



BANCO CENTRAL DO BRASIL

Inflation Report



December 2004

Volume 6 – Number 4



Spanish coin of 8 reales with a 960 réis stamp



Spanish coin of 8 reales with a 960 réis reminting

Museum of Money of
Banco Central do Brasil Collection

960 réis

The transfer of the Portuguese Court to Rio de Janeiro, in 1808, constituted by about fifteen thousand people with different customs of those of the colonial population, demanded that serious measures were made to finance the expenditures of the Court and to increase the income of the Colony, now the headquarters of the Portuguese government.

The currency in Brazil was then constituted, to a large extent, of Spanish coins of 8 *reales*. In need of funds, D. João determined the stamping of these coins, acquired by 700/800 *réis*, increasing their face value to 960 *réis*. From 1810 on, these values were minted in new coins or reminted in the coins of 8 *reales*. These coins, with face value of 3 *patacas*, were called ***patacões***.



BANCO CENTRAL DO BRASIL

Inflation Report



ISSN 1517-7289
CGC 00.038.166/0001-05

Inflation Report	Brasília	v. 6	n. 4	Dec	2004	P. 1 - 150
------------------	----------	------	------	-----	------	------------

Inflation Report

Quarterly publication of the Monetary Policy Committee, according to Decree 3,088, dated 6.21.1999.

The texts and respective statistical tables and graphs are under the charge of the following component parts:

Department of Economics (Depec) and
(E-mail: depec@bcb.gov.br)

Research Department (Depep)
(E-mail: conep.depep@bcb.gov.br)

Reproduction permitted only if source is stated as follows: Inflation Report, volume 6, no. 4.

General Control of Publications

Banco Central do Brasil
Secre/Surel/Dimep
SBS – Quadra 3 – Bloco B – Edifício-Sede – M1
Caixa Postal 8.670
70074-900 Brasília – DF – Brazil
Phones: (5561) 414-3710 and 414-3567
Fax: (5561) 414-3626
E-mail: editor@bcb.gov.br

Number printed: 160 copies

Statistical Conventions:

- ... data not available.
- nil or non-existence of the event considered.
- 0 ou 0.0 less than half the final digit shown on the right.
- * preliminary data.

Hiphen between years indicates the years covered, including the first and the last year.

A bar (/) between years (1970/1975) indicates the average of the years covered, including the first and the last year or even crop or agreement year, when mentioned in the text.

Occasional discrepancies between constituent figures and totals as well as percentage changes are due to rounding.

There are no references to sources in tables and graphs originated in the Banco Central do Brasil.

Banco Central do Brasil Information Bureau

Address: Secre/Surel/Diate
Edifício-Sede – 2º subsolo
SBS – Quadra 3 – Zona Central
70074-900 Brasília – DF – Brazil
Phones: (5561) 414 (...) 2401, 2402, 2403, 2404, 2405, 2406
DDG: 0800 992345
Fax: (5561) 321-9453
Internet: <http://www.bcb.gov.br>
E-mail: cap.secre@bcb.gov.br

Contents

Foreword	5
Executive summary	7
Activity level	11
1.1 Retail sales _____	12
1.2 Output _____	14
Crops/livestock _____	14
Crop production _____	15
Livestock _____	16
Expectations for the 2004/2005 harvest _____	16
Industrial output _____	17
1.3 Labor market _____	20
Employment _____	20
Earnings _____	22
1.4 Gross Domestic Product _____	23
1.5 Investments _____	28
1.6 Conclusion _____	30
Prices	31
2.1 General indices _____	31
2.2 Consumer price indices _____	32
2.3 Monitored prices _____	39
2.4 Inflation core _____	40
2.5 Market expectations _____	41
2.6 Conclusion _____	42
Credit, monetary and fiscal policies	45
3.1 Credit _____	45
Targeted resources _____	46
Credit operations based on market resources _____	47
3.2 Monetary aggregates _____	49
Federal Public Securities _____	50
Real interest rates and market expectations _____	51

Capital market	51
Financial investments	52
3.3 Fiscal policy	53
Public sector borrowing requirements	53
Federal securities debt	56
Public sector net debt	56
3.4 Conclusion	61

International economy **63**

4.1 Economic activity	63
4.2 Monetary policy and inflation	66
4.3 International financial markets	67
4.4 World trade	71
4.4.1 Commodities	73
4.4.1.1 Petroleum	74
4.5 Conclusion	74

Foreign sector **75**

5.1 Exchange movement	76
5.2 Trade in goods	77
5.3 Services and income	79
5.4 Financial account	80
5.5 Indicators of external sustainability	85
5.6 Conclusion	89

Inflation outlook **91**

6.1 Determinants of inflation	92
6.2 Principal scenario: assumptions and associated risks	97
6.3 Inflation forecast	101

Boxes

Outlook for GDP in 2004 and 2005	25
Wholesale Price Index according to Processing Stage (IPA-EP)	33
Trajectory of Net Indebtedness and GDP Valuation Criteria	57
Balance of Payments Projections	81
External Sustainability Indicators	86
Banco Central's and Market's Inflation Forecasts	104
Inflation Expectations Surveys	107

Annex **111**

Economic policy measures **137**

Appendix **145**

Foreword

Inflation Report is a quarterly publication of the Banco Central do Brasil with the objective of evaluating the performance of the inflation targeting system and providing a prospective scenario for inflation. The national and international economic conditions underlying decisions taken by the Monetary Policy Committee (Copom) concerning the monetary policy management are presented.

The *Report* is divided into six chapters: Activity level; Prices; Credit, monetary and fiscal policies; International economy; Foreign sector and Prospects for inflation. With regard to the activity level, growth in retail sales, inventories, output, labor market and investments are investigated. In the following chapter, price analysis focuses on the results obtained in the quarter as a consequence of monetary policy decisions and the real conditions of the economy outside the realm of government action. The chapter referring to the credit, monetary and fiscal policies, the analysis is centered on the behavior of credit, financial and budget operations. In the chapter dealing with the international economy, the *Report* presents an analysis of the world's major economies and seeks to identify those conditions capable of impacting the Brazilian balance of payments. Insofar as the foreign sector chapter is concerned, analysis is targeted at economic-financial relations with the international community, with emphasis on trade results and foreign financing conditions. Finally, prospects on inflation growth are analyzed.

Executive summary

Continuous strong gross domestic product (GDP) growth in the third quarter of 2004 – for the fifth consecutive quarter – has boosted economic and social welfare indicators, such as consumption, payroll, and employment – the latter at a rate unprecedented in the recent past. However, strong output growth was also accompanied by inflation rates incompatible with the targeted medium-term inflation path. Persistent inflationary pressures were evident in wholesale and consumer prices, in the various consumer price core inflation measures, and in the rigidity of private sector inflation expectations.

The recent behavior of macroeconomic indicators demonstrates the sustainability of the growth cycle currently underway. In addition to the increase in payroll, in consumers' and firms' expectations, and in credit levels – factors likely to be important sources of growth in the coming year – the increase in investment has also played an important role in recent months.

Fixed-capital investment rose sharply in the third quarter of 2004. The revision of the national accounts data translated into an even stronger growth in fixed-capital investment in the first two quarters of the year. Notwithstanding this positive trend, the output gap estimates monitored by the Banco Central do Brasil (BCB) continue to point to a reduction in aggregate idle capacity. Given the high levels of capacity utilization, the inflation trajectory will be highly dependent on the expansion in the supply of goods and services, in order to adequately meet growing demand.

The recent performance of bank credit has reflected continued economic growth and a seasonal increase in credit demand from the productive sector. The latter was due to greater end-of-year activity and the dynamism of agricultural businesses. As far as credit costs are concerned, bank lending rates have reflected the upward movement in the Over-Selic rate, which began in September. Furthermore, lending interest rates were also

affected by a seasonally increase in shorter-term credit operations, contracted at higher interest rates.

Fiscal results have been positive at all levels of the public sector, and consistent with the fiscal targets set for 2004. The increase in consolidated primary surplus was driven by revenue growth attributable to the strong economy and a reduction in personnel expenditures, in the context of rising current expenditures and investment outlays. It should be emphasized that, in November, the net debt-to-GDP ratio reached its lowest level since June 2001, continuing to reflect the ongoing economic growth and the exchange rate appreciation.

The current account surplus continues to be supported by the performance of the trade balance, which reached a surplus of US\$30.2 billion through November, as well as by unilateral current transfers, which totaled US\$3 billion in the period. Even with the increase in net remittances in the income account, the country registered a current account surplus of US\$10.4 billion, compared to US\$3.7 billion in the same period of 2003. The current account surplus in the twelve months through November totaled US\$10.7 billion.

The pace of export growth is expected to slow in 2005. Meanwhile, the recovery in economic activity and the consequent rise in imports over the current year are compatible with the projection of a trade surplus of US\$25 billion for 2005. This level would represent a reduction compared to the 2004 result, due to the stronger growth of imports relative to exports.

Net foreign direct investment (FDI) flows have recovered, and their recent performance validates projections for the year-end result. For 2005, it is expected a US\$14 billion inflow in FDI. The recent behavior of net FDI and the expected evolution of private sector external debt rollovers have contributed to the positive outlook for the external accounts financing over the coming year, despite the expected reduction in gross international reserves to be caused, primarily, by repayments to the International Monetary Fund (IMF).

The inflation trajectory in recent months was positively affected by continued exchange rate appreciation and, mainly, by the behavior of food prices, in particular fresh products, the prices of which presented a sharp reduction. Nonetheless, indicators such as the diffusion index and core inflation measures point to persistent inflationary pressures, characterized by upward price momentum across a range of different segments.

Though the continuity of this scenario in the coming months depends on a sharp reduction in the risks associated to the international oil market, several domestic factors are cause for concern. The first is related to the disparity of industrial prices increases at the wholesale and retail levels, with a pass-through rate below that registered in recent periods. The second is a consequence of seasonal demand growth in December, which was further intensified this year by the high level of economic activity. Furthermore, some factors will tend to add pressure on inflation – albeit temporarily – in the coming months. In addition to the forecasted increases in regulated prices, seasonal increases in the prices of fresh food, leisure, and education are expected.

The benchmark scenario central forecast projects an inflation rate of 7.4% for 2004. In 2005, the path for the twelve-month-accumulated inflation points to a downward trend, from 7.1% in the first quarter to 5.3% at the end of the year, above the 5.1% objective pursued by Copom. For 2006, inflation is projected at 4%. The market scenario – based on private sector expectations for interest and exchange rates surveyed by the Investor Relations Group (Gerin) of the Banco Central do Brasil – forecasts an inflation equal to that of the benchmark scenario for 2004 (7.4%), 6.3% for 2005, and 5.0% for 2006. Under the benchmark scenario, the GDP growth forecast for 2004 is 5%, 0.6 p.p. higher than that projected in the September *Inflation Report*, while a 4% increase in GDP is forecasted for 2005.