reduce the economic growth pace in an orderly fashion. However, despite the increased volatility, the medium-term prospects for the Brazilian economy are still favorable.

Market inflation expectations, as surveyed by the BCB's Investor Relations Group (Gerin), have presented deterioration since May, mainly as a consequence of uncertainties surrounding the shifts in the external scenario. Even though it should be natural to observe an increase in the expectations for 2004 in response to external turbulence, the deterioration also affected longer terms, in such an intensity that exceeds the inflation reaction to exogenous shocks, in light of the monetary authority's determined commitment to fighting the secondary effects of such shocks.

The central inflation trajectory in the benchmark scenario, which includes the assumption of an unchanged Over-Selic rate at 16.0% and the exchange rate at R$3.10 to the end of the year, indicates an upward trend in the 12-month accumulated figures in the year, starting at 5.9% in the second quarter, and reaching 6.4% in the last quarter, thus above the central target set for the year (5.5%). For 2005, inflation in the benchmark scenario is projected at 4.4%, slightly lower than the 4.5% target for the year. In the market scenario, which incorporates the trajectories of the interest rate and the exchange rate as surveyed by the Gerin, inflation projections are higher than those in the benchmark scenario: 6.4% for 2004 and 5.4% for 2005.

Activity level

1

The activity level has continued expanding in the current year in a manner consistent with the scenario outlined in recent Inflation *Reports* and fully in line with economic growth projections for the year. Growth in recent months, which has been confirmed by the GDP result and monthly activity level indicators, has reflected continued recovery in internal demand coupled with a highly dynamic export sector performance.

Internally, consumption growth has been impacted not only by increased credit operations, a factor of great importance in the final months of last year, but also by expanding job opportunities and recovery in the purchasing power of income. These factors have contributed to sustaining retail trade activity, particularly involving sales of consumer durables, as demonstrated by trade sector surveys. Another important component of internal demand – investment – has, for the third consecutive quarter, continued the strong growth registered in the first quarter of 2004. This performance clearly reflects the soundness of the nation's economic fundamentals and, consequently, consolidation of positive expectations regarding economic performance in 2004. In the external scenario, exports have been a highly positive surprise, though the contribution of foreign trade to GDP growth is expected to decline somewhat as a result of the increased imports demanded by expanding activity.

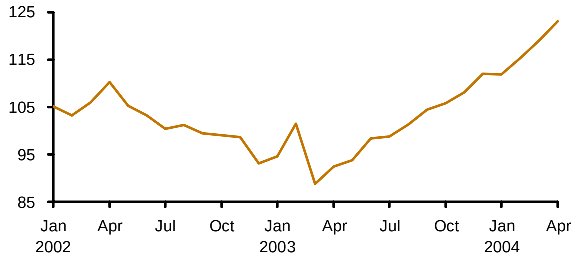
At the start of the year, the crop/livestock sector continued the highly dynamic drive that has marked recent periods, powered by the still ongoing expansion of foreign sales, particularly involving meats and derivatives, and by a bumper grain harvest. Despite isolated reductions forecast for this year, the sector's production is expected to close quite close to the 2003 record level. Output of the industrial sector remained high, though not quite as strong as the high rates registered in the second half of 2003. However, as stressed in the most recent *Report*, this is a tendency quite common in periods immediately following the start of recovery.

Adjusted stock levels, the results of sector-by-sector surveys and early figures for the second quarter clearly buttress predictions of solid manufacturing growth over the course of 2004. Parallel to this, the service sector also registered growth in the first quarter of this year, partly reflecting the performance of industry and crop/livestock farming. The same thing occurred in the previous two quarters and evidently confirms perceptions of a sustained upswing in economic activity.

1.1 Retail sales

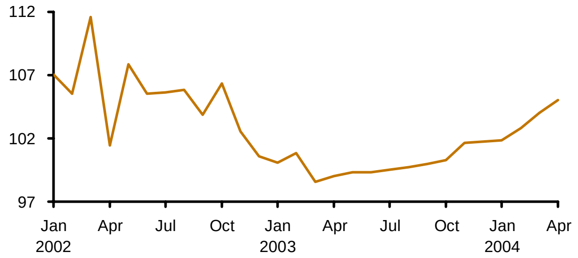
The retail sector growth trend evident since the start of the second half of 2003 was sustained into the early months of 2004. Initially driven by expanding credit, particularly operations targeted to financing consumer durables, this performance also reflected expanding job opportunities and income in the early months of the year. Consequently, demand for nondurable consumer goods, particularly supermarket products, apparel and footwear, recovered sharply in recent months, following the example of consumer durables, particularly in the segments of furniture and home appliances.

Sales Volume Index in the Retail Sector
Furniture and home appliances
Seasonally adjusted data
2003=100



Source: IBGE

Sales Volume Index in the Retail Sector
Supermarkets
Seasonally adjusted data
2003=100



Source: IBGE

According to the Monthly Trade Survey (PMC) released by the Brazilian Institute of Geography and Statistics (IBGE), the Index of Retail Sales Volume registered a high of 3.3% in the quarter ended in April 2004, compared to the November 2003-January 2004 quarter, based on the seasonally adjusted statistical series. All segments, with the exception of fabrics, apparel and footwear (-0.4%), registered positive results using this basis of comparison, with significant performances under furniture and home appliances, 7.7%, supermarkets, 2.2%, and fuels and lubricants, 1.2%. Automobiles, motorcycles, parts and spares, a segment that is not included in the general index, registered a 1.6% decline, using the same basis of comparison.

Contrary to what occurred in 2003, when the majority of states closed with volume reductions in retail sales, a breakdown of the twenty seven states surveyed shows that only three turned in negative results in the first four months of 2004, when compared to the same period of the previous year. The largest upturns were registered in Mato Grosso, 22.1%, Rondônia, 21.4%, and Espírito Santo, 20.1%. On the other hand, the only reductions occurred in Roraima, 16.8%, Piauí, 1.1%, and Pernambuco, 0.1%.

Sales Volume Index in the Retail Sector – Brazil

Percentage change

Itemization	2003	2004			
	Dec	Jan	Feb	Mar	Apr
In the month[1/]					
Retail sector	-0.2	2.0	0.3	1.6	1.8
Fuel and lubricants	-0.6	-0.1	-2.6	7.1	-1.5
Supermarkets	0.1	0.1	0.9	1.2	1.0
Textiles, clothing and footwear	-0.9	1.3	-1.2	2.3	-3.5
Furniture and home appliances	3.7	-0.1	3.1	3.2	3.4
Vehicles, motorcycles	-0.8	-2.1	2.2	-1.7	-2.9
Quarter/previous quarter[1/]					
Retail sector	2.1	3.1	2.8	3.4	3.3
Fuel and lubricants	2.8	2.7	0.0	0.6	1.2
Supermarkets	1.5	1.8	1.5	1.6	2.2
Textiles, clothing and footwear	2.3	1.2	0.3	0.6	-0.4
Furniture and home appliances	7.1	6.6	6.6	6.3	7.7
Vehicles, motorcycles	12.9	9.4	3.6	0.1	-1.6

Source: IBGE

1/ Seasonally adjusted data.

Sales Index in the Retail Sector – Brazil

2004, April

% accumulated growth in 2004

Itemization	Nominal revenue	Volume	Price change
Retail sector	9.6	8.0	1.5
Fuel and lubricants	-5.6	7.9	-12.6
Supermarkets	8.7	4.7	3.8
Textiles, clothing and footwear	9.5	0.1	9.4
Furniture and home appliances	28.5	25.9	2.1
Vehicles, motorcycles	19.9	12.9	6.3

Source: IBGE

Real sales of the retail sector

% accumulated growth in the year

Itemization	2004			
	Jan	Feb	Mar	Apr
Fecomercio SP	4.8	5.2	4.3	4.9
Fecomercio RJ	-0.2	-2.0	-1.7	-2.5
Fecomercio MG	-2.6	-4.8	0.7	1.2

Source: Fecomercio SP, Fecomercio RJ e Fecomercio MG

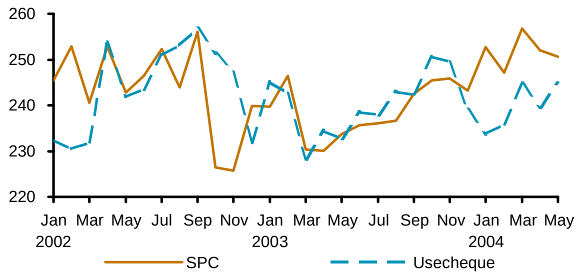
In accumulated figures for the first four months of the year, Nominal Sales Revenues expanded by 9.6% in comparison to the same period of 2003. This result was a consequence of a combination of increases of 8% in sales volume and 1.5% in retail prices, using the same basis of comparison. Mention should be made of the fact that accumulated inflation between the first four months of 2004 and the same period of 2003, measured by IBGE's Broad National Consumer Price Index (IPCA), came to 6.4%. Consequently, with exception of fuels and lubricants, all sectors turned in growth in nominal revenues higher than the median IPCA for the year, with particularly strong increases under furniture and home appliances, 28.5%, automobiles and motorcycles, 19.9%, and fabrics, apparel and footwear, with 9.5%.

Just as in the case of the IBGE survey, the results released by the Trade Federations of the different states confirmed the ongoing process of recovery in sales. Data accumulated up to April pointed to continuation of the growth that had occurred in the first quarter of the year, as real sales increased by 4.9% in the Metropolitan Region of São Paulo and 1.2% in Minas Gerais. The only exception was the State of Rio de Janeiro, with a reduction of 2.5%.

Other trade-related indicators pointed to continuity in the growth process. Based on seasonally adjusted data, the number of consultations with the Credit Protection Service (SPC), a survey released by the Trade Association of São Paulo (ACSP) and considered an indicator of installment purchases and purchases of greater aggregate value, registered growth of 2.2% in the quarter ended in May 2004, compared to the immediately previous quarter. Usecheque, used as an indicator of purchases of lower unit cost and immediate payment, registered an increase of 2.9%, using the same basis of comparison. Here, it is important to note, that major differences occurred in the results of the different indicators in 2004. In the case of the SPC, the accumulated result up to May pointed to growth of 7% compared to the same period of the preceding year, while Usecheque registered an increase of 1% using the same basis of comparison. This would suggest that recovery in credit based sales reflects the improved conditions offered to consumer, particularly regarding reductions in the median rates of interest charged in the trade sector.

At the end of the first quarter of 2004 and early months of the second quarter, default indicators remained stable in relation to the same period of the previous year. The median ratio between checks returned due to insufficient backing and total checks cleared came to 5.4% in the first five

Retail sales indicators
Seasonally adjusted data
1992=100



Source: ACSP

Default rates

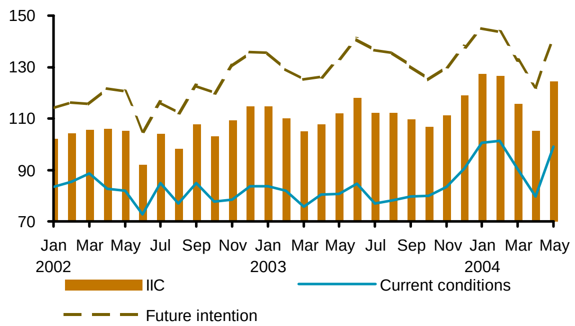
Rate

Itemization	2004					
	Jan	Feb	Mar	Apr	May	Year[1/]
SPC (SP)[2/]	4.7	7.2	6.5	6.4	5.1	6.0
Returned checks[3/]	5.5	5.4	5.7	5.4	5.2	5.4
Telecheque (RJ)[4/]	1.9	2.4	3.4	2.4	2.3	2.5
Telecheque (National)[4/ 5/]	2.7	2.7	3.6	2.6	2.3	2.8

Source: ACSP, Bacen and Teledata

1/ Annual average.
2/ New registrations (-) registrations cancelled out/effected consultations (t-3).
3/ Cheques returned due to insufficient funds/cleared cheques.
4/ Returned cheques/cleared cheques.
5/ Average in the following cities: Belém, Fortaleza, Recife, Salvador, Belo Horizonte, São Paulo, Curitiba, Porto Alegre, Ribeirão Preto and Rio de Janeiro.

Consumer Intention Index



Source: Fecomercio SP

months of 2004, as against 5.5% in the same period of the previous year. The national Teledata indicator, which also reflects the ratio between checks returned and received, confirms that default levels remained unvaried in the early months of the year. In the first five months of 2004, the indicator's average rate registered 2.8%, compared to 2.4% in the same months of the previous year.

ACSP data for the first five months of the year ratified the stability of default levels as evinced by national indicators, as the net rate in São Paulo closed at 6% compared to 6.5% in the same period of 2003.

The results of the surveys designed to evaluate consumer expectations pointed to upturn in optimism in the early months of the second quarter of 2004. The Consumer Intentions Index (IIC), released by the Trade Federation of the State of São Paulo (Fecomercio SP), registered an increase of 18.3% in May, compared to the previous month. Analyzed on a component-by-component basis, the Index of Future Intentions (IIF), which accounts for 60% of the overall index, expanded by 15.6%, and the Current Intentions Index (IIA), which accounts for the remainder of the general index, 24.5%. The move toward greater optimism is rooted in the overcoming of episodes that marked the political scenario and of the negative effects of performance in the early months of the year, coupled with the positive results registered by economic indicators, particularly inflation, employment, earnings and GDP.

The quarterly National Consumer Expectations Index (Inec), which is constructed on the basis of a survey carried out in the period extending from March 20 to 25, 2004, by the National Confederation of Industry (CNI), registered a falloff of 4.8% in the first quarter, when compared to the previous quarter. It is worth emphasizing that, despite this reduction, the index still stands at a level rarely surpassed since it was first calculated in May 1996.

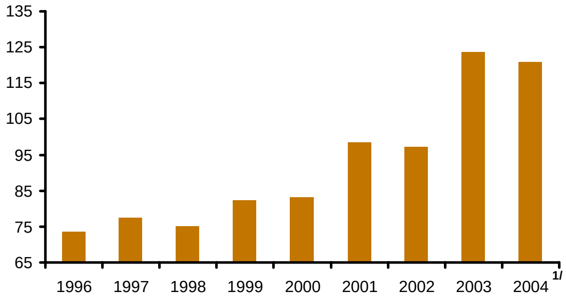
1.2 Output

Crop/livestock production

Based on data drawn from IBGE's Quarterly National Accounts, the crop/livestock sector has continued registering positive results, with 3.3% in the first quarter of 2004, compared to the final quarter of the previous year, and 6.4%, when viewed against the first three months of 2003. The dynamics of this sector were reflected in the performance of such products as rice, cotton seed and sugar cane. Despite these performances, the most recent IBGE field surveys – the Systematic Farm Production Survey (LSPA) – indicate a reduction in grain harvest estimates, caused mainly by the adverse climatic conditions that impacted some of the major crops, such as soybeans, corn and beans. In the case of the livestock sector, results have been quite positive and, above all else, have been driven by increased exports in response to growing world demand.

Crop output

Grain production
In million of tons



Source: IBGE
1/ Forecast.

According to the April LSPA, overall grain production is expected to reach a level of 120.9 million tons in 2004, or 9.1% below the initial estimate released by IBGE. Compared to the previous harvest, this figure would represent a drop of 2.2%. The falloff in this estimate is a consequence of adverse climatic conditions since the end of last year, particularly in the Central-West and South regions of the country, where the soybean crop has suffered the most severe losses. Among the other regions, the Northeast turned in the sharpest growth in grain output, with 36.9%, compared to the previous year, particularly as a result of favorable weather conditions in the west of Bahia, in Maranhão, Piauí and Ceará.

Estimated output of soybeans stands at 50 million tons of grain or 15.2% less than the original LSPA estimate for the current year and 2.8% lower than last year's production. The reduction in this estimate is a consequence of drought in the states of Rio Grande do Sul, Mato Grosso do Sul and Paraná, and excess rain in Mato Grosso and Goiás. In the latter case, the state was also impacted by a disease known as Asian rust.

Corn production in the first harvest of the year totaled 32.4 million tons or 6.7% less than in 2003, with reductions of 1.1% in the area under cultivation and 5.6% in productivity. Output in the second harvest totaled 10.7 million tons, representing a reduction of 19.8% when compared to the previous harvest. The adverse factors that impacted summer planting (first harvest) also impacted the winter harvest and resulted in cutbacks in the area under cultivation, delays in planting and lesser application of technology. Consequently, the area under cultivation dropped by 6% and yield diminished by 14.7%.

Agricultural production

In 1,000 tons

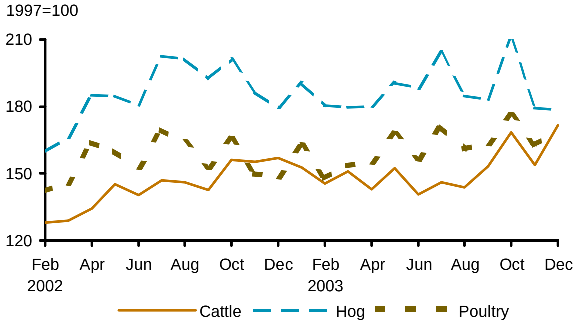
Itemization	Production 2003	2004[1/]	Percentage change
Grain production	123 632	120 906	-2.2
Cotton (seed)	1 451	2 244	54.7
Rice (in husk)	10 320	12 931	25.3
Beans	3 310	3 265	-1.4
Corn	47 988	43 047	-10.3
Soybean	51 482	50 024	-2.8
Wheat	6 029	6 099	1.2
Others	3 052	3 295	8.0
Other cultures			
Banana	6 775	6 598	-2.6
White potatoes	3 047	2 901	-4.8
Cocoa (beans)	170	178	5.1
Coffee (manufactured)	1 932	2 305	19.4
Sugar cane	389 849	398 264	2.2
Onions	1 194	1 209	1.3
Tobacco (in leaves)	657	886	34.9
Orange	16 903	16 989	0.5
Manioc roots	22 147	23 883	7.8
Tomatoes	3 694	3 139	-15.0

Source: IBGE

1/ Estimated.

Livestock production

Total weight



Source: IBGE

As far as rice is concerned, production totaled 12.9 million tons or 25.3% more than in the 2003 harvest. Price levels in 2003 were one of the driving forces underlying 15.1% expansion in the area under cultivation. At the same time, favorable weather conditions also contributed to 8.9% productivity growth.

With respect to the first bean harvest, production came to 1.6 million tons for a decline of 0.3% compared to the previous harvest. In this case the area under cultivation diminished by 2% while median productivity expanded by 1.7%. Despite climatic difficulties, the second bean harvest is expected to generate 1.3 million tons, or 3.7% more than in 2003, with growth of 3.5% in the area planted. Estimates for the third harvest indicate an output drop of 18.6%, caused by a 12.7% reduction in the area planted and a drop of 6.8% in productivity.

National output of processed coffee is estimated at 2.3 million tons, equivalent to 38.4 million bags and growth of 19.4% in the year. This result is a consequence of the two year cycle of this crop, with 2004 being considered a period of high profitability. Consequently, despite a reduction of 0.8% in the area under cultivation, productivity is expected to expand by 20.4%.

Production of sugar cane is forecast at 398.3 million tons, with positive growth of 2.2% in the year. Growth in the Chinese market and harvest failures in India and Thailand generated more attractive prices than those available on the internal market in 2003 and, consequently, acted as an incentive to growth in the area under cultivation.

Livestock

According to IBGE's quarterly survey, total carcass weight came to 1.4 million tons in the fourth quarter of 2003, with total growth of 6% in the year. Insofar as the third quarter of 2003 is concerned, growth came to 8.5%, based on seasonally adjusted data. In 2004, exports were the key to growth in this activity and came to a total of 179.9 thousand tons in the first three months of the year, with volume that was 17% greater than in the first quarter of 2003, according to data released by the Ministry of Development, Industry and Foreign Trade (MDIC).

Based on deseasonalized data, poultry production totaled 1.6 million tons in the final quarter of 2003, representing growth of 4.2% over the previous quarter. The accumulated

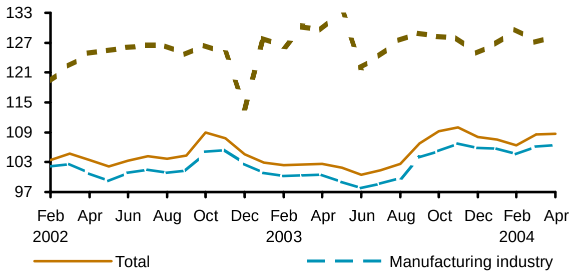
Industrial production

Itemization	2003 Dec	2004 Jan	Feb	Mar	Apr
					Percentage change
Industry (total)					
In the month1/	- 1.7	- 0.4	- 1.1	2.0	0.1
Quarter/previous quarter1/	5.3	2.2	- 1.2	- 1.4	- 0.6
Same month of the previous year	4.4	3.5	1.6	12.4	6.7
Accumulated in the year	- 0.1	3.5	2.5	5.9	6.1
Accumulated in 12 months	- 0.1	0.1	0.0	1.1	2.0
Manufacturing industry					
In the month1/	- 0.8	- 0.1	- 1.0	1.4	0.3
Quarter/previous quarter1/	5.1	3.0	0.1	- 0.4	- 0.3
Same month of the previous year	4.2	3.8	1.5	13.2	7.1
Accumulated in the year	- 0.3	3.8	2.6	6.3	6.5
Accumulated in 12 months	- 0.3	- 0.1	- 0.1	1.0	2.0
Mineral extraction					
In the month1/	- 2.3	1.5	2.3	- 2.0	1.0
Quarter/previous quarter1/	0.1	- 1.2	- 0.9	0.6	1.4
Same month of the previous year	9.3	- 2.1	2.7	- 2.5	- 1.3
Accumulated in the year	3.8	- 2.1	0.2	- 0.7	- 0.9
Accumulated in 12 months	3.8	2.8	2.5	1.8	1.4

Source: IBGE

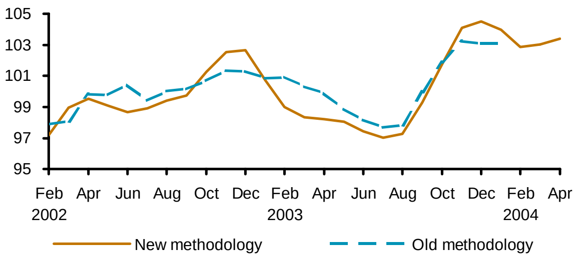
1/ Seasonally adjusted data.

Industrial production
Seasonally adjusted data
2000=100



Source: IBGE

Industrial production
Seasonally adjusted data
Quarterly moving average
2002=100



Source: IBGE

total for the year indicates production of 6.3 million tons, for growth of 3.7%. Just as occurred in the segment of cattle, the dynamics of this segment have persisted into 2004, as exports totaled 526.1 thousand tons in the first quarter of the year or 8.7% more than in the same period of the previous year.

In the segment of hog farming, carcass weight came to 483.8 thousand tons in the final quarter of 2003 and closed 3.1% above production in the immediately previous quarter, calculated on the basis of data purged of seasonal factors. In the year, swine production expanded by 1.7%. In 2004, exports totaled 83.3 thousand tons in the first three months of the year, for a reduction of 23.5% in relation to the figures for the same period of the previous year. This change in position was a result of the system of import quotas adopted by Russia, the major buyer market for Brazilian pork.

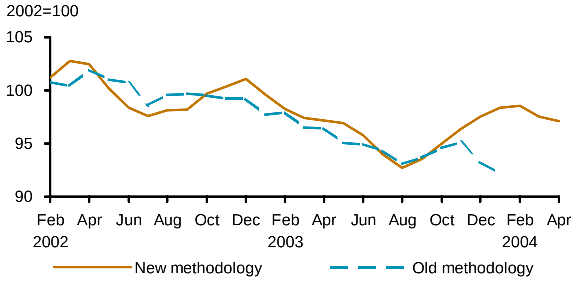
Industrial output

In the early months of the year, the industrial activity level remained quite close to the maximum output level achieved in the final months of 2003, as demonstrated by IBGE figures. Thus, the median index of the manufacturing sector dropped by 0.3% in the February-April quarter, compared to the November-January quarter, while mining production increased by 1.4% in the period, based on seasonally adjusted figures.

Compared to the same period of the previous year, accumulated figures for the first four months of the year point to growth of 6.1% in aggregate industrial production, based on expansion of 6.5% in manufacturing activity and a reduction of 0.9% under mining. Even when the rather weak basis of comparison is taken into account, the results of the manufacturing sector clearly reveal a much more dynamic pace of activity.

It should be stressed that, following the methodological review carried out by IBGE, the Monthly Industrial Survey – Physical Output statistical series pointed to a performance that was clearly different from that revealed by the older series and provided important new elements for interpreting the overall economic scenario. It is worth recalling that, aside from the alterations introduced into the weighting structure and into the methodology used to remove seasonal factors, these differences reflect the inclusion of both products and regions in the survey.

Semi and nondurable consumer goods
Seasonally adjusted data
Quarter moving average



Source: IBGE

Industrial production by category of use

Percentage change

Itemization	2003	2004			
	Dec	Jan	Feb	Mar	Apr
In the month[1/]					
Industrial production	- 1.7	- 0.4	- 1.1	2.0	0.1
Capital goods	- 8.0	1.7	- 1.9	1.9	1.5
Intermediate goods	- 0.2	0.4	0.1	1.4	0.4
Consumer goods	1.8	- 0.4	- 2.2	0.7	0.3
Durable	- 1.7	3.8	- 2.9	1.0	2.9
Semi and nondurable	3.4	- 1.4	- 1.4	- 0.2	0.2
Quarter/previous quarter[1/]					
Industrial production	5.3	2.2	- 1.2	- 1.4	- 0.6
Capital goods	14.7	10.3	0.0	- 1.5	- 1.8
Intermediate goods	2.2	0.5	- 0.2	0.6	1.4
Consumer goods	6.2	4.6	1.9	- 0.1	- 1.3
Durable	9.5	6.7	2.1	1.6	0.5
Semi and nondurable	4.3	3.5	2.2	0.0	- 1.3
In the year					
Industrial production	- 0.1	3.5	2.5	5.9	6.1
Capital goods	2.2	15.7	13.0	21.2	21.5
Intermediate goods	1.9	2.4	3.3	4.5	4.7
Consumer goods	- 2.8	2.3	- 0.1	4.9	5.1
Durable	3.0	14.9	9.3	20.6	21.1
Semi and nondurable	- 4.0	- 0.4	- 2.1	1.4	1.5

Source: IBGE

1/ Seasonally adjusted data.

According to the revised series, the recovery that occurred in the second half of 2003 was considerably more intense than the previous series had suggested. This result reflected more accentuated growth in the output of capital goods and consumer durables, pointing to the predominant role played by credit in motivating demand and, contrary to what had been suggested in the former series, demonstrated that production in the segments of semi and nondurable goods had gained strength since September 2003, only to fall off once again in the early months of 2004.

Analysis of use categories points to continued upward movement in the output of consumer durables, with deseasonalized growth of 0.5% in the February-April quarter, compared to the immediately previous quarter, raising accumulated growth in the first four months of the year to 21.1%, compared to the same period of 2003. Output of intermediate goods – the heading of greatest weight – also continued on an upward curve in the quarter, with growth of 1.4%. Production of capital goods fell by 1.8% in the period, due basically to the exceptional performance registered in November 2003. However, the accumulated output figure for this category in the year showed growth of 21.5%. In the same sense, output of the semi and nondurable consumer goods industry dropped by 1.3% in the quarter and expanded by 1.5% in the year.

Aside from the persistently positive performance of the different export sectors, it is important to note that industrial results also reflect a reaction on the part of those segments more dependent on internal demand. In this sense, growth was registered in the February-April quarter, compared to the immediately previous quarter, in the segments of apparel and accessories, 5.1%; wood, 4.3%; petroleum and alcohol refining, 4.3%; perfumes and cleaning products, 3.2%; and foodstuffs, 3%.

According to the National Association of Automotive Vehicle Manufacturers (Anfavea), production of the automotive industry, which had declined in the early months of the year, expanded by 3% in May, compared to the previous month. Based on the statistical series devoid of seasonal factors, internal sales expanded by 3.8%.

Based on seasonally adjusted data, real industrial sales expanded by 2.8% in the February-April quarter, compared to the previous period, according to figures released by the National Confederation of Industry (CNI). Growth in the number of hours worked in production came to 0.4%, using the same basis of comparison. Analyzing the same period

Automotive vehicles – Production and sales

Percentage change

Itemization	2003	2004				
	Dec	Jan	Feb	Mar	Apr	May
In the month[1/]						
Production	1.7	-1.0	-2.1	0.8	-5.6	3.0
Total sales	-2.2	4.9	-2.6	-1.7	-7.1	4.3
Domestic sales	-3.5	1.7	1.6	-6.0	-4.3	3.8
External sales	-4.6	20.7	-17.4	18.6	-14.3	-2.6
Quarter/previous quarter[1/]						
Production	21.6	14.0	4.0	0.1	-3.5	-3.7
Total sales	16.0	8.6	1.3	0.4	-3.7	-5.2
Domestic sales	21.8	12.4	1.8	-1.9	-3.8	-6.0
External sales	7.3	-0.2	-3.2	7.1	-1.9	-0.6
In the year						
Production	2.0	8.2	4.0	13.8	13.3	12.0
Total sales	2.3	20.1	10.0	17.0	14.6	14.6
Domestic sales	-4.9	16.8	10.3	18.2	18.2	18.7
External sales	26.0	31.1	8.9	13.5	5.3	4.2

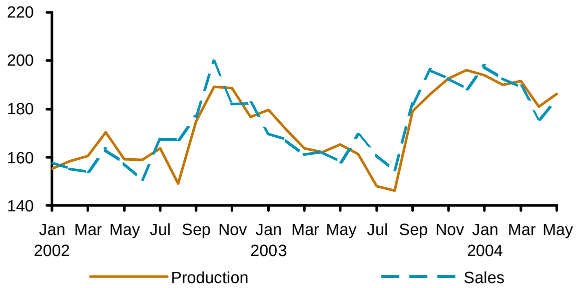
Source: Anfavea

1/ Seasonally adjusted data.

Vehicles – Production and sales

Seasonally adjusted data

1992=100

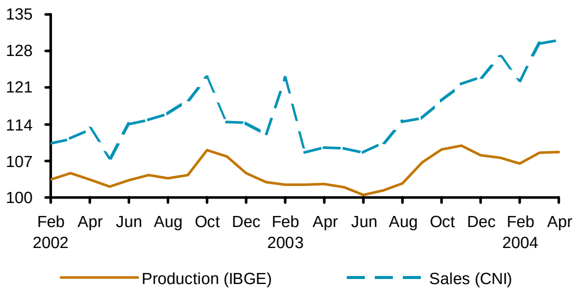


Source: Anfavea

Industrial production and sales

Seasonally adjusted data

2000=100



Source: IBGE and CNI

of time, real industrial sales in the State of São Paulo registered growth of 2.1% and hours worked expanded by 0.8%, according to a survey carried out by the Federation of Industries of the State of São Paulo (Fiesp).

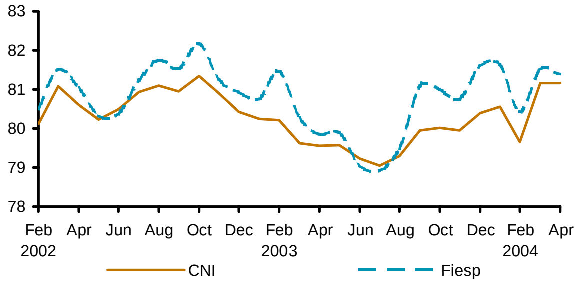
In the industrial sector, once seasonal adjustments are made, labor market indicators have demonstrated growth in the pace of activity. In this sense, CNI data reveal that employment in national industry expanded by 0.8% and real wages increased by 1.6% in the period from February to April, compared to the previous quarter. In São Paulo industry, the Fiesp survey points to positive growth of 1.2% in industrial employment and 2.2% in overall real wages, using the same basis of comparison.

Median utilization of installed output capacity climbed to 82% in the first quarter of 2004, 1.3 p.p. higher than in the same period of the previous year, according to data released by the Getulio Vargas Foundation (FGV). The segment of intermediate goods continued registering the highest level of utilization, with 87.2%, turning in growth of 7.9 p.p. and 3.2 p.p., respectively, in the levels registered by producers of capital goods and building materials, to 79.8% and 81.8% in the period. Among industrial segments, the level of utilization of installed capacity rose under perfumes, with 94.4%, and textiles, 89.3%, both of which are dependent on the internal market, while remaining high under paper, 92.4%, rubber, 90.9% and metallurgy, 90%.

Surveys carried out by the FGV and CNI at the end of the first quarter of the year indicated moderately positive expectations for the coming months. FGV's Manufacturing Industry Survey pointed to a demand level classified as robust by 18% of companies and weak by 12%, the first positive result since April 2001. Of the total companies surveyed, 56% forecast increases in demand in the April-June quarter and only 10% expected reductions. In much the same way, the outlook regarding employment was also positive as 35% of companies intended to hire labor, while 11% planned to reduce staff. This was the largest difference between these two figures since October 1986.

According to CNI's Industrial Survey, stocks of final products stand at the desired level and those of raw materials below that planned, suggesting that the process of stock adjustment has terminated. Consequently, new demand for industrial products will have to be met through increased production. On the other hand, the Industrial Business Confidence Index (Icei), though still in the optimistic band, declined in the April survey when compared to that of

Utilization of installed capacity
Seasonally adjusted data
Average percentage



Source: CNI and Fiesp

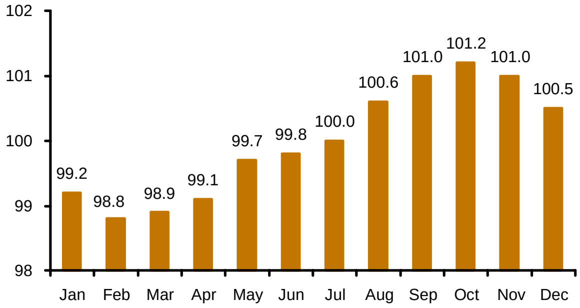
Manufacturing industry stocks[1/]

Itemization	2003				2004
	I	II	III	IV	I
Manufacturing industry					
Final products	53.5	56.3	54.6	52.1	50.6
Raw materials/intermediate goods	49.1	48.5	49.6	48.2	47.6
Large companies					
Final products	53.9	58.9	57.1	53.5	52.2
Raw materials/intermediate goods	51.9	52.6	52.9	50.6	49.7
Small and medium companies					
Final products	53.2	54.9	53.2	51.3	49.8
Raw materials and interm. goods	47.5	46.2	47.8	46.8	46.5

Source: CNI

1/ Values over 50 indicate stocks above the planned level.

Working population
Seasonal adjustment factors



Source: IBGE and Central Bank

January, reflecting the increased uncertainty that marked the period.

With this, the short-term outlook for industrial activity was generally positive, compared to the deterioration that had marked the first two months of the year. Aside from the external sector results, the dynamics of the internal market – driven by improved credit conditions and recovery in overall wages – should tend to contribute to industrial growth in the coming months.

1.3 Labor market

Employment

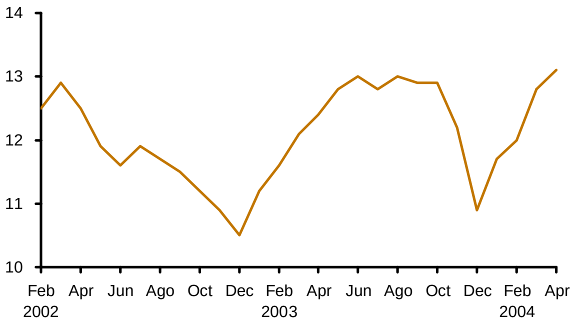
In the first four months of 2004, open unemployment measured by IBGE's Monthly Employment Survey (PME), moved along an upward curve, increasing from 10.9% in December 2003 to 13.1% in April of the current year, reflecting growth of 510 thousand jobless persons in the six metropolitan regions covered by the survey.

Growth in unemployment in the four month period reflected the loss of 174 thousand job opportunities, a figure considered consistent with the adverse seasonal pattern of the labor market[1] in the first half of the year and, more specifically, in the months of March and April, at the same time in which a contingent of 335 thousand workers was incorporated into the labor force. Of the latter total, only 92 thousand were classified within the Active Age Population (PIA), indicating a reduction in the number of those with no support whatsoever, defined as persons without employment but that were not classified as unemployed, since they were not looking for jobs. This is a natural process at the start of a period of increased economic activity.

The PME also indicates a drop of 0.6% in formal employment and growth of 4.1% in unregistered jobs up to April. The already mentioned trend toward expansion of the so-called informal labor market has been confirmed once again by the new methodology used in calculating the PME results. Analyzing the first four months of the year, the participation of informal employment increased from 29% in 2003 to 31% in the current year.

1/ The former PME seasonal factors were used as a basis, since the new series does not include enough events to undergo a seasonal factor purging approach.

Unemployment rate



Source: IBGE

Occupied people by categories of employment

Percentage change

Itemization	2003	2004			
	Dec	Jan	Feb	Mar	Apr
Total of occupied people	0.2	-2.1	0.0	0.4	0.7
By categories of employment					
Registered	-0.5	-0.7	-0.3	0.4	-0.1
Nonregistered	1.4	-4.3	-0.3	0.1	3.7
Non-earning workers, military and civil servants	-3.8	-2.4	0.0	-0.4	1.2
Self-employed	1.1	-0.7	0.5	1.3	-1.6
Employers	3.5	-8.0	2.9	1.9	0.5

Source: IBGE

Formal employment

New job openings (1,000 employees)

Itemization	2003	2004			
		Jan	Feb	Mar	Apr
Total	645.4	100.1	139.1	108.2	187.5
Manufacturing industry	128.8	36.1	38.1	50.7	64.4
Commerce	225.9	2.9	20.4	12.1	27.2
Services	260.3	34.1	52.4	35.6	49.0
Building	-48.2	14.0	1.6	7.6	12.7
Crop and livestock	58.2	11.1	15.1	-3.9	28.8
Public utilities	3.1	2.1	0.6	-0.4	0.5
Others[1/]	17.3	-0.2	11.0	6.3	4.9

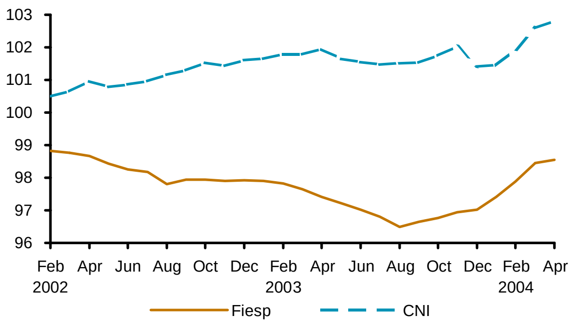
Source: MTE

1/ Includes mineral extraction, public administration and others.

Industrial employment

Seasonally adjusted data

2000=100



In contrast to the IBGE household survey, national data released by the Ministry of Labor and Employment (MTE) pointed to strong growth in formal employment in the first four months of 2004, principally in the interior of the country (see box: Recent Formal Employment Trends in the Country – page 22). According to information provided by companies to MTE's General File of the Employed and Unemployed (Caged), the first four months set new monthly records in the generation of job positions, with a total of 535 thousand hirings, as against 295 thousand in the same period of the previous year. A breakdown of the period in question shows that the largest growth in the year occurred under manufacturing, with 189 thousand positions, followed by services, with 171 thousand, commerce, with 63 thousand, and the construction industry, with a total of 36 thousand. The only sector that generated job positions at a rate below the previous year was crop/livestock farming, with 51 thousand positions compared to 77 thousand.

Seasonally adjusted data for twelve states released by the CNI for the manufacturing industry point to growth of 0.9% in the employment level in the quarter ended in April of this year, compared to the November 2003 to January 2004 quarter. Growth was more intense in the months of February and March, with monthly rates in the range of 0.5%. A state-by-state analysis shows expansion in most of the states in comparison to the level registered in 2003. According to these data, the only reductions occurred in Bahia, Rio de Janeiro and Paraná.

In the State of São Paulo, Fiesp data show that employment in the manufacturing sector expanded in the first four months of 2004, at a pace that was somewhat more accentuated than in the final months of 2003 when the process of recovery got under way. The growth registered in the first four months closed at 1%, when viewed against the immediately previous four month period.

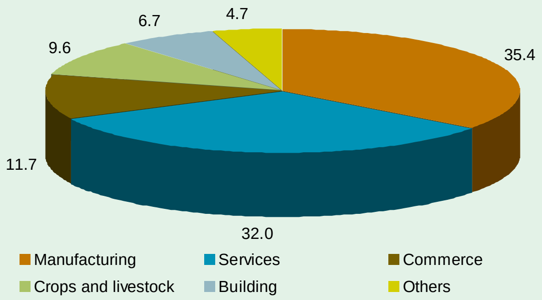
Earnings

The evolution of real worker earnings in the early months of this year confirmed the reversal in the downward trend that marked 2003. According to IBGE's PME, habitual median earnings came to R$868.50 in April, 2.9% more than last December in real terms, when the National Consumer Price Index (INPC) is used as deflator. To some extent, the recovery reflects the results of labor agreements in important categories and, above all, the relatively low levels of inflation

Recent Formal Employment Trends in the Country

Labor market indicators clearly mirror the ongoing process of economic recovery. Generation of jobs on the formal labor market in the first four months of 2004 expanded by 3.5% when viewed against the same period of 2003, totaling more than a half million new employment opportunities, according to Caged data issued by the Ministry of Labor and Employment.

Formal employment – New job openings
% by sector (from January to April 2004)

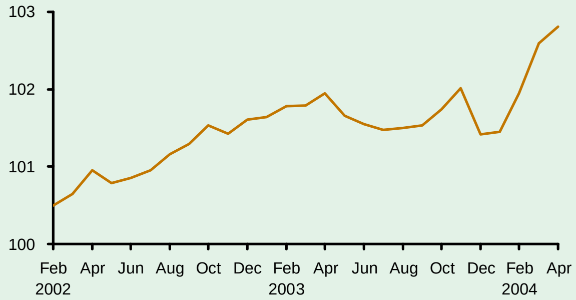


Source: MTE

On a sector-by-sector basis, creation of new job positions, which is usually led by the sector of services, has been greater in the industrial sector. This sector of activity has registered strong growth in recent months in response to the upturn in internal demand and continued expansion of exports of manufactured goods. While manufacturing was responsible for generating only 90 thousand jobs in the first four months of 2003, the total rose to 189 thousand new positions in the current year. The industrial segments that hired the largest number of workers in the period from January to April of this year were rubber, tobacco and leather, with 28 thousand; food and beverages, with 24 thousand; and textiles, with 21 thousand. The sector of services accounted for 171 thousand new positions, reflecting hiring in the areas of commerce and real estate administration, stocks and securities and technical services, with 55 thousand; and transportation and communications, with a total of 37 thousand. Crop/livestock farming participated with 51 thousand job positions in the year, or 27 thousand less than in the same period of 2003, while the construction industry generated 36 thousand openings, compared to a reduction of 26 thousand in 2003.

With respect to industrial employment, data released by CNI indicate that, following relative stability in the final three quarters of 2003, the number of

Industrial employment
Seasonally adjusted data
2000=100



Source: CNI

positions available in the sector has moved upward. In 2004, up to the month of April, the employment level expanded by 1.3% in the twelve states covered by the survey. It is worth mentioning that sectoral surveys carried out by CNI and FGV in the early days of April of this year clearly demonstrated that companies plan to continue hiring over the course of the second quarter of the year.

The dynamics of employment recovery have been shown to be quite different when metropolitan regions and the interior of the country are analyzed. Caged data indicate that since 2002, the interior regions of the country have opened a larger share of job positions. In this sense, an analysis of the ten states with the largest worker populations shows that, in 2001, the metropolitan regions of their state capitals registered expansion of 3.8% and the interior of these states turned in growth of 2.5% in formal employment. These positions were reversed in the two following years, as the state capitals closed with 2.7% and 2.4%, and the interior registered respective rates of 3.5% and 3.3%.

The following table shows the participation of the interior in job generation. In 2004, figures for the period up to April indicate that this process has accentuated. Of the 535 thousand positions created, 64% are located outside metropolitan regions.

Formal employment – Inland share in the creation of jobs

%

	Brazil[1/]	RJ	SP	MG	PR	SC	RS	BA	GO
2000	40,0	26,6	42,5	29,0	29,7	86,7	41,2	60,7	24,8
2001	53,9	31,1	48,5	60,0	73,4	87,7	55,5	64,2	43,4
2002	59,6	34,4	62,0	70,7	77,3	90,2	72,0	56,0	- 0,9
2003	62,9	29,9	57,3	66,1	85,5	85,5	67,8	78,3	48,0
2004[2/]	63,8	44,8	64,5	72,5	76,8	98,7	71,6	78,7	54,6

Source: MTE

1/ The Rio de Janeiro, São Paulo, Belo Horizonte, Curitiba, Florianópolis, Porto Alegre, Salvador, Recife, Fortaleza and Goiânia metropolitan regions, as well the capitals of the other states, are not included in the country total.

2/ Up to April.

More accentuated growth in the number of jobs available in the crop/livestock sector, which accounts for 93% of jobs in the interior, is the item most responsible for the shift in the dynamics of these two areas of the country. From 2000 to 2003, the sector registered annual growth of 4% in the number of jobs, reflecting the performance of crop/livestock farming, as well as absorption of the interior labor force into the formal economy. In 2004 up to the month of April, crop/livestock sector employment expanded by 4.4%.

However, the more accentuated growth trend in the interior of the country should not be attributed solely to the performance of the crop/livestock sector in recent years. Once this sector is excluded, manufacturing was the activity that most clearly reflected the shift of formal employment toward the interior of the country, moving from 66% of total vacancies generated in this sector in 2000 to about 90% in the following three years, indicating an intense process of geographic deconcentration of the industrial sector. Of the different states covered by the analysis, Paraná most clearly demonstrates this trend, as it moved from 6% participation of the interior in the generation of new industrial jobs in 2000 to 81% in 2003. In the State of São Paulo, a similar phenomenon occurred, with a rise from 59% to 85% in the period from 2000 to 2003. In Minas Gerais, Rio de Janeiro and Rio Grande do Sul, precisely the same thing occurred. In the sector of commerce, generation of jobs in the interior of the states expanded from 58% of the total, in 2000, to 69.5%, in the three subsequent years. In the service sector, the same tendency prevailed, albeit with less intensity, as the participation of the interior in formal employment generation moved from 40.4% to 48.6% in the same period.

In summary, formal employment has grown more sharply than in previous years. This trend has predominated in the interior of the country, when compared to metropolitan regions and has been a consequence mainly of the renewed dynamism of industrial and crop/livestock activities.

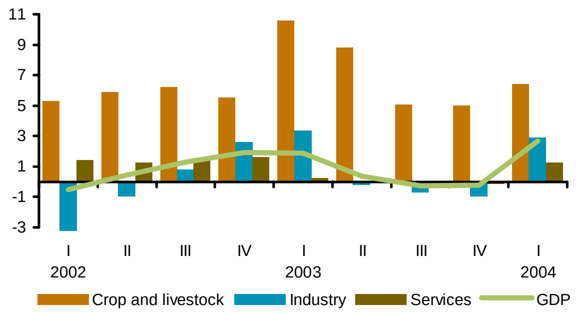
in the period. Compared to April 2003, however, earnings dropped by 3.5%.

In the same sense, a CNI survey of the manufacturing sector showed continuity in the recovery of worker earnings. In the twelve states covered by the study, the increase closed at 7.1% in the first four months of the year, compared to the same period of the preceding year. To some extent, this result was due to increases in wages paid in São Paulo industries, which have greater weight in the aggregate index. As a matter of fact, according to Fiesp, real median wages increased by 7.6% in the state, using the same basis of comparison.

1.4 Gross Domestic Product

Gross Domestic Product

% growth accumulated in the year



Source: IBGE

Gross Domestic Product

Percentage change

Itemization	2002				2004
	I	II	III	IV	I
Accumulated in the year	1.9	0.4	-0.3	-0.2	2.7
Accumulated in 4 quarters	2.5	1.9	0.7	-0.2	0.0
Quarter/same quarter of the previous year	1.9	-1.1	-1.5	-0.1	2.7
Quarter/previous quarter seasonally adjusted	-1.2	-0.9	0.5	1.5	1.6

Source: IBGE

In the first quarter of 2004, GDP expanded by 2.7% compared to the same period of the previous year, according to figures released by IBGE. Viewed under the prism of either supply or demand, this figure represented an across-the-board positive result. On a sector-by-sector basis, crop/livestock farming expanded by 6.4%, industry by 2.9%, and the service sector by 1.2%. As far as demand is concerned, the foreign trade sector barreled forward with 19.3% growth in exports, particularly involving consumer durables and capital goods, and 11.7% under imports, mainly reflecting recovery in the pace of economic activity. The increase in the volume of imports was particularly significant under intermediate goods. Parallel to this, internal demand also moved into a positive curve, with expansion of 2.2% under gross fixed capital formation, 1.5% in government consumption and 1.2% under household consumption, using the same basis of comparison.

Expansion in crop/livestock sector output reflected the ongoing process of growth in foreign sales of basic products, consistent gains in productivity and highly positive prices for farmers during all of 2003.

The 2.9% first quarter increase in the industrial sector, when compared to the same quarter of 2003, resulted from growth of 6% in the manufacturing sector and 1.3% in public utility industrial services. Output of the mining industry dropped by 3.9% in the period, mostly as a result of a 3.2% reduction in petroleum production registered by the National Petroleum Agency (ANP). Using this basis of comparison, the construction industry registered downward movement for the fifth consecutive quarter, closing with 2.3%.

Gross Domestic Product

Percentage change in the year

Itemization	2003 I Q	2003 II Q	2003 III Q	2003 IV Q	2004 I Q
Crop and livestock	10.6	8.8	5.1	5.0	6.4
Industry	3.3	-0.2	-0.7	-1.0	2.9
Mineral extraction	4.2	1.8	2.1	2.8	-3.9
Manufacturing	3.9	1.0	0.7	0.7	6.0
Construction	-0.9	-6.0	-7.7	-8.6	-2.3
Public utilities	8.1	3.1	2.5	1.9	1.3
Services	0.2	0.0	-0.3	-0.1	1.2
Commerce	-0.2	-2.0	-3.4	-2.6	5.1
Transportation	-4.0	-2.3	-1.6	-0.8	7.4
Communications	2.4	2.7	1.4	0.1	-1.9
Financial institutions	2.2	1.0	0.1	0.1	1.9
Other services	-0.1	-1.0	-0.6	-0.5	-2.1
Rents	0.4	0.6	0.6	0.9	1.1
Public administration	0.2	0.6	0.5	0.5	1.1
Financial dummy	4.4	1.7	0.6	0.3	0.3
Value added at basic prices	2.0	0.6	0.0	0.0	2.5
Taxes on products	0.5	-1.8	-2.4	-1.7	4.0
GDP at market prices	1.9	0.4	-0.3	-0.2	2.7

Source: IBGE

Gross Domestic Product

Percentage change in the year

Itemization	2003	2004 Estimated
Crop and livestock	5.0	4.0
Industry	-1.0	4.9
Mineral extraction	2.8	2.4
Manufacturing	0.7	6.1
Construction	-8.6	3.6
Public utilities	1.9	3.0
Services	-0.1	2.2
Commerce	-2.6	4.7
Transportation	-0.8	5.6
Communications	0.1	1.9
Financial institutions	0.1	3.2
Other services	-0.5	2.0
Rents	0.9	1.1
Public administration	0.5	1.0
Value added at basic prices	0.0	3.3
Taxes on products	-1.7	4.4
GDP at market prices	-0.2	3.5

Source: IBGE and Banco Central do Brasil

To a great extent, growth of 1.2% in the service sector was a consequence of positive performances in the sectors of transportation, 7.4%, commerce, 5.1%, and financial institutions, 1.9%, reflecting growth in the farm and industrial sectors. The segments of public administration and rents also contributed to these positive results.

When one considers the deseasonalized series, GDP turned in positive growth in the quarter when compared to the previous quarter for the third consecutive time. The 1.6% rate that marked the first quarter of the year not only ratified the growing dynamism of the economy, but also reflected positive performances under crop/livestock farming, industrial output, 1.7% and the service sector, 0.4%, using the same basis of comparison.

GDP growth in the first quarter of the year and the recent performance of sectoral indicators and demand were clearly consistent with the 3.5% estimate for GDP expansion in the current year. The deseasonalized result in the first quarter closed at 1.6% compared to the fourth quarter of 2003 requires a relatively discreet linear rate of 0.6% per quarter to reach the estimated annual result.

On a sector-by-sector basis, it is estimated that the crop/ livestock sector will expand by 4%, corresponding to a reduction in relation to the most recent previous estimate issued. The basic reasons for this falloff are a diminished soybean harvest and cutbacks in growth estimates for the corn and bean harvest, according to IBGE's LSPA. As positive factors, mention should be made of the coffee harvest and the continued vitality of livestock production.

In the industrial sector, estimates of a high of 4.9% for the sector are due to continued expansion in foreign sales and recovery in internal demand, a process first noted toward the end of 2003.

Growth in the service sector is estimated at 2.2%, due mainly to the positive performances expected under crop/livestock output and industry, both of which have a direct impact on the results of the subsectors of commerce, transportation, other services and financial institutions.

1.5 Investments

Just as occurred in the third and fourth quarters of 2003, outlays on investments continued on an upward curve in the

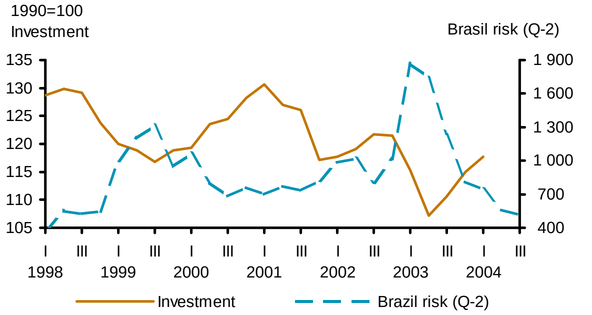
Gross Domestic Product

Itemization	2003				2004
	Quarter/previous quarter seasonally adjusted				
	I	II	III	IV	I
GDP at maket prices	-1.2	-0.9	0.5	1.5	1.6
Crop and livestock	2.9	1.0	-4.6	5.6	3.3
Industry	-2.7	-3.7	3.0	1.8	1.7
Services	-0.6	-0.1	0.2	0.8	0.4

Source: IBGE

Investment (FBCF) and Brazil risk

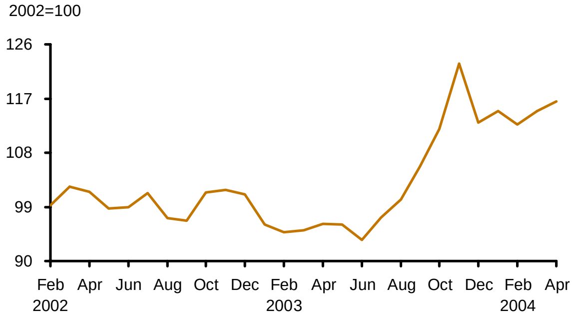
Seasonally adjusted data



Source: IBGE and JP Morgan

Capital goods production

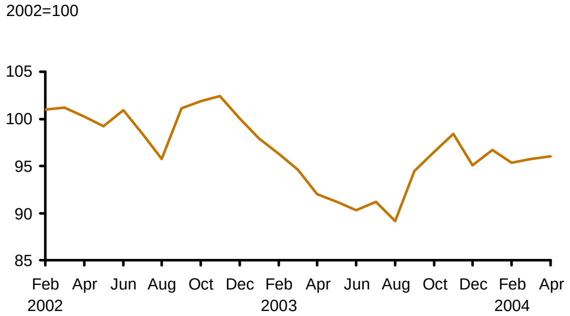
Seasonally adjusted data



Source: IBGE

Inputs production for the building industry

Seasonally adjusted data



Source: IBGE

first three months of the year, responding to more solid macroeconomic fundamentals and to new opportunities for gains as a result of the process of economic recovery. Evolution of country risk indicates that the upward trend in investment spending should continue over the coming months, contributing to the continuity of the recovery in the activity level and to re-equipping of the productive structure.

According to the Quarterly National Accounts released by IBGE, once stock variations are excluded, investments expanded by 2.2% in the first quarter of 2004, when viewed against the same period of the preceding year. This performance had already been signaled in the quarter by monthly indicators of gross fixed capital formation, with 0.5% in construction activity and 0.9% in capital goods output. It is important to stress that absorption of capital goods in the quarter has expanded at a lesser rate than production growth, since exports of machines and equipment expanded by 54.1% in the year up to March, and imports of these goods dropped by 0.1% in the same period.

Data released by the Brazilian Association of the Machine and Equipment Industry (Abimaq) confirmed the process of investment recovery in the early months of 2004, when compared to the results for the same four months of last year. In this sense, performance indicators for the mechanical capital goods industry signaled that, using this basis of comparison, the recovery process was under way, turning in expansion of 4.3% in utilization of installed output capacity and 6% in the real sales of the sector. In this case, the item of industrial products, machines and industrial equipment drawn from the Wholesale Price Index – Domestic Supply (IPA-OG) was used as the deflator. At the same time, exports of machines and equipment expanded by 32.1% and imports grew by 6%.

Statistics for production of farm machines, as released by Anfavea, also corroborate the upturn in investments, with growth of 29.2% in the production of farm machines and 20.1% in the output of trucks, in the first four months of the year, when compared to the same period of 2003.

According to Brazilian Development Bank (BNDES), disbursements by the BNDES System – BNDES, Special Industrial Financing Agency (Finame) and BNDES Participações S.A. (BNDESpar) – added up to R$12.1 billion in the first four months of 2004, corresponding to 74.3% more than in the same period of 2003. An analysis by sectors of activity indicates that financing granted to manufacturing rose by 74.4% while that channeled to commerce and the

Investment indicators

Itemization	2003	2004		
	Dec	Jan	Feb	Mar
Quarter/previous quarter[1/]				
Capital goods				
Absorption[2/]	12.3	8.2	-1.5	-3.4
Production	15.5	10.5	-0.7	-2.7
Imports	26.9	-9.9	-18.2	-14.4
Exports	16.0	11.3	0.6	5.5
Inputs for the building industry	5.5	3.6	-0.9	-1.0
In the year				
Capital goods				
Absorption[2/]	-8.2	3.7	0.1	6.6
Production	2.2	15.7	13.0	20.9
Imports	-17.5	-4.8	-10.3	-0.1
Exports	16.1	37.0	32.5	54.1
Inputs for the building industry	-6.1	-2.8	-3.5	0.5
BNDES financing	-10.4	24.1	35.7	54.5

Percentage change

Source: IBGE, Funcex and BNDES

1/ Seasonally adjusted data. In the month of January, monthly growth compared to December 2003.

2/ Production + imports - exports.

BNDES disbursement[1/]

Accumulated in the year (in R$ million)

Itemization	2003	2004			
		Jan	Feb	Mar	Apr
Total	33 534	2 238	5 215	8 508	12 102
Manufacturing industry	15 937	1 109	2 561	4 306	5 501
Commerce and services	12 844	518	1 531	2 595	4 432
Crop and livestock	4 595	600	1 092	1 569	2 091
Extraction industry	157	10	31	37	79

Source: IBGE

1/ Includes BNDES, Finame and BNDESpar.

service sector and to crop/livestock farming ended at respective levels of 51% and 157%. In the same period, resources targeted to the mining industry increased by 80.3%.

The Long-Term Interest Rate (TJLP), which is the basic cost of financing contracted with the BNDES system, has followed a consistently downward curve. After holding firm at 12% per year in the second and third quarters of 2003, the TJLP was cut to 11% per year (p.y.), 10% p.y. and 9.75% p.y. in the three subsequent quarters.

1.6 Conclusion

The recent evolution of the activity level and the results produced by prospective indicators – industrial surveys and expectation evaluation polls – has clearly ratified the fact that the Brazilian economy is expanding. Though increased foreign sales remain as the bulwark of this process, it is important to stress that the recovery of internal demand has played an increasingly more important role, particularly as of the second half of 2003, in the burgeoning pace of economic growth. In this sense, it is important to note expanded retail sales, together with the performance of industrial segments typically focused on internal demand. The results of these segments have been aided by improved credit conditions and, more recently, by recovery in real earnings and employment.

Parallel to these factors, the positive evolution of economic fundamentals – clearly evident in the consistency of prices with the predetermined inflation targets and the positive results that have marked public accounts and foreign trade – coupled with improved expectations at the level of both consumers and industrial businesspeople, are key elements to sustaining the current pace of growth in economic activity.

2 Prices

In the period extending from March to May, median price levels registered by the major indices were lower than in the previous quarter, indicating that the inflationary pressures evident at the start of the year had been overcome. It is important to stress that, despite the relatively high level of activity, these pressures were not reflected in across-the-board price increases nor did they establish a higher overall inflation plateau. As a result, wariness with regard to future inflation *vis-à-vis* the defined inflation target trajectory was dissipated.

In the quarter ended in May of this year, the dynamics of consumer price indices was impacted by pressures originating in nonearmarked prices, particularly under the headings of health, due to higher medicine prices, and apparel. Pressures in the period were also generated by increased commodity prices. In recent months, this latter factor resulted in a differentiated trajectory at the level of wholesale prices – more sensitive to external prices – and, consequently, in general price indices.

2.1 General price indices

General price indices

Monthly % change

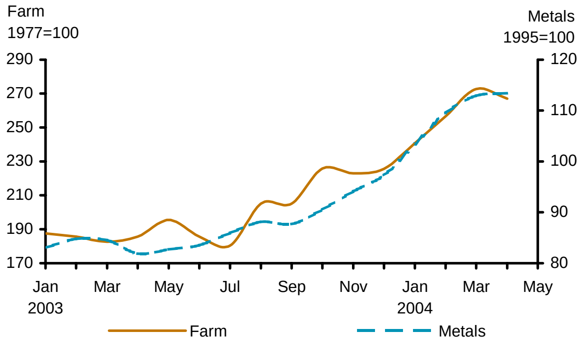
Itemization	2003	2004				
	Dec	Jan	Feb	Mar	Apr	May
IGP-DI	0.6	0.8	1.1	0.9	1.2	1.5
IPA	0.7	0.8	1.4	1.1	1.6	1.7
IPC	0.4	1.1	0.3	0.5	0.3	0.7
INCC	0.2	0.3	1.0	1.2	0.6	1.8

Source: FGV

After registering downward movement in March, general price indices shifted into an upward curve in the two following months. Growth in the General Price Index – Internal Supply (IGP-DI), calculated by the FGV, came to 1.15% in April and 1.46% in May. Basically, these highs reflected the behavior of wholesale prices for both farm and industrial products.

Farm prices, which were impacted by conclusion of the process of marketing the most recent harvest and by higher international commodity prices, registered growth of 1.5% in March, 0.8% in April and 2.7% in May, raising the total for the three month period to 5.1%, compared to -0.5% in the quarter ended in February. On a product-by-product

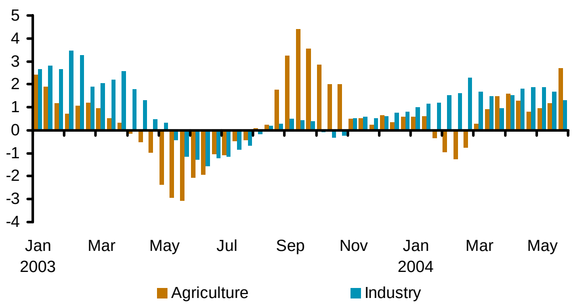
Commodities – Price evolution



Source: IMF and Commodities Research Bureau

Evolution of IPA (10, M and DI) – Agriculture and industry

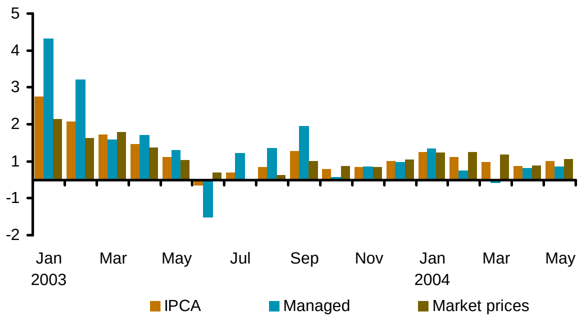
Monthly % change



Source: FGV

Evolution of IPCA

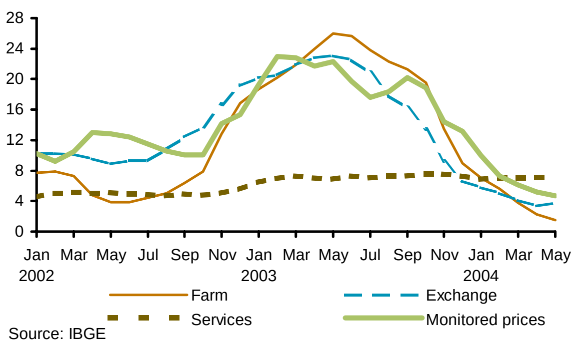
Monthly % change



Source: IBGE

IPCA – Major groups

12 month % change



Source: IBGE

basis, the increases registered under the prices of soybeans, milk, corn and wheat deserve particular mention.

The prices of industrial goods increased by 0.94% in March, 1.86% in April and 1.32% in May, raising the accumulated total to 4.2% in the three month period, compared to 4.4% in the December-February quarter. These growth levels reflected a steady rise in the prices of those commodities that account for significant participation in the productive chain. Consequently, the quarter registered increases of 12.5% under iron, steel and derivatives; 11.5% under fertilizers; 7.9% under nonferrous metals; 7.4% under paints and varnishes; 5.7% under mechanics and 5.3% under electric equipment.

2.2 Consumer price indices

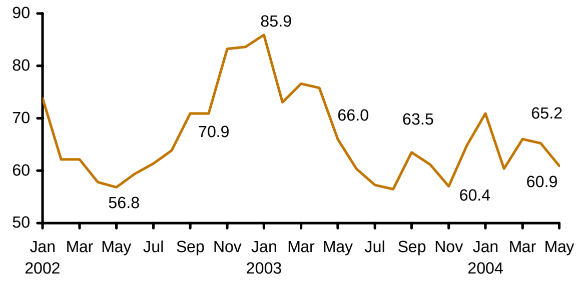
As measured by IBGE, monthly changes in the IPCA indicated consecutively lower rates from February to April of this year, before turning upward in May. The drop in inflation from 0.76% in January to 0.37% in April was caused as much by the behavior of nonearmarked prices – shifting from 0.73% to 0.39% in the period – as by government monitored prices, which dropped from 0.83% in January to 0.32% in April. In the month of May, sharper increases under nonearmarked prices and government monitored prices resulted in growth of 0.51% in the IPCA. The prices of alcohol and electricity rates increased sharply in the month. Aside from government monitored prices, increases in the prices of medicines and apparel and recovery in food prices, which had closed the previous month at a negative level, also brought pressure to bear on the IPCA.

Analysis of the different food products indicates that strong performances in the rice and bean harvests and the highly favorable seasonal period for production of meat and derivatives resulted in accumulated negative growth of 2% - despite the start of the milk production off-season – in the prices of semimanufactured food products in the quarter extending from March to May, compared to a rise of 1.6% in the three previous months. Climatic conditions better suited to in natura crops also resulted in lesser price increases for these goods in the quarter ended in May, closing at 2.6% as against 5.2% in the three previous months. In this context, food prices rose by 0.3% in the quarter ended in May, compared to 1.4% in the quarter ended in February.

Government monitored prices, which had grown by 1.6% in the December-February quarter, slowed somewhat in the

IPCA items[1/]

% of items with increase

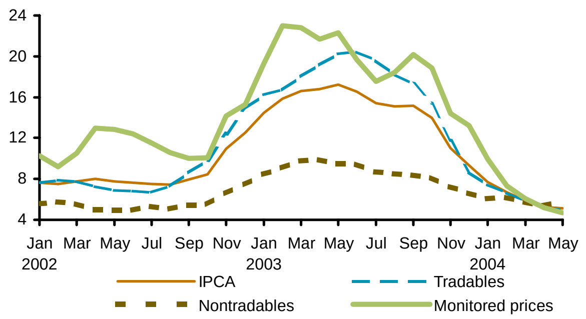


Source: IBGE

1/ IPCA is made up of 512 items.

IPCA – Itemized groups

12 month % change



Source: IBGE

Consumer prices and core inflation

Monthly % change

Itemization	2003	2004				
	Dec	Jan	Feb	Mar	Apr	May
IPCA	0.5	0.8	0.6	0.5	0.4	0.5
Exclusion	0.6	0.6	1.0	0.9	0.7	0.7
Trimmed means						
Smoothed	0.7	0.7	0.5	0.8	0.6	0.6
Non smoothed	0.5	0.6	0.3	0.7	0.5	0.4
IPC-Br	0.4	1.1	0.3	0.5	0.3	0.7
Core IPC-Br	0.5	0.7	0.5	0.5	0.5	0.6

Source: Bacen and FGV

period from March to May of this year, closing with growth of 0.6%. For the most part, this was due to declines in fuel prices up to April.

It should be stressed that, following a slight rise in January of this year, the proportion of the number of items that turned in positive price growth in the IPCA remained at the same level registered in the final months of 2003.

It is interesting to note the differences between inflation rates measured by different consumer prices indices. When a longer time horizon is utilized, IPCA rates were higher than those turned in by the Consumer Price Index – Brazil (IPC-Br) (see box IPCA, IPC-Fipe and IPC-Br: Methodological and Empirical Differences – page 32).

2.3 Government monitored prices

In the quarter extending from March to May, growth in government monitored prices came to 0.6%, corresponding to 0.17 p.p. of the 1.36% rate registered by the IPCA. In the same period, nonearmarked prices varied by 1.66%. Among the products that contributed positively to the result under government monitored prices, negative growth of 2.7% in gasoline prices and 14.6% under alcohol prices – principally as a result of the record sugar cane harvest – were particularly important, even though these prices had expanded at positive rates in May. In the opposite sense, one should underscore increases of 3.7% under water and sewage rates; 2.5% under electricity rates; and 3.9% in the price of bottled gas. Residential electricity rates increased in Fortaleza, 10%; Recife, 20.4%; Salvador, 8.3%; Belo Horizonte, 11.5%; and in Porto Alegre, 6.2%. At the same time, water and sewage rates increased by 11% in Salvador; 21% in Belo Horizonte; 11.6% in Goiânia; 5.5% in Porto Alegre; and 3.6% in Rio de Janeiro.

2.4 Inflation cores

The core measurement of the IPCA – excluding food taken at home and government monitored prices – came to 0.85% in March, 0.72% in April and 0.70% in May. These rates were consistently higher than the full index, since food prices moved steadily downward in the period. Accumulated growth over the last twelve months closed May at 7.15%.

IPCA, IPC-Fipe and IPC-Br: Methodological and Empirical Differences

Differences in the recent performances of various consumer price indices have resulted in difficulties in attempts to fathom the behavior of inflation. For instance, while the IPCA expanded by 5.15% in 12 months, covering the period from June 2003 to May 2004, the Consumer Price Index – Institute of Economic Research Foundation (IPC-Fipe) increased by 4.45% and the IPC-Br by 5% in the same period. The differences among these rates result from a series of factors of a methodological nature. The most important are as follows:

i. The IPCA calculates the change in the prices of goods consumed by families with median income levels ranging from 1 to 40 times the minimum monthly wage, in 9 metropolitan regions (Belém, Belo Horizonte, Curitiba, Fortaleza, Porto Alegre, Recife, Rio de Janeiro, Salvador and São Paulo), in the Federal District and in the municipality of Goiânia. The IPC-Fipe is a consumer price index that covers only the municipality of São Paulo and income levels ranging from 1 to 20 times the minimum monthly wage. The IPC-Br covers the same area as the IPCA, plus Florianópolis, and is based on income levels from 1 to 33 times the minimum monthly wage. One important difference between the IPCA and the IPC-Br is the variable of regional aggregation. While the IPCA uses the total urban income of each region as its weighting factor, the IPC-Br weights its figures according to the resident population.

ii. With regard to what is known as the consumption basket, the IPCA uses the Household Budget Survey (POF), which was carried out by IBGE in 1995 and 1996 and incorporated into the index as of August 1999, as its basis of calculation. More recently, IBGE released the results of a new POF, carried out between June 2002 and July 2003, but has not yet incorporated it into the weighting structure of its prices indices. The IPC-Fipe and the IPC-Br are based on the POF elaborated between 1998 and 1999 and adopted in January 2000.

iii. The calculation methodologies used by the different indices vary. The IPCA is a Laspeyres index that uses a formula given by: $\boxed{L_t = \frac{\sum_i p_{i,t} q_{i,0}}{\sum_i p_{i,0} q_{i,0}}}$,

in which $p_{i,t}$ is the price of good i in period t, and $q_{i,0}$ is the quantity consumed. This formula can be developed in order to make the effect of the weighting of the quantity consumed clear: $\boxed{L_t = \sum_i w_{i,0} \frac{p_{i,t}}{p_{i,o}}}$, in which $\boxed{w_{i,0} = \frac{p_{i,0} q_{i,0}}{\sum p_{i,o} q_{i,0}}}$, or , $w_{i,0}$ is the participation of outlays on good i in the initial period in the total spending of the consumer. Thus, the IPCA calculates the change in the prices of goods and services between two periods, weighted by the participation of outlays on each good in total consumption. Note that the index calculates the outlay with the same consumption in two different periods, thus avoiding substitution in consumption. On the other hand, the IPC-Fipe calculates the geometric median of the price relatives between two periods, weighted by the participation of the outlay on each good in total consumption. This index is given by: $\boxed{IG_t = \prod_i (\frac{p_{i,t}}{p_{i,0}})^{w_{i,0}}}$, in which $\prod$ is the product of the price relatives $\frac{p_{i,t}}{p_{i,0}}$, weighted by the participation of each good in total outlays ($w_{i,0}$). Note that the rise in the price of a good generates two effects for the consumer: on the one hand, the consumer loses buying power in terms of the good that had its price increased, reducing consumption of that good (income-effect); on the other, since there is an alteration in relative prices, the consumer reallocates his/her consumer spending in such a way as to substitute the products that became relatively more expensive for others that are relatively cheaper (substitution-effect). In the Laspeyres indices, such as the IPCA, price elasticity is zero (Leontief utility function). The substitution-effect is not perceived in consumption, thus generating an overestimated rate of inflation. In the case of the IPC-Fipe, the utility function is of the Cobb-Douglas type with price elasticity equal to one. This methodology makes it possible to substitute the consumption of goods and services that underwent increases in relative prices for those that became relatively cheaper and is therefore capable of perceiving the already cited substitution-effect.

iv. Finally, the IPCA, IPC-Br and IPC-Fipe deal differently with some of the increases in government managed contractual and monitored prices, such as increases in electricity and telephone rates. While the IPCA and IPC-Br are immediately affected when there is an increase, the IPC-Fipe is calculated on the basis of the cash concept or, in other words, the increase is included in accounting only when household spending is impacted. This treatment causes differences in the rates of monthly inflation that tend to disappear in the accumulated bimonthly figures.

Viewed over a long-term horizon, there is a tendency toward lower inflation under the IPC-Fipe compared to the IPCA, while there is greater proximity between the IPC-Br and the IPCA. The chart compares accumulated growth in the period under the IPCA and IPC-Fipe from 1980 to 2003 and for the subperiods of 1980/94 and 1995/03. The IPC-Br only appears as of 2001, the year in which it was transformed into a national index. Prior to 2001, it covered only Rio de Janeiro and São Paulo. It should be noted that, in the last 24 months, the rate of inflation measured by the IPCA accumulated a difference of more than 100% compared to the IPC-Fipe.

Consumer Price Index

Long-term comparison

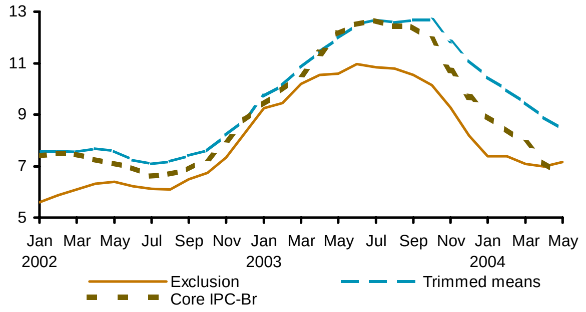
Period	Median annual growth (%)			Median annual difference (%)	Difference accumulated in the period[1/] (%)
	IPCA	IPC-Fipe	IPC-Br		
1980-1994	451.67	429.54	...	4.18	84.84
1995-2003	9.12	8.10	...	0.95	8.84
2001-2003	9.82	...	9.67	0.13	0.40
1980-2003	200.44	191.82	...	2.96[2/]	101.18[2/]

1/ The first two periods refer to the difference between IPCA and IPC-Fipe and the third period refers to th difference between IPCA and IPC-Br.
2/ Refers to the ratio between IPCA and IPC-Fipe.

In summary, the fact that price indices based on differentiated methodologies register distinct performances over time is not atypical. The specificities of the IPCA, IPC-Br and the IPC-Fipe suggest that the indices do not necessarily converge, though the IPCA and IPC-Br come quite close over the short-term. Aside from this, the IPC-Fipe tends to register price change that are lower than those perceived by the IPCA over the long-term.

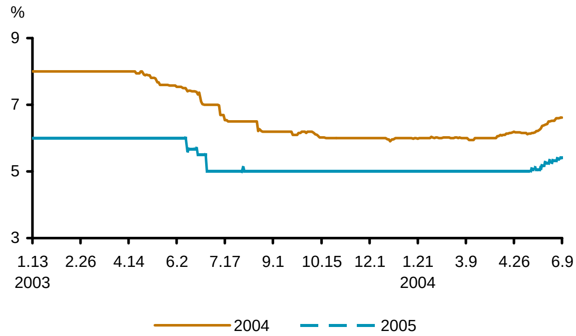
Core inflation

12 month % change

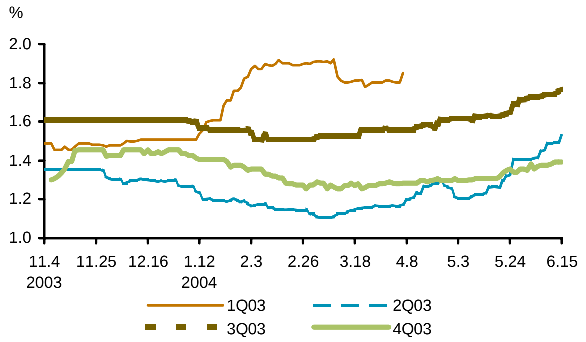


Source: Bacen and FGV

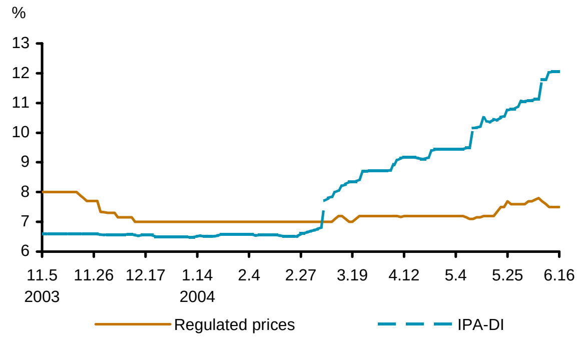
Daily evolution of market expectations for inflation (IPCA) (median)



Daily evolution of market expectations for quarterly IPCA in 2004 (median)



Daily evolution of market expectations for regulated prices and IPA-DI in 2004 (median)



The IPCA core, calculated on the basis of rounded medians, registered a rate of 0.76% in March, 0.57% in April and 0.59% in May. This measurement excludes items that have registered monthly growth above the distribution percentile of 80 and below the distribution percentile of 20. In this context, the items that have only one variation each year are smoothed or, in other words, their growth is redistributed in equal shares into the month of the change and into the eleven subsequent months. In the last twelve months, the accumulated high came to 8.46%. Without the process of smoothing, the core based on rounded medians came to 0.65% in March; 0.45% in April; and 0.43% in May, accumulating a twelve month total of 5.46%.

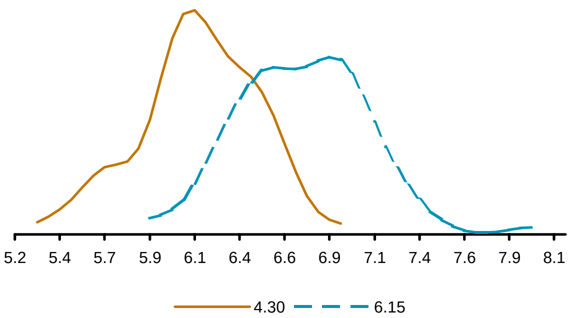
The inflation core for FGV's IPC-Br, calculated on the basis of rounded medians, registered growth of 0.53% in March and April and 0.57% in May. In the last twelve months, the core remained relatively stable, with an accumulated high of 6.64%, compared to monthly medians of 0.52% in the December-February quarter and 0.54% in the quarter ended in May.

2.5 Market expectations

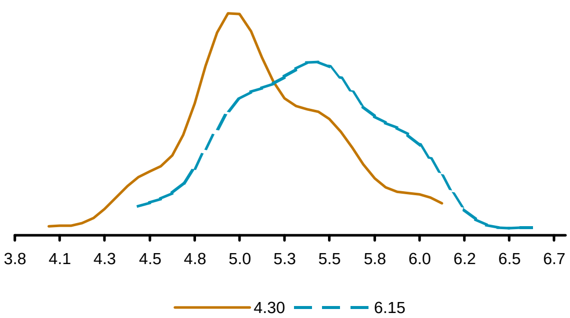
After remaining stable during the first four months of the year, varying within the limits of 6% and 6.2%, median market expectations for the 2004 IPCA moved upward as of the second week of May, reaching a level of 6.8% on June 15. For the most part, variations in the median in the first four months of the year were a consequence of incorporation of the results obtained in surveys of prices and publication of several price indices into inflation forecasts. Consequently, the revisions introduced into the scenario as viewed by the market tended to impact only very short-term inflation forecasts, without contaminating medium and long-term forecasts. As a matter of fact, median market expectations for the IPCA for the second half of 2004 and 2005 remained relatively stable in the period, at 2.9% and 5%, respectively.

As of the second week of May, the market consensus regarding the IPCA began reflecting deterioration in macroeconomic expectations involving the rate of exchange, inflationary pressures generated by government monitored prices and larger increases in wholesale prices. In this environment, median market expectations for the average rate of exchange in 2004 shifted from R$2.95/US$1.00 on May 10 to R$3.03/US$1.00 on June 15, and the median forecast of changes in government monitored prices moved from 7.1% to 7.5% on the same dates. In terms of

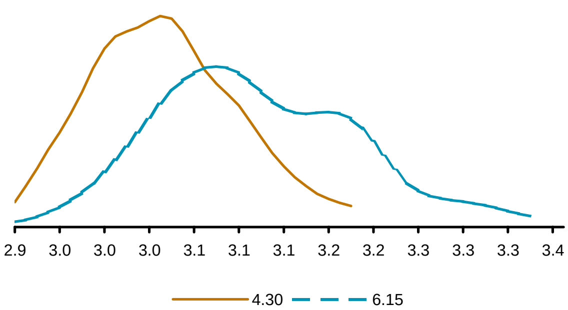
Probability density of expectations for IPCA (2004)



Probability density of expectations for IPCA (2005)



Probability density of expectations for exchange rate in the end-of-period (2004)



magnitude, the sharpest shift occurred under expectations of wholesale price growth, which moved from 9.5% to 12% in the period. This scenario revision was accompanied by a perception of a less relaxed medium-term monetary policy, as reflected in the increase in median expectations for the Special System of Clearance and Custody (Selic) rate from 15.3% to 15.7%.

As a consequence of the changes expected by the market in the macroeconomic scenario, median IPCA expectations for 2004 moved from 6.2% in the second week of April to 6.8% in mid-June. For 2005, median IPCA expectations were revised upward once again – albeit with less intensity – from 5% to 5.4%. The distribution of expectations of the institutions that participated in the survey indicates that the revision was a generalized phenomenon, a fact that is clearly reflected in the shift of the 2004 and 2005 distribution curves to the right. At the same time, it is possible to note a certain flattening of the curves, indicating an increase in market uncertainties regarding the trajectory of inflation. This greater dispersion of inflationary expectations follows the pattern shown by the other variables that impact their dynamics, such as exchange.

2.6 Conclusion

Despite the May high, recent evolution of inflation indices and their cores corroborated the absence of widespread pressures on price levels and, at the same time, was shown to be consistent with the targets defined for the year. It is important to note that several economic policy measures taken in the period were vital to achieving these positive results, since they made it possible to overcome the impact of adverse episodes that occurred on the internal political scenario, as well as the pressures generated on external markets, as evinced in higher commodity prices, particularly petroleum, and depreciation in the rate of exchange.

In this framework, positive fiscal result and adoption of timely monetary policy measures have played a critical role in forming expectations, particularly with respect to the future evolution of prices in an environment of gradual and consistent recovery of the pace of economic activity. Despite this outlook, passing pressures, such as those registered in May, will certainly continue to impact performance in the coming months as a result of the concentration of price increases under important monitored sectors, such as telephone and electricity rates, as well as the negative impact of seasonal factors on several significant products, particularly those that are more strongly influenced by international prices.

Credit, monetary and fiscal policies

3

3.1 Credit

Recent growth in financial system credit operations reflects positive performances in operations with both individuals and corporate entities. The increase in operations with individuals was sustained by personal credits, particularly payroll loans, and driven to a great extent by the downward movement in basic interest rates in the second half of 2003. The underlying reasons for this upturn were sharp reductions in funding rates and growing demand for consumer durables. Operations with corporate entities, independently of whether they were based on internal or external resources, also moved into an upward curve in the quarter ended in May. At the same time, the impact of operations with segments focused on exports persisted, particularly in the case of those involving the agribusiness sector.

Credit operations

R$ billion

Itemization	2004				Growth (%)	
	Feb	Mar	Apr	May	3 months	12 months
Total	412.0	416.8	426.3	436.1	5.9	15.0
Non-earmarked	228.9	232.7	239.8	248.4	8.5	15.6
Corporations	137.4	138.8	143.9	150.0	9.2	13.0
Ref. to exchange	49.7	50.7	53.4	57.5	15.7	12.3
Individuals	91.6	93.8	96.0	98.3	7.4	19.9
Earmarked	157.5	157.8	158.7	159.7	1.4	12.1
Housing	22.9	23.3	23.5	23.6	3.1	6.2
Rural	45.3	45.6	46.1	46.8	3.1	25.9
BNDES	87.6	87.3	87.4	87.8	0.3	8.2
Others	1.8	1.7	1.7	1.6	-9.5	-18.3
Leasing	9.8	10.0	10.2	10.2	4.1	24.1
Public sector	15.7	16.3	17.6	17.9	13.7	29.1
% participation:						
Total/ GDP	25.9	25.8	26.0	26.2		
Nonearm./GDP	14.4	14.4	14.6	14.9		
Earmarked/GDP	9.9	9.8	9.7	9.6		

As far as the conditions prevailing in the credit market are concerned, decreases were registered under both funding rates and the banking spread, despite the volatility that marked the financial market in May. This performance was particularly evident in operations with individual persons and was influenced by the increase in the relative participation of payroll loans. The fact that these operations involve lesser risk has contributed to reductions in both costs and default rates in financial system credit portfolios.

Consequently, the volume of financial system credit operations, which includes both nonearmarked and earmarked resources, added up to R$436.1 billion in May, for growth of 5.9% in the quarter and 15% in the last twelve months. Consequently, the percentage of loans in relation to GDP moved from 25.9% in February to 26.2% in May.

The stock of credits granted by private banks corresponded to 60.2% of the financial system total and closed May at a level of R$262.4 billion. Expansion of 6.6% in the quarter was powered by operations with industry, commerce and individual borrowers. The loan portfolio of public financial institutions reached a volume of R$173.8 billion, with growth of 4.8% in the period and particularly strong performances in the segments of services and individual borrowers.

With respect to the targeting of resources by segment of economic activity, operations with the private sector came to R$418.3 billion in May, for an increase of 5.6% in the quarter. Particular attention should be given to the quarterly rise of 7.6% in credits to individuals, with a total of R$104.8 billion. In the same sense, loans to industry totaled R$119.6 billion for an increase of 5% in the quarter. In this context, it is important to note the high levels of participation on the part of agribusiness and export sector activities.

Loans to commerce totaled R$47.2 billion, for growth of 7.7% in the quarter, with particularly strong performances in the retail automobile and food segments. The volume of financing contracted by the segment of other services reached R$74.9 billion, with growth of 5.1%. In this case, operations carried out by telecommunications companies occupied the lead position.

The balance of operations with the public sector totaled R$17.9 billion in May, following quarterly growth of 13.7% generated basically by financial assistance provided to electricity companies under the terms of an energy supply expansion program. The banking debt of the states and municipalities added up to R$12.5 billion and credits contracted by the federal government came to R$5.3 billion, with respective growth figures of 17.7% and 5.4%, in the period.

Leasing operations totaled R$10.2 billion, with growth of 4.1% in the quarter ended in May. Above all else, this performance reflected disbursements for acquisitions of vehicles, mostly on the part of the industrial and service segments, with respective growth of 65.9% and 22.2%.

Credit operations with earmarked resources

Credit operations based on earmarked resources totaled R$159.7 billion in May, with growth of 1.4% in the quarter. This performance reflected growth of 0.3% in the volume of financing granted by the BNDES system and 3.1% in operations involving loans to the rural and housing sectors.

From January to May, BNDES disbursements totaled R$13.9 billion, compared to R$8.8 billion in the same period of last

BNDES Disbursements

R$ million

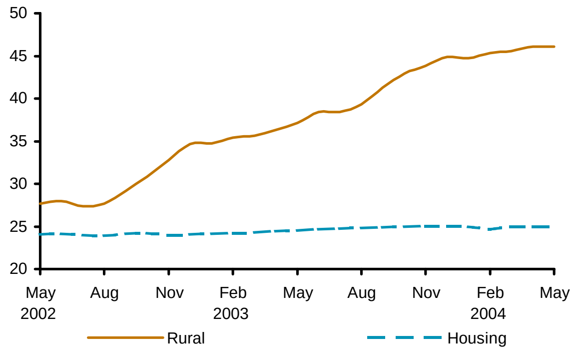
Itemization	Jan-May 2003	Jan-May 2004	Growth (%)
Total	8 753	13 913	59.0
Industry	3 918	6 095	55.6
Other transport equipment[1/]	877	1 423	62.3
Food and drink products	595	982	65.0
Machines and Equipment	118	411	248.3
Motor vehicles	511	1 418	177.5
Basic metallurgy	451	372	- 17.5
Commerce/Services	3 709	5 320	43.4
Electricity, gas and hot water	1 405	3 242	130.7
Commerce and reparation	567	493	- 13.1
Land transportation	994	1 176	18.3
Construction	188	510	171.3
Crop and livestock	1 127	2 499	121.7

Source: BNDES

1/ It includes aircraft industry.

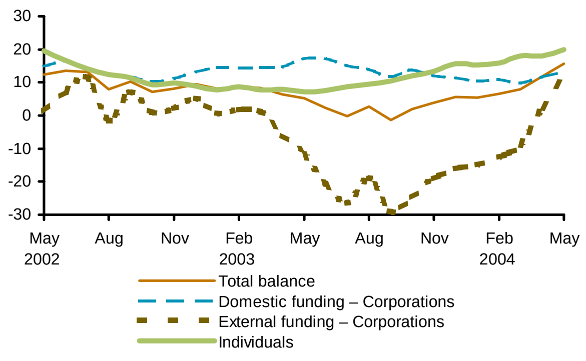
Rural and housing credit outstanding

R$ billion



Credit with nonearmarked resources

Percentage growth in 12 months



year. Funding releases to the industrial, commerce and service sectors led the way with respective expansion of 55.6% and 43.4%, with particular emphasis on financing to the automotive and aeronautics segments. With regard to credits granted to micro, small and medium businesses, the increase came to 48% when compared to the same period of 2003, with an accumulated total of R$4.4 billion, representing 32% of total disbursements.

Consultations sent to BNDES regarding future investments represented a total of R$34.8 billion in the first five months of this year, compared to R$12.4 billion in the same period of the previous year. It should be stressed that growth was registered in all segments, with highly favorable prospects for medium and long-term investments. With these results, requests submitted by the industrial sector added up to R$17.1 billion, surpassing the 2003 result of R$12 billion, particularly in the aeronautics, metallurgy and paper and cellulose industries. Growth of 188% in the segment of commerce and services also contributed to the increased volume of requests and closed with a volume of R$14.5 billion. The areas of activity with the highest levels of participation were energy, construction and telecommunications. Consultations submitted by the crop/livestock sector totaled R$3.2 billion, for growth of 48.4% in the year.

Rural credit operations totaled R$46.8 billion in May, with expansion of 3.1% in the quarter. Here, the highlights were financing channeled into agricultural investments, with growth of 4.2% in the period, and strong participation on the part of BNDES resources. Consequently, the participation of this modality in total rural financing came to 54.2%, with current expenditures and marketing operations accounting for 40.7% and 5.1%, respectively.

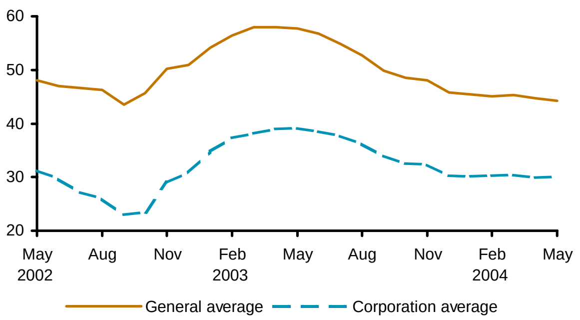
Financing targeted to the housing sector and channeled to both individuals and housing cooperatives totaled R$23.6 billion, with growth of 3.1% in the quarter. Operations contracted in the March-May quarter and based on savings account resources came to R$659 million, 54% more than in the same period of the previous year.

Credit operations with nonearmarked resources

Credit operations based on nonearmarked resources totaled R$248.4 billion in May, with quarterly growth of 8.5%. Consequently, the participation of loans in the financial system total increased from 55.6% in February to 56.9% in May.

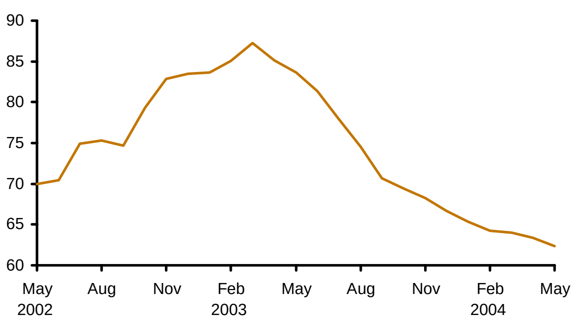
Credits channeled to corporate entities totaled R$150 billion in May, with growth of 9.2% in the quarter. The balance of credit operations based on internal resources added up to R$92.5 billion, for an increase of 5.5%, mainly as a result of a greater volume of operations in the modalities of invoice discounting and acquisitions of goods. Operations referenced to foreign currencies totaled R$57.5 billion, with growth of 15.7%. Here, it is important to stress the results obtained in the modalities of External Onlending operations, composed of resources targeted to development of internal activities, and Advances on Exchange Operations (ACC), due mostly to the positive performance of exports in the agribusiness sector.

Interest rates of credit operations with nonearmarked resources



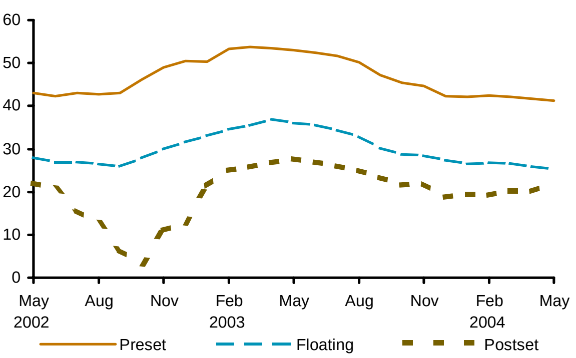
The stock of credits to individuals came to R$98.3 billion in May, with quarterly growth of 7.4%. Above all else, growth was driven by personal credit operations, particularly payroll loans (see box: Payroll Loans – page 43). Aside from these operations, another factor underlying this growth was that of vehicle acquisitions, particularly as a result of promotional campaigns carried out by factory authorized sales outlets, as they sold off stocks acquired in the period prior to the end of the provisional Industrialized Products Tax (IPI) reduction agreement.

Interest rates of credit operation preset rates – Individuals



Notwithstanding interest and exchange market volatility in the second half of May, which led to a slight rise in the costs of some financing lines, the median rate of interest on credit operations based on nonearmarked resources declined by 0.9 p.p. in the quarter, to a level of 44.2% per year in May. This result mostly reflected the cutback in basic interest rates in the months of March and April, with reductions of 0.25 p.p. in the two periods.

Interest rates of credit operations – Corporations



The median costs of operations with individual borrowers, contracted mainly at preset interest, slipped by 1.8 p.p. in the period, closing the month of May at 62.4% per year, the lowest level since the historical series was first recorded in July 1994. The most significant reductions were registered in financing targeted to acquisitions of goods, excluding vehicles, with 5.5 p.p., and in personal loans, with 3.9 p.p., attributed in this case to growth in the participation of payroll loans. The rates levied on operations based on special overdraft checks dropped by 2.4 p.p. in the period.

The median rate charged on loans with corporate entities fell by 0.2 p.p. in the quarter and closed at 30% per year. The downward movement in interest on contracts formalized at preset and floating rates, 1.1 p.p. and 1.6 p.p., respectively, was offset by a 2.8 p.p. rise in postset rates referenced to

Payroll Loans

In order to stimulate the nation's credit market, principally in the segment of individual borrowers, the federal government implemented a series of measures in the second half of 2003. Here, one should highlight Provisional Measure 130, dated 9.17.2003, which dealt with payroll credit operations. This measure, which was later transformed into Law 10,820, dated 12.17.2003, benefited workers covered by Consolidated Labor Legislation (CLT), making it possible for them to repay loans, financing and leasing operations through deductions against their wages.

Having defined the legal framework for these operations, specifying the responsibilities of employers and employees, this initiative is aimed at enhancing worker access to credit under more favorable conditions, particularly with respect to lower interest rates charged by financial institutions. It should be stressed that the deduction of installments directly against payroll sharply reduces the risk of default, which is the determining factor underlying the banking spread.

Another aspect covered by this measure was the possibility of agreements between financial institutions and companies and/or unions, with the purpose of defining the financial parameters and general conditions applicable to employees. Consequently, several financial institutions came to agreements with the major unions in order to make it possible to provide loans to a large number of workers.

Here, it should be noted that loans against payroll already existed prior to Provisional Measure 130, though they were restricted to public sector employees. At the same time, banks also made similar loans to workers whose wages were deposited at such financial institutions. In this case, the installments were deducted directly against the current account of the employee on the due date.

With issue of the aforementioned Provisional Measure, estimates were made of the potential demand for payroll credits. The total potential volume was estimated at R$30 billion, with a significant share of this amount being used to pay off debts with higher costs. In this case, the migration of debts, especially away from special overdraft accounts and credit cards, would contribute to reducing the cost of household indebtedness.

In this way, in order to verify the evolution of payroll loans, the major financial institutions active in the personal credit market were consulted in order to assess the potential development of this market. According to the initial results of this survey, growth in this segment intensified significantly as of March 2004. The delay to that point in time was due to the time required for these financial institutions to come to agreements with unions and companies and to make the required operational adjustments needed to begin working in this area.

Evolution in payroll deduction credit

R$ billion

Period	2004					Change %	
	Jan	Feb	Mar	Apr	May	1 month	3 months
Volume							
Payroll deduction credit in sample[1/] (a)	5.90	6.22	6.77	7.21	7.79	8.0	25.1
Household credit in sample (b)	23.18	24.20	25.19	26.11	27.08	3.7	11.9
Market household credit (c)	30.84	32.00	33.19	34.48	35.81	3.9	11.9
Participation %							
a/b	25.5	25.7	26.9	27.6	28.7		
a/c	19.1	19.4	20.4	20.9	21.7		
b/c	75.2	75.6	75.9	75.7	75.6		

1/ Main financial institutions that operate with payroll deduction credit to households.

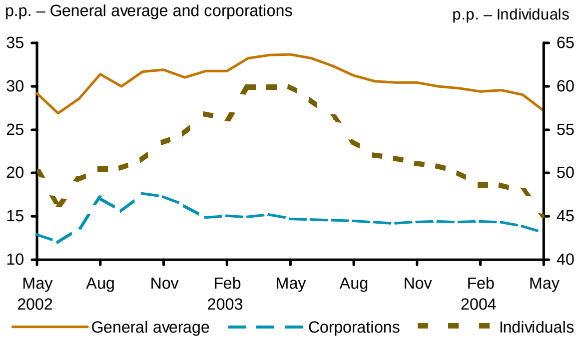
Based on the results of the survey, loans against payroll made by the financial institutions covered by the study (approximately 75% of the personal credit portfolio), totaled R$7.8 billion in May. In the period extending from March to May, these operations expanded by 25.1%, thus surpassing the performance of personal credit loans, which had registered growth of 11.9% in the same period.

This result demonstrates that, in terms of interest charged, this product has significant advantages over other lines of credit to individual persons, including other types of similar loans classified under personal credit operations. The median rate on payroll operations closed at 39.1% per year in May, which was lower than the rates charged on personal credits, with 72.7% per year, and special overdraft checks, with 140.5% per year.

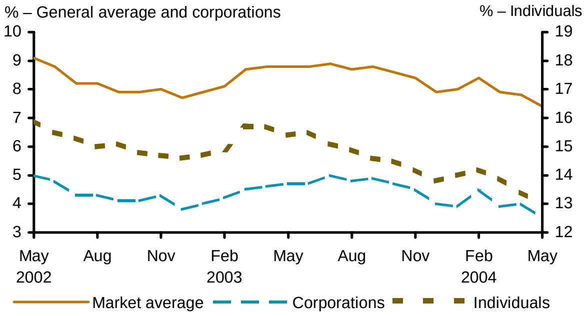
The fact of the matter is that the cost differential has stimulated borrowers to utilize the resources from these operations to settle debts contracted in other bank and commercial credit modalities. In this sense, it is important to stress the moderate growth registered in operations with special overdraft checks, with just 4.6% since September 2003, when Provisional Measure 130 was issued. This behavior has also contributed to considerable improvement in default indicators.

One should further stress that, in the month of June, Banco Central issued Circular 3,240, with regulations on remittances of information related to payroll credit operations, effective as of the second half of the year. As a result, normative instruments were defined that will make it possible to closely analyze and monitor the evolution of these loans.

Average spread of credit operations with nonearmarked resources

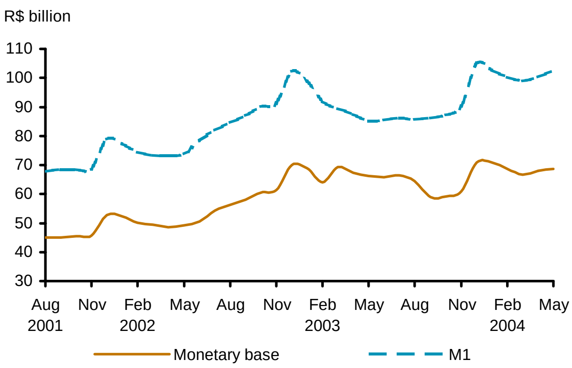


Default rate of credit[1/]

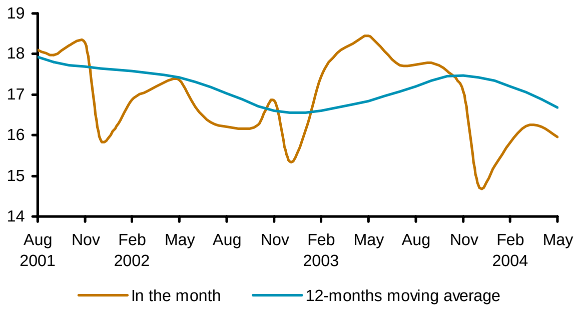


1/ Portfolio's percentage share of nonearmarked funds in arrears of more than 15 days.

Monetary base and M1 – Average daily balances



M1 – Income-velocity[1/]



1/ Defined as the ratio between 12 month accumulated GDP (valued by IGP-DI) and the monthly average balance of the monetary aggregate.

foreign currency, as a consequence of exchange rate volatility.

The banking spread in credit operations based on nonearmarked resources came to 27.2 p.p. in May, for a decline of 2.2 p.p. in the quarter. Aside from the reduction in funding rates, evolution of the spread in the period indicated an increase in the cost borne by financial institutions in obtaining funding as a result of the May increase in futures market interest rates. In loans to individual borrowers, the differential dropped by 3.4 p.p. compared to a falloff of 1.3 p.p. in operations with corporate entities.

Defaults in credit operations with nonearmarked resources declined by 1 p.p. in the quarter and corresponded to 7.4% of the portfolio. In the segment of individual borrowers, arrears of more than fifteen days totaled 13%, with a reduction of 1.2 p.p., as borrowers began to make use of payroll loans to pay off other debts. In contracts with corporate entities, defaults came to 3.5%, for a reduction of 1 p.p., due to renegotiation of electricity company debts.

3.2 Monetary policy

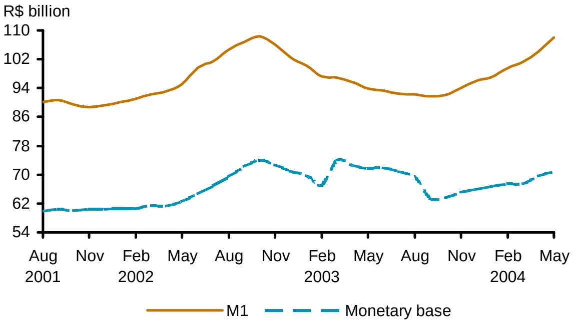
Monetary aggregates

At the end of the month of May, the median daily money supply balance (M1) closed at R$102.6 billion, for growth of 20.6% in the last twelve months, based on increases of 16.2% in the balance of currency held by the public and 23.4% in demand deposits. In keeping with the performance of this aggregate, the income velocity of the M1 components, which had been rising in 2004, shifted into a downward curve in May.

When deseasonalized data deflated by the IPCA are considered, it becomes evident that the upward movement in M1 generated by recovery in the level of economic activity has continued.

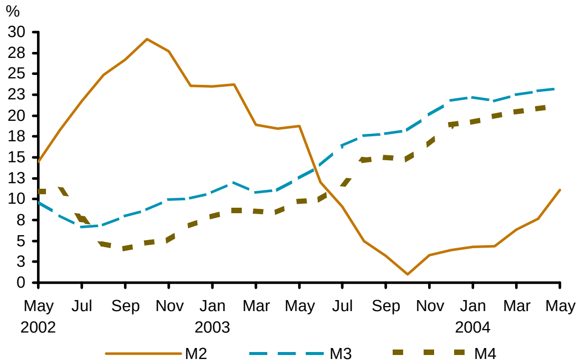
Analyzed under the prism of daily average balances, the monetary base came to R$68.6 billion at the end of May, for growth of 3.6% in twelve months. Among the components, the average balance of currency issued increased by 18% while that of banking reserves dropped by 17.6% under the impact of the reduction in the rate of compulsory reserves on demand deposits at the end of August 2003.

M1 and the monetary base at May 2004 prices seasonally adjusted[1/]

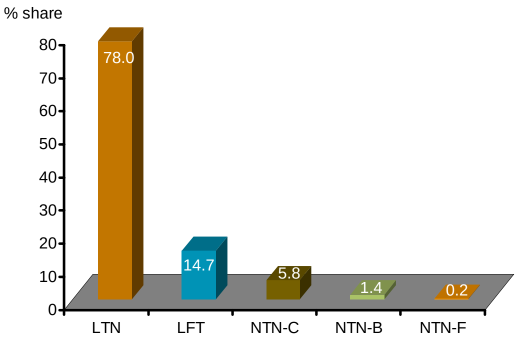


1/ Price index: IPCA.

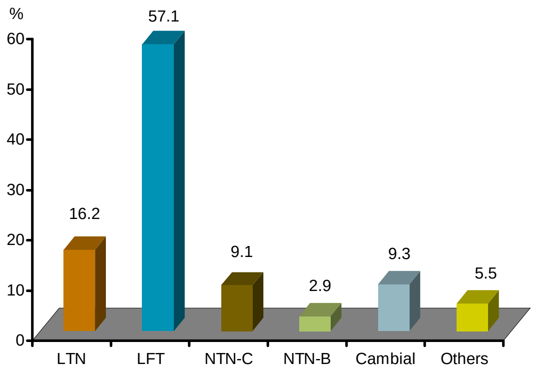
Broad money supply – 12-month percentage growth



Issues of federal public securities – March to May 2004



Federal securities debt structure – May 2004



With respect to the sources of primary currency issues in the March-May quarter, one should cite the contractive impact of R$22.1 billion generated by National Treasury operations. In the opposite sense, overall financial system operations generated growth of R$1.5 billion, of which operations with derivatives accounted for R$1 billion. Considering the R$2.1 billion reduction in monetary base demand in the quarter, the liquidity adjustment was achieved through operations with federal public securities in the amount of R$18.5 billion.

The broader money supply registered moderate growth in the March-May 2004 quarter influenced by contractive fiscal results at the level of the Federal Government and, in the opposite sense, by loans granted by the financial system. The M2 concept, which is equivalent to M1 plus savings deposits and papers issued by financial institutions, increased by 4.1% due basically to a 9.5% increase in private securities.

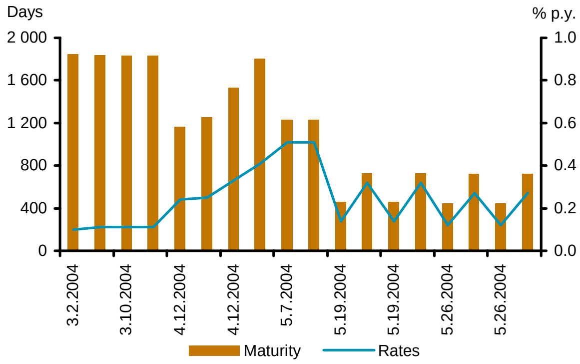
The M3 concept, which includes M2 plus quotas in fixed income funds and the federal public securities used as backing for the net financing position in repo operations carried out between the nonfinancial sector and the financial system, expanded by 3.3% in the quarter. The M4 concept, which encompasses M3 and public securities held by nonfinancial institutions, came to R$1,017 billion at the end of May, with growth of 3% in relation to February 2004.

Public securities

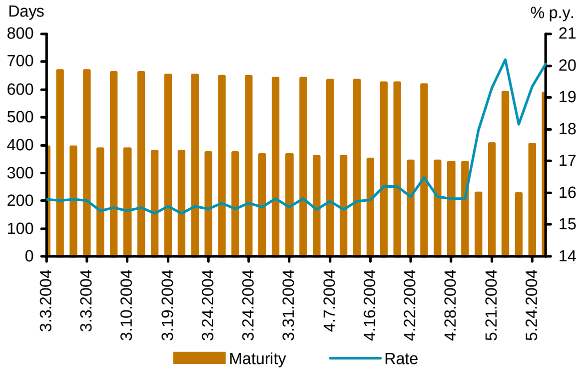
The uncertainties surrounding alterations in United States monetary policy and their impacts on the world economy influenced expectations of growth in Brazilian basic interest rates while also affecting the risk premium built into longer term rates. Consequently, the interest rate curve took on a positive incline. The increase in its vertices, particularly over the longer term, affected the rates agreed upon in public security auctions.

From March to May 2004, operations with federal public securities produced an expansionary impact of R$33.2 billion, based on National Treasury placements of R$45.4 billion and maturities of R$78.5 billion, including redemptions of papers issued by Banco Central. Auctions involving exchanges of papers added up to R$5.2 billion, concentrated mostly in operations with National Treasury Notes – Series C (NTN-C) and National Treasury Financial Bills (LFT).

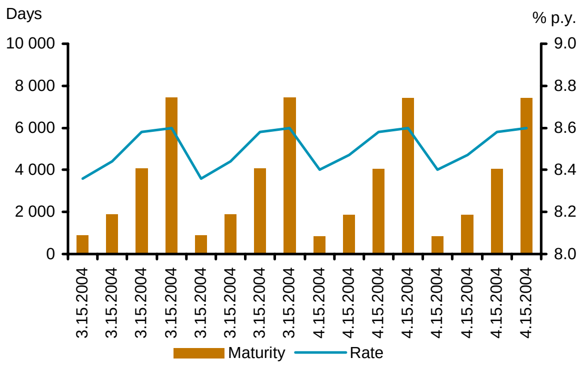
LFT placements – Maturity and rates



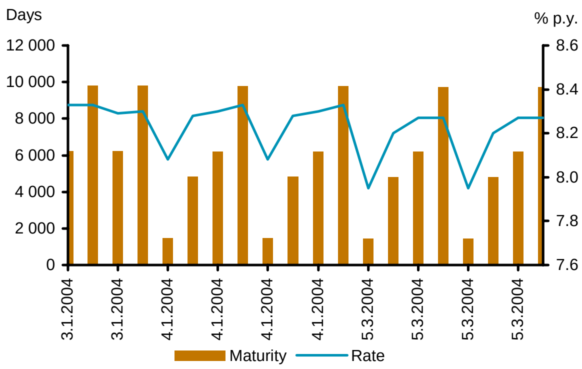
LTN placements – Maturity and rates



NTN-B placements – Maturity and rates



NTN-C placements – Maturity and rates



National Treasury issues were concentrated in preset papers, with National Treasury Bills (LTN) accounting for 78% of the total issued in the March-May quarter, despite representing only 4.4% of the volume negotiated in May. This performance reflected an alteration in the interest curve and growth in the earnings sought by the market, as the Treasury turned back proposals in several auctions and cancelled others. In turn, LFT accounted for 14.7% of placements in the period and for 83.9% of those made in May. National Treasury Notes – Series B (NTN-B) and National Treasury Notes – Series C (NTN-C) added up to 7.2% of the total, while National Treasury Notes – Series F (NTN-F) corresponded to only 0.2%.

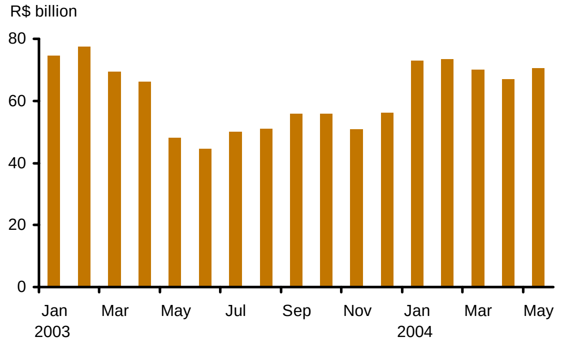
The composition of the internal Federal Public Securities Debt (DPMF) continued registering increases in the participation of preset papers, which came to represent 16.4% of the total in May, compared to 13.6% in February. The proportion of papers tied to the rate of exchange and the Selic rate declined from 10.2% to 9.3% and from 60.7% to 57.9%, respectively, excluding exchange swaps. When these swaps are included, there was a falloff from 19% to 16.6% in the fraction of the debt indexed to exchange and from 51.8% to 50.6% in the share indexed to the Selic rate. The participation of papers with indexing according to price indices came to 14.7% in May, for an increase of 0.9 p.p. in relation to February.

Based on the strategy of reducing debt exposure to changes in the rate of exchange, there were no sales of securities or exchange derivative contracts, resulting in net redemptions of US$10 billion. Maturities of Banco Central do Brasil Notes – Special Series (NBCE) and National Treasury Notes – Series D (NTN-D) accumulated a total of US$4.2 billion from March to May, and redemptions and exchange swap adjustments closed with US$5.9 billion. In the year up to May, net redemptions totaled US$17.6 billion.

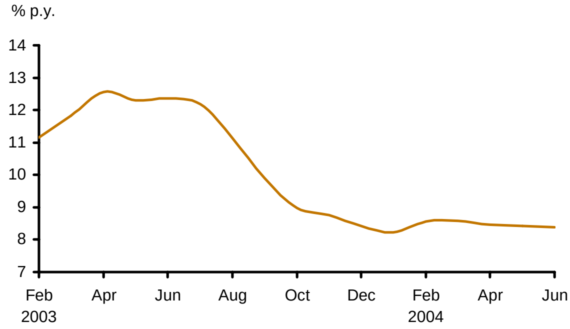
In the month of April, those seeking instruments with postset earnings and shorter maturities, mostly on the part of investment funds, began to eliminate their LFT positions and acquire LTN conjugated with Interbank Deposit (DI) sales contracts, which replicate the characteristics of an LFT with the desired term. This movement led to an increase in the discount on these papers, with losses for several fixed income funds, principally in those funds with portfolios concentrated in LFT with maturities of more than two years.

The net financing position registered a slight downward trend up to mid-May. National Treasury operations contributed to

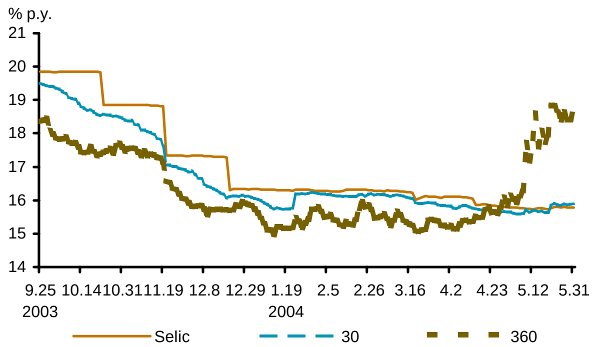
Net financing position of the federal public securities – Daily average



Ex-ante real interest rate deflated by 12-month IPCA forecast

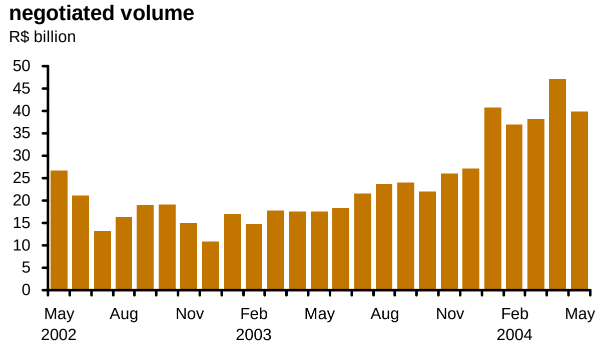


Selic x swap DI x Pre



Source: BM&F

One day DI future contract – Average negotiated volume



Source: BM&F

the reduction in the volume of turnover through repo operations, since these are able to attract larger volumes of resources. However, this situation was reversed by concentration in the May 19 LFT maturity, in the amount of R$31 billion, and adjustments with exchange swap operations. The median daily value of financing operations declined from US$70.1 billion in March to US$67 billion in April, before increasing once again to US$70.4 billion in May.

Real interest rates and market expectations

According to a survey carried out by Banco Central at the level of the financial market, the real ex-ante rate of interest for a term of one year came to 8.4% per year on June 18, compared to 8.6% per year at the end of February. To some extent, this result reflected market expectations regarding the twelve month rise in the IPCA, resulting from the possible impact of the recent change in international market oil prices on internal prices.

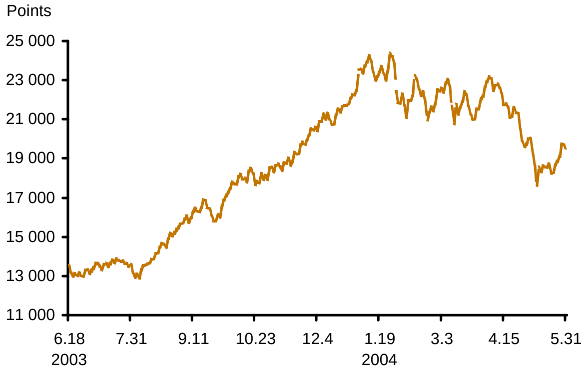
As of the month of April, both interest and exchange markets were characterized by greater volatility, principally as a result of expectations of an interest rate hike in the United States. The DI x pre swap reference rate for 360 day contracts came to 18.8% per year at the end of May, compared to 15.7% per year in February, raising the real ex-ante rate of interest to 12.1% per year.

One should highlight the fact that, in this quarter, the daily median of trading in one day DI futures contracts on the Commodities and Futures Exchange (BM&F) came to R$41.8 billion, representing growth of 22% in relation to the median registered in the December-February quarter. This result demonstrated the increased uncertainties found among economic agents, as well as increased demand on the part of investment fund managers.

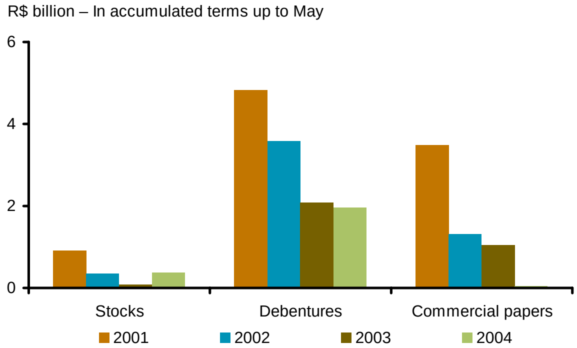
Capital market

With the increased level of financial market volatility, the São Paulo Stock Exchange Index (Ibovespa) registered a nominal reduction of 10.2% in May, closing the period at 19,544 points. The possibility of the Federal Reserve raising United States interest rates also affected the profitability of American exchanges, as evident in the falloffs of 3.7% in the quarter in the Dow Jones Industrial Average (DJIA) and of 2.1% in the National Association of Securities Dealers Automated Quotation (Nasdaq). The performance of

Ibovespa

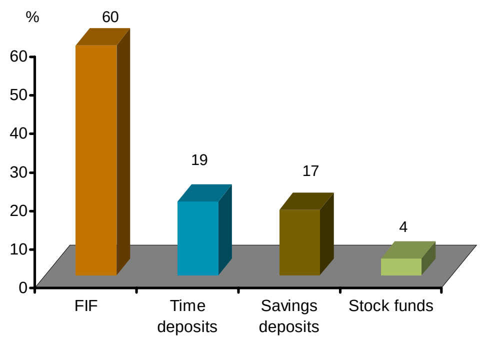


Primary issues in capital market

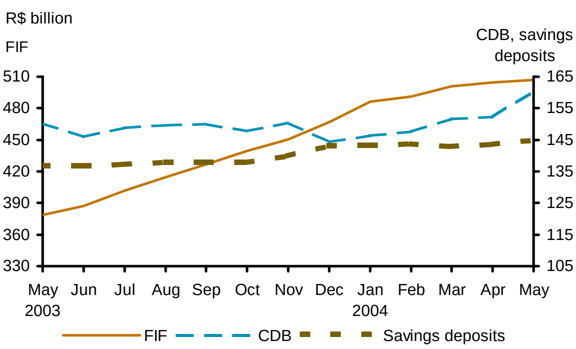


Source: CVM

Financial savings structure – 2004, May



Portfolio evolution of CDB, FIF and savings deposits



Ibovespa evaluated in dollar terms registered a decline of 16.3% in the period. However, despite this negative growth, the volume of external investments in the Brazilian market remained positive, with a net inflow of R$838 million in the quarter ended in May.

Monthly average trading from March to May came to R$1.1 billion, 6% less than in the previous quarter. Parallel to the increase in investor uncertainty, this result reflects the high level of the basis of comparison.

Financing of capital market companies through issues of stocks, debentures and promissory notes came to R$2.4 billion from January to May, compared to R$3.2 billion in the same period of 2003. The lesser volume of inflows was a partial reflection of more favorable conditions that existed for obtaining resources on the international market in the early months of the year.

Financial investments

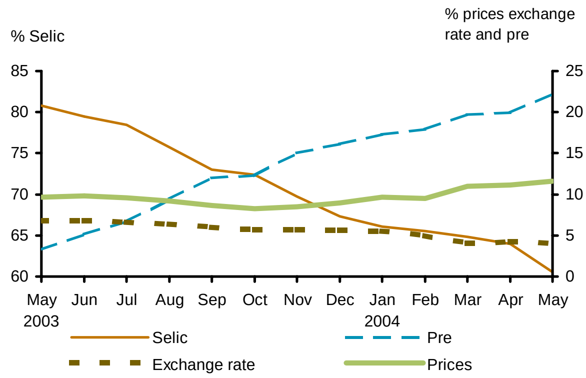
Financial investments, which include savings accounts, time deposits and investment funds, totaled R$825.9 billion in May 2004, with growth of 3.1% in relation to February.

At the end of May, Financial Investment Fund (FIF) equity came to R$505 billion, with growth of 2.8% in the quarter. In the months of April and May, the fund industry registered net outflows of resources as a result of the volatility of daily profitability levels in the period. As a matter of fact, negative returns were registered by several fixed income funds in the March-May quarter, as a result of the impact of the high in futures market interest rates on returns on preset papers, which represent the major share of these portfolios and are marked to market on a daily basis.

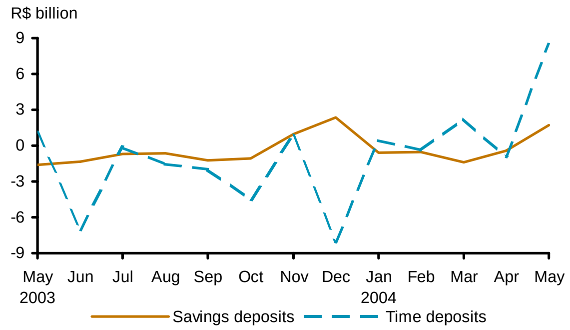
Analysis of the movement of resources among the different types of funds indicates increased demand for short-term funds, in detriment to fixed income funds. This behavior is a result of investor risk aversion, reflecting the volatility of interest rates, since short-term funds have portfolios composed of post set papers that accompany the Selic rate.

At the end of May, savings accounts and deposit accounts registered balances of R$145.2 billion and R$162.6 billion, respectively, with growth of 1.1% and 10.2%, compared to February. In the quarter, savings accounts registered a net negative inflow of R$109 million, while time deposits absorbed net inflows of R$9.7 billion.

Public securities in funds portfolio by indexator



Net inflow – Savings deposits and time deposits



Primary result of the consolidated public sector

Accumulated in the year — R$ million

Period	Actual	IMF – Basic path	
	Apr (a)	Jun (b)	(a/b) %
1999	-10 788	-12 883	83.7
2000	-17 275	-16 175	106.8
2001	-23 259	-21 473	108.3
2002	-20 520	-25 000	82.1
2003	-32 683	-34 500	94.7
2004	-32 429	-32 600	99.5

Primary result of the consolidated public sector

Accumulated in the year: Jan–Apr

Segment	2002		2003		2004	
	R$ bilhões	% PIB	R$ bilhões	% PIB	R$ bilhões	% PIB
Central government	-17.2	-4.2	-25.1	-5.4	-25.5	-5.0
Regional government	-4.7	-1.2	-6.1	-1.3	-6.6	-1.3
State companies	1.4	0.4	-1.5	-0.3	-0.3	-0.1
Total	-20.5	-5.1	-32.7	-7.0	-32.4	-6.4

In order to enhance competitiveness among the different types of financial investments, the government issued Provisional Measure 179, dated April 1, 2004, to go into effect as of August 1, 2004, making it possible to open investment deposit accounts that would not be subject to the Provisional Contribution on the Movement or Transmission of Values and Credits and Rights of a Financial Nature (CPMF). These accounts will be used exclusively for fixed and variable income financial investments, including savings deposit accounts.

The CPMF exemption granted to financial transactions among the different financial investment modalities has the objective of increasing the efficiency of reallocations of investment portfolios. At the same time, this measure altered the periods in which the income tax is levied, in order to make the tax structure compatible with the increase in the temporal horizon of these investments.

3.3 Fiscal policy

Public sector borrowing requirements

In April, the nonfinancial public sector registered a primary surplus of R$11.9 billion. When this result is incorporated, the surplus accumulated in the year rose to R$32.4 billion or 6.35% of GDP, compared to R$32.7 billion, or 6.99% of GDP in 2003. When one considers the accumulated 12 month balance, the primary surplus reached the mark of R$65.9 billion, or 4.23% of GDP, which is fully compatible with the target specified for the period.

The primary surplus obtained in the first four months of the year maintained the standard registered in previous years, as regards compliance with the target defined for the first six months of the year. In this sense, while the accumulated 2004 result corresponded to 99.5% of the target set for the first half of the year, this percentage came to 108.3% in 2001, 82.1% in 2002 and 94.7% in 2003. It should be stressed that this performance reflects the seasonal behavior of revenues and expenditures over the course of the year.

The Central Government (federal government, National Social Security Institute – INSS and Banco Central) accounted for R$25.5 billion, or 5% of GDP, of the overall primary surplus accumulated in the year; regional governments were responsible for R$6.6 billion, 1.3% of GDP; and state companies for R$269 million, 0.1% of GDP. The participation of the Central Government in the surplus obtained by the public sector increased from 76.7% in the first four months of 2003 to 78.7% in the corresponding period of 2004, while that of regional governments moved from 16.6% to 18.3% and the participation of state companies shifted in the opposite direction, with a decline from 4.63% in 2003 to 0.8% in 2004.

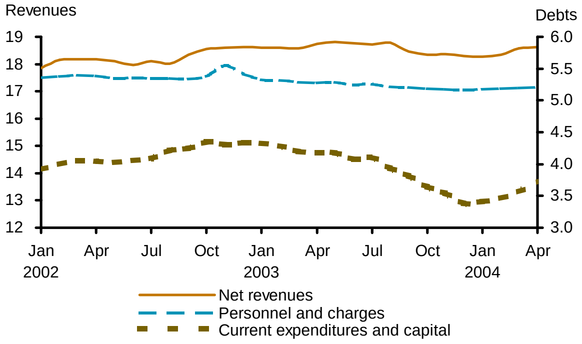
The Central Government surplus registered a decline corresponding to 0.37 p.p. of GDP between the first four months of 2003 and the same period of the current year, mostly as a result of growth in the INSS deficit. As a matter of fact, while the Federal Government surplus increased by 0.05 p.p. of GDP to 6.69%, the deficit in INSS accounts rose by o.35 p.p. to 1.68%, with the Banco Central deficit holding firm at the same level of 0.01% of GDP.

Basically, the federal government result benefited from revenue gains consequent upon renewed economic growth and, to a lesser extent, from changes in tax legislation. In the case of the first four months of 2003, the inflow of taxes and federal contributions registered a gain of R$11.5 billion, with real growth of 5.6% when the IPCA is used as deflator.

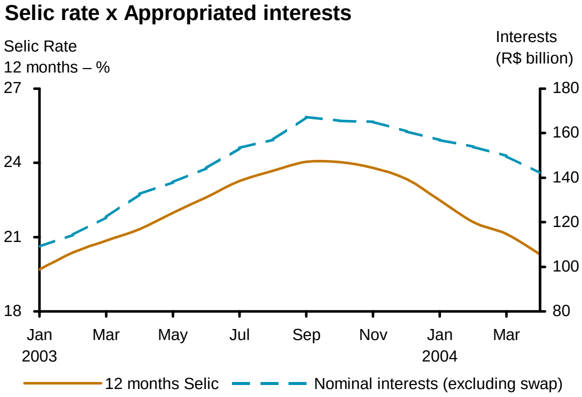
With respect to National Treasury spending, stress should be given to the increase from 4.32% to 4.52% of GDP in transfers to the States and Municipalities, demonstrating the impact of the distribution of the inflow of the Contribution on Intervention in the Economic Domain (Cide) in the amount of R$404 million. With the tax reform approved in December 2003 (Constitutional Amendment 42, 12.19.2003), the federal government began channeling 25% of the inflow of this contribution to the various states involved. Outlays on personnel and charges declined from 5.29% to 5.23% of GDP, while disbursements on current and capital outlays rose from 3.98% to 4.76% of GDP. In this case, a major contributing factor was a strong percentage increase in the level of utilization of already allocated resources by the ministries operating in the social area (Health, Education, Social Security and Social Assistance and Social Development) from 88% to 95.5%, and the other ministries, from 66% to 68.6%.

As far as INSS accounts are concerned, growth in the deficit reflected 23% expansion in overall spending, as a result of an increase of 18.2% in the median value of benefits paid generated by the minimum wage increase that went into effect in April 2003 and by the July 2003 increase in other benefits, together with growth of 861.2 thousand new benefits from January to April 2004, compared to the level registered in the first four months of the preceding year.

Revenues x Debts – Flows in 12 months – Federal Government – % GDP



Selic rate x Appropriated interests



Based on an assessment of the performance of inflow in the first four months of the year, the federal government was able to release budget allocations as of the month of March. With issue of Decrees 5,027, dated 3.31.2004, and 5,094, dated 6.1.2004, the executive branch added R$1.9 billion to the limit on the amounts to be set aside and payments to be effected against the budget allocations of its respective organs, funds and entities, compared to the amounts defined by Decree 4,992, dated 2.18.2004. It should be stressed that this decree also set aside R$6 billion in discretionary federal government spending. Basically, this measure had a preventive character and corresponded to R$3 billion in current expenditure outlays and R$3 billion in investments.

With regard to the result for regional governments, continued implementation of measures aimed at maintaining the operations of these levels of authority within the limits set down by the Fiscal Responsibility Act aided in maintaining the primary surplus in the first four months of the year at the same level attained in 2003. Other factors that favored this result were the positive impact of the increase in constitutional transfers that resulted from the new system of sharing Cide revenues and the gradual recovery of the inflow of the Tax on Operations involving the Circulation of Merchandise and the Rendering of Interstate and Intermunicipal Transportation and Communications Services, due to recovery in the level of economic activity.

State companies registered a surplus of R$269 million, compared to R$1.5 billion in the first four months of 2003. Basically, this reduction was due to the increase in the volume of dividends paid in the period.

The result of these figures was maintenance of fiscal equilibrium in all spheres, particularly in terms of the continued control of current expenditure outlays and the early impact of recovery in the activity level on the revenue flow. Aside from this, the participation of the government segment – particularly the Central Government – increased sharply in the formation of the public sector surplus, compared to the role played by state companies.

Total nominal interest appropriated reached a level of R$9.9 billion in April 2004 and R$41.3 billion (8.08% of GDP) in the four month period, compared to R$51.2 billion (10.96% of GDP) from January to April 2003. A reduction was registered in all public sector segments, following the downward trajectory of the Selic rate, which fell from 26.5% in April 2003 to 16% in April 2004. It is important to stress that, in the first four months of 2003, revenues of approximately R$8.8 billion consequent upon exchange swap operations were included in the calculation, while the result of these operations was practically nil in 2004.

In the month of April, the public sector primary result surpassed the volume of interest appropriated and, consequently, registered a nominal surplus corresponding to R$2 billion. In the four month period, the nominal deficit came to R$8.8 billion or 1.73% of GDP, compared to R$18.6 billion, or 3.97% of GDP, in the first four months of 2003.

With regard to the major sources of financing of the nominal deficit accumulated in the year, the securities and banking debts registered growth of R$38 billion and R$3.8 billion, respectively, and external financing and the monetary base closed with contraction of R$23.1 billion and R$7.6 billion.

Federal securities debt

Evaluated according to the portfolio position, the federal securities debt increased from R$737.3 billion (46.9% of GDP) in January 2004 to R$767.7 billion (47.1% of GDP) in April 2004. Among the factors that contributed to this increase, one should cite net primary market issues of R$750 million, incorporation of interest and 0.13% depreciation of the real against the dollar.

Excluding financing operations, the amortization schedule of the market securities debt registered the following configuration in April: R$187.4 billion, 24.4% of the total, with maturity in 2004; R$240.5 billion, 31.3% of the total, in 2005; and R$339.8 billion, 44.3% of the total, as of January 2006.

Exchange swap operations reached a level of R$56.8 billion in April, compared to R$75 billion in January. The result of these operations in the quarter, which is defined by the difference between DI profitability and exchange variation plus coupon, was favorable to Banco Central by R$1.3 billion, when analyzed on an accrual basis. According to the cash criterion, this results was favorable by R$832 million.

Net public sector debt

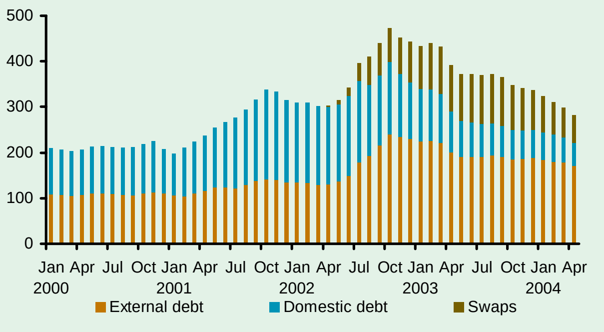
The net debt of the nonfinancial public sector totaled R$926.4 billion or 56.6% of GDP in April 2004, compared to R$924.4 billion or 57.3% of GDP in March and R$913.1 billion or 58.7% of GDP in December 2003.

Sensitivity Analysis of the Debt/GDP Ratio to Exchange Rate Fluctuations

Exchange rate fluctuations have had an important – albeit recently diminishing – influence on the evolution of the net public sector debt (DLSP), since they have a direct impact on the value of debts and assets expressed in reals and referenced to the dollar. The major components of the debt tied to the dollar are the external debt of the various public sector spheres, including state companies and, internally, securities indexed to exchange issued by the National Treasury and Banco Central. As assets that partially offset such debts, one should highlight international reserves deposited at Banco Central.

Another effect of exchange rate fluctuations on the net debt is related to the cash result of exchange swap operations carried out by Banco Central. Even though it does not constitute debt, exposure in swap operations (notional value) generates losses (gains) in the amount of the positive (negative) difference between exchange growth plus coupon and the rate of interbank loans (DI). This cash result constitutes a financial outlay (revenue) and is calculated as a component of the net public sector debt when the reconciliation of margins takes place.

Exchange exposure: net debt indexed to exchange rate and swaps exposure



Following an initial period of stability in the range of R$200 billion, exchange exposure increased in two stages: over the course of 2001 and as of mid-2002, reaching a maximum level of R$473 billion in October of this year. From that point forward, exchange exposure has dropped steadily, closing April 2004 at R$283 billion.

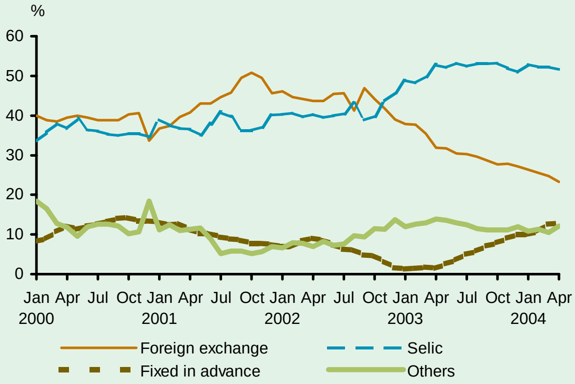
In periods of either growth or reduction in exchange exposure, it is principally the internal component of exposure, including swaps, that varies. Here, one should highlight the following factors: the direct impact of exchange variation, which depreciated in 2001 and 2002 and partially reversed course in 2003; growing market demand for exchange hedge in 2002; an explicit government policy aimed at reducing exchange exposure as of 2003; rolling steadily lesser shares of securities indexed to exchange and, principally swaps. Aside from this, net external debt amortizations were made in April 2004 in an amount equivalent to R$15 billion, through utilization of exchange obtained on the market.

The government's effort to reduce the exposure of its debt to exchange altered the profile of the public sector net debt in terms of the participation of the major indexing factors. The participation of the debt tied to the dollar which, in October 2001, came to represent 50.9% of net indebtedness, dropped to 23.3% in April 2004. At the same time, the debt tied to preset interest registered an upward trajectory as of 2003, moving from 1.4% in January of that year to 13% in April 2004. The same thing occurred under the debt tied to the Selic rate, which oscillated between 35% and 40% in the period from January 2000 to October 2002, moving to 51.6% in April 2004.

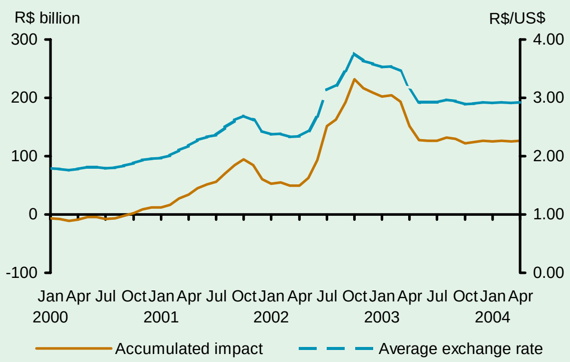
The exchange impact on DLSP, therefore, is a consequence of the participation of the net debt indexed to the dollar (debt less exchange assets), of the result of exposure in swap operations and of the magnitude of the depreciation or appreciation of the rate of exchange. Thus, the shift noted in the rate of exchange between January 2000 and October 2002 produced an impact on DLSP equivalent to R$232 billion, or 66% of DLSP growth in the period. On the other hand, between November 2002 and June 2003, exchange produced a contractive impact on the net debt equivalent to R$67 billion and remained relatively neutral from that point forward.

The alterations that occurred in the participation of the debt tied to the dollar, variations in the volume of exposure in exchange swap operations and the behavior of the rate of exchange produced alterations in the sensitivity of the net debt to exchange rate fluctuations. In 2000, one notes that a change of 1% in the rate of exchange generated an increase of approximately R$2 billion in DLSP. In October 2002, this impact peaked at R$4.7 billion. The reduction from that point forward was significant, as April 2004

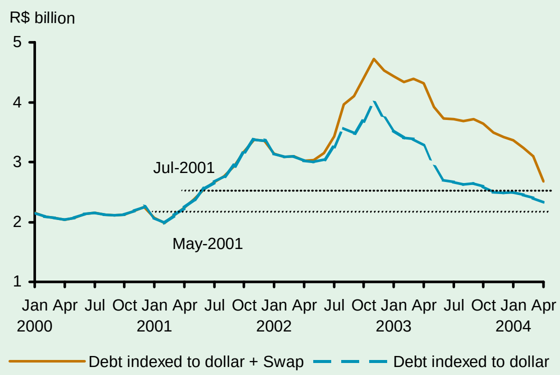
Net debt by indexing factor



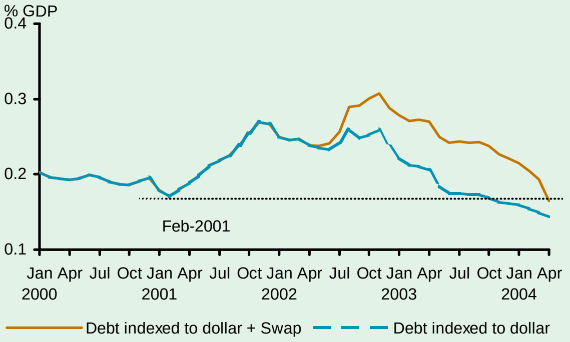
Impact of exchange rate variation in public sector net debt



Impact of 1% exchange rate change in PSND



Impact of 1% exchange rate change in PSNB/GDP ratio



closed with a figure of R$2.7 billion, which was equivalent to the level registered in July 2001.

Evaluated as a percentage of GDP, the impact of alterations in the rate of exchange on DLSP in April 2004 is equivalent to what was observed at the start of 2001 or, in other words, for each 1% increase in exchange, the DLSP/GDP ratio oscillates in the same direction by 0.16%. It should be noted that possible impacts of exchange on GDP are not considered in this exercise.

Net debt growth
Conditioning factors

Itemization	2002		2003		2004	
	December		December		April	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	881 108	55.5	913 145	58.7	926 398	56.5
Flows	**Accumulated in the year**					
Net debt – growth	220 241	2.9	32 037	3.3	13 253	- 2.3
Conditioning factors	220 241	13.9	32 037	2.1	13 253	0.8
PSBR	61 614	3.9	79 030	5.1	8 830	0.5
Primary	-52 390	- 3.3	-66 173	- 4.3	-32 429	- 2.0
Interest	114 004	7.2	145 203	9.3	41 259	2.5
Exchange adjustment	147 225	9.3	-64 309	- 4.1	4 477	0.3
Domestic securities debt 1/	76 662	4.8	-22 715	- 1.5	1 363	0.1
External debt	70 564	4.4	-41 594	- 2.7	3 114	0.2
Others 2/	753	0.0	16 712	1.1	- 79	0.0
Acknowledgement of debt	14 286	0.9	604	0.0	102	0.0
Privatizations	-3 637	- 0.2	0	0.0	- 78	0.0
GDP growth effect		- 11.0		1.2		- 3.1

1/ Dollar indexed to the internal securities debt.
2/ Parity of the currency basket taking part in the net external debt.

Exchange depreciation of 1.92% in the four month period contributed to the R$4.5 billion rise in the debt, including R$1.4 billion related to the internal securities debt indexed to the dollar and R$3.1 billion to the net external debt.

Analysis of the major factors that resulted in the 2.14 p.p. reduction in the net debt as a proportion of GDP in 2004 shows that the impact of growth in the valued GDP provoked a cutback of 2.95 p.p.. At the same time, moving in the opposite direction, borrowing requirements accounted for growth of 0.54 p.p., exchange depreciation for another 0.27 p.p. and debt recognition for 0.01 p.p.

The trajectory of the decline in the participation of the internal securities debt indexed to the dollar has contributed to the change in the profile of the net indebtedness of the nonfinancial public sector, generating a positive impact in terms of the vulnerability of the debt/GDP ratio to fluctuations in the rate of exchange (see box: Sensitivity Analysis of the Debt/GDP Ratio to Exchange Rate Fluctuations – page 56). This trend was further strengthened in April by external debt redemptions totaling R$14.9 billion in the month.

The gross general government debt (federal government, INSS, state and municipal governments) declined from R$1,274 billion (79% of GDP) in March to R$1,270 billion (77.6% of GDP) in April. External debt redemptions that occurred in the month contributed to this reduction.

3.4 Conclusion

The recent evolution of financial system credit operations was closely tied to operations with both individual borrowers and corporate entities. Personal credit operations, particularly those based on payroll loans, benefited from cutbacks in interest rates over the course of the final six months of 2003. The interest rate reduction resulted in lower funding costs and powered demand for consumer durables. In much the same way, operations involving corporate entities registered an upward trajectory in the quarter ended in May, including operations backed by both internal and external funding. Aside from this, the impact of operations with economic segments focused on export operations persisted, with a particularly strong performance on the part of agribusiness operations.

In keeping with the evolution of credit operations and the more intense pace of economic activity, monetary aggregates registered a steady rise in the period. Reductions in the basic interest rate throughout the entire final six months of 2003 resulted in sharp cutbacks in funding rates and clearly impacted credit demand and the rechanneling of the financial liabilities of companies.

Fiscal results registered up to April signal compliance with the target for the primary surplus in the first half of the year and, when the seasonal behavior of the principal revenue and expenditure headings are taken into consideration, were evidently compatible with the target defined for the year.

Here, one should underscore the initiative taken by the federal government to condition releases of discretionary spending to confirmation of the revenue levels forecast in the budget process, imposing conditional impediments on the use of such funding and/or gradually releasing the resources according to inflow results.

Aside from this, the performance of revenues has already begun incorporating the effects of the renewed pace of economic growth. As a result, revenues have moved to levels clearly compatible with the parameters defined for the year at the time of budget elaboration.

The debt/GDP ratio has continued on a downward curve. It is expected that this trajectory will be sustained by the reduction in interest on the debt, a lesser degree of vulnerability of debt to exchange rate fluctuations and a more favorable outlook for the growth of the economy.

The international economy 4

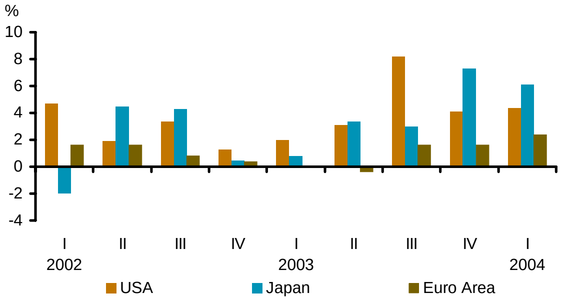
The results of first quarter growth in the world's major economies further strengthened expectations of a more promising economic scenario. The fact is that closely synchronized growth in the United States and Japan, coupled with still modest expansion in the euro area countries, has generated a tendency toward recovery on a world scale. The intense pace of activity in China has led the government of that country to adopt measures aimed at somewhat limiting expansion so as to avoid rekindling inflation. Despite these measures, it is still expected that the Chinese economy will expand by more than 7% this year. Evidently, the Latin American countries, and particularly Argentina, have clearly benefited from this process, with highly positive repercussions on Brazilian exports.

However, expectations of an interest rate hike in the United States and the evolution of petroleum prices led to increased market turbulence in recent months, requiring a series of technical adjustments in a framework marked by a mismatch between prices and economic fundamentals in both the industrialized and emerging nations.

4.1 Economic activity

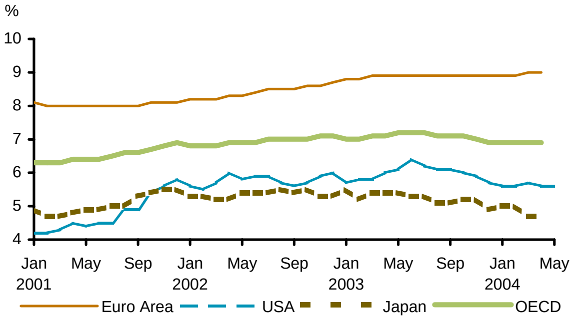
On a global scale, economic growth has become increasingly more evident since March 2003 and has been driven mostly by results in the United States and China. The positive impacts of the reactivation of the United States economy and rapid growth in the Chinese economy and trade sector have made a significant contribution to continued expansion in Japan and the start of recovery in the euro area countries. On the other hand, there are important risks implicit in the accelerated pace of growth in these economies, particularly when viewed in terms of possible interest rate increases in the United States and adoption of measures in China aimed at avoiding overheating that nation's economy.

GDP[1/]



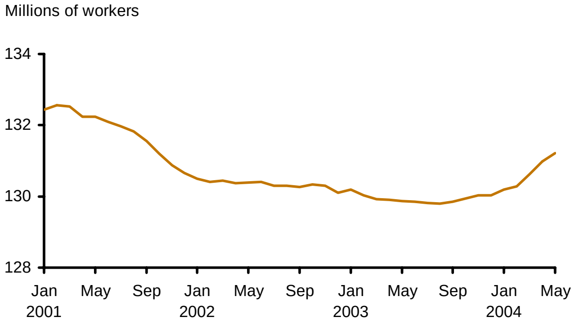
Sources: Bureau of Economic Analysis, Economic Planning Agency, Eurostat
1/ Quarterly growth. Seasonally adjusted annualized rate.

Unemployment rates



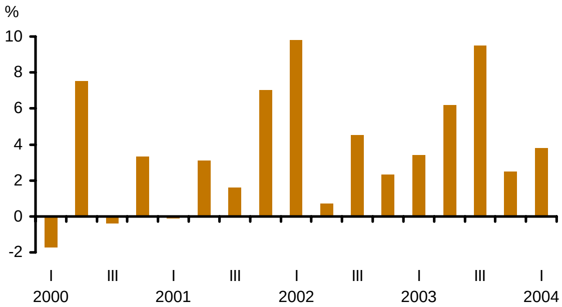
Sources: Eurostat, Bureau of Labor Statistics, Ministry of Public Management of Japan, OECD

USA – Non-farm payrolls



Source: Bureau of Labor Statistics

USA – Output per hour[1/]



Sources: Bureau of Labor Statistics
1/ Quarterly growth. Seasonally adjusted annualized rate.

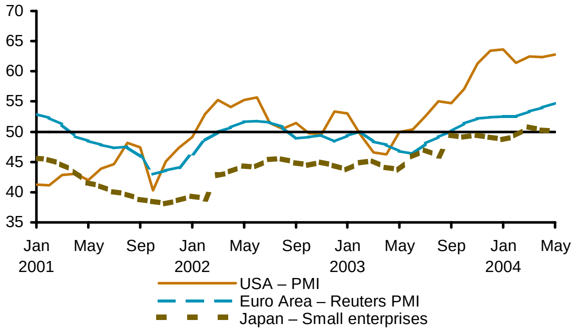
The United States economy continued on the accelerated growth trajectory that started in mid-2003. GDP growth in the first quarter of 2004 came to an annualized figure of 4.4% when compared to the previous quarter, while the final quarter of 2003 turned in expansion of 4.1%. The behavior of GDP components demonstrates that the upturn in the activity level has been driven by internal demand, since the net contribution of foreign trade was negative in the last two quarters. One should also note that the growth process originated in several different economic sectors. In this context, one could highlight consumption of services and nondurable consumer goods in the first quarter of the current year, together with increased corporate investment, higher inventories and greater military spending, all of which have clearly turned upward followed declines in the second half of 2003.

The consistency of more intense economic growth is also evident in labor market recovery, as unemployment has declined and the number of persons employed has risen sharply. Continued strong growth in productivity, which was well above the average for the last ten years in both 2003 and the early months of 2004, coupled with continued expansion in the utilization of installed output capacity, reaching a level of 76.9% in April, suggest a clearly favorable outlook for the sustainability of economic growth and the recovery of job levels. Leading indicators of economic activity levels, such as orders placed with industry and business expectations, also point to accelerated and continued expansion of the economy.

In Japan, GDP expanded at an annualized rate of 6.1% in the first three months of 2004, following growth of 7.3% in the fourth quarter of 2003. Sustained recovery in the corporate sector has had a strong ripple effect on the rest of the economy, as expanded profits have generated increased investment levels. The country has also benefited – mainly in terms of increased exports – from continued growth in China and the other economies of the region. The more positive overall situation also reflects expanding industrial output, higher business and consumer expectations and continued recovery in private consumption. The possibility of overcoming the problem of deflation and the advances made by the banking system in its efforts to resolve the problem of low quality credits are other factors underlying the positive outlook for the Japanese economy.

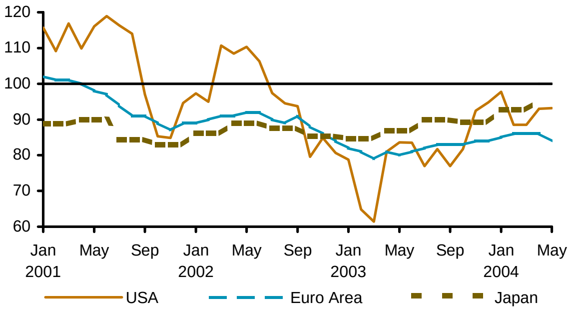
First quarter GDP growth in the euro area countries was higher than originally expected and closed with an annualized figure of 2.4%. However, the region's overall economic

Business confidence



Sources: Institute for Supply Management (ISM), Reuters, Shoko Chukin Bank

Consumer confidence



Sources: Conference Board, European Comission, Economic and Social Research Institute

scenario has not changed since last year. Economic expansion has been considerably slower than in the United States and Japan and is still conditioned to external demand, while internal consumption and investment levels have been insufficient to ensure their sustainability in an environment of high unemployment. At the same time, business and consumer expectations, which were quite optimistic in 2003, have shifted into a much more cautious stance. Thus, the positive signs of GDP growth at the start of the year are clearly no guaranty of continued recovery.

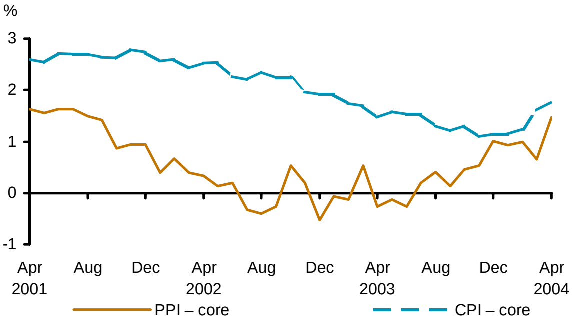
Chinese GDP expanded by 9.7% in the first quarter of the year in annualized terms, continuing the process of accelerated growth that marked all of 2003. Rising inflationary pressures led to adoption of measures aimed at curtailing the overheating of specific productive sectors. In this sense, mention should be made of increases in the compulsory deposits of the banking system and adoption of restrictions on credits and investments in steel, construction and other productive sectors considered already overheated. However, the measures taken to this point are still relatively restricted and the chances that China will adopt measures to significantly reduce the pace of growth are considered remote. Expectations are that there is little probability of adopting increases in real interest or radical alterations in the Chinese exchange policy strategy.

Latin America has also benefited from the upturn in world economic growth. The region's major economies registered strong growth under exports in both value, as a result of higher international commodity prices, and in volume. Argentina, Uruguay and Venezuela are recovering from periods of deep recession and are expected to achieve significantly high rates of expansion. The Economic Commission for Latin America and the Caribbean (Cepal) estimates that the Argentine economy will expand by 6.5% in 2004. Chile and Mexico are also expected to turn in considerably better performances this year, with respective growth rates of 4.7% and 3.4%.

4.2 Monetary and inflation policy

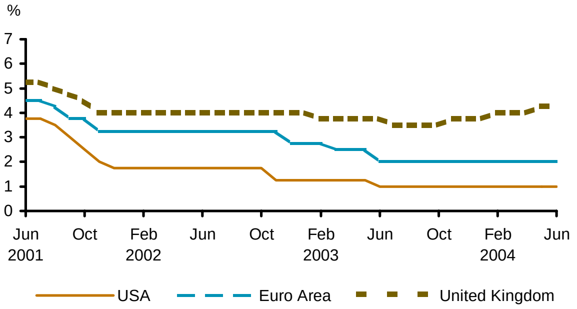
The generalized increase in prices in the United States in recent months has further strengthened perceptions that the Fed will soon increase that country's basic interest rate. The Producer Price Index (IPP) moved upward at an annual rate of 3.7% in April, driven by a high of 20.4% in the prices of raw materials, while the core rate, which had oscillated around zero, expanded by 1.5%. In the same sense, the

Core inflation – USA
Annual growth



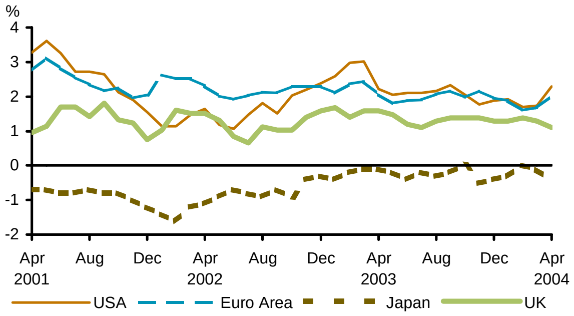
Source: Bureau of Labor Statistics

Official interest rates
Annual rates



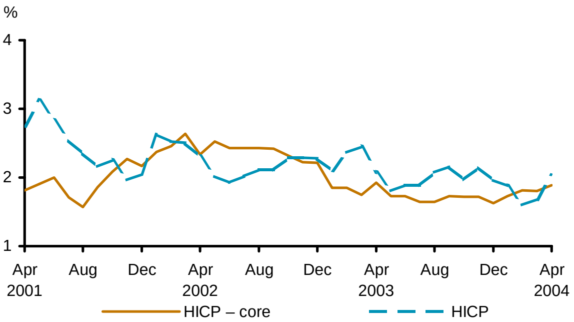
Sources: Federal Reserve, ECB and Bank of England

Consumer inflation
Annual growth



Sources: Bureau of Labor Statistics, Eurostat and Bloomberg

Consumer inflation – Euro Area
Annual growth



Source: Eurostat

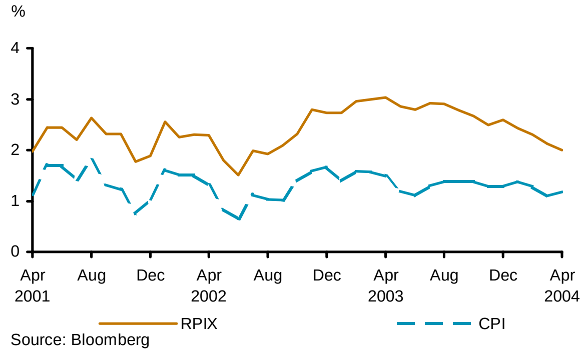
Consumer Price Index (CPI) registered an annual high of 2.3% in April, following a decline of almost 1.5 p.p. over the course of one year. The core index, which had declined steadily since mid-2002 until reaching a level of 1% at the end of last year, closed April at 1.8%. Though price growth figures were based on an already rather low starting point, the intensity of some variations – particularly in the case of raw materials – generated expectations of adoption of a more restrictive monetary policy. Up to the present, however, communications and decisions released by the Fed make it clear that this will be a gradual process.

In any case, it would now seem evident that the overall level of inflation in the United States has begun moving upward, as demonstrated by the behavior of core inflation. However, notwithstanding the ongoing process of economic recovery, the fact that idle output capacity remains high coupled with significant recent productivity gains should make it possible for companies to absorb cost pressures by reducing their profit margins before passing these costs on to consumers. In this same context, the recent trend toward appreciation of the dollar is expected to aid in attenuating the impact of the recent high in raw material prices on the cost structure of the American economy.

In May, inflation in the euro area countries came to 2.5%, the highest level of the last two years. To a great extent, this reflected the behavior of such items as food and energy. Though this does not yet represent a tendency toward an inflationary spiral, the simple fact that the overall level of inflation has shifted upward beyond the government defined target eliminates any probability of the European Central Bank (ECB) reducing interest rates in the coming months. The most probable scenario, therefore, is one of maintenance of basic interest rates in the current year, with a gradual upturn next year should the process of economic recovery be confirmed. The fact is that the recent high in inflation in the region can be attributed mainly to transitory factors. In this sense, core consumer inflation reached an annual level of 1.9% in April, with no clearly defined tendency.

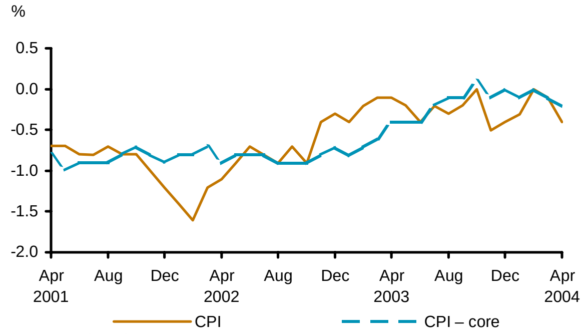
Once again, the Bank of England raised interest rates at the start of May to 4.25% per year, repo rate. Consumer inflation remains low and is not a source of short-term concern. Despite the fact that the central bank has stressed that its priority is to harness inflation at the annual target of 2% over a two year horizon, recent upward movement in real estate prices could become a determining factor in the forecast high in interest rates by the end of the year.

Consumer inflation – United Kingdom
Annual growth



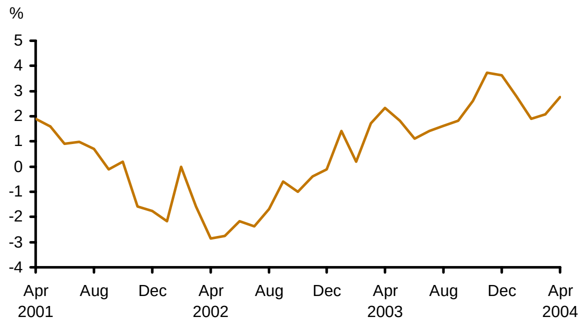
Source: Bloomberg

Consumer inflation – Japan
Annual growth



Source: Bloomberg

Consumer inflation – China
Annual growth



Source: Bloomberg

In Japan, monetary policy has been implemented with the objective of eliminating deflation. Price evolution has not yet shown clear and consistent signs of a sustained high, even though the economy has registered positive rates of growth for eight consecutive quarters. Recent appreciation of the dollar should eliminate the need for the Bank of Japan (BoJ) to constantly intervene in the exchange market to avoid losses of competitiveness in the export sector.

The government of China adopted measures aimed at reducing the rate of economic growth, raising some doubts with regard to the intensity of the impact of these measures on commodity markets and on economic expansion in the other countries of the region (see box: Risks of a Chinese Growth Slowdown – page 66). Compulsory deposits were raised three times in the last 12 months, though the rates are still not sufficiently high to hamper the rapid growth of internal credit operations. More recently, administrative measures were taken with the aim of generating more direct impacts, including the decision that financial institutions are to begin denying new loans to already overheated sectors. Since the country's monetary policy has been guided by its commitment to maintain the value of the domestic currency against the American dollar, it is probable that the central bank will wait for the Federal Reserve to take the first step and only then increase its own internal interest rates. However, it is important to perceive the relativity of the role of interest rates in capital allocations in China since the credit system is based more on government priorities than on price mechanisms. The annual rate of inflation climbed to 2.8% in April. Though high by the standards of recent years, this level does not represent an upward trend and, therefore, is not expected to provoke significant changes in current economic policy.

External financing conditions in Latin America have deteriorated as a result of wariness regarding the impact of an interest rate hike in the United States. However, in most countries of the region, strong balance of payments positions, fiscal consolidation and floating exchange have produced a scenario of considerably less vulnerability to the negative impacts of possible international market turbulence. In this context, recent increases in exchange rates and petroleum prices are not expected to have any significant impact on price levels, provided that they do not continue rising. The fact is that the upward shift in the overall level of inflation in several countries, for the most part reflects a move toward a new phase of economic growth.

Risks of a Chinese Growth Slowdown

The growth rates registered by the Chinese economy in 2003 and in the first quarter of 2004 clearly ratified the dynamism of that country's economy in recent years. However, inflation has been on the rise, having closed 2003 at 3.6% and registered annualized growth between 7% and 8% in 2004. This performance could provoke adoption of additional economic policy measures aimed at slowing the pace of growth and, in this way, reversing the sharp upturn in inflation with as little damage as possible to the growth process. Such measures would involve cutbacks in fiscal incentives, partial liberalization of the capital account, broad restructuring of the highly fragile banking system and a restrictive monetary policy.

Possible reductions in the pace of Chinese growth would primarily impact the commodities market, which has been benefiting from rising world demand. In the case of China, demand has been strongest for raw materials and farm goods. In 2003, China accounted for 5.3% of world imports, according to the World Trade Organization (WTO). In the case of soybeans, participation in world imports in 2002 closed at approximately 20%. In 2003, the country surpassed the United States in consumption of steel, copper and iron ore. In the latter case, Chinese consumption is expected to surpass that of Japan and consolidate that nation's position as the world's largest importer. The country consumes 26.8% of world steel exports, 34.1% of iron ore sales, 18.8% of aluminum, 10.7% of the world's nickel, 19.8% of copper and 40% of global cement exports.

Brazil is China's largest trading partner in Latin America. However, Brazilian sales to that country accounted for only 1.3% of overall Chinese imports in 2003. In that year, Brazilian sales to China expanded by 79.8%, closing at US$4.5 billion or 6.2%

Exports to China – FOB
Main products

US$ million

Itemization	Jan-Apr 2004	%	Jan-Apr 2003	%	2003	%
Total	26 038	100	20 756	100	73 084	100
China	1 567	6.0	1 185	5.7	4 533	6.2
Soybean	356	1.4	298	1.4	1 313	1.8
Iron ore	332	1.3	237	1.1	765	1.0
Soybean oil, crude	169	0.6	30	0.1	256	0.4
Flat-rolled products	143	0.5	111	0.5	460	0.6
Chemical wood pulp	98	0.4	85	0.4	266	0.4
Iron/steel semimanufactures	83	0.3	82	0.4	258	0.4
Hides and skins	54	0.2	32	0.2	116	0.2
Wood, sawn lenghtwise	44	0.2	32	0.2	111	0.2
Motor vehicles engines	31	0.1	19	0.1	125	0.2
Cars/tractors parts	27	0.1	59	0.3	164	0.2
Other	229	0.9	199	1.0	699	1.0

Source: MDIC/Secex

Exports – Main commodities – FOB

US$ million

Itemization	2002	2003	
		Actual	At 2002 prices
Total	10 139	13 561	11 889
Iron ore	3 049	3 456	3 201
Soybean	3 032	4 290	3 776
Soybean oil, crude	675	1 042	844
Flat-rolled products	813	1 410	1 217
Chemical wood pulp	1 160	1 744	1 540
Iron/steel semimanufactures	1 410	1 619	1 311

Source: MDIC/Secex

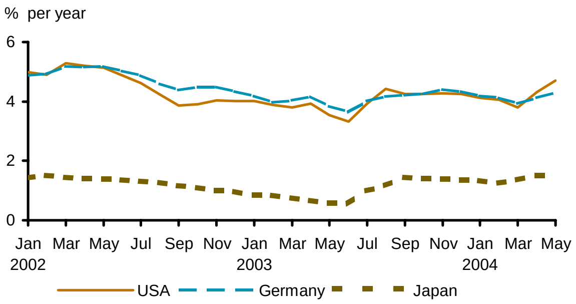
of total Brazilian exports, making China the third most important market for Brazilian foreign sales. In the first four months of the current year, these exports came to US$1.6 billion, equivalent to 6% of total exports in the period, accounting for growth of 32.2% in relation to the same period of 2003. Furthermore, the possible reduction of Chinese external demand would not have a particularly strong impact on Brazilian foreign sales.

More than 50% of Brazilian sales to China were concentrated under soybeans, mostly involving grain and unrefined oil, as well as iron ore. In the first case, soybean exports accounted for 29% of total exports to China in 2003 and 1.8% of total Brazilian foreign sales. At the same time, China is the major individual market of destination for Brazilian soybeans, with a total of 30.6% in 2003, while the European Union absorbs 53.6% and 8.1% is shipped to other Asian countries. Insofar as sales of soybean oil are concerned, exports to China, 24.6%, were surpassed only by shipments to Iran, 45.2%.

An exercise involving the six main commodities exported to China by Brazil, based on the hypotheses of a return to the international price levels in effect in 2002 and maintenance of the volume shipped to that country in 2003, points to the conclusion that overall Brazilian foreign sales would be reduced by US$1.7 billion, for the six products as a whole.

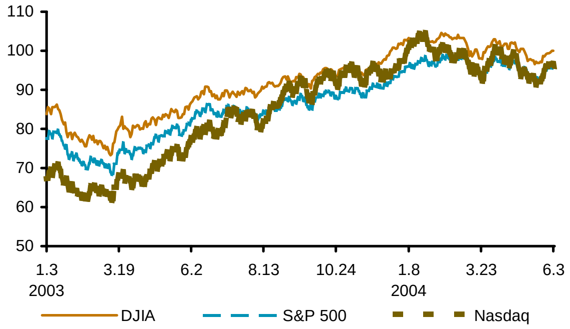
However, maintenance of 2003 volume is a highly conservative hypothesis since all of the commodities selected for the exercise have registered positive sales growth in the current year, when compared to the 2003 results. This has been especially true under soybean oil and iron ore. As far as commodity prices are concerned, the performance registered in the first quarter of the year and the still timid measures adopted up to the present with the aim of dampening the pace of Chinese economic activity, at the same time in which world demand is expected to pick up speed, suggest that any more significant impacts should not be expected before the end of the current year or the early part of 2004. Consequently, according to projections for the current year, the impacts of a possible reduction in Chinese economic growth on Brazilian exports should be quite limited, as regards both price and volume.

Yield on Government bonds[1/]



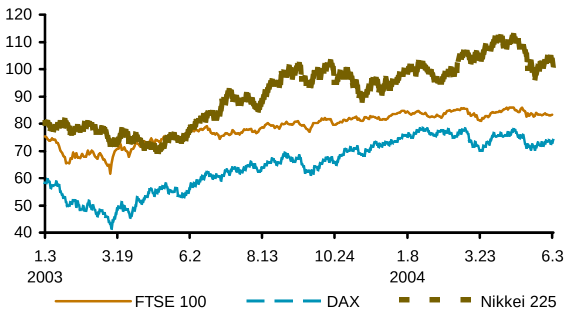
Source: Bloomberg
1/ Monthly average of nominal yields on 10 year bonds.

Stock exchanges – USA
1.4.2002=100



Source: Bloomberg

Stock exchanges – Europe and Japan
1.4.2002=100



Source: Bloomberg

4.3 International financial markets

As of the end of March, international financial markets began registering results that were quite different from the previous period when the principal characteristic was that of stability.

Since mid-April, the fixed income market has become considerably more volatile, once it became clear that United States monetary policy would tend to take a more neutral stance, in light of the consistency of renewed economic growth and elimination of the risk of deflation. Since then, the positive performance of labor market indicators and acceleration in core inflation indices in the United States generated a sustained high in earnings on United States short and long-term Treasury papers.

This upward trajectory, which was also evident in the long-term interest rates of other developed economies, corroborated market expectations that the removal of monetary momentum in the United States could occur in a much nearer future than originally thought possible. Since the end of May, following a period of relative calm, the level of annual earnings on United States Treasury bonds remained in the range of 2.5% for two year papers and 4.7% for 10 year papers, compared to 1.5% and 3.7%, respectively, in mid-March.

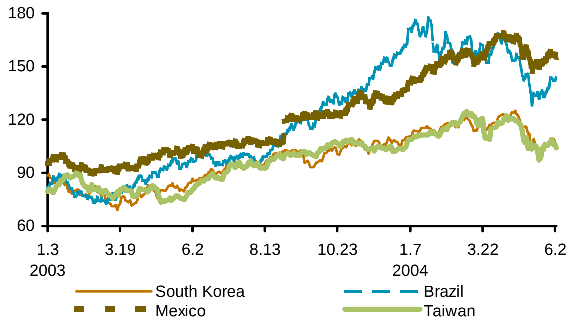
Insofar as the United States stock market is concerned, the DJIA and Standard & Poor's 500 (S&P 500) indices moved along a highly volatile trajectory, with losses in the range of 6% from early April to mid-May, while the Nasdaq, which encompasses shares of high-tech companies, dropped by 9.7%.

In that period, the falloff in world stock exchange prices also reflected uncertainties regarding decelerating economic activity in China, with evident impacts on stock prices in the emerging economies, particularly those of China's important trading partners in the Asian region. The Nikkei 225 index depreciated by 12%, while the Taiwan and South Korean exchanges registered losses of 18%.

Here, it should be stressed that, from April to mid-May, European stock markets were relatively less affected by general market wariness and, as a result, registered declines that varied between 1.7% in the case of the Financial Times Securities Exchange Index (FTSE 100) in England and 7% under the Deutscher Aktienindex (DAX) in Germany. In

Stock exchanges – Emerging markets

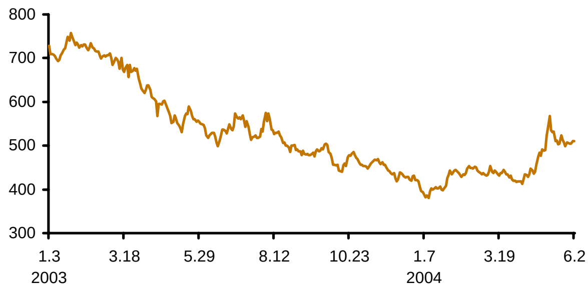
1.4.2002=100



Source: Bloomberg

Emerging Markets Bond Index (Embi+)

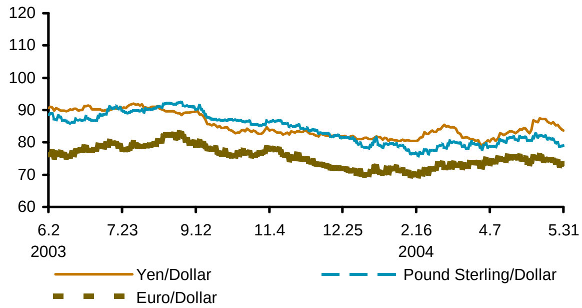
b. p.



Source: Bloomberg

Dollar exchange rates

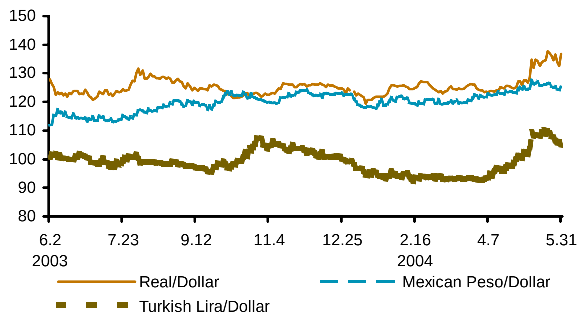
1.4.2002=100



Source: Bloomberg

Emerging markets currencies per US$

1.4.2002=100



Source: Bloomberg

Latin America, the Brazilian Ibovespa and the Mexican Mexbol declined by 21% and 10% respectively. It is important to stress that, since mid-May, most stock markets have registered recovery in stock prices.

In the month of April, international petroleum prices were pressured by growing tensions in the Middle East and perceptions of excess global demand. Definition of increasingly higher price levels acted as a catalyst of financial instability that persisted up to mid-May.

Despite positive performances in most of the emerging economies as regards macroeconomic fundamentals and the outlook for growth, as of mid-April the sovereign bond markets of these nations were hit by a considerable level of nervousness. The Emerging Markets Bond Index (Embi+) registered a highly volatile trajectory up to the first week of May, reflecting strong upward movement in the value of premiums on the papers issued by Turkey, Venezuela, Russia and Brazil.

In the second half of May, the volatility of financial markets in general lessened. As tensions decreased, stock market indices began moving upward, reductions were registered in premiums by the Embi+ and earnings on the long-term papers issued by the industrialized countries tended to stabilize at a somewhat lower level. It should be stressed that, given the reduction in premiums, Embi+ has settled back to a new level since the last week of May in the range of 507 points, compared to an average of 418 points since the start of April. Note that the new level is still considered to be rather low in historical terms.

The performance of exchange markets accompanied interest rate movements, with upward movement in the value of the United States dollar against the major currencies and those of the emerging countries, up to the second week of May. From that point forward, as expectations regarding the evolution of United States monetary policy began to shift, the dollar began depreciating against the same currencies, without however returning to the previously registered levels.

Considering rates of exchange on March 23, when expectations of an interest rate rise in the United States intensified, and those in effect on May 14, the dollar appreciated by 7.3% against the yen, 5% against the pound sterling and 4.6% and 4.4%, respectively, against the Canadian dollar and euro. In relation to the currencies of Turkey, Brazil and Mexico, the dollar appreciated at a more intense pace of 16.3%, 7.3% and 5.9%, in the same order.

The Institute of International Finance (IIF) forecasts that private investments in the emerging economies will reach US$225.6 billion in 2004, 16% more than in 2003, compared to the January forecast of US$196.2 billion. Latin America could be the target for flows of as much as US$43.1 billion, corresponding to expansion of 76.6% in comparison to the 2003 flow and 11.1% when viewed against the previous estimate. These projections are compatible with those of the International Monetary Fund (IMF) for international capital flows, as published in *World Economic Outlook* in April.

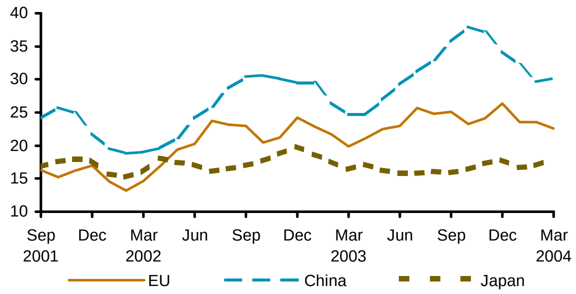
According to the IIF and IMF, economic growth and maintenance of consistent macroeconomic policies in the emerging countries should stimulate new growth in private capital flows to these nations in the current year. It is important to note that these projections were based on a scenario of gradual growth in international interest rates during the remainder of the year.

4.4 World trade

Trade flows in the first quarter of 2004 reflected continuation of the process of global recovery that began in the second half of 2003. The United States and the countries of Asia were the major axes around which this growth revolved.

Trade deficit – USA[1/]

US$ billion



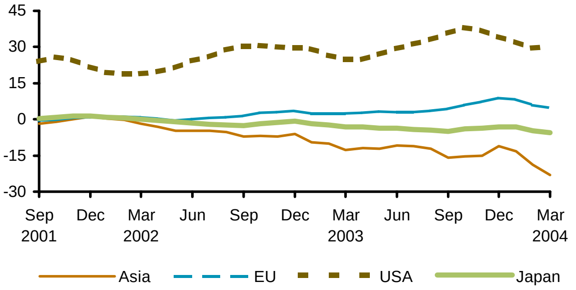
Source: Bloomberg
1/ Quarterly moving average.

Trade flows in the United States registered consistent increases in the first quarter of the year. The strength of the recovery in the United States was reflected in increased demand for imports, which expanded by 10.3% compared to the same quarter of 2003, particularly under acquisitions of capital goods and industrial inputs. Oil imports increased in both volume and prices as a result of increased internal consumption and higher international prices.

Exports expanded by 11.9% in the period, as a result of increased global economic activity and depreciation of the dollar. The growth process was a generalized phenomenon, but was particularly strong under sales of capital goods, industrial supplies and consumer goods. Though exports have been expanding since 2001, the pace of the increase in imports in recent months has been even more intense, as the trade deficit increased by 8.3% in the quarter.

In the euro area countries, foreign trade has been an important source of economic growth, as is evident in the fact that the trade surplus of the region increased by more than 100% in the first quarter of 2004, based on stable imports

Trade balance – China[1/]
US$ billion



Source: Bloomberg
1/ Quarterly moving average.

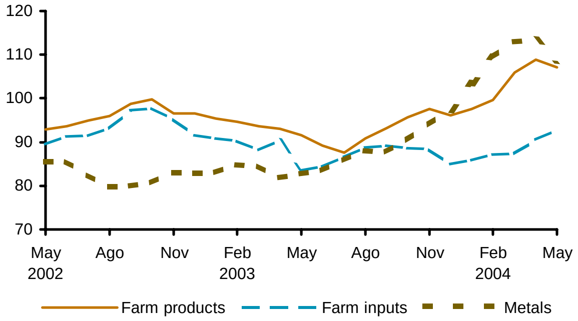
and 4% growth in exports. It should be noted that growth in the bloc's trade flows with China, Russia and Japan has increased, in detriment to operations with the United States and United Kingdom, with particularly strong expansion in German trade flows.

Asia is still the most dynamic region in terms of the activity level and international trade. In Japan, exports expanded by 11.7% in the first quarter of 2004, compared to the same period of 2003, and imports increased by 4.2%, generating growth of 52% in the balance of trade. Volume data, which are quite important to evaluating impact on GDP, point to an increase of 16.8% in exports and 13.9% under imports. In the month of February, the Japanese bilateral trade balance with China closed with a surplus, for the first time since 1994.

The Chinese balance of trade registered a deficit of 8.4 billion in the first quarter of 2004. This result was sharply higher than in the corresponding quarter of 2003 and was based on increases of 34.1% and 42.1%, respectively, in exports and imports. Strong Chinese demand for energy and raw materials, coupled with upward movement in the prices of these goods, explain the performance of the foreign trade sector. Another factor that contributed to the deficit in the period was a cutback in fiscal incentives to exports, as of Janeiro 2004. This decision resulted in anticipated shipments in the final quarter of 2003, while to some extent discouraging exports sector operations by cutting into its profit margins. Chinese government adoption of measures aimed at reducing investments could result in cutbacks in imports of raw materials and machinery and aid in correcting trade sector imbalances. In the same sense, the measures adopted to restrict credit are expected to have a similar impact.

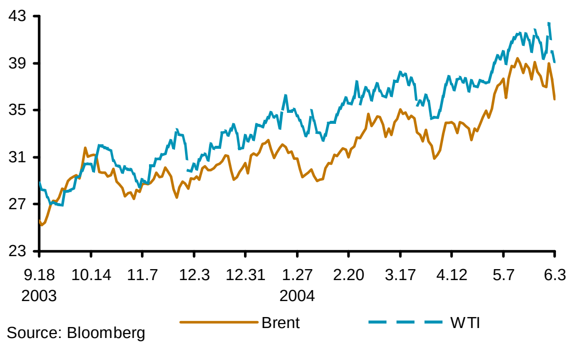
The Argentine trade surplus dropped by 34.3% in the first quarter of 2004, when compared to the same period of the previous year, due basically to 85% growth under imports. Export growth of 11% in the quarter was mostly a result of higher prices (in more specific terms, approximately 60% of this expansion). When one considers the same basis of comparison, the Mexican trade deficit increased by more than five times, as a result of 10.6% expansion under exports and 11.5% under imports. In the case of Chile, the trade surplus expanded by 128%, as a result of 39% growth in exports and 17.7% under imports. The Chilean trade surplus benefited from continued high international prices for metals.

Commodity price index in SDR
1995 = 100



Source: IMF

Oil – Spot market
US$ per barrel



Source: Bloomberg

4.4.1 Commodities

The commodities market has continued drawing benefits from world economic recovery, despite the fact that the prices of the major agricultural and metallic commodities have oscillated sharply in recent months.

The credit restrictions adopted by the Chinese government in the early months of the year imposed limits on import financing in that country and clearly impacted the prices of primary agricultural and mineral goods, since expanding Chinese demand for these products has been singled out as one of the major causes of the increases registered under commodity prices in the world market. This situation is even more evident in the cases of soybeans, copper and aluminum.

In the short-term, expectations are that the volatility of major commodity prices will continue, particularly as a result of even clearer signs of a dampening of Chinese economic expansion and the prospects of growth in United States interest rates. These fluctuations are expected to be even more severe in the case of farm commodities, which will depend for the most part on projections of the grain harvest in the major producer countries, particularly the United States, and on that country's stockpiles. However, over the medium and long-term, commodity prices are not expected to decline, particularly in light of the low level of world stockpiles, still strong demand and limited international output of the major metals.

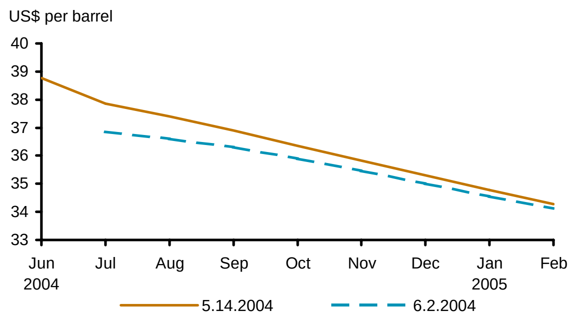
4.4.1.1 Petroleum

Political instability in the Middle East and low United States stock levels, coupled with recovery in that country and the pressures generated by Chinese demand, have contributed to the upward spiral in international oil prices, which have shot beyond the upper band limit of US$22-US$28/barrel defined by the Organization of Petroleum Exporting Countries (Opec).

On June 1, the per barrel price of West Texas Intermediate (WTI) came to US$42.33, reflecting an increase of 6.14% compared to the final May price, while the per barrel price of Brent-type oil increased by 5.41%. Between the end of March and May, the per barrel prices of Brent and WTI climbed by 14.28% and 11.52%, respectively.

Opec has been pressured to raise supply ever since it cut the volume of output by 1.5 million barrels/day (mbd) as of the month of April. Consequently, on June 3, the Organization decided to raise petroleum output by 2 mbd to 25.5 mbd, as of July 1. This was the largest increase in production quotas in the last ten years and represented a jump of 8%. The Opec agreement also calls for an additional output increase of 0.5 mbd as of August. The cartel is scheduled to meet again on July 21.

Brent Oil – Futures market



Source: Bloomberg

Analysis of the evolution of prices on the futures market suggests a downward tendency in oil prices in the coming months, particularly as a result of Opec's decision to raise production. However, it is highly doubtful that prices will descend into the range defined by the cartel, mainly in light of increased Chinese demand, greater seasonal consumption in the United States and continued terrorist threats, all of which will continue pressuring prices upward.

4.5 Conclusion

The recent positive performance of the world economy has made it necessary to revise growth estimates for 2004 and 2005. It is now expected that continued recovery in the profit levels of the business sectors of varied economic regions, resulting mostly from improved financing conditions and positive financial market evolution, will continue driving investments. At the same time, in response to increased demand, one can expect significant additional growth in world trade and worldwide processes of stock replenishment. Specific regions will continue drawing benefits from higher commodity prices, as a result of greater demand in the more dynamic economies.

GDP growth forecasts

%

	2004			2005		
	IMF	World Bank	OECD	IMF	World Bank	OECD
USA	4.6	4.6	4.7	3.9	3.2	3.7
Japan	3.4	3.1	3.0	1.9	1.4	2.8
Euro Area	1.7	1.7	1.6	2.3	2.3	2.4
Germany	1.6	-	1.1	1.9	-	2.1
France	1.8	-	2.0	2.4	-	2.6
Italy	1.2	-	0.9	2.0	-	1.9
China	8.5	-	8.3	8.0	-	7.8
Latin America	3.9	3.8	-	3.7	3.7	-
World	**4.6**	**4.6**	**-**	**4.4**	**4.1**	**-**

Sources: IMF, World Bank and OECD

These factors should be contrasted with the imminent attenuation of monetary incentives in the United States and other developed economies. These economies are now facing the possibility of renewed inflation, which has already been noted in the United States and China and is now being further intensified as a result of rising oil prices. Continuation of world economic growth must also deal with the risks that have been present since last year, including threats of geopolitical instability, the possibility of a reversal in the flow of capital resources to the emerging economies and fiscal and current accounts deficits registered in the United States. Though highly improbable over the short-term, a significant fiscal adjustment could result in an economic slowdown. Though the external imbalances of the United States have been partially offset by depreciation of the dollar, this is a problem that will not be resolved as long as domestic demand in that country expands at a faster pace than in other nations.

Over the short-term, underlying uncertainties regarding an expected monetary squeeze in the United States tend to introduce a certain degree of volatility into markets in general, since they will continue reacting every time the basic indicators of that are economy are periodically announced.

5 Foreign sector

The positive performance of Brazilian exports in the current year has made it possible for the country to obtain consistently larger trade surpluses, even in a framework of rising imports generated by the upturn in economic activity. In the same sense, the trade-related exchange balance turned in positive results, easily offsetting net remittances related to financial operations and closing with overall net inflows of external resources. Current accounts closed with a surplus, thus reducing balance of payments borrowing requirements and, consequently, increasing the Brazilian economy's resistance to adverse changes in the international economic environment.

Current accounts registered a surplus of US$2.4 billion in the first five months of the year, compared to a positive balance of US$43 million in the same period of 2003. Considering the balance accumulated in the 12 month period ended in May, this account turned in a surplus of US$6.4 billion, compared to a deficit of US$492 million in the corresponding period of 2003.

In this context, projections for the performance of the external sector of the economy included in this report are based on a trade surplus higher than that of 2003 and full rolling of medium and long-term private external liabilities, resulting in a highly positive balance of payments outlook for 2004 (see box: Balance of Payments Projection – page 78).

5.1 Exchange movement

The exchange market result for the year up to May reflected net contracting of US$8.3 billion, compared to US$1.9 billion in the same period of 2003. The trade-related exchange balance practically doubled, moving from US$9.4 billion to US$18 billion, driven by an increase of US$11 billion in exchange contracting for export operations, which closed at US$38.7 billion in the first five months of 2004. Contracting for purposes of imports reached US$20.6 billion and were US$2.3 billion higher than operations in the period from January to May 2003.

Foreign exchange transactions

US$ billion

Itemization	2003			2004	
	May	Jan-May	Year	May	Jan-May
Operations with clients in Brazil	0.5	3.0	2.4	1.7	8.8
Commercial	3.2	9.4	28.4	5.2	18.0
Exports	6.7	27.6	73.2	9.2	38.7
Imports	3.5	18.3	44.8	4.0	20.6
Financial[1/]	-2.6	-6.3	-26.0	-3.4	-9.2
Purchases	5.1	25.9	72.1	5.4	30.3
Sales	7.8	32.2	98.1	8.8	39.5
Operations with banks abroad (net)[2/]	0.1	-1.2	-1.7	-0.2	-0.6
Balance	0.6	1.9	0.7	1.6	8.3

1/ Excluding interbank operations and Banco Central foreign operations.
2/ Purchase/sale of foreign currency and gold in exchange for domestic currency. Exchange contracts.

Contracting operations on the financial exchange market registered net outflows of US$9.2 billion or US$2.9 billion more than in the equivalent period of 2003, due mostly to an increase of US$7.3 billion in foreign currency sale operations. Increases were registered in the volume of purchases, 17%, and in that of sales, 22.6%. Contracting of operations with institutions abroad (CC5) registered net remittances of US$565 million up to May, corresponding to US$590 million less than in the same months of the preceding year.

With the exchange market result, the exchange position of banks was reversed. At the end of 2003, the banking sector was in a US$2.8 billion sold position on the spot market. As of April, with the strong inflow of external resources, banks registered bought positions with US$1.2 billion in April and US$3 billion in May, corresponding to a difference of US$5.8 billion when compared to the end of last year.

Accumulated depreciation of the real against the United States dollar reached 8.3% in the first five months of the year, indicating the existence of significant uncertainty regarding the pace of the probable change in interest rate levels in United States in coming months, as well as the recent evolution of petroleum prices. Consequently, since mid-April, the exchange rate has been more volatile, closing May at R$3.1291 per dollar. When one considers the current bought position of banks, the continuity of positive exchange market flows and the behavior of current accounts, the most probable exchange rate scenario involves no significant pressures in the coming months.

5.2 Trade in goods

In the period extending from January to May 2004, exports reached US$34 billion, setting a new record for the first five months of the year, with growth of 25.3% when compared to the same period of 2003. Imports remained on the growth curve noted since the fourth quarter of 2003, reaching a level of US$4.8 billion in May or 25.1% more than in May 2003, and an accumulated total of US$22.7 billion in the year, for growth of 19.1% compared to the January-May period of the preceding year.

Trade balance – FOB

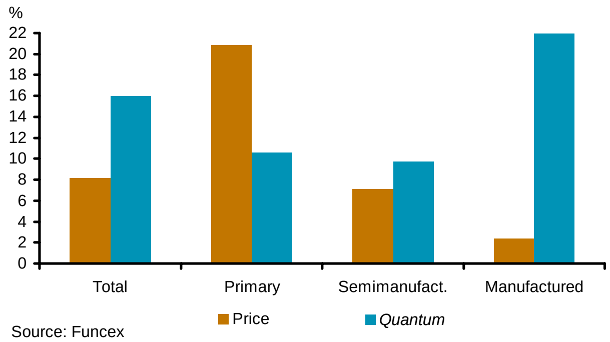
US$ million

Period		Exports	Imports	Balance	Trade flow
Jan-May	2004	33 979	22 735	11 243	56 714
Jan-May	2003	27 128	19 083	8 044	46 211
% change		25.3	19.1		22.7

Source: MDIC/Secex

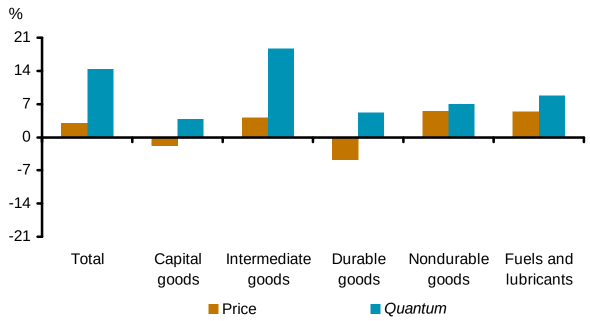
Note: In Jan-May/2003, 102 working days; in Jan-May/2004, 103 working days.

Exports – Price and volume indices
January-April 2004/2003



Source: Funcex

Imports – Price and volume indices
January-April 2004/2003



Source: Funcex

With the May trade surplus of US$3.1 billion, the accumulated surplus in the first five months of the year totaled US$11.2 billion. It is worth noting that the trade flow came to US$56.7 billion from January to May, corresponding to 22.7% more than in the same period of 2003.

The positive result of export operations in the first four months of the year was a consequence of 15.9% expansion in the volume of exports and 8.1% growth in prices, based on a comparison with the same period of 2003.

According to data released by the Center of Foreign Trade Studies Foundation (Funcex), foreign sales of basic products registered increases of 20.9% in prices, corroborating the high in international commodity prices, and 10.6% in volume, compared to the same period of 2003.

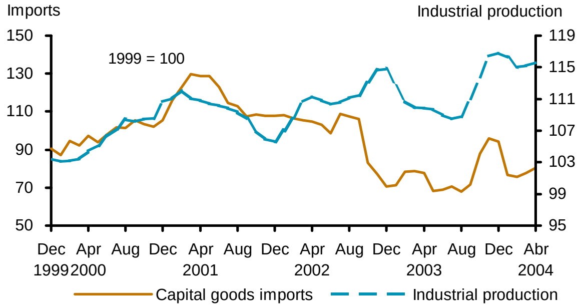
In the case of semimanufactured products, growth came to 9.7% in volume and 7.1% in prices in the four month period. Sales of manufactured goods, which account for more than half of total exports, benefited from recovery in the economies of the United States and Latin America, the major destinations of this category, with highs of 22% in exported volume and 2.4% in prices, in the four month period.

In the month of May, growth in exports reached the level of 27.4% for manufactured products, 27.2% for basic goods and 10.4% for semimanufactured products, compared to the same month of the previous year. It should be noted that sales of basic and semimanufactured goods benefited from the rise in external prices. In the first case, one should highlight such items as soy meal, with 47.1%; petroleum, with 45.8%; beef, 36.6%; and iron ore, with 35.6%. With regard to foreign sales of semimanufactured products, the most important price changes occurred under semimanufactured iron and steel goods, with 34.1%; unrefined soybean oil, with 30.1%; and unrefined aluminum, with 25.4%.

When total imports in the first four months of the year are considered, imported volume expanded by 14.3% while prices rose by 2.9%, compared to the same period of 2003. All of the final use categories registered growth in the quantum index, with 5.2% under consumer durables; 6.9% under nondurables; 8.7% in the case of fuels and lubricants; 3.9% in capital goods; and 18.8% under raw materials.

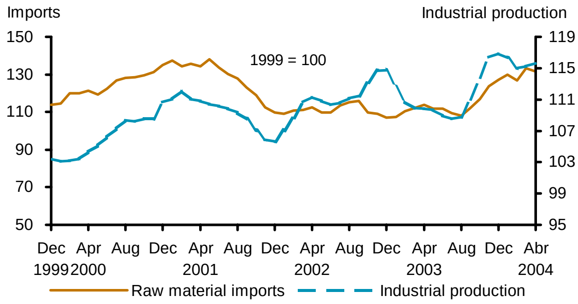
As far as evolution of the prices of imported goods is concerned, nondurable consumer goods led the way with growth of 5.5%, followed by fuels and lubricants with 5.3% and raw materials and intermediate goods with 4.1%. In

Capital goods imports x industrial production
Seasonally adjusted indices – 3 month moving average



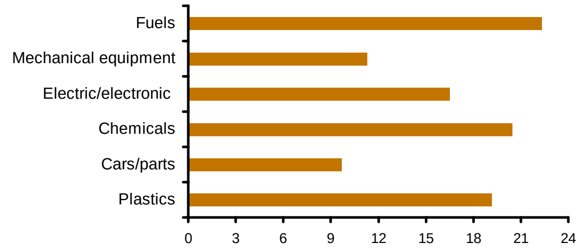
Sources: IBGE and Funcex

Raw material imports x industrial production
Seasonally adjusted indices – 3 month moving average



Sources: IBGE and Funcex

Imports by main sectors
January/May-2004/2003
Percentage change over the same period of the last year[1/]



Source: MDIC/Secex
1/ Daily average. In Jan-May/2003, 102 working days; in JanMay/2004, 103 working days.

the opposite sense, the prices of consumer durables dropped by 4.8% and those of capital goods by 1.8%.

Comparisons of volume indices for imports of capital goods and raw materials and intermediate goods with the industrial output index point to a positive and growing ratio over recent months. In this context, strong growth in the volume of imports under these segments indicates an ongoing process of industrial expansion.

Imports increased over the first five months of the year in most of the sectors analyzed, with particularly strong growth under fertilizers, with 65.4%; cotton, 61.3%; and paper and paper goods, 45.4%. It should be stressed that the increase in imports of fertilizers, which is a clearly seasonal phenomenon, was influenced mainly by levying of the Social Integration Program/Social Security Contribution (PIS/ Cofins) on imports. This was originally scheduled to go into effect as of May 1, but was suspended by a Provisional Measure issued one day prior to that date.

Aside from this, positive increases were also registered under imports of fuels and lubricants, with 22.3%; chemical products, 20.5%; plastics, 19.2%; electric-electronic home appliances, 16.5%; mechanical equipment, 11.3%; and automotive vehicles and parts, 9.7%. These groupings accounted for 63.2% of the nation's overall imports. Among the sectors that registered reduced imports in the period, the most important were cereals, 18.9%; milk and derivatives, 39.9%; and aluminum, with 3.6%.

With respect to the markets of destination for Brazilian exports in the first five months of the year, an increase of 74.1% was registered in sales targeted to Southern Common Market (Mercosul), driven by 78.5% expansion in sales to Argentina, compared to sales in the same months of 2003. At the same time, strong expansion was registered in exports channeled to the Latin American Association of Integration (Aladi), except Mercosul, with 43%; Eastern Europe, with 41.2%; the European Union, 27.2%; and Asia, with 20.4%. Though exports to the United States expanded by only 1.2% in the period, that country is still the major market of destination for the nation's foreign sales, with total acquisitions of US$7 billion, followed by Argentina, with US$2.6 billion, and China, with US$2.1 billion.

The momentum gained by export operations in recent years has been based not only on expanded sales to traditional trading partners, but also on exports to countries with which the nation has never previously registered significant sales

Exports and imports by geographic area – FOB
January-May

US$ million

Itemization	Exports			Imports			Balance	
	2003	2004	% change	2003	2004	% change	2003	2004
Total	27 128	33 979	25.3	19 083	22 735	19.1	8 044	11 243
Laia	4 412	6 879	55.9	3 306	3 671	11.0	1 106	3 208
Mercosur	1 834	3 193	74.1	2 391	2 404	0.5	- 558	789
Argentina	1 471	2 625	78.5	2 007	2 074	3.4	- 536	551
Other	363	568	56.2	385	330	- 14.4	- 22	238
Mexico	978	1 346	37.7	204	257	26.3	774	1 089
Other	1 600	2 340	46.3	711	1 011	42.1	889	1 330
USA[1/]	6 894	6 980	1.2	3 782	4 440	17.4	3 113	2 540
EU	6 759	8 595	27.2	5 271	5 800	10.0	1 488	2 796
E. Europe[2/]	742	1 048	41.2	364	502	37.9	378	546
Asia	4 337	5 223	20.4	3 430	4 138	20.7	907	1 085
Japan	817	988	20.9	945	1 026	8.6	- 128	- 38
South Korea	439	535	22.0	473	616	30.1	- 35	- 80
China	1 774	2 117	19.3	737	1 160	57.5	1 037	957
Other	1 307	1 583	21.1	1 275	1 337	4.8	32	246
Sundry	3 983	5 253	31.9	2 930	4 183	42.8	1 053	1 069

Source: MDIC/Secex

1/ Includes Puerto Rico.
2/ Albania, Bulgaria, Hungary, Poland, Slovak Republic, Czech Republic, Rumania and countries of the former Soviet Union.

Exports to Argentina and other countries – FOB
Monthly average January-May/2004

% change[1/]

Itemization	Argentina	Other	Total
Total	76.8	21.0	24.0
Manufactured products	85.3	18.5	24.3

Source: MDIC/Secex

1/ Over the same period of the last year.
Note: In Jan-May/2003, 102 working days; in Jan-May/2004, 103 working days.

value. In this context, foreign sales to the countries of Latin America that do not belong to the Laia group increased by 122.6% in the period extending from January to April 2004, compared to the same period of the previous year, followed by growth in exports to Africa, 62.3%; Eastern Europe, 52.9%; the Central American Common Market, 46.9%; and the European Free Trade Association, 42.7%; all of which registered rates higher than the 25.5% increase in overall exports in the period.

In terms of imports, purchases from all of the major economic regions expanded, with the exception of Mercosul, which remained stable. Here, purchases from Aladi (excluding the Mercosul countries) expanded by 38.5%, particularly those involving copper, gas, petroleum, electric and electronic apparatuses and components. Imports from Western Europe increased by 37.9%, with a particularly strong performance under fertilizers; those originating in Asia expanded by 20.7% and were concentrated under electric and electronic components and instruments, machines and equipment, chemical products and optical and precision instruments; imports from the USA grew by 17.4%, powered by purchases of machines and equipment, motors, aircraft engines and parts and electric and electronic components and apparatuses; and those from the European Union moved up by 10%, particularly machines and equipment, electric and electronic components and apparatuses, organic chemical products, auto parts and vehicles and pharmaceuticals.

As far as trade exchanges are concerned, the flow registered with the Laia countries increased from US$7.7 billion from January to May 2003 to US$10.6 billion in the same period of 2004. This performance reflected increases of 55.9% under exports and 11% under imports, with expansion of 78.5% in exports to Argentina, which came to a total of US$2.6 billion. As far as the European Union is concerned, the trade flow expanded by 19.7% to US$14.4 billion, while operations with the United States moved upward by 7% to a total of US$11.4 billion. In Asia, growth in trade flows with China increased by 30.5% and accounted for US$766 million of the total of US$1.6 billion in growth in trade exchanges with that region of the world.

5.3 Services and income

The positive 2003 performance under current accounts persisted into the first five months of the current year. This

Balance of Payments Projection

Uses and sources

US$ billion

Itemization	2003			2004		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Uses	-0.5	-8.6	-23.1	-0.3	-11.1	-34.4
Current account	0.9	0.0	4.1	1.5	2.4	2.5
Amortizations ML-term[2/]	-1.4	-8.7	-27.2	-1.8	-13.5	-36.9
Securities	-0.3	-2.7	-10.3	-0.8	-7.6	-20.4
Paid	-0.1	-2.4	-7.9	-0.8	-7.3	-20.1
Refinanced	0.0	0.0	-1.2	0.0	0.0	0.0
FDI conversions	-0.2	-0.3	-1.2	0.0	-0.3	-0.3
Suppliers' credits	-0.2	-0.7	-2.0	-0.2	-1.0	-2.6
Direct loans[3/]	-0.9	-5.2	-15.0	-0.9	-4.9	-13.9
Sources	0.5	8.6	23.1	0.3	11.1	34.4
Capital account	0.0	0.2	0.5	0.1	0.3	0.7
FDI	0.5	3.3	10.1	0.2	3.3	12.0
Domestic securities[4/]	0.1	0.5	3.1	-0.1	1.1	3.0
ML-term disbursements[5/]	2.0	6.7	22.9	1.0	7.8	29.4
Securities	1.3	2.3	11.8	0.3	4.2	16.6
Supliers' credits	0.1	0.5	1.0	0.1	0.4	1.3
Loans[6/]	0.6	3.9	10.1	0.7	3.3	11.5
Brazilian assets abroad	-0.3	-2.7	-8.9	-2.6	-0.8	-8.3
Loans to Bacen	0.0	3.9	4.8	0.0	-1.4	-4.3
Other[7/]	-0.6	0.7	-1.0	1.4	2.9	0.1
Reserve assets	-1.2	-4.0	-8.5	0.3	-2.2	1.8

1/ Forecast.
2/ Registers amortization of medium and long term supliers' credit, loans and securities placed abroad minus refinancing and discounts. Excludes amortizations referring to loans to Banco Central and intercompany loans.
3/ Registers amortizations loans borrowed from foreign banks, buyers,

The 2004 balance of payments projection stated in this Inflation Report has been updated in relation to the previous Report, in order to incorporate the results registered up to May together with the calculation of the external debt stock, based on the March position.

Current accounts are expected to close the year with a surplus of US$2.5 billion, equivalent to 0.4% of GDP, compared to the previous forecast of US$0.2 billion. The factors that contributed to the new result were mainly new values projected for the trade balance, interest and profits and dividends.

Exports accumulated in the year up to May came to US$34 billion. The daily median closed at US$330 million, for expansion of 24% compared to the same period of 2003. Based on this result, settlements of export exchange contracting operations and the seasonal nature of the series, the projection for exports in 2004 was revised upward from US$80 billion to US$83 billion. In the case of imports, the result up to May (US$22.7 billion) reflected 18% growth in the daily median to US$221 million. Consequently, the projection for 2004 imports was also revised upward from US$56 billion to US$57 billion. In this way, the trade surplus projection moved to US$26 billion or US$2 billion more than forecast in the March Inflation Report.

Net payments of interest projected for the year were reduced from US$14.4 billion to US$13.6 billion. On the one hand, this reduction reflects a downward revision of the external debt stock, calculated on the basis of the March 2004 position. This led to a cutback in forecast expenditures from US$15.9 billion to US$15.4 billion. On the other hand, the outlook for interest inflows in the year increased from US$1.5

billion to US$1.8 billion. With regard to profits and dividends, the increase in remittances in the period from January to May 2004, compared to the same period of the previous year, indicated the need for revising these outlays to US$8 billion, with net remittances forecast at US$7.2 billion.

Net remittances of the service account were slightly lower, falling from US$6.2 billion to US$5.8 billion. Based on the results registered in the early months of the year, current unrequited transfers were revised to an inflow level of US$3 billion, compared to the previous projection of US$2.5 billion.

The balance of payments financial account is expected to register larger net remittances than originally forecast in the March Inflation Report. This result reflects revised foreign direct investments and rates of rolling the medium and long-term private sector external debt.

Foreign direct investments accumulated a total of US$3.3 billion in the first five months of the year and, therefore, remained stable when compared to the same period of 2003. Revision of this projection from US$13 billion to US$12 billion not only includes the results up to this point in the year, but also considers the outlook for growth in the monthly flows of foreign direct investment in the June-December period to levels slightly below the monthly median registered in 2002, a performance that is clearly in keeping with the process of sustained recovery in the country's activity level.

The rates of rolling the private sector debt were revised to 100% in the year, with 95% for papers and 115% for direct loans. Revision of medium and long-term external debt amortizations for 2004 resulted in a reduction of US$1.8 billion in these commitments, which totaled US$36.9 billion, of which US$14.2 billion involved private papers and US$3.5 billion reflected direct private sector loans. Furthermore, the calculation of the rate of rolling includes the forecast exercise of US$1 billion in put/call options, of which US$268 million were already registered in the period from January to May. In this way, private sector indebtedness is not expected to exert any significant pressure on balance of payments financing in 2004.

Projection of the balance of payments also includes net inflows of portfolio investments totaling US$3 billion; net remittances of US$5.3 billion reflecting banking sector assets abroad, with repercussions on the exchange position of banks which is expected to close the year in a bought position of US$2.5 billion; inflows of US$4 billion in bonds of the Republic; amortizations of US$4.3 billion paid to the IMF; and equilibrium in short-term capital flows. The overall result of the balance is projected to be positive at US$1.8 billion.

Current account

US$ billion

Itemization	2003 May	2003 Jan-May	2003 Year	2004 May	2004 Jan-May	2004 Year[1/]
Current account	0.9	0.0	4.1	1.5	2.4	2.5
Trade balance	2.5	8.0	24.8	3.1	11.2	26.0
Exports	6.4	27.1	73.1	7.9	34.0	83.0
Imports	3.9	19.1	48.3	4.8	22.7	57.0
Services	-0.5	-1.7	-5.1	-0.2	-1.3	-5.8
Transportation	-0.1	-0.7	-1.7	-0.1	-0.7	-2.0
International travel	0.0	0.1	0.2	0.1	0.4	0.0
Computer and information	-0.1	-0.4	-1.0	-0.1	-0.5	-1.2
Operational leasing	-0.2	-0.7	-2.3	-0.1	-0.7	-2.3
Other	0.0	-0.1	-0.2	0.0	0.2	-0.4
Income	-1.4	-7.3	-18.6	-1.7	-8.8	-20.7
Interest	-0.9	-5.2	-13.0	-0.9	-5.7	-13.6
Profits and dividends	-0.6	-2.1	-5.6	-0.8	-3.2	-7.2
Compensation of employees	0.0	0.0	0.1	0.0	0.1	0.1
Current transfers	0.2	1.0	2.9	0.3	1.3	3.0

1/ Forecast.

Financial account

US$ billion

Itemization	2003 May	2003 Jan-May	2003 Year	2004 May	2004 Jan-May	2004 Year[1/]
Financial account	0.4	4.4	4.6	-2.2	-0.9	-4.9
Direct investments	0.5	2.6	9.9	0.2	2.9	11.0
Abroad	0.0	-0.7	-0.2	0.0	-0.4	-1.0
In Brazil	0.5	3.3	10.1	0.2	3.3	12.0
Equity capital	1.0	3.1	9.3	0.4	3.9	11.0
Intercompany loans	-0.5	0.2	0.8	-0.2	-0.5	1.0
Portfolio investments	0.9	2.1	5.3	-0.9	-3.1	-0.9
Assets	-0.2	-0.2	0.2	-0.2	-0.3	-0.1
Liabilities	1.0	2.4	5.1	-0.7	-2.7	-0.8
Derivatives	0.0	0.0	-0.2	-0.3	-0.2	0.0
Other investments	-0.9	-0.3	-10.5	-1.3	-0.6	-15.0
Assets	-0.3	-2.1	-9.5	-2.2	-0.2	-7.8
Liabilities	-0.6	1.9	-1.0	1.0	-0.4	-7.2

1/ Forecast.

result was impacted by the trade surplus, which remained on an upward growth curve as a consequence of the performance of the export sector and, to a lesser extent, of the 26.8% rise in the positive balance under unrequited transfers.

Net spending on services turned in a decline of 24.9% from January to May, compared to the result for the corresponding period of 2003. In the opposite sense, net remittances of income increased by 20.9%, using the same basis of comparison.

The net result of the service account indicated an increase of 1.3% under spending on transportation, with growth of 112.6% in net outlays on tickets and 10.1% in net spending on freight. International travel accumulated net revenues of US$377 million from January to May, compared to US$113 million in the corresponding period of 2003. Repeating the trend toward a surplus apparent since September 2002, the accumulated twelve month balance under this heading came to US$481.2 million, the highest since April 1990.

Net revenues on business, professional and technical services added up to US$1 billion from January to May, for an increase of 27.3% in the period. Net spending on equipment rentals totaled US$687 million, for a reduction of 4.7% compared to the same period of 2003. Net outlays on royalties and licenses added up to US$496 million and those involving computer and information services accounted for US$488 million. These figures were 13.9% and 25% higher than the results for the first five months of 2003, respectively.

Net remittances of income abroad reached US$8.8 billion from January to May 2004, corresponding to an increase of 20.9% over the same period of the preceding year. This result reflected a 50.8% high under net remittances of profits and dividends, which totaled US$3.2 billion. Net payments of interest expanded by 9.5% in the period, totaling US$5.7 billion.

5.4 Financial account

The balance of payments financial account registered net outflows of US$934 million from January to May. Net foreign direct investments added up to US$3.3 billion, encompassing US$3.9 billion in inflows in the form of stock participation and US$549 million in repatriations of intercompany loans.

BP financing sources
Selected items

US$ billion

Itemization	2003			2004		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Medium and long-term funds	1.6	3.2	13.4	0.7	5.8	20.5
Public bonds[2/]	1.0	1.0	4.5	0.0	1.5	4.0
Private debt securities	0.3	1.3	6.0	0.3	2.7	12.5
Direct loans	0.3	0.8	2.9	0.4	1.6	4.0
Short-term loans[3/]	-0.7	-0.8	-3.7	-0.2	-1.4	0.0
Short-term securities	0.0	2.2	0.3	-0.1	-0.4	0.0
Roll-over rates[4/]						
Public bonds	n.a.	n.a.	130%	n.a.	n.a.	73%
Private debt securities	219%	139%	138%	36%	80%	95%
Direct loans	179%	52%	85%	287%	156%	115%

1/ Forecast.
2/ Excludes bond swap in August 2003.
3/ Includes direct loans and trade credits transferred by banks.
4/ Roll-over rate equals the ratio of disbursements to amortizations, excluding amortizations of securities and loans converted into direct investment.

Foreign portfolio investments represented net remittances of US$2.7 billion, compared to a net inflow of US$2.4 billion in the same period of 2003. Stock investments accumulated net inflows of US$1 billion up to May. The rates of rolling long-term private sector bonds, notes and commercial papers closed at 80%, when compared to the 139% figure registered in the same period of 2003. The rate of rolling in relation to direct loans increased sharply, closing at 156% as against 52% in the corresponding period of 2003.

In the period extending from January to May 2004, gross international reserves expanded by US$1.2 billion to a level of US$50.5 billion, while net international reserves increased by US$3.9 billion to US$24.5 billion. Based on the IMF concept, adjusted net international reserves increased by US$4.8 billion to a level of US$22.2 billion. Banco Central interventions in the exchange spot market were concentrated in January and resulted in purchases of US$2.6 billion. With regard to external market operations, the most important were disbursement of US$1.5 billion in bonds of the Republic and payment of US$6.8 billion in external debt service, with US$2.7 billion in interest and US$4.2 billion in amortizations, excluding payments of US$1.4 billion to the IMF. Settlements of National Treasury purchases on the exchange market up to May targeted at covering the servicing of these commitments added up to US$6.5 billion and other operations generated outlays of US$1.2 billion.

It is estimated that, at the end of 2004, gross reserves added up to US$46.5 billion, for an annual reduction of US$2.8 billion due mainly to payments to the IMF. In 2004, external debt service payments are forecast at US$12.1 billion, coupled with US$4.3 billion in amortizations to the IMF. Disbursements to international organizations are projected at US$4 billion, while issues of bonds of the Republic are forecast at US$4 billion, together with exchange market interventions involving purchases of US$2.6 billion, already carried out earlier in the year. Aside from these operations, settlements of National Treasury purchases on the exchange market are expected to reach a level of US$6.6 billion. Based on the IMF concept, net reserves, which are not impacted by amortizations paid to that organization, are expected to add up to US$21.2 billion, with growth of US$3.8 billion compared to the position at the end of 2003. In the Banco Central concept, net international reserves should close the year at US$23.4 billion, with growth of US$2.8 billion in comparison to December 31, 2003.

Statement of international reserves

US$ billion

Itemization	2003 Jan-May	2003 Year	2004 Jan-May	2004 Year[1/]
Reserves position in previous period	37.8	37.8	49.3	49.3
Net Banco Central interventions	1.6	1.6	2.6	2.6
Spot and export lines	-0.2	-0.2	2.6	2.6
Repurchase lines	1.8	1.8	-	-
Debt servicing (net)	-3.8	-9.7	-6.8	-12.1
Interest	-2.1	-4.8	-2.7	-5.0
Credit	0.8	1.5	0.5	1.5
Debit	-2.9	-6.3	-3.1	-6.5
Amortization	-1.6	-4.9	-4.2	-7.0
Disbursements	1.5	5.4	1.5	5.5
Multilateral organizations	0.5	0.9	0.0	1.5
Sovereign bonds	1.0	4.5	1.5	4.0
International Monetary Fund	3.9	4.8	-1.4	-4.3
Disbursement	4.1	17.6	-	-
Amortization	-0.2	-12.8	-1.4	-4.3
Others[2/]	1.7	3.9	-1.2	-1.2
Treasury's purchases	0.7	5.5	6.5	6.6
Change in assets	5.5	11.5	1.2	-2.8
Gross reserves position	43.4	49.3	50.5	46.5
Net reserves position:				
Arrangement with IMF[3/]	14.2	17.4	22.2	21.2
Central Bank concept	17.1	20.5	24.5	23.4

1/ Forecast.
2/ Includes payments/receipts in the framework of the Reciprocal Credit Agreement (CCR), fluctuations in prices of securities, exchange parities and price of gold, discounts and premiums, duty fees and release of collaterals.
3/ In order to comply with the performance criterion, in the framework of the IMF Arrangement, the calculation parameters for the net adjusted reserves – as defined in the Technical Memorandum of Understanding (TMU) of the third review of the Stand-By Arrangement – should be observed. In this case, the net adjusted reserves denominated in US$ take into account the parities set on dates established by the TMU to figure out the assets denominated in currencies unlike the US$, including the special drawing rights (SDR). The same methodology is applied in the case of the gold price. Also, pursuant the TMU, the outstanding debt with the IMF should be excluded from the reserve assets (international liquidity concept), as well as the deposits in banks domiciled abroad, though headquartered in the country, and the securities issued by residents that surpass altogether US$1,023 million.The exceeding value up to May 2004 was US$921 million.

5.5 Conclusion

In the first five months of the year, the balance of trade turned in a surplus of US$11.2 billion and current unrequited transfers registered significant improvement compared to the January-May 2003 result. Even with the rise in net remittances in the income account, the country obtained a surplus of US$2.4 billion in current account, compared to US$4.3 billion in the same period of 2003. Considering the result accumulated over 12 months, the positive balance in current account totaled US$6.4 billion, equivalent to 1.24% of GDP, the best result since February 1993.

The current outlook is for continued current account surpluses in the year, particularly as a result of strong growth in the operations of the export sector. On the other hand, the growth registered under imports in 2004 is consistent with the scenario of renewed economic activity and in no way compromises the projected annual surplus of US$26 billion, a figure sharply higher than in 2003.

Both the rates of rolling private sector debt and net flows of foreign direct investments, which are somewhat lower than previously projected, have aided in dissipating lingering uncertainties regarding the financing of external accounts. Further strengthening this rather favorable picture, the positive flow registered on the contracted exchange market in the first five months of the year, a heading that was reflected mainly in the exchange position of banks, and the prospects signaled by the recent issue of sovereign bonds at a time of high international market volatility, clearly make it possible to reaffirm the conclusion that there will be no difficulties in financing the 2004 balance of payments. As a matter of fact, the strong improvement registered under external accounts in the recent past should make it possible to close 2004 with a reserve level equal to or higher than in 2003, even if some deterioration is registered in financing conditions over the coming months.

6 Inflation outlook

This chapter of the *Inflation Report* presents Copom's evaluation of the evolution of the factors underlying recent inflation, together with the outlook for inflation up to the end of 2005. These projections are based on two principal scenarios for the future growth of both interest and exchange rates. The benchmark scenario is based on the assumption that basic interest rates will remain unaltered at the level defined by Copom at its most recent meeting on June 15 and 16 or, more specifically, at 16% per year over the projection horizon and that exchange-rate will also remain unaltered close to the level in effect on the eve of that meeting (R$3.10 per US dollar). The market scenario uses the interest and exchange rate trends indicated by the survey among professional analysts carried out by Gerin. It is important to stress that these trends must not be understood as Copom forecasts of the future behavior of interest or exchange rates.

The inflation and GDP growth forecasts presented in this *Report* are not point estimates. They incorporate probability intervals that reveal the degree of uncertainty that existed at the moment in which the interest rate decision was made. Inflation forecasts depend not only on the interest rate hypothesis, but also on a series of hypotheses involving the behavior of relevant exogenous variables or, in other words, those beyond Banco Central control. The set of hypotheses considered most probable by Copom is used to construct the scenario to which the Committee assigns the greatest weight in making interest rate decisions. By expounding upon these hypotheses in this *Report*, Copom is seeking to enhance the transparency of monetary policy decisions and thereby increase their effectiveness in controlling inflation, which is evidently its overriding objective.

6.1 Determinants of inflation

The outlook for the second quarter of 2004 remains positive, as the economy moves forward in a sustained process of expanding activity. Considering that the various sectors leading the growth process have idle output capacity sufficient to meet growing demand without bringing added pressures to bear on prices, the recovery process is clearly compatible with the already defined inflation targets. This is evident in the fact that inflation has declined in relation to the level registered at the start of the year, thus further reinforcing indications that recovery can move forward without generating undue additional inflationary pressures.

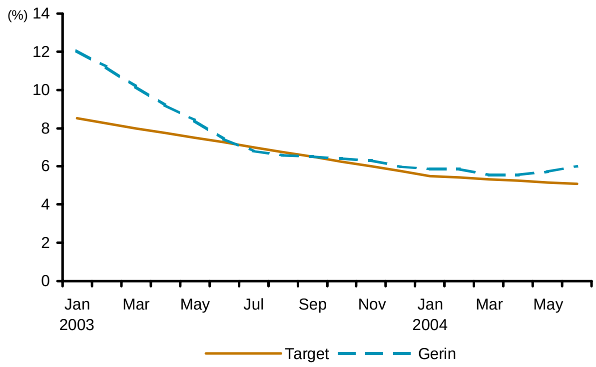
The performance of price indices further corroborates Copom's decision to reduce the Selic rate target to 16.25% per year in March and to 16.00% in April, where it was maintained at the May and June meetings.

In relation to the most recent *Report*, the new factor is the external scenario, with the changes that have occurred as a result of higher oil prices and the restructuring of investment portfolios as a result of expectations of an interest rate hike in the United States. Even though this turbulence is expected to be short-lived, there is a risk of undue contamination of inflation expectations. Consequently, it is considered advisable to maintain a cautious monetary policy stance in order to ensure continuation of the ongoing convergence of inflation toward the established targets.

Price data for the second quarter of 2004 indicate that, despite recovery in the activity level, inflation declined in the early part of the year, following a trajectory clearly consistent with the established targets. The IPCA, which registered monthly growth of 0.37% in April, compared to 0.47% in the previous month, increased by 0.51% in May. However, these increases were not generalized but rather concentrated in the segments of medicines, electricity, new and used cars and some foodstuffs. This concentration is also evident in the decline in the proportion of segments that registered positive growth in May (60.9%, against 65.2% in April). If the IPCA increases by 0.52% in June, as forecast by the five institutions with the best performances in short-term forecasting, according to the *Gerin Market Report* issued on June 11, 2004, inflation accumulated in the second quarter of 2004 will close at 1.43%, or less than the 1.85% level registered in the first quarter. IPCA growth accumulated in twelve months closed May at 5.15%, the lowest level since July 1999 and well within the target defined for 2004.

Core inflation figures also suggest an absence of inflationary pressures generated by economic recovery. When the core inflation is calculated by the exclusion of regulated and food at home prices, it registered 0.70% in May, the third consecutive month of downward movement, while the twelve-month-accumulated ahead figure continued on a downward growth curve, with only a marginal rise in May. Following 8.17% growth in December, the results since the end of the first quarter were 7.09% in March, 7.00% in April and 7.15% in May. The same performance is detected when the core inflation is calculated through the use of the trimmed mean method with smoothing, producing growth figures of 0.76%, 0.57% and 0.59% from March to May, while the accumulated result over twelve months dropped from 11.11% in December to 9.46% in March and 8.46% in May. When the core is calculated through the same procedure, but without smoothing, the growth figures closed at 0.65% in March, 0.45% in April and 0.43% in May, while twelve-month–accumulated core inflation dropped from 7.35% at the end of 2003 to 6.11% at the end of the first quarter of 2004, and 5.4% in May.

Twelve-month ahead inflation



Market expectations for inflation gathered by Gerin showed deterioration in May, basically as a result of uncertainties caused by changes in the external scenario. In the most recent *Inflation Report*, the median of these expectations points to inflation of 6.0% in 2004, 5.0% in 2005 and 5.5% twelvemonths ahead. In the week prior to Copom's June meeting, inflation expectations for 2004 indicated 6.61% for 2004, 5.46% for 2005 and 5.98% for the following twelve months, as indicated in the accompanying graph. Though it is natural that there would be some upward movement in inflation expectations for 2004 in response to external turbulence, the rise also extended to longer range horizons with an intensity well beyond the persistence of the reaction of inflation to exogenous shocks, in light of the monetary authority's unswerving commitment to combating what are in fact the secondary effects of such shocks.

The process of renewed growth in the activity level has continued uninterrupted, as demonstrated by the coincident and leading indicators of demand (consumption, industrial and retail sales, job and income generation) and supply (investments). Real GDP registered expansion of 1.6% in the first quarter of 2004 compared to the previous quarter (deseasonalized data), corresponding to annualized growth of 6% for the second consecutive quarter. Even if the level of real GDP were to remain stable in the coming three quarters, the projected rate of growth in 2004 would be 2.8%. However, the momentum generated by credit and its multiplying effects, real growth in overall wages and sharp upward movement in job creation clearly confirm expectations of growth above this level in 2004, when the typical seasonal effects of this period of the year are ignored.

On the demand side, growth can be noted in the leading and coincident indicators of consumption for April and May, indicating that expansion is being increasingly sustained by rising internal demand, as has been projected since the September 2003 *Inflation Report*. Recovery in the merchant trade sector is evident in IBGE data for April, indicating an increase of 9.89% in retail sales, compared to April 2003, and accumulated 2004 growth of 8.01%. The IIC calculated by Fecomercio SP further strengthens the conviction that the process of economic recovery is under way. In more specific terms, following three consecutive months of downward movement, the results for the month of May pointed clearly to a process of recomposition, as the index climbed to one of its highest levels, with growth of 18% in relation to April.

The continuity of recovery is patently clear in the industrial sector, particularly sharp upward movement in the output of intermediate goods and rising sales of semi and nondurable consumer goods. IBGE deseasonalized data point to accumulated growth of 6.1% in industrial output in the year, with a positive contribution in 13 of the 26 segments analyzed. All of the different use categories turned in positive April expansion compared to March, with particularly strong results under consumer durables, which expanded by 2.9%.

The upturn in the pace of economic activity was also confirmed by labor market figures, as industrial surveys indicated expectations of growth in hirings by the productive structure, coupled with an expanded job supply in recent months, as well as recovery in earnings levels, as overall wages increased and real wages paid by the industrial sector also expanded. In the last few months, the number of jobs created was quite significant as is demonstrated by MTE deseasonalized data, indicating growth in formal employment in the first quarter of 2004 in all segments of activity (total industry, commerce, services and construction). Data drawn from the General File of the Employed and Unemployed (Caged) point to expansion in the number of workers employed in the formal sector of the economy for the fourth consecutive month. It is important to note that April registered the best results in the generation of formal employment positions since 1992, the first year this survey was carried out. Expanded unemployment in recent months can be attributed to the fact that the economically active population has grown more rapidly than the pace of job creation. This is considered a typical seasonal pattern for this period of the year and, at the same time, is quite common at the start of periods of job market recovery, when a considerably large number of people who had previously given up looking for work return to the market.

As far as the fiscal situation is concerned, the results have been quite positive. The primary surplus accumulated over twelve months up to the end of April was 4.23% of GDP, fully compatible with the 2004 target of 4.25% of GDP and the reduction of the debt/GDP ratio, in a context of world economic recovery and responsible fiscal policy.

In the external scenario, though the degree of volatility increased, financial flows improved, despite the momentary falloff in the flow of foreign direct investments. Anticipated funding operations carried out at the start of the year to take advantage of high levels of liquidity impacted the rates of rolling during the half-year period, contributing to high rates in the first quarter that made it possible to accumulate international reserves at lower rates than in the second quarter of 2004.

Recent periods of increased exchange rate volatility did not interrupt Banco Central's strategy of gradually reducing its exchange liabilities, since lesser demand for exchange hedging made it possible to reduce the internal exposure of the public sector by US$26 billion between January 2003 and May 2004. This strategy of not fully renewing monetary policy instruments denominated in foreign currency at maturity produced a situation in which the share of the total securities debt, including swaps, has declined from its maximum value of 40.7% in September 2002 to 16.6% in May 2004.

Exports have provided a steady and consistent adjustment in the current account balance, reaching a level corresponding to 15.3% of GDP in the first four months of 2004 (in 1999, this value was 8.9%). The expected slowdown in China´s economic growth is not expected to have a significant impact on these results, considering that the Chinese economy accounts for only about 6.3% of Brazilian foreign sales and that the growth of the Chinese economy should still be quite high, in the range of 7.0% per year, even if the expected reduction truly occurs.

The performance of the export sector was the major instrument responsible for the adjustment of Brazilian current accounts, with approximately 5.8% of GDP between 1999 and 2004, thus strengthening the economy's capacity to respond to external shocks. In this context, it is important to highlight the reduction in the interest payments/exports ratio, the net external debt/exports ratio and the net external debt/GDP ratio.

Banco Central do Brasil's perception is that the situation of external instability – rooted in the oil price high and expectations of higher United States interest rates – tends to be short-lived and, to the extent that the sources of uncertainty are eliminated, volatility will decline and the external front will stabilize once again. Even if more adverse scenarios occur and volatility remains high for a longer-than-expected period, the strengthening of the Brazilian economy's resistance to shocks – brought about by a combination of renewed growth, price stability, cutbacks in public sector borrowing requirements, reductions in the volume of debt tied to exchange and adjustments in the current account balance – the effects on Brazil are expected to be considerably less intense than in previous periods of external turmoil.

In summary, it has become clear that the economy is in a process of renewed and sustained economic activity, without generating pressures capable of jeopardizing the specified inflation targets. Even if an external shock of even greater magnitude and duration than the shocks built into the more pessimistic scenarios were to occur, the Brazilian economy is in a much more comfortable situation to cope with such shocks than in the past and to maintain the forward momentum of growth and price stability over the medium-term.

6.2 Main scenario: assumptions and associated risks

The projections with which Copom is now working are based on a series of hypotheses dealing with the behavior of the major economic variables. These hypotheses and the respective associated risks constitute the main scenario upon which Copom bases its decisions.

Since publication of the most recent *Report*, the most important alteration with which Copom has worked is the increased volatility of the external environment. Basically, this volatility is rooted in the uncertainties surrounding the dynamics of United States monetary policy in the coming months, now that the monetary authority of that country has begun signaling that the basic interest rate will soon move into a progressively upward curve. Coupled with this factor, one cannot ignore the uncertainties bred by the trajectory of oil prices in the near future and the possibility that the Chinese economy will be able to face a slowdown in the country's economic growth in a well ordered manner. However, despite the increased volatility of the recent past, the outlook for the Brazilian economy over the medium term is quite positive.

From Copom's point of view, the instability of recent weeks is far from reflecting a state of crisis since the major underlying causes are clearly a passing phenomenon, at the same time in which the foundations of the Brazilian economy are quite solid. Much of the volatility consequent upon the effects of the change in the American interest rate curve, for example, will tend to dissipate naturally over the medium-term, as the uncertainties regarding United States monetary policy are gradually resolved. As far as oil prices are concerned, since the recent upward trend in prices has been more a consequence of expectations of increased demand and not the result of the impact of exogenous factors on supply, the current trajectory will tend to move to a level that is sustainable when viewed in the context of world economic growth. Given the record levels of recent years, the most probable scenario for the medium-term is to settle back to a level somewhat below the prices now in effect. Aside from this, sharp increases in fuel prices had already been incorporated into the Copom forecasting scenarios since the start of the year. Finally, in relation to China, there is good reason to believe that the performance of the Brazilian export sector will not be overly impacted by a possible cutback in the Chinese rate of economic growth, particularly in light of the magnitude of the expected deceleration.

Notwithstanding this favorable evaluation in relation to the medium-term, Copom members are convinced that the current context of doubts in relation to the evolution of the external scenario has generated a degree of short-term volatility that will tend to increase uncertainties regarding the future behavior of inflation, making it difficult not only for the monetary authority to evaluate scenarios, but even to coordinate the expectations of private agents. In this context, volatility caused by risk factors that are not expected to prevail over the medium-term, when the external scenario has been more clearly defined, could impact inflation expectations in a more lasting manner.

As a matter of fact, Copom members concluded that, over the short-term, the behavior of inflation expectations has become a relatively more important source of risk. The deterioration perceived in expectations since the Copom meeting in May was not limited to 2004 but also impacted projections over longer term horizons. With the transitory shocks that have impacted the inflation trajectory, it would be reasonable to expect more intense deterioration concentrated over shorter term horizons when the first effects of the shocks are felt, precisely the period in which the reaction of monetary policy will not yet have produced effective results.

The magnitude of the deterioration observed at the same time for longer term horizons is not compatible with the notion that, in the presence of occasional more permanent supply shocks, monetary policy will not manage to absorb the secondary impacts of such shocks. Such deterioration is not shown in the inflation projections of the different models used by the Committee, even when these projections incorporate scenarios that are particularly unfavorable to the evolution of the major determinants of the most recent shocks.

Among the risks already discussed in previous *Reports* and that are consistently monitored by Copom, it is possible to highlight that: i) the delayed effects of the monetary policy implemented in recent quarters on prices have not yet been fully felt; ii) there are still important doubts with regard to the recent pace of growth in potential product.

The doubts that have arisen with regard to the recent growth of potential product are a consequence of several factors: (i) given the structural changes that have occurred in the economy in recent years and the turbulent external environment that has prevailed in this period, it is difficult to estimate the structural rate of potential GDP growth; (ii) recent data on the domestic absorption of capital goods have been a positive surprise, though indications of national accounts over a longer term horizon suggest some degree of concern with the rates of savings and investments in the Brazilian economy, and the possibility of these two factors sustaining more vibrant potential GDP growth; (iii) for the medium term, one must know whether sectors that are rapidly moving toward the limits of their installed output capacity have investment plans capable of providing a sufficiently rapid response, and what are the conditions for the output capacity of the following sectors. It is essential that an environment that is increasingly more propitious to investment be created in order to avoid localized bottlenecks and to ensure that the aggregate rate of growth does not get mired down at a level below what could be achieved with the factors currently operating in the country.

Since its April meeting, Copom has, within the framework of the instruments used to aid in monetary policy decisions, used inflation projections based on a scenario that assumes lesser persistence of the inflation registered in the first quarter, in keeping with the pattern that has marked recent years of a seasonal falloff in inflation under market prices in the second and third quarters. In this *Report*, Copom has given greater emphasis to projections constructed without the hypothesis of lesser persistence, since the rates of inflation for the first two months of the second quarter are already well known, at the same time in which market prices turned in atypical increases in the month of May.

As far as government regulated prices are concerned, the benchmark scenario presupposes growth of 7.7% in 2004, representing a small rise in relation to the result stated in the previous *Inflation Report* (7.3%). The model of endogenous determination of government regulated prices maintains a growth figure of 6.0% for 2005. The increase in the prices of petroleum derivatives announced by Petrobras on June 15 is below the figure included in projections for 2004. In the case of gasoline, the projection of an increase for the year as a whole remains 9.5%; the fact is that this projection incorporates an increase just a bit higher than 9.5% between May and December 2004, considering that retail prices declined between December 2003 and May 2004 (2.0%, according to the IPCA). For the other regulated prices, the increases are projected at 11% for electricity, 6.9% for bottled gas and 6.1% for fixed telephone services. Compared to the most recent *Report*, despite the forecast of lesser growth (from 10% to 6.9%) in the prices of bottled gas, overall government regulated prices were revised due to a higher projection of growth in electricity rates in the current year from 6.9% to 11%.

Also in the context of the benchmark scenario, it is assumed that interest rates will hold firm at 16%, which is the target set by Copom at its June meeting, with exchange at a constant R$3.10.

This procedure of maintaining constant interest and exchange rate targets is standard in Copom price simulations, as already stated in previous *Inflation Reports*. The benchmark scenario that was elaborated is compatible with a spread for the six-month pre-DI swap rate of 39 p.b. for the final quarter of 2004 and 60 p.b. for the final quarter of 2005.

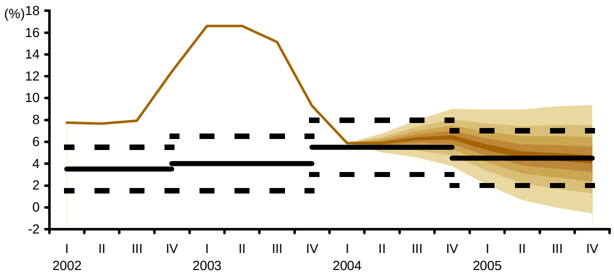
The effects of increased external scenario uncertainties were reflected in the trajectories of interest and exchange rates that characterize the market scenario. The values estimated by the market for the exchange rate in the final quarters of 2004 and 2005 were R$3.10 and R$3.23, respectively. Forecasts for the exchange rate at the end of 2004 increased, at the same time in which the forecast for the end of 2005 declined, when compared to the rates stated in the most recent *Report* (R$3.07 and R$3.24, respectively). Projections for the Selic rate were raised to 15.0% at the end of 2004 and 13.35% for 2005 (as against 14.0% and 12.6%, respectively, in the March *Report*), resulting in projected spreads for six-month pre-DI swaps of 38 p.b. and140 p.b. for 2004 and 2005, respectively. The projected increase in the exchange rate at the end of the period is consistent with an inflation rate of 7.6% for government regulated prices. The lesser projection for regulated prices is due to sharper exchange rate appreciation in July and August (R$3.08 in the two month period) in the market scenario, when compared to a constant trajectory of R$3.10 in the benchmark scenario.

As far as fiscal policy is concerned, the results obtained up to May offer additional security that the hypothesis of compliance with the target of 4.25% of GDP for the consolidated public sector primary surplus will be met. The same hypothesis has been maintained for the two coming years.

6.3 Inflation forecast

Based on the assumptions and associated risks analyzed by Copom, together with the stock of available information, projections were constructed for the accumulated-twelve- month IPCA, based on the interest and exchange rate trajectories incorporated into the benchmark and market scenarios. In the case of the benchmark scenario, it is assumed that the rate of interest will remain at 16% per year, the level defined at the most recent Copom meeting, and that the exchange rate will hold steady at a level quite close to that in effect in the days prior to the meeting (R$3.10). In the market scenario, using the expectations gathered by Gerin as the basis for analysis, the rate of interest drops to 15% per year in the final quarter of 2004 and 13.35% in the final quarter of 2005. The exchange rate averages R$3.10 in the final quarter of 2004 and R$3.23 in the final quarter of 2005.

Forecasted IPCA-inflation with interest rate constant at 16% p.y. (Benchmark scenario)
Inflation fan chart



Note: Accumulated inflation in 12 months (% p.y.).

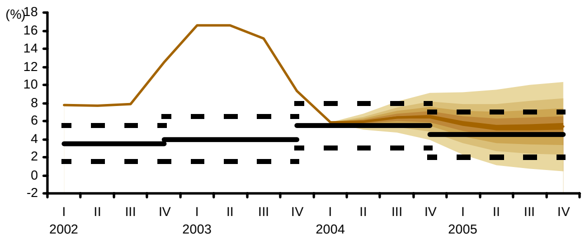
The central thrust of the benchmark scenario indicates an upward trend in accumulated-twelve-month inflation over the course of the year, starting at 5.9% in the second quarter and reaching 6.4% in the final quarter, thus closing above the target midpoint of 5.5% specified for 2004. This rise is a consequence of the impact of recent external scenario volatility, marked by exchange rate realignment, expectations of longer lasting pressures on

IPCA-inflation with interest rate constant at 16% p.y.
(Benchmark scenario)

Year	Q	Confidence interval						Central projection
		50%						
			30%					
				10%				
2004	2	5.5	5.7	5.8	6.0	6.1	6.2	5.9
2004	3	5.6	5.9	6.1	6.4	6.7	7.0	6.3
2004	4	5.3	5.8	6.2	6.6	7.0	7.5	6.4
2005	1	4.1	4.7	5.2	5.8	6.3	6.9	5.5
2005	2	3.1	3.8	4.5	5.1	5.8	6.5	4.8
2005	3	2.7	3.5	4.3	5.0	5.7	6.5	4.6
2005	4	2.4	3.2	4.0	4.8	5.6	6.4	4.4

Note: Accumulated inflation in 12 months (% p.y.).

Forecasted IPCA-inflation with market expected interest and exchange rates
Inflation fan chart



Note: Accumulated inflation in 12 months (%p.y.).

IPCA-inflation with market expected interest and exchange rates[1/]

Year	Q	Confidence intervals						Central projection
		50%						
			30%					
				10%				
2004	2	5.6	5.7	5.9	6.0	6.1	6.3	5.9
2004	3	5.7	6.0	6.3	6.6	6.8	7.1	6.4
2004	4	5.4	5.9	6.3	6.7	7.1	7.6	6.5
2005	1	4.3	4.9	5.5	6.0	6.5	7.1	5.7
2005	2	3.6	4.3	5.0	5.6	6.3	7.0	5.3
2005	3	3.4	4.2	5.0	5.7	6.4	7.2	5.3
2005	4	3.4	4.2	5.0	5.8	6.6	7.4	5.4

Note.: Accumulated inflation in 12 months (% p.y.).
1/ According to Gerin.

March 2004 *Inflation Report* forecasts

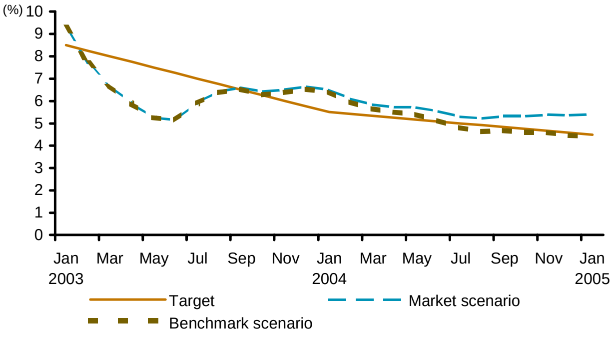
Period	Benchmark scenario	Market scenario
2004 I	5.8	5.8
2004 II	5.4	5.7
2004 III	5.1	5.7
2004 IV	5.2	6.2
2005 I	4.7	6.0
2005 II	4.0	5.3
2005 III	4.3	5.5
2005 IV	4.2	5.4

international market oil prices and the consequent rise in the inflation expectations of agents for 2004 and 2005. Between the final quarter of this year and the first quarter of 2005, accumulated-twelve-month inflation declines, as a result of substitution of a higher rate in early 2004 (1.85% in the first quarter) with a more moderate rate (1% in the same period of 2005). Furthermore, there is a downward trend in the following quarters, due to the lag in the impact of the maintenance of the Selic rate at a constant level and a lower projection of inflation in regulated prices. For 2005, the projection of inflation for the benchmark scenario is 4.4%, or less than the 4.5% target set for the year.

By incorporating a trajectory marked by depreciation for the exchange rate and a reduction in the interest rate over the forecast horizon, the market scenario projects higher rates of inflation than the benchmark scenario, with 6.5% for 2004 and 5.4% for 2005. In both 2004 and 2005, these projections are higher than the midpoints of the respective target intervals. Just as occurs in the reference scenario, inflation accumulated in twelve months increases over the course of the year. In the first quarter of 2005, inflation of 1.1% below that of the first quarter of 2004 generated a reduction of approximately 0.8 p.p. in accumulated-twelve-month inflation. Over the course of the following quarters, inflation declines but the reduction is less than the one projected in the benchmark scenario, given the depreciation of exchange and the interest rate reduction expected by the market in 2005. As described in section 6.2, the market scenario assumes inflation of 7.6% in regulated prices for 2004, slightly less than the 7.7% rate built into the benchmark scenario.

A comparison of the trajectories presented in this *Report* with those published in the previous *Report* and reproduced alongside this text shows an increase in projections in both scenarios for 2004. In March, the benchmark scenario pointed to a gradual reduction in inflation and a small increase in the final quarter of the year. The central projection for 2004 inflation, however, was 1.2 p.p. below the current projection. The increase in the inflation projection is partly due to a rise in estimated growth in regulated prices in the current year, moving from 7.3% in March to 7.7% and, principally, to the upward movement in the projection of market price inflation, from 4.4% to 5.9%. In the case of the trajectories for 2005, the benchmark scenario registered a small change – projected inflation was increased by just 0.2 p.p. Projections of the market scenario remained stable, with a rise of 0.3 p.p. for 2004 and maintenance of the 5.4% level for the end of 2005.

Twelve-month ahead inflation

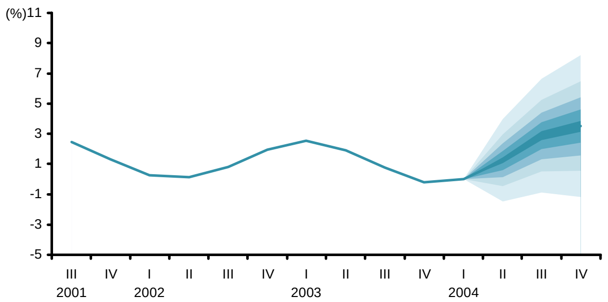


The graph shows the evolution of accumulated-twelve-month-ahead inflation according to the benchmark scenario and the market scenario in this *Report*, together with the estimated trajectories of the targets for 2003, 2004 and 2005. These trajectories are constructed on the basis of accumulated inflation up to May 2004 with the rates projected as of that month. It is possible to note that, according to the benchmark scenario, accumulated twelve-month-ahead inflation is above the trajectory of the targets as of September 2003. However, over the course of 2004, this projection declines and after July remains consistently below the trajectory of the targets. However, according to the market scenario for the exchange and interest trajectory, projections remain above that of the target from the end of 2003 onward, as stated in the previous *Report*.

In the two most recent Copom meetings, the Committee also considered inflation projections for the twelve-month period corresponding to the second half of 2004 and the first half of 2005. This is a horizon that generates results that are more sensitive to the monetary policy decisions taken over the coming months than the results of calendar year 2004. At the same time, it is a horizon covered by inflation projections that are more reliable than those already available, so far ahead of calendar year 2005.

Inflation projected for this twelve-month period, in both the benchmark and market scenarios, is located in the interval between the central targets set by the National Monetary Council (CMN) for calendar years 2004 and 2005.

GDP growth with interest rate constant at 16% p.y.
Benchmark scenario
Output fan chart



The output fan chart constructed on the basis of the benchmark scenario hypotheses is also presented. It should be underscored that forecasting errors consequent upon GDP growth projections are considerably larger than in the case of inflation projections. The model used in the projections works with a breakdown of product into two components that are not directly observable – potential output and product gap – and, aside from this, the calculation of output level is more complex and less precise than that of inflation. According to the benchmark scenario, forecast growth for 2004 is 3.5%, the same level projected in the last two *Inflation Reports*.

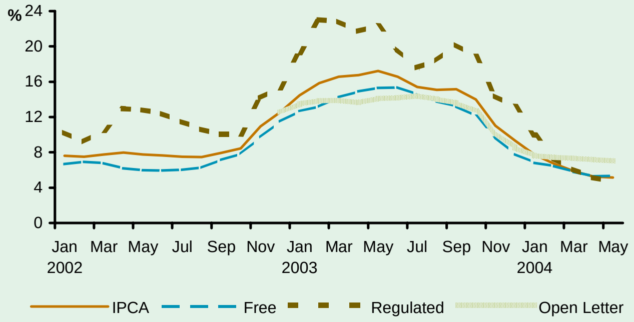
IPC: Inertia, Exchange, Expectations and Relative Prices

This box examines the recent behavior of the IPCA, under the prism of the major factors that explain its dynamics or, more specifically, the evolution of inflation expectations and the performance of relative prices, analyzing the prices that are freely determined by market forces and those that are regulated by contract and monitored by the government.

As stressed in previous Banco Central documents, the upswing in inflation that occurred in the second half of 2002 was caused by a loss of confidence in the evolution of the Brazilian economy and by a sharp rise in international market aversion to risk, both of which occurred in that year. In that process, accumulated year-over-year inflation rose from 7.5% in August 2002 to a maximum of 17.2% in May 2003. From that point forward, it is important to note that the trajectory was clearly downward. In a framework of gradual improvement in expectations regarding the future of the economy, monetary policy measures managed to produce a consistent and steady drop in inflation, as the accumulated-twelve-month IPCA slipped to 5.2% in May 2004, the lowest level since July 1999.

IPCA, free, and regulated inflation and Open Letter projection

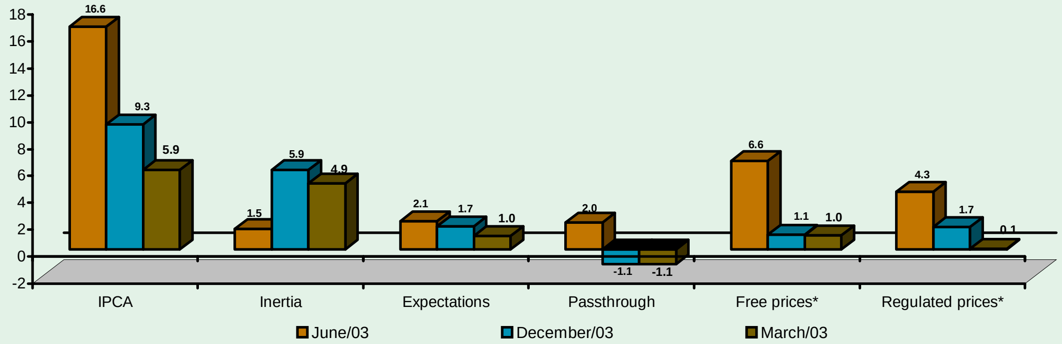
Accumulated in 12 months



At the same time, as can be seen in the graph alongside this text, this downward inflation trajectory followed the trend projected in the Open Letter from the Governor of Banco Central to the Minister of Finance, dated January 21, 2003. Though effective twelve-month-accumulated inflation was slightly higher than that projected for the start of 2003, from that point forward the two curves show a clear tendency toward convergence until the initial differential is finally reversed at the beginning of 2004, when accumulated-twelve-month inflation closed below the projected level (5.3%, as against 7.2% respectively, in April 2004). Looking at the period as a whole, one perceives that the two curves have evolved in very like manners. This performance not only demonstrates the good performance of the forecasting models used by Banco Central, but also that inflation has remained on a path toward convergence with the targets.

In order to evaluate the behavior of the major inflationary factors in the period, an exercise was performed breaking down the rate of accumulated-twelve-month inflation, just as was done in previous open letters. This exercise uses estimates of the structural models for three distinct moments: June 2003 (quarter in which accumulated inflation peaked); December 2003 (equivalent to inflation in calendar year 2003) and March 2004 (already terminated quarter in which accumulated inflation reached its lowest level). The graph below breaks down IPCA growth for each period into the following components: i) exchange depreciation; ii) inertia inherited from the share of inflation that exceeded the target in the previous period (calculated for June 2003 and March 2004) through interpolation of the targets for each year); iii) expectations of inflation above the target; iv) market price inflation, excluding the effects of the previous items; and v) inflation in government regulated prices, excluding the effects of items "i" and "ii". The following graph shows the participation of each one of these components in total IPCA.

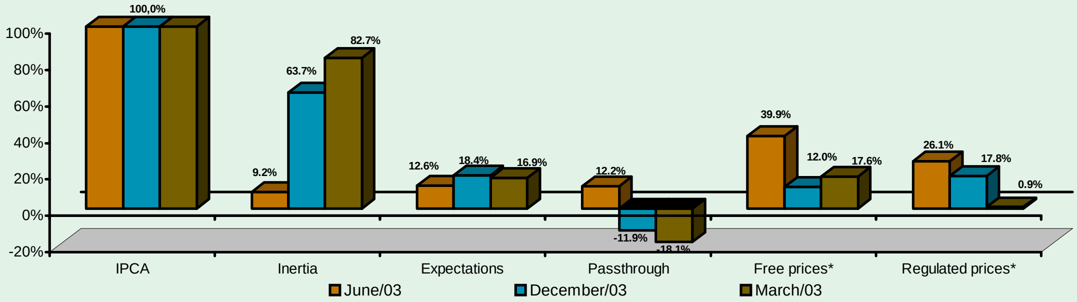
Decomposition of accumulated twelve-month inflation



* Excluding pass-through, inertia and expectations.
** Excluding pass-through and inertia.

Decomposition of accumulated twelve-month inflation

Percentage of total IPCA



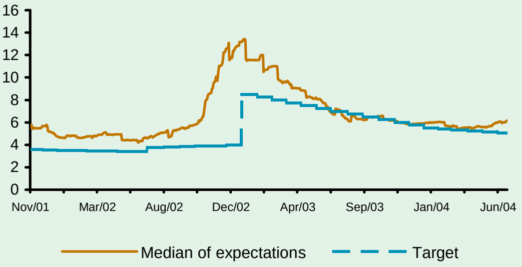
* Excluding pass-through, inertia and expectations.
** Excluding pass-through and inertia.

Reflecting the path already stressed, the graph shows that the twelve-month-accumulated inflation rate moved from 16.6% in June 2003, to 5.9% in March 2004. The increases in inflation rates in the final quarter of 2002 and in the first quarter of 2003 generated a powerful impact on the following quarter as a result of inertial mechanisms. For this reason, once the target is deducted, the inertial component made the largest contribution to price growth in the two periods under analysis – 5.9 percentage points for inflation in the twelve-month period ended in December 2002 and 4.9 p.p. for the period up to March 2004, accounting for 63.7% and 82.7% of the IPCA for each period, respectively.

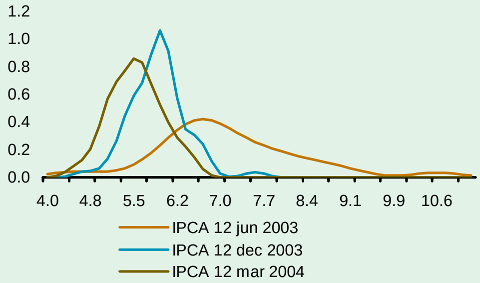
The effect of exchange rate variation on inflation was estimated at 2.0 percentage points in the first period, corresponding to 12.2% of the IPCA. This result was caused by the lag in the pass-through mechanism of exchange growth in 2002, when the exchange rate started from a median of R$/US$2.50 in the second quarter and climbed to R$/US$3.68 on average in the final three months of the year. With the reversal of exchange rate depreciation, this factor represented a deflationary factor in the subsequent two periods.

With the shock that occurred in 2002, inflation expectations deteriorated sharply. This was reflected in the increase in the contribution to the IPCA of the share of expectations that surpassed the target from the first to the second period under analysis – from 12.6% to 18.4%. As of mid-2003, with the recovery of confidence in macroeconomic policy, median inflationary expectations for the next twelve months dropped sharply, converging toward the adjusted targets, as demonstrated in the following graph.

Median of twelve-month-ahead IPCA expectations and target trajectory



Expectational distribution of twelve-month-ahead IPCA



Consequently, there was a reduction in the contribution of expectations above the target for accumulated-twelve-month inflation in the period ended in March 2003, to 16.9% of the IPCA.

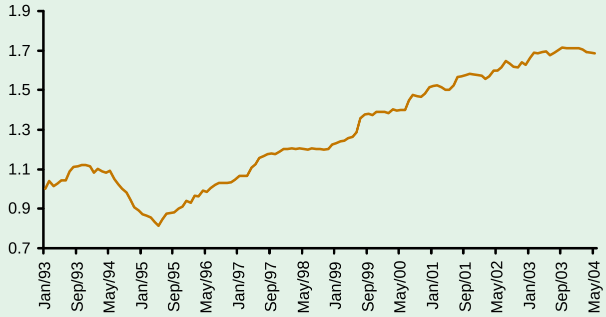
The analysis above is restricted to the examination of the contribution of median market expectations to inflation. However, viewed as a mechanism for coordinating expectations, the effectiveness of the inflation targeting system is determined not only by the behavior of the median, but of the entire spectrum of the inflationary expectations of economic agents.

To overcome this gap, the graph alongside presents the probability density of market inflation expectations for the next twelve months on the same three dates specified in the breakdown exercise: June 2003, December 2003 and March 2004. In this way, we are able to aggregate more information to the analysis on the role of expectations, making it possible to examine how their convergence or dispersion has contributed to the evolution of price levels. Between June and December 2003, not only did median inflation expectations drop by about 1 percentage points, but the more pessimistic forecasts (more than 8%) gave way to expectations that were closer to the median. As a result the distribution curve lost weight in the upper tail and moved upward at the center. In other words, there was a significant reduction in the degree of market skepticism with regard to the convergence of inflation to the target trajectory. Between December and March, the median dropped further and was accompanied by a slight increase in the upper and lower distribution tails – graphically, corresponding to the reduction in the height of the distribution center. Looking at the entire period, however, it is evident that monetary policy managed to improve the overall array of inflation expectations considerably.

Finally, particular attention should be given to the evolution of market prices and those regulated contractually and through monitoring. The participation of both groups was greater in the first period, when they contributed with 39.9% and 26.1% of the IPCA, respectively. In the other two periods, the share of market prices was significantly less and remained relatively stable (1.1 and 1.0 percentage points). Government monitored prices registered a consistent downward tendency in participation in the increase in price levels in each period, indicating that the greater pressure on inflation exerted by this group in recent years has been dissipated.

Ratio between regulated and free prices 1993 - 2004

Basis: jan/93=100

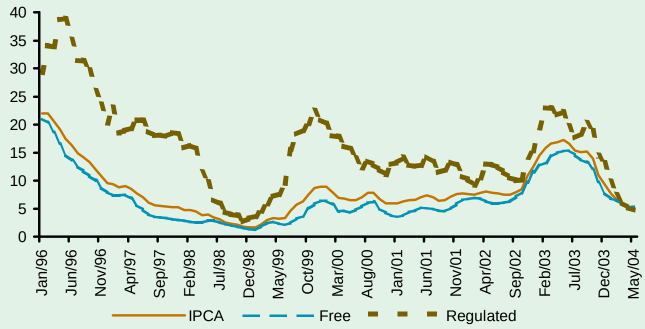


As shown in the graph at the side, since mid-1995 the grouping of government administered prices has registered significantly higher growth than in the case of market prices. This behavior was impacted by a diversity of factors, such as: i) the process of privatization of some public services; ii) withdrawal of the subsidies granted to some of the items included in the grouping of administered prices; iii) the increase in international market oil prices; and iv) devaluation of the exchange rate, with fluctuation of the Real as of 1999. Consequently, since that time, there has been an ongoing process of change in the relative prices of the economy that has been strongly impacted by the rate of inflation.

Aside from direct pressures on price levels, this process has still another effect. Since government administered prices have a strongly backward-looking component (some items are adjusted partly on the basis of past IGP growth), at the same time in which they are greatly dependent on international oil prices and an important exchange pass-through component, this adjustment in relative prices determined a higher degree of persistence of the rate of inflation, requiring a greater effort on the part of Banco Central in combating the secondary effects of the rise in prices and implying higher costs in terms of product in the process of lowering inflation.

IPCA, free and regulated inflation

Accumulated in 12months



Thus, it is important that price realignment converge to the inflation target so that this effect on product will be reduced or avoided and pressure on inflation will be less intense. The graph at the side of this text shows that this may be occurring – the process of alteration in relative prices, underway since 1995, seem to be stabilizing. There is a convergence in the increase of the two groups of prices to the target and, for the first time since the inflation targeting system was adopted, the upward movement in regulated prices was less intense than under market prices, as the accumulated-twelve-month figures closed at 4.7% and 5.3%, respectively, in May.

Autoregressive Vectors

The autoregressive models (VAR) first appeared in the 1980s as a response to criticisms of the large number of restrictions imposed on estimates by structural models. The idea was to develop dynamic models with a minimum of restrictions, in which all economic variables would be dealt with as endogenous. Thus, the VAR models examine the linear relations between each variable and its own lagged values and all of the other variables, with the only restrictions to the structure of the economy being: the choice of the relevant set of variables and the maximum number of lags involved in the relations among them. In the VAR models, the number of lags is normally chosen on the basis of statistical criteria, such as those of Akaike or Schwarz.

Obviously, there are limitations to the VAR models that have been widely discussed and researched in the following decades. Two limitations are often stressed. The first refers to the high number of parameters of the VAR models, with reflections on the size of the sample required to obtain a reliable estimate. The second concerns the fact that each VAR model is simply a reduced form or, in other words, the same relations among the variables and their lags are simultaneously compatible with various different models that also describe contemporary relations among the variables (called "structural forms").

A simple manner of attenuating the overparameterization of the VAR models is to make the coefficients of some variables equal to zero. The BVAR (Bayesian Vector Autoregression) arose as a more satisfactory response to this problem. In the BVAR models, instead of determining the exclusion of specific variables, an option is made to stipulate an a priori probability distribution (informative) for each one of the coefficients. This a priori distribution is combined with the sample information to generate estimates. Therefore, this process differs from the classic estimation used in the VAR models.

With regard to the finding that VAR models are mere reduced forms that, in themselves, do not allow for identification of the true structural form, it should be stated that this identification is important for certain purposes and that there are established procedures for dealing with the problem. However, if the purpose is simply to generate forecasts for the future trajectory of the variables that make up the VAR, it is not therefore necessary to recover the structural parameters. The projections would be the same, no matter what the true structural form is, provided that it be compatible with the reduced form and, therefore, could simply be produced on the basis of the reduced form.

The Banco Central do Brasil Research Department (Depep) developed two VAR models and two BVAR models that generate monthly forecasts of inflation for market prices. These forecasts are combined with the forecasts of government regulated prices developed by the Banco Central do Brasil Economic Department (Depec) and, in this way, generate the IPCA forecasts. As of March 2004, two of these models have also been used to generate industrial output forecasts. All of these forecasts have the objective of aiding Banco Central in its monetary policy decisions. The four models currently used by Depep are presented below.

Chart 1 presents the variables found in each model and the number of lags. In each case, the number of lags is chosen on the basis of the Akaike (AIC) and Schwarz (SC) criteria.

Chart 1 – Models' variables

	Var1	Var2	BVar1	BVar2
Endogenous	growth in the real rate of interest, nominal exchange rate growth, regulated-price inflation, market-price inflation	growth in the nominal interest rate, growth in the money stock, growth in industrial output, nominal exchange rate growth, regulated-price inflation, market-price inflation	growth in the nominal interest rate, growth in the money stock, growth in industrial output, nominal exchange rate growth, regulated-price inflation, market-price inflation	growth in the nominal interest rate, growth in the money stock, growth in industrial output, nominal exchange rate growth, regulated-price inflation, market-price inflation
Exogenous	constant, three trend dummies, eleven seasonal dummies	constant, three trend dummies, eleven seasonal dummies	constant, three trend dummies	constant, three trend dummies, eleven seasonal dummies
Lags	2	6	6	6

The model designated Var1 is a VAR model with monthly data composed of the following endogenous variables: growth in the real rate of interest, nominal exchange rate growth, inflation of government regulated prices and market price inflation. Two lags from all the variables are included. The model also has the following exogenous variables: constant, three trend dummies for the period of declining inflation (from the start of the sample – August 1994 up to an including June 1997) and eleven seasonal dummies.

The model designated Var2 is a VAR model with monthly data composed of the following endogenous variables: growth in the rate of nominal interest, growth in the money stock, growth in industrial output, nominal exchange rate growth, inflation in government regulated prices and market price inflation. Six lags from all the variables are included. The model contains the same exogenous variables found in Var1.

The model designated BVar2 is a BVAR model with monthly data composed of the same endogenous and exogenous variables found in Var2. Just as in Var2, six lags from the endogenous variables are included. The difference in relation to the Var2 model is in the Bayesian estimation technique used in BVar2. Finally, the BVar1 model differs from BVar2 in the fact that it excludes the eleven seasonal dummies.

Just as in Graph 1, Chart 2 presents the projections one step forward in the VAR and BVAR models and the values observed for market price inflation.

Since the industrial output data publication lag is greater than that of inflation, at the Copom meeting in month t, the most recent available data refer to month t-2. Thus, for the month t meeting, projections are made for the value of industrial output in month t-1. Since the March 2004 Copom meeting, the Var2 and BVar2 models have been utilized to generate these projections, which are considered alongside the projections based on coincident indicators of industrial output. Though the BVar1 model is also capable of generating forecasts for industrial output, a decision was made to utilize only the projections of the Var2 and BVar2 models, since the BVar1 model does not contain seasonal dummies.

Graph 1 – Projections of the VAR and the BVAR models for market-price inflation – One step ahead

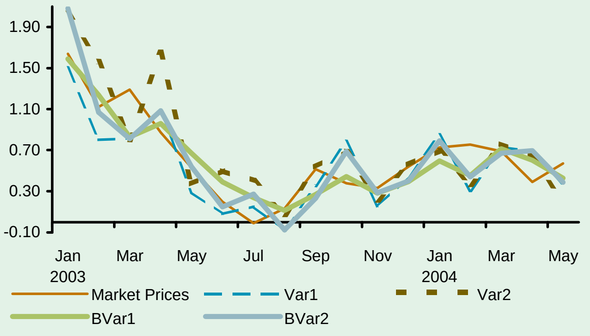
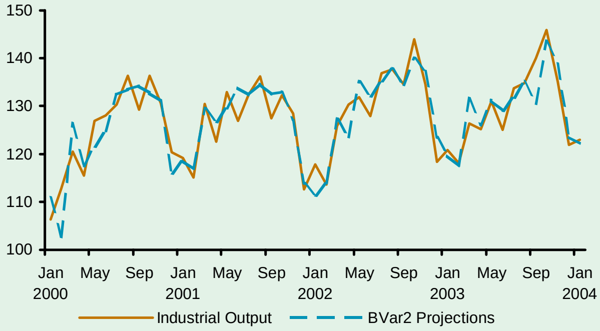


Chart 2 – Projection Models

		Market Prices	Var1	Var2	BVar1	BVar2
2003	Jan	1.64	1.51	2.03	1.59	2.08
	Feb	1.12	0.80	1.56	1.24	1.07
	Mar	1.29	0.82	0.80	0.83	0.81
	Apr	0.87	1.09	1.65	0.96	1.08
	May	0.53	0.29	0.37	0.67	0.54
	Jun	0.20	0.08	0.50	0.39	0.15
	Jul	-0.01	0.15	0.40	0.24	0.27
	Aug	0.13	-0.08	0.07	0.11	-0.08
	Sep	0.52	0.35	0.54	0.27	0.23
	Oct	0.38	0.79	0.69	0.44	0.69
	Nov	0.33	0.15	0.22	0.28	0.28
	Dec	0.54	0.44	0.56	0.39	0.40
2004	Jan	0.73	0.85	0.69	0.60	0.79
	Feb	0.75	0.30	0.37	0.45	0.44
	Mar	0.69	0.73	0.76	0.71	0.67
	Apr	0.39	0.69	0.64	0.60	0.69
	May	0.57	0.37	0.20	0.43	0.39
MSE[1/]			0.07	0.12	0.04	0.06

1/ Mean Square Error.

Graph 2 – Projections of the BVar2 model for industrial output – One step ahead



A preliminary diagnosis of the predictive performance of these models for industrial output one step forward can be obtained by comparing the projection that they would have generated in the past with the data that effectively occurred. Graph 2 shows the results of this experiment with the BVar2 model for the period between January 2000 and January 2004.

Annex

Minutes of the 94th Meeting of the Monetary Policy Committee (Copom)

Date: March 16th, from 3:45PM to 7:15PM, and March 17th, from 3:45PM to 7:15PM
Place: BCB's Headquarters meeting room of the 8th floor (on March 16th) and 20th floor (on March 17th) – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua
Alexandre Schwartsman
Antônio Gustavo Matos do Vale
Eduardo Henrique de Mello Motta Loyo
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

Department Heads (present on March 16th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on March 17th)
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on March 16th)
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo - Advisor to the Board
Hélio José Ferreira – Executive Secretary
João Batista do Nascimento Magalhães – Special Advisor to the Governor
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

Recent Evolution of Inflation

1. In February, there was price deceleration in most part of consumer goods. This fact impacted the evolution of both consumer price indices and core inflation measures, which cooled down in the month. However, there are still pressures coming from the rise in the international prices of commodities, affecting especially wholesale industrial prices. Yet, it is important to highlight the effects of the change in the Cofins legislation over the relative prices, whose most evident impacts also affect wholesale industrial prices.

2. The Broad National Consumer Price Index (IPCA) rose 0.61% in February, compared to a 0.76% rise in the previous month, after three consecutive months of acceleration. The IGP-DI reached 1.08%, remaining in an upward trend for

the fourth consecutive month. This acceleration, in comparison to the one verified in the previous month, was mainly a consequence of the IPA-DI acceleration to 1.42% from the 0.75% previously recorded, once that the IPC-Br decelerated to 0.28% in February, from 1.08% in January. The 12-month accumulated variation of the IPCA, IGP-DI and IPA-DI remained in a downward trend in February, standing at 6.69%, 5.69% and 4.45%, respectively.

3. The most important individual contribution to the IPCA variation came from the readjustment of school fees, with a 0.31 p.p. contribution to the overall monthly index. The group food and beverage items, which recorded a variation of 0.15% compared to the 0.88% increase in the previous month, reflected the effects of the new harvest into prices, a paramount factor that contributed to the IPCA deceleration in February. The fall in the prices of fuel-alcohol is also highlighted, as a consequence of an excessive production.

4. Still regarding the February IPCA, free prices increased 0.75%, accounting for 0.54 p.p. of the monthly index variation, while the 0.26% increase in the regulated prices accounted for the remaining 0.07p.p. In the first group, the rise in school fees and in the prices of cars, fresh food items and beans are highlighted. Concerning regulated prices, the rise in water and sewage tariffs as well as in the prices of bottled gas and health insurance prevailed, fact that was partially offset by the decrease in fuel prices.

5. The Wholesale Price Index (IPA) presented a 1.42% variation in February, compared to the 0.75% variation in the previous month. Despite the continuous fall in agriculture prices, industrial prices showed sharp increase in the period. The agriculture IPA dropped 0.76% in February, compared to the 0.34% fall in January. This pattern reflects mainly a trend reversion in the prices of cereals and grains (rice, beans and corn) due to the new harvest period. The price decreases in the group animal and by-products (cattle, pork and milk) also contributed to the negative IPA result. The industrial prices variation reached 2.3%, as against a 1.2% increase in January, mainly influenced by the price behavior of food products (oils and greases), chemical products (plastic materials and fertilizers), mechanics and electric material. The rise in metallurgy prices (iron, steel and by products, and non-ferrous metals) still presented the greatest contribution to the absolute variation of the industrial IPA, 0.36 p.p., despite the decrease in the monthly variation from January (5.2%) to February (4%). It is worth mentioning that the generalized pattern of items with positive variations in the industrial-IPA – 66.7% of the items presented price increases – indicates the influence of the change in the Cofins legislation over prices.

6. The core IPCA inflation calculated excluding household food items and regulated prices was the only core measure to increase in February, posting a 1% rise in the month, in comparison to a 0.64% increase in January. The intense variation of school fees, with a total weight of 8.8% in the IPCA, explains the rise in the index in the period. The 12-month accumulated variation stood at 7.39% in February, repeating the previous month result.

7. The core IPCA inflation calculated under the smoothed trimmed-mean method rose to 0.48% in February against 0.73% in January, posting a 9.97% accumulated variation in the last 12 months. The result calculated without the smoothing procedure for pre-selected items reached 0.28% in February, in comparison to 0.63% in the previous month. The 12-month accumulated variation totaled 6.45%, the lowest result recorded since the end of 2002.

8. Core IPC-BR inflation, calculated under the symmetric trimmed-mean method by Fundação Getúlio Vargas (FGV), reduced to 0.46% in February, compared to 0.65% in January, posting an 8.45% accumulated variation in the last 12 months.

9. The consumer prices deceleration is expected to continue in March, and the IPCA should show this behavior, following the food items trend and the end of educational items readjustments. As to the wholesale prices, agriculture prices should maintain their favorable performance, reflecting the price trends of cereals and fresh food items. Industrial prices should be pressured by inputs readjustments, albeit in a lower intensity than the observed in February.

Assessment of Inflation Trends

10. The identified shocks and their impacts were reassessed according to new available information.

The scenario considered in the simulations assumes the following hypotheses:

a. The projections for the evolution of gasoline and bottled cooking gas prices in 2004 were maintained at 9.5% and 10%, respectively;

b. The projection for household electricity tariffs was slightly increased to 6.9%, from 6.3% in the previous Copom meeting. Regarding telephone tariffs, the assumption of a 6.8% elevation in 2004 was maintained;

c. Regarding all regulated prices, with a total weight of 28.9% in the February IPCA, a 7.3% rise is projected, 0.4 p.p. below the projection made in the previous meeting;

d. The projection for the readjustment of all regulated prices for 2005 was maintained at 6.0%. This figure results from a model of endogenous determination, which takes into account seasonal components, the exchange rate behavior, market prices inflation and the IGP-DI change;

e. The projection for the 6-month spread over the Selic rate, following the specification of a Vector Autoregressive model using the Selic and swap rates on the eve of the Copom meeting, starts from an –80 b.p. average in the first quarter of 2004 and reaches 50 b.p. in the end of 2005.

11. Regarding fiscal policy, it is assumed that the primary surplus target of 4.25% of the GDP for 2004 and the following two years will be achieved. The related assumptions considered in the previous meeting were maintained.

12. Considering the benchmark scenario hypotheses, including the maintenance of the Over-Selic rate at 16.5% p.a. and of the exchange rate close to the level prevailing on the eve of the Copom meeting (R$2.91), IPCA inflation was projected below the 5.5% target for 2004 and below the 4.5% target for 2005. According to the market scenario, which takes into account the consensus exchange rate and Selic rate paths as surveyed by the BCB´s Investor Relations Group (Gerin) on the eve of the Copom meeting, inflation is projected above the central targets of 5.5% and 4.5% for 2004 and 2005, respectively.

Monetary Policy Decision

13. After three consecutive months of increases, the inflation registered by the IPCA decreased to 0.61% in February, 0.15 p.p. below the January result. There was a significant decrease in inflation in tradable and regulated items, which fell to 0.07% and 0.26%, respectively. Inflation in the non-tradable items rose almost 0.7 p.p. in the period, reaching 1.64% in February, strongly influenced by the increase in school fees. If this item were excluded, non-tradable items inflation would have been 0.73%, what would represent a 0.24 p.p. fall, compared to January. Inflation measured by other consumer price indices, such as IPC-Fipe and IPC-Br, showed a decrease of 0.5 p.p. and 0.8 p.p., respectively, compared to January. However, general price indices showed mixed evidences, with a decrease in the IGP-M and an increase in the IGP-DI. This increase was mainly caused by the higher inflation in wholesale industrial prices, which reached 2.29% in February, 1.1 p.p. above the value registered in January.

14. The fall of consumer inflation in February can be more clearly seen in the behavior of the core inflation calculated under the trimmed-mean method. Core inflation calculated under the smoothing of pre-selected items method decreased to 0.48% from 0.73%, the lowest figure recorded since June 2002, and the core inflation calculated without the smoothing procedure decreased to 0.28% from 0.63%. Core inflation calculated by excluding household food items and regulated prices rose to 1.00% from 0.65%. However, as occurred in the non-tradable items group, this increase is due to the school fees behavior. If this item were excluded, core inflation calculated by excluding household food items and regulated prices would have decreased to 0.45% in February. The better behavior of consumer inflation can also be seen in the the drop in the IPC-Br core and in the ratio of items of the IPCA with positive variation in the month, which decreased to 60.4% from 70.9%, below the average observed in the last three quarters of 2003.

15. According to the IBGE, the GDP fell 0.2% in 2003, in relation to 2002. Despite the fact that the GDP growth stood below the expected, output performance remained qualitatively consistent with

the benchmark scenario that the Copom has been working with, especially regarding the economic cycle. More specifically, in the second semester of 2003, the economy began a recovery process, and posted a 1.5% growth in the last quarter of the year, compared to the previous quarter, which is equivalent to an annual rate of more than 6%. Economic indicators available so far suggest that there has been a sustained economic growth path since the beginning of the year. Due to the significant growth in the last quarter of 2003, it is likely that the GDP data in the first quarter of 2004 indicate a cooling down on economic activity.

16. Industrial production kept the recovery trend, having presented a 0.8% growth in January, compared to December, according to the IBGE seasonally adjusted data. Semi and non-durable goods output presented growth for the first time since last September, suggesting that growth recorded in the other sectors of economy has been influencing this sector, which had not presented recovery so far, through the marginal increase in employment and real earnings. Quarterly moving average behavior has presented a continuous industrial output growth, although in lower rates than the ones recorded in the last quarter of 2003. For February, considering previous indicators, it is not possible to discard a fall in the industrial production, which is perfectly compatible with the usual patterns of a sustained growth recovery, with short-term oscillations around the trend. Moreover, in February there were only eighteen working days, as against twenty working days in the same month of 2003, harming the comparison against the same month in 2003. In addition, in two out of the five last years, Carnival was in March, which may affect the seasonal adjustment of the series. Industrial production can benefit from the low inventory levels, compensating the negative short-term scenario. Considering that different sources provide data for industrial sales and industrial production, for the fourth consecutive month the former recorded higher growth than the latter, which was 2.8% in January, according to the National Confederation of Industry (CNI). This fact may give additional stimulus to production, associated to the inventories build-up dynamics.

17. According to IBGE data, seasonally adjusted by the BCB, retail sales fell 0.3% from November to December. Yet, retail sales in São Paulo grew 8.7% in January, in relation to the previous month, according to Fecomercio data, seasonally adjusted by the BCB. Considering the behavior of new credit concessions, it is likely that the data on the January-February period show some decrease in the consumption of durable goods, such as automobiles, furniture and domestic appliances. In March, the Consumer Intention Index (IIC) stood above the critic value of 100, signaling that there are positive perspectives; however, the fall in relation to February suggests lower consumption growth in the short-term. Following the growth in the real income observed in the last months of 2003, supermarket sales, which concentrate non-durable goods, have presented progressive recovery.

18. The consolidation of positive data in the economic activity continues to be followed by expressive indicators in the external sector, posting a favorable combination of economic policy results that had not been seen in Brazil for several years. In February, the trade balance surplus reached US$2 billion and, for 2004, a US$24 billion surplus is forecast, which is a very satisfactory result considering the expected economic growth for this year. Compared to the same period last year, in February, exports and imports grew 27.1% and 6.9%, respectively. Due to the favorable performance of the trade balance, the current account result presented a surplus in February, accumulating US$0.9 billion in 2004. Despite the excellent results in the external accounts, there was an increase in the sovereign risk perception: the country-risk measured by the Brazil Embi+ increased to 560 b.p. from values around 520 p.b. from the February to the March eves of the Copom meetings, after having increased almost 100 p.b. from January to February. In spite of the reduction in the private external funding, the dollar remained stable, at values around R$2.90 on the eve of the Copom meeting. Regardless of the higher volatility that has been observed in the last two months, the Copom maintains the evaluation that the external scenario is very favorable, presenting perspective of world economic growth and high international liquidity.

19. After three consecutive months of deterioration, inflation expectations for the first quarter of 2004

dropped, according to a survey conducted by the Investor Relations Group – Gerin. The 0.61% inflation in February was bellow the 0.70% expected on the eve of the previous Copom meeting. The median of March inflation expectations also dropped from the eve of the February meeting to the March meeting, to 0.42% from 0.43%, for the full sample of the institutions participating in the survey, and to 0.40% from 0.43%, for the institutions with more accurate forecasts in the short run (Top 5 Forecasting Institutions). Hence, for the full sample, the expectation for the first quarter fell to 1.80% from 1.90%, and for the Top 5 Forecasting Institutions, it fell to 1.78% from 1.98%. The median of market expectations to 2004 and 2005 remained stable at 6.0% and 5.0% respectively, and the expectations to the next 12 months decreased to 5.41% from 5.70% in the period.

20. According to the benchmark scenario considered by the BCB inflation forecasts, which assumes the maintenance of the Over-Selic rate at 16.5% p.a. and the foreign exchange rate at R$2.91, the projected inflation is below the targets of 5.5% for 2004 and 4.5% for 2005. In accordance with the market scenario, which includes the market expected path to the exchange rate and to the Over-Selic rate on the eve of the Copom meeting, the BCB inflation forecasts lie above the targets for 2004 and 2005. Compared to February, there was an increase in the projections, because in both scenarios the February inflation forecast was much below the effective one, even though both of them considered a GDP growth for the fourth quarter above the effective, a regulated prices variation greater than expected by the Copom, which has been revised downwards since its meeting in February, and 12-month-ahead inflation expectations higher than the ones currently verified.

21. As in previous meetings, the Copom also examined the projections produced according to the same methodology, and according to the same benchmark and market scenarios for the interest and exchange rates paths, taking into account the Top 5 short-term inflation expectations for March and hence, projecting inflation for the following months. In this exercise, considering the benchmark scenario, the projected inflation for 2004 is slightly above the target, and for 2005, it is bellow the target. However, the projected inflation for 2004 and 2005 are below the February results for the same exercise, due to the substitution of the lower figure effectively observed for the expected inflation of the Top 5 forecasters for the month of February, to the reduction of expected inflation by those institutions for March and to the reasons mentioned in the paragraph above, regarding the GDP performance in 2003, the reduction in the projection for the regulated prices for 2004 and the downwards improvement of the 12-months-ahead inflation expectations. According to the same methodology, the projected inflation for the market scenario is above the 2004 and 2005 targets, although lower than the ones projected in February, due to the same reasons mentioned above.

22. The Copom also evaluated a third set of scenarios, which supposes lower inflation persistence. These scenarios consider the hypothesis under which part of the high inflation of the first quarter of the year will not impact the following quarters' and that there could even be a reversion in the inflation increases that occurred in the period due to momentary unfavorable weather conditions. This hypothesis becomes more likely the more efficient the monetary policy is in exercising its coordinating role, preventing punctual inflation increases caused by supply shocks, by seasonal factors and by attempts to restore margins from contaminating inflation expectations. For this hypothesis the Copom considered that part of inflation in the first quarter was due to a seasonal shock and that other shocks of the same fashion will also affect inflation in each quarter of the year and in 2005. The magnitude of each quarterly typical shock was estimated to reproduce, in the Copom projection models, the same seasonal standard observed in the recent series of free prices. As in the exercise described in the previous paragraph, the inflation of the first quarter is the one expected by the short-term Top 5 institutions. According to this procedure, considering the benchmark scenario exchange and interest rates trajectories, the forecast inflations for 2004 and 2005 are below the targets. When market expected exchange and interest rates are considered, inflation remains above the target for 2004, although closer to the target value than in the exercise that only encompasses the expectations of the Top 5 institutions for the first quarter, and the inflation for 2005 remains unchanged.

23. The Copom members evaluated that the risk of not fulfilling the 2004 inflation target reduced since the last meeting, due to the IPCA result and its cores in February and to lower inflation expectations for the short run and for the next twelve months. Moreover, it was consensual that the evaluation of this more favorable scenario is a result of the recent monetary policy decisions, which have been mitigating the pass-through from the rises in industrial costs to retail costs and the second order effects of inflationary surprises of January and February. The conduction of the monetary policy at the beginning of the year was decisive to revert the environment in which the leading sectors in the economic rebound could pressure prices upward, expecting that demand conditions would absorb the increases. Therefore, the risk of higher inflation diminished while the risk of unsustained economic activity remained low.

24. It was also consensual the interpretation that the main risk for consumer inflation in the next months consists on the contamination of the increases of wholesale industrial prices to retail prices. It is important to notice that this element is not incorporated into any of the projected scenarios analyzed above, except for the limited effects on the results of the IPCA for the first quarter, since there is no perceptible signal of transmission through any other channel, such as market expectations for the IPCA during the next quarters. The experience of the last years suggests that when the industrial IPA pass-through influences the part of IPCA represented by the industrialized products, it is usually fast. In this sense, the recent results of the deceleration of consumer prices are quite encouraging, despite the acceleration of the wholesale prices. The usual high speed of this pass-through enables to foresee that the remaining uncertainties about the increase in consumer prices as a result of pressures caused by wholesale prices will soon be solved.

25. Great part of the increase in wholesale prices in the last months can be explained by supply shocks, among which the different impacts caused by the Cofins ratio and levies throughout the productive chains and the increase in the international price of some commodities and intermediate inputs. There are still no elements allowing for a satisfactorily accurate measure of the magnitude of the potential impact of these shocks over the consumer prices, although there are preliminary indications, for example, that the effect of the Cofins may be small. Economic theory and the best monetary policy practice recommend the partial accommodation of increases in consumer prices caused by supply shocks. The Copom adopted this procedure in the recent past, announcing during 2002 revisions in the objective to be sought in that year and establishing adjusted targets for the inflation in 2003 and 2004. However, there is no automatic procedure that can be adopted in any circumstance, as the optimum degree of accommodation may depend on factors such as the stage of the economic cycle at which the economy is found, the unique demand conditions among the sectors that are differently affected by the shocks, the distance between current inflation and the desirable inflation in the medium and long terms, and the direct response of the private agents' inflation expectations to the shock. The Copom understands that the current circumstances do not recommend the adoption of procedures willing to accommodate the recent supply shocks.

26. Three members of the Copom considered more appropriate to keep unchanged the basic Over-Selic rate in this meeting. These members recommended greater caution in the conduct of the monetary policy in the short term, proposing that eventual cuts in the target for the Over-Selic rate should be left for a subsequent moment, when there may be additional evidences that the higher inflation rates of January and February might not contaminate the inflation of the following months and when the impact of the recent increases in the wholesale prices over the future dynamics of the consumer prices may not be significant. This caution would increase the probability of both a steady anchorage of the inflationary expectations and the behavior of the price-makers to consolidate a favorable level of inflation, such as the one considered by the scenarios of low inflation persistence analyzed by the Copom. Therefore, these three members voted for the maintenance of the target for the Over-Selic rate at 16,5% a.a.

27. However, for most part of the members of the Copom, the immediate fall of the Over-Selic rate in

0.25 p.p. can be justified by the recent behavior of the price indices, the lower inflation expectation for both the short-term and the next twelve months and the low intensity of the wholesale pass-through to the retail prices. These considerations indicate that the maintenance of the Over-Selic rate in January and February was enough to increase the probability of materialization of low inflationary persistence scenarios considered by the Committee, moving away the danger that the inflation increase recorded from December to February could contaminate inflation expectations and provoke a change in the inflationary dynamics. Therefore, this easing of the monetary policy reflects the necessary caution in the administration of the risks between inflation and the continuity of the restore of the economic activity.

28. As a result, the Committee decided, by six votes to three, to reduce the target for the Over-Selic rate to 16.25% p.a. from 16.5% p.a.

29. At the closing of the meeting, it was announced that the Copom would meet again on April 13, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in Communiqué 11,516, of October 15, 2003.

Summary of Daty Analyzed by the Copom

Economic Activity

30. According to the Federação de Comércio do Estado de São Paulo, retail sales in São Paulo metropolitan area increased 8.7% in January compared to December (seasonally adjusted). This result reflected an 8.9% increase in consumer goods sales, due to the increases of 8.7% and 12.3% in semi and non-durable goods sales, respectively, while the durable goods sales decreased 0.3%. The automotive sales increased 4% and construction inputs sales decreased 2.1%.

31. On February, consultations to the São Paulo Trade Association and the Usecheque showed a decrease of 2.8% and an increase of 0.3%, respectively (seasonally adjusted), indicating caution in the retail activity.

32. The Federação de Comércio do Estado de São Paulo survey on consumer confidence showed a 8.6% decrease in March, the second consecutive reduction in the consumption intentions. This result reflected the decrease not only in the present but also in the future consumption intentions. However, the result of 115.8, in a scale ranging from 0 to 200, reflects an overall positive sentiment, although weaker, mainly regarding future consumption intentions.

33. Regarding investment data, the capital goods output increased in January (compared to the previous month) after two months of decrease. Machinery and equipment production and construction industry input increased 4.5% and 1.1%, respectively, while capital goods imports decreased 14.1%. The machines and equipment exports increased 0.01% (all data seasonally adjusted). The increase in the capital goods production spread over all sectors, except for transport equipment.

34. According to the IBGE research, after the decrease of 1% in December, interrupting a sequence of five positive results, the Brazilian industrial production increased 0.8% in January, seasonally adjusted. Out of the twenty segments surveyed, seventeen presented increase, as well as in three out of four categories of use. Intermediary goods production decreased 0.8%, after six months of an upward trend, mainly reflecting the reduction of oil extraction due to platforms maintenance. After the decline of semi and non-durable goods production for three consecutive months, there was a 2.2% increase, while capital and durable goods productions increased 4.5% and 3%, respectively. Compared to the same month of the previous year, industrial production grew 1.7% in January.

35. Regarding the performance of the manufacturing activity in January, National Confederation of Industry (CNI) statistics showed sales dynamism. Real sales grew 2.7% in the month (seasonally adjusted), increasing for the seventh consecutive month. Compared to the same month of 2002, real sales increased 10.8%, registering the third consecutive positive rate. The seasonally adjusted worked hours increased 0.5% in January, after a decrease of 2.1% in December. The level of capacity utilization, seasonally adjusted, remained at 80.3% in January, practically the same level of December 2003.

36. In February, the automotive sector output presented a 1.6% decline. Vehicles production and external sales decreased 9.3% and 33.5%, respectively, compared to last month (seasonally adjusted data).

Labor Market

37. The index of employment increased 0.5% month-on-month in January compared to December (seasonally adjusted), and 3.2% year-on-year, according to the Ministry of Labor. According to the IBGE's survey, the unemployment rate in the six main metropolitan areas, after two consecutive declines, increased to 11.7% in January, from 10.9% in December. The same survey also registered that the employed workers average real earning deflated by the INPC decreased 13.9% in December 2003, compared to the same month in 2002. Considering the average wage, which does not include extraordinary revenues, the available data up to January show a 6.2% decrease compared to the same month of 2003.

38. In the industrial sector, according to the CNI, there was a 0.2% (s.a.) increase in employment in January, after a decline of 0.3% in December 2003, compared to the previous month. After seven months of increase, seasonally adjusted industry real payroll decreased 0.4% in January, compared to December 2003.

Credit and Delinquency Rates

39. Non-earmarked credit increased 2.1% in February, after the seasonal decrease in January. Regarding credit to companies, there was a 2.1% increase, mainly due to advance on export contracts and vendor. Regarding credit to households, there was also a 2.1% increase, mainly in personal credit with payroll-discounted repayment. Regulated by the Provisional Measure 130, these modalities have been replacing other forms of credit that have higher cost, such as overdraft account and credit card, among others.

40. The average interest rate on non-earmarked credit registered another fall in February, 0.3 p.p., reaching 45.1% p.a. The decline in rates was more significant for households, which fell 1.2 p.p., reaching 64.2% p.a. The average interest rate on credit provided to companies reached 30.2% p.a., stable in relation to last month. The delinquency rate on non-earmarked credit increased 0.3 p.p. in February, reaching 8.3%, as a consequence of the 0.2 p.p. increase in non-performing credit to individuals and of the 0.5p.p. increase in credit to companies.

41. Regarding the retail sector, there was a slight seasonal worsening in the default figures in February, compared to the previous month. ACSO data show that net default rates increased to 7.2% in February from 4.7% in January.

External Environment

42. The latest indicators signal to the maintenance of the global economy recovery, although in a lower pace and below market expectations. World economy is still vulnerable to non-economic issues and the events in Madrid reinforce cautionary position when evaluating short-term trends for the economy.

43. In the U.S., negative indicators, as the broadening of budgetary and trade deficits, prevailed over positive figures, such as the increases in both wholesale sales and consumer credit, in January. The recovery is still slow in Europe, while Japanese growth rate was revised downward in the last quarter of 2003. The Japanese government points the improvement in private consumption as a factor favoring economic expansion this year, together with the significant increase in exports, despite the concerns about the effects of the appreciation of yen on the trade balance.

44. Labor market remains recovering at a modest pace in the main economies. In the U.S., unemployment rate remained at 5.6% in February, with not many new job positions, reinforcing the effects of a higher productivity in the recent economic recovery. Businessmen sentiment worsened in February in the U.S., and was it stable in Japan and Europe. Consumer confidence declined in the U.S., but it increased in Japan and in the Euro Area.

45. In the absence of inflationary pressures, the basic interest rates remained steady in the central economies. In the U.S., the poor performance in the labor market corroborates the evaluation that the fed

fund rates should remain stable in the short-run. This behavior benefits the financing of external needs of the emerging countries, contributing to the downward trend for the country risk rates measured by Embi+, momentarily interrupted by the effects of the events in Madrid.

46. In the FX markets, there is a consensus about the continuity of the dollar depreciation due to the increasing U.S. current account deficit. The dollar depreciation together with the disequilibrium provoked by strong Chinese demand has been affecting commodity prices, which reached high levels in February.

47. The oil price has increased again since the beginning of February, reflecting the producers' decision to reduce output by 1 million barrels/day, starting April 1st. However, other factors have been contributing to prices increase, such as the crisis in Venezuela, the low levels of U.S. stocks of gasoline, and recently, the unpredictable effects of the Madrid events.

Foreign Trade and Balance of Payments

48. The Brazilian trade balance posted a US$2 billion surplus in February. Exports totaled US$5.7 billion and imports, US$3.7 billion, with increases of 27.1% and 6.9%, respectively, compared to the February 2003 daily averages. In the first 10 working days of March, the trade surplus totaled US$911 million, with increases of 22.7% and 26.9% in exports and imports, respectively, compared to same period of the previous year. Up to the second week of March, trade surplus reached US$4.5 billion in the year, compared to US$3.8 billion in the first three months of 2003.

49. The current account registered a US$0.2 billion surplus in February, reversing the deficit of the same magnitude registered in February 2003, and accumulating a US$5 billion surplus in 12 months (0.98% of the GDP). Income and services registered a US$2 billion deficit, compared to US$1.5 billion in February 2003. Financial account balance presented a US$1.1 billion deficit in the month, from a US$43 million surplus in February 2003, reducing the surplus accumulated in the year to US$2.7 billion. Rollover rates remained high not only for direct loans (164% from 39% in February 2003) but also for private securities placed abroad (255% from 188%). Net FDI totaled US$1 billion in February, accumulating US$2 billion in the year. At the end of February, international reserves stood at US$53 billion, and the net adjusted international reserves (IMF agreement concept) stood at US$21.2 billion.

Money Market and Open Market Operations

50. After the last Copom meeting, the future interest rates presented greater volatility, with the 1-year and 2-year rates ranging between 15.25% and 15.94%, and between 15.31% and 16.11%, respectively. In addition to the political scenario, other factors contributed to this movement, such as the 2003 GDP and the January industrial production results, the United States labor market data, inflation indices released showing different behavior between consumer and wholesale prices, and the lower market expectations for the next twelve months IPCA. However, despite the volatility observed, on March 16 the yield curve had already returned to a level similar to the one observed on February 18. Comparing both dates, the 3-month, 6-month and 1-year interest rates decreased 0.06 p.p., 0.08 p.p. and 0.13 p.p., respectively, while the 2-year interest rate remained stable. Real interest rate, measured by the quotient between the 1-year nominal rate and the inflation expectation for the next twelve months, increased to 9.4% from 9.1%, and the forecast real rate for 2004 increased to 9.1% from 8.9%.

51. The BCB did not carry out rollover auctions to the FX securities and swaps maturing on March 1st, 10 and 18. Including the biannually interest rates coupons, the net redemption of FX instruments in March, up to March 18, reached US$2.6 billion, and US$10.2 billion in the year.

52. The National Treasury carried out four LTN auction, totaling R$8.8 billion. In the two first tranches, securities maturing in January and July 2005 were placed, and in the last two tranches, securities maturing in April 2005 and January 2006 were placed. The National Treasury also carried out an auction of a NTN-F maturing on January 1st

2008, which financial volume reached R$278.4 million. The LFT and NTN (C and B) issues reached R$570.7 million and R$699.5 million, respectively.

53. The BCB maintained in its open market operations the 3-month fixed and the 2-week indexed repurchase operations, as well as the daily liquidity management operations, with tenor of two working days. The BCB also carried out 6 fixed rate repos with tenure up to 3 working days. The excess liquidity drained from the market averaged by the operations with tenure below thirty days was R$55.3 billion.

54. In February, the net securitized domestic public debt increased 0.8%, equivalent to R$5.8 billion. The dollar-linked share decreased to 19%, representing a reduction of 2 p.p. in the month and of 18 p.p. since the beginning of 2003.

Minutes of the 95th Meeting of the Monetary Policy Committee (Copom)

Date: April 13th, from 4:45PM to 7:30PM, and April 14th, from 3:30PM to 4:15PM
Place: BCB's Headquarters meeting room of the 8th floor (on April 13th) and 20th floor (on April 14th) – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua
Alexandre Schwartsman
Antônio Gustavo Matos do Vale
Eduardo Henrique de Mello Motta Loyo
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

Department Heads (present on April 13th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on March 14th)
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on April 13th)
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo - Advisor to the Board
Hélio José Ferreira – Executive Secretary
João Batista do Nascimento Magalhães – Special Advisor to the Governor
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

Recent Evolution of Inflation

1. The inflation recorded deceleration in March, confirming the expectations for the period. The Broad National Consumer Price Index (IPCA) registered 0.47% in March, compared to 0.61% in February, accumulating 1.85% in the first quarter of 2004. The IGP-DI reached 0.93% in March, compared to 1.08% registered in the previous month, totaling 2.84% in the first quarter of the year. This performance was mainly a consequence of the Wholesale Price Index (IPA-DI) behavior, with an increase of 1.09% in the month and of 3.30% in the first quarter of the year. The 12-month accumulated changes of the IPCA, IGP-DI and IPA-DI remained in a downward trend in March, standing at 5.89%, 4.94% and 3.59%, respectively.

2. Regarding the IPCA, the reduction of the monthly change was mainly due to the smaller impact of the school fees readjustment in the month. This readjustment was the main factor of pressure in February. In addition, fuel-alcohol prices remained on a declining trend (-12.87%), reflecting a favorable harvest of sugar cane.

3. The main individual contribution to the March IPCA inflation came from new cars prices, 0.07 p.p., due to a 2.33% increase registered as a consequence of rise in production costs, as well as of the end of the special tax on industrialized products regime. Amongst the items with greater price increase, one highlights cigarettes, with a total contribution of 0.06 p.p., and sewage and water supply, with price readjustment in four cities, with 0.05 p.p. Food and beverages registered a 0.43% increase, compared to the 0.15% increase in February, mainly driven by the prices of soy oil and eggs.

4. Regarding regulated prices, there has recently been above-than-expected price increases in certain items. As an example, the price readjustments for sewage and water supply in Brasília and Belo Horizonte reached 20% and 21%, respectively, much higher figures than any 12-month accumulated inflation index. In addition to this item, recent announcements of price readjustments of electricity in Minas Gerais and Pernambuco are also above previously expected. These increases consider inflation-indexed costs, price increases due to investments in the distribution and a part of the 2003 readjustment that is being applied this year.

5. Still regarding the IPCA evolution in March, market prices changed 0.69%, accounting for 0.49 p.p. of the monthly variation of the index, while the 0.07% fall in the regulated prices contributed with –0.02 p.p. In the first group, the rise of tradable goods prices contributed 0.27 p.p. for the IPCA monthly change, while non-tradable goods contributed with 0.22 p.p. Regarding regulated prices, the negative change was due to the reduction of fuel prices, which prevailed over the increases of water and sewage tariffs and bottled gas prices.

6. The IPA-DI decreased 1.09% in March, in comparison to 1.42% in February. This result followed the industrial prices trajectory, as the Agricultural IPA reverted its trend in March, after reductions of 0.76% an 0.34% in February and January, respectively, mainly due to price increases of 10.98%, 12.17% and 7.01% of soy, eggs and fresh food items, respectively. However, the prices of rice, cattle and sugar cane remained in a downward trend.

7. Industrial IPA rose 0.94% in March, compared to 2.29% in February, mostly influenced by prices of the following items: chemicals (decrease in alcohol prices and deceleration of price rises of both plastic and fertilizers); food products (with the effects of oil and fat losing ground); mechanics; electric material; wood and furniture; paper and cardboard; rubber; and fabric, clothing and shoes (deceleration of rises). Price increases in the metallurgy sector (iron, steel and by-products and non-ferrous metals) continued to present the highest contributions to the absolute Industrial IPA change (0.37 p.p.) in March, when the variation stood at the same level registered in the month, 4%.

8. The core IPCA inflation calculated excluding household food items and regulated prices was the only core measure to decrease in March, to 0.85% compared to a 1.00% rise in February, partially due to the end of school fees rises that had been pressuring the previous month results. The 12-month accumulated change reached 7.09% in March.

9. The core IPCA inflation calculated under the smoothed trimmed-mean method rose to 0.76% in March from 0.48% in February, posting a 9.47% accumulated variation in the last 12 months. The result calculated without the smoothing procedure for pre-selected items reached 0.65% in March, accumulating 6.11% in 12 months. As occurred with the full IPCA, the 12-month accumulated core indices registered in March the lowest changes since the end of 2002, despite being above the full IPCA change.

10. Core IPC-BR inflation, calculated under the symmetric trimmed-mean method by Fundação Getúlio Vargas (FGV), rose to 0.53% in March, compared to 0.46% in February, accumulating 7.87% in the last 12 months.

11. In April, consumer price indices should be influenced by price rises of medicine and clothing, and, among regulated items, of water and sewage and household electricity. The magnitude and the pace of the pass-through of wholesale industrial price increases to consumer prices have been unsurprised.

Assessment of Inflation Trends

12. The identified shocks and their impacts were reassessed according to new available information. The scenario considered in the simulations assumes the following hypotheses:

a. The projections for the evolution of gasoline prices in 2004 were maintained at 9.5%. The projections for bottled cooking gas were revised to 6.9% in the year, 3.1 p.p. below March projections;

b. The projection for household electricity tariffs increased to 8.5% from 6.9% since the last Copom meeting. Regarding telephone tariffs, the Copom maintained its projections practically unchanged, from 6.8% in the previous meeting to 6.7%;

c. Regarding all regulated prices, with a total weight of 28.8% in the March IPCA, a 7.4% rise is projected, 0.1 p.p. above the projection made in the previous meeting;

d. The projection for the readjustment of all regulated prices for 2005 was maintained at 6.0%. This figure results from a model of endogenous determination, which takes into account seasonal components, the exchange rate behavior, market prices inflation and the IGP change;

e. The projection for the 6-month spread over the Selic rate, following the specification of a Vector Autoregressive model using the Selic and swap rates on the eve of the Copom meeting, starts from a -81 b.p. in the second quarter of 2004 and reaches 55 b.p. in fourth quarter of 2005.

13. Regarding fiscal policy, it is assumed that the primary surplus target of 4.25% of the GDP for 2004 and the following two years will be achieved. The related assumptions considered in the previous meeting were maintained.

14. Considering the hypothesis of a lower persistence of inflation, considered by the Copom since March, and the benchmark scenario hypotheses, including the maintenance of the Over-Selic rate at 16.25% p.a. and of the exchange rate close to the level prevailing on the eve of the Copom meeting (R$2.88), IPCA inflation was projected slightly below the 5.5% target for 2004 and below the 4.5% target for 2005. According to the market scenario, which takes into account the consensus exchange rate and Selic rate as surveyed by the BCB´s Investor Relations Group (Gerin) on the eve of the Copom meeting, inflation is projected above the central targets for both 2004 and 2005.

Monetary Policy Decision

15. The inflation registered by the IPCA decreased by the second consecutive month, to a level close to the ceiling of market expectations for the month. The pressure has been higher among market prices with a change of 0.68% and 0.69% in tradable and non-tradable items, respectively. Regulated prices fell (-0.07%) and contributed significantly to the March inflation reduction. So far, non-tradable items have contributed more intensely to inflation in 2004, with a 3.33% variation in the first quarter of 2004, while tradable and regulated items changed 1.29% and 1.03%, respectively. As a consequence of this increase to 3.33% (1Q04) from 1.19% (4Q03) in the non-tradable inflation rate, the contribution of this group to the IPCA increased 0.66 p.p. in first quarter of this year compared to the last quarter of 2003, explaining almost all inflation acceleration in 2004. Inflation measured by other national consumer indices was close to the ones observed in the IPCA. However, general price indices have shown relatively higher rates. The IGP-DI increased 0.93% in March, after increasing 0.80% and 1.08% in January and February, respectively.

16. In contrast with the deceleration of the headline index, the various core IPCA measures calculated under the trimmed-mean method increased in March, reversing the February fall. Core inflation calculated with smoothing of pre-selected items increased to 0.76%, from 0.48%, and the core inflation calculated without the smoothing procedure rose to 0.65, from

0.28%. Core inflation calculated by excluding household food items and regulated prices decreased to 0.85% in March, from 1.00% in February. The ratio of items of the IPCA with positive variation in the month increased to 66.0%, from 60.4%, but kept within the usual range. It should be noted that increases in the measures of core inflation and inflation dispersion could be justified as a consequence of recent increases in wholesale prices, even if the pass-through remains moderate, as expected, and compatible with a favorable inflation scenario.

17. Economic activity continues its recovery trend, despite the 1.8% fall in industrial production in February, compared to January. This fall, anticipated in the March minutes, is fully consistent with usual economic recovery cycles and is related to the sharp rebound of the second half of 2003. The recovery was fast and intense, which became clear in the new industrial output series released in April by the IBGE. According to this new series, in the second half of 2003 the industrial production was 4.2% higher than in the first half of 2003, while the old series recorded a 2.3% growth for the same period. The highest industrial production level in Brazilian history was reached in November, with a seasonally adjusted growth of 9.6%, compared to the trough observed in June. However, according to the new series, industrial production has been declining since November, in spite of signals showing a continuous economic recovery. The new series also shows a higher growth in the semi and non-durable goods sectors. While the old series indicated December 2003 as the month with the lowest output in 2003, according to the new series, there was a peak in this month, with a seasonally adjusted growth of 9.2% compared to the trough in July.

18. Several leading and coincident indicators confirm the Copom's evaluation regarding the positive activity trend. Packaging paper production sustained the upward trend initiated in September. Automobile production increased again in March. Average real earnings in the six metropolitan areas in the IBGE's monthly employment survey increased in February for the second consecutive month. According to data from the CNI to Brasil and Fiesp to São Paulo, real earnings in the industry are currently in higher levels than the ones observed in 2002. Regarding Fiesp data, employment growth in the first quarter of 2004 was the highest since 1999, indicating that industrial production growth is already affecting job creation. Retail sales, according to IBGE data seasonally adjusted by the BCB, increased 2.1% in January compared to the previous month, reaching a level 6.1% higher than the same month of 2003. According to Fecomércio-SP data seasonally adjusted by the BCB, real sales in the greater São Paulo continue to increase, showing a 2.0% growth in February, compared to the previous month. Credit operations also sustained an upward trend. Despite the fall in consumer sentiment in March and April, retail sales have apparently not been affected.

19. Brazilian external accounts continue to show very impressive positive results. The trade balance in March was 73.3% higher than in the same month of 2003, and reached US$6.2 billion in the first quarter of the year, compared to US$3.8 billion in the same period of 2003. Despite economic growth this year, the BCB projects a trade balance surplus similar to 2003. The current account remains positive, accumulating a US$1.7 billion surplus in the first quarter of 2004. The country-risk measured by the Brazil Embi+ stabilized again, after increasing in the January-February period. From the eve of the Copom meeting in March to April, the Brazil Embi+ fell to a level close to 540 b.p., from 560 b.p. The exchange rate remained almost stable, around R$2.90/US$1.00.

20. In general, the external environment remains favorable. World growth perspectives help the Brazilian trade balance. Furthermore, the anticipation of an interest rate hike in the U.S. after the disclosure of sales and consumer inflation data in March, should not change significantly costs and availability of external funding to Brazil in 2004, despite eventual turbulence in the short run. The scenario of a rise in the FED funds is already incorporated in asset prices. In addition, the remarkable adjustment in the Brazilian current account and the reduction of the FX-linked public debt contribute significantly to mitigate not only the effects of a deterioration in international liquidity to the financing of the Balance of Payments, but also its effects on the foreign exchange market.

21. Although inflation in the first quarter was higher than expected, market expectations remained relatively stable. The small increase in expected

inflation is mainly due to the incorporation of the January-March actual rates. At the end of December, according to the Gerin, inflation expectations for the first quarter of 2004 stood at 1.51%, while actual inflation reached 1.85%. The effect on expectations to 2004 was marginal, as expectations remained satisfactorily anchored. Inflation expectations for 2005 remained steady at 5.00%. Inflation expectations for the next 12 months rose slightly to 5.48%, from 5.41%, since the last Copom meeting.

22. Copom considered BCB's inflation projections under the hypothesis of a low degree of persistence of the first quarter inflation, following the seasonal inflation pattern observed in the last years. According to the benchmark scenario, which supposes the maintenance of the Selic rate at 16.25% p.a. and the exchange rate at R$2.88 during the forecasting horizon, inflation is slightly below the 5.5% target for 2004 and below the 4.5% target for 2005. According to the market scenario, which incorporates consensus exchange rate and Selic rate on the eve of the Copom meeting, the BCB's projections are above the targets for 2004 and for 2005. Accumulated inflation for 2004 rose in the two scenarios because inflation was higher-than-expected in March. The market scenario projects higher inflation rates than the benchmarked scenario because it assumes a declining trend for the interest rate, as well as a small increase of the exchange rate.

23. As the projected inflation for April in the two scenarios was very close to the one expected by the Top 5 forecasting institutions (institutions with more accurate forecasts in the short run), incorporating these expectations into projection scenarios, as recently done by Copom, does not change projected inflations for 2004 and 2005 significantly.

24. Considering these inflation scenarios, the Committee decided, unanimously, to reduce the target for the Over-Selic rate to 16% p.a., without bias. The Committee understood that this reduction is coherent with the last meeting diagnosis, which considers more likely the benign scenario of low inflation persistence in the next months, and the low pass-through from wholesale prices to retail prices.

25. The Copom evaluated that the cautious monetary stance has been essential to increase the likelihood of inflation converging to the target. Accordingly, inflation indicators must continue consistent with the low inflation-persistence hypothesis that has been considered.

26. The monetary stance is different during crises periods, such as the one observed at the end of 2002 and the beginning of 2003, or during times of greater macroeconomic stability, as the one recently established. Therefore, when the crisis is reverted, as the interest rate is still considerably high, interest rate cuts are larger. However, a different interest rate dynamics should take place during times of greater macroeconomic stability, when inflation convergence to the targeted path, along with sustained economic recovery, should be monitored more carefully.

27. The Committee stresses that it is pointless to infer that the more moderate cut of interest rate corresponds to a negative evaluation about the future behavior of inflation, or that it should cause pessimism about the future path of economic activity. On the contrary, a natural result of the progressive normalization of the economic environment is precisely the fall in the average interest rate cuts. In addition to allowing further monetary easing, this procedure enables a smooth transition to a scenario of price stability with economic growth, with smaller market interest rates volatility in the medium run.

28. At the closing of the meeting, it was announced that the Copom would meet again on May 18, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in Communiqué 11,516, of October 15, 2003.

Summary of Data Analyzed by the Copom

Economic Activity

29. The statistics concerning the output and sales in February 2004 should be analyzed with caution, once that in this year, differently from the previous year, Carnival holidays happened in February. The smaller number of working days in February 2004 (18),

compared to 2003 (20), in spite of having different impact throughout the economic sectors, might cause misleading month-on-month and year-on-year comparisons of the output and sales flows. These distortions may not be completely eliminated with the application of usual seasoning adjustment procedures and tend to diminish February 2004 results and increase those of March.

30. According to Federação de Comércio do Estado de São Paulo, retail sales increased 2% in February compared to January, seasonally adjusted. In the year up to February, there was a 5.9% increase compared to the same period in 2003.

31. The consultations to the São Paulo Trade Association and the Usecheque showed increases of 3.7% and 4.3% month-on-month, respectively, in February, seasonally adjusted. In the year up to March, the same indicators revealed expansions of 7.2% and 0.8%, respectively.

32. The Federação de Comércio do Estado de São Paulo survey on consumer confidence showed a decrease of 9.1% in April, the third consecutive fall. The result reflects the decrease of both present and future consumption intentions. The index decreased to 105.2, in a scale ranging from 0 to 200.

33. Regarding investment data, the capital goods output decreased in February (compared to the previous month). Machinery and equipment production and construction industry input decreased 2.4% and 3.1%, respectively, while capital goods imports and exports increased 18.9% and 1.2%, respectively

34. The first release of the Brazilian industrial production, according to the new methodology of IBGE research, showed a decrease of 1.8% in the s.a. industrial activity in February compared to January. Considering categories of use, this movement was generalized, with higher intensity in the productions of durable consumption goods and capital goods, which had been increasing in the last six months. Therefore, the negative results in February reflect mostly the last month's production high level. Compared to the same month of the previous year, industrial production grew 1.8% in February, the sixth consecutive positive change in this comparison basis.

35. In March, the automotive sector output presented a 0.3% increase. Vehicles external sales increased 18.6%, while internal sales decreased 6.1% compared to last month (seasonally adjusted data). In 2004, up to March, the automotive production, the vehicles external and internal sales increased 13.5%, 13.4% and 18.4%, respectively.

Labor Market

36. The index of employment increased 0.4% month-on-month in February compared to January (seasonally adjusted), and 3.4% compared to the same month of 2003, according to the Ministry of Labor. According to the IBGE's survey, the unemployment rate in the six main metropolitan areas reached 12% in February, compared to 11.7% in the previous month. The result was due to an increase of the economic population while the number of employed workers remained practically stable from January to February. The same IBGE research registered, in February, a 0.5% increase (compared to January) in the employed workers average real earning, deflated by the INPC.

37. In the industrial sector, according to the CNI s.a. data, the employment and the industry real payroll increased 0.4% and 1.1% in February, respectively, compared to the previous month. Compared to the same month of the previous year, industry real payroll increased 7.2%, the fourth consecutive positive change in this comparison basis.

External Environment

38. World economic indicators signal to the maintenance of the global economy growth, mainly in the U.S. and Asia. More recent estimates point to more vigorous economic growth in 2004, despite the low reaction of the European economy. However, economic optimism can be harmed by an eventual worsening of the politic environment.

39. In the U.S., employment data signal to the recovery of labor market, with the creation of 308 thousand new job positions – therefore, above the expectations. The initial requests of job claims have also been presenting weekly decreases. However, it is still early to conclude about a steady recovery

trend, since the unemployment rate increased to 5.7% in March from 5.6% in February. Other economic indicators point to the maintenance of the economic growth in the first quarter, such as the increase of 0.7% in the industrial production in February, and the expansion of 1.8% of the retail sales in March, which was greater than the one-year result.

40. The recovery remains low in Europe, due to the lack of reaction of the domestic demand components in the region, especially in Germany. According to the European Commission, around six countries in the region should surpass the fiscal deficit limit of 3% established by the Stability and Growth Agreement. The impossibility to broaden the fiscal and monetary stimulus adds more skepticism to the recovery in the Euro Area.

41. Business confidence improved in the U.S. and in Japan in March, but remained stable in Europe. Consumer expectations remained stable in the U.S. and Europe and presented slight improvement in Japan.

42. In the absence of inflationary pressures, the basic interest rates remain steady in the central economies. However, the most prominent indicators of labor market in the U.S. anticipated the market expectations that the Federal Reserve would initiate the process of increasing the interest rates this year. There was positive reaction among the rates of the US government securities and the treasuries of the European economies. The futures markets have showed high volatility. In the FX markets, there is a consensus about the continuity of the dollar depreciation due to the increasing U.S. current account deficits.

43. Prices of commodities reached the highest levels in March. Grain inventories have been maintained in historically low levels due to the atmospheric conditions of the last years and to the recent harvest shock in the South hemisphere. Along with the strong world demand, this fact has pressured the prices. Metal prices have also been kept above the historical averages, reflecting the demand pressures and low inventories. Regarding oil, pressure over prices is also a result of the increase in the tensions in Iraq.

Foreign Trade and Balance of Payments

44. The Brazilian trade balance posted a US$2.6 billion surplus in March. Exports and imports increased 25% and 18.8%, respectively, compared to the March 2003 daily averages. In the first 2-weeks (6 working days) of April, the trade surplus totaled US$576 million, and US$6.7 billion in the year, compared to US$4.5 billion registered in the same period of 2003.

45. Considering the first quarter, exports totaled US$19.4 billion, and imports, US$13.3 billion, with daily averages of US$313.7 million and US$214.2 million, respectively. Compared to the same period of last year, exports and imports increased 27.2% and 16.2%, respectively. In the accumulated of the year, considering the six working days of April, exports amounted US$21.5 billion and imports, US$14.7 billion, registering a positive balance of US$6.7 billion. The daily average of exports reached US$315.9 million in the period, 27% above the value observed in the same period of 2003. Considering imports, the daily average of US$216.6 million was 17.6% above the value registered in the same period of last year.

Money Market and Open Market Operations

46. After the March Copom meeting, the futures yield curve registered significant change in its slope, with reduction in the short-term interest rates and increase in the rates with tenures longer than one year. The main factors that contributed to the slowdown movement of the short part of the curve were the reduction of the Over-Selic Target and the favorable expectations of the inflation trajectory. This movement was partially reverted by the fact that the IPCA and its cores were above market expectations. Yet, the long part of the yield curve was influenced by the greater placement of National Treasury Bills (LTN) by the National Treasury and by the increase of interest rates of U.S. treasuries. Between March 17 and April 13, the 1-month and 6-month interest rates decreased 0.23 p.p. and 0.16 p.p., respectively, while the 1-year, 2-year and 3-year rates increased 0.11 p.p., 0.33 p.p. and 0.48 p.p., respectively. The ex-ante real interest rate, measured by the quotient between 12-month nominal interest rate and the 12-month ahead inflation expectations, remained at 9.4%.

47. Similarly to what has been occurring since the middle of December of last year, the BCB did not carry out auctions to rollover securities and Fx swaps maturing in the period. Thus, including interests, the net redemption of these instruments in the year, up to the end of April, will amount US$14.1 billion, of which US$3.8 billion only in this month.

48. The National Treasury carried out four selling auctions of LTNs, maturing in April 2005 and January 2006 and totaling R$19.1 billion. The issue of National Treasury Notes – Series C (NTN-Cs) amounted to R$ 2.2 billion, of which R$1.3 billion settled in local currency.

49. The BCB maintained in its open market operations the weekly post-fixed repo operations, with tenure of two weeks, and the fixed operations, with tenure of three months, as well as the 2-working-day daily liquidity management operations. The BCB also carried out in this period 11 fixed rate repos falling due between 1 and 3 working days. The excess liquidity drained from the market and sterilized by the operations maturing before 30 days averaged R$50.9 billion in the period.

50. In March, the net securitized domestic public debt increased 2.2%, basically due to the net placement of R$6.1 billion of securities and the interest appropriation. The fixed rate share increased to 15.4% from 13.6%, while the dollar-linked share decreased to 17.7% from 19%.

Minutes of the 96th Meeting of the Monetary Policy Committee (Copom)

Date: May 18th, from 4:45PM to 7:00PM, and May 19th, from 3:30PM to 6:15PM
Place: BCB's Headquarters meeting room of the 8th floor (on May 18th) and 20th floor (on May 19th) – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua
Alexandre Schwartsman
Antônio Gustavo Matos do Vale
Eduardo Henrique de Mello Motta Loyo
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

Department Heads (present on May 18th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on May 19th)
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on May 18th)
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo - Advisor to the Board
Hélio José Ferreira – Executive Secretary
João Batista do Nascimento Magalhães – Special Advisor to the Governor
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

Recent Evolution of Inflation

1. Consumer inflation showed a new deceleration in April. The Broad National Consumer Price Index (IPCA) rose 0.37%, compared to 0.47% in March, accumulating 2.23% in the January-April period. The IGP-DI registered a 1.15% change in April (0.93% in March), totaling a 4.02% variation in the first four months of the year. The IGP-DI rise is explained by the behavior of the Wholesale Price Index (IPA-DI), which presented a 1.57% variation in the month (1.09% in March and 4.92% accumulated up to April). The accumulated IPCA variation in twelve months reached 5.26% in April, the lowest rate since the second half of 1999, at the same time as the IGP-DI and the IPA-DI stood at 5.71% and 5.14%, respectively.

2. The lower IPCA variation was largely caused by the turnaround in food prices, which registered a 0.34% decline in April, compared to a 0.43% increase in March. This reversal reflected the supply increase due to the harvest period.

3. The main individual contribution to the 0.37% IPCA change came from medicine prices (a 3.0% rise), partly capturing the 5.7% average readjustment given by the *Regulation Chamber* to certain controlled products. Among other pressures, electricity tariffs, pasteurized milk, clothes and bottled cooking gas are highlighted. Among items with price decreases, the most important ones were meat, gasoline, fuel alcohol and rice.

4. Still regarding the evolution of the IPCA in April, market prices increased 0.39% (0.69% in March), accounting for 0.28 percentage points of the monthly IPCA rate, while the 0.32% variation in regulated prices accounted for the remaining 0.09 percentage points. Concerning regulated prices, the major impacts came from the elevation of electricity tariffs in six cities and urban buses tariffs in Curitiba and Porto Alegre, besides the increase of bottled cooking gas prices.

5. The increase in wholesale prices, as captured by the IPA-DI, was a result of higher pressure from industrial prices (a 1.86% rise in April, compared to 0.94% in March). Agriculture prices dropped by 0.8% in April, compared to a 1.48% rise in March. Increasing commodity prices were the main cause of pressure on industrial wholesale prices. Fuel, sugar, pharmaceutics and agricultural machinery presented the highest price changes.

6. All measures of IPCA core inflation declined in April. The core calculated excluding household food items and regulated prices posted a 0.72% change (0.85% in March), accumulating 7.0% in twelve months.

7. IPCA core inflation calculated by the smoothed trimmed-mean method decreased to 0.57% in April from 0.76% in March, totaling 8.90% in the last twelve months. Without the smoothing procedure for pre-selected items, the IPCA core reached 0.45% in the month and 5.68% in the last twelve months, compared to 0.65% and 6.11%, respectively, in March.

8. IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) using the symmetric trimmed-mean method, stood at 0.53% in April, the same change recorded in March, accruing 7.15% in twelve months.

9. In May, consumer inflation should be affected by medicine, health insurance and clothes prices, as well as by the adjustment in electricity tariffs in various cities and the recovery of fuel alcohol prices. Moreover, an unexpected turnaround in the downward trend of food prices has been noticed in the first weeks of the month, as shown in the partial IPC-S and IPC-Fipe results.

Assessment of Inflation Trends

10. The identified shocks and their impacts were reassessed according to new available information. The scenario considered in the simulations assumes the following hypotheses:

a. The projections for the evolution of gasoline and bottled cooking gas prices in 2004 were maintained at 9.5% and 6.9%, respectively;

b. The projections for household electricity tariffs increased to 11%. For fixed telephone tariffs, the Copom maintained the adjustment estimate at 6.7% for the year;

c. Regarding all regulated prices, with a total weight of 28.6% in the April IPCA, a 7.7% rise is projected, 0.3 p.p. above the projection made in the previous meeting;

d. The projection for the readjustment of all regulated prices for 2005 was maintained at 6.0%. This figure is endogenously determined, taking into account seasonal components, the exchange rate, market prices inflation and the IGP-DI change;

e. The projection for the 6-month spread over the Selic rate, following the specification of a Vector Autoregressive model based on the Selic and the swap rates on the eve of the Copom meeting, increases from -38 basis points in the second quarter of 2004 to 59 basis points in the fourth quarter of 2005.

11. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of the GDP for 2004 and the following two years will be achieved. The related assumptions considered in the previous meeting were maintained.

12. Considering the benchmark scenario hypotheses - the Over-Selic rate at 16.0% p.a. and the exchange rate at the level seen on the eve of the Copom meeting (R$3.10), and also considering the hypothesis of a lower degree of inflation persistence, as assumed by the Copom since March, IPCA inflation was projected slightly above the 5.5% target for 2004 and below the 4.5% target for 2005. According to the market scenario, which takes into account the consensus exchange rate and Selic rate as surveyed by the BCB´s Investor Relations Group (Gerin) on the eve of the Copom meeting, inflation is projected above the central targets for both 2004 and 2005.

Monetary Policy Decision

13. The inflation measured by the IPCA decreased in April for the third month in a row. As in recent months, market prices inflation has been higher than regulated prices inflation (0,39% compared to 0.32%). Amongst market prices, for the first time since October 2003, tradable goods inflation (0.50%) was higher than non-tradable goods inflation (0.25%). However, for the year to April, non-tradable goods prices increased 3.59% and were the ones that most contributed to the 2.23% IPCA inflation. Prices of tradable goods rose 1.80% in the period, while regulated prices rose 1.35%. Other national consumer indices registered inflation similar to the IPCA in April, such as the Consumer Price Index – Domestic Supply (IPC-DI). However, general price indices have recorded higher rates. The IGP-DI increased 1.15% in April, accumulating a 4.02% rise in the year. Industrial wholesale inflation has increased, though the pass-trough to consumer inflation has been lower than expected.

14. Core consumer inflation in April also declined compared to March. The smoothed trimmed-mean core fell to 0.57% in April from 0.76% in March. The non-smoothed trimmed-mean core declined to 0.45% in April from 0.65% in March. Core inflation excluding household food items and regulated prices still posted a high rate (0.72%), albeit lower than the previous month (0.85%).

15. Certainly, the April’s IPCA result does not imply that inflation is accommodating at a lower level. Still, it is an evidence of the seasonal relief that had already been incorporated to the Copom’s forecasting exercises. The IPCA behavior has been consistent with the Copom´s assessment and projections, under a hypothesis of low inflation persistence in the first quarter of the year.

16. Economic activity has sustained the recovery trend since the second half of 2003, as confirmed by several indicators. Industrial production increased 2.1% in March compared to February, seasonally adjusted. In comparison with the first quarter of 2003, industrial output grew 5.8%, led by capital and durable goods. According to the industrial survey, all regions showed a positive performance, except Rio de Janeiro. Industrial sales remained strong throughout the quarter and inventories diminished, in line with the results of the FGV industrial survey, in which only 7% of the firms recorded excessive inventories in the first quarter of the year, compared to 10% in the previous quarter and 12% in the first quarter of 2003.

17. According to IBGE data, seasonally adjusted by the BCB, retail sales have maintained an uninterrupted growth trend since March 2003. In March 2004, retail sales reached the highest level in the last two years, up 1.1% in comparison to February. Sales in the first quarter increased 3.3%

compared to the last quarter of 2003, seasonally adjusted. The improvement in activity can also be depicted from the Fecomercio SP consumer sentiment survey. Consumer confidence improved in May to a level similar to January and February – the highest since the survey began, in March 1999.

18. Labor market indicators, which usually react with a lag in recovery cycles, have also improved. According to data from *Cadastro Geral de Empregados e Desempregados* (Caged) of the Ministry of Labor and Employment, the average formal employment between January and April stood 3.5% above the same period of last year. In the first four months of 2004, 535 thousand jobs were created, the best performance since 1995. For comparison, during last year 645 thousand jobs were created. The National Industry Confederation (CNI) and the Federation of Industries of the State of São Paulo (Fiesp) data for employment and industrial wages in March also grew, compared to February. Similarly, industrial employment data published by the IBGE show an employment expansion of 0.4% in March and 0.9% in the first quarter (s.a.), while worked hours grew 1.5% in the quarter. According to the IBGE survey, industrial wages increased 9.3% in the first quarter of 2004, year-on-year, while CNI estimated a 6.6% increase.

19. It is important to notice that the activity rebound continued during the first quarter of 2004, despite the widespread apprehension that the Copom's decision to keep unchanged the Over-Selic rate in January and February could have halted the process. Such concerns were probably enhanced by the negative industrial output figures for January and February. However, variables directly linked to demand, such as retail and industrial sales, together with industrial output for March, confirmed that the recovery process had not lost momentum. Several indicators released since then have indicated that the expectational effects of the Copom decision in January and February, as anticipated by the Committee, were successful in influencing the inflation dynamics in the short-run, without damaging the cyclical rebound that was already spread out.

20. Brazilian external accounts have continued posting expressive positive results. In April, the trade balance reached US$2.0 billion, totaling US$8.1 billion in the year, compared to US$5.5 billion in the same period of 2003. The Central Bank estimates a 2004 trade surplus similar to 2003. The current account accumulated a US$0.9 billion surplus in 2004, despite a negative result in April, a consequence of Brady bonds interest payments. The improvement in both the trade balance and the current account has continued reflecting exports growth (25% in the first four months of the year), regardless of the imports increase (18%). First quarter data indicate that exports growth is mainly a result of higher quantities.

21. The most meaningful alteration in the economic environment since the April Copom meeting has occurred in the external scenario, due to the change in market sentiment regarding the US monetary policy and the increase in oil prices. Although some reallocation of investment portfolios had already been anticipated, the move was more abrupt than expected. The short-term instability impacted several currencies, as well as emerging markets risk premiums. From April to May Copom meetings, the exchange rate depreciated to R$3.10 from R$2.89 per US dollar, and the country-risk measured by the JP Morgan Embi+ increased to 728 basis points from 543 basis points. However, this greater instability does not characterize a crisis, due to both its temporary nature and the sound fundaments of the Brazilian economy.

22. Brazil is in a much better situation to react to external events than it was in the past, given the substantial fiscal and external adjustments it has achieved. The Brazilian government has been giving solid proof of fiscal responsibility, as noted in the recent decision about the minimum wage readjustment. Moreover, economic activity indicators, including the ones referring to the labor market, have been providing unquestionable evidence of the Brazilian sustained economic recovery, diminishing concerns that have fuelled volatility in the last weeks.

23. Since the last Copom meeting, crude oil prices have exacerbated the upward trend that had already been observed beforehand. If this trend results from higher demand perspectives, and not from exogenous supply constraints, it will find natural limits in its own

effects over the world economic growth. Given the recent record levels, the most likely scenario for the next months is some accommodation in prices. The Copom has been explicitly including in its projections an increase in domestic gasoline prices. Specifically, Copom's scenarios incorporate a 9.5% increase in gasoline prices in 2004, which would translate into an increase of 11.8% during the remaining of the year, considering the prices' fall since January. If oil prices remain high in the medium-term, characterizing a supply shock of a more permanent fashion, it will be necessary to revaluate this projection and its likely primary and secondary inflationary impacts.

24. In addition to the increase in oil prices and to the uncertainty related to the US monetary stance, there has been a certain concern regarding the possibility of a slowdown in China, a country responsible for a significant share of Brazilian exports growth. In the last twelve months, exports to China represented around 6% of total Brazilian exports. Exports to China increased US$381 million in 2004, equivalent to 7% of the exports increase this year. Regarding the magnitude of the expected deceleration of the Chinese economy (to around 7.0% from 9.5%), the direct effect on Brazilian exports does not seem to be strong. There are also indirect effects, due to the reduction of Brazilian exports prices. However, it is important to notice that export prices increases have accounted for just 25% of exports expansion in the last twelve months to March. In other words, prices explain just US$3.5 billion out of the US$14 billion exports growth. Thus, there are reasons to believe that the Brazilian exports performance won't be strongly affected by a possible reduction in the pace of the Chinese economic growth.

25. Market inflation expectations increased, reflecting an environment of greater uncertainty. However, the increase was small and expectations remained properly anchored. The median of inflation expectations for 2004 reached 6.22% on the eve of the meeting, compared to 6.00% at the end of December. For the first time this year, 2005 inflation expectations increased, to 5.06% from 5.00%. The median of inflation expectations for the next 12 months increased to 5.67% from 5.48%, between the eves of the last two Copom meetings.

26. As in previous meetings, the Copom examined chiefly the inflation outlook under the hypothesis of a low degree of persistence of the first quarter inflation. This hypothesis is based on a seasonal relief in market prices inflation in the second and third quarters, as observed in previous years. Inflation projections in the benchmark scenario, based on an unchanged Over-Selic rate at 16.0% and the exchange rate at R$3.10 throughout the projection horizon, point out to an inflation rate slightly above the target of 5.5% for 2004 and below the 4.5% target for 2005. In relation to April, there was an increase in the 2004 inflation projection, mainly caused by a more depreciated exchange rate. In the market scenario, which takes into account the exchange rate and Over-Selic rate expected by the market on the eve of the Copom meeting, inflation projections remain above the targets for 2004 and 2005. In fact, for 2004 inflation projections for the benchmark and for the market scenarios are close to each other, because, if on the one hand, interest rates are lower in the market scenario, on the other hand, the exchange rate is also more appreciated. For 2005, the market scenario projects higher inflation than the benchmark one, because the former supposes a declining interest rate path and a slightly depreciated exchange rate.

27. The Copom also analyzed the inflation projections for the next 12 months, corresponding to the second half of 2004 and the first half of 2005. This is a period when inflation outcomes will be more sensitive to monetary policy decisions taken in the next months, and at the same time, it presents more reliable inflation projections than the ones already available for 2005. The projected inflation for this 12-month period, on both the benchmark and market scenarios, remains within the central targets established by the National Monetary Council for 2004 and 2005.

28. Although the recent realignments in the exchange rate and in oil prices may have a long-lasting component, the Copom members were unanimous in considering that the Brazilian economy, due to the soundness of its fundaments, is in a position to absorb this external shock without damaging the macroeconomic stability and growth perspectives. The significant adjustment of the current account, the reduction of the FX-linked debt, the adjustment of the consolidated public sector

accounts, the combination of floating exchange rate with inflation targeting, the economic activity rebound in the last quarters and the credibility gains in macroeconomic management help to absorb the consequences of the external shock.

29. Even in less favorable scenarios than the most likely ones analyzed by the Copom, it is possible to be optimistic about economic growth with price stability prospects in the medium-term. Considering that oil prices and the exchange rate remain unchanged, and assuming the maintenance of the Over-Selic rate at 16.0%, the Copom forecasts an inflation rate closer to the target (5.5%) than to the upper limit of the tolerance interval (8.0%) for 2004. The same forecast indicates a convergence of inflation to the target of 4.5% in 2005. Therefore, considering this less likely hypothesis, the flexibility of the inflation targeting regime, when cautiously used, would avoid high costs in terms of inflationary acceleration.

30. In an inflation targeting regime, the Central Bank policy-making is based on the assessment of different scenarios for the most important variables affecting inflation dynamics. The uncertainties about the external scenario have been responsible for a short-term volatility that increased the uncertainty about future inflation behavior. As a consequence, both the assessment of alternative scenarios by the monetary authority and the coordination of private agent's expectations become more difficult. In this environment, the volatility triggered by risk factors that should not prevail in the medium-term, when the external scenario will be cleared, could affect inflation expectations for a longer period.

31. Three members of the Copom considered relatively low the risk of a contagion of inflation expectations by the short-term volatility and voted for a decrease of 25 basis points in the Over-Selic rate. However, six members considered that this risk could increase substantially if the monetary policy did not take into account the even remote possibility that some changes in the external scenario might be permanent. In addition, the majority judged that, as the uncertainties in the projection scenarios increased significantly, the best policy to be adopted is the one usually taken by Central Banks in similar circumstances: not to change the monetary instruments as much as they could be in a situation without this additional uncertainty. Therefore, these six members understood that the most adequate decision would be to keep the Over-Selic rate unchanged.

32. As a result, the Committee decided, by six votes to three, to maintain the target for the Over-Selic rate at 16.0% p.a.

33. At the closing of the meeting, it was announced that the Copom would meet again on June 15, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in Communiqué 11,516, of October 15, 2003.

Summary of Data Analyzed by the Copom

Economic Activity

34. The production and sales data for March 2004 should be carefully analyzed, as the carnival holiday in 2004 was in February. As a consequence, there were more working days in March 2004 (23) than in the same period of the previous year (19). This effect has different impacts among the sectors and can distort the monthly and annual comparisons of production and sales. Such distortions are not completely eliminated by usual seasonally adjusted methods.

35. According to IBGE's retail monthly survey, retail sales maintained the recovery trend in March and increased 1.1% compared to the previous month (seasonally adjusted data). This result was better than the ones released by regional Trade Federations. However, it is important to notice that the methodology and the geographic coverage of these surveys are rather distinct.

36. IBGE estimated that retail sales increased 9.9% in the first quarter of the year, in comparison with the same quarter of 2003, above the 6.75% inflation in the period.

37. According to Fecomercio-SP, real retail sales in the great São Paulo grew 2.8% in March, compared to the same month of 2003. The expansion in the first

quarter of the year was 4.4%, led by the growth in sales of appliances, clothing, fabric and shoes.

38. The consultations to the São Paulo Trade Association and the Usecheque, in April, decreased 1.8% and 2.1%, respectively, compared to the previous month, after seasonal adjustment. In the year, up to April, these same indicators expanded 7.8% and 0.5%, respectively.

39. The Fecomercio-SP survey pointed to a recovery of consumer confidence in May, after three consecutive monthly falls. The Consumer Confidence Index increased 18% compared to the previous month, reaching 124.4 points, in a scale ranging from 0 to 200. The recovery was due to the increases of 24.5% in current conditions and of 15.6% in expectations. This result reflected, mostly, the improvement in expectations of consumers with earnings up to ten minimum wages, while consumers with higher earnings were more cautious in assessing the current and future economic scenario.

40. Regarding investment, in March, capital goods domestic production and construction industry inputs recovered, accumulating, in the first quarter, increases of 20.9% and 0.5%, respectively, compared to the same period of 2003. Capital goods absorption increased 6.6% in the same period, despite the significant expansion of 54.1% in exports, mainly agricultural machinery. Another investments indicator, the BNDES credit operations, increased 74.3% from January to April 2004, compared to the first four months of 2003. Credit for the industrial sector, which represents around 46% of the total, grew 74.5%, while credit for the agricultural sector for the commerce and services sectors increased 157.2% and 51.1%, respectively.

41. The IBGE estimated an increase of industrial production of 2.1% in March, compared to February (seasonally adjusted). This increase was widespread, encompassing eighteen out of the twenty-three activities, and three out of the four use categories. Considering the quarterly moving average, output remained unchanged from February to March, after a decline at the beginning of the year. In the first quarter of 2004, industrial production increased 5.8% compared to the same period of 2003, with production expansion in twenty of the surveyed activities and in all use categories. The increases of 20.9% in capital goods production and of 20.5% in durable goods production should be highlighted.

42. The CNI data regarding industry performance in March, compared to the previous month, showed an increase of 3.5% in real sales and a decrease of 0.1% in worked hours, considering seasonally adjusted series. Real sales and worked hours increased 12.1% and 2.5%, respectively, compared to the first quarter of 2003. The installed capacity utilization level increased 3.1%, compared to February, s.a., and 1% in the first quarter of 2004, compared to the same period of 2003.

43. The industrial output expansion in March is likely to persist, according to an FGV survey carried out in April, with 1,005 companies all over the country. According to this survey, industrial inventory levels are well balanced, ending an adjustment process initiated in July 2003.

44. According to the FGV survey, business sentiment improved in regard to both demand and employment, considering a 3-month horizon.

45. In April, the automotive sector output increased 11.6%, with the production of around 170 thousand units, compared to the same month of 2003. In the first four months of 2003, vehicles output, domestic sales and exports increased 13.2%, 18.1% and 4.2%, respectively, in comparison to the same period of last year.

Labor Market

46. Formal employment increased 0.4% in April compared to March (seasonally adjusted), and 3.5% in the first four months of 2004, according to the Ministry of Labor and Employment. In the first four months of the year, 535 thousand jobs were created, the highest number ever registered for this period of the year.

47. According to the IBGE's employment survey, the unemployment rate in the six main metropolitan areas increased to 12.8% in March compared to 12.0% in the previous month. The result was due to an increase of 1.4% the economically active

population. The same survey registered in March a 1.4% increase in average real earnings, posting a third consecutive month increase.

48. In the industrial sector, according to CNI seasonally adjusted data, employment and real payroll increased 0.5% and 0.9% in March, respectively, compared to the previous month. In the first quarter of 2004, employment and real payroll increased by 0.3% and 6.6%, respectively, compared to the same period of last year.

Credit and Delinquency Rates

49. Non-earmarked credit increased 3.1% in April, collaborating for a continuous trend in the credit expansion, with a special contribution of the acquisition of goods operations, corporate credit and operations linked to external resources, for companies and personal credit as well. The portfolio balance for companies with domestic and external resources increased 2.6% and 5.5%, respectively and for household operations, 2.3%.

50. The average interest rate on non-earmarked credit registered a decrease of 0.6 p.p., in April, reaching 44.7% p.a. The result was due to declines of 0.5 p.p. and 0.7 p.p. in average lending rates to companies and to households, respectively. The delinquency rate on non-earmarked credit decreased 0.2 p.p. in April, to 7.7%, as a consequence of the 0.5 p.p. fall in non-performing credit to individuals. Non-performing credit to companies increased 0.1 p.p. in April.

51. Regarding delinquency in the retail sector, in April there were falls of 14.6% in the number of new files and 10.9% in the number of cancelled files, compared to the previous month. The net default rate remained practically stable at 6.4% in April. In the year to April, the number of new files increased 4.2%, but the number of cancelled files increased 7.7%, bringing the net default rate in 2004 to a level 8.7% below the one in the same period of 2003.

External Environment

52. In the first quarter of this year, GDP grew 4.2% in the US, 2.4% in the Euro Area, 5.6% in Japan, and 9.8% in China. In Germany, GDP growth presented the highest figure since the first quarter of 2001, boosted by exports.

53. In the U.S., labor market data showed new jobs creation, reduction of the unemployment rate and fall of unemployment claims. Other economic indicators point to the sustainability of GDP growth, such as the expansion of industrial orders, industrial production, installed capacity and productivity.

54. In the U.S., business sentiment in the services sector improved in April, while those from the industrial sector remained stable. In Europe, business sentiment also improved. In Japan, the Shoko Chukin index, for small and medium corporations, remained above the optimistic level, in spite of having slowed down in April. Consumer sentiment improved in the US and Japan, and remained stable in Europe.

55. The Bank of England raised the repo rate by 25 basis points on May 6. In the US, inflationary pressures were moderate in April, in spite of the vigorous economic growth. In China, consumer inflation rose again in April, increasing the concern of monetary authorities with respect to the inflation effects of the significant economic growth.

56. Global markets suffered with high volatility in the past weeks, anticipating the effects of the expected increase in the US interest rates and the measures adopted by the Chinese government to decelerate economic growth. US Treasuries yields increased, a trend followed by the Treasuries of Japan and Europe. Emerging markets bonds fell, with generalized increases in country risk indicators, currency depreciations against the US dollar and sharp falls in stock exchanges indices. In the FX market, the US dollar appreciated against other hard currencies, in spite of high US fiscal and trade deficits.

57. Apart from oil, commodity prices fell after peaking in March, even though current levels are still well above the historical averages. Oil prices, on the contrary, increased in the past weeks, mainly as a result of political tensions in the Middle East, of heated world demand, and of the fact that refineries are operating close to capacity in a period of high seasonal consumption of gasoline in the US.

Foreign Trade and Balance of Payments

58. The Brazilian trade balance posted a US$2 billion surplus in April. Exports and imports increased 15.4% and 16.1%, respectively, compared to the April 2003 daily averages. In the first two weeks of May, the trade surplus totaled US$1.2 billion, with exports and imports increasing by 11.9% and 20.9%, respectively, compared to the average figures of May 2003.

59. In April, total exports totaled US$6.6 billion, led by manufactured goods exports (US$3.8 billion, +23.3% compared to April 2003). Semi-manufactured and primary products reached US$0.8 billion (+13.3%) and US$1.9 billion (6.3%), respectively. Imports totaled US$4.6 billion in the month. All import categories increased as compared to April 2003 results, with highlight to raw material and intermediate goods (+19.6%).

60. The current account registered a US$735 million deficit in April, accumulating a US$948 million surplus in the year, compared to a US$821 million deficit in the same period of 2003. In the first four months of this year, the trade balance posted a US$8.1 billion surplus, services and income account posted a US$8.2 deficit, and current transfers posted a US$1 billion surplus. Net FDI accumulated US$3.1 billion in the year, compared to US$2.8 billion in the same period of last year. In the first four months of 2004, the rollover rate of private debt was slightly above 100%. At the end of April, international reserves reached US$50.5 billion, and adjusted net reserves, according to the IMF concept, stood at US$22.4 billion.

Money Market and Open Market Operations

61. The market perception of a tighter U.S. monetary policy triggered a movement of portfolio reallocations, affecting emerging markets' assets and, particularly, Brazil's assets. Domestic interest rates rose significantly in the period, and the futures yield curve reverted the downward slope that had been observed since April 2003. From April 14 to May 19, the 3-month, 1-year and 2-year rates increased to 0.09 p.p. from -0.46 p.p., to 2.23 p.p. from -0.68 p.p., and to 3.67 p.p. from -0.17 p.p., respectively. As a consequence, the ex-ante real interest rate increased to 11.8%.

62. The BCB did not carry out auctions to rollover securities and Fx swaps maturing in the period. Including interests, the net redemption of these instruments in the year, up to the end of May, will amount to US$17.6 billion.

63. The National Treasury carried out four selling auctions of LTNs and four auctions of LFTs, totaling R$11.3 billion and R$3.1 billion, respectively. No bidding was accepted on the auction of May 4, and the auctions scheduled for the coming two weeks were canceled, given market volatility. For the same reason, the Treasury carried out three auctions to buy LFTs maturing in 2007, 2008, and 2009, totaling R$3.4 billion. The issue of National Treasury Notes – Series C (NTN-Cs) amounted to R$2.3 billion, of which R$1.5 billion settled in exchange for other National Treasury's securities.

64. The BCB maintained in its open market operations the weekly post-fixed repo operations, with tenure of two weeks, the fixed operations, with tenure of three months, as well as the 2-working-day liquidity management operations. The BCB also carried out in this period 7 fixed rate repos falling due between 1 and 2 working days. The excess liquidity drained from the market with operations shorter than 30 days averaged R$41.3 billion.

65. In April, the net securitized domestic public debt increased R$7.8 billion. Due to the net redemption of R$11.6 billion of securities and FX swaps, the dollar-linked share decreased to 16.3%. The fixed rate share increased to 15.8% from 15.4%.

Economic policy measures

Financial system and credit market-related measures

Circular 3,229, 3.25.2004 – Altered the procedures of the alternative methodology for calculating exposure in gold, foreign currencies and assets and liabilities subject to exchange variation. The alteration refers to inclusion of gold in the listing of currencies that can be considered jointly for purposes of calculating exchange exposure, should the financial institution opt to offset contrary positions. In this way, positions in United States dollars, euros, pounds sterling, yen, Swiss francs and gold can be offset, in such a way as to incorporate the effect of the diversification into the calculation of the capital required for coverage of market risk.

Resolution 3,178, 3.29.2004 – Reduced the Long-Term Interest Rate (TJLP) for the second quarter of 2004 from 10% per year to 9.75% per year.

Resolution 3,179, 3.29.2004 – Revoked Resolution 2,389/1997, which dealt with the prohibition on credits granted to users of international credit cards. Considering the dynamics of current exchange policy, as well as the impact on balance of payments adjustment, this prohibition is no longer required. When introduced, its purpose was to curtail growing outlays on international travel.

Resolution 3,181, 3.29.2004 – Defined procedures for transferring federal public securities classified within the category of papers held to maturity, which constitute the share of the portfolio of financial institutions that is not evaluated at market value, but rather at acquisition cost plus earnings received. The papers thus classified may be sold, without altering the financial institution’s intention at the time it classified such papers, provided that the transfer occur simultaneously to acquisition of new papers of the same nature, in an equal or greater amount than those sold, but with a longer maturity term, since the purpose of this type of operation is to lengthen the public debt maturity profile. The amount of this category transferred in the period, as well as the impact of these operations on the result should be detailed in the explanatory notes appended to financial statements.

Resolution 3,188, 3.29.2004 – Authorized cooperative banks to receive rural savings deposits and altered the minimum percentage of investment of these deposits in rural credit. Cooperative banks are those in which stock control belongs to central credit cooperatives; these institutions already channel a major share of their loan portfolios into rural sector operations. Previously, receiving rural savings was authorized exclusively to Banco do Brasil, Banco do Nordeste do Brasil and Banco da Amazônia. With respect to the change in the minimum investment percentage, it was altered from 40% to 65%, making it equal to the percentage of real estate savings that must be channeled into housing credits. For those institutions already allowed to obtain rural savings deposits, the increase in this percentage will be introduced progressively, according to a schedule to take effect on September 1, 2004. Cooperative banks must comply with the investment requirement once they have received rural savings deposits for six months.

Provisional Measure 179, 4.1.2004 – Altered the law that instituted the Provisional Contribution on Operations or Transmission of Amounts and Credits and Rights of a Financial Nature (CPMF). As of August 1, 2004, the opening of investment deposit accounts will be obligatory for purposes of financial investments through financial institutions and other institutions authorized to operate by Banco Central. The purpose of these accounts is to receive the resources originating in the demand deposit account of the person holding title to the investment. These resources will be channeled exclusively to some modality of investment in fixed or variable income operations, while movements among the different financial investments will be permitted without generating levying of the CPMF. The charging of this contribution will only occur when the investment deposit account receives amounts originating in a demand deposit account. In this sense, the objective of this Provisional Measure is to achieve greater efficiency in the allocation of resources on the financial market, while enhancing competition among the different investment alternatives available to savers. With respect to savings deposits, investments may be made and maintained without the need for investment deposit accounts. Furthermore, stock purchase and sale operations and contracts referenced to stocks or stock indices are not included under investment deposit accounts, since these operations are not subject to the CPMF. Judicial deposit accounts and payroll deposits are also exempt from the requirement for investment deposit accounts.

Circular 3,235, 4.22.2004 – Among other matters, deals with the opening, maintaining and operation of the investment deposit accounts covered by Provisional Measure 179. These accounts may be maintained in the form of individual and joint accounts but cannot be operated through the use of checks or magnetic cards and possible positive balances will not be entitled to earnings. Individuals or corporate entities that are holders of demand deposit accounts or savings accounts at the same institution or in another institution are exempt from compliance with the traditional formalities required for opening accounts, provided that the information on the identification of the financial institution, branch and account is stated on the respective account opening proposal. Debits effected against the investment deposit account, when the resources have not been allocated to financial investments, will have to be paid exclusively to the beneficiary through a credit entry to that person's demand deposit account.

Circular 3,236, 5.6.2004 – Altered the calculation base of the compulsory reserve and additional reserve requirement on demand deposits. As of August 2, 2004, balances registered on each business day under the heading of Deposits for Investment, created by Circular 3,235, were included in the calculation base of this compulsory deposit, considering that the amounts transferred to this account continue as demand deposits until such time as they are channeled into financial investments.

Resolution 3,196, 5.27.2004 – Extended the period of the exemption from compulsory reserve on demand deposits, applicable to the deposits received by pioneering branches. This exemption, which expired on May 28, 2004, was extended for one more year. According to Resolution 2,099, dated 8.17.1994, a pioneering branch is that branch installed in a market that has no other bank branch nor advanced service outlet belong to a multiple bank that has a commercial portfolio, commercial bank or the Federal Savings Bank. Those branches that lose this condition as of May 31, 2004 will no longer be exempt from the aforementioned reserves.

Resolution 3,197, 5.27.2004 – Treats of operations involving exchanges and loans of securities. Financial institutions and other institutions authorized to operate by Banco Central are entitled to borrow securities as well as to exchange and lend securities included in their respective portfolios, in cases involving operations that are settled financially within chambers that provide clearing and settlement services. These operations can be carried out with individual persons and corporate entities independently of whether they are components of the financial system and have the objective of enhancing the liquidity and dynamism of the secondary public and private securities market, to the extent that they make it possible to perform overdraft operations with the guaranty of the chambers referred to above.

Resolution 3,198, 5.27.2004 – Altered and consolidated the norms related to the rendering of services of independent auditing to financial institutions and other institutions authorized to operate by Banco Central. The alterations refer to the formation of the auditing committee at closed capital institutions. This committee is an entity that will provide advisory services to the institution's administration and will have the primary tasks of evaluating the effectiveness of the independent and internal audits and verifying compliance with the recommendations of the auditors. It was determined that, in those cases in which closed capital entities lead conglomerates that include open capital institutions, with a single committee for the entire group, that committee will also have the participation of three independent members, as well as the three already designated directors, with the purpose of guarantying the interests of those holding stock in the open capital institutions. Alternatively, those institutions that are members of the conglomerates that have shares negotiated on the Exchange may constitute their own committees, in which members would have no involvement in the administration of the entity.

Circular 3,240, 6.9.2004 – This instrument defined procedures for remitting information to Banco Central do Brasil on simplified accounts, microcredits based on demand deposit resources and payroll loans. These data must be sent by the following financial institutions: multiple banks, commercial banks, the Federal Savings Banks, credit cooperatives composed of small businesspersons, micro-businesspersons and micro-entrepreneurs and credit cooperatives that freely admit members. These statements are to be sent every two months and are to include monthly information for the base dates of February, April, June, August, October and December and are to be remitted by the final day of the month subsequent to the two month period. The first remittance of the statement on the channeling of demand deposit resources should be retroactive to base date September 2003, while all other information should backdate to January 2004. It should be stressed that the first data are to be provided by September 30, 2004.

Fiscal policy measures

Provisional Measure 179, 4.1.2004 – Authorized financial institutions to open investment deposit accounts. This new modality of account allows investors to rechannel their investments without being subject to payment of the Provisional Contribution on Financial Operations (CPMF). The purpose of this measure is to make reallocation of investor positions more agile and, in this way, optimize investment returns and reduce the sharp competition among products and financial agents. The Provisional Measure goes into effect as of 8.1.2004. However, only as of 8.1.2006, will it be possible to credit the amounts consequent upon redemptions, settlements, assigns or recontracting of financial investments existent on 7.31.2004 directly to the beneficiary in investment deposit accounts.

Provisional Measure 182, 4.29.2004 – Set the minimum wage at R$260.00 to go into effect as of 5.1.2004. The increase represented growth of 7.0181% (measured by the National Consumer Price Index – INPC) and a real increase of 1.2280%. In turn, the value of the so-called family-wage calculated per child or similar person up to fourteen years of age or incapacitated persons of any age, was set at R$20.00 for the insured party with earnings of no more than R$390.00. Above this limit and up to R$586.19, the value of the family wage was set at R$14.09. The budget-financial impact of this measure foreseen for 2004 was estimated at R$2,222.3 million, of which R$1,878.6 million were already foreseen in the Annual Budget Law (Law 10,837, dated 1.16.2004). The additional impact of R$343.7 million should be covered by reallocations of budget resources.

Decree 5,027, 3.31.2004 – Compared to the amounts specified by Decree 4,992, dated 2.18.2004, expanded the amount that executive branch organs, funds and entities are allowed to operate, commit to spending and utilize in payments by R$800 million. As a preventive measure, the aforementioned decree set aside R$6 billion in federal government discretionary spending.

Decree 5,094, 6.1.2004 – Compared to the amounts specified by Decree 4,992, dated 2.18.2004, expanded the amount that executive branch organs, funds and entities are allowed to operate, commit to spending and utilize in payments by R$1,100 million. As a preventive measure, the aforementioned decree set aside R$6 billion in federal government discretionary spending.

Measures related to external sector

Camex Resolution 7, 3.4.2004, republished on 4.1.2004 (section 2) – Instituted the Export Financing and Guaranty Committee (Cofig), which is a component of Camex, created by Decree 4,993, dated 2.18.2004.

Law 10,844, 3.4.2004 – Deals with Banco Central do Brasil credits against financial institutions accredited to operate in the framework of the Reciprocal Payments and Credit Agreement (CCR) and takes other measures. Conversion of Provisional Measure 142, dated 12.2.2003, into law.

Secex Circular 14, 3.17.2004 – Based on the rules covering Brazil-Mexico automotive trade, as defined in the Economic Complementation Agreement between Mercosul and Mexico, announced an import quota of 165,000 vehicles, and revoked Circular 23/2003.

Camex Resolution 8, 3.29.2004 – Altered the ad valorem rates of the Import Tax on Capital Goods and Informatics and Telecommunications Goods mentioned therein, as ex-tariff rates, to 2% (two percent).

Camex Resolution 9, 3.31.2004, republished on 4.23.2004 – Reduced the Import Tax rate on medicines and pharmaceutical products on the list specified therein to zero percent.

Provisional Measure 177, 3.25.2004 – Determined norms on the Additional Charge on Freight for Merchant Marine Renovation and the Merchant Marine Fund and revoked the legislation specified therein.

Bacen Circular 3,231, 4.2.2004 – Announced the new Import Exchange Regulations, as Chapter 6 of the Consolidation of Exchange Rules.

STN Directive 180, 3.31.2004 – Authorized issue of National Treasury Notes Series I (NTN-I), in the amount of R$7,911,294.05 (seven million, nine hundred and eleven thousand, two hundred and ninety four reals and five centavos), referenced to 12.15.2003, recorded under Amounts to be Paid 2003, to be used in the payment of interest rate equalization of financing for exports of Brazilian goods and services with Proex support.

STN Directive 181, 3.31.2004 – Authorized issue of National Treasury Notes Series I, NTN-I, in the amount of R$24,212,956.17 (twenty four million, two hundred and twelve thousand, nine hundred and fifty six reals and seventeen centavos), referenced to 3.15.2004, to be used in the payment of interest rate equalization of financing for exports of Brazilian goods and services with Proex support.

Bacen Circular Letter 3,131, 4.13.2004 – Altered the Regulations on Exchange Contracts and Classification of Free Rate Exchange Market Operations. Changes were introduced into title 14 – Nature of the Operation, of the Regulations on Exchange Contracts and Classification of Free Rate Exchange Market Operations, which constitutes Chapter 1 of the Consolidation of Exchange Rules (CNC), in order to include a specific code for inflows and conversions of credits to absorb the losses of companies receiving foreign direct investment.

Bacen Circular 3,234, 4.16.2004 – Altered exchange regulations in order to foresee the possibility of digital signatures on exchange contracts through utilization of digital certificates issued within the Public Keys Infrastructure (ICP-Brazil), and takes other measures.

SRF Normative Instruction 417, 4.27.2004 – Updated and consolidated legislation on the Special Customs Regime of Industrial Depots under Computerized Control (Recof) and revoked legislation cited therein.

Camex Resolution 10, 4.28.2004 – Altered the ad valorem rates of the Import Tax on Capital Goods and Informatics and Telecommunications Goods, included on the appended list, as ex-tariff, to 2% (two percent) up to 6.30.2006.

Law 10,865, 4.30.2004 – Deals with the Contribution to Social Integration Program (PIS) and Program of Civil Service Asset Formation (Pasep) and the Contribution to Social Security Financing on imports of goods and services. Conversion of Provisional Measure 164/2004 into law.

Provisional Measure 183, 4.30.2004 – Reduced the rates of Social Integration Program (PIS) and Program of Civil Service Asset Formation (Pasep) and the Contribution to Social Security Financing (Cofins) on imports and internal marketing of fertilizers and agricultural pesticides and herbicides classified in Chapter 31 of the NCM.

Decree 5,057, 4.30.2004, rectified on 5.20.2004 – Reduced the specific rates of Social Integration Program (PIS) and Program of Civil Service Asset Formation (Pasep) and the Contribution to Social Security Financing (Cofins) to zero on imports of the chemical and pharmaceutical products listed therein.

Decree 5,059, 4.30.2004 – Reduced the specific rates of Social Integration Program (PIS) and Program of Civil Service Asset Formation (Pasep) and the Contribution to Social Security Financing (Cofins) on imports and marketing of gasoline, diesel oil, liquefied petroleum gas (LPG) and aviation kerosene.

Decree 5,062, 4.30.2004 – Determined the coefficient for reduction of the specific rates of Social Integration Program (PIS) and Program of Civil Service Asset Formation (Pasep) and the Contribution to Social Security Financing (Cofins), as dealt with in articles 51 and 52 of Law 10,833/2003.

Secex Circular 27, 5.5.2004 – Announced that consolidated and selected information targeted to Brazil is available on the General System of Preferences of the European Union, which is to remain valid until 12.31.2005.

STN Directive 223, published on 5.5.2004 – Authorized issue of National Treasury Notes – Series I (NTN-I), in the amount of R$1,770,876.31 (one million, seven hundred and seventy thousand, eight hundred and seventy six reals and thirty one centavos), referenced to 4.15.2004, to be used in the payment of interest rate equalization of financing for exports of Brazilian goods and services with Export Financing Program (Proex) support.

STN Directive 224, published on 5.5.2004 – Authorized issue of National Treasury Notes – Series I (NTN-I), in the amount of R$4,125,860.30 (four million, one hundred and twenty five thousand, eight hundred and sixty reals and thirty centavos), referenced to 12.15.2003, recorded under Amounts to be Paid 2003, to be used in the payment of interest rate equalization of financing for exports of Brazilian goods and services with Export Financing Program (Proex) support.

Appendix

Banco Central do Brasil Management

Members of the Monetary Policy Committee (Copom)

Banco Central do Brasil Management

Board

Henrique de Campos Meirelles
Governor

Afonso Sant'Anna Bevilaqua
Deputy Governor

Alexandre Schwartsman
Deputy Governor

Antonio Gustavo Matos do Vale
Deputy Governor

Eduardo Henrique de Mello Motta Loyo
Deputy Governor

João Antônio Fleury Teixeira
Deputy Governor

Luiz Augusto de Oliveira Candiota
Deputy Governor

Paulo Sérgio Cavalheiro
Deputy Governor

Sérgio Darcy da Silva Alves
Deputy Governor

Members of the Monetary Policy Committee (Copom)

Voting members

Henrique de Campos Meirelles
Governor

Afonso Sant'Anna Bevilaqua (Dipec)
Deputy Governor

Alexandre Schwartsman (Direx)
Deputy Governor

Antonio Gustavo Matos do Vale (Dilid)
Deputy Governor

Eduardo Henrique de Mello Motta Loyo (Diesp)
Deputy Governor

João Antônio Fleury Teixeira (Dirad)
Deputy Governor

Luiz Augusto de Oliveira Candiota (Dipom)
Deputy Governor

Paulo Sérgio Cavalheiro (Difis)
Deputy Governor

Sérgio Darcy da Silva Alves (Dinor)
Deputy Governor

Non-voting members

Altamir Lopes
Head of the Departament of Economics (Depec)

Daso Maranhão Coimbra
Head of the Departament of International Reserve Operations (Depin)

José Antonio Marciano
Head of the Departament of Banking Operations and Payments System (Deban)

José Pedro Ramos Fachada Martins da Silva
Head of the Investor Relations Group (Gerin)

Marcelo Kfoury Muinhos
Head of the Research Departament (Depep)

Sérgio Goldenstein
Head of the Departament of Open Market Operations (Demab)

Acronyms

Abimaq	Brazilian Machinery Manufacturers Association
ACC	Advances on Export Contracts
ACSP	São Paulo Trade Association
Aladi	Latin American Integration Association
Anfavea	National Association of Automotive Vehicle Manufacturers
ANP	National Petroleum Agency
b.p.	Basis point
Bacen	Central Bank of Brazil
BM&F	Brazilian Mercantile & Futures Exchange
BNDES	Brazilian Development Bank
BNDESpar	BNDES Participações S.A.
BoJ	Bank of Japan
BP	Balance of Payments
BVAR	Bayesian Vector Autoregression
Caged	General File of the Employed and Unemployed
Camex	Foreign Trade Council
CCR	Reciprocal Credit and Payment Agreement
Cepal	Economic Commission for Latin America and the Caribbean
Cide	Contribution on Intervention in the Economic Domain
CLT	Consolidated Labor Legislation
CMN	National Monetary Council
CNC	Committee for Trade Negotiations
CNI	National Confederation of Industry
Cofig	Export and Guarantee Financing Committee
Cofins	Social Security Financing Contribution
Copom	Monetary Policy Committee
CPMF	Provisional Contribution on Financial Transactions
DAX	Deutscher Aktienindex
Depec	Department of Economics
Depep	Economic Research Department
DI	Interfinancial Deposit
DJIA	Dow Jones Industrial Average
DLSP	Net public sector debt
DPMF	Federal public securities debt
ECB	European Central Bank
Embi+	Emerging Market Bond Index Plus
EU	European Union
Fecomercio SP	Trade Federation of the State of São Paulo

FGV	Getulio Vargas Foundation
Fiesp	Federation of Industries of the State of São Paulo
FIF	Financial Investment Funds
Finame	Special Industrial Financing Agency
FOB	Free on Board
FTSE 100	Financial Times Securities Exchange Index
Funcex	Foreign Trade Study Center Foundation
GDP	Gross Domestic Product
Gerin	Investor Relations Group of the Central Bank of Brazil
HICP	Harmonized Consumer Price Index
IBGE	Brazilian Institute of Geography and Statistics
Ibovespa	São Paulo Stock Exchange Index
Icea	Index of Current Economic Outlook
Icei	Current Industrial Employment Index
ICP-Brasil	Public Keys Infrastructure
IEC	Consumer Expectation Index
IGP	General Price Index
IGP-DI	General Price Index – Domestic Supply
IIA	Current Intentions Index
IIC	Consumer Intention Index
IIF	Institute of International Finance
IIF	Institute of International Finance
IMF	International Monetary Fund
Inec	Consumer Expectation National Index
INPC	National Consumer Price Index
INSS	National Social Security Institute
IPA	Wholesale Price Index
IPA-DI	Wholesale Price Index – Domestic Supply
IPA-OG	Wholesale Price Index – Overall Supply
IPC	Consumer Price Index
IPCA	Broad National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPC-DI	Consumer Price Index – Domestic Supply
IPC-Fipe	Consumer Price Index – Institute of Economic Research Foundation
IPI	Industrialized Products Tax
IPP	Producer Price Index
ISM	Institute for Supply Management
LFT	National Treasury Financing Bills
LPG	Liquefied Petroleum Gas
LSPA	Systematic Farm Production Survey
LTN	National Treasury Bills
mbd	Million barrels per day
MDIC	Ministry of Development, Industry and Commerce
Mercosul	Southern Common Market
MP	Provisional Measure
MTE	Ministry of Labor and Employment
Nasdaq	National Association of securities Dealers Automated Quotation
NBCE	Banco Central do Brasil Note – Special Series
NCM	Common Mercosul Nomenclature
NTN-B	National Treasury Note – Series B

NTN-C	National Treasury Note – Series C
NTN-D	National Treasury Note – Series D
NTN-F	National Treasury Note – Series F
NTN-I	National Treasury Note – Series I
OECD	Organisation for Economic Co-Operation and Development
Opec	Organization of Petroleum Exporting Countries
p.p.	Percentage points
p.y.	Per year
Pasep	Program of Civil Service Asset Formation
PIA	Active Age Population
PIS	Program of Social Integration
PMC	Monthly Trade Survey / Montly Survey of Trade (do IBGE)
PME	Monthly Employment Survey
PMI	Purchasing Managers Index
POF	Survey on Family Budget
Proex	Export Financing Program
Recof	Special Customs System for Industrial Deposit with Information System Control
RPIX	Retail Prices Index excluding Motgage Interest Payments
S&P500	Standard and Poor's 500
SDR	Special Drawing Rights
Secex	Foreign Trade Secretariat
Selic	Special System of Clearance and Custody
SPC	Secretariat of Complementary Social Security
TJLP	Long-Term Interest Rate
TMU	Technical Memorandum of Understanding
USA	United States of America
VAR	Value at Risk
WTI	West Texas Intermediate