

## **POLITICAL CRISIS**

### **Crisis Forces Resignations of PT Leaders**

The government's political crisis continued to accumulate victims last week.

Under pressure from government officials and congressional leaders, the top three officials of the government's PT Party all submitted their resignations. The first to step down was the party's secretary general Silvio Pereira who was shortly followed by PT treasurer Delúbio Soares.

After first refusing to resign, PT president José Genoino on Saturday told the party's national council that in order to permit a restructuring of the party's leadership he had decided to leave his post.

Genoino's announcement came the day after another stunning new development when a PT official was caught at São Paulo's Cumbica airport attempting to board a flight to the northeastern city of Fortaleza with a suitcase filled with R\$200,000 (US\$84,000) in cash. The Federal Police also found US\$100,000 in US\$100 bills hidden in the underwear of José Adalberto Vieira da Silva, an official of the PT in the state of Ceará and the cabinet head of Genoino's brother, José Nobre Guimarães, a state assemblyman.

Guimarães was also in São Paulo to attend the weekend meeting of the PT's national council but said he had no knowledge of why his aide was in the city. Silva told police the money came from the sale of vegetables but it was later learned that Silva is not a farmer. The incident came at a moment when Genoino was attempting to defend himself and his party from accusations that the PT made payoffs to congressmen to secure their votes on government bills.

Although he resigned, Genoino repeated his claims that no payoffs were made.

Following the collapse of the PT leadership, it was announced that Education Minister Tarso Genro will be the PT's new president, Labor Minister Ricardo Berzoini will be the new secretary general and PT Congressman José Pimentel, also from Ceará, will be the new party treasurer. The PT's communications secretary Marcelo Sereno also resigned and will

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## EXECUTIVE SUMMARY--FOR JULY 4-8, 2005

### Corruption Scandals

Under pressure from government officials and congressional leaders, the top three officials of the government's PT Party all submitted their resignations including PT president José Genoïno.

Genoïno's announcement came the day after a PT official was caught at São Paulo's Cumbica airport attempting to board a flight with a suitcase filled with cash and US\$100,000 hidden in his underwear.

The incident came at a moment when Genoïno was attempting to defend himself and his party from accusations that the PT made payoffs to congressmen to secure their votes on government bills.

Press reports last week also focused on the operations of state company pension funds and the activities of Luiz Gushiken, in charge of publicity and communications for the government. It was reported that since the start of the Lula government, Gushiken's former company increased its revenues by 600%.

The steady stream of accusations and revelations is beginning to have a serious impact on Lula's public image. In a survey taken June 21-29 by the Ipsos-Opinion polling firm and cited by Veja magazine, 55% of the respondents said they believe Lula was aware of the alleged PT payoff scheme in Congress.

### The Financial Market

The financial market last week again turned its attention to the political crisis. The Bovespa index fell 3.51, registering five consecutive declines. On the exchange market, the dollar firmed for most of the week, increasing 0.76% to R\$2.375.

### Cabinet

In the next stage of his cabinet reshuffle, President Lula last week named three members of the PMDB Party to take over government ministries in an effort to strengthen the government in Congress.

Lula also stated that he would name union leader Luiz Marinho as his new labor minister, replacing Ricardo Berzoini.

### Business

After showing no growth in April, industrial production in May expanded 1.3% versus April and 5.5% compared with May 2004. For the year through May, production expanded 4.7% versus the same period last year and on an annualized basis output rose 7.5% in May.

The increase in production in May came as a surprise following the release of numbers showing a decline in industrial sales for the month. Sales fell 1.5% versus May 2004, according to the National Confederation of Industry (CNI).

The National Auto Manufacturers Association (Anfavea) announced that auto production in the first semester totaled 1.202 million vehicles, an increase of 15.7% over the same period in 2004.

This increase was due primarily to exports whose revenues jumped 36.6% in the semester to US\$5.06 billion. Domestic sales also improved, climbing 10.7% versus the first half of 2004.

### Intellectual Property

The government announced that it had reached an agreement with the US pharmaceutical firm Abbot Laboratories and as a result was dropping its threat to break Abbott's patent on the anti-AIDS drug Kaletra.

According to the Health Ministry, Abbott agreed to lower the price of Kaletra in Brazil and will also freeze the drug's price for six years and transfer voluntarily the technology for Kaletra's production to the state-owned laboratory Formanguinhos.

### Inflation

The Broad Consumer Price Index (IPCA), the index used by the government to track compliance with its inflation targets, posted deflation of 0.02%, the lowest result since June 2003.

In the first semester, the IPCA totaled 3.16% and annualized inflation in June was 7.27%. This year's target for the index is 5.1%.

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be replaced by former health minister Humberto Costa. These changes will force President Lula to expand his cabinet reform.

Throughout the week, prominent PT politicians and government officials called for the resignations of the party's leaders. The situation of the top three became virtually untenable following the publication in *Veja* magazine of an article stating that Genoinio and Soares had used advertising executive Marcos Valério de Souza as the guarantor of a PT loan of R\$2.4 million (US\$1.02 million) and Souza had made one of the loan's payments. Souza is accused of having made payoffs to congressmen in the name of the PT.

Press reports last week also focused on the operations of state company pension funds and the activities of Luiz Gushiken, in charge of publicity and communications for the government. It was reported that since the start of the Lula government, Gushiken's former company increased its revenues by 600%. The company provides consulting services for pension funds and nearly all of its income comes from state companies and unions.

It was also learned that the Banco Rural and the BMG Bank, both of which have been cited in the congressional bribery scandal, have received large investments from state company pension funds. Souza's alleged payoffs to congressmen were supposedly made via withdrawals from the Banco Rural while the BMG bank was the source of the controversial loan to the PT guaranteed by Souza. Gushiken, ex-PT communications secretary Marcelo Sereno and former cabinet head José Dirceu were responsible for naming the directors of the leading state company pension funds whose investment decisions have poured millions of reals into the two banks.

Prior to the Lula government, Petros, the pension fund of state oil company Petrobrás, had no investments in either bank but has since placed R\$78 million (US\$33 million) in two BMG investment funds and R\$24.5 million (10.3 million) US\$ in a Rural fund. Real Grandeza, the pension fund of state power company Furnas, invested R\$363 million (US\$153 million) in the two banks last year. These and other investments made by state company pension funds helped BMG increase its profits last year by 205% over 2003.

The steady stream of accusations and revelations is beginning to have a serious impact on Lula's public image. In a survey taken June 21-29 by the Ipsos-Opinion polling firm and cited by *Veja* magazine, 55% of the respondents said they believe Lula was aware of the alleged PT payoff scheme in Congress. Out of these persons, 16% said they believe Lula was involved in the scheme. Regarding the PT Party, 54% of the poll's respondents said they believe the party's leadership was involved in the scandal and 48% stated that the PT is not an honest party.

*Veja* also published an article that raised questions about the business activities of Lula's son, Fabio Luis Lula da Silva. According to *Veja*, Lulinha as he is known, is the partner in a games company which over the last year has received R\$5 million (US\$2.1 million) in investments from Telemar, Brazil's largest phone company. While Telemar is a private company, 25% of its capital is held by the federal Economic and Social Development Bank (BNDES). State company pension funds also have holdings in Telemar, *Veja* said.

As the barrage of accusations continued to mount, Lula last week stayed out of sight, avoiding public appearances and refraining from public statements. Aides described Lula as ill-humored with his mood oscillating daily between depression and anger.

The *Globo* newspaper, meanwhile, published an article stating that the ex-driver of Congresswoman Neide Aparecida (PT-GO) delivered a package containing US\$200,000 from the PT to politicians allied with the party in the state of Goiás.

The driver, Wendell Resende de Oliveira, told *Globo* that he was ordered by Aparecida to travel to the PT's headquarters in São Paulo where he met with a secretary of Delúbio Soares who gave him the package containing the money. According to Oliveira, he and the secretary then counted the bills.

He returned with the money to Goiás where he said it was used to finance the campaigns of local politicians running for office in last year's municipal elections. *Globo* claimed that one of the candidates who received part of the money was Carlos Soares, the brother of Delúbio who is originally from Goiás and a close friend of Congresswoman Aparecida.

The relentless pace of the corruption scandals continued with an agreement between government and opposition leaders to install a separate investigative committee (CPI) to concentrate on the congressional

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bribery scandal. The government had wanted this committee to be restricted to the lower house but the opposition succeeded in extending it to include senate representatives. In an important concession, however, the opposition agreed that the committee would also look into accusations that the government of ex-president Fernando Henrique Cardoso bought support for a constitutional amendment that permitted Cardoso to run for re-election.

The new CPI will only begin its work in August but when it does Congress will be working with three corruption investigations at the same time—the postal service CPI, an investigation of bribery charges brought against an ex-aide of former cabinet head José Dirceu and the congressional scandal.

### **Valério Denies Involvement in Payoff Scheme**

In over 13 hours of testimony Wednesday before the special congressional committee (CPI) investigating the postal service bribery scandal, advertising executive Marcos Valério de Souza denied accusations that he made payoffs to congressmen in the name of the PT Party, the party of the government.

Souza said he had no knowledge of any payoff scheme in Congress and had no involvement in any such operation. Regarding questionable withdrawals totaling R\$21 million (US\$8.8 million) from the bank accounts of his two advertising firms, Souza said the money was used to pay suppliers and to make investments. He refused, however, to provide details of these payments and investments, saying that he would only do this “in the adequate forum,” an indication that he expects to eventually be involved in legal proceedings regarding the charges against him.

Members of the committee said after Souza’s testimony that they would wait for the executive’s banking records to arrive and then would likely call him to testify again. The committee has already voted to request the banking, tax and phone records of Souza and his two companies.

When asked to explain why several of the large withdrawals from his company’s accounts occurred shortly before or during visits to Brasília made by Souza or close to congressional votes on important government bills, Souza said this was mere coincidence.

He admitted to having close ties with PT leaders and to having served as the guarantor of a bank loan to the PT, on which he made one payment. According to Souza, he guaranteed the loan because of his friendship with ex-PT treasurer Delúbio Soares but asked the bank to remove his name as the loan’s guarantor when he was forced to make the first loan payment because, he said, the PT did not have funds to cover the payment.

It was learned during the week Souza had guaranteed a second bank loan to the PT. Epoca magazine published on its web site a copy of a contract for a R\$3 million (US\$1.2 million) loan in which Souza’s signature can be seen as one of the loan’s guarantors. The contract was also signed by ex-PT treasurer Delúbio Soares and former PT president José Genoino. The contract for the loan from the Banco Rural was signed in May 2003. PT officials later admitted that the loan was made and that Souza had guaranteed it.

In his statements before the congressional committee, Souza said he had never registered any financial gains from his connections with the PT and these ties had no effect on his firms’ contracts with several government agencies, including the Banco do Brasil and the post office.

On other points:

- Souza accused his ex-secretary with attempting to blackmail him. In her testimony before the Federal Police and the lower house ethics council, the secretary said that large sums of cash were withdrawn by Souza’s firms and taken to Brasília.

- He denied an accusation made by Congressman Roberto Jefferson (PTB-RJ) that he had delivered R\$4 million (US\$1.6 million) from the PT to Jefferson to cover the costs of PTB candidates in the municipal elections of 2004.

- He attempted to play down the importance of his firms’ government contracts, claiming that they account for no more than 20% of the two companies’ annual revenues of R\$400 million (US\$167 million). He also stressed that most of these contracts were first signed during the government of ex-president

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Fernando Henrique Cardoso.

- He stated that he accompanied executives of the BMG bank when they met with ex-cabinet head José Dirceu at the presidential palace sometime in the first months of 2003. BMG provided the controversial loan to the PT guaranteed by Souza and, according to *Veja* magazine the bank had insisted on meeting with Dirceu before approving the loan. Souza, however, said the meeting with Dirceu and bank officials did not deal with the loan but with other matters.

Meanwhile, press reports brought up other questions involving Souza. According to the *Globo* newspaper, one of Souza's firms, DNA Propaganda, remitted to the United States US\$750,000 in some 50 operations. The paper said the post office CPI would investigate these remittances.

The Reuters news agency reported that a review of bank withdrawals made by Souza's two advertising firms showed that several large withdrawals were made at the same time that Congress was voting on important government bills. On November 30 of last year, Congress approved a presidential decree giving Central Bank president Henrique Meirelles the status of minister. According to Reuters, the day before the vote and on the day itself, R\$480,000 (US\$203,000) was withdrawn from a bank account of SMP&B. Other such coincidences were noted by Reuters when Congress approved the minimum salary increase last year and during voting on the government's tax reform in September 2003.

The *Folha de S. Paulo* newspaper said that a review of the bank withdrawals made by Souza's firms showed electronic transfers of values totaling R\$902,000 (US\$377,000) which was deposited in the account of Glênio Guedes, a prosecutor of the tax department. Guedes was mentioned by Souza's ex-secretary in her testimony before the Federal Police and has been removed from his position because of his ties with Souza.

It was learned that according to Central Bank records, the bank deposits and withdrawals of Souza's two advertising firms totaled R\$836 million (US\$352 million) between 1999 and May of this year. Out of this total, the Council for the Control of Financial Activities (Coaf) informed the committee that it could not identify the origin of R\$459 million (US\$193 million). Coaf called these operations "incompatible with the assets, economic activity or professional occupation and presumed financial capacity of the client (Souza)."

### **Congressman Says Valério Helped Decide Appointments**

The political crisis took another unexpected turn Tuesday with the accusation by a prominent congressman from the PMDB Party that advertising executive Marcos Valério de Souza participated in discussions on the selection of appointees for key positions within the government.

Congressman José Borba, the lower house leader of the PMDB, a government ally, was responding to accusations that he received payoffs from the PT. In a note explaining his relationship with the PT and Souza, Borba said he had discussed with PT leaders and Souza "the nomination of their supporters for positions in the administration."

The note went on to say that Souza "was part of the group of the PT that exercised effective political and administrative influence in the government."

Opposition congressional leaders called for an investigation of Borba and even government leaders admitted they were shocked by his statement. Thus far in the scandal investigation, Souza has been accused of making payoffs from the PT to congressmen but until Tuesday there had been no indication that the advertising executive had any political influence within the government or that he had participated in the division of government positions between the PT and its allies.

Souza, however, denied that he took part in discussions on the selection of nominees for important government positions.

Borba in his statement also denied having ever received any payoffs from the PT.

Fernanda Karina Somaggio, Souza's ex-secretary, said in an interview carried by the *Globo* TV network that Borba had maintained close ties with Souza. According to *Globo*, Borba was in a branch of the Banco Rural in Brasília on December 3, 2003, the same day that one of Souza's firms, SMP&B, withdrew R\$200,000 (US\$84,000) from its account in the bank. Congressman Roberto Jefferson has charged that

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Souza used the Rural branch to make payments to congressmen.

Borba, meanwhile, resigned his post as PMDB party leader in the Chamber of Deputies.

## **BUSINESS**

### **Industrial Production Recovers in May**

Industry in May showed signs that it is recovering from the stagnation that marked the start of the year.

After showing no growth in April, national output expanded 1.3% versus April and 5.5% compared with May 2004, according to the government's statistics bureau IBGE. This was only the second time in 2005 that industrial production expanded from the previous month. Output declined in both January and February while remaining stable in April. The year-on-year expansion, however, was below April's 6.3% growth

Pushed by credit sales, durable consumer goods again led industrial sectors in May, expanding 3.7% from April and 21.4% versus May 2004.

"The maintenance of credit conditions together with foreign sales continue to maintain the increase in the production of durable goods," said Isabella Nunes Pereira, in charge of the survey.

Capital goods also did well with 3.4% growth from April and 3.5% year-on-year, evidence that companies are continuing to invest in new projects. The output of intermediate goods rose 0.8% from April and 2.7% year-on-year. Non-durable and semi-durable goods registered an expansion of 0.6% versus April and 7.5% compared with May of last year.

"All of industry is showing signs of recovery. Until April, the trend indicators showed stability in production. With the addition of May's figures, thus curve has turned upwards," said IBGE's Pereira.

Brazil's increasing petroleum production impacted on May's figures as the mineral extraction sector expanded by 2% from April compared with 1.1% for all other industrial sectors.

For the year through May, industrial production expanded 4.7% versus the same period last year and on an annualized basis output rose 7.5% in May.

The increase in industrial production in May came as a surprise following the release Wednesday of numbers showing a decline in industrial sales for the month. Sales fell 1.5% versus May 2004, according to the National Confederation of Industry (CNI).

Pereira speculated that the drop in sales may have been due to falling prices as shown in the deflation registered for May and June by leading indices.

Average capacity utilization also declined, dropping from 82.1% in May of last year to 81.9%. Industrial employment was unchanged from April, ending 18 straight months of rising employment. Versus May 2004, however, employment expanded 5.72% and payroll rose 9.22%. Hours worked in production also increased 7.55% compared with May 2004.

Versus April, sales in May fell 0.33% and hours worked in production declined 0.12%. For the year through May, sales expanded 1.73% and hours worked improved 7.1%.

CNI economist Flávio Castelo Branco blamed May's weak results on the impact of rising interest rates.

### **Auto Production Rises 15% in First Semester**

The National Auto Manufacturers Association (Anfavea) announced that auto production in the first semester totaled 1.202 million vehicles, an increase of 15.7% over the same period in 2004.

This increase was due primarily to exports whose revenues jumped 36.6% in the semester to US\$5.06 billion. Domestic sales also improved, climbing 10.7% versus the first half of 2004.

Production in June totaled 215,700 vehicles, up 0.4% from May. Domestic sales rose 3.9% from May and were up 13.6% compared with June of last year.

Despite the positive numbers, Anfavea president Rogelio Golfarb warned that the depreciation of the dollar versus the real is cutting into the profits of the auto manufacturers.

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“The profitability of the sector is in a free fall with the impact of the exchange rate on exports. For exports, profits have already disappeared,” he said.

### **Crisis Lowers Consumer Confidence**

The accumulation of corruption scandals and the resulting political crisis are now beginning to be felt beyond Brasília.

The Getúlio Vargas Foundation announced that its monthly consumer confidence index detected a downturn in optimism in June, blamed on the corruption scandals. When questioned on the status of the economy, 35.6% of the respondents said it had worsened compared with 28% in May. For the coming six months, 20% said the economy will continue to deteriorate, up from 16% in May. Regarding the situation of their own families, 21% said it was worse in June, up from 20% in May and 8% predicted it would continue to deteriorate over the next six months, up from 6.5% in May.

Over half of the respondents, 52.9%, said they plan on reducing their purchases of durable goods over the next six months compared with 50% in May.

“The political turbulence with the economic slowdown left consumers less optimistic especially regarding the situation of the country,” said Vargas Foundation economist Aloisio Campelo.

## **THE FINANCIAL MARKET**

### **Crisis Drives Down Share Prices, Firms Dollar**

The financial market last week again turned its attention to the political crisis, ignoring positive numbers on the economy released during the week.

The Bovespa index fell 3.51, registering five consecutive declines. On the exchange market, the dollar firmed for most of the week, increasing 0.76% to R\$2.375.

Despite the recent scandals, foreign investors in June increased their purchases of Brazilian shares. The month ended with net new foreign investments of R\$354 million (US\$149 million), ending three months of declining foreign purchases. In June, foreign investors accounted for 31.9% of the month's volume followed by institutional investors, 27.6% and individuals, 25.3%.

On Friday, the shares of mining company Vale do Rio Doce climbed 3% after it was announced that US rating agency Moody's had raised Vale to investment grade. The mining giant thus becomes the first Brazilian company to reach this level.

Foreign investors have also not lost their appetite for Brazilian debt paper. Since the political crisis erupted, Brazilian firms and banks have conducted US\$3.3 billion in foreign issues including a US\$345 million issue announced Tuesday by the Itaú Bank.

On foreign markets, Brazil's country risk premium rose 2.25% last week to 409 basis points.

### **Brazil Considering Debt Swap To Remove C-Bond**

The National Treasury stated Wednesday that it is studying the possibility of conducting a swap operation to withdraw Brazil's C-Bond from the international market and replace it with new debt that would lower the government's borrowing costs.

A product of Brazil's 1994 Brady Plan debt restructuring, the C-Bond for many years was the country's benchmark foreign bond and a reference for emerging market debt. Today, there are US\$5.6 billion worth of C-Bonds in the hands of foreign investors. These bonds, however, have trailed the rally in Brazilian debt over the past two years and the C-Bond has been replaced as Brazil's benchmark bond by the Global 40 bond.

The Treasury said in an e-mail statement that it may carry out the transaction "soon" without providing

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more information.

The C-Bond started to lose its rank as the most actively traded emerging-market bond when its price approached par value amid a Brazilian debt rally in 2003. The government has an option to buy back, or call, the bond twice a year at par value, which has made traders reluctant to push its price above 100 cents.

The bond's price, as a result, has risen less than 19 cents on the dollar since the rally began in August 2003 while the Global 40 bond has surged more than 38 cents on the dollar in the same period. That price distortion has reduced investor interest in the C Bond, curbing its trading.

Because the C-Bond bond has lagged behind the broader rally in Brazilian debt, it is believed that the government will be able to issue the new bonds at a higher price and lower yield than it buys back the C-bonds, thus reducing its borrowing costs. Analysts said Brazil's debt profile would improve which could help lower the country's risk premium.

### **BNDES Loans Increase 10% in Semester**

Loans for business from the National Economic and Social Development Bank (BNDES) increased 10% in the first semester to R\$20 billion (US\$8.4 billion), a record for the period.

The increase was led by industry whose loans climbed 39% to R\$10.4 billion (US\$4.3 billion). Loans to the export sector rose 31% to R\$2.4 billion.

Consultations for future loans increased 25%, involving plans for projects with a total value of R\$47.6 billion (US\$20 billion).

In June alone, BNDES loans increased 21% versus June 2004 to R\$4.9 billion (US\$2 billion) and consultations soared 225% to R\$12 billion (US\$5 billion).

According to BNDES president Guido Mantega the numbers show that the political crisis has not caused companies to reduce their investment plans.

"I want to contradict the predictions that the political crisis is having an influence on investments. This is not true and does not correspond to the data that we are seeing at the bank," said Mantega.

After a slow start to the year, BNDES loan approvals and disbursements have now quickened but the bank is still well below the pace needed to meet this year's goal of R\$60 billion (US\$25.3 billion) in new loans. Mantega, though, insisted that the bank will be able to release R\$40 billion (US\$16.8 billion) in financing in the second half of the year.

## **TRADE**

### **Brazil and U.S. Reach Agreement on Cotton Dispute**

Just hours after the United States announced an important concession in its cotton dispute with Brazil, the government said it had decided to suspend plans to retaliate against Washington before the World Trade Organization.

The Bush administration announced Tuesday that it is proposing legislation that will end the so-called "Step 2" cotton subsidies program in order to comply with a recent WTO cotton decision in relation to the dispute with Brazil.

The proposed statutory changes would eliminate the Step 2 program, remove a one-percent cap on fees that can be charged under the export credit programs, and terminate the Intermediate Export Guarantee Program (GSM-103).

The U.S. Department of Agriculture said that repealing the Step 2 program would remove both the export subsidies and import substitution subsidies that the WTO cited and address issues related to suppression of cotton prices in world markets.

In response, Roberto Azevedo, the head of the Foreign Ministry's trade disputes department, told a news conference in Brasília that the government would suspend, at least temporarily, plans to retaliate.

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Nevertheless, Azevedo added that Brazil reserves the right to take action in the immediate future if the US does not proceed with its commitment to introduce legislation to end the Step 2 program. With this in mind, Brazil Tuesday filed a request before the WTO for authorization to retaliate against the US, seeking US\$2.9 billion in damages.

According to Azevedo, this action was taken because of WTO procedural rules and was part of an agreement reached with Washington. By that agreement, Azevedo said that Brazil has the right to proceed with WTO grievance procedures if it does not believe that the US is moving to implement a March WTO decision that favored Brazil in the cotton dispute.

In that decision, the WTO upheld a 2004 ruling in favor of Brazil and gave Washington until July 1 to eliminate its export subsidies for cotton and 15 months to end domestic subsidies.

On July 1, the US Department of Agriculture announced compliance with the first part of the WTO decision but stated that any initiative to end the Step 2 program would have to come from congress.

Brazil at first withheld comment, stating only that it would review the USDA announcement and later issue a statement. On Monday, Brazilian officials said the statement would be issued on Tuesday and added that Brazil was ready to file a grievance before the WTO because of the Step 2 issue. But because of the agreement cited by Azevedo, Brazil's response was moderated.

"The Brazilian government recognizes that these are positive steps," Azevedo said, referring to the US statement on Tuesday. "But we will examine if they are sufficient."

Brazilian cotton production has doubled over the last decade and Brazil has gone from a cotton importer to the world's fifth largest exporter. But government officials claim that Brazil could export more were it not for the subsidies granted US cotton producers. These subsidies, Brazil claims, have also lowered international cotton prices.

## **Exports of Agribusiness up 10% in Semester**

Agribusiness exports in the first semester rose 10.2% versus the same period in 2004 to US\$20.2 billion, a record for the semester.

Despite a 20% decline from last year, the soy complex again led the sector with total exports of US\$4.3 billion. Exports of beef, pork and poultry increased 31.5% to US\$3.6 billion. Sugar and alcohol ranked third with exports of US\$2 billion, up 73%.

Other areas with significant export results were wood products, US\$1.9 billion, paper and pulp, US\$1.6 billion, leather, skins and footwear, US\$1.4 billion, and coffee, US\$1.3 billion.

For the 12 months ending in June, agribusiness exports totaled US\$40.7 billion, up 14.7%.

## **GOVERNMENT**

### **Lula Names Three PMDB Leaders as Ministers**

In the next stage of his cabinet reshuffle, President Lula last week named three members of the PMDB Party to take over government ministries in an effort to strengthen the government in Congress.

Eletrobrás president Silas Rondeau was named Minister of Mines and Energy, Senator Hélio Costa was named Communications Minister and Congressman Saraiva Felipe is the new Health Minister. While increasing the PMDB's participation in the government, the decisions also weaken the PT Party. Departing health minister Humberto Costa was a PT nominee as was ex-mines and energy minister Dilma Rouseff who recently took over as cabinet head.

The announcement of the increased role for the PMDB, however, was not well received by the party's seven governors who had opposed a closer approximation with the Lula government. The governors released a note calling for the party to expel the three new ministers.

On Friday, Lula also stated that he would name union leader Luiz Marinho as his new labor minister,

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replacing Ricardo Berzoini. Marinho is currently president of Brazil's leading federation of unions, CUT. His selection was criticized by business leaders who questioned whether he would be able to act objectively because of his close association with organized labor.

Aides said that Lula would complete his cabinet reform this week.

## **Support for Zero Deficit but Concerns with How To Do It**

Business and political leaders last week expressed support for the idea of a zero deficit program for the government but also questioned whether it would be politically viable at the present moment. Finance Minister Antônio Palocci also made it clear that the government has no interest in setting a zero deficit goal.

The idea was first proposed by Congressman Antônio Delfim Neto and was discussed in depth Tuesday night at a dinner hosted by Delfim and attended by leading businessmen, politicians and government officials, including Palocci.

Currently all of the government's fiscal targets are centered on the primary surplus which excludes interest payments. While the government has been successful in meeting these targets, the nominal deficit remains a problem and is likely to end the year in the range of 2.3% of GDP. This deficit continues to feed the public debt, now at 50.3% of GDP and the government's main fiscal liability.

Under Delfim's proposal, the nominal deficit would be gradually reduced until eliminated in a period of four to five years. To do this, the primary surplus would have to be raised to between 4.75% and 5% of GDP. In addition to lowering and eventually eliminating the nominal budget deficit, the Delfim plan would reduce the public debt in terms of GDP and permit the Central Bank to lower interest rates drastically.

Businessmen who were present at the dinner, said the zero deficit idea was well received by virtually everyone in attendance. But several politicians questioned whether it would be possible to reduce government spending at a moment when the government is the target of two corruption investigations and is clearly on the defensive.

The idea of raising taxes to eliminate the budget deficit was rejected, leaving only the alternative of cutting spending. A third option would be to reduce the government's mandated spending which covers over half of the budget. This, however, would require political negotiations involving state and local governments, a difficult scenario.

Armando Monteiro, president of the National Confederation of Industry (CNI), said that there was concern among those present that a zero deficit fiscal program would force the government to cut its spending on social programs which would be politically unworkable.

On Wednesday, Palocci said that with a long-term fiscal effort, it would be possible over a period of "four, five or six years" to eliminate the nominal budget deficit. But he added that the government would never agree to set this as a target.

Palocci also denied that the discussions to improve the government's finances constitute a diversion to draw attention away from the corruption scandals. During Tuesday's dinner, Palocci assured those present that the scandals would not affect government policies and the government has not been paralyzed by the political crisis.

## **INTELLECTUAL PROPERTY**

### **Brazil and Abbott Reach Agreement on Price of Anti-AIDS Drug**

The government announced Friday that it had reached an agreement with the US pharmaceutical firm Abbot Laboratories and as a result was dropping its threat to break Abbott's patent on the anti-AIDS drug Kaletra.

According to the Health Ministry, Abbott agreed to lower the price of Kaletra in Brazil and will also freeze the drug's price for six years and transfer voluntarily the technology for Kaletra's production to the state-

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owned laboratory Formanguinhos. Production by the government firm would start in 2009, the ministry said, but this was denied by an Abbott spokeswoman who said that Abbott will "start transferring technology in 2009...but Brazil will not be able to manufacture the drug before the patent expires" in 2015.

The ministry did not state what the new unit price of Kaletra would be but in previous negotiations with Abbott the government had insisted that the price be lowered from its current level of US\$1.17 to US\$0.68. Abbott also declined to disclose financial terms of the agreement. It said in a statement that the agreement doesn't set a per-capsule price for the drug. Instead, the price will be set based on the number of patients taking the medicine.

"The agreement accomplishes Abbott's objectives of helping Brazil expand patient access to Kaletra while preserving the company's intellectual property rights, which Abbott was not willing to negotiate," the statement said.

The ministry stated that the price reduction would permit a savings of US\$18 million in 2006 and US\$259 million over the next six years. The ministry said it expected the number of Kaletra users to nearly triple to about 60,000 people six years from now from about 23,400 current patients.

The government bought Abbott's Kaletra for the first time in 2002 at US\$1.60 a dose, costing the government US\$35.2 million for its anti-AIDS program which provides the AIDS cocktail free of charge to patients. Since then, Brazil's purchases of the drug have almost tripled to US\$91.6 million.

Two weeks ago, the government broke off talks with Abbott on lowering the price of Kaletra and President Lula authorized the Health Ministry to break Abbott's patent on the drug if the company did not agree to lower its price by July 7. Brazil has in the past reached similar agreements with pharmaceutical companies after threatening to break patents, but it has yet to break any.

## **INFLATION**

### **Indices Show Deflation in June**

Three inflation indices last week reported deflation for the month of June.

The Broad Consumer Price Index (IPCA), the index used by the government to track compliance with its inflation targets, posted deflation of 0.02%, the lowest result since June 2003. In May, the IPCA was 0.49%. Core inflation also fell, declining from 0.56% in May to 0.37%.

According to the Brazilian Institute of Geography and Statistics (IBGE), responsible for calculating the index, June's decline was due primarily to the depreciation of the dollar. Other factors were declining farm prices, which permitted a 0.67% drop in food prices for consumers, and an 8.79% decline in the price of alcohol fuel.

In the first semester, the IPCA totaled 3.16% and annualized inflation in June was 7.27%. This year's target for the index is 5.1%.

The General Price Index (IGP) of the Getúlio Vargas Foundation also registered deflation in June.

Led by a 0.76% decline in wholesale prices, the index posted deflation of 0.45%. This was the second consecutive month of deflation for the index. Consumer prices also fell, declining by 0.05%. The IGP in the first semester recorded inflation of 1.53% and the annualized rate in June was 6.5%.

The IGP is used to determine the level of the annual readjustment in phone rates.

With food prices in decline, inflation in São Paulo fell in June to its lowest level in five years, according to the University of São Paulo's Economic Research Institute (Fipe).

The Fipe rate registered deflation of 0.20%, the lowest monthly rate since February 2000. Food prices declined 1.39% as the farm sector recovers from the first quarter's drought in the southern states. Transportation costs fell 0.11% thanks to a 9.75% decline in the price of alcohol fuel.

For July, Fipe is projecting inflation close to zero but is maintaining its year-end forecast of a rate between 5% and 5.5%.

In the Central Bank's weekly survey of financial market analysts, the average projection for this year's

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IPCA fell for the seventh consecutive week, dropping below 6% to 5.94%.

## **OTHER DEVELOPMENTS**

### **Congress Approves Referendum on Gun Ban in October**

Congress Thursday completed approval of a decree calling for a national referendum on the question of banning the sale of firearms in Brazil.

The nationwide vote will be held on October 23 when voters will be asked to respond yes or no to the question, Should the commerce of firearms and ammunition be banned in Brazil? As in normal elections, all persons 18 and over will be required to vote.

The campaigns for and against the proposal will be led by congressional groups representing the two positions. Each will be granted free air time during the month prior to the vote.

### **Crop Forecast Projects 5% Decline**

In its latest crop forecast, the Agriculture Ministry estimated the 2004/2005 harvest at 112.4 million tons, down 5.7% from 2003/2004 and 14.8% less than December's crop forecast.

Because of this year's drought in the southern states, the soy crop forecast was reduced by 18.2% to 50.2 million tons. Losses in the state of Rio Grande do Sul were estimated at 74.9%. The corn crop also suffered, declining 19.4% to 8.4 million tons.

The largest increase from the December forecast was registered by the rice crop which was projected at 13.3 million tons, up 5.2%.

### **Petrobrás Sets New Oil Production Record**

State oil company Petrobrás set a new production record in June when the average daily output was 1.75 million barrels.

Production in the first semester averaged 1.6 million barrels/day, an increase of 11.5% over the same period in 2004. To reach self-sufficiency, Brazil today must produce an average of 1.8 million barrels/day. On June 23, Petrobrás reached 1.83 million barrels, the highest output of the month.

June was the third consecutive month to set a production record. After declining in 2004, oil production is rising again as new offshore fields come online. Most of Brazil's oil comes from the fields of the Campos Basin, off the coast of Rio de Janeiro. In June, production from the Campos fields averaged 1.47 million barrels/day.

## 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		96,470		62,780		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
May	9,819	43,472	6,367	27,825	3,452	15,646	38,098
June	10,207	53,678	6,176	34,007	4,031	19,671	38,259

### LABOR

	January	February	March	April	May	June	July
Unemployment Brazil (IBGE, %)	10.2	10.6	10.8	10.8	10.2		
Unemployment Greater São Paulo (Dieese, %)	16.7	17.1	17.3	17.5	17.5		
SP Industrial Employment (Fiesp, monthly % variation)	0.41	0.64	0.27	0.61	0.34		
Minimum Wage	R\$260	R\$260	R\$260	R\$260	R\$300	R\$300	R\$300

### INDUSTRY

Period	Result	Variation in %		
		Month*	Year To Date	Year-on-Year**
Industrial production (IBGE)	May	-	4.7	5.5
Fiesp Industrial Activity	May	-	4.7	4.4
Auto production (1,000 vehicles)	June	215.7	15.7	15.3

\* 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					
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	2.830	-1.39	7.5
April	2.5313	-5.06	2.830	0	10.6
May	2.4038	-5.04	2.770	-2.12	15.2
June	2.3504	-2.22	2.740	-1.08	16.5
July*	2.3683	0.76	2.720	-0.73	14.8

\* as of July 8

## MONETARY AGGREGATES

Period	Quantity		Variation in %		
	R\$ million	US\$ million	Month	Year to Date	
Money Supply (M1)*	May	115,984	48,250	2	-9.3
Monetary Base*	May	79,731	33,168	2.5	-10.1
M4*	May	1,169,667	486,590	1.1	5.4
Private Securities*	May	230,912	96,061	0.4	11.9
Savings Accounts*	May	159,383	66,304	0	0.1

\* as of end of month

## INVESTMENTS

Options	Closing (July 8)	Variation Week	Variation Month (July)
Black Market Dollar	R\$2.72	-0.73%	-0.73%
Gold	R\$32.20	-0.92%	-2.72%
São Paulo Stock Exchange	24,422	-3.51%	-2.51%
31-day CDs (fixed rate), annual yield	19.66%	-	-
CDI	19.70%/year	-	-
Savings Deposits (maturing July 20)	0.81%/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	
September	49,496
October	49,416
November	50,133
December	52,935
2005	
January	54,022
February	59,017
March	61,960
April	61,591
May	60,709

## INTEREST RATES

	Period	Rate
SELIC	July 8	19.75%/year
ACC, 180 days	July 8	14.4%/year plus exchange correction
One-day Loans (Hot Money)	July 8	2.75%/month
Leasing	July 8	36%/year plus exchange correction
Export Notes	July 8	11.00%/yr plus exchange correction
Credit Cards	July 8	9-10%/month
Special Checks	July 8	147.5%/year

## INFLATION

Index	Period	Month	Year	12 Months
IPCA	June	-0.02	3.16	7.27
IGP	June	-0.45	1.53	6.50
IGP-M	June	-0.44	1.75	7.12
FIPE	June	-0.20	2.72	6.51

## RETAIL SALES (nationwide--IBGE)

	Period	Variation in %		
		Month	Year to Date	Year-on-Year
Total Sales	April	-0.23	5.00	3.40
Durable Goods	April	1.06	19.60	23.93
Semidurables	April	13.72	5.10	14.77
Nondurables	April	-0.47	3.88	-1.22
Vehicles	April	-1.21	4.14	5.57

\* in comparison with previous month