BANCO CENTRAL DO BRASIL

Minutes of the 112th Meeting of the Monetary Policy Committee (Copom)

Date: September 13th, from 4:55PM to 7:15PM, and September 14th, from 4:30PM to 7:30PM
Place: BCB Headquarters meeting rooms - 8th floor on September 13th, and 20th floor on September 14th – 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 September 13th)
Altamir Lopes – Economic Department
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
Marcelo Kfoury Muinhos – Research Department (also present on September 14th)
Jose Antônio Marciano – Department of Banking Operations and Payments System

Other participants (present on September 13th)
Alexandre Pundek Rocha – Advisor to the Board
Carlos Hamilton Vasconcelos Araújo – Deputy Head of Research Department
Flávio Pinheiro de Melo – Advisor to the Board
Jocimar Nastari – Press Secretary
Katherine Hennings – Advisor to the Board

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

Recent Economic Developments

1. In August, IPCA inflation continued to moderate and shift to a lower level than that registered at the beginning of the year. With the 0.17% increase in August, average monthly inflation for the June-August period was 0.13%, versus 0.66% for the March-May period. The downward shift in inflation is partly attributable to the sharper than normal decline in food prices. Furthermore, the average change in all nine categories of the IPCA in the June-August period was below that of the previous three-month period, with the exception of personal expenses and communications. Tradable goods prices fell in the period, due to ongoing exchange rate appreciation. Non-tradable goods price inflation was also significantly lower, at an average of 0.2% in the June-August period, from 0.5% in the previous three months. Additionally, the IPCA diffusion index fell to 48.4%, the lowest level since 1998, signaling that the reduction in inflation has been generalized across the economy.

2. Core inflation measures declined, although less sharply than headline inflation. Core inflation by exclusion, smoothed trimmed-means, and non-smoothed trimmed-means core inflation all declined, to average 0.33%, 0.43%, and 0.28% in the June-August period, respectively, from 0.56%, 0.66%, and 0.55% in the previous three-month period. Therefore, after trending sideways at elevated levels during the first five months of the year, the three

measures of core inflation have recently shown decisive signs of accommodation to lower levels. Of note, three-month moving average core inflation in August fell to the lowest level registered since the beginning of 2001.

3. In August, the General Price Index (IGP-DI) fell 0.79%, the sharpest decline in four consecutive monthly declines. The Wholesale Price Index (IPA-DI) was again the main driver, dropping 1.04% in August, and accompanied by a 0.44% decline in the Consumer Price Index (IPC-DI) and virtually no change in the National Index of Civil Construction (INCC). The IGP-DI has risen only 0.32% in the year through August, while the IPA-DI has declined 1.57%. The uncharacteristic decline in the IPA-DI reflects the drop in the prices of consumer goods (despite the increase in consumer durables prices) and production inputs. The decline is also attributable to the rare confluence of a sharp decline in wholesale agricultural prices (–5.19% in the year) and a more modest decline in wholesale industrial prices (–0.33%). Preliminary indicators for September suggest that both the IGP-DI and the IPA-DI will continue to decline – IGP-M data for the first ten days of September (–0.56%) suggest the fifth consecutive, and largest, monthly decline in the index. For both year-to-date and 12-month trailing inflation, the general price indices have recorded lower inflation than the IPCA, suggesting a consistent reduction in wholesale prices, with favorable spillovers for consumer prices (and regulated prices) for next year. 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. Economic activity rebounded in the second quarter of 2005, confirming the outlook articulated in the June Inflation Report. Quarter-on-quarter seasonally adjusted growth of 1.4% (the eighth consecutive quarter of growth) raised first half 2005 growth to 3.4% in year-on-year terms. Industry, agriculture, and services performed strongly, posting quarter-on-quarter growth of 3.0%, 1.1%, and 1.2%, respectively. The pick-up in activity was most visible in the components of domestic demand. There was a 4.5% expansion in gross fixed capital formation, after two quarters of declines, and a 0.9% increase in household consumption, after a contraction in the first quarter. Exports of goods and services rose 2.6%, the ninth consecutive quarter of growth, while imports rose 2.4%. The rebound in consumption and private investment strengthens expectations that, in the medium- and long-term, these components will continue to be the main drivers of economic growth. Of note, the Brazilian Institute of Geography and Statistics (IBGE) upwardly revised data for first quarter GDP to show quarter-on-quarter seasonally adjusted growth of 0.4% (above the initial 0.3% estimate). Leading indicators of economic activity suggest growth will continue in the coming quarters.

5. Industrial production fell a month-on-month seasonally adjusted 2.5% in July, in line with leading and coincident indicators for the series. The magnitude of the drop likely reflected an atypical fewer working days in July (21) relative to June (22), due to moving holidays not considered in the seasonal adjustment methodology (Corpus Christi fell in May instead of June), and the occurrence of five weekends in July. The drop in industrial production occurred after four consecutive increases, and the overall tendency of the series suggests continued growth, with industrial production at generally high levels by historical standards. The smoother three-month moving average series registered the third consecutive month of growth and a new historic high in July, 4.1% above the value of July 2004. Leading and coincident indicators suggest industrial production will rebound in August, with continued growth in the three-month moving average series.

6. All use categories of industrial production declined in the seasonally adjusted series, due to the calendar effects described above. Capital goods production posted the sharpest decline, down 7.6%, followed by intermediate and consumer goods, with contractions of 1.9% and 1.7%, respectively. In the year-to-date, the performance is positive, with capital goods production, intermediate goods, and consumer goods growing 2.6%, 1.8%, and 8.2%, respectively. In addition, the three-month moving average series for capital goods, intermediate goods and consumer durable goods increased 0.4%, 0.1% and 2.1%, respectively, reaching, in all three cases, new historic highs. Consumer durable goods production has been the most dynamic in recent months, posting a sixth consecutive monthly increase in July, for an accumulated 12-month expansion of 19.2%.

7. July labor market data remained strong, showing labor market trends evolving in step with the strong performance of economic activity. The unemployment rate measured by the IBGE was 9.4% in July, holding steady vis-à-vis June, and at the lowest level for the series as measured since October 2001. The number of employed individuals rose 3.4% in the year, over the same period of 2004. Average real incomes rose 2.3% relative to June, reflecting the decline in consumer price inflation and the gains obtained by workers in salary negotiations.

Manufacturing employment fell 0.2% in July, as measured by the National Industry Confederation (CNI) and seasonally adjusted by the BCB, after rising steadily throughout the year, but nevertheless accumulating a year-to-date increase of 6.0% and a twelve-month rise of 6.1%. Real manufacturing payrolls rose 0.8% in July, for a cumulative year-to-date increase of 9.0% and a twelve-month increase of 9.7%, exceeding employment growth and signaling an increase in the average salary. Labor market indicators suggest that the increase in the quantity of jobs is being accompanied by an improvement in the quality of industrial employment. Formal employment, measured by the Ministry of Labor and Employment also continued to rise, with the creation of 117,473 positions in July, for year-to-date job creation of just over 1 million positions, and cumulative twelve-month job creation of 1.3 million positions.

8. As described in the August Copom Minutes, retail sales rose 1.2% in June, according to seasonally adjusted data from the IBGE, for a year-to-date expansion of 4.6%, driven by favorable labor market and credit conditions. As in prior months, and in line with the recent performance of industrial production, growth was driven by furniture and household appliance sales, which rose 4.3% in June, versus May. IBGE also upwardly revised its retail sales data for May, showing a much stronger growth of 1.2% (versus 0.4% in the initial report), seasonally adjusted. As a result, the three-month moving average series showed growth of 0.9% in June, relative to May. With the May data revision, all retail sectors posted two consecutive months of growth, with the exception of fabric, clothing, and shoes. Of note, hyper- and supermarket sales in May were upwardly revised, from a contraction of 0.4% to an increase of 0.7%. Despite the lack of more current retail sales data, available indicators suggest that July performance will be similar to that of June. In addition, retail sales are expected to gain momentum in the coming months, despite the fact that, in September, the consumer confidence index measured by the São Paulo Retail Trade Association (Fecomercio-SP) declined for the second consecutive month and reached the lowest level since April 2004.

9. Installed capacity utilization in the manufacturing sector, as measured by the CNI and seasonally adjusted by the BCB, fell to 81.8% in July, from 82.7% in June. Quarterly data from the Getúlio Vargas Foundation (FGV), seasonally adjusted by the BCB, shows that capacity utilization reached 84.7% in July, a slight increase from the 84.2% registered in the previous reading, in April. Both series show that capacity utilization remains at high levels by historical standards. The relative stability of the index seems to be associated with the maturation of investments, given that industrial production rose in the period. 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 fell 5.5% in July, affected by the number of working days in the month, but registered an expansion of 3.8% in the year-to-date. The less volatile quarterly series for gross fixed capital formation rose 4.5% in the second quarter of the year, quarter-on-quarter, accumulating an 8.6% increase in the last four quarters, versus a 4.3% increase in GDP in the same period. The 28.3% increase in capital goods imports in the year through July also bodes well for the investment outlook.

10. The most recent external accounts data provide further evidence that the external sector will outperform this year. The trade balance in the twelve months through August exceeded US$ 40 billion, with exports reaching US$ 111 billion (up 25%) and imports at US$ 71 billion (up 23.9%), for total external trade of US$ 182 billion. Both exports and imports decelerated slightly at the margin. In contrast, capital goods imports rose 41.3% in August, versus August 2004, and 24% in the last twelve months, the highest growth rate since March 1998. The strong performance of the trade accounts in the twelve months through August underpinned the current account surplus of US$ 12.5 billion, equivalent to 1.8% of GDP. While the contribution of external demand to economic growth has diminished somewhat, it remains positive and above that expected at the beginning of the year.

11. International financial market volatility remained elevated, and the scenario considered by the Committee at its August meeting remained relatively unchanged. A detailed evaluation of the potential effects of Hurricane Katrina on the global economy appears premature, despite growing expectations for at least a temporary effect on the U.S. economy. In early August, Brazilian country risk fell close to the historic lows reached in October 1997. As could be expected in a large emerging market economy with a floating exchange rate, the reduction in Brazilian country risk was accompanied by exchange rate appreciation. Liquidity conditions and financial market stability remain tied to macroeconomic conditions in the industrialized countries, especially the United States, and to the Fed’s potential monetary policy response to economic developments. In general, recent indicators suggest a

favorable outlook, in the sense that the Fed will continue to raise interest rates at a measured pace. An additional point of concern is the current 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, the Copom continues to assign a low probability to a significant deterioration in international financial markets.

12. After reaching record highs in August, international oil prices fell slightly in September. Despite this reduction, prices remain at elevated levels. As emphasized in the August Copom Minutes, a key concern is that oil prices could remain at higher-than-expected levels for an extended period of time. The August Minutes also highlighted the possibility that recent oil price behavior could reduce the plausibility of the Copom's baseline oil price scenario, with an increasingly high likelihood of increases in domestic gasoline prices in 2005. This possibility was realized in early-September, with the increase in domestic fuel prices. While international oil prices continue to represent a risk to the future inflation path via the effects on oil-intensive products, as well as private sector inflation expectations, the recent increase in domestic fuel prices should alleviate pressures on future inflation. The Committee's baseline scenario assumes that there will be no further increases in domestic gasoline prices in 2005.

Assessment of Inflation Trends

13. 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 the adjustment of gasoline prices for 2005 rose to 7.5% from 0%. The projection for the prices of bottled gas was reduced to –1.7% from 0%;

b) The projection for fixed line telephone rate adjustments in 2005 was raised 0.6 p.p. to 6.7%. The projection for household electricity rate adjustments was reduced to 7.6% from 8.2%;

c) For all regulated prices, which represented a total weight of 29.8% in the August IPCA, the Copom raised its projection for 2005 adjustments to 7.8% from 7.0%;

d) The projection for regulated price adjustments in 2006 was lowered to 5.3% from 5.7%. The reduction was due to the sharp drop in the IGPs and their twelve-month ahead projections. The increase in available information since the last Copom meeting enabled the individual projection of a larger number of regulated price changes for 2006. 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 VAR model based on the Selic and swap rates on the eve of the Copom meeting, increases from an average of –90bps in the third quarter of 2005, to 34 bps in the fourth quarter of 2006.

14. 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 August meeting were maintained.

15. Since the August meeting, median IPCA inflation expectations for 2005 declined to 5.19% from 5.40%. Inflation expectations may be susceptible to some upward revision, as they have only partially captured the recent increase in domestic fuel prices. However, it bears emphasizing that inflation expectations fell for the fourth consecutive month in September, in part due to the larger than expected decline in the IPCA in August, and moved increasingly in line with the 5.1% inflation objective for 2005. Expectations for 2006 IPCA inflation fell to 4.80% from 4.98%. In addition, the distribution of the projections has moved toward a mode that is closer to the 4.5% target established by the CMN (National Monetary Council) for the year. 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 environment.

16. The 2005 inflation forecast under the benchmark scenario – which assumes the maintenance of the Selic rate at 19.75% p.a. and the exchange rate at R$/US$ 2.35 during the forecast period – declined relative to the August Copom meeting, falling below the 5.1% inflation objective for the year. The improvement was due primarily to the lower-than-expected inflation result for August, the widening of the output gap, and the downward revision of some regulated price adjustment forecasts for the year, which counterbalanced the adverse effect of the increase in gasoline prices. The forecasts based on the market scenario – which incorporates the consensus exchange rate and Selic rate trajectories on the eve of the Copom meeting – were above the 5.1% objective, but declined relative to August. For 2006, the benchmark scenario forecast declined and remained below the target established by the CMN. The forecast under the market scenario fell slightly, but remained above the target.

17. The Committee also analyzed inflation forecasts for the twelve-month periods ending in March, June, and September 2006. The forecasts for these periods will be more responsive to current monetary policy decisions than those for calendar year 2005, and also more reliable than those for calendar year 2006. The forecasts under the benchmark scenario 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

18. The Copom reaffirms the view 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 pressure. In addition, the external scenario remains favorable, particularly with regard to external financing conditions for the country. While international oil prices have remained at elevated levels in recent months, the recent adjustment of domestic gasoline prices eliminated a key point of uncertainty for the inflation outlook for 2005 and especially 2006. There are, therefore, more definite signs of a benign inflationary environment. As in the August meeting, the Copom emphasizes that the main challenge for monetary policy is to now ensure consolidation of the favorable developments anticipated for the future.

19. In an inflation-targeting regime, the monetary authority assesses alternative scenarios for the evolution of the principal variables that shape price dynamics, in order to orient its decision-making process. The recent consolidation of favorable inflation dynamics should significantly reduce uncertainties regarding future inflation, and make it easier for the monetary authority to evaluate potential scenarios and coordinate private sector expectations. Furthermore, the persistence of a tighter monetary policy stance should help to bring inflation in line with short-term objectives, in an environment in which activity indicators have demonstrated consistent strength and short-term inflation results owe to specific factors that may reverse in the future. Such a policy should have more lasting effects on longer-term inflation expectations, thereby significantly reducing the costs associated with the monetary authority's efforts to bring inflation in line with the target path.

20. The uninterrupted convergence of inflation to the target path and the resulting consolidation of a more robust environment for 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 believes 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. 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.

21. The Copom therefore unanimously decided to reduce the Selic target to 19.50% p.a., without bias, and closely follow the evolution of the inflation outlook until the next meeting, at which time it will define the next steps in its monetary policy strategy.

22. At the conclusion of the meeting, it was announced that the Copom would reconvene on October 18 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

23. The IPCA rose 0.17% in August, bringing year-to-date inflation to 3.59% and twelve-month trailing inflation to 6.02%. The August result was driven solely by the increase in regulated prices, which rose 0.69%. Market prices fell 0.05%, with notable declines in food and beverage prices (–0.73%) outweighing other price increases.

24. The General Price Index (IGP-DI) fell 0.79% in August, the fourth consecutive monthly decline. With the August result, year-to-date IGP-DI inflation was 0.32%, and twelve-month trailing inflation was 2.71%. The Wholesale Price Index (IPA-DI), the sub-index with the largest weight in the IGP-DI, declined for the fourth consecutive month, posting –1.04% and bringing the year-to-date result to –1.57% and the twelve-month trailing result to an increase of 1.16%. The Consumer Price Index-Brasil (IPC-Br) fell 0.44% in the month, driven by the 1.57% decline in food prices, while the National Index of Civil Construction (INCC) rose 0.02%.

25. The drop in the IPA-DI in August reflected a decline in both agricultural and industrial prices. Agricultural wholesale prices fell 2.47% (–1.60% in July), due mainly to the sharp decline in prices of animal and animal derivative products, as well as the decline in prices of legumes, fruits, cereals, and grains, which had posted a modest increase in July. The drop in industrial prices was stronger in August, down 0.57% versus -0.38% in July. The result was primarily due to the drop in chemical prices (–0.67%), after rising in the prior month (0.26%). Meanwhile, other important manufactured products, such as foodstuffs and metals, continued to register price declines. The IPA-DI by production stage showed a 1.22% decline in final goods prices and a 0.81% decline in intermediate goods prices, contractions that outpaced the declines of July. The prices of raw materials fell 1.26% in August, following a 1.70% decline in July.

26. Smoothed trimmed-means core IPCA inflation fell to 0.36% in August, from 0.45% in July, for a twelve-month trailing increase of 7.20%. Non-smoothed trimmed-means core IPCA rose 0.28% in August, versus 0.31% in July, for a twelve-month trailing increase of 5.82%. Core inflation calculated by the exclusion of household food and regulated prices fell in August to 0.26%, from 0.37% in July, with a twelve-month cumulative increase of 6.56%.

27. The IPCA diffusion index (measuring the number of items in the IPCA registering price increases) dropped to 48.4% in August, from 53.7% in July.

28. IPC-Br core inflation, calculated by the Getúlio Vargas Foundation (FGV) under the symmetric trimmed means method, reached 0.07% in August, the lowest monthly result since November 1998. Year-to-date through August, IPC-Br inflation was 3.69%, with a trailing twelve-month increase of 5.46%.

29. Inflation is expected to accelerate in September due to the fuel price increase implemented on September 10. The impact of the gasoline price adjustment on IPCA inflation is projected at 0.32 p.p., divided between the months of September and October.

Economic Activity

30. São Paulo Trade Association (ACSP) data showed a seasonally adjusted 1.1% increase in database consultations for credit sales in August, compared to July, while the number of consultations of the Usecheque system fell 1.9%. In the year through August, these indicators rose 5.7% and 3.5%, respectively, compared to the same period of the previous year.

31. The monthly Fecomercio-SP survey showed a 13.1% month-on-month drop in the Consumer Confidence Index in September, due to a 13.4% drop in consumer expectations and a 12.7% decline in perceptions of current economic conditions.

32. Investment indicators declined in July. Domestic production and imports of capital goods fell 7.6% and 1.6%, respectively, on a month-on-month seasonally adjusted basis. Construction input production fell 3.5%. In the

year through July, compared to the same period of 2004, these indicators registered expansion of 2.6%, 28.3%, and 3.8%, respectively.

33. According to the IBGE's Monthly Industrial Survey (PIM), industrial production contracted a month-on-month seasonally adjusted 2.5% in July, after expanding for four consecutive months. This contraction partially reflected the timing of the Corpus Christi holiday, which fell in May this year instead of June. This effect is not addressed by the seasonal adjustment method used for the PIM and resulted in a higher base comparison for June. Manufacturing output contracted 1.9%, while mining fell 1.1%. In the year through July, industrial production rose 4.3%, due to the 4.0% increase in manufacturing and the 10.5% increase in mining.

34. Seasonally adjusted data for industrial production showed that 20 of the 23 sectors surveyed declined in the month. All use categories contracted in July, with particularly sharp declines for capital goods production (–7.6%) and consumer durable goods production (–5.9%). The production of intermediate goods, with the largest weight in the industrial production index, fell 1.9%, while semi- and non-durable consumer goods fell 0.8%.

35. CNI manufacturing data showed declines of 0.3% and 2.2% in real sales and hours worked in July, respectively, on a month-on-month seasonally adjusted basis. Compared to the same month of 2004, real sales fell 2.9%, while hours worked increased 2.8%. Installed capacity utilization reached a seasonally adjusted 81.8% in July, declining 0.9 p.p. relative to June, though the seasonally adjusted data was also affected by the Corpus Christi holiday effect.

36. Seasonally adjusted leading industrial activity indicators (energy consumption, automobile production, and heavy vehicle tolls paid) suggest a rebound of industrial activity in August.

Labor Market

37. The formal employment index rose 0.4% in July (month-on-month, seasonally adjusted), according to the Ministry of Labor and Employment. Compared to July 2004, there was a 5.6% increase in formal employment, with a net creation of almost 1.4 million jobs, mainly in commerce (7.5% increase).

38. According to the IBGE survey in the six main metropolitan regions of the country, the unemployment rate remained unchanged at 9.4% in July, 1.8 p.p. below the July 2004 rate. The month-on-month stability in July reflected unchanged labor force and employed workers. Real average earnings, at R$967, posted a 2.3% increase in July, month-on-month.

39. According to CNI indicators seasonally adjusted by the BCB, industrial employment fell 0.2% and real payrolls increased 0.8% in July, month-on-month, and rose 3.9% and 9.3%, respectively, relative to July 2004.

Credit and Delinquency Rates

40. Non-earmarked credit grew 1.6% in August (month-on-month). Credit operations with individuals rose 3.4%, driven mainly by the expansion of personal credit and credit for the acquisition of goods. Corporate credit with domestic funding increased 0.6%, while externally funded operations dropped 0.9%.

41. The average interest rate on non-earmarked credit increased 0.3 p.p. in August. The average rate on personal credit operations remained unchanged at 64.4% p.a., while the average rate on corporate credit increased 0.2 p.p., to 33.2% p.a.

42. Delinquency rates for non-earmarked credit (loans in arrears for more than fifteen days) rose 0.1 p.p. in August, to 7.6%. Delinquency rates for credit operations with individuals increased to 12.4% in August, from 12.0% in July. Delinquencies in corporate credit operations increased to 3.6% in August, from 3.5% in July.

43. Net delinquency rates for retail credit, measured by the ACSP, increased to 4.7% in August, from 4.2% in July, due to the expansions of 4.8% and 8.3% in the number of cancelled registers and in the number of new registers in the month, respectively.

External Environment

44. Recent indicators show sustained global economic growth, although slightly uneven, when compared to 2004. U.S. GDP grew 3.3% on an annualized basis in the second quarter, according to the revised data. The sharp contraction in inventories suggests a favorable outlook for the third quarter. Japan and the Euro Area show mild growth. Expectations for Japanese economic growth have improved, since the increase in domestic consumption plays an important role in the sustainability of economic growth. The main risks to sustained global economic growth are high oil prices, the impact of which is already being felt on consumer expectations in the main economies, and a reversion in real estate prices. Although the main indicators of U.S. real estate prices remain high, they have shown a downward trend, as mentioned in the last *Beige Book.*

45. The damage caused by Hurricane Katrina at the end of August introduced uncertainty into the economic outlook. Although the effects of such catastrophes on the overall economy tend be relatively muted, the region most affected is responsible for the bulk of oil extraction, refining and distribution in the U.S. Consequently, the supply contraction introduced additional pressure on oil prices, which may translate into inflationary pressures and reduced disposable income and consumer confidence. The potential for the FOMC to interrupt its monetary tightening cycle, to compensate for Hurricane Katrina's likely impact on economic activity, contributed to sharp declines in the U.S. yield curve and in emerging market bond spreads. However, in early September, oil prices declined and the U.S. yield curve returned to previous levels. If economic trends prevailing prior to Hurricane Katrina are maintained, it is more likely that the U.S. will continue to tighten monetary policy at a measured pace.

Foreign trade and international reserves

46. Results for the external trade accounts confirmed the sustainability of strong external position observed recently, with practically all measures of external trade exceeding historical highs. Year-to-date, the trade surplus reached US$ 28.3 billion and, in the twelve months through August, reached US$ 40.1 billion, growing 29.4% and 28.6%, respectively, over the previous period. Total external trade reached US$ 123.8 billion and US$ 182.3 billion for the same periods, for growth of 22.8% and 26.1%. In the first six working days of September, the trade balance reached US$ 1.4 billion, with export growth of 15.2% and an import contraction of 5.3%, over the average daily levels reached in September 2004.

47. Exports reached US$ 11.3 billion in August, a record level. Average daily exports rose 19.9% compared to August 2004. Manufactured exports, totaling US$ 6 billion, reached a record high for the month, both in terms of price and range of items exported. Of note, were increases in exports of radio transmitters, refined sugar, metal laminates, transport equipment, airplanes, auto parts, tractors, passenger cars, and gasoline. Sales of raw materials and semi-manufactured goods also reached record levels in August. The rise of 23.8% in raw material exports was due, primarily, to the 88.9% increase in crude oil exports. Coffee bean, meat, and iron ore exports also posted above average growth.

48. In the year through August, manufactured goods rose to represent 54.7% of total exports, up from 52.9% in the same period of 2004. In addition to ongoing export product diversification, there has also been export market diversification, with notable growth in exports to new markets.

49. For the first time, imports breached the US$ 7 billion mark, reaching US$ 7.7 billion, up 30.6% in daily average terms, compared to August 2004. All import categories increased in the month, over the same month of the previous year. In the year through August, there was a 28.8% increase in capital goods imports, 21.8% for fuel and lubricants, 20.3% for consumer goods, and 18.1% for raw materials and intermediate goods, all measured in daily averages compared to the same period last year.

50. At the end of August, international reserves totaled US$ 55.1 billion, an increase of US$ 388 million in the month. Net adjusted reserves reached US$ 40.4 billion, down US$ 48 million in the month.

Money Market and Open Market Operations

51. In the period following the August Copom meeting, the yield curve shifted downward, mainly due to uncertainties regarding the domestic outlook. At the beginning of September, rates trended downward, on the back of the drop in actual and expected inflation and the release of weaker-than-expected July industrial production data. The reductions in oil prices, country risk, and the exchange rate appreciation were also supportive. Between August 17 and September 14, one-, three-, and six-month and one-year interest rates fell 0.11 p.p., 0.10 p.p., 0.01 p.p. and 0.05 p.p., respectively. Meanwhile, two- and three-year interest rates fell more sharply, by 0.39 p.p., and 0.55 p.p., respectively. Real interest rates measured by the differential between the one-year forward nominal interest rate and twelve-month ahead inflation expectations remained relatively stable, at 12.53% (versus 12.54%).

52. From August 18 to September 14, there was no issuance or redemption of exchange rate-linked debt instruments, such that the net redemption of these instruments in the year held steady at US$ 15.1 billion.

53. Since the August meeting, the National Treasury raised a total of R$16.2 billion via fixed-rate securities issuance: R$15.8 billion via issuance of LTNs maturing in 2006, 2007, and 2008; and R$388.4 million via issuance of NTN-Fs maturing in 2010 and 2012. Issuance of floating-rate LFTs, with maturities in 2008 and 2009, totaled R$7.7 billion.

54. In its open market operations, the BCB conducted four weekly three-month fixed rate repo operations, as well as shorter-term repo operations (nine of which were overnight lendings, and five 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 months averaged R$46.4 billion. Operations with tenors less than thirty days averaged R$1.3 billion.

55. Aimed at reducing excess liquidity projected for the fourth quarter, the BCB purchased LTNs maturing in October, selling in exchange LTNs maturing in January 2006 from its portfolio. These operations totaled R$6.5 billion.

56. In August, net securitized public sector debt increased 0.6%, to R$921 billion. Net redemptions totaling R$7.8 billion partially compensated accrued interest. The fixed-rate share of net domestic debt rose to 23.9% from 22.4% in July.