BANCO CENTRAL DO BRASIL

# Minutes of the 121st Meeting of the Monetary Policy Committee (Copom)

**Date**: August 29th, from 5:30PM to 8:30PM, and August 30th, from 4:30PM to 8:00PM
**Place:** BCB Headquarters meeting rooms - 8th floor on August 29th and 20th floor on August 30th – Brasília – DF

**In attendance:**
**Members of the Committee**
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua
Alexandre Antonio Tombini
Antonio Gustavo Matos do Vale
João Antônio Fleury Teixeira
Mário Magalhães Carvalho Mesquita
Paulo Sérgio Cavalheiro
Paulo Vieira da Cunha
Rodrigo Telles da Rocha Azevedo

**Department Heads (present on August 29th)**
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on August 30th)
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Ivan Luís Gonçalves de Oliveira Lima – Open Market Operations Department
Radjalma Costa – Department of Banking Operations and Payments System
Renato Jansson Rosek – Investor Relations Group

**Other participants (present on August 29th)**
Alexandre Pinheiro de Moraes Rego – Special Advisor to the Governor
Alexandre Pundek Rocha – Advisor to the Board
André Minella – Deputy Head of the Research Department
Flávio Pinheiro de Melo – Advisor to the Board
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 Economic Developments

1. After decelerating for three consecutive months, IPCA inflation reached 0.19% in July. This result was slightly above market expectations on the eve of the disclosure of the index, but well below expectations at the end of June. In the year through July, IPCA inflation totaled 1.73%, roughly the half of the result observed in the same period of last year (3.42%). Twelve-month trailing inflation reduced to 3.97% in July down from 5.70% in January, the lowest level for the series since June 1999, when the inflation target regime was implemented. The inflation increase in July was mainly driven by the increase in both market prices, such as household workers costs and perishable food prices and in regulated prices, such as bus fares. A benign inflation scenario continues to evolve in line with the targets path, with favorable prospects for inflation in the coming years.

2. The acceleration of headline inflation in July was reflected in all IPCA core inflation measures. Core inflation by exclusion of household food items and regulated prices increased to 0.14% in July, up from deflation in the previous two months. Smoothed trimmed means core remained stable relative to June, reflecting the implicit inertial component. On the other hand, non-smoothed trimmed means core increased 0.20% in July, up from 0.07%

in June. The three core measures continue to be in line with the targets path. Moreover, on a twelve-month trailing basis, the core inflation by exclusion (3.85%) and the non-smoothed core inflation (4.04%) stood below the center of the target, similarly to the headline result. On the other hand, the smoothed core inflation has converged more slowly to the target, reaching 5.54% in the last twelve months ended in July, down from 5.71% in the last twelve months ended in June.

3. In contrast with consumer price inflation, the General Price Index (IGP-DI) decelerated to 0.17% in July, up from 0.67% in June, for a 1.45% increase in the year through July, compared to 1.11% in the same period of last year. In the twelve months through July, the IGP-DI increased 1.56%, compared to 0.98% in the twelve months through June. The IGP-DI fall in July was mainly driven by accommodation in wholesale price inflation and in construction costs. After presenting deflation in the three-month period ended in April, the IPA-DI increased to 0.46% in May and 1.06% in June, reducing to 0.17% in July. The most important drivers of the July result were the fall in agricultural prices (to 0.45% in July down from 1.66% in June) and in industrial prices (to 0.08% from 0.88%, in the same period). Even after rising 2% in the June-July period, the agricultural IPA accumulated a 6% decrease in the twelve months through July. On the other hand, the industrial IPA increased 3.2% in the twelve months through July, up from 2.8% in June. Wholesale price inflation may continue to positively influence consumer price inflation in the coming quarters, despite the elevated prices of some important international commodities. As emphasized in recent Copom Minutes, the continuity and strength of this pass-through will depend on demand conditions and price-setters' expectations for the future inflation path.

4. Industrial output recorded -1.7% in June, on a month-on-month seasonally adjusted basis, down from 1.6% in May, according to data from the Brazilian Institute of Geography and Statistics (IBGE). On a three-month moving average basis, industrial output slightly decreased in June, virtually unchanged relative to the record high registered in May. Industrial production fell by 0.6% in June, compared to the same month last year, after a 4.8% increase in May, according to the same comparison basis. In the first half of the year, industrial output expanded by 2.6%, compared to the same period last year, while twelve-month industrial production reached 2%, down from 2.6% in April and May. It bears emphasizing that the industrial output result in June demands cautious interpretation due to the influence of one-off factors. In fact, leading and coincident indicators suggest industrial output expansion in July, in both month-on-month seasonally adjusted terms and on a three-month moving average basis. Despite weaker-than-expected June results, this contraction should not interrupt the gradual industrial output process expected in previous Copom's Minutes, particularly in light of the negative events in June, of the release of the first leading results for July and of the several incentive factors, such as the monetary easing implemented since September 2005.

5. Disaggregated industrial data in June shows that intermediate goods and capital goods production decreased by 0.5% and 2%, respectively, while durable consumer goods production grew 0.2%, compared to the same month last year. On a month-on-month seasonally adjusted basis, intermediate goods output decreased almost 2% in June, after expanding at a vigorous pace in May. In the year through June, the main drivers of industrial growth have been durable consumer goods production (7.5%) and capital goods production (5%). The expansion of durable goods production reflects, among other factors, the recovery of real earnings and the expansion of credit. The expansion of capital goods production is due to positive prospects for domestic demand, and also to the influence of favorable international prices for some industrial sectors, in line with the last FGV survey, which revealed that 54% of the participants are likely to invest more in 2006 than they did in the previous year.

6. The unemployment rate increased to 10.7% in July from 10.4% in June, as against the 9.4% reached in the same month last year. However, the average unemployment rate in the year through July was virtually unchanged compared to the same period last year, notwithstanding the 3.6% increase in labor force in July, compared to the same month last year. That result reflects that employed people grew 2.1%, according to the same comparison basis, indicating that the pace of jobs creation remains robust. The purchase power of workers decreased a month-on-month 0.7% in July, despite the 3.4% increase in July relative to the same month last year, and 4.2% in the year through July relative to the same period last year. As a result, real payrolls increased 6.2%, according to the same comparison basis. According to the National Industry Confederation (CNI), manufacturing employment decreased a month-on-month seasonally adjusted 0.2% in June, after four consecutive months of increase, but expanded 1.3%, compared to the same month last year. According to this comparison basis, manufacturing employment has grown

for 29 consecutive months. In the last twelve months, the expansion totaled 2.2%. According to the Ministry of Labor and Employment (MTE), formal employment grew a month-on-month seasonally adjusted 0.6% in July, confirming the continuity of the ongoing expansion. In the twelve months through July, it increased by 5%, mainly driven by the expansions of 9.9% in civil construction and 6.2% in the retail sector. With the creation of 154,357 jobs in July (1.2 million in the last twelve months), year-to-date formal job creation increased to 1,078,155.

7. IBGE seasonally adjusted data recorded a month-on-month seasonally adjusted 0.4% decrease in retail sales for June. This was the first decrease after three consecutive months of expansion. Retail sales increased 4.1% in June and 7.3% in May, compared to the same months of 2005. Sales expanded by 5.7% in the first half of the year, compared to the same period last year, and 5.3% in the last twelve months. In June, the seasonally adjusted sales in three out of four retail categories dropped. Only hyper-, supermarkets, beverages and tobacco sales increased, reflecting strengthening of the labor market. Despite the decrease in June, retail sales have outperformed industrial output and reflect favorable demand conditions. Retail sales expansion is expected to continue in the coming months, fostered by positive labor market and income developments, credit expansion and the monetary easing cycle, as well as by the recovery in consumer confidence and the expansionary impacts of the minimum wage rise.

8. Installed capacity utilization in the manufacturing industry increased for the second consecutive month, to 82.2% in June up from 82.1% in May, according to CNI data seasonally adjusted by the BCB. In the first half of the year, the average installed capacity utilization stood 0.8 p.p. below the levels registered in the same period of 2005, although this difference has marginally decreased. This decline partially reflects the improvements in the productive capacity. In fact, recent data regarding output, absorption of capital goods and civil construction inputs suggest the expansion of investments. For example, in the year through June, the absorption of capital goods expanded by 9.7%, compared to the same period of 2005. The main drivers of this result were the increases in capital goods imports volume (29.6%) and in capital goods production (5.0%). Civil construction inputs expanded by 4.7%, according to the same comparison basis. Therefore, despite favorable prospects for aggregate demand expansion, relevant supply unbalances are not anticipated in the coming quarters. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments with regard to the expansion of supply to adequately meet demand conditions.

9. The trade balance continues to present robust results in 2006, confirming previous Copom assessments regarding important structural changes in the Brazilian external trade. In the year through July, trade balance reached US$ 25.2 billion, above the level reached in the same period last year. Twelve-month trailing surplus through July reached US$45.2 billion, above the previous month, but slightly below the US$45.8 billion record high reached in March. Despite trade surpluses remain at elevated levels, this process was already expected and suggests the start of a new adjustment dynamics for the trade flows. Even so, twelve-month trailing exports through July reached US$128.1 billion, a new record high for the series. Similarly, imports have also continued to outperform, reaching a new record in July, US$82.9 billion, according to the same comparison basis. As a consequence, robust external results are expected in 2006 and 2007. The current account surplus stood at US$ 3 billion in July, a record high for the series, for a US$12.5 billion surplus in the twelve months through July, or 1.45% of GDP.

10. Regarding the international scenario, it bears emphasizing the interruption in the monetary policy tightening cycle in the US, after seventeen consecutive interest rate increases. Despite the fact that additional increases cannot be discarded, the uncertainties regarding the monetary policy stance in the US are much weaker. On the other hand, concerns about the long monetary tightening cycle increased the fear of a recession in the US economy.

11. The deterioration of the international scenario in the last months, especially with regard to higher risk aversion and lower international liquidity, had limited influence domestically. In fact, after an up-tick in May, the sovereign risk reached historically low levels in the last days. This fact corroborates recurrent analysis, expressed in previous Press Releases and Inflation Reports, that the Brazilian economy is more resilient to external shocks. In this context, the Copom reaffirms that the continued disinflation, robust and persistent trade surpluses, accumulation of international reserves, adequate public sector's primary surpluses, improved public sector's debt profile and buyback of external debt have strengthened the domestic resilience to external shocks. The

improvement in domestic resilience to shocks reflected the evidence that the domestic economy has sustained the growth trend despite the long monetary adjustment process in course in the US, Euro zone and Japan. Therefore, the Copom continues to assign low probability to a significant deterioration in international financial market conditions that could affect Brazilian external financing.

12. Another concern regarding the international scenario is the oil prices. Despite the decline observed since the last Copom meeting, oil prices remain at elevated levels, standing 20% above the level observed at the end of 2005. In addition, oil prices still present high volatility, reflecting geopolitical tensions. However, the current scenario might reflect structural unbalances in the oil market: oil prices might not face a temporary increase, but may resist at elevated levels longer than previously expected. As in previous months, the future oil prices trajectory still encompasses great uncertainty, and a significant downturn in prices seems less likely to occur in the short run. Therefore, as mentioned in last Copom Minutes, the scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2006, has become less likely to occur, and consequently, the risks related to its materialization have increased significantly. Shall the trends recently observed materialize, the Copom may have to incorporate in the benchmark scenario an increase in domestic oil prices in 2006. In addition, apart from the effects of an increase in domestic fuel prices, the elevation in international oil prices affects the domestic economy through productive chains, such as the petrochemical, as well as through the deterioration of market inflation expectations.

## Assessment of Inflation Trends

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

a) Compared to the values considered in the July Copom meeting, the projection for gasoline and bottled gas prices adjustments in 2006 remained in 0% and 0.1%, respectively;

b) Considering the same comparison basis, the projections for fixed line telephone and household electricity adjustments in 2006 remained in 2.7% and –0.9%, respectively;

c) The Copom maintained the 4.4% adjustment projection for all regulated prices in 2006. These items, according to the weights released by the IBGE, represent 31.19% of the total July IPCA;

d) According to the endogenous determination model, the projection for regulated prices inflation in 2007 decreased to 6.1% from 6.2%. This model considers the effects of seasonal components, exchange rate, market prices inflation and the IGP;

e) The projection for the spreads over the Selic rate, using a Vector Autoregressive model based on the Selic and 180-day swap rates on the eve of the meeting, stood at -35 b.p. in the third quarter of 2006, reaching -4 b.p. in the last quarter of 2006 and 59 b.p. in the last quarter of 2007.

14. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of GDP in 2006 and 2007 will be achieved. The related assumptions considered in the previous meeting were maintained.

15. Since the July Copom meeting, median IPCA inflation expectations for 2006, compiled by the BCB's Investor Relations Group (Gerin), decreased to 3.68% from 3.77%. The twelve-month ahead inflation expectations increased to 4.43% from 4.33%. For 2007, inflation expectations remained in line with the 4.50% target established by the CMN. As mentioned in previous Minutes, these developments suggest the consolidation of a more favorable long-term macroeconomic scenario.

16. The 2006 inflation forecast under the benchmark scenario – which assumes the maintenance of the Selic rate at 14.75% and the exchange rate at R$/US$ 2.15 during the forecast period – remained almost stable compared to the values considered at the July Copom meeting, below the 4.50% target established by the CMN for the year. The forecast based on the market scenario – which incorporates the consensus exchange and Selic rates

trajectories collected by Gerin on the eve of the Copom meeting – also remained almost stable relative to the values considered in the July Copom meeting, below the target for the year. The projections for 2007, according to both scenarios, also remained relatively stable compared to the July projections, below the 4.50% target in the benchmark scenario and above the 4.50% target in the market scenario.

## Monetary Policy Decision

17. The Copom reaffirms the view that monetary policy has both contained short-term inflationary pressures and consolidated a more favorable long-term macroeconomic environment. The economic activity data still suggest expansion in line with the supply conditions in the next quarters, with low likelihood of significant pressure over inflation. Moreover, despite the prospects of lower liquidity in international markets, due to the interest rates increase in industrialized economies, and to oil prices swings at historically high levels, the external outlook remains favorable, particularly regarding Brazilian external financing. Therefore, even taking into account that part of the favorable results for the short-term inflation tends to revert in the future, the scenario for the inflation trajectory remains benign. As in the July meeting, the Copom emphasizes that the main challenge of the monetary policy in this context is to guarantee the consolidation of anticipated favorable developments.

18. The uninterrupted convergence of inflation to the targets path and the resulting consolidation of a durable macroeconomic stability will contribute to the progressive reduction of macroeconomic risk perception underway. The scope for a reduction in real interest rates in the future will naturally follow as a consequence of this perception improvement. The Copom evaluates that its cautionary monetary policy stance has been critical to increasing the probability of inflation convergence to the targets path. For this to materialize, however, it is important that forward-looking inflation indicators remain consistent with the recent benign inflation outlook.

19. The Copom emphasizes that there are important lags in monetary policy transmission to economic activity and inflation. Since the beginning of the monetary easing cycle, in September 2005, the Selic rate has been reduced by 500 b.p., with the greater part of the reduction concentrated in 2006. Consequently, the activity level has not completely mirrored the effects of the interest rates cuts, as well as the effects of the recent activity resumption on inflation have not completely materialized.

20. During the coming months, employment and income expansions and credit growth will continue to bolster economic activity. As mentioned in the July Copom Minutes, activity level should also reflect the effects of the new minimum wage and the fiscal impulse occurred since the last quarter of 2005 and expected for the rest of 2006. Therefore, the effects of interest rates cuts will add up to other factors that will contribute to demand expansion.

21. Given the reasons stated above, the Copom considered the convenience to reduce the Selic rate by 25 basis points. Despite considering that several factors would justify such decision, the Copom members concluded that, at the present moment, a 50 basis points reduction in the Selic rate would be a better response of the current monetary conditions to the improved inflation outlook observed between the July and August meetings. In light of this fact, the Copom unanimously decided to continue the monetary policy easing process begun in the September 2005 meeting and reduce the Selic rate target to 14.25% p.a., without bias, and follow the evolution of the macroeconomic scenario until the next meeting, at which time it will define the next steps in its monetary policy strategy.

22. Given the existing incentives for expanding aggregate demand, the uncertainties surrounding the monetary policy transmission mechanisms and the lower distance between the current Selic rate and the medium-term interest rates, the Copom understood that the maintenance of important achievements in disinflation and in preserving economic growth, with job creation and rising real incomes, may demand a more cautious monetary easing stance. This argument is even more relevant in light of the fact that the monetary policy decisions in the coming months will produce concentrated impacts for 2007.

23. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing alternative scenarios for the main variables that determine price dynamics. Despite the decrease in international financial markets volatility, some factors that caused heightened volatility in May still persist. In such an environment, the monetary authority must remain vigilant so that short-term uncertainties do not contaminate

longer time horizons. In case of an exacerbation of the risk factors monitored by the Copom, the monetary policy strategy will be promptly adapted to the circumstances.

24. At the conclusion of the meeting, it was announced that the Copom would reconvene on October 17th, for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 13,821 of October 31, 2005.

## SUMMARY OF DATA ANALYZED BY THE COPOM

### Inflation

25. The IPCA increased 0.19% in July, up from -0.21% in June. Three out of the nine surveyed groups presented negative change: clothing (-0.24%), communication (-0.07%) and housing (-0.02%). Personal outlays (0.67%), health and personal care (0.44%) and transportation (0.37%) were the main group drivers of the July result. The prices of food and beverages increased 0.09% in the month, after five consecutive monthly falls, mainly due to the elevation in the prices of fruit and rice. The main individual drivers of IPCA inflation in July were gasoline, bus fares and household workers, which contributed 0.04 p.p., 0.03 p.p. and 0.03 p.p., respectively. The IPCA rose by 1.73% in the year through July and 4.03% in the last twelve months.

26. Regulated prices grew 0.33% in July and 7.93% in the last twelve months, while market prices increased by 0.13% and 2.21% in the same periods, respectively. Amongst market prices, prices of tradable goods remained stable in July, while the prices of non-tradable goods rose 0.25%. On a twelve-month trailing basis, tradable and non-tradable prices increased 0.46% ad 4.28%, respectively.

27. The IGP-DI increased 0.17% in July, for cumulative changes of 1.45% in the year through July and 1.56% in twelve months. The IPA (Wholesale Prices Index, the sub-index with the largest weight in the IGP-DI), decelerated in July, increasing 0.17%, down from 1.06% in June, for cumulative changes of 1.39% in the year through July and 0.95% in twelve months. The IPC-Br grew 0.06% in the month, after recording -0.4% in June, reflecting the upturn in food prices (0.15% in July up from -1.68% in the previous month). The INCC also decelerated in July, increasing by 0.47% down from 0.90% in June, reflecting the reduced impact of wage adjustments.

28. The deceleration in wholesale price inflation in July was driven by lower changes in both agricultural and industrial prices. The agricultural IPA reached 0.45%, down from 1.66% in June, reflecting the fall in the prices of soy, corn, poultry, beans and sugar cane, which outweighed the increases in the prices of rice, legumes, fruit and bovines. Industrial prices showed an average increase of 0.08% in July, down from 0.88% in June, mainly due to the fall in the prices of metal-intensive commodities. According to the processing stages of production, only final goods showed price acceleration, increasing 0.58% up from -0.06% in June. The prices of intermediate goods declined 0.21%, while the prices of raw materials increased 0.37%, after posting 1.29% and 2.15% in June, respectively.

29. All IPCA core inflation measures sustained their declining trend on a twelve-month basis. The core under the smoothed trimmed means method stood at 0.29% in July, totaling 5.54% in twelve months, compared to 5.71% in June. The non-smoothed trimmed means core reached 0.20% in July, decreasing to 4.04% in twelve months, down from 4.16% in June. The core excluding household food and monitored prices rose by 0.14%, reaching 3.85% in the last twelve months, down from 4.09% in the previous month.

30. The IPC-Br core inflation, calculated by the FGV under the symmetric trimmed means method, reached 0.11%, totaling 1.68% in the year through July and 3.11% in the last twelve months.

31. The IPCA diffusion index (measuring the number of items in the IPCA registering price increases) stood at 56.3% in July, up from 49.2% in June.

32. The partial results of consumer price indices confirm favorable expectations for the August IPCA, despite the upturn in food prices, especially rice and perishable products. At the wholesale level, the increase in the prices of bovines, legumes and fruit in the agricultural sector, and of machinery and fuel and lubricants, among industrial prices, were the main drivers of the IPA acceleration in partial August results.

## Economic Activity

33. Economic activity indicators showed unfavorable results in June, contrasting with the expansive trend observed in the last months. These results were greatly influenced by punctual factors in the period, such as the soccer world championship, scheduled inactivity in Petrobras platforms and the strike at the Federal Revenue and Customs Administration, which restricted imports of inputs. Those factors negatively influenced production indicators and, to a lower extent, also affected demand performance in the month.

34. According to IBGE's monthly survey, retail sales decreased a month-on-month seasonally adjusted 0.4% in June, after growing for three consecutive months. Only hyper- and supermarket sales, food products, beverages and tobacco expanded on a month-on-month basis (1%). In the first half of the year, retail sales rose by 5.7%, compared to the same period of 2005, with highlights to the increases observed in furniture and home appliances (9%) and hyper- and supermarkets sales, food products and beverages (7.6%), reflecting credit expansion and real earnings growth.

35. São Paulo Trade Association (ACSP) data, seasonally adjusted by Banco Central do Brasil, presented different behavior in July. Consultations to the Usecheque system increased 0.6%, while database consultations for credit sales declined by 0.6%. In the year through July, those indicators expanded by 6.5% and 3.3%, respectively, compared to the same period of 2005.

36. Regarding investment indicators, both capital goods and civil construction inputs production showed month-on-month seasonally adjusted reductions of 1.0% and 0.8%, respectively, in June. Capital goods imports increased 9.3%, seasonally adjusted, according to the volume index calculated by the Funcex. In the first half of the year, these indicators rose by 5.0%, 4.7% and 28.8%, respectively, compared to the same period of 2005. Capital goods production for energy increased 37.1%, for construction, 17.5% and, for mixed use, 10.1%, while capital goods production for agriculture fell 18.6%, in the same period. For industrial use, serialized production of equipment decreased 2.8%, while non-serialized production increased by 4.4%, in the same period.

37. According to the IBGE's Monthly Industrial Survey (PIM), industrial production recorded a month-on-month seasonally adjusted -1.7% in June. Mining decreased 3.4%, mainly driven by the scheduled inactivity in seven Petrobras platforms, while manufacturing industry fell by 1.9%, according to the same comparison basis. In the first half of 2006, industrial production reached 2.6%, compared to the same period of 2005, mainly driven by the expansions of 2.3% in manufacturing industry and 8.4% in mining.

38. All use categories fell in June, on a month-on-month seasonally adjusted basis. Intermediate goods and capital goods production decreased by 1.9% and 1.0%, respectively, while durable consumer goods and semi- and non-durable goods production fell by 1.1% and 1.0%, respectively. In the first half of the year, compared to the same period of 2005, all categories expanded, with highlights to durable goods production (7.5%) and capital goods production (5.0%).

39. Seasonally adjusted data for industrial production showed that 17 of the 23 sectors surveyed decreased in June. The main drivers of the result were the fall in the production of vehicles, other chemical products, mining industry, machinery and equipment, other transportation equipment and electronic material and communication equipment. Pharmaceutical products, refined oil and alcohol production recorded monthly expansions.

40. Automobile production grew a month-on-month seasonally adjusted 5.2% in July, for a 4.4% growth in the year through July, compared to the same period of 2005. Domestic and external sales increased 8.1% and 7.1%, respectively, in July. In the year through July, domestic sales increased 9.1%, while external sales decreased 4.1%, compared to the same period of the previous year.

41. Other indicators referring to industrial performance in July pointed to a recovery in activity, such as the positive monthly changes related to highway tolls (ABCR index), own electric charge (ONS), steel production and corrugated cardboard shipment, considering seasonally adjusted data.

## Surveys and Expectations

42. The Fecomercio-SP survey showed a month-on-month 4.5% decrease in consumer confidence (ICC) in August, reaching 128.6 points, a record low for the last nine months, but a 2% expansion relative to the same month of 2005. The two components of the ICC declined in August: the Current Economic Conditions (Icea) decreased 6.3%, while expectations, captured by the Consumer Expectation Index (IEC), decreased by 3.3%. According to the Fecomercio–RJ survey, the IEC increased a month-on-month 5.0% in July, and 9.4% compared to the same month of 2005.

43. According to the FGV survey, which encompassed 2,000 homes in the seven main capitals of the country, the ICC increased 0.9% in July, compared to the previous month, recording improvements of 1.5% in the present situation assessment and 0.7% in the 6-month ahead expectations.

44. Still according to FGV, industrial activity current outlook is similar to that observed in July 2005, with prospects of measured industrial growth. Inventory levels are considered normal. Average industrial capacity utilization reached 84.9%, a record high for this time of the year since 1980. The forecasts for the coming months are more optimistic in general, with highlights to the improvement in the industrial employment and business overall situation. The survey revealed that 34% of companies intend to raise prices, compared to 28% in April, while 10% of companies intend to reduce prices, down from 17% in the last quarter. Regarding investment, 53.6% of companies project higher costs than those registered in 2005, in real terms. Intermediate goods producers record the higher willingness to invest.

## Labor Market

45. According to the Ministry of Labor and Employment, 154,357 new jobs were created in July, spread among all great activity sectors. On a month-on-month seasonally adjusted basis, formal employment increased 0.4%, mainly driven by the 1.3% expansion in civil construction. In the year through July, 1,078 thousand new jobs were created, compared to 1,084 thousand jobs created in the same period of 2005.

46. According to the IBGE survey in the six main metropolitan regions of the country, the unemployment rate reached 10.7% in July, up from 10.4% in June, 1.3 p.p. above the observed in July 2005. The up-tick in the unemployment rate reflected a lower-pace increase in employed population (0.4%) compared to the increase in labor force (0.8%), a typical phenomena registered at the current stage of expansion. In the year through July, the average unemployment rate reached 10.2%, equal to the rate recorded in the same period last year.

47. Real average earnings reached R$1,028.50 in July, increasing 3.4% compared to July 2005, despite the 0.7% decline relative to the previous month. Real payrolls increased 5.5% in the last twelve months, notwithstanding the 0.3% fall in the month.

48. According to CNI, the amount of employed people decreased 0.2% in June in the industrial sector, seasonally adjusted, accumulating expansions of 1.4% in the first half of the year and 2.2% in the last twelve months.

49. According to Dieese, 271 wage negotiations were conducted in the first half of the year, producing the best results for workers since the start of this study, in 1996. In 81.9% of the negotiations, workers were favored with gains above the INPC cumulative change in each basis date, and in 13.7% of the negotiations, readjustments followed the index development. Wage negotiations have allowed the immediate application of negotiated readjustment indicators, which account for 97% of the readjustment registered in the first half of 2006.

## Credit and Delinquency Rates

50. Non-earmarked credit, used as reference for interest rates, grew 1.3% in July and 22.0% in twelve months. Credit for individuals rose 1.5% in the month and 28.2% in twelve months. Personal credit operations and credit to acquisition of vehicles grew 30.1% and 33.8% in twelve months, respectively. Corporate credit operations with domestic funding declined 0.2% in the month, but increased 20.1% in twelve months, while externally funded operations increased 5.3% in the month and 9.3% in twelve months.

51. The average interest rate on non-earmarked credit sustained the downward trend in July, reaching 42.2% p.a., 5.0 p.p. below the July 2005 level. The average rate on credit for individuals decreased to 54.3% p.a., compared to 61.3% p.a. in the same month of 2005, while the average rate on corporate credit decreased 4.7 p.p., to 28.3% p.a., in the same period.

52. Delinquency rates in the financial system (loans in arrears for more than ninety days) hit 4.8% in July. Delinquency rates for corporate credit operations reached 2.4%, while credit operations with individuals stood at 7.5%.

53. Net delinquency rates for retail credit, measured by the ACSP, stood at 3.9% in July, down from 5.0% in June, due to the 2.6% fall in new registers and the 6.0% increase in cancelled registers. In the year through July, the average default rate reached 6%, equal to the rate recorded in the same period last year.

## External Environment

54. After the break in the long monetary tightening cycle in August, uncertainties regarding the short-term monetary policy of the Fed and the US economy persist. There are evidences of inflationary pressures and recent data showed sharper-than-expected drop in real state sales, enhancing the fear of stronger deceleration of the US economy.

55. In the last days, this fear has provoked volatility in the markets, mainly in the US stock markets, whose liquidity decreased mainly due to the lengthening of summer vacations and the end of financial balances releases. Moreover, the stocks of commodity-producer companies whose prices were at historically high levels have faced selling pressure, as a result of a possible sharper deceleration of the global economy.

56. On the other hand, favorable economic growth prospects persist in Japan and in the Euro Area, although the risks of price rises may be higher than expected in the Euro Area.

57. Aiming at containing the strong pace of GDP expansion, estimated at 10.9% in the first half of 2006, the Central Bank of China increased by 27 basis point its loans and 1-year deposit interest rates, once local interest rates were too low for the current investment scenario. The 1-year loan interest rate increased to 6.12% and the 1-year deposit rate grew to 2.52%.

58. Oil prices remained high and volatile due to geopolitical factors. However, according to analysts, an accommodation in oil prices is expected as a result of diminishing conflicts in the Middle East and weaker concerns regarding the strategic US oil inventories. Moreover, oil output is expected to increase in 2007, driven by the launch of several projects in the Saudi Arabia, Niger and Angola.

## Foreign trade and international reserves

59. In July, Brazilian external trade confirmed the ongoing expansion, recording new record highs in exports and imports. Total external trade reached US$21.6 billion and the trade balance surplus recorded US$5.6 billion. In the year through July, exports reached US$74.5 billion and imports, US$49.4 billion, for a US$123.9 billion total external trade and a US$25.2 billion trade surplus. In the first four weeks of August (19 working days), the trade surplus reached US$3.9 billion, as a result of US$11.5 billion exports and US$7.6 billion imports.

60. Exports totaled US$13.6 billion in July, with a daily average of US$648.7 million, 23.1% above the July 2005 result. Manufactured, semi-manufactured and primary products reached daily averages of US$323 million, US$89.9 million and US$221.7 million, respectively, all record highs, totaling increases of 21.1%, 33.6% and 21.0% over July 2005 daily averages. The three main exports drivers were primary goods: iron ore (US$1.1 billion), soybean (US$978 million) and raw oil (US$870 million), totaling respective increases of 63.9%, 46.6% and 2.4% over July 2005 results.

61. Among the semi-manufactured, there were noticeable increases in raw sugar exports (US$515 million), totaling a 118.3% increase and cast iron (US$200 million). Manufactured exports were driven by external sales of vehicles, the main manufactured good exported, which fell 3.7% to US$397 million in the month, and increases of 54.3% in fuel oils and 283.4% in ethylic alcohol, respectively, amounting US$372 million and US$289 million. Export volumes increased for all export sectors, especially manufactured goods with low weight in total exports, and confirm the export diversification process.

62. Imports totaled US$8 billion in July, with a daily average of US$380.2 million, a 31.8% increase over July 2005. All import categories expanded, measured in daily averages: consumer goods (52.8%), with highlights to vehicles (254.9%); fuel and lubricants (42%); capital goods (28.3%); and raw materials and intermediated goods (26.1%).

63. At the end of July, international reserves totaled US$66.8 billion, a US$4.1 billion increase relative to June.

## Money Market and Open Market Operations

64. After the July Copom meeting, the yield curve shifted downward for all tenors. Between July 17 and August 28, one- three- and six-month rates fell 0.36 p.p., 0.34 p.p. and 0.30 p.p. respectively, driven by the Copom decision, by the downward trend inflation and by the expectation of continuous easing monetary cycle. The medium and long term interest rates, despite more volatile, also recorded significant drops, as a result of the improved external outlook, especially after the FOMC decision to keep unchanged the US basic interest rate in the August meeting and the release of several favorable US economic indicators. One-, two- and three-year rates fell respectively 0.33 p.p., 0.66 p.p. and 0.79 p.p. Real interest rates measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectation declined to 9.31 on August 28 from 9.75% on July 17.

65. On July 20 and August 17, the BCB conducted exchange rate swap auctions, in which the BCB assumes a long FX position and short interest rate position. With these operations, which totaled US$2.8 billion, the BCB anticipated the redemption of the swaps due August 1 and September 1. As a result, the net redemption of FX instruments totaled US$ 11.3 billion in the year.

66. In its open market operations, the BCB continued to conduct weekly three- and five-month fixed rate repo operations, as well as daily liquidity management operations with tenure up to two working days. Moreover, between July 18 and August 28, the BCB conducted 27 overnight repo operations, 24 of which were overnight borrowings. Three- and five-month operations recorded daily averages of R$64 billion, of which R$57.4 billion were five-month operations. Operations with tenors less than thirty days, including the daily liquidity management operations, averaged R$32.8 billion, borrowing.

67. In its open market operations – aimed at reducing excess liquidity projected for the fourth quarter of 2006 – the BCB conducted six auctions to sell from its portfolio LTNs maturing in January 2007, and buy LTNs maturing in October 2006, for a total amount of R$5.2 billion.

68. Between July 18 and August 28, the National Treasury raised a total of R$29.8 billion in fixed-rate securities: R$27.0 billion via issuance of LTNs maturing in 2007, 2008, and 2009 and R$2.8 billion in NTN-Fs maturing in 2012 and 2014. Issuance of LFTs totaled R$24.7 billion, for securities maturing in 2009 and 2011. Issuance of inflation-linked NTN-Bs reached R$7.9 billion, for securities maturing in 2009, 2011, 2015, 2024, 2035

and 2045. The Treasury also conducted auctions to anticipate the redemption of LTNs maturing on October 1, and of NTN-Bs of several maturities, totaling R$1.9 billion and R$276 million, respectively.