



BANCO CENTRAL DO BRASIL

Minutes of the 136th Meeting of the Monetary Policy Committee (Copom)

Summary

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Inflation
Economic Activity
Surveys and Expectations
Labor Market
Credit and Delinquency Rates
External Environment
Foreign Trade and International Reserves
Money Market and Open Market Operations

Date: July 22nd, from 5:00PM to 7:30PM, and July 23rd, from 4:30PM to 7:00PM

Place: BCB Headquarters meeting rooms - 8th floor on July 22nd and 20th floor on June 23rd – Brasília – DF

In attendance:

Members of the Committee

Henrique de Campos Meirelles – Governor
Alexandre Antonio Tombini
Alvir Alberto Hoffmann
Anthero de Moraes Meirelles
Antonio Gustavo Matos do Vale
Maria Celina Berardinelli Arraes
Mário Gomes Torós
Mário Magalhães Carvalho Mesquita

Department Heads (present on July 22nd)

Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on July 23rd)
Luiz Donizete Felício – Open Market Operations Department
José Antônio Marciano – Department of Banking Operations and Payments System
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on July 22nd)

Alexandre Pinheiro de Moraes Rego – Press Secretary
Alexandre Pundek Rocha – Advisor to the Board
Eduardo José Araújo Lima – Advisor to the Research Department
Flávio Pinheiro de Melo – Advisor to the Board
Maria Goreth Miranda Almeida Paula – Advisor to the Executive Office of Special Studies
Sergio Almeida de Souza Lima – Executive Secretary

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



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Recent Economic Developments

1. IPCA inflation accelerated in May and June to 0.79% and 0.74%, respectively, up from 0.55% in April. As a consequence, inflation reached 3.64% in the first half of 2008 – the highest 6-month change observed since May 2005, up from 2.08% in the same period of 2007. Twelve-month trailing inflation continued to accelerate. In fact, after reaching 5.04% in April, it totaled 5.58% in May and 6.06% in June (compared to 3.69% in the same month of 2007). Under this comparison basis, the acceleration of consumer price inflation essentially mirrors the behavior of market prices, which increased more rapidly than regulated prices. In deed, market prices and regulated prices increased 7.98% and 1.77%, respectively, in the twelve months through June, compared to 4.10% and 2.78% in the twelve months through June 2007. Moreover, despite the BRL appreciation, the prices of tradable goods accelerated, reaching 7.78% (compared to 3.14% in June 2007), according to the same comparison basis. Regarding the prices of non-tradable goods, greatly pressured by the behavior of perishable food and services prices, twelve-month trailing inflation was even higher (8.16%), evidencing the influence of domestic factors over inflationary dynamics. For instance, the price of services increased 5.75% in June 2008, up from 5.19% in December and 4.95% in June 2007, according to the same comparison basis. Preliminary data for July point to the continuity of consumer inflation at elevated levels, despite some moderation at the margin. In short, since the end of 2007, inflation has diverged from the targets path.

2. The three main underlying inflation measures calculated by the BCB have evolved in line with the headline index. The core inflation by exclusion of household food items and regulated prices, the smoothed trimmed means core inflation and the non-smoothed trimmed means core inflation measures increased from 0.53%, 0.48% and 0.41% in April, to 0.68%, 0.50% and 0.55% in May, and to 0.55%, 0.49% and 0.48% in June, respectively. Similarly to headline inflation, the three core inflation measures remarkably accelerated in the first half of the year, compared to the same period of 2007, with increases from 2.02%, 1.86% and 1.63% to 3.26%, 2.52% and 2.64% for the core inflation by exclusion, smoothed and non-smoothed trimmed means core inflation, respectively. On a twelve-month trailing basis, the three core inflation measures continued to follow the behavior of headline inflation. Core inflation by exclusion of household food items and regulated prices continued to increase significantly, to 5.37% in June, up from 5.03% in May and 4.66% in April. Smoothed trimmed means core inflation showed similar behavior (4.72% in June, up from 4.56% in May and 4.36% in April), whereas the non-smoothed trimmed means core inflation increased to 4.65% in June, up from 4.39% in May, and 4.14% in April. As a consequence, all core inflation measures stand above the central value for the inflation target. Moreover, it bears emphasizing that the behavior of diffusion indices suggests increased dissemination of the inflationary process, confirming the analysis present in previous Copom Minutes.

3. The General Price Index (IGP-DI) inflation increased to 1.89% in June, up from 1.88% in May and 1.12% in April. On a twelve-month trailing basis, IGP-DI inflation accelerated to 13.96% in June, up from 12.14% in May, 10.24% in April and 3.96% in June 2007. In the twelve months through June, the IGP-DI increase reflected the behavior of the three main components. The Consumer Price Index-Brazil (IPC-Br) increased 5.96% (3.98% in June 2007), while the Wholesale Price Index (IPA-DI) totaled 17.90% (3.76% in June 2007). According to the same comparison basis, the Civil Construction National Index (INCC) increased 9.13% (5.20% in June 2007). Regarding the agricultural IPA, inflation reached 37.91% (8.07% in the twelve months through June 2007). It also bears highlighting the continuity of upward pressures over wholesale industrial prices, a process that began in the second half of 2007 and does not signal accommodation. In the first half of 2008, wholesale price inflation increased 8.47%, up from 1.52% in the same period of 2007. In addition, in the last twelve months, wholesale industrial price inflation increased 11.58% in June, up from 4.42% in December 2007. As mentioned in previous Copom Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend on current and prospective demand conditions and price-setters' expectations for the future inflation path.

4. After the last Copom meeting, the IBGE released data for 2008 first quarter GDP. Data showed robust growth rates in the first quarter of 2008, both for accumulated results in the year (5.8% up from 5.4% in the fourth quarter of 2007), and for year-over-year results (5.8% as against 6.2% in the previous quarter). On the aggregate demand side, gross fixed capital formation continues to post strong figures, growing by 15.2% in the first quarter of 2008, year-over-year. The expansion of household consumption, which tends to be less volatile than investment along the cycle, retreated from 8.6% in the last quarter of 2007, to still robust 6.6% in the first quarter of the year, under the same comparison basis. On the aggregate supply side, it bears emphasizing the increase in industrial



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production (6.9%), led by manufacturing industry (7.3% growth) and by civil construction industry (8.8% expansion) in the first quarter of the year, year-over-year.

5. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output increased 0.1% in May, after growing by 0.7% in the previous month. Still considering the seasonally adjusted series, after the 0.2% expansion observed in April, industrial output retreated 0.5% in May, month-on-month, partially reflecting the unusual holiday schedule observed this year. It bears noticing that general industrial output grew 6.2% in the year through May, with respective increases of 6.2% and 6.1% in manufacturing and in mining output. On a year-over-year basis, industrial output expanded by 2.4% in May (even with less two working days), with changes of 2.1% and 7.2%, respectively, in manufacturing industry and in mining. The data already released for the last months point, in short, to the continuity of the industrial production expansion cycle, despite at a more moderate pace and subject to possible limits to supply expansion.

6. Among the use categories, according to data seasonally adjusted by the IBGE, capital goods production retreated 4.9% in May, after increasing by 1.0% in April. Regarding the other use categories, intermediate goods production increased 0.3%, durable consumer goods production retreated by 1.3% for and semi- and non-durable consumer goods production expanded by 1.3%. In the year, capital goods production leads the expansion, with a 16.3% increase, followed by the 13.7% elevation in durable consumer goods production. Despite the strong fall observed in May, there are no sufficient evidences of inflection in the expansion process of capital goods production, which has been mainly driven by the consolidation of positive prospects for the continuity of economic growth. On its turn, the dynamism of durable consumer goods production reflects, predominantly, credit conditions, which remain more favorable than historical patterns. The existence of signs pointing to pressure over the availability of production factors suggests that accommodation in the pace of industrial activity expansion can be greatly associated to productive capacity restrictions, added up to imports penetration increase.

7. Labor market continues to present quite favorable performance. The unemployment rate in the six metropolitan regions covered by the Monthly Labor Survey (PME) decreased to 7.9% in May, down from 8.5% in April. As a result, the average unemployment rate in the first five months of the year was 1.6 p.p. below that observed in the same period of 2007. According to data seasonally adjusted by the BCB, the unemployment rate decreased to 7.6% in May down from 8.0% in April, a record low for the month since the start of the historical series in 2002. In May, real average earnings fell 1.0% month-on-month and increased 1.5% year-over-year. In the first five months of 2008, real average earnings increased 2.4%, while employment grew 3.9%. As a consequence, real payrolls expanded by 6.4% (6.2% growth in May in year-over-year terms), continuing to constitute a key driver for domestic demand growth. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment increased by 0.2% in May (compared to 0.1% in April and 0.2% in March). In year-over-year terms, employment grew 3.8%, totaling 4.2% growth in the last twelve months. Still regarding employment, data from the Ministry of Labor and Employment (MTE) indicate the continuity of strong expansion in formal employment this year, with the creation of 202.9 thousand jobs in May and 309.4 thousand jobs in June. June results corresponds to a 48.9% increase over the previous record high for the month, registered in 2004 (207.9 thousand jobs) and a 2.5% increase over the record high in the series observed in April 2007 (301.9 thousand jobs). In the first half of the year, employment reached a record high of 1,361.4 thousand hires, an evidence of the labor market heat. Formal employment grew by 0.7% in June, seasonally adjusted, and observed data point to a 5.8% expansion in formal employment in the last twelve months. The agricultural sector presented the highest hiring rate in June, with the creation of 92.6 thousand new jobs, a record high for the series in the month, followed by the services sector (73.4 thousand new jobs), also a record high for the period. The manufacturing industry recorded 52.2 thousand new jobs, up from 27.8 thousand in June 2007, whereas the retail sector recorded 48.2 thousand new jobs (28.2 thousand in June 2007) and the civil construction recorded 36.8 thousand new jobs (18.5 thousand in June 2007). Besides the process of formalization in the labor market, these data evidence the strong dynamism in labor force demand. In fact, formal employment grew by 6.2% in 2008.

8. In line with the positive developments in the labor market and with credit expansion, retail sales continue to record positive performance, indicating that the pace of domestic demand growth remains robust, and signs of cooling cannot be perceived. According to data seasonally adjusted by the IBGE, expanded retail sales grew by 0.8% in May, after increasing 1.4% in April and 1.3% in March, and growing by 11.3% year-over-year and 14.2% in the first five months of 2008. Expanded retail sales three-month moving average increased 1.2% in May, month-on-



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month, representing the 25th consecutive monthly increase. According to data seasonally adjusted, on a month-on-month basis, it bears emphasizing the expansion in “office, computing and communication material and equipment” (5.1%) and “other personal and domestic articles” (2.0%). In 2008, accumulated growth was more significant in “office, computing and communication material and equipment” (28.8%), “vehicles, motorcycles, parts and pieces” (21.4%) and “other personal and domestic articles” (20.4%). Despite the rise in the prices of food, hyper- and supermarket sales, food products, beverages and tobacco showed a 6.8% significant growth in 2008. The steady growth of retail sales has, therefore, reflected the performance of both the sectors more sensitive to income and employment expansions and those more sensitive to credit conditions. For the next quarters, the continuity of the current expansion cycle of retail sales is expected, and will continue to be underpinned by employment and income growth, credit expansion and the maintenance of consumer confidence at high levels. Sector indicators, for instance, relative to automobile sales in June, corroborate this assessment.

9. The installed capacity utilization rate (Nuci) in the manufacturing industry reached 82.7% in May down from 83.1% in April, according to CNI data seasonally adjusted by the BCB. According to data seasonally adjusted by CNI, since March the Nuci in the manufacturing industry has showed stability in a level slightly below the record high observed for the series in November 2007 (82.97%). Without the seasonal adjustment, the Nuci stood almost at the same level registered in May 2007. As a consequence, the average rate in the first five months of 2008 was 1.0 p.p. above the level observed in the same period of 2007. The monthly Nuci calculated by Fundação Getúlio Vargas (FGV) reached 86.4% in June, according to the observed series, standing significantly above the 84.7% level registered in the same month of 2007. The elevation in the Nuci in June 2008, year-over-year, is also observed for the production of civil construction inputs sector (5.1 p.p.), for the consumer goods sector (4.8 p.p.) and for the capital goods sector (3.9 p.p.). For the intermediate goods sector, the Nuci stood 0.2 p.p. below the level observed in June 2007. The maintenance of installed capacity utilization rates at historically high levels occurs in several sectors despite investments accumulated in the last twelve months. Indeed, in May 2008, according to seasonally adjusted data, the absorption of capital goods decreased 3.1%, influenced by the 4.9% reduction in the capital goods production, despite the 12.6% volume growth of capital goods imports in volume, favored by the end of strike on Brazilian Tax Authority. In the same period, the production of civil construction inputs increased 5.8%. Considering that the absorption of capital goods in 2008 presented a robust result (18.8%), expressed in the significant growth of capital goods imports (34.0% in volume) and of capital goods production (16.3%), it is premature to assume the last monthly data for the absorption of capital goods as a trend signal. In the same period, the production of inputs for civil construction industry increased by 9.3%. In short, recent data indicate that, although investment has been contributing to soften the increasing trend of capacity utilization rates, the maturation of investment projects has not been sufficient, until now, to significantly limit existing mismatches regarding the evolution of aggregate supply and domestic demand. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments related to the expansion of supply of goods and services, to adequately meet demand conditions.

10. The trade balance continues to present deceleration at the margin, a trend that was already expected, and is in line with assessments present in Inflation Reports and previous Copom Minutes. In the last twelve months through June the trade surplus reached US\$30.8 billion (35.2% below June 2007). Exports and imports totaled US\$178.1 billion and US\$147.3 billion, equivalent to 18.7% and 43.7% growth, respectively, in the last twelve months, compared to the same period ended in June 2007. As highlighted in previous Copom Minutes, imports have been growing faster than exports, both due to the strengthening of the BRL and to the robust economic activity in the country, notwithstanding the elevated price levels of several commodities included in the Brazilian export basket. The decrease in trade surplus contributed to the US\$15.2 billion current account deficit registered in the twelve months through May 2008, equivalent to 1.1% of GDP. Foreign direct investment reached US\$38.0 billion in the same period, equivalent to 2.8% of GDP.

11. Regarding the external scenario, the world economy still shows divergent pressures. On the one hand, even though economic activity, in general, has been stronger than anticipated in the majority of countries in the first semester, which in some cases resulted in upward revisions in growth projections for the year, the more recent data shows some signs of weakening, especially in mature economies. This trend should continue during the second semester. On the other hand, the increase in the prices of raw material, and the pressures of heated demand over the capacity of supply expansion, which are particularly evident in emerging economies, have resulted in strong acceleration of current inflation, significantly impacting, in several cases, inflationary



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expectations. In addition, a severe financial crisis in the U.S. and, at a lower extension, in Europe, is added up to this difficult macroeconomic scenario. In this context, although the existence of strong inflationary pressures is cause of concern for the majority of monetary authorities, policy reactions, aiming to control demand, have occurred unsynchronized, situation that tends to persist. Specifically, the US economy seems to have entered a process of economic stagnation since the last quarter of 2007, and still suffers the impact of the crisis in the real estate sector, with spillover effects on the labor market, whose weakening, in combination with higher oil prices, affects consumer confidence, contributing importantly to depress consumption. Even if the influence of monetary and fiscal stimulus can reduce the risk of a significant contraction in activity, the dominant scenario continues to point to a more consistent recover only from 2009. Even after significant strengthening of the capital basis of relevant financial institutions, uncertainties still remain about the length and amplitude of the effects of the US subprime mortgages market crisis over US and European banking system and over credit conditions for households and corporate. The systemic risk perception increased again in the last weeks, as financial problems have worsened due to a cyclic deterioration in credit quality, which tends to reinforce the tightening of financial conditions, increasing the risk of slowdown intensification. The dominant view seems to be that the economic activity in Europe - despite the better-than-expected performance at the start of the year, anchored in the German economy - and in Japan might also decelerate in the second half of the year. In the central economies, therefore, the prospects for adoption of monetary tightening policies seem limited. On the other hand, despite some moderation at the margin, economic growth in emerging economies is still strong and, so far, it has apparently been little affected by the US mortgage crisis, offsetting the effects of economic deceleration in mature economies. In fact, in light of pressures over the availability of production factors, inflation acceleration points to the continuity of monetary tightening policies in emerging economies. In this context, volatility and risk aversion indicators in international financial markets have increased considerably since the last Copom meeting. However, the policies aimed at reducing the external vulnerability of the economy have been successful, contributing to mitigate, but not to eliminate, the effects of the external scenario difficulties over the Brazilian economic activity, whose dynamism has essentially been driven by domestic demand.

12. Oil prices, systematic source of uncertainty stemming from the international scenario, continue highly volatile and are still in high historical levels. This behavior reflects structural changes in global energy markets, which have blocked the recovery of inventory levels traditionally observed, in addition to recurrent geopolitical tensions. Despite significant uncertainties inherent to oil prices forecasts, the main scenario considered by the Copom forecasts unchanged domestic gasoline prices in 2008, although the probability of materialization of an alternative scenario is relevant. However, apart from the behavior of domestic gasoline prices, one should recognize that the consistent elevation of international oil prices impacts domestic economy both through productive chains, such as the petrochemical, as well as through the deterioration of inflation expectations. The prices of other commodities, especially grains, which have also increased significantly since the last Copom meeting, despite more pessimism about the prospects for global economic growth and the turmoil on global financial markets, continue, with few exceptions, to record increases in the year.

Assessment of Inflation Trends

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

- a) The projected adjustments for gasoline and bottled gas prices were maintained at 0% for 2008;
- b) The projections for electricity price adjustments and fixed telephone prices were maintained at 1.1% and 3.5% in 2008, respectively;
- c) The projection for regulated prices inflation, based on individual items, was maintained at 4.0% for 2008. This set of prices, according to data released by the IBGE, corresponded to 29.81% of the total June IPCA;
- d) The projection for regulated prices inflation in 2008 was altered to 4.8% from 4.5%, considered in the previous meeting. This projection is based on the endogenous determination model for regulated prices, which computes seasonal components, foreign exchange rate changes, market prices inflation and the IGP (General Price Index) variation;



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e) The projection for the spreads over the Selic rate based on the 360-day swap rates estimates a 131bps spread in the fourth quarter of 2008 and 87bps spread in the last quarter of 2009. The identified shocks and their impacts were reassessed according to newly available information.

14. Regarding fiscal policy, the projections assume the achievement of the public sector primary surplus target of 3.8% of GDP in 2008 and 2009, increased by 0.5 p.p. The related assumptions considered in the previous meeting were maintained.

15. Since the June Copom meeting, according to median IPCA inflation expectations compiled by the BCB's Investor Relations Group (Gerin), the 2008 IPCA variation increased significantly, reaching 6.53% from 5.48%. Twelve-month ahead inflation expectations also elevated to 5.44% up from 5.01%, considering the medians of expected monthly rates. For 2009, inflation expectations also increased to 5.00% up from 4.60%.

16. Considering the hypothesis under the benchmark scenario – which assumes the maintenance of the exchange rate at R\$1.60/US\$1.00 and the Selic rate at 12.25% during the forecast period – the projection for the 2008 IPCA increased significantly compared to the figure considered at the June Copom meeting, remaining above the 4.5% target established by the National Monetary Council (CMN). According to 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 – IPCA inflation forecast for 2008 also increased remarkably compared to the figure considered at the previous Copom meeting, and is also above the central target for the year. Regarding 2009, projections based on both benchmark and market scenarios increased compared to the figures considered at the June meeting, and are also above the 4.5% central target.

Monetary Policy Decision

17. The Copom evaluates that monetary policy should contribute for the consolidation of a favorable long-term macroeconomic environment. Economic activity data indicate that the pace of domestic demand expansion continues quite robust, and is at least partially the cause of the short-term inflationary pressures, despite strong imports growth and the favorable investment performance. Even in the context of a moderate deceleration of global growth and higher volatility observed in global markets since mid-2007, the Committee believes, based on information available at the moment of its meeting, that the balance of payments should not represent an imminent risk to the inflationary scenario. However, in general terms, the influence of the external scenario on the future trajectory of Brazilian inflation continues subject to contradictory effects and highly uncertain. On the one hand, the prospects of a possible more pronounced deceleration of global activity in the coming months points to an accommodation of both commodities prices and external demand. On the other hand, the recent trajectory of price indices both in mature and in emerging economies evidences the existence of mismatches between the supply and demand growth, and consequently, of significant inflationary risks to the global economy. In light of the deterioration of inflation prospects, in a more uncertain environment, the Committee evaluates that the risk of materialization of a less benign scenario continues to increase. The Copom emphasizes that the main challenge of monetary policy in this context is to guarantee the maintenance of favorable results achieved in the last years. Particularly, monetary policy should act so that initially limited impacts on price indices, partially derived from relative prices adjustments that occur in global scale, do not cause persistent deterioration of inflation dynamics due to worse expectations. The Copom thinks that the maintenance of monetary stability is an essential condition for the relative prices system to continue efficiently guiding the necessary adjustments on current consumption and production patterns of the economy.

18. The Copom considers that the probability that inflationary pressures initially limited represent risks to domestic inflation trajectory has increased, as the heating of domestic demand and market of factors, as well as the possibility of emergence of supply restrictions in some sectors, may increase the pass-through of wholesale prices over consumer price inflation. The Committee evaluates that the prospects for this pass-through, as well as for the propagation of initially localized pressures to consumer prices, depend in a critical manner on inflation expectations, which increased significantly in the last weeks and continue to be carefully monitored. Additionally, it is worth highlighting that although the external sector induces some discipline in tradable goods inflation, imports



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prices have been increasing strongly; furthermore, heated domestic demand may trigger more intense inflationary pressures in the non-tradable sector - in services prices, for instance. In this context, the Copom will act aiming to ensure that inflation control gains achieved in recent years become permanent. In this respect, the Committee will continue to carefully monitor the evolution of inflation and the several core inflation measures, as well as of inflation expectations within the forecast period, prepared to promptly adjust the monetary policy stance in order to avoid the consolidation of a scenario in which one-off price adjustments become persistent or generalized.

19. The preservation of inflation rates in line with the targets path and the consequent consolidation of a long-term stable macroeconomic environment will contribute for the maintenance of the progressive reduction of macroeconomic risk perception that has been occurring in the last years. The Copom thinks that the persistence of a cautious and timely monetary policy stance has been critical to increase the probability that in Brazil inflation will continue to evolve according to the targets path, even in light of global inflationary pressures. For this to materialize, however, it is necessary that forward-looking inflation indicators, particularly the expected dynamic of aggregate supply and demand, converge throughout the relevant period for the monetary policy.

20. The Copom emphasizes, once again, that there are important time lags between the implementation of monetary policy and its effects on economic activity and inflation. Therefore, the evaluation of alternative options for monetary policy should necessarily focus on the forward-looking inflation scenario and its risks, instead of current inflation indices.

21. During the coming months, despite the more moderate credit growth pace due to an increase in funding costs, and real payroll expansion should continue to bolster economic activity. The effects of governmental transfers expected for this and the next quarters should also add up to the factors that will sustain demand, but with less intensity than previously anticipated, as mentioned in the previous Copom Meeting Minutes. These considerations become even more relevant considering the clear signs of heated aggregate demand, the dissemination of pressures stemming from adjustments in relative prices, and the fact that the monetary policy decisions will have concentrated effects in the last months of 2008 and in 2009.

22. The Copom recognizes the important contribution of investment to expand productive capacity. It should be noticed that the possible accommodation of commodities prices could contribute to avoid that inflationary pressures intensify even more. However, the Copom evaluates that the pace of domestic demand expansion, which should continue to be underpinned, among other factors, by income and credit growth, continues to present significant risks to inflationary dynamics. In this context, the consistent and prompt reduction of the mismatch between the expansion of supply of goods and services and the increase of demand continues to be vital to the assessment of different possibilities of monetary policy stance.

23. International evidence and Brazilian experience indicate that higher inflation rates lead to higher risk premium, shorter planning horizons and, as a consequence, lower potential economic growth, besides having regressive effects on income distribution. Moreover, in the current circumstances, there is the risk that economic agents start to attribute higher probability that inflation increases will become persistent, which would reduce the efficacy of the monetary policy. Therefore, the Copom's strategy aims to bring inflation rates back to the 4.5% midpoint target promptly, that is, already in 2009. This approach takes into account the time lags in the transmission mechanism and has proved to be the most adequate to deal with uncertainties intrinsic in the process of monetary policy formulation and implementation.

24. The Copom evaluates that, in light of the economy heating signals, as illustrated by the acceleration of some wholesale prices and the evolution of core inflation measures, and by the fast increase in inflation expectations, the risks for the materialization of a benign inflationary scenario, in which IPCA would remain in line with the targets path, are relevant. In fact, the deterioration of the forward-looking scenario is already present in the inflation projections considered by the Committee. The Copom also considers that the persistence of significant mismatch between the paces of expansion of aggregate supply and demand has increased the risk for the inflationary dynamics. In these circumstances, monetary policy should act vigorously through the adjustment of the basic interest rate while the balance of risks to the inflationary dynamics requires, in order to, on the one hand, reduce such mismatch and, on the other hand, avoid that inflationary pressures initially localized on price indices lead to persistent deterioration of expectations and of the inflation forward-looking scenario.



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25. In this context, evaluating the macroeconomic scenario and aiming to promote the prompt convergence of inflation towards the target path, the Committee unanimously decided to raise the Selic target rate to 13.00% p.a., without bias.

26. Under the inflation-targeting regime, the Copom decides according to inflation prospects, the analysis of several alternative scenarios for the evolution of the main variables that determine the prospective price dynamics and the balance of risks associated to its projections. Domestic demand continues to expand vigorously, backing-up economic activity dynamism, including sectors little exposed to external competition, at a time when the effects of important incentive factors, such as income growth, are still perceived. On its turn, the contribution of the external sector to a benign inflationary scenario, in light of robust domestic demand growth and the increase of global inflationary pressures, seems to become less effective, at a moment when the effects of investment over productive capacity of the economy still need to consolidate. In such environment, the monetary authority should act in order to avoid that short-term uncertainties contaminate longer time horizons. Evidently, if the risk profile changes in a matter that implies shifts in the basic inflation prospective scenario considered at the present moment, the Committee will promptly adjust the monetary policy stance to the circumstances.

27. At the conclusion of the meeting, it was announced that the Copom would reconvene on September 9th 2008, for technical presentations, and on the following day, to discuss the monetary policy decision, as established in Communiqué 16,051 of September 3rd, 2007.

SUMMARY OF DATA ANALYZED BY THE COPOM

Inflation

28. IPCA increased 0.74% in June, decelerating relative to the June IPCA-15 (0.90%) and May IPCA (0.79%) results. Food and beverages prices increased 2.11%, contributing 0.47 p.p. to the monthly index result, showing acceleration of the upward trend registered in April and May. Market prices increased 0.96% in June, down from 1.02% in the previous month, with price elevations in tradable goods (1.19%) and non-tradable goods (0.75%). Regulated prices increased 0.22%, down from 0.26% in May. The diffusion index reached 67.19% in June, down from 71.35% in May, with a 63.67% average in 2008. In the last twelve months through June, IPCA increased 6.06%, up from 5.58% in May, due to elevations of 7.98% in market prices and 1.77% in regulated prices.

29. The IPCA core inflation measures decelerated month-on-month, but accelerated on a 12-month trailing basis. The core excluding household food and regulated prices increased 0.55% in June, down from 0.68% in May, totaling 5.37% in the last twelve months, up from 5.03% in the previous month. The non-smoothed trimmed means core totaled 0.48% in June, down from 0.55% in May, and the twelve-month change increased to 4.65% up from 4.39%. The smoothed trimmed means core reached 0.49% in June, down from 0.50% in April, totaling 4.72% in the last twelve months, up from 4.56% in April.

30. IGP-DI inflation increased 1.89% in June, up from 1.88% in May, accumulating 13.96% in the last twelve months. Among the index components, only the IPA accelerated month-on-month (2.29% against 2.22% in May), reaching 17.90% in twelve months. IPC-Br increased 0.77%, after increasing 0.87% in May, totaling 5.96% in twelve months. INCC inflation increased 1.92% in June, down from 2.02% in the previous month, accumulating a 9.13% increase in the last twelve months.

31. The lower IPC-M change in June reflected, mainly, inflation deceleration in the groups food and health and personal care, which increased 1.85% and 0.58%, down from 2.33% and 0.81% in the previous month. The IPC-Br core increased 0.44%, repeating May's result, totaling 3.75% in twelve months.

32. The higher IPA increase in June reflected a more significant high of agricultural prices, while industrial prices showed deceleration. Agricultural prices increased 3.88% in May, up from 2.47% in May, totaling 37.91% in the last twelve months. The industrial IPA increased 1.69%, down from 2.13% in May, accumulating 11.58% in twelve months. In June, considering the processing stages, the IPA showed acceleration in the prices of



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intermediate goods (2.59%) and gross raw materials (3.33%), up from 2.32% and 2.96%, respectively, in the previous month. The prices of final goods decelerated, with increase of 0.99% in June down from 1.45% in May. In twelve months, still considering the IPA in terms of processing stages, prices of intermediate goods, gross raw materials and final goods increased 13.92%, 38.89%, and 8.75%, respectively.

33. July preliminary figures, coming from IGP-10 and IPC-S, pointed towards the continuity of the deceleration of wholesale industrial prices, civil construction and consumer prices, particularly food. Conversely, wholesale agricultural prices showed new inflationary pressure, influenced by price increases in soy, cattle and corn.

Economic Activity

34. According to seasonally adjusted data from the IBGE's monthly survey (PMC), retail sales increased 0.6% in May, month-on-month. Expanded retail sales, which include construction material and vehicles and motorcycles, parts and pieces, increased 0.8% month-on-month. Seven out of the ten segments surveyed by the IBGE elevated, emphasizing the increases of 5.1% in the sales of office, computing and communication material and equipment; of 2% in the sales of personal and domestic outlays; and 1.1% in the sales of hyper- and supermarkets, food products, beverages and tobacco. Sales of fabric, clothing and shoes retreated 1% while vehicles remained stable during the month.

35. In year-over-year terms, expanded retail sales increased 11.3% in May, accumulating 14.2% in the year. Under both periods, there was generalized growth in all segments, with emphasis in those more influenced by credit supply such as: office, computing and communication material and equipment; vehicles, motorcycles, parts and pieces; and furniture and home appliances.

36. According to São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, database consultations for credit sales and those consultations to the Usecheque system increased 0.6% and 0.3%, respectively, in June, month-on-month. Compared to the first half of 2007, there were respective increases of 7.3% and 6.6%.

37. Regarding investment indicators, domestic production of capital goods decreased 4.9%, while the production of construction inputs increased 5.8% in May, month-on-month seasonally adjusted. Compared to May 2007, these indicators increased 5.8% and 6.4%, respectively. Still regarding the production of capital goods, the month-on-month decrease was due to the behavior of serialized product sub sectors for industrial use, transportation equipment and mixed use. On a year-over-year basis, the positive evolution of capital goods production reflects mainly the expansion of agricultural equipment (24.1%) and transportation equipment (11.2%).

38. Capital goods imports increased month-on-month 12.2% in May, according to Fundação Centro de Estudos do Comércio Exterior (Funcex) data, seasonally adjusted by the BCB. These imports, confirming the expansionist trajectory of investments in Brazilian economy, show a 35.3% increase in capital goods imports year-over-year.

39. CNI indicators, seasonally adjusted by the BCB, showed retreat of industrial activity in May, month-on-month, with decreases of 1.0% and 0.6% in industrial real revenues and in hours worked in production, respectively. Compared to May and the first five months of 2007, industrial real revenues increased 5.3% and 7.9%, respectively, and hours worked in production, 2.7% and 5.8%, in the same order. Installed capacity utilization (Nuci) reached 82.7% in May, 0.4 p.p. below the April level, considering seasonally adjusted data, and stayed practically stable (83.2%), compared to the May 2007 level.

40. According to IBGE's Monthly Industrial Survey (PIM), industrial production decreased 0.5% in May month-on-month, seasonally adjusted. Sixteen out of the twenty-seven activities surveyed recorded production decrease in May, while by use categories, it bears noticing the falls in both the production of capital goods (4.9%), after a four-month increase and in durable consumer goods (1.3%). The production of intermediate goods elevated by 0.3%, while the production of semi-durable and non-durable consumer goods increased by 1.3%. On a year-over-year basis, production increased in all categories in May, but the expansion rates were significantly lower than those in the previous months, mainly due to fact that May 2008 had two workdays less than May 2007. In the first



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five months of 2008, year-over-year, industrial production increased 6.2%, with highlights to the growth rates of capital goods production and durable consumer goods production, 16.3% and 13.7% respectively. In the same period, the production of intermediate goods and semi- and non-durable consumer goods expanded by 5.2% and 1.8%, respectively. On a twelve-month trailing basis, industrial output went to 6.7% in May, down from 6.9% in April, showing slight deceleration at the margin, partially due to the fact that this year the *Corpus Christi* holiday happened in May instead of June, as in the two last years.

41. Vehicles production reached 303.8 thousand units in June, according to Anfavea, increasing 15% year-over-year. Considering seasonally adjusted data, the production of vehicles remained stable month-on-month, with a 1.8% expansion in the production of trucks, and decreases in the production of buses and automobiles. According to the same comparison basis, the production of agricultural machinery increased by 12.3%. In the first half of the year, the production of vehicles and agricultural machinery increased 22.0% and 38.7%, respectively, compared to the same period of 2007. In the same period, total vehicles sales increased 20.3%, with 28.1% expansion in domestic sales and 0.7% decrease in exports.

42. According to the survey carried out by the IBGE in June, planted area was estimated at about 47.1 million hectares, a 3.9% increase relative to 2007. The grains harvest should reach 143.6 million tons in 2008, increasing 7.9% year-over-year. This result encompasses increases of 11.0%, 10.7% and 3.2% in the production of rice, corn and soybean, respectively, which are responsible for 90% of total grains production and occupy 82% of total planted area. The survey also estimated a 14% increase in sugar cane production, with a 13% expansion in planted area, and a 27.3% increase in coffee production, an effect of the biannual cyclic recovery in productivity.

Surveys and Expectations

43. The Fecomercio-SP survey showed an 8% month-on-month decrease in the Consumer Confidence Index (ICC) in July, month-on-month, reflecting the 7.9% and 8.0% retractions in Current Economic Conditions Index (Icea) and in Consumer Expectations Index (IEC), respectively. The ICC grew by 0.9% year-over-year, due to a 1.7% expansion in the IEC and a 0.2% retraction in the Icea.

44. According to the FGV survey, the ICC decreased 6.5% in June, month-on-month. Both current situation assessments and the expectations for 6-month ahead expectations deteriorated, decreasing by 6.3% in the Current Situations Index (ISA) and by 6.6% in the Expectations Index (IE). The survey also registered decreases of 1.7% and 6.0% in the ICC and IE, respectively, and a 6.6% expansion in the ISA, year-over-year.

45. Still according to the FGV, the Industry Confidence Index (ICI) reached 121.8 points in June, up from 119.9 in May. The indicator stood 3.5 p.p. above the level registered in the same month of 2007, reflecting the elevations of 3.7 p.p. in the ISA and 3.4 p.p. in the IE.

46. According to the FGV Manufacturing Industry Survey, installed capacity utilization (Nuci) reached 86.4% in June, standing 0.8 p.p. above the May level, with highlights to the 1.9 p.p. increase in the capital goods segment, which reached 89.4%. The Nuci increased 1.7 p.p. year-over-year in June, with increases of 5.1 p.p. in the production of construction material, 4.8 p.p. in consumer goods and 3.9 p.p. in capital goods segments, while the production of intermediate goods segment decreased by 0.2 p.p.

Labor Market

47. According to the Ministry of Labor and Employment, 309.4 thousand new formal jobs were created in June 2008, totaling 1,361.4 thousand new jobs in the first half of the year. Employment level increased by 0.7% month-on-month in seasonally adjusted terms, expanding in all sectors, with highlights to the 1.3% expansion in the construction sector and the creation of 92.6 thousand new jobs in the agriculture sector.

48. According to the IBGE employment survey (PME) carried out in the six main metropolitan areas of the country, the unemployment rate reached 7.9% of economically active population (PEA) in May, down from 8.5% in the previous month and 10.1% in May 2007. The month-on-month decrease of the unemployment rate in May



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reflected the increase of 89 thousand employed workers and the decrease of 60 thousand workers who left the labor market. Year-over-year, occupation increased 4.6%, while the PEA increased 2.1%. Private sector workers increased 0.4% month-on-month in May, representing 53 thousand jobs, of which the majority (45 thousand) as informal workers. The number of self-employed workers increased 0.45%, while the number of employers decreased 3.1%. Year-over-year, formal workers in the private sector led occupation growth (9.5% increase), the number of employers and self-employed workers increased 4.3% and 0.6%, respectively, while the number of informal workers decreased by 0.9%.

49. The same survey showed that average real earnings of occupied workers decreased 1.0% in May, month-on-month, and increased 2.4% in the year, maintaining a 1.5% increase year-over-year. Real payrolls decreased 0.5% in May, month-on-month, but increased 6.4% in the year and 6.2% year-over-year.

50. According to CNI data seasonally adjusted by the BCB, employment in manufacturing industry increased 0.2% in May, month-on-month. Year-over-year, employment in the manufacturing industry and industrial real payroll increased 3.8% and 4.0%, respectively, in May. In the first five months of 2008, the same indicators increased by 4.5% and 5.6%, respectively, year-over-year.

Credit and Delinquency Rates

51. Credit operations in the financial system expanded by 2.6% in May, expanding by 32.4% on a twelve-month trailing basis. According to the same comparison bases, non-earmarked credit operations increased 2.9% and 36.1%, respectively, while earmarked credit operations elevated 1.9% and 24.0%, respectively. Among the non-earmarked operations, leasing operations remained strong, with expansions of 128.6% and 86.9% for credit to individuals and to corporate, respectively, in the last twelve months. Regarding earmarked credit, it bears highlighting the 26.5% and 21.9% increases in operations related to housing and the agricultural sector, respectively, according to the same comparison basis. Considering other sectors, loans to industry increased 1.6% month-on-month in May and 38.2% in twelve months.

52. The average interest rate on non-earmarked credit operations, used as reference for interest rates, reached 37.6% p.a. in May, up from 37.4% p.a. in April and 37.2% p.a. in May 2007. The average rate on credit for individuals reached 47.4% p.a., while the average rate on corporate credit increased 26.9% p.a., compared to 48.4% p.a. and 24.3% p.a., respectively, in May 2007.

53. The average tenure on non-earmarked credit operations, used as reference for interest rates for individuals reached 370 days in May, remaining almost stable since January, when it breached, for the first time, the one-year record. The average tenure of corporate credit operations reached 299 days, while the average tenure for credit operations to individuals totaled 457 days, up from 252 days and 398 days, respectively, in May 2007.

54. Delinquency rates in the financial system (non-earmarked loans, used as reference for interest rates, in arrears for more than ninety days) reached 4.2% in May, a 0.6 p.p. decrease year-over-year. Delinquency rates for credit operations with corporate and individuals reached 1.8% and 7.3%, respectively, compared to 2.6% and 7.2% in May 2007.

55. Net delinquency rate for retail credit, measured by the ACSP, reached 5.7% in June, up from 5.1% in the same month of 2007. In the first half of 2008, the average delinquency rate stood at 7.1%, up from 6.7% in the same month of the previous year.

External Environment

56. Inflation rise remains as the main international outlook concern, adding uncertainties to the environment in which economic growth deceleration predominates. In addition to the restore of financial sector turmoil and the concerns with banks and mortgage companies solvency, there are worries regarding the possibility of more drastic contamination of emerging markets. The commodities markets, including oil, remain steady driven by the strong demand and by the pressured supply.



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57. Inflation rates have been reaching their highest levels observed since the last decades in both on yearly and monthly bases, due to the rises in food and energy prices. These rises have concerned central banks in light of the possibility of transmission to wages and expectations. Business feeling remains cautious in the majority of the countries, while consumer expectations have been deteriorating. Stock market indices declined to bear market, rising concerns that shocks generated by high-risk mortgage crisis can lead the US economy to a sharper deceleration, restraining global growth.

58. The US economy continues to face uncertainties regarding the prospects for markets, economy and inflation. Liquidity in the big mortgage funding institutions was under observation, motivating the approval of a plan by federal authorities to help them. According to the Federal Reserve, there are more concerns related to inflation than to economic growth, despite there are still significant risks of lower economic growth. Consumer price index (CPI) increased 1.1% in June, month-on-month, the highest monthly rise since June 1982.

59. In Japan and in the Euro Area, economic growth has decelerated, mainly due to the effects of high energy and raw materials prices. Despite maintaining much higher economic growth pace when compared to the global average, the Chinese economy also decelerated in the first half of the year, with 10.4% GDP growth in the first half of the year, down from 12.2% in the same period of 2007. In the second quarter of 2008, GDP grew 10.1%, down from 10.6% in the first quarter and 11.9% in the same period of 2007.

Foreign Trade and International Reserves

60. Brazilian trade surplus reached US\$2.7 billion in June, totaling surpluses of US\$ 11.4 billion in the year and US\$ 30.8 billion in the last twelve months. In the first half of the year, exports reached US\$90.6 billion, and imports, US\$79.3 billion, growing by 24.8% and 51.8%, respectively, year-over-year. Total external trade recorded a US\$169.9 billion record in the first semester, totaling US\$325.3 billion in twelve months, also a record high for the historical series.

61. In June, exports totaled US\$18.6 billion, reaching an US\$885.4 million daily average, a 35% growth year-over-year. Imports totaled US\$15.9 billion in the month, with a US\$756 million daily average, a 62.6% increase year-over-year.

62. International reserves totaled US\$200.8 billion in June, with increases of US\$2.9 billion in the month and US\$20.5 billion relative to the end of 2007.

Money Market and Open Market Operations

63. In the period between the May and the June Copom meetings, the yield curve shifted upwards in all extension. In the external scenario, oil prices reached historically high levels and the concerns regarding US banks financial health continued, causing risk aversion increase. In the domestic outlook, the persistence of current inflation rates at elevated levels and the deterioration of inflationary expectations also contributed to the interest rate rises. Between June 2 and July 21, one-, three-, and six-month rates went up by 58 bps, 62 bps and 68 bps, respectively. Moreover, one-, two- and three-year rates increased by 77 bps, 82 bps, and 75 bps, respectively. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectations, increased to 8.79% on July 21, up from 8.66% on June 2.

64. On June 27, the BCB carried out reverse FX swap auction amounting US\$1.5 billion, with the rollover of July redemptions.

65. In its open market operations, the BCB carried out, from June 3 to July 21, weekly five- and seven-month fixed rate repo operations, borrowing. The average daily balance of these operations reached R\$72.8 billion, of which R\$51.4 billion were seven-month operations. In the same period, the BCB conducted 39 overnight repo operations, borrowing. The BCB also conducted daily, at the end of day, two-working-day-tenure liquidity management operations. Operations with tenors less than thirty days, including daily liquidity management



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operations, averaged R\$37.0 billion, borrowing. In addition, on June 5, 11, 18 and 25 and July 1 and 9, the BCB conducted borrowing operations with tenures from 11 to 35 working days, totaling R\$114.8 billion, R\$9.0 billion, R\$13.4 billion, R\$9.0 billion, R\$39.2 billion and R\$37.7 billion, respectively. These operations averaged R\$155.1 billion, on a daily basis.

66. Between June 3 and July 21, the National Treasury raised a total of R\$34.8 billion, of which R\$12.5 billion in fixed-rate securities: R\$7.7 billion via issuance of LTNs maturing in 2008, 2009 and 2010, and R\$4.8 billion in NTN-Fs maturing in 2012, 2014 and 2017. Issuance of LFTs totaled R\$18.0 billion, for securities maturing in 2012 and 2014. Issuance of inflation-linked NTN-Bs reached R\$4.3 billion, for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045.

67. In the same period, the Treasury conducted auctions to sell LTNs maturing in July and October 2009 and bought LTNs maturing in July and October 2008, totaling R\$0.3 billion. Issuance of inflation-linked NTN-Bs for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045, settled in other National Treasury securities, totaled R\$6.1 billion. The Treasury also conducted sales auctions of LFTs maturing in 2012 and 2014, which totaled R\$3.2 billion, receiving LFTs maturing in 2008 as payment, and purchase auctions to buy LTNs and NTN-Bs, totaling R\$2.4 billion and R\$31 million, respectively.