

COMMENTS ON THE BRAZILIAN ECONOMY

In brief...

A Congressional probe into alleged corruption practices dominated the political scene forcing the resignation of President Lula's chief of cabinet. Markets continued to ignore politics and kept improving on the strength of domestic economic fundamentals and ample international liquidity. With disinflation surprising on the positive side, the Central Bank (CB) ended the monetary tightening cycle. Fiscal accounts remained above target and the trade surplus reached record high levels.

Congressional investigation deepens...

Representative Roberto Jefferson, until then one of President Lula's most important political allies, was accused of commanding a corruption scheme at the post office. In a poignant 7-hour nationally televised deposition before a congressional committee, Mr Jefferson pointed the finger at cabinet chief Jose Dirceu as commanding a bribery scheme to guarantee a government majority in Congress. The national press unveiled evidence suggesting that an advertising agency with important contracts with government agencies might have been the vehicle for the alleged corruption practices. President Lula's response was to send Mr Dirceu back to Congress to defend himself against Mr Jefferson's accusations. He also promised a major cabinet reshuffle to strengthen his government's support base in Congress and help setting it apart from the continuing congressional probe. At month's end, President Lula dismissed from the power giant Furnas corporation three directors who had been accused of misconduct by Mr Jefferson.

...but markets remain tranquil...

Markets decided to bet that President Lula will not be personally tainted by the corruption probe, and were moreover pleased that finance minister Palocci gained more strength in the government as a consequence of Mr Dirceu's departure. Thus, Marcos Lisboa, a former Palocci adviser, was appointed as the new CEO of the national reinsurance company. The new cabinet chief, Ms Dilma Rousseff, seems as critical of the current austere monetary and fiscal policies as Dirceu was. But she has much less political clout than Dirceu, who is second only to Lula in the Workers' Party's hierarchy.

...and continue to improve...

On the strength of domestic economic fundamentals and abundant international liquidity, markets continued to improve. At month's end, Brazil's BR 40 bond spread over US Treasuries declined to 410bp from 424bp in May. Over the same period, the local 1y interest rate swap fell to 18.2% from 18.7%. The exchange rate appreciated to R\$2.35 to the USD from R\$2.40 in May. Following a

worldwide trend, the stock market weakened in local currency terms but, thanks to the appreciation of the Real, managed to gain 1.6% in USD terms.

Central Bank closes the tightening cycle...

With consumer price inflation dropping to 0.1% in June and the wholesale price index accusing deflation for the 2nd month in a row, the CB finally decided to stop raising interest rates and maintained the overnight rate constant at 19.75%. Domestic economic activity definitely slowed down from the rapid pace of a year ago, but, with some help of favorable seasonal factors, employment continued to expand and industrial production to grow in May.

Fiscal accounts are in order...

The primary (or non-interest) surplus of the public sector reached R\$6.3 billion in May, a record-high level for the month. Over a 12-month period, the primary surplus stands at 5.02% of GDP, comfortably above the 4.25% target for the year. On the same basis, the nominal (or with-interest) public sector accounts registered a deficit of 2.6% of GDP in May. But, thanks to the favorable impact of the appreciation of the Real on the dollar-denominated debt, the public sector net debt declined marginally to 50.3% of GDP from 50.4% in April.

...and the external accounts remain positive...

The trade surplus posted a record-high level of \$4.0 billion in June, with merchandise exports for the first time surpassing the mark of \$10 billion in a month. In May the current account was positive at \$615 million, but foreign direct investment, net of Brazilian direct investment abroad, was null, while profit remittances grew on the power of the appreciation of the Real. With a sovereign 10y bond issue of \$600 million the government completed the \$6 billion it needed to refinance its foreign debt obligations for the year.

Furthermore...

In a month, dominated by politics, the government issued a decree easing taxes on fixed investment, particularly those export-related or for the housing market. Congress was transfixed with the corruption probe, but at month's end managed to finalize voting on a constitutional amendment completing the social security reform for the public sector approved last year. This month, attention will continue to focus on the evolution of the Congressional probe and the promised cabinet reform. This will hopefully permit President Lula to restart reform voting in Congress, rather than becoming a "lame duck" for the remaining year and a half of his term.

ECONOMIC DATA

July 01, 2005

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12-Month Period	
														Last	Proj. (3)
INFLATION RATE (1)(2)															
2004	CPI (IPCA)	0.8	0.6	0.5	0.4	0.5	0.7	0.9	0.7	0.3	0.4	0.7	0.9	7.6	6.5
	WPI	1.0	0.8	1.3	1.7	1.5	1.7	1.6	1.4	0.9	0.4	1.0	0.8	15.1	21.5
	IGPM	0.9	0.7	1.1	1.2	1.3	1.4	1.3	1.2	0.7	0.4	0.8	0.7	12.4	16.8
2005	CPI (IPCA)	0.6	0.6	0.6	0.9	0.5	0.1							7.4	6.1
	WPI	0.2	0.2	0.9	1.0	(0.8)	(1.0)							6.8	(3.2)
	IGPM	0.4	0.3	0.9	0.9	(0.2)	(0.4)							7.1	0.8
MONETARY AGGREGATES (1) (4)															
2004	M1	(10.6)	1.5	(1.8)	0.2	3.4	1.2	0.7	2.5	3.8	(0.0)	3.3	12.8	16.7	7.1
	M4	1.6	1.4	0.9	0.5	1.5	1.1	1.1	1.0	1.4	0.9	1.6	1.9	15.8	11.9
2005	M1	(7.1)	(0.9)	(0.8)	(2.7)	2.0								14.5	(5.9)
	M4	1.0	0.8	2.2	0.2	1.1								15.3	14.9
INTEREST RATES (5)															
2004	Overnight (Interbank rate in R\$)	16.3	16.3	16.1	15.8	15.8	15.8	15.9	16.2	16.7	17.2	17.8		16.3	15.8
	One-year interest rate (in R\$)	15.7	15.7	15.3	16.1	18.8	17.0	17.6	18.0	17.4	17.9	17.9	17.8	17.1	17.3
	One-year interest rate (in USD)	3.1	3.0	2.2	2.5	3.6	3.1	2.4	2.8	2.4	2.2	2.8	2.8	2.8	3.1
2005	Overnight (Interbank rate in R\$)	18.2	18.7	19.3	19.5	19.8	19.7							17.9	19.7
	One-year interest rate (in R\$)	18.8	18.5	19.2	19.2	18.7	18.2							18.3	18.7
	One-year interest rate (in USD)	3.8	3.8	4.4	3.9	3.9	4.1							3.3	4.0
STOCK MARKET															
IBOVESPA, São Paulo Stock Exchange Market Index															
2004	Traded Volume (daily average in US\$ mm.) (6)	409	372	329	338	286	272	311	335	331	384	373	446	348.8	298.6
	Index Variation (end of month in US\$)	(3.5)	0.5	2.0	(12.5)	(6.2)	9.0	8.4	5.3	4.6	(0.8)	14.0	7.2	2.3	(3.3)
2005	Traded Volume (daily average in US\$ mm.)	408	665	543	475	401	513							432.2	463.3
	Index Variation (end of month in US\$)	(6.0)	16.9	(8.0)	(1.7)	6.8	1.6							4.1	2.3
EXCHANGE RATE															
(End of month)															
2004	(a) R\$/US\$ (7)	2.94	2.91	2.91	2.94	3.13	3.11	3.03	2.93	2.86	2.86	2.73	2.65	---	---
	(b) % monthly change	1.8	(0.9)	(0.2)	1.2	6.3	(0.7)	(2.6)	(3.1)	(2.6)	(0.1)	(4.4)	(2.8)	(8.1)	30.3
2005	(a) R\$/US\$ (7)	2.62	2.60	2.67	2.53	2.40	2.35							---	---
	(b) % monthly change	(1.1)	(1.1)	2.7	(5.1)	(5.0)	(2.2)							(24.4)	(39.6)
INT'L RESERVES (US\$ billion) (8)															
(Last day of period)															
2004	Net	25.1	24.8	24.9	24.7	24.5	25.0	25.1	24.6	24.9	24.2	24.2	27.5		
	Gross	53.3	53.0	51.6	50.5	50.5	49.8	49.7	49.6	49.5	49.4	50.1	52.9		
2005	Net	30.0	34.8	39.5	39.0	39.2									
	Gross	54.0	59.0	62.0	61.6	60.7	59.9								
MAIN BRAZILIAN BONDS (%) (9) (10)															
2004	BR 40	Price	109.3	105.3	107.0	93.1	90.2	94.3	98.2	107.1	112.1	112.9	115.2	118.7	
		Spread	527	593	581	703	730	679	636	555	485	492	449	404	
	"C" BOND	Price	97.6	95.9	97.6	91.8	89.3	92.0	94.3	98.1	98.9	99.4	100.6	102.5	
		Spread	527	593	566	651	710	634	579	508	475	473	403	358	
2005	BR 40	Price	115.8	115.9	111.4	113.3	118.9	120.4							
		Spread	454	428	477	478	424	410							
	"C" BOND	Price	102.3	101.8	98.9	100.3	102.1	102.4							
		Spread	361	344	412	399	363	358							
<p>(1) End of month values. Percentage change over the previous period.</p> <p>(2) WPI (Wholesale Price Index) and IGPM (General Price Index, Market) from the Vargas Foundation; CPI (IPCA) (Consumer Price Index) from IBGE. The last figure for the CPI refers to the 30-day period ending on the 15th of this last month; previous figures refer to the full monthly period. Figures for the IGPM [a weighted average of Vargas Foundation's consumer price index (30%), WPI (60%), and national construction price index (10%)], always refer to the 30-day period ending on the 20th of each month.</p> <p>(3) Based on the average of the last three months.</p> <p>(4) M1 = currency and demand deposits; M4 = M1 + saving deposits, CDs, money market funds, and Treasury bills.</p> <p>(5) Annual yields, in percentage terms, gross of 20% withholding tax on nominal income on nonbank operations. End of period values, except for the overnight rate, which is the cumulative value for the month. The USD rate is a swap rate and is deliverable in R\$.</p> <p>(6) Daily average = total monthly volume / business days.</p> <p>(7) Average of the offer rate of the last business day of the month.</p> <p>(8) On the liquidity concept. Net reserves exclude only IMF loans.</p> <p>(9) Price = Closing price of the last business day; percentage of face value.</p> <p>(10) Spread = spread over US Treasury bond of equivalent duration, in basis points.</p>															

ECONOMIC DATA (Cont'd)

July 01, 2005

GDP (1)	2002				2003					2004				2005	
	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1
Index (1990 = 100)	133.3	134.8	135.7	134.1	133.9	134.0	134.5	136.8	134.8	139.3	140.8	142.6	143.2	141.5	143.6
% quarterly change	0.6	1.2	0.7	1.9	(1.4)	0.1	0.4	1.7	0.5	1.8	1.1	1.3	0.4	4.9	0.3
ECONOMIC ACTIVITY													Year		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average		
2004 Industrial Production (2)	103.6	103.6	105.6	105.9	108.1	108.6	109.3	110.3	110.1	110.0	110.2	111.4	108.1		
Capacity Utilization (3)	80.9	80.7	81.5	81.6	82.1	83.2	83.5	83.5	83.5	83.8	83.3	82.8	82.5		
2005 Industrial Production (2)	110.8	109.3	110.9	110.8									110.0		
Capacity Utilization (3)	82.5	82.7	82.3	82.1									82.6		
2004 Retail Sales (4)	104.3	105.2	106.3	108.2	110.1	109.9	109.7	109.5	108.6	109.7	111.1	113.3	108.8		
Consumer Confidence (5)	127.3	126.7	115.8	109.3	124.8	117.7	118.7	121.3	128.8	142.5	145.6	141.1	126.6		
2005 Retail Sales (4)	112.4	110.8	112.3	112.0									111.9		
Consumer Confidence (5)	145.7	147.3	146.4	142.0	134.1	133.1							141.4		
EMPLOYMENT (%)													Year		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Average		
2004 Unemployment Rate (6)	11.7	12.0	12.8	13.1	12.2	11.7	11.2	11.4	10.9	10.5	10.6	9.6	11.5		
Employment Level (7)	104.7	104.7	105.2	106.0	106.8	107.3	108.3	108.6	109.7	110.0	110.4	110.5	107.7		
2005 Unemployment Rate (6)	10.2	10.6	10.8	10.8	10.2								10.5		
Employment Level (7)	109.0	108.6	109.4	109.5	110.8								109.5		
PUBLIC SECTOR ACCOUNTS (8)													last		
(% of GDP)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12 months		
2004 Nominal Balance (9)	(3.0)	(4.2)	(2.7)	(1.7)	(2.1)	(2.0)	(2.1)	(1.8)	(2.0)	(2.0)	(2.0)	(2.7)	(2.7)		
Primary Balance (10)	5.2	4.0	5.2	6.1	5.9	5.8	5.6	5.8	5.6	5.6	5.3	4.6	4.6		
Net Public Debt (11)	57.0	56.7	55.6	54.8	55.1	54.2	53.3	52.4	52.0	51.9	51.1	51.7			
2005 Nominal Balance (9)	(0.6)	(2.9)	(2.3)	(1.2)	(1.9)								(2.6)		
Primary Balance (10)	7.4	5.2	6.2	7.3	6.6								5.0		
Net Public Debt (11)	51.4	51.2	51.1	50.4	50.3										
BALANCE OF PAYMENTS													last		
(US\$ billion)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Acc May	Acc Jun	12 months
2004 Trade Balance	1.6	2.0	2.6	2.0	3.1	3.8	3.5	3.4	3.2	3.0	2.1	3.5	11.2	15.0	33.7
Exports	5.8	5.7	7.9	6.6	7.9	9.3	9.0	9.1	8.9	8.8	8.2	9.2	34.0	43.3	96.5
Imports	4.2	3.8	5.3	4.6	4.8	5.5	5.5	5.6	5.8	5.8	6.1	5.7	22.8	28.3	62.8
Current Account	0.7	0.2	0.7	(0.8)	1.5	2.0	1.8	1.7	1.7	1.0	(0.2)	1.2	2.3	4.4	11.7
Net Direct Investment (12)	0.9	1.0	0.5	0.4	0.2	0.3	1.0	(0.8)	0.2	1.2	1.2	2.8	2.9	3.2	8.7
Total External Debt (13)	216.3	214.9	213.5	205.8	207.2	205.6	203.0	203.2	202.2	203.2	203.5	201.4			
2005 Trade Balance	2.2	2.8	3.3	3.9	3.5	4.0							15.6	19.7	38.4
Exports	7.4	7.8	9.3	9.2	9.8	10.2							43.5	53.7	106.8
Imports	5.3	5.0	5.9	5.3	6.4	6.2							27.8	34.0	68.5
Current Account	0.8	0.1	1.8	0.8	0.6								4.1		13.4
Net Direct Investment (12)	1.1	0.8	0.6	3.1	0.0								5.7		11.4
Total External Debt (13)	199.8	202.7	201.9												
(1) IBGE data, seasonally adjusted by IBGE. (2) IBGE index for Brazil, average 2002=100, seasonally adjusted by IBGE. (3) CNI index for Brazil, seasonally adjusted by CNI. (4) IBGE data, seasonally adjusted by IBGE. Nationwide index for inflation-adjusted retail sales, 2003 = 100. (5) FCESP survey data on São Paulo (metropolitan region) consumer expectations for their current and future economic conditions, with a range from 0 (absolute pessimism) to 200 (absolute optimism). (6) IBGE household data for the six major Brazilian metropolitan regions, labor force with ten years of age or more, 30-day search period, not seasonally adjusted. (7) IBGE household data on employed population for the six major Brazilian metropolitan regions, average 2002=100, not seasonally adjusted. (8) Includes federal, state and municipal governments, with respective non-financial enterprises (plus the Central Bank). Accumulated flows in the year to date, except for the net public debt. (9) Net public sector borrowing requirements, computed according to the IMF standards, i.e., excluding the capital losses/gains resulting from exchange rate changes. (10) Non-interest balance. (11) Gross debts of the general government less credits of the general government, plus net debts of Central Bank and public enterprises. (12) Includes intra-firm loans; net of Brazilian direct investment abroad. (13) Central Bank data on total short, medium and long-term external debt of public and private sectors (excluding intercompany loans that are included in FDI).															