ISSN 1517-7289

BANCO CENTRAL DO BRASIL

# Inflation Report

June 2003

Volume 5 – Number 2

# Inflation Report

ISSN 1517-7289
CGC 00.038.166/0001-05

| | | | | | | |
|---|---|---|---|---|---|---|
| Inflation Report | Brasília | v. 5 | no. 2 | Jun | 2003 | P. 1 - 180 |

# 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 5, no. 2.

**General Control of Subscription:**

Banco Central do Brasil
Demap/Disud/Subip
SBS – Quadra 3 – Bloco B – Edifício-Sede – 2°ss
Caixa Postal 8.670
70074-900 Brasília (DF) – Brazil
Phone: (55.61) 414-3165
Fax: (55.61) 414-1359

Number printed: 150 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: (55.61) 414 (....) 2401, 2402, 2403, 2404, 2405, 2406
DDG: 0800 992345
Fax: (55.61) 321 9453
Internet: http://www.bcb.gov.br
E-mail: cap.secre@bcb.gov.br

# Contents

# 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

The deceleration in economic activity expected to materialize in early 2003 was confirmed as GDP growth stalled in the first quarter of the year and the industrial and retail sectors posted negative results in April. The slowdown was driven mainly by a drop in domestic demand, which intensified as the first four months of the year progressed. The slower growth of industrial exports, which had reached high levels after growing continually through 2002, also contributed to the slowdown in economic activity.

Considering that exports have been growing at a slower pace, the speed and intensity of any resumption of economic growth in the next few months will depend on further improvement in the domestic indicators observed recently – particularly on a decreasing inflation rate and on the recovery of expectations. In 2003, GDP growth is expected to reach 1.5%–1.8%, depending on the evolution of interest rates and the exchange rate.

The financial system's stock of credit dropped in the first quarter as a result of the effect of the exchange rate appreciation on foreign-currency portfolios and a drop in the demand for credit. Corporations limited their demand for loans to the level necessary to meet cash flow needs and decided to postpone medium and long-term investments. Likewise, consumers limited their borrowing to rotating credits, which are principally aimed at complementing their income, rather than financing durable goods purchases. At the same time, financial institutions took a conservative posture with respect to lending, as evidenced by their increased client selectivity and higher interest rates.

The fiscal performance of all three levels of government continues to be positive, with the public sector registering a primary surplus of R$ 32.7 billion in the first four months of the year. This result and the exchange rate appreciation produced a R$ 41.3 billion (4.35% of GDP) decline in the net public sector debt, which fell to 52.2% of GDP in April. Special mention should also be made of the federal administration's introduction into Congress and subsequent efforts to ensure the passage of reforms necessary for the structural sustainability of the fiscal accounts, namely constitutional amendments dealing with tax reform and the reform of the social security system.

External financing conditions improved significantly in the first five first months of 2003 relative to the last three months of 2002. With no significant changes to the projections for the net flows of services and income, and the continuation of trade surpluses, net inflows of foreign direct investment will be more than sufficient to finance the current account deficit. In addition, the renewed flow of foreign credit with better rollover rates for direct loans and medium-term and long-term securities indicates that the financing profile of the balance of payments has improved.

In the first quarter of 2003, global economic growth stalled as a result of unfavorable expectations on the eve of the war in Iraq. Although it is still too early to make a precise evaluation of the post-war macroeconomic scenario, the relatively rapid resolution of the conflict has so far not confirmed the projections of a strong boost in the level of economic activity in industrialized countries. The prospects for global growth in the second half of the year will be determined by fiscal and monetary policies in the major economies.

Inflation has been declining this year. Three basic factors explain this recent behavior. First, the high inflation rates registered early this year were caused by the delayed effects on prices of the marked exchange rate depreciation observed last year and by the higher persistence of inflationary pressures, as a higher percentage of agents raised prices and salaries based on accumulated inflation. Second, monetary policy has reduced inflation and inflationary pressures by controlling the level of aggregate demand. Third, the recent exchange rate appreciation reduced pressures on corporate costs and wholesale prices. Although retail prices of tradable goods are still showing some resistance to reflect the exchange rate appreciation fully, consumer prices have tended to stabilize without pressures for new adjustments.

The persistence of inflation was caused by price adjustments aimed at recovering profit margins in the initial months of the year. This behavior resulted in a drop in sales in an environment marked by lower demand and a monetary policy aimed at preventing price adjustments that would tend to perpetuate inflation.

In the baseline scenario, which assumes that the Selic rate will remain at 26% p.a. and the exchange rate at US$1= R$2.85, the central path expected for 12-month inflation will reach a peak of 17% in the second quarter of 2003 and will drop continually thereafter. Inflation projected for 2003 and 2004 is 10.2% and 4.2%, respectively. In a scenario that includes the interest rates and exchange rate expected by the market, inflation rates of 10.8% in 2003 and of 6.0% in 2004 are projected.

The inflation projected for 2003 is above the adjusted target of 8.5%, but its path has confirmed the projections made in the March inflation Report, according to which inflation would begin to drop as early as the second quarter of the year to levels consistent with those mentioned in the Open Letter sent by the Governor of the Central Bank of Brazil to the Minister of Finance on 1.21.2003. Some risk factors may still undermine these projections, particularly in regards to the speed at which inflation will drop. However, the behavior of inflation in the second quarter suggests that these risks have decreased since the last Report.

The evolution of expected market price inflation and the path of the targets set for 12-month ahead inflation have been converging rapidly. The most recent figure for expected 12-month ahead inflation is 7.4%, which is close to the path of the corresponding 12-month ahead target of 7.2%. The path of the 12-month ahead target estimated in June 2003 corresponds to inflation of 7%.

# 1 – Activity level

The economic activity level remained stable in the first quarter of the current year, when compared to the previous period. This result interrupted the gradual growth trajectory that had been observed over the course of 2002. Insofar as production is concerned, stability resulted from differentiated performances of the various economic sectors, among which the crop/livestock sector turned in particularly strong final figures. In general, this sector has benefited from favorable prices, at the same time in which the sector's current statistics point to a record grain harvest, with the highest rate of annual crop growth since 1992. In the industrial sector, the behavior of output followed the same pattern as in 2002 and was strongly dependent on those economic segments focused more intensively on export operations. However, the positive performance of these segments at the start of the year was not sufficient to sustain the growth trajectory in industrial output that had marked the previous year. In comparison to the final quarter of the year, manufacturing activity in the early months of 2003 dropped sharply, particularly as a consequence of declining internal demand.

At the level of components, growth in demand reveals the factors that were most responsible for the loss of economic momentum in the early months of 2003. Consumption has followed a downward curve, reflecting rather unfavorable credit conditions, reductions in the buying power of wages and very little in terms of job generation. Investments also slipped in the first quarter of the year, moving in precisely the opposite direction of what had occurred in the final six months of 2002. Growth in these outlays, which normally respond to changes in the economic climate with some degree of lag, reflected the uncertainties that prevailed during the presidential election campaign. This was particularly true in terms of deteriorating expectations and exchange depreciation, with repercussions on monetary policy implementation. Finally, the performance of the foreign trade sector has turned in rather exceptional results when compared to the figures for the same period of the previous year. However, comparisons of seasonally adjusted short-term exports and imports also pointed to deceleration in this growth factor.

Thus, though the coming together of these factors ratifies the outlook for positive economic growth in the current year, both the magnitude of this expansion and the growth trajectory over the coming months will be conditioned by consolidation of growth in internal indicators, particularly the effects of a downturn in inflation and recently perceived recovery in expectations regarding internal demand. It should also be recalled that the very low reference base in the first half of 2002 has also contributed to the growth result.

## 1.1 Retail sales

Retail activity indicators showed a sales reduction in the early months of 2003, compared to the results of the corresponding periods of the previous year. On the other hand, leading indicators of consumer behavior point to a reversal in this trend over the coming months.

The results of the nationwide Monthly Trade Sector Survey, issued for the month of April by the Brazilian Institute of Geography and Statistics (IBGE), indicated a 5.5% decline in the Sales Volume Index of the retail trade sector in the first four months of 2003, compared to the result of the same period in 2002. A breakdown by specific activities shows that the largest reductions occurred in the segments of furniture and home appliances, with 11.7%, fuels and lubricants, with 6.4%, and hyper and supermarkets, food products, beverages and tobacco, with 6.2%. Sales of the grouping of automobiles, motorcycles, parts and spares, which are not included in the calculation of the general index, registered a reduction of 13.6% in the four month period, interrupting the process of recovery that began in the first quarter of 2002. On a state-by-state basis, the principal reductions occurred in Acre, Amazonas and Espírito Santo. On the other hand, the best performances in the retail trade sector were registered in Rondônia, Piauí and Paraná.

**Sales volume index in the retail sector – Brazil**

Percentage change

| Itemization | 2002 | | | | 2003 | |
|---|---|---|---|---|---|---|
| | I Q | II Q | III Q | IV Q | I Q | Apr |
| Same period of the previous year | | | | | | |
| Retail sector | -0.8 | -0.9 | 0.9 | -1.9 | -6.0 | -5.8 |
| Fuel and lubricants | 5.3 | 1.5 | 9.6 | 6.1 | -6.3 | -7.0 |
| Supermarkets | 0.0 | -1.7 | -1.5 | -3.7 | -7.9 | -6.6 |
| Textiles, clothing and footwear | -2.5 | -5.3 | 2.9 | -0.3 | -0.4 | -0.4 |
| Furniture and white goods | -1.4 | 4.0 | 0.1 | -4.2 | -10.0 | -12.0 |
| Other domestic goods | -4.6 | -0.6 | 0.9 | -1.5 | -1.6 | -2.6 |
| Vehicles, motorcycles | -23.4 | -19.8 | -12.0 | -11.5 | -10.1 | -13.7 |
| Accumulated in the year | | | | | | |
| Retail sector | -0.8 | -0.8 | -0.2 | -0.7 | -6.0 | -5.5 |
| Fuel and lubricants | 5.3 | 3.3 | 5.5 | 5.6 | -6.3 | -6.4 |
| Supermarkets | 0.0 | -0.9 | -1.1 | -1.8 | -7.9 | -6.2 |
| Textiles, clothing and footwear | -2.5 | -4.1 | -1.7 | -1.3 | -0.4 | -0.5 |
| Furniture and white goods | -1.4 | 1.3 | 0.9 | -0.6 | -10.0 | -11.7 |
| Other domestic goods | -4.6 | -2.6 | -1.4 | -1.4 | -1.6 | -2.0 |
| Vehicles, motorcycles | -23.4 | -21.6 | -18.6 | -17.0 | -10.1 | -13.6 |

Source: IBGE

It is worth noting that reduction in the Sales Volume Index in the first four months of 2003 was to a great extent due to a 21.9% median price increase in the trade sector, during the four month period between 2003 and 2002. This rate is above the 15.9% accumulated inflation rate for the same period, according to the IBGE's Broad National Consumer Price Index (IPCA). Thus, with the exception of commercial activities in the segments of automotive vehicles and fabrics, apparel and footwear, which registered price increases of 5.5% and 9.8%, respectively, in the period, the activities of other segments were characterized by the rebuilding and even broadening of profit margins, as demonstrated by price increases that were similar to or greater than the level of inflation registered in the period.

**Sales volume index in the retail sector – Brazil**
April, 2003

Percentage % in 2003

| Itemization | Nominal revenue | Volume | Price change |
|---|---|---|---|
| Retail sector | 15.3 | -5.5 | 21.9 |
| Fuel and lubricants | 32.4 | -6.4 | 41.5 |
| Supermarkets | 15.8 | -6.2 | 23.5 |
| Textiles, clothing and footwear | 9.2 | -0.5 | 9.8 |
| Furniture and white goods | 2.7 | -11.8 | 16.4 |
| Other domestic goods | 12.3 | -2.0 | 14.5 |
| Vehicles, motorcycles | -8.9 | -13.6 | 5.5 |

Source: IBGE

Statistics released by the Trade Federation of the State of São Paulo (Fecomercio SP) confirmed the reduction registered in the national indicator. Physical sales of the retail trade sector in the Metropolitan Region of São Paulo registered a decline of 7.3% in the first quarter of 2003, when compared to the same period of the preceding year. Analyzed according to specific activities, sales of consumer goods dropped by 8.4%, reflecting downward movement of 22.8% in sales of semidurable consumer goods and 19.2% in those of consumer durables, coupled with growth of 1.2% in the sales of nondurable goods, using the same basis of comparison. In the automotive trade sector, the final result was a reduction of 1.7% as a result of growth of 5.2% in sales of auto parts and accessories and a 3% falloff under factory authorized vehicle outlets. The less accentuated drop in the automotive sales segment, particularly through factory authorized

**Effective physical sales of the retail sector in São Paulo**

Percentage change

| Itemization | 2002 | | 2003 | | | |
|---|---|---|---|---|---|---|
| | Nov | Dec | Jan | Feb | Mar | Apr |
| In the month[1/] | | | | | | |
| General | -0.3 | -10.4 | 4.2 | 7.2 | -14.7 | -1.5 |
| Consumer goods | -3.8 | -8.8 | 5.8 | 7.8 | -16.1 | 0.4 |
| Durable | -4.0 | -3.5 | 0.9 | 6.7 | -9.1 | -0.5 |
| Semidurable | -10.6 | -13.4 | -7.6 | 13.8 | -8.2 | 3.6 |
| Nondurable | -2.0 | -5.1 | 0.9 | 7.2 | -18.2 | -1.8 |
| Automotive trade | 0.6 | -6.1 | -0.1 | 6.2 | -5.8 | -4.6 |
| Vehicle concessionaires | -1.2 | -6.7 | 0.5 | 7.5 | -5.9 | -3.3 |
| Autoparts and accessories | 16.8 | -11.4 | 0.7 | -2.1 | -1.9 | -5.3 |
| Building materials | 2.5 | -4.1 | -10.0 | 6.0 | -3.1 | 1.2 |
| Quarterly moving average[1/] | | | | | | |
| General | -0.6 | -5.5 | -8.4 | -6.8 | -3.8 | -4.7 |
| Consumer goods | -1.2 | -6.5 | -10.0 | -6.2 | -2.5 | -3.1 |
| Durable | -6.4 | -7.4 | -8.7 | -4.7 | -1.7 | -0.6 |
| Semidurable | -1.5 | -11.3 | -21.5 | -20.5 | -14.7 | -2.1 |
| Nondurable | 2.6 | -2.6 | -6.6 | -4.4 | -4.9 | -7.4 |
| Automotive trade | 4.3 | -1.2 | -4.9 | -4.6 | -2.1 | -1.6 |
| Vehicle concessionaires | 3.7 | -3.3 | -7.6 | -5.9 | -1.7 | 0.1 |
| Autoparts and accessories | 6.0 | 8.6 | 9.7 | -0.9 | -4.3 | -8.5 |
| Building materials | 4.4 | -2.2 | -6.3 | -9.5 | -9.2 | -4.3 |
| In the year | | | | | | |
| General | 1.3 | 0.2 | -5.4 | -1.2 | -7.3 | -9.3 |
| Consumer goods | 3.9 | 2.3 | -5.4 | -1.4 | -8.4 | -10.3 |
| Durable | -3.1 | -5.5 | -19.8 | -16.7 | -19.2 | -19.9 |
| Semidurable | -11.5 | -13.3 | -29.7 | -22.7 | -22.8 | -20.9 |
| Nondurable | 9.6 | 9.0 | 8.9 | 12.9 | 1.2 | -1.6 |
| Automotive trade | -21.0 | -20.3 | -9.1 | -2.6 | -1.7 | -5.6 |
| Vehicle concessionaires | -24.0 | -23.3 | -12.6 | -4.4 | -3.0 | -7.2 |
| Autoparts and accessories | -7.2 | -5.9 | 8.7 | 6.6 | 5.2 | 3.0 |
| Building materials | -11.7 | -10.0 | -5.3 | -1.6 | -2.7 | -3.3 |

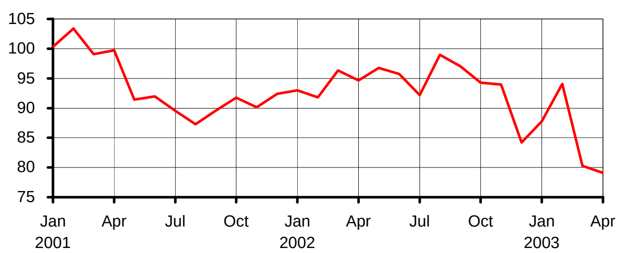
Source: Fecomercio SP

1/ Seasonally adjusted data.

**Effective physical sales of the retail sector in São Paulo**

Seasonally adjusted data

2000=100




Source: Fecomercio SP

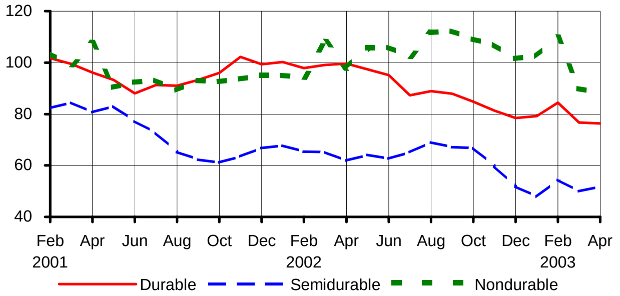
outlets, can be explained to some extent by the aggressive sales strategies adopted by the sector, including cutbacks in financing interest and strong promotional campaigns. Sales of building materials declined by 2.7% in the period.

Data available for the month of April and purged of seasonal impacts, point to a somewhat less intense sales decline than that registered in the previous month. In this sense, the general index registered a reduction of 1.5% in relation to March, reflecting expansion of 0.4% in consumer goods and 1.2% in building, coupled with a reduction of 4.6% in the automotive trade.

Aside from specific surveys related to the trade sector, other sales indicators also pointed to a downturn in consumption. According to the São Paulo Trade Association (ACSP), consultations with the Credit Protection Service (SPC) and Usecheque declined by 3.7% and 1%, respectively, in the first five months of 2003, compared to the figures for the same period in the preceding year. It is important to observe that the drop in the number of consultations regarding installment sales reflects deteriorating consumer credit conditions. Data for the month of May of this year, from which seasonal factors have been removed, indicate monthly growth of 1.5% in consultations with the SPC, while those targeted to the Usecheque system dropped by 0.1%.

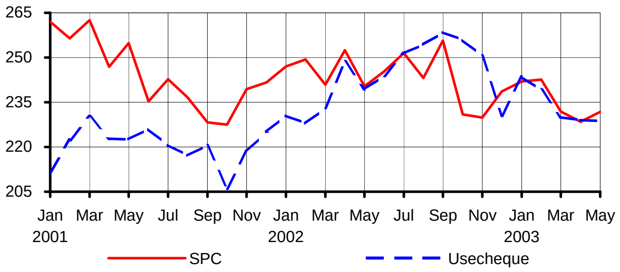
Default indicators remained relatively stable at the start of 2003. The ratio of checks returned due to insufficient backing to total checks cleared came to an average of 5.5% in the first five months of the year, compared to 5.1% in the same period of the previous year. Data released by the ACSP for the month of April showed that the median net

**Consumer goods - effective physical sales**
Seasonally adjusted data
2000=100




Source: Fecomercio SP

**Retail sales indicators**
Seasonally adjusted data
1992=100




Source: ACSP

**Default rates**

Rate

| Itemization | 2002 | 2003 | | | | | |
|---|---|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr | May | Year |
| SPC (SP)[1/] | 1.9 | 6.2 | 6.8 | 7.2 | 7.0 | 5.2 | 6.8 |
| Returned checks[2/] | 4.1 | 5.3 | 5.0 | 5.9 | 5.6 | 5.6 | 5.4 |
| Telecheque (RJ)[3/] | 1.1 | 2.3 | 2.4 | 2.9 | 2.1 | ... | 2.4 |
| Telecheque (National)[3/ 4/] | 1.2 | 2.5 | 2.3 | 2.8 | 2.1 | ... | 2.4 |

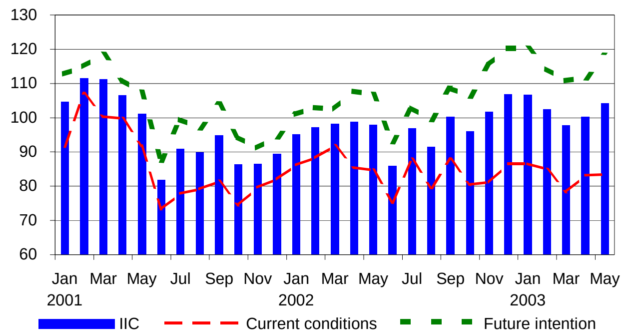
Source: ACSP, Bacen and Teledata

1/ New registrations (-) registrations cancelled out/effected consultations (t-3).
2/ Cheques returned due to insufficient funds/cleared cheques.
3/ Returned cheques/cleared cheques.
4/ Average in the following cities: Belém, Fortaleza, Recife, Salvador, Belo Horizonte, São Paulo, Curitiba, Porto Alegre, Ribeirão Preto and Rio de Janeiro.
5/ Annual average.

rate of new entries at the SPC, net of cancellations, came to 6.8% in the first four months of the year, as compared to 7.2% in the same period of 2002. In the month of May, the number of new negative entries dropped by 2.7%, when compared to April, thus reducing the net default rate to 5.2%, as against 7% in April. In the case of the national Teledata indicator, which measures the ratio between checks returned and received, the median came to 2.4% in the first four months of the year, compared to 2.6% in the same period of the previous year. It should be underscored that, in recent months, the average interest rates levied by credit operations increased while average financing terms shrank. According to a survey of interest rates released by the National Association of Finance, Management and Accounting Executives (Anefac), the median rate from January to April 2003 came to 8.36% per month, compared to 7.94% per month, in the same period of 2002.

The results of the surveys designed to assess current performance and consumer expectations pointed to improvement in the latter case. The Consumer Intentions Index (IIC), released by Fecomercio SP, showed significant improvement compared to the result for the start of 2002 and closed the month of May at 104.3, as against 97.9 in the same month of the previous year, based on a scale that goes from 0 to 200. The Index of Future Intentions, which accounts for 60% of the general index, registered growth of 5.8% in relation to the previous month and 10.6% when compared to May 2002. The Index of Current Intentions, which is responsible for 40% weight in the general index, increased by 0.4% in the month, but declined by 1.4% over a twelve month horizon.

Consumer Intention Index (IIC)




Source: Fecomercio SP

A similar performance was registered by the National Index of Consumer Expectations (INEC), which is a quarterly index calculated by the National Confederation of Industry (CNI). Following strong growth at the end of last year that can be explained partly by the end of the electoral process, the INEC dropped in the first quarter of 2003, compared to the final quarter of 2002. However, this reduction was not sufficient to offset previous growth and the index expanded by 1.8% in comparison to the same period of 2002. The Consumer Expectation Index (IEC), which is released by the Fecomercio RJ Institute registered a performance that was quite similar to the other leading indicators, closing May 2003 with growth of 3.9% when compared to April. This represented the third consecutive month of positive expansion.

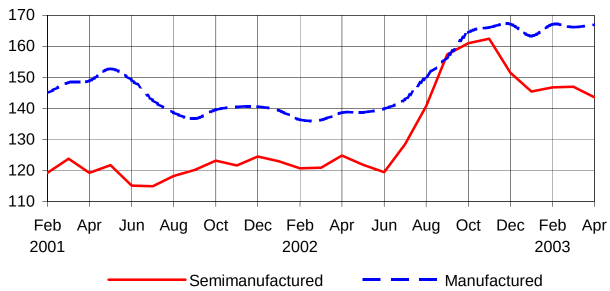
# 1.2 Production

## Industrial output

Industrial exports (volume)

Seasonally adjusted data

Quarterly moving average – 1996=100




Source: Funcex

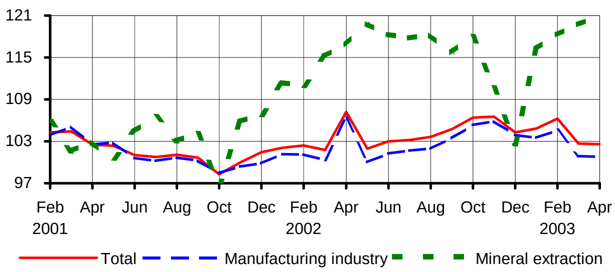
In the early months of 2003, industrial indicators pointed to a process of declining activity, thus ratifying the deceleration that had marked the end of the previous year. Aside from the low level of internal demand, this behavior reflected recent growth in foreign trade operations. Foreign sales of manufactured and semimanufactured goods, which had been the major factor underlying growth in the manufacturing sector over the course of 2002, have lost some degree of growth momentum, after moving to rather high levels of production when viewed in terms of the historical statistical series. Compared to the early months of 2002, the results for the industrial sector remained positive.

When viewed in terms of monthly growth figures, analysis of manufacturing output in the early months of 2003 is somewhat hampered by a rather atypical calendar, given that the carnival holidays occurred in March. Based on data purged of seasonal influences, a comparison of the first quarter with the final quarter of 2002 minimizes these distortions. This comparison revealed a drop of 1.1% in the output of general industry, resulting from a 2% decline in the activities of the manufacturing sector and growth of 6.9% in the mineral extraction industry in the period, according to the results of the Monthly Industrial Survey (PIM), released by IBGE.

**Industrial production**

Seasonally adjusted data

2000=100




Source: IBGE

Evaluation of results on a sector-by-sector basis indicates an across-the-board downturn in the recent pace of industrial activity, demonstrating that macroeconomic conditions are determining factors in the performance of the industrial sector. Comparisons between the results for the first quarter of the current year and the final quarter of 2002, encompassing the nineteen segments of the manufacturing sector covered by the IBGE survey show that only five registered positive growth: electric and communications equipment, with 5.7%, wood, with 4.7%, chemicals, 2.5%, paper and cardboard, with 0.2%, and tobacco, 42.2%. The growth rates of the first two segments benefited from a rather low basis of comparison, since both of these headings turned in negative results in 2002. Chemicals and paper and cardboard were impacted by the performance of the export sector, while tobacco, which has very little overall participation in industrial product, has historically registered rather volatile production results.

Compared to the same periods of 2002, the positive results of this year's production figures can, to a great extent, be explained by the upward movement in industrial exports. It is important to observe in this context that performances varied greatly from one industrial segment to another, principally as a result of the impacts of exchange rate growth on relative prices.

According to the PIM, in the first quarter of 2003, industrial product expanded by 2.3%, in relation to the first quarter of the previous year. The mineral extraction industry registered growth of 4.8% and, continuing the trajectory that began in 1997, its performance has surpassed that of the other industrial segments, as a result of strong growth under petroleum extraction. In the manufacturing sector, the segments that turned in the sharpest growth, using the same basis of comparison, were as follows: tobacco, 13.9%; mechanics, 11.2%; wood, 8.4%; metallurgy, 8.3%; leather and hides, 7.9%; rubber, 5.7%; and transportation equipment, 5.5%. On the other hand, negative results were registered under pharmaceutical goods, 15.4%; apparel and footwear, 14.9%; plastics, 8.6%; furniture, 7.5% and textiles, 5.7%.

**Industrial production**

Percentage change

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr |
| Industry (total) | | | | | |
| In the month 1/ | - 2.1 | 0.5 | 1.4 | - 3.4 | - 0.1 |
| Quarter/previous quarter 1/ | 1.8 | 0.3 | - 0.7 | - 1.1 | - 1.3 |
| Same month of the previous year | 5.0 | 2.6 | 4.0 | 0.6 | - 4.2 |
| Accumulated in the year | 2.3 | 2.6 | 3.3 | 2.3 | 0.6 |
| Accumulated in 12 months | 2.3 | 2.6 | 3.0 | 3.4 | 2.5 |
| Manufacturing industry | | | | | |
| In the month 1/ | - 1.9 | - 0.4 | 1.1 | - 3.5 | - 0.2 |
| Quarter/previous quarter 1/ | 2.6 | 0.8 | - 0.9 | - 2.0 | - 2.3 |
| Same month of the previous year | 6.3 | 2.4 | 3.6 | 0.1 | - 5.1 |
| Accumulated in the year | 1.3 | 2.4 | 3.0 | 2.0 | 0.1 |
| Accumulated in 12 months | 1.3 | 1.7 | 2.1 | 2.6 | 1.7 |
| Mineral extraction | | | | | |
| In the month 1/ | - 7.3 | 13.3 | 1.7 | 1.2 | 1.0 |
| Quarter/previous quarter 1/ | - 5.8 | - 6.4 | - 2.1 | 6.9 | 8.9 |
| Same month of the previous year | - 4.0 | 4.2 | 6.7 | 3.8 | 3.5 |
| Accumulated in the year | 10.7 | 4.2 | 5.4 | 4.8 | 4.5 |
| Accumulated in 12 months | 10.7 | 10.4 | 10.5 | 9.6 | 8.8 |

Source: IBGE

1/ Seasonally adjusted data.

Ratifying the relationship between strong production growth and expanded exports, one should note that the first quarter of the year was marked by expanded external sales of important segments of the areas of mechanics, metallurgy, transportation equipment and rubber, compared to the same period of 2002. Thus, the volume of automotive vehicles exported increased by 43.1% in the period, followed by exports of machines and tractors, 35.2%, rubber, 32.7%, other metallurgical products, 30.2%, steel, 22.8%, and nonferrous metallurgy, 18.9%.

Utilizing data from which seasonal influences have been removed, the result of April industrial output indicated stability in relation to the previous month, and a downturn of 4.2% when compared to April 2002. As already stated, these rates should be viewed with some degree of caution, since the number of business days in March 2003 was less than in March of the previous year, due to the carnival festivities. At the same time, April 2003 had two days less than April 2002, due to the Easter holidays in that month and the fact that Tiradentes Day fell on a Sunday. Furthermore, when one observes that a breakdown of the April results points to accumulated growth of 0.6% in the year, as against 2.3% when the first quarter of this year is compared to the same period of last year, the conclusion to be drawn is that the level of activity declined in the period.

Analysis of industrial performance by use categories demonstrates that external demand has influenced the performance of the sector in highly differentiated manners. Output of intermediate goods, which includes such important export segments as metallurgy, paper and cardboard, among others, registered the highest level of expansion among the various categories with expansion of 4.3%, when the first quarter of the current year is compared to the corresponding period of 2002. Output of capital goods expanded by 0.5%, while production of consumer durables and nondurables and semidurable goods registered downward movement of 0.9% and 3.4%, respectively.

**Industrial production by category of use**

Percentage change

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr |
| In the month[1/] | | | | | |
| Industrial production | - 2.1 | 0.5 | 1.4 | - 3.4 | - 0.1 |
| Capital goods | - 8.5 | 5.3 | 1.0 | - 3.7 | 1.4 |
| Intermediate goods | - 1.1 | 1.3 | - 0.1 | - 0.7 | - 1.5 |
| Consumer goods | - 1.8 | - 2.3 | 4.7 | - 8.1 | 1.1 |
| Durable | - 2.5 | - 1.5 | 2.0 | - 20.5 | 12.0 |
| Semi and nondurable | - 1.8 | - 2.3 | 5.5 | - 5.1 | - 0.8 |
| Quarter/previous quarter[1/] | | | | | |
| Industrial production | 1.8 | 0.3 | - 0.7 | - 1.1 | - 1.3 |
| Capital goods | 1.7 | 0.7 | - 2.1 | - 0.6 | - 0.5 |
| Intermediate goods | 1.8 | 1.1 | 0.2 | 0.4 | - 0.6 |
| Consumer goods | 1.2 | - 1.2 | - 1.5 | - 3.3 | - 2.7 |
| Durable | 6.5 | 2.2 | - 1.4 | - 8.6 | - 10.4 |
| Semi and nondurable | - 0.5 | - 2.4 | - 1.7 | - 1.8 | - 0.5 |
| In the year | | | | | |
| Industrial production | 2.3 | 2.6 | 3.3 | 2.3 | 0.6 |
| Capital goods | - 1.0 | 2.9 | 1.8 | 0.5 | - 1.5 |
| Intermediate goods | 3.0 | 4.9 | 4.7 | 4.3 | 2.7 |
| Consumer goods | 0.6 | - 4.1 | - 0.8 | - 2.9 | - 5.2 |
| Durable | 2.8 | 5.6 | 7.6 | - 0.9 | - 4.6 |
| Semi and nondurable | 0.0 | - 6.6 | - 3.1 | - 3.4 | - 5.3 |

Source: IBGE

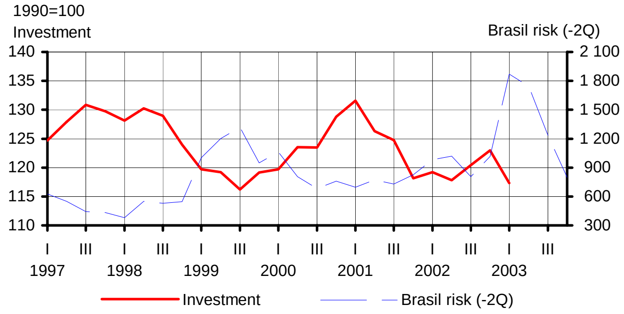
1/ Seasonally adjusted data.

Based on deseasonalized figures, a comparison with the fourth quarter of 2002, shows that the sectors that were most sensitive to the evolution of expectations and credit conditions turned in the sharpest declines in production levels. Thus, output of capital and consumer goods registered negative growth rates of 0.6% and 3.3%, respectively, principally as a result of 8.6% downward movement in the production of consumer durables. Production in the segment of intermediate goods increased by 0.4% in the period.

The rather limited expansion registered by capital goods in the first quarter of this year, when viewed against the same period of 2002, resulted from the conjugation of highly differentiated movements among the various components. The positive performance of agriculture stimulated production of capital goods and parts for the farm sector, with respective growth rates of 12.2% and 6.7%. In the case of industrial capital goods, growth in the period came to 16.3%, while the segment of transportation equipment registered 9.5%, with a particularly strong performance under aircraft production. On the other hand, capital goods used in the construction industry and in electricity generation and distribution closed with respective negative growth rates of 16% and 36.7%. Viewed in terms of evolution since the final quarter of 2002, production of industrial capital goods and transportation equipment registered steady, albeit somewhat lesser growth, of 3.5% and 0.6%, in that order, while capital goods for the electric power sector moved sharply upward, with growth of 8.3% in the period. The other segments, including capital goods for the farm sector, turned in production declines.

**Investment (FBCF) and Brasil risk**

Seasonally adjusted data




Source: IBGE and JP Morgan

Mention should be made of the fact that, with the exception of several export sectors, industry has operated with relatively high idle capacity. With this, companies have not made significant investments in the modernization or expansion of output capacity and this, in turn, has generated negative impacts on the performance of the capital goods sector. Despite the stagnation of the early months of the year, emphasis should be given to the fact that, according to the Ministry of Planning, Budget and Management and the National Bank of Economic and Social Development (BNDES), this segment may well benefit from ongoing projects targeted at revitalizing the shipbuilding industry, rail transportation and modernization of the truck fleet. However, the results of this process will only appear with some degree of lag. Another factor that should benefit this sector is the upward movement in expectations that has been perceived by both internal and external indicators.

**Consumer goods – Selected segments**

Quarter/same quarter of the previous year

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr |
| Semidurable and nondurable goods | | | | | |
| Pharmaceutical products | -6.0 | -11.9 | -12.3 | -15.4 | -19.1 |
| Footwear goods | 5.5 | 6.2 | 7.3 | -2.5 | -9.2 |
| Clothing and cloth goods | -15.9 | -18.8 | -19.8 | -22.5 | -27.1 |
| Perfumery, soaps and candles | 15.3 | 11.1 | 6.3 | -0.4 | -4.0 |
| Alcohol distillation | -7.2 | -13.6 | 4.2 | -4.2 | 20.3 |
| Durable goods | | | | | |
| Furniture | -1.1 | -3.5 | -0.9 | -7.5 | -13.3 |
| TV and radio sets | -3.1 | -12.2 | -14.6 | -22.7 | -23.1 |

Source: IBGE

In the subcategory of semidurable and nondurable consumer goods, several segments registered accumulated negative results in the year up to March. Among these, the most important were pharmaceutical products, footwear, apparel, perfumes and alcohol distillation.

Insofar as consumer durables are concerned, the segments of furniture and electric-electronic equipment, principally image and sound, registered accentuated production declines. With regard to automotive vehicles, data released by

**Vehicles – Production and sales**

Percentage change

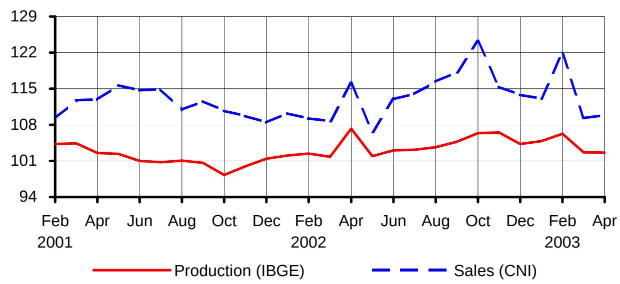
| Itemization | 2002 Dec | 2003 Jan | Feb | Mar | Apr | May* |
|---|---|---|---|---|---|---|
| In the month[1/] | | | | | | |
| Production | -4.2 | 1.9 | 1.8 | -17.9 | -0.7 | 4.5 |
| Sales | -1.8 | -6.4 | 9.8 | -21.2 | -3.1 | 1.7 |
| Domestic sales | 1.9 | -10.5 | 7.2 | -22.1 | -5.9 | 1.9 |
| External sales | -4.0 | 13.8 | -4.4 | -8.3 | 2.2 | 0.0 |
| Quarter/previous quarter[1/] | | | | | | |
| Production | 18.9 | 11.1 | 1.5 | -5.2 | -10.7 | -15.6 |
| Sales | 16.8 | 2.0 | -3.0 | -10.2 | -11.3 | -19.3 |
| Domestic sales | 18.2 | -3.3 | -7.7 | -16.7 | -16.2 | -24.1 |
| External sales | 24.3 | 27.7 | 16.2 | 9.4 | -2.3 | -5.9 |
| In the year | | | | | | |
| Production | -1.4 | 17.8 | 21.4 | 10.5 | 4.3 | 3.9 |
| Sales | -0.9 | 9.9 | 17.4 | 7.9 | 3.5 | 2.9 |
| Domestic sales | -2.8 | -0.7 | 8.1 | -1.9 | -6.6 | -6.6 |
| External sales | 6.1 | 72.8 | 65.8 | 54.7 | 47.6 | 39.5 |

Source: Anfavea

1/ Seasonally adjusted data.
* Preliminary.

**Industrial production and sales**

Seasonally adjusted data
2000=100

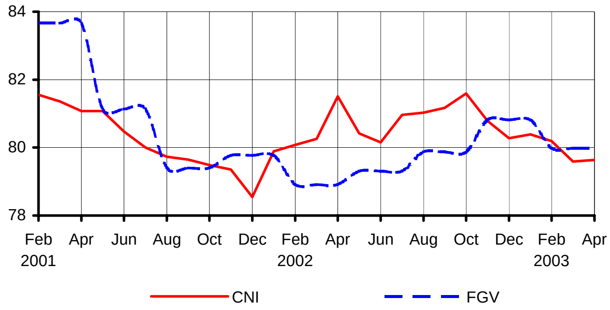



Source: IBGE and CNI

the National Association of Automotive Vehicle Manufacturers (Anfavea) indicated growth in external sales of 54.7%, compared to the results of the first quarter of this year and the corresponding period of 2002. With this result, this industrial segment was one of the mainstays of the 10.5% growth in production. However, when one utilizes the fourth quarter of 2002 as the reference, export growth came to 9.4% and was offset by a reduction of 16.7% in domestic market sales. Thus, production of automotive vehicles registered a drop of 5.2% in the period, in seasonally adjusted terms. In the month of April, exports expanded by 2.2% and production declined by 0.7%. Preliminary data for the month of May indicate a gain of 4.5% in automotive production compared to the previous month. At the same time, internal sales turned in a slight degree of recovery, with expansion of 1.9%, while foreign sales remained stable.

The behavior of CNI industrial indicators reinforces perceptions of downward movement in industrial activity in the early months of the year, despite the fact that the overall situation of industry was somewhat better than at the start of 2002. In this context, real sales expanded by 4.7% in the first quarter of this year, compared to the corresponding period of 2002, while personnel employed and hours worked in production increased by 1.2% and 1.7%, in that order. In terms of negative factors, one should underscore the fact that overall real wages fell by 6.7%, reflecting the inflation spike that occurred in the second half of last year. A comparison of the indicators for the first quarter of this year with those of the preceding quarter, however, point to a production downturn. Based on this reference and incorporating seasonal adjustments, real sales dropped by 2.5% and hours worked in production slipped by 1%. In the month of April, these indicators registered monthly rates of 0.5% and 0.2%, respectively.

**Utilization of installed capacity**
Seasonally adjusted data
Average percentage




Looking at industry as a whole, figures released by the CNI show that median utilization of installed capacity in the first quarter of the year came to 80.1%, the same level registered in the corresponding period of 2002. In April of this year, utilization of installed capacity reached a level of 79.6%, compared to 81.5% in the same month of the previous year based, once again, on CNI data. The index released by the Getulio Vargas Foundation (FGV) for the first three months of the year came to 80% following removal of seasonal factors. This result was slightly below the 80.8% mark registered in the final quarter of 2002.

In general, data for São Paulo industry, released by the Federation of Industries of the State of São Paulo (Fiesp), kept pace with the nationwide figures released by the CNI, particularly under the headings of utilization of installed capacity, real sales and hours worked in production. Consequently, these indicators registered growth or stability in comparison with those for the same period of the previous year. However, when compared to the median rates of the latter months of 2002, the final figures were negative.

**Manufacturing industry stocks**[1/]

| Itemization | 2002 | | | | 2003 |
|---|---|---|---|---|---|
| | I | II | III | IV | I |
| Manufacturing industry | | | | | |
| Final products | 50.4 | 53.1 | 48.5 | 46.2 | 51.0 |
| Raw materials and interm. goods | 47.7 | 48.2 | 49.2 | 47.6 | 47.3 |
| Large companies | | | | | |
| Final products | 50.4 | 53.7 | 49.9 | 45.8 | 52.4 |
| Raw materials and interm. goods | 49.5 | 50.7 | 51.2 | 47.1 | 51.3 |
| Small and medium companies | | | | | |
| Final products | 50.3 | 52.8 | 47.7 | 46.4 | 50.2 |
| Raw materials and interm. goods | 46.7 | 46.9 | 48.1 | 47.9 | 45.1 |

Source: CNI

1/ Values over 50 indicate stocks above the planned level.

With regard to inventory positions, the Industrial Survey carried out by the CNI revealed that the relative levels of raw materials and intermediate products continued on a downward curve and, at the end of the month, were quite close to the planned levels. On the other hand, companies accumulated undesirable inventories of final products in the period. The survey *Sondagem Conjuntural*, which is carried out by the FGV, corroborates these results: the percentage of companies that responded that they were carrying excessively large inventories increased from 8% to 12% in the last quarter. The observation that companies consider that they have accumulated excessively large inventories of final products and that, even considering the downward movement registered in recent quarters, intermediate stocks are at a level only slightly below that desired suggests that the process of adjustment has continued as a result of the high cost of maintaining stocks. At the end of last year, stocks diminished as a result of higher than expected sales. Consequently, inventories were replenished at the start of the current year. However, the pace of sales slackened and companies once again accumulated higher than desired stock levels.

Notwithstanding the difficulties of the early months of the year caused by low levels of domestic demand, a survey carried out by CNI at the end of March and early April revealed that the business community shared a more positive outlook regarding output conditions for the coming six months. With this, both expectations and revenues improved, raw material acquisitions increased and hirings turned upward. Expectations in the export sector were not significantly affected by the recent valuation of the real against the American dollar, as the corresponding items in the CNI survey declined by only 2.5 p.p. to 56.3. The Industrial Business Confidence Index (ICEI) dropped slightly from 58.9 to 57.2. These indicators point to relative stability or even moderate growth in the coming months.

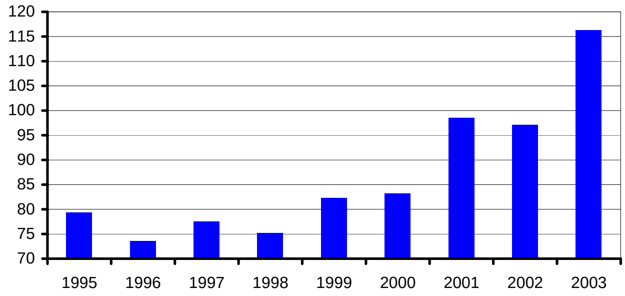
## Crop/livestock output

## Crops

The strong performance of the crop/livestock sector was the highlight of the early months of the year. Price growth over the course of 2002, particularly in the case of products of importance to the foreign trade sector, acted as an added incentive to greater production. With this, output of soybeans, wheat and corn, together with meat, played leading roles in the evaluation of the recent performance of the sector. On the other hand, products that are marketed mostly on the internal market and have considerable weight on price indices, such as rice and beans, registered the lowest growth, despite price evolution that was favorable to producers.

According to the April 2003 Systematic Survey of Farm Production (LSPA), which is calculated by IBGE, total Brazilian production of cereals, legumes and oil-bearing crops could reach as high as 116.3 million tons in 2003, corresponding to 19.7% more than in 2002.

**Grain production**
In million of tons




Source: IBGE

Also according to the IBGE, climatic conditions were highly favorable to crop production during the initial cycle, with rainfall that was sufficient for the desired level of crop development and, consequently, appropriate conditions for the first harvest of the year. In that harvest, the country's major crops registered higher productivity than in the previous harvest. From that point forward, as the summer harvest drew to a close, emphasis of the LSPA shifted to those products that have a second harvest and a winter harvest, including corn, second harvest beans, wheat, barley, rye, oats, triticale and sunflower seeds.

**Agricultural production**

In 1,000 tons

| Itemization | Production | | Percentage |
|---|---|---|---|
| | 2002 | 2003[1/] | change |
| Grain production | 97 134 | 116 298 | 19.7 |
| Cotton (seed) | 1 407 | 1 457 | 3.6 |
| Rice (in husk) | 10 472 | 10 852 | 3.6 |
| Beans | 3 051 | 3 231 | 5.9 |
| Corn | 35 500 | 43 539 | 22.6 |
| Soybean | 42 027 | 50 558 | 20.3 |
| Wheat | 2 926 | 4 250 | 45.2 |
| Others | 1 751 | 2 411 | 37.7 |
| Other cultures | | | |
| Banana | 6 504 | 6 437 | -1.0 |
| White potatoes | 2 885 | 2 878 | -0.2 |
| Cocoa (beans) | 175 | 175 | 0.0 |
| Coffee (beans) | 2 494 | 2 155 | -13.6 |
| Sugar cane | 363 721 | 383 256 | 5.4 |
| Tobacco (in leaves) | 657 | 656 | -0.2 |
| Orange | 18 447 | 18 459 | 0.1 |
| Manioc roots | 23 131 | 22 465 | -2.9 |

Source: IBGE

1/ Estimated.

On a regional basis, the survey pointed to forecasts of harvest growth in all of the various areas of the country, with 23.8% in the south, 17.8% in the central-west region, 4.9% in the southeast, 33.9% in the northeast and 21.9% in the north of the country. Estimated crops are: 53.2 million tons. for the South region; 36.9 million tons. for the Center-West region; 8.6 million tons. for the Northeast and 2.7 million tons. for the North region.

With respect to the major crops, soybean production is expected to expand by 20.3% to 50.6 million tons. Since prices declined as the harvest advanced and the value of the real increased, marketing of the soybean crop was relatively slow. However, it should be stressed that, despite the lower levels, soybean prices are still higher than in the same period of the previous year. All of the different regions are expected to register output growth in 2003, with forecasts of 22.9% in the south, 21.9% in the northeast, 19.5% in the central-west region and 10% in the southeast. The nation's largest producers are expected to register strong harvest growth, with 41.7% in Rio Grande do Sul, 19.4% in Mato Grosso, 16.6% in Goiás and 13.1% in Paraná. When one views all of the regions as a single whole, this year's soybean harvest was produced in 12.6% more area than the previous harvest, indicating growth of 6.8% in the average yield of the product.

Corn production in the current year – including both the 1st and 2nd harvests – is estimated at 43.5 million tons, for growth of 22.6%. This year's crop occupied an area that was 6.8% greater than the previous harvest and the median yield expanded by 14.8%. The harvests of the major corn production states will be greater this year, with expansion of 31.9% in Paraná and 6.7% and 1.1%, respectively, in Minas Gerais and São Paulo.

The first corn harvest is expected to reach 34 million tons or 16.1% more than in the previous year. Due to regional peculiarities, this harvest is now at varied stages of maturation, harvesting and marketing, depending on the region and state in question. The area planted increased by 3.5% and average yield increased by 12.2%. With regard to the 2nd corn harvest, growth is forecast at 18% in the area under cultivation, 53% in production and 29.7% in productivity.

The growth registered in total corn production was extremely opportune, when one considers that shortages of this product generated powerful impacts on segments in which corn is a major input, such as poultry and hog farming. However, this growth did not produce any significant decline in corn prices in the first quarter of 2003. This is explained by the relatively high level of demand caused by expanding livestock production, particularly in the area of poultry. Price growth in the coming months will be determined basically by the second corn harvest, which will have a direct impact on prices at the end of the summer, when the harvest is under way.

Production of rice is expected to grow by 3.6%, coming to a level of 10.9 million tons in 2003, as a result of 0.9% growth in the area under cultivation and 2.7% in average yield. Fundamentally, this growth will be a consequence of production increases of 4.4% and 25% in the central-west and northeast regions, respectively, since production in the southern region, which is responsible for approximately 60% of total rice harvested, is expected to decline by 1.5%. Despite this growth, it is important to clarify that imports will be needed since rice production will not be sufficient to ensure internal supply. In the light of this situation, the price of rice at the consumer level is not expected to change significantly.

The first bean harvest is forecast at 1.7 million tons or 1.8% more than the 2002 harvest. In the case of the 2nd harvest, growth is forecast at 14.9%, with a total of 1.2 million tons. It should be observed that this estimate is subject to change since, in the northeast region, which accounts for approximately 40% of national output, the forecasts for a number of important production centers, such as Bahia and Pernambuco, are still quite preliminary. Market prices have stimulated increased cultivation, indicating a positive outlook in all of the different production regions.

Forecast wheat production was favored by price evolution, which came to 4.3 million tons, for growth of 45.2% in 2003. The harvest in the State of Paraná, which is the largest national producer of wheat, is expected to close at 2.8 million tons, or 83.5% more than in the previous harvest.

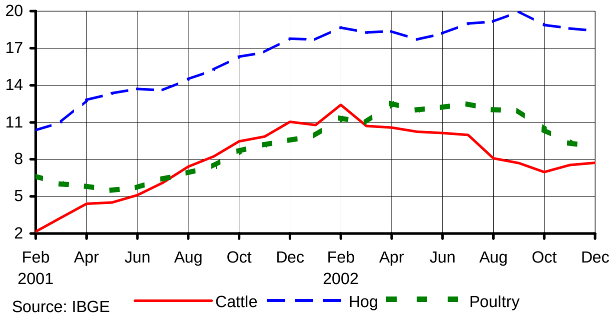
Output of cotton in seed (both herbaceous and arboreous) is estimated at 1.5 million tons, for growth of 3.6% over the 2002 total. This increase is a consequence of the conjugation of a decline of 0.8% in area under cultivation and growth of 4.5% in productivity.

## Livestock

Repeating the 2002 trajectory, livestock production in the last quarter registered positive performances in all of the different segments. This result was calculated by IBGE's Quarterly Survey of Livestock Slaughters. Basically, this performance is a consequence of continued growth in foreign sales.

In 2002, 7.3% more cattle were slaughtered than in 2001, with a total number of 19.8 million animals. At the same time, carcass

**Livestock production**
Total weight
Percentage change in 12 months




Source: IBGE

weight increased by 7.7%. Considering the result for the fourth quarter of the year, 5.5 million head of cattle were slaughtered, for growth of 12.5% over the total number in the same period of 2001.

With respect to hog farming, growth in slaughters came to 16.2% in the fourth quarter of 2002, compared to the same period of 2001. The total number of animals slaughtered closed at 5.9 million. The level of slaughters in the fourth quarter revealed a tendency to return to a more normal level, following the accentuated growth registered in the third quarter of the year. The increase in slaughters in that period was mostly due to higher production costs generated by the corn supply crisis. In 2002, 22.3 million animals were slaughtered, representing growth of 18.1% over 2001. Total growth in carcass weight came to 18.4% in the year.

With regard to poultry production, total slaughters and carcass weight increased by 8.6% and 9%, respectively in 2002. Here, one should stress that, just as occurred in hog farming, the poultry sector was directly impacted in 2002 by high production costs, particularly feed prices. In this case, upward movement in prices was due to the restricted supply of corn and depreciation of the rate of exchange which had a direct impact on corn imports. Average monthly slaughters came to 249.1 million in the first quarter, rising to 263.8 million in the last quarter. Total poultry slaughters in the year came to 3.1 billion.

Here, mention should be made of the fact that, despite lags in livestock data, several indicators suggest continued growth in the sector in the early months of this year. The PIM index of animal slaughters (excluding poultry) which is released by the IBGE registered growth of 0.7% in the first quarter of 2003 in relation to the final quarter of 2002, based on seasonally adjusted statistical data. Using the same reference base, the index of slaughters and preparation of poultry expanded by 1.2%.

# Crop and Livestock Plan (2003-2004)

**Agricultural plan – 2003/2004**

In R$ million

| Objective | Credit granted 2002/2003 | Flow forecast 2003/2004 | Percentage change |
|---|---|---|---|
| Total | 25 866 | 32 550 | 25.8 |
| At fixed interest rate | 18 670 | 22 150 | 18.6 |
| Current expenditures/flow | 14 040 | 16 400 | 16.8 |
| BNDES investments | 2 830 | 4 000 | 41.3 |
| Constitutional funds | 1 200 | 1 000 | - 16.7 |
| Agricultural Finame | 500 | 500 | 0.0 |
| Rural Proger | 100 | 250 | 150.0 |
| At market interest rate | 3 000 | 5 000 | 66.7 |
| Pronaf – Familiar agriculture | 4 196 | 5 400 | 28.7 |

Source: Ministry of Agriculture

According to the Crop and Livestock Plan 2003/2004, announced by the Ministry of Agriculture, Livestock and Supply (Mapa), resources available to farmers in the 2003/2004 farm year should come to a total of R$32.6 billion, of which R$16.4 billion will be targeted to current expenditures and marketing, R$5.8 billion to investments (BNDES Program, Special Farm Finame, Constitutional Funds for the North, Northeast and Central-West Regions and the Employment and Income Generation Program – Proger Rural), aside from forecasts of an additional R$5 billion at market interest and R$5.4 billion through the National Program for Strengthening Family Farming (Pronaf), managed by the Ministry of Agrarian Development (MDA). This volume corresponds to an increase of 25.8% over the amount granted in 2002.

The resources managed by Mapa will total R$27.2 billion, for growth of 25.3% when compared to the programmed funding for the 2002/2003 harvest. Of this total, R$22.2 billion will be invested at fixed rates of interest, with R$16.4 billion being targeted to current expenditures and marketing and R$5.8 billion to investment programs and modernization of productive rural capital, based on resources from BNDES, Constitutional Funds and Proger Rural.

Floor Price Guaranty Policy (PGPM) is to be reinvigorated, principally for basic food products, including rice, corn, beans and manioc. These prices were defined on the basis of an analysis of the cost variables of production in the different regions of the country and of market fundamentals and outlook, such as supply and demand, export and import parities, as well as other variables.

Resources targeted to Proger Rural will increase by 150% and will be targeted to producers with annual gross income above the limit reserved to Pronaf clients. The purpose here is to reach a greater number of rural workers, who hold areas of up to fifteen fiscal modules and have annual gross income of up to R$80 thousand. The needs of these producers are to be met through the program's agents: Banco do Brasil S.A. (BB), Banco do Nordeste do Brasil S.A. (BNB), Banco Cooperativo Sicredi (Credit Cooperative System) – Bansicredi and the Banco Cooperativo do Brasil (Bancoob).

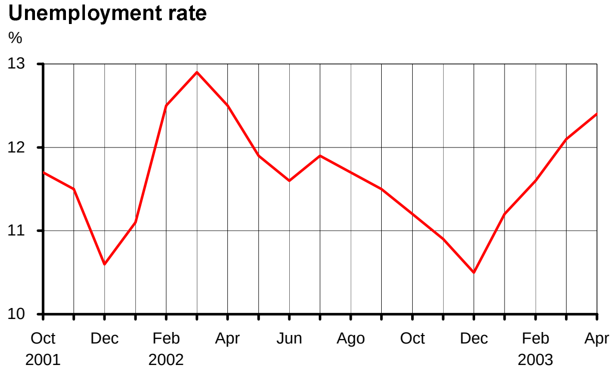
With respect to the Program of Support to the Marketing and Warehousing of Products, as well as the basic PGPM and rural credit instruments - Federal Government Acquisitions (AGF), Federal Government Loans (EGF), Rural Producer Bills (CPR), Rural Promissory Notes and Invoices – and the Special Line of Marketing Credits (LEC), Mapa's budget proposal targets R$3 billion to direct acquisitions of products, options contracts and price equalization programs based on sale option contracts, product outflow premiums (PEP) and product outflow value (VEP). These instruments will be utilized according to market circumstances, when more effective measures are required by the government.

Public food stocks are to be replenished up to the minimum of 3 million tons of corn, equivalent to approximately one month of consumption, 1.5 million tons of rice, or 45 days of consumption, 30 thousand tons of manioc flour and 50 thousand tons of beans.

# 1.3 Labor market

## Employment

**Unemployment rate**




Source: IBGE

Analysis of the labor market in the early months of 2003 indicates growth in informal employment, according to indicators released by the Ministry of Labor and Employment (MTE) and IBGE. In the context of the low level of activity that characterized the period, unemployment increased during the quarter. In the industrial sector, the employment level has shown some signs of recovery, with the exception of the São Paulo and Rio de Janeiro markets.

According to the Monthly Employment Survey (PME), which is released by the IBGE, the rate of open unemployment increased over the course of the first four months of 2003, a performance that is considered one of the basic traits of the early months of the year. In April, 12.4% of the total labor force were seeking jobs, compared to 12.1% and 11.6% in March and February, respectively. In comparison to the same month of 2002, the rate dropped by 0.1 p.p. In twelve months, growth in the number of job positions did not accompany expansion of the overall labor force, generating a lag of 117 thousand positions.

With respect to the previous methodology, it should be noted that the rate of open unemployment reached a 2002 average of 11.7%, compared to 7.1% when the former weekly rate for the same period is used. The growth that resulted from adoption of the new methodology was a consequence of alterations in the time during which a person seeks employment. The reference of one week used in the previous system shifted to the thirty days prior to the survey, incorporating a largest number of people into the labor force than in the previous system.

**Occupied people by categories of employment**

In 1,000,000

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr |
| Total of occupied people | 18.1 | 18.3 | 18.2 | 18.2 | 18.3 |
| By categories of employment | | | | | |
| Registered | 8.4 | 8.2 | 8.3 | 8.2 | 8.1 |
| Nonregistered | 3.8 | 3.9 | 3.8 | 4.0 | 4.0 |
| Non-earning workers, military and civil servants | 1.4 | 1.4 | 1.3 | 1.3 | 1.4 |
| Self-employed | 3.5 | 3.5 | 3.6 | 3.5 | 3.6 |
| Employer | 0.8 | 1.0 | 1.0 | 1.1 | 1.0 |

Source: IBGE

From January to April 2003, an analysis by employment categories indicated differentiated behaviors among the most important segments. Compared to December, there was a reduction of 247 thousand registered job positions, while the number of unregistered workers increased by 220 thousand vacancies. A comparison between April of this year and April 2002 shows that the two categories registered respective growth in job positions totaling 260 thousand and 327 thousand, respectively. The level of occupation in the segment of the self-employed has fluctuated since the previous year, but still managed to register April growth of 71 thousand workers, compared to December, and 237 thousand, compared to the same month of 2002.

MTE data registered growth in formal employment in the early months of 2003, albeit at a less accentuated pace than in the previous year. From January to April, 295 thousand positions were created, almost 100 thousand less than in the same period of 2002. Among the activities

**Formal employment**

New job openings (1,000 employees)

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | In the year | Jan | Feb | Mar | Apr |
| Total | 762.4 | 35.5 | 84.0 | 21.3 | 154.0 |
| Manufacturing industry | 161.2 | 26.6 | 2.3 | 12.2 | 48.8 |
| Commerce | 283.3 | -2.8 | 14.0 | -5.5 | 18.2 |
| Services | 285.8 | 11.5 | 49.7 | 11.4 | 34.4 |
| Building | -29.4 | -5.7 | -7.3 | -13.4 | 1.0 |
| Public utilities | 5.3 | 1.0 | 0.8 | 0.2 | 0.6 |
| Others1/ | 56.3 | 4.9 | 24.6 | 16.4 | 51.0 |

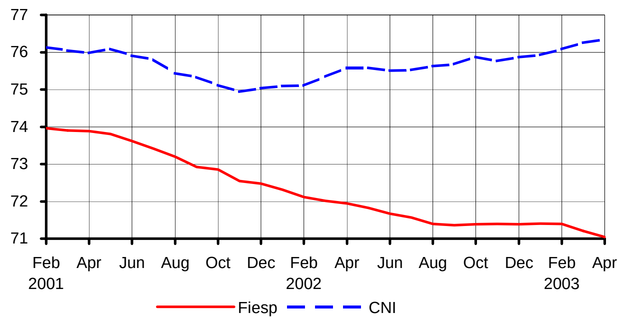
Source: Ministry of Labor and Employment

1/ Includes mineral extraction, public administration, crop and livestock and others.

**Industrial employment**

Seasonally adjusted data

1992=100




in question, 107 thousand jobs were created in the service sector. In manufacturing, 90 thousand new jobs were created, while the farm sector generated 77 thousand and commerce an additional 24 thousand. In the construction industry, available job positions fell by 25 thousand in the period. However, in the month of April, hirings surpassed firings, thus interrupting the sequence of negative balances in the six previous months.

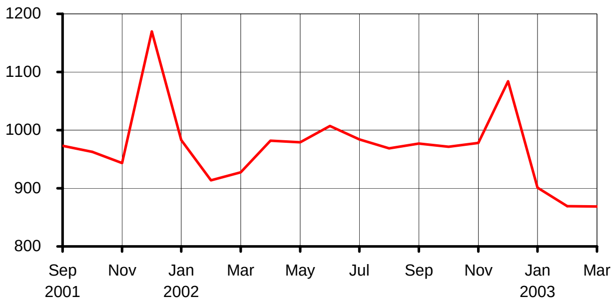
With respect to industrial employment, a Fiesp survey at the start of 2003 indicated deceleration in the pace of layoffs that was characteristic of 2002. In the year up to April, the reduction in the employment level came to 1.1%, which was less than the accumulated total of 1.9% over twelve months. In the weekly Fiesp survey of 47 employer associations, employment registered positive monthly balances in the number of hirings in the first quarter of 2003, following eight consecutive months of downward movement. Up to the month of April, more than 5.8 thousand jobs were created, despite the reduction that occurred in the final month, with elimination of 3 thousand positions.

In the states surveyed by the CNI, the industrial employment level registered recovery as of January, following a downward curve in the last three months of 2002. Employment registered a high of 0.5% in April, when compared to March, and reached the highest level since June 2001. In the year, the increase came to 1.1%, when viewed against the same period of 2002. For the most part this growth was driven by industries from the south of the country and the states of Minas Gerais, Bahia and Ceará.

## Earnings

In the early months of 2003, worker earnings followed a downward trajectory, despite adjustments in important labor categories that were mostly based on inflation figures for recent months. As a matter of fact, wage negotiations in several important sectors that serve as references for other categories, such as construction and metallurgical workers, obtained higher wages either in the form of salary increases or bonuses calculated on the basis of the evolution of price indices.

**Real average earnings**
In R$ of the last month, deflated by INPC




Source: IBGE

Using IBGE's National Consumer Price Index (INPC) as deflator, average real earnings declined by 3.6% in February, when compared to the previous month, followed by an additional 0.1% in March. In comparison to March of the previous year, the downturn came to 6.3%. Among the various labor categories, the self-employed registered the sharpest losses with a decline of 0.9% in the month of March, followed by unregistered workers with 0.8%. An analysis of earnings in the first quarters of 2003 and 2002 indicates losses in all categories, with 17.9% in the segment of the self-employed, 3.6% for unregistered workers and 3.3% for those employed in the formal sector of the economy.

**Real wages in the manufacturing industry**

% accumulated growth in year

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | | Jan | Feb | Mar | Apr |
| CNI | | | | | |
| Overall real wages | -0.6 | -5.1 | -6.1 | -6.6 | -6.9 |
| Fiesp | | | | | |
| Overall real wages | 3.2 | -1.0 | -2.8 | -3.5 | -3.9 |
| Average real wages | 5.7 | 0.2 | -1.7 | -2.4 | -2.8 |

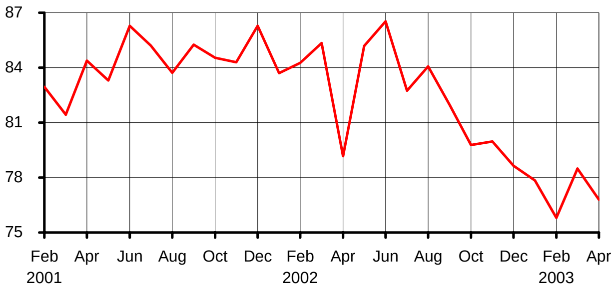
Source: CNI and Fiesp

In the manufacturing sector, real wages registered a sharp drop in purchasing power in the first four months of 2003, when compared to the end of the previous year. In São Paulo, the reduction in the period came to 2.8%, utilizing data deflated by the Consumer Price Index of the Economic Research Institute Foundation (IPC-Fipe). Parallel to this result, the CNI registered a falloff of 6.9%, using the INPC as deflator.

## Unit Cost of Labor and Productivity

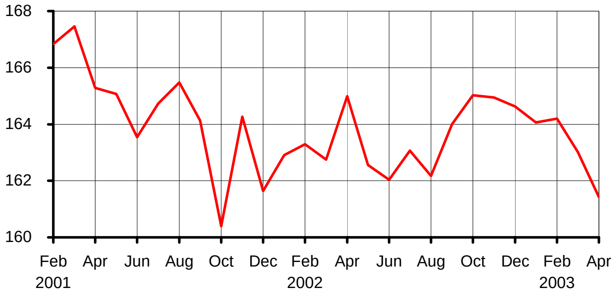
In the case of the manufacturing sector, the Unit Cost of Labor (UCL) is the ratio between overall real wages, as announced by CNI, and the physical output of the sector, according to IBGE. This indicator registered a persistent downward slide since the start of the second half of 2002, with few exceptions, basically reflecting the decline in

**Unit Cost of Labor**
Seasonally adjusted data
1992=100




Source: IBGE, CNI and Banco Central do Brasil

**Productivity**
Seasonally adjusted data
1992=100



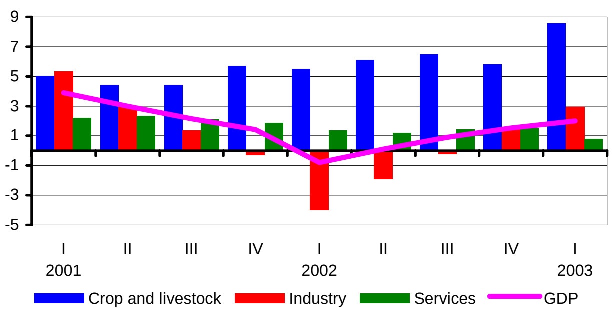

Source: IBGE, CNI and Banco Central do Brasil

real wages paid. From January to April, the UCL dropped by 7.2% compared to the result for the same period of the previous year, with salaries deflated by the INPC. In the deseasonalized statistical series, the falloff came to 2.2% in April. Analysis of movable quarters since August of last year shows the same trajectory.

In the first four months of the year, productivity in the manufacturing sector registered an almost uninterrupted downward slide, continuing the trend that had first begun in November 2002. In April, productivity, which is defined in terms of the ratio between the index of physical output of the sector, as announced by IBGE, and the indicator of hours worked in production, calculated by the CNI, came to the level registered in October 2001, which was the lowest of the last three years. In the month, the falloff came to 1% when compared to March, based on deseasonalized data, and 0.9% in the four month period, when viewed against the final four months of the previous year. In accumulated terms for the year, the reduction closed at 0.1%.

A state-by-state analysis indicates 21.1% productivity growth in Espírito Santo in the first quarter of the year, compared to the same period of 2002. The corresponding rates in other major states were as follows: Rio de Janeiro, with 7.9%, Paraná, with 6.3% and São Paulo, with 3.3%. In the other states, productivity rates declined, with particularly strong losses in Minas Gerais, with 9.2%, and Bahia, with 8.5%.

**Gross Domestic Product**
% growth accumulated in the year




Source: IBGE

## 1.4 Gross Domestic Product

According to the IBGE, Gross Domestic Product (GDP) expanded by 2% in the first quarter of 2003, compared to the same period of 2002. Basically, this positive result was caused by the performance of the foreign trade sector, with

**Gross Domestic Product**

Percentage change

| Itemization | 2002 I | 2002 II | 2002 III | 2002 IV | 2003 I |
|---|---|---|---|---|---|
| Accumulated in the year | -0.80 | 0.10 | 0.90 | 1.52 | 2.00 |
| Accumulated in four quarters | 0.26 | -0.01 | 0.49 | 1.52 | 2.21 |
| Quarter/same quarter of the previous year | -0.80 | 0.97 | 2.47 | 3.44 | 2.00 |
| Quarter/previous quarter seasonally adjusted | 1.85 | -0.21 | 1.01 | 0.72 | -0.06 |

Source: IBGE

**Gross Domestic Product**

Percentage change in the year

| Itemization | 2001 | 2002 I H | 2002 III Q | 2002 Year | 2003 I Q |
|---|---|---|---|---|---|
| Crop and livestock | 5.7 | 6.11 | 6.46 | 5.79 | 8.58 |
| Industry | -0.3 | -1.90 | -0.23 | 1.52 | 2.94 |
| Mineral extraction | 3.9 | 12.99 | 12.24 | 10.39 | 4.83 |
| Manufacturing | 1.0 | -0.81 | 0.39 | 1.93 | 3.74 |
| Construction | -2.6 | -7.42 | -5.25 | -2.52 | -1.72 |
| Public utilities | -5.6 | -6.71 | -1.74 | 1.53 | 5.70 |
| Services | 1.9 | 1.18 | 1.43 | 1.49 | 0.78 |
| Commerce | 1.5 | -0.97 | -0.05 | 0.16 | -0.07 |
| Transportation | 5.2 | 0.55 | -0.14 | -0.92 | -5.12 |
| Communications | 9.9 | 7.40 | 7.21 | 7.40 | 0.08 |
| Financial institutions | 0.3 | 0.30 | 1.59 | 2.19 | 1.63 |
| Other services | 1.3 | 0.68 | 0.65 | 1.03 | 2.73 |
| Rents | 2.1 | 1.76 | 1.89 | 1.67 | 1.74 |
| Public administration | 0.8 | 1.36 | 1.42 | 1.34 | -0.07 |
| Financial dummy | 1.3 | -1.04 | 0.76 | 1.94 | 2.35 |
| Value added at basic prices | 1.4 | 0.56 | 1.27 | 1.84 | 2.13 |
| Taxes on products | 1.8 | -3.57 | -2.05 | -0.98 | 0.86 |
| GDP at market prices | 1.4 | 0.10 | 0.90 | 1.52 | 2.00 |

Source: IBGE

**Gross Domestic Product**

Quarter/previous quarter seasonally adjusted

| Itemization | 2002 I | 2002 II | 2002 III | 2002 IV | 2003 I |
|---|---|---|---|---|---|
| GDP at maket prices | 1.85 | -0.21 | 1.01 | 0.72 | -0.06 |
| Crop and livestock | 0.01 | 2.23 | 0.66 | 0.78 | 3.67 |
| Industry | 1.81 | 2.05 | 1.16 | 1.67 | -2.17 |
| Services | 0.81 | 0.01 | 0.61 | 0.21 | 0.01 |

Source: IBGE

growth of 20.2% in exports and a drop of 4.6% in imports. Internal demand dropped sharply, as reflected in a 1.5% loss in gross fixed capital formation, a drop of 2.3% in household consumption and a decline of 0.2% in government consumption.

Among the various sectors, crop and livestock farming registered the highest rate of growth, with 8.6% in the year, based on strong expansion in exports and continued productivity gains. The industrial sector expanded by 2.9%, as a result of growth of 4.8% in mineral extraction, generated mostly by a 4.5% rise in oil production. The only secondary sector to register negative growth was the building industry, with a downturn of 1.7%, caused by a lack of adequate home financing. In the service sector, growth of 0.8% was mostly due to the results registered by the sectors of financial institutions, rentals and other services. The subsector of communications turned in growth of 0.1%, a mark that is considered well below the tendency evident in recent quarters. Other sectors registered negative growth, as transportation and commerce closed with reductions of 5.1% and 0.1%, in that order, mirroring the process of decelerating economic activity.

In the first quarter of 2003, GDP declined by 0.06%, measured on the basis of the statistical series free of seasonal influences, when compared to the final quarter of 2002. This result is a clear sign of a loss of dynamics in relation to the result registered over the course of last year. The major cause of the result was the performance of the industrial sector, with a decline of 2.17%, on the same basis of comparison. The crop/livestock sector registered expansion of 3.67%, while the service sector remained stable.

# Estimates of GDP in 2003

The persistence of adverse economic factors over the course of the first half of this year – particularly, growing uncertainties regarding the outbreak of war in the Persian Gulf region and, internally, the difficulties faced in efforts to lower inflation to the levels prior to the exchange shock – resulted in less growth in the level of activity and redefined the economic outlook for the coming months.

In relation to the end of 2002 and first quarter of this year, changes in the economic scenario were evident, principally, in the performance of internal demand indicators, which dropped at a pace that was significantly more intense than in previous periods. In the light of these factors, the outlook for GDP growth in 2003 was revised downward to lower than previously forecast monthly results and a level between 1.5% and 1.8% for the year as a whole.

**Gross Domestic Product – Estimate**

Percentage change in the year

| Itemization | Weight[1/] | I Q[2/] | 2003 | |
|---|---|---|---|---|
| | | | Scenario I | Scenario II |
| Crop and livestock | 8.2 | 8.6 | 5.8 | 5.8 |
| Industry | 37.8 | 2.9 | 0.7 | 1.3 |
| Mineral extraction | 3.4 | 4.8 | 7.8 | 7.8 |
| Manufacturing | 22.4 | 3.7 | 0.7 | 1.3 |
| Construction | 8.0 | -1.7 | -5.4 | -4.0 |
| Public utilities | 4.0 | 5.7 | 6.3 | 6.5 |
| Services | 60.4 | 0.8 | 1.5 | 1.7 |
| Commerce | 7.3 | -0.1 | 0.5 | 0.9 |
| Transportation | 2.2 | -5.1 | -1.2 | -0.8 |
| Communications | 3.2 | 0.1 | 3.3 | 4.0 |
| Financial institutions | 8.6 | 1.6 | 2.2 | 2.3 |
| Other services | 10.7 | 2.7 | 2.2 | 2.3 |
| Rent | 11.2 | 1.7 | 1.8 | 1.8 |
| Public administration | 17.2 | -0.1 | 1.0 | 1.0 |
| Value added at basic prices | 100.0 | 2.1 | 1.5 | 1.9 |
| Taxes on products | 12.4 | 0.9 | 0.7 | 1.1 |
| GDP at market prices | 112.4 | 2.0 | 1.5 | 1.8 |

Source: IBGE

1/ Estimated to 2002.
2/ Effective data.

This estimate of GDP expansion is based on remarkable growth in crop/livestock output, and moderate growth in industry and under services. It should be underscored that expected growth in the current year presupposes recovery in the level of activity in the second half-year presupposes recovery in the level of activity in the second half-year following the prospect for an upturn in internal demand. These movements will cause more intense repercussions on the tertiary sector and particularly on the industrial sector, thus incentivating recovery of this segment.

Growth estimated for the crop/livestock sector is based on strong 19.7% expansion in the grain harvest, according to the IBGE forecast. Here, one should note that the period from 1999 to 2002 registered average annual crop/livestock output growth of 5.5% per year, reflecting, in terms of demand, rapidly expanding exports, which were stimulated by exchange depreciation and, on the supply side, by significant productivity gains.

The most expressive alterations have been incorporated into estimates for the industrial sector, reflecting growth of 3.2% for the year at the end of 2002, 2.1% at the end of the first quarter and between 0.7% and 1.3% in the current scenario. These alterations are a result of the fact that certain segments of the sector are considerably more sensitive to the behavior of interest rates and internal expectations, particularly, the construction industry and, in the case of manufacturing, the categories of capital goods and consumer durables. Here, one should stress that the carry-over of the products of the manufacturing sector and building industry, indicate changes of -1.4% and -9.3%, respectively, for 2003, according to sectoral data released by IBGE up to April. Growth used in estimating GDP presupposes recovery in manufacturing and construction in the second half of the year. It is important to note that this expectation is based on the outlook for more favorable evolution of interest rates and rising confidence levels when compared to the first half of the current year.

Estimates for the service sector – between 1.5% and 1.7% – are also below those stated in the previous Inflation Report and give due consideration to the effects of the drop in industrial output on the sectors of commerce and transportation, as well as the downturns in the growth rates estimated in the most recent GDP result for the subsectors of communications and public administration, compared to the results of recent years. In contrast to this, one should highlight the positive fact that there has been some degree of positive movement in formal employment, which is an indicator of the behavior of the subsector of other services.

The overall outlook for GDP viewed under the prism of demand indicates that, even though there has been some degree of reduction when compared over shorter term horizons, the foreign trade sector will be the major underpinning of the growth process, contributing a full 2 p.p. to GDP growth, with an increase in foreign sales of just over 11% and a falloff in imports in the range of 1.5%. On the other hand, internal demand is expected to register a downturn between 0.3 p.p. and 0.5 p.p., as a result of lesser household consumption, with slight upward movement in government consumption, and cutbacks in investments.

For 2003, it is estimated that GDP will expand between 1.5% and 1.8%. This percentage is below the 2.2% figure presented in the most recent Inflation Report, dated March 2003. The basic reason for this reduction is the persistence of a series of adverse economic conditions and their repercussions on the level of internal demand.

## 1.5 Investments

**Investment indicators**

% accumulated growth in year

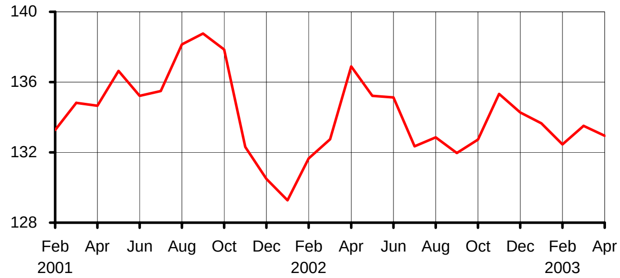
| Itemization | 2002 | | | | 2003 | |
|---|---|---|---|---|---|---|
| | I Q | II Q | III Q | Year | I Q | Apr |
| Capital goods | | | | | | |
| Absorption[1/] | -7.7 | -5.7 | -4.4 | -7.1 | -8.5 | -11.9 |
| Production | -1.7 | -0.9 | -2.2 | -1.0 | 0.5 | -1.5 |
| Imports | -19.1 | -19.0 | -12.5 | -18.1 | -28.4 | -30.6 |
| Exports | -7.7 | -15.5 | -13.7 | -5.9 | -15.4 | -9.3 |
| Inputs for the building industry | -8.7 | -7.3 | -5.4 | -2.8 | -2.0 | -5.2 |
| BNDES financing | 14.0 | 25.7 | 45.4 | 48.4 | -9.4 | -10.2 |

Source: IBGE, Funcex and BNDES

1/ Capital goods production + imports - exports.

**Capital goods production**

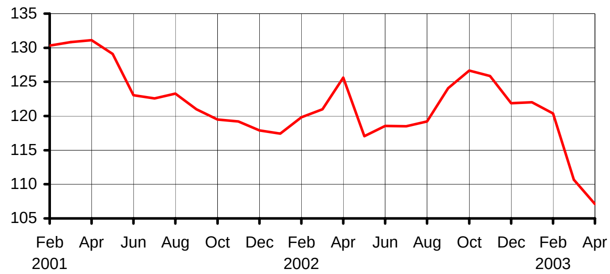
Seasonally adjusted data
Quarterly moving average




Source: IBGE

**Production of construction inputs**

Seasonally adjusted data
1992=100




Source: IBGE

According to the Quarterly National Accounts released by IBGE, investments – excluding inventory changes – dropped by 1.5% in the first quarter of 2003, compared to the same period of 2002. This result was determined by the performance of several monthly indicators of gross fixed capital formation which – using the same basis of comparison – registered reductions of 2% in building activity and 28.4% and 15.4%, respectively, in imports and exports of machines and equipment, parallel to 0.5% growth in the production of capital goods. In this context, absorption of machines and equipment declined by 8.5% in the period. Indicators released up to April continue to show downward movement in gross fixed capital formation. Thus, once these results are incorporated, the level of activity in the construction industry dropped by 5.2%, imports of machines and equipment by 30.6%, exports of these goods, 9.3% and output of capital goods, by 1.5%, in the first four months of the year, when compared to the corresponding period of 2002. The reduction in capital goods absorption came to 11.9%, using the same reference base.

The falloff in investments was more intense when viewed in terms of short-term comparisons. In this context, analysis of deseasonalized data indicates that gross fixed capital formation dropped by 4.6% in the first quarter of this year, when viewed

**Production of capital goods**

Percentage change

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr |
| Quarter/previous quarter[1/] | | | | | |
| Capital goods | 1.7 | 0.7 | -2.1 | -0.6 | -0.5 |
| Industrial | 11.4 | 11.1 | 6.7 | 3.5 | -2.1 |
| Serial | 14.5 | 15.6 | 10.2 | 7.0 | -0.8 |
| Nonserial | 0.5 | -5.0 | -7.7 | -10.0 | -8.6 |
| Agricultural | 1.2 | -13.8 | -16.2 | -9.6 | 4.8 |
| Farm parts | 1.3 | -0.6 | -3.9 | -0.2 | -0.4 |
| Building | -8.4 | -4.1 | -6.2 | -3.4 | -4.2 |
| Electric energy | -3.4 | 9.5 | 14.8 | 8.3 | -1.9 |
| Transportation | 6.3 | 10.6 | 7.0 | -0.6 | -11.5 |
| Mixed | -1.9 | -5.4 | -7.9 | -4.9 | 0.1 |
| In the year | | | | | |
| Capital goods | -1.0 | 2.9 | 1.8 | 0.5 | -1.5 |
| Industrial | 5.2 | 20.9 | 19.4 | 16.3 | 13.1 |
| Serial | 1.9 | 29.9 | 26.9 | 23.1 | 20.0 |
| Nonserial | 20.2 | -6.7 | -5.7 | -7.6 | -11.4 |
| Agricultural | 18.6 | 3.8 | 10.1 | 12.2 | 13.5 |
| Farm parts | 0.3 | 3.5 | 3.0 | 6.7 | 6.4 |
| Building | 0.0 | -18.2 | -14.4 | -16.0 | -18.1 |
| Electric energy | -27.0 | -25.2 | -34.1 | -36.7 | -37.3 |
| Transportation | 8.1 | 17.2 | 15.1 | 9.5 | 4.0 |
| Mixed | -0.9 | -3.3 | -2.2 | 0.4 | -1.6 |

Source: IBGE

1/ Seasonally adjusted data.

**Production of automotive vehicles**

Percentage change

| Itemization | 2002 | 2003 | | | | |
|---|---|---|---|---|---|---|
| | Dec | Jan | Feb | Mar | Apr | May* |
| In the month[1/] | | | | | | |
| Farm machines | -1.5 | -3.5 | 2.1 | -2.1 | 5.9 | 3.0 |
| Busses | -0.5 | 25.9 | -18.0 | -8.3 | -9.9 | 4.9 |
| Trucks | -0.1 | 16.8 | -1.8 | -14.5 | 1.1 | -10.7 |
| Quarter/previous quarter[1/] | | | | | | |
| Farm machines | 5.2 | -6.4 | -8.7 | -8.1 | -0.2 | 3.0 |
| Busses | 20.5 | 28.7 | 19.3 | 12.0 | -13.2 | -18.1 |
| Trucks | 14.0 | 24.0 | 20.4 | 13.5 | -1.5 | -13.7 |
| In the year | | | | | | |
| Farm machines | 17.3 | 4.8 | 7.8 | 8.7 | 8.2 | 10.3 |
| Busses | -2.9 | 10.9 | 2.1 | 0.3 | -3.8 | -2.0 |
| Trucks | -11.5 | 29.2 | 27.3 | 18.9 | 10.6 | 8.2 |

Source: Anfavea

1/ Seasonally adjusted data.
* Preliminary.

against the level registered in the previous quarter. Basically, this movement was a consequence of reductions of 5.7% in the output of building industry inputs and 0.6% in the production of capital goods, as is evident in the fact that, in precisely the opposite direction, the exports of this category declined by 14.9% and imports increased by 10% in the period.

A breakdown of capital goods production in the first four months of 2003 shows growth of 13.5% in the segment of goods for the farm sector, 6.7% in parts for farm machines and 4% in transportation equipment. The increase in the production of machines and other farm equipment has maintained the trajectory observed in recent years, accompanying the performance of crop/livestock output.

Data released by Anfavea clearly ratify the behavior of activities related to the farm sector. Output of farm machines increased by 10.3% in the first five months of 2003, compared to the same period of 2002. Using the same basis of comparison, production of trucks expanded by 8.2%.

Disbursements of the BNDES System – BNDES, Special Industrial Financing Agency (Finame) and BNDES Participações S.A. (BNDESpar) – came to a total of R$6.9 billion in the first four months of 2003. This result was 10.2% below the amount disbursed in the same period of 2002.

A breakdown by sectors of activity shows that financing provided to the manufacturing sector registered a nominal decline of 2.8% while that targeted to commerce and the sector of services and crop/livestock activities, dropped by 12.4%

and 24.4%, respectively. Financing channeled to the mining sector declined by 30.2%.

**BNDES disbursement**[1/]

| Itemization | 2002 | 2003 | | | |
|---|---|---|---|---|---|
| | | Jan | Feb | Mar | Apr |
| Accumulated in the year (in R$ million) | | | | | |
| Total | 37 419 | 1 804 | 3 839 | 5 495 | 6 931 |
| Manufacturing industry | 17 178 | 1 236 | 1 845 | 2 500 | 3 140 |
| Commerce and services | 15 482 | 400 | 1 666 | 2 397 | 2 935 |
| Crop and livestock | 4 509 | 154 | 310 | 560 | 813 |
| Extraction industry | 250 | 14 | 18 | 38 | 44 |

Source: IBGE

1/ Includes BNDES, Finame and BNDESpar.

The Long-Term Interest Rate (TJLP), which is the basic cost for financing contracted with the BNDES System, remained practically stable over the course of 2002, moving from 10% per year in the first quarter of 2002 to 9.5% per year in the second quarter, and returning to 10% per year in the following quarters. In the first quarter of 2003, the rate increased to 11% per year, moving to 12% per year as of April 2003.

## 1.6 Conclusion

Interruption of the GDP growth trajectory in the first quarter of 2003 and the negative sector-by-sector results registered in April indicators for both industry and commerce, confirmed the downturn in the level of activity that began toward the end of last year. The major determining factor of this performance was the decline registered under internal demand, which was particularly intense in the early months of the year. Aside from this, the loss of vigor in the economy can also be attributed to the lesser pace of industrial exports, when compared to the rather high levels of expansion over the course of 2002.

Since there is not a great deal of room for further export growth, recovery in the pace of economic activity in the coming months, together with the intensity of that process, will depend on the consolidation of favorable growth in internal economic indicators. And here, one should stress the recently observed reduction in inflation and increasingly clearer signs of improved expectations and the impact of these factors on internal demand.

# 2 – Prices

In the second quarter of the year, inflation remained on a downward curve, suggesting that the impact of the exchange shock on price growth was nearing exhaustion. Despite this, persistent inflation hindered a more significant drop in prices. Monetary policy measures were taken with the objective of restricting passthrough of price increases registered in sectors directly affected by changes in the rate of exchange. These measures played a significant role in this process and could even be perceived in the trajectory of the prices of nontradables, particularly services.

Aside from the positive performance registered under those prices that are more susceptible to changes in exchange rates, the decline in the level of inflation in recent months reflected reductions both in the prices of foodstuffs as a consequence of such factors as the farm harvest and good climatic conditions, as well as in those of government managed prices.

## 2.1 General prices indices

Following relatively high inflation in the first three months of the year, the general prices indices began moving downward as of the month of March. Growth in the General Price Index – Internal Supply (IGP-DI) came to 0.41% in April and -0.67% in the month of May. This was the first case of deflation in this index since June 1999 and was caused mostly by the performance of the wholesale prices for both farm and industrial

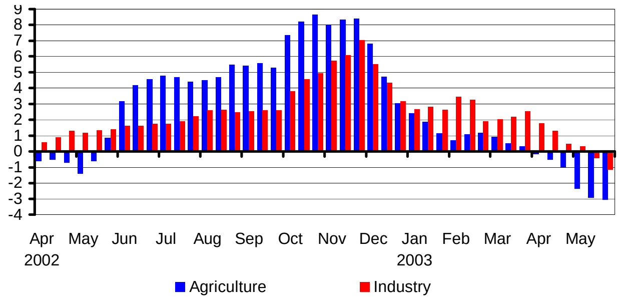
**General indices**

Monthly % change

| Itemization | 2002 | | | | 2003 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May |
| IGP - DI | 2.2 | 4.2 | 5.8 | 2.7 | 2.2 | 1.6 | 1.7 | 0.4 | -0.7 |
| IPA | 3.3 | 6.0 | 7.5 | 3.1 | 2.2 | 1.7 | 1.9 | 0.1 | -1.7 |
| IPC | 0.6 | 1.1 | 3.1 | 1.9 | 2.3 | 1.4 | 1.1 | 1.1 | 0.7 |
| INCC | 0.6 | 1.1 | 2.5 | 1.7 | 1.5 | 1.4 | 1.4 | 0.9 | 2.8 |

Source: FGV

**Evolution of IPA (10, M and DI) – Agriculture and industry**
Monthly % change

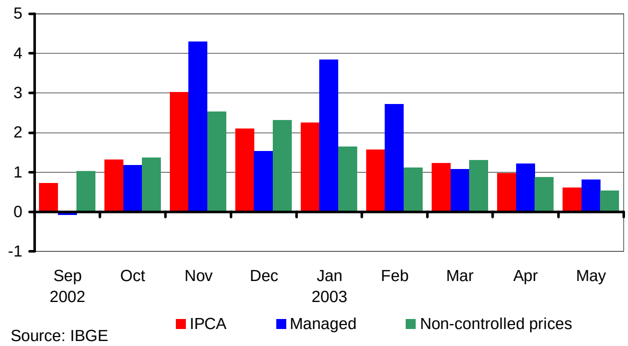



Source: FGV

products. In the first grouping, the start of the process of marketing the new harvest, coupled with upward movement in the rate of exchange, were the factors that contributed to the decline in the segment's prices, with growth of -0.99% in April and -3.88% in May. On a product-by-product basis, the trajectory of farm prices was mainly due to falloffs in the prices of soybeans and corn and to the behavior of the prices of meats in general, with an across-the-board decrease. The prices of industrial products at the wholesale level also reflected recent evolution of exchange rates. Thus, following a high of 2.56% in March, these prices fell by 1.15% in May due, mostly, to reductions under fuels and lubricants (6.5%), plastics (5.9%), fertilizers (5.5%) and mining (2.9%). Accumulated growth in farm prices closed at -3.7% in the quarter ended in May, as against 5.5% in the previous quarter, while industrial prices registered 1.9%, as compared to 7.9%, in the same periods.

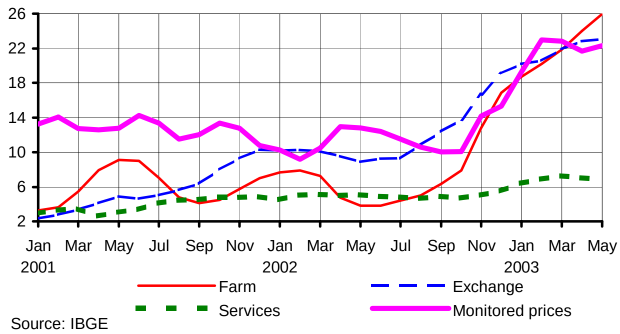
## 2.2 Consumer price indices

**Evolution of IPCA**
Monthly % change




Source: IBGE

**IPCA – Itemized groups**
12 month % change




Source: IBGE

Monthly IPCA growth followed a downward curve since January of this year, principally as a result of lesser pressures under market prices and government managed prices. The reduction in inflation from 2.25% in January to 0.61% in May was, above all, a consequence of downward movement under food prices from 2.15% to 0.63%. This was the grouping with the highest level of participation in the composition of the index. At the same time, growth in government managed prices fell from 3.83% to 0.81%, in the same period.

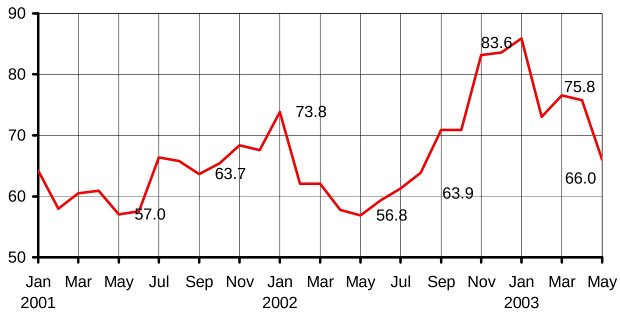
The start of the farm harvest and 18.5% appreciation in the rate of exchange in the year up to May resulted in lesser growth in industrialized food prices, particularly those of sugars and derivatives, oils, fats and bakery goods. Parallel to this, climatic conditions were better suited to the cultivation of in natura products. As a consequence, the prices of these goods dropped by a rather sharp 6.3% in May, compared to growth of 7.17% in March, ending the second quarter with accumulated growth of 2.2%. However, the prices of semi manufactured products continued exerting upward pressures on prices, mostly as a consequence of the rice harvest failure and the start of the off-season period of milk production.

Government monitored prices, which had turned in 6.6% growth in the first two months of the year, registered deceleration from March to May and closed the quarter with 3.1%. To a great extent, this performance was due to lesser increases under urban bus fares, since six different metropolitan regions had registered fare hikes in the January to February period, and to reductions in fuel prices following sharp upward movement at the start of the year.

Aside from the items of foodstuffs and monitored prices, the prices of other products impacted by 2002 exchange depreciation began turning downward, particularly in the month of May. Among these products, mention should be made of goods for personal hygiene, cleaning articles, electric-electronic goods and furniture and utensils.

**IPCA items**

% of items with increase



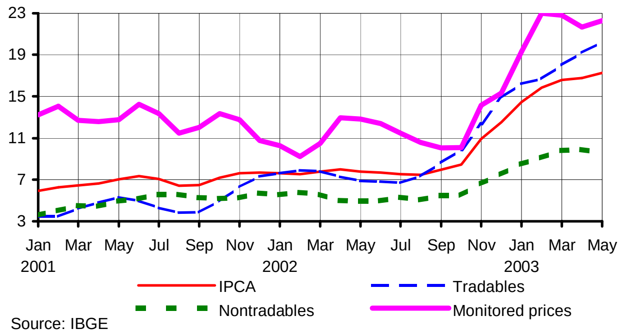

Source: IBGE

It should be noted that the proportion of the number of items that registered positive price growth in the IPCA dropped back to the level registered prior to the exchange shock. This performance indicates that the generalized passthrough of the impact of exchange rate depreciation to prices that had been registered in the second half of 2002 and start of 2003 has, for all practical purposes, run out of steam.

With the May result, the IPCA registered growth of 6.8% in the year, mostly as a consequence of increases of 10% in the prices of government monitored goods and services in the period, coupled with 7.4% expansion in the prices of industrialized foodstuffs, 13.6% growth in the prices of cleaning material and 10.4% in those of pharmaceutical products. The accumulated index turned in growth of 2.84% in the March-May quarter, compared to 6.04% in the February-April quarter.

## 2.3 Government managed prices

**IPCA – Itemized groups**
12 month % change




Source: IBGE

In the quarter extending from March to May, growth in government managed prices totaled 3.13%, corresponding to 0.89 p.p. of the 2.83% growth registered by the IPCA. In the same period, market prices increased by 2.71%. Among the increases in government managed prices that contributed to this result, mention should be made of 8.87% growth under the heading of water and sewage services; 5.39% under urban bus fares; and 5.44% under bottled gas. Residential electricity rates increased by 10.1% and were the item that made the largest contribution to growth in the quarterly IPCA, with 0.41 p.p. Aside from the annual increase in Fortaleza (31.29%), Recife (28.47%), Salvador (28.61%), Belo Horizonte (31.53%) and Porto Alegre (14.98%), public illumination fees were introduced in several regions of the country. This item was responsible for the following increases in residential electricity rates: 4.03% in São Paulo, 5.45% in Goiânia, 4.81% in Curitiba, 2.8% in Fortaleza, 3.56% in Rio de Janeiro and 8.65% in Below Horizonte.

Fuel prices moved into a downward curve as a result of falloffs in international petroleum prices and appreciation of the real against the dollar. The prices of gasoline and diesel oil dropped by 4.52% and 3.87%, respectively, in the quarter, as a result of May reductions of 6.5% and 8.6% in the prices charged by Petrobras for gasoline and diesel oil at the refinery level.

## 2.4 Core inflation

The IPCA core is measured by excluding household foodstuffs and government monitored prices and closed at 1.13% in March, 0.81%

in April and 0.56% in May, and was consistently lower than the full index. Accumulated growth in the last twelve months came to 10.58% in the month of May.

**Core inflation**

Monthly % change

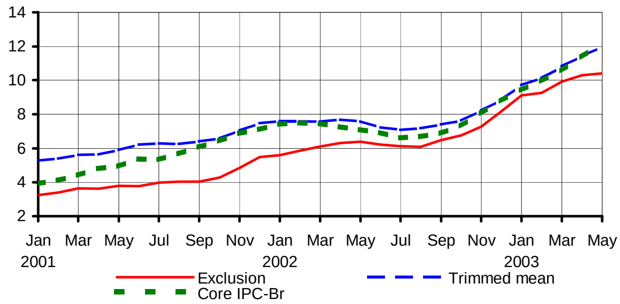
| Itemization | 2002 | | | | 2003 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May |
| IPCA | 0.7 | 1.3 | 3.0 | 2.1 | 2.3 | 1.6 | 1.2 | 1.0 | 0.6 |
| Exclusion | 0.6 | 0.7 | 1.2 | 1.7 | 1.4 | 1.0 | 1.1 | 0.8 | 0.6 |
| Trimmed means | | | | | | | | | |
| Smoothed | 0.8 | 0.8 | 1.3 | 1.4 | 1.3 | 0.9 | 1.2 | 1.1 | 1.0 |
| Non smoothed | 0.6 | 0.9 | 1.7 | 1.5 | 1.7 | 1.0 | 1.0 | 0.9 | 0.6 |
| IPC-Br | 0.7 | 1.1 | 3.1 | 1.9 | 2.3 | 1.4 | 1.1 | 1.1 | 0.7 |
| Core IPC-Br | 0.7 | 1.0 | 1.5 | 1.4 | 1.3 | 0.9 | 1.1 | 1.2 | 1.1 |

Source: Bacen and FGV

When one considers the core IPCA calculated on the basis of median averages, growth came to 1.23% in March, 1.1% in April and 1% in May. This measurement excludes the items with monthly growth above the 80% distribution percentile or below the 20% distribution percentile. In this context, the items that have only one value change in each year are smoothed or, in other words, their growth is redistributed in equal installments both in the month of the change and in the eleven subsequent months. In the last twelve months, expansion accumulated a high of 11.98%. It should be stressed that, due to the smoothing of specific items, the core calculated in this manner will reflect the effects of the exchange shock for a longer period of time. In the absence of smoothing, the core by median average would register growth of 0.64%in May.

**Core inflation**

12 month % change



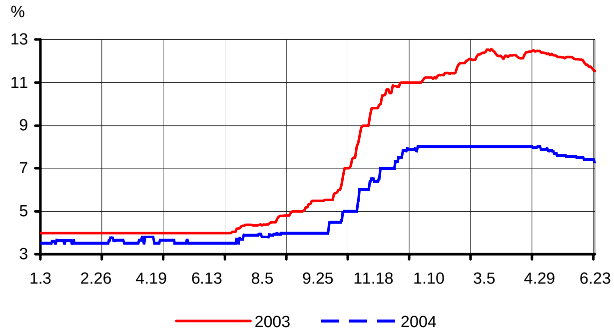

Source: Bacen and FGV

Core inflation for the Consumer Price Index – Brazil (IPC-Br), calculated according to the median average, was also quite high, with annual growth of 1.07% in March, 1.2% in April and 1.05% in May. In the last twelve months, the core accumulated a high of 12.14%, evincing a certain degree of stability when compared to the monthly average of the last two quarters.

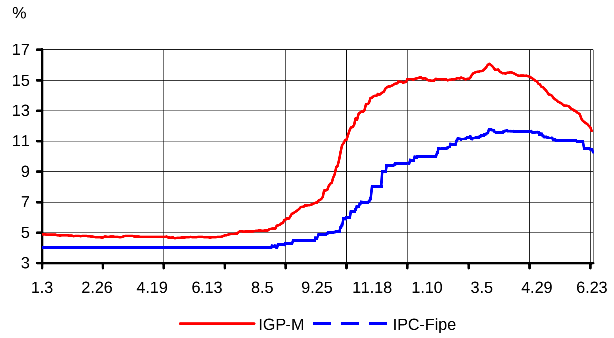
## 2.5 Market expectations

The Investor Relations Executive Management Staff (Gerin) of Banco Central do Brasil carries out a daily survey involving a sampling of an average of approximately seventy consulting companies and financial institutions, with the objective of detecting market expectations regarding the evolution of the major economic variables.

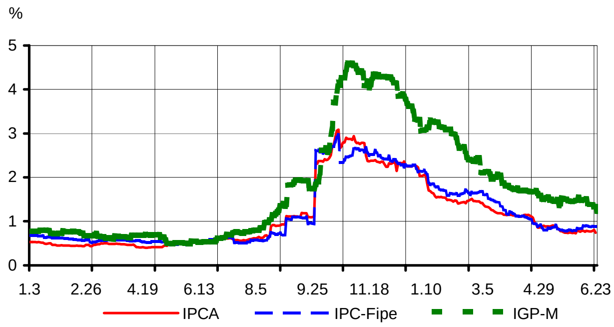
**Daily evolution of market expectations for inflation (IPCA) (median)**



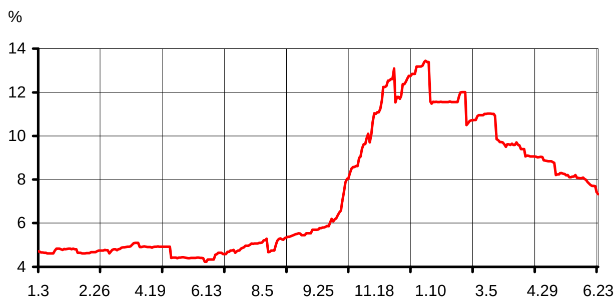

**Daily evolution of market expectations for inflation in 2003 (median)**




**Standard deviation of market expectations for inflation in 2003**




**Daily evolution of the market expectations for the IPCA accumulated over the next 12 months (median)**




Median inflationary expectations for 2003, measured by the IPCA, diminished from 12.19% on March 21, 2003, to 11.53%, on June 23, 2003. For 2004, expectations moved from 8% to 7.3%, between the two days considered. With respect to the medians indicated by the top five short-term forecasters (Top five), their expectations increased from 11.65% to 11.71%, for 2003, and declined from 8.8% to 7% for 2004.

With respect to the IGP-M, median expectations for 2003 moved from 15.85%, on March 21, 2003, to 11.64%, on June 23, 2003. For 2004, expectations dropped from 8.7% to 7.5%. Expectations regarding the IPC-Fipe in 2003 dropped from 11.61% on March 21, 2003, to 10.29% on June 23, 2003. For 2004, expectations remained at 7%, for the same dates.

Insofar as the median short-term expectations of the Top five are concerned, there was a drop from 14.93% to 11.03%, for 2003, and from 6.5% to 6% for 2004, in the case of the IGP-M.

The standard deviations of the price indices expected for 2003, which stood at levels of 1.18% for the IPCA, 1.87% for the IGP-M and 1.35% for the IPC-Fipe on March 21, 2003, dropped to respective levels of 0.74%, 1.22% and 0.88%, on June 23, 2003. For 2004, standard deviations dropped for the same dates as follows: IPCA, from 1.62% to 1.06%; IGP-M, from 2.4% to 1.71%; and IPC-Fipe, from 1.56% to 1.29%.

When one considers median expectations for accumulated inflation in the coming 12 months, as measured by the IPCA, there was a decline from 9,62% on March 21, 2003 to 7.34%, on June 23, 2003.

## 2.6 Conclusion

The factors responsible for the reduction in inflation in recent months have continued to the present, though they have been partly offset by persistent inflation. Consequently, expectations are that figures for the month of June will show an even further downturn in prices. As a matter of fact, the effects of exchange appreciation and the favorable seasonality of farm prices are still being felt, particularly at the wholesale level, which has registered negative partial growth rates for the month of June. Aside from these factors, one should also note that the impact of changes in government-monitored prices in the month of May has practically run its course.

In the month of July, changes in electricity prices in São Paulo, coupled with increases in telephone rates, are expected to exert the greatest pressure on inflation. However, these factors are not expected to be sufficient to alter the overall price trajectory, which, in the context of a relatively stable dollar and rather severely restricted demand, are expected to converge toward the path of the inflation targeting.

# 3 – Credit, monetary and fiscal policies

## 3.1 Credit

Growth in financial system credit operations in the quarter extending from March to May was compatible with the economic scenario of the period, as reflected in a slowdown in the pace of productive activity, high rates of interest and declining real overall wages. In this framework, investment and consumer decisions were postponed as companies and households took steps to restrict their indebtedness to short-term operations, particularly revolving credits transactions.

**Growth in credit operations**

R$ billion

| Itemization | 2003 | | | | Growth | |
|---|---|---|---|---|---|---|
| | Feb | Mar | Apr | May | 3 months | 12 months |
| Total | 381.5 | 380.3 | 377.6 | 380.4 | -0.3 | 10.7 |
| Nonearmarked | 214.9 | 215.5 | 214.6 | 214.8 | -0.1 | 5.2 |
| Legal entities | 135.9 | 135.9 | 133.3 | 132.8 | -2.3 | 3.9 |
| Ref. to exchange | 56.8 | 55.7 | 52.3 | 51.2 | -9.9 | -11.9 |
| Individuals | 79.0 | 79.6 | 81.3 | 82.0 | 3.8 | 7.2 |
| Earmarked | 143.8 | 142.5 | 141.5 | 143.8 | 0.0 | 21.1 |
| Housing | 21.8 | 22.0 | 22.1 | 22.2 | 1.7 | 3.5 |
| Rural | 35.4 | 35.7 | 36.3 | 37.1 | 4.8 | 34.0 |
| BNDES | 85.3 | 83.4 | 81.7 | 82.6 | -3.2 | 20.2 |
| Others | 1.2 | 1.4 | 1.4 | 1.9 | 55.0 | 126.4 |
| Leasing | 8.9 | 8.6 | 8.3 | 8.3 | -6.9 | -22.6 |
| Public sector | 13.9 | 13.8 | 13.2 | 13.5 | -2.8 | 34.5 |
| **% participation:** | | | | | | |
| Total/ GDP | 23.7 | 23.5 | 23.4 | 23.8 | | |
| Nonearm./GDP | 13.4 | 13.3 | 13.3 | 13.4 | | |
| Earmarked/GDP | 8.9 | 8.8 | 8.8 | 9.0 | | |

With regard to the supply of resources, just as occurred in previous periods, the uncertainties that reigned on credit markets, particularly as a result of high levels of defaults, led financial institutions to adopt more selective and conservative postures in granting new financing. These conditions were a consequence of monetary policies and contributed to growth in the average costs of lending operations in the quarter.

Thus, the volume of financial system credit operations, including those based on earmarked and nonearmarked resources, totaled R$380.4 billion in May, reflecting a decline of 0.3% in the quarter. The participation of total loans in relation to GDP moved from 23.7% in February to 23.8% in May.

The balance of operations carried out by private banks added up to R$230.3 billion, accounting for 60.5% of the total. These operations registered a downturn of 1.6% in the period, concentrated mostly in cutbacks in the debts of the industrial and service sectors. The portfolios of public financial institutions came to R$150.4 billion, with growth of 1.8%, concentrated mostly in the rural sector borrowers.

Operations channeled to the private sector totaled R$366.9 billion in the month of May, for a decline of 0.2% in the quarter. Here, one should note the 3.6% quarterly reduction in financial system credits to the industrial sector, which closed at R$112.8 billion. Growth reflected reductions in the investments of the manufacturing sector, as well as exchange valuation on contracts with the sectors of energy and steel. In the same sense, the volume of operations with the segment of services dropped by 3.8% in the quarter and closed at R$65.7 billion. Here, the major factor was the process of debt settlement by telecommunications companies.

Loans contracted by commerce totaled R$39.9 billion, for a reduction of 0.2% in the quarter. This decline was compatible with decreased household consumption intentions, consequent upon deterioration in the purchasing power of wages and salaries.

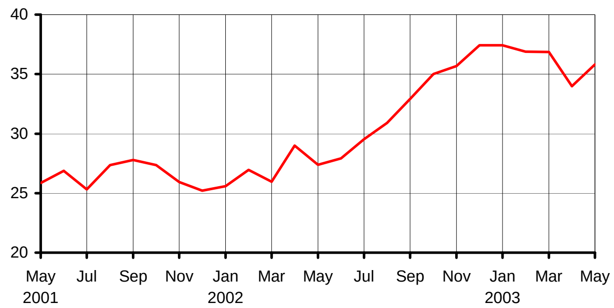
Operations with the public sector registered decline of 2.8% and closed at R$13.5 billion. This result was a consequence of the behavior of the states and municipalities banking debt, which dropped by 6.7% in the quarter, rising to a level of R$9.5 billion. Credits contracted by the federal government totaled R$4 billion in May, corresponding to growth of 8.1%.

Leasing operations totaled R$8.3 billion, for a decline of 6.9% in the period extending from March to May. In this particular case, one should highlight the process of settlement of operations, particularly by service companies. However, this reduction was less than in the previous quarter (5.5%), as a result of growth in new operations with legal entities.

## Credit operations with earmarked resources

The share of credit operations contracted on the basis of earmarked resources, including operations with interest rates defined in government programs or onlending operations, came to an May total of R$143.8 billion, remaining stable in the quarter. This result was basically impacted by operations carried out by the BNDES System, which registered a balance of R$82.6 billion, reflecting a decline of 3.2% in the period. In the opposite sense, operations with the rural and housing sectors turned in positive growth in the quarter.

**BNDES disbursements**
Accumulated in 12 months
R$ billion




Financing granted by BNDES in the period extending from January to May 2003 totaled R$8.8 billion, for a reduction of 15.6%, compared to the result for the same period of 2002.

A breakdown by economic activities shows that credits granted to companies involved in services and commerce turned in a reduction of 8% in the period, resulting in an accumulated flow of R$3.7 billion. This performance was a consequence of a 30.8% drop in financing granted to the sector of energy, a falloff that is at least partially explained by a comparison with the voluminous amounts released in the early months of 2002.

Aside from this, mention should also be made of the 21.2% reduction in disbursements to the manufacturing sector, which came to a total of R$3.9 billion. Basically, this result was caused by the falloff of 57.1% in financing provided to the aircraft industry, as well as by reduced contracting of resources on the part of the food industry and the sector of machines and equipment.

Crop/livestock activity absorbed R$1.1 billion in the first five months of the year, reflecting a drop of 17.6% compared to the analogous 2002 result. The underlying reason for this was the lesser supply of resources through the Program of Modernization of the Farm Tractor Fleet and Associated Implements and Harvesters (Moderfrota).

The flow of financing targeted to export activities declined by 22.6%, reaching a level of R$2.2 billion. In this case, there was a particularly sharp falloff in operations with the aircraft industry.

Consultations with the BNDES, considered a reliable indicator of future medium and long-term investments on the part of the productive sector, came to a total of R$11.9 billion in the first five months of the year, revealing a drop of 35.9% when compared to the same period of 2002. For the most part, this result was caused by a 64% reduction in the sectors of services and commerce, which registered total consultations in the amount of R$4.5 billion. However, one must clarify that, just as occurred in the case of disbursements, the sharp falloff was mainly caused by the segment of electricity and gas. Another factor that contributed to this result was the downturn in the segments of communications, air transportation and basic sanitation.

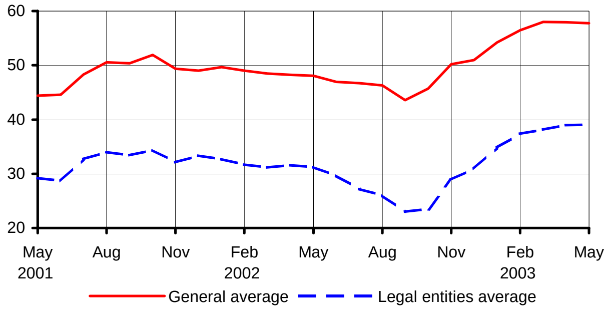
Requests on the part of the manufacturing sector came to R$5.3 billion, corresponding to an increase of 20.7% in relation to the total for the same period of the previous year. This performance was a consequence of growth in the demand of the sectors of paper and cellulose, petroleum and alcohol refining, basic metallurgy and the chemical industry.

The balance of rural credit operations came to R$37.1 billion, with growth of 4.8% in the quarter. Here, the most important operations were those contracted with public banks, which accounted for 61.4% of the total, mostly targeted to the current expenditures and marketing of the grain harvest. In relation to total rural financing, investments accounted for 53.5%, while current expenditures and marketing were responsible for 38.8% and 7.7%, respectively.

The stock of financing for the housing sector, including operations with both individual persons and housing cooperatives, came to a total of R$22.2 billion, with growth of 1.7% in the quarter. Growth was conditioned by the exhaustion of the resources made available by the Worker Support Fund (FAT), since financial institutions had already complied with the required level of investments in home financing.

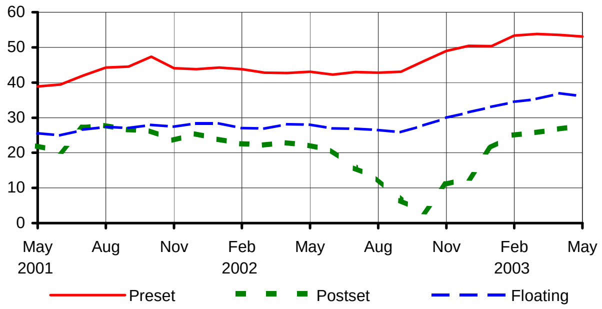
# Credit operations with nonearmarked resources

**Interest rates of credit operations with nonearmarked resources**
% p.y.



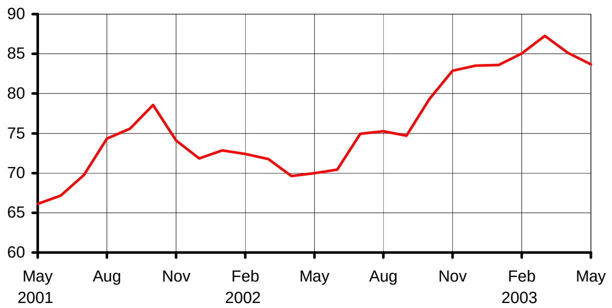

The average rate of interest on credit operations utilizing nonearmarked resources increased by 1.3 p.p. in the last three months and closed the month of May at 57.8% per year. The increases in the Selic rate target and in the rate of compulsory reserves on demand deposits were the factors that had the greatest impact on the behavior of lending rates in the quarter and, especially, in the month of March. In the subsequent months, as the general economic scenario improved as evinced by the drop in interest rates on the futures market, the cost of credit moved into a downward curve, with cutbacks in the various types of longer term credits.

**Interest rates of credit operations – Legal entities**
% p.y.



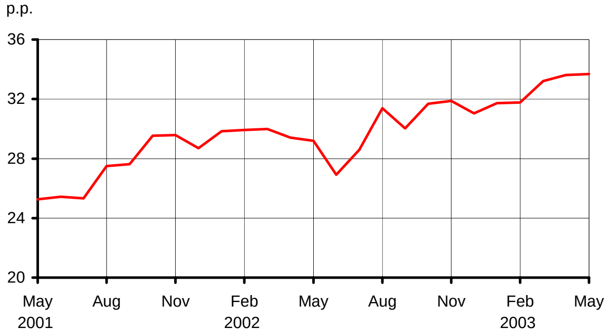

Growth in the median rate of interest was caused by an increase of 1.7 p.p. in the rates contracted with legal entities, which came to an average of 39.1% per year. This result was explained by the behavior of postset operations referenced to exchange, which turned in an increase of 2.6 p.p. in the quarter. In just the opposite sense, the average cost of preset contracts slipped by 0.3 p.p., as a result of the cost of internal funding operations.

**Interest rates of credit operations  preset rates – Individuals**
% p.y.




The average rate on loans to individual persons contracted mostly on the basis of preset interest came to 83.7% per year in the month of May, or 1.4 p.p. less than in February. The principal portfolio in this segment – vehicle financing – registered a sharper reduction of 5.8 p.p., as a consequence of the decline in the cost of medium and long-term funding operations and of the promotional campaigns carried out by the automotive companies as an instrument for leveraging their sales, with rates closing at 47.4% per year. In personal credit operations, the volume of which was around the same level as vehicle financing, registered a decline of 0.8 p.p. in the median rate negotiated in the quarter, which closed at 98.1% per year. In the opposite sense, the rates practiced in operations with special overdraft checks moved upward by 4.5 p.p. and closed at 177.6% per year, suggesting that the relative inelasticity of demand for these resources has contributed to increases in their costs.

**Median spread of credit operations with nonearmarked resources**

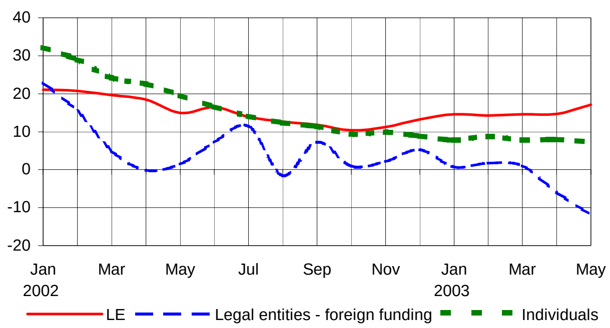



The banking spread in credit operations based on nonearmarked resources came to 33.7 p.p. in May, or 1.9 p.p. more than in the month of February. The increase in the rate of compulsory reserves on demand deposits and growth in the default rate were the major determinants of this movement.

The total volume of credit portfolios based on nonearmarked resources came to R$214.8 billion in the month of May, registering stability in the quarter. Consequently, these operations came to represent 56.5% of the financial system stock, compared to 56.3% in the month of February.

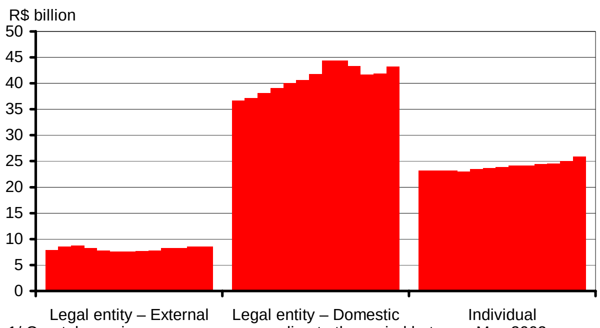
**Growth of credit with nonearmarked resources**

Percentage variation in 12 months




The balance of operations with legal entities totaled R$132.8 billion, reflecting a drop of 2.3% in the quarter. To some extent, this performance is explained by the falloff of 9.9% in portfolios referenced in foreign currency, which came to a total of R$51.2 billion. Here, stress should be given to the impact of exchange appreciation of 16.8% in the period on the stocks of external onlending operations and import financing, which was somewhat attenuated by growth in loans based on Advances on Exchange Contracts (ACC).

**Growth in credit granting with nonearmarked resources[1/]**




1/ Quartely moving average corresponding to the period between May 2002 and May 2003.

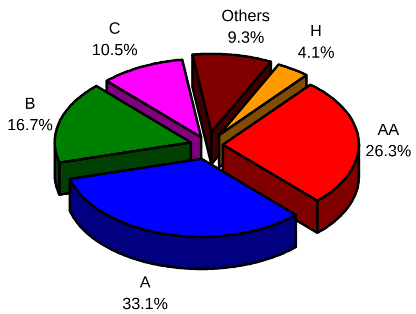
Credit granted in modalities based on external funding operations expanded by 3.8%, according to the criterion of quarterly averages. Here, the most important item was the performance of export financing.

In the case of operations based on internal resources, the stock reached a level of R$81.6 billion, for quarterly growth of 3.1%. Basically, this is explained by changes in the portfolios of guarantied overdraft accounts and working capital operations. Growth in these credit lines can be viewed as a result of settlement of debts indexed to exchange, which were substituted by contracts referenced to the rates on Interbank Deposit Certificates (CDI), as well as to the fact that many businesses opted to contract debts through revolving credit operations to be used, for the most part, in replenishing their cash flows. Insofar as disbursements financed with internal resources are concerned, the period was marked by a decline of 0.4% in the period.

The volume of credits channeled to individual persons came to R$82 billion, for a quarterly increase of 3.5%. This performance reflects the need felt by families to supplement household income through the use of special overdraft checks and credit card operations, as their real earnings levels deteriorated. With regard to the terms of operations in this market segment, one should note that financing for the acquisition of goods declined, as the use of revolving credit operations increased, and average terms dropped from 304 days to 292 days.

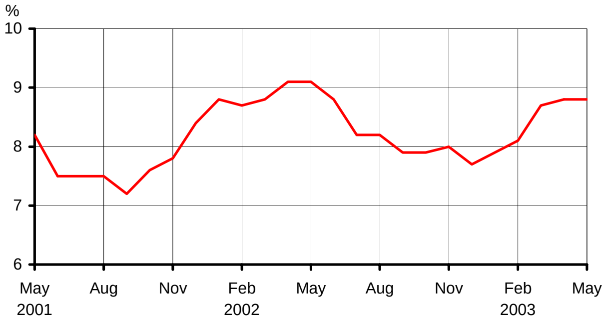
## Credit quality

**Credit operations in the financial system by levels of risk – May 2003**




With respect to the profile of the financial system credit portfolio, the participation of operations classified as normal risk (from AA to C) dropped from 87.1% in February to 86.6% in the month of May, resulting in a volume of R$329.5 billion. This decline resulted from reductions in debts referenced to foreign currency, as a consequence of exchange appreciation and contract settlements. The balance of loans registered under risk level 1 (from D to G) added up to R$35.5 billion and came to correspond to 9.3% of the portfolio, compared to 9.6% in the previous period. This growth was a consequence of reclassification of the debts of electric power companies to risk level 2 (level H), as the participation of this category moved from 3.3% to 4.1%.

Default rate of credit[1/]




1/ Portfolio's percentage share of nonearmarked funds in arrears of more than 15 days.

With regard to the quality of credit portfolios based on free resources, there was an increase of 0.7 p.p. in the default rate from February to May to a level of 8.8%. This movement is attributed to changes in family income which also impacted the payment capacity of companies. Thus, defaults registered growth of 0.5 p.p. in both segments and came to 4.7% in operations with legal entities and 15.4% in those involving individual borrowers.

Total provisions set aside by the financial system added up to R$29.9 billion in the month of May, with growth of 7.9% in the quarter, a figure considered compatible with the increase in the risk level of the credit portfolio. The relative participation of provisions in total credits came to 7.9%, corresponding to 9.1% in public banks and 7.1% in private banks.

## Credit Cooperatives

Credit cooperatives (CC) offer their members alternatives for financing production or consumption based on banking credit, with the possibility of improved access conditions, tailored services, better terms and interest while, at the same time, providing the membership with an additional option for making demand deposits. With this, the CC have the potential for expanding access to credit and to other banking products (charging, agreement-based receiving of payments, custody, financial investments, among others), with positive impacts on economic activity. In much the same way, CCs reach a public not normally covered by the banking system and can become instruments for reducing social and income inequalities.

The activities of the CCs are restricted in geographic terms. The area covered by a CC is limited by the possibility of effective participation and assemblies of the membership (control, operations, and rendering of services). Consequently, the activities of these institution take on a specifically local character and have the capacity of contributing to reductions in regional inequalities, while stimulating growth of the community and avoiding the rechanneling of monetary and credit flows to large financial centers.

Regulations specify that CCs must follow prudential indicators, just as other institutions have to. These rules deal with requirements for prior authorization in order to operate; rules

Table 1

| Credit Union (CU) | Resolution 2.771/2000 | Resolution 3.058/2002 | Circular 3.147/2002 | Resolution 3.106/2003 |
|---|---|---|---|---|
| Content of the rule | - New rules for the establishment and operation of the CU were passed.<br>- Reduction in the minimum capital for its establishment, and an Adjusted Net Worth (PLA) was adopted.<br>- Risk concentration limits were made more flexible. | - Establishes CU for micro and small entrepreneurs without demanding the segmentation by specialized business sectors.<br>- Such CU´s should join to Central CU and publish financial statement. | - The Basel Index for the CU was changed. | - New rules for the establishment and operation of the CU were passed.<br>- Resolutions 2.771 and 3.058 were revoked.<br>- The establisment of CUs with the free participation of members was made possible. |
| Free association | - Prohibited. | - Eased. | - No change. | - Accepted. Joining central CU and investing in credit at least 50% of the average amount of deposits is required. |
| Cooperative Credit System | - central CUs are responsible for supervising and auditing the single CU associated. | - No change. | - No change. | - No change. |
| Minimum Social Capital | - In the case of CU joined to central CU, it dropped from R$35,000.00 to R$3,000.00; and from R$50,000.00 to R$4,300.00 in the case of CU non-associated with central CU.<br>- For the central CU, it reduced from R$400,000.00 to R$60,000.00. | - R$40,000.00, for the CU established by micro and small entrepreneurs.<br>- No change for the others. | - No change. | - No change for single CU associated or not with central CU.<br>- For the CU`s mentioned in Res. 3.058, it was reduced to R$10,000.00.<br>- For the free association CU, R$10,000.00 if the area where it operates does not have a population under 100 thousand people, or up to R$6 million, in the opposite case. |
| Minimum Adjusted Net Worth (PLA) | - In the case of CU associated with central CUs, R$30,000.00 and R$60,000.00, respectively, after three and five years after the establishment; in case of non-associated CU, R$43,000.00 and R$86,000.00. The previous values were R$70,000.00, for the associated CU and R$100,000.00 for the non-associated, two years later.<br>- For the central CU, R$150,000.00 and R$300.000,00, respectively. The previous value was R$800.000,00 two years later. | - For the CU established by micro and small entrepreneurs, it should reach R$80,000.00 two years later and R$160,000.00 in four years.<br>- No change for the others. | - No change. | - No change for single CU associated or not with central CU.<br>- For the CU established by Res. 3.058, it was reduced from R$60,000.00 to R$120,000.00, two and four years later.<br>- For the free association CU, R$60.000,00 and R$120.000,00, if the area where it operates there is a population under 100 thousand people. |
| Basel Index | - 20% | - No change. | - 13% for the central CU and 15% for the CU associated with central CU. No change for the others. | - No change. |
| Limits of the PLA as regards the concentration of risk/customer. | - 25% in bonds of controlled or associated company.<br>- 20% in credit operations of the central CU with a single CU associated.<br>- In operations with a single associated member, 10% for CU associated with central CU and 5% for the non-associated. | - No change. | - No change. | - No change. |
| Credity Guaranty Fund (FGC) | - Deposits in CU are not guaranteed by the FGC. | - No change. | - No change. | - No change. |
| Credit Operations | - Only with associated members. | - No change. | - No change. | - No change. |
| Exceeding resources | - Free investment in the financial market. | - No change. | - No change. | - No change. |

on capital adjusted by risk; the need for internal controls; diversification of risk, with limits on the concentration of credit operations; among others. However, in light of their specific characteristics, the CCs have several additional restrictions and more rigid limitations. Evolution of these rules is shown in the accompanying Table 1.

Regulations on CCs seek to ensure adoption of appropriate financial and capitalization practices on the part of these financial institutions as well as their capitalization in order to protect them against adverse results. The objective is to preserve the solidity of this segment of the financial system.

The Brazilian cooperative credit system is organized in such a way that the members participate in individual cooperatives, which are able to associate themselves to central cooperatives for the purpose of obtaining gains in scale and centralizing financial, control and supervisory operations. In their turn, the central cooperatives are entitled to join cooperative confederations, which provide them with the services of integration, control and standardization. In Brazil, there are now two confederations: Sicoob, headquartered in Brasília, and Sicred, which is headquartered in Porto Alegre.

Table 2
**Credit cooperatives and the financial system**

**Cooperatives** R$ million

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Mar/2003 | % change 2003/1997 |
|---|---|---|---|---|---|---|---|---|
| Demand deposits | 435 | 1,356 | 1,545 | 1,866 | 2,383 | 3,303 | 3,534 | 712.9 |
| Time deposits | 644 | 946 | 1,229 | 1,679 | 1,787 | 1,982 | 2,209 | 243.0 |
| Credit operations | 1,366 | 2,109 | 2,584 | 3,196 | 4,117 | 4,952 | 5,235 | 283.2 |
| Net worth | 778 | 1,177 | 1,471 | 1,734 | 2,142 | 2,725 | 2,849 | 266.3 |
| Overall total assets | 2,496 | 4,261 | 5,663 | 7,137 | 9,375 | 12,420 | 13,555 | 443.0 |
| Nº of cooperatives | 1,100 | 1,198 | 1,253 | 1,311 | 1,379 | 1,477 | 1,480 | 34.5 |

**SFN** R$ million

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Mar/2003 | % change 2003/1997 |
|---|---|---|---|---|---|---|---|---|
| Demand deposits | 31,220 | 31,214 | 38,648 | 48,619 | 54,266 | 71,046 | 59,803 | 91.5 |
| Time deposits | 87,965 | 90,823 | 96,650 | 92,520 | 110,459 | 140,727 | 149,182 | 69.6 |
| Credit operations | 257,914 | 274,730 | 285,775 | 320,023 | 332,384 | 378,307 | 380,382 | 47.5 |
| Net worth | 65,083 | 81,339 | 96,013 | 104,592 | 127,908 | 149,483 | 168,247 | 158.5 |
| Overall total assets | 802,612 | 817,065 | 870,024 | 987,086 | 1,108,606 | 1,312,759 | 1,356,278 | 69.0 |

**Cooperatives' share in relation to the SFN (%)**

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Mar/2003 | Growth p.p. 2003/1997 |
|---|---|---|---|---|---|---|---|---|
| Demand deposits | 1.39 | 4.34 | 4.00 | 3.84 | 4.39 | 4.65 | 5.91 | 4.52 |
| Time deposits | 0.73 | 1.04 | 1.27 | 1.81 | 1.62 | 1.41 | 1.48 | 0.75 |
| Credit operations | 0.53 | 0.77 | 0.90 | 1.00 | 1.24 | 1.31 | 1.38 | 0.85 |
| Net worth | 1.20 | 1.45 | 1.53 | 1.66 | 1.67 | 1.82 | 1.69 | 0.50 |
| Overall total assets | 0.31 | 0.52 | 0.65 | 0.72 | 0.85 | 0.95 | 1.00 | 0.69 |

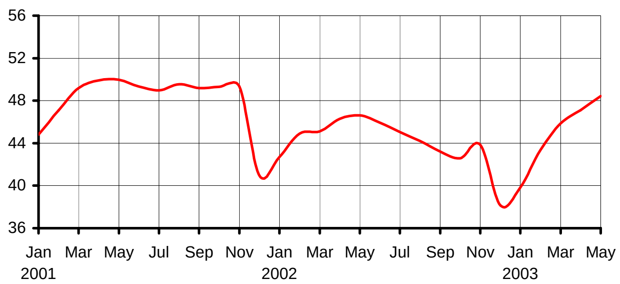
Source: Banco Central

With respect to the number of CCs, their participation in the National Financial System has been increasing, despite the fact that a major share of them are still very small institutions. Though the number of these institutions has increased by 34.5% from 1,100 in 1997 to 1,480 in March 2003, the total number of credit operations expanded by 283% in nominal terms in the same period, moving from R$1.37 billion to R$5.2 billion, as shown in the Table 2.

When one considers the low level of CC participation in relation to the entire National Financial System, it is easy to perceive the enormous potential that exists for growth in this segment, a potential that is already perceptible in the recent expansion of this segment, in both absolute and relative terms. Particularly in recent years, the expansion of the segment of CCs indicates the importance of the market niche in which they operate – in view of the possibility of expanding the supply of loans to organized productive sectors, composed basically of small scale producers – as well as the deficiencies that exist in the way in which they meet these needs. Growth in the cooperative credit movement has been favored by a more flexible approach to the restrictions applicable to their formation and activities, while preserving the required strictness of prudential regulations, clearly demonstrating the importance of this segment to the regulatory and supervisory authority.

## 3.2 Monetary aggregates

**Currency outside banks – Income-velocity[1/]**

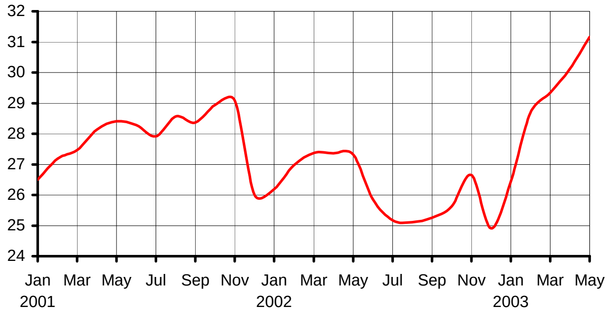



1/ Defined as the ratio between 12 month accumulated GDP (valuated by IGP-DI) and the monthly average balance of the monetary aggregate.

At the end of May, the money supply (M1) came to R$85.1 billion in terms of average daily balances, registering a decline of 16.8% in the year. Among its components, the balance of currency held by the public dropped by 17.5% and demand deposits slipped by 16.3%, reflecting a return to what is considered a normal pattern, following the atypical expansion registered during the course of the second half of 2002. The income velocity of the M1 components has moved on an upward curve in the year, mirroring the moderate growth registered in economic activity and reductions in credit operations.

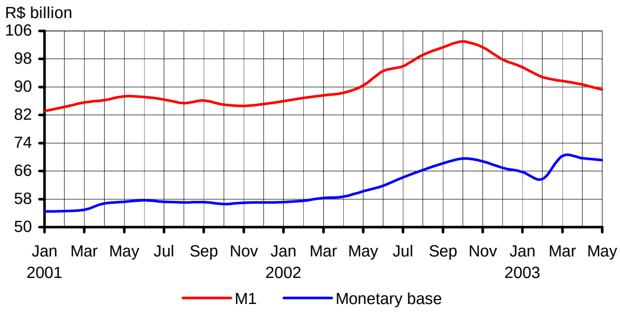
When deseasonalized data deflated by the IPCA are analyzed, one notes a reversal in the upward trajectory of M1 that resulted from the transitory impact of the adverse factors noted as of June 2002.

**Demand deposits – Income-velocity**[1/]



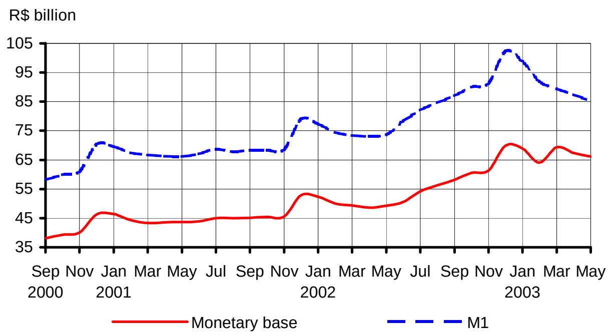

1/ Defined as the ratio between 12 month accumulated GDP (valuated by IGP-DI) and the monthly average balance of the monetary aggregate.

**M1 and Monetary base at May 2003 prices seasonally adjusted**[1/]

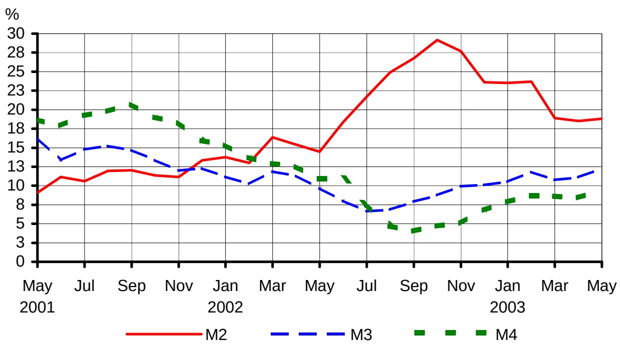



1/ Price index: IPCA

**Monetary base and M1 – Average daily balances**




**Broad money supply – 12 month percentage growth**




The average daily monetary base balance accompanied the downward movement in demand deposits and registered a drop of 5.3% in the year, to a May level of R$66.2 billion. Here, note should be taken of the performance of the base as of March, generated by the increase in the rate of compulsory reserves on demand resources from 45% to 60%. Thus, the average balance of currency issued dropped by 17.4% in the year, while that of banking reserves increased by 20.9%.

In the B1 concept, which is defined as the restricted monetary base plus additional amounts of earnings on demand resources, the monetary base came to R$70.2 billion, in terms of average daily balances in the month of May. It is important to observe that the contribution of the additional amounts cited above has diminished since February to a May total of R$4 billion as a result of the performance of demand deposits.

With regard to the broad money supply, the March-May quarter was marked by relative stability and was impacted basically by reductions in financial system credit operations and reductions in the stocks of federal public securities consequent upon exchange appreciation. The M2 concept, which encompasses M1 plus savings deposits and securities issued by financial institutions, registered a reduction of 1.4% in the quarter, as a result of declines of 8.1% in M1 and 1.8% in the balance of savings accounts. M3, which includes M2, fixed income fund quotas and federal public securities used as backing for the net financing position in repo operations, increased by 1.9% in the quarter, mostly as a result of 6.2% growth in fund quotas, which reflected the strong inflow registered by investment funds, with an accumulated total of R$14.9 billion in the quarter. The M4 concept, which is equivalent to M3 plus public securities held by nonfinancial entities, increased by 1.6%.

## Federal public securities

Improvement in the expectations of financial agents made it possible to carry out operations with federal public securities in such a way as to obtain longer terms on the papers issued and cost reductions in the rolling of the public debt.

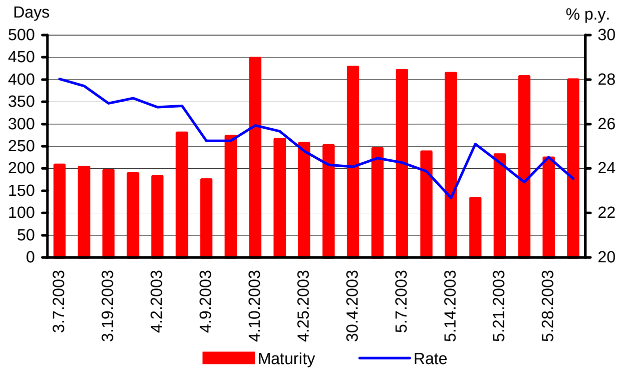
During the course of the March-May quarter, redemptions of securities came to approximately R$105.3 billion. In contrast, auctions totaled R$110.8 billion, of which R$23.9 billion referred to exchanges of Treasury Financing Bills (LFT) with maturities scheduled for the April to August 2003 period, for longer term LFT. These exchanges were intended to dilute the concentration of short-term maturities of these papers.

When exchange auctions are excluded, approximately 73.9% of the papers placed on the market were tied to the Selic rate (LFT). In their turn, preset papers (National Treasury Bills – LTN) represented 23.1% of the offers accepted. The larger volume of issues of preset papers demonstrates the confidence of agents in the continued downward movement of the basic short-term rate of interest. Placements of National Treasury Notes – Series C (NTN-C), which are papers indexed to the price index, represented 2.9% of total papers auctioned in the quarter.

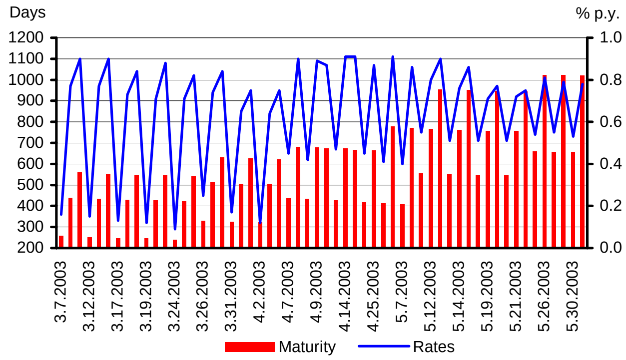
As a result, the participation of preset papers in the total securities debt increased from 2.3% at the beginning of March to 3.3% at the end of May. Parallel to this, the participation of papers indexed to the Selic rate decreased from 69.3% to 67.2%, while that of securities indexed to exchange dropped from 16.8% to 14.4%, in the same period.

At the same time in which the market became more receptive to preset papers, placements were able to obtain a more favorable time

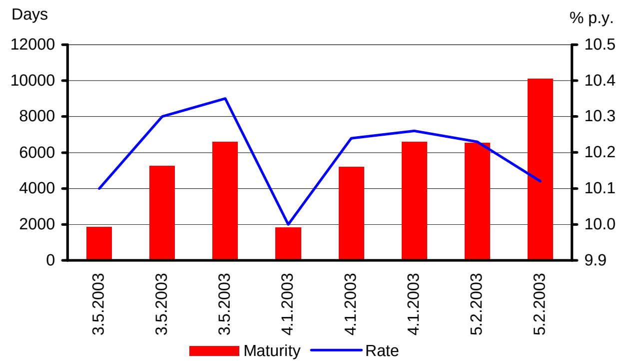
**LTN placements – Maturity x rates**



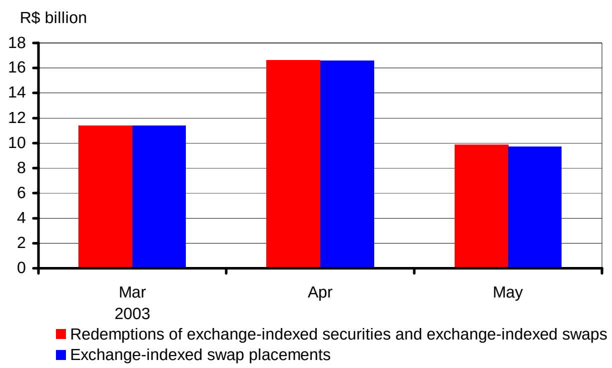

**LFT placements – Maturity and rates**




**NTN-C placements – Maturity x rates**




**Exchange-indexed securities and swaps**




horizon. In the case of LFT, the maturity term of the papers issued came to as much as 1,024 days. LTN were issued with terms of as long as 448 days, which had not been achieved since January 2002. NTN-C, in their turn, were auctioned with maturities of as long as 2031.

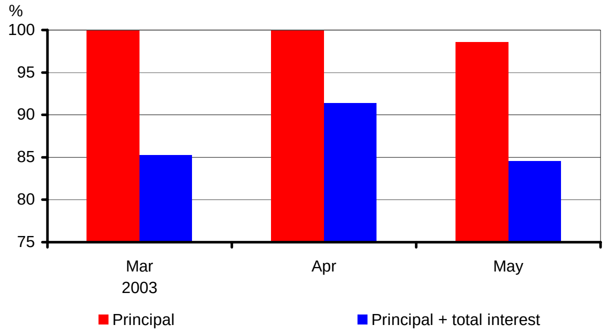
With regard to the cost of rolling the debt, note should be taken of the interest rates practiced in operations with preset papers. In keeping with the inversion of the interest rate curve used on the futures market as of April, LTN reached a placement rate that was below the basic rate of interest. In mid-May, for example, LTN were auctioned with a term of 414 days at a rate of 22.68% per year, or 382 base points below the target in effect for the Selic rate.

In the case of LFT, despite issue of securities with longer maturity terms, there was a reduction in discount rates. Thus, on March 7, LFT were issued with a term of 558 days at the rate of 0.9% per year and, on May 30, with a term of 1,020 days and a discount of 0.78% per year.

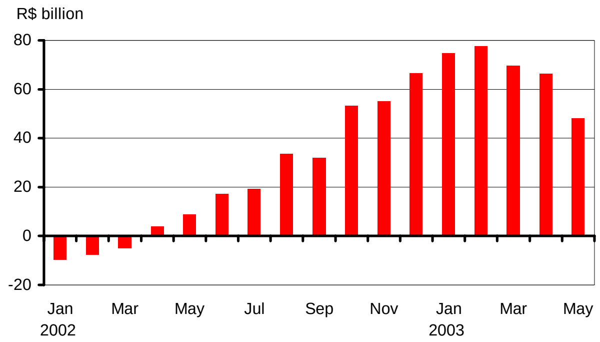
The rolling of securities and exchange swap contracts achieved the objective of covering the totality of maturing principal. In the quarter, redemptions of exchange securities came to R$37.9 billion, including swaps and considering only the principal involved. Placements came to a total of R$37.7 billion, resulting in an exchange turnover equivalent to 99.6%. When principal plus intermediate and final interest are considered, rolling reached a level of 87.6% of maturities.

On May 26, Banco Central announced that it would no longer determine a fixed percentage for the rolling of the maturities of debts indexed to

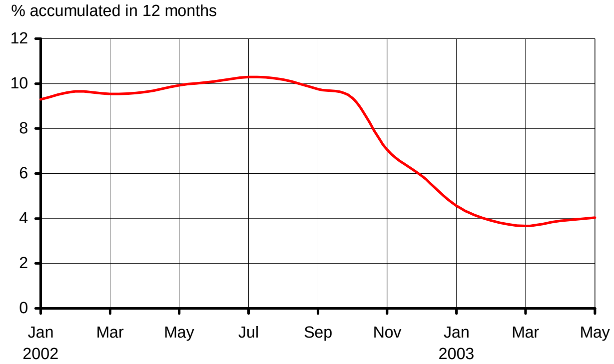
Turnover of exchange-indexed securities and swaps



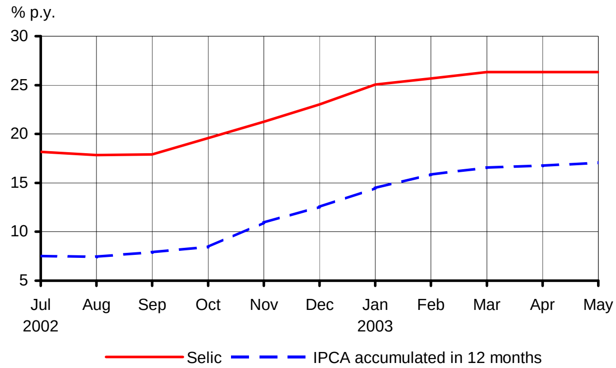

Net financing position of the federal public securities




Ex-post real interest rate deflated by IPCA




Selic x IPCA




exchange, specifying that this percentage could be lesser or greater than the 100% defined up to that time. This measure was aimed at gradually reducing the public sector's exchange exposure, provided that favorable market conditions be preserved.

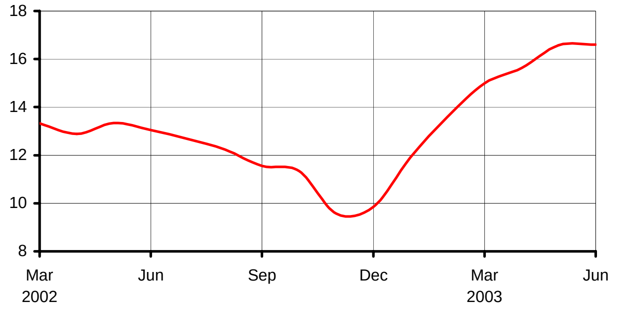
With regard to the daily control of liquidity conditions through financing operations, Banco Central continued the strategy adopted since January, based on repo operations with longer terms. In the period under consideration, operations of up to 28 days were carried out, with rates that varied between 100% and 100.2% of the Selic rate. Here, one should underscore the reversal in the tendency of upward movement in the net financing position. Among the determinant factors of this movement, mention should be made of adjustments in derivative operations, in the amount of R$13 billion, and entries in the National Treasury operating account, with R$17 billion.

## Real interest rates and market expectations

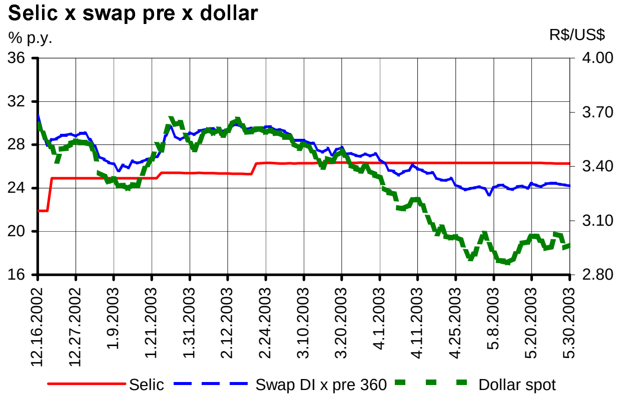
Deflated by the Broad National Consumer Price Index (IPCA), the accumulated twelve month Selic rate came to 4% per year in the month of May, interrupting the downward trajectory noted in the last two quarters. This movement was a consequence of upward movement in the Selic rate target, in the period from October to February.

In keeping with the reversal in the trajectory of the real ex-post interest rate, a real rate of 16.6% per year is projected for the coming twelve months. This projection is based on maintenance

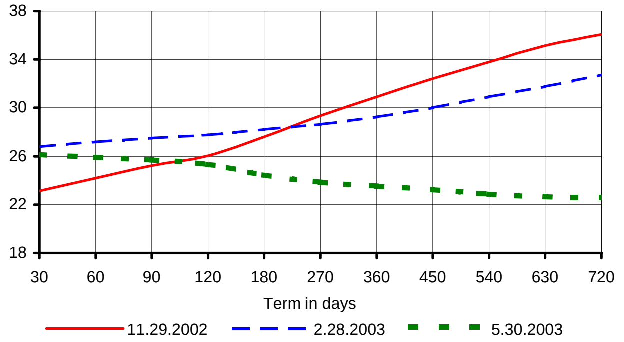
***Ex-ante* real interest rate deflated by IPCA**
% accumulated in 12 months



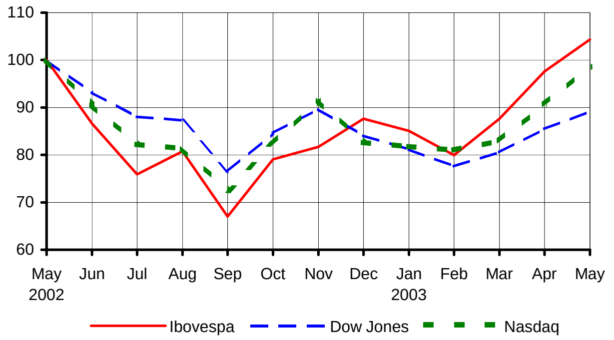

**Selic x swap pre x dollar**
% p.y.




**Yield curve – Swap pre**
% p.y.




**Stock exchange**
2002, May = 100




of the Selic rate at 26% per year and market expectations for the IPCA gathered by the Banco Central survey among financial institutions[1].

In this context, at the end of May, the DI swap x pre reference rate for contracts with terms of 360 days came to 23.5% per year, compared to 29.2% per year, in the month of February, the rate of the United States dollar came to R$2.97/US$1, compared to R$3.56/US$1, in that month.

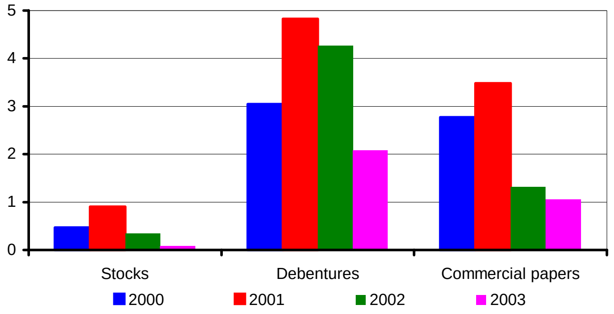
Parallel to this movement, the interest rate curve generated by the reference rate of DI swap x pre contracts at the end of the quarter registered a negative inclination, indicating expectations of an interest rate reduction in coming months. The difference between the rates for one year contracts and 30 day contracts moved from 2.5 p.p. in February to -2.6 p.p., in May.

## Capital markets

As of the month of February of this year, the São Paulo Stock Exchange (Bovespa) registered a positive performance, mostly as a result of a more favorable economic climate. The Index (Ibovespa) registered a high of 30.6% in the period, reaching a level of 13,421 at the end of May, the highest level since May 2002.

The change in the Ibovespa expressed in dollars came to 56.9% in the quarter, while the National Association of Securities Dealers Automated Quotations (Nasdaq) and the Dow Jones Industrial Average (DJIA) moved upward by respective rates of 21.9% and 14.9%. The possibilities of gains as a result of the depreciated value of stocks leveraged the volume of trading

**Primary issues in capital market**
R$ billion – Accumulated in the year

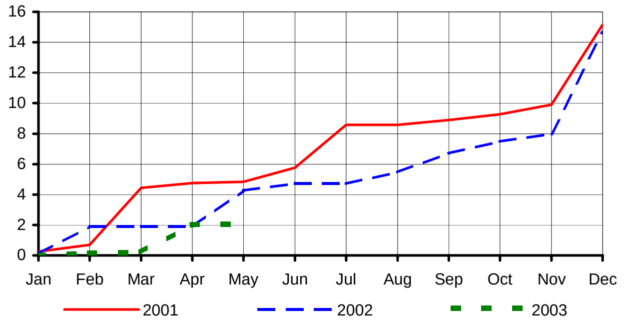



Source: CVM

at Bovespa, as is evident in the fact that, in the period from March to May, the daily average volume of trading came to R$734 million, or 34% more than in the previous quarter.

The end of the war in Iraq contributed to the reduction in international investor risk aversion and resulted in increased system liquidity and the return of investments to emerging economies. This scenario, coupled with the favorable outlook involving the tax and social security reform bills now before the National Congress and increased market confidence regarding the evolution of inflation, contributed to the reduction of the Brazil risk which, measured by the Emerging Market Bond Index (Embi-Brasil), came to 795 points at the end of May, compared to 1,178 points at the end of February.

**Corporate bonds**
R$ billion – Accumulated in the year



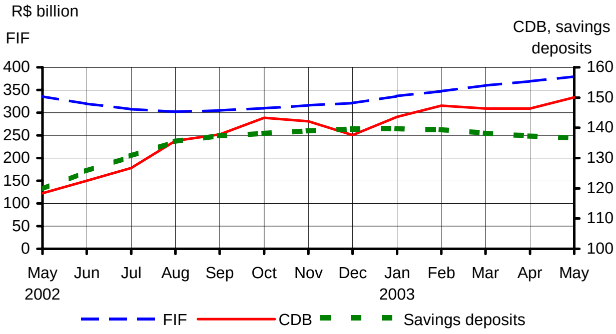

Source: CVM

However, following the example of the credit market, recent improvement in expectations did not trigger renewed business investment, that would be reflected in the volume of funding contracted on the corporate debt market. Thus, issues of stocks, debentures and promissory notes registered at the Securities and Exchange Commission (CVM) up to the month of May came to a total of R$3.2 billion, compared to R$5.9 billion in the same period of the previous year. Here, one should highlight the increase in the relative participation of issues of promissory notes, which are classified as short-term securities, from 22% to 33%.

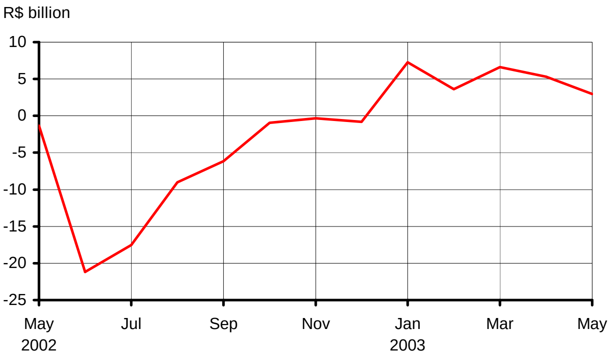
Among debenture issues, 87% of the R$2.1 billion registered refer to just one operation carried out by a company from the electricity sector. The purpose of this operation was to substitute debt indexed to exchange variation by debentures indexed by the CDI rate.

# Financial investments

**Portfolio evolution of time deposits, FIF and savings deposits**

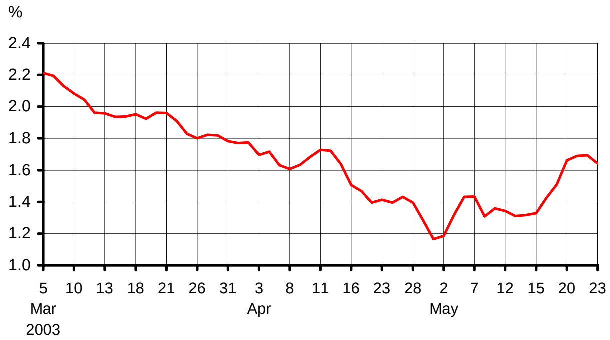



**FIF - Net inflow**

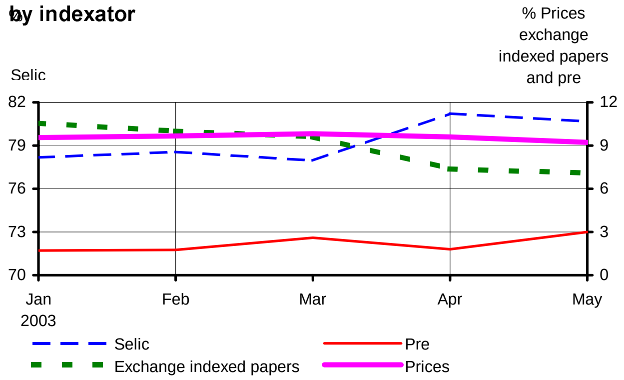



**FIF daily earnings**

In accumulated terms during 21 working days




**Growth in public securities in funds portfolio by indexator**




The balance of financial investments, which includes savings accounts, investment funds and time deposits, came to R$677.7 billion in May, for growth of 4% in comparison to the February result.

The capital of Financial Investment Funds (FIF) moved to a May level of R$378.7 billion, with growth of R$31.3 billion in the quarter and R$57.3 billion in the year. Emphasis should be given here to the strong net inflow registered in the March to May quarter, totaling R$14.9 billion, and a total of R$25.8 billion in the year. This is considered a positive sign of the return of resources that had migrated to other investments in 2002. Another factor to be considered in this context is the impact consequent upon the positive flow of external resources in 2003.

With regard to earnings on FIF, viewed in the context of the accumulated total over 21 business days, the end of April was marked by a sharp decline, when the rate hit its lowest level of the quarter, closing at 1.2%. This result can be attributed to the impact of investment funds referenced to exchange and to the reduction in the profitability of the funds tied to price indices.

As a matter of fact, the participation of public securities indexed to exchange and the General Price Index – Market (IGP-M) in investment fund portfolios declined, evincing the increase in investment fund demand for fixed income applications and those backed by the DI rate.

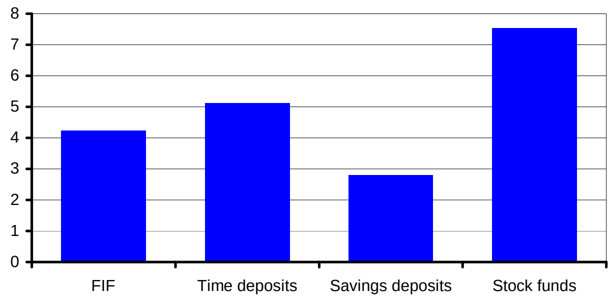
Stock funds, which include investment funds in stocks and securities (FITVM) and mutual privatization funds (FMP), registered net worth of R$32.8 billion, with growth of R$2.2 billion in the quarter and R$606 million in the year.

The capital of savings accounts came to R$136.8 billion in the month of May, with consecutive monthly losses of resources since October 2002. In the quarter, the net loss came to R$6.1 billion, with R$8.2 billion in the year. This performance is a consequence of the return of resources originating in the FIF which had migrated to this modality of financial investment.

In May, the balance of time deposits came to R$150.3 billion, with growth of 2% in relation to the February position, but with a net negative inflow of R$5 billion in the quarter, for much the same reason as occurred under savings accounts.

**Financial investments earnings**

In accumulated terms from March to May/2003 (%)




With respect to the nominal profitability of financial investments in the period, stock funds closed with the highest rate, 8.1%, followed by the rates on time deposits, 5.6%, FIF, 4.6%, and savings accounts, 2.8%.

Considering that the Ibovespa registered nominal upward movement of 30.5% in the quarter, one should highlight the profitability of stock funds. The distancing of the profitability of stock funds from the Ibovespa is a result of amortizations of quotas referring to closed stock funds. In the case of the closed funds, amortization is considered as payment of part of the value of the quotas to all of the fund's quota holders, without reducing the number of quotas. The fact of whether a specific fund is open or closed is determined by its bylaws, which specify the conditions under which the resources can be withdrawn.

# 3.3 Fiscal policy

## Public sector borrowing requirements

The nonfinancial public sector registered a primary surplus of R$9.8 billion in the month of April, compared to R$9 billion in the corresponding month of the previous year. With this result, the surplus accumulated in the year came to R$32.7 billion, equivalent to 6.53% of GDP, compared to R$20.5 billion, or 5.15% of GDP in 2002.

The primary surplus accumulated by the Central Government (Federal Government, National Social Security Institute (INSS) and Banco Central) totaled R$25.1 billion or 5.01% of GDP; that involving regional governments closed at R$6.1 billion, or 1.21% of GDP; and that of state companies ended with R$1.5 billion, or 0.3% of GDP.

Continuing with the comparison of the accumulated result in relation to the previous year, the growth of the nonfinancial public sector surplus by 1.38% of GDP was generated by expanded surpluses registered by the Central Government, regional governments and state companies by respective rates of 0.68%, 0.03% and 0.66% of GDP.

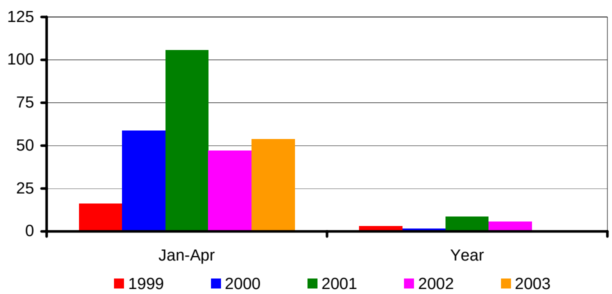
With respect to the Central Government result, in the first four months of 2003, total revenues as a proportion of GDP declined from 26% to 23.7%. This reduction was a consequence of the atypical inflow of R$5.5 billion, or 1.38% of GDP, in the first four months of 2002, under the heading of payment of pension fund debts in arrears, a heading that did not exist in 2003. Aside from this, it also reflected the inflow loss under the Industrialized Products Tax (IPI), due to the falloff in sales of vehicles and reductions in the rates of the tax on exports. A final factor that deserves mention is the loss registered under the Contribution on Intervention in the Economic Domain (Cide-fuel), as a consequence of judicial decisions favorable to taxpayers.

With respect to the expenditure column, the four most representative headings moved downward, as a proportion of GDP. The reduction came to 1.22 p.p. in current and capital outlays, 0.93 p.p. under personnel and social charges, 0.53 p.p. in social security benefits and 0.5 p.p. in transfers to states and municipalities.

Particular note should be taken of the Central Government primary surplus in April, which came to R$10.3 billion, compared to R$3.5 billion in the previous month and R$5.7 billion in April 2002. Growth in relation to the previous month's result was basically a consequence of the behavior of the revenue inflow in April: payment of the first installment or full payment of the income tax; a greater number of weeks of the generating fact (five in April and four in March), with repercussions on the inflow of the income withholding tax, Tax on Credit, Exchange and Insurance Operations, or those related to Stocks and Securities (IOF) and the Provisional Contribution on the Movement or Transmission of Values and Credits and Rights of a Financial Nature (CPMF); and inflow of R$1.5 billion under the heading of partial quota of financial compensation for the working of petroleum and natural gas reserves. With respect to twelve month growth, expansion in the net inflow came to R$5.1 billion.

In the early months of the year, the fact that primary surpluses greater than the annual target were obtained does not necessarily mean that these margins will be maintained through to the end of the period since, when one considers the seasonality of public sector revenues and expenditures, the end of each fiscal year is normally marked by a tendency toward convergence of programmed and effective results.

**Annual target percentage performance of the primary surplus**
%




The figures from recent years clearly exemplify this behavior. A case in point is 2001, when the primary surplus obtained in the first four months of the year came to 6.17% of GDP, representing an excess of 105.7% in relation to the annual target surplus of 3% of GDP, then in effect. This should be contrasted with the annual result which came to an excess of 8.7%. The surplus of 6.53% of GDP registered in the first four months of 2003 represented an excess of 53.6% compared to the target for the year, and was quite similar to that registered in 2000, when the annual target was achieved with a margin of just 1.76%.

With regard to nominal interest, R$6.4 billion were appropriated in the month of April based on the accrual criterion, compared to R$14.5 billion in February, and R$12.7 billion in March. Above all else, this performance was generated by the result of exchange swap operations, which closed with a result that was unfavorable to Banco Central by R$937 million in February. However, in March and April, this result had represented gains of R$2.4 billion and R$11.1 billion, respectively.

In accumulated terms for the year, total nominal interest appropriated came to R$51.3 billion or 10.23% of GDP, compared to R$30.4 billion, or 7.64% of GDP in the previous year. A breakdown by segment of government indicates that the total appropriated by the Central Government registered growth corresponding to 0.63% of GDP, compared to 2002, while, in the case of regional governments, growth reached 2.29% of GDP and, in that of state companies, the level of interest appropriated in the previous year was maintained.

The increase in nominal interest appropriated in the four month period by the central government was basically a consequence of the increase of 1.9 p.p. in the accumulated Selic rate in the period to 7.66% on the major share of the debt stock, despite the favorable result of R$8.8 billion in swap operations in the period. Aside from this, the Central Government appropriated negative interest of R$6.1 billion on its assets in dollars with other segments of the government, as a result of the restructuring of external debts (Notification MF-30, Paris Club, Brazil Investment Bond Exchange Agreement – BIB, Medium and Long-term Debt, Sanitation Sector Modernization Program – PMSS), resulting from exchange appreciation of 18.22% in the four month period. One should underscore the fact that, in the first four months of 2002, just the opposite occurred, with appropriation of interest revenues in the amount of R$1.3 billion, as a result of exchange depreciation in the period.

As far as regional governments are concerned, the increase of R$13.4 billion in the volume of interest appropriated in the year was due basically to growth in the evolution of the IGP-DI in the four month period from 1.18% in 2002 to 5.96% in 2003. This index updates the state and municipal debts renegotiated under the terms of Law

9,496/1997, which represent 77% of the net indebtedness of that level of government.

Analysis of the accumulated flow of the last twelve months indicates that total interest appropriated by the public sector in April came to R$134.8 billion, or 9.47% of GDP, compared to R$135.4 billion, or 9.71% of GDP, in March.

Viewed under the prism of the nominal concept, public sector borrowing requirements, which encompass the primary result and nominal interest appropriated, registered a surplus of R$3.5 billion in April. In the year, these requirements registered a deficit of R$18.6 billion or 3.71% of GDP, compared to R$9.9 billion, or 2.49% of GDP, in the same period of 2002.

Analyzing the major source of financing of these requirements in the year, the securities debt continued with R$30.6 billion, while the banking debt, monetary base and external financing registered reductions of R$5.5 billion, R$5.1 billion and R$1.7 billion, respectively.

In the twelve month period ended in April, public sector borrowing requirements totaled R$70.3 billion or 4.93% of GDP, compared to R$71.8 billion or 5.15% of GDP in the previous month.

## Federal securities debt

Evaluated on the basis of portfolio position, the federal securities debt increased from R$636.9 billion, or 40.3% of GDP in January, to R$644.4 billion, corresponding to 40% of GDP in April. This result reflected net issues of R$6.5 billion on the primary market and incorporation of R$23.5 billion referring to interest offset to some extent by the R$22.5 billion reduction consequent upon 18% appreciation of the real in relation to the dollar in the period under consideration.

The share of the federal securities debt indexed to the dollar dropped from R$134.9 billion in January to R$97.2 billion in April, reflecting net redemptions of R$18.1 billion on the primary market and appreciation of the real against the dollar. In the period, the participation of exchange securities in the total federal securities debt fell from 21.2% to 15.1%, while the participation of the preset debt remained at 1.9% and that of the debt referenced to the Selic rate moved from 62.4% to 67.7%.

The amortization schedule of the securities debt on the market – excluding the securitized debt, financing operations and securities registered at Cetip – registered the following configuration in April: R$179.7 billion, 27.9% of the total maturing in 2003; R$155.8 billion, 24.2% of the total, in 2004; and R$308.9 billion, 47.9% of the total, as of January 2005.

Exchange swap operations in April came to R$98.4 billion, compared to R$96.7 billion in January. The result of these operations defined as the difference between the profitability of DI and exchange variation plus coupon in the quarter was favorable to Banco Central by a total of R$12.5 billion in the cash concept, and R$14.3 billion, when viewed on an accrual basis, Of this amount, R$2.7 billion referred to provisions for future reconciliation of SC2 contracts, the settlement of which only occurs at the maturity of each contract.

## Net public sector debt

The net debt of the nonfinancial public sector came to R$839.8 billion in April, corresponding to 52.18% of GDP, compared to R$881.1 billion, or 56.53% of GDP in December 2002.

Exchange appreciation of 18.22% in the four month period generated a debt reduction of R$64.4 billion, of which R$22.9 billion involved internal security debts indexed to the dollar and R$41.5 billion reflected net external debt.

Analysis of the major determinants of the reduction of the net debt as a percentage of GDP, corresponding to 4.35 p.p. in the four month period, indicates that evolution of borrowing requirements, including the primary result and nominal interest appropriated, provoked an increase of 1.15 p.p.. In the same sense, the impacts of the change in parity of the currency basket of the net external debt and acknowledgement of debts reached respective levels of 0.24 p.p. and 0.04 p.p.. In contrast to this, the impact of exchange appreciation on the internal securities debt and net external debt and the effect of growth in national product, valuated by the centered IGP-DI, contributed with reductions of 4 p.p. and 1.78 p.p., respectively.

The gross general government debt, which includes the federal government, state governments and municipal governments, came to R$1,131.3 billion, or 70.3% of GDP, compared to R$1,174.9 billion, or 72.9% of GDP, in December 2002. Exchange appreciation in the four month period was the major determinant of this reduction.

## 3.4 Conclusion

The stock of financial system credit operations registered downward movement in the quarter, clearly impacted by the effects of exchange appreciation on portfolios referenced to foreign currency and by cutbacks in demand for banking resources on the part of economic agents. In this sense, companies restricted demand for credit to meet their cash flow needs and opted to postpone medium and long-term investment decisions. In much the same way, households restricted their indebtedness to revolving credit operations basically for purposes of supplementing family income in detriment of consumer durables financing operations. At the same time, financial institutions adopted a more conservative stance in the granting of credits, marked by greater selectivity and higher rates of interest.

Thus, the stability of demand for currency that marked the period can also be attributed to the modest performance of the bank credit market. In other words, the fact that, in real terms, the money supply was brought back to the trajectory that preceded the process of expansion that marked the previous year evinces the reversal of the atypical migration of financial assets and the effects of monetary policy, in that which refers to the narrowing of the credit flow. Obviously, this had favorable repercussions on price formation.

The fiscal performance of the three spheres of government has continued registering highly robust results, with a primary surplus of R$32.7 billion up to April. As a result of this surplus and the reduction in the rate of exchange, the net public sector debt dropped by R$41.3 billion in the period, corresponding to 4.35% of GDP and closing at 52.2% of GDP. For the most part, the surplus has reflected maintenance of control of discretionary expenditures. Aside from this, the government has made a significant effort to ensure approval of reform bills, having remitted constitutional amendment proposals to the National Congress dealing with the tax and social security reform, both of which stand as important contributions to the structural sustainability of public accounts.

# 4 – International economy

The pace of world economic recovery has been considerably slower than originally expected at the start of the current year, as the various nations, and particularly the more industrialized States, have gradually lowered their growth projections for the year to a level practically equal to 2002. The war in the Middle East injected a great deal of uncertainty into the overall world economic outlook and has clearly acted as a damper on the major economic indicators, making it exceedingly difficult to identify the outlook for the coming months.

The current situation has been clearly reflected in the indicators used by a variety of countries and particularly in the more advanced nations. Thus, the overall situation has been marked by sluggish output growth, low interest rates and inflation, with deflation, stagnation and growing unemployment in a number of countries, coupled with deteriorating fiscal accounts, less dynamic international trade flows, decreased volatility in commodity prices and uncertainties regarding the behavior of petroleum prices on futures markets. In this case, it should be stressed that oil prices dropped sharply with the end of the war in Iraq and recovery in Venezuelan output and were marked by sharp instability in the following months.

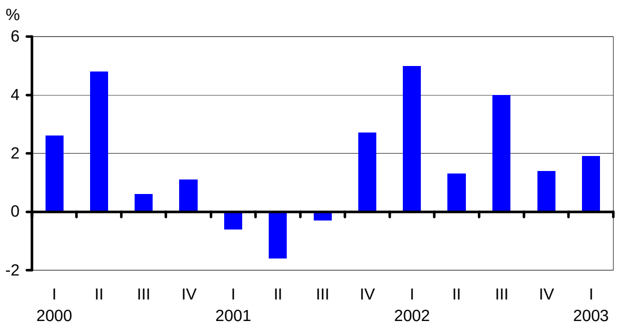
In this context, the countries of Asia turned in the sharpest growth as a consequence of strong demand in China, South Korea, the countries of Southeast Asia and India, despite the still difficult to measure impacts of the Severe Acute Respiratory Syndrome – SARS epidemic.

It should be highlighted that capital flows to emerging economies, which have registered below the average flows when compared to annual figures of the nineties, are gradually starting to rebuild their volume, particularly in the case of portfolio investments and loans of the non-financial sector.

## 4.1 Economic activity

However, the overall pace of global economic activity showed no significant improvement in recent months, even though some of the negative factors that had marked the first quarter of the year had dissipated or at least diminished in importance in April and May. Among these, one could cite the war in Iraq and such domestic political conflicts as those that occurred in Venezuela and Nigeria, with considerably negative impacts on world oil prices. Taking all of these factors together, the growth pace of the world economy was more moderate than had been expected at the start of the year. As a result, the outlook is now for annual growth equivalent to or even less than that registered in 2002.

GDP – USA[1/]

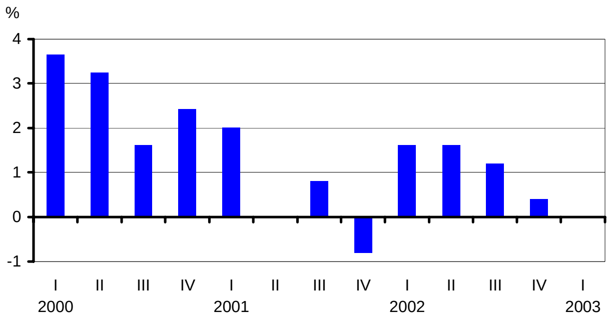


Source: Bureau of Labor Statistics
1/ Quarterly change seasonally adjusted annualized rate.

In the first quarter of 2003, GDP in the United States registered annualized quarterly growth of 1.9%, compared to 1.4% in the final quarter of 2002. Several different supply indicators point to a continued decline in the level of activity. This was particularly true in the case of industrial output, which registered negative monthly results in both March and April and continued mired in a situation of stagnation since the second half of 2001. Aside from this, new construction starts dropped by 6.8% in April, when compared to the previous month. With respect to demand, the results were more positive, turning in strong recovery in confidence indicators and a favorable performance under internal consumption. Here, it should be stressed that consumer spending, which is responsible for approximately two thirds of the American GDP, moved upward in monthly terms by 0.5% in March and 0.1% in April.

The United States labor market continued on a downward trajectory in the early months of 2003, reflecting the low level of economic growth and the ongoing process of corporate restructuring taking place in that country. Unemployment moved to 6.1% in May, after closing April at 6% and February and March at 5.8%. The level of nonfarm employment declined in the period from February to May, though at a lesser pace. In the specific case of the manufacturing sector, the level of employment dropped for the thirty fourth consecutive month.

**GDP – Euro Zone**[1/]

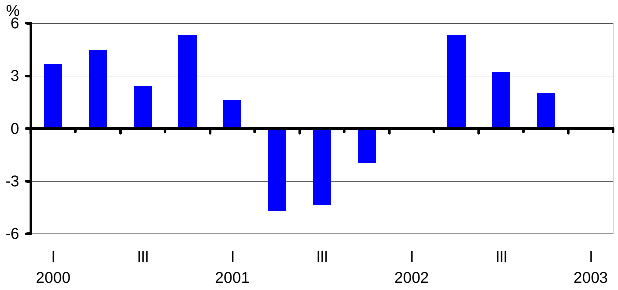



Source: Eurostat
1/ Quarterly change seasonally adjusted annualized rate.

In the euro zone countries, the economic downturn was even more persistent than originally expected. Annualized quarterly GDP growth came to only 0.4% in the final quarter of 2002, dropping to zero in the first quarter of 2003. At the start of the month of June, the European Commission estimated that quarterly GDP growth should remain between zero and 0.4% in the second and third quarters of the year. The situation is particularly serious in Germany, now mired in a full-blown recession. German GDP registered annualized quarterly growth of -0.1% in the fourth quarter of 2002 and -0.9% in the first quarter of 2003. Sharp upward movement in the value of the euro has evidently jeopardized the export sector, which was clearly the driving force underlying the economy in 2002. Consequently, economic growth has become more dependent on reactivation of domestic consumption. On the other hand, exchange appreciation has facilitated efforts to reduce inflation and interest by stimulating internal demand. However, sales performance at the retail level was far from promising in the first quarter of the year, as consumer confidence levels remained low.

Though there has been greater emphasis on adjustments in corporate balance sheets, coupled with investment cutbacks, the sector of large corporations in the euro zone has also been going through a period of restructuring. Unemployment in the bloc has moved upward in the major economies. The rate of unemployment in the euro zone countries, which stood at 8.1% at the start of 2002, moved to 8.7% in January 2003 and 8.8% in April. In Germany, the rate was below 10% up to October 2002, before rising to 10.3% in January and 10.7% in April and May.

GDP – Japan[1/]

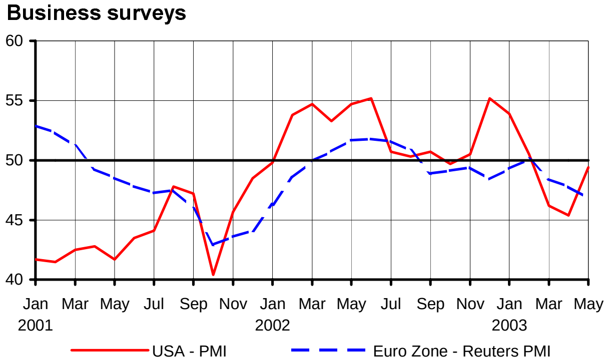



Source: Economic Planning Agency
1/ Quarterly change seasonally adjusted annualized data.

In Japan, following 3.2% and 2% growth in the final two quarters of 2002, GDP expansion in the first quarter of 2003 was nil. Industrial output moved on a downward curve from January to April, registering a drop of 1.2% in the final month of the period. Imports by other East Asian countries are expected to register negative growth as of May, as a consequence of the impact of the SARS epidemic on consumption levels in the region. The effects of the epidemic have also contributed negatively to Japanese retail sales, registering a drop of 2.3% in April compared to the result of the previous month.

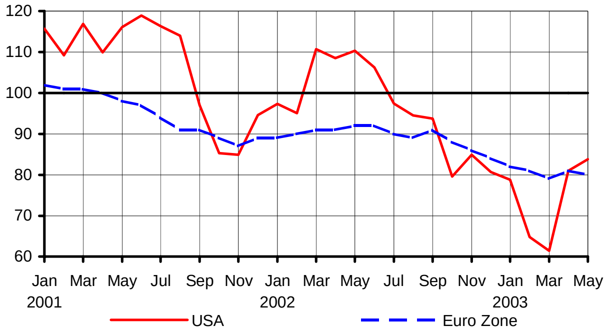
Unemployment in Japan slipped from 5.5% in January to 5.4% in March and April and has continued at what is considered a very high level in historical terms. It should be recalled that, up to June 2001, unemployment remained below 5%, while the period up to March 1998 was marked by unemployment of less than 4%.

Business surveys




Source: Institute for Supply Management (ISM), Reuters

Expectation indices in the United States and Euro zone turned in highly differentiated performances, marked by greater pessimism in the European bloc. In the United States, the most important business sector indicator, the Purchasing Managers Index (PMI), which is issued by the Institute for Supply Management (ISM), expanded sharply in May, reaching a level of 49.4 points, after declining to 46.2 points in March and 45.4 points in April. However, this indicator did remain below 50, reflecting a predominance of expectations of downward movement in the manufacturing sector, which is responsible for one fifth of the United States economy. The ISM index for the service sector rose from 50.7 points in April to 54.5 points in the month of May. Consumer confidence registered even more accentuated growth and was favored by the end of the war in Iraq, by reduced energy costs and recovery in stock prices. Thus, following a decline to 61.4 points in March, the Conference Board indicator moved to 81 points in April and 83.8 points in the month of May. The index calculated by the University of Michigan registered similar results, moving from 77.6 points in March to 86 points in April and 92.1 points in the month of May.



Source: Conference Board, European Comission

In the Euro zone countries, the two major business sector indicators, which are estimated by the European Commission and Reuters, registered sharp declines in the early months of 2003. The same thing occurred in the indices calculated in France and Italy by the *Institut National de la Statistique et des Études Économiques* (Insee) and by the *Istituto di Studi e Analisi Economica* (Isae), respectively. The only index to register some degree of recovery in the month of May was the IFO, which is used to measure German business confidence. With regard to consumer confidence, the results were quite similar and reflected relative indifference regarding the end of the war and much greater concern in the face of high levels of unemployment. In Japan, the Tankan index remained relatively stable in the first quarter of the year, while indicators of manufacturing activities and supply and demand conditions continued at negative levels.

Though the spread of the SARS epidemic had been sharply reduced by the beginning of June, the disease did have the result of introducing a new factor of uncertainty into the global economic scenario, even though the immediate effects have been practically restricted to such East Asian countries and Hong Kong, Singapore and China. The true economic impact of the epidemic will only be known in the coming months, though it is already obvious that severe drops were registered in retail sales and tourism and transportation services in the affected countries. The volume of sales dropped by 0.4% in China and 5% in South Korea in the month of April, when compared to the previous month. In several countries, the tourist inflow fell by 50% in April, compared to April 2002. It should be emphasized that tourism accounts for 9% of GDP and 7% of employment in the developing countries of Asia, corresponding to 2% of GDP in China and 5% of GDP in Hong Kong. Based on the assumption that the epidemic will be brought under control by the third quarter of the year, the negative impact is projected at 1.5 p.p. of 2003 GDP in such countries as China, Hong Kong and Singapore. At the same time, Thailand, Malaysia and the Philippines, which are even more dependent on tourism, will be further affected by falloffs in their exports to China and Hong Kong. On the other hand, judging by the April results, the drop registered in the manufacturing sector would seem to be limited.

In Latin America, the macroeconomic scenario improved considerably in the first quarter of the year, when compared to the previous year, which was a period marked by an accentuated decline in international financial flows, a worsening of the terms of trade in countries that are not oil producers and instability in several countries of the region. Just as occurred in Brazil, the accentuated drop in risk perceptions coupled with exchange stabilization contributed to strong recovery in the international financial flows targeted to the region. In the case of the labor market, however, the situation remained negative, principally in countries that had recently been impacted by severe economic crises, such as Argentina, Venezuela and Uruguay, all of which registered unemployment in the range of 20%.

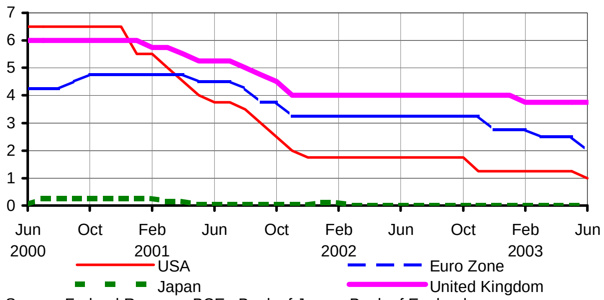
According to the Economic Commission for Latin America and the Caribbean (Cepal), following the long recession that began in 2001, the region began moving forward at a gradual pace that is expected to result in regional growth of approximately 2% in 2003, when the recovery taking place in Argentina will begin impacting this result.

Cepal has forecast expansion of 4% for the Argentine GDP, following four consecutive years of economic recession. Above all else, the recovery registered in Argentina has been sustained by growth in export operations and by an ongoing process of import substitution. Though the value of the peso increased before stabilizing at the start of the year, exchange depreciation *vis-à-vis* the previous year stimulated the competitiveness of Argentine products on international markets and this, in turn, has had a very positive impact on the recovery of industrial activities, particularly in those sectors focused on export markets. One should also note that, in 2003, there was considerable improvement in the terms of trade of a series of commodities of importance to that country's foreign sales. With recovery in expectations, internal demand has turned gradually upward. Among the major concerns of the new government administration, one should highlight the reestablishment of a favorable investment climate and negotiation of a new agreement with the International Monetary Fund (IMF), considered a step of essential importance to the restructuring of the nation's external debt. The tendency is that the required process of adjustment will be gradual, particularly when one considers the country's political and social scenario following the severe economic crisis that hit the nation so recently. Though public accounts have already registered a primary surplus, expectations are that the adjustment process will only intensify as of 2004.

## 4.2 Monetary policy and inflation

Interest rates in the major economies remain at historically low levels. In the United States and United Kingdom, for example, rates stand at their lowest level in more than forty years. Following a period of stability during most of 2002, when interest rates remained unchanged for almost the entire year, the recent interest rate cutback adopted by both the European Central Bank (ECB) and the Federal Reserve may well reflect adoption of a more aggressive stance on the part of central banks, with the overall objective of attempting to stimulate world economic growth. However, the scope for conventional monetary policy has been gradually reduced, as inflation has declined to very low levels and the pace of economic recovery throughout the world has been sluggish.

**Official interest rates**
Annual rates



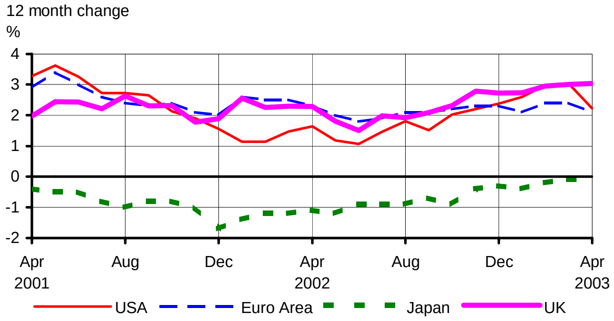

Source: Federal Reserve, BCE, Bank of Japan, Bank of England

The ECB reduced its interest rate by 50 base points to just 2% per year on June 5. The factors underlying this decision were upward movement in the value of the euro, decelerating inflation and weak economic growth in the bloc. On the same day, the Bank of England decided to maintain its basic rate at 3.75% per year, particularly as a consequence of the recent inflation spike caused partly by depreciation of the pound sterling. In the United States, basic interest rates changed on June 25, for the first time in the year, moving from 1.25% to 1% per year for the fed funds target. However, recent declarations attributed to Federal Reserve authorities have sought to emphasize the risks of low inflation at a time of poor economic growth. In Japan, government interest rates remain nil.

In the month of May, the ECB modified the institutional definition of price stability, and committed itself to pursuing a 2% per year inflation target. This decision represented an attempt to correct the alleged deflationary bias of the bank's monetary policy framework, which had set the annual inflation target at up to 2% which, in practical terms, means from 0% to 2%. Viewed from this angle, the incentives were not equally distributed in such a way as to guaranty that a more activist monetary policy would be implemented every time inflation closed above or below that target.

**Consumer prices**

12 month change




Source: Bureau of Labor Statistics, Eurostat, Bloomberg, Office for National Statistics

Inflation rates have declined to dangerously low levels in the United States and Euro zone, generating a generalized wariness of a possible threat of deflation. According to the most recent data, annual growth in core consumer inflation came to 1.5% in March in the United States, and 1.7% in April in the Euro zone. Though these rates are practically identical, a recent publication issued by the IMF states that Germany is now at greater risk of deflation than the United States[1].

In Latin America, economic trends are determined by commercial and financial factors. Thus, in those countries in which trade flows with the United States are a predominant factor, monetary policy has been more expansionary such as, for example, in Mexico and the Andean countries. On the other hand, in those nations in which international financial instability has strongly impacted domestic markets, such as in South America and, particularly, the Mercosul

1/ "Deflation: Determinants, Risks, and Policy Options - Findings of an Interdepartmental Task Force", dated April 30, 2003: according to the IMF view Germany, Japan, Hong-Kong and Taiwan belonged to the group with greater risk of deflation. Indeed, in the three latter cases, those countries have already undergone deflationary processes.

member states, a more contractive monetary policy has been implemented as one of the most important instruments for girding up national currencies. The recent normalization of financial flows and increased confidence levels, coupled with stronger fiscal positions, indicates a possibility of a more flexible monetary policy in the near future.

In Asia, the predominant tendency is toward greater monetary policy expansion, as evinced by the recessive impacts of the SARS epidemic. China, Hong Kong and Taiwan are mired in deflation, while in Korea, Thailand, Malaysia and the Philippines both activities and prices seem to have turned downward. In Indonesia, high inflation has also moved into a downward curve.

## 4.3 Fiscal policy

Insufficient economic growth and the expansionary fiscal policy implemented by the United States government reversed the course of the nation’s fiscal position, which had closed the 2001 fiscal year in September of that year in a surplus position. The situation is further aggravated by a tax cut of approximately US$350 billion approved in May and distributed over the next ten years. The principal measure in this regard was the temporary reduction in taxation on dividends and capital gains, scheduled to remain in effect until 2009. The program is expected to result in an increase of US$61 billion in the 2003 fiscal deficit and US$149 billion in fiscal year 2004. The accumulated twelve month public deficit closed April at US$295 billion, reflecting a rise of US$64 billion since the end of 2002. It is estimated that the deficit will surpass the mark of US$400 billion, or approximately 3.8% of GDP in fiscal year 2003. On the other hand, the fiscal package is expected to add an additional 1 p.p. to economic growth between mid-2002 and 2004. The Congress also approved a rise in the public debt ceiling from US$6.4 trillion to US$7.3 trillion.

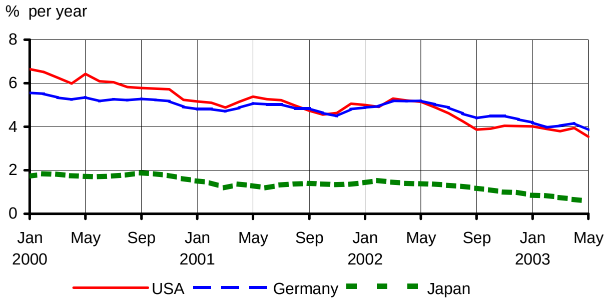
The aggregate public deficit of the Euro zone countries increased from 1.6% of GDP in 2001 to 2.2% of GDP in 2002. The European Commission, which estimates the deficit for the region at 2.5% of

GDP for 2003, issued an official notification to Germany and France to reduce their public deficits to the limit of 3% of GDP, as defined by the Stability and Growth Pact. The German and French deficits came to respective levels of 3.6% and 3.1% of GDP in 2002 and are estimated at 3.4% and 3.7%, respectively in 2003. According to European Commission estimates, there is also a possibility that Italy will surpass the deficit ceiling in 2004. In this context, there is no space for applying fiscal incentives. However, when one considers the modest rates of economic growth achieved by these countries, it is evident that there is little possibility of adoption of more severe fiscal adjustments over the short-term.

Among the emerging Asian economies, the public deficit is expected to increase in 2003, as a result of fiscal packages announced in April and May in Hong Kong, China, Singapore, Malaysia and Taiwan, with the objective of offsetting the economic impact of the SARS epidemic. The volume of fiscal incentives vary between 0.1% of GDP in Singapore and 2% of GDP in Malaysia. In China, the package came to US$2.7 billion, or 0.2% of GDP.

In Latin America, expectations are that fiscal policy will continue on a contractive course, as the major economies of the region adopt fiscal adjustment programs, in many cases as components of agreements with the IMF. With these programs of fiscal austerity, it is expected that the regional median public deficit will decline sharply in 2003. In this context, fiscal policy will not generate any additional dynamism in the level of the region's internal demand.

**Yield on Treasury bonds**[1/]



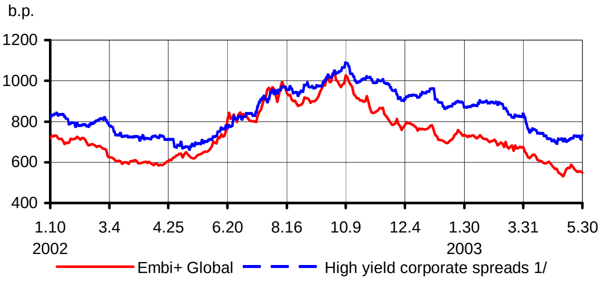

Source: Bloomberg
1/ Monthly average of nominal yields on 10 - year bonds.

## 4.4 International financial market

The cycle of expansionary monetary policies in the industrialized nations and reductions in the levels of uncertainty on a world scale brought about by the rapid end to the war in Iraq, produced an environment of high liquidity in the international financial system. This scenario contributed to a process of investor migration toward higher risk assets, in order to increase earnings above those produced by the fixed income markets of the United States, Europe and Japan. This tendency is evident in the earnings curves produced by long term securities issued by the respective governments.

**Risk indicators**

Spreads over US Treasury bonds

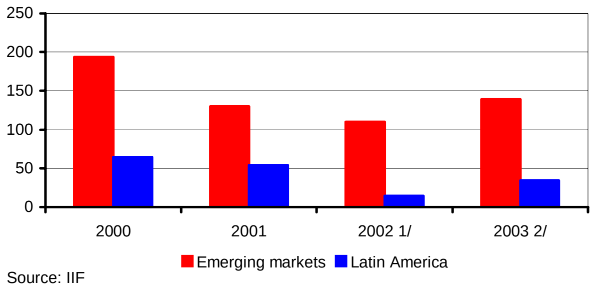



Source: Bloomberg
1/ American companies.

With respect to emerging markets, the scenario of high liquidity and investor demand for more attractive earnings resulted in increased absorption of international capital flows. The result of this movement was a sharp drop in spreads, particularly in those countries that managed to improve the levels of confidence in their macroeconomic fundamentals, such as Brazil and Turkey. In this sense, the change in the Embi+Global, which is the standard index for measuring the risk level of fixed income assets in emerging countries, registered a 21% reduction from March to May. The reduction in the degree of risk aversion in relation to investments in emerging countries has also contributed to the generalized decline in the spreads consequent upon high risk investments at the global level. This is evident in the simultaneous falloff in the spreads charged by American companies with higher risk levels.

**Net capital flows**

US$ billion

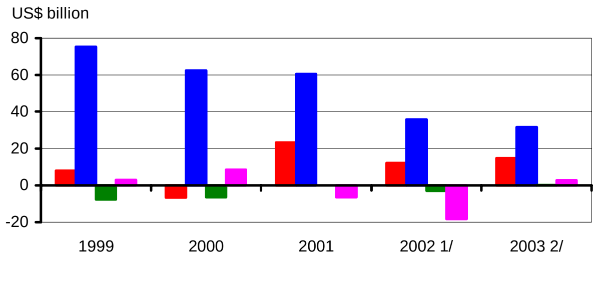



Source: IIF
1/ Estimate.
2/ Forecast.

Review of the May projections made by the Institute of International Finance (IIF) confirms that the flow of capital to the emerging markets should increase to US$139.1 billion in 2003, compared to US$110.2 billion in 2002, and US$129.9 billion in 2001, mostly reflecting growth in portfolio investments and nonfinancial sector loans. Foreign direct investments, however, remained rather low.

The IIF also reveals that net inflows of capital to Latin America should recover in 2003, when viewed against 2002, though the final figure will still remain well below that of previous years. Due to a great extent to improvement in the perception of the risks inherent to the Brazilian economy, private capital flows to Latin America are expected to climb to US$34 billion in 2003, compared to US$14.4

**Net capital flows to Latin America**

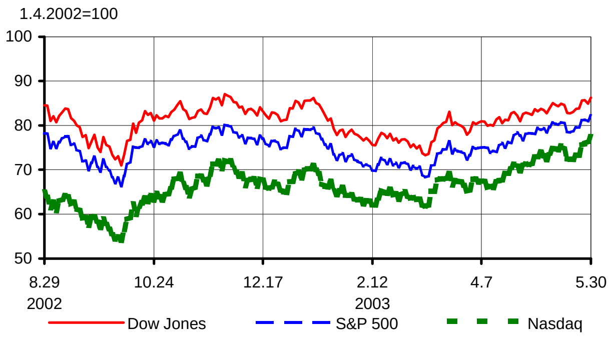



Source: IIF
1/ Estimate.
2/ Forecast.

billion in 2002, and US$53.9 billion in 2001. This growth is sustained by the reversal in the sign of portfolio investments, by growth in the loans of the nonfinancial sector and by increases in the rates of rolling debts contracted with the international banking sector.

Stock markets were more heavily impacted by military operations in Iraq and announcement of first quarter corporate results than by the macroeconomic indicators that pointed toward conflicting tendencies regarding the possibility of economic recovery in the United States, Europe and Japan. The end of the war and the positive results of large scale corporations were the underlying locomotives of the process of market recovery that began in February and, despite a brief downward slide in March, gained additional strength in April and May.

**USA – Stock exchanges**

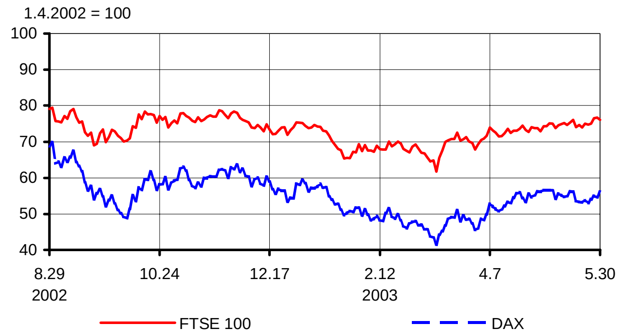



Source: Bloomberg

The positive results of American companies mirror the structural adjustments introduced into their liabilities as a consequence of personnel cutbacks and renegotiation of debts, coupled with the more favorable environment of low interest rates, diminishing leverage levels and reductions in exposure in high risk assets. In this context, the New York Stock Exchange's Dow Jones Industrial Average and Standard & Poor's 500 (S&P 500), and the Nasdaq Index registered positive results between 10% and 20% in the period from March to May 2003. Using the same basis of comparison, the Financial Times Securities Exchange Index (FTSE 100), used on the London Exchange, and the *Deutscher Aktienindex* (DAX), utilized on the Frankfurt exchange, moved upward at rates varying between 10% and 25%.

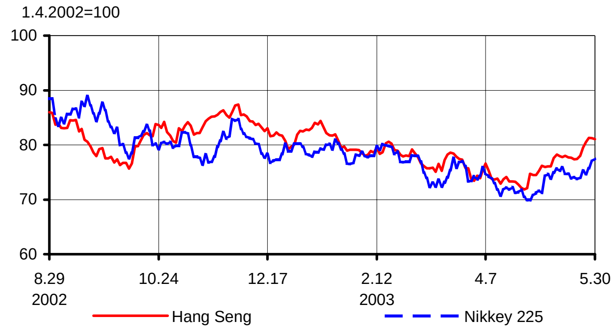
The upward movement in American stock exchanges in the half-year period increased the ratio between stock prices and company profits to historically high levels, thus suggesting positive expectations in relation to corporate results over the course of the

Europe – Stock exchanges




Source: Bloomberg

Asia – Stock exchanges

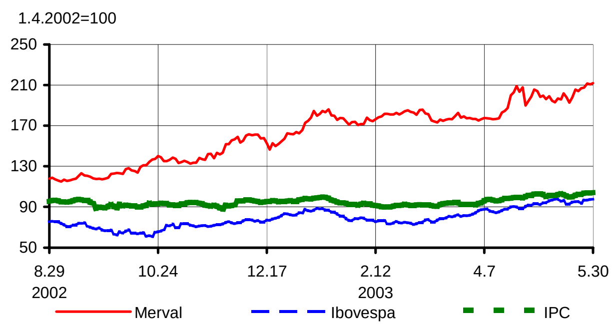



Source: Bloomberg

year. However, the rather unsteady recovery of the economy could well have a negative impact on corporate results and even threaten stock market performance in the second half of the year.

Aside from accompanying the trends of the European and United States markets, Asian financial markets were impacted by uncertainties related to the impact of the SARS epidemic on economic growth and the situation of the Japanese banking network, following federal intervention in the country's fifth largest bank. From March to April, the worsening of the SARS outbreak in China and Hong Kong and the alerts raised by the World Health Organization (WHO), recommending suspension of travel to that region of the world provoked a downturn in stock market performance, mostly as a result of falloffs in the value of the stocks of companies from the services and hotel sectors. Starting in the month of May, however, recovery in the markets of the United States and Europe and lesser dissemination of SARS injected new optimism into the market and provoked upward movement in market performance. From April to May, the Nikkey 225 index, used on the Tokyo exchange, and the Hang Seng index, used on the Hong Kong market, registered positive growth rates of 6% and 10%, respectively.

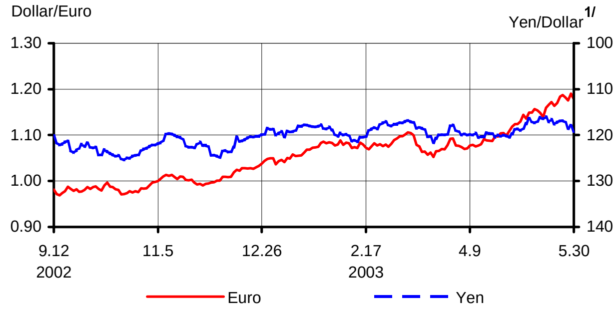
Latin America – Stock exchange




Source: Bloomberg

Growth in the investments of nonresidents and improvement in the macroeconomic environment of Brazil and Argentina resulted in recovery in Latin American stock markets. In this sense, the Ibovespa, used on the São Paulo market, the Merval, used in Buenos Aires, and the *Precios y Cotizaciones* (IPC) used in Mexico city registered respective positive rates of expansion ranging from 12% to 19% from March to May 2003.

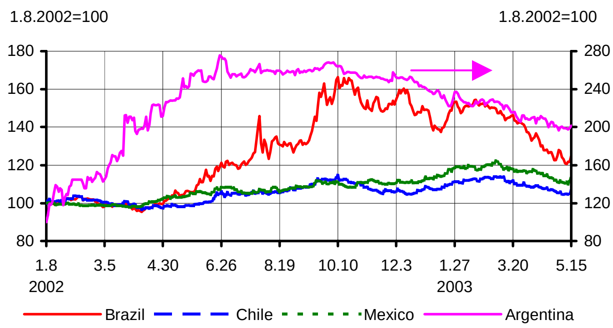
US dollar exchange rates




Source: Bloomberg
1/ Reversed scale.

The trend toward depreciation of the dollar on the world market was further accentuated in the second quarter of the year and reflected expectations in relation to the deliberate policy adopted by the American government to stimulate a weak dollar, as a strategy measure for adjusting that country's current account deficit which came to approximately 5% of GDP at the end of 2002. In the month of May, the American currency reached a record level of US$1.19 per euro, with nominal depreciation of 13% in the year. In relation to the yen, the value of the dollar remained stable, partly as a response to Bank of Japan timely interventions aimed at preserving parity between the two currencies.

Latin America currencies per US$



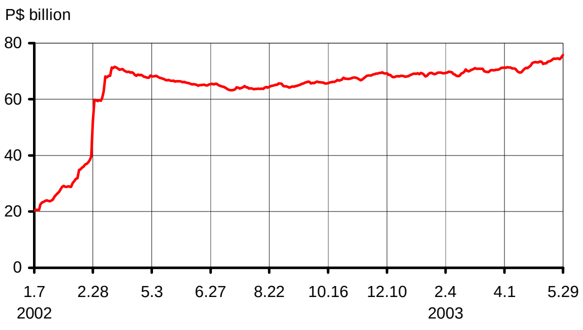

Source: Bloomberg

The Latin American currencies were favored by growth in international capital flows and also registered upward movement against the American dollar in 2003. This movement occurred at differentiated levels, to the extent that the currencies of both Brazil and Argentina appreciated sharply as they adjusted in value following the strong processes of depreciation that occurred in 2002. Insofar as the Argentine peso is concerned, upward movement was a consequence of an excess supply of dollars generated by a high trade balance surplus, as well as of the fact that the country did not meet its foreign debt service payments. This imbalance led the Argentine Central Bank (BCRA) to adopt the strategy of purchasing dollars and increasing the nation's international reserve level in order to guaranty a favorable rate of exchange for its exports.

The banking industry in the United States and Europe has registered a satisfactory performance and managed to preserve adequate levels of capitalization and solidity. In the United States, the environment of low interest has benefited the banking sector which, according to a report issued by the Federal Deposit Insurance Corporation (FDIC) in the month of June, registered record profits of US$29.4 billion in the first quarter of 2003. To a great extent, this result reflected growth in demand for mortgage credits, increases in the book value of security assets and improved credit quality.

In Asia, the state of the banking system remains unstable. In May, the Japanese government intervened in the fifth largest bank in the country after discovering that its rate of capital adequacy had fallen below the level required for domestic banks. A bail out operation became necessary in order to avoid an even greater banking crisis and protect stockholders – including other major banks and insurance companies – against possible losses. Although the government has managed to eliminate the risks of short-term systemic crises, the long-term outlook for the Japanese banking sector remains uncertain. In China, the high level of participation of bad loans in the assets of the system's four largest banks has clearly diminished confidence in the health of the banking system. Notwithstanding the fact that this situation compromises the sector's performance in terms of growth and profitability, the high degree of state control over the Chinese banking system diminishes the probability of a short-term banking crisis that could generate negative impacts on the country's economic growth, with repercussions on the other economies of the region.

**Argentina – Bank deposits**



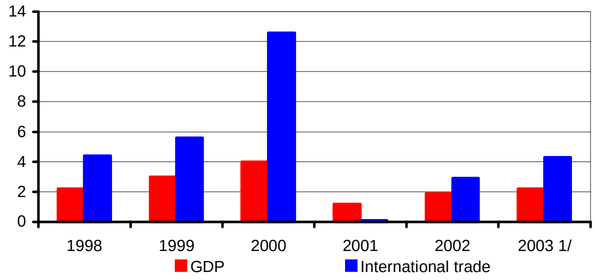

Source: BCRA

Insofar as Latin America is concerned, the Argentine financial system still provokes a great deal of wariness. The gradual lifting of restrictions on bank withdrawals from both demand and time deposits that began in 2002 has not resulted in reductions in financial system deposits, due mostly to the rather attractive interest rates offered by the banking sector. However, the highly restricted credit market remains as a major obstacle to the expansion and diversification of the banking system's asset portfolio, clearly compromising its solvency, since the capital of Argentine banks has been strongly concentrated in public securities.

# 4.5 World trade

World GDP and international trade

Percentage change in twelve months




Source: IMF-World Economic Outlook - Apr 2003

1/ Projection

In 2002, world trade in goods and services registered growth of 2.9%, surpassing growth in world output by 1 p.p. According to the IMF, growth in 2003 should reach a level of 4.3%. However, it should be recalled that the very sluggish pace of world economic recovery and the still unpredictable consequences of the SARS epidemic for the international trade of the Asian countries will most probably generate important negative repercussions on this forecast.

The deficit in the American balance of trade in goods came to US$136.4 billion in the first quarter of 2003, or 3% more than in the preceding quarter. This result was a consequence of more intense growth under imports than under exports. Exports, which are historically more sensitive to depreciation of the dollar, increased by 1%, while imports, reflecting the lack of dynamism in the United States economy and upward movement in petroleum prices, expanded by 1.9%.

In the Euro zone countries, the trade surplus dropped in the first quarter of 2003, when compared to the previous quarter. Deseasonalized data point to a reduction in the bloc's exports, indicating both appreciation of the euro against the American dollar and the low level of world economic activity. Imports expanded at a moderate pace, as a result of growth in petroleum prices and the weak performance of the economies of the region. In Germany, Europe's largest economy, the balance of trade has continued in a surplus position, mostly reflecting sharp growth in trade with China. In France, exports declined at a sharper pace than imports during the period. In the United Kingdom, which has the second largest GDP in Europe, the balance of trade in goods remained in a deficit position.

The Asian economy has been driven by China and is still the region with the world's best trade flow. Estimates suggest that Chinese GDP growth in the first quarter of 2003 was quite close to the annual rate of 9.9%, expressed in seasonally adjusted data, due to rather high levels of both investments and exports. The dynamics of the region's economy have been sustained by demand for exports within the region itself, as demand from the United States and, principally, Europe has diminished. The countries of northern Asia have drawn the greatest benefits from the economic performance of China. This has been particularly true in Taiwan, followed by South Korea and Japan. The benefits for the countries of the Association of Southeast Asian Nations (Asean) are somewhat less, since they have less significant economic ties to China.

The effects of SARS on the region's external trade will be perceived in data for the second quarter of the year. Initially, the impact will be reflected in lesser exports from China, followed by a reduction in imports, with repercussions on the foreign trade of the other countries of the region, particularly Taiwan, as a result of the country's strong economic ties to China.

In Japan, the foreign trade balance reflected a downturn in export operations. Sales of machines, the nation's major export product, remained on a downward curve, at the same time in which imports turned upward as a result of higher petroleum prices. The spread of the SARS epidemic is expected to impact Japan's foreign trade in the coming months, particularly when one considers that the countries of Asia and, particularly Chinacountie, have been responsible for maintaining demand for Japanese products, while demand in the United States has weakened.

In Latin America, the Argentine balance of trade registered a strong surplus in the first quarter of the year. Improvement in the international prices of exportable products accounted for the growth in exports, as is evident in the fact that the volumes of foreign sales remained stable. Though below historic levels, the progressive increase in imports has been consistent with recovery in the business cycle and indicates improvement in the level of domestic economic activity.

The Mexican trade balance registered a falloff in the deficit in the first quarter of 2003. However, this result reflected marginal growth in exports in the period as a result of weak demand in the United States, which is that country's major trading partner, despite the favorable effects of growth in petroleum prices. The foreign sales of the "maquiladoras" remained on a generally downward curve. Growth in imports was less than that of exports in the quarter, though foreign purchases of capital goods did expand in the month of March following ten consecutive months of negative results.

## 4.6 Commodities

In the month of February, depreciation of the dollar and in the prices of the stocks of American businesses stimulated the sharpest rise in gold prices in the last six years. In March, the prices of this metal dropped in relation to the previous month's level, though they did improve somewhat in the following month. They then remained at that level, which represented annual valuation of approximately 10% in May. The interest rate cutback in the Euro zone is expected to pressure gold prices downward, since these prices are defined in dollars.

The continuity of growth in world steel production, which registered growth of 8.8% in the output of gross steel and 9% in that of iron ore, is expected to ensure that mining companies will enjoy excellent results in 2003. The prices of nickel, palladium and platinum moved upward, while copper and zinc prices tended downward.

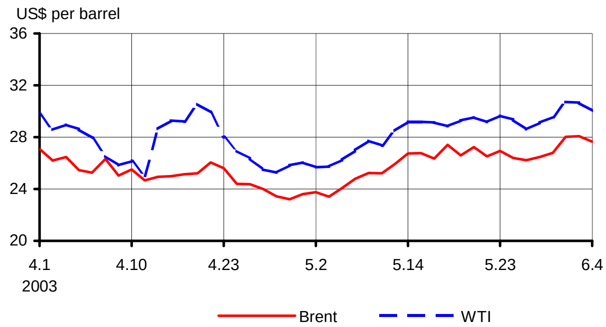
With regard to farm commodities, just as occurred with most other grains, the estimated rise in the 2003/2004 soybean harvest will not be sufficient to rebuild stocks of the product. It is now expected that current prices will be maintained to the end of the year with only slight decreases, thus ensuring the profitability of the sector. World soybean production is greater this year in comparison to the previous year, with growth in both productivity and area under cultivation.

It is estimated that growth in corn consumption will exceed output expansion, generating a reduction in stocks and an upward trend in prices. This movement is also expected in the cases of rice and wheat.

In the latter case, output should end the year with stocks that are 14% below the result of last year.

The oil market registered some degree of fluctuation in the second quarter as a result of events in the Middle East and variations in stocks of the product in the industrialized nations, once winter had ended in the northern hemisphere.

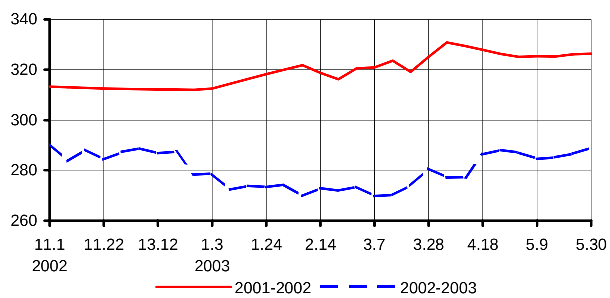
**Oil – Spot market**




Source: Bloomberg

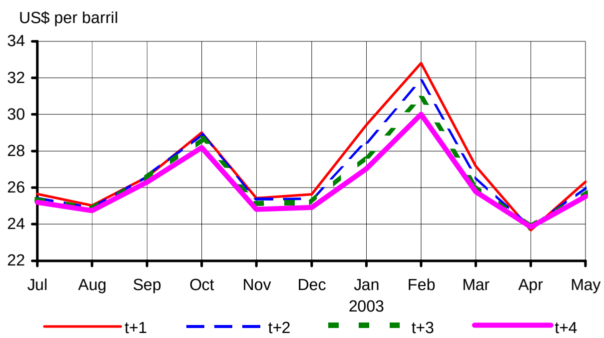
**Oil – USA: commercial stocks**

Million of barrels




Fonte: U.S. Energy Department

**Oil – Futures market**




Source: Bloomberg

Starting in mid-March, expectations of a rapid resolution of the war in Iraq and a gradual return of Venezuelan output to its potential level with the consequent drop in the threat of global supply shocks, triggered the start of downward movement in the prices of Brent-type petroleum, which dropped from US$28 per barrel on March 31 to US$23 per barrel on April 30. In the same period, the price of West Texas Intermediate (WTI) dropped from US$31 per barrel to US$25 per barrel.

Starting in May, less than expected growth in American commercial stocks, which remained relatively stable compared to expectations for the period following the end of winter, plus declarations on the part of leaders of the Organization of Petroleum Exporting Countries (Opec), indicating possible cutbacks in the production quotas of the member states during the current year, brought added pressures on petroleum prices. As a result, Brent type moved to US$28 per barrel on June 2, and WTI moved to US$30.7 per barrel on the same date.

In the case of the futures market, initial expectations of a coalition victory could result in rapid growth in Iraqi production led to increased market optimism regarding a possible substantial increase in world supply and, consequently, downward movement in futures prices. On April

30, the prices of Brent type petroleum were approximately US$23.5 per barrel for subsequent delivery periods. However, the risks of terrorist attacks in the Middle East and a worsening of political conflicts in Venezuela and Nigeria could, to some degree, affect supply, while estimates of increases in demand, should there be an upturn in economic recovery in the United States and Europe as of the second half of the year, point to a price structure in the range of US$25 to US$26 per barrel in the coming months.

## 4.7 Conclusion

In the first quarter of 2003, growth in the world economy remained sluggish as a result of the rather somber expectations that preceded the war in Iraq. Though any precise evaluation of the macroeconomic scenario in the postwar period would be quite premature, the relatively rapid end to the conflict has not yet been reflected in a strong upturn in the activity level of the industrialized countries, as had been predicted.

On the other hand, the economic impact of the SARS epidemic appears to have remained restricted to east Asia. Just as had occurred since last year, the world economy depends on an upturn in the United States economy since the other major economic areas, such as the Euro zone and Japan, remain stagnant. Though the upturn had not been consolidated by the middle of the second quarter of the year, the outlook is still for more consistent recovery in the United States, particularly as a consequence of the coming together of several favorable factors: relatively stable petroleum prices, positive results on financial markets and the business sector, reduced inventory levels, improved expectations, fiscal stimuli and continued monetary policy support in a context of declining inflation.

On the other hand, recovery in employment levels could require more time, particularly in light of the process of restructuring undertaken in response to economic deceleration and low stock market prices in 2002. On the other hand, it should be stressed that the high deficit in the current accounts of the United States economy, which tends to be partially offset by depreciation of the dollar, has hampered the

United States from playing a decisive role in regaining growth in other economies.

In general, the outlook for vigorous economic growth in the second half of the year is restricted by the possibilities of applying incentive policies in order to achieve greater dynamics in national economies, due either to the limitations of fiscal incentives, or to the very narrow room for further reductions in interest rates in the major economies.

# 5 – Foreign sector

The steady downward slide in the value of the current account deficit has been generated mainly by trade balance improvement, coupled with a continued flow of foreign direct investment. The result of these factors has been progressively better financing conditions for the nation's external accounts. At the same time, the improved environment for obtaining external funding has resulted in an increased rate of rolling the medium and long-term debt, while simultaneously augmenting net funding inflows through issues of short-term papers.

## 5.1 Trade in goods

**Trade balance – FOB**

US$ million

| Period | Exports | Imports | Balance | Trade flow |
|---|---|---|---|---|
| Jan–May 2003 | 27 128 | 19 144 | 7 984 | 46 272 |
| Jan–May 2002 | 20 973 | 19 055 | 1 919 | 40 028 |
| % change | 29.3 | 0.5 | | 15.6 |

Source: MDIC/Secex

Note: In 2002, 103 working days; in 2003, 102.

In the first five months of 2003, the Brazilian balance of trade continued on the trajectory begun in July 2002, registering consecutive monthly surpluses in excess of one billion dollars. The May surplus came to a full US$2.5 billion, the highest monthly figure in the history of Brazilian foreign trade, raising the accumulated surplus for the January to May period to US$8 billion.

Among the factors underlying this growth, mention should be made of 29.3% expansion under exports, to a record total of US$27.1 billion for the period, while imports remained relatively stable in the range of US$19.1 billion. Consequently, the nation's trade flow for the period was the highest in history, closing at a level of US$46.3 billion, or 15.6% above the January-May 2002 result.

The change in the level of the surplus was mostly due to growth in foreign sales which, in turn, was generated to some extent by depreciation in the real rate of exchange from mid-2002 onwards. Compared to median depreciation in the first half of the year, effective median depreciation of the nation's currency in the final six months of 2002 came to 34.6%, using the INPC as deflator. However, a comparison between the median rates of the first four months of 2003 and the second half of 2002 indicates valuation of 4.7%, which is a factor that could have an unfavorable impact on growth in the trade surplus over the coming months. However, at the same time, it should be stressed that maintenance of strong balance of trade surpluses will also be stimulated by expansion in the number of markets to which Brazil ships its products. It is important to recall here that the country has made a particularly strong effort in recent years to promote its goods in a variety of markets, while implementing an internal process of substituting products that have long been imported by a number of different sectors.

Aside from this, it is important to mention that improvements in the performance of the trade sector began precisely in the period in which export prices were on a downward curve in the second half of 2002. In recent months, however, this process has reversed course and, should the current upswing in export prices continue into the future, it will certainly act as an additional factor in sustaining the burgeoning trade surpluses.

**Exports by aggregate factor – FOB**
Daily average – January–May

US$ million

| Itemization | Accumulated | | |
|---|---|---|---|
| | 2002 | 2003 | % change |
| Total | 203.6 | 266.0 | 30.6 |
| Primary products | 51.2 | 76.3 | 49.1 |
| Industrial products | 145.0 | 184.0 | 26.9 |
| Semimanufactured good: | 28.3 | 40.1 | 41.6 |
| Manufactured goods | 116.7 | 143.9 | 23.3 |
| Special operations | 7.4 | 5.6 | - 23.9 |

Source: MDIC/Secex

Note: In 2002, 103 working days; in 2003, 102.

In the period from January to May 2003, growth in foreign sales has been mostly due to the performance of sales of basic and semimanufactured products, which have registered median daily growth of 49.1% and 41.6% respectively, in relation to the levels registered in the same period of 2002. Exports of manufactured goods expanded by 23.3% and special operations declined by 23.9%.

Data released by the Center of Foreign Trade Studies Foundation (Funcex) for the January-April period showed highs in both prices and

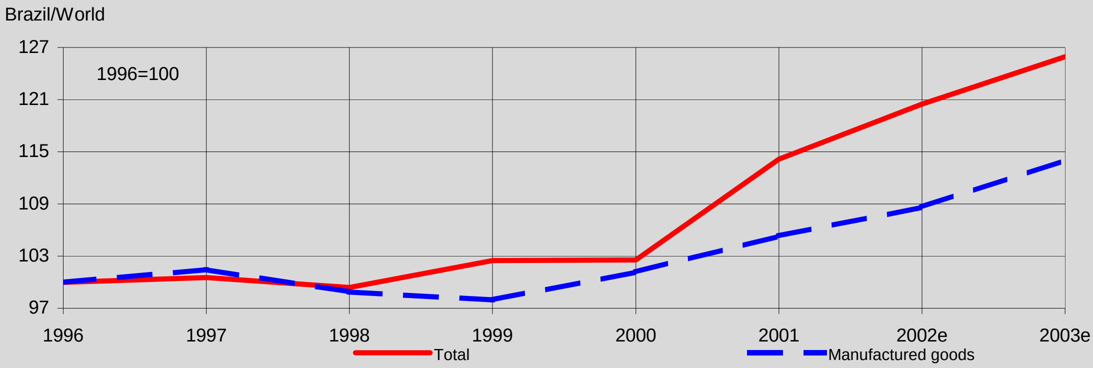
# Growth an Diversification of Exports

With adoption of a floating exchange rate system in Brazil in 1999, the current account deficit of the balance of payments dropped sharply from a level of 4.2% of GDP in 1998 to an estimated 0.9% in 2003. The performance of the balance of trade has become an essential element in the process of foreign sector adjustment. This has been especially noteworthy in the growth registered by the export sector, particularly in terms of the value of the nation's foreign sales (25.5%, from 1997, the highest level prior to adoption of free floating exchange, to 2003, estimated at US$66.5 billion), and in the reduction in import operations (18%, idem, with an estimated value of US$49 billion in 2003).

The factors that have clearly been responsible for this growth, include, among other items, the real level of exchange, the competitiveness of national production, the level of internal and external activity, market diversification and the tax load.

When the export sector is analysed, it is interesting to compare the recent growth in the volume of the nation's foreign sales in terms of both the overall world total and in the context of manufactured goods. As is shown in Graph 1, as of 1999, there has been greater relative expansion in the volumes exported by Brazil. And, it is now forecast that, when compared to 1996, the 2003 totals will expand at a pace that will be greater than the estimated 26% rates of expansion in total world exports. At the same time, Brazilian exports of manufactured goods will also expand at a rate above the 14% level registered internationally. This impact in terms of quantities is somewhat attenuated by lesser prices, which is a characteristic of periods following real currency devaluations in economies with reduced levels of participation in world markets.

**Graph 1 – Change of the Brazilian share in the volume of world exports**




**Source**: WTO and Funcex
**e**: BCB estimates: World - WEO data, Apr/2003 (exported volume of goods and services, total, and for developed countries);
Brazil - 9% growth of the exported volume, 2003, total and manufactured goods.

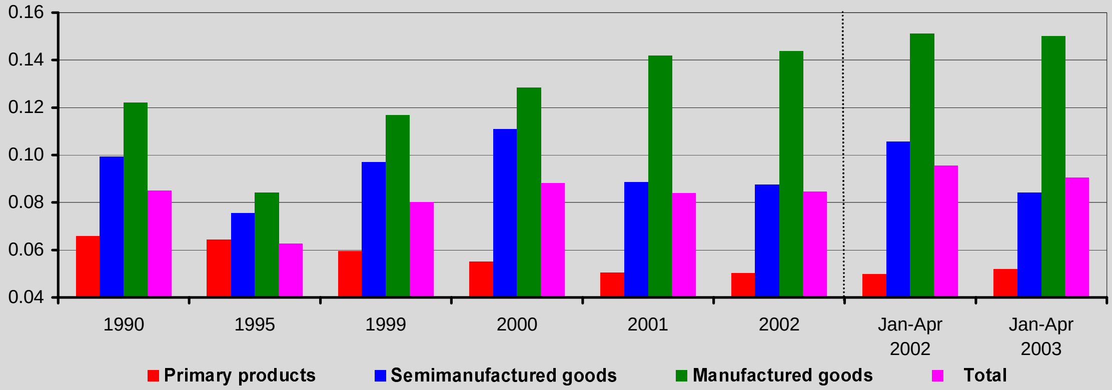
The recent performance of the export sector reflects the efforts made by the government and private sector. In the first case, one should cite the following:

a) trade promotion and market diversification, with formalization of trade agreements (such as the Mercosul-Mexico Automotive Agreement, incorporated into Brazil's legal structure, and the Bilateral Agreement with Chile, both of which were regulated toward the end of 2002) and the sending of trade missions to China and India in 2002 and to Russia in May of this year. Other new missions are scheduled to visit the nations of Asia and the Middle East in the near future.
b) passage of Law 10,637, dated 12.30.2002, eliminating cumulative levying of the Social Integration Program/Program of Civil Service Asset Formation (PIS/Pasep) on export operations. This measure brought particularly important benefits to the export sector. It should also be stressed that the tax reform proposal sent to Congress by the government eliminates cumulative levying of the Contribution to Social Security Financing (Cofins) for some sectors of economic activity and incorporates into the Constitution the elimination of the Tax on the Circulation of Merchandise and the Rendering of Interstate and Intermunicipal Transportation Services and Communications (ICMS) from products to be exported, accompanied by compensatory rules to be defined in legislation;
c) incorporation of new exporters and markets, as a result of the activities carried out by the Export Promotion Agency (Apex-Brasil); and
d) expansion of financing for export activities, with inclusion of funding provided by the BNDES.

In terms of market diversification, Graph 2 shows the evolution of the index of concentration of Brazilian exports, broken down by major product categories. Viewed in terms of total exports, concentration increased in 1999 and 2000 before declining in 2001 and in the first four months of 2003. Sales of manufactured products registered the highest level of concentration by market when compared to the other product categories, with steady growth in concentration in the period from 1999 to 2002, and a small reduction in the first four months of the current year, when compared to the same period of 2002. Lesser market concentration is desirable in order to achieve a more stable flow of exports by reducing the impacts of economic or political difficulties that may occur in specific trading partners. Brazil currently exports to more than 200 countries, according to data released by the Secretariat of Foreign Trade (Secex).

In terms of products, Brazilian exports are highly diversified, even when viewed in the international context, according to a survey released by the United Nations Conference on Trade and Development (UNCTAD), covering approximately 150 countries in 1990 and 2000 (www.unctad.org/Templates/WebFlyer.asp?intItemID=2082&lang=1). According to the

Graph 2 – Brazil's export concentration index by country of destination[1/]




**1/** Herfindahl-Hirschmann index which varies from 0 (null concentration) to a maximum concentration. The occurrence of maximum concentration means that overal total exports of the segment would be destined to a single country.

survey, in 2000, Brazil had one of the lowest indices of concentration according to exported products and was classified in ninth position. Of the eight countries classified above Brazil, three of them (United Kingdom, Holland and Turkey) had the same level as Brazil in that year. Aside from this, among the countries with the highest levels of diversification registered in the survey, only Brazil and China, as well as Turkey, managed to reduce their levels of concentration in the period between the two years analyzed.

Parallel to this, when one considers the total number of companies involved in export activities, Brazil has managed to incorporate an increasingly larger number of new participants, according to data released by Secex and the Center of Foreign Trade Studies Foundation

**Concentration of exports by products**[1/]

Select countries

| Country | 1990 | 2000 |
|---|---|---|
| Italy | 0.06 | 0.06 |
| Austria | 0.06 | 0.07 |
| China | 0.08 | 0.07 |
| United States of America | 0.08 | 0.08 |
| France | 0.06 | 0.08 |
| Denmark | 0.07 | 0.08 |
| Czech Republic | ... | 0.08 |
| Poland | 0.08 | 0.08 |
| Brazil | 0.10 | 0.09 |
| Memo: | | |
| Argentina | 0.14 | 0.14 |
| Chile | 0.40 | 0.29 |
| Mexico | 0.32 | 0.13 |

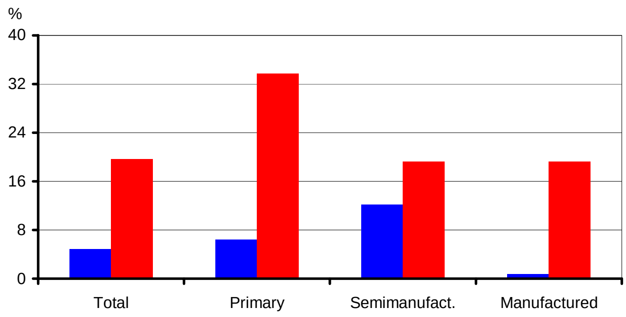
**Source:** UNCTAD, by using modified version of Herfindahl-Hirschmann, Index for 239 products at three-digit SITC, Rev. # 2 level.

**1/** Herfindahl-Hirschmann index wich varies from 0 (null concentration) to a maximum concentration. The occurrence of maximum concentration would mean that the country's total foreign sales are concentrated in a single product.

(Funcex). According to Funcex (www.funcex.com.br), the number of Brazilian exporter companies in 2001 came to 16,821, with incorporation of 2,855 new companies, when compared to the situation in 1998. Basically, this growth was concentrated in industrial companies (1,354 new exporters) and commercial companies (850 companies). According to data recently released by Secex, the number of exporters has expanded considerably, with incorporation of 513 new exporters in the first four months of 2003, compared to the total for the same period of 2002.

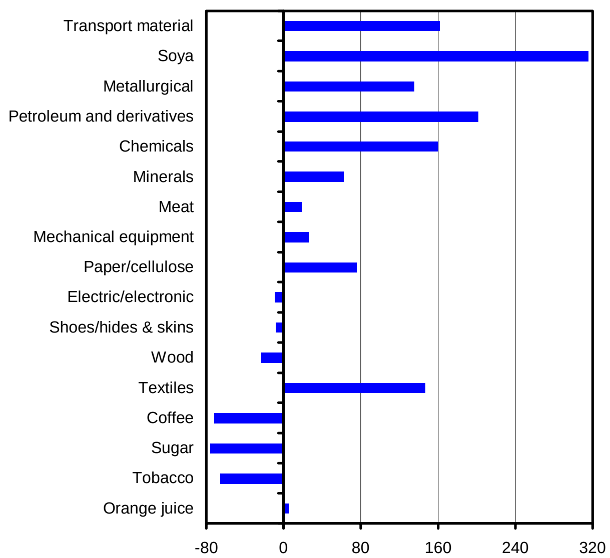
Based on an evaluation of market diversification by products and exporters, Brazilian data point to the nation's enhanced external competitiveness that followed upon adoption of free floating exchange. Consequently, recovery of internal demand is expected to have little short-term impact on foreign sales.

**Exports – Price and volume index**
**January–April 2003/2002**




Source: Funcex

**Exports by sectors – FOB – January–May/2003**
Percentual change from the same period of the last year



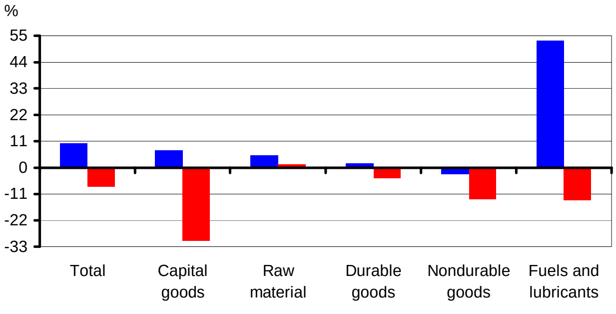

Source: MDIC/Secex

volumes exported in all categories, when compared to the same period of 2002. The volume increase was even more expressive than the price high, reaching a level of 33.7% in the heading of basic products and 19.2% in that of semimanufactured and manufactured goods. With respect to prices, the addition came to 6.4% for basic products, 12.2% for semimanufactured goods and 0.8% for manufactured products.

A sector-by-sector breakdown indicate that the largest growth under basic product exports was registered under soybeans and derivatives and petroleum and its derivatives. The value of foreign sales of soybean and related goods in the January to May period was four times greater than in the same period of 2002, while the value of petroleum and derivative sales was three times greater. Aside from these goods, one should also highlight growth under exports of transportation equipment, with the highest absolute rate of expansion in value terms; chemical products; textiles and metallurgical goods, which more than doubled in the period.

The sectors that turned in the largest reductions were coffee, particularly exports of coffee beans, sugar and tobacco and its products.

**Imports – Price and volume index**
**January–April 2003/2002**

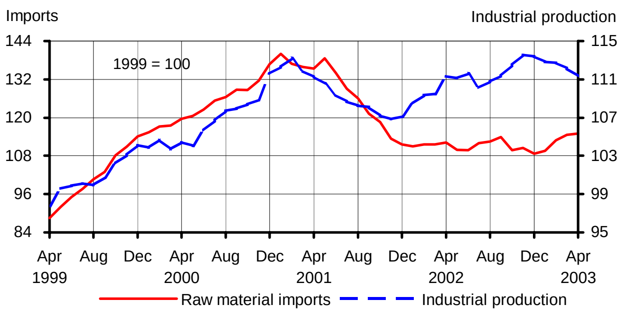



Source: Funcex

With respect to import operations, the value of these operations registered practically no change in the period extending from January to May 2003, compared to the same period of the previous year, and closed at US$19.1 billion. As a matter of fact, stability was mostly due to price increases, particularly in the case of petroleum, in the period under consideration. This is evident in the fact that data released by Funcex for the January to April period, showed reductions in the volume of imports in all categories, with the sole exceptions of raw materials and intermediate goods.

The increase in the quantity imported of this latter category of products was, to some extent, due to alterations introduced into the drawback system in mid-2002. These changes were particularly beneficial for such export segments as fruits, cotton, shrimp, chicken meat and pork. In the period from January to May, daily average imports of raw materials and intermediate goods increased by 8%. In this case, the sharpest growth occurred under imports of naphthas, with 59.5%, due principally to increases in international petroleum prices as a result of the war in Iraq.

**Raw material imports x industrial production**
Seasonally adjusted indices – 3 month moving average




Source: IBGE and Funcex

It is interesting to note that the once highly divergent trajectories followed by imports of raw materials and intermediate products in the past when compared to the output of the manufacturing sector diminished sharply, suggesting a considerable degree of substitution of previously imported raw materials and intermediate goods. This decline, which was a consequence of lesser production and increased imports, did not, however, reflect any degree of exhaustion of the process of import substitution.

**Imports by end-use category – FOB**
Daily average – January–May

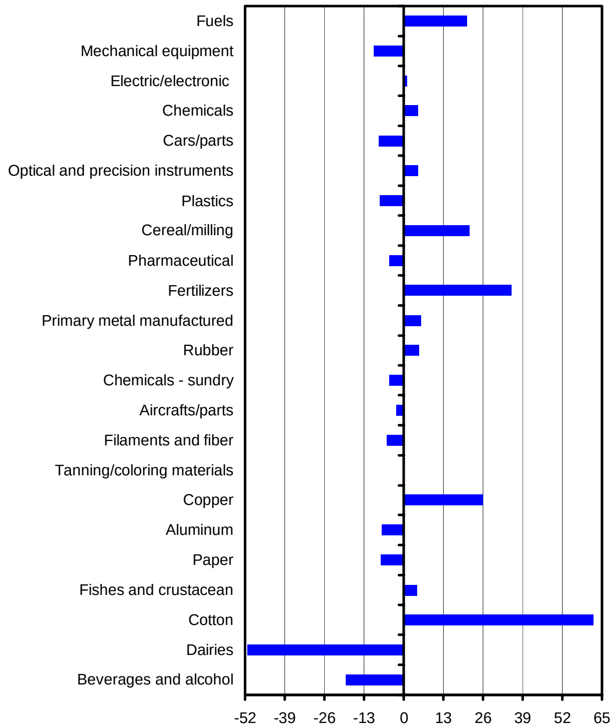
US$ million

| Itemization | 2002 | 2003 | % change |
|---|---|---|---|
| Total | 185.0 | 187.7 | 1.5 |
| Capital goods | 47.9 | 40.5 | - 15.5 |
| Raw materials | 91.0 | 98.3 | 8.0 |
| Naphtha | 2.6 | 4.1 | 59.5 |
| Consumer goods | 23.4 | 21.5 | - 8.1 |
| Durable | 9.8 | 9.7 | - 1.1 |
| Passenger vehicles | 3.1 | 2.7 | - 13.9 |
| Nondurable | 13.7 | 11.9 | - 13.1 |
| Fuels | 22.6 | 27.3 | 20.8 |
| Crude petroleum oil | 12.1 | 16.5 | 35.9 |

Source: MDIC/Secex

Note: In 2002, 103 working days; in 2003, 102.

**Imports by sectors – January–May/2003**
Percentage change over the same period of the last year




Source: MDIC/Secex

Foreign purchases of fuels and lubricants also registered growth in the period under consideration, coming to a level of 20.8% when analyzed on the basis of daily averages, despite some degree of falloff in imported quantity. For the most part, this increase was due to high petroleum prices, since imports of this product increased by 35.9% in the period.

Daily average imports of capital goods registered the sharpest decreases in the period under analysis, with 15.5%, due to cutbacks in imported volume. When compared to the growth of the manufacturing sector which increased by approximately 3.3% in the first quarter of the year when viewed against the same period of the preceding year, this performance was a further indication of the ongoing process of substitution of previously imported goods by nationally made products. The conditions required for this process of substitution have existed since alteration of exchange policy in January 1999.

With regard to imports classified under the heading of consumer durables, the reduction came to 1.1%, mostly due to a 13.9% drop in imports of passenger cars. In the case of nondurables, which are the only heading to register reductions in both prices and quantities, the falloff ended at 13.1% up to May, according to data released by Funcex for the January to April period.

An evaluation on a sector-by-sector basis pointed to substantial growth in daily average imports of cotton, with 62.2%, fertilizers, with 35.3%, copper and its products, with 26%, cereals and products resulting from grinding, with 21.4%, and fuels and lubricants, with 20.6%, based on the results for the period from January to May 2003, compared to the same period of the preceding year.

On the other hand, one should highlight the reductions under imports of mechanical equipment, with 9.8%, automotive vehicles and parts, 8.2%, and pharmaceutical products, 4.8%, among others. In light of the magnitude of their reductions, mention should also be made of the 51.2% drop in imports of milk and derivatives and the 19% falloff in foreign purchases of beverages and alcohol, though the overall participation of these goods in the nation's imports is already rather small.

Absolute growth of US$6.2 billion in the Brazilian balance of trade in the period extending from January to May 2003, compared to the same period of 2002, can be explained by significant improvement in the balances of transactions with the major partners and blocs.

The highest growth in the balance occurred in trade with the United States, the nation's largest individual trading partner. In this case, the surplus expanded by US$1.7 billion, reflecting an increase of US$1.1 billion in exports and a reduction of US$587 million in imports. The factors that contributed most significantly to growth in exports were sales of fuel oils and petroleum, which were six times greater than in the same period of 2002. Foreign sales of passenger cars, automotive engines, cellulose and gasoline also registered strong upward movement in the period, surpassing the mark of 40%. On the other hand, among the major products imported from the USA, purchases of aircraft engines and turbines and parts, integrated circuits and microelectronic equipment and computers registered reductions of more than 30%.

Bilateral trade with China generated expansion of US$1 billion in the Brazilian trade surplus, reflecting increases of 229.8% in exports and 38.9% in imports. Growth in foreign sales to China classified that country as the second most important individual market of destination for Brazilian exports in the period from January to May 2003. Among the most important products

**Exports and imports by geographic area – FOB**

January–May

US$ million

| Itemization | Exports | | | Imports | | | Balance | |
|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | % change | 2002 | 2003 | % change | 2002 | 2003 |
| Total | 20 973 | 27 128 | 29.3 | 19 055 | 19 144 | 0.5 | 1 919 | 7 984 |
| Laia | 3 727 | 4 412 | 18.4 | 3 574 | 3 305 | - 7.5 | 153 | 1 107 |
| Mercosur | 1 248 | 1 834 | 47.0 | 2 463 | 2 391 | - 2.9 | -1 215 | - 557 |
| Argentina | 803 | 1 471 | 83.2 | 2 100 | 2 006 | - 4.5 | -1 297 | - 535 |
| Other | 445 | 363 | - 18.4 | 363 | 385 | 6.1 | 82 | - 22 |
| Mexico | 834 | 978 | 17.3 | 234 | 204 | - 13.1 | 599 | 774 |
| Other | 1 646 | 1 600 | - 2.8 | 877 | 711 | - 18.9 | 769 | 889 |
| USA 1/ | 5 800 | 6 895 | 18.9 | 4 366 | 3 778 | - 13.5 | 1 435 | 3 116 |
| EU | 5 277 | 6 759 | 28.1 | 5 299 | 5 267 | - 0.6 | - 22 | 1 491 |
| E. Europe 2/ | 546 | 743 | 36.0 | 275 | 363 | 32.3 | 271 | 379 |
| Asia | 2 518 | 4 337 | 72.3 | 3 105 | 3 431 | 10.5 | - 587 | 906 |
| Japan | 766 | 817 | 6.7 | 1 005 | 947 | - 5.8 | - 239 | - 129 |
| South Korea | 287 | 439 | 52.7 | 452 | 473 | 4.8 | - 165 | - 35 |
| China | 538 | 1 774 | 229.8 | 530 | 736 | 38.9 | 8 | 1 037 |
| Other | 927 | 1 308 | 41.1 | 1 118 | 1 275 | 14.1 | - 191 | 33 |
| Sundry | 3 105 | 3 983 | 28.3 | 2 437 | 2 999 | 23.0 | 667 | 984 |

Source: MDIC/Secex

1/ Includes Puerto Rico.

2/ Albania, Bulgaria, Hungary, Poland, Slovak Republic, Czech Republic, Rumania and countries of the former Soviet Union.

channeled to that market, the following deserve highlighting: soybeans, iron ore, flat rolled products, cellulose, iron and steel semimanufactured goods, with growth of more than six times over the 2002 total, and auto parts with a fivefold increase. Insofar as imports are concerned, China was Brazil's seventh largest supplier, with such products as coke and semicoke, coal and parts for transmission and reception equipment.

Trade with Japan and South Korea remained in a deficit position, though the respective negative results did decline by US$110 million and US$130 million. The strongest growth was registered in sales to South Korea in the period in question, with expansion of 52.7%.

Among the goods exported to Japan, the most important were sales of iron ore and unwrought aluminum. In the latter case, growth came to more than 50%. With regard to exports, the lead items were auto parts, ball bearings and gears and engines for automotive vehicles.

Trade with the totality of Asian countries generated absolute growth of US$1.5 billion in the balance of trade, moving from a deficit of US$587 million to a surplus of US$906 million. Exports to the region increased by US$1.8 billion, compared to growth of US$327 million in imports.

The surplus in operations with the countries of the European Union expanded by US$1.5 billion in the period in reference. This, for the most part, was a result of increased exports, since imports from that region dropped by just US$32 million. Foreign sales to that region of the world consisted mostly of basic products, such as soybeans, soy meal, iron ore, while imports from that region were composed mostly of products connected to the automotive sector, such as auto parts, engines and vehicles.

An analysis of exports to the EU indicates that the sharpest growth occurred in sales to the Netherlands and Germany, with respective growth rates of 38.5% and 48.5%.

The surplus in trade transactions with the Latin American Integration Association (Laia) increased by US$953 million in the January-May

2003 period, registering growth of 18.4% under exports and a reduction of 7.5% under imports. The major factors underlying this result was a reduction of US$762 million in the deficit with Argentina, reflecting growth of 83.2% in Brazilian exports and a reduction of 4.5% under imports.

**Exports to Argentina and other countries – FOB**
January–May 2003

| Itemization | Argentina | Other | Total |
|---|---|---|---|
| | % change[1/] | | |
| Total | 83.2 | 27.2 | 29.3 |
| Manufactured products[2/] | 87.2 | 18.2 | 22.1 |

Source: MDIC/Secex

1/ From the same period of the last year.
2/ Includes manufactured product reexports.

The increase in foreign sales to Argentina in the period under consideration was mostly concentrated in the automotive sector, with substantial expansion in sales of automobiles, auto parts, cargo vehicles, tires and auto engines.

One should also highlight growth of US$175 million in the trade surplus with Mexico, which increased its purchases of Brazilian goods by 17.3%. For the most part, this result was due to sales of automotive sector products, which accounted for approximately 50% of the total exported. These figures, evidently, were a consequence of the automotive agreement in effect between the two nations. Aside from automotive sector products, other important exports included transmission and reception equipment, principally mobile phones, and flat rolled iron or steel products. Brazilian imports from Mexico dropped by 13.1% in the period.

## 5.2 Services and income

Compared to 2002, the progressive improvement in current accounts already noted in the previous report, continued throughout the first five months of the current year. The trade balance surplus continued expanding and net remittances of services and income turned downward.

Net outlays on services diminished by 22.6%. Net spending on transportation registered a reduction of 28.5%, with declines of 36.3% under net spending on travel tickets and 33.4% under net outlays on freights. International travel accumulated net revenues of US$113 million, compared to net outlays of US$452 million from January to May 2002. Net spending on computer and information services added up to US$390 million, for a reduction of 22.1% in the period.

**Current account**

US$ billion

| Itemization | 2002 Jan-May | 2002 IV Q | 2002 Year | 2003 Jan-May | 2003 Year 1/ |
|---|---|---|---|---|---|
| Current account | -7.1 | -0.3 | -7.7 | 0.0 | -4.2 |
| Trade balance | 1.9 | 5.3 | 13.1 | 8.0 | 17.5 |
| Exports | 21.0 | 16.8 | 60.4 | 27.1 | 66.5 |
| Imports | 19.1 | 11.6 | 47.2 | 19.1 | 49.0 |
| Services | -2.2 | -1.1 | -5.0 | -1.7 | -5.4 |
| Transportation | -0.9 | -0.5 | -2.0 | -0.7 | -2.3 |
| International travel | -0.5 | 0.2 | -0.4 | 0.1 | -0.6 |
| Computer and information | -0.5 | -0.3 | -1.1 | -0.4 | -1.2 |
| Operational leasing | -0.6 | -0.5 | -1.7 | -0.7 | -1.6 |
| Other | 0.3 | -0.1 | 0.2 | -0.1 | 0.2 |
| Income | -7.6 | -5.2 | -18.2 | -7.3 | -18.7 |
| Interest | -5.5 | -3.8 | -13.1 | -5.2 | -13.5 |
| Profits and dividends | -2.1 | -1.4 | -5.2 | -2.1 | -5.2 |
| Compensation of employees | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 |
| Current transfers | 0.8 | 0.8 | 2.4 | 1.0 | 2.5 |

1/ Forecast.

Net remittances of income abroad totaled US$7.3 billion from January to May 2003, for a reduction of 3.7% in relation to the flow remitted in the same period of the previous year. Interest remittances declined by 6% to US$5.2 billion, and those involving profits and dividends increased by 3.7% to a total of US$2.1 billion.

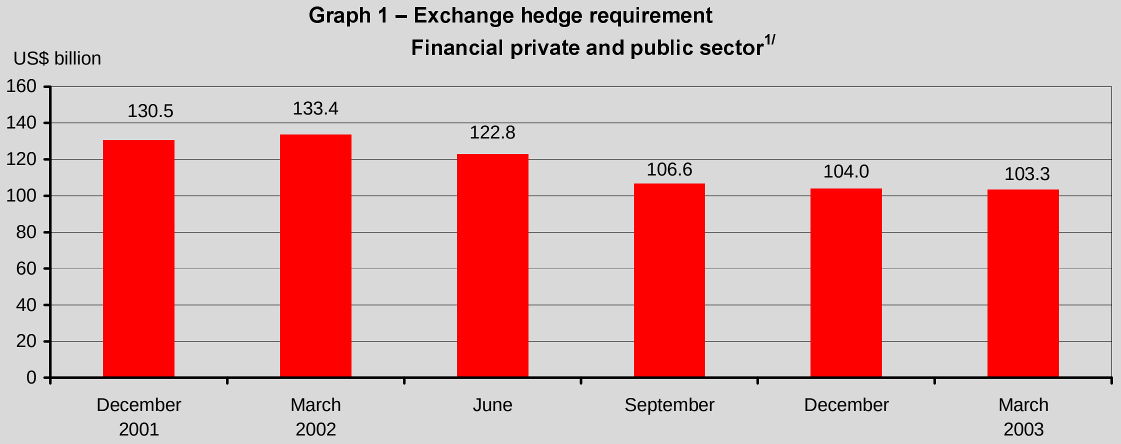
For 2003, the trade balance surplus is projected at US$17.5 billion, with growth of 10.2% in exports and 3.8% under imports. Net outlays on services and net remittances of income are expected to close just slightly higher than the 2002 figures. With this, expectations are that the current account deficit will close with a reduction of US$3.5 billion.

## Exchange Hedge

Here, the potential need for exchange hedge is assessed and the percentage rate met by the government sector is calculated.

From December 2001 to March 2003, the need for exchange hedge dropped by US$27.2 billion as pointed out in Graph 1. This decrease was concentrated in the second and third quarters of 2002, with US$26.8 billion, as a result of the reduction in foreign portfolio investments and short-term loans. Fundamentally, this movement was determined by exchange depreciation and reductions in the external flows registered in the period.

The need for exchange hedge in the Brazilian economy was estimated on the basis of the International Investment Position (PII), which encompasses the liabilities and assets of residents in relation to those of nonresidents.




1/ As of December, 2002 estimated data based on balance of payment flows.

The PII is calculated at quarterly intervals and is released with a lag of six months. Thus, the most recent position dates to September 2002, and the other quarters are estimated according to balance of payments flows. Foreign direct investments, foreign portfolio investments, operations with derivatives, trade credits, loans, and funding available in currency and deposits correspond to modalities of foreign sector operations of PII. For external assets, international reserves are included under this heading.

External liabilities included under Foreign Direct Investments, derivative operations, securities and stocks negotiated in the country (foreign portfolio investment items) and currency and deposits are expressed in national currency and, subsequently, converted into foreign currency on the basis of the sale rate in effect at the end of the period. This procedure is justified methodologically given that the stock of such liabilities in the country is maintained in national currency. With this, aside from the effect of floating exchange, price growth also impacts the stocks and securities negotiated in the country, in much the same way as accumulated profits/losses influence the stock of foreign direct investment. The other items are recorded and expressed in foreign currency.

External liabilities for which the nonfinancial public sector is responsible are not considered as generators of demand for exchange hedge and, therefore, are excluded from the calculation of potential demand. In this specific case, possible national currency depreciation would be absorbed through reductions in the external assets of the public sector (international reserves) or monetary base expansion and/or public sector indebtedness in national currency.

The external liabilities of the private and public financial sectors were obtained by deducting the liabilities of the public nonfinancial sector in relation to total external liabilities. Aside from this, the share of private external liabilities referring to export financing credit lines was also ignored, since the export revenues earmarked to these operations can be interpreted as protection against exchange rate variations.

The external liabilities of the private sector in Foreign Direct Investments are subdivided into intercompany loans and capital participation. In the latter case, referring to the proprietorship of companies and their physical assets. The possibility of remitting exchange listed under the liability heading of "capital participation" would, on the part of the nonresident, mean abandoning the market and selling the company in question to a resident. In general, decisions as far reaching as these involve significant costs and occur only after a relatively long time period has elapsed following inflow of the capital. In this way, the gross external private and public financial sector liabilities were adjusted through exclusion of the liabilities allocated under "capital participation".

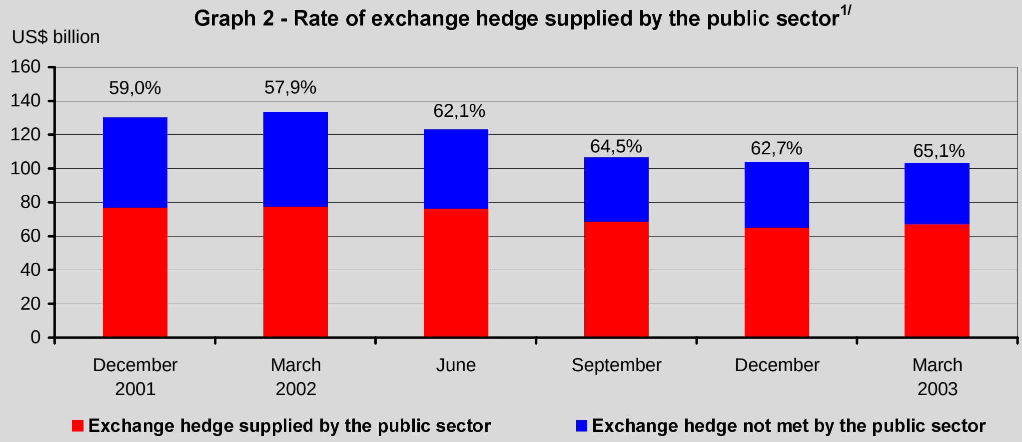
A share of the demand for exchange hedge generated by the adjusted gross external liabilities of the private and public financial sector can be met by external assets held by these same sectors. In a manner analogous to liabilities, assets classified as direct Brazilian investments abroad – capital participation was not considered as a source of exchange hedge. Gross external liabilities, adjusted by excluding Foreign Direct Investments and debts earmarked to exports, less external assets, adjusted through exclusion of capital participation and international reserves, results in adjusted net external liabilities, which define the need for exchange hedge.

The volume of exchange hedge provided by the public sector was composed of two elements: the stock of public securities denominated in national currency and indexed to exchange, and the stock of swap contracts in which Banco Central acquired papers indexed to the nominal rate of exchange and becomes creditor of flows indexed to the DI rate. Since the two instruments are recorded and settled in national currency, the expression in foreign currency is impacted by the nominal sale rate of exchange on the date of the position, in a manner quite similar to the elements of external liabilities.

Over the course of the period, the exchange hedge supplied by the public sector registered a reduction of US$12.8 billion, moving from US$80 billion in December 2001 to US$67.2 billion in March 2003. In the second quarter of 2002, the reduction in the exchange hedge supplied by the public sector was US$8.6 billion.

The ratio between the exchange hedge supplied by the public sector and the exchange hedge needs of the private and public financial sectors defines the exchange hedge rate provided by the public sector, as by Graph 2.

Graph 2 - Rate of exchange hedge supplied by the public sector[1/]




1/ As of December, 2002 estimated data based on balance of payment flows.

While the stock of exchange hedge provided by the public sector declined over the course of the period extending from December 2001 to March 2003, the need for hedge diminished more intensively. As a result, the trajectory of the exchange hedge rate registered slight upward movement, closing at just over 60%. Depreciation of national currency occurred in the second and third quarters of 2002 reduced external liabilities in the modalities recorded in national currency, but expressed in foreign currency. At the same time, it reduced the stock of hedge supplied by the public sector, since this is also recorded in national currency but expressed in foreign currency.

## 5.3 Financial account

**Financial account**

US$ billion

| Itemization | 2002 | | | 2003 | |
|---|---|---|---|---|---|
| | Jan-May | IV Q | Year | Jan-May | Year[1/] |
| Financial account | 4.1 | -1.5 | 8.4 | 2.9 | 4.4 |
| Direct investments | 7.1 | 3.7 | 14.1 | 2.6 | 8.0 |
| Abroad | -0.9 | -0.2 | -2.5 | -0.7 | -2.0 |
| In Brazil | 8.1 | 3.9 | 16.6 | 3.3 | 10.0 |
| Equity capital | 6.7 | 3.3 | 17.1 | 3.1 | 9.4 |
| Intercompany loans | 1.4 | 0.6 | -0.5 | 0.2 | 0.6 |
| Portfolio investments | 2.5 | -2.2 | -5.1 | 2.1 | 3.0 |
| Assets | -0.2 | 0.1 | -0.3 | -0.2 | 0.0 |
| Liabilities | 2.7 | -2.3 | -4.8 | 2.4 | 3.0 |
| Derivatives | -0.4 | 0.0 | -0.4 | 0.0 | 0.5 |
| Other investments | -5.2 | -2.9 | -0.2 | -1.8 | -7.1 |
| Assets | -0.5 | -1.0 | -3.2 | -2.9 | -4.5 |
| Liabilities | -4.7 | -1.9 | 3.0 | 1.1 | -2.6 |

1/ Forecast.

In the first five months of the year, the financial account registered net inflows of US$2.9 billion, including net IMF disbursements of US$3.9 billion in the month of March. Net foreign direct investments added up to US$3.3 billion, of which US$3.1 billion took the form of stock participation and US$167 million that of intercompany loans.

Foreign portfolio investments added up to net inflows of US$2.4 billion, while stock investments registered net inflows of US$499 million. Funding operations based on long-term private papers gained ground that had been lost in the past while the net inflow through short-term securities remained stable. The rate of rolling long-term

**BP financing sources**
Selected items

US$ billion

| Itemization | 2002 | | | 2003 | |
|---|---|---|---|---|---|
| | Jan-May | IV Q | Year | Jan-May | Year[1/] |
| Medium and long-term funds | 6.4 | 0.9 | 8.5 | 3.2 | 10.7 |
| Public bonds | 4.1 | 0.0 | 4.1 | 1.3 | 3.1 |
| Private debt securities | 1.4 | 0.2 | 2.1 | 1.0 | 4.9 |
| Direct loans | 0.9 | 0.7 | 2.3 | 0.8 | 2.8 |
| Short-term loans[2/] | 0.1 | -1.1 | -3.0 | 0.1 | 1.5 |
| Short-term securities | -0.5 | -0.2 | -0.8 | 2.2 | 2.5 |
| Roll-over rates[3/] | | | | | |
| Public bonds | 471% | 0% | 198% | n.a. | 86% |
| Private debt securities | 60% | 10% | 31% | 142% | 100% |
| Direct loans | 61% | 69% | 64% | 51% | 75% |

1/ Forecast.
2/ Includes direct loans and trade credits transferred by banks.
3/ Roll-over rate equals the ratio of disbursements to amortizations, excluding amortizations of securities and loans converted into direct investment.

private securities (bonds, notes and commercial papers) came to 142%, or considerably more than the 31% level registered in 2002. The rate of rolling direct loans came to 51%. For the remainder of the year, it is expected that the level achieved up to May will be consolidated, as private papers are fully rolled and growth is achieved in the rolling of direct loans.

Progressive reductions in the current account deficit together with continued net inflows of foreign direct investment, albeit at a level that is still below that achieved in the recent past, have been the major factors responsible for the reduction in balance of payment borrowing requirements. In this context, other factors of importance were the rate at which long-term debt was rolled and net inflows of short-term resources.

In accumulated terms for the year up to May, gross international reserves expanded by US$5.6 billion to US$43.4 billion. Here, the most important operations were those related to the IMF Financial Assistance Program (PAF), with net revenues of US$3.9 billion, based on disbursement of US$4.1 billion and amortizations of US$234 million in the period. Banco Central intervention in the domestic exchange market registered net purchases of US$1.6 billion, particularly involving repurchase lines, with acquisitions of US$1.8 billion. Outlays on the servicing of the foreign debt added up to US$3.1 billion. Of the US$502 million disbursed in operations with international organizations, US$500 million originated in the International Bank for Reconstruction and Development (IBRD), within the PAF framework. The Republic also made a bond issue of US$1 billion at the start of the month of May, with maturity in January 2007. Other operations generated revenues of US$1.7 billion.

At the end of 2003, it is estimated that gross international reserves will total approximately US$39.6 billion. The major elements in this result are operations in the PAF framework, including drawdowns of US$13.4 billion and amortizations of US$12.7 billion. For the

**Uses and sources**

US$ billion

| Itemization | 2002 | | | 2003 | |
|---|---|---|---|---|---|
| | Jan-May | IV Q | Year | Jan-May | Year[1/] |
| Uses | -19.2 | -9.0 | -38.8 | -9.8 | -32.5 |
| Current account | -7.1 | -0.3 | -7.7 | 0.0 | -4.2 |
| Amortizations ML-term[2/] | -12.0 | -8.7 | -31.1 | -9.8 | -28.4 |
| Securities | -4.7 | -3.1 | -11.9 | -2.7 | -9.6 |
| Paid | -3.5 | -2.5 | -9.2 | -3.0 | -9.9 |
| Nationalization debt | 0.0 | 0.0 | -0.3 | 0.0 | 0.0 |
| Refinanced | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| FDI conversions | -1.2 | -0.6 | -2.8 | 0.3 | 0.3 |
| Suppliers' credits | -1.3 | -0.7 | -2.7 | -1.1 | -2.8 |
| Direct loans[3/] | -6.0 | -5.0 | -16.6 | -6.0 | -16.0 |
| Sources | 19.2 | 9.0 | 38.8 | 9.8 | 32.5 |
| Capital account | 0.1 | 0.1 | 0.4 | 0.2 | 0.0 |
| FDI | 8.1 | 3.9 | 16.6 | 3.3 | 10.0 |
| Domestic securities[4/] | 2.3 | 0.8 | 1.8 | 0.5 | 2.1 |
| ML-term disbursements[5/] | 9.4 | 3.4 | 18.6 | 6.6 | 21.9 |
| Securities | 5.5 | 0.2 | 6.2 | 2.3 | 7.9 |
| Supliers' credits | 0.5 | 0.2 | 1.3 | 0.4 | 1.9 |
| Loans[6/] | 3.3 | 3.0 | 11.1 | 3.9 | 12.0 |
| Brazilian assets abroad | -1.3 | -0.9 | -5.1 | -3.5 | -5.5 |
| Loans to Bacen | -4.3 | 3.0 | 11.5 | 3.9 | 0.8 |
| Other[7/] | 1.5 | -3.1 | -4.6 | 2.7 | 3.5 |
| Reserve assets | 3.3 | 1.8 | -0.3 | -4.0 | -0.3 |

1/ Forecast.
2/ Registers amortization of medium and long term supliers' credit, loans and securities placed abroad minus refinancing and discounts. Excludes amortizations referring to loans to Banco Central and intercompany loans.
3/ Registers amortizations loans borrowed from foreign banks, buyers, agencies and multilateral organizations.
4/ Includes foreign investment in equity and debt securities traded in the domestic market.
5/ Excludes intercompany loans disbursements.
6/ Includes multilateral and bilateral financing and buyers' credits.
7/ Registers net values of bond swaps, short-term securities, short-term trade credit, financial derivatives, nonresident deposits, other liabilites and errors & omissions.

year as a whole, payments of external debt service are projected at US$7.2 billion; disbursements from international organizations should come to US$2.6 billion; bond of the Republic issues will total US$3 billion; revenues on interventions in the domestic exchange market are estimated at US$1.6 billion; and other revenues are estimated at US$1.1 billion. Net reserves, which are compatible with the concept stated in the agreement with the IMF, are expected to increase from US$14.2 billion in 2002 to US$14 billion in 2003, thus remaining US$9 billion above the lower parameter defined by the Technical Memorandum of Understanding (TMOU) formalized in September 2002.

## 5.4 Conclusion

In the first five months of 2003, balance of payments financing conditions improved sharply when compared to the final quarter of 2002. The current accounts result reflected a sharp decline in the deficit, with foreign direct investments corresponding to more than 300% of these borrowing requirements. Since there were no significant alterations in projections of net flows of services and income, the surplus performance of the balance of trade and net inflows of foreign direct investments are expected to be sufficient to finance current accounts with considerable leeway. Aside from this, renewed inflows of external resources will certainly facilitate the rolling of direct loans and other papers and should result in reduced demand for foreign currency resources.

**Statement of international reserves**

US$ billion

| Itemization | 2002 Jan-May | 2002 IV Q | 2002 Year | 2003 Jan-May | 2003 Year[1/] |
|---|---|---|---|---|---|
| Reserves position in previous period | 35.9 | 38.4 | 35.9 | 37.8 | 37.8 |
| Net Banco Central interventions | - | -3.3 | -9.1 | 1.6 | 1.6 |
| Spot and export lines | - | -2.6 | -7.3 | -0.2 | -0.2 |
| Repurchase lines | - | -0.6 | -1.8 | 1.8 | 1.8 |
| Debt servicing (net) | -2.8 | -1.8 | -7.1 | -3.1 | -7.2 |
| Interest | -1.7 | -0.9 | -3.5 | -1.5 | -2.3 |
| Credit | 0.6 | 0.4 | 1.6 | 0.8 | 1.8 |
| Debit | -2.2 | -1.3 | -5.1 | -2.2 | -4.1 |
| Amortization | -1.2 | -0.9 | -3.6 | -1.6 | -4.9 |
| Disbursements | 3.9 | 0.2 | 5.3 | 1.5 | 5.6 |
| Multilateral organizations | - | 0.2 | 1.3 | 0.5 | 2.6 |
| Sovereign bonds | 3.9 | - | 3.9 | 1.0 | 3.0 |
| Exceptional financing (IMF) | -4.3 | 3.0 | 11.5 | 3.9 | 0.8 |
| Disbursement | - | 3.1 | 16.0 | 4.1 | 13.4 |
| Amortization | -4.3 | -0.1 | -4.6 | -0.2 | -12.7 |
| Others[2/] | 0.2 | 1.3 | 1.4 | 1.7 | 1.1 |
| Change in assets | -3.0 | -0.6 | 2.0 | 5.5 | 1.8 |
| Gross reserves position | 32.9 | 37.8 | 37.8 | 43.4 | 39.6 |
| Net reserves position - Arrangement with IMF[3/] | 28.7 | 14.2 | 14.2 | 14.2 | 14.0 |

1/ Forecast.
2/ Includes pre-payment to Poland in November 2001. Includes payments/receipts in the framework of the Reciprocal Credit Agreement (CCR), fluctuations in prices of securities, exchange parities and price of gold, discounts and premiums, duty fees and release of collaterals.
3/ In order to comply with the performance criterion, in the framework of the International Monetary Fund Arrangement, the calculation parameters for the net adjusted reserves - as defined in the Technical Memorandum of Understanding (TMU) of the third review of the Stand-By Arrangement - should be observed. In this case, the net adjusted reserves denominated in US$ take into account the parities set on dates established by the TMU to figure out the assets denominated in currencies unlike the US$, including the special drawing rights (SDR). The same methodology is applied in the case of the gold price. Also, pursuant the TMU, the outstanding debt with the IMF should be excluded from the reserve assets (international liquidity concept), as well as the deposits in banks domiciled abroad, though headquartered in the country, and the securities issued by residents that surpass altogether US$1,023 million.The exceeding value as of May 2003 was US$3,244 million.

# 6 – Inflation outlook

This chapter of the Inflation Report presents the Monetary Policy Committee's (Copom) assessment of the recent evolution of inflation and the prospects for inflation through 2004. The projections presented herein are based on the assumption that the basic interest rate will remain unchanged during the period under analysis at 26% a year, which is the rate set by the Copom at its last meeting, held on June 17 and 18, and that the exchange rate will remain unchanged at a level close to the one registered on the eve of the meeting (R$2.85). It is important to note that these procedures are strictly technical. Hence, these assumptions should not be taken as forecasts of the future interest rate or exchange rate path.

The inflation and GDP growth forecasts presented in this Report are not meant to be restricted to point estimates. They are projected within probability intervals, reflecting the degree of uncertainty when setting the basic interest rate. Inflation forecasts are based not only on the interest rate assumption, but also on a set of assumptions concerning the behavior of relevant exogenous variables, namely, those that cannot be directly controlled by the Central Bank. The set of assumptions believed by the Copom to be the most likely make up the baseline scenario. This report also presents an alternative scenario based on the path of the interest rate and of the exchange rate expected by analysts according to information provided to the Central Bank collected in a survey coordinated by its Investor Relations Group (Gerin). The Copom's forecasts presented in this Report are intended to enhance monetary policy transparency and its effectiveness in controlling inflation, which is its main objective.

## 6.1 Determinants of inflation

Inflation has been on a downward path throughout this year. Three basic factors explain this recent behavior. First, the still high inflation rates registered early this year were caused by the delayed effects on prices of the marked exchange rate depreciation observed last year, and by an increase in the degree of inflation persistence, with a higher percentage of agents raising prices and salaries based on past inflation. Second, monetary policy has reduced inflation expectations and inflationary pressures by controlling the level of aggregate demand. Third, the recent exchange rate appreciation reduced pressures on corporate costs and wholesale prices. Although tradable goods prices are still showing some resistance to reflect all of the effects of the recent exchange rate appreciation, consumer prices stabilizing without pressures for new adjustments.

One factor that contributed to the high inflation in the first quarter of the year was the increase in inflationary persistence. Higher inflation persistence means that the share of price adjustments based on the inflation rate accumulated over the previous 12-month period increased and that the share of prices adjustmented based on future inflation decreased.

As a result of this greater persistence, monthly inflation has been dropping at a lower than expected speed since the peak of 3% observed in November 2002. IPCA inflation only dropped below 1% in April, and subsequently declined further to 0.61% in May. Similar behavior has been observed in market prices, with market price inflation dropping slowly from 2.5% in November to 0.5% in May.

Higher inflation persistence derived from large price readjustments aimed at recovering profit margins in the initial months of the year. This behavior led to a strong drop in sales in a scenario of lower demand and a monetary policy committed to preventing price readjustments that could perpetuate inflation at high levels.

Regulated prices have also contributed to higher-than-expected inflation in the initial months of the year. Regulated price inflation accumulated over the three-month period ending in May was 3.1%, 0.4 p.p. above market price inflation. In the first five months of the year, managed prices accumulated inflation of 10%, against the 5.6% inflation of market prices. Electricity rates and urban bus fares account for half of the inflation of managed prices registered during this period. Even after the recent drop in consumer prices, the price of gasoline still accounts for 12% of the inflation of managed prices accumulated in the year to May.

With respect to the level of economic activity, it should be stressed that the deceleration mentioned in the last Inflation Report continues. It is important to highlight that the economic growth registered in different sectors of the economy has been asymmetrical. Positive monthly growth rates have been observed in export-oriented and agriculture/livestock sectors – albeit at a decreasing pace in the case of exporters – while a continued deceleration has been registered in the remaining sectors of the economy.

At the aggregate level, industrial production has been marked by stagnation when its data are adjusted to eliminate statistical distortions derived from the occurrence of holidays in past months. In April, seasonally adjusted manufacturing output dropped slightly. For the second quarter, leading indicators of economic activity continue to point to a deceleration.

Gross Domestic Product also remained stable in the first quarter of 2003, as compared to the previous quarter. However, the behavior of the different sectors of the economy was heterogeneous. While the service sector was stable and the industrial sector contracted 2.2%, the agricultural and livestock sector posted positive growth of 3.7%. Real GDP growth is expected to reach 1.5% – 1.8% in 2003. This lower projection in relation to the last Report is due to the incorporation into the forecast of the results for first quarter GDP growth and leading and coincident indicators, such as industrial production, for the second and third quarters.

Regarding aggregate supply, the asymmetry in sectoral installed capacity utilization observed in the March Report remains the same. According to the Getulio Vargas Foundation (FGV), only three of the manufacturing sector's 21 products posted utilization rates above the level of 90% in

April, namely, metallurgical products, paper and cardboard, and rubber, which are in sectors that are more export-oriented. For export-oriented sectors, the main determinant of prices is the international price converted into reais. As a result of lower world demand, of the recent appreciation of the exchange rate, and of intentions to invest in installed capacity, no pressures for additional price adjustments in these sectors are expected. In the remaining sectors of the economy, the use of the installed capacity is low and, consequently, no pressure on prices has been observed in them.

From the standpoint of the demand, the contribution of the foreign trade sector to economic growth in 2003 is expected to continue to be positive, albeit at a lower level as compared to 2002. Data on the national accounts released by the IBGE (Brazilian Institute for Geography and Statistics) suggest that in the first quarter of 2003 exports have not contributed to the growth of aggregate demand as much as they did in the previous quarter. However, the external adjustment is still under way. Export continue to grow, while the trade surplus, which totaled $8 billion in the year up to May, continues to rise. The trade surplus estimated for 2003 was raised to US$ 17.5 billion, representing an increase of US$4.4 billion in relation to 2002. Therefore, the trade balance has been playing an important role in boosting economic activity. However, it should be highlighted that even if the trade surplus posts a much larger increase in 2003 compared to 2002, the marginal contribution to economic growth will be lower, given the lower growth rates of exports in the second half of 2003.

In May, the 12-month current account deficit dropped to 0.1% of GDP from 1.7% of GDP in December 2002 and 4.6% of GDP in December 2001. At the same time, the performance of capital inflows continues to be positive in relation to roll-over rates and to the tenors of new issues.

According to the IBGE, aggregate investment dropped in the first quarter of 2003 in relation to the previous quarter. In 2003, investment spending will continue to play a limited role in sustaining economic growth. However, some investment indicators may increase in the coming quarters as a result of high capacity utilization and a larger number of orders in export-oriented sectors.

Government spending continues to be determined by concerns regarding the medium and long-term path of the net debt. The 12-month consolidated public sector primary surplus hit the mark of 4.5% of GDP in April of this year, a figure that illustrates the fiscal effort being made by the government, as a result of which the target of 4.25% of GDP in 2003 is expected to be met.

Consumption contributed to the deceleration of economic growth in the first four months of 2003. According to the IBGE, the volume of retail sales in Brazil fell by 11.3% in March and by 6.0% in the first quarter compared to the same periods last year. The behavior of the credit market and of real incomes contributed to this decline.

Conditions in the market for bank credit are still restrictive (see the *Box* on Banking Spreads). The average banking spread has leveled out at the highest level of the past four years, driven in particular by the 5.5 p.p. increase in the spread on credits to individuals between the end of 2002 and May 2003. The financial system's total outstanding credit increased slightly this year.

Aggregate worker income fell over the first quarter, although the salaries of important categories of workers were increased in line with high rates of past inflation. Although these salary adjustments were more concentrated in sectors related to tradable goods, which benefited from adjustments in relative prices last year, salary adjustments in certain sectors traditionally oriented to the domestic market, such as civil construction, may bring about pressures to restore the purchasing power of salaries this year. At present it is important to remain on alert to avoid the return of a wage-price spiral, which could lead to a return of informal indexation mechanisms in the economy.

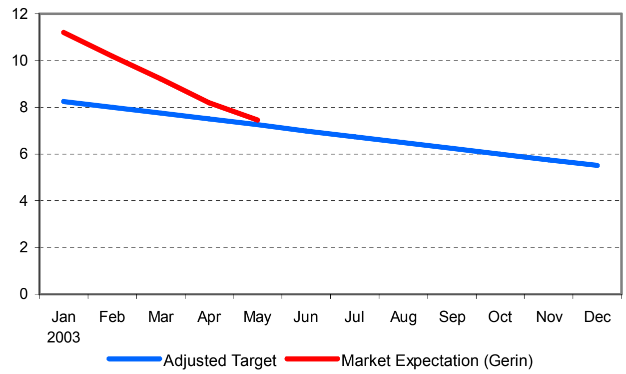
Finally, the recent exchange rate appreciation impacted consumer and wholesale price indices differently. In the wholesale market, inflation as measured by the IPAs and IGPs dropped so sharply that outright deflation was observed in May. The inflation rate for consumers, in turn, dropped more slowly to reach 6.8% over the first five months of the year and 17.2% over the 12-month period ending in May. The main source of this asymmetry is the degree and speed of the passthrough of the depreciation/appreciation of the exchange rate to prices. Due to the higher weight of tradable items in the composition of wholesale price indices and the collection method used, these indices absorbed the exchange rate depreciation registered last year more rapidly and have likewise responded more intensely and immediately to the recent exchange rate appreciation. The impact of the change in the exchange rate on the consumer price index is in turn less intense and marked by a larger time gap, since the cost changes associated with the exchange rate affect wholesale costs before retail costs. The slower effect of the recent exchange rate appreciation on consumer price indices might have been caused by the higher persistence of inflation and by the caution exercised by corporations before adjusting their prices under the risk that the exchange rate appreciation could be temporary.

In sum, as a result of three factors – control of aggregate demand, inflationary persistence, and exchange rate appreciation – the rate of inflation slowed consistently in recent months, albeit at a slower than desired pace. Analysis of core inflation and market expectations is an important tool in evaluating the prospects for future inflation.

Core inflation continues to decline. Excluding managed prices, core inflation was 0.53% in May, compared to 0.87% in April. The behavior of core inflation calculated with the exclusion of managed and household food prices were similar, as it dropped from 0.81% to 0.56% between April and May. In May, core inflation calculated by the trimmed mean methodology increased 1.0%, as compared to 1.1% in April. According to the trimmed mean methodology, adjustments in the prices of certain items that tend to be concentrated in a few short periods of the year are smoothed over time so they are not systematically excluded from core inflation. When there are shocks concentrated in a recent period, core inflation tends to be contaminated by this past pressure and to show some resistance to any downward trend. If core inflation is estimated without this smoothing effect, a deceleration can also be observed and the figures become somewhat lower: 0.86% and 0.64% in April and May. Another way to measure the trimmed mean core and to preserve the smoothing but avoid the contagion caused by the exchange rate shock would be to replace the smoothed values in the current period by those observed over the past 12 months. Based on this criterion, core inflation would be 0.85% and 0.76% in April and May.

Expected inflation (IPCA) for 2003 is beginning to drop, as indicated by the survey of economic analysts carried out by the Central Bank of Brazil's Investor Relations Group (Gerin). Since the Copom meeting in April, the median of expectations dropped from 12.5% to 11.5% on June 23. On that date, the inflation expected by analysts for the 12-month period ending in June 2004 was 7.4%, a much lower figure than the 11.0% rate observed early in March.

**Accumulated IPCA-inflation in the 12-months ahead**




The graph at left shows the evolution of market expectations and the path of the inflation targets, both for 12-month ahead inflation. Most recently, 12-month ahead inflation expectations stood at 7.4%, which is close to the 12-month ahead inflation target trajectory of 7.2% measured in May 2003.

The 12-month ahead target trajectory measured in June 2003 corresponds to an inflation rate of 7%.

## 6.2 Baseline scenario: assumptions and associated risks

The Copom forecasts are based on a set of assumptions about the behavior of key economic variables. This set of assumptions and respective associated risks are part of the baseline scenario under which the Copom makes monetary policy decisions.

The main risk factors for inflation in the coming quarters are the larger degree of inflationary persistence and the inflation of managed and monitored prices, which is expected to reach its peak in the third quarter of 2003 due to the concentration of price adjustments of fixed telephone services and residential electricity rates in this period. As in previous Reports, the Copom expects the exchange rate to remain constant along the forecast horizon at a rate close to the one observed on the eve of the meeting (R$2.85). In this Report an alternative scenario will be introduced, based on the interest and exchange rate path as projected by market analysts and surveyed by the Investor Relations Group (Gerin). Under this scenario, the assumptions for the exchange rate in the last quarter of 2003 and 2004 are, respectively, R$3.21 and 3.51, and for the interest rate, 21.8% and 16.8%.

For the set of regulated prices in the IPCA, which had a weight of 28.6% in May, an increase of 14.1% is anticipated for 2003. The inflation projected for managed prices in 2003 since the March Report (16.8%) is lower as a result of the exchange rate appreciation that has occurred since the last report and of lower projections for the price readjustments of electricity generators and fixed telephone companies.

The Copom assumes that for 2004, the regulated price inflation will be 8.9%. Except for fixed telephone service rates, an inflation rate of 7.9%, equal to expected IGP inflation, is anticipated for all regulated prices. The March Report projected inflation of 9% for all regulated prices in 2004.

In the baseline scenario, the projection of price adjustments for oil products continues to be based on the methodology used in the last Reports. Thus it considers the gap between domestic prices charged by refineries and international prices converted into reais, as well as the price path projected by the futures markets. Given the exchange rate appreciation and the drop registered in the international price of oil since the last Report, the projection for oil products dropped over the period. In the case of gasoline prices, an inflation rate of 5.3% is projected for 2003, as opposed to the 12.4% inflation projected in the last Report. The price of bottled cooking gas is projected to rise by 2.4% in 2003. The projection for this year incorporates the price readjustments that have occurred to date.

It is assumed that residential electricity rates will rise by 23.4% in 2003. This rise, 13.9% of which has already occurred in the first five months of the year, incorporates the public lighting tax charged in various Brazilian capitals, which was captured in the May IPCA. In relation to the March Report, the price adjustment projected for electricity rates in 2003 dropped by 4.1 p.p. as a result of the tariff review and of the exchange rate appreciation observed since then. The tariff review is a procedure provided for in concession contracts and is supposed to be carried out at four-year intervals, taking into account the evolution of the costs of concessionaires and investments made over the period. For instance, the review carried out on the rates charged by the Eletropaulo Company, which the regulatory agency Aneel has already announced, resulted in an increase of 9.6%, which will come into effect July 4. As for the exchange rate, it can affect price adjustments both directly and indirectly, through its impact on the IGPs.

Fixed telephone rates are expected to rise by around 20% in 2003, with the increases concentrated in July. This projection is 2 p.p. lower than the one used in the forecasts made in the March Report.

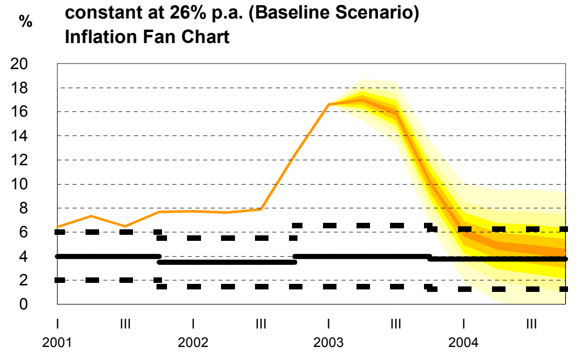
The spread between the six-month rate and the Selic rate, as calculated according to a new specification of the VAR model using the Selic rate and swap in levels as variables, and supposing that the Selic rate will remain at 26% a year, was projected to hit the mark of -100 basis points in the third quarter of 2003, based on the level registered on the eve of the Copom meeting, and to rise gradually to 50 basis points at the end of 2004.

As in the March Report, no factors that could restrict the growth of aggregate supply have been identified. For agriculture/livestock products, the Copom maintained the underlying assumption made in the last Reports that their prices will evolve in line with market price inflation up to the end of 2004.

Regarding fiscal policy, it is assumed that the target of 4.25% of GDP set for the primary surplus of the consolidated public sector in 2003 and in the two following years will be achieved.

# 6.3 Inflation forecast

**Forecasted 12-month IPCA-inflation with Selic interest rate constant at 26% p.a. (Baseline Scenario)**
**Inflation Fan Chart**




Accumulated inflation in 12 months (% p.a.).

**12-month IPCA-inflation with 26% p.a. fixed interes rate. (Baseline Scenário)**

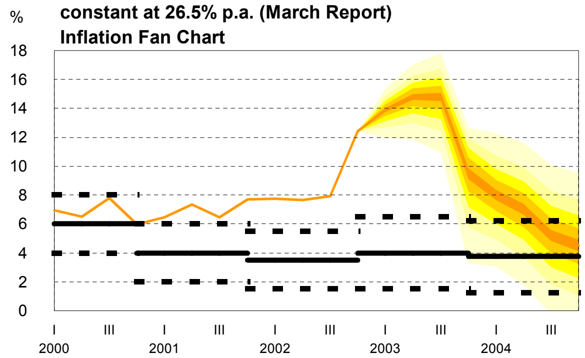
| Year | Q | Confidence Intervals | | | | | | Central |
|---|---|---|---|---|---|---|---|---|
| | | 50% | | | | | | |
| | | | 30% | | | | | |
| | | | | 10% | | | | Projection |
| 2003 | 2 | 16.3 | 16.6 | 16.9 | 17.1 | 17.4 | 17.7 | 17.0 |
| 2003 | 3 | 14.8 | 15.3 | 15.7 | 16.1 | 16.5 | 17.0 | 15.9 |
| 2003 | 4 | 8.7 | 9.3 | 9.9 | 10.4 | 11.0 | 11.6 | 10.2 |
| 2004 | 1 | 4.2 | 5.0 | 5.6 | 6.2 | 6.9 | 7.6 | 5.9 |
| 2004 | 2 | 2.9 | 3.8 | 4.5 | 5.2 | 5.9 | 6.7 | 4.8 |
| 2004 | 3 | 2.5 | 3.4 | 4.2 | 5.0 | 5.7 | 6.6 | 4.6 |
| 2004 | 4 | 2.1 | 3.0 | 3.8 | 4.6 | 5.4 | 6.3 | 4.2 |

Accumulated inflation in 12 months (% p.a.). The values correspond to the ones shown in the inflation fan chart.

Based on the assumptions and associated risks considered by the Copom and on all the information currently available, 12-month IPCA inflation was projected using a basic interest rate of 26% a year, as set at the meeting held on 17–18 June 2003, and an exchange rate close to the one observed on the eve of the Copom meeting (R$ 2.85). Inflation forecasts based on market expectations for the Selic rate and the exchange through the forecast horizon are also presented.

The central path expected for 12-month inflation reaches a peak of 17% in the second quarter of 2003 and drops continually thereafter. Inflation rates of 10.2% and 4.2% have been projected for 2003 and 2004, respectively. Two sharp drops in the inflation path are anticipated: the first one in the third and fourth quarters of 2003, when inflation is expected to drop from 15.9% to 10.2%, and the second one between the fourth quarter of 2003 and the first quarter of 2004, when accumulated inflation is expected to fall from 10.2% to 5.9%. These drops reflect the fact that the high inflation rates registered in the fourth quarter of 2002 (6.6%) and in the first quarter of 2003 (5.1%) were replaced by much lower forecasted inflation rates, namely, 1.3% and 1.1% per quarter, in the respective periods in 2003 and 2004.

**Forecasted 12-month IPCA-inflation with Selic interest rate constant at 26.5% p.a. (March Report)**
**Inflation Fan Chart**

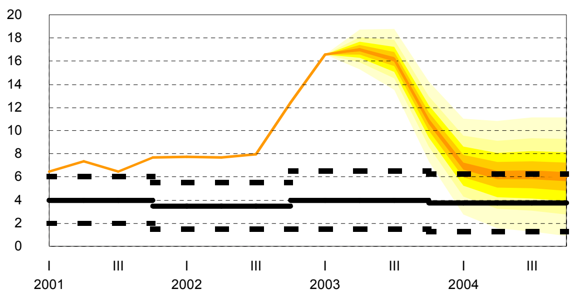



Accumulated inflation in 12 months (% p.a.).

The format of the path presented in this Report is similar to the one shown in the March 2003 Report. In March, inflation was forecasted at 10.8% in 2003 4.1% in 2004. The new lower projection for 2003 resulted mainly from a new projection for regulated price inflation in the third quarter, which dropped from 6.1% to 2.9%, contributing to the drop of 0.9 p.p. in the projected IPCA. This reduction is due to the review of the rates charged by electricity concessionaires and by fixed telephone companies, and to the direct and indirect effects of the exchange rate appreciation through its impact on IGP inflation and the drop in the prices of oil products. The inflation projected for market prices in 2003 has remained practically unchanged at 8.6%, while the projection for the second quarter is expected to drop by about 0.1 p.p. in relation to the March projection and the projection for the last quarter is expected to rise by about 0.2 p.p. from the projection in the last Report. These reviews are justified by the exchange rate appreciation and by the delayed effects of the drop of 0.5 p.p. in interest rates, respectively.

The current projection for 2004 is 0.1 p.p. above the one made in March due to the higher estimate for market price inflation, which increased from 2.2% to 2.4%. For regulated prices, the projection remained almost stable, changing from 9.0% to 8.9%.

**Forecasted 12-month IPCA-inflation with market expected interest and exchange rates.** [1]
**Inflation Fan Chart**




Accumulated inflation in 12 months (% p.a.).
1 - Gerin - 06/17/2003

**12-month IPCA-inflation with market expected interest and exchange rates.**[1]

| Year | Q | Confidence Intervals 50% | 30% | 10% | | | | Central Projection |
|---|---|---|---|---|---|---|---|---|
| 2003 | 2 | 16.3 | 16.6 | 16.9 | 17.1 | 17.4 | 17.7 | 17.0 |
| 2003 | 3 | 15.1 | 15.6 | 16.0 | 16.4 | 16.8 | 17.2 | 16.2 |
| 2003 | 4 | 9.4 | 10.0 | 10.5 | 11.1 | 11.6 | 12.2 | 10.8 |
| 2004 | 1 | 5.2 | 6.0 | 6.6 | 7.2 | 7.9 | 8.6 | 6.9 |
| 2004 | 2 | 4.3 | 5.1 | 5.8 | 6.5 | 7.3 | 8.1 | 6.2 |
| 2004 | 3 | 4.2 | 5.0 | 5.8 | 6.6 | 7.4 | 8.2 | 6.2 |
| 2004 | 4 | 3.9 | 4.8 | 5.6 | 6.4 | 7.2 | 8.1 | 6.0 |

Accumulated inflation in 12 months (% p.a.). The values correspond to the ones shown in the inflation fan chart.

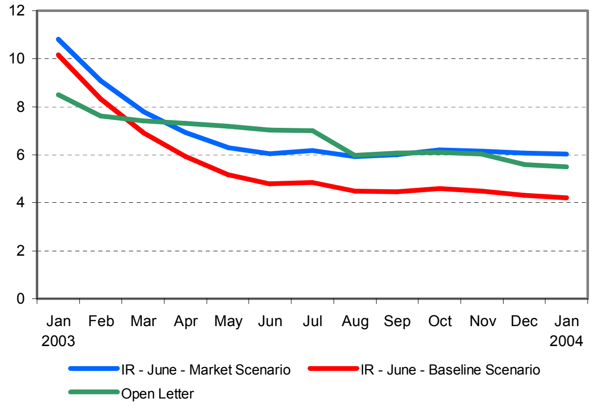
1 - Gerin 06/17/2003

An inflation fan chart with projections that incorporate the median market expectations for the exchange rate and Selic rate on the eve of the Copom meeting is also presented. In this scenario, the figures for the last quarter of 2003 and 2004 are R$3.21 and R$3.51 for the exchange rate and 21.8% and 16.8% for the Selic rate. The remaining assumptions are the same as those spelled out in the baseline scenario. Because of the exchange rate depreciation and lower interest rates, this scenario projects higher inflation rates: 10.8% in 2003 and 6.0% in 2004.

The inflation path outlined in the Open Letter of 01.21.2003 did not constitute an inflation forecast, but rather a path consistent with the adjusted inflation targets, based on the assumption of regulated price inflation of 14% in 2003. In the current baseline scenario, regulated price inflation in 2003 is very close to that figure, namely, 14.1%.

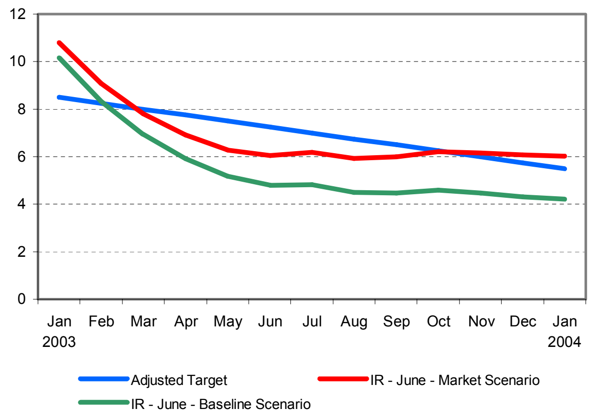
The inflation projected for 2003 is above the adjusted target of 8.5%, but its path has been in line with the forecast made in the March Report, according to which inflation would begin to fall in the second quarter of the year to levels consistent with those indicated in the Open Letter sent by the Governor of the Central Bank of Brazil to the minister of Finance on 01.21.2003.

**Accumulated IPCA-inflation in the 12-months ahead**




The graph at left shows the evolution of 12-month ahead inflation[1] contained in the Open Letter of 01.21.2003 and in the baseline scenario of this Report. As can be seen, the projections associated with the baseline scenario of this Report have been systematically below those published in the Open Letter since March. This behavior is qualitatively the same as that observed in the March Report. As for the projection using market expectations of the interest rate and exchange rate, they are around the path shown in the Open Letter.

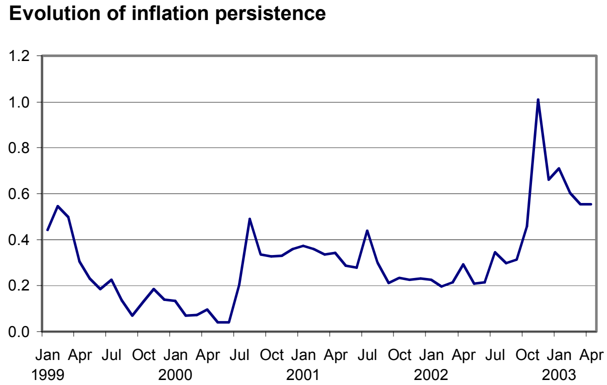
**Accumulated IPCA-inflation in the 12-months ahead**




The graph at left shows once more the baseline projection and that of the market, compared to the path of the adjusted targets. It should be noted that the market projection is lower than the targets throughout most of the period, but ends 2004 slightly above the target, while the projection in the baseline scenario is consistently below the adjusted target after March 2003. The reason for the difference is the baseline scenario's use of a constant interest rate (at 26%).

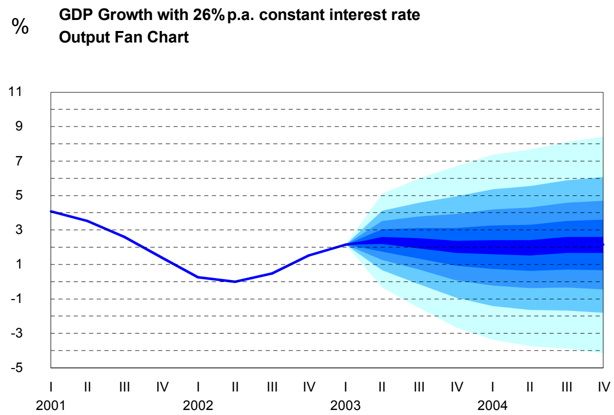
There are still considerable risks involved in consolidating this path, particularly with respect to the speed of the rediction in inflation. However, the behavior of the inflation rate in the second quarter suggests that these risks have decreased since the last Report.

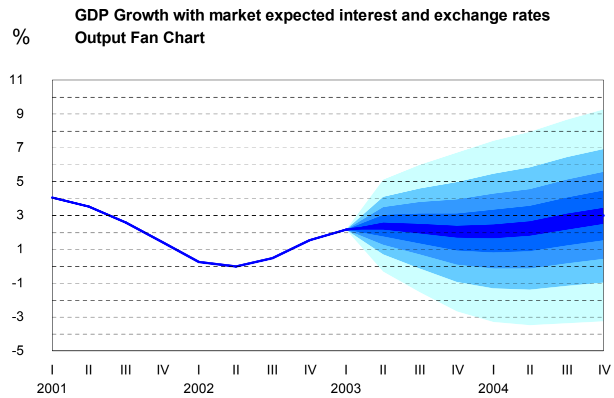
[1] For 2004, an option was made to present the annualized inflation accumulated up to the end of the year instead of using the inflation forecasts for 2005. This procedure is justified by the high degree of uncertainty involved in projecting inflation for 2005, particularly with respect to the evolution of managed prices.




With respect to inflationary persistence, there is more evidence that it has not permanently diverged from historical levels. Persistence can be measured by the coefficient of inflation over the period through the Phillips curve. The graph at left shows the evolution of the degree of persistence since 1999 estimated through models that utilize monthly data. As shown in the graph, there was a significant increase in November 2002, at the same time that inflation rose. Since then, the degree of persistence has been dropping, although it is still above the figures that prevailed up to the third quarter of last year.

The Copom constantly assesses the degree of inflation persistence in the economy. This has been done in part by comparing the model that is currently utilized to forecast inflation with another specification that incorporates a higher degree of persistence. It has been noticed that the model that is currently used more accurately forecasted May inflation, which is the first indication that the degree of inflation persistence can return to the historical average. As a result, the scenarios presented in this report utilized the standard specification for persistence.



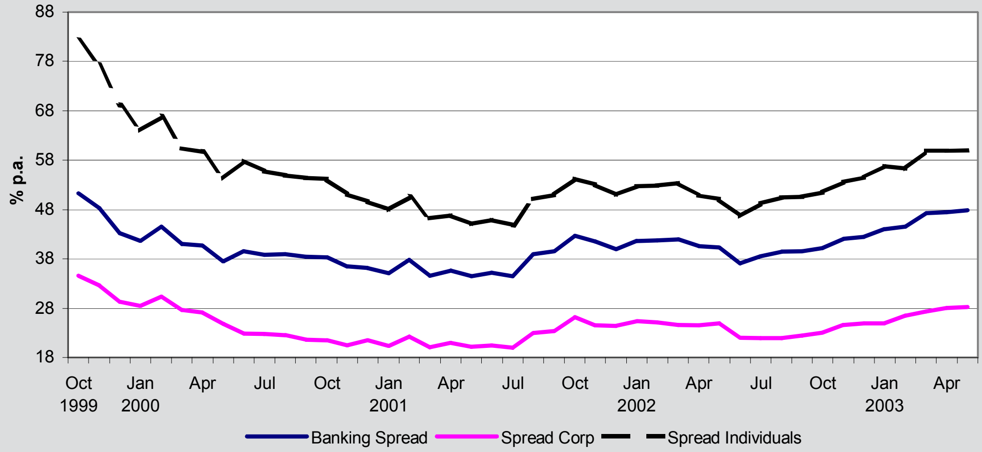

As in previous Reports, a fan chart for output growth based on market expectations for the paths of the exchange rate and the Selic rate is shown. It should be stressed that the forecasting errors associated with GDP growth projections are considerably larger than in the case of inflation projections both because GDP growth projections involve the trajectory of two non-directly observable components, namely, potential output and the output gap, and because calculating output is, by definition, a more complex and less precise task than calculating the inflation rate. According to the baseline scenario, which assumes that the basic interest rate will remain at 26% until the end of 2004, the projected growth in 2003 is 1.5%. The central projection for GDP growth with the exchange and interest rates projected by the market and collected by Gerin is around 1.8%.

## Banking Spreads – Recent Evolution

The behavior of banking spreads, which are defined as the difference between lending and borrowing rates, have attracted the attention of the Central Bank since it launched its "Interest Rates and Banking Spreads" project in October 1999. As part of this project, the authorities adopted a number of measures with the aim of forcing banking spreads down by enhancing the competition between financial institutions, stimulating the credit market, reducing the fiscal wedge, etc. One should recognize, however, that much still remains to be done in order to foster the development of the credit market in Brazil.

Figure 1 illustrates the behavior of banking spreads both for individual borrowers and corporations since October 1999.

**Figure 1: Banking Spread - % p.a.**




The figure shows that banking spreads stopped dropping in mid-2001 and began to rise again as of mid-2002 after a somewhat lethargic period.

The purpose of this note is to suggest that the higher spreads registered recently are related to cyclical factors reflecting the more pessimistic economic expectations observed in the second half of 2002 rather than to structural factors. In other words, the note aims to draw a distinction between the permanent or structural components of banking spreads and the cyclical or short-term components. In relation to the former, studies carried out by the Central Bank indicate that certain factors associated with the fiscal wedge, bankruptcy rates, the quality of bank guarantees, and the availability of effective means to recover or renegotiate overdue debts are important determinants of banking spreads.

A simple way to carry out the decomposition mentioned above is to make an approximate calculation of the permanent component using the Hodrick-Prescott (HP) filter. Using this methodology, the cyclical component can be identified as the difference between the original series and the trend component.

The application of this method to the series of banking spreads for individuals and corporations generated the results shown in figures 2 and 3, respectively.[1]

**Figure 2: Spread for Individuals: Trend and Cycle**

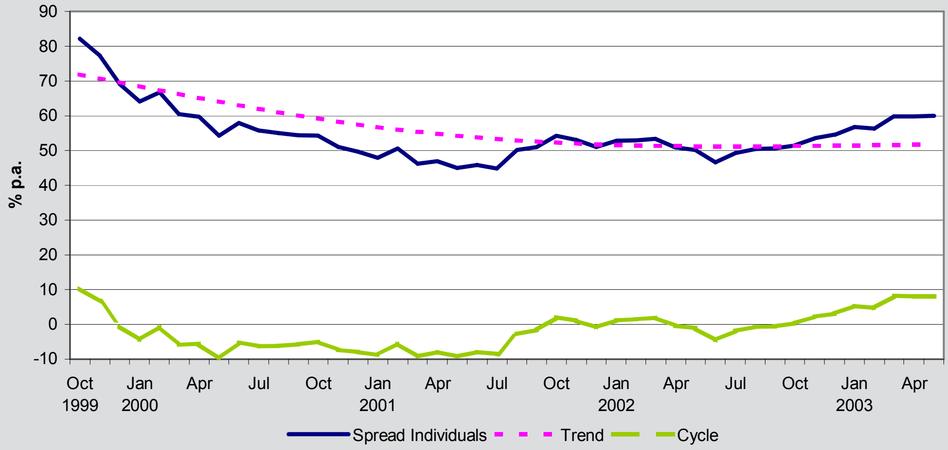
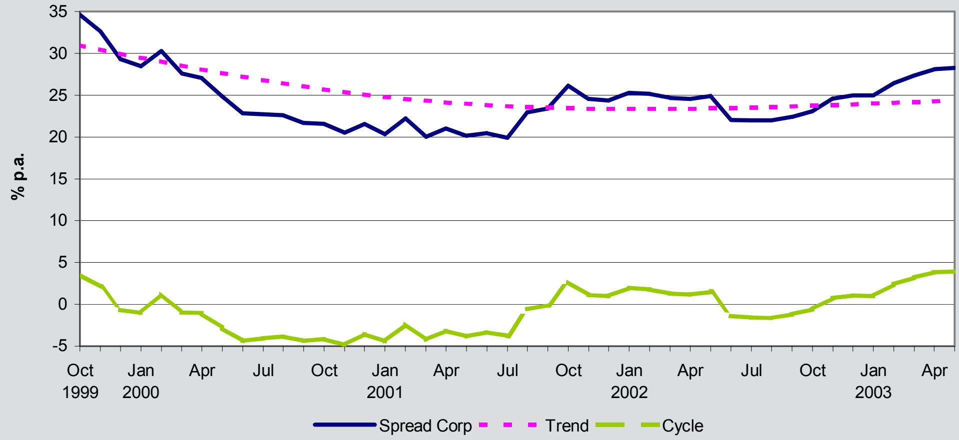



**Figure 3: Spread for Corporations: Trend and Cycle**




1 The HP filter was applied to the monthly observations made from January 1995 to April 2003.

The decomposition that was carried out suggests that the recently observed rise in banking spreads for both individuals and corporations was basically caused by cyclical factors and not by permanent factors. For lending to individuals, the total spread went up from 46.6% a year in June 2002 to 60% a year in May 2003, representing a rise of 13.4 percentage points. Over this period, the trend component of the spread for individuals rose only slightly from 51.3% a year in April 2002 to 51.9% a year in May 2003, while the cyclical component increased by 12.7 percentage points. For corporations, the total spread rose from 22% a year in August 2002 to 28.3% a year in May 2003, representing a rise of 6.3 percentage points. Over this period, the trend component of the spread for corporations went up from 23.4% a year to 24.4%, while the cyclical component rose by 5.5 percentage points.

In order to characterize the factors responsible for the changes observed in the cyclical components of banking spreads more precisely, correlation coefficients between these variables and the cyclical components of some relevant economic variables were calculated both for contemporary observations and for observations with lags. Tables 1 and 2 summarize the results obtained for banking spreads applied to individuals and to corporations, respectively.[2]

The first observation worth stressing is the high correlation between banking spreads and variables such as the Selic rate, industrial output, and reserve requirements. Other variables, such as inflation, do not have a high correlation with banking spreads.

Table 1: Correlation between cyclic spread for individuals and other variables

| | t | t-1 | t-2 | t-3 | t-4 | t-5 | t-6 |
|---|---|---|---|---|---|---|---|
| **Selic** | 0.611 | 0.662 | 0.691 | 0.677 | 0.627 | 0.622 | 0.545 |
| **Inflation** | 0.024 | 0.079 | 0.148 | 0.173 | 0.156 | 0.116 | 0.047 |
| **Output** | -0.598 | -0.525 | -0.47 | -0.388 | -0.295 | -0.177 | -0.066 |
| **Bankruptcy** | 0.216 | 0.238 | 0.226 | 0.198 | 0.237 | 0.314 | 0.286 |
| **C Bond** | 0.387 | 0.473 | 0.51 | 0.507 | 0.465 | 0.423 | 0.353 |
| **Compulsory** | 0.629 | 0.695 | 0.702 | 0.707 | 0.7 | 0.65 | 0.599 |

2/ The cyclical components of the economic variables were calculated in the same manner as the cyclical components of banking spreads. The sampling period was January 1995-April 2003. The definition of the variables is as follows: *selic rate* is the one-day Selic rate capitalized and standardized for a month of 21 working days; *inflation* is the monthly change of the IGP-DI; *output* is the logarithm of industrial output without seasonal adjustments calculated by the IBGE, *bankruptcy rate* is the rate of delinquency calculated by the São Paulo Trade Association; *C-Bond* is the spread of the bond in question over a US Treasury bond with an equivalent maturity; reserve requirement is the sum of all deposits banks are required to make with the Central Bank for deposits of their clients as a proportion of the domestic financial system's total deposits.

Table 2: Correlation between cyclic spread for corporations and other variables

| | t | t-1 | t-2 | t-3 | t-4 | t-5 | t-6 |
|---|---|---|---|---|---|---|---|
| **Selic** | 0.688 | 0.738 | 0.703 | 0.677 | 0.609 | 0.545 | 0.441 |
| **Inflation** | -0.012 | 0.04 | 0.116 | 0.148 | 0.166 | 0.15 | 0.067 |
| **Output** | -0.515 | -0.416 | -0.352 | -0.287 | -0.15 | -0.002 | 0.135 |
| **Bankruptcy** | 0.241 | 0.279 | 0.21 | 0.191 | 0.246 | 0.298 | 0.234 |
| **C Bond** | 0.347 | 0.406 | 0.414 | 0.411 | 0.388 | 0.349 | 0.287 |
| **Compulsory** | 0.546 | 0.575 | 0.589 | 0.596 | 0.613 | 0.585 | 0.525 |

The first observation worth stressing is the high correlation between banking spreads and variables such as the Selic rate, industrial output, and reserve requirements. Other variables, such as inflation, do not have a high correlation with banking spreads.

Another important observation is that the higher correlation is not instantly observed for many variables, but rather occurs with some lag. For reserve requirements for example, the most pronounced effect occurs with a gap of 3 months in lending to individuals and 4 months in lending to corporations. This suggests that the current behavior of banking spreads may still be reflecting reactions to the economic environment observed a few months before and not necessarily the current evolution of the economy. This observation is important, because many analysts have been demanding immediate reductions in banking spreads as a result of improvements observed in recent macroeconomic indicators.

Two observations should be made at this point. The first one is that correlation does not indicate causality. That is, no causal inference can be derived from the data presented above. The second one is that the correlations presented here are not partial, that is, they do not control for the effect that other variables may be simultaneously causing on the variables.

.

# Annex

## Minutes of the 82nd Meeting of the Monetary Policy Committee (Copom)

**Date:** March 18th and 19th
**Place:** Central Bank's Headquarters meeting room of the 8th floor (on Mar 18th) and 20th floor (on Mar 19th) – Brasília – DF

**Called to Order:** 4:00 PM on Mar 18th and 11:15 AM on Mar 19th
**Adjourned:** 7:00 PM on Mar 18th and 3:00 PM on Mar 19th

**In attendance:**
**Members of the Committee**
Henrique de Campos Meirelles – Governor
Beny Parnes
Ilan Goldfajn
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Luiz Fernando Figueiredo
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

**Department Heads (all present on March 18th)**
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserve Operations Department
José Antonio Marciano – Department of Banking Operations and Payment System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on March 19th)
Sérgio Goldenstein – Open Market Operations Department

**Other participants (all present on March 18th)**
Antônio Carlos Monteiro – Executive Secretary
Alexandre Pundek Rocha – Advisor to the Board
João dos Reis Borges Muniz – Press Secretary

Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, designed to comply with the inflation targets established by the government.

**Economic activity**

Recently released economic indicators showed some loss of dynamism in industrial activity and the retail sector. Export growth and import substitution continue to support aggregate demand, partially offsetting the contractionary effect of the decrease in real incomes and the worsening in credit conditions.

According to the IBGE, in January, the national retail sales index fell 4.9% compared to January of last year. With respect to the 12-month accumulated index, the decline seen in recent months worsened slightly (1% in January compared to 0.7% at the end of 2002). By sector, *supermarkets, food products, beverage and tobacco* was the segment responsible for most of the decrease in sales for the second consecutive month, reflecting the decline in workers' real incomes due to higher prices of food and cleaning and personal hygiene products.

The Fecomércio–SP survey showed a decline in consumer confidence in March, with the IIC falling to 97.8 from 102.5 in February, reflecting a decrease of 7.7% in current consumer intentions and 3% in future intentions. These declines suggest the reversal of the optimistic sentiment seen immediately after the presidential elections, due to concerns over unemployment, inflation and the international scenario.

Regarding defaults on retail credit, ACSP statistics reveal that the number of new delinquency registrations fell by 2.2% in February as compared to January, but the amount of canceled registrations decreased 7.1%, also compared to January. Thus, the net default rate increased to 6.8% in February from 6.2% in the previous month.

The delinquency rate on non-earmarked bank credits increased 0.2 p.p. in February, to 8.4%. The default rate for individuals and corporate loans reached 15.1% and 4.5%, respectively. The average interest rate on bank credits increased 2.6 p.p. in February to 56.5% p.a.

Total non-earmarked bank credits increased 0.8% in February, reflecting mainly the seasonal growth of operations with individuals, which increased 1.2%. Credits to companies increased

0.5%, with the expansion largely funded domestically. Of note in this area is the growth of ACC operations, which have been favored by the normalization of external bank-to-bank trade lines.

Investment indicators improved slightly in January, after the downward trend observed in the second half of 2002 due to the uncertainties that marked the period. The domestic output of machines and equipment, the volume of capital goods imports and the production of inputs for civil construction increased 5.1%, 16.7% and 0.6%, respectively, compared to December (s.a.).

Industrial output in Brazil increased 0.7% in January compared to the previous month, s.a., according to the IBGE. The rise was the result of a 13.7% increase in mineral extraction, as manufacturing output fell 0.2%. This behavior in the mineral extraction sector was a consequence of the normalization of activities in Brazil's oil and gas fields, after prescheduled maintenance interruptions in the last two months of 2002.

Regarding the evolution of the manufacturing sector, the January result confirms the signs of a slowdown in industrial activity, with the exception of the sectors closely linked to external trade. In fact, industrial sales fell 0.1% in January according to the CNI, the third consecutive monthly fall.

Data for the automobile sector up to February also confirm that exports are contributing strongly to the improvement in the trade balance. Seasonally adjusted data shows that wholesale domestic auto sales declined 2.4% in February and 6.9% in the quarter ended last month, while auto exports increased 0.3% and 23.6%, respectively, in the same periods.

In the labor market, legally registered employment increased 0.2% month-on-month in January, s.a., and 3.5% compared to January 2002, according to the Ministry of Labor. According to the new methodology for the Monthly Employment Survey, the unemployment rate measured by IBGE in the six main metropolitan regions reached 11.2% in January, compared to 10.5% in December. This rise repeated the normal seasonal pattern for January, when there are more unemployed workers seeking for jobs.

With respect to the external accounts, the trade balance posted a US$1.1 billion surplus in February, accumulating a US$2.3 billion surplus in the first two months of 2003. Considering daily averages, exports increased 23% in February and 22.4% in the first two months of the year, compared to the values registered in the same periods of 2002. Imports increased 2.7% in February and decreased 0.5% in the first two months of the year. In the first two weeks of March (8 working days), the trade surplus totaled US$491 million. The expansion of exports resulted mainly from the continuous growth of sales to the US and China, and the recovery of trade with Argentina, in addition to the increase in prices of important export commodities.

Summing up, economic activity lost momentum at the end of 2002 and in the beginning of this year, even though exports have continued to grow. There are signs that domestic demand has weakened due to the drop in real income as a consequence of higher inflation, a trend only partly attenuated by extraordinary disbursements from the FGTS. Additionally, consumer expectations have shown a reversal of the optimism seen during the governmental transition.

**External environment**

The uncertainty regarding the possibility of a military confrontation in Iraq was the major development in the international economic scenario. This environment contributed to volatility in the financial markets. In recent days, with the war coming closer after the US ultimatum, stock prices rose, oil prices declined and the US dollar appreciated, reversing previous trends. Notwithstanding these short-term developments, recent indicators have shown that the main economies are facing difficulties in consolidating their fundamentals, mainly with worsened fiscal accounts and less room to maneuver monetary policy.

In the US, GDP growth decelerated strongly in the last quarter of 2002, falling to 1.4% p.a., according to preliminary data. The US current account deficit increased in the fourth quarter, reaching 5% of GDP in 2002. In February, retail sales fell 1.7% and the unemployment rate rose to 5.8%, with the elimination of 308 thousand jobs. Consumer confidence indicators worsened significantly while those related to business expectations are barely above the indifference level. Inflation measured by the PPI increased 1%, accumulating a 3.5% increase in the 12 months ending in February, under the pressure of the recent increase in fuel prices.

The Euro area continues to grow slowly, led by the weak performance of the German economy. The fiscal deficit in Germany surpassed the limit set by the European Union, which may lead to fiscal tightening. The ECB reduced the basic interest rate by 0.25 p.p. in March, setting it at 2.5% p.a., the lowest level of the last three years. European consumer confidence has been hurt by expectations of war in Iraq and increasing unemployment.

**Prices**

In February, inflation decelerated to its lowest rates since last October. The IPCA increased 1.57% compared to 2.25% in January, accumulating an increase of 3.86% in the first two months of the year and 15.85% in 12 months. The IGP-DI increased 1.59% in February, compared to 2.17% in the previous month, accumulating an increase of 3.8% in the first two months of the year and 30.73% in 12 months.

In the IPCA, inflation in both free market prices and regulated and monitored prices decelerated, posting increases of 1.10% and 2.71%, respectively, compared to 1.64% and 3.83% in the previous month. Among free market prices, the main increases occurred in school fees and perishable food due to seasonal reasons, with both categories rising by 6.5%. Important food products in the consumer basket—soybean oil, rice, meat and chicken—registered price declines of 0.75%, 0.73%, 0.57% and 0.49%, respectively. Among regulated prices, the largest contributions came from the 5.9% increase in urban transport, 3.3% increase in gasoline, 11.8% increase in alcohol-based fuel, and 3.5% increase in telephone fares. It should be highlighted that the price of bottled cooking gas declined by 3.7%.

With respect to the IGP, the IPA sub-index increased 1.71% in February as compared to 2.21% in January, with the deceleration due to the behavior of industrial prices, as agricultural price inflation increased slightly, from 1.16% to 1.20%. This increase reflected the unfavorable contribution of grains and exporting commodities, and higher increases in the prices of legumes and fruits. Industrial prices decelerated broadly, increasing 1.91%, as compared to 2.64% in January. Of the most heavily weighted segments, only the prices of chemical products decelerated less sharply, due to increases in the prices of fuel and lubricants, fertilizers and plastic.

In March, inflation measured by the main price indices will continue to fall although it will remain at high levels compared to the average for this month in previous years. Considering the IPCA, regulated and monitored prices will decelerate strongly, due to the end of the impacts of the recent readjustments. Regarding free market prices, increases in the prices of medicines will be the main source of pressure, while clothing will contribute favorably for seasonal reasons. With respect to wholesale prices, agricultural products will contribute to the reduction of the indices, mainly as the result of lower price increases for grains and some vegetables.

**Money market and open market operations**

In the period after the Copom decision in February, the reduction of country risk, the appreciation of the exchange rate and the deceleration of inflation contributed to consecutive and significant reductions in the slope of the yield curve. On March 18, the eve of this month's Copom meeting, the spreads of the 1-month and 1-year interest rates were 5 b.p. and 57 b.p., respectively.

Securities and FX swaps maturing since the previous meeting were fully rolled over through swaps. The US$1.3 billion maturing on March 5 was rolled over with terms ranging from 3 to 67 months (12.4 months on average). The favorable bid/ask ratio allowed the rollover in a single auction. Of the US$1.9 billion rolled over on March 13, two auctions occurred, with the tenor of the swaps ranging from 2 to 49 months (8.2 months on average). The rollover of securities and FX swaps maturing on April 1 was held in advance, and through an auction on March 14 a total of US$0.8 billion was placed, about 25% of the total to mature. The improvement in country risk and capital inflows contributed to the progressive reduction of the interest rates in these auctions.

The Treasury has resumed the offer of LTNs, which had not occurred since last November. In the period between the February and March meetings, R$2.4 billion were placed, with decreasing rates following the reduction of the yield curve. LFTs were offered four times during this period, with placements totaling R$21.8 billion. The average tenor rose as a result of higher demand for longer-term LFTs, due to the significant reduction in the price discount of shorter tenor securities. A total of R$0.6 billion of NTN-Cs was placed, with tenors of 5, 14 and 18 years. Aiming at reducing the concentration of LFT maturities in upcoming months, the Treasury carried out an auction substituting longer tenor bonds for R$2.1 billion in securities with maturities in the next 1 to 2 months.

The settlement of securities between February 20 to March 19 caused a contractionary monetary impact of R$2.7 billion, due to net placements of R$4.8 billion of LFTs and R$2.4 billion of LTNs, partially offset by net redemptions of FX-indexed securities (R$4.5 billion).

In the same period, the Central Bank intervened in the money market through repo operations ranging from 7 to 30 days, and through daily liquidity management operations with maturities of 2-working days, with the aim of reducing the need for daily interventions and withdrawing excess liquidity through longer-term operations.

**Assessment of inflation trends**

The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypotheses:

1. The projection for the increase in gasoline prices rose to 12.4% from 8.0% for 2003 since the February Copom meeting. Considering the adjustments up to February, this hypothesis assumes the price of gasoline remains stable until the end of the year. An increase of 4.2%

is forecast for the price of bottled cooking gas in 2003, of which 0.7% occurred in the year to February. This forecast is 2.2 p.p. below the previous meeting.

2. As compared to the previous meeting, the forecast rise in household electricity tariffs for 2003 is roughly stable, standing at 27.5% compared to 27.1% in February.

3. For the set of regulated and monitored prices, which had a weight of 28.3% in the February IPCA, an increase of 16.8% is projected for 2003, of which 6.6% has already occurred in the first two months of the year. The increase of 0.9 p.p. compared to the forecast at the February meeting already took place. The forecast for the increase in the regulated prices from March to the end of the year remained practically stable at 9.5%. For 2004, the forecast for the increase in these prices is 9%, practically unaltered since the previous meeting (8.7%).

4. The projection for the 6-month spread over the Selic rate, following a new specification of the VAR model using the variables Selic rate and swap rate in levels, was 70 b.p. in the days before the meeting, rising gradually to 100 b.p. in the beginning of 2004.

Core inflation calculated with the exclusion of household food items and of regulated and monitored prices fell to 1.0% in February, confirming the deceleration trend observed since December, but still higher than the first three quarters of 2002. The 12-month accumulated change was 9.4%. Core inflation calculated under the trimmed-mean method registered a 0.9% increase in February, also decelerating since December (1.4%), but also higher than the first three quarters of 2002. In the last 12 months, the trimmed-mean core increased by 10.1%, as compared to 9.7% in January. Regarding core inflation of the IPC-BR, calculated under the symmetric trimmed-mean method, the rate reached 0.9% in February and 9.9% in 12 months.

The accumulated variation for the IPCA in 12 months increased to 15.8% in February, as compared to 14.5% in January, due to the exclusion of the February 2002 inflation (0.4%) and the inclusion of the February 2003 inflation (1.6%). In the last 12 months, free market prices contributed 9.4 p.p. to inflation, while regulated and monitored prices contributed 6.4 p.p.

Regarding fiscal policy, it is assumed that the primary surplus target for this year (4.25% of the GDP) will be accomplished. The other related assumptions established in the February Copom meeting were maintained.

From the simulation exercises with several specifications of the structural model, it has been concluded that the maintenance of the interest rate in 26.5% p.a. and of the exchange rate at the level prevailing on the eve of the Copom meeting indicates inflation above the adjusted target of 8.5% for 2003.

**Monetary policy guidelines**

Economic activity continues to decelerate, as already diagnosed in the minutes of the February Copom meeting. Manufacturing production fell 0.2% in January. However, mineral extraction grew by 13.7%, due to the normalization of activities in the oil sector, offsetting the decline in manufacturing and resulting in a 0.7% growth for overall industrial production.

Results for the current account, which were roughly balanced in the first two months of the year, point to the consolidation of the external sector adjustment. There are signals of improvement in the capital account, and new issues abroad have been announced, most of which are shorter than 1 year. Rollover rates continue to recover, although they are at a reduced level, which contributed to negative FX flows in the first days of March.

The financial markets improved significantly between the February and March meetings. Sovereign risk fell to 1,067 b.p. from 1,333 b.p. The real appreciated by 5% and the 21-day dollar volatility fell sharply to 12.2% from 20.5% in the same period. Demand for public securities remained high. The Treasury resumed placements of LTNs. Discounts on short term LFTs fell.

There are signs that inflation is falling. Monthly IPCA inflation decreased from the 3.02% peak in November to 2.25% in January and 1.57% in February. The fall of inflation in free market prices is even clearer. Free market price inflation registered a peak of 2.53% in November, and then declined to 2.32% in December and 1.12% in February, the lowest rate since September 2002. The trimmed-mean core, which had been stable at 1.30% since November, fell to 0.93% in February.

In February, regulated and monitored price inflation (2.7%) was 2.4 times higher than free market price inflation. Although they had a weight of 28.3% in the IPCA, these prices were responsible for 48% of the inflation in January and February, and for 41% of the inflation accumulated in the last 12 months. The four items that contributed the most in the set of regulated and monitored prices were alcohol-based fuel (11.8%), urban transport (5.9%), telephone (3.5%) and gasoline (3.3%), due to changes in the administration of the ICMS tax.

After the price adjustments in January and February, the forecast for regulated and monitored price inflation in 2003 increased 0.9 p.p., reaching 16.8%. According to this new forecast, the primary effect of the shock of regulated and monitored prices on overall inflation was revised, implying a 1 p.p. rise in the adjusted inflation target for 2003, according to the methodology described in the Open Letter of the Governor of the Banco Central do Brasil to the Ministry of Finance of January 21, 2003. However, the Copom considers it premature to modify the adjusted target at this time due to the high volatility of international oil prices, and believes it is preferable to wait for more information about the adjustments that could affect regulated prices.

The downward trend for inflation was maintained in some inflation measures that consider the first weeks of March, such as the first estimate for the IGP-M and the four-week Fipe indices. Additionally, price surveys in the first two weeks of March confirm the expectations of a decrease in inflation, especially in the food and beverage, education and transport categories, which produced the largest pressures in February. Notwithstanding these developments, there are some significant ongoing price increases, such as in the prices of perishable food in greater São Paulo, alcohol-based auto fuel, and medicines. Based on price surveys and market expectations, inflation measured by the IPCA in March is expected to be below 1%, the lowest in the last 6 months.

The median of market expectations for the IPCA interrupted the upward trajectory that had been observed for seven consecutive weeks and moved back to 12.33% on the eve of the Copom meeting. This expectation incorporates the results of the two first months of the year, both high and strongly affected by the increases in regulated prices. The median of market expectations for the IPCA accumulated in the next 12 months fell to 9.7% from 10.7% between the February and March meetings. The focus on the forward inflation rate is important, since it highlights the perception of a downward trend. Monetary policy is concerned about the future trajectory of inflation.

Even though the forecast inflation for 2003 in the baseline scenario is above the adjusted target of 8.5%, the outlook for inflation from the second quarter onward, as assessed by the Copom, is positive. First, the Copom considers that monetary policy has been able to bring inflation to a trajectory compatible with the one outlined in the Open Letter to the Ministry of Finance from the second quarter of this year on. Second, it is premature to evaluate the full effect of the monetary policy actions implemented in recent months. Alternative scenarios with inflation trajectories close to the adjusted target for 2003 were also evaluated by the Copom.

As a result, the Copom decided to maintain the target for the Selic rate at 26.5%.

Notwithstanding this decision, the Copom understands that there are considerable risks to the realization of more favorable inflation trajectories, including those associated with external uncertainties due to the war in Iraq. There are doubts about the speed of the disinflation and the degree of inflationary inertia. A slower fall of inflation has a chance of interrupting the convergence of the inflation to its target, since future readjustments of prices and wages may be based on accumulated inflation instead of on current and expected inflation. As a result, the Copom decided to adopt an upward bias.

At the close of the meeting, it was announced that the Committee would meet again on April 22, for technical presentations, and on the following day, in order to discuss the monetary policy guidelines, as established in the Communiqué 10,187, of October 2, 2002.

## Minutes of the 83rd Meeting of the Monetary Policy Committee (Copom)

**Date:** April 22nd, from 3:30PM to 6:30PM, and 23rd, from 11:30AM to 1:30PM
**Place:** Central Bank's Headquarters meeting room of the 8th floor (on Apr 22nd) and 20th floor (on Apr 23rd) – Brasilia – DF

**In attendance:**
**Members of the Committee**
Henrique de Campos Meirelles – Governor
Beny Parnes
Ilan Goldfajn
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

**Department Heads (all present on Apr 22nd)**
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserve Operations Department
Ivan Luis Gonçalves de Oliveira Lima – Open Market Operations Department
José Antonio Marciano – Department of Banking Operations and Payment System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on Apr 23rd)

**Other participants (all present on Apr 22nd)**
Antônio Carlos Monteiro – Executive Secretary
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo – Advisor to the Board
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and prospects for the Brazilian and international economies under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

**Recent evolution of inflation**

Consumer price inflation slowed in March, although by less than expected by the estimates of both the Central Bank and market participants. Monthly inflation remains relatively high. Despite the deceleration in the prices of agricultural products, wholesale inflation increased due to the behavior of industrial goods prices.

The IPCA increased 1.23% in March, as compared to 1.57% in the previous month, accumulating 5.13% in the first quarter of 2003, and 16.57% in 12 months. The deceleration in the monthly rate of IPCA inflation was due to fewer readjustments in urban transportation fares, to the dissipation of the impact of the seasonal readjustments of school fees, to the slight fall of gasoline prices, and to lower inflation in the price of alcohol-based motor fuel, items that have put pressure on the index in February.

Regulated prices increased 1.07% in March, as compared to 2.71% in February. Free market prices increased 1.29% in March as compared to 1.11% in the previous month, mainly due to the acceleration of price increases for food, particularly perishable food, medicines, cleaning and personal hygiene products, and clothing.

The IGP-DI increased 1.66% in March, as compared to 1.59% in February, accumulating 5.52% in the quarter, and 32.75% in 12 months. The upward pressure on the IGP-DI resulted from the behavior of wholesale prices, which increased 1.93% as compared to 1.71% in February. The IPC-Br increased 1.06%, as compared to 1.37% in the previous month, while the INCC remained stable.

The agricultural component of the IPA increased 0.32%, pressured by prices of legumes and fruit, as a result of adverse weather conditions. Other important items such as cereals and grains, vegetable oils, , and export crops registered nominal price decreases, due to the exchange rate appreciation and the behavior of international prices. The industrial component of the IPA increased 2.56% as compared to 1.91% in February, reflecting increases in the prices of chemicals (fuel and plastic raw materials), metal products (iron, steel and by-products), pharmaceutical products (medicines and hygiene), and plastic (resins).

Core IPCA inflation calculated by excluding household food items and regulated prices reached 1.13% in March, as compared to 1.00% in February, breaking the deceleration observed since December. The accumulated change in 12 months reached 10.2%, as compared to 9.4% in February.

Core IPCA inflation calculated under the trimmed-mean method registered a 1.23% increase in March, as compared to 0.93% in the previous month. In the last 12 months, trimmed-mean core inflation accumulated a 10.8% increase, as compared to 10.1% in February.

Core IPC-BR inflation calculated under the symmetric trimmed-mean method increased 1.07% in March, as compared to 0.93% in the previous month, slightly above the 1.06% increase in the headline index for the month. In 12 months, core IPC-Br inflation accumulated a 10.6%increase, as compared to 9.94% in February.

In April, inflation may continue its recent declining trend, reflecting the dissipation of the effects of the recent increase in the prices of medicines, the reduction of agricultural prices and the recent behavior of the exchange rate, whose influence can be seen mainly in wholesale food prices. However, the drop in inflation will be attenuated by new readjustments of regulated prices, particularly household electricity tariffs, with increases in Belo Horizonte, Fortaleza, Salvador, Recife, and Porto Alegre.

**Assessment of inflation trends**

The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypotheses:

Estimated price adjustments for gasoline and bottled gas for 2003 have fallen since the last Copom meeting to 8.4% from 12.4% and to 1.6% from 4.2%, respectively. These projections incorporate the adjustments of the first months of the year and price reduction from May onward.

With respect to household electricity tariffs, estimated readjustments have decreased by 3 p.p. to 24.5%. This decrease is the result of the appreciation of the real observed since the last Copom meeting.

Regulated prices, which had a 28.6% weight in the March IPCA, are forecast to increase 15.3% in 2003. The appreciation of the real, lower adjustments for electricity and the decrease in the price of oil by-products were mostly responsible for the fall of 1.5 p.p. from the March projections for regulated prices.

For 2004, the estimated readjustment for the set of regulated prices is 8.5%, a 0.5 p.p. fall compared to the projections at the last meeting. This result is a consequence of the decrease in the expectation of 2004 IGP-M.

The projection for the 6-month spread over the Selic rate, following the specification of the VAR model using the Selic and swap rates in levels, is at 60 b.p. in the 3Q03, gradually rising until the end of 2004.

Regarding fiscal policy, it is assumed that the public sector will accomplish primary surplus target for this year and the following two years (4.25% of the GDP). The other related assumptions established in the March Copom meeting were maintained.

Considering the baseline scenario hypotheses, including a steady interest rate at 26.5% p.a. and the exchange rate at the level prevailing on the eve of the Copom meeting, inflation is projected above the adjusted target of 8.5% for 2003.

**Monetary policy decision**

Inflation remains on a downward trend. However, recent inflation results were above Copom projections and the medians of both market expectations and *Top 5* (best forecasters) market expectations. The current results indicate a higher degree of inflation persistence, which is key for the disinflation outlook.

In March, free market prices increased as a result of price increases in items that are sensitive to past exchange rate changes, such as medicines and cleaning and hygiene products, as well as increases in perishable food prices. With the exception of ‘Services’ prices, which have a 20.6% weight in the index, all the other sub-groups in the IPCA posted relatively high levels of inflation. As a result, the monthly increase of core inflation was above 1%.

The slower decline in inflation indicates a higher degree of inertia in the formation of prices in the economy, although this may be a temporary phenomenon. The degree of inflation inertia depends directly on the link between price and wage readjustments. There is a risk of future price and wage readjustments being based on accumulated inflation instead of on future inflation.

Other factors that impact consumer price inflation, such as the exchange rate and economic activity, have been contributing to a more rapid convergence of inflation to its targets.

Recent figures on economic activity, when adjusted for the distortions provoked by the timing of the Carnival holiday this year, show signs of a downturn in the first quarter of 2003. This trend has materialized despite the increase of exports and domestic production of import-substituting goods. The decline in activity can be attributed to the decrease in real wages and tightening of credit conditions for consumers. Leading indicators for March suggest that the level of activity will remain weak.

The nominal exchange rate appreciated around 12% in the period following the last Copom meeting as a result of improvement in the BoP. The trade surplus increased, and the current account registered a surplus in 1Q03, indicating a deepening of the external adjustment of the Brazilian economy. The sustainability of this trend, however, is dependent on a reduction of inflation, which is needed in order to preserve the change in relative prices that has occurred in the last year.

External funding conditions have improved. Brazil risk measured by the Embi+ has decreased more than 200 b.p. since the last Copom meeting, in line with the onshore yield curve. External funding from private sources has resumed, and March rollover rates for notes and commercial paper reached 82%, as compared to 65% in the same period of 2002. It is important, however, to achieve an improvement in the quality of external funding, with longer tenors and lower costs. Indeed, in April, new issues were announced with a slight lengthening of tenors. Demand for domestic securities has also increased, allowing the Treasury to issue LTNs and LFTs with longer maturities.

These factors contributed to an improvement in the inflation outlook, even taking into consideration the failure of inflation to fall more sharply in recent months. As a result, the Copom decided to maintain the target for the Selic rate at 26.5%.

The Copom also decided to withdraw the upward bias, which allowed the Governor to increase the Selic rate anytime between regular Copom meetings. Although there are doubts about the speed of the decline in inflation and questions regarding the extent to which the increase in inflation inertia is temporary or permanent, they will not be clarified between the monthly meetings, but over the longer term.

At the closing of the meeting, it was announced that the Committee would meet again on May 20, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in the Communiqué 10,187, of October 2, 2002.

## SUMMARY OF DATA ANALYZED BY THE COPOM

### Economic activity

Output and retail sales indicators grew in February as compared to January, s.a., and compared to February 2002. These results should be taken with caution, however, since the Carnival holidays occurred in March rather than in February as in 2002.As a result of more working days in February of 2003 (20) as compared to the previous year (18), comparisons of monthly and yearly production and sales data are statistically distorted, and will tend to overestimate the results of February this year and to underestimate the results of March, even after standard seasonal adjustment

According to the IBGE, the national retail sales index fell 1.98% in February, compared to February last year; in January, the index fell 4.87% compared to the same month of 2002. This result is also affected by the calendar-effect, which will tend to reduce the fall. Adjusting for working days, sales would have fallen 6.1% in February. In the first two months of 2003, the volume of retail sales decreased 3.47%, accumulating a 1.02% fall in 12 months. The major segments responsible for the negative results were “hypermarkets,” supermarkets, food products, beverage and tobacco. These declines reflect decreases in worker’s real incomes due to higher prices of food and cleaning and personal hygiene products.

Brazilian industrial production increased 0.7% in February as compared to the previous month, s.a., and 4.1% as compared to February 2002, according to the IBGE’s monthly survey. Discounting the calendar-effect, industrial production would have fallen 0.7% month-on-month (s.a.) and 1.1% year-on-year in February. 10 out of the 20 sectors surveyed expanded in March, with the biggest increase in mineral extraction (2.4%), as compared to the 0.6% in manufacturing. By categories of use, the production of intermediate goods was stable while other categories registered increases: 1.1% in capital goods, 1.2% in durable consumer goods, and 5.1% in semi-durable and non-durable consumer goods.

Manufacturing data released by the CNI indicated a recovery of industrial activity in February as compared to the previous month, with real sales increasing by 7.4% and hours worked rising by 0.7%, s.a. These indicators increased 11.5% and 3.3% year-on-year respectively.

In the auto sector, March production and sales fell close to 20% from February, partially reflecting the effect of the Carnival holiday.

Investment expanded again in February, mainly due to increased production and imports of capital goods. The domestic production of machinery and equipment and the volume of both imports and exports of capital goods registered increases of 1.1%, 35.4%, and 26.3% in the month, respectively, s.a. The production of inputs for construction, however, decreased 2% month-on-month.

The monthly Fecomércio-SP survey showed an improvement in consumer confidence in April, with the Consumer Intentions Index reaching 100.3, as compared to 97.8 in March (on a 0-200 scale). Both components increased: current intentions rose 6.2 points and future intentions rose 0.8 points. This recovery, after two months of decreases, was due to the improvement of expectations about unemployment, inflation and the political scenario, despite increasing concerns about the external front.

**Labor market**

Legally registered employment increased 0.2% month-on-month in February, s.a., and 3.5% compared to February 2002, according to the Ministry of Labor and Employment. According to the new methodology for the IBGE’s employment survey, the unemployment rate in the six main metropolitan areas reached 11.6% in February, compared to 11.2% in January.

According to the survey, workers’ real average income in January 2003 was 8.3% below the January 2002 level, using the INPC as a deflator. According to the CNI, in the industrial sector the real payroll in February this year was 7.2% lower than in February 2002.

**Credit and delinquency rates**

Total non-earmarked bank credit was nearly stable in March relative to February (+0.3%), as a result of the deceleration of economic activity and higher interest rates. Domestically funded credit to companies increased 1.5%, while externally funded credit to companies decreased 2.1%, mainly as a result of the 5.9% exchange rate appreciation in the month.

Credit to individuals increased 0.7% month-on-month, reflecting the concentration of taxes and school fee expenses in the beginning of the year. Moreover, the fall in real income is contributing to an increase in household indebtedness, particularly with short-term credit.

The delinquency rate on non-earmarked bank credits increased 0.6 p.p. in March to 8.7%. For individuals the rate increased 0.8 p.p. to 15.7%, while for companies it increased 0.3 p.p. to 4.5%. The average interest rate on bank loans increased 1.3 p.p. to 57.8% p.a., the highest rate since June 2000.

Regarding defaults on retail credit, ACSP statistics reveal that the number of new delinquency registrations and the amount of cancelled registrations increased 18.8% and 10.5% respectively in March, compared to February, raising the net delinquency rate to 7.2% from 6.8% in February. The volume of returned checks reached 5.9% of total settled checks in March, the highest in the last 10 years.

**External environment**

After the beginning of the war in Iraq, uncertainties on the external front subdued with indications that the war would be short and that there would be no significant damage to Iraqi oil fields. However, after some initial improvement in the international financial scenario, uncertainties about the future performance of the global economy resumed.

The recovery of the global economy continues to depend on a recovery of growth in the U.S. So far this year, the degree of this recovery has been unclear, as the most recent indicators were influenced by the uncertainties related to the war in Iraq.

With the end of the war, consumer and business expectations may improve in the short-run, allowing some recovery in retail sales, reduction in inventories and resumption of industrial production, which may help the labor market.

The stabilization in oil prices may revert inflationary pressures recently observed in the OECD economies, although it is premature to infer a trend for petroleum prices, given the recent announcement of cuts in output from OPEC members, and uncertainties about the rhythm of exports from Iraq.

Finally, the spread of SARS is a new concern for the world economy, and growth in China and the countries of Southeast Asia may be significantly damaged, after they experienced the highest global GDP growth rates in 2002.

**Foreign sector**

The trade surplus was US$1.5 billion in March, accumulating a US$3.8 billion surplus in the first quarter of 2003, and US$15.9 billion in 12 months. Considering daily averages, exports increased 29.4% in March and 24.5% in 1Q03, compared to 2002. Imports increased 8% and 2.2% year-on-year, respectively, in the same periods. Up to the 3rd week of April (13 working days), the trade surplus totaled US$1.1 billion, with a 29.7% increase in exports and a 1% increase in imports compared to the daily averages in April 2002.

The expansion of exports in the first quarter occurred for all categories of products and the main consumer markets, mainly due to higher volumes and a slight increase in prices of important exported products. The increase in the value of imports was mainly due to the rise in oil prices.

**Money market and open market operations**

After the last Copom meeting, the yield curve shifted upwards, and the spreads of the 1-month and 6-month interest rates increased to 25 b.p. from 5 b.p. and to 69 b.p. from 22 b.p. respectively. Subsequently, with the reduction of country risk, new external funding, the appreciation of the exchange rate and the quick end of the war in Iraq, the yield curve shifted downwards and inverted through January 2004. On April 22nd, the spreads of the 1-month and 6-month rates were –40 b.p. and –168 b.p. respectively.

Exchange rate linked securities and FX swaps maturing since the previous meeting were fully rolled with FX swaps. The US$3.1 billion in FX instrument maturing on April 1st were rolled over with terms ranging from 2 to 58 months (9 months on average). The US$0.9 billion maturing on April 17th was rolled over through swaps with terms ranging from 6 to 57 months (18 months on average). The US$1.1 billion maturing on April 23rd was rolled over through swaps with terms ranging from 4 to 57 months (15 months on average).

Since the March Copom meeting, the Treasury has offered LTNs five times and placed a total of R$5.8 billion of these securities. The significant demand for these securities allowed higher offers and the lengthening of tenures up to 15 months. Moreover, the reduction in the slope of the yield curve opened up room for placements at lower rates than those observed in the previous period. Longer term LFTs were also issued.

The settlement of securities between March 20th and April 23rd produced an expansionary impact of R$5.8 billion on the monetary base as a result of net redemptions of R$8.8 billion of FX-indexed securities and R$6.3 billion in LTNs, partially offset by net placements of R$9.4 billion of LFTs.

In the same period, the BCB intervened in the money market with 1-week and 1-month repo operations, and conducted daily liquidity management operations with maturities of 2 working days. These operations withdrew excess liquidity of R$69.3 billion on average.

## Minutes of the 84th Meeting of the Monetary Policy Committee (Copom)

**Date:** May 20th, from 3:30PM to 6:30PM, and 21st, from 10:30AM to 1:30PM
**Place:** Central Bank's Headquarters meeting room of the 8th floor (on May 20th) and 20th floor (on May 21st) – Brasília – DF

**In attendance:**
**Members of the Committee**
Henrique de Campos Meirelles – Governor
Antônio Gustavo Matos do Vale
Beny Parnes
Ilan Goldfajn
João Antônio Fleury Teixeira
Luiz Augusto de Oliveira Candiota
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

**Department Heads (all present on May 20th)**
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserve Operations Department
José Antonio Marciano – Department of Banking Operations and Payment System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on May 21st)
Sérgio Goldenstein – Open Market Operations Department

**Other participants (present on May 20th)**
Antônio Carlos Monteiro – Executive Secretary
Alexandre Pundek Rocha – Advisor to the Board

Flávio Pinheiro de Melo – Advisor to the Board
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of, and prospects for the Brazilian and international economies under the monetary policy framework, designed to comply with the inflation targets established by the government.

**Recent evolution of inflation**

In April, most measures of inflation registered their smallest monthly increases since September of 2002. This development was most pronounced in wholesale price indices, mainly due to the effects of the recent exchange rate appreciation and seasonal contribution of agricultural goods prices. The decline in consumer price inflation was smaller, reflecting a modest deceleration in market price inflation and increases in regulated prices.

The IPCA increased 0.97% in April, in comparison to 1.23% in the previous month, accumulating 6.15% in the first four months of 2003 and 16.77% in 12 months. The IGP-DI increased 0.41% in April, compared to 1.66% in March. The IPA-DI rose by 0.07% in April, in comparison to 1.93% in the previous month. The 12-month increase of the IGP-DI and IPA-DI fell after having increased for eleven consecutive months, totaling 32.37% and 42.65%, respectively.

The deceleration of IPCA inflation resulted exclusively from the evolution of market prices, which increased 0.87% in April, compared to 1.29% in March. Among market prices, the main contribution to the slowdown came from food prices, thanks particularly to the normalization of the supply of perishable foods, reflecting more favorable weather conditions. As a consequence, prices of perishable food increased 1.78% in April, in comparison to 7.17% in March. Among tradable goods apart from food items, the smaller increase of the IPCA was due to the behavior of the prices of medicines, household goods and cleaning and personal hygiene products, which increased less than in the previous month. However, due to seasonal effects, clothing items posted a higher increase in April (1.03%) than in March (0.6%).

Regulated prices increased 1.21% in April, up from 1.08% in March, contributing 0.35 p.p. to the IPCA result in the month. An increase in the price of electricity made the largest single contribution to the increase in the IPCA (0.13 p.p), reflecting tariff hikes in six metropolitan regions. Additionally, urban bus tariffs, bottled cooking gas (whose price remained stable at the refinery level), water and sewage tariffs and the price of airplane tickets all registered increases.

Regarding the evolution of wholesale prices, one should highlight the effects of the exchange rate appreciation and the normalization of the supply of perishable foods. The agricultural component of the IPA decreased 0.99% in April, after a 0.3% increase in March, mainly due to declines in the prices of fruits and legumes (7.05%) and export crops (5.49%). The industrial component of the IPA increased 0.48%, compared to 2.56% in March, reflecting the deceleration of price increases in most of the industrial sectors.

Core IPCA inflation calculated by excluding household food items and regulated prices was 0.81% in April, compared to 1.13% in March, but still above the levels observed in the first three quarters of 2002. The accumulated change in 12 months was 10.53%.

Core IPCA inflation calculated under the trimmed-mean method registered a 1.10% increase in April, higher than the headline index. In the last 12 months, trimmed-mean core inflation accumulated an increase of 11.43%, as compared to 10.8% in March.

Core IPC-Br inflation calculated under the symmetric trimmed-mean method registered a 1.2% increase in April. In 12 months, core IPC-Br inflation accumulated a 11.37% increase.

In May, the positive effects of the exchange rate appreciation on inflation are likely to increase, particularly on wholesale prices, as signaled by recent previews of the IGP-M. With respect to consumer prices, tradable goods will also benefit from the exchange rate appreciation, and in conjunction with the fall of perishable food and fuel prices will contribute to the downward trend of inflation. However, upward pressures from clothing prices and electricity tariffs (due to both increase of household electricity and implementation of public light tariffs) will prevent this effect from being more pronounced.

**Assessment of inflation trends**

The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypothesis:

Estimated price adjustments for gasoline in 2003 are around 6%, including the reduction at the beginning of May. The projection for the readjustment of the price of bottled cooking gas for 2003 increased to 4.5%, due to the 4.13% increase in April.

With respect to household electricity tariffs, estimated readjustments decreased again as a result of the exchange rate appreciation, reaching 23.7% for 2003. This rate could be lower, were it not for the charges of public lighting in several capitals, including Curitiba, São Paulo, Fortaleza, Recife, Belo Horizonte, Goiânia and some municipalities of greater Rio de Janeiro.

Regulated prices, which had a 28.6% weight in the April IPCA, are forecast to increase 14.9% in 2003. Despite the increase of in the projection for bottled cooking gas, the decrease of gasoline prices, the exchange rate appreciation and the consequent reassessment of electricity price readjustment resulted in a 0.4 p.p. fall from the April projections for regulated prices.

The projection for the 6-month spread over the Selic rate, following the specification of the VAR model using the Selic and swap rates on the eve of the Copom meeting was 80 b.p. for 4Q03, gradually rising to 150 b.p. at the end of 2004.

Regarding fiscal policy, it is assumed that the public sector will accomplish the primary surplus target for this year and the following two years (4.25% of the GDP). The other related assumptions established in the April Copom meeting were maintained.

Considering the baseline scenario hypotheses, including a steady interest rate at 26.5% p.a. and the exchange rate at the level prevailing on the eve of the Copom meeting, inflation is projected above the adjusted target of 8.5% for 2003.

**Monetary policy decision**

Inflation remains on a downward trend. Wholesale price inflation has been decreasing more than consumer price inflation. There is evidence that the dynamics of the two groups of prices have been different. At the wholesale level, the exchange rate appreciation and the normalization of the supply of perishable food have been the main factors underlying the decrease in inflation.

However, the deceleration of consumer price inflation has not been as significant. Regulated prices increased by 0.34 p.p. more than market prices, due to items such as water and sewage, bottled cooking gas, electricity, urban bus fares, airplane tickets, motor oil and cellular phones. Market price inflation declined, largely due to smaller price increases in services and items linked to the exchange rate.

GDP may close the first quarter of 2003 roughly stable in comparison to the previous quarter. On the one hand, manufacturing output fell. On the other hand, the mineral extraction industry, the agricultural sector and the tradable goods sector registered positive performance.

The resistance to a more rapid decline in consumer price inflation points to the existence of increased inflation persistence in the economy. The prices of important groups in the consumption basket have increased significantly, although at a decelerating rate, including beverages, canned products, cleaning and personal hygiene products and furniture and utensils. Consequently, core inflation still remains at a high level.

This persistence is due to wage and price readjustments that have occurred since the beginning of the year and that have been based on the high inflation rate accumulated in the last twelve months, rather than assessments of future inflation. Also, businesses have made an effort to regain profit margins in a scenario of falling aggregated demand. This behavior resulted in a significant decrease in sales. Retail sales decreased 6% in the first quarter of the year compared to the same period of the previous year.

The Copom believes that monetary policy should not ratify price and wage readjustments based on past inflation, due to the risk of perpetuating higher inflation.

There are initial signs that monetary policy is curbing inflation. The Copom as well as market participants expect inflation to maintain a declining trend towards its target. These favorable expectations regarding inflation are based on the following assumptions: (i) inflation persistence is temporary; (ii) the recent exchange rate appreciation positively affects price dynamics (in the same way that the exchange rate depreciation affected inflation).

Since inflation remains relatively high, it is still premature to conclude that inflation persistence is definitively decreasing and that the effect of the exchange rate appreciation on prices is significant. Thus, the Copom concludes that the decrease of inflation depends on the maintenance of its current effort.

As a result, the Copom decided, unanimously, to maintain the target for the Over-Selic rate at 26.5% p.a.

At the closing of the meeting, it was announced that the Copom would meet again on June 17, for technical presentations and on the following day, in order to discuss the monetary policy decision, as established in the Communiqué 10,187, of October 2, 2002.

## SUMMARY OF DATA ANALYZED BY THE COPOM

### Economic activity

Carnival holidays in March reduced the number of working days to 19, compared to 20 days in the previous month and in March 2002. As a result, the comparisons of production and sales data contain statistical distortions that have not been eliminated by the usual seasonal adjustment. The March 2003 results are underestimated the same way that data in February was overestimated.

Having eliminated the working day effect by using the quarterly moving average, it is clear that the growth rates of industrial production and industrial and retail sales decreased in 1Q2003, compared to the same period last year and the last quarter of 2002.

According to the IBGE, the national retail sales index fell 11.3% in March and 6% in the 1Q2003, when compared to the same period of 2002. The negative performance hit all the retail sectors and states in Brazil. Data from Fecomércio–SP also show a fall of 4.7% in real retail sales in the metropolitan area of São Paulo in March, compared to the same month in 2002. However, accumulated sales in the first quarter showed an increase of 7.3%.

Data on sales with checks and credit purchases, released by the ACSP, confirmed the downward trend of the retail market in March and in the first quarter of this year.

The monthly Fecomércio–SP survey showed an improvement in consumer confidence in May. The IIC reached 104.3, compared to 100.3 in April (out of a 0-200 range). Both components of the IIC increased: current consumer intentions rose by 0.4 p.p. while future intentions increased by 5.7 p.p.

The main investment indices declined in 1Q2003. The difficult economic scenario and the governmental transition period contributed to a postponement of investment decisions, both in the public and the private sectors. Civil construction, which is responsible for more than 60% of gross fixed capital formation, decreased 2.1%, compared to the first quarter of 2002. Considering s.a. data, the fall in the first quarter this year reached 5.7%, in relation to the last quarter of 2002.

Although capital goods production was roughly stable in the first quarter compared to the same period of 2002 (increase of 0.5%), it fell 3.5% in relation to the last quarter of 2002, s.a. By sector, it is important to note the continuous expansion in the production of machinery and agricultural equipment, due to the increase in the income of the agricultural sector and the significant decrease in energy generating equipment. This decrease was a consequence of the high figures registered last year, when investment in this area was stimulated by the energy crisis.

Industrial production decreased 3.4% in March compared to the previous month, s.a., according to the IBGE. Discounting the working days effect, industrial production recorded an increase of 0.1% in the month.

The data shows that the behavior of the industrial sector in March was consistent with developments that have been observed since mid-2002, with the best performance in the intermediate goods sector, relating to the expansion of exports, and the agricultural and oil extraction sectors. The consumer goods sector showed significant declines.

Considering 1Q2003, the manufacturing and mineral extraction industries increased 2.1% and 4.8%, respectively, compared to 1Q2002. Industry grew 2.5% year-on-year, but fell 1.1% in relation to the performance observed in 4Q2002.

Data on real sales and hours worked in the manufacturing sector released by the CNI also indicated a decrease of industrial activity during the first quarter. Although the accumulated data in the quarter posted positive growth compared to the same period last year (7,4% and 2,4%, respectively), they were lower by 2.5% and 1% in relation to the data observed in the last quarter of 2003. Installed capacity utilization reached 79.8% in March, s.a., compared to 80.2% recorded in the same month of 2002.

Other indicators related to industrial performance showed positive results in April. Production of corrugated paperboard grew 11.3% month-on-month, s.a., according to the data released by the ABPO. Gross steel production increased 2.5% month-on-month, according to data released by the IBS.

**Labor market**

Legally registered employment increased 0.2% month-on-month in April, s.a., and 3.3% in the first four-months compared to the same period of 2002, according to the Ministry of Labor and Employment. According to the new methodology for the IBGE's employment survey, the unemployment rate in the six main metropolitan areas reached 12.1% in March, compared to 11.6% in February, despite the increase of 0.1% in the number of employed workers in the same period.

The IBGE also verified an increase in informal work in the last twelve months. While the number of formal employees increased 3.3% between March of 2002 and March of 2003, the number of informal employees grew 9.3%. In addition, according to the PME, the average real wage of employed workers fell by 4.9% compared to the same month of 2002. In the industrial sector, according to the CNI, the real payroll in March was 7.7% lower than in March 2002.

**Credit and delinquency rates**

Total non-earmarked bank credit decreased 0.4% in April, with the largest decline in the corporate portfolio as a result of the effects of the 13.8% exchange rate appreciation on dollar-indexed loans. Domestically funded credit to companies grew 1%, driven mostly by the increase of corporate overdraft accounts and working capital loans. The results indicate that companies have been choosing short-term debt in order to recompose cash flows. ACC operations grew 1.7%, mirroring the robust performance of the export sector and the progressive normalization of external commercial lines. Credit to individuals increased 2.2%, highlighting larger demand for short-term credits.

The average interest rate on credit operations in April increased 0.6 p.p., reaching 58.4% p.a. In the month, fixed rate loans fell in some segments, mirroring the reduction in the slope of the yield curve as a result of the improvement in the sovereign-risk premium and the expectations of falling inflation.

The delinquency rate on non-earmarked bank credits increase to 8.8% in April from 8.7% in March. For individuals the rate remained at 15.7% while for companies it increased 0.1 p.p. to 4.6%.

Regarding default rates on retail credit, there was a slight improvement in April. ACSP data showed that the number of new delinquency registrations and the amount of cancelled registrations fell 13.2% and 8.1%, respectively, compared to the previous month, reducing the net delinquency rate to 7%, compared to 7.2% in March. The volume of returned checks fell from 5.9% of the total settled in March to 5.6% in April.

**External environment**

GDP in the Euro Area and Japan remained stable in 1Q2003 compared to the previous quarter, while in the US GDP growth (1.6% annualized) was lower than expected.

The recovery of the global economy continues to depend on a stronger recovery of growth in the US, which is still showing evidence of macroeconomic fragilities: industrial production fell 0.5% in April; capacity utilization stands at 74.4%, the lowest level since 1983; retail sales declined; and the trade deficit increased.

The unemployment rate in the Euro area increased in April, reaching 8.7%, while in the US it stood at 6%. Business confidence in industrialized countries points to a contraction in economic activity. Regarding consumers, pessimism persists in Europe. However, there was a slight improvement in the US.

In addition to the weak performance of industrialized economies, the spread of SARS is a new concern for the world economy, and growth in China and the countries of Southeast Asia may be significantly damaged. The volatility of oil prices remains high, and the downward trend in prices was partially reversed after the approval of the cut in production by OPEC countries, and the disturbance caused by a new wave of terrorist attacks.

The inflation shows signs of falling in the main economies. In the US, consumer price indices in April registered the largest fall in nineteen months, fostering the perception that deflation risks are increasing. The weakening of the dollar may decrease this perception, and contribute to an improvement in the activity and a reduction of the US trade deficit. However, the appreciation of the euro increases the risks of deflation and recession in Europe.

Central banks decided to keep interest rates unaltered in their last meetings. Official interest rates remain at their lowest levels of the last four decades in the US (1.25%), the Euro area (2.5%), and the UK (3.75%). In Japan, they have been zero since 1999.

**Foreign sector**

The trade surplus reached US$1.7 billion in April, accumulating US$5.5 billion in the first four months of 2003, basically due to the performance of exports which have grown sharply, while imports remained stable.

Exports reached US$5.7 billion in April and US$20.8 billion year-to-date, increasing 23.1% in the month and 25.6% in the first four months compared to 2002. Imports decreased 3.6% in April, reaching US$4 billion, and increased 1.8% in the first four months of the year, reaching US$15.3 billion, compared to 2002.

Current account showed a deficit of US$966 million in April, 50.9% less than in the same month of 2002. The deficit in the services and income account reached US$2.9 billion, not completely compensated by the positive results of the trade balance (US$1.7 billion) and unilateral transfers (US$205 million). The 12-month current account deficit reached 0.74% of GDP in April.

**Monetary market and open market operations**

After the last Copom meeting, the yield curve shifted downwards, mainly for maturities over 6 months, increasing the negative slope of the curve. A decline in sovereign country risk, appreciation of the exchange rate, deceleration of inflation and market expectations of a larger reduction of inflation in the second half of the year contributed to this movement. On May 20th, the spreads of 6-month and 1-year rates were –204 b.p. and –293 b.p. respectively, compared to –166 b.p. and –179 b.p. on April 23rd.

Securities and swaps maturing since the previous meeting have been rolled over through swaps with terms ranging from 4 to 56 months (11 months on average). Lower placement rates, as compared to the previous period, were due to the overall reduction in the dollar-linked interest rate curve.

Since the March Copom meeting, the Treasury has offered LTNs five times, for an amount totaling R$9.9 billion. The significant demand for these securities and the movement in the domestic yield curve allowed the offer of increasing amounts, longer average tenures, and lower rates than in the previous period. Four issues of LFTs were also made at longer terms and lower rates, totaling US$23.7 billion.

The settlement of securities between April 24th and May 21st caused a contractionary monetary impact of R$8.2 billion, as a result of net placements of R$9.9 billion in LTNs and US$3.3 billion in LFTs, partially offset by net redemptions of R$5.2 billion of dollar indexed securities.

In the same period, the Central Bank intervened weekly in the open market through 1-week, 2-week, and 1-month repo operations, and conducted daily liquidity management operations with maturities of 2 working days. These operations withdrew excess liquidity of R$52.8 billion on average.

As a result of the appreciation of the real, domestic securitized public debt fell by R$5.3 billion (-0.8%) in April, while the share linked to the dollar decreased to 30.4% from 34.7%.

## Acronyms

| | |
|---|---|
| **ABPO** | Brazilian Corrugated Board Association |
| **ACSP** | São Paulo Trade Association |
| **b.p.** | basis points |
| **CNI** | National Confederation of Industry |
| **Fecomércio-SP** | São Paulo State's Federation of Commerce |
| **FGTS** | Time in Service Guarantee Fund |
| **GDP** | Gross Domestic Product |
| **IBGE** | Brazilian Institute of Geography and Statistics |
| **IBS** | Brazilian Steel Institute |
| **ICMS** | Tax on the Circulation of Goods and Services |
| **IGP–DI** | General Price Index – Domestic Supply |
| **IGP–M** | General Price Index – Market |
| **IIC** | Consumer Intentions Index |
| **INCC** | National Index of Civil Construction |
| **IPA** | Wholesale Price Index |
| **IPCA** | Consumer Price Index - Extended |
| **IPC–BR** | Consumer Price Index – Brazil |
| **IPC-FIPE** | Consumer Price Index of the Economic Research Institute Foundation |
| **LFT** | National Treasury Bills (floating) |
| **LTN** | National Treasury Letters (fixed rate) |
| **NTN–C** | National Treasury Note – C Series (price index) |
| **OPEC** | Organization of the Petroleum Exporting Countries |
| **p.a.** | per annum |
| **p.m.** | per month |
| **p.p.** | percentage point |
| **PME** | Monthly Employment Survey |
| **PPI** | Producer Price Index |
| **s.a.** | seasonally adjusted |
| **SARS** | Severe Acute Respiratory Syndrome |
| **VAR** | Vector AutoRegressive |

# Economic policy measures

## Measure related to the financial system and credit market

**Circular 3,182, 3.6.2003 –** deals with procedures for operating authorization, stock control transfers, stock reorganization and cancellation of operating authorization for micro-entrepreneur credit companies. The objective of the alterations introduced by this instrument is to introduce less rigid regulations for such companies, when compared to other institutions authorized to operate by Banco Central. Consequently, for micro-entrepreneur credit companies to be authorized to operate, the interested parties must, upon request, clarify the characteristics of the project, while other financial institutions must submit economic-financial feasibility studies of their projects. Aside from this, the obligation that the asset and liabilities statements of the legal entities that control such companies be audited by independent auditors was eliminated, when control is exercised by Public Interest Civil Society Organizations (Oscip).

**Resolution 3,072, 3.27.2003 –** set the Long-Term Interest Rate (TJLP) at 12% per year for the second quarter of 2003. In the previous quarter, the TJLP was 11% per year.

**Resolution 3,074, 4.24.2003 –** deals with maintenance of the capital for the Reserve for Fostering Currency Stability and Use of Checks (Recheque) at Banco Central do Brasil. Recheque is a fund managed by Banco Central and is based on resources originating in the service fee charged to banking institutions for inclusion of entries in the Reference File of Issuers of Checks with Insufficient Backing (CCF), utilized for purposes of furthering campaigns on the appropriate use of checks. With constitution of the Credit Guaranty Fund (FGC) in 1995, designed for the purpose of covering deposits against financial institutions, it was decided that Recheque would be eliminated and that its capital would be transferred to the FGC. Once the period of FGC constitution had passed and in light of the maturity of this instrument, the National Monetary Council issued the aforecited Resolution determining that Recheque funds would remain under the management of Banco Central and would be utilized for purposes of sponsoring campaigns targeted at fostering the stability of national currency and the correct use of checks, as well as for dissemination of information on and improvements in the CCF.

**Resolution 3,081, 5.29.2003 –** deals with the rendering of independent auditing services to financial institutions and other institutions authorized to operate by Banco Central. The major innovation refers to the obligation of constituting audit committees for those institutions that have Base Capital equivalent to or greater than R$ 200 million. Audit committees are to be composed of at least three members with maximum tenures of five years and such entities must be in full operation by December 21, 2003. Among the responsibilities of these committees, the following deserve emphasis: recommendation of the institution to be contracted to provide the services of independent auditing, as well as substitution of such entity, should this be deemed necessary; evaluation of the effectiveness of the independent and internal audits and verification of compliance on the part of management with the recommendations made by the auditors. The stated Resolution also instituted new rules to insure the independence of the audit, which could result in revision of the contracts between financial institutions and their independent auditors. Adaptation to these requirements must be completed by January 1, 2004.

**Resolution 3,082, 5.29.2003 –** extended the period of exemption from compulsory reserves on demand deposits, applicable to the deposits received by pioneering branches. This exemption, which was previously scheduled to expire on May 31, 2003, was extended to May 28, 2004. According to the terms of Resolution 2,099, dated 8.17.1994, a pioneering branch is defined as a branch located in a market that has no other branch or advanced service outlet of a multiple bank with a commercial portfolio, commercial bank or the Federal Savings Bank. Those branches that lose this classification as of June 2, 2003, will no longer be entitled to the exemption for the stated deposits.

## Fiscal policy measures

**Constitutional Amendment 40, 9.29.2003 –** altered the text of article 192 of the Federal Constitution in such a way as to permit the various segments of the national financial system to be regulated by more than one item of enabling legislation.

**Law 10,684, 5.30.2003 –** deals with installment payments of debts with the Secretariat of Federal Revenue and National Social Security Institute (INSS), under the terms of the Fiscal Recovery Program (Refis), and altered tax legislation. The most important topics of the law are as follows:

a) Contribution to the Financing of the Social Security System (Cofins): increase in the rate on the monthly revenues of financial institutions from 3% to 4%;
b) Social Contribution on Profits (CSLL): raising of the calculation base for service companies that pay the cited contribution on the basis of presumed profit from 12% to 32% of gross revenues;
c) PIS/Pasep and Cofins: crop/livestock production and rural electrification cooperatives are permitted to exclude from the calculation base of their contributions the costs aggregated to the products and services marketed by their associates, involving generating facts that occurred as of 10.26.1999. Exempts revenues on the marketing of raw materials, intermediate products and packaging material from such contributions, when they are produced in the Manaus Free Zone, for use in the industrialization process by the industrial establishments located there;
d) Integrated System of Payments of the Taxes and Contributions of Microbusinesses and Small Scale Companies (Simples): extension of the possibility of opting for the Simples to daycare centers and preschool institutions, primary school establishments, lottery shops, outsourced postal branches and passenger and cargo land transportation automotive vehicle driver training centers;

e) Fiscal Recovery Program (Refis): distribution of debts with the Secretariat of Federal Revenue and Office of the Attorney General of the National Treasury, due to mature up to 2.28.2003, in up to 180 monthly installments, and those debts referring to Pasep, for which the states, Federal District and municipalities are liable in up to 120 months; and
f) PIS/Pasep: exclusion of revenues consequent upon services rendered by journalistic, broadcasting and sound and image companies from the new system of taxation (Law 10,637, 12.30.2002). With this exclusion, such revenues are taxed on the basis of the previous rules or, in other words, at the rate of 0.65%.

**Decree 4,709, 5.29.2003 –** readjusted the benefits maintained by the Social Security System by 19.71%, effective as of July 1, 2003. For those benefits that were increased as a result of the alteration in the value of the minimum wage, the stated increase is to be deducted at the time of the 19.71% increase, according to rules to be defined by the Ministry of Social Security. For the benefits granted in the period from July 2002 to May 2003, the readjustment factors decline gradually, starting at 18.98% (July 2002) and ending at 0.38% (May 2003).

## Measures related to external sector

**Ministry of Justice Directive 169, dated 2.21.2003 (*) Republished in the DOU dated 3.5.2003 –** determined that, in operations involving imports, exports or re-exports of chemical products subject to control and inspection, the individual or legal entity should request issue of Prior Authorization from the Federal Police Department. The said request is to be made through the use of a specific petition and is to be accompanied by such documents as a pro forma invoice, authorization, certificate of non-objection or a similar document issued by the appropriate entity of the importer country or the country of final destination. The procedures related to the import, export and re-export operation are subject to obligatory administrative processing through Siscomex.

**Bacen Circular 3,181, 3.6.2003 –** defined the form, limits and conditions of declarations of properties and valuables held abroad by individuals or legal entities resident, domiciled or headquartered in the country.

**Law 10,643, 3.14.2003 –** authorized the executive branch to donate vaccines and equipment essential to combating foot-and-mouth disease to Paraguay.

**Provisional Measure 113, 3.26.2003 (Transgenic Soybeans) –** defined rules for marketing the output of the 2003 soybean harvest and takes other measures. One of the objectives of this measure is to ensure consumers of the right to reliable information on the origin and possibility of occurrences of Genetically Modified Organisms (GMO) in food products based on soybeans.

**Camex Resolution 7, 3.25.2003 (Ex-tariff) –** altered the ad valorem rates of the Import Tax on Capital Goods and Informatics and Telecommunications Goods and the components of the Integrated Systems specified therein to 4%, until 12.31.2004. In this latter case, the tax treatment foreseen only applies in cases involving imports of the totality of the specified components in each system to be utilized together in the productive activity of the importer.

**Camex Resolution 8, 3.25.2003 –** extended the 0% rate of the Import Tax applicable to the List of Medicines contained in Appendix V of Camex Resolution 42, dated 12.26.2001, to 6.30.2003.

**Camex Resolution 11, 3.28.2003 (Ex-tariff) –** altered the ad valorem rates of the Import Tax levied on Capital Goods and Informatics and Telecommunications Goods and on the components of the Integrated Systems specified therein to 4% until 12.31.2004. In the latter case, the tax treatment foreseen only applies in cases involving imports of the totality of the specified components in each system to be utilized together in the productive activity of the importer.

**Secex Circular 23, 4.10.2003 –** distributed the import quota of 140,000 vehicles for the first year (2003) of effectiveness of the automotive agreement between Brazil and Mexico, among the companies specified therein.

**Bacen Circular 3,187, 4.16.2003 –** altered articles 9 and 10 of Circular 2,677, dated 4.10.1996, which deals with national currency accounts held by those domiciled abroad and treats of the question of international transfers in reals.

**Law 10,659, 4.22.2003 –** introduced new composition into article 4 of Law 6,704, dated 10.26.1979, which deals with export credit insurance. This alteration has the objective of granting IRB-Brasil RE authority in the name of the federal government and in the framework of Export Credit Insurance, to contract qualified institutions to operate in this insurance segment, with the objective of performing all services related to credit insurance, including analysis and monitoring of operations involving the rendering of guaranties against extraordinary commercial risks and political risks, according to the terms of Law 6,704/1979. Conversion of Provisional Measure 95, dated 12.26.2003, into law.

**Law 10,664, 4.22.2003 –** altered Laws 8,248, dated 10.23.1991, 8,387, dated 12.30.1991, and 10,176, dated 1.11.2001, which deal with the capacity and competitiveness of the information technology sector. Conversion of Provisional Measure 100, dated 12.30.2003, into Law.

**Decree 4,680, dated 4.24.2003 (Transgenic Products) –** regulated the right to information guarantied by Law 8,078, dated 9.11.1990, with respect to food products and food ingredients for human or animal consumption that may contain or may be produced on the basis of genetically modified organisms, without prejudice to compliance with other applicable norms.

**Bacen Resolution 3,075, 4.24.2003 –** deals with special conditions for financing machines and implements based on resources managed by the National Bank of Economic and Social Development (BNDES) – Special Agricultural Finame.

**Camex Resolution 13, 5.12.2002 (Ex-tariff) –** altered the ad valorem rates of the Import Tax levied on Capital Goods and Informatics and Telecommunications Goods and on the components of the Integrated Systems specified therein to 4% until 12.31.2004.

In the latter case, the tax treatment foreseen only applies in cases involving imports of the totality of the specified components in each system to be utilized together in the productive activity of the importer.

**SRF Normative Instructions 330 and 331, 5.27.2003, 332, 5.29.2003 and SRF Directive 885, 5.27.2003 –** regulated the rules that govern the new system of access to the Siscomex Export Module via the Internet and its procedures.

**Bacen Circular 3,190, 4.28.2003 –** revoked Circular 3,146, dated 8.30.2002, and similar rules, that deal with foreign currency sale auctions carried out by Banco Central do Brasil and earmarked to the granting of advances on export exchange contracts.

# Appendix

## Banco Central do Brasil Management

## Members of the Monetary Policy Committee (Copom)

# Banco Central do Brasil Management

**Board**

**Henrique de Campos Meirelles**
Governor

**Antonio Gustavo Matos do Vale**
Deputy Governor

**Beny Parnes**
Deputy Governor

**Ilan Goldfajn**
Deputy Governor

**João Antônio Fleury Teixeira**
Deputy Governor

**Luiz Augusto de Oliveira Candiota**
Deputy Governor

**Paulo Sérgio Cavalheiro**
Deputy Governor

**Sérgio Darcy da Silva Alves**
Deputy Governor

# Members of the Monetary Policy Committee (Copom)

**Voting members**

**Henrique de Campos Meirelles**
Governor

**Antonio Gustavo Matos do Vale**
Deputy Governor

**Beny Parnes**
Deputy Governor

**Ilan Goldfajn**
Deputy Governor

**João Antônio Fleury Teixeira**
Deputy Governor

**Luiz Augusto de Oliveira Candiota**
Deputy Governor

**Paulo Sérgio Cavalheiro**
Deputy Governor

**Sérgio Darcy da Silva Alves**
Deputy Governor

**Non-voting members**

**Altamir Lopes**
Head of the Department of Economics (Depec)

**Daso Maranhão Coimbra**
Head of the Department of International Reserve Operations (Depin)

**José Antonio Marciano**
Head of the Department of Banking Operations and Payments Sistem (Deban)

**Marcelo Kfoury Muinhos**
Head of the Research Department (Depep)

**Sérgio Goldenstein**
Head of the Department of Open Market Operations (Demab)

# Acronyms

| | |
|---|---|
| **Abimaq** | Brazilian Association of Machinery and Equipment Industry |
| **ac.12m.** | In accumulated terms for 12 months |
| **ac.a.** | In accumulated terms for the year |
| **ACC** | Anticipated Exchange Rate Contracts |
| **ACSP** | São Paulo Trade Association |
| **ADR** | American Depositary Receipts |
| **AIE** | Energy International Agency |
| **Aneel** | National Electric Energy Agency |
| **Anefac** | National Association of Finance, Administration and Accounting Executives |
| **Anfavea** | National Association of Automotive Vehicle Manufacturers |
| **ANP** | National Petroleum Agency |
| **Apex-Brasil** | Autonomous Social Service Export Promotion Agency of Brazil |
| **BAI** | Business Activity Index |
| **Banacci** | Grupo Financiero Banamex - Accival |
| **Banxico** | Bank of Mexico |
| **BIB** | Brazil Investment Bonds |
| **BIS** | Bank for International Settlements |
| **BIT** | Informatics and Telecommunication Goods |
| **BM&F** | Commodities & Futures Exchange |
| **BNDES** | National Bank of Economic and Social Development |
| **BNDESpar** | BNDES Participações S.A. |
| **BoJ** | Bank of Japan |
| **Bovespa** | São Paulo Stock Exchange |
| **Cadin** | Information File on Outstanding Credits of the Federal Public Sector |
| **Caged** | General Reference File of the Employed and Unemployed |
| **Camex** | Chamber of Foreign Trade |
| **CAN** | Andean Community Member Countries |
| **CBEE** | Brazilian Emergency Energy Marketing Company |
| **CBO** | Congressional Budget Office |
| **CCR** | Reciprocal Payments and Credits Agreement |
| **CDB** | Bank Deposit Certificates |
| **CDE** | Energy Development Account |
| **CDI** | Interbank Deposits Certificate |
| **CDL** | Net Domestic Credit |
| **CEF** | Federal Savings Bank |
| **Cepal** | Economic Commission for Latin America and the Caribbean |

| | |
|---|---|
| **Cetes** | Treasury Certificates |
| **Cetip** | Center of Financial Liquidation and Custody of Securities |
| **CFT-E** | Treasury Financial Certificates |
| **CGPC** | Council of Complementary Social Security Management |
| **Cide** | Contribution on Intervention in the Economic Domain |
| **CIP** | Interbank Chamber of Payments |
| **CIR** | Currency System |
| **CMN** | National Monetary Council |
| **CNI** | National Confederation of Industry |
| **Cofins** | Contribution to Social Security Financing |
| **Compe** | Central Clearance System of Checks and Other Papers |
| **Copom** | Monetary Policy Committee |
| **Cosif** | Accounting Plan of National Financial System Institutions |
| **CPI** | Consumer Price Index |
| **CPMF** | Provisional Contribution on Operations or Transmission of Values and Credits and Rigths of a Financial Nature |
| **CSLL** | Social Contribution on the Profits of Legal Entities |
| **CSN** | National Steel Company |
| **CVM** | Securities and Exchange Commission |
| **CVRD** | Vale do Rio Doce Company |
| **DAX** | Deutscher Aktienindex |
| **Demab** | Department of Open Market Operations |
| **Depec** | Department of Economics |
| **DI** | Deposits among financial institutions |
| **Diset** | Board of Sectoral Studies |
| **DJIA** | Dow Jones Industrial Average |
| **DLSP** | Net public sector debt |
| **DOC** | Credit documents |
| **DOU** | Federal Official Gazette |
| **DRU** | Disencunberment of Federal Government Funds |
| **DV** | demand deposits |
| **EC** | European Commission |
| **ECB** | European Central Bank |
| **EMI** | Monthly Industrial Estimator |
| **EU** | European Union |
| **FAT** | Worker Support Fund |
| **FBC** | Gross Capital Formation |
| **FBCF** | Gross Fixed Capital Formation |
| **FECMG** | Trade Federation of the State of Minas Gerais |
| **Fecomercio SP** | Trade Federation of the State of São Paulo |
| **Fed** | Federal Reserve Bank |
| **Fenabrave** | National Federation of Automotive Distribution |
| **FGTS** | Severance Fund Contribution |
| **FGV** | Getulio Vargas Foundation |
| **Fiesp** | Federation of Industries of the State of São Paulo |
| **FIF** | Financial investment funds |
| **Finame** | Special Industrial Financing Agency |

| | |
|---|---|
| **FITVM** | Investment funds in securities and stocks |
| **FMI** | International Monetary Fund |
| **FMP** | Mutual Privatization Funds |
| **FNIT** | National Transportation Infrastructure Fund |
| **FOMC** | Federal Open Market Committee |
| **FRA** | Forward Rate Agreement |
| **FTSE** | Financial Times Securities Exchange Index |
| **Funcafé** | Coffee Economy Defense Fund |
| **GCI** | Brazil - Investor Relations Group |
| **GDDS** | General Data Dissemination System |
| **GDP** | Gross Domestic Product |
| **Gerin** | Investor Relations Group |
| **HCPI** | Harmonized Consumer Price Index |
| **IBGE** | Brazilian Institute of Geography and Statistics |
| **Ibovespa** | Bovespa Index |
| **IBRD** | International Bank for Reconstruction and Development |
| **ICEI** | Industrial Confidence Indicator |
| **ICMS** | Tax on the Circulation of Merchandise and Services and the Rendering of Interstate and Intermunicipal Transportation Services and Communications |
| **ICU** | Installed Capacity Utilization |
| **IDB** | Interamerican Development Bank |
| **IED** | Direct Foreign Investments |
| **IF** | Financial institution |
| **IFO** | Institute for Economic Research |
| **Igae** | Global Indicator of Economic Activity |
| **IGP-DI** | General Price Index - Internal Supply |
| **IGP-M** | General Price Index - Market |
| **IHT** | Index of Hours Worked by Laborer |
| **IIA** | Index of Current Intentions |
| **IIC** | Consumer Intentions Index |
| **IIF** | Index of Future Intentions |
| **IIF** | Institute of International Finance |
| **Imacec** | Monthly Economic Activity Indicator |
| **INCC** | National Cost of Construction Index |
| **Indec** | Instituto Nacional de Estadísticas y Census |
| **INE** | Instituto Nacional de Estadísticas |
| **Inegi** | National Institute of Statistics, Geography and Informatics |
| **INPC** | National Consumer Price Index |
| **Insee** | Institut National de la Statistique et des Études Économiques |
| **INSS** | National Social Security Institute |
| **IOF** | Financial Operations Tax |
| **IPA** | Wholesale Price Index |
| **IPA-DI** | Wholesale Price Index - Domestic Supply |
| **IPA-OG-DI** | Wholesale Price Index - Overall Supply - Industrial Products |
| **IPA-OG-PI** | Wholesale Price Index - Overall Supply - Industrialized Products |
| **IPC** | Consumer Price Index |
| **IPC** | Índice de Precios al Consumidor |

| | |
|---|---|
| **IPCA** | Broad National Consumer Price Index |
| **IPC-BR** | Consumer Price Index – Brazil |
| **IPC-Fipe** | Consumer Price Index issued by the Institute of Economic Research Foundation |
| **Ipea** | Institute of Applied Economic Research |
| **IPI** | Industrialized Products Tax |
| **Ipim** | Índice de Precios Internos al por Mayor |
| **IPM** | Índice de Precios al por Mayor |
| **IPO** | Index of Occupied People |
| **IPP** | Producer Price Index |
| **IR** | Income Tax |
| **IRF-M** | Market Fixed Income Tax |
| **IRRF** | Withheld Income Tax |
| **Isac** | Synthetic Index of Construction Activity |
| **Isae** | Istituto di Studi e Analisi Economica |
| **ISM** | Institute for Supply Management |
| **IVA** | Tax on Aggregate Value |
| **IVF** | Index of Physical Volume |
| **Laia** | Latin American Integration Association |
| **LBTR** | Gross Settlement in Real Time |
| **LDL** | Postponed Net Settlement |
| **LDO** | Budget Guidelines Law |
| **Lecops** | Province Liability Cancellation Bill |
| **LFT** | Treasury Financing Bills |
| **LRF** | Fiscal Responsibility Law |
| **LSPA** | Systematic Farm Production Survey |
| **LTN** | National Treasury Bills |
| **MAA** | Ministry of Agriculture and Supply |
| **MAE** | Electricity Wholesale Market |
| **Mapa** | Ministry of Agriculture, Livestock and Supply |
| **mdb** | million barrels per day |
| **MDIC** | Ministry of Development Industry and Foreign Trade |
| **MEC** | Ministry of Education |
| **Mercosul** | Southern Common Market |
| **Moderfrota** | Program of Modernization of the Fleet of Farm Tractors and Associated Implements and Harvesters |
| **MTE** | Ministry of Labor and Employment |
| **Nafta** | North-American Free Trade Association |
| **Nasdaq** | National Association of Securities Dealers Automated Quotations |
| **NBCE** | Banco Central Notes - Special Series |
| **NCM** | Common Mercosul Nomenclature |
| **NFSP** | Public Sector Borrowing Requirements |
| **NTN-B** | National Treasury Notes - Series B |
| **NTN-C** | National Treasury Notes - Series C |
| **NTN-D** | National Treasury Notes - Series D |
| **NYSE** | New York Stock Exchange |
| **OCDE** | Organization for Economic Development Cooperation |
| **OFPUB** | System of Electronic Formal Public Offers |

| | |
|---|---|
| **OMC** | World Trade Organization |
| **Opec** | Organization of Petroleum Exporting Countries |
| **p.a.** | per annum |
| **p.b.** | Base points |
| **p.m.** | per month |
| **p.p.** | percentage point |
| **p.y.** | per year |
| **PAF** | Financial Assistance Program |
| **Pasep** | Program of Civil Service Asset Formation |
| **PCC** | Job Position Classification Plan |
| **PEA** | Working Population |
| **Pesa** | Special Program for Asset Reordering |
| **PIM** | Monthly Industrial Survey |
| **PIS** | Social Integration Program |
| **PLE** | Required Net Worth |
| **PMAT** | Program of Tax Administration Modernization and Management of Basic Social Sectors |
| **PMC** | Monthly Trade Survey |
| **PME** | Monthly Employment Survey |
| **PMI** | Purchasing Managers Index |
| **PMPP** | currency held by the public |
| **PMSS** | Program of Modernization of the Sanitation Sector |
| **PNB** | Gross National Product |
| **PPE** | Specific Price Share |
| **PPI** | Producer Price Index |
| **PR** | Reference Worth |
| **Procera** | Special Program of Credits to Agrarian Reform |
| **Proex** | Export Financing Program |
| **Proinfa** | Program of Incentives to Alternative Electricity Sources |
| **Pronaf** | National Program of Strengthening Family Farming |
| **PSBR** | Public Sector Borrowing Requirements |
| **RCC** | Resolution and Collection Corporation |
| **Refis** | Fiscal Recovery Program |
| **RGPS** | General Social Security System |
| **RJU** | Single Juridical System |
| **RMSP** | Metropolitan Region of São Paulo |
| **RV** | Sale Registration |
| **SCC** | Swap Contract with Periodic Adjustment |
| **S&P** | Standard and Poor's |
| **Selic** | Special System of Clearance and Custody |
| **SFH** | Housing Financial System |
| **SGP** | Generalized System of Preferences |
| **Simples** | Integrated System of Tax and Contribution Payments by Micro and Small Business |
| **Sindimaq** | National Union of the Machine Industry |
| **Sitraf** | Fund Transfer System |
| **SIUP** | Public utility industrial services |
| **SPB** | Brazilian Payments System |
| **SPC** | Credit Protection Service |

| | |
|---|---|
| **SRF** | Supplementary Reserve Facility |
| **STR** | Reserve Transfer System |
| **TEA** | Scheduled Electronic Transfer |
| **TEC** | Common External Tariff |
| **Tecban** | Banking Technology Corp. |
| **TED** | Available Electronic Transfer |
| **TJLP** | Long-Term Interest Rate |
| **TN** | National Treasury |
| **TR** | Reference Rate |
| **UE** | European Union |
| **UCL** | Unit Cost of Labor |
| **Unicad** | System of Information on Entities of Interest to Banco Central |
| **USA** | United States of America |
| **VAT** | Value Added Tax |
| **VSR** | Amounts Subject to Reserve |
| **WPI** | Wholesale Price Index |
| **WTO** | World Trade Organization |