BANCO CENTRAL DO BRASIL

Minutes of the 129th Meeting of the Monetary Policy Committee (Copom)

Date: September 4th, from 5:00PM to 7:20PM, and September 5th, from 5:00PM to 7:30PM
Place: BCB Headquarters meeting rooms - 8th floor on September 4th and 20th floor on September 5th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Alexandre Antonio Tombini
Antonio Gustavo Matos do Vale
Mário Gomes Torós
Mário Magalhães Carvalho Mesquita
Paulo Sérgio Cavalheiro
Paulo Vieira da Cunha

Department Heads (present on September 4th)
Altamir Lopes – Economic Department
André Barbosa Coutinho Marques – Investor Relations Group
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on September 5th)
Ivan Luis Gonçalves de Oliveira Lima – Open Market Operations Department
Luiz Fernando Cardoso Maciel – Department of Banking Operations and Payments System
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department

Other participants (present on September 4th)
Adriana Soares Sales – Deputy Head of the Research Department
Alexandre Pinheiro de Moraes Rego – Press Secretary
Flávio Pinheiro de Melo – Advisor to the Board
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. IPCA inflation increased 0.24% in July, down from 0.28% in May and June, totaling 2.32% in the first seven months of 2007, compared to 1.73% in the same period of last year. Although 12-month inflation (3.74%) has situated below that of July 2006 (3.97%), acceleration at the margin has been observed for the fourth consecutive month. This behavior was partially expected due to the exceptionally low inflation recorded in the second quarter of

2006 (monthly average of only 0.03%), as a result of the downturn in food prices at the time. It bears emphasizing that recent inflation acceleration essentially reflects the behavior of market prices, which have increased more rapidly than regulated prices in 2007, a reversal in the dynamics observed in the recent years. In fact, market prices and regulated prices recorded 2.89% and 1.07% in the year through July, and 4.43% and 2.22% in the last twelve months. Despite the BRL appreciation in 2007, there are price pressures, among market prices, stemming from tradable goods. In the twelve months through July, tradable goods inflation totaled 4.00%, up from 0.46% observed in the same period of last year, whereas inflation acceleration for non-tradable goods was more modest, totaling 4.85%, up from 4.28% in the same period of 2006. Preliminary inflation indicators for August, such as the IPCA-15, show the continuity of inflation acceleration, and suggest that such process might become more widespread. Notwithstanding the recent occurrence of inflation developments less benign than previously anticipated, price dynamics still indicates that inflation should continue to evolve according to the targets path.

2. In line with headline inflation, the three IPCA core inflation measures calculated by the BCB declined in July, with highlights for the core inflation by exclusion of household food items and regulated prices, which totaled 0.07% in July, down from 0.22% in June. Smoothed and non-smoothed trimmed means core inflation measures reached 0.20% and 0.17%, respectively. In the year through July, core inflation by exclusion of household food items and regulated prices reached 2.10%, below the rate observed last year (2.30%) and headline inflation (2.32%). In the same period, smoothed and non-smoothed trimmed means core inflation also stood below headline inflation, totaling 2.06% and 1.81%, respectively, down from 3.05% and 2.04% recorded in 2006. On a twelve-month trailing basis, the three core inflation measures, as well as headline inflation, stood below the 4.50% target for the year. Core inflation by exclusion of household food items and regulated prices and smoothed and non-smoothed trimmed means core inflation measures, reached 3.36%, 3.63% and 2.53%, down from 3.85%, 5.53% and 4.04% recorded in the same month of 2006. Similarly to the headline inflation, core IPCA-15 inflation measures for August suggest acceleration and higher diffusion of inflation.

3. The General Price Index (IGP-DI) inflation stood at 1.39% in August, up from 0.37% in July. In the year through August, IGP-DI inflation increased 3.24%, up from 1.87% in the same period of last year. On a twelve-month trailing basis, acceleration was sharper, totaling 5.19%, up from 2.78% in the same period last year. This move was driven by the similar behavior of the Consumer Price Index-Brazil (IPC-Br), which increased 4.47%, up from 2.40% and the IPA-DI, which totaled 5.49%, up from 2.56%, in the same periods. Despite at high levels, inflation as measured by the Civil Construction National Index (INCC) showed stability (5.05% this year, compared to 5.23% last year). Regarding wholesale prices, agricultural prices rallied, resulting in a 14.87% change in Agricultural IPA in the last twelve months through August, in contrast to a 2.42% deflation in the same period of last year. On the other hand, industrial prices behaved positively in the period, recording 2.65%, down from 4.17% in August of last year. However, regarding wholesale industrial prices, there are signs of acceleration at the margin. As highlighted in previous Copom Minutes, the effects of wholesale prices over consumer inflation will depend on current and prospective demand conditions and price-setters' expectations for the future inflation path.

4. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output grew 0.6% in July, continuing to show a robust expansion trend, even if relatively less intense than in June. Still considering the seasonally adjusted series, industrial output declined 0.4% in July, month-on-month. However, industrial output grew 6.8% in July relative to the same month last year. In the year through July, industrial output grew by 5.1%, and on a twelve-month trailing basis, 4.2%. The month-on-month decline observed in July was exclusively due to the performance of manufacturing industry, which retracted 0.7%, since mining expanded by 1.0%. In the last twelve months through July, manufacturing industry grew 4.0%, while mining expanded by 6.1%. For August, the few leading and coincident indicators available for industrial production are not inconsistent with the continuity of the industrial expansion cycle, which will be favored by the several stimulus factors that influence economic activity, including the monetary easing already implemented.

5. Among the use categories, only durable consumer goods production increased in July (0.8%), on a month-on-month basis, according to data seasonally adjusted by the IBGE, while the sharper decline occurred in the production of semi- and non-durable consumer goods production (3.3%). On the other hand, in the year through July, capital goods production strongly grew by 17.0%, and durable consumer goods expanded by 5.9%. The dynamics of durable consumer goods production reflects, to a large extent, the remarkable improvement in credit conditions, when compared to historical levels. The accelerated expansion of capital goods production is due to the

consolidation of positive prospects for the continuity of domestic demand growth, which has reflected not only the improvement of income and the expansion of credit, but also the perception of higher macroeconomic stability.

6. Labor market continues to present fairly positive developments. The unemployment rate in the six main metropolitan regions covered by the Monthly Labor Survey (PME) decreased again in July and stood at 9.5%. Compared to the same month of last year, it declined 1.2 p.p. in July, the sixth consecutive fall according to this comparison basis, so that the average unemployment rate reduced by 0.4 p.p. in the year through July, compared to the same period last year. The purchasing power of employed workers decreased month-on-month 1.2% in July. However, it increased 2.5% relative to the same month last year, and 4.2% in the year through July. As a consequence, real payrolls expanded by 7.2% in the year through July, compared to the same period of last year, becoming a key driver for sustained aggregate demand growth. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment increased month-on-month 0.3% in July and 3.7% compared to July 2006. Regarding formal employment, data from the Ministry of Labor and Employment (MTE) confirm the continuity of strong expansion. Job creation grew month-on-month seasonally adjusted 0.3%, expanding by 4.9% both in the year through July and in the last twelve months, with highlights to employment expansions in the civil construction industry (6.8%) and in the retail sector (6.0%). These figures corroborate the creation of 1.2 million formal jobs in the year through July and 1.4 million formal jobs in the last twelve months.

7. In line with the positive developments in labor market, and with the expansion of credit, retail sales continue to record positive performance. Retail sales increased 0.4% month-on-month in June, the sixth consecutive expansion, according to data seasonally adjusted by the IBGE. Compared to the same month of 2006, retail sales increased by 11.8%. In the first half of 2007, relative to the same period of last year, retail sales grew by 9.9%, and in the last twelve months, by 8.2%. Amongst the sales, it bears emphasizing the expansion of fabric, clothing and shoes (16.6%) and furniture and domestic appliances (16.2%), compared to the same month of last year. These developments confirm the view expressed in previous Copom Minutes that both the expansion of income and the improvement of consumer credit conditions are crucially important to the strengthening of aggregate demand growth. In fact, expanded retail sales, which include the sales of civil construction material and vehicles, motorcycles, parts and pieces, grew by 17.4% in June, compared to the same month of 2006, in line with the performance observed in the recent months. For the next quarters, it is expected the strengthening of retail sales, boosted by the increase in employment and income, credit expansion and by the recovery of consumer confidence, which so far has not been affected by the higher volatility in the financial markets.

8. The installed capacity utilization rate in the manufacturing industry, according to CNI data seasonally adjusted by the BCB, stood at 82.4% in July, 0.3 p.p. above the rate observed in June, which had declined 0.3 p.p. relative to May. Therefore, the installed capacity utilization rate in July almost resumed the rate observed in May, a record high for the series. According to CNI data, installed capacity utilization in the manufacturing industry in July stood 2.0 p.p. above the rate observed in the same month of 2006, the twelfth consecutive expansion under this basis. In the year through July, the installed capacity utilization average rate stood 1.8 p.p. above the observed in the same period of 2006 and 1.2 p.p. above the rate observed in the same period of 2005 and 2004. Such increase reflects, unmistakably, economic activity acceleration, despite the strong expansion of investment. In fact, in the year through July, the absorption of capital goods grew 17.2%, in line with the significant increase in capital goods imports (30.3% in volume), as well as in capital goods production (17.0%). Moreover, in the same period, the production of civil construction inputs increased 4.1%. The most recent data indicate that investment has contributed to a slowdown in the elevation of capacity utilization rates, but has not been sufficient to avoid the persistence at relatively high levels, which coincided, in the past, with periods of inflation acceleration. In this context, the expansion of investment and the maturing of projects will be fundamental to avoid sharp mismatches regarding the evolution of aggregate supply and demand. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments with regard to the expansion of supply of goods and services to adequately meet demand conditions.

9. Despite the deceleration, at the margin, the trade balance continues to present robust performance, confirming the evaluations reported in Inflation Reports and previous Copom Minutes that depict important structural changes in the Brazilian foreign trade. In the year through August, the trade surplus reached US$27.5 billion, a 7.5% decrease relative to the same period of 2006. Exports rose 15.9%, to US$102.4 billion, while imports increased 27.8%, to US$74.9 billion. As stressed in previous Copom Minutes, imports have been growing more

rapidly than exports at the margin, due not only to the strengthening of the BRL, but also, and mainly, to the higher level of economic activity. On the other hand, the effects of US real state sector crisis over global growth may slow down global demand for Brazilian exports. In any way, these two movements point out to an adjustment process in the trade balance, due to important structural changes in the Brazilian foreign trade over the recent years.

10. International financial markets have experimented periods of financial turmoil since the last Copom meeting. There is greater perception that investments in US real state have triggered losses – not so far fully assessed in extension and distribution - over financial institutions in developed economies. This uncertain global financial scenario resulted in liquidity problems across credit and money markets. Central banks, particularly those of Europe and in the US, have promptly answered by increasing liquidity provisions and facilitating the access to the discount window. However, these economies continue to have problems of asymmetric access to interbank credit, despite at a less intensive manner than observed in mid-August. These developments had important impact over monetary policy prospects in developed economies, towards limiting, at least in the short term, the scope for restrictive stance. In particular, the probability of additional monetary tightening in the US seems reduced, not only due to the problems of interbank liquidity, but also because, even considering that part of the adjustments in the US activity level in response to the crisis may already have occurred, it is more likely that spillover effects on the financial sector and the consumer confidence cause a stronger economic deceleration. Even considering that Europe and the major Asian countries record robust expansions, despite the economic cooling in Japan, the US crisis may have negatively impact world growth. However, the Brazilian economy remains sound and shows greater resilience to face the international markets turmoil. So far, the international crisis does not seem to have significantly impacted inflation and domestic economic activity, unequivocal evidence of the benefits stemming from the highly improved external solvency over the recent years. It must be recognized, however, that the external scenario became more uncertain than evaluated in the previous Copom meeting, and that the changes in the international market sentiment and the increase in the risk perception must be closely monitored.

11. Oil prices, another source of international uncertainty, remains at elevated levels and still presents high volatility. On one hand, this behavior reflects structural shifts in global demand for energy and, on the other hand, recurrent episodes of geopolitical tensions. Despite the uncertainties surrounding the expectations about the future trend for oil prices, the main scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2007, remains plausible. Moreover, the prices of other commodities also present high volatility, due to the heightened uncertainty about the prospects for global growth and the recent turmoil on global markets.

Assessment of Inflation Trends

12. 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 July Copom meeting, the projection for gasoline and bottled gas prices adjustments in 2007 were both maintained at 0%;

b) The projections for electricity and fixed telephone price adjustments in 2007 were modified to, respectively, –4.4%. and 2.8%;

c) The projection for regulated prices inflation in 2007 was maintained at 3.2%. These items, according to the weights released by the IBGE, represent 30.91% of the total July IPCA;

d) The projection for regulated prices inflation in 2008 was also maintained, at 4.5%. 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, estimates a 5 bps spread in the fourth quarter of 2007, reaching 74 bps in the last quarter of 2008. The identified shocks and their impacts were reassessed according to newly available information.

13. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 3.8% of GDP in 2007 and 2008 will be achieved, adjusted by the possibility of a 0.45 p.p. reduction in this percentage due to the implementation of the PPI (Investment Pilot Program). The related assumptions considered in the previous meeting were maintained.

14. Since the July Copom meeting, median IPCA inflation expectations for 2007, compiled by the BCB's Investor Relations Group (Gerin), increased to 3.92% up from 3.7%. This growth was mainly driven by the addition of the inflation occurred in July and by the increase in the inflation expectations for the others months of the third quarter of 2007. Twelve-month ahead inflation expectations reached 3.87%, up from 3.5%. For 2008, inflation expectations remained at 4%. These developments continue to suggest the consolidation of a favorable macroeconomic scenario.

15. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the Selic rate at 11.5% and the exchange rate at R$1.95/US$ during the forecast period – the projection for the 2007 IPCA increased substantially compared to the value considered at the July Copom meeting, but remained below the 4.5% target established by the CMN for the year. According to the forecast based on the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – IPCA inflation forecast for 2007 also increased compared to the value considered at the July Copom meeting, but remains below the central target for the year. The projection for 2008 based on the benchmark scenario increased significantly, while the projection based on the market scenario reduced in relation to July, but both remained below the 4.5% target.

Monetary Policy Decision

16. 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 indicate that the intensity of demand expansion can increase the probability of important pressures over inflation in the short-run. In addition to investment expansion, imports growth has remarkably contributed to slow down this process, complementing domestic production and, therefore, limiting potential inflationary effects stemming from aggregate demand sustained growth. Moreover, despite uncertainties regarding the continuity of the strong growth in the international economy and the volatility increase in global markets since the last Copom meeting, the prospects for Brazilian external financing in the forecast period suggest, according to newly available information, that the balance of payments may not present a risk to the inflation scenario. Therefore, even with the increase in uncertainty, inflation prospects remain in line with the targets trajectory. As in recent meetings, 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.

17. The Copom evaluates that emerging local inflationary pressures are more likely to represent risks to domestic inflation trajectory, because the heated demand can increase the pass-through of wholesale prices over consumer price inflation. Additionally, the heated domestic demand can trigger inflationary pressures in the non-tradable sector. The Copom also observes that the increase in IPCA inflation expectations for 2007 and for twelve months ahead, despite to levels below the targets established for 2007 and 2008, is a process that must be carefully monitored. In this sense, 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, discriminating between one-off and persistent or generalized price increases, and promptly adjusting the monetary policy stance to the circumstances.

18. 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 increase the probability of inflation convergence to the targets path. For this to materialize, however, it is important that forward-looking inflation indicators, in particular the expected dynamic of aggregate demand and supply, remain consistent with the recent benign inflation outlook observed in the last quarters.

19. 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 825 b.p., with the bulk of the reduction concentrated in the last nine months. Consequently, the activity level has not completely mirrored the effects of the interest rates cuts yet, as well as the effects of the economic activity 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.

20. During the coming months, employment and income expansions and credit growth will continue to bolster economic activity, despite the current inflation acceleration and some increase in the market interest rate. As mentioned in recent Copom Minutes, activity level should also reflect the effects of governmental transfers and other fiscal impulses expected for the next quarters of the year and for 2008. 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 clear signs of heated aggregate demand, and the fact that the monetary policy decisions will have limited effects in 2007 and predominant impacts in 2008.

21. The pace of domestic demand may continue to be sustained by factors such as the impulse derived from the monetary policy easing implemented this year, but it may still bring non-insignificant risks to the inflationary dynamics. Conversely, the last developments suggest that the contribution of the external sector to the consolidation of a benign inflationary scenario may become less effective.

22. Aiming at consolidating a stable and predictable environment, the Copom has privileged a strategy to avoid a volatile inflationary trajectory. This strategy takes into consideration the lags in the transmission mechanisms and has been the most adequate to deal with the uncertainty related to the process of monetary policy formulation. That is the reason why variables such as inflation projections and the preventive stance in the decision-making process of the Copom are so important. In this context, the Committee considered the option of keeping the basic interest rate unaltered.

23. Despite recognizing that several factors would already support the decision of keeping the Selic rate unaltered this meeting, the Committee evaluated the macroeconomic scenario and understood that the balance of risks to the evolution of future inflation would still justify an additional monetary stimulus. Therefore, the Committee unanimously decided to reduce the Selic target rate to 11.25% p.a., without bias. The Copom will carefully monitor the evolution of the macroeconomic scenario until its next meeting, to define the next steps on its monetary policy stance.

24. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing several alternative scenarios for the evolution of the main variables that determine price dynamics and its balance of risks. Domestic demand continues to expand vigorously, backing-up the economic activity recovery. This expansion encompasses some sectors little exposed to external competition, at the time when the effects of important incentive factors, such as the monetary easing already implemented, are still not fully perceived. In spite of not being an imminent threat to inflation prospects, the contribution of the external sector to the maintenance of a benign inflationary scenario may become less effective. In such environment, the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons.

25. At the conclusion of the meeting, it was announced that the Copom would reconvene on October 16th 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

26. The IPCA-15 went up 0.42% in August, up from 0.24% in July and 0.29% in June, totaling 2.85% in the year and 3.95% in twelve months. The prices of food and beverages increased 1.61%, up from 1.27% in July,

contributing 0.34 p.p. for the index, mainly driven by the growth in the prices of bovine, milk and its by-products. The prices of perishable food retreated again in August, following the pattern that has been observed since May. The 1.02% average increase in fixed telephone prices contributed 0.04 p.p. for the IPCA-15 increase. Energy, gasoline and alcohol prices contracted in August and altogether influenced the IPCA-15 with -0.14 p.p.

27. Market prices inflation totaled 0.66% in August, up from 0.35% in July, while regulated prices decreased to -0.12%, down from -0.01%, in the same period. In twelve months, market prices accumulated 4.72%, and regulated prices, 2.25%. Among market prices, the prices of non-tradable goods increased 4.88%, while the prices of tradable goods totaled 4.56%, according to the same comparison basis.

28. The several IPCA-15 core inflation measures showed that inflation increased in August, not only on a month-on-month, but also on a twelve-month trailing basis. The smoothed trimmed means core rose 0.34% in August, up from 0.21% in July. In twelve months, the variation totaled 3.60%, against 3.52% in July. The non-smoothed trimmed means core reached 0.37% in August, up from 0.15% in July, totaling 2.76% in twelve months. Finally, the core excluding household food and regulated prices reached 0.26% in August, up from 0.1% in July, totaling 3.38% in twelve months.

29. The IGP-DI increased 1.39% in August, compared to 0.37% in July, the highest rate recorded since June 2004. In the last twelve months, the IGP-DI totaled 5.19%, against 4.17% observed in July. Higher inflation in the prices of wholesale products was responsible for the acceleration of the IGP-DI, primarily due to the increase in agricultural prices. The IPA-DI increased 1.96%, up from 0.42% in July, reaching 5.49% in twelve months and 4.02% in the year through July. The prices of agricultural products grew 6.15%, up from 1.79% in July, while the prices of industrials increased 0.61%, up from –0.01% in the previous month.

Economic Activity

30. According to IBGE’s monthly survey (PMC), retail sales increased month-on-month seasonally adjusted 0.4% in June. All activities with seasonally adjusted data increased, with highlights to furniture and home appliances, which increased 1.2%. Sales of vehicles and motorcycles, parts and pieces, which are not part of the general retail sales index, grew 4.2% in the month. Regionally speaking, 15 out of 27 Federation Units achieved positive results in the period.

31. Moreover, retail sales increased 11.8% in June, compared to the same month of last year, driven by increases in all its components segments, mainly in fabrics, apparel, and shoes (16.6%); furniture and home appliances (16.2%). Expanded retail sales, including civil construction inputs and vehicles, motorcycles, parts and pieces, registered a 17.4% increase, with highlights to a 31.8% expansion in motor vehicles.

32. Retail sales performance reflects the continuity of payroll growth and better credit conditions, together with the impacts of social programs and the recovery of the agricultural sector. Retail sales increased 9.9% in the first half of 2007, compared to the same period of 2006, while expanded retail sales increased by 13.6%. It bears emphasizing the increase in the sales of vehicles (22.8%) and furniture and domestic appliances (16.5%), in the same period. On a regional basis, all states recorded growth in retail sales under this comparison basis, and the most significant expansions occurred in the Northeastern and Northern regions, especially due to the impact of federal government social assistance programs in these regions.

33. São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, showed decreases of 0.8% in consultations to the Usecheque system and 0.2% in database consultations for credit sales in August, on a month-on-month basis. Compared to August 2006, these indicators rose by 5.5% and 5.9%, respectively.

34. Regarding investment indicators, civil construction inputs production reduced month-on-month 0.2% in July, while capital goods production declined 1.3%, seasonally adjusted. The monthly contraction of capital goods production does not represent a change in the trend, in view of the intense expansion in this cycle, evidenced by a 17% growth in the first seven months of 2007, and 12.3% in the last twelve months. In the year through July, compared to the same period of 2006, domestic production of capital goods increased 19.7%, with significant

elevations in the production of capital goods for energy (18.7%), for mixed use (15%) and for construction (13.6%). Production of capital goods for agriculture expanded by 35.3% in the same period, while twelve-month trailing production reached 14.6% in July, after 7.5% in June, confirming the recent good performance in this sector.

35. Industrial production reduced month-on-month 0.4% in July, according to IBGE's Monthly Industrial Survey (PIM) seasonally adjusted data, after nine months of consecutive increases. On a three-month moving average basis, which attenuates punctual oscillations, industrial activity increased 0.6% in July, expanding for the thirteenth consecutive month. Industrial production rose by 6.8%, compared to July 2006, and expanded by 5.1% in the first seven months of 2007 and 4.2% in the last twelve months.

36. Among use categories, production of durable consumer goods increased 0.8%, while other categories posted the following reductions in the month: semi- and non-durable goods production (-3.3%), capital goods production (-1.3%) and intermediate goods production (-0.1%). In the year through July, production of capital goods expanded by 17%, sustaining double-digit industrial expansion since the beginning of the year, followed by durable consumer goods (5.9%), intermediate goods (4.2%), and semi- and non-durable goods (3%).

37. Disaggregated data of seasonally adjusted industrial activity showed that the 5.1% growth in the industrial production reflects that 22 out of the 27 sectors surveyed grew in July, with highlights to machines and equipment (17.4%), motor vehicles (10.3%), basic metallurgy (7.6%) and other chemical products (6.3%). The main negative drivers were electronic material and communication equipment (–7.4%).

38. Still considering the industrial activity, according to CNI data seasonally adjusted by the BCB, hours worked in production expanded by 0.7% and real industrial sales increased 3.7% in July, month-on-month. In the year through July, these indicators increased by 4.7% and 6.5%, respectively, compared to the same period of 2006. After seasonal adjustment, installed capacity utilization reached 82.4% in July, up from 82.1% in June. Considering observed data, utilization level reached 82.5%, 0.1 p.p. above the July 2006 figure.

39. According to Anfavea, vehicles production reached 268.2 thousand units in July, a new monthly record. According to data seasonally adjusted by the BCB, vehicles production expanded by 7.6%, on a month-on-month basis, and 20.3% compared to July 2006. Considering the month-on-month seasonally adjusted series, domestic sales increased by 3% and exports, by 26.7% in July. Compared to the first seven months of 2006, vehicles production increased by 8.4% in 2007 and domestic sales increased by 21.6%, while exports decreased 8%. According to the same comparison basis, production of agricultural machines grew 26.5% and production of trucks grew 23.4%, mirroring increases in investment and recovery of the agricultural sector in the current harvest.

40. According to the IBGE, the July estimate for the grains harvest pointed to a 14% increase in 2007, year-on-year. National production of grains should reach 133.4 million tons, due to good weather conditions and the production incentive driven by the increase in international agricultural commodities prices. In the survey, the main forecast production increases related to wheat (60.6%), cottonseed (30.5%), corn (21.3%), and soy (11.2%), while the main production decrease related to rice (4%). If other products are considered, besides grains, the survey pointed to a 15.1% decrease in the coffee production, mainly due to the biennial negative harvest, and 12.7% increase in sugar cane production, reflecting the 10.4% expansion in planted area, boosted by the growing interest in ethanol production.

Surveys and Expectations

41. The Fecomercio-SP monthly survey showed a 0.2% increase in the Consumer Confidence Index (ICC) in August, month-on-month. The two ICC components presented divergent behavior, with the Consumer Expectation Index (IEC) increasing month-on-month 2.3% in August, and the Current Economic Conditions Index (Icea) declining by 2.5%. In fact, the Icea remained above the IEC for the eighth consecutive month. Compared to August 2006, ICC and Icea increased by 1.6% and 14%, respectively, while the IEC decreased by 5.7%.

42. According to the FGV survey, which encompasses two thousand homes in the seven main state capitals of the country, the ICC increased 1% month-on-month in August. This result is due to the improvement in both the

assessment of the present situation (1.3%) and in the 6-month ahead expectations (0.8%). Compared to August 2006, the ICC rose 6.5%, mainly because of the 9.9% increase in the present situation index.

43. Still according to the FGV, the Industry Confidence Index (ICI) increased to 121.8 in August from 121.7 in July, reaching a new record high for the series started in April 1995. The ICI rose 14.2% relative to August 2006, expanding by 11.7% in the first seven months of the year, compared to the same period of 2006. Among the items in the ICI related to the present situation, it bears highlighting that, for the first time since April 1995, the share of surveyed participants that evaluate inventories as insufficient outpaced the share of those which evaluate inventories as excessive. The level of installed capacity utilization reached 85% in August, up from 83.6% in August 2006.

44. According to the July FGV's Manufacturing Industry Survey – Special Items, 38% of the surveyed institutions affirmed to have invested more in fixed capital in the first half of 2007 than in the previous semester, while 21% responded the contrary. As in the April's Survey investment projections for this period pointed to 34% and 21%, respectively, the new survey indicates acceleration of investment in the second quarter of the year. For the second half of 2007, 42% of the surveyed institutions keep their projections of investment increase, while 19% intend to invest less. In the capital goods and construction material sectors, investment intentions seem to have cooled, while intermediate goods producers remain willing to invest.

Labor Market

45. According to the Ministry of Labor and Employment, 127 thousand new formal jobs were created in July. In the year through July, 1,222.5 thousand new jobs were created, a 13.4% increase compared to the same period of 2006. These new hirings raised employment by 4.9%, according to the same comparison basis, reaching all major sectors of economy, with highlights to employment expansions in civil construction (6.8%) and in commerce (6.0%). In the seasonally adjusted series, the employment index increased month-on-month 0.3% in July, also spread among all sectors.

46. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate stood at 9.5% in July 2007, down from 9.7% in the previous month. This decline was due to the 0.2% increase in employed population and the stability of economically active population (PEA). Employment in the private sector increased 0.7% in July, reflecting the 1.2% expansion in the number of formal workers and the 0.9% reduction in the number of informal employees. The number of employers declined 2.4%, while self-employed workers decreased by 1.2%. In the year through July, compared to the same period of 2006, the average number of employed workers expanded by 2.9%, mainly due to the increases of 4.2% and 5.3% in formal employment and self-employed workers, respectively.

47. The same survey showed that real average earnings reached R$1,108.30 in July, a 1.2% decrease month-on-month. Compared to the same month of last year, real average earnings increased 2.5% in July 2007, and 4.2% in the year through July. Real payroll decreased by 1% in July 2007, but expanded by 5.6% relative to the same month of last year and 7.2% in the year through July.

48. According to CNI data seasonally adjusted by the BCB, manufacturing employment increased 0.1% in June, month-on-month. In the first half of the year, this figure expanded by 3.4%, while real manufacturing payroll raised 4.8%.

49. According to Dieese data, 280 wage negotiations were carried out in the first half of 2007, when workers obtained the best results since the beginning of these surveys, in 1996. In different occasions, around 87.5% of the negotiations led to wage raises above the INPC (National Consumer Price Index) variations, while other 9.6% negotiations equaled the index variations. Wage adjustments have been favored by economic growth and low and stable inflation, which allow full and immediate compensation of past inflation, together with real wages increases sustained by productivity gains.

Credit and Delinquency Rates

50. Credit operations in the financial system increased 1.7% in July, growing by 11.0% and 21.5% in the year and in the last twelve months, respectively. Earmarked credit operations expanded 0.6% month-on-month and 13.8% in twelve months, while non-earmarked credit operations increased by 2.2% and 25.1%, according to the same comparison bases. On a twelve-month trailing basis, among non-earmarked credit operations, leasing operations should be highlighted again, due to the 74.8% and 63.1% expansions observed in credit to individuals and to corporate operations, respectively. Concerning earmarked credit, the significant increases related to housing (22.0%) and the agricultural sector (21.1%), according to the same comparison basis. Loans to industry grew 2.5% in July and 22.1% in twelve months, whereas credit to commerce increased 0.8% and 17.5%, according to the same comparison bases.

51. The average interest rate on credit rates stood at 35.9% p.a. in July, a new record low for the series, leveling 6.3p.p. below the July 2006 result. The average rate on credit for individuals reached 47.0% p.a., down from 54.3% p.a. in the same month of 2006. The average rate on corporate credit decreased 5.3 p.p. in twelve months, standing at 23.0% p.a.

52. The average tenure of credit operations for individuals reached 407 days in July, compared to 341 in the same month of the previous year. The average tenure of personal credit operations totaled 434 days, an 87-day extension relative to July 2006, as a consequence of the increasing share of payroll-deducted contracts. In addition, it bears emphasizing the elevation of the average tenure of vehicles acquisition operations, which reached 567 days, up from 515 days in the last twelve months.

53. Delinquency rates in the financial system (non-earmarked loans in arrears for more than ninety days) reached 4.7% in July, remained unchanged relative to the previous month and decreased 0.1 p.p. relative to July 2006. Delinquency rate for corporate credit operations stood at 2.4%, a 0.1 p.p. decrease in the month, and remained stable in the last twelve months. Delinquency rate for credit operations with individuals reached 7.1% in July, decreasing 0.4 p.p. relative to the same month of 2006.

54. Net delinquency rate for retail credit, measured by the ACSP, reached 4.5% in July, compared to 3.9% in the same month of 2006 and to the 5.3% average of 2006.

External Environment

55. Global economic activity continued to expand in the first half of 2007, according to data recently released. The US economy recovered in the second quarter, with a 4% annualized growth. Japan and Euro area economies sustained their growth trend, with signs that their respective domestic demands have become more significant in this process. Emerging economies, led by fast growth in China, India and Russia, also showed robust expansion, favored by high liquidity e increasing commodities prices.

56. The turmoil caused by US subprime mortgages market, in mid-July, affected the credit market and other assets, spread risk aversion and reduced international liquidity. As a consequence, overall outlook became highly volatile, causing significant falls and massive sales in stock markets, lower global liquidity and some decline in energy and commodities prices. Under these circumstances, the main central banks carried out important short-term open market operations, aiming at keeping their respective basic interest rates close to the targets.

57. A lot of uncertainties still affect the markets, and it is not clear the time they will take to overcome it. Concerns about the subprime market and broader issues regarding the US credit market will continue to drive the scenario. Normal uncertainty, related to economic indicators and the coming decisions of the main central banks, will also be present, injecting volatility until the extension of the problem becomes clear, particularly in relation to the financial effects of subprime contracts. There is some consensus that the subprime mortgages crisis will hit the real sector of US economy and affect the country's growth, but the consequences over global economy tend to be less important.

Foreign Trade and International Reserves

58. Between January and August, Brazilian external trade confirmed the ongoing expansion, and reached record highs both in exports and in imports. The trade surplus reached US$27.5 billion in the period and US$ 44.2 billion in twelve months, while the external trade amounted US$ 177.4 billion and US$ 259.5 billion, respectively, in the same periods.

59. Exports totaled US$15.1 billion in August, with a US$656.6 million daily average, 10.5% above the August 2006 result. Manufactured, semi-manufactured and primary products reached daily averages of US$7.6 billion, US$ 2.1 billion and US$5.1 billion, respectively, totaling increases of 3.3%, 6.5% and 20.5% over August 2006 daily averages.

60. Imports totaled US$11.6 billion in August, a record high for the series, with a US$502.9 million daily average, a 26.9% increase over the same month of 2006. All import categories expanded, measured in daily averages, especially capital and consumer goods, which increased 42.7% and 30.5%, respectively: raw materials and fuels and lubricants grew by 29.3% and 2%, respectively, according to the same comparison basis.

61. At the end of August, international reserves totaled US$161.1 billion, increasing US$5.2 billion in the month, US$75.3 billion in the year, and US$89.6 billion compared to August 2006.

Money Market and Open Market Operations

62. After the July Copom meeting, the yield curve shifted strongly upward, particularly the long-tenure ones, influenced by the worsening of the US subprime mortgages market crisis, which effects impacted the market credit and the international liquidity. The concerns regarding the contagion gripping to the real sector and the increase of the risk aversion drove the migration to safer assets, which consequently led to BRL depreciation, the fall of the Ibovespa (Bolsa de Valores de São Paulo Index) and the Brazilian country risk increase. The coordinated action of several central banks, which provided liquidity to the interbank market, and the 0.5 p.p. fall of the discount rate of the Federal Reserve (Fed) on August 17, contributed to soften the stress in international financial markets and, as a result, the partial downward move of the yield curve. Between July 16 and September 3, one- and three-month rates fell 0.29 p.p. and 0.16 p.p., respectively, while the six-month rate increased 0.14 p.p. In addition, One-, two- and three-year rates also increased 0.57 p.p., 1.06 p.p. and 1.11 p.p., respectively. Real interest rates measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectations grew to 7.31% on September 3 from 6.95% on July 16.

63. In its open market operations, the BCB carried out, from July 17 to September 3, weekly five- and seven-month long fixed rate repo operations. The average daily balance of these operations amounted R$88.7 billion, of which R$62.7 billion were seven-month operations. In the same period, the BCB also conducted 37 overnight repo operations aimed at draining the excess liquidity from the market. On July 19, August 6 and August 13, the BCB also conducted borrowing operations with tenures of 17, 23 and 18 working days, respectively. In addition, the BCB 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$22.7 billion, borrowing.

64. Between July 17 and September 3, the National Treasury raised a total of R$22.8 billion, of which R$10.6 billion in fixed-rate securities: R$6 billion via issuance of LTNs maturing in 2008, and 2009 and R$4.6 billion in NTN-Fs maturing in 2011, 2013 and 2017. Issuance of LFTs totaled R$3.2 billion, for securities maturing in 2013. Issuance of inflation-linked NTN-Bs reached R$9 billion, for securities maturing in 2009, 2012, 2017, 2024, 2035 and 2045, of which R$4.6 billion were settled in other National Treasury securities.

65. In the same period, the Treasury conducted auctions to sell LTNs maturing in April and October 2008 and bought LTNs maturing in October 2007 and LTNs or NTN-Fs maturing in January 2008. These operations totaled R$3.3 billion. Similarly, the Treasury conducted auctions to sell LFTs maturing in 2013, totaling R$1.6 billion, and bought LFT maturing in 2007. The Treasury also conducted auctions to buy LTNs, NTN-Fs and NTN-Bs, amounting R$ 5.4 billion, R$ 152 million and R$ 131 million, respectively.