Credit, monetary and fiscal policies

3

3.1 Credit

In August, financial system credit totaled R$541.2 billion, an increase of 4.4% in the June-August period and 18.7% over twelve months. The ratio of total loans to GDP rose to 28.7%, from 27.4% in May, and 25.4% in August 2004.

Table 3.1 – Credit operations

R$ billion

	2005				% growth	
	May	Jun	Jul	Aug	3 months	12 months
Total	518.4	525.6	533.0	541.2	4.4	18.7
Non-earmarked	302.1	306.5	312.4	317.4	5.1	22.8
Corporations	167.9	169.9	172.1	172.4	2.7	11.7
With external funding	48.1	47.8	48.5	48.1	0.0	-11.3
Individuals	134.2	136.6	140.3	145.0	8.1	39.3
Earmarked	180.3	182.3	183.1	185.6	2.9	11.4
Housing	25.0	25.3	25.6	25.6	2.5	7.2
Rural	56.7	57.0	56.0	55.6	-1.9	15.4
BNDES	94.9	96.2	97.6	100.5	6.0	10.4
Others	3.7	3.8	3.8	3.9	3.6	7.8
Leasing	16.6	17.2	17.5	18.2	9.3	54.8
Public sector	19.4	19.6	20.0	20.1	3.3	4.4
% participation:						
Total/ GDP	27.4	27.8	28.3	28.7		
Non-earmarked/GDP	16.0	16.2	16.6	16.8		
Earmarked/GDP	9.5	9.6	9.7	9.9		

Similar to prior months, non-earmarked lending drove credit activity in the June-August period. This was particularly true for personal credit, reflecting demand for payroll-deducted loans and consumer durable goods financing. Earmarked lending was primarily driven by credit growth at the National Bank of Economic and Social Development (BNDES), mostly to the export sector and to fixed capital investment.

Private financial institutions accounted for R$334.6 billion in credit operations, a 6.3% increase in the three-month period. Just as in the previous three-month period, the most important credit segments were personal and corporate loans. Lending by public sector banks totaled R$206.7 billion, with moderate growth of 1.5% in the period.

Lending to the private sector, including non-earmarked and earmarked resources, totaled R$521.1 billion in August, reflecting an increase of 4.4% in the three-month period. For the most part, this result was generated by the 8.1% increase in personal loans, to R$159.3 billion. Lending to industry rose 3.3% in the three-month period through August, reaching a total of R$132.7 billion, and driven by lending to the automotive, steel, and aircraft industries. Lending to the services sector totaled R$86.8 billion, up 5.8% from the three-month period ended in May, driven by lending to communications, energy and credit card companies. Lending to the retail sector rose 2.8%, to R$59.4 billion.

In August, bank loans to the public sector reached R$20.1 billion, an increase of 3.3% from May. The increase reflected a 6.5% increase in lending to states and municipalities, to

R$15.3 billion, concentrated primarily in the electricity generation and distribution segments. Lending to the federal government fell 5.6% to R$4.8 billion, mainly due to a reduction in lending to the natural gas sector.

At end-August, the leasing portfolio totaled R$18.2 billion, an increase of 9.3% in the three-month period. Growth was most robust for leasing operations with the services sector and individuals, with leased goods concentrated in machines and equipment, and vehicles. The volume of new leasing contracts in the three months through July totaled R$4.4 billion, an increase of 4.1% compared to the February-April period, with increases in both contract value and the number of contracts signed with the services and retail segments.

Earmarked credit

In the three-month period through August, credit operations with earmarked resources rose 2.9%, to R$185.6 billion. This growth reflected a 6% expansion in the BNDES portfolio, to R$100.5 billion, driven by on-lending operations to other financial institutions, as well as a 2.5% increase in housing finance.

From January to August, BNDES disbursements totaled R$24.5 billion, an increase of 16.7% compared to the same period of 2004. On a sector-by-sector basis, lending to the industrial sector totaled R$11.7 billion, an increase of 39.5%, driven by lending for machines and equipment and other transportation equipment. Lending to the retail and services sector totaled R$10.1 billion, an increase of 17.2% in the period, focused primarily on the transportation and telecommunications sectors. Meanwhile, lending to the agricultural sector dropped 33.7% compared to the January-August period of 2004, to R$2.6 billion. Of the total amount disbursed, R$7.2 billion corresponded to lending to micro-, small- and medium-sized enterprises, an increase of 6.6% in the period.

Credit applications sent to BNDES, used as an indicator of future investment, totaled R$52.6 billion in the first eight months of the year, an increase of 7.2% over the same period of 2004. Applications by the industrial sector totaled R$32.1 billion, an increase of 30.4%, driven by the aircraft export sector. Meanwhile, retail and services sector applications fell 7.1% to R$17.9 billion, due to reduced demand from the construction sector. Applications by the agricultural sector totaled R$2.6 billion, a decline of 49.6% in the year.

Table 3.2 – BNDES disbursements

R$ million

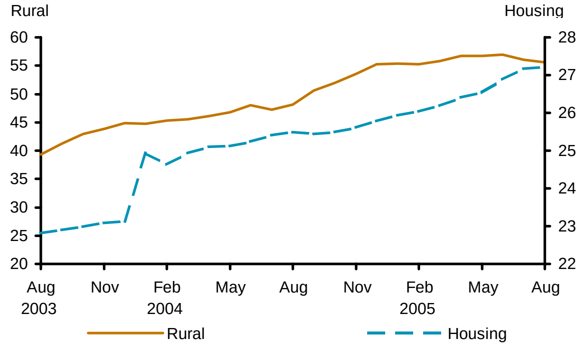
	Jan-Aug		% growth
	2004	2005	
Total	20 978	24 479	16.7
Industry	8 421	11 747	39.5
Other transportation equipment[1/]	2 693	3 400	26.3
Motor vehicles	1 459	1 831	25.5
Machines and equipment	447	1 244	178.3
Food and drink products	1 181	925	- 21.7
Metallurgy	496	925	86.5
Cellulose and paper	556	705	26.8
Commerce/Services	8 647	10 138	17.2
Overland transport	2 020	3 745	85.4
Electricity, gas and hot water	4 077	2 971	- 27.1
Construction	608	879	44.6
Vehicle dealer ship and reparation	608	466	- 23.4
Crop and livestock	3 911	2 594	- 33.7

Source: BNDES

1/ Includes aircraft industry.

Figure 3.1 – Rural and housing credit

R$ billion



The rural credit portfolio declined 1.9% in August, compared to May, to R$55.6 billion. The drop was due to a seasonal decline in credit for current agricultural expenditures, and postponement of credit operations related to the 2005/2006 harvest season.

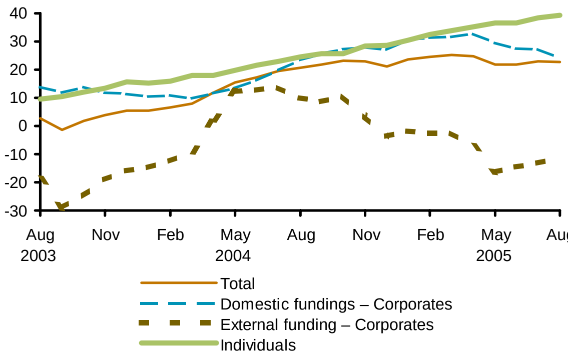
Credit to the housing sector, excluding non-earmarked resources, totaled R$25.6 billion in August, an increase of 2.5% compared to May. Loans financed with savings account resources totaled R$1.1 billion in the three-month period ended in July, 2.9% above the amount registered in the three-month period ended in April. Of this total, 56.3% was targeted to new home construction.

Continuing the measures adopted in 2005 to stimulate the housing sector, the National Monetary Council (CMN) set a target of 50% growth in housing finance for the third quarter of the year, compared to the same period of 2004. Financial institutions were given the option of either attaining this growth rate or complying with the minimum reserve requirement of 65% of their savings account balances. For the first and second quarters of the year, the targeted increases were 30% and 45%, respectively. Coupled with changes in the rules aimed at stimulating lower-cost housing finance and the decision to raise the maximum financed value to as much as R$350 thousand, the new measures contributed to improve the mortgage market. As a result, the cumulative flow of resources in the January-July period totaled R$2.7 billion, an increase of 68.7% over the same period of the previous year.

Non-earmarked credit

Figure 3.2 – Non-earmarked credit

% growth in 12 months



Lending with non-earmarked resources totaled R$317.4 billion in August, reflecting growth of 5.1% in the three-month period and 22.8% over twelve months. Non-earmarked lending as a percentage of total loans remained virtually unchanged, at 58.6% in August, versus 58.3% in May.

Credit to the corporate sector rose 2.7% in the three-month period, to R$172.4 billion in August. This result reflected a 3.7% increase in domestically funded loans, to R$124.7 billion, and stability in foreign currency denominated loans, totaling R$48.1 billion.

Personal loans totaled R$145 billion in August, an increase of 8.1% since May, driven by a 9.6% increase in consumer goods financing, and an 8.7% increase in personal credits.

Figure 3.3 – Interest rates on non-earmarked credit

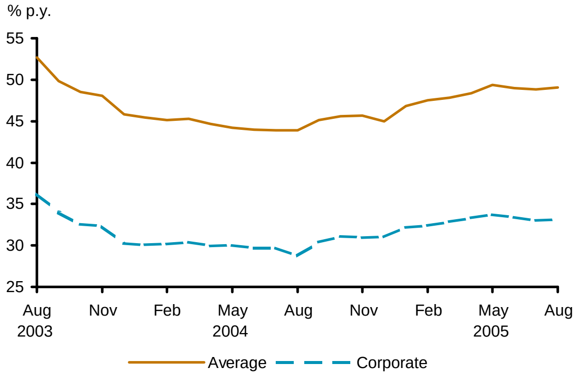


Figure 3.4 – Interest rates on fixed rate credit – Individuals

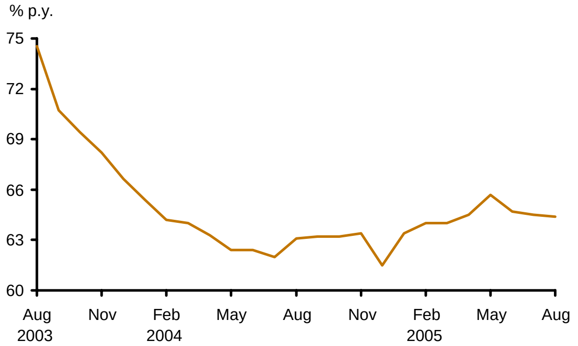


Figure 3.5 – Average spread on non-earmarked credit

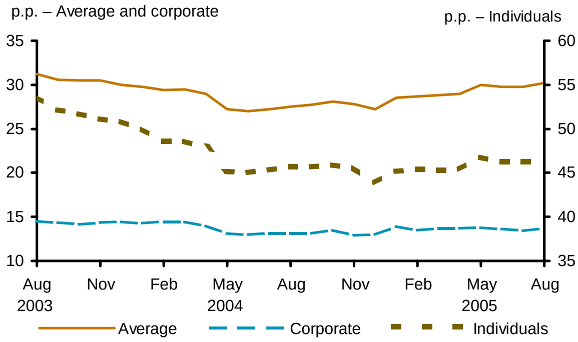
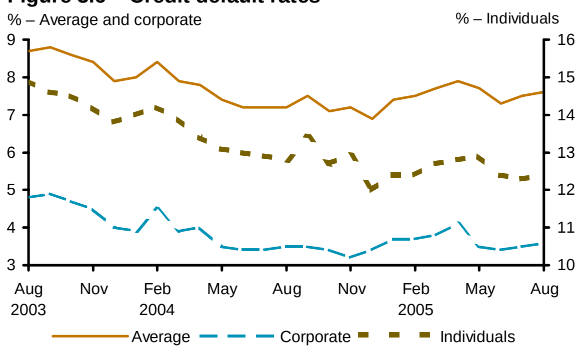


Figure 3.6 – Credit default rates[1/]



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

With respect to personal credit operations, information gathered from the thirteen leading financial institutions involved in payroll-deducted lending indicates an increase of 15.5% in this credit modality. With regard to financing for the acquisition of goods, the formation of partnerships between large retail outlets and major financial institutions has not only increased the dynamism of this segment, but has also had a positive influence on sales.

The growing participation of lower-cost credit modalities – such as payroll-deducted loans and goods financing – has contributed to a reduction in non-earmarked lending interest rates. The average rates for this segment and for loans to individuals stood at 49.1% per year and 64.4% per year in August, respectively, dropping 0.3 p.p. and 1.3 p.p. compared to May.

Interest rates on consumer durables financing declined, in line with trends in the longer end of the yield curve and the greater credit supply resulting from agreements between financial institutions and large retailers. Of particular note were the reductions of 4.1 p.p. and 1.7 p.p., respectively, in the rates on financing of other goods and auto loans. Furthermore, the average rate on personal credit operations dropped 0.1 p.p., compared to May, and closed at 77.1% per year. The key driver of this decline was the growing participation of payroll-deducted loans, which registered average interest rates of 36.6% p.a. in August.

The average interest rate on loans to the corporate sector came to 33.2% p.a. in August, a decline of 0.5 p.p. compared to May. Interest rates on foreign currency denominated lending dropped 1 p.p., while the interest rates on floating and fixed rate loans declined 0.3 p.p. and 0.2 p.p., respectively.

The banking spread for non-earmarked credit operations was 30.2 p.p. in August, an increase of 0.2 p.p. compared to May. The average spread increased in the period as a result of the relative expansion in the volume of credit to individuals, which has a higher spread than that of lending to the corporate sector. Corporate and personal lending spreads fell 0.1 p.p. and 0.6 p.p., respectively.

Non-earmarked credit defaults were 7.6% in August, a decline of 0.1 p.p. in the quarter. Arrears in the personal lending portfolio came to 12.4%, a reduction of 0.5 p.p. compared to May. Among other factors, this downward movement reflected growth in payroll-deducted loans, which have a considerably lower default rate and have been used

Figure 3.7 – Monetary base and M1 – Average daily balances

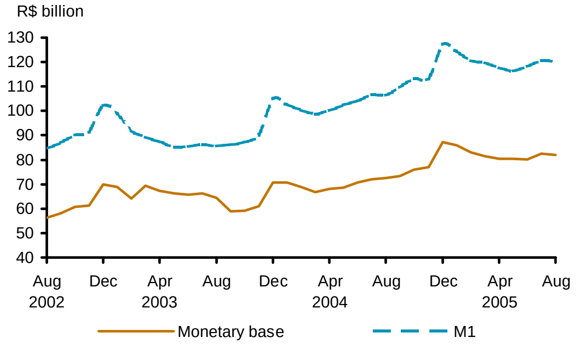
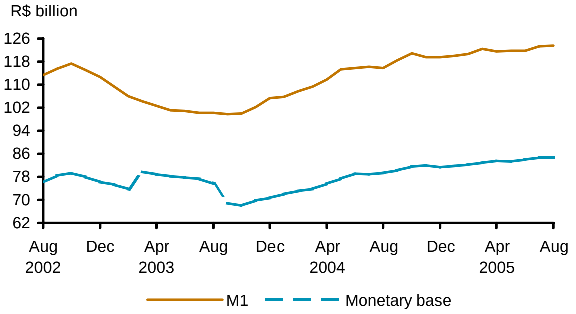
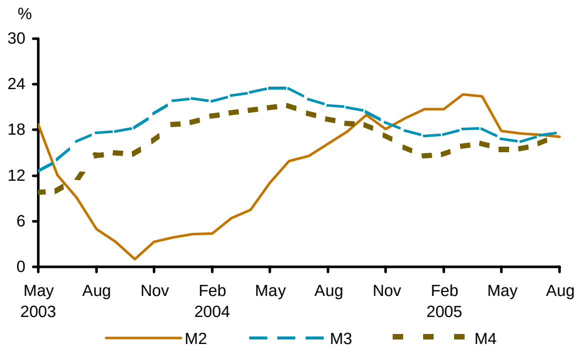


Figure 3.8 – M1 and monetary base at August 2005 prices seasonally adjusted[1/]



1/ Deflated by: IPCA.

Figure 3.9 – Broad money supply 12-month growth



primarily to pay down other outstanding banking debts. The default rate on corporate loans was 3.6%, an increase of 0.1 p.p. in the three-month period.

3.2 Monetary aggregates

The money supply (M1) totaled R$120.2 billion in August, measured as average daily balances, an increase of 13.1% in the last twelve months. This result reflected growth of 13.1% in the average balance of both currency held by the public and demand deposits.

Seasonally-adjusted and IPCA-deflated M1 rose 2.2% in the June-August period, basically reflecting the level of economic activity as well as strong growth in credit operations.

The average monetary base totaled R$82.1 billion in August, up 13.2% over twelve months, reflecting increases of 13.7% in the average balance of currency issued and 12.1% in banking reserves.

With regard to the sources of primary currency issuance in the three-month period ended in August, National Treasury operations contributed to a contraction of R$1.4 billion. At the same time, overall operations with the financial system produced an expansionary impact of R$547 million, due primarily to normalization of payments related to the Agricultural Activity Guarantee Program (Proagro) and releases of reserve requirements on the deposits of the Brazilian System of Savings and Loans (SBPE), which led to a joint increase of R$377 million. Coupled with redemptions of federal public securities totaling R$917 million, these factors led to an R$88 million expansion in base money demand.

Growth of the broad money supply was driven by expansion in financial system credit operations and incorporation of investment earnings. The M2 money supply concept, which includes M1, savings deposits and securities issued by financial institutions, increased 4.5% compared to May and 17% over twelve months, with a strong 8% increase in time deposits in the three-month period ended in August. The balance of savings accounts increased 1.8% in the period.

Analysis of the M3 concept, which includes M2, fixed income fund quotas and the federal public securities used to back repo operations carried out between the non-financial sector and the financial system, expanded 5% compared to May and 17.7% over twelve months. Mention should be made

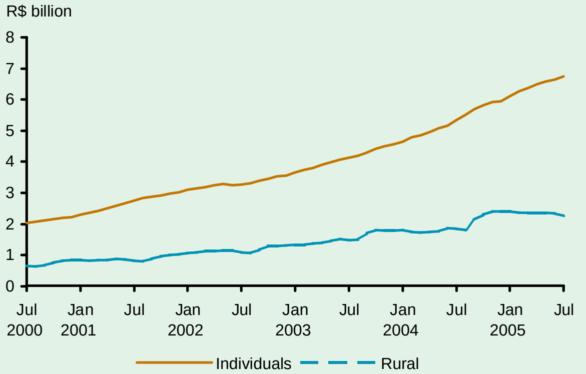
Complementary Statistics on Financial System Credit

Financial system credit grew a significant 18.7% in the twelve months through August, bringing the stock of outstanding credit to R$541.2 billion. Consequently, financial system credit as a percentage of GDP rose to 28.7%, from 25.4% in August 2004.

Non-earmarked credit (equivalent to 58.6% of the outstanding credit stock) posted the most robust growth, rising 22.8% over the past twelve months. Non-earmarked credit growth was driven by an expansion of credit to individuals, in the form of payroll-deducted loans (particularly to retirees in the Social Security system, post-May 2004) and loans for the purchase of consumer durable goods.

The credit data regularly published by the Banco Central do Brasil does not, however, represent the full universe of non-earmarked credit operations. If one includes other entities in the financial system, such as credit unions, the pace of recent credit growth is even more brisk.

Figure 1 – Credit unions



Household access to credit from credit unions has risen in recent years, due to the favorable economic environment, as well as measures that improved the organizational structure and performance of these entities.

Furthermore, the deepening of credit granted by credit unions is one of the goals pursued by the government in its efforts to strengthen and broaden credit union penetration in the country, as emphasized in Resolution 3106 of June 2003, which authorized the establishment of non-affiliated credit unions in cities and towns with populations less than 100,000 individuals.

Figure 2 – Leasing operations

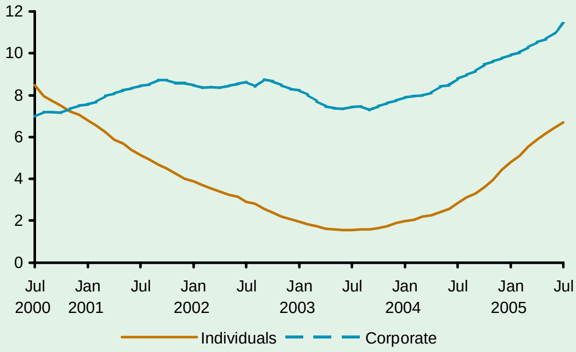
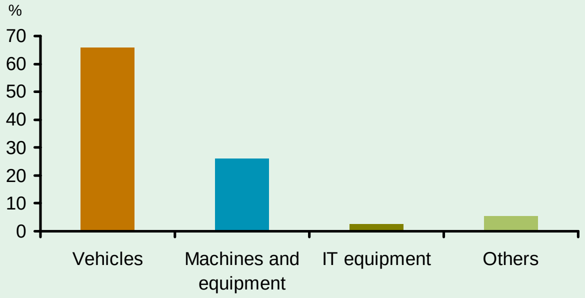


Figure 3 – Leasing operations by type of goods – June, 2005



Source: Abel

As a result, from June 2000 to July 2005, the number of credit unions in Brazil increased from 1,216 to 1,436, and the total stock of credit outstanding rose from R$2.6 billion to R$9.0 billion. Of note, virtually the entirety of this credit is non-earmarked.

Data on leasing operations are also not currently included in the non-earmarked credit data published by the Banco Central do Brasil, in compliance with the norm that stipulates the credit operations to be used in the calculation of reference interest rates. Leasing operations have been an important stimulus for corporate investment in recent years, but were virtually unutilized by individuals following the floating of the exchange rate in 1999, due to legal challenges to exchange rate adjustment clauses in the contracts. However, leasing has regained force among individuals more recently, with the majority of contracts now fixed-rate, and supported by new regulations issued in May 2003, which clarified the legal framework pertaining to collateral. The growth of leasing has also been underscored this year by the notable increase in debenture issuance by leasing companies.

The volume of leasing operations has risen from R$8.9 billion in June 2003 to R$18.2 billion in August of this year, with a particularly notable increase in the participation of household leasing contracts, from 7.9% of total to 28.3%, as measured by the Brazilian Leasing Association (Abel). The majority of leasing contracts are automobile leases (66%), followed by machinery and equipment (26.1%).

The inclusion of credit data from credit unions and leasing in total non-earmarked credit raises this segment's participation in total financial system credit to 61.7%, as of August. The incorporation of this additional data has been made possible by the more detailed information submitted by financial institutions, particularly to the BCB's Credit Information System (SCR).

The development and sophistication of Brazilian financial markets in recent years has led the Banco Central do Brasil to continually improve its bank supervision processes, as well as advance the collection and dissemination of new macro- and microeconomic indicators. The reformulation of credit indicators is part of this process, with the aim of making data more comprehensive and transparent. The release of credit data by type of bank ownership (i.e. foreign, domestic, or government-owned) is noteworthy. The BCB maintains an ongoing commitment to perfecting the quality and depth of its data dissemination practices.

of the net inflow of R$18 billion registered by mutual funds in the June-August period. The M4 concept, which includes M3 plus public securities held by non-financial entities, closed with a balance of R$1.2 trillion in August, reflecting increases of 5.3% in the three-month period and 17.7% in twelve months.

Federal public securities

In the three-month period ended in August, net federal public security issuance produced an expansionary impact of R$7.7 billion, due to R$91.9 billion in issuance and R$99.6 billion in redemptions, excluding swap operations totaling R$15 billion. In the period, National Treasury Bills (LTN) accounted for 63.4% of total issuance, and National Treasury Financing Bills (LFT) for 28.7%.

The daily average net financing position in the open market increased from R$38.5 billion in May to R$41.6 billion in August. In July, the daily average came to R$50.7 billion as a result of the impact of LTN maturities totaling R$37.3 billion on the first business day of the month. During the course of the three-month period, the BCB continued its preventative approach to liquidity adjustment, carrying out joint LTN sale and purchase operations worth approximately R$16 billion.

Over the course of the period, there was a concentration of liquidity management repo operations in tenors over 30 days.

The maturity of exchange-rate linked debt was limited to a single reverse swap operation worth US$385 million. There were no swap placements, due to the low demand for foreign currency hedge.

Figure 3.10 – Net financing position of the federal public securities – Daily average

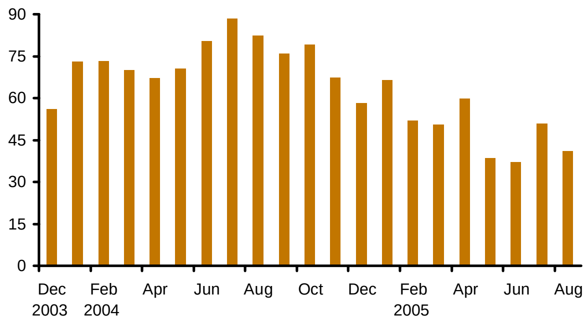
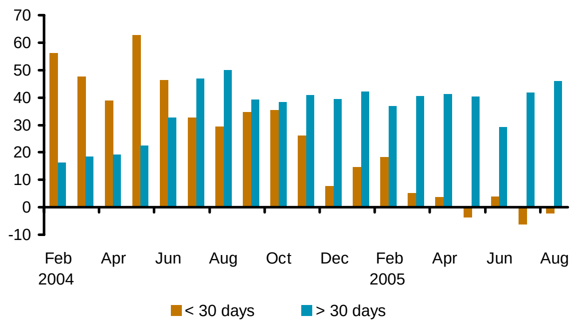


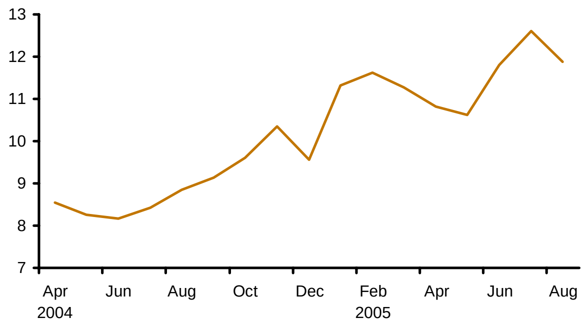
Figure 3.11 – Central Bank repo operations – Maturity – End of period



Real interest rates and market expectations

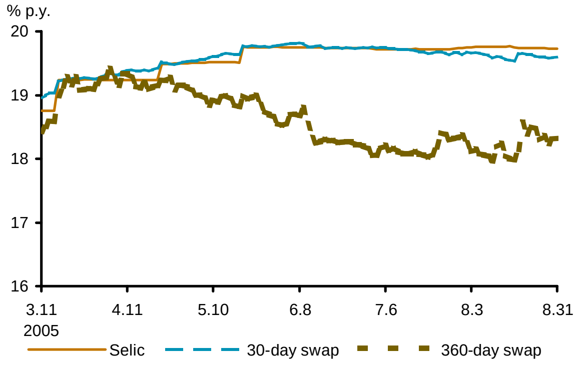
Based on the August 26 survey of market expectations conducted by the BCB's Investor Relations Group, the real one-year ex-ante Selic interest rate was 12% p.a., up from 10.6% p.a. at the end of May. The rise in the real rate reflected the downturn in twelve-month ahead market inflation expectations, from 5.9% in May to 4.7%. On August 29, the reference rate for 360-day DI swap contracts x pre closed at 18.2% p.a., compared to 18.7% p.a. at the end of May.

Figure 3.12 – Ex-ante real interest rate – Deflated by 12-month IPCA expectations



Capital markets

Figure 3.13 – Selic x swap DI x Pre



Source: BM&F

Figure 3.14 – Ibovespa

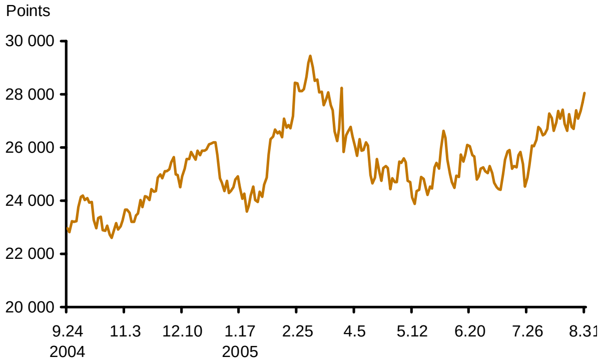


Figure 3.15 - Net foreign investment in Bovespa

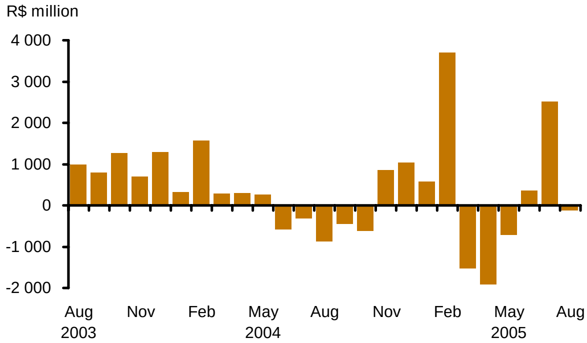
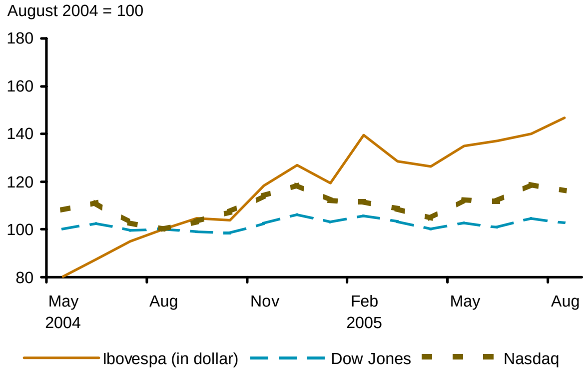


Figure 3.16 – Stock exchanges



The São Paulo Stock Exchange Index (Ibovespa) rose 11.3% as of end-August, compared to end-May, to close at 28,044 points. The announcement of favorable economic activity indicators coupled with the downward movement in price indices bolstered investor confidence. It is important to note that this movement occurred despite oil price increases and domestic political uncertainties.

International investors began returning to the Bovespa, accounting for inflows of R$2.7 billion in the June-August period.

In dollar terms, the Ibovespa was up 13.1% in the period. The Dow Jones index remained stable, at 10,482 points, while the Nasdaq rose 4.1%.

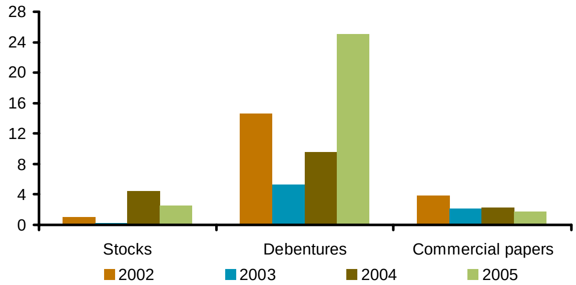
Based on primary market issuance registered at the Securities and Exchange Commission (CVM), the volume of capital market inflows to companies through stocks, debentures and promissory notes totaled R$9.8 billion in the three-month period ended in August. Debenture placement totaled R$6.9 billion, driven by transactions involving leasing companies, steel producers, electricity and sanitation companies, together with R$2 billion in stock issuance and R$800 million in promissory notes. The cumulative total for the year through August registered debenture issuance of R$25 billion, an increase of 487% compared to the same period of 2004. The volume of registration requests for new debenture issuance at the CVM totaled R$12.2 billion at the end of August.

Domestic savings

Savings accounts, time deposits and investment funds totaled R$1 trillion in August, an increase of 5.9% compared to May.

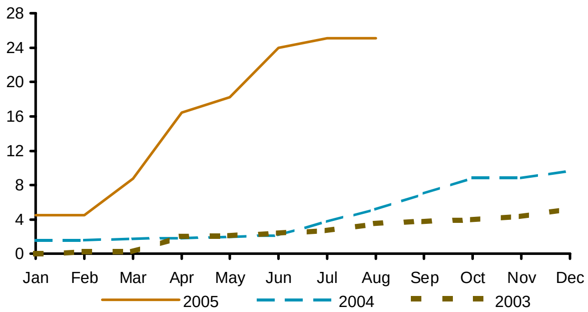
Investment funds registered net inflows of R$18.7 billion, for net worth of R$616.9 billion, an increase of 6% in the period. Net inflows in August totaled R$12.8 billion and were concentrated in fixed income funds (R$6.3 billion) and multi-market funds (R$2.3 billion). In the three-month period, investment fund composition remained relatively unchanged, with fixed income funds accounting for 53.1% of total investments, followed by benchmark funds, 22.8%; multi-market funds, 20.1%; short-term funds, 3.6%; and foreign currency funds, 0.4%.

Figure 3.17 – Primary issues in the capital market
R$ billion – Accumulated through August



Source: CVM

Figure 3.18 – Debentures
R$ billion – Accmulated in the year



Source: CVM

Figure 3.19 – CDB, FIF and savings deposits
R$ billion

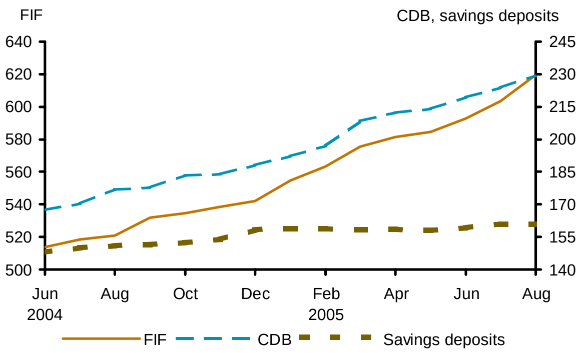
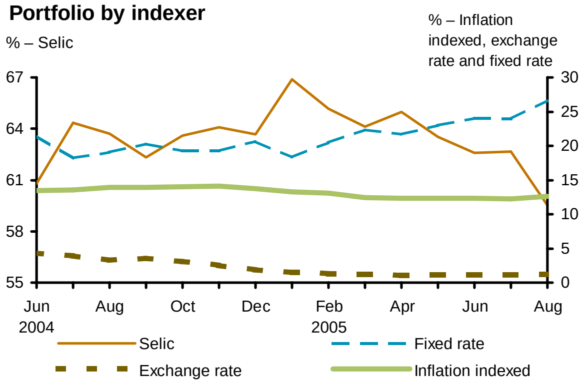


Figure 3.20 – Public securities in investment funds – Portfolio by indexer



Expectations for monetary easing were evident in the composition of public securities included in investment fund portfolios. The participation of fixed rate securities rose from 23.0% in May to 26.6% in August, while that of Selic-indexed securities dropped from 63.5% to 59.5%. Inflation-indexed securities and FX-linked securities remained relatively stable in the three-month period, closing at 12.6% and 1.2%, respectively.

The August balances of time deposits and savings accounts totaled R$231.7 billion and R$160.1 billion, respectively, corresponding to increases of 8.3% and 1.3%, compared to May. Time deposits continued registering strong net inflows, with approximately R$8.7 billion in the three-month period and a cumulative R$20.8 billion in 2005. Meanwhile, savings accounts posted net redemptions of R$1.4 billion and R$6.8 billion, over the same time periods.

Resolution 3,272, of March 24, 2005, went into effect on July 1, requiring financial institutions to register securities issued, accepted or guaranteed by them (except stocks) in financial settlement registration systems authorized by the BCB or the CVM. A comparison between the first half of July and the first half of June indicates that the stocks of Bank Deposit Certificates (CDB), Bank Deposit Receipts (RDB), and Interbank Deposits (DI) registered with the Securities Custody and Settlement Center (Cetip) expanded 11.8%.

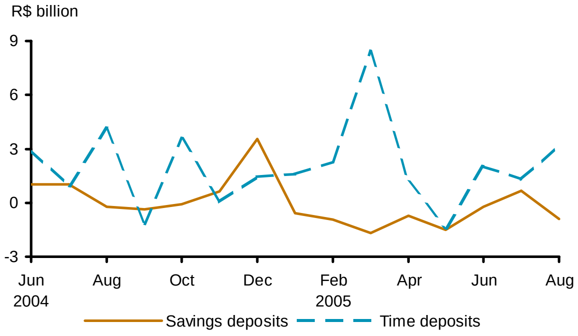
The net worth of stock funds and mutual privatization funds (FMP), which invest the resources of the Employment Compensation Fund (FGTS), totaled R$42.1 billion and R$7.7 billion in August, respectively. In the three-month period, stock funds registered returns of 4.1% and FMP closed with 21.1%. For the most part, these gains were generated by upward movement in the value of Petrobras and Vale do Rio Doce stocks.

3.3 Fiscal policy

Fiscal policy has been implemented with the aim of ensuring public sector debt sustainability. In this context, the authorities formulated, announced and complied with fiscal targets regarding the primary results for the non-financial public sector.

The Budget Guidelines Law for 2006 maintained the 2005 consolidated public sector primary surplus target of 4.25% of GDP. The target was distributed as follows: 2.45% for

Figure 3.21 – Net inflow – Savings deposits and time deposits



the fiscal and social security budgets and 0.7% for the Global Federal Enterprise Spending Program. The primary surplus target for states and municipalities was set at 1.1% of GDP. It is important to stress that current legislation permits offsetting among the targets defined for the fiscal and social security budgets and the Global Spending Program.

The bill introduced to the National Congress was elaborated in such a way as to continue the process of fiscal austerity and maintain macroeconomic stability. Compared to previous fiscal years, budget guidelines legislation introduced several innovations. Among these, the following procedures deserve mention:

a) Tax revenue ceiling: estimated federal tax revenues, net of refunds and tax incentives, may not surpass 16% of GDP in 2006. Atypical revenues and those resulting from social contributions are excluded from the estimate;
b) Anti-cyclical adjustment mechanism: the primary surplus target for the consolidated public sector should be adjusted upward or downward by a maximum of 0.25% of GDP in the budget proposal and at the time of the bi-monthly reassessment, depending on the pace of economic activity. Possible reductions in the primary surplus target depend on continued downward movement in the debt/GDP ratio at a pace equal to, or greater than, that registered on average in the 2004/2005 period;
c) Public investment pilot program: the primary surplus may be reduced by as much as R$3 billion in order to meet the demands of infrastructure programming which will be included as a specific appendix in the 2006 budget bill;
d) Spending ceiling: the allocations authorized for current primary spending stated in the fiscal and Social Security budgets, excluding constitutional transfers and revenue sharing operations, may not exceed 17% of GDP.

With respect to the minimum wage increase, the procedures adopted in 2005 were maintained, granting a real minimum wage increase equivalent to real per capita GDP growth in 2005.

Public sector borrowing requirements

The cumulative public sector primary surplus through July totaled R$68.7 billion, or 6.3% of GDP, compared to R$52.8 billion, or 5.4% of GDP, in the same period of 2004. This was the strongest result for this basis of comparison, in terms of both value and as a percentage of GDP, since the series

Table 3.3 – Public sector borrowing requirements – Primary result

Accumulated in the year			R$ million
Period	Actual	Target	Difference
	(I)	(II)	(I - II)/(II) (%)
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
2005/Jan-Apr	-44 012	-35 780	23.0
2005/Jan-Aug	-68 745[1/]	-60 184	14.2

1/ January to July.

Table 3.4 – Public sector borrowing requirements – Primary result

Accumulated in the year

	July					
	2003		2004		2005	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central government	-32.7	-3.7	-39.6	-4.0	-46.0	-4.2
Sub-national governments	-9.0	-1.0	-11.6	-1.2	-14.9	-1.4
State companies	-2.6	-0.3	-1.6	-0.2	-7.8	-0.7
Total	-44.3	-5.1	-52.8	-5.4	-68.7	-6.3

was first released in 1991. The 0.9 p.p. of GDP increase in the period reflected improvement in the surpluses at all levels of government, with a 0.2 p.p. increase for both the central government and sub-national governments, and a 0.5 p.p. increase for state-owned companies. The cumulative non-financial public sector primary surplus through July was 14.2% above the target defined by the government up to August and equivalent to 82% of the annual target.

The central government primary surplus reflected an increase in revenues equivalent to 1.03 p.p. of GDP. To some extent, this was a consequence of the positive performance of activity, particularly in specific segments of industry and the service sector. Using the IGP-DI as deflator, real growth in the personal income tax revenues was 16.8%, while the Social Contribution on Net Profits rose 16.7%. The increase in the level of economic activity played an important role in the 6.3% rise in the revenues of the Social Security Financing Contribution (Cofins) and the 3.7% increase in Industrialized Products Tax revenues.

Central government spending closed at 16.6% of GDP in the first seven months of 2005, versus 16.4% of GDP in the corresponding period of the previous year. Outlays on current and capital spending rose R$9.6 billion while spending on personnel and payroll charges expanded R$2.4 billion, reflecting respective growth rates of 20.5% and 5%. The increase registered under current and capital outlays reflected spending generated by the restructuring of liabilities – on-lending to Emgea – and registration of operations under the Special Asset Restructuring Program (Pesa) in the federal debt subject to judicial execution. In the previous year, there were no corresponding outlays. Furthermore, one should emphasize increases in spending consequent upon acquisitions of land for agrarian reform purposes, 79.4%, and alterations in the law of the elderly, which generated direct impacts on the granting of assistance benefits under the Organic Social Assistance Law (Loas), with 22.7%.

Reflecting the evolution of formal sector employment, Social Security revenues increased 0.16 p.p. of GDP in the first seven months of 2005, compared to the same period of 2004, corresponding to 5.24% of GDP. Nevertheless, the social security deficit expanded by the equivalent of 0.63 p.p. of GDP in the period, with increases of 3.8% in the number of retirement benefits, 21.4% in illness assistance benefits and 17% in the volume of assistance operations – Loas.

The result for sub-national governments has been conditioned by the positive performance of the Circulation of

Table 3.5 – ICMS revenues – Accumulated Jan-Jun

			R$ million[1/]
	2004	2005	Growth (%)
Brazil	71 397	75 166	5.3
São Paulo	23 811	24 780	4.1
Rio de Janeiro	7 166	6 613	- 7.7
Minas Gerais	6 598	7 615	15.4
Rio Grande do Sul	4 836	5 177	7.0
Paraná	4 223	4 208	- 0.4
Bahia	3 672	3 774	2.8
Santa Catarina	2 802	3 229	15.2
Pernambuco	1 913	2 064	7.9
Goiás	2 043	1 988	- 2.7
Espírito Santo	1 872	2 258	20.6
Others	12 462	13 461	8.0

1/ At June/2005 prices (deflated by IGP-DI).

Table 3.6 – Public sector borrowing requirements

				Accumulated in the year
	July			
	2004		2005	
	R$ billion	% GDP	R$ billion	% GDP
Uses	19.4	2.0	23.5	2.1
Primary	- 52.8	- 5.4	- 68.7	- 6.3
Interest	72.2	7.3	92.3	8.4
Sources	19.4	2.0	23.5	2.1
Domestic financing	43.9	4.5	64.8	5.9
Securities financing	48.3	4.9	98.7	9.0
Bank financing	1.6	0.2	- 27.8	- 2.5
Others	- 6.0	- 0.6	- 6.1	- 0.6
External financing	- 24.5	- 2.5	- 41.3	- 3.8

Merchandise and Services Tax (ICMS) revenues, the principal source of tax revenues at the state level. Data for the first half of 2005 show that, using the IGP-DI as deflator, the ICMS inflow totaled R$75.1 billion in the period, for real growth of 5.3% compared to the first half of 2004. In this case, the strongest growth was registered in Espírito Santo, 20.6%; Minas Gerais, 15.4%; Santa Catarina, 15.2%; Pernambuco, 7.9%; Rio Grande do Sul, 7%; and São Paulo, 4.1%.

On a sector-by-sector basis, tax revenues at the state level varied sharply. In São Paulo, the best performances occurred in the services sector, 8.3%; electricity, 6.4%, and petroleum, 5.9%. In Minas Gerais, the highest growth rates were registered in industry, 19.4%; electricity, 21.3% and services, 13.6%. In Rio de Janeiro, the real ICMS inflow dropped 7.7% in the period, affected by atypical tax payments of approximately R$457 million by Petrobras in January 2004.

Cumulative nominal interest on an accrual basis reached R$92.3 billion, or 8.4% of GDP, through July, versus R$72.2 billion, or 7.3% of GDP, in the same period of 2004. This growth was a consequence of a 1.7 p.p. increase in the cumulative Selic rate in the period.

The non-financial public sector borrowing requirement stood at R$23.5 billion, or 2.1% of GDP, through July, compared to R$19.4 billion, or 2% of GDP, in the same period of 2004.

With regard to the sources of financing for the public sector borrowing requirement in the period, domestic securitized debt, including BCB repo operations, rose R$98.7 billion. Meanwhile, external debt and banking financing dropped R$41.3 billion and R$27.8 billion, respectively.

Federal debt

In the first seven months of 2005, federal securitized debt rose from R$810 billion, or 43.7% of GDP, to R$915.7 billion, or 48.4% of GDP. In the period, net primary market issuance totaled R$28.1 billion, while accrued interest reached R$80.9 billion. The 9.9% appreciation of the *real* against the dollar, contributed to an approximately R$3.6 billion reduction in the debt.

The value of dollar-indexed domestic federal debt, including swaps, dropped from R$80.1 billion in December 2004 to R$38.3 billion in July 2005, due to the R$32.8 billion reduction in swaps, net FX redemptions totaling R$7.6

Figure 3.22 – Federal securities debt structure per indexer

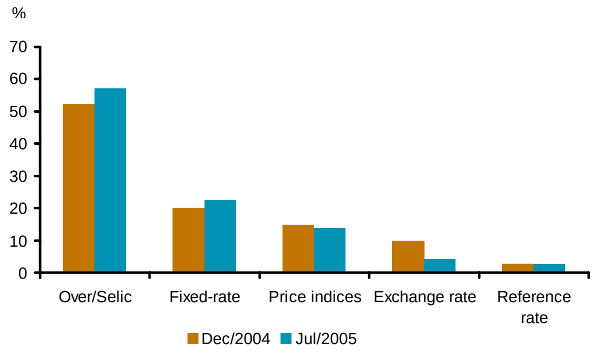


Figure 3.23 – Public sector net debt/GDP ratio

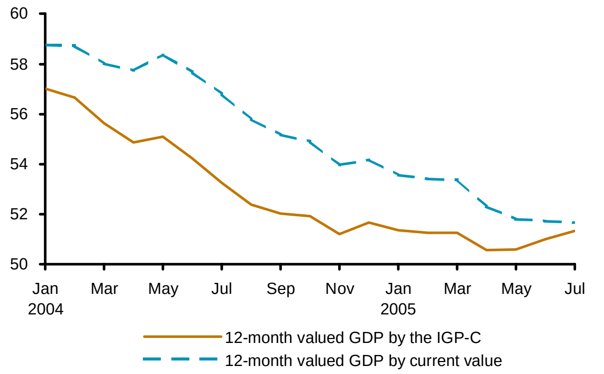
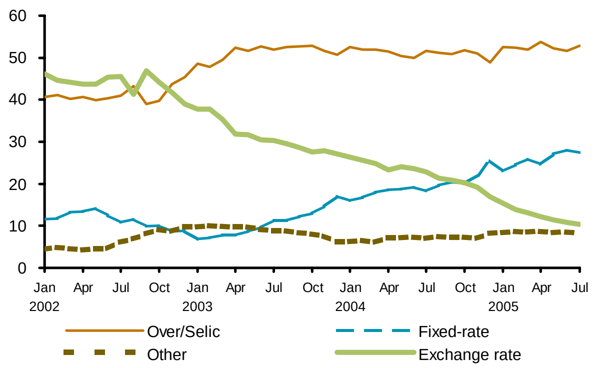


Figure 3.24 – Net public debt: Share per indexer



billion, and the appreciation of the *real*. The participation of dollar-indexed securities, including swaps, in total federal securitized debt fell from 9.9% to 4.2% and the fixed rate debt increased from 20.1% to 22.4%, a level not recorded since mid-1998.

In July, the amortization schedule for outstanding public debt, excluding financing operations, was as follows: R$151 billion, 16.5% of the total, maturing from August to December 2005; R$366.7 billion, 40.0% of the total, in 2006; and R$398 billion, 43.5% of the total, after January 2007.

In July, FX swaps outstanding totaled R$5.5 billion, down from R$28.7 billion in January. Adjusted by the difference between DI returns and exchange rate variation plus coupon, these operations produced a positive result of R$1.7 billion for the BCB in the first seven months of the year (accrual basis), and R$1.6 billion on a cash basis.

Net public sector debt

The net public sector debt (DLSP) in July totaled R$971.8 billion (51.3% of GDP), compared to R$957.0 billion, (51.7% of GDP) at the end of 2004. These results reflected interest appropriation of R$92.3 billion, as well as the primary surplus of R$68.7 billion and the R$14.2 billion impact of currency appreciation. As a share of GDP, DLSP dropped 0.4 p.p. in the period, notwithstanding an increase of 0.8 p.p. from April to July, resulting from the recent behavior of the IGP-DI, the index used as the GDP deflator.

Foreign currency-linked debt as a percentage of net public sector debt fell to 10.3% in July, from 14.5% in December 2004, and 46.9% in September 2002. Net fixed rate debt has risen from 6.9% of total debt in January 2003, to 17% in December 2004, and 27.4% in July 2005.

The gross general government debt (federal government, social security, state and municipal governments) totaled R$1,405 billion (74.2% of GDP) in July, compared to R$1,398 billion (73.8% of GDP) in June, and R$1,332 billion (71.9% of GDP), in December 2004.

3.4 Summary

In the June-August period, bank credit activity was primarily driven by lending with non-earmarked resources, due to increased demand for payroll-deducted loans and consumer durables purchase financing. Meanwhile, earmarked credit was driven by BNDES lending to the export sector and to fixed capital investments.

At the same time as bank credit demand was rising (with declining defaults), the volume of corporate financing via capital markets rose steadily, particularly stock and debenture issuance. Cumulative debenture issuance in the year quintupled, compared to the same period of 2004. At the same time, the large volume of new issuance registrations at the CVM indicates that this tendency will continue.

Fiscal austerity will continue, guaranteeing the public debt sustainability. One should highlight both the positive results achieved in the debt capitalization, at rates well below the Selic rate, as well as the reduction in its volatility, due as much to a decrease in foreign currency exposure as to greater participation of fixed rate debt.

Public Sector Debt

On a monthly basis, the Banco Central do Brasil releases data on net consolidated public sector debt (NPSD) and gross general government debt (GGGD), reported as both the stock outstanding and as a percentage of GDP. The NPSD represents the netting of the consolidated public sector liabilities and assets, while the GGGD represents only the liabilities of the general government. Therefore, there are two main differences between these concepts: (i) the definition of the public sector; and (ii) the netting of financial assets in the NPSD.

With regard to the definition of public sector, the NPSD encompasses the consolidated non-financial public sector, which includes the Federal Government, Central Bank, state and municipal governments, and state-owned companies (federal, state, and municipal). In contrast, the GGGD covers only the general government – the Federal Government, states, and municipalities. Therefore, the concept of the general government – used to facilitate international comparisons, as well as to capture total gross debt of ultimate fiscal origin, excluding state-owned enterprises and effects directly related to Central Bank functions – is distinct from that of the public sector, more commonly used in Brazil.

An increase in the assets of state-owned companies or the BCB generates a reduction in the net public sector debt, without affecting the gross general government debt, since assets are not accounted for in the latter indicator. The same occurs in the case of a decline in the debt of state-owned companies or the BCB.

Figure 1 and 2 show the evolution of the NPSD and GGGD, in absolute terms and as a percentage of

Figure 1 – NPSD and GGGD

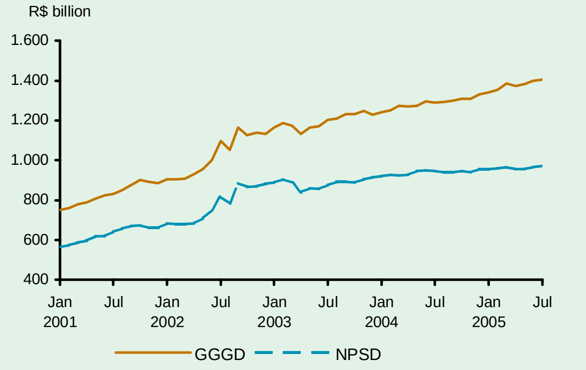
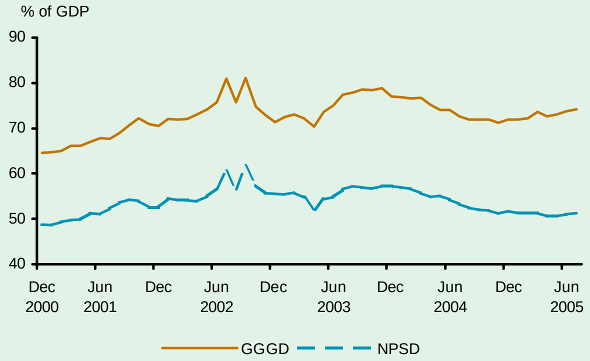


Figure 2 – NPSD and GGGD



GDP. The debt burden continues to rise in nominal terms in the recent past. However, as a share of GDP, the NPSD and GGGD declined by 5.9 p.p. and 2.8 p.p., respectively, from December 2003 to July 2005.

Furthermore, in December 2000, the GGGD was equivalent to 64.6% of GDP, and rose to 74.2% of GDP in July 2005. In the same period, the NPSD rose from 48.8% of GDP to 51.3%. The greater expansion in gross debt increased the difference between the two indicators from 15.8 p.p. of GDP in December 2000, to 22.9 p.p. as of July 2005.

The more marked increase in the GGGD, versus the NPSD, from December 2000 to July 2005 was driven by a change in the composition of the Banco Central's securities portfolio, in turn prompted by the May 2000 Fiscal Responsibility Law, which forbid the issuance of BCB securities. Under this Law, securities issued by the Banco Central were bought back and monetary policy began to be conducted solely with National Treasury securities acquired by the BCB in the market. The impact of this swap operation was neutral on the NPSD, because the Banco Central, in purchasing National Treasury securities to rebuild its portfolio, increased its debt burden by issuing base money, but also increased its assets. Meanwhile, the increase in the Treasury's debt was neutralized by the increase in its cash position.

On the other hand, the effect of this transaction on the GGGD was an increase by the amount equivalent to the increase in National Treasury debt, equivalent to 4.9 p.p. of GDP.

In addition, the greater increase in the GGGD was driven by the increase in the Federal Government's deposits held at the Banco Central, due to the increase in fiscal revenues in the period. This growth in deposits at the BCB led to a reduction in the NPSD, with no impact on the GGGD.

Of note, including public sector debt held by the Central Bank in the gross debt concept represents a conservative approach, as international practice typically excludes debt used for the implementation of monetary policy from the gross debt.

Figure 3 – General Government: gross debt, net debt and credits

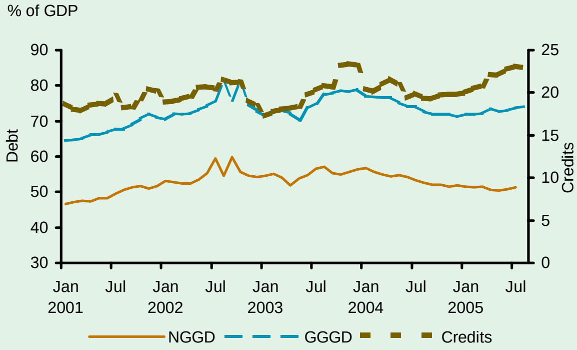
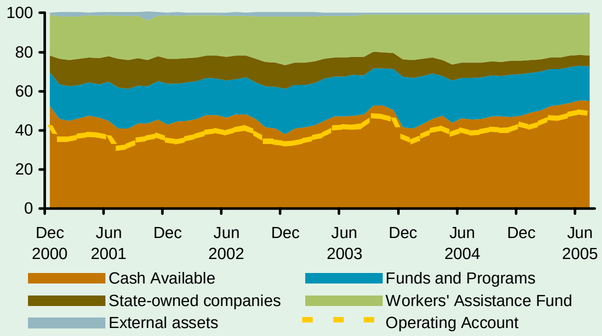


Figure 4 – Percentage breakdown of the General Government credits



To further complement fiscal sector analysis, the BCB publishes data on the net general government debt (NGGD), subtracting from the GGGD the assets of the federal and sub-national governments, thereby affording a comparison of the general government's gross and net debt, along the lines of that available for the public sector.

Graph 3 shows the evolution of the GGGD and the NGGD as a percentage of GDP. The difference between these two indicators was equivalent to 18.7% of GDP in December 2000, rising to 22.9% in July 2005. This increase is attributable to the rise in general government assets, which grew on the order of 4.2 p.p. of GDP in the period. Graph 4 shows the relative composition of the assets netted from gross debt to arrive at the net debt concept. Cash available is the largest component, representing 55.1% of total assets as of July 2005, with particular emphasis for the Federal Government's cash position at the BCB, representing 48.6% of the total.