



BANCO CENTRAL DO BRASIL

Minutes of the 137th Meeting of the Monetary Policy Committee (Copom)

Summary

Recent Economic Developments
Assessment of Inflation Trends
Monetary Policy Decision
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: September 9th, from 5:20PM to 7:30PM, and September 10th, from 5:00PM to 8:10PM

Place: BCB Headquarters meeting rooms - 8th floor on September 9th and 20th floor on September 10th – 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 September 9th)

Adriana Soares Sales - Department of Banking Operations and Payments System
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on September 10th)
João Henrique de Paula Freitas Simão – Open Market Operations Department
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on September 9th)

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
José Linaldo Gomes de Aguiar – Executive Secretary
Katherine Hennings – Advisor to the Board

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.



BANCO CENTRAL DO BRASIL

Recent Economic Developments

1. IPCA inflation retreated in July and August, to 0.53% and 0.28%, respectively, down from 0.74% in June. As a consequence, inflation reached 4.48% in the first eight months of 2008 – the highest in the period since 2004 – up from 2.80% in the same period of 2007. Twelve-month trailing inflation showed the first deceleration since October 2007. In fact, after reaching 6.06% in June, it totaled 6.37% in July and 6.17% in August (compared to 4.18% 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. Indeed, market prices and regulated prices increased 7.64% and 2.84%, respectively, in the twelve months through August, compared to 5.0% and 2.37% in the twelve months through August 2007. Moreover, despite the BRL appreciation, the prices of tradable goods accelerated, reaching 6.82% (compared to 4.82% in August 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 (8.41%), evidencing the influence of domestic factors over inflationary dynamics. For instance, the price of services increased 5.91% in August 2008, up from 5.19% in December and 4.98% in August 2007, according to the same comparison basis. Preliminary data for September point to consumer inflation index similar to that observed in August, despite higher than the September 2007 index. In short, despite some improvement in the inflationary dynamics at the margin, the reversal of the progressive divergence of inflation from the targets path, which had been observed since the end of 2007, hasn't consolidated yet.

2. The three main underlying inflation measures calculated by the BCB have evolved in line with the headline index, notwithstanding the non-uniform characteristic. 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 changed from 0.55%, 0.49% and 0.48% in June, to 0.39%, 0.36% and 0.43% in July, and to 0.50%, 0.36% and 0.42% in August, respectively. Similarly to the headline inflation, the three core inflation measures remarkably accelerated in the first eight months of the year, compared to the same period of 2007, with increases from 2.45%, 2.47% and 2.24% to 4.18%, 3.26% and 3.52% for the core inflation by exclusion, smoothed and non-smoothed trimmed means core inflation, respectively. On a twelve-month trailing basis, the core inflation by exclusion of household food items and regulated prices continues to record substantial increase, rising from 5.37% in June to 5.71% in July and 5.87% in August. On the other hand, the smoothed and non-smoothed trimmed means core inflation have shown relative stability, under this criterion, in the last months. The smoothed trimmed means core inflation increased from 4.72% in June to 4.89% in July and 4.85% in August, whereas the non-smoothed trimmed means core inflation increased from 4.65% in June to 4.93% in July and 4.92% in August. As a consequence, all core inflation measures stand above the central value for the inflation target. Moreover, it bears emphasizing that the behavior of the IPCA diffusion index, whose average is the highest recorded since 2004, continues to suggest dissemination of the inflationary process, confirming the analysis present in previous Copom Minutes.

3. The General Price Index (IGP-DI) inflation decelerated to -0.38% in August (the first monthly deflation since March 2006), down from 1.12% in July, and 1.89% in June. On a twelve-month trailing basis, IGP-DI inflation increased 14.81% in July, up from 13.96% in June, but retreated to 12.80% in August, up from 5.19% in August 2007. In the twelve months through August, the IGP-DI increase reflected the behavior of the three main components. The Consumer Price Index-Brazil (IPC-Br) increased 5.93% (4.47% in August 2007), while the Wholesale Price Index (IPA-DI) totaled 15.70% (5.49% in August 2007). According to the same comparison basis, the Civil Construction National Index (INCC) increased 11.40% (5.05% in August 2007). Regarding the agricultural IPA, inflation reached 22.51% (14.87% in the twelve months through August 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 show consistent signs of accommodation. In the first eight months of 2008, wholesale industrial price inflation increased 10.87%, up from 2.12% in the same period of 2007. In addition, in the last twelve months, wholesale industrial price inflation increased 13.37% in August, 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.



BANCO CENTRAL DO BRASIL

4. After the last Copom meeting, the IBGE released data for second quarter GDP. Data showed sustainable robust growth rates, both for accumulated results in the year (6.0% up from 5.9% in the previous quarter), and for year-over-year results (6.1% as against 5.9% in the previous quarter). On the aggregate demand side, it bears emphasizing the strength of gross fixed capital formation, which grew by 16.2% in the second quarter of 2008, year-over-year. The expansion of household consumption, which tends to be less volatile than investment along the cycle, has also been significant, 6.7%, according to the same comparison basis. As a consequence, the contribution of domestic absorption for GDP growth remained around 8.5%, in line with the observed in the first quarter of the year, and well above the 6.9% contribution observed at the end of 2007. On the aggregate supply side, industrial production expanded by 5.7%, led by the 4.8% growth in the manufacturing industry and 9.9% growth in the civil construction industry, in the second quarter of 2008, year-over-year. However, the great highlight was the 7.1% expansion in the agribusiness production. The change of GDP deflator at market prices accelerated from 5.0%, year-over-year, in the first quarter of the year, to 6.3% in the second quarter, in line with the inflationary acceleration observed in the period.

5. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output increased 1.1% in July, after growing by 0.8% in the previous month. Still considering the seasonally adjusted series, after the 2.8% expansion observed in June, industrial output increased by 1.0% in July, month-on-month, partially reflecting the unusual working day distribution observed this year. It bears noticing that general industrial output grew 6.6% in the year through July, with respective increases of 6.5% and 6.8% in manufacturing and in mining output. On a year-over-year basis, industrial output expanded by 8.5% in July (with one more working day), the same growth recorded in manufacturing and extraction industries. The data already released for the last months point, in short, to the continuity of the industrial production expansion cycle, despite some accommodation at the margin may occur, due to restrictions to supply expansion in some sectors, as well as to the effects of the monetary policy change in Brazil and to the deceleration of external demand.

6. Among the use categories, according to data seasonally adjusted by the IBGE, capital goods production increased 1.2% in July. Regarding the other use categories, intermediate goods production increased 1.1%, semi- and non-durable consumer goods production remained stable and durable consumer goods production retreated by 5.2%. In the year, capital goods production leads the expansion, with an 18.1% increase, followed by the 13.2% elevation in durable consumer goods production. The recovery of the capital goods production in June and July more than offset the strong fall occurred in May, evidencing the strength of this segment, which has been mainly a result of the consolidation of favorable prospects for the continuity of macroeconomic stability. On its turn, the expansion of durable goods production reflects, predominantly, credit conditions, which remain more favorable than historical patterns.

7. Labor market continues to present quite favorable performance. The unemployment rate in the six metropolitan regions covered by the Monthly Labor Survey (PME) reached 8.1% in July, a 0.3% month-on-month growth, but 1.4% below July 2007. As a result, the average unemployment rate in the first seven 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 reached 8.0% in July up from 7.7% in June, showing stability in historically low levels in the last months. The nominal average earnings increased 10.5% in July, year-over-year, led by public sector employees, a record high for the series since December 2005. In July, real average earnings increased 0.1% month-on-month and 3.0% year-over-year. In the first seven months of 2008, real average earnings increased 2.4%, while employment grew 4.0%. As a consequence, real payrolls expanded by 6.5% (7.2% growth in July 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 0.5% in July (compared to 0.5% in June and 0.2% in May). In year-over-year terms, employment grew 4.0%, totaling 4.3% growth in the last twelve months. According to data seasonally adjusted by the IBGE, manufacturing employment increased by 0.7% in July (compared to 0.5% in June and -0.1% in May). In year-over-year terms, manufacturing employment grew 2.8%, totaling 2.9% 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 309.4 thousand jobs in June and 203.2 thousand jobs in July, a record high for the monthly historical series. In fact, July result corresponds to a 60% increase year-over-year. In the first seven months of the year, employment reached a record high of 1,564.6 thousand hires, 27% above the previous record high observed for the historical series in 2004, an evidence of the labor market heat. Formal employment



BANCO CENTRAL DO BRASIL

grew by 0.6% in July, seasonally adjusted, and observed data point to a 6.0% expansion in formal employment in the last twelve months. The services sector presented the highest hiring rate in July, with the creation of 51.3 thousand new jobs, the second best result of the series for the month, followed by the agricultural sector (44.9 thousand new jobs), also the second best result of the series for the month. The manufacturing industry recorded 37.5 thousand new jobs, up from 29.0 thousand in July 2007, whereas the retail sector recorded 25.3 thousand new jobs (27.9 thousand in July 2007) and the civil construction recorded 35.1 thousand new jobs (19.0 thousand in July 2007). In addition to the process of formalization in the labor market, these data evidence the strong dynamism in labor force demand. In fact, formal employment grew by 6.3% in the year through July.

8. In line with the positive developments in the labor market and with credit expansion, retail sales still 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 1.3% in June, after increasing 1.1% in May and 1.5% in April, and grew by 14.1% year-over-year in June and 14.3% in the first half of 2008. Expanded retail sales three-month moving average increased 0.9% in June, month-on-month, representing the 26th consecutive monthly increase. According to seasonally adjusted data, on a month-on-month basis, it bears emphasizing the expansion in “fuels and lubricants” (2.1%), “vehicles, motorcycles, parts and pieces” (1.7%) and “fabric, clothing and shoes” (1.7%). In the year through June, cumulative growth was more significant in “office, computing and communication material and equipment” (30.9%), “vehicles, motorcycles, parts and pieces” (22.3%) and “other personal and domestic articles” (21.5%). Despite the rise in food prices, hyper- and supermarket sales, food products, beverages and tobacco showed a 5.9% significant growth, under the same comparison basis. 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, favored by the increase in fiscal transfers, employment and income growth, credit expansion and the maintenance of consumer confidence at high levels. Notwithstanding, as time goes by, the change in the monetary policy stance will be relevant to restrain the retail sales expansion pace.

9. The installed capacity utilization rate (Nuci) in the manufacturing industry reached 83.7% in July, up from 83.1% in June, according to CNI data seasonally adjusted by the BCB. According to data seasonally adjusted by CNI, the Nuci in the manufacturing industry, which had retreated in May, resumed growth in June and July, reaching a record high in July for the observed series (83.5%). Without the seasonal adjustment, the Nuci stood 1.47 p.p. above the same level registered in July 2007. As a consequence, the average rate in the first seven 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 86.5% in August, according to the observed series, standing 0.8 p.p. above the level registered in the same month of 2007. The elevation in the Nuci in August 2008, year-over-year, is also observed in the production of civil construction inputs (8.5 p.p.), of consumer goods (2.7 p.p.) and of capital goods (1.1 p.p.). For the intermediate goods sector, the Nuci stood 0.1 p.p. below the level observed in August 2007. The maintenance of installed capacity utilization rates at historically high levels occurs in several sectors despite investments occurred in the sector in the last twelve months. In fact, recent data about the absorption of capital goods still don't allow the conclusion of inflexion in the investment expansion trend. Capital goods production increased by 8.2 % in June and 1.2% in July, after a 5.0% fall observed in May. Capital goods imports, in volume, changed 12.8%, 14.0% and -16.5%, in May, June and July, respectively, whereas capital goods exports changed 8.9%, 9.4% and -5.2%, respectively, in the same months. According to seasonally adjusted data, the absorption of capital goods increased 1.3% in the quarter ended in July, accumulating a 19.6% expansion in 2008. In the same period, the production of civil construction inputs increased by 4.2% (10.5% in 2008). In short, evidences suggest that, although investment has been importantly contributing to soften the increasing trend of capacity utilization rates, the maturation of investment projects has not been sufficient, so far, to significantly limit the existing mismatches regarding the evolution of 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 register deceleration at the margin, a trend that has already been expected, and which is in line with assessments present in Inflation Reports and previous Copom Minutes. In the last twelve months through August the trade surplus reached US\$29.5 billion (33.3% below August 2007). Exports and imports totaled US\$189.1 billion and US\$159.6 billion, equivalent to 24.5% and 48.2% growth, respectively, according to



BANCO CENTRAL DO BRASIL

the same comparison basis. 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 expansion of domestic absorption, notwithstanding the elevated price levels of several commodities included in the Brazilian export basket. The decrease in trade surplus contributed to the US\$19.5 billion current account deficit registered in the twelve months through August 2008, equivalent to 1.4% of GDP. Foreign direct investment reached US\$30.1 billion in the twelve months through July, equivalent to 2.2% of GDP.

11. Regarding the external scenario, the global economy still shows divergent pressures, with more evident signs of deceleration and still high inflation rates. The prevailing interpretation still points to the expansion, at a moderate pace, of economic activity in 2008 and 2009, but data released in the last few weeks indicate a more intense cooling of activity in mature economies, mainly in the Euro area, the United Kingdom and Japan, while signs of economic activity deterioration also appeared in the US, despite the fiscal and monetary stimuli previously adopted. There are evidences that the deeper weakening of economic activity in Europe and parts of Asia was predominantly due to the negative shock in the terms of trade caused by the elevation of commodities prices (which could be reversing). The secondary effects derived from the increase in raw materials prices, and the pressures of heated demand over supply expansion capability, which are particularly evident in emerging economies, have sustained current inflation rates at high levels, with significant consequences, in several cases, over inflation expectations. Furthermore, a severe financial crisis in the USA and, to a minor extent, in Europe, must be added to this adverse scenario. In this context, although the presence of inflationary pressures has been a concern for an important number of monetary authorities, their policy reactions have been heterogeneous, and this situation tends to persist. The US economy, specifically, started to decelerate in the last quarter of 2007 and it still continues to suffer the impacts of the housing sector crisis, with spillover effects on the labor market, whose weakening, together with the increase in the prices of oil by-products, has reduced consumer's confidence, significantly contributing for depressing expenditure. Although fiscal and monetary stimuli have limited the risks of a deeper activity contraction, the dominant expectation still indicates a more consistent recovery only from 2009 on. Even after an important reinforcement of the capital base of significant financial institutions, uncertainties about the extension and length of the US mortgage crisis developments over the local and European banking systems still prevail, as well as about the impacts over the credit availability for business and households in those regions. Systemic risk perception is still high, as financial problems have aggravated due to a cyclical deterioration in credit quality, which tends to tighten financial conditions and, as a consequence, the risk of more intense economic deceleration. In this context, US government intervention in large mortgage companies can be seen as a necessary condition, although probably insufficient to overcome such crisis. Most common opinion among analysts indicates that activity in Europe and Japan should decelerate throughout the second half of 2008. In developed economies, therefore, prospects for the adoption of tightening policies seem limited; on the other hand, although showing some moderation at the margin, emerging countries growth remains strong and, up to now, was apparently little affected by the mortgage crisis in the US, partially counterbalancing the activity deceleration in mature economies. In fact, due to the pressure over the availability of production factors, the inflation elevation pointed to the maintenance of monetary tightening policies in several emerging economies. The prospects for the monetary policy in emerging countries became even more complex in the last weeks, when several currencies, not only from commodity-exporting countries, significantly depreciated in relation to the US\$, in the midst of an increase of volatility and risk aversion indicators in international financial markets. Nevertheless, policies aiming at the reduction of external vulnerability of Brazilian economy have been successful, contributing to reduce, though not eliminate, the effects of the external environment on local economic activity, which has been driven essentially by domestic demand.

12. Oil prices remain highly volatile, but reduced considerably since the last Copom meeting. Future markets and the consensus among analysts suggest that oil prices could stabilize around current levels. However, uncertainty concerning these evaluations is remarkably high, as the prospective scenario depends on the evolution of demand, especially in emerging countries, on the supply's reaction to stimuli derived from previous changes on relative prices, besides geopolitical issues that affect oil prices. Nonetheless, despite the great uncertainty regarding oil prices trajectory, the main scenario adopted by the Copom, which assumes unchanged gasoline prices in 2008, remains plausible. However, it bears highlighting that, no matter the behavior of domestic gasoline prices, international oil prices at historically high levels affect domestic prices both through productive chains, such as the petrochemical, as well as by the deterioration they may cause on economic agents' inflation expectations. The prices of other commodities also showed important reductions since the last Copom meeting, finally reacting to the greater pessimism about the prospects for global economic growth and to the continuity of the global financial



BANCO CENTRAL DO BRASIL

markets turmoil, but except for industrial inputs like nickel and copper, they continued to increase on a twelve-month trailing basis.

Assessment of Inflation Trends

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

- a) The projected adjustments for gasoline and bottled gas prices were maintained at 0% for 2008;
- b) The projections for electricity prices adjustments and fixed telephone prices were maintained unchanged at 1.1% and 3.5%, respectively, for 2008;
- c) The projection for regulated prices inflation in 2008, based on individual items, was maintained at 4.0%. This set of prices, according to data released by the IGBE, corresponded to 29.69% of the total August IPCA;
- d) The projection for regulated prices inflation in 2009 was maintained at 4.8%. 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;
- e) The projection for the spreads over the Selic rate, on the benchmark scenario, based on the 360-day swap rates estimates a 173 bps spread in the fourth quarter of 2008 and 106 bps 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 July Copom meeting, according to the median IPCA inflation expectations compiled by the BCB's Investor Relations Group (Gerin), the 2008 IPCA variation decreased to 6.27%, down from 6.53%. Twelve-month ahead inflation expectations also reduced, to 5.22%, down from 5.44%, considering the medians of expected monthly rates. Inflation expectations for 2009 remained at 5.0%.

16. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the exchange rate at R\$1.70/US\$1.00 and the Selic rate at 13.00% during the forecast period – the projection for the 2008 IPCA inflation decreased relative to the figure considered at the July Copom meeting, but remained 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 declined compared to the figure considered at the previous Copom meeting, but remained above the central target for the year. Regarding 2009, projections based on both scenarios decreased compared to the figures available at the July meeting; however, they remained above the central target for that year.

Monetary Policy Decision

17. The Copom evaluates that the 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 it is at least partially responsible for the inflationary acceleration observed since the end of 2007, despite strong imports growth and the favorable investment performance. Even in the context of a deceleration of global growth this year 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. In general terms, the influence of the external



BANCO CENTRAL DO BRASIL

scenario on the future trajectory of Brazilian inflation continues to be subject to contradictory effects and surrounded by significant uncertainties. On the one hand, the prospects of more pronounced deceleration of global activity in the upcoming months, which are apparently consolidating, point to an accommodation of both commodities prices and external demand, and can also influence local financial conditions. On the other hand, the cooling trend has caused an increase in risk aversion, impacting the demand for Brazilian assets, and consequently, depreciating their prices. In this scenario, the additional reduction of net exports can occur, with similar effects over the behavior in the prices of certain Brazilian assets. Moreover, the recent trajectory of price indices still evidences the existence of mismatches between the supply and demand growth, and consequently, of significant inflationary risks, in several economies, even though the intensity is now probably lower than in the middle of last year. In light of the deterioration of inflation prospects occurred in the last months, in a more uncertain environment, the Committee evaluates that the risk of materialization of a less benign scenario is still high. 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 the worsening of expectations. The Copom thinks that the maintenance of monetary stability is an essential condition for the relative prices system to continue efficiently signaling the necessary adjustments on current consumption and production patterns of the economy.

18. The Copom considers that the probability that initially localized inflationary pressures represent risks to domestic inflation trajectory continues to be high, 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 to 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 remain in levels incompatible with the inflation target path and continue to be carefully monitored. Additionally, it is worth highlighting that although the external sector exerts some discipline on tradable goods inflation, imports prices have hiked in a strong manner. 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 carefully monitor the evolution of inflation and the several core inflation measures, as well as of inflation expectations within the forecast period, and will be 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 maintenance of inflation rates in line with the targets path and the consequent consolidation of a long-term stable macroeconomic environment will contribute for the progressive reduction of macroeconomic risk perception. The Copom thinks that the persistence of a cautious and timely monetary policy stance has been critical to increase the probability, even in light of global inflationary pressures, that inflation in Brazil will evolve according to the targets path in 2009. For this higher probability to continue 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, credit growth, despite the more moderate 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. These considerations become even more relevant considering the clear signs of heated domestic demand, the dissemination of pressures stemming from adjustments in relative prices, also over the labor market, and the fact that the monetary policy decisions will have concentrated impacts in 2009.

22. The Copom recognizes the important contribution of investment to expand productive capacity. Moreover, it bears noticing that the accommodation of commodities prices, whose more consistent evidence appeared in the



BANCO CENTRAL DO BRASIL

last weeks, 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 the 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, as well as the Brazilian experience, indicates that high inflation rates lead to higher risk premium, shorter planning horizons and, as a consequence, to the reduction of 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, established by CMN, promptly, in other words, in 2009. This strategy will have its results evidenced throughout time, takes into account the time lags in the transmission mechanism and is the most adequate to deal with uncertainties inherent to the process of monetary policy formulation and implementation.

24. The Copom evaluates that, in light of the economy heating signals and the behavior of inflation expectations, the risks for the materialization of a benign inflationary scenario, in which IPCA would resume the evolution in line with the targets path, are relevant. In fact, the deterioration of the forward-looking scenario is still 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 continues to represent risk for the inflationary dynamics. Under these circumstances, monetary policy should continue to act through the adjustment of the basic interest rate, while the balance of risks to the inflationary dynamics requires. This adjustment aims, on the one hand, to reduce such mismatch and, on the other hand, to avoid that inflationary pressures initially localized over price indices lead to persistent deterioration of expectations and of the inflation forward-looking scenario.

25. Some members of the Committee believe that, since the last meeting, several signs of strong deterioration in activity in developed economies have been relevant, resulting in improvement of global inflation prospects, partially due to the fall in commodities prices. Such scenario would have potential contractionary impacts, also through financial deleverage consequences over credit conditions, which would add up to the lagged effects of monetary policy over the country's economic activity, with implications for the projected inflation scenario. Indeed, those Copom members understood to be more appropriate, at this early time, to raise the basic interest rate by 50 b.p.

26. Most Committee members, however, currently understand that in spite of the deterioration on the global economic growth prospects, the risks to the materialization of a benign inflation scenario in the country have not presented enough improvement yet. In particular, those members understand that up to now there is not enough evidence of reduction of mismatch between the demand and supply expansion rhythms, as perceived by the intense use of productive factors, and that the expectations anchorage to the target path still needed to be reinforced. In such context, those Committee members understood to be more appropriate to raise the basic rate by 75 b.p.

27. In such context, evaluating the macroeconomic scenario, the Copom decided to raise the Selic rate to 13.75% p.a., with no bias, aimed to promptly promote convergence of inflation to the target path. Five votes were for the monetary policy action, while three votes were in favor of elevating the Selic rate by 50 b.p.

28. Under the inflation-targeting regime, the Copom guides its decisions according to the projected inflation, the analysis of several alternative scenarios for the evolution of the main variables that determine the forward-looking prices dynamics, as well as the balance of risks associated to their projections. Domestic demand has continued to expand strongly and supports the economic activity dynamics, including sectors less exposed to external competition, when the effects of stimuli factors, such as income growth, are still acting over the Brazilian economy. On its turn, the external sector contribution to a favorable inflationary scenario, in light of the strong rhythm of domestic demand expansion, of global inflationary pressures, as well as depreciation in the prices of Brazilian assets, have become less effective, at a moment when the effects of investment over the productive capacity of the economy still need to consolidate. In such environment, the monetary authority should act in order to avoid that the



BANCO CENTRAL DO BRASIL

higher uncertainty detected in short-term horizons disseminate to longer-term horizons. Evidently, if the risk profile changes in a manner 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.

29. At the conclusion of the meeting, it was announced that the Copom would reconvene on October 28th 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

30. IPCA increased 0.28% in August, decelerating relative to July (0.53%). Food and beverages prices, which increased 9.59% in the year through August, reverted its upward trend and decreased 0.18% in August. Market prices increased 0.25% in the month, compared to 0.50% in July, with price elevations of 0.19% for tradable and of 0.31% for non-tradable goods. Regulated prices increased 0.35% (0.60% in July). The diffusion index reached 63% in August, up from 59.4% in July, in the opposite direction of the deceleration index rate. IPCA has showed a 6.17% increase over the last twelve months, down from 6.37% in July, with 8.04% increase on market prices and 2.60% on regulated prices.

31. Core inflation indices were relatively stable in August, except for the core excluding household food and regulated prices, which increased 0.50% up from 0.39% in July, totaling 5.87% in the last twelve months. The non-smoothed trimmed means core reached 0.42% in August (0.43% in July) and 4.92% in the last twelve months. The smoothed trimmed mean core reached 0.36% in August, the same as July, reaching 4.85% in the last twelve months.

Economic Activity

32. According to seasonally adjusted data from the IBGE's monthly survey (PMC), expanded retail sales, which include construction material and vehicles and motorcycles, parts and pieces, increased 1.3% in June, month-over-month. Nine out of the ten segments surveyed by the IBGE elevated, emphasizing the increases of fuel and lubricants (2.1%) and vehicles and fabric, clothing and shoes (1.7%). The sales of other personal and domestic outlays decreased 0.8% in the month.

33. Comparing 2008 to 2007 figures, sales grew 14.1% in June and 14.3% in the first half of 2008, considering expanded retail sales. Under both periods, there was generalized growth in all segments, with highlight for 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.

34. 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 decreased 2.5% and 1.5% in August, respectively, month-on-month. In the year through August, these indicators increased 7.3% and 5.5%, compared to the same period of 2007.

35. Regarding investment indicators, domestic production of capital goods and of construction typical inputs grew 1.2% and 2.1%, respectively, in July, month-on-month seasonally adjusted. These indicators grew 22.3% and 14.4%, respectively, year-over-year. In the year through July, production of construction typical inputs grew 10.5%, reflecting the investment's strength in the sector. In the same period, the production of capital goods grew 18.1%, also reflecting investments growth, in particular those related to the modernization and expansion of production capacity of the agricultural, transportation and electrical energy sectors.

36. Capital goods imports decreased 16.5% in July relative to June, when the same indicator grew 14% relative to May, according to the quantum indices from Fundação Centro de Estudos do Comércio Exterior (Funcex), seasonally adjusted by the BCB. Those variations mainly reflected the normalization of imports procedures after



BANCO CENTRAL DO BRASIL

the interruption of the services during part of the second quarter of the year. The July indicator was stable compared to the first half of 2008 average, but presented a 52% growth year-over-year. In the year through July, the imports quantum index grew 38.9%, up from 36.5% in the year through June, confirming the contribution of capital goods imports in the current cycle of investments in the Brazilian economy.

37. Credit loans granted by the Development Bank (BNDES) directed to mid- and long-term investments reached R\$45.4 billion in the year through July, a 46% growth over the same period of 2007. In the last twelve months through July, disbursements totaled R\$79.1 billion, a 30% expansion relative to the same period of 2007, with highlights to the 74% increase in infrastructure disbursements.

38. Seasonally adjusted CNI indicators showed a 1% expansion in industrial real revenues in July, month-on-month, and a 0.9% decrease in hours worked in industrial production. In the year through July, compared to the same period of 2007, industrial real revenues grew 9% and hours worked in industrial production increased 6.1%. Installed capacity utilization (Nuci) reached 83.7% in July, 0.7 p.p. above the June level, considering seasonally adjusted data, reaching a new record high for the series. Observed data reached 83.9%, 1.5 p.p. above the July 2007 level.

39. According to IBGE's Monthly Industrial Survey (PIM), industrial production increased 1% in July month-on-month, seasonally adjusted. Seventeen out of the twenty-seven activities surveyed recorded production increase in July. By use categories, it bears noticing the increases in the production of both capital goods (1.2%) and intermediate goods (1.1%). The production of durable consumer goods decreased 5.2%, after increasing 7.7% in the previous month, while the production of semi-durable and non-durable consumer goods was stable, after accumulating a 2.6% increase in two consecutive months of growth. On a year-over-year basis, industrial production increased 8.5% in July, with increases in all use categories and in 23 sectors, with highlights to the expansions of vehicles (17.3%), machines and equipment (12.5%) and basic metallurgy (10%). In the year through July, industrial production increased 6.6%, with highlights to the growth of capital goods production and durable consumer goods production, 18.1% and 13.3%, respectively. In the same period, the production of intermediate goods and semi- and non-durable consumer goods expanded by 5.6% and 2.1%, respectively. On a twelve-month trailing basis, industrial output expanded by 6.8% in July, after registering 6.7% both in May and in June.

40. Vehicles production reached 314.7 thousand units in August, according to Anfavea, increasing 12.8% year-over-year. Considering seasonally adjusted data, the production of vehicles decreased 0.5% month-on-month. In the year through August, the production of vehicles and agricultural machinery increased 20.4% and 31.9%, respectively, compared to the same period of 2007. According to the same comparison basis, vehicles domestic sales increased 25.1%, while exports decreased 3.3%.

Surveys and Expectations

41. The Fecomercio-SP survey showed a 4.5% increase in the Consumer Confidence Index (ICC) in August, month-on-month, mainly due to the 7.7% increase in Consumer Expectations Index (IEC). The Current Economic Conditions Index (Icea) increased 0.2% in the same period. The ICC grew by 5.2% year-over-year, due to expansions of 7% and 2.6% in the IEC and in the Icea, respectively.

42. According to the FGV survey, the ICC increased 6.2% in August, month-on-month. The assessments of both current situation and expectations regarding upcoming months improved, increasing by 9.3% in the Current Situations Index (ISA) and by 4.6% in the Expectations Index (IE), according to the same comparison basis. The survey also registered decreases of 1% and 1.9% in the ICC and in the IE, respectively, and a 0.9% expansion in the ISA, year-over-year.

43. Still according to the FGV, the Industry Confidence Index (ICI) reached 122.8 points in August, up from 121.5 in July. The indicator stood 0.9 p.p. above the level registered in the same month of 2007, reflecting the elevations of 1.4 p.p. in the IE and 0.4 p.p. in the ISA. Out of the items related to the current situation, demand level, mainly domestic, and current situation of business continue to present favorable evaluation. Businessmen keep confident about increasing production in the quarter ended in October.



BANCO CENTRAL DO BRASIL

44. According to the FGV Manufacturing Industry Survey, installed capacity utilization (Nuci) reached 86.5% in August, standing 0.4 p.p. above the July level, and 0.8 p.p. above the August 2007 level.

Labor Market

45. According to the Ministry of Labor and Employment, 203.2 thousand new formal jobs were created in July 2008, totaling 1,564.6 thousand new jobs in the year. Employment level increased by 0.6% month-on-month in seasonally adjusted terms, expanding in all sectors, with highlights to the 1.5% expansion in the construction sector and the creation of 51.3 thousand new jobs in the services sector.

46. According to the IBGE employment survey (PME) carried out in the six main metropolitan areas of the country, the unemployment rate reached 8.1% of economically active population (PEA) in July, up from 7.8% in the previous month and 9.5% in July 2007. The month-on-month increase of the unemployment rate in July reflected the decrease of 55 thousand employed workers and the increase of 7 thousand workers who joined the labor market. Year-over-year, occupation increased 4%, while the PEA increased 2.5%. Private sector workers increased 0.4% month-on-month in July, representing 53 thousand new jobs, even with the reduction of 38 thousand formal jobs. The number of self-employed workers decreased 2.3%, while the number of employers increased 0.6%. Year-over-year, formal workers in the private sector led occupation growth (7.8% increase), the number of employers and informal workers increased 4.6% and 4.1%, respectively, while the number of self-employed workers decreased by 0.7%.

47. The same survey showed that average real earnings of occupied workers increased 0.1% in July, month-on-month, and 3% year-over-year. Real payrolls decreased 0.1% in July, month-on-month, but increased 6.5% in the year through July and 7.2% year-over-year.

48. According to CNI data seasonally adjusted by the BCB, employment in manufacturing industry increased 0.6% in July, month-on-month. Year-over-year, employment in the manufacturing industry and industrial real payroll increased 4.4% and 5.7%, respectively, in July. In the first seven months of 2008, the same indicators increased by 4.4% and 5.6%, respectively, year-over-year.

Credit and Delinquency Rates

49. Outstanding credit in the financial system reached R\$1,086 billion in July, setting a new record of volume to GDP ratio, 37%. Credit operations in the financial system expanded by 1.7% in July, totaling 32.7% expansion on a twelve-month trailing basis. According to the same comparison bases, non-earmarked credit operations increased 1.9% and 35.9%, respectively, while earmarked credit operations elevated 1.2% and 25.4%, respectively. Among the non-earmarked operations, leasing operations remained strong, with expansions of 141.7% and 78.4% for credit to individuals and to corporate, respectively, in the last twelve months. Regarding earmarked credit, it bears highlighting the 30.2% and 28.1% increases in operations related to housing and the agricultural sector, respectively, according to the same comparison basis. Considering other sectors, loans to industry increased 1.5% month-on-month in July and 36.9% in twelve months.

50. The average interest rate on non-earmarked credit operations, used as reference for interest rates, reached 39.4% p.a. in July, up from 38% p.a. in June and 35.9% p.a. in July 2007. The average rate on credit for individuals reached 51.4% p.a., while the average rate on corporate credit increased 27.5% p.a., compared to 47% p.a. and 23% p.a., respectively, in July 2007.

51. The average tenure on non-earmarked credit operations, used as reference for interest rates for individuals reached 373 days in July, 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 467 days.

52. Delinquency rates in the financial system (non-earmarked loans, used as reference for interest rates, in arrears for more than ninety days) stood at 4.2% in July, a 0.5 p.p. decrease year-over-year. Delinquency rates for



BANCO CENTRAL DO BRASIL

credit operations with corporate and individuals reached 1.7% and 7.3%, respectively, compared to 2.4% and 7.1% in July 2007.

53. Net delinquency rate for retail credit, measured by the ACSP, reached 6.3% in July, up from 4.5% in the same month of 2007. In the year trough July, the average delinquency rate stood at 7%, up from 6.4% in the same month of the previous year.

External Environment

54. In the international outlook, the concerns regarding inflation and global demand deceleration are increasing, specially, the smaller growth of industrialized economies. Despite the 3.3% growth of the U.S. economy in the second quarter, boosted by positive contribution of net exports and by the effects of the fiscal stimulus to consumption, the signals that the European economies are closer to a recessive process are more evident. Emerging economies maintain robust growth, specially the Asian economies, although they record activity level cooling, compared to the high expansion rates recorded in 2007. Moreover, it cannot be discarded greater economic activity cooling in these countries, in case the global economic deceleration is more intense and persistent.

55. Regarding inflation, the recent fall of commodities prices, including oil prices, can provoke the accommodation of prices at a lower level in the middle run. However, available data confirm that the annual inflation levels remain high and the risks to inflation are greater in the short run, in face of the possibility of pass-through of this trend to wages and expectations. Despite the strong deterioration of the British economy, the Bank of England maintained the interest rate at 5% p.a. in the last Monetary Policy Committee Meeting, due to the inflationary pressures. Regarding the European Central Bank, the interest rate was also maintained at 4.25% p.a.

56. The international financial market turmoil remains, although with less intensity. The strong commitment of important central banks to provide the necessary liquidity to the good run of the interbank market, as well as the prospect that significant part of the losses has been already registered by the financial institutions, have been fundamental for the recent performance of financial market. Some recovery signals have been observed, specially in the stock and credit default swaps (CDS) markets, although there are still traces of localized pressures, mainly in the interbank markets, whose spreads related to the basic interest rates still remain at high levels.

Foreign Trade and International Reserves

57. Brazilian trade surplus reached US\$2.3 billion in August, totaling surpluses of US\$ 16.9 billion in the year and US\$ 29.5 billion in the last twelve months. In the year through August, exports reached US\$130.8 billion, and imports, US\$113.9 billion, growing by 29.3% and 53.8%, respectively, year-over-year. Total external trade recorded a US\$244.8 billion record in the year through August, totaling US\$348.6 billion in twelve months, also a record high for the historical series.

58. In August, exports totaled US\$19.7 billion, reaching a US\$940.3 million daily average, a 43.2% growth year-over-year. Imports totaled US\$17.5 billion in the month, with a US\$832.3 million daily average, a 65.6% increase year-over-year.

59. International reserves totaled US\$205.1 billion in August, with increases of US\$1.6 billion in the month and US\$24.8 billion relative to the end of 2007.

Money Market and Open Market Operations

60. In the period between the July and the September Copom meetings, the yield curve shifted upwards in short terms and shifted downwards in longer terms, driven by the decision of the Copom to increase the Selic target rate by 75 b.p. The deceleration observed in several current inflation indices and the fall in the prices of commodities also contributed to decrease the longer terms yield curve. However, since the beginning of September, the decrease movement of longer terms yield curve was partially reverted by the worsening of the external outlook,



BANCO CENTRAL DO BRASIL

with the dollar appreciation and the increase of risk aversion as a result of the fear of global economy deceleration. Between July 21 and September 8, one-, three-, and six-month rates increased by 83 bps, 78 bps and 61 bps, respectively. Moreover, two- and three-year rates fell by 57 bps, and 69 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 8.96% on September 8, up from 8.79% on July 21.

61. On July 28 and August 26, the BCB carried out reverse FX swap auction amounting US\$2.7billion, with the rollover of August and September redemptions.

62. In its open market operations, the BCB carried out, from July 22 to September 8, weekly five- and seven-month fixed rate repo operations, borrowing. The average daily balance of these operations reached R\$63.1 billion, of which R\$44.9 billion were seven-month operations. In the same period, the BCB conducted 35 overnight repo operations, borrowing. The BCB also conducted daily, at the end of day, one- and two-working-day-tenure liquidity management operations. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R\$35.5 billion, borrowing. In addition, on July 24 and 30, and on August, 6, 13, 20 and 27, the BCB conducted borrowing operations with tenures from 11 to 19 working days, totaling R\$10.5 billion, R\$14.1 billion, R\$6.6 billion, R\$5.6 billion, R\$20.5 billion and R\$3.6 billion, respectively. Moreover, the BCB also conducted, on July 24, a borrowing operation with tenure of 35 working days amounting R\$157.4 billion. These operations averaged R\$186.8 billion, on a daily basis.

63. Between July 22 and September 8, the National Treasury raised a total of R\$21.9 billion, of which R\$13 billion in fixed-rate securities: R\$6.0 billion via issuance of LTNs maturing in 2009 and 2010, and R\$7.0 billion in NTN-Fs maturing in 2012, 2014 and 2017. Issuance of LFTs totaled R\$4.7 billion, for securities maturing in 2012 and 2014. Issuance of inflation-linked NTN-Bs reached R\$4.2 billion, for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045.

64. In the same period, the Treasury conducted auctions to sell LTNs maturing in July and October 2009 and bought LTNs maturing in October 2008, totaling R\$1.1 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\$7.3 billion. The Treasury also conducted sales auctions of LFTs maturing in 2012 and 2014, which totaled R\$0.8 billion, receiving LFTs maturing in 2008 as payment, and purchase auctions to buy LTNs and NTN-Bs, totaling R\$0.5 billion and R\$83 million, respectively.