BANCO CENTRAL DO BRASIL

Minutes of the 100th Meeting of the Monetary Policy Committee (Copom)

Date: September 14th, from 4:30PM to 7:00PM, and September 15th, from 3:55PM to 7:15PM
Place: BCB's Headquarters meeting room of the 8th floor (on September 14th) and 20th floor (on September 15th) – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua
Alexandre Schwartsman
Antônio Gustavo Matos do Vale
Eduardo Henrique de Mello Motta Loyo
João Antônio Fleury Teixeira
Paulo Sérgio Cavalheiro
Sérgio Darcy da Silva Alves

Department Heads (present on September 14th)
Altamir Lopes – Economic Department
José Antônio Marciano – Department of Banking Operations and Payments System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on September 15th)
Renato Jansson Rosek – International Reserves Operations Department
Sérgio Goldenstein – Open Market Operations Department

Other participants (present on September 14th)
Flavio Pinheiro de Melo – Advisor to the Board
Hélio José Ferreira – Executive Secretary
João Batista do Nascimento Magalhães – Special Advisor to the Governor
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

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

Recent Evolution of Inflation

1. In August, the Broad National Consumer Price Index (IPCA) rose by 0.69%, down from 0.91% in July. The IPCA fall was mainly due to the lower impact of tariffs that pressured the July IPCA (electricity and fixed telephone). On the other hand, bad weather conditions affected prices of fresh food. The rise in prices of sugar cane by-products also affected inflation, including the indirect impact on gasoline prices (in Brazil, alcohol fuel is added to gasoline). The IPCA accumulates a 5.14% change in the first eight months of the year, and a 7.18% variation in twelve months.

2. The General Price Index (IGP-DI) rose by 1.31% in August, compared to 1.14% in July, thus accumulating a 9.53% change in the first eight months of the year. The acceleration of the IGP-DI in August was due to higher pressures at both the wholesale and the consumer levels. The Consumer Price Index – Brazil (IPC-Br) rose by 0.79%, while the Wholesale Price Index (IPA-DI) rose by 1.59%, from 0.59% and 1.35%, respectively, in July. The National Index of Civil Construction (INCC), with a 10% weight in the IGP-DI, rose by 0.81%, down from 1.12% in July. Up to August, the IPC-Br, IPA-DI and INCC accumulate changes of 5.11%, 11.58%, and 7.79%, respectively.

3. Alcohol fuel (0.10 p.p.) and gasoline (0.07 p.p.) were the main individual contributions to the August IPCA inflation. Food prices rose by 0.85% (0.67% in July), accounting for 0.20 p.p. of the monthly IPCA change, mainly due to the 8.1% increase in fresh food prices. The surge in sugar cane prices led to the prices increases of crystal sugar (5.42%) and refined sugar (14.67%). Conversely, important products in the consumer basket registered new price falls in August, including rice, black beans and soy oil.

4. In August, market prices increased by 0.60% (0.52% in July), accounting for 0.43 p.p. of the monthly IPCA variation, while the 0.92% increase in regulated prices was responsible for the remaining 0.26 p.p. Among market prices, there were pressures coming from non-tradables, which contributed with 0.30 p.p. for the IPCA change, more noticeably from fresh food and maids and housekeeping cleaners. Tradable prices contributed with 0.12 p.p., mainly due to increases in the prices of sugar and new and second-hand cars. Regarding regulated prices, in addition to the price increases of gasoline and alcohol-fuel, there were residual effects of the increases in electricity, fixed telephone prices, and urban buses fares that had already pressured the IPCA in July.

5. The IPA-DI acceleration in August reflected the rise of both agricultural and industrial prices. The Agriculture-IPA increased by 0.53% (0.26% in July), due to price raises of vegetables, fruit, sugar cane and pork, while cereals and export-oriented crops continued to present price decreases. The industry-IPA increased by 1.98% (from 1.76% in July), mainly due to the acceleration of prices of iron, steel and by-products, plastic materials, paper and cardboard, mechanics and electrical materials, wood and rubber.

6. Wholesale industrial prices (except fuel) accumulate a 4.97% change in the three-month period ended in August. In the same period, industrial products (except fuel) in the IPCA register a 1.51% average increase. Therefore, there is a significant potential of lagged impacts on consumer prices in the next few months, due to the pass-through of the wholesale industrial inflation.

7. In August, the IPCA core inflation measured by excluding household food items and regulated prices registered a 0.56% variation (0.46% in July), accumulating a 5.59% change in the year and 7.47% in twelve months. The smoothed trimmed-mean IPCA core stood at 0.55%, the same as in July, totaling 4.93% in the year and 8.01% in the last twelve months. Without the smoothing procedure for pre-selected items, the core recorded 0.53% (0.59% in July), 4.11% in the year and 5.95% in twelve months.

8. The IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed-mean method, stood at 0.42% in August (0.36% in July), accumulating 4.09% in the year and 6.18% in the last twelve months.

9. In September, consumer-prices inflation should decline, mainly due to lower pressures from regulated prices and from fresh food prices. However, uncertainties stemming from the gap between wholesale and consumer industrial inflation persist. Likewise, the scenario for international oil prices remains uncertain, constituting a potential risk to domestic inflation.

Assessment of Inflation Trends

10. The identified shocks and their impacts were reassessed according to new available information. The scenario considered in the simulations assumes the following hypotheses:

    a. The Copom's projection for the increase of oil prices in 2004 was maintained at 9.5%, while the projection for the increase of bottled gas prices was reduced to 6.2% from 6.8%;

b. The projection for the readjustment of household electricity prices in 2004 was revised downwards to 11.5% from 11.6%, while the projection for the readjustment of fixed telephone tariffs was increased to 13.9% from 12.8%;

c. Regarding all regulated prices, with a total weight of 28.95% in the August IPCA, the Copom projects an average rise of 8.5% in 2004, 0.2 p.p. higher than projected in the August meeting;

d. The projection for the readjustment of all regulated prices for 2005, following the model of endogenous determination, which takes into account seasonal components, the exchange rate, market prices inflation and the IGP-DI change, was increased to 6.9% from 6.3%;

e. The projection for the 6-month spread over the Over-Selic rate, following the specification of a Vector Autoregressive model based on the Selic and the swap rates on the eve of the Copom meeting, decreases from 93 basis points in the third quarter of 2004 to 63 basis points in the fourth quarter of 2005.

11. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of the GDP for 2004 and the following two years will be achieved. The related assumptions considered in the previous Copom meeting were maintained.

12. Considering the benchmark scenario hypotheses, including the maintenance of the Over-Selic rate at 16.0% p.a. and of the exchange rate close to the level prevailing on the eve of the Copom meeting (R$2.90), the IPCA inflation was projected above the 5.5% target for 2004 and above the 4.5% target for 2005. According to the market scenario, which takes into consideration the consensus Over-Selic rate and the exchange rate as surveyed by the BCB's Investor Relations Group – Gerin on the eve of the Copom meeting, inflation is projected above the targets for both 2004 and 2005.

Monetary Policy Decision

13. The IPCA deceleration to 0.69% in August from 0.91% in July was due to lower pressures on regulated prices, while market prices rose mainly because of increases in fresh food prices. In 2004, market prices inflation averaged 0.60% per month (exactly the same figure registered in August). Only in April did this variation stay below 0.50%. Thus market prices inflation remained systematically above the levels consistent with the inflation targets set for this year and for 2005. Since May, the accumulated change in 12 months of tradable, non-tradable and regulated prices in the IPCA has been showing an upward trend. Regarding wholesale inflation, the IPA-DI increased to 1.59% in August from 1.35% in July. Similarly to what happened in the past, the recent acceleration in industrial wholesale prices shall impact consumer inflation over the next few months. The intensity of this pass-through will depend on final demand conditions.

14. The IPCA cores remained relatively stable, but in high levels. In the June-August period, the core measured by excluding household food items and regulated prices accumulated an annualized rate of 6.4%, considerably lower than the headline index (9.6%). This difference reflects the substantial contribution of regulated prices and food to inflation in the period. Even excluding the most noticeable sources of pressure on consumer inflation in this period, the 6.4% annual change signals an underlying trend that is not consistent with the inflation target path. In the year up to August, the core by exclusion is still above the headline inflation. The trimmed-mean IPCA cores also remain high, with annualized changes of 6.6% (non-smoothed) and 7.0% (smoothed) in the June-August period, and 6.2% and 7.5%, respectively, in the accumulated of the first eight months of 2004.

15. Economic activity has continued to gather momentum. According to the Brazilian Institute of Geography and Statistics (IBGE), the GDP grew 4.2% in the first half of 2004 compared to the same period of 2003, led by the manufacturing (7.3%) and trade (7.6%) sectors. Seasonally adjusted GDP grew for three quarters in a row at annualized rates above 6%. In July, industrial production continued its upward trend, growing 0.5% over June (seasonally adjusted), and 1.1% in the quarterly moving average. The industrial production seasonally adjusted series has been growing continuously since February. Since May, the series has been above the previous record high, and, even at these high levels, presented vigorous increases in June and July. In the three months ended in July, there was a 3.8% expansion compared to the period ended in April.

16. The labor market continued to respond to the activity rebound. According to the IBGE, the unemployment rate fell in July for the third consecutive month, standing at 11.2%. Despite the unfavorable seasonality, unemployment rate returned to the levels of December 2003, considerably lower than the 12.8% registered in July 2003. The level of employment has followed an upward trend since January, with a 0.9% growth in July, seasonally adjusted. The level of formal employment, according to the Ministry of Labor and Employment, increased by 0.8% in July, and by 4.1% in the first seven months of the year, with 1,236,689 jobs created in the period, compared to 598,140 and 741,977 in the same periods of 2003 and 2002, respectively.

17. According to the monthly employment survey of the IBGE, the upward trend in real payroll initiated in January accelerated in June and July. However, average real earnings grew at a slower pace, reflecting the increase of jobs with relatively lower wages. Negotiations for wage readjustments in the first half of the year were very favorable to the recovery of labor income. The Inter-union Department of Statistics and Socioeconomic Studies (Dieese) informed that 47% of the negotiations resulted in readjustments above the INPC inflation, while 32% had readjustments equal to the accumulated INPC. Even with readjustments equal to past inflation, average real earnings tend to increase if future inflation declines, comparatively to past inflation. The current perspective is that negotiations in the second half of this year will be highly favorable to the recovery in labor income.

18. The recovery in real earnings is an important source of sustainability to the expansion of the aggregate demand, and is paramount for the continuation of the economic rebound in a more balanced and disseminated way. As mentioned in the Minutes of the Copom meeting in July, goods whose sales are less sensitive to credit and more sensitive to income have been showing an accelerating growth trend, mainly as a consequence of the recovery in the labor market. The negative performance of the output of semi and non-durable goods in July, with a seasonally adjusted decline of 1% in relation to June, does not seem to indicate a reversion in this trend. In particular, that latest result reflects a negative performance in the pharmaceutical products sector, which is not attributable to labor income dynamics, as opposed to the positive results of several economic activities strongly dependent on income.

19. As the industrial production surpasses historical high levels, an important concern to monetary policy is the capacity of the productive sector to accommodate the demand expansion. According to the FGV, the industry presented relatively low levels of idle capacity in July, and in some sectors, the installed capacity utilization was close to historical peaks. This information has been corroborated by the National Industry Confederation (CNI) data, according to which the level of industrial capacity utilization reached 82.8% in July (seasonally adjusted), a historical record. It is important to notice that, as the idle capacity is reduced, there is a gradual effect over the inflation dynamics, because even when production is beyond the existing limits, the marginal cost increases. Emergency measures, such as multiple shifts in production, or imports that would not be competitive in normal market conditions, may be able to avoid shortages, but would not mitigate price pressures inherent to a progressively higher level of capacity utilization.

20. As the initial monetary impulse loses momentum, and the economic recovery process begins to be sustained on its self-propagation mechanisms, it is natural and sound that, at the margin,

production and sales growth rates decelerate. It is even more natural and sound that this deceleration takes place in a situation in which growth rates have been, on average, unusually high, even for initial stages of a cyclical recovery, and the aggregate production level has overcome previous historical highs. Even though the industry growth rates have declined since May, the latest results still show a rather robust growth rate.

21. A few recent indicators have been interpreted as evidence that a more pronounced deceleration is progressing in a spontaneous fashion, despite the fact that it is difficult to identify turning points in volatile series, such as the ones regarding the level of economic activity. Industrial sales fell 0.4% in July, according to seasonally adjusted data from CNI. The exchange rate appreciation contributed to this result, as nominal exports revenues in Brazilian *Reais* decreased. Packaging paper shipments fell 4.2% in August, according to data from the Corrugated Paperboard Association (ABPO), seasonally adjusted by the BCB. However, this decrease should be interpreted with caution, as it follows an extraordinary increase of 5.1% in the previous month. Inversely, other important coincident indicators still grew in August, as in the case of vehicles and steel production. In spite of being plausible that some spontaneous accommodation is in fact in course or on the way, there is no data confirming beforehand an accommodation trend intense enough to rule out any concern about a potential gap between supply and demand, as well as about its effects over the inflation dynamics, given the current level of production.

22. Recent data suggests that fixed capital investment is recovering in an encouraging way. According to the national accounts, measured by the IBGE, the gross fixed capital formation grew 11.8% in the second quarter of 2004, year-on-year, a better performance than the first four quarters of each previous cyclical rebounds in the last 10 years. Domestic absorption of capital goods (capital goods output plus net imports) grew 27.2% from June 2003 to July 2004, again, better than the 13 first months of each of the three previous cyclical rebounds. The historical series of gross fixed capital formation shows, naturally, high degree of correlation with installed capacity utilization and, with some lags, with the sovereign risk. The performance of these leading indicators confirms that there is room for expansion in fixed capital investment in the next months. Although investment has been particularly promising since the beginning of the current growth cycle, the pace of output recovery has also been more intense than usual, which gives room to the uncertainties concerning the speed at which the output gap is closing.

23. As to the external transactions, exports expanded by 34.8% in the period from January to August, in relation to the same period of the previous year. Imports also increased strongly (29.6%) in the same period. The trade balance and the current account registered surpluses of US$ 22.0 billion and of US$ 8.0 billion, respectively, in the January to August period. From January to June, the manufactured exported volume grew 25.9%. Regarding primary products, the 17.3% increase in the exported volume was accompanied by a 23.1% increase in prices. As far as imports are concerned, durable goods volume rose by 24.8%, while raw materials and intermediate goods increased by 21.5%, in a sharp response to the stronger domestic demand.

24. Recent data indicate that the growth pace of the U.S. economy has slowed down, while inflation has remained subdued. As a consequence, a more intense hike in U.S. interest rates has become less likely. In contrast to the tension in the second quarter of the year, international financial markets have remained calm. This favorable environment facilitated the financing of the Brazilian external needs and had positive effects over the Brazil risk-premium and the exchange rate, which appreciated to R$/US$2.90 in the first ten days of September, from R$/US$3.00 in August.

25. International oil prices, on the other hand, continue to be a source of concern. Even though the prices have fallen from the historical records of August, oil prices remain high and very much sensitive to any threat to the larger exporters supply capacity. It is important to emphasize, though, that the existing lag between domestic and international gasoline prices is being temporarily mitigated by a deviation in the international price of gasoline from that of the crude oil. As

mentioned in the August Copom's Minutes, the inflationary risk associated to oil is not only restrained to domestic gasoline prices, but also encompasses other oil intensive products.

26. Inflation expectations collected by the Gerin have deteriorated again since the last Copom meeting. The median for the 2004 IPCA increased to 7.37%, from 7.18% on the eve of the August meeting. As to the expectations for the 2005 IPCA, the deterioration that had only been affecting the mean and the standard deviation of the distribution, finally affected the median, which increased to 5.70%, from 5.50% in August. For the next 12 months, the median market expectations fell to 6.19% in September, from 6.22% in August, mainly due to the exclusion of the relatively high inflation expectations for August/2004 and the incorporation of a lower expected inflation rate for August/2005. Although the deterioration of expectations has been triggered by the exchange rate depreciation of the second quarter and reinforced by the concerns about oil prices, the reversion of this trend will depend not only on the recent exchange rate appreciation and an eventual more favorable scenario for oil prices but also on other developments, such as the domestic demand conditions and the inflation results along the incoming months.

27. The Copom projections for the 2004 inflation rate have not changed substantially since the last meeting, in both the benchmark scenario and the market scenario. In both cases the projected inflation is above the 5.5% target. For 2005, the projections made in the benchmark scenario in the previous meeting already pointed out to an inflation rate above the 4.5% target. However, projections were revised upwards due to the incorporation of greater readjustments of regulated prices for the next year, of 6.90%, instead of 6.3%. The market scenario projects inflation rates above the ones of the benchmark scenario – thus, above the inflation target – because it assumes that there will be a slight reduction in the Over-Selic rate in 2005, and some exchange rate depreciation throughout the projection horizon.

28. The fact that several inflation indices will overcome the 5.5% central target set by the National Monetary Council (CMN) for 2004 will affect, by means of inflationary inertia mechanisms, the inflation rate in 2005. The inertia hits both the regulated prices, due to readjustment clauses based on past inflation, and market prices, whose formation depends partially on future inflation expectations and partially on past inflation. Copom's estimates indicate that inflationary inertia would have an impact of 0.9 p.p. over the inflation rate for 2005, in the absence of any monetary response. The Copom understands that the flexibility of the inflation-targeting regime allows for the inertia not to be fully fought in a single year, as a way to promote a smoother transition to the inflation targets in the medium run. Similarly to the strategy that was adopted in the past, the Committee understands that it should fight in 2005 a third (1/3) of the referred inertia, temporarily accommodating the remaining two thirds. This decision means that the monetary policy instruments will be calibrated in order to pursue in 2005 an inflation rate of 5.1%, which corresponds to the 4.5% central target set by the CMN, plus 0.6 p.p. related to the partial accommodation of the inflationary inertia inherited from 2004.

29. Even though the procedure employed by the Copom to estimate the inflationary inertia is very similar to the one used in the past to calculate the inertial component of the adjusted inflation targets, the Committee understands that the current circumstances do not recommend that adjusted target procedures should be entirely reproduced. In particular, the system of adjusted targets allowed for, besides the anticipated decision to partially accommodate the inertia inherited from the previous year, new adjustments throughout the year by the incorporation of the primary effect of certain shocks. The increased stability of Brazil allows for the monetary conduct to be guided in 2005 by a predetermined objective for inflation, restricted to the central target set by the CMN plus the partial accommodation of the inflationary inertia. The establishment of such an objective at this moment is due to the fact that the monetary policy has its effects over economic activity and inflation within some lags, and therefore, requires adjustment with the due anticipation to obtain the desired effects.

30. It is important to underline that the Copom interprets the 5.1% objective for the inflation rate in 2005 as a judicious exercise of the flexibility represented by the tolerance interval established by the CMN around the central inflation target, which remains unaltered. The fact that the monetary policy will have as an objective an inflation rate that is above the central target even before the beginning of the year suggests that the new shocks that may affect the inflation dynamics should be treated asymmetrically. Therefore, the Copom will have to be even less tolerant in relation to shocks that may increase inflation above the 5.1% objective for 2005, at the same time benefiting from eventual favorable shocks as an opportunity to bring actual inflation close to its target path set by the CMN.

31. The Copom members agreed that, if the current monetary stance were maintained unchanged, the strong economic expansion would not spontaneously accommodate to a pace consistent with the convergence of inflation to its path. The inflation projections by the Committee confirm the increasing risk that inflation could deviate from its targets. In particular, these projections already point out to an inflation rate above the 5.1% objective for 2005, under the assumption that the Over-Selic rate is maintained at 16% throughout the projection horizon. The underlying inflation trend captured by the several core measures is relatively steady at levels that are inconsistent with the targets. Additional risks to inflation are the deterioration of market inflation expectations, the very indefinite outlook in the global oil market, and the potential pressure of the increase in wholesale industrial inflation, in an environment that favors the re-composition of profit margins, including the ones stemming from wages readjustments that tend to increase average real earnings.

32. The Copom members consensually concluded that the best stance was to initiate a process of moderate adjustment in the monetary policy instrument. Due to the existing time lags between the implementation of monetary policy and its effects over the economy, central banks have necessarily to act in a preventive way, before contemporary data attests that inflation is out of control or that there are excessive demand pressures. In fact, when considering the prospective scenario for the economy throughout a longer period, the monetary stance aims at avoiding that those risks do materialize. If current data already confirmed an inflation rate out of control or excessive demand pressures, the monetary policy response would have to be different from the one now considered by the Committee.

33. This moderate adjustment will aim at promoting the convergence of inflation to the targets path, already incorporating the objective of a 5.1% IPCA for 2005. By adjusting the activity recovery in the medium and long runs with the inflation targets, the Copom will avoid more drastic measures in the future in order to disinflate the economy, with eventual significant damages to the economic growth cycle. In this sense, the monetary adjustment main and final objective is to provide conditions for the long run sustainable growth.

34. Another consensual agreement was the evaluation that the adjustment should come in a gradual way, differently from the shock treatment recommended to crisis episodes faced by Brazil in the past. Five members of the Copom concluded that a 0.25 percentage point increase in the Over-Selic rate would be adequate to initiate the adjustment process, making it as smooth as possible, and minimizing the initial turbulence risks. The other three members voted for an increase of 0.5 p.p., which, according to their evaluation, would better signal the magnitude of the overall adjustment required to bring inflation back to the targets path, and would better correspond to the optimal speed of implementation of this adjustment process.

35. Therefore, the Copom decided by 5 votes to 3, to increase the Over-Selic rate target to 16.25% p.a., without bias.

36. At the closing of the meeting, it was announced that the Copom would meet again on October 19, for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 11,516, of October 15, 2003.

SUMMARY OF DATA ANALYZED BY THE COPOM

Economic Activity

37. According to IBGE's retail survey, in June, sales maintained the growth trend. Compared to June 2003, real sales and nominal revenues increased by 12.8% and by 15.6%, respectively. In the first half of 2004, the expansion rates reached 9.3% and 10.0%, respectively. The regional distribution of growth was generalized, encompassing all States in the country, except for Roraima. All groups encompassing the retail sector posted year-on-year growth rates in June, more noticeably in the sector of furniture and electrical appliances, which grew in a much higher pace than the aggregate retail group.

38. The São Paulo Trade Association (ACSP) data for July registered a 3.1% increase in credit retail sales, while the Usecheque system consultations fell 0.6%, both compared to June, s.a. In the year up to August, the same indicators rose by 7.6% and 1.5%, respectively.

39. The Federation of Commerce of São Paulo (Fecomercio) consumer sentiment survey showed that the Consumer Confidence Index (ICC) increased by 6.2% in September to 128.8 points (range 0 to 200). This increase was due to an 8.6% increase in future expectations by consumers (IEC) and an improvement of 1% in the current economic situation (ICEA).

40. Regarding fixed capital investment, the indicators show deceleration in July, without characterizing, though, change in the expansion trend. The domestic absorption of capital goods decreased by 0.5% in July, compared to June, s.a. This decrease was a result of the reduction of 1.1% in the domestic output and the increases of 1% in exports and 1.1% in imports. Despite this slight decrease, the domestic absorption of capital goods accumulated a 12.8% growth in the first seven months of the year, compared to the same period of 2003. This growth was a result of a 24.9% output growth and a 7.9% increase in capital goods imports, considering the same comparison basis, which more than compensated the 54.5% expansion in capital goods exports. In July, construction inputs continued to grow for the fifth consecutive month, posting an increase of 1.6% compared to the previous month, s.a. In the first seven months of the year, construction inputs grew 4.6% compared to the same period of 2003. In addition to these indicators, the National Bank for Economic and Social Development (BNDES) credit operations increased by 43% in the period January-August 2004, compared to the same period of last year, which ratifies the investments resume. Credit to infrastructure grew 67.8% in the same period, representing 39% of total credit outstanding. Credit operations to industry expanded by 30.1%, while credit to the agriculture sector grew 65.7%.

41. The IBGE's monthly industrial survey registered a 0.5% increase in industrial output in July, compared to June (s.a.), a historical high, after five consecutive months of growth. Out of the 23 activities surveyed, 16 registered increases in output, while out of the 4 categories, 2 expanded. Intermediate goods output increased by 2.3%, resuming the expansion trend interrupted last month. In the year up to July, industrial output increased by 7.8%, compared to the same period of 2003, with output expansion in 22 out of the 26 activities and in all use categories, with remarkable increases of 24.9% in the capital goods production and 24.5% in the durable goods production. Intermediate goods output grew 6.7%, following the same trend of exports and fixed capital investments. Semi and non-durable goods output grew 2% in the same period, as a result of the gradual recovery of labor income.

42. In July, the CNI recorded a 0.4% decrease in real industrial sales and a 1.9% increase in industrial worked hours, in comparison to June, s.a. Compared to the same month of 2003, real sales and worked hours increased by 19.5% and by 7.6%, respectively. The average level of industrial capacity utilization reached 82.8% in July, the highest ever, with a 0.3% monthly increase (s.a.). In

the first seven months of the year, capacity utilization expanded by 2.3%, compared to the same period of 2003.

43. In August, leading industrial indicators signal that the economic activity growth trend continues. Car industry produced 198 thousand vehicles, up 3.4% compared to July (s.a.), and 47% over August 2003. In the year up to August, car production increased by 21.3%, while domestic sales and exports expanded by 22.1% and by 17.4%, respectively, compared to the same period of 2003. Steel output also grew, albeit slightly, 0.3% in August, s.a. On the other hand, packaging paper shipments output decreased by 4.2% in August, after recording a strong expansion in July (5.1%), s.a., accumulating a 13.9% growth in the year to August.

Labor Market

44. Formal employment increased by 0.8% month-on-month in July s.a., and by 5.5% compared to July 2003, according to the Ministry of Labor and Employment. In the first seven months of the year, there was a 4.1% expansion in formal employment compared to the same period of 2003. The data indicate that employment has increased at a higher pace outside large urban areas.

45. The unemployment rate, measured by the IBGE in the six main metropolitan regions of the country, decreased in July for the third consecutive month, to 11.2%, after peaking to 13.1% last April. Total employed workers increased by 0.9% in July and by 2.6% in the year to July, while unemployed workers fell by 4.1% in the month. The estimated labor force totaled 21.5 million people, with increases of 0.3% in July, and 2.3% in the year, up to July.

46. Regarding the transformation industry, seasonally adjusted data from CNI showed an expansion of 1% in employed workers and a slight decrease of 0.1% in real payroll in July, compared to June. In the first seven months of the year, real payroll and employed workers increased by 7.9% and by 1.6%, respectively, compared to the same period of 2003.

47. According to data from Dieese, in the first half of the year, 262 wage negotiations were carried out in the country, which produced the best results obtained by workers since 1996. Around 47% of the negotiations registered wage readjustments higher than the INPC variation and, in 32% of the negotiations, the readjustments were in line with the index. Moreover, there was a significant reduction in the share of wage readjustments given in installments, which represented 10% of the total in 2004, compared to 30% in 2003.

Credit and Delinquency Rates

48. Non-earmarked credit operations increased by 1.6% in August. Corporate credit with domestic funding expanded by 3.2%, while corporate credit with external funding fell by 2.9%. Individual credit operations increased by 2.6%, accumulating 24.6% in twelve months.

49. The average interest rate on non-earmarked credit remained unchanged in August at 43.9% p.a. This rate was a result of the 1.1 p.p. increase of the average rate for individuals, which totaled 63.1% p.a., despite the fall of 0.9 p.p. in the average rate for corporate, which stood at 28.8% p.a.

50. The default rate measured by the ACSP grew to 3.9% in August, after having reached 3.3% in July, the lowest level of the year. In the year to August, the average default rate recorded a 10.9% decrease compared to the same period of 2003. The total number of cancelled and new files increased by 10.3% and by 6.2%, respectively, in the year to August. The number of returned checks, compared to the total number of checks, was kept unchanged at 5.1% in July, also reaching the lowest level of the year.

External Environment

51. Recent indicators suggest that world economic growth is building up in the third quarter, after some deceleration in the previous quarter. In the U.S., wholesale sales, civil construction expenditure and capacity utilization grew month-on-month in July. In August, industrial output grew and unemployment rate declined, while retail sales fell. In Germany, industrial output and manufacturing orders increased in July, after decreases in the previous month. In Japan, industrial capital goods expenditure increased in the second quarter, while in China, despite the growth deceleration measures, industrial output grew again in August.

52. Regarding foreign trade, there are signs of significant growth. In Japan, exports grew 14.8% in July, the second highest rate since 1985, and the external trade surplus reached US$42.7 billion in the year up to July, compared to US$38.1 billion in the same period of 2003. In Germany, exports also grew in July. In August, China recorded the fourth consecutive monthly trade surplus, 40% above the one registered in the same month of 2003. In the U.S., the trade deficit reduced in July, to US$50.2 billion. On the other hand, in the United Kingdom, the deficit in goods and services increased in the same month.

53. Regarding business expectations, there was generalized slowdown in the main economies in August. However, in the U.S., expectations are favorable, reflecting the economic momentum. The consumer confidence varied among the countries: there was expansion in Japan, slowdown in the U.S. and stability in the Euro Area.

54. Consumer prices indicators decreased in the main economies in July, alleviating the risks of inflation acceleration. In the U.S., in the Euro Area and in the United Kingdom, consumer price indicators declined in July, while in China, despite the higher monthly variation in August, the 12-month accumulated inflation remained unchanged at 5.3%. Wholesale prices in the U.S. decreased in August, as a consequence of the slowdown in the prices of oil, food and vehicles. US core inflation, which excludes electricity and food prices, declined 0.1%, the first negative value in six months. On the other hand, in China, wholesale inflation increased in August.

55. The Bank of England kept unchanged its repo rate at 4.75% p.a. In the U.S., the Federal Reserve decided to raise the target for the fed funds rate by 25 b.p., to 1.5% p.a., in the August meeting.

56. In the international financial markets, the volatility reduced and assets appreciated. Regarding the commodity markets, there was slight retraction in the prices of food products, and a new increase in metal prices. Oil prices have fallen in the last weeks, but the market has remained volatile and lacking a clear trend, still representing a risk to price stability and to the global economic growth.

Foreign Trade and Balance of Payments

57. The Brazilian trade balance posted a US$3.4 billion surplus in August, while total external trade turnover amounted to US$14.7 billion. Exports and imports increased by 35% and by 43.9%, respectively, compared to August 2003 daily averages. Brazilian trade surplus reached US$1.2 billion in September, up to the second week, (7 working days), with exports and imports growing at 30.6% and 24.6%, respectively, compared to September 2003 daily averages.

58. In August, Brazilian exports totaled US$9.1 billion, registering historical records for primary, manufactured and semi-manufactured goods. Imports reached US$5.6 billion, the highest monthly figure in 2004, confirming the trend observed since the last four months of 2003. All categories of imports grew, compared to the values of August 2003.

59. In August, the current account registered a US$1.8 billion surplus, accumulating a US$8.0 billion surplus in the year. In the year to August, the trade balance and current transfers posted US$22.0 billion and US$2.2 billion surpluses, respectively, while the services and income account posted a US$16.1 billion deficit. Net foreign direct investment reached US$6.1 billion in August,

accumulating US$11.7 billion in the year to August. At the end of August, international reserves stood at US$49.6 billion, while adjusted net reserves stood at US$22.6 billion (IMF concept).

Money Market and Open Market Operations

60. After the August Copom's meeting, the domestic yield curve moved upwards for maturities up to two years, and moved slightly downwards for longer tenures. The determinant factor underlying the yield curve move was the market's interpretation of the August Copom's Minutes. From August 18 to September 15, the spread on the 3-month, 6-month and 1-year rates in relation to the Over-Selic rate increased by 0.47 p.p., by 0.28 p.p. and by 0.17 p.p., respectively, while the 2-year and the 3-year rates decreased by 0.01 p.p. and by 0.17 p.p. In the same period, the real interest rate measured by the ratio between the one-year nominal interest rate and the 12-month-ahead inflation expectations increased to 10.9% from 10.6%.

61. Due to the weak demand for Fx hedge, the BCB did not carry out auctions to rollover US$1.1 billion in securities and Fx swaps coming due on September 16. As a consequence, the net redemption of Fx-linked securities and swaps in the year up to September totals US$24.6 billion.

62. The National Treasury carried out one buying and four selling auctions of LTNs, totaling a net placement of R$9.3 billion. Four selling auctions of LFTs were also carried out, placing R$13.2 billion maturing in 2005, 2006 and 2007. In the same period, there were one buying auction and one selling auction for National Treasury Notes – Series B and C (NTN-Bs and NTN-Cs), which amounted to R$493 million in net sales, R$155 million of which settled in currency and the rest settled in exchange for other National Treasury's securities. The expectations of increases in the real interest caused the rise in the NTN-C coupons. On the August 30 auction, the rate of the NTN-C maturing in 2008 increased to 8.60% from 7.75% in the previous month.

63. The BCB maintained in its open market operations the weekly post-fixed repo operations (2-week tenure) and the fixed repo operations (3-month tenure), as well as its daily liquidity management operations (2-working-day tenure). The BCB also carried out in this period 15 fixed rate overnight repos, fourteen of which with a one-working-day tenure and one with a three-working-day tenure. The frequent overnight operations have enabled the reduction of the gap between the Over-Selic rate and its target, from 0.13 p.p. on August 18 to 0.03 p.p. on September 15. In the period after the August Copom's meeting, the excess liquidity drained from the market with operations shorter than 30 days fell to R$31.6 billion on average, while with the 3-month tenure operations, it rose to R$48.8 billion on average.

64. In August, the net securitized domestic public debt grew 0.3%. The fixed share increased to 16.7% from 15.1% in July, due to the net placement in the month. On the other hand, the dollar-linked share decreased to 13.2% from 14.1%, due to the net redemption of Fx instruments and to the Brazilian *Real* appreciation.