



BANCO CENTRAL DO BRASIL

Minutes of the 127th Meeting of the Monetary Policy Committee (Copom)

Summary

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Date: June 5th, from 5:00PM to 7:30PM, and June 6th, from 5:00PM to 8:00PM

Place: BCB Headquarters meeting rooms - 8th floor on June 5th and 20th floor on June 6th – Brasília – DF

In attendance:

Members of the Committee

Henrique de Campos Meirelles – Governor
Alexandre Antonio Tombini
Antonio Gustavo Matos do Vale
Mário Gomes Torós
Mário Magalhães Carvalho Mesquita
Paulo Sérgio Cavalheiro
Paulo Vieira da Cunha

Department Heads (present on June 5th)

Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on June 6th)
Ivan Luis Gonçalves de Oliveira Lima – Open Market Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
Renato Jansson Rosek – Investor Relations Group

Other participants (present on June 5th)

Adriana Soares Sales – Deputy Head of the Research Department
Alexandre Pinheiro de Moraes Rego – Special Advisor to the Governor
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo – Advisor to the Board
Katherine Hennings – Advisor to the Board
Jocimar Nastari – Press Secretary

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

Recent Economic Developments

1. IPCA inflation totaled in April and May 0.25% and 0.28%, respectively, down from 0.37% in March. As a consequence, inflation through May stood at 1.79%, above the 1.75% rate reached in the same period of last year. Regulated prices totaled 1.35%, down from 2.70%, according to the same comparison basis, contributing to contain inflation, once market prices reached 2.01% in the period, above the 1.27% observed in the same period of 2006. Twelve-month trailing inflation through May reached 3.18% (compared to 4.23% through May 2006), while market



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prices increased 3.32% and regulated prices grew by 2.88% (2.48% and 8.24%, respectively, through May 2006). Month-on-month inflation deceleration in April and May was a result of market prices inflation decline (0.19% and 0.25%, respectively, down from 0.44% in March), in contrast with regulated prices inflation acceleration (0.39% and 0.35% in April and May, respectively, up from 0.21% in March). In addition, tradable goods price inflation accelerated 0.25% and 0.48%, respectively, in April and May, up from 0.21% in March, in contrast with non-tradable price inflation, which totaled 0.13% and 0.03%, down from 0.66%, according to the same comparison basis. Services inflation reached 0.18% in April and 0.26% in May, totaling 4.87% in the last twelve months. Dampened inflationary pressures at the end of 2006 and at the start of 2007 indicate that inflation should evolve according to the targets path.

2. IPCA core inflation measures did not follow the declining headline inflation behavior. Core inflation by exclusion of household food items and regulated prices increased month-on-month 0.29% in April and 0.33% in May, up from 0.23% in March. On the other hand, smoothed trimmed means core stood at 0.29%, virtually unchanged relative to March, while the non-smoothed trimmed means core increased 0.28% in April and 0.30% in May, up from 0.24% in March. In the year through May, core inflation by exclusion and smoothed and non-smoothed trimmed means core measures recorded 1.80%, 1.51% and 1.40%, respectively, below the rates observed at the same period of 2006. In the last twelve months, smoothed trimmed means core totaled 3.68% in May and 3.86% in April, down from 3.98% in March. On the other hand, on a twelve-month trailing basis, core inflation by exclusion and non-smoothed trimmed means core increased in April and May, relative to March, but stood below the 4.5% central target for 2007.

3. The General Price Index (IGP-DI) inflation averaged 0.29% in the first quarter of the year (0.07% in the same period of 2006), but decelerated in April and May, averaging 0.15%. This deceleration influenced similarly the behavior of two out of the three great IGP-DI components: the Consumer Price Index-Brazil (IPC-Br) reached 0.28%, down from 0.50%, while the Wholesale Price Index (IPA-DI) declined to -0.01%, down from 0.21%. On the other hand, the Civil Construction National Index, which averaged 0.31% in the first quarter of the year, averaged 0.81% in the two months ended in May, due to pressures stemming from raw material costs and wage adjustments. In the last twelve months through May, the IGP-DI reached 4.38%, up from -0.14% in the same period of 2006. In light of the 3.12% elevation of the IPC-Br in the last twelve months through May, the IGP-DI increase in the same period was, to a large extent, influenced by the IPA-DI and the INCC changes, which totaled 4.76% and 5.18%, respectively. The IPA-DI acceleration was mainly driven by agricultural prices, which increased 9.13%, while industrial prices only increased 3.46%. As highlighted in previous Copom Minutes, the effects of wholesale prices over consumer inflation will depend on prospective demand conditions and price-setters' expectations for the future inflation path.

4. Despite recording some accommodation in April, industrial output continues to present robust growth trend. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output grew 0.6%, compared to the previous month, maintaining the growth pace observed in March, and registered the thirteenth consecutive expansion. Compared to the same month of last year, industrial output grew 6%, the highest rate observed since June 2005 under this comparison basis, reflecting the expansion in 20 out of the 27 activities surveyed. In the last twelve months, industrial output expanded by 3.3%, with 3.1% for manufacturing industry and 5.7% for mining. For May, the few leading and coincident indicators available for industrial production suggest the continuity of the ongoing expansion. The several incentive factors to economic activity, including the monetary easing already implemented, suggest that the expanding trend in industry shall continue in the upcoming months.

5. Disaggregated industrial data showed month-on-month seasonally adjusted expansion of 15.4% in capital goods production and 4.2% in the production of intermediate goods. Compared to the same month last year, capital goods production expanded by 17.4%, while intermediate goods production increased by 5.3%. According to the same comparison basis, durable goods production increased by 5.4%. The dynamics of capital goods production reflects the consolidation of positive prospects for domestic demand growth and the influence of favorable international prices in some sectors. In addition, the expansion of intermediate goods production in the first four months of the year suggests a more generalized acceleration in industrial activity.

6. In line with the usual seasonal pattern at the start of the year, the unemployment rate increased in the first months of 2007 to 10.1% in March and April up from 8.4% in December 2006. However, in the year through April,



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the average unemployment rate stood 0.2 p.p. below that observed at the same period last year. The purchasing power of workers increased 5% according to the same comparison basis, a record high for the series. Real payrolls increased 8% in the year through April, compared to the same period last year, an important factor sustaining the growth of aggregate demand. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment increased month-on-month 0.4% in April and March, after totaling 0.2% in February, reaching a record high for the series started in 2003. In addition, manufacturing employment expanded by 3.1% in April, compared to the same month of last year. Regarding formal employment, data from the Ministry of Labor and Employment (MTE) confirms the continuity of expansion in April, with the creation of 302 thousand new jobs (0.5% growth on a month-on-month seasonally adjusted basis) and 1,361 thousand jobs in the last twelve months. As a consequence, in the year through April, as well as on a twelve-month trailing basis, formal job creation grew 4.8%, with highlights for civil construction (7.5%) and mining (4.8%).

7. Retail sales increased 1.1% month-on-month in March, after expansions of 0.4% in February and 2% in January, according to data seasonally adjusted by the IBGE. With this result, retail sales expanded 2.8% in the first quarter, quarter-on-quarter. Compared to the same quarter of 2006, retail sales expansion reached 9.7% in the first quarter of the year, outpacing the 7.0% expansion recorded in the last quarter of 2006. For this robust performance of retail sales, which indicates strong growth of domestic demand, contributed both items more sensitive to payroll expansion, such as “other items of personal and domestic use” (21.8% expansion, according to this comparison basis) and those that are usually more sensitive to credit conditions, such as furniture and domestic appliances (20.5% expansion in the period). Expanded retail sales, which include the sales of civil construction material and vehicles, motorcycles, parts and pieces, increased 13.2% in March, compared to the same month of 2006, the ninth consecutive month that expanded retail sales exceeded retail sales. For the rest of the year, it is expected the continuity of retail sales expansion, boosted by the increase in employment and income, credit expansion, the monetary easing process and by the recovery of consumer confidence.

8. Installed capacity utilization in the manufacturing industry averaged 81.0% in the year through April, up from 79.1% in the same period of 2006, according to CNI data without seasonal adjustment. The installed capacity utilization rate, according to CNI data seasonally adjusted by the BCB, stood at 81.8% in April, 3.1 p.p. above that observed in the same month of 2006, and 0.5 p.p. below the record high for the series observed in July 2004. According to CNI data seasonally adjusted by the CNI, installed capacity utilization reached 82.6% in April, a new record high for the series. Disaggregated indicators calculated by CNI indicated that 15 out of 19 sectors exceeded the average installed capacity utilization, compared to eleven sectors at the same month of last year. This dynamics reflects the intensification of economic activity, although recent data relative to production and absorption of capital goods indicate that investment expansion remains robust. In the year through April, the absorption of capital goods robustly increased 20.1%, compared to the same period of 2006. This result reflects the increase in capital goods imports (32% in volume), as well as capital goods production (15.4%). The production of inputs for civil construction increased 3.5%. In light of the recent installed capacity utilization rates, the continuity of investment expansion will be essential to avoid relevant imbalances between aggregate supply and demand. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments with regard to the expansion of supply of goods and services to adequately meet demand conditions.

9. The trade balance continues to present robust performance, confirming the evaluations based upon Inflation Reports and previous Copom Minutes that depict important structural changes in the Brazilian foreign trade. After reaching in 2006 a US\$ 46.1 billion record high, a 3.2% increase over the 2005 result, the trade balance continuous to register vigorous surpluses that encourage analysts to review positively their forecasts. In the year through May, the trade surplus reached US\$16.9 billion, a 9.3% increase relative to May 2006. Exports rose 21.2%, to US\$60.1 billion, while imports increased 26.7% to US\$43.2 billion. As observed in previous Copom Minutes, imports have been growing more rapidly than exports at the margin, due not only to higher level of economic activity, but also to the strengthening of the BRL, which points to a healthy adjustment process of the trade balance.

10. With regard to the international scenario, uncertainties surrounding the monetary policy stance in the US persist. Signals that inflation could be running above the FOMC comfort zone indicate that expectancies of an easing cycle starting this year may have been premature. Moreover, additional interest rate increases in the US



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cannot be discarded. Similarly, the possibility of stronger-than-expected economic deceleration and its potential effects over the other worldwide economies cannot be ignored. On the other hand, the strengthening of economic activity in Europe and the continuity of the robust expansion of the major countries in Asia have so far compensated for the moderate economic deceleration in the US. The maintenance of growth rates at historically high levels has caused higher inflationary pressures especially over raw materials and food prices. In this context of robust global growth, the economy and prices of Brazilian assets have shown both remarkable resilience to the fluctuations in international financial markets, thanks to the improvement in economic fundamentals in the recent years, and to a very benign behavior of export prices. In this sense, in addition to showing more resilience to changes in international markets sentiment, the Brazilian economy trails a growth cycle with price stability. Considering all this factors, the Copom continues to consider that the international scenario is favorable.

11. Oil prices, another external source of uncertainty, rose since the last Copom meeting and still present volatility. The recent levels of international prices of this commodity seem to be reflecting both structural shifts in global demand for energy and recurrent episodes of geopolitical tensions. Despite significant risks inherent to forecasts on future oil prices trajectory, the main scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2007, continues plausible.

Assessment of Inflation Trends

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

a) Compared to the values considered in the April Copom meeting, the projection for gasoline and bottled gas prices adjustments in 2007 were both maintained at 0%;

b) The projection for electricity and fixed telephone price adjustments in 2007 were modified relative to the April forecasts. The new projections for electricity and fixed telephone are -0.9% and 3.3% respectively;

c) The projection for regulated prices inflation in 2007 decreased to 3.6% from 4.2% (projection of the April Copom meeting). These items, according to the weights released by the IBGE, represent 30.99% of the total May IPCA;

d) The projection for regulated prices inflation in 2008 was also changed, to 4.8%. This projection is based on the endogenous determination model for regulated prices. This model considers the effects of seasonal components, exchange rate change, market prices inflation and the IGP;

e) The projection for the spreads over the Selic rate, using a Vector Autoregressive model based on the Selic and 180-day swap rates on the eve of the meeting, estimates a 6 bps in the fourth quarter of 2007, reaching 70 bps in the last quarter of 2008.

13. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 3.8% of GDP in 2007 and 2008 will be achieved, adjusted by the possibility of a 0.45 p.p. reduction in this percentage due to the implementation of PPI (Investment Pilot Program). The related assumptions considered in the previous meeting were maintained.

14. Since the April Copom meeting, median IPCA inflation expectations for 2007, compiled by the BCB's Investor Relations Group (Gerin), decreased to 3.5% from 3.8%. This reduction was mainly driven by a decrease of inflation expectations for the third quarter of 2007. The twelve-month ahead inflation expectations decreased to 3.37% down from 3.64%. For 2008, inflation expectations remained at 4%. As mentioned in previous Minutes, these developments suggest the consolidation of a more favorable long-term macroeconomic scenario.

15. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the Selic rate at 12.5% and the exchange rate at R\$1.95//US\$ during the forecast period – the projection for the 2007 IPCA reduced compared to the values considered at the April Copom meeting, remaining below the 4.5% target



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established by the CMN for the year. The forecast based on the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – situated below the values considered in the April Copom meeting and below the central target for the year. The projection for 2008, based on the benchmark scenario, stayed relatively stable in relation to the April projection, remaining below the 4.5% target. Under the market scenario, the projection still remains above the 4.5% target.

Monetary Policy Decision

16. The Copom reaffirms the view expressed in previous Minutes, that in addition to containing short-term inflationary pressures, monetary policy has also contributed significantly for the consolidation of a favorable long-term macroeconomic environment. Economic activity data point to strengthened demand expansion, but still do not suggest high probability of important pressures over inflation in the short-run. Imports expansion has contributed significantly to this process, complementing domestic production and, therefore, limiting potential inflationary effects of aggregate demand sustained growth. Moreover, despite the uncertainties regarding the continuity of the strong growth recently observed in the international economy, the prospects of lower liquidity in important international markets, and the volatility increase in the global markets, the external outlook remains favorable. Particularly regarding Brazilian external financing, the combination of significant trade surpluses and increasing capital inflows suggests that the balance of payments will continue to perform robustly. Therefore, the prospects for the inflation trajectory remain benign. As in recent meetings, the Copom emphasizes that the main challenge of the monetary policy in this context is to guarantee the consolidation of positive developments anticipated for the future.

17. The Copom evaluates that the more benign behavior of inflation in the recent months, in contrast with relatively high monthly rates that had persisted since the end of 2006, confirms the convergence of inflation trajectory to the targets path. The emergency of global inflationary pressures still does not present risks for the domestic inflation trajectory in the short run, but a heated demand could increase the pass-through of wholesale prices pressures to consumer prices. In this sense, the Copom will continue to manage the monetary policy stance so that the gains obtained in inflation control in recent years become permanent. In this respect, the Copom will carefully monitor the evolution of inflation and the several core inflation measures in the upcoming months, discriminating between one-off and persistent or generalized price increases, and promptly adjusting the monetary policy stance to the circumstances.

18. The preservation of inflation rates in line with the targets path and the consolidation of a long-lasting stable macroeconomic scenario will contribute to the progressive reduction of macroeconomic risk perception underway. The scope for a reduction in real interest rates in the future will naturally follow as a consequence of this improved perception. The Copom evaluates that its cautious monetary policy stance has been critical to increase the probability of inflation convergence to the targets path. For this to materialize, however, it is important that forward-looking inflation indicators remain consistent with the recent benign inflation outlook observed in the last quarters.

19. The Copom emphasizes, once again, that there are important time lags in the transmission of monetary policy stance to economic activity and inflation. Since the beginning of the monetary easing cycle, in September 2005, the Selic rate has already been reduced by 725 b.p., with the bulk of the reduction concentrated in the last nine months. Consequently, the activity level has not completely mirrored the effects of the interest rates cuts, as well as the effects of the economic activity resumption on inflation have not completely materialized. Therefore, the evaluation of alternative monetary policy stances should necessarily focus on the prospective inflation scenario and its risks, instead of current inflation indicators.

20. During the coming months, employment and income expansions and credit growth will continue to bolster economic activity. As mentioned in recent Copom Minutes, activity level should also reflect the effects of governmental transfers and other fiscal impulses occurred in 2006 and expected for the next quarters of the year. Consequently, the lagged effects of interest rates cuts on an increasingly robust aggregate demand will add up to other factors that will continue to contribute to this expansion. These issues become even more relevant considering the signs of heated aggregate demand, and the fact that the monetary policy decisions should have limited effects in 2007 and predominant impacts in 2008.



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21. In light of the existing incentives for expanding aggregate demand, the uncertainties surrounding the monetary policy transmission mechanisms, the lower distance between the current Selic rate and the medium-term equilibrium interest rates, and the interest rate cuts implemented since September 2005, the Copom members understood that the preservation of important achievements in disinflation and in preserving economic growth, with job creation and rising real income, demands a cautious monetary easing stance.

22. The Copom evaluated that, since the last meeting, influences of internal and external factors on the balance of risks for the expected inflation trajectory exacerbated, and in opposite directions. External sector, acting importantly to widen aggregate supply, continues to influence inflation prospects in a predominantly benign way. On the other hand, expansion of domestic demand may increase the risks to inflation dynamics on the medium-run.

23. Some participants of the Committee understood that, considering the extension of the easing process already implemented, the remaining uncertainties regarding the lagged impacts of the monetary easing, the expected behavior of the other sustaining factors of the expenditure, such as income growth, in a scenario of solid expansion of domestic demand for tradable and non-tradable goods and services, and of economic activity strengthening, the maintenance of the 25 b.p. reduction pace in the Selic target rate would contribute to extend the easing process over time.

24. However, the majority of the Committee argued that the contribution of the external sector for the consolidation of a benign outlook for inflation could be higher than previously expected, especially by controlling the prices of tradable goods and by increasing investments in a heated demand environment. Such contribution is favoring the equilibrium between aggregate demand and domestic supply growth rates at a pace in line with monetary policy decisions, without compromising the convergence for the inflation targets trajectory. Therefore, five members of the Committee understood that the risk balance to the evolution of future inflation would justify a 50 b.p. reduction in the Selic target rate.

25. Given the reasons stated above, the Copom decided to continue the monetary easing cycle and reduced the Selic target rate to 12.00% p.a., without bias. Five votes were for the Copom monetary policy action, while two votes were in favor of reducing the Selic target by 25 basis points.

26. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing alternative scenarios for the main variables that determine price dynamics and the balance of risks associated to the forecasts. Despite the remaining uncertainties regarding the US economy, the international scenario remains favorable, and benefits the external sector contribution for the maintenance of a benign inflationary outlook. On the other hand, a set of price pressures arises when domestic demand expands vigorously, backing-up the economic activity recovery. This expansion encompasses some sectors little exposed to external competition, when the effects of important incentive factors, such as the monetary easing already implemented, are not fully perceived. In such environment, the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons.

27. At the conclusion of the meeting, it was announced that the Copom would reconvene on July 17th 2007, for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 15,011 of October 31, 2006.

SUMMARY OF DATA ANALYZED BY THE COPOM

Inflation

28. The IPCA increased 0.28% in May, up from 0.25% in April, accumulating 3.18% growth in twelve months. In the year through May, the index increased 1.79%, above the 1.75% rise recorded in the same period of 2006. This rise in May reflected distinct behavior among the large groups. The main increases were for food and beverages, especially *in natura* milk; personal outlays, especially household workers; and clothing, as a result of seasonal pressures. In an opposite side, the lowest rates were for communication, housing, and transportation, due to the cooling of oil prices rises.



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29. Market prices inflation increased 0.25% in May, up from 0.19% in April, while regulated prices decreased totaled 0.35%, down from 0.39%, in the same period. In the last twelve months, market prices increased 3.32%, and regulated prices, 2.88%. Among market prices, the prices of non-tradable goods increased by 4.42%, mainly because of the 4.88% elevation in services prices, while the prices of tradable goods prices increased by 2.14%.

30. On a twelve-month trailing basis, smoothed trimmed means core measure maintained a downward trend, while the core excluding household food and regulated prices and the non-smoothed trimmed means core recorded rises. Even recording rises under these two criteria, the cores changes stood below the target for the IPCA. The smoothed trimmed means core increased 0.30% in the month, up from 0.29% in April, totaling 3.68% in the twelve months through May, down from 3.85% in April. The non-smoothed trimmed means core reached 0.30% in May, up from 0.28% in April, accumulating 2.39% in twelve months, compared to 2.33% in April. Finally, the core excluding household food and regulated prices reached 0.33% in May, up from 0.29% in the previous month, and accumulated 3.04% in twelve months, compared to 2.66% in the previous month.

31. The IGP-DI increased to 0.16% in May, up from 0.14% in April, accumulating 1.18% in the year through May and 4.38% in twelve months. Considering the main components of the index, the rate increase was, exclusively, a result of the INCC elevation, which reached 1.15% in the month, up from 0.46% in the previous month. The INCC result was mainly driven by the 1.81% increase in the cost of the workforce, due to wage readjustments in Brasília, Fortaleza, Florianópolis, Goiânia and São Paulo. The IPC-Br increased 0.25% in May, down from 0.31% in April, while the IPA-DI (Wholesale Prices Index) totaled -0.04% in May, down from 0.02% in the previous month.

32. The lower IPA inflation in May reflected the continuous reduction of agricultural prices, despite at a lower pace, and the cooling of industrial prices. The Agricultural IPA totaled -1.94% in May, compared to -2.44% in April, while the Industrial IPA recorded 0.58% and 0.84% for the same period. The main negative drivers were legumes and fruit, sugar cane, poultry and eggs, among agricultural prices, and moisturized ethylic alcohol and sugar, among industrial prices. The main pressures in May stemmed from the prices of *in natura* milk, fuel oil, non-ferrous metals, iron, steel and steel by-products and fertilizers. The IPA-DI increased 0.61% and 4.76%, in the year through May and in twelve months, respectively. According to the processing stages of production, the prices of final goods declined 0.15%, after a 0.85% elevation in April, mainly mirroring the deceleration of fuel prices, which totaled -1.10% in May, compared to 2.76% in April. The prices of intermediate goods increased 1.01% in May, up from 0.96% in April, with highlights to the prices of manufacturing materials and components. The prices of raw materials recorded -1.89% in May, compared to -2.78% in the previous month.

Economic Activity

33. According to IBGE's monthly survey, retail sales increased 1.1% in March, on a month-on-month seasonally adjusted basis. Among the activities composing the general index, only fuel and lubricants sales decreased (0.1% growth). The remaining segments expanded, with highlights to fabric, clothing and shoes (2.7% growth), and hyper- and super-markets, food products, beverages and tobacco (1.2% growth). Vehicles, motorcycles, parts and pieces, which does not compose the general retail sales index, increased 4.4% in the month. On a regional basis, 18 out of the 27 Brazilian states showed positive results in March, compared to February, seasonally adjusted, while all the units recorded rises in comparison to March 2006, with highlights to the increases recorded in the South and Mid-West, mirroring the effects of the income recovery in the agricultural sector.

34. Compared to March 2006, retail sales grew 11.5%, driven by the increases in all segments, mainly furniture and domestic appliances (18.1%) and hypermarkets (9.3%). Expanded retail sales increased 13.2%, highlighting the sales of vehicles, motorcycles, parts and pieces (18.5%).

35. Retail sales performance reflects the continuity of payroll growth and better credit conditions, together with the recovery of the crop and livestock sector. Retail sales increase reached 9.7% in the first quarter of 2007; expanded retail sales, which include civil construction inputs and vehicles, motorcycles, parts and pieces,



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increased by 11.8%, under the same comparison basis. It bears emphasizing the performance of furniture and domestic appliances (20.5%) and vehicles (17.4%).

36. São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, showed a 0.8% increase in database consultations for credit sales, and a 0.7% reduction in consultations to the Usecheque system in May, on a month-on-month basis. In comparison to May 2006, there were increases of 5.6% and 6.1%, respectively.

37. Regarding investment indicators, civil construction inputs production expanded month-on-month 1.3% in April, while capital goods domestic production fell 1.2%, seasonally adjusted. Capital goods contraction should not be interpreted as a trend change, in view of the 15.4% and 8.5% expansions registered in the first four months of 2007 and in the last twelve months, respectively. In the first four months of the year, capital goods production for mixed use increased by 17.0%; typically manufactured capital goods expanded by 17.7%, while capital goods production for energy and for civil construction grew 14.4% and 10.7%, respectively. Production of capital goods for agriculture expanded by 19.1% in the same period, while the negative twelve-month trailing production reduced to -4.3% in April, compared to -8.9% in March, confirming the upturn of the trend at the margin.

38. BNDES funding for medium- and long-term investment totaled R\$14.9 billion in the first four months of 2007, 39.8% above the amount disbursed in the same period of 2006. The recent acceleration of this indicator is also evident in the 21.9% expansion observed in the twelve months through April.

39. Industrial production declined 0.1% in April, according to IBGE's Monthly Industrial Survey (PIM) seasonally adjusted data. On a 3-month moving average basis, which attenuates punctual oscillations, industrial activity reached a record high for the thirteenth consecutive month, in April. Moreover, industrial production rose by 6.0%, compared to April 2006, and expanded by 4.3% and 3.3%, in the first four months of 2007 and in the last twelve months, respectively.

40. Considering seasonally adjusted data, mining production expanded by 0.3%, while manufacturing industry production remained stable. Regarding use categories, production of capital goods, intermediate goods and durable consumer goods reduced by 1.2%, 0.6% and 1.3%, respectively, while semi and non-durable goods production increased by 0.8%. Despite the reduction in April, capital goods production expanded by 15.4% in the year through April.

41. Disaggregated data of seasonally adjusted industrial activity showed that 12 of the 23 sectors surveyed grew in April, with highlights to beverages (4.3%) and other chemical products (2.3%). The main negative drivers were food (-1.9%), perfumes, soaps and cleaning products (-5.7%) and electronic materials and communication equipment (-3.4%).

42. Still considering the industrial activity, according to CNI data, seasonally adjusted by the BCB, hours worked in production expanded by 1.0% and real industrial sales declined 1.2% in April, month-on-month. In the year through April, these indicators increased by 3.6% and 4.8%, respectively, compared to the same period of 2006. After seasonal adjustment, installed capacity utilization stood at 81.9% in April, almost unchanged compared to the previous month (82.0%). Considering observed data, utilization level reached 81.7%, 3.2 p.p. above the April 2006 figure.

43. According to Anfavea, vehicles production reached 258.9 thousand units in May, a monthly record high, a 7.2% increase relative to the same month of 2006. According to data seasonally adjusted by the BCB, vehicles production expanded by 3.0%, after a 1.7% reduction in April, on a month-on-month basis. Sales of overall automotive industry increased 13.3%, relative to May 2006, totaling 263.8 thousand units, a monthly record high. As exports reduced by 7.6%, such performance was exclusively due to the domestic absorption, which increased 23.8% (also a record high for the series). Considering the month-on-month seasonally adjusted series, domestic sales increased by 4.7%, while exports expanded by 7.1%.

44. According to the IBGE, the current estimate for the crops harvest in the 2006-7 period pointed to a 13.0% increase, compared to the previous harvest. National production of grains should reach 132.3 million tons, due to



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good weather conditions and the production incentive driven by the increase of international agricultural commodities prices. In April's survey, the main forecast increases related to wheat (52.3%), cottonseed (30.1%), corn (20.6%), bean (10.2%) and soy (9.2%), while the main decreases related to coffee and rice production (15.3% and 4.1%, respectively). It still bears emphasizing the increase in land occupation for sugar cane production, driven by the growing interest in ethanol production. Sugar cane plantations increased by 8.9% in 2007, and the production should expand by 12.7%, year-on-year.

Surveys and Expectations

45. The Fecomercio-SP survey showed declines of 1% in the Consumer Confidence Index (ICC) in May, month-on-month, and 8.4%, compared to May 2006. The Current Economic Conditions Index (Icea) increased month-on-month 0.7% in May, while the Consumer Expectation Index (IEC) declined by 2.3%. In fact, the Icea remained above the IEC for the fifth consecutive month.

46. According to the FGV survey, which encompasses two thousand homes in the seven main state capitals of the country, the ICC increased 2.6% month-on-month in May. This result is due to the improvement in both the assessment of the present situation and in the 6-month ahead expectations. Compared to May 2006, the ICC rose 7.3%, mainly because of the 8.9% increase in the IEC.

47. Still according to FGV, the Industry Confidence Index (ICI), which encompasses six items of the Manufacturing Industry Survey, declined 1.8% month-on-month in May, after the record high observed in April. The ICI rose 15.9% relative to May 2006, totaling an 8.1% expansion in the first four months of 2007, compared to the same period of 2006. This result is due to the positive assessments about the expected level of demand and the predictions of higher hiring in industry. The level of installed capacity utilization reached 84.8% in May, up from 82.7% in May 2006.

48. According to the Manufacturing Industry Survey, carried out by FGV in April 34% of the companies surveyed affirmed that their investment in fixed capital is higher in the first half of 2007 than that observed in the previous half, while 21% affirmed that their investment is lower. The prediction of higher investment in the second half of 2007 also reached 34% of the companies, while 14% of the companies intend to invest less. The main reasons to invest in fixed capital quoted by the firms were: the expansion of production capacity (47%), and the increase in production efficiency (31%). The high tax burden was the main factor for inhibiting investments in fixed assets, totaling 49% of the answers, 4 p.p. above the proportion registered last year. The cost of credit was quoted by 18% of the companies, the lower relative frequency of the historical series started in 1998.

Labor Market

49. According to the Ministry of Labor and Employment, 302 thousand new formal jobs were created in April, a record high for the month, since the beginning of the series in 1985. In the first four months of the year, 701.6 thousand new jobs were created, 23.2% above the figure observed in the same period of 2006, driving employment expansion by 4.8%. In the last twelve months, expansion also reached 4.8%, with highlights to the 8.0% increase in civil construction employment and 5.7% in commerce employment. After seasonal adjustment, employment increased month-on-month 0.5% in April, with increases in all sectors.

50. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate stayed unchanged at 10.1% in April 2007. The unemployment rate stability reflects mainly the 0.33% and 0.34% decreases in employed population and economically active population (PEA), respectively. The reduction of 68 thousand employed workers was due to reductions of 2.4% in the number of informal workers and 3.0% in the number of civil and military servants and increase of 0.7% in the number of workers in the private sector. In the first four months of 2007, the average number of workers increased by 2.9%, relative to the same period of 2006, reflecting an expansion of investments and recovery of the agricultural sector. Among the workers in the private sector, the number of formal workers increased by 4.1%, while the number of informal workers remained stable, highlighting a qualitative improvement in the labor market.



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51. According to the same survey, real average earnings reached R\$1,114.00 in April, a 0.3% month-on-month increase and a 5% elevation compared to April 2006. Real payrolls decreased 0.1% month-on-month in April, reflecting the reduction in the number of formal workers, but maintained a yearly rising trend, with an 8.4% increase in April, compared to the same month last year, and 8.0% in 2007.

External Environment

52. The global economic environment remains favorable and with controlled risks. Recent data shows steady consumption in the US and slight acceleration of GDP growth in Europe and Asia. Despite the lower expansion (17% in 2006, compared to 34% in 2005), net private capital inflows for emerging markets reached a US\$ 647 billion record high.

53. In the US, the revised GDP growth rate in the first quarter decreased to 0.6% from 1.3%, the lowest rate since the 0.2% rate reached in the last quarter of 2002. However, important aggregate demand components remain robust, and can sustain larger expansion throughout the year. The consumption expansion, whose weight in total demand exceeds 2/3, increases to 4.4%, up from 3.8%. Combined with a reduction in inventories, this acceleration makes room to an increase in production. In the housing sector, the sales of new real state properties increased month-on-month 16.2% in April, smoothing the depressing effects over the economy. These data confirm the Federal Reserve Bank (Fed) perception of moderate acceleration of growth in the next quarters.

54. The confidence indices that measure consumers sentiment point to the same direction: the *Conference Board* rose to 108.0 in May, up from 106.3 in April, and the one from the Michigan University rose to 88.7, up from 87.1. The confidence index of the manufacturing industry increased to 54.7 in April, up from 50.9 in March, and reached the highest level of the last months. Month-on-month industrial production rose 0.7% in April, above market expectations, and the installed capacity utilization increased to 81.6%, up from 81.2%. The recent behavior of inflation reduces the expectations of inflation pressures. The consumer price index (CPI) increased 2.6% in the last twelve months through April, and its core, 2.3%, at a lower pace than the observed in the previous month. The producer price index (PPI) increased 0.7% and its core remained unchanged.

55. In the Euro zone, first quarter GDP grew 3.1%, relative to the same quarter of 2006, above market expectations. The German GDP also increased above expectations, 3.6% in the year and 0.5% in the quarter. The consumer confidence index reached 119.9 in May, up from 111 in April, the highest level observed since January 2001. However, twelve-month trailing inflation through May remained stable at 1.9%, in line with the European Central Bank (ECB) target. In Japan, despite below the 2.7% market expectations, GDP grew by 2.4% p.a. in the first quarter, confirming the maintenance of the growth pace.

56. In China, economy has continued to record robust expansion. Industrial production grew 17.4% in April, relative to April 2006, accumulating an 18% increase in 2007. Trade surplus reached US\$16.9 billion in April, a 144% increase over March, totaling US\$63.3 billion in the first four months of 2007, an 88% increase over the same period of 2006. The strong pace of activity has reflected in inflation. The Consumer Price Index increased 3% in the twelve months through April, while the Wholesale Price Index reached 2.9%, under the same comparison basis, up from 2.7% in March.

57. The Bank of England (BoE) raised its interest rate by 0.25 b.p., to 5.5% p.a., as a consequence of inflationary pressures, mainly stemming from services prices. The Consumer Price Index increased by 3.1% in the twelve months through March, exceeding the upper limit of the inflation target. However, with the 0.3% increase in April, the Consumer Price Index decreased to 2.8% in the twelve months through April. The Wholesale Price Index increased month-on-month 0.5% in April, down from 0.6% in March. On a twelve-month trailing basis, the index totaled 2.5% in April, down from 2.7% in March.

58. At the end of May, the Chinese government tripled a stamp tax on securities transactions to 0.3%, to cool the growth in the stock markets. As a consequence, the Shanghai composite share index fell by 6.5%, but spillovers for other international stock markets were limited. On May 31, the main European share index (FTEurofirst 300) reached a record high for the last six and a half years, boosted by mining and oil companies. Strong swings prevailed in FX markets, with devaluation of the US dollar.



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Foreign Trade and International Reserves

59. In the first five months of 2007, Brazilian foreign trade continued to expand. Trade surplus reached US\$16.8 billion in the period, and US\$47.9 billion in the twelve months through May, while total external trade totaled US\$103.3 billion and US\$248.8 billion, according to the same comparison bases.

60. Exports reached US\$13.6 billion in May, a record high for the month, with a daily average of US\$620.4 million, a 32.4% increase over May 2006. Manufactured goods external sales reached US\$7.1 billion in the month, a 21.9% increase over May 2006, considering daily averages. Primary products exports totaled US\$4.4 billion, and semi-manufactured ones, US\$1.9 billion, with respective increases of 49.6% and 46.9%, according to the same comparison basis. In addition to shipment records, international prices of important export products continued to increase, with highlights to orange juice (80.4%); raw soybean oil (34.6%); poultry (34.1%); metal laminates (32.7%) and iron/steel semi-manufactured (31.9%). In the first five months of 2007, exports continued to show diversification in terms of products, particularly regarding manufactured items with low share in total exports, and expansion of exports destinations.

61. Imports totaled US\$9.8 billion in May, a record high for the month, a 34.2% increase over May 2006. All categories expanded: raw materials (38.6%); consumer goods (33.5%); capital goods (28.8%); and fuels and lubricants (28.5%), according to the same comparison basis. Among imports of raw materials, it bears emphasizing imports of food, transportation equipment parts, mining products, non-food farming, chemicals and pharmaceutical products. Among consumer goods imports, it bears emphasizing the imports of clothes, beverages and tobacco, vehicles, furniture, beauty products and pharmaceutical products. Amongst capital goods imports, one should highlight imports of industrial machinery, machines and equipment for office and scientific service, and parts and pieces for capital goods.

Money Market and Open Market Operations

62. After the April Copom meeting, the yield curve shifted downward, mainly driven by Brazilian positive economic indicators and by the revised Brazil's sovereign ratings by two rating agencies. In light of an also favorable external environment, reflected in the persistent highs of the international stock markets, the positive FX flow allowed the appreciation of the real against the US dollar, contributing to a downward movement of domestic interest rates, mainly for the short term. In the last week of May, evaluations that Chinese stock markets were overheated led to profit realization in international stock markets, affecting the domestic interest rate market. Between April 16 and June 4, one-, two- and three-year rates reduced by 0.73 p.p., 0.90 p.p. and 0.95 p.p., respectively. One-, three- and six-month rates also declined 0.37 p.p., 0.44 p.p. and 0.60 p.p., respectively. The real interest rate measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectations fell to 7.31%, on June 4, down from 7.79%, on April 16

63. Between April 17 and June 4, the BCB conducted 11 reverse exchange rate swap auctions, totaling US\$11 billion.

64. In its open market operations, the BCB carried out, from April 17 to June 4, weekly five- and seven-month long fixed rate repo operations. The average daily balance of these operations amounted R\$73.1 billion, of which R\$56.1 billion were seven-month operations. In the same period, the BCB also conducted 28 overnight repo operations, of which 25 aimed at draining the excess liquidity from the market. In addition, in one repo operation aimed at draining the excess liquidity, the tenure totaled 32 working days. The BCB also conducted daily liquidity management operations with tenures up to two working days. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R\$14.6 billion, borrowing.

65. Between April 17 and June 4, the National Treasury raised a total of R\$76.9 billion, of which R\$37.2 billion in fixed-rate securities: R\$18.1 billion via issuance of LTNs maturing in 2008 and 2009 and R\$19.2 billion in NTN-Fs maturing in 2010, 2012 and 2017. Issuance of LFTs totaled R\$13 billion, for securities maturing in 2010 and 2012. Issuance of inflation-linked NTN-Bs reached R\$26.7 billion, for securities maturing in 2009, 2011, 2012, 2015, 2017, 2024, 2035 and 2045, of which R\$13.1 billion were settled via delivery of other securities.



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66. In the same period, the Treasury conducted auctions to sell LTNs maturing in April, July and October 2008 conjugated to the purchase of shorter-term LTNs, totaling R\$9.0 billion. The Treasury also conducted auctions to sell LFTs maturing in 2010 and 2012, totaling R\$4.5 billion, accepting as payment LFTs maturing in 2007. Moreover, the Treasury conducted auctions to buy LTNs maturing in July 2007, totaling R\$5.9 billion and NTN-Bs totaling US\$246 million.