

# Brazil Report

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MAY 12, 2005

## APRIL 2005

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### The Financial Market

The dollar ended April at R\$2.529, down 5.21% for the month. This was the largest decline of the year for the dollar.

Throughout April, the Central Bank stayed out of the exchange market, suspending its dollar purchases. The bank also cancelled all of its exchange swap auctions on the futures market. Although exports have not been affected by the weakened dollar, exporting firms are convinced that the effects of the exchange rate will begin to be seen in the second semester.

In April, Brazilian stocks were the month's worst investment. The Bovespa index of the São Paulo Stock Exchange dropped 6.64%, its second worst result of the year.

On foreign markets, Brazil's country risk premium ended April at 455 basis points. This was virtually unchanged from March's final premium of 454 points.

**OUTLOOK:** The dollar is continuing to decline and has now fallen below R\$2.50. The Central Bank has shown no inclination to resume its dollar purchases. With exports at their current high levels and Brazil's interest rates attracting speculative capital, it is entirely possible that the dollar will fall even more, approaching R\$2.40. Once the dollar falls below R\$2.45, however, private sector pressure will increase for measures to strengthen the US currency. For the moment, the Central Bank appears to believe that a weak dollar is important in controlling inflation. But if exports start to suffer, we expect some action to be taken to reverse this situation.

### Monetary Policy

The Central Bank in April maintained its tight monetary policy with its eighth straight increase in the Selic rate.

While most analysts had expected the bank's monetary policy committee (Copom) would hold the Selic at 19.25% a year, Copom instead approved a quarter-point hike, raising the rate to 19.50%, the highest level since the Selic stood at 20% in September 2003. Brazil's real rate, discounting inflation, rose to 13.3%, still the highest in the world and far above second place Turkey, at 7.3%.

Business leaders and economists joined forces in condemning the increase which the Central Bank again justified as necessary to control inflation.

But despite eight consecutive months of rising interest rates, inflation is continuing to increase as are

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the inflation projections of the financial market. The results of respected inflation indices for April all showed increases and the financial market's projection for this year's Broad Consumer Price Index (IPCA) rose to 6.2% in April compared with the Central Bank's target of 5.1%. The IPCA is the index used by the government to track Brazil's compliance with its inflation targets.

Prior to the April increase in the Selic rate, economic indicators were already showing a slowdown in the economy blamed in large part on the Central Bank's monetary policy. Following the April Copom decision, several economists said they were lowering their projections for this year's economic growth to the range of 3%.

The Central Bank is also prepared to raise the Selic rate for a ninth straight month in May because of still uncontrolled inflationary pressures.

In the minutes of April's Copom meeting, the bank's directors said that higher international oil prices increase the possibility that the government will have to boost the domestic price of gasoline. The minutes also warned that a drought in Brazil's southern states might drive up food prices.

**OUTLOOK:** The Copom minutes have raised the prospect of another quarter-point hike in the Selic rate in May. For certain, the rate will not decline. Despite growing criticism from the private sector, the Central Bank and the government remain committed to a tight monetary policy to control inflation. This guarantees that rate reductions will only occur when inflation is clearly in decline which today is not the case.

## Business

After two months in decline, industrial production expanded by 1.5% in March from February.

March's recovery left output down 0.2% compared with December of last year, according to the government's statistics bureau, IBGE. Year-on-year, production in March expanded 1.7% and the first quarter ended with a 3.9% expansion versus the same period in 2004. On an annualized basis, output in March was up 7.6%.

March's expansion exceeded financial market expectations of an increase of around 0.7%. Despite the uninterrupted increase in the Selic rate since September of last year, industry continues to benefit from expanded credit and record exports.

But while industrial production expanded in the quarter, it did so at a reduced pace. In the first quarter of 2004, production rose 6.3% compared with this year's 3.9%.

Also despite the improvement in production in March, industrial sales fell 1.12% from February and the quarter ended with a 1.54% decline versus the final quarter of 2004.

In addition, the National Association of Motor Vehicle Manufacturers (Anfavea) announced that auto production, sales and exports fell in April versus March.

Production totaled 203,400 vehicles in April, down 6.9% from March but still 19.7% over the results of April 2004.

Vehicle sales in April totaled 137,667 units, down 7.9% from March but up 19.2% from April 2004. Exports in April were US\$881.9 million, down 5.9% from March but up a spectacular 34.7% from the same month of 2004.

Although exports this year are running at a record pace and have been the main force behind the also record pace of production totals, Anfavea president Rogelio Golfarb warned that the firming of the real is eliminating the automakers' profits from their exports.

Meanwhile, retail sales in São Paulo expanded by 14.72% in March versus March 2004, according to the state's federation of commerce (Fecomércio-SP). This left the quarter's sales up 6.59% compared with the first quarter of 2004.

Although credit sales continue to be the primary force behind retail sales, consumers are finding it increasingly difficult to meet their payments. The Serasa bank credit information service announced that the delinquency rate among consumers rose 24.5% in March from February and 16.2% versus March 2004. For the first quarter, the delinquency rate expanded 11.6% versus the same period last year.

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In addition, the consumer confidence index of the Getúlio Vargas Foundation fell in April for the third straight month.

In reviewing the results, survey coordinator Aloisio Campelo said: "The succession of interest rate increases is starting to affect economic growth and provoke doubts among consumers."

**OUTLOOK:** The numbers on business activity released in April show mixed results. The combination of increased industrial production and falling sales could easily lead to an undesired accumulation of inventories. Exports continue to be the saving factor but the steady devaluation of the dollar presents a major threat to exports. If interest rates do not decline and the dollar remains at its current level, the second semester will likely register a decline in both industrial production and sales.

## Inflation

The government's inflation target for 2005 became more distant with the announcement that the Broad Consumer Price Index (IPCA) registered an April inflation rate of 0.87%, up from 0.61% in March.

The IPCA is used to track Brazil's compliance with its inflation targets and with the April result, the IPCA for the year now stands at 2.68%, more than half the year-end target of 5.1%. April's inflation was also the highest for the index since July of last year.

Electricity rates, urban bus fares and the prices of medications, all of which are under government controls, accounted for over half of April's inflation but food prices tripled, going from an increase of 0.26% in March to 0.81% in April. Food prices were affected by the drought in the southern states which has reduced Brazil's grains output this year.

**OUTLOOK:** April's IPCA result has increased the possibility of yet another increase in the Selic rate. For May, the IPCA should decline and remain at reduced levels for the rest of the year. Even with this, however, the final inflation rate for the year will exceed the government's target of 5.1% and likely will be over 6.3%.

## Public Accounts

The consolidated public sector posted a primary surplus of R\$27.677 billion (US\$10.9 billion) in the first quarter, an increase of 34.8% versus the surplus for the same period in 2004.

The fiscal tightening was necessary to deal with a 20.9% jump in debt servicing costs which reached R\$37.9 billion (US\$14.9 billion) thanks to the steady increase in the Selic rate. Last year, the average Selic was 16.25% a year but in 2005 it is expected to average close to 19%. Over half of the public debt is indexed to the Selic.

Despite rising debt servicing costs, the public debt in terms of GDP is in decline. It fell from 51.6% of GDP last December to 50.8% in March.

The amount of the debt indexed to the exchange rate remained low in March, amounting to 13.08% of the total debt. In March of last year, these exchange papers were 24.74% of the debt.

March alone registered a primary surplus of R\$12.258 billion (US\$4.8 billion), the highest monthly surplus on record. The annualized surplus in March was R\$88.26 billion or 4.85% of GDP, far above this year's target of 4.25%.

**OUTLOOK:** The year began badly with reduced surpluses in January and February. But March's numbers have left the government again on pace to meet its surplus target of 4.25% of GDP. As occurred in 2004, the surplus is being guaranteed through increasing tax revenues which have compensated for higher levels of government spending. This situation should continue for the remainder of the year. The government is continuing to speak of tax relief measures but this appears unlikely given the government's

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heavy dependence on tax collections to produce its monthly surpluses.

## Labor

The unemployment rate in Brazil's six largest metropolitan areas rose slightly in March, climbing from 10.6% in February to 10.8%.

Compared with the 12.8% rate of March 2004, however, there was a significant decline.

The average salary of workers in the areas surveyed rose 0.5% from February and 1.7% versus March of last year. Also the number of workers employed by the formal economy, with higher salaries, increased 6.2% year-on-year, more than the 5.7% increase for workers in the informal economy.

Unemployment in Greater São Paulo rose in March for the second straight month, according to the Interunion Department of Socio-Economic Studies and Statistics (DIEESE) and the Seade Foundation.

The jobless rate rose from 17.1% in February to 17.3% which translates into 1.71 million unemployed persons in the metropolitan area. Despite the increase, the March rate was the lowest for the month since 2001. Last year, March's unemployment rate was 20.6%.

The formal job market continued to expand in the first quarter but at a reduced pace in comparison with last year, according to results released by the Labor Ministry.

The number of workers employed by the formal economy increased by 102,965 in March, the second highest result ever for the month, trailing only last year's record of 108,212 new jobs.

This left the total increase in formal employment in the first quarter at 292,222, down 15.8% from the same period last year which also set a record.

The services sector registered the largest expansion in March with a gain of 54,136 jobs followed by industry, 17,959, retail, 13,962, the public sector, 6,767, and the construction industry, 6,252.

**OUTLOOK:** After increasing in January and February, the unemployment rate has now stabilized and should decline in the second quarter. Salaries are rising but at a slow pace that is unlikely to be felt by the economy.

## Foreign Accounts

Brazil in March recorded another major current account surplus, totaling US\$1.758 billion, the highest surplus on record for a month of March.

This raised the annualized surplus to US\$12.713 billion (2.05% of GDP). March's positive numbers were due to the month's trade surplus of US\$3.3 billion which more than covered the deficit of US\$1.9 billion in the services account. Another US\$338 million entered the country's accounts through remittances from Brazilians living abroad.

Foreign direct investment in March totaled US\$1.4 billion, double the result for March of last year. The first quarter posted net FDI of US\$3.489 billion.

Brazil's reserves in March rose US\$2.9 billion to US\$62 billion. Discounting IMF loans, the total was US\$35.515 billion. The Central Bank raised its projection for the year-end net reserves total by US\$6 billion to US\$37.302 billion.

Brazil's foreign debt in January was US\$199.797 billion, down US\$1.577 billion from December.

**OUTLOOK:** The current account surplus continues to set records. More importantly, FDI numbers are running ahead of last year when FDI totaled US\$18 billion.

## Trade

The weakening of the dollar had no apparent impact on Brazil's exports in April.

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With exports of US\$9.202 billion versus imports of US\$5.326 billion, April produced a surplus of US\$3.876 billion, the highest ever for Brazil. This raised the year's surplus to US\$12.194 billion compared with US\$8.09 billion for the same period in 2004.

Exports in April averaged US\$460 million a day, another all-time record and 39.6% over April 2004. Year-on-year, exports of basic goods soared 49.3%, shipments of semi-manufactured goods jumped 56.6% and exports of manufactured goods rose 30%.

Imports averaged US\$266 million a day, a record for months of April. Versus April of last year, imports increased 15% but were down 0.7% from this March.

**OUTLOOK:** Although April's trade figures showed no signs of a slowdown in Brazil's exports, several sectors are warning that unless the dollar gains strength their exports will fall sharply in the second semester. There is consensus that with the dollar below R\$2.50, it is merely a question of time before exports are affected. Government officials, however, have thus far refused to accept this and continue to point to the monthly surpluses as proof that the exchange rate is not a factor.

## Politics

In April, President Lula's popularity suffered its largest decline since he took office, according to a nationwide public opinion poll taken by the Sensus polling firm.

Lula's approval rating tumbled six points, falling from 66.1% in February to 60.1%. Those expressing disapproval of the president rose from 26.5% to 29% in the April 12-14 survey. The poll, however, showed little variation in the public's rating of the government. In the poll, 41.95% gave the government a positive rating compared with 42.6% in February, and 16% rated it negatively, up from 13.9% in the previous poll.

The poll also demonstrated that if a presidential election were held today, Lula would be re-elected easily. In nine simulated elections, with varying numbers and names of other candidates, Lula would be re-elected in the first round in eight, according to the poll. Only in a simulation with eight candidates running, would a runoff election be required with Lula again the winner.

The poll also showed growing pessimism with the country's social problems. Despite the government's emphasis on anti-poverty programs, 64.6% of the poll's respondents said poverty has increased in the last six months. In addition, an overwhelming 85% said that crime is getting worse.

**OUTLOOK:** Even with April's decline in Lula's approval rating, the president remains highly popular. No opposition political leader comes close to him and the prospects for a Lula victory in the 2006 presidential election are high.

## BRAZIL IN NUMBERS

### TRADE

Period	Exports (in US\$ million)		Imports (in US\$ million)		Balance (in US\$ million)		
	Month	Year (cumulative)	Month	Year (cumulative)	Month	Year (cumulative)	12 Months (cumulative)
1981		23,680		22,086		-1,594	
1982		20,313		19,396		817	
1983		21,900		15,428		6,472	
1984		27,005		13,937		13,068	
1985		25,639		12,189		13,450	
1986		22,393		14,045		8,348	
1987		26,213		15,061		11,152	
1988		33,740		14,680		19,060	
1989		34,421		18,293		16,128	
1990		31,414		20,424		10,750	
1991		31,620		21,041		10,579	
1992		36,207		20,542		15,665	
1993		38,701		25,652		13,049	
1994		43,590		33,167		10,423	
1995		46,493		49,656		-3,157	
1996		47,738		53,281		-5,544	
1997		52,986		61,358		-8,372	
1998		51,120		57,550		-6,430	
1999		48,011		49,210		-1,199	
2000		55,086		55,777		-691	
2001		58,223		55,580		2,643	
2002		60,298		47,188		13,110	
2003		73,084		48,253		24,831	
2004							
November	8,159	87,280	6,082	57,084	2,077	30,196	32,947
December	9,190	96,470	5,696	62,780	3,494	33,690	33,690
2005							
January	7,444	7,444	5,261	5,261	2,183	2,183	34,285
February	7,756	15,200	4,970	10,231	2,786	4,969	35,099
March	9,251	24,451	5,902	16,132	3,349	8,319	35,846
April	9,202	33,653	5,326	21,458	3,876	12,194	37,764

### LABOR

	November	December	January	February	March	April	May
Unemployment Brazil (IBGE, %)	10.6	9.6	10.2	10.6	10.8		
Unemployment Greater São Paulo (Dieese, %)	17.4	17.1	16.7	17.1	17.3		
SP Industrial Employment (Fiesp, monthly % variation)	0.09	-0.44	0.41	0.64	0.27		
Minimum Wage	R\$260	R\$260	R\$260	R\$260	R\$260	R\$260	R\$300

### INDUSTRY

Period	Result	Variation in %		
		Month*	Year To Date	Year-on-Year**
Industrial production (IBGE)	March	-	3.9	1.7
Fiesp Industrial Activity	March	-	4.6	1.7
Auto production (1,000 vehicles)	April	203.4	14.7	19.2

\* compared with previous month \*\* compared with same month last year

## EXCHANGE RATES

Period	Commercial Dollar (end of month in R\$)	Variation Month (%)	Black Market Dollar (end of month in R\$)	Variation Month (%)	Spread Commercial/Black (end of month, in %)
2003					
April	2.8898	-13.82	3.060	-11.30	5.8
May	2.9656	2.62	3.090	0.98	4.1
June	2.8720	-3.16	3.010	-2.59	4.8
July	2.9655	3.26	3.000	-0.33	1.1
August	2.9665	0.03	3.030	1.00	2.1
September	2.9234	-1.45	3.010	-0.66	2.9
October	2.8562	-2.30	2.950	-1.99	3.2
November	2.9494	3.26	3.000	1.69	1.7
December	2.8892	-2.04	3.030	1.00	4.8
2004					
January	2.9409	1.79	3.050	0.66	3.7
February	2.9138	-0.92	2.960	-2.95	1.5
March	2.9086	-0.18	2.990	1.35	3.1
April	2.9447	1.24	3.000	0.33	1.8
May	3.1291	6.26	3.170	5.67	1.3
June	3.1075	-0.69	3.210	1.26	3.2
July	3.0268	-2.60	3.180	-0.93	5.0
August	2.9338	-3.07	3.170	-0.31	8.0
September	2.8586	-2.56	3.120	-1.58	9.1
October	2.8565	-0.07	3.070	-1.60	7.4
November	2.7307	-4.40	3.000	-2.28	9.8
December	2.6544	-2.79	3.010	0.33	13.3
2005					
January	2.6248	-1.12	2.980	-1.00	13.5
February	2.5950	-1.14	2.870	-3.69	10.5
March	2.6680	2.74	2.870	0	7.5
April	2.5313	-5.06	2.800	-2.44	10.6

## MONETARY AGGREGATES

	Period	Quantity		Variation in %	
		R\$ million	US\$ million	Month	Year to Date
Money Supply (M1)*	March	117,205	43,929	-0.8	-8.4
Monetary Base*	March	78,276	29,338	-1.1	-11.8
M4*	March	1,150,517	431,228	1.8	4.1
Private Securities*	March	225,064	84,356	5.4	9.1
Savings Accounts*	March	159,533	59,794	-0.5	-0.2

\* as of end of month

## INVESTMENTS

Options	Closing (April 29)	Variation Week	Variation Month (April)
Black Market Dollar	R\$2.80	-0.70%	-2.44%
Gold	R\$35.30	-0.56%	-4.34%
São Paulo Stock Exchange	24,843	0.30%	-6.64%
31-day CDs (fixed rate), annual yield	19.16%	-	-
CDI	19.43%/year	-	-
Savings Deposits (maturing May 2)	0.67%/month	-	-

## RESERVES

Period	Ready Reserves (in US\$ million at end of period)
1989	7,268
1990	8,751
1991	8,552
1992	19,008
1993	25,900
1994	36,471
1995	50,449
1996	59,039
1997	51,359
1998	43,600
1999	35,554
2000	32,949
2001	35,844
2002	37,823
2003	49,296
2004	
June	49,805
July	49,666
August	49,594
September	49,496
October	49,416
November	50,133
December	52,935
2005	
January	54,022
February	59,017

## INTEREST RATES

	Period	Rate
SELIC	April 29	19.50%/year
ACC, 180 days	April 29	5.2%/year plus exchange correction
One-day Loans (Hot Money)	April 29	2.20%/month
Leasing	April 29	36%/year plus exchange correction
Export Notes	April 29	3.90%/yr plus exchange correction
Credit Cards	April 29	9-10%/month
Special Checks	April 29	7.80%/month

## INFLATION

Index	Period	Month	Year	12 Months
IPCA	April	0.87	2.68	8.07
IGP	April	0.51	2.24	10.22
IGP-M	April	0.86	2.42	10.74
FIPE	April	0.83	2.56	7.94

## RETAIL SALES (nationwide--IBGE)

	Period	Variation in %		
		Month*	Year to Date	12 months
Total Sales	February	1.32	3.84	8.95
Durable Goods	February	16.10	17.93	26.24
Semidurables	February	-1.02	1.63	5.22
Nondurables	February	-0.22	3.09	7.05
Vehicles	February	-2.03	4.90	17.92

\* in comparison with same month in previous year

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