



Inflation Report

2007

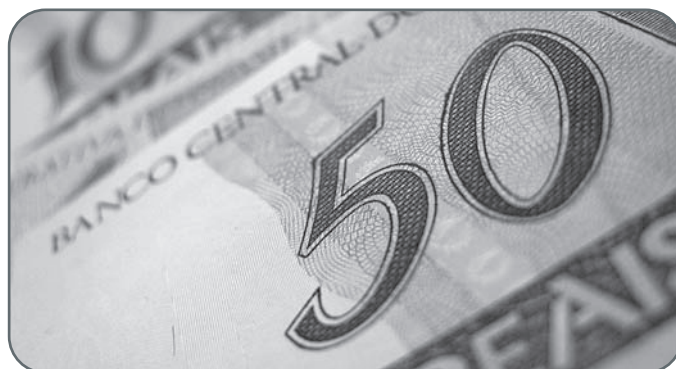


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Statistical Conventions:

- ... data not available.
- nil or non-existence of the event considered.
- 0 ou 0.0 less than half the final digit shown on the right.
- * preliminary data.

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A bar (/) between years (1970/1975) indicates the average of the years covered, including the first and the last year or even crop or agreement year, when mentioned in the text.

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Contents

Foreword	5
Executive summary	7
Economic activity	11
1.1 Retail sales	12
1.2 Production	15
Crop/livestock output	15
Crops	15
Livestock	16
Industrial output	17
1.3 Labor market	22
Employment	22
Income	23
1.4 Gross Domestic Product	24
1.5 Investments	25
1.6 Conclusion	27
Prices	33
2.1 General indices	33
2.2 Consumer price indices	34
2.3 Regulated prices	35
2.4 Cores	35
2.5 Market expectations	36
2.6 Conclusion	37
Credit, monetary and fiscal policies	39
3.1 Credit	39
Credit operations with earmarked resources	40
Credit operations with nonearmarked resources	41
3.2 Monetary aggregates	45
Federal public securities and Bacen open market operations	46
Real interest rates and market expectations	48
Capital market	48
Financial investments	49

3.3 Fiscal policy	50
Public sector borrowing requirements	50
Evolution in 2006	50
Evolution in January 2007	53
Federal securities debt	54
Net public sector debt	55
3.4 Conclusion	55

International economy **63**

4.1 Economic activity	63
4.2 Monetary policy and inflation	65
4.3 International financial markets	66
4.4 World trade	70
4.4.1 Commodities	71
4.4.1.1 Oil	72
4.5 Conclusion	72

External sector **79**

5.1 Exchange	80
5.2 Trade in goods	81
5.3 Services and income	84
5.4 Financial account	87
5.5 External sustainability indicators	90
5.6 Conclusion	91

Inflation outlook **93**

6.1 Determinants of inflation	94
6.2 Benchmark scenario: assumptions and risks	103
6.3 Inflation forecast	110

Boxes

Recent Behavior of Capital Goods Output	19
System of National Accounts – Reference 2000	28
Financing Alternatives to Bank Credits	42
Public-Private Partnerships	57
Fiscal and External Sustainability Indicators	73
Inflation Decomposition – 2006	113
Determinants of Interest Rate Maturity Risk Premium	116

Annex **119**

Appendix **143**

Foreword

Inflation Report is a quarterly publication of the Banco Central do Brasil with the objective of evaluating the performance of the inflation targeting system and providing a prospective scenario for inflation. The national and international economic conditions underlying decisions taken by the Monetary Policy Committee (Copom) concerning the monetary policy management are presented.

The *Report* is divided into six chapters: Economic activity; Prices; Credit, monetary and fiscal policies; International economy; External sector and Inflation outlook. With regard to the activity level, growth in retail sales, inventories, output, labor market and investments are investigated. In the following chapter, price analysis focuses on the results obtained in the quarter as a consequence of monetary policy decisions and the real conditions of the economy outside the realm of government action. The chapter referring to the credit, monetary and fiscal policies, the analysis is centered on the behavior of credit, financial and budget operations. In the chapter dealing with the international economy, the *Report* presents an analysis of the world's major economies and seeks to identify those conditions capable of impacting the Brazilian balance of payments. Insofar as the foreign sector chapter is concerned, analysis is targeted at economic-financial relations with the international community, with emphasis on trade results and foreign financing conditions. Finally, prospects on inflation growth are analyzed.

Executive summary

The Brazilian economy posted across-the-board expansion in the final two quarters of 2006, including not only supply as well as demand sectors. The outlook for 2007 points to further growth, primarily as a consequence of price stability, which has brought considerably less macroeconomic uncertainty, making it feasible to extend the reach of these decisions to much longer temporal horizons, while also stimulating progressive reductions in risk premiums. Therefore, the major contribution of monetary policy for the sustainable growth of the economy has been the improvement of macroeconomic conditions.

In this context, the Monetary Policy Committee (Copom) will continue to monitor closely the evolution of internal and external scenarios, as well as with the positive and negative risks associated with inflation projections, acting in order to ensure that inflation will converge to target.

Analysis of demand components shows sharp growth in Gross Fixed Capital Formation (FBCF) compared to the performance of household consumption in line with projections of even sharper economic growth in the coming quarters. Despite seasonal components, the steady growth in credit operations in the quarter ended in January partially reflects the positive macroeconomic environment and the impact of the gradual easing of monetary policy since September 2005. Credit growth, with stable default levels and increasingly longer maturities, associated with expanding employment, increasing real worker compensation and higher consumer confidence, will certainly contribute to the sustained domestic demand, particularly in regard to household consumption. In fact, the beginning of 2007 was characterized by a sharp upswing in revolving credit operations and personal loans, while payroll-deducted loans have been kept at high levels. On the other hand, business loans demand cooled as companies resorted increasingly to capital market operations.

With regard to the labor market, formal employment and real overall wages have evolved positively. Data released by the Brazilian Institute of Geography and Statistics (IBGE) and the Ministry of Labor and Employment (MTE) confirm continued growth in formal job openings and suggest that this trend will continue in 2007.

The recent evolution in public sector accounts indicates that the debt/GDP ratio remains on a downward-slope and that this trend will be further strengthened in 2007 by the gradual easing of monetary policy restrictions. Improvement in the Net Public Sector Debt (DLSP) profile, marked by lesser volatility in financing costs and longer maturity terms, reflects both efficient management of public sector liabilities and growing confidence on the part of economic agents. Recently adopted measures in the context of financial and budget programming further reinforced this confidence by enhancing the predictability of compliance with fiscal targets defined for the year.

The 2006 balance of payments posted its fourth consecutive current account surplus, indicating the magnitude of the ongoing structural adjustment of the nation's foreign accounts. Despite expanding imports, the major item underlying this process has been increasingly more positive trade balance results. These developments have made it possible to reduce net external public sector liabilities through both accumulation of international reserves and reductions in the external debt stock. Among the benefits garnered in recent months, mention should be made of sharp improvement in the nation's risk position, which dropped to 178 basis points in February, the lowest level since this series was first calculated in 1994, together with consolidation of expectations that the country will achieve investment grade ratings over the medium term. For 2007, despite the recent turmoil in international financial markets, the outlook for global liquidity remains positive, pointing towards the continuity of capital inflows for emerging markets. At the same time, positive expectations regarding world economic growth in 2007 have created a scenario of continued strong balance of trade surpluses.

Inflation for 2006 measured by the Broad Consumer Price Index (IPCA) dropped for the fourth consecutive year and closed below the target center (4.50%) defined by the National Monetary Council (CMN) for the first time since the implementation of the inflation targeting regime, in June 1999. Closing at 3.14%, inflation dropped 2.55 p.p. compared to the 2005 level. This result confirmed the positive consumer inflation scenario forecast repeatedly in

previous *Reports* and Copom Minutes. To a great extent, this scenario, which is expected to persist through the coming quarters, reflects the impact over time on inflation of the monetary policy adopted in recent years on inflation, at the same time in which it has paved the way for a process of sustained economic growth.

As mentioned in previous *Reports*, in the wake of the evident success achieved in the process of disinflation of the Brazilian economy in recent years, the inflation targeting system has entered a new stage aimed at consolidating stability around a target trajectory centered at 4.5% per year through 2008. Based on international experience, it is only natural that during this phase of price stabilization, effective rates of inflation will range around the midpoint of the upper and lower bounds defined by the monetary authority. This situation sharply contrasts with the performance registered during the disinflation process of recent years when inflation remained systematically above the target center during most of that period, though well within the established upper and lower bounds as of 2004.

The central projection for the benchmark scenario points to 3.8% inflation in 2007, well below the 4.50% target center defined by the CMN. As pointed out in the most recent *Inflation Report*, cumulative 12-month IPCA growth has gradually tended towards the inflation target center over the projection horizon, mostly reflecting the impact of Selic rate cutbacks. Cumulative 12-month inflation forecasts dropped to just 2.8% in the first quarter of 2007, before rising in the second and third quarters to 3.5% and 4.0%, respectively. For the final quarter of 2008, forecast cumulative 12-month inflation reached 4.4%, still below the 4.50% target center, though relatively higher than the projection for the same period in 2007 (3.8%).

In the market scenario, the forecast for 2007 cumulative inflation is 0.2 p.p. above the benchmark scenario projection (4.0% against 3.8%), well below the 4.50% target. Just as in the case of the benchmark scenario, projections for cumulative 12-month inflation indicate acceleration in the second and third quarters of 2007 and deceleration in the final quarter. Compared to the benchmark scenario, the slightly higher inflation forecasts for the final three quarters of 2007 were led by expectations put forward by analysts regarding Selic rate reductions and exchange rate depreciation over the projection horizon. The four-quarter cumulative inflation forecast rises to 5.0% at the end 2008.

In the benchmark scenario, a comparison of the projections presented in this *Report* with those announced in the previous *Report* points to a slight reduction (0.1 p.p.) in estimated inflation for 2007 and 2008. This occurred despite the 50 basis point reduction in the Selic rate since December 2006 and, on the one hand, has been generated to a great extent by the drop in 2007 and 2008 inflation expectations (from 4.1% to 3.8% and from 4.3% to 4.0%, respectively) and, on the other, by revision of projections of regulated prices in 2007 (from 4.8% to 4.5%) and exchange rate appreciation (R\$2.10 against R\$2.15, used in the December *Report*). In the market scenario, the drop in inflation forecasts was more accentuated than in the benchmark scenario, with 0.30 p.p. for 2007 and 0.40 p.p. for 2008. Aside from the factors mentioned above, this reduction also reflects attenuation of expectations regarding nominal exchange depreciation over the projection horizon considered.

Analysis of the benchmark scenario indicates a rise in 2007 gross domestic product (GDP) growth from 3.8% to 4.1%.

The pace of economic activity intensified throughout 2006 in a framework of price stability. Continued gradual easing of monetary policy restrictions aided in consolidating this process and generated expectations of more rapid and sustained economic expansion.

Calculated without the methodological alterations introduced by the IBGE¹, Gross Domestic Product (GDP) grew 2.9% in 2006. This expansion was driven mainly by accelerated third and fourth quarter growth and was compatible with the evolution of leading sectoral indicators and the scenario described in the December “Inflation Report”. Viewed in the broad concept, retail sales, which had risen 3.4% in the 12-month period through June, increased 6.4% in the year. It is important to note that marginal evolution of sales was particularly intense in the fourth quarter, with an increase of 8.6% compared to the same quarter of 2005. Using the same basis of comparison, overall wages of the employed population increased 5.7% through June, 6.7% in 2006 and 8.1% in the final quarter of the year.

Investments evolved in a similar manner, with increasingly greater cumulative 12-month growth between the end of the first and second halves of 2006, coupled with strong marginal growth in the fourth quarter of the year.

Consequently, the more accentuated second half GDP growth process incorporated the homogeneous behaviors of consumption and investments. In aggregate terms, growth in GFCF surpassed that of household consumption, clearly demonstrating the solidity of the current process of economic expansion.

In the labor market, both formal employment and real overall wages expanded. As regards the latter, growth was significantly impacted by the downturn in inflation rates.

1/ See box System of National Accounts – Reference 2000, page 28, in this “Inflation Report”.

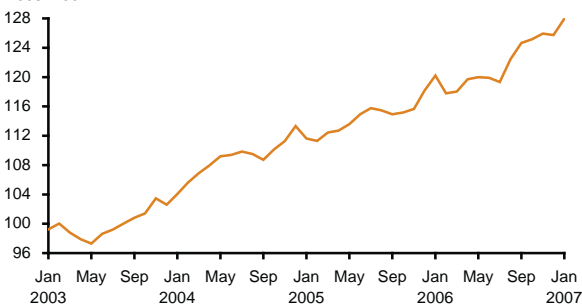
1.1 Retail sales

In 2006, retail activity indicators showed continuation of the growth trajectory already evident in 2004 and 2005. Early results for 2007, coupled with the evolution of factors that determine the thrust of retail sector activities, such as real income, credit market conditions and consumer confidence, indicate that growth will continue throughout the year.

According to IBGE's Monthly Retail Survey (PMC), the Retail Sales Volume Index rose 6.2% in 2006. Using the broad retail trade sector concept, which also encompasses the segments of building materials and automobiles, motorcycles, parts and spares, growth closed at 6.4%. The sector registered across-the-board sales increases, with the sole exception of an 8% decline under fuels and lubricants. The segments that registered the sharpest sales growth in 2006 were furniture and home appliances, 10.2%; hypermarkets, supermarkets, food products, beverages and tobacco, 7.5%; automobiles, motorcycles, parts and spares, 7.2%; and building materials, 4.7%. These data suggest that both rising income and the increased availability of credit have contributed to sustaining growth in household consumption.

Figure 1.1 – Retail sales

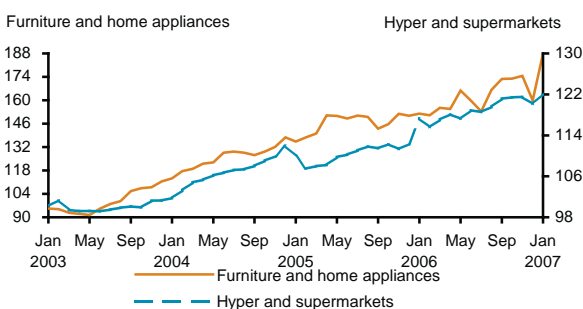
Seasonally adjusted data
2003=100



Source: IBGE

Figure 1.2 – Retail sales

Seasonally adjusted data
2003=100



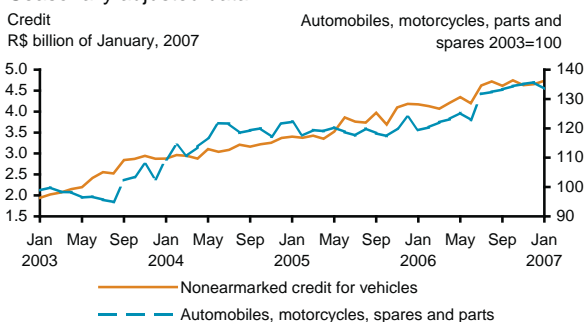
Source: IBGE

An analysis at the margin suggests a continued positive performance in the retail trade sector in 2007. In this context, seasonally adjusted sales expanded 2% in the three-month period ended in January, compared to the three-month period ended in October 2006. Positive sales performances were registered by all of the various segments, led primarily by fabrics, apparel and footwear, 3.8%; fuels and lubricants, 2.7%; and furniture and home appliances, 2%, using the same basis of comparison.

Sales of automobiles, motorcycles, parts and spares, which are not included in the restricted index, increased 1.1% in the quarter ended in January. When positive credit and labor market conditions are taken into account, this segment is expected to post highly positive results in 2007. This is already evident in figures released by the National Federation of Automotive Vehicle Distribution (Fenabrave), showing 18.3% growth in new vehicle sales through the first half of March, compared to the same period of 2006. Sales of building material increased 5.3% in the three-month period ended in January 2007, compared to the same period of the previous year. It is important to note that this result has not been seasonally adjusted, since the series dates back only to January 2004.

Figure 1.3 – Retail sales

Seasonally adjusted data



Source: IBGE and Banco Central do Brasil

Table 1.1 – Retail sales

2007, January

	% accumulated growth in 2006		
	Nominal revenue	Volume	Price
Retail sector	8.3	8.5	-0.2
Fuels and lubricants	2.3	2.5	-0.2
Hyper and supermarkets	5.8	4.9	0.9
Fabrics, apparel and footwear	11.1	6.5	4.3
Furniture and home appliances	18.7	24.1	-4.4
Broad retail sector	9.6	10.2	-0.5
Automobiles and motorcycles	11.7	14.3	-2.3
Building materials	11.5	8.0	3.2

Source: IBGE

Nominal sales revenues increased 8.3% in January 2007 compared to the same period of the previous year, mostly as a result of 8.5% growth in sales volume and a drop of 0.2% in retail prices. Excluding fuels and lubricants, nominal revenues expanded in all of the other segments, surpassing the 3% rate of inflation registered by IBGE's IPCA in the period.

With the exception of Mato Grosso (drop of 9.8%), all of the other states registered positive retail sales growth in 2006. The sharpest increases occurred in Roraima, 30.1%; Acre, 27.5%; Amapá, 23.6%; Alagoas, 18.7%; and Tocantins, 18.7%. Based on seasonally adjusted data for the three-month periods ended in January 2007 and October 2006, the strongest growth occurred in Alagoas, 7.3%; Acre, 7.1%; Mato Grosso, 5.5%; Mato Grosso do Sul, 4.9%; and the Federal District, 4.6%; while the sharpest drops were registered in Piauí, 5.1%; Roraima, 4.8%; Rondônia, 2.8%; Rio Grande do Norte, 2.2%; and Paraíba, 1%.

In 2006, retail sales increased in all of the five major regions² in the country, with 12.6% in the North region and 10.3% in the Northeast. Sales in the Southeast, South and Central-West regions increased 7%, 2.7% and 1.6%, respectively, in the year. The differences among regional results originated in the fact that the impact of federal government social assistance programs on consumer income is greater in the North and Northeast, while the crisis in the farm sector has had a more intense impact on the income of specific sectors in other regions of the country. However, a recent uptick in the activities of this sector reflects some degree of retail sales recovery in such specific regions as the South and Central-West in 2007.

The regional behavior of retail sales viewed in the broad concept followed the pattern already evident in the restricted concept. The only state to close with an annual decline in retail sales was Mato Grosso, 7.1%, while the other states mentioned above registered considerably more dynamic performances, including Amazonas, where sales expanded 20.7%, compared to 13.6% in the restricted concept.

Seasonally adjusted data released by the São Paulo Trade Association (ACSP) for the three-month periods ended in February 2007 and November of last year indicate that sales of high unit value goods have, to a certain extent, leveled off at a rather high plateau, while sales of items of lesser unit value and, therefore, more sensitive to consumer income, expanded in the period. Using this basis of comparison, the

2/ Data for the different regions were obtained by aggregating the sales volume index of each state. This procedure considered the participation of the gross sale revenues variable of each state in the total gross revenues of their respective regions, as shown on Table 11 of IBGE's 2004 Annual Retail Survey.

Table 1.2 – Retail sales

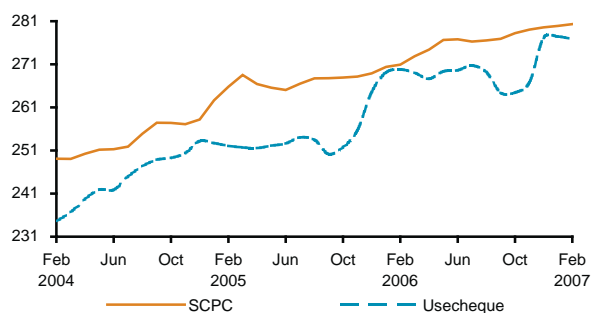
	% change				
	2006				2007
	Sep	Oct	Nov	Dec	Jan
In the month^{1/}					
Retail sector	1.8	0.4	0.6	-0.2	1.8
Fuels and lubricants	-0.6	-0.5	2.0	0.5	2.7
Hyper and supermarkets	1.3	0.2	0.1	-1.1	1.7
Fabrics, apparel and footwear	2.8	-3.2	5.6	-2.3	3.1
Furniture and home appliances	3.9	0.1	0.9	-8.4	17.5
Automobiles and motorcycles	0.6	0.9	0.5	0.4	-1.6
3-month period/previous 3-month period^{1/}					
Retail sector	1.9	3.6	3.9	2.8	2.0
Fuels and lubricants	2.2	3.1	2.1	1.8	2.7
Hyper and supermarkets	1.4	2.1	2.0	1.1	0.4
Fabrics, apparel and footwear	1.4	4.1	5.3	3.2	3.8
Furniture and home appliances	2.5	6.9	8.5	3.1	2.0
Automobiles and motorcycles	7.0	5.3	4.1	2.0	1.1
In the year					
Retail sector	5.8	5.9	6.2	6.2	8.5
Fuels and lubricants	-9.2	-8.9	-8.4	-8.0	2.5
Hyper and supermarkets	7.6	7.5	7.6	7.5	4.9
Fabrics, apparel and footwear	1.7	1.4	2.0	1.9	6.5
Furniture and home appliances	9.6	10.5	10.9	10.2	24.1
Automobiles and motorcycles	5.3	6.6	7.1	7.2	14.3

Source: IBGE

1/ Seasonally adjusted data.

Figure 1.4 – Retail sales indicators

Seasonally adjusted data – Quarterly moving average



Source: ACSP

Table 1.3 – Default rates

	%					
	2006			2007		Year ^{1/}
	Oct	Nov	Dec	Jan	Feb	
Returned checks^{2/}						
Brazil	6.2	6.2	5.5	6.3	...	6.3
Northern region	9.8	9.6	8.6	9.6	...	9.6
Northeast region	9.0	8.8	8.0	8.6	...	8.6
Southeast region	5.6	5.6	5.0	5.8	...	5.8
Central-western region	7.1	7.0	6.3	7.3	...	7.3
Southern region	5.9	5.8	5.2	6.1	...	6.1
SCPC (SP) ^{3/}	6.1	5.3	-0.6	5.6	6.3	6.0

Source: Banco Central do Brasil and ACSP

1/ Annual average.

2/ Returned checks/cleared checks.

3/ [New registrations (-) registrations cancelled]/[consultations (t-3)].

number of contacts with the Credit Protection Service Center (SCPC), used as an indicator of installment purchases, and with Usecheque, an indicator of check-based sales, increased 0.5% and 3.8%, respectively.

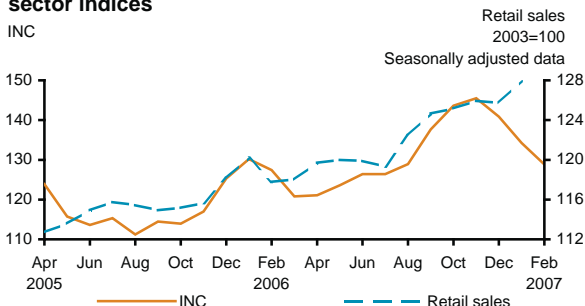
At the end of 2006 and early days of 2007, default indicators stood at a higher level than in the corresponding periods of previous years. Nonetheless, these figures were considered compatible with growth in retail sales. The ratio between the number of checks returned due to insufficient backing and total checks cleared in the country reached 6.3% in January 2007, repeating the result for the corresponding months of 2006. It should be stressed that this ratio is more accentuated in the North and Northeast regions of the country, precisely where sales have turned in their most dynamic performances. ACSP data for the first two months of the year indicate a slight rise in defaults from an average of 5.4% to 6%, compared to the same period of 2006.

Surveys on the evolution of consumer expectations indicate that early 2007 results were somewhat below those of the final quarter of the previous year, though still higher than in early 2006. The National Confidence Index (INC), released by the ACSP, closed February at 128.8 points against 134.2 points in January and 127.4 points in February 2006, thus remaining at a high level. In the month under consideration, the only region in which the INC did not decline was the Northeast. With regard to composition of the index, consumers showed greater wariness as regards the security of their jobs and investment capacity.

The Consumer Confidence Index (ICC), released by the Trade Federation of the State of São Paulo (Fecomercio-SP), registered a 0.7% rise in the quarter ended in March, compared to the three-month October-December 2006 period. When the various components are considered, the Consumer Expectations Index (IEC), which represents 60% of the general index, dropped 5.2%, and the Current Economic Conditions Index (Icea), which accounts for the remainder of the general index, rose 10.3% in the period.

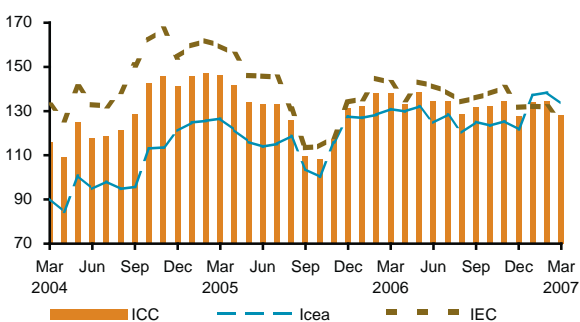
The National Consumer Expectations Index (Inec), measured by the National Confederation of Industry (CNI) on the basis of a survey carried out in the December 7-10, 2006 period, indicated a fourth quarter 2006 rise, with increases of 1.2% compared to the three-month period ended in September and 9.8% compared to the same period of the previous year. The optimism perceived by the Inec survey in the final quarter of 2006 was due mainly to positive expectations regarding the evolution of income, as demonstrated by 14.3% growth over the December 2005 position in the component that evaluates

Figure 1.5 – National Consumer Confidence and Retail sector indices



Source: ACSP and IBGE

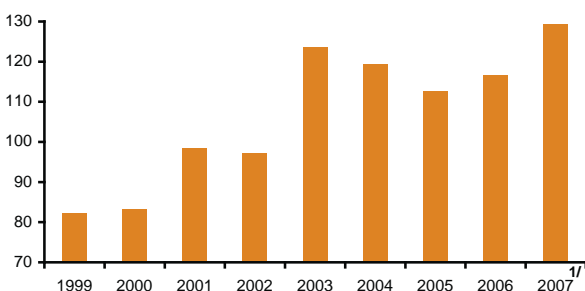
Figure 1.6 – Consumer Confidence Index



Source: Fecomercio SP

Figure 1.7 – Grain production

In million of tons



Source: IBGE
1/ Estimate.

this item. This result was 5.1% above the previous record for this series, set in September of that year. Consumers were less optimistic regarding inflation and employment than in the survey carried out in the third quarter of 2006.

The ICC, calculated by the Getulio Vargas Foundation (FGV) and composed of five questions included in the Consumer Expectations Survey, is based on a sampling of 2000 households in seven Brazilian state capitals. This index registered a drop of 1.3% in February 2007, compared to the previous month. Reductions also occurred in both the index that evaluates the current situation and that dealing with expectations for the coming months.

1.2 Production

Crop/livestock output

According to IBGE's Quarterly National Accounts, seasonally adjusted production of the crop/livestock sector expanded 0.2% in the fourth quarter of 2006, compared to the previous quarter, closing with cumulative 3.2% expansion in 2006. For 2007, the Systematic Farm Production Survey (LSPA) shows positive results for the corn, bean, soybean and sugarcane crops. The livestock segment is expected to continue the positive performance of recent years, despite a decline in 2006 exports, particularly in the segments of poultry and pork.

Crops

LSPA estimates for the 2007 harvest indicate 129.4 million tons of grain, 11% more than in the previous year. Growth of 17.1% is forecast for the southern region of the country, with 4.7% for the central-west region.

Soybean output is expected to total 56.7 million tons, for growth of 8.5% in the year. The area under cultivation is expected to decline 5.7%, reflecting migration of some farmers to more profitable crops like corn and sugarcane. Productivity is expected to increase 15.1%, as a result of increased cultivation in more productive land areas and favorable climatic conditions during the sowing period.

The corn harvest is estimated at 49.2 million tons. Annual growth is forecast at 15.8%, backed by 4.4% growth in the area under cultivation and 10.9% in productivity. The major determining factors underlying this performance

Table 1.4 – Farm production

	Production		% change 2007/06
	In 1,000 tons		
	2006	2007 ^{1/}	
Grain production	116 572	129 424	11.0
Cotton (seed)	1 817	2 307	27.0
Rice	11 505	11 045	-4.0
Beans	3 406	3 881	13.9
Corn	42 476	49 175	15.8
Soybean	52 235	56 700	8.5
Wheat	2 373	3 464	46.0
Others	2 761	2 852	3.3

Source: IBGE

^{1/} Estimate.

are more favorable climate conditions and better prices, reflecting increased international demand coupled with expectations of increased corn-based ethanol production in the United States.

The bean and herbaceous cotton seed harvests are forecast at 3.9 million and 2.3 million tons, respectively, in 2007, with increases of 13.9% and 27%. Production of rice is estimated at 11 million tons, down 4% compared to 2006. This performance reflects an unfavorable trajectory in the price curve of this product.

Sugarcane output is estimated to end 2007 at 490 million tons, 7% more than in the previous harvest. The area under cultivation is estimated at 6.6 million hectares, representing an annual increase of 6%, while the increase in average productivity is forecast at 0.9%. The development projected for this crop reflects good climatic conditions and greater external demand for sugar and alcohol. According to the Foreign Trade Secretariat (Secex), a component of the Ministry of Development, Industry and Foreign Trade (MDIC), foreign sales of sugar and ethyl alcohol totaled 2.9 million tons and 545.2 million liters, respectively, in the first two months of 2007, mirroring growth of 49.9% and 78.9% compared to the same period of 2006.

The coffee bean harvest is projected at 2.1 million tons, down 17.6% in annual terms. Though the area under cultivation will remain relatively stable, the projected 17.2% drop in average yield will reflect the low point of the two-year crop cycle.

Wheat production should reach 3.5 million tons, for annual growth of 46%. This forecast incorporates the clearly unfavorable results registered in the most recent harvest, which was sharply impacted by climatic adversities and clearly noncompetitive prices. The overall area under cultivation is expected to expand 13.8%, while average productivity should increase 28.3% in the year.

Livestock

According to the most recent Quarterly Animal Slaughter Survey, released in December 2006 by IBGE, cattle production reached 5.1 million tons in the first nine months of the year, for growth of 6.3% over the same period of 2006. Using the same basis of comparison, output of poultry and swine closed at 6.1 million tons and 1.7 million tons, for growth of 4.8% and 5.8%, respectively.

Table 1.5 – Livestock production

Total slaughters

Itemization	% accumulated growth in the year								
	2006								
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Cattle	8.6	6.7	9.1	4.5	6.0	5.5	5.2	5.5	6.3
Swine	12.7	9.9	9.0	4.7	5.8	5.4	6.2	6.4	5.8
Poultry	17.2	15.4	15.6	9.8	8.0	5.8	5.6	5.4	4.8

Source: IBGE

Foreign sales of beef totaled 1.2 million tons in 2006, for growth of 12.9% compared to 2005. In the opposite sense, exports of poultry and pork declined 6.4% and 16.4%, respectively, in the period.

Industrial output

In the three-month period ended in January 2007, industrial output expanded 1% in seasonally adjusted terms compared to the August-October 2006 period, indicating that the current cycle of industrial sector growth begun toward the end of 2005 has continued and is expected to turn in even better results in 2007. The industrial sector expanded 0.3% and 1% in the three-month periods ended in October and July 2006, compared to the equivalent previous periods.

For the most part, this behavior reflects manufacturing sector performance which, though it has expanded at a lesser pace than the mining sector, has shown evident signs of recovery since the second half of 2006, with 12-month growth moving from 1.6% in June 2006 to 2.7% in January 2007. Growth came to 1% and 0.4% in the three-month periods ended in January 2007 and October 2006, respectively.

The mining sector has benefited from the incentive of continued high prices for mineral commodities. Growth in this segment remains strong, reaching 2.6% in the three-month period ended in January, compared to the corresponding period ended in October 2006. This was the second highest level of seasonally adjusted three-month growth registered since August 2005, using this basis of comparison.

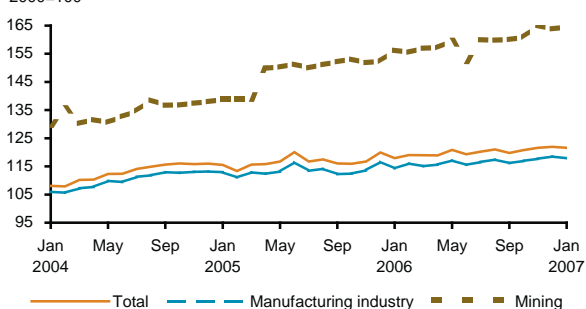
Utilizing seasonally adjusted data, the industrial segments that registered the highest rates of growth between the three-month periods ended in January 2007 and October 2006 were other transportation equipment, 8.2%; office machines and computer equipment, 7.7%; publishing, printing and reproduction of recordings, 6.9%; and beverages, 5.4%. In the opposite sense, it is important to stress the reductions that occurred in the output of the sundry sector, 9.5%; medical-hospital, optical and other types of instrumentation equipment, 15.1%; tobacco, 7.5%; and electronic equipment, apparatuses and communications equipment, 4.8%.

Using the same basis of comparison, it is important to underscore 6.6% growth in the output of capital goods, driven primarily by the segments of office machinery and computer equipment, electric machines, apparatuses and equipment, machines and equipment and other types of transportation equipment. This performance marked

Figure 1.8 – Industrial production

Seasonally adjusted data

2000=100



Source: IBGE

Table 1.6 – Industrial production

	% change			
	2006			2007
	Oct	Nov	Dec	Jan
Industry (total)				
In the month ^{1/}	0.9	0.7	0.3	-0.3
3-month period/previous 3-month period ^{1/}	0.3	0.4	0.9	1.0
Same month of the previous year	5.0	4.1	0.3	4.5
Accumulated in the year	2.9	3.0	2.8	4.5
Accumulated in 12 months	2.7	3.0	2.8	2.9
Manufacturing industry				
In the month ^{1/}	0.7	0.6	0.7	-0.5
3-month period/previous 3-month period ^{1/}	0.4	0.4	0.9	1.0
Same month of the previous year	5.0	3.9	-0.1	4.5
Accumulated in the year	2.7	2.8	2.6	4.5
Accumulated in 12 months	2.5	2.8	2.6	2.7
Mining				
In the month ^{1/}	0.5	2.6	-0.8	0.4
3-month period/previous 3-month period ^{1/}	1.9	3.0	2.1	2.6
Same month of the previous year	4.8	8.8	7.9	5.1
Accumulated in the year	7.1	7.3	7.4	5.1
Accumulated in 12 months	7.6	7.5	7.4	6.7

Source: IBGE

1/ Seasonally adjusted data.

Table 1.7 – Industrial production by category of use

	% change			
	2006			2007
	Oct	Nov	Dec	Jan
In the month^{1/}				
Industrial production	0.9	0.7	0.3	-0.3
Capital goods	-0.4	1.7	7.3	1.7
Intermediate goods	-0.2	1.8	0.3	-0.3
Consumer goods	1.2	0.0	0.5	-0.6
Durables	3.0	-0.3	-0.2	2.1
Semi and nondurables	0.5	-0.5	1.0	-0.9
3-month period/previous 3-month period^{1/}				
Industrial production	0.3	0.4	0.9	1.0
Capital goods	2.6	1.4	3.4	6.6
Intermediate goods	-0.3	-0.6	0.0	1.0
Consumer goods	-0.2	0.2	0.8	0.6
Durables	-0.9	-1.6	0.2	0.7
Semi and nondurables	-0.3	-0.2	0.2	0.1
In the year				
Industrial production	2.9	3.0	2.8	4.5
Capital goods	5.5	5.7	5.7	18.0
Intermediate goods	2.0	2.1	2.1	3.2
Consumer goods	3.8	3.9	3.3	3.0
Durables	6.9	7.1	5.8	4.7
Semi and nondurables	2.9	2.9	2.7	2.6

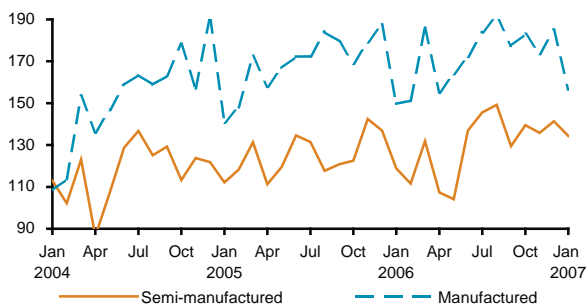
Source: IBGE

1/ Seasonally adjusted data.

Figure 1.9 – Industrial exports – Volume

Seasonally adjusted data

2002=100



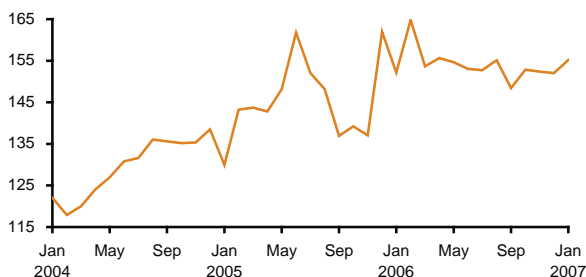
Source: Funcex

Figure 1.10 – Industrial production

Consumer goods

Seasonally adjusted data

2000=100



Source: IBGE

continuation of the output growth process under this use category that began in the three-month period ended in June 2006. Production of intermediate goods increased 1% in the three-month period ended in January, followed by consumer goods, with 0.6%. Output of semi-durable and nondurable consumer goods and consumer durables expanded 0.1% and 0.7%, respectively.

According to seasonally adjusted data, regional industrial output indices registered highs in ten of the thirteen states analyzed and in the northeast region in the three-month period ended in January, compared to the corresponding period ended in October. The highest rates of growth occurred in the states of Goiás, 4.9%, and Paraná, with 4.9% also, while negative rates occurred in Ceará, 2.2%, in the northeast region, 0.5%, and São Paulo, 0.4%.

According to CNI statistics purged of seasonal factors by the Central Bank's Department of Economics (Depec), real industrial sales increased 3.6% in the quarter ended in December, compared to the July-September 2006 period, when sales had increased 2% using the same basis of comparison. Real sales accelerated in the second half of 2006, posting growth of 4.4% over the previous half-year period, when real sales had expanded 0.9% using the same basis of comparison. CNI data from which Depec has removed seasonal factors also indicate that hours worked rose 1.1% in the October-December period, compared to July-September 2006.

Data on industrial employment released by CNI indicate employment growth in the sector. According to CNI, personnel employed by industry rose 1.1% in seasonally adjusted terms in the fourth quarter of 2006, compared to the previous quarter, following 1.2% and 0.7% in the second and third quarters of that year, respectively. According to data seasonally adjusted by Depec, growth in industrial employment reached 1.8% in the second half of 2006, against 1.2% in the previous half-year period. In contrast to CNI data, seasonally adjusted statistics on salaried employed personnel in the industrial sector dropped 0.1% in the October-December quarter, compared to the three-month period ended in September. This result followed consecutive growth figures of 0.4% in the three-month periods ended in June and September 2006.

According to CNI data from which Depec has removed seasonal factors, the level of utilization of the installed industrial capacity reached 81.9% in December 2006, compared to 82.2% in September and 81.9% in December of the previous year. Utilizing seasonally adjusted FGV

Recent Behavior of Capital Goods Output

Table 1 – Growth of industrial and capital goods output

Period	Industry	%	
		Capital goods	
2003	0.1	2.2	
2004	8.3	19.7	
2005	3.1	3.6	
2006	2.8	5.7	

Source: IBGE

According to the IBGE's Monthly Industrial Survey (PIM-PF), industrial activity expanded 2.8% in 2006. All of the various use categories posted positive growth, led by 5.7% expansion in the production of capital goods. This was the fourth consecutive positive annual result and brought the four-year 2003-2006 average growth rate to 7.5%. More recent data suggest that this tendency will continue through the coming months, indicating a positive outlook for steady growth in the productive output capacity of the Brazilian economy.

A breakdown of 2006 capital goods output according to destination indicates positive growth in the performance of manufacturing, construction and electricity in the coming years. High rates of growth in the output of capital goods for these segments and

Table 2 – Capital goods selected indicators

Itemization	Percentage share ^{1/}	In the month ^{2/}	In the 3-month period ^{2/}	% change		
				Growth over previous year		In 2006
				Month/	3-month period/	
				Month	3-month period	
Capital goods output	100.0	1.7	6.6	18.0	10.3	5.7
For industrial purposes	16.8	4.8	3.6	26.8	16.6	5.5
In series	14.0	2.8	1.0	30.1	17.6	5.2
On an order basis	2.8	2.2	-1.1	10.8	10.8	6.9
Farm	4.8	8.5	28.4	9.4	6.4	-16.5
Farm components	0.1	-68.4	136.7	-36.8	5.0	-38.9
Construction	3.6	5.2	6.1	11.8	2.5	8.2
Electricity	5.3	33.2	2.7	16.6	2.5	22.2
Transportation equipment	36.2	-4.6	1.1	12.6	3.1	-1.6
Mixed use	33.1	1.6	4.7	18.9	16.3	11.6

Source: IBGE

1/ Estimated.

2/ Seasonally adjusted.

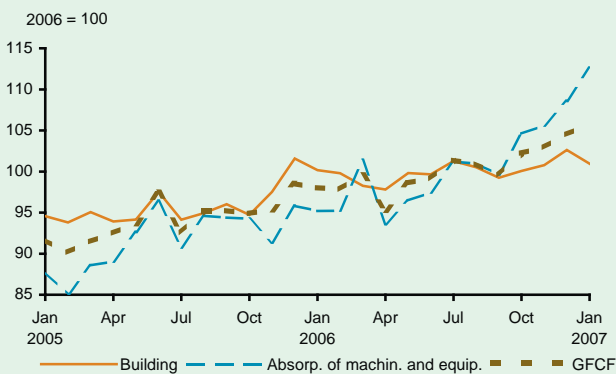
capital goods for mixed use, accounting for a joint total of 60% of overall capital goods produced, guaranteed the positive performance of the capital goods industry in 2006. The segments that turned in negative output results were those related to transportation equipment, with a drop of 1.6% following 2005 expansion of 6.6%, and the farm sector where, for the second consecutive year, production reflected farm income losses in the last two years.

More recent data, encompassing the three-month period ended in January 2007, show across-the-board growth in output for the different sectors, led by recovery in capital goods production for the farm sector, including output of machines and parts. At the same time, data released by the National Association of Automotive Vehicle Manufacturers (Anfavea) for the month of February indicate continued growth in the output of farm machinery, suggesting an ongoing process of recovery in this sector generated by both a larger agricultural harvest and a new cycle of farm machinery renovation in general.

Steady growth in the output of capital goods is important in light of its direct relationship with GFCF and, consequently, with the country's investments. According to IBGE's Quarterly System of National Accounts, GFCF expanded in 2006 at a rate of 6.3% compared to the previous year. This growth was due both to the construction industry and absorption of capital goods or, in other words, internal production plus net imports of capital goods.

Capital goods output in 2006, coupled with imports, were also stimulated by lower relative prices, ensuring growth in capital goods absorption with positive impacts on GFCF. Differently from what occurred in 2004, it is worth mentioning that the volume of exports in 2006 declined 0.6%, while capital goods imports rose 24% in volume, according to the Foreign Trade Studies Center Foundation (Funcex). In 2004, exports of capital goods increased 71.1% compared to the previous year. In terms of their impact on the volume of capital goods incorporated by the economy, this performance neutralized 10.2% growth in imports. In that year, annual estimated growth in absorption in the range of 20% reflected 19.7% expansion in internal capital goods output.

Figure 1 – Investment – Seasonally adjusted series



Another topic that deserves consideration is the growth resulting from capital goods production for industrial purposes. The sector registered highs of 5.5% in 2006 and 16.6% in the quarter ended in January 2007, compared to the same period of the previous year. Since this sector is focused primarily on meeting industrial demand, these data indicate growth in the output capacity of the manufacturing sector, contributing directly to sustained economic expansion.

The positive performance of the industrial sector has been reflected in confidence indicators. The Industrial Survey carried out by CNI for the fourth quarter of 2006 suggests more optimistic expectations on the part of industrial executives for the first six months of 2007. CNI's Executives Industrial Confidence Index, which is based on the results of the Industrial Survey, reached 59 points in the most recent study carried out in the fourth quarter of 2006. This result corresponded to increases of 4 points compared to the third quarter survey and 1.8 points when viewed against the final three months of 2005. Corroborating CNI data, the Manufacturing Industry Survey released monthly by FGV indicates an increase in the Expectations Index from 96.8 in December 2006 to 103.5 in February 2007, revealing evident improvement in the confidence level of industrial executives for the coming months.

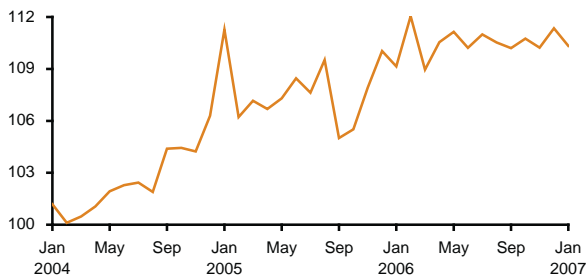
In this scenario, capital goods output data indicate a robust growth trend and suggest that this trajectory will continue into the future. Parallel to this, with country risk at historically low levels, expectations of sharp GDP growth and exchange stability at a level quite close to that of 2006, coupled with the expectations shown by the surveys released in the Central Bank Market Report will certainly contribute to continued growth in capital goods absorption and, consequently, in GFCF.

Figure 1.11 – Industrial production

Semi and nondurable goods

Seasonally adjusted data

2000=100



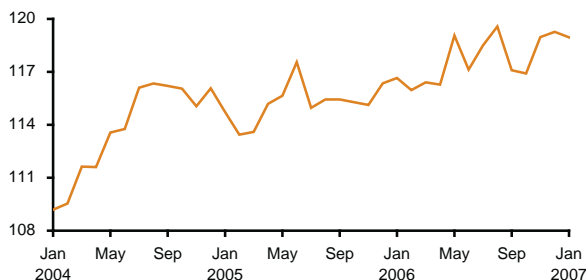
Source: IBGE

Figure 1.12 – Industrial production

Intermediate goods

Seasonally adjusted data

2000=100



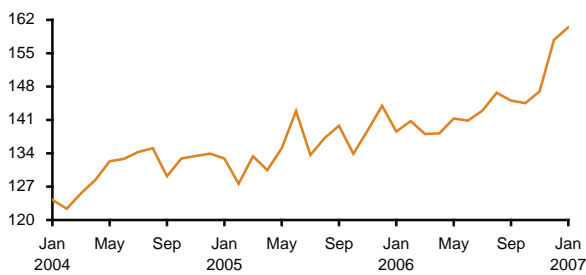
Source: IBGE

Figure 1.13 – Industrial production

Capital goods

Seasonally adjusted data

2000=100

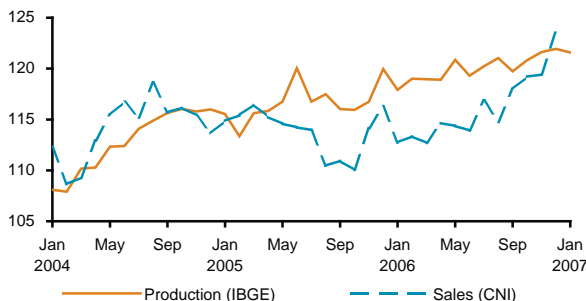


Source: IBGE

Figure 1.14 – Industrial production and sales

Seasonally adjusted data

2000=100



Source: IBGE and CNI

data, the same variable climbed to 83.4% in January, 0.3 p.p. above the level registered last October and 0.6 p.p. above the January 2006 result. Considering the statistical series observed³, the index reached 84% in February 2007, in comparison to 82.8% in the same month of 2006. This result was impacted by growth of 85.2%, compared to 78.7% in the capital goods industry.

Recovery in manufacturing sector activity will also be determined by inventory adjustments in the fourth quarter of 2006. According to CNI's Industrial Survey, stocks of final products declined in the period among large, medium and small companies. The resulting index, which represents the difference between real stocks and planned stocks, closed at 50.6 points, a level indicating that real inventories were compatible with the desired levels. Stocks of raw materials and intermediate products also closed nearly the level desired by the industrial sector.

Industry executives expressed considerable optimism with respect to economic conditions in the first half of 2007. The fourth quarter 2006 CNI Industrial Survey registered increased optimism regarding economic conditions in the following six months, compared to the third quarter results. The FGV Manufacturing Industry Survey for February 2007 showed monthly increases of 7.5 points in the Current Situation Index (CSI) and 4.8 points in the Expectations Index (EI). In the latter case, the index reveals the expectations of businesspersons regarding the following months, indicating an increase of 7.4% in optimism regarding production, compared to the January 2006 figure.

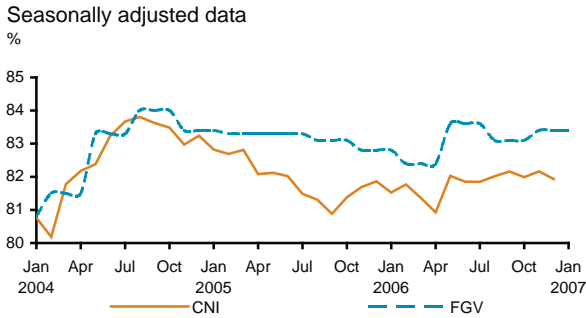
1.3 Labor market

Employment

According to IBGE's Monthly Employment Survey (PME), which includes six metropolitan regions, the process of job market recovery begun in the second half of the year continued through December 2006. With the end of the holiday season in January 2007, the employment level declined somewhat, with elimination of 143,000 positions in the November 2006-January 2007 period. However, the number of persons employed increased 2.6% compared to the January 2006 figure.

3/ FGV data on utilization of installed industrial capacity became monthly as of October 2005. Consequently, a sufficient number of observations does not exist that would make it possible to use the seasonally adjusted filter. The quarterly series (for January, April, July and October) began in April 1995, making it possible to estimate the seasonally adjusted series.

Figure 1.15 – Utilization of installed capacity in the manufacturing industry



Source: CNI and FGV

Table 1.8 – Manufacturing industry inventories^{1/}

	2006			
	I Q	II Q	III Q	IV Q
Manufacturing industry				
Final products	52.3	53.8	51.9	50.6
Raw materials/intermediate goods	48.5	49.3	49.2	49.3
Large companies				
Final products	53.9	55.4	54.4	51.7
Raw materials/intermediate goods	50.7	52.5	52.0	51.5
Small and medium companies				
Final products	51.4	53.0	50.6	50.1
Raw materials/intermediate goods	47.3	47.6	47.7	48.2

Source: CNI

^{1/} Values over fifty indicate inventories above the planned level.

Figure 1.16 – Unemployment rate

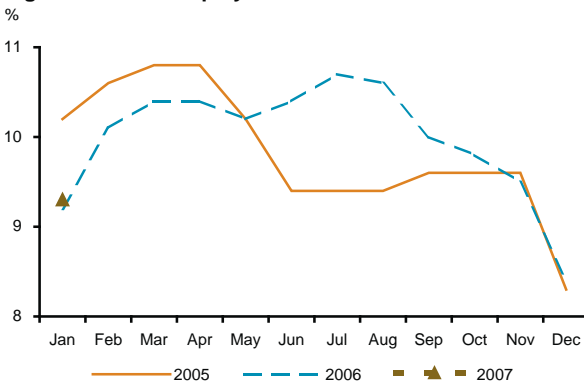


Table 1.9 – Formal employment

	New job openings – Accumulated in the period (1,000 employees)					
	2006					2007
	I Q	II Q	III Q	IV Q	Year	Jan
Total	339.7	584.1	460.0	- 155.1	1 228.7	105.5
Manufacturing industry	68.0	146.9	131.8	- 96.4	250.2	39.1
Commerce	5.5	66.2	104.7	160.4	336.8	- 9.9
Services	158.7	166.1	171.3	25.4	521.6	47.3
Building	41.4	37.5	52.5	- 45.6	85.8	11.7
Crop and livestock	39.1	152.5	- 7.2	- 177.8	6.6	17.2
Public utilities	4.2	3.6	2.7	- 3.2	7.4	0.8
Others ^{1/}	22.8	11.3	4.3	- 18.0	20.3	- 0.8

Source: MTE

^{1/} Includes mining, public administration and others.

On average, unemployment in the three-month period ended in January closed at 9.1%, compared to 10.1% in the three-month period through October. The 0.9 p.p. increase in unemployment in January to a level of 9.3%, compared to December, was typically seasonal in nature, and reflected layoffs of temporary workers contracted toward the end of the year.

IBGE's PME showed reductions in the number of registered and nonregistered workers in the November-January period. It is important to recall, however, that the drop in the number of registered workers is a seasonal phenomenon, while reductions in the number of nonregistered workers reflects a trend evident since February 2005. The 153,000 private sector jobs eliminated in the three-month period ended in January 2007 included 21,000 registered positions and 132,000 nonregistered workers.

Data released in the MTE's General File of Employed and Unemployed Persons (Caged) reveal highly positive results in generation of registered worker positions, with 1,229,000 new positions in 2006. In the year, the job supply increased 5.7% in both the building industry and commerce, followed by 4.8% in the service sector. According to Caged, 564,000 jobs were created in metropolitan regions in 2006, compared to 570,000 in 2005, while other regions of the country generated 664,000 and 684,000 positions, respectively.

More recent Caged data suggest continuation of the formal employment trend in the current year. January witnessed creation of 105,468 positions, approximately 22% more than in January 2006. In the three-month period ended in January, growth in formal employment reached 1.2% compared to the three-month period ended in October, with 1.6% in the sector of commerce, 1.2% under services and 1.1% in manufacturing.

According to CNI data gathered among twelve state federations, manufacturing sector employment increased 2.2% in 2006, with an increase of 1.1% in the final quarter of the year, compared to the three-month period ended in September.

Income

Average real income regularly received by workers in the six major metropolitan regions covered by the PME increased at an average rate of 1.2% in the November-January 2007 period, compared to the August-October 2006 period. Average earnings reached R\$1,066.10 in January, reflecting

Figure 1.17 – Employment in the manufacturing industry – Quarterly moving average
Seasonally adjusted data

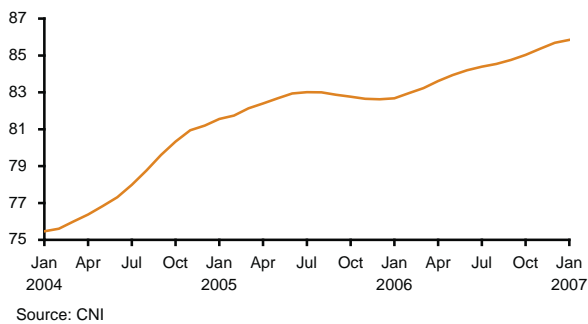


Figure 1.18 – Average real regular earnings^{1/}
In R\$ of January 2007, deflated by INPC

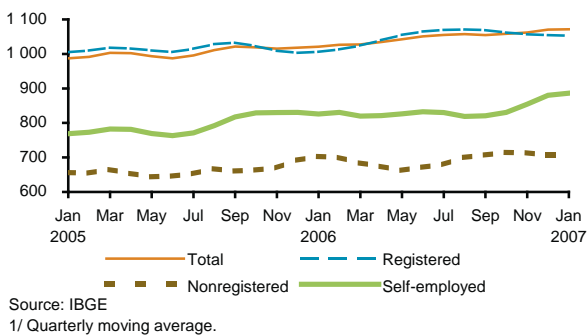


Table 1.10 – Gross Domestic Product at market prices

	2005	2006				% growth
		I Q	II Q	III Q	IV Q	
Accumulated in the year	2.3	3.3	2.2	2.5	2.9	
Accumulated in 4 quarters	2.3	2.4	1.7	2.3	2.9	
Quarter/same quarter of the previous year	1.4	3.3	1.2	3.2	3.8	
Quarter/previous quarter ^{1/}	0.7	1.2	0.6	0.8	1.1	
Crop and livestock	2.4	2.3	1.3	1.2	0.2	
Industry	1.0	1.4	0.0	0.8	1.6	
Services	0.6	0.6	0.6	0.5	0.8	

Source: IBGE

1/ Seasonally adjusted data.

a nominal increase of 8.1% compared to the same month of 2006. In real terms, using IBGE's National Consumer Price Index (INPC) as deflator, the increase came to 4.7%.

Real overall wages, a concept described as the product of real average income regularly received divided by the number of persons employed, expanded an average of 1.6% in the three-month period ended in January, compared to the August-October period, and 7.8% when viewed against the same period of the previous year. Evidently, these figures indicate an ongoing steady increase in labor earnings.

1.4 Gross Domestic Product

According to IBGE's Quarterly National Accounts, GDP expanded 2.9% in 2006. Once again, positive growth occurred in all product components. From the viewpoint of demand, however, just as occurred in 2005, the external sector made a negative contribution of 1.4 p.p., in contrast to positive 3.7 p.p. growth in internal demand, resulting in a 0.5 p.p. positive contribution to inventory formation.

Cumulative results for the year showed growth in all major production sectors. Crop/livestock output rose 3.2%, mainly as a result of a 3.6% high in the grain harvest. Crop production turned in average productivity gains of 8.4%, primarily due to improved climatic conditions, while the area under cultivation declined 4.4%. In the livestock segment, both internal demand and exports of beef cattle increased.

Industrial activity rose 3% in 2006, with positive growth in all of the different subsectors. Mining industry output expanded 5.6%, reflecting increases of 5.6% in oil output, according to figures released by the National Petroleum Agency (ANP), and 10.9% in production of iron ore. Parallel to these results, building industry activity increased 4.5%, coupled with 3.3% growth in public utility industrial services, mainly involving electricity generation. The manufacturing sector posted output growth of 1.9%.

Service sector product expanded 2.4% in 2006, with positive performances in the sectors of commerce and transportation, with respective growth rates of 4% and 2.2%. In the same sense, growth occurred in the segments of financial institutions, 2.6%; other services, 2.5%; rentals, 2.2%; public administration services, 2.1%. The only subsector to register negative growth in 2006 was that of communications, with 0.9%.

Table 1.11 – Gross Domestic Product

Accumulated in the year

	2005	2006				% growth
		I Q	II Q	III Q	IV Q	
Crop and livestock	0.8	-0.5	0.3	2.5	3.2	
Industry	2.5	4.8	2.6	2.7	3.0	
Mining	10.9	12.6	6.7	5.6	5.6	
Manufacturing	1.3	2.7	1.0	1.4	1.9	
Construction	1.3	7.0	4.7	5.0	4.5	
Public utilities	3.6	4.2	2.8	3.0	3.3	
Services	2.0	2.7	2.3	2.3	2.4	
Commerce	3.3	4.9	3.6	3.5	4.0	
Transportation	3.2	3.6	2.2	2.4	2.2	
Communications	0.1	0.0	-1.5	-1.2	-0.9	
Financial institutions	2.4	2.9	2.2	2.5	2.6	
Other services	1.3	2.9	2.9	2.7	2.5	
Rents	2.5	2.4	2.4	2.2	2.2	
Public administration	1.7	2.1	2.0	2.0	2.1	
Financial dummy	2.1	2.7	1.8	2.3	2.5	
Value added at basic prices	2.1	3.0	2.0	2.4	2.7	
Taxes on products	3.9	5.9	4.0	4.0	4.4	
GDP at market prices	2.3	3.3	2.2	2.5	2.9	

Source: IBGE

Table 1.12 – Gross Domestic Product^{1/}

Accumulated in the year

	2005	2006				% growth
		I Q	II Q	III Q	IV Q	
GDP at market prices	2.3	3.3	2.2	2.5	2.9	
Household consumption	3.1	3.6	3.8	3.7	3.8	
Government consumption	1.6	1.9	1.9	1.9	2.1	
GFCF	1.6	9.0	5.9	6.0	6.3	
Exports	11.6	9.3	4.1	5.3	5.0	
Imports	9.5	15.9	13.9	16.1	18.1	

Source: IBGE

1/ Seasonally adjusted.

Table 1.13 – Gross Domestic Product

Quarter/previous quarter

Seasonally adjusted

	2005	2006				% growth
		IV Q	I Q	II Q	III Q	
GDP at market prices	0.7	1.2	0.6	0.8	1.1	
Crop/livestock	2.4	2.3	1.3	1.2	0.2	
Industry	1.0	1.4	0.0	0.8	1.6	
Services	0.6	0.6	0.6	0.5	0.8	
Household consumption	1.0	0.4	1.3	0.8	1.5	
Government consumption	0.1	1.2	0.5	0.2	0.6	
GFCF	1.4	2.3	-0.1	2.8	2.0	
Exports	1.6	4.7	-7.0	8.2	-0.6	
Imports	-0.7	12.4	-0.7	9.0	2.2	

Source: IBGE

Improvement in economic performance in 2006 can be assessed by growth in GDP and domestic demand (consumption and GFCF) over four quarters. Following a decline in the four quarter period ended in June 2006, when growth came to only 1.7%, the pace of GDP growth closed the year with a high of 2.9%. The increase in domestic demand was even more significant, as overall expansion in the four quarters of the year moved from 2.5% in 2005 to 2.9% in the first quarter of the year, 3% in the second, 3.5% in the third and a cumulative overall 2006 result of 3.9%.

Based on seasonally adjusted data and considering growth at the margin, GDP registered a fourth-quarter rise of 1.1%, compared to the third quarter of the year. This figure was clearly in line with the results suggested by both leading and coincident indicators. Crop/livestock output increased 0.2% in the quarter, due primarily to the results achieved by the livestock segment, since such important crops as wheat were adversely impacted by climatic adversities. Using the same basis of comparison, industry and services posted increases of 1.6% and 0.8%.

Analysis from the viewpoint of demand reveals factors that clearly favor the sustainability of the growth process. Quarterly growth in GFCF came to 2%, while household and government consumption increased 1.5% and 0.6%, in that order. With regard to the external sector, exports dropped 0.6% and imports rose 2.2% in a quarter-on-quarter comparison in the final three months of the year.

Following incorporation of a more optimistic scenario for the crop/livestock sector, forecast to expand 4.8% against the previous estimate of 3.7%, expectations for the Brazilian economy in 2007 are quite positive. Central Bank estimates of GDP growth were revised upward from 3.8% to 4.1%. Estimates for the industrial and service sectors were revised from 4.7% and 2.4%, respectively, to 5% and 2.6%. It is important to underscore that the change in GDP estimates incorporates only recent economic results, without taking into account the future positive impacts of the Growth Incentive Program (PAC) announced by the government, as well as methodological alterations in the National Accounts adopted by IBGE.

1.5 Investments

According to the Quarterly National Accounts, when stock variations are excluded, investments increased 6.9% in the fourth quarter of 2006, compared to the same period

of 2005. This was the fifth consecutive quarter of positive growth using this basis of comparison. In comparison to the immediately previous quarter, growth closed at 2%, calculated on the basis of seasonally adjusted data, following 2.8% expansion in the third quarter. The excellent fourth-quarter performance contributed to 6.3% growth in GFCF in 2006.

The investment increase reflected in national accounts was deemed compatible with growth in leading monthly indicators of GFCF. Production of building industry inputs grew 3% in the fourth quarter of 2006, compared to the same quarter of the previous year, while output and imports of capital goods expanded 7.8% and 26.6%, in that order, resulting in 12.5% growth in absorption of this product category, using the same basis of comparison.

Compared to the same period of 2005, growth in capital goods output in the fourth quarter of 2006 was driven by 16.9% expansion in the production of mixed use products and 16.4% growth under capital goods for industrial purposes (See box Recent Behavior of Capital Goods Output, page 19 in this Report). Output in the segments of capital goods for industrial use (including both those produced in series and those produced on an order basis) also increased when this basis of comparison is utilized. In this context, it is important to mention that recovery in goods produced in series has been clearly consolidated.

Among capital goods segments, only output of capital goods for agricultural use and parts for farm machinery declined in the final quarter of 2006, compared to the same period of 2005. This was the 10th consecutive negative result using this type of comparison. However, at the margin, data revealed a turnaround in this trajectory. When the seasonally adjusted series are considered, the two segments registered strong fourth quarter growth, compared to the third quarter, indicating recovery in farm sector income. This idea is further corroborated by more recent seasonally data adjusted by Anfavea, which show growth of 3.9% and 0.5% in the production of farm machinery in January and February of this year, respectively, compared to the previous month.

The outlook for investment performance in 2007 is also positive. This scenario is further reinforced by the evolution of such leading indicators as Brazil risk, measured by the Emerging Markets Bond Index Plus (Embi+), interest rate levels, such as the Long-Term Interest Rate (TJLP) and the Selic benchmark rate, all of which are now at their historically lowest levels. Other factors to be considered are the volume of investments foreseen in the PAC, as well

as the complementary investments still to be made in the framework of that program.

1.6 Conclusion

In the final two quarters of 2006, the Brazilian economy showed across-the-board acceleration of growth, in terms of the various economic sectors and demand components. Continuation of this trajectory, to some extent driven by the impact of monetary policy easing on credit, has become an additional factor in consolidating the current high level of activity through 2007.

Analysis of the various demand components revealed stronger growth in GFCF compared to household consumption, meaning that the pace of the growth process will increase in coming quarters. Consequently, the outlook for continued expansion in productive capacity during the remainder of the year is quite positive, and will certainly reflect the historically low levels of both Brazil risk and interest rates, in a framework of price stability and business community optimism. Household consumption will reflect the real income gains of the population, improved credit conditions and a higher level of consumer confidence.

System of National Accounts – Reference 2000

As a March of this year, IBGE will introduce alterations into the System of National Accounts (SNA), using a new reference in publishing National Accounts data. Among the major changes, the following deserve mention: adoption of the year 2000 as initial reference; broadening of the data base, using information from various surveys carried out by IBGE and by external sources; and methodological changes in the manner in which activities are measured in important segments of the economy.

The major objective of the change in the initial reference year from 1990 to 2000 is incorporation of new data sources and new structures, with the ultimate aim of more precisely portraying the real functioning of the economy. However, these incorporations do not imply modifications in the conceptual structure of the system which will still be based on the Resources and Uses Tables (RUT) and the Integrated Economic Accounts (IEA) with the values at current and constant prices of the previous year, as recommended by the System of National Accounts (1993)¹.

The new SNA will expand detailed information on activities and products for the RUT and on sectors for the IEA. Compilation of the RUT, which was broken down into 80 products and 43 activity sectors, will now have 293 products and 149 activities for compiling data and 110 products and 55 activities for publication, using activities that are fully compatible with the National Classification of Economic Activities (NCEA). Though referenced to the year 2000, the data of the new series will date back to 1995.

1/ System of National Accounts 1993 of the United Nations, World Bank, International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), Statistical Office of the European Communities (Eurostat).

Another important modification in the New System of National Accounts (NSNA) is utilization of new data sources. Here, it is important to stress full incorporation of continuous annual IBGE surveys: the Annual Industrial Survey (PIA), the Annual Service Survey (PAS), the Annual Trade Survey (PAC), the Annual Building Industry Survey (PAIC) and the Household Sampling National Survey (PNAD). This incorporation will make it possible to establish a structural benchmark as backing for the SNA. Aside from the annual surveys, other IBGE surveys are also being used more widely: the Informal Urban Economy Survey, the Farm Survey, the Demographic Census and the Consumer Expenditure Survey (POF). Here, one should mention the importance of the latter survey in the annual estimation of Final Household Consumption. Data from several external sources are also being incorporated, including: the Federal Revenue Secretariat (SRF); Corporate Balance Sheets; the Accounting Plan of National Financial System Institutions (Cosif); the Brazilian Electricity Regulatory Agency (Aneel); the National Petroleum Agency (ANP); the National Telecommunications Agency (Anatel); the Foreign Trade Secretariat (Secex) and the Secretariat of Complementary Social Security (SPC). It is important to note that inclusion of data sources at regular predetermined intervals brings homogeneity to the series.

With respect to the methodological alterations to be implemented, particular mention should be made of calculation of the production volumes of the public administration and of financial activity. These alterations will make GDP behavior less rigid by substituting low variation proxies over the course of economic cycles with others that are more closely correlated to the evolution of the economy. Consequently, these alterations will provide a more accurate view of economic activity at each moment in time.

Regarding the public administration, the value of the sector's production (intermediate consumption plus added value) is measured by costs since output is composed basically of noncommercial production. As a result, it cannot count on market pricing in the strict sense. The difference between the previous and the current methodologies is found in estimating added value, which will incorporate fixed capital consumption measured by the permanent inventory method.

The most important methodological change and the one that will introduce increased volatility into real GDP evolution is alteration of the proxy utilized in volume indices. In the previous methodology, population growth for all the components of public administration production was adopted, while the price index was estimated in an implicit manner, since values at current prices are withdrawn directly from public administration balance sheets at the three levels of government. In the new methodology, each production component will have a specific volume index. In the calculation of intermediate consumption at constant prices for the previous year, several price indices are used, mostly involving items from the Wholesale Price Index (IPA) and the IPCA, associated to each one of the products consumed by this activity. Consequently, the volume index is obtained implicitly. In a similar manner, the value of fixed capital consumption is also deflated and the volume index is obtained in an implicit manner. In this case, the price indices that serve as references are the same ones used to deflate gross fixed capital formation, broken down into machines and equipment and construction. In terms of earnings, the evolution of employed personnel as calculated in the PNAD was adopted as the volume index, while the price index was calculated implicitly.

These changes represent quality gains in estimation of public administration production, while simultaneously making its forecasting more difficult, since each one of the components has a specific volume index, substituting population growth which varies very little from one year to the next. It is important to note that all of the cited modifications referred to public administration services that, based on the previous methodology, represent about 70% of government consumption. The other 30% are related to health and public education. In the latter cases, no alterations were introduced into their measurement methodologies.

With regard to financial activity, a volume index is developed for each component of financial intermediation, in contrast to the previous system in which the volume index of the entire segment was given by average growth in the added-value of the economy. The volume index of directly measured financial services is obtained implicitly through deflation of the value of bank tariffs, using a specific

price for the sector as deflator. The volume index of indirectly measured financial intermediation services (Sifim) is obtained implicitly based on the ratio between the sum total of assets and liabilities of the sector at constant prices of the year in question and at current prices for the previous year. The sum total of assets and liabilities at constant prices is obtained through deflation of the current value in the year in question by the implicit deflator of GDP. Aside from these changes in volume indices, the distribution of the Sifim by users of the service was also completed, implying elimination of the fictitious financial dummy activity.

With the important innovations adopted in the System of National Accounts Brazil – Reference 2000, including new weightings, expansion of data sources and methodological updates, one can expect that this new system will result in qualitative gains in the measurement of the country's economic reality.

Driven by seasonal pressures on the prices of perishable foodstuffs and by increases in public transportation fares, alcohol prices and education costs, growth in consumer price indices accelerated in the three-month period ended in February 2007.

General price indices decelerated during the same period, due to lesser variation in wholesale farm prices, which had risen sharply in the three-month period ended in November. Industrial prices remained relatively stable, despite pressures generated by the major metallic commodities.

Though cumulative consumer inflation in the three-month period ended in February expanded when compared to the September-November period, overall 12-month inflation dropped from one period to the other. With regard to the remainder of the year, expectations indicate that inflation will remain well within the parameters defined by the CMN.

2.1 General indices

Cumulative growth in the General Price Index (IGP-DI), calculated by the FGV for the December-February period, closed at 0.93%, compared to 1.62% in the three-month period ended in November. Basically, this reduction reflected a drop in wholesale prices, caused by deceleration under farm product prices.

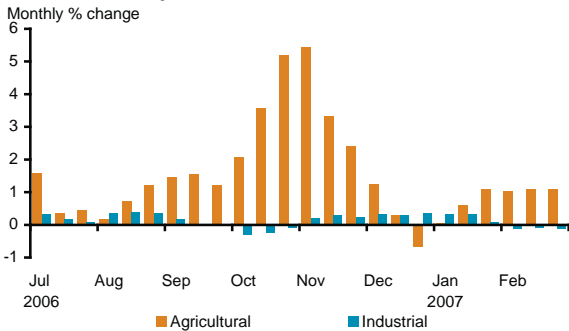
The Wholesale Price Index (IPA-DI) expanded 0.62% in the three-month period ended in February, compared to 2.21% in the September-November 2006 period. For the most part, this drop resulted from deceleration under crop/livestock product prices, which rose 1.49% compared to 8.99% in September-November 2006. This result clearly demonstrated the evident downward trend in the prices of animal origin products and their derivatives, particularly beef, milk and pork products, despite a sharp rain-provoked rise in the prices of perishable foodstuffs.

Table 2.1 – General price indices

	Monthly % change				
	2006			2007	
	Oct	Nov	Dec	Jan	Feb
IGP-DI	0.81	0.57	0.26	0.43	0.23
IPA	1.16	0.75	0.11	0.32	0.19
IPC-Br	0.14	0.24	0.63	0.69	0.34
INCC	0.21	0.23	0.36	0.45	0.21

Source: FGV

Figure 2.1 – IPA-10, IPA-M and IPA-DI – Agricultural and industrial prices



Source: FGV

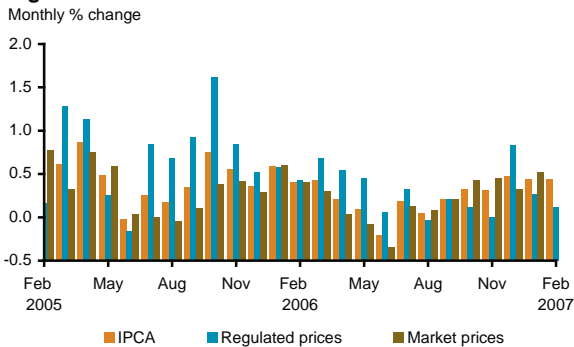
In the three-month period ended in November, the prices of industrial goods increased 0.34%, against 0.15% in the previous three-month period. This acceleration was caused by increased pressures generated by the prices of the mining industry, as well as those of iron, steel and derivatives. Using the same basis of comparison, these prices rose 3.74% and 1.97%, respectively, against -0.96% and -0.64%.

The Consumer Price Index-Brazil (IPC-Br) posted growth of 1.66% in the three-month period ended in February, compared to 0.57% in the September-November period. In more specific terms, this growth was generated by seasonal variations in the costs of education, reading material and leisure and transportation.

In 2006, the IGP-DI increased 3.79%, the third lowest annual result since the index was created in 1944, while the IPA-DI expanded 4.29%, reflecting increases of 6.92% in farm product prices and 3.46% in the prices of industrial products. The IPC-Br and the National Cost of Construction Index (INCC) rose 2.05% and 5.04%, respectively, in 2006, compared to 4.93% and 6.84% in the previous year.

2.2 Consumer price indices

Figure 2.2 – IPCA

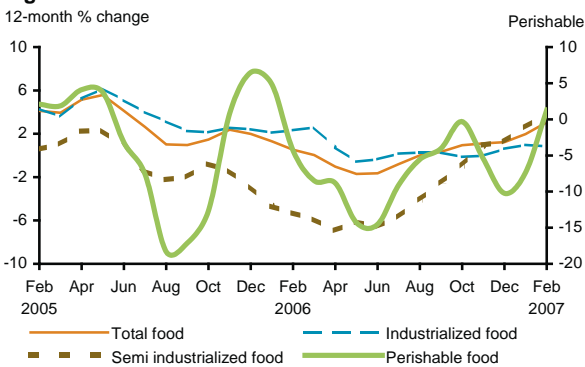


Source: IBGE

Calculated by IBGE, the IPCA increased 3.14% in 2006, the second lowest annual cumulative result since the series started in 1980. This result was based on increases of 4.27% in the prices of monitored goods and services and 2.57% in market prices, compared to 8.96% and 4.32%, respectively, in the previous year.

In the three-month period ended in February 2007, IPCA growth rates came to 1.37%, against 0.85% in the September-November period. This growth was generated by increases under regulated prices from 0.33% to 1.22%, and from growth in market prices from 1.09% to 1.43%. This price behavior is considered fully consistent with the seasonal nature of the period under consideration. The items that had the greatest impact on the price rise were urban bus fares, leisure activities, health plans and meals, as well as perishable foodstuffs, and courses of study, due to their seasonal nature.

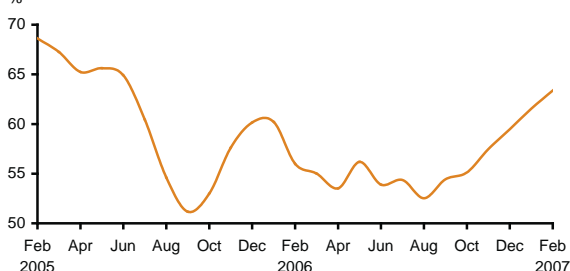
Figure 2.3 – IPCA – Food



Source: IBGE

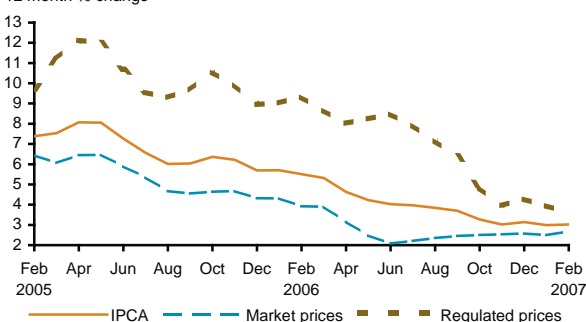
The diffusion index, which is an indicator of the proportion of items included in the IPCA that registered positive growth, posted an average of 60.3% in the three-month period ended in February, compared to 57.5% in the September-November 2006 period.

Figure 2.4 – IPCA
% of items with increase
Quarterly moving average
%



Source: IBGE

Figure 2.5 – IPCA
12 month % change



Source: IBGE

Table 2.2 – IPCA

	Weights	% change			
		2006 Year	2007 Jan Feb		2007 Year
IPCA	100.00	3.14	0.44	0.44	0.88
Market prices	68.85	2.57	0.52	0.59	1.11
Regulated prices	31.15	4.27	0.27	0.12	0.39
Main items		0.00	0.00	0.00	0.00
Electricity	3.81	0.27	-1.04	-0.01	-1.05
Water and sewage	1.61	4.99	0.00	0.00	0.00
Urban bus	3.78	8.12	1.66	1.60	3.29
Air ticket	0.28	-9.62	0.27	0.27	0.54
Gasoline	4.68	2.94	-0.57	-0.86	-1.43
Bottled cooking gas	1.21	7.49	-0.04	-0.05	-0.09
Medicine	2.99	4.62	0.30	0.00	0.30
Health plans	3.26	9.51	0.75	0.75	1.51

Source: IBGE

Table 2.3 – Consumer prices and core inflation

	Monthly % change				
	2006			2007	
	Oct	Nov	Dec	Jan	Feb
IPCA	0.33	0.31	0.48	0.44	0.44
Exclusion	0.30	0.23	0.34	0.41	0.52
Trimmed means					
Smoothed	0.32	0.27	0.38	0.39	0.24
Non smoothed	0.19	0.12	0.27	0.35	0.22
IPC-Br	0.14	0.24	0.63	0.69	0.34
Core IPC-Br	0.17	0.26	0.31	0.26	0.16

Source: IBGE, Bacen and FGV

Seasonal pressures on price indices caused by the costs of courses and fuel alcohol will tend to dissipate in the coming months. This factor and the reduction in the prices of important primary sector segments will contribute to a dampening of IPCA growth in the next few months.

2.3 Regulated prices

In 2006, regulated prices increased 4.27%, accounting for 1.74 p.p. of the total change in the IPCA in the year. The strongest pressures originated in intercity bus fares, 8.87%; urban bus fares, 8.12%; bottled gas, 7.49%; and health plans, 12.29%.

In the December-February period, market prices and regulated prices included in the IPCA increased 1.43% and 1.22%, respectively, compared to 1.09% and the 0.34% in the three-month period ended in November. Growth in regulated prices accounted for 0.38 p.p. of 1.37% IPCA inflation in the three-month period ended in February.

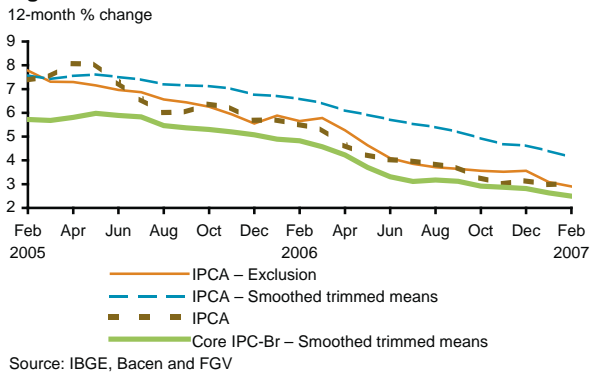
Intercity bus fares increased 5.76% in the three-month period, while urban bus fares rose 8.05%, led by 17.65% in Salvador, 15% in São Paulo, 8% in Belo Horizonte, 8.11% in Porto Alegre and 5.26% in Rio de Janeiro. Gasoline prices fell 1.83% in the three-month period and electricity prices dropped 1.27%, closing at -1% in São Paulo, -1.07% in Rio de Janeiro and -7.87% in Porto Alegre.

2.4 Cores

Reflecting the seasonal nature of the general index, inflation cores turned in their highest growth in the December-February 2007 period, compared to September-November 2006. Calculated with exclusion of regulated prices and food consumed at home, the IPCA core posted a cumulative high of 1.28% in the three-month period, compared to 0.76% in the previous period. Notwithstanding this rise, the indicators showed deceleration in cumulative 12-month terms from 3.52% in November to 2.9% in February.

Applying the smoothed trimmed-means methodology to predefined items, growth in the core came to 1.01% in the three-month period ended in February, reflecting positive growth compared to the results for the September-November 2006 period. Using the trimmed-means methodology without smoothing, the inflation core posted cumulative growth of 0.83% in the three-month period ended in February. These

Figure 2.6 – Core inflation



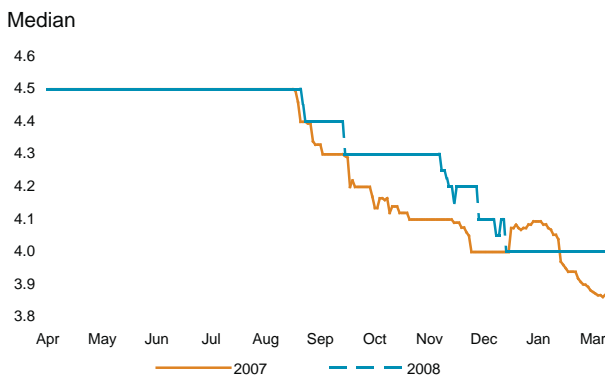
increases reflect pressures exerted on the general index by seasonal factors and tariff increases, particularly public transportation fares.

In the case of FGV’s IPC-Br inflation core, calculated according to the trimmed-means method, the tendency registered in the three-month period ended in February was clearly upward, with an increase of 0.73% compared to 0.67% in the three-month period ended in November.

2.5 Market expectations

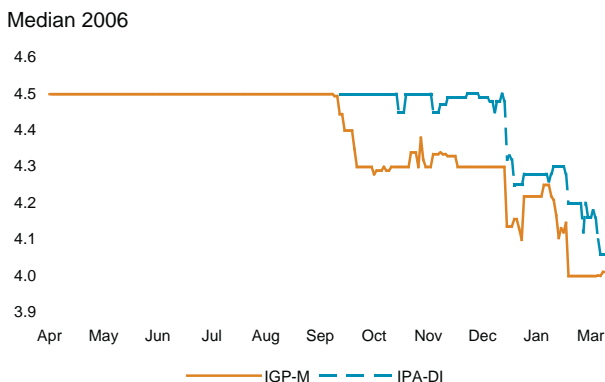
Since the end of 2006, the median of expectations gathered by the Investor Relations Group (Gerin) for 2007 IPCA dropped from 4% to 3.9% in the first week of March. Inflation expectations for 2008 also declined, moving from 4.1% to 4%. These projections are clearly consistent with the 4.5% target defined by the CMN, with a margin of two points up or down.

Figure 2.7 – IPCA



As regards 12-month ahead IPCA inflation, expectations diminished from 4.1% at the end of 2006 to 3.8% in the first week of March, thus confirming perceptions of a benign inflation scenario. Expectations of lesser inflationary inertia and compliance with inflation targets for the fifth consecutive year contributed importantly to the downward adjustment in future inflation expectations.

Figure 2.8 – IGP-M and IPA-DI



Expectations regarding general price indices in coming years also dropped slightly. For 2007, the median of forecasts for the General Price Index – Market (IGP-M) and for the IPA-DI in the first week of March were both equivalent to 4.1%, compared to the respective medians of 4.3% and 4.5% projected for these two indices at the end of 2006. For 2008, the median of market projections for the IGP-M and IPA-DI were cut to 4% and 4.1%, respectively.

In their turn, expectations regarding changes in regulated prices continued contributing to forecasts of less inflationary inertia, thus facilitating anchoring of expectations to the target trajectory. The median of expectations point to correction of 3.8% for regulated prices in 2007 (first week of March), compared to 4% in the previous estimate at the end of 2006. The projection for 2008 remained stable at 4%.

Market projections for the rate of exchange indicate downward movement, reflecting perceptions that the current positive scenario for the nation’s external accounts will continue into the future. In terms of both average and end-of-period rates,

Figure 2.9 – Exchange rate

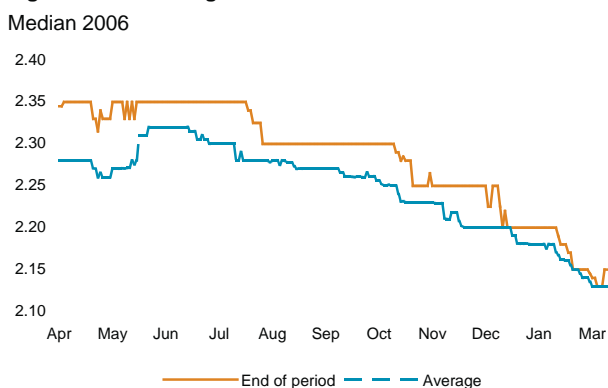


Table 2.4 – Summary of market expectations

	9.29.2006		12.29.2006		3.9.2007	
	2007	2008	2007	2008	2007	2008
IPCA	4.3	4.4	4.0	4.1	3.9	4.0
IGP-M	4.5	4.5	4.3	4.2	4.1	4.0
IPA-DI	4.5	4.3	4.5	4.3	4.1	4.1
Regulated Prices	4.5	4.2	4.0	4.0	3.8	4.0
Selic (end-of-period)	12.5	12.0	11.8	11.0	11.5	10.5
Selic (average)	13.0	12.0	12.3	11.5	12.2	11.0
Exchange rate (end-of-period)	2.33	2.48	2.25	2.35	2.15	2.22
Exchange rate (average)	2.26	2.35	2.20	2.30	2.13	2.19
GDP growth	3.5	3.5	3.5	3.5	3.5	3.5

the median of exchange rates for 2007 dropped in recent months, coming to R\$2.13/US\$ and R\$2.15/US\$ in the first week of March, compared to R\$2.20/US\$ and R\$2.25/US\$, respectively, at the end of 2006. In the same period, projections for 2008 for the average and end-of-period rates of exchange dropped from R\$2.30/US\$ to R\$2.19/US\$ and from R\$2.35/US\$ to R\$2.22/US\$.

With regard to implementation of 2007 monetary policy, projections for Selic rate evolution accompanied the downward trend in prospective inflation indicators. Projections for 2007 average and end-of-period Selic rates were revised downward from 12.3% and 11.8% at the end of 2006 to 12.2% and 11.5% per year, respectively, in the first week of March. Projections for the final 2008 Selic rate indicated 10.5% per year in the first week of March, compared to 11% per year at the end of 2006.

In recent months, the market has sustained its forecast of 3.5% GDP growth in both 2007 and 2008. With gradual incorporation of the PAC effects, coupled with methodological alterations implemented by IBGE, these projections are expected to change.

2.6 Conclusion

Increases in consumer inflation rates at the end of 2006 and early 2007 reflected changes in public transportation fares, annual increases in education costs and such seasonal factors as higher prices for perishable foodstuffs and alcohol. Consequently, these changes do not reflect alterations in inflation expectations for the remainder of the year, since the trajectory will remain squarely within the upper and lower limits determined by the CMN.

The positive outlook for inflation in coming months has been reinforced by increased convergence in the growth registered among the different core measurements. Convergence of the underlying inflation trends among themselves and toward the target helps to anchor inflation expectations and thereby contributes to consolidation of a stable macroeconomic environment. In its turn, this environment clearly favors more rapid and sustainable rates of economic growth.

Credit, monetary and fiscal policies

3.1 Credit

In the three-month period ended in January, credit operations evolved at a pace consistent with declining interest and the benign macroeconomics scenario. This was evident in such factors as increasingly longer financing terms and stable delinquency levels, and played an important role in sustaining aggregate demand.

Following the seasonal decline in loan demand at the end of the year as a result of payment of the Christmas bonus, household demand for bank credits increased in early 2007, primarily as a result of the traditional concentration of outlays on taxes and education-related services in that period of the year. After a period of strong growth in the final months of 2006, business credit operations dropped in January accompanying the characteristic falloff in the pace of business activities at that time of the year.

Considering both nonearmarked and earmarked resources, financial system lending operations totaled R\$738.7 billion in January, up 5.9% in the three-month period and 21.4% in twelve months. The overall stock of loans granted reached 34.3% of GDP, against 33.1% in October and 31% in January 2006. The participation of private national banks in the total credit portfolio closed at 41.1%, followed by public sector institutions, 36.9%, and foreign banks, 22%.

In terms of allocation among the various activity segments, loans targeted to the private sector reached R\$719.9 billion in January, 6% more than in October. In this context, it is important to highlight growth in financing granted to other services, 9.4%, particularly telecommunications investments; industry, 8%, concentrated mainly in the segments of steel, mining and agribusiness; and individual borrowers, 5.3%. Moving in the opposite direction, loans to commerce dropped 0.2% in the three-month period.

Loan operations contracted by the public sector totaled R\$18.9 billion, for growth of 1.9% compared to October.

Table 3.1 – Credit operations

	R\$ billion					
	2006			2007		% growth
	Oct	Nov	Dec	Jan	3 months	12 months
Total	697.6	717.0	733.8	738.7	5.9	21.4
Nonearmarked	475.9	489.2	499.7	501.5	5.4	23.7
Earmarked	221.7	227.9	234.1	237.2	7.0	16.7
% participation:						
Total/ GDP	33.1	33.7	34.3	34.4		
Nonearmarked/GDP	22.6	23.0	23.4	23.3		
Earmarked/GDP	10.5	10.7	10.9	11.0		

Figure 3.1 – Credit by capital control of financial institutions

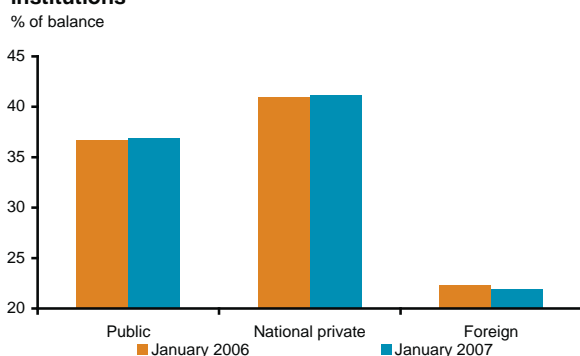


Figure 3.2 – Credit by borrower's economic activity – National private institutions

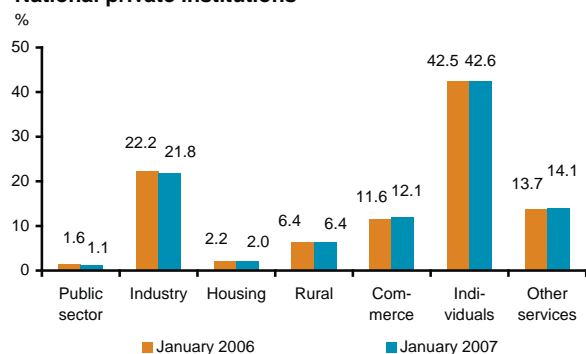


Figure 3.3 – Credit by borrower's economic activity – Public institutions

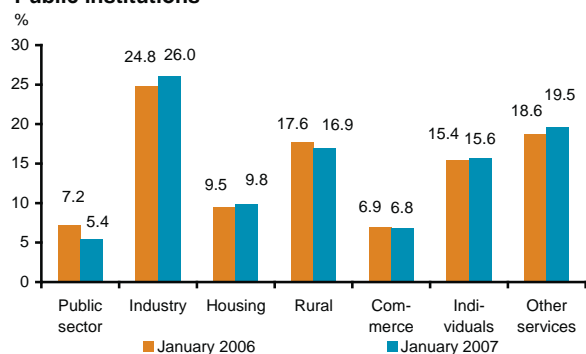


Figure 3.4 – Credit by borrower's economic activity – Foreign institutions

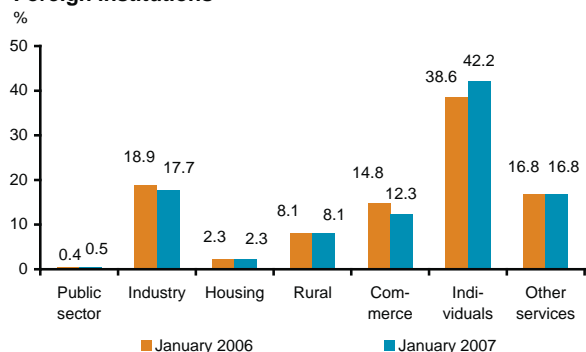
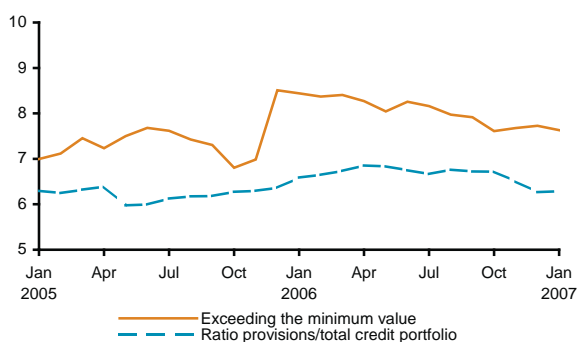


Figure 3.5 – Provisions of total financial system credit %



Basically, this result reflected 3% expansion in financing channeled to state and municipal governments, which registered an overall stock of R\$14.6 billion, concentrated mostly in disbursements to the segments of electricity and basic sanitation works. On the other hand, the federal government banking debt dropped 1.8%, closing at R\$4.3 billion as a consequence of amortization of contracts with the gas distribution segment.

The volume of provisions set aside by the financial system totaled R\$46.5 billion in January, down 0.9% in the three-month period. The ratio between provisions and the total value of the credit portfolio dropped from 6.7% in October to 6.3% in January, with a falloff from 7.5% to 6.6% in the case of public sector institutions. Defaults in operations with the financial system moved from 3.9% in October 2006 to 3.6% in January 2007, considering only arrears of more than 90 days.

Credit operations with earmarked resources

Loans based on earmarked resources totaled R\$237.2 billion in the three-month period ended in January, corresponding to growth of 7% over the October position and 16.7% in twelve months. For the most part, the three-month result reflected the performance of National Bank of Economic and Social Development (BNDES) lending operations and credits targeted to the rural segment.

The balance of financing granted by BNDES totaled R\$140.5 billion in January, 59.2% of the segment's total. Compared to October, growth of 7.8% resulted from increases of 9.2% in directly contracted operations and 6.3% in onlendings to the financial system.

In January, BNDES disbursements totaled R\$4.7 billion, up 88.1% over the same period of the previous year. This result reflects strong growth from a level of R\$651 million in January 2006 to R\$3.1 billion in funding channeled to industry and, more specifically, growth in operations with the sectors of basic metallurgy and food and beverages. Funding granted to the segment of commerce and services dropped 16.4%, reflecting lesser demand on the part of land transportation and commerce and vehicle repairs, while operations channeled to the crop/livestock sector remained stable during the period.

Consultations with BNDES, which reflect potential medium and long-term investment disbursements, reached a level of R\$9.7 billion in January, for growth of 47.9% compared

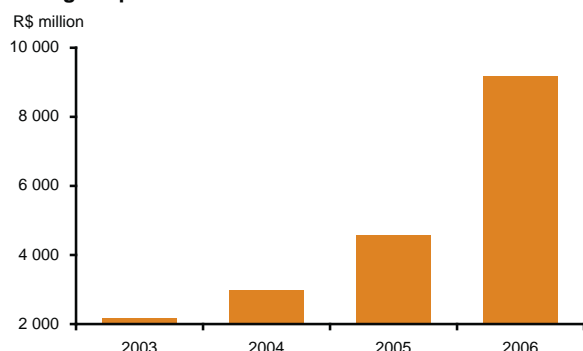
Table 3.2 – Earmarked credit operations

	R\$ billion						
	2006			2007		% growth	
	Oct	Nov	Dec	Jan	3 months	12 months	
Total	221.7	227.9	234.1	237.2	7.0	16.7	
BNDES	130.3	134.4	138.8	140.5	7.8	13.8	
Direct	67.1	69.3	71.7	73.2	9.2	12.4	
Onlendings	63.2	65.2	67.1	67.2	6.3	15.3	
Rural	51.6	53.1	54.4	54.9	6.4	21.8	
Banks and agencies	49.2	50.7	51.9	52.4	6.4	21.3	
Credit unions	2.3	2.5	2.4	2.5	7.4	35.3	
Housing	33.6	34.1	34.5	35.4	5.3	22.6	
Others	6.2	6.2	6.4	6.5	5.0	10.0	

Table 3.3 – BNDES disbursements

	R\$ million		
	January		% growth
	2006	2007	
Total	2 488	4 681	88.1
Industry	651	3 080	373.1
Other transportation equipment ^{1/}	0	90	-
Motor vehicles	177	206	16.4
Basic metallurgy	37	1 917	5081.1
Food and beverages	147	311	111.6
Chemical	27	84	211.1
Petroleum, coke and alcohol refining	8	72	800.0
Commerce and services	1 440	1 204	-16.4
Land transportation	794	627	-21.0
Electricity, gas and hot water	177	109	-38.4
Construction	130	99	-23.8
Commerce and vehicle repairs	202	116	-42.6
Crop/livestock	397	397	0.0

Source: BNDES

^{1/} Includes aircraft industry.**Figure 3.6 – Credit to housing with resources from savings deposits**

to January 2006. For the most part, this evolution reflected growth of R\$3 billion in operations with the sector of commerce, including services, with increased demand in the segments of post and telecommunications services and construction. Requests on the part of industry fell 1.4%, totaling R\$4.8 billion, with a sharp drop in requests submitted by the aircraft industry.

Financing channeled to the rural sector totaled R\$54.9 billion in January. Growth of 6.4% compared to October was, to some extent, generated by the performance of agricultural current expenditures and investment credits. The participation of these two headings in the segment total increased from 37.5% and 51.6%, respectively, in October, to 38.8% and 50%.

The volume of credits to the housing sector for purposes of acquisitions and construction of new housing totaled R\$35.4 billion, for growth of 5.3% compared to October 2006 and 22.6% in the last twelve months. Credits granted through the use of savings account resources, responsible for a major share of these disbursements, expanded 101% in 2006.

Credit operations with non earmarked resources

Credit operations based on non earmarked resources totaled R\$501.5 billion in January, up 5.4% compared to October and 23.7% in twelve months. Credit operations contracted by corporations totaled R\$259.2 billion, for growth of 5.4% over the October position and 23% in twelve months (see box Financing Alternatives to Bank Credit, page 42).

With regard to reference credits, these operations accounted for 83% of the total corporate loan portfolio in January. Operations based on domestic resources expanded 6.1% in the three-month period and 19.9% in twelve months, closing at R\$163.1 billion. This performance was furthered by greater demand for working capital, particularly among large-scale companies. Loans referenced to foreign currency totaled R\$52.4 billion, corresponding to a drop of 1.5% in the three-month period and 11% growth in twelve months.

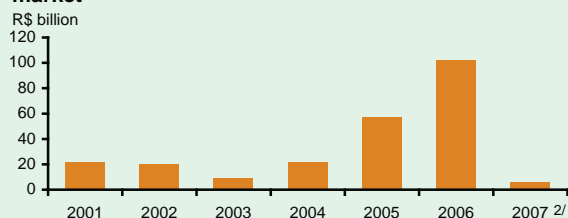
Leasing operations with corporations, mostly involving vehicles, added up to R\$21.1 billion in January, for growth of 17.3% in the three-month period and 63.3% in twelve months. Loans targeted to individual borrowers totaled R\$242.4 billion, for growth of 5.3% compared to October and 24.5% in twelve months. Evolution of the share represented by reference credits, accounting for 81% of the total portfolio

Financing Alternatives to Bank Credits

Table 1 – Growth of credit operations targeted to corporations

Itemization	2002	2003	2004	2005	2006
Volume (R\$ billion)					
Nonearmarked	149.6	154.6	179.4	213.0	260.7
Earmarked	146.4	162.6	180.8	203.3	234.1
Total	296.0	317.3	360.2	416.3	494.8
Percentage (% GDP)					
Nonearmarked	9.4	9.7	9.7	10.9	12.2
Earmarked	9.2	10.2	9.8	10.5	11.0
Total	18.7	19.9	19.4	21.4	23.1

Figure 1 – Consolidated primary issues in the capital market^{1/}



Source: CVM

^{1/} Primary offers of stocks, debentures, promissory notes and FIDC quotas registered at CVM.

^{2/} Accumulated up to February.

Driven by low rates of inflation, the positive macroeconomic scenario of recent years has had a significant impact on the expectations of economic agents, while acting as an incentive to business and corporate investment decisions. Consequently, demand for credit on the part of these borrowers has increased sharply, encompassing both traditional financial system operations and alternative domestic and external financing sources.

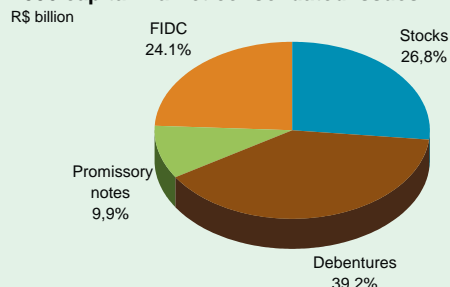
In this context, the volume of credit targeted to corporate borrowers expanded 37.2% since December 2004, rising to R\$494.8 billion at the end of 2006. To a great extent, this growth was powered by a significant cutback in the cost of loans and financing as a result of a more flexible monetary policy since September 2005. With this, the ratio between total credit granted to the segment and GDP expanded from 19.4% to 23.1% in the period (Table 1).

Parallel to growth in bank credits for the business sector, utilization of alternative financing sources, particularly funding obtained on the internal capital market, also expanded sharply. This evolution benefited from adoption of microeconomic measures aimed at strengthening this market. Among these, it is important to highlight passage of new legislation on open capital corporations, the new bankruptcy law, consolidation of corporate governance practices with creation of the New Market and improvement in the operating rules of Receivables-Backed Investment Funds (FIDC).

Primary capital market issues^{1/}, including placements of stocks, debentures, promissory notes and FIDC quotas, totaled R\$101.7 billion in 2006, for growth of 374% compared to 2004 (Figure 1).

^{1/} Primary offers registered at the Securities and Exchange Commission (CVM).

Figure 2 – Percentage share of major instruments in 2006 capital market consolidated issues^{1/}



Source: CVM
 1/ Primary offers of stocks, debentures, promissory notes and FIDC quotas registered at CVM.

Debenture issues totaled R\$69.5 billion, for growth of 622% using the same basis of comparison, setting a new record for this funding instrument. However, it is important to note that leasing companies accounted for the major share of these issues, with 65.6% in 2006. Once placements of these companies are excluded, the volume of debentures totaled R\$23.9 billion in 2006, corresponding to 151% growth over the 2004 result.

Development of this instrument was impacted by creation of standardized debentures through CVM Instruction 404, dated February 13, 2004. This measure sought to make issues more uniform, while also determining that they should be evaluated by risk rating agencies, with primary distribution in stock exchanges and the over-the-counter market.

In 2006, primary stock issues totaled R\$14.2 billion, for growth of 218% over the 2004 result. Here, the highlights were operations in the construction and electricity sectors, which accounted for 40% of total volume. The positive performance of the variable income market is evident in strong growth in the number of companies now operating on the stock markets. According to data released by the São Paulo Stock Exchange (Bovespa), 26 companies carried out capital opening operations in 2006, compared to just seven in 2004.

The volume of FIDC quotas reached R\$12.8 billion, with growth of 150% from 2004 to 2006. Of this total, commercial and/or industrial credit securities, clearly an alternative to bank credit, totaled R\$4.2 billion in 2006, corresponding to 32.8% of new issues.

Figure 3 – Primary issues of quotas of Receivables-Backed investment funds



Source: CVM
 1/ Accumulated up to February.

It is important to stress that sharp growth in business funding operations through the capital market was also powered by favorable conditions regarding investor demand for these papers. Thus, the scenario of economic stability, coupled with declining interest, contributed not only to reducing the profitability of public securities, generating a positive impact on the public sector's financial situation, but also to curtailing capital market funding costs and favoring issues of private corporate bonds.

Expansion of capital market-based business financing has been registered particularly among large-scale

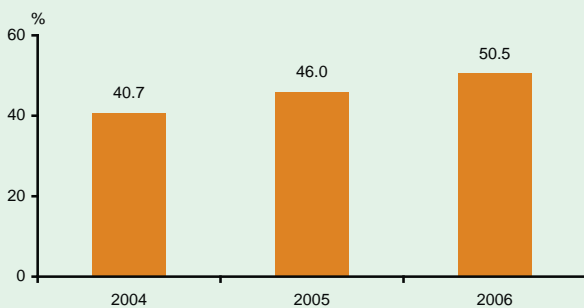
companies, thus reducing the participation of these borrowers in bank credits. Consequently, financial institutions have sought to expand the credit supply targeted to micro, small and medium enterprises, for the added reason that such operations have traditionally been more profitable.

As a result of this process, data drawn from the annual balance sheets of four large-scale private banks indicate that the relative participation of micro, small and medium enterprises in corporate credit operations rose from 40.8% in 2004 to 50.5% in 2006, as shown in Figure 4. These companies have resorted to the bank credit market mostly as a result of more favorable lending and financing conditions, including lower interest and longer contract maturities, together with the more dynamic pace of economic activity.

At the same time, one should stress the importance of external financing sources for large-scale nonfinancial companies, in the form of loans or security placements. For the most part, these operations have been driven by international liquidity conditions coupled with declining country risk. In 2006, the volume of external credit operations contracted by Brazilian companies reached US\$9.3 billion², up 56% compared to the previous year.

Initial 2007 results show consolidation of the capital market as an alternative source of credit. Primary offers of stocks, debentures, promissory notes and FIDC quotas registered at the CVM totaled R\$6 billion in the first two months of 2007, compared to R\$7.1 billion in the same period of 2006. Here, it is important to underscore 90% growth in stock issues, rising to a total of R\$4 billion. On the other hand, debenture issues totaled R\$250 million, compared to R\$2.5 billion in the same period of 2006. At the end of February 2007, ten primary debenture offers were under analysis at the CVM, with a total value of R\$4.6 billion, aside from twenty primary stock issues.

Figure 4 – Participation of micro, small and medium businesses in corporate credit operations



Source: Institutions' Financial Statements.

2/ US\$14.5 billion in credits granted to the mining sector were excluded, due to their nonrecurring character.

Table 3.4 – Nonemarked credit operations

	R\$ billion						
	2006			2007		% growth	
	Oct	Nov	Dec	Jan	3 months	12 months	
Total	475.9	489.2	499.7	501.5	5.4	23.7	
Corporations	245.8	253.4	260.7	259.2	5.4	23.0	
Domestic funding	192.6	199.8	208.1	206.7	7.4	26.4	
Reference credit ^{1/}	153.7	158.5	165.0	163.1	6.1	19.9	
Leasing	18.0	19.2	20.9	21.1	17.3	63.3	
Rural	1.7	1.5	1.4	1.4	-20.2	-33.4	
Others	19.2	20.6	20.8	21.2	10.2	69.8	
External funding	53.2	53.6	52.6	52.4	-1.5	11.0	
Individuals	230.1	235.7	239.0	242.4	5.3	24.5	
Reference credit ^{1/}	189.0	192.0	191.8	196.5	4.0	22.4	
Credit unions	9.5	9.6	9.8	9.9	4.9	17.9	
Leasing	13.2	13.5	13.6	13.8	4.2	55.4	
Others	18.4	20.6	23.8	22.1	20.3	31.4	

1/ Interest rate reference credit, defined according to Circular 2,957, dated 12.30.1999.

Figure 3.7 – Interest rates on nonemarked credit operations

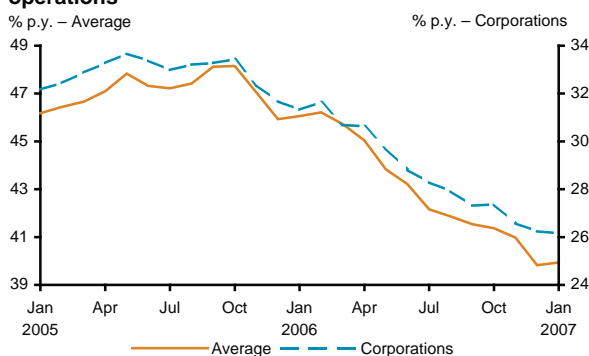
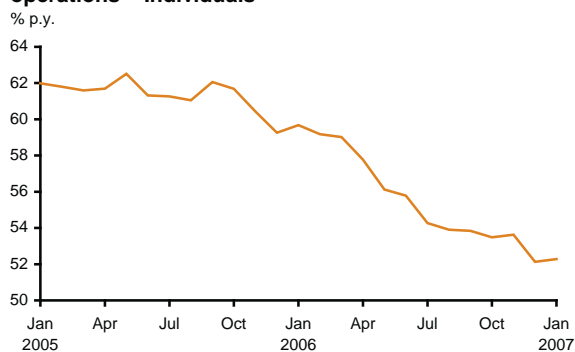


Figure 3.8 – Interest rates on fixed rate credit operations – Individuals



of this segment, was generated by loans in the modality of personal loans and auto loans, which increased 3.9% and 4.7%, respectively, in the three-month period, and 24.9% and 24.1% in twelve months. Growth in personal loans was for the most part tied to payroll-deducted loans, with growth from 45.6% in January 2006 to 54.8% in January 2007, in terms of participation in the total volume of operations.

The average cost of reference credits based on nonemarked resources reached 39.9% per year in the month of January. The 1.5 p.p. drop in the three-month period reflected reductions of 1.2 p.p. in average charges on operations with corporations and individual borrowers, which closed at respective levels of 26.2% and 52.3%. In the same sense, the banking spread dropped 0.6 p.p. in the period, closing at 27.4 p.p.

It should be stressed that, since the start of the process of easing monetary policy in September 2005, interest and spreads on credit operations have performed in highly distinct manners. Accompanying the cumulative 6.75 p.p. drop in the Selic rate through January 2007, the average rate on loans dropped 8.2 p.p. and the spread fell 1.8 p.p. To some extent, lesser flexibility in the spread reflects growth in defaults during the period under consideration, together with stability in the other components involved, alterations in the composition of borrowers and lengthening of loan maturities.

Defaults in the credit portfolio based on nonemarked resources remained stable at 5.1% in January, with a slight 0.1 p.p. falloff compared to October in the segment of individual borrowers.

The average term of credit operations based on nonemarked resources reached 297 days in January, compared to 283 in October and 266 in the same month of 2006. The three-month results reflected increases of sixteen and thirteen days, respectively, in the average maturities of operations targeted to individual borrowers and corporations. To some extent, this was a consequence of increases of 378 days and 52 days registered in the real estate financing contracts of the respective segments.

3.2 Monetary aggregates

Using the concept of average daily balances, the restricted money supply (M1) reached R\$157.6 billion at the end of February. The 19.6% growth registered in the last twelve months was caused by increases of 20.7% in the average balance of currency held by the public and 18.9% in demand deposits.

Figure 3.9 – Average spread on nonemarked credit operations

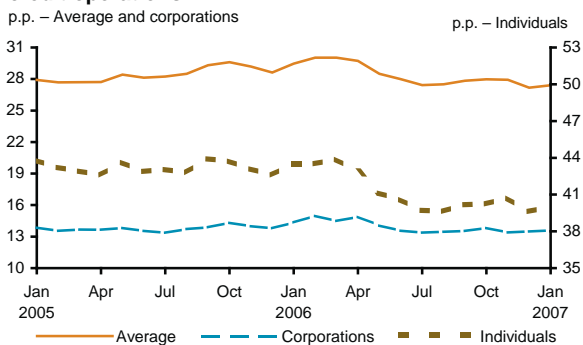
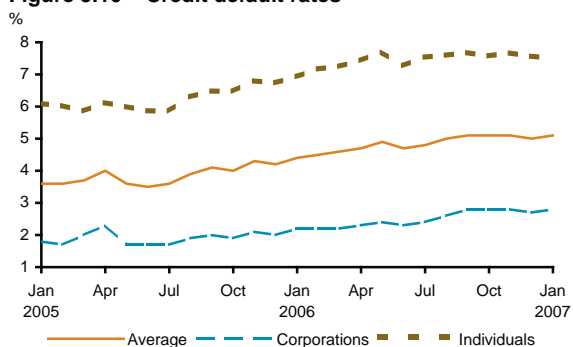


Figure 3.10 – Credit default rates^{1/}



1/ Nonemarked credit in arrears of more than ninety days.

Figure 3.11 – Average term of credit operations – Calendar day

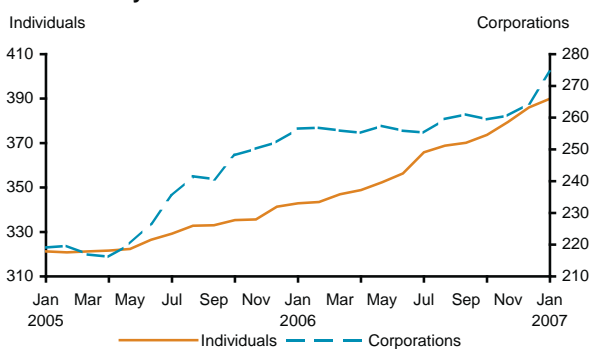
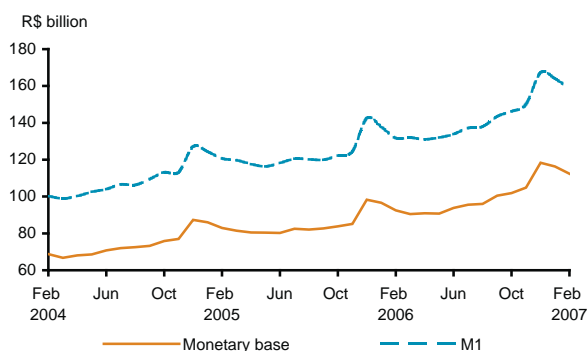


Figure 3.12 – Monetary base and M1 – Average daily balances



Utilizing seasonally adjusted data deflated by the IPCA, the M1 aggregate expanded 0.8% in the three-month period ended in February, compared to the period ended in November. For the most part, continuation of the expansionary trend observed in 2006 has been sustained by the increased pace of lending operations.

Viewed in terms of average daily balances, the monetary base reached R\$112 billion in February. In keeping with the evolution of M1, 12-month growth of 21.1% reflected increases of 22.8% in the average balance of currency issued and 17.3% in banking reserves.

Considering the end-of-period position, the monetary base declined R\$198 million in the three-month period ended in February. External sector operations were the major factor underlying growth in this aggregate, with an impact of R\$34.4 billion resulting from net Central Bank purchases of exchange on the interbank exchange market. In the opposite sense, net placements of federal public securities and National Treasury operations resulted in monetary contraction of R\$26.6 billion and R\$8.2 billion, respectively. Other operations with the financial system produced expansion of R\$214 million.

Analysis of the M2 concept, which aggregates investment deposits, savings deposits and securities issued by financial institutions into M1, shows money supply growth of 1.9% over the November position and 13% compared to February 2006. The balance of savings deposits in the three-month period expanded 6.6%, while the balance of private securities dropped 1%. To some extent, movement of these assets reflected the seasonal effect of payment of the Christmas bonus.

The M3 concept, which incorporates fixed income fund quotas and the federal public securities used as backing for the net financing position in repo operations between the nonfinancial sector and the public financial sector into M2, totaled R\$1.4 trillion in February, up 4.4% compared to November. It is important to stress that the three-month period was marked by 6.6% growth in fund quotas. The M4 concept, which encompasses M3 plus the public securities held by nonfinancial entities, totaled R\$1.6 trillion in February, for growth of 4.3% in the three-month period. Compared to February 2006, growth in the M4 balance reached 18%.

Federal public securities and Bacen open market operations

The net balance of primary market federal public security operations reflected contraction of R\$4.4 billion in the

Figure 3.13 – M1 and monetary base at February 2007 prices seasonally adjusted^{1/}

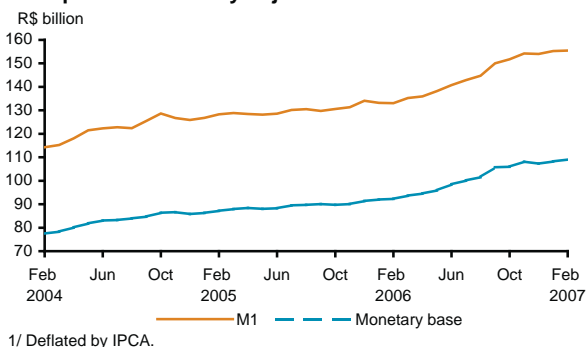


Figure 3.14 – Broad money supply 12-month growth

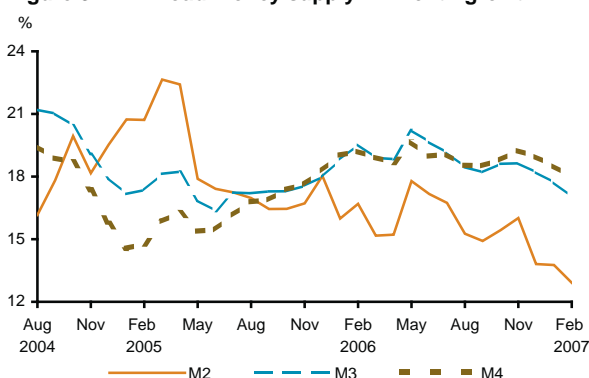


Figure 3.15 – Net financing position of the federal public securities – Daily average

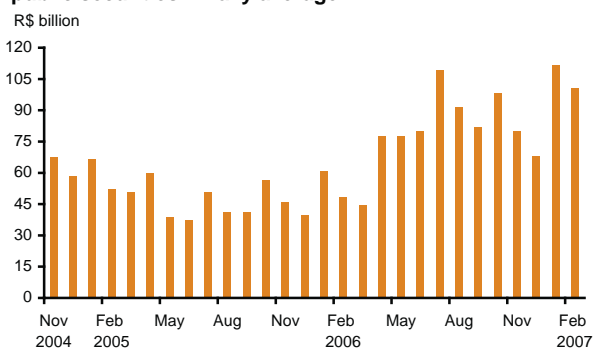
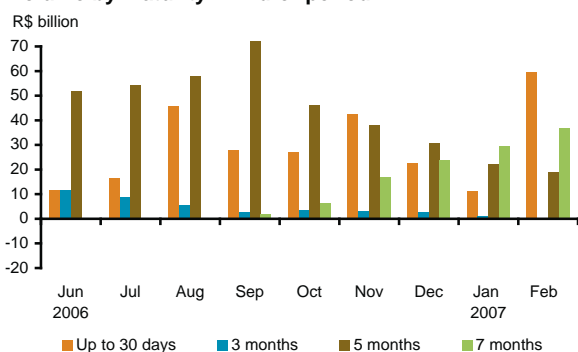


Figure 3.16 – Central Bank repo operations – Volume by maturity – End-of-period



three-month period ended in February, with issues of R\$122.2 billion and redemptions of R\$117.8 billion. Exchanges totaled R\$32 billion and were mostly concentrated under National Treasury Bills (LTN), accounting for 62% of the total value negotiated in debt rollover operations.

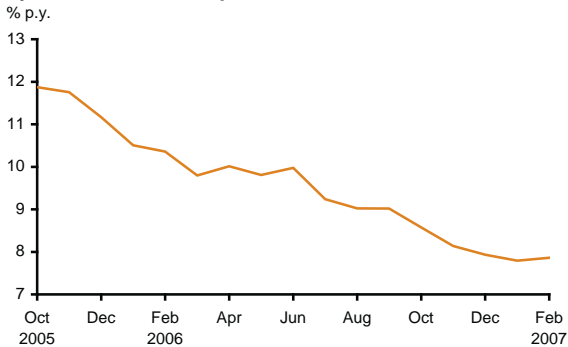
In the month of January, the National Treasury released the Annual Financing Plan (PAF) for 2007. Among the federal public debt management guidelines, the most important are the strategies aimed at lengthening average debt maturities, substituting securities indexed to exchange and to the Selic rate for securities with fixed earnings rates or inflation-indexed papers, together with development of the forward interest rate structure for federal public securities on the internal and external markets. In keeping with these objectives, the National Treasury has sought to implement an ideal fixed rate security issuance structure, interrupting offers of 18-month LTN in January 2007 and setting the maturity horizon of these securities at 12 and 24 months. In the same sense, starting on the same date, National Treasury Notes – Series F (NTN-F) registered a maximum maturity of ten years, substituting the previous maximum of seven years. As a result, the issuance structure of fixed-rate securities will have benchmarks of 6, 12 and 24 months for LTN and three, five and ten years for NTN-F.

In the period extending from December to February, Central Bank purchases of dollars on the exchange spot market and expansionary National Treasury operations increased system liquidity. In order to adjust liquidity conditions and considering that LTN maturities are concentrated in early January, the Central Bank increased the average net financing position in federal public securities from R\$68.1 billion in December to R\$100.5 billion in February. Also with regard to monetary authority activities in the management of liquidity conditions, average daily fixed-rate repo operations with terms of five and seven years moved from R\$30.8 billion and R\$23.7 billion, respectively, in December, to R\$18.8 billion and R\$36.7 billion in February. In this case, the position in three-month operations was reduced to zero in the period. The increase in the volume of resources with longer terms aided in increasing the effectiveness of Central Bank liquidity management.

At the same time, the Central Bank operated on the dollar futures market through placements of US\$3.2 billion in reverse swaps. In contrast, US\$35.5 million in public securities indexed to exchange and US\$3.5 billion in reverse exchange swaps were redeemed.

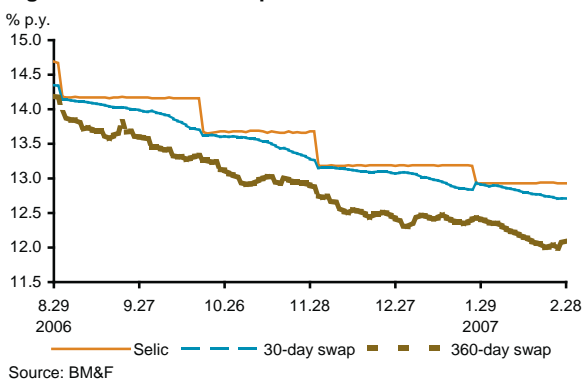
Real interest rates and market expectations

Figure 3.17 – Ex-ante real interest rate – Deflated by 12-month IPCA expectations



Over the course of the three-month period, futures interest rates in DI x pre swap contracts declined in all of the different vertices, particularly in the case of longer-term contracts. The change in the public debt profile, with growth in the participation of fixed-rate securities together with longer maturity terms have been factors of fundamental importance in altering the risk structure of the Brazilian public debt and reducing its sensitivity to short-term interest rates. The rate of 360-day DI x pre swap contracts at the end of February stood at 12.1% per year, a 65 point reduction compared to the end of November.

Figure 3.18 – Selic x swap DI x Pre

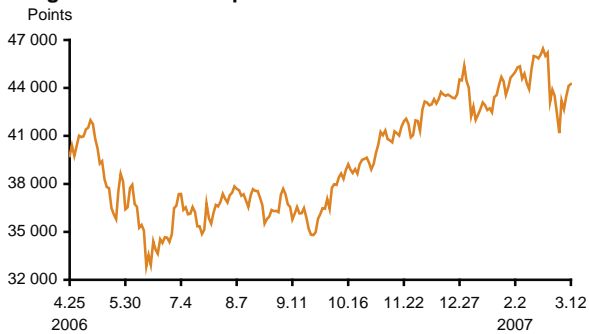


The real ex-ante Selic interest rate for the next twelve months reached 7.9% per year compared to 8.1% per year at the end of November, calculated on the basis of Gerin's February 28 Market Report survey.

Capital market

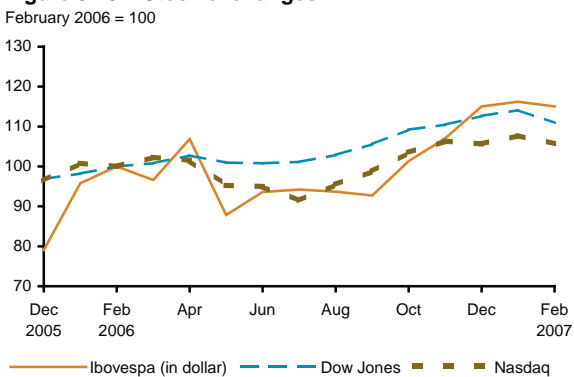
Following a sequence of record setting closings culminating at 46,452 points on February 22, the São Paulo Stock Exchange Index (Ibovespa) registered 43,892 points at the end of that month, mirroring an increase of 4.7% compared to the end of November. The performance registered in the major part of the quarter was conditioned by the downward trajectory of oil prices, maintenance of United States interest rates and reductions in country risk which, taken together with the ongoing process of Brazilian monetary policy easing, clearly favored the expectations of investors. Nonetheless, increased volatility in stock prices as of the final week of February caused by the drop in the Chinese stock market interrupted Ibovespa's upward trend, closing March 12 at 44,249 points.

Figure 3.19 – Ibovespa



The average volume of trading in the three-month period ended in February totaled R\$3.3 billion, for growth of 34.7% compared to the three-month period ended in November. In dollar terms, the Ibovespa expanded 9.4% in the aforementioned period, while the Dow Jones and Nasdaq increased 0.79% and -1.21%, respectively.

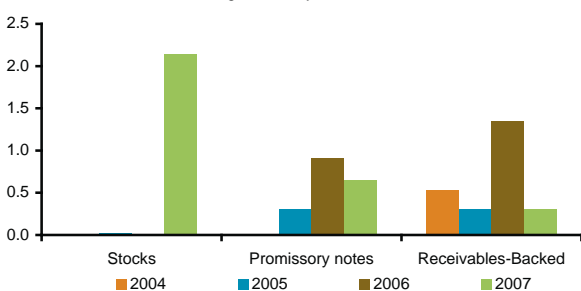
Figure 3.20 – Stock exchanges



The impact of the interest rate reduction on the profitability of public securities and reductions in capital market funding costs favored issuance of private corporate bonds. Business financing through capital market operations based on issuance (primary offers registered at Securities and Exchange Commission – CVM) of stocks, debentures,

Figure 3.21 – Primary issues in the capital market

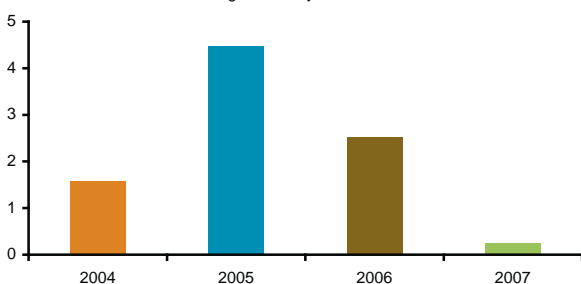
R\$ billion – Accumulated through February



Source: CVM

Figure 3.22 – Debenture primary issues in the capital market

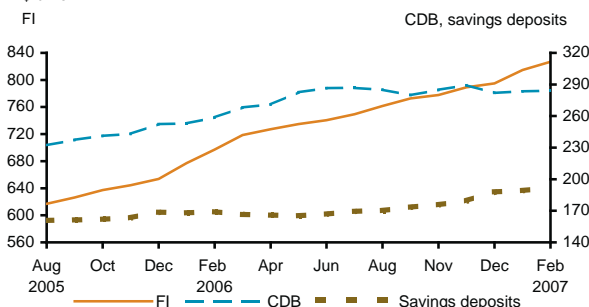
R\$ billion – Accumulated through February



Source: CVM

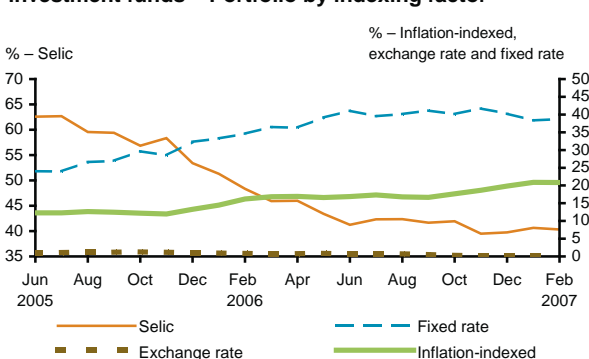
Figure 3.23 – CDB, FI^{1/} and savings deposits

R\$ billion



1/ Excludes investment funds in stocks and external debt.

Figure 3.24 – Participation of public securities in investment funds – Portfolio by indexing factor



promissory notes and placements of credit rights receivables totaled R\$27.3 billion in the three-month period ended in February. New debenture issues totaled R\$18.2 billion in the quarter, for growth of 344% over the same period of the previous year. In this context, it is important to stress operations in the sectors of finance, mining and energy, while funding operations through stocks and credit rights totaled R\$4.5 billion and R\$3.3 billion, respectively, for increases of 80% and 83%, using the same basis of comparison.

Financial investments

The balance of financial investments in investment funds, time deposits and savings deposits totaled R\$1.3 trillion in February, for growth of 4.7% compared to November.

When exchange funds, short-term funds, fixed income funds, multimarket funds and referenced funds are taken into consideration, the net worth of investment funds increased 4.8% in the three-month period, totaling R\$827 billion. The relative participation of multimarket funds reached 24.1% in February, compared to 22.8% in November, while that of referenced funds dropped from 22.2% to 20.7% and the participation of fixed income funds remained stable at approximately 52%.

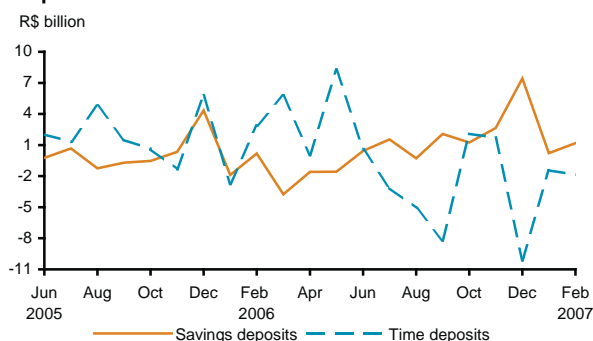
The participation of public securities in total investment fund financial assets dropped from R\$491.2 billion in October to R\$474.1 billion in January. On the other hand, the stock of repo operations reached R\$166 billion, with growth of 36.8% in the October-January period. With regard to private securities, the stock of corporate bonds increased 9.4% while bank securities dropped 1.8%.

The net worth of extramarket investment funds, which manage the resources belonging to the indirect federal administration, totaled R\$24 billion in February, for growth of 11.8% compared to November. Net inflows in the period came to a total of R\$1.9 billion.

Resources invested in variable income funds totaled R\$92.2 billion, for three-month growth of 12.6%, clearly compatible with the evolution of the Ibovespa. Of this total, stock funds contributed R\$81.4 billion, while Mutual Privatization Funds (FMP-FGTS) and Mutual Privatization Funds – Free Portfolio (FMP-FGTS-CL) registered a joint total of R\$10.8 billion.

In the three-month period ended in February, the balance of savings accounts increased 6.8%, reaching R\$191.7 billion,

Figure 3.25 – Net inflow – Savings deposits and time deposits



while total time deposits dropped 1.9% in the period, closing at R\$284 billion. The positive performance of savings accounts reflected net inflows of R\$8.8 billion in the period, as a result of seasonal factors and expectations related to increased profitability in this modality, when compared to other fixed income financial investments.

3.3 Fiscal policy

In January, the federal government issued a series of measures in the PAC framework designed to create conditions for the Brazilian economy to achieve more vigorous growth in coming years, provided that fiscal sustainability conditions be preserved through maintenance of surplus targets compatible with reductions in the net debt/GDP ratio.

In the fiscal arena, the measures proposed by the PAC include infrastructure investments, with the possibility of raising the resources channeled into the Pilot Investment Project (PPI) in 2007 from 0.2% to 0.5% of GDP; expansion of credit and public sector financing; reduction of taxation and tax system improvements; and long-term fiscal measures, including control of growth in personnel outlays at the three levels of government.

In February, a decree dealing with budget and financial programming was issued for the purpose of defining the executive branch disbursement schedule for 2007. With revision of the economic scenario used in projecting the various aggregates in annual budget legislation, it became necessary to impose conditions on spending totaling R\$16.4 billion, so as not to jeopardize the surplus target for the fiscal year.

Public sector borrowing requirements

Evolution in 2006

The consolidated nonfinancial public sector primary surplus reached 4.32% of GDP in 2006, surpassing the 4.25% target defined for the year, thus contributing to a reduction in the net debt/GDP ratio for the third consecutive year. The central government and regional governments turned in surpluses below those of the previous year, while surpluses registered by state-owned companies increased.

The central government result, which includes the National Treasury, Social Security System and Central Bank, was

Table 3.5 – Public sector borrowing requirements – Primary result

	Accumulated in the year					
	2004		2005		Jan (R\$ billion)	
	R\$ billion	% GDP	R\$ billion	% GDP	2006	2007
Central government	-55.7	-2.9	-51.4	-2.5	-3.3	-11.8
Sub-national governments	-21.3	-1.1	-19.7	-0.9	-2.6	-3.8
State companies	-16.4	-0.8	-19.1	-0.9	2.9	2.2
Total	-93.5	-4.8	-90.1	-4.3	-3.1	-13.5

impacted by increased outlays on personnel, current and capital expenditures and the Social Security deficit. Total central government spending increased 13.9% in 2006, while revenues, net of transfers to states and municipalities, rose 11.4%.

Despite growing at a lesser pace than spending, net central government revenues increased 0.7 p.p. of GDP in 2006, primarily as a result of the excellent performance of the oil sector and metallic mineral production, both of which aided in increasing the income tax inflow. Aside from these factors, regular payments of the income tax levied on the financial sector were reinitiated, after being interrupted by judicial decisions in 2005.

Viewed individually, National Treasury revenues posted nominal growth of 10.5%, while spending increased 13.3%. More moderate growth under revenues was caused by reductions in taxation on productive investments since 2005. This factor has contributed to cutbacks in the inflow of some taxes, particularly the Industrialized Products Tax (IPI) and the Contribution to Social Security Financing (Cofins).

Among inflows in the grouping of non-tax revenues, one should stress revenues involving royalties on oil extraction and inflows in the form of dividends, which expanded from R\$4.9 billion in 2005 to R\$9.7 billion in 2006. The increase in the volume of dividends paid in 2006 was, above all, due to the increased profitability of companies, principally Banco do Brasil, Caixa Econômica Federal and BNDES.

With regard to National Treasury outlays, the most accentuated increases were registered under personnel and payroll charges, 13.9%, and current and capital spending, 14.8%, reflecting 28.6% growth in allocations to unemployment compensation and other programs supported by the Worker Support Fund (FAT) and 25.8% in spending on assistance benefits backed by Social Assistance Law (Loas), both of which were strongly impacted by the minimum wage increase.

The 2006 Social Security deficit increased 0.07 p.p. of GDP, compared to the previous year, registering revenue growth of 0.32 p.p. of GDP and an 0.39 p.p. of GDP increase under spending. To some extent, the revenue increase was impacted by growth in job positions on the formal market and by increases in overall wages.

Growth in payments of Social Security benefits resulted basically from increases in the average value of benefits,

Table 3.6 – National Treasury Expenditures

Itemization	2005		2006		Jan (R\$ million)	
	R\$ million	% GDP	R\$ million	% GDP	2006	2007
Total	287 842	14.9	326 124	15.6	28 395	26 936
Transfers to states and municipalities	83 937	4.3	92 780	4.4	8 434	8 133
Personnel and social charges	92 231	4.8	105 031	5.0	10 024	10 223
Capital and current expenditures	111 122	5.7	127 618	6.1	9 935	8 587
Worker Support Fund	11 900	0.6	15 299	0.7	951	851
Subsidies and economic subventions	10 333	0.5	9 551	0.5	2 200	316
Loas/RMV	9 253	0.5	11 639	0.6	851	1 053
Other capital expenditures	79 635	4.1	91 129	4.4	5 934	6 367
National Treasury transfers to the Central Bank	553	0.0	695	0.0	2	- 7

Source: Minifaz/STN

Figure 3.26 – Growth in the average number of benefits issued by Social Security/ RGPS (2006/2005)

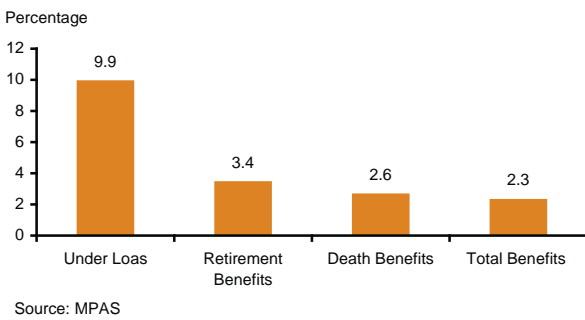


Figure 3.27 – Real and nominal minimum wage^{1/}

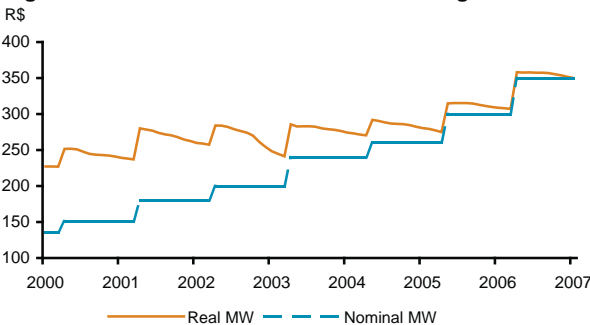


Figure 3.28 – Impact of 1 p.p. increase in the value of the 2007 minimum wage

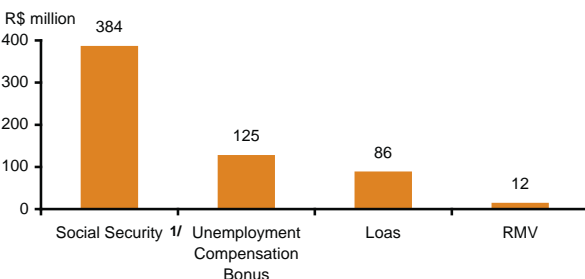
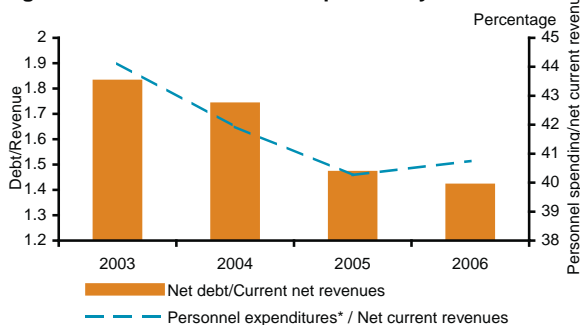


Figure 3.29 – States: Fiscal Responsibility Law



caused, in turn, by the minimum wage hike, and in the average number of benefits paid per month.

Real growth in the minimum wage generated repercussions on the accounts of the three levels of government. At the federal level, the impact was caused above all by outlays on Social Security benefits, Lifetime Monthly Income (RMV), Loas and unemployment insurance and wage bonuses. Based on these benefits, the 2007 Budget Guidelines Law estimated that each one percentage point increase in the value of the minimum wage generates additional spending of R\$607 million in the year. In the case of regional governments, the impact of spending increases tends to be proportionately greater, considering that a large number of employees, particularly in municipalities, receive no more than the minimum wage.

Constitutional transfers of federal resources to states and municipalities increased 10.5% in 2006. This growth was compatible with the 10.3% increase in the income tax inflow, the major source of revenue sharing funds.

Inflows of the Tax on the Circulation of Merchandise and Services (ICMS), the primary source of revenues at the state level, registered real growth of 8.6% in 2006, using the IGP-DI as deflator. Among the various states, the strongest growth occurred in São Paulo, 11.3%, under the impact of the ICMS Fiscal Debt Payment Program, which reduced fines and interest on payments of arrears.

Despite growth in federal revenue transfers and the ICMS inflow, the regional government primary surplus dropped 0.16 p.p. of GDP in 2006. In this case, the sharpest drop occurred in the results generated by municipalities.

Notwithstanding the decline in the 2006 surplus, analysis of the performance of the states based on such indicators as the ratio between net debt and net current revenues, one of the major parameters defined by the Fiscal Responsibility Law, recent years have shown a clear tendency toward improvement in the fiscal area. When all of the states and the Federal District are considered, the ratio between these two variables closed December 2006 at 1.42, compared to 1.74 in 2003. The ratio between outlays on executive branch personnel and net current revenues has shown a similar downward trend in recent years.

The positive domestic and international economic scenarios have guaranteed continued positive results for state-owned companies. One should stress that the primary surplus of state level government companies expanded 73% in 2006,

mainly as a result of capitalization of an energy company through primary stock issuances.

Nominal interest appropriated showed a reduction equivalent to 0.45 p.p. of GDP in 2006, as the average Selic rate declined from 19.1% in 2005 to 15.1% in 2006. The cumulative values incorporate the impact of the higher rates of interest at the start of the year and, in the coming months, will begin showing the result of the downward curve followed by the Selic rate during the period under analysis.

The nominal deficit of the nonfinancial public sector, which includes the primary result and nominal interest appropriated, expanded 0.07 p.p. of GDP in 2006, compared to the previous year.

With regard to the sources of nominal deficit financing in 2006, just as occurred in the previous year, it should be highlighted steady reductions in external financing, coupled with growth in the internal securities debt, the major financing source.

Evolution in January 2007

In January 2007, the public sector registered a primary surplus of R\$13.5 billion, the best result for that month since the series was first calculated in 1991. The central government surplus totaled R\$11.8 billion, while regional governments showed a surplus of R\$3.8 billion. In contrast, state-owned companies closed with a deficit of R\$2.3 billion, primarily as a result of payments of interest on their own capital resources during the period.

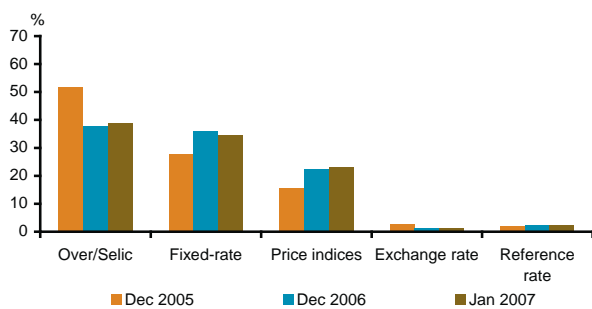
Compared to the same month of the previous year, the improved central government result was impacted by the fact that, unlike 2006, there was no concentration of judicially determined Social Security payments in 2007 nor outlays on capitalization of Asset Management Company (Emgea), which had totaled R\$1.5 billion in 2006. Parallel to this, growth in National Treasury revenues during the period reached 14.3%, with particularly strong growth under the corporate income tax and Social Contribution on Net Profits (CSLL), both of which were impacted by anticipated payment and recovery of debts in arrears. Another factor that contributed to growth in revenues was the increased inflow of dividends, which moved from R\$717 million in January 2006 to R\$1.4 billion in 2007.

Considering cumulative 12-month flows, the primary surplus of the consolidated public sector reached R\$100.5 billion, corresponding to 4.79% of GDP.

Table 3.7 – Public sector borrowing requirements

Itemization	Accumulated in the year			
	2006		2007 - jan	
	R\$ billion	% GDP	R\$ billion	% GDP
Uses	69.9	3.3	0.5	0.3
Primary	-90.1	-4.3	-13.5	-7.6
Interest	160.0	7.7	13.9	7.9
Sources	69.9	3.3	0.5	0.3
Domestic financing	183.4	8.8	14.7	8.3
Securities debt	155.1	7.4	34.5	19.6
Bank debt	7.8	0.4	-8.2	-4.7
Others	20.5	1.0	-11.5	-6.6
External financing	-113.5	-5.4	-14.2	-8.1

Figure 3.30 – Federal securities debt structure by indexing factor^{1/}



^{1/} It excludes swap.

Figure 3.31 – Swap and open market position

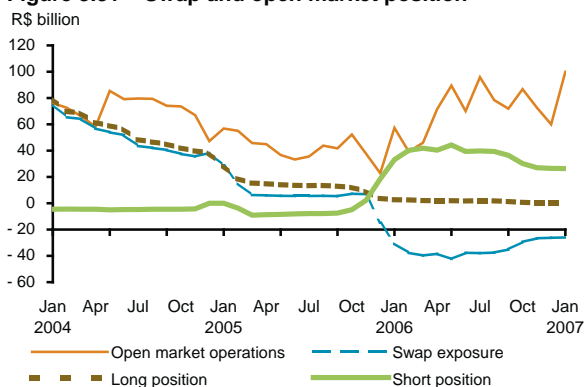


Table 3.8 – Repo operations – Open market

Balances and percentage share

	R\$ million					
	Up to 1 month		More than 1 month		Total	
	Balance	%	Balance	%	Balance	%
2003 Dec	43 742	78.5	11 975	21.5	55 717	100
2004 Mar	47 718	72.1	18 440	27.9	66 158	100
Jun	46 509	58.8	32 578	41.2	79 088	100
Sep	34 839	47.0	39 250	53.0	74 089	100
Dec	7 797	16.5	39 410	83.5	47 207	100
2005 Mar	5 239	11.5	40 506	88.5	45 744	100
Jun	4 099	12.3	29 165	87.7	33 264	100
Sep	-6 857	-16.4	48 591	116.4	41 734	100
Dec	-24 430	-106.9	47 286	206.9	22 856	100
2006 Mar	-8 399	-18.3	54 395	118.3	45 996	100
Jun	7 241	10.3	62 821	89.7	70 062	100
Sep	19 120	26.6	52 779	73.4	71 899	100
Dec	5 800	9.7	54 231	90.3	60 030	100
2007 Jan	46 943	47.0	52 882	53.0	99 825	100

Nominal interest appropriated on an accrual basis totaled R\$13.9 billion in January. With this result, the nominal deficit came to R\$0.5 billion, against R\$14.9 billion in January 2006.

Over twelve months, nominal interest appropriated and the nominal deficit reached 7.4% and 2.6% of GDP, respectively, continuing the downward trajectory that has marked recent months.

Federal securities debt

In keeping with the federal government's strategy of minimizing long-term financing costs and maintaining prudent risk levels, the federal securities debt profile showed increased participation on the part of fixed-rate securities and inflation-indexed securities, coupled with a cutback in the participation of securities indexed to exchange. At the end of 2006, the stock of the federal securities debt evaluated according to the portfolio position reached R\$1,093.5 billion, up 0.9 p.p. of GDP compared to the previous year.

The federal securities debt stock in January totaled R\$1,088 billion, 50.6% of GDP, compared to R\$1,063 billion, 50.4% of GDP, in October 2006. Growth in the three-month period reflected net primary market redemptions of R\$11 billion, the R\$0.1 billion impact of 0.9% appreciation of the real against the dollar and incorporation of R\$36 billion in interest. In the period under consideration, it is important to stress that participation of the fixed rate debt moved from 32.8% to 34.5%.

Using January 2007 as the basis of comparison, the amortization schedule of the securities debt on the market shows that, excluding financing operations, 29% of the total matures in 2007, 24.7% in 2008 and 46.4% as of January 2009. In January 2006, this schedule showed maturities of 33.4% of the securities debt on the market in that year, with 27.1% in the following year and 39.5% after two years.

Exchange swap operations reached a negative total of R\$26 billion in January 2007. Defined as the difference between Interfinancial Deposit (DI) profitability and exchange variation plus coupon, these operations produced a R\$629 billion negative result for the Central Bank in the three-month period ended in January, when viewed according to the cash concept. With this, the cumulative result of these operations since early 2002 has been a positive total of R\$7.6 billion for the Central Bank.

Net public sector debt

Table 3.9 – Net debt growth

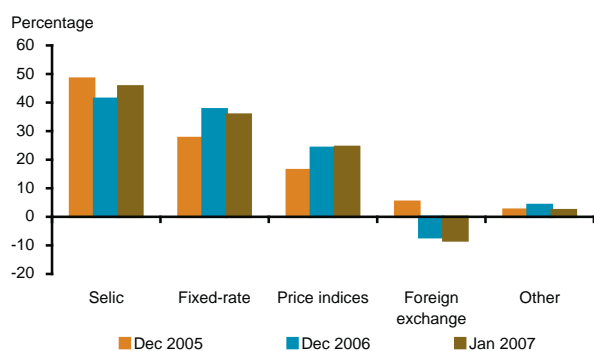
Conditioning factors

Itemization	2005		2006		2007-Jan	
	R\$ million	% GDP	R\$ million	% GDP	R\$ million	% GDP
Total net debt –						
Balance	1 002 485	51.5	1 067 363	50.0	1 067 894	49.7
Flows	Accumulated in the year					
Net debt – Growth	45 488	-0.2	64 879	-1.5	531	-0.3
Conditioning factors	45 488	2.3	64 879	3.0	531	0.0
PSBR	63 641	3.3	69 883	3.3	470	0.0
Primary	-93 505	-4.8	-90 144	-4.2	-13 457	-0.6
Interest	157 146	8.1	160 027	7.5	13 927	0.6
Exchange adjustment	-18 202	-0.9	-4 881	-0.2	388	0.0
Domestic securities debt ^{1/}	-4 554	-0.2	-2 222	-0.1	-89	0.0
External debt	-13 648	-0.7	-2 659	-0.1	477	0.0
Others ^{2/}	-2 258	-0.1	2 302	0.1	1 576	0.1
Skeletons	3 262	0.2	-375	0.0	-1 903	-0.1
Privatizations	-954	0.0	-2049	-0.1	0	0.0
GDP growth effect		-2.5		-4.6		-0.3

1/ Domestic dollar-indexed securities.

2/ Parity of the basket of currencies underlying the net external debt.

Figure 3.32 – PSND – Percentage share by indexing factor



PSND totaled 50.0% of GDP at the end of 2006, against 51.5% of GDP in December 2005. This was the third consecutive decline using this basis of comparison. In January 2007, PSND reached 49.7% of GDP, demonstrating that the downward trajectory has continued. Considering the fiscal targets defined for the year and the outlook for more favorable evolution under nominal interest appropriated, this trend is expected to continue through 2007.

The 1.5 p.p. reduction registered in 2006 reflected the annual primary surplus of 4.32% of GDP, on the one hand, and growth in valued GDP and asset sales, on the other. Moving in the opposite direction, appropriations of nominal interest were the major determining factor underlying growth in the debt/GDP ratio.

Following the example of the federal securities debt, the PSND profile indicated a benign macroeconomic scenario. Participation of fixed rate debt in total PSND increased 10 p.p. in the year, while the share indexed to the Selic rate dropped 7.1 p.p. and that tied to exchange became negative, indicating a net creditor balance. One should highlight growth in the share of credits tied to exchange in January 2007.

The gross general government debt, including the federal government, National Social Security Institute (INSS) and regional governments, reached R\$1,548.7 billion in January 2007, corresponding to 72% of GDP, compared to 72.9% in December 2006 and 74.7% in 2005.

3.4 Conclusion

The behavior of the various money supply measuring instruments reflected the process of monetary policy easing, coupled with natural growth in demand for currency that is typical of periods of disinflation.

Continuation of growth in credit operations during the three-month period ended in January revealed both the seasonal characteristics of the period and the favorable macroeconomic environment, coupled with the ongoing process of monetary policy easing. Continued growth in credits contracted with the financial system was the major support for domestic demand and consumption, in a context of stable default levels and lengthening maturities.

The behavior of credit operations in early 2007 indicates an increased number of contracts formalized at the household level, particularly concerning revolving credit and personal loans. In this context, the modality of payroll-deducted loans remained as the most important. Opposite results have been registered under credits channeled to productive activities, primarily due to the seasonal nature of credit demand in the business community at the start of each year. However, the positive evolution of BNDES disbursements and new consultations clearly indicates that investments will expand.

The recent evolution of public sector accounts resulted in a downward trajectory of the debt/GDP ratio, a process that should be further stimulated over the course of the year by the ongoing easing of monetary policy. Improvement in the PSND profile, with reductions in volatility and longer maturity terms, reveals that public sector liabilities have been suitably managed at the same time in which the confidence of economic agents has increased. Recently adopted measures in the framework of financial and budget programming further reinforce this confidence, to the extent in which they enhance the foreseeability of compliance with the fiscal targets defined for the year.

Public-Private Partnerships

Implementation of public-private partnerships (PPP) has expanded in many countries in the recent past. This mechanism is used as a response to demand for greater investments at a time in which the public sector has been unable to expand its investments as a consequence of high levels of indebtedness. In Brazil, Law 11,079, passed in December 2004, regulates these partnerships. This law incorporates instruments utilized in other countries and seeks to make such operations highly transparent. The objective of this box is to present an overview of the PPP format and, in light of international experience, how it is to be dealt with in fiscal accounts and statistics. The underlying reason for this is the need for preserving the quality of Brazilian public sector information, once the partnership system is implemented in the country.

In traditional public sector investments, the government formalizes contracts with the private sector to construct a specific public sector asset, including highways, hydroelectric plants, and so forth. Once these have been built, the government assumes control and operation of the undertaking. In this framework, both project design and financing are also the responsibility of the government. The PPP mechanism is normally initiated through formalization of a contract between the government and private sector through which the latter will provide specific services. In this case, the private sector is charged with the measures leading up to construction of the asset required for rendering of such services. In return for the services, the earnings of the private sector entity can be paid exclusively by the government or by the government and final consumers of the services involved. Once the initially contracted period of services is concluded, the asset may or may not revert to government control.

Adoption of the PPP presupposes increased efficiency in allocations with greater involvement of the private sector. The contracts clearly define the quality of the services to be rendered, while risk transfers to the private sector are an added factor in ensuring PPP efficiency. At the same time, there is a strong international consensus regarding the importance of transparency in the operations of these partnerships as one way of ensuring their success.

Evaluation of the risks involved in the projects is one of the most important questions related to PPP. Among the risks considered, the most important are those related to construction of the assets, in light of possible changes in construction and maintenance costs; financial risks, related to possible fluctuations in interest and exchange rates; and the risk of availability, related to the quality and availability of the services, in those cases in which these services are provided only partially or in a manner that conflicts with the standards defined in the contract. Furthermore, there is also a risk related to demand for the services to be provided by the PPP, considering the possibility that utilization of the asset in question may not generate the initially expected return. Finally, there are risks related to the residual value of the assets at contract conclusion, which may also be different from the initially foreseen value. Measures can be taken to reduce PPP risks, including issue of well-elaborated regulatory standards, clear definitions of responsibilities and correct valuation of the projects.

Accounting and dissemination of PPP data are not yet based on norms considered internationally acceptable. Some countries and international organizations have sought to develop studies with this purpose in mind. Among these, one should highlight the rules released by the United Kingdom and by the Statistical Office of the European Communities (Eurostat). The central question as regards accounting concerns the decision on how to classify investments to be made or, in other words, whether they should be classified as public or private.

The position adopted by the United Kingdom, one of the pioneering countries in the use of PPP contracts, is that a fundamental decision must be made with regard to proprietorship of PPP assets, depending on

analysis of the risks involved. This analysis follows certain quantitative and qualitative criteria. In the first case, various types of risk are given consideration, based on estimates that must obey quantifiable parameters. In the second case, analysis is made of aspects such as autonomy in management of the asset. If the conclusion drawn is that the public partnership bears the major share of the risk, the asset must be registered in its balance sheet, together with liabilities originating in that asset.

Eurostat takes an analogous position, considering that when transfer of risk to the private sector is limited, PPP assets must be considered as public. Following the recommendations of the Agency, for assets to be considered private and registered in government accounts only as an extra budget heading, the private sector must assume the risk of construction and, at the same time, at least the risk of availability or demand. Responsibility for implementation of the Eurostat recommendations is shouldered by the national statistics agencies of the member countries.

Risk analysis guarantees classification of the assets and liabilities involved in the contracts and makes it possible to calculate the fiscal impact of PPP through traditional measurements of public sector borrowing requirements. If a PPP contract exists in which the government pays the private partner for utilization of services rendered, and if the PPP assets are considered private, then the payments made by the government must be considered as primary spending. For assets considered as public, payment of the corresponding debt must be included in the general calculation of debt service and payments for services rendered must be classified as primary outlays.

Considerable care must be taken with regard to guarantees rendered by the government in PPP contracts. Many of the countries that utilize the PPP mechanism require that these guarantees be clearly reported. This is the orientation adopted by the International Monetary Fund's Code of Good Practices in Fiscal Transparency¹. In those cases in which the government assumes contractual responsibilities for purchase of the services to be provided by the private partner, future outlays

1/ Code of Good Practices in Fiscal Transparency (at www.imf.org/external/mp/fad/trans/code.htm)

consequent upon this obligation must be reported, as is done in the United Kingdom. These outlays can be considered primary future spending in the calculation of the trajectory of the primary result, indicating the extent to which fiscal policy will be conditioned by assumption of these commitments. However, this methodology has been questioned since it includes spending that, in final analysis, depends on contingent factors, such as the quality and timeliness of the services to be rendered.

In the case of Brazil, implementation and management of partnership contracts must be done through specifically structured companies. This procedure is also adopted in other countries. The basic criterion for registration of partnerships in the accounting statements of public entities must reflect the essence of its economic relationship with the SPE created to make the PPP operational. All of the accounting rules are regulated by the National Treasury Secretariat (STN) and are applicable to the three levels of government and their respective state-owned companies.

The STN determined that assumption of a relevant share of at least one of the risks of demand, availability or construction by the public partner is sufficient cause for the SPE assets to be registered in the balance sheets of the public sector entity, in contrast to assumption of debts of equal value as a result of the risks assumed. This procedure is similar to that adopted by Eurostat, albeit more restrictive. In the case of demand risk, the relevant share represents 40% or more of the minimum expected revenues of the project; in the case of construction risk, 40% or more of the contracted cost or the same percentage with regard to cost variations in excess of the originally contracted value; and, in the case of availability risk, the guarantee to the private partner of payment of at least 40% of the payments due, independently of the availability of the service. Here, one should give due attention to the possibility of the contract itself calling for alterations in the initial risk conditions, a fact that can lead to alterations in proprietorship of the asset.

The risks assumed as a result of the guarantees provided by the public partner must be provisioned on the basis of a methodology that reflects the present value of the estimated liabilities. On the other hand,

contingent assets and liabilities must be registered and maintained in compensation accounts until such time as they are recognized as asset accounts. Constitution of the PPP guarantor fund, if it occurs, must be registered as investment.

The Law also determines that the federal government may only contract PPP when, in the previous year, the sum total of continuous spending resulting from all partnerships already contracted did not exceed 1% of net current revenues of that year and annual outlays on contracts formalized in the ten subsequent years do not exceed 1% of net current revenues projected for the respective fiscal years.

In the framework of the federal government, technical and economic studies of the first PPP have already been approved by the National Accounts Court (TCU). This project involves maintenance and expansion of the capacity of the BR-324 highway between the cities of Salvador and Feira de Santana and of the BR-116 highway from Feira de Santana to the border between the states of Bahia and Minas Gerais. At the state level, various states, including São Paulo, Minas Gerais and Rio Grande do Sul, have already initiated PPP programs and several partnerships are now being implemented. Others, such as Rio de Janeiro, are now discussing a variety of projects.

The accounting rules established by the STN to be applied to PPP are based on best international practices and on criteria that prioritize the economic nature of transactions, while providing an excellent foundation for calculating the fiscal impact of the partnerships and facilitating the task of calculating and disseminating data by those responsible for compiling fiscal statistics. In the case of fiscal information released by the Central Bank, the requirements of transparency and incorporation of PPP assets and liabilities into public sector balance sheets, with the risks being assumed by the public sector, will make it possible to steadily monitor net debt and borrowing requirements according to the current methodology. Nonetheless, given the wide variety of formats that partnerships can assume, the possibility of operations that require specific treatment in fiscal statistics will be dealt with on a case-by-case basis after a detailed study of the concrete situations involved.

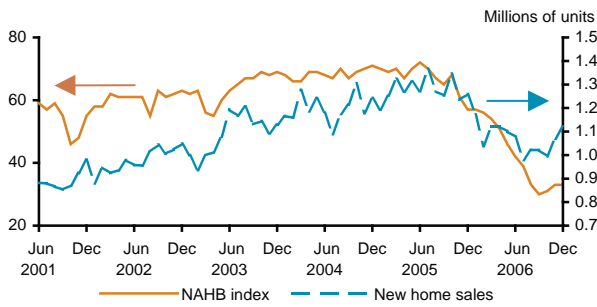
The positive fourth quarter 2006 performance of the world economy suggests consolidation of a scenario of gradual deceleration in activity levels in 2007. On the one hand, this outlook is based on gradual cooling of the United States economy, despite real estate market turbulence in that country, and, on the other, continued strong growth in Japan, Western Europe and the emerging economies. However, corroboration of this scenario will depend on the success achieved in curtailing oil prices and on whether it will be possible to limit the impact of both real estate sector troubles on American consumer spending and deceleration of the United States economy on events in other economic regions.

In the quarter ended in February, financial market liquidity remained high. Not only did this aid in improving the economic fundamentals of the emerging economies while lowering international investor risk aversion, it also resulted in valuation of the assets of those economies. Nonetheless, the Shanghai Stock Market Index plummeted 8.8% on February 27. Coupled with concerns regarding the sustainability of United States economic growth and the undoing of carry trade operations financed in yen and Swiss francs, this movement triggered across-the-board losses in major international stock exchanges and, consequently, a sharp uptick in the volatility of financial asset prices and risk perceptions. In this scenario, which prevailed through March 5, demand for less risky assets spiraled. Between March 6 and March 12, risk indicators and stock market indices managed to recoup some of the losses registered in the previous period.

4.1 Economic activity

Driven by 4.2% growth in private consumption, United States GDP expanded 2.2% in the final quarter of 2006. Powered to some extent by declining oil prices, the solidity of consumer spending is demonstrated by positive growth in consumer confidence indices and the fact that real

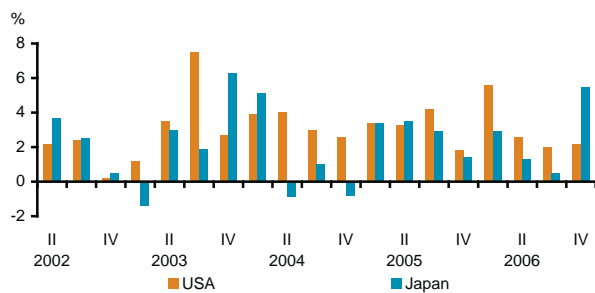
Figure 4.1 – USA – New home sales x NAHB index^{1/}



Source: National Association of Realtors and National Association of Home Builders
1/ Confidence index of home builders.

estate market losses have not yet generated any significant repercussions. On the other hand, private fixed investment dropped 8.5% as a result of declines in both residential and nonresidential investment. Though real estate activity has shown signs of recovery since October, the existence of an excessively large volume of homes up for sale has dampened new housing starts.

Figure 4.2 – USA and Japan – GDP^{1/}

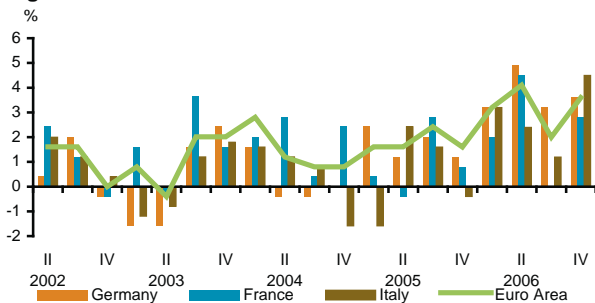


Sources: Bureau of Economic Analysis and Economic and Social Research Institute
1/ Quarterly growth. Seasonally adjusted annualized rates.

Despite a drop in the pace of hirings in February, the labor market remains strong, with unemployment of 4.5% in that month. The manufacturing sector has eliminated jobs, primarily in the automotive industry, mainly as a result of stocks accumulated between May and September 2006. In November, the expectations index released by the Institute for Supply Management (ISM) dropped below 50 points for the first time since May 2003, revealing a significant level of pessimism among manufacturing industry executives.

In Japan, the economy expanded 2.2% in 2006, against 1.9% in 2005. The pace of activity accelerated in the final quarter, when GDP expanded 5.5% in annualized terms. Above all else, growth has been driven by domestic demand and sustained by discreet but solid growth in consumer spending and steady expansion in gross fixed capital formation. Consumption reflects the labor market situation, characterized by low unemployment levels and slight growth in average earnings. Expectations for 2007 point to a moderate drop in the activity level caused by a slowdown in external demand and gradually expanding domestic consumption.

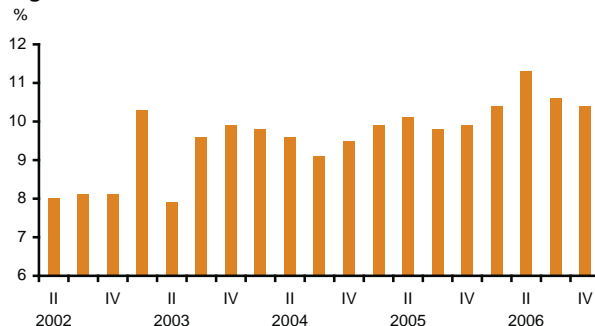
Figure 4.3 – Euro Area – GDP^{1/}



Source: Eurostat
1/ Quarterly growth. Seasonally adjusted annualized rates.

Following 1.4% growth in the previous year, the Euro Area economy expanded 2.6% in 2006, the best performance since 2000. To some extent, this result reflected an annual decline of 1 p.p. in unemployment in the region, which closed January 2007 with a jobless rate of 7.4%. Growth in the activity level accelerated in the fourth quarter, with annualized quarterly expansion of 3.6%, powered mainly by rising private investment throughout the year in an environment of recovery in corporate sector assets, coupled with increased sales in Germany as consumers anticipated purchases to avoid the increase in the value added tax as of January 2007. At the end of 2006, when Slovenia adopted the common currency, the bloc's industrial activity came to include thirteen countries, opening the way for more positive growth in the coming months.

Figure 4.4 – China – GDP^{1/}



Source: Bloomberg
1/ Growth rate over the same period of previous year.

Despite application of administrative measures and monetary policy restrictions aimed at dampening the overheated pace of investment and credit growth in China, that country's economy expanded 10.7% in 2006, the highest rate since

1996. The activity level was sustained primarily by the robusticity of gross fixed capital formation which, though it declined somewhat during the year, still registered 24% positive growth in nominal terms. Industrial output expanded 16.6% and retail sales rose 13.7%. Burgeoning domestic consumption has contributed to the sustainability of economic growth, making it less dependent on external demand. Although industrial output and investment indicators in the final months of the year showed some signs of a slowdown, 2007 is still expected to close with economic growth in the range of 10%.

4.2 Monetary policy and inflation

The falloff in oil prices as of mid-2006 had the effect of reducing world inflation. This tendency will be further strengthened by declines in the pace of United States economic activity and, to a lesser extent, by the drop in Chinese activity, coupled with intensification of monetary restrictions in Europe. This scenario has aided in curtailing inflationary expectations and could lead central banks to begin easing monetary controls earlier than expected.

In the United States, cumulative 12-month inflation reached 2.1% in January, a level somewhat lower than in the first half of 2006. This result, together with economic growth below the potential level, has made it possible for the Federal Reserve System (Fed) to hold its annual Fed fund target unchanged at 5.25% since June 2006. Despite the risks involved, this scenario is expected to persist. The fact is that, on the one hand, the American economy has grown at a sustainable pace, driven by a consumption level sufficient to offset real estate market difficulties, at the same time in which unemployment remains low and utilization of installed output capacity high. Evidently, these factors indicate a risk of upward movement in inflation rates. On the other hand, it is now expected that average 2007 oil prices will be lower than in 2006, making acceleration of headline inflation rather unlikely, while rent values are expected to decline as the prices of new homes have plummeted. Taken together, these factors not only indicate that the Fed will probably maintain its current posture, but also point to a potential reduction in the inflationary core.

In the Euro Area, inflation dropped back to the 1.9% per year level posted in November and December 2006, before dropping once again in January 2007 to 1.8%. Since liquidity remains strong, at the same time in which credit, currency and utilization of installed industrial capacity have hit

Figure 4.5 – Official interest rates

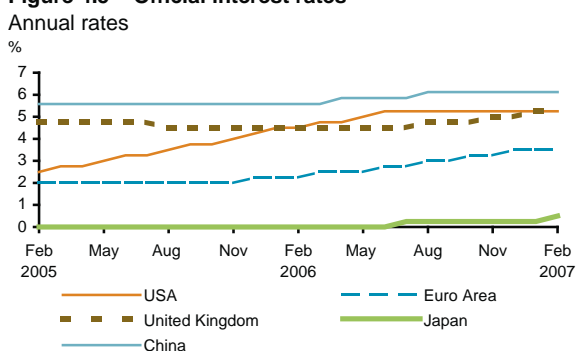


Figure 4.6 – Inflation – USA

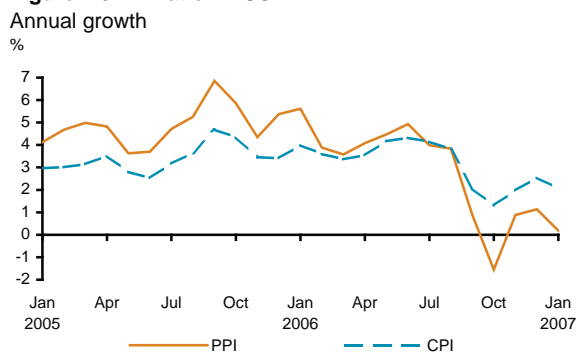
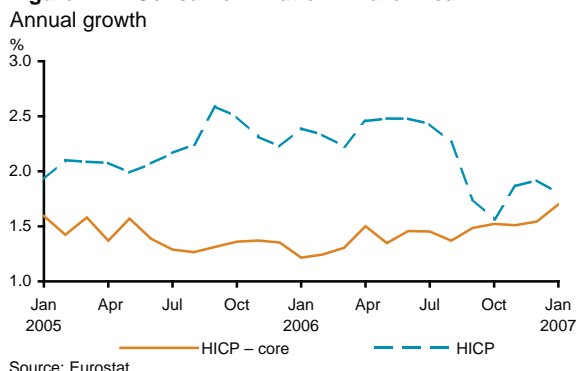


Figure 4.7 – Consumer inflation – Euro Area



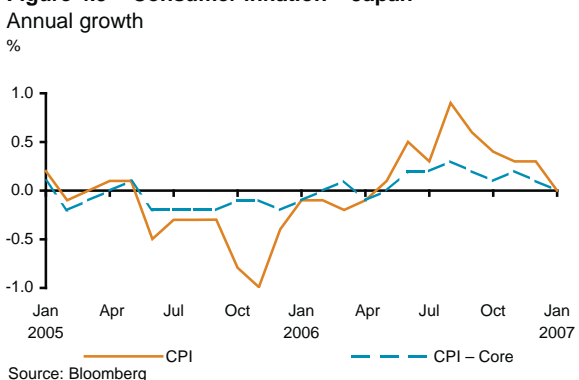
historic highs, the European Central Bank (ECB) has insisted on the need for close monitoring of prices and, in this sense, has continued the cycle of monetary restrictions, raising the basic rate of interest successively to 3.5% per year in December and 3.75% in March.

Figure 4.8 – Consumer inflation – United Kingdom



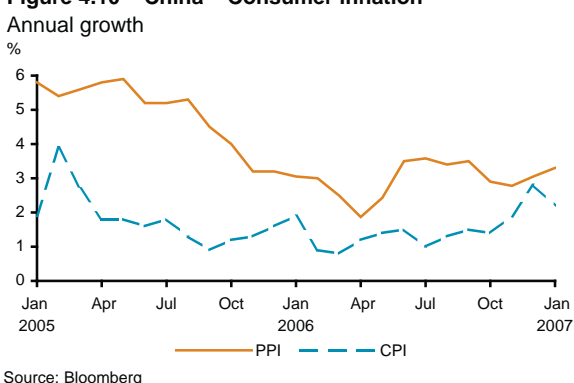
In the United Kingdom, increases in food and education prices as well as taxes generated additional pressures on inflation, posting a high in the second half of 2006 and closing the 12-month period through December at a record level of 3% per year, before dropping back to 2.7% in January 2007. In the face of this trend, the Bank of England’s Monetary Policy Committee raised the repo rate to 5.25% per year in January. Current expectations indicate that, after absorbing the tax increases, internal energy prices have accompanied the decline in international prices. With these factors, coupled with the increase in basic interest rates, inflation is expected to return to the 2% target level in 2007.

Figure 4.9 – Consumer inflation – Japan



Following a seven-month hiatus, the Bank of Japan (BoJ) raised the overnight rate to 0.5% per year in February, thus reducing liquidity without, however, hampering the accommodative character of its monetary policy, as is evident in the fact that real interest remains below 0.5% per year. Despite deflation pressure resulting from reductions in the prices of services and energy, the BoJ took the position that utilization of resources has increased and that domestic consumption has embarked on a moderate growth trend that, over the long-term, would result in higher prices.

Figure 4.10 – China – Consumer inflation

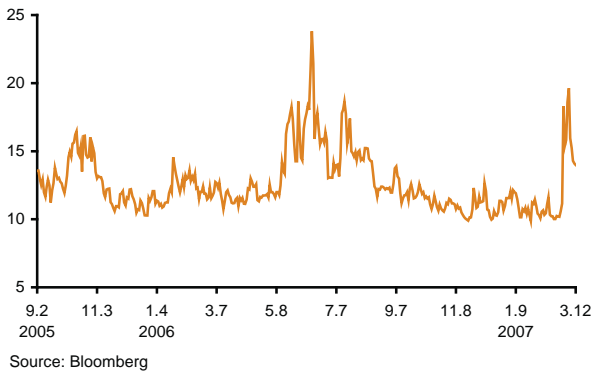


At the beginning of the year, the Peoples’ Bank of China (PBC) raised reserve requirements from 9% to 10% in order to continue the process of monetary sterilization. Despite the more liberal approach taken to regulated prices, productivity growth surpassed wage gains and aided in curbing prices. In a scenario of low inflation – cumulative 12-month growth rates of 2.8% in December 2006, 2.2% and 2.7% in January and February 2007, respectively, were generated basically by seasonal growth in food prices – the PBC’s decision to raise reserve requirements while holding the basic rate of interest to 6.12% per year in effect since August demonstrates that the institution does not intend to increase its international reserve stock, which totaled US\$1.07 trillion in December 2006.

4.3 International financial markets

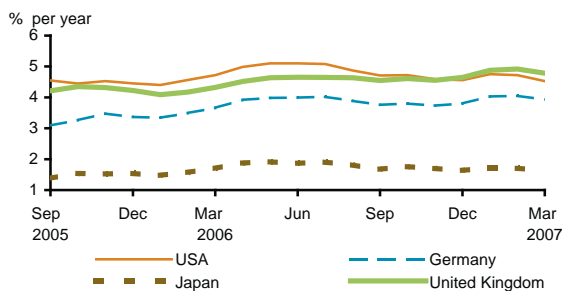
The Chicago Board Options Exchange Volatility Index (VIX), which measures the implicit short-term volatility

Figure 4.11 – VIX



of Standard & Poor's 500 (S&P500) and is considered a thermometer of investor risk aversion, fluctuated between 9.9 and 12.7 in the period extending from December 1 to February 26, averaging 11, compared to an average of 11.4 in the quarter ended in November. On February 27, stock exchanges all over the world registered significant losses, following the drop posted at the Shanghai Exchange, while the VIX index registered 18.31, a 64.2% high compared to the previous day. While volatility remained intense through March 5, when the index hit 19.63, the VIX index dropped to 13.99 on March 12.

Figure 4.12 – Yield on government bonds^{1/}

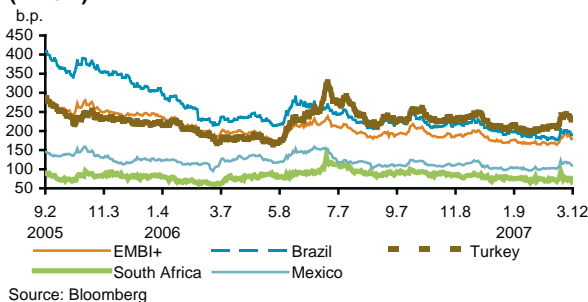


^{1/} Monthly average of nominal yields on 10-year bonds, up to March 12, 2007.

Expectations regarding the permanence of Fed funds at 5.25% per year for a longer than originally anticipated period provoked a rise in earnings on long-term American bonds. As of December 4, when annual returns on 10-year United States Treasury bonds stood at 4.42%, the lowest level of the last eleven months, the earnings curve on these papers reversed course and climbed to 4.89% on January 29. Since that time, however, earnings on 10-year United States bonds dropped once again, closing March 12 at an annual rate of 4.55%. Part of this movement reflected pursuit of lower risk assets as a consequence of increased market volatility.

A similar performance was registered under long-term German and British securities. German bonds rose 43 basis points between November 30 and February 13 and from that point through March 12 lost nineteen basis points. Ten-year bonds issued by the United Kingdom, which had registered yearly earnings below those of their United States counterparts since September 2005, reversed course as of the end of November and produced annual earnings higher than those offered by the American Treasury. Between November 30 and February 1, earnings on British papers expanded fifty basis points. From that point forward, the rates on these papers dropped nineteen basis points through March 12. In their turn, Japanese securities turned in somewhat different behavior, fluctuating around 1.7% per year, with a final March 12 annual rate of 1.62%.

Figure 4.13 – Emerging Markets Bond Index Plus (Embi+)



Lesser risk aversion has impacted the trajectory of the Embi+, the risk indicator applied to emerging economies. In the three-month period ended in February, this indicator registered an average of 173 points, after dropping to its lowest historical value of 165 points on February 6, compared to 194 points in the three-month period ended in November. On February 27, the turbulence that broke out on the Chinese stock market generated repercussions throughout the world, pushing the Emerging Markets Bond Index Plus (Embi+) up 9.4%, compared to the previous day, to a level of 187 points before closing March 12 at 180 points. Analysis of

final February figures shows that Embi+ indicators for Brazil, Turkey, South Africa and Mexico registered reductions of 12.6%, 4.1%, 3.5% and 5.8%, respectively, compared to November 30.

Figure 4.14 – Stock exchanges – USA, Europe and Japan

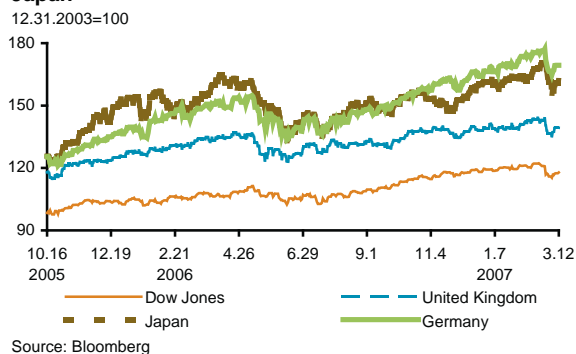


Figure 4.15 – Stock exchanges – Emerging markets

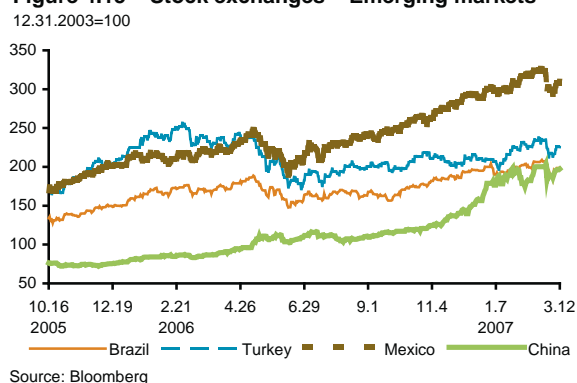
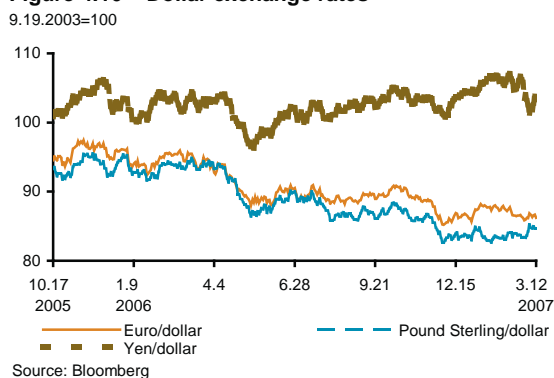


Figure 4.16 – Dollar exchange rates



The major stock exchange indices turned in positive growth in 2006 as the American Dow Jones, British Financial Times Securities Exchange Index (FTSE 100), German *Deutscher Aktienindex* (DAX) and Japanese Nikkei closed with annual increases of 16.3%, 22%, 10.7% and 6.9%, respectively. Among the emerging economies, Brazil's Ibovespa, Mexico's IPC and China's Shanghai index expanded 32.9%, 48.6% and 130%, in the same period. More recently, exchanges in Germany, the United States and Japan posted respective growth rates of 11.4%, 3.4% and 11.9% between November 30 and February 26, while the Brazilian, Mexican and Chinese exchanges closed with respective growth of 10.2%, 12.4% and 44.8%. Starting on the 27th of the month, exchanges all over the world shifted into a downward curve, with declines of 7%, 4.6% and 8.4% in the German, American and Japanese stock exchanges, respectively, and 10.9%, 8.1% and 8.4% in the Brazilian, Mexican and Chinese stock exchanges, in that order. On March 6, exchanges across the world registered a new high. Between March 6 and 12, stock exchanges posted partial recovery of recent losses. The DAX, Dow Jones and Nikkei rose 2.8%, 2.2% and 3.9%, respectively, in the period under consideration, while the Brazilian, Mexican and Chinese stock indices posted gains of 7.5%, 5.7% and 6.1%, respectively.

Exchange market performance was affected by more precise evaluations of the activity level in the United States and an across-the-board increase in market interest rates in that country. With this, the dollar appreciated against the pound sterling, euro and yen, as of early December. Between December 4 and February 12, appreciation of the American currency reached 1.8%, 3% and 5.8% compared to the aforementioned currencies. Though it remained practically stable against the euro between February 26 and March 12, the increase in international market risk aversion intensified the upward movement of the dollar against the pound sterling (1.6%).

Returning to the trend begun in the second quarter of 2006, appreciation of the dollar against the yen brought the rate of exchange between the two currencies to the level in effect in March 2003, when the United States initiated its process of economic recovery and Japan was mired in a situation of chronic deflation. Nonetheless, the undoing of carry trade operations backed by resources raised by international investors on the Japanese market provoked

4.2% depreciation of the dollar against the yen, between February 26 and March 5. This figure declined to 2.4% on March 12. Following devaluation against the euro and pound, dropping to the lowest historical level and the lowest point since August 1998, the yen appreciated 2.5% and 4.1%, respectively, compared to the same currencies, in the period from February 26 to March 12.

Up to that point, the impact of the rise in international market risk aversion on the currencies of the emerging countries had been considerably less than when the events of last May began. The currencies most seriously impacted were those of South Africa and Turkey, with devaluations of 3.7% and 1.5% against the dollar between February 26 and March 12.

However, it is important to stress that positive international capital flows, coupled with adoption of macroeconomic policies aimed at reducing inflationary pressures and curbing aggregate demand, have contributed to exchange stabilization since December, particularly in Turkey and Hungary.

It is important to note that the South African currency reacted in a highly differentiated manner against the dollar, when compared to the Turkish and Hungarian currencies, with depreciation of 5.9% between January 2 and March 12, despite the fact that the same conditioning factors were present in South Africa and the rand had depreciated at a much sharper pace since the end of February 2007. This evolution was also influenced by January alterations in commodity prices, since these prices have a powerful impact on the South African current account balance and on the amounts needed to finance it, particularly when one considers the importance of that country's stock market and mining companies in attracting external investments.

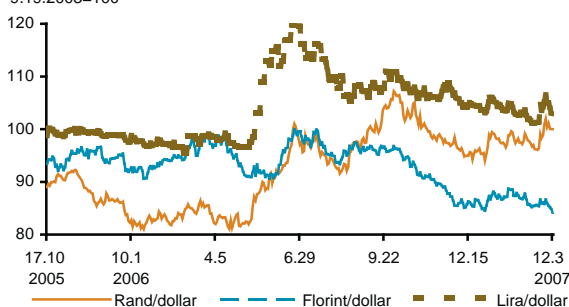
Following the rise in risk aversion levels between last May and June, expectations regarding recovery of international capital flows to the emerging markets were easily surpassed, provoking a substantial increase in Institute of International Finance (IIF) estimates of private capital flows to those markets in 2006. According to the January IIF report, private capital flows to the emerging economies were US\$83.8 billion above the Institute's final September 2006 projection and closed in the range of US\$502 billion in 2006, due primarily to growth in bank loans and portfolio investments.

The forecast reduction of just 1.5% in private capital flows, compared to the 2005 record, is worthy of note, despite the fact that net flows of direct investments and net security issuances abroad dropped by respective levels

Figure 4.17 – Emerging markets currencies

South Africa, Hungary and Turkey

9.19.2003=100



Source: Bloomberg

Table 4.1 – Private capital flows to emerging economies

	US\$ billion		
	2004	2005	2006
Private capital flows	348.9	509.2	501.7
Equity	195.1	254.5	255.0
Direct Investment	156.0	198.7	185.3
Portfolio	39.1	55.8	69.7
Private creditors	153.8	254.7	246.7
Commercial banks	60.9	141.8	143.3
Nonbanks	92.9	112.9	103.4

Source: IIF

of approximately US\$13.4 billion and US\$9.5 billion. Nonetheless, it is important to consider that the reduction in net issuance of securities abroad mainly reflects pre-financing and debt buyback operations that became considerably more attractive as a consequence of positive market conditions and the strong current account positions held by several countries. In the same sense, the cutback in net direct investments in the emerging economies at least partially reflects growth in the capital flows of those economies, particularly from China and Brazil, to other countries, including emerging countries not covered in the IIF sample, as well as developed nations.

In this regard, preliminary data published by the United Nations Conference on Trade and Development (UNCTAD) for developing countries indicate growth from US\$334.3 billion to US\$367.7 billion in 2006 overall flows of foreign direct investment to these economies, excluding the value of national investments abroad from the net result of each of the countries involved.

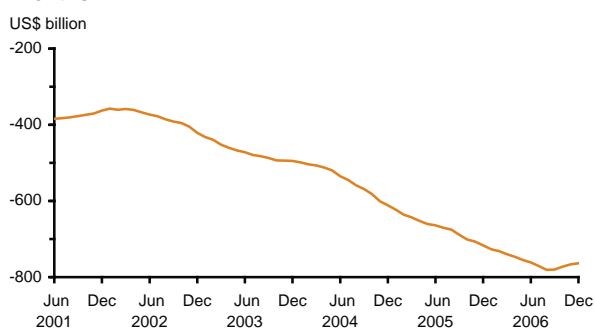
4.4 World trade

In 2006, international trade continued expanding at a much faster pace than economic growth. Depreciation of the dollar had only moderate impacts on trade flows and, as of September, reversed the trend toward an even larger United States trade deficit compared to the rest of the world. Among other factors, the sustainability of this turnaround will depend on whether oil prices will continue stable.

In 2006, United States imports were 53% greater than exports, resulting in a deficit of US\$763.6 billion, 6.5% more than in the previous year. On the other hand, the negative balance moved downward during the entire year, as exports expanded at a more rapid pace than imports, resulting in a 4.4% reduction in the fourth quarter trade deficit compared to the three previous months. This evolution was caused as much by the impact of dollar depreciation and world economic growth, which clearly favored export sector performance, as by a slight drop in domestic demand, with negative impacts on overall imports. It is important to note that the oil trade accounted for 89% of the increase in the deficit in 2006.

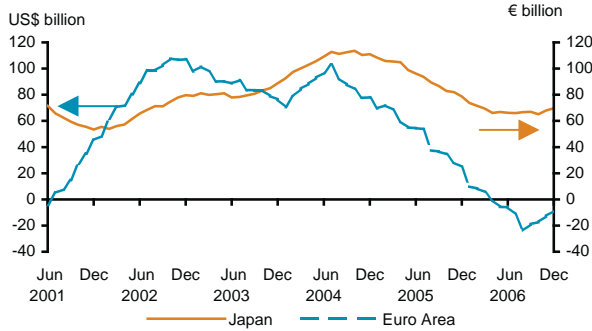
The 2006 oil price high was a factor of importance in reversing the Euro Area trade balance result from a €8.2 billion surplus in 2005 to a deficit of €16.2 billion in 2006, despite the fact that the drop in these prices made it possible to adjust

Figure 4.18 – USA – Trade balance accumulated in 12 months



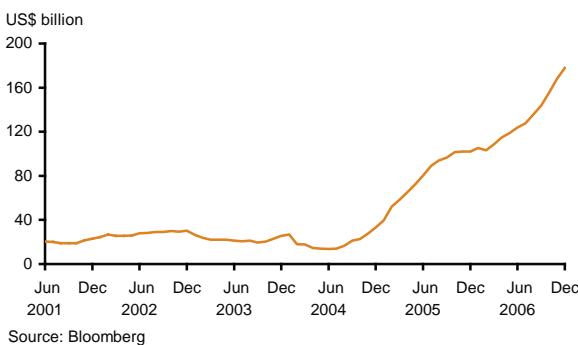
Source: Bloomberg

Figure 4.19 – Japan and Euro Area – Cumulative 12-month trade balance



external accounts in the second half of the year, accompanied by gradual growth in the trade balance surplus. Purchases and sales of manufactured goods expanded at equivalent rates, while imports of primary products increased, particularly as a result of the evolution of oil prices. Among the major European economies, one should highlight the solid export performances of the United Kingdom and Germany, with growth of 17% and 14%, respectively, in the first 11 months of 2006, compared to the same period of 2005. In France and Italy, growth came to 6% and 9% in that order, using the same basis of comparison.

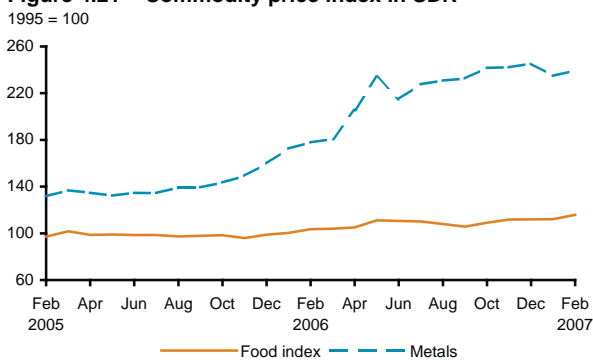
Figure 4.20 – China – Cumulative 12-month trade balance



Japanese exports remained strong in 2006, with acceleration as of September as a result of American purchases of automobiles and auto parts and continued strong Chinese demand. Exports increased 9.6% in the year and imports rose 12.8%, mainly as a result of increased oil prices. Even with the drop in oil prices and depreciation of the yen, imports remained strong in the final months of the year, further corroborating the solidity of domestic demand.

China's trade performance set new records in 2006 and once again contributed decisively to the country's economic growth, as imports posted relative growth and exports declined. However, recent evolution has not avoided growth in the trade balance surplus from US\$102 billion in 2005 to US\$177.8 billion in 2006, based on annual growth of 27.2% in exports and 19.9% in imports.

Figure 4.21 – Commodity price index in SDR



4.4.1 Commodities

Expectations for metallic minerals in 2007 are closely tied to economic growth and, more specifically, to expansion of the Chinese economy. The metallic commodities index rose 2% in February following a January decline of 4.3%, though this is not interpreted as an upward trend. While drops in some prices, such as copper, have caused some skepticism regarding future performance, the fundamental points that will define the medium-term trend are tied to structural factors and will continue to determine the next price plateau.

Farm commodity prices registered 3.4% monthly growth in February 2007, with sharp highs under soybean and corn prices, following a 0.1% decline in January of this year. Sugar, coffee, wheat and cotton prices posted a short-lived decline in the early part of the year.

4.4.1.1 Oil

Once the pressures that marked the April-August 2006 period had subsided, international spot market prices for Brent-type oil dropped back into the range of US\$60 per barrel at the end of the year. Despite cutbacks in Russian supplies and in the Organization of Petroleum Exporting Countries (Opec) oil output, coupled with long-standing problems in the Middle East, the less rigorous winter in the Northern Hemisphere contributed to the price decline. However, this trend reversed course in February as the prices of this commodity shifted upward following an unexpected drop in Northern Hemisphere temperatures.

Futures market prices absorbed the impact of spot market shifts. At the end of 2006, Brent-type oil was priced at US\$66.20 per barrel for delivery in December 2007. One month later, at the end of January, this price had dropped to US\$62.15, only to rise once again to US\$64.44 on March 12. In the space of 71 days, Brent-type oil prices for December 2007 dropped US\$1.76, thus reinforcing expectations of prices in the range of US\$60, a level considered acceptable by Opec in order to maintain long-term equilibrium between world supply and demand. The International Energy Agency (IEA) forecast growth of 1.6 million barrels/day in 2007 world demand.

4.5 Conclusion

The continuity of positive world economic performance has been linked to the impact of possible slowdowns in the United States and Chinese economies. Confirmation that the current cycle of global expansion is now in its intermediate stage and not in its final stage should generate a more benign scenario for the evolution of business activity and consumer demand. Formation of this scenario should be further stimulated by expectations of decreased monetary restrictions imposed by major central banks, in a framework of moderate growth with no apparent signs of an inflationary uptick.

Despite recent turbulence, particularly in stock markets, the outlook for global liquidity is quite favorable, indicating that capital flows will continue at current levels in 2007, including those channeled to the emerging economies.

Nonetheless, this scenario is not devoid of risks, as reflected in uncertainties regarding short-term financial market adjustment, oil price growth and persistent global macroeconomic imbalances.

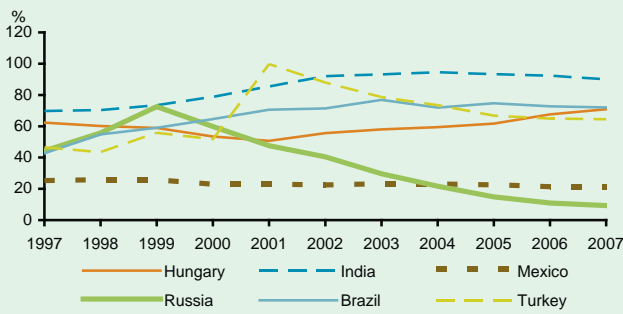
Fiscal and External Sustainability Indicators

Just as occurred with recently observed turbulence, the instability registered in international financial markets in the period extending from May to June 2006 had a negative impact on the assets of emerging economies, revealing the effects of a possible reduction in global liquidity levels on investor risk perceptions. Starting in the middle of last June, country risk indicators, stock exchanges, exchange markets and security markets varied sharply among the different emerging economies. This trend was interpreted as a sign of greater investor selectivity regarding those markets, prioritizing economies with more solid macroeconomic fundamentals. The objective of this box is to further the discussion of fiscal and external sustainability initiated in previous inflation reports.

Fiscal sustainability indicators are constructed according to future estimates of government revenues and expenditures, based on the current indebtedness level, the economic policy in effect and projections of real economic growth and exchange and interest rates. The criterion used makes it possible to evaluate the impact of continued application of fiscal policy on the debt/GDP ratio. Parallel to this, analysis of the debt structure is required in order to evaluate short-term fiscal risks. In this sense, information on maturities and the public debt profile are important. The fiscal sustainability approach will be applied to three aspects: interest rate risk, exchange risk and liquidity risk.

Data drawn from Moody's Statistical Handbook – Country Credit, published in November 2006, were used to compare the fiscal sustainability indicators of a group of selected countries. The countries chosen were Hungary, India, Mexico, Russia, Brazil

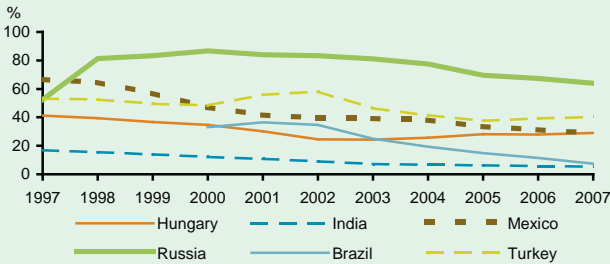
Figure 1 – General government debt/GDP



Source: Moody's Statistical Handbook – Country Credit, November 2006.
 Note: 2006 and 2007 data are estimated.

and Turkey. According to Moody's, the first four are classified as investment grade, while Brazil and Turkey are included in the group considered speculative grade. Figure 1 shows the gross debt/GDP ratio of the general government of the selected group. Utilization of this indicator in the comparison among countries is subject to certain restrictions¹, though it is well worth noting the evolution of the specific indicator for each country. With the exception of Hungary, all of the various countries registered tendencies toward stabilization or even reductions in this indicator. At the other extreme, Russia was impacted by oil industry revenues and, consequently, posted a sharp reduction in the debt/GDP ratio. In Brazil, this ratio, which climbed to 76.9% in 2003, has been dropping and is forecast to close 2007 at 72%, according to Moody's.

Figure 2 – General government foreign currency debt/general government debt^{1/}



Source: Moody's Statistical Handbook – Country Credit, November 2006
 1/ Includes exchange-indexed debt.
 Note: 2006 and 2007 data are estimated.

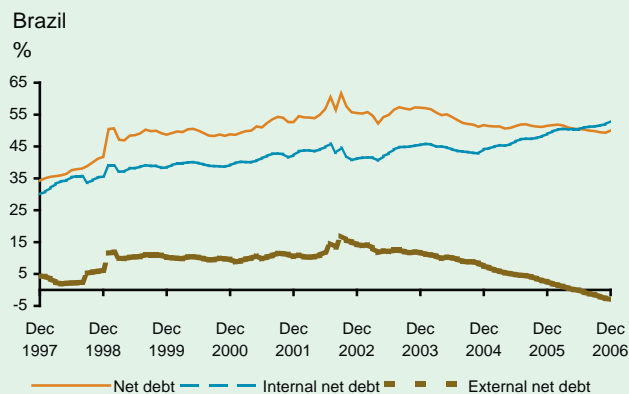
A second source of concern for investors is related to public sector exchange exposure. Figure 2 shows the ratio between general government debt in foreign currency, including debt indexed to foreign currency, and the gross overall general government debt. When utilized on a large scale, indebtedness in foreign currency may be related to a lack of investor confidence in a country's domestic currency, caused by inflationary expectations generated by possible monetization of the debt. An alternative proposed by investors would be financing through increasingly higher interest rates and a greater volume of short-term maturities. A high indicator signals risk of intense growth in the indebtedness level and its costs, should the domestic currency be sharply devalued. Note on Figure 2 that the Brazilian indicator, after reaching 36.4% in 2001, has been dropping systematically and is now expected to close in the range of the 7.4% at the end of 2007, according to Moody's own projection.

Indicators regarding Brazil that are not available for other countries in Moody's publication were also considered: net debt/GDP ratio, net debt indexing factors and short-term solvency indicators. The data include statistics released regularly by the Central Bank.

As noted in Figure 3, the net debt/GDP ratio reached 61.7% in September 2002. In recent years, the

1/ See Moody's Statistical Handbook – Country Credit, November 2006 edition.

Figure 3 – General government net debt/GDP



evolution of this indicator showed rapid growth at two specific moments in time: between December 1998 and the January 1999, the ratio increased 8.8 p.p. and, between April and September 2002, 7.8 p.p. In both cases, the major factor responsible for this evolution was intense depreciation of the real during those periods. Figure 3 also shows stronger external debt growth, compared to the net internal debt, in both periods. Since June 2006, the Brazilian public sector has been a net creditor in external assets. Consequently, should depreciation of the Brazilian currency occur today, the result from the point of view of the net debt would be a reduction in this indicator, contrary to what occurred in the past.

It is important to note that this situation implies lesser risk than when the public sector is a net debtor in foreign currency. The unfavorable scenario from the exchange point of view, that is, appreciation of the real, when the public sector is creditor in foreign currency, would contribute to lesser inflation and the possibility of lower interest rates and would eventually result in less charges for the Treasury. On the other hand, when the public sector is a net debtor, the unfavorable exchange scenario, with depreciation of the real, would lead to higher inflation and interest rates, thus increasing the impact on the public debt.

Figure 4 – Net debt by indexing factor

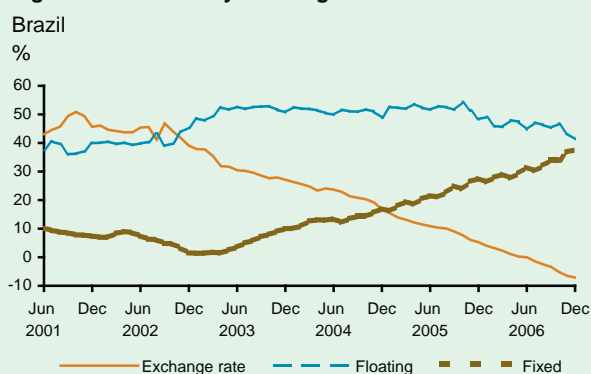


Figure 4 shows the evolution of the nonfinancial public sector net debt profile, broken down by indexing factors. Reduction of the debt indexed to foreign currency occurred parallel to an increase in the percentage of the fixed rate debt, as the participation of the debt indexed to the Selic rate (postset), with 54.3% in October 2005, shifted to 41.3% in December 2006. This evolution reduced the net debt exposure of the Brazilian public sector to the risks of higher interest rates or exchange depreciation.

Finally, evaluation of fiscal sustainability must also involve analysis of short-term solvency. Figure 5 shows the evolution of two solvency indicators: the first indicates the ratio between the federal short-term securities debt (maturing in twelve months) and the total federal securities debt on the market; the second indicates the number of months of the securities debt that can be paid through the use of available National Treasury funds in the Central Bank (operating account), considering the hypothesis that the Treasury

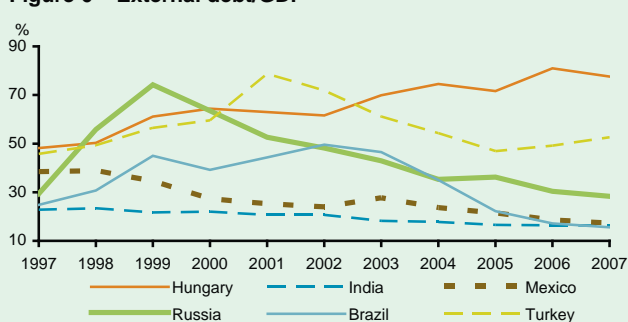
Figure 5 – Solvency in the short-term



does not roll debt maturities in the period². The first indicator shows that, since mid-2004, there has been an ongoing process of decreasing the percentage of the short-term debt compared to total debt. It is important to perceive that this process occurred together with an increase in the percentage of the fixed-rate debt, as shown in Figure 4. The second indicator shows that the National Treasury has maintained a comfortable level of available resources over recent years, with an average sufficiently large to redeem securities to mature in the six following months. Last December, available resources were sufficient to pay 7.4 months of securities debt.

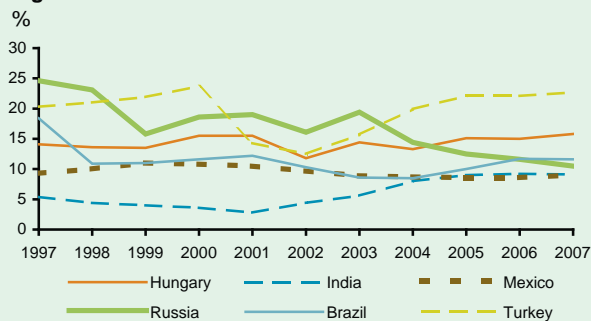
Studies on external sustainability tend to concentrate on the analysis of indicators related as much to external debt as to international reserves. The reserve level and the size of the contracted debt affect the external sustainability of a country because of their impact on the country's capacity to effect regular payments of its liabilities, primarily at moments of international financial market instability.

Figure 6 – External debt/GDP



Source: Moody's Statistical Handbook – Country Credit, November 2006.
Note: 2006 and 2007 data are estimated.

Figure 7 – Short-term external debt/total external debt



Source: Moody's Statistical Handbook – Country Credit, November 2006.
Note: 2006 and 2007 data are estimated.

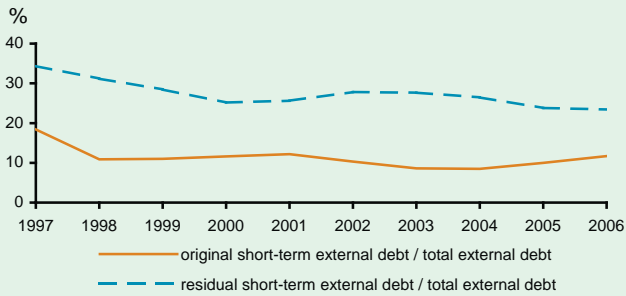
The comparison of external sustainability indicators is, once again, based on Moody's publication. Considering the external debt/GDP ratio, the indicator for Hungary shows a growth trend estimated at 81% at the end of 2006. In the case of Turkey, after following a downward trend, the indicator turned upward once again in 2006 and is now expected to continue this trend through 2007. The Brazilian indicator showed an upward trajectory through 2002, when it reached 49.6%. From that moment forward, this index dropped to a point in which expectations pointed to 17.2% in 2006, coupled with a further drop to 15.6% in 2007.

Analysis of external sustainability also demands a study of the indicators that portray debt maturity. Large volumes of short-term maturities imply risks of rolling the debt at a moment of international market stress. The indicator in Figure 7 shows the proportion of the external debt with original maturities of less than one year. In Turkey, the indicator increased 9.6 p.p. from 2002 to 2005 and, from that point forward, continued at a level in the range of 22%. In India,

2/ This indicator was constructed by dividing available National Treasury resources at the Central Bank of Brazil by the total of the short-term securities debt and multiplying this result by 12.

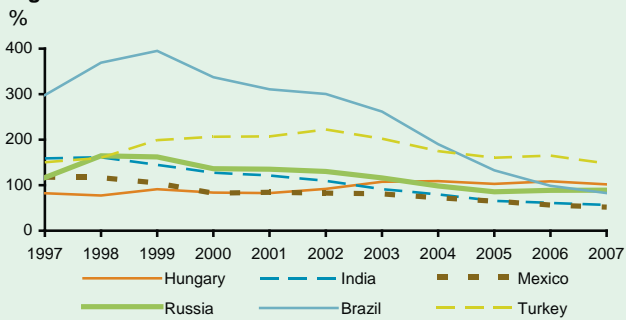
the high reached 4.6 p.p. in the same period and, since that time, has hovered in the range of 9%. In Brazil, after showing stability at around 10% from 2002 to 2005, the indicator is estimated to end 2006 at 11.7%.

Figure 8 – Brazil: Original and residual short-term external debt



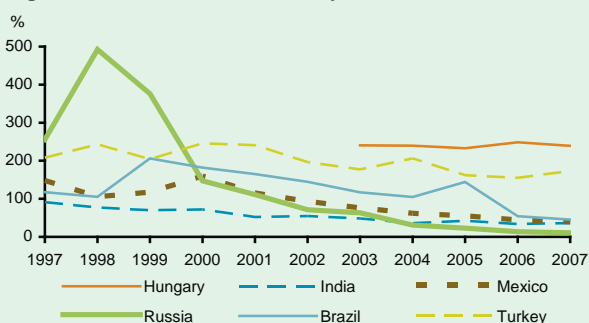
Source: Banco Central do Brasil and Moody's Statistical Handbook – Country Credit, November 2006.

Figure 9 – External debt/current account revenues



Source: Moody's Statistical Handbook – Country Credit, November 2006. Note: 2006 and 2007 data are estimated.

Figure 10 – External vulnerability indicator



Source: Moody's Statistical Handbook – Country Credit, November 2006. Note: 2006 and 2007 are data estimates.

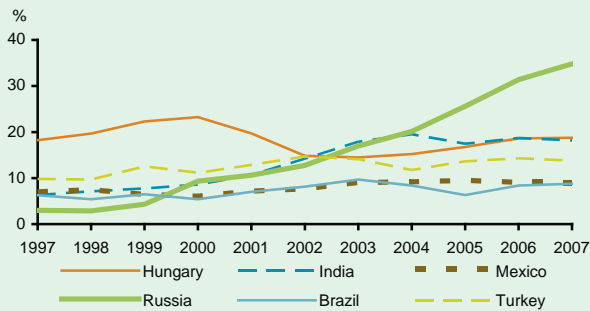
The information on the short-term debt included in Figure 7 refers only to debt with original maturity of less than one year. Figure 8 also includes data on the residual short-term debt, exclusively for Brazil. In other words, it aggregates the debt originally issued as long-term debt but which became short-term debt before maturity into the short-term indicators shown in Figure 7. In this case also, the trajectory of the curve that relates the residual short-term debt to the total external debt shows positive evolution in the Brazilian indicator in recent years.

Another widely used measurement is the ratio between the external debt and current account revenues. In general, the higher this rate, greater will be the probability of a country coming up against interruptions in its capacity to service the debt in situations of adverse shocks. Figure 9 shows improvement in this indicator for Brazil, which had been double that of the group of selected countries through 2003. Moody's estimates shows that the Brazilian indicator is located at the midpoint of the selected countries in 2006, with relative improvement for 2007.

The next indicator, denominated the external vulnerability indicator, draws a relationship between the possibilities of foreign currency flight and official international reserves. This indicator is the result of division of the original short-term external debt, plus the long-term external debt maturing in 12 months and total deposits of nonresidents by official international reserves. This ratio indicates whether the immediately available resources of the country are sufficient for all external debt payments in the absence of debt rollovers. In this way, the index evaluates the country's capacity to withstand temporary reductions in investor confidence at times of decreasing international liquidity. A higher ratio can signal vulnerability. The index presented in Moody's report suggests greater vulnerability in Turkey and Hungary (Figure 10), countries that have registered current account deficits in recent years.

In Brazil, the indicator improved as of 1999, with the sole exception of 2005. For 2006, estimates suggest vulnerability at a level lower than the average for the group analyzed, while expectations for 2007 indicate that reserves will be sufficient to pay twice the value of the total debt maturing in the twelve following months, with no rollovers.

Figure 11 – International reserves/GDP



Source: Moody's Statistical Handbook – Country Credit, November 2006.
Note: 2006 and 2007 data are estimated.

At the same time, the ratio between international reserves and the GDP of the group of countries under analysis is also considered (Figure 11). Data indicate that, in the Brazilian case, though this ratio has followed an upward trajectory in the more recent period, it is still well below that registered by the other countries under analysis.

The indicators registered in this box show positive evolution of fiscal and external sustainability indices in recent years. If, from the fiscal point of view, the ratio between gross debt and GDP in Brazil surpasses the average of the countries included as investment grade, Brazilian vulnerability to exchange shocks, particularly insofar as the public sector is concerned is less than that of the group of countries from some viewpoints.

In 2006, the balance of payments registered its fourth consecutive annual current account surplus. This result clearly demonstrates the magnitude of the ongoing structural process of strengthening the nation's external accounts, based primarily on steadily expanding trade balance surpluses. It is important to stress that this performance has occurred within a scenario marked by growing imports and consequent expansion in overall trade flows.

These highly favorable results have also made it possible to adopt a consistent policy in the management of net public sector external liabilities, which have been considerably reduced as a result of strong growth in international reserves and cutbacks in the external debt stock. International reserves set a new record, surpassing the mark of US\$100 billion at the end of February, while external placements of sovereign bonds aided significantly in building more complete interest rate curves, including in national currency.

In much the same way, reflecting the positive dynamics of the nation's exports, international reserves and external debt, sustainability indicators rose to record levels, not only strengthening the positive evolution of sovereign risk classifications, but also consolidating the already excellent outlook for improvement in the classifications attributed to the country by international rating agencies.

With regard to the exchange market, net 2006 inflows of external resources expanded when compared to the previous year and this trend continued through the first two months of 2007. For the most part, the increase in the surplus was brought about by positive results in the exchange trade balance, despite a significant reduction in the financial account deficit, which was impacted by net inflows of resources targeted to foreign direct and portfolio investments.

As regards 2007, expectations indicate continuation of the excellent balance of payments financing conditions that existed in 2006. In relation to the previous Inflation

Report, projections for 2007 were altered as a result of data for the period through February, including information on net Central Bank market exchange purchases and sovereign bond disbursements, coupled with the new December 2006 external debt position. As a result, projections for amortizations and interest payments were also revised, including the effects of National Treasury buybacks of external securities.

Parallel to this, considering past data and estimates for foreign direct investment inflows, alterations were introduced into trade surplus and current account forecasts for 2007. Estimates of 100% rolling of private medium and long-term debt were maintained. Based on these projections, together with National Treasury market acquisitions of US\$9.1 billion in bond-related external debt service, the exchange market will certainly continue in a surplus position making it possible for the banking sector to maintain an increasingly larger stock of assets abroad, estimated to reach US\$8.4 billion. Estimated final 2007 international reserves are expected to increase US\$19.9 billion.

5.1 Exchange

In 2006, the exchange market registered sharp growth in the surplus of trade segment exchange contracting operations and, more importantly, a reduction in the deficit registered by financial segment contracting operations. This scenario made it possible to harmonize continued application of the National Treasury's policy of acquiring the resources needed to service its external debt on the market, maintenance of the buyback program involving bonds issued by the Republic and acceleration of net Central Bank purchases, while maintaining the basic premises of not creating tendencies nor increasing exchange rate volatility and adjusting the volume of purchases to liquidity conditions.

Contracted exchange generated net inflows of US\$37.3 billion in 2006, compared to US\$18.8 billion in 2005. The net balance in the commercial segment increased 11.3%, rising to US\$57.6 billion, with 17.4% growth under exports and 21.8% under imports. The element most responsible for growth in the exchange surplus was the performance of the financial segment in which net outflows dropped from US\$32.5 billion in 2005 to US\$20.3 billion in 2006, with growth of 62.5% in foreign currency purchases and 41.3% in sales. Increased inflows targeted to direct investments and portfolio investments and private external debt rollover rates of more than 100% were the major factors underlying the reduction in the deficit registered under financial segment

exchange contracting operations. Strong inflows to fixed income securities were generated by the incentives provided by Provisional Measure 281, dated February 2006, converted into Law 11,312, dated 6.27.2006, and by rising international investor confidence, as reflected in strong demand for Brazilian corporate stocks.

In the first two months of 2007, net inflows came to US\$10.7 billion, compared to US\$9.7 billion in the same period of 2006. Net inflows in the commercial segment reached US\$14.8 billion, compared to US\$8.1 billion in the first two months of 2006. Contracting operations in the financial segment produced net outflows of US\$4 billion, compared to net inflows of US\$1.6 billion in the same period of the previous year. In this segment, foreign currency purchases, US\$36.9 billion, and sales, US\$40.9 billion, surpassed the results for the first two months of 2006 by 21.1% and 41.8%, respectively. Under both commercial and financial operations, one should stress the strong impact of anticipated payment of direct loans, US\$6 billion, financed through inflows in the form of anticipated export payments. Though they had no impact on the exchange flow, these operations raised both the commercial segment surplus and the deficit in exchange contracted by the financial segment.

In 2006, the banking segment absorbed the excess exchange surplus not acquired by the Central Bank. Consequently, the exchange position of banks on the spot market moved from a short position equivalent to US\$4.1 billion at the end of 2005 to a short position of US\$2 billion in December 2006. In February 2007, however, the short position held by banks reached US\$6.1 billion.

5.2 Trade in goods

In the first two months of 2007, the trade balance posted a US\$5.4 billion surplus, with US\$21.1 billion in exports and US\$15.7 billion in imports and an overall trade flow of US\$36.8 billion.

Broken down by aggregate factor categories, the average daily value of exports registered across-the-board growth in the first two months of the year, compared to the same period of 2006. Foreign sales of semimanufactured goods increased 29.1%, followed by basic products with 26.3% and manufactured goods, 10.3%.

The dynamics of semimanufactured exports is evident in growth in foreign sales of copper cathodes, 543%; raw

Table 5.1 – Foreign exchange flows

	US\$ billion				
	2006			2007	
	Feb	Jan-Feb	Year	Feb	Jan-Feb
Operations with clients in Brazil	7.7	9.7	37.3	7.0	10.7
Trade operations	4.9	8.1	57.6	4.7	14.8
Exports	10.6	20.0	144.4	12.2	29.6
Imports	5.6	11.9	86.8	7.5	14.8
Financial operations ^{1/}	2.8	1.6	-20.3	2.3	-4.0
Purchases	16.8	30.4	195.4	19.7	36.9
Sales	14.0	28.8	215.7	17.4	40.9
Net flows	7.7	9.7	37.3	7.0	10.7

1/ Excluding interbank operations and Central Bank foreign operations.

Table 5.2 – Trade balance – FOB

Period	Exports	Imports	Balance	US\$ million
				Total trade
Jan-Feb 2007	21 064	15 691	5 373	36 755
Jan-Feb 2006	18 021	12 401	5 620	30 422
% change	16.9	26.5	-4.4	20.8

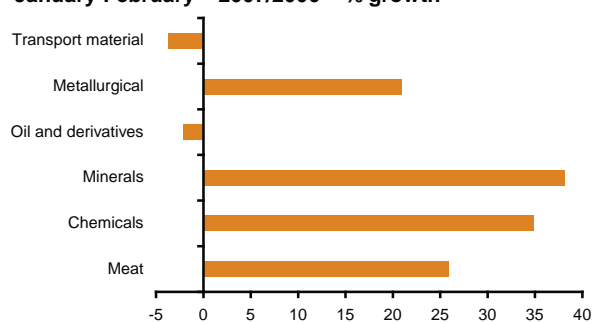
Source: MDIC/Secex

Table 5.3 – Exports by aggregate factor – FOB

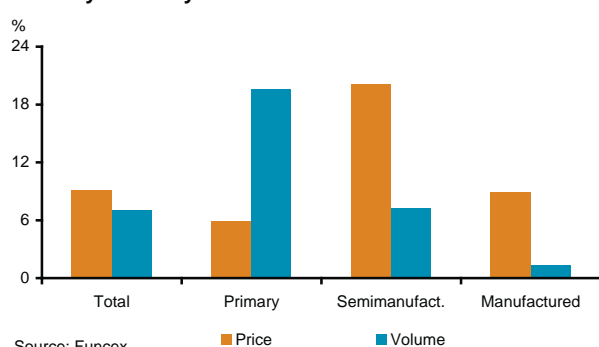
Daily average – January-February

	US\$ million		
	2006	2007	% change
Total	526.6	450.5	16.9
Primary products	152.4	120.7	26.3
Industrial products	362.6	318.0	14.0
Semimanufactured goods	81.1	62.8	29.1
Manufactured goods	281.4	255.2	10.3
Special operations	11.6	11.8	- 1.7

Source: MDIC/Secex

**Figure 5.1 – Main exports
January-February – 2007/2006 – % growth**

Source: MDIC/Secex

**Figure 5.2 – Exports – Price and volume index
January-February – 2007/2006**

Source: Funcex

Table 5.4 – Imports by end-use category – FOB

Daily average – January-February

Itemization	US\$ million		
	2006	2007	% change
Total	310.0	392.3	26.5
Capital goods	64.5	81.0	25.7
Raw materials	158.5	197.8	24.9
Naphtha	5.1	6.0	17.0
Consumer goods	36.8	50.0	35.9
Durable	16.6	22.2	34.2
Passenger vehicles	3.5	5.2	46.5
Nondurable	20.2	27.7	37.3
Fuels	50.3	63.4	26.0
Crude oil	26.8	39.0	45.1

Source: MDIC/Secex

sugar, 70.3%; and leather and hides, 45.3%. In the case of basic products, emphasis should be given to growth in corn grain, 260%; beef, 61.3%; and iron ore, 33.7%. Among products classified as manufactured goods, it is important to highlight 52.5% growth in exports of ethyl alcohol, a product that has assumed an increasingly more significant role among Brazilian exports due to its importance as an alternative renewable energy source, at a time when oil prices have risen steadily. Other manufactured goods that turned in strong positive foreign sales growth in the period under comparison were cargo vehicles, 145%; machines and equipment for earthmoving, drilling, and so forth, 84.6%; and refined sugar, 57.8%.

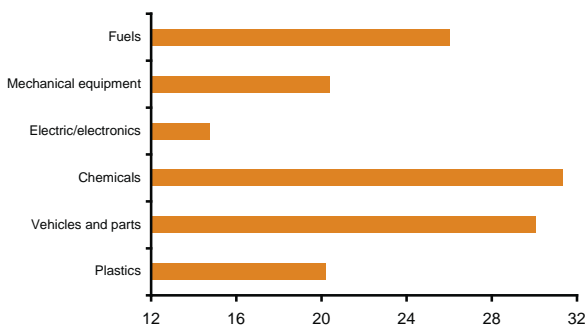
Analyzed according to major economic sectors, exports of transportation equipment and oil and derivatives dropped compared to the January-February 2006 period. Moving in the opposite direction, exports of mineral ores increased 38.2% in the period; followed by chemical products, with 34.9%; meats, 26%; and metallurgical goods, 20.9%. When added to foreign sales of oil and derivatives, the exports of the latter five sectors accounted for 57.3% of total foreign sales in the period.

Export performance in the first two months of 2007 showed strong growth in the prices of products of importance to the Brazilian foreign sales sector, generating an overriding impact on the value of the exports of all of the aggregate factor categories. According to data released by the Foreign Trade Studies Center Foundation (Funcex), the price and volume indices of semimanufactured products expanded 20.1% and 7.3%, respectively, compared to the same period of the previous year; indices applied to manufactured goods rose 8.8% and 1.3%; and prices of basic products increased 5.9% and 19.5%, in the same order.

Compared to the same period of 2006, imports in the first two months of the year expanded 26.5%, posting increases in all of the different use categories. Purchases of raw materials and intermediate goods, which accounted for approximately half of imports, increased 24.9% in the period, led by mineral products, 31%; chemical and pharmaceutical products, 25.1%; and intermediate goods – parts and spares, 10.6%.

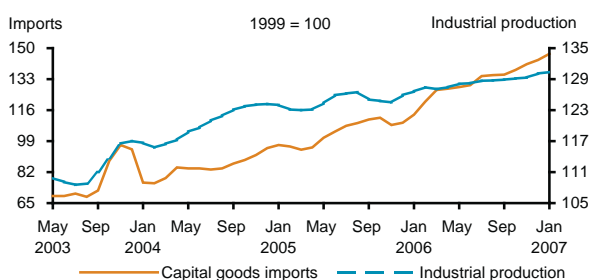
Driven by increases under the headings of furniture and other residential equipment, 52.4%; automotive vehicles, 42%; personal use and adornment articles, 36.7%; and domestic machines and apparatuses, 30.5%, foreign purchases of consumer durables expanded 34.2%. Imports of nondurable consumer goods turned in the most dynamic performance,

**Figure 5.3 – Imports by main products
January-February – 2007/2006 – % change**



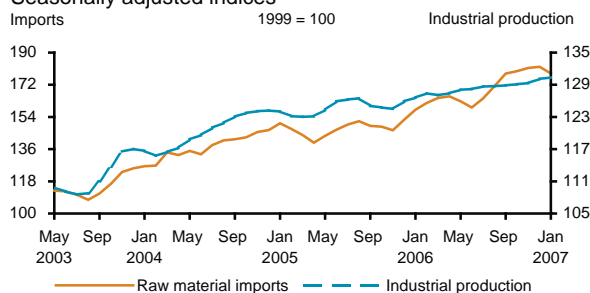
Source: MDIC/Secex

**Figure 5.4 – Capital goods imports x industrial
production – 3-month moving average
Seasonally adjusted indices**



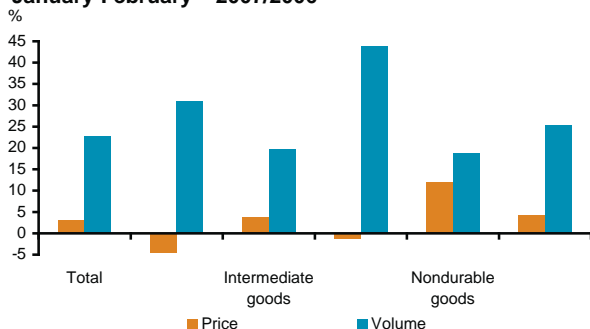
Source: Funcex and IBGE

**Figure 5.5 – Raw material imports x industrial
production – 3-month moving average
Seasonally adjusted indices**



Source: Funcex and IBGE

**Figure 5.6 – Imports – Price and volume index
January-February – 2007/2006**



Source: Funcex

with 37.3% growth using the same basis of comparison. Here, the highlights were increases in acquisitions of textile products, 75.7%; pharmaceutical goods, 42.8%; and food products, 25.3%.

Imports of capital goods increased 25.7% in the period, reflecting increases in acquisitions of parts and spares for industrial capital goods, 91.6%; office machines and apparatuses, scientific services, 26.3%; and industrial machinery, 16.9%.

Purchases of fuels and lubricants expanded 26% in the year through February, compared to the same period of the previous year, mainly as a result of volume growth.

Classified according to major sectors, imports turned in generalized growth in the January-February 2007 period, compared to the same period of the preceding year. Purchases of the six major importer sectors, which accounted for 60.3% of total foreign purchase in the period, posted strong growth, particularly under chemical products, 31.3%; followed by automotive vehicles and parts, 30%; and fuels and lubricants, 26%; mechanical equipment, 20.4%; plastics, 20.2%; and electric-electronic equipment, 14.7%.

According to Funcex, the increase in the value of imports in the two-month period resulted from 3.1% growth in prices and 22.8% in volume. All of the various use categories registered growth in imported volume, led by 43.9% for consumer durables; 31.1% for capital goods; 19.8% for raw materials and intermediate products; 18.9% for nondurable consumer goods; and 25.4% for fuels and lubricants. The final figure indicates that self-sufficiency in domestic oil production does not mean the country's independence in relation to imported oil and derivatives, since Brazilian refineries are not yet adapted to refining the heavy oil produced internally. In all of the various use categories, volume growth easily surpassed price variations, which dropped in the categories of capital goods, 4.5%, and consumer durables, 1.3%.

With respect to geographic distribution, the strongest growth in the first two months of 2007 in exports in the Latin American Integration Association (Aladi) framework occurred to Mercosur nonmembers, with the exception of Mexico. With regard to Mercosur, the reduction in its relative participation resulted, above all, from less accentuated growth in sales to the Argentine market. This performance can be partially explained by restrictions imposed by Argentina on inflows of certain Brazilian products as of January, as a reaction to Brazil's decision not to renew the

Table 5.5 – Exports and imports by area – FOB

Daily average – January-February

Itemization	US\$ million							
	Exports			Imports			Balance	
	2006	2007	%	2006	2007	%	2006	2007
	change			change				
Total	451	527	16.9	310	392	26.5	140	134
Aladi	104	119	14.5	52	68	32.6	53	51
Mercosur	45	52	14.4	29	38	32.5	16	13
Argentina	38	43	12.7	25	35	37.0	13	8
Other	7	9	23.8	4	4	0.3	4	5
Mexico	17	17	-4.7	4	5	56.4	14	11
Other	42	51	22.6	19	25	28.5	22	26
USA ^{1/}	88	89	0.9	54	65	20.4	34	23
EU	99	135	36.3	74	86	17.1	25	48
E. Europe	11	16	40.2	5	7	44.7	6	9
Asia	65	73	12.5	79	98	23.2	-15	-25
Japan	15	16	7.4	15	15	1.9	0	1
South Korea	7	6	-6.9	11	12	3.8	-4	-5
China	21	28	29.3	24	37	52.7	-3	-10
Other	22	23	5.5	29	34	16.5	-7	-11
Others	84	96	14.0	46	68	45.8	38	28

Source: MDIC/Secex

1/ Includes Puerto Rico.

bilateral agreement voluntarily restricting exports of kitchen appliances and footwear to that country. The United States remains the principal individual buyer of Brazilian exports, despite a drop in that country's relative participation from 19.5% to 16.8%. Using the same basis of comparison, the largest growth rates occurred under sales to Eastern Europe, 40.2%; the European Union, 36.3%; and Aladi countries, 14.5%. Mention should also be made of 12.5% growth in Brazilian exports to Asia, though sales targeted to South Korea dropped 6.9%.

Broken down by countries and economic blocs, Brazilian imports posted across-the-board growth in the first two months of 2007, compared to the same period of the previous year. The largest growth occurred in purchases from Mexico, 56.4%; followed by imports from Eastern Europe, 44.7%; Mercosur, 32.5%; and the countries of Asia, 23.2%. The Asian countries remained as the major suppliers of goods to Brazil, accounting for 24.9% of the country's imports, led by growth of 52.7% in purchases from China. Trade with that region of the world registered a deficit of US\$1 billion in the period. The European Union remained as the second most important supplier market, even though its relative participation dropped from 23.8% to 22% in the period. The share of Brazilian imports held by Aladi increased slightly, surpassing the participation of the United States which, however, remained as the largest individual supplier.

Table 5.6 – Current account

	US\$ billion						
	2006			2007			
	Feb	Jan-	Year	Feb	Jan-	Year ^{1/}	
		Feb	Feb		Feb		
Current account	0.6	0.3	13.5	0.6	0.9	7.7	
Trade balance	2.8	5.6	46.1	2.9	5.4	37.0	
Exports	8.8	18.0	137.5	10.1	21.1	149.0	
Imports	6.0	12.4	91.4	7.2	15.7	112.0	
Services	-0.6	-1.0	-9.4	-0.7	-1.3	-10.4	
Transportation	-0.2	-0.3	-2.9	-0.3	-0.5	-3.6	
International travel	-0.1	-0.1	-1.4	-0.1	-0.2	-1.8	
Computer and informat.	-0.1	-0.3	-1.9	-0.2	-0.4	-2.1	
Operational leasing	-0.3	-0.7	-4.9	-0.4	-0.8	-5.0	
Other	0.1	0.4	1.7	0.2	0.6	2.1	
Income	-1.8	-4.8	-27.4	-1.9	-3.7	-23.4	
Interest	-1.0	-2.5	-11.3	-0.8	-2.2	-7.9	
Profits and dividends	-0.8	-2.4	-16.4	-1.0	-1.7	-15.7	
Compensation of employment	0.0	0.0	0.2	0.0	0.1	0.2	
Current transfers	0.3	0.6	4.3	0.3	0.6	4.5	

1/ Forecast.

5.3 Services and income

The cumulative 12-month current account surplus reached US\$14.1 billion in February 2007, corresponding to 1.46% of GDP, compared to US\$13.4 billion in the corresponding period of the previous year. Despite 12.1% growth in the service deficit, the increase in the overall surplus was generated as much by trade balance and unrequited transfers, as by a 2% reduction in the income account deficit. It should be stressed that the increase in the service deficit reflected growth in revenues, 23.1%, and spending, 19.3%, in all of the various segments, with the exception of financial services, communications and government services.

In the first two months of 2007, current accounts registered a positive balance of US\$919 million, compared to US\$339 million in the corresponding two month period of the previous year. On the one hand, the surplus reflected a US\$5.4 billion trade balance surplus and unrequited transfers in a total amount of US\$639 million, reflecting a reduction of 4.4% and an increase of 13.5%, respectively, using the same

basis of comparison. In the opposite sense, net remittances in the service account totaled US\$1.3 billion, while the income account registered net outlays of US\$3.7 billion, corresponding to growth of 32.4% and -22.4%, respectively.

The major contribution to the cumulative deficit in the 12-month period ended in February was that of operational leasing, US\$5.1 billion, compared to US\$4.2 billion in the corresponding period of the previous year. To some extent, this result was a consequence of greater in country utilization of capital goods belonging to nonresidents, a system that generates positive repercussions on the economy's productive capacity level. In the first two months, net outlays on operational leasing totaled US\$835 million, an increase of 25.8% compared to the same period of 2006.

Net remittances for purposes of international travel totaled US\$1.6 billion in twelve months, 56.8% more than in the corresponding period ended in February 2006. Particular mention should be made of steady and sustained growth in revenues, which totaled US\$4.5 billion, reflecting 12.5% growth in the period, the highest level since the series was first calculated in 1947. Though spending has been increasing steadily since August 2003, growth has become even more accentuated, closing at 21.4%. For the most part, this performance reflects increases in domestic income and exchange rate appreciation. In the first two months of 2007, the international travel account posted a deficit of US\$174 million, with record revenues and spending for the two-month period.

Net remittances on transportation reached US\$3 billion in the period extending from March 2006 to February 2007, compared to US\$2.1 billion in the same period of 2006. This behavior reflected two major factors: 23% growth in spending primarily as a result of increased import operations and their impact on freight outlays, together with a reduction in the operating network of a major Brazilian airline company, resulting in greater outlays on tickets as a result of increased utilization of foreign airlines.

In the income account, it is important to highlight growth in interest revenues as a consequence of expanded asset holdings by Brazilians abroad, together with the increase in the nation's international reserve position and, in 12-month cumulative terms, the continued impact of appropriations of interest revenues involving securities used as guarantees for the servicing of renegotiated debt.

Net outlays on interest totaled US\$10.9 billion in the 12-month period ended in February 2007, compared to

US\$13.8 billion in the corresponding period of 2006. The underlying causes of this result were stability in spending and 132% growth in revenues. It should be emphasized that the initial impact of repurchases of government securities, thus anticipating interest payments with the objective of reducing future outlays, is to generate added pressure on spending. In the January-February 2007 period, the income account showed net interest payments of US\$2.2 billion, compared to US\$2.5 billion in the same period of 2006, a reduction of 13.6%.

In the 12-month period ended in February 2007, net remittances of profits and dividends surpassed interest remittances, reflecting the predominant position of foreign direct and portfolio investments in the country over the external debt stock in the composition of external liabilities. In the period extending from March 2006 to February 2007, net remittances of profits and dividends added up to US\$15.6 billion, against US\$13.3 billion in the corresponding period of 2006, posting growth of 20.5% under expenditures and 87.7% under revenues. The tendency toward greater growth in revenues evident since June has been caused by growth in the stock of direct Brazilian investments abroad.

Companies from the industrial and service sectors accounted for 51.7% and 45.9% of gross profit and dividend remittances, respectively, resulting from 2006 direct investments. There was no significant concentration of gross revenues in any single economic activity. Here, analysis shows concentration of 12.2% in the sector of financial intermediation and 11.9% and 11.4%, respectively, in the segments of electricity, gas and hot water and automotive vehicle manufacturing and assembly. In the first two months of 2007, net remittances of profits and dividends added up to US\$1.7 billion, compared to US\$2.4 billion in the corresponding period of 2006.

The trend toward gradual but uninterrupted growth in net unrequited transfers continued in 2006 and the early part of 2007. Net cumulative 12-month inflows reached US\$4.4 billion in February 2007, compared to US\$3.6 billion in February of the previous year. In the first two months of 2007, unrequited transfers produced net inflows of US\$639 million, for growth of 13.5% compared to the same period of 2006.

Projections for the current account surplus were altered from US\$4.5 billion in the December 2006 "Inflation Report" to US\$7.7 billion or 0.8% of GDP. Basically this alteration reflects increases in the annual growth rates achieved by exports, from 6.1% to 8.4%, and imports, from 19.4% to 22.4%. Consequently, the estimate for the trade surplus was expanded from US\$35 billion to US\$37 billion.

Projections for net outlays on services, interest, and profits and dividends were also altered. The first two of these items moved to US\$10.4 billion and US\$7.9 billion, respectively, representing reductions of 6.7% and 9.9%, while projections for profits and dividends increased 12.3% to a total level of US\$15.7 billion.

5.4 Financial account

The balance of payments financial account posted net inflows of US\$27.4 billion in the 12-month period ended in February 2007, thus reversing the US\$12.7 billion deficit registered during the corresponding period of 2006, which included payment of US\$23.3 billion to the IMF. Of this total, US\$20.4 billion referred to anticipated amortizations that totally paid off the country's liabilities with that organization. In the period under analysis, portfolio investments and other investments produced net inflows of US\$8.8 billion and US\$19 billion, respectively, despite the fact that direct investments closed with net outflows of US\$637 million.

In the first two months of 2007, the balance of payments financial account registered net inflows of US\$14.1 billion, compared to US\$3.1 billion in the corresponding period of 2006. In the two-month period, direct investments stood at net inflows of US\$7.2 billion, composed of net returns on Brazilian direct investments abroad, US\$3.4 billion, and net inflows of foreign direct investments, US\$3.8 billion.

As already mentioned in previous reports, external assets expanded significantly, reflecting the increasing degree of expansion of Brazilian companies into international markets. The companies involved in this process managed to increase the scale of their operations and have carved out important niches in the world market. This process results in greater direct investments abroad which, according to the most recent estimate available, for September 2006, totaled US\$87 billion. It is important to state that this amount does not reflect the operations that generated the greatest impacts in 2006, since these were concentrated in the fourth quarter of the year. Of these, the most important totaled US\$14.6 billion and occurred in the month of October involving a Brazilian company from the mining sector.

Brazilian Direct Investments Abroad (BDIA) added up to US\$20.9 billion in the 12-month period ended in February, compared to US\$5.4 billion from March 2005 to February 2006. This result was strongly influenced by the above cited operation and was responsible for the fact that BDIA

Table 5.7 – Financial account

Itemization	US\$ billion					
	2006			2007		
	Feb	Jan- Feb	Year	Feb	Jan- Feb	Year ^{1/}
Capital account	0.2	3.1	16.4	8.8	14.1	10.8
Direct investments	-0.9	-0.6	-8.5	0.8	7.2	14.5
Abroad	-1.8	-3.0	-27.3	-0.6	3.4	-5.5
In Brazil	0.9	2.3	18.8	1.4	3.8	20.0
Equity capital	0.6	1.7	15.4	1.2	3.3	20.0
Intercompany loans	0.3	0.6	3.4	0.2	0.5	0.0
Portfolio investments	4.4	4.9	8.6	3.5	5.1	12.4
Assets	0.7	1.0	-0.4	0.0	-0.2	-1.2
Liabilities	3.7	3.9	9.1	3.4	5.3	13.6
Derivatives	0.1	0.1	0.4	0.0	0.0	0.0
Other investments	-3.4	-1.3	15.9	4.6	1.8	-16.1
Assets	-2.4	-2.7	-3.2	1.2	3.0	-12.4
Liabilities	-1.0	1.5	19.0	3.3	-1.2	-3.7

1/ Forecast.

Table 5.8 – BP financing sources

Selected items

	US\$ billion					
	2006			2007		
	Feb	Jan- Feb	Year	Feb	Jan- Feb	Year ^{1/}
ML-term funds	3.0	5.4	33.5	1.7	5.4	20.0
Public bonds	0.4	1.4	4.8	0.7	1.4	1.6
Private debt securities	2.2	3.3	10.3	0.7	3.3	13.3
Direct loans	0.4	0.7	18.4	0.3	0.7	5.1
Short-term loans (net) ^{2/}	-2.4	-0.8	-3.3	2.2	-0.8	0.0
Short-term securities (net)	-0.1	-0.6	0.1	0.9	-0.6	0.0
Roll-over rates (%)						
Private sector:	695%	663%	206%	141%	34%	100%
Debt securities	653%	757%	206%	107%	210%	163%
Direct loans	2225%	279%	205%	1289%	7%	50%

1/ Forecast.

2/ Includes direct loans and trade credits transferred by banks.

surpassed Foreign Direct Investments (FDI) in Brazil for the first time, when both figures are viewed in net values.

In cumulative terms, FDI increased in the 12-month period ended in February. This was the seventh consecutive month of positive growth and corresponded to net inflows of US\$20.2 billion, compared to US\$15.3 billion in the corresponding previous period, with growth of 31.9%. Net inflows in stock participation reached US\$16.9 billion. Conversions of different types of liabilities accounted for US\$2.3 billion of this total, while intercompany loans reached up to US\$3.3 billion. For 2007, the forecast for net FDI inflows was revised to US\$20 billion.

Distribution of the economic activity sectors receiving FDI flows – equity participation, excluding investments in goods and real estate – was highly diversified. In 2006, financial intermediation companies received 13.5% of gross inflows, followed by companies from the electricity, gas and hot water sectors, with 10.5%. None of the other sectors reached a participation level of more than 10%.

The foreign portfolio investments account registered net inflows of US\$10.4 billion in the 12-month period ended in February, compared to US\$6.9 billion in the corresponding period of 2006. The behavior of flows distributed by financial instrument was somewhat differentiated: net investments in stocks showed inflows of US\$8.1 billion, compared to US\$7.6 billion in the previous year; foreign investments in fixed income securities registered net inflows of US\$2.3 billion, compared to US\$715 million in remittances; and notes and commercial papers posted net inflows of US\$1.8 billion, against net remittances of US\$786 million. Consequently, the mid-2006 reduction in net inflows into stocks and fixed income securities negotiated in Brazil, basically reflecting international scenario uncertainties, was reversed. It should be noted that, though marked by fluctuations, net disbursements of foreign investments into stocks remained high.

Foreign investments in fixed income securities negotiated in the country posted cumulative net inflows of US\$10.1 billion in the 12-month period ended in February, compared to US\$2.4 billion in the corresponding period of 2006. This performance was attributed to the impact of Law 11,312, dated 6.27.2006.

Foreign portfolio investments showed net disbursements of US\$5.3 billion in the first two months of 2007, compared to US\$3.9 billion in the corresponding two-month period of the previous year.

Table 5.9 – Uses and sources

	US\$ billion					
	2006			2007		
	Feb	Jan- Feb	Year	Feb	Jan- Feb	Year ^{1/}
Uses	-2.7	-7.1	-30.6	-2.3	-7.4	-22.1
Current account	0.6	0.3	13.5	0.6	0.3	7.7
Amortizations ML-term ^{2/}	-3.4	-7.5	-44.1	-2.9	-7.7	-29.8
Securities	-2.3	-4.9	-25.6	-2.6	-0.9	-13.3
Paid	-2.3	-4.9	-24.2	-2.6	-0.9	-13.3
Refinancing	0.0	0.0	-0.7	0.0	0.0	0.0
FDI conversions	0.0	-0.1	-0.7	0.0	0.0	0.0
Suppliers' credits	-0.1	-0.2	-1.7	-0.1	-0.1	-1.9
Direct loans ^{3/}	-1.0	-2.3	-16.9	-0.2	-6.7	-14.6
Sources	2.7	7.1	30.6	2.3	7.4	22.1
Capital account	0.0	0.1	0.9	0.1	0.0	1.0
FDI	0.9	2.3	18.8	1.4	2.4	20.0
Domestic securities ^{4/}	2.9	4.1	14.7	3.2	0.5	12.0
ML-term disbursements ^{5/}	3.4	6.9	43.7	2.1	2.7	27.6
Securities	2.6	4.7	15.8	1.5	2.2	14.9
Suppliers' credits	0.1	0.1	0.8	0.0	0.1	1.2
Loans ^{6/}	0.8	2.1	27.1	0.6	0.4	11.5
Brazilian assets abroad	-3.4	-4.6	-30.4	0.6	5.6	-19.1
Other ^{7/}	-0.3	1.8	13.4	4.2	1.8	0.0
Reserve assets	-0.8	-3.5	-30.6	-9.3	-5.6	-19.5

1/ Forecast.

2/ Registers amortization of medium and long-term suppliers' credit, loans and securities placed abroad minus refinancing and discounts. Excludes amortizations referring to loans to IMF and intercompany loans.

3/ Registers amortizations loans borrowed from foreign banks, buyers, agencies and multilateral organizations.

4/ Includes foreign investment in equity and debt securities traded in the domestic market.

5/ Excludes intercompany loans disbursements.

6/ Includes multilateral and bilateral financing and buyers' credits.

7/ Registers net values of bond swaps, short-term securities, short-term trade credit, financial derivatives, nonresident deposits, other liabilities and errors & omissions.

In the 12-month period through February, the sovereign bond market showed net remittances of US\$11 billion, reflecting such factors as anticipated redemptions of US\$11.9 billion in debt, including the buyback program, public offers and application of anticipated payment clauses, as well as the original maturities schedule. In 2007, one should highlight inflow of US\$500 million in the month of January as a result of reopening of Global 37, issued in January 2006 in a total amount of US\$2.5 billion; issuance of Global BRL 28, denominated in real, with disbursements of US\$1.5 billion, equivalent to US\$715 million in February, coupled with the March reopening of this bond, in the amount of R\$750 million, accounting for US\$361 million.

Other investments registered net inflows of US\$19 billion in the 12-month period ended in February, compared to net outflows of US\$28.6 billion in the corresponding period of 2006. Other Brazilian investments posted net inflows of US\$2.6 billion, against US\$6.8 billion in the previous period. Here, one should stress net granting of US\$2.8 billion in loans abroad and reduction of US\$6.3 billion in the balance of currency deposits abroad.

Other foreign investments registered net inflows of US\$16.4 billion in the 12-month period ended in February, compared to net outflows of US\$21.8 billion in the corresponding period of 2006. A breakdown of this US\$38.3 billion reversal indicates that US\$4.5 billion referred to net growth in the granting of trade credits and US\$33.3 billion in growth in net granting of loans. The cumulative 12-month total through February 2006 includes US\$23.3 billion in payments to the IMF.

Rollover rates for medium and long-term operations in the private and public financial sectors reached 192% in 2006. The rollover rate for the private sector was 206% for direct loans and securities. For 2007, average rollover rates are estimated at 100%.

In 2006, international reserves expanded US\$32 billion, reaching their highest annual level, US\$85.8 billion. Net Central Bank exchange market purchases reached US\$34.3 billion. Among external operations, the most important were amortizations of US\$20 billion, particularly those involving sovereign bonds, US\$17.2 billion, as listed below: US\$6 billion in external debt security buyback operations (face value); US\$1.3 billion as a result of public tender offers; US\$5.8 billion resulting from exercise of the Brady bond call option; US\$648 million originating in security exchange operations; and US\$3.4 billion in originally forecast amortizations. Aside from these operations, amortizations with the Paris Club totaled US\$2.6 billion and

Table 5.10 – Balance of payments – Market

Itemization	US\$ billion					
	2006			2007		
	Feb	Jan- Feb	Year	Feb	Jan- Feb	Year ^{1/}
Current account	0.7	0.2	10.6	0.3	0.3	3.2
Capital (net)	3.8	6.0	21.9	6.7	9.2	18.8
FDI	0.9	2.3	18.8	1.4	3.8	20.0
Portfolio investment	2.9	4.1	14.7	3.2	3.7	12.0
ML-term loans	1.4	0.6	6.9	-1.5	-7.0	-3.8
Trade credits - SML-term	-0.7	1.4	6.9	3.1	4.9	-0.4
Banks	-2.4	-0.8	-3.5	2.2	2.2	0.3
Other	1.7	2.2	10.4	0.8	2.7	-0.7
BDIA	-1.3	-3.2	-32.3	-1.2	2.0	-10.7
Other	0.7	0.8	6.9	1.7	1.8	1.6
Financial gap	4.5	6.2	32.5	7.0	9.5	22.1
Banco Central net intervent.	-2.4	-4.8	-34.3	-8.8	-13.7	-13.7
Bank deposits	-2.1	-1.4	1.9	1.8	4.2	-8.4

1/ Forecast.

Table 5.11 – Statement of international reserves

Itemization	US\$ billion			
	2006		2007	
	Jan-Feb	Year	Jan-Feb	Year ^{1/}
Reserve position in				
previous period	53.8	53.8	85.8	85.8
Net Banco Central purchases	4.8	34.3	13.7	13.7
Debt servicing (net)	-6.9	-22.8	-2.6	-4.8
Interest	-1.4	-2.8	-0.8	-0.3
Credit	0.3	2.8	0.7	4.5
Debit	-1.7	-5.6	-1.5	-4.8
Amortization	-5.5	-20.0	-1.8	-4.5
Disbursements	1.4	6.6	1.2	2.2
Multilateral organizations	-	1.2	-	0.6
Sovereign bonds	1.4	5.5	1.2	1.6
Others ^{2/}	-0.2	1.5	-0.3	-0.3
Treasury's purchases	4.5	12.3	3.3	9.1
Change in assets	3.6	32.0	15.2	19.9
Gross reserve position	57.4	85.8	101.1	105.7

1/ Forecast.

2/ Includes payments/receipts in the framework of the Reciprocal Credits and Payments Agreement (CCR), fluctuations in prices of securities, exchange parities and price of gold, discounts and premiums, duty fees and release of collaterals.

were concentrated in the first five months of the year. Total disbursements reached US\$6.6 billion, with US\$5.4 billion derived from issues of bonds of the Republic and US\$1.2 billion in loans by international organizations. Net interest outlays totaled US\$2.8 billion, resulting from revenues of US\$2.8 billion in earnings on reserves and spending of US\$5.4 billion involving sovereign bonds, US\$125 million in payments to the IMF and US\$83 million to the Paris Club. Settlements of National Treasury purchases on the market totaled US\$12.3 billion, while other operations raised the stock an additional US\$1.5 billion.

In the first two months of 2007, international reserves set a new record with a total amount of US\$101.1 billion. Net Central Bank purchases on the exchange spot market reached US\$13.7 billion. In the framework of external operations, the highlights were amortizations of US\$1.8 billion in sovereign bonds. Net interest outlays reached US\$841 million, based on revenues of US\$673 million in earnings on reserves and outlays of US\$1.5 billion in bond operations; together with US\$1.2 billion in disbursements in sovereign bonds. Settlements of National Treasury purchases added up to US\$3.3 billion, while other operations generated spending of US\$302 million.

It is estimated that the international reserve position will total US\$105.7 billion at the end of 2007, reflecting US\$19.9 billion expansion compared to 2006. The increase forecast for 2007 is based on revenues of US\$4.5 billion in earnings on reserves; disbursements of US\$600 million from international organizations; and amortization of US\$138 million referring to the Multi-Year Deposit Facility Agreement (MYDFA). Other elements are net Central Bank purchases of US\$13.7 billion already completed up to February, coupled with bond disbursements totaling US\$1.6 billion. All of the other external liabilities for which the National Treasury is liable are estimated at US\$9.1 billion and are scheduled to be settled with resources acquired on the domestic exchange market.

5.5 External sustainability indicators

Considering February 2007 estimates of external liabilities, the favorable trajectory of sustainability indicators has been maintained, mainly as a consequence of the performance of exports, GDP and international reserves. The net debt, estimated for the February 2007 position, totaled US\$170 billion, reflecting a reduction of US\$2.5 billion compared to the December position, while the total net debt dropped US\$17.6 billion.

Table 5.12 – Sustainability indicators

	US\$ billion					
	2005		2006			2007
	Sep	Dec	Jun	Sep	Dec	Feb ^{1/}
Exports of goods	112.9	118.3	125.5	132.3	137.5	140.5
Exports of goods and services	128.0	134.4	143.2	150.9	156.9	160.7
Debt service	52.8	66.0	76.8	67.7	56.9	60.3
Total external debt	183.2	169.5	156.7	159.6	172.5	170.0
Net external debt	110.0	101.1	79.4	70.8	74.7	57.1
International reserves	57.0	53.8	62.7	73.4	85.8	101.1
GDP	749	796	873	915	960	966
Indicators						
Total external debt/GDP (%)	24.5	21.3	17.9	17.4	18.0	17.6
Net external debt/GDP (%)	14.7	12.7	9.1	7.7	7.8	5.9
Total external debt/exports	1.6	1.4	1.2	1.2	1.3	1.2
Total external debt/exports of goods and services	1.4	1.3	1.1	1.1	1.1	1.1
Net external debt/exports	1.0	0.9	0.6	0.5	0.5	0.4
Net external debt/exports of goods and services	0.9	0.8	0.6	0.5	0.5	0.4
Debt service/exports (%)	46.7	55.8	61.2	51.1	41.4	42.9
Debt service/exports of goods and services (%)	41.3	49.2	53.7	44.8	36.2	37.5
Reserves/total external debt (%)	31.1	31.7	40.0	46.0	49.8	59.4

1/ Estimated data.

The debt service/exports ratio increased from 41.4% in December 2006 to 42.9% in February. Comparison with exports of goods and services shows a similar trend, with growth from 36.2% to 37.5%. The ratios of total debt/GDP and total net debt/GDP dropped from 18% to 17.6% and from 7.8% to 5.9%, respectively, using the same basis of comparison.

The coefficient of total debt over exports dropped from 1.3 to 1.2, while the net total debt to exports ratio dropped from 0.5 in December 2006 to 0.4 in February. Using exports of goods and services as denominator, these same ratios registered respective results of 1.1 and 0.4 in February. It should be stressed that all of the coefficients above are the best ever registered since the series first started in 1970.

The participation of international reserves in the total external debt increased from 49.8% in December to 59.4% in February. This was the most comfortable level ever registered and benefited significantly from the US\$15.2 billion increase in reserves. In the same period, reserves came to represent 239% of the short-term external debt with residual maturities, which includes the short-term debt stock and the share of medium and long-term debt to mature in the coming twelve months. This position represented an increase of 26.3 percentage points compared to December 2006.

5.6 Conclusion

The outlook for 2007 indicates that the excellent conditions for financing the balance of payments will remain in effect. With continuation of consistent macroeconomic policies, the outlook for the world economy in 2007 is quite favorable, with continued growth in world demand, albeit at a rate that will likely be somewhat lower than in recent years. Strengthening of the balance of payments as a result of record trade surpluses and strong capital inflows has resulted in a more robust international reserve position, coupled with cutbacks in the external debt total, particularly in the public sector. Taken together, these factors clearly enhance external sustainability conditions. Over recent months, this scenario has made it possible to achieve significant improvement in the country's risk classification, which dropped to 178 points in February, the lowest level since this series was first started in 1994. These movements have clearly consolidated expectations that Brazil will achieve investment grade classification over the medium-term.

This chapter of the *Inflation Report* presents Copom's assessment of the behavior of the Brazilian economy since publication of the most recent *Report* in December 2006, together with an analysis of the inflation outlook through 2008 and GDP growth to end-2007. Inflation projections are presented in two main scenarios. The first, designated the benchmark scenario, assumes that the Selic rate will remain unaltered at 12.75% per year over the forecasting horizon, the level defined by Copom at its most recent meeting on March 6-7, and that the exchange rate will remain in the range registered in the days immediately prior to that meeting (R\$2.10 per United States dollar). The second scenario, known as the market scenario, utilizes the consensus interest and exchange rates expectations compiled in BCB's Investor Relations Group (Gerin) survey of private sector analysts in the days preceding the March Copom meeting. It should be stressed that these scenarios are mere tools used to provide information to the monetary policy decision-making process and their assumptions should not be understood as Copom's forecasts of future interest and exchange rates behavior.

The inflation and GDP growth forecasts included in this *Report* are not point estimates. These forecasts incorporate probability intervals that reflect the level of uncertainty present when the interest rate decision was made. Inflation forecasts do not depend exclusively on interest and exchange rates assumptions, but also involve assumptions on the behavior of specific exogenous variables. The set of hypotheses considered most probable by Copom is used to construct the scenarios to which it attributes greatest weight when taking interest rate decisions. On presenting these assumptions in this *Report*, Copom's objective is to enhance monetary policy transparency and improve its effectiveness in controlling inflation, which is its primary objective.

6.1 Determinants of inflation

The seasonally adjusted IBGE data series prior to adoption of the new National Accounts methodology indicates that, at market prices, GDP posted 1.1% quarter-to-quarter growth in the fourth quarter of the year (practically identical to the 1.2% growth rate registered in the first quarter of 2006), with 3.8% expansion compared to the same quarter of the preceding year. Consequently, 2006 GDP growth closed at 2.9%, 0.6 p.p. above the 2005 result. With the fourth quarter 2006 result, the Brazilian economy has expanded for 13 consecutive quarters compared to the same period of the previous year, for the first time since the fourth quarter of 1986. Though growth in 2006 was not significantly higher than the average for the last 25 years, the current cycle has been marked by unprecedented stability when compared to the Brazilian historical pattern. Thus, the Committee has ratified the scenario presented in recent *Inflation Reports*, indicating that the pace of Brazilian economic growth should accelerate in 2007. Such factors as price stability, strengthening of the labor market, expanding real income, increased investment intentions, a more ample credit supply, declining external vulnerability, less intense macroeconomic uncertainty, as well as the ongoing process of monetary policy easing should certainly be sufficient to further accelerate Brazilian economic growth in the coming quarters. Over the course of 2007, the PAC will also generate significant impacts, particularly on investments.

IPCA inflation in 2006 dropped for the fourth consecutive year and, for the first time since adoption of the inflation target system in June 1999, closed below the target center (4.50%) defined by the National Monetary Council (CMN). Inflation closed at 3.14%, 2.55 p.p. below the 2005 result, indicating consolidation of the benign consumer inflation scenario predicted repeatedly in previous *Reports* and Copom Minutes. To a great extent, this scenario, which is expected to continue through the coming quarters, reflects the intertemporal effects on inflation of the monetary policy adopted in recent years. By making it possible for economic agents to take decisions with a lesser degree of macroeconomic uncertainty, price stability allows them to extend these decisions over a longer temporal horizon, while gradually reducing risk premiums. Evidently, the major contribution that monetary policy can make to sustainable economic development is precisely the improved macroeconomic environment.

Despite recent pressures generated by rising fuel alcohol prices, IGP-DI inflation has apparently begun leveling off

following a period in the months leading up to November 2006 when it surpassed the level of consumer inflation. Two major factors seem to have contributed to the dynamics of wholesale prices: continued strengthening of the national currency and the apparent easing of the sharp rise in farm prices during the June-November 2006 period. Based on the IPA-DI, cumulative 12-month wholesale inflation dropped in January following eight consecutive months of steadily higher rates. Though this rate moved upward once again in February, it still remained below the December level. These numbers suggest that, particularly in the farm sector, the process of realignment of relative prices may well be coming to an end, as forecast in the previous *Inflation Report*. Despite these positive signs, 12-month wholesale farm price inflation has not eased yet, having risen from 6.92% in December 2006 to 7.38% in January and 9.39% in February 2007. As stressed in the Copom Minutes, the impact of wholesale farm and industrial prices on consumer inflation will depend on prospective demand conditions and the expectations of price-setters regarding the future inflation path.

As far as the external scenario is concerned, one can not ignore the possibility of a new interest rate spike in the United States, though the more probable scenario would seem to indicate that the process of monetary policy adjustment has ended and that easing of monetary policy could get under way before the end of 2007. On the other hand, there is growing concern that the US economy could turn sharply downward or, though this possibility is considered considerably more remote, plunge into a recession due mainly to the impact of current real estate market difficulties on consumer spending. It is important to recall that the increase in volatility observed in international financial markets in recent weeks, initially thought to be a consequence of events occurring in Asia (expectations of lesser capital market incentives in China and exiting of carry trade positions in Japan), has been precisely rising doubts with regard to the future trajectory of the United States economy. However, stronger than expected growth in the Japanese economy in the final quarter of last year, coupled with robust expansion in both the German and British economies, have managed to sustain the positive momentum of the world economy, while attenuating the impact of deceleration in the USA. On the other hand, mirroring geopolitical tensions, oil prices, a recurrent source of international uncertainty, not only remained volatile but even increased in recent weeks following the sharp falloffs that occurred earlier in the year. In summary, any attempt to forecast medium and long-term oil prices would surely be a highly uncertain endeavor.

In this framework, the first quarter of the year was marked by continuation of Copom's efforts to ease monetary policy begun in September 2005. After reducing the basic interest rate target 650 b.p. between the September 2005 and November 2006 meetings, the Committee cut an additional 25 b.p. from the Selic rate target at its January and March 2007 meetings, raising the total cutback to 700 b.p. In 2006 alone, the reduction came to a very significant 475 basis points, with 200 b.p. concentrated in the second half of the year. The Selic rate now stands at 12.75% per year, the lowest level since it was created in 1986.

IPCA evolution indicates that inflation dynamics in the early part of 2007 were clearly compatible with the target path or, in other words, fully aligned with the benign price scenario consolidated since last year. This is clear in the fact that the IPCA rose just 0.44% in both January and February. The January rate was the lowest for that month since the series was first calculated in 1980. Cumulative 12-month inflation dropped from 3.14% in December to 3.02% in February, reflecting a substantial 2.49 p.p. decline compared to the February 2006 figure of 5.51%. Using this basis of comparison, it is important to note that the January rate was the lowest since March 1999 (consequently, the lowest since the inflation target regime was adopted in June 1999). One should also stress the converging process that prices variations for the major types of goods included in the IPCA have been exhibiting. For example, the difference between the quarterly inflation average for regulated and contractually monitored goods and market goods has been negative for five consecutive months, for the first time since July 1995. Analysis of cumulative 12-month inflation in February shows that this difference dropped to its lowest level since October 2004. The process of convergence is also evident when one analyzes the dispersion of inflation rates among tradable goods, nontradables and regulated and contractually monitored goods, since the standard deviation among the three rates fell in February to its lowest level since October 2004.

Despite monthly highs in the core inflation by exclusion compared to December, the positive behavior of headline inflation in the early part of the year was also reflected in BCB core measures. As a matter of fact, the core by exclusion of monitored prices and household food prices increased from 0.34% in December to 0.41% in January and 0.52% in February, while the trimmed-means cores with and without smoothing of predefined items posted inflation of 0.39% and 0.35% in January and 0.24% and 0.22% in February, compared to 0.38% and 0.27% in December,

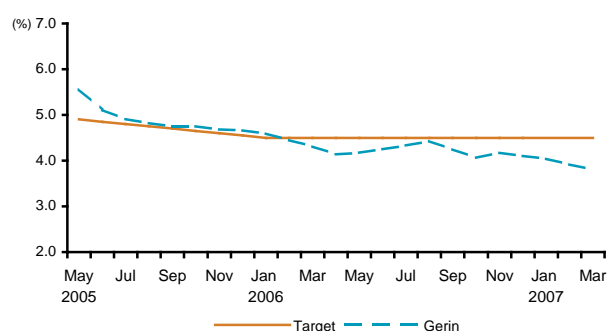
respectively. One should note, however, that cumulative 12-month inflation continued dropping in the early months of the year, independently of the considered core, with significant deflation compared to the same period of the previous year. The core by exclusion of monitored prices and household food prices dropped 2.75 p.p. in February, compared to the same month of the previous year, closing at 2.90%. The trimmed-means cores with and without smoothing dropped 2.45 p.p. and 3.02 p.p. to levels of 4.14% and 2.29%, respectively. Despite the larger inertial component of the smoothed core, one should observe that, for the first time since 2001, the January result was below the target center, followed by a February drop to the lowest point since September 1999.

On the other hand, it is important to highlight the fact that the historically low levels of cumulative 12-month inflation registered in recent months, including both headline inflation and cores, have been generated to a great extent by substitution of the relatively high levels registered in early 2006 with much more positive recent results. Consequently, these record lows should not be interpreted as reductions in cores or headline inflation in recent months. The impact of the process of statistical substitution is expected to run its course by the second quarter of 2007, when both 12-month core measures and headline inflation itself will more closely reflect the dynamics of inflation in recent months. This evaluation is backed by some factors, particularly the impact of fiscal impulses on aggregate demand and the lag with which the effects of the process of monetary policy easing dating to September 2005 have been felt.

Measured by the IGP-DI, inflation increased to 0.43% in January, compared to 0.26% in the previous month, and dropped to 0.23% in February. Cumulative 12-month growth through February reached 3.80%, the same level registered in December (3.79%). Before that, however, the 12-month cumulative rate registered in January marked the first month-to-month reduction since May 2006. Thus, recent numbers suggest that the broader concept of inflation, which had climbed to levels above consumer inflation, has begun converging to the latter levels. In the early part of the year, all IGP-DI components showed monthly dynamics quite similar to the aggregate index or, in other words, they rose in January and dropped in February, when compared month-to-month. The IPC rose 0.69% in January (0.63% in December) and 0.34% in February. The IPA-DI rose 0.32% in January (0.11% in December) and 0.19% in February. The INCC increased 0.45% in January (0.36% in December) and 0.21% in February. The cumulative 12-month IPA-DI

moved from 4.29% in December to 3.79% in January, the first fall-off in this comparison in the last eight months. In February, the rate increased to 4.12%, but remained below the December level. This behavior suggests that the process of relative price realignment evident in the final months of 2006 – led, above all, by farm prices – is petering out, as predicted in the most recent *Inflation Report*. Therefore, expectations are that, in the coming quarters, wholesale prices will aid in channeling inflation toward the target path. This contribution will depend on prospective demand conditions, together with the expectations of price-setters in relation to the future trajectory of inflation.

Figure 6.1 – Inflation target path and market expectations for twelve-month ahead inflation



As expected, the continued leveling off of inflation in early 2007 was reflected in inflation expectations for this and the coming year. As compiled by Gerin, the median of expectations regarding IPCA growth in 2007 dropped from 4.07% in the days leading up to the January Copom meeting to 3.88% just prior to the March meeting. In their turn, median expectation for 2008 remained anchored at 4.50% for approximately one year, before dropping sharply following publication of the most recent *Report*, pointing to a level of 4.0% in the days prior to the March Copom meeting. As highlighted in previous Copom documents, these developments heralded consolidation of an increasingly more favorable macroeconomic environment over longer-term horizons.

GDP data at market prices for 2006, as released recently by IBGE demonstrate that growth accelerated in the fourth quarter, based on either annual or quarterly comparisons. According to seasonally adjusted IBGE data, the Brazilian economy expanded 1.1% on a quarter-to-quarter basis, with 3.8% expansion over the same quarter of 2005 (0.6 p.p. above third quarter growth). Consequently, cumulative GDP growth closed 2006 at 2.9%, surpassing the 2005 figure of 2.3%. Though 2006 economic growth was below expectations at the start of the year, it is important to analyze the current cycle of Brazilian economic expansion in qualitative terms. Analysis of the historical data series shows that, for the first time since the fourth quarter of 1986, the economy has posted positive growth results for 13 consecutive quarters compared to the corresponding quarter of the previous year. Therefore, it is becoming increasingly evident that the erratic growth pattern so characteristic of the Brazilian economy for decades has apparently become a thing of the past. This new reality reinforces the perspective that the Brazilian economy may well have entered an unprecedented phase of sustained expansion that could certainly intensify in coming quarters. Among other factors, this evaluation is supported by declining inflation,

improved labor market indicators, expanding real income, growing investment rate as a proportion of GDP, coupled with investment intentions, lesser external vulnerability and reduced macroeconomic uncertainties.

On the supply side, crop/livestock production expanded 3.2% in 2006, while industrial output rose 3% and the service sector posted 2.4% growth. Following an unsatisfactory performance in 2005 (growth of 0.8%) and in the first half of 2006, the crop/livestock sector recovered sharply in the second half of the year, closing with a higher rate of growth than the other sectors of the economy. In the industrial sector, it is important to highlight the performance of mining activity (growth of 5.6% in the year), followed by construction (expansion of 4.5%). In the service sector, commerce registered the best result with 4.0%. Viewed under the prism of demand, the performance of gross fixed capital formation was highly encouraging, posting growth of 6.3% (the second best result in the last nine years). Household consumption (3.8% growth) also performed above average, due mostly to increased labor earnings and an expanding credit market. As expected, analysis of national accounts show that imports of goods and services increased sharply (18.1%) and, contrary to the rather pessimistic prognoses that marked early 2006, exports of goods and services expanded 5%.

As occurred in the early months of 2006, balance of trade results clearly frustrated less optimistic expectations. Despite the growing strength of the national currency in 2006, the trade balance opened 2007 with highly robust results, though a certain cooling of surpluses was perceptible at the margin. As forecast in previous *Reports* and Copom Minutes, the country's commercial transactions with the rest of the world showed the first signs of a shift into a new dynamics in the future. This change is welcome, since it reveals the existence of a natural and healthy process of adjustment in the nation's external accounts toward a situation of long-term equilibrium. This adjustment has been influenced as much by the price effect, evident in the evolution of nominal exchange rates, as by the income effect, based on increased expansion of aggregate demand. In fact, the trade balance surplus reached US\$5.4 billion in January and February, a level 4.5% below the result for the same two month period of the previous year. The cumulative 12-month balance, however, reached US\$45.8 billion in February, still somewhat higher than in the same month of the previous year (US\$45.4 billion).

Despite the fact that the volume of imports has expanded more rapidly than exports, the relative stability of the

country's trade surplus has been sustained by higher prices for exported goods or, in other words, by the positive dynamics of the terms of trade. Exported value has set successive new records, reaching the unprecedented 12-month level of US\$140.5 billion through February, 16.0% higher than in the same period of the previous year. Parallel to this, the value of imports has expanded at an even more rapid pace, closing the 12-month period through February at US\$94.7 billion, reflecting 25.0% growth over the February 2006 result. With this, Copom forecasts for 2007 indicate a trade surplus somewhat below the results of the last two years, but still quite high when viewed in terms of Brazil's historical results. In other words, there are no expectations of any significant turnaround in the trajectory of the enormous trade balance surpluses registered in the recent past. The current account balance posted surpluses of US\$325 million and US\$593 million in January and February, respectively, raising the 12-month cumulative result through February to US\$14.1 billion, equivalent to 1.5% of GDP.

According to BCB seasonally adjusted CNI data, Installed Capacity Utilization Level (UCI) in the manufacturing sector was rather erratic in the final quarter of last year, falling in October to 81.9%, before increasing to 82.1% in November and dropping back once again to 81.9% in December. The December result (0.2 p.p. below the December 2005 level) interrupted a series of five consecutive months of positive growth compared to the same month of the previous year. In 2006, average utilization of installed output capacity closed 0.14 p.p. below the 2005 average. However, it is important to stress that this ratio changed dramatically between the first and second halves of the year. More specifically, compared to the average for the same periods of 2005, the first half of the year closed with -0.82 p.p., shifting to 0.54 in the second half. Despite growth in manufacturing activity, relative stability in the average level of installed capacity utilization in 2006 partly reflects expansion in the economy's productive capacity. More recent data on production and absorption of capital goods suggest growth in the volume of investments. For example, capital goods absorption increased 6.8% in the final quarter of 2006, compared to the previous quarter, resulting in significant 8.9% cumulative expansion in 2006. This result was decisively impacted by 24.0% growth in the volume of capital goods imports in 2006 and, to a lesser extent, by 5.7% expansion in capital goods output. With these results, despite expectations of continued growth in aggregate demand in 2007, there are no expectations of any significant lags in relation to aggregate supply over the coming quarters. As stressed in the Minutes of Copom meetings, there is a very close relation between inflation

trends and current and prospective developments regarding expansion in the supply of goods and services required to meet growing demand.

According to seasonally adjusted IBGE data, after some ups and downs in industrial output in the first three quarters of 2006, the final three months of the year were marked by steady expansion, with clear signs of an increase in the pace of industrial activity. In the manufacturing sector, performance in the final quarter of 2006 was quite similar to that of industry as a whole, registering output growth for three consecutive months for the first time since October 2004. It is important to note that the falloff in industrial output in January 2007 (0.3%) was a passing phenomenon, impacted by technical stoppages in the petroleum industry. On the one hand, recent dynamics suggest that the lag between industrial output and sales is dwindling while, on the other hand, the pace of economic activity has gained momentum. In 2006, industrial output expanded 2.8%, while manufacturing and mining grew at respective rates of 2.6% and 7.4%. As far as industry in general is concerned, one should highlight 5.7% and 5.8% growth in the output of capital goods and consumer durables, though each segment registered its own specific dynamics. While growth in capital goods output was concentrated in the second half of the year, the production upturn under consumer durables occurred exclusively in the first quarter of 2006. In more specific terms, growth in the output of consumer durables basically reflects rising employment and real income and an expanding credit supply, while growth in capital goods output reveals a positive outlook for overall economic expansion, backed mainly by domestic demand. Note should also be taken of expanded production of “Office Machinery and Computer Equipment”, with 51.6% in 2006. This result could well be a consequence of enhanced economic efficiency.

The accelerated pace of activity in the fourth quarter of 2006 had positive repercussions on the job market. According to the PME, unemployment hit 10.7% in July (the highest level of the year), before dropping steadily to a level of 8.4% in December. As expected, seasonal factors typical of the early part of the year pushed the unemployment rate to 9.3% in January 2007, 0.1 p.p. above the level for the same period of the previous year, albeit 0.9 p.p. below the January 2005 level. The average unemployment rate for 2006 as a whole closed 0.15 p.p. above the 2005 mark, but 1.49 p.p. below the 2004 result. In 2006, both the overall labor force and the number of persons employed expanded 2.6%. To some extent, growth in the overall labor force reflects greater optimism among workers regarding the

probability of finding jobs, a phenomenon that is typical of periods of economic expansion. As stated in the *December Report*, once the initial impact of the newfound optimism has passed, the unemployment rate is expected to fall even more sharply.

According to CNI statistics, seasonally adjusted by BCB, the level of employment in the manufacturing sector expanded for six consecutive months from July to December 2006. Strictly speaking, the only decline in all of 2006 occurred in July (just -0.01%), as industrial employment expanded 2.2% in the year. Also, compared to the same month of the preceding year, industrial employment in December posted the 35th consecutive positive result. As far as formal employment is concerned, data released by the Ministry of Labor and Employment indicates strong 2006 expansion, repeating the results of previous years. More specifically, 1.23 million jobs were created in 2006, compared to 1.25 million in 2005. It can be presumed that these results will diminish in the coming years, with the potential decline in the number of workers available in the informal sector of the economy. Growth in employment levels coupled with declining inflation generated gains in the purchasing power of workers. In 2006, average real earnings habitually received by workers increased 4.1%. In January 2007, purchasing power increased 4.7% compared to the same period of 2006. Real wages earned by the working population, in turn, posted strong 6.7% growth in 2006, closing January 2007 at 7.4% above the results for the same month of the previous year.

In 2006, seasonally adjusted IBGE data show that retail sales expanded 6.2%. Following reductions in June and July, retail sales recovered sharply, posting four consecutive months of positive growth: 2.5% in August, 1.8% in September, 0.4% in October and 0.5% in November. In the month of December, sales dropped 0.5%, to some extent reflecting anticipated payment of the 13th annual wage to retirees and pensioners in the month of September, since this payment is normally effected in early December. The purely temporary nature of the December falloff was corroborated by 1.8% growth in the month of January, the 38th consecutive month of positive growth in retail sales compared to the same month of the previous year. Cumulative 12-month sales expanded 6.31% in January, marking not only the fifth consecutive month of sales growth, but also the highest growth figures since September 2005. The highlights of the retail trade sector in 2006 were 10.3% expansion in sales of furniture and home appliances and 7.6% in the sales of hypermarkets, supermarkets and food products. In negative terms, the most important result was the 8.0% drop in fuel and lubricant

sales in the year, mainly reflecting higher fuel prices and the pursuit of such alternative energy sources as natural gas for vehicle use. Viewed from a different angle, one should note that the positive sales performance was not limited to income and employment sensitive items, but extended also to goods that are more sensitive to credit. For the coming quarters, expectations point to continued growth in retail sales, driven by steady growth in employment and income, a more ample volume of credit and the gradual easing of monetary policy, coupled with recovery in consumer confidence.

6.2 Benchmark scenario: assumptions and risks

Copom projections are based on a set of assumptions regarding the behavior of the major macroeconomic variables. These assumptions and their associated risks form the benchmark scenario underlying the Committee's decision-making process.

In general, the risks to the prospective dynamics of inflation remain quite similar to those identified in the December *Report*, but with greater uncertainty regarding the external scenario and alteration in the array of risks associated to the domestic scenario. Externally, doubts persist regarding United States monetary policy and economic activity, together with some degree of deterioration in the outlook for oil prices. Though markets generally believe that the process of monetary policy adjustment in the United States has run its course, one cannot completely disregard the possibility of additional increases in that country's interest rates. On the other hand, investor sensitivity to data that could indicate a sharper drop in US economic activity seems to have increased. This was the central point responsible for alterations in confidence levels and for the increase in volatility that characterized international financial centers in recent weeks, though uncertainties regarding Asian economies and markets persisted. More specifically, concern has been rising regarding the possible adoption of economic restraints in China and the extent of carry trade positions financed in yen. As far as the internal scenario is concerned, the farm price high has begun leveling off at the wholesale level. One should also note that 2007 will be marked by a review of energy prices in important electricity concessions, a procedure that will generate impacts on inflation projections (potentially benign) will be concentrated within this year. On the other hand, as stated by Copom in previous *Reports*, the extent of the process of monetary easing implemented

since September 2005 and the lag with which the monetary policy transmission mechanism operates imply increased uncertainty regarding the future dynamics of inflation. Effects of the fiscal impulses registered in 2006 and those expected for the current year must be added to these factors.

As far as the external scenario is concerned, an important alteration in relation to the December *Report* was the increase in international financial market volatility, though potentially transitory, triggered by the Shanghai stock market collapse, but concentrated in growing uncertainties regarding United States economic performance and, to a significant degree, in the magnitude of risk asset positions financed in yen. In the United States, negative growth in household investments for three consecutive quarters, a sharp increase in subprime real estate mortgage defaults and an increasingly tighter real estate credit market have increased the probability of a much sharper adjustment in this sector, while raising the specter of an even more significant economic downturn. This scenario has generated market expectations of an easing of United States monetary policy in the second half of 2007. On the other hand, persistent inflation at levels above the presumed comfort zone of the American Federal Reserve could inhibit the capacity of monetary authorities to respond adequately to a substantial downturn in economic activity. Nonetheless, continued recovery in Japan and Europe, marked also by monetary contraction, coupled with strong growth in important emerging economies, still point to a positive outlook for the world economy as a whole, albeit with considerably less optimism than in 2006.

It is important to highlight that, by improving its economic fundamentals, especially external solvency indicators, the Brazilian economy has demonstrated the success achieved in creating greater resistance to the impact of international financial market turbulence, at the same time in which it is still considered an attractive target not only for portfolio investments, but also for growing volumes of direct investment. This assessment is backed, for example, by still very low levels of country risk premium recently observed, compared to historical standards. In more specific terms, Brazil's average country risk premium measured by the Embi has dropped steadily from 542 b.p. in 2004 to 399 b.p. in 2005, 235 b.p. in 2006 and approximately 180 b.p. before the recent rise in volatility levels. One should also highlight the ongoing reduction of the difference between the country risk premium and the average risk premium of other emerging countries. Parallel to this, the rise in the country risk premium was no more than a relatively small increase of 20 b.p. during the recent period of turbulence, fully reversed by mid-March.

Emphasis should also be given to the fact that the increase in Brazil's risk premium was smaller than the average for other emerging economies. This trajectory suggests consolidation of a lower level of sovereign risk, reflecting the fact that the country has become more resistant to shocks and better able to attract a sustained flow of external investments. In this context, Copom has reaffirmed that steadily declining inflation, large and persistent trade surpluses, generation of adequate primary surpluses, rebuilding of the international reserve position, improvements in the internal public debt profile and repurchases of sovereign bonds on international markets have made the country increasingly more resilient to external shocks. Above all else, the country's increased resistance is reflected in the fact that the domestic economy has continued growing during the long process of interest rate adjustments in major world economies. As a result, Copom has attributed low probability to a scenario of international financial market deterioration sufficient to jeopardize private sector financing conditions.

Oil prices have been a systematic source of international uncertainties in recent years. Financial market turbulence impacted oil prices, interrupting the downward trend evident since August 2006. Despite this increase, prices remain quite close to those in effect in the final quarter of last year. However, in nominal terms, oil prices are still high and sharply volatile by historical standards, reflecting such factors as climate and geopolitical tensions, among others. Prices remained well above those in effect in 2001-2003. To some extent, current price levels may reflect structural imbalances in the oil market and suggest not only changes in the price plateau, but also that these prices may well remain higher than expected for a considerably longer period of time. In summary, the scenario for international oil prices is less favorable than at the end of 2006.

With regard to the internal scenario, it is Copom's understanding that economic activity data suggest low probability of any significant short-term inflationary pressures. Expanding imports are an important element in this process, since they complement domestic output and aid in limiting expectations of inflationary impacts generated by sustained growth in aggregate demand. Parallel to this, inflation expectations remain well anchored for both 2007 and 2008. On the other hand, one must recognize that fiscal impulses in 2006 and those expected for 2007 are factors that will further stimulate aggregate demand. More importantly, in keeping with Copom's evaluations published in previous *Reports*, uncertainties have grown with respect to the future dynamics of inflation as a result of the intensity and lags

with which the monetary policy transmission mechanism operates, particularly in the context of the cumulative easing of monetary policy since September 2005. It is important to stress that the risks associated to these uncertainties are important to monetary policy implementation, even when one considers the impact on domestic prices of recent growth in imports.

Farm prices are still a source of inflationary pressures. Farm products prices contributed to the inflation decline in 2005, when they dropped 6,32%, and in the first half of 2006, as evident in the cumulative 13.20% reduction in the 12-month period ended last March. Since June 2006, however, prices have risen in most months, posting cumulative 12-month expansion of 9.38% through February. For 2007, even when one considers that the larger share of agricultural output to be targeted to energy production could result in some cutbacks in areas now used for food production, the outlook is for a very successful harvest, evidently the best way of dampening the above-mentioned pressures. Though a certain reduction in farm price pressures at the margin can be noted (compared to the September-November period, wholesale farm prices grew at a lesser pace in the December-February period), the impact on consumer prices will still be felt over the very short-term.

Copom understands that rising consumer inflation at the end of 2006 and start of 2007 has been caused to a great extent by the expected reversal of the favorable dynamics of food prices in recent months, by significant fare increases in urban transportation systems and by seasonally higher school tuitions. The Committee considers that these pressures will be transitory and will dwindle in importance over time, without necessarily contaminating indices over a longer time horizon. Nonetheless, Copom will continue acting to ensure that the gains obtained in recent years in combating inflation are preserved. To do this, it will closely monitor the evolution of inflation and its various core measures in coming months, discriminating between temporary increases and persistent or generalized price hikes, so as to be able to readily adjust its monetary policy posture to the circumstances of the moment.

As stated in previous *Reports*, much of the prospective dynamics of the price formation process involves possible imbalances between aggregate demand and supply. The December *Report* pointed to intensification of the pace of economic growth in the final months of 2006, raising annual GDP growth 0.6 p.p. above the 2.3% result posted in 2005. Data on gross fixed capital formation have evolved positively, expanding 6.3% in 2006, well above product growth. This

result suggests a steady process of expansion in the economy's output capacity. Over the same time span, the average rate of utilization of output capacity was 0.14 p.p. below the 2005 level, according to CNI data. Considered together with an analysis of recent data on capital goods production and absorption and with statistics on production of inputs for the building industry, the dynamics of this process indicate continuity in projects involving expanded output capacity. As a matter of fact, capital goods absorption increased 8.9% in 2006. In general, economic activity data suggest low probability of significant short-term pressures on inflation.

Inflation expectations for 2007 and 2008 show a decline compared to the levels in effect in the final quarter of last year. Despite some degree of volatility, the median of inflation expectations for 2007 dropped from 4.0% at the end of December to 3.9% at the end of February. As regards 2008, median expectation slipped from 4.1% to 4.0%. Consequently, due to Copom's unequivocal commitment to the target path, the expected scenario continues to be one in which short-term inflationary pressures are held in check, at the same time in which the positive outlook over longer-term horizons solidifies.

As already mentioned, the Wholesale Price Index (IPA-DI) has been pressured by farm prices. Parallel to this performance, industrial prices have remained relatively steady, with a cumulative 12-month increase of just 2.48% through February. Consequently, there is no expectation of consumer price pressures generated by pass-through of higher industrial prices at the wholesale level. In any case, the impact of changes in wholesale prices on consumer prices will depend on prospective supply and demand conditions and the expectations of price-setters in relation to the future inflation path.

Copom has taken the position that the monetary policy stance adopted in recent quarters has contributed importantly to consolidating an increasingly more favorable macroeconomic environment over longer-term horizons, with a benign scenario as regards inflation. In this context, the major monetary policy challenge is to guarantee that the positive developments expected in the future will be effectively achieved. Inflation rates consistent with the target trajectory and the resulting solidification of a scenario of lasting macroeconomic stability will contribute to consolidating the process of gradual reduction of macroeconomic risk perceptions that has occurred in recent years, with highly positive impacts on sustained economic expansion. The space for lower real rates of interest in the future will be created naturally, as a consequence of improved perceptions.

Once again, Copom has insisted that important lags exist between monetary policy implementation and its effects on activity levels and inflation. Since September 2005 when the process of monetary policy easing began, 700 b.p. have been chopped off the basic rate of interest, mostly during the course of 2006 (475 b.p.). Therefore, the tendency over time will be for the impact of interest rate reductions in 2006 overlaps with the initial impacts of more recent reductions. Though the pace of activity has certainly picked up since the third quarter of last year, a significant share of the effects of interest rate cutbacks on activity levels has yet to be felt, in the same way that the impact of activity on inflation has not yet fully materialized. Consequently, evaluation of alternative monetary policy decisions must necessarily concentrate on an analysis of the prospective scenario for inflation and its associated risks, instead of prioritizing current values registered by this variable.

Growth in employment and income, coupled with a more ample credit supply, will continue driving aggregate demand in the coming quarters. At the same time, one must add to these factors the impacts of larger government spending and transfers, as well as other fiscal impulses that occurred in 2006 and are expected in 2007. Consequently, the effects of the interest rate cutback on aggregate demand will be added to other factors considered important drivers of demand growth. These considerations become even more relevant when one takes into account signs of continued growth in demand, short-term pressures on inflation and the fact that the impacts of monetary policy decisions will be felt in the second half of 2007 and, to a progressively greater degree, in 2008. Based on these considerations, Copom decided to attenuate the process of monetary policy easing by reducing the Selic rate target by 0.25 p.p. at its January and March meetings.

The Committee will continue to keep a close eye on both the internal and external scenarios, together with the positive and negative facets of the risks associated to inflation projections, all with the objective of ensuring that inflation will converge toward the target path.

Considering already existent incentives to growing aggregate demand, the uncertainties surrounding monetary policy transmission mechanisms, the lesser gap between the current basic interest rate, expected medium-term interest rates and the reductions implemented since September 2005, it is Copom's understanding that further easing of monetary policy must be done in a parsimonious fashion in order to preserve the success already achieved in combating inflation and ensuring economic growth with rising employment and real income.

The projection for contractually regulated and monitored prices in 2007 was revised downward from 4.8% in the December 2006 *Inflation Report* to 4.5%. This projection is based on the assumption of null cumulative growth in the prices of gasoline and bottled gas in 2007, with 3.3% growth in the average prices of electricity and 3.9% in fixed telephone rates. The projection for contractually regulated and monitored prices for 2008 was maintained at 5.6%, the same projection made in December 2006. The items for which a larger volume of information is available were projected individually, while projections for other items were based on the endogenous determination model of regulated prices, which considers seasonal components, exchange rate variations, market price inflation and inflation measured by the General Price Index (IGP).

Based on traditionally adopted procedures, the benchmark scenario assumes a constant rate of exchange over the forecasting horizon at R\$2.10, quite close to the rate in effect in the period prior to the March Copom meeting, and a Selic rate of 12.75%, set at that time. This information reflects expected paths for 180-day swap pre-DI rates with spreads of 49 b.p. and 72 b.p. in relation to the Selic rate in the final quarter of 2007 and 2008, respectively.

Exchange rate expectations gathered by Gerin among private-sector analysts decreased when compared to the figures released in the December 2006 *Inflation Report*. Expectations for the final quarter of 2007 shifted from R\$2.25 to R\$2.14 and from R\$2.36 to R\$2.21 in the final quarter of 2008. The outlook for the Selic rate also indicated downward movement. For the final quarter of 2007, projections dropped from 11.92% to 11.55%, with a reduction from 11.09% to 10.57% for the final quarter of 2008. This trajectory is consistent with spreads of -12 b.p. for six month pre-DI swaps in the final quarter of 2007 and -103 b.p. in the final quarter of 2008. Reflecting the impact of stronger exchange rate depreciation than in the benchmark scenario, projections indicate growth of 4.6% and 6.1% in regulated prices in the 2007 and 2008 market scenario, respectively.

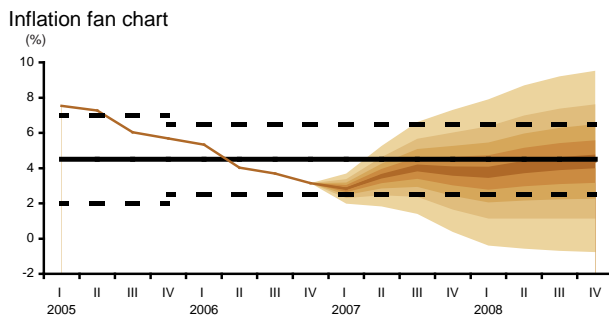
With regard to fiscal policy, the projections presented in this *Report* assume compliance with the 4.25% of GDP primary surplus target in 2007 and 2008, with the possibility of this percentage being reduced by as much as 0.5 p.p. as a consequence of implementation of the Pilot Investment Program.

6.3 Inflation forecast

Based on the assumptions and associated risks discussed above as assessed by Copom, together with the available information set, projections were developed for four-quarter cumulative IPCA growth compatible with the interest and exchange rate paths specified in the benchmark and market scenarios. The benchmark scenario assumes that the Selic rate will remain at 12.75%, the rate defined at the March Copom meeting, and that the rate of exchange will remain constant at R\$2.10 per US dollar over the forecasting horizon. Based on data gathered by Gerin from among a significant number of institutions, the expected interest rate path in the market scenario indicates an average Selic rate of 12.95% per year in the first quarter of 2007, dropping to 11.55% per year in the final quarter of 2007 and 10.57% per year in the final quarter of 2008. The exchange rate path starts at an average of R\$2.11 in the first quarter of 2007, shifting to R\$2.14 and R\$2.21 in the final quarters of 2007 and 2008, respectively.

As far as the benchmark scenario is concerned, the forecast indicates 3.8% inflation in 2007, below the 4.50% central forecast defined by the CMN as the target. In a manner quite similar to what is stated in the most recent *Inflation Report*, Figure 6.2 shows a tendency for 12-month IPCA cumulative inflation to converge to the central forecast of the inflation target over the forecasting horizon. Basically, this reflects the impacts consequent upon Selic rate reductions. Table 6.1 indicates that 12-month cumulative inflation drops to its lowest level (2.8%) in the first quarter of 2007, before turning upward in the second and third quarters, reaching 3.5% and 4.0%, respectively. This movement reflects higher projections for both regulated prices and market prices in the second and third quarters of 2007, compared to the amounts registered in the same period of 2006. On the other hand, the data included in Table 6.1 indicate a reduction in 12-month cumulative inflation in the final quarter of 2007 (0.2 p.p. compared to the previous quarter). This drop was caused by the fact that the projection for market price inflation in the fourth quarter of 2007 closed below observed inflation in the same period of 2006, with just the contrary occurring under regulated prices. According to the benchmark scenario, the estimated probability of inflation rising beyond the upper limit of the tolerance interval in 2007 stands at 10%, compared to 15% in December. Furthermore, one should stress that the forecast for 12-month cumulative inflation reaches 4.4% in the final quarter of 2008 and, despite acceleration in the projection for the same period of 2007 (3.8%), remains below the central target of 4.50%.

Figure 6.2 – Forecasted IPCA-inflation with interest rate constant at 12.75% p.a. (Benchmark scenario)



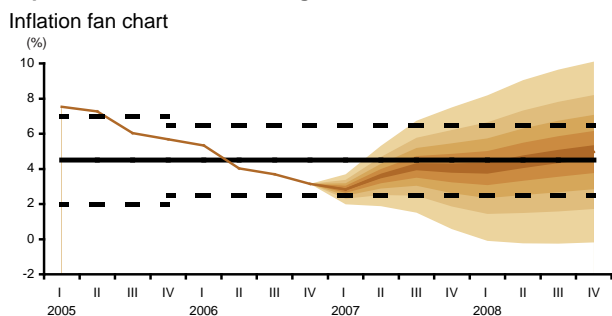
Note: Accumulated inflation in 12 months (% p.a.).

Table 6.1 – IPCA-inflation with interest rate constant at 12.75% p.a. (Benchmark scenario)

Year	Q	Confidence interval					Central projection	
		50%	30%	10%	50%	30%		
2007	1	2.5	2.6	2.8	2.9	3.0	3.2	2.8
2007	2	2.8	3.1	3.4	3.7	4.0	4.3	3.5
2007	3	2.9	3.4	3.8	4.2	4.6	5.1	4.0
2007	4	2.4	3.0	3.6	4.1	4.6	5.3	3.8
2008	1	2.1	2.8	3.4	4.1	4.7	5.5	3.8
2008	2	2.2	3.0	3.7	4.4	5.1	6.0	4.1
2008	3	2.2	3.1	3.9	4.6	5.4	6.3	4.3
2008	4	2.3	3.2	4.0	4.8	5.6	6.5	4.4

Note: accumulated inflation in 12 months (% p.a.).

Figure 6.3 – Forecasted IPCA-inflation with market expected interest and exchange rates



Note: Accumulated inflation in 12 months (% p.a.).

Table 6.2 – IPCA-inflation with market expected interest and exchange rates ¹

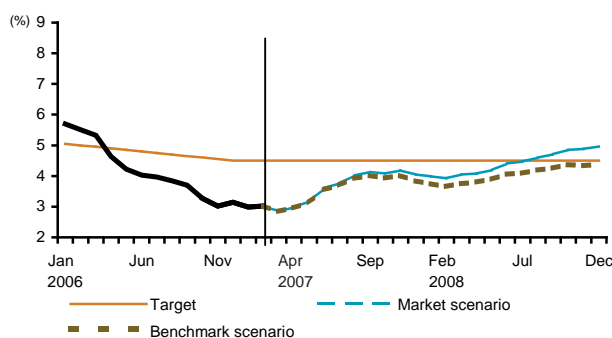
Year	Q	Confidence interval					Central projection	
		2.5%	3.0%	3.5%	4.0%	4.5%		
2007	1	2.5	2.6	2.8	2.9	3.0	3.2	2.8
2007	2	2.9	3.2	3.5	3.7	4.0	4.3	3.6
2007	3	3.0	3.5	3.9	4.3	4.7	5.2	4.1
2007	4	2.6	3.2	3.8	4.3	4.8	5.5	4.0
2008	1	2.3	3.1	3.7	4.4	5.0	5.7	4.0
2008	2	2.5	3.3	4.1	4.8	5.5	6.3	4.4
2008	3	2.7	3.5	4.3	5.1	5.9	6.7	4.7
2008	4	2.8	3.8	4.6	5.4	6.2	7.1	5.0

Note: accumulated inflation in 12 months (% p.a.).
1/ According to Gerin.

Table 6.3 – December 2006 Inflation Report forecasts

Period	Benchmark scenario	Market scenario
2006 IV	3.1	3.1
2007 I	2.7	2.7
2007 II	3.5	3.6
2007 III	4.0	4.3
2007 IV	3.9	4.3
2008 I	4.1	4.6
2008 II	4.4	5.0
2008 III	4.5	5.3
2008 IV	4.5	5.4

Figure 6.4 – Forecasts and target path for twelve-month cumulative inflation



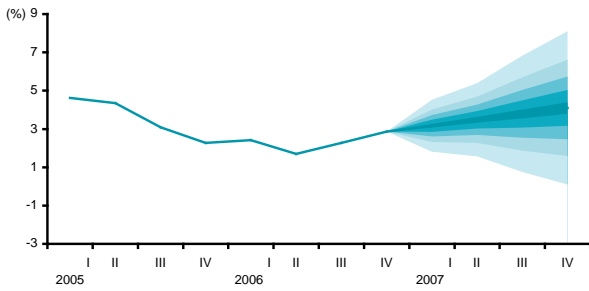
In the market scenario, the forecast for 12-month cumulative inflation in 2007 closes just 0.2 p.p. above the forecast for the reference scenario (4.0% compared to 3.8%), still well below the central target value of 4.50%. Just as in the benchmark scenario, the forecasts for 12-month cumulative inflation presented in Table 6.2 and illustrated in Figure 6.3 indicate acceleration in the second and third quarters of 2007, with deceleration in the latter period. Compared to the benchmark scenario, the slightly higher forecasts for inflation in the last three quarters of 2007 result from analysts' expectations of a Selic rate reduction and exchange depreciation over the forecasting horizon. According to the market scenario, the probability of inflation surpassing the upper limit of the tolerance interval for 2007 is 12%, compared to 19% in the December Report. At the same time, one should note that the projection for cumulative four-quarter inflation is an increase to 5.0% over the course of 2008.

Table 6.3 shows the central inflation values forecast presented in the December 2006 Inflation Report. Comparing these forecasts with current forecasts, the benchmark scenario shows a slight reduction (0.1 p.p.) in inflation estimates for both 2007 and 2008. Despite the reduction of 50 b.p. in the Selic rate since the release of the most recent Report, this movement was, to a great extent, due to the decrease in inflation expectations for 2007 (from 4.1% to 3.8%) and for 2008 (from 4.3% to 4.0%), and to revision of forecasts for 2007 variation in regulated prices (from 4.8% to 4.5%) and exchange appreciation (R\$2.10, against R\$2.15, considered in the December Report). In the market scenario, the falloff in inflation projections was more accentuated than in the benchmark scenario, 0.30 p.p. for 2007 and 0.40 p.p. for 2008. Aside from reflecting the factors stated above, this reduction also mirrors declining expectations of nominal exchange depreciation over the forecasting horizon.

Figure 6.4 shows the evolution of the forecast for 12-month cumulative inflation in both the benchmark and market scenarios, together with the target path through the fourth quarter of 2008. As diagnosed in previous Reports, the tendency toward decline in forecasts of 12-month cumulative inflation through the first quarter of 2007 is maintained, rising further on over the forecasting horizon. Nonetheless, a slight reduction in the forecast for 12-month cumulative inflation is noted in both scenarios in the final quarter of 2007 and first quarter of 2008. One should also note that the forecasts in both scenarios are below the central value of the target path through the second quarter of 2008. Starting in the third quarter of that year, benchmark scenario inflation forecasts remained below the central value of the target path

Figure 6.5 – GDP growth with interest rate constant at 12.75% p.a. (Benchmark scenario)

Output fan chart



over the entire horizon considered. However, in the case of the market scenario, inflation forecasts closed above the central value of the target path as of the third quarter of 2008.

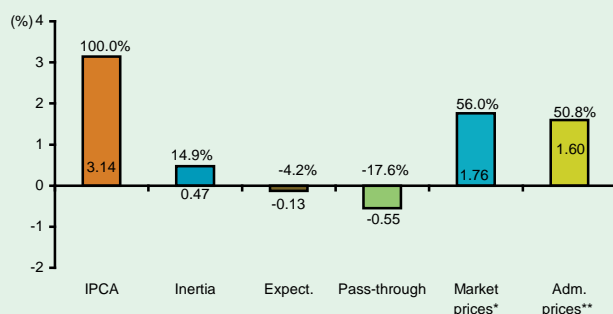
Figure 6.5 shows the output growth possibilities based on the assumptions of the benchmark scenario. Considering that the model that generates forecasts utilizes two components that are not directly observable – potential output and output gap – one should stress that forecasting errors for GDP growth are considerably greater than in the case of inflation projections. According to this scenario, the GDP growth forecast for 2007 is 4.1%, 0.3 p.p. above that projected in the December 2006 *Inflation Report*.

Inflation Decomposition – 2006

This box examines the behavior of 2006 inflation, based on estimates of the contribution of the major factors that explain its dynamics. The procedure¹ consists in decomposing changes in the Broad National Consumer Price Index (IPCA) for the calendar year in the following components: (i) exchange rate changes; (ii) inertia from the difference between previous year's target and actual inflation; (iii) the difference between inflation expectations of the agents and the inflation target; (iv) market prices inflation, excluding the impacts of the three previous items; and (v) inflation of contractually administered and regulated prices, purged from the impacts of items (i) and (ii). It should be stressed that these estimates are approximations based on models and, therefore, are subject to the uncertainties inherent to the process.

Inflation closed 2006 at 3.14%, declining for the fourth consecutive year. Considering the two large groupings of prices utilized in the IPCA, market prices inflation closed at 2.57% and regulated prices at 4.27%. Just as occurred in 2004 and 2005 (Table 1), excluding the combined impact of pass-through, inertia and expectations, the major contribution to IPCA's inflation was due to the behavior of market and regulated prices. As a matter of fact, when the exclusions above are considered, market prices contributed 1.76 p.p. of 2006's inflation, while the contribution of regulated prices was 1.60 p.p. In relative terms, the impact of market and regulated prices on inflation reached 56.0% and 50.8%, respectively (Figure 1).

Figure 1 – Inflation decomposition: 2006



* Excluding the effects of the pass-through, inertia and expectations.

** Excluding the effects of the pass-through and inertia.

1/ The procedure utilized is described in Freitas, Minella and Riella (2002), "Metodologia de Cálculo da Inércia Inflacionária e dos Efeitos do Choque dos Preços Administrados", Banco Central do Brasil, Technical Note, no. 22.

Table 1 – Inflation decomposition: 2002 – 2006 (p.p.)

Component	2002	2003	2004	2005	2006
IPCA inflation (variation %)	12.50	9.30	7.60	5.69	3.14
Inertia	0.93	5.90	0.28	0.77	0.47
Expectations	1.65	1.70	0.37	0.27	-0.13
Pass-through	5.82	-1.10	-0.34	-2.06	-0.55
Market prices inflation*	2.28	1.10	4.35	3.41	1.76
Administered prices inflation**	1.85	1.70	2.93	3.31	1.60

* Excluding the effects of the pass-through, inertia and expectations.

** Excluding the effects of the pass-through and inertia.

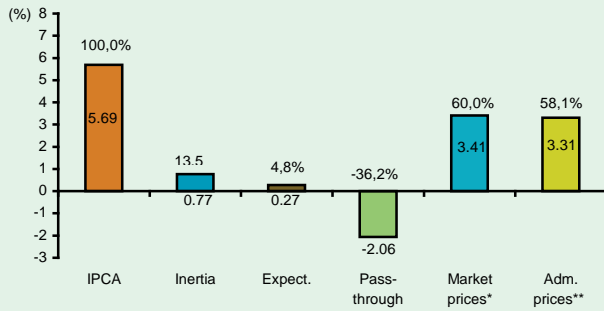
It is estimated that the combined impact of the inertia from the difference between actual inflation and the target for 2005, in the difference between inflation expectations of the agents and the target and the pass-through resulted in the 0.21 p.p. reduction in the IPCA.

It is important to note that, since 2003, variations in the exchange rate have systematically contributed to inflation reductions and that this contribution in 2006 came to approximately one fourth of that observed in the previous year. In the strict sense, in 2006, the change in the exchange rate accounted for -0.55 p.p. of growth in the IPCA, equivalent to 17.6% of the total in relative terms. Of these -0.55 p.p., -0.14 p.p. were due to the impact of exchange rate changes on market prices and -0.41 p.p. on regulated prices. Consequently, this stands as a demonstration of the role played by the exchange rate as an important, albeit not dominant, element of the monetary policy transmission mechanism. In this regard, the contribution of a varied set of factors was important to the behavior of the exchange rate. More specifically, one should cite strong balance of trade surpluses, the positive scenario on international financial markets, the effects of economic policy measures on risk perceptions when these measures strengthen the Brazilian economy's capacity to withstand shocks.

With regard to the impact of the difference between agent expectations and the target on total IPCA growth in 2006, one should note that the contribution of this factor has been gradually decreasing in importance in recent years, becoming negative for the first time since 2002. In an algebraic perspective, this result simply reflects the convergence of inflation expectations to the target trajectory observed in the recent past. Viewed in terms of the efficacy of the

macroeconomic policy implemented in the period under analysis, the result strengthens the evaluation that the policy in question has been successful in the sense of consolidating the creation of a stable macroeconomic scenario that is gradually becoming more favorable to an accelerated and sustained process of economic growth as now envisioned for the Brazilian economy.

Figure 2 – Inflation decomposition: 2005



* Excluding the effects of the pass-through, inertia and expectations.
 ** Excluding the effects of the pass-through and inertia.

As demonstrated in Figures 1 and 2, inflationary inertia – calculated on the basis of the share of inflation of the previous year that exceeded the targets for that year – made a lesser contribution to inflation in 2006 in absolute terms than in the previous year. This result is a natural consequence of the coming together of observed inflation with the target trajectory. Furthermore, it is worth mentioning that 58% of total inertia estimated for 2006 corresponds to the inertia of market prices.

In summary, inflation dropped 2.55 p.p. between 2005 and 2006. Excluding the effects of inertia, expectations and pass-through, the major determining factors underlying this movement were the reduction in market and regulated prices variation, reflecting positive supply shocks, particularly the reduction in food prices, as well as the effects of the monetary policy implemented in recent years.

Determinants of Interest Rate Maturity Risk Premium

In the September 2006 *Inflation Report*, the box “Informational Content of Interest Rate Spreads” presents evidence that the forecasting power of interest rate spreads increased and that risk premiums for maturity implicit in long-term interest rates diminished in recent years.

In this box, the determinant factors of the risk premium are examined. As a first step, a space-state model is specified and estimated in order to measure risk premium. In an algebraic perspective or in other words, $f_{t,j}$ is the forward interest rate negotiated in period t with maturity in $t+j$, which can be broken down as follows:

$$f_{t,j} = E_t [r_{t+j}] + t_{t,j}, \quad (1)$$

in which $E_t [r_{t+j}]$ represents the expectations of agents for the spot rate j periods ahead, given the information available at moment t , and $t_{t,j}$, the maturity premium. If we subtract the spot rate of interest j periods ahead from both sides of the equation (1), we obtain the excess return associated to the forward rate of interest ($x_{t+j,j} = f_{t,j} - r_{t+j}$), as shown below:

$$x_{t+j,j} = t_{t,j} + u_{t+j}, \quad (2)$$

in which $u_{t+j} = E_t [r_{t+j}] - r_{t+j}$ is the agents’ forecasting error.

Considering that the premium is a non-observed variable, it will be estimated through the Kalman Filter, requiring the following structure:

$$t_{t,j} = t_{t-1,j} + v_t, \quad (3)$$

in which v_t is a component error, which is independent,

identically and normally distributed with zero average and σ_v^2 variance.

In the forward interest rate estimation procedures, monthly end-of-period data for six-month and one year spot interest rates in the Brazilian forward structure were used, covering the period extending from January 1995 to September 2006. On the other hand, considering that both the risk aversion indicator and the debt profile are available only as of January 2000, the interval January-2000/September-2006 was considered in the analysis of the determinants of the risk premium.

In the explanation of the process that generates the risk premium, indicators of global liquidity were utilized, together with variables that reflect the evolution of the fundamentals of the domestic economy. The index of global risk aversion constructed by Merrill Lynch was used as proxy for international liquidity. With regard to domestic fundamentals, indicators of the liquidity of the economy (international reserves), composition of the internal public debt, inflation, economic activity, capital flows and the exchange rate were utilized.

Table 1 – Interest Rate Risk Premium Determinants

Variable	coefficient
Constant	-0.0040 (0.0033)
Risk Aversion [t]	0.0028 *** (0.0011)
Inflation [t]	0.0072* (0.0026)
Price-Indexed Bonds Participation [t]	-0.0834 *** (0.0439)
Exchange Rate Variation	0.2085 * (0.0357)
Risk Premium [t-1]	0.8999 * (0.0500)
R ²	81.28%
F-Statistic	60.07
p-value	0.0000

Standard errors are provided between parentheses

*,** and *** stand for statistical significance at the 1, 5 and 10% levels, respectively.

Table 1 presents the results of the estimation of equation (2), according to the method of Ordinary Least Squares, with the Newey-West correction for serial correlation and heteroscedasticity. Among the different specifications evaluated, an option was made for the model that showed the most significant parameters from the statistical point of view and the best explanatory power.

On the basis of Table 1, it is possible to infer that international liquidity (global risk aversion) has a fundamental role in explaining the risk premium implicit in domestic interest rates. It is clear that different domestic indicators also have an important role in determining risk premium. The results of the economic exercise offer evidence that the reduction of inflation and variations in exchange rates seen in the recent past, as well as changes in the public debt profile, contributed to reductions in risk premiums implicit in domestic interest rates.

Minutes of the 124th Meeting of the Monetary Policy Committee (Copom)

Date: January 23rd, from 4:30PM to 7:40PM, and January 24th, from 4:30PM to 8:00PM

Place: BCB Headquarters meeting rooms – 8th floor on January 23rd and 20th floor on January 24th – Brasília – DF

In attendance:

Members of the Committee

Henrique de Campos Meirelles – Governor
Afonso Sant’Anna Bevilaqua
Alexandre Antonio Tombini
Antonio Gustavo Matos do Vale
Mário Magalhães Carvalho Mesquita
Paulo Sérgio Cavalheiro
Paulo Vieira da Cunha
Rodrigo Telles da Rocha Azevedo

Department Heads (present on January 23rd)

Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on January 24th)
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 January 23rd)

Alexandre Pinheiro de Moraes Rego – Special Advisor to the Governor
Alexandre Pundek Rocha – Advisor to the Board

André Minella – Deputy Head of the Research Department

Flávio Pinheiro de Melo – Advisor to the Board

Jocimar Nastari – Press Secretary

Katherine Hennings – Advisor to the Board

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

Recent Economic Developments

1. IPCA inflation accelerated in the last quarter of 2006, averaging 0.37% up from 0.15% in the third quarter and 0.03% in the second quarter of last year. In December, inflation reached 0.48%, above the 0.31% recorded in November and slightly above expectations registered on the eve of the IPCA release, and also above the expectations that prevailed at the end of December. Twelve-month trailing inflation also accelerated in December, compared to 3.02% in November. Favorable developments in the last months contributed to reach an inflation of 3.14% in 2006, down from 5.69% in 2005, the lowest annual inflation since the adoption of the inflation targeting regime, in 1999. Market prices increased 2.57% in 2006 (tradable prices contributed 1.31%, while non-tradable prices accounted for 3.99%), whilst regulated prices increased 4.27%. Therefore, for the third consecutive year, inflation stood within the tolerance

intervals established by the National Monetary Council. Inflation acceleration in December was due to the increase in regulated prices (0.83% up from 0.00% in November), mainly driven by the urban bus fares, and not completely offset by the decrease in market prices inflation (0.32% down from 0.45% in November). Amongst market prices, tradable prices inflation decreased to 0.40% in December down from 0.54% in November, while non-tradable prices decreased to 0.24% down from 0.37%. Services inflation stood at 0.19% in December, unchanged relative to November, and slightly below the 0.22% observed in December 2005. In 2006, services inflation decreased to 5.48%, down from 6.78% in 2005. Partial January data, already captured by the IPCA-15 and underlying inflation measures, suggest that the short-term increasing IPCA trend should intensify. Despite the recent inflation acceleration in the last months, the most likely scenario is that inflation evolves according to the targets path.

2. Similarly to the headline result, IPCA core inflation measures calculated by the BCB also increased in December, on a month-on-month basis. Core inflation by exclusion of household food items and regulated prices increased to 0.34% in December, up from 0.23% in November and 0.30% in October. Smoothed trimmed means core increased to 0.38%, up from 0.27% in November and 0.32% in October, and continued to record the strongest rigidity among the three core measures. Conversely, after registering reduction in November to 0.12% down from 0.19% in October, the non-smoothed trimmed means core increased to 0.27% in December. Despite the recent increases, the cores continue to present a downward trend on a twelve-month basis, except for the core by exclusion, which slightly increased. According to the same comparison basis, the inflation cores recorded 3.56%, 4.63% and 2.76%, respectively, in December, compared to 3.52%, 4.68% and 2.83% in November. Similarly to the headline result, both the core inflation by exclusion and the non-smoothed trimmed means core stood below the central target in 2006. On the other hand, the smoothed core inflation has converged more slowly to the target, reaching 4.63% in 2006, and therefore, above the central target for the year.

3. The General Price Index (IGP-DI) inflation decelerated in the last two months of 2006, to 0.26%

in December, down from 0.57% in November and 0.81% in October. This deceleration was mainly driven by wholesale price inflation. The Wholesale Price Index (IPA-DI) inflation cooled to 0.11% in December, down from 0.75% in November. On the other hand, both the INCC-DI and the IPC-DI increased in December, month-on-month. The downturn in IPA-DI was due to the deflation in agricultural prices in December (-0.66% down from 2.39% in November), after several consecutive increases, whilst industrial prices accelerated. As a consequence, the IGP-DI increased 3.79% in 2006, up from 1.22% in 2005. This acceleration was driven by wholesale price inflation, and more specifically, by the significant upturn in agricultural prices in the second half of the year. After several months of deflation (reaching -3.14% in the twelve months through April), the IPA-DI reached 4.29% in 2006. After recording -13.19% in the twelve months through March, the Agricultural IPA totaled 6.92% in the year. 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. Industrial production, according to IBGE month-on-month seasonally adjusted data, expanded by 1.0% in October and 0.8% in November. Compared to the same months last year, the increases totaled 4.9% and 4.2%, respectively. In the year through November, industrial production reached 3.1%, while on a twelve-month trailing basis, industrial output reached 3.0%, the third positive result according to the same comparison basis, and indicating industrial activity acceleration. On a three-month moving average basis, industrial production increased for the eightieth consecutive month in November. The expansion in manufacturing activity in November reached 14 out of the 23 activities with seasonally adjusted data, with highlights to other transportation equipment (10.1%) and beverages (4.8%). For December, leading and coincident indicators suggest accommodation of the trend, which should not surprise in light of the strong increment recorded in the preceding months. However, several incentive factors, including the monetary easing already implemented and the fiscal impulses, suggest that the expanding trend in industry shall accelerate in 2007.

5. Disaggregated industrial data showed month-on-month seasonally adjusted expansions of 2.2% in capital goods production and 1.6% in intermediate goods production, after two months of contraction, but a 0.1% reduction in durable consumer goods production in November. Compared to the same month last year, all categories increased, with highlights to the expansions of durable consumer goods production (10.4%) and capital goods production (7.9%). In the year through November these use categories increased by 7.3% and 5.7%, respectively. The strong growth of durable consumer goods production reflects, among other factors, the recovery of real earnings and the expansion of credit. The expansion of capital goods production is due to positive prospects for domestic demand growth, and also to the influence of favorable international prices in the purchase of capital goods destined to several industrial sectors.

6. Labor market performance remains positive, with decreasing unemployment rate, creation of formal jobs and higher purchase power of workers. The unemployment rate in the six main metropolitan areas reached 9.5% in November, compared to 9.8% in October and 9.6% in November 2005. Rio de Janeiro, Belo Horizonte and Porto Alegre metropolitan areas recorded the lowest unemployment rates for November months since the beginning of the IBGE series. The unemployment rate contracted in all the six metropolitan areas surveyed, except for Rio de Janeiro, which recorded stability. As a result, the average unemployment rate in the year through November was 0.2 percentage points higher than that of the same period last year, notwithstanding the 2.4% expansion in labor force. The number of employed people grew 2.2% in the year through November and 3.0% in the month, compared to the same month last year, indicating that the pace of jobs creation remains robust. Still in November, the purchase power of workers increased a month-on-month 0.6% and 5.7% over the same month last year, for a 4.3% expansion in the year through November. In addition, real payrolls increased 6.6% in the same period, an important factor for the growth of aggregate demand. According to the National Industry Confederation (CNI), manufacturing employment increased a month-on-month seasonally adjusted 0.5% both in October and in November, consolidating a five-consecutive-month expansion.

Compared to the same months last year, manufacturing employment grew 3.2% and 3.9%, respectively. In the year through November, it reached 2.1%, compared to the same period last year. Regarding formal employment, data from the Ministry of Labor and Employment (MTE) confirm the continuity of the ongoing expansion. In November, the number of jobs increased 0.4%, on a month-on-month seasonally adjusted basis. In the year through November, the number of jobs expanded by 4.9%, the same rate observed in the last twelve months, mainly driven by the expansions of 9.4% in civil construction and 6.0% in the retail sector. With the creation of 32,579 jobs in November, formal job creation reached 1,546,179 in 2006. In the twelve months through November, 1,259,460 jobs were created.

7. Retail sales continued to expand in November 2006. IBGE data recorded a month-on-month seasonally adjusted 0.6% in retail sales for November and 0.5% for October. Compared to the same months of last year, retail sales grew 7.0% in October and 9.2% in November. In the year through November, retail sales expanded by 6.2%, mainly driven by furniture and domestic appliances sales (10.9%) and hyper- and supermarket sales (7.6%). The positive performance of retail sales is not restricted to income- and labor-sensitive items, but also comprises credit-sensitive items. Expanded retail sales, which include the sales of construction material and vehicles, motorcycles, parts and pieces, increased 10.2%, compared to November 2005 results, reflecting expansions of 10.4% and 12.2%, respectively, in the sales of these segments, fostered by positive credit conditions. In the year through November, expanded retail sales expanded by 6.5%. Retail sales expansion is expected to continue in 2007, boosted by positive labor market and income developments, credit expansion and the effects of the monetary easing cycle, as well as by the recovery in consumer confidence.

8. Installed capacity utilization in the manufacturing industry reached 82.1% in November up from 82.0% in October, according to CNI data seasonally adjusted by the BCB. Considering non-seasonally adjusted data, the average installed capacity utilization through November stood 0.2 p.p. below that of the same period last year. Since July, utilization rates have been at higher levels than those

observed in the same months of 2005. Disaggregated indicators compiled by the FGV show utilization rates at historically high levels for civil construction and capital goods, whose production has vigorously expanded. Despite industrial production growth, average utilization has shown relative stability, which reflects the improvements in the productive capacity. In fact, recent data regarding output and absorption of capital goods suggest a robust ongoing expansion of investments. In the year through November, the absorption of capital goods expanded by 9.2%, mainly driven by the increases in capital goods imports volume (24.0%) and in capital goods production (5.7%). Civil construction inputs expanded by 4.9%, according to the same comparison basis. Therefore, despite the ongoing aggregate demand expansion, relevant aggregate supply imbalances that could jeopardize 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.

9. The trade balance continues to present robust results, confirming previous Copom assessments regarding important structural changes in the Brazilian external trade. In 2006, the trade balance reached US\$46.1 billion, 3% above the level reached in 2005. This result was driven by the record results of exports (US\$137.5 billion) and imports (US\$91.4 billion). Despite significant, twelve-month trailing surplus through December was lower than the US\$46.3 billion record high observed in October. As a result of domestic demand recovery, imports have outperformed on the margin, gradually compressing trade balance results. As a consequence, external results in 2007 are expected to be lower than those observed in 2005-2006, but still high for the Brazilian historical standards. The current account surplus stood at US\$1.5 billion in November, reaching US\$13.2 billion in the year, or 1.6% of GDP, for a US\$14.0 billion surplus in the twelve months through November, or 1.5% of GDP.

10. Regarding the international scenario, the uncertainties regarding the monetary policy stance in the US persist. Although additional interest rate increases cannot be discarded, the consensus points

to the fact that the tightening cycle may have already ended. On the other hand, even though the recession scenario in the US economy seems to be less plausible, there are uncertainties about the magnitude of the US economy deceleration. The uncertainties regarding monetary policy in Europe and Japan also persist. However, it bears emphasizing, so far, the limited effects of the less clear international outlook observed in the last months, when the concerns stated above were already present, particularly with regard to the increased risk aversion, commodities prices trajectory, and lower international liquidity. In fact, after an up-tick in May, the sovereign risk reached historically low levels in the last months. This fact corroborates recurrent analysis, expressed in previous Press Releases and Inflation Reports, that the Brazilian economy is more resilient to external shocks. In this context, the Copom reaffirms that the continued disinflation, robust and persistent trade surpluses, adequate public sector's primary surpluses, the buildup of international reserves, improved public sector's debt profile and buyback of external debt have strengthened the domestic resilience to external shocks. Therefore, the Copom continues to assign low probability to a significant deterioration in international financial market conditions that could affect Brazilian external financing.

11. Another concern regarding the international outlook, oil prices, has continued to dampen. Oil prices slightly decreased since the last Copom meeting, contributing to cool down uncertainties associated with its evolution and effects on the world economy. Oil prices are below the lowest prices observed in the last 18 months, due to the exceptionally mild winter in the Northern Hemisphere and apparent difficulties that Opec faced to control supply. In spite of the recent decrease, oil prices still present high volatility, reflecting, among other factors, geopolitical tensions and weather conditions. However, the scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2007, has become more likely to occur, and the risks related to its materialization have decreased significantly. Despite the stability in domestic gasoline prices, changes in international oil prices affect domestic oil prices, for instance, through productive chains, such as the petrochemical, as well as through the deterioration of market inflation expectations.

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 December Inflation Report, the projection for gasoline and bottled gas prices adjustments in 2007 were both changed to 0%;

b) Considering the same comparison basis, the projections for household electricity and fixed telephone prices adjustments in 2007 were changed to 4.6% and 3.9%, respectively;

c) The projection for regulated prices inflation in 2007 decreased to 4.5% from 4.8% (December Inflation Report). These items, according to the weights released by the IBGE, represent 31.04% of the total December IPCA;

d) The projection for regulated prices inflation in 2008 was maintained at 5.6%, as presented in the December Inflation Report. This projection for regulated prices is based on the endogenous determination model. 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 53 b.p. in the fourth quarter of 2007, reaching 70 b.p. in the last quarter of 2008.

13. 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 Plan). The related assumptions considered in the previous meeting were maintained.

14. Since the November Copom meeting, median IPCA inflation expectations for 2007, compiled by the BCB's Investor Relations Group (Gerin), decreased slightly to 4.07% from 4.10%. This decrease was

mainly driven by lower inflation projected for the second and third quarters of the year. The twelve-month ahead inflation expectations decreased to 4.04% from 4.17%. For 2008, inflation expectations decreased to 4.0% from 4.3%. As mentioned in previous Minutes, these developments suggest the consolidation of a more favorable long-term macroeconomic scenario.

15. The 2007 inflation forecast under the benchmark scenario – which assumes the maintenance of the Selic rate at 13.25% and the exchange rate at R\$/US\$2.15 during the forecast period – decreased compared to the values considered at the November Copom meeting, remaining below the 4.50% target established by the CMN for the year. The forecast based on the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – also remained below the values considered in the November Copom meeting, and below the central target for the year. The projections for 2008, according to both scenarios, reduced relative to the November projections, remaining below the 4.50% target in the benchmark scenario, and above the 4.50% target in the market scenario.

Monetary Policy Decision

16. The Copom reaffirms the view expressed in previous Minutes, that besides 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 likelihood of important pressures over short-run inflation. Imports expansion has contributed significantly to this process, complementing domestic production and, therefore, limiting potential inflationary effects of aggregate demand sustained growth. In addition, despite the prospects of lower liquidity in international markets, due to the interest rates increase in industrialized economies, the external outlook, particularly regarding Brazilian external financing, remains favorable even in a context of moderation in international growth. The favorable external outlook strengthened as international oil prices decreased significantly in the last weeks. Therefore, the prospects for the inflation trajectory

remain benign. As in the November meeting, the Copom emphasizes that the main challenge of the monetary policy in this context is to guarantee the consolidation of future positive developments.

17. The Copom evaluates that pressures stemming from food and regulated prices, mainly public transportation fares in some state capitals, have driven the short-term inflation increase. Since these effects have not exhausted yet, upcoming inflation indicators will likely 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.

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 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.

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 650 b.p., with the greater part 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.

20. During the coming months, employment and income expansions and credit growth will continue to bolster economic activity. As mentioned in the November 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.

21. Given the reasons stated above, the Copom considered again, as in its three previous meetings, the convenience of reducing the Selic target by 25 basis points. The Copom members consensually concluded that several factors would justify such decision, and that it would contribute to increase the total adjustment to be implemented. However, there was no consensus that the lower pace of the monetary easing should start at the present meeting. Three members of the Committee voted for a 50-basis-point reduction in the Selic target, considering that the current balance of risks justified such decision.

22. On the other hand, the majority of the members of the Copom emphasized that the information available at that moment justified a change in the pace of the ongoing monetary easing process. Given 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, these Copom members understood that the preservation of important achievements in disinflation and in preserving economic growth, with job creation and rising real income, demanded a more cautious monetary easing stance. This argument is even more relevant considering the signs of heated aggregate demand, the short-term inflation pressures and the fact that the monetary policy decisions should have

concentrated effects in the second half of 2007 and 2008, progressively.

23. Therefore, the Copom decided to reduce in the Selic target by 25 basis points to 13.00% p.a., without bias. Five votes were for the Copom monetary policy action, while three votes were in favor of reducing the Selic target by 50 basis points.

24. 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 new elements of uncertainty came up. On the other hand, a set of price pressures, apparently temporary, arises when domestic demand already expands robustly. In such an environment, the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons. Evidently, in case of an exacerbation of the risk factors monitored by the Copom, the monetary policy strategy will be promptly adapted to the circumstances.

25. At the conclusion of the meeting, it was announced that the Copom would reconvene on March 6th 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. IPCA inflation increased 0.48% in December, up from 0.31% in the previous month. Such acceleration was mainly driven by an upturn in transports prices, which contributed 0.24 p.p. for the monthly result. Other groups also showed price elevations, with highlights to clothing (1%); personal outlays (0.44%); and food and beverages (0.39%), the last two with lower changes than in the previous month. IPCA inflation totaled 3.14% in 2006, the lowest variation since 1998, when it reached 1.65%. Comparing the two semesters of 2006, the index performed similarly, posting 1.54% and 1.58% in the first and second semesters, respectively. Food and

beverages increased by 1.23% in 2006, far below the IPCA change.

27. Market prices variation decreased to 0.32% in December, down from 0.45% in November, for a 2.57% change in 2006. In the year, tradable and non-tradable goods prices rose by 1.31% and 3.99%, respectively. Regulated prices had a punctual contribution for the IPCA acceleration in December, which did not affect the declining trend observed during the year. Regulated prices variation stood at 4.27% in 2006, compared to 8.96% in the previous year.

28. The IGP-DI increased 0.26% in December, totaling 3.79% in 2006. The IPA (Wholesale Prices Index, the sub-index with the largest weight in the IGP-DI) decelerated to 0.11% in December from 0.75% in November, for a 4.29% increase in the year. The IPC-Br reached 0.63% in the month, up from 0.24% in November, mainly due to the elevation of urban bus fares; the index totaled 2.05% in 2006. The INCC increased 0.36% in December, up from 0.23% in November, for a 5.04% elevation in the year.

29. The deceleration in wholesale price inflation in December reflected the fall of agricultural prices and the slight acceleration in industrial prices. The Agricultural IPA reduced 0.66%, down from 2.39% in November, with highlights to the reduction in the prices of bovines, rice and sugar cane; in the year, the index rose by 6.92%. The Industrial IPA increased 0.36% in December, up from 0.22% in the previous month, for a 3.46% elevation in the year. According to the processing stages of production, only intermediate goods recorded price increase in December (0.37%). The prices of final goods declined 0.15%, after a 0.37% elevation in November. The prices of raw materials decelerated in December, falling 0.05% after the 3.03% increase in the previous month. In the year, the prices of raw materials increased by 10.07%, pressuring the IPA result; prices of intermediate and final goods rose by 3.49% and 1.22%, respectively.

30. All IPCA core inflation measures increased in December on a month-on-month basis, but sustained their declining trend on a twelve-month trailing basis, including the December results, except for

the stability recorded in the core by exclusion of household food items and regulated prices. The non-smoothed trimmed means core reached 0.27% in December, up from 0.12% posted in November, increasing to 2.76% in twelve months. The core under the smoothed trimmed means method stood at 0.38% in December, up from 0.27% in November, totaling 4.63% in 2006. The core excluding household food and regulated prices reached 0.34% in December, up from 0.23% in the previous month, for a 3.56% expansion in 2006.

31. The IPC-Br core inflation, calculated by the FGV under the symmetric trimmed means method, increased to 0.31% in December, for a 2.82% expansion in the year.

Economic Activity

32. According to IBGE's monthly survey, retail sales increased a month-on-month seasonally adjusted 0.6% in November. The four activities with seasonally adjusted data increased, with highlights to the increases observed in fabric, clothing and shoes (5.7%) and fuel and lubricants (2.0%).

33. Retail sales increased 9.2% in November, compared to November 2005, mainly driven by the increases in furniture and home appliances (14.9%) and hyper- and super-market sales (9.7%). Expanded retail sales, including civil construction inputs and vehicles, motorcycles, parts and pieces, grew 10.2%, according to the same comparison basis, evidencing increases of 10.4% and 12.2% of these segments, respectively, driven by favorable credit conditions. In the year through November, retail sales increased by 6.2%, while expanded retail sales reached 6.5%.

34. São Paulo Trade Association (ACSP) data in December, seasonally adjusted by the BCB, showed a 0.4% decline in database consultations for credit sales and a 3.5% increase in consultations to the Usecheque system, on a month-on-month basis. In 2006, these indicators expanded by 3.3% and 5.6%, respectively.

35. Regarding investment indicators, capital goods and civil construction inputs production grew a month-on-month seasonally adjusted 2.2% and 1%, respectively, in November. Capital goods imports fell

7.2%, according to the same comparison basis. In the year through November, these indicators increased by 5.7%, 4.9% and 24.0%, respectively, compared to the same period of the previous year. Also in the year through November, capital goods production for energy increased 26.7%, for construction, 9.3%, and of mixed use, 11.4%, while capital goods production for agriculture fell 18.7%.

36. According to the IBGE's Monthly Industrial Survey (PIM), industrial production increased a month-on-month seasonally adjusted 0.8% in November, reaching a record high for the series. Industrial production expanded by 4.2%, compared to the same month of 2005, and 3.1% in the year through November, for a 3% growth on a twelve-month trailing basis, respectively.

37. According to IBGE's monthly survey, the 0.8% growth in industrial production in November reflected monthly expansions of 2.2% and 0.8% in mining and manufacturing industry, respectively. Regarding use categories, capital goods and intermediate output increased by 2.2% and 1.6%, respectively, while consumer goods production fell 0.1%, driven by the decreases in durable goods (0.1%) and non-durable goods production (0.6%).

38. Seasonally adjusted data for industrial production showed that 14 of the 23 sectors surveyed increased in November, mainly in other transportation equipment (10.1%), beverages (4.9%) and oil and alcohol refine (4.6%). Clothing and accessories, perfume and cleansing products and vehicles recorded declines of 2.1%, 1.4% and 1%, respectively.

39. The 3.1% growth in industrial output, in the year through November, compared to the same period of 2005, was driven by the expansions of 7.3% in mining and 2.8% in manufacturing industry. All use categories grew in November, with highlights to durable consumer goods production (7.3%). Capital goods, semi- and non-durable goods and intermediate goods production increased by 5.7%, 2.9% and 2.1%, respectively, according to the same comparison basis.

40. Seasonally adjusted data for industrial production showed an increase in production in 21 of the 26 sectors surveyed, boosted by the 52.8% expansion

in the production of office machines and data equipment, such as computers and monitors. It bears emphasizing the increases of 10.4% in machines production, electrical materials and devices, mainly transformers and the 7.3% growth in mining output, particularly iron ore and oil.

41. CNI manufacturing data showed decreases of 0.6% in hours worked in production and 0.8% in real industrial sales in November, on a month-on-month seasonally adjusted basis. In the year through November, these two indicators increased by 1.8% and 1.5%, respectively, compared to the same period of 2005. Installed capacity utilization reached a month-on-month seasonally adjusted 82.1% in November, up from 82.0% in the previous month. Without seasonal adjustments, installed capacity utilization leveled at 82.5%, 0.4 p.p. above the November 2005 result.

42. Vehicles production totaled 185 thousand units in December, decreasing 4.6% on a month-on-month seasonally adjusted basis. Domestic sales grew 7.8% and exports, 6.4%, according to the same comparison basis. Year-on-year vehicles production expanded by 3.1%; domestic sales increased by 11.1%, while exports declined by 5.8%.

Surveys and Expectations

43. The Fecomercio-SP survey showed a 5.1% month-on-month expansion in the Consumer Confidence Index (ICC) in January. Both ICC components increased: Current Economic Conditions Index (Icea) rose 12.7%, while the Consumer Expectation Index (IEC) increased by 0.3%. The ICC expanded by 1.6%, compared to the same month last year.

44. According to the FGV survey, which encompassed 2,000 homes in the seven main state capitals of the country, the ICC increased 2.2% month-on-month in December, recording a 3.3% increase in the present situation assessment and a 1.5% improvement in the 6-month ahead expectations.

45. Still according to FGV, the Industry Confidence Index (ICI), which encompasses six items of the Manufacturing Industry Survey, declined 0.8%

month-on-month in December, but expanded by 9.5% compared to December 2005. On a month-on-month basis, there was stability in the assessment about the present situation and deterioration of 1.4% in the expectations for the upcoming months.

Labor Market

46. According to the Ministry of Labor and Employment, 32,579 new jobs were created in November, with expansion in the commerce and services sectors and contraction in the manufacturing industry, agriculture and civil construction. On a month-on-month seasonally adjusted basis, formal employment increased 0.4%. In the year through November, 1,546 thousand new jobs were created, corresponding to a 4.9% expansion compared to the same period of 2005, with highlights to the 9.4% increase in civil construction.

47. According to the IBGE survey (PME) in the six main metropolitan areas of the country, the unemployment rate reached 9.5% in November, down from 9.8% in October, standing 0.1 p.p. below the observed in November 2005. Average unemployment rate stood at 10.1% in the year through November, 0.2 p.p. above the level registered in the same period of 2005, as a result of the increases of 2.2% in the number of employed workers and 2.4% in labor force. Real average earnings reached R\$1,065.38 in November, with a 0.6% month-on-month increase and a 5.7% expansion in comparison to November 2005. Real payrolls, defined as the product of real average earnings and the number of employed workers, expanded 1.0% in November, month-on-month, and 8.8% compared to November 2005. In the year through November, these indicators rose by 4.3% and 6.6%, respectively.

48. According to CNI, industrial employment increased 0.5% in November, seasonally adjusted, totaling a 2.1% growth in the year.

Credit and Delinquency Rates

49. Credit operations in the financial system increased 2.3% in December, for a 20.7% expansion in 2006. Non-earmarked credit increased 2.1% month-on-month and 23.8% in twelve months, while earmarked

credit operations expanded by 2.7% and 14.6%, respectively, according to the same comparison bases.

50. Non-earmarked credit, used as reference for interest rates, decreased 0.1% month-on-month in December, for a 23.6% expansion in 2006. Credit for individuals increased 1.4% in the month and 25.2% in the last twelve months. Corporate credit operations with domestic funding increased 4.3% in the month and 20.4% in twelve months, while externally funded operations decreased 1.9% and expanded by 9.4%, according to the same comparison bases, respectively. Still regarding non-earmarked credit, leasing operations for individuals and for overall corporate credit operations expanded by 76.1% and 42.1%, respectively, in the in the last twelve months.

51. The average interest rate on credit operations decreased again in December, reaching 39.8% p.a., 6.1 p.p. below the December 2005 level. The average rate on credit for individuals reached 52.1% p.a., compared to 59.3% p.a. in the same month of 2005, while the average rate on corporate credit decreased 5.5 p.p., to 26.2% p.a., in the same period.

52. Delinquency rates in financial system (non-earmarked loans in arrears for more than ninety days) reached 5% in December, decreasing 0.1 p.p. in the month and increasing 0.8 p.p. in the year. Delinquency rates for corporate credit operations decreased 0.1 p.p. in the month and expanded 0.7 p.p. compared to December 2005, reaching 2.7%. Delinquency rates for credit operations with individuals stood at 7.6%, decreasing 0.1 p.p. in the month and increasing 0.9 p.p. in twelve months.

53. Net delinquency rates for retail credit, measured by the ACSP, reached -0.6% in December, repeating a seasonal phenomenon caused by the reduction of new registers and the expressive increase in canceled registers in December. In the year, the number of new and canceled registers increased 5.0% and 3.3%, respectively, while the average default rate reached 5.3%, compared to 5.0% in 2005.

External Environment

54. Global growth should remain robust in 2007, despite some deceleration relative to 2006.

55. Although risks to the concretization of this scenario persist, the stability observed in the US real estate market, the support to domestic demand in Japan stemming from the heated labor market and high private investment levels and the continued expansion of consumption and investment in Europe shall not only assure output expansion close to potential levels in the main economic areas, but also support one more year of consistent expansion in international trade.

56. Although the cooling of domestic demand in the main economic areas and of international trade expansion and the economic reforms in course in China can decelerate the country's economy, the Chinese GDP growth may remain high, favoring the demand for intermediate goods and services produced in other Asian countries and also the demand for commodities produced in other regions. In the same way, the continued substitution of alternative energy sources for oil, driven by oil prices elevation in the last years, should contribute to keep the international prices of these products at high levels.

57. The main risk to this favorable scenario in 2007 is the increase of inflationary pressures driven by an eventual elevation in international oil prices, mainly related to geopolitical factors and to cost pressures stemming from US low unemployment rates.

Foreign Trade and International Reserves

58. In December, Brazilian foreign trade continued to expand, with new record highs in exports and imports for the month. Total external trade reached US\$19.5 billion in the month, for a US\$5 billion trade surplus, a record high for December and the second highest monthly level for the series. All 2006 results are historical records, indicating the improvement in Brazilian foreign trade. Exports totaled US\$137.5 billion, imports reached US\$91.4 billion, and total external trade totaled US\$228.9 billion, for a US\$46.1 billion trade surplus. In the three first week of January (fourteen working days), the trade surplus reached US\$1.7 billion, a result of US\$7.3 billion exports and US\$5.6 billion imports.

59. World economic growth favored the increase in the demand for goods and international prices,

mainly commodities prices. In the year, the elevation in prices prevailed over the expansion of shipped volumes, resulting in growth in the three exports categories. Moreover, it bears emphasizing the ongoing diversification process, with generalized increase in shipping, particularly with regard to manufactured goods with low weight in total exports, and the expansion of exports destination.

60. Exports reached US\$12.2 billion in December, with a daily average of US\$611.8 million, a 23.5% increase over December 2005. In 2006, the exports of manufactured, semi-manufactured and primary products recorded record highs. Manufactured goods external sales reached US\$74.7 billion, a 15.6% increase in the year, considering the daily average. Primary products exports totaled US\$40.3 billion, and semi-manufactured ones, US\$19.5 billion, with respective increases of 16.9% and 23.3% in 2006.

61. Imports totaled US\$7.2 billion in December, a 21.0% increase considering daily averages, compared to December 2005. Fuel and lubricants imports decreased 13.7%, while other imports expanded in the period, particularly consumer goods imports (49.7%). In 2006, imports expanded by 25.2%, measured in daily averages, compared to 2005, with increases in all categories: consumer goods (42.6%), mainly automobiles (136.0%); fuels and lubricants (28.2%); capital goods (23.9%); and raw materials and intermediate goods (20.8%).

62. In December, international reserves totaled US\$85.8 billion, increasing US\$2.7 billion in the month and US\$32.0 billion in the year.

Money Market and Open Market Operations

63. After the November Copom meeting, the yield curve shifted downward, particularly the long-tenure ones. This movement began immediately after the meeting, reflecting the Committee decision to reduce the Selic rate by 0.50 p.p., and lasted for all December, in light of good results for domestic inflation. External conditions also favored this reduction, such as prospects of cooling in the US economy and the favorable outlook for inflows to emerging countries. In the beginning of January, however, the FOMC Minutes raised concerns about

the US economy developments. Employment and activity data released right after that reinforced those concerns and, in addition to the fall in the prices of commodities in international markets, caused a temporary increase in the long-term rates in local market. Since January 18, however, data regarding inflation in the US, in line with expectations, contributed to a downturn in the yield curve. Between November 27 and January 22, one-, three- and six-month rates declined 0.46 p.p., 0.55 p.p. and 0.53 p.p., respectively. One-, two- and three-year rates reduced 0.59 p.p., 0.82 p.p. and 0.96 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 decreased to 7.99% on January 22, down from 8.41% on November 27.

64. Between November 28 and January 23, the BCB conducted two reverse exchange rate swap auctions. The first one, on December 14, anticipated the redemption of the swap due January 2nd and reached US\$1.6 billion. The February 1st maturity rollover was accomplished on January 23 and totaled US\$742 million.

65. In its open market operations, the BCB carried out, from November 28 to January 22, weekly five- and seven-month long fixed rate repo operations. The average daily balance of these operations amounted R\$55.3 billion, of which R\$28.0 billion were five-month operations. In the same period, the BCB also conducted 37 overnight repo operations, 35 of which 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 the daily liquidity management operations, averaged R\$32.0 billion, borrowing.

66. Between November 28 and January 22, the National Treasury raised a total of R\$59.7 billion, of which R\$37.1 billion in fixed-rate securities: R\$17.9 billion via issuance of LTNs maturing in 2007, 2008 and 2009 and R\$19.2 billion in NTN-Fs maturing in 2010, 2012, 2014 and 2017. Issuance of LFTs totaled R\$13.5 billion, for securities maturing in 2010 and 2012. Issuance of inflation-linked NTN-Bs and NTN-Cs reached, respectively, R\$7.4 billion, for

securities maturing in 2009, 2011, 2015, 2024, 2035 and 2045, and R\$1.7 billion, for securities maturing in 2017, 2021 and 2031.

67. In the same period, the Treasury conducted auctions to sell LTNs maturing in July and October 2007 and, later, in October 2007 and April 2008, conjugated to the purchase of shorter-term LTN

or LFT maturing in 2006, totaling R\$12.2 billion. The Treasury also conducted auctions to sell LFTs maturing in 2010 and 2012, totaling R\$1.5 billion, accepting as payment LFTs maturing in 2006 or in the first half of 2007. Still, the Treasury conducted auctions to buy LTNs maturing in January and April 2007 and NTN-Bs with several maturities, totaling R\$6.2 billion and R\$180 million, respectively.

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

Date: June 5th, from 5:00PM to 7:30PM, and June 6th, from 5:00PM to 8:00PM

Place: BCB Headquarters meeting rooms – 8th floor on June 5th and 20th floor on June 6th – Brasília – DF

In attendance:

Members of the Committee

Henrique de Campos Meirelles – Governor

Alexandre Antonio Tombini

Antonio Gustavo Matos do Vale

Mario Gomes Torós

Mário Magalhães Carvalho Mesquita

Paulo Sérgio Cavalheiro

Paulo Vieira da Cunha

Department Heads (present on June 5th)

Altamir Lopes – Economic Department

Carlos Hamilton Vasconcelos Araújo – Research Department (also present on June 6th)

Ivan Luis Gonçalves de Oliveira Lima – Open Market Operations Department

José Antonio Marciano – Department of Banking Operations and Payments System

Renato Jansson Rosek – Investor Relations Group

Other participants (present on June 5th)

Adriana Soares Sales – Deputy Head of the Research Department

Alexandre Pinheiro de Moraes Rego – Special Advisor to the Governor

Alexandre Pundek Rocha – Advisor to the Board

Flávio Pinheiro de Melo – Advisor to the Board

Katherine Hennings – Advisor to the Board

Jocimar Nastari – Press Secretary

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 totaled in April and May 0.25% and 0.28%, respectively, down from 0.37% in March. As a consequence, inflation through May stood at 1.79%, above the 1.75% rate reached in the same period of last year. Regulated prices totaled 1.35%, down from 2.70%, according to the same comparison basis, contributing to contain inflation, once market prices reached 2.01% in the period, above the 1.27% observed in the same period of 2006. Twelve-month trailing inflation through May reached 3.18% (compared to 4.23% through May 2006), while market prices increased 3.32% and regulated prices grew by 2.88% (2.48% and 8.24%, respectively, through May 2006). Month-on-month inflation deceleration in April and May was a result of market prices inflation decline (0.19% and 0.25%, respectively, down from 0.44% in March), in contrast with regulated prices inflation acceleration (0.39% and 0.35% in April and May, respectively, up from 0.21% in March). In addition, tradable goods price inflation accelerated 0.25% and 0.48%, respectively, in April and May, up from 0.21% in March, in contrast with non-tradable price inflation, which totaled 0.13% and 0.03%, down from 0.66%, according to the same comparison basis. Services

inflation reached 0.18% in April and 0.26% in May, totaling 4.87% in the last twelve months. Dampened inflationary pressures at the end of 2006 and at the start of 2007 indicate that inflation should evolve according to the targets path.

2. IPCA core inflation measures did not follow the declining headline inflation behavior. Core inflation by exclusion of household food items and regulated prices increased month-on-month 0.29% in April and 0.33% in May, up from 0.23% in March. On the other hand, smoothed trimmed means core stood at 0.29%, virtually unchanged relative to March, while the non-smoothed trimmed means core increased 0.28% in April and 0.30% in May, up from 0.24% in March. In the year through May, core inflation by exclusion and smoothed and non-smoothed trimmed means core measures recorded 1.80%, 1.51% and 1.40%, respectively, below the rates observed at the same period of 2006. In the last twelve months, smoothed trimmed means core totaled 3.68% in May and 3.86% in April, down from 3.98% in March. On the other hand, on a twelve-month trailing basis, core inflation by exclusion and non-smoothed trimmed means core increased in April and May, relative to March, but stood below the 4.5% central target for 2007.

3. The General Price Index (IGP-DI) inflation averaged 0.29% in the first quarter of the year (0.07% in the same period of 2006), but decelerated in April and May, averaging 0.15%. This deceleration influenced similarly the behavior of two out of the three great IGP-DI components: the Consumer Price Index-Brazil (IPC-Br) reached 0.28%, down from 0.50%, while the Wholesale Price Index (IPA-DI) declined to -0.01%, down from 0.21%. On the other hand, the Civil Construction National Index, which averaged 0.31% in the first quarter of the year, averaged 0.81% in the two months ended in May, due to pressures stemming from raw material costs and wage adjustments. In the last twelve months through May, the IGP-DI reached 4.38%, up from -0.14% in the same period of 2006. In light of the 3.12% elevation of the IPC-Br in the last twelve months through May, the IGP-DI increase in the same period was, to a large extent, influenced by the IPA-DI and the INCC changes, which totaled 4.76% and 5.18%, respectively. The IPA-DI acceleration

was mainly driven by agricultural prices, which increased 9.13%, while industrial prices only increased 3.46%. 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. Despite recording some accommodation in April, industrial output continues to present robust growth trend. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output grew 0.6%, compared to the previous month, maintaining the growth pace observed in March, and registered the thirteenth consecutive expansion. Compared to the same month of last year, industrial output grew 6%, the highest rate observed since June 2005 under this comparison basis, reflecting the expansion in 20 out of the 27 activities surveyed. In the last twelve months, industrial output expanded by 3.3%, with 3.1% for manufacturing industry and 5.7% for mining. For May, the few leading and coincident indicators available for industrial production suggest the continuity of the ongoing expansion. The several incentive factors to economic activity, including the monetary easing already implemented, suggest that the expanding trend in industry shall continue in the upcoming months.

5. Disaggregated industrial data showed month-on-month seasonally adjusted expansion of 15.4% in capital goods production and 4.2% in the production of intermediate goods. Compared to the same month last year, capital goods production expanded by 17.4%, while intermediate goods production increased by 5.3%. According to the same comparison basis, durable goods production increased by 5.4%. The dynamics of capital goods production reflects the consolidation of positive prospects for domestic demand growth and the influence of favorable international prices in some sectors. In addition, the expansion of intermediate goods production in the first four months of the year suggests a more generalized acceleration in industrial activity.

6. In line with the usual seasonal pattern at the start of the year, the unemployment rate increased in the first months of 2007 to 10.1% in March and April up

from 8.4% in December 2006. However, in the year through April, the average unemployment rate stood 0.2 p.p. below that observed at the same period last year. The purchasing power of workers increased 5% according to the same comparison basis, a record high for the series. Real payrolls increased 8% in the year through April, compared to the same period last year, an important factor sustaining the growth of aggregate demand. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment increased month-on-month 0.4% in April and March, after totaling 0.2% in February, reaching a record high for the series started in 2003. In addition, manufacturing employment expanded by 3.1% in April, compared to the same month of last year. Regarding formal employment, data from the Ministry of Labor and Employment (MTE) confirms the continuity of expansion in April, with the creation of 302 thousand new jobs (0.5% growth on a month-on-month seasonally adjusted basis) and 1,361 thousand jobs in the last twelve months. As a consequence, in the year through April, as well as on a twelve-month trailing basis, formal job creation grew 4.8%, with highlights for civil construction (7.5%) and mining (4.8%).

7. Retail sales increased 1.1% month-on-month in March, after expansions of 0.4% in February and 2% in January, according to data seasonally adjusted by the IBGE. With this result, retail sales expanded 2.8% in the first quarter, quarter-on-quarter. Compared to the same quarter of 2006, retail sales expansion reached 9.7% in the first quarter of the year, outpacing the 7.0% expansion recorded in the last quarter of 2006. For this robust performance of retail sales, which indicates strong growth of domestic demand, contributed both items more sensitive to payroll expansion, such as “other items of personal and domestic use” (21.8% expansion, according to this comparison basis) and those that are usually more sensitive to credit conditions, such as furniture and domestic appliances (20.5% expansion in the period). Expanded retail sales, which include the sales of civil construction material and vehicles, motorcycles, parts and pieces, increased 13.2% in March, compared to the same month of 2006, the ninth consecutive month that expanded retail sales exceeded retail sales. For the rest of the year, it is expected the continuity

of retail sales expansion, boosted by the increase in employment and income, credit expansion, the monetary easing process and by the recovery of consumer confidence.

8. Installed capacity utilization in the manufacturing industry averaged 81.0% in the year through April, up from 79.1% in the same period of 2006, according to CNI data without seasonal adjustment. The installed capacity utilization rate, according to CNI data seasonally adjusted by the BCB, stood at 81.8% in April, 3.1 p.p. above that observed in the same month of 2006, and 0.5 p.p. below the record high for the series observed in July 2004. According to CNI data seasonally adjusted by the CNI, installed capacity utilization reached 82.6% in April, a new record high for the series. Disaggregated indicators calculated by CNI indicated that 15 out of 19 sectors exceeded the average installed capacity utilization, compared to eleven sectors at the same month of last year. This dynamics reflects the intensification of economic activity, although recent data relative to production and absorption of capital goods indicate that investment expansion remains robust. In the year through April, the absorption of capital goods robustly increased 20.1%, compared to the same period of 2006. This result reflects the increase in capital goods imports (32% in volume), as well as capital goods production (15.4%). The production of inputs for civil construction increased 3.5%. In light of the recent installed capacity utilization rates, the continuity of investment expansion will be essential to avoid relevant imbalances between 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. The trade balance continues to present robust performance, confirming the evaluations based upon Inflation Reports and previous Copom Minutes that depict important structural changes in the Brazilian foreign trade. After reaching in 2006 a US\$46.1 billion record high, a 3.2% increase over the 2005 result, the trade balance continuous to register vigorous surpluses that encourage analysts to review positively their forecasts. In the year through May, the trade surplus reached US\$16.9 billion, a

9.3% increase relative to May 2006. Exports rose 21.2%, to US\$60.1 billion, while imports increased 26.7% to US\$43.2 billion. As observed in previous Copom Minutes, imports have been growing more rapidly than exports at the margin, due not only to higher level of economic activity, but also to the strengthening of the BRL, which points to a healthy adjustment process of the trade balance.

10. With regard to the international scenario, uncertainties surrounding the monetary policy stance in the US persist. Signals that inflation could be running above the FOMC comfort zone indicate that expectancies of an easing cycle starting this year may have been premature. Moreover, additional interest rate increases in the US cannot be discarded. Similarly, the possibility of stronger-than-expected economic deceleration and its potential effects over the other worldwide economies cannot be ignored. On the other hand, the strengthening of economic activity in Europe and the continuity of the robust expansion of the major countries in Asia have so far compensated for the moderate economic deceleration in the US. The maintenance of growth rates at historically high levels has caused higher inflationary pressures especially over raw materials and food prices. In this context of robust global growth, the economy and prices of Brazilian assets have shown both remarkable resilience to the fluctuations in international financial markets, thanks to the improvement in economic fundamentals in the recent years, and to a very benign behavior of export prices. In this sense, in addition to showing more resilience to changes in international markets sentiment, the Brazilian economy trails a growth cycle with price stability. Considering all this factors, the Copom continues to consider that the international scenario is favorable.

11. Oil prices, another external source of uncertainty, rose since the last Copom meeting and still present volatility. The recent levels of international prices of this commodity seem to be reflecting both structural shifts in global demand for energy and recurrent episodes of geopolitical tensions. Despite significant risks inherent to forecasts on future oil prices trajectory, the main scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2007, continues plausible.

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

b) The projection for electricity and fixed telephone price adjustments in 2007 were modified relative to the April forecasts. The new projections for electricity and fixed telephone are -0.9% and 3.3% respectively;

c) The projection for regulated prices inflation in 2007 decreased to 3.6% from 4.2% (projection of the April Copom meeting). These items, according to the weights released by the IBGE, represent 30.99% of the total May IPCA;

d) The projection for regulated prices inflation in 2008 was also changed, to 4.8%. 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, estimates a 6 bps in the fourth quarter of 2007, reaching 70 bps in the last quarter of 2008.

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 PPI (Investment Pilot Program). The related assumptions considered in the previous meeting were maintained.

14. Since the April Copom meeting, median IPCA inflation expectations for 2007, compiled by the BCB's Investor Relations Group (Gerin), decreased to 3.5% from 3.8%. This reduction was mainly driven by a decrease of inflation expectations for the third

quarter of 2007. The twelve-month ahead inflation expectations decreased to 3.37% down from 3.64%. For 2008, inflation expectations remained at 4%. As mentioned in previous Minutes, these developments suggest the consolidation of a more favorable long-term macroeconomic scenario.

15. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the Selic rate at 12.5% and the exchange rate at R\$1.95/US\$ during the forecast period – the projection for the 2007 IPCA reduced compared to the values considered at the April 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 April Copom meeting and below the central target for the year. The projection for 2008, based on the benchmark scenario, stayed relatively stable in relation to the April projection, remaining below the 4.5% target. Under the market scenario, the projection still remains above 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 point to strengthened demand expansion, but 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 uncertainties regarding the continuity of the strong growth recently observed in the international economy, the prospects of lower liquidity in important international markets, and the volatility increase in the global markets, the external outlook remains favorable. Particularly regarding Brazilian external financing, the combination of significant trade surpluses and increasing capital inflows suggests that the balance of payments will

continue to perform robustly. Therefore, the prospects for the inflation trajectory remain benign. 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 the more benign behavior of inflation in the recent months, in contrast with relatively high monthly rates that had persisted since the end of 2006, confirms the convergence of inflation trajectory to the targets path. The emergency of global inflationary pressures still does not present risks for the domestic inflation trajectory in the short run, but a heated demand could increase the pass-through of wholesale prices pressures to consumer prices. 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 in the upcoming months, 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 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 725 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, 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.

20. 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 the next quarters of the 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, and the fact that the monetary policy decisions should have limited effects in 2007 and predominant impacts in 2008.

21. 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 cautious monetary easing stance.

22. The Copom evaluated that, since the last meeting, influences of internal and external factors on the balance of risks for the expected inflation trajectory exacerbated, and in opposite directions. External sector, acting importantly to widen aggregate supply, continues to influence inflation prospects in a predominantly benign way. On the other hand, expansion of domestic demand may increase the risks to inflation dynamics on the medium-run.

23. Some participants of the Committee understood that, considering the extension of the easing process already implemented, the remaining uncertainties regarding the lagged impacts of the monetary easing, the expected behavior of the other sustaining factors of

the expenditure, such as income growth, in a scenario of solid expansion of domestic demand for tradable and non-tradable goods and services, and of economic activity strengthening, the maintenance of the 25 b.p. reduction pace in the Selic target rate would contribute to extend the easing process over time.

24. However, the majority of the Committee argued that the contribution of the external sector for the consolidation of a benign outlook for inflation could be higher than previously expected, especially by controlling the prices of tradable goods and by increasing investments in a heated demand environment. Such contribution is favoring the equilibrium between aggregate demand and domestic supply growth rates at a pace in line with monetary policy decisions, without compromising the convergence for the inflation targets trajectory. Therefore, five members of the Committee understood that the risk balance to the evolution of future inflation would justify a 50 b.p. reduction in the Selic target rate.

25. Given the reasons stated above, the Copom decided to continue the monetary easing cycle and reduced the Selic target rate to 12.00% p.a., without bias. Five votes were for the Copom monetary policy action, while two votes were in favor of reducing the Selic target by 25 basis points.

26. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing alternative scenarios for the main variables that determine price dynamics and the balance of risks associated to the forecasts. Despite the remaining uncertainties regarding the US economy, the international scenario remains favorable, and benefits the external sector contribution for the maintenance of a benign inflationary outlook. On the other hand, a set of price pressures arises when domestic demand expands vigorously, backing-up the economic activity recovery. This expansion encompasses some sectors little exposed to external competition, when the effects of important incentive factors, such as the monetary easing already implemented, are not fully perceived. In such environment, the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons.

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

Summary of Data Analyzed by the Copom

Inflation

28. The IPCA increased 0.28% in May, up from 0.25% in April, accumulating 3.18% growth in twelve months. In the year through May, the index increased 1.79%, above the 1.75% rise recorded in the same period of 2006. This rise in May reflected distinct behavior among the large groups. The main increases were for food and beverages, especially *in natura* milk; personal outlays, especially household workers; and clothing, as a result of seasonal pressures. In an opposite side, the lowest rates were for communication, housing, and transportation, due to the cooling of oil prices rises.

29. Market prices inflation increased 0.25% in May, up from 0.19% in April, while regulated prices decreased totaled 0.35%, down from 0.39%, in the same period. In the last twelve months, market prices increased 3.32%, and regulated prices, 2.88%. Among market prices, the prices of non-tradable goods increased by 4.42%, mainly because of the 4.88% elevation in services prices, while the prices of tradable goods prices increased by 2.14%.

30. On a twelve-month trailing basis, smoothed trimmed means core measure maintained a downward trend, while the core excluding household food and regulated prices and the non-smoothed trimmed means core recorded rises. Even recording rises under these two criteria, the cores changes stood below the target for the IPCA. The smoothed trimmed means core increased 0.30% in the month, up from 0.29% in April, totaling 3.68% in the twelve months through May, down from 3.85% in April. The non-smoothed trimmed means core reached 0.30% in May, up from 0.28% in April, accumulating 2.39% in twelve months, compared to 2.33% in April. Finally, the core excluding

household food and regulated prices reached 0.33% in May, up from 0.29% in the previous month, and accumulated 3.04% in twelve months, compared to 2.66% in the previous month.

31. The IGP-DI increased to 0.16% in May, up from 0.14% in April, accumulating 1.18% in the year through May and 4.38% in twelve months. Considering the main components of the index, the rate increase was, exclusively, a result of the INCC elevation, which reached 1.15% in the month, up from 0.46% in the previous month. The INCC result was mainly driven by the 1.81% increase in the cost of the workforce, due to wage readjustments in Brasília, Fortaleza, Florianópolis, Goiânia and São Paulo. The IPC-Br increased 0.25% in May, down from 0.31% in April, while the IPA-DI (Wholesale Prices Index) totaled -0.04% in May, down from 0.02% in the previous month.

32. The lower IPA inflation in May reflected the continuous reduction of agricultural prices, despite at a lower pace, and the cooling of industrial prices. The Agricultural IPA totaled -1.94% in May, compared to -2.44% in April, while the Industrial IPA recorded 0.58% and 0.84% for the same period. The main negative drivers were legumes and fruit, sugar cane, poultry and eggs, among agricultural prices, and moisturized ethylic alcohol and sugar, among industrial prices. The main pressures in May stemmed from the prices of *in natura* milk, fuel oil, non-ferrous metals, iron, steel and steel by-products and fertilizers. The IPA-DI increased 0.61% and 4.76%, in the year through May and in twelve months, respectively. According to the processing stages of production, the prices of final goods declined 0.15%, after a 0.85% elevation in April, mainly mirroring the deceleration of fuel prices, which totaled -1.10% in May, compared to 2.76% in April. The prices of intermediate goods increased 1.01% in May, up from 0.96% in April, with highlights to the prices of manufacturing materials and components. The prices of raw materials recorded -1.89% in May, compared to -2.78% in the previous month.

Economic Activity

33. According to IBGE's monthly survey, retail sales increased 1.1% in March, on a month-on-month

seasonally adjusted basis. Among the activities composing the general index, only fuel and lubricants sales decreased (0.1% growth). The remaining segments expanded, with highlights to fabric, clothing and shoes (2.7% growth), and hyper- and super-markets, food products, beverages and tobacco (1.2% growth). Vehicles, motorcycles, parts and pieces, which do not compose the general retail sales index, increased 4.4% in the month. On a regional basis, 18 out of the 27 Brazilian states showed positive results in March, compared to February, seasonally adjusted, while all the units recorded rises in comparison to March 2006, with highlights to the increases recorded in the South and Mid-West, mirroring the effects of the income recovery in the agricultural sector.

34. Compared to March 2006, retail sales grew 11.5%, driven by the increases in all segments, mainly furniture and domestic appliances (18.1%) and hypermarkets (9.3%). Expanded retail sales increased 13.2%, highlighting the sales of vehicles, motorcycles, parts and pieces (18.5%).

35. Retail sales performance reflects the continuity of payroll growth and better credit conditions, together with the recovery of the crop and livestock sector. Retail sales increase reached 9.7% in the first quarter of 2007; expanded retail sales, which include civil construction inputs and vehicles, motorcycles, parts and pieces, increased by 11.8%, under the same comparison basis. It bears emphasizing the performance of furniture and domestic appliances (20.5%) and vehicles (17.4%).

36. São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, showed a 0.8% increase in database consultations for credit sales, and a 0.7% reduction in consultations to the Usecheque system in May, on a month-on-month basis. In comparison to May 2006, there were increases of 5.6% and 6.1%, respectively.

37. Regarding investment indicators, civil construction inputs production expanded month-on-month 1.3% in April, while capital goods domestic production fell 1.2%, seasonally adjusted. Capital goods contraction should not be interpreted as a trend

change, in view of the 15.4% and 8.5% expansions registered in the first four months of 2007 and in the last twelve months, respectively. In the first four months of the year, capital goods production for mixed use increased by 17.0%; typically manufactured capital goods expanded by 17.7%, while capital goods production for energy and for civil construction grew 14.4% and 10.7%, respectively. Production of capital goods for agriculture expanded by 19.1% in the same period, while the negative twelve-month trailing production reduced to -4.3% in April, compared to -8.9% in March, confirming the upturn of the trend at the margin.

38. BNDES funding for medium- and long-term investment totaled R\$14.9 billion in the first four months of 2007, 39.8% above the amount disbursed in the same period of 2006. The recent acceleration of this indicator is also evident in the 21.9% expansion observed in the twelve months through April.

39. Industrial production declined 0.1% in April, according to IBGE's Monthly Industrial Survey (PIM) seasonally adjusted data. On a 3-month moving average basis, which attenuates punctual oscillations, industrial activity reached a record high for the thirteenth consecutive month, in April. Moreover, industrial production rose by 6.0%, compared to April 2006, and expanded by 4.3% and 3.3%, in the first four months of 2007 and in the last twelve months, respectively.

40. Considering seasonally adjusted data, mining production expanded by 0.3%, while manufacturing industry production remained stable. Regarding use categories, production of capital goods, intermediate goods and durable consumer goods reduced by 1.2%, 0.6% and 1.3%, respectively, while semi and non-durable goods production increased by 0.8%. Despite the reduction in April, capital goods production expanded by 15.4% in the year through April.

41. Disaggregated data of seasonally adjusted industrial activity showed that 12 of the 23 sectors surveyed grew in April, with highlights to beverages (4.3%) and other chemical products (2.3%). The main negative drivers were food (-1.9%), perfumes, soaps and cleaning products (-5.7%) and electronic materials and communication equipment (-3.4%).

42. Still considering the industrial activity, according to CNI data, seasonally adjusted by the BCB, hours worked in production expanded by 1.0% and real industrial sales declined 1.2% in April, month-on-month. In the year through April, these indicators increased by 3.6% and 4.8%, respectively, compared to the same period of 2006. After seasonal adjustment, installed capacity utilization stood at 81.9% in April, almost unchanged compared to the previous month (82.0%). Considering observed data, utilization level reached 81.7%, 3.2 p.p. above the April 2006 figure.

43. According to Anfavea, vehicles production reached 258.9 thousand units in May, a monthly record high, a 7.2% increase relative to the same month of 2006. According to data seasonally adjusted by the BCB, vehicles production expanded by 3.0%, after a 1.7% reduction in April, on a month-on-month basis. Sales of overall automotive industry increased 13.3%, relative to May 2006, totaling 263.8 thousand units, a monthly record high. As exports reduced by 7.6%, such performance was exclusively due to the domestic absorption, which increased 23.8% (also a record high for the series). Considering the month-on-month seasonally adjusted series, domestic sales increased by 4.7%, while exports expanded by 7.1%.

44. According to the IBGE, the current estimate for the crops harvest in the 2006-7 period pointed to a 13.0% increase, compared to the previous harvest. National production of grains should reach 132.3 million tons, due to good weather conditions and the production incentive driven by the increase of international agricultural commodities prices. In April's survey, the main forecast increases related to wheat (52.3%), cottonseed (30.1%), corn (20.6%), bean (10.2%) and soy (9.2%), while the main decreases related to coffee and rice production (15.3% and 4.1%, respectively). It still bears emphasizing the increase in land occupation for sugar cane production, driven by the growing interest in ethanol production. Sugar cane plantations increased by 8.9% in 2007, and the production should expand by 12.7%, year-on-year.

Surveys and Expectations

45. The Fecomercio-SP survey showed declines of 1% in the Consumer Confidence Index (ICC) in May, month-on-month, and 8.4%, compared to May

2006. The Current Economic Conditions Index (Icea) increased month-on-month 0.7% in May, while the Consumer Expectation Index (IEC) declined by 2.3%. In fact, the Icea remained above the IEC for the fifth consecutive month.

46. According to the FGV survey, which encompasses two thousand homes in the seven main state capitals of the country, the ICC increased 2.6% month-on-month in May. This result is due to the improvement in both the assessment of the present situation and in the 6-month ahead expectations. Compared to May 2006, the ICC rose 7.3%, mainly because of the 8.9% increase in the IEC.

47. Still according to FGV, the Industry Confidence Index (ICI), which encompasses six items of the Manufacturing Industry Survey, declined 1.8% month-on-month in May, after the record high observed in April. The ICI rose 15.9% relative to May 2006, totaling an 8.1% expansion in the first four months of 2007, compared to the same period of 2006. This result is due to the positive assessments about the expected level of demand and the predictions of higher hiring in industry. The level of installed capacity utilization reached 84.8% in May, up from 82.7% in May 2006.

48. According to the Manufacturing Industry Survey, carried out by FGV in April 34% of the companies surveyed affirmed that their investment in fixed capital is higher in the first half of 2007 than that observed in the previous half, while 21% affirmed that their investment is lower. The prediction of higher investment in the second half of 2007 also reached 34% of the companies, while 14% of the companies intend to invest less. The main reasons to invest in fixed capital quoted by the firms were: the expansion of production capacity (47%), and the increase in production efficiency (31%). The high tax burden was the main factor for inhibiting investments in fixed assets, totaling 49% of the answers, 4 p.p. above the proportion registered last year. The cost of credit was quoted by 18% of the companies, the lower relative frequency of the historical series started in 1998.

Labor Market

49. According to the Ministry of Labor and Employment, 302 thousand new formal jobs were

created in April, a record high for the month, since the beginning of the series in 1985. In the first four months of the year, 701.6 thousand new jobs were created, 23.2% above the figure observed in the same period of 2006, driving employment expansion by 4.8%. In the last twelve months, expansion also reached 4.8%, with highlights to the 8.0% increase in civil construction employment and 5.7% in commerce employment. After seasonal adjustment, employment increased month-on-month 0.5% in April, with increases in all sectors.

50. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate stayed unchanged at 10.1% in April 2007. The unemployment rate stability reflects mainly the 0.33% and 0.34% decreases in employed population and economically active population (PEA), respectively. The reduction of 68 thousand employed workers was due to reductions of 2.4% in the number of informal workers and 3.0% in the number of civil and military servants and increase of 0.7% in the number of workers in the private sector. In the first four months of 2007, the average number of workers increased by 2.9%, relative to the same period of 2006, reflecting an expansion of investments and recovery of the agricultural sector. Among the workers in the private sector, the number of formal workers increased by 4.1%, while the number of informal workers remained stable, highlighting a qualitative improvement in the labor market.

51. According to the same survey, real average earnings reached R\$1,114.00 in April, a 0.3% month-on-month increase and a 5% elevation compared to April 2006. Real payrolls decreased 0.1% month-on-month in April, reflecting the reduction in the number of formal workers, but maintained a yearly rising trend, with an 8.4% increase in April, compared to the same month last year, and 8.0% in 2007.

External Environment

52. The global economic environment remains favorable and with controlled risks. Recent data shows steady consumption in the US and slight acceleration of GDP growth in Europe and Asia. Despite the lower expansion (17% in 2006, compared to 34% in 2005),

net private capital inflows for emerging markets reached a US\$647 billion record high.

53. In the US, the revised GDP growth rate in the first quarter decreased to 0.6% from 1.3%, the lowest rate since the 0.2% rate reached in the last quarter of 2002. However, important aggregate demand components remain robust, and can sustain larger expansion throughout the year. The consumption expansion, whose weight in total demand exceeds 2/3, increases to 4.4%, up from 3.8%. Combined with a reduction in inventories, this acceleration makes room to an increase in production. In the housing sector, the sales of new real state properties increased month-on-month 16.2% in April, smoothing the depressing effects over the economy. These data confirm the Federal Reserve Bank (Fed) perception of moderate acceleration of growth in the next quarters.

54. The confidence indices that measure consumers' sentiment point to the same direction: the *Conference Board* rose to 108.0 in May, up from 106.3 in April, and the one from the Michigan University rose to 88.7, up from 87.1. The confidence index of the manufacturing industry increased to 54.7 in April, up from 50.9 in March, and reached the highest level of the last months. Month-on-month industrial production rose 0.7% in April, above market expectations, and the installed capacity utilization increased to 81.6%, up from 81.2%. The recent behavior of inflation reduces the expectations of inflation pressures. The consumer price index (CPI) increased 2.6% in the last twelve months through April, and its core, 2.3%, at a lower pace than the observed in the previous month. The producer price index (PPI) increased 0.7% and its core remained unchanged.

55. In the Euro zone, first quarter GDP grew 3.1%, relative to the same quarter of 2006, above market expectations. The German GDP also increased above expectations, 3.6% in the year and 0.5% in the quarter. The consumer confidence index reached 119.9 in May, up from 111 in April, the highest level observed since January 2001. However, twelve-month trailing inflation through May remained stable at 1.9%, in line with the European Central Bank (ECB) target. In Japan, despite below the 2.7% market expectations, GDP grew by 2.4% p.a. in the first quarter, confirming the maintenance of the growth pace.

56. In China, economy has continued to record robust expansion. Industrial production grew 17.4% in April, relative to April 2006, accumulating an 18% increase in 2007. Trade surplus reached US\$16.9 billion in April, a 144% increase over March, totaling US\$63.3 billion in the first four months of 2007, an 88% increase over the same period of 2006. The strong pace of activity has reflected in inflation. The Consumer Price Index increased 3% in the twelve months through April, while the Wholesale Price Index reached 2.9%, under the same comparison basis, up from 2.7% in March.

57. The Bank of England (BoE) raised its interest rate by 0.25 b.p., to 5.5% p.a., as a consequence of inflationary pressures, mainly stemming from services prices. The Consumer Price Index increased by 3.1% in the twelve months through March, exceeding the upper limit of the inflation target. However, with the 0.3% increase in April, the Consumer Price Index decreased to 2.8% in the twelve months through April. The Wholesale Price Index increased month-on-month 0.5% in April, down from 0.6% in March. On a twelve-month trailing basis, the index totaled 2.5% in April, down from 2.7% in March.

58. At the end of May, the Chinese government tripled a stamp tax on securities transactions to 0.3%, to cool the growth in the stock markets. As a consequence, the Shanghai composite share index fell by 6.5%, but spillovers for other international stock markets were limited. On May 31, the main European share index (FTEurofirst 300) reached a record high for the last six and a half years, boosted by mining and oil companies. Strong swings prevailed in FX markets, with devaluation of the US dollar.

Foreign Trade and International Reserves

59. In the first five months of 2007, Brazilian foreign trade continued to expand. Trade surplus reached US\$16.8 billion in the period, and US\$47.9 billion in the twelve months through May, while total external trade totaled US\$103.3 billion and US\$248.8 billion, according to the same comparison bases.

60. Exports reached US\$13.6 billion in May, a record high for the month, with a daily average of US\$620.4 million, a 32.4% increase over May

2006. Manufactured goods external sales reached US\$7.1 billion in the month, a 21.9% increase over May 2006, considering daily averages. Primary products exports totaled US\$4.4 billion, and semi-manufactured ones, US\$1.9 billion, with respective increases of 49.6% and 46.9%, according to the same comparison basis. In addition to shipment records, international prices of important export products continued to increase, with highlights to orange juice (80.4%); raw soybean oil (34.6%); poultry (34.1%); metal laminates (32.7%) and iron/steel semi-manufactured (31.9%). In the first five months 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.

61. Imports totaled US\$9.8 billion in May, a record high for the month, a 34.2% increase over May 2006. All categories expanded: raw materials (38.6%); consumer goods (33.5%); capital goods (28.8%); and fuels and lubricants (28.5%), according to the same comparison basis. Among imports of raw materials, it bears emphasizing imports of food, transportation equipment parts, mining products, non-food farming, chemicals and pharmaceutical products. Among consumer goods imports, it bears emphasizing the imports of clothes, beverages and tobacco, vehicles, furniture, beauty products and pharmaceutical products. Amongst capital goods imports, one should highlight imports of industrial machinery, machines and equipment for office and scientific service, and parts and pieces for capital goods.

Money Market and Open Market Operations

62. After the April Copom meeting, the yield curve shifted downward, mainly driven by Brazilian positive economic indicators and by the revised Brazil's sovereign ratings by two rating agencies. In light of an also favorable external environment, reflected in the persistent highs of the international stock markets, the positive FX flow allowed the appreciation of the real against the US dollar, contributing to a downward movement of domestic interest rates, mainly for the short term. In the last week of May, evaluations that Chinese stock markets were overheated led to profit realization in international stock markets, affecting the domestic

interest rate market. Between April 16 and June 4, one-, two- and three-year rates reduced by 0.73 p.p., 0.90 p.p. and 0.95 p.p., respectively. One-, three- and six-month rates also declined 0.37 p.p., 0.44 p.p. and 0.60 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 fell to 7.31%, on June 4, down from 7.79%, on April 16.

63. Between April 17 and June 4, the BCB conducted 11 reverse exchange rate swap auctions, totaling US\$11 billion.

64. In its open market operations, the BCB carried out, from April 17 to June 4, weekly five- and seven-month long fixed rate repo operations. The average daily balance of these operations amounted R\$73.1 billion. The BCB conducted 28 overnight repo operations, of which 25 aimed at draining the excess liquidity from the market. In addition, in one repo operation aimed at draining the excess liquidity, the tenure totaled 32 working days. 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\$14.6 billion, borrowing.

65. Between April 17 and June 4, the National Treasury raised a total of R\$76.9 billion, of which R\$37.2 billion in fixed-rate securities: R\$18.1 billion via issuance of LTNs maturing in 2008 and 2009 and R\$19.2 billion in NTN-Fs maturing in 2010, 2012 and 2017. Issuance of LFTs totaled R\$13 billion, for securities maturing in 2010 and 2012. Issuance of inflation-linked NTN-Bs reached R\$26.7 billion, for securities maturing in 2009, 2011, 2012, 2015, 2017, 2024, 2035 and 2045, of which R\$13.1 billion were settled via delivery of other securities.

66. In the same period, the Treasury conducted auctions to sell LTNs maturing in April, July and October 2008 conjugated to the purchase of shorter-term LTNs, totaling R\$9.0 billion. The Treasury also conducted auctions to sell LFTs maturing in 2010 and 2012, totaling R\$4.5 billion, accepting as payment LFTs maturing in 2007. Moreover, the Treasury conducted auctions to buy LTNs maturing in July 2007, totaling R\$5.9 billion and NTN-Bs totaling US\$246 million.

Appendix

Banco Central do Brasil Management

Members of the Monetary Policy Committee (Copom)

Banco Central do Brasil Management

Board

Henrique de Campos Meirelles

Governor

Alexandre Antonio Tombini

Deputy Governor

Antonio Gustavo Matos do Vale

Deputy Governor

Mário Magalhães Carvalho Mesquita

Deputy Governor

Paulo Sérgio Cavalheiro

Deputy Governor

Paulo Vieira da Cunha

Deputy Governor

Rodrigo Telles da Rocha Azevedo

Deputy Governor

Members of the Monetary Policy Committee (Copom)

Voting members

Henrique de Campos Meirelles
Governor

Alexandre Antonio Tombini
Deputy Governor

Antonio Gustavo Matos do Vale
Deputy Governor

Mário Magalhães Carvalho Mesquita
Deputy Governor

Paulo Sérgio Cavalheiro
Deputy Governor

Paulo Vieira da Cunha
Deputy Governor

Rodrigo Telles da Rocha Azevedo
Deputy Governor

Non-voting members

Altamir Lopes
Head of the Department of Economics (Depec)

Carlos Hamilton Vasconcelos Araujo
Head of the Research Department (Depep)

Ivan Luis Gonçalves de Oliveira Lima
Head of the Department of Open Market Operations (Demab)

José Antonio Marciano
Head of the Department of Banking Operations and Payments System (Deban)

Márcio Barreira de Ayrosa Moreira
Head of the Department of International Reserve Operations (Depin)

Renato Jansson Rosek
Head of the Investor Relations Group (Gerin)

Acronyms

ACSP	São Paulo Trade Association
Aladi	Latin American Integration Association
Anatel	National Telecommunications Agency
Aneel	Brazilian Electricity Regulatory Agency
Anfavea	National Association of Automotive Vehicle Manufacturers
ANP	National Petroleum Agency
BDIA	Brazilian Direct Investments Abroad
BNDES	National Bank of Economic and Social Development
BoJ	Bank of Japan
Bovespa	São Paulo Stock Exchange
Caged	General File of Employed and Unemployed Persons
CEI	Integrated Economic Accounts
CMN	National Monetary Council
CNI	National Confederation of Industry
Cofins	Contribution to Social Security Financing
Copom	Monetary Policy Committee
Cosif	Accounting Plan of National Financial System Institutions
CSI	Current Situation Index
CSLL	Social Contribution on Net Profits
CVM	Securities and Exchange Commission
DAX	<i>Deutscher Aktienindex</i>
Depec	Department of Economics
DI	Interfinancial Deposit
ECB	European Central Bank
EI	Eligible Interest Bonds
EI	Expectations index
Embi+	Emerging Markets Bond Index Plus
Emgea	Asset Management Company
Eurostat	Statistical Office of the European Communities
FAT	Worker Support Fund
FDI	Foreign Direct Investment
Fecomercio SP	Trade Federation of the State of São Paulo
Fenabrave	National Federation of Automotive Vehicle Distribution
Fed	Federal Reserve System
FGV	Getulio Vargas Foundation
FIDC	Receivables-Backed Investment Funds
FMP-FGTS	Mutual Privatization Funds – FGTS
FMP-FGTS-CL	Mutual Privatization Funds – FGTS – Free Portfolio
FSTE	Financial Times Securities Exchange Index

Funcex	Foreign Trade Studies Center Foundation
GDP	Gross Domestic Product
Gerin	Executive Investor Relations Group
GFCF	Gross Fixed Capital Formation
IBGE	Brazilian Institute of Geography and Statistics
Ibovespa	São Paulo Stock Exchange Index
ICC	Consumer Confidence Index
Icea	Current Economic Conditions Index
ICMS	Tax on the Circulation of Merchandise and Services
IEA	International Energy Agency
IEA	Integrated Economic Account
IEC	Consumer Expectations Index
IGP-DI	General Price Index
IGP-M	General Price Index – Market
IIF	Institute of International Finance
IMF	International Monetary Fund
INC	National Confidence Index
INCC	National Cost of Construction Index
Inec	National Consumer Expectations Index
INPC	National Consumer Price Index
INSS	National Institute of Social Security
IPA-DI	Wholesale Price Index
IPCA	Extended National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPI	Industrialized Products Tax
ISM	Institute for Supply Management
Loas	Social Assistance Law
LSPA	Systematic Farm Production Survey
LTN	National Treasury Bills
MDIC	Ministry of Development, Industry and Foreign Trade
MPME	Micro, small and medium enterprises
MTE	Ministry of Labor and Employment
MYDFA	Multi-Year Deposit Facility Agreement
Nasdaq	National Association of Securities Dealers Automated Quotation
NCEA	National Classification of Economic Activities
NSNA	New System of National Accounts
NTN-F	National Treasury Notes – Series F
OECD	Organization for Economic Cooperation and Development
Opec	Organization of the Petroleum Exporting Countries
p.p.	Percentage points
PAC	Annual Trade Survey
PAC	Growth Incentive Program
PAF	Annual Financing Plan
PAIC	Annual Building Industry Survey
PAS	Annual Service Survey
PBC	People's Bank of China
PIA	Annual Industrial Survey
PIM-PF	Monthly Industrial Survey – Physical Production
PMC	Monthly Retail Trade Survey
PME	Monthly Employment Survey

PNAD	Household Sampling National Survey
POF	Consumer Expenditure Survey
PPI	Pilot Investment Project
PPP	Public-Private Partnerships
PSND	Public Sector Net Debt
RMV	Lifetime Monthly Income
RUT	Resources and Uses Tables
SCPC	Credit Protection Service Center
Secex	Foreign Trade Secretariat
Selic	Special System of Clearance and Custody
S&P 500	Standard and Poor's 500
Sifim	Indirectly Measured Financial Intermediation Services
SNA	System of National Accounts
SPC	Secretariat of Complementary Social Security
SRF	Federal Reserve Secretariat
SRF	Supplemental Reserve Facility
STN	National Treasury Secretariat
TCU	National Accounts Court
TJLP	Long-Term Interest Rate
UNCTAD	United Nations Conference on Trade and Development
VIX	Chicago Board Options Exchange Volatility Index
WPI	Wholesale Price Index