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Monthly Report

February

A positive outcome: The Central Bank and Treasury performances

During 2007, the public debt administration went through two different stages: the first half of the year bringing positive news, and the second half being affected by the external volatility scenario. However, results can be considered satisfactory, considering the uncertainty that stressed the financial sector on the last six months of the year, but eventually did not affect the achievement of goals stipulated in the Annual Financing Plan 2007. Moreover, this edition of Sinopse introduces the evaluation of João Henrique de Paula Freitas Simão, chief of the Brazilian Central Bank Open Market Operations Department on monetary policy conduction for the period.

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The first half of 2007 was characterized by positive prospects, according to a path of declining interest rates, the increase in economic activity, a controlled inflation and the upgrade of sovereign risk by credit rating agencies into one level below investment grade. Yields remained a negatively inclined curve during the period, in a decreasing course, showing a positive strategy picture for the improvement of public debt profile.

The placement strategy of the Treasury was affected during the second half of the year. That was mainly due to the external volatility, result of America's real-estate market crisis, with possible effects on the economy of that country, consequently showing a prospect of changes in the Brazilian economic policy, preventing monthly schedules to be performed as originally planned. To start with, there were less fixed rate bonds issues, including auctions suspended and turning down of proposals (particularly NTN-F, longer maturities fixed-rate bonds), once the Treasury did not want to sanction the increase of interest rates, possibly contaminated by the adverse situation adverse. In mid-month August these placements were reintroduced paying higher premiums, therefore increasing cost per issues. However, in September they were reduced, allowing offering lower rates. Until the end of the year, the area faced ups and downs in auctions rates, always influenced by financial news, domestic and external.

As a consequence, last months registered net bonds redemption of R$ 50.4 billion, being R$ 34.8 billion of fixed rate bonds. Regarding these bonds, the most affected by a higher uncertainty situation, rollover rate for the period was 72.9% against previous 133% in the first half of the year. In both semesters of 2006, rate was quite high: 131.2% in one and 143.7% in two. Second half of 2007 also showed a reduction of fixed rate bonds average, reaching 28.2 months in May, and closing the year with an 18 month average.

In contrast, we saw a more active presence of the Central Bank within the open market. There was an increase of net average balance of borrower repo operations. During the year, participation of repo business for maturities between two weeks and three months went from zero in January to 47% of the total in December, while the very short ones (up to 13 calendar days) fell from 53% into 7%. It is also worth mentioning the participation of seven month operations that at the end of the year represented 29% of the total, reaching 43% of the total in March and May.

Even considering that public debt administration during second half of 2007 demanded a higher effort of the National Treasury, its strategy for improving the public debt profile was not very much affected by the deterioration of the external scenario deterioration, as may be seen in the results of DPMFi – Domestic Federal Public Debt, compared to Annual Financing Plan 2007 projections. All the indicators remained within or quite near to the projected interval of that document. Another indicator showing that international volatility impact was well absorbed comes from the comparison to previous crises, when it was observed a smaller tendency of agents to buy fixed bonds, concurrently to the increase of demand by those pegged to SELIC rate and US dollar. Public debt data, four months after beginning of the higher volatility period, show it was not necessary reorienting the management conduction.

Domestic Federal Public Debt (DPMFi) average maturities went to 36.5 months, therefore exceeding the 36 month stipulated maximum interval, rewarding Treasury strategy of increasing average time of issues and bonds switching to longer term maturities. In the case of fixed bonds, the total becoming due in one year and between one and two years fell from 52.9% and 32.22% of the total, in December 2006, into 44.74% and 26.11%, respectively in the same month of 2007, while bonds becoming due between two and three years, and between four and five years went from 6.65% and 0.33% into 17.08% and 6.47% of the total. In this respect, it is worth pointing out the first issue of 10 year fixed rate bonds, NTN-F (National Treasury Notes – Series F - Fixed rate linked to IRR, Internal Rate of Revenue) becoming due in 2017, and the one with longer maturity, exceeding the NTN-F 2014. These figures are reflected in the percentage of DPMFi becoming due in 2 months, which fell from 35.7% at the end of 2006, into 30.2% last year, consequently representing a risk reduction in debt refunding.

The participation of fixed rate bonds in Domestic Federal Public Debt (DPMFi) - 37,3% - was a little over the inferior limit of the projected interval (37%) since Treasury, influenced by the unfavorable external situation, decided to reduce issues of these bonds. International unsteady situation uncertainties avoided a higher participation of these bonds in the total debt profile, compared to 2006: 36.16% against 37.31%, inversely to what happened from 2005 to 2006, when growth was of 8.27 p.p. and the participation remained next to the maximum limit of 37%. As for the stock of bonds pegged to price indexes (26.3% of the total) it was near the ceiling stipulated by the document of the Treasury: 27%. Together, prefixed rate bonds and those whose remuneration is linked to price indexes were in 2007, 63.6% of the total of DPMFi, compared to previous year 58.6%.

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New dealers' rules promote secondary market

Along 2007, besides the improvement of debt profile, we saw the striving of the government to promote bonds secondary market, encouraging the increase of electronic trade and a higher transparence of information. That year, the National Treasury and the Central Bank kept improving the public bond dealers' system, doing regulatory alterations. Main changes were:

• The number of primary dealers was reduced from 12 to 10. According to the Treasury that fact would increase competition among institutions during the accreditation process, requiring a better dealers' performance when participating in public offers and in the secondary market, and the pledge to do repo operations. Still according to the Treasury, "with a more restricted group of dealers, there will be a higher need of commitment of accredited institutions to their obligations regarding the Treasury and Central Bank",

• Concerning the assessment of operations, an alteration was made in the multipliers of nominal value of bonds of definitive operations and public offers, giving a higher weight to participation in operations of longer average duration, particularly the ones with fixed rate bonds and remunerated by IPCA (Extended Consumer Price Index);

• Also for assessment purposes, definitive operations among market participants with bonds becoming due in 90 or less days, no longer were taken into account;

• The maximum number of institutions that might simultaneously be present in both groups (primary and specialist) was reduced from four to three;

• Regarding performance goals, for primary dealers it became compulsory having a participation of 4% (formerly: 3.5%) in operations resulting from public offers;

• In sales based on Treasury public offer average prices, each group of dealers was assigned with 50% of the bonds (previously 60% were assigned to primary and 40% to specialists).

Strategy remains the same for 2008. In the beginning of the year was published the Joint Normative Ruling nº 15, modifying the establishment of goals for institutions duly authorized to act as dealers, with the purpose of increasing transparency of public federal bonds trade in the secondary market. The main change refers to requirements for specialist dealers regarding trade electronic systems. Previous rules already anticipated the intention of using that criterion, valid for that segment of dealers, as an alternative to goals such as a minimum number of business days for definitive operations with selected maturities. The new regulation excludes these goals and also others related to repo operations, that had to be attended by both primary and specialist dealers. Besides including the presentation of offers in trade electronic systems as a new assessment criterion, the just edited ruling also stimulates these agents to expand their performance by means of duly authorized information spread systems. It is expected to see an increase of electronic environment businesses, which already expanded 23% in 2007, compared to 2006.

Annual Financing Plan 2008 foresees continuity of debt rescheduling

By end of January, the Treasury released prospects for the current year through its Annual Financing Plan 2008. The document introduces public debt financing strategy, detailing several scenarios used to draw up goals – one of them considering lack of significant external or domestic shocks, other with a positive external scenario, and a third one including risk of international market problems, possibly slowing interest rates cut pace. It is worth mentioning that the first two goals consider there is room for reintroducing the interest rates decline.

Treasury has informed that DPMFi 2008 maturities correspond to R$ 386.8 billion, being R$ 291 billion referred to principal and the balance to interests. From that total, 54.7% are fixed rate bonds, 32.9% interest rate indexed, and 11.8% price index remunerated. Maturity percentage of price index remunerated bonds compared to those pegged to interest rates may be explained by the average issue maturity, much longer than the total public federal debt average maturity.

As for issue strategy, the Treasury will use the same as previous years: to continue working rescheduling average debt maturities and reducing short term maturities, mainly issuing fixed rate bonds and pegged to price indexes, to keep improving the public debt composition. Treasury states that “this strategy will allow developing fixed interest rate curves and price index remunerated bonds, vital for particularly guiding market evolution of these bonds, and capital markets, at greater length”. Treasury estimates that public federal debt stock is between R$ 1.48 and R$ 1.54 trillion, against R$ 1.33 trillion at the end of 2007, while average maturity debt, that ended 2007 being 39.2 months, will increase to a range between 42 and 46 months by the end of this year. Quite the opposite to what

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happened in previous years, the document introduces results projected only for the public federal debt, without specifying domestic and external debt figures.

The Central Bank maintains its monetary policy conduction

The interruption of process for reducing the SELIC rate and the worsening of external scenario did not affect market liquidity conditions of the bank reserves, according to the evaluation of chief of Demab - The Brazilian Central Bank Open market Operations Department - João Henrique de Paula Freitas Simão. He considers there was no impact in the performance of the Central Bank regarding their open market transactions for the period, and therefore guarantees keeping the monetary policy conduction as normal.

Mr. Freitas Simão believes that fostering new dealers' open market rules released in January, is aligned with efforts made during last years by the Central Bank and the National Treasury to strengthen the public bonds secondary market. The new rule would be an additional measure pointing out that objective: "The more active dealers' participation in electronic pits provides a higher transparence and will improve mechanisms of price forming in that market", states Freitas Simão.

Regarding several technologic improvements recently introduced in the SELIC - Special System for Settlement and Custody - such as new functionalities and the presentation of Ofpub module – Formal Electronic Public Offer –, Freitas Simão states that these enhancements are among Demab initiatives oriented to a constant perfecting of the system. Besides other developed innovations, we can mention the IOS – SELIC Operational Interface -, allowing new ways of consulting and transmitting commands. "The agility and safeness of SELIC contributes to improve the performance of primary and secondary bond markets and to introduce Central Bank monetary policy actions" he concludes.