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BANCO CENTRAL DO BRASIL

Inflation Report

September 2004

Volume 6 – Number 3

5 cruzeiros, 1943, printed in chalcography and offset by the American Bank Note Company

On the back of the 5 cruzeiros note, a picture of Antonio Parreiras, "A Conquista do Amazonas"

Museum of Money of Banco Central do Brasil Collection

National Treasury Issuance

During the World War II (1939-1945), the value of the Brazilian exports of foodstuffs and raw materials reached record levels. At the same time, the difficulties brought by the war to the countries involved in it reduced Brazilian imports. Consequently, the Brazilian currency attained great stability.

Due to the lack of raw material for coin manufacturing, the note issuance of 1, 2 and 5 cruzeiros was authorized, and it became policy to adopt similar measure whenever there were difficulties in issuing coins.

The increase of issuances – due to the increasing need to exchange the foreign currency which arrived with the profits from exports – resulted in inflation.

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Statistical Conventions:

...	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.
*	preliminary data.

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

At the end of the second quarter of the current year, economic indicators pointed to a historically high level of production as a result of the recovery that began in the second quarter of 2003. Initially powered by the highly dynamic export sector and expanding credit, the process was gradually reinforced by growth in income and employment in 2004. More recent data indicate that growth continued into the third quarter.

With consolidation of this scenario, themes related to the outlook for expanding the productive capacity of the economy in order to meet expanding demand and ensure the sustainability of the growth process became subjects of importance in the economic debate. With respect to both current and perspective indicators, macroeconomic indicators are in a considerably better position now than they were in other recent episodes of vigorous recovery, making it possible to ensure that the current cycle will be marked by greater continuity than in the past. Among the factors underlying the enhanced robustness of macroeconomic fundamentals in the current cycle, mention should be made of the simultaneous occurrence of a consolidated scenario of fiscal responsibility and public debt sustainability, an initially comfortable position for the balance of payments current account result, a real rate of exchange that has remained fully aligned with market forces and an inflationary process that is under control.

Increased confidence in the solidity of macroeconomic fundamentals, reinforced by microeconomic measures targeted at consolidating a favorable business environment, will certainly aid in attracting the investments required for a more regular and accelerated growth trajectory. Recent evolution of capital formation and investment intention indicators has been consistent with the start of this process and has taken on special importance in the current scenario of continuous growth in the utilization of installed industrial output capacity. This is a question that provokes some worry due to its magnitude and sectoral scope, since reductions in idle output capacity gradually tend to impact the dynamics of prices.

In the June-August quarter, financial system credit operations continued on the upward trajectory that has marked recent months. This trend has been fully consistent with the evolution of the level of economic activity. The increase occurred in operations based on domestic resources and contracted with legal entities while, in the case of households, the dominant factors were greater demand for personal credit and consumer goods financing, in detriment to revolving credit operations. At the same time, the period has been marked by a movement in the direction of normalization of the banking debt. This is evident in the downturn in default rates, particularly among households and has been driven by migration into operations with lower rates of interest and by growth in income and employment.

The fiscal results registered up to July were fully compatible with the targets set for the year. Aside from this, there was lesser dependence on the performance of state companies, as the participation of these companies in the public sector surplus in the January-July quarter registered a reduction when compared to previous years. On the other hand, governments increased the surplus accumulated in the year as a result of a combination of increased inflows, caused by growth in the activity level, reductions in outlays on personnel and social charges and growth in spending on current expenditures and investments.

With respect to the debt/gross domestic product ratio, it is important to note that the year witnessed a decline equivalent to 3.4 p.p. of the GDP. Continued equilibrium in all public sector segments, reductions in median Selic rates when compared to those in effect in 2003 and GDP expansion are the factors most responsible for the decline registered in that ratio. These same factors, coupled with lesser vulnerability of the debt to exchange rate fluctuations, should continue to contribute to the steady downturn in the debt/GDP ratio.

The current account surplus increased sharply in the first eight months of the year, compared to the results for the same period of 2003. It is important to note that this improvement occurred despite a rise in net remittances under the income account, as a result of the larger trade surplus registered in the period and of inflows of current unrequited transfers.

Current expectations point to continued strong trade balance results, even though imports are expected to expand sharply as a result of the scenario of economic recovery. In this sense, another factor that will certainly contribute to this process will be the upturn in world economic activity in the second half of 2004, particularly if the rather limited impact of the petroleum price rise on the more developed economies continues, when compared to previous episodes. Aside from this, foreign direct investment flows recovered sharply in the July-August period.

The recent behavior of foreign direct investment flows, together with the rates at which private sector debt has been rolled – even though, in this case, these rates were lower than in previous months, have certainly contributed to warding off possible uncertainties regarding financing of the nation's external accounts. The outlook for the future performance of the external accounts are consistent with generation of a substantially positive flow on the exchange market, indicating that there will be no greater difficulties in financing the balance of payments in the remaining months of 2004 and in the coming year.

The elements responsible for the rise in inflation in the June-August period were monitored prices, prices administered by contract and the prices of *in natura* foodstuffs, since specific increases under these products reflect seasonal climatic shocks. However, the different measurements of core inflation – including those that purge the notorious influence of monitored prices, contract prices and prices of food taken at home – remained at relatively stable albeit high levels, indicating an underlying inflationary trend that is incompatible with the trajectory of targets.

The deteriorating inflationary expectations of private agents for 2004 and 2005, which were initially caused by exchange depreciation in the second quarter, continued into the third quarter as a result of spiraling oil prices and, in more general terms, of revisions in projections for the General Price Index (IGP), monitored prices and prices administered by contract. Additional momentum originated in the high levels of the inflation cores and significant revisions of 2004 economic growth projections.

It is important to mention that the pressures caused by international market prices of petroleum and derivatives in recent months have become an important risk factor for the domestic inflation scenario. Though monetary policy projections have incorporated some leeway for the inflationary impacts of possible fuel price increases, the international market is still quite volatile, making its impossible to perceive any clearly discernible tendencies in these prices. On the other hand, considerable improvement was registered in international financial markets as a result of the release of data on the United States economy, indicating somewhat slower growth than originally expected. While allowing the

Federal Reserve to continue its policy of gradually raising basic interest rates, this scenario has contributed to attenuation of the so-called Brazil risk and to exchange appreciation, thus reducing the inflationary risks originating in this source.

The central trajectory associated with the reference scenario, which assumes maintenance of interest rates at 16.25% per year and a constant rate of exchange equivalent to R$2.90 over the horizon of the projection, results in inflation of 7.2% in 2004, well above the central target of 5.5% defined for the year. The fact that 2004 inflation will close above the central target led the Monetary Policy Committee (Copom) to announce that it will begin to apply monetary policy in such a way as to hold inflation to 5.1% in 2005. This objective corresponds to the central target of 4.5% stipulated by the National Monetary Council (CMN) plus 0.6 p.p., offsetting 2/3 of the inflationary inertia that will be carried over from 2004 to 2005. For 2005, the inflation projection derived from the reference scenario is 5.6% - therefore, above the 5.1% objective defined by Copom. The market scenario, which utilizes the interest and exchange trajectories found in the survey carried out among professional analysts by the Banco Central Investor Relations Management Staff (Gerin), projects higher inflation rates than the reference scenario, 7.4% for 2004 and 6.4% for 2005. According to the scenarios delineated in this report, product growth for 2004 is 4.4%, 0.9 p.p. higher than that projected in the previous *Inflation Report*.

1 Activity level

The pace of economic activity continued expanding in the second quarter and early part of the third, thus confirming the outlook defined on the basis of prospective indicators in the previous Inflation Report. Though the growth that has occurred in recent months was certainly foreseen, the intensity of the process has surpassed expectations, as evinced by the fact that, at the end of the first quarter of the year, output indicators had already climbed to historically high levels.

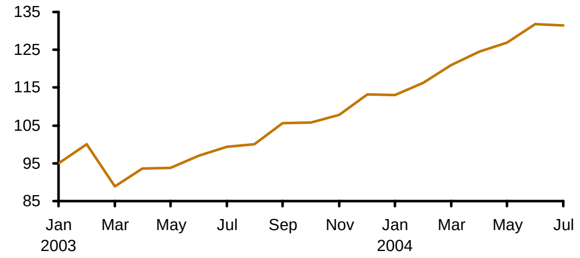
The strength of the economic upturn is due to the dual factors of dynamic growth in the export sector and consolidation of expanding internal demand. Internally, it is important to stress expanding income as the factor that has fired consumer spending. This is evident in the increased output and sales of items that are less sensitive to credit conditions, such as foodstuffs and apparel. At the same time, sectors in which internal demand is more sensitive to credit conditions, such as capital goods and consumer durables, which have played a leading role in the economy's response to the more relaxed monetary policy in effect since last year, have registered consistently high growth under both output and sales in recent months.

Parallel to export growth, the recovery in internal demand has steadily raised the level of utilization of the nation's installed industrial capacity. This movement has been more significant in those sectors that have drawn the greatest benefit from external market operations, since they have been working at already high levels of utilization for quite some time. However, it is important to note that the increase in investment flows, stimulated by both the positive overall outlook and by the generalized reduction in idle capacity, particularly in the different export segments, has tended to accelerate the pace at which the industrial sector is expanding its output capacity.

In the crop/livestock sector, estimates of this year's grain harvest have been revised downward as a result of climatic difficulties encountered particularly in the soybean and corn crops. Production of meats and derivatives, on the other hand, has managed to preserve the dynamics of past periods, driven above all else by continued growth in foreign sales.

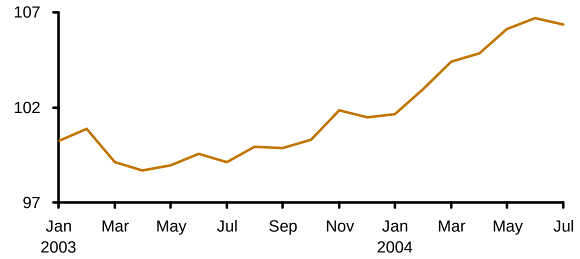
1.1 Retail sales

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

Sales Volume Index in the Retail Sector – Brazil

Percentage change

Itemization	2004					
	Feb	Mar	Apr	May	Jun	Jul
In the month[1/]						
Retail sector	0.5	0.7	1.9	1.0	0.1	0.1
Fuel and lubricants	-0.1	3.0	-0.9	-1.0	1.0	0.2
Supermarkets	1.3	1.4	0.4	1.2	0.5	-0.3
Textiles, clothing and footwear	-2.7	2.8	-2.1	5.8	0.8	-2.4
Furniture and home appliances	2.9	4.0	2.8	2.0	3.8	-0.3
Vehicles and motorcycles	-0.4	0.3	-1.4	9.8	1.8	-0.9
Quarter/previous quarter[1/]						
Retail sector	2.6	2.5	2.5	3.2	3.3	2.6
Fuel and lubricants	1.4	1.8	1.9	2.4	0.7	0.1
Supermarkets	1.3	1.8	2.4	3.0	2.8	2.2
Textiles, clothing and footwear	1.4	0.8	-0.4	1.7	2.9	5.0
Furniture and home appliances	7.3	7.2	8.3	8.7	9.4	7.8
Vehicles and motorcycles	1.7	0.4	-0.7	2.6	5.7	9.8

Source: IBGE
1/ Seasonally adjusted data.

The growth curve followed by the retail trade sector since mid-2003 has been maintained in 2004. Reflecting the increase in labor-based income, the current year has witnessed consolidation of a similar growth process under nondurable consumer goods, particularly supermarket products, apparel and footwear. At the same time, sales of consumer durables continued along a strong growth curve, despite lesser growth in credit operations in recent months.

According to the Monthly Trade Survey (PMC), which is released by the Brazilian Institute of Geography and Statistics (IBGE), the Index of Retail Sales Volume, which is based on deseasonalized data, registered a high of 2.6% in the quarter ended in July, when compared to the previous quarter. All of the different activities registered positive results in the period, with particularly strong performances under furniture and home appliances, 7.8%, and fabrics, apparel and footwear, 5%. The segment of automobiles, motorcycles, parts and spares, which is not included in the general index, registered an increase of 9.8%, using the same basis of comparison. In July, this indicator registered positive growth for the seventh consecutive month, according to the deseasonalized series.

A state-by-state breakdown indicates that the volume of retail sales expanded in the quarter ended in July in all of the states analyzed, with the sole exception of Tocantins, which registered a deseasonalized decline of 3.3%. Also based on deseasonalized data, the sharpest increases were registered in Amazonas, 16.8%, Rondônia, 10.8%, and Mato Gross do Sul, 7.4%.

In the first seven months of 2004, nominal sales revenues expanded by 11.8%, compared to the same period of 2003. This result was a consequence of combined increases of 9.7% in sales volume and 1.8% in retail prices. It should be stressed that, compared to the same period of 2003, median prices in the first seven months of 2004, increased by 6.2%, according to IBGE's Broad National Consumer Price Index (IPCA). In the period under consideration, all of the different sectors turned in growth in nominal revenues that was higher

Sales Index in the Retail Sector – Brazil
2004, July

Itemization	Nominal revenue	Volume	Price
	% accumulated growth in 2004		
Retail sector	11.8	9.7	1.8
Fuel and lubricants	-2.6	6.7	-8.7
Supermarkets	9.4	6.1	3.1
Textiles, clothing and footwear	17.3	7.4	9.2
Furniture and home appliances	32.3	29.8	1.9
Vehicles and motorcycles	26.6	17.5	7.7

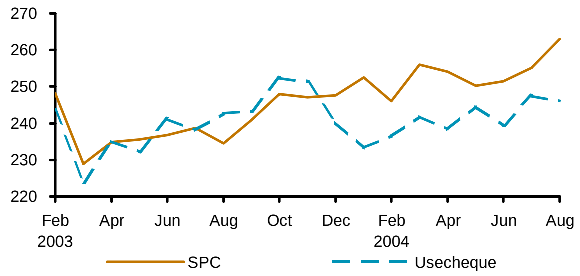
Source: IBGE

Real sales of the retail sector[1/]

Itemization	2004					
	% accumulated growth in the year					
	Jan	Feb	Mar	Apr	May	Jun
SP	4.8	5.2	4.3	4.9	5.1	6.3
RJ	-0.2	-2.0	-1.7	-2.5	-2.0	-1.6
MG	-2.6	-4.8	0.7	1.2	0.9	1.9

Source: Fecomercio SP, Fecomercio RJ and Fecomercio MG
1/ Data referring to the metropolitan areas of the state capitals.

Retail sales indicators
Seasonally adjusted data
1992=100



Source: ACSP

than price growth, with exception of fuels and lubricants. The most important segments were furniture and home appliances, 32.3%, automobiles and motorcycles, 26.6%, and fabrics, apparel and footwear, 17.3%.

Sectoral surveys of the various state trade federations confirmed continued sales growth in the first half of 2004. Thus, real revenues in the first six months of 2004, compared to the same period of 2003, expanded by 6.3% in São Paulo and 1.9% in Minas Gerais, considering the metropolitan regions of the state capitals. In Rio de Janeiro, there are positive signs that the downward trend that marked the start of the second quarter of 2004 is gradually being reversed, despite a reduction of 1.6% in revenues in the period.

Other indicators related to the sector of commerce indicate an upturn in retail activities in the first half of the year, showing that this movement continued into the early months of the second half. The number of consultations with the Credit Protection Service Center (SPC), which is an indicator of installment purchases and goods of larger aggregate value, released by the São Paulo Trade Association (ACSP), expanded by 7% in the first six months of the year, compared to the same period of 2003. In the quarter ended in August, the indicator based on seasonally adjusted data expanded by 1.2% compared to the quarter ended in May. Usecheque, which is an indicator of low value purchases with immediate payment, also released by the ACSP, registered growth of 1.2% using the same basis of comparison.

Another factor that contributed to continued growth in the sector of commerce was the downturn in the level of defaults at the end of the first half of 2004 and start of the second half, compared to the corresponding periods of the previous year. Thus, the ratio between checks returned due to insufficient backing and total checks cleared registered the lowest rate of the year, 5%, in the month of August. The median rate for the first eight months of the year came to 5.3%, compared to 5.4% in the same period of the previous year. Growth in the national Teledata indicator, which also reflects the ratio between checks returned and received, ratified the downward trend, which closed at 2.1% in July of the current year, compared to 2.6% in the same month of 2003.

ACSP statistics for the start of the second half of 2004 corroborate the downward curve in the rate of default registered by national indicators. In the first eight months of the year, the net rate in São Paulo came to 5.2% as against

Default rates

Rate

Itemization	2004						
	Mar	Apr	May	Jun	Jul	Aug	Year[1/]
SPC (SP)[2/]	6.5	6.4	5.1	4.3	3.3	3.9	5.2
Returned checks[3/]	5.7	5.4	5.2	5.1	5.1	5.0	5.3
Telecheque (RJ)[4/]	3.4	2.4	2.3	2.1	2.0	...	2.3
Telecheque (National)[4/ 5/]	3.6	2.6	2.3	2.1	2.1	...	2.6

Source: ACSP, Bacen and Teledata

1/ Annual average.

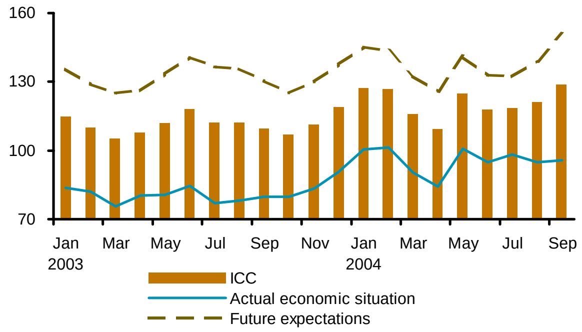
2/ New registrations (-) registrations cancelled out/effected consultations (t-3).

3/ Checks returned due to insufficient funds/cleared checks.

4/ Returned cheques/cleared checks.

5/ Average in the following cities: Belém, Fortaleza, Recife, Salvador, Belo Horizonte, São Paulo, Curitiba, Porto Alegre, Ribeirão Preto and Rio de Janeiro.

Consumer Confidence Index



Source: Fecomercio SP

5.8% in the same period of 2003. In August, the net rate came to 3.9%, after registering the lowest level of the year, 3.3%, in the previous month.

The results of the surveys on consumer expectations pointed to considerable optimism in the third quarter of 2004, thus confirming the perception that expansion in the sector of commerce would continue. The Consumer Confidence Indicator (ICC), which is released by the Trade Federation of the State of São Paulo (Fecomercio SP), registered growth of 4.8% in the July-September quarter, compared to the previous quarter. At the component level, the Consumer Expectations Index (IEC), which represents 60% of the general index, increased by 5.6%, while the Index of Current Economic Conditions (Icea), which represents the remainder of the general index, increased by 3.1%.

The IEC, which is published by the Trade Federation of the State of Rio de Janeiro (Fecomercio RJ), registered an upward trend in the level of optimism among Rio de Janeiro consumers, turning in a performance quite similar to that of São Paulo. The IEC turned in median growth of 2.4% in the quarter ended in August, compared to the quarter ended in May, and 15.9% in the first eight months of 2004, compared to the same period of the preceding year.

1.2 Output

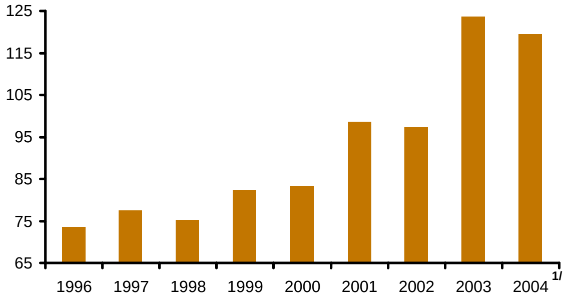
Crop/livestock production

In the first six months of 2004, crop/livestock production expanded by 5.7%, when viewed against the same period of the previous year, according to IBGE's Quarterly National Accounts. Production in the second quarter of the current year expanded by 5% compared to the corresponding quarter of 2003, but fell by 0.3%, in deseasonalized terms, when viewed against the first quarter of 2004. The latter results can be attributed to the falloff in the soybean harvest.

According to the Systematic Survey of Farm Production (LSPA), which is carried out monthly by IBGE, expansion was registered in the harvest of such important grains as rice, wheat and cotton seeds, partially offset by reductions in the soybean, corn and bean harvests, which were impacted by climatic adversities. With regard to livestock, the sector continues registering positive results due, above all else, to growth in foreign sales.

Crop production

Grain production
In million of tons



Source: IBGE
1/ Forecast.

Agricultural production

In 1,000 tons

Itemization	Production		Percentage
	2003	2004 1/	change
Grain production	123 632	119 479	-3.4
Cotton (seed)	1 451	2 326	60.3
Rice (in husk)	10 320	13 263	28.5
Beans	3 310	3 133	-5.3
Corn	47 988	41 891	-12.7
Soybean	51 482	49 181	-4.5
Wheat	6 029	6 246	3.6
Others	3 052	3 438	12.7
Other cultures			
Banana	6 775	6 576	-2.9
White potatoes	3 047	2 838	-6.9
Cocoa (beans)	170	178	5.1
Coffee (manufactured)	1 997	2 439	22.2
Sugar cane	389 849	422 318	8.3
Onions	1 194	1 160	-2.9
Tobacco (in leaves)	656	925	41.0
Orange	16 903	17 043	0.8
Manioc roots	22 147	24 066	8.7
Tomatoes	3 694	3 366	-8.9

Source: IBGE
1/ Estimated.

According to the July LSPA, national grain production in 2004 is expected to reach 119.5 million tons or 3.4% less than in 2003. The summer harvest, which accounts for about 86% of crop output, is now nearing conclusion. About the only thing lacking is to consolidate estimates for the second harvest and winter harvest, which are periods in which the corn and wheat crops normally turn in their best results, in that order.

The performance of the soybean, corn and, to a lesser extent, the bean crop, was the major factor underlying the 2004 harvest. Despite an increase of 15.7% in the area reserved to soybeans, output – initially forecast at 59 million tons – came to just 49.2 million tons, for a reduction of 4.5% when compared to 2003. The harvest failure was caused by adverse climatic factors, particularly in Mato Grosso and Paraná, as the harvest yield declined by 17.4%.

Output of corn – first harvest – totaled 31.2 million tons, with a reduction of 10% compared to the 2003 harvest. Median productivity fell by 7.7%, as a result of climatic factors, and the area planted diminished by 2.3%, partly as a result of the spread of soybean production. Estimates for corn production – second harvest – indicate 10.6 million tons, reflecting a drop of 20.1% compared to the 2003 results. This reduction was a consequence of cutbacks in the area planted and in yield, due to adverse climatic factors.

Bean production for the year's three harvests is expected to reach 3.1 million tons or 5.3% less than in 2003, closing with a reduction of 4.5% in yield. The good harvest registered in the previous year contributed to a falloff in the prices of this product and convinced many producers to migrate to such crops as soybeans and corn.

Production of wheat, which is the principal winter crop, is expected to close at 6.3 million tons or 3.6% more than in the 2003 harvest. The area planted expanded by 9.2%, while productivity dropped by 5.1%. Despite climatic adversities in the southern region, the State of Paraná, the nation's largest producer, registered a strong increase in its harvest, which could close as high as 3.2 million tons. The estimate of a larger national harvest and an increased world supply of the product has aided in reducing prices on both the internal and external markets.

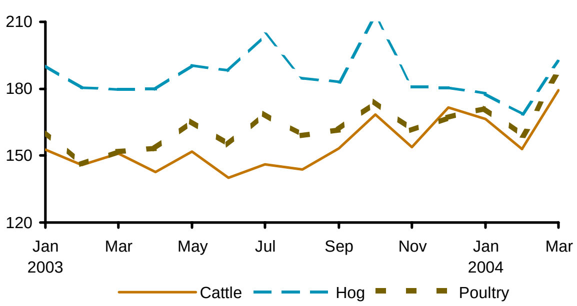
Among other crops, particular mention should be made of coffee and sugar cane. National coffee production is expected to close at about 2.4 million tons, with growth of 22.2% over the 2003 harvest. To some extent, this increase is explained by expected growth of 23% in productivity, which is a reflection of the low level productivity registered in 2003 as a result of climatic difficulties. One should also highlight improvement in the quality of the product, which has contributed importantly to increased foreign sales.

The sugar cane harvest is calculated at 422.3 million tons, representing growth of 8.3% compared to 2003. The area planted increased by 3.3%, while productivity is expected to expand by 5.8%. Despite the positive harvest performance, climatic factors resulted in some delay in the harvest in the southern region, which had a negative impact on the quality of the cane. This fact, together with the rechanneling of production into sugar output, contributed importantly to upward movement under alcohol prices. At the same time, the recent decision taken by the World Trade Organization (WTO) to veto sugar production subsidies in the European Union (EU), coupled with growth in alcohol demand in the United States and European and Asian countries, and increased internal demand for dual fuel vehicles, was a factor that clearly stimulated Brazilian production and exports of sugar cane derivatives.

Livestock production

Livestock production

Total weight



Source: IBGE

According to the quarterly survey of animal slaughters released by the IBGE, total carcass weight of cattle slaughters came to 1.4 million tons in the first quarter of 2004, reflecting growth of 11% compared to the same period of 2003, and 4.1%, when based on deseasonalized data, compared to the result for the fourth quarter of last year. According to the Ministry of Development, Industry and Foreign Trade (MDIC), exports totaled 235.2 thousand tons in the May-July quarter, with growth of 69%, compared to the figures registered in the same quarter of 2003.

Poultry production came to 1.7 million tons in the first quarter of this year. This result reflects expansion of 12.9% compared to the same period of 2003 and 3.9% against the final quarter of 2003, when deseasonalized data are used. Exports totaled 650.7 thousand tons in the May-July quarter, with growth of 54.9% compared to the same period of 2003.

With respect to hog farming, total carcass weight came to 457.9 thousand tons in the first three months of the year, reflecting a drop of 2.1% in relation to the first quarter of the previous year. An analysis based on the deseasonalized statistical series indicates volume that was 2.6% below that of the fourth quarter of 2003. With respect to exports, the registered volume in the quarter extending from May to July came to 126.9 thousand tons, or 2% more than in the same period of 2003.

Crop and Livestock Plan (PAP) 2004/2005

According to the PAP 2004/2005, released by the Ministry of Agriculture, Livestock and Supply (Mapa), the credit volume available for the next harvest should come to R$39.5 billion or 45.5% more than in the previous harvest. Of this total, R$28.8 billion will be targeted to current expenditures and marketing and R$10.7 billion to investments, of which 80% will be channeled into the Mapa-BNDES System programs. Among the highlights, it is important to mention the resources targeted to the Program of Modernization of the Farm Tractor Fleet and Like Implements and Harvesters (Moderfrota), R$3.5 billion; the Program of Agricultural Modernization and Conservation of Natural Resources (Moderagro), R$600 million; the Program of Incentives to Irrigation and Storage (Moderinfra), R$700 million; the Program of Cooperative Development for Aggregating Value to Crop/Livestock Production (Prodecoop), R$550 million; and the Agribusiness Development Program (Prodeagro), R$600 million.

Aside from these resources, the National Program for Strengthening Family Agriculture (Pronaf), which is managed by the Ministry of Agrarian Development (MDA), will have a budget of R$7 billion, representing an increase of 30% compared to the last harvest.

In order to expand the supply of credit to the sector, the compulsory rate of investment in rural credit by Banco do Brasil rural savings accounts was raised by 10 p.p. to 50%, while cooperative banks – Banco Cooperativo do Brasil S.A. (Bancoob) and Banco Cooperativo Sicredi (Bansicredi) – were authorized to operate in this modality and are required to invest 65% of their deposits in rural credit operations. Aside from this, the government, in collaboration with the private sector, has refined new funding instruments targeted at internal and external savings, including the Agribusiness Certificate of Receivables (CRA), the Agriculture and Livestock Deposit Certificate (CDA) and the Agribusiness Warrant.

With respect to the traditional instruments used to support marketing operations and guarantied income, the following instruments were maintained: Federal Government Acquisitions (AGF), the Special Credit Line (LEC), Sales Option Contracts, repurchase or assigns of these contracts, Production Outflow Awards and Product Marketing Value (PEP and VEP, in that order), the Rural Product Bill (CPR), as well as operations with Promissory Notes and Rural Invoice (DR). Currently, the principal requirement for Federal Government Loans (EGF) is the placing of a lien on the merchandise financed in the operation, with no substitution of guaranties except in specifically defined cases.

Industrial output

Industrial output has expanded sharply in recent months and has been sustained by the consolidation of recovery in domestic demand and the excellent performance of the export sector. Having registered three consecutive months of record growth in May, June and July, these results clearly confirm the vigor of the ongoing process of expansion, indicating that the negative monthly rates registered in the first two months of the year were no more than a passing breather in the growing pace of manufacturing activity, following the strong expansion that marked the second half of 2003.

Industrial output expanded by 3.8% in the May-July quarter, compared to the quarter ended in April, according to deseasonalized data drawn from the Monthly Industrial Survey (PIM), released by the Brazilian Institute of Geography and Statistics (IBGE). Analyzing the comparison between production accumulated in the first seven months of 2004 and 2003, growth came to 7.8%. These results reflect expansion in the manufacturing sector, with 3.6% in the quarter and 8.2% accumulated in the year, plus the relative stability of the mineral extraction sector, which registered growth of 0.2% and 0.5% using the same basis of comparison. In the monthly deseasonalized series, industrial production in July 2004 was 8.3% higher than the median level in 2002 and 12.6% more than the low point registered in June 2003.

The positive results permeated all use categories, though expansion was clearly led by production of consumer durables and capital goods. Output of consumer durables registered a deseasonalized increase of 9.9% in the quarter extending from May to July, compared to the previous quarter, and an increase of 24.5% in the first seven months of the current year, viewed against the same period of 2003. In its turn, output of capital goods increased by 6.4% in the quarter and 24.9% in the first seven months of the year.

Industrial production

Percentage change

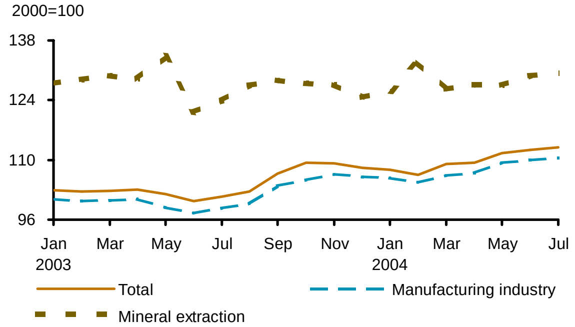
Itemization	2004 Apr	May	Jun	Jul
Industry (total)				
In the month[1/]	0.3	2.1	0.7	0.5
Quarter/previous quarter[1/]	- 0.1	2.3	3.1	3.8
Same month of the previous year	6.7	7.8	13.0	9.6
Accumulated in the year	6.1	6.4	7.5	7.8
Accumulated in 12 months	2.0	2.8	3.9	5.0
Manufacturing industry				
In the month[1/]	0.5	2.3	0.5	0.4
Quarter/previous quarter[1/]	- 0.2	1.9	2.9	3.6
Same month of the previous year	7.1	8.5	13.3	9.8
Accumulated in the year	6.5	6.9	8.0	8.2
Accumulated in 12 months	2.0	2.9	4.1	5.2
Mineral extraction				
In the month[1/]	0.8	- 0.1	1.8	0.4
Quarter/previous quarter[1/]	2.3	- 0.5	- 0.2	0.2
Same month of the previous year	- 1.3	- 4.9	7.2	5.4
Accumulated in the year	- 0.9	- 1.7	- 0.3	0.5
Accumulated in 12 months	1.4	0.4	1.3	1.9

Source: IBGE

1/ Seasonally adjusted data.

Industrial production

Seasonally adjusted data



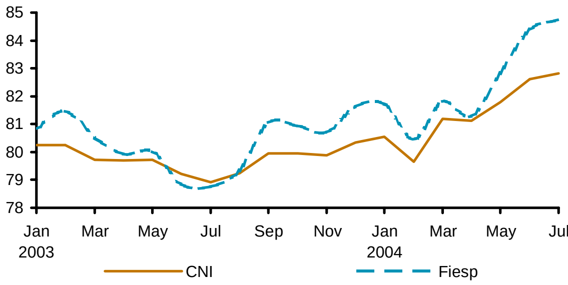
Source: IBGE

Industrial production by category of use

Itemization	2004			Percentage change
	Apr	May	Jun	Jul
In the month[1/]				
Industrial production	0.3	2.1	0.7	0.5
Capital goods	2.0	3.8	0.7	- 1.1
Intermediate goods	0.3	2.0	0.0	2.3
Consumer goods	0.4	1.2	1.5	- 0.7
Durable	3.4	3.9	3.8	1.1
Semi and nondurable	0.4	1.3	0.5	- 1.0
Quarter/previous quarter[1/]				
Industrial production	- 0.1	2.3	3.1	3.8
Capital goods	- 0.8	5.0	6.3	6.4
Intermediate goods	1.6	2.8	2.8	3.5
Consumer goods	- 1.0	- 0.1	1.5	2.4
Durable	0.9	4.2	7.3	9.9
Semi and nondurable	- 1.6	- 1.3	0.7	1.5
In the year				
Industrial production	6.1	6.4	7.5	7.8
Capital goods	22.3	23.5	25.1	24.9
Intermediate goods	4.8	5.3	6.2	6.7
Consumer goods	4.7	4.7	5.8	6.0
Durable	21.0	21.5	24.0	24.5
Semi and nondurable	1.1	0.9	1.8	2.0

Source: IBGE
1/ Seasonally adjusted data.

Utilization of installed capacity
Seasonally adjusted data
Average percentage



Source: CNI and Fiesp

These results were generated by such segments as machines and equipment for the mining sector and construction, 40.4%; trucks and buses, 36.7%; construction and assembly of vessels, 18%; construction and assembly of aircraft, 17.3%; tractors, machines and equipment for the farm sector, 15.8%; and machines and equipment for industrial and commercial ends, 11.2%,

The evolution registered in the production of semidurable and nondurable consumer goods further strengthened perceptions that the recovery process had begun impacting sectors that are focused on the internal market and less sensitive to credit conditions. Production of this category turned in growth of 1.5% in the May to July quarter, compared to the previous quarter, according to deseasonalized data. In this case, the most important headings were production of soaps, detergents and cleaning products, 21.1%; fruit, vegetables, gravy and spice conserves, 9.7%; slaughters of swine and cattle and preparation of meats, 9.3%; perfumes and cosmetics goods, 8.1%; coffee, 7.4%; and footwear, 6.7%. In the first seven months of 2004, production of semidurable and nondurable consumer goods expanded by 2% when viewed against the same period of the previous year. Output of intermediate goods, which encompasses mining, turned in below average results: deseasonalized growth of 3.5% in the May-July quarter, compared to the previous quarter, and 6.7% in the first seven months, viewed against the corresponding period of 2003.

Acceleration in the pace of industrial activity was not concentrated in isolated sectors. Quite to the contrary, a segment-by-segment analysis demonstrates that positive performances were registered in twenty six segments of the manufacturing industry, while only four closed with negative growth when the May-July quarter is compared to the previous quarter in deseasonalized terms. A considerably more detailed breakdown, using the same basis of comparison, indicates that production growth of 82% was registered in the sixty six segments of the PIM. In this case, these series are sufficiently extensive to allow for deseasonalization.

Industrial exports continued exerting a powerful influence on the performance of the sector. The volumes of external sales of semimanufactured and manufactured products expanded by 14.7% and 13.8%, respectively, in the May-July quarter, compared to the previous quarter, after being seasonally adjusted. The highlights in the period were growth in exports of capital goods, 22.9%, and consumer durables, 24.5%. In the first seven months of 2004, exports of semimanufactured goods increased by 11.5% while those

Automotive vehicles – Production and sales

Itemization	2004				Percentage change
	Apr	May	Jun	Jul	Aug
In the month[1/]					
Production	-3.7	3.2	5.4	7.2	3.3
Total sales	-10.6	4.2	15.0	6.6	-1.3
Domestic sales	-5.6	3.1	9.9	3.2	-4.3
External sales	-17.6	-2.2	40.4	0.4	8.7
Quarter/previous quarter[1/]					
Production	-1.1	2.2	3.1	9.2	12.6
Total sales	-3.4	-5.4	-3.8	9.2	18.2
Domestic sales	-3.4	-6.5	-3.5	4.8	10.7
External sales	0.1	0.9	-1.3	16.8	33.2
In the year					
Production	13.3	12.3	14.8	18.0	21.3
Total sales	15.0	14.4	15.6	18.8	20.6
Domestic sales	18.2	18.0	20.4	21.4	22.0
External sales	6.5	5.5	4.4	12.5	17.4

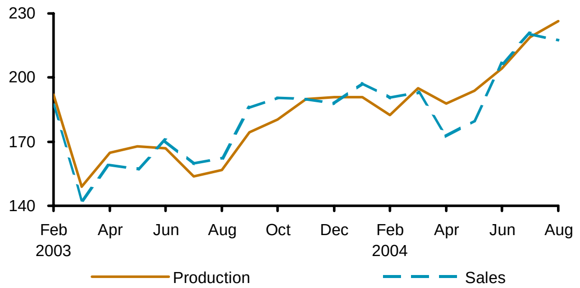
Source: Anfavea

1/ Seasonally adjusted data.

Vehicles – Production and sales

Seasonally adjusted data

1992=100

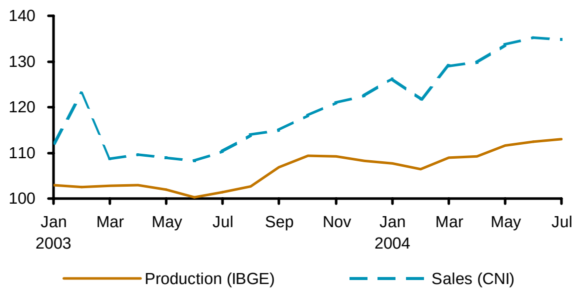


Source: Anfavea

Industrial production and sales

Seasonally adjusted data

2000=100



Source: IBGE and CNI

involving manufactured goods expanded by 25.9%, in relation to the same period of the previous year.

Recovery in manufacturing activity since mid-2003 has impacted the level of utilization of industrial output capacity (see box: Industry: Productive Capacity and Investments). The average level of utilization of installed capacity has been systematically growing, having reached 84.1%, according to deseasonalized data, in the second quarter of the year, as calculated by the Getulio Vargas Foundation (FGV). Among the different use categories, the most significant progress in the quarter compared to the previous quarter occurred in the consumer goods industry, 6.2 p.p., and capital goods, 3.8 p.p. Even so, the segments involved in the production of intermediate goods have continued registering high levels of utilization of idle capacity. However, the ongoing recovery in investment levels, which has been occurring since the third quarter of 2003, has tended to attenuate potential limitations on the performance of the productive chain.

Other indicators ratified the recent upturn in industrial output. The automobile industry has turned in an exceptional performance in recent months, in terms of production and internal and external sales. According to the National Association of Automotive Vehicle Manufacturers (Anfavea), the sector's output increased by 12.6%, while internal sales rose by 10.7% and foreign sales expanded by 33.2%, in the June-August quarter, as against the same period of 2003, expressed in deseasonalized terms. In the first eight months of the year, compared to the same period of 2003, production, internal sales and exports expanded by respective rates of 21.3%, 22% and 17.4%.

Based on deseasonalized data, real industrial sales in the quarter extending from May to July followed a consistent growth trajectory, registering 6.1%, compared to the previous quarter, according to figures released by the National Confederation of Industry (CNI). Despite differences of coverage and methodology among the available industrial production and sales indices, the quarterly comparison does demonstrate that the pace of sales growth has remained higher than output growth, suggesting that, in aggregate terms, the already observed tendency toward stock adjustments continued. The Situation Survey carried out by the FGV and released in July confirms this hypothesis. According to this survey, the situation of stocks was considered normal for 72% of industry, the highest percentage reached by this indicator since the series was started. CNI data corroborate the perception of normality in the stocks of final products.

Industry: Productive Capacity and Investments

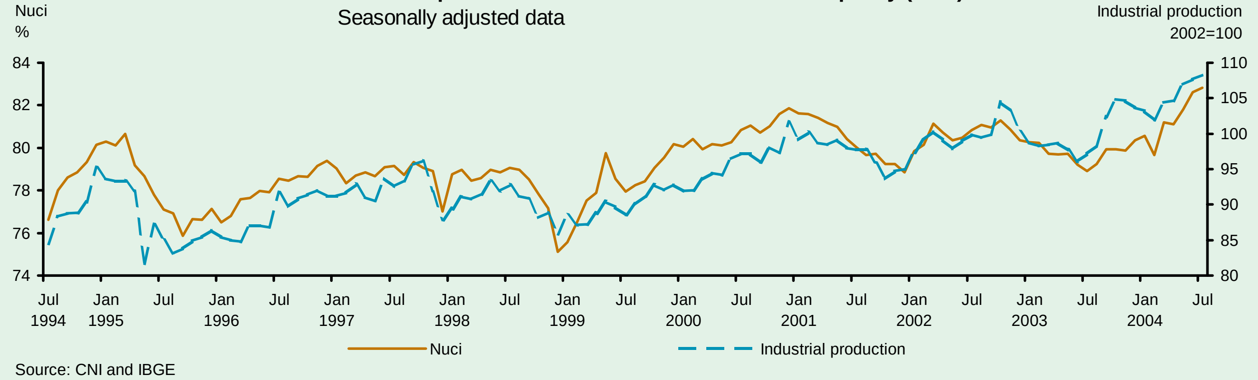
The vigorous pace of industrial activity, which is already expanding at historically record levels, has given rise to doubts regarding the sector's capacity to readily meet additional demand while ensuring the continuity of the growth process, while becoming an important source of monetary policy concern. As a matter of fact, assessments of the recent growth in indicators of the Level of Installed Industrial Capacity Utilization (Nuci) point to steady growth and clearly justify monitoring, particularly in certain intermediate goods sectors.

The median Nuci has been systematically expanding since mid-2003, reaching 84.1% in the second quarter of this year. Based on deseasonalized data released by the Getulio Vargas Foundation (FGV), this level had not been reached since the 2000-2001 growth cycle. The highest value previously registered occurred in the first quarter of 1995, in the wake of implementation of the Real Plan.

Another Nuci industrial measurement, calculated by the National Confederation of Industry (CNI) in twelve states, also indicates growth, moving to 82.8% in July 2004, the highest level ever recorded in this series. Thus, just as in the FGV data, previous Nuci peaks are noted in 1995, as a consequence of the Real Plan, and in 2000, following the exchange system shift and implementation of the inflation targeting system.

FGV data show that all categories registered Nuci indices higher than those of 2002 and 2003 in the second half of 2004, turning in the highest level under intermediate goods, 87.1%. Analysis of the

Industrial production and utilization of installed capacity (Nuci)
Seasonally adjusted data



Source: CNI and IBGE

21 major sectors reveals that the highest levels were found mainly in the intermediate goods segment, particularly under paper and pulp, rubber and plastics, metallurgy, textiles and mechanics.

Utilization of installed capacity (Nuci)

%

	2004 II Q[1/] (current Nuci)	Record[1/]	Period	Average[1/] (M)	Standard devation (DP)	Current Nuci - (M + DP)
Manufacturing industry	84.1	85.2	I-1995	80.2	3.4	0.5
Capital goods	82.4	84.7	IV-2000	73.7	6.0	2.8
Intermediate goods	87.1	89.6	III-1996	84.9	2.3	-0.1
Consumer goods	81.0	87.6	IV-1994	78.5	4.3	-1.8
Building material	81.0	86.0	IV-2000	78.6	5.8	-3.4
Perfumes, soaps and candles	90.6	91.6	III-1994	75.7	8.6	6.3
Mechanics	87.1	87.1	II-2004	74.9	7.3	4.9
Food products	85.2	85.6	III-2003	78.4	3.8	3.0
Textiles	91.0	91.2	IV-2002	84.2	4.7	2.1
Paper and cardboard	95.3	95.6	IV-1994	90.5	3.0	1.8
Furniture	84.0	85.3	I-1995	76.8	5.6	1.6
Metallurgy	92.1	93.0	III-1996	86.9	3.6	1.5
Plastics	85.4	87.6	IV-1994	78.0	6.7	0.7
Rubber	93.6	94.7	IV-1994	87.3	6.1	0.1
Electric and communications equipment	78.9	83.2	IV-1995	73.4	6.6	-1.2
Wood	86.4	94.9	IV-2000	82.7	5.1	-1.4
Clothing, footwear and cloth goods	84.0	88.0	II-2000	79.2	6.3	-1.5
Other	81.1	86.5	IV-1998	74.7	8.5	-2.2
Chemicals	83.8	90.1	I-1995	84.6	1.8	-2.5
Nonmetallic minerals	80.0	87.4	I-1995	79.1	5.5	-4.6
Leather and hides	79.5	86.4	IV-1999	78.8	5.6	-4.8
Editorial	77.4	90.4	II-1995	76.8	7.3	-6.8
Beverages	72.7	90.0	II-1991	72.5	8.5	-8.3
Transportation equipment	76.2	91.4	I-1995	79.3	6.3	-9.4
Pharmaceuticals	60.9	88.0	IV-1997	75.3	7.9	-22.3
Tobacco	58.9	97.5	II-1993	75.2	9.2	-25.5

Source: FGV

1/ Seasonally adjusted data.

In the metallurgical industry, the segments with the highest occupation levels are metallurgical products for household use and iron and steel goods (primary, semifinished). In the food industry, the highest occupation levels are found under preparation of milk and dairy products and slaughters and conserves of products of animal origin (meat and fish). In the chemical industry attention should be given to items manufactured on the basis of resins, fibers and artificial yarns while, in the segment of transportation equipment, producers of parts and spares for vehicles are nearing their capacity limit. It should be underscored that the conclusions of a technical note recently elaborated by CNI[1] converged in the same direction, indicating that, in specific sectors which are operating at historically high levels, investments are needed to ensure the continuity of the growth process.

Though data broken down by sector indicate that few segments are operating at levels near their record highs, a more careful analysis of these data, delving into their growth standards over the course of time, reveals that the high registered in the Nuci is not a phenomenon as concentrated as it might seem at first glance. The current level of Installed Capacity Utilization (UCI) is higher than the sum of the median[2] and the standard deviation of the series in nine of the twenty one principal segments, while five other segments are close to this situation.

Many industrial segments that have registered higher installed output capacity utilization are those that have registered substantial export growth in recent years, as demonstrated in the following chart, which draws a relation between export growth and the Nuci of corresponding sectors stated in Foreign Trade Study Center Foundation (Funcex) and FGV surveys. It should be mentioned that, driven by this growth, companies belonging to these segments have been investing with the aim of expanding their output capacity. Despite this, when one takes due account of the investment maturation period, it is possible that the installed capacity of certain segments may be insufficient to meet full export potential and domestic demand growth, at one and the same time.

1/ MOL, FONSECA, R. Increase of the installed capacity demands an up turn in investments Brasília: CNI, August 2004 (Technical Note 1).
2/ Deseasonalized data since 1991.

Exports (*quantum*) and Nuci – Selected segments

%

Selected segments	Exports			Associated segment[2/]	Nuci	
	2002	2003	2004[1/]		2004 II Q	Recorde
Manufactured	5.2	20.9	24.9			
Semi-manufactured	14.0	9.7	9.9			
Capital goods	-5.9	16.1	52.3	Capital goods	82.4	84.7
Intermediate goods	10.4	15.6	13.5	Intermediate goods	87.1	89.6
Tractors and related machinery	4.0	54.8	65.5	Mechanics	87.1	87.1
Textile	-4.6	39.2	9.5	Textiles	91.0	91.2
Paper, cardboard and related machinery	4.7	27.1	11.0	Paper and cardboard	95.3	95.6
Nonmetallic metallurgy	19.5	4.7	11.5	Metallurgy	92.1	93.0
Metallurgy – Others	17.1	4.7	10.2	Metallurgy	92.1	93.0
Siderurgy	19.3	15.9	4.5	Metallurgy	92.1	93.0
Rubber	8.0	23.8	5.5	Rubber	93.6	94.7
Wood and furniture	18.2	21.5	31.5	Furniture	84.0	85.3
Parts and other vehicles	-3.5	1.9	28.8	Transportation equipment	76.2	91.4
Autovehicles	4.2	37.6	42.6	Transportation equipment	76.2	91.4

Source: Funcex and FGV

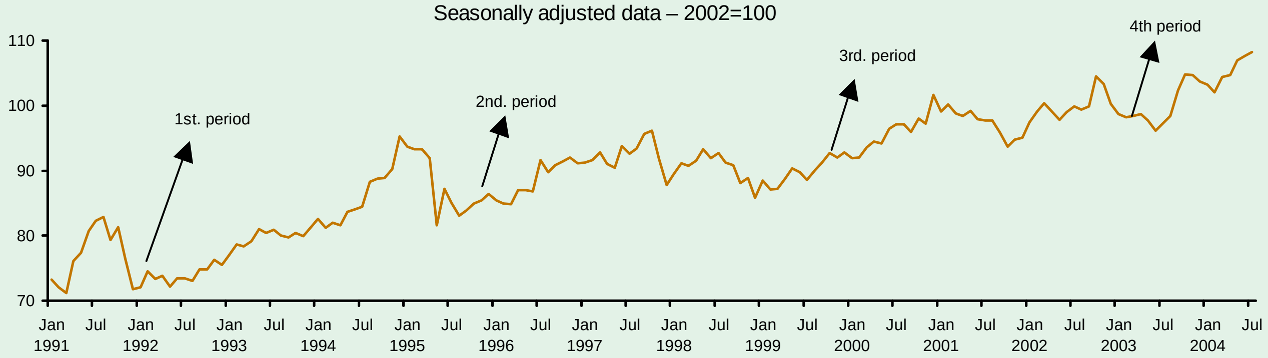
1/ Up to June.
2/ Approximation; there is no exact correspondence between the IBGE, FGV and Funcex classification.

In aggregate terms, investment indicators demonstrate that productive capacity is expanding, thus attenuating concerns regarding bottlenecks in the growth process over the medium-term. Since the third quarter of 2003, Gross Fixed Capital Formation has registered positive growth when compared to the immediately previous quarter in the deseasonalized series, having expanded by 6.8% in the first half of 2004 compared to the same period of the previous year, according to Quarterly National Accounts. Another indicator that evinces expanded investment flows is that of capital goods absorption. Analyzing the first seven months of 2004, against the same period of the preceding year, capital goods output increased by 24.9% and imports expanded by 7.9%. These growth figures insured absorption expansion of 12.8% even though foreign sales increased by 54.5% in the period.

It should be stressed that the period in which this investment cycle began – third quarter of 2003 – came as a surprise to analysts who, at the time, pointed to excess idle output capacity and the still incipient growth process as barriers to investment recovery. Apparently, the outlook for gains in light of expectations of recovery in internal demand and the strengthening of economic fundamentals, particularly in the external accounts framework, together with fiscal management and inflation control, prevailed over investment decisions.

The intensity at which investments expanded in this period shows the influence of these aspects. Analyzing data from 1991 onward, four periods of upward movement in industrial activity, including the current moment, can be distinguished. The three previous periods began in the third quarter of 1992 and in the fourth quarter of 1995 and 1999.

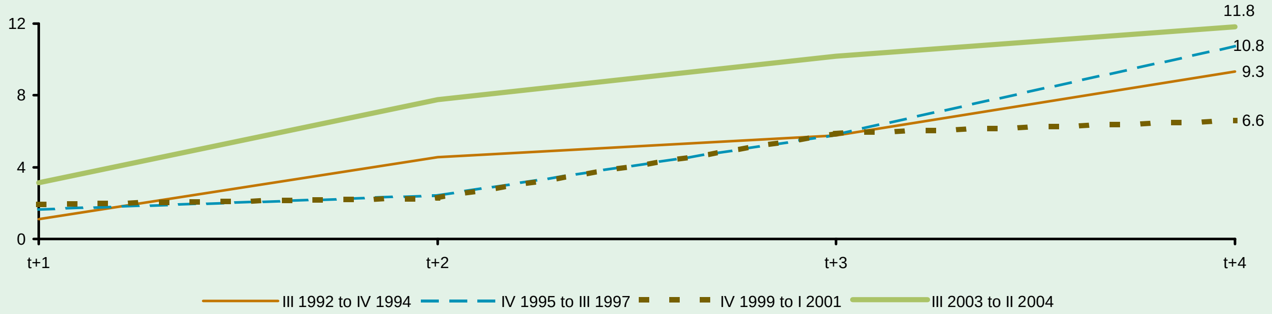
Industrial production
Seasonally adjusted data – 2002=100



Source: IBGE

In all these periods, investments kept pace with output growth. However in the current movement, recovery of these flows has been more intense, as shown by quarterly national accounts data.

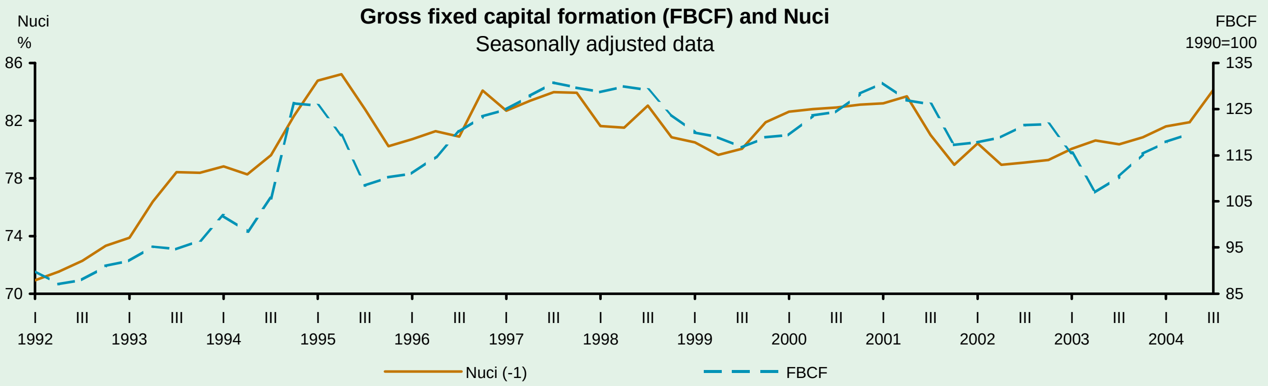
Gross fixed capital formation (FBCF)
Percentage accumulated in the quarters



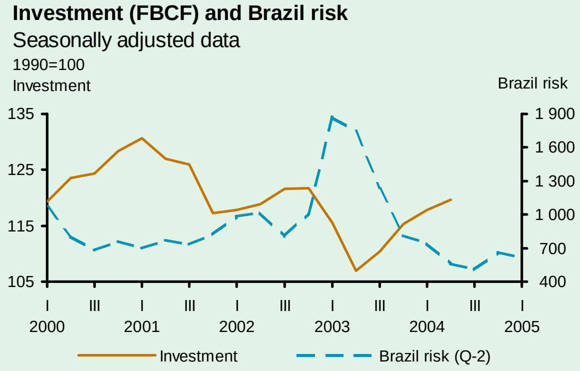
Source: IBGE

Parallel to this, leading investment indicators suggest that the current movement should continue. The level of installed capacity utilization is closely correlated to the evolution of gross capital formation. This is a consequence of the natural reaction of companies to expand capacity when bottlenecks in the productive flow come on the horizon. Thus, the sharp growth in occupation of output capacity heralds continued investments.

Another leading variable of the investment level – perception of country risk – points in the same



Source: IBGE and FGV



Source: IBGE and JP Morgan

direction. The lower Brazil risk level, as measured by Emerging Market Bond Index Plus (Embi+), and its downward trajectory in recent months have positively impacted the expectations of businesspersons and consumers, just as the credit costs borne by companies that borrowed abroad have acted as an additional incentive to continued investment growth.

In summery, the steady increase in the level of utilization of installed industrial output capacity as demonstrated by FGV and CNI data, has given rise to concern at the magnitude and the sectoral scope of that increase, since reductions in idle capacity tend to influence the dynamics of price structures. It should be underlined that, even when production is well below the physical limits of existent facilities, the unit cost of the additional goods to be produced already begins rising or, in other words given the available fixed factors, marginal costs normally move upward with the level of production. This phenomenon – it should be added – stands as economic justification so that in conventional supply and demand diagrams, supply curves follow an upward format, drawing a relationship between higher price levels and larger quantities transacted. Emergency measures, such as multiple productions shifts or increased imports which would not be competitive under normal market conditions, may be capable of avoiding supply shortfalls, but they do not mitigate the pressures of costs inherent to a progressively higher occupation level. However, one should note increased investment flows as well as the positive outlook for the coming months, since these reflect the efforts made to expand industrial production capacity, a process that will certainly result in a return to mere comfortable installed industrial output levels.

Manufacturing industry stocks[1/]

Itemization	2003			2004	
	II	III	IV	I	II
Manufacturing industry					
Final products	56.3	54.6	52.1	50.6	50.3
Raw materials/intermediate goods	48.5	49.6	48.2	47.6	48.7
Large companies					
Final products	58.9	57.1	53.5	52.2	52.1
Raw materials/intermediate goods	52.6	52.9	50.6	49.7	51.5
Small and medium companies					
Final products	54.9	53.2	51.3	49.8	49.4
Raw materials/intermediate goods	46.2	47.8	46.8	46.5	47.3

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

According to the CNI, the dynamics of the industrial sector was reflected in deseasonalized increases of 1.9% in employment and 1.4% in the overall wages of the sector, in the May to July quarter, when compared to the previous quarter.

Business expectations point to short-term optimism. The Industrial Businesspersons Confidence Indicator (Icei), which is calculated by the CNI, closed July at the highest level for this time of the year since 2000. The FGV Situation Survey also confirmed this finding by demonstrating that 57% of the companies surveyed foresaw increased demand between July and September while only 9% forecast declines. In the same sense, 53% of companies intended to increase their production in the period cited, while 8% expected reductions. Projections for the labor market are positive, as the proportion of the companies that intend to contract additional labor was 27 p.p. higher than those that planned layoffs. This was the best result for this time of year since 1986.

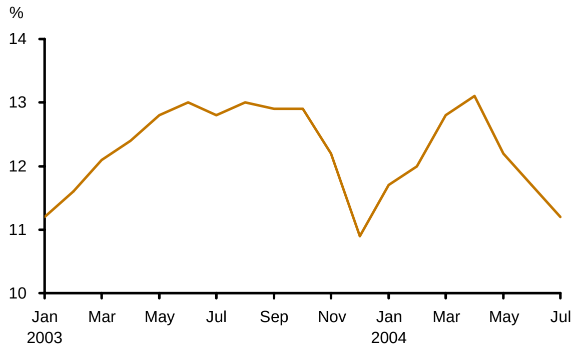
Therefore, industrial indicators clearly support expectations that industry will continue expanding, generating positive repercussions on the job market. In its turn, recovery in the labor market is expected to play a role of increasing importance in stimulating internal demand, adding to the aggregate momentum and aiding in progressively establishing a new balance in terms of the relative performance of the various sectors of the economy.

1.3 Labor market

Employment

In recent months, the job market has reflected the expanded pace of economic activity. Creation of new job positions intensified as of the second quarter, as indicated by IBGE's Monthly Employment Survey (PME), which incorporates six metropolitan regions, as well as by the nationwide data released by the Ministry of Labor and Employment (MTE).

Unemployment rate



Source: IBGE

The rate of open unemployment calculated by the PME registered successive monthly declines from April onward, when the rate peaked at 13.1%, before dropping to 11.2% in July. As a result of this evolution, the median rate of unemployment in the first seven months of the year closed 0.2 p.p. below the rate in the same period of 2003. It should be stressed that the reduction in the jobless rate that has occurred since April was mainly a consequence of generation of new job openings, as the economically active population remained stable in the period. According to the PME, 347.6 thousand positions were created in the quarter extending from May to July, in contrast to the elimination of 43.5 thousand jobs in the corresponding period of 2003.

Occupied people by categories of employment

Percentage change

Itemization	2004			
	Apr	May	Jun	Jul
Total of occupied people	0.7	0.8	0.4	0.9
By categories of employment				
Registered	-0.1	1.5	0.3	0.2
Nonregistered	3.7	1.8	-0.1	0.4
Non-earning workers, military and civil servants	1.2	1.1	1.2	4.7
Self-employed	-1.6	-2.6	0.2	2.7
Employers	0.5	3.9	3.2	-1.4

Source: IBGE

Formal employment

New job openings (1,000 employees)

Itemization	2004				In the year
	Apr	May	Jun	Jul	
Total	187.5	291.8	207.9	202.0	1 236.7
Manufacturing industry	64.4	89.5	47.5	56.0	382.4
Commerce	27.2	39.9	28.3	33.6	164.4
Services	49.0	56.1	39.6	42.7	309.5
Building	12.7	14.7	10.0	10.7	71.3
Crop and livestock	28.8	86.9	78.5	55.2	271.6
Public utilities	0.5	0.8	0.5	0.9	5.0
Others[1/]	5.0	4.0	3.5	3.0	32.5

Source: MTE
1/ Includes mineral extraction, public administration and others.

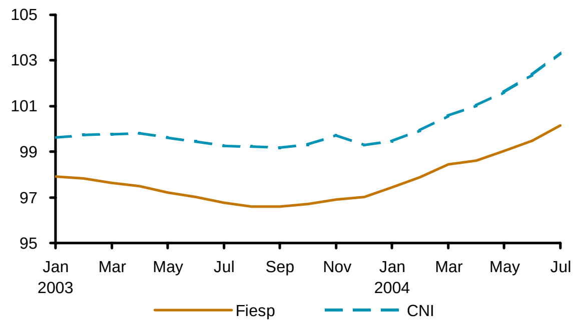
An analysis of the different categories indicates that most of the new jobs were concentrated in the formal sector of the economy, with 162.7 thousand openings in the May-July quarter, demonstrating the increased confidence of the business community in the recovery of the economy. At the same, 90 thousand openings were created among nonregistered workers, with an additional 94.9 thousand in other categories.

With respect to formal employment, MTE data for the entire country indicate that the growth that marked the May-July period has continued. The period was marked by 702 thousand hirings, compared to 303 thousand in the same quarter of 2003. The balance for the first seven months of the year totaled 1,237 thousand new vacancies, as against 598 thousand in 2003 and 742 thousand in 2002. The more accelerated pace at which jobs have been created has been an across-the-board phenomenon in the various sectors of the economy. Job growth has been most intense in the manufacturing sector, responsible for generating 382 thousand vacancies up to July, compared to 118 thousand in 2003, reflecting strong recovery in manufacturing activity. The service sector contributed with 309 thousand positions, while crop/livestock farming contributed with 272 thousand and commerce accounted for 164 thousand, numbers that are significantly higher than those registered in the same period of 2003 (169 thousand, 232 thousand and 69 thousand, respectively). One should also stress the growth registered in the construction industry, which generated 71 thousand positions in the period, compared to 17 thousand from January to July 2003.

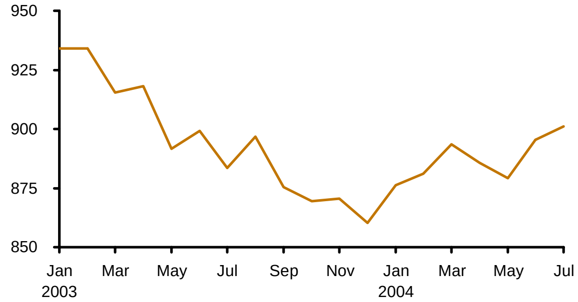
The process of job creation registered by the MTE has been more intense than that perceived by the PME and suggests that the labor market in the interior of the country has become significantly more dynamic, when compared to metropolitan regions, as indicated in the last Inflation Report. To some extent, one can attribute this difference to the dynamics and formalization of employment in the crop/livestock sector and the process of geographic deconcentration of industry.

With regard to employment in the industrial sector, statistics calculated by sectoral entities confirmed the highly positive movement that has marked the period. According to a twelve

Industrial employment
Seasonally adjusted data
2000=100



Real average habitual earnings
In R$ at July 2004 prices, deflated by INPC



Source: IBGE

state CNI survey, the level of employment registered a deseasonalized increase of 1.6% in the second quarter when compared to the first. In June and July, the job level reached a point that had only been achieved in September 1998, which is fully consistent with the record levels of industrial output indicated by the IBGE for the period. Among the states covered by the survey, Goiás and Amazonas turned in the sharpest growth in jobs when compared to the previous year, with respective increases of 11.5% and 8.2%, in the first six months of the year.

According to the Federation of Industries of the State of São Paulo (Fiesp), industrial employment in São Paulo increased by 1% in the first half of the year, compared to the same period of 2003. In June, employment measured by Fiesp expanded in deseasonalized terms by 0.5% compared to the previous month. Aside from this, statistics released by the state's employer associations indicated the opening of 42 thousand vacancies from January to July.

Income

After registering declines in the months of April and May, the median habitual income of workers moved into a positive curve in the two following months, thus regaining the trend that began at the start of the year. According to the PME, real income, using the IBGE's National Consumer Price Index (INPC) as deflator, increased by 2% in July, compared to the level registered in the same month of 2003, registering the first positive growth figure for the series in this type of comparison. In accumulated terms for the year up to July, however, average purchasing power declined by 2.6%, compared to the same period of 2003. This result reflected reductions of 3.6% in the real earnings of public sector employees and 0.5% in the earnings received by private sector employees.

A survey carried out by the Inter Trade Union Department of Statistics and Socio-Economic Studies (Dieese), based on reports provided by union entities involved in collective bargaining processes, indicated improvement in wage negotiations in the first half of 2004, compared to the same period of previous years. In this sense, 79.4% of the negotiations resulted in increases equal to or greater than inflation measured by the INPC and accumulated in the twelve month period prior to negotiations, making this figure the highest percentage since 1996. Another indicator that demonstrates the strengthening of the positions assumed by workers in wage negotiations is the sharp cutback in the

Wage negotiations – 1st half 2004

Readjustments in comparasion to INPC[1/]	Industry	Commerce	Services	Total[2/] %
Superior	57.9	37.5	34.7	47.3
Equal	25.7	37.5	39.8	32.1
Inferior	16.4	25.0	25.5	20.6
Share[3/]	53.4	9.2	37.4	100.0

Source: Dieese
1/ INPC acumulated in the last twelve months up to negotiation.
2/ 262 negotiations.
3/ Sectoral share of companies included in the Survey.

Real wages in the manufacturing industry

% accumulated growth in the year

Itemization	2004			
	Apr	May	Jun	Jul
CNI				
Overall real wages	7.2	7.5	7.8	7.9
Fiesp				
Overall real wages	8.2	8.4	8.4	8.5
Average real wages	7.8	7.6	7.4	7.1

Source: CNI and Fiesp

Gross Domestic Product – On the demand side

Percentage change in the year

Itemization	2003				2004	
	I Q	II Q	III Q	IV Q	I Q	II Q
GDP at market prices	1.9	0.4	-0.3	-0.2	2.7	4.2
Family consumption	-3.0	-4.5	-4.2	-3.3	1.2	3.1
Government consumption	-0.1	0.5	0.6	0.6	1.5	1.4
Gross fixed capital formation	-1.7	-6.2	-7.2	-6.6	2.2	6.8
Exports	18.4	24.3	15.8	14.2	19.3	17.8
Imports	-5.8	-5.9	-5.8	-1.9	11.7	13.0

Source: IBGE

number of phased-in increases from 2003 to 2004, from 30% to 10%.

In sectoral terms, industry stands as the segment that has offered the largest increases in the course of the first half-year period. In that period, 25.7% of industrial companies granted wage hikes based on the change in the INPC, while 57.9% agreed to higher increases. Workers in the areas of services and commerce obtained similar results, with 75% of the negotiations resulting in wage increases equal to or greater than the INPC. In contrast, the figure for the service sector was only 24%, while commerce closed with 67%. In regional terms, the increases were higher in the southern region, where 91% of the agreements reached in the first half of the year incorporated rates equal to or greater than the change in the INPC. In the southeast and northeast regions, this percentage came to 73% and 69.7%, respectively.

According to the CNI, the earnings of workers in the manufacturing sector increased at positive rates in the first seven months of 2004, with median monthly gains of 7.8%, compared to the same months of 2003, as this sector continued to lead all others in terms of wage increases. This analysis is valid for all the states surveyed, with the largest gains being registered in Bahia, 16.6%, Goiás, 15.1%, Santa Catarina, 13.5%, and Rio Grande do Sul, 10.3%.

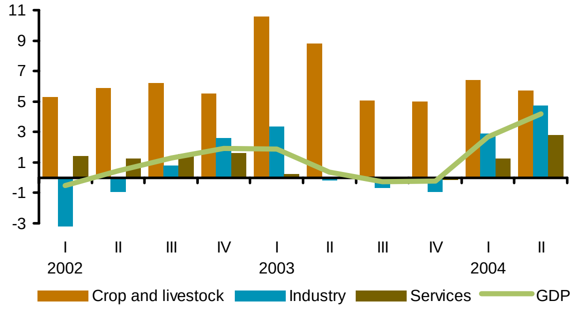
Overall wages have reflected growth in employment and median wages in the industrial sector. In the first seven months of 2004, compared to the same period of the previous year, overall wages paid in the sector increased by 8.5% in the State of São Paulo, according to Fiesp, and 7.9%, in the thirteen states surveyed by the CNI. Comparing the deseasonalized data for the quarters ended in July and April, growth rates came to 1.5% and 1.4%, respectively.

1.4 Gross Domestic Product

GDP expanded by 4.2% in the first half of 2004, compared to the same period of 2003. Using this basis of comparison, this was the best result since 2000. It is important to note that this growth was a generalized phenomenon among the components of this aggregate, independently of whether the figure is broken down by product or by demand.

Among the components of demand, the dynamics of the foreign trade sector was maintained, as exports increased by 17.8% and imports grew by 13% in the half-year period.

Gross Domestic Product
% growth accumulated in the year



Source: IBGE

Gross Domestic Product

Itemization	2003				2004	
	I	II	III	IV	I	II
Accumulated in the year	1.9	0.4	-0.3	-0.2	2.7	4.2
Accumulated in 4 quarters	2.5	1.9	0.7	-0.2	0.0	1.7
Quarter/same quarter of the previous year	1.9	-1.1	-1.5	-0.1	2.7	5.7
Quarter/previous quarter seasonally adjusted	-1.1	-1.2	0.4	1.7	1.7	1.5

Percentage change

Source: IBGE

Gross Domestic Product

Quarter/previous quarter, seasonally adjusted

Itemization	2003				2004	
	I	II	III	IV	I	II
GDP at maket prices	-1.1	-1.2	0.4	1.7	1.7	1.5
Crop and livestock	2.5	0.1	-3.0	5.0	3.3	-0.3
Industry	-2.8	-3.5	3.0	1.7	1.5	0.2
Services	-0.5	-0.5	0.1	1.1	0.5	2.5

Source: IBGE

The 3.1% increase in household consumption in the same period is seen to be particularly relevant to the process of sustained economic growth, particularly when one considers that it accounts for 56.9% of the composition of the GDP and turned in negative results in the last three years. Positive growth under this component in the first half of the year reflected upward movement in income, particularly under the heading of overall wages, mirroring the steady recovery in employment levels. Fixed gross capital formation was the internal demand component that expanded most sharply in the first six months of the year, compared to the same period of 2003, with expansion of 6.8%. This behavior resulted from increased investments in both construction and capital goods. Here, the investment absorption level increased by 21% in the same period, a pace that was fully consistent with the outlook for expansion in the activity level and with the positive performance of the country's economic fundamentals. Finally, growth of 1.4% in government consumption in the half-year period remained at a level quite similar to that registered in the first quarter of the year.

In sectoral terms, the crop/livestock sector expanded by 5.7% in the first half of the year, compared to the same period of the previous year, while industry and the service sector turned in growth of 4.7% and 2.8%, respectively. Growth in the crop/livestock sector has continued reflecting the dynamics of primary product exports with a volume increase of 14.4%, using the same basis of comparison, according to data calculated by the Center of Foreign Trade Studies Foundation (Funcex), at the same time in which the productivity of the sector also increased. Both of these movements were driven by maintenance in 2004 of the highly favorable farm product prices in effect during all of 2003.

Expansion in the industrial sector reflected growth of 7.3% in manufacturing and 2% in public utility industrial services and in the construction industry. Mineral production declined by 2.9% in the half-year period and was impacted mainly by the 1.8% reduction in petroleum output, according to statistics released by the National Petroleum Agency (ANP).

Expansion of the service sector included practically all of the various subsectors, with the strongest performances being registered under commerce, 7.6%; transportation, 6.9%; financial institutions, 3.6%; public administration services, 1.5%; rentals, 1.3%; as well as "other services", with 2.6%. The communications sector turned in a reduction of 1%, using the same basis of comparison.

GDP Growth Estimates

The pace of economic expansion in the second quarter of this year surpassed expectations at the start of the period, particularly with regard to industrial activity. In light of this performance and the outlook for the final two quarters of 2004, estimates of real GDP growth for the year were revised upward from 3.5%, stated in the preceding Inflation Report, to 4.4%.

After hitting historical highs at the end of the first quarter, manufacturing output continued on an intense growth curve in the second quarter of the year[1], reflecting the continuity of the recovery in internal demand coupled with rising exports. In the same period, in the secondary sector, the construction industry registered the highest growth rates since 2000.

The dynamics of the industrial sector has impacted the service sector, generating particularly strong repercussions on the performance of the sub sectors of commerce and transportation, as well as financial institutions and other services, which registered strong growth in the second quarter.

The crop/livestock sector has continued registering a positive performance, thus confirming growth expectations for the year. The negative second quarter result, calculated on the basis of seasonally adjusted data, compared to the previous quarter, was expected due to the failure in the soybean harvest which had its greatest impact in this period.

1/ Emphasis should be given to the fact that, in seasonally adjusted terms, the general industry result for the second quarter did not register this growth, due perhaps to methodological problems rooted in the PIM. Based exclusively on data drawn from the new PIM, general industry (manufacturing and mining) registered seasonally adjusted growth of 3.1% in the second quarter compared to the first quarter.

Gross Domestic Product

Itemization	2003 Pesos	2003 %	2004 Estimated
			Percentage change in the year
Crop and livestock	10.2	5.0	4.3
Industry	38.7	-1.0	6.0
Mineral extraction	4.0	2.8	2.1
Manufacturing	23.7	0.7	7.6
Construction	7.1	-8.6	4.6
Public utilities	3.8	1.9	3.0
Services	56.7	-0.1	2.9
Commerce	7.7	-2.6	7.5
Transportation	2.0	-0.8	6.0
Communications	2.6	0.1	1.1
Financial institutions	7.3	0.1	3.8
Other services	10.3	-0.5	3.2
Rents	10.5	0.9	1.2
Public administration	16.3	0.5	1.2
Value added at basic prices		0.0	4.2
Taxes on products	11.8	-1.7	6.5
GDP at market prices	111.8	-0.2	4.4

Source: IBGE and Banco Central do Brasil

Perceptions of a continued growth trajectory in these sectors over the course of the year have been reinforced by the recent evolution of the factors that condition demand. Steady growth in overall wages in recent months – due to recovery in both income and employment – and the continuity of expansion in credit operations are elements that tend to support increased consumer outlays. Parallel to this, investment indicators have evolved positively and should register growth in the final two quarters of the year, thus confirming the expectations delineated by leading indicators. In the external scenario, export operations will tend to continue at the high level registered in the first eight months of the year. An additional factor that should produce a positive impact is the relatively favorable outlook for recovery in the activity level of the world economy in the second half of 2004, notwithstanding the recent oil price spiral.

Gross Domestic Product

Percentage change in the year

Itemization	2003				2004	
	I Q	II Q	III Q	IV Q	I Q	II Q
Crop and livestock	10.6	8.8	5.1	5.0	6.4	5.7
Industry	3.3	-0.2	-0.7	-1.0	2.9	4.7
Mineral extraction	4.2	1.8	2.1	2.8	-3.9	-2.9
Manufacturing	3.9	1.0	0.7	0.7	6.0	7.3
Construction	-0.9	-6.0	-7.7	-8.6	-2.3	2.0
Public utilities	8.1	3.1	2.5	1.9	1.3	2.0
Services	0.2	0.0	-0.3	-0.1	1.2	2.8
Commerce	-0.2	-2.0	-3.4	-2.6	5.1	7.6
Transportation	-4.0	-2.3	-1.6	-0.8	7.4	6.9
Communications	2.4	2.7	1.4	0.1	-1.9	-1.0
Financial institutions	2.2	1.0	0.1	0.1	1.9	3.6
Other services	-0.1	-1.0	-0.6	-0.5	-2.1	2.6
Rents	0.4	0.6	0.6	0.9	1.1	1.3
Public administration	0.2	0.6	0.5	0.5	1.1	1.5
Financial dummy	4.4	1.7	0.6	0.3	0.3	3.3
Value added at basic prices	2.0	0.6	0.0	0.0	2.5	3.9
Taxes on products	0.5	-1.8	-2.4	-1.7	4.0	6.6
GDP at market prices	1.9	0.4	-0.3	-0.2	2.7	4.2

Source: IBGE

Investment indicators

Percentage change

Itemization	2004			
	Apr	May	Jun	Jul
Quarter/previous quarter1/				
Capital goods				
Absorption2/	0.2	3.5	3.7	1.8
Production	-0.8	5.0	6.3	6.4
Imports	4.3	5.1	2.9	0.3
Exports	8.1	16.1	13.3	18.4
Inputs for the building industry	-0.3	2.8	2.7	3.8
In the year				
Capital goods				
Absorption2/	9.9	12.2	13.8	12.8
Production	22.3	23.5	25.1	24.9
Imports	3.9	5.9	8.9	7.9
Exports	50.5	47.4	52.3	54.5
Inputs for the building industry	1.7	2.2	3.8	4.6
BNDES financing	74.3	59.0	47.7	36.4

Source: IBGE, Funcex and BNDES
1/ Seasonally adjusted data.
2/ Production + imports - exports.

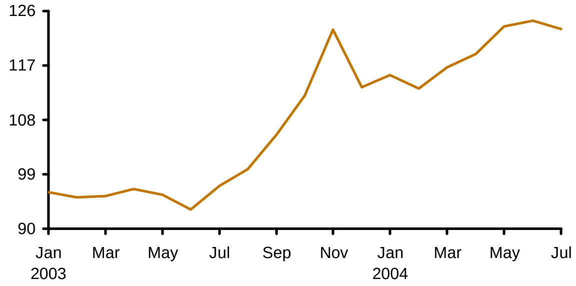
The quarterly series of seasonally adjusted national accounts must still be viewed with some degree of caution, since methodological difficulties are encountered in linking the data generated by the new PIM to the national accounts series. These series are to be revised by IBGE when the third quarter GDP figures are released. Despite this, the deseasonalized series indicated GDP growth for the fourth consecutive quarter, with an increase of 1.5% in the second quarter of the year. In this comparison, the output of the crop/livestock sector declined by 0.3%, basically as a result of the downturn in the volume of the soybean harvest, since the harvest of this product has its greatest weight in the second quarter. Output of the industrial sector remained stable, notwithstanding sectoral indicators that pointed to strong growth in the period, using the same basis of comparison. The distortions rooted in the linking of the PIM can explain this disparity. The service sector expanded by 2.5% in the period, using the same reference base.

1.5 Investments

Outlays on investments followed an upward curve over the course of the first half of 2004, following a trend that had begun at the start of the previous half-year period. Among the factors that have contributed to this positive performance, it is important to underscore the continued growth of export sectors, consolidation of the process of renewed expansion in other productive segments and the strengthening of the nation's economic fundamentals.

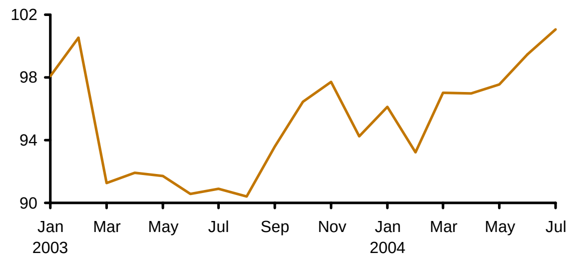
According to the Quarterly National Accounts published by the IBGE, investments – excluding stock variations – increased by 6.8% in the first six months of 2004, when compared to the same period of 2003. This performance had already been anticipated by monthly indicators of gross fixed capital formation, which had registered positive growth in the first six months of the year, with 3.8% for construction activity and 25.1% for the production of capital goods. Absorption of capital goods in the half-year period continued expanding, albeit at a lesser pace than capital goods output, since exports of machines and equipment expanded by 52.3% and imports grew by 8.9% in the period. Already available indicators for the month of July continue pointing to growth in gross fixed capital formation, as output of construction industry inputs and capital goods expanded by 4.6% and 24.9%, respectively, when compared with the first seven months of 2004 and the same period of 2003. Exports and imports of capital goods increased by 54.5% and 7.9%, using the same basis of comparison.

Capital goods production
Seasonally adjusted data
2002=100



Source: IBGE

Inputs production for the building industry
Seasonally adjusted data
2002=100



Source: IBGE

Production of capital goods

Percentage change in the year

Itemization	2004			
	Apr	May	Jun	Jul
In the year				
Capital goods	22.3	23.5	25.1	24.9
Industrial	10.9	12.7	14.8	15.0
Serial	16.4	18.0	19.9	20.2
Nonserial	-15.9	-13.8	-11.6	-11.5
Agricultural	25.1	22.1	20.5	16.5
Farm parts	22.9	9.6	7.3	3.3
Building	28.9	25.6	28.1	32.3
Electric energy	12.3	14.9	11.8	12.9
Transportation	19.2	21.7	24.3	25.2
Mixed	25.3	25.5	27.6	26.6

Source: IBGE

Reflecting the positive evolution of the indicators of gross fixed capital formation, the participation of investments in GDP has been recovering. Looking at the first quarter of 2004, this participation corresponded to 22.2%, according to the Quarterly National Accounts released by the IBGE, compared to 20.1% in 2003. Monthly indicators point to continued expansion of this participation, which is fundamental to sustaining the process of renewed economic activity. However, it should be noted that the participation of investments in GDP is still well below the level registered in the second quarter of 1994, when participation set a record of 25.1%.

Analysis of capital goods production broken down by destination of the product reveals the scope of the increase in investments in the first half of the year and the start of the second. Thus, up to July, production of goods targeted to the construction industry expanded by 32.3%; while the output of capital goods for the transportation sector registered 25.2%; machines and tractors for the farm sector closed with 16.5%; production of parts for the farm sector came to 3.3%; and industrial goods produced in series closed with 20.2%.

Data released by the Brazilian Association of the Machines and Equipment Industry (Abimaq), for the January-July period, reflect recovery in investments, turning in positive growth in all of the indicators for the industry of mechanical capital goods. Median utilization of installed capacity moved from 76.5% in the first seven months of 2003 to 80.6% in the corresponding period of 2004. Using the same basis of comparison, real revenues of the sector increased by 7.9%, using the heading of Industrial Products, industrial machines and equipment of the FGV's Wholesale Price Index – Overall Supply (IPA-OG) as deflator; exports of machines and equipment expanded by 33% and imports in this category grew by 13.2%; the average number of weeks to fill orders in portfolio increased by 2.2% and the number of employees in the sector rose by 9.7%.

More recent data released by Anfavea also reflects the upturn in investments. Output of machines and equipment expanded by 17.7% in the first eight months of 2004, compared to the same period of 2003, with growth of 26.9% in the output of harvesters and 14.9% under wheeled tractors. Using the same basis of comparison, production of trucks expanded by 34.3% and that of buses by 9.3%.

Disbursements by the BNDES System – National Bank of Economic and Social Development (BNDES), the Special

Production of automotive vehicles

Itemization	2004				
	Apr	May	Jun	Jul	Aug
In the month[1/]					
Farm machines	-6.7	-2.4	2.5	0.2	3.0
Busses	-5.7	5.5	13.3	9.5	-13.9
Trucks	2.2	1.8	6.4	1.6	3.6
Quarter/previous quarter[1/]					
Farm machines	13.9	9.6	-2.4	-3.7	-0.4
Busses	-14.8	6.2	13.1	19.5	16.6
Trucks	7.1	11.3	11.9	10.4	11.0
In the year					
Farm machines	29.4	24.4	21.2	19.7	17.7
Busses	-0.1	2.0	5.9	9.0	9.3
Trucks	20.3	25.0	29.4	32.2	34.3

Percentage change

Source: Anfavea
1/ Seasonally adjusted data.

BNDES disbursement[1/]

Accumulated in the year (in R$ million)

Itemization	2003	2004		
		I Q	I H	Jul
Total	33 534	8 508	18 033	20 982
Manufacturing industry	15 937	4 306	7 393	8 289
Commerce and services	12 844	2 595	7 298	8 630
Crop and livestock	4 595	1 569	3 185	3 900
Extraction industry	157	37	157	163

Source: BNDES
1/ Includes BNDES, Finame and BNDESpar.

Industrial Financing Agency (Finame) and BNDES Participações S.A. (BNDESpar) – added up to R$20.9 billion in the first seven months of 2004, a figure that is 36.4% higher than that registered in the same period of 2003. By sector of activity, financing granted to mining and manufacturing increased by 120% and 29.8%, respectively; those channeled to commerce and services, by 29.6%; and those targeted to the crop/livestock sector, 72.1%.

The Long-Term Interest Rate (TJLP), which is the basic cost of financing contracted with the BNDES System, remained at 9.75% per year in the second and third quarters of 2004, compared to 10% per year in the first quarter.

1.6 Conclusion

At the end of the second quarter of the year, economic activity indicators revealed a historically high production level. These levels resulted from the process of recovery under way since 2003. This process was initially sustained by the export sector and expanding credit and, later, by expanding income and employment.

With consolidation of this situation, themes related to the sustainability of the growth process have gained importance in the economic debate. With regard to current indicators and the outlook for the future, the macroeconomic fundamentals are better positioned now than in any other recent strong upturns in activity. Consequently, the current cycle will certainly be more durable than past episodes. The simultaneous occurrence of a consolidated framework of fiscal responsibility and sustainability of the public debt, an initially comfortable position for the balance of payments current account result, a real rate of exchange in line with market forces and inflation that is clearly under control have all contributed to make the macroeconomic fundamentals of the current cycle considerably more robust.

Increased confidence in the solidity of macroeconomic fundamentals, reinforced by measures of a microeconomic nature that make it possible to consolidate a favorable business climate, will aid in bringing about the investments needed for a more stable and accelerated growth process. Recent evolution of capital formation indicators and investment conditions is consistent with the start of this process.

Prices

2

The upturn in consumer inflation in the June-August period, when compared to the three previous months, resulted to a great extent from increases in government monitored prices and food prices. At the wholesale level, the recent dynamics of industrial prices has created significant potential for pass-through to retail prices in the coming months. Core inflation for the IPCA remained stable, albeit relatively high. Inflation expectations of private agents for both 2004 and 2005 deteriorated since issue of the most recent Inflation Report.

2.1 General price indices

Growth in general price indices remained relatively high in the quarter ended in August, primarily as a result of pressures generated by the retail segment. The General Price Index – Domestic Supply (IGP-DI), which is calculated by the FGV, increased by 3.8% in the three month period, compared to 3.6% in the quarter ended in May. Wholesale prices remained as the primary cause of the upward movement in the general index. When one analyzes the components of the IGP-DI, the Wholesale Price Index – Domestic Supply (IPA-DI) registered growth of 4.6% in the period, while the Consumer Price Index – Brazil (IPC-Br) increased by 2.2% and the National Cost of Construction Index (INCC) rose by 2.7% (growth in the quarter ended in May came to 4.4%, 1.5% and 3.6%, in the same order).

General price indices

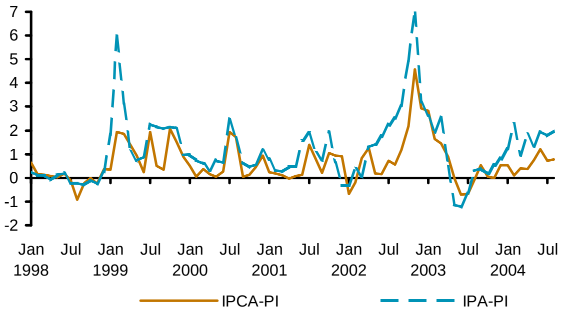
Monthly % change

Itemization	2004							
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
IGP-DI	0.8	1.1	0.9	1.2	1.5	1.3	1.1	1.3
IPA	0.8	1.4	1.1	1.6	1.7	1.6	1.4	1.6
IPC	1.1	0.3	0.5	0.3	0.7	0.8	0.6	0.8
INCC	0.3	1.0	1.2	0.6	1.8	0.7	1.1	0.8

Source: FGV

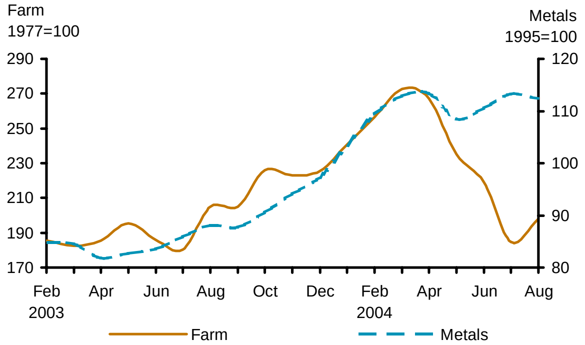
Pressure on the IPA-DI originated in the segment of industrial products, which are responsible for 73% of the composition of the index. In this case, prices rose by 5.8% from June to August, compared to 4.2% in the previous quarter. This movement was driven by increases in fuel prices and higher international commodity prices. In the quarter, the largest increases were registered in the segments of iron, steel and derivatives, with 15.4%; plastics, with 10.8%; and fuels and lubricants, with 10.5%.

IPCA-PI and IPA-PI
Monthy % change



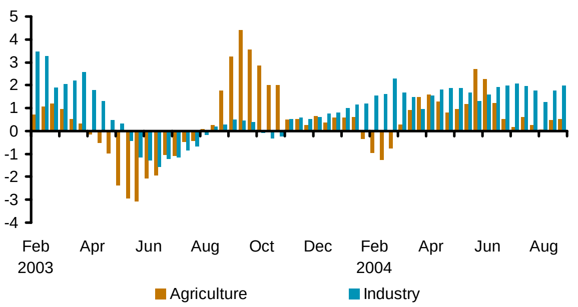
Source: IBGE and FGV

Commodities – Price evolution



Source: IMF and Commodities Research Bureau

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



Source: FGV

It is important to stress that the recent high in the industrial Wholesale Price Index (IPA) will tend to impact consumer prices in the coming months. As presented in the Inflation Report issued in March of this year (Box: Growth in Industrial Product Prices), the evolution of industrial prices at the wholesale level (IPA – industrial products) bears a very close relation with industrial prices at the retail level (IPCA – industrial products). Econometric estimates based on these indices demonstrated that 43% of the increases in industrial prices are transferred to consumers within approximately two months. Therefore, the recent gap that has opened between these price headings stands as a potential source of pressure on the IPCA in the near future.

Farm prices at the wholesale level registered a high of 1.3% in the June-August quarter, compared to 5.1% in the three previous months. The factors that contributed to this downturn were the prices of corn, beans – both as a consequence of positive results in the year's second and third harvests – and of soybeans, reflecting adjustments in estimates of international market demand and the positive outlook for the next United States harvest. One should further emphasize the upward movement that occurred in the prices of sugar cane, particularly in the month of August, with 4.4%, in response to greater internal demand for both alcohol and sugar as well as price increases on international markets, due primarily to an Asian harvest that was brought in below expectations.

With respect to consumer prices, the major influences originated under government monitored prices and the grouping of food products, particularly in the months of July and August. It should be stressed that FGV consumer price indices are more sensitive to changes in the prices of *in natura* products than IBGE indices, mostly as a consequence of the differences that exist between their weighting structures. To some extent, this methodological difference explains the differences of behavior of the two indices in recent months, particularly in July, when growth in the prices of *in natura* products slowed and in August, when these prices recovered sharply.

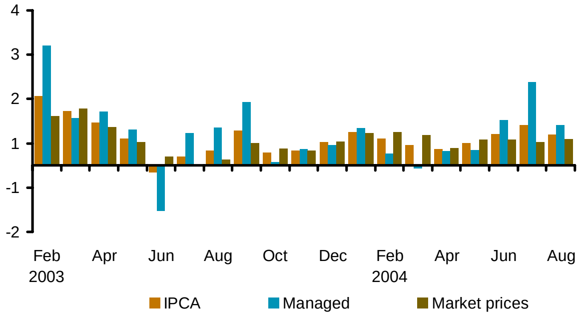
2.2 Consumer price indices

Broad National Consumer Price Index

In the June-August quarter, the IPCA accumulated growth of 2.3%, turning in the largest quarterly median of the year. Government monitored prices – fixed telephone service, electricity, urban transportation and fuels – were the items

Evolution of IPCA

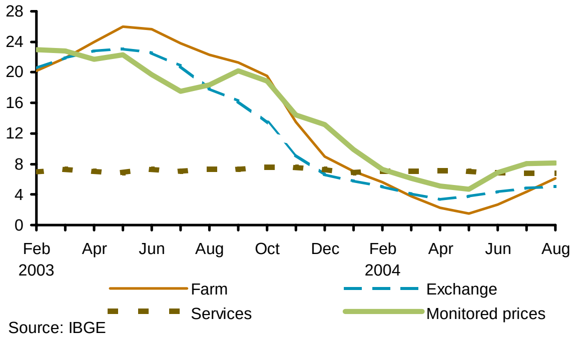
Monthly % change



Source: IBGE

IPCA – Major groups

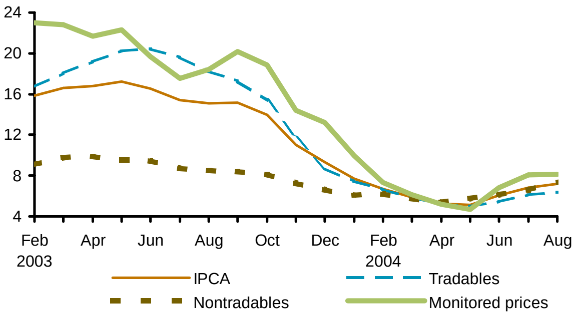
12 month % change



Source: IBGE

IPCA – Itemized groups

12 month % change



Source: IBGE

most responsible for this behavior. At the same time, after registering rather discrete growth in the March-May quarter, with just 0.3%, food prices once again began generating significant pressure on the index, with expansion of 2.3% in the three following months. The IPCA accumulated an increase of 5.14% in the first five months of the year.

In the month of June, government monitored prices – particularly increases in fuel prices (gasoline and alcohol) – accounted for 40% of the 0.71% growth in the index. In July, the IPCA registered a rate of 0.91%, the largest rise of the year. The percentage continued reflecting increases in petroleum derivatives, electricity and fixed telephone rates. Monitored prices contributed with 59% of the result in that month. Aside from this group, other sources of pressure were food costs, particularly milk, dairy products, sugars and derivatives, as a consequence of the off-season production period. In August, the IPCA cooled, with growth of 0.69%. The deceleration was a result of the reduced impact of public sector rate changes, though the upward movement in the prices of the grouping of food products continued, closing with 0.85%.

When one analyzes market prices, the growth figures for June, July and August were 0.58%, 0.52% and 0.6%. The increase in the latter month resulted basically from growth in the prices of *in natura* food products. In the year up to August, market prices accumulated an increase of 4.9%.

2.3 Government monitored prices

While growth in market prices came to 1.7% from June to August, the upward movement in monitored prices reached a level of 3.9% and contributed 1.1 p.p. to the IPCA rate in the quarter. Several different items of considerable weight turned in strong upward movement in the quarter, particularly alcohol, with 27.4% and gasoline, with 7.8%. Electricity rates were increased in four of the 13 regions covered by the IPCA: Curitiba, 10.4%, and São Paulo, 14.7%, in July; and Belém and Brasília, 4.3% and 0.8%, respectively, in the month of August. Urban bus fares increased by 6.6% in Rio de Janeiro, in the month of June. The average increase of 4.5% in fixed telephone rates, which went into effect in all parts of the country at the beginning of July, also made a significant contribution to the high registered under monitored prices. Aside from this, tolls and interstate bus fares were increased by 7.3% and 5.9%, respectively, in the quarter.

Stress should be given to the fact that the major increases in monitored prices projected for 2004 have already been implemented. As a result, the pressures generated by this grouping are expected to be considerably less intense in the coming months. However, price indices will still be impacted by increases in electricity rates in Goiânia, Porto Alegre and Rio de Janeiro, as well as by the extraordinary increase of approximately 6% in fixed telephone rates. This increase, which is to be introduced on a step-by-step basis on the first of September and the first of November, is the result of a decision taken by the Brazilian High Court of Justice (STJ), which decided to overturn a previous injunction that had determined the IPCA was to be used to calculate telephone rate increases in 2003. As a result of this decision, the index foreseen in the original concession contracts, which is the IGP-DI, was re-established as the calculation reference. Aside from these increases, one must also consider the possibility of increases in fuel prices, depending on the evolution of international market prices.

2.4 Inflation cores

Consumer prices and core inflation

Monthly % change

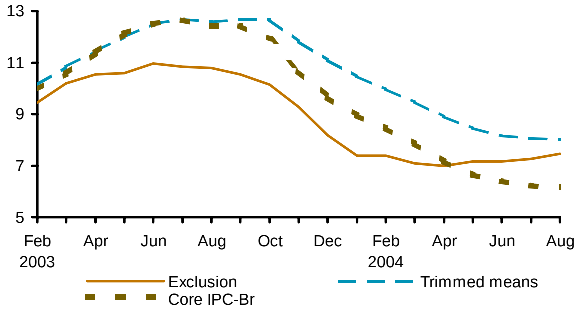
Itemization	2004							
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
IPCA	0.8	0.6	0.5	0.4	0.5	0.7	0.9	0.7
Exclusion	0.6	1.0	0.8	0.7	0.7	0.5	0.5	0.6
Trimmed means								
Smoothed	0.7	0.5	0.8	0.6	0.6	0.6	0.5	0.5
Non smoothed	0.6	0.3	0.7	0.5	0.4	0.5	0.6	0.5
IPC-Br	1.1	0.3	0.5	0.3	0.7	0.8	0.6	0.8
Core IPC-Br	0.7	0.5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

Source: Bacen and FGV

The IPCA core, which is calculated by excluding food taken at home and monitored prices, came to 0.53% in June, 0.47% in July and 0.56% in August. Contrary to what occurred in accumulated terms in the year up to May, in June, July and August the core closed below the full index, indicating the pressures generated in those months by government monitored prices and food products. However, in annualized terms, growth from June to August was equivalent to inflation of 6.4%, despite the fact that the core excluded precisely those items that had made the most important individual contributions to the full index in the quarter. Accumulated growth in the last twelve months came to 7.5% in August and, in the first eight months of 2004, the core calculated on the basis of the aforementioned exclusions, came to 5.6%.

Core inflation

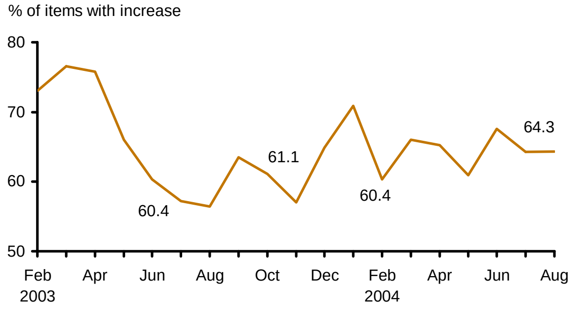
12 month % change



Source: Bacen and FGV

The core for the IPCA calculated on the basis of trimmed medians came to 0.60% in June and 0.55% in July and August, closing the quarter with an annualized high of 7%. The accumulated high in the last twelve months is 8%, with 4.93% in the year up to August. This measurement excludes the items that registered monthly growth above the 80 percentile level or below the 20 percentile level in terms of distribution. In order to avoid completely losing the contribution of the items that undergo price increases just once a year, since these changes would tend to fall within the excluded percentiles, a smoothing procedure is utilized or, in other words, the change is redistributed in equal shares

IPCA items[1/]

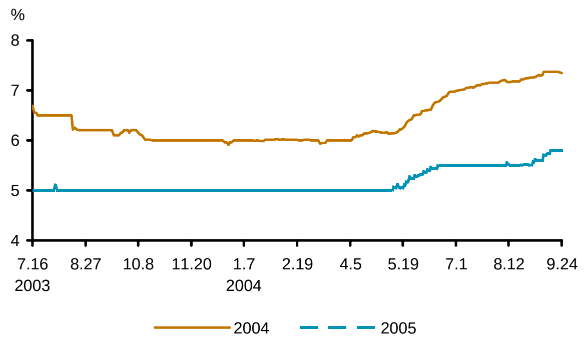


Source: IBGE
1/ IPCA is made up of 512 items.

Summary of market expectations

	3.31.2004		6.30.2004		9.24.2004	
	2004	2005	2004	2005	2004	2005
IPCA	6.0	5.0	7.0	5.5	7.3	5.8
IGP-M	7.7	5.5	10.9	6.0	12.6	6.5
IPA-DI	8.7	6.0	13.2	6.3	15.2	7.0
Managed prices	7.2	6.0	7.8	6.5	8.5	7.1
Selic (end of period)	14.0	12.5	15.0	13.5	17.00	15.25
Selic (average in the period)	15.2	13.3	15.8	14.1	16.25	16.08
Exchange rate (end of period)	3.05	3.25	3.10	3.25	3.00	3.17
Exchange rate (average in the period)	2.97	3.15	3.03	3.16	2.99	3.10
GDP	3.50	3.70	3.50	3.50	4.50	3.60

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



in the month of the change and in the eleven subsequent months. Without the smoothing procedure, the core based on trimmed medians registered growth of 0.48% in June, 0.59% in July and 0.53% in August, resulting in an annualized high of 6.6% in the quarter while accumulating 6% in the last 12 months and 4.11% in 2004.

In the case of FGV's IPC-Br, core inflation calculated on the basis of trimmed medians registered growth of 0.50% in June, 0.36% in July and 0.42% in August. This core accumulated 6.18% in the last twelve months and 4.09% in the year.

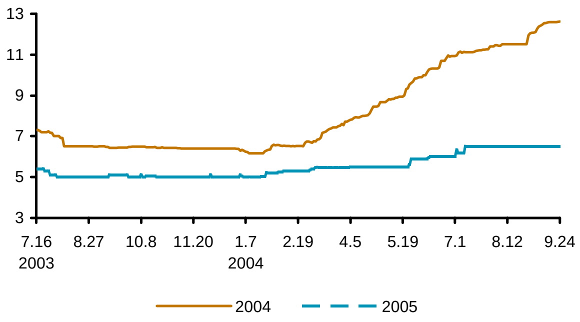
In August, 64.3% of the items included in the IPCA registered positive growth in prices. This was just slightly below the 2004 median of 64.9%.

2.5 Market expectations

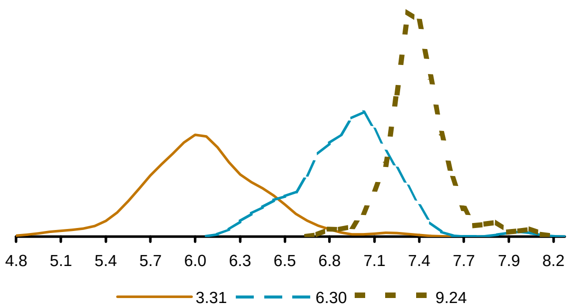
In the third quarter of the year, market expectations for inflation continued on an upward curve, thus maintaining the tendency begun in the second quarter. As a matter of fact, median expectations for the 2004 IPCA rose from 7.0% at the end of June to 7.3% on September 24. In the same period, median expectations for the IPCA 2005 moved from 5.5% to 5.8%. With respect to median expectations for the General Price Index – Market (IGP-M), the result in the same period moved from 10.9% to 12.6% (2004) and from 6.0% to 6.5% (2005). It should be noted that increases in third quarter inflationary expectations for both the IPCA and the IGP-M were below those registered in the second quarter.

The increase in inflation expectations in the third quarter was a consequence of the dynamics of expectations regarding growth in government monitored prices, product growth, exchange and the Selic rate. Over the course of the quarter, the market raised its forecasts with regard to growth in monitored prices for 2004 from 7.8% to 8.5% and, in 2005, from 6.5% to 7.1%, partially reflecting the increase in forecasts of the general price index. With respect to economic activity, the market has begun working with a more expansionary scenario, with median GDP growth expectations for 2004 moving from 3.5% to 4.5%. Among the factors with potentially positive impact on inflation expectations, the trajectory expected for the rate of exchange reversed course as the value of the real shifted into an upward curve. Finally, over the course of the quarter, the market revised its medium term perception of monetary policy,

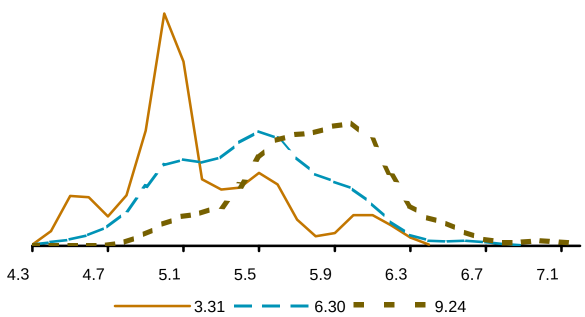
Daily evolution of market expectations for inflation (IGP-M) (median)



Probability density for IPCA expectations (2004)



Probability density for IPCA expectations (2005)



raising median expectations for the Special System of Clearance and Custody (Selic) rate at the end of 2004 from 15.0% to 17.0%.

The increase in median IPCA expectations in the quarter was accompanied by a drop in the growth coefficient for 2004, indicating a reduction of dispersion among the participants in the survey regarding the result of inflation. This, evidently, is a natural reflection of the reduction in lingering uncertainties as the end of the year draws near. The growth coefficient for 2005 remained stable. The distribution of IPCA expectations among the institutions participating in the survey indicates across-the-board deterioration, as reflected in the shift of the 2004 and 2005 distribution curves to the right.

2.6 Conclusion

The acceleration registered in inflation in the June to August period was pressured by increases in monitored prices and in the prices of *in natura* foodstuffs. Though these specific increases reflected seasonal climatic shocks and clauses defining increases in original concession contracts, calculations of the tendencies underlying inflation that are not impacted by these factors, such as the core inflation calculations that exclude food taken at home and monitored prices, remained reasonably stabilized at rather high levels when compared to the trajectory of inflation targets.

In prospective terms, the gap that has recently opened between industrial prices at the wholesale and retail levels generates pressures that will impact the results of consumer price indices in the near future.

Mention should also be made of the fact that the pressures generated by growth in the international prices of petroleum and derivatives in the last several months represent an important risk factor for the internal inflation scenario. Though monetary policy projections have incorporated some leeway for the inflationary impacts of possible increases in fuel prices, the international market remains highly volatile, making it very difficult to clearly distinguish any real trend in these prices.

Finally, deterioration of the inflationary expectations of private agents for 2004 and 2005, which initially was a result of exchange depreciation in the second quarter, continued into the third quarter of the year as a result of revisions in IGP projections and in expectations of the behavior of monitored prices, partly as a result of the risk represented by the lag in domestic gasoline prices. An additional impulse was generated by the fact that the underlying inflationary tendency, as perceived in the various measurements of the inflation core, has stabilized at a rather high level, as well as by the fact that growth estimates for the economy have been revised.

Credit, monetary and fiscal policies

3

3.1 Credit

In the period extending from June to August, financial system credit operations continued on the growth curve that had marked previous months. This trajectory is consistent with the process of renewed economic activity, marked by expanding internal demand and a strong performance by the export sector. In the period, increases were registered in loans to legal entities based on internal resources, as well as in credits to individual borrowers. Aside from this, default rates also continued declining, primarily as a result of improvements in income and employment conditions.

In August, the stock of financial system credits reached R$452.8 billion, for growth of 3.8% in the quarter and 17.5% over twelve months, and were equivalent to 26.4% of GDP as against 26.1% in May. The balance of operations carried out by private financial institutions closed at R$274.3 billion, for growth of 4.6% in the quarter. Here, the most important segments were individual borrowers and commerce. The public bank portfolio totaled R$178.5 billion, reflecting expansion of 2.7%, primarily as a result of operations with individual persons and other services.

Growth in credit operations

R$ billion

Itemization	2004				Growth	
	May	Jun	Jul	Aug	3 months	12 months
Total	436.0	442.8	446.9	452.8	3.8	17.5
Non-earmarked	248.2	251.7	254.2	258.3	4.1	20.8
Corporations	149.9	151.7	152.8	154.3	2.9	18.3
Ref. to exchange	57.5	55.9	55.8	54.2	-5.7	10.1
Individuals	98.2	100.0	101.4	104.0	5.9	24.6
Earmarked	159.4	161.8	162.7	163.9	2.9	10.9
Housing	23.6	23.6	23.8	23.9	1.4	4.7
Rural	46.7	48.0	47.2	48.1	3.0	22.5
BNDES	87.8	88.9	90.3	90.5	3.1	8.8
Others	1.3	1.4	1.4	1.4	9.5	-45.7
Leasing	10.6	10.7	11.3	11.3	6.8	34.2
Public sector	17.9	18.5	18.6	19.2	7.6	27.2
% participation:						
Total/ GDP	26.1	26.1	26.2	26.4		
Nonearm./GDP	14.9	14.9	14.9	15.0		
Earmarked/GDP	9.5	9.6	9.5	9.5		

Credits channeled to the private sector totaled R$433.6 billion in August, with growth of 3.7% in the quarter. Insofar as business activity is concerned, operations with the industrial segment came to R$120.9 billion, for growth of 1%, mainly as a result of credits granted to the chemical, automotive and petroleum industries. Loans to commerce increased by 6.8%, totaling R$50.3 billion, a performance that was compatible with increased sales at the retail level. Loans to the sector of services came to R$76.4 billion, for a high of 2.2%, the most important being credits extended to electricity and transportation companies.

The public sector banking debt came to R$19.2 billion in August, for growth of 7.6% in the quarter. Financing extended to the states and municipalities accumulated R$13.9 billion, for growth of 10.7%. Basically, this performance reflected disbursements to state companies under the terms of the electric power growth program. Credits to the federal government came to R$5.3 billion, for an increase of 0.2% in the period. In this case, one should highlight the amortization of operations involving gas piping projects.

The lease portfolio totaled R$11.3 billion in August, with an increase of 6.8% in the quarter. In this case, one should highlight operations with the service sector and individual borrowers. New credit operations carried out in the period extending from June to August came to R$3 billion, distributed into 73 thousand contracts. Here, the principal modality was automobile financing. This result corresponds to an increase of 27% in value and 59.5% in the number of contracts, compared to the quarter ended in May.

Credit operations based on earmarked resources

BNDES Disbursements

R$ million

Itemization	Jan-Aug		Growth
	2003	2004	(%)
Total	16 972	24 271	43.0
Industry	6 996	9 104	30.1
Other transport equipment[1/]	2 375	2 897	22.0
Motor vehicles	776	1 477	90.3
Food and drink products	901	1 340	48.7
Cellulose and paper	200	606	203.0
Basic metallurgy	642	526	- 18.1
Machines and equipment	209	482	130.6
Commerce/Services	7 365	10 839	47.2
Electricity, gas and hot water	3 078	4 892	58.9
Land transportation	1 709	2 532	48.2
Construction	456	816	78.9
Commerce and reparation	987	673	- 31.8
Crop and livestock	2 611	4 327	65.7

Source: BNDES

1/ It includes aircraft industry.

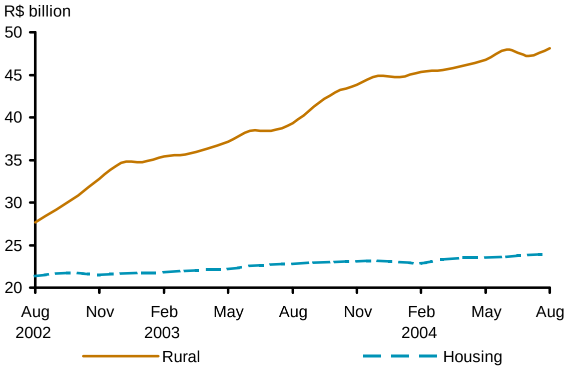
Credit operations backed by earmarked resources added up to R$163.9 billion in August, with growth of 2.9% in the quarter. This evolution reflected expansion of 3.1% in financing granted by the BNDES system, which registered a balance of R$90.5 billion, and 3% in the case of loans to the crop/livestock sector.

Disbursements by BNDES totaled R$24.3 billion from January to August, with growth of 43% in relation to the same period of 2003. In sectoral terms, financing channeled to industry added up to R$9.1 billion, registering a high of 30.1% in the period, driven by the automotive and aircraft segments. Credits granted to the sectors of commerce and services expanded by 47.2% to R$10.8 billion, with particularly strong performances in the sectors of energy and urban transportation. Credits granted to crop/livestock activities totaled R$4.3 billion, with growth of 65.7% in the year. In this case, the highlights were releases through the Program of Modernization of the Farm Tractor Fleet and Like Implements and Harvesters (Moderfrota). Operations with micro, small and medium businesses targeted principally to the crop/livestock and infrastructure sectors corresponded to 32% of total disbursements, expanding by 32% from January to August, compared to the same period of 2003.

Consultations submitted to BNDES totaled R$55.5 billion in the first eight months of 2004, with growth of 146% compared to the same period of 2003. Though it was influenced by the low basis of comparison, this growth indicates a positive outlook for new investments when viewed in the context of the improved economic situation. Requests received from the industrial sector added up to R$28 billion, compared to R$8.2 billion in the corresponding period of 2003. In this case, the most important areas were the sectors of aircraft, metallurgy and paper and pulp. Requests presented by the segment of commerce and services came to R$22.1 billion, or 102% more than the volume observed in 2003, with particular emphasis on the performance of the electricity and construction segments. With regard to the crop/livestock sector, requests for credit totaled R$5.3 billion, representing an increase of 56% in the year.

With regard to the financing of productive sector projects by BNDES, it is important to cite the allocation of R$2.5 billion as of August of this year to the National Industrial Structure Modernization Program (Modermaq). These resources are targeted to acquisitions of national machines and equipment and are limited to 90% of the value of the good to be acquired, with preset interest rates of up to 14.95% per year and a payment term of up to 60 months.

Rural and housing credit outstanding



The rural sector credit portfolio registered growth of 3% in the quarter, reaching a level of R$48.1 billion. Here, the highpoints were obligatory investments in the marketing of the 2003/2004 harvest, as well as onlendings of fund and program resources to agricultural investments. Consequently, the participation of these modalities in rural credit operations moved from 6.6% and 51.9% in May to 8.3% and 52.8% in August, respectively. In the opposite sense, the share referring to current expenditure operations declined by 2.6 percentage points (p.p.), following a seasonal trend marked by the falloff in business prior to planting of the new harvest.

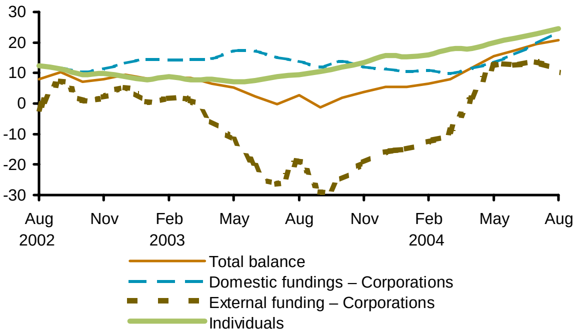
Operations contracted by the housing sector came to R$23.9 billion in August, for growth of 1.4% in the quarter. Disbursements with savings account resources totaled R$687 million in the quarter ended in July, or 14.7% more than the total registered in the quarter closed in April, while investments originating in the Severance Fund Contribution (FGTS) totaled R$704 million, with growth of 7.2%, using the same basis of comparison.

Credit operations based on nonearmarked resources

The volume of credit operations backed by market resources totaled R$258.3 billion in August, with growth of 4.1% in

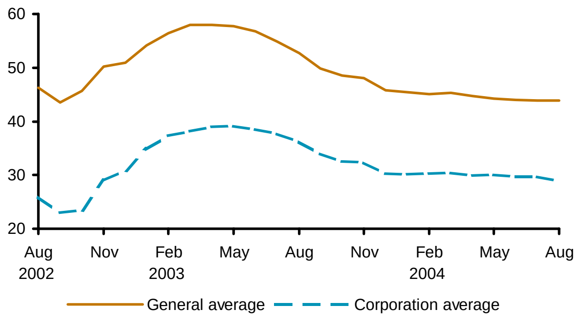
Credit with nonearmarked resources

Percentage growth in 12 months



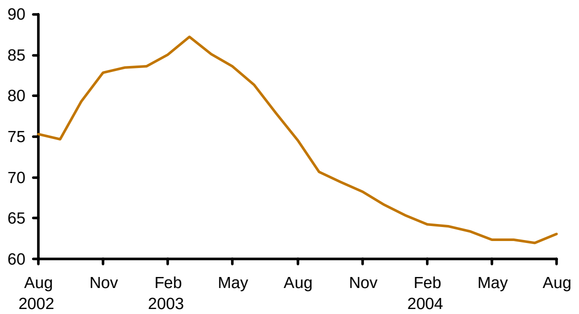
Interest rates of credit operation with nonearmarked resources

% p.y.



Interest rates of credit operation preset rates – Individuals

% p.y.



the quarter and 20.8% in the twelve-month period. As a result, the relative participation of these operations in the financial system total remained at 57%.

Credit operations targeted to legal entities came to R$154.3 billion, with quarterly growth of 2.9%. Loans based on internal resources were driven by the recovery in the pace of economic activity and registered upward movement of 8.3% in the period to a level of R$100.1 billion. The portfolios referenced to foreign currency, which registered a stock of R$54.2 billion, dropped by 5.7% in the quarter ended in August. These results reflected the accounting effect of negative exchange growth in the period, as well as the high volume of settlements in operations involving Advances on Exchange Contracts (ACC), as a consequence of the end of the farm harvest.

Loans channeled to individuals added up to R$104 billion in August, with growth of 5.9% in the quarter. This performance is mainly a result of the evolution of personal credit operations, particularly those involving payroll loans. The system of loans deducted from payroll expanded sharply and provoked a reduction in the utilization of special overdraft checks. These operations resulted in longer terms in operations with individual persons, at the same time in which they resulted in improvement in the debt profile. Parallel to this, one should stress the performance of financing for acquisitions of goods, particularly vehicles, mainly as a result of improved income and employment conditions.

The average rate of interest on credit operations based on market resources diminished by 0.3 p.p. in the quarter, reaching a level of 43.9% per year in August. This behavior reflected a reduction in the rates on loan contracts with businesses, principally those referenced to foreign currency since the cost of these operations was impacted by exchange appreciation over the course of the quarter. In the segment of individual borrowers, the level of charges increased as a result of upward movement in futures market interest rates which, in turn, increased as a result of market expectations regarding the risks of inflationary pressures caused by rising petroleum prices.

The average cost of credits for legal entities declined to 28.8% per year, 1.2 p.p. below the rate calculated in May. In contracts formalized at postset rates referenced to exchange and with preset charges, respective declines of 3.4 p.p. and 0.8 p.p. were registered, in contrast to growth of 0.3 p.p. in the cost of loans contracted at floating interest.

Evolution of the Banking Spread in Brazil (2000 to 2004)

Evolution of the banking spread, understood as the differential between the cost of funds to financial institutions and the rates charged by them on loan and financing operations, reflects both current and structural factors. In this sense, the economic outlook affects the perception of financial institutions regarding risk, at the same time in which it conditions monetary policy, and may demand alterations in basic interest rates and in compulsory reserve rates with the aim of guarantying price stability. These aspects impact definition of the lending rates and funding costs of financial institutions.

Parallel to these considerations, structural aspects related principally to difficulties involved in obtaining information and to deficiencies in the institutional and legal environment hamper a steady reduction in banking spreads, as this indicator tends to remain at permanently high levels. On the basis of this diagnosis, Banco Central initiated a project in 1999 called “Interest and the Banking Spread”, for the purpose of introducing a series of structural and microeconomic measures aimed at steadily reducing spreads and thereby improving credit market efficiency.

In this context, the most important initial measures were increased transparency and competition in credit operations, by requiring dissemination of information on the interest rates levied by the different financial institutions. To achieve this, Banco Central uses the Internet to inform the public of the interest charged by these institutions, thus making it possible for bank clients and the market itself to compare these cost factors. Aside from this, an effort has been made to improve the quality and detailing of information on interest rates, so as to make it possible for Banco Central to monitor these indicators more precisely.

Another highly relevant measure aimed at improving the availability of information on credit operations was development of the Credit Information System (SCR), based on utilization of the Risk Center, created in 1997. The SCR, which brings together detailed information on debtors with banking debts of more than R$5 thousand, will make it possible to improve the decision-making process regarding the granting and management of credit. This factor alone will play a significant role in reducing the default level, which is a major factor in defining the banking spread. The system will also make it possible for clients to negotiate better credit operation rates and conditions since their reference information will be available to all institutions.

At the same time, in order to reduce the legal risk involved in credit operations, an effort has been made to create more suitable credit instruments, while also enhancing guaranties. In this sense, it is important to stress the creation of Bank Credit Bills, which are papers that can be processed more rapidly should it become necessary to execute debts by judicial means, thus reducing the traditional sluggishness of the court system in this area. Furthermore, emphasis should also be given to changes regarding guaranties of loans and financing, as a result of the extension of the system of chattel mortgages to other goods and rights, such as securities and other credits. This aspect will benefit a greater number of credit operations with this type of guaranty and thereby contribute to a lowering of interest rates, as occurs for example in vehicle acquisition contracts.

Aside from the measures already cited, mention should also be made of the new proposed Bankruptcy Law, now before the National Congress. Among other alterations, this legislation is aimed at enhancing the legal security of institutions when granting credits to corporations. Among the proposals presented, there would be an important change in the order of creditor priority in cases of bankruptcy, placing the rights of the tax authorities on an equal footing with those holding real guaranties.

Up to the moment, the various measures taken have produced more significant progress with regard to the diagnosis and dissemination of information on credit, considering that these new instruments will require a certain period of time to consolidate their position on the market. Parallel to this, more significant cutbacks in interest rates and banking spreads became more difficult as a consequence of the adverse scenario that existed at certain moments in this process. Evidently, these events have had serious repercussions on the expectations of agents and on monetary policy.

At the same time, it is important to stress that alterations in spread levels also reflect changes in the relative participation of the various modalities in total credits based on market resources, as well as their impact on costs. This aspect, considering that the spread is calculated on the basis of the difference between lending and funding rates, is a consequence of the fact that the respective rates express median values weighted by the volumes of each modality of the segments of legal entities and individual borrowers.

Growth of banking spread

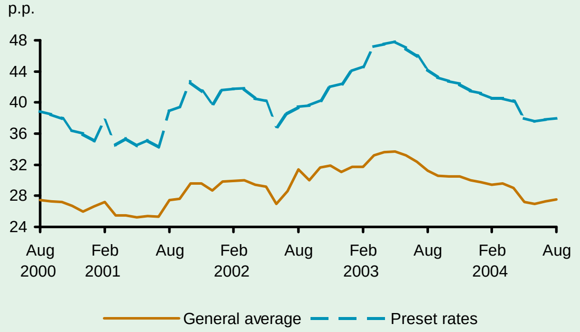
p.p.

Itemization	August				Change	
	2001	2002	2003	2004	12 months	24 months
Total	27.5	31.4	31.3	27.5	-3.8	-3.9
Corporate	11.6	17.2	14.5	13.1	-1.4	-4.1
Corporate preset	22.9	22.0	28.7	24.3	-4.4	2.3
Working capital	15.9	13.3	21.5	18.8	-2.7	5.5
Vendor	4.3	5.6	7.4	5.4	-2.0	-0.2
Corporate post set	3.2	17.3	4.0	3.4	-0.6	-13.9
Corporate floating	8.4	8.6	9.5	9.8	0.3	1.2
Individuals	50.1	50.5	53.6	45.7	-7.9	-4.8
Overdraft check	139.8	140.3	142.6	125.4	-17.2	-14.9
Personal credit	59.2	59.6	66.6	56.4	-10.2	-3.2
Vehicle acquisition	17.4	22.1	20.5	18.3	-2.2	-3.8

At the same time, it is important to note that the difference between the spread levels of the two segments is, among other factors, attributed to the higher levels of defaults in operations with individual borrowers. The spreads on these operations, however, have been dropping as the portfolios of vehicle acquisition contracts have expanded and, more recently, with introduction of the system of payroll loans. In the latter case, the rates on these operations are significantly lower since payments are deducted directly from the wages of the debtors.

One should also add that the different levels of costs charged in these credit modalities and, consequently, the respective levels of the spread to a great extent reflect the guaranties given. In this way, in the case of corporate entities, lower spreads are found in vendor operations, which is a type of operation in which the selling company provides what amounts to an endorsement of the client, compared for example to the spreads found in working capital loans. In operations with individual borrowers, there are important differences between the financing of vehicles and other goods, when compared to personal credits. Furthermore, it is important to emphasize the high spread charged on operations with special overdraft checks, which is a consequence of the demand that financial institutions maintain this credit line available to their clients without being able to

Average spread of credit operations with nonearmarked resources



predict when it will be used, without even mentioning the lack of guaranties.

Another aspect that deserves mentioning involves the methodology applied to calculating spreads, encompassing preset loans, postset loans (referenced to foreign currency) and loans granted at floating rates (mostly indexed to Interfinance Certificate of Deposit – CDI). This composition sharply reduces the cost of intermediation in the segment of corporate entities, because of the strong participation of such operations as Advances on Export Contracts (ACC) and external onlendings, as well as contracts indexed to floating rates.

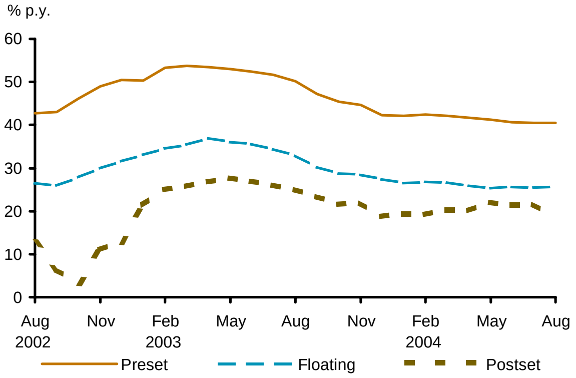
The modalities based on resources contracted abroad have lower spreads, because these operations are normally negotiated by large scale companies, mostly involved in export operations, using their external revenues as guaranties of the financing. In the same way, operations at floating rates also tend to have lower spread levels as a consequence of a series of factors, including the transfer of market risk related to changes in the interest rates to the borrower of the credit. Operations with preset charges, which tend to predominate in the segment of individual borrowers, have higher spreads, because of the margin of safety applied by financial institutions to cover the risks of possible increases in their funding costs.

With respect to the evolution of spreads in the last four years, very different phases can be distinguished both in terms of the preset differential and the total spread. Thus, both indicators registered downward movement up to the end of the first half of 2001, influenced by the positive results registered by the economy and the downward movement registered under lending rates. From that point forward, this trend reversed course as the Selic rate increased and the futures interest market became increasingly more volatile, as the internal economic situation deteriorated. The upward movement in the total and preset differentials continued to the start of 2002, interrupted only during a very brief period of decline in the second quarter of 2002.

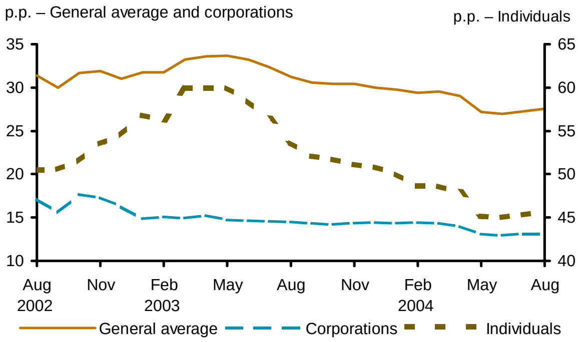
As of the second half of 2002, the situation of uncertainty produced by economic policy and increased foreign investor aversion to risk provoked greater exchange volatility and a shortfall in the supply of external funding. Facing this situation, the country adopted a restrictive monetary policy once again, with new increases in both the Selic target and compulsory rates, both of which impacted market interest rates. The evolution of the spread accompanied this trend and moved upward until mid-2003. Since June 2003, when a more flexible monetary policy was adopted, these differentials have followed a downward curve that continued through to July 2004.

Preservation of the environment of macroeconomic stability will certainly favor reductions in intermediation costs. At the same time, improvement and consolidation of the legal framework applicable to credit operations, coupled with development of the recent risk management instruments, will tend to contribute to even more effective medium-term cutbacks in banking spreads.

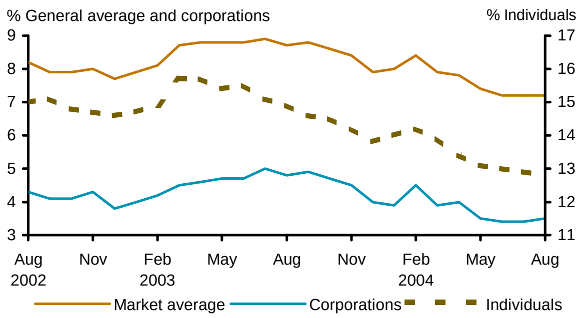
Interest rates of credit operations – Corporations



Average spread of credit operations with nonearmarked resources

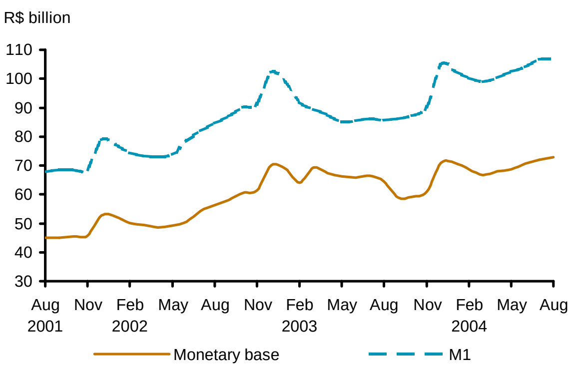


Default rate of credit[1/]



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

Monetary base and M1 – Average daily balances



In operations with individual persons, the median rate of interest increased by 0.7 p.p. in the quarter, coming to 63.1% per year in August. This result was based on increases of 1.1 p.p. and 1 p.p., respectively, in the cost of personal credit loans and vehicle acquisition financing. These modalities are more sensitive to changes in futures market interest rates, since their maturity terms are significantly longer than in other modalities.

In credit operations based on market resources, the banking spread came to 27.5 p.p. in August, with growth of 0.3 p.p. in the quarter. The spread on loans with individual persons rose by 0.5 p.p., while remaining stable in contracts with legal entities.

The quality of the credit portfolio based on market resources registered relative improvement in the June-August quarter, when arrears of more than fifteen days are considered. In this sense, total defaults diminished by 0.2 p.p. in the period, coming to 7.2% in August. In the segment of individual borrowers, defaults dropped by 0.3 p.p. to 12.8% and, in the case of legal entities, remained at 3.5%.

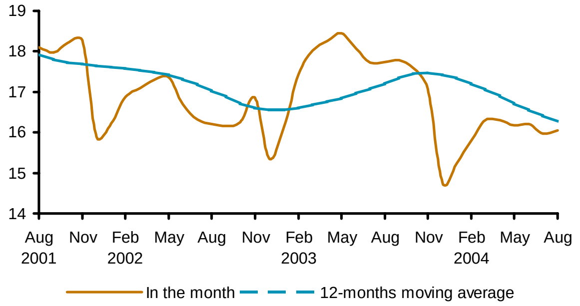
3.2 Monetary aggregates

Viewed in terms of median daily balances, the money supply (M1) came to R$106.3 billion in August. Growth of 23.9% registered in the last twelve months corresponded to expansion of 21.1% in currency held by the public and 25.8% in demand deposits. In the June-August quarter, the income velocity of M1, defined as the ratio between GDP and the monetary aggregate, continued on the downward curve that began in May.

When deseasonalized data deflated by the IPCA are considered, the M1 aggregate remained stable, albeit high, in the June-August quarter, mainly reflecting sharp growth in the pace of economic activity and the evolution of credits granted.

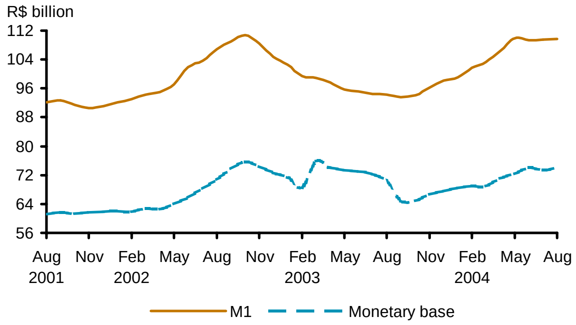
In the month of August, median daily monetary base balances totaled R$72.5 billion, with growth of 12.4% in twelve months. This behavior reflected expansion of 22.3% in the median balance of currency issued and the reduction of 4.1% in banking reserves. It should be noted that the growth registered under this heading has distanced itself from the performance of demand deposits due mostly to the reduction in the rate of compulsory reserves on demand resources at the end of August 2003, from 60% to 45%.

M1 – Income-velocity[1/]



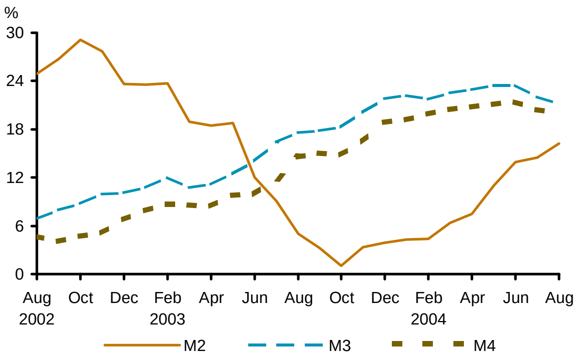
1/ Defined as the ratio between 12 month accumulated GDP (valued by IGP-DI) and the monthly average balance of the monetary aggregate.

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



1/ Price index: IPCA.

Broad money supply – 12-month percentage growth



With respect to the sources of primary currency issues, the movement registered in the National Treasury (TN) operating account produced a contractive impact of R$10.8 billion in the June-August quarter. In the same sense, overall operations with the financial system generated a contractive result of R$5.1 billion. Here, particular mention should be made of the R$2.7 billion adjustment in operations with derivatives; the inflow of R$902 million related to insufficient investments in microcredit operations, since the first verification of compliance with this requirement took place on August 20; and deposits originating in the additional reserve requirement on deposits and the compulsory reserve on the deposits of the Brazilian System of Savings and Loans (SBPE) which, together, added up to R$1.3 billion. These results and the increase of R$5.4 billion in demand for banking reserves produced net redemptions of R$21.3 billion in federal public securities, in the quarter ended in August.

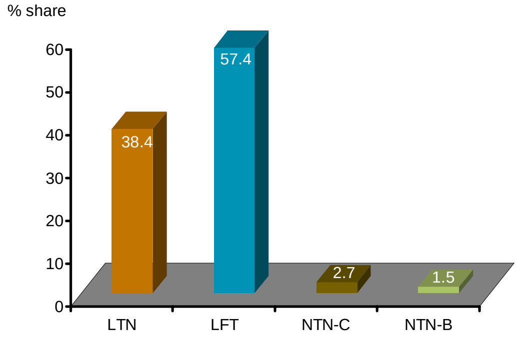
With regard to the evolution of the money supply in the broad sense (M2), credits granted and positive exchange flows in the period produced an expansionary impact. Consequently, the M2 concept, which includes M1 plus savings deposits and papers issued by financial institutions, increased by 5.3% in the quarter and 16.2% in twelve months while, in the second quarter, these variations had come to 4.8% and 11%, respectively. Among the components, the most important were growth of 7.5% in time deposits, impacted by the migration of resources away from investment funds, following a tendency that had already been noted in the previous quarter.

M3, which encompasses M2 plus quotas in fixed income funds and the net position in federal securities held by the public, as a result of repo operations, expanded by 4.2% in relation to May 2004 and 21.2% over twelve months. The increase of 3.2% in the quotas of fixed income funds resulted basically from capitalization of their earnings, since the period was marked by migration of resources toward other financial assets. The M4 concept, which encompasses M3 plus public securities held by nonfinancial entities, came to R$1.1 trillion at the end of August, with growth of 3.5% in the quarter.

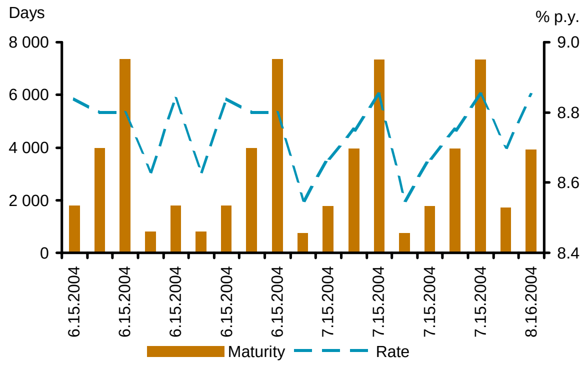
Federal public securities

From June to August, operations with federal public securities produced an expansionary impact of R$12.6 billion, based on placements of R$64.8 billion and

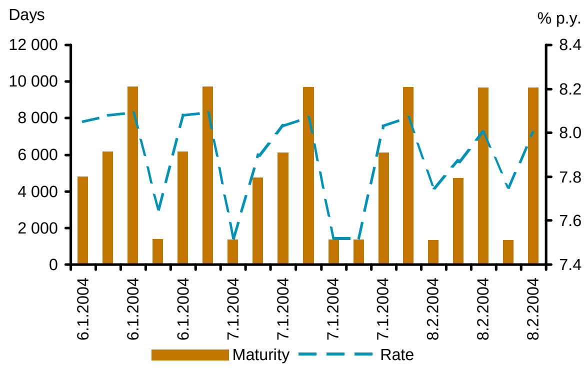
Issues of federal public securities – June to August 2004



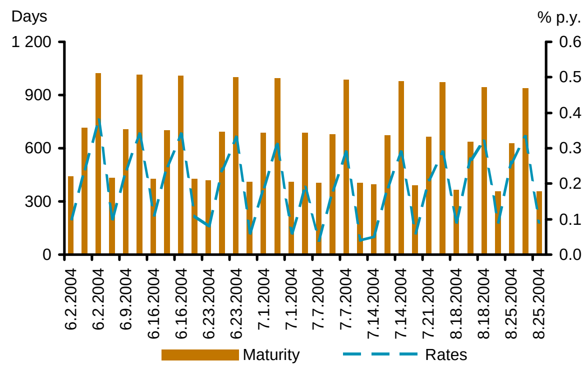
NTN-B placements – Maturity and rates



NTN-C placements – Maturity and rates



LFT placements – Maturity and rates



redemptions of R$79 billion, excluding operations involving exchanges of National Treasury Notes – Series B (NTN-B) and National Treasury Notes – Series C (NTN-C), which totaled R$3.6 billion.

In the quarter, issues were concentrated in National Treasury Financing Bills (LFT), which are indexed to the Selic rate and accounted for 57.4% of the total auctioned. National Treasury Bills (LTN), which are preset papers, accounted for 38.4% of placements, while papers tied to price indices accounted for 4.2%. In the course of the quarter, the participation of LTN in monthly National Treasury issues expanded from 16.1% in June to 56.8% in August, while that of LFT declined from 76.9% to 42.4% in the same interval.

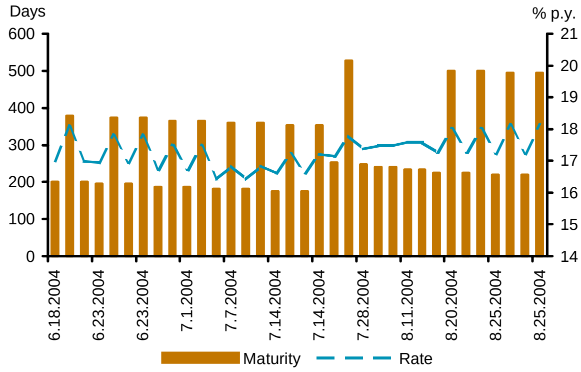
The recent increase in international market oil prices had a negative impact on inflation expectations for 2004 and 2005. In this context, the interest curve, which had tended downward up to the start of July, shifted into an upward curve, impacting the interest rates demanded on the public securities market.

The rates contracted in LFT and LTN auctions registered an upward trend as of the second half of July, to the point that, on some occasions, the rates proposed by financial institutions were rejected. At the beginning of August, the National Treasury began operating more intensively on the secondary market, holding LFT purchase and sale auctions with the aim of mitigating the increase in discounts on these papers. At the end of the month, papers with maturities in August 2005, May 2006 and March 2007 were negotiated with discounts of 0.09%, 0.26% and 0.33% per year, respectively, compared to 0.04%, 0.18% and 0.29% per year, at the beginning of July.

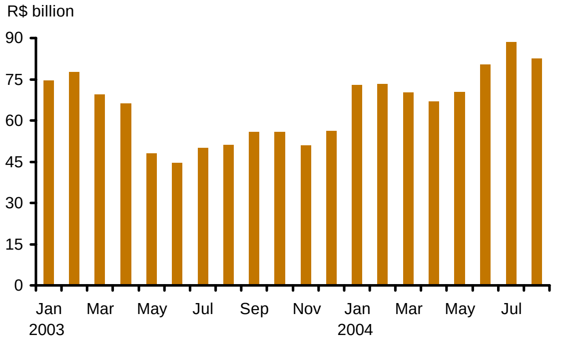
Parallel to this, on July 23 the National Treasury lengthened the maturities of LTN offered, placing papers with maturities in April 2005 and in January 2006. In the final auction of the quarter, these papers were negotiated at 17.2% per year and 18.1% per year, respectively, compared to rates of 17.1% per year and 17.8% per year, on the date of the initial auction.

With regard to the rolling of the share of the public debt indexed to the rate of exchange, Banco Central held exchange swap auctions once again, though these were limited to only a partial rolling of the papers and settled exchange swaps. The exchange turnover came to 18.4%, considering only the maturing principal. From June to August, maturities totaled US$6.1 billion, with US$3.6 billion in exchange swap operations and US$2.6 billion in public

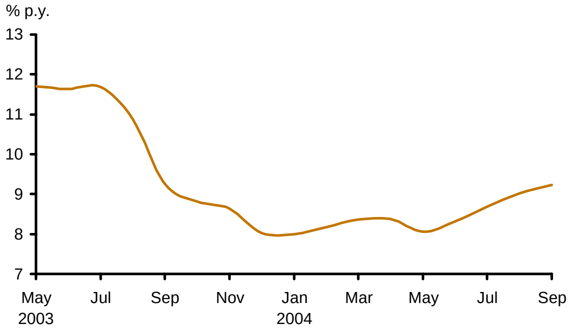
LTN placements – Maturity and rates



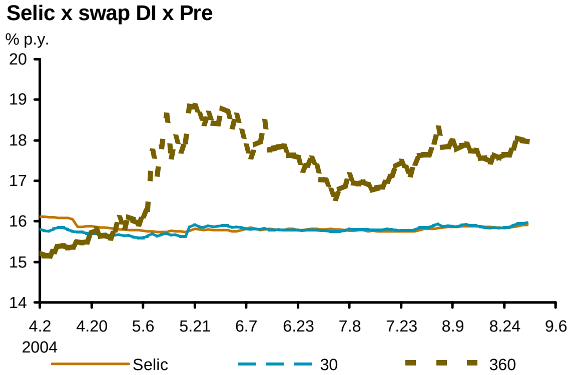
Net financing position of the federal public securities – Daily average



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



Selic x swap DI x Pre



Source: BM&F

securities indexed to the rate of exchange, Banco Central Notes – Special Series (NBCE) and National Treasury Notes – Series D (NTN-D). Placements came to US$1.3 billion in new exchange swap contracts in three auctions held in the period.

The median monthly volume of repo operations targeted at controlling liquidity increased from R$70.4 billion in May to R$88.5 billion in July, before dropping back to R$82.4 billion in August. This movement was impacted by strong concentration of public security maturities in July, R$32.6 billion, resulting in an expansionary factor of R$21.3 billion in the quarter.

The strategy of rolling excess liquidity on the market is still being done through preset forward operations with terms of three months, postset repo operations with maturities of two weeks and very short-term preset operations, aside from the traditional operations targeted at leveling liquidity at the end of the day. It should be noted that, in recent months, the volume involved in longer-term forward operations moved from R$25.8 billion at the start of June to R$46.6 billion at the end of August.

Real interest rates and market expectations

Based on the median IPCA projections gathered by Banco Central's Gerin, the real ex-ante rate of interest for the coming 12 months came to 9.2% per year on September 17, compared to 8.3% per year at the end of June.

The consolidation of expectations that the Federal Reserve (Fed) would follow a very gradual process of raising basic interest rates in the United States had a positive impact on the Brazilian market in terms of the reduction of the interest reference rate for DI x pre one year swap contract, which came to 17% per year in June compared to 18.8% per year in the previous month.

However, the deterioration of market expectations regarding the future evolution of the IPCA, due to some extent to the rise in international market oil prices and their possible impact on the trajectory of the Selic rate, were determining factors in the repositioning of the interest curve. In this context, the rate for one year contracts came to 18% per year in August, at the same time in which inflation expectations for the coming 12 months came to 6.27%, as compared to 5.98% in May, when the IPCA is used as parameter.

Capital market

The reduction in uncertainties regarding the pace of the interest rate rise in the United States and the release of several indicators confirming renewed Brazilian economic growth provoked a reversal in the downward trend registered on the São Paulo Stock Exchange Index (Ibovespa) since the month of February. Consequently, the Ibovespa rose by 16.7% in the quarter ended in August, reaching a level of 22,803 points at the end of that month. In dollar terms, growth came to 24.4%.

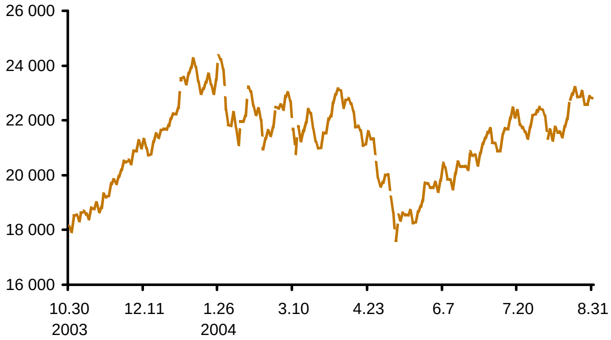
In the same period, the Dow Jones Industrial Average (DJIA) and the National Association of Securities Dealers Automated Quotation (Nasdaq) slipped by 0.1% and 7.5%, respectively, under the influence of contradictory indicators regarding the vigor of economic recovery in the United States.

In the quarter extending from June to August, foreign investors effected redemptions of approximately R$1.7 billion in stock exchange investments in Brazil. However, the median daily volume negotiated registered growth of 5.6% in the quarter, coming to R$1,129 million, particularly as a result of increased participation on the part of individual investors.

The financing of companies on the capital market through primary issues of stocks, debentures and promissory notes came to R$6.6 billion from January to August, compared to R$4.7 billion in the same period of 2003. Though this result is below that registered in 2001 and 2002, the increased interest of companies in obtaining resources through the capital market, mainly by means of debentures, was clearly evinced in the increased volume of requests under analysis at the Securities and Exchange Commission of Brazil (CVM), which came to R$2.2 billion at the end of August.

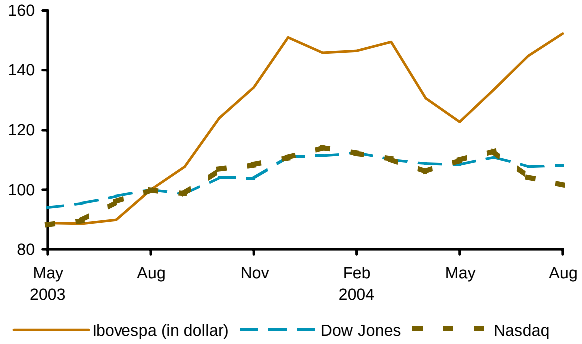
Ibovespa

Points



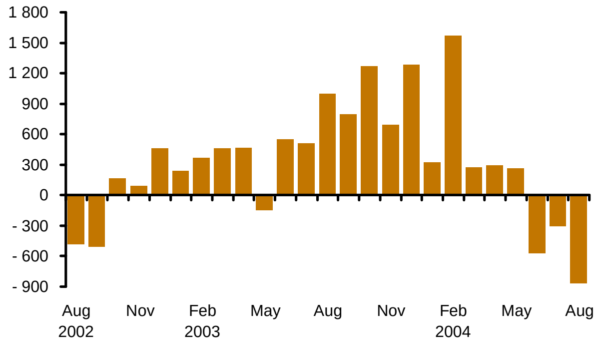
Stock exchanges

2003, August = 100



Net foreign investment in Bovespa

R$ million



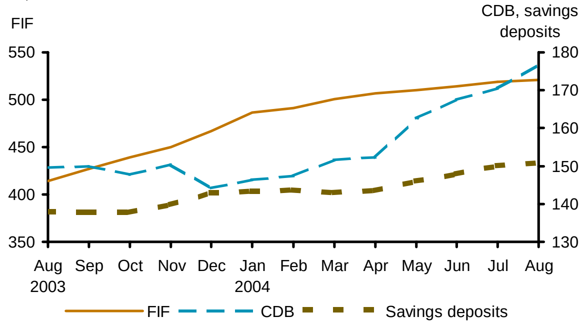
Financial investments

The balance of financial investments, which encompass savings accounts, time deposits and investment funds, totaled R$872.2 billion in August, with growth of 4.7% compared to May 2004.

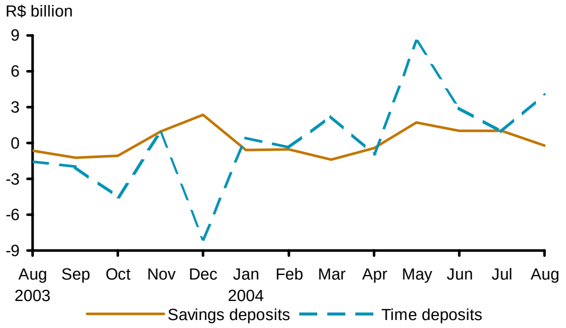
The equity of investment funds came to R$520.9 billion at the end of August, with a net negative inflow of R$6.3 billion in the June-August quarter. It should be underlined that this movement was a consequence of migration of resources into savings accounts and time deposits.

Portfolio evolution of CDB, FIF and savings deposits

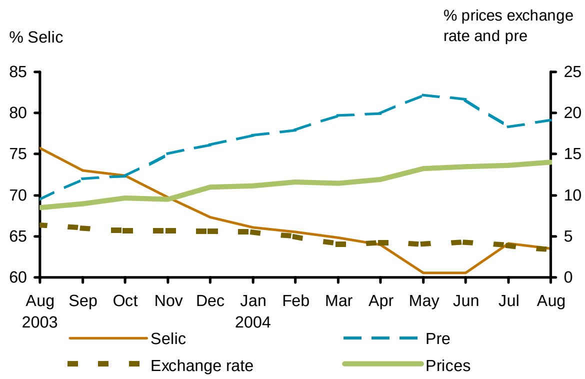
R$ billion



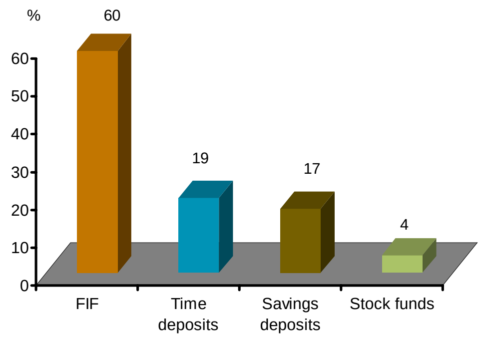
Net inflow – Savings deposits and time deposits



Public securities in funds portfolio by indexator



Financial savings structure – 2004, August



Primary result

Accumulated in the year R$ million

Period	Occurrence	IMF – Performance criteria	
	Jan-Jul (I)	Jan-Sep (II)	(I)/(II) (%)
1999	-20 410	-23 788	85.8
2000	-24 736	-29 000	85.3
2001	-33 131	-34 400	96.3
2002	-32 882	-41 000	80.2
2003	-44 329	-54 200	81.8
2004	-52 796	-56 900	92.8

In the month of August, the balances of savings accounts and time deposits totaled R$150.8 billion and R$176.7 billion, respectively. The significant net inflows of these investments in the quarter, with respective totals of R$1.8 billion and R$8 billion, suggest growth in demand for investments with lesser volatility in relation to profitability.

With regard to net inflows of resources through different types of investment funds, emphasis should be given to inflows through funds referenced to interbank deposits (DI), since this portfolio is mostly composed of preset papers. Expectations of a decline in the Selic rate target noted up to mid-July resulted in net redemptions of these funds. Since that time, these expectations were reversed and migrations in the framework of the investment fund industry came to favor DI funds, in detriment to fixed income funds, which have a large volume of preset papers in their portfolios. In consolidated terms, there was an increase in the participation of postset papers in financial investment funds.

Stock funds, which include investment funds based on investments in stocks and securities (FITVM) and mutual privatization funds (FMP), which invest FGTS resources, registered equity of R$41.3 billion in August, with growth of 11.8% in the quarter and median profitability of 10.6%.

With regard to the profitability of other financial investments in the quarter, financial investment funds (FIF) and time deposits generated earnings of 3.8% and 3.7%, respectively, while savings accounts turned in a level of 2.1%.

3.3 Fiscal policy

Public sector borrowing requirements

In the month of July, the nonfinancial public sector registered a primary surplus of R$6.6 billion. The surplus accumulated in the year turned in the best result since the series was first calculated in 1991, reaching a level of R$52.8 billion, or 5.59% of GDP, compared to R$44.3 billion or 5.2% of GDP in 2003. In 12 months, the primary surplus came to R$74.6 billion, 4.65% of GDP.

The result obtained up to July corresponds to 92.8% of the indicative target for the January-September period, set at R$56.9 billion. Here, it is important to underscore that this performance was a consequence of the seasonal behavior of revenues and spending over the course of the year and does not necessarily imply extra leeway for additional budget expenditures. In 2001, the accumulated surplus up to July corresponded to 96.3% of the target set up to September, compared to 80.2% and 81.8% of the respective targets in the two subsequent years.

The central government (federal government, National Social Security Institute – INSS and Banco Central) accounted for R$39.6 billion of the surplus accumulated from January to July, equivalent to 4.2% of GDP; regional governments accounted for R$11.6 billion, or 1.2% of GDP; and state companies for R$1.6 billion or 0.2% of GDP.

Here, one should highlight the increase in the surpluses of the central government and regional governments, and the reduction in the surplus of state companies, when compared to the 2003 result. In this way, the participation of the central government in the public sector surplus increased from 73.7% in the first seven months of 2003 to 75.1% in the corresponding period of 2004, while the participation of regional governments moved from 20.3% to 21.9%, and that of state companies moved in the opposite direction, dropping from 6% to 3%. As a proportion of GDP, the central government surplus increased by 0.37 p.p., while that of regional governments expanded by 0.17 p.p. and the surplus of state companies fell by 0.14 p.p.

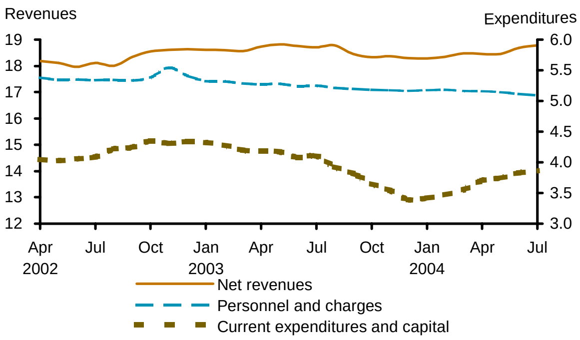
Primary result of the consolidated public sector

Accumulated in the year: Jan-Jul

Segment	2002		2003		2004	
	R$ billion	% PIB	R$ billion	% PIB	R$ billion	% PIB
Central government	-23.0	-3.1	-32.7	-3.8	-39.6	-4.2
Regional government	-7.6	-1.0	-9.0	-1.1	-11.6	-1.2
State companies	-2.3	-0.3	-2.6	-0.3	-1.6	-0.2
Total	-32.9	-4.4	-44.3	-5.2	-52.8	-5.6

When one considers the three segments that form the central government, the federal government registered a surplus of R$54.3 billion and INSS and Banco Central closed with respective deficits of R$14.6 billion and R$112 million. The increase of R$9.4 billion in the federal government result, corresponding to 0.48 p.p. of GDP, indicated growth in the inflow of federal taxes and contributions, mainly as a result of the upturn in the pace of economic activity. Compared to the first seven months of 2003, the revenue gain came to R$25.5 billion, reflecting real growth of 9.4% when the IPCA is used as deflator.

Revenues x expenditures – Flows in 12 months – Federal government – % GDP



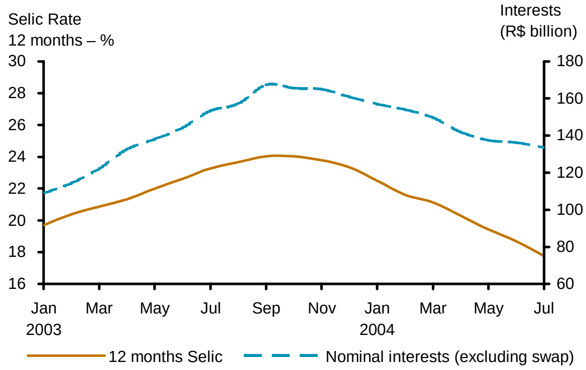
With regard to spending, federal government outlays came to 14.09% of GDP from January to July 2004, compared to 13.71% of GDP in the same period of the previous year. Among the components, outlays on personnel and social charges fell from 5.26% of GDP to 5.06%, and constitutional transfers to the states and municipalities shifted from 4.23% of GDP to 4.04%, while current expenditure and capital outlays increased by 0.77 p.p. of GDP to 4.94%. Spending by INSS totaled 6.83% of GDP, compared to 6.32% from January to July 2003.

The result for regional governments was influenced mainly by the impact of renewed economic activity on the ICMS inflow which, in the first half of 2004, registered real growth of 5.2%, using the IGP-DI as deflator, compared to the result for the same period of 2003. Mention should also be made of an additional important factor that has aided in achieving fiscal equilibrium in this segment: the ongoing implementation of the guidelines set down in the Fiscal Responsibility Law, particularly as regards the limits imposed on indebtedness and current expenditure outlays.

In its session on 8.18.2004, the Federal Supreme Court (STF) decided to maintain the charging of the social security contribution of federal, state and municipal civil service retirees and pensioners, as determined by Constitutional Amendment 41/2003. Though the exemption level was raised and the amounts to be paid were standardized, the decision preserved the positive impact of these contributions on the finances of the three levels of government, particularly in light of the fact that this measure represents important relief in terms of the deficit registered by the civil service social security system.

In this way, public sector fiscal equilibrium benefited above all from the improved performance of government segments, compared to that of state companies, reflecting the quality improvement achieved as a result of the fiscal adjustment.

Selic rate x appropriated interests



Nominal interest appropriated in July 2004 came to R$10.4 billion. In accumulated terms for the year up to July, the total came to R$72.2 billion or 7.6% of GDP, compared to R$89.3 billion or 10.5% of GDP in 2003. For the most part, this reduction is explained by the downward trajectory of the Selic rate, which moved from 24.5% per year in July 2003 to 16% per year in July 2004. It should be noted that the volume of interest appropriated from January to July 2003 included the favorable results of exchange swap operations, in the amount of R$10.1 billion, while the result of these operations in 2004 was practically nil.

Public sector borrowing requirements

Accumulated in the year: Jan-Jul

Itemization	2003		2004	
	R$ billion	% PIB	R$ billion	% PIB
Uses	44.9	5.3	19.4	2.1
Primary	- 44.3	- 5.2	- 52.8	- 5.6
Interest	89.3	10.5	72.2	7.6
Sources	44.9	5.3	19.4	2.1
Internal borrowing	48.3	5.7	43.9	4.7
Security debt	67.6	7.9	48.3	5.1
Bank debt	- 16.0	- 1.9	1.6	0.2
Others	- 3.3	- 0.4	- 6.0	- 0.6
External borrowing	- 3.4	- 0.4	- 24.5	- 2.6

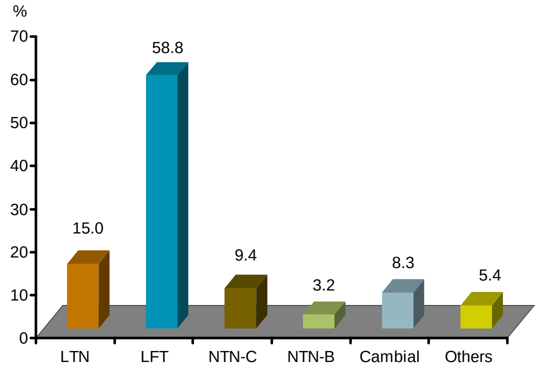
In July, public sector borrowing requirements viewed in the nominal concept, which includes the primary result and nominal interest appropriated, registered a deficit of R$3.8 billion. In accumulated terms for the year up to July, the nominal deficit totaled R$19.4 billion, 2.1% of GDP, compared to R$44.9 billion or 5.3% of GDP in 2003.

With regard to the primary sources of financing for the year's accumulated nominal deficit, the securities debt and banking debt registered increases of R$48.3 billion and R$1.6 billion, respectively, while external financing registered a reduction of R$24.5 billion.

Federal securities debt

Evaluated according to the portfolio position, the federal securities debt dropped from R$767.7 billion, 46.6% of GDP, in April 2004, to R$759.2 billion, 44.4% of GDP, in July 2004. This variation resulted from net redemptions of R$40.2 billion in the primary market, incorporation of interest and 2.79% depreciation of the real against the dollar.

Federal securities debt structure – July 2004



The share of the federal securities debt indexed to the dollar dropped from R$68.1 billion in April to R$63.1 billion in July, as a result of net exchange redemptions of R$8.6 billion. In the period, once exchange swap contracts are excluded, the participation of exchange securities in the total federal securities debt dropped from 8.9% to 8.3%, while that of papers referenced to the Selic rate slipped from 59.7% to 59.6%. When swap contracts are considered, the participation of papers indexed to the rate of exchange fell from 16.3% to 14.1% and that of papers tied to the Selic rate increased from 52.3% to 53.8%. In its turn, the participation of the preset debt declined from 15.8% to 15.1%.

The amortization schedule of the securities debt on the market, excluding financing operations, registered the following configuration in July: R$107.2 billion, 14.1% of the total, with maturity in the period from August to December 2004; R$280.6 billion, 37% of the total, in 2005; and, R$371.4 billion, 48.9% of the total, as of January 2006.

In July, exchange swap operations came to R$43.6 billion, compared to R$56.8 billion in April. The result of these operations in the quarter, defined as the difference between the profitability of the DI and exchange growth plus coupon, produced a negative impact of R$934 million on Banco Central, considered on an accrual basis, and R$227 million, when viewed according to the cash criterion.

Net public sector debt

The net debt of the nonfinancial public sector totaled R$945.7 billion in July, corresponding to 55.3% of GDP, compared to R$926.4 billion or 56.3% of GDP in April, and R$913.1 billion or 58.7% of GDP in December 2003.

Net debt growth
Conditioning factors

Itemization	2002		2003		2004	
	December		December		July	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	881 108	55.5	913 145	58.7	945 659	55.3
Flows	**Accumulated in the year**				**July**	
Net debt – Growth	220 241	2.9	32 037	3.3	32 514	- 3.4
Conditioning factors	220 241	13.9	32 037	2.1	32 514	1.9
PSBR	61 614	3.9	79 030	5.1	19 408	1.1
Primary	-52 390	- 3.3	-66 173	- 4.3	-52 796	- 3.1
Interest	114 004	7.2	145 203	9.3	72 204	4.2
Exchange adjustment	147 225	9.3	-64 309	- 4.1	11 120	0.7
Domestic securities debt[1/]	76 662	4.8	-22 715	- 1.5	3 387	0.2
External debt	70 564	4.4	-41 594	- 2.7	7 733	0.5
Others[2/]	753	0.0	16 712	1.1	2 385	0.1
Acknowledgement of debt	14 286	0.9	604	0.0	- 322	0.0
Privatizations	-3 637	- 0.2	0	0.0	- 78	0.0
GDP growth effect		- 11.0		1.2		- 5.3

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

Exchange depreciation of 4.76% in the period from January to July 2004 contributed to the R$11.1 billion rise in the debt, including R$3.4 billion referring to the internal securities debt indexed to the dollar and R$7.7 billion related to the net external debt.

Analyzing the factors responsible for the decline of 3.4 p.p. in the net debt as a proportion of GDP in 2004, the effect of GDP growth accounted for a reduction of 5.3 p.p., while borrowing requirements, exchange depreciation and growth in the parity of the basket of currencies that form the net external debt accounted for increases of 1.14 p.p., 0.65 p.p. and 0.11 p.p., respectively.

The gross debt of the general government (Federal Government, INSS and state and municipal governments) registered a decline in the month, moving from R$1,295 billion or 76.4% of GDP, in June, to R$1,289 billion, 75.4% of GDP, in July. With respect to December 2003, the decline corresponded to 3.6 p.p. of GDP.

3.4 Conclusion

Financial system credit operations in the June-August quarter, continued on the upward trajectory that has marked recent months, a tendency that is clearly consistent with the improvement in economic activity. The increase was registered in operations contracted with legal entities and backed by domestic resources while, at the household level, the most important factor was the increased demand for personal credit and for consumer goods financing, in detriment to the use of the revolving credit modality.

In this sense, the most important headings were operations targeted at business investments, including both nonearmarked credits to meet demand for goods, as well as the various modalities of earmarked credits in operations based on BNDES resources. At the same time, the period was marked by a trend toward the normalization of banking debt, as rates of default declined, particularly at the household level. This process benefited from migration to operations with lower interest rates as well as from growth in income and employment.

Fiscal results up to July came to levels that were compatible with the targets set for the year. Aside from this, there was lesser dependence on the performance of state companies, since the participation of these entities in the public sector surplus dropped in relation to previous years. Governments accounted for growth in the surplus accumulated in the year, resulting from a combination of expanded inflows, particularly as a result of the increased pace of economic activity, reductions in outlays on personnel and charges, and higher current expenditure and investment outlays.

With respect to the debt/GDP ratio, the reduction in the year came to 3.4 p.p. of GDP. The factors most responsible for the decline registered in this ratio were continued fiscal equilibrium in all public sector segments, downward movement in the Selic rate compared to the levels practiced in 2003 and positive GDP growth. These same factors, allied to lesser vulnerability of the debt to exchange rate fluctuations, should continue contributing to the falloff in the debt/GDP ratio.

The international economy

4

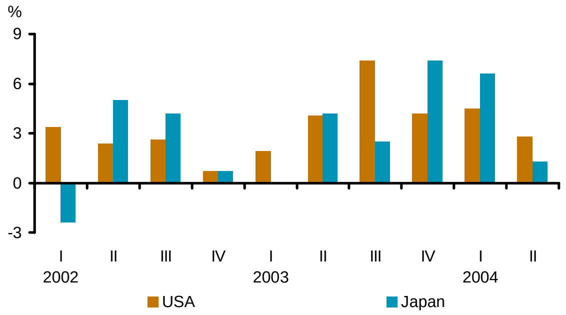
Starting in the second quarter of this year, the pace of world economic growth reflected lower rates of expansion in the countries that had sustained the upturn to that point in time. To some extent, this movement was a consequence of a steady rise in petroleum prices and of a managed deceleration in the Chinese economy. In this context, the fear that the Fed would have to adopt more intense increases in basic interest rates in the United States dissipated. Markets slowly adjusted as they became convinced not only that the Fed would maintain its gradualist approach, but that it considered United States inflation to be at an acceptable level. This situation worked to the benefit of the emerging economies, as they preserved their attractiveness to foreign investors, particularly in terms of the rates of return they were able to offer.

Though there was some degree of decline in the pace of global economic growth, the international economy has continued registering significant expansion, as revealed by activity indicators available for the third quarter of the year. Growth in world exports has continued and can be partly explained by the behavior of international commodity prices, which has also had a positive impact on the developing nations.

4.1 Economic activity

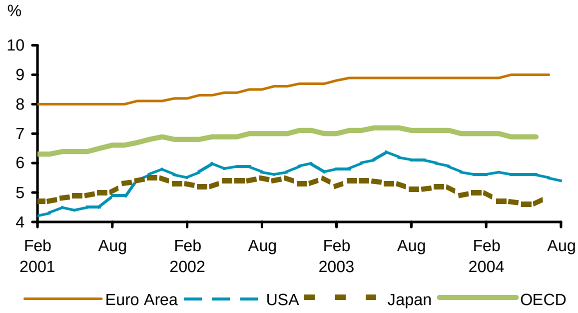
The activity level of the world economy decelerated sharply in the second quarter of 2004. The United States and China, the two countries mainly responsible for the world scale recovery that began in 2003, registered less intense expansion, particularly as a result of lesser consumer spending in the first case and government policies targeted at cooling down the already torrid pace of growth in China. The strong recovery registered by Japan in the two previous quarters was also interrupted, as a result of a more moderate pace of domestic consumption. The persistent

USA and Japan – GDP[1/]



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

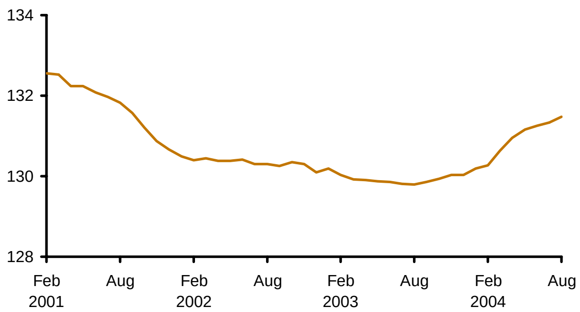
Unemployment rates



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

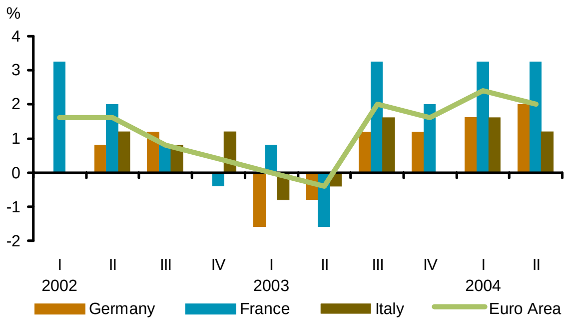
USA – Non-farm payrolls

Millions of workers



Source: Bureau of Labor Statistics

Euro Area – GDP[1/]



Source: Eurostat
1/ Quarterly growth. Seasonally adjusted annualized rate.

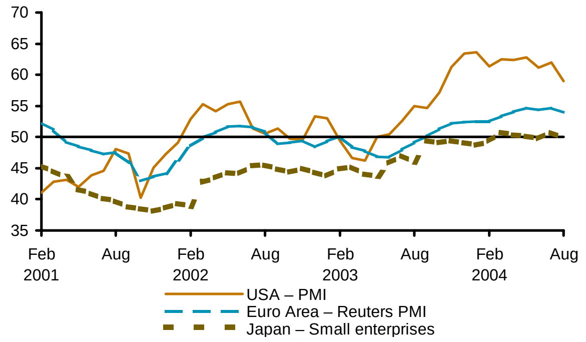
and accentuated upward movement in petroleum prices impacted the available income of major oil importers, though the effects were less intense than had occurred in previous periods of oil price highs.

From the first to the second quarters, annualized quarterly GDP growth dropped from 4.5% to 2.8% in the United States and from 6.6% to 1.3% in Japan. In the case of the United States economy, the strong growth registered in private investments was not sufficient to offset lesser personal consumption outlays, particularly in the case of consumer durables. Though there was some degree of recovery in consumption in July, there are fears that the sustainability of this process may be compromised by the decline in the growth of personal income, a heading that depends directly on employment levels. In Japan, despite consistent trade balance results, domestic demand fell sharply in the second quarter, generating repercussions as much on consumer spending as on public and private investments. This performance was reflected in zero growth in industrial output in the month of July.

Labor markets in the United States and Japan reflected deceleration of the process of recovery in economic activity. Thus, starting in June, the pace at which new jobs were created in the United States economy turned sharply downward, despite the fact that the overall jobless rate fell from 5.6% in June to 5.4% in August. In Japan, the rate of unemployment moved from 4.6% in June to 4.9% in July, reversing the downward trajectory registered since the start of 2003.

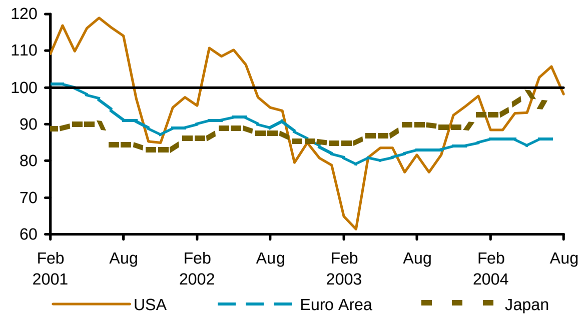
In the Euro zone countries, the pace of recovery in the economic activity level has been more moderate than in the other industrialized economies. The effects of deceleration in other parts of the world were also felt in the region, as quarterly GDP expansion in the second quarter closed at an annualized rate of 2%, compared to 2.4% in the previous quarter. Product growth followed the same tendency in effect since last year and was basically driven by exports. The individual performances of the region's major economies have not been uniform. In France, the good results registered in 2003 continued into the current year, registering annualized GDP growth of 3.2% in the first two quarters of this year. In Germany, these rates came to 1.6% in the first quarter of the year and 2% in the second, compared to respective levels of 1.6% and 1.2% in Italy in the same two quarters. The major differential between these performances consisted of more intense expansion in domestic consumption in France.

Business confidence



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

Consumer confidence



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

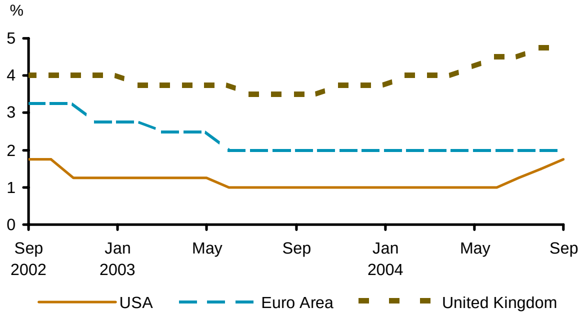
Marked by intense industrial expansion, burgeoning exports and a significant inflow of foreign direct investment, the strong growth registered in the Chinese economy generated increased inflationary pressures and bottlenecks in the supply of such necessities as coal, electricity, petroleum and transportation services. In light of this situation, the Chinese government decided to adopt measures that would moderate the pace of economic growth in that country, with the overriding objective of reducing the tensions uncovered in the productive chain and guarantying the continuity of a sustained process of economic expansion. Put into practice as of June 2003, these measures involved restrictions on currency expansion and greater control over the credits extended to the economic segments that were expanding most intensely. The impact of such measure has not yet been felt in terms of an accentuated downturn in the pace of the nation's growth, though there are signs of some degree of deceleration in the volume of retail sales and industrial output as of the second quarter of 2004. The sectors most directly impacted by these measures, such as cement, aluminum and vehicles, registered the sharpest downturns.

The central banks of the United States and Euro zone countries remain optimistic with regard to future growth. However, at the same time, the major indices of business and consumer expectations in the industrialized countries have accompanied the relative instability of the economic data registered between the end of the second quarter and the start of the third. With respect to business confidence in the United States and Japan, the results of these indices have fluctuated significantly since the middle of the second quarter, though they are still at a level compatible with strong economic expansion. In the Euro zone countries, these indices tended to fluctuate at a level that reflects a trend toward stability, with the exception of France where they pointed to positive expansion. In general, consumer confidence indices performed in a similar manner, though particular mention should be made of the sharp August drop registered in the Conference Board Index in the United States and of the tendency toward stability in the French index, which contrasts sharply with the downturns registered by the German and Italian indices.

4.2 Monetary policy and inflation

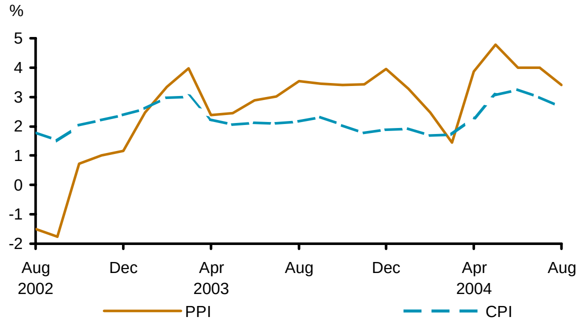
Thanks to the high quality communications work performed by the Fed, which coordinated the process of formation of expectations over the course of recent months, once the rise in the fed funds target had been consummated, it caused

Official interest rates
Annual rates



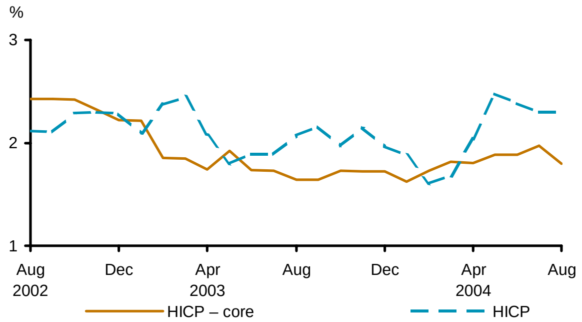
Source: Federal Reserve, ECB and Bank of England

Inflation – USA
Annual growth



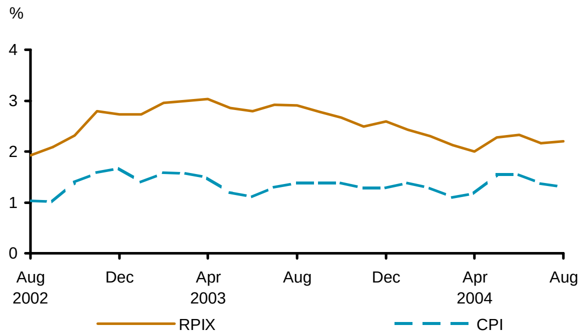
Source: Bureau of Labor Statistics

Consumer inflation – Euro Area
Annual growth



Source: Eurostat

Consumer inflation – United Kingdom
Annual growth



Source: Bloomberg

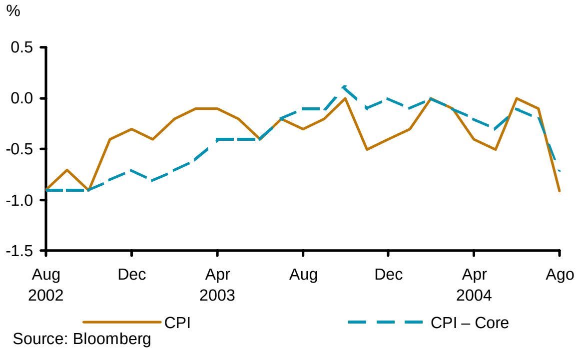
no significant impacts on the earnings produced by Treasuries, even after the successive increases of 0.25 p.p. in August and September. More recently, the release of indicators that point to a downturn in both growth and inflation in the United States, with deflation in consumer prices in July, increased the conviction that the central bank will continue its policy of gradually increasing interest rates. As a matter of fact, with the exception of the prices of raw materials, inflation in the United States has not increased despite the shift in the overall level in the second quarter of the year. Consequently, unless petroleum prices register a new and significant high, the scenario of moderate inflation is expected to consolidate in the coming months, as evinced by signs of moderation in the pace of job market hirings and the still rather low level of utilization of installed industrial capacity.

In the Euro zone countries, inflation showed signs of a downturn in July. However, inflation measured by the Harmonized Indices of Consumer Prices (HICP) remains above the 2% target and expectations are that the government interest rates in effect since June of last year will be maintained at their current level in the coming months. Despite a moderate high in the first six months of the year, core inflation moved into a downward curve as of July and dropped below the 2% mark. The deflationary impacts of appreciation of the euro and low growth in the region in the midst of a significant product gap should aid in maintaining inflation close to the government target, despite the recent upswing in petroleum prices.

In the United Kingdom, independently of current inflationary conditions, the policy of reducing the money supply continued. At the start of August, the Bank of England raised the basic interest rate once again, this time by 0.25 p.p. This was the fourth rise in the year and a new increase in the basic rate to 5% per year is expected before the year is out. Annual consumer inflation remained stable, in a comfortable range of 1.5%, compared to the official target of 2%. At the moment, it is difficult to predict just how long the central bank will continue its policy of deflating the real estate market bubble, though it is considered possible that the contractive monetary policy posture will be attenuated in the coming year.

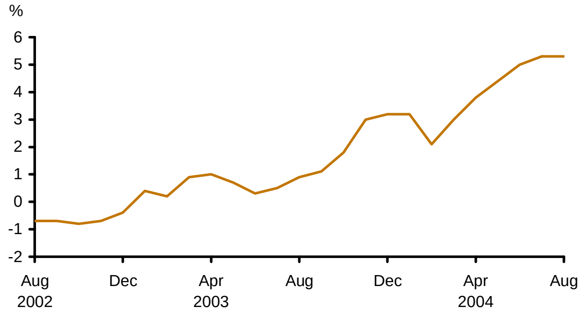
In the last five months, Japanese authorities have not altered the specified government target for banking reserves at the Bank of Japan (BoJ), which remains at between ¥30 trillion and ¥35 trillion. Despite uninterrupted growth in the last eight quarters, monetary policy has still not managed to

Consumer inflation – Japan
Annual growth



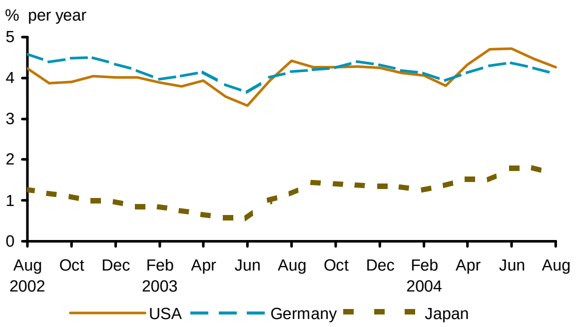
Source: Bloomberg

Consumer inflation – China
Annual growth



Source: Bloomberg

Yield on Government bonds[1/]



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

eliminate deflation. Consequently, the end of the zero interest policy cannot be foreseen. The recent trend toward depreciation of the dollar should demand new and significant BoJ interventions in order to avoid losses of competitiveness in the export market, which is the principal foundation of the Japanese economy. At the same time, however, there may be changes in the upper and lower limits of the targets in such a way as to better absorb the expansionary impact on the monetary aggregates.

In China, annual consumer inflation increased to 5.3% in July and remained at that level in August. The economy is expanding rapidly and government policy on the parity of the renminbi has yet to be defined and there is little expectation that this definition will be forthcoming in the near future. In any case, credit controls and the restructuring of government banks could, to a limited extent, generate results such as those desired as a result of a possible appreciation of the renminbi.

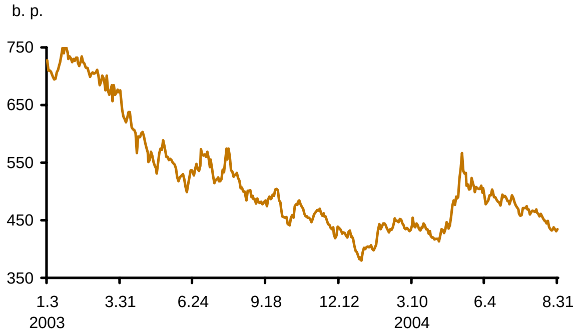
4.3 International financial markets

In the quarter ended in August, the factors that had the greatest impact on international financial assets were, on the one hand, lesser uncertainties regarding the future trajectory of inflation and interest rates in the United States and, on the other, continued volatility and uncertainty surrounding oil prices and their influence on the performance of the world's major economies.

With respect to United States monetary policy, since mid-May the Fed has indicated its intention of gradually reversing its expansionary posture. Though later decisions followed this tendency, above all else the indicator of economic activity and inflation released in the intervening period consolidated market confidence that this strategy would not only be maintained, but would also be an important and effective instrument in curtailing the inflationary pressures to which past monetary policy may have given rise. Despite an even more volatile environment, the consolidation of this confidence began pushing market interest rates in the more mature economies into a downward trajectory, at the same time in which perceptions of risk in relation to the emerging economies also tended to wane.

In the United States, annual rates of interest, which had reached mid-June levels of 2.93% for two year papers

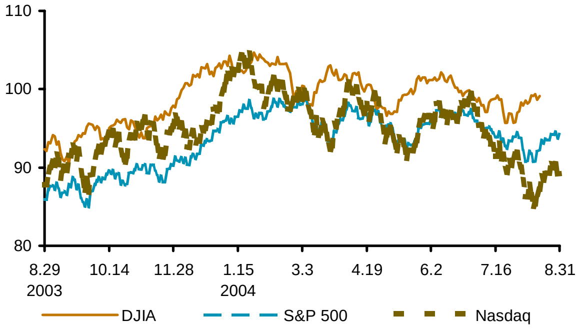
Emerging Markets Bond Index (Embi+)



Source: Bloomberg

Stock exchanges – USA

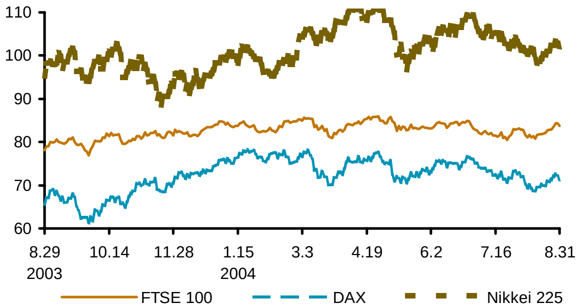
1.4.2002=100



Source: Bloomberg

Stock exchanges – Europe and Japan

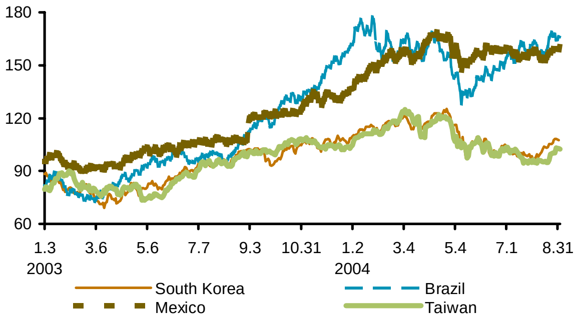
1.4.2002=100



Source: Bloomberg

Stock exchanges – Emerging markets

1.4.2002=100



Source: Bloomberg

and 4.87% for 10 year papers, fell to 2.38% and 4.11%, respectively, at the end of August. In the same period, the longer term interest rates of the other developed economies diminished at a less accentuated pace, though they did tend to follow the trajectory of earnings levels on United States securities.

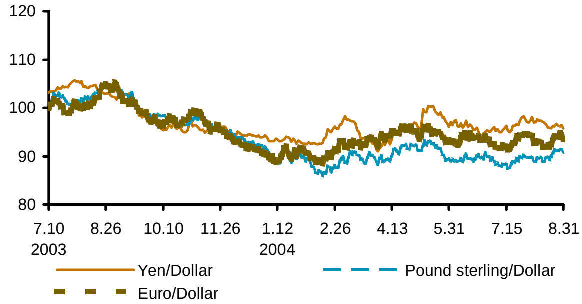
The recovery in the value of emerging country debt papers that followed upon the downturn in risk perceptions began in the month of May, when the government began signaling for the first time that the elimination of the monetary incentive in the United States would be a very gradual process, and has continued since July, as this process has moved forward at the expected pace. The premium indicated by the Emerging Markets Bond Index Plus (Embi+) dropped by 22.8%, falling from a peak of 567 points on May 10 to 438 points on August 31. In the same period, the Embi+ premiums of Brazil, Turkey and Venezuela diminished by respective rates of 38%, 35% and 28%. The least accentuated decline in the Embi+ premium occurred in Russia, with approximately 18%, reflecting the negative impact of the case involving Yukos, the largest Russian petroleum company, on that nation's financial assets.

Variable income assets have demonstrated increased sensitivity to the uncertainties rooted in the pace of growth in the United States economy and in the steady rise in petroleum prices, following a downward trajectory during most of the period initiated in July. In the United States, these factors plus the announced results of corporate profits were responsible for the continued volatility of stock markets, which closed with significant losses. Between the start of the month of July and the first fifteen days of August, the DJIA and Standard & Poor's (S&P 500) declined by 4.9% and 5.7%, respectively, while the Nasdaq index, which reflects stocks in high technology companies fell by 12.8%.

In the same period, the Japanese Nikkei index 225 dropped by 9.6%. The evolution of the stock markets of most other nations registered performances that were quite similar to the American exchange. The Deutscher Aktienindex (DAX) in Germany and the Financial Times Securities Exchange Index (FTSE 100) in England turned in downturns of 9.6% and 2.8%, in that order. In France, Italy and Spain, the CAC, MIB and IBEX turned in respective declines in the range of 6%. Among emerging economies, the Taiwan and Thailand indices registered equal falloffs of 7.7%, while the Russian index dropped by 4.4%. In Latin America stock exchanges, the *Índice de Precios e Cotizaciones* (IPC) in Mexico declined by 4.6%, and the Argentine Merval fell by 1.8%, while the Brazilian Ibovespa remained stable.

Dollar exchange rates

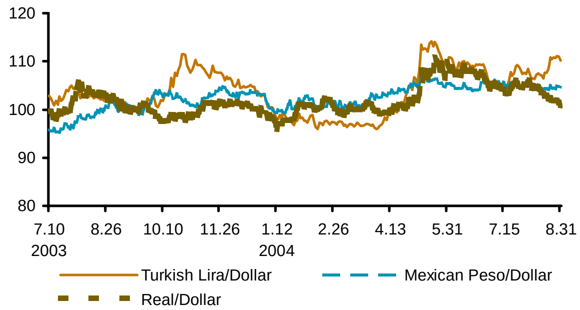
9.19.2003=100



Source: Bloomberg

Latin America and Turkey currencies

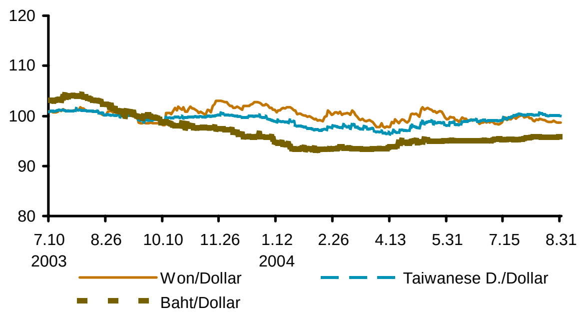
9.19.2003=100



Source: Bloomberg

Asian Emerging markets currencies

9.19.2003=100



Source: Bloomberg

With attenuation of the risk of an interruption in the petroleum supply, it became evident that inflation was under control in the major economies while highly favorable stock prices drove recovery in share prices. This movement took hold as of the second half of August and was particularly strong in Asian stock markets, which have registered gains since the start of that month.

In terms of the median level for the period from June to August, the rate of the United States dollar fell by 1.8% against the pound sterling and 1.6% against the euro, compared to the median registered in the April-May period. In relation to the yen, the dollar remained stable using the same basis of comparison.

Improved financing conditions as of June contributed importantly to the at least partial reversal of the process of depreciation of the currencies of Brazil, Turkey and Mexico against the dollar which had accumulated during the more critical period of uncertainties regarding the evolution of inflation and monetary policy in the United States. Thus, the real appreciated by 6.3% against the dollar, when one compares the median quotations of the second half of August with those of the second half of May. Using the same basis of comparison, the Turkish lira appreciated by 2.4% and the Mexican peso rose by 1.1%.

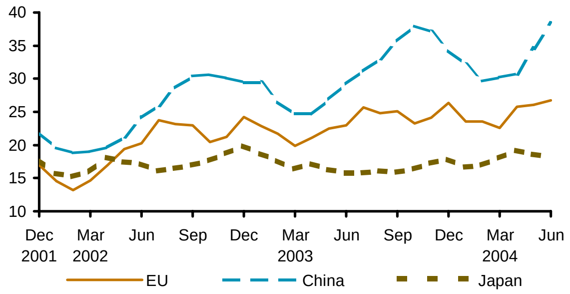
Given their concern with preserving the competitiveness of their exports when compared to those of China, the exchange markets of the emerging Southeast Asian countries were strongly impacted by Chinese exchange policy. On average, the rates of the currencies of Thailand and Taiwan devalued against the dollar by 1.95% and 1.56%, respectively, when compared to the average rates of exchange in the final halves of May and August. The Korean currency registered average valuation of 1.7% against the dollar in the same period.

4.4 World trade

In the second quarter of the year, international trade flows reflected the loss of dynamism in the major economies that had led the process of economic recovery, while the oil price high generated deterioration in the terms of trade of the oil importing countries.

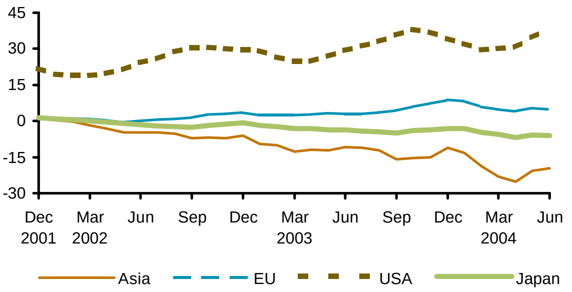
Basically, the United States balance of trade reflected the lag between the pace of the country's growth and that of the rest of the world. Though it has been declining, strong internal demand resulted in sharp growth in imports including

Bilateral trade deficit – USA[1/]
US$ billion



Source: Bloomberg
1/ Quarterly moving average.

Bilateral trade balance – China[1/]
US$ billion



Source: Bloomberg
1/ Quarterly moving average.

both petroleum and nonpetroleum goods, while exports had to cope with a market characterized by weak demand, particularly as a result of deceleration in Japan and Europe. With this, the trend toward an expanded deficit in trade in goods and services persisted, coming to an accumulated total of US$576 billion in the twelve-month period up to June. Once again, this result gave rise to international concerns with regard to the problem of financing this debt.

In the Euro zone countries, foreign trade influenced the economic performance of the region, particularly in Germany, where the sector's contribution to GDP growth in the second quarter was the largest since 1991. Trade flows in the Euro zone increased in the period under consideration, including in the area of intraregional trade. The trade surplus dropped in comparison to the first quarter, as growth in imports surpassed that of exports. In the United Kingdom, the trade deficit hit a new record, mainly as a result of deterioration in the petroleum account, reflecting the larger volume of imports in the period.

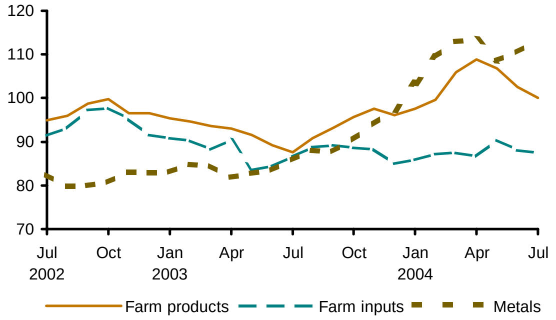
In China, trade flows surpassed expectations, when one considers the measures taken to dampen the growth process in mid-2003. The high level of exports offset the cutback in investments and could significantly soften the impact of the decline in economic activity. There are signs, however, that the exports of the sectors most seriously impacted by the restrictive measures have yet to be affected. Despite the fact that imports have remained high, demand has lessened, thus jeopardizing the pace of export growth registered by the emerging Asian nations. Despite this, data for the month of June indicate a reversal in this tendency and an upturn in the region's foreign sales.

The effects of the economic downturn in China on the foreign trade of Japan, the country's major trading partner, were limited. Chinese demand remained as the major incentive to the expansion of Japanese exports in the second quarter of the year, followed by United States demand. Driven by the pace of economic activity, Japanese imports expanded and had a downward impact on the country's balance of trade. Aside from the restrictions being applied in China, a possible loss of dynamism in the American economy or appreciation of the yen against the dollar stand as the principal risks to the performance of Japanese foreign sales. An additional concern is the steady rise in petroleum prices, since the country imports practically all of its needs.

The synchrony between the Mexican economy and American economic cycles is clear in Mexican foreign trade results, as the exports of the sector of *maquiladoras* have become increasingly more dynamic, even in relation to Chinese competition. The price of petroleum had a positive impact on the nation's trade, since Mexico is a net exporter of this product. In Argentina, the trade surplus remained high in the second quarter of 2004. The performance of soybean products and the high prices of this commodity sustained exports during the period and offset the June falloff in sales to China. However, the tendency toward reductions in the prices of several farm commodities is expected to increase pressures on the trade surplus, since the upturn in the nation's economy has resulted in strong import expansion. In Chile, the dynamic nature of the export sector was focused mainly on high copper prices.

4.4.1 Commodities

Commodity price index in SDR
1995 = 100



Source: International Monetary Fund

Commodities have benefited sharply from the good performance of the world economy. Though commodity prices have declined somewhat in recent months, they are still higher than the average registered in the last two years. Insofar as metals are concerned, prices have recovered in recent months, following a period of decline.

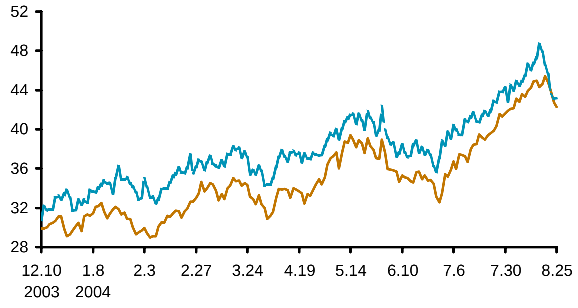
As a result of the short production cycle and the fact that harvest periods in the northern and southern hemispheres do not coincide, the prices of farm commodities have been more volatile, with an overall downward trajectory. However, the outlook is for medium term stability, should international trade continue at its present pace. The prices of some products, such as soybeans, are expected to rise, particularly as a result of a smaller United States harvest. The same thing is expected under sugar, as international prices have recovered, following signs of downward movement at the start of the year caused by expectations of a glut of the product on world markets. Insofar as cotton, cocoa and corn are concerned, medium term expectations point to a slight price decline.

With respect to the major metallic commodities, the international market has performed well as a result of the demand pressures generated by the performance of the world economy. In the quarter ended in June, the prices of aluminum, steel and copper have fluctuated sharply, as a result of investor speculation and deceleration of Chinese economic growth. However, over the median term, difficulties involved in meeting world demand will tend to push prices upward.

4.4.1.1 Petroleum

The per barrel price of petroleum has risen in recent months, principally as a result of turmoil in the Middle East, declining stocks in the major consumer countries and moderate but positive economic growth in the second quarter in the United States, Japan and the European Union. It is also important to stress that strong growth in China, the world's second largest consumer, has also impacted prices. According to the Organization of Petroleum Exporting Countries (Opec), growth in Chinese petroleum imports forecast for 2004 and 2005 will account for one third of expansion in world demand. Other factors that have contributed to increased volatility are political instability in Venezuela and the still unresolved situation at the Russian Yukos petroleum company.

Oil – Spot market
US$ per barrel



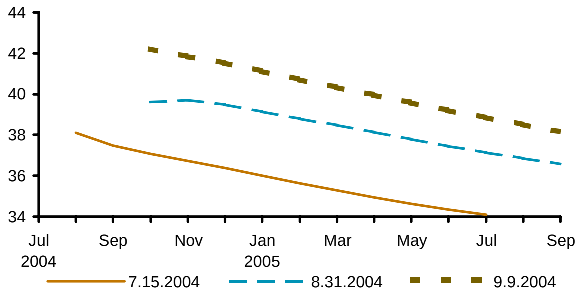
Source: Bloomberg

Though Opec raised supply to 25.5 million barrels/day (mbd) as of June and by an additional 0.5 mbd on August 1, prices did not decline as expected. It is important to note, however, that a chronic imbalance between supply and demand that would justify the current level of per barrel prices on the spot and futures market simply does not exist. The connection that one can establish between current prices and economic fundamentals would be based above all else on the possibility that grave interruptions on the part of exporters exposed to serious geopolitical risks could sharply narrow the margin that currently exists between world supply and demand.

Since the end of the first quarter of this year, the per barrel price for West Texas Intermediate (WTI) has not only moved upward but fluctuated intensely, reaching a median daily level of US$40.82 in July and a historic high of US$47.86 on August 20. In the same sense, the median price of Brent type petroleum, which is the reference for the European Market, moved from US$37.92 in May to US$43.21 in August, closing August 19 at US$45.42.

Brent Oil – Futures market

US$ per barrel



Source: Bloomberg

The evolution of the prices of Brent type petroleum on the futures market indicates a clearly downward trend. However, it is important to underscore that the curves related to more recent dates have registered still higher prices, suggesting that the falloff in the per barrel price – if such a decline is confirmed – will be a very gradual process, with median prices remaining sharply above the upper band limit of US$22–US$28/barrel defined by Opec.

4.5 Conclusion

Early indicators on the pace of recovery at the international level in the third quarter are not yet conclusive, though they

Oil Price Oscillations and Their Impacts on the Economy

1. Introduction

The persistent rise in international market oil prices since mid-2003 has generated concern in the major importer countries and in Brazil. This box analyzes the causes of this rise, the outlook for prices and the reasons why this process has had a very small impact on the Brazilian economy.

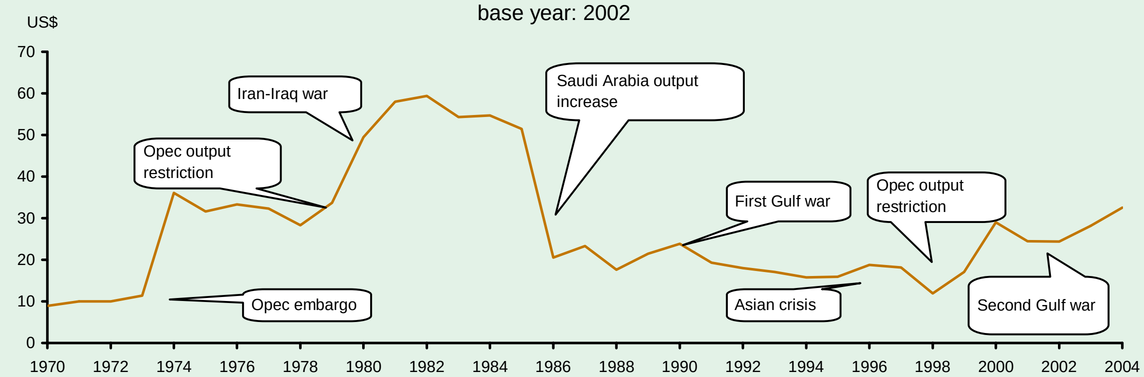
2. Reasons underlying recent price movements

Just as occurs with most prices in the economy, oil prices shift with the forces of supply and demand. Among the most important factors that have restricted supply, one should underscore strengthening of the Organization of Petroleum Exporting Countries (Opec) as of 1999, definition and compliance with production quotas, as well as the temporary willingness of such other large producers as Russia, Norway and Mexico to follow Opec guidelines. At the same time, there is political instability in the Middle East, particularly as a result of the Iraqi conflict. Mention should also be made of the fact that, in recent years, investments in expanded production capacity have declined as a result of the price reduction that marked 1998 and 1999. In the United States, the level of gasoline stocks has dropped, while that of idle output capacity in the Opec countries has fallen dangerously. Aside from this, depreciation of the dollar, the basic currency used in oil transactions, resulted in price alterations aimed at offsetting exchange rate losses. Finally, more recently, it is important to stress the crisis of the Yukos company, one of Russia's major petroleum companies, and the repercussions that situation could have on Russian exports.

As far as demand is concerned, one should consider the effects of the operations of investment funds on the futures market. Starting in 1983, this market took on added importance in the formation of oil prices. Since the start of the Iraqi war, these funds have increased their positions in an attempt to cover the risk of an abrupt interruption in the petroleum supply. This risk is a result of the difficulty involved in restoring and expanding oil production in that country and the fear of terrorist attacks against petroleum facilities in Saudi Arabia, which is the world's largest exporter and the only country capable of rapidly taking up the slack in the case of an abrupt reduction in world supply, as occurred in the first Gulf war and in the recent Venezuelan crisis.

In terms of pressure on demand, one could highlight renewed growth in the United States and Japan, sharp expansion in China and other Asian nations responsible for considerable petroleum consumption and the occurrence of a particularly strong winter in the northern hemisphere. Finally, airline companies, which are obviously intense consumers, have been recovering, while the United States, China and India have been trying to rebuild and even expand their stocks.

Petroleum: real prices
base year: 2002



Source: Opec (price based on combination of weighted indices of a group of countries, on the exchange rates against the US dollar, and on consumer prices when compared to those in the USA.

3. The importance of Opec

Opec accounts for approximately 80% of reserves, 40% of output and 50% of world oil exports. Whenever there is a sharp drop in world output, the Opec members with the highest levels of idle capacity are the first sources of added production to offset losses. Recently, Opec raised output by 2.5 million barrels/day (mbd), effective as of July and August, in order to attenuate market pressures. However, the very narrow margin of idle output capacity that now exists could result in further price instability, in such a way that it may become difficult for important producers to neutralize the risk of a supply interruption.

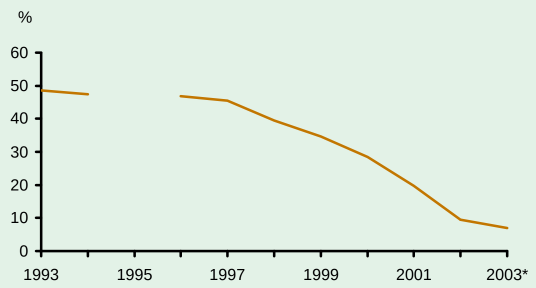
The reserves/output ratio or, in other words, the time during which known reserves would last at the current pace of production is only 15 years for nonmember countries, compared to almost 100 years for the member countries. For this reason, there is considerable expectation of an increase in the weight of Opec in world production in the coming decades.

4. The market in Brazil

According to the National Petroleum Agency (ANP), Brazilian petroleum reserves at the end of 2003 stood at 10.6 billion barrels, 90% of which are located at sea. This volume is equivalent to 18 years of production. In 2003, apparent consumption came to 1.6 mbd, with output of 1.5 mbd and imports of 0.1 mbd.

From 1993 to 2003, Brazilian reserves expanded by about 8% per year, production by 9% per year and consumption by 2% per year. Thus, net imports – including derivatives – dropped by 16% per year and external dependence fell from 49% to 7% of domestic consumption. Current forecasts now indicate that this difference will be totally eliminated in the next few years.

Brazil – External dependence
Import/consumption

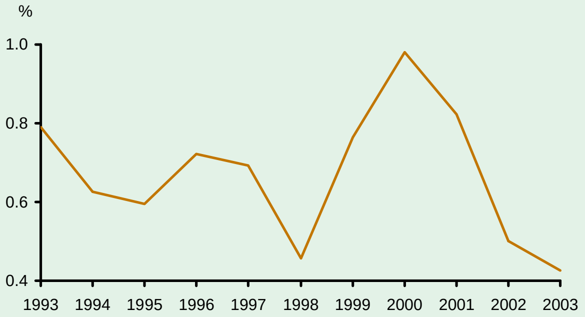


Source: ANP (1995 with no data)
* BCB estimate

From 1993 to 2003, the Brazilian deficit in trade involving this product fell from US$3.4 billion to US$2.1 billion. The remaining deficit is more a question of price differentials caused by differences in quality than of the volume of exports and imports. In 2003, the median price per barrel exported came to US$24 while that of imported oil closed at US$30.

Not only did the nation's dependence on external sources of this product drop sharply between 1993 and 2003, but the relative weight of this product in the economy also declined. In this sense, the deficit in oil trade fell from 0.8% to 0.4% of GDP, from 9% to 3% of the country's total exports and, between

Brazil – Petroleum balance
Net imports/GDP



Source: ANP and Petrobras

1996 and 2003, from 21% to 5% of the revenues earned by Petrobras, the nation's major company in this sector.

In terms of 2004, if one were to assume maintenance of the net balance of volume imported in 2003, an increase of 10% in international oil prices would have an impact of approximately US$200 million on the balance of trade. This impact is equivalent to just 0.3% of total exports, to 0.5% of Petrobras revenues and 0.04% of GDP.

From the strategic point of view, aside from the abrupt falloff in external dependence on petroleum, it is important to mention that, differently from other countries, Brazil has consolidated experience in the use of alcohol should there occur a breakdown in the oil supply. Aside from this, current production of automobiles features what are known as flexible engines (fueled by gasoline and/or alcohol), further enhancing the nation's capacity to substitute gasoline with alcohol in its fuel supply. On the other hand, following the example of several other countries, Brazil is investing heavily in the use of natural gas as an alternative to oil.

5. Final comments

The recent rise in petroleum prices on the international market is partially a consequence of the effectiveness of Opec policy and partially a result of situational factors. Though the risk premium of an abrupt interruption in supply is already to some extent built into prices, there is little doubt that this premium will be maintained in the future and possibly even increased. This would be one consequence of the fact that producer countries have only a very limited current margin of the idle production capacity that would be needed to offset shortages, coupled with uncertainties surrounding future supply and expectations of a further increase in the weight of Opec in global supply.

Considering that investments in oil production have a relatively long period of maturation and that political forces at the international level do not seem to be converging toward a peaceful solution to Middle East problems in the near future, there is the danger of exacerbated speculative movements on the market and, consequently, of increases in the sensitivity of oil prices to geopolitical factors.

However, compared to the situation that existed in the two previous oil crises, the world economy has decreased its dependence on this product. In the industrialized nations, consumption per unit of gross domestic product dropped by half between 1973 and 2002. Aside from this, the level of current prices is far from the historic peak that marked the start of the 80s in deflated terms.

In Brazil, the indirect effect of the increase in oil prices on the cost structure of the economy produces a strong impact on price indices, though the effect of income transfers from the country to suppliers abroad is significantly less than in the past and well below what occurs in countries that are more dependent on oil imports.

do point to a more favorable situation in the second half of 2004. Consequently, the economic deceleration that marked the quarter ended in June does not seem to represent a trend.

The behavior of oil prices is one of the major variables that will impact international economic performance in the second half of the year. Up to the moment, the impact resulting from this shock has been rather limited, particularly when compared to past episodes, and will tend to remain limited should expectations of price stabilization be confirmed. Nonetheless, the volatility and degree of uncertainty regarding the future evolution of prices remain high. At the same time, the magnitude of the impact that a possible oil price spiral would have on the activity level and on inflation in the central economies, without even mentioning the nature of the monetary policy response that would be forthcoming in those countries, is also uncertain.

Given the importance of job generation to the sustainability of growth in consumption and economic activity in the United States, the attention of the Fed and of financial markets will be focused on the performance of the labor market in the world's largest economy over the short and medium-terms.

Another important risk on the international scenario is that which could be caused by an accentuated deceleration in Chinese growth, the effects of which would be quite strong in specific regions, particularly Japan and the emerging Asian nations. Parallel to this, other recurrent risks continue, such as geopolitical instability and the imbalances caused by the twin deficits in the United States economy.

5 Foreign sector

Over the course of the current year, the major characteristic of Brazilian external accounts has been the continuity of the process of current account adjustment. This process has been marked by generation of increasingly larger surpluses and, consequently, reductions in balance of payments borrowing requirements and a growing awareness that the Brazilian economy's capacity to ward off the impacts of adverse events in the international economic arena has been clearly enhanced.

The behavior of external debt indicators corroborates perceptions of a reduction in the economy's vulnerability, as evinced by steady expansion under exports, now expected to close the year at practically double the level registered in 1999, while sharply reducing the country's external liabilities.

In the first eight months of the year, current accounts turned in a surplus of US$8 billion, compared to just US$2.5 billion in the same period of 2003. In the 12 month period ended in August, the surplus came to US$9.5 billion, compared to US$3.5 billion in the corresponding period of the preceding year. The major variable of the adjustment has been the growing trade surplus, as exports expanded by 34.8% up to August, compared to the same period of 2003, and 29.2% in the last twelve months.

In this context, the outlook for financing the balance of payments is strongly positive. According to projections of the performance of the external sector published in this Report, the 2004 trade surplus will close approximately 20% above that of 2003 while the rolling of private medium and long-term external liabilities will be less expressive, as a result of the exchange generated by trade operations and lesser demand for foreign loans. In much the same way, balance of payments projections for 2005 incorporate continued high trade surpluses and rates of rolling the medium and long-term private debt at levels similar to those expected for the current year.

5.1 Exchange

Up to the month of August, the results of exchange market operations reflected a net reduction of US$4.6 billion, compared to US$3.6 billion in the same period of 2003. The trade exchange balance moved from US$16.9 billion to US$25.8 billion, driven by the contracting of exchange operations by the export sector. These operations totaled US$60.7 billion in the first eight months of 2004 or US$14.3 billion more than in the corresponding period of 2003. Exchange operations contracted for import purposes totaled US$34.9 billion or US$5.4 billion more than in the January-August 2003 period.

Foreign exchange transactions

US$ billion

Itemization	2003			2004	
	Aug	Jan-Aug	Year	Aug	Jan-Aug
Operations with clients in Brazil	1.5	5.0	2.4	1.5	8.2
Commercial	2.2	16.9	28.4	2.1	25.8
Exports	5.9	46.4	73.2	7.2	60.7
Imports	3.7	29.5	44.8	5.1	34.9
Financial[1/]	-0.7	-12.0	-26.0	-0.6	-17.6
Purchases	5.8	44.3	72.1	13.0	54.2
Sales	6.5	56.2	98.1	13.6	71.7
Operations with banks abroad (net)[/2]	-0.1	-1.4	-1.7	-2.1	-3.6
Balance	1.4	3.6	0.7	-0.6	4.6

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

On the financial exchange market, operations generated net outflows of US$17.6 billion or US$5.6 billion more than in the equivalent period of 2003. This result reflected a rise of 27.5% in foreign currency sale operations, compared to an increase of 22.3% in purchases of exchange, reflecting the reduction in the rates of rolling over private sector medium and long-term credits.

At the end of 2003, the banking sector held a short position of US$2.8 billion on the spot market. In contrast to the exchange market result, the position of the banks reversed in the period from April to July, as the sector closed the month of May with a long position of US$3 billion. In August, the sector moved once again into a short position of US$505 million.

The rate of exchange closed the month of August with R$2.9338 per dollar. The pace of United States economic activity at a level somewhat below that expected allowed the Fed to maintain its gradualist monetary policy, thereby attenuating possible negative impacts on the Brazilian economy. In this framework, considering the continuity of the current account adjustment and positive exchange market flows, predictions are that the market will not be subject to any significant pressures in the coming months.

5.2 Trade in goods

In the first eight months of the year, foreign sales came to US$61.4 billion or 34.8% more than in the corresponding period of 2003. Imports added up to US$39.4 billion and the trade surplus closed at US$22 billion. It should be stressed that the overall trade flow came to US$101 billion, 32.7% more than in the January-August 2003 period.

Trade balance – FOB

US$ million

Period	Exports	Imports	Balance	Trade flow
Jan-Aug 2004	61 355	39 392	21 963	100 747
Jan-Aug 2003	45 510	30 385	15 126	75 895
% change	34.8	29.6		32.7

Source: MDIC/Secex
Note: In Jan-Aug/2003, 166 working days; in Jan-Aug/2004, 168 working days.

Exports by aggregate factor – FOB

Daily average – January-August

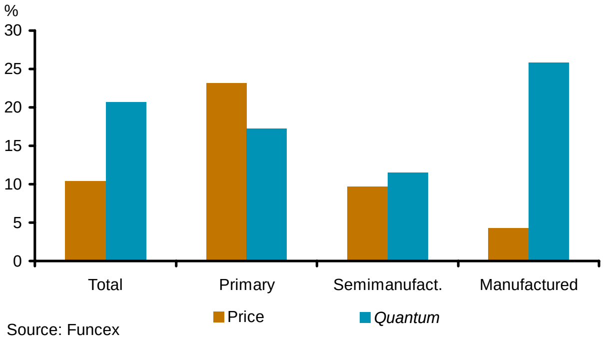
US$ million

Itemization	Accumulated		
	2002	2003	% change
Total	274.2	365.2	33.2
Primary products	79.8	115.5	44.8
Industrial products	189.2	243.9	28.9
Semimanufactured goods	41.9	50.7	20.8
Manufactured goods	147.2	193.3	31.3
Special operations	5.2	5.8	10.9

Source: MDIC/Secex

Note: In Jan-Aug/2003, 166 working days; in Jan-Aug/2004, 168 working days.

Exports – Price and volume index
January-July 2004/2003



Source: Funcex

Imports by end-use category – FOB

Daily average – January-August

US$ million

Itemization	2003	2004	% change
Total	183.0	234.5	28.1
Capital goods	38.8	45.4	17.0
Raw materials	97.9	125.6	28.2
Naphtha	2.9	3.1	4.2
Consumer goods	21.2	26.0	22.8
Durable	9.2	12.2	32.5
Passenger vehicles	2.3	2.3	- 3.2
Nondurable	11.9	13.8	15.2
Fuels	25.1	37.4	49.2
Crude oil	14.2	26.1	83.2

Source: MDIC/Secex

Note: In Jan-Aug/2003, 166 working days; in Jan-Aug/2004, 168 working days.

In the month of August, exports totaled US$9.1 billion, approximately the same level attained in the last three months. When daily medians are analyzed, growth came to 0.7% compared to the previous month and 35% when viewed against August 2003.

The trend toward growth in foreign sales has been accompanied by a sharp increase in imports, demonstrating basically that the pace of economic activity is on the rise. In this framework, external purchases totaled US$5.6 billion in August, the best monthly result in the year and one that clearly confirms the process of expansion that began in the middle of the fourth quarter of 2003.

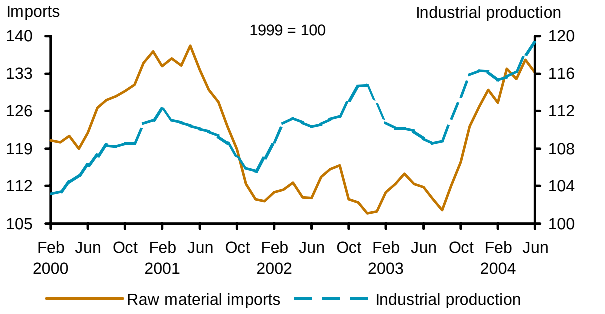
Exports accumulated in the period extending from January to August set value records for the period for all three product categories, when viewed in aggregate terms. With this result, median daily sales of basic goods came to US$115.5 million, for growth of 44.8% compared to the corresponding period of 2003. The underlying cause of this rise was a combination of higher prices and larger exported volumes, particularly involving soybean-based goods. Exports of semimanufactured goods totaled US$50.7 million and manufactured goods came to US$193.3 million, both of which are expressed in median daily sales. These figures represented respective rates of growth of 20.8% and 31.3%, using the same basis of comparison.

It is important to underline the strong growth registered in the exports of states that have traditionally had relatively little significance in the nation's foreign sales. This has been one result of efforts to diversify and decentralize the nation's export activities in regional terms. According to MDIC data, in the January-August 2004 period, exports of sixteen of the twenty seven states registered growth in foreign sales that was higher than the rate of export growth for the nation as a whole.

Funcex data for the January-July period demonstrate that growth in Brazilian exports has reflected increases in both prices and volume. As a matter of fact, in the period under consideration, the prices of exports increased by 10.4% and the volume exported expanded by 20.7%, when compared to the January-July 2003 period.

A breakdown by use categories shows increases of 17.3% in the volume of sales and 23.1% in the prices of basic products. With regard to semimanufactured goods, growth rates came to approximately 11.5% and 9.7%, while expansion under manufactured goods closed at 25.9% and 4.3%, in the same order.

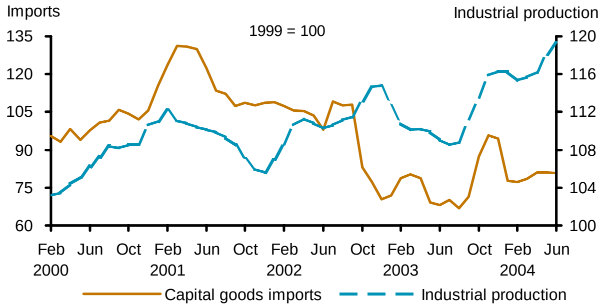
Raw material imports x industrial production
Seasonally adjusted indices – 3 month moving average



Source: IBGE and Funcex

All of the different categories of goods registered growth under imports. Average daily purchases of raw materials and intermediate goods, representing about 53.6% of total imports, expanded by 28.2% in the first eight months of the year, when compared to the same period of the preceding year. This growth is clearly compatible with the recent acceleration in industrial output and with the outlook for an increased flow of investments. Imports of fuels and lubricants expanded by 49.2%, with 83.2% growth under petroleum. At the same time, foreign purchases of consumer goods increased by 22.8%, with increases of 32.5% under consumer durables and 15.2% under nondurables, while imports of capital goods increased by 17%.

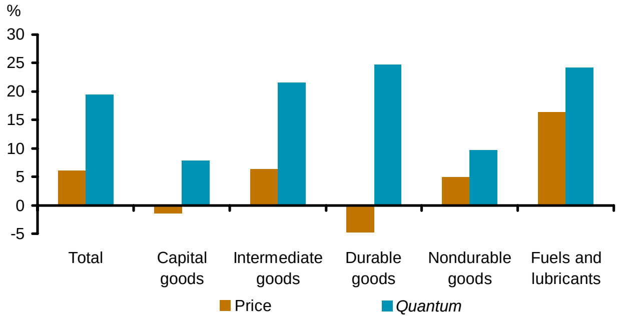
Capital goods imports x industrial production
Seasonally adjusted indices – 3 month moving average



Source: IBGE and Funcex

Growth under imports in the January to July period, compared to the same months of 2003, was primarily a consequence of 19.4% expansion in volume. The same period was marked by a rise of 6% in prices, driven by a 16.4% increase under fuels and lubricants, a heading that also registered 24.1% expansion in imported volume. With regard to the other categories, all of them registered growth in imported volume, with 7.9% under capital goods, 21.5% under intermediate goods, 24.8% in the case of consumer durables and 9.6% for nondurable consumer goods. Price growth was not uniform, as the prices of intermediate goods increased by 6.4% and those of nondurable consumer goods increased by 4.9%, while the prices of consumer durables and capital goods declined by 4.8% and 1.4%, respectively.

Imports – Price and volume index
January-July 2004/2003



Source: Funcex

Analysis of the major markets of destination for the nation's exports based on the daily median from January to August, 2004, indicate strong growth in sales to the Southern Common Market (Mercosul) member countries, compared to exports in the first eight months of 2003. Basically, this movement was a consequence of growth of 76.4% in sales to Argentina, which were concentrated in manufactured goods. It is important to underscore also the growth registered in exports to the Latin American Integration Association (Laia), excluding Mercosul member countries, 50%; Mexico, 45.7%; European Union, 33.6%; China, 30.2%; and Eastern Europe, 24.5%. In the same period, exports targeted to the United States expanded by 12.8%.

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

	% change[1/]		
Itemization	Argentina	Other	Total
Total	76.4	30.6	33.2
Manufactured products	81.8	26.0	31.3

Source: MDIC/Secex
1/ Over the same period of the last year.
Note: In Jan-Aug/2003,166 working days; in Jan-Aug/2004, 168 working days.

Insofar as imports are concerned, increases were registered in purchases from Eastern Europe, 83.9%; China, 77.2%; South Korea, 53.8%; Laia, excluding Mercosul countries, 42.9%; and Mexico, 37.2%. It should be stressed that imports

Exports and imports by geographic area – FOB
Daily average – January-August

US$ million

Itemization	Exports			Imports			Balance	
	2003	2004	% change	2003	2004	% change	2003	2004
Total	274	365	33.2	183	234	28.1	91.1	130.7
Laia	46	73	58.8	31	37	17.6	14.7	36.3
Mercosur	20	34	70.7	22	24	7.8	- 2.4	9.8
Argentina	16	28	76.4	18	21	14.3	- 2.4	7.1
Other	4	6	47.8	4	3	- 22.4	- 0.1	2.7
Mexico	10	15	45.7	2	3	37.2	8.3	12.3
Other	16	25	52.7	7	10	42.2	8.8	14.2
USA1/	67	75	12.8	36	45	23.1	30.7	30.9
EU2/	69	92	33.6	52	60	17.1	17.0	31.2
E. Europe3/	8	9	24.5	2	4	83.9	5.1	4.9
Asia	46	57	25.3	33	45	36.6	12.6	12.1
Japan	9	11	16.9	9	11	14.2	- 0.4	- 0.2
South Korea	5	5	10.6	4	7	53.8	0.7	- 1.1
China	18	23	30.2	8	13	77.2	10.1	9.7
Other	14	18	29.7	12	14	22.3	2.1	3.6
Sundry	40	58	47.8	28	43	51.4	11.1	15.4

Source: MDIC/Secex
1/ Includes Puerto Rico.
2/ Also includes ten countries that jointed in 2004.
3/ Eight countries that former were included in this group are now in the EU.

Current account

US$ billion

Itemization	2003			2004			2004
	Aug	Jan-Aug	Year	Aug	Jan-Aug	Year1/	Year1/
Current account	1.2	2.5	4.0	1.8	8.0	6.7	0.1
Trade balance	2.7	15.1	24.8	3.4	22.0	30.0	24.5
Exports	6.4	45.5	73.1	9.1	61.4	90.0	94.5
Imports	3.7	30.4	48.3	5.6	39.4	60.0	70.0
Services	-0.5	-3.2	-5.1	-0.5	-2.8	-5.8	-6.9
Transportation	-0.1	-1.1	-1.8	-0.2	-1.3	-2.0	-2.1
International travel	0.0	0.1	0.2	0.0	0.4	0.0	0.0
Computer and informat.	-0.1	-0.6	-1.0	-0.1	-0.8	-1.2	-1.3
Operational leasing	-0.3	-1.4	-2.3	-0.1	-1.3	-2.3	-2.4
Other	0.0	-0.1	-0.2	-0.1	0.2	-0.4	-1.1
Income	-1.2	-11.3	-18.6	-1.5	-13.3	-20.7	-20.5
Interest	-0.8	-8.2	-13.0	-1.0	-8.9	-13.6	-13.2
Profits and dividends	-0.4	-3.2	-5.6	-0.5	-4.6	-7.2	-7.3
Compensation of emplo.	0.0	0.1	0.1	0.0	0.1	0.1	0.0
Current transfers	0.2	1.9	2.9	0.3	2.2	3.2	3.0

1/ Forecast.

from the Mercosul countries increased by only 7.8% in the first eight months of the year, with growth of 14.3% in purchases on the Argentine market, and a decline of 22.4% in imports from the other countries of the bloc.

5.3 Services and income

In the first eight months of 2004, the current transactions account further expanded the positive result that marked 2003. Stress should be given to the fact that, despite the growth registered under imports, the trade surplus expanded principally as a consequence of the upturn in the base of economic activity and expansion of 14.7% in the positive balance of unrequited transfers in the period.

Net outlays on services declined by 12.9% from January to August, compared to the result for the corresponding period of 2003. In the opposite sense, net remittances of income expanded by 17.7%, using the same basis of comparison.

The heading of international travel registered net revenues of US$355 million from January to August, compared to US$87 million in the corresponding period of 2003. Repeating the performance achieved since September 2002, the surplus under this heading came to US$486 million accumulated over twelve months, with revenues of US$3 billion in the same period. The transportation account registered growth of 14.7% in net remittances, with increases of 83.5% under net outlays on travel tickets and 30.4% in net spending on freights.

Net revenues on business, professional and technical services added up to US$1.6 billion from January to August, with growth of 25.7% in the period. Net spending on equipment rentals totaled US$1.3 billion, 11% less than in the same period of 2003. Net spending on computer and information services came to US$803 million, while that related to royalties and licenses closed with US$760 million, surpassing the amount registered in the first eight months of 2003 by 26.1% and 6.6% respectively.

Net remittances of income abroad came to US$13.3 billion, or 17.7% more than in the same period of 2003. This result reflected a rise of 41.4% in net remittances of profits and dividends, which came to a total of US$4.6 billion. Net payments of interest increased by 8.8% in the period, closing with a total of US$8.9 billion.

5.4 Financial account

The balance of payments financial account registered net outflows of US$6.7 billion from January to August.

Net foreign direct investments came to US$11.7 billion, compared to US$5.7 billion in the same period of 2003. Inflows in the form of stock participation came to US$12.7 billion, while repatriations of intercompany loans totaled US$949 million, compared to inflows of US$5.2 billion and US$513 million, respectively, in the first eight months of 2003.

Foreign portfolio investments reflected net remittances of US$3.9 billion, compared to net inflows of US$2.3 billion in the equivalent period of 2003. Stock investments accumulated net inflows of US$477 million up to August, a level lower than in the previous year. The rates of rolling long-term private sector bonds, notes and commercial papers closed at 50%, compared to 145% in the same period of 2003, while the rate for direct loans closed at 109%, as against 73% in the same period of 2003.

The turnaround in the position of balance of payments borrowing requirements was caused by successive current account surpluses and recovery in net foreign direct investment flows. On the other hand, since the month of March, the rates of rolling these operations have remained at a somewhat lower level.

The reduction that occurred in the median rate of renewal of external maturities is partly explained by the anticipated contracting of operations over the course of 2003 and early 2004 and, to some extent, by the reduction in demand for external credits on the part of Brazilian businesses. There is no indication of a shortfall in the supply of external financing for the Brazilian private sector, contrary to what occurred in previous periods in which the level of debt rollovers declined.

From January to August 2004, gross international reserves increased by US$298 million to US$49.6 billion, while net international reserves moved upward by US$4.1 billion to US$24.6 billion. Based on the International Monetary Fund (IMF) concept, net adjusted international reserves expanded by US$5.2 billion to US$22.6 billion. Banco Central interventions in the exchange market were concentrated in January and resulted in purchases of US$2.6 billion. With regard to external operations, the most significant were issues of US$3 billion in bonds of the Republic and payment of US$11.4 billion in external debt services, including US$3.9

Financial account

US$ billion

Itemization	2003			2004			2005
	Aug	Jan-Aug	Year	Aug	Jan-Aug	Year[1/]	Year[1/]
Financial account	-0.8	7.3	4.6	-3.0	-6.7	-9.9	-9.8
Direct investments	1.1	5.1	9.9	-0.8	3.5	9.0	12.0
Abroad	0.1	-0.6	-0.2	-6.9	-8.2	-8.0	-2.0
In Brazil	1.0	5.7	10.1	6.1	11.7	17.0	14.0
Equity capital	0.7	5.2	9.3	6.6	12.7	17.0	14.0
Intercompany loans	0.3	0.5	0.8	-0.5	-0.9	0.0	0.0
Portfolio investments	-1.2	2.3	5.3	-0.3	-4.3	-6.5	-0.2
Assets	0.3	0.0	0.2	0.2	-0.4	-0.1	0.0
Liabilities	-1.5	2.3	5.1	-0.5	-3.9	-6.4	-0.2
Derivatives	0.0	-0.1	-0.2	0.0	-0.5	0.0	0.0
Other investments	-0.6	0.0	-10.4	-1.9	-5.3	-12.4	-21.6
Assets	0.4	-2.0	-9.5	-0.8	0.1	-3.1	-12.4
Liabilities	-1.0	2.0	-1.0	-1.1	-5.5	-9.3	-9.3

1/ Forecast.

BP financing sources

Selected items

US$ billion

Itemization	2003			2004			2005
	Aug	Jan-Aug	Year	Aug	Jan-Aug	Year[1/]	Year[1/]
Medium and long-term funds	0.5	7.1	13.4	0.5	8.7	14.7	15.6
Public bonds[2/]	0.0	2.2	4.5	0.0	3.0	4.0	6.0
Private debt securities	0.3	3.1	6.0	0.2	3.4	7.4	7.7
Direct loans	0.1	1.7	2.9	0.3	2.3	3.2	2.0
Short-term loans[3/]	-0.9	-2.8	-1.4	-0.1	-0.4	0.0	0.0
Short-term securities (net)	-0.3	1.4	0.3	1.0	0.6	0.0	0.0
Roll-over rates[4/]							
Public bonds	n.a.	70%	127%	n.a.	76%	74%	123%
Private sector:	119%	107%	108%	40%	64%	69%	70%
Private debt securities	101%	145%	138%	17%	50%	61%	70%
Direct loans	209%	73%	85%	190%	109%	100%	70%

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.

Statement of international reserves

US$ billion

Itemization	2003	2004			2005
	Year	Jan-Aug	Sep-Dec	Year 1/	Year 1/
Reserves position in previous period	37.8	49.3	49.6	49.3	45.9
Net Banco Central interventions	1.6	2.6	-	2.6	-
Spot and export lines	-0.2	2.6	-	2.6	-
Repurchase lines	1.8	-	-	-	-
Debt servicing (net)	-9.7	-8.7	-3.6	-12.3	-11.1
Interest	-4.8	-3.9	-1.4	-5.3	-5.0
Credit	1.5	0.8	0.5	1.3	1.2
Debit	-6.3	-4.6	-1.9	-6.6	-6.2
Amortization	-4.9	-4.9	-2.2	-7.0	-6.1
Disbursements	5.4	3.5	1.5	5.0	8.0
Multilateral organizations	0.9	0.5	0.5	1.0	2.0
Sovereign bonds	4.5	3.0	1.0	4.0	6.0
International Monetary Fund	4.8	-2.7	-1.6	-4.3	-6.7
Disbursement	17.6	-	-	-	-
Amortization	-12.8	-2.7	-1.6	-4.3	-6.7
Others 2/	3.9	-1.0	-	-1.0	-
Treasury's purchases	5.5	6.6	-	6.6	-
Change in assets	11.5	0.3	-3.7	-3.4	-9.8
Gross reserves position	49.3	49.6	45.9	45.9	36.1
Net reserves position:					
Arrangement with IMF 3/	17.4	22.6	20.6	20.6	18.3
Central Bank concept	20.5	24.6	22.5	22.5	19.4

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 International Monetary Fund 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 August 2004 was US$907 million.

billion in interest and US$7.6 billion in amortizations, including payment of US$2.7 billion to the IMF. Settlements of National Treasury exchange market purchases up to August for the purpose of meeting these commitments added up to US$6.6 billion, while other operations generated outlays of US$1 billion.

At the end of 2004, it is estimated that gross reserves will come to US$45.9 billion, for a reduction of US$3.4 billion over the course of the year, due mainly to payments to the IMF. In 2004, external debt service payments are forecast at US$12.3 billion, together with US$4.3 billion in amortizations with the IMF. Disbursements from international organizations are projected at US$1 billion, together with bonds of the Republic totaling US$4 billion, all of which have already been concluded, and US$2.6 billion in purchase interventions in the exchange market, which have also been fully completed. Parallel to these operations, National Treasury exchange market purchases are expected to add up to US$6.6 billion in already completed operations. In the IMF concept, net reserves, which are not affected by amortizations to that organization, should close at US$20.6 billion, with growth of US$3.3 billion compared to the end of 2003. Net international reserves in the Banco Central concept will close the year at US$22.5 billion, with growth of US$2 billion compared to December 31, 2003.

For 2005, it is estimated that, based on the liquidity concept, reserves will come to US$36.1 billion, with negative growth of US$9.8 billion in relation to the end of the previous year. Of this total, US$6.7 billion refer to net amortizations paid to the IMF. The debt service is expected to come to US$11.1 billion, when payments to the IMF are excluded. Issues of sovereign bonds are expected to account for inflows of US$6 billion, while disbursements to organizations will come to US$2 billion. In this scenario, based on the IMF concept, international reserves at the end of 2005 are projected at US$18.3 billion and net international reserves in the Banco Central concept are estimated at US$19.4 billion. It is important to emphasize that this projection for the balance of payments, particularly as regards the trajectory of international reserves, does not consider possible Banco Central exchange market interventions, but rather limits itself to indicating an excess of exchange on the market in the range of US$10 billion as the final result of all other flows.

5.5 External vulnerability indicators

Vulnerability indicators

Itemization	2002	2003			2004	
	Dec	Jun	Sep	Dec	Mar	Jun
						US$ billion
Exports	60.4	68.3	69.6	73.1	77.5	83.4
Debt service	51.0	48.8	48.8	54.1	56.1	58.0
Total foreign debt	210.7	218.9	219.7	214.9	213.5	204.7
Net total foreign debt	165.0	163.1	158.4	151.0	147.5	144.9
International reserves	37.8	48.0	52.7	49.3	51.6	49.8
GDP	459	477	485	493	508	527
Indicators						
Total debt/GDP (%)	45.9	45.9	45.3	43.6	42.0	38.8
Net total debt/GDP (%)	35.9	34.2	32.7	30.6	29.0	27.5
Total debt/exports	3.5	3.2	3.2	2.9	2.8	2.5
Net total debt/exports	2.7	2.4	2.3	2.1	1.9	1.7
Debt service/exports (%)	84.5	71.4	70.1	74.0	72.4	69.6
Reserves/total debt (%)	18.0	21.9	24.0	22.9	24.2	24.3

The positive performance of the external sector of the Brazilian economy is also reflected in improvement in the nation's vulnerability indicators. The factors mainly responsible for this are the dynamism of the export sector and reductions in the country's external liabilities. Following the peaks registered in 1999 as a result of exchange devaluation in that year, the indicators deteriorated once again in 2002, as a result of the electoral uncertainties that marked that period. Since then, however, vulnerability indicators have followed a steadily downward trajectory.

Exports in the current year are expected to practically double the 1999 result. The total foreign debt closed June 2004 at US$204.7 billion, US$15.1 billion below the figure for September 2003. At the same time, the net debt – which excludes international reserves, Brazilian credits abroad and the assets of commercial banks – which came to US$174.5 billion in 1999 and US$165 billion in December 2002, diminished to US$144.9 billion in June of this year.

Consequently, vulnerability indicators have turned in a highly positive performance. The total debt/GDP ratio diminished from 45.9% in December 2002 to 38.8% in June 2004. During the same period, the total net debt/GDP ratio diminished from 35.9% to 27.5%, while the total debt/exports ratio dropped from 3.5 to 2.5 and the total net debt/exports ratio slipped from 2.7 to 1.7. An equally positive performance was registered in the debt service/exports indicator, which registered a decline of 14.9 p.p. in the period under analysis and closed the month of June at 69.6%. In much the same way, the indicator that shows the participation of reserves in the total external debt also registered an improved performance in the period, shifting from 18% to 24.3%.

5.6 Conclusion

In the first eight months of the year, the balance of trade registered a surplus of US$22 billion, while inflows generated by current unrequited transfers came to R$2.2 billion, representing joint growth of R$7.1 billion compared to the same period of 2003. Even with the rise in net remittances in the income account, the country obtained a current accounts surplus of US$8 billion, compared to US$2.5 billion in the same period of 2003. Analyzing the

Balance of Payments Projections

The projections for the 2004 balance of payments published in this Inflation Report were updated in relation to those issued in the previous Report, incorporating the results registered up to August and the effects of the calculation of the stock of external indebtedness, based on the June position. This box presents the first projections for the results of external accounts in 2005.

The forecast for the current account surplus in 2004 was expanded to US$6.7, or 1.2% of GDP, compared to the previous projection of US$2.5 billion. Basically, this increase was a consequence of strong growth in exports, which is expected to continue through the final months of the year.

Foreign sales accumulated in the year up to August came to US$61.4 billion, with a daily average of US$365.2 million or 33.2% more than that registered in the same period of 2003. When one analyzes this result together with the partial results for September, in light of settlements of export-related exchange contracting operations and the seasonal nature of the series, the value projected for exports in the year was revised upward from US$83 billion to US$90 billion. Imports accumulated up to August came to US$39.4 billion, with a daily average of US$234.5 million or 28.1% more than in the same period of 2003. The projection for imports in 2004 was also revised upward from US$57 billion to US$60 billion. Consequently, the trade surplus is expected to close at US$30 billion or US$4 billion more than forecast in the June Report.

Net payments of interest and net remittances of profits and dividends projected for the year were maintained at US$13.6 billion and US$7.2 billion. In

Uses and sources

US$ billion

Itemization	2003 Aug	2003 Jan-Aug	2003 Year	2004 Aug	2004 Jan-Aug	2004 Year[1/]	2005 Year[1/]
Uses	-2.8	-15.5	-23.1	-0.6	-14.3	-28.1	-30.1
Current account	1.2	2.5	4.1	1.8	8.0	6.7	0.1
Amortizations ML-term[2/]	-4.1	-18.0	-27.2	-2.4	-22.3	-34.8	-30.2
Securities	-3.2	-6.9	-10.3	-1.5	-11.3	-18.9	-16.9
Paid	-2.0	-5.3	-7.9	-1.1	-10.7	-18.3	-16.0
Refinanced	-1.2	-1.2	-1.2	0.0	0.0	0.0	0.0
FDI conversions	0.0	-0.4	-1.1	-0.3	-0.6	-0.6	-0.9
Suppliers' credits	-0.1	-1.2	-2.0	-0.2	-1.5	-2.3	-2.1
Direct loans[3/]	-0.7	-9.9	-15.0	-0.7	-9.4	-13.6	-11.2
Sources	2.8	15.5	23.1	0.6	14.3	28.1	30.1
Capital account	0.0	0.3	0.5	0.1	0.5	0.7	0.0
FDI	1.0	5.7	10.1	6.1	11.7	17.0	14.0
Domestic securities[4/]	0.3	1.1	3.1	-0.3	0.4	1.0	3.0
ML-term disbursem.[5/]	2.7	14.2	23.0	0.9	12.6	21.6	24.4
Securities	1.7	6.7	11.8	0.2	6.4	11.5	13.7
Supliers' credits	0.1	0.7	1.1	0.1	0.6	1.0	1.3
Loans[6/]	1.0	6.7	10.1	0.6	5.6	9.1	9.4
Brazilian assets abroad	0.8	-2.1	-7.2	-7.0	-8.2	-10.6	-14.4
Loans to Bacen	0.0	8.2	4.8	0.0	-2.7	-4.3	-6.7
Other[7/]	-1.6	-2.3	-2.7	0.4	0.9	0.2	0.0
Reserve assets	-0.4	-9.5	-8.5	0.5	-1.0	2.5	9.8

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, agencies and multilateral organizations.
4/ Includes foreign investment in equity and debt securities traded in the domestic market.
5/ Excludes intercompany loans disbursements.
6/ Includes multilateral and bilateral financing and buyers' credits.
7/ Registers net values of bond swaps, short-term securities, short-term trade credit, financial derivatives, nonresident deposits, other liabilites and errors & omissions.

the same way, net outlays in the service account were held to US$5.8 billion. Current unrequited transfers, in their turn, were revised to a net inflow of US$3.2 billion, compared to US$3 billion in the previous projection.

The annual updated projection for the net result of the balance of payments financial account, US$9.9 billion, foresees remittances greater than forecast in the June Report. This result reflects the revision of the rates of rolling over the private sector medium and long-term external debt and lesser net investments in stocks.

Foreign direct investments accumulated a total of US$11.7 billion in the first eight months of the year, 105% more than in the same period of 2003. Basically, the revision of this projection from US$12 billion to US$17 billion incorporates the result registered in the month of August, US$6.1 billion, resulting from the operation of an international stock swap by the food and beverage sector.

Private sector rollover rates were revised to 70% in the year, with 60% for papers and 100% for direct loans. The review of the medium and long-term external debt amortization schedule for 2004, based on the new stock calculated as the June position, resulted in a reduction of US$1.9 billion in previously programmed commitments, closing at US$34.8 billion. Calculation of the rate of rolling also includes the forecast that put/call options worth US$1 billion will be exercised. Of this total, US$587 million occurred in the period from January to August. Since demand for external financing will be less, even when one views net amortizations, the indebtedness of the private sector is not expected to exert pressures on balance of payments financing in 2004. In contrast to this, these net amortizations will result in a reduction of the private external debt stock and thereby contribute to continued sharp improvement in external vulnerability indicators.

Balance of payments projections for 2004 also include net inflows of US$1 billion in portfolio investments; constitution of assets abroad by banks in the amount of US$0.9 billion, with repercussions on the exchange position of banks, which is expected to close the year in a short position of US$1.9 billion; inflows of US$4 billion in bonds of the Republic; amortizations of

US$4.3 billion with the International Monetary Fund (IMF); and equilibrium in short-term capital flows. The overall result of the balance will close with a positive US$2.5 billion result.

In this scenario, viewed in the context of the international liquidity concept, the year is expected to close with reserves of US$45.9 billion, representing a reduction of US$3.4 billion compared to the volume at the end of 2003. Net reserves, not affected by amortizations with the IMF, are expected to expand. Viewed under the prism of the Banco Central concept, reserves are estimated at US$22.5 billion, with growth of US$2 billion compared to 2003. According to what is determined in the MTE, net adjusted reserves – IMF concept – are expected to reach US$20.6 billion, with growth of US$3.3 billion in relation to December 31, 2003.

For 2005, the Banco Central projection points to a state of equilibrium in current transactions, as a result of a small trade surplus. Thus, exports are to expand by 5%, compared to the result expected for 2004, closing at US$94.5 billion and imports are forecast to increase by 16.7% to US$70 billion. The service account should generate net remittances of US$6.9 billion, compared to US$5.8 billion in 2004, primarily as a result of larger outflows in the transportation, financial services and equipment rental accounts. Net remittances of interest and profits and dividends are to remain stable, at the same time in which a slight alteration is expected in the revenues of current unrequited transfers, shifting from US$3.2 billion in 2004 to US$3 billion in the coming year.

The balance of payments financial account will continue in a deficit position in 2005, reflecting the rolling of 70% of private medium and long-term loans, compared to total medium and long-term amortizations of US$30.2 billion, with US$1 billion in exercises of put/call options and amortizations of US$6.7 billion with the IMF.

In 2005, net inflows of foreign direct investments are projected at US$14 billion, representing a reduction compared to 2004 and recovery when viewed against the 2003 figure of US$10.1 billion. In their turn, stock investments are expected to register net inflows of US$3 billion, a level higher than the amount projected for 2004. At the same time, the projection for issues of bonds of the Republic totals US$6 billion.

In this scenario, the 2005 balance of payments is fully financed, with the banking sector constituting assets worth US$10 billion abroad, in contrast to an exchange surplus registered in the period. The overall result of the balance of payments should remain positive, at a level of US$9.8 billion.

In the liquidity concept, international reserves are expected to decline in 2005, mainly as a result of payments to the IMF, closing at about US$36.1 billion. Following the Banco Central concept, net reserves should come to US$19.4 billion at the end of 2005, reflecting a reduction of US$3.1 billion compared to 2004. Net adjusted reserves, viewed under the IMF concept, are expected to reach US$18.3 billion, corresponding to a decline of US$2.3 billion using the same basis of comparison. It is important to underscore the fact that this projection regarding the reserve position does not take account of possible exchange market interventions by Banco Central while, in the same period, the balance of payments indicates a surplus of approximately US$10 billion in terms of the exchange market result.

accumulated 12-month result, the positive current account balance came to US$9.5 billion.

The current outlook points to continued positive results in the export sector. On the other hand, growth registered under imports during the course of this year is consistent with the scenario of the upturn in economic activity and in no way jeopardizes projections of a 2004 balance of trade surplus of US$30 billion, or approximately 20% more than in the preceding year. For 2005, stronger growth under imports compared to exports is expected to generate a trade surplus of US$24.5 billion.

The flow of net foreign direct investments has moved into a process of recovery and recent performance confirms estimates for the year. For the most part, this is a consequence of improvement in the pace of internal economic activity, confirmation of a scenario of a moderate rise in United States interest rates and more favorable perceptions with regard to the emerging economies.

Both the recent performance of net foreign direct investment flows and the rates of private sector rolling of debts, in this case at a level below that of previous years, have clearly contributed to warding off any concerns regarding the financing of external accounts. Further strengthening the positive outlook for the evolution of these accounts, the maintenance of a positive exchange market flow in the first eight months of the year clearly supports expectations that the country will face no difficulties in financing its balance of payments in the remaining months of the current year and over the course of 2005.

Inflation outlook

6

This chapter of the *Inflation Report* presents Copom's analysis of the evolution of the factors underlying recent inflation, as well as the inflation prospects up to the end of 2005. The projections in this report are based on two main scenarios for the future path of interest and exchange rates. The benchmark scenario is based on the assumptions that, during the period covered by this projection, the Selic rate will remain unchanged at 16.25% per year, the level defined by Copom at its latest meeting on September 14 and 15, and that the exchange rate will keep close to the level prevailing on the day prior to the meeting (R$2.90 per US dollar). The market scenario considers the interest and exchange rate trends found in the survey carried out among professional analysts by Gerin, from Banco Central do Brasil. It is important not to view these trajectories as forecasts made by Copom on the future behavior of interest or exchange rates.

The inflation and GDP growth forecasts released in this *Report* are not point estimates. They incorporate probability intervals that reveal the degree of uncertainty present at the moment in which the interest rate decision was taken. Inflation forecasts depend not only the interest rate hypothesis, but also on a series of other hypotheses regarding the behavior of relevant exogenous variables, which are, precisely, those beyond the control of Banco Central. The set of hypotheses considered most probable by Copom is used to construct the scenarios to which the Committee attributes the greatest weight when taking decisions regarding interest rates. By expounding these underlying assumptions in this *Report*, Copom seeks to lend greater transparency to monetary policy decisions, thus enhancing their effectiveness in controlling inflation, the Committee's primary mission.

6.1 Determinants of inflation

The distinguishing feature of the internal macroeconomic scenario in the third quarter of 2004 was the confirmation of a sharp upturn in the pace of economic activity, as evidenced by output, sales and employment indicators announced during the period. However, the positive scenario for the economic activity occurred in a climate of growing concern with inflationary pressures, a consequence of a behavior previously observed in wholesale and consumer price indices and of latent risks to the inflation path. This concern is reflected in higher inflation expectations of private agents and in Copom's own projections. Given the recent high levels of industrial capacity utilization, the current and prospective increase in goods and services supply in order to meet a growing demand will be crucial determinants of inflation in the coming quarters. Cautious assessment of these developments is important to ensure that output growth will occur at a sustainable pace, not requiring further sacrifices in the future to reverse an already solidified deterioration of price behavior.

Regarding the external sector, the positive fact is the calmer environment in international financial markets, which clearly confirms the expectations of Copom in the previous *Inflation Report* that the wave of turbulence of the second quarter would be a temporary phenomenon. Fears that the Federal Reserve would be compelled to abandon its gradualist strategy and rapidly increase the United States interest rates seem to have waned. The greater stability in the international financial market brought positive impacts on the risk premium of Brazilian bonds abroad and on the exchange rate, which has slipped from a June level of about R$3.10 to near R$2.90 at the beginning of September. On the other hand, international oil prices remain a major source of concern, with current prices not only high, but also extremely volatile.

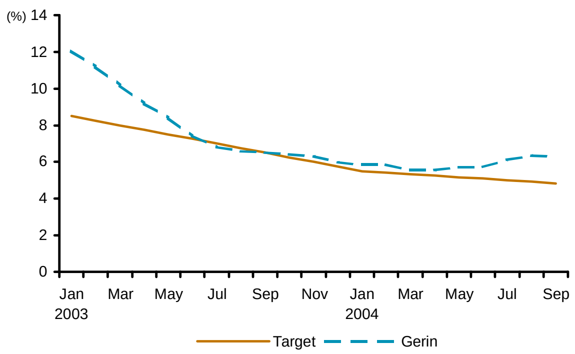
Given the above scenario, Copom held the Selic rate at 16.00% from April to August. At its September meeting, the committee decided to initiate a process of moderate monetary policy adjustment, raising the basic interest rate to 16.25% per year.

Inflation measured by the IPCA – the reference price index for monetary policy – has accelerated in recent months, moving upward in May, June and July, when it reached 0.91%, retreating to 0.69% in August. With these results, the accumulated IPCA inflation in the January-August period was 5.14%. The acceleration from May to July reflected significant impacts generated by price increases in specific items of regulated prices' components, the whose dissipation was responsible for the August decline. Free price inflation remained high, reflecting increases in the prices of *in natura* crops.

IPCA core inflation continued relatively stable, albeit high, suggesting an underlying inflationary tendency incompatible with the path of the defined targets. The June-August quarter accumulated core inflation – measured by excluding regulated prices and household food prices and by the symmetric trimmed mean methodology, with or without smoothing of the series – increased in rates equivalent to annualized rates between 6.4% and 7%. Results of this magnitude for the core calculated by exclusion are particularly significant since it purges the most notorious sources of pressure on the IPCA in the period, regulated prices and household food prices.

Wholesale prices growth remained high, surpassing the consumer inflation. Though monthly IPA rates did not present significant fluctuation since the second quarter, recent months have witnessed acceleration in the segment of industrial prices. Historic pass-through from wholesale to retail prices suggests that this movement of the industrial IPA is an important source of pressure on the coming IPCA results.

Twelve-month ahead inflation



Remains relevant the concern cited in the June *Inflation Report* regarding the deterioration of market expectations for inflation, surveyed by Gerin among professional analysts. In June, a certain degree of deterioration in short-term expectations was justified in light of the external turbulences that marked the period. However market expectations indicated persistent inflationary pressures even over longer horizons. Though there has been considerable improvement in external financial market conditions, expectations have not only not reversed the initial deterioration, but have continued on an upward path for 2004 and the coming year. This movement was sustained by the international oil price spiral, by higher projections of increases regulated prices and by a substantial reassessment of the prospective scenario for growth in the domestic economy's growth. On September 10, the median of these expectations pointed to 7.4% inflation in 2004 and 5.7% in 2005, as against 7.0% and 5.5%, respectively, at the end of June.

On the production side, GDP data released by IBGE ratified the strong economic growth foreseen by different indicators for industrial sectors. GDP expanded by 4.2% in the first half of 2004, compared to the same period of 2003. Crop/livestock production, industrial output and services increased by 5.7%, 4.7% and 2.8%, respectively. In the second quarter, GDP expanded by 1.5% compared to the previous quarter (seasonally adjusted data), in an annualized growth higher than 6.0% for the third consecutive quarter. Market expectations regarding GDP growth in 2004 were revised upward, moving from 3.5% at the end of June to 4.3% on September 10.

The industrial segment kept expanding at an accelerated pace, even with the record levels of recent months. In accumulated January-July figures, industrial production expanded by 7.8% compared to the same period of 2003, with special mention to capital goods (24.9%) and to consumer durables (24.5%). In the monthly deseasonalized series, IBGE's industrial production index expanded by 0.5% in July.

On the demand side, household consumption increased by 3.1% in the first semester of 2004, according to IBGE's national accounts, compared to the same period of the preceding year. The volume of retail sales has continued to expand at a rapid pace, according to IBGE's PMC, accumulating an increase of 9.7% in the first seven months of 2004, compared to the same period of 2003. The seasonally adjusted sales volume increased for the seventh consecutive month in July. Growth in economic activity was also reflected in the foreign trade sector, with a 29.6% accumulated increase in imports, from January to August 2004, compared to the same period of 2003. In its turn, the external market continued favorable for Brazilian exports, with a 34.8% growth rate in the period.

The labor market has responded positively to the performance of both sales and production. According to IBGE's PME, the rate of open unemployment in the nation's six major metropolitan regions dropped for the third consecutive month in July, closing at 11.2%. The PME employment rate registered deseasonalized growth of 0.9% in July, thus contributing to the upward movement in the growth of real overall wages in June and July. Real average income also presents an upward trend, despite the negative impact of increased employment in relatively lower paying-jobs. A Dieese survey indicates that the results of collective bargaining in the first half of the year were highly favorable to wage recovery, with 79.4% of wage increases equal to or greater than the twelve-month accumulated INPC for the period prior to negotiations. Nationwide data on formal employment calculated by MTE indicate creation of 1,237 new vacancies for formal jobs in the first seven months of the year, with a particularly strong labor market performance in cities other than the states´capitals.

As emphasized in the minutes of recent Copom meetings, these favorable labor market conditions have aided considerably in further strengthening the growth tendency in production and in industrial and retail commerce sales. The recovery has gradually spread through other segments, with improvement in the performance of areas that are more dependent on labor income and less sensitive to credit conditions or to the external market. Production of semi and nondurable consumer goods has reacted to increased demand, registering growth of 2.0% in the January-July period of 2004, compared to the same period of the previous year, and 1.5% expansion in the May-July quarter compared to the previous quarter, based on deseasonalized IBGE data. In summary, the evidence is that the recovery in the economic activity depends less on monetary stimulus now than was the case at the start of the process. At this moment, the recovery seems to depend more on an improved labor market performance, including gains in real income levels. This finding strengthens the importance of maintaining inflation on a path that is compatible with the medium-term targets, while ensuring that the process of recomposing real labor income will continue, in such a way that the growth cycle can be maintained in a sustained and balanced manner among the different segments of the economy.

The high levels of sales and output registered in recent months have had significant impacts on the industry capacity utilization. According to FGV data deseasonalized by the Central Bank of Brazil, the capacity utilization level reached 84.1% in July, near to the 85.2% level registered in the first quarter of 1995, the series' peak since 1990. CNI data corroborate this diagnosis, indicating a deseazonalized utilization level of 82.8% in July, a new record for this series. Though the behavior of the utilization level has been highly heterogeneous among sectors, out of nine of the 21 main industrial segments covered by the FGV survey have utilization levels higher than the sum of the mean and the standard deviation of the respective series, while another five are quite close to this situation. In some industrial segments, capacity utilization has reached levels rarely matched since the series was first calculated.

In the current stage of sales and production growth and increased levels of industry capacity utilization, the performance of investments has become of fundamental importance to expand the growth potential of the economy and to avoid that the growth in demand turns into source of inflationary pressures. Recent indicators show encouraging signs of an upturn in the investment flow, compared to the rather depressed level of previous years. According to the national accounts calculated by IBGE, gross fixed capital formation expanded by 6.8% in the first half of 2004, compared to the first six months of 2003. In the first seven months of the current year, domestic absorption of capital goods – production of these goods plus imports less exports – was 12.8% higher than in the same period of 2003. Recovery in gross fixed capital formation and domestic absorption of capital goods was more intense since the start of the recovery process in mid-2003 than in equivalent periods of the three previous recoveries. The result of this performance has been an increase in the investment rate as a ratio of GDP, which moved from 17.4% at the end of 2003 to 22.2% in the first quarter of 2004, according to IBGE's national accounts.

The historical series on gross fixed capital formation indicates a strong correlation with the indices of industry capacity utilization and, with a slightly larger lag, with the Brazil risk. These leading indicators suggest that investments should continue to expand over the coming months. In any case, the uncertainties raised in the minutes of recent Copom meetings and in the *Inflation Reports* of previous quarters concerning the speed of a more immediate expansion of productive capacity and the long-term growth tendency of the potential output of the economy remain. That growth is natural in moments of sharp expansion as the present one, in which consecutive quarters of rapid growth follow upon the pattern of slow and irregular growth of recent years. In view of the production levels already achieved and the tendency that demand will continue expanding, the pace at which the output gap is eliminated has become an evident source of concern for monetary policy.

6.2 Main scenario: assumptions and associated risks

The projections used by Copom are based upon a set of hypotheses on the behavior of the major economic variables. This set of hypotheses and the risks associated to them are elements of the benchmark scenario used by Copom as the basis for its decisions.

Since the publication of the last *Inflation Report*, important changes have occurred in the benchmark scenario considered by Copom. Risks to the dynamics of inflation are present in both the external and internal environments although, in both cases, the composition of these risks is different from what existed three months ago. At the domestic level, uncertainties regarding the magnitude of the remaining lagged effects of the more relaxed monetary policy give space to questions related to the productive capacity of the economy. In the external environment, the turbulence that hit international financial markets was overcome, although the threat represented by the dynamics of oil prices has taken on greater importance.

The volatility of international financial markets – particularly regarding the prices of emerging market assets – diminished due to a consensus about the real possibility of the Federal Reserve to continue the gradualism on its strategy of tightening the monetary policy until the long-term equilibrium interest rate for the United States economy is reached. The consolidation of the Fed's gradualist strategy, with consequent improvement in Brazil's external financing conditions, favouring the reduction in country risk and an appreciation of the exchange rate when compared to the second quarter, was facilitated by a less vigorous growth of the United States economy than previously expected. Despite this, demand for Brazilian exports remains high and expanding.

On the other hand, spiraling international oil prices have become increasingly important since June. Oil prices remain at high levels and extremely sensitive to any threat to the supply capacity of the major producers. Copom's benchmark scenario assumes an international price for WTI petroleum in the range of US$35 per barrel, reflecting a projection of an increase of 9.5% for gasoline over the course of 2004. At the moment, despite much higher oil prices than the projection above, the current gap in the domestic price of gasoline is temporarily mitigated by an atypical distancing of international gasoline prices in relation to crude oil prices. The evident risk is that this scenario may have to be reassessed, a risk that could materialize in a greater increase in gasoline prices in 2004 or in a still larger gap to be corrected in 2005. One should also note that, according to the minutes of recent Copom meetings, the risk of inflation associated to oil prices goes beyond the question of domestic gasoline prices, due to their impact on more oil-intensive productive chains and on the inflationary expectations of private agents.

In the domestic scenario, as already stated in section 6.1, the recovery of the Brazilian economy has continued at an accelerated pace. The more relaxed monetary policy and more favorable real exchange rate contributed to the first stage of recovery in the activity level, which was initially led by the sectors related to exports and those directly benefited from improvement in credit conditions. In the more recent stage, there are clear signs that the process of recovery has spread to other sectors where domestic demand depends less on credit and more on labor income. Although the upturn was foreseeable in all these aspects, its vigor in recent months came as a surprise to most analysts, despite having already reached significantly high levels of output. This better-than-expected performance triggered a widespread reassessment of GDP growth forecasts for 2004, and is a clear expression of the uncertainties that surrounding the intensity of the lagged effects of the monetary impulse and to which the *Inflation Reports* for December 2003 and March and June 2004 called attention.

It is natural that the direct effects of the monetary impulse will gradually lose importance and that, on the demand side, growth becomes increasingly sustained by its own specific dynamics of income increase. As stressed in the *Inflation Reports* for the last two quarters, the risks of a gap between aggregate supply and demand tend to become concentrated in the pace of growth of the economy's productive capacity. The levels of output in recent months reflect in relatively high levels of capacity utilization in several sectors of the economy, some of them near their historical peaks. At the same time, some uncertainty remains about the speed at which sectors with lower or fast-declining levels of idle capacity will be able to increase their capacity and meet growing demand. The same uncertainty appears in methods of estimating the aggregate productive capacity of the economy – the so-called potential output - and in the forecasting of its future trajectory. However, the same methods clearly evidence that the degree of idleness – the so-called output gap – has been dropping rapidly (see box Potential GDP and the Output Gap: Updating and New Estimates) in line with sectoral information. Copom understands that the accelerated pace of eliminating the output gap represents an important risk, under the current circumstances, to the convergence of inflation to the targets path.

Another risk factor that, as stated in the June *Inflation Report*, still deserves attention is the deterioration in private agents' inflation expectations. In order to achieve convergence of inflation to the inflation targets, with the best possible result in terms of the activity level, it is essential that expectations not only interrupt the ongoing process of deterioration, but that they are aligned with the inflation rate that is intended to be achieved. The absence of autonomous factors capable of spontaneously fostering this realignment has made the process dependent on unmistakable monetary policy signals.

An additional source of risk for inflation is the recent acceleration of industrial prices at the wholesale level that, in the coming months, should impact correlated items in retail price indices. At the beginning of the year, there was a wave of increases in IPCA industrial prices, following a rise in the industrial component of the IPA. On that occasion, cautious monetary policy was crucial to curb the propagation of these increases. The current circumstances, in which the conditions required to recover profit margins appear to be better than at early this year, suggest that there is now greater potential for more intensive pass-throughs, thus requiring greater caution in monetary policy.

In a more propitious environment to recover profit margins, it is also important not to grant wage increases based on the assumption that monetary policy will accommodate automatic pass-throughs to prices. Progressive recovery in real wages is crucial to sustaining the growth process. However, in order to maintain the stability, it must occur nominal increases consistent with the hypothesis that inflation will remain low, and not more generous ones followed by a more intense inflationary corrosion in the future.

As explained in the minutes of the September meeting of Copom, the Committee decided that monetary policy should be calibrated in such a way as to achieve 5.1% IPCA inflation in 2005. This results from adding 0.6 p.p. to the central target of 4.5% set by the CMN, corresponding to the absorption of 2/3 of inflationary inertia that will be transmitted from 2004 to 2005. The box Procedure for Calculating Inflationary Inertia in 2005 explains the procedure for calculating inflationary inertia, defined as the contribution to 2005 inflation rooted in the fact that the relevant inflation indices will surpass the 5.5% IPCA target in 2004.

Expliciting the Copom intents to achieve 5.1% inflation in 2005 could not be delayed, considering that monetary policy works with lags and that it would make no sense to start an adjustment process of the monetary policy instrument without making it clear which are the objectives that this adjustment seeks to achieve in terms of the convergence of inflation to the targets path. On the other hand, neither it would be advisable to anticipate this announcement even further, since it would happen under still rather unreliable projections for 2004 inflation, on whose basis the inertia carried over to 2005 is calculated. At this moment, Copom feels prepared to make these calculations, even though they are based on inflation projections for the remaining months of 2004, to announce a definitive objective for inflation in 2005 not to be altered or adjusted. An inflation rate of 5.1% in 2005 is, therefore, the entirely predetermined objective that will orient the calibrating of the monetary policy instrument over the relevant horizon.

The benchmark scenario projects a variation of 8.5% for regulated prices in 2004, higher than the 7.7% forecast in the preceding *Report*. In the case of gasoline, the projection of a 9.5% increase for 2004 remains. Regarding other regulated prices, the forecast for bottled gas was reduced from 6.9% to 6.2% in 2004, while the projection for residential electricity and fixed telephone serviced raised from 11.0% to 11.5%, and from 6.1% to 13.9%, respectively. The model for the endogenous determination of regulated prices projects a growth of 6.9% for 2005, an increase of 0.9 p.p. compared to the previous *Report's*.

Still relating to the benchmark scenario, it is assumed the maintenance of the Selic rate at 16.25%, the target set by Copom at its September meeting, and the exchange rate constant at R$2.90 until the end of 2005. This is a standard procedure in Copom's simulations, as stated in previous *Inflation Reports*. The benchmark scenario is compatible with a spread for the six-month pre-DI swap rate of 87 p.b. for the final quarter of 2004, and 38 p.b. for the same period of 2005.

The reduction in international financial market turbulence was reflected in the exchange rate path in the market scenario. The exchange rate estimated by the market was R$3.02 for the final quarter of 2004 and R$3.17for the final quarter of 2005, both below the rates stated in the latest *Report* for those periods (R$3.10 and R$3.23, respectively). At the same time, private agents also reassessed the projected path for monetary policy, raising their forecasts for the Selic rate from 15.00% to 16.42% at the end of 2004 and from 13.35% to 15.12% at the end of 2005. These new values result in spreads projected for 180-day swap operations of 77 p.b for 2004 and 4 p.b for 2005. The expected increase for regulated prices in the market scenario is 8.8% for 2004 and 7.4% for 2005.

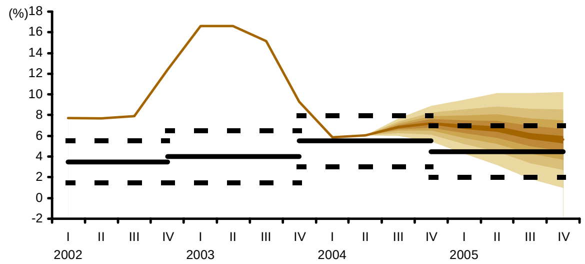
Concerning the fiscal policy, the results obtained up to July 2004 offer additional security that the hypothesis of compliance with the targets for the primary surplus of the consolidated public sector in 2004 and the next two years.

6.3. Inflation forecast

Based on the assumptions considered by Copom, their associated risks and the information available, projections were constructed for accumulated IPCA growth in four quarters,

Forecasted IPCA-inflation with interest rate constant at 16.25% p.y. (Benchmark scenario)

Inflation fan chart



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

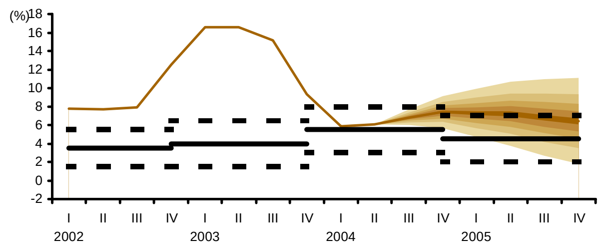
IPCA-inflation with interest rate constant at 16.25% p.y.
(Benchmark scenario)

Year	Q	Confidence interval 50%	30%	10%	10%	30%	50%	Central projection
2004	3	6.5	6.6	6.8	6.9	7.0	7.2	6.8
2004	4	6.5	6.8	7.1	7.3	7.6	7.9	7.2
2005	1	5.8	6.3	6.7	7.1	7.5	8.0	6.9
2005	2	5.2	5.8	6.4	6.9	7.5	8.1	6.6
2005	3	4.3	5.0	5.7	6.3	7.0	7.7	6.0
2005	4	3.7	4.5	5.3	6.0	6.7	7.5	5.6

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 50%	30%	10%	10%	30%	50%	Central projection
2004	3	6.5	6.6	6.8	6.9	7.0	7.2	6.8
2004	4	6.7	7.0	7.3	7.5	7.8	8.1	7.4
2005	1	6.2	6.7	7.1	7.5	7.9	8.4	7.3
2005	2	5.8	6.4	7.0	7.5	8.0	8.6	7.2
2005	3	5.1	5.8	6.5	7.1	7.8	8.5	6.8
2005	4	4.5	5.3	6.1	6.8	7.5	8.3	6.4

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

adopting the interest and exchange rate hypotheses included in the benchmark and market scenarios. In the benchmark scenario, it is assumed that the Selic rate will be maintained at 16.25% per year, the level defined at the September 2004 Copom meeting, and that the exchange rate will remain constant at a level close to that in effect on the eve of the meeting (R$2.90). In the market scenario, using expectations gathered by Gerin, the basic rate of interest was revised upward to 16.42% per year in the fourth quarter of 2004 and downward from that point forward, until reaching 15.12% per year in the final quarter of 2005. The United States dollar rate closes at an average of R$3.02 in the final quarter of 2004 and R$3.17 in the final quarter of 2005.

The central path associated to the benchmark scenario indicates an upward tendency in the four-quarter-accumulated inflation in 2004, from 6.8% in the third quarter to 7.2% in the fourth thus above the 5.5% target set for the year. This increase in inflation, which reflects a higher rate in the fourth quarter of 2004 than in the fourth quarter of 2003, is primarily associated to the economic recovery, with a reduction in the output gap, and of the deterioration in the inflation expectations of private agents that, given demand conditions, impacts directly on the formation of current prices and also contributes to reduce the expected real interest rate. From the final quarter of 2004 to the first quarter of 2005, the four-quarter -accumulated inflation dropped by 0.3 p.p., as the particularly high rate of inflation (1.9%) registered in the first quarter of 2004 was substituted by a more moderate level (1.6%) in the same period of 2005. A downward trend is also noted over the course of the year as a result of the lagged effects of the Selic rate rise in September, remaining constant since then. For 2005, the inflation projected by the benchmark scenario was set at 5.6%, higher than the 5.1% target adopted by Copom for annual inflation.

It is important to reiterate, as underscored in the minutes of the September meeting of Copom, that the tolerance interval defined by CMN around the central target of 4.5% for 2005, which ranges from 2% to 7%, was not altered. According to the confidence interval shown in the probability table beside, the probability of surpassing the upper limit of the tolerance interval is approximately 31%, based on the hypotheses of the benchmark scenario.

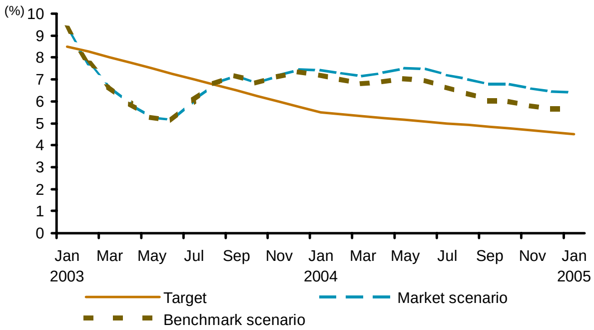
Since it incorporates an interest rate decline and exchange devaluation over the forecast horizon, the market scenario projects inflation rates of 7.4% and 6.4% for 2004 and 2005, respectively, both higher than those forecasted in the benchmark scenario and, therefore, more distant from the path of the specified targets. In a similar way as in the benchmark scenario, the four-quarter-accumulated inflation increases in the last two quarters of 2004. In 2005, an inflation rate of 1.8% in the first quarter, lower than that for the same period in 2004, results in a small reduction in accumulated inflation. Over the course of the following quarters, inflation declines at a sharper pace, albeit by a lesser proportion than in the benchmark scenario, due to exchange rate depreciation and reduction in interest rates expected by the market for 2005. The market scenario assumes 8.8% inflation for regulated prices in 2004, as against 8.5% in the benchmark scenario.

June 2004 *Inflation Report* forecasts

Period	Benchmark scenario	Market scenario
2004 II	5.9	5.9
2004 III	6.3	6.4
2004 IV	6.4	6.5
2005 I	5.5	5.7
2005 II	4.8	5.3
2005 III	4.6	5.3
2005 IV	4.4	5.4

A comparison of the trajectories presented in this *Report* with those in the June *Report*, whose central projections of which are presented in the table beside, shows that the projections increased in both the benchmark and market scenarios. In June, the benchmark scenario had already shown an upward inflation trend for 2004, but the central projection was 0.8 p.p. below the present level. This rise is due to a higher expected increase in regulated prices, which shifted from 7.7% to 8.5%, and to an increase in the forecasts for free prices inflation from 5.9% in the latest *Report* to 6.7% now. For 2005, the benchmark scenario registered a more significant change: the forecasted inflation increased by 1.2 p.p., as a consequence of a higher projection of regulated prices for next year, higher inflation expectations and, finally, a higher of economic activity level. The inflation path of the market scenario increased by 0.9 p.p. for the end of 2004 and by 1.0 p.p. in accumulated terms for 2005.

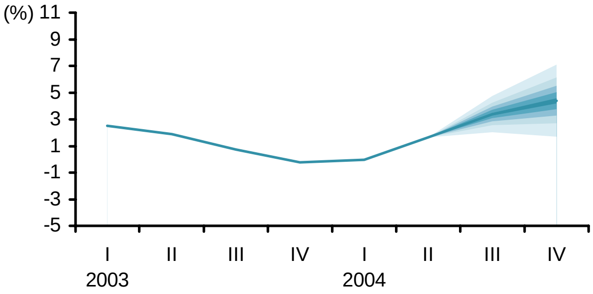
Twelve-month ahead inflation



The graph beside shows the evolution of accumulated-four-quarter-ahead inflation according to the benchmark and market scenarios stated in this *Report*, together with the interpolated trajectories of the targets for 2003, 2004 and 2005. These trajectories are constructed by the sum of accumulated inflation up to August 2004 with the inflation rates forecasted for that month onwards. Consequently, as discussed in the June *Report*, according to the benchmark scenario, accumulated-four-quarter-ahead inflation surpasses the targets path since September 2003. However, differently from the projections stated in the June *Report*, inflation remains, at the moment, above the targets path, in spite of a decline over 2004. Just as in the previous *Report*, projections for the market scenario are consistently above the interpolated trajectory of the targets since the end of 2003, and the gap becomes even greater with the new forecasts.

As in previous Reports, the output fan chart constructed on the basis of the benchmark scenario hypotheses is also

GDP growth with interest rate constant at 16.25% p.y.
Benchmark scenario
Output fan chart



presented. It should be noted that the forecasting errors resulting from GDP growth projections are considerably higher than in the case of inflation forecasts, considering that the model works with a decomposition of output into two components not directly observed – potential output and output gap – and, at the same time, the calculation of the output level is more complex and less precise than that of inflation. According to the benchmark scenario, the forecasted growth for 2004 is 4.4%, 0.9 p.p. higher than in the June *Inflation Report*.

Potential GDP and Output Gap: Updating and New Estimates

Potential output is defined as the maximum output level that an economy can attain without generating inflationary pressures, also termed the maximum sustainable output level. In its turn, the output gap is defined as the difference between effective output and potential output. Both variables are key elements for the analytical framework that serves as the basis for formulating, analyzing or evaluating monetary policy. The output gap plays a central role as indicator of inflationary pressures.

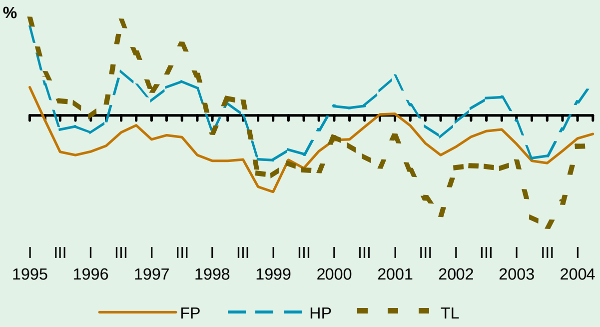
One notorious difficulty in measuring potential output and output gap is that they cannot be obtained directly through simple measurement of economic data, but must be estimated. Given the relevance of this subject to monetary policy, this box aims at continuing the discussion on methodologies for calculating potential output and output gap initiated in the September 1999 and December 2003 *Inflation Report*. At the same time, updated estimates of these variables are also presented.

Literature on estimating potential output can be divided into two main currents. On the one hand, there are studies based on purely statistical models that, by applying a filter to the output series, come to potential output and, by calculating its residue, to output gap. The other current incorporates the fundamentals of economic modeling into the estimation method. Among these, one should cite the impact of observed growth in the stock of output factors on the output capacity of the economy and available evidence on the non-inflationary utilization level of existent stock. Among specialists, there is no consensus regarding the superiority of one or the other methodological current, and those in charge of monetary policy formulation deem it advisable to monitor the results obtained through various methods, giving preference to one or the other according to the specific circumstances in which they are working.

Banco Central closely monitors different indicators of potential output and output gap. In keeping with the basic lines presented in literature, Banco Central measures the variables through purely statistical models and models based on economic fundamentals. The September 1999 *Inflation Report* describes the methods used to estimates potential output through linear trend extraction and application of the Hodrick-Prescott filter. In its turn, the December 2003 *Inflation Report* describes a method of estimating output gap based on economic fundamentals and constructed on the basis of a Cobb-Douglas production function.

Output gap evolution – 1995-I to 2004-II

Production Function, HP Filter, Linear Trend



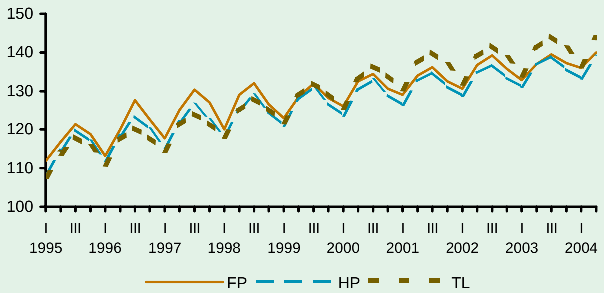
The first two graphs update the results presented in the September 1999 and December 2003 *Inflation Report* and contain the evolution of the output gap and potential output measured by the three methods cited, for the period extending from the first quarter of 1995 to the second quarter of 2004. It should be noted that in the graph referring to potential output, a seasonal component was added to the estimated trend.

The graph referring to growth of the output gap clearly indicates that the process of the expanding distance between effective and potential output – in other words, an increasing degree of idleness – found to exist in mid-2003, has been reversed. As a matter of fact, for the first half of 2004, the HP filter already indicates a positive gap, while two other methods point to effective output near potential output, though they also indicate negative gaps.

Potencial output evolution – 1995-I to 2004-II

Production Function, HP Filter, Linear Trend

Index – base: average 1990=100

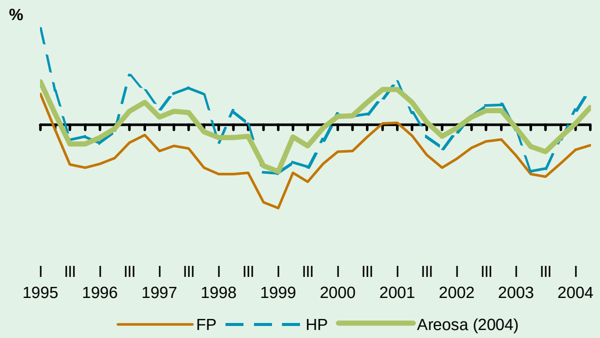


A new approach being developed at Banco Central do Brasil modifies the technique presented in the December 2003 *Inflation Report*. This modification consists in simultaneously estimating potential output, the natural rate of unemployment, the participation of capital in income and the non-inflationary utilization rate of installed capacity, assuming a production technology of the Cobb-Douglas type (Areosa, 2004)[1]. This estimation is an innovative solution since the parameters of the production function and the

1/ Areosa, M. B. M. (2004) "Combining Hodrick-Prescott Filtering with a Production Functional Approach to Estimate Output Gap", published on the Banco Central do Brasil portal (www.bcb.gov.br/?SEM5ANOS).

Output gap evolution – 1995-I to 2004-II

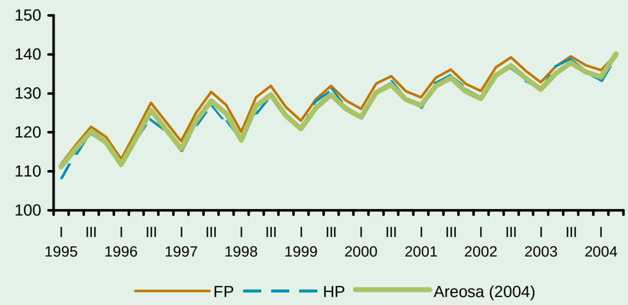
Production Function, HP Filter and Areosa (2004)



Potencial output evolution – 1995-I to 2004-II

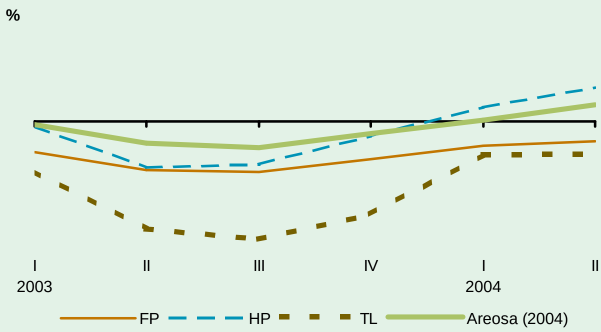
Production Function, HP Filter and Areosa (2004)

Index – base: average 1990=100



Output gap evolution – 2003-I to 2004-II

All output gaps



non-observed components of potential output are obtained from a joint optimization and not by means of individualized estimations for these variables. However, the method requires that specific weights be attributed to the HP filters that are applied to each one of the primitive series.

The two following graphs show the output gap and potential output series generated by the FP, HP and Areosa techniques. It is important to observe that the Areosa technique has points in common with both the HP and FP methods, a fact that becomes evident in the results. The gap variations in Areosa are similar to those of the FP model, while their level is close to that of the HP model.

Joint analysis of the graphs indicates that the four methods provide measurements of potential output with relatively synchronized movements. In the first part of the sample, however, the potential output generated by the linear trend is less than that generated by the other techniques. This situation reverses as of the first quarter of 1999. The change may be a result of the low capacity of the linear trend method to perceive the effects of structural breakdowns.

This brief analysis demonstrates that identification of measurements suited to potential output and output gap is no easy task. The difficulty becomes even greater when one seeks to build future forecasting paths for these variables which are essential since monetary policy, given the temporal lags of their impacts on the economy, must operate in a proactive manner. Despite these methodological difficulties, all the current evidence for Brazil points to an unmistakable tendency to closing the output gap. This can be more clearly visualized in the accompanying graph which, specifically for 2003 and the first half of 2004, shows the output gap estimated by the four methods.

Procedure for Calculating Inflation Inertia in 2005

As announced in the minutes of the September Copom meeting, monetary policy instruments will be calibrated in order to pursue a 5.1% rate of inflation in 2005, corresponding to the central target of 4.5% set by CMN, plus 0.6% as partial absorption of the inflation inertia inherited from 2004. Consequently, it is necessary a more detailed explanation of the procedure used to calculate this inertia.

Inflationary inertia is defined as the share of 2005 inflation that, by means of inflationary feedback mechanisms, will result from changes in 2004 price indices above the target set by CMN for the IPCA. The inertia is patent in the behavior of free prices and regulated prices. Aside from the IPCA itself, which is the price index used as reference for inflation targets, the IGP-DI plays an important role in determining inertia, since it is used as the indexing factor in contract clauses for price adjustment. Calculated inertia would be nil if these two indices registered in each quarter of 2004 an increase equivalent to ¼ of the IPCA target for this year. The procedure for calculating inertia is as follows:

1. Contribution of the IGP-DI to administered prices:

(i) The IGP-DI shock in each quarter of 2004 is calculated. This shock is defined as the difference between the effective IGP-DI in each quarter and 1/4 of the IPCA inflation target in the year. Since the values for IGP-DI in the final months of 2004 are not yet known, the median of current expectations for IGP-DI in those months – as found in the Gerin survey – are used in lieu of the effective values.

(ii) IGP-DI inertia in each quarter of 2005 is calculated. This inertia is defined as the impact of IGP-DI shocks in 2004 calculated in (i) on the change in this index in 2005. This impact is calculated according to the equation that characterizes the dynamics of IGP-DI in the model of endogenous determination of regulated prices used by Copom.

(iii) The joint impact of the IGP-DI shock in 2004 and its inertia in 2005 – the results of (i) and (ii) above – on the increases in electricity and telephone rates in each quarter of 2005 is calculated at this point. These calculations are made by the Central Bank of Brazil, taking in consideration the rules on increases specified in each concession company contract, the same procedure routinely used in the forecasting exercises of regulated prices. Following that, utilizing the weight of these two sectors in the IPCA, the impacts of these increases on IPCA in each quarter of 2005 are calculated. These impacts are designated by I_T^{ELEC} *and* I_T^{TEL} for the quarter t (t=1.2.3.4) in the cases of electricity and telephone rates, respectively.

(iv) Subsequently it is calculated the joint impact of the IGP-DI shock in 2004 and of its inertia in 2005 – the results of (i) and (ii) above – on increases in other regulated prices in each quarter of 2005, excluding electricity and telephone. In this calculation, it is assumed that the other regulated prices depend on IGP-DI figures in the current and previous quarters according to the model of endogenous determination of regulated prices used by Copom. Following that, using the weight of both sectors in the IPCA, excluding electricity and telephone rates, the impact of these increases on the IPCA in each quarter of 2005 is calculated. This impact is designated by I_t^{dpa}, for quarter t (t=1.2.3.4).

2. *Contribution of the IPCA to free prices and total inertia:*

The contribution of the IPCA to the inertia of free prices and total inertia are calculated recursively, quarter by quarter, based on the specification of the Phillips curve used in Copom's projection models, in which free price growth in each quarter depends on IPCA inflation in the immediately previous quarter.

(i) The IPCA shock in the final quarter of 2004 is calculated. This shock is defined as the difference between IPCA growth in the quarter and 1/4 of the IPCA target in the year. Since the effective value of the IPCA in the final quarter of the current year is not yet known, Copom's own projection is used instead, according to the benchmark scenario.

(ii) IPCA shock in the final quarter of 2004 is multiplied by the inertia coefficient of the Phillips curve in the Copom models and by the weight of free prices in the IPCA, thus obtaining the contribution of free prices to IPCA inertia in the first quarter. This contribution is designated by I_1^{market}.

(iii) Total inertia, designated by I_I, in the first quarter of 2005 is calculated, adding the already calculated contributions of electricity, of telephone rates and of other regulated prices to the contribution of free prices: $I_1 = I_1^{market} + I_1^{elec} + I_1^{tel} + I_1^{dpa}$.

(iv) Total inertia in the first quarter of 2005, I_I, is multiplied by the inertia coefficient of the Phillips curve and by the weight of free prices in the IPCA, thus obtaining I_2^{market}, the contribution of these prices to inertia in the second quarter of 2005.

(v) Total inertia in the second quarter of 2005 is calculated, $I_2 = I_2^{market} + I_2^{elec} + I_2^{tel} + I_2^{dpa}$.

(vi) Procedures (iv) and (v) are repeated for the third and fourth quarters of 2005. In other words, for t=3 and t=4, the contribution of market prices, I_t^{market}, results from multiplying I_{t-1} by the inertia coefficient of the Phillips curve and by the weight of market prices in the IPCA, and total inertia in the quarter is given by $I_t = I_t^{market} + I_t^{elec} + I_t^{tel} + I_t^{dpa}$.

(vii) Total inertia in 2005 is calculated by the sum of the inertia in the four quarters of the year, obtained by the recursive process above or, in other words $I_1 + I_2 + I_3 + I_4$.

The result of this procedure is total inertia of 0.9 p.p. in the 2005 IPCA. Given the decision to accommodate 2/3 of this inertia, 0.6 p.p. was added to the 4.5% target set for 2005 by the CMN, thus attaining the 5.1% objective announced by Copom.

Annex

Minutes of the 97th Meeting of the Monetary Policy Committee (Copom)

Date: June 15th, from 4:45PM to 7:00PM, and June 16th, from 3:30PM to 6:15PM
Place: BCB's Headquarters meeting room of the 8th floor (on June 15th) and 20th floor (on June 16th) – 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 June 15th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves Operations Department
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Luiz Fernando Cardoso Maciel – Department of Banking Operations and Payments System
Marcelo Kfoury Muinhos – Research Department (also present on June 16th)
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on June 15th)
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 May, the main inflation indicators increased, mainly due to specific pressures on fresh food prices, harshly affected by climate adversities. The Broad National Consumer Price Index (IPCA) rose 0.51%, compared to a 0.37% increase in April, accumulating a 2.75% change in the year up to May. The IPCA change in the last twelve months stood at 5.15%, the lowest variation since the adoption of the inflation-targeting regime in 1999.

2. The General Price Index (IGP-DI) rose by 1.46% in May, compared to 1.15% in April, totaling a 5.54% change in the first five months of 2004. The IGP-DI acceleration was due not only to wholesale-prices inflation (1.71%), but also to

stronger pressures from consumer prices (0.71%) and construction industry costs (1.83%). The variation of the IGP-DI and of the Wholesale Price Index (IPA-DI) in the last twelve months to May stood at 7.97% and 8.76%, respectively.

3. In May, the IPCA upsurge primarily reflected the turnaround in food prices, which increased 0.23% from a negative 0.34% in April. Climate adversities and the milk inter-harvest period explain this shift. Food-prices inflation was not generalized, as important products (manioc flour, meat, bean, rice, eggs, chicken, fish and soy oil) registered price falls.

4. For the second consecutive month, medicine was the main individual contributor to the IPCA inflation (0.10 p.p.), reflecting the readjustments authorized by the sector's Regulation Chamber. Energy and vehicles contributed each with 0.06 p.p., while pasteurized milk and clothes contributed with 0.05 p.p. each. Together, these five items accounted for 0.32 p.p. of the 0.51% IPCA change.

5. Market prices increased 0.57%, compared to 0.39% in April. Excluding food, these prices increased 0.74% as against 0.75% in April. Regulated prices rose by 0.35% (0.32% in April), impacted by the increase in energy prices in six State capitals and in fuel-alcohol prices, which recovered from a sharp reduction from January to April. Market prices accounted for 0.41 p.p. of the monthly IPCA, while regulated prices contributed with the residual 0.10 p.p.

6. The IPA-DI registered a 1.71% variation in May, from 1.57% in April. The accelerating trend resulted from the increase in the agriculture IPA, which rose to 2.71% in the month, compared to 0.8% in April, mainly influenced by the prices of fresh food products, meat and chicken. The industrial IPA decreased to 1.32%, compared to 1.86% in April.

7. Core inflation measures remained relatively stable in May, compared to April. The IPCA core inflation calculated by excluding household food items and regulated prices posted a 0.70% change (0.72% in April), accumulating 7.15% in the last twelve months. When calculated under the smoothed trimmed-mean method, the core increased to 0.59% (0.57% in April), totaling 8.46% in twelve months. Without the smoothing procedure for pre-selected items, the IPCA core recorded 0.43% in the month and 5.46% in twelve months, compared to 0.45% and 5.68%, respectively, in April.

8. The IPC-Br core inflation measure, calculated by the Getulio Vargas Foundation (FGV) under the symmetric trimmed-mean method, stood at 0.57% in May, accumulating 6.64% in 12 months.

9. In June, inflation should be influenced by the increase in the prices of gasoline (the readjustment to consumers, effective since June 15th, is expected to average 4.5%) and of fuel-alcohol, still recovering from the significant price decrease that took place from February to April. Food prices are also expected to continue affecting inflation, especially meat and dairy products, due to the beginning of the inter-harvest period. As to the wholesale, besides the agricultural price pressures, some deceleration in the industrial price variation is expected, apart from fuel.

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 prices were maintained at 11% for 2004. Yet, for fixed telephone prices, the Copom revised the adjustment estimate to 6.1% for the year, 0.6 p.p. lower than in the previous meeting;

c. Regarding all regulated prices, with a total weight of 28.6% in the May IPCA, a 7.7% rise is projected, the same as in the previous meeting;

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

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 39 basis points in the second quarter of 2004 to 60 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, including the maintenance of the Over-Selic rate at 16.0% p.a. and the exchange rate at the level observed on the eve of the Copom meeting (R$3.10), the IPCA inflation was projected 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 Over-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. In May, the IPCA inflation edged up in comparison to April but it did not deviate from market consensus. Similar to previous months, the strongest pressure stemmed from market prices. For the second consecutive month, tradable prices presented a higher increase than non-tradable prices. An unusual feature was the unfavorable trend in food prices. Other national consumer-price indices also edged up in May, like the IPC-DI (up 0.71% from 0.31% in April). Wholesale inflation also increased but, contrary to previous months, the main pressure stemmed from agriculture prices, while industrial prices changes decelerated. The pass-through of wholesale prices to consumer prices remains below usual. Wholesale-industrial prices should continue to decelerate due to the recent trend of commodity prices. Agriculture prices, however, represent an important source of pressure over inflation in the short run, larger than the seasonal pattern at this time of the year.

14. In May, IPCA core measures remained relatively stable compared to April. Core inflation calculated under the trimmed-mean method, with and without the smoothing procedure of pre-selected items, rose by 0.59% and 0.43%, respectively. Core inflation excluding food items and regulated prices stood at 0.70%. In the year to May, the cores calculated under the trimmed-mean methods continued close to the headline inflation (with and without smoothing changed 3.19% and 2.46%, respectively), differently from the core by exclusion, which rose by 3.97%.

15. Recent economic activity indicators confirm, undoubtedly, the continuity of the economic rebound process initiated in the second quarter of 2003. The recovery trend was corroborated by the GDP figures for the first quarter of 2004. Real GDP grew 1.6% quarter-on-quarter, seasonally adjusted. In comparison with the same quarter of 2003, real GDP rose by 2.7%. In order to achieve the 3.5% estimated growth rate for the year, it is necessary for the GDP to grow on average 0.5% per quarter during the next three quarters. In an extremely unrealistic scenario in which the seasonally adjusted GDP remains flat in the next three quarters, the 2004 GDP would grow 2.8%.

16. The industrial production levels of March were maintained in April, while growth prospects remained favorable. Industrial production grew 0.1% month-on-month in April, seasonally adjusted, accumulating a 6.1% growth in the year, compared to the same period of 2003. Capital goods (up 21.4%) and durable consumer goods (up 21.1%) are the categories leading the industrial growth cycle. According to CNI data, seasonally adjusted by the BCB, real industrial sales grew 3.7% month-on-month in April, confirming the growth trend initiated in the second half of 2003.

17. In April, retail sales sustained the growth pace, reaching the highest levels since the IBGE initiated the retail survey in January 2000. Sales grew 1.8% compared to March, adding to a 5.4% increase in the November-April period compared to the previous six months. Consumer confidence measured by the Federação do Comércio do Estado de São Paulo (Fecomercio SP) fell in June, but the average index for the first semester is still 6.8% higher than the level registered in the same period of the previous year. Credit operations continued to expand for both individuals and companies, despite the fall of non-

earmarked credit concessions in May. Several other coincident and leading indicators reinforce the perception of a continued economic recovery, such as packaging paper shipments, which grew 8.4% in the first five months of the year compared to the same period of 2003.

18. Even though the exports have been playing an important role to economic activity rebound, as a consequence of the significant adjustment of the external accounts, domestic demand has been increasing its relative importance to the sustained economic growth. This importance tends to broaden as the recovery of employment and real payroll lead to higher consumption. In April, employment in the manufacturing sector increased, while real payroll registered a slight decrease, although it kept in an upward trend. There are three reasons why employment growth has not yet reduced the unemployment rate. Firstly, this period of the year is usually characterized by a seasonal increase in the unemployment rate, independently on the economic cycle. Secondly, the recovery process has stimulated workers to search for jobs, even those who had not been searching for occupation for some time. As a consequence, labor force increases causing the unemployment rate to rise. Lastly, the unemployment rate is calculated in the largest urban areas, where employment growth has been not as strong as in medium and small urban areas, as well as in the rural areas. According to the Ministry of Labor and Employment, the level of formal employment in the first four months of the year increased 3.2% in the metropolitan regions and 3.8% out of those regions, both compared to the same period of 2003.

19. Brazilian external accounts have continued to register expressive positive results. Despite the increase in imports, the trade balance posted a US$3.1 billion surplus in May, a historical record. The BCB's revised upwards its trade balance estimate for the year to US$ 26 billion from US$24 billion. The current account balance has remained positive, accumulating a US$2.4 billion surplus in the year up to May, close to the estimated surplus for the whole year.

20. The external scenario has somewhat stabilized since the last Copom meeting, even though the high volatility environment has persisted. Although tension in the oil market has lessened, there are still uncertainties regarding the expected path of the fed funds rate in the U.S. The exchange rate has remained slightly above R$3.10/US$, and its 21-day volatility reached the highest level since May 2003. The country risk measured by the JP Morgan Chase's Embi+ decreased from 728 b.p. in the period immediately before the last Copom meeting to 670 b.p. on the eve of this meeting.

21. Since the last Copom meeting, oil prices have fallen approximately 11%, following the OPEC decision to increase output. The 10.8% wholesale readjustment in gasoline prices announced by Petrobrás on June 15 stood close to the figures expected by the Committee, and partially closed the gap between internal and external prices.

22. Market inflation expectations deserved special attention by the members of the Copom. The deterioration observed since the last meeting was not limited to 2004 IPCA expectations (the median rose to 6.71% from 6.22%), but also affected longer-terms expectations: for the next twelve months, the median projection increased to 6.03% from 5.67%, while for 2005, the median, that was anchored around 5%, moved up to 5.44%. In a scenario of temporary shocks affecting the inflation path, it would be more reasonable to observe a sharper deterioration in inflation expectations in shorter horizons, when the first order effects are concentrated and monetary policy effectiveness is limited. The Committee members share the conviction that the magnitude of the deterioration observed for longer horizons is not compatible with the view that, in the presence of eventual supply shocks of a more permanent nature, the monetary policy will not accommodate its secondary effects. Such deterioration is also not compatible with the inflation forecasts produced by the different models used by the Copom, even if these projections take into account particularly unfavorable scenarios to the evolution of the main determinants of the recent shocks.

23. Since the meeting in April, the Copom has assessed inflation prospects based on the assumption of a low degree of persistence of the first quarter inflation, as observed in previous years when there was a seasonal relief in market prices inflation in the

second and third quarters. Considering the inflation in April and May, and the non-usual increase of market-prices inflation in May, the Copom assessed with greater emphasis the inflation projections made without the assumption of low persistence. Inflation projections in the benchmark scenario, based on an unchanged Over-Selic rate at 16.0% and the exchange rate at R$3.10/US$ throughout the projection horizon, point out to an inflation rate above the target of 5.5% for 2004 and below the target of 4.5% for 2005. 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. Compared to May, there was a slight increase in the projections for 2004 in both scenarios, basically caused by the higher inflation expectations for 2004 and 2005.

24. As in the previous meeting, the Copom also considered 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 decisions taken in the next few months, and at the same time, it presents more reliable inflation projections than the ones already available for 2005. 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.

25. In an inflation-targeting regime, the Central Bank policy-making process is based on the assessment of different scenarios for the most important variables affecting inflation dynamics. The current uncertainties concerning the external scenario have been responsible for a short-term volatility that tends to increase inflation uncertainty. As a consequence, the coordination of private agent's inflation expectations became more difficult. The inflation rate increase in the short-term, caused by either seasonal factors or financial assets prices volatility, should not contaminate private expectations for longer periods. Like in the previous meeting, the Committee assessed that the macroeconomics perspectives for the medium-term are still favorable. In the short-term, however, inflation expectations have become a relatively more important risk factor than in the last month.

26. Even considering less favorable scenarios, the Copom is still optimistic about the achievement of economic growth with price stability. Considering the hypothesis that important external variables continue under pressure for a longer period, the flexibility of the inflation-targeting regime could judiciously absorb the primary shocks associated with this pressure. However, it would be paramount for monetary policy to fight the second order effects of these shocks. In this case, economic activity could benefit from the progressive recovery of real earnings, which depends on a price stability environment in the medium-term.

27. As a result, the Committee decided, unanimously, to maintain the target for the Over-Selic rate at 16.0% p.a., without bias.

28. At the closing of the meeting, it was announced that the Copom would meet again on July 21, 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. Retail sales continued to expand in April, according to the IBGE's retail survey. Sales and nominal revenues increased 9.9% and 9.2%, respectively, in comparison to April 2003. In the year up to April, sales and nominal revenues rose 8.0% and 9.6%, respectively.

30. The São Paulo Trade Association (ACSP) data for May registered a 0.5% reduction of consultations related to credit sales, while the Usecheque system consultations increased 2.2%, compared to the previous month (seasonally adjusted). In the year up to May, the same indicators increased 7.0% and 1.0%, respectively.

31. The Fecomercio-SP monthly survey indicated a decrease in the Consumer Confidence Index (ICC) in June, after a sharp increase in the previous month. In June, the ICC declined 9.1% month-on-month, standing at 113.1 points (range 0 to 200). This performance was a result of a decrease of 18% and 5% in current and future conditions, respectively. Despite the fall, the ICC still reveals consumers' optimism.

32. In the first quarter of 2004, capital goods and construction inputs production increased 21.5% and 1.6%, respectively, compared to the same period of 2003. Domestic absorption of capital goods increased 9.3% in the same period, despite the 50.5% exports increase, led by agricultural machinery. BNDES credit operations increased 59% from January to May, in comparison to the same period of 2003.

33. The IBGE's monthly industrial survey registered a 0.1% increase in industrial output in April, compared to March, seasonally adjusted, with increases of 1.0% and 0.3% in mining and in the manufacturing industry, respectively. Out of the 23 sectors surveyed, 13 registered increased output. In the first four months of the year, industrial output increased 6.1%, compared to the same period of 2003. Semi and non-durable goods production started to recover, albeit still modestly, in tandem with the gradual improvement of labor market conditions.

34. In April, the National Industry Confederation (CNI) recorded a 3.7% increase in real sales and a 1.9% increase in worked hours, in comparison to March, seasonally adjusted. Compared to the first four months of 2003, real sales and worked hours increased 13.6% and 2.8%, respectively. The level of capacity utilization declined 0.1% month-on-month in April, but increased 1.3% in the year up to April, compared to the same period of 2003.

35. The car industry produced 177,000 vehicles in May, up 3.9% compared to April and 7.7% above May 2003, seasonally adjusted. In the year up to May, output increased 12.1%, and domestic sales and exports expanded 18.7% and 4.2%, respectively, compared to the same period of the previous year.

Labor Market

36. The formal employment index increased 0.4% month-on-month in April (seasonally adjusted), and 3.9% year-on-year, according to the Ministry of Labor and Employment. In 2004, there has been an expansion of 2.3% in formal employment, compared to December 2003. The data indicate that hiring has increased at a higher pace outside large urban areas, where employment increased 2.7% in the year up to April, whereas in the main metropolitan areas the growth rate stood at 1.9%.

37. The unemployment rate measured by IBGE in 6 metropolitan areas increased to 13.1% in April, despite the 0.7% increase in the number of employed workers. In April, the labor force rose 1%, and the number of unemployed increased 3.2%. Also in April, IBGE recorded a 0.7% fall in average real earnings, compared to March.

38. According to CNI seasonally adjusted data, employed workers and real payroll in the industrial sector remained stable in April, compared to the previous month. For the January-April period, real payroll and employed workers increased 7.1% and 0.4%, respectively, compared to the same period of 2003.

Credit and Delinquency Rates

39. Non-earmarked credit operations grew 3.6% in May. Corporate credit with external and domestic funding increased 2.3% and 7.6%, respectively, while individuals credit outstanding increased 2.5% in May.

40. The average interest rate on non-earmarked credit registered a decrease of 0.5 p.p. in May, reaching 44.2% p.a. The result was due to a decline of 0.9 p.p. in the average lending rates to individuals, to 62.4% p.a., while the average rate to companies presented a slight increase of 0.1p.p. to 30.0% p.a. The decrease in the average interest rate to individuals reflected mainly an increase of credit operations with payroll-deducted repayments.

41. Regarding delinquency in the retail sector, there was an increase of 11.6% in the number of cancelled files and stability in the number of new registers in May, compared to the previous month. As a consequence, the net default rate, measured by ACSP, decreased to 5.1% in May from 6.4% in April. The average default rate in the first 5 months of the year stood at 6.0%, 0.5 p.p. lower than the level observed in the same period of 2003.

External Environment

42. World economic growth has continued to gain momentum, despite the geopolitical risks. In Japan, GDP growth was revised upwards in the last two quarters. Meanwhile, other indicators have been confirming the economic rebound, mainly boosted by

the vigorous regional trade. In the U.S., the latest economic indicators have ratified economic expansion, particularly those related to the labor market. Recovery in Europe, however, has persisted sluggish.

43. Inflation concerns increased worldwide. The Bank of England has raised its basic interest rate by 0.25 p.p. for the second consecutive month, to 4.5% p.a. In the U.S., prices have been rising under control, reflecting mainly the impacts of energy prices. In China, the consumer price index increased again in May to 4.4% compared to the same month of 2003; authorities seem more worried about the effects of the vigorous economic growth over the price level.

44. Market volatility has decreased in the latest few weeks. However, adjustments in financial prices continue, anticipating the effects of the expected rise in the US fed funds and the measures adopted by the Chinese government to reduce the country growth pace. Markets have stabilized in emerging economies, giving way to a slight recovery of the stock markets and an appreciation of the currencies against the U.S. dollar. The dollar has continued to appreciate against strong currencies, in spite of the fiscal and trade deficits experienced by the U.S. economy.

45. Commodities prices fell in May, but the upward trend prevailing until the end of March has kept prices above their historical average. Oil price pressures continued up to the beginning of June, mainly as a result of political tensions in the Middle East and of high global demand. In order to+ help preventing prices from moving upwards, OPEC decided to increase production from July 1st by 2 million barrels/day, which may be supplemented by other 500 thousand barrels/day from August on.

Foreign Trade and Balance of Payments

46. The Brazilian trade balance posted a US$3.1 billion surplus in May, when the total external trade reached US$12.8 billion. Exports and imports increased 24.6% and 25.1%, respectively, compared to the May 2003 daily averages. In the first two weeks of June (8 working days), the trade surplus totaled US$1.3 billion, with exports and imports increasing by 44.9% and 48.6%, respectively, compared to the average figures of June 2003.

47. In May, the current account registered a US$1.4 billion surplus, accumulating a US$2.4 billion surplus in the year. In the period, the trade balance posted a US$11.2 billion surplus while the services and income account presented a US$10.2 billion deficit. Net FDI inflows reached US$207 million in May, accumulating US$3.3 billion in the year, equivalent to the amount registered in the same period of last year. At the end of May, international reserves reached US$50.5 billion, while net reserves stood at US$22.2 billion (IMF concept).

Money Market and Open Market Operations

48. Over the past weeks, there has been high volatility in the yield curves. From the last Copom meeting, the 3-month and 6-month rates have increased 0.21 p.p. and 0.11 p.p. respectively, influenced by the revision of inflation expectations. On the other hand, the 1-year and 2-year rates have decreased 0.16 p.p. and 0.62 p.p. respectively.

49. For the first time in the year, the BCB carried out an auction to rollover dollar-linked securities and swaps, maturing on June 17. In this event, US$326.6 million in swaps were contracted (33.2% of principal coming due), with tenures of 7 and 19 months. Including interests, the net redemption of these instruments in the year up to June amounted to US$18.4 billion.

50. Due to market volatility, the National Treasury did not carry out any selling auction of LTNs in the period. However, simultaneous buying and selling auctions were carried out on May 20 and 21, aiming at giving liquidity to these securities when prices presented more volatility. Three LFTs auctions were carried out totaling R$9.9 billion, maturing in 2005, 2006, and 2007. The issuance of National Treasury Notes – Series B and C (NTN-Bs and NTN-Cs) amounted to R$ 2.4 billion, R$1.4 billion of which settled in exchange for other National Treasury's securities.

51. The BCB maintained in its open market operations the weekly post-fixed repo operations (2-week tenure) and the fixed repo operations (3-month tenure), as well as the 2-working-day liquidity management operations. The BCB also carried out

in this period 13 fixed rate repos falling due between 1 and 4 working days. Due to the net redemption of securities, the excess liquidity drained from the market with operations shorter than 30 days and with 3-month tenure averaged R$59.4 billion and R$23.5 billion, respectively.

52. In May, the net securitized domestic public debt decreased R$19.3 billion due to the net redemption of R$31.1 billion of LFTs. The dollar-linked share increased 0.3 p.p. to 16.6%, as a result of the exchange rate depreciation and the net redemption of R$11 billion in Fx securities and swaps.

Minutes of the 98th Meeting of the Monetary Policy Committee (Copom)

Date: July 20th, from 4:45PM to 7:00PM, and July 21st, from 4:00PM to 6:15PM
Place: BCB's Headquarters meeting room of the 8th floor (on July 20th) and 20th floor (on July 21st) – 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 July 20th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves Operations Department
José Antônio 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 July 21st)
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on July 20th)
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo - Advisor to the Board
Hélio José Ferreira – Executive Secretary
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 June, the Broad National Consumer Price Index (IPCA) rose 0.71%, up from 0.51% in May, accumulating a 3.48% change in the first half of the year, and a 6.06% variation in twelve months. The monthly IPCA acceleration in June was mainly due to the increase in the prices of fuel and food.

2. The General Price Index (IGP-DI) rose 1.29% in June, compared to 1.46% in May, accumulating a 6.90% change in the first half of 2004. In June, the deceleration of the IGP-DI was a consequence of a lower increase in wholesale prices and in construction industry costs, while consumer-price inflation registered a slight increase. The Wholesale Price Index (IPA-DI) rose by 1.57% in the month and 8.38% in the first half of the year. Regarding 12-month rates, the IGP-DI and IPA-DI reached 10.13% and 11.76% in June, respectively.

3. The main individual contributor to the IPCA inflation was gasoline (0.14 p.p.), reflecting the pass-through to consumers of the gasoline price increase by distributors on June 15 (10.8%), and the 11.35% surge in alcohol-

based fuel prices. As a consequence, transportation prices increased 1.58% in June, contributing with 0.33 p.p. to the monthly IPCA change.

4. Food prices rose 0.72% and accounted for 0.17 p.p. of the June IPCA change. Climate adversities affected the supply of some products such as onions, tomatoes and vegetables. The inter-harvest period was responsible for the increase in the prices of milk and dairy products, such as cheese, yogurt and powdered milk.

5. Market prices increased 0.58%, compared to 0.57% in May, accounting for 0.42 p.p. of the monthly IPCA, while the increase of 1.03% in regulated prices was responsible for the remaining 0.29 p.p. The relative stability in market prices inflation was a consequence of the deceleration in non-food prices, which attenuated the impact of the acceleration in food prices. Concerning regulated prices, urban and interstate transport fares contributed to the surge, together with gasoline and alcohol-fuel prices.

6. In June, the IPA-DI grew 1.57% (1.71% in May). This reduction was a consequence of the deceleration of agriculture wholesale inflation, which rose 0.52% in June compared to 2.71% in May. In the same period, industrial wholesale inflation increased to 1.97% from 1.32%, mainly pressured by the price readjustment of fuel and fertilizers, which caused an increase of 5.37% in chemical prices, compared to 1.72% in May.

7. The IPCA core inflation, calculated by excluding household food items and regulated prices, registered a 0.53% variation in June (0.70% in May), accumulating 7.17% in 12 months.

8. The IPCA core inflation, calculated under the smoothed trimmed-mean method, increased to 0.60% in June from 0.59% in May, totaling 8.16% in the last 12 months to June. Without the smoothing procedure for pre-selected items, the core IPCA recorded 0.48% in June and 5.56% in twelve months, compared to 0.43% and 5.46% rates in May.

9. The Consumer Price Inflation - Brazil (IPC-Br) core, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed-mean method, stood at 0.50% in June, compared to 0.57% in May, accumulating 6.39% in the last twelve months.

10. In July, consumer inflation should be affected by the readjustment in regulated prices (electricity, gasoline, alcohol-fuel, fixed telephone and urban bus in Rio de Janeiro). Among market prices, food is expected to continue affecting inflation, especially meat and dairy products, still pressured by the inter-harvest period. Moreover, due to seasonal reasons, school vacation time is expected to raise entertainment prices. Regarding wholesale inflation, pressures over the prices of animals and by-products, fuels and fertilizers are expected to continue. These pressures should be partially offset by the deceleration of other industrial prices.

Assessment of Inflation Trends

11. 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 Copom’s projection for the increase of oil prices in 2004 was maintained at 9.5%. The projection for the increase of cooking gas prices was slightly reduced to 6.8% from 6.9%;

b. The projections for the readjustment of household electricity prices in 2004 increased to 11.6% from 11.0% in the previous Copom meeting. Regarding fixed telephone services, the Copom revised its estimate for the annual adjustment to 12.8% from 6.1%. This revision follows the Supreme Judicial Court decision to reinstate the IGP-DI index instead of the IPCA index for purposes of the annual adjustment in 2003, overturning a lower court ruling;

c. Regarding all regulated prices, with a total weight of 28.6% in the June IPCA, a 8.3% rise is projected, 0.6 p.p. above the projection made in the previous meeting;

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

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 51 basis points in the second quarter of 2004 to 58 basis points in the fourth quarter of 2005.

12. 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.

13. Considering the benchmark scenario hypotheses, including the maintenance of the Over-Selic interest rate at 16.0% p.a. and of the exchange rate close to the level prevailing on the eve of the Copom meeting (R$3.00), IPCA inflation was projected above the 5.5% target for 2004 and slightly above the 4.5% target for 2005. According to the market scenario, which takes into consideration the consensus Over-Selic rate and exchange rate as surveyed by the BCB's Investor Relations Group - Gerin on the eve of the Copom meeting, inflation is projected above the targets for both 2004 and 2005.

Monetary Policy Decision

14. In June, market prices inflation registered the highest rate for the month in the last several years. From February to May, market prices increased systematically above regulated prices, accumulating 2.42% against 0.86% of the regulated. In June, however, inflation was pressured not only by market prices (up 0.58%) but also by regulated prices (up 1.03%, partly due to the rise in gasoline prices), thus resulting in the 0.71% IPCA variation for the month. In the first half of the year, market prices surged 3.77%, equivalent to a 7.69% annualized rate. Other nationwide consumer-inflation indices also posted high changes in the last two months, as in the case of the IPC-DI (0.71% and 0.78% in May and June, respectively). The IPA-DI has also recorded high changes throughout this year, mainly pressured by industrial prices, up 9.96% in the January to June period.

15. IPCA trimmed-mean core measures have stood relatively stable in the past few months, albeit at figures incompatible with the medium-term inflation targets. In the first half of the year, the smoothed and non-smoothed trimmed-mean cores posted 3.79% and 2.96%, respectively, or annual figures of 7.72% and 6.00%, respectively. Core inflation excluding household food items and regulated prices stood at 4.52% in the same period (9.24% in annual terms), well above the 3.48% headline inflation.

16. Economic activity has continued to present a vigorous growth rate, outstripping every month the growth rate projected at the end of 2003. Several leading and coincident indicators anticipate continuous growth for the near future. For instance, packaging paper shipments, which have been growing since the second half of 2003, rose 1.5% in June compared to May (data from the Corrugated Paperboard Association - ABPO, seasonally adjusted by the BCB).

17. In May, industrial production posted a historical high, overcoming the previous peak of November 2003. Industrial production grew 2.2% month-on-month, seasonally adjusted, and 7.8% compared to May 2003, the eighth consecutive positive year-on-year rate. In the January-May period, industrial output increased 6.5% compared to the same period of last year. Real industrial sales increased 3.0% in May compared to April, reaching the highest figure ever recorded for the series, which began to be released in December 1991 (data from the National Industry Confederation - CNI, seasonally adjusted by the BCB).

18. Retail sales have also kept its growth trend initiated in the second half of 2003. Similarly to the industrial output, sales have also overcome historical records. After reaching the highest figure for the index in April, sales grew 0.7% month-on-month in May, seasonally adjusted, a 10.0% increase compared to the same month of the previous year. Sales expansion comprises almost all retail sectors, not only the ones more credit-sensitive but also the ones that respond to the evolution of real earnings. In July, consumer confidence measured by the *Federação do Comércio do Estado de São Paulo* (Fecomercio-SP) increased 4.9% compared to June.

19. The economic activity rebound has caused an increase in the manufacturing industry level of capacity utilization, which reached record highs for the recent years. According to data seasonally adjusted by the BCB, the quarterly FGV industrial

survey reported a capacity utilization of 81.9% in April (the highest rate in the last three years), while the monthly CNI survey recorded 81.8% in May (the second highest level of the series since December 1991). The marginal production growth deserves special attention, considering that it has been increasing continuously for the last months, suggesting a faster occupation of the existing idle capacity.

20. Conversely, capital goods sector has presented the highest growth rates amongst the industrial sectors. In the year up to May, capital goods output grew 22.5% compared the same period of 2003. Capital goods absorption (domestic production plus net imports) grew 11.4% in the same period. In such an environment, which combines fast demand growth with the recovery of fixed capital investment, the estimate of the output gap, crucial to evaluate inflationary pressures, becomes more uncertain. As stressed in the June *Inflation Report*, there is strong evidence that the capacity utilization is heterogeneously distributed among the different productive sectors, making it important to maintain a favorable environment for fixed capital investment, mainly on those sectors with lower idle capacity, thus enabling output to increase without causing inflationary pressures.

21. Although external demand has played a paramount role to the initial cyclical rebound, domestic demand has been increasingly important. This is not unexpected, considering the relatively small share of the external sector on the Brazilian GDP. There are two major factors behind the increase in domestic demand: credit expansion and the recovery of the labor market. According to data produced by CNI, seasonally adjusted by the BCB, employment in the manufacturing sector, after recording in February the highest level of the series since the end of 1998, still presented continuous growth in the following three months (0.3% in May, compared to April). A similar trend has also been observed for real payroll, which attained levels equivalent to those verified in the first half of 2001. In June, according to the Ministry of Labor and Employment, formal employment increased again, accumulating a growth rate of 3.9% in the first half of 2004, compared to the same period of 2003, which corresponds to the creation of 1 million jobs, the highest job creation in the first half of any year.

22. In the June minutes, the Copom emphasized some reasons why the current economic recovery lagged its effects on the urban unemployment rate estimated by the Brazilian Institute of Geography and Statistics (IBGE). Those reasons include the unemployment rate seasonal behavior, the labor force increase and the higher expansion of employment out of the largest urban areas. However, in May these factors were offset by other factors that caused the reduction in the unemployment rate, to 12.2% from 13.1% in April.

23. The Brazilian external sector has continued to post sizeable results. The trade balance registered a US$3.8 billion surplus in June, a new historical high, accumulating a US$15.0 billion surplus in the first half of the year. Both marginal exports and imports have grown significantly. The BCB's trade balance projection remains at a high level (US$ 26 billion in 2004), despite the economic activity rebound. As to the current account, the first half of 2004 surplus reached US$2.5 billion.

24. The external scenario has improved since the last Copom meeting, although some tension has persisted, mainly due to new hikes in oil prices. The pressures on the exchange rate and the country risk have subdued. As a consequence, the exchange rate has appreciated to R$3.00/US$ from R$3.16/US$, with reduced volatility, and the country risk measured by the JP Morgan Chase's Embi+ decreased to 587 b.p. from 705 b.p. On the other hand, the Brent oil price, after falling in June, increased 12.8%. Even considering a more favorable outlook in the last few weeks due to a less uncertain monetary policy in the U.S., the scenario is not completely consolidated, indicating that new episodes of volatility might occur in the future.

25. The deterioration of market inflation expectations, initiated in May, has continued in July, especially for 2004. The median market expectations for IPCA for this year rose to 7.10% from 6.71%, and for 2005, to 5.5% from 5.44%. Inflation expectations for the next twelve months increased to 6.27% from 6.03%.

26. Despite the recent exchange rate appreciation, the deterioration of inflation expectations, the higher-than-expected June inflation and the increase in the expected annual adjustment of fixed telephone services explain

the increase in the Copom's inflation projections for 2004 and 2005. The benchmark scenario projections, based on unchanged Over-Selic and exchange rates throughout the projection horizon, point out to an inflation rate above the 5.5% target for 2004 and slightly above the 4.5% target for 2005. The market scenario, which takes into account the consensus Over-Selic and exchange rates on the eve of the Copom meeting, projects inflation rates above the ones of the benchmark scenario (i.e., above the targets for 2004 and 2005). The Committee also assessed a third hybrid scenario, considering the market exchange rate expectations and an unchanged Over-Selic rate, coming to an inflation projection that stands between the inflation outcomes estimated on the two usual scenarios.

27. As in previous meetings, the Committee 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 in which inflation will be more sensitive to monetary decisions taken in the next few months, and at the same time, it presents more reliable inflation projections than the ones for the full 2005. The projected inflation for this 12-month period, both on the benchmark and market scenarios, stood slightly above the interval between the central inflation targets for 2004 and 2005.

28. As highlighted in previous Copom's minutes, the unstable external scenario has generated a short-term volatility that tends to broaden the uncertainty about the future behavior of inflation. On the one hand, this uncertainty has diminished in the last weeks. On the other hand, several other factors were responsible for the deterioration of the Copom's inflation projections since the last meeting, despite the exchange rate appreciation in the period. Those factors include the increase of the private-sector inflation expectations, the upward review of fixed telephone tariffs and the acceleration of the economic activity pace.

29. Regarding economic activity, although fixed capital investment has been recovering, the level of capacity utilization has also increased, reaching historical highs. The fast increase in aggregate demand and in fixed capital investment have generated higher uncertainty about the capacity to expand the supply of goods and services without triggering inflationary pressures. Even considering that monetary policy must be oriented to accommodate the primary effects of supply shocks as those recently observed, it is important to avoid the secondary effects of inflation increases, containing the upward revision of inflation expectations. In addition, it is also essential to carefully evaluate the current and future supply and demand conditions of the economy.

30. The Committee's members believe that the maintenance of the current Over-Selic rate for a long period should consolidate a favorable inflation scenario, with the convergence of market inflation expectations and the actual inflation rate to the inflation targets. However, the monetary authority restates that a more active policy stance will be adopted if the projected inflation deviates from the targets, due to an eventual deterioration of the factors that were responsible for the recent increase in inflation projections for 2004 and 2005.

31. Even with a deteriorated inflationary environment, and the respective change in the required monetary policy stance, there are no reasons to review economic growth expectations. Indeed, by fighting the second-order effects of the shocks recently observed, the monetary policy is aimed at preserving the medium-term sustainable growth, promoting the balance between the aggregate demand expansion and the broadening of the productive capacity of the economy.

32. Considering the reasons stated above, the Committee decided, unanimously, to maintain the target for the Over-Selic rate at 16.0% p.a., without bias.

33. At the closing of the meeting, it was announced that the Copom would meet again on August 17, for technical presentations, and on the following day 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. According to IBGE's retail survey, sales increased 10.0% in May, compared to the same month of 2003. In the year up to May, retail sales and the retail nominal revenue increased 8.5% and 9.8%,

respectively, compared to the same period of 2003. The regional distribution of growth was generalized, encompassing all States in the country, except Roraima. All groups encompassing the retail sector showed year-on-year growth in May, with highlights to furniture and electrical appliances.

35. The São Paulo Trade Association (ACSP) data for June registered a 0.2% increase in credit retail sales, while the Usecheque system consultations decreased 2.2%, both compared to May and seasonally adjusted. In the first half of 2004, the same indicators rose by 7.0% and 1.2%, respectively.

36. The Fecomercio-SP consumer sentiment survey showed that confidence improved in July, after falling in June. In the month, the Consumer Confidence Index (ICC) increased 0.9%, standing at 118.7 points (range 0 to 200).

37. Regarding fixed capital investment, capital goods output and construction inputs continued to grow in May, accumulating year-on-year expansions of 22.5% and of 1.8%, respectively. Domestic capital goods absorption increased 11.4% in the same comparison basis. The National Bank for Economic and Social Development (BNDES) credit operations increased 47.7% in the first half of 2004. Credit operation to the industrial sector (about 41% of the total credit outstanding) expanded by 27.7%, while credit to commerce and services sector increased by 52.8%, and credit to agriculture sector increased 101.3%.

38. The IBGE's monthly industrial survey registered a 2.2% increase in industrial output in May, compared to April, seasonally adjusted. The manufacturing industry expanded 2.4%, while mining activity remained stable. Out of the 23 activities surveyed, 18 increased output, and all categories of use expanded. In the year up to May, industrial output increased 6.5%, compared to the same period of 2003, with output expansion in 22 out of the 26 activities and in all use categories, with highlights to the activities benefited from the favorable performance of the exports and agribusiness sectors, as well as from credit expansion. The recovery of semi and non-durable goods production, albeit less intense, have increased in tandem with the gradual improvement of domestic demand.

39. In May, the CNI recorded a 3.0% increase in real industrial sales and a 1.3% increase in industrial worked hours, in comparison to April, seasonally adjusted. Compared to the same month in 2003, real sales and worked hours increased 20.3% and 3.8%, respectively. The level of capacity utilization reached 81.8%, with a 0.8% monthly increase, seasonally adjusted, and a 1.6% growth in the yearly average up to May, compared to the same period of 2003.

40. In June, already published indicators point to a continued expansion in industrial output. Steel output grew 2.5%, seasonally adjusted, accumulating a 5.4% growth in the first half of the year. The car industry produced 187 thousand vehicles, up 4.5% compared to May (seasonally adjusted), and 27.7% above June 2003. In the first half of 2004, car production increased 14.8%, while domestic sales and exports expanded 20.7% and 3.8%, respectively, compared to the same period of last year.

Labor Market

41. The seasonally adjusted formal employment index increased 0.5% in June, compared to May, and 4.8% compared to June 2003, according to the Ministry of Labor and Employment. In the first half of the year, a 3.9% expansion was recorded, corresponding to the creation of more than 1 million jobs.

42. According to the IBGE, the unemployment rate in the six main metropolitan areas of the country declined to 12.2% in May from 13.1% in April. The number of employed workers increased 0.8%, the highest change in the year, while the number of unemployed workers declined 6.7%. The estimated labor force totaled 21.5 million people, with a decline of 0.2%. The same survey registered that the average real earning (deflated by the INPC) in May was 1.4% below the one in May 2003. Real payroll, however, grew 1.5% in the month, year-on-year, reflecting the employment growth.

43. According to CNI seasonally adjusted data, real payroll and employed workers increased 0.2% and 0.3% in May, respectively, compared to April. In the year up to May, real payroll and employed workers increased 7.5% and 0.7%, respectively, compared to the same period of 2003.

Credit and Delinquency Rates

44. Non-earmarked credit operations grew 1.5% in June. Corporate credit with domestic funding increased 3.9%, while credit with external funding decreased 2.6%. Individuals credit outstanding increased 1.8% in June, accumulating a 21.9% rise in twelve months.

45. The average interest rate on non-earmarked credit decreased 0.2 p.p. in June to 44% p.a. The result was due to a decline of 0.3 p.p. in the average lending rates to companies, which fell to 29.7% p.a., while the average rate to individuals remained stable at 62.4% p.a.

46. Regarding delinquency in the retail sector, the net default rate measured by ACSP decreased to 4.3% in June, the lowest level in the year. In the year up to June, the number of cancelled files and new negative files increased 10.2% and 6.5%, respectively. The number of checks returned in comparison to the total number of checks decreased to 5.1% in June, the lowest level of the year.

External Environment

47. World economic growth continued to gain momentum at the end of the first half of 2004. In Japan, the economy has firmly recovered, mainly boosted by the vigorous regional trade, with improvements in the corporate sector transmitted to consumers. Economic recovery in Europe is still slow, while in the U.S. the economy has expanded at a moderate pace, reinforcing expectations of a gradual monetary policy adjustment. Consumers' and producers' inflation showed declines in June in the main industrialized economies.

48. In June, the U.S. industrial production declined 0.3%, the sharpest fall since April 2003 and immediately after a 0.9% increase in May. The capacity utilization level decreased to 77.2% compared to 77.6% in May. The manufacturing activity registered its first monthly decline in thirteen months. There was also a decline in retail sales, the highest in eighteen months, mainly due to a decrease of 4.3% in vehicles sales.

49. Further to the U.S. economy, labor market registered an increase of 112 thousand jobs in June, against the average of 300 thousand in the previous three months. However, the number of new unemployment claims has stood below 350 thousand since March, which is historically consistent with the creation of around 200 thousand new jobs. The trade balance registered a lower-than-expected US$46 billion deficit in May, a trend explained by the dollar depreciation, with exports and imports increasing 4.2% and 0.5%, respectively. The federal government registered a US$19.1 billion budget surplus in June, accumulating a US$326.6 billion deficit in the fiscal year to June.

50. Regarding business confidence, the services BAI index in the U.S. declined in June. In Japan, the Tankan indicator increased for the fifth consecutive month, registering a record high since 1991. In Europe, business confidence remained flat, although consumer confidence increased. The US consumer confidence increased in June to 101.9, after remaining nearly unchanged at 93.1 in the previous month. In Japan, consumer confidence also rose significantly.

51. After the FOMC's decision to increase the fed funds rate in 25 b.p. at the end of June, the markets reacted positively, with some volatility in the stock market due to the release of corporate balances. The main commodity prices registered some accommodation in the international market, but still remaining above historical averages. Oil prices have maintained an upward trend, influenced by new attacks to Iraq oil pipelines and by the problems faced by the Russian oil company Yukos.

52. In China, the 9.6% annual growth in the second quarter, although expressive, was below the expected 10% rate. The monetary and credit measures adopted by the Chinese government have been limiting investment in the most dynamic sectors, aiming at controlling inflationary pressures. Consumer prices increased 5.0% in June compared to the same month of 2003, and producer prices grew 6.4% in the same comparison basis.

Foreign Trade and Balance of Payments

53. The Brazilian trade balance posted a US$3.8 billion surplus in June and the external trade totaled US$14.8 billion. Exports and imports increased 51.2%

and 49.2%, respectively, compared to June 2003 daily averages. In the first three weeks of July (12 working days), the Brazilian trade surplus totaled US$1.7 billion, an increase of 47.2% and 42.5% in exports and imports, respectively, compared to the average figures of July 2003.

54. In June, the current account registered a US$2.1 billion surplus, accumulating a US$4.4 billion surplus in the year. In the first half of the year, the trade balance and the current transfers posted US$15.0 billion and US$1.6 billion surpluses, respectively, while the services and income account posted a US$12.2 billion deficit. Net Foreign Direct Investment reached US$737 million in June, accumulating US$4.0 billion in the first half of the year. In the same period, external direct loans and private securities rollover rates reached 136% and 64%, respectively. At the end of June, international reserves stood at US$49.8 billion, while net reserves stood at US$22.8 billion (IMF concept).

Money Market and Open Market Operations

55. The improvement in the external environment after the June Copom's meeting influenced the domestic yield curve. From June 16 to July 21, the spread on the 6-month rate in relation to the Over-Selic rate decreased to 0.78 p.p. from 1.06 p.p.; the spread on the 1-year rate decreased to 1.25 p.p. from 2.01 p.p.; and the spread on the 2-year rate decreased to 1.95 p.p. from 2.98 p.p. As a consequence, the real interest rate measured by ratio of the one-year nominal interest rate to the 12-months-ahead inflation expectations declined to 10.1%.

56. In the period between the last Copom meetings, the BCB carried out an auction to rollover Fx swaps. In this auction, US$673.6 million in swaps were contracted (27% of the principal coming due on July 1st), with tenures of 6 and 24 months. The BCB decided not to rollover the maturing of around US$1 billion on July 15, due to the low demand for Fx hedge. Therefore, the net redemption of Fx linked securities and swaps will total US$3.6 billion at the end of July and US$22.0 billion in the year to July.

57. Due to lessened market volatility, the National Treasury resumed LTNs placements, carrying out five offerings of securities maturing in January and July 2005, totaling R$12.1 billion. Five LFTs auctions were also carried out, totaling R$17.6 billion maturing in 2005, 2006 and 2007. The issuance of National Treasury Notes – Series B and C (NTN-Bs and NTN-Cs) amounted R$ 2.5 billion, R$1.1 billion of which settled in currency and the rest settled in exchange for other National Treasury's securities.

58. The BCB maintained in its open market operations the weekly post-fixed repo operations (2-week tenure) and the fixed repo operations (3-month tenure), as well as the 2-working-day liquidity management operations. The BCB also carried out in this period 16 fixed rate repos falling due between 1 and 2 working days. In the period, the excess liquidity drained from the market with operations shorter than 30 days and with 3-month tenure averaged R$55.2 billion and R$34.2 billion, respectively.

59. In June, the net securitized domestic public debt increased R$9.8 billion due to interest rates accrual. The dollar-linked share decreased to 16.6%, which represented a fall of 0.8 p.p. in the month and 6.3 p.p. in 2004.

Minutes of the 99th Meeting of the Monetary Policy Committee (Copom)

Date: August 17th, from 4:45PM to 7:00PM, and August 18th, from 3:45PM to 6:25PM
Place: BCB's Headquarters meeting room of the 8th floor (on August 17th) and 20th floor (on August 18th) – 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
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

Department Heads (present on August 17th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves Operations Department
José Antônio 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 August 18th)
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on August 17th)
Eduardo Fernandes – Advisor to the Board
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 July, the Broad National Consumer Price Index (IPCA) rose 0.91%, up from 0.71% in June and 0.51% in May. The IPCA accumulates a 4.42% change in the first seven months of the year, and a 6.81% variation in twelve months. The IPCA rise in July can be ascribed to the increase in specific regulated prices. Some important components of the IPCA in fact decelerated, as in the case of food.

2. The General Price Index (IGP-DI) rose 1.14% in July, compared to 1.29% in June, thus accumulating an 8.11% change in the first seven months of 2004. The deceleration of the IGP-DI in July was due to lower pressures at both the wholesale and the consumer levels. The Wholesale Price Index (IPA-DI), which accounts for 60% of the General Index, rose by 1.35%, down from 1.57% in June. The Consumer Price Index – Brazil (IPC-Br) rose by 0.59%, compared to 0.78% in the previous month. Finally, the National Index of Civil Construction (INCC), with a 10% weight in the IGP-DI, rose by 1.12%, up from 0.70% in June.

3. The main individual contributions to the July IPCA inflation was electricity (0.17 p.p.) and fixed telephone tariffs (0.16 p.p.). Auto-fuel contributed with 0.12 p.p., partially reflecting the 10.8% gasoline price increase to distributors on June 15, as well as the rise in alcohol-based fuel prices. Food prices rose 0.67% (0.72% in June), accounting for 0.15 p.p. of the monthly IPCA change. The inter-harvest period was responsible for specific pressures on the prices of milk and dairy products. Potatoes, sugar, black beans, wheat flour and bread also suffered price increases, while soy oil, vegetables, *carioca* beans and rice prices fell.

4. In July, market prices increased 0.52% (0.58% in June), accounting for 0.37 p.p. of the monthly IPCA variation, while the increase of 1.89% in regulated prices was responsible for the remaining 0.54 p.p. The deceleration of market prices inflation was

disseminated in both food and non-food prices. In fact, 50.3% of the goods and services included in the IPCA basket increased at a lower monthly rate in July, compared with 43.2% in June. Regarding regulated prices, besides gasoline, alcohol-fuel, electricity and fixed telephone prices, road tolls and urban and interstate buses fares also contributed to the rise.

5. The IPA-DI deceleration in July reflected lower rises in both agricultural and industrial prices. The Agriculture-IPA changed 0.26% in July (0.52% in June). This reduction was a consequence of the decrease in prices of cereals and export-oriented crops, as well as lower pressures from the prices of animals and by-products, vegetables, fruit and vegetal oils. In the same period, the industry-IPA decreased to 1.76% from 1.97%, mainly due to the deceleration of chemical prices (to 2.96% from 5.37% in June). Other segments that registered lower changes in July, compared to June, include mechanical, electrical material, leather, personal care, and tobacco.

6. In July, the IPCA core inflation, measured by excluding household food items and regulated prices, registered a 0.47% variation (0.53% in June), accumulating 5.02% in the year and 7.27% in 12 months. The smoothed trimmed-mean core decreased to 0.55% from 0.60% in June, totaling 4.36% in the year and 8.05% in the last 12 months. Without the smoothing procedure for pre-selected items, the core recorded 0.59% (0.48% in June), 3.56% in the year and 5.76% in twelve months.

7. The IPC-Br core, calculated by the Getulio Vargas Foundation (FGV) under the symmetric trimmed-mean method, stood at 0.36% in July (0.50% in June), accumulating 6.21% in the last twelve months.

8. In August, consumer-prices inflation should fall, mainly due to lower regulated-prices inflation. Regarding wholesale inflation, a deceleration is also expected as anticipated by the results of the IGP-10 and the first ten-day period of the IGP-M, notwithstanding the continuity of specific adjustments due to increases in international commodity prices.

Assessment of Inflation Trends

9. 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 Copom’s projection for the increases of oil and of cooking gas prices in 2004 were maintained at 9.5% and 6.8%, respectively;

b. The projections for the readjustment of household electricity prices and fixed telephone tariffs in 2004 were also unchanged at 11.6% and 12.8%, respectively;

c. Regarding all regulated prices, with a total weight of 28.7% in the July IPCA, the Copom maintained the projection of an 8.3% average rise for 2004;

d. The projection for the readjustment of all regulated prices for 2005, following the model of endogenous determination, which takes into account seasonal components, the exchange rate, market prices inflation and the IGP-DI change, was increased to 6.3% from 6.0%;

e. The projection for the 6-month spread over the Over-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, decreases from 88 basis points in the third quarter of 2004 to 61 basis points in the fourth quarter of 2005.

10. 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 Copom meeting were maintained.

11. Considering the benchmark scenario hypotheses, including the maintenance of the Over-Selic rate at 16.0% p.a. and of the exchange rate close to the level prevailing on the eve of the Copom meeting (R$3.00), the IPCA inflation was projected above the 5.5% target for 2004 and above the 4.5% target for 2005. According to the market scenario, which takes into consideration the consensus Over-Selic rate and the exchange rate as surveyed by the BCB’s Investor Relations Group -– Gerin on the eve of the Copom meeting, inflation is projected above the targets for both 2004 and 2005.

Monetary Policy Decision

12. In July, the IPCA inflation acceleration was strongly influenced by the 1.89% increase in regulated prices. Market prices inflation remained high (0.52%), albeit slightly lower than in June (0.58%). Regulated prices have accumulated a 4.69% increase in the first seven months of 2004, compared to 4.42% in the IPCA, thus reverting the trend observed up to June, when market prices changes systemically surpassed regulated prices variations. As to the wholesale inflation, there has been some deceleration since June, both in the agricultural and industrial segments, even though it has remained high. The IPA-DI increased 1.35%, accumulating 9.84% in the year.

13. The smoothed trimmed-mean core IPCA stood at 0.55% in July. Although this has been the lowest rate since February 2004, it is incompatible with the medium-term inflation targets. The non-smoothed trimmed-mean core posted 0.59%, for the first time since February 2003above the smoothed trimmed-mean core. In the first seven months of the year, the smoothed and non-smoothed trimmed-mean cores registered 4.36% and 3.56%, respectively, equivalent to annualized figures of 7.59% and 6.19%. Core inflation excluding household food items and regulated prices stood at 0.47% in July, the lowest rate in the year. However, the core by exclusion accumulated in the January-July period (5.01%) is well above the headline inflation.

14. Economic activity has continued to grow vigorously, as proved by different production, sales and employment indicators. According to the Brazilian Institute of Geography and Statistics – IBGE, industrial output grew 7.7% in the first half of the year, compared to the same period of 2003. In monthly terms, industrial production grew 0.5% in June (seasonally adjusted), reaching a new historical high, approximately 12% above the recent trough observed in June 2003. Several leading and coincident indicators suggest that the industrial rebound gained momentum in July, as signaled by the shipments of packaging paper (up 3.4% compared to June, s.a.) and by the production of vehicles (up 5.2%, same comparison basis).

15. According to the National Industry Confederation – CNI, industrial sales rose by 16.8% in the first half of the year, compared to the same period of 2003. In June, industrial sales increased 1.2%, s.a., compared to the previous historical high in May. The CNI data have continued to point out a higher growth pace for industrial sales than for industrial production.

16. According to the IBGE, retail sales have also expanded, not only in nominal terms (up 10.92% in the first half of the year, compared to the same period of 2003) but also in volume (up 9.33%). These are the highest growth rates for retail sales since 2001. According to the National Association of Autovehicles Manufacturers – Anfavea, domestic car sales increased 3.2% in July, month-on-month seasonally adjusted, and 21.4% in the January-July period, compared to the same period of 2003.

17. The labor market has benefited from the activity rebound. According to the IBGE, the unemployment rate fell in June for the second consecutive month, to 11.7%. Data from CNI and from the Federation of Industries of São Paulo State – Fiesp confirm a continuous expansion in the level of employment and in the real payroll in the manufacturing industry. According to CNI, real payroll grew 7.8% in the first half of the year. The level of formal employment, according to the Ministry of Labor and Employment, surged 0.5% in June, with more than 1 million jobs created in the first half of the year.

18. As a natural consequence of what has been occurring in the labor market, the recovery process disseminated, reaching not only the credit-sensitive and exports-oriented activities, but also activities dependent on labor market conditions. According to the IBGE, sales in supermarkets, hypermarkets, food, beverages and tobacco rose by 2.8% in the second quarter (seasonally adjusted) and accumulated a 5.4% expansion in the first half of the year, compared to the same period of 2003. In the same comparison basis, sales of fabrics, clothing and shoes increased 3.1% and 7.3%, respectively. Non-durable goods output has also been reacting to the increase in demand and grew 2.1% in the first half of the year, compared to the same period of 2003. In other words, different indicators demonstrate that the activity level is now less supported by the monetary stimulus that triggered the recovery and more dependent on the

labor market, as well as on gains in real earnings ensured by the reduction of inflation.

19. Meanwhile, the sectors more sensitive to credit conditions, that have led the economic rebound, have not yet shown any accommodation in the growth pace. According to the IBGE, furniture and appliances sales increased 9.4% in the second quarter (quarter-on-quarter, s.a.), following a 7.2% expansion in the first quarter of the year. Cars and autoparts sales rose by 6.3% against –0.3% in the same periods. The same trend is noticed for durable consumer goods, whose growth rate increased to 7.2% in the second quarter of this year.

20. The quarterly FGV industrial survey reported a capacity utilization of 84.1% in July, s.a., close to the 85.2% historical peak reached in the first quarter of 1995. The level of idle capacity varied heterogeneously among the sectors. From July 2003 to July 2004, capital goods industry increased its capacity utilization to 82.0% from 71.6%, approaching its historical peak of 84.7%. Consumer goods industry performed similarly, raising its capacity utilization to 83.9% from 76.0%, compared to a historical peak of 87.8%. On the other hand, capacity utilization in the intermediate goods industry remained flat in the period, in the range between the average and the historical peak, an interval much narrower than in other sectors. The heterogeneity is even clearer when the data are disaggregated by industrial subsector, with some subsectors close to historical highs and some others that have not yet reached their average levels (the series starts in 1990).

21. Capital goods absorption (domestic production plus net imports) has continued its expansionary trend. Comparing the first half of the year with the same period of 2003, capital goods absorption grew 13.8%. The consolidation of this trend is crucial for the economy to broaden its growth potential. At this stage, however, it is particularly difficult to project the output gap, in an environment of a sharp expansion of demand, as has been observed in the last few quarters.

22. Exports, which are still expanding at a fast pace, accumulated a 34% increase in the first half of the year, compared to the first half of 2003. In the same period, total imports grew 27% and non-oil imports grew 23%, reflecting the strong recovery of domestic demand. The trade balance accumulated a US$18.5 billion surplus in the first seven months of the year, while the current account registered a US$6.2 billion surplus in the same period. Evidence that the U.S. economy may be growing below what was previously expected, with weaker inflationary pressures, lessened the risk of a faster monetary tightening by the Federal Reserve. As a consequence, market volatility has diminished in the last few weeks, what contributed to the maintenance of the Brazilian sovereign risk below 600 basis points. The exchange rate oscillated around the July average (R$3.04/US$), appreciating to around R$3.00/US$ on the eve of the Copom meeting.

23. Oil prices are the main concern in the external front. The recent trend reinforces the fears that oil prices may reach and persist for a longer period of time at higher levels than the ones recently considered as the most likely scenario, even if some reversion in relation to the recent hikes occurs. The Copom’s projection for the increase of gasoline prices in 2004 was maintained at 9.5%, which is enough to eliminate the gap between domestic and international prices, considering crude oil at around US$35 per barrel. This benign scenario has been sustained due to the diagnosis that part of the recent volatility in oil prices is due to speculative factors that may dissipate, even in the presence of some geopolitical risks. However, since the last Copom meeting, the balance of risks regarding oil prices increased. These risks may cause a higher-than-expected increase in gasoline prices in 2004, or a greater lag between domestic and international prices to be corrected in 2005. Moreover, regardless of the evolution of domestic gasoline prices, the increase in international oil prices is transmitted to the domestic economy, partly through the intermediate productive chains, such as the petrochemical, and also through the deterioration in inflation expectations of the private sector.

24. The deterioration of market inflation expectations for 2004, initiated in May, has continued since the last Copom meeting. The median IPCA expectation increased to 7.18% from 7.10%. The median expectation for the next twelve months decreased to 6.22% from 6.27%, and the main reason why this happened lies in the fact that the inflation

expectation for July 2005 was lower than the one for July 2004. The median of inflation expectations for 2005 remained steady at 5.50%, albeit the mean and the standard deviation of the surveyed sample increased somewhat, a clear evidence of a more pessimistic sentiment of the private sector regarding the 2005 inflation.

25. The Copom's inflation projections, both in the benchmark and in the market scenarios, have slightly increased compared to last month. The impact caused by the combination of higher market inflation expectations for 2004 and the increase in projected regulated prices in 2005, to 6.3% from 6.0%, more than offset the effect on the inflation projections caused by the increase in the yield curve. The benchmark scenario projections, based on unchanged Over-Selic and exchange rates throughout the projection horizon (at 16% p.a. and R$3.00/US$, respectively), point out to an inflation rate above the 5.5% target for 2004 and above the 4.5% target for 2005. It should be stressed that the projected deviation in relation to the 2005 target is much lower than the one projected for 2004. The market scenario, which takes into account the consensus Over-Selic and exchange rates on the eve of the Copom meeting, projects inflation rates above the ones of the benchmark scenario (i.e., above the targets for 2004 and 2005), since it considers a reduction of the Over-Selic rate and a more depreciated exchange rate. The Copom also assessed a third hybrid scenario, considering an unchanged Over-Selic rate and the exchange rate path expected by the market. Compared to the market scenario, inflation projections were identical for 2004 and slightly below for 2005.

26. As in previous meetings, the Committee also analyzed the inflation projections for the next 12 months, corresponding to the second half of 2004 and the first half of 2005. The projected inflation for this period, both in the benchmark and market scenarios, stood above the interval between the central inflation targets for 2004 and 2005.

27. The strong and continuous economic rebound, which already reaches historical highs, requires extra caution in the conduct of monetary policy, aimed at preserving the balance between aggregate supply and demand. The level of capacity utilization has rapidly increased, approaching historical records in some sectors. Recent data for capital goods domestic absorption and for civil construction activity indicate that fixed capital investment is recovering. However, during periods of reversion in the economic activity cycle, in which fast expansion follow the slow and erratic growth pattern of the last few years, it is natural to have a high degree of uncertainty regarding the speed of growth of the productive capacity in sectors whose current levels of capacity utilization are already high, and also regarding the potential growth trend. In this scenario, with the fast increase in aggregate demand, it is fundamental to carefully assess the risk of an eventual narrowing of the output gap.

28. In the previous Copom´s meetings, the Committee´s members stressed that the maintenance of the current Over-Selic rate for a long period would consolidate a favorable inflation scenario, with the convergence of the actual inflation rate to the inflation targets. However, the monetary authority admitted that a more active policy stance could be adopted if inflation projections deviated from the targets, due to an eventual deterioration of the underlying factors that led to the increase in inflation projections. The Committee´s members understand that since the last meeting two factors enhanced the risks that could jeopardize the accomplishment of the inflation targets. The first one is the increase in oil prices. The possibility of a higher and longer rise in oil prices than previously projected, not accompanied by an adjustment of the monetary policy, could produce second-order effects incompatible with the inflation-targeting regime. The second factor, partially a consequence of the increase in oil prices, is the deterioration of inflation expectations for 2005, which had been steady for some time. As the scenario is not consolidated yet, the Copom will be cautious to the new developments of these factors.

29. Even if the inflationary scenario should require an adjustment of the Over-Selic rate in the future, it is important to reiterate that it should not impact the sustainable growth process of the Brazilian economy. On the contrary, monetary policy contributes to growth by fighting second-order effects of the supply shocks, and by promoting the balance between the expansion of aggregate demand and the broadening of the economy's productive capacity. Moreover, sustaining

inflation in a path consistent with the inflation targets is essential to preserve real earnings, fundamental for the continuous and balanced expansion of the domestic demand, and for the dissemination of the economic growth benefits to the population.

30. Considering the reasons stated above, the Committee decided, unanimously, to maintain the target for the Over-Selic rate at 16.0% p.a., without bias.

31. At the closing of the meeting, it was announced that the Copom would meet again on September 14, for technical presentations, and on the following day 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

32. According to IBGE's retail survey, sales expanded for the sixth consecutive month in June, increasing by 0.17% month-on-month, seasonally adjusted. Compared to June 2003, real sales and nominal revenues increased 12.8% and 15.6%, respectively. The regional distribution of growth was generalized, encompassing all States in the country, except Roraima. All groups encompassing the retail sector posted year-on-year growth rates in June, with highlights to furniture and electrical appliances, which increased 36.3%.

33. The São Paulo Trade Association (ACSP) data for July registered a 1.2% increase in credit retail sales, while the Usecheque system consultations rose 3.4%, both compared to June, seasonally adjusted. In the year up to July, the same indicators rose by 7.0% and 1.8%, respectively.

34. The Federation of Commerce of São Paulo (Fecomercio) consumer sentiment survey showed that the Consumer Confidence Index (ICC) increased 2.2% in August, standing at 121.3 points (range 0 to 200). This increase was due to improved future expectations by consumers.

35. Regarding fixed capital investment, capital goods output and construction inputs continued to grow in June, accumulating year-on-year expansions of 25.2% and of 3.4%, respectively. Capital goods imports increased 8.9% in the same comparison basis. The domestic capital goods absorption rose by 13.8%, despite the 52.3% increase of exports, mainly agriculture machinery. The National Bank for Economic and Social Development (BNDES) credit operations increased 47.7% in the first half of the year, compared to the same period of 2003. Credit operations to industry (about 41% of total credit outstanding) expanded by 27.7%. Credit to commerce and the services sector increased by 52.8%, and credit to the agriculture sector grew 101.3%.

36. The IBGE's monthly industrial survey registered a 0.5% increase in industrial output in June, compared to May (seasonally adjusted). The manufacturing industry expanded 0.4%, while mining activity increased 1.8%. Out of the 23 activities surveyed, 13 registered increases in output, while out of the 4 categories, 3 expanded. Intermediate goods output decreased 0.4%, after five consecutive months of increase. In the year up to June, industrial output increased 7.7%, compared to the same period of 2003, with output expansion in 22 out of the 26 activities and in all use categories, with highlights to export-oriented and agribusiness activities, as well as credit-sensitive activities. Semi and non-durable goods production increased 2.1%, reflecting the gradual recovery of the labor market.

37. In June, the CNI recorded a 1.2% increase in real industrial sales and a 0.9% increase in industrial worked hours, in comparison to May, seasonally adjusted. Compared to the same month in 2003, real sales and worked hours increased 27.7% and 8.2%, respectively. The level of average capacity utilization in industry reached 83.2%, the highest ever, with a 1.7% monthly increase (seasonally adjusted). In the first half of the year, capacity utilization expanded 2.1%, compared to the same period of 2003.

38. According to the FGV industrial survey nationwide, the average level of capacity utilization stood at 84.1% in July, s.a. This level is the highest since 2000 and is approximately 4 p.p. above the 1990-2004 historical average, albeit still below the record high of 85.2% registered in April 1995. The mechanic industry is in the historical high, while other six industries are close to the historical peaks.

Transportation material and pharmaceutical products are the only two industries that remain below the respective historical average.

39. The FGV survey and the CNI business sentiment survey pointed out improved confidence in July. These surveys also perceived a better prospect in terms of domestic demand.

40. In July, leading indicators anticipate a continued expansion in industrial output. Packaging paper shipments expanded 3.8% in the month, s.a., accumulating a 13.0% growth in the year. The car industry produced 189 thousand vehicles, up 5.2% compared to June (seasonally adjusted), and 38.8% above July 2003. In the year to July, car production increased 18.0%, while domestic sales and exports expanded 21.5% and 12.5%, respectively, compared to the same period of last year.

Labor Market

41. The formal employment increased 0.5% in June, compared to May, s.a., and 4.8% compared to June 2003, according to the Ministry of Labor and Employment. In the first half of 2004, there was a 3.9% expansion in formal employment compared to the same period of last year. This result corresponded to 1,034,656 new employed workers in the first half of the year, compared to 560,907 in the first half of 2003.

42. The unemployment rate, measured by the IBGE in the six main metropolitan regions of the country, decreased in June for the second consecutive month, standing at 11.7% after peaking to 13.1% last April. Total employed workers increased 0.4% in June, while unemployed workers fell 4.1%.

43. In industry, seasonally adjusted CNI data showed expansions of 0.7% in employed workers and 1% in real payroll in June, compared to May. In the first half of the year, real payroll and employed workers increased 7.8% and 1.2%, respectively, compared to the same period of 2003.

Credit and Delinquency Rates

44. Non-earmarked credit operations increased 1.2% in July. Individual credit operations increased 1.8%, while corporate credit expanded 0.8%, led by the increase of 1.3% in credit with domestic funding. Corporate credit with external funding fell 0.2%.

45. The average interest rate on non-earmarked credit decreased 0.1 p.p. in July, standing at 43.9% p.a. Corporate interest rates remained stable at 29.7% p.a., while the average rate for individuals decreased 0.4 p.p. to 62% p.a. Total delinquency in non-earmarked credit maintained the downward trend in July, falling to 7.1% from 7.2% in June, specially due to the 0.3 p.p. fall in individual default rate.

46. The default rate measured by the ACSP fell in July to the lowest level of the year. The total number of cancelled and new files increased 10.4% and 6.5%, respectively, in the year to July. The number of returned checks, compared to the total number of checks, decreased to 5.1% in June, also reaching the lowest level of the year.

External Environment

47. Recent indicators suggested some deceleration of the world economy growth, partially attributed to oil prices increases. The second quarter U.S. GDP stood at 3.0% in annual terms, below expected. The Japanese GDP grew 0.4% in the second quarter, also below expectations, while the Euro Zone economy grew 0.5%, below the 0.6% rate recorded in the first quarter of the year.

48. The slower U.S. GDP growth in the second quarter of the year was led by the reduction in consumption growth, which increased 1.0% in the second quarter, compared to 4.1% in the first quarter. In China, industrial production increased 15.5% in July, year-on-year, the lowest rate in the last twelve months. On the other had, the Economic Commission for Latin America and the Caribbean (ECLAC) revised the growth forecast for the region in 2004 to 4.5% from 4.0% estimated in May.

49. Regarding monetary policy, the Bank of England raised its repo rate by 25 b.p., to 4.75%, while the European Central Bank decided to maintain its basic interest rate unchanged at 2.0%, regardless of the increase in oil prices. In the U.S., the Federal Reserve decided to raise the target for the fed funds rate by 25

b.p., considering that the weaker activity level in June and July was transitory, owing primordially to the rise in energy prices, and that the economy was prepared to resume a stronger pace of expansion in the near future.

50. The continuous increases in oil prices posed risks to global economic growth and price stability, as well as limited the recovery of asset prices. The interaction between geopolitical factors (tensions in the Middle East, uncertainties about the future of Yukos and the referendum in Venezuela), growing demand and constrained supply contributed to increase oil prices, reaching record levels in August.

Foreign Trade and Balance of Payments

51. The Brazilian trade balance posted a US$3.5 billion surplus in July. Exports and imports increased 54.0% and 42.3%, respectively, compared to July 2003 daily averages. Total external trade reached US$14.5 billion in July, accumulating a historical high for a 12-month-period (US$141.7 billion). In the first two weeks of August (10 working days), the trade balance surplus totaled US$1.7 billion, with increases of 34.9% for exports and of 34.7% for imports, year-on-year.

52. In July, Brazilian exports totaled US$9.0 billion, registering historical records for manufactured and semi-manufactured goods. Manufactured exports reached US$4.7 billion, while primary exports totaled US$2.8 billion and semi-manufactured exports amounted to US$1.3 billion, with increases of 47.3%, 71.5%, and 43.7%, respectively, compared to the same period of 2003.

53. Imports totaled US$5.5 billion, maintaining the upward trend initiated at the end of 2003. All categories grew, led by fuel (up 121.5%), consumer goods (+38.3%), raw material and intermediate goods (+34.6%) and capital goods (+23.8%).

54. In July, the current account registered a US$1.9 billion surplus, accumulating a US$6.2 billion surplus in the year. In the first seven months of the year, the trade balance and current transfers posted US$18.5 billion and US$1.9 billion surpluses, respectively, while the services and income account posted a US$14.1 billion deficit. Net foreign direct investment reached US$1.5 billion in July, accumulating US$5.5 billion in the first seven months of the year. At the end of July, international reserves stood at US$49.7 billion, while adjusted net reserves stood at US$23.0 billion (IMF concept).

Money Market and Open Market Operations

55. After the July Copom's meeting, the domestic yield curve moved upwards, mainly in its longer end. The determinant factor justifying the yield curve move was the market's interpretation about the July Copom's minutes, but international markets volatility and some internal political noises also contributed for the move. From July 21 to August 18, the spread on the 3-month and 6-month rates in relation to the Over-Selic rate increased 0.13 p.p. and 0.38 p.p., respectively, while the 1-year and the 2-year rates increased 0.56 p.p. and 0.47 p.p. In the same period, the real interest rate measured by the ratio between the one-year nominal interest rate and the 12-month-ahead inflation expectations increased to 10.6% from 10.1%.

56. In the period between the last Copom meetings, the BCB carried out an auction to rollover securities and Fx swaps coming due on August 12. In this auction, US$281 million in swaps were contracted (18% of the principal coming due), with tenures of 11 and 17 months. The net redemption of Fx-linked securities and swaps in the year to August totals US$23.4 billion.

57. The National Treasury carried out four offerings of LTNs, totaling R$5.5 billion. Four LFTs auctions were also carried out (three selling and one buying, the latter simultaneously to the second selling auction), placing net R$3 billion maturing in 2005, 2006 and 2007. In the same period, there were one buying auction and one selling auction for National Treasury Notes – Series B and C (NTN-Bs and NTN-Cs), which amounted R$737 million in net sales.

58. The BCB maintained in its open market operations the weekly post-fixed repo operations (2-week tenure) and the fixed repo operations (3-month tenure), as well as its daily liquidity management operations. The BCB also carried out in this period 16 fixed rate overnight repos. The higher frequency of these operations after July 28 enabled the reduction of the gap between the Over-Selic rate and its target, from 0.25 p.p. on July 27 to 0.13 p.p. on August 18.

In the period after the July Copom’s meeting, the excess liquidity drained from the market with operations shorter than 30 days fell to R$34.5 billion on average, while with the 3-month-tenure operations, it rose to R$46.9 billion on average.

59. In July, the net securitized domestic public debt was stable. The fixed share decreased to 15.1% from 16.8% in June, due to the net redemption in the month. The dollar-linked share also decreased, to 14.1% from 15.8% in June.

Economic policy measures

Measures Related to the Financial System and Credit Market

Resolution 3,209, 6.30.2004 – Maintained the Long-Term Interest Rate at 9.75% (TJLP), to be applied in the third quarter of 2004.

Resolution 3,210, 6.30.2004 – Set the inflation target for 2006 at 4.5% with a tolerance interval of plus or minus 2.0 percentage points.

Resolution 3,211, 6.30.2004 – Altered and consolidated rules dealing with the opening, maintenance and operation of special demand deposit accounts and savings accounts. These accounts can be opened exclusively by individual persons who do not have other demand deposit accounts. The utilization of checks to operate such accounts is prohibited. At the same time, the holder of such accounts is not required to present proof of income. Institutions are not permitted to charge for opening and operating such accounts. It should be stressed that, at any time whatsoever, the balance of such accounts and the sum total of monthly deposits is limited to a maximum of R$1,000.00. With implementation of this measure, this amount is no longer restricted, provided that the holder of the account is a beneficiary of a microcredit operation based on the terms of Resolution 3,109, dated 7.24.2003. In this case, the limit is increased by the amount of the credit granted.

Resolution 3,214, 6.30.2004 – Deals with the supply of purchase option contracts involving farm products supported by Floor Price Guaranty Policy (PGPM) in auctions of public stocks.

Resolution 3,220, 7.29.2004 – Altered the rules for calculating the amounts to be invested in microcredit operations targeted to the low-income population and micro-entrepreneurs. As determined in Resolution 3,109/2003, commercial banks, multiple banks with commercial portfolios, the Federal Savings Bank and credit cooperatives are obligated to channel a minimum of 2% of their deposit balances into microcredit operations. The alterations refer to the periods of calculation, deposit and the date of verification of compliance with this requirement. The period of calculation, which was previously defined as July 1 to June 30 of the following year, was redefined as the twelve month period prior to the month preceding that in which verification of the deposit is carried out. Verification of compliance, which previously occurred on the 15th business day of the month of August of each year, is now carried out on the 20th day of each month or on the 1st subsequent business day. If they are not invested in microcredit operations, the resources corresponding to this requirement are to be deposited in cash at Banco Central do Brasil on the day on which compliance is verified and are to remain unavailable to the institution in question until the date of the following deposit. Such deposits at Banco Central do Brasil will not be entitled to earnings.

Circular 3,248, 7.29.2004 – Among other matters, deals with the opening, maintenance and operation of deposit accounts for investment purposes, as referred to in Law 10,892, dated 7.13.2004, revoking Circular 3,235, dated 4.22.2004. In relation to the revoked Circular cited above, the major alterations were:

a) change of the date on which operation of such investment deposits accounts is to be initiated from August 2 to October 1, 2004;
b) prohibition of the opening of joint investment deposit accounts in those cases in which one of the account holders is a corporate entity;
c) clients are given the prerogative of deciding to open savings accounts as part of the investment deposit accounts;
d) foreign investors, investment funds or clubs and holders of current accounts not subject to the levying of the Provisional Contribution on Financial Transactions (CPMF) are dispensed from the obligation of opening investment deposit accounts.

Law 10,931, 8.2.2004 – Deals with the individualization of real estate undertakings, Real Estate Credit Bills, Real Estate Credit Bonds and Bank Credit Bonds. In this context, it should be stressed that the major alteration refers to the institution of the special taxation system, which consists of charging a rate of 7% of the monthly revenues received by the real estate undertaking subjected to the system of individualized accounting. In this case, the assets of the individual undertaking are separated from those of the incorporator, as determined in Provisional Measure 2,221, dated 9.4.2001, for payment of the following taxes:

a) Corporate Income Tax (IRPJ);
b) Social Contribution on Net Income (CSLL);
c) Contribution to the Financing of the Social Security System (Cofins);
d) Contribution to the Program of Social Integration/ Program of Civil Service Assets Formation (PIS/Pasep). Consequently, the land and accessions of an undertaking and other properties and rights connected to it bear no responsibility for other debts of the incorporator related to those taxes.

CVM Normative Instruction 409, 8.18.2004 – Defined new rules for the investment fund segment to go into effect 90 days after publication. The major changes were as follows:

a) fund management may be exercised not only by financial institutions but also by nonfinancial corporate entities authorized by the Securities and Exchange Commission of Brazil (CVM);
b) the requirement that all funds are obligated to release information on their major characteristics in the form of a prospectus, containing information on investment policy and the risks involved;
c) definition of categories for the classification of funds as follows:
    i) short-term funds, exclusively for purposes of investment in federal public securities;
    ii) referenced funds, denominated by a performance indicator, with at least 80% of the fund's equity represented by federal securities and fixed income assets, for which the issuer has a low credit risk;
    iii) fixed income funds, stock funds and exchange funds, which should have at least 80% of their asset portfolios referenced to the risk factor that gives its name to this particular class;
    iv) external debt funds, with investment of at least 80% of their equity in federal government external debt securities;
    v) multimarket funds, referring to those in which there is no commitment to concentrate in any specific risk factor.

Resolution 3,229, 8.26.2004 – For purposes of compliance with the demand that 2% of the balances of demand deposits be invested in microcredit operations, this Resolution permitted financial institutions to calculate the following operations:

a) transfer of resources to micro-entrepreneur credit companies (SCM) by means of interbank deposits, in the case of operations carried out by targeted productive microcredits;
b) acquisition of this credit modality from Public Interest Civil Society Organizations (OSCIP) and Nongovernmental Organizations (NGOs).

In both cases, the effective rate of interest charged to the borrower may not exceed 4% per month and the sum total of these resources is restricted to 30% of the value of the required investments. Targeted productive microcredit is understood as an operation granted for purposes of meeting the financial needs of micro and small business undertakings.

Fiscal Policy Measures

Law 10,878, 6.8.2004 – A provision was added to Law 8,036, dated 5.11.1990, in such a way as to make the operation of Severance Fund Contribution (FGTS) referenced accounts more flexible, in the case of personal need in which the urgency and gravity of the situation was caused by natural disaster.

Provisional Measure 193, 6.24.2004 – Authorized the federal government to transfer an amount equivalent to R$900 million to the states, Federal District and municipalities, with the objective of stimulating the nation's exports, based on the criteria, time periods and conditions stated in this Provisional Measure.

Constitutional Amendment 44, 6.30.2004 – Raised the participation of the states and municipality from 25% to 29% of the Contribution on Intervention in the Economic Domain (Cide-fuel). It should be stressed that the participation of the states and municipalities in the Cide inflow was authorized by Constitutional Amendment 42, dated 12.19.2003, and went into effect in January of this year.

Provisional Measure 197, 7.7.2004 – Created the National Industrial Structure Modernization Program (Modermaq), with the objective of fostering and stimulating general industrial modernization while making the capital goods sector more dynamic. Modermaq encompasses financing for the acquisition of machines and equipment and other capital goods, with the objective of stimulating creation of jobs, increasing productivity and enhancing the technological development of the national industrial structure.

Decree 5,146, 7.20.2004 – Authorized inclusion of electric power transmission undertakings that are part of the Basic Network of the National Interconnected System, in the National Privatization Program (PND) and determined that the National Electric Power Agency (Aneel) should foster and monitor processes involving the tendering of these concessions.

Law 10,925, 7.23.2004 – Reduced the Program of Social Integration/Program of Civil Service Asset Formation (PIS/Pasep) and Social Security Financing Contribution (Cofins) rates on internal market imports and marketing of fertilizers and agricultural pesticides and eliminated the levying of these contributions on revenues generated by the sale of beans, rice, manioc flour, farm production inputs, vaccines for veterinary use, among other products.

Provisional Measure 201, 7.23.2004 – Authorized review of the social security benefits that went into effect after February 1994 and payment of amounts in arrears under the conditions specified therein.

Provisional Measure 202, 7.23.2004 – For purposes of the levying of the income withholding tax and annual income tax returns, this measure excluded the amount of R$100.00 per month from total taxable income originating in salaried labor paid in the period from August to December 2004.

Decree 5,164, 7.30.2004 – Reduced the Program of Social Integration/Program of Civil Service Asset Formation (PIS/Pasep) and Social Security Financing Contribution (Cofins) rates to zero on financial revenues earned by legal entities subject to the system of noncumulative levying of the stated contributions. These measures do not apply to financial revenues originating in interest on the entity’s own capital nor to revenues consequent upon hedge operations.

Law 10,931, 8.2.2004 – Instituted the special system of taxation applicable to real estate incorporations. The system is optional and irrevocable while the incorporator’s credit rights or obligations persist in relation to those acquiring the real estate in question. The option for the special system of taxation will go into effect once the following requirements are satisfied:

a) delivery of the option declaration at the appropriate unit of the Secretariat of Federal Revenue, according to the terms of the regulations to be defined; and
b) definition of the land and accessions included in the real estate incorporation, as determined in Law 4,591, dated 12.16.1964.

Provisional Measure 205, 8.6.2004 – Authorized payment of the economic grant to Banco do Brasil S.A. in the interest rate equalization modality in credit operations for purposes of investment in the area covered by the Central-West Constitutional Financing Fund (FCO), backed by resources obtained from the Worker Support Fund (FAT). Providing of the grant is limited by the terms of this Provisional Measure to credit operations totaling up to R$1 billion, in operations contracted with productive sectors in the Central-West Region, formalized by 6.30.2005.

Provisional Measure 206, 8.6.2004 – Instituted the Tax System for Stimulating the Modernization and Expansion of the Port Structure (Reporto); expanded the period allowed for deposit of the Industrialized Products Tax (IPI) (altered from half-monthly to monthly payments); expanded the existent tax exemption on Real Estate Bonds (LH) and extended the exemption to Real Estate Credit Bills (LCI) and Certificates of Real Estate Receivables (CRI), when such are held by individual persons; altered the tax treatment for financial investments through a differentiated type of treatment for both fixed income and variable income investments.

Decree 5,172, 8.6.2004 – Reduced the rate of the Financial Operations Tax (IOF) from 7% to 4% on life insurance operations, effective as of September 2004. In September 2005, the rate will drop to 2% and, in September 2006, to zero.

Decree 5,173, 8.6.2004 – Intensified the process of attenuating the tax burden on capital goods by reducing the rate of the Industrialized Products Tax (IPI) from 3.5% to 2%. Furthermore, expanded the list of machines and equipment included in this process, by introducing 29 additional product lines. This measure represents continuation of the policy of reducing taxes on capital goods that began with issue of Decree 4,955, which reduced the IPI rate on these capital goods from 5% to 3.5%.

Law 10,933, 8.11.2004 – Approved the Multiannual Plan (PPA) for the 2004/2007 period, in compliance with the provision in art. 165 of the Federal Constitution. The sum of the physical goals of the projects defined for the period covered by the PPA represents the limit to be observed by budget guideline legislation and budget law and later additional credits. In their turn, the amounts allocated to each activity are for purposes of reference and do not represent limits on the programming of the outlays stated in budget legislation.

Law 10,934, 8.11.2004 – Approved the guidelines for elaboration of the Federal Budget for 2005 (LDO/2005). This law determined that the 2005 budget must maintain the same primary surplus target defined for 2004 or, in other words, 3.15% of Gross Domestic Product (GDP). With this, the consolidated target set for the nonfinancial public sector was maintained at 4.25%.

Decree 5,183, 8.13.2004 – Defined the conditions and requirements for application of the provision in art. 9 of Provisional Measure 2,159-70, dated 8.24.2001. The stated Measure reduced the income tax rate on remittances abroad to zero when such remittances are to be used exclusively for payment of expenses related to:

a) market research for Brazilian export products;
b) participation in expositions, fairs and similar events, including rentals and leases of stands and exposition sites, when such activities are related to the promotion of Brazilian products;
c) publicity in the framework of such events.

Decree 5,184, 8.16.2004 – Created the Energy Research Company (EPE) with the objective of rendering services in the area of studies and research in support of energy sector planning, in such areas as electric power, petroleum, natural gas and its derivatives, mineral coal, renewable energy sources and energy efficiency, among others.

Provisional Measure 209, 8.26.2004 – With regard to benefit plans of a social security nature, allowed complementary pension fund entities and insurance companies created as of January 1, 2005 and structured in the defined and variable contribution modalities to opt for a taxation system in which amounts paid to the participants or beneficiaries in the form of benefits or redemptions of accumulated amounts are subject to the income withholding tax at the following rates:

a) 35%, for resources accumulated over a period equal to or less than two years;
b) 30% for resources accumulated over a period of four years or less and a minimum of two years;
c) 25% for resources accumulated over a period of six years or less and a minimum of four years;
d) 20% for resources accumulated over a period of eight years or less and a minimum of six years;
e) 15% for resources accumulated over a period of ten years or less and a minimum of eight years; and
f) 10% for resources accumulated over a period of more than ten years.

The period of accumulation is understood as the time period elapsed between the inflow of the resources into the benefit plan maintained by the complementary pension fund entity, by an insurance company or at Individual Programmed Retirement Fund (Fapi) and the payment referring to the redemption or benefit, with due consideration of the time of permanence, the form and time of reception and the amounts paid.

External Sector Measures

STN Directive 261, 5.20.2004 (DOU 5.21.2004) – Authorized issue of National Treasury Notes, Series I (NTN-I), in the amount of R$55,973,711.00 (fifty five million, nine hundred and seventy three thousand, seven hundred and eleven reals), referenced to 5.15.2004, to be used in payment of interest rate equalization in the financing of exports of Brazilian goods and services supported by Export Financing Program (Proex).

Brazil-China Memorandum of Understanding in the Area of the Health and Phytosanitary Security of Food Products (DOU 6.8.2004) – This Memorandum has the purpose of fostering bilateral communication and cooperation in the area of health and phytosanitary security of food products. With this in mind, the parties involved agreed to establish a mutual consultation mechanism that would operate in keeping with the principles, regulations, rights and obligations stipulated in the Agreement on Application of Health and Phytosanitary Measures of the World Trade Organization (WTO), subject to the rules and regulations of each country.

Brazil-China Memorandum of Understanding on Cooperation between the Brazilian Ministry of Planning, Budget and Management and the Chinese Ministry of Trade (DOU 6.8.2004) – This Memorandum has the objective of intensifying economic-commercial relations between the two countries, on the basis of the principles of equality and mutual benefits. The parties commit themselves to taking advantage of a series of initiatives that encompass the areas of trade, transportation infrastructure and energy and mutual investments, in order to reinforce interchanges of products, technology and services.

Camex Resolutions 16, 6.11.2004 (Republished in the DOU dated 6.18.2004), 21, 7.20.2004 (DOU 7.22.2004) and 23, 8.24.2004 (DOU 8.26.2004) – Altered the ad valorem rates of the Import Tax on Capital

Goods and Informatics and Telecommunications goods involving products specified as ex-tariff to 2% (two percent) up to 6.30.2006.

Decree 5,106, 6.15.2004 (DOU 6.16.2004) – Published the list of Mercosul tariff concessions in the framework of the Agreement on the Global Trade Preferences System among developing countries, promulgated by Decree 194, dated 8.21.1991.

Bacen Resolution 3,203, 6.17.2004 – Deals with the opening, maintenance and operation of demand deposit accounts for Brazilian individuals who are temporarily abroad.

Bacen Circular 3,241, 6.17.2004 – Issued title 13 (Payments of Imports in Reals) of the Import Exchange Regulations, which form chapter 6 of the Consolidated Exchange Rules (CNC). Title 13 of chapter 6 of the CNC issued by the Bacen Circular dated 4.2.2002 is voided.

STN Directive 300, 6.23.2004 (DOU 6.25.2004) – Authorized issue of National Treasury Notes, Series I (NTN-I), in the amount of R$10,574,941.05 (ten million, five hundred and seventy four thousand, nine hundred and forty one reals and five cents), referenced to 6.15.2004, to be used in the payment of interest rate equalization in the financing of exports of Brazilian goods and services supported by Export Financing Program (Proex).

Bacen Circular 3,242, 6.23.2004 – Altered Floating Rate Exchange Market Regulations. Eliminates the prohibition on the granting of credit-to-credit card users for the financing of goods and services acquired abroad.

Bacen Circular 3,243, 6.23.2004 – Altered the provisions on the utilization of international credit cards. Permits multiple banks with commercial portfolios and the Federal Savings Bank to accept international credit cards as instruments for making deposits in the demand deposit accounts cited in Bacen Resolution 3,203, dated 6.17.2004.

Bacen Resolution 3,213, 6.30.2004 – Deals with utilization of credit cards in order to make deposits in demand deposit accounts and for transmitting payment orders.

Camex Resolution 18, 6.30.2004 (DOU 7.1.2004) – Extended the reduction in the rate of the import tax to zero on the medicines and pharmaceutical goods cited in Annex I to 12.31.2004 and the rates on medicines and pharmaceutical goods contained in Appendix II of this Resolution to 7.31.2004.

Camex Resolution 20, 7.6.2004 (DOU 7.1.2004) – Altered the Common Mercosul Nomenclature (NCM) and the rates of the Import Tax included in the Common External Tariff (TEC) and treated in Appendix I of Camex Resolution 42, dated 12.26.2001, and included the codes specified in Appendix III of the same Resolution (pharmaceutical goods/medicines).

Secex Circular 39, 6.30.2004 (DOU 7.2.2004) – Announced that the Manual on the Tariff Quota System of the European Community for Jute and Cocoa Fiber Products, Handmade Products and Products Woven in Manual Looms is available.

Bacen Resolution 3,217, 6.30.2004 – Permitted anticipated settlement of liabilities involving external credit, leasing and short-term import operations.

Bacen Resolution 3,219, 6.30.2004 – Redefined the criteria applicable to the operations of the interest rate equalization system of the Export Financing Program and revokes BCB Resolution 2,799/2000.

Decree 5,127, 7.5.2004 (DOU 7.6.2004) – Reduced the Program of Social Integration/Program of Civil Service Asset Formation (PIS/Pasep) and Social Security Financing Contribution (Cofins) rates to zero on the chemical products classified in Chapter 29 of the Common Mercosul Nomenclature (NCM) and of the pharmaceutical products cited therein.

Provisional Measure 197, 7.7.2004 (DOU 7.8.2004, rectified on 7.9.2004) – Created the National Industrial Structure Modernization Program (Modermaq) and takes other measures.

MDIC Directive 183, 7.20.2004 (DOU 7.21.2004) – Announced the criterion to be applied in distributing the exportable volume of 5,000 tons of *in natura* beef among national companies, in the Hilton Quota modality, granted to Brazil by the European Union for the period between 7.1.2004 and 6.30.2005.

Provisional Measure 202, 7.23.2004 (DOU 7.26.2004) – Reduced the rates of the Program of Social Integration/ Program of Civil Service Asset Formation (PIS/Pasep) and Social Security Financing Contribution (Cofins) contributions on the revenues earned on sales of merchandise for consumption or industrialization in the Manaus Free Zone (ZFM), by corporate entities established outside the ZFM.

Law 10,925, 7.23.2004 (DOU 7.26.2004) – Reduced the Program of Social Integration/Program of Civil Service Asset Formation (PIS/Pasep) and Social Security Financing Contribution (Cofins) rates on imports and internal market marketing of fertilizers and farm pesticides and revokes the rules cited therein. Conversion of Provisional Measure 183 into Law, dated 5.10.2004.

STN Directive 381, 7.23.2004 (DOU 7.27.2004) – Authorized issue of National Treasury Notes Series I (NTN-I), in the amount of R$71,358,632.22 (seventy one million, three hundred and fifty eight thousand, six hundred and thirty two reals and twenty two cents), referenced to 5.17.2004, to be utilized in the payment of interest rate equalization in the financing of exports of Brazilian goods and services supported by Export Financing Program (Proex).

Camex Resolution 22, 7.20.2004 (DOU 7.29.2004) – Altered the List of Exceptions to the Common External Tariff, the List of Convergence of the Informatics and Telecommunications Sector and takes other measures.

Bacen Resolution 3,222, 7.29.2004 – Deals with the opening of foreign currency deposit accounts in the name of residents in the country and abroad.

Bacen Circular 3,250, 7.30.2004, and Bacen Resolution 3,221, 7.29.2004 – Defined conditions for registration of resources obtained on the international market through foreign market issues of securities denominated in reals.

Bacen Circular 3,249, 7.30.2004 (DOU 8.2.2004) – Released the Regulations on International Freight, which becomes Chapter 7 of the Consolidation of Exchange Rules. The provisions govern transfers of amounts from and to the international market as a result of international cargo transportation activity, independently of the transportation modality utilized. Revokes the rules cited therein.

Decree 5,165, 8.2.2004 (DOU 8.3.2004) – Regulated Provisional Measure 197, dated 7.7.2004, which creates the National Industrial Structure Modernization program (Modermaq) and takes other measures.

Circular 3,251, 8.3.2004 – Disciplined utilization of credit cards issued abroad, as treated in Resolution 3,213/2004, in the name of individual persons, for the cases specified therein.

Resolution 3,227, 8.5.2004 – Defined the conditions for granting financing under the terms of National Industrial

Structure Modernization Program (Modermaq). The limit on investments was set at up to R$2,500,000,000.00 (two billion and five hundred million reals) in the twelve months subsequent to the date on which this Resolution went into effect.

Secex Circular 47, 8.2.2004 (DOU 8.4.2004) – Released information on the Annual Review of the General System of Preferences of the United States for 2003, the result of which was published in Volume 69, no. 128, of the Federal Register, dated 7.6.2004.

Provisional Measure 206, 8.6.2004 (DOU 8.9.2004) – Altered taxation of the financial and capital market, instituted the Tax System for Incentives to the Modernization and Expansion of the Port Structure (Reporto) and takes other measures.

Decree 5,183, 8.13.2004 (DOU 8.16.2004) – Regulated the reduction of the Income Tax rate on remittances abroad, under the terms of article 9 of Provisional Measure 2,159-70, dated 8.24.2001, and takes other measures. Tax reduction applicable in the payment of expenditures related to market research for Brazilian export products, participation in expositions, fairs and similar events, publicity in the framework of such events.

Decree 5,195, 8.26.2004 (DOU 8.27.2004) – Deals with the reduction of the Program of Social Integration/Program of Civil Service Asset Formation (PIS/Pasep) and Social Security Financing Contribution (Cofins) contribution rate to zero on imports and internal market sales operations involving fertilizers and farm pesticides, as treated in article 1 of Law 10,925, dated 7.23.2004, and takes other measures.

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

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
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Deputy Governor

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Deputy Governor

Eduardo Henrique de Mello Motta Loyo
Deputy Governor

João Antônio Fleury Teixeira
Deputy Governor

Paulo Sérgio Cavalheiro
Deputy Governor

Sérgio Darcy da Silva Alves
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 Association of the Machinery and Equipment Industry
ABPO	Brazilian Corrugated Board Association
ACC	Advances on Exchange Contracts
ACSP	São Paulo Trade Association
AGF	Federal Government Acquisitions
Aladi	Latin American Integration Association
Aneel	Brazilian Electricity Regulatory Agency
Anfavea	National Association of Automotive Vehicle Manufacturers
ANP	National Petroleum Agency
Bacen	Central Bank of Brazil
Bancoob	Banco Cooperativo do Brasil
Bansicredi	Banco Cooperativo Sicredi
BNDES	Brazilian Development Bank
BNDESpar	BNDES Participações S.A.
BoJ	Bank of Japan
Camex	Foreign Trade Council
CCR	Reciprocal Credit and Payment Agreement
CDA	Agriculture and Livestock Deposit Certificate
CDI	Interfinance Certificate of Deposit
Cepal	Economic Commission for Latin America and the Caribbean
Cide	Contribution on Intervention in the Economic Domain
CMN	National Monetary Council
CNC	Consolidation of Exchange Norms
CNI	National Confederation of Industry
Cofins	Contribution for the Financing of Social Security
Copom	Monetary Policy Committee
CPMF	Provisional Contribution on Financial Transactions
CPR	Rural Product Bill
CRA	Agribusiness Receivables Certificate
CRI	Certificate of Real Estate Receivables
CSLL	Social Contribution on Net Profit
CVM	Securities and Exchange Commission of Brazil
DAX	Deutscher Aktienindex
DI	Interfinancial Deposit
Dieese	Inter Trade Union Department of Statistics and Socio-Economic Studies
DJIA	Dow Jones Industrial Average
DR	Rural Invoice
ECB	European Central Bank

EGF	Federal Government Loans
Embi+	Emerging Market Bond Index Plus
EPE	Energy Research Company
EU	European Union
Fapi	Individual Programmed Retirement Fund
FAT	Worker Support Fund
FCO	Constitutional Fund for the Financing of the Central-West Region
FDI	Foreign Direct Investments
Fecomercio RJ	Trade Federation of the State of Rio de Janeiro
Fecomercio SP	Trade Federation of the State of São Paulo
Fed	Federal Reserve System
FGTS	Severance Fund Contribution
FGV	Getulio Vargas Foundation
Fiesp	Federation of Industries of the State of São Paulo
FIF	Financial Investment Funds
Finame	Special Industrial Financing Agency
FITVM	Funds based on investments in stocks and securities
FMP	Mutual privatization funds
FOB	Free on Board
FOMC	Federal Open-Market Committee
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 Indices of Consumer Prices
IBGE	Brazilian Institute of Geography and Statistics
Ibovespa	São Paulo Stock Exchange Index
ICC	Consumer Confidence Index
Icea	Index of Current Economic Conditions
Icei	Current Industrial Employment Index
ICMS	Tax on the Circulation of Merchandise and Services
IEC	Consumer Expectation Index
IGP	General Price Index
IGP-DI	General Price Index – Domestic Supply
IGP-M	General Price Index – Market
IIC	Consumer Intention Index
IMF	International Monetary Fund
INCC	National Cost of Construction Index
INPC	National Consumer Price Index
INSS	National Social Security Institute
IOF	Financial Operations Tax
IPA-DI	Wholesale Price Index – Domestic Supply
IPA-OG	Wholesale Price Index – Overall Supply
IPCA	Broad National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPC-DI	Consumer Price Index – Domestic Supply
IPI	Industrialized Products Tax
IRPJ	Corporate Income Tax
ISM	Institute for Supply Management
LCI	Real Estate Credit Bill

LDO	Budget Directives Law
LEC	Special Credit Line
LFT	National Treasury Financing Bills
LH	Mortgage Bill
LSPA	Systematic Farm Production Survey
LTN	National Treasury Bills
Mapa	Ministry of Agriculture, Livestock and Supply
mbd	Million barrels per day
MDA	Ministry of Agrarian Development
MDIC	Ministry of Development, Industry and Commerce
Mercosul	Southern Common Market
Moderagro	Program of Agricultural Modernization and Conservation of Natural Resources
Moderfrota	Program of Modernization of the Farm Tractor Fleet and Like Implements and Harvesters
Moderinfra	Program of Incentives to Irrigation and Storage
Modermaq	National Industrial Structure Modernization Program
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
NGO	Non-governmental Organizations
NTN-B	National Treasury Note – Series B
NTN-C	National Treasury Note – Series C
NTN-D	National Treasury Note – Series D
NTN-I	National Treasury Note – Series I
Nuci	Level of Installed Industrial Capacity Utilization
OECD	Organisation for Economic Co-Operation and Development
Opec	Organization of Petroleum Exporting Countries
Oscip	Organization of the Civil Society for Public Interest
p.p.	Percentage points
p.y.	Per year
PAP	Crop and Livestock Plan
Pasep	Program of Civil Service Asset Formation
PEA	Working Population
PEP	Production Outflow Awards
PGPM	Floor Price Guaranty Policy
PIM	Monthly Industrial Survey
PIS	Program of Social Integration
PMC	Monthly Trade Survey / Montly Survey of Trade (do IBGE)
PME	Monthly Employment Survey
PND	National Privatization Program
PPA	Multiannual Plan
Prodeagro	Agribusiness Development Program
Prodecoop	Program of Cooperative Development for Aggregating Value to Crop/Livestock Production
Proex	Export Financing Program
Pronaf	National Program for Strengthening Family Agriculture
Reporto	Port Restructuring Program
S&P500	Standard and Poor's 500
SBPE	Brazilian System of Savings and Loans
SCM	Micro-business credit companies
SCR	Credit Information System

SDR	Special Drawing Rights
Secex	Foreign Trade Secretariat
Selic	Special System of Clearance and Custody
SPC	Secretariat of Complementary Social Security
STF	Federal Supreme Court
STJ	Brazilian High Court of Justice
STN	National Treasury Secretariat
TEC	Common External Tariff
TJLP	Long-Term Interest Rate
TMU	Technical Memorandum of Understanding
TN	National Treasury
USA	United States of America
VEP	Product Marketing Value
WTI	West Texas Intermediate
WTO	World Trade Organization
ZFM	Manaus Free Trade Area