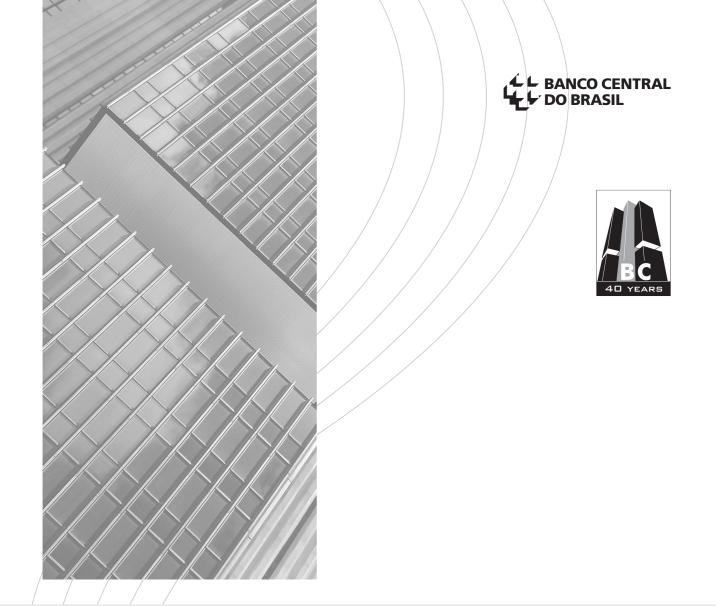


Inflation Report

March 2005 Volume 7 — Number 1







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Inflation Report

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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

Macroeconomic indicators continue to demonstrate the growth of the Brazilian economy, which, according to national accounts data, has been maintained for six consecutive quarters. The continuity and strength of the current expansion has been evidenced not only in the annual GDP growth achieved in 2004, but also in the ongoing favorable performance of the external trade accounts, the positive results across a range of industrial sectors, and the strong recovery of fixed capital investment, after several years of modest performance. On the other hand, the economic expansion is now proceeding at a more moderate pace, and more consistent with supply conditions, such that it will not result in significant inflationary pressures. Despite the rise in the 2005 inflation forecast, expectations are for the convergence of inflation to the target path beginning in the second quarter of 2006.

The social impacts of the expansion in economic activity can be observed, mainly, in labor market developments. Employment levels have increased at a fast pace – reaching a record level, in terms of formal employment. In addition, the growth of personal consumption expenditures in 2004, the highest in the last ten years, is evidence of the improvement in the economic well being of the population.

Activity indicators suggest that the deceleration of the economic expansion since the second half of 2004, has continued through the beginning of this year. This is typical in recovery cycles, and should prove supportive of the sustainability of the current economic growth process. The recent evolution of consumer and business expectations, as well as the outlook for exports, fixed capital investment, and consumer spending confirm the prospects for continued growth.

The more moderate performance of bank credit in the three months ending in February was due to seasonal factors. While corporate credit demand was lower, due to reduced business activity, consumer credit demand remained robust,

as households took loans to cover expenses that are typically concentrated in the beginning of the year.

The growing share of payroll-deducted loans in consumer credit is noteworthy, as this instrument has been consolidating a role as a less onerous credit alternative (particularly relative to revolving loans) to complement personal income in the first quarter of the year. The shift toward payroll-deducted loans contributed to lower delinquency rates and interest rates, despite the fact that, at the same time, the monetary policy tightening was pressing lending interest rates up.

In 2004, the sharp decline in the net public sector debt to GDP ratio, and the reduction of the share of the debt linked to the exchange rate, supported an improvement in countryrisk and reinforced expectations for benign public sector debt dynamics in the short- and medium-term. This perception was strengthened by the inclusion of a 4.25% primary surplus target in the 2005 budget, a signal that the fiscal discipline will persist.

The improvement in the balance of payments, beginning in 2003, was driven by the performance of the current account, and particularly the exceptional performance of the trade balance, which posted surpluses throughout the period. The successive current account surpluses, summed to net foreign direct investment flows, rose from US\$14.9 billion (2.91%) of GDP) in the twelve-month period ending in January 2004, to US\$30.2 billion (4.98% of GDP) in the twelve-month period ending in January 2005.

In 2005, although net foreign direct investment should slightly decline compared to 2004 and a partial rollover of private external debt is expected, the balance of payments financing should pose no major difficulty, enabling an accumulation of gross international reserves.

The surge of inflation at the end of 2004 and the beginning of this year resulted from: (i) overheated demand, as suggested by the evolution of core inflation and the diffusion index; (ii) supply-side pressures, particularly the increase in the price of perishable foods and important production inputs; and (iii) backward-looking indexation mechanisms, even noncontractual, such as education and regulated price adjustments.

The latter two factors can be characterized as transitory, tending to exert less influence on inflation in the coming months. Inflation in the near future could reflect, on the one hand, the favorable seasonality of agricultural prices and, on the other, the lower adjustments in regulated prices. Demand, in turn, should reflect the impact of the monetary tightening cycle.

The central forecast of the benchmark scenario suggests inflation of 5.5% in 2005. The 0.2 p.p. increase in relation to the forecast in the last Inflation Report was primarily due to the higher than projected inflation in the first two months of the year. The benchmark scenario inflation forecast for 2006 is 3.8%, 0.2 p.p. below that of the December *Inflation Report*.

The market scenario, using the consensus Selic rate and exchange rate projections compiled by the BCB's Investor Relations Group (Gerin), forecasts inflation of 6.1% for 2005 and 4.8% for 2006. Both are above the benchmark scenario forecast, due to the projected path of the exchange rate. In turn, the projections are below those presented in the last Inflation Report due to a reduction in projected exchange rate depreciation and the expectation of a more elevated yield curve. According to the benchmark scenario, the GDP projection for 2005 is 4%, the same rate as in the December Inflation Report.

Economic activity

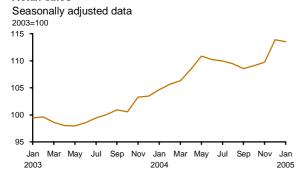
The economic activity expansion continued through end-2004, posting the strongest growth rate since 1994. Growth in the final months of the year was largely driven by domestic consumption, which reflected ongoing credit growth and the recovery in wages. Continued export growth also contributed to sustaining growth at the end of the year.

Activity results for early 2005 indicate some deceleration, in line with leading indicators in the second half of last year. As stated in the December 2004 Inflation Report, this deceleration was expected, in the wake of achievement of historically high output levels. At the same time, the deceleration has contributed to the sustainability of the current growth cycle. Of note, despite continued economic growth in recent months, the level of installed capacity utilization dropped slightly, suggesting that investments that had begun to increase in the second half of 2003 were nearing maturity.

Fixed capital investment in 2004 registered the sharpest growth since the beginning of the 1990s, the period for which revised National Accounts data are available. Consequently, despite a reduction at the margin in the final quarter of the year, investments remained at a historically high level and, according to leading indicators, the outlook for 2005 is positive.

Labor market conditions have improved significantly, mirroring the dynamics of the economy. Unemployment declined and hiring increased, particularly in the formal segment, and across practically all sectors of the economy. As a result, income grew at the same time as economic agents demonstrated continued confidence in the economy. These factors had a positive impact on aggregate demand and, consequently, completed the virtuous cycle of growth.

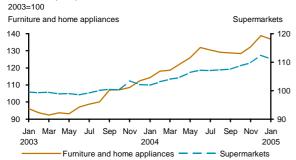
Retail sales



Source: IBGE and Banco Central do Brasil

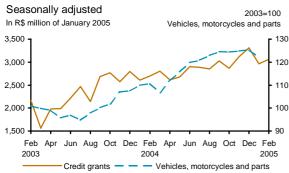
Retail sales

Seasonally adjusted data



Source: IBGE and Banco Central do Brasil

Retail sales



Source: IBGE and Banco Central do Brasil

Retail sales 1.1

After trending sideways through the third quarter of 2004, retail sales regained momentum in the final quarter of the year and early 2005. End-of-year sales easily surpassed the previous years' performance, with growth in 2004 the highest on record since 2000, when the national survey was first conducted. Although growth in durable and semi-durable consumer goods sales, which are more sensitive to credit conditions, was outstanding in 2004, the rise in non-durable consumer goods sales, which are more income sensitive, was also significant.

Credit growth reflected improvement in default levels, reductions in interest rates on personal loans, and a recovery in consumer expectations. The positive impact on real incomes caused by job growth was also an important factor.

According to the Brazilian Institute of Geography and Statistics (IBGE), retail sales volume rose 9.2% in 2004. Sales under all activity segments increased, with particularly strong performance of furniture and home appliance sales (26.4%); supermarkets (7.2%); fabric, apparel and footwear (4.7%); and fuels and lubricants (4.6%). Sales of automobiles, motorcycles and auto parts, a segment that is not included in the general index, rose 17.8% in the year, driven by the 26.4% expansion in automobile loans to individuals.

Among the 27 states surveyed, only Roraima registered a decline in retail sales in 2004. The sharpest increases occurred in Mato Grosso (22.4%); Rondônia (21.8%); Amazonas (18.2%); Espírito Santo (16.2%); and Maranhão (15.0%).

In January 2005, nominal retail sales rose 13% year-onyear, with a 6.2% increase in volumes and a 6.3% increase in prices. In the period, all sectors posted nominal revenue growth that exceeded the 6.6% year-on-year increase of the Broad National Consumer Price Index (IPCA). Particular mention should be made of the growth in nominal revenues from furniture and home appliance sales (26.3%), and automobiles and motorcycles (27.7%), both of which were influenced by the credit expansion.

Recent trends in wages and consumer confidence suggest continued solid performance of retail sales in early 2005. In the three months ended in January, real retail sales rose 3.1% (seasonally adjusted) relative to the preceding three months,

Seasonal Adjustment of Retail Sales

The IBGE does not yet release retail sales data in seasonally adjusted terms, as it does for the National Accounts and the monthly industrial survey. The reason is the relatively short time series for the survey (initiated in January 2000, with only 60 observations through December 2004), a critical factor for the quality of the seasonal adjustment. However, the need to monitor activity trends at the margin, particularly domestic consumption, led the BCB and market analysts to perform their own seasonal adjustments of the retail sales series.

Though several seasonal adjustment procedures exist, there is still some degree of subjectivity depending on the interpretation given by the analyst to the characteristics of the series. For this reason, it is quite common to come up with different seasonal adjustments and, therefore, very different adjusted data series, which can make it difficult to provide an economic interpretation of a specific variable. This box presents the BCB's methodology for seasonally adjusting the retail sales data series.

Seasonal adjustment of the retail sales data series is done with the X-12-ARIMA method, developed by the U.S. Census Bureau. Among the tests and specifications considered in the adjustment process, the following deserve mention:

- i. Seasonality significance test;
- ii. Composition method (multiplicative or additive);
- iii. ARIMA model used for series extension;
- iv. Treatment for purposes of correcting calendar effects (days of the week/weekends, business days/holidays, moving holidays);
- v. Identification and adjustment of outliers.

The first test refers to the existence (or not) of seasonal influences on the series. Though this influence may sometimes be observed graphically in series with well-defined stationary behavior, on other occasions the seasonal effect can be confused with other components of the series (trend-cycle and irregular component). In retail sales, seasonal effects in December are clearly identifiable in overall sales and in the segments of supermarkets, fabrics, apparel and footwear, and furniture and home appliances. Automobiles, motorcycles and auto parts, and fuel and lubricants do not have graphically distinguishable seasonal characteristics, but the presence of seasonality is identified through specific significance tests (Kruskal-Wallis). In the case of fuel and lubricants, a seasonal increase in consumption in the third quarter of the year is clearly evident, followed by the fourth quarter. Automobiles, motorcycles and auto parts present seasonal components in the fourth quarter.

The method related to the structure of the series refers to the model to which the variable is best suited – additive or multiplicative:

Additive Model: SAt = Xt - (St + Kt) = Ct + It. Multiplicative Model: $SAt = Xt / (St \cdot Kt) = Ct \cdot It$.

In which:

SAt = data with seasonal adjustment in period t;

Xt = data observed in period t;

St = seasonal factor in period t;

Kt = combined calendar factors (days of the week,

leap years, Easter effects, etc.) in period t;

Ct = trend-cycle component in period t;

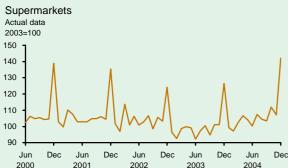
It = irregular component in period t.

The ARIMA model refers to the model adjusted for extension of the series, required in the calculation of the moving averages used in the estimation of trend-cycle and seasonal components, allowing for the use of symmetric filters. It is a RegARIMA model, in which, aside from the ARIMA terms, the regressors referring to the calendar and outlier effects are included. Estimation of the RegARIMA model tends to make the seasonal adjustment process more stable. In the case of retail sales, these series were expanded for the twelve previous months and the twelve months subsequent to the data period.

Retail sales Actual data 2003=100 160 150 140 130 120 110 100 90 .lun Dec .lun Dec .lun Dec .lun Dec .lun Dec 2000 2001 2002 2003 2004

Source: IBGE

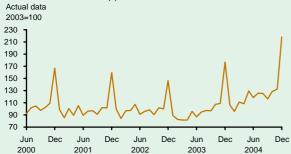
Retail sales



Source: IBGE

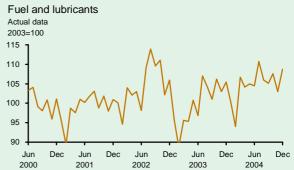
Retail sales

Furniture and home appliances



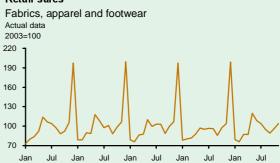
Source: IBGE

Retail sales



Source: IBGE

Retail sales



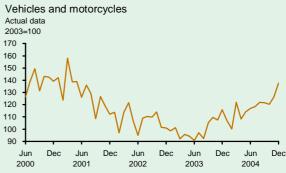
2002

2003

2004

2000 Source: IBGE 2001

Retail sales



Source: IBGE

The number of occurrences of each day of the week (Mondays, Tuesdays and so forth), as well as the occurrence of holidays, are factors that must be considered in the seasonal adjustment process. For data specifically on the retail sector, the influence of these effects is strong and the adjustment requires that they be considered. For example, consider that Saturday is normally a high sales day. Consequently, if a particular month has a greater number of Saturdays when compared to the average number of Saturdays in that month in other years, there will

Retail sales Seasonally adjusted data 2003=100 116 113 110 107 104 101 98 Dec Jun Jun Jun Jun Dec Jun 2000 2001 2002 2003 2004 Adjusted considering calendar effects Actual data

Source: Banco Central do Brasil

be a tendency for this month to register greater sales when compared to the standard. The evolution of seasonally adjusted retail sales data is quite different depending on whether one does or does not consider these influences, particularly for purposes of short-term evaluation¹.

The treatment given by the BCB to the above-mentioned factors was in line with the following criteria:

- Adjustment for the Easter period, available as an option in most econometric packages, is used whenever statistically significant, considering the number of days of influence corresponding to the event (between parentheses in the table of specifications below);
- II. For the series in which only the carnival effect is shown to be relevant, the solution used by IBGE itself for the adjustment of industrial output series was followed. A matrix designated "carnival" was used, and is composed of only one column in which, when carnival occurs in February, the values of "+1" and "-1" are attributed to February and March, respectively (and the opposite when carnival occurs in March), and zero for the other months;
- III. For the series in which, aside from the other factors, the specific days of the week and holidays are important, an adjustment matrix_is used. This matrix, designated "CB" (calendar Brazil) is composed of eight columns, in which the first six supply the numbers for Mondays, Tuesdays, Wednesdays, Thursdays, Fridays and Saturdays (excluding holidays) for each month; the seventh column contains the number of Sundays and holidays in the month; and the eighth column corresponds to carnival².

All of the stated regressors, as well as possible outliers, depending on the significance level, were estimated in the RegARIMA³. It is worth recalling that the seasonally adjusted series is "purged" of

^{1/} For the period extending from January 2000 to December 2004, the standard deviation of the monthly rates of growth in the seasonally adjusted general retail sales series without correction for these effects, is double the value of the standard deviation of the monthly rates of growth of the same series with complete adjustment, including correction of the number of business days, Sundays and carnival and Easter holidays.

^{2/} Note that the sum of each line of the first seven columns of the matrix corresponds to the number of days of the month in such a way that the effects of the occurrence of leap years are automatically adjusted.

^{3/} It should be stressed that use of the matrix CB reduces the number of degrees of freedom in the adjustment, due to the larger number of regressors.

seasonal and calendar influences, but includes any possible outliers that are withdrawn only during the intermediate procedure for calculating the moving averages, being reincorporated into the series at the adjustment conclusion4.

The following table summarizes the specifications, and the graphs below present the evolution of the seasonally adjusted retail sales series.

Retail sales seasonal adjustment - Specifications

Seasonal adjustment		Decomposition	Arima Model	Interventions ^{1/}
Retail sales	Yes	Multiplicative	(011) (011)	CB; Easter (1)
Fuel and lubricants	Yes	Multiplicative	(011) (011)	Carnival;
				TC 2002:8
Supermarkets	Yes	Multiplicative	(011) (011)	CB; Easter (1)
				LS 2002:12
Fabrics, apparel and footwear	Yes	Multiplicative	(210) (011)	Carnival;
				AO 2001:7 ; TC 2003:5
Furniture and home appliances	Yes	Multiplicative	(011) (011)	Carnival; Easter (15)
Vehicles and motorcycles	Yes	Multiplicative	(012) (011)	CB;
				TC 2002:8

Source: Banco Central do Brasil

^{1/} Automatically Identified Outlier (AO) considers the month as atypical; LS considers change of level in the month; TC considers temporary change of level in the month.

^{4/} In finalizing the procedures, one verifies whether the seasonal adjustment was carried out appropriately, observing the absence of residual seasonality and whether the statistics M and Q are acceptable. It is worth mentioning that the process is not static, and there may be a need for revising the specifications from time to time.

Retail sales Seasonally adjusted data 2003=100 115 110 105 100 95 Jun Dec Jun Dec Dec Dec

2002

2003

2004

Source: Banco Central do Brasil

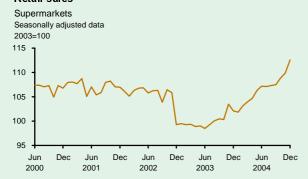
2001

Retail sales Fuel and lubricants Seasonally adjusted data 2003=100 116 111 106 101 96 91 Dec Dec Jun Dec Dec Dec Jun Jun Jun Jun 2000 2001 2002 2003 2004

Source: Banco Central do Brasil

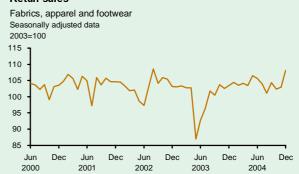
Retail sales

2000



Source: Banco Central do Brasil

Retail sales



Source: Banco Central do Brasil

Retail sales

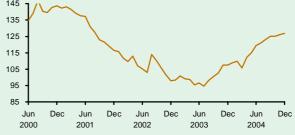
Furniture and home appliances Seasonally adjusted data



Source: Banco Central do Brasil

Retail sales

Vehicles and motorcycles Seasonally adjusted data 2003=100 145



Source: Banco Central do Brasil

Retail sales

					% c	hange
	2004					2005
	Aug	Sep	Oct	Nov	Dec	Jan
In the month ^{1/}						
Retail sector	-0.5	-0.8	0.5	0.6	3.8	-0.3
Fuel and lubricants	-0.5	0.9	-0.7	0.4	0.7	-1.9
Supermarkets	0.2	0.2	1.1	1.0	2.4	-1.2
Fabrics, apparel and footwear	-2.7	3.3	-1.8	1.3	4.3	-0.4
Furniture and home appliances	-1.0	-0.3	-0.3	3.1	5.0	-1.5
Vehicles and motorcycles	1.8	1.3	-0.1	0.3	0.4	-2.6
Quarter/previous quarter ^{1/}						
Retail sector	1.2	-0.5	-1.2	-0.7	1.5	3.1
Fuel and lubricants	-0.6	-0.7	-0.5	-0.2	0.2	0.1
Supermarkets	2.1	1.1	0.9	1.4	2.8	3.0
Fabrics, apparel and footwear	-1.0	-1.9	-2.5	0.0	1.7	3.9
Furniture and home appliances	6.6	2.1	-0.6	-0.6	2.8	5.6
Vehicles and motorcycles	8.7	6.0	4.4	2.8	1.7	0.0
In the year						
Retail sector	9.4	9.4	9.3	9.0	9.2	6.2
Fuel and lubricants	6.0	5.8	5.3	4.8	4.6	-1.1
Supermarkets	5.8	6.2	6.7	6.6	7.2	6.3
Fabrics, apparel and footwear	6.3	6.0	5.2	4.7	4.7	4.2
Furniture and home appliances	29.7	28.6	27.5	26.9	26.4	19.6
Vehicles and motorcycles	19.2	18.8	17.8	17.7	17.8	11.4

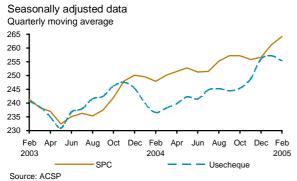
Source: IBGE and Bacer 1/ Seasonally adjusted data

Retail sales 2005, January

Price
6.3
16.5
3.1
10.4
5.6
7.9

Source: IBGE

Retail sales indicators



with particularly strong growth in furniture and home appliances (5.6%) and fabrics, apparel and footwear (3.9%).

Leading indicators of the retail sector also suggest continued growth in early 2005, driven by both credit conditions and improved labor market conditions. The number of consultations of the Credit Protection Service (SPC), an indicator of installment purchases calculated by the São Paulo Trade Association (ACSP), posted seasonally adjusted growth of 3.3% in the three months ended in February, versus the previous three months. Usecheque consultations, which are an indicator of upfront purchases of a relatively lower value than those recorded in the SPC, registered growth of 2.7% in the same period.

Default indicators continued to decline at end-2004 and early-2005. The ratio of checks returned due to insufficient funds to total checks came to 4.7% in December, the lowest level of the year. In January, this ratio was 5.3%, 0.2 p.p. below that registered in the same month of 2004. The Teledata default indicator, which measures the ratio between checks returned and checks received, was 3% in February, versus 2.7% in the same month of 2004.

According to the ACSP, the net default rate (the ratio of the number of new defaults less those canceled and the consultation base with a three month lag), came to 5.8% in the first two months of 2005, down from 5.9% in the same period of the previous year. At the end of 2004, this rate dropped due to the number of cancellations; for the whole year, cancellations dropped by 13.4%, while new occurrences increased by 7%. The net rate was negative in December for the first time since December 1967.

The results of the consumer sentiment surveys indicate that the optimism of end-2004 carried over into the beginning of 2005. The Consumer Confidence Index (ICC), which is calculated by the Trade Federation of the State of Sao Paulo (Fecomercio SP), rose 1.1% in February, compared to the previous month, registering the highest level since the series began in June 1994. At the component level, the Consumer Expectations Index, which accounts for 60% of the general index, expanded 1.4%, and the Current Economic Conditions Index, which represents the remainder of the general index, rose 0.6%.

The National Consumer Expectations Index (INEC) also underscores the strong consumer sentiment. The INEC, which is calculated quarterly by the National Industry Confederation (CNI) and based on a survey conducted in

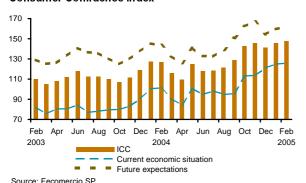
Default rates

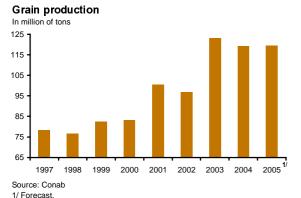
							Rate
Itemization	2004				2005		
	Sep	Oct	Nov	Dec	Jan	Feb	Year ^{1/}
SPC (SP) ^{2/}	4.4	4.1	3.8	-3.4	4.7	7.0	5.8
Returned checks ^{3/}	5.4	5.9	5.3	4.7	5.3		5.3
Telecheque (RJ) ^{4/}	2.1	2.5	2.1	1.7	2.6	3.1	2.2
Telecheque (National)4/ 5/	2.3	2.7	2.4	1.7	2.7	3.0	2.8

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





Agricultural production

In 1.000 tons

	Production		% change
	2004	2005 ^{1/}	
Grain production	119 152	123 408	3.6
Cotton (seed)	2 099	2 233	6.4
Rice	12 808	12 809	0.0
Beans	2 994	2 838	-5.2
Corn	42 192	39 040	-7.5
Soybean	49 770	57 028	14.6
Wheat	5 851	6 022	2.9
Others	3 438	3 439	0.0

Source: Conab 1/ Estimated

end-November, rose 0.8% in the fourth quarter relative to the prior quarter.

1.2 Output

Crops/livestock

According to IBGE National Accounts data, crop and livestock production rose 5.3% in the year, with growth of 2.9% in the final quarter of 2004, compared to the same period of 2003. In 2005, crop production is expected to reach a level similar to that registered in 2004.

Crop output

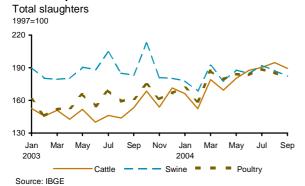
Based on the special survey of the grain harvest carried out by the National Supply Company (Conab) and released by the Ministry of Agriculture in March, production of grains and cereals is expected to total 119.5 million tons, with growth of 0.3% when compared to the previous harvest. This total is 8% below the November forecast of 131.9 million tons, since it incorporates the impact of the drought that hit the states of Rio Grande do Sul, Goiás, São Paulo and Mato Grosso do Sul, particularly affecting the summer soybean and corn harvests. The forecast for lower crop output should also be evident in the next IBGE Systematic Farm Production Survey (LSPA), due to be released at the end of March.

Conab estimates national soybean output at 53 million tons this year, 6.7% more than in 2004. This increase is based on projections for 7.6% growth in the area under cultivation and a drop of 0.8% in average productivity.

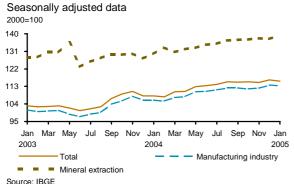
National corn output is estimated at 39 million tons this year, 7.5% below 2004 and nearly 19% below 2003. The accumulated output drop in the last two years is due to higher input costs and greater competition in soybean production. Domestic demand, estimated at 41.2 million tons, will be totally covered by domestic supply, since transition stocks total 4 million tons.

The rice harvest is estimated to hold steady at 12.8 million tons. The area under cultivation is projected to expand 3.3%, while average productivity is expected to drop by 3.2%. Bean production in 2005 is projected to total 2.8 million tons across the three harvests, a reduction of 5.2% versus the

Livestock production



Industrial production



Industrial production

				%	change
	2004				2005
	Sep	Oct	Nov	Dec	Jan
Industry (total)					
In the month ^{1/}	- 0.1	0.2	- 0.3	1.2	- 0.5
Quarter/previous quarter ^{1/}	2.4	1.6	0.8	0.6	0.4
Same month of the previous year	7.5	3.2	7.8	8.3	5.9
Accumulated in the year	9.0	8.4	8.3	8.3	5.9
Accumulated in 12 months	7.2	7.5	8.0	8.3	8.5
Manufacturing industry					
In the month ^{1/}	0.0	- 0.5	0.4	1.4	- 0.3
Quarter/previous quarter ^{1/}	2.2	1.2	0.6	0.6	0.9
Same month of the previous year	7.5	3.1	7.8	8.4	5.9
Accumulated in the year	9.3	8.6	8.5	8.5	5.9
Accumulated in 12 months	7.4	7.6	8.2	8.5	8.7
Mineral extraction					
In the month ^{1/}	0.3	0.2	0.4	- 0.2	1.1
Quarter/previous quarter ^{1/}	2.3	2.1	1.4	1.0	0.9
Same month of the previous year	6.3	6.2	6.0	6.8	7.4
Accumulated in the year	3.6	3.9	4.1	4.3	7.4
Accumulated in 12 months	4.1	4.3	4.5	4.3	4.9

Source: IBGE

1/ Seasonally adjusted data

previous year. The area to be harvested declined 8.8%, while average productivity is expected to increase by 3.9%.

According to the January LSPA, sugar cane production should total 408.2 million tons, a reduction of 0.3% compared to 2004. Growth in the area under cultivation should total 1.1% and productivity is expected to decline by 1.4% in the year.

The same survey indicates that the coffee harvest will total 2.4 million tons, 4.5% less than the previous year's harvest. This result reflects seasonal harvest cycles, as well as climactic irregularities in several production regions. The area under cultivation slipped by 1.1% and average productivity is expected to fall 4.2% in 2004.

Livestock

According to the IBGE, total slaughters in the third quarter of 2004 came to 1.6 million tons of cattle, 1.8 million tons of poultry and 477.5 thousand tons of swine, corresponding to growth of 29.6%, 13.3% and 1.9%, when compared to the same quarter of 2003. In seasonally adjusted terms, growth came to 6.3%, 1.2% and 0.6%, respectively, quarter-onquarter. Exports of cattle, poultry and swine in the fourth quarter totaled 255.3 thousand tons, 122.2 thousand tons, and 645.4 thousand tons, with growth of 42.5%, 8.4% and 31.6%, respectively, relative to the same quarter of 2003.

Industrial output

Industrial activity expanded through the end of 2004 and beginning of 2005, though at a more moderate pace than earlier 2004. In the year, industrial output increased 8.3%, surpassing the growth rates registered in 1993 (7.5%) and 1994 (7.6%), and close to the growth rate achieved in 1986, when industrial activity rose 10.9%.

A breakdown of industrial output by use category reveals the factors that influenced industrial performance in 2004. Consumer durable goods production posted the highest growth in the year (21.8%), outpaced only by the result in 1993, and was driven by the production of automobiles and electric and electronic goods. The performance of these sectors, the first to recover in the second half of 2003, was a consequence of two main factors: credit growth and continued strong export performance.

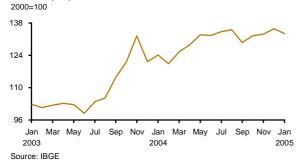
Industrial production by category of use

				9	6 change
	2004				2005
	Sep	Oct	Nov	Dec	Jan
In the month ^{1/}					
Industrial production	- 0.1	0.2	- 0.3	1.2	- 0.5
Capital goods	- 4.0	2.3	0.5	1.7	- 1.5
Intermediate goods	- 0.3	- 0.2	- 1.0	1.2	- 1.3
Consumer goods	1.5	- 0.5	0.7	2.5	1.5
Durable	- 1.9	- 2.1	0.8	2.8	- 4.3
Semi and nondurable	1.9	- 0.5	0.2	3.3	3.7
Quarter/previous quarter ^{1/}					
Industrial production	2.4	1.6	0.8	0.6	0.4
Capital goods	1.2	- 0.6	- 1.6	0.6	1.2
Intermediate goods	2.9	1.4	0.1	- 0.6	- 0.9
Consumer goods	2.0	1.9	1.9	2.1	3.0
Durable	5.2	1.9	- 1.3	- 1.2	- 0.9
Semi and nondurable	0.9	1.0	1.6	2.1	4.0
In the year					
Industrial production	9.0	8.4	8.3	8.3	5.9
Capital goods	24.9	22.4	20.4	19.7	6.8
Intermediate goods	7.6	7.3	7.4	7.4	3.9
Consumer goods	7.7	7.0	7.2	7.3	8.5
Durable	24.7	22.6	22.3	21.8	3.5
Semi and nondurable	4.0	3.5	3.7	4.0	9.8

Source: IBGE

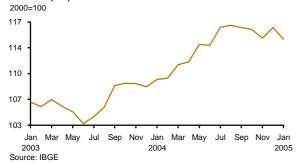
Industrial production

Capital goods Seasonally adjusted data



Industrial production

Intermediate goods Seasonally adjusted data



Credit growth reflected growing domestic confidence. In addition, the greater use of payroll-deducted loans and the reduction in defaults, among other factors, favored a reduction in consumer interest rates - for example, the average annual interest rate on personal consumption loans fell from 48.7% in 2003 to 39.3% in 2004. Exports of consumer durables were driven by world economic growth and by productivity gains in Brazilian industry. The volume of consumer durable exports increased 30.4% in 2004, according to data released by the Foundation of Foreign Trade Studies Center (Funcex).

Output of capital goods also registered strong growth in 2004, at 19.7%, the highest level since 1986, following a trajectory similar to that registered by consumer durables. Over the course of the year, production remained high and was sustained by investment, primarily as a result of improved expectations and growth in the level of installed capacity utilization. The sector has also benefited from credit growth, including both non-earmarked and earmarked credits, the latter mainly through the National Bank of Economic and Social Development (BNDES). The increase in capital goods exports, up 71.1% in the year according to Funcex, was an additional factor underlying the performance of the sector.

The more muted growth of nondurable consumer goods production in 2004 vis-à-vis other categories of final goods was in line with expectations for the sector, since production of these goods is primarily driven by income growth. According to data from the IBGE's monthly employment survey, real wages expanded by approximately 9.6% in 2004, when compared to the previous year. Despite this, the 4% growth in the production of nondurable consumer goods represented the sharpest increase since 1995.

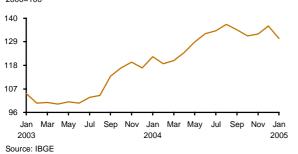
Results for the industrial sector for early 2005 indicate that the expansion has continued, though at a more moderate pace. According to seasonally adjusted data from IBGE, industrial output expanded 0.4% in the three months ended in January, versus 1.6% in October and 3.7% in July. This slowdown was expected since the factors that initially drove the expansion have cooled, while the level of installed capacity utilization has risen.

In the three months ended in January, both the manufacturing and mining sectors grew 0.9%, in seasonally adjusted terms compared to the preceding three-month period, and drove the 0.4% increase in industrial production over the period. Over the same period, consumer durable goods production fell 0.9% and consumer nondurable goods production rose

^{1/} Seasonally adjusted data

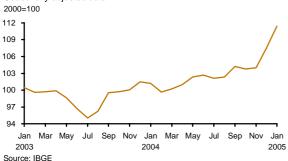
Industrial production

Consumer goods Seasonally adjusted data 2000=100



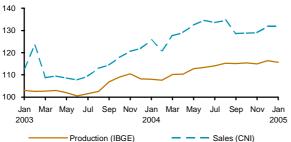
Industrial production

Semi and nondurable goods Seasonally adjusted data



Industrial production and sales

Seasonally adjusted data 2000=100 140



Source: IBGE and CNI

Industrial exports - Volume

Seasonally adjusted data 2002=100



Source: Funces

4%. While the accommodation in consumer durable goods production was expected, given its strong growth earlier in 2004, it is expected a stronger contribution of consumer nondurable goods to growth in line with the recovery in incomes.

From November to January, capital goods output recovered, with an increase of 1.2% compared to the three months ended in October, in seasonally adjusted terms. This result confirms the transitory downturn in capital goods output in September (a month-on-month fall of 4%). The outlook for investment in 2005 appears positive, as demonstrated by such leading indicators as the high level of installed capacity utilization and declining country risk.

The downturn of 0.9% in intermediate goods output in the three months ended in January, compared to the three months ended in October, accompanied the recent deceleration of industrial activity. This segment posted growth of 3.6% and 1.4% in the three months ended in July and October, respectively. The negative rate registered in the November-January period was mainly driven by the results of textiles, wood, rubber and plastics, and basic metals.

The deceleration of industrial activity is also evident in the results of specific sectors. Based on seasonally adjusted data across 22 manufacturing segments, 13 registered a fall in output in the November-January period, compared to the three months ended in October. The largest falloffs in the period were: tobacco, 14.9%; textiles, 5.2%; wood, 4.7%; machines and equipment, 4.5%; and rubber and plastics, 4%. In the three months ended in October, only six manufacturing segments had registered downturns in production.

According to CNI data seasonally adjusted by the BCB, in the three months ended in January, real industrial sales increased 0.1%, compared to the three months ended in October. This result reflected some degree of accommodation in the sector, after a long period of robust growth – in 2004, real sales rose an accumulated 14.3%. Despite the recent stability in industrial sales, CNI indicators for the industrial labor market evolved positively in recent months, signaling a continued growth trend in the sector. Hours worked, employment and overall wages paid by the manufacturing sector expanded by 1.9%, 1.2% and 3%, respectively, comparing the November-January period versus the August-October period.

Vehicles - Production and sales

				% change
	2004			2005
	Oct	Nov	Dec	Jan
In the month ^{1/}				
Production	-4.2	1.9	4.8	-7.5
Total sales	-2.3	2.6	10.7	-14.4
Domestic sales	-3.3	1.3	12.8	-17.2
External sales	6.3	2.5	4.5	-1.5
Quarter/previous quarter ^{1/}				
Production	6.9	0.5	-1.4	-0.9
Total sales	4.2	-3.5	-0.9	0.6
Domestic sales	0.5	-2.1	0.5	0.8
External sales	12.6	-7.6	-1.0	1.0
In the year				
Production	20.9	20.8	21.0	3.1
Total sales	19.3	18.9	19.6	-4.1
Domestic sales	20.1	18.7	19.0	-11.6
External sales	17.4	19.2	21.2	18.3

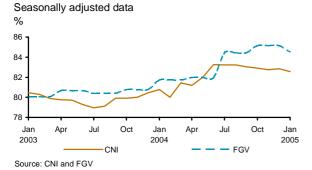
Source: Anfavea

Vehicles - Production and sales



Source: Anfavea

Utilization of installed capacity in the manufacturing industry



Industrial exports demonstrate that, despite the recent downturn, manufacturing activity has continued to expand. According to seasonally adjusted Funcex figures, the volume of external sales increased by 6% for semimanufactured goods and 9.4% for manufactured products in the three months ended in January, versus the August-October period. At the same time, imports of capital and intermediate goods expanded by 16.7% and 9.1%, respectively.

After registering growth of 21% in 2004 and setting a new annual sales record of 2,210,000 units, automobile output decelerated at the end of 2004 and early part of 2005. According to the National Association of Automotive Vehicle Manufacturers (Anfavea), production in the three months ended in January fell by 0.9% in relation to the August-October period, based on seasonally adjusted data. Domestic sales increased 0.8% and foreign sales 1%, using the same basis of comparison.

The level of installed capacity utilization, calculated on the basis of seasonally adjusted FGV data, was 85.2% in October 2004, falling to 84.5% in January 2005. To some extent, this behavior reflected the maturation of investments made since the third quarter of 2003.

Analysis on the basis of use categories indicates that the utilization level for the output of intermediate goods remained relatively stable and at a high level, at 88.4% in January, versus 88.6% in October. The sharpest drop in the period was noted for consumer goods, falling from 80.4% to 77.6%, 10 p.p. below the record high registered in 1994.

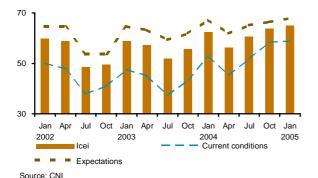
The Industrial Confidence Index (Icei), which is calculated by CNI, reached 64.9 points in January, up from 63.8 points in October 2004. The optimism of the business community was driven by improved perceptions of both current conditions and expectations for the next six months, with confidence at levels just below the record highs registered in January 2000.

Industrial inventory levels recovered in the fourth quarter of 2004. A national quarterly survey carried out by CNI indicated that inventories had reached a level of 51.3 points for final goods – using a scale from zero to 100, in which levels above 50 indicate larger than desired inventories – and 49.8 points for raw materials. In the quarter ended in September, these levels were 49.6 and 48.4, respectively.

In summary, industrial indicators continue to point to a high production level, with some accommodation in the pace of

^{1/} Seasonally adjusted data

Business Confidence Index



Manufacturing industry stocks^{1/}

Itemization	2003	2004			
	IV	ı	П	III	IV
Manufacturing industry					
,	50.4	50.0	500	40.0	540
Final products	52.1	50.6	50.3	49.6	51.3
Raw materials/intermediate goods	48.2	47.6	48.7	48.8	49.8
Large companies					
Final products	53.5	52.2	52.1	51.5	53.8
Raw materials/intermediate goods	50.6	49.7	51.5	51.2	53.6
Small and medium companies					
Final products	51.3	49.8	49.4	48.6	50.0
Raw materials and interm. goods	46.8	46.5	47.3	47.6	47.8

Source: CNI

1/ Values over 50 indicate stocks above the planned level

Unemployment rate 14 13 12 11 10 Sep Jan Jan Mar May Jul Nov Jan Mar May Sep Nov 2003 2004 2005 Source: IBGE

Formal employment

New job openings (1,000 employee						
	2004				2005	
	Oct	Nov	Dec	Year	Jan	
Total	130.2	79.0	-352.1	1 523.3	116.0	
Manufacturing industry	53.0	8.0	-111.7	504.9	32.8	
Commerce	48.2	84.8	10.9	403.9	11.2	
Services	46.2	47.8	-66.3	470.1	54.5	
Building	1.3	-13.7	-35.3	50.8	7.9	
Crop and livestock	-16.2	-44.6	-125.5	79.3	4.1	
Public utilities	-0.6	-1.2	-1.0	4.6	2.7	
Others ^{1/}	-1.6	-2.1	-23.2	9.7	2.8	

1/ Includes mineral extraction, public administration and others

growth, which appears compatible with reaching a more sustained growth path. Positive expectations at the sectoral level, continued export growth, and the dissemination of the effects of the recovery on the labor market further reinforce the favorable outlook for industrial production in the coming months.

Labor market 1.3

Employment

The rate of unemployment, measured by the IBGE, fell to 9.6% in December, compared to 11.4% in the same month of 2003. This fall was triggered by the economic recovery and consequent new job creation, as reflected in the sharp upward movement in the number of employed persons (711,000) in the period. In January 2005, the rate of unemployment stood at 10.2%, a level compatible with seasonality in the early part of the year. However, this figure was still 1.5 p.p. below the level registered in January last year.

Ministry of Labor and Employment (MTE) data posted record levels for the monthly growth in the number of formal sector jobs in 2004. There were 1,523 thousand new jobs created in the year, the best result ever registered by the MTE. Manufacturing was the sector that generated the largest number of jobs, with 504.9 thousand, thereby surpassing the service sector, which has historically been the largest job creator, accounting for 470.1 thousand jobs in 2004. Commerce created 403.9 thousand jobs, compared to 79.3 thousand for the agricultural sector, and 50.8 thousand for the construction industry.

The greater than expected reduction in job creation in December 2004 led some observers to conclude that the virtuous cycle in the labor market was nearing conclusion. However, in January, formal employment expanded sharply once again, generating 116 thousand new jobs in the month, versus 100 thousand in January 2004. The decline in job creation in December was partially due to the larger number of new hires during the year, partly temporary or seasonal.

In the manufacturing sector, CNI statistics collected in twelve states showed an average increase of 3.5% in manufacturing employment in the year. In seasonally adjusted terms, the rates of growth in the third and fourth quarters of the year, when compared to the immediately preceding quarters, was 2.5% and 1.6%, respectively.

Formal employment

		New job openings (1,000 employee					
	January to	In December	(B)/(A)	In the year			
	November						
	(A)	(B)	(%)				
2000	883.4	- 225.8	25.6	657.6			
2001	845.0	- 253.9	30.1	591.1			
2002	1 011.9	- 249.5	24.7	762.4			
2003	945.4	- 299.9	31.7	645.4			
2004	1 875.4	- 352.1	18.8	1 523.3			

Source: MTE

Manufacturing industry Seasonally adjusted data

Real payroll Employmen 114 110 108 110 106 106 104 102 102 100 98 98

Jan Mar

2004

Jul.

Employment

May

Sep Nov

96

.lar

2005

Source: CNI

2003

Jan Mar Mav

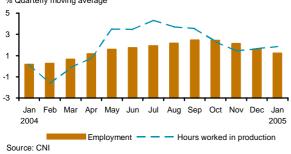
Jul Sep Nov

Real payroll

94

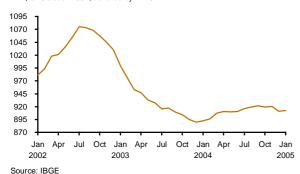
Industrial employment and hours worked in production

Seasonally adjusted data % Quarterly moving average



Average real regular earnings

In R\$ of October 2004, deflated by INPC



Earnings

According to the IBGE survey in the six main metropolitan regions of the country, real average regular earnings fell 0.7% in 2004. This result suggests that the fall in real earnings caused by high inflation in the second half of 2002 and early part of 2003 was not yet recovered, though at the margin there was some improvement. For example, real earnings increased 2.4% in the fourth quarter of 2004, compared to the same period of the previous year. Additionally, in January 2005 the expansion was 2.2%, relative to January 2004.

According to CNI figures, real wages in the manufacturing sector, deflated by the National Consumer Price Index (INPC), showed signs of recovery in the fourth quarter of 2004, posting seasonally adjusted growth of 3.2%, relative to the third quarter. In the year, real industrial payrolls increased 9%.

Gross Domestic Product

According to IBGE, GDP expanded by 5.2% in 2004, the highest annual rate since 1994, when growth reached 5.9%. The 2004 GDP growth reflected the recovery in domestic demand due to the positive evolution of economic fundamentals (which stimulated investment, generated improved credit conditions and gradually expanded income), coupled with the continued strong performance of exports. In the year, household consumption and fixed capital investment expanded by 4.3% and 10.9%, respectively, while exports grew by 18% and imports by 14.3%. A breakdown of 2004 GDP growth shows that 4.1 p.p. was attributable to the domestic market and 1.1 p.p. to the external market.

Sectoral results accumulated in the year also mirrored the evolution of demand components. Crop/livestock production, driven by export sales, rose 5.3%. Industrial activity expanded by 6.2%, driven by robust growth in all subsectors, with the exception of mining, which fell 0.7% (mainly due to a 0.9% drop in crude oil and NGL output). It should be underscored that the performance of oil output reflected periods in which production was suspended at certain platforms for maintenance purposes. The 7.7% increase in manufacturing reflected, primarily, the evolution of credit, which leveraged the production of durable goods, as well as continued growth in exports. The construction industry posted growth of 5.7%, after registering three consecutive years of decline. To some extent, this recovery is the consequence of an upturn in investment. Public utility

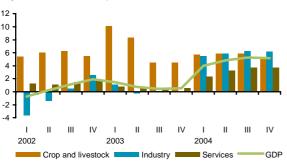
Gross Domestic Product

		% change in the y			
	2003	2004			
		IQ	ΙΙQ	III Q	IV Q
Crop and livestock	4.5	5.8	5.9	5.9	5.3
Industry	0.1	5.5	5.9	6.3	6.2
Mineral extraction	2.9	2.2	2.1	2.1	-0.7
Manufacturing	1.1	9.1	7.9	7.4	7.7
Construction	-5.2	-0.8	2.9	5.9	5.7
Public utilities	2.7	1.5	3.7	4.2	5.0
Services	0.6	2.4	3.3	3.7	3.7
Commerce	-1.9	4.8	6.9	8.1	7.9
Transportation	1.4	10.6	8.0	5.3	4.9
Communications	1.8	-1.4	-0.6	1.0	2.0
Financial institutions	0.6	2.1	3.3	4.0	4.3
Other services	0.5	2.1	4.5	5.4	5.6
Rents	1.3	1.2	1.3	1.6	1.8
Public administration	1.0	2.0	2.2	1.9	1.6
Financial dummy	0.6	0.4	2.9	4.0	4.4
Value added at basic prices	0.7	4.0	4.6	4.9	4.8
Taxes on products	-1.1	4.0	6.4	8.2	8.5
GDP at market prices	0.5	4.0	4.8	5.3	5.2

Source: IBGE

Gross Domestic Product

% growth accumulated in the year



Source: IBGE

Gross Domestic Product - Demand side

	% change in the year						
	2004						
	IQ	ΙΙQ	III Q	IV Q			
GDP at market prices	4.0	4.8	5.3	5.2			
Households consumption	1.6	3.0	4.0	4.3			
Government consumption	0.8	0.8	0.6	0.7			
Gross fixed capital formation	1.8	7.5	11.5	10.9			
Exports	20.5	18.9	18.6	18.0			
Imports	12.5	13.4	14.9	14.3			

Source: IBGE

services (basically electricity generation), expanded 5% as a result of the economic recovery.

Growth of 3.7% in the services sector was driven by positive results across all components. Commerce and transportation were impacted by economic growth and posted respective growth rates of 7.9% and 4.9%. Growth rates for other services and financial services reached 5.6% and 4.3%, respectively. The growth rates for communications, rentals and public administration were 2%, 1.8% and 1.6%, respectively.

The seasonally adjusted expansion of 0.4% of GDP in the fourth quarter of 2004, relative to the third quarter, confirmed the moderation in the pace of economic growth, a tendency that was already signaled by sectoral production indicators. Using the same basis of comparison, GDP had registered growth rates of 1.8%, 1.5% and 1.1% in the first three quarters of 2004, respectively.

All sectors posted positive growth in the fourth quarter, when compared to the third. Crop/livestock production expanded 2%, after contracting in the third quarter. In line with monthly activity indicators, industry expanded 0.5%, which was somewhat lower than in previous quarters. The services sector registered positive growth for the sixth consecutive quarter, reaching 0.5%.

In the fourth quarter, GDP results met expectations for the period and were compatible with growth forecasts for 2005. The growth projection for 2005 assumes continued growth in domestic demand, based on a gradual recovery in the labor market and a moderate expansion in credit, as well as increased investment spending, driven by the consolidation of positive economic fundamentals.

Investment 1.5

Investment increased sharply in 2004, in line with the outlook at the end of 2003. According to Quarterly National Accounts data, released by IBGE, gross fixed capital formation expanded 10.9% in 2004, the best performance since 1994.

The evolution of monthly sectoral indicators suggested a solid performance for investment. Construction inputs expanded 5.7% in 2004. Parallel to this, production, exports and imports of capital goods increased by 19.7%, 71.1%

Gross Domestic Product

% change 2004 Ш IV Ш 4.0 4.8 5.3 5.2 Accumulated in the year 1.2 2.6 4.2 5.2 Accumulated in 4 quarters Quarter/same quarter of the previous year 4.0 5.6 6.1 4.9 Quarter/previous quarter 1.5 seasonally adjusted 18 1 1 0.4

Source: IBGE

Gross Domestic Product - Quarter/previous quarter Seasonally adjusted

			Ç	% change
	2004			
	I	II	III	IV
GDP at market prices	1.8	1.5	1.1	0.4
Crop and livestock	2.5	0.5	-1.9	2.0
Industry	1.4	1.2	2.7	0.5
Services	1.1	1.5	0.7	0.5

Source: IBGE

Gross Domestic Product

			% change	in the year
	2003		2004	2005
	Weights	%		Estimated
Crop and livestock	9.9	4.5	5.3	4.8
Industry	38.8	0.1	6.2	4.6
Mineral extraction	3.9	2.9	-0.7	4.1
Manufacturing	24.2	1.1	7.7	5.2
Construction	7.2	-5.2	5.7	3.3
Public utilities	3.4	2.7	5.0	4.1
Services	56.7	0.6	3.7	3.1
Commerce	7.7	-1.9	7.9	6.6
Transportation	2.4	1.4	4.9	4.7
Communications	3.2	1.8	2.0	3.1
Financial institutions	7.0	0.6	4.3	3.5
Other services	10.4	0.5	5.6	3.2
Rents	10.2	1.3	1.8	1.5
Public administration	15.8	1.0	1.6	1.9
Value added at basic prices		0.7	4.8	3.8
Taxes on products	11.5	-1.1	8.5	6.0
GDP at market prices	111.5	0.5	5.2	4.0

Source: IBGE and Banco Central do Brasil

and 10.2%, respectively, resulting in growth of 6.7% in capital goods absorption in the year.

A breakdown of capital goods production data reveals that growth in the year was broad-based. Production of goods for the construction industry increased 38% and that of capital goods for the transportation sector, 25.6%, driven mostly by items related to aircraft and truck assembly. Production of machines and tractors for the agricultural sector rose 6.4%, after having increased by 21.9% in 2003, while output of serial and mixed capital goods related to the process of re-equipping industrial capacity, posted growth of 20.2% and 14.8%, respectively.

According to Anfavea, farm machinery production expanded 13.9% in 2004 and was mainly driven by the 13.6% and 11.9% growth in the output of harvesters and wheeled tractors, respectively. Meanwhile, truck and bus production expanded by 35.5% and 6.5%, respectively.

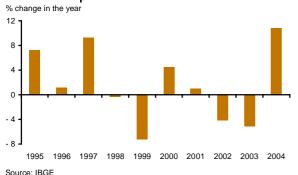
Despite strong growth in 2004, gross fixed capital formation declined by 3.9% in seasonally adjusted terms in the final quarter of the year, when compared to the third quarter. This decline at the margin, which followed a quarter in which investment expanded by 6.8% compared to the previous quarter, is compatible with the volatility normally registered by this indicator. However, despite the quarterly decline, the level of investment has remained high. At the same time, leading indicators for investment in recent months has been favorable, suggesting that in 2005 investment will be consolidated at a level consistent with the continuation of strong levels of output growth.

Several of the available indicators for early 2005 confirm the outlook for a continuation of the recovery in investment. Disbursements of the BNDES System – BNDES, the Special Industrial Financing Agency (Finame) and BNDES Participações S.A. (BNDESpar) – advanced at a favorable pace, after registering expansion of 18.8% in 2004 when compared to 2003. In January 2005, disbursements rose 69.5% above the same month of 2004.

The Long Term Interest Rate (TJLP), which is the basic cost of financing for loans from the BNDES system, remained at 9.75% per year for the fourth consecutive quarter, after having reached 10% per year in the first quarter of 2004.

Indicators for the mechanics capital goods industry, as released by the Brazilian Association of the Machinery and

Gross fixed capital formation



Production of capital goods

% change in the year							
	2004	2004					
	Sep	Oct	Nov	Dec	Jan		
Capital goods	24.9	22.4	20.4	19.7	6.8		
Industrial	16.6	16.5	16.4	16.1	1.7		
Serial	21.2	20.9	20.6	20.2	0.2		
Nonserial	-8.1	-7.6	-6.7	-6.6	10.6		
Agricultural	12.3	10.3	7.6	6.4	-20.0		
Farm parts	-5.9	-8.1	-7.6	-7.5	-70.0		
Building	38.2	38.0	39.1	38.0	34.8		
Electric energy	14.8	13.2	12.4	12.5	19.3		
Transportation	25.9	24.8	24.8	25.6	19.4		
Mixed	25.7	20.7	16.5	14.8	4.1		

Source: IBGE

Production of vehicles

% char					
	2004			2005	
	Oct	Nov	Dec	Jan	Feb
In the month ^{1/}					
Farm vehicles	3.9	-4.4	-5.5	5.1	-7.6
Busses	7.2	17.7	-3.3	-4.5	-7.2
Trucks	-8.0	5.8	5.5	-7.6	-4.4
Quarter/previous quarter ^{1/}					
Farm vehicles	1.6	-1.3	-2.8	-5.2	-6.5
Busses	-4.7	2.3	11.4	18.9	3.9
Trucks	5.8	3.3	1.2	2.5	-0.3
In the year					
Farm vehicles	15.1	13.9	13.9	2.2	-8.2
Busses	5.1	4.7	6.5	65.0	43.7
Trucks	35.6	34.5	35.5	33.3	23.2

Source: Anfavea

1/ Seasonally adjusted data

Equipment Industry (Abimaq), also pointed to a highly positive performance in early 2005. Real revenues of companies that are Abimaq members, deflated by wholesale prices, posted growth of 19.1% in the three months ended in January, when compared to the result for the same period of 2004.

The components of capital goods absorption also registered positive growth in the three months ended in January, as against the August-October period. In seasonally adjusted terms, the increase in the production of capital goods, imports, and exports were 1.2%, 16.7%, and 14.3%, respectively. Production of construction inputs declined 1.8%, using the same basis of comparison.

1.6 Summary

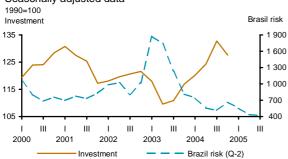
In 2004, the activity level registered a performance that has only rarely been seen in contemporary Brazilian economic history. The economy grew at significant rates and overall economic data mirrors the robustness of the current growth cycle. This is very clear in the strong trade balance results, the across-the-board expansion of industrial production – including the production of both durable and nondurable consumer goods for the domestic market – and, above all else, the sharp increase in investment after several years of only modest results.

The expansion of economic activity for six consecutive quarters has had favorable social impacts, particularly for the labor market, as evident in the strong growth in employment levels – a historic high, in the case of formal employment - together with the rise in household consumption, which has reached its highest level of the last ten years.

Activity indicators suggest that the expansion has cooled somewhat, particularly since the second half of 2004 and into the early part of 2005. As discussed in the December issue of the Inflation Report, this deceleration contributes to the sustainability of the current growth cycle. The recent evolution of business and consumer sentiment, coupled with exports growth and investment expansion, has contributed to the outlook for ongoing activity expansion.

Investment and Brazil risk

Seasonally adjusted data



Source: IBGE and JP Morgan Chase

BNDES disbursement^{1/}

Accumulated in the year (in R\$ million)

	/tocamalatea in the year (in the million)					
	2004			2005		
	Jan	Jan IH Year		Jan		
Total	2 237	18 033	39 834	3 791		
Manufacturing industry	1 109	7 393	15 539	2 099		
Commerce and service	518	7 298	17 122	1 181		
Crop and livestock	600	3 185	6 930	499		
Extraction industry	10	157	243	12		

Source: BNDES

1/ Includes BNDES, Finame and BNDESpar.

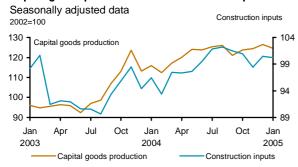
Investment indicators

				% change	
	2004			2005	
	Oct	Nov	Dec	Jan	
Quarter/previous quarter ^{1/}					
Capital goods					
Absorption	5.7	-0.4	-6.9	-6.4	
Production	-0.6	-1.6	0.6	1.2	
Imports	2.7	6.5	8.7	16.7	
Exports	12.3	18.6	35.0	14.3	
Inputs for the building industry	1.9	-0.9	-1.9	-1.8	
In the year					
Capital goods					
Absorption	9.8	7.7	6.7	2.2	
Production	22.4	20.4	19.7	6.8	
Imports	7.0	7.6	10.2	34.6	
Exports	65.5	64.6	71.1	68.9	
Inputs for the building industry	6.0	5.6	5.7	2.6	
BNDES financing	42.9	23.6	18.8	69.5	

Source: IBGE, Funcex and BNDES

1/ Seasonally adjusted data.

Capital goods production and construction inputs



Source: IBGE

Prices

Inflation remained high at the end of 2004 and in the first two months of 2005, particularly consumer price inflation. Though inflation has been strongly impacted by seasonal pressures, mainly linked to perishable foods and education expenses, there was also a broader dissemination of price increases in the period.

The rise in the number of products with monthly price increases and the continuation of core inflation at high levels are further evidence of ongoing inflation pressures. After a year of steady income growth, the economic rebound at the end of 2004, notably in the retail sector, created conditions that facilitated both the pass-through of cost increases to final prices and the recovery of profit margins in specific economic activities.

General price indices

Monthly % change 2004 2005 Sep Oct Nov Dec Jan Feb IGP-DI 0.5 0.5 0.5 0.3 0.4 0.8 IΡΑ 0.7 0.6 1.0 0.5 0.1 0.4 IPC 0.0 0.1 0.4 0.9 0.4 INCC 1.2 0.6 0.7 0.5 0.8 0.4

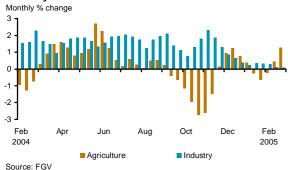
Source: FGV

General price indices 2.1

The general price indices, calculated by the FGV, decelerated in the three-month period through February. This deceleration reflected lower wholesale and civil construction price inflation, which more than compensated for the rise in consumer price inflation. Wholesale price inflation fell sharply as a result of subdued industrial prices, notably among those goods that had registered sharper increases last year. Agricultural prices rose slightly, after posting negative changes in the previous quarter.

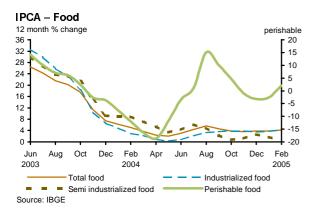
Industrial wholesale prices registered a 0.8% increase in the three-month period through February, compared to 4.3% in the previous three-month period. This deceleration reflected reduced raw material price pressures. In particular, plastic materials prices fell 0.6% in the December/February period, versus a 13.1% increase in the September/November period. For the same months, iron, steel and derivatives prices rose 2.8%, versus 11.6%; fertilizer fell 5.3%, versus a 1.1% decline; and electrical equipment rose 0.7%, versus 2.9%.

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

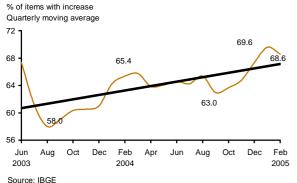


Evolution of IPCA





IPCA



On the other hand, agricultural wholesale price inflation rose from -3.2% in the three-month period ended in November, to 1.4% in the following three-month period. This change was driven by the negative effect of weather conditions on perishable food prices, which increased by 31.4% in the period, compared to an 18.1% decline in the previous period. Despite this trend, animal products prices continued to fall.

The Consumer Price Index – Brazil (IPC-Br) introduced upward pressure on the general price indices, registering a 1.9% rise in the three-month period ended in February, versus 0.5% in the previous three-month period. This result was mainly a consequence of increases in the prices of food and education, among others.

Consumer price indices

The Broad National Consumer Price Index (IPCA), measured by the IBGE, rose by 7.6% in 2004, reflecting increases of 10.2% in regulated prices and 6.5% in market prices.

Monthly IPCA inflation increased after November, for a cumulative 2.0% in the three-month period ended in February, versus 1.5% in the previous three-month period. This acceleration was mainly caused by the rise in market prices (accounting for more than 70% of the index), to 2.0% from 0.9%.

Though price increases in the period have been broad in scope, it is important to highlight the increases in education costs, cigarette prices, cars and, due to poor weather conditions in certain regions, perishable foods and beans.

The IPCA diffusion index, defined as the share of items registering price increases, averaged 68.6% in the threemonth period ended in February, versus 64.8% in the previous three-month period. The broader dissemination of price increases has been observed since the second half of 2003, though they declined in February, when compared to January.

The recent seasonal pressure from education and perishable food prices is expected to dissipate in the coming months. This factor, in addition to the ongoing decline in the prices of primary products, is expected to slow inflation. On the other hand, the recent increase in urban bus fares in the city of São Paulo, as well as expected increases in the price of medicines, should exert upward pressures on inflation.

IPCA 12 month % change 20 16 12 8 Apr Jun Aug Oct Dec Feb Apr Jun Feb Aug 2003 2004 -IPCA Regulated prices Source: IBGE

Consumer price

	Monthly % change					
	Weights	2004			2005	
		Nov	Dec	Year	Jan	Feb
IPCA	100.0	0.7	0.9	7.6	0.6	0.6
Market prices	70.4	0.4	0.6	6.5	0.6	0.8
Regulated prices	29.6	1.4	1.4	10.2	0.5	0.2
Main items						
Electricity	4.7	-0.4	-0.1	9.6	1.3	0.3
Water and sewage	1.8	0.0	1.8	10.4	0.4	1.7
Real estate tax	1.1	8.0	0.8	9.6	0.2	0.7
Gasoline	4.3	2.6	5.1	14.7	0.1	-0.8
Fuel alcohol	1.2	11.2	2.8	31.6	-1.2	-1.4
Health plans	2.5	0.9	1.0	10.5	0.9	0.9
Fixed telephone lines	3.5	2.7	0.4	14.8	0.0	0.0

Source: IBGE

Consumer prices and core inflation

Monthly % char						change
	2004				2005	
	Sep	Oct	Nov	Dec	Jan	Feb
IPCA	0.3	0.4	0.7	0.9	0.6	0.6
Exclusion	0.4	0.6	0.6	0.7	0.6	0.9
Trimmed means						
Smoothed	0.6	0.6	0.6	0.7	0.7	0.6
Non smoothed	0.4	0.6	0.6	0.7	0.6	0.4
IPC-Br	0.0	0.1	0.4	0.6	0.9	0.4
Core IPC-Br	0.4	0.4	0.4	0.5	0.6	0.4

Source: Bacen and FGV

2.3 Regulated prices

Regulated prices increased 10.2% in 2004, and were responsible for 38.7%, or 2.94 p.p. of the 7.6% IPCA increase in the year. The greatest pressures stemmed from fixed telephone rates (14.8%), household electricity (9.6%), water and sewage (10.4%), health plans (10.5%), and real estate taxes (9.6%). Also notable were the pressures from gasoline and fuel-alcohol prices (14.7% and 31.6%, respectively, compared to 1.2% and -12.6% changes in 2003). These two items, taken together, were responsible for virtually 12% of the IPCA change in 2004.

In the three-month period ended in February, regulated prices increased 2.1%, versus 2.8% in the previous three-month period. Regulated prices contributed 0.62 p.p. of the 2.0% IPCA change in the period, with increases in several items with significant weights in the index.

In particular, electricity rates rose 1.4% in period, mostly due to the 12.7% increase in the rates charged by Ampla, the former Rio de Janeiro Electricity Company. The prices of gasoline and diesel oil increased 4.3% and 6.4%, respectively, reflecting hikes of 4.2% and 8% in the refineries as of November 26. Urban bus fares increased 6.7% in Fortaleza, and water and sewage rates rose 26.5% in Fortaleza, 11.7% in Rio de Janeiro and 25.8% in Brasília.

In the coming months, regulated prices will be pressured by adjustments of household electricity rates in April in the states of Pernambuco, Minas Gerais, Rio Grande do Sul, Bahia and Ceará; of urban bus fares in São Paulo, as of March 5, and in Porto Alegre, as of March 13; and of telephone rates (fixed to mobile).

Core inflation

Core inflation measures in the three-month period ended in February posted annualized rates that were inconsistent with the inflation target path.

IPCA core inflation calculated by excluding household food and regulated prices recorded a 2.2% cumulative increase in the three-month period ended in February, versus the cumulative increase of 1.5% in the previous three-month period. The acceleration reflected pressures from the prices of food away from home, tuition fees, electronic appliances, domestic help and new cars.

Market Prices Behavior in 2004

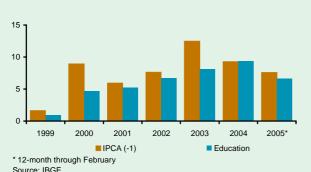
Consumer price

		Annual % chang			% change
	Weight	Variation		Contribution	
		2003	2004	In 2004	Share
IPCA	100.0	9.3	7.6	7.6	100.0
Market prices	71.1	7.8	6.5	4.7	61.3
Tradables	40.1	8.7	6.3	2.5	33.3
Non tradables	31.0	6.7	6.9	2.1	28.0
Regulated prices	28.9	13.2	10.2	2.9	38.7
Items					
Food and beverages	23.1	7.5	3.9	0.9	11.8
Housing	16.6	12.3	7.1	1.2	15.5
Housing products	5.6	6.9	5.4	0.3	4.1
Apparel	5.2	10.2	10.0	0.5	6.8
Transportation	21.2	7.3	11.0	2.3	30.7
Health and personal care	10.5	10.0	6.9	0.7	9.5
Personal expenses	9.1	9.6	6.9	0.6	8.3
Education	4.8	10.2	10.4	0.5	6.4
Communications	3.8	18.7	13.9	0.5	6.8

Source: IBGE

Evolution of IPCA and education

Annual % change



In 2004, IPCA inflation rose 7.6%, below the 9.3% rate registered in 2003 and within the inflation target defined by the National Monetary Council (CMN) for the year (5.5% + /- 2.5%). Market prices rose 6.5%, versus 7.8% in 2003, while regulated prices increased 10.2%, compared to 13.2% in the previous year. The rise in market prices was responsible for 4.66 p.p. of headline IPCA inflation in 2004, while regulated prices contributed 2.94 p.p., corresponding to 61.3% and 38.7%, respectively, of the annual inflation rate.

In the year, market prices were positively impacted by favorable developments in the food supply and by the exchange rate appreciation. The decline in the prices of rice, perishable food and soybean oil (-17.1%, -3.2% and -11.3%, respectively), helped to curtail the average increase in food prices, from 7.5% in 2003 to 3.9% in 2004.

The impact of exchange rate appreciation is clear in the dissimilar behavior of tradable and nontradable price inflation. Tradable goods inflation decelerated from 8.7% in 2003 to 6.3% in 2004, while nontradable goods and services inflation rose from 6.7% to 6.9% in the period. It is important to emphasize that even those tradable goods that registered large price increases in 2004, such as medicines, decelerated sharply in comparison to the previous year.

The decline in market price inflation in 2004 could have been more accentuated had it not been for three factors: (i) backward-looking prices; (ii) international oil prices; and (iii) the rise in metal prices, particularly iron and steel.

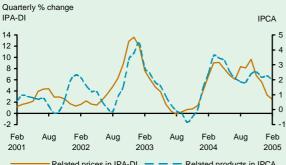
Price of oil and derivatives - Influence Quarterly % change IPA-DI IPCA 14 5 10 6 2 -2 Feb Feb Feb Feb Feb Aua Aua Aug Auc 2001

Related products in IPCA

Source: IBGE and FGV

Price of iron and steel - Influence

Related products in IPA-DI



Source: IBGE and FGV

Though sharper in the case of regulated prices, as a result of contractual indexation, backward-looking price adjustments are also evident in some market prices, particularly in the case of education enrollment and monthly tuition fees.

The impact of higher international oil prices is mainly felt on regulated prices, and particularly fuel prices. However, it is important to underscore that the surge in international oil prices also affected market price inflation in 2004. In effect, the 32.8% average increase in oil prices introduced significant pressure on chemical and plastic wholesale prices, which posted an average increase of 24.4%. At the consumer level, the average price increase of cleaning and plastic products, shoes, hygiene products and other goods that utilize chemical and plastic inputs was 6.4% in the year.

Like oil, international metal prices rose sharply in 2004, mostly as a consequence of strong global growth. This trend had a particularly significant impact on certain consumer goods that are iron and steel-intensive. In particular, consumer durable price inflation accelerated from 3.9% in 2003 to 8.9% in 2004, and car prices rose 13.7% in the year, the largest increase since 2000. The average increase in the year of prices of goods that utilize iron and steel was 32.9% at the wholesale level and 10.5% at the retail level.

The impact of the oil and metal price shocks on 2004 inflation can be estimated by excluding cleaning and plastic products, shoes, hygiene products, kitchen apparel, electro-electronics, cars, motorbikes and repair goods from the IPCA. In this case, market price inflation would have been 5.9% in the year, significantly below the actual 6.5% increase.

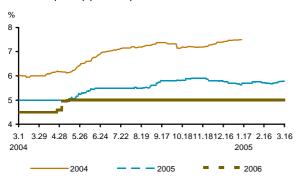
Core inflation

12-month % change 13 9 7 5 Feb Apr Jun Aug Oct Dec Feb Apr Jun Aug Oct Dec Feb 2003 2004 IPCA exclusion IPCA - Smoothed trimmed means

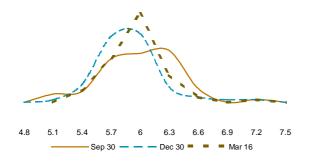
Source: Bacen and FGV

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

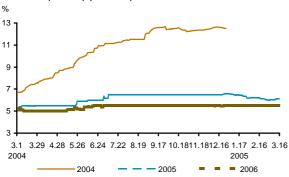
Core IPC-Br



Probability density for IPCA expectations (2005)



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



The smoothed trimmed-means core inflation rose from 1.7% in the three-month period through November to 1.9% in the following three-month period. The non-smoothed trimmedmeans core, in the same periods, rose from 1.5% to 1.7%.

The IPC-Br core inflation, calculated by FGV under the trimmed-means method, increased by 1.5% in the threemonth period ended in February, compared to 1.2% in the previous three-months.

Market expectations

According to a survey carried out by the BCB's Gerin, market inflation expectations for the IPCA remained relatively stable in the first quarter of the year. The median of market expectations for the 2005 IPCA ranged between 5.7% and 5.8% during the period. For 2006, the median of market expectations for the IPCA remained at 5.0%, stable since the middle of the second quarter of last year.

The stability of the median of IPCA expectations for 2005 has been accompanied by the fall in the degree of dispersion of the sample. The distribution of survey participants' expectations has gradually converged around the median. For 2006, there were no significant changes in the distribution.

With regard to market expectations for the IGP-M, a slight reduction for 2005 was observed during the quarter (6.1%). This reduction followed a period of stability that lasted the entire second half of 2004. For 2006, the median of IGP-M expectations remains at 5.5%.

The behavior of inflation expectations in the first quarter of the year can be explained by the constant revisions in market expectations for the exchange rate trajectory and the monetary policy stance, as well as by the reversal in estimates for the adjustment of 2005 regulated prices. These expectations increased from September to December, before dropping back to the levels forecasted in September. The long-term expected trajectory for the exchange rate was revised, with a downward shift in the 2005 median from R\$/US\$2.88 at the end of December to R\$/US\$2.71 in mid-March: for 2006, the median fell from R\$/US\$3.06 to R\$/ US\$2.90 in the same period. For the end-of-period exchange rate, a similar move was recorded.

Over the course of the quarter, the market also revised its medium term monetary policy expectations, by increasing

Summary of market expectations

	9.	30.20	04	12	12.30.2004			3.16.2005		
	2004	2005	2006	2004	2005	2006	2005	2006		
IPCA	7.3	5.8	5.0	7.5	5.7	5.0	5.8	5.0		
IGP-M	12.4	6.5	5.5		6.6	5.5	6.1	5.5		
IPA-DI	15.2	7.0	6.0	15.1	6.9	5.9	6.2	5.8		
Regulated Prices	8.5	7.0	5.9	9.9	7.1	6.0	7.0	5.8		
Selic (end-of-period)	17.0	15.3	14.0		16.0	14.4	17.0	15.0		
Selic (average)	16.3	16.1	14.5		17.1	14.7	18.5	15.8		
Exchange rate (end-of-period)	3.00	3.15	3.30		2.95	3.13	2.80	2.99		
Exchange rate (average)	2.98	3.10	3.25		2.88	3.06	2.73	2.90		
GDP growth	4.5	3.5	3.5	5.1	3.5	4.0	3.7	3.7		

the expected Selic rate from 17.1% p.a. to 18.5% p.a. (2005) average), and from 16.0% p.a. to 17.0% p.a. (end-of-2005). For 2006, the median of market expectations for the average Selic rate increased from 14.7% p.a. to 15.8% p.a., while the end-of-year rate rose 14.4% p.a. to 15.0% p.a.

2.6 Summary

The upsurge of inflation at the end of 2004 and beginning of 2005 resulted from: (i) supply shocks, mainly the hikes in the prices of perishable foods and important raw materials; (ii) indexation mechanisms, driving adjustments in education costs and in backward-looking regulated prices; and (iii) strong demand, caused by expanded income and credit.

The first two factors are temporary, and will have a lesser impact on inflation over the coming months, due to favorable seasonal effects on food prices and lower regulated price adjustments. Meanwhile, in the coming months, demand is expected to reflect the impact of the recent monetary policy tightening.

Credit, monetary and fiscal policies



3.1 Credit

In the three-month period through February, credit growth was mainly attributable to seasonal factors (in the nonearmarked segment) and to the increase in BNDES loans (in the so-called earmarked or directed-lending segment). With regard to non-earmarked credit, personal credit expanded sharply in response to the concentration of household financial commitments in the beginning of the year (taxes, education fees, etc.), and was further supported by the easier access to payroll-deducted loans. Corporate credit expanded moderately.

Total credit reached R\$498.3 billion in February, an increase of 3.9% relative to November and 20.5% compared to February 2004. Credit-to-GDP reached 26.7% in February, versus 26.1% in November.

Credits granted by private financial institutions reached R\$300.3 billion in February, up 2.7% compared to November, mainly due to the increase in credit to individuals. Loans by state-owned banks totaled R\$198 billion, up 5.9% compared to November, with particularly strong growth in export loans and rural credit.

In February, loans to the private sector totaled R\$479.2 billion, an increase of 4.1% compared to November. Financing to the services sector grew 3.1%, with a particularly strong performance in aircraft export financing; to industry, rose 1.6%, mostly to the vehicles, mining and paper and pulp industry; and to commerce, up 3.4%, mostly to supermarkets and home appliance outlets.

Credit to the public sector reached R\$19.1 billion in February, a decline of 1.5% relative to November, due to credit amortizations by state-owned electricity and oil companies. Sub-national government credit operations fell 0.8%, to R\$14.2 billion in February.

Credit operations

					R\$	billion
	2004		2005		% growth	
	Nov	Dec	Jan	Feb	3	12
					months n	nonths
Total	479.6	485.0	491.7	498.3	3.9	20.5
Non-earmarked	272.7	271.4	277.5	284.5	4.3	24.3
Corporate	160.4	158.1	160.5	163.7	2.1	19.2
With external funding	50.0	46.2	47.5	48.5	-2.8	-2.3
Individuals	112.4	113.3	117.0	120.8	7.5	31.8
Earmarked	174.1	180.4	180.4	179.6	3.2	12.9
Housing	24.1	24.3	24.4	24.5	1.7	7.2
Rural	53.6	55.3	55.3	55.2	3.0	21.9
BNDES	92.9	97.2	97.0	96.4	3.7	10.0
Others	3.5	3.6	3.6	3.6	1.4	5.8
Leasing	13.3	14.0	14.6	15.0	12.7	53.1
Public sector	19.4	19.2	19.1	19.1	-1.5	21.8
% participation:						
Total/ GDP	26.1	26.2	26.5	26.7		
Non-earmarked/GDP	14.9	14.7	14.9	15.2		
Earmarked/GDP	9.5	9.8	9.7	9.6		

In February, total leasing operations reached R\$15 billion, an increase of 12.7% relative to November. New credit volume rose 14.1%, and new contracts increased 11.1%, to 112 thousand contracts. This performance was attributable to increased operations with individuals, mainly for auto financing, which accounts for approximately 67% of total leasing.

Earmarked credit

Earmarked credit totaled R\$179.6 billion in February, with growth of 3.2% compared to November. This performance reflected a 3.7% expansion in financing granted by BNDES and a 3% growth in rural credit.

In the first two months of the year, BNDES disbursements totaled R\$6.3 billion, an increase of 20% over the same period of 2004. A sectoral breakdown indicates that disbursements to industry increased by 18.6%, mainly driven by the aircraft industry; disbursements to commerce and services increased by 53.1%, with particularly strong performance of transportation and energy; and financing to farm activities dropped 23.3%.

Applications for credit with BNDES totaled R\$8 billion in the January-February period, a 44.4% decline compared to the same period of 2004. This reduction was concentrated in the mining and aircraft industries and in commerce and services, particularly the construction industry. Once the requests submitted by these sectors are excluded, the volume of consultations in the period increased by 8%.

Financing to the farm sector totaled R\$55.2 billion in February, with growth of 3% in relation to November. These loans were mostly concentrated in working capital (43.5% of total rural credit) and investment (52% of total), compared to 42.7% and 50.1% in November, respectively. Sales and marketing loans dropped from 7.2% of total rural credit in November to 4.5%, due to seasonal factors.

House financing, including both operations with individuals and credit unions, totaled R\$24.5 billion in February, up 1.7% versus November. This result was mainly impacted by a 36.2% increase in disbursements funded by saving accounts, used to finance 14.6 thousand houses. New houses represented 52.3% of the total granted, as against 41.3% in the September-November period.

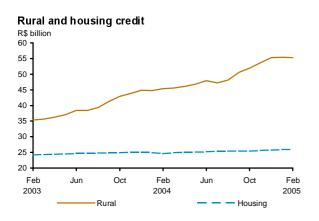
BNDES Disbursements

R\$ million

			ττφ πιπιοπ
·	Jan-Feb		% growth
	2004	2005	
Total	5 215	6 257	20.0
Industry	2 592	3 075	18.6
Other transportation equipment 1/	346	1 603	363.3
Motor vehicles	672	167	- 75.1
Food and drink products	527	260	- 50.7
Cellulose and paper	66	134	103.0
Metallurgy	196	175	- 10.7
Machines and equipment	222	171	- 23.0
Commerce/Services	1 531	2 344	53.1
Electricity, gas and hot water	334	887	165.6
Overland transport	418	881	110.8
Construction	328	156	- 52.4
Vehicle dealer ship and reparation	238	90	- 62.2
Crop and livestock	1 092	838	- 23.3

Source: BNDES

1/ Includes aircraft industry



Non-earmarked credit

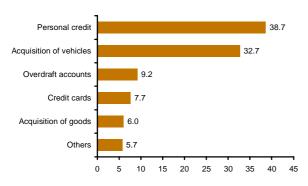
% growth in 12 months



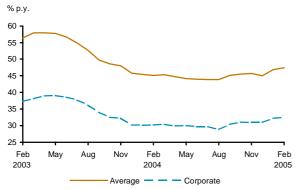
Distribution of corporate credit modalities - %

February, 2005 Working capital 25.6 Guaranteed overdraft accounts 16.4 Advances on export contracts 15.5 Foreign lending 6.1 Vendor Discounting of trade bills Acquisition of goods Import financing Others 10 15 20 25 30 5

Distribution of credit modalities - Individuals - % February, 2005



Interest rates on non-earmarked credit



Non-earmarked credit

In February, non-earmarked credit totaled R\$284.5 billion, accounting for 57.1% of total credit and up 4.3% compared to November. Corporate credit reached R\$163.7 billion, an increase of 2.1% versus November. Corporate credit with domestic funding grew 4.3% as a result of seasonal demand for inventory recomposition and cash flow adjustment. Corporate credit with external funding fell 2.8%, primarily as a result of the real's appreciation and the significant volume of amortizations.

Credit to individuals totaled R\$120.8 billion in February, increasing 7.5% in relation to November. The demand for credit was affected by the concentration of household financial commitments in the early part of the year, particularly spending on education and taxes. Growth was concentrated in payroll-deducted credit contracts, particularly among retirees, and loans for durable goods acquisition, mostly auto loans.

The average cost on non-earmarked credit reached 47.5% per year in February, up 1.8 p.p. in relation to November, reflecting the monetary tightening as of September, as well as the impact of the seasonal increase in more costly credit instruments.

The average interest rate for individuals increased by 0.6 p.p. in the three-month period to February, to 64% per year. For overdraft accounts, personal credit, and auto loans, rates increased 4.4 p.p., 1.5 p.p. and 0.6 p.p., respectively.

The average interest rate for corporates increased from 30.9% per year in November to 32.4% in February. This reflected higher rates across the main credit instruments, as well as changes in the relative weight of each instrument in total credit. In particular, the relative participation of lower cost credit lines, such as Advances on Export Contracts (ACC), diminished, while higher cost operations such as working capital and overdraft credits expanded.

The banking spread for non-earmarked credits came to 28.8 p.p. in February. The 1 p.p. increase in the November-February period was concentrated in overdraft accounts and working capital loans. The increased weight of credit to individuals in total non-earmarked credit also impacted the overall result, since these operations have higher average spreads.

Defaults on non-earmarked credits reached 7.3% in February, an increase of 0.1 p.p. compared to November.

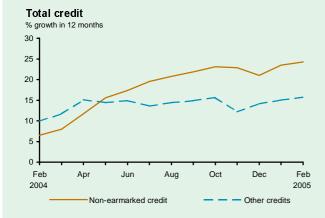
Recent Credit Trends

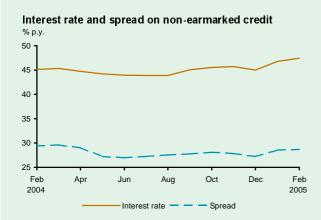
Total financial system credit – both earmarked and non-earmarked – has increased steadily since 2004, reaching R\$498.3 billion in February this year. This represents a 20.5% increase in twelve months, and outpaces the 8.4% growth registered in 2003. Credit growth has been driven by consumption and investment demand, and has been an important underpinning of the economic recovery. The credit expansion was also supported by the easing of monetary policy in the second half of 2003.

The pick-up in domestic demand, along with export growth, has been a key driver of the economic recovery – and has been sustained by the expansion of credit. Of particular note, demand for consumer durables (which is highly sensitive to credit conditions) increased briskly at the outset of the recovery. In constrast, the demand for nondurable consumer goods began to pick up further into the recovery, in response to the improvement in labor market conditions.

Credit growth has been most robust in the nonearmarked segment. Non-earmarked credit grew 24.3% in the twelve months through February, the strongest pace since 2001, to R\$284.5 billion. Earmarked credit operations increased 12.9% in the twelve months through February, to R\$179.6 billion, primarily driven by loans for crop and livestock activities.

Over the past year, the credit market has generally been characterized by a reduction in interest rates and lengthening of loan tenors, as well as an improvement in asset quality. However, the monetary policy tightening cycle begun in September 2004 contributed to an increase in the cost of credit, particularly for fixed-rate loans.





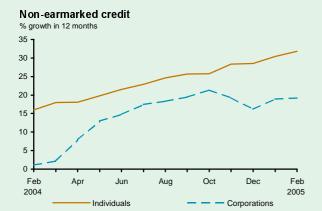
Interest rates on non-earmarked credit have followed the monetary policy cycle. Through the first half of 2004, the average interest rate declined steadily, to 43.9% p.a. in August from 45.8% in December 2003. Then, beginning in September, lending interest rates began to increase, reaching 47.5% p.a. in February. The behavior of banking spreads mirrored that of lending rates, dropping to 27 p.p. in June (the lowest level since June 2002), and then increasing in the latter half of the year. Nevertheless, the 28.8 p.p. spread registered in February remained 0.6 p.p. below that of the same month of 2004.

The average maturity of non-earmarked credit increased by 14 days in the last twelve months, to 234 days as of February, owing to an improvement in financial institutions' risk perceptions (in line with the more stable economic environment). Following a seasonal increase in the first quarter of 2004, the default level fell over the course of the year, with the percentage of arrears greater than 15 days dropping to 7.3% in February. The reduction in defaults was attributable to the favorable impact of the economic recovery on employment and earnings, and signals that the expansion of credit is occurring on a sustainable and prudent basis.

Another important development in the credit market has been the brisk pace of acquisitions and mergers among banks. These strategies are aimed at expanding consumer credit operations, given the growth potential in this segment (particularly in a context of enhanced economic stability and ongoing improvements in employment and income). Deals have involved acquisitions of the portfolios of smaller institutions specialized in this market niche, as well as partnerships with retailers.

Non-earmarked credit to individuals has shown particularly robust growth, and is evidence of the direction of more resources toward the consumer segment. In February 2005, these operations totaled R\$120.8 billion, an increase of 31.8% over the last twelve months. Demand was greatest for instruments with longer maturities and lower interest rates, such as personal credits and vehicle acquisitions.

The growth of personal loans has been particularly strong, expanding 46%, to R\$46.7 billion. For the



Total volume by modality - Individuals 50 40 30 20 10 Feb Aug Oct Feb Apı Jun 2004 2005 Personal credit Acquisition of goods Overdraft accounts

most part, this is attributable to the growth in payrolldeducted loans, which have lower credit risk and interest rates.

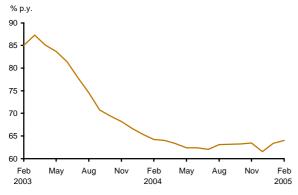
According to a survey carried out by the BCB among thirteen of the largest institutions in the personal credit segment, payroll-deducted loans totaled R\$13.6 billion in February, increasing 98.7% over twelve months. The growing share of payroll-deducted loans has contributed to the overall reduction in personal loan interest rates, with positive implications for the profile of household indebtedness, as well as on the average tenor of personal credit operations, which increased by 46 days in the last twelve months to 281 days.

The growth of payroll-deducted loans was particularly driven by the increase in operations with retirees and pensioners in the National Social Security Institute (INSS) in the second half of 2004. This expansion reflected agreements signed between financial institutions and the INSS, resulting in a significant expansion of the eligible client base. According to Dataprev statistics, these operations totaled R\$3.6 billion through the middle of February, with a total of 1.4 million contracts. The growth outlook for this segment is quite strong, particularly since only 7.5% of eligible recipients have entered into loan contracts.

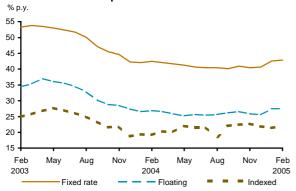
The expansion in loans for consumer durable goods acquisition, including vehicles, has also been significant, supported by the reduction in interest rates in the first half of 2004 and the growth in income and employment. The auto loan portfolio totaled R\$39.5 billion in February, an increase of 26.3% over twelve months, while loans for other consumer goods rose 36%, to R\$7.3 billion.

The outlook for 2005 suggests continued credit growth, particularly in the personal loan segment and driven by payroll-deducted loans. However, the pace of the credit expansion is expected to ease relative to 2004, in line with the current monetary policy cycle.

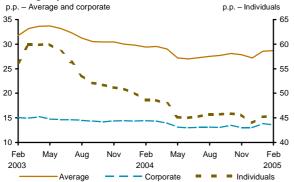
Interest rates on fixed rate credit - Individuals



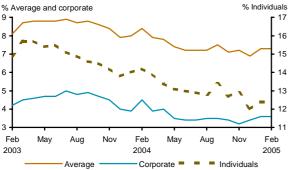
Interest rates on corporate credit



Average spread on non-earmarked credit



Credit default rates11



1/ Non-earmarked credit in arrears of more than 15 days

Despite the seasonal increase in the early months of the year, arrears on operations with individuals declined by 0.5 p.p. to 12.4%, in contrast to a 0.4 p.p. rise to 3.6% in the corporate segment.

Monetary aggregates 3.2

Money supply (M1) totaled R\$120.7 billion at the end of February. The 20.3% growth in the twelve months through February was caused by a 19.8% increase in currency held by the public and a 20.7% rise in demand deposits.

With lower seasonal demand for currency, M1 incomeelasticity increased in the December-February period. Considering a moving twelve-month average, the GDP-M1 ratio continued the downward trajectory noted in 2004.

Seasonally adjusted data in real terms show that the M1 upward trajectory in the December-February period is consistent with continued expansion in economic activity and in credit operations.

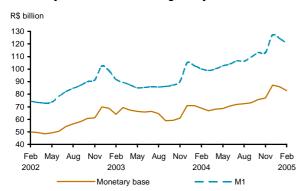
The monetary base totaled R\$82.9 billion in February, an increase of 20.6% over twelve months. Currency expanded by 20.1% and banking reserves grew 21.7%.

Among the factors driving the monetary expansion in the December-February period, was the R\$23.6 billion impact from the BCB's acquisitions in the interbank foreign exchange market. In contrast, National Treasury operations and operations with the financial system resulted in contractionary impacts of R\$6.6 billion and R\$3.3 billion, respectively. This result, coupled with the R\$4 billion increase in monetary base demand, favored a net placement of R\$9.7 billion in federal public securities in the period.

The broad money supply behaved similarly to M1 in the December-February period. M2, which encompasses M1, saving accounts and time deposits, expanded by 4.6% in the three-month period, and 20.7% in twelve months.

M3, which encompasses M2, mutual funds and federal public securities used in repo operations carried out between the nonfinancial sector and the financial system, expanded by 4.3% in the December-February period and 17.6% in twelve months. The M4 concept, which includes M3 plus public securities held by nonfinancial entities, totaled R\$1.1 trillion in February, up 4.1% in the three-month period and 14.9% over twelve months.

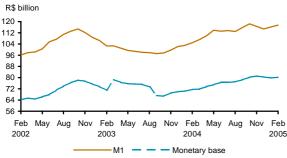
Monetary base and M1 - Average daily balances



M1 - Income-velocity1/ 19 18 17 16 15 Feb May Nov Feb May Feb Feb 2002 2003 2004 2005 In the month 12-months moving average

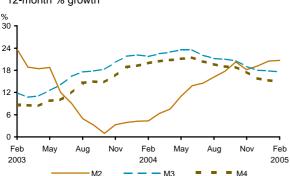
1/ Ratio between 12 month accumulated GDP and average M1

M1 and monetary base at February 2005 prices seasonally adjusted1/



1/ Deflated by: IPCA.

Broad money supply 12-month % growth



Federal public securities

The net placement of federal public securities in the threemonth period ended in February totaled R\$13.5 billion, with placements of R\$90.8 billion and redemptions of R\$77.4 billion. The average term of the securities issued increased for both fixed and floating rate securities, moving from 18.1 months in November 2004 to 25.5 months in February.

In February, the Treasury issued National Treasury Notes - Series F (NTN-F) maturing in January 2010. This was the longest maturity for a fixed rate public bond ever issued in Brazil. The increase in demand for longer term fixed rate bonds led the National Treasury to make larger offers of these securities since November 2004, via issuance of the 2008 NTN-F.

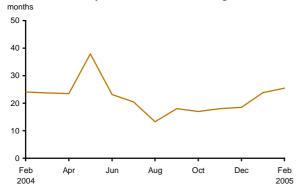
In the period, the Commodities & Futures Exchange (BM&F) issued two new derivative instruments: the IPCA futures contract and the coupon DI x IPCA futures contract. By fostering greater demand and liquidity, these contracts will aid the portfolio management of IPCA-indexed NTN-B holders. Development of this market is expected to encourage increased issuance of inflation-indexed public securities, which have the longest tenors among those issued by the Treasury.

In February, the National Treasury announced the 2005 Annual Financing Plan. Among its general guidelines are: (i) lengthening of the average debt tenor; (ii) reduction of the share due to mature in twelve months; and (iii) substitution of Selic and exchange rate indexed bonds for fixed rate and inflation-indexed securities. In light of the expected reduction in excess liquidity in the banking system, the plan projects an increase in the domestic securitized federal debt. Since this increase is compensated by a decline in the BCB's repo operations, there will be no impact on the net public sector debt.

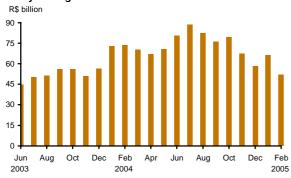
Parallel to the contractionary monetary impact of the net placement of bonds, the increased demand for money in the three months ending in February enabled a reduction in the average monthly balance of liquidity management operations conducted by the BCB. The amount fell to R\$52.1 billion in February 2005, from R\$67.2 billion in November 2004.

Since December the BCB has conducted exchange operations - sales coupled with purchases of National Treasury Bills (LTN) from its own portfolio – that redeemed shorter tenor bonds and aimed to influence medium-term

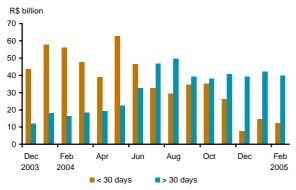
Issues of federal public securities - Average tenor



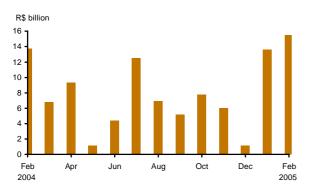
Net financing position of the federal public securities -Daily average



Central Bank repo operations - Maturity



Net redemption of exchange rate securities and swaps



liquidity conditions. In January, the BCB also conducted outright sales of LTNs. The exchanges totaled R\$12.1 billion and the sales totaled R\$9.4 billion.

Despite the net excess liquidity position in the financial system, the BCB has at times injected small amounts of liquidity into the system. This situation is a result of the lengthening of repo operations, as well as outright sales and exchanges of LTNs.

With the objective of accelerating the reduction in the public sector's foreign exchange exposure, the BCB began conducting reverse FX swap auctions in February, in which the BCB assumes a long FX position and a short interest rate position. These contracts are, effectively, FX-linked debt redemptions, to the extent that their cash flow matches that of outstanding FX swap contracts. These instruments were issuedfour times in February, with placements of US\$5.3 billion. Other FX-linked debt redemptions totaled US\$5.2 billion, with US\$2 billion in FX swap maturities and US\$3.2 billion in FX-linked public securities.

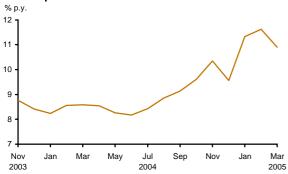
Real interest rates and market expectations

Based on the mid-March BCB survey, the real one-year ex-ante interest rate was 10.9% p.a., versus 10.3% p.a. at the end of November. This change reflects the effects of the monetary policy tightening cycle initiated in September, and corresponds to a 0.1 p.p. increase in the expected Selic rate, and a reduction in expected IPCA inflation for the coming twelve months.

The behavior of futures market interest rates – as reflected in the 360-day DI swap x fixed rate – was impacted by the uncertainties surrounding the pace and timing of the Selic rate adjustment. The downward trend through December in longer term swap rates reversed in early 2005, primarily due to expectations of a more prolonged domestic tightening cycle and, on the external front, to fears of a faster pace of increase in U.S. interest rates.

In the final week of February, however, the market reduced its interest rate expectations, in response to the release of that month's Copom meeting minutes. Subdued wholesale price inflation and stability in consumer price inflation led markets to expect a pause in monetary tightening. One-year swap rates rose to 18.5% p.a. at end-February, an increase of 0.6 p.p. compared to November, notwithstanding the 1.5 p.p. increase in the Selic rate target in the period.

Ex-ante real interest rate - Deflated by 12 month **IPCA** expectations



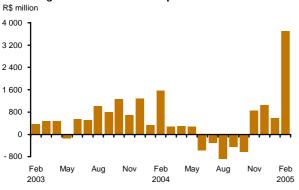
Selic x swap DI x Pre



Source: BM&F

Ibovespa Points 29 000 27 000 25 000 23 000 21 000 19 000 17 000 5.10 6.16 7.21 8.25 9.30 11.8 12.14 1.18 2.25 4.1 2004 2005

Net foreign investment in Bovespa



Capital market

The São Paulo Stock Market Index (Ibovespa) closed February at 28,139 points, an increase of 12% compared to end-November. During the three-month period, the Ibovespa hit a record high of 28,436 points. The period was also marked by an increase of 25.6% in trading volumes, with daily trading averages of R\$1.6 billion, consistent with market valuation and net foreign portfolio inflows.

The appreciation of the *real* increased the Ibovespa returns in dollar terms to 17.8% in the November-February period, while the Dow Jones Index (DJIA) and the Nasdaq posted returns of 3.2% and -2.2%, respectively.

The outlook for greater capital gains stimulated net foreign inflows into the São Paulo stock market, totaling R\$5.3 billion in the period and reversing the June-October 2004 outflow. The strategy of portfolio diversification as a hedge against dollar depreciation encouraged foreign investors to take positions in the local capital markets.

Primary market issuance of shares, debentures, and promissory notes registered with the Securities and Exchange Commission (CVM), reached R\$4.8 billion in the first two months of 2005, versus R\$1.6 billion in the same period of 2004. The issuance of debentures was most robust. accounting for 93.4% of total issuance. In contrast to 2004 issuance, which primarily targeted debt rollover and liability reduction, 2005 debenture issuance has been concentrated among leasing companies and project finance.

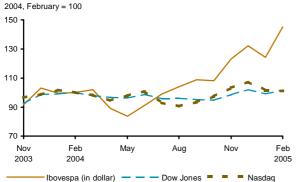
Financial investments

Financial investments, which include savings accounts, time deposits and investment funds, totaled R\$947.4 billion in February, a growth of 5.7% relative to November 2004.

The net worth of financial investment funds (FIF) reached R\$562.2 billion, a 4.5% increase, with R\$6.2. billion in net inflows in the three months ending in February. In December, the mutual funds industry registered net outflows (R\$4.6 billion), due to seasonal factors.

Analysis of the consolidated investment fund portfolio indicates an increase in fixed rate securities from 19.3% to 20.5% of the overall portfolio, and of floating rate securities from 64.1% to 65.2%. The share of FX-linked securities dropped from 2.5% to 1.3%, as a result of net redemptions

Stock exchanges



Primary issues in capital market R\$ billion - Accumulated through February

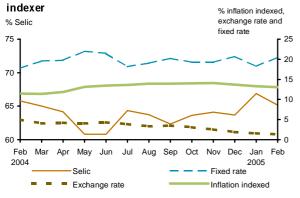
3 2 Stocks Debentures Commercial papers 2002 2003 2005 **2004**

CDB, FIF and savings deposits R\$ billion

Source: CVM

FIF 570 CDB, savings deposits 200 190 550 180 530 170 160 510 150 490 140 Feb Jun Dec Feb Apı Aug 2004 2005 CDB = Savings deposits

Public securities in investment funds - Portfolio by



of FX-linked securities and the depreciation of the U.S. dollar. Participation of inflation-indexed securities declined from 14.1% to 13.1%.

Savings accounts and time deposit balances totaled R\$158.9 billion and R\$196.9 billion, respectively, in February, a rise of 3.3% and 7% compared to November. In the period, savings accounts and time deposits registered net inflows of R\$2.1 billion and R\$5.3 billion, respectively. The introduction of the new investment account (exempted from the tax on financial transactions - CPMF), coupled with the benefits of not marking to market fixed income securities, made Bank Certificates of Deposit a more attractive investment. Among private securities, those linked to the DI rate were in greatest demand in the period, since expectations pointed to an increase in the Selic interest rate.

Stock funds, which include the mutual privatization funds with Employment Compensation Fund (FGTS) resources, registered R\$52.8 billion in total equity, with accumulated returns of 10.7% in the three months ended in February. Using FGTS resources, the Petrobras and Vale do Rio Doce privatization funds posted earnings of 24% and 35%, respectively.

Fiscal policy

Public sector borrowing requirements

The primary surplus of the nonfinancial public sector reached R\$81.1 billion or 4.6% of GDP in 2004, compared to R\$66.2 billion (4.3% of GDP) in 2003. The increase of 0.3 p.p. of GDP in the 2004 primary surplus reflected growth of 0.49 p.p. in the Central Government result and 0.11 p.p. in the sub-national governments results, together with a reduction of 0.24 p.p. for state-owned enterprises.

In January 2005, the public sector primary surplus totaled R\$11.4 billion, the best result for the month since the series was first released. The Central Government and sub-national governments posted surpluses of R\$8.5 billion and R\$3.3 billion, respectively, and state –owned enterprises registered a deficit of R\$0.4 billion.

In 2004, the Central Government registered a surplus of R\$52.4 billion, with a surplus of R\$84.7 billion for the federal government and deficits of R\$32 billion for the National Social Security Institute (INSS) and R\$336 million for the BCB.

Net inflow - Savings deposits and time deposits

R\$ billion



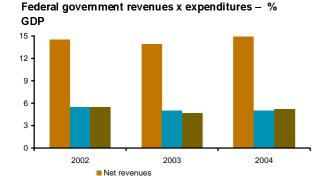
Public sector borrowing requirements - Primary result

Accumula	ted in the year		R\$ million
Period	Occurrence	IMF – Target	Margin
	(1)	(II)	(I - II)/(I) (%)
1999	-31 087	-30 185	3.0
2000	-38 157	-36 720	3.9
2001	-43 655	-40 200	8.6
2002	-52 390	-50 300	4.2
2003	-66 173	-65 000	1.8
2004	-81 112	-71 500	13.4

Public sector borrowing requirements - Primary result

Accumulated in the year

Segment	2003		2004		2005-Ja	an
	R\$	%	R\$	%	R\$	%
	billion	PIB	billion	PIB	billion	PIB
Central government	-38.7	-2.5	-52.4	-3.0	-8.5	-5.6
Sub-national governments	-13.8	-0.9	-17.5	-1.0	-3.3	-2.1
State companies	-13.6	-0.9	-11.2	-0.6	0.4	0.3
Total	-66.2	-4.3	-81.1	-4.6	-11.4	-7.4



■ Current expenditures and investments

Payroll and social charges

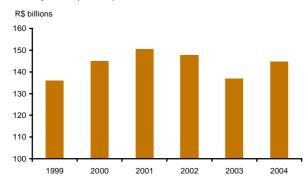
The results of the federal government were driven by revenue growth equivalent to 0.87 p.p. of GDP, due basically to the upturn in economic activity. It should be stressed that revenue growth was also driven by alterations in the legislation covering the Social Integration Program (PIS) and the Contribution to Social Security Financing (Cofins) introduced by law 10,865/2004, which extended these taxes to all imported goods and services, effective as of May 2004. The objective of this measure was to harmonize the tax treatment of domestic production and imports.

Expenditures grew 0.47 p.p. of GDP in 2004. Declines of 0.03 p.p. of GDP were registered under revenue sharing funds and outlays on personnel and social charges. Outlays for other current and capital expenditures increased by 0.52 p.p. of GDP. One should emphasize that, among other items, this line-item encompasses spending on assistance benefits, particularly those granted in the framework of the Organic Law on Social Assistance (LOAS), which increased from R\$4.4 billion to R\$7.5 billion, and expenditures on public investments, which increased from R\$5.1 billion to R\$9.2 billion, in 2004. Furthermore, outlays on other current and capital expenditures were pressured by spending on education and health, both of which have their own specific dynamics. Annual outlays on education must not be below 18% of the overall tax inflow, less 20% classified as Nonearmarked Federal Investment Resources and constitutional transfers. At the same time, disbursements for health and services must be equivalent to the previous year's level plus indexation at the nominal rate of GDP growth.

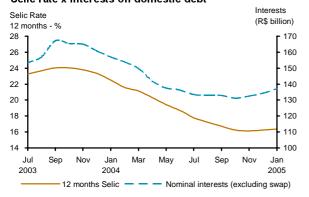
INSS revenues increased from 5.18% of GDP in 2003 to 5.32% in 2004, driven by growth in formal employment and an increase in the contribution ceiling. Outlays on benefit payments also rose, from 6.88% of GDP to 7.15%, impacted by an increase of 11.1% in the average value of benefits paid due to the minimum wage increase, and 4.08% growth in the average monthly quantity of benefits paid. Furthermore, there was an increase under the heading of "judicially determined payments", due mostly to court cases involving increases in retirement benefits.

The result for sun-national governments remained positive over the course of 2004, due primarily to the response of the Tax on the Circulation of Merchandise and Services (ICMS) to expanding economic activity. Growth in these revenues, deflated by the IGP-DI, increased 5.7% in the year. With regard to expenditures, compliance with the limitations imposed on indebtedness and administrative

ICMS Inflow - Accumulated in the year at December 2004 prices (IGP-DI)



Selic rate x interests on domestic debt

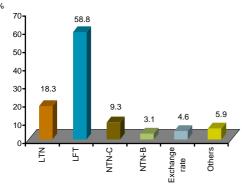


Public sector borrowing requirements

Accumulated in the year:

	2004		2005 – Jan	
	R\$ billion	% PIB	R\$ billion	% PIB
Uses	47.1	2.7	0.9	0.6
Primary	- 81.1	- 4.6	- 11.4	- 7.4
Interest	128.3	7.3	12.3	8.0
Sources	47.1	2.7	0.9	0.6
Internal borrowing	88.9	5.1	8.6	5.6
Security debt	68.6	3.9	26.5	17.4
Bank debt	9.4	0.5	- 13.2	- 8.7
Others	10.9	0.6	- 4.7	- 3.1
External borrowing	- 41.8	- 2.4	- 7.7	- 5.0

Federal securities debt structure - January 2005



expenditures ensured the continuity of the fiscal performance of this segment.

The surplus of state-owned enterprises in 2004 was below that of 2003. This decline reflected the deficit registered in the first half of the year, when there was a greater concentration of investment outlays and dividend distributions. Reversal of these factors in the second half of the year enabled state-owned enterprises to accumulate a surplus in the range of 0.6% of GDP in 2004, compared to 0.9% in the previous year.

Nominal interest paid in 2004 totaled R\$128.3 billion, or 2 p.p. of GDP less than in the previous year. This figure is a result of a lower Selic rate in 2004, as well as the lower net debt/GDP ratio in the year. In 2004, gains on Banco Central FX-swap operations came to R\$6 billion, as against R\$15.6 billion in 2003.

The strong increase in the nonfinancial public sector primary surplus coupled with a marked reduction in interest expenses resulted in a significant decline in the public sector borrowing requirements to R\$47.1 billion, or 2.7% of GDP, in 2004. This result is equivalent to 60% and 76% of the deficits accumulated in 2003 and 2002, respectively. As a proportion of GDP, the nominal deficit in 2004 represents the best result since this series was first created in 1991.

The public sector borrowing requirements accumulated in 2004 was financed by: debt issuance, R\$68.6 billion; monetary base, R\$10.9 billion; and growth of R\$9.4 billion in bank debt. There was a reduction of R\$41.8 billion in the net external debt in the year.

In January 2005, the public sector borrowing requirements totaled R\$902 million, versus US\$15.3 billion in the previous month and R\$4 billion in January 2004. This was primarily driven by the evolution of the primary surplus.

Federal debt

Federal debt increased from R\$776.5 billion, 42.7% of GDP, in October 2004, to R\$826.7 billion, 44.6% of GDP, in January 2005. This increase reflected net primary issuance of R\$22.4 billion and interest of approximately R\$31.5 billion. The 8.1% appreciation of the *real* against the dollar that occurred in the November-January period resulted in a R\$3.7 billion reduction in the balance of federal debt in the.

Domestically-issued dollar-linked federal debtdecreased from R\$49.5 billion in October 2004 to R\$41.7 billion in January 2005, as a result of net redemptions worth R\$9.2 billion and real appreciation. When FX-swap contracts are excluded, the participation of dollar-linked debt in the total debt dropped from 6.4% in October to 4.6% in January, while the share of Selic-indexed papers shifted from 59% to 59.5%. When swap contracts are included, the participation of dollar-linked securities fell from 11.2% to 8.1% and the share held of Selic-indexed papers from 54.2% to 56%. The share of the fixed rate debt, reflecting net issues of R\$11.9 billion in LTN and R\$1.6 billion in NTN-F, increased by 1.3 p.p. to 18.7% in the period.

The amortization of the federal debt, excluding new issuance, was as follows as of January: R\$318.4 billion, 38.5% of the total, maturing from February to December 2005; R\$253.2 billion, 30.6% of the total in 2006; and R\$255.1 billion, 30.9% of the total maturing in January 2007.

FX-swap operations totaled R\$28.7 billion in January, compared to R\$37.6 billion in October last year. In the period, the BCB gain with these operations totaled R\$4.7 billion (accrual basis), and R\$4.1 billion (cash basis).

Net debt growth Conditioning factors

	2003		2004		2005 – Ja	an
	R\$	%	R\$	%	R\$	%
	million	GDP	million	GDP	million	GDP
Total net debt –						
Balance	913 145	57.2	956 994	51.9	955 900	51.5
Flows	Accumul	ated in	the year			
Net debt – Growth	32 037	1.7	43 851	- 5.3	-1 094	- 0.3
Conditioning						
factors	32 037	2.0	43 851	2.4	-1 094	- 0.1
PSBR	79 030	4.9	47 144	2.6	905	0.0
Primary	-66 173	- 4.1	-81 112	- 4.4	-11 373	- 0.6
Interest	145 203	9.1	128 256	7.0	12 277	0.7
Exchange						
adjustment	-64 309	- 4.0	-16 193	- 0.9	-1 693	- 0.1
Domestic securit	ies					
debt ^{1/}	-22 715	- 1.4	-3 335	- 0.2	- 365	0.0
External debt	-41 594	- 2.6	-12 858	- 0.7	-1 329	- 0.1
Others	16 712	1.0	7 137	0.4	- 75	0.0
Skeletons	604	0.0	5 841	0.3	- 230	0.0
Privatizations	-	-	- 78	0.0	-	-
GDP growth effect	t	- 0.3		- 7.7		- 0.3

^{1/} Domestic dollar - Indexed securities

Net public sector debt

The net debt of the nonfinancial public sector was R\$955.9 billion, or 51.5% of GDP, in January, versus R\$957 billion, or 51.9% of GDP, in December 2004. For the most part, this reduction was caused by the primary surplus, currency appreciation and GDP growth, which compensated interest payments.

It should be stressed that, in 2004, the net public sector debt registered a sharp reduction (5.3 p.p. of GDP) compared to 2003, thus interrupting the upward trajectory in effect since 1994. This improvement highlighted the convergence of several positive factors, including continued fiscal equilibrium, economic growth, lower interest costs, and relative exchange rate stability.

The gross general government debt (federal government, National Social Security Institute – INSS, state governments and municipal governments) increased to R\$1,339.6 billion, 72.2% of GDP, in January, compared to R\$1,331.8 billion, 72.2% of GDP, in December 2004, and R\$1,228.6 billion, 76.9% of GDP, in December 2003.

3.4 Summary

The moderate growth of credit operations in the three-month period ended in February was seasonal. At the same time as reduced business activity created less corporate demand for funding, borrowing by households continued to expand, basically for the purpose of meeting financial commitments concentrated at the start of the year.

Aside from this, mention should be made of the growing participation of payroll-deducted loans, clearly consolidating the role played by this lower-cost credit alternative, particularly when compared to the overdraft operations traditionally usued to complement household income. It is important to recognize that this shift has contributed significantly to lower default and interest rates, even though these operations were impacted by monetary policy adjustments in the period.

The sharp downturn in the consolidated public sector net debt/GDP ratio, together with lower foreign exchange exposure of the public sector, contributed to an improved perception of country risk and strengthened expectations regarding short and medium-termdebt sustainability.

This perception is further strengthened by the ongoing 2005 fiscal effort, as reflected in the primary surplus target of 4.25% of GDP.

Fiscal commitments, positive expectations regarding economic growth and lesser vulnerability to exchange rate fluctuations clearly demonstrate that the 2005 net public sector debt/GDP ratio will not be greater than that registered in the preceding year.

International economy

The global economy continues to post sustained, above average growth, although the pace of growth has varied markedly across regions. The expansion has been driven by favorable financial conditions and strong corporate sector performance across a range of countries.

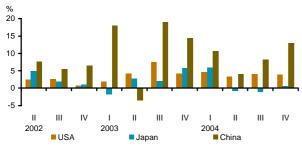
The global economic cycle has been beneficial for emerging market economies. The contribution of such factors as expanding world trade, strong commodity prices and abundant global liquidity, coupled with the macroeconomic adjustments that have been implemented in these countries in recent years, have created an environment that is considerably less vulnerable to shocks.

However, important vulnerabilities remain in the global economy. Among these are the current account and fiscal deficits in the United States, with potential repercussions for its monetary policy implementation, and the high and volatile oil prices. While these factors have somewhat tempered the global growth outlook, the factors underlying the current global expansion suggest that a significant rate of growth will still be achieved in 2005.

Economic activity 4.1

In 2004, global GDP expanded 5% according to the estimates of major international organizations, after having increased by 3.9% in 2003. The United States economy grew 4.4% in the year, versus 3% in 2003. China, which to a considerable extent has been driving the global expansion by absorbing an increasingly greater volume of exports from other Asian countries and the rest of the world, registered a sharp 9.5% rise in GDP, despite the administrative measures adopted in the middle of the year to prevent the overheating of the economy. Though GDP growth in Japan declined from the second to the fourth quarters, the strong growth that marked the first quarter of the year ensured annual GDP growth of

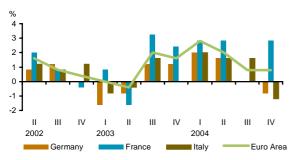
USA, Japan and China - GDP1



Sources: Bureau of Economic Analysis, Economic and Social Research Institute, JP Morgan

1/ Quarterly growth. Seasonally adjusted annualized rates

Euro Area - GDP1



1/ Quarterly growth. Seasonally adjusted annualized rates

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IV

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2003

IV

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2004

Source: Bureau of Labor Statistics 1/ Nonfarm business sector. Quarterly growth. Seasonally adjusted

IV

annualized rates

П

2001

USA - Productivity^{1/}

IV

2.7% in 2004, the best result since 1996. In the Euro Zone countries, GDP recovered strongly, reaching 2% in the year compared to 0.5% in 2003, though the pace of growth was still below the rates registered in other regions of the world.

According to the United Nations' Economic Commission for Latin America and the Caribbean (ECLAC), Latin America expanded by 5.5% in 2004 and benefited from the upturn in the pace of global economic activity. More specifically, Latin America benefited from the favorable evolution in the terms of trade, with positive repercussions for unemployment rates in the region, which dropped from 10.7% in 2003 to 10%.

The outlook for the global economy in 2005 remains positive, though the pace of growth will decline in several major regions. Global GDP growth is expected to close in the range of 3.5%, driven by 8.5% growth in China and 3.5% growth in the United States. Japan and the Euro Zone countries are expected to register growth below 2%, while the rate of growth projected for Latin America should reach 4%. Still low real interest rates and strong corporate profitability should continue to positively affect global economic growth.

The major risks to global economic performance are: (i) the instability inherent in the fiscal and current account deficits in the United States, the immediate effects of which are expected to be discrete and concentrated in the financial markets; (ii) the possibility of a deceleration in the Chinese economy which, in light of the recent evolution of macroeconomic indicators, is not expected to occur in 2005; and (iii) the sharp increase in oil prices.

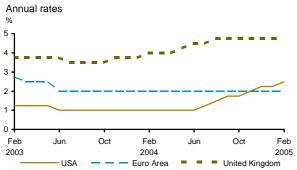
With regard to oil prices, the prospects for sustained high prices remain uncertain, and furthermore, rising prices were dealt with effectively in 2004. Thus, greater attention has been given to the possibility of a significant downturn in the United States economy as a result of waning productivity gains, as evident in the final two quarters of 2004. The key question is whether this shift could result in a substantial reduction in economic growth, which could in turn generate inflationary pressures if aggregate demand remains strong. The Federal Reserve estimates that productivity gains will return to levels close to those observed in the recent past, though at the same time, it stresses that the monitoring of productivity will be crucial to monetary policy implementation in the coming months.

Consumer inflation



Source: Bureau of Labor Statistics, Eurostat and Bloomberg

Official interest rates

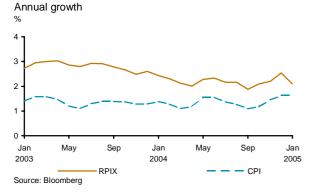


Source: Federal Reserve, ECB and Bank of England

Consumer inflation - Euro Area

Annual growth 3 May Sep .lan Mav .lan Jan Sep 2003 2004 2005 HICP Source: Eurostat

Consumer inflation - United Kingdom



Monetary policy and inflation 4.2

In the beginning of the year, inflation decelerated in the major economies, reflecting the delayed impacts of reduced oil price pressures and tighter monetary policy, particularly in the United States. Nonetheless, recent upward momentum in oil prices could eliminate part of this improvement in inflation in the coming months, though it will not represent a serious threat to price stability.

In the United States, continued economic growth, steady reductions in the output gap, and the current level of inflation suggest that the Federal Reserve will continue the policy initiated in mid-2003 of increasing interest rates at a pace that is likely to be measured. In the February meeting, the fed funds target was raised to 2.5% p.a., remaining since end-2004 above that of the Euro Zone countries.

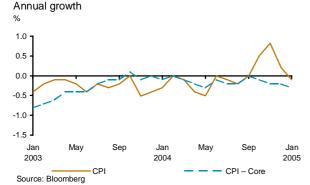
In the Euro Zone countries, January inflation remained below the official target of 2% for the first time since April 2004, and core inflation decelerated to an annual pace of 1.6%. The European Central Bank (ECB) is expected to maintain an unaltered monetary policy in the coming months since, though the short-term scenario would seem to point to continued dollar depreciation, an increase in United States interest rates would tend to contribute to a reduction of Euro appreciation vis-à-vis the dollar.

In March, the Bank of England held its repo rate at 4.75% p.a. for the seventh consecutive month. Though consumer price inflation has increased in recent months, it remains at a comfortable level of 1.6%, below the 2% target defined for purposes of price stability. Evidence indicates that tighter monetary policy has been quite successful in controlling aggregate demand and in correcting financial imbalances, as is evident in a more moderate pace of consumer spending and more muted real estate market activity.

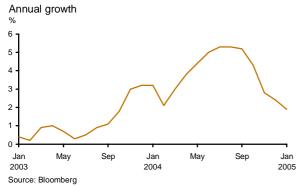
Prices in Japan declined once again in January and core inflation remained negative. Wholesale price inflation also decelerated in the early part of the year, contributing to a potential reduction in pass-through to consumer prices in the near future. In this context, there are no expectations for a change in the monetary policy stance of the Bank of Japan (BoJ), which has been characterized by zero interest rates and a gradual expansion of the official target range for banking system reserves.

Despite higher than expected economic growth, inflation in China dropped sharply in the last five months to January,

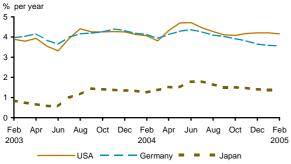
Consumer inflation - Japan



Consumer inflation - China



Yield on Government bonds1/



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

Stock exchanges - USA



thereby at least temporarily dissipating fears of inflationary risks linked to industrial overheating. In accumulated twelvemonth terms, consumer price inflation dropped to 1.9% in January from 5.3% in August.

International financial 43 markets

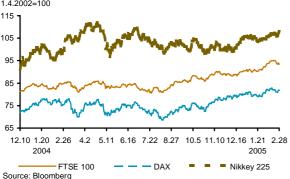
Two ongoing financial market trends deserve mention: (i) ample international liquidity and reduced risk aversion; and (ii) low long-term interest rates in the United States. The pursuit of higher returns has resulted in a steady improvement in financing conditions for emerging market countries, the high yield segment, and even low-rated borrowers (sovereign and private). There have even been positive spillovers for equity markets, particularly in emerging market countries.

In the United States, short-term rates have been more sensitive to changes in the medium-term monetary policy outlook, since these rates are directly influenced by the announcement of economic indicators and the interpretation of Federal Reserve statements. The gradual increase in the fed funds rate and the repeated signaling that the Federal Reserve would continue the process of monetary tightening have had a relatively moderate impact on longer-term interest rates, contributing to a flattening of the yield curve. In the three months ended in February, yields on two-year U.S. Treasury notes rose from 3% to 3.6%, while yields on ten-year securities declined, from 4.4% to 4%. However, yields on ten-year securities backed up in the second half of February, returning to approximately 4.4%.

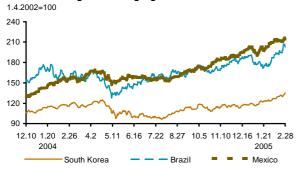
Yields on ten-year Japanese and European government securities have performed in line with United States securities of similar tenors. The persistence of low longterm interest rates also reflects some degree of skepticism with regard to the strength of the recovery of these economies, thus weakening expectations for increases in official interest rates.

Equity market performance, particularly in the United States, remains highly sensitive to the effects of higher oil prices on the pace of the global economic recovery. The negative impacts of high and volatile oil prices on confidence, however, have been partially offset by the search for yield, providing added momentum particularly to the equity markets of emerging market countries.

Stock exchanges - Europe and Japan 1.4.2002=100

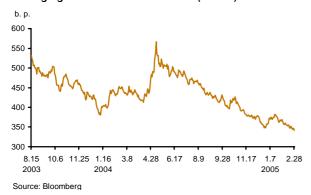


Stock exchanges – Emerging markets



Emerging Markets Bond Index Plus (Embi+)

Source: Bloomberg



Private capital flows to emerging markets

			US	S\$ billion
2003	20	04	20	05
•	Oct/04 ^{1/}	Jan/05 ^{2/}	Oct/04 ^{1/}	Jan/05 ^{1/}
120.8	113.8	159.9	77.6	127.5
210.7	225.9	279.1	229.4	275.9
122.5	137.6	165.3	142.7	176.6
90.6	113.7	129.5	117.4	142.8
31.8	23.9	35.8	25.3	33.8
88.2	88.3	113.8	86.7	99.3
26.4	32.8	49.2	37.0	42.2
61.8	55.5	64.6	49.7	57.1
	120.8 210.7 122.5 90.6 31.8 88.2 26.4	Oct/04 ¹ / 120.8 113.8 210.7 225.9 122.5 137.6 90.6 113.7 31.8 23.9 88.2 88.3 26.4 32.8	Oct/04 ^{1/} Jan/05 ^{2/} 120.8 113.8 159.9 210.7 225.9 279.1 122.5 137.6 165.3 90.6 113.7 129.5 31.8 23.9 35.8 88.2 88.3 113.8 26.4 32.8 49.2	2003 2004 20 Oct/04 ^{1/2} Jan/05 ^{2/2} Oct/04 ^{1/2} 120.8 113.8 159.9 77.6 210.7 225.9 279.1 229.4 122.5 137.6 165.3 142.7 90.6 113.7 129.5 117.4 31.8 23.9 35.8 25.3 88.2 88.3 113.8 86.7 26.4 32.8 49.2 37.0

Source: IIF 1/ Forecast

2/ Estimate

In this context, in the three months ended in February, the Dow Jones, Standard & Poor's 500 and Nasdaq registered returns of 3.2%, 2.4% and -2.4%, respectively, while the Japanese Nikkei was up 7.7%. In Europe, Germany's DAX, the Financial Times Securities Exchange Index (FTSE 100), and France's CAC advanced 5.4%, 5.6%, and 7.3%, respectively. In emerging market countries, equity market increases were particularly notable in South Korea (Kospi), 15.2%, Mexico (IPC), 13.8%, Russia (RTS), 12.2%, Brazil (Ibovespa), 11%, and Argentina (Merval), 31.7%.

A confluence of positive factors – among which are lower nominal and real fixed income yields in the industrial countries, the gradual recovery in the global economy, greater risk appetite, and improved fundamentals in emerging market countries - has generated a sustained reduction in the Emerging Markets Bond Index Plus (Embi+). The Embi+ reached 341 basis points above comparable U.S. Treasuries at end-February, the lowest level in the last five years, while the EMBI+ subindices for Russia, Turkey, Brazil and Venezuela closed at 179 bps, 237 bps, 391 bps, and 437 bps, respectively. In comparison to the peak registered in May last year, the risk premiums of these countries declined by 50%, 57%, 52% and 43%, respectively. Although there is scope for a possible price correction driven by profit taking, the medium-term outlook for the emerging economy sovereign debt market remains favorable (barring unanticipated global financial shocks).

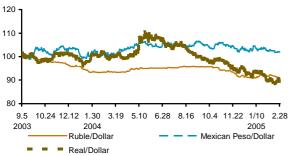
Abundant international liquidity has resulted in stronger investor appetite for new emerging market bond issues, both sovereign and private, at increasingly long tenors. Of particular note are the thirty-year bonds issued by Latin American economies, contributing to a rise in the average maturity of government issues in the region from 12.1 years in 2003 to 16.5 years in the first three quarters of 2004, according to the December issue of the BIS quarterly review.

Projections released in the month of January by the Institute of International Finance (IIF) indicate that private capital flows to emerging market countries in 2005 will decline by 1.1%, when compared to 2004, notwithstanding forecasts for 6.8% growth of foreign direct investment. According to the IIF, portfolio investment, bank loans, and other private credits are expected to decline by respective rates of 5.6%, 14.2% and 11.6%.

The outlook for capital flows in 2005 may appear contradictory both in relation to the evolution of private capital

Latin American and Russian currencies

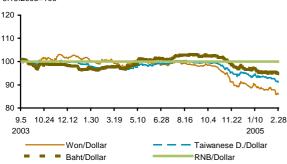
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Source: Bloomberg

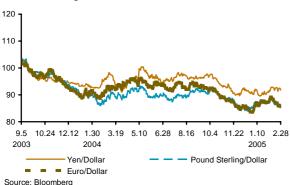
Asian emerging markets currencies

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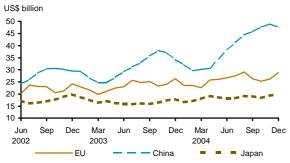


Source: Bloomberg

Dollar exchange rates



USA - Trade deficit1/



Source: Bloomberg 1/ Quarterly moving average flows last year and in terms of the favorable outlook described previously. However, it should be recalled that estimates of capital flows in 2004 incorporate strong speculative inflows into China and Russia in the final quarter of that year, driven by expectations for the appreciation of their currencies vis-à-vis the U.S. dollar.

Favorable supply conditions in the foreign exchange market and the prevailing optimism with respect to 2005 contributed to ongoing emerging market currency appreciation in the early months of the year against the U.S. dollar. This includes the currencies of several Asian countries that have used fixed or managed exchange rate systems.

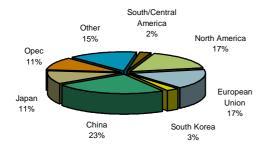
The reduction in the United States federal government deficit in the early months of the fiscal year begun last October, the presentation of the budget bill to Congress proposing spending restrictions in fiscal year 2006, and the first political overtures toward reform of the social security system favored appreciation of the dollar against major international currencies. This appreciation was reversed in mid-February, with the announcement of a higher than expected United States trade deficit for December.

There appears to be very little risk of uncontrolled dollar depreciation, to the extent that the rise in United States interest rates and the increasing interest rate differential vis-à-vis other developed countries favors its stabilization over the course of 2005.

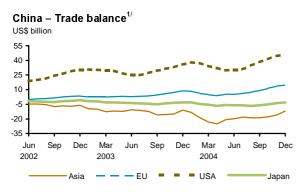
World trade 4.4

International trade flows declined in the final quarter of 2004, with deterioration in the trade balance of Euro Zone countries, Japan and especially the United States, where the trade deficit spiraled to historically high levels in October and November. In China, foreign trade followed an opposite course, as exports expanded sharply in the quarter, while imports cooled. This reflected the measures taken in the preceding months to reduce the pace of economic expansion. Aside from the falloff in global demand, appreciation of the euro contributed to the reduction in the rate of export growth in the countries of the Euro Zone. Moderation in commodity prices, particularly food products, and the recovery in the domestic economies were responsible for the reduction of the trade surplus in several of the major Latin American countries.

USA - Trade deficit in goods by selected countries and areas – 2004^{1/}

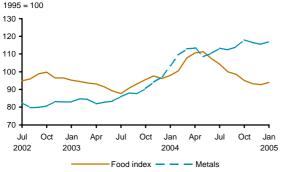


Source: U.S. Department of Commerce/Bureau of Economic Analysis 1/ Venezuela is included only in Opec group



Source: Bloomberg 1/ Quarterly moving average

Commodity price index in SDR



Source: International Monetary Fund

Oil - Spot market US\$ per barre 56 52 48 44 40 36 32 28 9.1 9.30 10.29 11.29 12.30 1.31 4.5 2004 2005 WTI Brent Source: Bloomberg

World trade flows are expected to increase strongly in 2005, albeit at rates below those of 2004. This deceleration will be consistent with the deceleration in global growth. The World Bank has estimated that the volume of world trade will expand by 8.4% in 2005, compared to 10.2% in 2004. The estimate released by the IMF for 2005 is 7.2%, versus 8.8% in 2004.

4.4.1 Commodities

In the first two months of 2005, metallic commodities remained at the high price levels reached in 2003 and 2004. Chinese demand remains the main source of pressure on these prices, which are expected to increase in 2005. This outlook reflects the 3% increase in the price of copper in the first two months of 2005, as prices moved to the highest level of the last sixteen years. At the same time, iron ore prices recently rose in some contracts by as much as 71.5%.

After a sharp downturn in the second half of 2004, and falling to a January level that was the lowest since June 2002, soybean prices increased 20% in February, reflecting reduced harvest in South American due to a prolonged drought. However, market forecasts are that soybean prices will not rise sharply, since the United States harvest is expected to be quite robust.

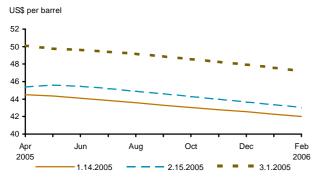
Coffee prices continued to increase in the first two months of the year (+15.5% in the futures market), in light of expectations of supply constraints in 2005 and 2006. It is also possible that orange juice prices will move sharply upward this year, due to the harvest failure in Florida. Sugar prices are expected to continue the upward trajectory begun in 2004, despite having dipped slightly in February, since global stocks will remain low and demand for ethanol is strong.

4.4.1.1 Oil

Oil prices rose in the first two months of the year. The outlook for a reduction in prices is not favorable, given greater than previously estimated global demand, U.S. dollar depreciation, consecutive reductions in Russian output, and a harsh winter in the northern hemisphere.

Not even the 24% reduction in Chinese oil imports in January, compared to the same month of 2004, or the recovery in global inventories of gasoline and crude oil, have been enough to ease pressures in the oil market. Thus, in the first two

Brent Oil - Futures market



Source: Bloomberg

months of this year, average oil prices have been approximately 34% higher than in the first quarter of last year and, furthermore, oil price futures indicate that these prices will remain high.

4.5 Summary

More recent economic indicators, particularly in the United States and China, have confirmed that global economic activity has maintained the pace of growth that marked the final quarter of 2004, with highly positive implications for global growth this year. However, some uncertainties that could jeopardize growth persist, particularly those involving structural imbalances in the world's major economies, especially in the United States. Adjustments in the U.S., together with the volatile behavior of oil prices, may impose limits on the global economic expansion.

Over the short term, however, the favorable outlook for international interest rates and for growth in the United States, in world trade and in emerging market countries are expected to persist. This outlook is based on stable inflation expectations in the main economies, which should lead to a monetary policy stance similar to 2004.

External sector

International market conditions in the recent past have been quite favorable to Brazil, with positive impacts on the balance of payments. Coupled with consistent macroeconomic policies, the balance of payments improvement paved the way for easier private sector access to international financial markets, with lower spreads and, as of last November, with the first external bonds denominated in reais.

In the course of 2004, balance of payments projections were successively revised, at the same time in which the Brazilian economy experienced one of its best performances in many years. The country's exports continued expanding and, for the second consecutive year, contributed significantly to a positive current account result. The reduction in external indebtedness achieved through amortizations with the IMF and partial rollover of private debts reduced Brazilian country risk. Higher GDP in current dollars, higher exports and higher international reserves contributed to the improvement in external sustainability indicators.

The favorable external sector results continued into early 2005. In the three-month period ended in February, the current account posted a US\$2.1 billion surplus, as against US\$1.2 billion in the same period of 2003/2004. In the twelve-month period through February, the surplus totaled US\$11.7 billion, compared to US\$5.1 billion in the twelvemonth period ended in February 2004. The positive current account performance was driven mainly by the trade surplus and, to a lesser extent, by the increased positive current unilateral transfers.

Though somewhat lower than in 2004, projections of a strong 2005 current account surplus, coupled with robust net foreign direct investment inflows, and rollover rates consistent with the external borrowing requirements, enabled maintenance of the positive balance of payments projection.

Foreign exchange transactions

				US\$	billion
	2004			2005	
	Feb	Jan-	Year	Feb	Jan-
		Feb			Feb
Operations with clients in Brazil	1.2	4.7	11.9	3.9	5.7
Commercial	1.7	4.2	36.7	3.5	5.5
Exports	6.0	12.5	93.5	8.0	15.4
Imports	4.2	8.3	56.8	4.4	9.9
Financial ^{1/}	-0.5	0.5	-24.7	0.4	0.2
Purchases	5.7	13.6	84.6	8.7	15.2
Sales	6.2	13.1	109.4	8.3	15.0
Operations with banks abroad (net) ^{2/}	0.1	0.0	-5.6	0.0	-0.4
Balance	1.3	4.7	6.4	3.9	5.3

^{1/} Excluding interbank operations and Central Bank foreign operations

Trade balance - FOB

					US\$ million
Period		Exports	Imports	Balance	Trade
					flow
Jan-Feb	2005	15 200	10 230	4 969	25 430
Jan-Feb	2004	11 521	7 966	3 555	19 487
% change	•	31.9	28.4		30.5

Source: MDIC/Secex

5.1 Foreign exchange flows

In the first two months of 2005, net foreign exchange market inflows totaled US\$5.3 billion, 12.9% above the same period of 2004. Net financial settlements linked to trade operations reached US\$5.5 billion, compared to US\$4.2 billion in 2004, totaling US\$15.4 billion in financial settlements of export contracts and US\$9.9 billion of import contracts (up 22.6% and 18.8%, respectively, compared to the first two-months of 2004).

Financial operations posted a net flow of US\$199 million in the period, compared to US\$481 million in the first two months of 2004. Purchases in the foreign exchange market reached US\$15.2 billion and sales totaled US\$15 billion.

Considering the BCB's acquisitions in the foreign exchange market and net foreign exchange inflows, the short position held by the banking system increased from US\$1.4 billion at end-2004 to US\$2.7 billion in January and US\$3.4 billion in February.

Trade balance 5.2

In February, exports set a new record high for the month (US\$7.8 billion). In terms of daily averages, exports grew 21.6% month-on-month and 35.5% compared to February 2004. In the first two months of the year, exports totaled a record US\$15.2 billion, with 31.9% growth over the corresponding period of 2004.

Imports continued on the upward trajectory that began in the fourth quarter of 2003, reaching US\$10.2 billion in the first two months of 2005, for growth of 28.4% over the corresponding period of the previous year. This total – also a new record for the period – surpassed the previous record set in 2001 by US\$1.2 billion. In the month of February, imports totaled US\$5.0 billion, for 10.2% growth over the previous month and 32.5% over February 2004. In terms of daily averages, this figure represents growth of 10.2% in comparison to the previous month and 32.5% against February 2004.

The trade surplus and total external trade in the month set new records for February, at US\$2.8 billion and US\$12.7 billion, respectively. The accumulated totals for the year indicate 39.8% expansion in the trade surplus and 30.5% in total trade, compared to the same period of the previous year.

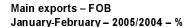
^{2/} Purchase/sale of foreign currency and gold in exchange for domestic currency. Exchange contracts.

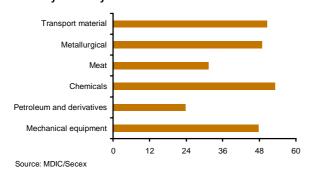
Exports by aggregate factor - FOB

January-February

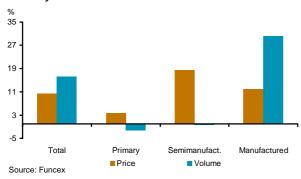
			US\$ million
Itemization	Accumulated		
	2004	2005	%
			change
Total	11 521	15 201	31.9
Primary products	3 357	3 629	8.1
Industrial products	7 974	11 269	41.3
Semi-manufactured goods	1 867	2 391	28.1
Manufactured goods	6 108	8 878	45.4
Special operations	190	302	59.6

Source: MDIC/Secex





Exports - Price and volume index January - 2005/2004



Imports by end-use category - FOB January-February

US\$ million Itemization 2004 2005 % change Total 7 966 28 4 10 230 Capital goods 1 585 2 035 28 4 Raw materials 4 365 5 437 24.6 Naphtha 121 183 51.4 Consumer goods 891 1 111 24.7 Durable 441 491 11.4 Passenger vehicles 95 93 - 1.8 Nondurable 450 620 37.8 Fuels 1 125 1 647 46.3 Crude oil 740 1 191 61.0

Source: MDIC/Secex

It should be stressed that, in February, all of the 12-month cumulative foreign trade results set new records. In particular, exports surpassed the US\$100 billion level and total external trade increased to US\$165.2 billion.

In February, exports of primary goods came to US\$1.9 billion, an increase of 22.6% over the previous month and 15% compared to February 2004. Exports of semimanufactured goods totaled US\$1.2 billion, with respective increases of 22.5% and 39%, while exports of manufactured goods reached US\$4.5 billion, for growth of 21.9% and 44.6%.

In the two-month period, exports of primary products totaled US\$3.6 billion, with growth of 8.1% compared to the same period of the previous year. Sales of semimanufactured and manufactured goods totaled US\$2.4 billion and US\$8.9 billion, for respective increases of 28.1% and 45.4%. The sharp growth of manufactured goods was driven by exports of aircraft, cars, steel products, footwear, and vehicle engines.

Exports registered across-the-board expansion in all of the major products in the first two months of the year, compared to the same period of 2004. The only exception was soybean sales, with a decline of 14%. The highlights were chemical products, 53.3%; transportation equipment, 50.6%; metallurgical goods, 49%; mechanical equipment, 47.8%; meats, 31.5%; and oil and derivatives, 23.8%. These products accounted for 61.8% of overall exports.

According to Funcex, January exports registered an increase of 10.3% in prices and 16.1% in volume, compared to the same month of the previous year. The price indices of all categories increased, by 18.5% for semimanufactured goods, 11.8% for manufactured goods and 3.7% for primary goods. In terms of volume, exports of manufactured products were the only category to register positive growth in the period.

Imports expanded in the first two months of 2005 in all use categories, when compared to the same period of the previous year. The best performance was capital goods, up 28.4%, and fuels and lubricants, up 46.3%. In the latter case, growth was driven by increased oil purchases.

In February, imports increased in all of the major use categories, compared to the same month of 2004. Consequently, imports of fuels and lubricants expanded by 94.7%, as purchases of petroleum increased by 114% and

Raw material imports x industrial production

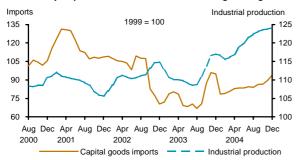
Seasonally adjusted indices - 3 month moving average



Source: IBGE and Funcex

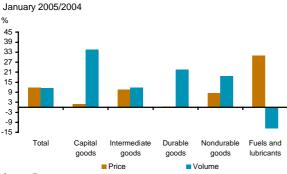
Capital goods imports x industrial production

Seasonally adjusted indices - 3 month moving average



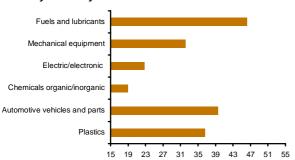
Source: IBGE and Funcex

Imports - Price and volume index



Source: Funcex

Main imports January-February - 2005/2004 - %



Source: MDIC/Secex

those of raw materials expanded by 25.1%. Imports of capital and consumer goods reflected an upturn in investment, as well as recovery of income and employment, with expansion of 22.4% and 20.4%, respectively. Imports of consumer durables increased by 5.4% and of nondurable consumer goods rose 35.2%.

Compared to the same month of 2004, growth in imports in January reflected increases in both prices and volume. As far as prices are concerned, fuels and lubricants rose 31.1%, intermediate good increased by 10.7% and nondurable consumer goods by 8.7%. Parallel to these results, capital goods imports registered 34.6% volume growth, with particularly strong performances of parts and spares for capital goods and industrial machinery accessories, while expansion of consumer durables rose 22.5% and growth of non-durables was 18.7%. At the same time, the imported volume of fuels and lubricants decreased by 12.6%.

Analysis of Brazilian imports on a product-by-product basis indicates significant growth in imports of some specific goods. Imports of vehicles, automobiles and parts increased 39.5%; plastics, 36.6%; mechanical equipment, 32.1%; and fuels and lubricants, 46.3%, all comparing the first two months of 2005 with the same period of 2004.

With regard to markets for Brazilian exports, the highest growth rates in January-February (year-on-year) were: Mexico, 54.6%; Latin America (excluding Mercosul), 53.3%; the USA, 42%; Eastern Europe, 36%; Argentina, 36.9%; Asia, 24%, and the European Union, 15.4%.

With regard to imports, only those from Eastern Europe and Uruguay/Paraguay, declined in the two-month period, 14.6% and 4.1%, respectively. Significant growth was registered in purchases from Mexico, 68.7%; China, 54.7%; South Korea, 42%; Japan, 37.7%; the European Union, 34.9%; and Argentina and USA, both with 15.9%.

Services and income 5.3

The January-February trade surplus came to US\$5 billion. setting a new record for the period. This result, coupled with the net inflow of current unilateral transfers, contributed to the US\$935 million current accounts surplus, despite some deterioration in the service and income account result. In the twelve month period ended in February, the current account registered a surplus of US\$11.7 billion, equivalent to 1.92% of GDP, the second best result in value and third

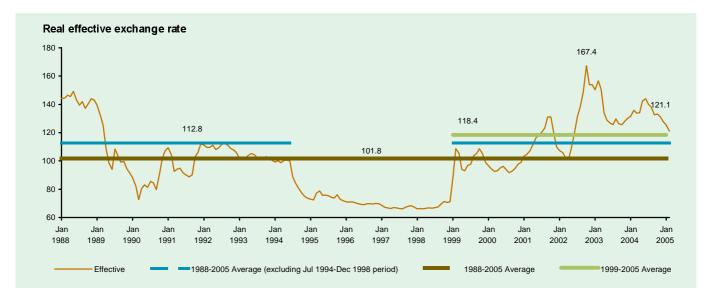
Sustainability of Brazilian Exports

In 2004, the trade balance set several record highs. Exports and imports totaled US\$96.5 billion and US\$62.8 billion, respectively, for a total external trade of US\$159.3 billion and a trade surplus of US\$33.7 billion. The exports/GDP ratio also reached an historic high in 2004. This box analyzes the sustainability of these export trends in 2005.

Among the frequently highlighted risks to 2005 export performance are: (i) deceleration of global growth; and (ii) effects of the Brazilian real's appreciation as of mid-2004. With regard to the first factor, the probability that this deceleration will significantly impact exports in 2005 has declined, since projections for global growth and global trade have been revised upward (although they remain somewhat below the 2004 figures).

On the other hand, the impact of the real's appreciation on exports should be carefully assessed. First, it should be noted that the real effective exchange rate (the *real* in relation to the currencies of Brazil's main trading partners, deflated domestically by the IPCA and externally by wholesale price indices), demonstrates that, although the real appreciated by 16% between June 2004 – its peak for the year – and February 2005, it actually depreciated 1.9%, when comparing the average of the twelve month period ending in February to the previous twelve months.

The diagnosis is entirely different when the real effective exchange rate is compared to its 1988/2005 average. Taking June 1994 as base year (= 100), the average real effective exchange rate was 101.8 in the period from January 1988 to February 2005. If the period from July 1994 to December 1998 is



excluded, the average rises to 112.8. If only the period of the floating exchange rate regime is considered (from January 1999), when the sharp 1999 and 2002 depreciations occurred, the average value is 118.4. These values are below the average of both the twelve-month period ending in February 2005 (133.6) and the current value (121.1, at February 2005). Depreciation of the average real effective exchange rate in the twelve months ending in February 2005 (133.6) in relation to the periods above ranges from 12.8% to 31.1%. Using the February rate and the same comparison basis, depreciation stood between 2.2% and 18.9%.

The foreign trade estimates of the BCB and the market participants surveyed by Gerin indicate continued positive results in 2005. With regard to exports, the BCB revised its projections from US\$100 billion in the December 2004 Inflation Report to US\$105 billion, while the median of market expectations gathered by Gerin increased by 4.7% in the year through mid-March, to US\$104.7 billion. Trade surplus projections also increased in the period, from US\$25 billion to US\$27 billion in the BCB's estimates and from US\$26.3 billion to US\$28.1 billion, according to the median of market expectations. This increase in projections is also reflected in the current account. The BCB increased its forecast by US\$2.1 billion, while the median of market expectations collected by Gerin shifted from US\$3.1 billion to US\$4.2 billion.

Another factor supporting the upward revision of export projections was the recent rise in the prices of several commodities exported by Brazil, such as the 71.5% increase in the price of iron ore, which may account for a direct impact on exports between US\$1.8 billion and US\$2.5 billion this year. Farm commodities such as sugar and coffee have also posted good price performances. Even the price of soybeans, which had declined from mid-2004 through January, increased in the major commodity exchanges in February.

Consequently, continued strong international demand - albeit probably below the previous year's pace, a depreciated real effective exchange rate, and improved export prices indicate that Brazilian exports will continue to expand in 2005.

Exports and imports by area - FOB

January-February

							US\$	millior
	Exports				S	Balanc	е	
	2004	2005	%	2004	2005	%	2004	2005
		(change			change		
Total	11 521	15 201	31.9	7 966	10 230	28.4	3 555	4 971
Laia	2 278	3 290	44.4	1 346	1 542	14.6	932	1 748
Mercosur	1 086	1 462	34.6	909	1 028	13.2	177	433
Argentina	894	1 225	36.9	784	909	15.9	110	315
Other	191	237	23.8	124	119	- 4.1	67	118
Mexico	383	593	54.6	74	125	68.7	309	467
Other	809	1 236	52.7	363	389	7.0	446	847
USA ^{1/}	2 397	3 403	42.0	1 558	1 807	15.9	839	1 597
EU ^{2/}	3 090	3 567	15.4	2 051	2 767	34.9	1 039	800
E. Europe ^{3/}	285	388	36.0	189	161	- 14.6	96	227
Asia	1 677	2 080	24.0	1 434	2 129	48.5	244	- 49
Japan	366	476	30.0	344	474	37.7	22	3
South Korea	189	186	- 1.8	199	283	42.0	- 10	- 98
China	635	670	5.5	419	649	54.7	216	21
Other	486	748	53.8	471	723	53.6	16	25
Others	1 793	2 472	37.9	1 388	1 824	31.4	405	648

Source: MDIC/Secex

Current account

					US\$	billion
	2004			2005		
	Feb	Jan-	Year	Feb	Jan-	Year ^{1/}
		Feb			Feb	
Current account	0.2	0.9	11.7	0.1	0.9	2.1
Trade balance	2.0	3.6	33.7	2.8	5.0	27.0
Exports	5.7	11.5	96.5	7.8	15.2	105.0
Imports	3.8	8.0	62.8	5.0	10.2	78.0
Services	-0.2	-0.3	-4.8	-0.4	-0.6	-6.9
Transportation	-0.1	-0.2	-2.1	-0.1	-0.2	-2.1
International travel	0.1	0.2	0.4	0.0	0.1	0.0
Computer and informat.	-0.1	-0.2	-1.2	-0.1	-0.3	-1.3
Operational leasing	-0.1	-0.3	-2.2	-0.3	-0.6	-2.4
Other	0.1	0.3	0.4	0.2	0.4	-1.1
Income	-1.8	-2.9	-20.5	-2.5	-3.9	-21.2
Interest	-1.2	-2.3	-13.4	-1.2	-2.2	-13.6
Profits and dividends	-0.6	-0.7	-7.3	-1.3	-1.7	-7.8
Compensation of emplo.	0.0	0.0	0.2	0.0	0.1	0.2
Current transfers	0.2	0.5	3.3	0.2	0.5	3.2

^{1/} Forecast

best as a share of GDP since the series was first calculated in 1947.

Net outlays on services totaled US\$641 million, compared to US\$252 million in the first two months of 2004. Using the same basis of comparison, net outlays on equipment rentals totaled US\$589 million, followed by computer and information services, US\$267 million, and royalties and licenses, US\$234 million, with respective increases of 129%, 33.4% and 20.3%. Net expenditures on transportation totaled US\$213 million, for a reduction of 14.5% in the period. International travel generated net revenues of US\$60 million - compared to US\$195 million in the first two months of 2004, reflecting an increase of 61.4% in outlays, linked to expansion in nominal income and the recent appreciation of the real. Net revenues on business, professional and technical services expanded 45.1%, totaling US\$734 million.

Net income remittances from abroad closed at US\$3.9 billion in January-February 2005, 35% above the corresponding period of 2004. Interest remittances fell from US\$2.3 billion to US\$2.2 billion and profit and dividend remittances increased from US\$679 million to US\$1.7 billion in the period.

For 2005, trade surplus is projected at US\$27 billion, with 8.8% growth of exports and 24.2% growth of imports. This result, coupled with assumptions of an 11.5% expansion in net outlays on services and net income remittances, and stability in net inflows of unilateral transfers, leads to a current account surplus forecast of US\$2.1 billion.

5.4 Capital account

The balance of payments capital account registered net inflows of US\$5.5 billion in the first two months of 2005, compared to US\$3.2 billion in the same period of 2004. Foreign direct investment totaled US\$2.1 billion, 3.5% above the same period of last year. This result is based on net inflows of US\$763 million in equity investment in Brazilian companies, and US\$1.3 billion in intercompany loans.

Net inflows of foreign portfolio investment totaled US\$3.7 billion in the first two months of the year, compared to US\$3.6 billion in the same period of 2004. Net equity investments reached US\$1.7 billion, with US\$1.5 billion in domestically traded stocks and remittances of US\$140 million in American Depositary Receipts (ADR). Net investments in fixed income securities totaled US\$2 billion, as private securities

^{1/} Includes Puerto Rico.

^{2/} Includes ten countries that joined the EU in 2004

^{3/} Eight countries that were formerly included in this group are now in the EU

Capital account

					US	billion
	2004			2005		
	Feb	Jan-	Year	Feb	Jan-	Year ^{1/}
		Feb			Feb	
Capital account	-0.4	3.2	-8.0	4.4	5.5	-6.0
Direct investments	1.0	1.9	8.7	0.8	2.0	14.0
Abroad	0.0	-0.1	-9.5	-0.1	-0.2	-2.0
In Brazil	1.0	2.0	18.2	0.9	2.1	16.0
Equity capital	1.2	2.4	18.6	0.0	0.8	14.0
Intercompany loans	-0.2	-0.4	-0.4	0.9	1.3	2.0
Portfolio investments	1.0	3.6	-4.8	3.5	3.9	-1.6
Assets	0.0	0.1	-0.8	0.2	0.2	0.0
Liabilities	0.9	3.6	-4.0	3.3	3.7	-1.6
Derivatives	0.0	0.1	-0.7	0.1	0.1	0.0
Other investments	-2.4	-2.4	-11.3	0.0	-0.4	-18.4
Assets	-1.2	-0.9	-1.5	0.4	1.4	-9.3
Liabilities	-1.2	-1.5	-9.8	-0.4	-1.8	-9.1

1/ Forecast.

BP financing sources

Selected items

					US	\$ billion
	2004			2005		
	Feb	Jan-	Year	Feb	Jan-	Year ^{1/}
		Feb			Feb	
Medium and long-term						
funds	1.1	3.7	14.8	2.5	2.9	14.3
Public bonds	0.0	1.5	5.7	1.9	1.9	4.5
Private debt securities	0.9	1.9	5.3	0.4	0.8	7.9
Direct loans	0.1	0.3	3.8	0.2	0.3	2.0
Short-term loans ^{2/}	-0.7	-0.9	-2.1	0.0	-0.1	0.0
Short-term securities						
(net)	0.0	0.0	0.4	0.1	0.1	0.0
Roll-over rates						
Private sector:	239%	237%	65%	64%	75%	70%
Debt securities	255%	286%	49%	59%	87%	70%
Direct loans	163%	113%	127%	83%	52%	70%

registered net outflows of US\$426 million and public sector bonds accounted for net inflows of US\$1.9 billion. Commercial paper and notes posted net revenues of US\$314 million, versus US\$841 million in the first two months of the preceding year. Short-term securities registered net inflows of US\$61 million.

In January-February 2005, the rollover rate for mediumand long-term private sector debt was 75%, or 87% for securities (bonds, notes and commercial paper) and 52% for direct loans. For 2005, rollovers are projected to be 70%, for both securities and direct loans.

In the first two months of 2005, gross international reserves increased by US\$6.1 billion, to total US\$59 billion, the highest level since August 1998. Under the IMF concept, adjusted net international reserves also increased by US\$6.1 billion, to total US\$31.4 billion, the best result since September 2001. With the favorable liquidity conditions in the period, the BCB acquired US\$6.3 billion on the spot exchange market. With regard to sovereign external debt operations, there were issuances of US\$1.9 billion and interest payments of US\$1.3 billion.

Amortizations of US\$177 million and interest payments of US\$17 million referring to the Paris Club, as well as interest payments of US\$316 million to the IMF also deserve mention. Earnings on reserves totaled US\$185 million and settlements of National Treasury purchases on the domestic foreign exchange market totaled US\$194 million. Other operations generated outflows of US\$796 million.

It is estimated that gross reserves will decline by US\$4.4 billion by the end of 2005, compared to end-2004, and close the year at US\$48.6 billion. Projections for the whole year incorporate gross payments of US\$13 billion in external debt service, amortizations of US\$7 billion with the IMF, disbursements of US\$2 billion from multilateral organizations, and bond issues of US\$4.5 billion. Settlements of National Treasury purchases on the domestic foreign exchange market are estimated at US\$2.5 billion. Considering the IMF concept, net reserves, which are not affected by amortizations with the Fund, should increase by US\$3.1 billion to a total of US\$28.4 billion.

^{2/} Includes direct loans and trade credits transferred by banks

Balance of Payments Projections

Uses and sources

					US\$	billion
	2004			2005		
	Feb	Jan-	Year	Feb	Jan-	Year ^{1/}
		Feb			Feb	
Uses	-1.4	-2.3	-21.6	-1.3	-2.1	-27.8
Current account	0.2	0.9	11.7	0.1	0.9	2.1
Amortizations ML-term ^{2/}	-1.6	-3.2	-33.3	-1.5	-3.0	-29.9
Securities	-0.6	-0.9	-17.6	-0.7	-0.9	-17.0
Paid	-0.4	-0.7	-16.4	-0.7	-0.9	-17.0
FDI conversions	-0.3	-0.3	-1.2	0.0	0.0	0.0
Suppliers' credits	-0.2	-0.3	-2.4	-0.2	-0.4	-2.1
Direct loans 3/	-0.8	-2.0	-13.3	-0.5	-1.7	-10.8
Sources	1.4	2.3	21.6	1.3	2.1	27.8
Capital account	0.1	0.1	0.7	0.1	0.1	0.5
FDI	1.0	2.0	18.2	0.9	2.1	16.0
Domestic securities ^{4/}	0.6	1.1	2.1	1.5	1.8	3.0
ML-term disbursem.5/	1.4	4.5	20.4	2.8	3.5	23.2
Securities	0.9	3.4	11.0	2.3	2.7	12.4
Supliers' credits	0.0	0.1	1.0	0.0	0.1	1.3
Loans ^{6/}	0.4	1.0	8.4	0.4	0.7	9.5
Brazilian assets abroad	-1.1	-0.9	-11.2	0.6	1.5	-11.5
Loans to Bacen	0.0	0.0	-4.4	0.0	0.0	-7.0
Other ^{7/}	-0.9	-0.6	-2.0	0.3	0.0	0.0
Reserve assets	0.3	-3.9	-2.2	-4.8	-6.8	3.7

^{1/} Forecast.

Projections for the 2005 balance of payments were updated in relation to those presented in the December 2004 Inflation Report, incorporating alterations in external debt service consistent with the debt stock in December 2004; in exports and imports and direct foreign investments, as a result of the recent behavior of these flows; in the exchange position of banks and in the stock of international reserves, once the impacts of the changes in the balance of payments hypotheses and of the policy of reconstituting international reserves had been computed.

The 2005 current account result is estimated at US\$2.1 billion, 0.3% of GDP. This was higher than the previous projection, which had indicated a situation of equilibrium. Basically, the new forecast resulted from strong trade balance results that occurred in the early part of the year and expectations that these results would continue.

In the first two months of the year, accumulated exports totaled US\$15.2 billion, with a daily median of US\$390 million, 31.9% more than in the same period of 2004. The contracting of exchange for export purposes registered a daily median of US\$394 million, for growth of 32.4%, using the same basis of comparison. Aside from these factors, increases in the prices of products with significant weight among Brazilian exports were announced, such as the 71.5% spurt in iron ore prices. Furthermore, considering the continuation of this tendency in the partial results for the month of March, together with the seasonal nature of the series, the value projected for 2005 exports was revised upward from US\$100 billion to US\$105 billion. It is important to highlight that, in February 2005, the twelve month accumulated export value came to US\$100 billion.

^{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 International Monetary Fund (IMF) 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.

Imports accumulated in the year up to February added up to US\$10.2 billion, with a daily median of US\$262 million, 28.4% more than in the same period of 2004. The daily median of exchange contracted for purposes of import operations increased by 18.8% when a comparison is drawn between the first two months of 2004 and 2005, a factor that also reflects the trend toward further acceleration. Thus, projected imports for 2005 where also revised upward from US\$75 billion to US\$78 billion. With these hypotheses for exports and imports, the trade balance surplus is expected to close at US\$27 billion, US\$2 billion above the level forecast in the December 2004 Inflation Report.

The projection for net interest outlays was revised from US\$13.7 billion to US\$13.6 billion, based on the new external indebtedness position for December 2004, which pointed to a reduction in the stock for the month of September 2004.

The projection for the balance of payments financial account, deficit of US\$6 billion, indicates a reduction in net remittances as a result of expectations regarding the expanded inflow of foreign direct investments and a new estimate of amortizations, the calculation of which was based on the December indebtedness position.

Net inflows of foreign direct investments, which had already shown signs of acceleration in the fourth quarter of 2004, totaled US\$2.1 billion in the first two months of 2005, maintaining a monthly median of US\$1 billion. When one considers the maintenance of economic growth and, furthermore, the inflow of resources originating in acquisitions of minority stock positions in companies belonging to the food and beverage sector, the projection for net inflows of foreign direct investments was revised upward from US\$14 billion to US\$16 billion.

Medium and long-term amortizations were revised from US\$30.5 billion to US\$29.9 billion as a result of the amortization profile generated by the external debt position for December 2004. Despite this, the hypothesis of rolling 70% of the private external debt was maintained.

Balance of payments - Market

					US\$	billion
	2004			2005		
	Feb	Jan-	Year	Feb	Jan-	Year ^{1/}
		Feb			Feb	
Current account	0.4	1.0	14.5	0.9	2.2	7.1
Capital (net)	0.7	2.2	-11.4	2.2	1.8	6.5
Foreign direct investment	1.0	2.0	18.2	0.9	2.1	16.0
Portfolio investment	0.7	1.1	2.2	1.6	1.9	3.0
Medium and long term loans	0.1	0.4	-13.5	-0.3	-0.9	-8.4
Trade credits - Short,						
medium and long term	-1.3	-1.2	-3.4	-0.4	-1.0	-0.5
Banks	-1.0	-1.3	-4.3	-0.2	-0.4	0.3
Other	-0.3	0.1	0.9	-0.2	-0.6	-0.8
Brazilian investment abroad	0.0	-0.3	-13.4	0.0	-0.7	-4.0
Of which: operations with						
foreign institutions	-0.1	-0.4	-3.7	-0.2	-0.9	-2.0
Other	0.2	0.1	-1.4	0.5	0.5	0.3
Financial gap	1.1	3.2	3.1	3.0	4.0	13.6
Banco Central net interventions	0.0	-2.6	-5.3	-3.7	-6.3	-6.3
Bank deposits	-1.1	-0.6	2.2	0.6	2.2	-7.3

expand by US\$7.3 billion, compared to US\$8.5 billion projected in the December 2004 Inflation Report. Though the increase projected for the trade surplus and for the net inflow of foreign direct investments, both forecast at US\$2 billion, contributed to growth of the same magnitude in bank assets, net Banco Central exchange market purchases of US\$6.3 billion in January and February reduced the external assets belonging to the private sector. Thus, a balance of payments deficit of US\$3.7 billion is projected for the year, as against US\$9.7 billion in the December 2004 Inflation Report.

Banking sector assets held abroad are expected to

1/ Forecast

Sustainability indicators

					US\$	billion
	2002	2003	2004			
	Dec	Dec	Mar	Jun	Sep	Dec
Exports	60.4	73.1	77.5	83.4	90.6	96.5
Debt service	49.9	53.0	54.9	55.8	56.5	51.9
Total external debt	210.7	214.9	213.5	205.6	202.2	201.4
Net total external debt	165.0	151.0	147.5	145.4	141.1	135.7
International reserves	37.8	49.3	51.6	49.8	49.5	52.9
GDP	459	507	528	553	579	603
Indicators						
Total external debt/GDP (%)	45.9	42.4	40.4	37.2	34.9	33.4
Net total external debt/GDP (%)	35.9	29.8	27.9	26.3	24.4	22.5
Total external debt/exports	3.5	2.9	2.8	2.5	2.2	2.1
Net total external debt/exports	2.7	2.1	1.9	1.7	1.6	1.4
Debt service/exports (%)	82.7	72.5	70.9	66.9	62.4	53.8
Reserves/total external debt (%)	18.0	22.9	24.2	24.2	24.5	26.3

Statement of international reserves

			U	S\$ billion
	2004		2005	
	Jan-	Year	Jan-	Year ^{1/}
	Feb		Feb	
Reserve position in				
previous period	49.3	49.3	52.9	52.9
Net Banco Central purchases	2.6	5.3	6.3	6.3
Debt servicing (net)	-1.3	-12.6	-1.5	-11.8
Interest	-1.1	-5.5	-1.3	-5.5
Credit	0.2	1.1	0.2	1.2
Debit	-1.4	-6.6	-1.5	-6.7
Amortization	-0.2	-7.1	-0.2	-6.3
Disbursements	1.5	6.7	1.9	6.5
Multilateral organizations	-	1.0	-	2.0
Sovereign bonds	1.5	5.7	1.9	4.5
International Monetary Fund	-	-4.4	-	-7.0
Disbursement	-	-	-	-
Amortization	-	-4.4	-	-7.0
Others ^{2/}	-0.3	1.2	-0.8	-0.8
Treasury's purchases	1.2	7.3	0.2	2.5
Change in assets	3.7	3.6	6.1	-4.4
Gross reserve position	53.0	52.9	59.0	48.6
Net reserve position:				
IMF Concept ^{3/}	21.2	25.3	31.4	28.4
Central Bank concept	24.8	27.5	34.8	30.1

^{1/} Forecast.

5.5 External sustainability indicators

In the final quarter of 2004, external sustainability indicators reflected the positive performances of the export sector, international reserves, GDP, and external debt. In the year, total external debt dropped by US\$13.5 billion, closing at US\$201.4 billion, and net external indebtedness diminished by US\$15.3 billion to US\$135.7 billion.

Thus, in comparison to 2003, the total external debt/GDP ratio dropped to 33.4% from 42.9%, while the total net external debt/GDP ratio shifted from 29.8% to 22.9%. As a percentage of exports, external debt service fell from 72.5% in 2003 to 53.8% in 2004, while the reserves/external debt ratio improved in the same period, from 22.9% to 26.3%.

Summary

The reduction in the balance of payments financing needs in the last years was generated by the performance of the current account and, fundamentally, by the exceptional trade balance result, with record surpluses during the entire period. Consecutive current account surpluses, summed with net inflows of foreign direct investments, increased from US\$15.5 billion, or 3.0% of GDP, in the twelve-month period through February 2004, to US\$30.0 billion, or 4.9% of GDP, in the twelve months through February 2005.

In 2005, the net foreign direct investment flows are expected to close slightly below the 2004 total, with continued issuance in the global bonds market and private debt refinancing at rollover rates in a range of 70%.

Net BCB foreign exchange purchases from December 2004 to February totaled US\$8.9 billion which, coupled with US\$1.9 billion in sovereign bond issuance in February, contributed to the expansion of total international reserves by US\$6.1 billion to US\$59.0 billion, the highest level since August 1998. In much the same manner, net adjusted reserves (IMF concept) expanded by US\$6.1 billion to US\$31.4 billion, the highest level since September 2001. In the year, gross reserves are projected to decline by US\$4.4 billion, partly as a result of US\$7 billion in loan amortizations with the IMF.

Continued large trade surpluses, the reduction in the external debt stock – as evident in rollover rates below 100% and

^{2/} Includes payments/receipts in the framework of the Reciprocal Credits and Payments Agreement (CCR), fluctuations in prices of securities, exchange parities and price of gold, discounts and premiums, duty fees and release of collaterals.

^{3/} The Technical Memorandum of Understanding (TMU) of the third review of the IMF Stand-By Arrangement specifies certain parameters for the calculation of net international reserves to determine if they comply with the performance criterion established in the agreement. The TMU specifies that the US\$ valueof non-US\$ denominated assets (including the SDR) is calculated using exchange rates set on dates established in the TMU. The same methodology is applied in the case of the price of gold. Pursuant to the TMU, outstanding debt with the IMF is excluded from reserve assets (international liquidity concept). Also excluded from reserve assets in the sum of BCB deposits in Brazilian-owned banks domiciled abroad and BCB holdings of securities issued by Brazilian entities exceeding US\$1,023 million. In February 2005, the sum of BCB deposits in Brazilian-owned banks domiciled abroad and BCB holdings of securities issued by Brazilian entities exceeded the ceiling by US\$850 million.

payments to the IMF – and sharp forecast improvement in adjusted net reserves underlie a scenario of a considerably more resilient Brazilian external position. The reduction in external vulnerability has clearly been recognized by the markets, as is evident in the downward trajectory of risk premiums on sovereign and private bonds.

Prospects for inflation

This chapter of the *Inflation Report* presents the Copom's evaluation of the Brazilian economy since the release of the last *Report*, as well as the prospects for end-2006 inflation and 2005 GDP growth. The inflation projections are presented under two main scenarios. The benchmark scenario assumes that the Selic rate will remain unchanged throughout the forecast period, at 19.25% p.a. (the rate decided at the most recent Copom meeting in March) and that the exchange rate will remain around the value observed in the days immediately preceding the Copom meeting (R\$/US\$2.70). The market scenario incorporates the market consensus exchange rate and Selic rate forecasts as surveyed by Gerin on the eve of the March Copom meeting. These scenarios serve only as tools for the adjustment of monetary policy, and their assumptions should not be viewed as the Copom's projections for the future behavior of the exchange rate and Selic rate.

The inflation and GDP growth forecasts released in this Report are not point estimates. They incorporate probability intervals that specify the degree of uncertainty present at the moment in which the interest rate decision was made. The inflation forecasts depend not only on the Selic rate assumption, but also on a set of assumptions about the behavior of relevant exogenous variables that cannot be controlled by the BCB. The set of assumptions considered most probable by the Copom comprise the scenario to which the Committee attributes the most weight when making the Selic rate decision. The presentation of these scenarios in this *Report* aims to enhance the transparency of monetary policy decisions, thereby contributing to the monetary authority's efficacy in controlling inflation, which is its most important objective.

6.1 Inflation drivers

Since the publication of the December *Inflation Report*, economic activity has expanded; however, it showed some deceleration at the margin. Given the surge in economic activity in the previous quarters, this accommodation was broadly expected, and is consistent with sustainable economic growth. The 2004 GDP result – the fastest expansion since 1994 – confirmed the strong growth suggested by leading indicators during the year.

In this context, monthly headline and core inflation rates rose in the last quarter of 2004. The data available for the beginning of 2005 seem to point to a reversal in this trend, with diminishing pressures from wholesale prices and some deceleration of core consumer price inflation. While current headline and core inflation and market expectations for 2005 remain at high levels, and the risks of future price pressures persist, the most recent data indicate an increased likelihood that consumer price inflation rates will converge to the target path pursued by the monetary authority.

In an environment of high installed capacity utilization, the inflation trajectory will primarily depend upon current and future supply and demand conditions, as repeatedly mentioned in recent editions of the *Inflation Report* and of the Copom Meeting Minutes. In 2004, investment registered the highest annual growth rate since 1994, which suggests a comfortable future supply of goods and services. In the last quarter of the year, fixed-capital investment declined; however, this fall, following the sharp growth observed in the previous quarters, and mainly in the third quarter, may reflect only a temporary adjustment, in line with the normal volatility in the investment data series. Nevertheless, an important concern regarding prospective inflation dynamics is the performance of aggregate supply in the coming quarters.

Regarding the external front, international financial market conditions remain favorable, despite some deterioration since the February Copom meeting. In the United States, the Fed's heightened concerns about inflation and the comments of Fed officials regarding the adequacy of the price adjustment in long-term securities led to an increase in the long-end of the yield curve, with consequences for emerging market countries. Brazilian country risk increased and, in line with the movements in other emerging market currencies, the exchange rate depreciated. On the other hand, the capital account, favored by abundant external liquidity, combined with the current account surpluses, has contributed to favorable conditions in the currency market.

However, liquidity conditions and market stability remain tied to macroeconomic conditions in the industrialized countries, especially the United States, and to the possible response of the Fed' monetary policy stance to the evolution of these conditions. New data suggesting an economic scenario that would require a shift in the Fed's policy of measured interest rate increases tends to result in higher volatility in international asset prices. This instability may worsen if there is a sharp exchange rate adjustment in the main countries, driven by external account imbalances. Despite the volatility registered in recent weeks, the Copom still assigns a low probability to a significant deterioration in international financial markets, due to sharp changes in the US monetary policy stance.

After declining at the end of 2004, oil prices have increased and registered high volatility, surpassing in March the record levels reached in October last year. This volatility reflects new data on demand conditions, potential supply restrictions, and oil inventories in the main consumer markets.

Considering the scenario described above, the Copom continued, from January to March, the process of monetary policy adjustment initiated in September 2004. In January, February and March, the Selic rate increased 0.5 p.p. per month, closing the quarter at 19.25% p.a.

IPCA inflation – which is the reference price index for monetary policy decision-making - declined to 0.58% in January, after accelerating for three consecutive months through December. February IPCA recorded a 0.59% increase, with a cumulative increase of 1.17% in the first two months of the year. Tradable goods and regulated prices decelerated in January and February. On the other hand, prices of non-tradable goods continued to accelerate.

In 2004, IPCA inflation reached 7.60%, below the 8.00% upper limit of the tolerance interval established by the CMN, and also below the 9.30% inflation recorded in 2003. Market prices increased 6.55% in 2004, versus 7.79% in 2003, while regulated prices edged down to 10.19% in 2004, from 13.20% in the previous year. Market prices contributed 4.66 p.p. to 2004 inflation, while regulated prices contributed 2.94 p.p., which correspond to shares of 61.3% and 39.7%, respectively, for 2004 inflation.

Core IPCA inflation remained at high levels, incompatible with the inflation target path. The cores measured under the three calculation criteria – by the exclusion of household food and regulated prices, and under the trimmed means

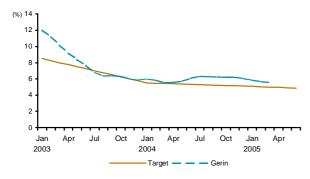
methods, smoothed and non-smoothed – accelerated from October to December, and decelerated modestly in early 2005. The recent deceleration would have been clearer had school tuition adjustments not strongly impacted the February core by exclusion. In the three-month period ended in February, the cores by exclusion and under the trimmed means methods, smoothed and non-smoothed, recorded cumulative annualized increases of 9.0%, 8.0% and 6.9%, respectively.

IGP-DI inflation, after decelerating in December and January, increased slightly in February, mirroring the behavior of the Wholesale Price Index (IPA), which was recently affected by the acceleration in agriculture prices. Industrial IPA, on the other hand, has decelerated continuously since November. The recent slowdown in industrial IPA inflation reflects, to some extent, the recent exchange rate appreciation and the monetary policy stance, and may have positive spillovers on future consumer price inflation. The magnitude of this pass-through will depend on demand conditions and the expectations of price setters regarding the future inflation trajectory, as repeatedly mentioned in recent Copom Meeting Minutes.

Market expectations collected by Gerin were little influenced, in recent months, by favorable developments that could dampen inflationary pressures, such as signs of a deceleration in economic growth, the fall of wholesale industrial prices, the revision of market expectations for the exchange rate trajectory, and the more restrictive monetary stance. The median of market expectations for 2005 IPCA inflation declined from 5.80% in the beginning of December to 5.68% at the end of February. In mid-March, expectations reversed and increased to 5.77%. This hike is tied to higher-thanexpected adjustments of some regulated prices, such as urban bus fares, and to less favorable external conditions. The expectations for twelve-month ahead inflation and for 2006 inflation have remained virtually unchanged.

GDP data released by IBGE confirm the ongoing recovery in economic activity, despite some recent accommodation. The 2004 cumulative GDP growth was 5.2% year-on-year. Industrial production and agriculture posted the strongest results, expanding 6.2% and 5.3%, respectively, while services grew 3.7%. In the fourth quarter, GDP grew 0.4% (quarter-on-quarter, seasonally adjusted). Agriculture recorded the best performance, with 2.0% growth, following a decline of 1.9% in the previous quarter, while industrial production and services grew 0.5%. Since last year, driven by the surge in investment and household consumption, domestic demand has assumed an increasingly important role in the sustainability of growth.

Evolution of market expectations and targets for twelve-month ahead inflation



Industrial production has presented some volatility (monthon-month, seasonally adjusted), following continuous expansion from February through August 2004. Industrial production grew in December and edged down in November and January, in the IBGE-revised series. As emphasized in several Copom Meeting Minutes, after a series of monthly results such as those observed since the second half of 2003, some accommodation could be expected, since monthly industrial production rates are volatile, with short-term oscillations around the trend. The January result reflected a lower-than-expected deceleration, and it does not suggest a downward trend in industrial production. In fact, the threemonth moving average for industrial production has been stable in recent months, at levels above the highs reached in mid-2004. Also, January industrial production was 5.9% above the same month of last year, and leading and coincident indicators point to an increase in February. The three-month moving average recorded 0.39% growth between October and January. This performance is due to the combination of asymmetric behaviors of components. Semi-durable and non-durable goods production grew 4.03% in this period, which confirms that recent growth has been sustained by income- and employment- sensitive sectors. Capital goods production also increased in the period, while durable and intermediate goods production declined. In the twelve months to January, industrial production expanded at high rates, recording an increase of 8.5% compared to the same period of the previous year.

On the demand side, household consumption rose 1.3% in the fourth quarter, quarter-on-quarter seasonally adjusted, and increased 4.3% in the year. In 2004, retail sales grew 9.25% in real terms, and 12.97% in nominal terms, according to IBGE. After trending sideways in the three-month period ending in October, retail sales expanded in the last two months of the year, according to data from IBGE, seasonally adjusted by the BCB. The fall of 0.3% recorded in January is not significant, if we consider that it occurred immediately following 3.8% month-on-month sales growth in December. Regarding foreign trade, imports grew 33.5% in value terms, in the twelve months through February, compared to the same period of the previous year, on the back of the strong expansion in domestic demand. External demand for Brazilian products remained solid, supporting the 33.9% exports growth in the period.

The expansion of sales and production continued to have positive implications for the labor market. The unemployment rate fell to 9.6% in December, the lowest level since the adoption of the new IBGE methodology in 2001. November

and January also posted historical lows, versus the same months of previous years. Employment grew 3.54% in the main metropolitan regions in the twelve-month cumulative series to February, versus the previous twelve months. In 2004, real wages increased 9.64%. According to CNI, real manufacturing wages fell slightly in January, following uninterrupted growth from March 2003 to December 2004, seasonally adjusted by the BCB. Formal employment rose 5.1% in 2004, according to the Ministry of Labor and Employment. In January, additional 115,972 new formal jobs were created, for a twelve-month cumulative increase of 1.5 million.

As highlighted in the December Inflation Report and in the last three Copom Meeting Minutes, these favorable labor market developments have helped to sustain the output expansion and industrial and retail sales, and encouraged changes in the composition of economic activity. In recent months, income- and employment-sensitive sectors have become progressively more important, to the relative detriment of credit-sensitive sectors. In 2004, the growth rates for semi-durable and non-durable consumer goods production were still much lower than those of capital goods and durable consumer goods production. In addition, a qualitative change in the composition of retail sales has also been observed, with highlights in the less credit-sensitive sectors, especially hyper- and supermarket sales, as well as a recovery in the fabric, apparel and footwear shoes segments in recent months. Favorable prospects for the labor market also suggest additional room for improvement in income-sensitive sectors. This change in the composition of economic activity, favoring a more balanced contribution across sectors to the expansion, is characteristic of the economy's convergence toward a sustainable growth path.

The latest results for sales and production, which remained high despite a slight accommodation in the pace of expansion, are mirrored in installed capacity utilization. According to data from the FGV, seasonally adjusted by the BCB, installed capacity utilization reached 84.5%, a slight reduction from the October figure (85.2%). Installed capacity utilization measured by CNI, seasonally adjusted by the BCB, has also posted high figures from November to January, although slightly below those registered from June to September.

Given the high levels of output and installed capacity utilization, it is crucial to monitor the performance of investment, in order to avoid the emergence of inflationary pressures. According to the IBGE, fixed-capital investment grew strongly at 10.9% in 2004, although a modest

deceleration was observed in the fourth quarter, versus the previous quarter, seasonally adjusted. Following the strong expansion rates in the previous quarters, mainly the 6.8% increase recorded in the third quarter, such a decline in fixedcapital investment was predictable. Domestic absorption of capital goods – production plus imports less capital goods exports – decreased 0.8% in January, seasonally adjusted. In 2004, domestic absorption of capital goods rose 6.4%, while capital goods production increased 19.7%.. As a consequence, investment increased from 19.8% of GDP in 2003 to 22.3% in the first three quarters of 2004, according to the IBGE. However, as mentioned in the December *Inflation Report*, it is important to highlight that as a result of the inclusion of fourth quarter investment data, the several measures of the output gap monitored by the Copom continue to indicate a reduction in idle capacity in the economy, in aggregate terms.

As investment is highly correlated with installed capacity utilization and, with a longer lag, with Brazilian country risk, the behavior of these leading indicators suggests that investment may continue to expand in the coming months. Investment data have been encouraging, but the uncertainties regarding the pace of output capacity expansion and the long-term trend of potential output persist, as mentioned in recent Copom Meeting Minutes and in previous *Inflation Reports*. Such uncertainties are naturally enhanced in the current environment, in which there has been a rapid quarterly expansion, after years of slow and irregular growth. Even with the recent accommodation in the pace of growth, the monetary policy stance should remain vigilant to ensure the demand and supply expand at a similar pace and do not introduce significant price pressures.

6.2 Baseline scenario: assumptions and risks

The projections of the Copom are based on a set of assumptions about the behavior of the main economic variables. This set of assumptions and the associated risks compose the baseline scenario, on which the Committee bases its decision-making process.

The same risks to inflation dynamics, identified in the December issue of the *Inflation Report*, are still present, despite the improvement in the domestic scenario and, on the other hand, the deterioration in the external scenario. Domestically, the main risks are tied to: (i) uncertainty about

the expansion of productive capacity to satisfy the increasing demand for goods and services; (ii) behavior of market inflation expectations; and (iii) the pass-through of current inflation to longer time horizons. The uncertainties regarding the external environment are due to: (i) trend of the U.S. yield curve; (ii) rising international oil prices; and (iii) increasing food commodity prices.

Since the release of the last *Inflation Report*, the economy has expanded; however, as expected, it has expanded at a lower pace than that of 2004. Following the initial strong impulse at the outset of the recovery, it is natural that growth tends to converge to rates more compatible with the expansion of productive capacity. This accommodation is in line with a scenario of sustained growth, with a lower probability of demand growth putting pressure on inflation and real income recovery. The GDP leading indicators point to estimates, for the first half of 2005, similar to those recorded in the last guarter of 2004.

As exhaustively emphasized in previous *Inflation Reports*, the prospective inflation dynamics depend on ultimate imbalances between aggregate demand and supply. Average installed capacity utilization slightly declined in the early months of 2005, compared to the levels of last quarter of 2004, except for the capital goods sector. At the same time, output composition is shifting, with higher expansion in more income-sensitive sectors with idle capacity, to the relative detriment of more credit-sensitive sectors, to which capacity utilization was more intense during the last quarters. Despite high aggregate capacity utilization levels, the stable macroeconomic framework, coupled with robust investment indicators, point to aggregate supply expansion consistent with lower inflation risks.

On the other hand, market inflation expectations remain in high levels when compared to the inflation target path, and were little influenced by the favorable developments that could have dampened inflationary pressures. Despite the increase in 2005 inflation expectations since the February Copom meeting, expectations for twelve-month ahead inflation and for 2006 inflation have remained virtually unchanged, suggesting that the more restrictive monetary policy stance has prevented short-term inflationary pressures from contaminating longer forecast periods. However, the convergence of inflation to the target path with the least possible impact on the activity level requires the convergence of inflation expectations to the target path.

The potential risk to inflation caused by industrial prices rises diminished since the December Inflation Report. The 0.79% increase in wholesale industrial prices in the three-month period through February partly reflects the recent exchange rate appreciation and the monetary policy stance, with possible favorable effects on future consumer price inflation. On the other hand, wholesale agriculture inflation increased in recent weeks, due to bad weather conditions. These price increases could be reinforced in the coming months by the increases in international agricultural commodity prices. As mentioned in the last section, the intensity of the pass-through from wholesale to consumer price inflation will depend on prospective demand conditions and price setters' expectations relative to the inflation trajectory.

In recent months, the Copom has mentioned specific factors, which could harm the inflation convergence process. Of particular concern was the intensity of self-propagating forces in the economic cycle, tied mainly to income and employment dynamics, and the possibility of greater inflation persistence, given aggregate demand conditions. In the committee assessment, data released thus far, including signs of easing in the acceleration of inflation registered in the fourth quarter of 2004, reduce the likehood of these risks.

These risk factors, however, should not be interpreted as evidence of the loss of monetary policy effectiveness as a result of recent credit and fiscal developments. Independent of the specific importance of these developments to current performance, it is important to highlight that every expansionary impulse requires an adequate monetary policy response, but does not necessarily represent the loss of effectiveness of conventional monetary policy instruments. Credit growth as a result of the introduction of new personal loan contracts is an important structural advance that, in addition to making a permanent contribution toward the efficiency of financial intermediation, should also increase monetary policy effectiveness in the medium run. In the opinion of the Committee members, there is no evidence to suggest that monetary policy will be unable to assure convergence to the inflation target path during the period required to consolidate this structural change. Furthermore, the monetary policy stance implemented in recent months takes into consideration the fiscal policy impact on aggregate demand and, ultimately, on inflation. Clearly, reductions in fiscal expenditures reinforce the efforts of monetary policy to control inflation, and improvements in the public accounts contribute to further reductions in real interest rates in the medium run. However, again, it does not mean that the current fiscal policy stance makes conventional monetary policy instruments inefficient in the control of inflation.

On the other hand, while still favorable, international capital market conditions have recently deteriorated. In the United States, heightened inflation concerns expressed by the Federal Reserve and the comments of FED authorities regarding the adequacy of the price adjustment of long-term bonds provoked an increase in the long end of the yield curve, with repercussions for emerging market countries. Brazilian country risk increased and, following the adjustment in several other emerging market currencies, the real depreciated. As stressed in prior Inflation Reports, abundant international liquidity and global market stability remain tied to macroeconomic conditions in the industrialized countries, especially the U.S., and to the FED's potential monetary policy response to economic developments. Despite the recent volatility, the Copom continues to assign a low probability to a significant deterioration in international financial markets driven by abrupt changes in the conduct of U.S. monetary policy.

Since the beginning of 2005, international oil prices have registered high volatility at high levels, exceeding in March the record levels reached in October last year. These recent hikes have been driven by news related to supply conditions, rising demand, bad weather conditions in the northern hemisphere and the fall in available oil inventories. With the increase in oil prices, international gasoline prices have returned to levels above those in the domestic market. The persistence of prices at these levels remains surrounded by a considerable degree of uncertainty, such that the Copom maintained the assumption in its baseline scenario that domestic fuel prices will not be upwardly adjusted in 2005. However, the more unfavorable external environment now represents a bigger risk to the future inflation trajectory than it previously did. Even if this recent uptick in international prices has not translated into an increase in domestic gasoline prices, it affects the prices of petroleum derivatives, as well as market inflation expectations.

Despite the deterioration of the external outlook, current data and favorable projections for the trade balance increase the country's resilience to external risks. The high current account surplus, in addition to favorable external financing conditions, have contributed to an important increase in international reserves. International reserves recomposition, together with the reduction of FX-linked debt, has gradually enhanced the Brazilian economy's resilience to international financial market turbulence.

The benchmark scenario considers a 6.9% change in regulated prices for 2005, up from the 6.7% forecast of the last Inflation Report. The projection for the adjustment of both gasoline and bottled gas prices for 2005 remained unchanged at 0%. Projections for adjustments of fixed telephone rates increased to 8.7% from 7.7%, and household electricity remained unchanged at 9.5% for 2005. The projection for regulated price adjustments in 2006, following the model of endogenous determination, stands at 5.1%.

The benchmark scenario also assumes the maintenance of the Selic rate at 19.25% p.a. (Selic target decided on the March Copom meeting) and the exchange rate unchanged at R\$/US\$2.70 through the end of 2006. Still according to the benchmark scenario, the projection for the 6-month spread over the Selic rate totals 33 basis points in the second quarter of 2005 and 43 basis points in the last quarter of 2006.

The balance of payments improvements influenced the expectations in the market scenario. The expectations for the exchange rate fell to R\$/US\$2.78 for the last quarter of 2005 and to R\$/US\$2.97 for the last quarter of 2006, down from R\$/US\$2.99 and R\$/US\$3.25, respectively, considered in the December *Inflation Report*. Meanwhile, the market reassessed the monetary policy trajectory, increasing the Selic projections to 17.42% from 15.75% for the last quarter of 2005 and to 15.13% from 14.14% for the last quarter of 2006. These new forecasts are in line with the projection for the spreads based on the 6-month swaps (-24 basis points and -281 basis points) for the last quarters of 2005 and 2006, respectively. In the market scenario, increases of 7.6% and 6.3% are projected for all regulated prices, for 2005 and 2006, respectively.

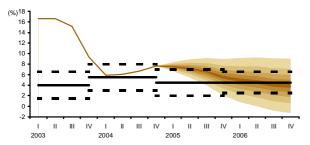
Regarding fiscal policy, the results through February 2005 further support the likelihood that the consolidated public sector primary surplus targets for 2005 and the coming two years will be achieved.

6.3 Inflation forecasts

Based on both the previously discussed assumptions and associated risks, four-quarter accumulated IPCA projections were made, using the interest and exchange rates paths in the benchmark and market scenarios. The benchmark scenario assumes the Selic rate unchanged at 19.25% p.a. (set up at the March Copom meeting) and the exchange rate at R\$/US\$2.70 (rate on the eve of the March meeting). Under the market scenario, which incorporates the market expectations collected by Gerin, the average Selic rate increases to 19.08% p.a. in

Forecasted IPCA-inflation with interest rate constant at 19.25 p.a. (Benchmark scenario)

Inflation fan chart



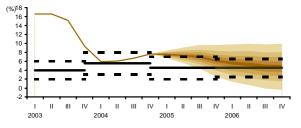
Note: Accumulated inflation in 12 months (% p.a.)

IPCA-inflation with interest rate constant at 19.25 p.a. (Benchmark scenario)

Confidence interval								
	50%							
Year	Q			30)%			Central
				10%				projection
2005	1	7.2	7.3	7.5	7.6	7.7	7.9	7.5
2005	2	6.5	6.8	7.0	7.3	7.6	7.9	7.2
2005	3	5.5	5.9	6.3	6.7	7.2	7.6	6.5
2005	4	4.1	4.7	5.2	5.8	6.3	6.9	5.5
2006	1	3.3	4.0	4.7	5.3	5.9	6.7	5.0
2006	2	2.7	3.5	4.3	5.0	5.7	6.5	4.6
2006	3	2.1	2.9	3.7	4.5	5.3	6.1	4.1
2006	4	1.7	2.6	3.5	4.2	5.1	6.0	3.8

Note: accumulated inflation in 12 months (% p.a.)

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



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

IPCA-inflation with market expected interest and exchange rates1/

Confidence intervals								
Year	Q			30)%			Central
				10%				projection
2005	1	7.2	7.3	7.5	7.6	7.7	7.9	7.5
2005	2	6.6	6.9	7.2	7.4	7.7	8.0	7.3
2005	3	5.9	6.3	6.7	7.1	7.6	8.0	6.9
2005	4	4.7	5.3	5.8	6.4	6.9	7.5	6.1
2006	1	3.9	4.6	5.2	5.9	6.5	7.3	5.6
2006	2	3.4	4.2	4.9	5.6	6.4	7.2	5.3
2006	3	2.8	3.7	4.5	5.2	6.0	6.9	4.9
2006	4	2.7	3.6	4.4	5.2	6.0	6.9	4.8

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

1/ According to Gerin.

the second half of 2005; after that, it gradually declines to 17.42% in the fourth quarter of 2005, and 15.13% at the end of 2006. The average exchange rate depreciates from R\$/ US\$2.65 in the first quarter of 2005 to R\$/US\$2.78 and R\$/ US\$2.97 in the last quarters of 2005 and 2006, respectively.

The central inflation path under the benchmark scenario falls from 7.5% in the first quarter of 2005 to 5.5% at year-end, above the 5.1% inflation objective for 2005. The downward inflation path is tied to the lagged effects of the Selic rate adjustment process conducted by the Copom since September. The table at left shows that the most notable drop in projected inflation occurs between the third and the fourth quarters of the year, when the four-quarter accumulated IPCA inflation forecast declines 1.0 p.p., due to the substitution of a lower forecast (1.01%) in the fourth quarter of 2005 for the higher rate (2.00%) registered in the same period of 2004. Under the benchmark scenario, the probability of exceeding the upper limit of the tolerance interval for 2005 inflation (7%) is around 24%, slightly below that of the December Inflation Report (25%). Similarly, 2006 inflation projections also show a downward trend. Four-quarter accumulated projected IPCA inflation falls from 5.0% in the first quarter of the year to 3.8% in the last quarter; therefore, below the central inflation target for 2006 (4.5%).

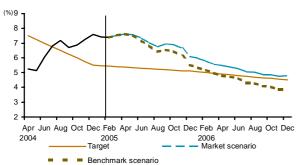
Under the market scenario – which incorporates expectations for a decline in interest rates and for exchange rate depreciation throughout the forecast period – inflation projections were higher than those under the benchmark scenario. Accumulated inflation projections for 2005 (6.1%) and 2006 (4.8%) are both above the central inflation targets. Although four-quarter accumulated IPCA inflation forecasts show a downward trend under the benchmark scenario, those calculated under the market scenario decline more slowly, due to the decline in the Selic rate and the exchange rate depreciation expected by the market. For this reason, the probability of exceeding the upper limit of the tolerance interval for 2005 inflation is higher under this scenario – around 33% – although lower than that estimated on the December Inflation Report (39%).

As described in the last section, for all regulated prices in 2005, a 6.9% increase is projected under the benchmark scenario, versus a 7.6% increase projected under the market scenario. For 2006, a 5.1% increase is projected under the benchmark scenario, versus a 6.3% increase projected under the market scenario. Both projections for 2006 are based on the model of endogenous determination for regulated prices, habitually used by the Copom.

December 2004 Inflation Report forecast

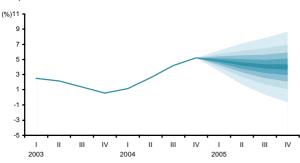
Period	Benchmark scenario	Market scenario
2005 I	7.1	7.2
2005 II	6.6	7.1
2005 III	5.9	6.8
2005 IV	5.3	6.3
2006 I	5.0	5.8
2006 II	4.9	5.5
2006 III	4.4	5.2
2006 IV	4.0	5.0

Forecast and target paths for twelve-month ah ead cumulative inflation



GDP growth with interest rate constant at 19.25 p.a. Benchmark scenario

Output fan chart



The comparison between the inflation trajectories presented in this *Inflation Report* and those released in the December *Inflation Report* (the central projections are presented in the table at left), shows an increase in IPCA inflation projections for the first quarters of 2005 in both benchmark and market scenarios, although of a lower magnitude in the latter. For calendar-year inflation, however, the forecasts under the two scenarios behaved differently: under the market scenario, the IPCA inflation forecast fell to 6.1% from 6.3%, whereas under the benchmark scenario, the forecast increased to 5.5% from 5.3%. The decline under the market scenario is mainly due to current expectations for exchange rate (R\$/US\$2.78 at the close of 2005) compared to that projected in the previous Inflation Report (R\$/US\$2.99) and to a higher interest rate trajectory – 17.42% p.a. at the close of 2005 projected in this Report, versus 15.75% p.a. projected in the previous one. On the other hand, under the benchmark scenario, the higher 2005 inflation projection was due to the higher-than-expected headline inflation for the first months of the year, slightly above December forecasts. The projections for 2006 cumulative inflation decreased 0.2 p.p., under both scenarios.

The graph at left shows twelve-month cumulative inflation, based on both the benchmark and market scenario forecasts of this Inflation Report, and also the inflation path interpolated from the inflation targets (for 2005, the 5.1% inflation objective was considered). Through February 2005, the data refer to the twelve-month cumulative inflation. As of March, the trajectories are based on the sum of inflation through February in addition to the projections beginning in March. For instance, the December 2005 projection incorporates the inflation rates registered in the first two months of the year, plus the inflation projections for the coming months. Under the benchmark scenario, cumulative inflation is above the target path through early 2006, and below the target path as of April 2006. Under the market scenario, cumulative inflation is above the target path through the close of 2006, though declining as of mid-2005 and with higher convergence to the target path than in the December Inflation Report.

The output growth fan chart at left is based on the benchmark scenario assumptions. It is important to highlight that the probability of projection errors associated with GDP growth is much higher than that for inflation projections. This is because the GDP projection model is based on the decomposition of GDP into two components that are not directly observable – potential output and the output gap. Moreover, the measurement of the output level is more complex and less accurate than that of inflation. Under the benchmark scenario, the projection for 2005 GDP growth is 4%, the same as projected in the December *Inflation Report*.

The Term Structure of Interest Rates and the Cost of Credit

The text box, "Interest Rates, the Cost of Credit, and Economic Activity", published in the September 2003 Inflation Report, examined the impact of the term structure of interest rates on the cost of credit and. ultimately, on aggregate demand. This box revisits the topic, incorporating new data and updating the analysis to reflect recent monetary policy developments.

The key points of the September 2003 analysis were: (a) the monetary authority sets only the nominal short-term interest rate (the overnight or Selic rate). Even at relatively short tenors, market interest rates can deviate from the overnight interest rate, as occurs when market participants expect changes in the monetary policy stance; (b) the term structure of interest rates determines the nominal cost of credit for various contractual instruments and tenors; (c) private consumption and investment decisions are affected by, among other factors, the real expected cost of credit; and (d) the transmission of monetary policy involves time-lags. In summary, changes to the overnight interest rate do not immediately affect the real cost of credit, or consequently, aggregate demand.

In September 2003, there were signs of a recovery in economic activity, in response to the reduction in long-term interest rates that began in March, which was, in turn, driven by the market's anticipation of the monetary easing that the Copom would initiate in June. The reduction in long-term interest rates led to an inversion of the yield curve in the second quarter of 2003 and laid the

groundwork for a reduction in bank lending rates, which stimulated the recovery of economic activity as of the third quarter of 2003.

The economic recovery initiated in the third quarter of 2003 has followed a classic monetary impulse cycle – initially supported by demand for credit-sensitive goods, then more broadly disseminated within the economy via improvements in confidence, employment, and real wages – but, nevertheless, there were some delays in identifying the recovery. The fact that the Brazilian economy was in the midst of a sustained recovery was only broadly recognized in the first quarter of 2004.

As was the case in the second half of 2003, there has recently been some difficulty in identifying the effects of monetary policy on activity. Two factors have exacerbated this difficulty: (1) the relatively sudden return of the positive slope of the yield curve in the first half of 2004, followed by a gradual reduction in the spread between long- and short-term interest rates; and (2) innovations in the credit market, such as the creation of new personal loan instruments (namely, payroll-deducted loans), which, due to lower inherent credit risk, contributed to a reduction in banking spreads.

The graph to the left demonstrates that, beginning in May 2004, market interest rates diverged from the overnight interest rate, and more recently, the curve has inverted in the long end (the 360-day rate is lower than the overnight rate). Furthermore, the graph seems to indicate that long-term interest rates reflected an expectation that the Copom would initiate a monetary tightening cycle, in response to the growing divergence between the Copom's inflation projections and the target path, as well as the deterioration in the external environment (namely, oil price volatility).

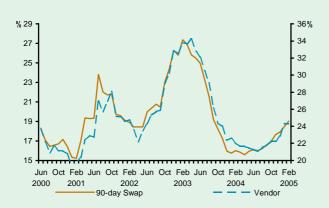
The recent increase in the term structure of interest rates is not, therefore, unprecedented, nor does it imply the loss of monetary policy effectiveness. The process under way since May 2004 is similar to that of early 2001 or the second

Over-Selic, 180-day and 360-day swap rates

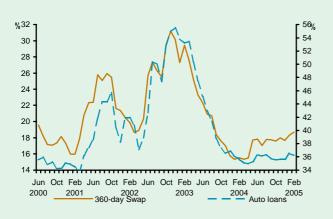


Market interest rates and credit cost - Different types of loans









half of 2002, and opposite that of the second quarter of 2003 (when market interest rates reflected an expectation of a relaxation in the monetary policy stance, in response to the more favorable inflation outlook).

With regard to the impact of innovations in the credit market on bank lending rates, the four charts at left illustrate the relationship between the cost of credit for different types of loans, and market interest rates for comparable maturities. These charts underscore that lending rates across a range of credit modalities remain highly dependent on market interest rates, although structural factors have probably contributed to the decoupling of rates in recent months. This phenomenon is more marked in the cases of personal credit and auto loans, segments where structural innovations are particularly evident and competition among financial institutions is more intense. However, even in these cases, the currently observed decoupling is not unprecedented in the historical series.

Enhancing the efficiency of financial intermediation has been an explicit economic policy goal for several years in Brazil, and structural advances on this front should also improve the effectiveness of monetary policy over the medium term. As these structural changes in the credit market are consolidated, divergences of expected inflation from the target path will be able to be corrected with a lower adjustment in real interest rates.

Finally, with regard to the response of economic activity to monetary policy stimulus, there is no evidence of abnormalities in recent months. The graph on the next page, which shows 360-day real interest rates (deflated by expected inflation) compared to six-month ahead seasonally adjusted installed capacity utilization, demonstrates that the monetary tightening begun in the second half of 2004 has been gradually adjusting output growth to the pace of productive capacity growth.

360-day real interes rates and installed capacity utilization (t+6)



Minutes of the 103rd Meeting of the Monetary Policy Committee (Copom)

Date: December 14th, from 4:50PM to 7:09PM, and December 15th, from 4:40PM to 7:00PM Place: BCB's Headquarters meeting rooms – 8th floor on December 14th and 20th floor on December 15th – 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 Rodrigo Telles da Rocha Azevedo Sérgio Darcy da Silva Alves

Department Heads (present on December 14th)

Altamir Lopes – Economic Department Daso Maranhão Coimbra – International Reserves **Operations Department** José Pedro Ramos Fachada Martins da Silva -**Investor Relations Group** Luiz Fernando Maciel – Department of Banking **Operations and Payments System** Marcelo Kfoury Muinhos - Research Department (also present on December 15th) Sérgio Goldenstein – Open Market Operations Department

Other participants (present on December 14th)

Alexandre Pundek Rocha – Advisor to the Board

Flavio Pinheiro de Melo – Advisor to the Board Hélio Mori – 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. Consumer price inflation accelerated in November, due to market and regulated price increases. Wholesale prices also increased, mainly due to the growing season effect, which caused a reversion of the prior months' downward trend in agricultural prices. Industrial prices, although decelerating, sustained a relatively high change.
- 2. The Broad National Consumer Price Index (IPCA) increased 0.69% in November, compared to 0.44% in October, accumulating a 6.68% change in the year and a 7.24% change in twelve months. The monthly result of the IPCA mainly reflected regulated prices increases, in particular, fuel, telephone, airplane tickets and urban bus fares. The impact of these increases was partially offset by the continued decline of fresh food prices.

- The General Price Index (IGP-DI) rose 0.82% in November, compared to 0.53% in October, totaling an 11.56% increase in the year. Among the IGP-DI components, the Consumer Price Index - Brazil (IPC-Br) increased 0.37% in November, after a 0.10% increase in October. The National Index of Civil Construction (INCC) increased 0.71%, below the 1.19% increase in October, due to the reduction of construction material prices and the stability in labor costs. The Wholesale Price Index (IPA-DI) increased to 1.00% in November from 0.61% in October, accumulating a 14.13% change in the year. In the period of twelve months ended in November, the IGP-DI and the IPA-DI accumulated changes of 12.23% and 14.97%, respectively.
- Regarding the November IPCA, regulated prices increased 1.41%, with a 0.41 p.p. share in the overall result, of which 0.22 p.p. was due to fuel prices. Fuelalcohol prices increased 11.2%, and gasoline prices rose 2.6%. Additionally, bottled cooking gas increased 1.5% and telephone tariffs rose 2.7%, as a consequence of the second installment of the extraordinary readjustment determined by the Supreme Judicial Court.
- 5. Market prices in the IPCA increased 0.39% in November, compared to 0.29% in October, accounting for 0.28 p.p. of the monthly index change. The increase in market prices was mainly due to tradable goods, the prices of which increased 0.47%; nontradable goods increased 0.29%. The smaller change in non-tradable goods prices was due to the 5.0% decrease in fresh food prices, which alleviated the increases in other items, in particular, vehicle repairs and condominium taxes. Among tradable goods, the increases in clothes, cattle and chicken meat, tobacco and automobiles prices should be highlighted.
- 6. The acceleration of the IPA-DI in November was due to the reversion in agricultural prices, which increased 0.14%, after declining 2.73% in October and 0.64% in September. The prices of cattle, eggs and coffee were key drivers, while the prices of rice, soy, corn, vegetables and fruit continued to decline. Wholesale industrial prices inflation moderated in the period, reaching 1.30% in November, compared to 1.83% in October. The price increase was less intense among some intermediary goods, mainly iron, steel

- and derivatives, wood, plastic material and plastic material products, while final consumer goods and investment goods increased in the month.
- The IPCA core inflation remained at high levels in November. Excluding household food items and regulated prices, the core reached 0.57% in November, compared to 0.55% in October, accumulating 7.90% in twelve months. The core calculated under the smoothed trimmed-mean method increased to 0.62%, compared to 0.60% in the previous month, and totaled 7.58% in the last twelve months. The same core measure, calculated without the smoothing procedure, increased to 0.57% in November from 0.55% in October, accumulating 6.25% in twelve months.
- The IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed-mean method, reached 0.41% in November, compared to 0.43% in October, totaling an increase of 5.85% in the last twelve months.
- The IPCA diffusion index has shown an increase in the number of items with positive price rises. In November, the index increased to 67.6% compared to 66.4% in October and 60.4% in September. The persistence of high core inflation and the recent behavior of the diffusion index indicate the dissemination of price increases across several sectors of the economy.
- 10. In December, the IPCA should persist at a relatively high level. Further increases of fuel-alcohol prices, the readjustment of gasoline prices announced on November 26, and the urban bus fare increases in Recife and Belo Horizonte should be emphasized. Among market prices, the favorable contribution of food might be lower, mainly due to fresh products prices.

Assessment of Inflation Trends

- 11. The inflation shocks and their impacts were reassessed according to new available information. The scenario considered in the simulations assumed the following hypotheses:
- a) The projection for the readjustment in gasoline prices during 2004 was increased to 13.0% from 9.5%. Regarding bottled cooking gas, the projected readjustment for 2004 was revised to 6.5% from

- 5.0%. For 2005, the Copom projects the prices of gasoline and bottled gas to remain unchanged;
- b) Regarding household electricity prices, the Copom reduced the 2004 projections by 0.2 p.p. to 10.0%. For 2005, a 9.5% increase is estimated. The projections for the fixed telephone prices in 2004 were not changed, remaining at 14.8%. For 2005, a readjustment of 7.7% is projected;
- c) For all regulated prices, which represented a total weight of 29.2% in the November IPCA, a 9.8% increase for 2004 is projected (0.8 p.p. above the previous meeting projection);
- d) Still regarding all regulated prices, it is estimated an increase of 6.7% in 2005, down from 7.2% in the November Copom meeting;
- e) The projection for the 6-month spread over the Over-Selic rate, following the specification of a Vector Autoregressive model based on the Over-Selic and the swap rates on the eve of the Copom meeting, stood at 52 b.p. in the fourth quarter of 2004, 56 b.p. in the last quarter of 2005 and 53 b.p. at the end of 2006.
- 12. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.5% of GDP for 2004 and of 4.25% for the following two years will be achieved. The related assumptions considered in the previous Copom meeting were maintained.
- 13. Assuming the maintenance of the Over-Selic rate at 17.25% p.a. and of the exchange rate at the level prevailing on the eve of the Copom meeting (R\$/ US\$2.75), the IPCA inflation rate was projected above the 5.5% central target for 2004 and above the 5.1% objective for 2005. Taking into account 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 was also projected above the central target for 2004 and above the objective for 2005.

Monetary Policy Decision

14. IPCA inflation accelerated for the second consecutive month in November, increasing to 0.69%

- from 0.44% in October and 0.33% in September. This acceleration was mainly due to regulated price increases, especially fuel prices. This acceleration happened despite the decline in household food prices for the third consecutive month. The IPCA inflation acceleration between September and November was observed in its three components: tradable, nontradable and regulated prices.
- 15. The IGP-DI also accelerated in November for the second consecutive month, increasing 0.82%, compared to 0.53% in October and 0.48% in September. Industrial IPA-DI inflation accumulated a 19.05% change between January and November. In the IPA-DI measured according to the production stage, intermediary goods increased 25.34% in the same period. This wholesale price inflation continues to represent a potential pressure on consumer prices in the coming months. The intensity of the passthrough will depend on prospective demand conditions and market inflation expectations; the evidence that this transmission has not happened yet with the intensity and velocity observed in the past does not mean that the pressure has definitely vanished.
- 16. IPCA core inflation continued to accelerate in November, according to the three criteria – by excluding regulated prices and household food, by smoothed and by non-smoothed trimmed-means. Also according to two of the three criteria (exclusion and smoothed trimmed-mean), the accumulated change in core inflation in 12 months was above the IPCA in the same period. The cores remain at levels incompatible with the medium-run inflation targets.
- 17. The significant activity rebound mentioned in the Copom Minutes during the year, based on monthly indicators of industrial output, sales, and employment, was ratified by the third quarter GDP result. GDP grew 5.3% in the first three quarters of the year compared to the same period of 2003, and 1.0% from the second to the third quarter in seasonally adjusted terms. Industry was the sector that increased most according to both criteria. The GDP data also confirmed that growth is being supported by domestic demand. Considering quarter-on-quarter seasonally adjusted data, families' consumption increased the same or more than GDP, both in the second and third quarters of 2004. Fixed capital investment also

outpaced GDP growth for four consecutive quarters, increasing 11.8% in the year, and 6.7% quarter-onquarter, seasonally adjusted. After the release of the third quarter data by the Brazilian Institute of Geography and Statistics (IBGE), the median of market expectations for the 2004 GDP growth was adjusted upwards, to 5.08% from 4.60% in the week previous to the November Copom meeting.

- 18. Industrial output declined 0.4% in October in seasonally adjusted terms. This decline, however, was lower than suggested by the behavior of leading and coincident industrial indicators. The decline in October was led by the credit sensitive industries (durable and capital goods), which had been growing at very high rates for several months. Industry has shown an already anticipated qualitative change, being stimulated progressively by the sectors that are more income sensitive. In the year to October, industrial output grew 8.3% compared to the same period of the previous year, the highest rate since the beginning of the 90's. In twelve months, industry grew 7.4%.
- 19. Leading and coincident indicators for November anticipate a new decline in the industrial output seasonally adjusted series. However, as discussed in previous Copom Minutes, this specific performance does not signal a reversion in the industrial output growth trend, as a strong isolated increase cannot be considered as an indicator of acceleration in production. After a sequence of growth rates as witnessed in the recent past, it is reasonable to observe some temporary accommodation, since industrial activity rates are volatile, with short-run variations around the growth trend.
- 20. The variation of the number of working days makes the analysis of the monthly economic activity data even more difficult, particularly regarding industrial output. In October 2004 there were only 20 working days, compared to 23 working days in the same month of 2003 and an average of 21.5 in the last eleven years, distorting both the comparison between years and the seasonally adjusted data series. The correction of this distortion is not trivial, because the number of working days obviously affects industries that produce only on these days, though there is no direct impact for the industries with continuous production cycles. The same problem will happen in December, but inversely, because the month will have 23 working days compared

to only 21 in 2003. Thus, recent monthly activity indicators will be clearer just after the release of new data in the coming months.

- 21. The labor market has continued to improve significantly. According to the IBGE, urban employed workers and real wages increased 2.9% and 1.6%, respectively, between January and October. The unemployment rate decreased to 10.5% in October, compared to 10.9% in the previous month and 12.9% in October 2003. The October result was equal to that of December 2002, the lowest value since the IBGE changed the methodology in 2001, and the expectation is for additional declines in the last two months of the year. According to the Ministry of Labor and Employment, formal employment increased 4.8% in the first ten months of the year, compared to the same period of 2003, with increases in all sectors, especially the manufacturing sector. Data from the National Industry Confederation (CNI) indicate a continuous increase in employment and real wages in the manufacturing in the year up to October.
- 22. Retail sales increased 0.3% between September and October, according to IBGE data, seasonally adjusted by the BCB. Sales and nominal revenues increased 7.8% and 11.9%, respectively, in twelve months. According to quarterly moving averages, the sales of automobiles and motorcycles, along with supermarket sales, continued to grow, while the sales of appliances and furniture, and fabric, clothes and shoes decreased. However, appliances and furniture, and vehicles and motorcycles continue to present the highest growth rates over twelve months. Even with the recent accommodation, retail sales accumulated a growth rate of 9.3% in the ten first months of 2004, compared to the same period of 2003. The increase varies from 5.2% in the fabric, clothes and shoes sector, to 27.6% in the appliances and furniture sector.
- 23. Due to the significant activity expansion in recent quarters, the performance of aggregate supply in the coming quarters continues to be an important concern for the Copom. Investment performance has been promising, though the level of capacity utilization remains high. The domestic absorption of capital goods increased 12.2% between January and October, despite a decrease in October caused by the required registration of an oil platform, produced and managed

domestically, as an exported product. The CNI installed capacity index declined in October for the second consecutive month in seasonally adjusted terms, after reaching an historical high in August. The different output gap measures continued to narrow, even after the inclusion of the third quarter GDP data. Thus, monetary policy has to continue monitoring the additional expansion of demand.

- 24. The external trade surplus has remained robust despite the increase in domestic activity. Exports have maintained high growth rates, accumulating 31.6% in the year up to November, compared to the same period of 2003. The export volume of manufactured goods, which represent the largest share among exports (around 56% of the total), expanded by 22.9% between January and October, compared to the same period of the previous year. Due to the activity rebound, imports demonstrated similar dynamism, with an increase of 28.9% between January and November. The import volume of raw materials and durable consumer goods grew 21.1% and 22.5%, respectively, in the year to October. In the period of twelve months ended in November, the trade surplus totaled US\$32.9 billion, providing a positive balance in the current account of US\$10.7 billion, or 1.8% of the GDP.
- 25. In a more favorable global environment, the Brazilian country risk premium continued to decline and the BRL appreciated against the dollar. The prospects remain positive, in large part because the Federal Reserve (Fed) will probably continue its moderate tightening. Actually, in 2004, liquidity remained favorable, except for a short period in the second quarter, when the markets expected a change in the Fed's stance. Since the end of 2003, the Copom has been working with a scenario of a low probability of abrupt movements in the U.S. fed funds rate, which actually happened. The continuity of this favorable environment will depend on new economic data for industrialized economies, especially the United States, and on international oil prices. The recent exchange rate moves represent an additional concern, since a process of disorderly adjustment, which is not likely to happen, would cause significant instability in the international financial markets.
- 26. In the beginning of December, the Central Bank resumed the purchase of foreign currency. As emphasized in a Communiqué released last January,

- the BCB aims at increasing the country's international reserves in the medium-run and not at attaining any quantitative target. This policy will continue to be based on liquidity conditions, and will objective not to add volatility to the exchange rate market and not to interfere in the floating exchange rate trend. This process should be understood, therefore, as an effort to rebuild international reserves in an inflation-targeting regime with a floating exchange rate. It should not be understood as the establishment of other targets, such as a ceiling or a floor to the foreign exchange rate. The BCB has also achieved, since May 2003, extremely positive results regarding the decrease of the share of the public debt linked to the exchange rate.
- 27. After reaching record levels in October, international oil prices have fallen; nevertheless, they still remain at high levels. Oil price prospects remain highly uncertain, primarily due to uncertainties regarding the continuity and the magnitude of the recent price correction. In any case, the reduction in oil prices since October supports the Copom forecasting scenario, which treats the sharp oil price deterioration as a latent risk and not as a baseline scenario hypothesis. On the domestic front, the Copom projects that there will be no fuel price adjustments in 2005. If a more favorable international oil price scenario materializes, it is possible that there may actually be downward adjustments to domestic oil product prices next year. As emphasized in the September Copom Minutes, having set the 5.1% inflation objective for 2005, new inflation shocks will be treated asymmetrically. This means that the Copom will take full advantage of favorable shocks, such as unanticipated reductions in fuel prices, as an opportunity to achieve the 4.5% inflation target set by the CMN.
- 28. Since the November Copom meeting, the median of IPCA inflation expectations for 2004 has deteriorated to 7.38% from 7.19%. In contrast, the median of IPCA inflation expectations for 2005 improved, falling to 5.78% from 5.90%. Nevertheless, this improvement could be considered relatively modest in light of the recent developments that reduced inflationary pressures for the next year, such as signs of moderation in the pace of economic growth, the exchange rate appreciation, the reduction of important international commodity prices, and unequivocal signs of a more restrictive monetary policy stance.

- 29. The Copom inflation projections for 2004 increased mainly due to the end-of-November adjustment in gasoline prices. For 2005, projections for both the benchmark and market scenarios declined in relation to the November meeting. In the benchmark scenario - which assumes an Over-Selic rate of 17.25% p.a. and an exchange rate of R\$/ US\$2.75 – the exchange rate appreciation, the increase in the short end of the yield curve, the anticipation for 2004 of the readjustment of gasoline prices, and a small reduction in inflation expectations more than compensated for the narrowing of the output gap, causing a reduction in the projected inflation. However, the projection still remains above the 5.1% objective. In other words, even if the Over-Selic rate and the exchange rate remain unchanged throughout 2005 at the levels preceding the December Copom meeting, inflation would be above the 2005 monetary policy objective. The projections based on the market scenario, which incorporates the Over-Selic rate and exchange rate projected by the market on the eve of the Copom meeting, stand above the benchmark scenario, due to the exchange rate depreciation and the interest rate decline expected through the projection period. In this case, the projected inflation would be even more distant from the 5.1% targeted by monetary policy.
- 30. Since September, the deviation between the Copom inflation projections and the inflation target has narrowed. However, the projected inflation persists above the 5.1% objective for 2005, despite the disinflation contributions of the reduction in international oil prices, the appreciation of the exchange rate and some evidence of more balanced economic growth. In order to ensure the convergence of inflation to the targeted path, the Copom members determined that the gradual interest rate adjustment process should continue at the originally foreseen pace. The Committee assumes that the combination of the ongoing adjustment process followed by a sufficiently long period of unchanged interest rates should significantly reduce the likelihood that the future inflation path diverges from the targets.
- 31. Considering the reasons stated above, the Copom unanimously decided to increase the Selic rate target to 17.75%, with no bias.

- 32. As stressed in the November Minutes, the Committee emphasizes that the persistence of the monetary adjustment process in the originally foreseen pace and magnitude requires that there is not an exacerbation of the risk factors that the Committee has closely monitored in the recent months, and that there is not an interruption in the process of convergence of the private sector inflation expectations to the inflation targets. The Copom will be prepared to change the pace and magnitude of the monetary adjustment process if it assesses that there are risks for the inflation to deviate from the target path.
- 33. At the close of the meeting, it was announced that the Committee would meet again on January 18, 2005, for technical presentations, and on the following day, to discuss the monetary policy decision, as established in Communiqué 12,631 of October 29, 2004.

Summary of Data Analyzed by the Copom

Economic Activity

- 34. According to the IBGE's retail survey, which encompasses all the states of the country, retail sales were stable in October, seasonally adjusted by the BCB. Hyper and supermarket sales maintained their growth trend, while the sales of fuel and of fabric, clothing and shoes fell in the month in seasonally adjusted terms. Furniture and electrical appliances, which had been showing notable growth rates in the year, expanded again in October after falling in September. In the year to October, the retail activity expanded 9.3% compared to the same period of 2003; compared to the same month of 2003, the retail activity expanded 8.5% in October. The yearon-year growth in retail sales occurred in 25 out of the 27 states in the country.
- 35. In September, the São Paulo Trade Association (ACSP) registered increases of 0.5% and 2.5% in the number of credit sales consultations and of the Usecheque system, respectively, both compared to the previous month, seasonally adjusted. In the year to November, the same indicators rose by 6.4% and by 1.4%, respectively.

- 36. The Federação do Comércio do Estado de São Paulo (Fecomercio-SP) consumer sentiment survey indicated that the Consumer Confidence Index decreased by 3.1% in December to 141.1 points (range 0 to 200). This was a result of an improvement of 6.6% in the Index of Current Economic Conditions and a 7.6% decrease in the Index of Consumer Expectations.
- 37. Regarding fixed capital investment, the domestic absorption of capital goods declined 22.0% in October, compared to September, on a seasonally adjusted basis. The increase of 51.6% in capital goods exports was the main reason behind this decline, along with the reductions of 1.3% and 7.7% in domestic output and capital goods imports, respectively. The sharp jump in exports was driven by the sale of a domestically-produced oil exploration platform-ship, which remained leased in the country. The domestic absorption of capital goods accumulated a 12.2% growth in the year to October, as a result of the 21.8% growth in domestic output and 3.5% growth in imports. Production of civil construction inputs fell 1.3% month-on-month in October, seasonally adjusted, accumulating an increase of 5.8% in the year to October.
- 38. The IBGE's registered a 0.4% decline in industrial output in October, seasonally adjusted, relative to the prior month. Considering the quarterly moving average, industrial output recorded an historic high in October, slightly above the level recorded in September
- 39. The breakdown of industrial output data showed the October decline was a result of the performance of 14 out of the 23 activities, seasonally adjusted. The most notable declines were in the sectors of food, rubber and plastic, vehicles, and perfumes. The sectors that demonstrated notable growth were oil refining and alcohol production, chemical products, machines and electrical materials and metallurgy. Regarding the use categories, capital and durable goods production recorded the most important declines, although these categories have recorded the greatest expansion along the year.
- 40. In the year to October, industrial output grew 8.3%, when compared to the same period of 2003. Output expanded in all use categories and in 26 out

- of the 27 industrial activities surveyed. Capital goods and intermediary goods output grew 21.8% and 7.3%, respectively, favored by the increase in exports and in fixed capital investment. The production of durable goods increased 22.6%, and semi- and non-durable goods production grew 3.5% in the same period, reflecting the expansion of credit and the gradual recovery of labor income.
- 41. In October, the CNI recorded a 0.5% increase in real industrial sales and a 0.3% decrease in industrial worked hours, compared to September, in seasonally adjusted terms. Compared to the same month of 2003, real sales and worked hours increased by 6.0% and by 4.5%, respectively. The average level of industrial capacity utilization reached 82.9% in October, with a 0.1 p.p. decline relative to September. In the year to October, capacity utilization expanded by 3.1%, compared with the same period of 2003.
- 42. Leading indicators suggest stability in industrial output in November, seasonally adjusted. Auto manufacturing increased 1.5% and the number of road tolls paid by trucks increased 0.5% in November. On the other hand, both packaging paper shipment and oil shipment decreased by 0.6%.

Labor Market

- 43. Formal employment increased by 0.5% monthon-month in October, seasonally adjusted, and by 6.5% compared to October 2003, according to the Ministry of Labor and Employment. In the year to October, there was a 4.8% expansion in formal employment, with the creation of 1,796 thousand jobs. Job creation was led by manufacturing. Data have also continued to indicate that employment has increased at a higher pace outside large metropolitan areas.
- 44. The unemployment rate, measured by the IBGE in the six main metropolitan areas of the country, fell to 10.5% in October, the lowest level of the series since a new methodology was adopted in 2001. The fall in the unemployment rate reflected the effects of the activity rebound on the labor market. The number of employed workers increased by 0.2% in October and the number of unemployed workers fell 4.1%. The work force totaled 21.7 million people, corresponding to a 0.3% fall in the month.

- 45. Still regarding the employment survey, average real earnings totaled R\$900.20 in October. Average nominal earnings grew by 8.3% year-on-year, and 2.6% in real terms when deflated by the National Consumer Price Index (INPC).
- 46. In the industrial sector, according to seasonally adjusted data from CNI, employed workers and real wages increased by 0.5% and 0.6%, respectively, in October, compared to September. In the first ten months of the year, real wages and employed workers increased by 8.7% and 2.8%, respectively, compared to the same period of 2003.

Credit and Delinquency Rates

- 47. Non-earmarked credit operations increased by 1.7% in November. Corporate credit with domestic funding expanded by 2.5% in the month, mainly as a result of the seasonal growth of credit demand in the period. In twelve months, this segment grew by 28.1%, driven by more robust economic activity. Corporate credit with external funding fell by 4.2% in November, as a result of the BRL appreciation. Credit operations with individuals increased by 3.7% in November and by 28.6% in the year, mainly driven by the expansion in personal credit operations.
- 48. The average interest rate on non-earmarked credit recorded a small increase of 0.1 p.p. in November, reaching 45.7% p.a. This increase was a result of the 0.2 p.p. rise in the average rate for individuals, which stood at 63.4% p.a. The average corporate rate stood at 30.9% p.a., recording a 0.2 p.p. fall in the period.
- 49. The default rate measured by the ACSP fell to 3.8% in November from 4.1% in October, mainly due to the decline of new registers in the month. In the year to November, the average default rate recorded a 10.7% decline compared to the same period of 2003.

External Environment

50. Indicators suggest that global economic growth has continued to build momentum, although at a more moderate pace due to the lower growth of the Japanese and the Euro Area economies in the third quarter. The U.S. and China have continued to lead global growth. High oil prices and concerns regarding the

- sustainability of the U.S. fiscal and current account deficits suggest a moderate global expansion in 2005.
- 51. The third quarter U.S. GDP growth of 3.9%, seasonally adjusted, confirmed the country's growth sustainability, led by household consumption and fixed capital investment. In Japan, a new methodology led to a downward revision of GDP growth rates, with an expansion of just 0.2% in the third quarter. In Europe, the recovery remains slow. The recovery is jeopardized by high energy prices and the Euro appreciation, which affects exports.
- 52. Inflation has remained under control in the main economies, although price indices rose in October, as a result of the ongoing increases in oil prices. Regarding Japan, the price indices signaled the end of a long deflation trend. In China, consumer price inflation stood at 2.8% in the year to November.
- 53. The Bank of England maintained its repo rate unchanged at 4.75% p.a. in December. In the Euro-Area, the European Central Bank kept the interest rate at 2% p.a., despite the fact that inflation exceeded the ECB's target. In the U.S., the Federal Reserve decided to raise the target for the fed funds rate to 2.25% p.a., the fifth consecutive increase this year. It is expected that the Federal Reserve will continue its policy of gradual tightening in 2005.
- 54. Oil prices have fallen since the second week of October, though they still represent a risk of volatility to the markets, particularly the stock market. The dollar has continued to depreciate against other currencies, mainly against the euro and the yen. The issuance of emerging market sovereign and corporate bonds has continued to benefit from favorable global liquidity conditions and by the reduction in spreads over U.S. Treasuries.

Foreign Trade and Balance of Payments

55. In November, the Brazilian trade balance posted a US\$2.1 billion surplus, accumulating a US\$30.2 billion surplus in the year and US\$32.9 billion in twelve months. Exports and imports increased by 36.4% and by 42.6%, respectively, compared to the November 2003 daily averages. Total external trade reached US\$14.2 billion in November, accumulating

US\$144.4 billion in the year to November and US\$155.1 billion in twelve months. In the first two weeks of December (eight working days), the trade surplus reached US\$1.1 billion, with exports and imports growing by 32.6% and 51.3%, respectively, compared to December 2003 daily averages.

- 56. Brazilian exports totaled US\$8.2 billion in November. Manufactured, primary and semimanufactured goods exports totaled US\$4.7 billion, US\$2.1 billion and US\$1.3 billion, respectively. Besides the increase in volumes, important export products have registered price increases. Imports reached the highest level in the year, totaling US\$6.1 billion in the month, with increases in all categories.
- 57. At the end of November, international reserves stood at US\$50.1 billion, while adjusted net reserves stood at US\$22.2 billion (IMF concept).

Money Market and Open Market Operations

58. After the November Copom meeting, futures interest rates for maturities up to six months increased, while rates for longer maturities decreased. On December 15, the yield curve showed a negative slope from the 6-month vertices. The perception of market participants that the monetary tightening cycle would persist influenced the short end of the yield curve. The long end of the yield curve was influenced by falling oil prices, the reduction in the sovereign risk, evidence of decelerating economic activity, and operations in the derivatives market. Between November 17 and December 15, the 1-month and 6-month interest rates increased by 0.35 p.p. and by 0.04 p.p., respectively, while the 1-year, 2-year and the 3-year rates decreased by 0.22 p.p., 0.49 p.p. and 0.60 p.p., respectively. In the same period, the real interest rate measured by the ratio between the oneyear nominal interest rate and the 12-month-ahead inflation expectations reached 10.9%.

- 59. The BCB did not carry out auctions to roll over FX securities and swaps maturing in December. As a consequence, the net redemption of FX-linked securities and swaps in the year totaled US\$27.8 billion, including interest paid to debt holders.
- 60. Between the November and December Copom meetings, the National Treasury carried out four selling auctions of LTNs maturing between October 2005 and July 2006, totaling a placement of R\$15.1 billion. The National Treasury also carried out four NTN-Fs auctions maturing in January 2008, totaling R\$518.6 million, and seven LFTs auctions maturing in 2005, 2006 and 2007, four of which were selling auctions and three of which were exchange auctions. The net sales of LFTs totaled R\$11.3 billion, and the exchange auction totaled R\$5.7 billion.
- 61. In its open market operations, the BCB carried out a weekly operation aimed at reducing the liquidity at the beginning of 2005. This operation consisted of a selling auction of LTNs maturing in April 2005, linked to a buying auction of LTNs maturing in January 2005. The operation totaled R\$6.7 billion. In addition, the BCB maintained the weekly post-fixed repo operations (4-week tenure) and the fixed repo operations (3month), as well as its daily liquidity management operations (two-working-day tenure). The BCB also carried out in the period 10 repos, five of which were overnight borrowings, four were borrowings with a two-working-day tenure and one was an overnight lending. In the period, the excess liquidity drained from the market with operations shorter than 30 days averaged R\$25.0 billion, and with 3-month-tenure operations averaged R\$41.3 billion.
- 62. In November, net securitized domestic public debt grew 1.1%, due to an R\$1.0 billion net placement and accrued interest. On the other hand, the dollar-linked share decreased to 10.3% in November from 11.2% in October, due to the net redemption of FX instruments and to the BRL appreciation.

Minutes of the 104th Meeting of the Monetary Policy Committee (Copom)

Date: January 18th, from 4:30PM to 7:09PM, and January 19th, from 4:20PM to 6:30PM Place: BCB's Headquarters meeting rooms – 8th floor on January 18th and 20th floor on January 19th - Brasília - DF

In attendance:

Members of the Committee

Henrique de Campos Meirelles - Governor Afonso Sant'Anna Bevilaqua Alexandre Schwartsman Antônio Gustavo Matos do Vale Eduardo Henrique de Mello Motta Loyo João Antônio Fleury Teixeira Paulo Sérgio Cavalheiro Rodrigo Telles da Rocha Azevedo Sérgio Darcy da Silva Alves

Department Heads (present on January 18th)

Ivan Luís Gonçalves de Oliveira Lima – Open Market Operations Department José Antônio Marciano – Department of Banking **Operations and Payments System** José Pedro Ramos Fachada Martins da Silva – **Investor Relations Group** Luiz Sampaio Malan – Economic Department Marcelo Kfoury Muinhos – Research Department (also present on January 19th) Renato Jansson Rosek – International Reserves **Operations Department**

Other participants (present on January 18th)

Eugênio Pacceli Ribeiro - Advisor to the Board Flavio Pinheiro de Melo – Advisor to the Board Hélio Mori – Advisor to the Board Jocimar Nastari – Press Secretary

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

- Consumer price inflation accelerated again in December, due to stronger increases in market prices and the continuation of regulated prices readjustments at high levels. Wholesale price inflation declined, mainly due to the deceleration of industrial price increases, the effect of which counterbalanced higher agricultural prices.
- The Broad National Consumer Price Index (IPCA) increased 0.86% in December, compared to 0.69% in November, totaling a 7.60% change in the year. The December IPCA reflected pressures on both market and regulated prices. The main drivers were gasoline, meat, urban bus fares, clothing, chicken, housemaid services, fuel-alcohol, and water and sewage prices, responsible for 0.61 p.p. of the monthly index.
- The General Price Index (IGP-DI) rose 0.52% in December, compared to 0.82% in November, for an accumulated 12.14% increase in 2004. Among the IGP-DI components in December, the Consumer Price Index – Brazil (IPC-Br) increased 0.63%, compared to 0.37% in November. The National Index of Civil Construction (INCC) increased 0.51%, decelerating from the 0.71% registered in November, due to a decline in construction materials inflation. The Wholesale Price Index (IPA-DI) declined to 0.48% from 1.0% in November, for a 14.67% cumulative increase in the year.
- Market prices increased 0.62% in the December IPCA, compared to 0.39% in November, accounting for 0.44 p.p. of the monthly index change. Regulated prices increased 1.43%, with a 0.42 p.p. share in the overall result, of which 0.24 p.p. was due to fuel prices.
- 5. The wholesale price deceleration in December, as measured by the IPA-DI, was mainly caused by industrial prices, which decelerated to 0.38%

compared to 1.30% in November, due to lower rises for chemical, metallurgical, mechanical and electrical products. Agricultural price inflation rose significantly, to 0.75% in December from 0.14% in November, mainly due to an increase in the prices of fruits and legumes. Prices of animal products continued to exert pressures, due to the inter-harvest period, while the prices of cereals and grains maintained a downward trend, impacted by international prices and the exchange rate. In the IPA-DI measured according to the production stage, final and intermediate goods price increases decelerated in December, while the increase in the prices of raw materials was virtually unchanged.

- 6. IPCA core inflation remained at high levels in December. Excluding household food items and regulated prices, the core reached 0.67%, compared to 0.57% in November, for a cumulative 7.95% increase in the year. The core calculated under the smoothed trimmed-means method reached 0.67%, compared to 0.62% in the previous month, and totaled 7.52% in 2004. The same core measure, calculated without the smoothing procedure, increased to 0.66% from 0.57% in November, for a cumulative 6.38% increase in 2004.
- 7. The IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed-means method, reached 0.48% in December, compared to 0.41% in November, for a total increase of 5.87% in 2004.
- 8. In December, the IPCA diffusion index increased to 68.0%, compared to 67.6% in November and 66.4% in October. The persistence of high core inflation and the behavior of the diffusion index indicate the dissemination of price increases across several sectors of the economy.
- 9. The variation of the IPCA in January should be lower than December, but still at a level inconsistent with the 2005 inflation target. Electricity in Rio de Janeiro, meat and clothing prices will exert inflationary pressures.

Assessment of Inflation Trends

10. The inflation shocks and their impacts were reassessed according to newly available information.

The scenario considered in the simulations assumed the following hypotheses:

- a) The projection for the readjustment in both gasoline and bottled gas prices for 2005 remained unchanged at 0%;
- b) Projections for readjustments to both household electricity and fixed telephone prices for 2005 were also unchanged, at 9.5% and 7.7% respectively;
- c) An increase of 6.7% in all regulated prices, which represented a total weight of 29.4% in the December IPCA, is projected for 2005, in line with the previous meeting;
- d) The projection for the readjustment of all regulated prices for 2006, following the model of endogenous determination, which takes into account seasonal components, the exchange rate, market price inflation, and the IGP-DI change, stands at 5.1%;
- e) The projection for the 6-month spread over the Selic rate, following the specification of a Vector Autoregressive model based on the Over-Selic and the swap rates on the eve of the Copom meeting, declines from 77 basis points in the first quarter of 2005 to 51 basis points in the last quarter of 2006.
- 11. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of the GDP for 2005 and 2006 will be achieved. The related assumptions considered in the December Copom meeting were maintained.
- 12. Assuming the maintenance of the Over-Selic rate at 17.75% p.a. and the exchange rate at the level prevailing on the eve of the Copom meeting (R\$/US\$2.70), the IPCA inflation rate was projected above the 5.1% objective for 2005. Using the consensus Over-Selic rate and exchange rate compiled by the BCB's Investor Relations Group (Gerin) on the eve of the Copom meeting, inflation was also projected above the 2005 objective.

Monetary Policy Decision

13. IPCA inflation stood at 0.86% in December, well above market consensus, accelerating for the third

consecutive month. The acceleration occurred across all three components - tradable, non-tradable and regulated prices. The increase in regulated prices, notably fuel, continued to put pressure on inflation. Household food prices reversed the downward trend observed in recent months, ceasing to contribute to lower inflation. Nonetheless, IPCA inflation accelerated in December even excluding household food prices.

- 14. In 2004, IPCA inflation accumulated a 7.60% increase, below the upper limit (8.0%) of the tolerance interval set by the National Monetary Council, and also below the 9.30% inflation registered in 2003. Market prices increased by 6.55% (7.79% in 2003), while the increase in regulated prices averaged 10.19% (13.20% in the prior year). Therefore, market prices contributed 4.66 p.p. while regulated prices contributed the remaining 2.94 p.p. to the annual inflation, corresponding to 61.3% and 38.7% of the rate, respectively. In 2003, market prices and regulated prices were responsible for 59.6% and 40.4% of the IPCA, respectively. Hence, the contribution of market prices to inflation increased in 2004. Additionally, of the 1.70 p.p. reduction in the 2004 IPCA, 0.9 p.p. was due to the drop in market price inflation, and 0.8 p.p. was due to lower regulated price inflation.
- 15. In December, the IGP-DI decelerated to 0.52%. from 0.82% in November. Wholesale prices were the main contributor to the IGP-DI reduction, declining to 0.48%, from 1.00% in November. Deceleration of industrial wholesale prices (0.38% in December compared to 1.30% in November) offset higher inflation in agricultural prices. In the year, the cumulative increase in industrial wholesale prices stood at 19.50%. In the IPA-DI by the production stage, intermediate goods prices increased 25.84%. Despite the recent deceleration of the Industrial component, cumulative wholesale price inflation in 2004 continues to represent a potential pressure on consumer prices in the coming months. The intensity of the pass-through will depend on prospective demand conditions and market inflation expectations, as assessed in previous Copom Minutes.
- 16. IPCA core inflation measures continued to accelerate in December, according to the three criteria – by excluding regulated prices and household food, by smoothed, and by non-smoothed trimmed-means.

Similarly to that observed for the headline index, this acceleration has occurred for the third consecutive month. The cumulative change in core inflation excluding regulated prices and household food was above the headline IPCA in 2004, for the first time since 1996. The cores, in addition to presenting an underlying inflation trend incompatible with the medium-run inflation target, accelerated in recent months.

- 17. Industrial output declined 0.4% in November in seasonally adjusted terms, in line with the projection in previous Copom Minutes. However, considering revised monthly industrial production data released by the Brazilian Institute of Geography and Statistics (IBGE) for October, which demonstrate stability instead of the original 0.4% drop, the level of the series increased as compared to previous estimates. The seasonally adjusted quarterly moving average series shows output declining in November for the first time since February. The decline was led by the drop in intermediate goods, which represent the heaviest weight in the industrial production index, while groups directly linked to final demand have grown. In the year to November, industrial output grew 8.3%, compared to the same period of the previous year. Durable and capital goods have continued to be the highlights, with growth rates above 20%. For semiand non-durable consumer goods, the seasonally adjusted quarterly moving average series have posted the highest output level since August 2003, when these sectors resumed growth. This behavior confirms the change in the composition of economic activity, with growth being increasingly sustained by more incomeand employment-sensitive sectors.
- 18. Leading and coincident indicators of industrial activity signal an increase in output in December. This expectation, in addition to the upward revision of the October figure, is consistent with the continuity of the expansion of industrial output observed since the second half of 2003, although not necessarily at the same pace as observed in the initial phases, given the relative accommodation registered in recent months. As noted in prior Copom Minutes, it is normal that, after the initial strong impulse, the growth process converges to rates consistent with the pace of output capacity expansion. Furthermore, it is reasonable to expect a temporary accommodation after a monthly sequence of high growth rates.

- 19. The labor market continues to show signs of improvement. The unemployment rate remained stable in November (10.6%), due to an increase in the labor force relative to the total employed population. The November unemployment rate was among the best results observed under the new IBGE methodology introduced in 2001, and well below the 12.2% rate of November 2003. According to the Ministry of Labor and Employment, formal employment increased 5.1% in 2004, with the creation of 1,523,276 jobs. In December, however, net hires were negative. According to the IBGE, the number of workers and payroll increased 3% and 2% in the year to November, respectively, while real average wages declined 1% in the same period. Data from the National Industry Confederation (CNI) indicate continued growth of industrial employment and real wages in November.
- 20. According to the IBGE, retail sales increased 0.4% in November, seasonally adjusted by the BCB. Sales and nominal revenue increased 8.33% and 12.08%, respectively, in twelve months. Sales of furniture and appliances, and vehicles and motorcycles continue to present the strongest growth (26.19% and 17.45%, respectively). Supermarket sales, although increasing at lower rates, continue to support growth at the margin. On a quarterly moving average basis, aggregate sales continued to increase, although at lower rates and tending toward stability. The Consumer Confidence Index measured by the Federação do Comércio do Estado de São Paulo (Fecomercio-SP) remained at high levels in January. The positive results for employment and wages suggest that sales dynamism will be sustained.
- 21. As repeatedly emphasized in prior Copom Minutes, and due to the significant activity expansion observed since end-2003, the performance of aggregate supply in the coming quarters remains an important concern for prospective inflation dynamics. The CNI's installed capacity index decreased modestly in November in seasonally adjusted terms for the third consecutive month. The domestic absorption of capital goods increased 7.3% from January to November compared to the same period of last year, despite the decrease in October caused by the required registration of an oil platform, produced and managed domestically, as an exported product. Capital goods output maintained robust growth rates in the year. In

- the third quarter of the year, fixed capital investment as a share of GDP remained stable, when compared to the cumulative data up to the second quarter of 2004. Recent performance of the activity level, capacity utilization and fixed capital investment do not demonstrate a significant change from the scenario discussed in prior Copom meetings, of a closure of the output gap despite the recovery in investment from the low levels of recent years. Therefore, monetary policy must remain particularly vigilant with regard to the pace of additional demand expansion.
- 22. The external trade surplus increased 36.0% in 2004. Exports increased 32.0%, while imports expanded 29.9%, as a consequence of stronger domestic demand. Among exports, manufactured sales continue to present the highest volume growth rate (22.6% from January to November). Raw materials and durable consumer goods imports registered notable volume increases, growing 21.3% and 27.2%, respectively, in the same period. The favorable trade surplus supported the 2004 current account surplus of US\$ 11.7 billion, equivalent to 1.9% of GDP.
- 23. The international capital market environment, despite still favorable, has deteriorated slightly compared to the December Copom meeting. The Brazilian country risk premium, which had declined at the end of last year, increased modestly in the first half of January, following the release of the December FOMC Meeting Minutes. International liquidity and markets stability remain tied to macroeconomic conditions in the industrialized countries, especially the United States, and to the possible response of the Fed's monetary policy to these economic developments. Thus, new information suggesting an economic scenario that would alter the Fed's current policy of gradual interest rate increases will result in greater asset price volatility. This instability could be exacerbated if the major economies' exchange rates undergo sharp adjustments due to the imbalance in these countries' external accounts.
- 24. International oil prices reverted the downward trend observed between October and the middle of December. Prices have been volatile due to news regarding possible supply restrictions among exporting countries, the available of oil reserves in the main consuming countries, and the severity of the northern hemisphere winter. This recent evolution,

besides underscoring the uncertainty regarding oil price trends, pushed again international gasoline prices above domestic prices, leaving small room for a reduction of domestic fuel prices throughout 2005. However, the Copom continues to assume there will be no change in domestic fuel prices in 2005.

- 25. Since the December Copom meeting, the median of market expectations collected by Gerin for the 2005 IPCA inflation declined to 5.70% as of January 14, from 5.78%. Expectations, however, increased marginally if compared to the level in the week ending on January 7 (5.67%). The decline in inflation expectations remains modest, considering the favorable events that could contribute to dampen inflationary pressures in 2005, such as the signs of deceleration in economic growth, exchange rate appreciation, the decline in international commodity prices, and the signaling of a more restrictive monetary policy.
- 26. The Copom's inflation forecast for 2005 presented a minimal decline compared to those released in the December Inflation Report. In the benchmark scenario - which considers the maintenance of the Over-Selic rate at 17.75% p.a. and the exchange rate at R\$/US\$ 2.70 during the forecast period – exchange rate appreciation, an increase in the yield curve, and the modest decline in inflation expectations compensated the inertial effects of the up tick in December inflation. Nevertheless, the inflation forecast for 2005 remains above the 5.1% objective. The forecasts based on the market scenario – which incorporates the consensus exchange rate and Over-Selic rate trajectories on the eve of the Copom meeting – exceed the benchmark scenario forecasts, due to the expected exchange rate depreciation and decline in the interest rate during the forecast period. For 2006, the benchmark scenario forecast is below the target established by the National Monetary Council (CMN) for the year, while the market scenario forecast is above the target.
- 27. Since the beginning of the monetary policy adjustment process, in September, the deviation between the Copom's inflation forecasts and the inflation target trajectory has narrowed. Some factors, however, represent risks to the process of inflation convergence to the target trajectory during the coming months. First, it is possible that self-propagating forces stimulate aggregate demand more than expected in

- the forecast exercises. The uncertainty surrounding the intensity of these forces in the Brazilian economy is similar to those related to the immediate monetary policy transmission, especially because the country did not experience sustained growth in the last years. Second, the stickiness of inflation, given current aggregate demand conditions, could also prove more intense than that estimated with data available for the Brazilian economy. The recent acceleration of core inflation and the upward revision of industrial output could evidence risks to the monetary management, or, alternatively, could only reflect the usual transmission lags between monetary policy, activity and inflation.
- 28. Considering the likelihood that recent consumer price dynamics could actually represent a deterioration of the risks to meet the inflation target trajectory, the Copom examined the possibility of accelerating the pace of interest rate adjustment. However, there was consensus among the Committee members that available data would not justify such acceleration. The members of the Copom confirm their conviction that additional phases of the current process of monetary adjustment, followed by a sufficiently long period of stable interest rates, will be sufficient to align the future path of inflation with the monetary policy objective. Clearly, if the inflationary process proves resistant to the monetary stance adopted since September, or if other risk factors deteriorate, the monetary authority will be prepared to adjust the pace and magnitude of the interest rate adjustment process to the circumstances.
- 29. Considering the reasons stated above, the Copom unanimously decided to increase the Selic rate target to 18.25%, with no bias.
- 30. At the close of the meeting, it was announced that the Committee would meet again on February 15, 2005, for technical presentations, and on the following day, to discuss the monetary policy decision, as established in Communiqué 12,631 of October 29, 2004.

Summary of Data Analyzed by the Copom

Economic Activity

31. According to the IBGE retail survey, which covers all states of the country, retail sales (seasonally

adjusted by the BCB) expanded moderately in November. All components of the index increased in the month, with particularly notable and continued growth in furniture and electrical appliance sales. Auto, motorcycle and parts sales, which are not included in the general index, declined again in November. In the year to November, retail activity expanded 9%, compared to the same period of 2003. Meanwhile, retail activity expanded 6.4% in the month of November, on a year-over-year basis, with growth recorded in 26 out of the 27 states in the country.

- 32. In December, São Paulo Trade Association (ACSP) data registered a 0.9% seasonally adjusted month-on-month increase in both the number of credit sales consultations and of the Usecheque system. In the year to December, the same indicators rose by 6% and by 2.2%, respectively.
- 33. The Fecomercio-SP consumer sentiment survey indicated that the Consumer Confidence Index increased by 3.3% in January to a record level of 145.7 points (range 0 to 200), due to increases of 3.2% in the Index of Current Economic Conditions and 3.3% in the Index of Consumer Expectations.
- 34. Regarding fixed capital investment, the indicators showed a recovery in November compared to the previous month. Domestic output and capital goods imports increased 0.2% and 9.9%, respectively, in seasonally adjusted terms. However, the 24.8% fall in capital goods exports was the main reason driving the 20.2% increase in the domestic absorption of capital goods in the month. It is important to highlight that, in October, capital goods exports were driven by the sale of a domesticallyproduced oil exploration platform-ship, which remained leased in Brazil. The growth of the domestic absorption of capital goods, cumulative to November, was 7.3%, despite an increase of 52.5% in capital goods exports. This growth was a result of a 20.4% increase in domestic output and 4% growth in imports. Production of construction inputs fell 2.7% month-on-month in November, seasonally adjusted, but registered a cumulative increase of 5.7% in the year to November.
- 35. The IBGE registered a 0.4% decline in industrial output in November, seasonally adjusted, relative to

- the prior month. On a quarterly moving average basis, industrial output stood at a level slightly below that of October (when an historic high was recorded), signaling an accommodation trend after the notable expansion recorded in recent months.
- 36. The breakdown of industrial output data showed the decline in November was a result of the performance of 16 out of the 23 components, seasonally adjusted. The most notable declines were in the sectors of pharmaceuticals, metallurgy, electrical equipment and materials and metal products. The sectors that demonstrated notable growth were electronic material, communications equipment and food. Regarding the use categories, intermediate goods - with the heaviest weight in industrial production - were the sole category to record a decline (1.1%), for the third consecutive month. The production of capital and durable goods increased 0.2% in November, accumulating the highest expansion rate in the year. Semi- and non-durable goods production grew 0.5% in the month.
- 37. In the year to November, industrial output grew 8.3%, when compared to the same period of 2003. Output expanded in all use categories and in 26 out of the 27 industrial activities surveyed. Capital goods and intermediate goods output grew 20.4% and 7.4%, respectively, supported by the increase in exports and in fixed capital investment. The production of durable goods increased 22.3%, and semi- and non-durable goods production grew 3.8% in the same period, reflecting the expansion of credit and the gradual recovery of labor income.
- 38. In November, the CNI recorded a 0.2% decline in real industrial sales and a 0.2% increase in industrial hours worked, compared to October, in seasonally adjusted terms. In the year to November real sales and hours worked increased by 14.9% and 5.7%, respectively, compared to the same period of 2003. The average level of industrial capacity utilization, in seasonally adjusted terms, reached 82.9% in November, with a 0.1 p.p. decline relative to October. In the year to November, capacity utilization expanded by 3.2%, compared to the same period of 2003.
- 39. Leading indicators suggest expansion in industrial output in December, compared to November, in

seasonally adjusted terms. Increases in steel output and auto manufacturing led the expansion. Packaging paper shipments, the number of road tolls paid by trucks, and electrical energy also expanded.

Labor Market

- 40. In December, formal employment increased by 0.1% seasonally adjusted, month-on-month, according to the Ministry of Labor and Employment. In the year, there was a 5.1% expansion in employment, with the creation of 1,523 thousand jobs, led by manufacturing.
- 41. The unemployment rate, measured by the IBGE in the six main metropolitan areas of the country, reached 10.6% in November, compared to 10.5% in the previous month. The increase in the unemployment rate, despite the 0.4% monthly expansion in the employed workers rate, was due to growth of the labor force, possibly led by the gradual improvement in general labor market conditions.
- 42. In the industrial sector, according to seasonally adjusted data from CNI, employed workers and real wages increased by 0.5% and 1.2%, respectively, in November, compared to October. In the year to November, real wages and employed workers increased by 8.9% and 3.2%, respectively, compared to the same period of 2003.

Credit and Delinquency Rates

- 43. Non-earmarked credit operations declined 0.3% in December, as a result of the 7.3% decline in exchange rate-linked credit, driven by BRL appreciation. Corporate credit with domestic funding expanded by 1.4% in the month, mainly as a result of the seasonal growth of credit demand in the period. In the year, this segment grew by 27.1%, driven by more robust economic activity. Credit operations with individuals increased by 1.1% in December and by 28.9% in the year, driven mainly by the expansion in personal credit, and particularly payroll-deducted loans.
- 44. The average interest rate on non-earmarked credit declined to 45.0% p.a. in December from 45.7% p.a. in November. The average corporate rate stood at 31.0% p.a., recording a 0.1 p.p. rise in the

- period. Regarding credit to individuals, the average rate stood at 61.5% p.a., recording a 1.9 p.p. decline.
- 45. The default rate on non-earmarked credit fell by 0.7 p.p., to 6.7% in December compared to November. The use of the 13th wage to pay debts was the main contributor to the 1.2 p.p. drop in the individuals default rate, which stood at 11.7% in December. In corporate operations, the default rate recorded a 0.1 p.p. decline and was 3.1% at the end of 2004.
- 46. The default rate measured by the ACSP fell to 3.4% in December from 3.8% in November. The number of cancelled files exceeded new files in the month. This occurred just once more in the historical series, in December 1967. The meaningful growth of cancelled files was a result of a campaign to recover credits in arrears for more than two years. In the year to December, the average default rate stood at 4.2%, below the 5.2% registered in 2003.

External Environment

- 47. The U.S. current account deficit and oil price volatility remain the main focus of global financial markets. Despite the dollar depreciation, the U.S. trade deficit has increased, reaching a new record of US\$60.3 billion in November. Given the inflexibility of exchange rate in Asian countries, especially China, the euro continues to absorb the majority of pressure from the U.S. currency depreciation.
- 48. Regarding oil, although the short-term outlook anticipates strong price volatility, the marginal recovery of the OECD and particularly U.S. stocks and the slower growth of demand signal the stability of prices this year. Agricultural and metal commodity prices recorded a decline, with the exception of coffee, sugar and steel.
- 49. In the U.S., the fall of the Producer Price Index in December somewhat cooled expectations for a faster pace of monetary tightening. Thus, the Fed should maintain the gradual pace of monetary tightening throughout the year. Considering the expected maintenance of interest rates in the Euro Area, the yield differential of U.S. dollar-denominated assets should increase during the year, facilitating the financing of the U.S. current account deficit.

Foreign Trade and Balance of Payments

- 50. In December, the Brazilian trade balance posted a US\$3.5 billion surplus, and a historical cumulative balance of US\$33.7 billion surplus for the year (US\$24.8 billion in 2003), of which US\$96.5 billion were exports and US\$ 62.8 billion were imports. In December, exports and imports increased by 30.3% and 36.0%, respectively, compared to December 2003 daily averages. Total external trade reached US\$14.9 billion in December, or a cumulative US\$159.3 billion for the year, compared to US\$121.4 billion in 2003, signaling a new plateau for external trade. In the first two weeks of January (ten working days), the trade surplus reached US\$916 million, with exports and imports growing by 29.5% and 32.6%, respectively, compared to January 2004 daily averages.
- 51. Brazilian exports totaled US\$9.2 billion in December, posting the highest level of the series for this month. Manufactured, primary and semimanufactured goods exports totaled US\$5.7 billion, US\$2.1 billion and US\$1.2 billion, respectively. In addition to the increase in volumes, key export products have registered price increases and shipments have continued to expand, both to traditional markets and new destinations. Imports reached a record level in December, totaling US\$5.7 billion in the month, with increases in all categories compared to the same month of 2003.
- 52. International reserves increased US\$3.6 billion in 2004, to a level of US\$52.9 billion, while adjusted net reserves stood at US\$25.3 billion (IMF concept), recording an US\$ 8.0 billion increase compared to the same period of 2003.

Money Market and Open Market Operations

53. After the December Copom meeting, futures interest rates increased, particularly for maturities from six months up to 1 year. The positive slope of the yield curve widened up to the nine month vertices. This behavior was influenced by the following factors: the perception of market participants from the December Copom Minutes that the monetary tightening cycle would continue; the release of inflation indices and respective cores above market

expectations; and the persistence of 2005 inflation expectations at high levels. The yield curve was also influenced by several external factors, especially the revision of expectations regarding the pace of the Fed's tightening, after the release of the December FOMC Meeting Minute. Between December 15 and January 19, the 1-month and 6-month interest rates increased by 0.65 p.p. and 0.87 p.p., respectively, while the 1-year, 2-year and the 3-year rates increased by 0.86 p.p., 0.56 p.p. and 0.26 p.p., respectively. In the same period, the real interest rate measured by the ratio between the one-year nominal interest rate and 12-month-ahead inflation expectation reached 12.0%.

- 54. The BCB did not carry out auctions to roll over FX securities and swaps maturing in January. As a result, the net redemption of FX-linked securities and swaps totaled US\$4.9 billion, including interest paid.
- 55. Between the December and January Copom meetings, the National Treasury carried out selling auctions of LTNs maturing in October 2005, January 2006 and July 2006, for a total placement of R\$14.4 billion. The National Treasury also carried out four NTN-Fs auctions maturing in January 2008, totaling R\$783 million, and seven LFTs auctions maturing in 2005, 2006 and 2007, four of which were selling auctions and three of which were exchange auctions. The selling auctions of LFTs totaled R\$20.7 billion, and the exchange auctions totaled R\$18.4 billion.
- 56. In its open market operations, on December 17 the BCB carried out an operation aimed at reducing liquidity in the first quarter of 2005. This operation consisted of a selling auction of LTNs maturing in April 2005, linked to a buying auction of LTNs maturing in January 2005. Similarly, on January 7 and January 14, the BCB carried out a selling auction of LTNs maturing in July 2005, linked to a buying auction of LTNs maturing in April 2005. The operations totaled R\$5.3 billion. In addition, the BCB maintained the weekly Selic-indexed repo operations (1-month tenure) and the fixed-rate repo operations (3-month), as well as its daily liquidity management operations (two-working-day tenure). The BCB also carried out 16 very short-term repos, of which, nine were overnight borrowings, three were borrowings with a

two- to five-working-day tenure, and four were overnight lending. In the period, the excess liquidity drained from the market with operations shorter than 30 days averaged R\$19.5 billion, and with 3-month-tenure operations averaged R\$41.6 billion.

57. In December, net securitized domestic public debt grew 3.4%, due to a R\$15.8 billion net placement and accrued interest. The dollar-linked share in net securitized domestic debt decreased to 9.9% in December from 10.3% in November.

Minutes of the 105th Meeting of the Monetary Policy Committee (Copom)

Date: February 15th, from 4:44PM to 6:52PM, and February 16th, from 4:00PM to 6:30PM **Place:** BCB's Headquarters meeting rooms – 8th floor on February 15th and 20th floor on February 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 Paulo Sérgio Cavalheiro Rodrigo Telles da Rocha Azevedo Sérgio Darcy da Silva Alves

Department Heads (present on February 15th)

Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserves
Operations Department
Ivan Luís Gonçalves de Oliveira Lima – Open
Market 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 February 16th)

Other participants (present on February 15th)

Alexandre Pundek Rocha – Advisor to the Board Eugênio Pacceli Ribeiro – Advisor to the Board Flavio Pinheiro de Melo – Advisor to the Board Katherine Hennings – Advisor to the Board João Batista do Nascimento Magalhães – Special Advisor to the Governor Jocimar Nastari – Press Secretary Hélio Mori – Advisor to the Board

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

Recent Evolution of Inflation

- 1. Consumer price inflation decelerated in January, but remained at a relatively high level, given the target set by the National Monetary Council. Reduced pressures from regulated prices were an important driver of the deceleration, while market prices remained virtually unchanged versus the previous month except those inflation indices that capture seasonal adjustments in education prices in January. Regarding wholesale prices, the deceleration in industrial price increases was accompanied by a decline in agricultural prices.
- 2. The Broad National Consumer Price Index (IPCA) increased 0.58% in January, compared to 0.86% in December, bringing the twelve-month cumulative change to 7.41% in January, versus 7.60% in the previous month. The deceleration in regulated prices was notable in the period a 0.51% increase (contributing 0.15 p.p. in the index) compared to 1.43% in December. The result in January was mainly due to the conclusion of fuel price readjustments, which had been important at the end of 2004.
- 3. Market prices in the IPCA increased 0.61% in January, compared to 0.62% in the previous month, thus contributing 0.43 p.p. to the monthly increase of the

index. In this segment, perishable food prices increased 3.73% in the month, after four consecutive declines. Due to this increase, overall food prices increased 0.78% in January, despite the deceleration of animal products prices. Market prices excluding food prices increased 0.53% in January, compared to 0.61% in December, reflecting the behavior of clothing prices, which increased 0.23% compared to 1.59% in December.

- 4. The General Price Index (IGP-DI) rose 0.33% in January, compared to 0.52% in December, accumulating 11.61% in twelve months. Among the IGP-DI components in January, the Consumer Price Index – Brazil (IPC-Br) increased 0.85%, compared to 0.63% in December, mainly due to food and education prices. The National Index of Civil Construction (INCC) increased 0.75%, accelerating from the 0.51% registered in December, due to increases in the prices of construction inputs and labor costs. The Wholesale Price Index (IPA-DI) declined to 0.08% from 0.48% in December, for a 13.9% cumulative increase in twelve months.
- 5. The wholesale price deceleration in January, as measured by the IPA-DI, was mainly caused by agricultural prices, which declined 0.63% compared to a 0.75% increase in December. In this group, despite price increases for vegetables, fruits, beans, corn and coffee, the declines in wheat and animal products prices prevailed. Besides the decline in agricultural prices, the favorable evolution of the IPA-DI in January was also due to continued cooling in industrial prices, which increased 0.33% in January compared to 0.38% in the previous month, mainly due to the deceleration in the prices of plastic materials, processed meat and fish and fuel. In the IPA-DI measured according to the production stage, final and intermediate goods price increases slowed in January, while prices of raw materials declined.
- 6. IPCA core inflation decelerated slightly in January, but remained at high levels. Excluding household food items and regulated prices, the core reached 0.56% in January, compared to 0.67% in December, for a cumulative increase of 7.85% in twelve months. The core calculated under the smoothed trimmed-means method reached 0.66%, compared to 0.67% in the previous month, and totaled 7.45% in twelve months. The same core measure,

- calculated without the smoothing procedure, decreased to 0.59% from 0.66% in December, for a cumulative 6.34% increase in twelve months.
- 7. The IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed-means method, reached 0.61% in January, compared to 0.48% in December, for an accumulated twelve-month increase of 5.83%.
- 8. In December, the IPCA diffusion index increased to 73.6%, compared to 68% in December and November, despite lower inflation in the period. The persistence of high core inflation and the behavior of the diffusion index indicate the dissemination of price increases across the economy.
- 9. The IPCA tends to come under pressure in February, due to the seasonal impact of education costs and the projected readjustments for regulated prices. Perishable food prices should continue on the upward trend begun in January, due to unfavorable weather conditions during the harvest. In wholesale prices, besides the influence of perishable food prices, prices of iron, steel and byproducts should continue to exert pressure. On the other hand, the declines in the prices of animal products tend to continue. Moreover, the exchange rate appreciation should favorably influence domestic prices, mainly commodities such as soy, corn and wheat.

Assessment of Inflation Trends

- 10. The inflation shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumed the following hypotheses:
- a) The projection for the readjustment of both gasoline and bottled gas prices for 2005 remained unchanged at 0%;
- b) Projections for readjustments of fixed telephone rates for 2005 increased to 8.7% from 7.7%, while projections for the readjustment of household electricity remained unchanged at 9.5% for 2005;
- c) An increase of 6.7% in all regulated prices, which represented a total weight of 29.6% in the

January IPCA, is projected for 2005, as in the previous meeting;

- d) The projection for the readjustment of all regulated prices for 2006, following the model of endogenous determination, which takes into account seasonal components, the exchange rate, market price inflation, and the IGP-DI change, stands at 5.1%;
- 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, declines from 70 basis points in the first quarter of 2005 to 49 basis points in the last quarter of 2006.
- 11. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of GDP for 2005 and 2006 will be achieved. The related assumptions considered in the January Copom meeting were maintained.
- 12. Assuming the maintenance of the Selic rate at 18.25% p.a. and the exchange rate at the level prevailing on the eve of the Copom meeting (R\$/US\$2.60), the IPCA inflation rate was projected above the 5.1% objective for 2005, but below the central target for 2006. Using the consensus Selic rate and exchange rate compiled by the BCB's Investor Relations Group (Gerin) on the eve of the Copom meeting, inflation was also projected above the 2005 objective and the 4.5% target for 2006.

Monetary Policy Decision

13. The IPCA rose 0.58% in January, breaking the acceleration trend observed since last October. The deceleration in IPCA headline inflation was mainly due to the deceleration in clothing and transportation price inflation, with the latter influenced by the absence of fuel price increases (a key driver of transportation price rises during the fourth quarter of 2004). The category of food, beverage, and housing continued to post high monthly inflation rates. Relative to December, regulated price inflation decelerated, while market prices continued to increase at a pace similar to previous months. The IPCA deceleration in January was also due to a break in the trend of high monthly increases in tradable goods prices, in

contrast to non-tradable goods, which continued to increase for the fourth consecutive month. Despite the deceleration in the monthly IPCA inflation, the dissemination of price increases in recent months across the consumer basket continues to expand.

- 14. IGP-DI inflation decelerated again in January, to 0.33% from 0.52% in December. The main contributor to the deceleration was again the IPA-DI, which rose 0.08%, versus 0.48% in December. According to production stage criteria, the IPA result for January was particularly influenced by the deceleration in the prices of gross raw materials, agricultural goods, final goods, food and fuel. The low changes in the IPA in recent months are, in part, due to the recent exchange rate appreciation and may affect positively the future evolution of consumer prices. Naturally, the intensity of this pass-through will depend on prospective demand conditions and price setters' expectations regarding the future inflation path, as highlighted in previous Copom Minutes.
- 15. In January, core IPCA inflation calculated by excluding household food items and regulated prices broke the acceleration trend observed in recent months. Twelve-month accumulated inflation under this measure, however, remains above IPCA headline inflation. Core IPCA inflation calculated under the non-smoothed trimmed means method also slowed, while core inflation calculated under the smoothed method remained virtually unchanged. Despite the marginal deceleration, the annualized rates of core inflation under all three criteria remain high and incompatible with the inflation target path.
- 16. Industrial output increased 0.6% in December, in month-on-month seasonally adjusted terms. The increase was over a higher base, following IBGE's upward revision of the series. The revision modified the prevailing view regarding recent industrial performance, since, contrary to what was suggested by October and November preliminary data, the fourth quarter result increased compared to the third quarter. The highlight of the December result was the 3.4% seasonally adjusted increase in semi- and non-durable consumer goods production. This performance confirms the recent shift in the composition of economic activity, as growth has increasingly been sustained by the more income- and employment-sensitive sectors. In December, on a quarterly moving average basis,

industrial output continued the growth trend observed since February, although at a lower pace in recent months. In the year, industrial output increased 8.3%, the highest rate since 1986. Capital goods and consumer durables presented the highest growth rates, of 19.7% and 21.8%, respectively. Non-durable and semi-durable goods production increased at a slower pace (4.0%), suggesting that there is room for a continued improvement in the performance of these sectors.

17. The result for December and the subsequent series revisions show that industrial output increased more than expected in recent months. For January, leading and coincident indicators signal an accommodation in industrial activity. Real industrial sales measured by the National Industry Confederation (CNI) increased less than IBGE manufacturing industry output in recent months, suggesting a shift in the pace of inventory accumulation in the sector. However, inventory indicators show that they remain at desirable levels, compatible with economic growth. One should expect temporary accommodation in the pace of industrial output growth, but still consistent with a scenario in which there is a continuation of the expansion begun in the second half of 2003. As noted in previous Copom Minutes, it is normal that, after the initial strong impulse at the outset of the economic recovery, the growth process tends to converge to rates more compatible with the pace of output capacity expansion.

18. According to IBGE data, the unemployment rate declined to 9.6% in December from 10.6% in the previous month. This seasonal pattern is typically observed at the end of the year, and tends to reverse in the first quarter. The unemployment rate observed in December, however, is lower than the level observed in December 2003 (10.9%) and is the lowest level observed under the new IBGE methodology introduced in 2001. The number of employed workers has continually increased during the year, accumulating growth of 3% in 2004. Payrolls increased 2.3% in the year, while the real average earnings declined 0.8%. Formal employment measured by the Ministry of Labor and Employment increased with the creation of 115,972 jobs in January, or 1.539 million on a twelve-month accumulated basis. Data from the CNI indicate continued growth of manufacturing employment since December 2003. The CNI also showed that real industrial payrolls have

continued to grow in December, sustaining the trend begun in March 2003.

19. Preliminary data for retail sales suggest a strong expansion in December. According to data from the Federação do Comércio do Estado de São Paulo (Fecomercio-SP), real sales grew 5.0% in December year-on-year. Data from Fecomercio-RJ and Fecormercio-MG, seasonally adjusted by the BCB, indicate month-on-month increases of 6.9% and 1.1% in real sales in December for the metropolitan regions of Rio de Janeiro and Belo Horizonte, respectively. The Consumer Confidence Index (ICC) measured by the Fecomercio-SP remains at high levels in February. This index, associated with the increase in employment and wages, suggests that retail sales momentum will be sustained, particularly sales of semi- and non-durable goods.

20. As repeatedly emphasized in prior Copom Minutes, and due to the significant activity expansion observed since end-2003, the performance of aggregate supply in the coming quarters remains an important concern for prospective inflation dynamics. Average installed capacity utilization, measured quarterly by the FGV and seasonally adjusted by the BCB, remains at high levels, despite the modest reduction in January, to 84.5%, versus 85.2% in October 2004. The level of capacity utilization for capital goods production increased again in January, after declining in October, while the level of capacity utilization for intermediate goods production remained practically unchanged and at high levels. In terms of composition, a decline in capacity utilization is evident among credit-sensitive sectors, while income-sensitive sectors, such as clothes and footwear, remain at high or increasing levels. CNI's installed capacity index (seasonally adjusted by the BCB) increased 0.2% p.p. in December to 83.0%, remaining at the elevated levels observed since June, in a context of ongoing industrial production expansion. In regard to fixed-capital investment, domestic absorption of capital goods increased 6.7% in 2004, with a notable 19.7% growth in capital goods production in the period. The positive trend of the business confidence index for the manufacturing sector, as well as the continuation of Brazilian sovereign risk at reduced levels, suggests a favorable environment for the continuity of fixedcapital investment growth.

- 21. Brazil continued to register large surpluses in the external trade accounts in the beginning of the year. Exports grew 32.5% in January on a twelve-month accumulated basis. As a result of strong domestic demand, imports grew 30.6%. The trade balance totaled US\$34.3 billion, a 36% twelve-month accumulated expansion relative to the same period through January 2004. In volume terms, comparing December figures to the same month of 2003, manufactured goods exports have continued to post record growth rates, while fuels and lubricants and durable consumer goods were the main drivers of imports. The favorable trade surplus supported the US\$11.8 billion current account surplus, equivalent to 1.9% of GDP, in the cumulative twelve months through January.
- 22. The international capital market environment has remained favorable. After the release of the December Federal Open Market Committee (FOMC) Minutes, markets registered some turbulence, leading to an increase in the Brazilian country risk. However, with market stabilization, the Brazilian country risk premium has gradually declined, recently reaching 400 basis points. As mentioned in the last Copom Minutes, abundant international liquidity and market stability remain tied to macroeconomic conditions in the industrialized countries, especially the United States, and to the Federal Reserve's potential monetary policy response to economic developments. New information suggesting an economic scenario that would alter the Fed's current stance could result in greater asset price volatility. This instability could be exacerbated if the major economies' exchange rates undergo sharp adjustments due to the imbalance in these countries' external accounts.
- 23. International oil prices have moved to higher levels since the December Copom meeting. Price volatility has mirrored news regarding possible supply restrictions among exporting countries, demand conditions and available oil reserves in the main consumer countries. In the context of a highly volatile oil price scenario, international oil prices stand below domestic oil prices. However, given the oil price volatility observed in recent months, these developments do not mean that there will be sufficient room to reduce domestic oil prices during the year. The committee continues to assume there will be no change in domestic fuel prices in 2005.

- 24. Since the December Copom meeting, the median of market expectations for the 2005 IPCA inflation increased slightly to 5.72% from 5.70%. As mentioned in prior Copom Minutes, inflation expectations for 2005 remain high, despite favorable events that could dampen inflationary pressures, such as the signs of deceleration in economic growth, exchange rate appreciation, the decline in important commodity prices, and the signaling of a more restrictive monetary stance in the last months.
- 25. Under the benchmark scenario which considers the maintenance of the Selic rate at 18.25% p.a. and the exchange rate at R\$/US\$ 2.60 during the forecast period – inflation forecasts remained virtually stable, presenting a marginal reduction compared to the January meeting inflation forecast, but still above the 5.1% inflation objective for the year. The exchange rate appreciation and the increase in the yield curve balanced the effects of higher-than-expected January inflation and anticipated increases in regulated prices during the year. The forecasts based on the market scenario – which incorporates the consensus exchange rate and Selic rate trajectories on the eve of the Copom meeting – exceeded the benchmark scenario forecasts, but were lower than last month's forecasts, owing to the lower-than-expected exchange rate depreciation and the expectation of a higher interest curve. For 2006, the forecasts also showed improvement at the margin, with the benchmark scenario forecast below the target established by the National Monetary Council for the year, and the market scenario forecast above the target.
- 26. Since the beginning of the monetary policy adjustment process, inflation expectations and forecasts have improved, although the current headline and core inflation are still incompatible with the medium-term targets. The more restrictive monetary policy stance adopted since September 2004 will increase the likelihood that the deceleration of wholesale price inflation positively influences consumer price inflation. Moreover, there is the possibility that the positive seasonal effects of food prices will be registered earlier this year than in prior years. Combined, these factors may contribute to attainment of inflation rates in the first half of the year that bolster confidence in the convergence of 2005 inflation to the target path.

- 27. This increase in the likelihood of inflation convergence to the target path is tied to the response of economic activity and inflation to the monetary policy stance. In the January Minutes, the Copom mentioned specific factors, among the uncertainties regarding macroeconomic projections, which could harm the convergence process. Of particular concern was the intensity of self-propagating forces in the economic cycle, tied mainly to income and employment dynamics, and the possibility of greater inflation persistence, given aggregate demand conditions. In the evaluation of the committee members, data released thus far, including signs of a break in the inflation acceleration registered in the fourth quarter, reduce the likelihood of realization of the risks mentioned in January.
- 28. These risk factors should not be interpreted as evidence of the loss of monetary policy effectiveness as a result of recent credit and fiscal developments. Independent of the specific importance of these developments to current performance, it is important to highlight that every expansionary impulse requires an adequate monetary policy response, but does not necessarily represent the loss of effectiveness of conventional monetary instruments. Credit growth as a result of the introduction of new personal loan contracts is an important structural advance that, in addition to making a permanent contribution toward improving the efficiency of financial intermediation, should also increase monetary policy effectiveness in the medium run. In the opinion of the Copom members, there is no evidence to suggest that monetary policy will be unable to assure convergence to the inflation target path during the period required to consolidate this structural change. Furthermore, the monetary stance implemented in recent months takes into consideration the fiscal policy impact on aggregate demand and, ultimately, on inflation. It is undeniable that reductions in fiscal expenditures reinforce monetary policy's efforts to control inflation, and that improvements in the public accounts contribute to further reductions in real interest rates in the medium run. However, again, it does not mean that the current fiscal policy stance makes conventional monetary policy instruments inefficient in the control of inflation.
- 29. With a reduction in the risks of convergence of inflation to the target path, the Copom understood

- that the process of interest rate adjustment should be maintained at the originally projected pace. The committee members still agree that this adjustment, followed by a sufficiently long period of stable interest rates, will be sufficient to align the future path of inflation with the monetary policy objective.
- 30. Considering the reasons stated above, the Copom unanimously decided to increase the Selic rate target to 18.75%, with no bias.
- 31. Although the current monetary policy decision brings the Selic interest rate close to a level that, according to the Copom's opinion, will promote inflation convergence to the target path, the Copom recognizes that it is still not possible to assume, with this decision, the conclusion of the adjustment process initiated in September. The extent of additional tightening will depend on confirmation in the data of the favorable scenario that is beginning to materialize, and on economic agents' perception that interest rates will remain constant for a sufficiently long period of time at the conclusion of the process.
- 32. Clearly, in the case of a reversal in the evolution of the projected inflation outlook or of an exacerbation of the other risk factors followed closely by the Copom, the monetary authority will be prepared to adjust the pace and magnitude of the interest rate adjustment process to the circumstances.
- 33. At the conclusion of the meeting, it was announced that the Copom will reconvene on March 15 for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 12,631 of October 29, 2004.

Summary of the Data Analyzed by the Copom

Economic Activity

34. Regional retail trade association data showed that the expansion in retail sales activity continued in December. According to Fecomercio-SP, real sales grew 5.0% on a year-on-year basis in December in São Paulo, driven by household appliances and automobile sales. In Rio de Janeiro, data from Fecomercio-RJ showed a 6.9% month-on-month

seasonally adjusted increase in sales in December. The retail sales survey of Fecomercio-MG also showed a real month-on-month seasonally adjusted increase of 1.1% in sales in Belo Horizonte.

- 35. In January, São Paulo Trade Association (ACSP) data showed a 3.5% increase in the number of database consultations for credit sales and a 1.5% reduction in consultations of the Usecheque system, both on a month-on-month seasonally adjusted basis. Together, these indicators showed a 1.6% month-on-month seasonally adjusted increase, signaling the continuity of retail sales growth in early 2005.
- 36. The favorable outlook for retail sales is further confirmed by the evolution of consumer expectations at the beginning of the year. The February Fecomercio-SP survey showed a 1.1% month-onmonth increase in the Consumer Confidence Index (ICC), above the record level reached in January. The increase in the month was attributable to increases of 0.6% in the Current Economic Conditions Index and 1.4% in the Consumer Expectations Index.
- 37. Investment indicators registered month-onmonth expansion in December. Domestic production and capital goods imports increased 1.6% and 9.9% respectively, in seasonally adjusted terms, accumulating growth of 19.7% and 10.2% in 2004. The production of construction inputs grew 1.8% in December, in seasonally adjusted month-on-month terms, accumulating growth of 5.7% in the year.
- 38. According to IBGE, in December industrial production grew 0.6%, month-on-month seasonally adjusted, with a 0.8% increase in manufacturing, and a 0.3% decrease in mining. Industrial production reached a new record level in the month.
- 39. Analysis of industrial production by activity reveals that the growth in production in December reflected increases in 16 of the 23 activities, and growth in all use categories. In the month, notable growth was registered in petroleum refining and fuelalcohol production, as well as metal products, food, vehicles, and pharmaceutical products. By categories of use, semi- and non-durable consumer goods production stood out with the highest growth rate in

the month and a record production level, confirming recovery in domestic demand.

- 40. In 2004, industrial production increased 8.3%, with a broad-based expansion that encompassed all use categories and the 13 states included in the survey. Production of capital goods and intermediate goods grew 19.7% and 7.4%, respectively, accompanying the increase in exports and fixedcapital investment. Intermediate goods production growth was below that of the industrial average, due to lower growth in the production of construction inputs (5.7%) and packaging (2.9%), and the 3.8% contraction in the production of fuel and lubricants. Consumer durable goods production increased 21.8%, while semi- and non-durable goods production grew 4.0%, reflecting the expansion of credit and the gradual improvement of labor market conditions.
- 41. CNI manufacturing data showed increases of 2.0% in industrial sales and 2.5% in hours worked in December, on a month-on-month seasonally adjusted basis. In the year, industrial sales increased 14.3% and hours worked increased 6.2%. Installed capacity utilization reached 83.0% in December, with a seasonally adjusted monthly increase of 0.2%, and 3.1% for the year.
- 42. The CNI quarterly Industrial Business Confidence Index reached 64.9% in January, up from 63.8% in October, on a scale of 0 to 100, with values above 50 indicating an improving situation or optimistic expectations. According to the same survey, final goods inventories grew relative to October, with levels slightly above companies' projections. Stocks of raw materials and intermediate goods also increased in the fourth quarter of 2004, remaining, however, within projected levels.
- 43. Inventory data from the quarterly Manufacturing Industry Performance Survey, conducted by FGV, also demonstrated inventory growth at the beginning of this year, relative to that observed in October. Despite the increase, the data suggest normalization relative to the historical series. Furthermore, according to this survey, the level of installed capacity utilization reached 84.5% in January, a decline of 0.7 p.p. in seasonally adjusted terms versus October.

44. Leading indicators for the industrial sector signal some decline in January, compared to December, in seasonally adjusted terms. Particularly notable are the negative monthly variations in automotive production, the number of road tolls paid by trucks, and shipments of corrugated cardboard.

Labor Market

- 45. According to the IBGE survey in the six main metropolitan regions of the country, the unemployment rate reached 9.6% in December, versus 10.6% in November and 10.9% in December 2003. The decline in unemployment stemmed from the 0.1% monthly increase in the number of employed individuals and the 1.1% decline in the labor force, estimated at 21.6 million individuals.
- 46. In the industrial sector, according to the CNI indices seasonally adjusted by the Central Bank, employment and real payrolls increased 0.2% and 0.6%, respectively, in December on a month-on-month basis. In 2004, real payroll grew 9.0% and employed workers grew 3.5%.

Credit and Delinquency Rates

- 47. Non-earmarked credit operations expanded 2.3% in January. Credit operations with individuals increased 3.3%, driven mainly by the expansion in overdrafts, credit cards and personal credits - all instruments typically used to pay expenses at the beginning of the year. Corporate credit with domestic funding expanded by 1.2% in the month, as a result of low seasonal demand and sizeable loan repayments by corporates, mainly in vendor and trade bill discount lines. Corporate credit with external funding increased 2.6%, after consecutive declines since June 2004.
- 48. The average interest rate on non-earmarked credit increased from 45.0% p.a. in December to 46.8% p.a. in January. The average corporate rate stood at 32.2% p.a., recording a 1.2 p.p. increase in the period. Regarding credit to individuals, the average rate stood at 63.4% p.a., recording a 1.9 p.p. increase in the period.
- 49. The default rate on non-earmarked credit (considering payments delinquent for 15 days or more) increased 0.4%, reaching 7.3% in January. This

seasonal growth was a result of the 0.5% increase in individuals credit arrears, which stood at 12.4%, as well as the 0.2% increase in corporate credit arrears, which reached 3.6%.

50. The default rate in retail sales measured by the ACSP increased to 4.7% in January, the same level as January 2004 and above the 2004 average of 4.2%.

External Environment

- 51. In the US, despite the deceleration in the fourth quarter, estimates of real GDP growth exceed 4% for 2004 and are expected above 3.5% for 2005. The favorable outlook is also evident in the containment of inflation and the moderate interest rate increases in the long end of the Treasury yield curve. In addition, it has become consensual that the Federal Reserve will maintain its measured pace of interest rate increases during the year.
- 52. Inflation has remained under control in Europe, despite the recent surge. In the Euro Area, core inflation is slightly below the 2% target and, in the United Kingdom, at the target. In China, annualized consumer price inflation recorded a notable decline to 2.4% in December, from 5.3% in the middle of the year, while GDP growth exceeded expectations, reaching 9.5% in 2004.
- 53. Prices of agricultural commodities continued to decline, driven by an expected increase in the year's harvest. Regarding oil, although futures prices have moved to levels below the October lows, there are still uncertainties regarding future supply and demand dynamics, which keep prices above US\$40 per barrel.

Foreign Trade and Balance of Payments

54. In January, the Brazilian trade balance posted a US\$2.2 billion surplus, the highest monthly result ever recorded in the first month of the year. Exports and imports increased 28.3% and 24.8%, respectively, compared to January 2004 daily averages, to reach US\$7.4 billion and US\$5.3 billion. In the first two weeks of February (seven working days), the trade surplus reached US\$1,049 million, with exports and imports growing by 34.0% and 32.4%, respectively, compared to February 2004 daily averages.

- 55. In the twelve months through January, total external trade, the trade surplus, and exports reached record levels, of US\$161.9 billion, US\$34.3 billion and US\$98.1 billion, respectively. The three categories of export goods reached record twelve-month cumulative levels; of particular note was the US\$ 54.3 billion level recorded by manufactured goods exports.
- 56. International reserves increased US\$1.1 billion in January, to a level of US\$54.0 billion, while adjusted net reserves stood at US\$27.1 billion (IMF concept), recording a US\$ 1.8 billion increase compared to the same period of 2004.

Money Market and Open Market Operations

- 57. After the January Copom meeting, the yield curve shifted upward for maturities up to 2 years and downward for longer maturities. The upward shift was accentuated by the release of the January Copom Minutes, of core inflation rates that were considered high by the market, and by the persistence of 2005 inflation expectations at levels close to 5.7%. On the other hand, the downward shift in the long end of the yield curve was driven by the reduction of the country risk, the BRL appreciation and by inward foreign capital flows. Between January 19 and February 16, the 1-month, 6-month and 1-year interest rates increased by 0.58 p.p., 0.55 p.p., and 0.43 p.p., respectively, while the 2-year and the 3-year rates decreased by 0.04 p.p. and 0.40 p.p., respectively. In the same period, the real interest rate measured by the differential between the one-year nominal interest rate and the 12-monthahead inflation expectations reached 12.32%.
- 58. With the objective of accelerating the reduction in the public sector's foreign exchange exposure, on February 2 the Banco Central began to conduct FX swap auctions, in which the Banco Central assumes a long FX position and short interest rate position. The two auctions conducted thus far totaled US\$1.4 billion. As a result, the net redemption of FX instruments totaled US\$6.3 billion since the beginning of 2005.

- 59. Between the January and February Copom meetings, the National Treasury raised a total of R\$12.9 billion via auctions of LTNs, with maturities in January 2006, April 2006, July 2006 and July 2007. The National Treasury raised an additional R\$764 million via three NTN-Fs auctions, with maturities in January 2008 and January 2010. The Treasury also conducted seven auctions of LFTs maturing in 2006 and 2007, four of which were sales and three of which were exchanges. The four sales of LFTs totaled R\$12.2 billion, and the three exchanges totaled R\$6.4 billion.
- 60. In its open market operations aimed at reducing excess liquidity projected for the first quarter – on January 21, February 2 and February 16, the BCB sold LTNs with maturities in July 2005 and purchased LTNs maturing in April 2005. These operations totaled R\$1.9 billion. In addition, on January 28, February 4, and February 11, the BCB also sold LTNs maturing in July 2005, totaling R\$5.6 billion.
- 61. The BCB also intervened in the open market on a weekly basis with 3-month fixed-rate repo operations and 1-month floating-rate repo operations, and conducted daily liquidity management operations. The BCB also conducted fourteen fixed-rate overnight repo operations, five of which were overnight borrowings and nine of which were overnight lending. The excess liquidity sterilized from the banking reserves market via operations with tenors less than 30 days averaged R\$13.2 billion, and the amount sterilized via operations with three-month tenors averaged R\$42.0 billion.
- 62. In December, net securitized domestic public debt grew 2.0%, due to an R\$5.4 billion net placement and accrued interest. The dollar-linked share in net securitized domestic debt decreased to 8.0% at the end of January from 9.9% on December 31, due to the BRL appreciation and the net redemption of R\$13.3 billion in FX instruments.

Economic policy measures

Measures related to the financial system and credit market

Circular 3,265, 12.15.2004 – Altered the operational limits applicable to repo operations. A limit of up to 30 times base capital was defined for repo operations involving all of the securities issued by the National Treasury, Banco Central and credits securitized by the National Treasury. Previously, this limit varied from one security to another, with the limit of up to 30 times applicable only to Treasury Financing Bills (LFT) and Banco Central Bills (LBC). With regard to private securities, the limit was changed from two to five times base capital.

Resolution 3,249, 12.16.2004 – Maintained the Long-Term Interest Rate (TJLP) at 9.75% per year for the first quarter of 2005.

Resolution 3,253, 12.16.2004 – Revoked the minimum limit on credit investments by free membership credit cooperatives, which had been set at 50% of deposits received. This more flexible approach was adopted in light of the high costs involved in the process of controlling these investments. These costs are no longer considered justified, particularly when viewed in the context of the evolution of aspects regarding the stock holding composition and operations of free membership cooperatives.

Resolution 3,259, 1.28.2005 – Altered the targeting of resources obtained through savings accounts by entities included within the Brazilian System of Savings and Loans (SBPE). In this sense, one should stress that these institutions were dispensed from depositing at Banco Central the funds not invested in housing financing operations in the months of January, February and March 2005, provided that new financing channeled into acquisitions and production of real estate, within the framework of the Housing Finance System (SFH), be 30% greater than the amounts registered in the same period of 2004.

Resolution 3,260, 1.28.2005 – Altered Resolution 3,203/ 2004, which dealt with the opening of demand deposit accounts for individual Brazilian persons temporarily abroad. This measure also permitted the opening of savings deposit accounts for the same persons, though it was determined that the sum total of deposits made to the accounts of the same account holder and originating in remittances from abroad to a single institution or several institutions belonging to the same financial conglomerate must not be greater than R\$10,000.00 (ten thousand reais) per month. Parallel to this, this measure also made it possible to use credit cards issued in the country or abroad as instruments for making deposits in such savings accounts.

Resolution 3,261, 1.28.2005 – Authorized commercial banks, multiple banks without investment portfolios and the Federal Savings Bank to act as investment fund managers, as well as to participate in the securities distribution system. In practical terms, these activities were already performed by these institutions. However, with the new investment fund regulations issued as a result of Instruction 409 issued by the Securities and Exchange Commission (CVM) express authorization became necessary, since these are institutions authorized to operate by Banco Central.

Fiscal policy measures

Law 11,079, 12.30.2004 – Instituted general rules for tenders and for the contracting of public-private partnerships in the framework of the Federal, state, Federal District and municipal governments. For the purposes of this law, public private partnerships are administrative concession contracts that operate in one of two modalities: sponsored or administrative. These are defined as follows:

- a) sponsored concessions: this is a public utilities or public works concession covered by law 8,987, dated 2.13.1995, that, aside from rates charged to users, also involves financial payments made by the public partner to the private partner;
- b) administrative concession: this is a contract that calls for the providing of services with the public administration as the direct or indirect user, though it can also involve execution of works or the supply and installation of goods.

The major objective underlying the contracting of publicprivate partnerships is to make feasible the investments that the country so sorely needs, without withdrawing from the State responsibility for fostering growth. In its first stage, the government hopes to execute approximately 25 projects over three years, with investments estimated at R\$13 billion. Among the priorities are recovery of the highway network, construction of railway segments and port improvement.

Provisional Measure 232, 12.30.2004 – introduced a 10% correction into the progressive table of the Personal Income Tax (IRPF); incorporated alterations into the legislation governing the Corporate Income Tax (IRPJ), the Social Contribution on Net Profits (CSLL) and Program of Social Integration/Program of Civil Service Asset Formation (PIS/Pasep), and adopted other measures. The most relevant topics in the measure are as follows:

- a) IRPJ and CSLL: the calculation base of these taxes levied on companies that are taxed on the basis of presumed profit was raised from 32% to 40% of presumed profit;
- b) IRRF: increase from 1% to 1.5% in the rate levied on the earnings obtained by companies that provide transportation, medical, janitorial and conservations services, among others;
- c) Cofins, PIS and CSLL: broadening of the list of service companies subject to withholding;
- d) Exchange variation: taxation of exchange variation consequent upon stock participation abroad.

Provisional Measure 233, 12.30.2004 – Created the National Social Security Authority.

Law 11,101, 2.9.2005 – Approved the Bankruptcy and Business Recovery Law, substituting the former legislation dated 1945. Among the major changes, one should site the substitution of the process of credit composition with extrajudicial or judicial recovery. These mechanisms are considerably broader in scope and ensure that companies in difficulty will be able to renegotiate their debts with creditors. In the context of extrajudicial recovery, agreements between creditors and debtors are permitted, particularly in less complex situations. In this case, once it is determined that certain legal procedures are being followed, the task reserved to the judge is only that of approving the agreements. In its turn, judicial recovery involves compliance with a series of procedures. According to this process, the company submits a recovery plan that must be approved by the General Meeting of Creditors (workers, creditors holding real guaranties and other creditors) within a period of six months, at the end of which bankruptcy must be decreed by the judge.

Measures related to the external sector

Law 10,973, 12.2.2004 (DOU 12.3.2004) - Deals with incentives to scientific and technological innovation and research in the framework of the productive system and takes other measures.

Law 10,978, 12.7.2004 (DOU 12.8.2004) - Creates the National Industrial Structure Modernization Program (Modermaq) and takes other measures. Conversion of Provisional Measure 197, dated 7.7.2004, into law.

Bacen Circular 3,264, 12.9.2004 – Announced alterations in Import Exchange Regulations. Determined that payments of imports with terms of up to 360 days may be made in any currency, including the real, independently of which currency is registered on the Import Declaration (DI).

Camex Resolution 35, 12.13.2004 (DOU 12.15.2004) -Extended the safeguard measure applied to imports of finished toys, as dealt with in Camex Resolution 47, 12.18.2004.

Camex Resolution 38, 12.13.2004 (DOU 12.21.2004) -Altered the Export Tax levied by Camex Resolution 1, dated 1.15.2004, on leather and hides classified under positions 4104.11 and 4104.19 of the Mercosul Common Nomenclature (NCM).

Bacen Resolution 3,250, 12.16.2004 - Authorized Brazilian investments abroad through the holding of international stock conferences, based on payment in kind or exchanges of stock participation held by individuals or legal entities resident, domiciled or headquartered in Brazil, consequent upon sale of stock control in a Brazilian company. This rule was regulated by Bacen Circular 3,268, 12.16.2004.

Law 11,033, 12.21.2004 (DOU 12.22.2004) - Altered financial and capital market taxation; instituted the Tax System for Stimulating Modernization and Expansion of the Port Structure (Reporto); altered laws 10,865, dated 4.30.2004, 8,850, dated 1.28.1994, 8,383, dated 12.30.1991, 10,522, dated 7.19.2002, 9,430, dated 12.27.1996 and 10,925, dated 7.23.2004; and took other measures. Conversion of Provisional Measure 206, dated 8.6.2004, into law.

Law 11,051, 12.29.2004 (DOU 12.30.2004, rectified by DOU 1.4 and 11.2005) – Deals with the discounting of credits in calculation of the noncumulative Social Contribution

on Net Profits (CSLL) and the Contribution to PIS/Pasep and Cofins and takes other measures. Conversion of Provisional Measure 206, dated 8.6.2004, into law.

Law 11,080, 12.30.2004 (DOU 12.31.2004) -Authorized the executive branch to institute the Autonomous Social Service, designated the Brazilian Industrial Development Agency (ABDI), and took other measures. ABDI was instituted by Decree 5,352, 1.24.2005.

Law 11,077, 12.30.2004 (DOU 12.31.2004) (Informatics Law) – Altered law 8,248, dated 10.23.1991, law 8,387, dated 12.30.1991, and law 10,176, dated 1.11.2001, dealing with training and competitiveness in the informatics and automation sector and takes other measures.

Bacen Resolution 3,260, 1.28.2005 – Altered Resolution 3,203/2004, which deals with the opening of demand deposit accounts and savings deposit accounts for individual Brazilians temporarily abroad, while also permitting utilization of credit cards to make deposits in such accounts. Limits the sum total of deposits made into a single financial institution or jointly into various financial institutions that are part of a single financial conglomerate to R\$10,000.00 (ten thousand reais). Regulated by Bacen Circular 3,277, 2.23.2005.

Decree 5,361, 1.31.2005 (DOU 2.1.2005) – Deals with implementation of Economic Complementation Agreement 59 formalized by Argentina, Brazil, Paraguay, Uruguay, the Mercosul Member States and Columbia, Ecuador, Venezuela and the Andean Community Member States.

Camex Resolutions 34, 1 and 3 of 12.2004, 1.17.2005 and 2.17.2005, respectively (DOU 12.7.2004, 1.19.2005 and 2.22.2005/2005) (Ex-Tariff) - Altered the ad valorem rates of the Import Tax to 2% (two percent) on capital goods included in the appended list, under Ex-tariff conditions, and adopted other measures.

Camex Resolutions 4, 3.3.2004 (DOU 3.7.2005) -Altered the TEC List of Exceptions. Fifteen steel products were included with a zero Import Tax rate, encompassing cold rolled coils, hot rolled coils and tinplate. At the same time, products from the medical sector, barley and some fertilizers were excluded.

Law 11,101, 2.9.2005 (DOU 2.9.2005) (New Bankruptcy Law) - Regulated judicial and extrajudicial recovery and the bankruptcy of businesspersons and businesses.

Law 11,092, 2.12.2005 (DOU, 2.9.2005) – Defined rules for the planting and marketing of output of genetically modified soybeans from the 2005 harvest, altered law 10,814, dated 12.15.2003, and took other measures.

Bacen Circular 3,278, 2.23.2005 (Census of Brazilian Capital Abroad – CBE) – Defines the form, limits and conditions applicable to the declaration of properties and values held abroad by individuals and legal entities resident, domiciled or headquartered in the country.

Bacen Resolution 3,265, 3.6.2005 – Determined that the Floating Rate Exchange Market and the Market Rate Exchange Market would be united in the Exchange Market. With unification of these exchange markets, there will no longer be regulatory differences between the market rate exchange market (MCTL) and the floating rate exchange market (MCTF). The result is a single exchange market subject to a single set of rules. With unification of these markets, transfers of foreign currency abroad through the accounts of nonresident financial institutions ("CC5") cease to exist.

Resolution 3,266, 3.6.2005 (Export Exchange **Regulations**) – Deals with the new export exchange regulations.

Bacen Circular 3,280, 3.10.2005 (International Exchange and Capital Market Regulations – RMCCI) – Released the International Exchange and Capital Market Regulations, covering national or foreign currency operations carried out between individuals or legal entities resident, domiciled or headquartered abroad and takes other measures. The RMCCI regulates Bacen Resolutions 3,265 and 3,266, which deal with the unification of the exchange markets and with the new export exchange regulations, approved by the National Monetary Council on 3.4.2005. Effective as of 3.14.2005, it also abolished the Consolidated Exchange Rules (CNC) and revoked several previously issued circulars and circular letters.

Bacen Resolution 3,262, 2.3.2005 – Deals with investment of the resources of the Merchant Marine Fund (FMM).

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 SchwartsmanDeputy 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

Rodrigo Telles da Rocha Azevedo 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

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

Rodrigo Telles da Rocha Azevedo

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 Machines and Equipment Industry

ABPO Brazilian Corrugated Board Association

ACSP São Paulo Trade Association

Anfavea National Association of Automotive Vehicle Manufacturers

ANP National Petroleum Agency

b.p. Basis point

BM&F Brazilian Mercantile & Futures Exchange

BNDES Brazilian Development Bank **BNDESpar** BNDES Participações S.A.

BoE Bank of England
BoJ Bank of Japan

Bovespa São Paulo Stock Exchange

Bradies Renegotiated Bonds of the Republic

CAC Class Action Clause

Caged General File of the Employed and Unemployed

CMN National Monetary Council

CNI National Confederation of Industry

Conab National Supply Company
 Copom Monetary Policy Committee
 DAX Deutscher Aktienindex
 Depec Department of Economics
 DI Interfinancial Deposit

Dieese Inter Trade Union Department of Statistics and Socio-Economic Studies

DJIA Dow Jones Industrial Average

DLSP Net public sector debt

Embi+ Emerging Market Bond Index Plus

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

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

IBGE Brazilian Institute of Geography and Statistics

Ibovespa São Paulo Stock Exchange Index **Ibre** Brazilian Institute of Economics **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

General Price Index - Market **IGP-M** Institute of International Finance IIF **IMF** International Monetary Fund National Cost of Construction Index **INCC INPC** National Consumer Price Index **INSS** National Social Security Institute

Wholesale Price Index according to Processing Phases **IPA-EP**

Broad National Consumer Price Index IPCA

Consumer Price Index - Brazil IPC-Br

LGN Liquified Natural Gas

Systematic Farm Production Survey **LSPA**

National Treasury Bills LTN

Program of Modernization of the Farm Tractor Fleet and Like Implements and Harvesters Moderfrota

MPC Monetary Policy Committee

National Association of Securities Dealers Automated Quotation Nasdaq

NTN-B National Treasury Note - Series B NTN-C National Treasury Note - Series C NTN-F National Treasury Note - Series D

Organization of Petroleum Exporting Countries Opec

Percentage points p.p.

Per year p.y.

PIM Monthly Industrial Survey

PMC Monthly Trade Survey / Montly Survey of Trade (from IBGE)

Monthly Employment Survey **PME**

Selic Special System of Clearance and Custody SPC Secretariat of Complementary Social Security

TJLP Long-Term Interest Rate

Technical Memorandum of Understanding **TMU**

USA United States of America WTO World Trade Organization