BANCO CENTRAL DO BRASIL

Minutes of the 113th Meeting of the Monetary Policy Committee (Copom)

Date: October 18th, from 4:55PM to 7:15PM, and October 19th, from 4:30PM to 7:30PM
Place: BCB Headquarters meeting rooms - 8th floor on October 18th and 20th floor on October 19th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Afonso Sant'Anna Bevilaqua
Alexandre Antonio Tombini
Alexandre Schwartsman
Antônio Gustavo Matos do Vale
João Antônio Fleury Teixeira
Paulo Sérgio Cavalheiro
Rodrigo Telles da Rocha Azevedo
Sérgio Darcy da Silva Alves

Department Heads (present on October 18th)
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on October 19th)
Daso Maranhão Coimbra – International Reserves Management Department
Ivan Luís Gonçalves de Oliveira Lima – Open Market Operations Department
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Jose Antônio Marciano – Department of Banking Operations and Payments System

Other participants (present on October 18th)
Flávio Pinheiro de Melo – Advisor to the Board
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

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

Recent Economic Developments

1. IPCA monthly inflation doubled in September (0.35%) as against August (0.17%). Despite this increase, the IPCA quarterly moving average remained at low levels by historical standards, down to 0.26%, versus 0.64% recorded in September 2004. The acceleration in monthly inflation was expected, as it was driven primarily by the mid-September fuel price increase (responsible for 40% of the IPCA change). The effect of the fuel price increase is also expected to carry over into the October inflation results. The behavior of the IPCA diffusion index provides further evidence that the September up-tick in inflation was due to one-off factors – it remained at 51.4%, the third lowest level since the floating of the currency, in January 1999, albeit slightly up from 48.4% in August. Market prices posted virtually no change, for the third consecutive month. Among its components, tradable goods prices fell for the fourth consecutive month, while non-tradable goods recorded monthly average inflation of 0.22% in the four months ended in September, versus 0.78% in the preceding four-month period. As mentioned in prior Copom Minutes, the uncharacteristically sharp and lasting reduction in food prices in recent months has helped the favorable consumer price inflation trend. However, the contribution of the food price effect to inflation is declining at the margin. Regulated prices recorded average inflation of 0.57% in the four months through September, versus 0.71% in the February-May period.

2. Recent core inflation trends also suggest an accommodation to levels below those prevailing at the start of the year. Core inflation by exclusion, smoothed trimmed means and non-smoothed trimmed means core inflation rose 0.30%, 0.51%, and 0.34%, respectively, in September. The more moderate increase in core by exclusion, versus the headline index, reflects the fact that the IPCA increase in September was largely due to the increase in fuel prices and to the more moderate reduction in food prices, both of which are excluded from this core inflation measure. In the four months through September, core inflation by exclusion, smoothed trimmed means and non-smoothed trimmed means cores averaged 0.32%, 0.45%, and 0.30%, respectively, versus 0.66%, 0.64%, and 0.52% in the four months ending in May. While the September result broke the steady downward trend in monthly core inflation observed since April, twelve-month trailing inflation under the three core measures has continued to decline since May.

3. The General Price Index (IGP-DI) fell 0.13% in September, declining for the fifth consecutive month and approaching levels observed at the start of the year. The drop in the IGP-DI was again driven by deflation in the Wholesale Price Index (-0.28%). IGP-DI inflation in the year through September reached a modest 0.19%, while twelve-month trailing inflation came to only 2.08%. The IPA-DI, which also declined for the fifth consecutive month, posted deflation of 1.84% in the year-to-date, and twelve-month trailing inflation of only 0.22%. The atypical, ongoing stability of wholesale prices reflects the behavior of consumer (excluding durables) and producer prices. Of particular note, the stability of the IPA-DI is attributable to the sharp 9.91% trailing twelve-month fall in wholesale agricultural prices, in conjunction with the moderate 3.89% increase in wholesale industrial prices (the lowest increase since January 1999). Leading IGP-10 data for October suggest continued wholesale agricultural price deflation, but an increase in wholesale industrial prices, driven mainly by the fuel price increase. In both the year-to-date and the twelve months through September, the General Price Indices have recorded inflation below that of the IPCA – underscoring the consistent accommodation of wholesale prices and the potential positive spillovers to consumer prices in the coming quarters. As emphasized in prior Copom Minutes, the intensity and continuity of this pass-through in the coming months will depend on demand conditions and price-setters' expectations for the future inflation path.

4. After the 1.9% reduction in July, in line with revised data released by the Brazilian Institute of Statistics and Geography (IBGE), industrial production rose a seasonally adjusted 1.1% in August, as previewed by leading and coincident indicators. The August result brought industrial production growth to 4.3% in the year-to-date and 5.1% over the past twelve months. Over the course of the year, the monthly values in the seasonally adjusted series alternated periods of growth, stability and contraction but, in general, industrial production has remained at elevated levels by historical standards. The more stable three-month moving average series underscores the strong performance of industrial production, rising in August for the fifth consecutive month and reaching a new record high, 3.6% above the value observed in August 2004. Leading and coincident indicators suggest a slowdown in industrial activity in September.

5. In August, all use categories of industrial production recorded seasonally adjusted growth. Capital goods production rose the most (3.1%), followed by consumer and intermediate goods, up 1.3% and 0.1%, respectively. The three-month moving average series showed stability in capital goods production, a modest decline in intermediate goods production, and a 0.6% increase in consumer goods production. In contrast to prior months, the greater dynamism of consumer goods production was due to the production of semi- and non-durables, which rose 1.6% relative to July, while durable goods production fell 1.7%. Semi- and non-durable consumer goods production rose 6.4% in the year-to-date, and 5.7% over the past twelve months, reflecting the growing importance of income gains in the current expansion. Despite the drop in August, consumer durable goods production is up 15.7% in the year-to-date and over the past twelve months, well above the average overall industrial production result.

6. The labor market remained firm in August, in step with the more stable macroeconomic environment and the historically elevated levels of economic activity. The unemployment rate measured by the IBGE was 9.4% in August, unchanged for the third consecutive month, two percentage points below the level registered in August 2004, and the lowest level for the series as measured since October 2001. The number of employed persons rose 3.4% in the year, compared to the same period of 2004. Workers continued to recover purchasing power, with real average incomes rising 3.7%, relative to August 2004, the largest year-on-year increase in the series - underscoring the positive effect of the drop in inflation on real wages. According to the National Industry Confederation (CNI), manufacturing employment rose 5.6% year-to-date through August, and 5.9% in the twelve

months through August, while real payrolls increased 8.9% and 9.5% in the same periods, thus evidencing that the increase in jobs is being accompanied by an improvement in the quality of industrial employment. Formal employment, measured by the Ministry of Labor and Employment (MTE), also continued to rise. With the creation of 189,458 positions in September, year-to-date formal job creation exceeded 1.4 million positions.

7. Seasonally adjusted data from the IBGE showed a 0.4% reduction in retail sales in August. This contraction was wholly attributable to the 2.4% drop in fabric, clothing, and shoe sales, as all other categories posted growth. Of note, the month-on-month reduction in fabric, clothing, and shoe sales in August followed a robust 7.1% expansion in July. Despite the August drop, the three-month moving average for overall retail sales shows an expansion of 0.3%, the fifth consecutive increase. Furthermore, retail sales are up 4.86% in the year-to-date and 6.30% in the past twelve months. The performance largely reflects positive labor market developments, as described above, and credit growth. Despite the lack of detailed current data, available indicators suggest that retail sales will continue to expand in the coming months.

8. Installed capacity utilization in the manufacturing industry, as measured by the CNI and seasonally adjusted by the BCB, rose to 82.0% in August, from 81.6% in July. Capacity utilization remains at elevated levels by historical standards, although dropping below the record levels reached in the second half of 2004. As emphasized in prior Copom Minutes, the relative stability of capacity utilization could be due to the maturation of investments, given that industrial production growth has outpaced installed capacity utilization in recent months. The persistence of historically high levels of installed capacity utilization makes the inflation path more dependent on the capacity of current and prospective supply increases to meet demand conditions. With regard to investment, capital goods absorption registered an expansion of 4.7% in the year through August, driven largely by the rise in capital goods imports (up 30.2% in volume terms over the same period of the previous year). While there is stronger evidence of a recovery in investment, the performance of aggregate supply in the coming quarters remains a key point of concern with regard to future inflation dynamics.

9. Recent data confirm that external trade performance in 2005 will outpace that of last year. In September, twelve-month cumulative exports exceeded US$112 billion, driven primarily by the growth in manufactured exports. In addition, the twelve-month cumulative trade balance exceeded US$41 billion, with imports totaling US$72 billion. Exports rose 24.7% in value terms over the preceding twelve months, while imports rose 22.5%. Export and import (excluding capital goods) growth has decelerated at the margin, despite the rise in oil prices. Capital goods imports rose 31.9% in September compared to the same month of 2004, for a cumulative 29.2% expansion in 2005 and 25.6% over the past twelve months. Therefore, throughout the course of 2005, the relative participation of capital goods imports in total imports has risen, to the detriment of raw material and intermediate goods imports. In line with preliminary data, the strong performance of the trade accounts in the twelve months through September contributed to a current account surplus of US$13 billion, or 1.8% of GDP. While the contribution of external demand to the ongoing economic expansion has diminished somewhat in recent months, it remains important and above that expected at the start of the year.

10. International financial markets remained characterized by relatively high volatility; however, there was not a significant change in the scenario considered by the Copom at its September meeting. In the final week of September, Brazilian country risk fell close to the historic lows reached in 1997, only to partially retrace those gains in October, despite the improved sovereign credit outlook communicated by two ratings agencies. These favorable developments were counterbalanced by concerns about the path of U.S. inflation, mainly in the wake of fuel price increases. In the short term, liquidity conditions and financial market stability remain tied to macroeconomic conditions in the U.S., and to the Fed’s potential monetary policy response. In general, recent indications suggest that the Fed will probably continue to raise interest rates at a measured pace. An additional point of concern is the external account imbalances in some of the largest economies and the possibility that eventual adjustments will result in significant currency movements. Despite these concerns, about which there is a significant degree of uncertainty and scope for an increase in short-term volatility, the Copom continues to assign a low probability to a significant deterioration in international financial market conditions.

11. International oil prices have fallen from the peak levels recorded in August. Meanwhile, international gasoline prices have recently de-linked from oil prices to reach record highs, due to the damage to refining capacity in the Gulf of Mexico caused by Hurricane Katrina. In both cases, while there has been a considerable reduction

from peak levels, prices remain high and may remain at higher-than-expected levels for an extended period of time. On the domestic front, the fuel price increase implemented in mid-September, which will still carry over into the October IPCA, prompted the Copom to work with a domestic fuel price scenario in which there is no further gasoline price increases in 2005. Nevertheless, given the uncertainties surrounding the path of international oil prices, rising oil prices continue to represent a risk factor for the future inflation path, given that these prices can be passed through to the domestic economy via their effects on oil-intensive products as well as private sector inflation expectations.

Assessment of Inflation Trends

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

a) The projection for gasoline price adjustments in 2005 remained unchanged at 7.5%. The projection for bottled gas prices was increased to –1.2% from –1.7%;

b) The projection for fixed line telephone rate and household electricity adjustments in 2005 remained unchanged at 6.7% and 7.6%, respectively;

c) For all regulated prices, which represented a total weight of 29.9% in the September IPCA, the Copom maintained its projection for 2005 adjustments at 7.8%;

d) The projection for regulated price adjustments in 2006 was reduced to 5.1% from 5.3%. There was an increase in the number of items for which price changes were individually projected, contributing to greater precision in the 2006 projections. For the remaining items, the projection continued to follow the model of endogenous determination, which takes into account seasonal components, the exchange rate, market price inflation, and the change in the IGP;

e) The projection for the six-month spread over the Selic rate, using a Vector Autoregressive model based on the Selic and swap rates on the eve of the Copom meeting, increases from an average of –86 basis points in the last quarter of 2005, to 33 basis points in the last quarter of 2006.

13. Regarding fiscal policy, it is assumed that the consolidated public sector primary surplus target of 4.25% of GDP for 2005 and 2006 will be achieved. The related assumptions considered in the September meeting were maintained.

14. Since the September Copom meeting, median IPCA inflation expectations for 2005, compiled by the Investor Relations Group at the BCB, rose slightly, from 5.19% to 5.24%. The increase is mainly due to the fact that the September surveys did not fully capture the effects of the mid-September fuel price increases. Despite the recent slight rise, expectations remain close to the 5.1% inflation objective pursued by the Central Bank. For 2006, expectations have fallen more markedly, to 4.6% from 4.8%, but nevertheless remain slightly above the 4.5% target established by the National Monetary Council (CMN). As mentioned in prior Copom Minutes, these developments suggest that the recent monetary policy stance has both contained short-term inflationary pressures and contributed to the consolidation of a more favorable longer-term macroeconomic scenario.

15. The 2005 inflation forecast under the benchmark scenario – which assumes the maintenance of the Selic rate at 19.50% p.a. and the exchange rate at R$/US$ 2.25 during the forecast period – remained unchanged from the prior Copom meeting, falling below the 5.1% inflation objective for the year. The forecasts based on the market scenario – which incorporates the consensus exchange rate and Selic rate trajectories on the eve of the Copom meeting – declined relative to the September Copom meeting and are now in line with the 5.1% inflation objective. For 2006, the benchmark forecast declined, remaining below the 4.5% target established by the CMN. The forecast under the market scenario was unchanged, above the inflation target.

16. The Copom also analyzed inflation forecasts for the twelve-month periods ending in March, June, and September 2006. The forecasts for these periods are more responsive to current monetary policy decisions than

those for calendar year 2005, and also more reliable than those for calendar year 2006. The benchmark scenario forecasts for these periods were below the target inflation path values interpolated from the 5.1% objective for 2005 and the 4.5% target for 2006.

Monetary Policy Decision

17. The Copom reaffirms the view expressed in prior Minutes, that actual and expected inflation results demonstrate that the monetary tightening cycle begun in September 2004 has contained short-term inflationary pressures and consolidated a more favorable long-term macroeconomic environment. Economic activity continues to expand, but at a pace more compatible with supply conditions, such that it will not exert significant inflationary pressures. In addition, despite the recent increase in financial market volatility and the persistence of high oil prices, the external environment remains favorable, particularly with regard to external financing conditions for the country. There are, therefore, more definite signs of a benign inflationary environment. As in the September meeting, the Committee emphasizes that the main challenge for monetary policy is to ensure the consolidation of these favorable developments.

18. The Copom considers that the recent spike in short-term inflation is being driven largely by the domestic fuel price adjustment implemented in mid-September, as well as by the partial reversal of the favorable food price dynamics. The effects of these factors have not been fully reflected in September inflation results and will therefore affect inflation measures to be released in the coming weeks. Since these are transitory pressures, it is expected that they will fade over time without necessarily contaminating longer time horizons. Nevertheless, the Copom will continue to direct its policy actions toward ensuring that the gains achieved in reducing inflation are made permanent. To this end, in the coming months, the Copom will closely follow the evolution of headline and core inflation, distinguishing between one-off and more generalized price adjustments, and quickly adapting its monetary policy stance to the circumstances.

19. The uninterrupted convergence of inflation to the target path and the resulting consolidation of a more robust and lasting macroeconomic stability will contribute to the progressive reduction in perceived macroeconomic risk, a process already underway for several years in Brazil. The scope for a reduction in real interest rates in the future will naturally follow. The Copom considers that its cautious monetary policy stance has been critical in increasing the probability of inflation convergence to the target path. For this to materialize, however, it is important that forward-looking inflation indicators remain compatible with the more recent benign inflation outlook. Therefore, the easing of monetary policy will not compromise the important achievements made in recent months in lowering inflation and preserving economic growth with job creation and rising real incomes.

20. The Copom therefore unanimously decided to reduce the Selic target to 19.00% p.a., without bias. Given the uncertainties surrounding the monetary policy transmission mechanisms and the risks associated to the outlined scenarios, the Committee considers that it will be necessary to closely follow the evolution of the inflation outlook until its next meeting, at which time it will define the next steps in its monetary policy strategy.

21. At the conclusion of the meeting, it was announced that the Copom would reconvene on November 22 for technical presentations, and on the following day to discuss the monetary policy decision, as established in Communiqué 12,631 of October 29, 2004.

SUMMARY OF DATA ANALYZED BY THE COPOM

Inflation

22. The IPCA rose 0.35% in September, bringing year-to-date inflation to 3.95% and twelve-month trailing inflation to 6.04%. The rise in the IPCA in the month was primarily due to the increase in regulated prices, which rose 0.92%, contributing 0.28 p.p. to the monthly result - gasoline prices individually contributed 0.14 p.p. Market prices rose 0.1% and, again, the fall in food and beverage prices (-0.25%) counterweighed the impact of other price increases.

23. The IGP-DI fell 0.13% in September, its fifth consecutive monthly decline. Considering the September result, year-to-date IGP-DI inflation was 0.19%, and twelve-month trailing inflation was 2.08%. Among its components, the Consumer Price Index-Brasil (IPC-Br) rose 0.09% in the month, mainly due to the 4.75% rise in gasoline prices. Food prices fell 1.03%, in line with recent declines. The National Index of Civil Construction (INCC) rose 0.24%, reflecting generalized increases in service and input prices, and labor cost increases in the city of Belém. The Wholesale Price Index (IPA-DI), the sub-index with the largest weight in the IGP-DI, fell for the fifth consecutive month (-0.28%), bringing the year-to-date result to -1.84% and the twelve-month trailing result to 0.22%.

24. While wholesale prices declined again in September, the pace of their decline has eased, mainly due to the reversal in the path of industrial prices. The contraction in wholesale agricultural prices intensified to –3.17% in September, from –2.47% in August, driven by the sharp drop in the prices of animals and animal derivatives and crops for export. Meanwhile, industrial prices rose 0.67%, after declining for four consecutive months, reflecting primarily the performance of chemical prices, which rose 2.94% in September versus -0.67% in August, due to the increase in fuel and plastics prices. Other important manufacturing segments, such as foodstuffs and metals, continue to post declining prices, albeit less so than in the previous month. The IPA-DI by production stage registered a reversal in intermediate goods prices, with an increase of 0.91%, a deceleration in decline of final goods prices, and a sharper drop in raw materials prices, compared to the results of August.

25. All IPCA core inflation measures rose in September, compared to August. Smoothed trimmed means core inflation rose to 0.51% in September (versus 0.36% in August), for a twelve-month trailing increase of 7.15%. Non-smoothed trimmed means core inflation rose to 0.34% in September (from 0.28% in August), bringing twelve-month trailing inflation to 5.78%. Core inflation calculated by the exclusion of household food and regulated prices also rose in September, to 0.30% from 0.26% in August, for twelve-month trailing inflation of 6.44%.

26. The IPCA diffusion index (measuring the number of items in the IPCA registering price increases) was 51.4%, the third lowest level since the floating of the currency, in January 1999.

27. IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed means method, rose to 0.29% in September, from 0.07% in August. Year-to-date through September, IPC-Br inflation was 3.99%, with a trailing twelve-month increase of 5.37%.

28. Consumer price inflation is expected to rise in October, due to the lingering impact of the fuel price increase implemented on September 10. Other regulated prices, such as health plans and water and sewage fees, should also contribute to a rise in inflation. Food prices are also expected to begin rising, after a prolonged period of contraction.

Economic Activity

29. According to the IBGE's survey, retail sales fell 0.4% in September relative to August. All categories rose, except for fabric, clothing and shoes, which contracted 2.4% in the month. Retails sales have risen 4.9% year-to-date, and 6.3% on a cumulative 12-month basis.

30. São Paulo Trade Association (ACSP) data showed a seasonally adjusted 0.6% decline in database consultations for credit sales in September, compared to August, while the number of consultations of the Telecheque system fell 2.5%. In the year through September, these indicators rose 5.6% and 2.8%, respectively, compared to the same period of the previous year.

31. Net delinquency rates for retail credit, measured by the ACSP, increased to 4.9% in September, from 4.7% in August, for a cumulative 13.4% rise in the year through September.

32. Investment indicators expanded in August. Domestic production of capital goods and construction inputs increased 3.1% and 0.5%, respectively, on a month-on-month seasonally adjusted basis. In the year through August, compared to the same period of 2004, these indicators increased 2.7% and 1.0%, respectively. According to the Fundação Centro de Estudos do Comércio Exterior (Funcex), the volume of capital goods imports rose 41.8% in August and 30.2% in the year through August. Medium- and long- term loans disbursed by the Banco Nacional de Desenvolvimento Econômico (BNDES), reached R$28.8 billion in the year through August, exceeding by 18.4% those disbursed in the same period of 2004.

33. According to the IBGE's Monthly Industrial Survey (PIM), industrial production increased a month-on-month seasonally adjusted 1.1% in August. This result was due to the 1.2% increase in manufacturing output. Mining fell 0.3%. In the year through August, industrial production rose 4.3%, due to the 4.0% increase in manufacturing and the 10.1% increase in mining.

34. Seasonally adjusted data for industrial production showed that 11 of the 23 sectors surveyed increased in August, with tobacco, medicine, machinery and equipment, oil refining and alcohol production as the main drivers of the result. Except for consumer durable goods production, all use categories expanded in August, following the broad-based decline in July. Capital goods production registered the sharpest monthly increase (3.1%). Semi- and non-durable consumer goods grew 1.6%, showing the important role of domestic demand in the overall manufacturing result. Intermediate goods production, with the largest weight in the industrial production index, grew 0.1%, for a 1.6% cumulative increase in the year through August.

35. CNI manufacturing data showed a decline of 0.9% in real sales and an increase of 0.2% in hours worked in August, respectively, on a month-on-month seasonally adjusted basis. In the year through August, these indicators increased 1.8% and 6.2%, respectively. Installed capacity utilization reached a seasonally adjusted 82.0% in August, up 0.4 p.p. relative to July. Without seasonal adjustments, installed capacity utilization reached 82.9%, 1.2% below that posted in August 2004.

36. Sector leading indicators point to a fall in industrial activity in September. Data related to automobile production, highway tolls, and energy consumption confirm this trend.

Surveys and Expectations

37. The Fecomercio-SP survey showed a 0.99% month-on-month decline in the Consumer Confidence Index in September, due to the 3.28% fall in the index of current economic conditions and the 0.41% improvement in consumer expectations.

38. According to FGV, consumer confidence rebounded in September, after a three-month decline. Five out of the eight main items of the survey improved, in comparison to August, while one remained stable and only two worsened. Results related to the current situation were better than those of August, on average, and in relation to the future, pessimism declined.

39. Preliminary data related to the next quarterly FGV Industrial Survey show that the evaluation of the current and future business environment is improving, in comparison to the results of July. Regarding the current situation, global demand and inventory levels were viewed more favorably. Forecasts for the coming months show the continuity of the expansion of domestic demand, a reduction of external demand, and higher levels of employment.

Labor Market

40. According to the Ministry of Labor and Employment, formal employment increased 0.4% in September (month-on-month, seasonally adjusted). All sectors but agriculture showed employment expansion. With the net creation of 1.3 million jobs, the overall index rose 5.1% in comparison to September 2004, increasing 7.3% in commerce, 5.6% in services, 6.0% in civil construction and 4.2% in industry.

41. According to the IBGE survey in the six main metropolitan regions of the country, the unemployment rate remained stable in August, at 9.4% of the labor force. This level is 2 p.p. below that of August 2004. Total of employed individuals, estimated at 19.9 million, increased 0.4%, the same rate observed for the labor force. Purchasing power continued to recover in August. Real average earnings of employed individuals, estimated at R$973.20, rose 0.7% and 3.7% in comparison to July and August 2004, respectively.

42. According to the BCB's seasonal adjustment of the CNI indices, real industrial payrolls rose 0.5% in August, on a monthly basis, while industrial employment remained stable. In the year through August, these indicators rose 8.9% and 5.6%, respectively.

External Environment

43. International financial markets have continued to reflect the uncertainties related to higher oil prices and the effects of Hurricane Katrina on the global economy. While oil prices fell to lows in mid-October that were not seen since June, they remain elevated and represent a risk to global economic growth. The effects of Hurricane Katrina should be restricted to the U.S. economy, with only short-term consequences for the broader global economy.

44. The Federal Reserve is expected to continue increasing interest rates at a measured pace, keeping inflation expectations under control. Despite the fact that the September consumer inflation result exceeded market expectations, driven by high energy prices, the favorable core inflation reading could help to reduce uncertainties about the pace of interest rate increases, as it suggests that price pressures are not broadly disseminated throughout the economy.

45. Inflation concerns are persistent in the other developed countries, in line with the high levels and volatility of oil prices. However, despite concerns about the scope for current oil prices to contaminate medium term inflation expectations, there were no changes in Euro Area or United Kingdom interest rates. Chinese GDP grew 9.4% on an annualized basis in the third quarter, compared to the same period of the previous year, while consumer and producer price indices have decelerated.

Foreign trade and international reserves

46. Results for the external trade accounts in September confirmed the sustainability of the strong external position observed recently, with practically all measures of external trade exceeding record highs. In September, the trade balance reached US$ 4.3 billion and total external trade reached US$16.9 billion. Year-to-date, the trade surplus reached US$ 32.7 billion and, in the twelve months through September, stood at US$ 41.3 billion. For the same periods, total external trade reached US$ 140.8 billion and US$ 184.6 billion, respectively. In the first nine working days of October, the trade balance reached US$ 1.7 billion. For the same period, exports and imports grew 24.3% and 2.6%, respectively, over the average daily levels reached for the same period of 2004.

47. Exports reached US$ 10.6 billion in September, with growth of 19.2% over the average daily levels reached in September 2004. Manufacturing exports, totaling US$ 5.9 billion, reached a record high for the month, growing 21.9% over the average daily level. Of particular note, were increases in exports of radio transmitters, fuel oil, earth-moving machines, cargo vehicles, tractors, auto parts, passenger cars, airplanes and vehicle engines. Manufacturing exports also showed signs of greater increases of exported goods with a traditionally small participation in total exports, furthering the export diversification process. The 22.8% increase in raw material exports was due, primarily, to the 68.9% increase in crude oil exports. Coffee bean, meat, and iron ore exports also

posted above average growth. Sales of semi-manufactured goods decreased 3.1% over the average daily levels reached in September 2004, due to the performance of soybean oil and iron and steel products.

48. Imports totaled US$6,3 billion in September, a 9.6% increase in daily average terms, compared to September 2004. Except for raw materials and intermediate goods imports, which fell 0.9%, all import categories expanded in the month. Of note were increases of 31.9% and 21.4% in capital and consumer goods imports, respectively. In the year through September, there was a 29.2% increase in capital goods imports, 20.5% for consumer goods, 20.3% for fuel and lubricants and 15.7% for raw material and intermediate goods, all measured in daily averages compared to the same period last year.

49. At the end of September, preliminary information showed international reserves and net adjusted reserves of US$57 billion and US$ 42.9 billion, an increase of US$1.9 billion and US$2.5 billion in the month, respectively, relative to end-August.

Money Market and Open Market Operations

50. In the period following the September Copom meeting, the yield curve shifted downward for tenors less than 1 year, on the back of the drop in actual and expected inflation. In contrast, rates shifted upward in the long end of the curve, driven by the worsening of the external outlook: concerns about U.S. inflation led to increases in U.S. Treasury yields and to volatility in global equity indices. Between September 14 and October 19, one-, three-, and six-month interest rates fell 0.37 p.p., 0.42 p.p. and 0.27 p.p., respectively. Meanwhile, the one-year rate remained unchanged, and the two- and three-year interest rates rose 0.30 p.p., and 0.58 p.p., respectively. Real interest rates measured by the differential between the one-year forward nominal interest rate and twelve-month ahead inflation expectations increased to 12.64% on October 19 from 12.55% on September 14.

51. From September 15 to October 19, the net redemption of FX instruments, including interest payments, totaled US$252 million, and US$15.3 billion in the year through October.

52. Since the September meeting, the National Treasury raised a total of R$30.3 billion via fixed-rate securities issuance: R$29.3 billion via issuance of LTNs maturing in 2006, 2007, and 2008; and R$1 billion via issuance of NTN-Fs maturing in 2010 and 2012. Issuance of floating-rate LFTs, with maturities in 2008 and 2009, totaled R$17.8 billion.

53. The BCB continued to conduct 3-month weekly repo operations and also introduced 5-month repo operations in October, aiming at a better distribution of redemptions. In addition, the BCB conducted twenty-two shorter-term repo operations (twelve of which were overnight lending, and ten of which were overnight borrowings). The BCB also conducted daily liquidity management operations. The excess liquidity sterilized from the banking reserves market via operations with tenors of three- and five-months averaged R$49.3 billion. Shorter-term operations averaged R$1.4 billion.

54. Aimed at reducing excess liquidity projected for the fourth quarter, the BCB sold LTNs from its portfolio and purchased, at a pre-established price, LTNs of shorter tenors. On September 14 and September 21, the BCB sold LTNs maturing in January 2006, and bought LTNs maturing in October 2005. These operations totaled R$3.8 billion. On October 5 and October 13, the BCB also sold LTNs maturing in April 2006, and bought LTNs maturing in January 2006. These operations totaled R$2.8 billion.

55. In September, net securitized public sector debt increased 1.3%, to R$933 billion, due to the accrual of interest and the net placement of R$2.1 billion in securities. The fixed-rate share of net domestic debt rose to 25.8% from 23.9% in August.