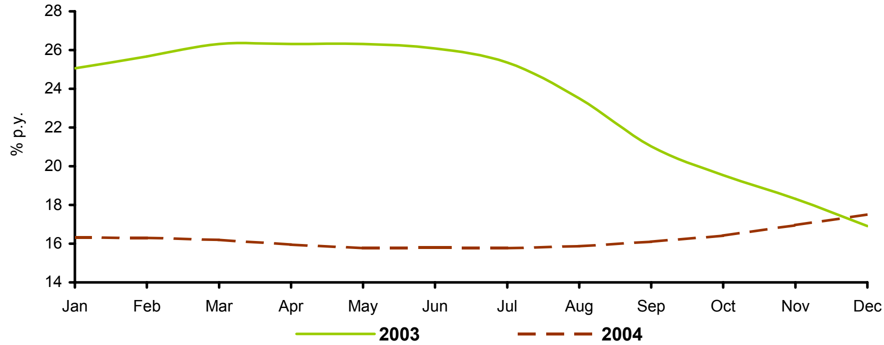
III

Capital and Financial Markets

Basic interest rate and market expectations

As of September 2004, Copom adopted a more restrictive monetary policy stance. Though it represented a reversal of the successive interest rate reductions adopted since mid-2003 and further intensified in the second half of that year, when the target for the basic interest rate dropped 10 p.p. to 16.5% per year in December, compared to 26.5% per year in June, adoption of the strategy of gradually raising rates was clearly the most appropriate option for preserving price stability in an environment characterized by rapidly expanding internal economic activity.

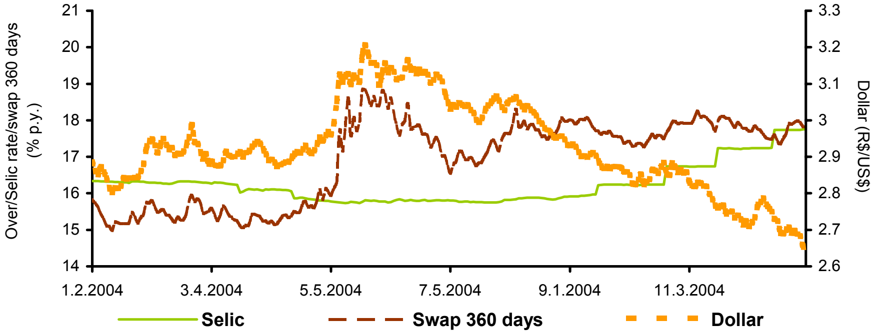
Graph 3.1
Over/Selic rate



At the start of the year, the perception that inflation could exceed the targets for 2004 and 2005 led Copom to adopt a more conservative monetary policy. This decision became clear when it decided to hold the basic interest rate at 16.5% per year in January and February. In the following two months, lesser exchange and interest rate market volatility, coupled with downward movement in the country risk level, resulted in consecutive 0.25 p.p. cutbacks in the Selic rate target. Keeping pace with the trajectory of basic interest rates, 360-day DI swap X pre contracts registered successive downturns in their interest curves, closing the first half of the year at 17% per year.

Graph 3.2

Over/Selic rate x dollar x swap 360 days

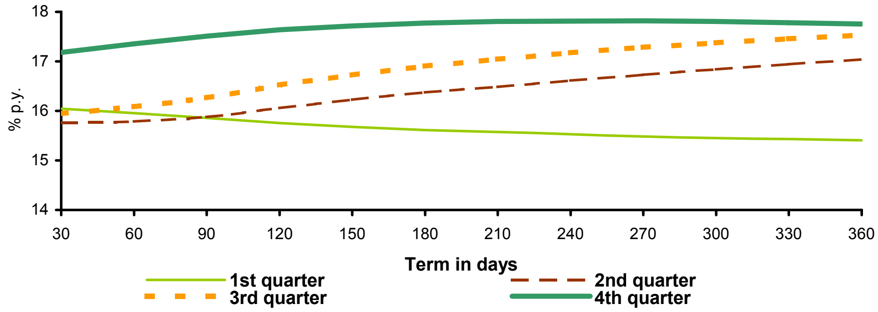


In the four following Copom meetings, it was decided to hold the basic rate at 16% per year. Subsequently, in response to deteriorating expectations regarding the possibility of compliance with predetermined inflation targets, BCB initiated a process of moderate monetary policy adjustments, gradually raising the Selic rate target by a cumulative total of 1.75 p.p. by December. In this context, 360-day DI swap x pre contracts closed the year at 17.8% per year, corresponding to a high of 1.95 p.p. over the rate in effect at the end of 2003.

Graph 3.3

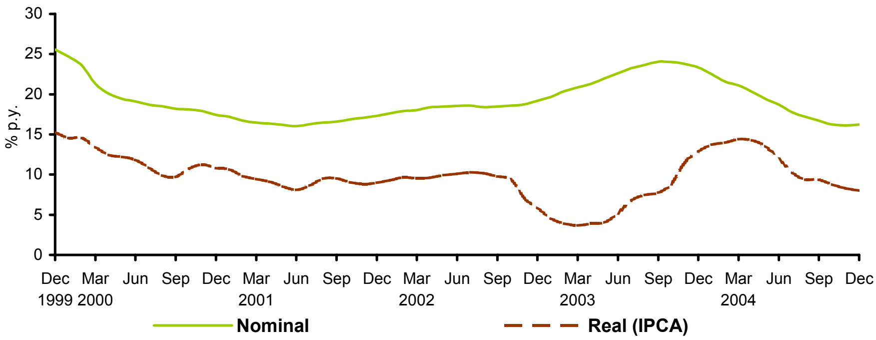
Yield curve – Swap DI x Preset

Quarterly average



Graph 3.4

Over/Selic rate accumulated in 12 months



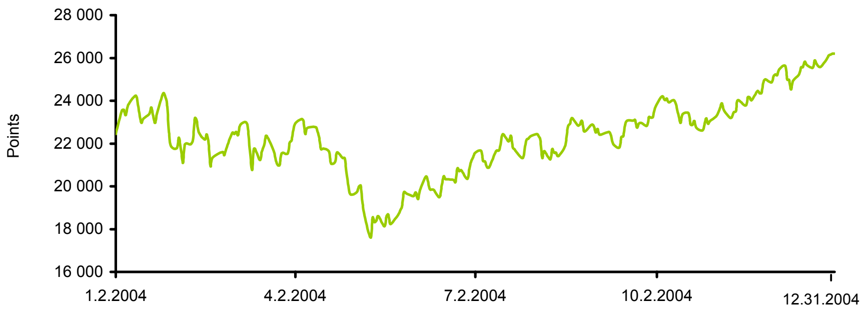
Taking due account of market expectations for inflation and the Selic rate in the coming twelve months, the real ex-ante December 2004 rate closed at 9.6% per year, as against 8.4% in the same month of the previous year. Deflated by the IPCA, the cumulative Selic rate hit 8%.

Capital market

The São Paulo Stock Exchange Index (Ibovespa) followed a downward curve in the early months of the year, registering a cumulative nominal decline of 12.1% through May compared to the final December 2003 figure. This performance, which matched what occurred in American exchanges, was generated by increased international and domestic market volatility caused by the situation in the Middle East, escalating oil prices and uncertainties surrounding the evolution of United States interest rates.

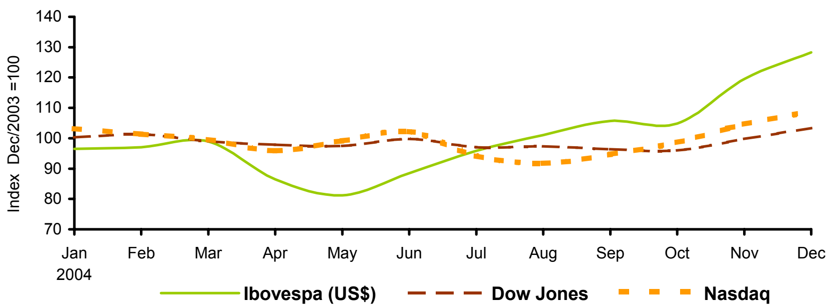
Beginning in May, however, the Ibovespa turned upward in a context of declining international market uncertainties and positive evolution in the major fundamentals of the Brazilian economy, moving to a high of 17.8% in the year and a new end-December record of 26,196 points. In dollar terms, the São Paulo Stock Exchange (Bovespa) showed

Graph 3.5
Ibovespa



Source: Broadcast

Graph 3.6
Ibovespa x Dow Jones x Nasdaq



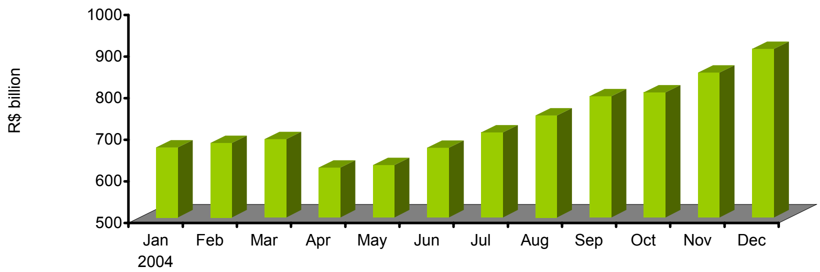
Source: Broadcast

even better results, with growth of 28.2% in the year, surpassing the position of the American exchanges, which only began recovering in November. In this sense, the Dow Jones and National Association of Securities Dealers Automated Quotations (Nasdaq) indices registered annual gains of 3.3% and 8.7%, respectively.

Expanding internal economic activity impacted business profits and resulted in improved expectations regarding the future evolution of stock prices. This scenario, coupled with an ongoing pursuit of new alternatives by international investors, generated net inflows of external resources to Bovespa in the amount of approximately R$ 1.8 billion. At the same time, average daily trading expanded to a total of 53,751 operations in 2004, 35.7% more than in the preceding year. Total trading volume reached R$ 304.1 billion, corresponding to annual growth of 48.6% concentrated primarily in the final months of the year.

At the end of 2004, the market value of the companies listed on the Brazilian exchange came to R$ 904.9 billion, for growth of 33.7% over the December 2003 figure. Here, Ibovespa companies accounted for a full 70.9% of the total.

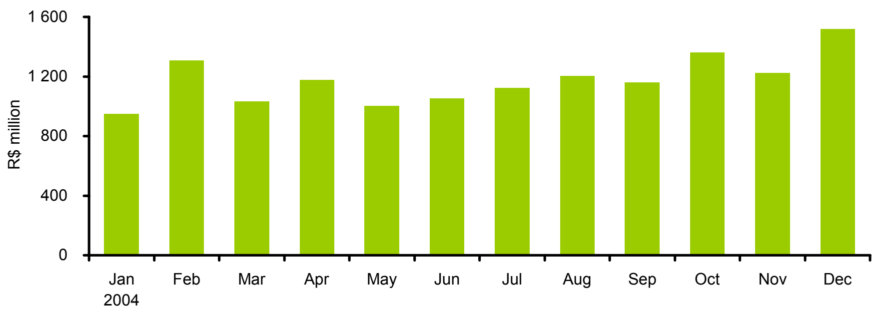
Graph 3.7
Market value
Open capital companies – Bovespa



Source: Bovespa

Business financing on capital markets through primary issues of stocks, debentures and promissory notes totaled R$ 16.3 billion, for an increase of 113.6% compared to 2003.

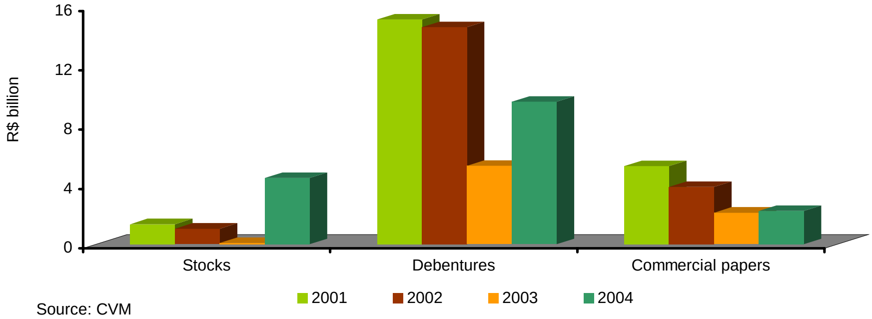
Graph 3.8
Traded average daily volume in Bovespa



Source: Bovespa

Debenture issues totaled R$ 9.6 billion, for growth of 82% over the 2003 result while stock issues closed at R$ 4.5 billion, compared to R$ 230 million in the previous year. Among the factors that contributed to the strengthening of capital markets were such microeconomic measures as adoption of Securities and Exchange Commission (CVM) Instruction 404[3] which stimulated growth in the corporate debt sector by requiring greater market transparency.

Graph 3.9
Primary market – Issues



Source: CVM

Table 3.1 – Primary issues of companies

Issues – CVM (R$ million)

Period	Stocks		Debentures		Commercial papers		Total	
	2003	2004	2003	2004	2003	2004	2003	2004
Jan	0	0	0	1 580	2	1	2	1 581
Feb	80	0	219	0	700	40	999	40
Mar	0	0	0	180	200	0	200	180
Apr	0	375	1 800	50	150	1	1 950	426
May	0	0	60	150	0	0	60	150
Jun	0	808	350	180	23	1	373	989
Jul	0	0	250	1 629	3	200	253	1 829
Aug	0	0	830	1 380	0	0	830	1 380
Sep	0	1 889	260	1 857	180	0	440	3 746
Oct	0	0	205	1 839	475	0	680	1 839
Nov	0	321	340	0	95	2 000	435	2 321
Dec	0	1 076	969	769	300	0	1 269	1 845
Total	80	4 469	5 283	9 614	2 128	2 242	7 491	16 326

Source: CVM

3/ CVM Instruction 404, dated 2.13.2004, sought to encourage the development of a debentures market. For that purpose, it created, in its art. 2º, the Standardized Debentures, thus making the debentures issues more uniform and determining the need for securities evaluation. When defining objective clauses, easy to understand and apply, the instruction has contributed to increase both the transparency and liquidity of this market.

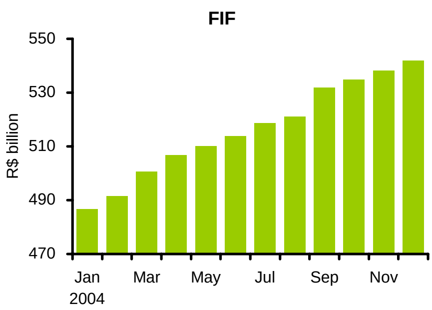
Financial investments

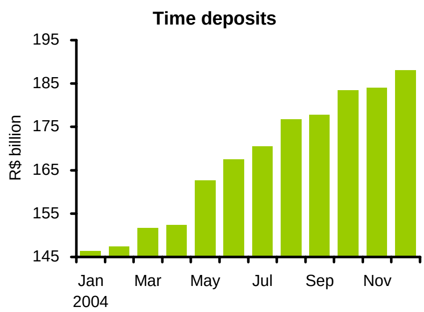
When savings accounts, investment funds and time deposits are included, the volume of financial investments came to R$ 914.5 billion in December 2004, for growth of 17.6% in the year.

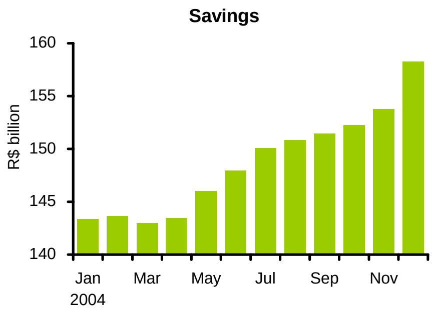
The net worth of financial investment funds (FIF) closed December at R$ 541.9 billion, for an annual increase of 16.1%, with net inflows of R$ 7.3 billion in 2004 compared to R$ 65.1 billion in the previous year. Funds registered net outflows of R$ 4.7 billion in the second quarter, primarily as a consequence of the volatility of returns in the period, principally in the case of fixed income funds. This performance reflected the high registered under futures interest rates in the earnings of preset securities which are adjusted at market prices on a daily basis.

Graph 3.10

Financial investments – Balances







With respect to the evolution of investment fund security portfolios, it is important to note that while the Selic rate followed a downward curve, the participation of preset papers increased from 17.2% in January to 21.5% in June, while the share of postset securities dropped from 66.3% to 60.8% in the same time span. In the second half of the year, this tendency reversed course. At the same time, one should stress that the participation of exchange-indexed securities dropped as a consequence of net redemptions of exchange securities and appreciation of the real during the year.

In December 2004, stock fund equity reached R$ 49.5 billion, for growth of 18.8% and profitability of 17.2% in the year. Among the various stock fund modalities, mutual privatization funds registered an equity increase of 21.7%.

The balance of time deposits closed the year at R$ 188.1 billion. The net inflow of R$ 21.7 billion in the year resulted from increased banking credits, considering that most of these operations are backed by time deposit resources. In the year, demand for postset and floating Bank Deposit Certificates (CDB) predominated. Savings deposits added up to R$ 158.3 billion, compared to R$ 143.1 billion in 2003, with net inflows of R$ 4.3 billion.

In order to enhance the efficiency of funding allocations on the financial market while fostering competition among the various types of investments, the federal government issued Provisional Measure 179, dated 4.1.2004, later converted into Law 10,892, dated 7.13.2004, making it possible to create specific deposit accounts for investment purposes that would be exempt from the Provisional Contribution on Financial Operations (CPMF).

In order to expand the period of permanence of resources in financial investments and, therefore, encourage long-term savings, the federal government issued Provisional Measure 206, dated 8.6.2004, later converted into Law 11,033, 12.21.2004. This measure altered the tax treatment accorded financial investments by establishing differentiated tax rates depending on the maturities of financial market operations. In this sense, rates varied from 22.5% for investments of up to six months to 15% for those with maturities of more than 24 months, effective as of 1.1.2005. In the case of investment funds, earnings appropriated on a half-yearly basis will be taxed at a rate of 20% for short-term funds and 15% for long-term operations.

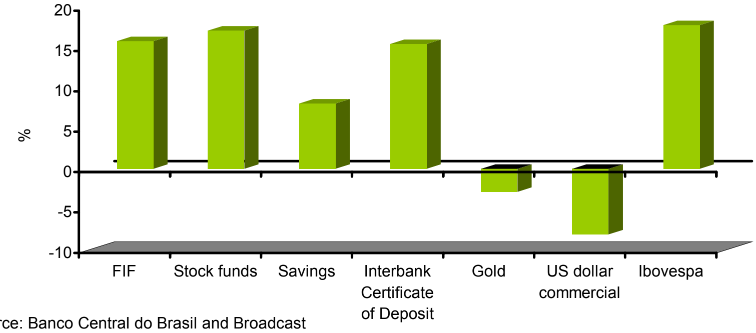
Normative Instruction 409 was issued by the CVM on 8.18.2004 and set down new rules for investment funds. Among the innovations included in this measure for the purpose of enhancing transparency and reducing the risks faced by holders of quotas in these funds, mention should be made of the obligation of classifying investment funds according to the composition of their assets: short-term, reference, fixed income, stock, exchange, external debt and multimarket.

Short-term funds are to channel their resources exclusively into federal public securities, with maturities no greater than 375 days and average portfolio maturities of less than 60 days. Fixed income, exchange and external debt funds are to target at least 80% of their portfolios into assets tied to the risk factor to which they refer.

Reference funds are to include their specific performance indicators in the official designations adopted for them and must have at least 80% of their assets in federal public securities and/or private papers, in which the issuer is classified as a low credit risk. Aside from this, these funds must have 95% of their portfolios indexed to a performance indicator. Multimarket funds must have investment policies that involve various risk factors.

Graph 3.11

Nominal income of major financial investments – 2004



Source: Banco Central do Brasil and Broadcast

Table 3.2 – Nominal income of financial investment – 2004

%

Itemization	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2004	Memo: 2003
FIF	1.42	0.97	1.35	0.99	1.26	1.27	1.23	1.22	1.21	1.19	1.17	1.49	15.82	22.88
Stock funds	-0.09	0.57	1.69	-6.90	-0.43	2.66	4.36	3.25	3.76	-0.01	2.49	5.13	17.14	38.78
Savings	0.63	0.55	0.68	0.59	0.66	0.68	0.70	0.70	0.67	0.61	0.62	0.74	8.10	11.10
CDB	1.18	1.02	1.29	1.10	1.18	1.18	1.22	1.24	1.25	1.17	1.20	1.45	15.49	22.33
Gold	-1.81	-2.37	6.22	-7.38	8.93	-2.90	-1.30	1.05	0.26	1.56	0.05	-4.14	-2.85	-0.77
US dollar commercial	1.79	-0.92	-0.18	1.24	6.26	-0.69	-2.60	-3.07	-2.56	-0.07	-4.40	-2.79	-8.13	-18.23
Ibovespa	- 1.73	- 0.44	1.78	- 11.45	- 0.32	8.21	5.62	2.09	1.94	- 0.83	9.01	4.25	17.81	97.33

Source: Banco Central do Brasil, CVM, Bovespa and BM&F