II

MONEY AND CREDIT

In 1999, monetary policy implementation was highlighted by reformulation of the operational rules applied to the setting of basic interest rates by Banco Central. The purpose was to achieve compatibility between the recently adopted floating exchange system and the inflation targeting mechanism. The previous rules remained in effect up to early March, according to which the Monetary Policy Committee (Copom) periodically defined both the Banco Central Base Rate (TBC) - corresponding to the price of discount window operations backed by federal securities, up to the operational limit determined according to the volume of the banking institution's demand and time deposits - and the Banco Central Financial Assistance Rate (Tban), a punitive rate that defined the cost of financial assistance in situations in which institutions had exceeded their operational limits.

In the previous system, whenever the rates defined by the market were above the rates specified by Banco Central, banking institutions were able to carry out arbitrage operations, with monetary authority financing of the securities involved. In normal circumstances, the monetary authority held total banking reserves to the level demanded by the market - basically, the amount of compulsory reserves on demand funding - and market equilibrium was achieved on the interbank market at rates close to the TBC. On the other hand, in situations of greater financial market instability, Banco Central tended to permit a gap between the banking reserve level and the amount callable, in order to facilitate daily calibration of basic interest rates, in such a way as to influence the rate through security financing operations.

The current structure for determining interest rates is based on adoption of over/Selic rate targeting as a basic monetary policy instrument, together with a bias that expresses the potential upward or downward tendency of the target. Targets are defined at the monthly Copom meeting. When a bias is defined by Copom, the Banco Central Governor has the authority to alter the target during the period between meetings and always in the direction of the bias.

The system of discount window operations was totally overhauled and subjected to the over/Selic rate plus an additional margin determined on the basis of the guaranties offered and the frequency with which an institution resorts to this mechanism. Operations guarantied by federal securities are subject to an additional 2% per year, independently of how many times they are used. Parallel to this, the financial costs consequent upon insufficiencies or overdrafts in the Banking Reserve account were redefined and referenced to the over/Selic rate, plus 14% per year and 20% per year, respectively. Previously, the costs on these operations were the Tban plus 12% per year and 18% per year. Finally, the voluntary interest-bearing deposits created in December 1998 were abolished.

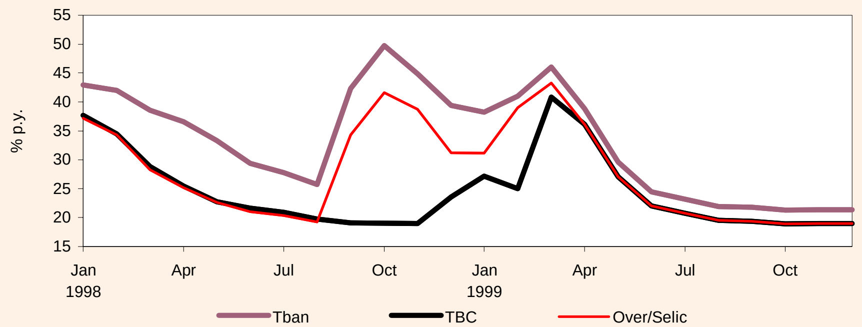
The restructuring of monetary policy operational rules presumes a more active role on the part of the monetary authority since basic market interest rates are now adjusted through interventions consistent with the target announced by Copom and no longer through arbitrage operations by financial institutions.

Analyzing the context of the previous operational rules, the over/Selic, which had opened January at 29% per year, rose gradually during the course of the month and reached a mark of 39% per year in February. With adoption of the new system, the Selic rate target for the period from March 5 to April 14 was defined at 45% per year with a downward bias. The change in interest rate levels in the first quarter of the year had the objective of raising the market's opportunity cost in establishing positions in foreign currency and, consequently, reducing exchange rate volatility and aiding in reversing expectations of an upswing in inflation.

The highly positive response of the major macroeconomic indicators and, particularly, the reversal of the process of exchange devaluation and the behavior of prices in the period, made it possible to begin a process of interest rate reductions that was to last the entire year. Thus, in the second quarter, the over rate target was rapidly cut to just 21% per year, with a downward bias, at the end of the first half of 1999.

In the second half of the year, the monetary authority took a more gradual approach in reducing the basic interest rate target. This more cautious approach had a preventive character aimed at avoiding the possibility of uncertainties

Graph 2.1
Interest rates



generated by internal supply pressures and an unstable international climate jeopardizing compliance with inflation targets. At the end of the year, the over Selic rate target was positioned at 19% per year with a downward bias. In effective terms, the rate for 1999 as a whole was 25.6%, as against 28.8% in the preceding year.

Here, due attention should also be given to the monetary policy passthrough mechanism to exchange rates since interest rate differentials and changes in risk levels as assessed by economic agents influence the formation and volatility of exchange rates. These interactions required complementary procedures aimed at avoiding undesirable exchange rate pressures on internal price levels. In this context, the most important measures were enhanced exchange market flexibility, direct monetary authority interventions through spread auctions and foreign currency sales and indirect interventions through net placements of securities with exchange indexing.

Simultaneously to the policy of reducing basic interest rates, Banco Central adopted measures aimed at cutting the banking spread by reducing the costs and risks of financial intermediation and favoring increased private outlays in this area. One step that was taken with the aim of generating an immediate impact was a cutback in the Financial Operations Tax (IOF) on personal credit operations to the same level as that levied on business credits.

With the same purpose in mind, the monetary authority reduced compulsory reserves. Following an increase from 25% to 30% on March 2, the reserve rate on time resources, callable in securities, was gradually cut as of May 6 until reaching a zero level on October 22. These reductions meant lesser volumes of papers earmarked to Banco Central. Consequently, these papers came to be included in the free portfolios of financial institutions, thus enhancing the flexibility available to these institutions in the use of these funds. The reduction in the reserve rate to zero on time resources resulted in the release of securities in the amount of approximately R$ 27 billion.

As of the month of October, the compulsory reserve rate on demand deposits and deposits subject to notification in effect since January 1997 was reduced from 75% to 65%. The consequent release of monetary resources obligatorily deposited at Banco Central increased the volume of available funding in the banking system by approximately R$ 2.7 billion.

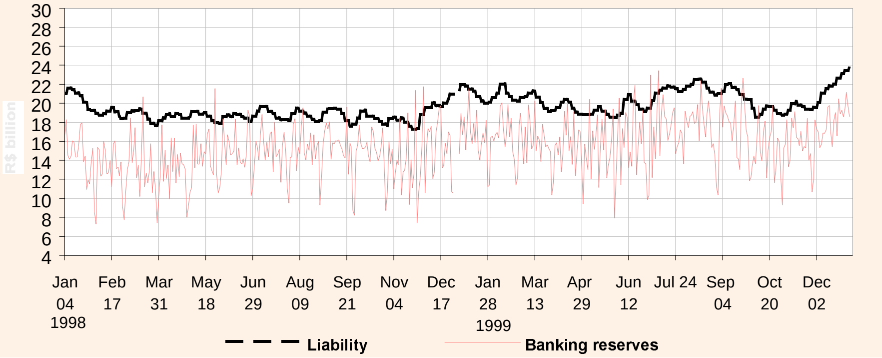
The time periods, rates and indexing factors of financial system operations were made more flexible so as to attenuate the risks of financial intermediation and facilitate compatibility in the rates and terms of asset and liability operations. When an operation is tied to an index derived from interest rates, the result is a reduction in market risk and lesser financial charges. In much the same way, the use of a price index attenuates uncertainties regarding the real rate of interest on the operation.

Parallel to these measures, two steps were taken to attenuate credit risks. The first was the broadening of the coverage of the Risk Analysis Center, by reducing the minimum value of the operations to be notified to that entity, followed by creation of the Bank Credit Bill, an instrument that can be more effectively processed through the judicial system. Starting in the month of August, deregulation of investment funds resulted in improved profitability conditions in a framework of declining interest and favored continued stability in financial savings, a factor of primary importance to controlling the demand pressures generated by the financial sector. This happens because the attractiveness of financial investments in general is impacted by both the level of basic interest rates and by the fiscal wedge on such operations. In more specific terms, given the new levels of interest rates, the attractiveness of fixed income funds would have been compromised if the rules in effect up to July had been maintained.

Table 2.1 - Collection rate on mandatory reserves

Period	Demand deposits	Time deposits	Savings deposits	Credit operations	FIF Short-term	FIF 30 days	FIF 60 days
Prior to Real Plan	40%	-	15%	-	-	-	-
1994 Jun	100%	20%	20%	-	-	-	-
Aug	"	30%	30%	-	-	-	-
Oct	"	"	"	15%	-	-	-
Dec	90%	27%	"	"	-	-	-
1995 Apr	"	30%	"	"	-	-	-
May	"	"	"	12%	-	-	-
Jun	"	"	"	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%	"	"	"	"	"
Dec	"	"	"	"	"	"	"

Graph 2.2
Banking reserves - valuated balances



One should stress Banco Central's efforts to improve and invigorate the federal security market since this is an area of great importance to monetary policy. Several procedures were initiated in 1999, while others were announced for later implementation. The primary objectives of these procedures are reductions in financial costs and the lengthening of the term and duration of the federal securities debt. Aside from the positive macroeconomic policy impacts, one should note that the more favorable characteristics of federal securities may actually improve financial system loan conditions to the extent that private funding instruments incorporate these characteristics.

Among the procedures initiated in 1999, particular mention should be made of the increase in the concentration of federal security maturities as a result of a series of placements with identical maturity terms. This fact provoked an increase in the volume of a specific type of security in circulation with identical redemption periods, thus positively affecting the pricing and liquidity of that paper. Furthermore, a measure in effect since August grants individuals and all legal entities the possibility of carrying out committed operations with any type of security and any maturity, provided that the earnings and profitability parameters be duly stipulated on the date of contracting. Up to that time, security trading with repurchase/resale commitments by individuals and legal entities not authorized by the regulations could only be carried out for a minimum period of 30 days, with backing in federal securities.

In the same context, one should note the position of the monetary authority in relation to the banking reserve market as of the second half of November. By no longer providing a daily offer of committed operations, the monetary authority now acts only when demand for banking reserves begins exerting excessive pressures on basic interest rates. Consequently, banking institutions are compelled to pursue balanced positions in their definitive operations with federal securities so that they will not suffer losses in the position closing auctions at the end of the day.

Banco Central issued a normative instrument on December 21 altering and consolidating the rules disciplining operations and commitments in this market, with the objective of creating more flexible trading conditions on the fixed income securities market in general. This measure focuses on forward, overdraft and options operations with fixed income securities and is expected to provoke an interest rate decline and a lengthening of the terms of National Financial System operations. Starting on the same date, the NBC-E coupon, which had previously been set at 6% per year for all issues, was determined for each specific issue so as to allow the monetary authority to signal the intended rate for competitive offers. In order to enhance the transparency and predictability of its operations, the National Treasury began announcing its schedule for public security offers as of November 25.

Among the measures announced for later implementation, emphasis should be given to issues of long-term preset papers in competitive offers with sale options, a procedure equivalent to the offer of insurance against unforeseen price fluctuations; public offers of long-term preset papers subsequent to reception of a firm purchase proposal from financial institutions representing their clients; regular and predefined auctions by the National Treasury involving purchases of its own securities, as an instrument for obtaining the qualitative alteration of its debt on the market; permission for separately trading the principal and coupons of exchange securities; operations with federal securities within the Special System of Liquidation and Custody (Selic) with liquidation on D+1 and incentives to the utilization of electronic systems for trading federal papers. Both of these have the objective of encouraging the participation of new economic agents in the market, such as individuals and nonfinancial legal entities.

Federal public securities

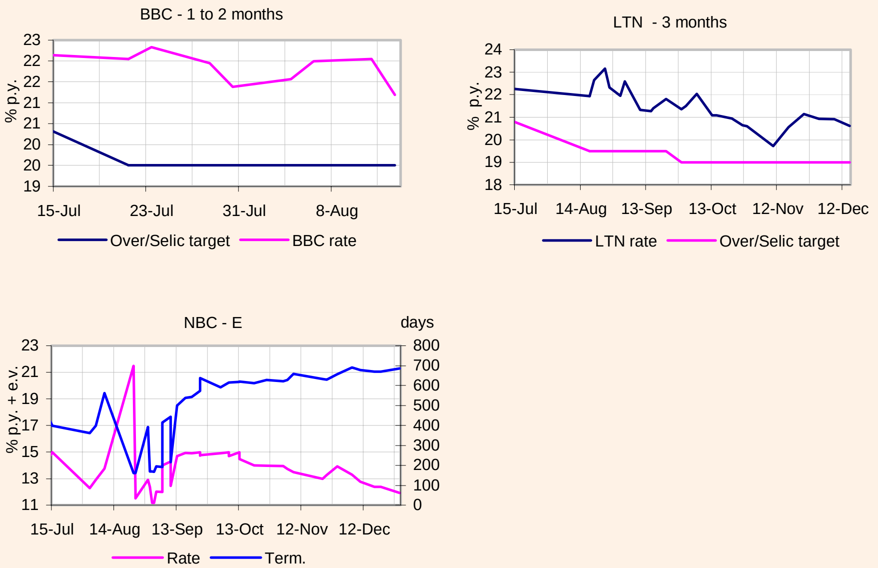
During the course of 1999, operations with federal public securities were carried out with the objective of lengthening the terms and duration and reducing the volume of the securities debt for which Banco Central was liable. Consequently, the participation of papers issued by the National Treasury in the total federal securities debt increased by 68% at the end of 1998 to 84% at the end of 1999. Issues of federal securities were characterized by public offers of very few types of securities and by strong concentration of maturities, so as to increase secondary market liquidity and stimulate interest rate cuts, and longer terms. In the early days of the year several different types of securities were offered. However, once that period had passed, Banco Central restricted itself to issuing NBC-E and BBC. The latter of these was issued in the period from April to August in a much smaller volume than the papers indexed to exchange, while the National Treasury limited itself solely to public offers of LFT and LTN and reintroduction of the NTN-C in December.

Effective as of March 22, the monetary authority adopted a new system for its exchange security auctions, eliminating the cut-off at a specified minimum price. According to the new methodology, the cut-off price is extended to all proposals with higher or equal prices, until reaching the volume the institution intends to place. This change in procedure had the objective of eliminating the risk of losses in acquisitions of these papers, inducing participants to propose prices of greater interest to them individually. In this way, it was possible to obtain better offers for issuers, principally on the part of those demanding hedging for liability operations indexed to foreign currency.

The participation of the financial volume of papers indexed to exchange in total Banco Central issues moved from 36% at the start of the year to 96% at the close, basically as a result of the change in the exchange rate level, net placements in periods of more restricted exchange market liquidity and substitution of other types of Banco Central-issued securities with National Treasury papers. Starting as of mid-April, NBC-E placement rates oscillated between 11% and 15% per year. On December 28, these papers were issued with coupons of 12% per year, a level similar to the rates negotiated for Brazilian foreign debt papers in the same period.

Over the course of 1999, the increase in the participation of LTN (preset) in total securities issued in public offers by the National Treasury from 3% to 16% resulted from the strategy adopted to reduce the volatility of the public debt, increase the efficacy of monetary policy through growth in the interest elasticity of the market price of federal securities and provide backing for market rates over the temporal horizon of the papers. In the second half of the year, placement rates were systematically higher than the over/Selic rate in effect on the day of the auction. This does not reflect an atypical LTN risk assessment, since the premiums in relation to the forward interest rates structure, based

Graph 2.3
Auctions - placement rates - 1999



on the DI futures market, did not exceed the level usually accepted by issuers. In the half-year period under analysis, the placement rates of preset three to seven month National Treasury papers came to between 19.7% and 23.1% per year.

Average LTN placement terms moved upward during the course of the year from 28 days in March, when placements were recommenced, to 134 days in July, the maximum term for the year. As of August, the average term had increased to 75 days. Following that month, the National Treasury once again adopted a policy of lengthening security terms, which reached an average of 119 days in December.

As of December, the National Treasury recommenced public offers of NTN-C - papers indexed to the IGP-M with 6% per year half-year coupons. The first auction occurred on December 1 and offered up to R$ 1 billion, with a term of three years and up to R$ 1 billion with terms of seven years. Here, just as in the case of NBC-E auctions, a single price was applied to all proposals accepted. Several modalities of securitized credits for which the National Treasury is liable, registered at the Center of Custody and Financial Liquidation of Securities (Cetip), were accepted for payment purposes. Evidently, this implies acceptance on the part of the party holding these papers of a predefined discount for the modality in question in relation to its current value as registered at Cetip.

The principal purpose underlying reintroduction of NTN-C was to strengthen the long-term parameters of the Brazilian economy as regards interest and inflation. Aside from this, given the maturities with which these papers are placed, they are to take on the role of backing for long-term liabilities. At the same time, acceptance of federal securitized credits for payment purposes is aimed at stimulating reduction of the federal internal debt voluntarily accepted by creditors and reducing the types of federal securities in circulation in order to increase secondary market liquidity.

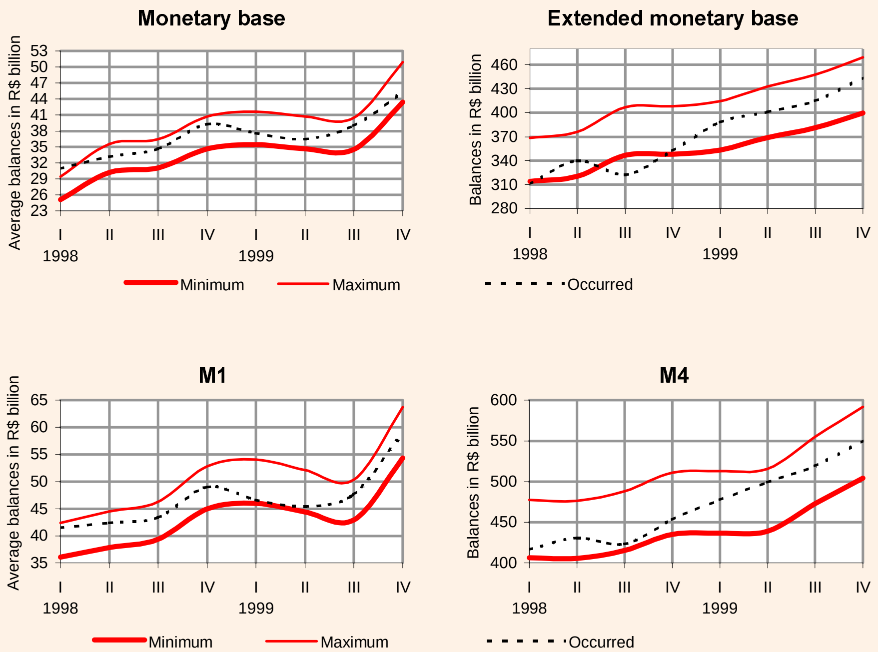
In the December first auction, the volume of papers placed with three year maturities corresponded to R$ 675 million, at a rate of 12% per year, while seven year papers came to R$ 325 million, at a rate of 12.5% per year. Of overall securities placed, 21% were liquidated with securitized credits, with an average discount of 15% in relation to the credits used for payment.

There were three distinct phases in terms of the duration of the federal securities issued in public offers during the year. In the first two months, the increase in the participation of exchange securities in the total debt issued, with an average duration of about nine months for NBC-E and 18 months for NTN-D and NBC-F, resulted in an increase in the average duration of the federal securities debt from 3.3 months at the end of 1998 to 4.9 months at the close of February 1999. As of March, this trajectory was reversed as a result of the impact of maturities of exchange securities on the market, to the point that duration moved back to the final level of the previous year in August. As a result of issues of longer term NBC-E - the average term climbed from 280 days in August to 681 days in December - the indicator came to 4.1 months at the end of the year.

Monetary aggregates

Among the factors that influenced the level and allocation of the portfolios of economic agents and aided in defining monetary aggregates, particularly in the case of the broader aggregates, the most important was the behavior of exchange rates and basic interest rates. Allocation of financial savings was significantly impacted by changes in price levels, introduction of the CPMF and measures adopted by the monetary authority with the intention of deregulating investment funds and the financial system in general.

Graph 2.4
Monetary base and money supply
Monetary program and values occurred



At the end of January and in early February, the behavior of demand deposits and currency outside banks was atypical, indicating increased public preference for liquidity, particularly in light of the uncertainties that arose in relation to the Brazilian economy following the exchange rate shock. In this framework, the defensive posture adopted by economic agents reduced the seasonal money supply decline in the months following the end-of-year peak.

Table 2.2 - Monetary program

R$ billion

Itemization	Restricted monetary base			Expanded monetary base		
	Minimum	Maximum	Confirmed	Minimum	Maximum	Confirmed
1998 1st Quarter	25.1	29.4	30.9	313.9	368.5	310.7
2nd Quarter	30.2	35.5	33.1	320.4	376.1	340.0
3rd Quarter	31.0	36.4	34.6	346.6	406.9	322.2
4th Quarter	34.6	40.7	39.3	347.7	408.2	352.3
1999 1st Quarter	35.4	41.6	37.6	353.0	414.4	388.0
2nd Quarter	34.6	40.7	36.5	368.9	433.0	400.8
3rd Quarter	34.5	40.5	39.0	381.3	447.6	414.9
4th Quarter	43.4	50.9	45.4	399.6	469.1	443.7

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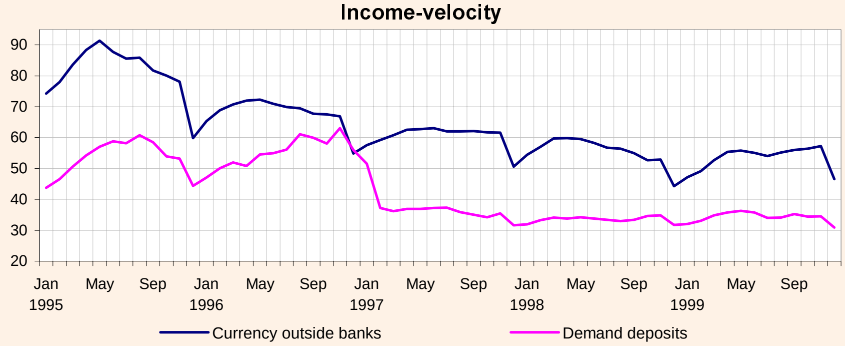
Graph 2.5

Currency outside banks and demand deposits

Income-velocity



The increase in basic interest rates to a level of 45% per year as of March, coupled with the drop in the activity level, aided in reversing expanding preference for liquidity. As a result, the average daily money supply balance dropped from R$ 48.4 billion in February to R$ 44.2 billion in May. The month of July was marked by strong monetary growth as a result of reintroduction of the CPMF which, since it was levied on current account debits for investment and withdrawal purposes, discouraged financial investments and reduced the income velocity of the currency. Growth in the money supply stock can also be attributed to the lag in the response to price level growth in the first half of the year.

By making it possible to allocate a larger share of financial savings to this type of investment, deregulation of investment funds stimulated maintenance of a small volume of resources in monetary assets. These factors may have led the public to reduce demand for currency as of mid-August and contributed to the 1% reduction in the average money supply stock in September, when set against the previous month. From that point forward, resources in transit originating in credit operations, growth in federal transfers to states and municipalities, growth in price levels, expectations of possible restrictions

Table 2.2 - Monetary program (concluded)

R$ billion

Itemization	Money supply (M1)			Money supply broader concept (M4)		
	Minimum	Maximum	Confirmed	Minimum	Maximum	Confirmed
1998 1st Quarter	36.1	42.4	41.5	406.6	477.3	416.9
2nd Quarter	37.9	44.5	42.4	405.8	476.3	431.1
3rd Quarter	39.4	46.3	43.4	415.8	488.1	423.5
4th Quarter	45.0	52.8	49.0	435.1	510.7	453.4
1999 1st Quarter	46.0	54.0	46.6	436.7	512.6	477.4
2nd Quarter	44.4	52.1	45.4	439.0	515.4	498.9
3rd Quarter	42.9	50.3	47.6	472.9	555.1	519.1
4th Quarter	54.3	63.7	59.0	504.2	591.9	550.2

on the processing of financial operations during the transition to 2000 and a series of seasonal factors, resulted in growth of this aggregate to a monthly average of R$ 59 billion in December, with expansion of 20.5% in the year.

Viewed under the prism of average daily balances per month, the monetary base expanded by 15.6% in the year and closed December at R$ 45.4 million. Among the monetary base components, the average monthly balance of currency issued registered an increase of 16% in the period, closing at R$ 27.3 billion, while banking reserves expanded by 15%, rising to an average of R$ 18.1 billion in December.

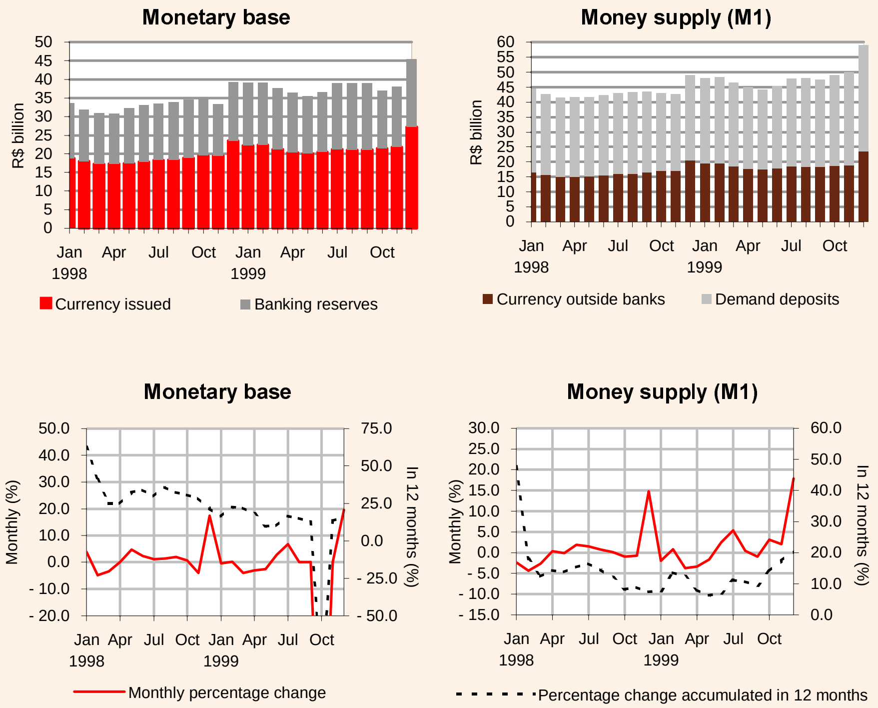
With regard to the liquidity level of the economy, the development of instruments that make it possible to invest available banking system funding coupled with the current compulsory reserve system have sharply restricted the role of the monetary base as a currency with high growth potential. In this way, evaluation of primary liquidity conditions requires that attention be given to the position of net financing of federal securities, which may be understood as a freely usable and interest-bearing banking reserve, in contrast to the balances of the banking reserve account which are compulsory and non-interest bearing.

The position of net financing of federal securities granted by the monetary authority, including the balance of financial assistance backed by federal papers, registered a monthly average of R$ 1.9 billion up to January 19, due to the seasonal increase in reserve requirements on demand resources and strong demand for banking reserves for liquidation of foreign currency purchase operations by financial institutions. The climate of uncertainty in relation to the evolution of the Brazilian economy generated by the change in the exchange rate system increased market preference for liquidity and reduced demand for federal public securities in definitive operations in both the primary and secondary markets, thus provoking a steady increase in banking system investments

Graph 2.6

Monetary base and money supply (M1)

Average daily balances



in committed operations. This process raised the average net volume of financing taken by Banco Central to R$ 28.8 billion in March.

As of the month of April, the turnaround in previously unfavorable expectations led to a reduction in the volume of funding taken by the monetary authority in this type of operation, so much so that the average for the month of September was practically negligible. In October, compulsory reserve rates on demand deposits were cut from 75% to 65%, while that applied to time deposits was reduced from 20% to 0%, thus aiding in raising the position of monetary authority financing of federal securities to the average of R$ 3.4 billion which was adjusted during the course of the month through R$ 3 billion in net placements of federal securities. In the remainder of the year, the monetary authority acted opportunely up to mid-December when it began granting financing as a result of increased seasonal currency demand.

As regards the factors that condition the monetary base, the National Treasury's single operating account and operations with the foreign sector were the major sources of contractive pressures in the year, registering respective net accumulated impacts of R$ 15.6 billion and R$ 14.9 billion. Coupled with the R$ 6.1 billion increase in demand for monetary base, these results made it possible to effect net federal security debt redemptions totaling R$ 31.2 billion, together with releases of compulsory cash reserves on investment funds and savings deposits totaling R$ 6.7 billion.

The monetary targets negotiated with the International Monetary Fund (IMF), in terms of ceilings for Net Domestic Assets (NDA) - difference between the monetary base and net international reserves of foreign assets - were fully complied with by Banco Central in each and every month of 1999 defined as performance criteria or, in other words, April, June and September. The effective CDL was R$ 1.3 billion below the ceiling in April, R$ 8.5 billion in June and R$ 2.6 billion in September.

The broad base - measurement of the monetary and quasi-monetary debt registered at Selic - closed the year at R$ 447.1 billion, for growth of 26.9% in the period. For the most part, growth can be attributed to the updating of the value of the federal

Table 2.3 - Factors conditioning the monetary base

Accumulated flows in the month (R$ million)

Period		National Treasury	Operations with federal securities	Foreign sector operations	Discount window operations
1998	Jan	- 978	-4 520	855	3 248
	Feb	- 32	- 199	5 773	-6 371
	Mar	794	-11 001	10 233	- 1
	Apr	-6 544	1 150	5 912	- 121
	May	- 471	2 497	-1 840	31
	Jun	1 215	6 167	- 962	29
	Jul	- 956	-2 662	- 476	- 36
	Aug	-8 643	12 889	-3 694	1 104
	Sep	- 681	17 684	-26 018	-1 224
	Oct	- 892	-7 520	-4 400	- 44
	Nov	2 773	6 362	- 259	- 139
	Dec	- 691	7 008	-6 554	- 89
1999	Jan	- 100	7 113	-4 756	-1 502
	Feb	- 815	-2 008	285	- 27
	Mar	-1 768	5 076	-3 812	- 316
	Apr	-2 650	3 631	-1 950	- 6
	May	25	3 254	659	- 30
	Jun	- 843	-6 657	8	- 7
	Jul	-1 627	9 333	- 13	- 7
	Aug	-6 434	-4 139	- 296	- 7
	Sep	-2 901	4 518	- 11	- 7
	Oct	723	- 69	-1 411	- 7
	Nov	607	1 201	- 823	- 7
	Dec	221	13 672	-2 759	- 15

(continues)

securities debt held by the market, consequent upon basic interest rate levels and exchange rate movements, and to security issues caused by state and municipal debt restructuring programs. The factors that aided in reducing growth were net reserves channeled to the National Treasury operating account and operations with the foreign sector.

In the broader concept of the money supply (M4), the balance came to R$ 550.2 billion at the end of December, with growth of 21.4% in the year. The impact of exchange devaluation was less intense under M4 than under the expanded base, considering that the major share of exchange securities tends to remain in the hands of financial institutions which normally demand a greater volume of protection for foreign resources inflows. Since the effective Selic rate came to 25.6% in the year, growth under M4 in the same period does not indicate significant primary expansion under internal financial savings, considering that the non-interest bearing share of the aggregate corresponds to only 11%.

Table 2.3 - Factors conditioning the monetary base (concluded)

Accumulated flows in the month (R$ million)

Period		Deposits			Other	Monetary
		Financial institutions	Investment funds	Total	accounts	base change
1998	Jan	236	- 219	17	114	-1 264
	Feb	- 665	- 70	- 735	91	-1 473
	Mar	286	- 201	85	785	894
	Apr	282	- 349	- 67	338	670
	May	270	- 31	239	- 12	444
	Jun	28	- 26	1	- 328	6 122
	Jul	- 190	- 20	- 209	104	-4 235
	Aug	509	- 2	507	264	2 427
	Sep	6 741	127	6 868	- 41	-3 411
	Oct	12 729	164	12 893	787	824
	Nov	48	32	80	-1 905	6 912
	Dec	9	- 225	- 216	- 17	- 558
1999	Jan	- 111	- 171	- 282	- 29	444
	Feb	89	496	585	201	-1 779
	Mar	227	2	229	- 34	- 625
	Apr	199	154	353	- 259	- 881
	May	107	42	149	27	4 083
	Jun	47	183	231	12	-7 257
	Jul	55	210	265	33	7 985
	Aug	- 64	3 629	3 565	18	-7 292
	Sep	528	0	528	- 26	2 100
	Oct	544	0	544	100	- 121
	Nov	485	0	485	25	1 488
	Dec	8	0	8	- 35	11 093

Table 2.4 - Financial assets

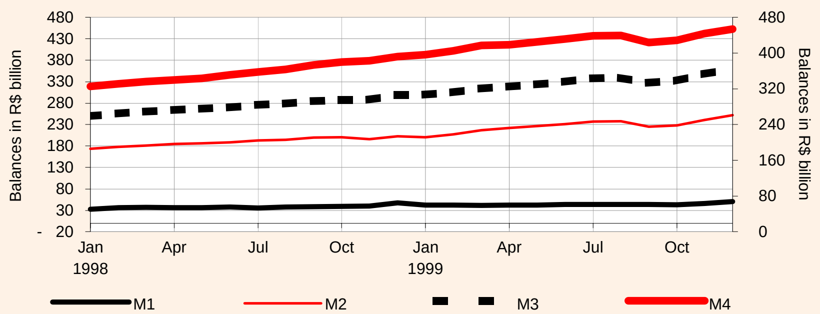
Percentage share in GDP[1/] (%)

Period		M1	M2	M3	M4
1998	Jan	4.76	22.38	33.47	44.25
	Feb	4.77	23.09	34.01	45.17
	Mar	4.66	24.11	34.92	46.36
	Apr	4.69	24.58	35.36	46.49
	May	4.70	25.00	35.76	46.97
	Jun	4.87	25.47	36.40	47.63
	Jul	4.86	26.29	37.38	48.52
	Aug	4.90	26.37	37.60	48.62
	Sep	4.87	24.88	36.30	46.91
	Oct	4.79	25.32	36.96	47.68
	Nov	5.12	26.75	38.54	49.19
	Dec	5.57	27.68	39.47	49.79
1999	Jan	5.34	27.97	39.54	49.55
	Feb	4.95	27.26	38.68	48.89
	Mar	4.66	27.18	38.56	48.87
	Apr	4.52	27.54	38.97	49.10
	May	4.51	28.08	39.58	49.68
	Jun	4.64	28.96	40.26	50.34
	Jul	4.78	29.36	40.47	50.16
	Aug	4.66	30.50	41.38	50.36
	Sep	4.53	30.53	41.17	50.04
	Oct	4.59	30.74	41.08	49.85
	Nov	4.78	31.10	41.25	49.86
	Dec	5.66	31.63	41.70	50.03

1/ Last 12 month GDP at prices of indicated month (deflator GPI-DS) having the series disclosed by IBGE as a base.

Graph 2.7

Financial assets - end-of-period



Financial system credit operations

In the first half of 1999, the financial system was marked by a conservative stance in its asset operations, greater selectivity in the granting of credit and preference for treasury operations. This performance, which had already become evident in previous years, was strengthened by the change in the exchange system and by variations in the interest rate trajectory early in the year. These factors, coupled with the absence of any significant degree of economic recovery, resulted in rather sluggish effective demand for financial resources to be used for consumption or maintenance and expansion of the productive sector.

At the same time, initial uncertainties generated by exchange rate fluctuations and their possible impacts on price levels increased the risk perceived by those offering and seeking resources, and had particularly strong repercussions on the volume of preset credit granted indexed to foreign currency.

As the exchange market normalized and expectations of higher inflation were shown to be unfounded, the interest rate trajectory began changing course before the end of the first half of the year, generating the conditions required for positive growth in credit demand, particularly on the part of the private sector. However, the upturn in economic growth consolidated only in the second half of the year, mostly as a consequence of measures taken to eliminate restrictions and reduce the costs of financial intermediation and expand the credit supply. In this framework, one should highlight reductions in compulsory deposits and in the IOF rates levied on loan operations.

Parallel to adoption of measures aimed at reducing margins in financial intermediation, others were taken to enhance credit market transparency and competition. Among these, one should note the obligation imposed on institutions to announce their interest rates on several different types of loans on a daily basis and specify interest rates, taxes and banking fees clearly on credit contracts, in such a way as to make the various cost components of financial intermediation perfectly clear to the party seeking credit.

Among the measures taken with the aim of stimulating loan demand, one should cite the Refis, which allows for normalization of federal government credits based on the debts of legal entities existent up to 8.31.1999, involving taxes and contributions, all according to the terms of Provisional Measure no. 1,923, dated 10.6.1999. The Program permits consolidation of existent debts indexed by the TJLP and the lengthening of payment terms, while also defining the percentage of the contributor's commitment of gross revenues, which cannot be less than 2%. In this way, normalization of the debtor's situation in the Federal Government File of Debtors in Default (Cadin) and the financial reordering of the debtor's operations are also viewed as a way of stimulating increased economic activity. By reducing default levels, more productive entities will be in a position to contract financing from federal development entities.

In the institutional field, the government took on the task of providing the credit market with the instruments needed to ensure normal contractual operations. By reducing risk and lowering the spread, these measures benefited savers, financial intermediaries and, principally, borrowers.

Provisional Measure no. 1,925, dated 10.14.1999, created a new financial instrument designated the Bank Credit Bill. This is a credit security issued by individuals or legal entities, with or without guaranties, in the benefit of the grantor institution and represents a firm, net and callable promise of payment in cash. The bill may be used in any type of credit operation, thus making it possible to reduce costs and enhance the uniformity and rapidity of judicial execution of institutions' illiquid credit portfolios.

Another advantage of the new credit security is to make it possible for institutions to securitize receivables through issue of certificates backed by these bills so that they will be able to negotiate the credits in question on the national or international markets. Creation of this secondary market is aimed at generating greater liquidity and, consequently, less risk in the pertinent operations.

At the same time, the minimum value of the contracts to be notified by financial institutions to the Central Risk System, which is monitored by Banco Central, was lowered from R$ 50 thousand to R$ 20 thousand.

Even though the alterations introduced with the aim of leveraging credit operations will only produce their full effects over the medium and long-term, there is no doubt that they have already contributed to the growth trajectory that became evident in the latter half of 1999. However, in accumulated terms for the year up to November, the performance of asset operations mirrored the uncertainties that had marked the first half of the year.

In this framework, in relation to GDP, the participation of normally performing financial system loans reached 23.8% in December, as against 28.0% at the end of the previous year, indicating that price growth expressed in nominal product and indexed by the IGP-DI was higher than growth in loans. The volume of these operations came to R$ 262.5 billion, remaining practically stable at 3% in the year as against 3.1% in 1998.

On a sector-by-sector basis, normally performing credits to the public sector came to R$ 25.7 billion, reflecting a drop of 22.2% in the year caused by the restrictions imposed on financing operations with the various spheres of the public administration. In this context, one should note that the balances of these financing operations up to September were not permitted to surpass the amounts registered in September 1997, indexed monthly by 80% of the Reference Rate (TR). According to the terms of Resolution no. 2,653, dated 9.23.1999, as of October, these operations were limited to 45% of the adjusted net worth of the grantor financial institutions with an overall limit of R$ 600 million for the contracting of new financial system operations.

Normally performing state and municipal banking debts registered a balance of R$ 20.9 billion, for a reduction of 24.3% in the year. One factor that contributed significantly to this result was the R$ 7.3 billion reduction in the balance of normally performing credits to the states and municipalities, as stipulated by the terms of Law no. 9,496, dated

9.11.1997. This norm authorized issue of federal securities in exchange for the assets maintained by the financial system against these public sector entities. Consequently, the states benefited from the lengthening of the debt term and the reduction in interest rate levels by turning over assets and assuming their debts with the federal government. Here, one should emphasize that the agreements signed with the federal government require compliance with fiscal targets and reductions in the presence of the state public sector in banking activities, under the terms of the Program of Incentives to the Reduction of the State Public Sector in Banking Activities (Proes). As far as the federal banking debt is concerned, the reduction in the year came to 11.8% with a balance of R$ 4.9 billion.

The balance of normally performing credits contracted by the private sector came to R$ 236.8 billion, with growth of 6.8% up to December, as compared to 5.7% in the previous year. These operations were concentrated mostly under guarantied overdraft accounts, personal credit operations and working capital operations.

Loans contracted by individuals increased by 14.9% in the year, despite the reduction that marked the first four months of the year. Insofar as loan operations with non-earmarked resources are concerned, personal credit operations expanded by 48.6% while financing for acquisitions of goods increased by 3.5%, indicating probable preference for nondurable consumer goods. As of the month of August, when the basic interest rate had practically returned to the level in effect prior to the worsening of the international financial crisis in the second half of 1998, several seasonal factors generated a positive impact on credit operations, including reductions in default levels following anticipated payment of the Christmas bonus and growth in demand for financing for acquisitions of goods (18.7%) as the end-of-year holidays approached. One should note that, in the month of June, the assets of the federal government's education credit program were incorporated into the assets of a public financial institution, thus explaining most of the 4.8% growth in the balance of operations with that sector in the period.

The segment of legal entities - industry, commerce and other services - registered growth of 11.6% in the banking debt balance, closing December with an accumulated total of R$ 122.8 billion. Available data on non-earmarked resources in December point to expansion of 10.8% in the balance of working capital credits and 14.5% in the short-term guarantied overdraft account. Credits earmarked to commercial, vendor and trade bill discounting operations expanded by 19.3% and 27.5%, respectively.

On a segment-by-segment basis, one should highlight credit operations with the sector of commerce, with a total of R$ 21 billion and growth of 16.3% in the year. Here, special mention should be made of the 7.5% growth in the third quarter of the year, mostly as a consequence of the financing of inventories for end-of-year sales. In that period, demand for financing in the sector of commerce was concentrated under guarantied overdraft accounts and revolving credit operations, which are normally more costly and centered on smaller size businesses, in detriment to trade bill discounting and vendor operations.

The balance of credit operations with the industrial sector came to R$ 71.3 billion, reflecting an increase of 19.1% in the year, part of which was generated by levying of exchange indexing. Insofar as the BNDES system is concerned, disbursements to the manufacturing and extractive industries came to R$ 8.4 billion, for growth of 29.6% in the year.

The segment that encompasses other services registered a debt stock with banks of approximately R$ 30.5 billion, reflecting a reduction of 4.9% in annual terms. To some extent, this result was generated by January payment-in-full of the financing contracted with the public financial system by the consortium of companies that acquired the Telebrás System.

Credits to the housing sector (individuals and housing cooperatives) registered a decline of 5.8%. This result was a consequence of the process of anticipated liquidation of contracts formalized under the terms of the Wage Variation Compensation Fund (FCVS). The balance of financing to this segment came to R$ 57.4 billion in December 1999. Growth in financing in that market depends basically on a consistent interest decline and consolidation of the secondary market for securities derived from the credit portfolio as defined in the rules governing the Real Estate Financing System (SFI).

In this framework, the National Monetary Council reduced the obligatory level of savings account resources to be invested in housing financing up to 12.31.1999 from 70% to 60% (Resolution no. 2,623, dated 7.29.1999). This period was later extended to 3.31.2000 (Resolution no. 2,677, dated 12.21.1999). It is important to stress that funding estimated at R$ 1.4 billion, generated by termination of contracts formalized under the terms of the FCVS - many of which were acquired with discounts by federal banks from restructured state financial institutions - has been used for purposes of granting new financing to this sector.

The balance of normally performing financing granted to the rural sector, including the agribusiness segment, came to R$ 21.9 billion in December, for positive growth of 6.2% in the year. The balance of credits reserved for investment purposes registered growth of 14.6%, while the balance for marketing operations declined as a result of the lag in the release of budgetary resources by the National Treasury to be utilized in interest rate equalization operations. As far as current expenditure financing is concerned, the fourth quarter witnessed growth of 16.7% as a result of the contracting of operations aimed at financing the planting of the 1999/2000 grain harvest.

Funding obtained through Resolution no. 2,483, dated 3.26.1998 - which deals with foreign resources inflows to be used in rural financing (agriculture and agribusiness)

- came to R$ 1.2 billion in December. In comparison to December 1998, there was a reduction of R$ 1.5 billion in rural activity financing operations. Here, the most important factor was the decline of R$ 940 million in the balance of marketing credits. This reduction resulted from devaluation of the rate of exchange at the start of the year.

With regard to the sources of the funding to be used in rural credit operations, there was a reduction of 39.3% in the balance of non-earmarked resources and growth of 15.7% in the balance of obligatory investments (on demand resources), both of which are mostly reserved to current expenditure financing (59.6% and 63.2%, respectively). In terms of refinancing operations and the on-lending of resources by the financial system to be used in rural sector operations - just as in the case of those originating in Rural Finame and Worker Support Fund operations - growth came to 5% in the period. Of this total, 69% is reserved to investment financing.

Insofar as the credit supply to less significant segments of the economy is concerned, more favorable conditions were created for working capital operations by Banco do Brasil and the Federal Savings Bank, utilizing PIS/Pasep Participation Fund resources.

Parallel to this, Resolution no. 2,627, dated 8.3.1999 created a credit system exclusively for micro-entrepreneurs. These operations will be restricted exclusively to financing operations with individuals and legal entities classified as microbusinesses, with the objective of making their operations feasible. In these cases, release of consumer credit operations is prohibited. The major sources of these funds are national and international development entities, state and municipal budgets and constitutional funds. The public sector is not allowed to hold stock participation in these companies.

These credit companies are subject to specific operational limits so that they will carry on their operations in a safe and efficient manner. At the same time, they are obligated to maintain minimum levels of paid-in capital and net worth and operate within debt and risk diversification limits, while the credits granted to each client are limited to a maximum of R$ 10 thousand.

When it regulated the subject, Banco Central centered previously informal mechanisms under its supervision in such a way that microcredit policy would be included in the general economic policy context and be transformed into an additional element for achieving the objective of a steady upturn in the growth trajectory, since this type of credit stimulates economic activity in sectors that have great potential for generating jobs.

Circular no. 2,934 was issued on 10.4.1999 and reduced the risk weighting factor applicable to loan operations guarantied by funds instituted by the Federal Constitution, specific legislation or created by government or private organizations. These funds have the purpose of sharing the risk of operations with small and microbusinesses.

Adoption of this measure could create the conditions required to expand the credit supply by increasing financial institution leverage.

The balance of credit operations in arrears and in liquidation, less income to be appropriated, totaled R$ 24.3 billion, for a reduction of 8.9% in the year. This falloff was concentrated mostly in the public financial system, where the participation of credits in default in the total financial system registered a reduction of 1.4 percentage points. Consequently, the ratio between bad credits and total financial system credits moved from 9.5% at the end of the previous year to 8.5% in December. Provisions for bad debts came to R$ 32.8 billion, with growth of 2.3% in the period. This total was 35.1% greater than the balance of credits in arrears and in liquidation.

To some extent, the default trajectory results from the financial impact of the initial charging of the Social Security Financing Contribution (Cofins) in February 1999, as specified in Law no. 9,718, dated 11.27.1998, particularly on the public financial system, as well as from interruption of the upward trend in private sector defaults.

The aforementioned instrument determines that 3% of the gross revenues of companies are to be channeled to Cofins, offsetting up to 1/3 of the Social Contribution on the Profits of Legal Entities (CSLL). Since income on matured loans that have not been paid nor executed judicially are included in the tax calculation base, banks have become more rigorous in submitting credit in default to the courts and have opted to classify part of these credits as losses. At the start of the year, this procedure was particularly common among public financial institutions and resulted in a reduction in the default rate of the public financial system. In the case of the private financial system, the reduction in the default rate occurred in December 1998 following approval of the law. It would seem likely that this reaction was due to the fact that private institutions had prepared themselves not only for adoption of these measure but also for reclassification of credits in arrears and in liquidation.

Insofar as the private financial system is concerned, the interruption in default rate growth was probably due to the change in the overall economic situation, which had been strongly impacted by the exchange system alteration and measures taken to ensure continued economic stability. Devaluation of the nation's currency increased the financial charges on credits tied to foreign currency, interest rate increases and the financial cost of loan operations. In this economic environment, private financial system defaults increased from 4.6% in January to 5.4% in May.

Toward the close of the first half of the year, national currency began rising in value, as the rate of exchange stabilized, and unfavorable expectations regarding the future of the Brazilian economy were seen to be unfounded. In this framework, interest rates turned downward, forcing a turnaround in the growth trajectory of private sector defaults, which dropped from 5.3% in June to 4.1% in December.

Accompanying the evolution of bad credits, the rate of provisioning - measured by the volume of provisions in relation to total credits - registered a reduction from 12% in January to 11.4% in December. Even so, this rate was well above the rate of default, demonstrating the defensive stance assumed by institutions.

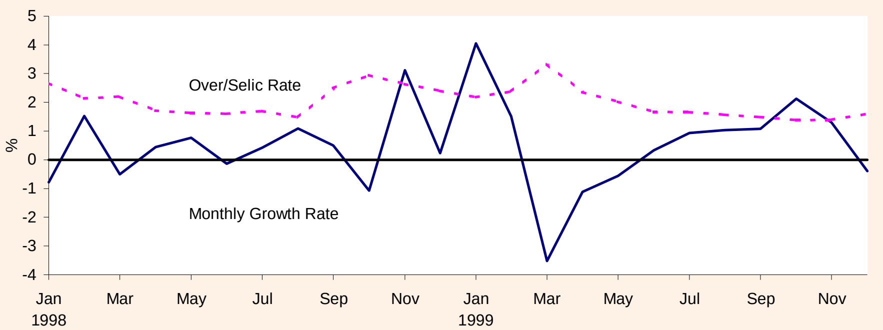
The provisioning level in the private financial system came to 7.6% of total credits in December, as compared to 8% in January, precisely the month in which expectations of deterioration in the quality of the credit portfolio, caused by the volume of debt referenced to foreign currency, became more evident. In the case of the public financial system, this rate closed December at 14.7%, while the January rate came to 15.1%.

On 12.21.1999, the National Monetary Council issued Resolution no. 2,682, introducing important changes into the criteria governing the classification of credit operations and constitution of provisions for bad credits. As of 3.1.2000, the criteria will no longer be restricted to the length of the default and the guaranties offered, but will also adopt such internationally accepted criteria as financial institution analysis of the potential borrower risk.

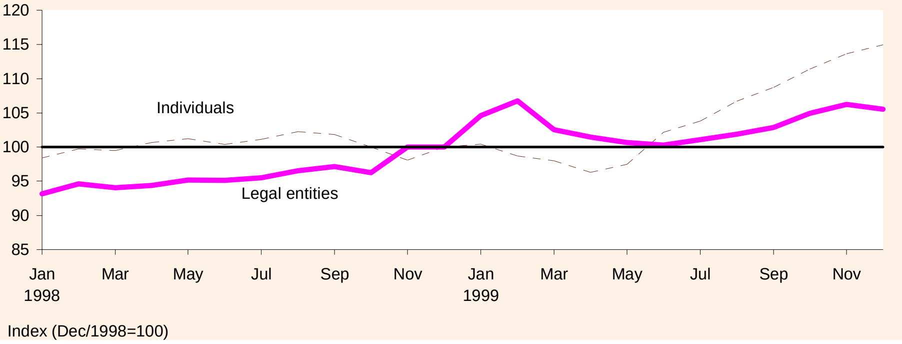
The major changes introduced by the new criteria, in comparison to the previous system, which was governed by Resolution no. 1,748, dated 8.30.1990, were as follows:

a) the establishment of nine borrower risk levels to be used by the financial institution, based on minimum periods of arrears and a series on internal and external data regarding the debtor, guarantors and the characteristics of the operation. Classification of the credits is to be revised periodically and on a monthly basis in cases of payment delays. Previously, credits were separated into normally performing operations, operations in arrears and in liquidation, depending on the period of default and the guaranties;
b) credits that are included in renegotiation process that were previously reclassified as normally performing credits, even when considered as losses, are to be classified at the same risk level as they were when in default;

Graph 2.8
Financial system loans: private sector

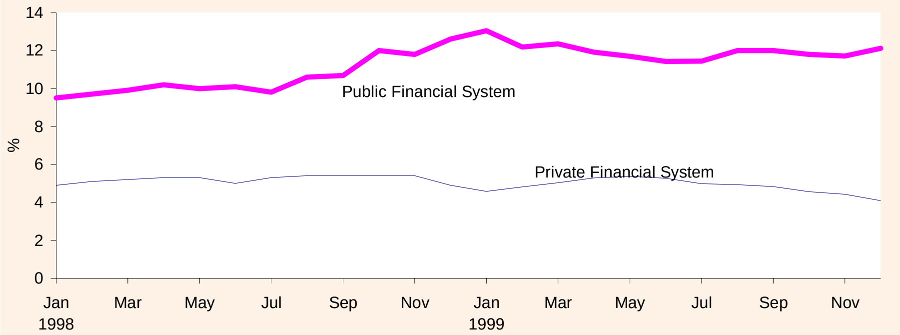


Graph 2.9
Growth in private financial system loans

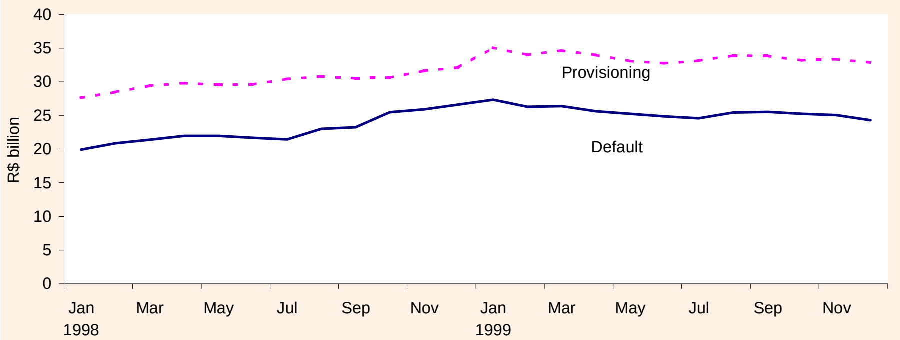


Index (Dec/1998=100)

Graph 2.10
Default rate



Graph 2.11
Default and provisioning of the financial system



c) the criteria for setting aside provisions for bad credits that previously depended on terms and guaranties, are to be determined on the basis of the risk level in which the borrower is classified. Furthermore, Banco Central may require reinforcement of the provision, based on information provided by the Credit Risk Center.

National Financial System

Following a long period of monetary stability that has effectively neutralized financial system utilization of inflationary gains to offset localized inefficiencies, financial system supervision has concentrated its attention on implementation of a more sophisticated risk control system and a more flexible approach to the rules applicable to the sector. Parallel to a greater opening to foreign capital inflows, these guidelines have generated considerable improvement in the operational profile and placed the national financial system squarely in the position of being able to perform its role of stimulating a process of steady and consistent growth based on private spending.

Since implementation of the Real Plan, prudential regulation has sought to encompass not only control over the liabilities of financial institutions but, above all, the relationship between the quality of an institution's investments and its own capital funding. In this sense, Resolution no. 2,606, dated May 27, 1999 defined limits for leveraging financial institutions in operations with market risks tied to exchange rate variations, at the same time in which it altered the Basel formula for capital adequacy in relation to the risk of these asset operations.

According to the general rule, the new limit determines that total exposure in gold and in assets and liabilities referenced to changes in the rate of exchange, calculated on a consolidated basis for the institutions and their controlled companies, can be no more than 60% of the value of adjusted net worth, which corresponds to the sum of principal and supplementary capital. This exposure to exchange risk corresponds to the difference between the bought and sold exposures or, in other words, it is the result of the asset

Table 2.5 - Credits granted by the financial system

Percentage share

Itemization	1997	1998	1999
Total	100.0	100.0	100.0
Deposit money banks	91.5	91.4	87.6
Commercial and multiple banks	78.4	80.0	66.6
Banco do Brasil	8.7	7.7	11.7
Other public banks	48.3	56.7	27.6
Private banks	21.5	15.5	27.3
Domestic	15.1	10.1	16.0
Foreign	6.4	5.4	11.3
Savings banks	13.1	11.4	21.0
Development and investment banks	5.5	5.9	8.4
BNDES	4.4	5.0	7.3
Others	1.1	0.9	1.1
Nonbanking financial institutions	3.0	2.7	4.0

and liability positions assumed in gold and foreign currencies that can impact assets according to future exchange rate variations. As examples of these assets and liabilities, one could cite securities and loans with exchange variation clauses. The limit went into effect in July 1999 and is verified daily by Banco Central. Institutions that have not complied with these rules lose their accreditation for this type of operation.

With these measures, the capital requirement for risk coverage purposes as determined by the Basel Accord criteria is no longer based only on the credit risk of a specific type of asset and swap operations, but now includes the market risk generated by the rate of exchange. Contrary to credit risk, this variable is independent of the quality of the borrower of financial institution resources, and involves all those who contract operations based on parameters subject to change as the economic situation of the country develops. With the new rules, it was possible to release the exchange position sold on October 28.

Another factor of importance to the strengthening of the financial system was alteration of the minimum amounts of paid-in capital and net worth permanently required of financial institutions. These amounts have not been altered since August 1994 and must be updated so that capitalization can keep step with the operational evolution of the financial system since implementation of the Real Plan. On May 27, Resolution no. 2,607 increased minimum required capital for all financial institutions. The level for commercial or multiple banks with commercial portfolios was raised from R$ 7 million to R$ 17.5 million, with final adjustment to be achieved by August 2001.

For the first time, Resolution no. 2,608 defined minimum capital limits for credit cooperatives, since the norm previously in effect referred only to the minimum amount of the capital declared in a company's articles of incorporation. The new requirements, coupled with adoption of more restrictive limits on indebtedness and risk diversification for cooperatives, are aimed at making this segment more efficient by avoiding the current situation of a multiplicity of very small institutions operating in this field.

With respect to management of third party capital, new rules were defined for the purpose of consolidating the segregation of these funds from those involved in the activities of the managing entity. In this way, the management entities are not permitted to hold stock in the institutions they administer, except at the time of their constitution, and further restrictions were imposed in terms of value and time periods. Parallel to this, administrators are not allowed to inject resources into the funds and are not permitted to be co-responsible for the operations of these entities.

Still in the area of prudential regulation, one should mention that the Brazilian payments system is being totally overhauled so as to reduce risk and increase efficiency. The system of payments is composed of the procedures, rules, instruments and operational systems that are utilized in an integrated manner to transfer funds from the payee to the party receiving the resources and, in this way, terminate a liability. No matter what the underlying reason, problems in fund transfers can result in the default of other participants that depend on these payments to preserve the health of their cash flows. Even financial institutions not directly involved with the bank in default may be affected. Thus, any interruption in the payment chain among participants can result in losses of confidence and destabilization of the entire financial system.

With this in mind, an effort has been made to adapt the system of payments in such a way that transactions can impact banking reserves in real time and not at the end of the day, as now occurs. Such an approach redefines the role of the monetary authority, now responsible together with the market for managing control of system solvency. Management of systemic risk is to be achieved through contingency mechanisms to be adopted by the various systems of financial liquidation, such as Selic and Cetip, and the participants will be fully informed of the risks involved in the systems in which they operate.

Banking supervision activities performed by Banco Central in 1999 led to the decree of extrajudicial liquidation of 19 institutions, most of which were stock and bond distribution companies and group buyer association administrators. Up to November 1999, the special management systems imposed on ten institutions were terminated. Most of these had occurred as a result of bankruptcies or transformation into ordinary liquidation. Viewed against the backdrop of the start of the Real Plan in July 1994, 107 institutions remain under special management systems that have not been terminated. All of these are involved in processes of extrajudicial liquidation. Of this grouping, most correspond to banks (28%), stock and bond distribution companies (19%) and group buyer associations (16%).

The current situation of the special management systems indicate that financial institutions have been adapting to the structural environment of low inflation, while they have been able to cope with the volatility of interest rates caused, to a great extent, by the adverse impacts of international financial market events and by fluctuations in the rate of exchange. Most of this performance should be attributed to improvement in banking supervision standards and in the system of risk control demanded by Banco Central in recent years.

One should also mention the success achieved in financial market preparation for the transition to the new millenium. This event was an opportunity that was utilized effectively to strengthen society's confidence in the National Financial System, since the operational security of the system not only weathered the test but demonstrated that it had been transformed into a system on any equal footing with broadly accepted international standards.

Financial institutions have been restructured with the aim of taking a more flexible approach to their operational rules. In this sense, one should note extinction of the minimum period for operations with earnings that are either preset or referenced to floating rates, as well as reduction of the minimum periods required for the various indicators. Thus, the TR and TJLP were given a minimum term of one month and the TBF was set at two months. At the same time, the TJLP which, up to June 1999, was restricted to the earnings on some funds and investments made by the BNDES and its agents and rural credit operations, can now be applied as reference to the earnings on any financial system asset and liability operations, while indexing to a specific price index has been permitted once again, provided that the interval between adjustments be no less than one year.

As of the month of August, less rigid norms were adopted for investment funds, according to which the funds themselves would be able to determine the grace periods to be observed for the granting of earnings to quota holders. At the same time, compulsory reserves on the assets of the funds were abolished. This more flexible approach has stimulated demand for short-term funds in light of the high level of expected earnings since, according to the previous rules, funds not subject to grace periods were obligated to maintain half of their portfolios in non-interest bearing deposits at Banco Central. Once the compulsory reserves had been eliminated and the period of negative net profitability resulting from the regressive levying of the IOF on earnings had elapsed, the profitability of investment funds will be more than double that obtained with the previous rules at a given rate of interest.

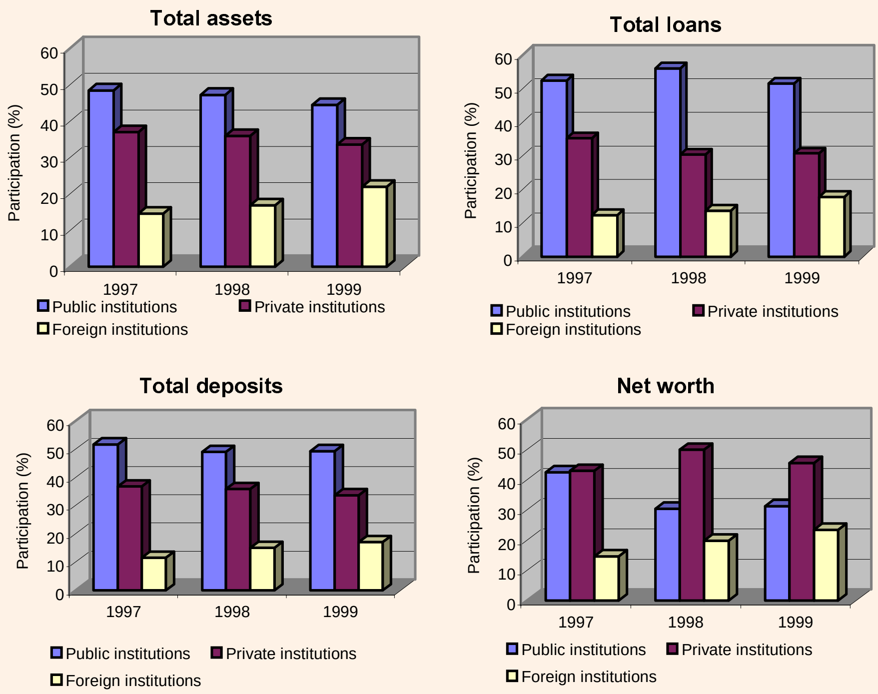
With respect to foreign resources inflows, Resolution no. 2,683, dated 12.29.1999, granted financial institutions the option of contracting external funding for free investment on the domestic market, without the need for the capital to remain in the country for the legally determined minimum period. At the same time, demand for a minimum period of amortization for the contracting, renewal and extension of the foreign loan operation was eliminated, with short-term capital flows being dependent only on the levying of the IOF. The objective of this measure was to stimulate institutions to seek out foreign sources of financing, since obligatory investments and minimum terms restrict the possibilities of allocating resources on the internal market, thus making it unfeasible for these funds to remain in the country for longer periods of time.

With regard to 1999 banking system performance, analysis of economic-financial indicators demonstrates on the one hand the operational adjustment through which these institutions have passed and, on the other, the possibilities for reducing the costs of financial intermediation or banking spreads and for increasing the volumes of credit operations. In the 1997-1998 period, the participation of foreign institutions in terms of total system net worth expanded from 15% to 20%. In relation to assets between 1998 and 1999, foreign participation moved from 17% to 22%.

In the last three years, reductions in administrative expenses per asset unit, recovery of the profitability of institutions' own capital resources and maintenance of the gross margins of financial intermediation clearly reflect the restructuring of both national and foreign, private and public institutions operating in Brazil. While the public subsystem has clearly become considerably leaner, foreign capital interests have increased their presence in the National Financial System, contributing to cost reductions and enhanced domestic market competitiveness, thus stimulating increased efficiency in the system as a whole.

Graph 2.12

National Financial System - participation by segment



Insofar as the restructuring of the public financial sector is concerned, the period for adhering to Proes, which was instituted in August 1996, came to a close. At the end of 1999, of the 45 existent state institutions, only three had not adhered to the program. Among the options offered, 10 had chosen extinction or ordinary liquidation, 13 had opted for privatization, 14 had been transformed into development agencies and only five had been restructured to continue their operations. During the course of the year, Banco Baneb, which had previously been under the control of the State of Bahia, was privatized and acquired by Banco Bradesco for R$ 260 million in an auction held in the month of June.

Finally, the downward trend in the leveraging of credit operations observed in the last three years, as shown in table 2.6, should be credited to adaptation of the institutions to the minimum capitalization rules determined for coverage of operation risks, as well as to a more conservative stance in relation to the granting of new loans. In this sense, with the incentive measures that have been taken, there is considerable room for growth in credit operations in a framework of lesser inherent risks.

Table 2.6 - Banking system indicators[1/]

Itemization	1997	1998	1999*
Credit operations leverage[2/]			
Public system	6.74	8.48	6.01
Private system			
Domestic	3.50	1.98	1.99
Foreign	3.55	2.28	2.30
Administrative expenditures by unit of asset			
Public system	3.16	3.05	2.37
Private system			
Domestic	3.33	3.16	2.37
Foreign	2.63	2.99	2.20
Profitability of net worth			
Public system	0.51	-2.19	7.53
Private system			
Domestic	-10.37	6.75	5.54
Foreign	-0.95	0.93	5.62
Gross operating profit margin[3/]			
Public system	1.15	1.18	1.32
Private system			
Domestic	1.17	1.29	1.33
Foreign	1.29	1.30	1.40

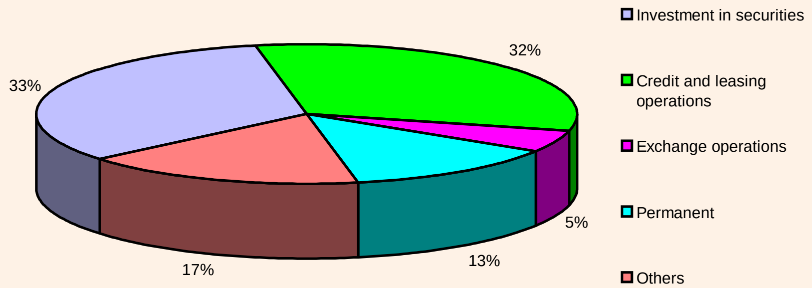
1/ Includes multiple banks, commercial banks, federal and state savings banks.

2/ It indicates how many times credit operations exceed net worth.

3/ Operating profit revenues in relation to operating profit expenditures. The main operating profit revenues refer to credit, exchange and securities operations. The main operating profit expenditures refer to inflow, exchange, loans, on-lendings and provision for hard-to-recover credits.

* Refers to Nov/1999.

Graph 2.13 - Assets' breakdown in the National Financial System - 1999



Graph 2.14 - Liabilities' breakdown in the National Financial System - 1999