

Cumulative inflation in the three-month period ended in May closed well below the rate for the three-month period through February, indicating that specific sources of inflationary pressures present in the final months of 2005 and early 2006 had been eliminated. Despite the increased pace of activity, these pressures did not affect the other prices of the economy nor did they raise inflation to a higher plateau.

Though less intense, consumer price inflation in the March-May period of 2006 was impacted by hikes in regulated prices, particularly medicines and gasoline.

## 2.1 General price indices

General price indices posted negative results in February and March, stability in April and positive rates in May. The General Price Index – Domestic Supply (IGP-DI) fell 0.05% in the three-month period through May, due to the evolution of both wholesale and consumer prices.

Wholesale industrial prices increased 0.67% in the three-month period ended in May. This was the second highest result for the year after January and was caused, among other factors, by exchange appreciation. The sharpest reductions occurred in the sectors of mechanics, plastics, fertilizers and paints and varnishes. Despite these results, higher international market prices for metallic commodities impacted domestic prices. Analysis of selected headings of the Wholesale Price Index – Industrial Products (IPA-PI) shows sharp increases in the segments of mining, electrical equipment and metallurgy, principally, nonferrous metals.

Wholesale farm prices dropped 4.3% in the three-month period through May, mainly as a result of ongoing marketing of the harvest and exchange rate appreciation. The sharpest declines were registered in the prices of cereals and grains, legumes and fruit, roots and tubers, pork, eggs and export crops.

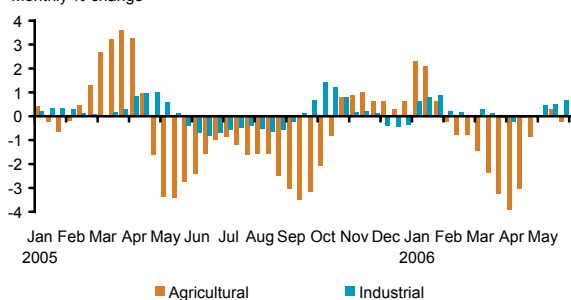
**Table 2.1 – General price indices**

	Monthly % change				
	2006				
	Jan	Feb	Mar	Apr	May
IGP-DI	0.72	-0.06	-0.45	0.02	0.38
IPA	0.81	-0.12	-0.82	-0.15	0.46
IPC-Br	0.65	0.01	0.22	0.34	-0.19
INCC	0.34	0.19	0.20	0.36	1.32

Source: FGV

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

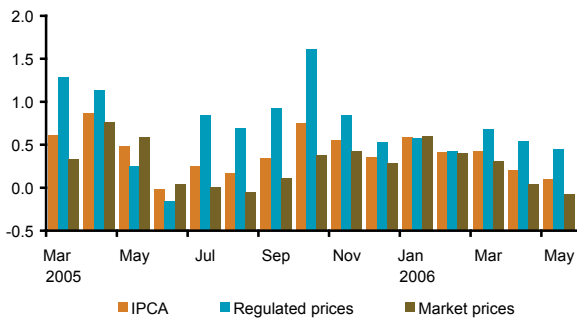
Monthly % change



Source: FGV

**Figure 2.2 – IPCA**

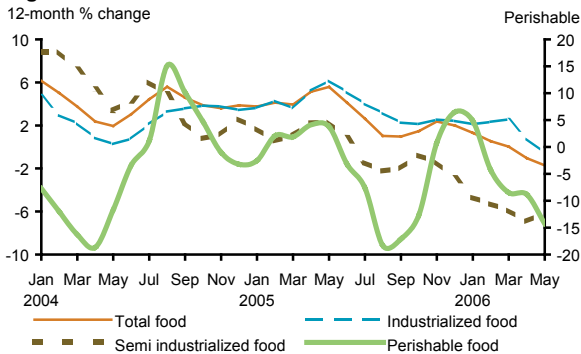
Monthly % change



Source: IBGE

**Figure 2.3 – IPCA – Food**

12-month % change

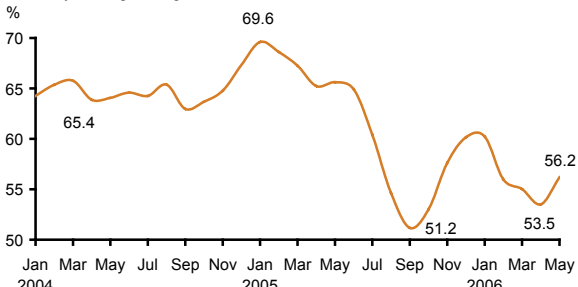


Source: IBGE

**Figure 2.4 – IPCA**

% of items with increase

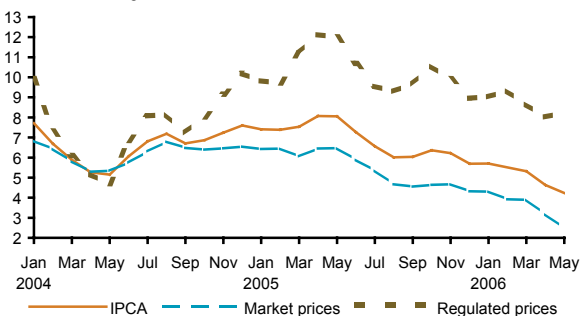
Quarterly moving average



Source: IBGE

**Figure 2.5 – IPCA**

12 month % change



Source: IBGE

With regard to consumer prices, the Consumer Price Index – Brazil (IPC-Br) increased 0.36% in the three-month period ended in May, compared to 1.13% in the three-month period through February. Just as occurred in the other consumer price indices, this result was generated mainly by lower food prices.

## 2.2 Consumer price indices

The IPCA increased 0.74% in the March-May period, compared to 1.37% in the three-month period ended in February, due mostly to reductions from 1.29% to 0.27% in growth under market prices. Monthly IPCA growth figures declined in the three-month period, dropping from 0.43% in March to 0.21% in April and to 0.10% in May.

The heading of food prices, the item of greatest weight in the general index, was mainly responsible for the decline in inflation between the three-month periods ended in May and February, with -0.54% and 0.1% respectively.

The positive outlook for the farm harvest, declining external demand for animal origin products and exchange appreciation were the elements responsible for the decline in industrialized foodstuff prices, particularly meats and seafood, milk and derivatives, oil and fats and bakery goods; and, in the prices of semi-manufactured food products, particularly beef and poultry.

More suitable weather conditions led to reductions in the prices of perishable goods in the three-month period. Fruit prices dropped 17.76%, compared to a 10.57% rise in the three-month period through February.

Three-month growth in regulated prices totaled 1.68%, slightly above the increase in the three-month period ended in February. This behavior was primarily due to increases in medicine, bottled gas and gasoline prices.

The proportion of IPCA headings that registered positive growth in 2006 remained below the levels registered in 2004 and 2005, when inflation closed within the tolerance interval but above the central target value defined by the National Monetary Council (CMN).

## 2.3 Regulated prices

Growth of 1.68% in regulated prices in the three-month period ended in May corresponded to 0.56 p.p. of the 0.74% IPCA rate. In the same period, market prices grew just 0.27%. The items primarily responsible for growth in regulated prices were a 3.14% rise in gasoline prices, caused by a sharp off-season increase in the price of alcohol – mixed into the gasoline supply in a proportion of 20% (25% prior to March 1) – and a 3.6% hike in medicine prices, including the average increase of 4.57% announced on April 1<sup>st</sup>. Other increases include 1.49% in water and sewage rates, 1.86% in electricity rates and 3.18% for bottled gas.

**Table 2.2 – IPCA**

	Weights	2006						% change
		Jan	Feb	Mar	Apr	May	Year	
IPCA	100.00	0.59	0.41	0.43	0.21	0.10	1.75	
Market prices	66.48	0.60	0.40	0.31	0.04	-0.08	1.27	
Regulated prices	33.52	0.58	0.42	0.68	0.54	0.45	2.70	
<b>Main items</b>								
Electricity	4.72	-0.94	0.15	0.38	1.23	0.24	1.05	
Water and sewage	1.95	0.21	0.00	1.84	-0.30	-0.04	1.71	
Urban bus	5.26	1.82	1.25	0.04	0.00	0.16	3.30	
Air ticket	0.69	-1.20	-1.43	-2.91	-0.65	-0.30	-6.34	
Gasoline	4.53	1.19	0.57	2.78	-0.09	0.44	4.96	
Bottled cooking gas	1.58	0.55	0.30	1.22	0.67	1.26	4.06	
Medicine	4.03	0.33	0.14	0.13	2.03	1.41	4.09	
Health plans	2.77	1.89	1.07	1.04	1.04	1.04	6.23	

Source: IBGE

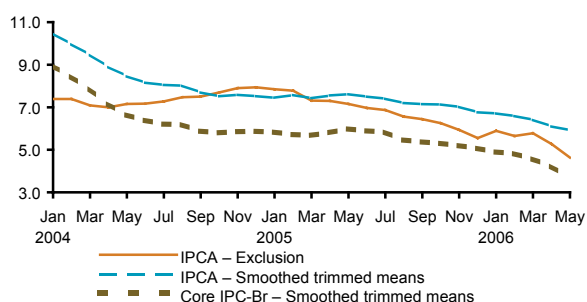
**Table 2.3 – Consumer prices and core inflation**

	2005					Monthly % change
	Jan	Feb	Mar	Apr	May	
IPCA	0.59	0.41	0.43	0.21	0.10	
Exclusion	0.87	0.71	0.53	0.22	-0.03	
<b>Trimmed means</b>						
Smoothed	0.61	0.49	0.45	0.41	0.47	
Non smoothed	0.61	0.42	0.30	0.19	0.24	
IPC-Br	0.65	0.01	0.22	0.34	-0.19	
Core IPC-Br	0.44	0.29	0.25	0.32	0.22	

Sources: IBGE, Bacen and FGV

**Figure 2.6 – Core inflation**

12-month % change



Source: Bacen and FGV

## 2.4 Core inflation

IPCA core inflation calculated by exclusion of household food and regulated prices registered 0.53% in March, 0.22% in April and -0.03% in May, for a cumulative 0.72% high in the three-month period. Deceleration in the three-month period reflected a declining trajectory in fuel alcohol price growth from 12.85% in March to -0.11% in April and -11.06% in May. The cumulative twelve-month rise in the core by exclusion totaled 5% in May.

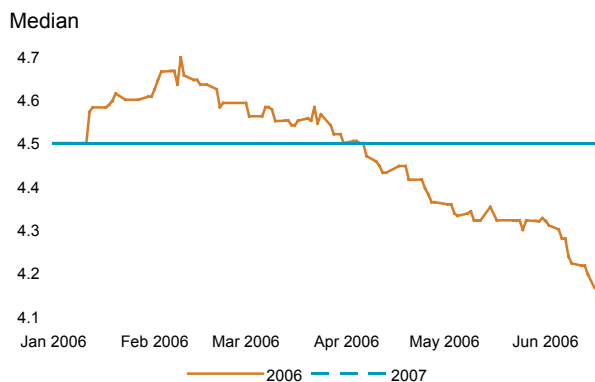
Smoothed trimmed-means IPCA core inflation increased 0.45% in March, 0.41% in April and 0.47% in May, registering the lowest three-month growth rate in the last five years (1.01%). Twelve-month growth, which has been declining since the end of 2003, totaled 5.92% in May. Non-smoothed trimmed-means core inflation rose 0.3% in March, 0.19% in April and 0.24% in May, for a cumulative twelve-month total of 4.35%.

Smoothed trimmed-means IPC-Br core inflation calculated by the FGV registered growth of 0.25% in March, 0.32% in April and 0.22% in May. In the last twelve months, the core registered a cumulative high of 3.70%.

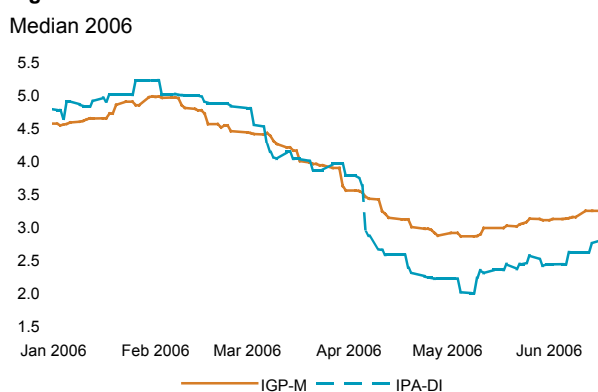
## 2.5 Market expectations

According to the survey carried out by the Bacen Investor Relations Group (Gerin), market projections for the 2006 IPCA declined from 4.5% to 4.2% in the second quarter, while projections for 2007 remained at the target center of 4.5% defined by the CMN for both years.

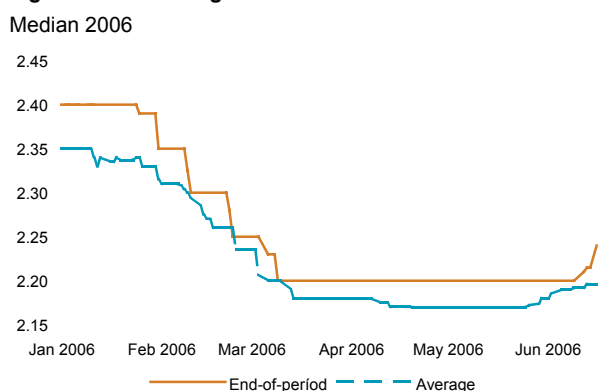
**Figure 2.7 – IPCA**



**Figure 2.8 – IGP-M e IPA-DI**



**Figure 2.9 – Exchange rate**



**Table 2.4 – Summary of market expectations**

	12.30.2005		3.31.2006		6.16.2006	
	2006	2007	2006	2007	2006	2007
IPCA	4.5	4.5	4.5	4.5	4.2	4.5
IGP-M	4.6	4.5	3.6	4.5	3.2	4.5
IPA-DI	4.8	4.7	3.8	4.6	2.8	4.5
Regulated Prices	4.5	4.3	4.5	4.1	4.5	4.5
Selic (end-of-period)	15.0	13.5	14.1	13.0	14.5	13.0
Selic (average)	15.9	14.5	15.3	13.6	15.4	13.6
Exchange rate (end-of-period)	2.40	2.55	2.20	2.34	2.24	2.35
Exchange rate (average)	2.35	2.45	2.18	2.28	2.20	2.32
GDP growth	3.5	3.5	3.5	3.6	3.6	3.7

Smoothed IPCA expectations for the next twelve months dropped from 4.3% to 4.2% in the three-month period.

Expectations for the other price indices further reinforced the environment of declining inflation that has prevailed in 2006. Median mid-June expectations for the General Price Index – Market (IGP-M) and Wholesale Price Index – Domestic Supply (IPA-DI) closed at 3.2% and 2.8%, well below March projections for these indices (3.6% and 3.8%). Figure 2.8 indicates a sharper decline in expectations up to early May, with an adjustment in the following period, partly reflecting interruption of wholesale price deflation in the February-April period. For 2007, market projections for the IGP-M remained stable at 4.5% during the entire three-month period, while IPA-DI forecasts dropped slightly from 4.6% in March to 4.5% in June.

The positive behavior of expectations in the second quarter of 2006 was reflected in economic growth forecasts. GDP growth projections for 2006 and 2007 were revised upward from 3.5% and 3.6% in the previous quarter to 3.6% and 3.7%, respectively.

Exchange rate expectations for 2006 and 2007 aided in consolidating the environment of lesser inflationary pressures, despite increased market volatility in the second half of the quarter. Considering both the average and end-of-period rates, median exchange rate expectations in 2006 remained practically stable in the three-month period, with R\$2.20/US\$ (average in period) and R\$2.24/US\$ (end-of-period) at the end of the first half of June as a result of international market turbulence, as shown in Figure 2.9. The long-term impact of the increased volatility is not yet clear. In the same period, expectations of the average rate of exchange in 2007 were revised upward from R\$2.28/US\$ to R\$2.32/US\$.

Regarding monetary policy implementation, the market adjusted its expectations to 2006 interest rate evolution, indicating perspectives of a more gradual easing of monetary policy. For 2006, projections for the end-of-period Selic rate moved from 14.1% per year (end of March) to 14.5% per year (mid-June), while expectations for 2007 remained stable at 13% per year.

## 2.6 Summary

Lesser growth in consumer price indices in recent months has confirmed the trajectory of convergence to the inflation

targets defined by the CMN. The diagnosis that the inflation spike in the transition from 2005 to 2006 was a temporary phenomenon has been confirmed by subsequent price indices. The drop in inflation occurred in all sectors and is evident in the various core indices.

The fact that downward movement in inflation occurred simultaneously with increased economic activity suggests a growth pace compatible with supply conditions with no significant pressures on prices. With regard to the international scenario, the conditions required for continued export growth have been positive, though certain risk factors should be considered in relation to internal prices, particularly the impact of increased volatility in financial markets and commodity prices, mainly involving metallic products and energy.