International economy

4

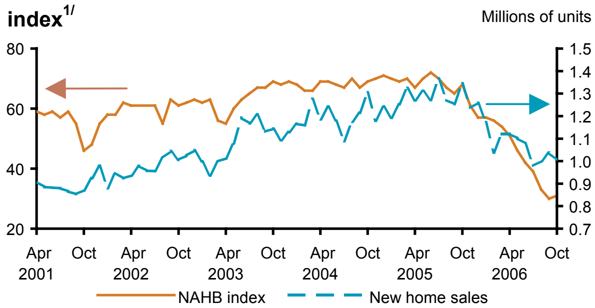
Growth in the world economy remains strong. However, with the downturn in activity levels in the United States and, to a lesser extent, in the Euro Area, Japan and China, the pace of growth was somewhat slower, particularly from the third quarter onward.

Deceleration in the pace of United States economic activity was caused primarily by a declining real estate market and is not expected to have serious impacts on Japan and the Euro Area. The underlying trend in these economies indicates continued growth, despite a temporary slowdown caused by short-term fluctuations in domestic demand. Signs of a slowdown in the Chinese economy are still insufficient to suggest that the accelerated growth process in that country may be nearing an end.

Though world economic activity has expanded at a lesser pace at the margin, forecasts project stronger growth in 2006 than in the previous year.

4.1 Economic activity

Figure 4.1 – USA – New home sales x NAHB index[1/]

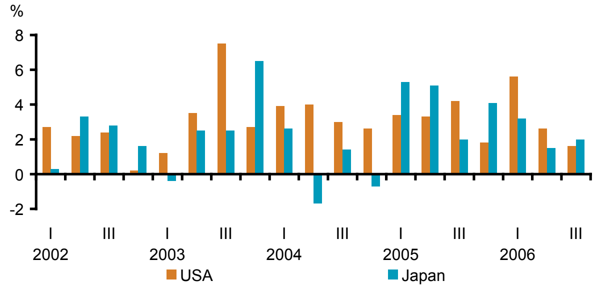


Source: National Association of Realtors and National Association of Home Builders
1/ Confidence index of home builders.

Annualized United States economic growth dropped from 2.6% in the second quarter to 2.2% in the third. This result reflected a sharp real estate market decline, with repercussions on residential investments and gross fixed capital formation. Although the overheated real estate sector generated strong growth in the number of new units on sale in recent years, the recent market slowdown has not resulted in lower prices but rather a strong falloff in new building starts, with direct impacts on the economic activity level. However, stabilization under several important sectoral indicators has led to a growing perception that the real estate market has put the most difficult phase of the adjustment cycle behind it.

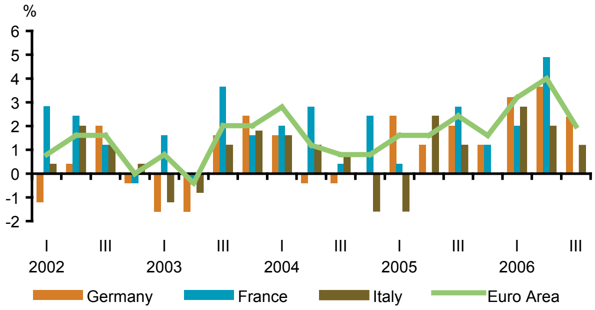
On the other hand, the additional real income generated by the oil price reduction will tend to shift toward consumption.

Figure 4.2 – USA and Japan – GDP[1/]



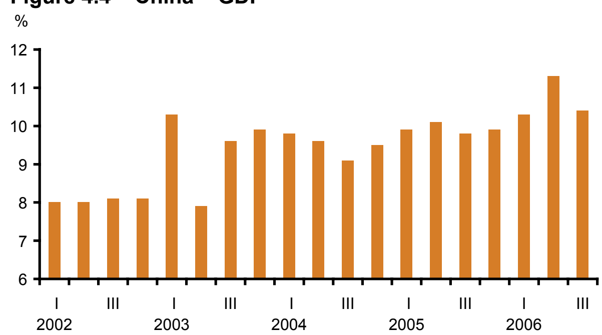
Sources: Bureau of Economic Analysis and Economic and Social Research Institute
1/ Quarterly growth. Seasonally adjusted annualized rates.

Figure 4.3 – Euro Area – GDP[1/]



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

Figure 4.4 – China – GDP[1/]



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

At the same time, the October drop in the jobless rate to 4.4% should result in wage and income gains, generating additional household spending and avoiding an even sharper decline in the activity level. Historically unprecedented corporate profits are another factor that will tend to sustain United States economic activity.

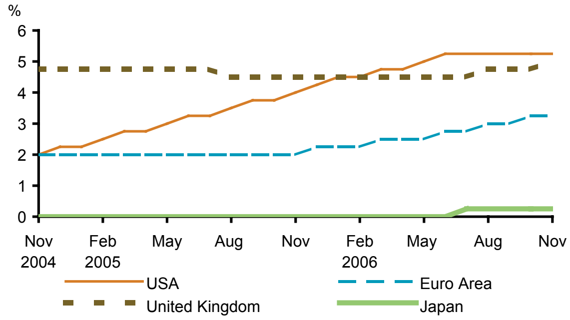
In the Euro Area, the three major economies registered third quarter deceleration. In France, negative performances under inventory replenishment and net exports resulted in annualized zero growth in the quarter, though domestic demand remained strong. It should also be noted that third quarter French GDP was impacted by passing statistical effects that will not be repeated in the fourth quarter. Parallel to this, manufacturing sector expectations in Germany and Italy peaked at their highest point in the last five years. On the other hand, there is concern at the impact of indirect taxes on German consumption. When one considers consistently positive job market results, the outlook for the Euro Area economy is rather bright, with 2.6% estimated growth in 2006. The United Kingdom is expected to close the year with a similar performance, since it has posted annualized GDP growth of 2.8% in each of the last four quarters.

In Japan, the preponderant factor underlying the second and third quarter GDP slowdown was less dynamic domestic consumption. In a scenario of strong corporate profits, private investment remained strong and has acted as the primary driver of forecast 2.7% economic growth in the year. As the job market continues improving, it is estimated that internal demand will return to a moderate growth trajectory in the coming months.

Powered mainly by investments in fixed assets, the Chinese economy has posted consistently high rates of growth. Third quarter GDP expansion decelerated, but still closed 10.4% above the result for the same period of 2005. The drop in fixed investments and industrial output as of May was not sufficient to provoke major shifts in economic activity trends, considering that these downturns were quite moderate and all other indicators pointed to continued highs. Government authorities have implemented administrative measures targeted at attenuating the pressures generated by such areas as lending to the private sector and to the building industry. These measures may eventually cool the already overheated economy down somewhat, though they have not yet generated any significant relief from the pressures generated by the segments in question.

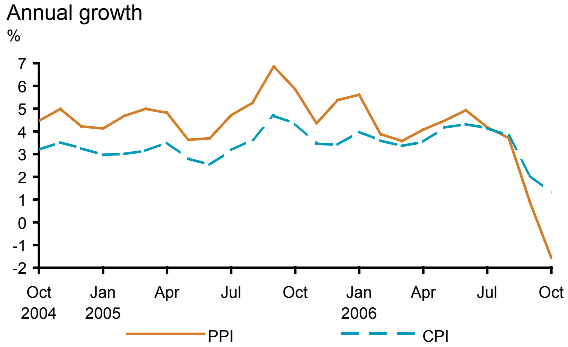
4.2 Monetary policy and inflation

Figure 4.5 – Official interest rates
Annual rates



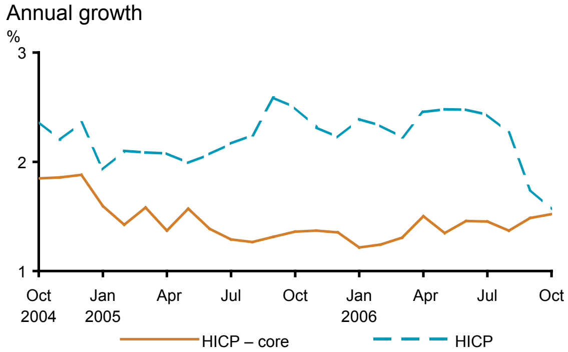
Source: Federal Reserve, ECB, BoJ and Bank of England

Figure 4.6 – Inflation – USA
Annual growth



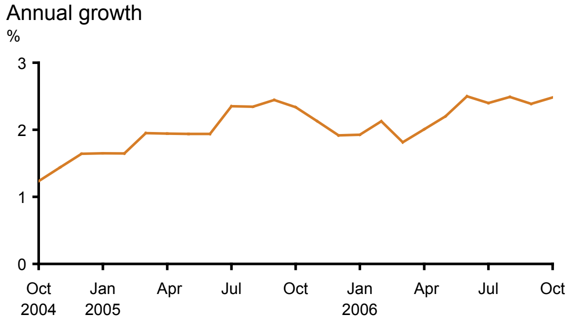
Source: Bureau of Labor Statistics

Figure 4.7 – Consumer inflation – Euro Area
Annual growth



Source: Eurostat

Figure 4.8 – Consumer inflation – United Kingdom
Annual growth



Source: Bloomberg

In recent months, world inflation has declined primarily as a result of falling oil prices. Though liquidity remains high in the Euro Area and China, the falloff in international economic activity, declining inflation and reduced medium-term inflationary expectations could lead central banks to ease monetary policy rigidity.

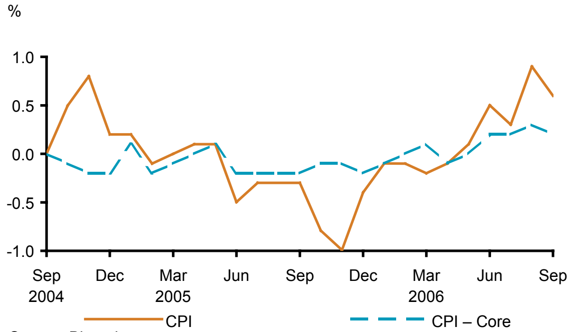
Annual inflation in the United States closed October at 1.3%, the lowest level since June 2002. This result plus a weak real estate market, though partially offset by increased consumer spending, generated economic growth well below the estimated potential level. As a result, the Federal Reserve System (Fed) has held the Fed fund target unchanged at 5.25% per year since June. In September, however, the real rate of interest (Fed funds deflated by annual growth in the GDP deflator core) reached 2.8%, while the difference between the effective quarterly Fed fund average (proxy for the cost of money) and nominal GDP growth (proxy for the return on money) also indicated a contractionary monetary policy posture, for the first time since the third quarter of 2001.

Differently from annual consumer inflation, which dropped to 1.6% in October, growth in the inflation core remained high in the Euro Area, mainly as a result of price pressures in the sectors of housing, education and food. In this scenario of continued abundant liquidity, declining unemployment and credit growth stimulated by low real rates of interest, the European Central Bank (ECB) has consistently reiterated the need for keeping a close eye on prices. The most probable scenario points to continuation of the tight monetary policy that has raised interest rates 100 basic points since December 2005 to a level of 3.25% per year in November.

In the United Kingdom, pressures exerted by food and education prices kept inflation at historically high levels in the range of approximately 2.5% per year from June to October, despite declining oil prices. This trajectory led the Bank of England's (BoE) Monetary Policy Committee to raise its repo rate to 5% per year in November. In a context of expanding currency and credit, coupled with lessening expectations regarding inflation over a two-year horizon, it is probable that the Bank of England will wait until at least the first quarter of 2007 before deciding whether it should raise basic interest rates.

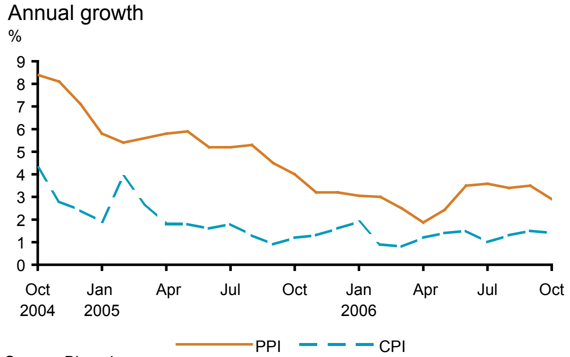
The Bank of Japan (BoJ) refrained from altering its 0.25% per year overnight rate. Declining consumption and bank

Figure 4.9 – Consumer inflation – Japan
Annual growth



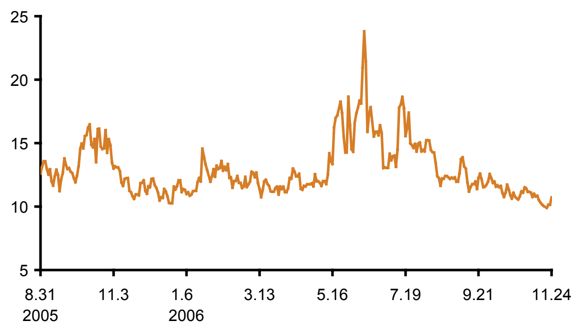
Source: Bloomberg

Figure 4.10 – China – Consumer inflation
Annual growth



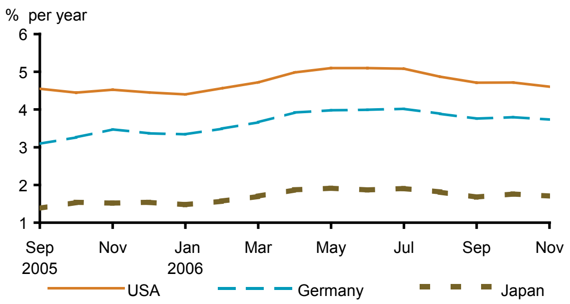
Source: Bloomberg

Figure 4.11 – VIX



Source: Bloomberg

Figure 4.12 – Yield on government bonds[1/]



Source: Bloomberg
1/ Monthly average of nominal yields on 10-year bonds up to November 24, 2006.

loans, lesser inflation expectations for 2007 and the outlook for a reduction in exports suggest that the Bank will interrupt the process of reducing the liquidity of the economy until at least 2007.

Though Chinese economic activity seems to have leveled off in recent months, the People's Bank of China (PBC) continued the process of gradually tightening the money supply. Although bank interest rates have been held to 6.12% per year since August, the PBC raised the reserve requirement rate in November (9% per year) for the third time in the year, with the objective of curtailing excess liquidity. Producer and consumer inflation dropped in October to respective levels of 2.9% per year and 1.4% per year, primarily as a consequence of declining oil prices, excess output capacity, growing productivity and, above all, administrative measures introduced with the aim of controlling prices.

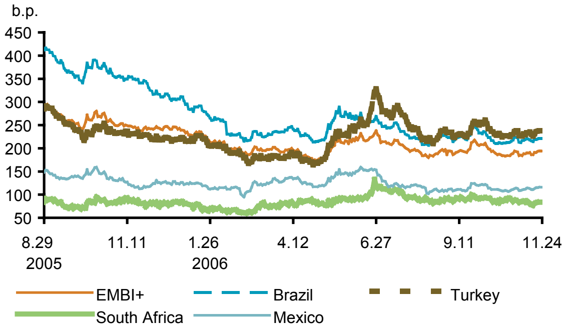
4.3 International financial markets

In the midst of growing concern with the situation of global liquidity and rising United States basic interest rates, the evident instability of international financial markets in May and June gave way to a scenario of low volatility and reduced risk aversion in the following months. 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 an indicator of investor risk aversion, dropped from 23.81 points on June 13, the highest level since the final May 2003 result, to 9.9 points in November, the lowest mark since January 1994, before closed November 24 at 10.73 points.

Annual returns on 10-year United States government bonds continued on the downward trajectory started toward the end of June, closing September at 4.54% per year, the lowest level since March, and continued at that rate through November 24. This figure represents a reduction of 0.7 p.p. compared to the June highpoint of 5.25% per year, the last time United States basic interest rates were raised. Annual returns on similar Japanese and German papers dropped from maximum levels of 2.01% and 4.14% per year, respectively, in May and July, to 1.66% and 3.7%, on November 24.

Reduced aversion to risk was reflected in the Embi+, the emerging market sovereign risk indicator. In the period extending from September 1 to November 24, the average value of the index reached 194 b.p., compared to 206 b.p. in

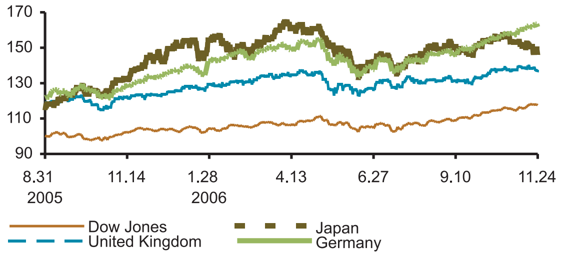
Figure 4.13 – Emerging Markets Bond Index Plus (Embi+)



Source: Bloomberg

Figure 4.14 – Stock exchanges – USA, Europe and Japan

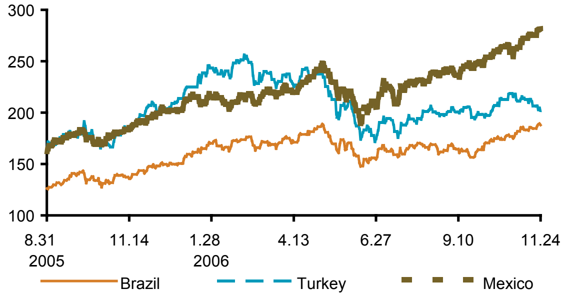
12.31.2003=100



Source: Bloomberg

Figure 4.15 – Stock exchanges – Emerging markets

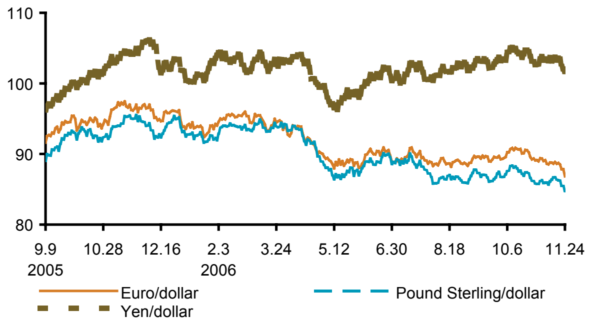
12.31.2003=100



Source: Bloomberg

Figure 4.16 – Dollar exchange rates

9.19.2003=100



Source: Bloomberg

the three-month period ended in August. The Embi+ closed November 24 at 194 points, the same level as on August 31. Using this comparison, the index dropped 0.9% in Brazil and 9.1% in South Africa, while registering increases of 2.1% in Turkey and 4.5% in Mexico.

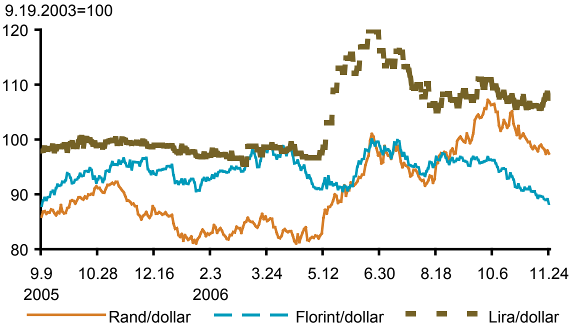
Excluding the Japanese market, the major stock exchanges registered positive growth in the three-month period through November. At the November 24 closing, the American Dow Jones Index, the British Financial Times Securities Exchange Index (FTSE 100) and the German *Deutscher Aktienindex* (DAX) registered the year's highest levels with growth of 7.9%, 3.7% and 9.4%, respectively, compared to August 31. The Japanese Nikkei index declined 2.5% in the same period. Among emerging countries, the Brazilian Ibovespa, the Mexican *Indice de Precios e Cotizaciones* (IPC) and the Turkish Istanbul Stock Exchange National 100 Index (XU100) expanded 15.3%, 17.8% and 0.8%, respectively. The Brazilian index surpassed the historical mark of 42 thousand points on November 23.

Compared to Japan and Europe, expectations of weaker economic activity in the United States that would require monetary policy alterations were one of the factors responsible for depreciation of the dollar against other international payment currencies. Through the first week of October, the dollar rate fluctuated in the range in effect at the end of July against the pound sterling, euro and yen. From that point forward, however, with the October 25 decision to maintain the Fed fund target and the announcement of declining American economic growth, the dollar initiated a period of depreciation.

The process of dollar depreciation intensified further when it became clear that the pace of economic activity, particularly in the United Kingdom, Euro Area and Japan, would remain strong through the remainder of 2006 and in 2007, at the same time in which the differentials between interest rates in those economies and the United States narrowed. The value of the dollar against the pound sterling, euro and yen dropped 1.4%, 2.1% and 1.3%, respectively, on November 24, compared to the end of August.

Persistent current account deficits resulted in depreciation of the currencies of South Africa and, to a lesser extent, Turkey between early September and the first week in October. However, from mid-October onward, the currencies of these countries and Hungary began appreciating against the dollar. In general, this turnaround was caused by new capital flows to emerging market stock exchanges, lesser

Figure 4.17 – Emerging markets currencies
South Africa, Hungary and Turkey



Source: Bloomberg

Figure 4.18 – Renminbi appreciation
Month average

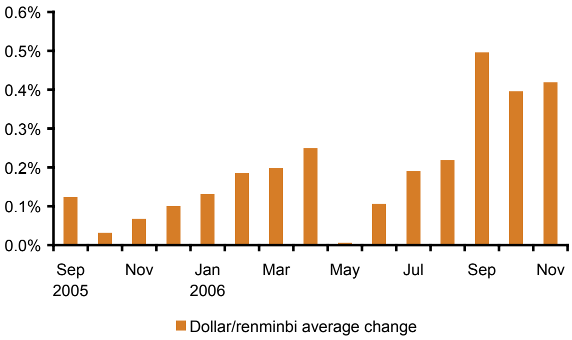
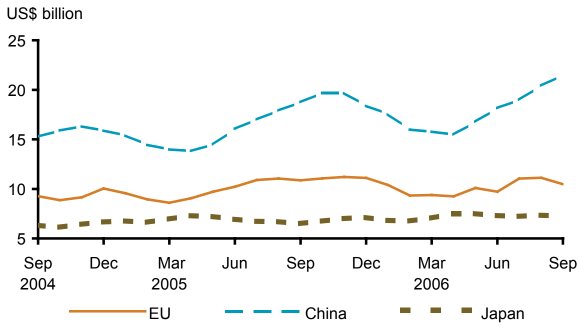
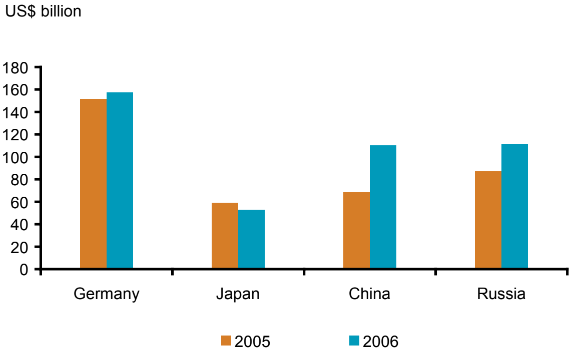


Figure 4.19 – USA – Bilateral trade deficit[1/]



Source: Bloomberg
1/ Quarterly moving average.

Figure 4.20 – Trade balance: Jan-Sep



Source: Bloomberg

volatility and reduced risk aversion in international markets. In the specific case of Hungary, this process also benefited from normalization of that country's political situation. In South Africa, the major factor was implementation of more restrictive monetary policies. By November 24, the Hungarian currency had appreciated 9% compared to the final August position, while the South African rand and Turkish lira remained relatively stable.

The renminbi appreciated sharply against the dollar, albeit slightly below the potential level expressed in the daily float band of +/- 0.3%. Between the end of August and November 24, the renminbi appreciated 1% against the dollar, the same level registered in the first seven months of 2006.

4.4 World trade

Trade volumes increased in the third quarter, primarily as a result of the impact of declining oil prices on trade flows.

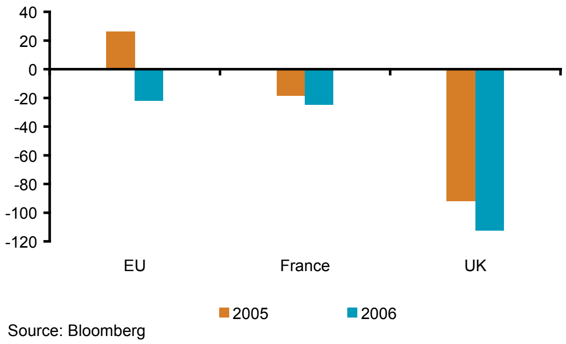
In the first nine months of the year, the United States trade deficit reached US$637 billion, 11.7% more than in the same period of 2005. Exports closed at US$759.5 billion and imports at US$1,396.5 billion, up 14.8% and 13.4%, respectively, in the period.

The Chinese trade surplus has set successive records, closing the first ten months of the year at US$133.6 billion, compared to US$101.7 billion during all of 2005. Exports totaled US$779.3 billion and imports came to US$645.6 billion, reflecting growth of 26.8% and 20.9%, respectively, compared to the same period of 2005. The monthly surplus set a new record of US$23.8 billion in October, due primarily to a reduction in import operations caused partly by measures adopted by the Chinese government to curtail growth. The country's international reserves passed the US$1 trillion landmark at the end of October.

Japanese trade balance results, on the one hand, reflected expanding exports to China and the United States and, on the other, imports of capital goods and declining demand for imported consumer goods. The January-October 2006 trade surplus reached US$52.5 billion, 20.5% below the figure for the same period of the previous year. More specifically, exports expanded 9% and imports increased 13.6%.

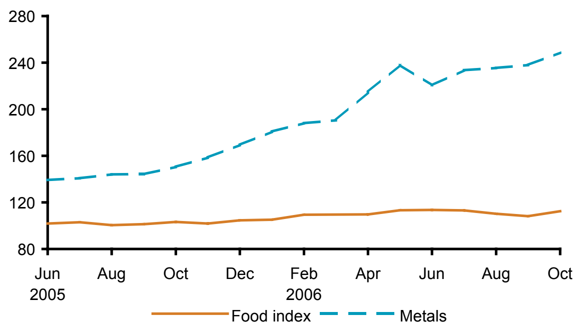
The Euro Area trade balance closed the first nine months of 2006 with a deficit of €17.7 billion. Exports totaled €1,007.3 billion and imports reached €1,025 billion, reflecting growth

Figure 4.21 – Trade balance: Jan-Sep
US$ billion



Source: Bloomberg

Figure 4.22 – Commodity price index in SDR
1995 = 100



Source: IMF

of 11.2% and 15.9% respectively, compared to the same period of 2005. To some extent, this performance reflected growth in the energy account and trade with China.

4.4.1 Commodities

Commodity prices remain high, mostly as a result of continued world economic growth, albeit at a more moderate pace. This was particularly true under metallic goods, while international prices of some farm commodities, particularly grains, showed signs of growth. Short-term price volatility has been caused by speculation and futures market technical adjustments, as well as by expectations regarding the upcoming harvest and output in the mining sector.

In the case of farm commodities, Australian and Argentine wheat harvest failures reduced global supply more than 20 million tons, driving wheat prices upward and provoking increases in corn and soybean prices. These three crops are included in the "animal feed complex" and, consequently, their prices tend to keep pace one with another. At the same time, rising prices reflect growing demand for biofuel production. In the United States alone, where ethanol is produced from corn, projections now point to an output increase from the current level of 4.8 billion gallons to as much as 8.5 billion in 2011.

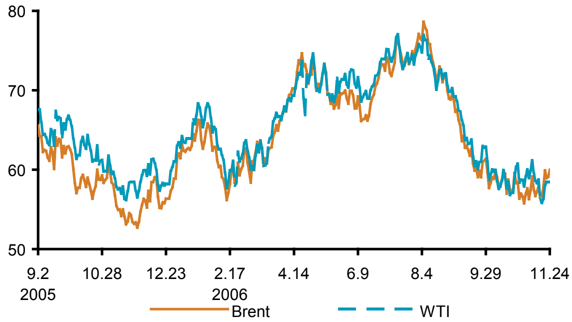
Since current forecasts point to a smaller international harvest of coffee and citrus fruits in 2007, the prices of these goods should remain strong. In the sugar-alcohol segment, growing demand for these two products is expected to pressure prices upward.

In a context of low stock levels and strong demand, the prices of basic metals have increased sharply in recent months, particularly nickel, copper and zinc. In this case, price behavior reflects the short-term outlook for continued insufficient stock levels, caused by unrest at various mines in different parts of the world and postponement of new operations.

An additional factor underlying strong growth in the segment of metals toward the end of November was depreciation of the American dollar, particularly for such precious metals as gold and silver.

Figure 4.23 – Oil – Spot market

US$ per barrel



Source: Bloomberg

4.4.1.1 Oil

Crude oil prices dropped sharply in the three-month period ended in November. Brent-type oil, which had risen to US$78.63 per barrel on August 7 dropped 23.7% through November 24. Despite announcement of a 1.2 million barrel per day (mbd) cutback in the Organization of the Petroleum Exporting Countries (Opec) output as of November, the turnaround in the upward oil price trajectory reveals both high international stock levels and still mild climatic conditions in the northern hemisphere.

Stocks held by the United States and the Organisation for Economic Co-operation and Development (OECD) reached higher than normal levels, registering an increase of 1.15 mbd in the third quarter, the largest third quarter increase since 1991. The International Energy Agency (IEA) reduced its forecast of world oil consumption in 2006 from 1.2% to 1.1%, but maintained its estimate for 2007 at 1.7%. Consequently, global 2006 consumption of this commodity should average 84.5 mbd, rising to 85.9 mbd in 2007. According to the IEA, crude oil supply will exceed demand in 2007, mainly as a consequence of increased output in non-Opec producer countries.

4.5 Conclusion

Though the evolution of the macroeconomic scenario would seem to strengthen expectations of an activity decline in the world economy, estimates for 2006 world economic growth now indicate better results than in 2005. Growth projections for 2007, however, have been reduced. In summary, the macroeconomic environment will be marked by low level inflation, low rates of interest, relatively strong foreign trade flows, still high commodity prices and a lesser degree of financial market volatility.

Though inflationary pressures that could result in interest rate hikes in specific regions of the world still exist, the overall outlook for inflation in the industrialized world is bright. In the United States, for example, though inflation indicators are somewhat above the Fed's comfort zone, the signs of a slowdown in the pace of that country's economy will tend to prolong the pause in the process of raising basic interest rates.

Global imbalances will continue, particularly the United States current account deficit and the Chinese current account surplus. In this scenario, considering that United

States and Euro Area monetary policies have moved in opposite directions, it is possible that the euro will be strengthened, making it a more important adjustment variable in the pursuit of global monetary equilibrium. No serious difficulties are expected in the financing of the balance of payments of emerging countries, particularly when one considers the highly positive outlook for international financial markets.