Introduction

In 2003, monetary policy was implemented in the framework of a fundamental commitment to preserving price stability. Consequently, the measures taken by Banco Central were aimed at reversing the climate of economic uncertainty that took root in the second half of 2002, as a result of a series of adverse internal and external factors.

The rise in inflation that occurred at the start of the year was caused partly by higher inflation in the final quarter of the previous year, indicating the presence of inertial components. Thus, it was recognized that this increase could not be attributed to some external shock nor could it be considered a temporary deviation from the long-term trajectory or no more than a passing phenomenon that would take care of itself over time. The upturn in inflation was recognized as a direct result of deteriorating expectations on the part of private agents and, as such, a reality that would demand rapid and firm action on the part of the monetary authority. Success in reversing the process of deteriorating expectations early on was important to minimizing the GDP reduction needed to ensure stability.

In this context, the Monetary Policy Committee (Copom) decided to increase the Selic rate target from 25% per year in December 2002 to 25.5% per year and 26.5% per year in January and February 2003, where it remained until June of that year. In February, the compulsory reserve rate on demand deposits was also increased. All of the measures adopted were further reinforced by an unflagging fiscal policy commitment to primary surpluses compatible with the sustainability of the public debt.

The initial results of the more stringent monetary policy and austere fiscal policy became evident in the first half of 2003. Soon after the decision to raise interest rates was taken, the rate of exchange turned sharply downward in March and April, falling from R$3.59/US$ in February to just below R$3.00 two months later.

However, at the same time, market expectations regarding inflation in 2003 and 2004 were somewhat harder to reverse. Up to the end of April, expectations for

2003 and 2004 remained at 12.5% and 8%, respectively, compared to targets of 8.5% (adjusted) and 5.5%. Obviously, expectations at these levels would make it increasingly difficult to achieve the defined targets while, at the same time, possibly even generating demand for adoption of some sort of indexing mechanisms. It was only after the Copom meeting in May that expectations showed the first signs of downward movement in the face of the consistently austere monetary policy followed by economic authorities.

In the middle of the year, a more flexible approach to monetary policy was adopted when it became clear that much of the uncertainty that had marked the economy had been dissipated as expectations regarding inflation began converging toward the predefined targets. With the reversal of expectations, control of aggregate demand and exchange appreciation, the rate of inflation shifted into a downward curve, making it possible for Copom to initiate the process of gradually reducing the Selic rate to a December level of 16.5%. In August, the rate of compulsory reserves on demand resources was reduced to that in effect prior to the February increase.

In this regard, Brazilian economic activity in 2003 can be divided into two distinct phases. The first extended from January to the end of the first six months and was marked by an adverse macroeconomic scenario, coupled with adoption of the measures required to overcome these difficulties. These measures included cutbacks in internal demand, particularly involving investment flows, since these reflected high rates of interest and the evolution of expectations and consumption – both of which were further impacted by deterioration in the purchasing power of earnings.

With inflation under control, the uncertainties surrounding the economy were dissipated and the process of regaining the pace of economic activity began in earnest toward the end of the first six months of the year. The downturn in inflation, coupled with a tendency toward lesser losses in real earnings and improved expectations and, principally, a more flexible monetary policy, marked the start of more dynamic industrial output, retail sales and outlays on investments. Recovery in the activity level in the second half of the year followed the same pattern seen in more recent recoveries and was driven initially and most intensively by increased demand for consumer durables and capital goods.

The two distinct periods of economic performance in 2003 were evident in the trajectory of GDP. Thus, in the first two quarters of the year, GDP declined by 0.8% and 0.9%, respectively, when compared to the previous quarters and despite strong and steady growth in the crop/livestock sector. Among other factors, the third quarter of the year reflected adoption of greater monetary policy flexibility and the start of recovery in the level of activity, as demonstrated by 0.1% GDP growth compared to the previous quarter. The interest rate reduction had a positive

impact on the expectations of both businesspeople and consumers and generated repercussions on production levels. Growth in industrial output was sustained by incentives to demand, particularly involving consumer durables and capital goods, both of which are more sensitive to changes in credit conditions.

In the fourth quarter of the year, the continued downward movement in interest rates impacted consumption levels. This factor, combined with the performance of the export sector and growth in capital goods output, was the major cause of greater economic dynamism in the final months of the year. In the fourth quarter, growth closed at 1.5%, compared to the previous quarter, with expansion of 7.3% in the crop/livestock sector, 1.2% in the industrial sector and 0.8% under services.

A sectoral analysis of 2003 GDP clearly confirms the relevance of the crop/ livestock sector in sustaining the activity level. This sector registered growth of 5% – the third consecutive year with expansion in this range – basically as a result of productivity increases made possible by expanded use of inputs and farm equipment and machines.

With respect to economic activity in 2003, one should further underline the positive performance of the export sector which, after setting a new record in 2002, registered steady positive growth during all of 2003. In terms of supply, this growth was particularly evident in the crop/livestock sector and in such specific industrial segments as metallurgy, mechanics and cellulose.

The adjustment in the nation's external accounts over the course of the year aided in offsetting the impact of deteriorating external financing conditions in the second half of 2002. In 2003 and, principally, in the final six months of the year, international market conditions were particularly favorable to Brazil in a number of different aspects. Sharp growth in international liquidity was reflected in across-the-board expansion in the stock exchanges of the emerging nations, mostly as a result of low rates of interest in the United States. Having achieved relative exchange rate stability, the nation's terms of trade improved sharply over the course of the year. All of these factors were obviously important to the balance of payments result.

During this process of adjustment, expectations in relation to the external sector of the economy improved steadily, particularly as of the month of August when the country managed to set consecutive monthly foreign sales records, as evident in increasingly positive trade balance surpluses. Current accounts closed with a surplus of 0.82% of GDP, the third highest level in history, compared to deficits of 4.6% and 1.66% of GDP, in 2001 and 2002, respectively. Obviously, the surplus result made an important contribution to the financing of external accounts. Consolidation of this process greatly facilitated placements of sovereign bonds

with lower spreads, making it easier for resident companies to tap into external funding sources. At the same time, the nation managed to roll its long-term debt operations at a rate in excess of 100% in the year or more than double the 2002 rate. Consequently, the net flow of capital into the country was positive and was accompanied by a much more favorable maturity structure.

As evident in the relatively high level of economic activity at the end of the year, the positive performance of the economy in the second half of 2003 reflected growth in the volume of credit granted, stronger retail sales, expanding export operations and the recent evolution of real earnings, with positive impacts on sales of nondurable consumer goods, which is the major category of final industrial products.

With respect to credit operations, costs were a major factor in the growth registered under this heading. From June to December, the median rate on credit operations in the segment of nonearmarked resources declined by 10.9 p.p., reflecting reductions of 8.4 p.p. on loans with legal entities and 14.8 p.p. in operations with individual borrowers. The banking spread diminished by 3.2 p.p. in the period. In this context, the first signs of increased credit demand were noted as of September, as the volume of these operations moved into an upward curve. This movement was strongest under credits to individual borrowers, particularly consumer financing operations involving acquisitions of durable consumer goods, mainly involving vehicles.

As far as credits granted to legal entities are concerned, performance in the final months of 2003 had not yet reached a level that could be described as a consistent recovery in business demand for credit. Consequently, expectations are that growth in demand for investment financing will be gradual and will accompany recovery in economic activity in general.

Sales of the retail trade sector showed some signs of recovery in the third and fourth quarters, mostly as a result of increased credit flows. According to the IBGE, the volume of retail sales in the country declined by 3.7% in 2003, despite the fact that deseasonalized data point to recovery in the second half of the year and, principally, in the final quarter. A breakdown of the results on a category-by-category basis indicates negative annual rates under all of the activities surveyed and particularly under supermarkets, fuels and lubricants and fabrics, apparel and footwear.

The recent trajectory of Brazilian exports has benefited from a series of positive factors. Just as there were no major setbacks, such as harvest failures, on the internal scenario, the external framework was marked by factors that had the result of driving Brazilian sales upward, particularly increases in commodity prices,

growing exports to Argentina and penetration of new markets for the nation's goods. Here, it is important to note that measures taken in recent years to promote and stimulate the country's foreign sales have played a highly important role.

The real median habitual earnings of Brazilian workers declined by 12.6% in 2003, mostly as a result of sluggish economic activity in the first six months of the year. The second half, on the other hand, witnessed a process of relative recovery caused by lesser inflation and improvements in the economic scenario that made it possible for important professional categories to negotiate significantly better contracts.

However, it is important to stress that the factors underlying demand could be somewhat less dynamic in 2004, as the recently registered upturn in activity may well continue at a somewhat less intensive pace. It is important to note, however, that this process of less intensive growth following in the wake of the sharp initial upturn reflects a pattern that also occurred in previous recoveries.