II

Money and Credit

Monetary policy

Monetary policy implementation in 2004 was targeted at achieving the overriding objective of preserving the gains inherent to price stability. In this sense, monetary policy instruments were used in such a way as to ensure sustained product growth, within a framework of expanding internal economic activity and sharp upward movement in both international liquidity and commodity prices driven, in turn, by world economic growth.

At the start of the year, Copom decided to interrupt the process of a gradually less restrictive monetary policy begun in June of the previous year. This decision was based on major economic indicators suggesting that a more cautious monetary policy would have to be adopted in order to meet 2004 inflation targets. The basic interest rate target was maintained at 16.5% per year at the ordinary January and February Copom meetings.

Although the March and April meetings cut the basic interest rate by additional amounts of 0.25 p.p., partly as a result of the outlook for declining inflation, starting in the month of May Copom opted not to alter the basic interest rate of 16% p.p. for four consecutive months. This position reflected increased uncertainties regarding the future evolution of inflation; in an environment of changing expectations with respect to United States interest rates, intense oil market volatility and rising internal market demand.

Despite gradually rising interest rates in the United States, coupled with economic indicators that showed no risk of an accentuated rise in inflation, there was a clear process of progressive deterioration in the expectations of market agents regarding internal prices in 2004 and 2005. Among the factors that contributed to this scenario, it is important to mention oil market volatility, depreciation of the real in the second quarter and uncertainties surrounding the sustainability of the more intense pace of expanding economic activity since, despite renewed investments, growth in the Brazilian economy in 2004 has resulted in increasingly greater occupation of installed industrial output capacity.

Considering that expanding economic activity and increased use of installed industrial output capacity were not compatible with recovery in investments and that inflation projections pointed to a growing risk of noncompliance with the predetermined targets, Copom decided to initiate a gradual process of raising basic interest rates as of September. Thus, at the ordinary meeting held in that month, the Selic rate target was raised 0.25 p.p., followed by consecutive increases of 0.50 p.p. in the three subsequent meetings, to a level of 17.75% per year at the end of the year.

Credit market conditions reflected monetary policy, as the rates negotiated generally accompanied alterations in the basic interest rate. In the wake of the period of moderate growth early in the year caused by seasonal factors, the credit stock increased steadily and kept pace with steadily expanding economic activity. It is important to stress that the higher costs of credit operations as of September did not have a significant impact on the volume of new operations, primarily as a result of increased seasonal demand for credit in the final months of the year. Furthermore, steady downward movement in default rates reflected improved employment and income levels in the economy.

Loans to individual borrowers increased in 2004, mainly as a result of expanded personal credit operations. Among these, the most important were payroll loans which have lesser interest rates due to the implicit guarantee of repayment of these credits. In the corporate sector, the volume of credit operations backed by internal resources expanded sharply, in detriment to those based on external resources.

Federal public securities

The Selic rate trajectory in 2004 impacted demand for federal public securities. In the period from January to April, issues were concentrated in National Treasury Bills (LTN), preset papers that accounted for 85.4% of the total. This is clearly a reflection of expectations of continuation of the downward movement in basic interest rates that began in the second half of 2003. In the month of May and in June, considerable speculation regarding the impact of a turnaround in United States monetary policy on the Brazilian basic rate stimulated issues of Treasury Financing Bills (LFT). These papers, which are indexed to the Selic rate, accounted for 78.7% of that total, as against 13% in the case of LTN. From July to December, the participation of LFT in total issues came to 43.8%, compared to 53.4% for LTN.

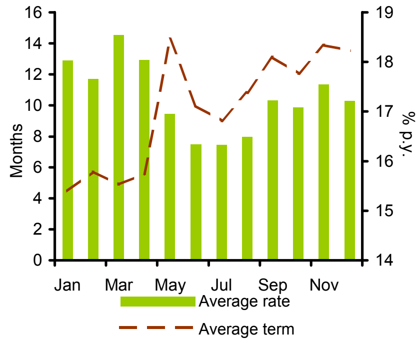
Consolidation of 2004 issues shows that LTN placements represented 57.6% of the total and LFT placements accounted for 37.4%. Issues of price-indexed papers, National Treasury Notes – Series B (NTN-B) and National Treasury Notes – Series C (NTN-C), which are indexed to the IPCA and to the General Price Index – Market (IGP-M), respectively, accounted for 4% of the papers auctioned, while National Treasury Notes – Series F (NTN-F), which are preset papers with intermediate financial flows (half-yearly coupons), registered 0.9%.

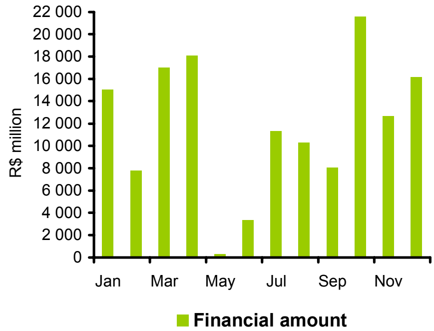
At the end of 2004, the participation of LFT in the total Internal Federal Public Securities Debt (DPMFi) came to 56.5%, while that of LTN reached 19.7%, and price-indexed securities accounted for 14.9%. In December of the previous year, these papers represented 60.6%, 12.5% and 13.6%, respectively.

Graph 2.1

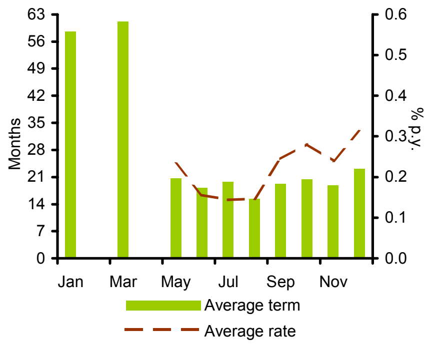
Auctions of federal public securities – 2004

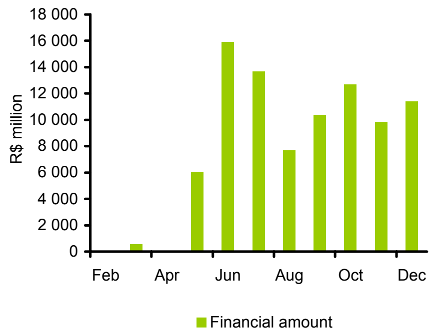
LTN





LFT





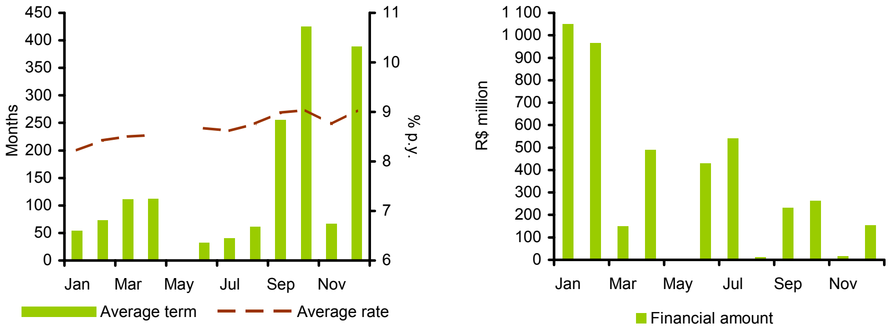
Lesser demand for exchange hedge in 2004 aided in reducing the level of internal public debt exchange exposure. In the three-month period extending from June to August, placements of exchange swaps totaled US$1.3 billion. In the year, the exchange turnover represented 5.1% of the principal maturing in the period, while redemptions came to US$25 billion. Consequently, considering derivative contracts, exchange exposure dropped from 22.1% in December 2003 to 9.9% in December 2004.

The average term of security issues dropped in 2004, primarily as a result of increased placements of preset papers and reductions in the maximum maturities of the LFT offered as of May from 1880 days to 1020 days. Thus, the average term of the public debt held by the public dropped from 31.3 months to 28.1 months. It is important to stress that, in September, for the very first time, the National Treasury placed NTN-B to mature in 2045 at a rate of 9.1% per year plus growth in the IPCA.

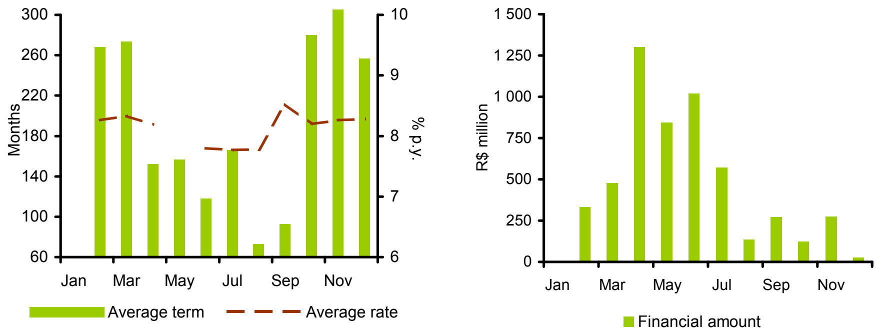
Graph 2.2

Auctions of federal public securities – 2004

NTN-B

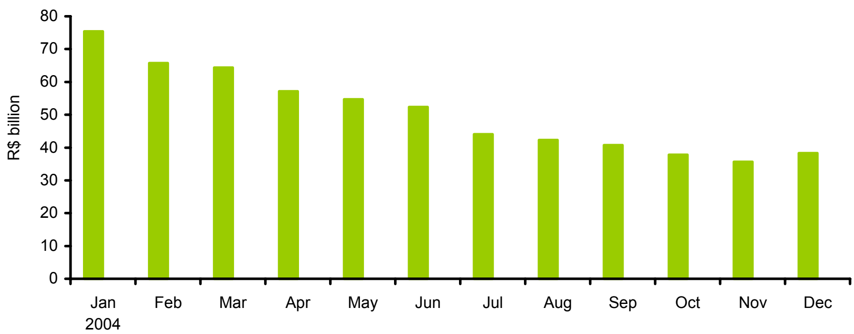


NTN-C



Graph 2.3

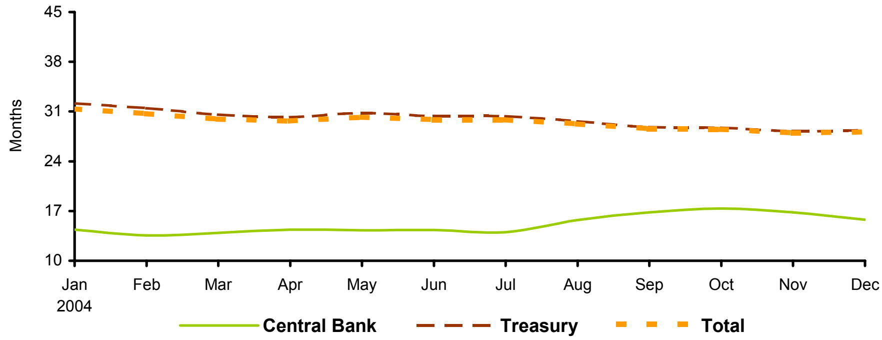
Balance of exchange-indexed swaps



The strategy of daily administration of financial system liquidity in order to hold the Selic rate within the parameters determined by Copom emphasized the importance of lengthening maturity terms. The operations carried out included three-month preset forward operations and postset repo operations in which maturity was lengthened from 14 to 28 days in September. Go around and leveling operations, aimed at daily adjustment of this excess, were contracted with terms ranging between one and four business days. In this way, BCB sought to obtain more effective control over the money supply by rolling excess liquidity through longer repo operations. In January, operations with maturities of more than 30 days accounted for 21.1% of the rollover operations. In December, this participation had risen to 71%.

Graph 2.4

Average term of the federal public securities debt



The liquidity position remained at a level similar to that in effect at the end of 2003, despite the expansionary pressures that occurred during the year. Thus, reflecting market purchases of dollars with the purpose of rebuilding the country's international reserve position, the daily average moved from R$56.2 billion in December 2003 to R$73 billion in January 2004. In July, the liquidity position moved to R$88.5 billion, primarily as a result of concentration of federal public security maturities. At the end of the year, this figure dropped to R$58 billion. This falloff was generated by seasonal monetary base expansion in December and the contractionary impact of public security operations on the primary market, together with adjustments in derivative operations brought about by devaluation of the dollar in the second half of the year.

Monetary aggregates

Above all else, the behavior of monetary aggregates in 2004 was caused by recovery in the pace of economic activity, as expanding aggregate demand stimulated a rapid rise in credit operations, as well as by a strong flow of external resources generated by the unprecedented trade balance surplus and foreign direct investments.

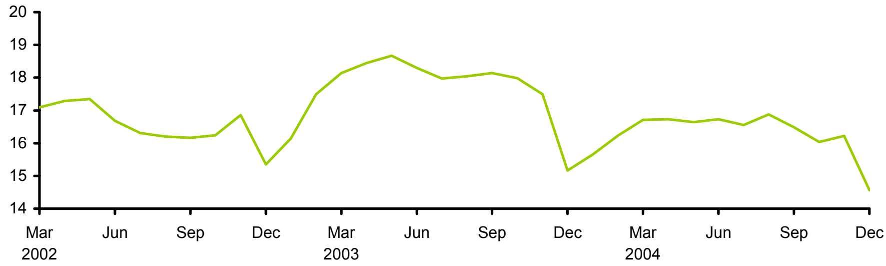
Another factor that deserves mention is Law 10,936, dated 8.12.2004, which extended the right to full one-time-only payment of monetary indexing of Employment Compensation Fund (FGTS) accounts, as specified in Law 110, 6.29.2001, to all account holders of sixty years of age or older and to all others, no matter what their age, when the value of the payment is equal to or less than R$100. This measure resulted in withdrawals of approximately R$3.2 billion by more than 630 thousand elderly people. Overall releases in the 2004 fiscal year came to a total of approximately R$11.2 billion, of which R$8.7 billion were effectively withdrawn.

Consequently, viewed in terms of the more restricted concept (M1), the average monthly money supply balance expanded 21.2% in the year, reaching a level of R$127.1 billion at the end of December. This growth was based on increases of 22.5% in the average balance of currency held by the public and 20.3% in the position of demand deposits. Reflecting these results, the income velocity of M1 components remained stable during the year, albeit at a level below 2003. Using seasonally adjusted data deflated by the IPCA, this monetary aggregate followed a steady upward curve, primarily as a result of consistent growth in economic activity and improved income and employment conditions.

In the concept of average daily balances, the monetary base totaled R$87.3 billion in December, registering 23.4% growth in the year. This result reflected expansion of 22.2% in currency issued and 26.3% in banking reserves.

Graph 2.5

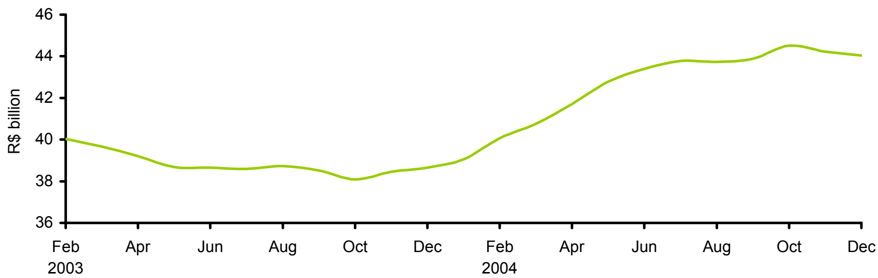
Money supply (M1) – Income velocity[1/]



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

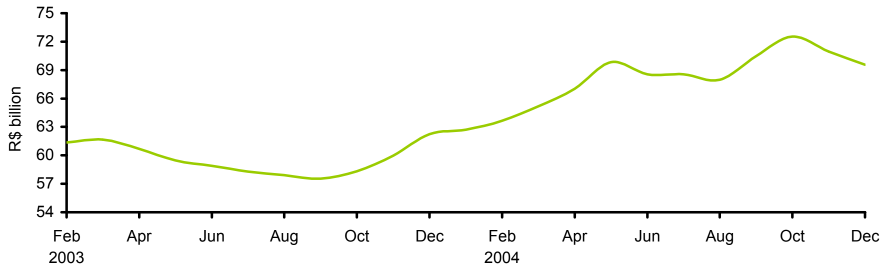
Graph 2.6

Currency outside banks – Seasonally adjusted at December 2004 prices[1/]



1/ Price index: IPCA.

Graph 2.7
Demand deposits – Seasonally adjusted at December 2004 prices[1/]



1/ Price index: IPCA.

With regard to the sources of primary currency issues, National Treasury operations – excluding security operations – were the major cause of monetary base contraction in the year, with a flow of R$48.3 billion. Here, one should highlight the tax inflow of R$302.2 billion, for growth of 17.7% compared to the previous year. Adjustments in derivative operations through exchange swaps generated contraction of R$6 billion. Aside from this, as determined by Resolution 3,109, dated 7.24.2003, inflows consequent upon insufficient investments in micro credit operations, an area in which compliance with minimum investment requirements was verified for the first time in August 2004, and deposits generated by the additional reserve on deposits and reserve requirements on the deposits of the Brazilian System of Savings and Loans (SBPE), came to a joint total of R$2.6 billion. Partially offsetting this result, external sector operations had an expansionary impact of R$14.6 billion, based on net sales of exchange on the interbank exchange market. With monetary base demand of R$15.5 billion in the year, the liquidity adjustment through net purchases of federal public securities came to a volume of R$57.8 billion.

BCB introduced alterations into reserve requirements on time deposits with the objective of equalizing competitive conditions among institutions of varying sizes, following a process of intervention in one banking institution. Consequently, Circular 3,262 was issued on 11.19.2004, determining that financial institutions would be obligated to deposit reserve requirements only on amounts in excess of R$300 million of total resources subject to reserve.

The broad monetary base, which includes the restricted base, compulsory reserves and federal public securities outside the BCB portfolio, closed the year at R$979.9 billion, for growth of 10.4% compared to 2003. On the one hand, this result reflected autonomous expansion consequent upon the updating of the federal securities debt on the market and, on the other hand, the contractionary impact of National Treasury operations, excluding security operations and adjustments in derivative operations.

Table 2.1 – Collection rate on mandatory reserves

Percentage

Period		Demand deposits[1/]	Time deposits[1/]	Savings deposits[1/]	Credit operations	FIF Short-term	FIF 30 days	FIF 60 days
Prior to Real Plan		50	-	15	-	-	-	-
1994	Jun[2/]	100 [2/]	20	20	-	-	-	-
	Aug	" [2/]	30	30	-	-	-	-
	Oct	" [2/]	"	"	15	-	-	-
	Dec	90 [2/]	27	"	"	-	-	-
1995	Apr	" [2/]	30	"	"	-	-	-
	May	" [2/]	"	"	12	-	-	-
	Jun	" [2/]	"	"	10	-	-	-
	Jul	83	"	"	"	35	10	5
	Aug	"	20	15	8	40	5	0
	Sep	"	"	"	5	"	"	"
	Nov	"	"	"	0	"	"	"
1996	Aug	82	"	"	"	42	"	"
	Sep	81	"	"	"	44	"	"
	Oct	80	"	"	"	46	"	"
	Nov	79	"	"	"	48	"	"
	Dec	78	"	"	"	50	"	"
1997	Jan	75	"	"	"	"	"	"
1999	Mar	"	30	"	"	"	"	"
	May	"	25	"	"	"	"	"
	Jul	"	20	"	"	"	"	"
	Aug	"	"	"	"	0	0	"
	Sep	"	10	"	"	"	"	"
	Oct	65	0	"	"	"	"	"
2000	Mar	55	"	"	"	"	"	"
	Jun	45	"	"	"	"	"	"
2001	Sep	"	10	"	"	"	"	"
2002	Jun	"	15	"	"	"	"	"
	Jul	"	"	20	"	"	"	"
2003	Feb	60	"	"	"	"	"	"
	Aug	45	"	"	"	"	"	"

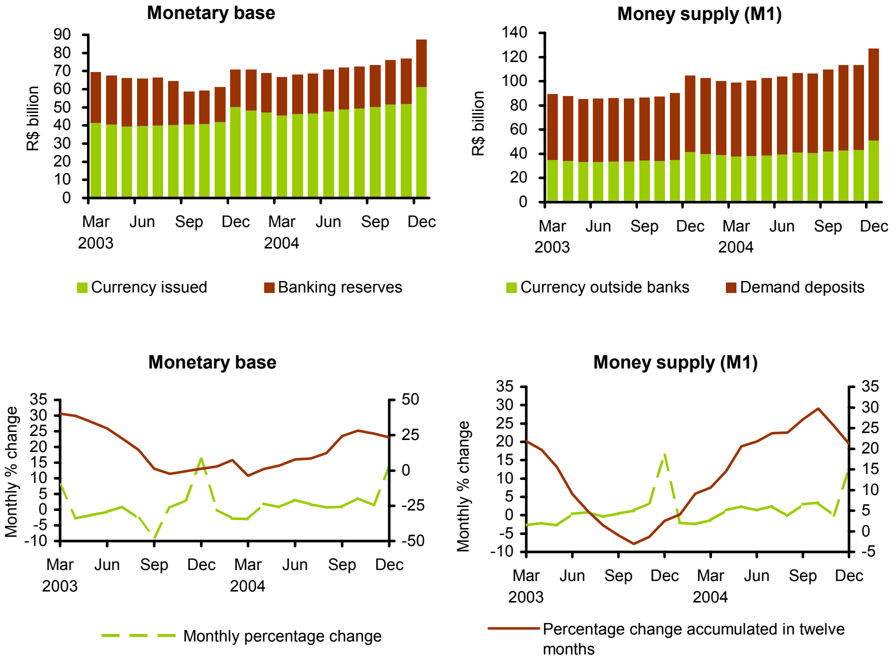
1/ As of August/2002, a new additional requirement on demand resources (3%), time deposits (3%) and savings deposits (5%) became effective. As of October/2002, rates for additional requirements on demand resources, time deposits and savings deposits moved to 8%, 8% and 10%, in that order.

2/ From June/1994 to June/1995 the 100% and the 90% rates refers to in addittional collection in relation to the base-period wich was calculated between June 23 and 30, 1994.
As of July 1995, the levying of compulsory deposits refers only to the arithmetic median of daily balances in each calculation period.

Graph 2.8

Monetary base and money supply (M1)

Average daily balances



The evolution of the broad money supply in 2004 was impacted principally by inflows of external resources and the expansionary nature of financial system credit operations. The M2 concept, which includes M1, savings deposits and securities issued by financial institutions, closed with growth of 19.5% in the year, led by 29.2% expansion in the balance of private securities. For the most part, this result reflected net inflows of R$21.7 billion in time deposits and R$4.3 billion in savings account deposits.

M3, which is composed of M2 plus fixed income fund quotas and the federal public securities used as backing for the net financing position in repo operations among the nonfinancial and financial sectors, rose 17.9% in the year. The M4 concept, which includes M3 and the public securities held by nonfinancial entities, increased 15.8% in the year, compared to 18.7% in 2003, reaching an end-2004 balance of R$1.1 trillion.

In line with the inflation target system and based on the expected performance of national income, interest rates, price indices and other similar indicators, the projections defined by monetary programming for the major monetary aggregates were fully complied with in 2004.

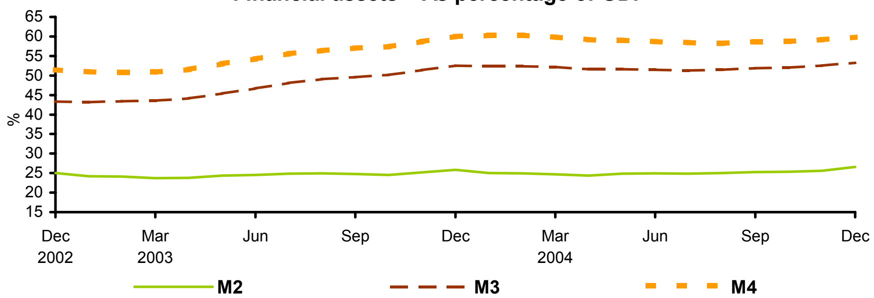
Table 2.2 – Financial assets

End-of-period balance R$ billion

Period		M1	M2	M3	M4
2003	Jan	92.5	388.5	693.3	818.1
	Feb	91.0	391.1	703.9	823.5
	Mar	87.1	385.2	707.8	827.4
	Apr	84.5	382.3	709.6	829.3
	May	83.3	385.4	718.2	839.3
	Jun	85.6	383.2	728.4	846.3
	Jul	84.3	385.7	746.0	862.7
	Aug	84.3	387.6	762.9	877.0
	Sep	85.4	388.1	775.9	893.4
	Oct	85.5	386.0	787.8	902.4
	Nov	92.1	398.4	811.6	927.6
	Dec	109.6	412.9	838.4	958.5
2004	Jan	98.1	405.1	847.2	973.3
	Feb	99.5	408.1	857.0	986.6
	Mar	97.7	409.8	867.1	995.0
	Apr	97.9	411.0	872.3	999.7
	May	101.3	427.8	886.9	1 014.7
	Jun	102.5	436.5	899.6	1 025.9
	Jul	103.2	441.9	910.4	1 037.4
	Aug	105.8	450.2	924.7	1 047.5
	Sep	109.9	457.3	939.0	1 062.1
	Oct	109.8	463.0	948.9	1 071.2
	Nov	113.4	470.8	966.5	1 088.7
	Dec	127.9	493.5	988.6	1 109.5

Graph 2.9

Financial assets – As percentage of GDP[1/]



1/ Last twelve month GDP at prices of indicated month (deflator: centered IGP-DI) based on the series released by IBGE.

Table 2.3 – Monetary program

R$ billion

Itemization		Restricted monetary base			Expanded monetary base		
		Minimum	Maximum	Confirmed	Minimum	Maximum	Confirmed
2003	1st quarter	56.4	76.3	69.3	697.3	943.4	810.2
	2nd quarter	62.3	84.3	65.7	716.4	969.2	804.5
	3rd quarter	60.6	82.0	58.9 [1/]	724.3	979.9	847.3
	4th quarter	60.1	81.3	70.8	750.7	1 015.6	886.9
2004	1st quarter	55.7	75.4	66.8	767.4	1 038.3	916.8
	2nd quarter	58.5	79.2	70.8	800.1	1 082.5	936.3
	3rd quarter	63.2	85.4	73.2	825.4	1 116.8	950.4
	4th quarter	73.6	99.6	87.3	880.0	1 190.6	979.2

(continues)

Table 2.3 – Monetary program (concluded)

R$ billion

Itemization		Money supply (M1)			Money supply broader concept (M4)		
		Minimum	Maximum	Confirmed	Minimum	Maximum	Confirmed
2003	1st quarter	83.9	113.5	89.4	719.5	973.5	827.4
	2nd quarter	81.4	110.2	85.4	749.7	1 014.3	846.3
	3rd quarter	84.4	99.0	86.1	756.4	1 023.5	893.4
	4th quarter	85.4	115.5	104.9	796.7	1 077.9	958.5
2004	1st quarter	81.1	109.7	98.9	823.8	1 114.5	995.0
	2nd quarter	85.8	116.1	104.0	876.0	1 185.1	1 025.9
	3rd quarter	94.4	127.7	109.5	908.1	1 228.6	1 062.1
	4th quarter	108.7	147.0	127.1	954.2	1 291.0	1 109.5

1/ Change inferior issuing limits, which have been altered according to the National Monetary Council authorization in 9.25.2003.

Financial system credit operations

Credit expansion was generated by increased demand for resources for consumption and investment purposes and was concentrated in portfolios referenced to nonearmarked resources. Credit growth was more significant in financing contracted with individual persons, particularly personal credit operations and, more specifically, payroll loans. In this sense, it should be stressed that growth in payroll loans has contributed significantly to improvement in the profile of household indebtedness, with longer maturities and lower lending rates.

In December 2004, the overall volume of financial system credits reached R$485 billion, for annual growth of 17.9%, corresponding to 26.2% of GDP as against 25.8% in 2003. Loans granted by the private financial system increased 19.9%, totaling R$293.3 billion, concentrated mainly in operations with individual persons and the sector of commerce.

Financing operations by public sector banks added up to R$191.7 billion, for growth of 15% in the year. In this case, the highlights of the year were operations with individual persons and the segments of other services and rural operations.

Table 2.4 – Balance of credit operations

Itemization	2002 Dec	2003 Dec	2004 Dec	R$ billion Growth (%) 2003
Total	379.5	411.4	485.0	17.9
Nonearmarked	212.4	224.2	271.4	21.0
Corporations	136.3	136.1	158.1	16.2
Ref. to exchange	57.2	48.0	46.2	-3.7
Individuals	76.2	88.1	113.3	28.6
Earmarked	144.1	163.1	180.4	10.6
Housing	21.6	23.1	24.3	4.9
Rural	34.7	44.9	55.3	23.3
BNDES	84.7	91.1	97.2	6.7
Others	3.1	4.1	3.6	-10.9
Leasing	9.5	9.1	14.0	55.0
Public sector	13.5	15.0	19.2	28.2
% participation:				
Total/GDP	23.9	25.8	26.2	
Nonearmarked/GDP	13.4	14.0	14.7	
Earmarked/GDP	9.1	10.2	9.8	

The stock of credits based on earmarked resources totaled R$180.4 billion in 2004, for growth of 10.6% in the year. For the most part, this performance reflected an increase of 23.3% in financing granted to the crop/livestock sector, as a result of releases of resources for investments and current outlays in the 2004/ 2005 harvest. BNDES system operations totaled R$97.2 billion in December, for growth of 6.7% in the period. These results were somewhat attenuated by securitization of electricity sector debts, as well as by exchange appreciation in contracts referenced to foreign currency.

In 2004, disbursements by the BNDES system totaled R$39.8 billion, with growth of 18.8% in the year. This growth was driven partly by improved expectations regarding the macroeconomic environment, as reflected in rising credit demand for investment purposes. Among the most important of these was the 33.3% rise in releases to the segment of services, primarily for investment in the energy and land transportation infrastructure. In the crop/livestock sector, operations contracted totaled R$6.9 billion, for annual growth of 50.8%, primarily as a consequence of continued sales of farm machinery and implements. Credits granted to the industrial sector, however, declined

1.9% in the period, closing at R$15.8 billion. One should also stress that 32% of disbursements, in a total amount of R$12.6 billion, were targeted to micro, small and medium businesses, reflecting an increase of 25.5% over the 2003 figure.

Table 2.5 – BNDES disbursements

R$ million

Itemization	Jan-Dec		Growth
	2003	2004	(%)
Total	33 534	39 834	18.8
Industry	16 094	15 782	-1.9
Other transport equipment[1/]	5 755	5 963	3.6
Food and drink products	1 981	1 888	-4.7
Cellulose and paper	430	1 052	144.7
Motor vehicles	2 651	2 568	-3.1
Basic metallurgy	997	741	-25.7
Commerce/Services	12 844	17 122	33.3
Electricity, gas and hot Water	5 166	6 663	29.0
Commerce and reparition	807	1 218	50.9
Land transport	2 862	4 499	57.2
Mail and telecommunications	252	1 645	552.8
Farming	4 595	6 930	50.8

Source: BNDES

1/ It includes aircraft industry.

Consultations with BNDES, the preliminary stage of medium and long-term financing operations, came to R$98.4 billion in 2004, against R$44.6 billion in the previous year. This performance was consistent with positive expectations regarding new investments and the increasingly more intense effort to expand output capacity. On a sector-by-sector basis, requests from the industrial sector totaled R$52.2 billion, with growth of 141% in the year, generated by greater demand on the part of the segments of metallurgy, air transportation and vehicles. Requests put forward by the service sector expanded 127%, reaching R$38.1 billion, concentrated primarily under electricity and gas and construction. Consultations involving the crop/livestock sector added up to R$8.1 billion, 33.4% more than in 2003.

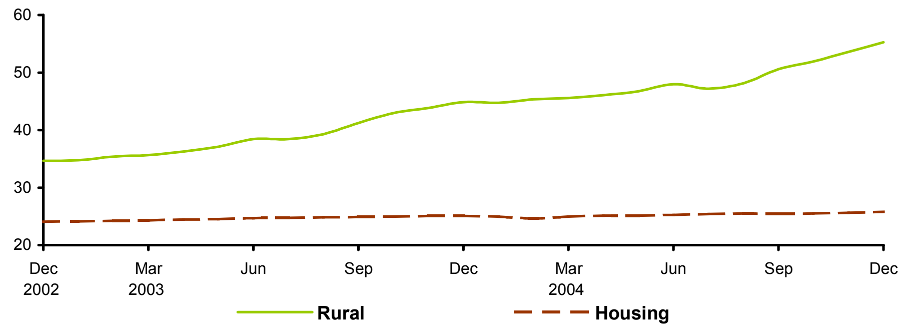
The balance of credit operations with the private sector totaled R$465.8 billion in 2004, representing annual growth of 17.5%. Credits channeled into business activities were driven by 26.3% annual growth in loans to commerce, totaling R$54.7 billion. Among these operations, the most important were those channeled to supermarkets, food and beverage industries and the automotive sector. Credits to the segment of other services closed at R$79.4 billion, representing an increase of 10.5%. Here, the highlights were disbursements to electricity companies, transportation and communications firms. Loans to industry closed at R$124.9 billion for growth of 6.9% in the year, concentrated mainly in the aircraft, automotive and energy sectors.

With respect to the credit market, mention should also be made of measures taken by the government to stimulate micro credit operations. Among these, it is important to highlight implementation of the National Targeted Productive Microcredits Program (PNMPO) which, aside from fostering inclusion of the banking sector, is also targeted at generating jobs and income among individuals and corporate entities responsible for small scale productive activities. This operational modality, which creates a direct relationship between the credit agent and the microentrepreneur at the place of the latter's activity, levies interest rates of up to 2% per year in direct operations and up to 4% per year in operations channeled through Civil Society and Public Interest Organizations (Oscip). It is important to mention that, at the core of this measure, was repeal of the maximum limit of R$1,000.00 per client, while the CMN was given responsibility for defining the maximum value of these operations among those carried out by banking institutions.

Financing granted to the crop/livestock sector continued the performance noted since 2002, with a total amount of R$55.3 billion in 2004, for growth of 23.3% over the previous year. Current expenditure operations closed at R$24.9 billion, with 80% involving obligatory investments. The share corresponding to agricultural investments added up to R$28.6 billion, of which funding in government programs backed 83.6%. In the Moderfrota framework, disbursements moved from R$1.8 billion in 2003 to R$2.4 billion in 2004.

The volume of housing credits, including both nonearmarked and earmarked resources, expanded 2.9% in 2004, reaching a total of R$25.8 billion. With respect to disbursements, releases of funding from savings accounts, the major source used by the segment, expanded 26.9% in the year and closed at R$3 billion, channeled basically into real estate acquisitions. Contracts at rates defined by Housing Finance System (SFH) rules came to R$2.7 billion, 89.7% of the total, with the remainder being financed at market rates.

Graph 2.10
Balance of rural and housing credit
R$ billion



In 2004, the public sector debt increased 28.2%, reaching R$19.2 billion. Operations contracted by states and municipalities totaled R$14.2 billion, for growth of 38.2% due primarily to releases of financing to electricity sector companies, as part of the program aimed at expanding the energy supply as defined in Law 10,438, dated 4.26.2002, and to urban transportation infrastructure. Loans to the federal government increased 6.4% to R$5 billion.

The portfolio of leasing operations increased 55% in the year to a total of R$14 billion. Operations with individual persons accounted for 26.9% of the portfolio, compared to 12.9% in 2003. Disbursements moved from R$6 billion in 2003 to R$12.8 billion, mainly involving auto loans and financing of machines and equipment.

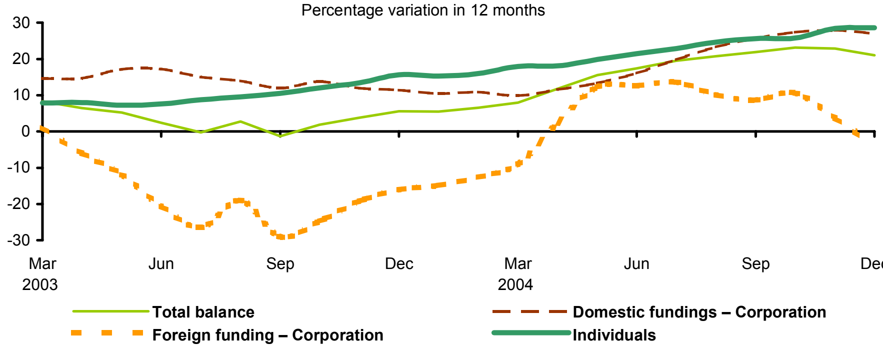
The stock of credits based on nonearmarked resources totaled R$271.4 billion, for growth of 21% in the year, the highest level since 2001. The balance of loans to individual persons increased 28.6%, rising to a total of R$113.3 billion. These operations were concentrated primarily in personal credit operations, reflecting sharp growth in payroll loans. Furthermore, one should emphasize growth in the financing of goods including both vehicles and other goods. This expansion became possible with lesser rates of interest in the first half of the year and growing income and employment in the second half.

The balance of credit operations with corporate entities increased 16.2% in the year, closing at R$158.1 billion. Of this total, R$111.9 billion referred to operations backed by internal resources with growth of 27% generated by the upturn in the level of economic activity. The balance of operations based on external resources totaled R$46.2 billion, with annual growth of 3.7%, powered primarily by excellent liquidity conditions on the international market, making it possible for companies to contract funding directly at the source. Another positive factor was exchange appreciation in the second half of 2004, encouraging anticipated settlement of debts.

Graph 2.11

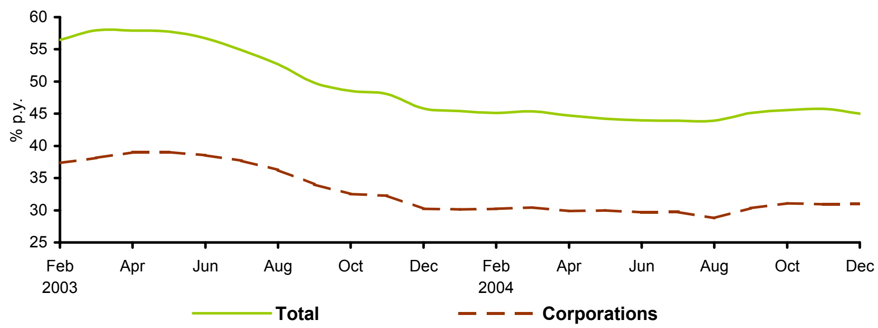
Growth of credit with nonearmarked resources

Percentage variation in 12 months



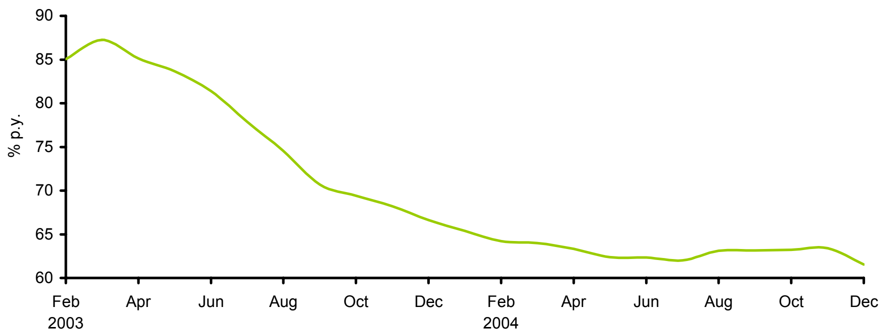
Interest rates on credit operations backed by nonearmarked resources turned in sharply different performances during the year, reflecting the alterations introduced into monetary policy. Consequently, in the first half, the average rate continued the gradual process of decline begun in 2003, closing August at 43.9% per year, corresponding to a drop of 1.9 p.p. compared to December of the previous year. Starting in September, the costs of bank loans accompanied upward movement in basic interest rates, shifting to 45% per year in December, though this figure was still 0.8 p.p. below December of the previous year.

Graph 2.12
Interest rates of credit operations with nonearmarked resources



The average rate on operations with individual persons, which are normally contracted at preset rates, reached 61.5% per year in December, corresponding to a reduction of 5.1 p.p. in the year. For the most part, this result reflected the larger volume of payroll loans. Average interest on this modality closed December at 39.2% per year, contributing to a 9.5 p.p. decline in the rates on personal credit operations to 70.8% in December.

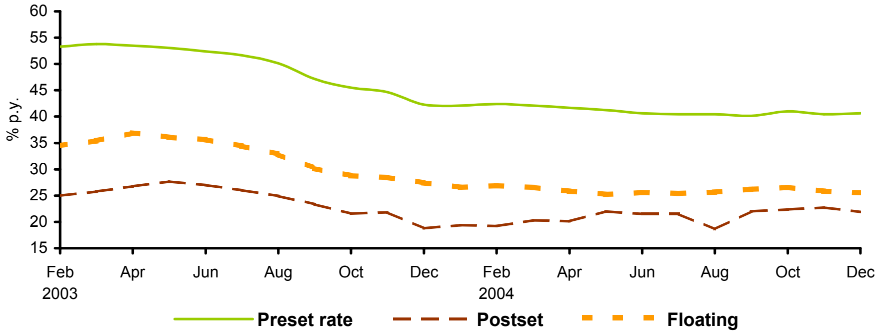
Graph 2.13
Interest rates of credit operations – Individuals



In the segment of corporate entities, average interest expanded 0.8 p.p. in 2004, closing December at 31% per year. This increase reflected a rise of 3.1 p.p. in the average rate on postset contracts, which closed at 21.9% per year, and reductions of 1.9 p.p. in the rates on operations with floating interest referenced to the rate on Interbank Certificates of Deposit and 1.7 p.p. in preset contracts, closing at 25.5% per year and 40.7% per year, respectively.

Graph 2.14

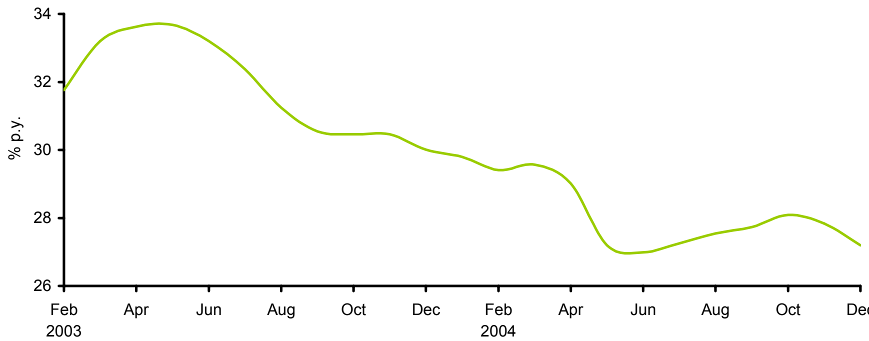
Interest rates of credit operations – Corporations



In credit operations based on nonearmarked resources, the banking spread accompanied lending rates, reaching 27 p.p. in June, the lowest level since June 2002, and moving steadily upward in the subsequent months. In December 2004, the spread came to 27.2 p.p., reflecting a reduction of 2.8 p.p. compared to December of the preceding year. At the same time, another factor that contributed to this result was the ongoing effort to reduce banking spreads as a result of measures taken in 2003. These measures included, among others, introduction of the system of payroll loans, programs aimed at attracting the low income population into the banking system and creation of investment accounts.

Graph 2.15

Spread of credit operations with nonearmarked resources

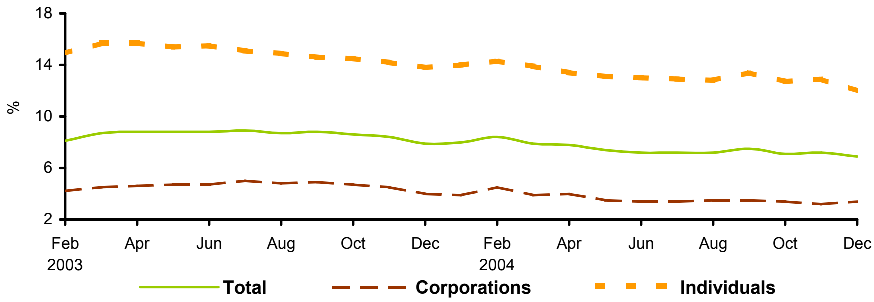


The average maturity of the credit portfolio based on nonearmarked resources closed December 2004 at 233 days, corresponding to an increase of thirteen days compared to December 2003. In the segment of corporate entities, the average term increased nineteen days, closing at 189 days, while operations with individual persons remained stable at 296 days. In this segment, it is important to emphasize the increase of 47 days in the average terms of personal loans to a total of 273 days, mainly reflecting the growing importance of payroll loans.

Following a seasonal high in the first quarter of the year, defaults on credit operations with nonearmarked resources moved downward during the course of the year. The percentage of arrears of more than fifteen days dropped 1 p.p., closing at 6.9% in December 2004, the lowest level in the history of this statistical series. The underlying causes of this performance were reductions of 1.8 p.p. in loans to individual borrowers and 0.6 p.p. in operations with corporate entities, which closed at respective levels of 12% and 3.4%.

Graph 2.16

Default rate of credit operations with nonearmarked resources[1/]

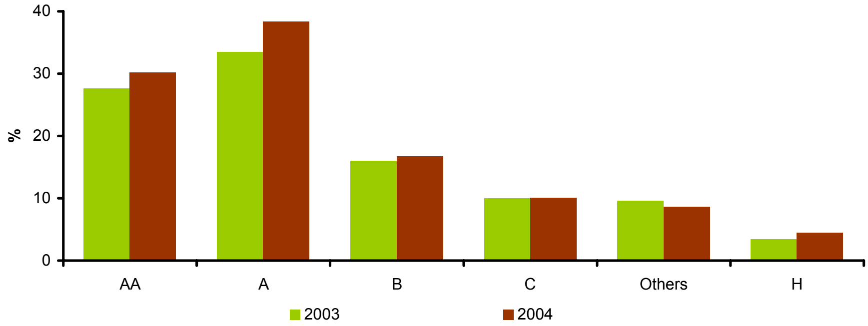


1/ Portifolio's percentage share in arrears of more than 15 days.

As reflected in lower default levels, the positive conditions that characterized the credit market in 2004 resulted in higher quality financial system loan portfolios, when viewed under the prism of risk levels. In this sense, the participation of operations classified as normal risk (levels AA to C) in the overall credit portfolio increased from 88% in December 2003 to 89.6% in December 2004. In the opposite direction, loans registered as risk level 1 (D to G) and risk level 2 (H), which requires full provisioning, declined from 7.9% and 4.1% to 7.2% and 3.2%, respectively, on the same dates.

Provisions set aside by the financial system totaled R$29.8 billion in December 2004, reflecting an annual decline of 0.3%. This volume corresponded to 6.2% of total credits, as against 7.3% in December 2003. The provisions set aside by private institutions diminished 2.3% while those reserved by the public financial system increased 2.1% in the period.

Graph 2.17
Financial system credit operations by risk level – December



National Financial System (SFN)

The evolution of the National Financial System clearly evinces the more flexible approach taken to the rules applicable to financial instruments and institutions, as well as an increasingly greater degree of adaptation to international rules. This became possible within the framework of the new Payments System, which has made it possible to enhance risk management by the system itself, while increasing the efficiency of intermediation activity. At the same time, the processes of stockholding acquisitions and reorganization demonstrate the need for adjusting the credit supply system in a scenario of sustained economic expansion.

With regard to controlling the risks to which financial institutions are subject, BCB issued Communiqué 12,746 in December 2004, announcing the procedures to be followed in implementing the new Basel Accord (Basel 2), based on a proposal recently put forward by the Bank for International Settlements (BIS). Compared to the previous Accord adopted by Brazil in August 1994, Basel 2 stresses procedures for banks that operate internationally, suggesting adoption of capital requirements based on the ratings released by external credit risk ratings agencies. Furthermore, the new Accord sets out capital requirements not only for credit risk and market risk, but also for operational risk, encourages the use of credit risk reduction techniques and increases the responsibility of supervisors in analyzing the internal assessment models utilized by banks.

The Communiqué mentioned above determines that ratings announced by external agencies will not be utilized in calculating capital for coverage of credit risks. In this case, the standard simplified approach is to be applied to the majority of financial institutions. This approach involves improvement of the current system, which is based on assets weighted by risk, while seeking to incorporate instruments that mitigate such risks. With regard to larger scale institutions that operate on the international market, they will be allowed to utilize the advanced approach based on an internal risk classification system to be evaluated by BCB. For implementation of the new Accord, a phased in planning process was defined that will begin in 2005 and is scheduled to be concluded in 2011.

Continuing in the context of evaluating asset quality, recent years have witnessed introduction of new risk mitigation instruments, such as earmarked credits and credit derivatives, at the same time in which clearance and settlement houses have improved risk management systems, within the framework of the new Payments System. These changes indicate that the National Financial System has already been preparing itself to adjust to the new Basel Accord which, contrary to the previous Accord, now recognizes the question of risk guarantees and transfers related to asset operations.

In keeping with the evolution of the risk monitoring process by the new Payments System, restricted repo operations were authorized involving any fixed income security. In these operations, the buyer of securities in a repo operation may effect definitive sale of the papers, maintaining the resale commitment with other securities. Previously, these operations were permitted only with papers issued by the National Treasury or BCB. However, in order to make it possible to use the other securities, operations must be registered and settled in financial terms within the same clearing house or clearing and settlement service, which then acts as the contracting party for purposes of settlement of the operations they have mediated.

Aside from this, as of the month of May, security exchanges and loans were permitted. In this sense, financial institutions may borrow securities, as well as exchange and lend securities that are part of their respective portfolios, in operations that have financial settlement through a clearinghouse or clearing and settlement service provider. These operations can be carried out with individual persons and corporate entities that may or may not be part of the National Financial System, thus enhancing the liquidity and dynamism of the secondary public and private securities market since it makes operations without coverage possible with the guarantees given by the clearinghouses.

Also in the context of prudential regulation, Circular 3,229 was issued in March 2004, permitting changes in the methodology used for calculating exposure in gold, foreign currencies and assets and liabilities subject to exchange variations, utilized in calculating the Basel ratio. Should the financial Institution opt to offset contrary positions in different currencies, it will be allowed to include gold on the list of currencies considered as a whole in calculating exchange, in such a way as to incorporate the effect of diversification on the calculation of the capital required to cover market risk.

With respect to improvement of the internal controls used by financial institutions, the BCB has altered the rules that define obligatory implementation of the audit committee, following examination of the cost-benefit relation involved in implementing this committee in smaller scale institutions. The committee is to act as an adviser to the senior management of the institution and has as its principal tasks evaluation of the effectiveness of independent and internal audits, while verifying compliance with the recommendations put forward by the auditors. Thus, implementation of the committee is now obligatory at those institutions that registered base capital equal to or greater than R$1 billion in the last two fiscal years. This represented a significant change in relation to the previous limit that was equal to or greater than R$200 million.

Going on to the criteria used in evaluating financial instruments, the various types of securities have been registered in three categories since April 2002: securities for trading, securities available for sale, both of which are evaluated at market value, and securities maintained in portfolio until maturity, which are evaluated at acquisition cost plus earnings. Once securities have been classified among those to be maintained until maturity, transfers to other categories are only permitted at the time of half-yearly balance sheets. In the December 2004 position, 70.9% of the National Financial System portfolio was designated as evaluated at market value.

With the objective of lengthening the public debt profile, permission was granted to sell federal securities classified in the category “held to maturity”, without in any way altering the intention of the financial institutions when they classified such securities, provided that transfer occur simultaneously with the purchase of new securities of the same nature in an amount equal to or greater than those sold, but with longer maturities.

As far as the new institutional modalities are concerned, formation of commercial banks under the direct stock control of the commodities and futures exchange was permitted. These banks will restrict their operations to contracting and investing resources, acting exclusively as central liquidator and custodian, providing services to the exchange and to the economic agents involved in operations on financial, physical and futures asset markets. Among their responsibilities, it is important to cite centralization of the accounts of clients participating in the market, reception of guarantees and settlement of operations. The authorization given to create such banks will allow for greater centralization of these operations, minimization of the risks implicit in the participation of a larger number of intermediating entities.

In the micro credit segment, one should highlight the adaptation of credit cooperatives to the new model defined as of the second half of 2003. Several projects were submitted to BCB requesting transformation of already existent restricted membership cooperatives into free membership cooperatives. A comparison with the banking segment shows that the participation of credit cooperatives expanded in the past year, thus creating greater possibilities of access to credit. In December 2004, credit operations contracted with these institutions reached 2.4% of the total National Financial System credit balance, as compared to 2.2% in 2003 and 1.8% in December 2002.

In the context of banking supervision, the year was marked by decrees imposing special administrative systems on seven institutions, with extrajudicial liquidation of four group buyer administration entities and one credit cooperative, as well as interventions in the Banco Santos and in an exchange brokerage company belonging to the same group. In

December 2004, 85 institutions including 17 banks remained subject to special systems of administration.

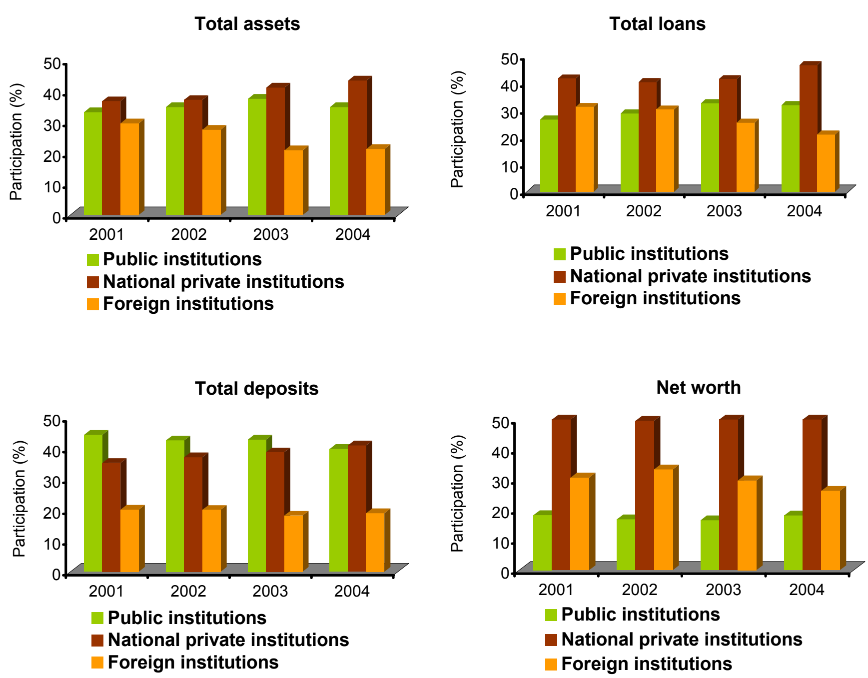
With regard to transfers of stock control, acquisitions in the year revealed a strategy aimed at obtaining the scale required to operate on the retail segment, above all on the part of private national banks. Consequently, in the first half of the year, Banco Bradesco acquired control of Banco Zogbi, thus ensuring itself of increased participation in the personal credit segment, and Banco ABN Amro acquired control of Banco Sudameris Brasil. In the second half of the year, Unibanco acquired control of Banco BNL do Brasil, which had previously been controlled by foreign capital.

The participation of foreign banks in total banking system assets remained relatively stable in the year, moving from 21% in December 2003 to 21.4% at the end of 2004, while the participation of private national banks moved from 41.3% to 43.6% in the same period.

It should be stressed that the reduction in foreign capital participation in banking system assets in recent years does not reflect withdrawal of this capital from the system, but rather processes of stockholding reorganization, in which foreign capital has opted no longer to control specific institutions, but rather to become minority stockholders in national groups.

Graph 2.18

Banking System – Participation by segment[1/]



1/ Consider only banking institutions, not consolidated by conglomerates.