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BANCO CENTRAL
DO BRASIL

Inflation Report

2007

September 2007
Volume 9 – Number 3

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Inflation Report

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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.

Hiphen between years indicates the years covered, including the first and the last year.
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.

Occasional discrepancies between constituent figures and totals as well as percentage changes are due to rounding.

There are no references to sources in tables and graphs originated in the Banco Central do Brasil.

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Contents

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: Activity level; Prices; Credit, monetary and fiscal policies; International economy; Foreign sector and Prospects for inflation. 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

Driven by growing demand, particularly in terms of household consumption and gross fixed capital formation, the Brazilian economy continued expanding in the first half of 2007. Taken together, these factors provided the conditions required for raising production, which has been supplemented by growing imports which, in turn, have played an important role in mitigating imbalances between supply and demand. Brazilian industry displayed its best results since 2004 and the outlook is for continued expansion in the coming months, as demonstrated by business expectations and the dynamics of capital goods imports. It is important to highlight strong second-quarter growth as Gross Domestic Product (GDP) expanded 1.3% in the industrial sector. This rate was significantly higher than the 0.4% mark registered in the first quarter of the year. As a result, contradicting more pessimistic analyses regarding the dynamics of the Brazilian manufacturing sector, this sector has leaded the nation's economic growth process.

Recovery in investments has been an important factor in sustaining the current growth cycle. Moreover, it stands as proof of the reduction in the macroeconomic uncertainties that marked recent years and, to a great extent, reflects a monetary policy committed to price stability. It is important to stress that expectations that investments will continue expanding are supported by highly positive business expectations regarding continued economic growth, expanding farm income and improved credit conditions. In this context, the factors sustaining investment growth should be sufficient to avoid possible increases in financing costs generated by increased financial volatility. When one considers the recent behavior of capacity utilization, investment growth is seen as fundamental to avoiding an even larger gap in the coming quarters between aggregate supply and demand, which could increase the risk of an inflationary uptick.

As regards consumption, benign evolution of credit and labor markets, coupled with increased transfers, have guaranteed increased retail sales. Despite a marginal decline, overall real payroll registered sharp growth (6.8%) in the first eight months of the year, compared to the same period of 2006, clearly reinforcing the position that this is an important factor in sustaining growth in aggregate demand. Expectations for the coming months suggest that the pace of consumption will level off to a certain degree, due, on the one hand, to less accentuated growth in available income as a result of the evolution of food prices and, on the other, to possible repercussions of the international financial market crisis on consumer confidence and credit costs. However, these developments are not expected to dampen the dynamics of the internal demand, which should continue driving the economy forward.

The evolution of monetary aggregates and the growth trajectory of financial system credit operations clearly evince the ongoing growth of internal demand. More favorable credit market conditions have made it possible to meet growing demand for bank resources, particularly those utilized to finance household consumption. In this sense, one should highlight the strong growth registered in payroll-deducted loans, auto loans, leasing operations and credit cards. Parallel to this, business credit demand has also remained growing, even in a framework of consolidation of primary private security issuances on the capital market as an alternative source of long-term financing. In general, therefore, the credit market does not yet seem to have been impacted in any significant way by the share of non-performing loans nor by the increased volatility that has affected markets in recent months.

Fiscal policy implementation has ensured compliance with the targets defined for the year, as well as continued compliance in the coming years. Coupled with the benign macroeconomic scenario, particularly as regards product growth and monetary policy implementation, current fiscal policy guidelines clearly indicate continuation of the downward trajectory of the debt/GDP ratio. It should be stressed that, by the increase in the debt management flexibility, the current net debt profile shows that the turbulence of the external economic environment has been neutralized. Consequently, there has been no need to adopt more restrictive fiscal measures in moments of greater stress.

Despite increased uncertainties regarding the level of global economic activity, the nation’s external accounts remain solid. Driven by the continued dynamics of the export sector, trade balance surpluses have been significant and, for the third consecutive year, are expected to close at approximately US$40 billion. It is important to stress that this result will be achieved at a time in which imports are growing sharply as a result of strong expansion in aggregate demand. In their turn, successive current account surpluses, coupled with stable inflation and accelerated economic growth, have provided the conditions required for strong net capital inflows in the form of foreign direct investments, stock investments and fixed income securities negotiated in the country. The positive scenario is expected to continue through the coming year. However, despite the fact that the performance of the trade balance surplus came as a surprise to many analysts, it would now seem that the expected process of gradual lowering of these surpluses has begun. This process is driven as much by the price effect, based on changes in the real exchange rate, as by the income effect, as reflected in increased aggregate demand. Despite this, this movement points towards a natural and healthy adjustment of external accounts, shifting toward a situation of long-term equilibrium.

As one element of the reinforcing of the nation's external accounts, mention should be made of the ongoing policy of expanding international reserves, while reducing and improving the external debt profile. Reflecting these developments, the risk levels attributed to Brazilian sovereign bonds during the year dropped to their lowest levels in history, despite episodes of turbulence on international financial markets. This has further reinforced expectations that Brazil's sovereign debt will be given an investment grade rating by specialized agencies. Just recently, Moody's rating agency concluded the process of revising the credit risk rating of the country's sovereign debt in foreign currency from Ba2 to Ba1. With this, the country's risk classification is now just one level removed from investment grade according to the three largest rating agencies, Fitch, Moody's and Standard & Poor's.

Continued high levels of financial flows, particularly in the case of foreign direct investments, suggest that the higher volatility of international financial markets has not had any significant impact on the risk perceptions of international investors in relation to the Brazilian economy. In this sense, even though liquidity on international financial markets may not returned to the levels found prior to the crisis in the subprime segment of the United States real estate market, the distinguished good fundamentals of the Brazilian economy, compared to other emerging economies, should continue sustaining strong inflows of external capital.

The benign scenario for consumer prices which had become increasingly more evident since the middle of last year has cooled somewhat. To a great extent, these developments have not come as a surprise, as demonstrated in previous *Reports* and in the Minutes of Monetary Policy Committee (Copom) meetings, which forecast that cumulative 12-month inflation would accelerate in the third quarter of the year. Though this acceleration has been more intense than expected, inflation measured by the Broad National Consumer Price Index (IPCA) has continued evolving according to the target path. On the other hand, it is important to stress that, in moments like the present, prudence in monetary policy implementation becomes even more important, considering that deterioration of the inflationary balance of risks reduces the safety margin of monetary policy.

The central projection in the benchmark scenario indicates inflation of 4.0% in 2007, 0.5 p.p. above the projection found in the most recent *Report*, and lower than the value of 4.5% for the target defined by the National Monetary Council (CMN). In its turn, the 4.2% figure projected for cumulative 2008 inflation, according to the benchmark scenario, is also higher (0.1 p.p.) than that stated in the last *Report*. According to the benchmark scenario, therefore, the tendency of cumulative 12-month IPCA inflation to converge to the center value of the target has gained momentum since June when viewed over the projection horizon.

In the market scenario, projections for the last two quarters of 2007 are in general quite similar to those found in the benchmark scenario. Just as in the case of the benchmark scenario, cumulative 12 month projections indicate acceleration in the third quarter and deceleration in the final quarter, closing the year at 3.9%. The projection for cumulative four-quarter inflation shows upward movement throughout 2008, closing the final quarter at 4.3%.

A comparison of the values presented in this *Report* with those announced in the previous *Report* indicates, according to the benchmark scenario, inflation projections for 2007 and 2008, an increase of 0.5 p.p. and 0.1 p.p., respectively. Basically, this reflects the effects of the 75 b.p. reduction in the Selic rate since June 2007. In the market scenario, inflation projections for 2007 show an increase (0.4 p.p.), followed by a decline in 2008 (0.3 p.p.) due fundamentally to the reduction in expectations of nominal exchange rate depreciation over the projection horizon considered.

According to the benchmark scenario, GDP projections for 2007 remained stable at 4.7%, the figure found in the June *Report*.

1 Economic activity

Once again, the evolution of internal demand has confirmed the scenario of accelerated economic activity indicated in previous “Inflation Reports”. Driven by the 2006-2007 growth cycle, improved credit market conditions, particularly in the segments of vehicles, furniture and home appliances, retail sales have expanded sharply since the third quarter of last year. Investments have also increased sharply since the third quarter of 2006, surpassing both average growth of the economy and increased family consumption in all of the following quarters.

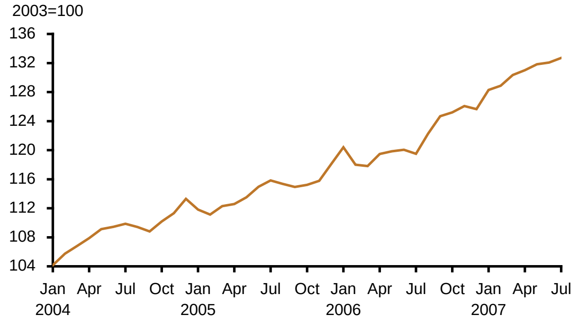
Expanded internal demand has created conditions propitious to an upturn in production and continued growth in imports. Brazilian industry turned in its best results since 2004 and is now immersed in the longest growth cycle since the early 1990s. When business expectations and the dynamics of capital goods imports are taken into consideration, forecasts point to continuation of this process through the coming months. Furthermore, it is important to stress the importance of growth in import operations as a factor of supply and demand equilibrium.

Reflecting the solidity of the underlying fundamentals of the Brazilian economy, this scenario of sustained growth is expected to persist into the coming months, despite the increased volatility of international markets caused by the recent subprime real estate mortgage crisis in the United States of America (USA). In this context, it is important to add that, through early September, the increased volatility of financial markets had not yet impacted business and consumer confidence indicators.

1.1 Retail sales

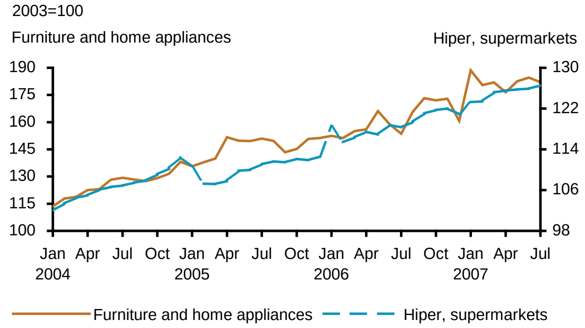
The pace of retail sales growth accelerated toward the end of the second and start of the third quarter of 2007. This performance was driven by segments that depend on credit

Figure 1.1 – Retail sales
Seasonally adjusted data



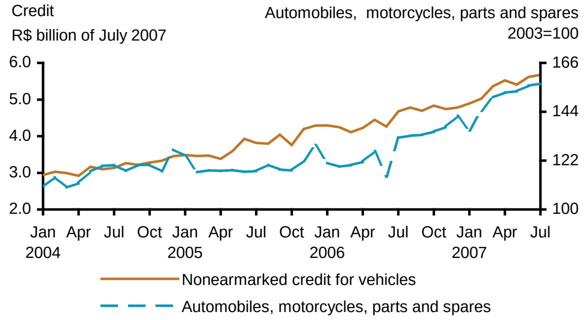
Source: IBGE

Figure 1.2 – Retail sales
Seasonally adjusted data



Source: IBGE

Figure 1.3 – Retail sales
Seasonally adjusted data



Sources: IBGE and Banco Central do Brasil

Table 1.1 – Retail sales
July 2007

	% accumulated growth in 2007		
	Nominal revenue	Volume	Price
Retail sector	10.7	9.7	0.9
Fuel and lubricants	2.0	5.4	-3.2
Hyper and supermarkets	10.9	6.6	4.0
Fabrics, apparel and footwear	14.4	10.1	3.9
Furniture and home appliances	12.4	16.7	-3.7
Expanded retail sector	13.8	13.6	0.2
Automobiles and motorcycles	20.3	22.9	-2.1
Building materials	13.2	9.5	3.4

Source: IBGE

market growth, as well as by the results generated in regions in which farm sector income plays a more important role. Marked by declining interest rates and longer payment terms, the benign credit market scenario, coupled with improved job market conditions, rising consumer expectations and expanded farm sector income were the major factors heralding continued growth in sales volume in the coming months.

According to the Monthly Retail Trade Survey (PMC), released by the Brazilian Institute of Geography and Statistics (IBGE), the seasonally adjusted volume of retail sales posted a high of 1.6% in the three-month period ended in July 2007, compared to the three-month period ended in April. With the exception of fuels and lubricants, which registered a 2.2% drop in sales, all of the various segments registered positive results when this basis of comparison is utilized. Particularly strong performances were registered under fabrics, apparel and footwear, 5.4%, and furniture and home appliances, 1.9%. Growth in sales of automobiles, motorcycles, parts and spares, a segment not included in the general index, closed the quarter at 4.1%.

Sales in the expanded retail sector, which includes the segments of building materials and automobiles, motorcycles, parts and spares, increased 14.8% in the three-month period ended in July 2007, compared to the same three-month period of the previous year. This result reflects strong sales growth in sectors in which performance is more dependent on credit conditions.

Sales of building material expanded 12.3% in the period. Confirming the expectations set out in the June 2007 Inflation Report, overall sales in this segment have expanded steadily since February and are expected to continue growing in the coming months. This expansion is a response to measures taken to stimulate the sector and to considerably more attractive long-term credit conditions.

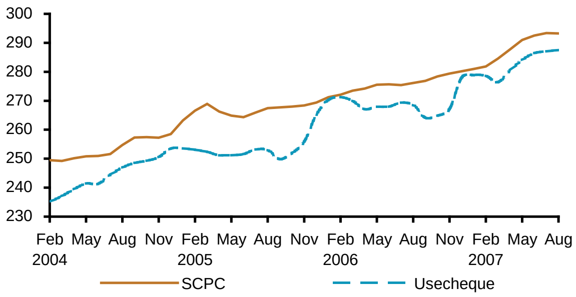
In the first seven months of 2007, retail trade sector sales expanded 9.7%, compared to the same period of 2006, in contrast to 5.2% in the corresponding period of the previous year. Analysis on a state-by-state basis shows across-the-board expansion throughout the country. Although growth in the northeast and northern regions was higher, reaching 29.2% in Alagoas; 15.9% in Maranhão; 13.9% in Acre; and 13.9% in Tocantins, the improved performance of cumulative 2007 sales was rooted basically in recovery in the southern and central-west regions, with expansion of 8% and 9.7%

Table 1.2 – Retail sales

				% change
	2007			
	Apr	May	Jun	Jul
In the month[1/]				
Retail sector	0.5	0.6	0.2	0.5
Fuel and lubricants	-1.4	-1.0	0.0	-0.5
Hyper and supermarkets	0.3	0.2	0.1	0.5
Fabrics, apparel and footwear	-2.5	7.6	-0.3	-3.4
Furniture and home appliances	-3.0	3.5	1.1	-1.4
Automobiles and motorcycles	1.4	0.4	1.6	0.6
3-month period/previous 3-month period[1/]				
Retail sector	2.7	2.7	1.9	1.6
Fuel and lubricants	2.3	0.1	-1.9	-2.2
Hyper and supermarkets	2.2	2.4	1.4	1.1
Fabrics, apparel and footwear	0.0	3.2	3.5	5.4
Furniture and home appliances	3.2	2.1	-1.3	1.9
Automobiles and motorcycles	7.9	8.2	7.2	4.1
In the year				
Retail sector	9.2	9.5	9.8	9.7
Fuel and lubricants	5.3	5.4	5.4	5.4
Hyper and supermarkets	6.4	6.8	7.0	6.6
Fabrics, apparel and footwear	6.1	8.6	10.0	10.1
Furniture and home appliances	18.5	16.5	16.4	16.7
Broad retail sector	12.6	12.9	13.6	13.6
Building materials	7.2	9.3	9.7	9.5
Automobiles and motorcycles	21.3	21.1	23.0	22.9

Source: IBGE
1/ Seasonally adjusted data.

Figure 1.4 – Retail sales indicators
Seasonally adjusted data – Quarterly moving average
1992=100



Source: ACSP

in the first seven months of the year, compared to just 0.6% and 2.1%, respectively, in the same period of 2006.

Compared to the same period of the previous year, nominal retail trade revenues expanded 10.7% in the first seven months of 2007. This growth was generated by 9.7% expansion in the volume of sales and 0.9% in prices. With the exception of fuels and lubricants, these results were well above the 3.2% inflation rate measured by the IPCA for the period. The segments that registered the most accentuated growth under Nominal Revenues were automobiles, motorcycles, parts and spares, with 20.3%; fabrics, apparel and footwear, 14.4%; and building materials, 13.2%.

The favorable retail sales scenario was also confirmed by other trade sector indicators. In this context, figures released by the National Federation of Automotive Vehicle Distribution (Fenabrave) showed that vehicle sales through factory authorized outlets expanded at a seasonally adjusted rate of 7.7% in the three-month period ended in August, compared to the three-month period through May. In the year through August, 1,237,504 automobiles were sold, corresponding to increases of 30.1% and 7.4%, respectively, compared to the previous year and the 1997 result, when the sector's sales set the historical record.

According to the São Paulo Trade Association (ACSP), consultations with the Credit Protection Service Center (SCPC) increased 0.8% in the three-month period ended in August, compared to the three-month period ended in May. This result reflected the performance of sales of goods with higher aggregate value and represented the 25th consecutive month of positive growth using this basis of comparison. The number of consultations with the SCPC increased 1.2% in the period, the fifth consecutive positive monthly result.

At the end of the second quarter of 2007 and early part of the third quarter, delinquency indicators were relatively stable compared to the corresponding periods of 2006. In the ACSP framework, defaults reached 5.8% in August, against 5.6% in the same period of the previous year. When the ratio between the number of checks returned due to insufficient backing and total checks cleared is considered, the respective rates came to 6% and 6.2%. The highest rates were registered in the north and northeast, precisely the regions in which retail sales expanded most sharply.

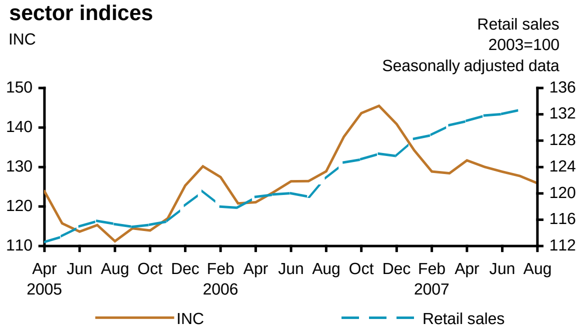
At the end of the second quarter and start of the third quarter of 2007, nationwide surveys aimed at evaluating consumer expectations indicated stability at a level higher than the

Table 1.3 – Default rates

	2007					%
	Apr	May	Jun	Jul	Aug	Year1/
Returned checks2/						
Brazil	6.4	6.6	6.2	6.1	6.0	6.4
Northern region	9.8	10.0	9.2	9.3	9.4	9.6
Northeast region	9.6	9.9	9.2	9.2	9.2	9.4
Southeast region	5.8	6.0	5.6	5.5	5.3	5.8
Central-west region	7.1	7.4	7.0	6.9	6.7	7.2
Southern region	5.9	6.2	5.7	5.6	5.6	6.0
SCPC (SP)3/	8.1	8.0	5.1	4.5	5.8	6.3

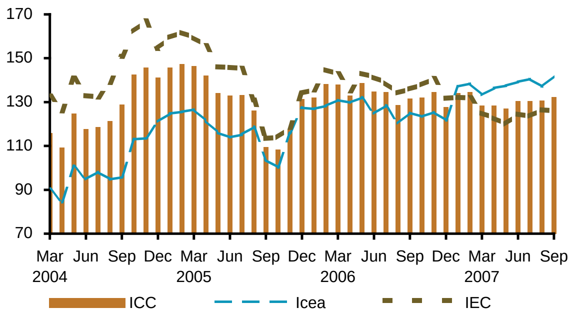
Sources: Banco Central do Brasil and ACSP
1/ Annual average.
2/ Returned checks/cleared checks.
3/ [New registrations (-) registrations cancelled]/[consultations (t-3)].

Figure 1.5 – National Consumer Confidence and retail sector indices



Sources: ACSP and IBGE

Figure 1.6 – Consumer Confidence Index



Source: Fecomercio SP

historical average, with continued short-term optimism at a level higher than under long-term expectations. The National Confidence Index (INC), elaborated for the ACSP by Ipsos Public Affairs (Ipsos), reached 125.9 points in August, compared to 128 points in July and 129 points in June. In the month of August, the INC registered strong recovery in the southern region, increasing 23.6% compared to July, while the other regions of the country posted declines. The Getulio Vargas Foundation's (FGV) Consumer Confidence Index (ICC) expanded 1.3% in August 2007, compared to the previous month, with highs of 1% in the component that evaluates the current situation and 0.8% in the component dealing with expectations for the coming months.

The quarterly National Consumer Expectations Index (Inec), elaborated by the National Confederation of Industry (CNI) on the basis of a survey carried out between June 28 and July 1, 2007, remained stable at a rather high level in the second quarter of the current year. All of the various components registered levels above the historical average for the period, particularly those that reflect future income expectations. These indicators demonstrate the benign labor and credit market scenarios.

The Consumer Confidence Index (ICC), released by the Trade Federation of the State of São Paulo (Fecomercio SP) and restricted to the metropolitan region of São Paulo, expanded 2% in the July-September period compared to the three-month period ended in June. The Consumer Expectations Index (IEC), which represents 60% of the general index, expanded 2.4% and the Index of Current Economic Conditions (Icea), 1.5%, reaching a record level in the historical series which dates back to June 1994.

1.2 Production

Crop/livestock output

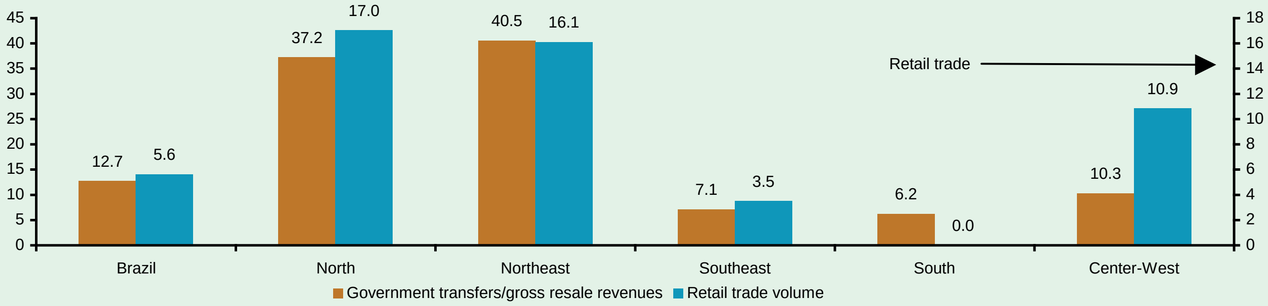
According to the Quarterly National Accounts, released by the IBGE, crop/livestock production expanded 0.2% in the second quarter of 2007, compared to the same period of the previous year, bringing cumulative expansion in the year to 1.4%. Here, it is important to stress that these results do not yet reflect either the positive performance of the 2006/2007 agricultural year, particularly as regards such crops as wheat and sugar cane which have harvest periods concentrated in the second half of the year, or the increased dynamics of the livestock sector. One should also add that growth in the supply of farm-based products

Retail Commerce – Effects of Transfers and Credit

The retail trade sector has posted more significant growth than other activity indicators. The positive results of this sector mainly reflect successive real gains in worker income, improved expectations driven by the environment of economic stability, increased government transfers and improved credit conditions. Based on an analysis broken down by geographic region and commercial segment, the objective of this box is to demonstrate the importance of government transfers and credit to the dynamics of the trade sector.

Analysis of the two major federal government transfers[1] (FGT), as a proportion of gross resale revenues[2] (GRR), indicates the existence of a positive correlation between this proportion and increased retail sales or, in other words, the higher the transfers/resale revenues ratio, the greater will be growth in retail trade activities.

Figure 1 – Government transfers as a proportion of the gross resale revenues and growth in the volume of retail trade in 2005



Sources: MDE and IBGE

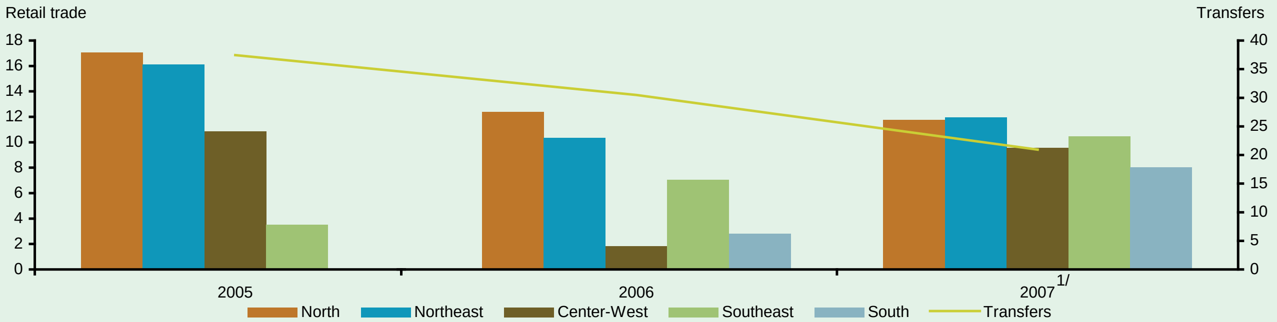
1/ Data available at the Ministry of Social Development for the following programs were utilized: "Benefício de Prestação Continuada" (ongoing assistance program) and "Bolsa Família" (family assistance program). Data are available in real, broken down by states for the years 2004, 2005, 2006 and 2007.

2/ Data on gross resale revenues of companies were utilized, as found in the most recent Annual Retail Survey (PAC), released by the IBGE for 2005.

This correlation can be seen in 2005, the most recent year for which information on gross revenues is available. In this context, Figure 1 shows that the overall volume of retail sales in the North and Northeast regions, which had the highest FGT/GRR, registered annual growth that was significantly greater than in the other geographic regions of the country.

Analysis of the evolution of retail sales in periods in which the FGT/GRR is not available can be carried out on the basis of correlations between the real growth figures for transfers and the volume of retail trade sales. Looking at monthly data since January 2004, real growth in transfers reached 37.5% in 2005, 30.5% in 2006 and 21% in the first six months of 2007, compared to the same period of the previous year, while the volume of retail sales increased 4.8%, 6.2% and 9.9%, respectively. Once again, sales in those regions in which transfers have greater weight are considerably more dynamic, registering growth for the same time periods equivalent to 17%, 12.4% and 11.8% in the North region and 16.1%, 10.4% and 12% in the Northeast region, in that order.

Figure 2 – Grouth in the volume of retail trade and governament transfers (%)



Sources: MDE and IBGE
1/ Cumulative data in the first half-year period.

For some states[3], a breakdown of the sales volume index by segments makes it possible to analyze sales in the segment of hypermarkets, supermarkets, food products, beverages and tobacco (VHS). Theoretically, these segments are more sensitive to increases in available income and government transfers. In this sense, the correlation indices

3/ The retail trade sector sales volume index is broken down into the segments of hypermarkets, supermarkets, food products, beverages and tobacco; fabrics, apparel and footwear; furniture and home appliances; pharmaceutical, medical, orthopedic, perfume and cosmetic articles; books, newspapers, magazines and stationary goods; office equipment and materials, computer and communications products and other personal and household articles. These figures are available for the states of Ceará, Pernambuco, Bahia, Minas Gerais, Espírito Santo, Rio de Janeiro, São Paulo, Santa Catarina, Rio Grande do Sul, Goiás and the Federal District.

between VHS and transfers for the period extending from January 2004 to June 2007 reached 0.98 in Pernambuco, 0.96 in Bahia and 0.92 in Ceará.

Taken together, these states absorbed 57% of total transfers to the Northeast region in the first half of 2007, registering strong growth in the volume of general retail trade sales, VHS and government transfers, compared to the first half of 2006, with respective levels of 13.9%, 10.2% and 33.9% in Pernambuco; 10.2%, 8.2% and 29.9% in Bahia; and 10.8%, 9.3% and 16.9% in Ceará.

Improved credit market conditions, as expressed in longer terms and lower interest within an environment of economic stability and strengthened expectations, have been a determining factor underlying the dynamics of the retail trade sector.

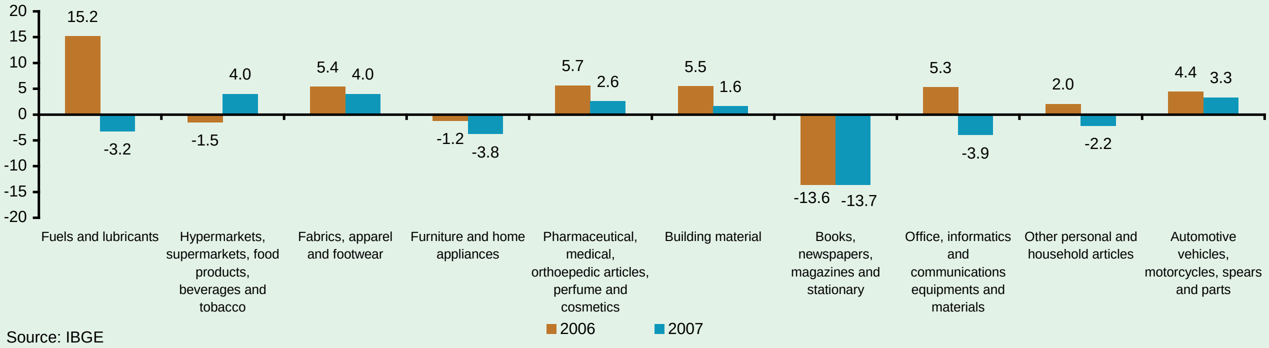
As a matter of fact, examination of Figure 3 reveals the dynamics of sales in segments that are more dependent on credit, when the first half of 2007 is compared to the same period of the previous year. This is particularly true in the segments of vehicles, motorcycles, parts and spares, with growth of 22.9%; furniture and home appliances, with 16.7%; and building materials, 9.5%; compared to the performance registered in the first seven months of 2006, when increases closed at 3.8%, 7.9% and 1% compared to the same period of 2005, respectively.

Figure 3 – Sales volume by retail trade segment
Cumulative January-July period (%)

Source: IBGE

It should be stressed that the performance of retail sales in the first seven months of 2007 also reflected sectoral growth in prices during that period. According to the terms of Figure 4, excluding the segment of hypermarkets, supermarkets, food products, beverages and tobacco, cumulative price growth in the period in those segments that have the greatest influence on retail trade sector results was below the cumulative January-July 2006 level, particularly in the cases of fuels and lubricants, other personal and household use articles and furniture and home appliances.

Figure 4 – Price growth by retail trade segment
Cumulative January-July period (%)



Source: IBGE

In short, the evolution of the retail trade sector bears a strong correlation with government transfers, mainly in the North and Northeast regions, consisting primarily of federal government assistance programs. In the same context, emphasis should be given to growth in sales in credit-dependent segments, in light of the ongoing improvement in credit market conditions and consolidation of positive consumer expectations.

puts to rest the hypothesis that higher food prices in the current year are a consequence of a supply shock.

Crops

Based on the Systematic Farm Production Survey (LSPA) carried out in August by the IBGE, the grain harvest is forecast to total 133.8 million tons in 2007. Forecast annual growth of 14.3% is based on a 14.7% increase in average productivity, since the area planted is expected to shrink 0.3%.

Soybean production is projected at 58.2 million tons, for annual growth of 11.2%, based on a decline of 6.4% in the area under cultivation and an 18.8% rise in average profitability. At the same time, output also benefited from highly positive climatic conditions during the period.

The corn harvest is estimated at 52.2 million tons. The 22.5% increase compared to the previous year was generated by 9.7% growth in the area under cultivation and 11.6% expansion in the average yield of this crop. This result reflects both favorable climatic conditions during the planting period, as well as the added incentive of higher international market prices, primarily as a result of production of corn-based ethanol in the United States.

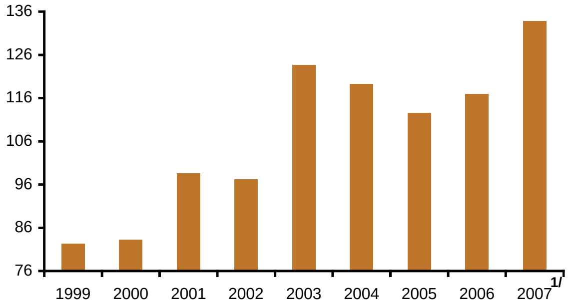
Bean production is expected to reach 3.4 million tons, approximately the same level as the previous harvest. The area under cultivation should diminish 2.3%, while average productivity will increase 0.7% in the year. The rice harvest is forecast at 11 million tons, 4% less than in 2006. This decline is consistent with the 2.5% drop projected for the area planted.

The cotton harvest is forecast at 2.4 million tons, 30.9% more than in 2006. This result is based on 22.8% growth in the area planted and 6.7% expansion in average productivity.

Wheat production is projected at 4 million tons, with annual growth of 61%. This result reflects both recovery of this crop, which had performed in a rather atypical manner in 2006, as well as the incentive provided by higher international prices generated by increased external demand for this commodity.

Figure 1.7 – Grain production

In million tons



Source: IBGE
1/ Estimate.

Table 1.4 – Farm production

In 1,000 tons

	Production		% change
	2006	2007 1/	2007/2006
Grain production	116 993	133 774	14.3
Cotton (seed)	1 816	2 378	30.9
Rice	11 505	11 043	-4.0
Beans	3 437	3 382	-1.6
Corn	42 632	52 205	22.5
Soybean	52 356	58 238	11.2
Wheat	2 482	3 997	61.0
Others	2 765	2 532	-8.4

Source: IBGE
1/ Estimate.

Livestock

According to the June 2007 Quarterly Survey of Animal Slaughters, released by the IBGE, beef production reached 1.8 million tons in the first quarter of the year, for growth of 13.5% compared to the same period of 2006. Using the same basis of comparison, production of poultry and swine totaled 2.1 million and 590 thousand tons, for a reduction of 0.3% and an increase of 11.3%, respectively.

Beef exports totaled 796.2 thousand tons in the first seven months of 2007, reflecting 22.2% growth compared to the same period of the preceding year. Exports of poultry and pork expanded 25.3% and 29% in the period, in that order, closing at 1.7 million and 297.5 thousand tons.

Table 1.5 – Livestock production

Total slaughters

% accumulated growth in the year

Itemization	2006			2007		
	Oct	Nov	Dec	Jan	Feb	Mar
Cattle	8.3	8.5	8.1	16.1	15.8	13.5
Swine	6.3	6.4	6.6	14.2	12.1	11.3
Poultry	4.6	4.1	3.4	1.6	0.1	-0.3

Source: IBGE

Industrial output

The pace of growth in industrial output intensified as of the second quarter of 2007, despite a short-lived downturn in the monthly indicator in July. Based on seasonally adjusted data, industrial output expanded 2.3% in the quarter ended in July, compared to the three-month period ended in April when growth came to 1.7%, using the same basis of comparison. In 2006, industrial output registered average quarterly growth of 0.8%.

The incentive provided by the reduction in medium and long-term credit costs and by accentuated growth in household consumption became even more evident in 2007. Viewed under the prism of seasonally adjusted figures, output of capital goods and consumer durables expanded 4.7% and 3.5%, respectively, in the three-month period ended in July, and 3.6% and 4.6% in the corresponding period through April, when viewed against the three-month periods ended in April and January, compared to 2006 quarterly averages of 1.9% and 1.2%.

The distribution of the physical output of the industrial sector among the activities surveyed by the Monthly Industrial Survey – Physical Production (PIM-PF) reveals greater dynamism in those segments that are more dependent on expanded internal demand. In this context, based on growth in the movable average of the 12-month period ended in July, compared to the corresponding period of 2006, production of office machinery and computer equipment increased 28.4%, followed by machines and equipment, together with furniture, with 13.2%; other transportation equipment, 9.6%; perfumes, soaps, detergents and cleaning products,

Table 1.6 – Industrial production

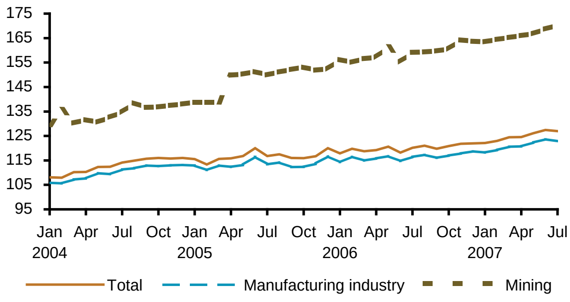
% change

	2007			
	Apr	May	Jun	Jul
Industry (total)				
In the month[1/]	0.1	1.3	1.1	-0.4
3-month period/previous 3-month period[1/]	1.7	2.2	2.3	2.3
Same month of the previous year	5.9	4.9	6.5	6.8
Accumulated in the year	4.3	4.4	4.8	5.1
Accumulated in 12 months	3.3	3.3	3.9	4.2
Manufacturing industry				
In the month[1/]	0.1	1.3	1.1	-0.7
3-month period/previous 3-month period[1/]	1.6	2.1	2.4	2.3
Same month of the previous year	6.0	4.9	6.4	6.8
Accumulated in the year	4.2	4.4	4.7	5.0
Accumulated in 12 months	3.1	3.1	3.7	4.0
Mining				
In the month[1/]	0.5	0.5	1.2	1.0
3-month period/previous 3-month period[1/]	0.8	1.3	1.7	2.0
Same month of the previous year	5.6	3.3	8.6	7.1
Accumulated in the year	5.6	5.1	5.7	5.9
Accumulated in 12 months	5.7	5.4	6.1	6.1

Source: IBGE

1/ Seasonally adjusted data.

Figure 1.8 – Industrial production
Seasonally adjusted data



Source: IBGE

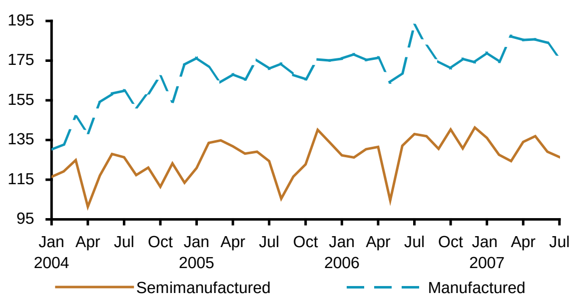
Table 1.7 – Industrial production by category of use

% change

	2007			
	Apr	May	Jun	Jul
In the month[1/]				
Industrial production	0.1	1.3	1.1	-0.4
Capital goods	-0.5	5.0	0.9	-1.3
Intermediate goods	-0.6	0.8	0.7	-0.2
Consumer goods	0.5	1.6	1.2	-0.9
Durables	-1.2	1.6	2.5	0.8
Semi and nondurables	1.0	1.1	2.8	-3.3
Quarter/previous quarter[1/]				
Industrial production	1.7	2.2	2.3	2.3
Capital goods	3.6	1.9	3.1	4.7
Intermediate goods	1.6	2.0	1.6	1.4
Consumer goods	1.6	2.1	2.7	2.6
Durables	4.6	4.0	2.8	3.5
Semi and nondurables	0.9	1.0	2.7	2.4
In the year				
Industrial production	4.3	4.4	4.8	5.1
Capital goods	15.6	16.6	16.6	17.0
Intermediate goods	4.2	3.9	4.1	4.2
Consumer goods	2.2	2.7	3.3	3.7
Durables	3.1	3.7	4.4	5.9
Semi and nondurables	2.0	2.4	2.9	3.0

Source: IBGE
1/ Seasonally adjusted data.

Figure 1.9 – Industrial exports – Volume
Seasonally adjusted data



Source: Funcex

7.3%; electric machines, apparatuses and equipment, 7.3%; beverages, 6.9%; and automotive vehicles, 6.3%. Moving in the opposite direction, the sharpest declines were registered under the production of electronic equipment, communications equipment and devices, 4.9%, due mainly to lesser exports of cell telephones; tobacco, with 4.4%; wood, 3.9%; and footwear and leather articles, 2.4%.

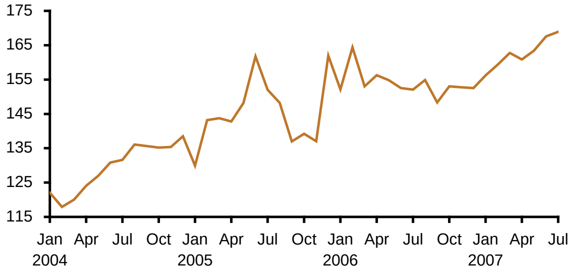
The ongoing process of farm income recovery generated increased production of goods for that sector. A comparison between average indices in the six-month period ended in June 2007, compared to the same period of the previous year, shows that production of fertilizers expanded 14.1%, that of insecticides, 9.9%, and output of farm machines and equipment increased 31.5%.

Regional production indicators (Regional PIM-PF) demonstrate that the process of accelerated industrial output growth evident since the end of 2006 and early part of the current year was more accentuated in the south of the country, a region in which, compared to the same period of the previous year, average output in the May-July period expanded 8.2% in Río Grande do Sul, particularly in the segments of oil refining and alcohol production, machines and equipment and automotive vehicles; followed by 6.1% in Santa Catarina, primarily in the areas of electric machines, apparatuses and equipment, apparel and accessories and foodstuffs; and 5.1% in Paraná, influenced by the dynamics of the segments of other chemical products, machines and equipment and automotive vehicles. In the opposite sense, physical output of the industrial sector in the state of Goiás dropped 1.9% in the period, accompanying the falloff registered in the segments of chemical products and food and beverages.

Despite the environment of strong growth in both production and imports of capital goods, the increased dynamics of the industrial sector raised the level of utilization of installed industrial output capacity in the early months of 2007. According to FGV's Manufacturing Industry Survey (SCIT), the Level of Utilization of Installed Capacity (Nuci) reached 85.7% in August, just 0.2 p.p. below the April 1995 record. The average Nuci for the first eight months of the year closed 1.5 p.p. above the level registered in the same period of 2006.

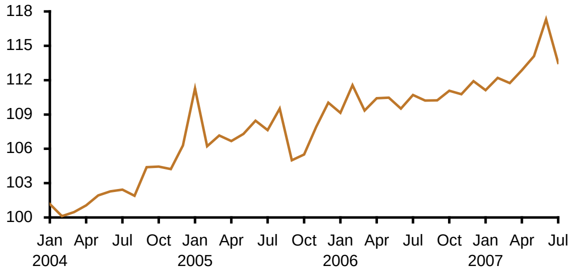
According to CNI figures that have been seasonally adjusted by the Department of Economics (Depec), the average Nuci of the manufacturing sector reached 82.4% in July.

Figure 1.10 – Industrial production
Consumer goods
Seasonally adjusted data
2000=100



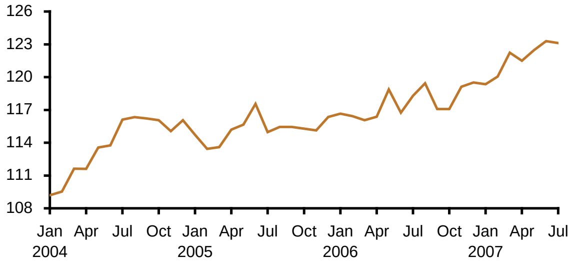
Source: IBGE

Figure 1.11 – Industrial production
Semi and nondurable goods
Seasonally adjusted data
2000=100



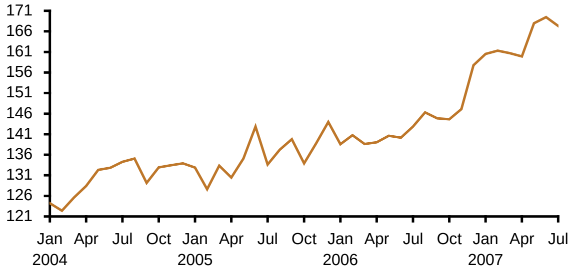
Source: IBGE

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

The average for the three-month period ended in that month reached 82.3%, 0.5 p.p. higher than in the February-April period. To some extent, this reflected increases in the sectors of rubber and plastic goods, 2.2 p.p., and automotive vehicles, 3.2 p.p. In the opposite direction, one should stress the falloff that occurred in the sectors of chemical products, 1.9 p.p. and wood products, 1.2 p.p.

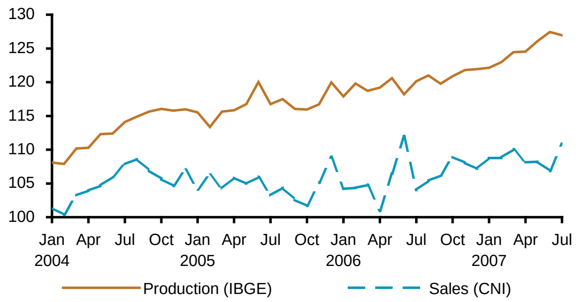
In general terms, production has expanded at a more intense pace than industrial employment, revealing a process of productivity gains that is typical of an expanding economic cycle that is rapidly absorbing capital good. When the results of IBGE's Monthly Industrial Survey-Employment and Wages (Pimes) regarding hours paid is taken into consideration, the productivity level of the manufacturing sector expanded 4.4% between the quarters ended in July 2007 and July 2006, with 3.3% in the mining industry and 4.4% in manufacturing.

In sectoral terms, emphasis should be given to productivity gains obtained in the segments of machines and equipment – excluding electric, electronic, precision and communications equipment, 10.2%, with increases of 19.1% in physical output and 8.1% in the number of hours paid; and apparel, 16.6%, resulting from a 10.4% increase in production and a 5.4% cutback in the number of hours paid. Productivity dropped 3.6% in the segment of coke, oil refining, nuclear fuels and alcohol, reflecting increases of 1.8% in production and 5.5% in the number of hours paid; and 2.3% in the sector of food and beverages, corresponding to increases of 3.3% in the number of hours paid and 0.9% in production.

According to the FGV, industrial stocks in the month of August registered their lowest level since April 1995, with 6% of companies considering them to be excessive and 7% deeming them insufficient. Basically, this result demonstrates the performance of the consumer goods sector, in which the number of companies that considered stocks to be insufficient was 14 p.p. greater than the number that considered them excessive.

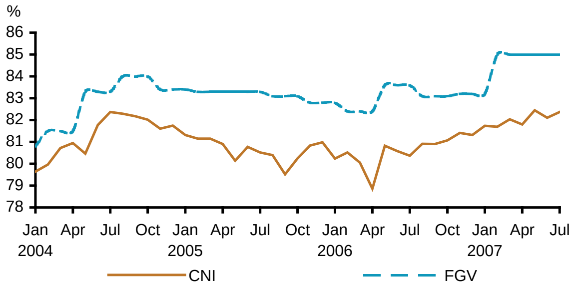
With respect to the current situation and expectations for the near future of the economy, businesspersons from the industrial sector demonstrate continued confidence. The Industrial Business Confidence Index (Icei), published by the CNI, reached 60.3 points in July. Here, it is important to stress that a 50 point level corresponds to stability in industrial activity. FGV's Industrial Confidence Index (ICI), which has a stability point of 100 points, closed

Figure 1.14 – Industrial production and sales
Seasonally adjusted data



Sources: IBGE and CNI

Figure 1.15 – Utilization of installed capacity in the manufacturing industry
Seasonally adjusted data



Sources: CNI and FGV

Table 1.8 – Manufacturing industry inventories[1/]

	2007			
	May	Jun	Jul	Aug
Manufacturing industry	99	98	100	101
Consumer goods	99	100	112	114
Capital goods	101	103	103	101
Building material	92	94	93	101
Intermediate goods	100	96	98	96
Segments				
Nonmetallic minerals	88	78	80	84
Metallurgy	101	101	98	102
Mechanics	104	108	111	98
Electric and communications equipment	102	96	96	100
Transportation equipment	106	105	127	128
Furniture	120	103	103	99
Paper and cardboard	94	100	105	99
Chemicals	103	99	98	98
Pharmaceuticals	99	100	97	96
Plastics	84	90	95	96
Textiles	76	83	76	71
Clothing, footwear and cloth goods	93	94	93	95
Food products	98	98	104	103
Others	92	89	86	93

Source: FGV
1/ Values over fifty indicate inventories above the planned level.

August at 121.8, the highest level since the series was first calculated in April 1995. This result was 0.1 p.p. higher than in July.

The optimism found within the industrial business community is reflected in both current and future investment intentions, a position that doesn't seem to have been undermined by the growing volatility of international financial markets. According to FGV's Manufacturing Industry Survey – Special Queries (SCIT-QE) carried out in the month of July, 38% of the companies contacted affirmed that they were investing more in the first half of this year than in the previous half-year period, representing a 4 p.p. increase compared to the April survey. In contrast, just 21% of those companies stated that they were investing less, thus repeating the percentage found in the April survey. With regard to the second half of 2007, 42% of the companies contacted stated that they intended to raise their investments, while 19% affirmed that they would reduce them. These results represent increases of 8 p.p. and 5 p.p., respectively, compared to the April results.

1.3 Job market

Employment

Labor market indicators registered positive results in the three-month period ended in July 2007, as unemployment declined and the level of formal employment increased.

According to the Monthly Employment Survey (PME), calculated by IBGE and covering six major metropolitan regions, the average level of open unemployment reached 9.5% in the June-August period, against 10.6% in the same period of 2006 and 10.1% in the three-month period ended in May. Annual growth reflected steady upward movement in employment levels, with 2.9% in the period under consideration compared to a 2.4% increase in the overall labor force.

Formal employment expanded 2.6% in the three-month period under consideration, while the number of unregistered employees dropped 0.2%. The number of persons classified as self-employed expanded sharply in 2007, posting 1.6% growth in the quarter, raising the cumulative increase for the year to 5.1%, followed by 4.7% growth in the number of registered employees and a 2.6% reduction in the number of unregistered workers.

Figure 1.16 – Unemployment rate

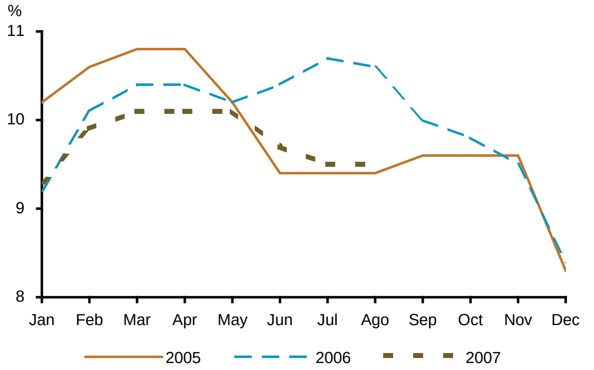
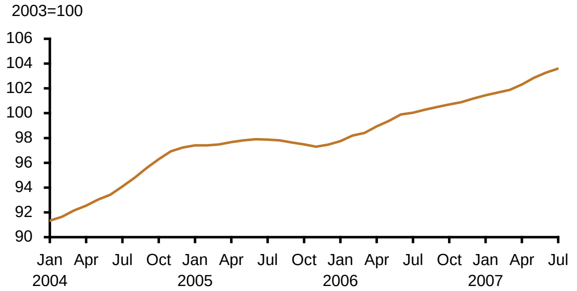


Table 1.9 – Formal employment

New job openings – Accumulated in the period (1,000 employees)	2007				
	I Q	I H	Jul	Aug	Year
Total	399,6	1 095,5	127,0	133,3	1 355,8
Manufacturing industry	110,4	299,5	29,0	39,4	367,9
Commerce	14,7	97,1	27,9	36,2	161,2
Services	166,7	327,6	38,2	59,0	424,7
Building	34,5	97,6	18,9	26,3	142,7
Crop and livestock	50,6	238,4	8,0	-30,8	215,6
Public utilities	2,5	5,5	0,5	0,5	6,5
Others[1/]	20,2	29,9	4,6	2,8	37,3

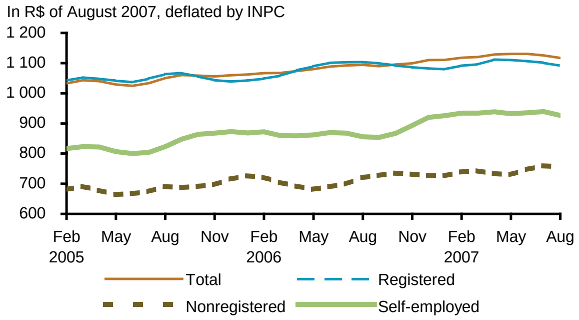
Source: MTE
1/ Includes mining, public administration and others.

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



Source: CNI

Figure 1.18 – Average real regular earnings[1/]



Source: IBGE
1/ Quarterly moving average.

According to the General File of Employed and Unemployed Persons (Caged), which is elaborated by the Ministry of Labor and Employment (MTE), 1,355,824 jobs were created during the year through August. This was the second best result for that time period since the series was first calculated in January 1985. This volume of new jobs reflected 5% growth in the number of registered employees, with a 7% increase in the construction industry, 6% in commerce, 4.9% in the manufacturing sector and 4.8% in services.

According to data drawn from the CNI survey of 12 state federations, employment in the manufacturing industry expanded 3.5% in the first seven months of 2007, compared to the same period of 2006. An analysis at the margin shows employment growth in this segment, with a 1.2% seasonally adjusted increase in the three-month period through July, compared to the three-month period ended in April.

Earnings

The real average earnings habitually received by workers in the six metropolitan regions covered by the PME expanded 3.8% in the first eight months of the year, compared to the same 2006 period, utilizing the National Consumer Price Index (INPC) as deflator. In the month of July, average earnings reached R$1,109.40, corresponding to a nominal increase of 7.1% compared to the same month of 2006. Using the same basis of comparison, real wages and real overall wages – the product of real average earnings habitually received in the principal job multiplied by the number of persons employed – expanded 1.2% and 4.1%, respectively.

1.4 Gross Domestic Product

According to the IBGE, GDP expanded 4.9% in the first half of 2007, compared to the same period of 2006, reflecting across-the-board positive growth among the different components whether viewed in terms of product or demand.

Analysis of demand components ratifies the importance of internal demand for sustaining the ongoing upturn in the pace of economic activity. In this sense, household consumption, which reflects income recovery and improved credit conditions, expanded 5.9% in the period, representing 60.4% of product. In the first six months of the year, Gross Fixed Capital Formation (GFCF) expanded 10.6% compared to the same period of 2006. This result reflected increases

Table 1.10 – Gross Domestic Product at market prices

% growth

	2006				2007	2007
	I Q	II Q	III Q	IV Q	I Q	II Q
Accumulated in the year	4.1	2.7	3.3	3.7	4.4	4.9
Accumulated in 4 quarters	3.3	2.9	3.3	3.7	3.8	4.8
Quarter/same quarter of the previous year	4.1	1.5	4.5	4.8	4.4	5.4
Quarter/previous quarter1/	1.4	-0.6	2.8	1.0	0.9	0.8
Crop and livestock	1.8	3.1	6.2	-1.1	-4.0	0.6
Industry	1.5	-2.6	3.5	1.5	0.4	1.3
Services	1.2	0.3	1.2	1.1	1.7	0.7

Source: IBGE
1/ Seasonally adjusted data.

Table 1.11 – Gross Domestic Product
Accumulated in the year

% growth

	2006				2007		
	I Q	II Q	III Q	IV Q	I Q	II Q	Year1/
GDP at market prices	4.1	2.7	3.3	3.7	4.4	4.9	4.7
Household consumption	4.0	4.1	4.1	4.3	6.0	5.9	6.0
Government consumptior	5.0	4.3	4.1	3.6	4.0	3.9	3.6
Gross fixed capital formation	11.8	8.5	8.4	8.7	7.3	10.6	9.6
Exports	8.2	3.0	4.5	4.6	5.9	9.5	5.3
Imports	15.6	14.4	16.5	18.1	19.9	19.3	18.4

Source: IBGE
1/ Estimate.

of 16.6% in the production of capital goods and 4% in investments targeted to the construction industry. Government consumption expanded 3.9% in the half-year period.

The contribution of the external sector to the GDP result remains negative. The -0.9 p.p. impact registered in the half-year period reflected increases of 9.5% under exports and 19.3% under imports. Here, it is important to stress that growth in external acquisitions is necessary in order to sustain the ongoing process of economic activity recovery.

The industrial sector registered the strongest growth in the first half of 2007, with 4.9%, followed by the sectors of services, 4.7%, and crop/livestock production, 1.4%.

The performance of the industrial sector resulted from 5% growth in the output of the mining industry, impacted mainly by expanded production of oil and gas, 3%. In the case of public utility industrial services, growth also closed at 5%, while the manufacturing sector expanded 5.1%. As far as the construction industry is concerned, growth came to 4.3% using the same basis of comparison.

Growth in the service sector (4.7%) reflected highly positive results in all of the various subsectors. In order of importance, the following deserve mention: commerce, with 7.1%, and transportation, 4.6%. Other segments that also contributed positive results were financial institutions, with 9.4%; the communications sector, with 7.4%; rental services, 4.1%; other services, with 3.1%; and public administration services, 1.9%.

The performance of the crop/livestock sector has not yet reflected the expected good results indicated by the LSPA, with a 14.3% high in the 2007 grain harvest. Consequently, this sector is expected to present significantly better results in the second half of the year.

Analysis of evolution at the margin shows that, according to seasonally adjusted data, GDP expanded 0.8% in the second quarter of 2007, compared to the previous quarter. On ratifying the performance of leading sectoral indicators, this result evinces the continuity of growth in economic activity, driven both by increased real income and employment and by the more flexible monetary policy adopted. Using this basis of comparison, GDP turned in positive growth for the fourth consecutive quarter.

Growth in the quarter resulted from advances in all sectors of activity, with expansion of 1.3% in the industrial

Table 1.12 – Gross Domestic Product
Accumulated in the year

% growth

	2006				2007		
	I Q	II Q	III Q	IV Q	I Q	II Q	Year 1/
Crop and livestock	-2.7	-2.5	2.4	4.1	2.9	1.4	4.5
Industry	5.0	1.9	2.5	2.8	3.0	4.9	4.6
Mining	14.0	6.8	6.1	6.0	4.1	5.0	6.2
Manufacturing	3.4	0.2	1.1	1.6	2.7	5.1	4.4
Construction	7.3	4.8	5.2	4.6	2.4	4.3	4.6
Public utilities	3.0	2.6	3.3	3.6	3.9	5.0	4.6
Services	4.4	3.7	3.7	3.7	4.6	4.7	4.3
Commerce	6.2	4.0	4.1	4.8	6.0	7.1	6.3
Transportation	5.0	3.1	3.0	3.2	3.5	4.6	5.2
Communications	1.2	0.2	1.9	2.3	7.3	7.4	5.4
Financial institutions	9.2	9.8	7.9	6.1	9.2	9.4	7.3
Other services	2.9	2.5	2.4	2.6	3.7	3.1	3.0
Rentals	4.2	4.3	4.5	4.3	4.2	4.1	4.1
Public administration	3.2	2.8	2.9	3.1	2.1	1.9	2.1
Value added at basic prices	3.9	2.5	3.1	3.5	4.0	4.5	4.4
Taxes on products	5.3	4.4	4.6	5.2	6.9	7.8	6.4
GDP at market prices	4.1	2.7	3.3	3.7	4.4	4.9	4.7

Source: IBGE
1/ Estimate.

Table 1.13 – Gross Domestic Product
Quarter/previous quarter
Seasonally adjusted

% growth

	2006				2007	
	I Q	II Q	III Q	IV Q	I Q	II Q
GDP at market prices	1.4	-0.6	2.8	1.0	0.9	0.8
Crop and livestock	1.8	3.1	6.2	-1.1	-4.0	0.6
Industry	1.5	-2.6	3.5	1.5	0.4	1.3
Services	1.2	0.3	1.2	1.1	1.7	0.7
Household consumption	-0.3	1.7	1.2	2.1	0.8	1.5
Government consumption	2.2	-0.1	0.8	0.0	2.7	0.2
Gross fixed capital formation	5.3	-2.9	5.2	2.0	2.7	3.2
Exports	0.5	-5.7	12.4	-1.4	1.0	0.9
Imports	7.1	1.9	8.6	3.4	4.1	1.5

Source: IBGE

sector, sustained primarily by the building industry and manufacturing sector. The sector of services grew 0.7%, while the crop/livestock sector expanded 0.6%.

With regard to demand components, mention should be made of continued growth in GFCF, with 3.2%. Family consumption expanded 1.5%, while government consumption rose 0.2%, and exports and imports increased at respective rates of 0.9% and 1.5%.

GDP results for the second quarter were consistent with annual growth estimates of 4.7%, as published in the previous Inflation Report. This rate was maintained in a scenario of sectoral alterations, with the forecast reduction in the crop/livestock sector being offset by the increased dynamics of industrial activity. Revision of crop/livestock output growth from 7% to 4.5% indicated growth below the level forecast in the second quarter, but concluded that strong growth would continue through the second half of the year, which is consistent with data drawn from the LSPA and increased internal and external demand for livestock products. The increase in industrial sector growth estimates from 4.4% to 4.6% incorporated the increased dynamics of the construction and manufacturing industries. Growth in services was maintained at 4.3%.

With regard to demand, projections of Gross Fixed Capital Formation growth were raised as a result of the accentuated dynamics shown by data on imports and production of capital goods, together with projections of government consumption, since growth under this heading in the first half of the year suggests a higher overall result for the year. Estimates for the external sector indicate reductions under both imports and exports, as the sector's contribution to GDP performance will continue negative. Family consumption remains at the rather high level of 6%.

1.5 Investments

According to the Quarterly National Accounts released by the IBGE, investments, excluding stock variations, expanded 10.6% in the first half of 2007, compared to the same period of 2006. In the second quarter, investments expanded 13.8% compared to the same period of the preceding year. This was the 14th consecutive quarter of positive growth utilizing this basis of comparison. Analysis at the margin based on seasonally adjusted data confirms the dynamics of the segment, showing growth of 3.2% in the second quarter compared to the previous quarter.

The positive performance of investments had already been anticipated by the trajectory of monthly Gross Fixed Capital Formation indicators. In the first half of the year, the construction industry expanded 4% compared to the same period of 2006, while absorption of capital goods, considered the principal component of Gross Fixed Capital Formation, posted growth of 15.3%. This result was based on increases in domestic output of capital goods, 16.6%, as well as exports of these products, 8.3%, and imports, with 30.8%.

The dynamics shown by domestic production of capital goods in the half-year period resulted from across-the-board sectoral increases, particularly involving production of parts for agricultural equipment, 80.7%; goods targeted to the farm sector, 31%; and typically industrialized goods, 20.5%. It should be stressed that strong growth in segments related to agricultural activity was clearly favored by the very low basis of comparison, though there is no denying that this growth clearly reflected a process of recovery.

Analysis at the margin revealed a drop in the production of capital goods and inputs for the construction industry, with monthly declines of 1.3% and 0.2%, respectively, in July, based on seasonally adjusted data. This movement should not be interpreted as a shift in the basic trend, since the intensity of these growth cycles, expressed in terms of expanded production in the first seven months of the year and in the last 12 months reached 17% and 4.1%, and 12.3% and 3.8%, respectively, compared to the corresponding periods of 2006.

The positive performance of investments is expected to continue through the coming months, following growth in such leading indicators as Brazil-risk, measured by the Emerging Markets Bond Index Plus (Embi+), released by J.P. Morgan; the interest rate level, now at a historically low level; and continued recovery in farm income.

1.6 Conclusion

The Brazilian economy continued expanding in the first half of 2007, with internal demand fully accounting for the dynamics of economic activity since the start of the second half of 2006.

Recovery in investment levels reflects both the positive expectations of businesspersons with regard to the continuity of economic growth and increased farm income, coupled with improved credit conditions. Positive growth in investments in an environment of accentuated expansion in the absorption of capital goods not only results in sustained economic growth but also suggests medium and long-term acceleration of this expansion. Nonetheless, it is possible that increased financial volatility and an increase in external financing costs could exert some impact in the sense of curtailing aggregate investments.

With respect to consumption, the benign evolution of credit and labor markets, despite a marginal reduction in the pace of growth under real overall wages, coupled with higher food prices, has acted as a guarantee of increased retail sales.

Expectations for the coming months suggest a relative leveling off of the pace of growth in consumption, resulting from both a less accentuated rise in available income, caused by higher food prices, as well as possible impacts of the international financial market crisis on consumer confidence. This movement is not expected to have any relevant impact on the dynamics of internal demand, which will continue sustaining a steady process of economic growth.

Prices

2

Compared to the three-month period ended in May, inflation accelerated in the June-August period. This movement, which was more intense when analyzed under the prism of general price indices, was generated mainly by the behavior of farm prices, though industrial prices also rose to some degree. Despite this performance, August inflation showed more consistent signs that internal demand has contributed to increased inflationary risks, thus facilitating passthrough of wholesale prices to consumers.

Other factors that contributed to the increased inflationary risk were the international financial crisis and its possible impacts, primarily on the prices of tradables.

In this context, IPCA core inflation in August moved upward in all three measurements calculated by the Brazilian Central Bank. This clearly confirms the scenario of increased dissemination of the inflationary process and greater medium and long-term inflation risk.

2.1 General indices

Compared to the previous three-month period, general price indices released by the FGV accelerated, as the General Price Index (IGP-DI) expanded 2.04% in the three-month period ended in August, against 0.51% in the March-May period. This uptick was generated by the evolution of wholesale prices, particularly in the case of farm products. In August, the IGP-DI increased 1.39%, the highest rate since May 2004.

Following sharp increases in both April and May, wholesale industrial prices remained practically stable in the two subsequent months before increasing 0.61% in August, raising cumulative growth in the three-month period to 0.51%. This performance reflected price reductions in the segments of mining, metallurgy, electric equipment and fuels

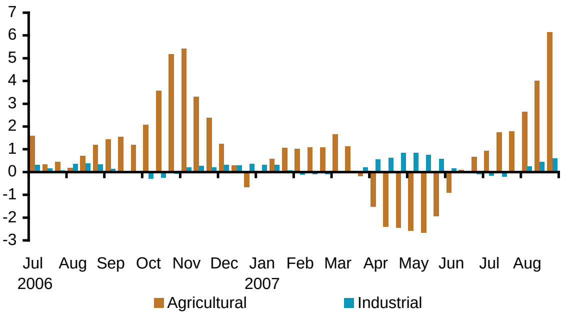
Table 2.1 – General price indices

Monthly % change

	2007				
	Apr	May	Jun	Jul	Aug
IGP-DI	0.14	0.16	0.26	0.37	1.39
IPA	0.02	-0.04	0.09	0.42	1.96
IPC-Br	0.31	0.25	0.42	0.28	0.42
INCC	0.45	1.15	0.92	0.31	0.26

Source: FGV

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



Source: FGV

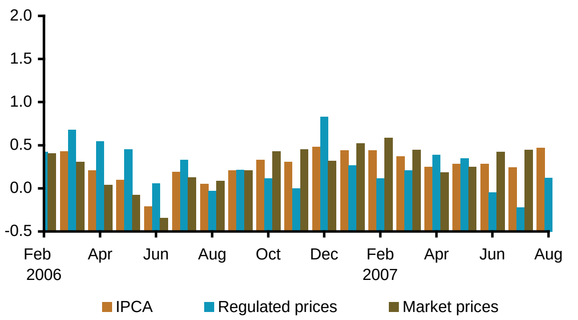
and lubricants, coupled with increases in the prices of food products, particularly animal origin goods. Demonstrating that the off-season harvest period had arrived, farm prices rose 8.77% in the period, compared to a 4.5% drop in the three-month period ended in May. This movement was generated primarily by price highs under wheat, beans, soybeans, beef, poultry, pork and fresh milk.

The Consumer Price Index – Brazil (IPC-Br) rose 1.12% in the three-month period ended in August, compared to 1.04% in the March-May period. Just as in the other consumer price indices, upward movement was powered by food prices.

2.2 Consumer price indices

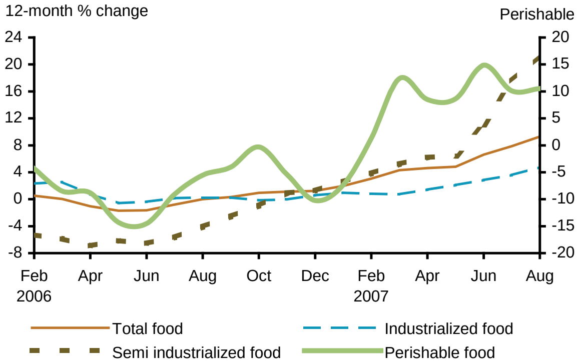
Extended National Consumer Price Index

Figure 2.2 – IPCA
Monthly % change



Source: IBGE

Figure 2.3 – IPCA – Food
12-month % change



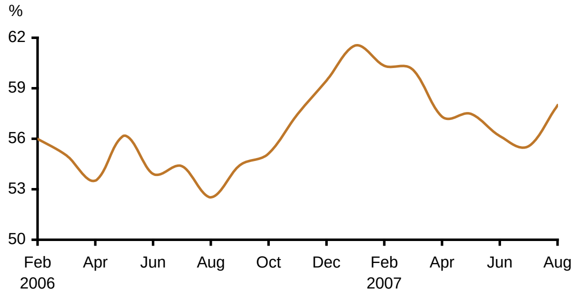
Source: IBGE

In the 12-month period ended in August, the IPCA increased 4.18%, the sharpest rise since May 2006. Analysis shows increases of 2.37% in the prices of regulated goods and services and 5% under market prices. Cumulative growth in the index came to 0.99% in the three-month period ended in August, compared to 0.9% in the March-May period, and was generated by growth rates of 1.5% and 0.88% in market prices and -0.14% and 0.95% in regulated prices, using the same basis of comparison. The IPCA posted monthly growth rates of 0.28% in June, 0.24% in July and 0.47% in August, the highest rate of the year.

Growth in market prices in the three-month period ended in August reflected expansion of 3.8% in the grouping of food products, compared to 1.17% in the previous three-month period. This increase was driven mainly by the prices of semimanufactured food products and reflected highs in the prices of beef, beans, milk and poultry. In contrast, when food prices are excluded, the increase in market prices came to 0.52% in the three-month period ended in August, compared to 0.76% in the previous three-month period. Here, it is important to stress growth of -0.96% in the grouping of residential articles and 0.72% under apparel prices.

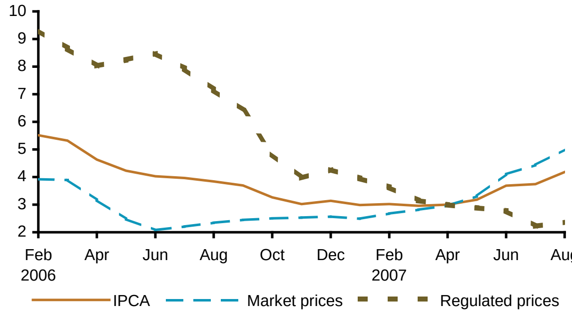
The IPCA diffusion index, which shows the proportion of items included in the index that posted positive growth, closed the June-August period with an average of 57.99%, compared to 57.47% in the three-month period ended in May and 60.33% in the December-February period. In terms of yearly averages, the trajectory of this indicator suggests a more favorable inflationary situation. Nonetheless, this indicator posted 63.28% in August, well above the 2005

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

% change

	Weights 2007	Apr	May	Jun	Jul	Aug	Year
IPCA	100.0	0.25	0.28	0.28	0.24	0.47	2.80
Market prices	69.23	0.19	0.25	0.43	0.45	0.62	3.53
Regulated prices	30.77	0.39	0.35	-0.05	-0.22	0.12	1.19
Main items							
Electricity	3.58	0.37	0.47	-0.07	-3.01	-0.49	-4.29
Water and sewage	1.61	0.72	0.19	0.38	0.23	0.02	2.81
Urban bus	3.82	0.03	0.24	0.00	0.00	0.43	4.10
Air ticket	0.28	-0.83	-0.43	0.38	0.21	2.19	2.08
Gasoline	4.53	0.66	0.33	-0.77	-0.51	-0.89	-1.89
Bottled cooking gas	1.17	0.23	-0.25	0.11	-0.18	0.05	-0.39
Medicine	2.94	0.50	0.68	-0.39	-0.32	0.04	0.55
Health plans	3.35	0.76	0.75	0.71	0.69	0.56	5.88

Source: IBGE

average of 60.87%, when the IPCA closed at 5.69%. This would suggest that the inflationary process may in fact have become more generalized.

Once the August result is incorporated, the IPCA accumulated growth of 2.8% in the year, against 1.78% in the corresponding period of 2006. Prices of regulated goods and services expanded 1.19% in the period, while market prices rose 3.53%.

2.3 Regulated prices

Regulated prices, which had accumulated an increase of 1.19% in the year, dropped 0.14% in the three-month period ended in August, corresponding to -0.04 p.p. of IPCA growth, as against an increase of 0.95% in the March-May period. To a great extent, the performance of these prices was driven by the more intense impact of reductions in electricity rates, gasoline and medicine prices, compared to the impact of increases in interstate bus fares, fixed telephone rates and airline tickets.

Fixed telephone rates rose 1.75% in the quarter, as a consequence of higher prices for basic phone services, 1.98%, and rates per pulse, 3.07%, as well as the shift of the system from pulses to minutes in connections in Rio de Janeiro and São Paulo. Interstate bus fares increased 4% in the three-month period, while airline tickets rose 2.79%.

Residential electricity rates dropped 3.55% in the three-month period, with reductions in São Paulo, 8.67%; Belém, 8.13%; and Rio de Janeiro, 2.18%. The prices of gasoline and medicines dropped 2.15% and 0.67%, respectively, in the three-month period ended in August, compared to increases of 1.72% and 0.92% in the March-May period.

2.4 Inflation core

Growth in the IPCA core, which excludes food taken at home and regulated prices, reached 0.35% in August, for a cumulative total of 0.64% in the three-month period ended in that month, compared to 0.86% in the March-May period. Viewed over the 12-month period ended in August, growth of the IPCA core reached 3.58%, while inflation measured by the headline index closed at 4.18%.

Table 2.3 – Consumer prices and core inflation

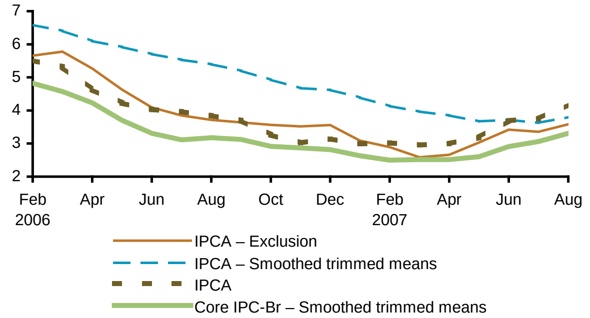
Monthly % change

	2007				
	Apr	May	Jun	Jul	Aug
IPCA	0.25	0.28	0.28	0.24	0.47
Exclusion	0.29	0.33	0.22	0.08	0.35
Trimmed means					
Smoothed	0.29	0.30	0.34	0.20	0.40
Non smoothed	0.28	0.30	0.23	0.17	0.43
IPC-Br	0.31	0.25	0.42	0.28	0.42
Core IPC-Br	0.32	0.30	0.34	0.26	0.37

Sources: IBGE, Bacen and FGV

Figure 2.6 – Core inflation

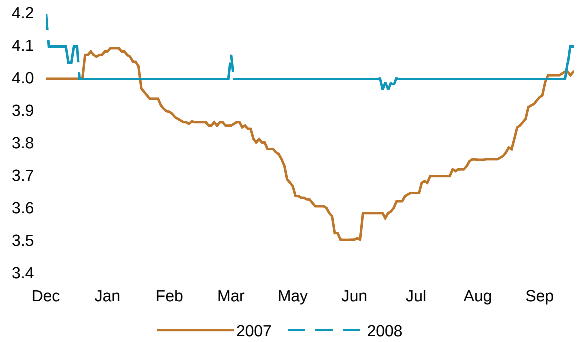
12-month % change



Sources: IBGE, Bacen and FGV

Figure 2.7 – IPCA

Median



Calculated according to the smoothed trimmed-means method, the IPCA core, which excludes those items in which monthly growth closed above 80% or below 20% of overall distribution, while smoothing out over 12 months those price increases concentrated in just a few months of the year, increased 0.4% in August[1]. The indicator, which had expanded 0.88% in the March-May period, registered cumulative growth of 0.93% and 3.79%, respectively, in the three-month period and in the 12 month period through August. The August result shows acceleration, closing at the highest level since May 2006, indicating that pressures on prices will increase over the coming months.

In the same sense, the inflation core calculated by the trimmed-means method without smoothing of specific items rose 0.43% in August, the sharpest increase since January 2006, closing the three-month period ended in that month at 0.83%, the same level registered in the previous three-month period. Cumulative growth in 12-month indicators through August reached at 2.96%.

Calculated by the FGV utilizing the smoothed trimmed-means method, the IPC-Br inflation core registered cumulative growth of 3.31% in the 12 month period ended in August, with monthly growth of 0.34% in June, 0.26% in July and 0.37% in August.

2.5 Market expectations

As collected by the Executive Investor Relations Group (Gerin), median expectations for 2007 IPCA inflation increased from 3.6% at the end of the second quarter to 4% in the third week of September. For 2008, inflation expectations increased to 4.1%. These projections are consistent with the annual inflation target of 4.5%, defined by the National Monetary Council (CMN).

Expectations regarding the evolution of 12-month IPCA inflation increased from 3.5% at the end of June to 3.8% in the third week of September. For the most part, this increase was generated by revision of projections for the third quarter of 2007, as a result of pressures generated on current inflation by the farm price high. Stability in projections for 2008 reflects perceptions of a continued benign inflationary scenario. Among the factors that have aided in holding future inflation expectations at a level below the 4.5% target,

1/ IPCA items smoothed: fuels (domestic), residential electricity, public transportation, fuels (vehicles), personal services, tobacco, courses, diverse courses and communications.

Figure 2.8 – IGP-M and IPA-DI

Median 2007

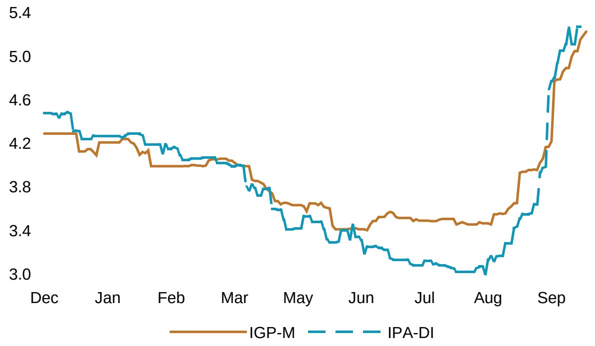


Figure 2.9 – Exchange rate

Median 2007

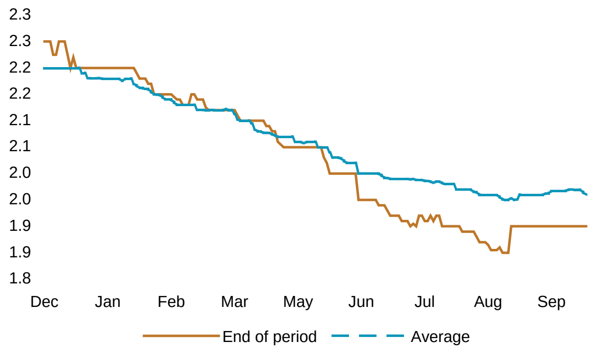


Table 2.4 – Summary of market expectations

	3.30.2007		6.29.2007		9.21.2007	
	2007	2008	2007	2008	2007	2008
IPCA	3.9	4.0	3.6	4.0	4.0	4.1
IGP-M	4.1	4.0	3.5	4.0	5.0	4.2
IPA-DI	4.0	4.0	3.1	4.0	5.3	4.3
Regulated Prices	3.8	4.0	3.1	3.8	2.4	3.8
Selic (end-of-period)	11.5	10.5	10.8	9.8	11.0	10.3
Selic (average)	12.2	11.0	11.8	10.1	11.9	10.6
Exchange rate (end-of-period)	2.11	2.20	1.90	2.00	1.90	1.94
Exchange rate (average)	2.10	2.17	1.99	2.00	1.96	1.90
GDP growth	3.5	3.6	4.3	4.1	4.7	4.4

mention should be made of the outlook for a lesser degree of inflationary inertia, together with compliance with inflation targets for the fifth consecutive year.

Estimates regarding growth in general price indices in 2007 have also risen. For 2007, median rates for the General Price Index – Market (IGP-M) and the Wholesale Price Index (IPA-DI) reached 5% and 5.3%, respectively, in the third week of September, as against 3.5% and 3.1%, at the end of June. For 2008, median market projections for IGP-M and the IPA-DI shifted from 4% to 4.2% and 4.3%, in that order.

The outlook for lesser increases in regulated prices has contributed to consolidation of a scenario marked by a lesser degree of inflationary inertia, thus facilitating anchoring of expectations to the target path. Median expectations regarding adjustments in regulated prices in 2007 reached 2.4% in the third week of September, against 3.1% at the end of June. For 2008, the projection remained at 3.8%.

Market projections for the rate of exchange reflect continued perception of a favorable external accounts scenario. Median expectations for the average rate of exchange in 2007 dropped from R$1.99/US$ at the end of June to R$1.96/US$ in the third week of September, while expectations for the end-of-period rate of exchange remained at R$1.90/US$. Utilizing the same basis of comparison, median expectations for the average rate of exchange in 2008 dropped from R$2.00/US$ to R$1.90/US$, while median expectations for the end-of-period rate moved from R$2.00/US$ to R$1.94/US$.

Projections for the Special System of Clearance and Custody (Selic) rate accompanied the trend toward increased uncertainty on world markets and deterioration of inflation expectations. The Selic rate projected for the end of 2007 was revised from 10.8% per year at the end of June to 11% in the third week of September, while the forecast for the average Selic rate moved 0.1 p.p., closing at 11.9% per year. At the same time, projections for the end-of-period Selic rate and its average for 2008 also increased 0.5 p.p. to respective levels of 10.3% per year and 10.6% per year in the period under consideration.

Projections for GDP growth in 2007 and 2008 increased from 4.3% to 4.7% and from 4.1% to 4.4%, using the same basis of comparison.

2.6 Conclusion

Price behavior in recent months and the rate of expansion of internal demand signal that the recent inflation high, initially centered on specific food products, has become a more generalized phenomenon. Consequently, the upward trend in inflation must be viewed with caution in the monetary policy framework, in order to gradually dissipate its temporary impacts, without allowing it to disseminate to other prices in the economy, particularly in light of the accentuated dynamics of the internal market.

3 Credit, monetary and fiscal policies

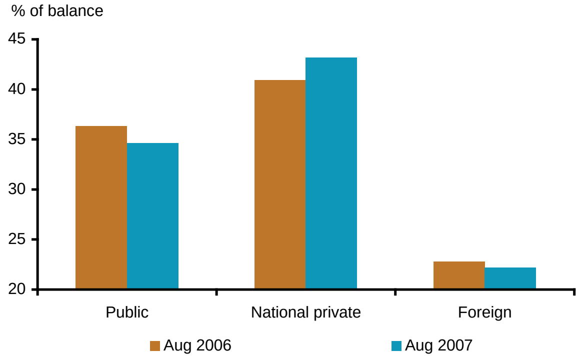
3.1 Credit

Table 3.1 – Credit operations

R$ billion

	2007				% growth	
	May	Jun	Jul	Aug	3 months	12 months
Total	788.9	799.8	818.0	841.5	6.7	24.8
Nonearmarked	548.7	557.3	572.8	590.7	7.6	28.6
Earmarked	240.2	242.5	245.2	250.8	4.4	16.6
% participation						
Total/ GDP	32.0	32.2	32.5	33.1		
Nonearmarked/GDP	22.2	22.4	22.8	23.2		
Earmarked/GDP	9.7	9.8	9.7	9.9		

Figure 3.1 – Credit by capital control of financial institutions



When operations based on both nonearmarked and earmarked resources are included, the volume of financial system credits reached R$841.5 billion in August, up 6.7% compared to May and 24.8% in 12 months. In percentage terms, these operations represented 33.1% of GDP, compared to 32% last May and 29.4% in August 2006.

In the three-month period ended in August, credit operations continued the growth registered during the year as a whole, reflecting both more favorable supply conditions, with longer terms and lower interest, and the benign performance of the job market. Greater demand for banking resources, particularly at the household level, has been an important factor underlying the dynamics of economic activity.

Credit market performance has been sustained by operations based on nonearmarked resources, particularly those targeted to consumption. These operations tended to be concentrated in modalities that offered lower interest rates and longer terms, such as payroll-deducted loans and auto loans. At the same time, business demand continued expanding at a pace compatible with the uptick in the activity level, with particularly strong performances in operations based on domestic resources. Parallel to growth in bank loans to individual borrowers, it is important to stress that the capital market has become an important alternative source of long-term financing, primarily in the case of large-scale corporations.

Analysis of credit distribution according to capital control of the financial institutions involved shows that loans granted by private national banks accounted for 43.2% of total credits, closing with a volume of R$363.2 billion in August. The 9.4% growth registered in comparison to May was due basically to the dynamics of operations with individual borrowers, other services and industry. Financing operations

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

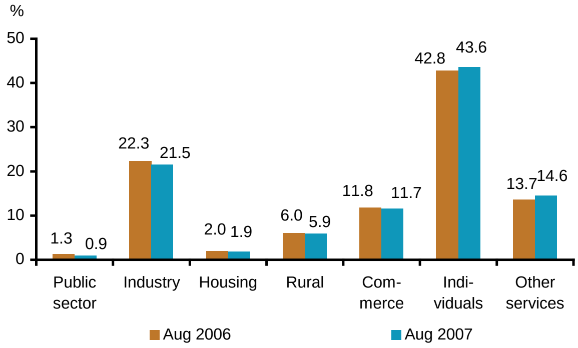


Figure 3.3 – Credit by borrower's economic activity – Public institutions

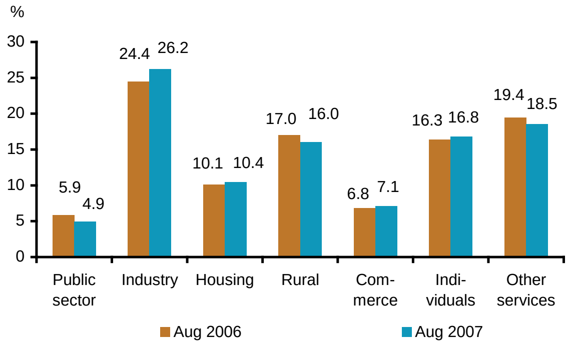


Figure 3.4 – Credit by borrower's economic activity – Foreign institutions

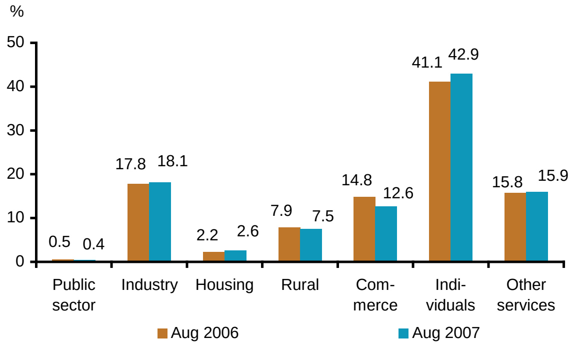
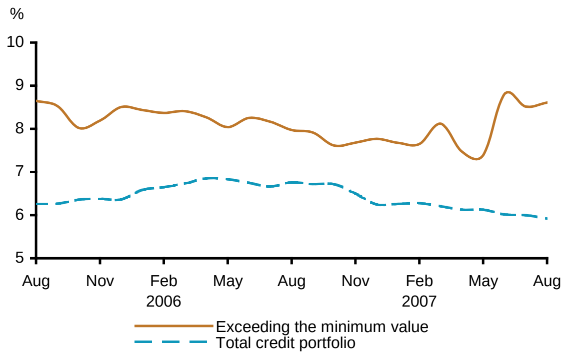


Figure 3.5 – Provisions of total financial system credit



carried out by foreign financial institutions and public banks reached R$186.9 billion and R$291.4 billion, respectively, with relative participation of 22.2% and 34.6%. Compared to the month of May, these operations expanded 6.8% and 3.3% and were also driven by the good results of operations with individual borrowers.

Credit operations with the private sector in the month of August totaled R$823 billion, an increase of 6.8% in the three-month period. Excluding operations in the rural and housing segments, lending to individual borrowers totaled R$287.6 billion, for growth of 8% in the period, while the balance of operations with industry expanded 7.8% to a level of R$188.3 billion, with particularly strong performances in the sectors of mining, agribusiness and energy. Loans to the segment of other services expanded 7.1% in the period, reaching R$136.6 billion. Here, the highlights were credit card management, telephone services and vehicle rentals, while loans to the sector of commerce expanded 7.1% to a level of R$86.6 billion, primarily focused on the segments of department stores and the automotive and food sectors.

Financing granted by the public sector totaled R$18.5 billion in August, a 1% drop compared to the month of May. The state and municipal government debt reached R$14.7 billion, up 0.4% in the three-month period. This result reflected both settlement of contracts tied to the Fund for Maintaining and Developing Basic Education (Fundeb) and amortizations of operations with electricity generation and distribution companies. Loans to the federal government dropped 5.9% to a level of R$3.8 billion, mostly as a result of payment of energy sector debts.

Considering loan operations based on both nonearmarked and earmarked resources matured for more than 90 days, the financial system delinquency rate closed August at 3.4%, reflecting a decline of 0.3 p.p. compared to the month of May. In a similar manner, the ratio of the volume of provisions set aside by the financial system to the overall loan portfolio diminished 0.2 p.p. in the three-month period, closing July at 5.9%. These rates were well within the historical parameters and are not expected to hamper continued robust growth in credit operations.

Earmarked credits

The stock of credits based on earmarked resources contracted in the month of August totaled R$250.8 billion, up 4.4% in the three-month period and 16.6% over 12 months. Evolution

Stages of Credit Growth

With the stability achieved in the wake of the Real Plan, attenuation of the uncertainties of economic agents triggered a period of sharp credit market growth in Brazil. The pace of economic activity accelerated with rising demand and the pursuit of profitable alternatives to financial system treasury operations, as new supply opportunities have arisen. This process occurred in three reasonably distinct stages of credit expansion: i) 1994 to 1995; ii) 2000 to 2002; and iii) 2004 to the present.

Figure 1 – Financial system credit operations
Growth in 12 months

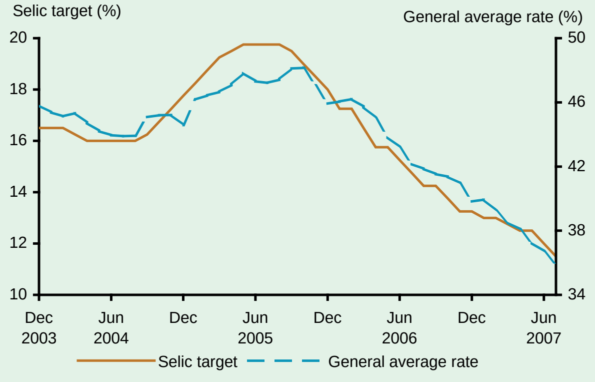
In the first stage, a drastic reduction in inflation generated enormous transfers of income to the less fortunate segments of society, resulting in a sharp rise in consumer spending and, consequently, greater demand for bank credits. As a matter of fact, the overall volume of credit operations reached R$238.9 billion in December 1995, with average growth of 34.5% in two years. In that period, the ratio between total credit and GDP rose from 29% to 32.1%.

Economic growth resulted in demand pressures that became evident, for example, in the rising utilization of installed industrial capacity, which shifted from

71% in December 1992 to 81.4% in March 1995. Starting in October 1994, monetary policy measures were implemented with the objective of restricting credit growth through the banking system. This was done by raising reserve requirements and introducing new requirements on time deposits and lending operations, while also reducing the number of installments in consumer loans. As a result, the rates of credit growth were relatively modest between 1996 and 1998.

The second period of expansion was preceded by important alterations in economic policy in 1999, with adoption of a more flexible exchange system, introduction of the inflation target system and implementation of a fiscal adjustment process. In the new macroeconomic framework, monetary policy gained in importance, as did the credit market in its role as a monetary policy transmission mechanism. In this framework, the evolution of lending operations in 2000 reflected the more flexible monetary policy adopted in 1999, following the positive results obtained with the floating rate exchange system and tightly controlled inflation. As a result, reductions in the Selic rate, reserve requirements on demand and time deposits and the Financial Operations Tax (IOF) on personal loans, drove the cost of credit operations sharply downward. Coupled with the positive performance of the major economic fundamentals, these conditions powered credit demand, as the volume increased 13.3% in 2000, closing the year at R$327 billion.

Figure 2 – Selic target x general average rate

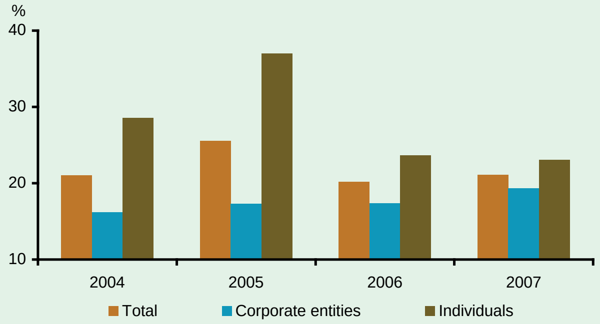


In 2001, monetary policy had to be adjusted as a result of the impacts caused by energy rationing and unfavorable developments in the international economy, as Argentina plunged into a period of crisis and the United States economy showed signs of a slowdown. Once the uncertainties evident in the period extending from 2002 to 2003 had been overcome. The Brazilian economy shifted into a new cycle of economic growth, marked once again by positive credit market developments.

The current stage of credit growth, which began in 2004, has been more consistent than in the past, particularly when one considers consolidation of the process of price stability and reinforcement of macroeconomic fundamentals, as evident in

Figure 3 – Credit operations with nonearmarked resources

Growth in 12 months



sharp improvement in the levels of sustainability of public finance and the balance of payments. This evolution has made it possible to take a gradual and consistently more flexible monetary policy approach, clearly favoring credit market development. In its turn, this has driven a more dynamic process of economic activity, powering output and sales of consumer durables and vehicles, two areas that are directly impacted by the increased credit supply. In this context, the overall volume of credit reached R$818 billion in July 2007, for cumulative expansion of 95.6% since December 2003. In the same time span, the ratio between this balance and GDP evolved from 24% to 32.5%.

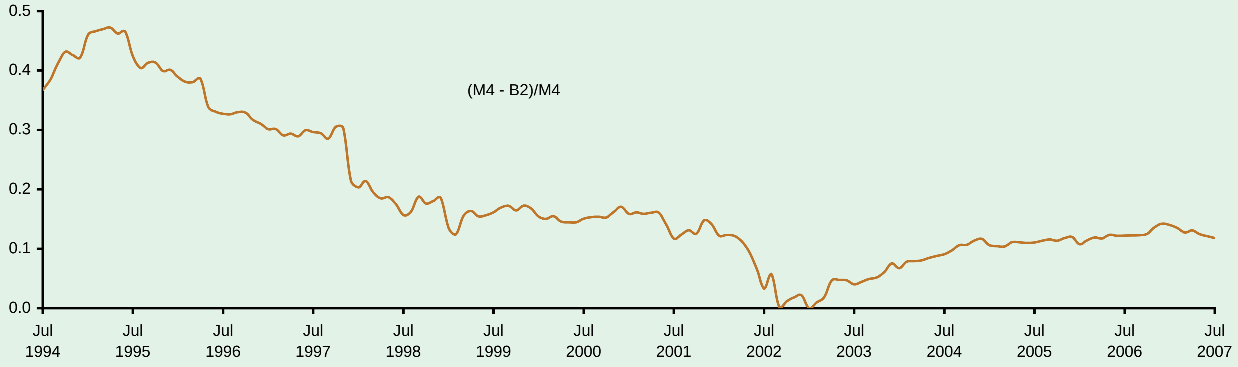
Just as in other recent phases of credit growth, the high tends to be more intense in the case of personal loans, which expanded 179.9% between December 2003 and July 2007, accounting for 49% of the total, while operations with corporate entities increased 87.8%. The participation of operations based on nonearmarked resources, which have a more direct impact on the level of credit market activity, rose from 61% to 70% of the total.

Credit operations have registered across-the-board growth, encompassing most modalities and segments of the economy. However, it is evident that recent performance is directly related to robust growth in several modalities, including leasing operations, an area in which the overall portfolio expanded from R$1.7 billion in December 2003 to R$20.3 billion in July 2007, auto loans, with growth from R$30 billion to R$72.2 billion in the same period, and most importantly payroll deducted loans, which reached a total of R$58.7 billion in July 2007, compared to an almost negligible total using the same type of comparison. These operations increased the population's access to banking resources with lower costs and longer maturity terms, thus making a decisive contribution to reductions in banking spreads and improvement in the household debt profile. At the same time, default rates remained low and stable, without in any way hampering continued credit expansion.

Parallel to these developments, the robustness and sustainability of current credit growth become even more evident when one utilizes the definitions of broad monetary aggregates as measurements of the availability of funding for credit operations. The broad monetary aggregate M4 is defined as total securities and currency issued by the financial system, including the Central Bank, National Treasury and state and municipal treasuries. The financial system obtains resources through issuance of securities and currency and lends these resources to the nonfinancial sector. This financial system liability to the nonfinancial sector is M4. In its turn, the expanded monetary base (B2) represents the monetary liabilities of the Central Bank and the Treasuries of the three spheres of government[1]. It corresponds to the share of M4 subject to the direct control of the government.

Figure 4 – Potential credit supply

Figure 5 – Potential credit supply compared to M4



Subtracting the accounts included in the broad monetary base concept (B2) from M4, one obtains an accounting identity that reflects the magnitude of the financial intermediation of deposit institutions to the nonfinancial private sector. In other words, the funding obtained by deposit institutions free of reserve requirements, less the public securities belonging to the portfolios of financial institutions.

1/ Evolution of the restricted monetary base became highly volatile with the sharp drop in inflation rates. B2 then became a benchmark, considering that this aggregate reveals the migrations between currency and quasi-currency with the greatest transparency.

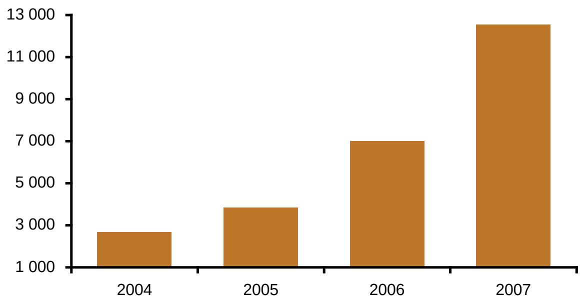
In summary, the difference between M4 and B2 explains the amount that deposit institutions have available to lend to individual borrowers and corporate entities, once they have set aside the resources deposited in the Central Bank or invested in public securities. Therefore, it is the amount that remains for lending purposes following the impact of government fiscal, monetary and exchange policies.

In Graphs 4 and 5, one observes substantial growth in the total potential financial system credit supply (M4 - B2) as of mid-2003, accompanied by stability in the ratio between potential supply and the broad monetary aggregate [(M4 - B2)/M4]. These vectors corroborate the continuity of the process of growth in credit operations, demonstrating that the potential supply is sufficiently stable to meet aggregate demand.

Table 3.2 – Earmarked credit operations

	2007				% growth	
R$ billion	May	Jun	Jul	Aug	3 months	12 months
Total	240.2	242.5	245.2	250.8	4.4	16.6
BNDES	138.4	139.4	142.4	146.4	5.8	13.7
Direct	68.0	67.0	67.4	70.5	3.6	5.7
Onlendings	70.4	72.4	75.0	76.0	8.0	22.4
Rural	57.1	57.6	56.7	57.4	0.6	20.6
Banks and agencies	54.3	54.8	54.1	54.6	0.6	19.4
Credit unions	2.7	2.8	2.6	2.8	0.6	50.6
Housing	38.0	38.7	39.3	40.1	5.4	22.6
Others	6.7	6.8	6.8	6.9	2.6	13.8

Figure 3.6 – Credit to housing with resources from savings deposits – July[1/]



1/ Disbursements accumulated in 12 months

Table 3.3 – BNDES disbursements

R$ million	Jan-Aug 2006	Jan-Aug 2007	% growth
Total	27 339	36 971	35.2
Industry	14 222	17 627	23.9
Other transportation equipment[1/]	3 878	1 301	-66.5
Motor vehicles	1 977	1 793	-9.3
Basic metallurgy	595	3 200	437.8
Food and beverages	2 362	3 629	53.6
Chemical	415	986	137.6
Petroleum, coke and alcohol refining	190	960	405.3
Commerce/Services	10 978	16 128	46.9
Land transportation	4 627	6 411	38.6
Electricity, gas and hot water	2 527	3 505	38.7
Construction	870	1 277	46.8
Commerce and repair of vehicles	731	1 348	84.4
Crop and livestock	2 139	3 215	50.3

Source: BNDES

1/ Includes aircraft industry.

of this heading mainly reflected growth in the housing sector, 5.4%, and in operations carried out by the National Bank of Economic and Social Development (BNDES), 5.8%, in an overall amount of R$146.4 billion, corresponding to 58.4% of total loan operations in the segment of earmarked resources. It is important to stress that credit onlending operations through financial institutions expanded 8%.

In August, the housing credit portfolio reached R$40.1 billion, for growth of 5.4% in the three-month period and 22.6% in 12 months, clearly reflecting the measures taken by the government to breathe greater dynamics into this segment in recent years. In this context, cumulative 12-month disbursements for the period ended in July of this year and backed by savings account resources totaled R$12.5 billion, 79.1% more than in the same period of 2006, while the total number of financed housing units increased approximately 63.9% in the period.

Rural sector financing totaled R$57.4 billion. Compared to May, the 0.6% increase reflected a seasonal decline in credit lines targeted to current agricultural spending operations, coupled with increases in the funds targeted to farm investment and marketing operations.

In the period extending from January to August, BNDES disbursements totaled R$37 billion, for growth of 35.2% compared to the same period of 2006, with positive growth in all economic activity sectors. Financing contracted with the industrial sector totaled R$17.6 billion, up 23.9% in the period. Here, it is important to stress growth in operations with the sectors of basic metallurgy and food and beverages. Loans to commerce and services expanded 46.9%, rising to R$16.1 billion, led by land transportation, energy and commerce and repair of vehicles. Disbursements targeted to crop/livestock activities totaled R$3.2 billion, while those channeled to micro, small and medium businesses reached R$9.9 billion, for respective growth rates of 50.3% and 44% in the period.

Consultations with BNDES, a measuring rod used to estimate potential disbursements for medium and long-term business investments, totaled R$75.6 billion in the first eight months of the year, 23.1% more than in the same period of 2006. For the most part, this performance was determined by 77.2% growth in contacts made by the segment of commerce, including services, with an overall volume of R$43 billion, driven mostly by construction and energy sector demand. Requests submitted by the industrial sector diminished 14.7%, closing at R$29.2 billion.

Here, it is important to emphasize the falloff in requests from the segments of basic metallurgy and other transportation equipment. Consultations related to crop/livestock activity totaled R$3.4 billion, for growth of 15.2% in the period.

Nonearmarked credits

Credit operations based on nonearmarked resources totaled R$590.7 billion in August, for growth of 7.6% in the three-month period and 28.6% over 12 months. Participation of these loans in the overall financial system credit total evolved from 69.6% in May to 70.2% in August.

The behavior of nonearmarked credits was determined mainly by growth in operations with individual borrowers, which expanded 8% in the three-month period and 30.1% over 12 months, closing with a total of R$290.3 billion. The share of interest rate reference credits represented 78.1% of total loans based on nonearmarked resources granted to individual borrowers. Among these operations, the most important were payroll-deducted loans, with growth of 6.7% in the three-month period and 37.7% over 12 months. Aside from these operations, mention should also be made of 6.2% three-month growth in auto loans, fully consistent with the strong upward movement registered under both production and sales of the automotive sector.

Aside from growth in reference credits, the performance of the portfolio based on nonearmarked resources targeted to individual borrowers registered sharp expansion in leasing operations. In this context, the balance of leasing operations reached R$21.8 billion in August, for growth of 17.5% in the three-month period and 79.8% over 12 months. (See box National Financial System Leasing Operations).

Mention should also be made of the performance of the component entitled "others" in the segment of individual borrowers. This heading posted the highest quarterly growth rate and incorporated credit card purchases with both immediate payment and installment payment without interest. These operations have expanded considerably, reflecting growth in the credit card market that has been sustained mainly by expansion in the client base and an abundant supply of credit.

Loans targeted to corporate entities totaled R$300.3 billion in August, reflecting 7.3% growth compared to May and 27.2% over 12 months. Credit modalities referenced to foreign currencies posted the strongest growth in the three-month period, with 13.5%, reaching a total of R$65.9 billion.

Table 3.4 – Nonearmarked credit operations

R$ billion

	2007				% growth	
	May	Jun	Jul	Aug	3 months	12 months
Total	548,7	557,3	572,8	590,7	7,6	28,6
Corporations	279,9	284,9	290,1	300,3	7,3	27,2
Domestic funding	221,9	227,5	229,8	234,4	5,7	26,8
Reference credit[1/]	173,0	177,7	180,0	181,9	5,2	22,4
Leasing	23,3	24,9	26,7	28,9	23,6	70,5
Rural	2,0	2,0	1,9	1,8	-6,7	-11,3
Others	23,6	22,9	21,2	21,8	-7,5	26,4
External funding	58,1	57,4	60,3	65,9	13,5	28,7
Individuals	268,8	272,5	282,7	290,3	8,0	30,1
Reference credit[1/]	215,4	217,4	221,9	226,7	5,2	23,1
Credit unions	10,8	11,0	11,2	11,5	6,6	24,5
Leasing	18,5	19,3	20,3	21,8	17,5	79,8
Others	24,1	24,8	29,2	30,4	26,3	72,2

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

Figure 3.7 – Interest rates on nonearmarked credit

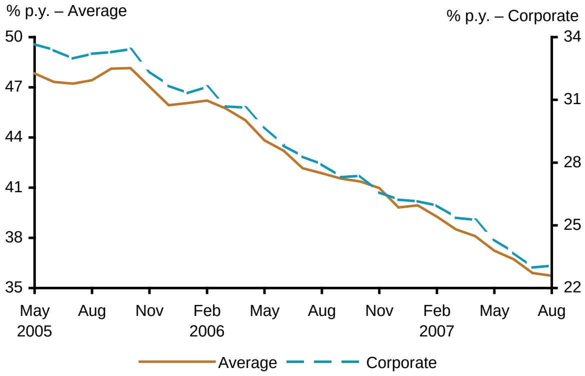
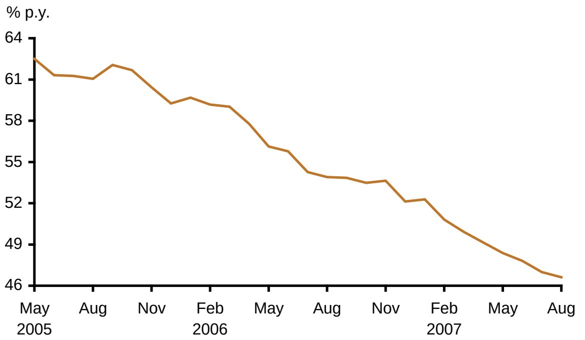


Figure 3.8 – Interest rates on fixed-rate credit – Individuals



National Financial System Leasing Operations

As one of the most dynamic types of credit operation, leasing has expanded sharply since 2004 and now plays a highly important role in productive sector investments, while also meeting family credit demand, particularly as regards vehicle acquisitions.

In August 2007, the overall balance of leasing contracts reached R$50.6 billion, for cumulative growth of 475.5% since January 2004. The relative participation of leasing in total credits based on nonearmarked resources rose from 4.1% in December 2004 to a current level of 8.6%. In the last 12 months, the balance of these operations expanded 74.4%, while such similar modalities as auto loans granted to individual buyers and loans for acquisitions of goods by corporate entities expanded 23.2% and 18.7%, respectively.

Figure 1 – Leasing operations – Volume

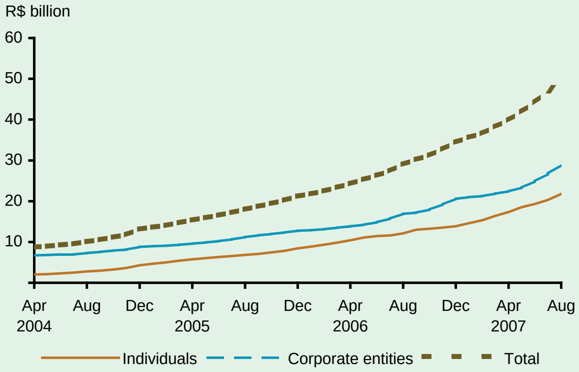
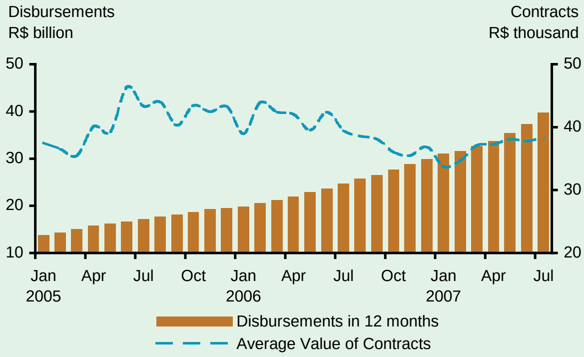


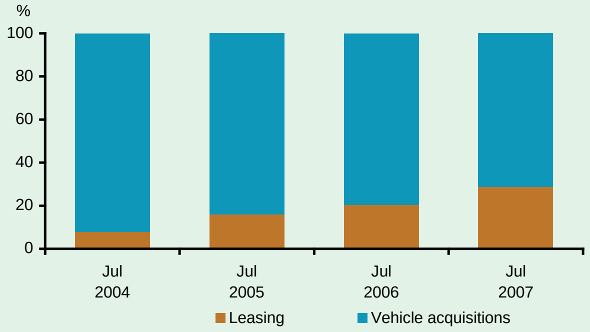
Figure 2 – Leasing operations



Source: Abel

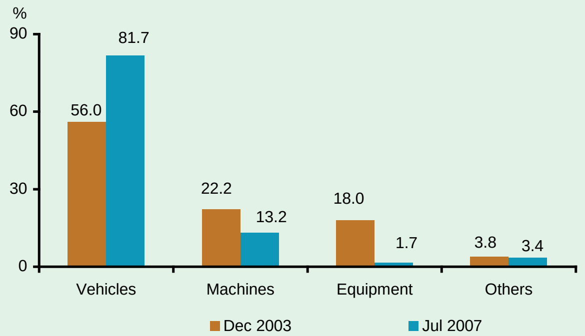
The growing participation of leasing operations among available alternatives for financing goods and vehicles is demonstrated by data on new contracting operations. In the 12-month period through July 2007, leasing operations approved totaled R$39.7 billion, including R$24.2 billion for individual borrowers and R$15.5 billion for legal entities, according to data released by the Brazilian Association of Leasing Companies (Abel). In the same time span, disbursements to corporate entities in the form of traditional bank loans for acquisitions of goods and to individual borrowers for vehicle acquisitions closed at respective totals of R$52.9 billion and R$60.3 billion. At the same time, the participation of contracts involving automotive vehicles in total operations increased from 56% in December 2003 to 81.7% in July 2007. In the opposite sense, the share involving machines, equipment and computer products dropped from 40.2% to 14.9%, using the same type of comparison.

Figure 3 – Individuals: disbursements in twelve months



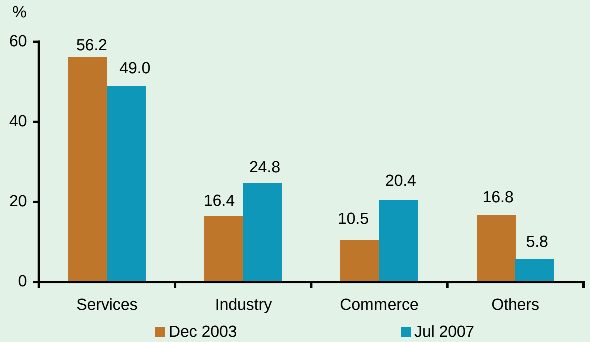
Source: Abel

Figure 4 – Leasing operations by kind of goods



Source: Abel

Figure 5 – Leasing by borrower's corporate entities



Source: Abel

One should stress that the cutback in interest rates and the availability of longer maturities in both traditional bank loans and leasing operations have had a positive impact on both segments. Rates for vehicle acquisitions by individual borrowers, which were quite similar to those on leasing operations targeted to the same purpose, dropped from 37.4% per year in the month of May 2005 to 28.7% per year in August 2007, while the average maturity of these contracts increased from 471 days to 572 days.

Broken down by borrower category, the balance of leasing operations with individual borrowers expanded 79.9% over 12 months, basically reflecting contracts in the automotive vehicle segment. In the same time period, the stock of financing operations contracted with corporate entities expanded 70.5%, concentrated mainly among companies that owned vehicle fleets. Distribution of the balance of leasing operations with corporate entities at the end of July showed that service companies accounted for 49%, industry for 24.8% and commerce for 20.4%.

In August, leasing companies, which account for 71.9% of total credits in this segment classified 94.8% of their operations as performing and 1.6% with arrears of more than 90 days. In the same period, National Financial System defaults closed at 3.4%, while 91.4% of operations were classified as performing.

The intensified use of leasing operations is reflected in the recent performance of debenture issues, the major instrument used in funding this segment. Issuances of securities registered at the Securities and Exchange Commission (CVM) added up to R$140 billion in the last three years, of which 68% corresponded to placements made by leasing companies. These securities were absorbed primarily by institutional investors and investment funds. A significant volume of their own resources was also involved, as demonstrated by the evolution of the net worth of leasing companies, which expanded 292.4%, reaching a level of R$41.4 billion in August 2007.

It is also important to highlight that the robust performance of the leasing market has benefited from a 2003 decision taken by the Higher Court of Justice (STJ), which recognized the legality of permitting installment payments of the Guaranteed Residual Value (VRG)[1] in leasing operations. Until that time, the controversy in the judicial environment had restricted expansion of these operations, which had declined steadily since 1999.

1/ Contractually stipulated amount for exercising the purchase option of the leased good or the amount contractually guaranteed by the lessee as the minimum amount that will be received by the lessor in the sale of the leased good to a third party, in those cases in which the purchase option is not exercised (MF Directive 564/78).

Figure 3.9 – Average spread on nonearmarked credit

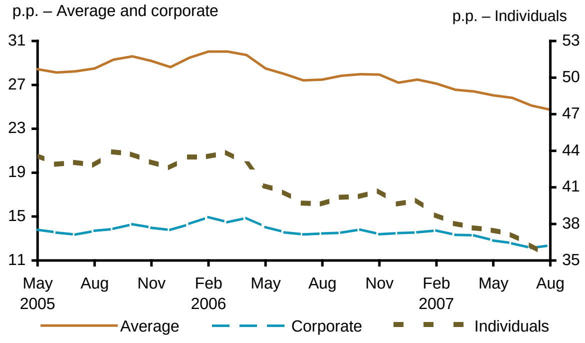
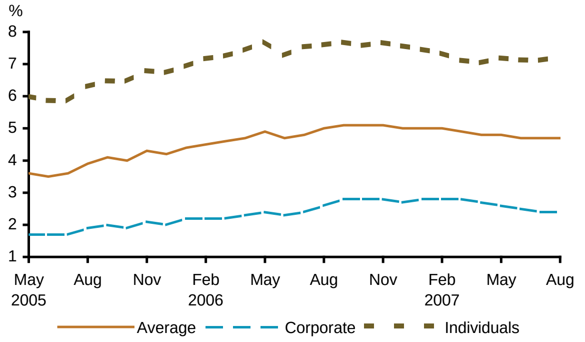
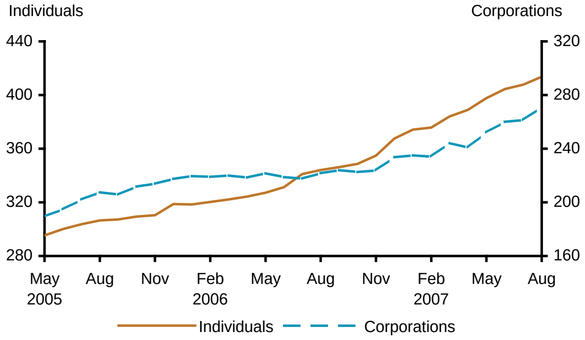


Figure 3.10 – Credit default rates[1/]



1/ Nonearmarked credit in arrears of more than 90 days.

Figure 3.11 – Average term of credit operations – Calendar day



Here, it is important to stress the increases registered in external onlending operations, with growth of 24.4% in the three-month period and 42.7% over 12 months, together with increased financing of imports, with respective levels of 23% and 37.5%.

The volume of modalities based on domestic resources reached R$234.4 billion, with growth of 5.7% in the three-month period. This result was mainly a consequence of 5.2% growth in credit reference operations, which accounted for 77.6% of total domestic resources, reflecting 10% growth in operations involving working capital, the major item in this segment. The balance of leasing operations reached R$28.9 billion, for growth of 23.6% in the three-month period and 70.5% over 12 months. In this case also, mention should be made of vehicle leasing operations.

In line with the more flexible monetary policy, the average rate of interest on credit reference operations dropped 1.5 p.p. in the three-month period ended in August, the lowest rate since the statistical series was first calculated in June 2000.

The average cost of operations with individual borrowers dropped 1.8 p.p. in the three-month period ended in August, closing with 46.6% per year, also the lowest level since the statistical series was first calculated in July 1994. Rate reductions were registered in all of the different modalities in this segment, with a particularly strong drop under personal loans, 1.8 p.p., vehicles, 1.1 p.p. and special overdraft checks, 0.8 p.p. One should highlight the importance of steady growth in payroll-deducted loans to the drop in credit cost for individual borrowers. In the segment of corporate borrowers, average charges declined 1.2 p.p. in the period, closing at 23.1%, the lowest level since June 2000.

Accompanying the cycle of declining rates, the banking spread reached 24.7 p.p. in August, a drop of 1.3 p.p. compared to May. This result reflected declines of 0.4 p.p. and 2.2 p.p., respectively, in the spreads of the segments of corporate entities and individual borrowers, which closed at 12.4 p.p. and 35.3 p.p. In the segment of individual borrowers, the spread reached its lowest level since July 2004.

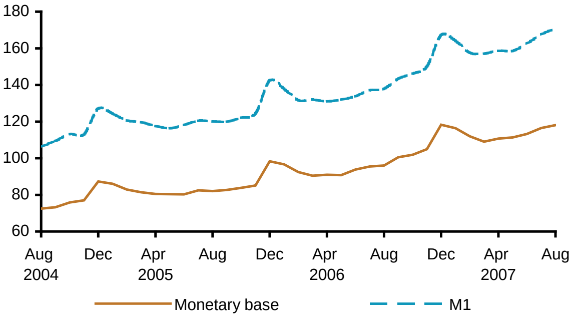
Including only arrears of more than 90 days, defaults in the segment of reference credits dropped 0.1 p.p. in the last three months and closed August at 4.7%. This result was a consequence of a 0.2 p.p. reduction in the segment of corporate entities, which closed at 2.4%, and of stability in arrears involving operations with individual borrowers, with 7.2%.

The average term of credit operations based on nonearmarked resources closed August at 339 days, compared to 280 days in the same month of 2006. In the segment of individual borrowers, the maturity term of operations increased 70 days, closing at 414 days. Above all else, this was impacted by growth in the modality of personal loans. The average term in operations with corporate entities reached 271 days, an increase of 49 days in the period, reflecting growth in operations involving working capital. The average terms registered in August represented the high points of the respective statistical series, both for individual borrowers and corporate entities, with respective increases of 105 and 135 days, compared to their low points. It should be mentioned that this situation occurred despite increased market volatility since mid-June.

3.2 Monetary aggregates

Figure 3.12 – Monetary base and M1 – Average daily balances

R$ billion

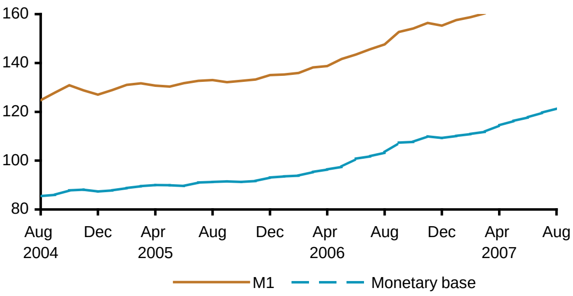


The average daily restricted money supply (M1) balance reached R$169.9 billion in August. The 23.2% growth rate registered in the last 12 months reflected increases of 19.3% in the average balance of currency held by the public and 25.7% in demand deposits.

When one considers seasonally adjusted data deflated by the IPCA, M1 expanded 5.6% in the three-month period ended in August, compared to the three-month period ended in May. The upward trajectory of this aggregate was driven by the level of economic activity and, more specifically, by the pace of growth in credit operations.

Figure 3.13 – M1 and monetary base at August 2007 prices seasonally adjusted[1/]

R$ billion



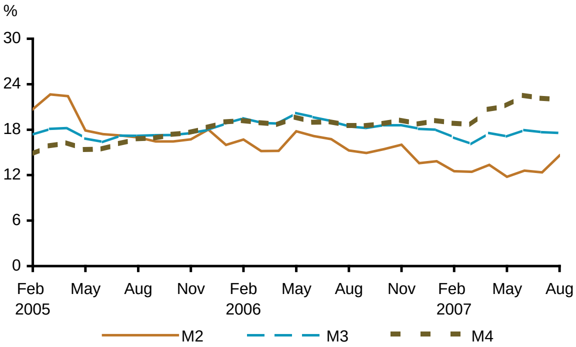
1/ Deflated by IPCA.

Evaluated according to average daily balances, the monetary base totaled R$117.4 billion in August, a level compatible with the trajectory of M1. The 22.3% rate of 12-month growth was caused by an increase of 18.8% in the average balance of currency issued and 30.5% in banking reserves.

With regard to the sources of primary currency issues in the three-month period ended in August, external sector operations expanded R$37.1 billion, as a result of net Central Bank exchange purchases on the interbank market. Moving in the opposite direction, contractionary impacts were registered as a result of National Treasury operating account transactions, R$9 billion, and other operations with the financial system, R$2.4 billion. In this segment, the highlights were reserve requirements of R$1.6 billion on deposits of the Brazilian System of Savings and Loans (SBPE) and R$1 billion in additional reserves on deposits. These factors, coupled with net placements of federal public securities in the amount of R$19.5 billion, resulted in R$6.2 billion in the monetary base growth in the three-month period, utilizing end-of-period balances.

In the M2 concept, which aggregates investment deposits, savings deposits and securities issued by financial institutions into M1, the money supply increased 4.8% compared to May and 14.6% when viewed against August 2006. The balances of savings accounts and private securities expanded 6.3% and 2.8%, respectively, in the three-month period.

Figure 3.14 – Broad money supply – 12-month growth



The balance of M3, which aggregates fixed income fund quotas and the federal public securities used as backing for the net financing position in repo operations carried out between the public and the financial sector into M2, posted a high of 3.4% compared to the month of May, closing at R$1.5 trillion. M4, which encompasses M3 plus public securities held by nonfinancial entities, registered a balance of R$1.8 trillion in August, posting growth of 4.2% in the three-month period and 22.6% in 12 months.

Federal public securities and Central Bank open market operations

National Treasury (TN) primary public security operations had an expansionary monetary impact of R$22.5 billion in the three-month period ended in August, as a result of R$93.9 billion in maturities, anticipated redemptions of R$4.6 billion and placements of R$75.9 billion in Internal Federal Public Securities Debt (DPMFi). Parallel to this, operations involving security exchanges were carried out in the amount of R$31.9 billion, of which 37% consisted of National Treasury Bills (LTN).

Continuing the process of substituting exchange-indexed securities and floating-rate securities by securities with fixed-rate earnings and inflation-linked securities, placements were concentrated in National Treasury Notes – Series B (NTN-B), with 32.8% of the total, and National Treasury Notes – Series F (NTN-F), representing 25.2% of total issuances. Since they are typically medium and long-term papers, the fact that these securities are well accepted by the market not only minimizes long-term financing costs, but also helps to lengthen average DPMFi maturities and, in this way, reduce National Treasury refinancing risk. At the end of

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

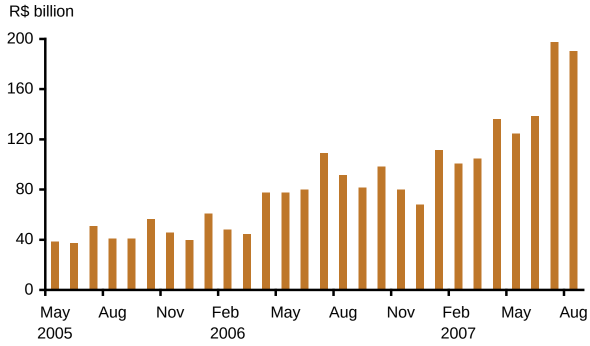


Figure 3.16 – Central Bank repo operations – Volume by maturity – End-of-period

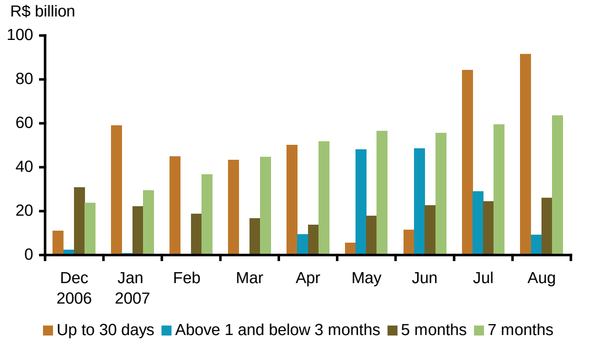
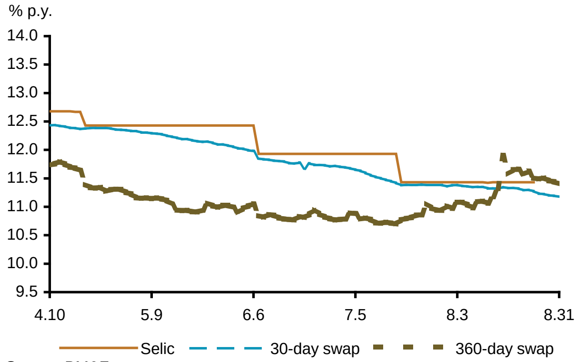
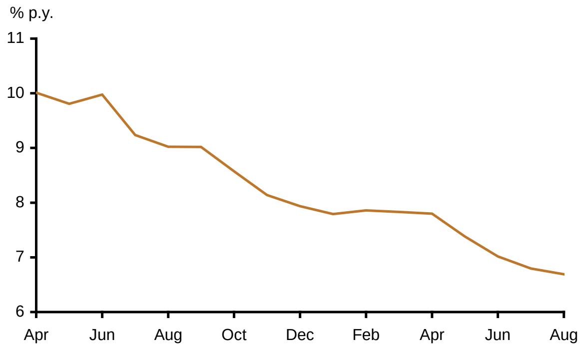


Figure 3.17 – Selic x swap ID x Pre



Source: BM&F

Figure 3.18 – *Ex-ante* real interest rate – Deflated by 12-month IPCA expectations



August, average maturities rose to 35.2 months, compared to 33.3 months at the end of May. As regards the debt profile, reinforcing the trend evident in the second quarter of 2007, fixed-rate securities accounted for the major share with 36.4% of DPMFi, and floating-rate securities represented 35.3% of the total debt on the market.

At the end of August, the net financing position of the monetary authority in federal public securities reached a daily average balance of R$189.1 billion, against R$130.2 billion in May. For the most part, this growth was tied to sterilization of both primary National Treasury operations and foreign currency purchases made by the monetary authority.

Reflecting increased uncertainties on the international scenario, which to a certain extent impacted market interest rates in Brazil, management of banking liquidity through repo operations was concentrated in very short-term operations, as the average balance expanded from R$5.7 billion in May to R$90 billion in August. One should stress that this growth was a consequence of LTN maturities totaling R$49.5 billion on the first business day of July, when the overall net financing position reached R$198.2 billion. In the case of maturities from 1 to 3 months, 5 months and 7 months, the average daily balance in the quarter varied from R$48.1 billion to R$9.7 billion; from R$17.8 billion to R$26.2 billion; and from R$56.6 billion to R$63.3 billion, respectively.

Further strengthening its active position as regards federal public debt exchange exposure, the Central Bank offered US$4.6 billion in reverse exchange swaps in the three-month period ended in August. Furthermore, mention should also be made of US$3 billion in maturities of this instrument and US$35.5 million in exchange securities. When swap operations are considered, the position of the debt exposed to exchange variations remained relatively stable, moving from -2.2% in May to -2.1% of total DPMFi in July.

Real interest rates and market expectations

Following successive rate reductions in the interest curve for all vertices, future interest rates of ID x pre swap contracts registered an inversion of the interest curve as of the 240 day vertex. The 360 day ID x pre swap contract registered an increase of 41 basis points, moving to 11.4% per year at the end of August, compared to 10.99% per year at the end of May. Among other factors, the reasons underlying this result were the increase in the level of investor uncertainty as evident, among other factors, in the country risk increase, which averaged 173 points in the three-month period ended in August, compared to 163 points in the previous three month period.

The real ex-ante Selic rate of interest for the coming 12 months, calculated on the basis of the Central Bank's August 31 market survey reached 6.7% per year, against 7.38% per year at the end of May.

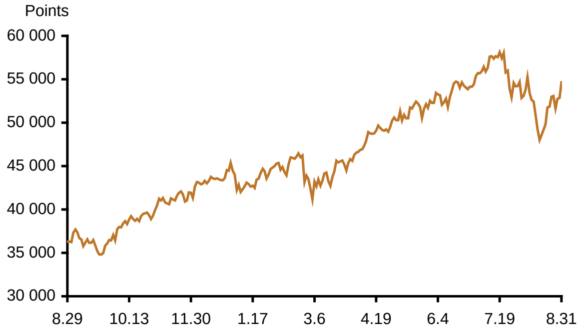
Capital market

The performance of the São Paulo Stock Exchange Index (Ibovespa), which had set successive closing records since March, reflected the volatility of international exchanges. At the end of August, the Ibovespa had increased 4.5% compared to the May position, closing at 54,637 points after fluctuating between a maximum of 58,124 points and a minimum of 48,015 points in the period. The average daily volume of trading at the São Paulo Stock Exchange (Bovespa) totaled R$5.1 billion in the three-month period ended in August, corresponding to an increase of 23.6% compared to the previous three-month period, and reached its maximum value of R$18.4 billion on August 15.

In dollar terms, the Ibovespa expanded 2.8% compared to the three-month period ended in May. In the same time span, the Dow Jones and Nasdaq indices posted reductions of 2% and 0.3%, respectively.

Total business financing through capital markets, including issuances of stocks, debentures, commercial papers and placements of receivables-backed funds, totaled R$46.5 billion in the three-month period ended in August. In recent years, growth in the use of debentures as an instrument for obtaining capital market funding has to some extent been generated by significant issuances by leasing companies. These companies accounted for 73% of issues in the first eight months of 2007, with a total amount of R$29 billion, against R$44.2 billion in the same period of 2006. Inflows through stocks and credit rights reached respective levels of R$13.2 billion and R$2.7 billion in the three-month period ended in August, compared to R$5.5 billion and R$3.3 billion in the corresponding period of the previous year.

Figure 3.19 – Ibovespa



Source: Bovespa

Figure 3.20 – Stock exchanges

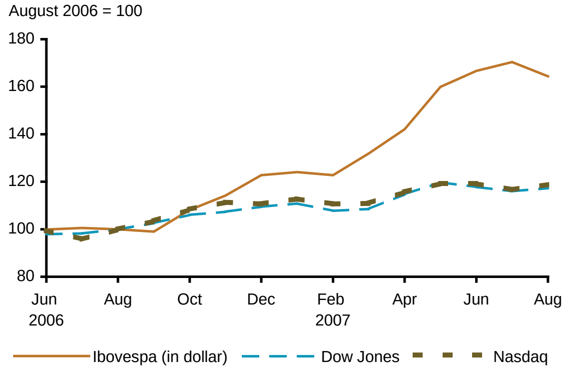
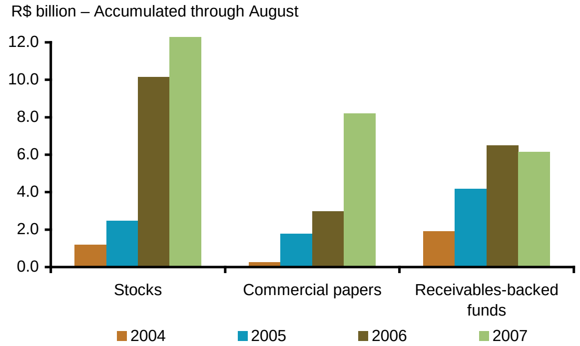


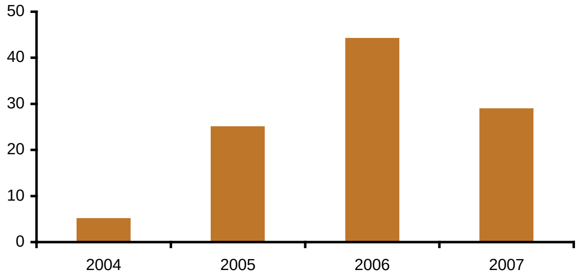
Figure 3.21 – Primary issues in the capital market



Source: CVM

Figure 3.22 – Debenture primary issues in the capital market

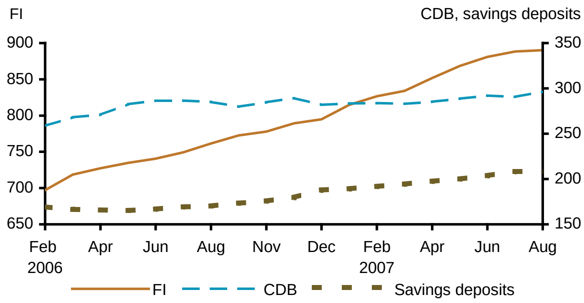
R$ billion – Accumulated through August



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

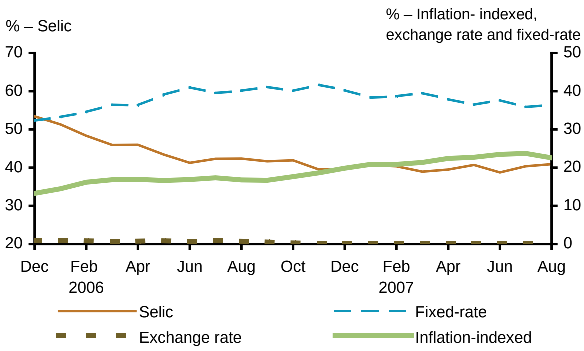
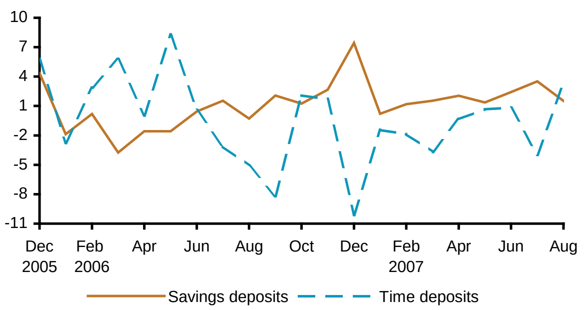


Figure 3.25 – Net inflow – Savings deposits and time deposits

R$ billion



Financial investments

Considering investment funds, time deposits and savings accounts, the balance of resources in financial investments reached R$1.5 trillion in August, for increases of 4.2% compared to May and 19.9% in 12 months.

When one includes exchange funds, short-term funds, fixed income funds, multimarket funds and referenced funds, the net worth of investment funds totaled R$889.2 billion in August, with 2.4% growth in the three-month period. It is important to highlight that the financial market turbulence that marked mid-August reduced the profitability of several different classes, resulting in net inflows of R$4.8 billion by referenced funds which had posted net withdrawals of R$11.1 billion through the end of July 2007. Relative participation of the fixed income, multimarket and referenced modalities came to 51.3%, 26.5% and 19%, respectively, in terms of their August positions.

The composition of the consolidated investment fund portfolio remained concentrated in public securities, with 57% of the total. Among private securities, the participation of corporate bonds has been increasing, moving from 4.9% in May to 5.1% on August 28, while the share held by bank securities dropped from 11.2% to 10.8%.

The net worth of extramarket investment funds, which administer the resources belonging to federal indirectly administered entities, totaled R$24.9 billion in August, corresponding to quarterly growth of 2.3%, despite net redemptions of R$101.9 million.

Notwithstanding financial market volatility and lesser stock profitability, the consolidated net worth of investment funds focused specifically on the variable yield market expanded 13% in the three-month period ended in August, with a total of R$123 billion. The net worth of Mutual Privatization Funds (FMP-FGTS) and Mutual Privatization Funds – Free Portfolio (FMP-FGTS CL) added up to R$13.4 billion, for growth of 10.6% compared to the May position.

In the three-month period under consideration, the balance of savings accounts expanded 6.4%, closing with R$212.8 billion, primarily as a result of net inflows of R$9.2 billion in the period. Over the same time span, time deposits expanded 3.2% to a level of R$298.1 billion, posting a net inflow of R$1.4 billion at the end of the three-month period.

3.3 Fiscal policy

The 2008 Budget Guidelines Law (LDO) was promulgated in August, determining that the public sector primary surplus target would be maintained at 3.8% of GDP. On a segment-by-segment basis, the targets were set at 2.2% for the Central Government, 0.65% for state-owned federal companies and 0.95% for regional governments and state-owned corporations at the state and municipal levels. The limit imposed on deductions of spending included in the Pilot Investment Project was expanded from R$11.3 billion forecast for the current year to R$11.8 billion.

Also in the month of August, the government sent the 2008 Annual Budget Law (LOA) and the Multi-Annual Plan (PPA) for the 2008/2011 period to the National Congress. The 2008 LOA bill determines that revenues and spending will increase as a percentage of GDP, maintaining the primary surplus determined in the 2008 LDO. For the medium-term, the PPA forecasts a reduction in primary revenues and expenditures.

Discussions are moving forward at the National Congress regarding extension of the Provisional Contribution on Financial Operations (CPMF) and the Release of Federal Government Resources Entitlements (DRU), since the validity of these two items expires at the end of the year. In order to maintain the plans and projects foreseen for the coming years, the government's intention is to extend them through 2011.

Public sector borrowing requirements

The cumulative nonfinancial public sector primary surplus through July 2007 reached R$79.6 billion, equivalent to 5.58% of GDP, suggesting compliance with the target surplus defined for the year. The increase of 0.76 p.p. of GDP, compared to the surplus registered in the same period of 2006, indicates the improvement achieved in the results of all of the various public sector segments. The cumulative surplus over the last 12 months reached 4.37% of GDP.

Table 3.5 – Public sector borrowing requirements – Primary result – January-July

	2004		2005		2007	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central government	-46.0	-3.8	-42.1	-3.2	-49.1	-3.4
Sub-national gov.	-14.9	-1.2	-13.2	-1.0	-21.8	-1.5
State companies	-7.8	-0.6	-7.4	-0.6	-8.7	-0.6
Total	-68.7	-5.7	-62.8	-4.8	-79.6	-5.5

The performance of the Central Government reflected a revenue increase of 13.2%, generated by the more intense pace of economic activity, increased overall wages and inflows resulting from programs that allow for installment payments of debts with the Federal Revenue Secretariat of Brazil (RFB), the Office of the Attorney General of the National Treasury and INSS.

Figure 3.26 – National Treasury gross revenue
Accumulated up to July

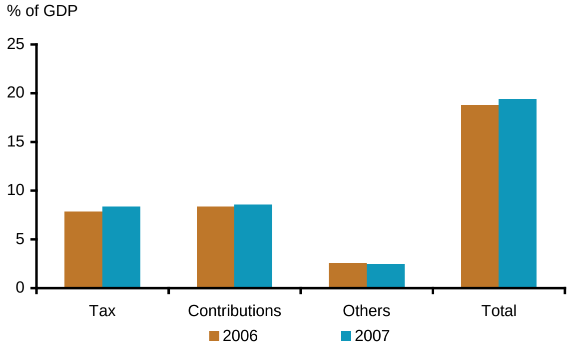


Figure 3.27 – Main economic sectors of RFB inflow (Jan-Jun/2007)

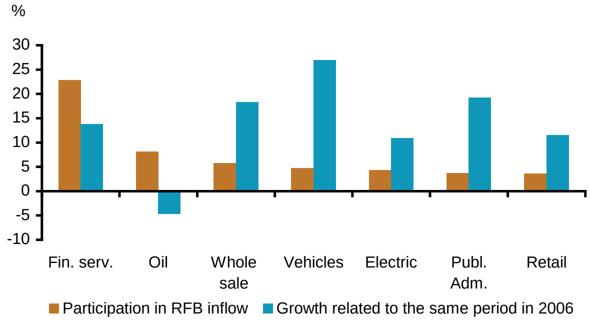


Table 3.6 – National Treasury expenditures
January-July

Itemization	2006		2007	
	R$ million	% GDP	R$ million	% GDP
Total	123 087	9.46	139 514	9.79
Personnel and social charges	58 308	4.48	66 448	4.66
Capital and current expenditures	64 424	4.95	72 828	5.11
Worker Support Fund	7 567	0.58	9 200	0.65
Subsidies and economic subventions	4 700	0.36	3 662	0.26
Loas/RMV	6 481	0.50	7 667	0.54
Other capital expenditures	45 676	3.51	52 299	3.67
National Treasury transfers to the Central Bank	354	0.03	238	0.02

Source: STN

Compared to the first seven months of 2006, Treasury revenues expanded 0.6 p.p. of GDP and were impacted by growth in the inflow of the Corporate Income Tax and the Social Contribution on Net Profits (CSLL), generated primarily by increased business profits, particularly in the automotive vehicles sector, and by renewed regular payments of these taxes by the financial sector, which had been suspended as a result of judicial demands.

The increase in automobile sales drove growth in payments of both the Industrialized Products Tax (IPI), which increased 17.3% in the period, and the Contribution to Social Security Financing (Cofins), 11.1%. Among federal taxes, one should also stress 37% growth in the individual income tax inflow, primarily as a result of increased payments on capital gains in property transfer operations; together with 10.4% growth in the income withholding tax, driven by growth in the tax levied on remittances abroad, other earnings and labor earnings. It is important to note that the final item was impacted by growth in overall wages.

Moving in the opposite direction, exchange appreciation and reductions in international oil prices contributed to a worsening of revenue inflows derived from royalties and special participation in the working and production of oil and natural gas reserves. As a result, the total inflow of financial compensation quotas dropped R$1.1 billion, compared to the previous year. Revenues on dividends also dropped in the first seven months of 2007, reflecting reductions in dividend payments by state-owned financial companies.

It is important to stress that, among the major sectors responsible for the inflow of taxes administered by the RFB, only oil derivatives and biofuels registered inflow reductions of approximately 4.7% in the first seven months of 2007. However, this sector remained the second most important source of federal taxes collected by the RFB, surpassed only by financial services. It is important to stress that the sector of automotive vehicles accounted for the largest increase in the tax inflow, when all of the major sectors are considered.

In the first seven months of the year, Treasury spending increased 0.33 p.p. of GDP, when compared to the corresponding period of 2006. In nominal terms, the increase came to R$16.4 billion, of which R$8.4 billion consisted of current and capital spending and R$8.1 billion of outlays on personnel and payroll charges.

Figure 3.28 – Federal Government: investment expenditures paid up to July

R$ billion

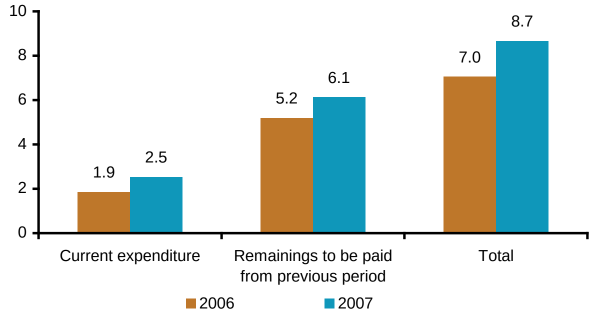


Figure 3.29 – Federal government: investment expenditures paid by body in 2007

R$ billion

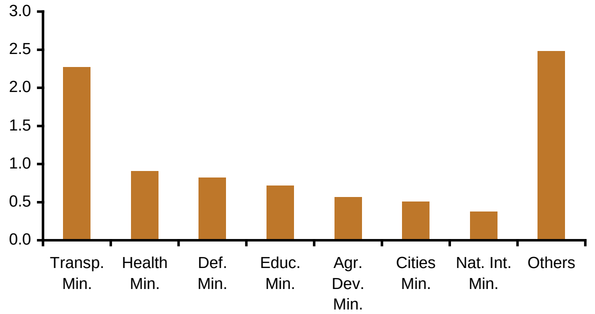
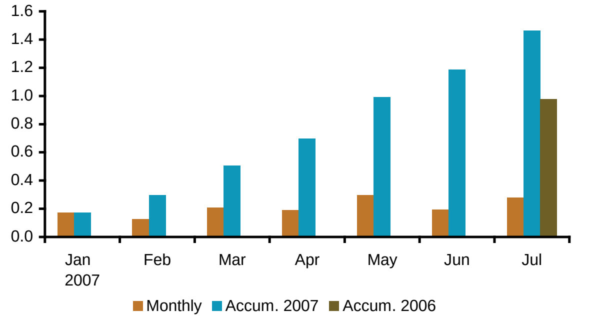


Figure 3.30 – Basic Investment Project (PPI) expenditures

R$ billion



Growth in outlays on personnel and payroll charges reflected a 13.6% executive branch wage increase, consequent upon the restructuring of civilian and military civil-service careers. Increased outlays in the legislative and judiciary branches and those of the Federal Public Prosecutor's Office reached 4.6%, to some extent reflecting the reduction in judicially determined payments to federal and labor court personnel.

In the first seven months of 2007, current and capital spending increased 0.16 p.p. of GDP. Here, it is important to highlight the 0.06 p.p. of GDP increase in FAT outlays, as a result of the minimum wage increase and the rise in the number of benefit payments from 11.8 million to 14.1 million. These two factors also contributed to an 18.3% increase in outlays on assistance benefits in the framework of the Social Assistance Law (Loas)/Lifetime Monthly Income (RMV), which expanded 0.04 p.p. of GDP, compared to the first seven months of 2006.

Spending on subsidies and economic grants declined in 2007, primarily as a result of the fact that there was no corresponding operation to the R$1.5 billion capitalization of Emgea in 2006. Spending on such programs as Rural Investments and Federal Government Acquisitions also declined. As a result of these factors, the total volume of spending on subsidies and grants declined more than R$1 billion.

Other current and capital outlays, including investments and other discretionary spending, such as programs aimed at combating poverty, expanded 14.5% in the first seven months of 2007.

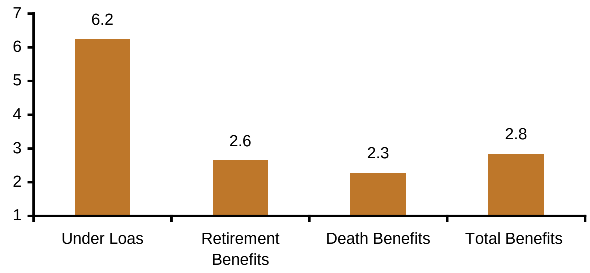
Specifically with regard to investments, it is important to highlight that both spending defined in the budget for the year and outlays to be made with funds set aside in previous fiscal years increased in 2007. Overall growth reached 22.9%, with spending in the fiscal year itself increasing 33.1%, reflecting the effort to accelerate public sector investments, as determined by current spending guidelines. The Ministry of Transportation concentrated 26.3% of federal government investment outlays in 2007, followed by the Ministries of Health and Defense.

Outlays included in the Investment Pilot Project that can be deducted from the primary surplus target defined for the year increased 49.6% in 2007, closing the month of July at R$1.5 billion. According to Budget Guidelines Law, the limit for deductions from the primary surplus target in the year is R$11.3 billion.

Table 3.7 – Social security primary result

			R$ billion
Itemization	2006	2006	2007
		Jan-Jul	Jan-Jul
Gross inflow	133.7	70.8	82.0
Cash refunds	-0.5	-0.2	-0.3
Transfers to third parties	-9.7	-5.7	-7.7
Net inflow	123.5	65.0	74.0
Social Security benefits	165.6	87.4	98.0
Primary Result	-42.1	-22.4	-24.0
Primary Result/GDP	-1.81%	-1.72%	-1.68%

Figure 3.31 – Growth in the average quantity of benefits granted by Social Security (Jan-Jul 2007/Jan-Jul 2006)



Source: STN

Figure 3.32 – Transfers to states and municipalities
Accumulated up to July

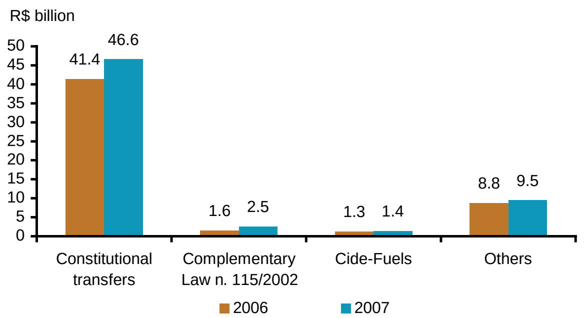
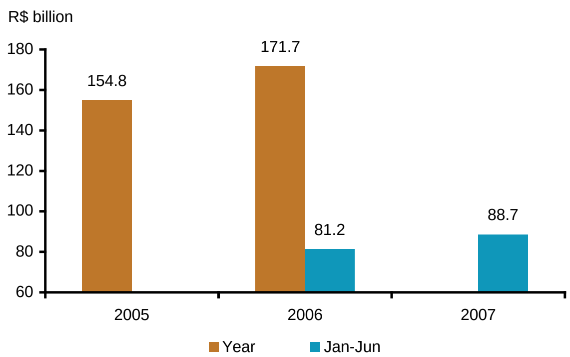


Figure 3.33 – ICMS inflow



In the first seven months of the year, the Social Security deficit reached R$24 billion, corresponding to a reduction of 0.04 p.p. of GDP, compared to the result for the same period of 2006. The net inflow increased 14%, driven by 15.6% growth in revenues earned on Social Security contributions, which reached 5.2% of GDP. This result was, above all else, driven by the increase in overall wages and the formal employment level.

Nominal growth in the Social Security deficit reflected an increase of 12.2% in outlays on benefits, which totaled R$98 billion in the first seven months of 2007, corresponding to 6.9% of GDP against 6.7% in the corresponding period of 2006. Basically, this evolution was a consequence of growth in the average value of benefits paid, as a result of the minimum wage increase and growth in benefits above the floor value, together with 2.8% expansion in the average monthly number of benefits paid.

In the first seven months of 2007, transfers to states and municipalities expanded 13%, compared to the same period of 2006 and closed at 4.22% of GDP. Transfers to constitutional funds followed growth in shared taxes and increased 12.5%. Here, one should stress growth of 60.9% in funding transferred as a result of reductions in export taxes.

Revenues earned through the Tax on the Circulation of Merchandise and Services (ICMS), the major state-level tax, increased 9.2% in the first half of 2007, closing at R$88.7 billion. The inflow of this tax in the southeast, central-west and north regions of the country increased at rates higher than the average.

With the increases registered in transfers and ICMS inflows, the primary surplus registered by regional governments expanded at a rate equivalent to 0.51 p.p. of GDP, mainly at the level of state governments. This was the best result since the statistical series was first calculated in 1991.

The primary surplus of state-owned companies in creased 0.04 p.p. of GDP in the first seven months of 2007, closing at R$8.7 billion, mostly as a result of economic improvement which has favored the performance of state-owned companies.

Nominal interest appropriations in 2007 reflected reductions in the Selic rate and alterations in the net debt profile, as fixed-rate securities and inflation-linked securities increased their participation. With these two factors, nominal interest

Figure 3.34 – Percentage growth of ICMS inflow per region
Jan-Jun 2007/Jan-Jun 2006

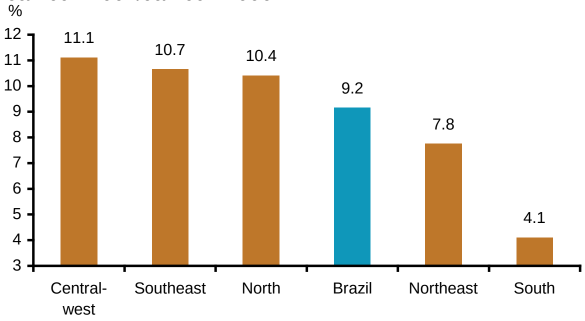
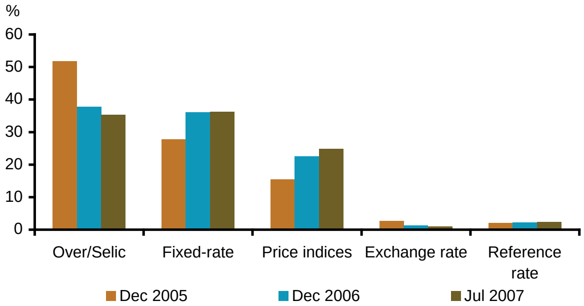


Table 3.8 – Public sector borrowing requirements – January-July

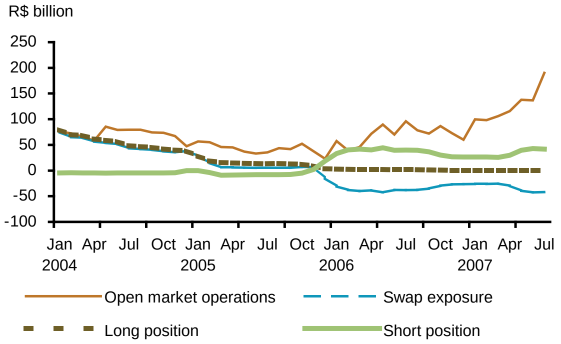
Itemization	2006		2007	
	R$ billion	% GDP	R$ billion	% GDP
Uses	32.3	2.5	13.4	0.9
Primary	-62.8	-4.8	-79.6	-5.5
Interest	95.1	7.3	92.9	6.5
Sources	32.3	2.5	13.4	0.9
Domestic financing	97.5	7.5	180.6	12.6
Securities financing	110.7	8.5	209.2	14.6
Bank financing	-7.9	-0.6	-25.9	-1.8
Others	-5.3	-0.4	-2.6	-0.2
External financing	-65.2	-5.0	-167.3	-11.7

Figure 3.35 – Federal securities debt structure by indexing factor1/



1/ It does not include swaps.

Figure 3.36 – Swap and open market position



appropriated has followed a downward curve. In cumulative terms, this reduction was equivalent to 0.79 p.p. of GDP in 2007 through July.

The nominal result for the nonfinancial public sector was a deficit of R$13.4 billion in the first seven months of 2007, compared to a deficit of R$32.3 billion in the corresponding period of 2006. This improvement reflected both growth in the primary surplus and reductions in nominal interest appropriated.

Following the example of previous years, the nominal deficit was financed through steady growth in the securities debt and reductions in other sources of financing, particularly external financing.

Federal securities debt

Evaluated according to the portfolio position, the federal securities debt reached R$1,171.1 billion in July 2007, corresponding to 47% of GDP. Growth of R$19.6 billion compared to the month of April reflected net redemptions of R$15.5 billion in the primary market, the R$1 billion financial impact of 7.7% exchange appreciation in the three-month period ended in July, and incorporation of approximately R$36.1 billion in interest.

In terms of composition, the federal securities debt has registered growth in the participation of fixed-rate securities and inflation-linked securities, in detriment to floating-rate securities. Nonetheless, it is important to acknowledge that financing taken by the Central Bank through open market operations increased from R$60 billion in 2006 to R$190.3 billion in July 2007.

When financing operations are excluded, the amortization schedule of the securities debt on the market at the month of July indicated that 9.8% of its total value will mature before the end of the year; 26.9% in 2008; and 63.3% as of January 2009. The average debt term shifted from 32.7 months in April to 35.6 months in June.

In July, exchange swap operations closed with a negative total of R$41.6 billion. Defined as the difference between the profitability of Interbank Deposits (ID) and exchange-rate growth plus coupon calculated according to the cash criterion, the result of these operations had a negative impact of R$4.2 billion on the Central Bank in the three-month period ended in July 2007, reflecting depreciation of the dollar against

Table 3.9 – 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
	Feb	41 464	42.2	56 883	57.8	98 347	100
	Mar	41 656	39.3	64 281	60.7	105 937	100
	Apr	-5 028	-4.3	120 726	104.3	115 698	100
	May	12 947	9.4	124 885	90.6	137 832	100
	Jun	10 198	7.5	126 562	92.5	136 760	100
	Jul	99 117	52.1	91 202	47.9	190 320	100

Table 3.10 – Net debt growth
Conditioning factors

Itemization	2005		2006		2007- July	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1002 485	46.5	1067 363	44.9	1104 706	44.4
Flows	**Accumulated in the year**					
Net debt – Growth	45 488	-0.5	64 879	-1.5	37 342	-0.5
Conditioning factors	45 488	2.1	64 879	2.7	37 342	1.5
PSBR	63 641	2.9	69 883	2.9	13 363	0.5
Primary	-93 505	-4.3	-90 144	-3.8	-79 578	-3.2
Interest	157 146	7.3	160 027	6.7	92 941	3.7
Exchange adjustment	-18 202	-0.8	-4 881	-0.2	16 578	0.7
Domestic securities debt[1/]	-4 554	-0.2	-2 222	-0.1	-1 727	-0.1
External debt	-13 648	-0.6	-2 659	-0.1	18 305	0.7
Others[2/]	-2 258	-0.1	2 302	0.1	7 370	0.3
Skeletons	3 262	0.2	- 375	0.0	1 296	0.1
Privatizations	-954	0.0	-2049	-0.1	-1265	-0.1
GDP growth effect		-2.6		-4.3		-2.0

1/ Domestic dollar-indexed securities.
2/ Parity of the basket of currencies underlying the net external debt.

the real in the period. Since they were first carried out in early 2002, these operations have generated a favorable impact on the Central Bank in the amount of R$2.1 billion.

Public Sector Net Debt

In July, the Public Sector Net Debt (PSND) totaled 44.4% of GDP, corresponding to a reduction of 0.5 p.p. compared to December 2006. This trajectory suggests that, at the end of the year, the debt/GDP ratio should decline for the fourth consecutive time when annual comparisons are utilized.

The primary surplus was the principal factor underlying the 0.5 p.p. reduction in GDP in the year, followed by the effects of nominal GDP growth and adjustments driven by stock sales. Moving in the opposite direction, mention should be made of incorporation of nominal interest, despite the reduction in value, and the adjustment resulting from cumulative 12.2% exchange appreciation through July.

When open market operations are included, the share of PSND indexed to the Selic rate increased 10.4 p.p. in the first seven months of 2007, while net credits indexed to exchange expanded 12.7 p.p. In recent months, growth in the share tied to net external credits has made it possible to appropriate net interest revenues in the external sector, because of the larger volume of interest revenues appropriated on international reserves, compared to appropriation of interest outlays on the external debt.

The Gross General Government Debt (GGGD) reached 65% of GDP in July. The 0.5 p.p. reduction compared to 2006 reflected the drop of 1.18 p.p. of GDP in the federal government external debt.

3.4 Conclusion

Parallel to the growth trajectory of financial system credit operations, the evolution of monetary aggregates indicates continued growth in internal demand. A more favorable credit supply has stimulated demand for bank resources, particularly involving operations targeted at consumption. In this sense, mention should be made of the strong growth registered in payroll deducted loans, auto loans, leasing operations and credit card transactions. Corporate credit demand has also followed an upward curve, even in a framework of consolidation of primary issuances of private securities on the capital market as an alternative source of long-term financing. Up to the present, growth in credit operations does not seem to have been impacted in any significant way by defaults nor by the increased market volatility noted in recent months.

With regard to earmarked credits, it is important to stress the performance of the home mortgage portfolio backed by savings account resources. The results in this segment clearly reflect measures taken recently by the government, including the possibility of contracting financing at fixed rates in the Housing Financing System framework. Expectations of continued economic stability over the long-term seem to have acted as a catalyst of the credit supply in this area.

With the more flexible monetary policy adopted, the average rate of interest on credit reference operations at the end of the three-month period dropped to the lowest level since the series was first calculated in June 2000, while the banking spread has diminished and the rate of default has stabilized.

Fiscal policy implementation has ensured compliance with the target set for the year, with all indications that this will continue into the coming years. Current fiscal policy guidelines, coupled with the benign macroeconomic scenario, particularly as regards product growth and monetary policy implementation, clearly indicate that the debt/GDP ratio will continue on its downward trajectory.

It is important to note that, by allowing for additional administrative flexibility, the current net debt profile tends to neutralize the effects of the turbulence that has marked the external economic environment, making it possible to avoid adoption of more restrictive fiscal measures in times of stress.

One should emphasize that continued growth in public sector revenues and spending at levels greater than product could generate negative impacts on competitiveness and the private sector’s financing and investment capacity. In this sense, government guidelines, including those underlying the PPA, indicate that this question is being dealt with, going so far as to suggest a return to more moderate rates of growth over the medium-term.

International economy

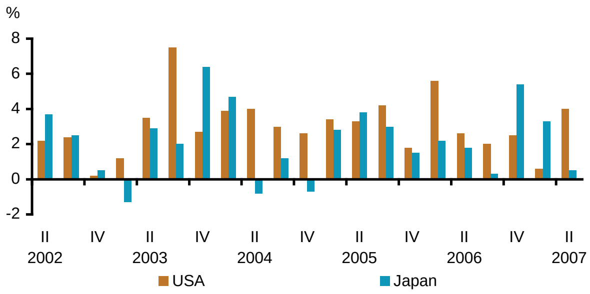
4

The first half of 2007 was marked by continued expansion of world economic activity, reflecting both renewed growth in the United States, particularly in the second quarter of the year, and more accentuated expansion in the Euro Area and Japan, as a result of burgeoning domestic demand. In this framework, the economies of the emerging countries showed steady robust expansion, particularly in the cases of China and India.

However, as United States real estate market defaults ballooned, the overall balance of risk to global growth deteriorated, particularly in terms of the impact of the crisis on financial institutions. Defaults on loans granted in the subprime segment spiraled, provoking successive shocks to the global credit market, with liquidity concentrated in a limited number of institutions, and increased credit costs. Market volatility and risk perceptions increased to historically unprecedented levels, leading major central banks to inject liquidity and, in this way, normalize the system. Though this measure did dampen financial market nervousness somewhat, confidence indicators in various countries were clearly impacted by the effects of this turbulence. Evidently, should this tendency persist or intensify, it would have obvious negative repercussions on global growth.

4.1 Economic activity

Figure 4.1 – USA and Japan – GDP[1/]

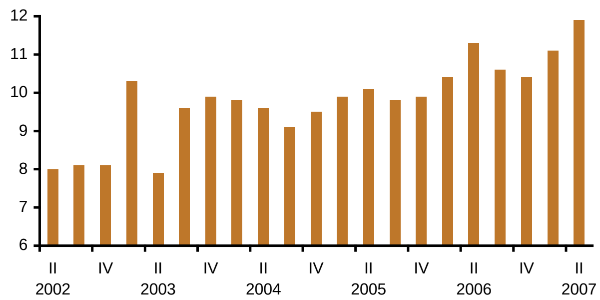


Sources: Bureau of Economic Analysis and Economic and Social Research Institute
1/ Quarterly growth. Seasonally adjusted annualized rates.

United States economic growth turned upward in the second quarter of 2007, while the Chinese economy continued expanding. In that period, the United States posted annualized growth of 4% and the Chinese economy expanded 11.9%, compared to the same period of 2006. In the previous quarter, these rates had closed at 0.6% and 11.5%, respectively.

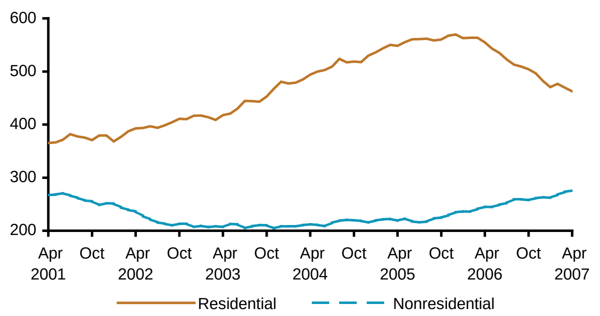
It is important to note that United States economic growth occurred despite a significant drop in consumption, primarily as a result of high gasoline prices, though the decline was

Figure 4.2 – China – GDP[1/]



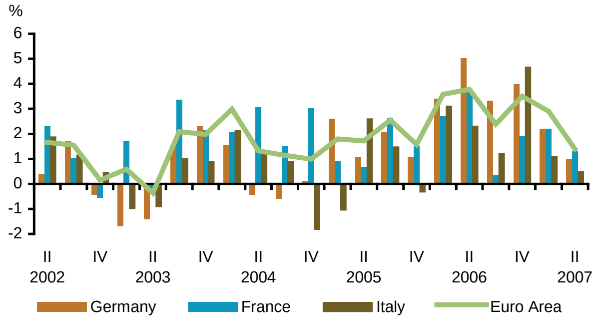
Source: Bloomberg
1/ Growth rate over the same period of preceding year.

Figure 4.3 – USA – Construction spending



Source: Bureau of Census
1/ Annualized. January/2000 constant prices.

Figure 4.4 – Euro Area – GDP[1/]



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

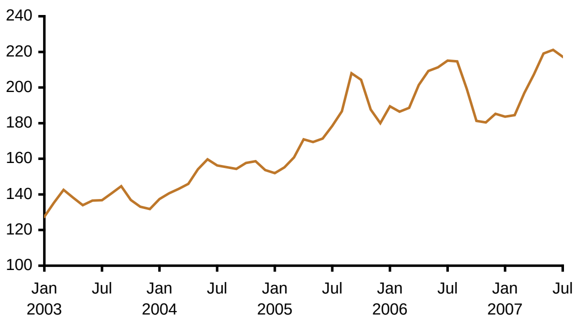
offset by increased nonresidential investment and exports. The ongoing process of growth in China was driven by the export sector and rapidly expanding internal consumption, neutralizing the successive contractionary measures adopted with the aim of reining in the overheated investment and credit markets. Chinese industrial output expanded 19.5% in the first half of the year, while investment in fixed assets increased 26.7%, compared to the same period of 2006.

The increase in defaults on the United States real estate market was evident in growing credit restrictions, reflected in higher mortgage interest rates and additional demands imposed on new contracts. These factors not only aided in reducing demand but further weakened the residential real estate market. Average real estate prices continued on a downward slide, dropping 3.2% in July 2007, compared to the same period of 2006. Though new housing starts dropped sharply over the course of the year, the stock of available units remained high, revealing not only a low volume of sales but the return of many units to the market. Nonetheless, when the third quarter got under way, there were no clear signs that the weakening of the residential real estate market would have a significantly strong impact on economic activity. In this context, the corporate sector found itself in a highly favorable position in July, marked by recouping of profits, which had declined in 2006, already adjusted inventory levels and strong demand, suggesting that this segment would continue expanding over the remainder of the year. In August, however, parallel to highly negative financial market news, consumer confidence indicators plunged in a manner that could well result in declining consumption in the coming months.

Annualized GDP growth in the Euro Area and Japanese economies reached 1.4% and 0.5%, respectively, in the second quarter of the year, compared to 2.9% and 3.2% in the quarter ended in March. Though the growth pace of these economies diminished in the second quarter, more recent statistics confirm sustained economic growth trajectories, driven by favorable external conditions and the benign evolution of internal demand, coupled with strong business profits and efficiency gains and consequent investment inflows.

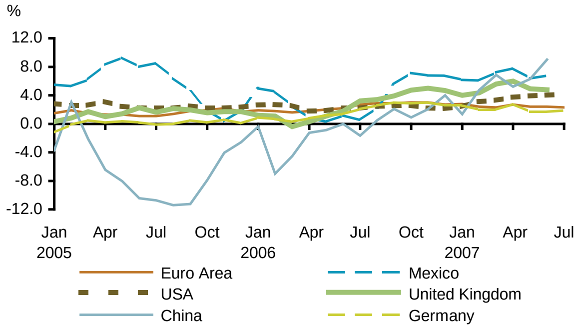
In July, Japanese industrial output declined 0.4% at the margin, after registering positive growth in the previous two months. In line with the positive evolution of macroeconomic indicators in July, unemployment dropped to 3.6% in Japan and remained stable at 6.9% in the Euro Area, signaling that household spending has remained high. In the Euro Area,

Figure 4.5 – USA – Energy Index



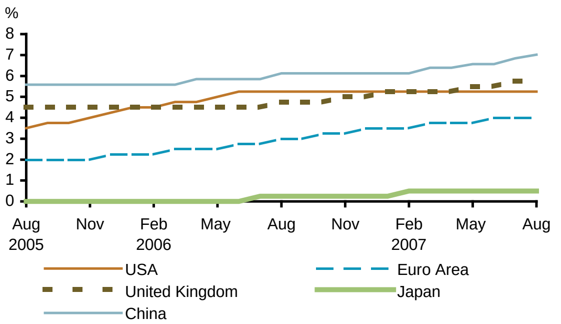
Source: Bureau of Labor Statistics

Figure 4.6 – Food inflation
Annual growth



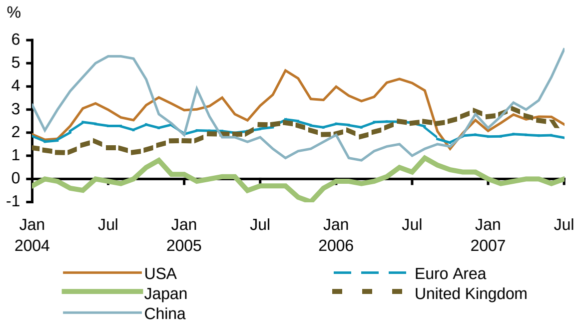
Source: Thomson Datastream

Figure 4.7 – Official interest rates
Annual rates



Sources: Fed, ECB, BoJ, Bank of England and The People`s Bank of China

Figure 4.8 – Consumer inflation
Annual growth



Sources: BLS, Eurostat, Bloomberg and ONS

the consumer confidence index dropped in August, while the industrial confidence index remained unchanged and the general economic sentiment index dropped slightly.

4.2 Monetary policy and inflation

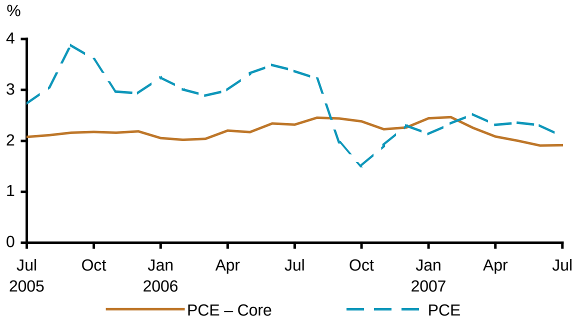
World inflation and the monetary policies practiced by the major central banks went through two distinct moments in the second quarter of the year. Initially, energy and food prices increased, reversing the downward trend of inflation. In that period, during which the global economy registered reductions in unemployment rates, increased utilization of production factors and a supply of agricultural commodities at a level compatible with rising global demand, central banks assumed more restrictive postures, with the exception of the United States Federal Reserves System (Fed), as a result of the deepening problems provoked by the subprime mortgage crisis. In the Euro Area, for example, expanding liquidity conditions and the need to anchor inflationary expectations led the European Central Bank (ECB) to raise its refi rate to 4% per year in June.

The increase in food prices reflected both demand pressures consequent upon growing consumer markets in the major emerging economies (Brazil, Russia, India and China – the BRIC countries) and increased demand for the grains used to produce bioenergy, particularly in the United States and China, as well as harvest failures in Southeast Asia.

Starting in mid-June, the perception increased that investments in United States real estate sector assets would generate losses for the financial institutions of mature economies of a magnitude and distribution not yet entirely understood. The situation of considerable uncertainty gave rise to liquidity problems on interbank markets. In light of this scenario, monetary authorities from the United States, the Euro Area, Japan, Australia, Russia, Canada and Switzerland, among others, expanded their open market operations, with the objective of injecting liquidity into the global financial system and avoiding the possibility of their basic rates remaining above the preestablished targets.

With the exception of China, where the cumulative 12-month consumer price index reached 5.6% in July, the more important economies have registered inflation declines, consistent with the falloff in energy prices. In the United States, cumulative 12-month growth in the consumer

Figure 4.9 – USA – Inflation
Annual growth



Source: Bureau of Labor Statistics

spending core remained stable at 1.9% in July, the lowest level since March 2004. For the second consecutive month, this result was well within the comfort zone defined by the Federal Reserve.

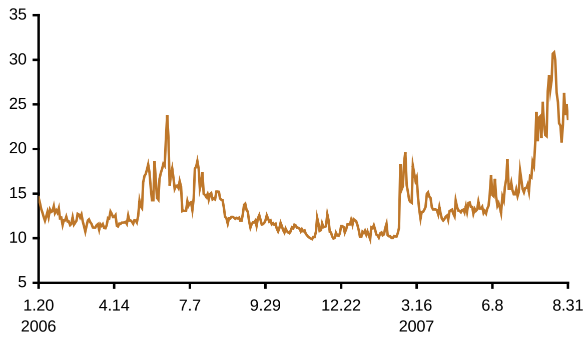
4.3 International financial markets

More recently, financial markets were impacted by the subprime market crisis. The combination of less rigid standards in granting new loans, a higher loan/property value ratio and reductions in home values have contributed to increased delinquency in United States mortgage loans, since the third quarter of 2005. The situation is particularly worrisome in Adjustable-Rate Mortgages (ARM), mainly in the subprime segment, which are loans granted to people who find it difficult to demonstrate their income levels or credit worthiness.

Since early 2007, many observers have issued warnings of the risks implicit in the sharp increase in American real estate market defaults. The dominant response was that the impact on the financial market would be limited and would be concentrated primarily on the real estate market itself, without contaminating other segments of the American and world economies. The sequence of events that followed, however, proved to be significantly more complex.

On June 15 of last year, Moody's reduced its rating of 131 assets backed by subprime mortgage loans and placed many others under review. Since that time, several events have occurred that drew the financial market into the crisis, as banks and investment funds rang up losses as a result of the long positions they held in assets backed up by subprime mortgage loans. On July 24, Countrywide, an important American real estate loan company, announced a drop in its profits, driving investors to rid themselves of higher risk assets and to pursue securities considered less risky. Parallel to this, information regarding a temporary suspension of operations involving investment fund quota redemptions as a result of a lack of a price standard, coupled with losses suffered by banks as a result of exposure to that type of asset, became considerably more frequent. The resulting informational asymmetry pushed interbank lending rates upward, forcing various central banks to inject liquidity into the system, with the intention of fostering smooth financial market operation. On August 17, the Federal Reserve gave temporary approval to a 50 basis point cutback in its discount window loan rate, reducing it to 5.75%, and

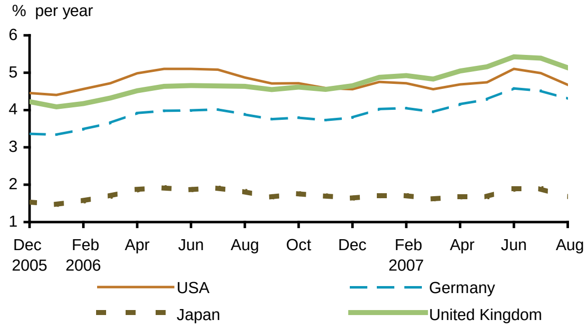
Figure 4.10 – VIX



Source: Bloomberg

Figure 4.11 – Yield on government bonds[1/]

% per year



Source: Bloomberg

1/ Monthly average of nominal yields on 10-year bonds, up to August 31 2007.

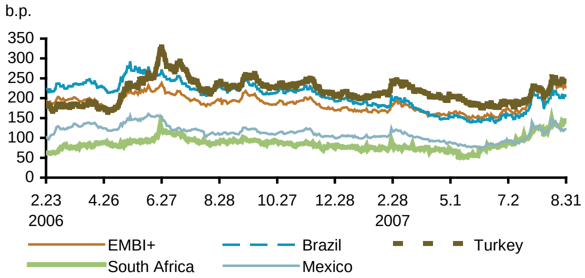
increased the term of the resale commitment of securities accepted as guarantee from 1 to 30 days. As a result of the signal given by the major central banks that they would inject liquidity to normalize the system, the overriding situation of market nervousness was assuaged and markets began operating with increased tranquility, though volatility levels remained high by recent standards. The fact of the matter is that signs of asymmetry in access to interbank credits in the mature economies persisted through the second week of September.

In this context, in the three-month period between June 1 and August 31, the Chicago Board Options Exchange Volatility Index (VIX), which measures the implicit short-term volatility of Standard & Poor's 500 (S&P 500) and is considered a risk aversion indicator by investors, fluctuated at a level sharply higher than in the three-month period ended in May, with averages of 19.2 and 13.8 points, respectively, based on daily closing values. Maximum volatility occurred on August 16 when the VIX hit 141% above the minimum value registered on June 1. The performance of the indicator in the three-month period ended in August showed an increase of volatility as of July 23, with the index average coming to 15.3 points through that date and 24.2 points in the period extending from July 24 to August 31. The VIX reached 23.4 points at the end of August.

In early June, growing concern with inflationary pressures and consequent expectations of more restrictive monetary policies pushed interest on 10-year government securities issued by Germany, Japan, the United Kingdom and the United States sharply upward through early July. Between May 31 and June 12, annual earnings on United States bonds moved from 4.89% to 5.29%, dropping back to 4.99% on July 2 and then increasing to 5.18% on July 6. The other countries also registered similar movement. However, since that date, the interest curves of government bonds have been influenced by the flight to quality, caused by increased risk perceptions rooted in international financial market turbulence. The prices of government bonds rose and annual earnings dropped. On August 31, annual returns on bonds issued by Germany, Japan, the United Kingdom and the United States reached respective levels of 4.24%, 1.61%, 5.04% and 4.53%, quite close to the minimum levels registered in each of these countries over the course of the entire period.

Higher risk perceptions were reflected in the Embi+, the emerging market risk indicator, which registered a trajectory similar to that of the VIX index. From June 1 to August 31, the Embi+ average stood at 188 points, with the sharpest

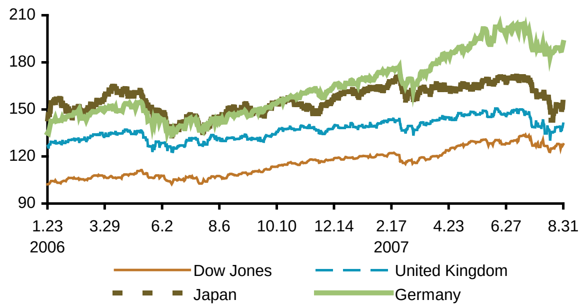
Figure 4.12 – Emerging Markets Bond Index Plus (Embi+)



Source: Bloomberg

Figure 4.13 – Stock exchanges – USA, Europe and Japan

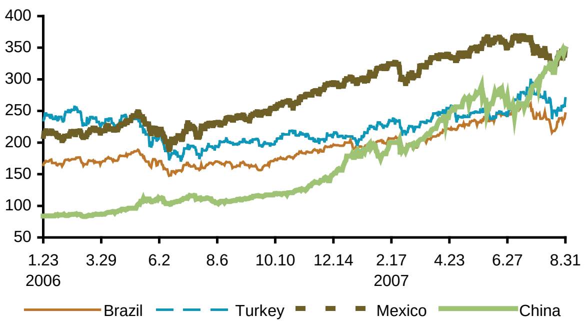
12.31.2003=100



Source: Bloomberg

Figure 4.14 – Stock exchanges – Emerging markets

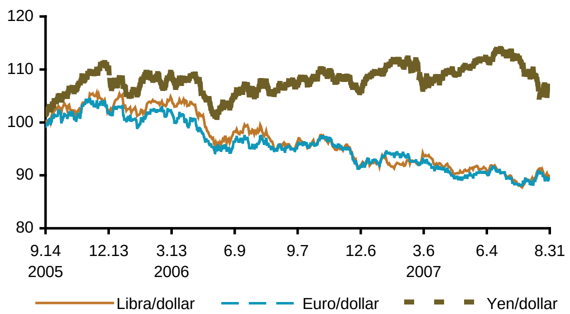
12.31.2003=100



Source: Bloomberg

Figure 4.15 – Dollar exchange rates

6.1. 2005=100



Source: Bloomberg

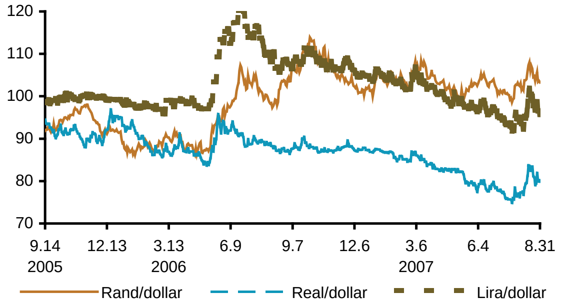
increase concentrated in the period after July 23, when the average reached 220 points compared to 165 points in the three-month period ended in May, when the indicator was marked by downward movement. Analyzed on the basis of a point-to-point comparison, the Embi+ increased 75 basis points, closing August 31 at 227 points. Brazil's Embi+, which has been consistently below the average indicators of the emerging countries since mid-April, posted an average of 173 points in the three-month period ended in August, with 206 points at the end of the period, reflecting a 45% high compared to the end of May. Using this type of comparison, the Embi+ of Turkey, South Africa and Mexico registered increases of 34%, 97% and 60%, in that order.

With the exception of the Chinese exchange, stock markets also reflected increased risk perceptions, with accentuated drops in the period extending from July 24 to August 17. In that time span, the United States Dow Jones Index, the Financial Times Securities Exchange Index (FTSE 100), utilized in the United Kingdom, the *Deutscher Aktienindex* (DAX) in Germany and the Japanese Nikkei registered respective drops of 7.9%, 11.6%, 8.5% and 15%. When the three-month period ended in August is considered, the reductions came to 2%, 4.8%, 3.1% and 7.3%.

With respect to the emerging countries, China's Shanghai Composite Index, which increased 27% in the three-month period and 13.1% during the most critical period of financial market turbulence, deserves special mention. Mexico's *Índice de Precios y Cotizaciones* (IPC), Argentina's Buenos Aires Stockmarket Index (Merval), South Africa's JSE All Share Index (Jalsh), Turkey's Istanbul Stock Exchange National 100 Index (XU100) and Brazil's Ibovespa posted losses of 13.6%, 20.4%, 13%, 20% and 17.3%, respectively, in the period extending from July 24 to August 16. In the three-month period, the Mexican and Argentinian exchanges registered losses of 3.3% and 8.1%, respectively, while the South African, Brazilian and Turkish exchanges posted respective increases of 0.1%, 4.5% and 6.6%.

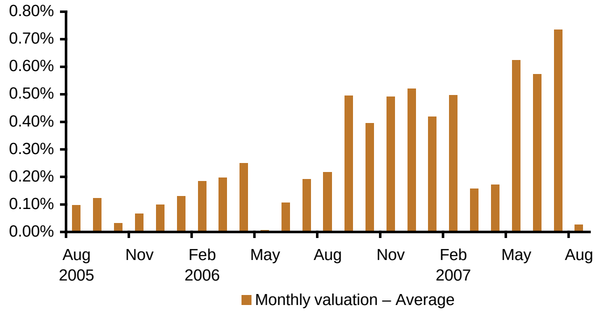
The exchange rates of the major economies were also impacted by the United States real estate credit market crisis. In the critical period, the wave of high-risk asset sales resulted in appreciation of the dollar against other currencies, with the exception of the yen, which became the major currency used in financing carryover strategies. These operations are canceled in times of greater risk, thus resulting in strong demand for the Japanese currency on

Figure 4.16 – Emerging markets currencies
South Africa, Brazil, Turkey
6.1.2005=100



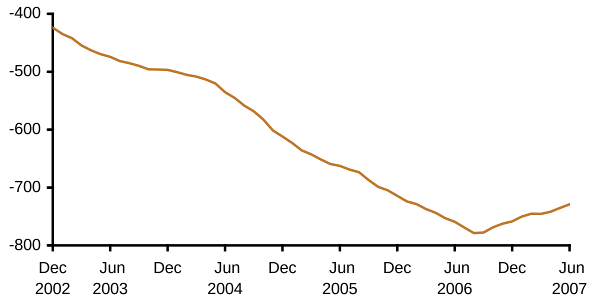
Source: Bloomberg

Gráfico 4.17 – Renminbi/dollar exchange rate
Monthly valuation – Average



Source: Bloomberg

Graph 4.18 – USA – Trade balance accumulated in 12 months
US$ billion



Source: Bloomberg

such occasions. In the period extending from July 24 to August 16, the dollar appreciated in relation to the pound sterling, 3.9%, and the euro, 2.8%, but depreciated 6% against the yen. When the final August and May positions are considered, the dollar registered respective depreciation of 1.8%, 1.3% and 4.9%.

Emerging country currency rates were more sharply impacted by financial market turbulence, since foreign investors had targeted these countries for injections of large amounts of resources channeled into local financial assets before the crisis had taken hold. Increased risk perceptions and consequent profit-taking with the so-called flight to quality resulted in withdrawals of part of these investments and their return to their markets of origin. From July 24 to August 16, the United States dollar appreciated 11.6% compared to the Brazilian real, 11.1% against the Turkish lira and 9.6% against the South African rand. From August 17 to 31, the exchange market trajectory reversed course, with the South African, Brazilian and Turkish currencies appreciating 4.4%, 4.4% and 6.2% against the dollar, in that order. In the three-month period, the dollar appreciated 0.4% against the rand and 2.2% against the real, while depreciating 1.2% against the Turkish lira.

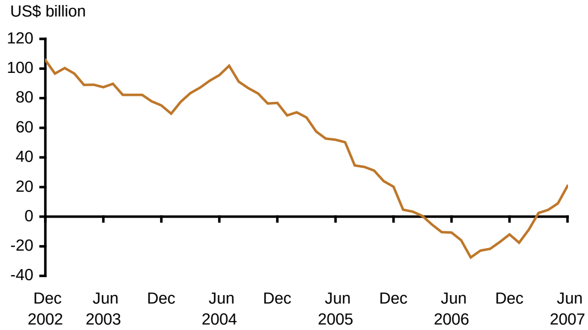
In China, restrictions imposed on capital movement, a strong balance of trade surplus and the existence of exchange bands resulted in a highly distinct performance by the renminbi, compared to the currencies of the other emerging countries. From July 24 to August 16, the Chinese currency depreciated only 0.6% against the United States dollar, while appreciating over the three-month period as a whole. A comparison between average exchange rates in the three-month periods ended in August and May and the rates in effect on the final day of each three-month period shows that the renminbi appreciated 1.5% and 1.4%, respectively, against the United States dollar.

4.4 World trade

According to the International Monetary Fund (IMF), world trade expanded 7.1% in 2007, against 9.4% in 2006. However, one should note that this robust performance may well be weakened, should the turbulence caused by the United States subprime crisis reduce the expected rate of world economic growth.

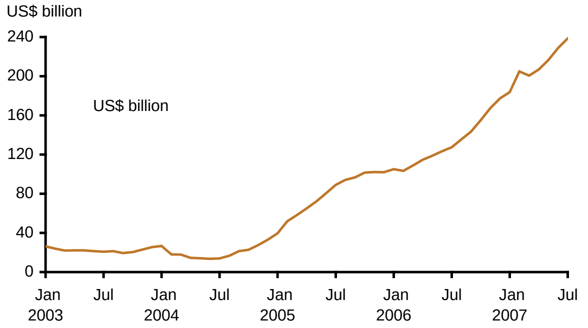
United States exports continued expanding sharply, driven mainly by demand in other economies. Growth in foreign

Graph 4.19 – Japan and Euro Area – Trade balance accumulated in 12 months



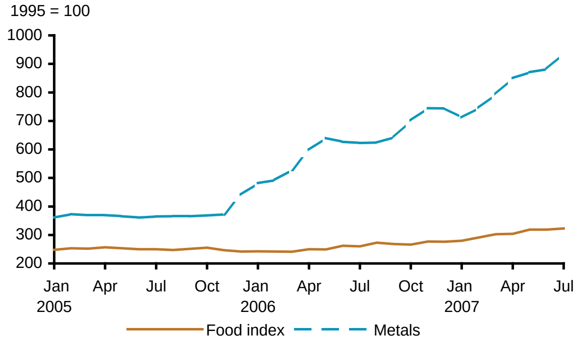
Source: Bloomberg

Graph 4.20 – China – Trade balance accumulated in 12 months



Source: Bloomberg

Figure 4.21 – CRB commodity price index



Source: Commodity Research Bureau (CRB)

sales has reduced that country's trade imbalance without any significant drop in trade flows. In the month of June, the trade deficit dropped 1.7% compared to May, closing at US$58.1 billion, with growth of 1.5% in exports and 0.5% in imports, with respective totals of US$134.5 billion and US$192.6 billion.

The Euro Area trade surplus reached €7.8 billion in June, against €1.7 billion in May and €1.6 billion in June 2006. In the first half of the year, exports from that region increased 9% and imports expanded 4%, closing with respective totals of €128.3 billion and €120.5 billion.

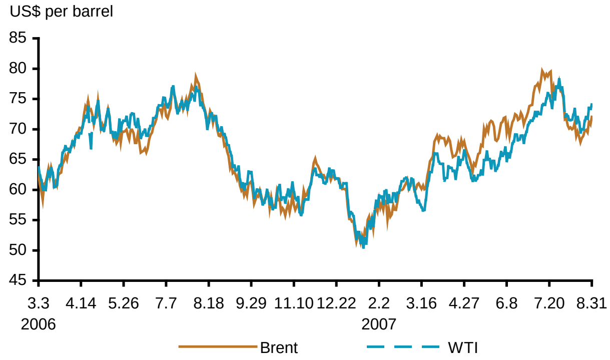
In the month of June, the Chinese government announced reductions in tax exemptions on exports of more than two thousand products, effective as of July 1, with the objective of dampening the rapid pace of trade balance growth. According to the National Reform and Development Commission, the Chinese trade surplus is expected to fluctuate between US$250 billion and US$300 billion in 2007, compared to US$177.5 billion in the previous year. In July, the Chinese trade surplus reached US$24.4 billion, reflecting a 10.4% reduction compared to June and a 67% rise when viewed against July 2006. The cumulative January-July trade surplus reached US$136.8 billion, up 81% compared to the same period of 2006.

4.4.1 Commodities

The nervousness provoked by the United States credit market crisis also contaminated international commodity prices. At the apex of the crisis, the reduction in commodity prices reflected settlements of long positions held by funds and speculators in that market. It should be mentioned that various commodities have been used as part of financial institution investment strategies, a factor that tends to broaden the co-relation of their prices with more traditional financial assets.

The prices of metallic commodities were highly volatile in the period between July 24 and August 31, with reductions in the prices of zinc, 16.6%; aluminum, 10.3%; nickel, 8%; and copper, 6.3%. The prices of farm commodities were subjected to lesser pressures during the period, as evinced by reductions in the prices of cocoa, 13.1%; sugar, 7%; and cotton, 4.5%; coupled with increases in the prices of wheat, 20.8%; corn, 9.2%; and soybeans, 4.4%.

Figure 4.22 – Oil – Spot market



Source: Bloomberg

4.4.1.1 Petroleum

On the spot market, the per barrel price of Brent-type oil fell 1% between the end of June and August, when it closed at US$72.06, after reaching US$79.64 on June 13. In the month of August, prices trended downward, despite increased international demand and repressed supply on the part of the Organization of Petroleum Exporting Countries (Opec). In September, this tendency reversed course and prices rose into the range of US$80.00 per barrel.

The petroleum futures market has been highly volatile during the entire year. Futures contracts negotiated on July 31 cited Brent-type oil for delivery in December 2007, at US$76.29, while contract value with the same maturity reached US$72.09 on August 31.

4.5 Conclusion

With the possible impact of weakened world financial markets on consumer spending, the risks to global economic growth worsened. One should highlight that the United States economy plays the central role in determining the pace of world economic expansion, though its impact has been decreasing. The side effects of real estate market difficulties on the credit supply and family wealth could intensify the downturn in the USA. Therefore, it is obvious that the performance of European and Asian economies will be of crucial importance to mitigating the effects of possible negative developments in the USA. It is important to note that most emerging countries have announced balanced fiscal budgets, relatively controlled inflation rates and comfortable foreign reserve situations, acting as a cushion against a possible sharper downturn in the United States.

At a moment of increased uncertainty, marked by simultaneous high levels of utilization of installed industrial output capacity and expectations of increased farm price pressures, central banks must cope with a very difficult task. At one and the same time, they must avoid systemic worsening in the reduction of the credit supply which would certainly occur should interbank market difficulties intensify, while also anchoring inflationary expectations, avoiding broadening of moral risk and preserving their credibility in combating inflation. Expectations indicate that, once the financial crisis is behind us, monetary authorities will adopt a more restrictive posture and Japan and the Euro Area will shift into a new cycle of interest rate highs.

Over the short term, a high degree of residual uncertainty on markets will persist, as concerns with the subprime crisis and broader credit market topics in the United States, and the impact of such events on financial institution liquidity become the major factors in determining market sentiments in relation to the macroeconomic scenario which, in itself, has also become considerably more uncertain.

International Financial Turbulence: Transmission Mechanisms

International financial markets have been immersed in a period of turbulence since mid-June and even more intensively as of the month of August. This turbulence has been characterized by a sharp increase in the volatility of asset prices, as exemplified by the Chicago Board Options Exchange's Volatility Index (VIX). This index, which measures the volatility of the American stock market, registered an average of 20.80% in the period extending from June 15 to September 15, compared to an average of 12.95% in the year through June 14. Brazilian assets and those of other emerging economies were also impacted by increased volatility, albeit on a lesser scale than in the past, accompanied evidently by increased risk aversion.

The origins of this new episode of financial turbulence were located far from the emerging markets, being centered in increased subprime mortgage defaults in the United States of America. These mortgage loans were granted to families that had poor credit ratings and/or difficulties in corroborating income levels compatible with the amounts borrowed. Though it is much too early to draw any lessons from this still ongoing episode, a brief analysis of transmission mechanisms can enhance understanding of these events, while helping to anticipate possible future developments.

Subprime mortgages and other types of loans were combined into synthetic assets backed by their respective cash flows or receivables in the securitization process (in other words, transformation of loans into net financial assets). In their turn, these assets were sold to investors, mainly entities created for this specific objective and frequently founded and sponsored by the banks themselves. These entities, which constitute investment vehicles, generally financed purchases of receivables through issuance of so-called asset-backed commercial papers (ABCPs).

It is important to note that securitization is an important financial innovation, since it can contribute to making access to credit more democratic. Though it is quite probable that excesses were committed in the process of forming subprime mortgages, measures that unduly hamper this type of innovation must be avoided. Obviously, securitization of receivables is not restricted to home property loans and, for example, could involve expected flows of credit card payments or loans for purchases of consumer durables, such as auto loans.

One of the effects of the securitization process is to segment the availability of information. More specifically, those initiating the mortgages have more information on the effective risk of default than those who are effectively exposed to that risk or, in other words, the investors who bought the securitized assets either directly or through short-term securities backed by receivables (issued by banks or, in the case of the ABCPs, nonbanking institutions). When they began to suffer unexpected losses in their ABCP portfolios, the uncertainties surrounding the real quality of the underlying assets – the mortgages – led investors to adopt a more defensive posture. Consequently, the ABCP market became illiquid and, in some cases, paralyzed operations.

As a result, investment vehicles encountered difficulties in coming up with sources of funding to finance their mortgage portfolios. With increasing frequency, they began resorting to short-term financing. With this, the nonbanking vehicles had to cope with mismatches between the maturities of the assets (long-term) and the sources of funding (short-term) typically used by banks.

As already stated, many of these vehicles were established and/or sponsored by banks that offered credit lines for support purposes. Thus, the investment vehicles came to issue very short-term securities or completely lost access to market financing (between early August and mid-September the value of ABCPs on the American market dropped 20%). In this framework, the sponsoring banking institutions had to honor the liquidity needs of the sponsored entities. With this, low levels of liquidity and the consequent difficulties encountered in pricing ABCPs on markets were transmitted to the banks.

Another characteristic of the securitization process was the fostering of banking de-intermediation or, in other words, reduction in the direct participation of banks in consumer financing and home investment. With the growing difficulties of nonbanking vehicles, the trend in recent months has been a certain level of banking re-intermediation, to the extent in which the banks absorb assets previously held by nonbanking institutions. This process naturally implies not only greater liquidity needs, but also increased capital needs as a result of current prudential rules applied to banks. In light of the Basel II Accord, contingent liquidity lines require capital allocations which, in turn, help to mitigate the risks of excessive exposure of banks to this type of structure.

On coping with the increasing uncertainties regarding their own needs for net resources and even greater uncertainties surrounding the needs of other institutions, banks began stocking liquidity. At that moment, very short-term interest rates began rising as a result of the liquidity squeeze, in certain cases moving to levels that were sharply higher than the rates defined by monetary policy decisions. On August 9, for example, overnight interest rates in Europe rose to 4.60%, compared to the policy target of 4%; in the United Kingdom, overnight rates exceeded the policy rate by 100 basis points; and, in the USA, the effective Fed fund rate was 16 basis points above the target, a very atypical difference. In response to this situation, important central banks, led by the European Central Bank (ECB) and the United States Federal Reserve had to inject considerable amounts of liquidity into the system in order to facilitate operation of interbank markets, while also issuing declarations indicating their willingness to take the measures required to guarantee market functioning.

On August 17, the American central bank reduced its discount window rate 50 basis points, extending that credit line by as much as 30 days, and re-emphasized its readiness to accept a wide ranging array of assets to guarantee its loans. At that moment, USA monetary authorities demonstrated increasing concern with the side effects of the financial turbulence on economic activity. To some extent, this anticipated the decision to reduce the basic monetary policy rate, which effectively occurred on September 18. Starting in the second half of August, very short-term rates once again moved closer to policy rates in Europe and the USA. However, the forward rate for up to three months continued at exceptionally high levels, leading the ECB to anticipate its announcement of a three-month interbank financing operation on September 6. Despite the measures taken by central banks, the subprime market crisis has continued generating repercussions, including the process of banking re-intermediation, thus requiring the total attention of monetary and supervisory authorities.

Here, it is important to stress that Brazilian markets operated normally during that entire period, though they were impacted by the increased volatility of the external scenario at certain moments in time. With this, at no time whatsoever was the Central Bank of Brazil required to inject liquidity into the interbank market, which still has a high level of liquidity. Despite this, the Central Bank, working with like institutions in other countries, continues closely monitoring ongoing developments on global markets.

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5 External sector

As highlighted in recent issues of the “Inflation Report”, the nation’s external accounts have evolved in a consistent manner, despite growing uncertainties regarding the level of world economic activity. This positive scenario is corroborated by projections for the remainder of this year and for 2008, thus facilitating economic policy management. Driven by the sustained dynamics of the export sector, foreign trade surpluses have been consistently strong and, for the third consecutive year, should close in the range of US$40 billion. This trajectory is considered particularly important considering that imports have expanded in a manner consistent with the increased pace of economic activity. In this context, overall trade flows have expanded steadily, broadening the economy’s opening to world markets.

The trade balance performance has been the major factor underlying successive current account surpluses, expected to reach US$7.8 billion in the current year. Parallel to this, a stable rate of inflation and expanding economic growth, both of which reflect strengthening of the country’s macroeconomic fundamentals, have clearly driven substantial net capital inflows in the form of foreign direct investments, stocks and fixed yield securities negotiated in the country and, together with current accounts, have contributed decisively to a continued overall high balance of payments surplus.

In this framework, policies designed to improve the nation’s capacity to withstand adverse external situations have continued. Thus, the international reserve position increased to a record level of US$161.1 billion in August, as the Central Bank acquired US$67 billion in exchange on the market. These acquisitions reflect consistent exchange market surpluses and are the result of implementation of an announced policy of not imposing any trends or minimum values on exchange fluctuations, as well as not adding to market volatility. Parallel to this, international market placements of sovereign bonds denominated in national currency at increasingly lower interest rates have reduced external debt exposure to exchange variations. Following this line, the National Treasury continued its policy of repurchasing external debt, thus improving the debt profile for coming years.

In light of this benign scenario, the risk rating agency, Moody's, raised its rating of the country's long-term sovereign external debt in foreign currency to a level just below investment grade. Just as occurred with the ratings previously granted by the other two major risk rating agencies, Standard & Poor's and Fitch, the announcement was made in a scenario of strong international financial market volatility, in contrast to what normally occurred in past periods of stress. The timing of the risk rating increase attests to the importance of the improvement achieved in the external fundamentals of the economy in recent years.

In more specific terms, it would seem that the increased volatility of international credit markets, accompanied by greater risk aversion, has had only marginal impacts on the country's external indicators. In this sense, according to data for the month of August, medium and long-term lending and financing operations registered rollover rates significantly above 100%, while the exchange market remained in a surplus position. The rate of exchange depreciated slightly; country risk increased, albeit to a still quite comfortable level; the international reserve position set a new record; and net short-term capital inflows declined mainly as a result of the prudential measures announced in June and scheduled to be implemented in early July. In this way, the less favorable world environment proved to be a new test of the country's capacity to withstand crises on the external scenario. Up to the moment, the economy has come through this period of testing with flying colors.

At the same time, this chapter announces new balance of payments projections for 2007, incorporating alterations in the external debt service, including both principal and interest, resulting from introduction of more recent data and the new debt position for the month of June. Forecasts for the current account result, for direct investments and portfolio investments, for short-term investment flows and for the overall balance of payments result have also been modified. Early balance of payments projections for 2008 are also presented in this Report, together with forecasts for the nation's international reserve position.

5.1 Exchange

In the first eight months of the year, the exchange market generated net inflows of US$70.1 billion, compared to US$26.9 billion in the corresponding period of the previous year. The trade surplus reached US$58.3 billion, corresponding to a 59.8% increase in the period, based on contracted exports worth US$124.4 billion and imports totaling US$66.1 billion, for increases of 35.4% and 19.4%, using the same basis of comparison.

Table 5.1 – Foreign exchange flows

US$ billion

	2006			2007	
	Aug	Jan-Aug	Year	Aug	Jan-Aug
Trade operations	3.8	36.5	57.6	6.9	58.3
Exports	12.4	91.9	144.4	17.2	124.4
Imports	8.6	55.4	86.8	10.3	66.1
Financial operations[1/]	-2.5	-9.6	-20.3	0.0	11.8
Purchases	14.4	118.9	195.4	28.5	213.8
Sales	16.9	128.4	215.7	28.6	202.0
Net flows	1.3	26.9	37.3	6.8	70.1

1/ Excluding interbank operations and Central Bank foreign operations.

From January to August 2007, net financial segment inflows totaled US$11.8 billion, compared to net outflows of US$9.6 billion in the same period of 2006, reflecting increases of 79.8% in purchases and 57.3% in foreign currency sales.

The cumulative exchange surplus in the first eight months of the year made it possible for the Central Bank to purchase US$67 billion in net exchange in the aforementioned period, against US$34.3 billion during all of 2006. The difference between the exchange market balance and net Central Bank acquisitions was determined by growth in the long position held by banks, closing August at US$1.7 billion, compared to the US$2 billion short position at the end of 2006.

5.2 Trade in goods

Table 5.2 – Trade balance – FOB

US$ million

Period	Exports	Imports	Balance	Total trade
Jan-Aug 2007	102 433	74 914	27 519	177 348
Jan-Aug 2006	88 380	58 633	29 747	147 012
% change	15.9	27.8	-7.5	20.6

Source: MDIC/Secex

The trade balance set new records for both exports, US$15.1 billion, and imports, US$11.6 billion, even in terms of daily averages. With the increased dynamics of the import segment, the monthly surplus came to US$3.5 billion or less than the total for the same month of 2006. The cumulative trade surplus for the first eight months of the year reached US$27.5 billion, down 7.5% compared to the corresponding period of 2006. Analysis shows that imports expanded 27.8%, closing with US$74.9 billion, while exports increased 15.9%, posting a final total of US$102.4 billion.

Table 5.3 – Exports by aggregate factor – FOB

Daily average – January-August

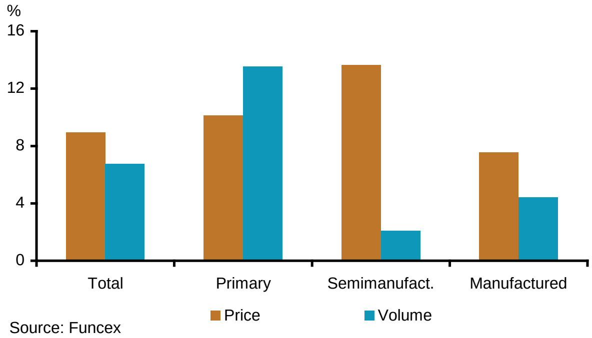
US$ million

	2006	2007	% change
Total	526.1	606.1	15.2
Primary products	154.5	191.6	24.0
Industrial products	359.3	402.3	11.9
Semimanufactured goods	72.7	83.7	15.0
Manufactured goods	286.6	318.6	11.2
Special operations	12.2	12.2	0.2

Source: MDIC/Secex

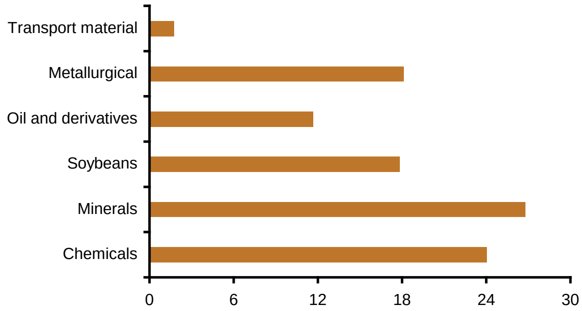
Compared to August 2006, increases were registered in the same month of 2007 in the daily average exports of all aggregate factor categories, as sales of basic products increased 20.5% and those of manufactured and semimanufactured goods expanded 6.4% and 3.3%, respectively. Among exports of basic products, the highlights were iron ore with growth of 15.7%; oil, 20.7%; soybeans, 13.9%; chicken meat, 26.2%; and soy meal, 7.6%. In the case of manufactured products, this performance reflected

Figure 5.1 – Exports – Price and volume index January-August – 2007/2006



Source: Funcex

Figure 5.2 – Main exports January-August – 2007/2006 – % growth



Source: MDIC/Secex

Table 5.4 – Imports by end-use category – FOB

Daily average – January-August

US$ million

Itemization	2006	2007	% change
Total	349.0	443.3	27.0
Capital goods	72.7	92.6	27.3
Raw materials	173.6	222.2	28.0
Naphtha	7.2	7.7	6.2
Consumer goods	44.0	58.4	32.9
Durables	22.1	29.0	31.0
Passenger vehicles	6.4	9.8	52.6
Nondurables	21.8	29.5	34.8
Fuels	58.7	70.0	19.2
Crude oil	37.6	41.3	9.9

Source: MDIC/Secex

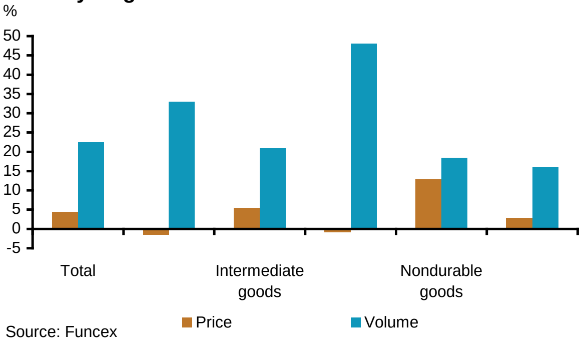
increases in sales of aircraft, 12.3%; auto parts, 6.1%; fuel oils, 17.9%; and cargo vehicles, 10.5%; while sales reductions were registered under automobiles, 4.4%; refined sugar, 3.6%; automobile engines, 12.4%; and gasoline, 6.1%. With regard to semimanufactured products, the highlights were increases in exports of cellulose, 25.8%; cast iron, 17.4%; iron alloys, 85.6%; and soybean oil, 59.6%; while declines occurred under sales of raw sugar, 20.3%; and semimanufactured iron/steel products, 39.9%.

Compared to the same period of the preceding year, an analysis of cumulative performance in the first eight months of 2007 indicates that daily average exports of basic products increased 24%; followed by semimanufactured goods, with 15%; and manufactured products, with 11.2%. According to Funcex, the 15.9% increase registered in exported value in the January-August 2007 period, compared to the same period of 2006, reflected increases of 9% in prices and 6.8% in exported volume. Using the same basis of comparison, export prices of basic, semimanufactured and manufactured products increased 10.1%, 13.6% and 7.6%, respectively, while exported volume rose 13.5%, 2.1% and 4.4%.

Analysis of exports by major economic sectors shows that daily average foreign sales of the six most important segments, accounting for 55.8% of cumulative foreign sales in the first eight months of the year, expanded when compared to the same period of 2006. Consequently, broken down by order of importance, sales of transportation equipment increased 1.7% in the period, followed by the sectors of metallurgy, 18.1%; oil and derivatives, 11.7%; soybeans, 17.8%; minerals, 26.8%; and the chemical products, with 24%. Moving in the opposite direction, the only items that registered sales declines in this type of comparison were sugar and electric and electronic equipment.

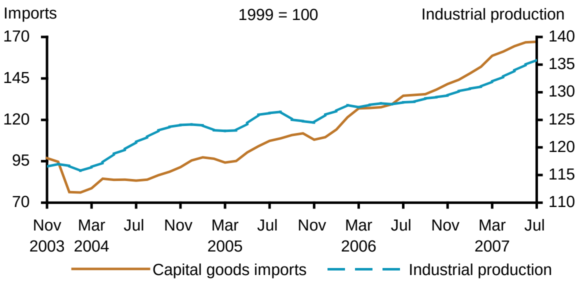
Just as occurred in the context of August exports, compared to the same period of 2006, increases were registered in the average daily value of imports of all final use categories. Acquisitions of capital goods expanded 42.3% in the period and were driven by increases in purchases of parts and spares for industrial capital goods, 106.8%; industrial machinery, 51.5%; and machines and apparatuses for office use and scientific services, 40.8%. Imports of consumer durables expanded 35.5%, reflecting growth in purchases of passenger cars, 65.6%; objects of adornment and personal use, 24.6%; and machines and apparatuses for domestic use, 18.8%, while acquisitions of nondurable consumer goods expanded 27.6%, reflecting increases in the segments of textiles, 122.7%; beauty products, 52.8%; and beverages and tobacco, 27.9%. Purchases of raw materials and intermediate goods, which accounted for approximately half of overall imports, expanded 29%, using the same basis of comparison, with particular emphasis on growth in purchases of transportation equipment accessories, 47.1%; chemical and pharmaceutical products, 29.4%; and mineral goods, 25.6%. Purchases of fuels and lubricants expanded 2.4% in the period.

Figure 5.3 – Imports – Price and volume index
January-August – 2007/2006



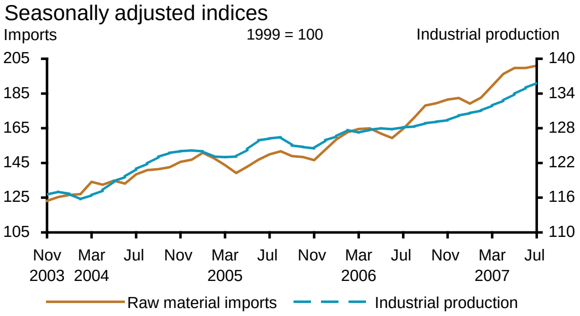
Source: Funcex

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



Sources: Funcex and IBGE

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



Sources: Funcex and IBGE

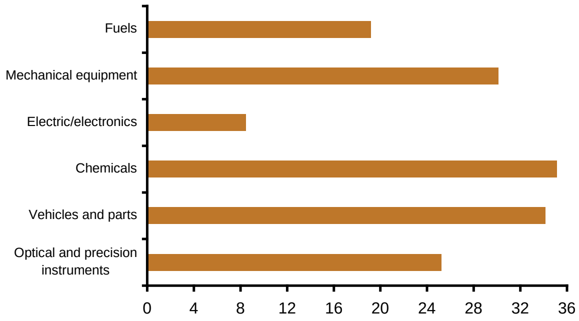
The performance of cumulative imports in the year through August ratifies the process of renewed growth in Brazilian economic activity, with strong increases compared to the same period of 2006 in acquisitions of all of the different final use categories. Purchases of nondurable consumer goods expanded 34.8%; followed by consumer durables, 31%, driven by 52.6% growth in acquisitions of automobiles; raw materials, 28%; capital goods, 27.3%; and fuels and lubricants, 19.2%.

According to the Foreign Trade Studies Center Foundation (Funcex), the 27.8% growth registered in the value of imports in the period extending from January to August 2007, compared to the same period of 2006, was generated by increases of 4.4% under prices and 22.5% in imported volume. The quantum impact was a determining factor in the performance of all use categories, registering increases in the imported volume of consumer durables, 48.1%; capital goods, 33%; raw materials and intermediate goods, 20.9%; fuels and lubricants, 16%; and nondurable consumer goods, 18.5%. The performance of import prices was by no means uniform, with increases under nondurable consumer goods, 12.9%; intermediate goods, 5.5%; and fuels and lubricants, 2.8%; and reductions under capital goods, 1.4%; and durable consumer goods, 0.9%.

The international price scenario has been quite favorable to the country's trade, since world demand for imported products included among Brazilian exports has been particularly sharp. On the other hand, a significant share of the prices of imported goods has been depressed and this has stimulated increases in external purchases required to modernize the nation's industrial structure, while curtailing growth in domestic prices.

Analysis of the major sectors shows that imports also registered across-the-board growth in the first eight months of the year, compared to the same period of the previous year. Broken down by order of importance, imports of fuels and lubricants increased 19.2% in the period, followed by

Figure 5.6 – Imports by main products January-August – 2007/2006 – % change



Source: MDIC/Secex

Table 5.5 – Exports and imports by area – FOB

Daily average – January-August

US$ million

Itemization	Exports			Imports			Balance	
	2006	2007	% change	2006	2007	% change	2006	2007
Total	526	606	15.2	349	443	27.0	177	163
Latin America	120	136	13.1	60	76	25.5	60	60
Mercosur	53	64	20.6	33	43	31.1	21	22
Argentina	45	53	18.4	30	39	30.4	16	15
Other	8	11	32.9	3	4	37.1	5	7
Mexico	18	16	-8.3	5	7	42.1	13	9
Other	49	55	12.6	23	26	14.1	26	29
USA[1/]	96	97	1.0	55	72	29.5	40	25
EU	118	149	26.2	78	101	28.4	39	48
E. Europe	14	16	13.8	5	10	109.0	9	6
Asia	81	98	20.9	87	110	26.8	-6	-13
Japan	15	17	13.6	15	18	13.2	0	0
South Korea	8	7	-3.4	13	13	-2.9	-5	-5
China	33	43	28.1	29	45	54.4	4	-2
Other	25	31	23.2	29	35	19.7	-5	-5
Others	98	112	14.0	63	75	18.6	35	37

Source: MDIC/Secex
1/ Includes Puerto Rico.

mechanical equipment, with 30.1%; electric-electronic goods, 8.5%; chemical products, 35.1%; automotive vehicles and parts, 34.2%; and optical, precision and medical instruments, 25.2%. Imports of these six sectors registered an overall total of 62.8% of foreign purchases in the period from January to August 2007.

The major markets of destination for Brazilian exports in the first eight months of the year were the European Union, which absorbed 24.5% of Brazilian foreign sales, and the Latin American Integration Association (Aladi), 22.4%, while the United States remained as the largest individual buyer, with 16% of Brazilian exports in the period. In the Aladi framework, sales targeted to the Southern Common Market (Mercosul) expanded 20.6% in terms of daily averages when compared to the same period of 2006, while those channeled to Mexico dropped 8.3%. At the same time, exports absorbed by the countries of Asia expanded 20.9% and were sustained by 28.1% growth in Chinese acquisitions.

With respect to the geographic distribution of Brazilian imports, emphasis should be given to increases in purchases of goods originating in Eastern Europe, 109%; China 54.4%; and Mexico, 42.1%. The Asian market continued as the principal supplier to Brazil, accounting for 24.8% of Brazilian foreign purchases, followed by the European Union, with 22.7%, while, in the case of Brazilian external purchases, those originating in the United States accounted for 16.2% of the total amount in the period, followed by those from China, with 10.1%, and those from Argentina, with 8.7%. It is important to note that, five years ago, the Asian economies accounted for 16.9% of Brazilian imports, a percentage that drops to 15.1% when the result for 10 years ago is considered. This trajectory exemplifies the growing commercial ties between Brazil and that area of the world. Purchases from Mercosul and the United States increased 31.1% and 29.5%, respectively, in terms of daily averages, compared to the first eight months of 2006.

5.3 Services and income

In the 12-month period ended in August 2007, the current account surplus reached US$10.6 billion, equivalent to 0.9% of GDP, compared to US$13.4 billion in the corresponding period of the preceding year, 1.34% of GDP. The high current account result was, at one and the same time, a reflection of reductions in the income account deficit and a stable trade performance, coupled with growth in net remittances under the service account. It is worth recalling that the average

Table 5.6 – Current account

US$ billion

	2006			2007			2008
	Aug	Jan-Aug	Year	Aug	Jan-Aug	Year1/	Year1/
Current account	2.2	8.0	13.6	1.4	5.0	7.8	3.2
Trade balance	4.6	29.7	46.5	3.5	27.5	40.0	34.0
Exports	13.7	88.4	137.8	15.1	102.4	155.0	167.0
Imports	9.1	58.6	91.3	11.6	74.9	115.0	133.0
Services	-1.0	-6.2	-9.7	-1.0	-7.8	-12.3	-12.0
Transportation	-0.3	-2.0	-3.1	-0.4	-2.5	-3.8	-3.9
International travel	-0.2	-0.8	-1.4	-0.3	-1.7	-2.8	-2.5
Computer and informat.	-0.1	-1.3	-1.9	-0.2	-1.4	-2.2	-2.2
Operational leasing	-0.4	-3.2	-4.9	-0.4	-3.5	-5.1	-5.2
Other	0.1	1.1	1.7	0.2	1.4	1.5	1.7
Income	-1.8	-18.3	-27.5	-1.5	-17.5	-24.0	-23.3
Interest	-0.7	-7.7	-11.3	-0.2	-5.7	-8.0	-6.9
Profits and dividends	-1.0	-10.7	-16.4	-1.4	-12.1	-16.5	-16.8
Compensation of employment	0.0	0.1	0.2	0.0	0.3	0.5	0.4
Current transfers	0.4	2.7	4.3	0.4	2.7	4.2	4.5

1/ Forecast.

current account deficit reached 2.57% of GDP in the period extending from 1970 to 2002 or, in other words, the sequence of surpluses registered since 2003 contrasts sharply with the historical pattern of the Brazilian economy. As the pace of internal economic activity has increased, the process of reversing the current account position over the long-term may well occur much more rapidly than in recent years.

In the first eight months of the year, net remittances on services totaled US$7.8 billion, while income remittances reached US$17.5 billion, for growth of 26.5% in the first case and a decline of 4.7% in the second, compared to the same period of 2006. Parallel to the increased deficit, it is important to note that the trend toward higher transaction values under the heading of services has continued, both in terms of revenues and expenditures, thus expanding the overall flow of trade in international services.

From January to August of this year, revenues on international travel reached US$3.3 billion and spending totaled US$5 billion, for respective growth rates of 12.8% and 33.4%, compared to the same period of 2006. Net outlays totaled US$1.7 billion in the period, against US$849 million in the previous period.

With respect to the income account, mention should be made of the increase in interest revenues generated by growth in Brazilian assets abroad, particularly expansion in the country's international reserve position. Net interest outlays reached a cumulative total of US$5.7 billion from January to August, compared to US$7.7 billion in the corresponding period of 2006. Earnings on reserves expanded 127.6%, using the same basis of comparison, and closed at US$3.8 billion.

Net remittances of profits and dividends totaled US$12.1 billion, compared to US$10.7 billion from January to August 2006. Over 12 months, net remittances reached a cumulative total of US$17.7 billion, surpassing the average of US$16 billion registered since June of last year.

In the first eight months of the year, net unilateral transfers totaled US$2.7 billion, slightly more than in the corresponding period of 2006. When cumulative flows over the 12-month period ended in August 2007 and the corresponding period of the previous year are compared, net inflows increased 8.6%.

5.4 Financial account

Table 5.7 – Financial account

US$ billion

Itemization	2006 Aug	2006 Jan-Aug	2006 Year	2007 Aug	2007 Jan-Aug	2007 Year1/	2008 Year1/
Capital account	2.1	8.2	15.1	1.7	68.2	66.6	2.6
Direct investments	-0.1	3.7	-9.4	3.8	31.9	24.0	18.0
Abroad	-1.3	-6.4	-28.2	1.8	5.4	-8.0	-10.0
In Brazil	1.2	10.2	18.8	2.0	26.5	32.0	28.0
Equity capital	0.6	6.9	15.4	1.1	19.3	23.9	24.8
Intercompany loans	0.6	3.3	3.4	0.9	7.2	8.1	3.2
Portfolio investments	0.6	-0.2	9.6	1.5	33.1	27.3	5.9
Assets	0.1	0.9	0.5	-0.1	-0.2	-1.0	-1.1
Liabilities	0.5	-1.1	9.1	1.6	33.3	28.3	7.0
Derivatives	0.0	0.2	0.4	-0.1	0.1	0.0	0.0
Other investments	1.6	4.5	14.6	-3.5	3.1	15.3	-21.2
Assets	0.9	-3.4	-8.9	-7.5	-33.4	-13.0	-21.4
Liabilities	0.7	7.8	23.5	4.1	36.5	28.3	0.2

1/ Forecast.

In August, the balance of payments financial account registered a surplus of US$1.7 billion, closing with a cumulative surplus of US$68.2 billion in the year. Direct Brazilian investments abroad registered net returns of US$5.4 billion in the year through August. Brazilian assets held abroad under the heading "capital participation" reached US$6.2 billion in the period under analysis, while intercompany loans posted net amortizations of US$11.6 billion.

Net inflows of foreign direct investments (FDI) totaled US$26.5 billion in the first eight months of the year, against US$10.2 billion in the corresponding period of the previous year. In terms of 12-month cumulative values, foreign direct investments reached a total of US$35.1 billion in August, the highest level ever recorded in the historical series. Net inflows into capital participation moved to US$19.3 billion in the year through August, while intercompany loans totaled US$7.2 billion.

Foreign portfolio investments posted a surplus of US$1.6 billion in August, for a total of US$33.3 billion in eight months. Portfolio investments negotiated in the country, stocks and fixed income securities registered net inflows of US$1.2 billion in the month, and US$26.6 billion in the year.

Table 5.8 – BP financing sources

Selected items

US$ billion

	2006 Aug	2006 Jan-Aug	2006 Year	2007 Aug	2007 Jan-Aug	2007 Year1/	2008 Year1/
Medium and long-term funds	1.0	11.2	33.5	2.4	18.9	22.9	13.7
Public bonds	0.0	1.9	4.8	0.0	2.9	2.9	0.0
Private debt securities	0.9	6.9	10.3	0.9	12.2	14.2	8.2
Direct loans	0.1	2.5	18.4	1.5	3.9	5.9	5.5
Short-term loans (net)2/	0.3	-1.1	-0.5	1.9	26.1	20.0	0.0
Short-term securities (net)	0.4	-0.1	0.1	0.4	3.5	1.0	0.0
Portfolio (net)	0.0	9.0	16.9	1.2	26.6	28.0	10.0
Roll-over rates (%)							
Private sector3/	219%	216%	206%	363%	112%	100%	100%
Debt securities	204%	248%	206%	449%	296%	174%	100%
Direct loans	347%	138%	205%	323%	38%	49%	100%

1/ Forecast.
2/ Includes direct loans and trade credits transferred by banks.
3/ Refers to the medium-and long-term disbursement over amortization ratio not including amortization related to converson of debt into direct investment.

With respect to foreign investments negotiated abroad, the major headings showed surpluses both in August and in cumulative terms for the year, with the sole exception of bonds which were impacted by the National Treasury buyback program. In the month of August, medium and long-term bonds registered net outflows of US$653 million, resulting from security repurchase operations. In the year, net outflows of funds totaled US$5.7 billion, with disbursements of US$2.9 billion and amortizations of US$8.6 billion.

Net inflows involving medium and long-term private securities reached US$706 million in August and US$7.4 billion in the first eight months of the year, a period in which net disbursements of short-term securities added up to US$3.5 billion.

The heading of other Brazilian investments reflected assets held abroad in the amount of US$7.5 billion in August, for a cumulative total of US$33.4 billion in the first eight months of the year. Basically, this amount reflected deposits of Brazilian banks abroad, US$20 billion, and deposits held by other sectors, US$12.8 billion.

Table 5.9 – Statement of international reserves

US$ billion

	2006		2007		2008
	Jan-Aug	Year	Jan-Aug	Year[1/]	Year[1/]
Reserve position in previous period	53.8	53.8	85.8	85.8	163.2
Net Banco Central purchases	23.4	34.3	67.0	67.0	-
Debt servicing (net)	-21.0	-22.8	-7.4	-7.2	0.4
Interest	-2.8	-2.8	-0.1	1.2	2.4
Credit	1.7	2.8	3.8	6.0	6.8
Debit	-4.5	-5.6	-3.9	-4.8	-4.4
Amortization	-18.3	-20.0	-7.4	-8.3	-2.0
Disbursements	2.6	6.6	2.9	2.9	-
Multilateral organizations	-	1.2	-	-	-
Sovereign bonds	2.6	5.5	2.9	2.9	-
Others[2/]	1.2	1.5	1.7	1.7	-
Treasury's purchases	10.4	12.3	11.2	13.0	6.4
Change in assets	16.5	32.0	75.3	77.4	6.8
Gross reserve position	70.3	85.8	161.1	163.2	170.0

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.

Net inflows involving other foreign investments reached US$4.1 billion in August. Supplier’s trade credits registered net remittances of US$239 million, basically involving net amortizations of short-term credits. Loan operations registered net disbursements of US$4.3 billion, based on net inflows of US$1.9 billion in short-term loans and net disbursements of US$2.4 billion in long-term loans. In the first eight months of the year, other foreign investments registered cumulative net inflows of US$36.5 billion. A breakdown of this result shows that short-term trade credits posted net disbursements of US$14.7 billion, reflecting the dynamics of export exchange contracting operations. The behavior of direct loans was quite different depending on the maturity of the operations in question: medium and long-term operations resulted in net outflows of US$4.7 billion, while short-term operations generated net inflows of US$26.1 billion.

In the first eight months of 2007, international reserves expanded US$75.3 billion, rising to a total of US$161.1 billion. In that period, Central Bank purchases on the exchange spot market totaled US$67 billion. Among external operations, the highlights were disbursements of US$2.9 billion in bonds of the Republic, while MYDFA-related amortizations totaled US$69 million. Parallel to these operations, other items that deserve mention were revenues of US$3.8 billion in earnings on reserves and interest outlays of US$22 million, of which US$17 million were paid to the IMF, US$4 million consisted of MYDFA- related and US$1 million were targeted to international organizations. Other operations generated an increase of US$1.7 billion in the overall stock.

At the end of 2007, the international reserve stock was estimated at US$163.2 billion, up US$77.4 billion in the year. When operations carried out in the first eight months of the year are included, payments on external debt servicing are forecast at US$170 million, coupled with sovereign bond issuances already made in the amount of US$2.9 billion. At the same time, settlements of Central Bank domestic exchange market purchases in the period extending from January to August are estimated at US$67 billion.

5.5 External sustainability indicators

In the first eight months of 2007, external sustainability indicators maintained the positive trajectory registered in the

Table 5.10 – Sustainability indicators

						US$ billion
	2005	2006		2007		
	Dec	Sep	Dec	Mar	Jun	Aug[1/]
Exports of goods	118.3	132.3	137.8	142.4	150.0	151.9
Exports of goods and services	134.4	151.2	157.3	162.7	171.2	173.9
Debt service	66.0	67.7	56.9	59.4	53.2	55.4
Total external debt	169.5	159.6	172.6	182.1	191.4	194.3
Net external debt	101.1	70.8	74.8	60.0	28.9	19.7
International reserves	53.8	73.4	85.8	109.5	147.1	161.1
GDP	883	1017	1067	1106	1149	1178
Indicators						
Total external debt/GDP (%)	19.2	15.7	16.2	16.5	16.7	16.5
Net external debt/GDP (%)	11.5	7.0	7.0	5.4	2.5	1.7
Total external debt/exports	1.4	1.2	1.3	1.3	1.3	1.3
Total external debt/exports of goods and services	1.3	1.1	1.1	1.1	1.1	1.1
Net external debt/exports	0.9	0.5	0.5	0.4	0.2	0.1
Net external debt/exports of goods and services	0.8	0.5	0.5	0.4	0.2	0.1
Debt service/exports (%)	55.8	51.1	41.3	41.8	35.4	36.5
Debt service/exports of goods and services (%)	49.2	44.7	36.2	36.5	31.0	31.8
Reserves/total external debt (%)	31.7	46.0	49.7	60.2	76.9	82.9

1/ Estimated data.

two previous years, mainly as a result of growth in export operations, GDP and international reserve.

The external debt service diminished US$1.5 billion, mostly as a result of the external debt sovereign bond buyback program initiated in January 2006. The participation of debt service in exports, which increased US$14.1 billion, dropped from 41.3% in December 2006 to 36.5% in August 2007.

In this same time period, the overall debt increased US$21.7 billion, based on an increase of US$23.5 billion in short-term debt and a reduction of US$1.8 billion in the medium and long-term debt; the total net debt dropped US$55.1 billion; and GDP expressed in dollars expanded US$110.4 billion. Consequently, the ratio of total debt to GDP increased 0.3 p.p. to 16.5%, while the ratio of total net debt to GDP fell 5.3 p.p. to a level of 1.7%, the lowest value since the historical series began in 1970.

The coefficients of total debt over exports and total net debt over exports reached 1.3 and 0.1, respectively, in August 2007.

The ratio between international reserves, which expanded US$75.3 billion, and the total external debt increased from 49.7% in December to 82.9% in August, the highest level since the ratio was first calculated in 1970. At the same time, reserves represented 250.7% of the short-term debts in the month of August, according to the criterion of residual maturity.

5.6 Conclusion

The cumulative balance of payments surplus in the first eight months of the year is already sufficient to finance 2007 external accounts. Despite signs of a reduction in the current account surplus and a smaller trade surplus, the trajectory of financial flows has been quite significant, as cumulative net inflows of foreign direct investments in the last 12 months reached a level of US$35.1 billion in August, the highest level since the series was first calculated.

Strengthening of the nation's external accounts has contributed positively to the ongoing policy of expanding international reserves, coupled with measures aimed at reducing external indebtedness, including buyback operations and qualitative issuances on the international market, including bonds denominated in real, as occurred in the first half of the year. Over the course of the year, the risk levels attributed to Brazilian securities dropped to their historic minimums, even in moments of external turbulence. Taken together, these factors generated the conditions required both for obtaining an investment grade rating and for consolidating the positive outlook for the medium-term macroeconomics scenario.

In this framework, the Moody's risk rating agency concluded the process of reviewing the credit risk rating of the country's sovereign debt, raising it from Ba2 to Ba1, in foreign currency. The country's risk rating by the three largest rating agencies, Fitch, Moody's and Standard & Poor's is just one level below investment grade. This evaluation reflects improvement in the overall government indebtedness profile, anticipation of a more rapid drop in government indebtedness indicators in the near future and expected continuation of the process of strengthening external debt indicators. The notification released by the agency reinforced the position that the fundamentals of the Brazilian economy are sound, mainly when measured against other emerging economies, particularly as regards its capacity to cope with adverse external economic situations. The two major factors in this analysis are the nation's highly diversified exports and the very robust international reserve position.

The continued high level of financial flows suggests that the more volatile environment of international financial markets has not had a significant impact on Brazil's balance of payments result. Though risk exposure levels and international investor liquidity may not return to the levels in effect prior to the subprime crisis in the United States real estate market, foreign investment inflows are expected to continue, attracted by the highly positive fundamentals of the Brazilian economy.

Balance of Payments Projections

The projections for the nation's external accounts published in this Inflation Report were updated in relation to the previous quarter's Report. Data observed during the period were incorporated in the following areas: impacts of the new external debt stock calculated for the month of June; and alterations in the international economic environment. Parallel to this, the first projections for next year's balance of payments were released.

Current accounts are expected to register a surplus of US$7.8 billion in 2007, equivalent to 0.63% of Gross Domestic Product (GDP), compared to US$10.7 billion in the previous projection. This reduction was due to increases in projections of the service account deficit from US$10.4 billion to US$12.3 billion; and income, from US$23.4 billion to US$24 billion; and the US$0.3 billion reduction in net inflows of current unilateral transfers to a level of US$4.2 billion.

In 2007 through the month of August, exports totaled US$102.4 billion for growth of 15.9% compared to the same period of the previous year. When this result and the recent seasonally adjusted performance of external sales are taken into consideration, the forecast for the year rose US$3 billion to a level of US$155 billion, corresponding to growth of 27.8% in the period. Since this performance is better than previously expected, projections for the year were revised upward from US$112 billion to US$115 billion. Projections for the trade balance surplus remained at US$40 billion.

The increase in the forecast service account deficit in 2007, evident in comparisons between the September and June Inflation Reports, was driven basically

Table 1 – Uses and sources

US$ billion

	2006			2007			2008
	Aug	Jan-Aug	Year	Aug	Jan-Aug	Year[1/]	Year[1/]
Uses	0.5	-21.9	-30.8	-0.3	-22.3	-28.2	-24.3
Current account	2.2	7.8	13.3	1.4	5.0	7.8	3.2
Amortizations ML-term[2/]	-1.7	-29.7	-44.1	-1.6	-27.3	-36.1	-27.5
Securities	-1.3	-21.3	-25.6	-0.9	-13.4	-17.8	-11.2
Paid	-0.8	-19.9	-24.2	-0.9	-13.2	-17.6	-11.2
Refinancing	-0.5	-0.7	-0.7	0.0	0.0	0.0	0.0
FDI conversions	0.0	-0.7	-0.7	0.0	-0.2	-0.2	0.0
Suppliers' credits	-0.1	-1.0	-1.7	-0.1	-1.0	-1.8	-2.8
Direct loans[3/]	-0.3	-7.4	-16.9	-0.7	-12.9	-16.5	-13.4
Sources	-0.5	21.9	30.8	0.3	22.3	28.2	24.3
Capital account	0.1	0.6	0.9	0.1	0.5	0.8	1.0
FDI	1.2	10.2	18.8	2.0	26.5	32.0	28.0
Domestic securities[4/]	0.0	8.7	14.7	0.8	23.3	24.0	10.0
ML-term disbursem.[5/]	1.9	18.8	43.7	4.3	24.1	31.2	24.7
Securities	1.4	9.5	15.8	0.9	15.1	17.0	8.2
Supliers' credits	0.1	0.6	0.8	0.3	0.8	1.8	3.1
Loans[6/]	0.4	8.8	27.1	3.1	8.2	12.4	13.4
Brazilian assets abroad	-0.2	-8.6	-36.1	-5.9	-28.1	-22.0	-32.5
Other[7/]	1.0	8.7	19.4	2.9	49.2	37.5	0.0
Reserve assets	-4.4	-16.5	-30.6	-3.9	-73.1	-75.2	-6.8

1/ Forecast.
2/ Registers amortization of medium and long-term supliers' 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 liabilites and errors & omissions.

by revisions in projections for international travel, transportation and other services. Powered by the exchange rate and recent income gains, international travel registered a deficit of US$1.7 billion in the year through August, resulting in revision of the annual projection to a level of US$2.8 billion, corresponding to an increase of US$1 billion in the forecast deficit. The projection for the transportation account deficit was raised US$200 million to a level of US$3.8 billion, as a result of the enhanced dynamics of the trade flow. At the same time, the projection for other services was cut from US$2.1 billion to US$1.5 billion, always based on a comparison between this Inflation Report and that of the previous quarter.

The increase in the projected deficit for the income account reflected the performance of profits and dividends, as the forecast negative result moved from US$15.7 billion in the June Inflation Report to US$16.5 billion in this Report. As analyzed in previous editions, the behavior of net remittances of profits and dividends has been impacted by business profitability as a result of foreign participation in the country, steady growth in the stock of foreign direct investments and exchange appreciation.

Projections for net inflows of foreign direct investments were significantly higher in this Inflation Report. Growth in the 2007 forecast reflected the strong performance of investments in the first eight months of the year, with a new record of US$26.5 billion. Driven by the solidity of the nation’s macroeconomic fundamentals and expectations of an investment grade rating, this result surpassed the previous projection of US$25 billion for the entire year. The new forecast, US$32 billion, implies a slight reduction in monthly flows during the remaining months of this year, compared to the same period of 2006, with a final result that will be somewhat lower than that registered in the 12-month period through August, US$35.1 billion. Net outflows of Brazilian direct investments were revised from US$10 billion to US$8 billion.

Foreign portfolio investments in the country, stocks and fixed income securities were also revised for the year as a whole. The scenario of international liquidity, combined with domestic economic fundamentals, resulted in significant inflows of US$23.3 billion through August, easily surpassing the previous projection of US$15 billion. At the same time, revision of the 2007 forecast considers the scenario of lesser international liquidity and increased short-term risk aversion, closing with a conservative estimate of US$24 billion.

Total medium and long-term amortizations for 2007 consequent upon the debt position for the month of June, US$36.1 billion, represent an increase of US$1.8 billion compared to the previous projection. The new estimate includes National Treasury buybacks of external debt securities on the market, with an overall financial value of US$2.5 billion from May to August. The rollover rates of foreign and private medium and long-term indebtedness were maintained at 100%, with rates of 50% for loans and 174% for securities. From January to August, the rollover rate of this debt reached 108%, with 279% for securities and 37% for loans.

In the first eight months of 2007, short-term capital posted net inflows of US$49.2 billion. This amount includes security issuances of US$3.5 billion and loans totaling US$26.1 billion abroad; foreign investments in securities in the country, US$4.9 billion; and short-term trade credit lines, with US$14.7 billion. When the prudential measures adopted by the Central Bank with the objective of reducing financial system exposure to foreign currencies and the new international scenario are taken into consideration, the projection for this capital in this Inflation Report is specified at US$37.5 billion for the year, with net outflows in the final four months of the year.

In this projection, the assets of commercial banks abroad will expand US$8 billion, shifting from US$11.9 billion in the previous projection, while the international reserve position is expected to close the year at US$163.2 billion, corresponding to growth of US$77.4 billion compared to the end of 2006.

For 2008, the balance of payments projection includes a current account surplus of US$3.2 billion. The trade balance surplus is expected to drop to US$34 billion, a level fully consistent with 15.7% growth in imports and 7.7% in exports. The service account is expected to close with a deficit of US$12 billion, with slight

Table 2 – Balance of payments – Market

US$ billion

Itemization	2006			2007			2008
	Aug	Jan-Aug	Year	Aug	Jan-Aug	Year[1/]	Year[1/]
Current account	2.0	6.2	10.3	0.7	1.2	1.8	-3.6
Capital (net)	1.3	16.4	25.7	7.5	85.7	73.1	20.0
Foreign direct investment	1.2	10.2	18.8	2.0	26.5	32.0	28.0
Portfolio investment	0.0	8.7	14.7	0.8	23.3	24.0	10.0
Medium and long term loans	0.6	-2.2	6.9	1.2	-8.0	-10.1	-2.8
Trade credits – Short, medium and long term	0.4	5.7	11.9	3.0	42.8	34.5	0.0
Banks	0.4	-1.2	-0.7	3.2	28.2	22.5	-0.2
Other	0.0	6.9	12.6	-0.2	14.5	12.0	0.2
Brazilian investment abroad	-1.5	-9.5	-34.5	-0.8	-8.1	-14.0	-16.1
Other	0.6	3.5	7.9	1.3	9.3	6.7	1.0
Financial gap	3.3	22.6	36.1	8.2	87.0	75.0	16.4
Banco Central net intervent.	-4.6	-23.4	-34.3	-3.1	-67.0	-67.0	0.0
Bank deposits	1.3	0.8	-1.7	-5.1	-20.0	-8.0	-16.4

1/ Forecast.

growth in net outflows under most headings offset by reductions in the international travel deficit and by growth in the positive balance under other services.

Net remittances of profits and dividends are expected to increase in the coming year, registering an estimated value of US$16.8 billion. At the same time, projections indicate a reduction in net interest outflows to a level of US$6.9 billion, a figure compatible with revenue growth estimated at US$9.1 billion, basically as a result of earnings on reserves. Revenues consequent upon current unilateral transfers are expected to reach US$4.5 billion in 2008.

Net inflows of foreign direct investments should total US$28 billion, slightly less than the level projected for 2007. It is estimated that Brazilian direct investments abroad will reach US$10 billion, with continued internationalization of Brazilian companies. Investments in stocks and domestic securities are expected to accumulate net inflows of US$10 billion in 2008.

Medium and long-term amortizations are projected at US$27.5 billion, including US$1 billion in put/call options, US$8.6 billion less than forecast for 2007. For 2008, it is projected that the entire external debt service in National Treasury bonds will be paid through purchases of exchange on the market.

It is estimated that the rollover rate of 100% will be maintained for loans and private medium and long-term securities, compared to respective amortizations, thus resulting in disbursements of US$24.7 billion.

In this scenario, the 2008 balance of payments is totally financed, with the banking sector increasing its assets abroad an additional US$16.4 billion. In their turn, reserve assets are expected to expand US$6.8 billion. Consequently, the stock of international reserves at the end of 2008 should reach a level of US$170 billion.

6 Inflation outlook

This chapter of the *Inflation Report* presents Copom's evaluation of the behavior of the Brazilian economy and of the international scenario since publication of the most recent *Report* in June 2007, together with an analysis of the inflation outlook through to the end of 2008 and of GDP growth through 2007. Inflation projections are presented in two major scenarios. The first, denominated the benchmark scenario, presumes that the Selic rate will remain unchanged at 11.25% per year over the forecasting horizon, the level defined by Copom at its most recent meeting, held on September 4 and 5, and that the rate of exchange will remain quite close to that in effect on the days leading up to that meeting (R$1.95 per US dollar). The second scenario, termed the market scenario, utilizes the trajectories for basic interest and exchange rates drawn from the survey carried out in recent weeks by Gerin among private sector analysts. It is important to stress that these scenarios are used only as support for monetary policy decisions and should not be viewed as Copom's forecasts regarding the future behavior of interest and exchange rates.

The inflation and GDP growth forecasts included in this *Report* are not point estimates. They express probability intervals that reveal the level of uncertainty present at the moment in which the decision on basic interest rates was taken. Inflation forecasts depend not only on hypotheses regarding interest and exchange rates, but also on others surrounding the behavior of exogenous variables. The set of hypotheses considered most probable by Copom is used to construct the scenarios to which the Committee attributes the greatest weight in its interest rate decisions. On setting out these hypotheses, Copom has the objective of making monetary policy decisions more transparent and, in this way, contributes to the effectiveness of those decisions in controlling inflation, which is its primary objective.

6.1 Determinants of inflation

According to seasonally adjusted IBGE data, GDP registered 0.8% quarter-on-quarter growth in the second quarter of 2007, and 5.4% when viewed against the same quarter of the previous year. This was the highest rate since the third quarter of 2004 and the second largest in the last 11 years or, in other words, since the fourth quarter of 1996. Consequently, growth in the first half of the year closed at 4.9%, with four-quarter expansion of 4.8%. It is important to stress the robustness of the current cycle of Brazilian economic growth, as evident in the fact that, compared to the corresponding quarter of the previous year, the economy has expanded for 22 consecutive quarters. At the same time, one should highlight the recent acceleration in Gross Fixed Capital Formation (FBCF), reflecting the outlook for continued macroeconomic stability, coupled with a positive scenario regarding longer-term economic evolution. Coupled with growth in household consumption (5.9%) in the first half of the year, FBCF performance shows that the current growth cycle has been driven primarily by internal demand. At a moment in which uncertainties are spreading regarding the future growth of the global economy, the dynamics of domestic demand have maintained a highly positive outlook for Brazilian economic activity. Therefore, the Committee has ratified the scenarios set out in recent *Inflation Reports*, according to which Brazil will register robust growth over the coming quarters. To achieve this, the key factors will be price stability, expanding investments, strengthening of the labor market, real income growth and a broader supply of credit. Here, one should also add lesser external vulnerability, reductions in macroeconomic uncertainties and a consistently watchful eye from monetary policy. Despite recent deterioration on international financial markets and greater uncertainties regarding the pace of growth in the more mature economies, these factors should be sufficient to guarantee continuation of the current growth process.

Following four consecutive years of declining inflation, culminating at just 3.14% in 2006, IPCA inflation shifted upward once again in 2007. As a matter of fact, cumulative 12-month inflation, which had dropped to just 2.96% in March, increased to 3.69% in June, climbing to 4.18% in August, making it probable that inflation will close the year at a much higher level than in 2006. Contrary to what occurred last year, when the benign behavior of inflation was impacted in a highly favorable manner by the exceptionally positive performance of food prices, 2007 inflation has been adversely impacted by the reversal of this process. On the other hand, the behavior of regulated prices in 2007 has been quite benign, as cumulative inflation through August closed at 1.19%, against 3.07% in the same period of 2006. Despite less favorable recent developments than originally expected, the price dynamics indicate that inflation will continue evolving according to the target path.

Similarly to consumer price inflation, broad inflation measured by general indices also turned upward in 2007. Twelve-month inflation measured by the IGP-DI, which closed 2006 at 3.79%, moved to 4.49% in March and 5.19% in August, closing at a level higher than consumer inflation (4.18%) measured by the IPCA. Despite this, the increase in the IGP-DI can, to a great extent, be explained by the behavior of the consumer prices covered by the IPC-Br, since this index rose from 2.05% at the end of 2006 to 4.47% in August, when viewed in cumulative 12-month rates. Using the same basis of comparison, growth in the National Cost of Construction Index (INCC) remained stable (5.04% against 5.05%), while the IPA-DI rose from 4.29% to 5.49%. It should be noted that, for the most part, upward movement in the IPA-DI was basically caused by farm prices, with cumulative 12-month growth of 14.87% through August (compared to inflation of 6.92% in December 2006), while industrial prices increased only 2.65% (against 3.46% in December of last year). While generating significant impacts on the prices of food products included in the IPCA, the upturn in farm prices also reflected the impact of the steady rise in the international market prices of such commodities as soybeans, rice and beef. Despite benign behavior until quite recently, signs of upward movement in wholesale industrial product prices, at the margin, are now evident.

Since the publication of the most recent *Report*, important changes have occurred on the external scenario. The June *Inflation Report* had already mentioned that financial market problems, particularly involving loan-backed securities and other liabilities, could have a significant impact on the world economy. At the time, this was no more than a word of caution regarding an external scenario that, in general, pointed to continued robust global growth, despite deceleration in the United States economy. Since that time, however, international financial markets have plunged into a period of significant turbulence. Perceptions that investments in assets originating in the United States real estate sector were at the roots of recent losses increased, though the extent and distribution of these losses among the financial institutions of the mature economies were not yet fully understood. This situation of increasing uncertainty gave rise to liquidity problems on international markets. Central banks, particularly in Europe and the USA, reacted promptly by increasing their liquidity provisions and facilitating discount window operations. However, these economies must still cope with problems of asymmetric access to interbank credits, though this situation seems to have improved somewhat when viewed in terms of mid-August data.

These developments had an important impact on the monetary policy outlook in the more mature economies, primarily in the sense of limiting the scope of contractionary measures, in light of the increased risk of a more accentuated economic downturn, at least over the short-term. More specifically, the need to mitigate the potential impact of financial turbulence on economic activity led the Fed to alter its monetary policy bias on August 17, followed by a larger interest rate cut than had been expected by market participants at its September 18 meeting. According to American monetary authorities, these measures suggest an increased possibility of the repercussions of the real estate sector crisis affecting the financial sector and consumer confidence, resulting in an even sharper downturn in economic activity. In Europe and in the major Asian economies, economic activity was more robust, despite a certain degree of cooling off in the Japanese economy. Nonetheless, this scenario of vigorous global activity could be adversely affected by the repercussions of the United States crisis. At the same time, some observers note that adoption of a more expansionary monetary policy by the major central banks could generate medium-term inflationary impacts. In short, one must recognize that, despite the opportune response to the increase in financial volatility by major central banks, the external scenario has become more uncertain than in the month of June, and that changes in sentiments and growing perceptions of risk must be closely monitored.

With respect to potential repercussions on the Brazilian economy of a possible more intense global process of deceleration, a number of preliminary considerations could be put forth. In the first place, since the current growth cycle has been powered to a great extent by internal demand and considering the initial repercussions of the crisis on exchange rates and domestic interest rates, the impacts of the external crisis would not seem sufficient to derail the Brazilian economy from its current growth path, a pace which has been significantly above than the average growth rate registered in recent years. Secondly, despite the uncertainties surrounding the effects of the crisis on the US economy and, to a lesser extent, on the world economy as a whole, it would seem reasonable to presume that, in the case of inflation, a global slowdown could have the effect of curtailing the upward spiral in commodity prices, with potentially positive impacts on the inflation outlook. In contrast, however, in this scenario, the continuity of the external sector contribution to a benign inflation scenario could be jeopardized. Therefore, the net effect on transmission to the domestic inflation scenario is *a priori* uncertain and the impact on the rate of domestic demand growth and consequently on the activity level would tend to be limited.

In this scenario, in the third quarter of the year Copom continued the process of monetary policy easing that had begun in September 2005. The Committee reduced the Selic rate target in 50 b.p. and in 25 b.p. at its July and September 2007 meetings, respectively. Consequently, since this process first began in September 2005, the overall reduction reached 850 b.p., with 200 b.p. in 2007 alone. Therefore, a significant part of the effects of the interest rate cuts has not yet been reflected in the activity level, nor have the effects of the activity level on inflation had time to materialize. Currently set at 11.25% per year, the Selic rate now stands at its lowest level since it was first created in 1986.

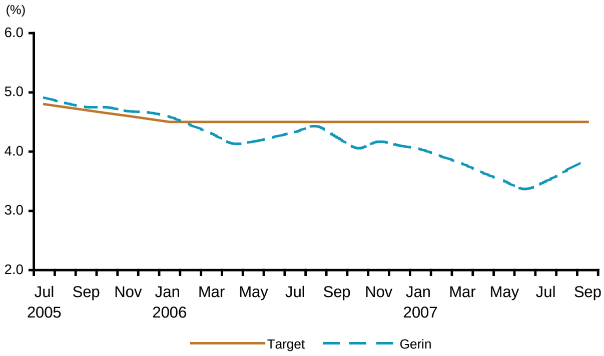
The benign scenario for consumer prices, which was building up since the midpoint of last year, has deteriorated. At least to some extent, since previous *Reports* and the Minutes of Copom meetings had forecast that cumulative 12-month inflation would accelerate over the course of the third quarter, these developments do not come as a surprise. Though acceleration was more intense than originally expected, IPCA inflation continued evolving according to the target path. After registering 0.28% in June and dropping to 0.24% in July, monthly inflation accelerated to 0.47% in August. Consequently, cumulative inflation in the year through August reached 2.80%, approximately one percentage point above the August 2006 rate (1.78%). Aside from this, after reaching 2.96% in March of this year, cumulative 12-month inflation has gradually accelerated, reaching 4.18% in August, compared to 3.84% in the same month of the preceding year. Contrary to what occurred in recent years, free prices in 2007 have risen more than regulated and contractually determined prices, considering that the latter have played an important role in mitigating inflation. In fact, while free prices rose 3.53% in the year through August, regulated prices increased just 1.19%. Viewed from a different angle, in 12-month cumulative terms, the difference between the rates of inflation registered by regulated and contractually monitored prices and free prices has been negative for the last four months. When free prices are viewed as a whole, nontradables inflation registered 3.81% in 2007, compared to 3.24% for tradables inflation, which accelerated despite exchange rate appreciation in 2007. The prices of services, in turn, registered growth of 3.74% in the year, a sharp drop compared to the 4.23% level in the same period of the previous year. One notes that, following the long April-August process of deceleration, cumulative 12-month services´ inflation stabilized at a relatively high level, though preliminary data for the month of September would seem to indicate more favorable results.

Two of the three major core measures calculated by the Central Bank accelerated in the first eight months of the year, compared to the corresponding period of 2006. In the year until August, the core by exclusion of regulated prices and the prices of food taken at home closed at 2.45%, slightly above the level registered in the same period of the previous year (2.43%). The core measured by trimmed-means with smoothing of predetermined items accelerated in the year through August (2.24% compared to 2.04%). In 12 months, the core by exclusion shows a reduction to a level of 3.58%, against 3.71% last year. Nonetheless, this index reflects significant growth when viewed against the 2.59% result registered in March 2007. Over 12 months, the decline in the smoothed trimmed-means core was greater, moving from 5.40% to 3.79%, a movement that was consistent with the inertial character of this measurement (which reached a minimum of 3.63% in July). In the same period of comparison, the non-smoothed trimmed-means core shifted from 3.75% in August 2006 to 2.96% this year. These figures were also higher than the minimum level of 2.23% registered in March 2007. Finally, it is important to stress that, just as in the case of headline inflation, these three measures of underlying inflation are well below the target center of 4.5% forecast for the coming years.

After increasing from 0.16% in May to 0.26% in June and 0.37% in July, IGP-DI inflation increased even further in the month of August, reaching 1.39%, the highest monthly rate since June 2004. With this result, cumulative growth in the year through August reached 3.24%, against 1.87% in the same period of the preceding year. Over 12 months, the increase was more accentuated (5.19% in the current year, against 2.78% in August 2006). The acceleration of the IGP-DI reflects both wholesale price increases, which have a weight of 60%, and consumer prices increase, whose weight amounts to 30%. Analysis at the component level shows that the IPC-Br accelerated sharply, rising 3.23% in the year through August, compared to 0.84% in 2006, while the INCC remained stable (4.10% in 2007, compared to 4.09% in 2006) and the IPA-DI increased from 1.93% to 3.10%. In the 12-month period through August, these three major components of the IGP-DI posted cumulative growth of 4.47%, 5.05% and 5.49%, respectively (2.40%, 5.23% and 2.56% in 2006). Aside from the evident upward movement, a breakdown of these figures shows that IGP-DI components registered inflation rates that were higher than that measured by the IPCA and, in the cases of the IPA-DI and INCC, higher than the 4.5% target defined by the CMN for this and the next two years.

As expected, the inflation surprises witnessed in recent months affected inflation expectations for this year and next year. For 2007, both the median and the mean of inflation expectations gathered by Gerin increased since publication of the previous *Report*. For 2008, the median remained stable over a relatively long period, despite the fact that the mean, which usually moves ahead changes in the median, had already begun shifting upward. The median of inflation expectations gathered by Gerin for 2007 IPCA moved from 3.50% in the period immediately prior to the June Copom meeting to 3.92% before the September meeting, and later surpassed the barrier of 4.00%. In turn, the median of expectations for 2008, which had been anchored at 4.00% at the time of the September Copom meeting, recently shifted upward to 4.10%.

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



Following the September Copom meeting, the IBGE announced that, at market prices, GDP had registered 0.8% quarter-on-quarter growth in the second quarter, and 5.4% when viewed against the same quarter of 2006. This was the highest rate since the third quarter of 2004 when the economy expanded 5.7%. The IBGE also announced that economic activity had expanded 4.9% in the first half of the year, compared to the same period of the preceding year, with cumulative 4.8% growth in four quarters when viewed against the immediately previous four-quarter period. Using this basis of comparison, this was the sharpest growth since the second quarter of 2005. Among the aggregate demand components, one should highlight Gross Fixed Capital Formation and imports, with respective growth rates of 13.8% and 18.7%, compared to the same quarter of the preceding year. The upturn in Gross Fixed Capital Formation is obviously important to the sustainability of the current growth cycle. At the same time, it stands as a proof that macroeconomic uncertainties have diminished in recent years, primarily as a result of a monetary policy committed to price stability.

As anticipated in previous *Inflation Reports* and in the Minutes of Copom meetings, national accounts confirm sharp growth in domestic demand. As a matter of fact, household consumption expanded 5.8% in the second quarter, compared to the same period of 2006. Coupled with strong growth in investments, this performance indicates that internal demand has been the major driving force underlying economic growth, though the export sector surpassed the less optimistic original forecasts. Following what was stated in the documents released by Copom, increased domestic demand reflects growth both in employment levels and wages, together with an expanded credit supply. In this regard, the favorable evolution of the latter two factors has not only been positive but has been influenced by the recent decrease in inflation.

With respect to aggregate supply, the three sectors posted strong results in the second quarter of this year. Industry expanded sharply, registering a growth rate (1.3%) that was considerably higher than in the first quarter (0.4%). Not only was this growth the leading factor in the process of economic expansion in general, but it also belied more pessimistic analyses of the dynamics of the Brazilian manufacturing sector. The 6.8% growth in industrial product, compared to the same period of the previous year, was the highest rate registered since the third quarter of 2004. The service sector also posted robust growth, and grew for the 16th consecutive quarter (0.7%), though this result was somewhat below the figure for the previous quarter (1.7%). Compared to the second quarter of 2006, growth in the service sector reached 4.8%. In its turn, the crop/livestock sector registered the least vigorous growth, particularly in the second quarter when expansion closed at only 0.6% and 0.2% compared to the first quarter of 2007 and second quarter of 2006, in that order. When viewed in inter-annual terms, this low growth contrasts with data estimated for the farm harvest, including a forecast of 14.3% 2007 expansion in the grain harvest, compared to 2006.

Despite the more intense pace of economic activity and the strengthening of the national currency, the balance of trade turned in very solid results. Though there has been some decline at the margin, the performance of the trade balance corroborates the evaluations put forward in *Inflation Reports* and the Minutes of previous Copom meetings regarding important structural changes in Brazilian foreign trade. In fact, the trade surplus through August reached US$27.5 billion, 7.5% less than in the same period of the previous year. Above all else, this result was due to the performance of the import sector, which posted 27.8% growth in the period, while exports expanded 15.9%. In the 12-month period through August, the trade surplus dropped slightly, closing at US$44.2 billion. This was the third consecutive monthly decline, the first time this has happened since May 2001. Though the performance of the trade balance has surprised many analysts, there is evidence that the expected process of weaking of trade surpluses has begun. This is a process driven both by the price-effect, as reflected in the real rate of exchange, and by the income-effect, resulting from increased domestic demand. Despite this, this movement would seem to point to a natural and healthy adjustment of the country's external accounts in its pursuit of long-term equilibrium.

Also with regard to foreign trade, though the volume of imports has expanded more sharply than exports in recent quarters, the increase in external purchases (27.5% in cumulative 12-month terms through August) has been generated primarily by purchases of capital goods (25.7%, using the same basis of comparison). In this sense, this development can, on the one hand, be understood as a harbinger of increased internal output capacity and, on the other, as an indicator of modernization in the country's already existent factories. Furthermore, one should note that growth in the value of exports (16.2% in cumulative 12-month terms through August) reflects increases in exported volume and not only in prices, particularly as regards the major commodities included among Brazilian foreign sales. Strictly speaking, the exports quantum expanded 5.9% in the 12-month period through August and, following a sharp reduction in the first half of 2006, has recovered in recent months. In their turn, prices rose 10% in the same period. In this context, though the 2007 trade balance surplus is expected to be lower than in the last two years, Copom has not predicted any abrupt turnaround in the steady process of generating large-scale trade surpluses as has occurred in the recent past. The current account balance registered a surplus of US$5.0 billion (0.6% of GDP) in the year through the month of August, and US$10.6 billion (0.9% of GDP) in the last 12 months.

According to CNI data, capacity utilization in the manufacturing sector reached 82.5% in July, rate 2 p.p. above that observed in the same month of 2006. With this result, the average rate of capacity utilization through July 2007 closed at 81.7%, 1.8 p.p. above that registered in the same period of last year. When compared to both 2005 and 2004, the difference reaches 1.2 p.p. The increase in the level of capacity utilization to historically high levels reflects acceleration in the pace of economic activity and has occurred despite sharp growth in the volume of investments in the economy. It is important to highlight that capital goods absorption through July expanded 17.2%, primarily as a result of strong growth of imports (30.3%

in volume terms) and increased production of capital goods (17.0%). One should also note that production of inputs for the construction industry expanded 4.1% in the same period. Considering the recent behavior of capacity utilization, acceleration of investment spendings will be a fundamental factor in avoiding a widening of the gap between the evolution of aggregate supply and demand in coming quarters, since such an occurrence could increase the risk of further increases in inflation.

Based on seasonally adjusted IBGE data, the quarterly moving average of the industrial output increased 0.6% in July. A month-on-month comparison shows that, following nine consecutive increases, the longest growth period since the historical series was first calculated in 1991, industrial output declined 0.4% in July, based on seasonally adjusted IBGE data. Even so, a comparison with July 2006 shows solid 6.8% growth, corresponding to the 13th consecutive positive result in this metric. In the year through July, the increase came to 5.1%, with a cumulative 12-month result of 4.2%. The dynamics observed in recent months suggest that the discrepancy detected between industrial output and sales are being gradually eliminated, thus reinforcing the position that the current growth cycle should continue into the coming months. It is important to highlight that robust growth in the manufacturing sector, with expansion of 5.1% through July, was to a great extent driven by 17.0% expansion in capital goods output and 5.9% in consumer durables. One should also stress solid 4.2% growth in the production of intermediate goods, following a long period of relative sluggishness. This is interpreted as a sign that growth is disseminating through various sectors of the economy, clearly demonstrating the solidity of the growth process as a whole.

The acceleration in the pace of economic activity in recent quarters has generated positive impacts on the labor market. For instance, unemployment seems to have begun falling, following a long period of stability. After remaining constant at 10.1% in the March-May period, the unemployment rate dropped to 9.7% in June and 9.5% in July and August. Compared to the same month of the preceding year, the August result represented the seventh consecutive decline in unemployment. Consequently, average unemployment through August closed 0.5 p.p. below the results for the same period of last year. In its turn, average real earnings dropped in August for the third consecutive month, but still closed the first eight months of the year with an increase of 3.8%. As a result, payroll increased 6.8% in the first eight months of the year, compared to the same period of 2006, thus reinforcing evidence that this is an important factor to sustaining growth in aggregate demand. According to CNI data, employment in the manufacturing sector expanded 3.5% in the first seven months of the year, precisely the same as the 12-month rate. With regard to formal employment, data released by the Ministry of Labor and Employment indicate that the strong growth registered in 2006 further intensified in 2007. In the first eight months of the year, 1.36 million jobs were created. As a result, led by the construction industry (7.0%) and commerce (6.0%), the level of formal employment increased 4.9% in the year.

According to the seasonally adjusted data by IBGE, retail sales increased 0.6% in May, 0.2% in June and the 0.5% in July, thus completing seven consecutive months of positive growth. As a result, retail sales in the first seven months of the year expanded 9.7% compared to the same period of 2006, with 8.7% growth in the 12-month period through July. Here, particular mention should be made of sales of furniture and home appliances, which expanded 16.7% in the year through July, compared to the same period of 2006. This process was clearly driven by continued growth in wages and employment levels, as well as better credit conditions. In the same period, sales of fabrics, apparel and footwear took on added importance, expanding 10.1%. One should also note that sales of vehicles, motorcycles, parts and spares, which are not included in the general index, turned in strong 22.9% growth over the first seven months of 2007, basically reflecting record vehicle sales. In the coming quarters, the outlook points to continued retail sales growth, which should be driven by expanding employment and income levels, by increasing credit supply, by the lagged impact of monetary policy, coupled with recovery in consumer confidence.

6.2 Benchmark scenario: assumptions and risks

Forecasts assessed by Copom are based on a set of hypotheses regarding the behavior of the major macroeconomic variables. These assumptions and their associated risks form the benchmark scenario that underlies the Committee's decision-making process.

The Committee understands that, since the last *Report*, the balance of risks to the expected inflation path has become less favorable from the viewpoint of both external and internal factors. In the domestic framework, the pace of demand growth, which is expected to continue due, among other factors, to the more flexible monetary policy implemented in the current year, is becoming increasingly more relevant as a source of risk to the dynamics of inflation. On the other hand, more recent events suggest that the external sector's contribution to consolidation of a benign inflationary scenario may well be losing its effectiveness.

The external scenario has changed significantly since June when international financial markets entered a period of turbulence. The difficulties of the United States real estate market rippled out into the financial system, creating problems on the interbank markets of the mature economies that still persist, despite the rapid action taken by most of the major central banks. These events generated important impacts on monetary policy outlook in the USA, Europe and Japan. Contractionary measures are not an option over the short term, at least until the effects of current financial market stress become clearer. At the same time, the potential impacts of this turbulence on economic activity may reduce the need for interest rate hikes in those economies. In the United States, for example, one cannot ignore the possibility that the September interest rate reduction will be followed by additional cutbacks.

Even considering that the United States economic activity may have already partially adjusted to the mortgage market crisis, increased the possibility that the side effects of real estate sector difficulties on the financial sector and consumer confidence could generate a considerably more profound economic slowdown. In Europe and the major Asian economies, economic activity is more robust, though there has been some dampening of the pace of activity in Japan. In any case, the crisis in the United States could generate negative impacts on this scenario of vigorous global economic activity. This evaluation is reinforced when one notes that rising inflation in Chinese should dominate monetary policy decisions. However, despite these added concerns, the outlook for world economic growth remains positive, albeit less optimistic and considerably more uncertain than at the time of publication of the most recent *Report*.

On the other hand, improvements in Brazilian economic fundamentals, particularly as regards external solvency indicators, make it more likely that the impacts on the domestic economy will be limited. The Brazilian economy has consistently shown itself to be more resilient to international market turbulence, which does not seem to have generated any significant impact on domestic inflation and economic activity, at least to the moment. More specifically, the prices and risk evaluation of

Brazilian assets have not suffered serious impacts, as occurred in previous periods of international financial stress. Actually, in the midst of this turbulence, the major rating agencies have maintained the country's classification quite close to investment grade. Furthermore, Brazil has been consistently targeted as a preferred destination not only for portfolio investments, but also for an increasingly larger amount of foreign direct investments. In this context, Copom reaffirms that, in light of the information currently available, there are no imminent balance of payments risks to the inflation scenario.

In recent years, oil prices have been a systematic source of international market uncertainty. Not only have they remained volatile but have actually increased in the last two quarters, setting all-time records in recent weeks. Recently, international price' level for this commodity seems to reflect important structural shifts in global energy demand, as well recurrent episodes of geopolitical uncertainties. Despite inherent uncertainty in future oil prices trajectory, the benchmark scenario adopted by Copom, with no change for domestic gasoline prices in 2007, remains plausible.

In the domestic scenario, the major cause for concern resides in the possibility that lags between aggregate supply and demand result in inflationary pressures. The Committee evaluates that the growth pace of domestic demand, which does not yet reflect the completely the monetary stimulus injected into the economy, represents a risk to the dynamics of inflation that cannot be ignored. This evaluation becomes clearer when one analyzes economic activity data, such as the high level of industrial capacity utilization and retail sales. Parallel to this, one should recognize that the fiscal impulses present in the current year and expected for 2008 stand as an additional incentive to domestic demand, at the same time in which demand for Brazilian exports has been much greater than expected. In this context and in line with Copom evaluation in previous documents, the uncertainties surrounding the future dynamics of inflation have increased, particularly as regards intensity and the lags inherent to the monetary policy pass-through mechanism. This becomes even more important when one recalls that the effects of the more flexible monetary policy implemented in the last two years are cumulative in nature.

GDP has continued expanding at a sustained pace, despite its slight deceleration in the first two quarters of 2007 – on a quarter-to-quarter basis. In an accumulated four-quarter, the 4.8% mark achieved in the second quarter was the highest since the second quarter of 2005. Particularly from the point of view of supply conditions, note should be taken of the rapid growth in gross fixed capital formation, which expanded 9.8% using the same basis of comparison. This performance signals that the productive capacity of the economy will continue expanding steadily in coming quarters. This evaluation is supported by the recent dynamics of capital goods production and absorption. Actually, estimates of capital goods absorption point to 16.2% growth in the first seven months of the year, compared to the same period of the previous year. However, one is forced to acknowledge that even though higher capital formation growth than GDP growth aids in mitigating the risks of intensifying lags between aggregate supply and demand, it is certainly not sufficient to eliminate them.

Despite the favorable dynamics of capital formation, the level of utilization of installed industrial capacity has grown to record levels since the second half of 2006. Though investments have helped delay the rise in capacity utilization, they have not been sufficient to avoid the maintenance of this utilization in historically high levels. When this occurred in the past, they coincided with periods of rising inflation. Considering the recent behavior of industrial capacity utilization rates, the continuous expansion of investment projects and its timely maturity will become even more important to avoid the mismatch between growth in domestic demand and supply, verified in the near past, last any longer than would be consistent with the maintenance of a price stability environment. Parallel to this, it is important to highlight that prospective inflation trends do not depend only on the degree of industrial idle capacity, given the important weight of the service sector not only in terms of GDP, but also as a component of the IPCA. In this context, it is important to note that the various labor market indicators have clearly accompanied expanding output, such as unemployment rate, number of jobholders, nominal and real earnings, overall wages and wage increases.

The external sector of the Brazilian economy plays an important role in holding inflation to low levels, and contributes positively to a benign inflation scenario over the forecast horizon, particularly with regard the discipline imposed over the tradable good prices and the increase in investments in a strong demand environment. Nonetheless, the gradual, but consistent, rise in inflation and inflation expectations suggests that domestic factors, primarily expanding demand, could be offsetting the positive contribution of the external sector that has become less effective.

Actually, though the inflation expectations remain below the 4.5% target for 2007 and 2008, they have being rising in recent months. Since the release of the most recent *Report*, expectations have evolved unfavorably, reaching levels well above those expected in recent months. For 2007, median of expectations moved from 3.6% to 4.0%. Higher short-term inflation still showed a limited impact on expectations for longer-term horizons. More specifically, median of expectations for 2008, which had remained stabilized at 4.0% for several months, recently moved beyond that point. The Committee evolves that the increase in inflation expectations for 2007, for the next 12 months, and recently for 2008, is a process that deserves careful monitoring.

With regard to risks, it is also important to consider price movements at the wholesale level and their possible repercussions on the consumer price index. In contrast to the previous quarter, the third quarter of this year was impacted by agricultural prices on the wholesale market. In cumulative 12-month terms, wholesale farm prices increased 14.9% through August. Wholesale industrial prices, in their turn, had shown rather benign behavior until recently, though there is increasing evidence that the situation may be changing. In any case, the impact of changes in wholesale prices on consumer inflation will depend essentially on the prospective conditions of supply and demand and the expectations of price-setters in relation to the future inflation path. Compared to previous quarters, Copom has concluded that the probability of initially limited inflationary pressures becoming a risk to the inflation trajectory has increased, since strong demand could worsen the pass-through of pressures on wholesale prices to consumer prices.

Regarding market prices, significant pressures remain on the prices of non-tradables, particularly in the case of services. More recently, similar developments have occurred under-tradables. In contrast, the outlook for regulated prices evolves to be more favorable. Without ignoring any developments related to the major components of inflation, Copom will continue acting in such a way as to ensure the preservation of the gains achieved in combating inflation in recent years. To do this, it will closely monitor the evolution of inflation in coming months, together with the different core measurements, distinguishing between isolated price increases of persistent or generalized ones, while promptly adjusting its monetary policy posture to changing circumstances.

One of the major characteristics of the inflationary uptick in the current year was the increase in food prices, in contrast to the benign behavior of these prices in 2006. Though there is some controversy regarding the origins of this movement, the dominant position is that domestic and international demand factors have played an important role. It is plausible to assume that the price pressures that have marked 2007 will, to a certain extent, be reversed in 2008. However, this hypothesis must be analyzed in light of expectations of expansion on global food demand and of relative shortages of resources to produce food, especially in mature economies. Furthermore, it is important to note that the experience of various central banks suggests that increases in the prices of highly visible items, such as energy and food, tend to have disproportionately important impacts on the formation of inflationary expectations[1].

Only rarely are episodes of accelerating inflation uniformly distributed among the different components of the price indices. As shown in a box in this *Report*, the periodicity of price changes is marked by intense heterogeneity from one sector to another. In recent months, the behavior of cores and indices of IPCA diffusion, service prices and wholesale industrial prices suggest that an inflationary process initially limited in scope may well become more disseminated. Therefore, it is the task of monetary policy to assume an attitude of vigilance to avoid the possibility that episodic and isolated price increases be disseminated throughout the economic system.

Based on inter-annual comparisons, the recent upturn in inflation has impacted real wages, as increases have become considerably more moderate in recent months. However, sustained by the delayed impact of the effects of a more flexible monetary policy, among other factors, employment growth has driven increases in overall real wages at a healthy pace and is expected to continue, albeit at a more moderate rate.

Credit has played an important role in sustaining growth in aggregate demand. After expanding at rather high rates for several quarters, it is natural that the pace of credit growth would begin leveling off. However, up to the present, neither the delinquency rate nor recent increases in market interest rates have been sufficient to harness credit growth, as is evident in the evolution of the various modalities of consumer financing. If the increase in market interest rate reflects the deteriorating of inflation expectations of investors, it will not have significant impact on the pace of growth in aggregate demand.

1/ See, for example, “Public Attitudes to Inflation and Interest Rates”, Quarterly Bulletin of the Bank Of England, second quarter 2007.

Increased financial market turbulence, coupled with signs of weakening in the United States economy, generated a monetary policy response on the part of the Federal Reserve, and represented a test for the notion of rotating growth, according to which Europe and Asia would take up the gap and ensure continuity of the process of world economic growth, despite a sharp downturn in the USA. One cannot ignore the possibility of a more intense slowdown in the world economy. However, at the same time, one should not automatically work with the thesis of deep economy slowdown; neither that in this case it will become an important factor in the mitigation of inflationary risks present in the Brazilian economy. Once again, it is important to recall that the process of Brazilian economic growth, which remains relatively less exposed to foreign trade and, therefore, is not closely synchronized to the business cycle of more mature economies, has been driven by vigorous growth in domestic demand.

Copom evaluates that the monetary policy posture adopted in recent years has contributed significantly to the consolidation of a favorable macroeconomic environment, even over longer term horizons, based on construction of a benign inflation scenario. With this new reality in mind, the major monetary policy challenge is to guarantee that the positive developments foreseen for the future are effectively brought to fruition. Inflation rates consistent with the target trajectory, coupled with solidification of a scenario of lasting macroeconomic stability, will contribute decisively to consolidation of the process of gradually diminishing perceptions of macroeconomic risks that has marked recent years. The space for lower real interest rates in the future will come about naturally, as a consequence of improved perceptions. These positive developments will also stimulate investments, particularly involving projects with long periods of maturation, and could contribute importantly to the sustainability of the growth process that is now taking place in the Brazilian economy.

The Committee highlights once more that there exist important lags between monetary policy implementation and its effects on activity and inflation rates. Consequently, when one considers that since the more flexible monetary policy cycle began in September 2005, basic interest rates have fallen 850 b.p. (475 b.p. in 2006), the tendency over time will be for the lagged impacts of the interest rate reduction that occurred last year to be felt simultaneously with the initial effects of 2007 reductions (200 b.p.). Though the economy has shown signs of robust expansion since the third quarter of last year, a significant share of the effects of interest rate cutbacks has not yet been felt in the activity level, in much the same way as the effects of activity on inflation have not yet had time to fully generate their impacts.

Assessments of alternative monetary policy decisions must necessarily concentrate on analysis of the prospective scenario for inflation and its associated risks, instead of prioritizing the current values of this variable. In this regard, growth in employment and income levels coupled with expanding credit will drive aggregate demand. One should add to these factors the effects of expansion in current government spending and transfers, as well as other factors of a fiscal nature. Combine with this scenario, the effects of the interest rate cutbacks cited in the previous paragraph on aggregate demand must also be considered, coupled with signs of strong demand and the fact that recent monetary policy decisions will mostly impact the economy in 2008.

In light of these considerations, Copom decided to reduce the Selic rate target by 0.50 p.p. and 0.25 p.p., respectively, at its July and September meetings. In order to consolidate an environment of stability and foreseeability, the Committee has opted for a strategy aimed at avoiding a volatile inflationary trajectory. This strategy gives due consideration to the lags inherent to the transmission mechanism and has demonstrated that it deals best with the uncertainties inherent to the process of monetary policy formulation. Thus, the importance attributed to inflation forecasts and, even more importantly, to preventive measures in the Committee's decision-making process. Within this process, prudence assumes a position of even greater importance particularly at moments such as these in which deteriorating inflationary risks diminished the monetary policy safety margin.

Projection for contractual and regulated prices in 2007 was recalculated from 3.6% in the June 2007 *Inflation Report* to 3.2%. This projection is based on the hypothesis of cumulative zero growth in gasoline and bottled gas prices in 2007. At the same time, average electricity and fixed telephone rates are expected to vary -4.4% and 2.8%, respectively. Projections for contractual and regulated prices increase for 2008 were maintained at 4.5%. Those items for which detailed information is available had their prices projected individually, while projections for other prices remain based on the endogenous model for determining regulated prices that takes due account of seasonal components, exchange rate variations, market price inflation and inflation measured by the General Price Index (IGP), which closed at 5.19% in the 12-month period through August.

According to traditional procedures, the benchmark scenario assumes maintenance of a constant exchange rate over the forecasting horizon, at R$1.95/US$, close to the level verified prior to the September Copom meeting, and a Selic rate target of 11.25%, the figure adopted at that meeting. These data generate the expected trajectories for the 180-day pre-DI swap rate with spreads of 3 b.p. and 48 b.p., in relation to the Selic rate, for the final quarter of 2007 and 2008, respectively.

According to survey gathered by Gerin among private-sector analysts, expectations for exchange-rate evolution indicated a reduction when compared to the figures released in the June *Inflation Report*. For the final quarter of 2007, expectations moved from R$1.95/US$ to R$1.90/US$ and from R$2.04/US$ to R$1.95/US$ for the final quarter of 2008. Expectations regarding the evolution of the average Selic rate increased slightly in relation to the amounts stated in the June *Report*. For the final quarter of 2007 and 2008, the average went from 10.98% to 11.05% and from 10% to 10.17%, respectively. This trajectory is consistent with zero rate spreads for six-month pre-DI swaps in the final quarter of 2007 and -20 b.p. in the final quarter of 2008. In the market scenario, it is assumed changes of 3.2% and 4.6% for regulated prices in 2007 and 2008, respectively.

Insofar as fiscal policy is concerned, the projections presented in this *Report* assume compliance with the primary surplus target of 3.8% of GDP in 2007 and 2008, adjusted by the possibility of a reduction of as much as 0.45 p.p. in this percentage, as a result of implementation of the Pilot Investment Program (PPI).

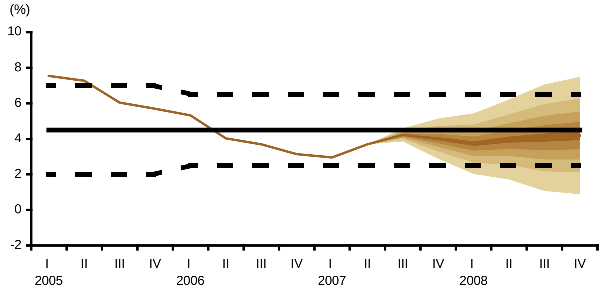
6.3 Inflation forecasts

Based on the assumptions above and their associated risks, as considered by Copom, and using the available information, forecast were made for four-quarter cumulative IPCA inflation, compatible with the interest and exchange rate paths that characterize the benchmark and market scenarios. The benchmark scenario considers a unvarying 11.24% Selic rate, as defined at the September Copom meeting, together with a constant exchange rate over the forecasting horizon at a level in effect in the period prior to that meeting (R$1.95 per United States dollar). In the market scenario, based on data gathered in Gerin's market surveys among a significant number of institutions, the expectations of market agents indicate an average Selic rate of 11.47% per year in the third quarter of 2007, dropping to 11.05% per year in the final quarter of 2007 and 10.17% per year in the final quarter of 2008. The exchange rate trajectory starts with an average of R$1.93 in the third quarter of 2007, reaching R$1.90 and R$1.95 in the final quarters of 2007 and 2008, respectively.

The central forecast associated with the benchmark scenario indicates a slight reduction in cumulative 12-month IPCA growth through the end of 2007, starting with 4.2% in the third quarter and closing the final quarter at 4.0%, below the 4.5% central value for the CMN target. However, as emphasized in the most recent *Inflation Report* and illustrated in Figure 6.2 and in Table 6.1, it is important to highlight that the trend toward convergence of cumulative 12-month IPCA growth to the inflation target center over the projection horizon has continued, reflecting, mainly, the effects associated with the reductions in the Selic rate. As regards the third quarter of 2007, the increase introduced into forecasts (0.5 p.p.), compared to those included in the most recent *Report*, mainly reflects the fact that market price inflation in the July-August period – which, among other factors, responds to past monetary policy decisions – had surpassed the forecast set out in the June *Report*, once the opposite was registered for the projections to regulated prices. On the other hand, the data included in Table 6.1 also indicate a reduction (0.2 p.p.) in the forecast of cumulative 12-month inflation in the fourth quarter of 2007, as a result of a lower forecast for market prices inflation in the final quarter of 2007, compared to the figure for the same period of 2006. Here, one should recall that the opposite occurred in the case of changes in regulated prices. Furthermore, it is important to stress that the cumulative 12-month inflation forecast comes to 4.2% in the final quarter of 2008, thus remaining somewhat below the central value of 4.5% for the target.

Figure 6.2 – Forecasted IPCA-inflation with interest rate constant at 11.25% p.a. (Benchmark scenario)

Inflation fan chart



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

Table 6.1 – IPCA-inflation with interest rate constant at 11.25% p.a. (Benchmark scenario)

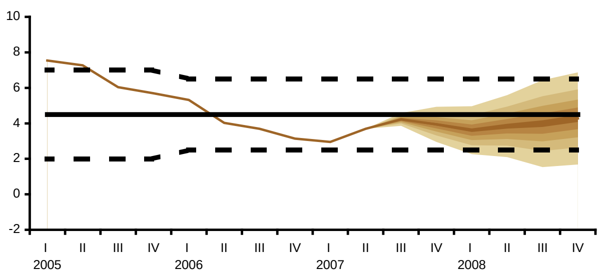
Year	Q	Confidence interval 50%	30%	10%		30%	50%	Central projection
2007	3	4.1	4.1	4.2	4.2	4.3	4.4	4.2
2007	4	3.5	3.7	3.9	4.1	4.3	4.5	4.0
2008	1	3.0	3.3	3.6	3.9	4.1	4.4	3.7
2008	2	3.0	3.4	3.8	4.1	4.5	4.9	4.0
2008	3	2.8	3.4	3.8	4.3	4.8	5.3	4.1
2008	4	2.8	3.4	3.9	4.4	5.0	5.5	4.2

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

Based on the confidence intervals presented in Table 6.1, the estimated probability of inflation exceeding the upper target limit in 2007 is practically nil in the benchmark scenario. Also according to this scenario, the expected trajectory for 2008 IPCA inflation is higher than in the most recent *Report*. This shift was caused by increase forecast for market prices inflation for the period, which, in turn, basically reflect the effects of the Selic rate reduction (75 b.p.) used in the forecast exercises, as well as the inertial effects of the forecasted inflation rise for 2007. The 4.2% rate forecasted for cumulative 2008 inflation in the benchmark scenario is lower, but still quite close to the central value (4.5%) for the target path determined by the CMN.

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

Inflation fan chart



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

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

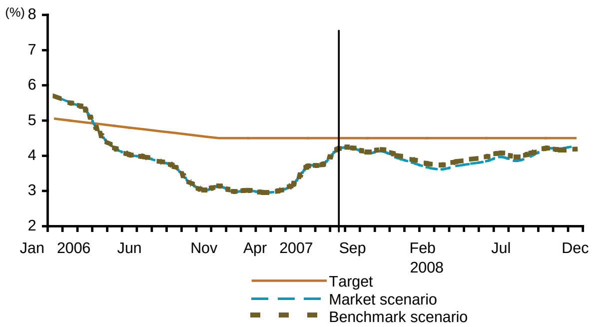
Year	Q	Confidence interval 50%	30%	10%	10%	30%	50%	Central projection
2007	3	4.1	4.1	4.2	4.2	4.3	4.4	4.2
2007	4	3.5	3.7	3.9	4.0	4.2	4.3	3.9
2008	1	3.1	3.3	3.5	3.7	3.9	4.2	3.6
2008	2	3.1	3.4	3.7	4.0	4.2	4.6	3.8
2008	3	3.0	3.4	3.8	4.2	4.6	5.0	4.0
2008	4	3.2	3.7	4.1	4.5	4.9	5.3	4.3

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

Table 6.3 – June 2007 "Inflation Report" forecasts

Period	Benchmark scenario	Market scenario
2007 I	3.0	3.0
2007 II	3.5	3.5
2007 III	3.7	3.7
2007 IV	3.5	3.5
2008 I	3.2	3.3
2008 II	3.6	3.8
2008 III	4.0	4.4
2008 IV	4.1	4.6

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



Market scenario forecasts shown in Figure 6.3 and Table 6.2 indicate a drop in inflation in the final quarter of 2007, closing the year at 3.9%, a figure quite near the benchmark scenario forecast and below the 4.5% central value for the 2007 target. The reduction is explained by the forecast for market prices inflation in the final quarter of 2007, compared to the figure for the same period of 2006, once the opposite occurred in the case of regulated prices. Compared to the benchmark scenario, the slightly lower inflation forecast in the final quarter of 2007 results basically from the market expectation of exchange rate appreciation through the end of 2007.

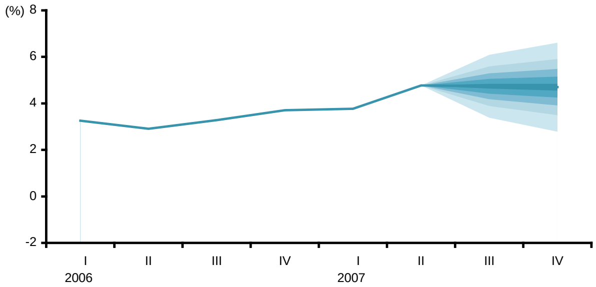
Similarly to what was observed to the benchmark scenario, the estimated probability of inflation surpassing the upper limit of the confidence interval for the market scenario for 2007 is practically eliminated. Also in terms of the market scenario, the inflation forecast for 2008 (4.3%), lower than the one estimated in June (4.6%), is below the central value of 4.5% for the target and quite close to the figure forecasted in the benchmark scenario (4.2%). Strictly speaking, in the market scenario, the forecast through the third quarter of 2008 are slightly lower, surpassing those of the benchmark scenario only in the final quarter of the coming year.

Table 6.3 presents the central values of the inflation forecasts presented in the June 2007 *Inflation Report*. The current benchmark and market scenarios forecasts for 2007 are 0.5 p.p. and 0.4 p.p. above those obtained in June, mainly due to the fact that, since that time, the rates of inflation registered have been higher than the prevalent expectations when June *Report* was published. For 2008, compared to forecast in June *Report*, the benchmark scenario present a rise (0.1 p.p.), while the market scenario present a reduction (0.3 p.p.). The increase in the benchmark scenario forecast is basically due to reduction in the interest rate path considered in the forecasts. In turn, the decline in the market scenario forecast results basically from a reduction in the expectations of analysts regarding exchange depreciation, even in the midst of growing uncertainties involving the international scenario, considering that median inflation expectations for 2008 remained at 4% up to the September Committee meeting.

As stated in Figure 6.4, there is an initial downward trend in forecasts for cumulative 12-month inflation and, later on, an upturn. One observes that, for both scenarios, forecasts are situated below the central value of the target path in the forecasting horizon, though they do converge toward this value. The minimum values of the forecasts for cumulative 12-month inflation are reached in the first quarter of 2008.

Figure 6.5 – GDP growth with interest rate constant at 11.25% p.a. (Benchmark scenario)

Output fan chart



However, from that point forward, there is a gradual across-the-board rise through to the end of the forecasting horizon.

Finally, based on benchmark scenario assumptions, the Figure 6.5 shows the output growth fan chart. Considering that the model that generates the forecasts uses two components not directly observable – potential output and output gap – it is important to stress that forecasting errors for GDP growth are considerably greater than those for inflation projections. According to this scenario, forecast GDP growth for 2007 is 4.7%, the same figure projected in the June *Inflation Report*.

Monetary Policy and Transmission Mechanism Lags

Monetary policy operates with lags or, in other words, the maximum impact of alterations in the basic interest rate on the economy is not immediate. This is one aspect with regard to which macroeconomists have come to a consensus, together with the fact that it has important implications for monetary policy implementation.

Monetary policy affects the price trajectory through various channels. The major channels are output/activity, the exchange rate, credit, the asset market in general and expectations. The processing time of each channel varies. The intensity of the monetary policy impact may also vary according to a series of institutional conditioning factors. For example, in economies in which credit represents an insignificant share of GDP, the credit channel is less important. Analogously, when, as a result of the existence of earmarked credit, the share of overall credit sensitive to changes in the basic interest rates is limited, the effectiveness of this transmission channel will also be restricted.

The output channel is the most traditional channel and the one that operates with the largest lag. Interest rate variations alter the pace of economic expansion, mainly through aggregate demand and, in this way, impact the readiness of agents to increase or reduce prices. This channel also impacts wage bargaining, thus generating repercussions, albeit indirectly, on business costs. When structural models are utilized, one normally notes that the output gap (measured as the difference between actual and potential output) initially reacts with a lag of one quarter in relation to interest rate changes. In its turn, the response of inflation to the output gap occurs one or two quarters later. Therefore, when using structural models, one notes that the first reaction of inflation to the product gap occurs only two or three quarters after the change in interest rates.

The maximum impact on inflation occurs only in the following quarters. This means that current inflation mainly reflects monetary policy decisions taken nine months ago.

The exchange-rate channel tends to operate with a lesser lag. Changes in domestic interest rates affect earnings on domestic securities compared to external securities, generating interest rate movements aimed at equalizing relative earnings (adjusted by the risk premium). Viewed from a different angle, changes in the relative earnings of assets generate alterations in net capital flows, thus impacting the exchange rate[1]. The prices of imported goods, expressed in national currency, are directly impacted by the exchange rate. In a similar manner, commodity prices are also affected by the exchange rate. The exchange-rate channel tends to operate more rapidly than the output channel, since it directly affects business costs (in the case of imports) and, in the case of commodities, the prices expressed in national currency. Consequently, exchange-rate changes tend to affect inflation in the current quarter or following quarter. However, this lag will depend more on the perceptions of agents as regards the persistence of the exchange-rate variation. For example, if an exchange-rate increase or reduction is considered temporary, agents will have a lesser incentive to transfer the alteration to prices. This can generate a “wait and see” behavior attitude, thus giving rise to a larger lag in the mechanism. There is also evidence that the speed of the exchange transmission depends on the position of the economy within the economic cycle. This means that an exchange depreciation that occurs at a moment of strong demand tends to generate a more rapid impact on prices than would occur in periods of more moderate economic activity.

The credit channel is defined in the literature as related to the balance sheet impact and bank loan channel. Changes in interest rates would impact the decisions of agents not only through the cost of credit and the opportunity cost, but also through their impact on the asset situation of the companies involved and on the willingness of financial agents to grant credit. In the case of Brazil, the strong increase in credit volume compared to GDP has enhanced the importance of this channel. However, it is

1/ This does not mean that the evolution of the exchange rate depends exclusively on differences of return. In the Brazilian case, for example, there is ample evidence that the behavior of the risk premium and trade flows plays a more important role in behavior of the exchange rate.

still quite small when compared to other countries. In a similar manner, the interest rate effect on financial assets (stocks, for example) has a lesser impact on the Brazilian economy than in other economies, due to a lesser degree of stock market development.

The expectations channel is related to all of the other channels. It refers to the fact that the expectations of agents regarding the future evolution of inflation (and, therefore, the future evolution of product, exchange rate, and monetary and fiscal policies themselves) impact the current behavior of prices. On setting prices, companies generally take the prospective environment into consideration. For example, if companies believe that future inflation will be 20%, their price changes will take this fact into consideration. Something quite similar occurs in wage negotiations. Since wage contracts in general are valid for at least one year, prospective inflation will certainly be a part of the calculation made by agents. The importance of expectations will depend on how relevant is the evaluation of the future scenario to agents in their decisions, as well as on the greater or lesser presence of institutional mechanisms with backward-looking clauses. The lag, with which this mechanism operates, in turn, depends on the degree of price rigidity. In other words, it depends on the frequency with which prices are altered.

Precise measurements of lags are quite difficult, since models are only approximations of reality and estimates involve a reasonable degree of imprecision. However, empirical evidence for a group of countries normally indicates a lag of three to five quarters between the moment of an interest rate alteration and the total impact of that alteration on inflation reaching 50%. For example, the Bank of England estimates that one can observe the maximum impact of a basic interest rate change on economic activity only after approximately one year – the lag of the impact on inflation would be much longer, approximately two years. The Swedish Riksbank assumes that an alteration in basic interest rates generates its strongest impact on inflation after one or two years. The European Central Bank, in turn, estimated that the impact of changes in the policy interest rate on GDP reaches its maximum level in two or three years, and that the impact on inflation has an even greater lag. The notion of a long transmission mechanism lag is also valid for developing economies. For instance, the Central Bank of Colombia estimates that the transmission of policy decisions to the economy occurs with a lag between 12 and 24 months. In Chile, estimates indicate a period of 24 months.

The presence of lags in the transmission mechanism has important implications for monetary policy implementation. In these conditions, monetary policy must be forward-looking or, in other words, central banks must act in such a way that inflation forecasts remain around the inflation target several quarters ahead. Recent developments in the economy must be evaluated not only from the point of view of their impact on current inflation, but more importantly in light of their future repercussions and effects.

Should the monetary authorities fail to consider existent lags, there will be at least two important consequences. The first of them is that they will be unaware of possible future repercussions of inflation, despite the existence of leading indicators or elements that point in this direction. For example, pressures on the rate of capacity utilization or signs of overheating in the labor market tend to be followed by future increases in inflation. If the central bank ignores these movements and reacts only when future inflation becomes a reality, as a result of transmission mechanism lags, the institution will be unable to cope effectively with the inflation rise. In the inflation targeting regime, the result may be the no fulfillment of the target.

The second consequence is the generation of unnecessary instability in the economy by reacting only to current inflation. This occurs mainly when current inflation movements are temporary in nature. One example could be a reduction in food prices due to exceptionally good harvest conditions, thus reducing current inflation. If the central bank does not view this as a passing phenomenon – understanding, therefore, that future inflation will not benefit from this factor – and adopts a more lenient monetary policy, such a decision could have a very important impact on inflation when those positive, albeit temporary, effects on inflation have run their course. The result will be generation of inflationary pressures in the future. At that moment, the central bank will react once again, generating a new cycle. The result will be fluctuations in inflation and output that could have been avoided had the monetary authority taken a forward-looking approach. Evidently, this type of stop-and-go monetary policy generates unnecessary instability in the economy.

A similar situation occurs during cycles in which more flexible or more rigid monetary policies are adopted. When the outlook for inflation shows improvement, monetary authorities begin reducing interest rates. At a certain point in this process, the effects on inflation are only partially felt as a result of existenting lags, thus allowing one to infer that the cycle should be continued without giving consideration to effects that will only occur in the future. If this perception is used for purposes of monetary policy implementation, future inflation may well overshoot the targeted level, generating a need for a new cycle of more rigid monetary policy and consequently greater instability in the economy.

In summary, the presence of significant temporal lags in the transmission mechanism demands that monetary policy be turned to the future and that central banks prioritize preventive strategies and not merely reactive strategies.

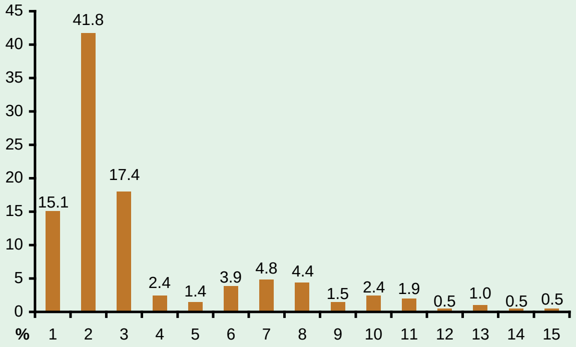
Price Rigidity in Brazil

Generally speaking, the longer the price setters take to react to the arrival of new information, the greater will be the persistence of inflation. In other words, higher degree of nominal price rigidity, or, higher inflation persistence, is associated with the delayed effects of current factors, as well as expectations, on inflation. Efficient conduct of monetary policy, therefore, requires that the policy makers have a good knowledge of the degree of inflation persistence. Specifically in the case of a central bank that targets inflation, evaluating better the degree of price rigidity means more information about the speed that inflation is likely to converge to its target, after the economy has been hit by a shock.

The literature on price rigidity, based on micro data, is relatively recent and more concentrated on developed economies[1]. Gouvêa (2007), which is the pioneering study for Brazil, describes the temporal and sectoral patterns of price adjustments using disaggregated data on price quotes that compound the Consumer Price Index (IPC) elaborated by the Getulio Vargas Foundation (FGV). The sample size spans from 1996 to 2006 covering the period after hyperinflation.

Computing the fraction of prices, in the index, that changes on a monthly basis (average monthly frequency of price adjustments) is one way of assessing the degree of nominal price rigidity in the economy. Based on the monthly frequency of nominal price adjustment it is possible to gauge the average duration of price spells or, in other words, of the average time interval in which prices remain constant. The monthly average frequency of price changes, during the sample period, for the Brazilian economy, is approximately 37%. The average duration of price

Figure 1 – Frequency Distribution of the Spell Average Duration



1/ See Bils and Klenow (2005) for a study developed for the United States. In order to access all of the papers produced for the Inflation Persistence Network (IPN), visit http://www.ecb.int/home/html/researcher_ipn_papers.en.html.

spells, calculated as the inverse of the frequency of price adjustments, is around 2.7 months. This result shifts to 3.8 months, when an alternative methodology is used. This latter approach makes use of the time series of price quotes in order to calculate the duration of price spells. Figure 1 shows that most price changes, approximately 59.8%, occur between two and three months. Those price changes occurring at two-month intervals are more frequent, approximately 42%, while monthly changes represent about 15%.

Figure 2 – Spell Average Duration: Economic Sectors

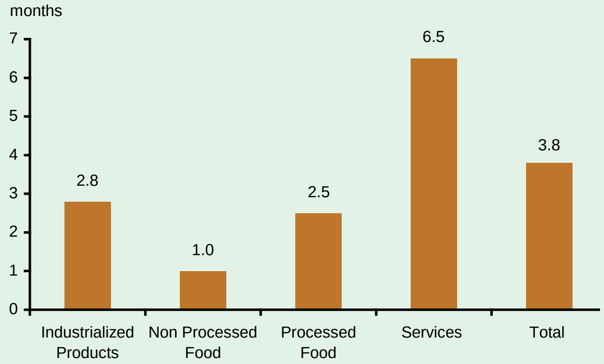
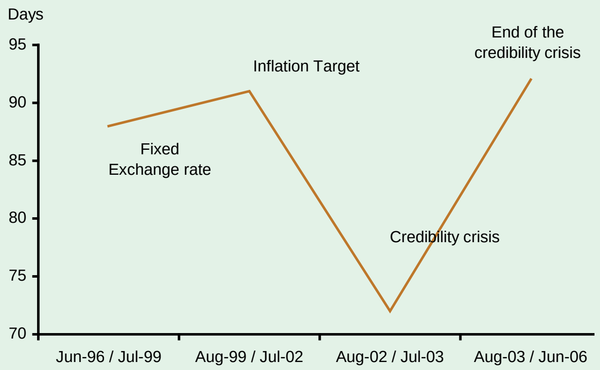


Figure 2 suggests that there is a strong evidence of heterogeneity on the behavior of price setters. Potentially, existence of heterogeneity in price setting is an important piece of information for monetary policy makers[2]. As a matter of fact, prices remain fixed for a period between one and almost three months prices, except by the service sector in which prices remain unchanged for six and a half months, on average. This result suggests a more persistent inflationary process in that specific segment of the economy. Higher rigidity of nominal prices in the service sector could be explained by the stronger influence of wages in the cost structure of companies that operate in that sector, compared to other sectors of the economy.

Other important stylized fact arises from the assessment of the proportions of times price change and from the magnitudes of these price changes. It is quite surprising that the proportion of prices that increase vis-à-vis those that decrease display high symmetry. Among all price changes, 54.5% are price increase and 45.5% are price decreases. On the other hand, average magnitude of positive price changes are, on average, 27% greater than the negative changes. This illustrates, coherently, the fact that aggregate rate of inflation is positive during the sample period.

Figure 3 – Spell Average Duration by Windows



Furthermore, it is important to highlight that the behavior of price setters changed in the period in which inflationary pressures became stronger. Figure 3 shows the change in the average duration of price spells over four distinct windows of time during the sample period. Acceleration of inflation between the second semester of 2002 and the first semester of 2003 coincides with lower average duration of price spells that decreased from almost 90 to 71 days in that period. Accordingly, after

2/ In recent theoretical literature, there are studies on the different impacts of incorporation of price heterogeneity in structural macroeconomic models. Carvalho (2005) demonstrates that one reason for the persistent behavior of inflation is found in the heterogeneity of price rigidity. Aoki (2001) concludes that a central bank must seek stabilization of an inflation core index composed of those sectors in which prices are more rigid.

August 2003, the aggregate rate of inflation decreases and the average duration of price spells returns to its previous level.

This box briefly summarized some important features of price rigidity in Brazil. It presented evidence that the monthly average frequency of price changes is approximately 37%, while the average duration of price spells would be 2.7 or 3.8 months, depending on the methodology applied to measure duration. Results show that there is a high degree of sectoral heterogeneity, since the service sector is marked by greater price rigidity. Distribution between the number of positive and negative price changes display high symmetry. Finally, the study suggests that changes in the aggregate inflation rate and the average size of price spells are negatively correlated[3].

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3/ In a recent study, Golosof and Lucas (2006) conclude that the frequency of price alterations increases with substantial disturbances in the average level of inflation, but that for environments in which average inflation is low, this behavior is most likely explained by idiosyncratic shocks.

Annex

Minutes of the 128th Meeting of the Monetary Policy Committee (Copom)

Date: July 17th, from 4:30PM to 7:10PM, and July 18th, from 5:00PM to 8:00PM
Place: BCB Headquarters meeting rooms – 8th floor on July 17th and 20th floor on July 18th – Brasília – DF

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

Department Heads (present on July 17th)
Altamir Lopes – Economic Department
Ariosto Revoredo de Carvalho – International Reserves Operations Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on July 18th)
João Henrique de Paula Freitas Simão – Open Market Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
Renato Jansson Rosek – Investor Relations Group

Other participants (present on July 17th)
Alexandre Pinheiro de Moraes Rego – Special Advisor to the Governor
Alexandre Pundek Rocha – Advisor to the Board
Katherine Hennings – Advisor to the Board
Sérgio Almeida de Souza Lima – Executive 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 0.28% in June, the same rate recorded in May, as regulated prices deceleration offset market prices acceleration. As a consequence, average monthly inflation recorded 0.27% in the second quarter of the year, down from 0.42% in the first quarter. On the other hand, IPCA inflation totaled 2.08% in the year through June, down from 1.54% in the same period last year, with market prices recording 2.43%, and regulated prices, 1.29%, compared to 0.92% and 2.76%, respectively, in the same period last year. Twelve-month trailing inflation has steadily accelerated, totaling 3.69% in June, up from 3.18% in May, 3% in April and 2.96% in March. This acceleration was due to the substitution of more elevated inflation rates observed in the last months (0.27% monthly average) for reduced inflation rates observed in the second quarter of 2006 (0.03% monthly average). Since May, market prices inflation has exceeded regulated prices inflation on a twelve-month basis, interrupting a trend observed for a long time. In June, these indicators reached 4.10% and 2.78%, respectively, according to the same basis. Disaggregated data show that non-tradable prices have driven market prices inflation, with twelve-month figure through June reaching 5.02%, while tradable

prices inflation stood at 3.14%. This fact occurred, despite significant deceleration in services inflation, totaling 4.95% in the twelve months through June, down from 6.27% observed in the same period of last year. Notwithstanding the inflationary acceleration in the first half of the year, compared to the same period of 2006, the Copom considers that inflation should continue to evolve according to the targets path.

2. IPCA core inflation measures did not reflect, in general, the declining headline inflation behavior in the second quarter. Only one out of the three core inflation measures calculated by the BCB decreased, quarter-on-quarter. Core inflation by exclusion of household food items and regulated prices averaged 0.28% in the second quarter, down from 0.39% in the first quarter of the year. On the other hand, smoothed trimmed means and non-smoothed trimmed means core inflation measures remained stable, averaging 0.31% and 0.27%, respectively. In the first half of year, significant reductions are emphasized, when compared to the same period of 2006. Core inflation by exclusion of household food items and regulated prices reached 2.03%, down from 2.15%, smoothed trimmed means core inflation totaled 1.86%, down from 2.75%, while non-smoothed trimmed means core inflation increased 1.63%, down from 1.84%. Al three core measures stood below the 2.08% headline inflation in the first half of the year. In the last twelve months through June, compared to the same period of last year, all inflation core measures showed significant drops: core inflation by exclusion increased 3.43%, down from 4.09%, smoothed trimmed means core totaled 3.72%, down from 5.71%, and non-smoothed trimmed means core reached 2.55%, down from 4.16%. Still on a twelve-month trailing basis, all three core inflation measures increased compared to the rates observed in May, but stood below the 4.5% central target for 2007.

3. The General Price Index (IGP-DI) inflation accelerated in the second quarter and reached 0.26% in June, up from 0.16% in May and 0.14% in April. In the first half of the year, inflation reached 1.44%, up from 1.28% in the same period of last year. This move was driven by the behavior of the Consumer Price Index-Brazil (IPC-Br), which increased 2.51%, up from 0.62% in the same period of 2006, while the Civil Construction National Index (INCC) remained virtually unchanged (3.51%, up from 3.36%), and the IPA-DI totaled 0.70% in 2007, down from 1.22% in 2006. In the last twelve months through June, the IGP-DI increased 3.96%, up from 0.98% in June 2006. Throughout the second quarter, the IPA-DI remained stable, reflecting the increase in industrial prices and a heterogeneous behavior of agricultural prices, which fell sharply from April through May, and recovered in June. The behavior of wholesale price inflation continues to mirror, in short, contradictory pressures stemming from, on the one hand, the elevation of international prices of commodities and foodstuff and, on the other hand, the strengthening of the BRL. As highlighted in previous Copom Minutes, the effects of wholesale prices over consumer inflation will depend on current and prospective demand conditions and price-setters' expectations for the future inflation path.

4. General industrial output, which encompasses extractivism and manufacturing industries, accelerated in the last months. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output grew 0.8% in May, up from 0.6% in April. Considering the reviewed figures for April, general industrial output recorded the eighth consecutive monthly expansion in May. Industrial output grew 4.9% in May, compared to the same month last year, 4.4% in the year through June, and 3.3% in the last twelve months, with a trend of acceleration at the margin under the two last criteria. IBGE data indicate that manufacturing industry also outperforms. On a three-month moving average basis, the manufacturing industry output index increased by 0.4% in February, 0.5% in March, 0.7% in April and 0.8% in May. In the last twelve months through May, manufacturing industry expanded by 3.1%, while mining increased by 5.4%. Among use categories, capital goods production outperformed in the year through May, growing strongly by 16.3%. In addition, the production of intermediate goods increased by 3.9% in the same period, after growing below the average of general industrial output in the period 2005-2006. For June, the leading and coincident indicators available for industrial production suggest the continuity of the growth cycle. Moreover, 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 quarters.

5. The unemployment rate in the six main metropolitan regions stood at 10.1% in May for the third consecutive month, 0.1 p.p. below the May 2006 result. In the year through May, the average unemployment rate reduced by 0.2 p.p., compared to the same period last year. Despite the slow decline in the unemployment rate, the number of employed workers increased 2.7% in the last twelve months through May, due to the growth of the economically active population (PEA), a process usually present in moments of economic expansion. The purchasing power of employed workers increased month-on-month 0.3% in May, unchanged relative to the previous month, and 3.9% relative to May 2006. In the year through May, it reached 4.8%, which contributed for the 7.8% expansion of real payrolls. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment increased month-on-month 0.4% in May and 3.5% compared to May 2006. Consequently, in the year through May, manufacturing employment robustly grew 4.1%. Regarding formal employment, data from the Ministry of Labor and Employment (MTE) confirm the continuity of strong expansion, with the creation of 182 thousand new jobs, a record high for the month of June, since the start of the series in 1985. Job creation grew month-on-month seasonally adjusted 0.4%, expanding by 4.9% in the year through June and 4.8% in the last twelve months. Therefore, 1,095.5 thousand jobs were created in the first half of the year, up from 924 thousand jobs in the same period of last year (a 18.6% growth), and 1.4 million in the last twelve months. The Copom considers that positive developments in the labor market will continue to be an important support channel to aggregate demand in the upcoming quarters.

6. Retail sales increased 0.5% month-on-month in May, the fifth consecutive expansion, according to data seasonally adjusted by the IBGE. In the quarter ended in May, relative to the same period of last year, retail sales recorded 9.9% real growth, compared to 9.4% in the quarter ended in April, while expanded retail sales, which include the sales of civil construction material and vehicles, motorcycles, parts and pieces, increased 13.7%, up from 13.4% in April. In May, retail sales increased by 10.4%, compared to the same month of 2006, for a 9.5% expansion in the year through May. In the last twelve months, expansion reached significant 7.5% and has accelerated at the margin. Compared to May 2006, "furniture and domestic appliances" sales grew 10.3%, while "fabric, clothing and shoes" grew by 16%. The steady performance of retail sales reflects both the expansion of income and employment and the improvement of consumer credit conditions. Expanded retail sales recorded 13% real growth in May, compared to the same month of 2006, the eleventh 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 (including through governmental transfers), credit expansion, the monetary easing process and by the recovery of consumer confidence. Moreover, the performance of retail sales suggests the continuity and likely strengthening of aggregate demand growth.

7. According to CNI data without seasonal adjustment, installed capacity utilization in the manufacturing industry averaged 81.5% in the first five months of 2007, compared to 79.5%, 80.4% and 79.8% in the same period of 2006, 2005 and 2004, respectively. The installed capacity utilization rate, according to CNI data seasonally adjusted by the BCB, stood at 82.7% in May, 0.7 p.p. above that observed in April, reaching a new record high for the series. Installed capacity utilization not only has grown significantly, but there are signs that the process has become more generalized, with many sectors operating close to their maximum rates. Data compiled by the FGV also show an upward trend for the utilization rates, which reached 84.7% in June, up from 82.3% in June 2006. Such increase reflects, unmistakably, economic activity acceleration, despite the strong expansion of investment. In fact, the absorption of capital goods in the year through May grew 16.1%, in line with the significant increase in capital goods imports (30.7% in volume), as well as in capital goods production (16.3%). Moreover, in the same period, the production of civil construction inputs increased 3.7%. The most recent data indicate that, despite quite robust, investment has not been sufficient to avoid a significant elevation of the capacity utilization rates in industry. This situation may reflect lags in the maturing of projects aimed at expanding the installed capacity or higher-than-expected strengthening in economic activity. In this context, the expansion of investment will be fundamental to avoid sharp mismatches regarding the evolution of aggregate supply and demand. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments with regard to the

expansion of supply of goods and services to adequately meet demand conditions.

8. The trade balance continues to present robust performance, despite the strengthening of the BRL, 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$ 46.5 billion record high, a 3.4% increase over the 2005 result, the trade balance continues to register strong positive performance. In the year through June, the trade surplus reached US$20.6 billion, a 6.2% increase relative to the same period of 2006. Exports rose 20.2%, to US$73.2 billion, while imports increased 26.7%, to US$52.6 billion. 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. Moreover, the Copom assesses that the demand for Brazilian exports has shown more intense than firstly anticipated, even resulting in acceleration, at the margin, of the quantum exported. Therefore, similarly to the observed in previous years, the most pessimistic expectations will be frustrated again in 2007, with the trade balance keeping a very positive performance.

9. With regard to the international scenario, uncertainties surrounding the monetary policy stance in the US persist. The prevailing opinion among international investors is that the start of an easing cycle this year seems to be postponed to the next year, meaning that the Fed Funds rate would be kept stable for many months ahead. However, interest rate increases in the US cannot be completely discarded. Similarly, the possibility of stronger-than-expected economic deceleration in the US cannot be ignored, especially if the effects of the present difficulties in the real state sector over the financial institutions and the household consumption increase in intensity and scope. On the other hand, the strengthening of economic activity in Europe and the continuity of robust expansion in the major Asian countries have underpinned world growth at higher-than-expected levels, despite the economic deceleration in the US. The maintenance of growth rates at historically high levels in many regions of the world has led to inflationary pressures, especially over raw materials and food prices, to which a significant number of central banks have answered by using monetary policy instruments. However, external demand for Brazilian goods, services and financial assets has, so far, remarkably benefited from the stage of the economic cycle and the global financial conditions. That demand also shows resilience to short-term fluctuations in both economic activity and international market sentiment. This external scenario, which the Copom continues to consider favorable, has helped the Brazilian economy to trail a growth cycle with price stability.

10. Oil prices, another external source of international uncertainty, rose since the last Copom meeting and still presents high volatility. On one hand, this behavior reflects structural shifts in global demand for energy and, on the other hand, recurrent episodes of geopolitical tensions. According to this perspective, if the trend observed in the last weeks persists, the main scenario considered by the Copom, which attributes no change to domestic gasoline prices in 2007, might become less plausible. Moreover, despite the eventual stability in domestic gasoline prices, international oil prices swings inexorably affect the domestic economy, for instance, through productive chains, such as the petrochemical, as well as through the impact over market inflation expectations.

Assessment of Inflation Trends

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

b) The projection for electricity price adjustments in 2007 was modified to -3.6%. The projection for fixed telephone price adjustment was maintained at 3.3%;

c) The projection for regulated prices inflation in 2007 decreased to 3.2%, down from 3.6% (projection of the June Copom meeting). These items, according to the weights released by the IBGE, represent 31.01% of the total June IPCA;

d) The projection for regulated prices inflation in 2008 was also changed, to 4.5%. This projection is based on the endogenous determination model for regulated prices. This model considers the effects of seasonal components, exchange rate change, market prices inflation and the IGP;

e) The projection for the spreads over the Selic rate, using a Vector Autoregressive model based on the Selic and 180-day swap rates on the eve of the meeting, estimates a -5 bps in the fourth quarter of 2007, reaching 71 bps in the last quarter of 2008. The identified shocks and their impacts were reassessed according to newly available information.

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

13. Since the June Copom meeting, median IPCA inflation expectations for 2007, compiled by the BCB's Investor Relations Group (Gerin), increased to 3.7% from 3.5%. This growth was mainly driven by the addition of the inflation occurred in May and June. Twelve-month ahead inflation expectations reached 3.5%, up from 3.37%. For 2008, inflation expectations remained at 4%. These developments continue to suggest the consolidation of a favorable macroeconomic scenario.

14. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the Selic rate at 12% and the exchange rate at R$1.90/US$ during the forecast period – the projection for the 2007 IPCA increased compared to the value considered at the June Copom meeting, but remained 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 – IPCA inflation forecast for 2007 also increased compared to the value considered at the June Copom meeting, but remains below the central target for the year. On the other hand, the projections for 2008, based on both the benchmark and the market scenarios, reduced in relation to June, remaining below the 4.5% target.

Monetary Policy Decision

15. 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 a strengthening of possibly more intense demand expansion, but still do not suggest high probability of important pressures over inflation in the short-run. In addition to investment expansion, imports growth has remarkably contributed to this process, complementing domestic production and, therefore, limiting potential inflationary effects of aggregate demand sustained growth. Moreover, despite uncertainties regarding the continuity of the strong growth recently observed in the international economy, prospects of additional monetary tightening in important international markets, and volatility increase in 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.

16. The Copom evaluates that the increase in global inflationary pressures still does not represent risks to short-term domestic inflation trajectory, but a heated demand could increase the pass-through of wholesale prices pressures to consumer price inflation. The Copom also observes that the increase of IPCA inflation expectations for 2007 and for the twelve months ahead, despite to levels below the targets established for 2007 and 2008, is a process that must be monitored. In this sense, the Copom will continue to manage the monetary policy stance so that the gains obtained in inflation control in recent years become

permanent. In this respect, the Copom will carefully monitor the evolution of inflation and the several core inflation measures, discriminating between one-off and persistent or generalized price increases, analyzing the impacts over short- and medium-term inflation expectations, and promptly adjusting the monetary policy stance to the circumstances.

17. 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.

18. 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 775 b.p., with the bulk of the reduction concentrated in the last nine months. Consequently, the activity level has not completely mirrored the effects of the interest rates cuts yet, as well as the effects of the economic activity on inflation have not completely materialized. Therefore, the evaluation of alternative monetary policy stances should necessarily focus on the prospective inflation scenario and its risks, instead of current inflation indicators.

19. 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 the first half of 2007 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 will have limited effects in 2007 and predominant impacts in 2008.

20. 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, will demand, at some moment, a more cautious monetary easing stance.

21. The Copom evaluated that, since the last meeting, influences of domestic and external factors over the balance of risks for the expected inflation trajectory have continued to perform in opposite directions. The external sector, acting importantly to increase 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 in the medium-term.

22. 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 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, deceleration in the reduction pace of the Selic target rate to 25 b.p. would contribute to extend the easing process over time.

23. However, the majority of the Committee argued that the contribution of the external sector for the consolidation of a benign outlook for inflation, especially by controlling the prices of tradable goods and by increasing investments, in a heated demand environment, reduces the risks present in the prospective scenario for inflation. 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 to the inflation targets trajectory. Therefore, four 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.

24. Given the reasons stated above, evaluating the prospects for inflation, the Copom decided to reduce the Selic target rate to 11.50% p.a., without bias. Four votes were for the Copom monetary policy action, while three votes were in favor of reducing the Selic target by 25 basis points. The Copom will assess the evolution of the macroeconomic scenario until its next meeting, to define the next steps on its monetary policy stance.

25. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing alternative scenarios for the main variables that determine price dynamics and its balance of risks. 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, 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 still not fully perceived. In such environment, the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons.

26. At the conclusion of the meeting, it was announced that the Copom would reconvene on September 4th 2007, for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 15,011 of October 31, 2006.

Summary of Data Analyzed by the Copom

Inflation

27. The IPCA increased 0.28% in June, repeating the May result. This monthly variation reflected increases in the prices of housing, clothing and, especially, food and beverages, and declines in the prices of other groups, especially transportation and personal outlays. The prices of milk and milk by-products responded for 0.14 p.p. of the monthly variation, up from 0.07 p.p. in May, again the drivers of the monthly IPCA.

28. Market prices increased 0.43% in June, up from 0.25% in May, while regulated prices totaled –0.05%, down from 0.35%, in the same period. In the last twelve months, market prices increased 4.1%, and regulated prices, 2.78%. Among market prices, the prices of non-tradable goods increased by 5.02%, while the prices of tradable goods prices increased by 3.14%.

29. The IPCA increased 2.08% in the first half of 2007, up from 1.54% in the same period of 2006, accumulating 3.69% growth in twelve months through June, up from 3.14% in the same period of 2006. This rise in the first half of the year reflected the continuity of the upturn in food prices started in the last quarter of 2006, due mainly to the increase in international prices. In this context, food prices grew 1.23% in 2006, well below the IPCA, but increased 2.34% in the last quarter of 2006. In the first half of 2007, the prices of the food and beverages rose 3.94%, totaling 3.94% in the last twelve months through June.

30. IPCA core inflation excluding household food and regulated prices, reached 0.22% in June, down from 0.33% in May, while the non-smoothed trimmed means core reached 0.23% down from 0.30% in May. In the last twelve months, these inflation core measures totaled 3.43% and 2.55% in June, compared to 3.04% and 2.39% in May. The smoothed trimmed means core increased 0.34% in the month, up from 0.30% in May, totaling 3.72% in the twelve months through June, up from 3.68% in May.

31. The IGP-DI increased 0.26% in June, up from 0.16% in May, totaling 1.44% in the first half of 2007 and 3.96% in twelve months. Considering the main components of the index, the IPA-DI (Wholesale Prices Index) rose 0.09% in June, up from -0.04% in May, accumulating 0.70% in the year and 3.76% in twelve months. The IPC-Br increased 0.42%, up from 0.25%, in the same period, totaling 2.51% in the first half and 3.98% in twelve months. The INCC rose

0.92% in June, down from 1.15% in May, reflecting deceleration in the prices of materials and services and labor force. This index accumulated increases of 3.51% in the year through June and 5.20% in the last twelve months.

32. The increase in the variation of IPC-Br in June reflected the 1.02% increase in food prices, up from -0.01% in May. The core of the index rose 0.34% in June, up from 0.30% in the previous month, accumulating 1.66% in the year through June and 2.91% in the last twelve months.

33. The IPA-DI change in June reflected, on the one hand, the reversion in the downward trend of agricultural prices, which increased 0.67%, up from -1.94% in May and, on the other hand, the deceleration in industrial prices, which totaled -0.09% in June, down from 0.58% in May. The main positive drivers for agricultural prices were *in natura* milk, grained soy, eggs and poultry, while the negative drivers were sugar cane, orange and manioc. Among industrial prices, the upward pressures stemmed from the prices of fuel oil, oil and fats, and milk and milk by-products, whereas the downward pressures stemmed from moisturized ethylic alcohol, sugar and pig iron. The IPA presented in June, according to the processing stages of production, stability in the prices of raw materials, deceleration in the prices of intermediate goods and increase in the prices of final goods. In the first half of the year, the prices of raw materials declined 3.62%, after substantial increase in 2006, while the prices of final and intermediate goods slightly increased compared to the previous semester. In the last twelve months through June these prices increased by 7.44%, 2.63% and 2.73%, respectively

Economic Activity

34. Considering seasonally adjusted data, GDP increased quarter-on-quarter 0.8% in the first quarter of 2007, compared to 1.1% in the last quarter of 2006. Compared to the same period of 2006, GDP increased by 4.3% in the first quarter of 2007, and accumulated 3.8% in four quarters, up from 3.7% in 2006.

35. The GDP evolution follows closely the performance of domestic demand. Considering seasonally adjusted data, gross fixed capital formation (FBCF) rose 2.1% in the first quarter of 2007, quarter-on-quarter, while government consumption increased 3.5%; household consumption, 0.9%; exports, 1.2% and imports, 4.1%. Compared to the first quarter of 2006, FBCF expanded by 7.2%; household consumption, 6%; government consumption, 4%; exports, 5.9%; and imports, 19.9%.

36. On the supply side, considering seasonally adjusted data, agriculture production declined 2.4% in the first quarter, quarter-on-quarter, while the production in industry and services rose 0.3% and 1.7%, respectively. Compared to the same period of last year, in the first quarter of 2007 agriculture grew 2.1%, industry, 3% and services, 4.6%.

37. Indicators related to the second quarter of 2007 suggest the continuity of economic activity growth.

38. According to IBGE’s monthly survey, retail sales increased 0.5% in May, on a month-on-month seasonally adjusted basis. All activities expanded, with the exception of fuel and lubricants sales (-1.2%) and vehicles, motorcycles, parts and pieces (-0.1%), which do not compose the general retail sales index.

39. Compared to May 2006, retail sales grew 10.3%, mainly driven by the increases in the sales of clothing and shoes (16%) and furniture and domestic appliances (10.4%); segments influenced by both the continuity of employment and income growth and better credit conditions.

40. Expanded retail sales, which incorporate the activities of vehicles, motorcycles, parts and pieces and civil construction inputs, increased 13% in May, compared to the same period of the previous year. The sales of these activities increased, 20% and 4.7%, respectively. The positive performance of these segments should persist during 2007, as a result of incentive measures to the civil construction sector and better credit conditions. In the year through May, expanded retail sales increased by 12.7%.

41. On a regional basis, 20 out of the 27 Brazilian states showed positive retail sales results in May, on month-to-month seasonally adjusted basis. The most significant expansions occurred in Pernambuco (6%), Sergipe (5.6%), Rio Grande do Norte (5.1%);

and Roraima (4.8%); while the main reductions were in Paraná (3.4%), Tocantins (1.6%) and Minas Gerais (1.4%). In the year through May, retail sales rose in all states, with highlights to the performance of Alagoas (31%); Acre (17.4%) and Maranhão (15.8%). The evolution of retail sales in the Northern and Northeastern regions partially reflects the impact of federal government social assistance programs in these regions.

42. São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, showed stability in database consultations for credit sales, and a month-on-month 1.2% increase in consultations to the Usecheque system in June. Compared to June 2006, these indicators rose by 6.4% and 8.8%, respectively.

43. Regarding investment indicators, civil construction inputs production expanded month-on-month 0.3% in May, while capital goods production rose 5.1%, seasonally adjusted. The imports of capital goods declined month-on-month seasonally adjusted 4.9%. This contraction does not represent a trend change, in view of the intense expansions in this cycle, evidenced by a 31.7% growth in the first five months of 2007 and 26.7% in the last twelve months. In the year through May, domestic production of capital goods increased by 16.3%, with significant elevations in the production of manufactured capital goods (18.6%), capital goods for mixed use (17.3%) and for energy (16.4%). Production of capital goods for agriculture expanded by 23.3% in the same period, while the negative twelve-month trailing production reached -0.6% in May, after -4.3% in April and -8.9% in March, confirming the recovery of the production in this sector.

44. BNDES funding for medium- and long-term investment totaled R$19.1 billion in the first five months of 2007, 39.9% above the amount disbursed in the same period of 2006. In the twelve months through May, R$ 57,7 billion was disbursed, a 26% expansion compared to the same period of last year, corroborating the recent acceleration of this investment indicator.

45. Industrial production grew 1.3% in May, according to IBGE’s Monthly Industrial Survey (PIM) seasonally adjusted data, reaching a 2.2% expansion in the quarter ended in May. On a three-month moving average basis, which attenuates punctual oscillations, industrial activity reached a record high for the fourteenth consecutive month, in May. Industrial production rose by 4.9%, compared to May 2006, and expanded by 4.4% in the first five months of 2007 and 3.3% in the last twelve months.

46. Considering seasonally adjusted data, manufacturing production expanded by 1.3%, while mining industry production declined by 0.2%. All use categories increased in the month: capital goods production increased by 5.1%, while consumer goods and intermediate goods production rose by 1.5% and 0.6%, respectively. In the year through May, production of capital goods expanded by 16.3%, leading industrial expansion, followed by intermediate goods (3.9%), durable consumer goods (3.7%) and semi- and non-durable goods (2.5%).

47. Disaggregated data of seasonally adjusted industrial activity showed that 15 out of the 23 sectors surveyed grew in May, with highlights to vehicles, pharmaceuticals, machines and equipment, and food, in order of importance. The main negative drivers were chemical products and beverages.

48. Still considering the industrial activity, according to CNI data, seasonally adjusted by the BCB, hours worked in production expanded by 0.3%, while real industrial sales declined 0.6% in May, month-on-month. In the year through May, these indicators increased by 3.6% and 4%, respectively, compared to the same period of 2006. After seasonal adjustment, installed capacity utilization reached 82.7% in May, up from 82% in April. Considering observed data, utilization level reached 83.2%, 1.8 p.p. above the May 2006 figure.

49. According to Anfavea, vehicles production reached 246.4 thousand units in June. According to data seasonally adjusted by the BCB, vehicles production expanded by 2.4%, on a month-on-month basis, and 9.6% compared to June 2006. Considering the month-on-month seasonally adjusted series, domestic sales increased by 1.7%, while exports decreased by 7.1%. Compared to the first half of 2006, vehicles production increased by 6.3% in 2007, while domestic sales increased by 19.1% and exports

decreased 10.9%. According to the same comparison basis, production of agricultural machines grew 20.6% and production of trucks grew 21.3%, mirroring increases in investment and recovery of the agricultural sector in the current harvest.

50. According to the IBGE, the June estimate for the grains harvest pointed to a 14% increase in 2007, year-on-year. National production of grains should reach 133.4 million tons, due to good weather conditions and the production incentive driven by the increase in international agricultural commodities prices. In the survey, the main forecast production increases related to wheat (60.6%), cottonseed (31.2%), corn (21.4%), and soy (11.3%), while the main production decreases related to coffee (15.1%) and rice (4.5%). It still bears emphasizing the increase in land occupation for sugar cane production, in line with the growing interest in ethanol production. Sugar cane plantations increased by 9.1% in 2007, and the production should expand by 12.7%, year-on-year.

Surveys and Expectations

51. The Fecomercio-SP survey showed stability in the Consumer Confidence Index (ICC) in July, month-on-month. The two ICC components presented divergent behavior, with the Current Economic Conditions Index (Icea) increasing month-on-month 1% in July, and the Consumer Expectation Index (IEC) declining by 0.8%. In fact, the Icea remained above the IEC for the seventh consecutive month. Compared to July 2006, the ICC and IEC declined by 3.1% and 10.9%, respectively, while the Icea increased by 9.5%.

52. According to the FGV survey, which encompasses two thousand homes in the seven main state capitals of the country, the ICC increased 0.6% month-on-month in June. This result is due to the improvement in both the assessment of the present situation (1.5%) and in the 6-month ahead expectations (0.1%). Compared to June 2006, the ICC rose 8%, mainly because of the 9.9% increase in the expectation index.

53. Still according to the FGV, the Industry Confidence Index (ICI), which encompasses six items of the Manufacturing Industry Survey, declined 0.6% month-on-month in June, the second consecutive fall, after the record high observed in April. The ICI rose 13.2% relative to June 2006, expanding by 10.5% in the first half 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 84.7% in June, up from 82.3% in June 2006.

Labor Market

54. According to the Ministry of Labor and Employment, 182 thousand new formal jobs were created in June. In the first half of the year, 1,095.5 thousand new jobs were created, a record high for the series, 18.6% above the figure observed in the same period of 2006. These new hirings raised employment expansion by 4.9% in the period, according to the same comparison basis. In the last twelve months, expansion reached 4.8%, with highlights to the employment increases in civil construction (7.4%) and in commerce (5.8%). After seasonal adjustment, employment expanded month-on-month 0.4% in June, with increases in all sectors.

55. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate remained unchanged at 10.1% in May 2007. The unemployment rate stability reflected mainly the 0.1% change in both employed population and economically active population (PEA). The number of employers declined 3.7%, while the number of self-employed workers expanded by 1.6%. In the first five months of 2007, the average number of workers increased by 2.9%, relative to the same period of 2006, reflecting the expansion of investment and recovery in the agricultural sector.

56. The number of workers in the private sector increased by 2.7%, with a 4.1% expansion in the number of formal workers and a 1.4% decline in the number of informal workers, highlighting a qualitative improvement in the labor market.

57. According to the same survey, real average earnings reached R$1,120.3 in May, a 0.3% month-on-month increase and a 3.9% elevation compared to May 2006. Real payrolls, a result of the average

earnings times the number of occupied workers, grew 0.4% month-on-month in May and 6.8% compared to the same month of last year, for a 7.8% expansion in the year through May.

58. According to CNI data, seasonally adjusted by the BCB, the number of workers in industry increased 0.4% in May, month-on-month. In the year through May, the number of workers in industry increased by 3.4%, while real payrolls in the sector expanded 5.5%.

Credit and Delinquency Rates

59. Non-earmarked credit, used as reference for interest rates, increased 1.4% in June and 20.3% in the last twelve months. Credit for individuals increased 1% in June, totaling a 22.8% increase in twelve months. Corporate credit operations with domestic funding increased 2.8% in the month and 19.6% in the last twelve months, while externally funded operations decreased 1.3% in June, but increased by 27.7% in twelve months.

60. The average interest rate on credit operations reached 37% p.a. in June, a record low for the historical series, 6.2 p.p. below the June 2006 result. The average rate on credit for individuals reached 48.4% p.a., down from 55.8% p.a. in the same month of 2006. The average rate on corporate credit decreased 5.1 p.p. in the last twelve months, reaching 23.7% p.a.

61. The average tenure of credit operations for individuals, excluding overdraft account, reached 431 days in June, compared to 356 in the same month of 2006. The average tenure of personal credit modality reached 433 days, increasing 95 days compared to the previous year, reflecting the increasing weight of payroll-deducted in this credit modality.

62. Delinquency rate in the financial system (non-earmarked loans in arrears for more than ninety days) reached 4.7% in June, decreasing 0.1 p.p. in the month and remaining stable relative to June 2006. Delinquency rate for corporate credit operations remained stable in the month (2.6%) and increased 0.3 p.p. in the last twelve months. Delinquency rate for credit operations with individuals reached 7.1%, decreasing 0.1 p.p. in the month and 0.2 p.p. relative to the same month of 2006.

63. Net delinquency rate for retail credit, measured by the ACSP, reached 5.1% in June, compared to 5% in the same month of 2006 and to the 5.3% average in 2006.

External Environment

64. The global economic activity performance remains above the long-term trend, contradicting the cooling expectations of the beginning of the year. The deceleration of the US economy is largely offset by the annualized GDP growth of Euro Area (3.1%), Japan (3.3%) and China (11.1%) in the first quarter, compared to the same period of 2006. The steady expansion in important economies also helped to offset the deceleration in the US economy.

65. Global financial conditions remain favorable due to abundant liquidity, which reflects the positive performance of stock exchange, the prices of emerging markets sovereign securities, and the steady corporate profits. This outlook is reinforced by the strong recovery in the global industrial production, by the robust employment growth, by the end of the US inventories adjustment process, and by the optimistic forecasts for global expansion.

66. However, some risks threaten this favorable outlook. The main risky factors are the new rises in the oil prices, which are close to the August 2006 record high; the probability of adoption of strong restrictive measures to fight inflationary pressures and contain the overheating, specially in China; the maintenance of the adjustments in the US real state market; and the contamination of the markets, specially in emerging countries, as a result of the turmoils in the Asian financial market, in the subprime US real state market and in the hedge funds.

Foreign Trade and International Reserves

67. In the first half of 2007, Brazilian foreign trade continued to expand. The trade surplus reached US$20.6 billion in the period, and US$47.6 billion in the last twelve months, while total external trade totaled US$125.8 billion and US$252.3 billion, according to the same comparison bases.

68. Exports reached US$13.1 billion in June, with a US$656 million daily record high average, a 20.2%

increase over June 2006. The expansion of shipped volumes and the prices increases drove the growth of Brazilian exports in the three goods categories. Manufactured goods exports reached US$7 billion in the month, with a US$350.8 million daily record high, a 19% increase over June 2006. Primary products exports totaled US$4 billion, and semi-manufactured ones, US$1.8 billion, with respective increases of 26.8% and 10%, according to the same comparison bases. Some important export products continued to present prices increases compared to June 2006, with highlights to orange juice (64.1%); raw soy oil (41.6%); poultry (33.8%); iron and steel semi-manufactured (31.5%); leather and skin (31.2%) and metal laminates (22.4%). Exports continued to show diversification in terms of products, particularly regarding manufactured items with low share in total exports, and expansion of exports destinations.

69. Imports totaled US$9.3 billion in June, with a US$465.2 million daily record high average, a 32.6% increase over the same month of 2006. All import categories expanded: raw materials (38.7%); capital goods (32.1%); consumer goods (31.8%); and fuel and lubricants (17%), according to the same comparison basis. Among the imports of raw materials and intermediate goods, it is noticeable the acquisition of primary food goods, transportation equipment, chemical and pharmaceutical products, non-food agricultural products and mineral products. Among the consumer goods, the main import drivers were clothing, vehicles, beverages and tobacco, beauty products, furniture and pharmaceutical products. The industrial machinery, office and scientific machines and equipment and parts and pieces drove capital goods imports.

70. In June, international reserves reached US$147.1 billion, a US$10.7 billion increase in the month, US$61.3 billion in the year and US$84.4 billion compared to June 2006.

Money Market and Open Market Operations

71. In the period between the June and July Copom meetings, the interest rate yield curve shifted downwards for short-term tenors, mainly driven by the favorable domestic economic outlook and by the perspective of a continuous monetary policy easing cycle. The June Copom decision (a 50 b.p. reduction of the Selic target), the ongoing appreciation of the BRL against the dollar, and the release, at the beginning of July, of current inflationary indices within the forecast intervals contributed to deepen the decline of the short-tenure side of the yield curve. Uncertainties regarding the performance of the U.S. economy, the financial losses in the US high-risk mortgage market and the expectation of monetary tightening in the main economies stimulated a migration movement of investments towards lower-risk assets and contributed to an increase in the longer-tenure side of the yield curve. Between June 4 and July 16, one-, three- and six-month and one-year rates reduced 0.55 p.p., 0.50 p.p., 0.39 p.p. and 0.24 p.p., respectively. Two- and three-year rates increased by 0.13 p.p. and 0.34 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 6.95%, on July 16, down from 7.31%, on June 4.

72. On June 21, the BCB conducted a reverse exchange rate swap auction, aimed at anticipating the redemption of the swaps due July 2, totaling US$1.5 billion.

73. In its open market operations, the BCB carried out, between June 5 and July 16, weekly five- and seven-month long repo operations. The average daily balance of these operations amounted R$79.4 billion, of which R$56.4 billion were seven-month operations. In the same period, the BCB also conducted 27 overnight repo operations, aimed at draining the excess liquidity from the market and a 29-working-day tenure long operation. 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$34.4 billion, borrowing.

74. Between June 5 and July 16, the National Treasury raised a total of R$56.3 billion, of which R$28.3 billion in fixed-rate securities: R$14.1 billion via the issuance of LTNs maturing in 2008 and 2009 and R$14.2 billion in NTN-Fs maturing in 2010, 2011, 2012, 2013 and 2017. The issuance of LFTs totaled R$6.4 billion, for securities maturing in 2010, 2012 and 2013. The issuance of inflation-linked NTN-Bs reached R$21.6 billion,

for securities maturing in 2009, 2012, 2017, 2024, 2035 and 2045, of which R$8.1 billion were settled in other National Treasury securities.

75. In the same period, the Treasury conducted auctions to sell LTNs maturing in April and October 2008, conjugated to the purchase of shorter-term LTNs maturing in July and October 2007 and January 2008, totaling R$4.9 billion. The Treasury also conducted auctions to sell LFTs maturing in 2010, 2012 and 2013, totaling R$4.7 billion, accepting as payment LFTs maturing in 2007. In addition, the Treasury conducted auctions to buy NTN-Bs, totaling US$153 million.

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

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

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

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

Other participants (present on September 4th)
Adriana Soares Sales – Deputy Head of the Research Department
Alexandre Pinheiro de Moraes Rego – Press Secretary
Flávio Pinheiro de Melo – Advisor to the Board
Katherine Hennings – Advisor to the Board

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

Recent Economic Developments

1. IPCA inflation increased 0.24% in July, down from 0.28% in May and June, totaling 2.32% in the first seven months of 2007, compared to 1.73% in the same period of last year. Although 12-month inflation (3.74%) has situated below that of July 2006 (3.97%), acceleration at the margin has been observed for the fourth consecutive month. This behavior was partially expected due to the exceptionally low inflation recorded in the second quarter of 2006 (monthly average of only 0.03%), as a result of the downturn in food prices at the time. It bears emphasizing that recent inflation acceleration essentially reflects the behavior of market prices, which have increased more rapidly than regulated prices in 2007, a reversal in the dynamics observed in the recent years. In fact, market prices and regulated prices recorded 2.89% and 1.07% in the year through July, and 4.43% and 2.22% in the last twelve months. Despite the BRL appreciation in 2007, there are price pressures, among market prices, stemming from tradable goods. In the twelve months through July, tradable goods inflation totaled 4.00%, up from 0.46% observed in the same period of last year, whereas inflation acceleration for non-tradable goods was more modest, totaling 4.85%, up from 4.28% in the same period of 2006. Preliminary inflation indicators for August, such as the IPCA-15, show the continuity of inflation

acceleration, and suggest that such process might become more widespread. Notwithstanding the recent occurrence of inflation developments less benign than previously anticipated, price dynamics still indicates that inflation should continue to evolve according to the targets path.

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

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

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

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

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

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

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

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

Minutes, the inflation trajectory is closely linked to current and prospective developments with regard to the expansion of supply of goods and services to adequately meet demand conditions.

9. Despite the deceleration, at the margin, the trade balance continues to present robust performance, confirming the evaluations reported in Inflation Reports and previous Copom Minutes that depict important structural changes in the Brazilian foreign trade. In the year through August, the trade surplus reached US$27.5 billion, a 7.5% decrease relative to the same period of 2006. Exports rose 15.9%, to US$102.4 billion, while imports increased 27.8%, to US$74.9 billion. As stressed in previous Copom Minutes, imports have been growing more rapidly than exports at the margin, due not only to the strengthening of the BRL, but also, and mainly, to the higher level of economic activity. On the other hand, the effects of US real state sector crisis over global growth may slow down global demand for Brazilian exports. In any way, these two movements point out to an adjustment process in the trade balance, due to important structural changes in the Brazilian foreign trade over the recent years.

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

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

Assessment of Inflation Trends

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

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

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

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

d) The projection for regulated prices inflation in 2008 was also maintained, at 4.5%. This projection is based on the endogenous determination model for regulated prices. This model considers the effects of seasonal components, exchange rate change, market prices inflation and the IGP;

e) The projection for the spreads over the Selic rate, using a Vector Autoregressive model based on the Selic and 180-day swap rates, estimates a 5 bps spread in the fourth quarter of 2007, reaching 74 bps in the last quarter of 2008. The identified shocks and their impacts were reassessed according to newly available information.

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

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

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

Monetary Policy Decision

16. The Copom reaffirms the view expressed in previous Minutes, that in addition to containing short-term inflationary pressures, monetary policy has also contributed significantly for the consolidation of a favorable long-term macroeconomic environment. Economic activity data indicate that the intensity of demand expansion can increase the probability of important pressures over inflation in the short-run. In addition to investment expansion, imports growth has remarkably contributed to slow down this process, complementing domestic production and, therefore, limiting potential inflationary effects stemming from aggregate demand sustained growth. Moreover, despite uncertainties regarding the continuity of the strong growth in the international economy and the volatility increase in global markets since the last Copom meeting, the prospects for Brazilian external financing in the forecast period suggest, according to newly available information, that the balance of payments may not present a risk to the inflation scenario. Therefore, even with the increase in uncertainty, inflation prospects remain in line with the targets trajectory. As in recent meetings, the Copom emphasizes that the main challenge of the monetary policy in this context is to guarantee the consolidation of positive developments anticipated for the future.

17. The Copom evaluates that emerging local inflationary pressures are more likely to represent risks to domestic inflation trajectory, because the heated demand can increase the pass-through of wholesale prices over consumer price inflation. Additionally, the heated domestic demand can trigger inflationary pressures in the non-tradable sector. The Copom also observes that the increase in IPCA inflation expectations for 2007 and for twelve months ahead, despite to levels below the targets established for 2007 and 2008, is a

process that must be carefully monitored. In this sense, the Copom will continue to manage the monetary policy stance so that the gains obtained in inflation control in recent years become permanent. In this respect, the Copom will carefully monitor the evolution of inflation and the several core inflation measures, discriminating between one-off and persistent or generalized price increases, and promptly adjusting the monetary policy stance to the circumstances.

18. The preservation of inflation rates in line with the targets path and the consolidation of a long-lasting stable macroeconomic scenario will contribute to the progressive reduction of macroeconomic risk perception underway. The scope for a reduction in real interest rates in the future will naturally follow as a consequence of this improved perception. The Copom evaluates that its cautious monetary policy stance has been critical to increase the probability of inflation convergence to the targets path. For this to materialize, however, it is important that forward-looking inflation indicators, in particular the expected dynamic of aggregate demand and supply, remain consistent with the recent benign inflation outlook observed in the last quarters.

19. The Copom emphasizes, once again, that there are important time lags in the transmission of monetary policy stance to economic activity and inflation. Since the beginning of the monetary easing cycle, in September 2005, the Selic rate has already been reduced by 825 b.p., with the bulk of the reduction concentrated in the last nine months. Consequently, the activity level has not completely mirrored the effects of the interest rates cuts yet, as well as the effects of the economic activity on inflation have not completely materialized. Therefore, the evaluation of alternative monetary policy stances should necessarily focus on the prospective inflation scenario and its risks, instead of current inflation indicators.

20. During the coming months, employment and income expansions and credit growth will continue to bolster economic activity, despite the current inflation acceleration and some increase in the market interest rate. As mentioned in recent Copom Minutes, activity level should also reflect the effects of governmental transfers and other fiscal impulses expected for the next quarters of the year and for 2008. Consequently, the lagged effects of interest rates cuts on an increasingly robust aggregate demand will add up to other factors that will continue to contribute to this expansion. These issues become even more relevant considering the clear signs of heated aggregate demand, and the fact that the monetary policy decisions will have limited effects in 2007 and predominant impacts in 2008.

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

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

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

24. Under an inflation-targeting regime, the monetary authority decides according to inflation prospects, analyzing several alternative scenarios for the evolution of the main variables that determine price dynamics and its balance of risks. Domestic demand continues to expand vigorously, backing-up the economic

activity recovery. This expansion encompasses some sectors little exposed to external competition, at the time when the effects of important incentive factors, such as the monetary easing already implemented, are still not fully perceived. In spite of not being an imminent threat to inflation prospects, the contribution of the external sector to the maintenance of a benign inflationary scenario may become less effective. In such environment, the monetary authority must remain vigilant, so that short-term uncertainties do not contaminate longer time horizons.

25. At the conclusion of the meeting, it was announced that the Copom would reconvene on October 16th 2007, for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 15,011 of October 31, 2006.

Summary of Data Analyzed by the Copom

Inflation

26. The IPCA-15 went up 0.42% in August, up from 0.24% in July and 0.29% in June, totaling 2.85% in the year and 3.95% in twelve months. The prices of food and beverages increased 1.61%, up from 1.27% in July, contributing 0.34 p.p. for the index, mainly driven by the growth in the prices of bovine, milk and its by-products. The prices of perishable food retreated again in August, following the pattern that has been observed since May. The 1.02% average increase in fixed telephone prices contributed 0.04 p.p. for the IPCA-15 increase. Energy, gasoline and alcohol prices contracted in August and altogether influenced the IPCA-15 with -0.14 p.p.

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

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

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

Economic Activity

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

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

32. Retail sales performance reflects the continuity of payroll growth and better credit conditions,

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

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

34. Regarding investment indicators, civil construction inputs production reduced month-on-month 0.2% in July, while capital goods production declined 1.3%, seasonally adjusted. The monthly contraction of capital goods production does not represent a change in the trend, in view of the intense expansion in this cycle, evidenced by a 17% growth in the first seven months of 2007, and 12.3% in the last twelve months. In the year through July, compared to the same period of 2006, domestic production of capital goods increased 19.7%, with significant elevations in the production of capital goods for energy (18.7%), for mixed use (15%) and for construction (13.6%). Production of capital goods for agriculture expanded by 35.3% in the same period, while twelve-month trailing production reached 14.6% in July, after 7.5% in June, confirming the recent good performance in this sector.

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

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

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

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

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

mirroring increases in investment and recovery of the agricultural sector in the current harvest.

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

Surveys and Expectations

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

42. According to the FGV survey, which encompasses two thousand homes in the seven main state capitals of the country, the ICC increased 1% month-on-month in August. This result is due to the improvement in both the assessment of the present situation (1.3%) and in the 6-month ahead expectations (0.8%). Compared to August 2006, the ICC rose 6.5%, mainly because of the 9.9% increase in the present situation index.

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

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

Labor Market

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

46. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate stood at 9.5% in July 2007, down from 9.7% in the previous month. This decline was due to the 0.2% increase in employed population and the stability of economically active population (PEA). Employment in the private sector increased 0.7% in July, reflecting the 1.2% expansion in the number of formal workers and the

0.9% reduction in the number of informal employees. The number of employers declined 2.4%, while self-employed workers decreased by 1.2%. In the year through July, compared to the same period of 2006, the average number of employed workers expanded by 2.9%, mainly due to the increases of 4.2% and 5.3% in formal employment and self-employed workers, respectively.

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

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

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

Credit and Delinquency Rates

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

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

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

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

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

External Environment

55. Global economic activity continued to expand in the first half of 2007, according to data recently released. The US economy recovered in the second

quarter, with a 4% annualized growth. Japan and Euro area economies sustained their growth trend, with signs that their respective domestic demands have become more significant in this process. Emerging economies, led by fast growth in China, India and Russia, also showed robust expansion, favored by high liquidity e increasing commodities prices.

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

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

Foreign Trade and International Reserves

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

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

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

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

Money Market and Open Market Operations

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

63. In its open market operations, the BCB carried out, from July 17 to September 3, weekly five- and

seven-month long fixed rate repo operations. The average daily balance of these operations amounted R$88.7 billion, of which R$62.7 billion were seven-month operations. In the same period, the BCB also conducted 37 overnight repo operations aimed at draining the excess liquidity from the market. On July 19, August 6 and August 13, the BCB also conducted borrowing operations with tenures of 17, 23 and 18 working days, respectively. In addition, the BCB conducted daily liquidity management operations with tenures up to two working days. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R$22.7 billion, borrowing.

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

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

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

Mario Gomes Torós
Deputy Governor

Mário Magalhães Carvalho Mesquita
Deputy Governor

Paulo Sérgio Cavalheiro
Deputy Governor

Paulo Vieira da Cunha
Deputy Governor

Members of the Monetary Policy Committee (Copom)

Voting members

Henrique de Campos Meirelles
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Deputy Governor

Antonio Gustavo Matos do Vale
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Mario Gomes Torós
Deputy Governor

Mário Magalhães Carvalho Mesquita
Deputy Governor

Paulo Sérgio Cavalheiro
Deputy Governor

Paulo Vieira da Cunha
Deputy Governor

Non-voting members

Altamir Lopes
Head of the Departament of Economics (Depec)

Carlos Hamilton Vasconcelos Araújo
Head of the Research Departament (Depep)

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

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

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

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

Acronyms

ACC	Advance on Exchange Contracts
ACSP	São Paulo Trade Association
Aladi	Latin American Integration Association
Aneel	Brazilian Electricity Regulatory Agency
Anfavea	National Association of Automotive Vehicles Manufacturers
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
CCR	Reciprocal Credit and Payment Agreement
CMN	National Monetary Council
CNI	National Confederation of Industry
Cofins	Contribution to Social Security Financing
Copom	Monetary Policy Committee
CSLL	Social Contribution on Net Profits
DAX	*Deutscher Aktienindex*
DBGG	Gross General Government Debt
DPMFi	Internal Federal Public Securities Debt
ECB	European Central Bank
Embi+	Emerging Markets Bond Index Plus
Emgea	Asset Management Company
FAT	Worker Support Fund
FDI	Foreign Direct Investments
Fecomercio SP	Trade Federation of the State of São Paulo
Fed	Federal Reserve System
FGV	Getulio Vargas Foundation
FMP-FGTS	Mutual Privatization Funds – FGTS
FMP-FGTS-CL	Mutual Privatization Funds – FGTS – Free Portfolio
FTSE 100	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
Icei	Industry Businessmen Confidence Index

ICI	Industrial Confidence Index
ICMS	Tax on the Circulation of Merchandise and Services
IEA	International Energy Agency
IEC	Consumer Expectations Index
IGP-DI	General Price Index
IGP-M	General Price Index – Market
II	Import Tax
INC	National Confidence Index
INCC	National Cost of Construction Index
IPA-DI	Wholesale Price Index
IPCA	Extended National Consumer Price Index
IPC	*Índice de Precios y Cotizaciones*
IPC-Br	Consumer Price Index – Brazil
Ipsos	Ipsos Public Affairs
IRPF	Individual Income Tax
IRPJ	Corporate Income Tax
IRRF	Income Tax Withholdings
LDO	Budget Guidelines Law
Loas	Social Assistance Law
LSPA	Systematic Farm Production Survey
LTN	National Treasury Bills
MDIC	Ministry of Development, Industry and Foreign Trade
MPC	Monetary Policy Committee
MTE	Ministry of Labor and Employment
MYDFA	Multi-Year Deposit Facility Agreement
Nasdaq	National Association of Securities Dealers Automated Quotation
NTN-B	National Treasury Notes – Series B
Opec	Organization of the Petroleum Exporting Countries
p.p.	Percentage points
p.y.	Per year
PAC	Growth Incentive Program
PAF	Annual Financing Plan
PBC	People's Bank of China
PEA	Overall Labor Force
PIA	Annual Industrial Survey
PIM-PF	Monthly Industrial Survey – Physical Production
PIR	Regional Industrial Survey
PMC	Monthly Retail Trade Survey
PME	Monthly Employment Survey
PPI	Pilot Investment Project
PSND	Public Sector Net Debt
RMV	Lifetime Monthly Income
S&P 500	Standard and Poor's 500
SCIT	Manufacturing Industry Survey
SCIT-QE	Manufacturing Industry Survey–Special Queries
SCPC	Credit Protection Service Center
Secex	Foreign Trade Secretariat
Selic	Special System of Clearance and Custody
VIX	Chicago Board Options Exchange Volatility Index
XU 100	Istanbul Stock Exchange National 100 Index