Introduction

The excellent results turned in by the Brazilian economy in 2004 were a consequence of the adequate control exercised by the Central Bank of Brazil´s (BCB) Monetary Policy Committee (Copom) over monetary policy instruments, guided by the fundamental objective of guarantying the gains inherent to price stability. Starting in September, therefore, the Committee adopted a strategy of gradually raising basic interest rates. The perception underlying this decision was that, if no alterations were adopted in the country's monetary policy stance, the strong upturn in the pace of economic activity would not of itself settle back to the level required to spontaneously close the product gap in a manner compatible with the continued convergence of inflation toward the trajectory of the predetermined targets.

The decision to raise the rate of the Special System of Clearance and Custody (Selic) represented a reversal of the process of lowering rates begun in mid-2003 and further intensified in the second half of that year, when the target for the basic interest rate dropped 10 percentage points (p.p.) to 16.5% per year in December, compared to 26.5% per year in June.

At the beginning of 2004, indications that inflation could exceed the targets set for that year and 2005 led Copom to adopt a more conservative monetary policy posture. This was evident in the decision to hold the basic interest rate target at 16.5% per year in the three-month period ended in February. The fundamental reason for this measure was the perception that, even though the behavior of inflation at that time was caused by extraordinary or seasonal factors and could possibly shift back into a trajectory compatible with the targets set for the coming months, compliance with the target required greater monetary policy wariness than had been previously foreseen.

In the two following months, Copom gave special attention to inflation projections formulated in the context of the hypothesis of a low degree of inflationary persistence in the first quarter of the year. This hypothesis was confirmed by seasonal attenuation of inflation in market prices in the second and third quarters of the year, in line with the pattern registered in recent years. In this framework, successive cutbacks of 0.25 p.p. were introduced into the Selic rate target in March and April.

In the four following meetings, Copom maintained the basic rate at 16% per year. In September, however, Copom recognized that growth in economic activity and the level of utilization of installed output capacity were clearly not compatible with recovery in investments and that projections for inflation suggested a growing risk of noncompliance with the targets. With this in mind, the Committee initiated a gradual process of basic interest rate hikes. In that month, the Selic rate was raised by 0.25 p.p., followed by consecutive increases of 0.50 p.p. in the following months, raising the rate to 17.75% per year at the end of 2004.

In this context, despite the impact of the strong upward spiral in international oil prices during the year, inflation closed below the 2003 level, reflecting deceleration in both market and regulated prices. The Broad National Consumer Price Index (IPCA), which is used to undergird the inflation targeting system, closed at 7.6%, well within the parameters defined for the 2004 target by the National Monetary Council (CMN).

It is important to recognize that the more rigid monetary policy adopted did not hamper the economy from expanding through the end of the year at an annual pace unmatched since 1994, all within a scenario of steady positive evolution of the nation's economic fundamentals since last year. The current year has been marked by a sharp rise in investment outlays, following years of only very modest growth.

Viewed under the prism of demand, 2004 growth in the activity level was driven by a continued strong export performance and internal market recovery. Expanded investments reflected the highly positive outlook for the economy evident since the second half of 2003, while growth in consumption was generated by the increased availability of credit, particularly in the first half of the year, with important repercussions on sales of consumer durables, and by growing income levels, primarily in the final months of the year. The latter factor, obviously, acted as a trigger to increased sales of nondurable consumer goods.

The enhanced dynamics of the economy in 2004 were also evident in job market indicators, particularly the employment level. New employment opportunities were created in all of the various sectors of the economy and at historically high levels.

Improvement in the nation's external accounts reflected the extraordinary performance of the trade balance which posted unprecedented surpluses in 2003 and 2004. The enormous transformations that have occurred in the external sector of the Brazilian economy began with adoption of the floating exchange system in 1999. Parallel to that, one should also stress the positive impacts of measures taken to simplify and streamline export operations, coupled with an aggressive trade promotion strategy aimed at diversifying and expanding the products exported by Brazilian companies and the markets to which they are targeted.

The positive results achieved by the external sector of the Brazilian economy not only expanded the activity level, but also made an essential contribution to significant improvement in external solvency indicators. Favored by expectations of strong world growth and an only moderate rise in United States interest rates, despite uncertainties regarding the medium-term performance of that economy in light of its burgeoning external and fiscal deficits, Brazil's country risk dropped sharply. In 2004, there is evidence that, at several moments in time, the downturn in country risk was powered by the progress achieved in the nation's internal economic fundamentals, as demonstrated by the exceptional trade surplus, current account results, despite strong growth in Gross Domestic Product (GDP), by substantial improvement in external and public debt indicators, and by a primary surplus well above the target agreed upon with the International Monetary Fund (IMF).

Since the end of 2003, international market conditions have been particularly favorable to Brazil from various points of view and, consequently, have generated highly positive impacts on the balance of payments result. Coupled with adoption of consistent macroeconomic policies, these results have made it possible to improve the country's sovereign rating, thus enhancing access to international financial markets, with lesser spreads and foreign debt security issues in national currency since last November. Other positive factors have been recovery in the international reserve position and stability and subsequent reductions in the external debt.

The contribution of the internal market to consistent recovery in the activity level can be summarized in increased credit and growing income. The process of expanded internal income reflected highly positive labor market evolution. In this sense, notwithstanding the fact that the overall labor force has expanded at a rate above that of previous years, strong growth in new hirings has resulted in declining unemployment in 2004, with positive expansion in all months of the year and in a broad diversity of economic sectors.

In the context of steadily declining default levels, credit operations reflected the process of expanding economic activity. Here, it should be noted that the increased costs of credit operations since September have not had an undue impact on the volume of new operations, particularly in light of the already traditional rise in demand that marks the final months of the year. Basically, growth in loans to individual borrowers in 2004 reflected personal credit operations and, more specifically, payroll loans, since these credits are offered at lower interest rates due to the considerably lesser risk of default. In the case of credits granted to corporate entities, the volume of operations backed by internal resources expanded in detriment to those linked to external resources.

In this framework, one should also stress the sharp downturn of 5.4 p.p. in the ratio between the net public sector debt and GDP, thus interrupting the upward trajectory of this indicator dating to 1994. This performance resulted from a combination of positive factors, among which one should highlight continued fiscal equilibrium in all segments of the economy, economic growth, lesser interest appropriations and exchange rate stability.

In 2004, the strategy of reducing the share of the internal public debt indexed to the dollar and purchasing exchange on the market for external debt payment purposes and replenishment of international reserve levels was maintained, primarily in light of the need to attenuate the vulnerability of the balance of payments and the public sector asset balance. Net BCB purchases and settlement of market debts by the National Treasury resulted in a gradual rebuilding of the country's international reserves. At the end of December, the international reserve position – viewed according to the liquidity concept – totaled US$52.9 billion, corresponding to an increase of US$3.6 billion compared to the end of 2003. At the same time, net adjusted reserves, as defined in the IMF agreement, totaled US$25.3 billion, representing growth of US$8 billion in relation to the same period of 2003.