BANCO CENTRAL DO BRASIL

Minutes of the 125th Meeting of the Monetary Policy Committee (Copom)

Summary

Date: March 6th, from 4:30PM to 7:40PM, and March 7th, from 4:50PM to 7:20PM
Place: BCB Headquarters meeting rooms - 8th floor on March 6th and 20th floor on March 7th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua (present only on March 6th)
Alexandre Antonio Tombini
Antonio Gustavo Matos do Vale
Mário Magalhães Carvalho Mesquita
Paulo Sérgio Cavalheiro
Paulo Vieira da Cunha
Rodrigo Telles da Rocha Azevedo

Department Heads (present on March 6th)
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on March 7th)
Ivan Luís Gonçalves de Oliveira Lima – Open Market Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on March 6th)
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.

BANCO CENTRAL DO BRASIL

Recent Economic Developments

1. IPCA inflation slightly declined in January and reached 0.44%, down from 0.48% in the previous month and 0.59% in the same month of last year. The January result stood slightly below expectations registered on the eve of the IPCA release, and slightly above the expectations that prevailed at the end of 2006. Inflation deceleration in January was mainly driven by the behavior of regulated prices, which increased 0.27% down from 0.83% in December. Market prices increased 0.52%, up from 0.32% in December (non-tradable prices contributed 0.80%, up from 0.24% in December, while tradable prices accounted for only 0.22%, down from 0.40% in the previous month). Amongst market prices, the sharpest increases were for ethanol (7.23%) and perishable food (5.38%). However, recent developments suggest the reversal of this trend. Services inflation stood at 0.48% in January, significantly above the December result (0.19%), but below the January 2006 figure (0.68%). Twelve-month trailing inflation decelerated in January to 2.99% down from 3.14% in December. Market prices inflation totaled 2.49% (tradable prices inflation contributed 1.19%, while non-tradable prices inflation accounted for 3.89%), whilst regulated prices reached 3.95%. Services inflation fell to 5.28% in January, down from 5.48% in December, according to the same comparison basis. Partial February data, already captured by the IPCA-15 and underlying inflation measures, suggest that inflation may be stabilizing. Despite the recent inflation acceleration observed at the end of 2006 and the start of 2007, the most likely scenario is that inflation evolves according to the targets path.

2. IPCA core inflation measures calculated by the BCB increased in January, on a month-on-month basis. Core inflation by exclusion of household food items and regulated prices totaled 0.41% in January, up from 0.34% in December and 0.23% in November. Smoothed trimmed means core, which had increased to 0.38% in December (up from 0.27% in November), reached 0.39%, and continued to record the strongest rigidity among the three core measures. Conversely, after increasing to 0.27% in December (up from 0.12% in November), the non-smoothed trimmed means core increased again to 0.35% in January. Despite the recent increases, the cores continue to present a downward trend on a twelve-month basis. According to this comparison basis, the inflation cores recorded 3.09%, 4.40% and 2.49% in January, respectively, compared to 3.56%, 4.63% and 2.76% in December.

3. The General Price Index (IGP-DI) inflation accelerated to 0.43% in January, up from 0.26% in December, but decreased to 0.23% in February. On a twelve-month trailing basis, after reaching 3.49% in January – the first fall observed since May 2006 – the IGP-DI inflation accelerated to 3.79% in February, virtually unchanged relative to December, suggesting accommodation of the index. IGP-DI components behaved similarly to the headline index at the start of the year, increasing in January and decreasing in February, on a month-on-month basis. The IPC-DI increased 0.69% in January (up from 0.63% in December) and 0.34% in February. The Wholesale Price Index (IPA-DI) inflation increased 0.32% in January (up from 0.11% in December) and 0.19% in February. Conversely, the INCC-DI increased 0.45% in January (up from 0.36% in December) and 0.21% in February. On a twelve-month trailing basis, the IPA-DI decreased to 3.79% in January down from 4.29% in December, the first deceleration in the last eight months, according to this comparison basis. This behavior suggests that the relative price adjustment observed during the last months of 2006 – mainly driven by agricultural prices – seems to have come to an end, as mentioned in the last Inflation Report. As highlighted in previous Copom Minutes, the effects of wholesale prices over consumer inflation will depend on prospective demand conditions and price-setters' expectations for the future inflation path.

4. Gross Domestic Product (GDP) grew 2.9% in 2006, accelerating in the fourth quarter, both compared to the same quarter of the previous year and on a quarter-on-quarter basis. According to IBGE seasonally adjusted data, GDP increased 1.1% quarter-on-quarter and 3.8% compared to the same quarter of 2005 (0.6 p.p. above the 3.2% observed in the third quarter). Moreover, data from the second and third quarters were revised, indicating a 0.2 p.p. growth elevation for each. Considering the historical series, for the first time since the end of 1986, economic activity has grown for thirteen consecutive quarters, when compared to the same quarter of the previous year, suggesting the consolidation of the expansion process.

5. On the supply side, 2006 GDP expanded by 3.2% in the agriculture sector, 3.0% in industry and 2.4% in services. After presenting unsatisfactory growth in 2005 (0.8%) and on the first half of 2006, agriculture rebounded in the second half of last year, expanding more than the other sectors. Regarding the industrial sector, it bears emphasizing the performances of mining (5.6% growth) and civil construction (4.5% growth). Regarding services, the retail activity outperformed, growing by 4.0%. On the demand side, gross fixed capital formation (FBCF)

presented an outstanding performance, growing by 6.3% (the second best result in the last nine years). Household consumption (3.8% expansion) also outperformed, mainly due to the income growth and positive credit market developments. Imports volume increased significantly (18.1%), in line with expectations. In contrast to pessimist expectations of the start of 2006, exports volume expanded by 5%.

6. Industrial production, according to IBGE month-on-month seasonally adjusted data, decreased by 0.3% in January. This result was strongly influenced by technical interruptions in Petrobras platforms. Despite trending sideways through the first nine months of 2006, manufacturing production grew in the last three months of the year, showing, undoubtedly, signs of industrial activity acceleration. For instance, manufacturing production expanded in all three months of last quarter, recording, for the first time since October 2004, three consecutive positive results. Industrial production increased by 2.8% in 2006, with expansions of 2.6% for manufacturing industry and 7.4% for mining. Capital goods production expanded by 5.7%, while durable goods production expanded by 5.8%. Industrial activity expanded for the tenth consecutive month in January on a seasonally adjusted three-month moving average basis, despite some deceleration at the margin. For February, leading and coincident indicators suggest expansion. Several incentive factors, including the monetary easing already implemented and the fiscal impulses, suggest that the expanding trend in industry shall accelerate in 2007.

7. Disaggregated industrial data showed month-on-month seasonally adjusted expansions of 1.7% in capital goods production and 2.1% in durable consumer goods production in January. This result points to the continuity, in 2007, of the robust performance for Gross Fixed Capital Formation (FBCF) observed last year. On the other hand, intermediate goods production contracted 0.3% in January, after two consecutive monthly increases, due to technical interruptions in the production of fuel and lubricants. Compared to the same month last year, all categories increased, with highlights to the expansions of capital goods production (18.0%). The expansion of durable consumer goods production reflects, among other factors, the recovery of real earnings and the expansion of credit. The strong expansion of capital goods production reflects both the activity rebound, positive prospects for domestic growth and favorable international prices in the purchase of goods destined to several sectors.

8. Labor market performance remains positive, with employment and income expansions. The unemployment rate in the six main metropolitan areas reached 8.4% in December. Porto Alegre, Recife, Rio de Janeiro and Salvador recorded the lowest rates for December months since the start of the IBGE series. The unemployment rate increased to 9.3% in January, in line with the seasonal pattern, similarly to the January 2006 figure. The unemployment rate stability results from the 2.6% expansion rate for both the number of employed people and the labor force. The number of formal workers in private sector grew 4.1%, whereas the number of informal workers decreased 3.3% in January, compared to the same month last year, indicating that the pace of formal jobs creation remains robust, with positive effects over labor market conditions and labor productivity. Still in January, real average earnings fell a month-on-month 1.1% and increased 4.7% over the same month last year. In addition, real payrolls increased 7.4% in January over the same month last year, sustaining the positive growth trend. According to the National Industry Confederation (CNI), manufacturing employment increased a month-on-month seasonally adjusted 0.2% in December, for a 4.2% growth over the last thirteen consecutive months of expansion, except for the stability observed in June 2006. Regarding formal employment, data from the Ministry of Labor and Employment (MTE) confirms the continuity of the ongoing expansion, despite the reduction of 317,000 jobs in December, a usual performance for this month. Formal job creation reached 1,228,686, totaling more than 4,000,000 formal jobs in the last three years. The number of formal jobs expanded by 4.9% in 2006, year-over-year, due to the expansions of 9.2% in civil construction, 6.0% in the retail sector, 5.3% in services and 3.4% in the industry sector. In January 2007, 105,468 jobs were created, totaling almost a 22% expansion over the same month last year. In the twelve months through January, formal job creation grew 4.8%, with highlights to civil construction (6.4%) and the retail sector (5.7%), whereas manufacturing employment increased by 4.4%.

9. Retail sales decreased 0.5% in December 2006, according to month-on-month seasonally adjusted IBGE data. This reduction interrupted a four-consecutive-month expansion period, which totaled a 5.4% increase. Even including the December result, the quarterly index increased 2.6% quarter-on-quarter, or 10.8% in annualized terms. Retail sales grew 5.7% in December, compared to the same month of last year, and 6.2% in 2006. This increase was mainly driven by hyper- and supermarket sales (6.8% growth), influenced by labor and income positive developments, and furniture and domestic appliances sales (6.1% growth), as a result of increased payroll and better credit conditions. The main negative driver was fuel and lubricants sales, which registered a 24-

consecutive-month contraction, despite the increase in the sales of vehicles. Expanded retail sales, which include the sales of civil construction material and vehicles, motorcycles, parts and pieces, increased 6.5% in December 2006, compared to December 2005 results. In 2006, expanded retail sales increased by 6.4%, mainly as a result of the performance in the second half of the year (increases of 4.1% in the first half and 8.5% in the second half of the year, compared, respectively, to the same periods the previous year). Considering that the factors that have been boosting private consume continue, such as the positive outcomes stemming from the increase in real payrolls, credit expansion and the lagged effects of the monetary easing cycle, retail sales results in December are in line with the usual pattern of high frequency indicators, and do not necessarily sign a downturn in retail sales expansion. In fact, the vehicle sales performance observed at the start of 2007 corroborates robust domestic demand.

10. Installed capacity utilization in the manufacturing industry in 2006 stood 0.14 p.p. below that observed in 2005. According to CNI data seasonally adjusted by the BCB, installed capacity utilization in the manufacturing industry reached 81.93% in December, up from 81.86% in the same month of 2005. Disaggregated indicators compiled by the FGV show utilization rates at historically high levels for capital goods and civil construction. The lower installed capacity utilization recorded in 2006 partially reflects improvements in the productive capacity. In fact, recent data regarding output and absorption of capital goods suggest a robust ongoing expansion of investments. The absorption of capital goods expanded by 5.6% in the last quarter of 2006, quarter-on-quarter, resulting in the significant 8.9% increase in 2006. This result was mainly driven by the increases of capital goods imports volume (24.0%) and at a lower, but robust pace, capital goods production (5.7%). Therefore, despite the expectation of aggregate demand expansion in 2007, relevant aggregate supply imbalances that could jeopardy the inflation targets 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.

11. Similarly to the results observed at the start of 2006, the trade balance continues to frustrate the less optimistic expectations, recording robust results at the start of 2007. However, on the margin, the trade surpluses have gradually been compressed, as expected. In fact, in January/February, the trade surplus reached US$ 5.4 billion, 4.5% lower than that observed in the same period last year. Despite this fact, exports reached a US$ 21.1 billion record high in the first two months of 2007, a 16.9% increase over the same period of 2006. In the twelve months through February, exports reached US$ 140.5 billion, also a record high. Imports reached US 15.7 billion in the first two months and US$ 94.7 billion in the last twelve months, both historical record highs. Imports have been growing more than exports on the margin, as a result of the domestic demand expansion. However, robust trade results are expected to continue in 2007. These favorable track records corroborate the analysis expressed in previous Copom Minutes regarding important structural changes in Brazilian external trade. The current account surplus stood at US$ 388 million in December, totaling US$ 13.5 billion in 2006, or 1.4% of GDP. In January, the current account surplus reached US$ 325 million, for a US$ 14.2 billion surplus in the twelve months through January, or 1.5% of GDP.

12. With regard to the international scenario, uncertainties surrounding the monetary policy stance in the US persist. Although additional interest rate increases cannot be discarded, the consensus points to the fact that the bulk of the US domestic interest rate increase may have already happened. On the other hand, it seems to have been an increase in the market sensibility to data indicating a more pronounced slowdown in the US economy. This slowdown was the focus of the volatility increase that characterized the international financial markets in the last weeks, although uncertainties regarding Asian economies and markets have contributed as well. In Copom´s view, these global financial markets instability and their consequences to the Brazilian asset prices do not characterize a crisis environment both due to its transitory causes and to the solid Brazilian macroeconomic fundamentals. The continued disinflation, robust and persistent trade surpluses, the accumulation of international reserves, adequate public sector's primary surpluses, improved public sector's domestic debt profile and buyback of external debt have strengthened the domestic resilience to external shocks. This increase in resilience to shocks was reflected in the fact that the Brazilian growth trend has been kept even in the context of interest rate adjustment in the industrialized countries. Therefore, the Copom continues to assign low probability to a significant deterioration in international financial market conditions that could affect Brazilian external financing.

13. The international oil prices recovered in the last weeks, after a strong decline before the last Copom meeting. In addition, oil prices still present high volatility, reflecting, among other factors, geopolitical tensions and climatic events. Despite this increased volatility in the oil markets, the main scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2007, continues plausible.

Assessment of Inflation Trends

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

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

b) Considering the same comparison basis, the projection for fixed telephone price adjustments in 2007 remained at 3.9%, while the projection for household electricity price adjustments decreased to 3.3% from 4.6%;

c) The projection for regulated prices inflation in 2007 was maintained at 4.5%. These items, according to the weights released by the IBGE, represent 31.15% of the total January IPCA;

d) The projection for regulated prices inflation in 2008 was maintained at 5.6%, the same projection presented in the last Copom meeting. This projection is based on the endogenous determination model for regulated prices. This model considers the effects of seasonal components, exchange rate change, market prices inflation and the IGP;

e) The projection for the spreads over the Selic rate, using a Vector Autoregressive model based on the Selic and 180-day swap rates on the eve of the meeting, stood at 40 b.p. in the fourth quarter of 2007, reaching 64 b.p. in the last quarter of 2008.

15. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of GDP in 2007 and 2008 will be achieved, adjusted by the possibility of a 0.5 p.p. reduction in this percentage due to the implementation of PPI (Investment Pilot Program). The related assumptions considered in the previous meeting were maintained.

16. Since the January Copom meeting, median IPCA inflation expectations for 2007, compiled by the BCB's Investor Relations Group (Gerin), decreased to 3.88% from 4.07%. This reduction was mainly driven by the incorporation of the January inflation rate and a decrease of inflation expectations for the first quarter of 2007. The twelve-month ahead inflation expectations decreased to 3.8% down from 4.04%. For 2008, inflation expectations were maintained in 4%. As mentioned in previous Minutes, these developments suggest the consolidation of a more favorable long-term macroeconomic scenario.

17. The 2007 inflation forecast under the benchmark scenario – which assumes the maintenance of the Selic rate at 13.0% and the exchange rate at R$2.10//US$ during the forecast period – was maintained compared to the values considered at the January Copom meeting, remaining below the 4.5% 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 – situated below the values considered in the January Copom meeting and below the central target for the year. The projection for 2008, in the benchmark scenario, was maintained in relation to the January projection, remaining below the 4.5% target. In the market scenario, despite the projection for 2008 was reduced, it still remains above the 4.5% target.

Monetary Policy Decision

18. The Copom reaffirms the view expressed in previous Minutes, that in addition to containing short-term inflationary pressures, monetary policy has also contributed significantly for the consolidation of a favorable long-term macroeconomic environment. Economic activity data still do not suggest high probability of important pressures over inflation in the short-run. Imports expansion has contributed significantly to this process,

complementing domestic production and, therefore, limiting potential inflationary effects of aggregate demand sustained growth. Moreover, despite the prospects of lower liquidity in international markets, due to the interest rates increase in industrialized economies, and the recent – and probably temporary - volatility increase in the global markets, the external outlook remains favorable. Particularly regarding Brazilian external financing, the Copom continues to assign low probability to a significant deterioration in international financial market conditions. Therefore, the prospects for the inflation trajectory remain benign. As in the January meeting, the Copom emphasizes that the main challenge of the monetary policy in this context is to guarantee the consolidation of positive developments anticipated for the future.

19. The Copom evaluates that the short-term inflation increase has been mainly determined by one-off factors, such as public transportation fares and food prices. Seasonal effects, such as higher education costs, impacted preliminary February inflation measures. Since these effects have not exhausted yet, upcoming inflation indicators will likely continue to reflect those increases. Due to the nature of such pressures, they are expected to be temporary, with decreasing intensity throughout time, without necessarily affecting longer-time horizons. However, the Copom will continue to manage the monetary policy stance so that the gains obtained in inflation control in recent years become permanent. In this respect, the Copom will carefully monitor the evolution of inflation and the several core inflation measures in the upcoming months, discriminating between one-off and persistent or generalized price increases, and promptly adjusting the monetary policy stance to the circumstances.

20. The preservation of inflation rates in line with the targets path and the consolidation of a long-lasting stable macroeconomic scenario will contribute to the progressive reduction of macroeconomic risk perception underway. The scope for a reduction in real interest rates in the future will naturally follow as a consequence of this improved perception. The Copom evaluates that its cautious monetary policy stance has been critical to 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 observed in the last quarters.

21. The Copom emphasizes, once again, that there are important time lags in the transmission of monetary policy stance to economic activity and inflation. Since the beginning of the monetary easing cycle, in September 2005, the Selic rate has already been reduced by 675 b.p., with the bulk of the reduction concentrated in the second half of 2006. Consequently, the activity level has not completely mirrored the effects of the interest rates cuts, as well as the effects of the economic activity resumption on inflation have not completely materialized. Therefore, the evaluation of alternative monetary policy stances should necessarily focus on the prospective inflation scenario and its risks, instead of current inflation indicators.

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

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

24. Given the reasons stated above, the Copom unanimously decided to continue the monetary easing cycle, started in the September 2005 meeting, and reduce the Selic target rate to 12.75% p.a., without bias.

25. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing alternative scenarios for the main variables that determine price dynamics. The international scenario remains favorable, but presents new elements of uncertainty and instability. On the other hand, a set of price pressures, apparently temporary, arises when domestic demand already expands vigorously. In such environment,

the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons.

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

SUMMARY OF DATA ANALYZED BY THE COPOM

Inflation

27. IPCA inflation increased 0.44% in January, down from 0.48% in the previous month. The slight decline was mainly driven by the lower increase in transportation prices, which contributed 0.62%, against a 1.14% increase in December. On the other hand, prices of food and beverages accelerated 0.84% up from 0.39% in the previous month, primarily due to the increase in the prices of perishable goods that mirrored the effect of the longer-than-expected rainy season. With the monthly result, the IPCA totaled 2.99% in the last twelve months, down from 3.14% at the end of 2006.

28. Market prices inflation reached 0.52% in January, up from 0.32% in December, while regulated prices inflation totaled 0.27%, down from 0.83% in the same period. Twelve-month trailing market prices inflation increased 2.49%, with tradable and non-tradable goods prices rising by 1.19% and 3.89%, respectively, while regulated prices inflation stood at 3.95% in the same period.

29. All three IPCA core inflation measures increased in January on a month-on-month basis. However, all of them sustained a declining trend on a twelve-month trailing basis. The non-smoothed trimmed means core reached 0.35% in January, up from 0.27% in December, reaching 2.49% in twelve months, for the first time below the lower limit of the inflation target. The core under the smoothed trimmed means method stood at 0.39% in January, up from 0.38% in December, totaling 4.4% in twelve months. Finally, the core excluding household food and regulated prices reached 0.41% in January, up from 0.34% in the previous month, for a 3.09% increase in the last twelve months.

30. The IGP-DI increased 0.23% in January, totaling 3.79% in the last twelve months. All the components of the index decelerated in February. The IPA (Wholesale Prices Index), the sub-index with the largest weight in the IGP-DI, decelerated to 0.19% down from 0.32% in January. The IPC-Br reached 0.34% in February, against 0.69% in the previous month, mainly due to the dampening of education costs. The IPC-Br Core under the symmetric trimmed means method calculated by FGV stood at 0.16% in February against 0.26% in January, totaling 2.50% in the twelve months through February. The INCC-DI increased 0.21% in February, down from 0.45% in January, due to reductions in the costs of labor force (to 0% down from 0.32%) and services and materials (to 0.40% down from 0.57%). The INCC-DI increased 5.15% in the last twelve months through January and 5.18% in the last twelve months through February.

31. The lower IPA inflation in February reflected the deceleration in industrial prices, considering that agricultural prices remained roughly stable during the month. The Agricultural IPA grew 1.08% in February, up from 1.07% in the previous month, while the Industrial IPA totaled -0.1%. Considering the three processing stages of production, only intermediate goods recorded a negative price variation in February, -0.08%, which was rather in line with the –0.07% rate observed in January. The prices of final goods grew 0.42% in February, after a 0.02% elevation in January. Conversely, the prices of raw materials decelerated to 0.42%, after a 1.43% increase in the previous month. In twelve months, the prices of raw materials increased by 12.12%, pressuring the IPA result; the prices of intermediate and final goods rose by 2.55% and 0.59%, respectively.

32. Partial February data, already captured by underlying inflation measures, show that inflation in February should be lower than the one measured in January. As shown by both IGP-10 and IGP-M, perishable food prices decelerated significantly and industrial prices presented negative change at the wholesale level. The IPA-M grew

0.21% against 0.40% in the previous month. Consumer price inflation, regarding the IGP-M components, the IPC-Br increased 0.43% in February, down from 0.81% in January, as a consequence of the fact that six out of seven classes of expenditures decelerated; with regard to the IPCA, the deceleration of the IPCA-15 was not that intense: 0.46% against 0.52% in January. This deceleration was mainly driven by the prices of services, which increased 1.33% in February, up from 0.40% in January, as a consequence of seasonal increases of tuition fees concentrated in February.

Economic Activity

33. GDP grew 2.9% in 2006, spread out among all its components. Regarding the production side, agriculture, industry, and services expanded by 3.2%, 3.0% and 2.4%, respectively. On the demand side, there were increases in gross fixed capital formation (6.3%), household consumption (3.8%), government consumption (2.1%), exports (5.0%) and imports (18.1%). The external sector contributed -1.4% p.p. to the GDP growth, while domestic demand and stocks were responsible for 4.3% p.p. and 0.5 p.p., respectively.

34. According to IBGE's monthly survey, retail sales decreased 0.5% in December, on a month-on-month seasonally adjusted basis. All activities composing the general index decreased on a monthly basis, and regionally, only 8 out of the 27 Brazilian states recorded growth for retail sales.

35. Compared to December 2005, retail sales grew 5.7% in December, mainly driven by the increases in the sales of hyper- and super-markets (6.8% growth) and furniture and home appliances (6.1% growth). These increases were directly influenced by the growth in payroll and better credit conditions. Year-over-year expansion of retail sales reached 6.2% in 2006.

36. Expanded retail sales, which include civil construction inputs and vehicles, motorcycles, parts and pieces, grew 6.5% in December, compared to the same month of 2005. Year-over-year figures reached a 6.4% growth, strongly influenced by the sales expansion in the second semester (8.5%), against the first semester (4.1%), compared to the same periods of 2005. Regionally, expanded retail sales grew in all states, except for Mato Grosso, with highlights to the performances of Northern and Northeastern states.

37. São Paulo Trade Association (ACSP) data, seasonally adjusted by the BCB, showed in January a 0.2% increase in database consultations for credit sales and a 5% decrease in consultations to the Usecheque system, on a month-on-month basis. Compared to January 2006, the consultations increased 4.9% and 2.6%, respectively. In February, the seasonally adjusted consultations data changed 0.7% and –0.2%, respectively. Compared to February 2006, there were increases of 4.8% and 2.3%, respectively.

38. Regarding investments indicators, capital goods domestic production and imports increased 1.7% and 9.6%, respectively, in January 2007, on a month-on-month seasonally adjusted basis. Civil construction inputs production decreased 1.6%, according to the same comparison basis, after three consecutive months of expansion. In the last twelve months through January, these indicators expanded 6.6%, 25.0% and 4.1%, respectively. According to the same comparison basis, capital goods production for energy increased 20.0%; for construction, 7.4%; and for mixed use, 12.0%; while capital goods production for agriculture decreased 14.2%.

39. According to IBGE's Monthly Industrial Survey (PIM) seasonally adjusted data, industrial production declined 0.3% in January, after three consecutive months of expansion. Compared to January 2006, industrial production increased 4.5%, for a 2.9% expansion in the last twelve months.

40. Considering seasonally adjusted data, in January general industry reflected the 0.4% monthly expansion in mining production, while manufacturing industry decreased 0.5%. Regarding use categories, it bears emphasizing the increase, for the third consecutive month, in capital goods production (1.7%). Durable goods production, in decline in the last two months of 2006, recovered in January, increasing 2.1%. Intermediate and non-durable goods production decreased 0.3% and 0.9%, respectively.

41. Disaggregated analysis of seasonally adjusted industrial activity data showed that 11 of the 23 sectors surveyed decreased in January, with highlights to oil refining and alcohol production (-4.7%); regarding increases, it bears emphasizing machines and equipment (6.1%); machines and electric equipment (7.3%) and medical-hospital equipment (10.6%). The most significant decreases were in edition, print and reproduction segment (-16.6%) and wood (-7.6%).

42. According to CNI data, seasonally adjusted by the BCB, hours worked in production and real industrial sales increased 0.6% and 3.5%, respectively, in December. In the year, these indicators increased 1.8% and 2.0%, respectively, compared to 2005. Installed capacity utilization reached 81.9% in December, down from 82.2% in the previous month. Considering the observed data, installed capacity utilization reached 80.1% in the month, 0.2 p.p. below the December 2005 result.

43. Vehicles production reached 201.1 thousand units in February 2007, decreasing 2% month-on-month, according to data seasonally adjusted by the BCB. Still considering seasonally adjusted data, domestic sales decreased 3.6%, while exports increased 5.3%. Compared to the first two months of 2006, vehicles production increased 1%; domestic sales expanded by 5.9%, while exports declined 13.2%.

44. According to data seasonally adjusted by the BCB, gross steel production increased 2.8% in January, month-on-month, and 4.9% compared to January 2006. Corrugated cardboard shipments changed 0.4% and –1.0%, according to the same comparison bases.

45. According to the IBGE, the first estimative for the crops harvest in the year 2006/2007 pointed to a 9.7% increase compared to the previous harvest. National production of cereals, legumes and vegetables should reach 127.9 million tons, due to good weather conditions and the production incentive driven by the increase in the prices of international agricultural commodities. The second-harvest soy and corn will strongly influence the agricultural production expansion this year.

Surveys and Expectations

46. The Fecomercio-SP survey showed a 0.3% month-on-month expansion in the Consumer Confidence Index (ICC) in February. The Current Economic Conditions Index (Icea) increased 0.9%, a record high for the series that began in June 1994. In addition, for the second consecutive month, the Icea remained above the Consumer Expectation Index (IEC). The IEC decreased 0.2%, signalizing that consumers are more cautious with the future economic expectations. The ICC decreased 2.7% compared to February 2006.

47. According to the FGV survey, which encompasses two thousand homes in the seven main state capitals of the country, the ICC declined 1.3% month-on-month in February. This result is due to the deterioration in the assessment of the present situation and in the 6-month ahead expectations. Compared to February 2006, the ICC increased 2.5%.

48. Still according to FGV, the Industry Confidence Index (ICI), which encompasses six items of the Manufacturing Industry Survey, increased 5.8% month-on-month in February, and 6.2% compared to the same month of 2006. On a month-on-month basis, there were increases of 6.8% in the assessment about the present situation and 4.9% in the expectations for the upcoming months.

49. According to the fourth quarter 2006 CNI Industrial Survey, 6-month ahead expectations are more optimistic compared to expectations of the third quarter. The result was reinforced by the January 2007 Industrial Entrepreneur Confidence Index (Icei), which reached a record high since January 2005.

Labor Market

50. According to the Ministry of Labor and Employment, 105,468 new jobs were created in January 2007, compared to 86,616 in January 2006, with increases in all sectors. The result is the second best for the month, since the beginning of the series in 1985, only below the January 2005 result, when 115,972 new jobs were created. In twelve months, 1,248 thousand new jobs were created. After seasonal adjustment, the employment

index increased 0.4% in the month. In twelve months, the expansion reached 4.8%, with highlights to the 6.4% increase in civil construction employment.

51. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate reached 9.3% in January, compared to 8.4% in the previous month and 9.2% in January 2006. The unemployment rate increase in January, month-on-month, reflects, mainly, the decrease in temporary jobs, which usually prevail in the end of the year. The number of employed workers increased 0.1% and the labor force decreased 1.2% in the month, while the population in active age (PIA) and the non-occupied population increased 0.2% and 10.7%, respectively. According to the same survey, real average earnings reached R$1,066.10 in January, a 1.1% decrease month-on-month, but a 4.7% increase compared to January 2006. Real payrolls decreased 2.2% month-on-month in January, but maintained a yearly rising trend, with a 7.4% increase in January, compared to 6.7% for the average of 2006.

52. According to CNI, industrial employment increased 0.2% month-on-month in December, seasonally adjusted. In 2006, the expansion totaled 2.2%.

Credit and Delinquency Rates

53. Credit operations in the financial system increased 0.7% in January, and accumulated a 21.4% expansion in twelve months. Non-earmarked credit increased 0.4% in the month and 23.7% in twelve months, while earmarked credit increased 1.3% and 16.7%, respectively.

54. Non-earmarked credit, used as reference for interest rates, increased 0.6% in January and 19.8% in twelve months. Credit for individuals increased 2.4% in January, for a 22.4% increase in twelve months. Corporate credit operations with domestic funding decreased 1.2% in the month and increased 19.9% in twelve months, while externally funded operations decreased 0.3% in January and expanded by 11.0% compared to January 2006. Still regarding non-earmarked credit operations, leasing operations for individuals and for overall corporate increased 55.4% and 63.3%, respectively, in twelve months.

55. The average interest rate on credit operations reached 39.9% p.a. in January, 0.1 p.p. above the December rate and 6.2 p.p. below the January 2006 result. The average rate on credit for individuals reached 52.3% p.a., down from 59.7% p.a. in the same month of 2006. The average rate on corporate credit decreased 5.1 p.p. in twelve months, reaching 26.2% p.a.

56. Delinquency rate in the financial system (non-earmarked loans in arrears for more than ninety days) reached 5.1% in January, increasing 0.1 p.p. in the month and 0.7 p.p. in twelve months. Delinquency rate for corporate credit operations increased 0.1 p.p. in the month and 0.6 p.p. compared to January 2006, reaching 2.8%. Delinquency rate for credit operations with individuals reached 7.5%, decreasing 0.1 p.p. in the month and increasing 0.6 p.p. in twelve months.

57. Net delinquency rate for retail credit, measured by the ACSP, reached 5.6% in January, and 6.3% in February, compared to the 4.8% and 6.1% rates observed in the same months of 2006 and to the 5.3% average in 2006.

External Environment

58. The abrupt 8.84% fall of the Shanghai Composite Index posted at the end of February, followed by significant falls in several stock exchanges, caused pressures in the international markets and raised the fear of investors that the good performance of the global economy should experience a sudden cooling. That would lead to a depletion of the robust liquidity that flows specially to emerging economies. The VIX index, which shows the implicit volatility in the options of the S&P 500 stock index and is considered an external market risk aversion index, increased 64% on a single day. On February 27, the Emerging Markets Bond Index Plus (EMBI+) increased by 32.0% in Poland, 21.0% in South Africa, 15.5% in Russia, 15.0% in Mexico, 13.0% in Philippines, 12.0% in Argentina and Brazil, 11.0% in Turkey and 4.0% in Chile.

59. The worries in the global financial markets were intensified by the uncertainties regarding the growth in the main economies, by the concerns with the carry-trade operations in yens and by the US sub prime mortgage market, granted to riskier costumers, at higher rates.

60. However, there is consensus that the shocks originated in Asia are temporary and should be overcome in the short term, since the global economy dynamic does not signal a significant change at the end of February, especially in the United States and in China. Furthermore, there are no evident signals that the financial markets experience liquidity troubles, which is determined by the low interest rates established by the central banks of the main economies.

61. Economic indicators released in the U.S. such as income, consumer spending and the industrial activity index (ISM) point to a moderate growth of the economy. According the Federal Reserve, the lower pace of US GDP growth in the fourth quarter of 2006, pointed by the revision to 2.2% growth down from 3.5% in annualized terms, is more adequate to the moderate current activity level in the country. The GDP growth is constrained by several factors, especially the cooling of the real state market, which points to stabilization.

62. Japanese economic recovery has consolidated, with positive contributions of consumption for growth, which was previously export-oriented, indicating good prospects for Asia. After growing 1.4% in 2005, the Euro Area grew 2.7% in 2006, the best performance since 2000. Activity level expansion intensified more in the fourth quarter, posting a 3.6% annualized quarterly growth. In spite of administrative and monetary policy measures adopted to restrain excessively heated investment and credit, Chinese economy grew 10.7% in 2006, the highest growth rate since 1996.

Foreign Trade and International Reserves

63. In the first two months of 2007, Brazilian foreign trade continued to expand. Trade surplus reached US$5.4 billion in the period, and US$45.8 billion in the twelve months through February, while total external trade totaled US$36.8 billion and US$235.2 billion, according to the same bases. External trade in February set new record highs: total trade totaled US$17.3 billion, for a US$2.9 billion trade surplus.

64. Exports reached US$10.1 billion in February, with a daily average of US$561.3 million, a 15.5% increase over February 2006. In addition to shipment records, in the beginning of 2007 exports continued to show diversification in terms of products, particularly regarding manufactured items with low share in total exports, and expansion of exports destinations. Manufactured goods external sales reached US$5.5 billion in the month, a 5.6% increase in the year, considering daily averages. Primary products exports totaled US$2.9 billion, and semi-manufactured ones, US$1.5 billion, with respective increases of 39.1% and 21.7%, according to the same comparison bases.

65. Imports totaled US$7.2 billion in February, a record high for the month, recording a 21.4% increase considering daily averages, over February 2006. All categories expanded, particularly consumer goods imports (36.6%), reflecting the 101.7% increase in automobiles imports. Imports of raw materials, capital goods, and fuels and lubricants grew 24.2%, 18.6%, and 6.6%, respectively, considering daily averages.

66. In February, international reserves totaled US$101.1 billion, increasing US$10.0 billion in the month, US$15.2 billion in the year, and US$43.7 billion compared to February 2006.

Money Market and Open Market Operations

67. The day after the January Copom meeting, the yield curve shifted slightly upward, with the short-tenure rates adjusting to the 25 b.p. decrease in the Selic target rate, and the long-tenure rates influenced by the negative behavior of U.S. stock exchanges. Since then through February 22, the yield curve shifted downward continuously. In the domestic front, the favorable inflation trajectory, decreasing inflation expectations and the appreciation of the exchange rate reasoned this movement. In the external front, the release of the FOMC statement and the speeches of the Fed governor in the Congress boosted the investors optimism, favoring capital flows for emerging

economies and contributing to a sharper decrease of the longer-tenure side of the yield curve. Afterwards, this reduction was partially reverted, due to higher volatility in international financial markets in light of uncertainties regarding the deceleration pace of the US economy, the Chinese stock exchange fall and the movement of reverting long positions in several currencies, particularly in yen. Between January 22 and March 5, one-, three- and six-month rates declined 0.19 p.p., 0.12 p.p. and 0.23 p.p., respectively. One-, two- and three-year rates reduced 0.24 p.p., 0.13 p.p. and 0.12 p.p., respectively. The real interest rate measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectations were maintained at 8.0%.

68. On February 13, the BCB conducted a reverse exchange rate swap auction, aimed at anticipating the redemption of the swap due March 1st, totaling US$452 million.

69. In its open market operations, the BCB carried out, from January 23 to March 5, weekly five- and seven-month long fixed rate repo operations. The average daily balance of these operations amounted R$54.8 billion, of which R$35.6 billion were seven-month operations. In the same period, the BCB also conducted 24 overnight repo operations aimed at draining the excess liquidity from the market. The BCB also conducted daily liquidity management operations with tenures up to two working days. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R$47.0 billion, borrowing.

70. Between January 23 and March 5, the National Treasury raised a total of R$42.9 billion, of which R$32.5 billion in fixed-rate securities: R$20.3 billion via issuance of LTNs maturing in 2007, 2008 and 2009 and R$12.2 billion in NTN-Fs maturing in 2010, 2012 and 2017. Issuance of LFTs totaled R$4.6 billion, for securities maturing in 2010 and 2012. Issuance of inflation-linked NTN-Bs reached R$5.8 billion, for securities maturing in 2009, 2011, 2015, 2024, 2035 and 2045.

71. In the same period, the Treasury conducted auctions to sell LTNs maturing in October 2007 and April 2008, conjugated to the purchase of shorter-term LTNs, totaling R$8.2 billion. The Treasury also conducted auctions to sell LFTs maturing in 2010 and 2012, totaling R$6.2 billion, accepting as payment LFTs maturing in the first half of 2007. Still, the Treasury conducted auctions to buy LTNs maturing in April 2007, totaling R$4.2 billion.