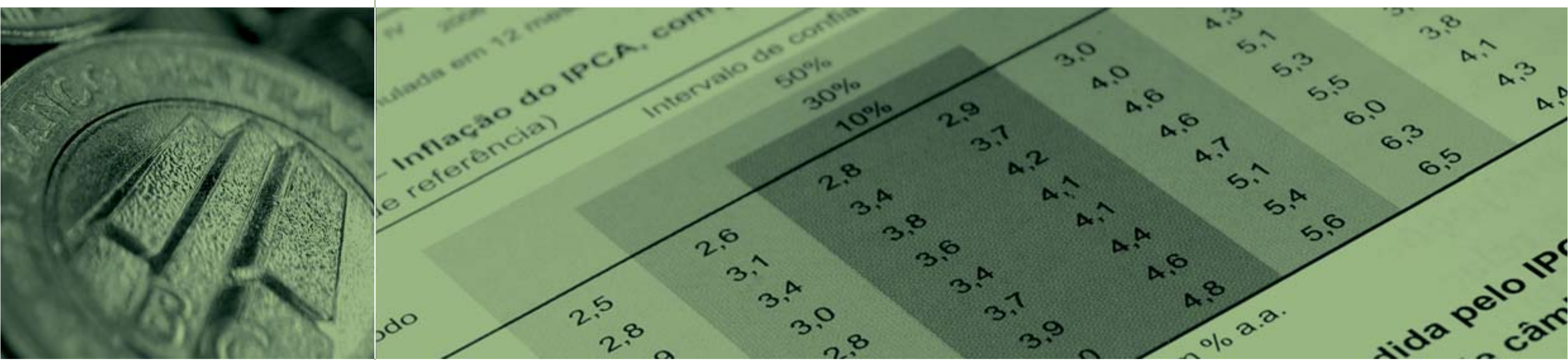
ISSN 1517-7289

Inflation Report



June 2008

Volume 10 – Number 2

BANCO CENTRAL DO BRASIL

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ISSN 1517-7289
CGC 00.038.166/0001-05

Inflation Report	Brasília	v. 10	n. 2	Jun.	2008	p. 1-153

Inflation Report

Quarterly publication of the Monetary Policy Committee, according to Decree 3,088, dated 6.21.1999.

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Number printed: 220 copies

Statistical Conventions:

...	data not available.
-	nil or non-existence of the event considered.
0 ou **0.0**	less than half the final digit shown on the right.
*	preliminary data.

Hiphen between years indicates the years covered, including the first and the last year.
A bar (/) between years (1970/1975) indicates the average of the years covered, including the first and the last year or even crop or agreement year, when mentioned in the text.

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

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

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Foreword

Inflation Report is a quarterly publication of the Banco Central do Brasil with the objective of evaluating the performance of the inflation targeting system and providing a prospective scenario for inflation. The national and international economic conditions underlying decisions taken by the Monetary Policy Committee (Copom) concerning the monetary policy management are presented.

The *Report* is divided into six chapters: Activity level; Prices; Credit, monetary and fiscal policies; International economy; Foreign sector and Prospects for inflation. With regard to the activity level, growth in retail sales, inventories, output, labor market and investments are investigated. In the following chapter, price analysis focuses on the results obtained in the quarter as a consequence of monetary policy decisions and the real conditions of the economy outside the realm of government action. The chapter referring to the credit, monetary and fiscal policies, the analysis is centered on the behavior of credit, financial and budget operations. In the chapter dealing with the international economy, the *Report* presents an analysis of the world's major economies and seeks to identify those conditions capable of impacting the Brazilian balance of payments. Insofar as the foreign sector chapter is concerned, analysis is targeted at economic-financial relations with the international community, with emphasis on trade results and foreign financing conditions. Finally, prospects on inflation growth are analyzed.

Executive summary

The economic activity continues impelled by domestic demand dynamics, which is translated essentially in investment strength and in household consumption. In fact, domestic demand contribution to the 5.8% expansion in Gross Domestic Product (GDP) in the first quarter of 2008, compared to the same period of the previous year, reached 8.5 p.p., against -2.6 p.p. of external demand. This GDP growth assumes even more relevant contours as it reflects the continuity of growth in every sector of the economy.

The expansion of household consumption and, especially, of investments, continues indicating the importance of the consolidation of macroeconomic stability. The benefits of stability are also reflected on the economy's resilience to the effects of turbulence originated in foreign financial markets as well as the revaluation of Brazilian sovereign risk to investment grade by major rating agencies.

The dynamics of domestic activity is also observed in the performance of the labor market. In fact, the Monthly Employment Survey of (PME) of the Brazilian Institute of Geography and Statistics (IBGE) shows that unemployment rate shows a declining trend since the third quarter of 2007, reaching in April its lowest level of the seasonally adjusted series. It should be highlighted the creation of new jobs in the formal labor market which in the first quarter, recorded a 7.1% increase in the number of employees, while the number of informal employees fell by 4%. One should also mention that even in the scenario of rising inflation rates prevailing in recent months, the labor income continued showing real gains.

The monetary aggregates continue in line with the performance of domestic demand and, in particular, with the growth in credit operations, which kept supporting the expansion of household consumption, especially regarding the acquisition of vehicles and other durable goods. Among credit segments one registers the growing proportion of transactions carried out with free resources, especially the upturn of leases. Despite some deterioration in financing conditions, corporate entities remain demanding credit, especially through working capital operations. In general, the default rate remains stable and does not threaten the soundness of the financial system.

The management of the fiscal policy continues ensuring the reduction of the ratio between the different concepts of debt and GDP, which in part also reflects the economic growth, even in a scenario of rising interest rates. The cumulative twelve months primary surplus reached, in April, a level consistent with the forecasted goal for the year, despite reductions observed at regional level and state enterprises. The expansion of the primary results in the first quarter of 2008, associated to the reduction in the appropriation of nominal interests, made it possible that for the first time in recent years a nominal surplus was booked in public accounts.

Even if, up to now, this has not materialized in a significant way, the uncertainty environment prevailing in international markets may impact the forecast scenarios for commodity prices, for capital flows and for growth rates of exports and production worldwide. Even though it is clearly difficult to anticipate what would be the impact on the Brazilian economy, the forecasts for the country's external accounts in 2008 incorporate the continuation of favorable conditions for financing the balance of payments. In particular, again in 2008 a strong net inflow of direct investments should occur. With regard to external accounts, it is also important to note that the year 2008 should record a current account deficit, after five years registering surpluses. This result is primarily due to the reduction in trade balance and increase in services and income remittances, especially of profits and dividends.

Inflation, measured by the Extended National Consumer Price Index (IPCA), reached 2.88% in the year's accumulated variation till May, against 1.79% in the same period of 2007. Since January, the twelve-month rate is above the central target, and the difference has been increasing since then. In fact, the twelve-month inflation up to May stands at 5.58% (against 4.56% in January and 3.18% in May 2007) and follows the upward trend started in 2007. This dynamics is due to the mismatch between the pace of expansion of domestic demand and supply in the context of pressures – observed in global scale – on the prices of farm products. Incidentally, behind these increases are structural factors that tend to persist, such as increased demand from major Asian countries as well as transitory factors, such as tariff and non-tariff restrictions imposed on trade of specific products for different countries.

The forecast linked to the baseline scenario indicates inflation of 6.0% in 2008, a level 1.4 p.p. higher than the one forecasted on the March Report, and markedly above the central value of 4.5% for the target set by the National Monetary Council (CMN). The forecast for the twelve months accumulated inflation starts at 5.9% in the second quarter of 2008, reaches the maximum value of 6.3% in the third quarter, slows down and ends the year at 6.0%. For 2009, it starts at 5.7% in the first quarter and moves to 4.7% in the last one, therefore, above the central value of 4.5% to the target. In this scenario, the forecast to the first quarter de 2010 also stands at 4.7% and to the second one it stands at 4.8%. One should mention that the decline of the inflation forecast through 2009 essentially reflects the fact that inflation expectations for both 2009 and 2010, find themselves under the expectations for the current year.

In the market scenario, as well as the reference scenario, inflation forecast for 2008 stands at 6.8%, 1.3 p.p. above the one shown on the last Report. Forecasts indicate acceleration of twelve-month accumulated inflation in the third quarter of 2008, occurring some slowdown in the final quarter, and ending the year at 6.0%, 1.5 p.p. above the central value of 4.5% target. In general, according to the market scenario, the forecast of accumulated twelve months inflation decreases in 2009 and ends the year at 4.7%, above the central value to the target set by the CMN. For the second quarter of 2010, the twelve months accumulated inflation stands at 4.9%.

According to the reference scenario, the forecast for GDP growth in 2008 remains at 4.8%, the value registered in the March Inflation Report.

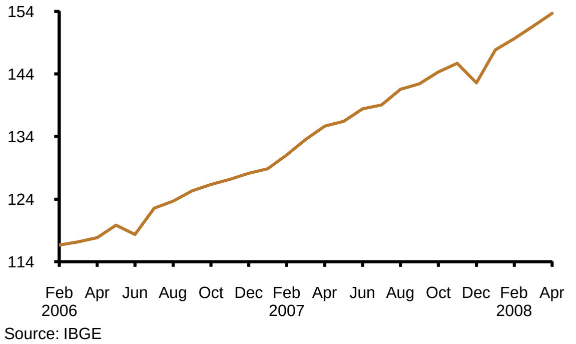
1 Economic activity

The Brazilian economy's pace of expansion at the beginning of 2008 continues stimulated by the upturn in domestic demand activity, for the eighth consecutive quarter, being the determinant of GDP growth. Domestic demand consolidation as the economy propeller reflects, to a large extent, the investment trend and household consumption, with developments over international trade, taking into account both the increased demand for imported goods and impact over exports due to higher consumption of the domestic production, movements required to guarantee the balance between demand and supply of goods and services.

In this scenario, domestic demand and the external sector contributions for the increase of 5.8% registered by the GDP in the first quarter of 2008, in regard to the same period in the previous year, reached 8.5% percentage points (p.p.) and -2.6% p.p., respectively. GDP growth becomes more relevant considering that the result reflects a continued generalized growth in all sectors of the economy, especially in industry, which had been stimulated by the construction industry favored by intensified spending in infrastructure and better credit conditions for the sector.

The upturn in domestic activity continues to reflect significant improvements, both quantitative and qualitative, in the labor market. IBGE's PME shows that unemployment rate follows a declining trajectory since the third quarter of 2007, reaching the lowest level of the seasonally adjusted series in April 2008. One should highlight that this movement results in the generation of new formal job positions in the labor market. In this sense, the number of formal job positions in the private sector increased 8.9% in the four first months of the year, against the same period in 2007, while the number of self-employed decreased 3.2%, in the same period. Additionally, even in a scenario of increased inflation rates, the employment income continues to show real gains.

Figure 1.1 – Extended retail sales
Seasonally adjusted data
2003 = 100



Source: IBGE

1.1 Retail trade

The trajectory, registered during 2007, of generalized increase in sales of durable, semi and nondurable goods, in all regions of the country, continued in the first months of 2008. This increase, consistent with an economic stability scenario, labor market strengthening and the high level of consumers' expectations, should continue in the coming months.

According to the IBGE's Monthly Retail Trade Survey (PMC), retail trade in the expanded concept, released with seasonal adjustments for the first time in February 2008, increased 4.3% in the quarter ended in April, in relation to that ended in January. Increases on sales were registered in 9 out of the 10 segments surveyed, particularly the ones related to vehicles and motorcycles and parts, 9.1%; furniture and appliances, 8.2%; office equipment and supplies, informatics and communications, 7.1%; books, newspapers, magazines and stationery, 4.6%, and construction material, 4.4%. Sales in the segments of hypermarkets, supermarkets, food, beverage and tobacco decreased 0.2% in the period.

Retail trade sales in the restricted concept, which excludes vehicles and motorcycles segments, parts and transportation material, increased 1.6% in the period. The continuity of a more vigorous growth trajectory in the retail sales, in the broad concept, started at the end of 2006, was associated to the upturn in the sales of the automotive sector, which, stimulated by the adoption of longer terms and more competitive interest rates, increased 9.1% in the quarter ended in April 2008, against that ended in January. Sales of construction materials, an additional segment included in the concept of expanded trade grew 4.4% on the same basis of comparison.

Retail sales expanded 15% in the first four months of the year against the same period in the previous year, registering a general increase in all major regions of the country. The largest increases occurred in the Mid-West, 16.4%, and South, 16.3%, followed by those in the Southeast, 15.9% Northeast, 13%, and North, 11.2%. Retail sales, viewed by units of the Federation, also registered widespread increase during the period, with emphasis on the results observed in Espírito Santo, 32.2%, Acre, 28.2%, Goiás, 25.2%, Rio Grande do Norte, 23%, Mato Grosso do Sul, 22.2%, and Mato Grosso, 21.4%.

The nominal revenue from expanded retail trade sales rose 19.3% in the first four months of the year, against the same period in the previous year, registering an increase of 15% in

Table 1.1 – Retail sales

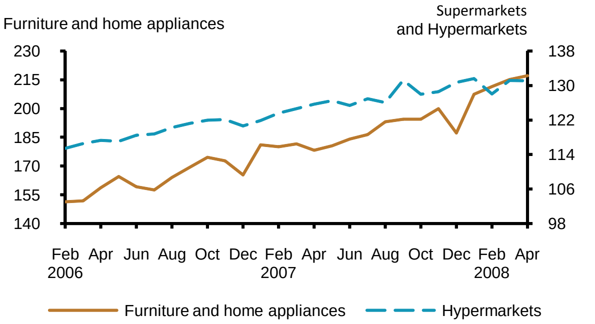
% change

	2008			
	Jan	Feb	Mar	Apr
In the month[1/]				
Retail sector	1.9	-0.8	1.5	0.2
Fuel and lubricants	1.2	2.3	1.6	0.5
Supermarkets	0.7	-2.7	2.4	-0.1
Fabrics, apparel and footwear	3.7	-4.7	6.4	0.5
Furniture and home appliances	10.8	1.9	1.7	0.9
Pharmac., medical, orthop. and perfumery articles	2.3	-3.8	2.6	1.8
Office, comp./comunic. equip.	2.7	2.7	-0.6	1.6
Books, newspaper, magazines,	-5.6	14.3	-6.1	2.0
Other art. of personal use	8.3	1.0	-1.2	-1.0
Broad retail sector	3.7	1.2	1.3	1.4
Building materials	2.9	3.0	1.0	1.0
Automobiles, motorcycles, parts and spares	4.0	5.6	0.5	2.7
3-Month Period/Previous 3-Month Period[1/]				
Retail sector	3.1	2.5	2.6	1.6
Fuel and lubricants	1.3	1.5	3.1	4.1
Supermarkets	1.5	0.7	0.9	-0.2
Fabrics, apparel and footwear	4.0	2.0	2.7	1.6
Furniture and home appliances	2.2	2.9	9.0	8.2
Pharmac., medical, orthop. and perfumery articles	3.2	2.8	2.2	0.6
Office, comp./comunic. equip.	1.7	3.3	4.5	4.6
Books, newspaper, magazines,	4.3	5.9	3.4	7.1
Other art. of personal use	4.2	4.6	6.9	4.0
Broad retail sector	1.8	1.8	3.8	4.3
Building materials	-0.1	-0.7	2.5	4.4
Automobiles, motorcycles, parts and spares	0.8	3.0	6.4	9.1
In the year				
Retail sector	11.8	12.3	11.8	11.0
Fuel and lubricants	3.1	5.1	5.2	6.0
Supermarkets	8.4	8.4	8.4	6.4
Fabrics, apparel and footwear	15.4	14.0	13.3	15.0
Furniture and home appliances	16.0	18.8	17.3	19.8
Pharmac., medical, orthop. and perfumery articles	16.2	15.2	13.2	13.6
Office, comp./comunic. equip.	8.1	12.7	11.5	11.3
Books, newspaper, magazines,	24.7	31.9	29.2	27.6
Other art. of personal use	29.6	28.6	28.3	23.3
Broad retail sector	14.4	16.4	14.8	15.0
Building materials	9.6	13.8	10.9	13.0
Automobiles, motorcycles, parts and spares	20.8	25.4	21.4	23.4

Source: IBGE

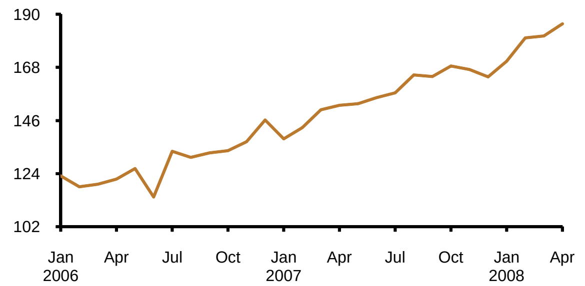
1/ Seasonally adjusted data.

Figure 1.2 – Retail sales
Seasonally adjusted data
2003 = 100



Source: IBGE

Figure 1.3 – Retail sales (automobiles, motorcycles, parts and spares)
Seasonally adjusted data
2003 = 100



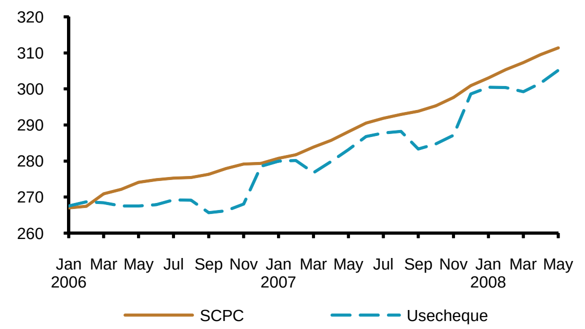
Sources: IBGE and Banco Central do Brasil

Table 1.2 – Retail sales
2008, April

	% accumulated growth in 2008		
	Nominal revenue	Volume	Price
Retail sector	15.8	11.0	4.3
Fuel and lubricants	4.6	6.0	-1.3
Hyper and Supermarkets	16.8	6.4	9.8
Fabrics, apparel and footwear	19.4	15.0	3.8
Furniture and home appliances	14.9	19.8	-4.1
Broad retail sector	19.3	15.0	3.7
Automobiles, motorcycles, parts and spares	26.2	23.4	2.3
Building materials	19.2	13.0	5.5

Source: IBGE

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



Source: ACSP

sales volume and 3.7% in prices. One should highlight that the nominal revenue related to all the segments surveyed showed higher increase than the variation of 3.9% registered by the Extended National Consumer Price Index (IPCA) in the same period, with emphasis to the expansion in the segments of vehicles, motorcycles and parts, 26.2%; the increase in the sales volume of construction materials, 19.2%, consistent with the upturn in the construction industry; and hypermarkets, supermarkets, food, beverage and tobacco, 16.8%, impacted by the increase in prices of foodstuffs.

The upturn in activity observed in retail trade sales, as confirmed by IBGE assessments, is justified by an increase of indicators in the sector. In this sense, statistics from the National Federation of Automotive Vehicle Distribution (Fenabrave) show that sales of new vehicles increased 14.6% in May against the same period in 2007, expanding 30.4% in the first five months of the year, compared to the same period of the previous year. Additionally, sales of automotive vehicles on the domestic market, released by the National Association of Automotive Vehicle Manufacturers (Anfavea), registered respective increases of 10.7% and 28.1% on the same basis of comparison.

Statistics released by the São Paulo Trade Association (ACSP) on trade performance in the State of São Paulo, suggests the continued expansion both in sales of durable goods, driven by credit conditions, and in those related to nondurable goods, impacted by the employment and income growth. In this sense, the number of consultations to the Credit Protection Service Center (SCPC), an indicator of long-term purchases, grew 2% in the quarter ended in May, compared to the one ended in February, while consultations to the Usecheque, an indicator of cash purchases, increased 1.6% in the period, according to seasonally adjusted data.

The increase in default indicators, at the beginning of 2008, is consistent with the upturn in retail trade. The ratio between the number of checks returned for insufficiency of funds and the total of checks cleared reached 6.1% in May, against 6.6% in the corresponding month of 2007, with emphasis on the rates of 9.2% and 9.1% observed respectively in the North and Northeast regions. On the other hand, ACSP statistics on the State of São Paulo registered net rates of default of 9% and 8%, respectively, in the respective months.

Results of assessments related to consumers' expectations, in the second quarter of the year, revealed a continued upward trajectory of optimism, with emphasis on short-term expectations.

Table 1.3 – Default rates

		2008					%
	Year[1/]	Jan	Feb	Mar	Apr	May	Year[1/]
Returned checks[2/]							
Brazil	6.2	6.2	6.5	6.3	6.1	6.1	6.2
Northern region	9.6	9.6	9.8	9.4	9.2	9.1	9.4
Northeast region	9.3	8.8	9.6	9.4	9.2	9.2	9.2
Southeast region	5.6	5.5	5.8	5.7	5.6	5.6	5.7
Center-western region	7.1	7.0	7.2	7.0	6.8	6.7	6.9
Southern region	5.9	5.9	6.2	5.9	5.8	5.7	5.9
SCPC (SP)[3/]	5.4	5.4	6.4	7.6	8.6	9.0	7.4

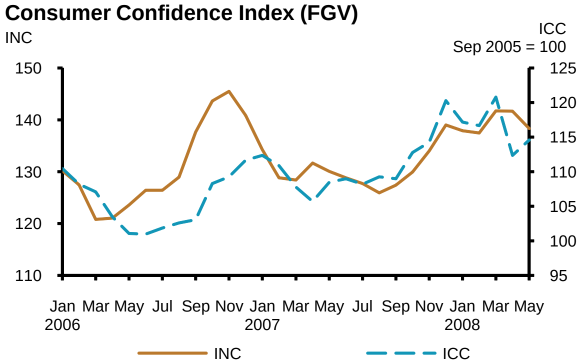
Sources: Banco Central do Brasil and ACSP

1/ Annual average.

2/ Returned checks/cleared checks.

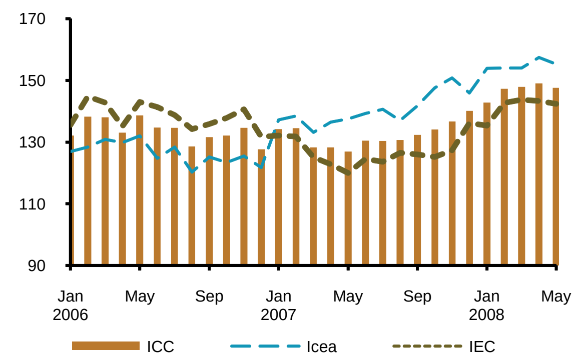
3/ [New registrations (-) registrations cancelled]/[consultations (t-3)].

Figure 1.5 – National Consumer Confidence and Consumer Confidence Index (FGV)



Sources: ACSP and FGV

Figure 1.6 – Consumer Confidence Index



Source: Fecomercio SP

The Getulio Vargas Foundation's (FGV), Consumer Confidence Index (ICC), registered a monthly increase of 2% in May, result of increases of 1.6% in the Expectations index (IE) and of 2.6% in the Current Situation Index (CSI). The indicator increase, which reached, in March, the highest level of the historic series initiated in September 2005, continues to confirm consumers' optimism with regard to the current situation.

The National Confidence Index (INC), measured by the Ipsos Public Affairs (Ipsos) to the ACSP, reached 138.3 points in May, against 141.6 points in April and 130 points in May 2007. The monthly cutback observed in the indicator mirrored, on the one hand, the lower consumer willingness to purchase higher value goods and the increased fear regarding unemployment, while, in turn, the increase in the component measuring confidence in relation to the local economic situation, acted the other way around.

The National Consumer Expectations Index (Inec), released on a quarterly basis, by the National Confederation of Industry (CNI), based on assessments carried out between March 19 and 23, showed continued expansion in the first quarter of the year, increasing 1.1% compared to December, and 3.1% against the same month of the previous year. This indicator increase, registered in the first quarter is the third highest result in all the series, lower only to the ones registered in September and December 2006, reflected improvement in the components which consider expectations regarding unemployment and income increase as well as greater concerns on assessments related to inflation prospects.

The Consumer Confidence Index (ICC), released by the Trade Federation of the State of São Paulo (Fecomercio SP) and restricted to the metropolitan region of São Paulo, dropped 1% in May, compared to the previous month, rising 16.2% in 12 months. One should highlight that the ICC is at a high level, registering the highest volume of all the series in April 2008. The ICC monthly evolution mirrored cutbacks of 0.7% in the Consumer Expectations Index (IEC) component, which represents 60% of the overall index and 1.4% in the Current Economic Conditions Index (Icea), which accounts for the rest of the index.

1.2 Production

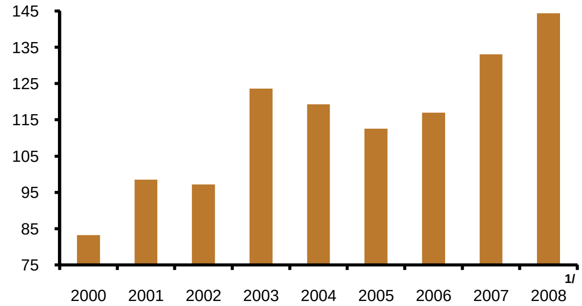
Farm production

The Quarterly National Accounts, released by IBGE, revealed that the crop and livestock production expanded 2.4% in the first quarter of 2008, as compared to the same period in 2007. The agricultural sector, according to the Systematic Farm Production Survey (LSPA) estimates for May, should continue to set out positive results in the current harvest, and sustainable development, especially regarding the performance of corn, rice, beans, coffee beans and sugar cane crops, while the upturn in activity of animal production is associated to the beef and poultry segments.

Crops

The grain harvest shall total 144.3 million tons in 2008. The annual growth of 8.4%, a result which incorporates a 3.7% increase in the harvested area and of 4,5% in average productivity, reflects favorable expectations for the crops of wheat, corn, rice, beans, and soy beans, while, on the other hand, it forecasts a cutback in germination of cotton seed.

Figure 1.7 – Grain production
In million tons



Source: IBGE
1/ Estimate.

Soy bean production, after expanding 10.7% in 2007, is expected to total 59.8 million tons of grains. The annual growth of 3.3% reflects increase forecast of 3.1% in the planted area and of 0.2% in the average yield.

Corn harvest was forecasted at 58.3 millions of tons. Forecasts for annual growth of 12.4%, mirrors increase of 4.6% in the planted area and of 7.5% in average yield, a growth associated to favorable international prices, which encouraged farmers to plant to the maximum tolerated limit in the cropping calendar and to invest in the sector.

Table 1.4 – Farm production

In 1,000 tons

	Production		% change
	2007	2008 1/	2008/2007
Grain production	133 101	144 340	8.4
Cotton (seed)	2 498	2 434	-2.5
Rice	11 048	12 173	10.2
Beans	3 245	3 500	7.9
Corn	51 831	58 280	12.4
Soybean	57 952	59 842	3.3
Wheat	4 089	5 162	26.2
Others	2 438	2 949	20.9

Source: IBGE
1/ Estimate.

The rice and beans harvest should come to 3.5 million and 12.2 million tons, respectively, in 2008, increasing, in the order, 7.9% and 10.2%, by comparison with 2007 figures.

Sugar cane production, in line with the strong international demand for sugar and for alcohol, should reach 585.6 million tons, rising 13.5% against the previous crop. This significant result, following the rise of 13.3% observed in 2007, led to expansions of 12.8% in the area under cultivation and of 0.6% in average yield.

Table 1.5 – Livestock production
Total slaughters

% accumulated growth in the year

Itemization	2007						
	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Cattle	9.0	7.7	6.1	4.9	3.3	2.4	1.8
Swine	10.7	9.1	8.4	7.4	7.2	7.0	6.0
Poultry	8.0	8.2	8.1	7.7	9.1	9.9	10.1

Source: IBGE

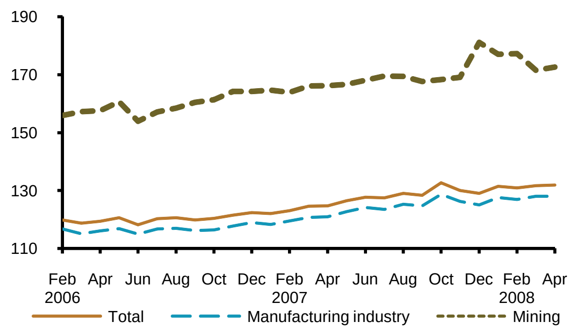
Table 1.6 – Industrial production

% change

	2008			
	Jan	Feb	Mar	Apr
Industry (total)				
In the month[1/]	1.9	-0.5	0.6	0.2
3-Month Period/Previous 3-Month Period[1/]	0.1	0.1	0.6	1.0
Same month of the previous year	8.7	9.7	1.4	10.1
Accumulated in the year	8.7	9.2	6.4	7.3
Accumulated in 12 months	6.3	6.8	6.6	7.0
Manufacturing industry				
In the month[1/]	2.0	-0.5	0.8	0.0
3-Month Period/Previous 3-Month Period[1/]	0.1	0.0	0.6	1.1
Same month of the previous year	8.8	9.7	1.4	10.4
Accumulated in the year	8.8	9.2	6.4	7.4
Accumulated in 12 months	6.4	6.9	6.7	7.0
Mining				
In the month[1/]	-2.3	0.1	-3.2	0.6
3-Month Period/Previous 3-Month Period[1/]	4.3	6.0	1.4	-1.1
Same month of the previous year	7.7	9.3	3.0	3.8
Accumulated in the year	7.7	8.5	6.5	5.9
Accumulated in 12 months	6.1	6.3	6.1	5.9

Source: IBGE
1/ Seasonally adjusted data.

Figure 1.8 – Industrial production
Seasonally adjusted data
2000 = 100



Source: IBGE

Coffee beans harvest, evincing the impact of a positive biannual cycle of this crop, should increase 27% in the year, a result of expansions of 0.7% in the area cultivated and of 26% in the average yield.

Livestock

According to the Quarterly Survey on Animal Slaughter, released by IBGE in March 2008, bovine production reached 7 million tons in 2007, rising 1.8% against the previous year. Considering the same comparison basis, the production of poultry and swine reached 9 million and 2.4 million ton, respectively, mirroring increases of 10.1% and 6%.

Exports of beef and pork totaled 342.2 thousand ton in the first quarter of the year, falling 24.8% against the same period of 2007 In the same period, external sales of pork reached 143.1 thousand ton, and the poultry meat, 1 million ton, registering, in order, falls of 12,3% and increase of 8,4% against the four first months of 2007.

Industrial production

The cycle of industrial growth initiated in 2006 accelerated its pace in 2007, stimulated by greater upturn in investment and domestic consumption activities, favored by an environment of stability and improvement in the macroeconomic foundations of the country. Recent results confirmed the continuity, at the beginning 2008, of an expansion trajectory, a movement reflecting businesses high levels of confidence and maintenance of strong growth in production of capital goods, particularly absorbed by domestic demand; this constitutes, therefore, a sign of expansion in medium term production capacity, which should continue throughout the year.

According to seasonally adjusted data from IBGE´s Monthly Industrial Survey's (PIM-PF) physical production index, industrial production increased 1% in the quarter ended in April, compared to the one ended in January, when it had expanded 0.1%, on the same comparison basis. In 2007, industrial production turned in an average quarterly increase of 1.8%.

The contraction in the long and medium-term credit and the scenario of consolidation of the stabilization process registered during 2006 had more accentuated impacts on the evolution of capital goods production in 2007 and, more

Table 1.7 – Industrial production by category of use

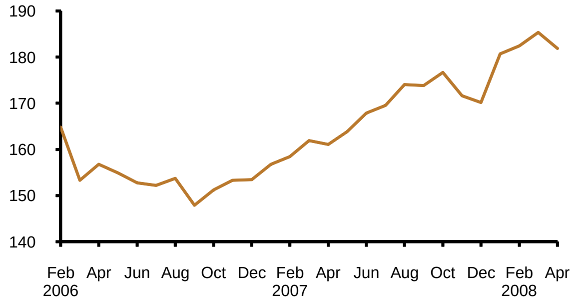
% change

	2008			
	Jan	Feb	Mar	Apr
In the month[1/]				
Industrial production	1.9	-0.5	0.6	0.2
Capital goods	1.0	3.0	1.3	1.6
Intermediate goods	1.5	-0.8	-1.0	-0.2
Consumer goods	3.3	-2.4	2.4	-0.7
Durables	6.2	1.0	1.6	-1.9
Semi and nondurables	2.2	-3.5	2.6	-1.5
Quarter/previous quarter[1/]				
Industrial production	0.1	0.1	0.6	1.0
Capital goods	3.8	3.3	3.8	5.2
Intermediate goods	1.6	2.1	1.1	-0.1
Consumer goods	-0.4	-1.3	0.3	0.1
Durables	-0.4	2.1	5.8	5.2
Semi and nondurables	-0.3	-1.7	-0.9	-1.6
In the year				
Industrial production	8.7	9.2	6.4	7.3
Capital goods	15.0	19.7	17.3	20.5
Intermediate goods	8.0	9.2	6.0	6.0
Consumer goods	8.0	6.8	4.1	5.5
Durables	15.7	18.1	13.7	15.9
Semi and nondurables	5.9	3.6	1.2	2.2

Source: IBGE

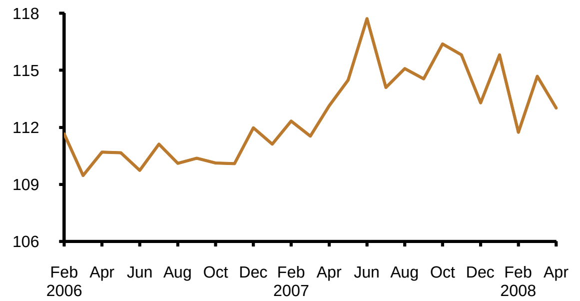
1/ Seasonally adjusted data.

Figure 1.9 – Industrial production
Consumer goods
Seasonally adjusted data
2000 = 100



Source: IBGE

Figure 1.10 – Industrial production
Semi and nondurable goods
Seasonally adjusted data
2000 = 100



Source: IBGE

strongly, at the beginning of 2008. In this sense, considering seasonally adjusted data, the production of these goods increased by 5.2% in the quarter ended in April, compared to the one ended in January, when it expanded 3.8% in the same type of comparison. The average quarterly growth in the production of capital goods came to 5.4% in 2007.

The production of durable consumer goods, highlighting the consolidation of domestic demand, grew 5.2% in the quarter ended in April, compared to the one ended in January, while that of semi and nondurable consumer goods and intermediate goods declined, in the order, 1.6% and 0.1% on the same basis of comparison.

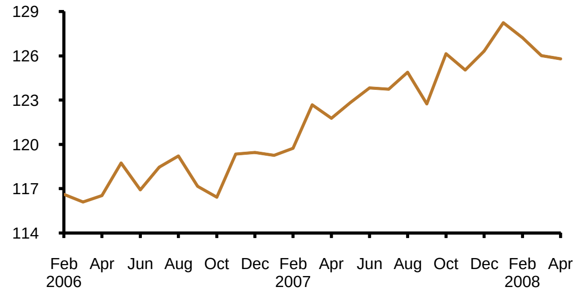
The analysis of the production of capital goods by destination shows a continued upturn in activity of the segments associated to goods targeted to transportation, mixed use and industry. In this sense, the production of capital goods for transportation increased 14.1% in the quarter ended in April, compared to one ended in January, while the one related to capital goods for mixed use increased 3.5%. The production of capital goods channeled to industry grew 3.3%, in the period, as consequence of expansion in the manufacturing of serial capital goods, 4%, and non-serial, 8%.

The physical production of 17 out of the 27 industrial activities surveyed by the IBGE showed growth in the quarter ended in April, compared to the one ended in January, with emphasis to other transportation equipment, 28.1%, automotive vehicles, 6.2%, publishing, printing and reproduction of recordings, 4.3%; machines and equipment, 3.5%, and diverse items, 2.9%. On the other hand, noteworthy are the cutbacks registered in activities related to office machines and informatics equipment, 10.9%, pharmaceuticals, 9.4% and beverages, 6.4%.

On the same basis of comparison, the regional production indicators (PIM-PF Regional) shows that physical production expanded more than the national average in nine of the thirteen states surveyed with emphasis on results from Ceará, 4.2%, Paraná, 3.5%; Espírito Santo, 2.7%; Goiás, 2.7%, São Paulo, 2.4% and Pernambuco, 1.8%. One should highlight that those variations, suggesting the broad occurrence of industrial growth in the country, took place in different sectors in each of the country's geographical regions.

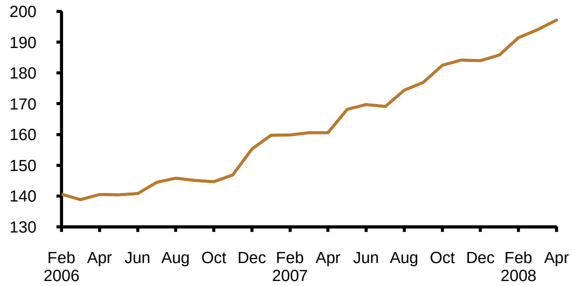
The segmentation of industries regarding the use of electric energy revealed that the production in the sector of low intensity played a relevant role in the increase of industrial production in the four first months of the year, against the

Figure 1.11 – Industrial production
Intermediate goods
Seasonally adjusted data
2000 = 100



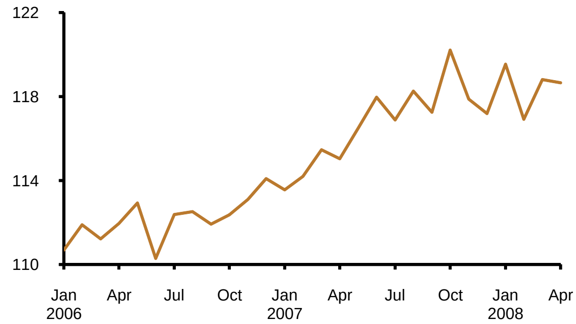
Source: IBGE

Figure 1.12 – Industrial production
Capital goods
Seasonally adjusted data
2000 = 100



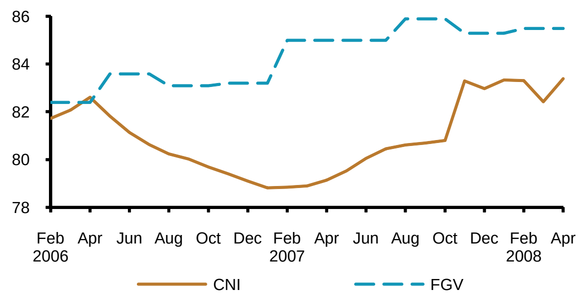
Source: IBGE

Figure 1.13 – Labor productivity[1/]
Seasonally adjusted data
2002 = 100



Source: IBGE

Figure 1.14 – Utilization of installed capacity in the manufacturing industry
Seasonally adjusted data
%



Sources: CNI and FGV

same period of the previous year. This segment increased 9.2%, in the period, while the production of industries of medium and high intensity spending of electric energy increased 5.4%.

Personnel employed and the number of hours paid in the industry increased by 0.4% and 1.1% respectively in the quarter ended in April, compared to that ended in January, using seasonally adjusted data. Labor productivity, estimated by the ratio between the indices of physical production and the number of hours paid, remained stable in the quarter, showing that the process of greater absorption of capital goods has not yet translated into productivity gains in industry.

The steady growth trend of industry at the beginning of 2008 is reinforced by FGV's and CNI's statistics about the Installed Capacity Utilization Level (Nuci). Considering seasonally adjusted data, this indicator, according to FGV, reached 85.5% in April, only lower than the 85.9% registered in October 2007, standing at a record level in the categories of capital goods, 88.3% and consumer goods, 86%. Breaking down by industrial sectors indicates that the installed capacity utilization level was equally a record one, in April, in the industries of non-metallic minerals, 88,3%; mechanic, 89.6%, transportation material, 92%; and foodstuffs, 85.8%, while in the chemical industries and others it stands at a level lower than the average of the last ten years. According to CNI, Nuci reached a record level of 83. 4% in April, increasing 1 p.p. compared to the previous months, considering seasonally adjusted data, and 1.5 p.p with regard to April 2007, regarding the observed series.

Considering FGV data, the Nuci reached 85.6% in May, against 85.1% in April and 84.4% in May 2007, with emphasis on the record levels of occupation with reference to the segments of construction material, 88.8%, and non-metallic minerals, 89.4%.

Industrial entrepreneurs' confidence indicators reveal a steady optimistic perception about the economic environment and the coming future, standing at a high level, despite a small correction on the margin. FGV's Industrial Confidence Index (ICI), considering seasonally adjusted data, released on a quarterly basis, reached 116.4 points in April, against 119.2 points in January. The two components of the indicator registered a drop in the period, especially the Expectations Index (IE), which fell 4.4 points to 108.9 points, while the Current Situation Index (ISA) decreased 1.3 point, to 123.8 points.

Table 1.8 – Industry Confidence Index[1/]

	2007		2008	
	Jul	Oct	Jan	Apr
Manufacturing industry	123.4	122.0	119.2	116.4
By category of use:				
Consumer goods	135.0	139.9	130.6	128.0
Capital goods	132.9	138.5	130.1	132.7
Building material	133.4	125.6	122.3	123.9
Intermediate goods	122.3	116.7	117.7	114.5
By component:				
Current Situation Index	129.7	127.1	125.1	123.8
Global demand level	124.3	120.3	118.2	119.5
Inventory level	103.8	103.4	105.3	100.8
Business situation	133.8	130.7	125.1	124.8
Expectations Index	117.0	117.0	113.3	108.9
Business situation	161.4	155.6	147.7	149.2
Employment	122.4	124.2	120.1	116.5
Physical production	133.3	136.3	134.8	121.7

Source: FGV
1/ The average of the last ten years is equal to one hundred. Values above one hundred indicate industrial activity expansion.

Figure 1.15 – Unemployment rate

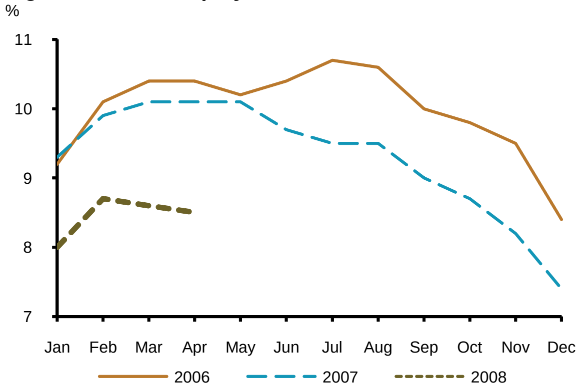
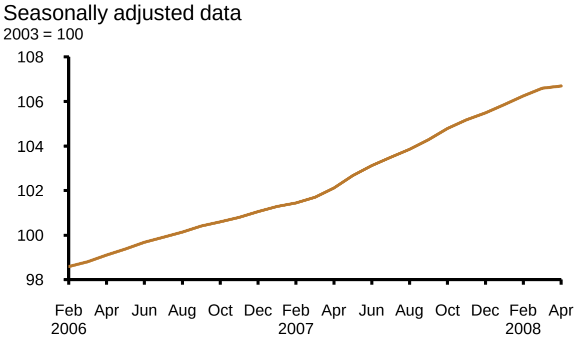


Figure 1.16 – Employment in the manufacturing industry – Quarterly moving average
Seasonally adjusted data



Source: CNI

1.3 Labor market

Employment

The expansion of the labor market in the first months of the year remains consistent with the upturn of economic activity, registering consecutive reductions on unemployment rate, which at its lowest level since the beginning of IBGE's PME, in March 2002. The decline in employment rate occurs in a scenario of increase in the formal employment rate, expressed by replacement of informal with formal employment position, a movement associated, to a large extent, to business confidence in the ongoing economic cycle of expansion. Additionally, the process of labor real earnings continues, an evolution observed even in a scenario of accelerated inflation, since the second half of 2007.

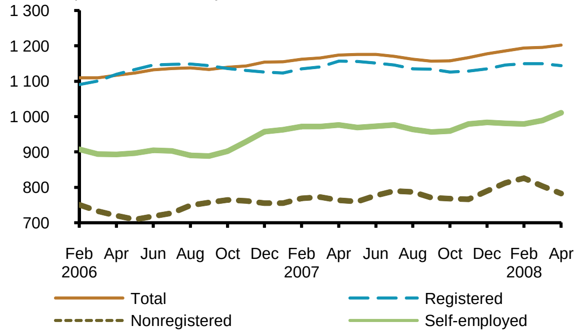
According to the PME, the average unemployment rate registered in the six metropolitan areas covered by the survey reached 8.5% in April, against 10,1% in the corresponding month of the previous year, being the eighth consecutive monthly result in which the rate is at the lowest level of the historical series for the respective month. In the quarter ended in April, the average unemployment rate closed at 1.5 p.p. lower than the one registered in the same period in 2007.

The employment rate increased 3.8% in the quarter ended in April, compared to the same period in 2007, indicating for the first time, since the beginning of 2005, an upward trend in the employment level. It was created 886 thousand of jobs in the area covered by the PME, which confirmed the continuity of the process of growing formalization of the labor market, with 850 thousand formal jobs. The number of informal workers dropped by 3.3% and the one of self-employed grew by 1.8% in the period.

According to the General File of Employed and Unemployed Persons (Caged), of the Ministry of Labor and Employment (MTE), 848.962 formal jobs were created in the four first months of 2008, the most significant result since the beginning of the series, in January 1985, the number of registered workers increased by 6.8% in the period, as a result of widespread expansion in the employment level of the main sectors of the economy, reaching 6.5% in commerce, 6.3% in the manufacturing industry and 5.5% in the service sector. One should highlight that the employment levels in the segments of manufacturing industry and services materialized historical records and the one related to commerce, the second highest level of the series. Additionally, the accelerated expansion rate of employment in the construction industry persists, reaching 16.3% against the first four months of 2007.

According to CNI survey, considering statistical data from twelve units of the Federation, industrial employment grew 4.7% in 2008, against the same period of the previous year. Margin analysis equally indicates an employment increase in this segment, reaching 0.8% in the quarter ended in April, compared to that ended in January, considering seasonally adjusted data.

Figure 1.17 – Average real regular earnings[1/]
In R$ of April 2008, deflated by INPC



Source: IBGE
1/ Quarterly moving average.

Table 1.9 – Formal employment

	2007	2008		
		Jan/Mar	Apr	Year
Total	1 617.4	554.4	294.5	849.0
Manufacturing industry	394.6	146.2	82.7	229.0
Commerce	405.1	19.3	34.7	54.0
Services	587.1	212.6	97.4	310.0
Building	176.8	99.7	32.1	131.7
Crop and livestock	21.1	48.7	38.6	87.3
Public utilities	7.8	4.1	1.6	5.7
Others[1/]	25.0	23.9	7.3	31.2

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

Earnings

In 2008, the average real income usually received by those occupied in the six metropolitan regions encompassed by the PME increased 2.4% in the quarter ended in April, against the same period of 2007, representing the ongoing trajectory of cumulative real earnings observed since that half-year. Considering job category, earnings reached 3.5% in the segment of self-employed, followed by those working in the private sector, unregistered workers, 2.5%, while that of formal employees turned in a decrease of 1.1%.

The real overall wages, product of the average real income usually earned by the number of those employed, grew 6.3%, on the same comparisons basis, while the average nominal income reached R$1,208.10 in April, increasing 8.4% against the same month of the previous year. The acceleration of wage earnings constitutes a demand supporting factor; however it may also become an inflationary fueling factor.

1.4 Gross Domestic Product

The GDP expanded 5.8% in the first quarter of 2008, compared to the same period in 2007, according to IBGE's Quarterly National Accounts System. This result highlighted the consolidation of domestic demand as a determinant of upturn in product activity, responding for 8.5 p.p. of the increase rate, while the external sector was responsible for 2.6 p.p. One should highlight that domestic demand constitutes the sole determinant for cumulative GDP growth in the year, since the first quarter of 2006. Additionally, the positive GDP performance in the beginning of 2008 reflected the positive results in all of its components, from both the production and demand viewpoints, with the exception of exports.

Table 1.10 – Gross Domestic Product
Quarter/previous quarter
Seasonally adjusted

% growth

	2007				2008
	I Q	II Q	III Q	IV Q	I Q
GDP at market prices	1.0	1.5	1.8	1.6	0.7
Crop and livestock	-0.9	0.7	6.8	0.2	-3.5
Industry	-0.4	1.7	1.9	1.1	1.6
Services	1.4	0.9	1.3	1.5	1.0
Households consumption	1.6	1.7	1.6	3.4	0.3
Government consumption	1.9	0.6	0.3	-0.2	4.5
Gross fixed capital formation	2.5	4.8	4.7	3.3	1.3
Exports	2.0	0.5	-0.1	3.9	-5.7
Imports	5.0	2.9	8.6	5.2	0.8

Source: IBGE

Table 1.11 – Gross Domestic Product at market prices

% growth

	2007				2008
	I Q	II Q	III Q	IV Q	I Q
Accumulated in the year	4.4	4.9	5.1	5.4	5.8
Accumulated in 4 quarters	3.9	4.8	5.1	5.4	5.8
Quarter/same quarter of the previous year	4.4	5.4	5.6	6.2	5.8
Quarter/previous quarter[1/]	1.0	1.5	1.8	1.6	0.7
Crop and livestock	-0.9	0.7	6.8	0.2	-3.5
Industry	-0.4	1.7	1.9	1.1	1.6
Services	1.4	0.9	1.3	1.5	1.0

Source: IBGE
1/ Seasonally adjusted data.

Table 1.12 – Gross Domestic Product

% growth

	2007				2008	
	I Q	II Q	III Q	IV Q	I Q	Year[1/]
GDP at market prices	4.4	4.9	5.1	5.4	5.8	4.8
Households consumption	5.7	5.7	5.8	6.5	6.6	6.6
Government consumption	3.7	3.5	3.4	3.1	5.8	4.3
Gross fixed capital formation	8.8	11.4	12.5	13.4	15.2	11.8
Exports	6.0	9.7	6.7	6.6	-2.1	3.3
Imports	19.8	19.2	19.6	20.7	18.9	21.3

Source: IBGE
1/ Estimated.

The performance of the domestic demand continues favored by the conditions of the credit market and by the level of confidence of business and consumers, which stimulate the levels of household consumption and investment decisions. In this environment, household consumption, which is also impacted by the trajectory of real wages and employment, increased 6.6% in the period, the eighteenth consecutive increase, on this basis of comparison. The Gross Fixed Capital Formation (GFCF), in line with the construction industry performance and with the strengthened production of capital goods, increased 15.2% in the period, while government consumption increased 5.8%. The external sector´s negative contribution to GDP growth, consistent with the process of strengthening of domestic demand, reflects a 2.1% drop in exports of goods and services and increase of 18.9% under imports.

From the production perspective, GDP performance in the first quarter of 2008, in relation to the same period of the previous year, was associated to the expansion in the production of the industrial sector, 6.9%; in services, 5% and in farming, 2.4%.

The increase in industry reflected an 8.8% expansion registered by the construction industry, consistent with the increased resources related to real estate financing and with the intensification of infrastructural works in the context of the Growth Incentive Program (PAC), and in manufacturing industry, 7.3% in the period. One should highlight the performance of farming defensive segments, 67.9%; tractors, machinery, farming equipment and parts and accessories, 47.4%; aircraft building and assembling, including fixing, 32.2%; and trucks and buses, including engines, 31.8%. With reference to the mineral extraction activity, a 3.3% growth was observed, driven by expansion in the iron ore segment, 10.8%, while production of electricity, gas and water, increased 5.5%.

The service sector, evincing the strengthening of domestic demand, expanded 5% in the quarter, with emphasis on the performance of the financial intermediation segments, insurance, complementary social security segments and services alike, 15.2%, information services, 9.5%;commerce, 7.7%, transportation, storage and postal services, 3.7%.

The crop and livestock sector grew 2.4% in the first quarter of 2008; result associated to the performance of representative crops in the first quarter of the year, such as cotton, corn and soybeans. The increase of the sector during the year should

Table 1.13 – Gross Domestic Product

	2007				2008	% growth
	I Q	II Q	III Q	IV Q	I Q	Year[1/]
Crop and livestock	3.7	2.3	4.5	5.3	2.4	5.0
Industry	3.2	5.1	5.0	4.9	6.9	5.3
Mining	4.0	5.0	3.9	3.0	3.3	6.7
Manufacturing	3.1	5.3	5.5	5.1	7.3	4.7
Construction	2.3	4.3	4.6	5.0	8.8	6.9
Public utilities	3.8	4.9	4.5	5.0	5.5	5.1
Services	4.5	4.5	4.5	4.7	5.0	4.4
Commerce	6.1	7.1	7.2	7.6	7.7	7.1
Transportation	3.8	4.9	4.8	4.8	3.7	5.3
Communications	7.3	7.1	7.6	8.0	9.5	6.0
Financial institutions	9.3	9.4	10.7	13.0	15.2	9.8
Other services	3.5	2.9	2.5	2.3	2.6	2.4
Rents	4.5	4.2	3.9	3.5	2.1	1.9
Public administration	1.5	1.1	1.1	0.9	1.1	2.2
Value added at basic prices	4.0	4.4	4.6	4.8	5.5	4.7
Taxes on products	6.9	8.1	8.3	9.1	8.0	5.7
GDP at market prices	4.4	4.9	5.1	5.4	5.8	4.8

Source: IBGE

1/ Estimated.

become more intense while grain crops, with more positive perspectives for the year, are harvested.

The GDP expanded 0.7% in the first quarter of 2008, in relation to the fourth quarter of the previous year, according to seasonally adjusted data. GDP growth on the margin continued to evince the major upturn in domestic demand, reflected both on the significant acceleration of investments and on the maintenance of household consumption growth. The support pattern of the current cycle of expansion of the Brazilian economy continues, therefore, with positive characteristics of its maintenance, mostly impacted by the steady growth in real income and employment and by the performance of the farming sector.

The GDP growth on the margin reflected industrial expansion of 1.6%, and 1% in the service sector and a 3.5% decline in farm production. Regarding the demand components, one should highlight that, in the period, the FBCF's continued growth of 1.3%, while household and government consumption expanded, respectively, 0.3% and 4.5%. Exports declined 5.7% and imports, increased 0.8%, the tenth consecutive quarterly positive result, considering seasonally adjusted data.

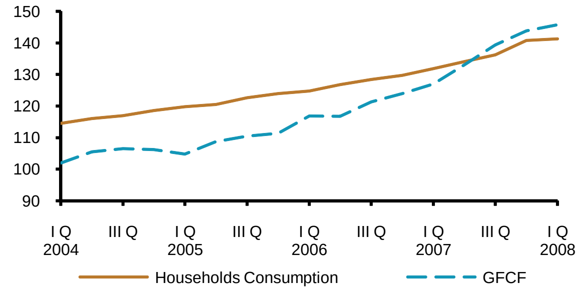
The forecast of 4.8% for the annual GDP growth, registered in the last "Inflation Report", was maintained, taking into account the economic performance in the first quarter of the year and its prospects, central in the recent increase of leading and coincident indicators, as regards the continuity of the Brazilian economy's expansion cycle during the year.

1.5 Investments

The consolidation of domestic demand as driving force of the expansion cycle of the Brazilian economy continues fundamentally associated to the strong investment performance, with positive effects on the productive capacity in the medium term. According to IBGE's Quarterly National Accounts, with the exception of stock variation, investments increased by 15.2% in the first quarter of 2008, in relation to the same period of 2007. This corresponded to the seventeenth consecutive expansion on this basis of comparison. The margin analysis continues to confirm the upturn in investment activity, which increased 1.3% in the period, as compared to the same period of 2007, considering seasonally adjusted data.

Figure 1.18 – Households Consumption and Gross Fixed Capital Formation[1/]

1995 = 100



Source: IBGE
1/ Seasonally adjusted data.

The strong growth in investments during the first quarter of the year had been anticipated by the trajectory of the GFCF monthly indicators. In this sense, the construction industry inputs increased 9.6% in relation to the first quarter of 2007, while production, imports, and exports of capital goods increased, in that order, 17.3%, 34% and 6.8% determining an increase of 23.5% in absorption of this product category.

The increased production of capital goods reflected a general expansion in the sector, with emphasis to the performance of goods designed to the farming sector, 53.8%; transportation equipment, 29%; goods targeted to the electric energy sector, 15.2%; and manufactured goods, 12.1%. It is worth mentioning that the upturn in activity in the segment associated to the farming sector should persist during the year, in line with forecasts of continued farming income recovery.

The recent performance of construction inputs production, as well as the production and import of capital goods, suggest steady strong investments. In this sense, these indicators, considering seasonally adjusted data, registered increases of 3.7%, 3.8% and 7% respectively, in the first quarter of the year, while exports decreased 1.7% on the same basis of comparison.

Disbursements from the National Bank of Economic and Social Development (BNDES) system totaled R$16.4 billion in the first quarter of 2008, a 45.4% increase over the same period of 2007. It should be highlight the increases in resources for the manufacturing industry, 50.7%, trade and services, 61.3%, and the farming sector, 14.9%, which represent, respectively, 45.5%; 46% and 7.8% of the total provided by the Bank.

1.6 Conclusion

The upturn in household consumption and, particularly, in investments, continues to demonstrate the importance of consolidating the process of strengthening the domestic demand for the continuous expansion cycle of the Brazilian economy. In this environment – in which both the country's economy has proved itself capable of facing the turmoil in the external financial markets, and risk rating agencies have confirmed the improved quality of domestic macroeconomic underpinnings – the conditions are in place to favor investment expansion at a level which guarantees, in the medium term, the balance between demand and supply of goods and services with no need for external accounts to suffer inappropriate pressures.

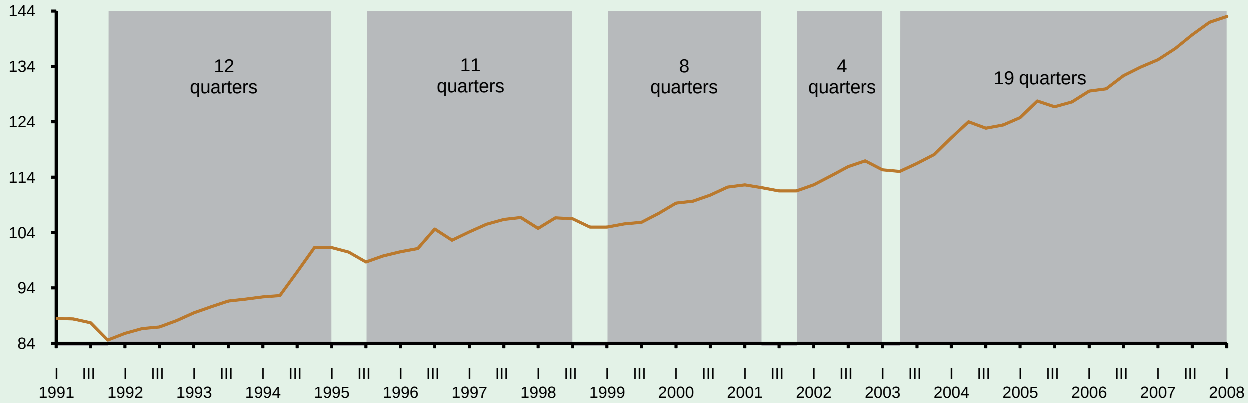
GDP growth remains, as a result of generalized expansions in its components, both from the viewpoints of production and demand. One should highlight, as in previous reports, that the prospects for expanding this cycle finds support in the optimism shown by consumers and entrepreneurs in diverse outlook surveys.

One should highlight that, in the medium term, growth in investments should be favored by the scenario of greater inflow of external resources, associated to the upgrading of the Brazilian economy to the investment grade. Meanwhile, the intensification of household consumption will continue to reflect, to a great extent, the qualitative and quantitative improvements in the labor market and in credit market conditions.

The Brazilian Economy – Growth Cycles and Constraints

The Brazilian Economy's current growth cycle, estimated by the Gross Domestic Product's (GDP) trajectory quarter series, released in the National Accounts of the Brazilian Institute of Geography and Statistics (IBGE), is the longest one since the beginning of the historical series, in 1991. Considering seasonally adjusted data, it is possible to indentify, as illustrated on Graph 1, five well characterized periods of the Brazilian economy expansion, initiated in the first quarter of 1992, in the fourth quarter of 1995, in the second quarter of 1999, and in the first quarter of 2002, and in the current cycle, initiated in the third quarter of 2003.[1]

Figure 1 – Evolution of GDP
1995 = 100 – Seasonally adjusted series



Besides being the longest, with 19 months up to the current moment, the current cycle registers cumulative GDP expansion of 24.3%, the highest rate amid the mentioned periods. Considering quarterly average rates, as illustrated on Table 1, GDP growth in the latest cycle increased by 1.2%, only lower than

1/ In this box, the interruption of an expansion cycle as of the occurrence of two consecutive redutions in the seasonally adjusted series of the quartertly GDP.

the average rate of 1.5% which marked the cycle following the introduction of the Real Plan.

In this context, this box aims to examine the constraints both to expansion and intensity of the current period of the Brazil's economic growth, with emphasis on strengthening the external accounts and the upturn in the activity level of domestic demand, especially referring to the investments trajectory.

Table 1 – Expansion cycles – Duration and growth rates

	Expansion periods				
	From III Q 1992 to I Q 1994	From IV Q 1995 to II Q 1998	From I Q 1999 to I Q 2001	From I Q 2002 to IV Q 2002	From III Q 2003
Number of quarters	12	11	8	4	19
Total growth (%)	19.7	8.1	7.3	4.9	24.3
Average growth (%)	1.5	0.7	0.9	1.2	1.2

Source: IBGE

The growth of external accounts, translating a sequence of five positive results in the balance of payments' current account, helped build a significant stock of international reserves and decrease in external liabilities, especially of the public sector, with effects on the perception, by external investors, of the risks involving the country's economy. In this environment, which enabled the adoption of macroeconomic policies appropriate to gains inherent to the stabilization process, enhanced the country's recognition, both by the markets and by risk classification agencies, resulting in adequate allocation of investments.

Improvements in fundamentals concerning the external accounts gain a more important feature when considering that, except for the expansion period ended in 2001, due to the rationing of electric energy, the other cycles were interrupted by shocks particularly associated to external vulnerability, as illustrated on Graph 2. In this sense, the end of the cycle initiated in the first quarter of 1992 was consequent upon the outbreak of the crisis in Mexico, from the outset of 1995, while the interruption of the growth period initiated at the end of 1995 mirrored the consecutive crises in Asia, in 1997, and in Russia, in the second half of 1998. The shortest expansion period, in 1992, reflected external financing difficulties linked to the crisis of the international investors´ confidence. This was partly associated to uncertainties prevailing during the presidential succession period.

During all these episodes, the dynamics of spreading the shocks mirrored the external sector´s vulnerability and demanded the prompt reaction of the monetary policy with the aim of adjusting the country's macroeconomic environment. In the period prior to the floating exchange rate, the shocks caused, at the

Figure 2 – International reserves and exchange rate

initial moment, high variations of the level of the reserves. After 1999, the impact started to initially occur on the foreign exchange rate, later causing inflationary pressures.

The prospects of continuity of the current expansion cycle are founded, however, on the greater soundness of the external accounts, as compared to the previous cycles.[2] In this sense, it should be pointed out, for example, that the participation of international reserves in the total external debt increased from 19.9%, in the beginning of 1999, to 93.2%, at the end of 2007, while the representativeness of the exchange-indexed debt in the total of the real estate debt decreased from 28.2%, also at the beginning of 1999, to 0.8%, at the beginning of 2008. Additionally, even in an external scenario of major financial markets, volatility the Brazil risk, measured by the Emerging Markets Bond Index Plus (Embi+), continued at a reduced level, while the two major risk- rating agencies raised the country's rating to investment grade.

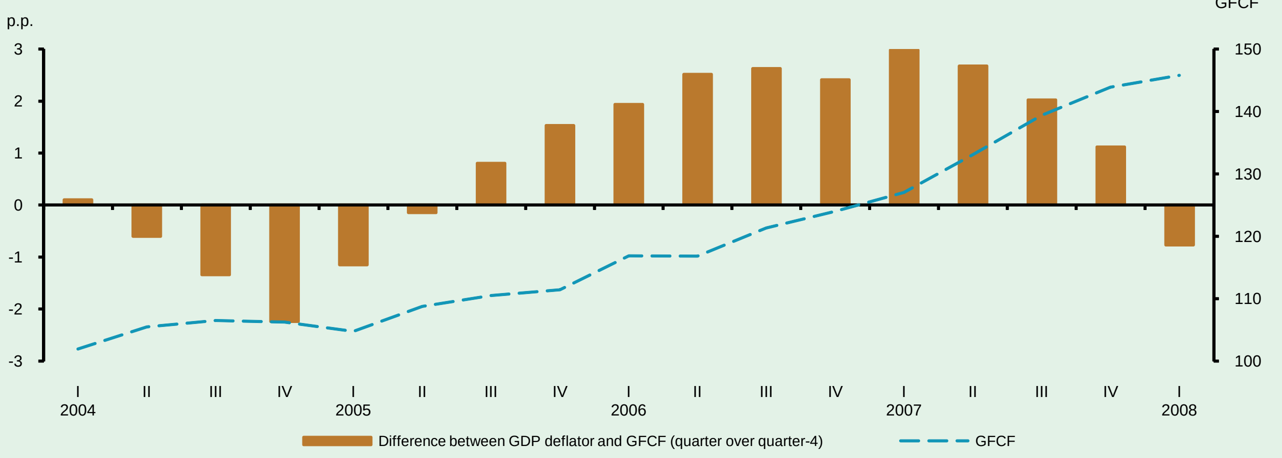
The evolution to investment level is an indicator of the soundness of the cycles of economic expansion. Although – excepting to the short-term cycle registered in the four quarters of 2002, when the investors' confidence still reflected the restriction imposed by the energy rationing, – in all the cycles considered there was an expansion of investments – currently, this process has proved to be sharper. In this sense, the Gross Formation of Fixed Capital (FBCF) accumulates expansion of 58.1% since the beginning of the current

2/ The recent evolution of the fundamentals related to the external sector of the Brazilian economy may be better understood after reading section 5.5 - External Sustainability Indicators, which is part of this Report.

cycle of economic growth, with emphasis both to the growth rates registered on the margin and to the recent increase of leading indicators, which equally suggest the maintenance of an upward trajectory of investments in the coming quarters.

Another incentive factor to the continued expansion in investments refers to the positive moment experienced by relative prices in this segment. According to Graph 3, from the third quarter of 2005 to the fourth quarter of 2007 the GDP deflator stood at a level higher than the FBCF deflator, despite the high demand for investments partly supplied by capital goods imports, in which case the expansion accumulated in the latest four years is twice as high as that of GDP.

Figure 3 – Gross Fixed Capital Formation and difference compared to GDP



This evolution, which has a favorable impact on the continuity of investments´ upward trajectory in the same period, becomes one of the elements in the consolidation of the domestic demand as a predominant factor in the maintenance of the current cycle of economic expansion, in parallel with the trajectories of credit, employment and real overall wages. However, in the opposite sense, it is associated to risks to the maintenance of the current economic growth pace, the downturn of the world´s economy, the increase in international prices of foodstuffs and other commodities, and its effects on domestic inflation and, finally, the impacts on inflation through the domestic demand performance.

Prices

2

The inflation, considering the behavior of consumer and wholesale price indices, continued to expand in the quarter ended in May. This movement, although mostly influenced by the pressures originated in the segment of foodstuffs, in line with a global process of increase in food prices (see box Food Inflation, pages 67 to 72), was also impacted by the performance of other economy prices, as confirmed by the behavior of the inflation cores and diffusion index. In this framework, the monetary policy is still targeted at preserving the gains derived from the process of economic stabilization.

2.1 General indices

Table 2.1 – General price indices

Monthly % change

	2008				
	Jan	Feb	Mar	Apr	May
IGP-DI	0.99	0.38	0.70	1.12	1.88
IPA	1.08	0.52	0.80	1.30	2.22
IPC-Br	0.97	0.00	0.45	0.72	0.87
INCC	0.38	0.40	0.66	0.87	2.02

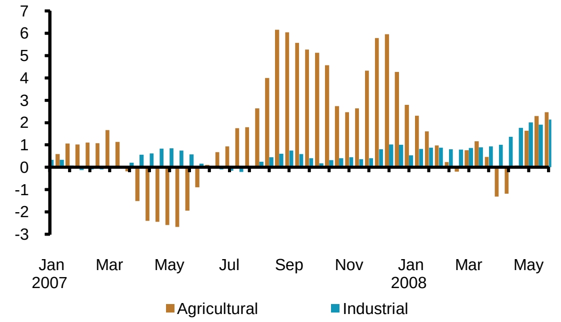
Source: FGV

The FGV General Price Index (IGP-DI) increased by 3.73% in the quarter ended in May, against 2.86% in the one ended in February, an upturn due to greater increase in both wholesale and consumer price indices.

Wholesale prices, measured by the Wholesale Prices Index (IPA-DI), with participation of 60% in the IGP-DI, increased by 4.38%, against 3.53% in the quarter ended in February, registering acceleration in industrial prices. The IPA-DI increase mirrored the upward movement in prices of industrial raw materials and the absence of seasonal cutbacks on farming prices, which increased by 3.02% in the quarter ended in May, against 5.73% in the one ended in February, following a cutback of 4.51% in the same period of 2007. The performance of this segment was a consequence of increments in the prices of rice, tomato, beef, milk, wheat, sugar cane and potatoes, offset, in part, by decreases in the prices of soybeans, orange, egg, cassava, beans, coffee and papaya.

Industrial prices increased by 4.9% in the quarter ended in May, against 2.7% in that ended in February. This was the highest quarterly rate registered since October 2004 and was consequent upon sharp increases in the prices of iron ore, fertilizers, milled rice, wheat flour, diesel oil and soybean oil.

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



Source: FGV

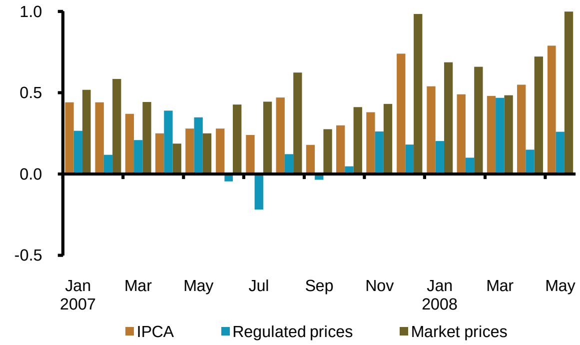
The performance of wholesale industrial prices evinced once again the impact of nonfood items in the inflation.

The Consumer Price Index – Brazil (IPC-Br) and the National Cost of Construction Index (INCC), with respective weights of 30% and 10% in the IGP-DI, showed variation of 2.05% and 3.59% in the quarter ended in May, against 1.69% and 1.37% in the quarter ended in February. The acceleration registered by the IPC-Br resulted in pressures associated to the foodstuffs, clothing and housing, while that related to INCC was due to pressures related to the components of services, labor force and materials.

The IGP-DI variation accumulated in twelve months reached 12.14% in May, against 7.89% in December 2007. In the same order, IPA-DI increased by 15.36% and 9.44%; the IPC-Br, 5.59% and 4.60%; and the INCC, 8.06% and 6.15%.

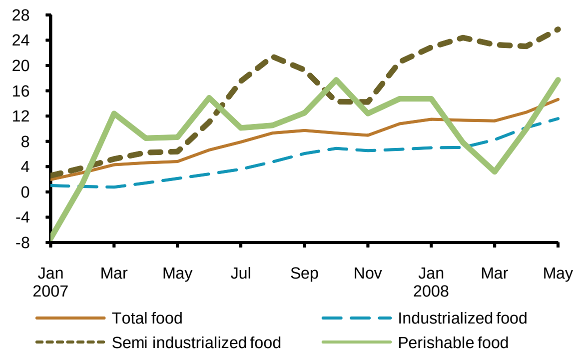
One should highlight that the 5.92 p.p. growth observed in the IPA-DI variation in twelve months was particularly associated to the growth in farming prices, which expanded by 33.65% in the twelve month period ended in May, the highest rate since July 2003. The evolution of prices in the wholesale segment represents growth of costs that will certainly affect consumer prices.

Figure 2.2 – IPCA
Monthly % change



Source: IBGE

Figure 2.3 – IPCA – Food
12-month % change



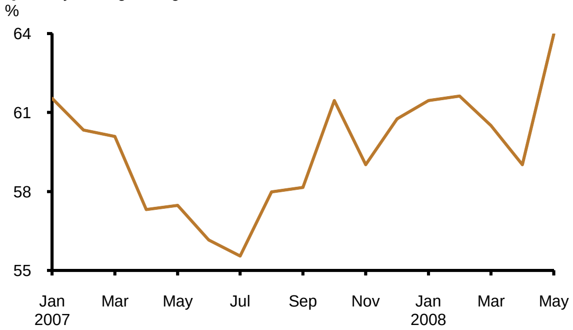
Source: IBGE

2.2 National Consumer Price Index

The accumulated IPCA increased 2.88% in the first five months of 2008, against 1.79% and 1.75%, respectively, in the same periods of 2007 and 2006. The indicator variation in 2008 mirrored growths of 3.62% in market prices and of 1.18% in regulated prices, against 2% and 1.34%, respectively, in the previous year.

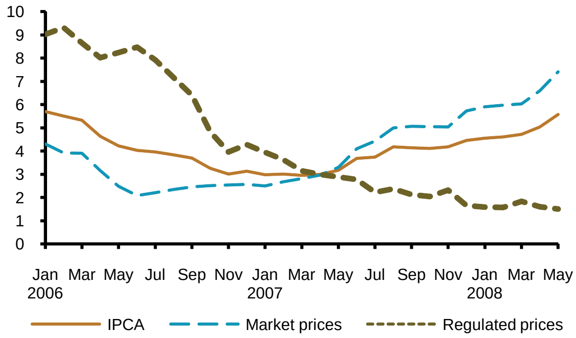
IPCA increased by 1.83% in the quarter ended in May, against 1.78% in that ended in February and 0.9% in the same period of 2007. This acceleration was registered even with the end of the seasonal pressure exercised by the item courses – which had not occurred, on this basis of comparison, since 2002. To a large extent, the performance of the IPCA is a consequence of increases in the prices of the foodstuffs, with emphasis on the segments of bakery, clothing and pharmaceuticals.

Figure 2.4 – IPCA
% of items with increase
Quarterly moving average



Source: IBGE

Figure 2.5 – IPCA
12 month % change



Source: IBGE

Table 2.2 – IPCA

% change

	Weights	2008					Year
		Jan	Feb	Mar	Apr	May	
IPCA	100.00	0.54	0.49	0.48	0.55	0.79	2.88
Market prices	70.03	0.69	0.66	0.48	0.72	1.02	3.62
Regulated prices	29.97	0.20	0.10	0.47	0.15	0.26	1.18
Main items							
Electricity	3.37	-0.53	0.14	1.40	-0.49	-0.60	-0.09
Water and sewage	1.61	0.00	0.00	1.43	0.41	0.23	2.08
Urban bus	3.77	1.19	0.49	0.06	0.10	0.31	2.16
Air ticket	0.28	0.12	0.31	0.36	0.31	2.26	3.39
Gasoline	4.31	-0.38	-1.42	0.76	-0.14	0.05	-1.14
Bottled cooking gas	1.13	0.29	-0.07	-0.21	-0.17	1.55	1.39
Medicine	2.87	0.15	0.39	0.14	1.18	0.97	2.86
Health plans	3.37	0.52	0.52	0.52	0.52	0.52	2.63

Source: IBGE

IPCA rates registered in the quarter ended in May 2008 and accumulated in the year reflected, mainly, the performance in the food and beverage segment, 4.18% against 1.17%, and clothing, 3.28% against 1.49%, offset, in part, by cutbacks registered in the transportation segment, 0.70% against 0.76%, and communication, 0.07% against 0.32%.

The diffusion index, that measures the number of items with positive variation in the IPCA, registered about 64% in the quarter ended in May, against 61.6% in that ended in February and 57.5% in 2007, highlighting the greater dissemination of price increases.

2.3 Government regulated prices

The 12-month accumulated variation of regulated prices, which has followed a declining trend since the second half of 2006 and has been registering levels lower than 3.00% since April 2007, reached 1.50% in May, the lowest percentage of the historical series.

The monitored prices increased by 0.88% in the quarter ended in May, accounting for 0.26 p.p. of the total variation of the IPCA in the period. The more accentuated variations occurred in the items diesel oil, 7.42%, air tickets, 2.95%; pharmaceuticals, 2.3%; and water and sewage tariffs, 2.08%. On the other hand, cutbacks were registered in the prices of the items intermunicipal bus, 1.35%, and public telephone, 0.31%.

The gasoline and diesel oil prices were readjusted, respectively, by 10% and 15% by Petrobras, since the first day of May. The increase in gasoline, fully offset by the Contribution on Intervention in the Economic Domain (Cide), will not have any effect on the consumer prices, while diesel readjustment will represent an increment of approximately 8%.

2.4 Inflation cores

The 12-month accumulated inflation core variations, repeating the trend initiated in the second half of 2007, showed acceleration during the quarter ended in May. The average variations accumulated in 12 months of the three core indicators calculated by the Central Bank increased by 4.66% in May, against 3.92% in December 2007.

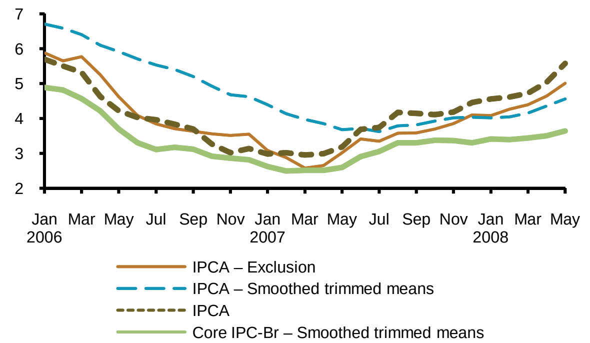
Table 2.3 – Consumer prices and core inflation

Monthly % change

	2008				
	Jan	Feb	Mar	Apr	May
IPCA	0.54	0.49	0.48	0.55	0.79
Exclusion	0.40	0.69	0.36	0.53	0.68
Trimmed means					
Smoothed	0.37	0.27	0.39	0.48	0.50
Non smoothed	0.41	0.36	0.41	0.41	0.55
IPC-Br	0.97	0.00	0.45	0.72	0.87
Core IPC-Br	0.36	0.15	0.31	0.38	0.44

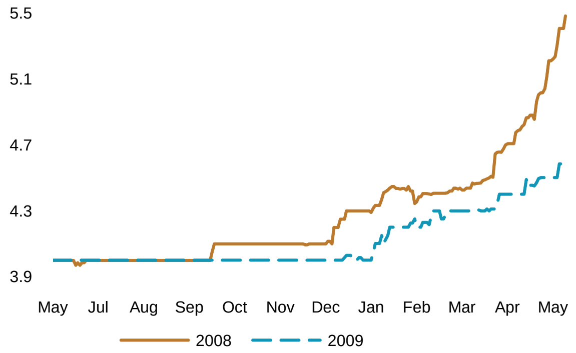
Sources: IBGE, Bacen and FGV

Figure 2.6 – Core inflation
12-month % change



Sources: IBGE, Bacen and FGV

Figure 2.7 – IPCA
Median



The core by excluding the regulated prices of goods and services and the prices of household food grew by 2.70% in the first five months of 2008, against 1.8% in the corresponding period of 2007. The indicator reached 1.58% in the quarter ended in May, against 1.7% in that ended in February, period of unfavorable seasonality, reflecting the impact of increase in school monthly tuition. The 12-month accumulated rate grew 5.03% in May, the highest level since April 2006.

The accumulated smoothed trimmed means increased by 1.38% in the quarter ended in May, against 1.05% in that ended in February, the most accentuated quarterly result registered since 2006. The variation accumulated in 12 months totaled 4.56% in May, against 4.05% in February, the highest rate observed since December 2006. The smoothed trimmed means quarterly variation reached 1.37% in May, against 1.23% in February, accumulating increments of 4.39% and 3.84% in twelve months.

The inflation core related to the FGV IPC-Br, calculated by trimmed means, increased by 1.13% in the quarter ended in May, against 0.76% in the quarter ended in February, the highest quarterly rate registered since July 2005.

2.5 Market expectations

The forecast for inflation expectations gathered by the Executive Investor Relations Groups (Gerin) increased since the end of the first quarter of the year. According to the Focus report, the median forecasts for the IPCA in 2008 rose from 4.50% to 5.50% (end of May). For 2009, the inflationary expectations also increased, from 4.30% to 4.60%, surpassing for the first time the center of the fixed target of 4.5%. The forecasts are in line with the 4.5% target with a tolerance margin of two points up or down established by the CMN.

The forecasts for twelve-month IPCA confirm the trend of deteriorating inflation expectations in the country. Over the last months, the expectations for the 12-month IPCA increased from 4.40% to 4.80% (last week of May).

The recent change in expectations for the variation of the general price index, stimulated by the performance of the prices of commodities, reinforced the perception of persistent inflationary pressures present on a global scale. For 2008, measures related to IGP-M and IPA-DI at the end of May increased 8.70% and 9.90%, respectively,

Figure 2.8 – IGP-M and IPA-DI

Median 2007

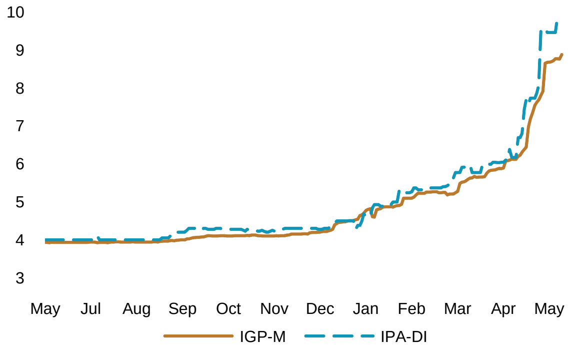


Figure 2.9 – Exchange rate

Median 2007

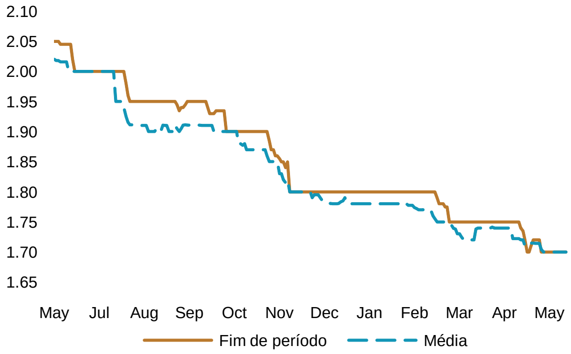


Table 2.4 – Summary of market expectations

	12.31.2007		3.31.2008		5.30.2008	
	2008	2009	2008	2009	2008	2009
IPCA	4.3	4.0	4.5	4.3	5.5	4.6
IGP-M	4.6	4.2	5.8	4.4	8.7	4.7
IPA-DI	4.5	4.0	5.8	4.4	9.9	5.0
Regulated Prices	3.7	4.0	3.5	4.0	3.7	4.5
Selic (end-of-period)	10.8	10.0	12.0	10.8	13.8	12.5
Selic (average)	11.2	10.2	11.7	10.8	12.5	12.8
Exchange rate (end-of-period	1.80	1.90	1.75	1.85	1.70	1.77
Exchange rate (average)	1.78	1.86	1.74	1.80	1.70	1.76
GDP growth	4.5	4.1	4.6	4.0	4.8	4.0

compared to the 5.80% forecast at the end of March for the two indices. For 2009, the medians of the market forecasts for IGP-M and for IPA-DI climbed from 4.40% to 4.70% and 5%, respectively.

The expectation for regulated prices, which represent almost one third of the IPCA composition, contributes to adjusting the future inflation expectation to lower levels. According to the Focus Report, the median of expectations forecasted a 3.70% correction for regulated prices in 2008 (at the end of May), compared to the previous forecast of 3.50% (end of March). For 2009, the readjusted forecast for regulated prices increased from 4 to 4.5%, in the same period.

Market forecasts for the foreign exchange rate maintained the expectations of continuity of a favorable scenario for the Brazilian external accounts. By considering both the average and the end-of-period rates, the medians for the foreign exchange rate in 2008 reached R$1.70/US$ (at the end of May), a higher decrease in comparison to the rates projected to the end of March, respectively, R$1,74/US$ and R$1,75/US$. In the same period, expectations for the average of foreign exchange rate projected for 2009 reduced from R$1.80/US$ to R$1.76/US$. Considering the end-of-period exchange rate, the cutback went from R$1.85/US$ to R$1.77/US$.

The revised forecast for the target of the Selic rate followed the trend of deteriorating inflation expectations. For the end of 2008, the market started to forecast a Selic of 13.75% p.y., considering the previous forecast (at the end of March) of 12% p.y. In addition, market forecasts a rate of 12.5% p.y. for the Selic at the end of 2009, against a previous forecast of 10.75 p.y (at the end of March).

Recently, the market revised its GDP growth forecast in 2008 from 4.6% to 4.8%, considering the medians registered in the end of March and May. However, the median of GDP forecast remained stable at 4% for 2009.

2.6 Conclusion

The acceleration of the inflation process initiated at the end of 2007 persisted during the first five months of 2008. This trend is a result of the continuous domestic demand upturn in activity in an environment of increasing credit volume and income gains by the labor force in a context of an external shock associated to increments in international prices of farm and metal commodities.

Credit, monetary and fiscal policies

3

3.1 Credit

The financial system credit operations continued registering significant expansion in the quarter ended in May, consistent with the upturn in domestic demand activity. Credit increase was conditioned by positive performances both with nonearmarked portfolio and with channeled resources, in a context of default stability and expansion – in the individual person segment – of medium-term operations. The demand for banking resources in this segment, however, a result of favorable conditions in the labor market, showed a relative margin downturn highlighting the decrease in the personal credit modality. Hirings by companies, however, continue in line with an upturn in economic activity, registering expansions, especially in loans backed by domestic resources. This activity upturn may also mirror a financial re-intermediation process, while the, capital market has shown to be a less effective borrowing source, than it was in 2007.

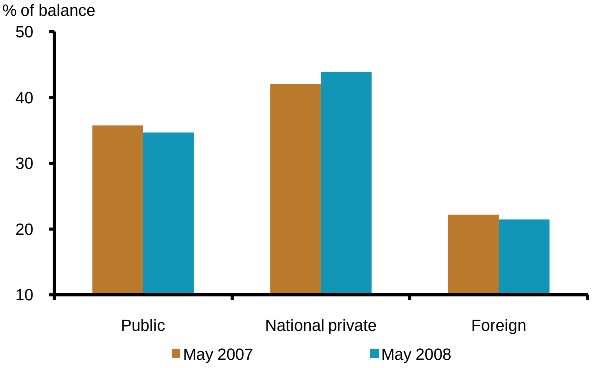
Table 3.1 – Credit operations

R$ billion

Itemization	2008				% growth	
	Feb	Mar	Apr	May	3 months	12 months
Total	959.5	993.1	1018.1	1044.4	8.8	32.4
Nonearmarked	680.1	705.7	725.7	746.5	9.8	36.1
Earmarked	279.4	287.4	292.4	297.9	6.6	24.0
% participation:						
Total/ GDP	35.0	35.9	36.2	36.5		
Nonearmarked/GDP	24.8	25.5	25.8	26.1		
Earmarked/GDP	10.2	10.4	10.4	10.4		

The nonearmarked and directed credit totaled R$1.044 billion in May, expending 8.8% in the quarter and 32.4% in twelve months. The relation between the total volume of credit and GDP reached 36.5%, against 35% in February and 31.9% in May 2007.

Figure 3.1 – Credit by capital control of financial institutions



Regarding the segmented credit supply by financing institutions´ capital holding, the operations granted by private national banks, boosted by increases in the segments of individual persons, industry and other services, reached R$457.9 billion in May, rising 8.6% in relation to February and corresponding to 43.8% of the financial system's total portfolio. Loans carried out by foreign banks, 21.5% of the financial system's total, increased by 6.4% in the period. One should highlight credit channeled to individuals, industry and commerce segments, while the stock of credit granted by public institutions, with emphasis on loans directed to industry, individuals and other services, grew by 10.7%, totaling R$362 billion.

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

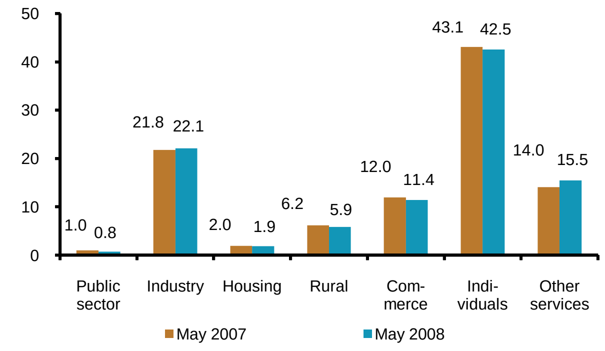


Figure 3.3 – Credit by borrower's economic activity – Public institutions

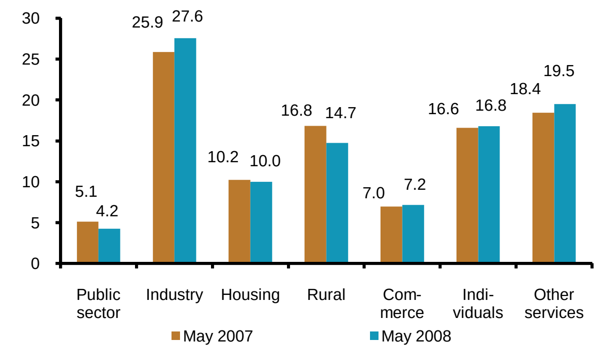


Figure 3.4 – Credit by borrower's economic activity – Foreign institutions

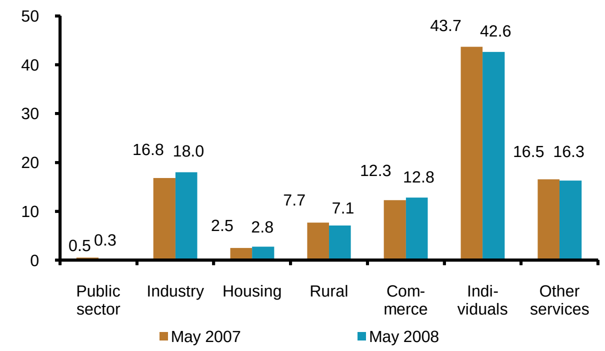
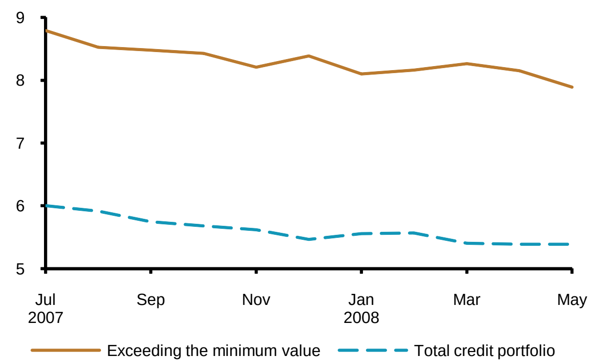


Figure 3.5 – Provisions of total financial system credit %



The financial system's loans to the private sector, considering the operations with nonearmarked and directed resources, reached R$1.025 billion in the quarter ended in May, with increase of 8.9% as compared to February. Individual portfolio grew by 7.5%, totaling R$351.3 billion, with emphasis on the modalities personal credit and vehicles leasing, while credit to industry, boosted by granting to the petrochemical, metallurgy and farming sectors, increased by 10.3% reaching R$241.3 billion. Credits directed to the services segment increased by 12.5% in the quarter, totaling R$178.1 billion. The most important were operations with credit card administration, communications and transportation sectors. Loans directed to the trade sector increased by 8.1%, totaling R$106.9 billion, with special mention to the activities related to farming, vehicles and department stores.

The balance of operations directed to the public sector reached R$19.6 billion in May, 4% higher than in February. The federal government's banking debt, mirroring the financing for the energy sector, increased 11.4%, reaching R$3.9 billion. The resources contracted by states and municipalities, concentrated on operations benefiting the basic sanitation sector with resources from the Employment Compensation Fund (FGTS), totaling R$15.7 billion, with an increase of 2.3% in the period.

The total provisions carried out by the financial system reached R$56.3 billion in May, with increase of 5.3% in the quarter, corresponding to 5.4% of the entire credit portfolio, against 5.6% in February. The default rate of the financial system, considering payment in arrears for over ninety days, closed at 3.1%, against 3.2% in February.

Credit operations with earmarked resources

Loans granted with earmarked resources totaled R$297.9 billion in May, increases of 6.6% in the quarter and 24% in twelve months. Credits granted by BNDES represent 57.9% of the segment's total, summing up R$172.5 billion, a 6.5% increase, as compared to February, results of expansion in directly granted operation, 6.3%, and transfers by financial institutions, 6.7%. Housing and rural credit registered respective increases of 7.9% and 6.3%, as compared to February.

Disbursements carried out by the BNDES totaled R$25.9 billion in the four–month period ended in April, growing 74.6% in the corresponding period of 2007. Loans

Table 3.2 – Earmarked credit operations

R$ billion

	2008				% growth	
	Feb	Mar	Apr	May	3 months	12 months
Total	279.4	287.4	292.4	297.9	6.6	24.0
BNDES	162.0	167.5	170.0	172.5	6.5	24.6
Direct	78.0	81.1	82.1	82.9	6.3	21.9
Onlendings	84.0	86.4	87.9	89.6	6.7	27.3
Rural	65.4	66.6	68.0	69.6	6.3	21.9
Banks and agencies	61.9	62.9	64.1	65.5	5.8	20.6
Credit unions	3.5	3.7	3.9	4.0	14.3	47.1
Housing	44.6	45.8	46.9	48.1	7.9	26.5
Others	7.4	7.5	7.6	7.7	4.5	14.1

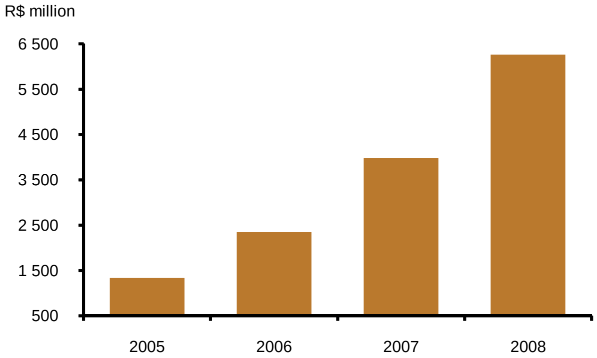
Table 3.3 – BNDES disbursements

R$ million

Itemization	Jan-apr		% growth
	2007	2008	
Total	14 845	25 922	74.6
Industry	7 054	12 363	75.3
Mining	628	818	30.3
Food products	1 114	3 398	205.0
Motor vehicles	602	2 122	252.5
Petroleum and alcohol refining	470	755	60.6
Electrical machines and apparatuses	241	344	42.7
Commerce/Services	6 297	11 792	87.3
Overland transportation	2 627	3 620	37.8
Electricity and gas	1 003	3 334	232.4
Construction	417	902	116.3
Crop and livestock	1 493	1 766	18.3

Source: BNDES

Figure 3.6 – Credit to housing with resources from saving deposits – Jan-Apr



contracted by the trade and services segments summed up R$11.8 billion, an 87.3% growth, basically conditioned by increased credit granting to the sectors of energy and land transportation. Operations directed to industries grew 75.3%, reaching R$12.4 billion, with emphasis on the sectors of automotive vehicles and foodstuffs, while the ones directed to farming summed up R$1.8 billion, an increment of 18.3% in the period.

Requests submitted to the BNDES, which represent potential demands for medium and long term investments, totaled R$58.7 billion in the first four months, 59.6% higher than that registered in the same period of 2007. This evolution was fundamentally conditioned to the growth of 75.9% in the requests from the trade and services segments, representing an upturn in activity in the sectors of electricity, construction industry and trade, totaling R$34.2 billion. Requests from the industrial sector expanded 44.1%, totaling R$22.7 billion, with emphasis to the sectors of foodstuffs, metallurgy and vehicles.

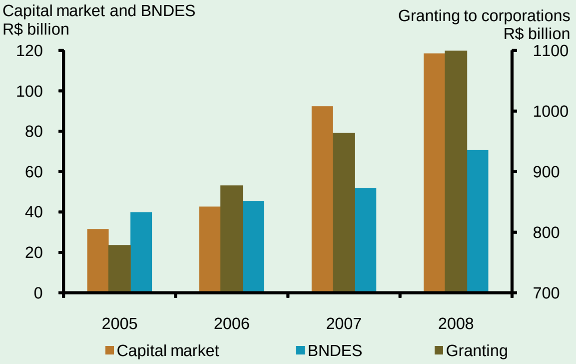
The rural credit portfolio totaled R$69.6 billion in May, expanding 6.3% in relation to February, highlighting mandatory resources investments and fund transfers and public program operations. The resources contracted for current expenditures, the most representative mode, grew 6.7% in the period, while the ones related to investments and trading rose 3.6% and 10.8%, respectively.

The credit balances directed to housing, including individuals and housing cooperatives, topped R$48.1 billion in May, rising 7.9% in relation to February and 26.5% in 12 months, with emphasis to FGTS resources and utilization of savings accounts. New disbursements with savings account resources totaled R$3.9 billion in the quarter ended in April, rising 41.5% in relation to the same period of the previous year, a result of 36% increase in financing under the Housing Financing System (SFH) regulation, which accounted for 80.4% of the direct credit granting to the sector, and 291% in those agreed upon with market interest rates. The total number of housing credit loans grew by 56.8%, in the period.

Nonearmarked Corporate Credit – Recent Evolution

The demand for corporate credit was intensive in 2007 and in the early months of 2008, a performance justified by the diverse liquidity instruments available on the market. The upturn in credit activity, expressed in the growth of operations related to capital market, to the National Bank of Economic and Social Development (BNDES) system and to the banking credit with nonearmarked resources, mirrored, mainly, the effects of the Brazilian economy's growth cycle on the economic agents' expectations, stimulating consumers´ income commitment and entrepreneurs´ decisions on investment expansion.

Figure 1 – Sources of financing to corporations
Cumulative 12-month amounts trough April of each year



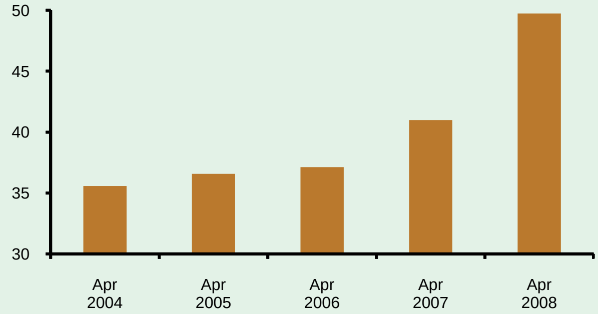
Increased demand for nonearmarked resources by the corporate segment translates the upward trend in economic activity, sustained by strengthened domestic demand, intensified since 2006. In this scenario, investment spending started to significantly increase, in response to both increased level of installed capacity utilization and to favorable conditions, in spending terms, of industrial base enhancement. In 2007, investments had a 13,4% annual increase, while consumption grew 6.5%.

Financing with nonearmarked resources contracted by the corporate sector has grown significantly, reaching a level higher than that of individuals. Considering operations with domestic resources and those backed by foreign currencies, credit value channeled to companies totaled R$378.6 billion in April this year, a 35.7% increase, as compared to the same period in 2007 and corresponding to 52.2% of the total portfolio with nonearmarked resources. In the same period, credits targeted to individuals increased by 34.1%, totaling R$347 billion.

The upturn in activity registered in the corporate segment had been impacted by the performance

Figure 2 – Nonearmarked credit – Balances
12-month growth (%)

Figure 3 – Working capital – Participation in the balances of corporations (reference credit, domestic resources)
%



of working capital credits, which reached R$117.4 billion in April 2008, an annual increase of 66.7%. This modality of operations started representing 49.7% of the total domestic credit benchmark portfolio, against 41% in April 2007. The accumulated granting increased 55.4% in the year, totaling R$63.1 billion, corresponding to 22% of corporate credits with domestic resources, against 14.3% in April 2007. One should highlight that the participation of the operations with fluctuating charges, of lower cost to borrowers, represented 55.8% of the total balance of working capital credits.

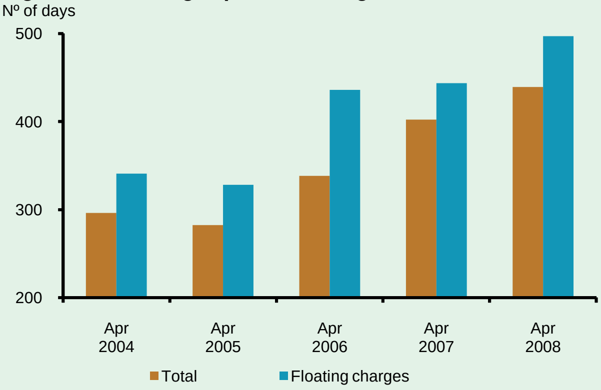
Working capital operations, usually designed to attend to cash-flow requirements, create a modality of credit quite attractive to companies, taking into account its reduced financial cost, operational flexibility and, more recently, the possibility of contracting with long-term maturities. In fact, in January 2008, the average term of these operations reached the highest level of 487 days, mirroring the intensification of contracting with debt terms higher than five years.[1]

Considering fixed interest rate operations, the interest rate average of working capital operations dropped from 38.8% per year (p.y), in August 2005, to 30.1% p.y, in April t 2008, while the average rate related to operations with floating interest rates dropped from 28% p.y to 19.5% p.y, during the same period. This aspect becomes more relevant when is observed that operations directed to the corporate segment are carried out, mainly, with financial charges and reduced spreads, basically represented by interest rates based on the rate related to interbank deposits.

Additionally, it is worth highlighting the increasing use of banking credit as bridge loans, a modality designed to supply resources in advance to capital market issuances and to merge and acquisition processes. Initially these credits finance those operations, being later replaced by the issuance of bonds in the capital market. The banking credit with nonearmarked resources fulfills, thereby, a complementary function in the process of the capital market's corporate financing.

1/ Statistics referring to the average-term are concerned to the portfolio total balance and not to new granting. Because of this aspect, data released took long to reflect the expansion of the debt terms observed in recent contracts.

Figure 4 – Working capital – Average terms



Significant working capital credit increase has also mirrored the increasing participation of operations with micro, small and medium-size companies in the credit operation of the main financial institutions. Based on data from the balance sheets of the country's four main banks, credit for these borrowers, including working capital and other modalities, such as receivables and BNDES transfers, topped R$106.6 billion in the first quarter of 2008, registering an increase of 48% in twelve months. Credit supply increase for this business segment is associated to strategies of financial institutions aiming at expanding their position in this market segment through the introduction of credit products adapted to the specific profile of these customers. This stance has been favoring the pace toward meeting a stronger demand for resources by these companies, taking into account the upturn of industrial activity and of trade sales.

One should also highlight the performance of the corporate leasing operations, in which case the balance totaled R$42.1 billion in April 2008, an 87.6% hike in the period of twelve months. This result highlights the growing importance of this credit instrument to make feasible potential productive investments, allowing, especially, the expansion of the vehicle fleets and acquisition of machines and equipment, and informatics equipment.

Nonearmarked credits

Table 3.4 – Nonearmarked credit operations

R$ billion

Itemization	2008				% growth	
	Feb	Mar	Apr	May	3 months	12 months
Total	680.1	705.7	725.7	746.5	9.8	36.1
Corporations	349.8	367.7	379.0	391.4	11.9	39.8
Reference credit[1/]	291.7	305.3	312.7	323.9	11.0	40.2
Domestic funding	220.6	226.9	236.2	247.6	12.3	43.2
External funding	71.1	78.4	76.5	76.2	7.1	31.2
Leasing[2/]	37.8	39.8	42.4	43.6	15.3	86.9
Rural[2/]	2.0	2.0	2.1	2.1	9.3	8.8
Others[2/]	18.3	20.6	21.9	21.7	19.0	-7.8
Individuals	330.4	338.0	346.7	355.2	7.5	32.1
Reference credit[1/]	250.0	253.6	258.1	261.9	4.7	21.6
Credit unions	13.2	13.5	13.8	14.0	6.5	30.3
Leasing	33.8	36.3	38.9	42.4	25.5	128.6
Others	33.4	34.6	35.9	36.9	10.4	53.3

1/ Interest rate reference credit, defined according to Circular n. 2,957 dated 12.30.1999.
2/ Operations backed by domestic resources.

Credit granted with nonearmarked resources topped R$746.5 billion in May, increasing 9.8% in relation to February and 36.1% in twelve months. Participation of these credits in the financial system total stock reached 71.5% in May, against 70.9% in February.

Corporate credit operations totaled R$391.4 billion in May, expanding 11.9% in the quarter and 39.8% in twelve months, notwithstanding some increase in the funding costs of the financial institutions. From this total, R$323.9 billion is referred to reference credit operations, representing 82.8% of credit for these borrowers, with respective growths of 11% and 40.2%, on the same basis of comparison.

The reference credit operations performance translated financing backed both in domestic and external resources, totaling R$247.6 billion and R$76.2 billion, respectively, in May, rising, in the order, 12.3% and 7.1%, in the quarter, and 43.2% and 31.2% in twelve months. The expansion of operations linked to domestic resources was conditioned to the upturn in working capital operations, which grew 18.5% and 77.6%, on the same basis of comparison. The most intensive demand in this modality has mirrored, especially, the increase of major companies contracting involving high-volume and longer-term operations, at least partially in replacement to the credit market operations, as well as the growth related to the micro and small business segment.

Loans backed by foreign resources increased 7.1% in the quarter and 31.2% in twelve months. The quarterly growth was associated to the rise of 24.7% in the balance of the segment financing to imports and others, which reached R$16.4 billion, while foreign transfers remained stable. One should highlight that this portfolio had a significant growth in March, 15.8%, translating the significant contracting volume which preceded the end of the Financial Operations Tax (IOF) exemption.

The stock of leasing operations reached R$43.6 billion in May, with rises of 15.3% in relation to February and 86.9% in twelve months, with emphasis on operations related to the segments of vehicles, machinery and equipment. It is worth mentioning that IOF exemption on leasing operations has turning into an additional incentive to these types of loans.

The stock of individual credit topped R$355.2 billion in May, with increases of 7.5% in relation to February and 32.1% in twelve months, highlighting that the portfolios of personal credit and vehicle financing corresponded altogether 76.1% of the total reference credit in this segment.

Personal credit stock grew by 6.9% in the quarter and 26.6% in twelve months, totaling R$115 billion. Payroll-deducted loans, accounting for this portfolio's most significant share, turned in a quarterly increase of 6.7%, indicating the somewhat sharp expansion of credit lines focused on income tax and Christmas bonus anticipation. Vehicle purchase financing registered a 1% growth in the quarter and 20.6% in twelve months, totaling R$84.3 billion.

Leasing operations totaled R$42.4 billion in May, increasing 25.5% as compared to February and 128% in twelve months. These operations, showing their enhanced appeal over vehicle financing as major activity, continues its accelerated expansion trend, representing 11.9% of the credit stock in the segment of individual persons, against 6.9% in the corresponding period of 2007.

The average interest rate of reference credit operations topped 37.6% p.y in May, registering an increase of 0.2 p.p. as compared to February and 0.4 p.p. in twelve months. The average cost of loans closed at 47.4% p.y in the segment of individuals, decreasing, in the order, 1.6 p.p. in the quarter and 1 p.p. in twelve months, while in the corporate segment the average rate reached 26.9% p.y., increasing 2.1% p.p. in the quarter and 2.6 p.p. in twelve months.

The growth in interest rates during the first months of the year, especially in the corporate segment, mirrored both the fiscal operations associated to the IOF and the anticipation of the characteristic effects due to the Social Contribution on Net Corporate Profits (CSLL) rate alterations. In particular, foreign resources transfer operations suffered downturns relatively to other modalities, consequent upon IOF exemption stoppage since March. The interest rate hike in the corporate segment was additionally impacted by increased funding costs associated to the behavior of interest rates in the market.

The banking *spread* closed at 24.5 p.p. in May, registering decreases of 1.5 p.p. both in relation to February and to twelve months. This result translated the occurrence of respective cutbacks of 3.4 p.p. and 4 p.p. in the individual segment and respective expansions of 0.4 p.p. and 1.7 p.p. in the corporate segment, with the *spread* reaching, respectively, 33.5 p.p. and 14.5 p.p.

Figure 3.7 – Interest rates on nonearmarked credit

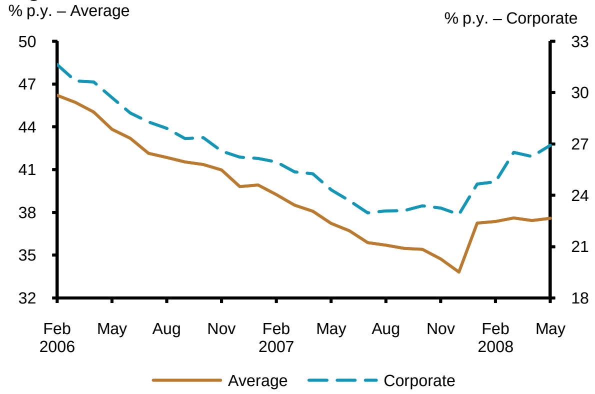


Figure 3.8 – Interest rates on fixed rate credit – Individuals

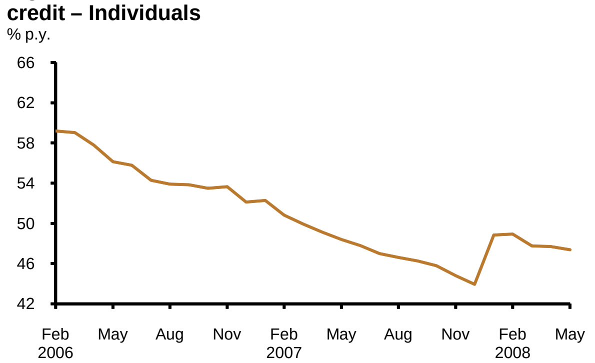
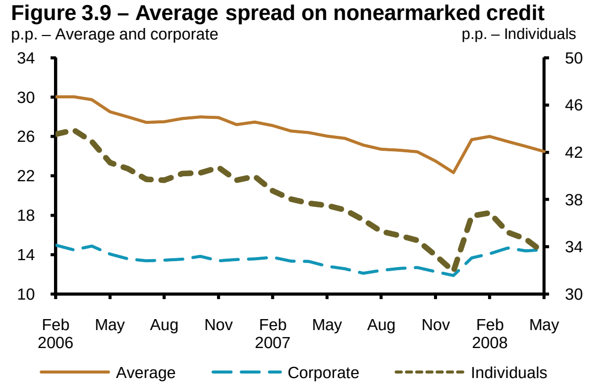


Figure 3.9 – Average spread on nonearmarked credit



Credit Operations for Vehicle Acquisitions – Recent Developments

Table 1 – Credit for the purchase of vehicles

R$ billion[1/]

Itemization	2005	2006	2007	2008	% change 12 months	% change 36 months
Total	46.7	65.6	85.7	123.1	43.7	163.6
Financing	41.0	55.2	68.3	84.2	23.3	105.4
Leasing	5.7	10.4	17.4	38.9	123.6	582.5

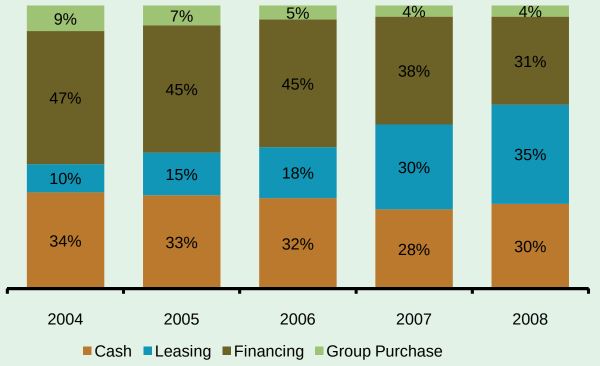
1/ Balances refer to the month of April.

In April the volume of credit channelled to acquisition of vehicles, including the modality of direct credit to consumer (CDC) and that by leasing companies, increased, 43.7% in twelve months and 163.6% in three years, reaching R$123.1 billion. This development, illustrated on Table 1, mirrored the improved conditions in the labor market, expressed in growth of formalization and of overall wages, and favorable conditions experienced by credit borrowers. In this sense, the average term of corporate credit for vehicle acquisition, excluding operations by leasing companies, reached 589 days in April 2008, against 472 days in the same month of 2005, while the average interest rate of this portfolio fell 7.2 percentage points (p.p.), in the same period, to 29.8%

The relative participation of the credit modalities intended for vehicle acquisition has changed in the latest years. The leasing companies operations, after the institutional improvements related to the recognition of the legality of installment payment within the Guaranteed Residual Value (GRV), in 2003, have shown a major upturn in activity, with a 123.6% increase in twelve months and 582.5% in the latest three years, compared to increases of 23.3% and 105.4% in the CDC type. Transforming into figures, the participation of leasing operations in the overall balance of credit for vehicle acquisition moved from 12.2%, in April 2005, to 31.6%, in April 2008.

The trend path of credits contracted with leasing companies changed significantly in the composition of disbursements for vehicle acquisition, according to Graph 1. According to the National Association of Automakers Financing Companies (ANEF), operations related to leasing were responsible, in the

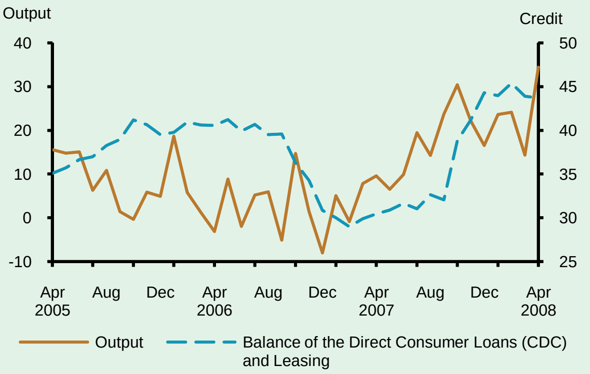
Figure 1 – Vehicle acquilition – Payment modalities[1/]



1/ The 2008 data refer to the 1st quater.

Figure 2 – Vehicles – Output and credit

12-month variation (%)

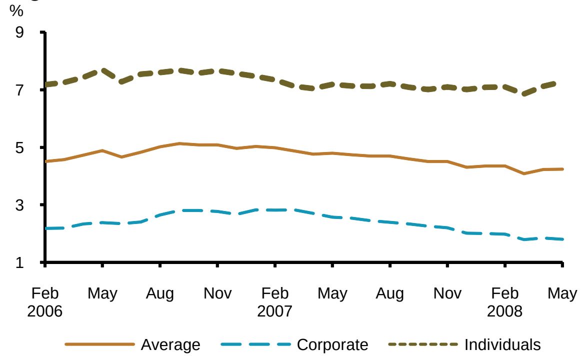


first quarter of 2008, for 35% of the new operations targeted to vehicle purchases, while the part related to the CDC modality corresponded to 31% of the total, against 10% and 47%, 2004. The major preference for leasing operations, observed in the latest years, were additionally stimulated by increasing of the Financial Operations Tax (IOF) on the direct financing to the consumer, since last January.

The increase in production and sales indicators of the automotive industry reflects, in a significant way, the upward trend of credit in this segment. This effect, illustrated on Graph 2, is enlarged while more favorable financing conditions foster a displacement of the demand in the automotive market, with increased search for vehicles, especially in the segment of used vehicles. As a result, the automotive market has registered consecutive records in production and sales reaching 300.6 thousand and 295 thousand units, respectively. The 12-month cumulative production summed up 3.2 million units in April. This represented 19.9% more than the total of the corresponding months in the previous year.

One should highlight that the upturn in activity of the automotive sector, even with the intensification of investments in the sector, has required increasing levels of installed capacity utilization. In this sense, the Installed Capacity Utilization Level (Nuci) index corresponding to the segment of transportation materials, which includes vehicle makers and the industries of automobile parts, reached 92.5% in May, against 86% in May 2007, while the indicator related to the Manufacturing Industry grew 1.2 p.p., to 85.6% in the period, highlighting the emergence of limits to the additional expansion of domestic supply – which has been supplemented by imports.

Figure 3.10 – Credit default rates[1/]



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

Figure 3.11 – Average term for credit operations – Calendar day

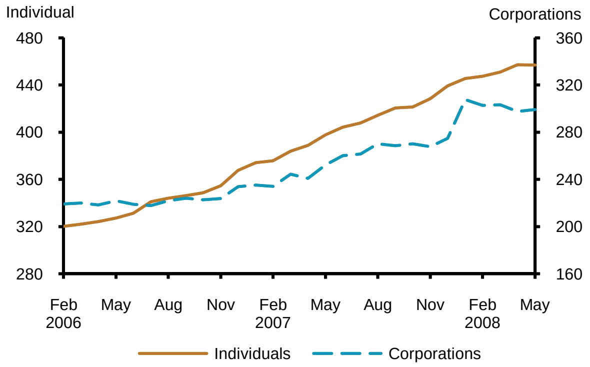
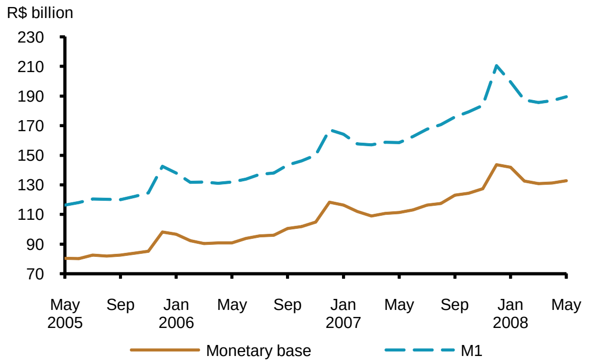


Figure 3.12 – Monetary base and M1 – Average daily balances



Default in the reference credit segment, considering operations in arrears for more than ninety days, increased by 4.2% in May, decreasing 0.2 p.p. in the quarter and 0.6 p.p. in twelve months. Delays concerning individual operations registered growth of 0.2 p.p. in the quarter and 0.1 p.p. in twelve months, while the ones registered in the context of corporate operations showed respective decreases of 0.2 p.p. and 0.8 p.p., totaling, in the order, 7.3% and 1.8%. One should highlight that the environment of accelerated credit expansion, considering the high volume of new contracts, favors the cutback in participation of delayed payment operations in the total portfolio.

The average term of the reference credit portfolio reached 370 days in May, showing stability in the quarter and growth of 48 days as compared to the same period in the last year. The indicator reached 299 days in the corporate segment and 457 in that related to individuals, registering respective annual increases of 47 days and 59 days, while in the quarter the average term related to corporate entities dropped 4 days and the one associated to individuals rose 10 days. The average related to individual portfolio corresponds to the highest in the series initiated in June 2000, a result attributed, mostly, to the growing participation of payroll-deducted loan and of vehicle financing operations.

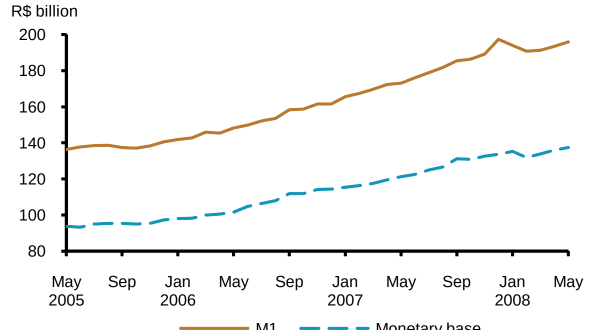
3.2 Monetary aggregates

The daily average balance of money supply (M1) topped R$187.7 billion in May, growing 0.4% in the month and 18.4% in twelve months, period in which the average balance of currency outside banks and demand deposits increased, respectively, 18.5% and 18.3%.

Considering seasonally adjusted IPCA deflated data, the M1 rose 2.7% in the quarter ended in May, in relation to the one ended in February, accumulating expansion of 13.2% in twelve months. The aggregate increase continues to be associated to domestic demand performance and, especially, to the expansion of credit operations.

The average daily balance of the monetary base reached R$132.7 billion in May, with increases of 0.1% in the quarter and 19.2% in twelve months, period of increases of 19.8% in the average balance of the currency issued and 18% in the one related to observed banking reserves.

Figure 3.13 – M1 and monetary base at May 2008 prices seasonally adjusted[1/]



1/ Deflated by: IPCA.

Figure 3.14 – Broad money supply 12-month growth

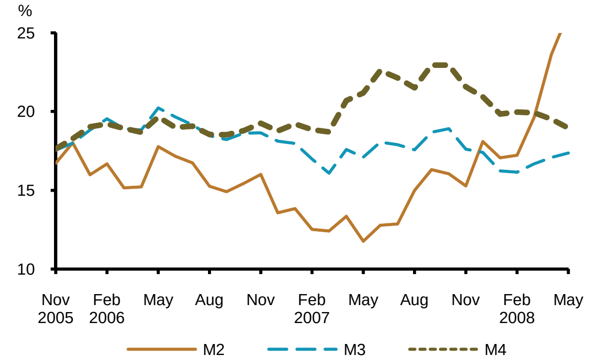
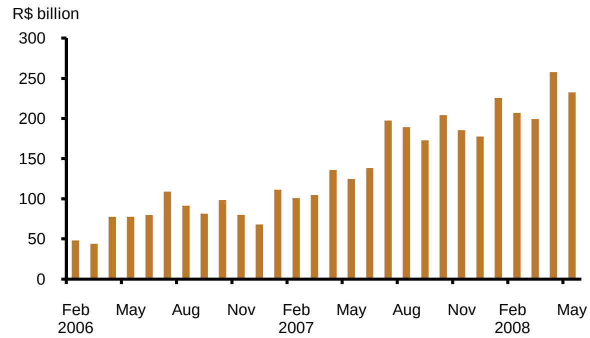


Figure 3.15 – Net financing position of the federal public securities – Daily average



Considering the end-of-period position, the monetary base expanded R$6.8 billion in the quarter ended in May. This result translated both expansionist impacts derived from net redemptions of R$20.4 billion of National Treasury's stocks, net purchases of R$12.9 billion currencies from the foreign exchange real state market by the Central Bank, and adjustments of R$1.4 billion in operations with derivatives, and from the contractive pressures resulting from the turnover of the National Treasury's single account, R$23.9 billion, as well as from inflows referring to additional requirements on deposits, R$3.9 billion.

The money supply in the M2 concept, which aggregated to M1 the investment deposits, savings and private deposits, totaled R$838.1 billion in May, increasing 10.5% in relation to February and 26.2% in twelve months. One should note that quarterly net inflows of R$69.9 billion registered by time deposits, contributing to the private stock balance expansion from R$330.6 billion, in February, to R$405.1 billion. Savings accounts deposits, which turned in net inflows of R$332.9 million in the quarter, representing 6.7% of the ones observed in the same period of the previous year totaled R$245 billion in May.

The M3 balance, a concept which aggregates to the M2 the investment funds share and repo operations backed in federal securities between the community and the financial sector, expanded 4.8% in the quarter ended in May, against the one ended in February, closing at R$1.7 trillion. Aside from the M2growth, This result translated an increase of R$19 million in repo operations and decrease of 2.4% in the investment fund quota balance, which totaled R$806.4 billion. The balance of M4, the largest concept of monetary aggregates, rose by 4.9% in the quarter and 19% in twelve months, reaching R$2 trillion.

Federal public securities and Central Bank open market operations

The National Treasury's (TN) primary operations with federal securities caused a expansionist monetary impact of R$16.3 billion in the quarter ended in May, result of placement of R$81.2 billion, maturities of R$94.5 billion and purchases and advanced redemptions of R$3 billion. Swap operations reached R$22.5 billion and were concentrated on the National Treasury Notes – series B (NTN-B), with participation of 36%.

Figure 3.16 – Central Bank repo operations – Maturity – End of period

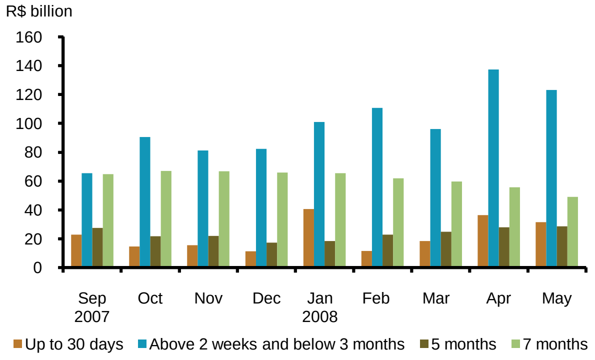
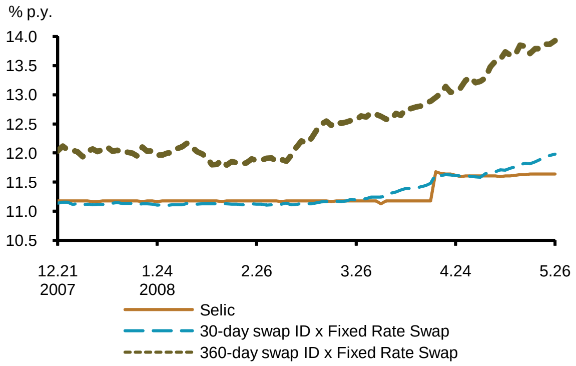


Figure 3.17 – Interest rate



Source: BM&F

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

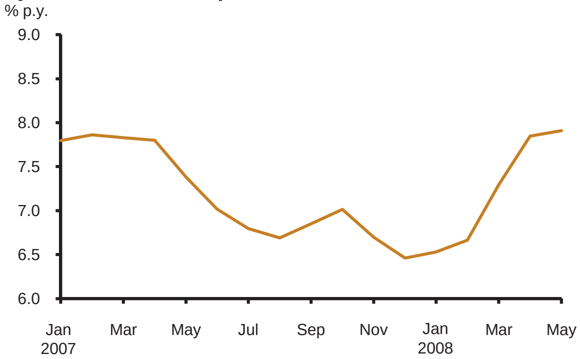


Figure 3.19 – Ibovespa

Source: Bovespa

Financing and *go around* operations carried out by the Central Bank, aiming at the adjustment of liquidity conditions, summed up an average daily balance of R$31.4 billion in May, against R$11.5 billion in February. The balance of operations with two-week to three-month terms and five-month-term increased, in the order, from R$110.7 billion and R$22.8 billion, in February, to R$123.3 billion and R$28.7 billion, respectively, in May. In the opposite sense, the balances of seven-month term operations dropped from R$61.9 billion, in February, to R$50 billion. The net open market financing position expanded from R$206.8 billion, in February, to R$232.3 billion, in May.

Real interest rates and market expectations

The future interest rate curves of the *ID x fixed rate Swap* contracts for May 30 showed increase in all vertices, in relation to the end of February, consistent with expectations related to the monetary policy management and to the growth in inflation rates. The *ID x fixed rate Swap* contract of 360 days rose 183 base points (b.p.), reaching 13.75% p.y., the highest rate since October 2006. At the same time, the country risk showed an average of 241 points in the quarter ended in May, against 238 points in that quarter ended in February.

The real *ex-ante* Selic interest rate for the coming months, calculated on the basis of the May 30 Market Survey Report, released by the Central Bank, topped 8% p.y., against 6.7% p.y at the end of February. This trend mirrored increased expectations for the twelve-month Selic rate, from 11.25% p.y., and IPCA, from 4.3% p.y. to 5.01 p.y.

Capital market

The sharp upturn of the São Paulo Stock Exchange Index (Ibovespa), registered in the quarter ended in May, translated the international financial markets volatility, largely a consequence of expansion movements followed by profit taking. The market instability, in the quarter, gave way to a tendency of significant profits, favored by greater participation of foreign investments with consequences both to the fall in USA interest rates and wariness to risk in the financial market, and to the Brazilian sovereign *rating* revision to investment grade category. In this environment, after a cutback of 6,728 points between the end of February and Mach 19, when it closed at 58.827 points, the Ibovespa resumed its upward movement, showing successive records,

Figure 3.20 – Stock exchanges
April 2007 = 100

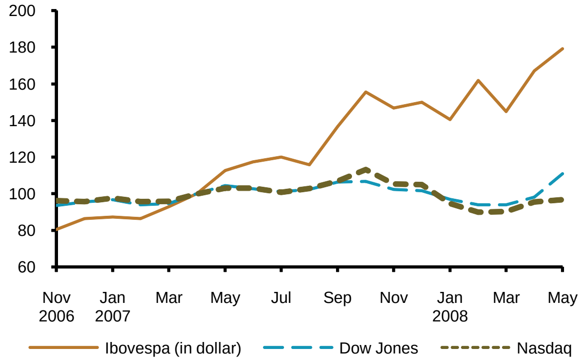
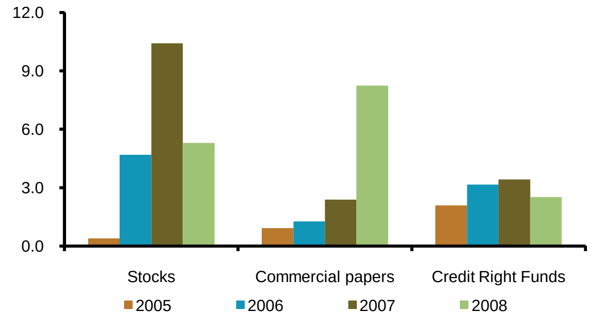


Figure 3.21 – Debenture primary issues in the capital market
R$ billion – Accumulated through May

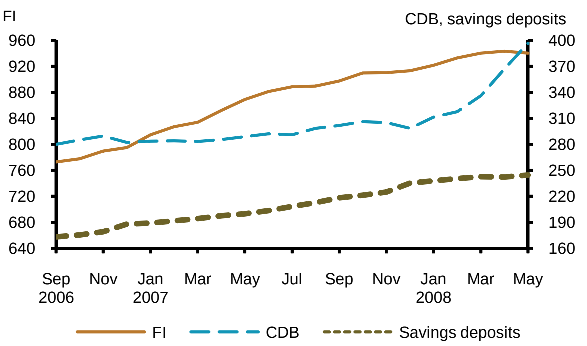
Source: CVM

Figure 3.22 – Primary issues in the capital market
R$ billion – Accumulated through May



Source: CVM

Figure 3.23 – CDB, FI[1/] and savings deposits
R$ billion



1/ Excludes investment funds in stocks and external debt.

with a maximum of 73.516 points in May 20. The indice reached 72,592 points at the end of May, rising 10.7% as compared to the one registered at the end of February, while daily average transactions at Bovespa totaled R$6.2 billion in the quarter ended in May, against R$6.1 billion in that ended in February, and R$4.8 billion throughout 2007.

Viewed in dollar terms, the Ibovespa turned in a quarterly increase of 14.4% in May, evincing the combined effects of indice growth in reais and foreign exchange amortization. The Dow Jones and NASDAQ indices increased by 3% and by 11.6% respectively, in the period, returning to the level of January 2008.

Corporate financing in the capital market, through issues of stocks, debentures, promissory notes and the collocation of credit right receivables, reached R$49.2 billion in the first five months of 2008, of which R$32.6 billion represented by debenture issuance. One should highlight that the sharp expansion in utilization of this funding instrument, observed in the first two months, was not confirmed in the following months, indicating cutback in its appeal due to impacts in both alterations in the levying on mandatory deposits, on leasing companies´ interfinancial deposits and of growing funding costs, in line with growth in future interests. One should highlight that the primary stock issues totaled R$5.3 billion, against R$10.4 billion in the first five months of 2007.

Financial investments

The balance of investment funds, time deposits and saving accounts totaled R$1.7 trillion in May, indicating expansions of 5.1%, in relation to February, and 19.1% in a twelve-month period.

The net worth of investment funds, taking into account foreign exchange, short term, fixed income, multimarket and indexed funds, increased 2.1% in the quarter, totaling R$1 trillion. Net redemptions totaled R$10.6 billion, registering net redemptions of R$13 billion of multimarket funds and net inflows of R$3.8 billion in short-term funds.

The consolidated portfolio of investment funds did not show significant changes in the quarter. Participations of federal securities, private securities and repo operations, major components of these funds assets, closed at 51.4%, 18.4% and 23.8%, respectively; it should be stressed that the participation of the inflation-indexed bonds in federal securities rose 4 p.p., to 71.8%, while those related to fixed rate bonds fell 4 p.p., to 28.1% of the total portfolio.

Figure 3.24 – Public securities in investment funds – Portfolio by indexer

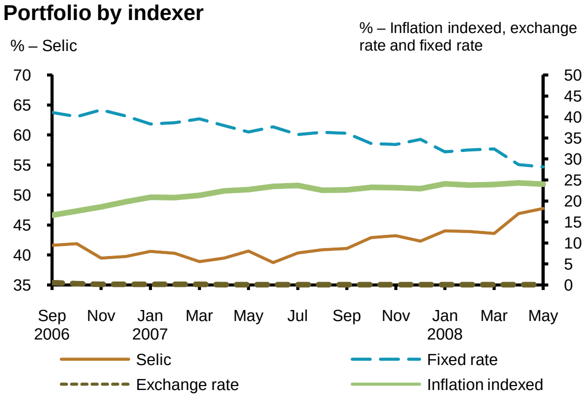
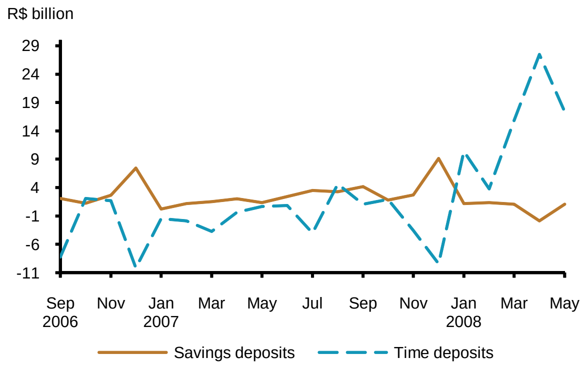


Figure 3.25 – Net inflow – Savings deposits and time deposits



Net worth of extramarket investment fund, which manages resources owned by the entities from the indirect federal administration, totaled R$28.5 billion at the end of May, registering net redemptions of R$144.5 million in the quarter.

Variable income funds totaled R$181.1 billion in the period, increasing 9.7% in relation to February and 66.4% in twelve months. Mutual Privatization Funds (FMP-FGTS) and Mutual Privatization Funds – Free Portfolio (FMP-FGTS-CL) net worth, totaled, taken together, R$20 billion, while those related to stock funds, highlighting the Ibovespa performance, in particular after the Brazilian sovereign debt risk rating to investment grade, reached R$161.1, billion, showing quarterly expansions of 10.1% and 9.6%, respectively.

The savings accounts balance grew by 1.7% in the quarter ended in May, reaching R$244.4 billion. Withdrawals were higher than new deposits by R$333 million, mirroring the negative net inflow of R$1.8 billion. Time deposits totaled R$396.5 billion, with increases of 24.9% in the quarter and 37.3% in twelve months, an evolution mostly associated to the increase of funding costs in the foreign market and to the loss in issuance of debentures, in response to the institution of reserve requirements over the leasing companies' interfinancial deposits.

3.3 Fiscal policy

The budgetary and financial programming and the monthly schedule of the Executive Branch disbursements became effective in April, with the publishing of Decree nº 6,439. In the same month, the Budget and Management Department sent to the National Congress a report with new forecasts for revenue and expenditures in 2008, resulting in growth of R$3 billion in the central government primary surplus target, to R$62.4 billion, in order to maintain it at 2.2% of the GDP.

In a second report sent to the National Congress, in May, revenues, including constitutional transfers, expanded by R$18.3 billion for the National Treasury and R$2.1 billion for Social Security, while the planned expenditures for the fiscal year increased R$13.4 billion, to R$529.9 billion. With reference to the National Treasury´s revenue increase, R$4.4 billion will be transferred to states and municipalities, by virtue of constitutional provisions, and R$7.5 billion will be absorbed by civil servants' wage readjustments and R$4.3 billion will be channeled to increase the allocation of discretionary spending.

In line with the productive development policy, announced by the federal government in May, alterations were introduced in the legislation aiming at the tax and financial unburdening of investments and exports. In this sense, the Provisional Measure nº 428 and the Decree nº 6,453, both dated December 5, 2008, provide:

a) reduction, from 24 to 12 months, of the Social Integration Program (PIS)/Contribution to Social Security Financing (Cofins) utilization period in the purchase of capital goods;
b) extension of the coverage of the Tax System for Incentive to Port Structure Modernization and Expansion (Reporto);
c) extension of the Special Capital Goods Acquisition System for Exporting Companies (Recap);
d) exemption of IOF levying on credit operations carried out by the BNDES;
e) extension of payment period of the Industrialized Products Tax (IPI) by the automotive sector;
f) double cutback of the Corporate Income Tax (IRPJ) and CSLL assessment base of expenditures with own staff training carried out by software corporations.
g) suspension of the IPI, PIS and Cofins levying on parts and materials directed to the construction of new ships, by national shipbuilding companies.
h) Accelerated amortization for the automotive sector with permission wherefore the amortization tax usually admitted be multiplied by four.

The stringent fiscal impact of these measures, in the period from 2008 to 2011, was estimated at R$21.4 billion, which R$3.6 billion in 2008; R$7.9 billion in 2009; R$6 billion in 2010; and R$3.9 billion in 2011.

Public sector borrowing requirements

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

	2006		2007		2008	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central government	-28.5	-3.9	-33.3	-4.1	-48.7	-5.4
Sub-national governments	-8.0	-1.1	-13.4	-1.7	-12.4	-1.4
State companies	-3.9	-0.5	-4.0	-0.5	-0.6	-0.1
Total	-40.4	-5.6	-50.7	-6.3	-61.7	-6.8

The nonfinancial public sector primary surplus reached R$61.7 billion in the first four months, 6.82% of the GDP, with GDP increase of 0.51 p.p. in the same period of 2007, registering GDP growth of 1.24 p.p. in Central Government surplus and respective drops in the GDP of 0.29 p.p. and 0.43 p.p. in the regional government and stated owned companies results.

The Central Government net revenues totaled R$192 billion in the first four months, a 21.2% of the GDP, a growth of 16.6% as compared to the same period of 2007, when they represented

Figure 3.26 – National Treasury gross revenue

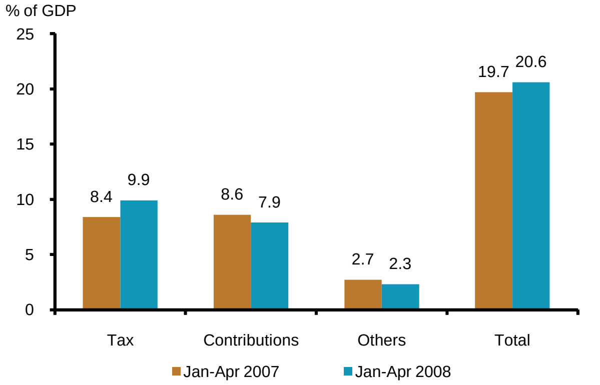


Table 3.6 – National Treasury Expenditures

Jan-Apr

Itemization	2007		2008	
	R$ million	% GDP	R$ million	% GDP
Total	109 073	13.5	124 765	13.5
Transfers to states				
and municipalities	33 246	4.1	41 902	4.1
Personnel and payroll charges	37 656	4.7	40 184	4.7
Capital and current expenditures	38 010	4.7	42 431	4.7
Workers Support Fund	3 930	0.5	4 852	0.5
Subsidies and economic				
subventions	1 606	0.2	1 652	0.2
Loas/RMV	4 206	0.5	4 994	0.5
Investment	4 693	0.6	5 374	0.6
Other capital expenditures	23 575	2.9	25 559	2.9
National Treasury transfers				
to the Central Bank	161	0.0	248	0.0

Source: Minifaz/STN

Figure 3.27 – Federal Government: investment expenditures paid

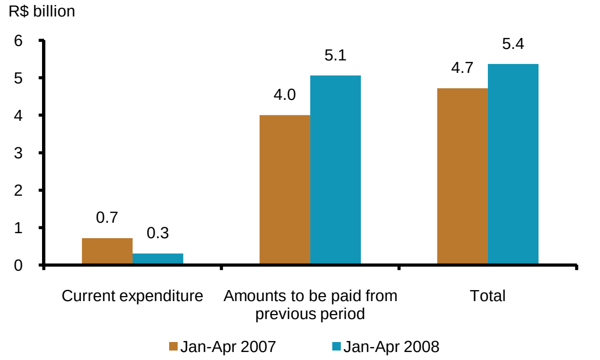
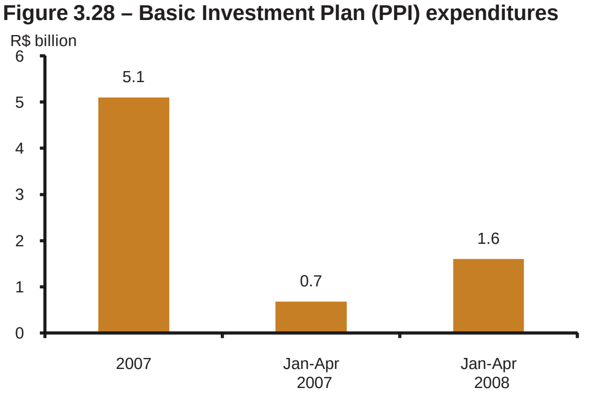


Figure 3.28 – Basic Investment Plan (PPI) expenditures



20.5% of the GDP. Growth in revenues was largely associated to the economic upturn and to administrative measures carried out by the Federal Revenue Secretariat and by the General Prosecutor of the National Treasury with the aim of recovering debts in arrears with regard to the maintenance of a regular flow of tax collection and contributions for which the Federal Government is liable.

Taxes which turned in more significant inflow increases in the period were IOF, 158.2%, indicating growth in rates since January 2008; the Import Tax(II), 32.8%, effect of increases of 44.2% in the value of imports in dollar terms and of 8.4% in the tax effective average rate; and the Income Tax (IR), 28.4%, a result consistent with the environment of overall earnings expansion of companies and workers.

Additionally, inflows linked to the CSLL increased 28.2% in the first four months, indicating inflow expansion based on corporate earnings, while Cofins translated the pace of economic activity, and the atypical tax collection event of R$512 million, arising out of legal deposits, grew by 20.5%. One should also highlight the increases of R$2.2 billion collection related to credit granting and R$2.3 billion related to financial compensation for participation quotas of petroleum royalties.

The Central Government expenditures represented 15.9% of the GDP in the first four months of 2008. The drop of 0.46 p.p. of the GDP, compared to the same period of the previous year, mirrored expenditure cutbacks both with regard to the National Treasury and to Social Security.

In the framework of the National Treasury expenditures, disbursements with payment of personnel and social charges topped R$40.2 billion in the first four months, falling 0.25 p.p. of GDP in comparison to the same period of the previous year.

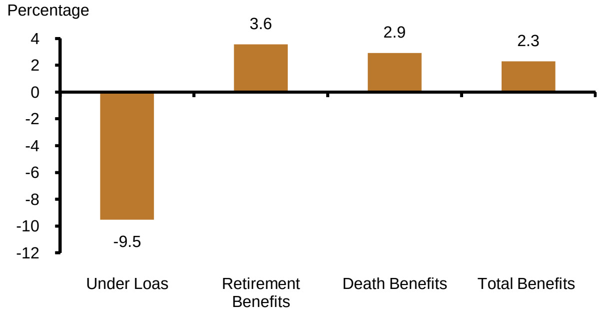
Additionally, the current and capital expenditures decreased by 0.04 p.p. of the GDP, despite the spending growth related to the Worker Support Fund (FAT) and to the Social Assistance Law (Loas)/Lifetime Monthly Income (RMV). It should be highlighted that FAT spending growth, to cover the unemployment insurance and the salary bonuses disbursements, was linked to the real minimum wage value and formal employment increases. Expenditures with subsidies and grants fell 0.02 p.p. of the GDP, in line with lower outlays with the Farm Activity Support Program, Price Support and the Federal Government Acquisitions Program, whereas the ones considered under the heading

Table 3.7 – Social security primary result
January-April

R$ billion

Itemization	2007	2008	Var. %
Gross inflow	45.6	53.9	18.2
Cash refunds	0.1	0.1	0.0
Transfers to third parties	4.4	5.9	34.1
Net inflow	41.1	47.9	16.5
Social Security benefits	55.1	60.4	9.6
Primary Result	-14.0	-12.5	-10.7
Net inflow/GDP	5.11%	5.29%	
Social Security benefits/GDP	6.86%	6.68%	
Primary Result/GDP	-1.75%	-1.38%	

Figure 3.29 – Growth in the number of benefits issued by Social Security (Jan-Apr 2008 average/Jan-Apr 2007 average)



Source: STN

Figure 3.30 – Transfers to states and municipalities

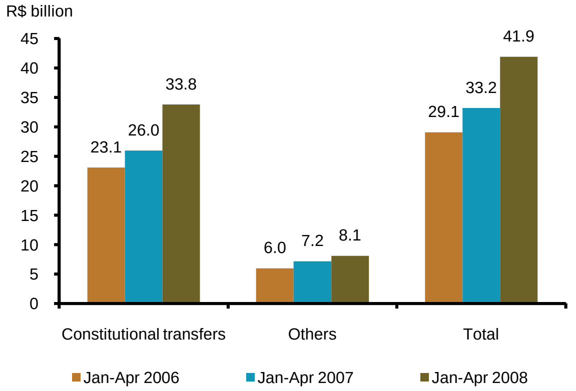
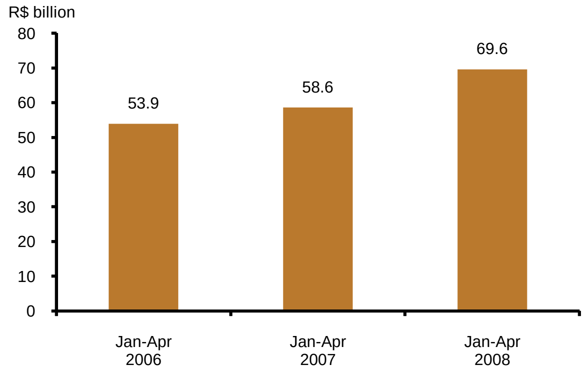


Figure 3.31 – ICMS inflow



other current and capital expenditures decreased 0.1 p.p. of GDP. The investment expenditures, included in this item, increased by 14.9%, while the ones included in the Pilot Investment Project grew by 141%.

The Social Security deficit reached R$12.5 billion in the first four months of 2008, falling 0.37 p.p. of GDP in relation to the corresponding period of the previous year. The net inflow showed growth of 16.6% in the first four months of the year, closing at R$47.9 billion and repesenting 5.29% of the GDP, against 5.11% of the GDP in the first four months of 2007. This behavior mirrored the continued impact of the overall wage spending process on payroll-related contribution.

Expenditures with social security benefits increased by 9.6%, reaching R$60.4 billion. As a GDP proportion, these expenditures decreased from 6.86%, in the four first months of 2007, to 6.68%, with emphasis on the drop in the health assistance component.

The constitutional transfers to states and municipalities totaled R$41.9 billion, growing 26.1% during period and representing 4.63% of the GDP, against 4.14% in the first four months of 2007. Growth in these transfers mirrored the shared taxes performance and the funds transfer originating in the working of petroleum and natural gas.

Inflow linked to the Tax on the Circulation of Merchandise and Services (ICMS), the most representative tax at state level, grew by 18.8% in the four months, impelled by performances registered in the Northeast region, 19.2%m and Southeast, 18.8%. The occurrence of surplus decrease in regional level, even in a scenario of expanding transfers and ICMS collection, which are responsible, taken altogether, for about 90% of states and municipalities collection, mirrors the strong growth in expenditures, which, considering available data for the first two months of the year, related to the states of São Paulo, Minas Gerais, Rio de Janeiro and Rio Grande do Sul, increased 18.9% in comparison to the first two months of 2007.

The states and municipalities' surplus, accumulated in twelve months, expressed as proportion of GDP, after showing growth trend in 2007, when decreased from 1.04% in April, to 1.2%, in August, showed, in recent months, a reversal of this trend, by reaching 1.09% in April 2008.

Apropriated nominal interests by the consolidated public sector in the first four months of 2008, considering the accrual basis, totaled R$54.9 billion, 6.06% of the GDP, against 6.36% of GDP in the corresponding period of 2007,

Figure 3.32 – Regional governments: primary surplus and tax inflow
Cumulative 12-month results

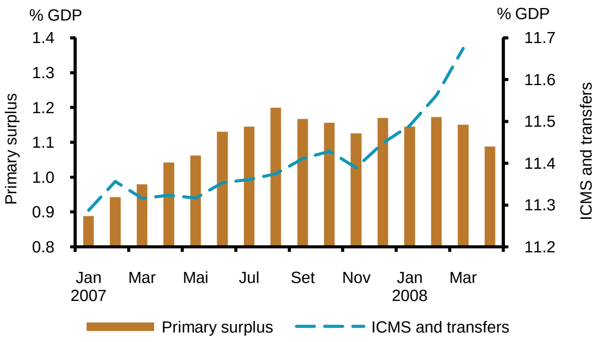


Figure 3.33 – SP, RJ, MG and RS primary expenditures
January-February

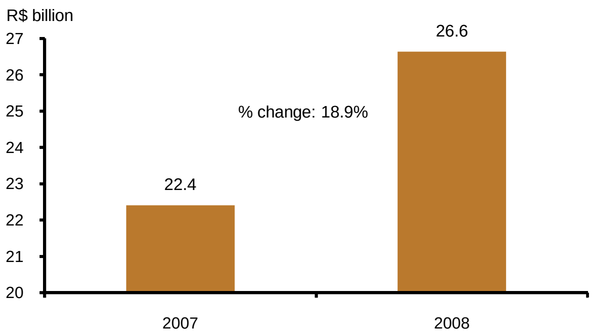
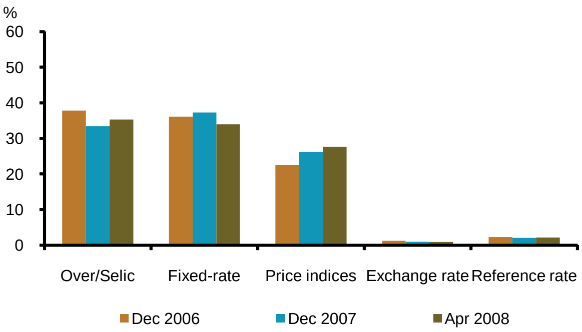


Table 3.8 – Public sector borrowing requirements – January-April

Itemization	2007		2008	
	R$ billion	% GDP	R$ billion	% GDP
Uses	0.4	0.1	-6.9	-0.8
Primary	-50.7	-6.3	-61.7	-6.8
Interest	51.1	6.4	54.9	6.1
Sources	0.4	0.1	-6.9	-0.8
Domestic financing	94.1	11.7	27.6	3.1
Securities financing	114.2	14.2	75.0	8.3
Bank financing	-13.9	-1.7	-25.6	-2.8
Others	-6.2	-0.8	-21.8	-2.4
External financing	-93.7	-11.7	-34.5	-3.8

Figure 3.34 – Federal securities debt structure by indexing factor1/



1/ It does not include swap.

a result consistent with the 0.49 p.p. cutback registered in the accumulated Selic rate of the respective periods.

The public sector borrowing requirements, in the nominal concept, registered surplus of R$6.9 billion from January to April, the first positive result observed in the corresponding period since the beginning of the historic series, in 1991, registering cutbacks in net external financing, R$34.5 billion; in net banking debt, R$25.6 billion, and in other domestic borrowing sources, R$21.8 billion, and, in the opposite sense, expansion of R$75 billion in securities debt.

Federal Securities Debt

The federal securities debt evinced by the portfolio position, reached R$1,218.7 billion in April, 43.3% of GDP, decreased 0.9 p.p. of GDP, compared to January. The quarterly growth translated contractive impacts related to the occurrence of net redemption of R$20.6 billion in the primary market, the financial effect of R$0.5 billion related to the 4.2% foreign exchange growth registered in the period and the nominal interest incorporation of R$35.8 billion.

The participation, in the total of federal securities debt, of securities linked to over/Selic rate and to price indices topped 29.4% and 23%, respectively, in April, registering increases, in order, of 0.2 p.p. and 0.1 p.p. in relation to January, while, on the other hand, the prefixed stocks representation, translated net redemptions of R$27.4 billion in the National Treasury Bills (LTN), fell 1.1 p.p., to 28.3% in the period. The participation of stocks linked to foreign exchange remained unaltered, at 0.8%.

In April, the schedule of the security debt amortization on market, except financing operations, registered the following distribution: R$183.2 billion, 15% of the total, with maturity in 2008, R$269.7 billion, 22.1% in 2009; and R$765.9 billion, 62.8%, since January 2010. One should highlight the continuity of the average term increase of federal security debt, which increased from 37.6 months, in January, to 39.3 months, in April 2008.

The foreign exchange *swap* operations reached negative R$37.4 billion in April. Considering the cash basis, the result of these operations, defined as the difference between the Interfinancial Deposit (DI) liability and the exchange variation plus coupon, was unfavorable to the Central Bank by R$2 billion, from February to April 2008. The accumulated result since 2002, when these operations initiated, was negative to the Central Bank by R$2.5 billion.

Table 3.9 – Repo operations – Open market

Balances and percentage share

R$ million

		Up to 1 month		More than 1 month		Total	
		Balance	%	Balance	%	Balance	%
2003	Dec	43 742	78.5	11 975	21.5	55 717	100
2004	Mar	47 718	72.1	18 440	27.9	66 158	100
	Jun	46 509	58.8	32 578	41.2	79 088	100
	Sep	34 839	47.0	39 250	53.0	74 089	100
	Dec	7 797	16.5	39 410	83.5	47 207	100
2005	Mar	5 239	11.5	40 506	88.5	45 744	100
	Jun	4 099	12.3	29 165	87.7	33 264	100
	Sep	-6 857	-16.4	48 591	116.4	41 734	100
	Dec	-24 430	-106.9	47 286	206.9	22 856	100
2006	Mar	-8 399	-18.3	54 395	118.3	45 996	100
	Jun	7 241	10.3	62 821	89.7	70 062	100
	Sep	19 120	26.6	52 779	73.4	71 899	100
	Dec	5 800	9.7	54 231	90.3	60 030	100
2007	Mar	41 656	39.3	64 281	60.7	105 937	100
	Jun	10 198	7.5	126 562	92.5	136 760	100
	Sep	7 561	4.3	168 525	95.7	176 086	100
	Dec	-1 460	-0.9	167 274	100.9	165 813	100
2008	Mar	37 349	18.2	167 643	81.8	204 991	100
	Apr	52 522	21.3	193 495	78.7	246 017	100

Figure 3.35 – Swap and open market position

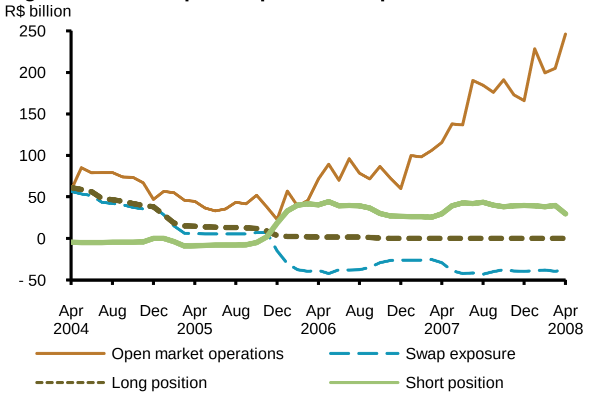
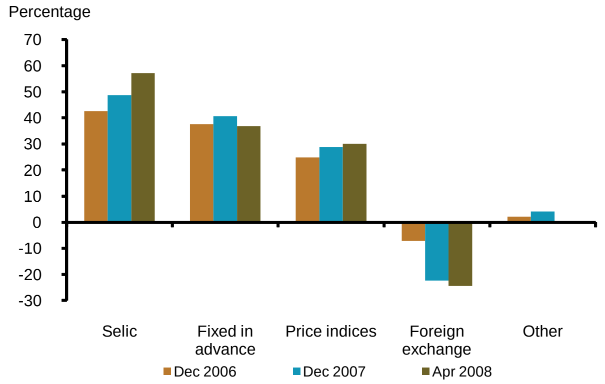


Figure 3.36 – NPSD – Percentage share of indexator



Public Sector Net Debt

The Public Sector Net Debt (PSND) totaled R$1.153,29 billion in April, 41% of the GDP, the best result since December 1998, while it closed at 38.9% of GDP. One should highlight that the PSND remains on a declining trend since September 2008, when topped by 56% of the GDP, the highest level since the series beginning, in 1991.

The DLSP decreased 1.72 p.p. of the GDP in relation to December 2007, an evolution associated, on one hand, to the nominal surplus incorporation in the year and to the valued GDP growth, while, conversely the adjustment arising out of the foreign exchange growth of 4.8% accumulated in the four months until April, contributing with 0.4 p.p. to the debt growth, acted in the opposite direction.

The net debt share indexed to the Selic rate grew from 48.7%, in December 2007, to 57.2% in April, while that linked to price indices increased 1.2 p.p., to 30.1%. The foreign exchange share, stimulated by the international reserves growth, decreased from -22.3% to -24.4%. The participation of fixed-rate debts and without earnings fell from 40.6% and 11.7%, respectively, to, in the order, 36.8% and 8.5%, in the same period.

The general government's gross debt, including the Federal Government, National Institute of Social Security (INSS) and regional governments, reached 56.9% of the GDP, in April, against 57.6% of the GDP, in March, and 57.2% of the GDP, in December 2007.

3.4 Conclusion

The evolution of monetary aggregates in the quarter ended in May has proved to be consistent with the dynamics of the domestic demand activity and, especially, with the maintenance of the pace of credit operations, which continued favoring household consumption expenditures, particularly with regard to the acquisition of vehicles and other durable consumer goods, as well as corporate investments, followed by enhancement of financing in financial institutions. At the same time, the default remains stable, without representing risks to the financial system soundness.

Among credit segments, noteworthy is the increasing participation of operations contracted with nonearmarked resources, while with regard to credit modalities, increased leasing operations reflect the incorporation of this additional

Table 3.10 – Net debt growth
Conditioning factors

Itemization	2006		2007		Apr 2008	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1 067 363	44.7	1 150 357	42.7	1 153 289	41.0
Flows	**Accumulated in the year**					
Net debt – Growth	64 879	-1.8	82 994	-2.0	2 932	-1.7
Conditioning factors	64 879	2.7	82 994	3.1	2 932	0.1
PSBR	69 883	2.9	57 926	2.1	-6 885	-0.3
Primary	-90 144	-3.8	-101 606	-3.8	-61 743	-2.3
Interest	160 027	6.7	159 532	5.9	54 858	2.0
Exchange adjustment	-4 881	-0.2	29 268	1.1	11 942	0.4
Domestic securities debt[1/]	-2 222	-0.1	-2 432	-0.1	- 554	0.0
External debt	-2 659	-0.1	31 701	1.2	12 496	0.5
Others[2/]	2 302	0.1	-2 305	-0.1	-2 026	-0.1
Skeletons	- 375	0.0	- 630	0.0	- 99	0.0
Privatizations	-2049	-0.1	-1265	0.0	0	0.0
GDP growth effect		-4.5		-5.1		-1.8

1/ Domestic dollar – Indexed securities.
2/ Parity of the basket of currencies in the net external debt.

activity as credit mode in view of IOF rate increase in other credit operations. Loans collected by companies translated the maintenance of interest rate at low levels, relatively to historic standards, and lengthening of maturities was boosted by working capital operations.

The recent increase in interest rates did not curb the credit expansion trend, a behavior which, considering the strong demand for loans, both by individuals and companies, shows that the growing participation of credit in the economy is consistent with the activity level and with the degree of institutional development of the national financial system.

Results concerning the first four months of the year evinced that the fiscal policy management continues to ensure the decrease of the ratio between distinct concepts of debt and GDP. The primary surplus accumulated in twelve months remains at a level consistent with the forecasted target for the year, despite the observed decrease in the regional areas and stated owned companies. The primary growth result, favored, in part, by a decrease in the Social Security deficit – determined by growth in inflows and by a reduction in benefits paid, and the fall of 0.30 p.p. of GDP registered in the nominal interest appropriation enabled that, for the first time, a nominal surplus in public accounts was accounted for, in the first four months of the year.

The recent growth in Selic rate, despite affecting the pace of reduction of the appropriated interests, may not compromise the declining trend of the debt/DGP ratio observed in the last years, which will continue mirroring the upturn in economic activity.

International economy

4

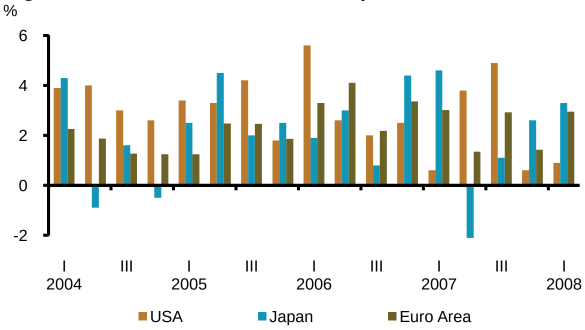
Nine months after the emergence of the subprime crisis in the North-American market and the consequent introduction of adjustments in asset prices and curtailment of financial markets' leverage, the world economy is going through a period of transition. Economic activity deceleration, previously restricted to the United States, started spreading to other regions, with slowest economic expansion being registered in some Asian economies and signs of decreased activity level observed in the United Kingdom and Spain.

Against this backdrop of domestic demand retraction in the mature economies, strong adjustments observed in the prices of commodities have pushed inflation upward, thus introducing an additional challenge to the central banks' monetary policy management aimed at the maintenance of financial stability, economic growth and inflation control.

In the Unite Stated, where the risks of economic activity contraction are more intense, successive decreases in basic interest rates were introduced, while in the Euro Area and Japan, inflationary risks might not only limit the concession of monetary incentives but also lead their respective central banks to adopt a more restrictive posture.

4.1 Economic activity

Figure 4.1 – USA, Euro Area and Japan – GDP1/

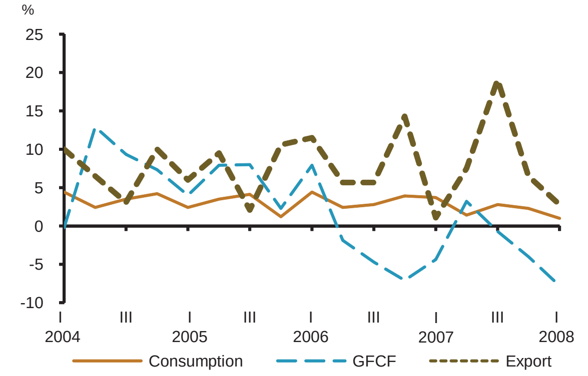


Sources: Bureau of Economic Analysis, Economic and Social Research Institute
1/ Quarterly growth. Seasonally adjusted annualized rates.

In contrast with the expectations formed since the outbreak of the crisis in the US subprime market, the European and Japanese economies posted annual respective growth rates of 3% and 3.3% in the first quarter of 2008, results above the average registered in recent years. On the other hand, these rates reached 0.9% and 1.6% in the United States and in the United Kingdom, respectively.

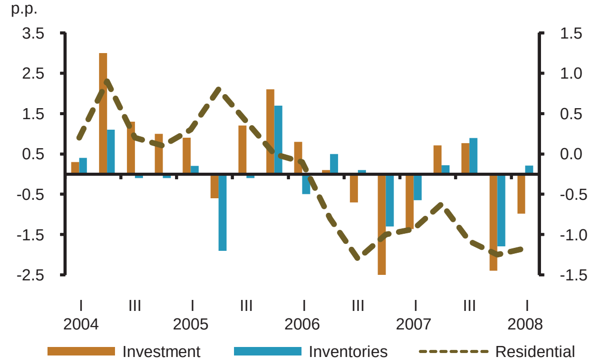
The modest result registered in the U.S. evinced, on the one hand, the negative contribution of 1.17 p.p. of the real estate market and, on the other, the positive contributions of the

Figure 4.2 – USA – GDP Components



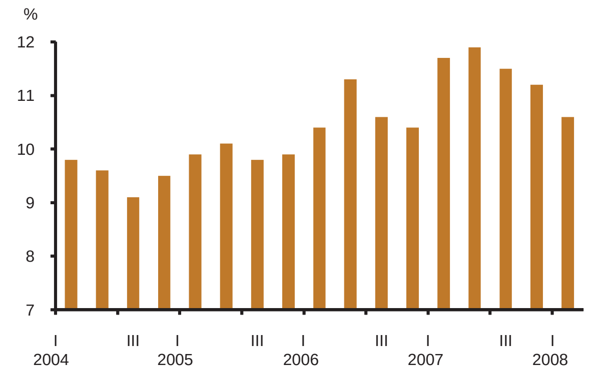
Source: Bloomberg

Figure 4.3 – Contribution to US GDP



Source: Bloomberg

Figure 4.4 – China – GDP[1/]



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

foreign sector, 0.8 p.p.; household consumption, 0.7 p.p.; and inventory expansion, 0.21 p.p.

Notwithstanding the euro appreciation, the increase in oil prices and the crisis negative impacts, the Euro Area economy registered a strong growth in the period. This performance was partially explained by the strength of the German economy, which posted an annual growth of 6.3% in the first quarter, as a result of the recovery in household spending, particularly with regard to stock accumulation. On the other hand, economic growth in Spain, where economic activity and labor market were affected by adjustments introduced in the construction sector, was limited to 1.1% in the period. One should highlight that those rates represented, in the order, the best and the worse rates registered in both economies in this basis of comparison since the introduction of the Euro.

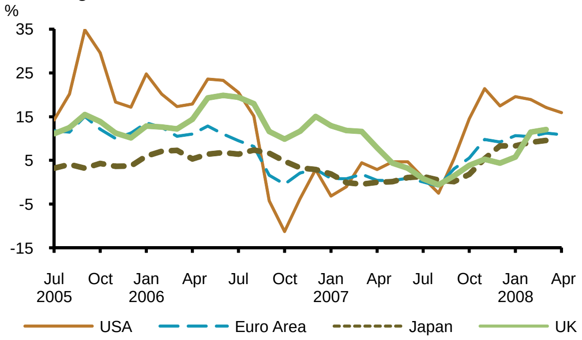
In the United Kingdom, even though the 5.3% growth rate registered in private consumption, the combined effects of the increase in the prices of imported products, the adjustments to the real estate market and the more restrictive credit conditions contributed to the shrinkage of economic growth. The performance of the real estate sector, in particular, has fueled fears of a deflation in household prices similar to that observed in the U.S. and of its potential negative effects on the financial institutions' balances.

The Japanese economy was impacted by annual increase of 3.4% in household consumption, compared to 1.7% in the previous quarter, and 19.5% in the exports of goods and services, propelled by the good performance of sales to emerging markets. One should underscore that the continuity of the Japanese GDP growth trend during the year will be conditioned by both the evolution of the price of commodities and the performance of corporate investments.

With regard to the emerging economies, it should be stressed the maintenance of annual growth rates higher than 10% in China, explained by structural changes in consumption and the maintenance of high investment levels that should contribute to sustain the country's economic growth throughout 2008.

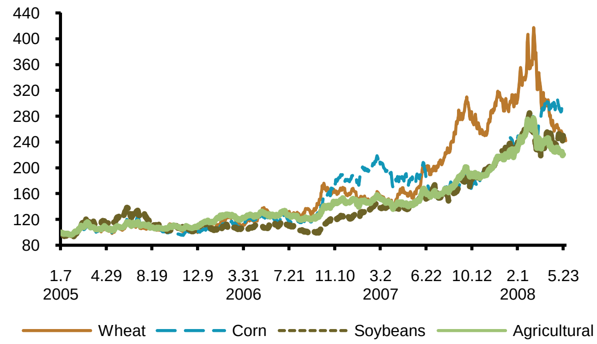
4.2 Inflation and monetary policies

Figure 4.5 – USA – Energy Inflation
Annual growth



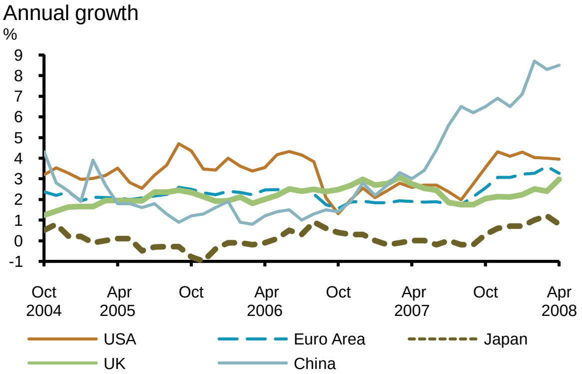
Source: Thomson Datastream

Figure 4.6 – Agricultural Index
31.12.2004 = 100



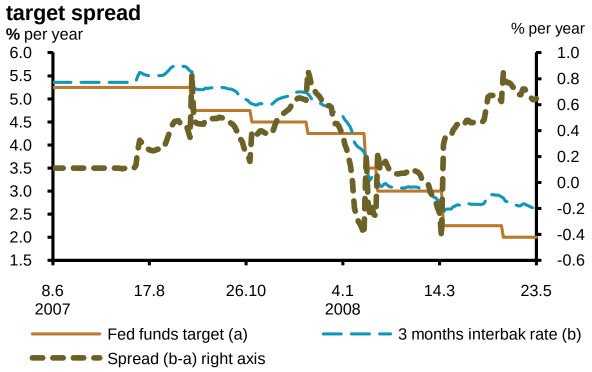
Source: Thomson Datastream

Figure 4.7 – Consumer inflation
Annual growth



Source: BLS, Eurostat, Bloomberg and ONS

Figure 4.8 - USA: Interbank and Fed funds target spread



Source: Thomson Datastream

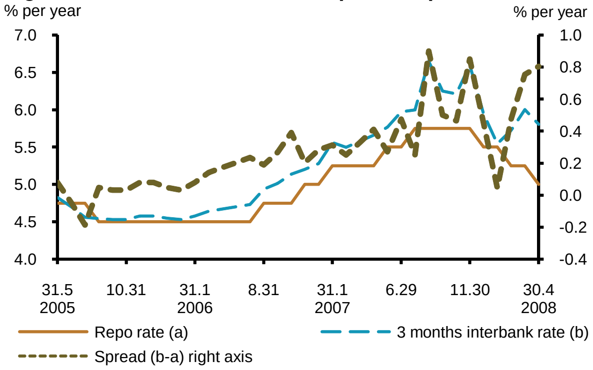
In the second quarter of 2008, the central banks in mature economies continued faced with the dilemma of choosing between fighting inflation and stimulating economic growth. Pressures on the prices of agricultural commodities resulting from the economic expansion of emerging economies, speculation on future markets and persistent tensions between supply and demand, coupled with the maintenance of high prices of oil, continue to impact inflation rates in mature and emerging or developing economies, especially in those countries where the item foodstuffs is more important.

Amidst the deterioration observed in the monetary market's liquidity conditions, as evinced by the systematic and progressive increase of spreads between 3-month and overnight interest rates on interbank markets, several Central Banks have extended their interventions to the short-term financing market by carrying out credit auctions. A series of important actions were taken by the Federal Reserve System (Fed), the Bank of England (BoE), the European Central Banks (ECB), the Swiss National Bank (SNB), and, more recently, the New Zealand Central Bank. These institutions did not only extended the terms for repurchase operations from 1 to 30 days but also started to accept mortgage-backed housing securities as collaterals.

In the U.S., the 12-month accumulated increases registered in the prices of energy, 15,9%, imported products – excluding oil – 6,2%, and foodstuffs, 5.1%, in April were responsible for the upturn in the consumer price index to 3.9%, above the Fed's comfort zone and with an upward trend. In this scenario, the Federal Open Market Committee (Fomc), in view of the perspective of a smoother than previously estimated economic slowdown, signaled the possibility of closing its cycle of loosen monetary policy after cutting Fed funds target by 100 b.p. to 2% in the quarter ended in April.

To cope with tighten credit conditions, the Fed increased the volume of resources available through the Term Auction Facility (TFA) to US$150 billion, extended to 28 days the terms for repurchase operations, which were limited to US$100 billion, and accepted to swap Treasuries securities for agencies debts, including mortgage-backed assets. The Fed also reduced the discount rate in order to maintain the spread between this rate and the fed funds target at 25 b.p., extending the term for these operations from 30 to 90 days. In addition, the Fed, jointly with the ECB and the SNB, in an attempt to reduce the pressure on the dollar in the offshore

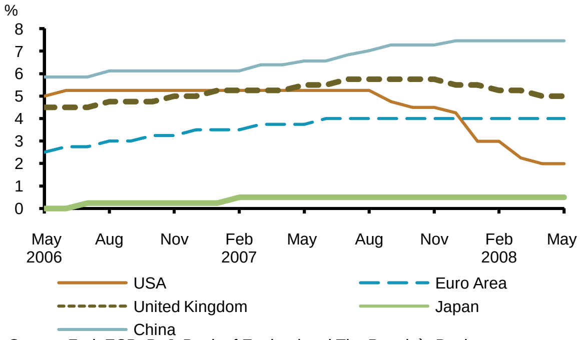
Figure 4.9 – UK: Interbank and repo rate spread



Source: Thomson Datastream

Figure 4.10 – Official interest rates

Annual rates



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

market, raised the swap lines to US$50 billion (Euro Area) and to US$12 billion (Switzerland).

In the month of March, the Fed also introduced two new liquidity assistance programs, the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF). Under the TSLF, the Federal Reserve will lend up to US$200 billion of Treasury securities to primary dealers institutions, not necessarily depositors, as required in the rediscount window and in the TAF auctions, secured for a term of 28 days in exchange for private AAA mortgage backed-securities. The PDCF, also targeted to primary dealers, consists in a temporary credit line with a wide range of collateral acceptance through which dealers receive a treatment similar to trade banks as they are provided with access to a type of rediscount. Thus, the Fed acts as a lender of last resort to institutions that do not belong to the bank's traditional scope of regulation and supervision.

In the United Kingdom, even though 12-month accumulated record expansions registered in producer and consumer price indices in the month of April, 7.5% and 3%, respectively, deteriorated credit conditions and less favorable economic growth perspectives have stimulated the BoE to reduce the basic interest rate to 5% p.y. and, at the same time, to expand the 3-month credit supply via repo operations from £10 billion, effective as of January, to £15 billion in April. Moreover, the BoE introduced, in the TSLF mode setup by the Fed, the Special Liquidity Scheme (SLS), an annual credit line of £50 billion through which banks may swap triple-A active mortgages existing until December 2007 for Treasury bonds especially issued for this purpose. For these annual swaps, renewable for two periods, requestors pay the three-month Libor rate and offer an amount of collaterals equivalent to 10% to 30% the value of the security.

In the Euro Area, the 12-month accumulated consumer price index reached 3.3% in April, after the record rate of 3.6% observed in March, as a result of pressures in the prices of foodstuffs, 6%, and energy, 10.8%. Even though this result is above the target of 2%, unfavorable perspectives for economic growth in the region has constrained the ECB to maintain the basic interest rate at 4%, in effect since June 2007. With regard to liquidity restrictions, the ECB continued its fundamental intervention on the monetary market by extending the swap agreement established with the Fed and injecting a large amount of resources through repo operations.

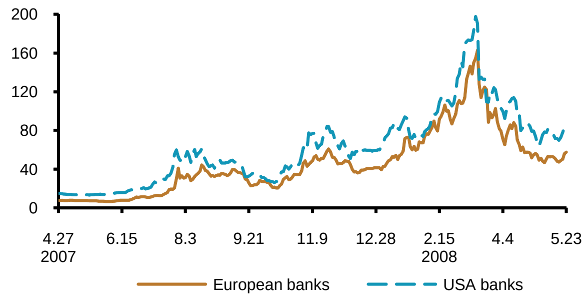
In Japan, the 12-month accumulated inflation, in spite of the Yen appreciation, reached 0.8% in April, while the overnight call rate has been maintained at 0.5% p.y. since February 2007. The structure of local banking system's liabilities, differently from that of the U.S. and Europe, incorporates a significant volume of long-term deposits, which contributes to attenuate the impact of the financial crisis. This allows the BoJ to act more discreetly, limiting itself to punctual injection of resources, as occurred with the allotment of ¥400 billion in March for reducing the differential between the effective overnight rate and the target for the basic interest rate.

The annual inflation rate in China, which has remained above 7% since the beginning of the year, pressured by the increase in the prices of foodstuffs, reached 8.5% in April. This led the People's Bank of China (PBC) to intensify the adoption of measures to curtail the economy's liquidity. The PBC restrictive posture has prioritized the increase in reserve requirements ratios and in discount rate, which was set at 16.5% in May. In addition, the PBC has expanded the issuance of securities for monetary sterilization and for accelerating the foreign exchange appreciation.

In Canada, where annual inflation is still lower than 2%, the BoC reduced the target for the basic interest rate to 3% p.y. in April and carried out new Term Purchase and Resale Agreements (TPRA) totaling C$1.34 billion.

4.3 International financial markets

Figure 4.11 – 5 year CDS Premiums of Major Banks[1/]



Source: Thomson Datastream
1/ Aritmethic average of 5-year CDS premiums for major European and USA banks. Since it's not a random sample, it may not reflect the behavior of the financial system as a whole.

After the strong turbulence registered on the international financial market in the first half of March, a strong commitment by important central banks in providing liquidity for the adequate interbank market operation, coupled with the prospect that most significant losses consequent upon the mortgage market crisis has already been accounted for by financial institutions, played an important role in reducing market's volatility. Signs of recovery were observed particularly in stock and credit default swap (CDS) markets, while on interbank markets persist some punctual traces of stress as spreads relative to basic rates remain at high levels.

The bank's CDS premiums – which measure the guarantee premium against default – in line with the troublesome scenario faced by several institutions, increased in the first half of March. Thus, average premiums related to five important U.S. and Europe banks registered, in the order, 197 b.p. in March 14 and 163 b.p. in March 17. The factors mentioned above, coupled with the announcement of the purchase of Bear Stearns by an important investment bank – funded by FedNY resources – and the raise of capital by some important banks sustained the low trend of CDS premiums in the quarter. In this scenario, on May 23, average premiums related to the United States and European institutions previously mentioned increased by 85.3 b.p. and 57.7 b.p, respectively.

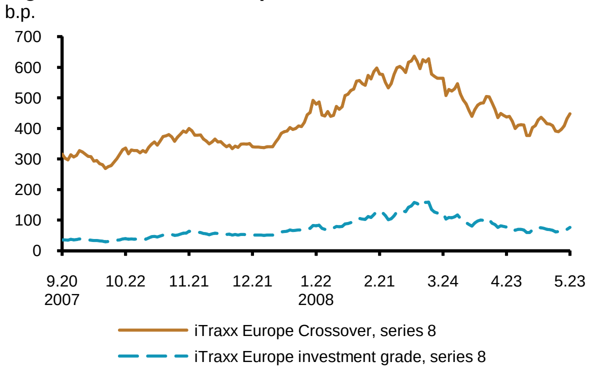
Similarly to the European and American banks' CDS, the premiums required to guarantee corporate loans – either with a high-risk or investment grade classification – in the United States and Europe, after reaching maximum points in March, started an upward trend. In Europe, the itraxx Crossover and the itraxx Investment Grade, which represent the required premium for corporations classified as high-risk and investment grade, increased, respectively, from 598 b.p. and 127 b.p, in February 29, to 448 b.p. and 75 b.p., in March 23, after 636 b.p. of March 10 and 160 b.p. of March 13, respectively.

The reduced demand for long-term government securities, observed since March, was associated to the falloff in risk perception by investors, who now consider these securities less attractive than other assets considered much more risky, a reversal of the previously observed "flight to quality", as well as deteriorated inflation perspectives. In this framework, the annual earnings on 10-year securities in the U.S. and Germany, which registered minimum values of 3.31% and 3.69%, respectively, on March 17, reached, in the order, 3.84% and 4.27% on March 23, while those with similar maturities in Japan and in the United Kingdom, after reaching, in that order, 1.26% and 4.29% in March 24, registered 1.17% and 4.92% on May 23, respectively.

The Chicago Board Options Exchange (VIX) index, which measures the Standard and Poor's (S&P500) implicit short-term volatility and is considered a aversion to risk indicator by investors, registered a positive performance until March 17, closing at 32.2 points, and begun a downward trend since then. The VIX moved from 26.5 points, on February 29, to 19.6 points on May 23.

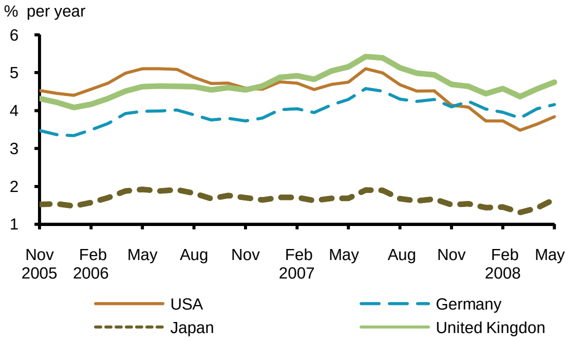
The Emerging Market Bond Index Plus (Embi+), a risk indicator for emerging markets, after reaching 325 b.p. in March 17, the highest value registered since June 13, 2005, started to follow a downward trend, closing at 261 b.p in

Figure 4.12 – iTraxx Europe



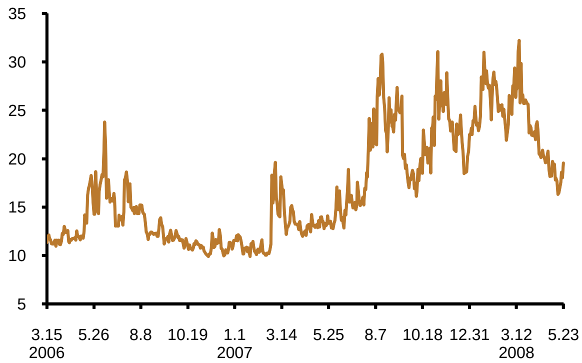
Source: Thomson Datastream

Figure 4.13 – Yield on government bonds[1/]



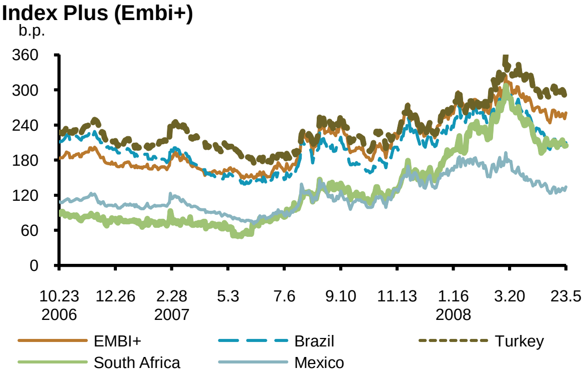
Source: Bloomberg
1/ Monthly average of nominal yields on 10-year bonds, up to May 23, 2008.

Figure 4.14 – VIX



Source: Thomson Datastream

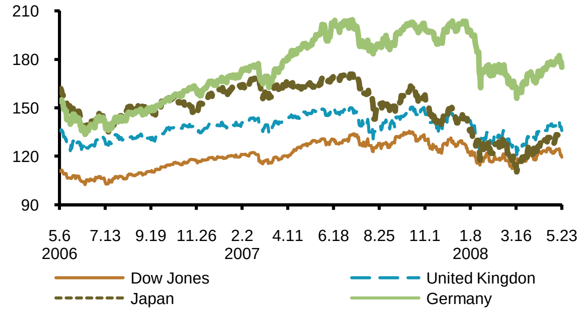
Figure 4.15 – Emerging Markets Bond Index Plus (Embi+)



Source: Bloomberg

Figure 4.16 – Stock exchanges – USA, Europe and Japan

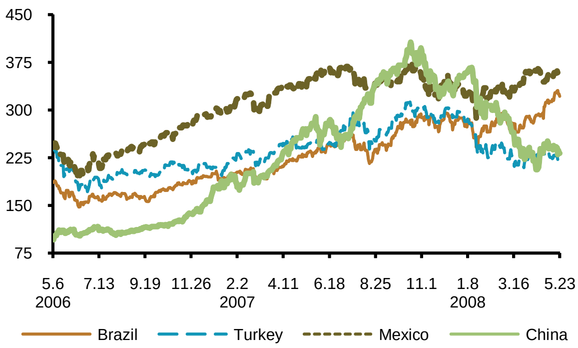
12.31.2003 = 100



Source: Bloomberg

Figure 4.17 – Stock exchanges – Emerging markets

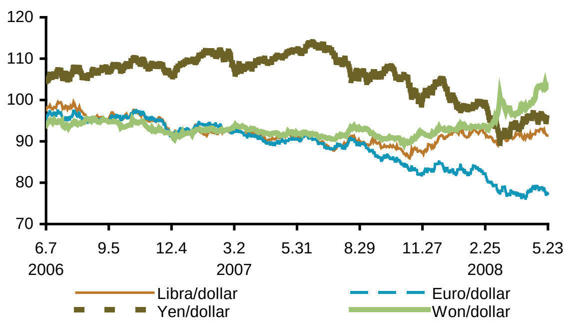
12.31.2003 = 100



Source: Bloomberg

Figure 4.18 – Dollar exchange rates

6.1. 2005 = 100



Source: Bloomberg

May 23, compared to 291 b.p. observed in February 29. The indicator related to the South Africa presented an intense volatility in the period, moving from 250 b.p., in February 29, to 307 b.p., in March 17, and 205 b.p. in May 23. On the other hand, the indicator related to Brazil, on the same dates, registered 265 b.p., 305 b.p and 210 b.p., respectively.

Stock markets registered a positive performance as financial markets signaled the end of the acute phase of the crisis, partially recovering the losses accumulated in the quarter ended in February. Between February 29 and May 23, the USA's Dow Jones, the Germany's *Deutscher Aktienindex* (DAX), the Japan's Nikkei and the United Kingdom's Financial Times' Securities Exchange Index (FTSE 100) grew by 1.7%, 2.9%, 3%, and 3.4%, respectively, accumulating, in the year, losses of 5.9%, 13.9%, 8.5% and 5.7%.

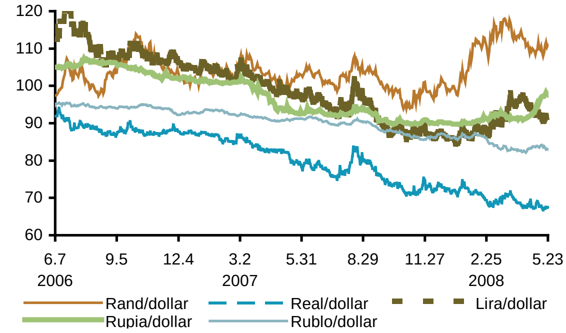
As in mature economies, the performance of stock market in emerging countries was favored by the cutback in the aversion to risk in financial markets. The lag among macroeconomic indicators in this group of economies was evinced by the heterogeneous results registered between February 29 and May 23, when the Turkey's Istanbul Stock Exchange National 100 Index (XU100) and the China's Shanghai Composite Index registered, in this order, losses of 10.8% and 20.1%, while the Mexico's *Indice of Precios y Cotizaciones* (IPC) and the Brazil's Ibovespa accumulated gains of 7.4% and 12.5%.

The North-American dollar exhibited different trends against the Pound Sterling, Euro and Yen in the quarter ended in May. From February 29 to May 23, continuing the trend initiated in November 2007, the U.S. currency appreciated 0.5% against the Pound. In contrast, the dollar depreciated against the Euro, 3.7%, and the Yen, 0.3%. The dollar quotation against the Japanese currency followed the degree of the investors' aversion to risk in the period, decreasing until March 17 and starting an upward trend since then. It should be mentioned that, since the Yen is used to finance carryover operations, its quotation reflects largely the degree of the investors' aversion to risk, which is reflected in the dismantling of such operations at moments of higher turbulence.

In the same period, the South Korean Won depreciated against the dollar, 11%, as a result of both the country's trade balance deterioration and the rules, effective as of 2007, restricting loan operations in foreign currency by South Korean corporations and foreign banks. In the year, until May 23, the dollar accumulated a depreciation of

Figure 4.19 – Emerging markets currencies

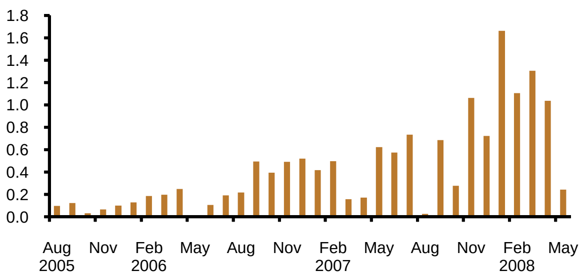
6.1 2005 = 100



Source: Bloomberg

Figure 4.20 – Renminbi/dollar exchange rate Month valuation – average[1/]

%

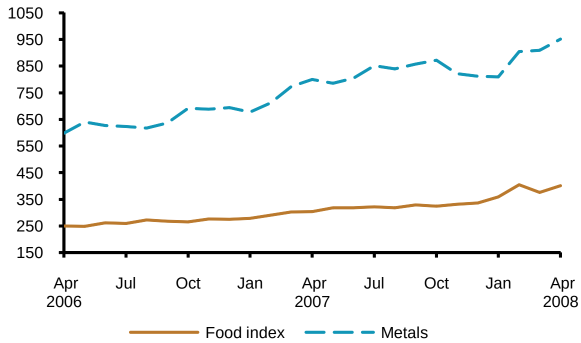


Fonte: Bloomberg

1/ Up to May 23, 2008.

Figure 4.21 – CRB commodity price index

1995 = 100



Source: Reuters-CRB

7.4% both in relation to the Euro and the Yen, and an appreciation against the Sterling Pound, 0.3%, and the Won, 11.8%.

In contrast to the general trend observed in mature economies, several central banks in emerging economies decided to raise their respective basic interest rates, thus favoring the process of appreciation of their currencies in relation to the dollar. Meanwhile, countries like India, Turkey and South Africa, which register high deficits in their current accounts, faced less favorable financing conditions that pressured their currencies downward. Considering the period from February 29 to May 23, the dollar devaluated against the Russian Rublo, 2%, against the South African Rand, 1.9%; and against the real, 1.8%, and appreciated against the Turkish lira, 2.2%, and the Indian rupia, 6.8%. In the year, until May 23, the dollar accumulated respective appreciations of 11.9%, 8.5% and 6.6% against the rand, rupia and lira, and depreciated 4.4% and 6.7% against the rublo and the real, respectively.

China has maintained the strategy of appreciating renmimbi against the dollar, limiting the variation to 0.5% per day, up or down. Between February 29 and May 23, the renmimbi grew by 2.4% compared to the dollar, accumulating depreciation in the year, 4,9%, and in 12 months, 9,3%.

4.4 Commodities

Notwithstanding the cutbacks registered in recent months, international prices of commodities continue at a high level, reflecting the influence of the new stage of development achieved by emerging economies in their respective levels of consumption and investment, the process of price transfer among different commodities, the reduction of historic stock levels and the intensification of bioenergy production.

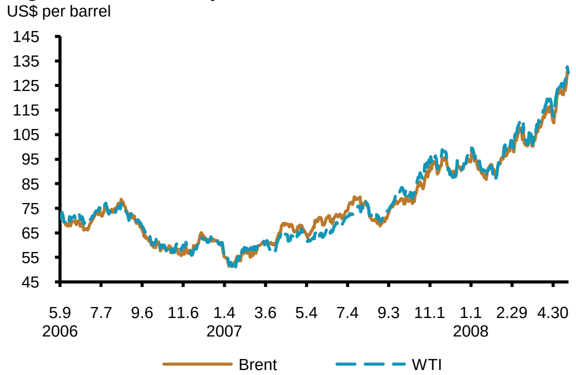
International average prices of agricultural commodities dropped about 16.7% between the end of February and May 23 because of cutbacks registered in the prices of sugar, 31.5%; wheat, 30.7%, and coffee beans, 19.7%, and increases in the prices of corn, 7.8%, and meat, 13.5%.

The North-American real estate activity downturn, coupled with the effect of corrections introduced on the market, apparently impacted by speculative activities, contributed to the 9.5% cutback registered in the prices of metallic commodities in the period, with emphasis to the drop in the prices of lead, 39.9%; nickel, 23.5%; zinc, 21.6%; and copper, 2.9%.

In the 12-month period ended in May, the Commodity Research Bureau (CRB) index turned in an increase of 27% in the prices of agricultural products and of 11% in the prices of metallurgy-related products.

4.4.1 Oil

Figure 4.22 – Oil – Spot market



Source: Bloomberg

The price per barrel of oil, which continued under pressure in recent months, surpassed US$100 in February, reaching historic records in the quarter ended in May. The price of Brent-type and West Texas intermediate (WTI) increased by 30% at the end of February and May 23, registering, in the order, US$130.15 and US$131.59. The upward trend observed in international oil prices reflects the tensions between the commodity supply and demand associated with the traditional geopolitical factors in the Middle East, the reduced expansion of production in the framework of the Organization of the Petroleum Exporting Countries (Opec), the North-American currency depreciation, the aggressive performance of investment funds and the Opec reluctance to increase production levels.

Prices on the futures market have been extremely volatile as a consequence of pressures on the spot market and of the performance of investment funds. The price per barrel of WTI type for contracts maturing in December 2008 and December 2009, moved from US$98.58 and US$95.84, at the end of March, respectively, to US$132.37 and US$130.84 in May 23.

4.5 Conclusion

The world economy seems to be going through a transition period characterized by lower growth and higher inflation in comparison to the performance registered in recent months. The North-American economy is expected to recover with the beginning of the process of tax refund and the cumulative effects generated by successive cutbacks of interest rates. Meanwhile, expectations concerning the main European economies for the next quarters as regards both activity level and, especially, inflation rates, indicate relative deterioration.

Financial markets have already signaled a recovery from the crisis of 2007, notwithstanding a new deterioration of indicators should not be excluded. However, the persistence of high oil prices becomes an additional challenge for economic policy makers.

As regard emerging and developing economies, the rise in the prices of commodities and oil continue favoring the economic performance of the producing countries; however, it constitutes an additional factor affecting inflation and foreign exchange rates, especially in Asian economies.

Food Inflation

Figure 1 – FAO: price indexes
1998-2000 = 100

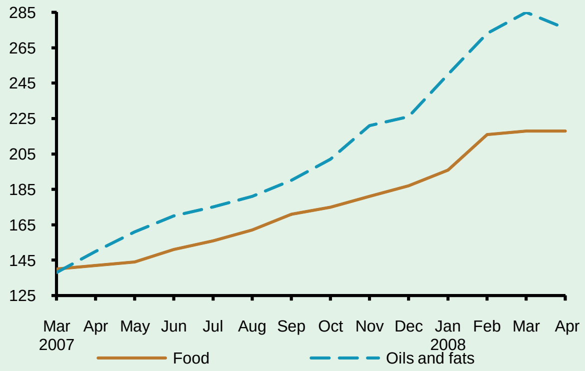
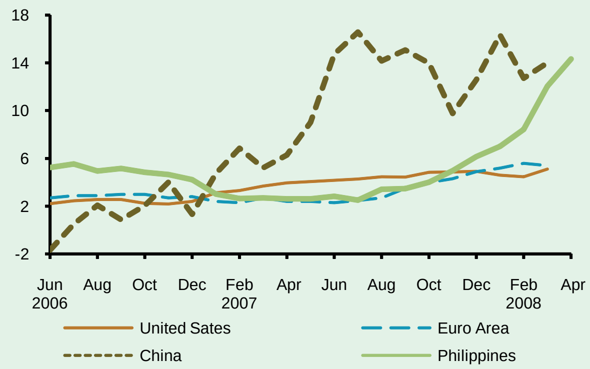


Figure 2 – Food inflation
% oya



After a long period of low inflation, partly explained by the reduced labor costs in the Southeast Asia, the world economy has been facing a process of upturn in prices since 2007. Inflationary pressures, which were restricted to the prices of oil and metallic commodities by mid-2007, now incorporates the high prices of soybeans, corn and wheat, products that exert a strong impact on the prices of meat, egg and milk. In this sense, the United Nations' Food and Agriculture Organization (UN/FAO) food price index, which includes 55 agricultural commodities, posted a 57% high between March 2007 and March 2008.

The rise in agricultural prices, captured differently by consumer price indices in mature[1] and emerging economies, certainly affects more severely the poorest countries. According to the UN/FAO, while food represents 10% to 20% of the baskets of consumption in mature economies, this ratio outperforms, in some cases, 80% of that in poor countries.

This inflation upward trend in a global scenario of low rates of unemployment, high rates of expansion of money supply and increased speculation with commodities, although primarily explained by pressures exerted on prices by the continued world economic growth, reflected especially in the strong demand increase observed in large emerging economies, is also conditioned by a supply shortage represented by low stocks of grains. This shortage is explained by the occurrence of adverse weather conditions in important producing regions, as well as the prevalence of inefficient patterns for allocation

1/ Cumulative 12-month inflation in the end of March 2008, considering the CPI and the food item separately, reached, respectively, 4.0% and 4.5% in the United States; 3.6% and 5.6% in the Euro Zone; 2.4% and 5.5% in the United Kingdom; and 1.2% and 1.6% in Japan..

of agricultural areas consequent upon protectionist policies, especially in mature economies.

Demand pressures

Table 1 – Asia: food inflation

% oya

	2004	2006	4Q 2007	Mar/2008
China	4.9	6.3	15.0	22.2
Indonesia	6.4	12.9	9.6	15.1
Hong Kong	1.7	2.6	6.5	10.4
Taiwan	3.3	-1.3	11.5	8.4
Philippines	8.1	4.7	3.8	8.0
Singapore	2.3	1.7	4.5	7.7
Thailand	4.3	6.0	3.0	6.2
Malaysia	2.9	3.0	3.0	4.9
India	2.7	8.7	2.9	3.5
Korea	4.9	1.5	4.2	1.8
Japan	1.2	0.7	0.5	0.9

Source: JPMorgan – Global Data Watch (05/02/08). Adapted.

The performance of prices of agricultural commodities reflects basically the strong demand pressures resulting from the rise in food consumption and in the production of biofuels.

The rising in food consumption.[2] particularly observed in emerging countries, reflects the persistent process of income gains registered in those economies with pent-up demand in this segment of goods. This movement, in view of the perspective of maintenance of growth rates in countries with high rates of population and poverty, demonstrate that pressures on food prices will continue in the upcoming years.

In the context of the emerging economies, food inflation in China, which was impacted by adverse weather conditions during last winter, has been recording high levels since December, registering 22.1% p.y. in April, as a result of strong increases in the prices of pork, 68.3%, and oil and edible fats, 46.6%. One should highlight that this evolution, notwithstanding the adoption of measures including the freezing of prices, the utilization of buffer stocks of pork and the introduction of taxes on the exports of grains, reflects the rise in the consumption of food products with high levels of animal protein – it is estimated that the average meat consumption per capita in China would go up to 50 kg in 2008, compared to approximately 20 kg in the late eighties –, a change in eating habits consequent upon the income increase coupled with the phenomenon of migration to the cities.

The second component of demand pressures refers to the growing utilization of grains in the production of bioenergy. According to F.O. Licht's World Ethanol and Biofuels Report, dated April 2008, the production of ethanol by means of grains in the U.S. and China consumed 4.5% of the total world

2/ Economic Council of the White House estimates show that food consumption in emerging countries grew about 45% between 2001/2007 and 1991/2000.

supply of grains in 2007. In China, even though corn production has grown by 21.9% between 2001 and 2005, local factories demand has expanded 84%, to 23 million tons. In the U.S., while the demand for corn utilized in the production of ethanol increased from 41 million tons, in the 2005/2006 harvest, to around 81 million tons in the 2007/2008 period, the corn cultivated area expanded only 19% during last harvest.

Similarly, the demand for fats and oils, which prices, according to the UN/FAO, registered an average increase of 98% between the first quarter of 2008 and 2007, has been strongly impacted by the production of biodiesel – in fact, the demand for vegetable oils for this purpose increased from 3.7% of total supply in 2006 to 5.9% in 2007.[3] One should also mention the pressures resulting from the reduction in the cultivation of soybean because of the growing urbanization in China and the replacement of soybean cultivation for corn in the U.S., where, according to the U.S. Department of Agriculture (USDA), the cultivated area diminished by 16% in 2007. Therefore, the price of soybeans, a product which global stocks represent only 10% of current world demand, stands at its highest level over the last 34 years.

Supply Components

With regard to supply pressures, it is important to highlight the rise in the costs of production faced by the food industry, the recurring crop failures in world grain production and the decimation of livestock in Asia.

The rise in the costs of production is explained by two factors. The first refers to the impact exerted by the high prices of oil on the prices of fertilizers, which have expanded sharply from 2007 onwards; on the prices of energy, since modern agriculture is increasingly energy-intensive; and on the costs of transportation, which not only affects the prices of food at the field, but also at the storage, processing and distribution stages.

3/ F.O. Licht's World Ethanol and Biofuels Report, op. cit.

The second component of cost pressure refers to the increasing consumption of grain in the production of agro-energy and the consequent reduction in the availability of these grains or their closest substitutes, which reflects not only on the prices of grains but also on the prices of animal feed and, as consequence, on the final prices of meat and dairy products. From this perspective, it is important to highlight the Brazilian contribution to alleviate some of these tensions, for instance, by expanding from 13.9 million hectares in 2001 to 22 million hectares in 2007 the area cultivated with soybeans.

It is also worth mentioning the occurrence of epidemics, like the outbreak of foot-and-mouth diseases and avian influenza in Asia, and adverse weather conditions, for instance the repeated severe droughts in Australia, the recent floods in Argentina, Malaysia, South Korea and India, the snowstorms in China, poor harvests in the United States, and the impact of drought on productivity on the dairy industry in New Zealand. In China, for example, the severity of the last winter was responsible for the death of nearly 16 million animals and the freezing of tons of vegetables, which contributed to aggravate the unbalance between supply and demand and raise inflation to a record level in more than a decade.[4] India and Malaysia, on the other hand, have had to deal with the shortage of edible oils, wheat and rice. UN/FAO also expressed its concerns that the current difficulties in Russia, Ukraine and United States harvests may add potentially negative pressures on food prices in the short term.

The food inflation also demonstrates the inadequate volume of world stocks of grains. In this sense, the stocks of wheat, which, according to the International Monetary Fund's (IMF) World Economic Outlook, were at their lowest levels over the last 26 years in the end of 2006 and beginning of 2007, were reduced from around 30% of world's demand in 2000 to 15% in 2007, according to the USDA. Even though UN/FAO estimates point to record grain harvests for 2008, the increasing demand for corn and wheat certainly will exceed their supply growth, thus exerting additional pressures on prices. This

4/ Data published by the China Ministry of Agriculture

Table 2 – Corn & Wheat – World Supply and Stocks

Millions of tons

	2004/2005	2005/2006	2006/2007	2007/2008
Corn				
Supply	715	696	704	769
Stock	131	123	106	109
Wheat				
Supply	627	622	594	602
Stock	151	148	124	110

Source: World Bank - Development Prospect Group (Dec/2007). Adapted.

assessment is corroborated by the World Bank, which sustains that the stocks of wheat will likely to be reduced in the short and medium term to the lowest levels since 1960.

Moreover, it should not be forgotten the turbulence introduced on the markets of agricultural commodities by the action of speculators, which, in an environment of uncertainty in global financial markets and declining activity in mature economies, have migrated to the market of real assets.

In summary, the upward trend of food prices is not due only to the effects of demand pressures resulting from the expanded consumption in large emerging economies and the production of biofuels in areas with restricted land availability, but also to the rising production costs and the rigidity in food supply, which effects, in some cases, are reinforced by non-commercial demand. In this sense, it should be highlighted the mismatch between the growth in world population and in food production: while global population grew by 25.7% between 1990 and 2007, food production increased merely 12.7%.[5]

In this scenario in which the most vulnerable countries are those more dependant on the imports of oil and agricultural products, and, in particular, the share of food prices in inflation is more pronounced, the action of central banks in the short term has been characterized by the adoption of a more restrictive posture, either through raising interest rates or interrupting the cycles of loosen monetary policy, notwithstanding the global economic slowdown, in an attempt to prevent that the process of adjustment in relative prices turns into uncontrolled inflation.

5/ Bradesco, daily highlights, December 14, 2007.

5 External sector

The analyses presented in the latest issues of this Inflation Report show that the evolution of the balance of payments' flow, reflected on five consecutive years of surplus in the current account, propitiated relative changes in the country's foreign accounts, registering strong growth in the stock of international reserves and decrease in external liabilities, especially in the public sector. This new Brazilian external position, which contributes to the decrease of our economy's vulnerability to external shocks, and the continuity of consistent macroeconomic policy, favored the recognition of the country as a positive and stable environment for investors by both market and risk assessment agencies.

Confirming expectations of obtaining the investment classification by risk assessment agencies, the Standard & Poor's (S&P) raised the country's rating to investment grade in April, while the Fitch Rating ended up with the same movement in May. The investment grade granted to Brazil by two out of the three most important risk assessment international agencies mirrored the monetary policy management by the Central Bank aimed at ensuring that behavior of domestic prices would be consistent with the established targets within the current monetary system adopted by the country. In this scenario, in which building international reserves topped US$200 billion, possible relative risks to the external debt service are significantly reduced.

The slump observed in the world economic scenario since mid 2007, the worsening expectations about the US economic performance and the international financial markets volatility had a limited impact on the Brazilian economy, corroborating the importance of the macroeconomic adjustments made in recent years, especially the strengthening of the country's external position – translated in the performance of sustainability indicators, while confronting the turbulences in the international market. In this sense, the measurement of the Brazil-risk, after ending 2007 at 221 points, expanded to 305 points, on March 17, and impacted by the aggravating uncertainties of the financial markets, showing, since that date, a declining trend, reaching 187 points on June 17.

The balance of payments experienced a global surplus result of US$16.6 billion in the first five months of the year. Net inflows in the capital and financial accounts totaled US$33 billion, of which US$14 billion corresponded to foreign direct investments (FDI), which easily compensated for the debt – after consecutive surpluses since 2003 – of US$14.7 billion registered in current transactions.

It is expected that the financial conditions of the balance of payments remain strong, despite registering the first deficit in current transactions, on an annual basis, since 2002. This result is consistent with the upturn in activity presented by the domestic demand. The changes in forecasts for the external sector accounts for the year, compared to those in the previous Inflation Report, detailed in a specificappendix, stem from results of incorporation occurred until May, including net purchases carried out by the Central bank on the market, the new indebtedness position related to March, new foreign investments prospects after the investment grade classification.

5.1 Exchange operations

The foreign exchange operations carried out by the market generated a surplus of US$15.8 billion in the first five months of 2008, against US$35.1 billion in the corresponding period of the previous year. The positive balance maintained the conditions for the National Treasury strategy of obtaining resources on the market to serve its external debt and of continuing the program of repurchases of securities issued by the Republic, still allowing the Central Bank to continue with foreign currency acquisitions on the market.

In the first five months of 2008, in an environment of greater wariness to risk by investors in the international financial market of Brazilian imports, net inflows in the foreign exchange market decreased 54.9% in relation to the same period of the previous year. Net inflows in the trade segment dropped by 31.8% during the period, totaling US$24.9 billion, against US$36.5 billion in the first five months of 2007, registering growth of 5.3% in exchange transactions for exports and 40.8% in those referring to imports. In the financial segment, net outflows of US$9 billion, as compared to US$1.4 billion in the same period in 2007, increases of 44.8% in purchases and of 50.8% in foreign currency sales were registered.

Table 5.1 – Foreign exchange flows

	2006			2007	
	May	Jan-May	Year	May	Jan-May
Trade operations	6.0	36.5	76.7	2.9	24.9
Exports	14.0	74.6	184.8	14.7	78.5
Imports	8.0	38.1	108.0	11.8	53.7
Financial operations[1/]	0.9	-1.4	10.7	-2.8	-9.0
Purchases	27.9	115.1	348.3	33.9	166.6
Sales	26.9	116.5	337.6	36.7	175.6
Net flows	6.9	35.1	87.5	0.1	15.8

1/ Excluding interbank operations and Central Bank foreign operations.

The cumulative exchange surplus in the first five months of 2008 made it possible for the Central Bank's net purchases to close at US$13.2 billion, against US$47.5 billion in the corresponding period of 2007. The difference between the balance of the foreign exchange market and the Central Banks' net purchases was determined by the expansion in the bank's short position, which reached US$12.2 billion at the end of May 2008, against US$7.3 billion at the end of 2007.

5.2 Trade in goods

In May, the balance of trade turned in a US$4.1 billion surplus, registering monthly records both in exports, US$19.3 billion, and imports, US$15.2 billion, which accumulated, in the order, US$72.1 billion and US$63.4 billion in the first five months of the year, showing respective increases of 19.9% and 46.3% in relation to the corresponding period of 2007. The cumulative balance of trade in the year, indicating a growing trend on imports, dropped 48.3% using the same basis of comparison.

Table 5.2 – Trade balance – FOB

US$ million

Period		Exports	Imports	Balance	Total trade
Jan-May	2008	72 054	63 398	8 656	135 452
Jan-May	2007	60 096	43 338	16 758	103 434
% change		19.9	46.3	-48.3	31.0

Source: MDIC/Secex

The average daily balance for exports, when viewed by aggregated factor, showed expansions in all three categories, in the year. The value of daily sales of basic products grew 35.4% in relation to that observed in the first five months of 2007, followed by the ones related to semimanufactured, 22.3%, and to manufactured goods, 13.2%.

Table 5.3 – Exports by aggregate factor – FOB
Daily average – January-May

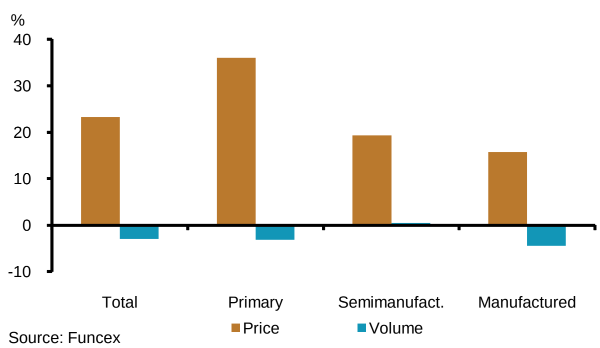
US$ million

	2007	2008	% change
Total	577.8	706.4	22.2
Primary products	176.8	239.4	35.4
Industrial products	389.4	448.0	15.0
Semimanufactured goods	80.2	98.1	22.3
Manufactured goods	309.2	349.9	13.2
Special operations	11.6	19.0	63.5

Source: MDIC/Secex

Among basic products, one should mention the performance of soybean exports, 68.4%; soybean meal, 53.4%; chicken meat, 47.5%; petroleum, 25%, iron ore, 15.6%, evolution linked, to some extent, to the normalization of exports activity with the end of the customs officers strike, on May 12.

Figure 5.1 – Exports – Price and volume index
January-May – 2008/2007



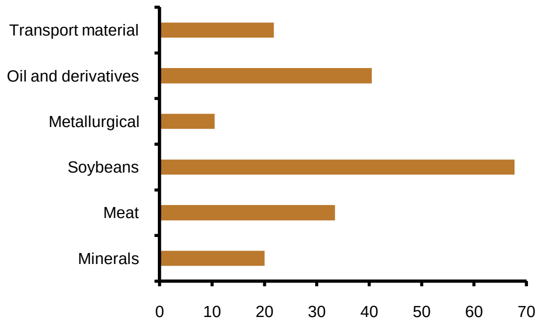
Source: Funcex

The expansion of semimanufactured good exports reflected the increase in external sales of iron alloys, 91.5%; cellulose, 49.2%; semimanufactured iron and steel products, 44%; and cast iron, 37.9%, while, in the opposite sense, raw sugar exports fell by 13.3%.

The performance of the exports of manufactured goods reflected in expansion in the sales of fuel oils, 84.4%; aircrafts, 52.3%; vehicle parts, 17.2%; and vehicles 10.2%, and, among the main items of the category, cutbacks on refined sugar exports, 20.1%; flat-rolled steel 10.5%; and footwear, 1.3%.

The performance of Brazilian exports in the year has reflected, mainly, the expansion of international prices, particularly commodities. According to the Foreign Trade Studies Center Foundation (Funcex), the price indices of products sold by the country grew 23.3% from January to May, compared to the same period in the previous year. On the same basis of comparison, the quantity exported registered a cutback of 3%, showing that these developments were impacted by the mentioned strike, but production should pick up, at least partially, in the next few months.

Figure 5.2 – Main exports
January-May – 2008/2007 – % growth



Source: MDIC/Secex

The stronger upturn in prices, observed in the basic products segment, led to growth of 36% in the analyzed period, while increases related to manufactured and semi-manufactured goods increased 15.8% and 19.3%, respectively. The most significant reduction in the exported quantity occurred in the category of manufactured goods, 4.4%, while semimanufactured products had an increase of 0.5%.

When viewed by product category, cumulative exports in the first five months of the year showed across the board increases, in relation to the same period of 2007, except for those related to sugar, which fell 14.7%, in the period. Sales related to the six most representative segments in export performance, when taken together, accounted for 58.6% of the total exported by the country in the period, showing the following growth rates: soybean, 67.7%; petroleum and derivatives, 40.5%, meat 33.5%; transportation materials, 21.8%; minerals, 20%; and metallurgical products, 10.5%.

Imports continue to show a growing trajectory in all of use categories, a movement consistent with the economic activity upturn. From January to May, external purchases grew 49.2%, considering average daily values, in relation to the same period of 2007. Consumer durables imports had the largest expansion, 64.8%, impelled by an increase of 117.2% in imports of passenger vehicles. The daily average value of raw materials and intermediate products grew 44.7%, with emphasis to transport equipment accessories, 48.1%, mineral products, 37.4%; chemical and pharmaceutical products, 37.2%, and intermediate parts and accessories, 32.3%.

Table 5.4 – Imports by end-use category – FOB
Daily average – January-May

US$ million

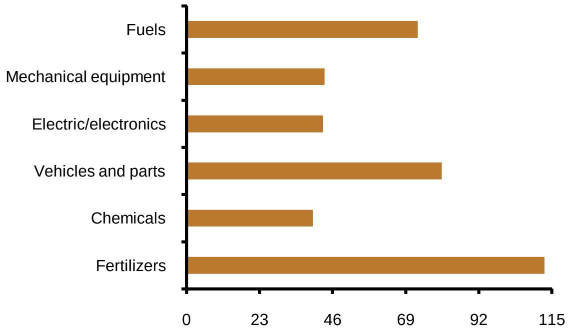
Itemization	2007	2008	% change
Total	416.7	621.5	49.2
Capital goods	87.7	129.4	47.5
Raw materials	209.8	303.6	44.7
Naphtha	7.5	11.0	45.5
Consumer goods	55.3	78.3	41.4
Durable	26.3	43.3	64.8
Passenger vehicles	8.1	17.6	117.2
Nondurable	29.1	34.9	20.2
Fuels	63.8	110.3	72.7
Crude oil	39.6	59.2	49.7

Source: MDIC/Secex

The average daily imports of capital goods increased by 47.5%, in the period, a result consistent with the multiplication of investments in industry. This growth mirrored, specially, expansions registered in purchases of industrial machinery, 53.6%; office machines and apparatuses for scientific use, 34.4%; and parts and spares for industrial capital goods, 42.4%.

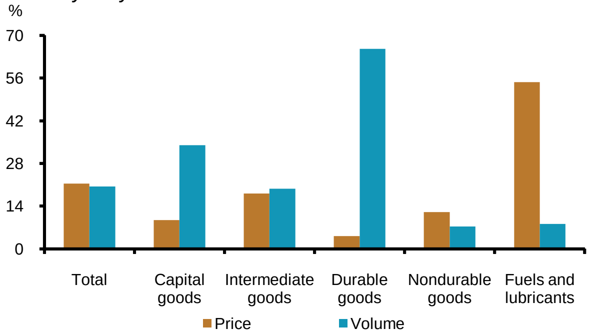
The imports of nondurable consumer goods, impacted by the upturns in pharmaceutical products, 10.8%, and

Figure 5.3 – Imports by main products
January-May – 2008/2007 – % change



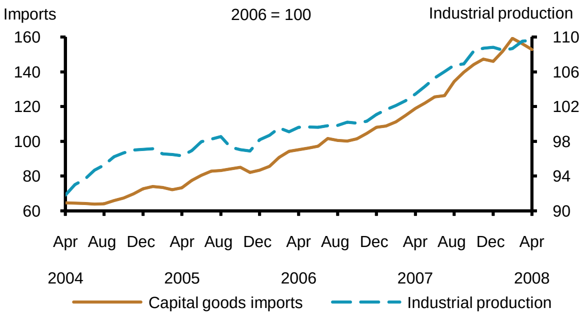
Source: MDIC/Secex

Figure 5.4 – Imports – Price and volume index
January-May – 2008/2007



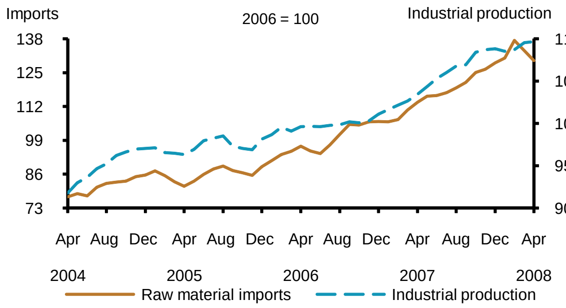
Source: Funcex

Figure 5.5 – Capital goods imports x industrial production – 3-month moving average
Seasonally adjusted indices



Sources: Funcex and IBGE

Figure 5.6 – Raw material imports x industrial production – 3-month moving average
Seasonally adjusted indices



Source:s Funcex and IBGE

foodstuffs, 28.2%; increased 20.2%, on the same basis of comparison, while purchases of fuels and lubricants grew 72.7%, impacted by the expansion of 49.7% in expenditures with external oil purchases.

The sectoral analysis of imports growth in the January-May period, compared to the corresponding period of the previous year, shows a sweeping growth of the major sectors of import list, with decrease only in the item beverage and alcohol. Considering the import daily average, it is worth noting the expansion of purchases of fertilizers, 112.6%; automotive vehicles and parts, 80.3%; fuels and lubricants, 72.7%; mechanic equipment, 43.4%; electric and electronic goods, 43%; and organic and inorganic chemical products, 39.8%. When taken together, these sectors account for 62.8% of imports in the period.

According to Funcex, the imported amount increased 20.4%, in the first five months of the year; compared to the same period in 2007, while import prices increased by 21.4%, registering different evolutions among the different categories of use. In this sense, the result of fuels and lubricants imports mirrored growth of 54.7% in prices and of 8.2% in volume. In the opposite sense, the performance of imports of consumer durables had respective increases of 4.1% and 65.6%, with emphasis to the growth in the imported amount of vehicles. Additionally, the increase in purchases of capital goods, raw materials and intermediate products and nondurable consumer goods were linked to respective growths of 34%, 19.7% and 7.3% on imported amounts and of 9.4%, 18.1% and 12.1% on prices.

The country's balance of trade with the main blocs and regions had a relative decline in comparison to the first five months of 2007, with the exception of the Mercosul Common Market (Mercosul), with which trade expansion reached by 34.3%. Trade flows, largely indicating the upward trend in imports, had a relative growth in all economic blocs and countries.

The major markets of destination of the Brazilian exports, in the first five months of the year, were still in the Euro Area, with participation of 24.9% in the total Brazilian external sales, and in the Aladi, with 22.4%; while the main single importer was the USA, with participation of 14.2%. Sales directed to China expanded 51.9%, in the period, contributing to the 40.2% growth observed in exports to Asia. During the same period, sales to Latin American Integration Association (Aladi) increased 22.8%, reaching 39.2% to the Mercosul, while exports to the European Union (EU) and the USA expanded by 21.4% and 5.3%, respectively.

Table 5.5 – Exports and imports by area – FOB

Daily average – January-February

US$ million

Itemization	Exports			Imports			Balance	
	2007	2008	% change	2007	2008	% change	2007	2008
Total	578	706	22.2	417	622	49.2	161	85
Latin America	129	158	22.8	73	104	42.8	56	54
Mercosur	59	83	39.2	41	58	41.4	18	24
Argentina	49	68	38.4	37	52	39.6	12	16
Other	10	14	43.7	4	6	58.2	6	8
Other	69	75	8.8	32	46	44.7	37	29
USA 1/	95	100	5.3	68	91	33.9	27	9
EU	145	176	21.4	94	131	39.1	51	46
E. Europe	15	20	33.5	8	18	109.2	7	2
Asia	89	125	40.2	104	170	63.9	-14	-44
China	37	56	51.9	41	70	72.1	-4	-14
Other	52	69	31.9	63	99	58.5	-10	-30
Others	104	126	21.2	69	108	55.1	35	19

Source: MDIC/Secex

1/ Includes Puerto Rico.

Table 5.6 – Current account

US$ billion

	2007			2008		
	May	Jan-May	Year	May	Jan-May	Year 1/
Current account	-0.4	0.6	-2.1	-0.6	-14.7	-21.0
Trade balance	3.6	15.4	36.4	4.1	8.7	25.0
Exports	13.4	58.8	157.1	19.3	72.1	182.0
Imports	9.8	43.3	120.6	15.2	63.4	157.0
Services	-1.2	-4.7	-13.4	-1.7	-6.8	-16.3
Transportation	-0.4	-1.8	-4.5	-0.5	-2.5	-6.5
International travel	-0.3	-0.7	-3.3	-0.6	-2.0	-5.0
Computer and informat.	-0.2	-0.9	-2.1	-0.2	-1.2	-2.3
Operational leasing	-0.5	-2.3	-5.8	-0.6	-2.5	-6.0
Other	0.1	1.0	2.3	0.1	1.3	3.5
Income	-3.2	-11.8	-29.2	-3.3	-18.1	-33.5
Interest	-0.3	-3.9	-7.3	-0.1	-2.7	-4.9
Profits and dividends	-2.9	-8.1	-22.4	-3.2	-15.6	-29.0
Compensation of employment	0.0	0.2	0.4	0.0	0.2	0.4
Current transfers	0.4	1.7	4.0	0.3	1.5	3.8

1/ Forecast.

Analysis of imports by countries and regions shows that 27.3% of the country's external purchases came from Asia, in the analyzed period, followed by those originated in the EU, 21%; Aladi, 16.8%; and the USA, 14.7%. Purchases from Asia registered higher increases in the period, 63.9%, with emphasis on those from China, representing 11.3% of the Brazilian imports, which grew by 72.1%. Imports originated in the Aladi grew 42.8% among which those from Mercosul expanded 41.4%, followed by those from the EU, 39.1%, and from the USA, 33.9%. One should still note that 109% increase in imports originated in Eastern Europe, a result that, even considering the relatively small participation of this bloc in the Brazilian total purchases, represents the continuity of a healthy diversification of our supply markets.

5.3 Services and income

The current account deficit reached US$14.7 billion in the first five months of this year, accumulating a negative result of US$15.2 billion in twelve months, 1.11% of GDP, against a US$13.4 billion surplus in the corresponding period of 2007, 1.15% of GDP. The account's growth mirrored both the balance of trade decline and the rising deficit in the services and income account, in the period.

The net remittances from services summed up US$6.8 billion, while those from income totaled US$18.1 billion, in the first five months of the year, increasing, in the order, 45.1% and 53.2% in relation to the corresponding period of 2007. Parallel to the deficit growth, one should note the rising trend of traded values both in revenues and expenditures.

Revenues referring to international travel reached US$2.5 billion and expenditures, US$4.5 billion, with respective expansions of 18.1% and 60.2% in relation to the same period of 2007. Net expenditures summed up US$2 billion in the period, against US$707 million in the first five months of the last year, a growth consistent with recent trends of available income from foreign exchange rate nominal growth. Considering the twelve-month period ended in May, the account showed net outflows of US$4.6 billion, 142.7% higher than the ones registered in the corresponding period of 2007, with expansions of 18.2% in revenues and 54.9% in expenditures, totaling, in the twelve-month period, US$5.3 billion and of US$9.9 billion, respectively, a record level.

With reference to the income account, one should note that the increase of 93.5% in net remittances of profits and dividends, which summed up US$15.6 billion in the first five months of the year, with emphasis to growth of 76.4% in gross expenditures. Net revenues of profits and dividends totaled US$30 billion in the twelve months ended in May, with gross outflows referring to direct foreign investments increasing US$9.3 billion, impelled by expansion in the financial services and automotive sectors, US$2.3 billion each, segments which were directly impacted by the turmoil in the international financial markets or have gone through periods of low profitability in foreign countries.

Net expenditures with interests, in line with the decrease in external liabilities, had a cutback of 32.1% in the five-month period ended in May, totaling US$2.7 billion. Gross revenues with interest grew 52.2% compared to the first five months of 2007, an evolution consistent with the expansion of Brazilian liabilities abroad, especially referring to the growth in international reserves, earnings on which grew 53.8% in the period, coming to US$3.1 billion.

The net unrequited transfers summed up US$1.5 billion in the first five months of the year, 7.2% lower than the level registered in the same period of 2007. In the last twelve months ended in May, these net inflows dropped 8.6%.

5.4 Financial account

Table 5.7 – Financial account

US$ billion

Itemization	2007			2008		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Capital account	15.7	49.8	88.4	3.6	32.7	41.4
Direct investments	1.3	14.0	27.5	-0.1	6.4	17.0
Abroad	0.8	3.5	-7.1	-1.4	-7.6	-18.0
In Brazil	0.5	10.5	34.6	1.3	14.0	35.0
Equity capital	0.2	8.4	26.1	0.3	8.3	26.4
Intercompany loans	0.3	2.1	8.5	1.0	5.7	8.6
Portfolio investments	4.5	19.3	48.4	2.5	12.9	19.6
Assets	-0.3	-0.1	0.3	0.3	0.0	-1.1
Liabilities	4.8	19.4	48.1	2.3	12.9	20.7
Derivatives	0.0	-0.2	-0.7	0.0	-0.3	0.0
Other investments	10.0	16.7	13.2	1.2	13.6	4.9
Assets	-2.8	-13.3	-18.7	1.0	-4.0	-20.6
Liabilities	12.8	29.9	31.9	0.2	17.6	25.4

1/ Forecast.

In May, the balance of payments financial account posted a US$3.6 billion surplus, totaling a balance of US$32.7 billion in the year. Brazilian direct investments abroad showed net outflows of US$7.6 billion in the first five months of 2008, of which US$5.5 billion refer to equity capital and US$2.1 billion to intercompany loans.

FDI net inflows closed at US$14 billion in the first five months of the year, against US$10.5 billion in the corresponding period of the previous year, registering net inflows in the capital participation of US$8.3 billion and intercompany loans of US$5.7 billion. The FDI net inflows accumulated in twelve months summed up US$38 billion in May, the highest value in the series, a result consistent with the observed growth of investments in the industrial sector.

Foreign portfolio investments registered a surplus of US$2.3 billion in May, totaling net inflows of US$12.9 billion in the first five months of the year From this total, US$5.4 billion refer to Brazilian companies bonds negotiated

Table 5.8 – BP financing sources
Selected items

US$ billion

	2007			2008		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Medium and long-term funds	1.3	10.6	24.3	1.5	7.3	17.2
Public bonds	0.4	2.5	2.9	0.5	0.5	0.5
Private debt securities	0.6	6.4	15.4	0.7	3.9	12.2
Direct loans	0.3	1.7	6.0	0.3	2.8	4.4
Short-term loans (net)[2/]	9.4	23.5	13.8	0.8	-0.8	-3.0
Short-term securities (net)	0.3	2.8	3.7	0.0	-1.0	0.0
Portfolio (net)	4.6	1.4	45.1	1.6	14.7	25.0
Roll-over rates (%)						
Private sector:	268%	66%	109%	228%	226%	100%
Debt securities	277%	235%	186%	434%	194%	100%
Direct loans	247%	19%	53%	108%	298%	100%

1/ Forecast.
2/ Includes direct loans and trade credits transferred by banks.

Table 5.9 – Statement of international reserves

US$ billion

	2007		2008	
	Jan-May	Year	Jan-May	Year[1/]
Reserve position in previous period	85.8	85.8	180.3	180.3
Net Banco Central purchases	47.5	78.6	13.2	13.2
Debt servicing (net)	-5.3	-7.8	-1.9	0.7
Interest	-0.4	1.5	0.9	3.5
Credit	2.0	6.3	3.1	7.8
Debit	-2.4	-4.9	-2.2	-4.3
Amortization	-4.9	-9.3	-2.7	-2.7
Disbursements	2.5	2.9	0.7	0.7
Multilateral organizations	-	-	0.2	0.2
Sovereign bonds	2.5	2.9	0.5	0.5
Others[2/]	-1.4	6.9	0.6	0.6
Treasury's purchases	7.3	14.0	5.0	7.1
Change in assets	50.6	94.5	17.6	22.3
Gross reserve position	136.4	180.3	197.9	202.6

1/ Forecast.
2/ Includes payments/receipts in the framework of the Reciprocal Credits and Payments Agreement (CCR), fluctuations in prices of securities, exchange parities and price of gold, discounts and premiums, duty fees and release of collaterals.

in the country which, after registering net outflows in January, once again showed net inflows as of March. Net revenues related to fixed-income bonds a segment negotiated in the country totaled US$9.3 billion in the first five months of the year, one should note that since mid-March, impacted by changes in legislation regulating portfolio investments, there was a strong decrease in these flows, contrasting with the growth in those channeled to Brazilian companies´ bonds.

Foreign investments in fixed income bonds negotiated abroad showed net amortizations in the first five months of 2008. Including the National Treasury repurchases program, the medium- and long-term bonds showed net amortizations of US$2.4 billion, of which US$2.7 billion refer to the bond face value and US$194 million refer to premiums of such operations. Additionally, disbursements of US$525 million were registered with reference to the Global 17 reopening, in May.

Net disbursements related to medium and long-term private bonds reached US$516 billion in May, accumulating net disbursements of US$1.8 billion in the first five months of the year, period in which short-term bonds showed net amortizations of US$1 billion.

The other Brazilian investments showed significant decrease of assets abroad in May, US$1 billion, accumulating US$4 billion of constitution in the first five months of the year, of which US$3.3 billion in currencies and deposits.

The other foreign investments had a US$195 million surplus in May, accumulating US$17.6 billion in the year. When this result is broken down, the short-term trade credit responded for net remittances of US$1.8 billion in the month and net inflows of US$8.4 billion in the first five months of the year, noting an upturn in foreign exchange contracting operations in exports, in accordance with the maturity 00of operations. Medium and long term loans summed up net disbursements of US$1.1 billion in May and of US$6.7 billion in the year, while short-terms loans registered net inflows of US$775 million and net amortizations of US$812 million, in the same periods.

International reserves grew US$17.6 billion in the first five months of the year, totaling US$197.9 billion. The Central Bank´s purchases on the foreign exchange spot market totaled US$13.2 billion while, among foreign operations, one should highlight the disbursements of US$525 billion in Republic bonds and of US$150 billion of inflow together with the Bird, besides amortizations of US$2.7 billion of sovereign bonds, including, in this last one, US$660 million related to operations of repurchase of external debt bonds, by the National Treasury. Interest net revenues reached US$863 million, a result of gross expenditures of US$2.2 billion with bonds and revenue interests of US$3.1 billion related to earnings on international reserves. The National Treasury's net purchases summed up US$5 billion, while other operations had revenues of US$599 million.

By the end of 2008, the international revenue stock is estimated to be a total of US$202.6 billion, with annual growth of US$22.3 billion. Including the result of the first five months, net revenues are forecasted at US$0.7 billion, related to the external debt services and disbursements of US$0.2 billion contracted with companies and of US$0.5 billion related to sovereign bonds, even considering that the National Treasury will purchase US$7.1 billion on the exchange domestic market to service its external debt.

5.5 External sustainability indicators

Considering the estimated external debt position for May, the external sustainability indicators in general maintained the positive trend observed in December 2007, an evolution consistent both with increases registered in exports, in nominal GDP in dollars and in the international reserves, and with cutback in the external debt service, easily offsetting the growth in total external debt.

In the analyzed period, the external debt service decreased in US$11.4 billion, while exports grew US$12 billion, movements reflected in the fall, from 32.3% to 23.4%, registered in the participation of the debt service in the country's external sales.

The total external debt grew US$9.8 billion, in the period, while the creditor position of the net total external debt increased from US$11.9 billion to US$21 billion. Taking into account that GDP estimated in dollars grew 3.6% in the period, a growth of 0.2 p.p., to 14.9% was observed in relation to the total external debt, while the net total debt participation in GDP moved from -0.9% to -1.5%, the lowest value for the series, initiated in 1970.

The total of external debt coefficients /exports and total net external debt/exports, remained stable in the period, at 1.2

Table 5.10 – Sustainability indicators[1/]

US$ billion

	2006	2007				2008
	Dec	Mar	Jun	Sep	Dec	May[2/]
Exports of goods	137.8	142.4	150.0	153.5	160.6	172.6
Exports of goods and services	157.3	162.8	171.4	175.9	184.5	198.9
Debt service	56.9	59.4	53.6	55.4	51.9	40.4
Total external debt	172.6	182.1	191.4	195.3	193.2	203.0
Net external debt	74.8	60.0	28.9	17.0	-11.9	-21.0
International reserves	85.8	109.5	147.1	163.0	180.3	197.9
GDP	1 072	1 125	1 185	1 247	1 314	1 361
Indicators						
Total external debt/GDP (%)	16.1	16.2	16.1	15.7	14.7	14.9
Net external debt/GDP (%)	7.0	5.3	2.4	1.4	-0.9	-1.5
Total external debt/exports	1.3	1.3	1.3	1.3	1.2	1.2
Total external debt/exports of goods and services	1.1	1.1	1.1	1.1	1.0	1.0
Net external debt/exports	0.5	0.4	0.2	0.1	-0.1	-0.1
Net external debt/exports of goods and services	0.5	0.4	0.2	0.1	-0.1	-0.1
Debt service/exports (%)	41.3	41.8	35.7	36.1	32.3	23.4
Debt service/exports of goods and services (%)	36.2	36.5	31.3	31.5	28.1	20.3
Reserves/total external debt (%)	49.7	60.2	76.9	83.4	93.3	97.5

1/ Excludes stock of principal, amortizations and interests concerning intercompany loans.
2/ Estimated data.

and -0.1, respectively, the lowest results registered since the beginning of the series, in 1970.

Still in the same period, international reserves reached a level virtually identical to the total external debt, with the relation between these two indicators increasing from 93.3% to 97.5%, the series' record, an evolution linked to the growth of US$17.6 billion in the international reserves, against US$9.8 billion in the total external debt.

5.6 Conclusion

The uncertainties still prevailing in international market will impact the forecasted scenarios for commodity prices, capital flows, growth rates for exports and world output. Nevertheless, forecasts related to the country's external accounts for 2008 incorporated the prevalence of favorable balance of payments financing conditions, an expectation justified, somewhat, by the Brazilian economy experience since the second half of 2007, when the international financial markets volatility, derived from the default in the subprime market, exerted a residual impact on the country's economy.

The 2008 fiscal year will register the first current account deficit in the last five years. This result, impacted by a decrease in the balance of trade and by the increase in net remittances of services and income, especially, of, should be financed with net inflows of the balance of payments´ financial account, with emphasis on direct foreign investments. One should note, above all, that the floating exchange rate must mitigate significant movements in the country's external accounts.

The significant piling of reserves continues reducing the country's exposure to risks connected to external shocks. In this context, it is plausible to conclude that, if consistence of macroeconomic policies persists, reflected on the accreditation of Brazil´s investment grade by two large risk rating agencies, even in a scenario of more volatile external environment, the Brazilian economy meets the requirements for maintenance of this expansionist cycle.

Balance of Payments Projections

Table 1 – Uses and sources

US$ billion

	2007			2008		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Uses	-2.0	-18.9	-36.6	-1.7	-23.0	-51.6
Current account	-0.2	1.9	1.5	-0.6	-14.7	-21.0
Amortizations ML-term[2/]	-1.9	-20.8	-38.1	-1.0	-8.3	-30.6
Securities	-1.3	-9.0	-20.6	-0.3	-5.1	-17.1
Paid	-1.3	-8.8	-19.9	-0.3	-5.1	-17.1
Refinancing	0.0	0.0	0.0	0.0	0.0	0.0
FDI conversions	0.0	-0.2	-0.7	0.0	0.0	0.0
Suppliers' credits	-0.1	-0.6	-1.5	-0.1	-0.7	-1.9
Direct loans[3/]	-0.5	-11.2	-16.1	-0.6	-2.5	-11.6
Sources	2.0	18.9	36.6	1.7	23.0	51.6
Capital account	0.1	0.4	0.8	0.1	0.3	0.9
FDI	0.5	10.5	34.6	1.3	14.0	35.0
Domestic securities[4/]	3.8	13.3	39.8	1.4	12.7	25.0
ML-term disbursem.[5/]	1.8	12.7	36.0	3.1	14.8	34.7
Securities	1.0	8.8	18.3	1.2	4.5	12.7
Supliers' credits	0.1	0.4	1.6	0.2	1.1	4.2
Loans[6/]	0.7	3.4	16.1	1.6	9.2	17.8
Brazilian assets abroad	-2.3	-9.8	-25.4	-0.1	-11.6	-39.7
Other[7/]	13.6	42.7	38.4	0.0	9.4	17.0
Reserve assets	-15.5	-50.9	-87.5	-4.0	-16.6	-21.3

1/ Forecast.
2/ Registers amortization of medium and long-term supliers' credit, loans and securities placed abroad minus refinancing and discounts. Excludes amortizations referring to loans to IMF and intercompany loans.
3/ Registers amortizations loans borrowed from foreign banks, buyers, agencies and multilateral organizations.
4/ Includes foreign investment in equity and debt securities traded in the domestic market.
5/ Excludes intercompany loans disbursements.
6/ Includes multilateral and bilateral financing and buyers' credits.
7/ Registers net values of bond swaps, short-term securities, short-term trade credit, financial derivatives, nonresident deposits, other liabilites and errors & omissions.

Projections for the external accounts published in the March Inflation Report have been updated by taking into account recent statistics and the impact of the new stock of external debt calculated for the month of March, including the new schedule for amortization and interest payments.

The forecast for the current account deficit in 2008 moved upward from US$12 billion to US$21 billion, in view of the worse than expected results observed in the first months of the year, the decrease of US$2 billion in the expected trade surplus and the increase of US$7 billion in the forecast deficit for the services and income account.

With regard to the balance of trade, the estimated annual growth of exports was maintained at 13.3%, while the rise in imports, in line with the upward trend observed in domestic demand, was revised to 30.2%. Thus, the trade surplus estimate was revised to US$25 billion, as compared to US$27 billion in the March Inflation Report.

The deficit in the services account is estimated at US$16.3 billion for 2008, for a US$1.9 growth compared to the previous estimate. This result is due to an expected increase in the deficit in the transportation account, to US$6.5 billion, as a consequence of expected enhanced dynamics in the foreign trade and a rising in sea freight on a global scale. The forecast for the deficit on international travel was also raised from US$4 billion to US$5 billion, based on the expansion of net outflows occurred so far, a movement consistent with the increase in available income and the nominal exchange rate.

The forecast for 2008 net interest payments was slightly raised, to US$4.9 billion, reflecting the new scheme for payments of interest on foreign debt and the expected trajectory for interest rates and for Brazilian assets abroad. Interest revenues are expected to mount to US$11.9 billion, of which US$7.8 billion related to earnings on international reserves, while expenditures are forecast at US$16.7 billion, based on the profile of the stock of external debt calculated in March 2008.

The most significant revisions in the current account occurred under the heading profits and dividends. By analyzing its performance in the year, one may observe that the additional flows of US$7.5 billion are due mainly to remittances of direct investment income, US$5.8 billion. Nearly two thirds of this expansion was concentrated on the financial, automotive vehicles and metallurgy sectors. The estimated value for net remittances of profits and dividends has been revised from US$24 billion to US$29 billion, the same level reached by the 12-month accumulated net outflows in the month of May, reflecting the expected of stabilization of these flows at current levels. The performance of expenditures continues to be influenced by the growth in the stock of foreign investments in the country, by the business profitability, in contrast to that observed in mature economies, and by the trajectory of the exchange rate. It is reasonable to attribute a pro-cyclical nature to this component of the current accounts, since remittances tend to intensify at periods of economic heating and to diminish in periods of economic accommodation, thus establishing an endogenous adjustment factor for the current account in relation to the domestic economic cycle.

The balance of payments financial account is expected to register a surplus of US$41.4 billion, US$17 billion higher than the March forecast, reflecting the improvements observed in the first five months of the year and the expected rise in the inflows of foreign direct and portfolio investments, the occurrence of net disbursements in other investments and expansion of the commercial banks' assets abroad. International reserves should close the year at US$202.6 billion, an increment of US$22.3 billion as compared to the end of 2007.

Table 2 – Balance of payments – Market

US$ billion

Itemization	2007			2008		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Current account	-0.6	0.6	-4.8	-1.3	-17.8	-28.8
Capital (net)	17.8	54.4	94.1	2.2	33.2	58.8
Foreign direct investment	0.5	10.5	34.6	1.3	14.0	35.0
Portfolio investment	3.8	13.3	39.8	1.4	12.7	25.0
Medium and long term loans	-0.5	-10.4	-9.8	0.4	1.6	-3.7
Trade credits – Short, medium and long term	12.2	37.1	36.1	-0.1	11.8	24.1
Banks	9.5	23.6	18.6	1.6	3.0	1.8
Other	2.7	13.6	17.5	-1.7	8.8	22.3
Brazilian investment abroad	0.2	-3.1	-14.8	-1.7	-9.3	-22.9
Other	1.6	6.9	8.3	0.8	2.5	1.3
Financial gap	17.2	54.3	89.3	0.9	15.4	30.0
Banco Central net intervent.	-14.6	-47.5	-78.6	-2.5	-13.2	-13.2
Bank deposits	-2.5	-6.8	-10.7	1.6	-2.2	-16.8

1/ Forecast.

As a result of the process of internationalization of Brazilian companies, which has accelerated in 2008, the forecast for the remittances of Brazilian direct investments abroad was raised from US$10 billion to US$18 billion, while foreign direct investment inflows are estimated at US$35 billion for the entire year, a result slightly higher than the record set in 2007 and higher than the forecast of US$32 billion calculated in the March 2008 Inflation Report.

The forecasts for medium and long-term external debt repayments were revised upward from US$28.7 billion to US$30.6 billion, reflecting the March profile of the stock of external debt, the forecast performance for the exercise of put/call options and the incorporation of the impact of repurchase operations carried out by the Treasury in the first four months of the year.

Projected medium and long-term investments in domestic stocks and papers were revised upward to US$25 billion, an increase consistent with the changes occurred in the first five months of the year and the expectations of investment grade ratings to be granted by two of the three largest international risk assessment agencies. Rollover rates for the medium and long-term private debt were maintained at 100%.

The total banking sector assets abroad are expected to increase US$16.8 billion in 2008, compared to US$5.6 billion estimated in March, primarily as a result of the rise in direct and foreign portfolio investments. Therefore, the balance of payments is expected to register a surplus of US$21.3 billion in 2008, compared to the US$13.4 billion March estimate. This result is consequent upon the incorporation of net purchases of foreign currency carried out by the Central Bank on the market in the first five months of the year and supposes that the Central Bank will no longer carry out additional currency purchases on the market and that the Treasury will fully serve its foreign debt by raising funds in the market. Therefore, the performance of the external accounts is expected to permit an adequate financing of the balance of payments in 2008.

Table 2 – Balance of payments – Market

US$ billion

Itemization	2007			2008		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Current account	-0.6	0.6	-4.8	-1.3	-17.8	-28.8
Capital (net)	17.8	54.4	94.1	2.2	33.2	58.8
Foreign direct investment	0.5	10.5	34.6	1.3	14.0	35.0
Portfolio investment	3.8	13.3	39.8	1.4	12.7	25.0
Medium and long term loans	-0.5	-10.4	-9.8	0.4	1.6	-3.7
Trade credits – Short, medium and long term	12.2	37.1	36.1	-0.1	11.8	24.1
Banks	9.5	23.6	18.6	1.6	3.0	1.8
Other	2.7	13.6	17.5	-1.7	8.8	22.3
Brazilian investment abroad	0.2	-3.1	-14.8	-1.7	-9.3	-22.9
Other	1.6	6.9	8.3	0.8	2.5	1.3
Financial gap	17.2	54.3	89.3	0.9	15.4	30.0
Banco Central net intervent.	-14.6	-47.5	-78.6	-2.5	-13.2	-13.2
Bank deposits	-2.5	-6.8	-10.7	1.6	-2.2	-16.8

1/ Forecast.

6 Inflation outlook

This chapter of the *Inflation Report* shows the assessment by the Monetary Policy Committee (Copom) on the performance of the Brazilian economy and the international scenario since the release of the March 2008 *Report*. It also provides the analyses of the inflation prospects up to the second quarter of 2010 and for Gross Domestic Product (GDP) growth up to the end of 2008. One should highlight that, in this *Inflation Report*, Copom starts to systematically release inflation projections for a period of two years, with the first period being the one that immediately follows the *Report* release month. This procedure is similar to the one adopted in case of *Reports* released in each December. Thus, *Reports* published in March, June and September, which used to consider inflation forecasts only for the current year and the next, henceforth will contain forecasts for the next eight quarters. The inflation forecasts are presented in two main scenarios. The first, named reference scenario, presupposes that the Selic rate will remain unchanged during the forecast horizon, at 12.25% per year, the level decided by Copom in its last meeting on June 4 and 5, and that the foreign exchange rate will remain at R$1.65/US$. The second, named market scenario, uses the paths for Selic rate and for the foreign exchange rate based on the survey carried out by Brazilian Central Bank's Gerin with private sector analysts, until the cutoff date of June 13, 2008. One should highlight that these scenarios serve only to signal the monetary policy decisions, and its assumptions do not consist and cannot even be seen as Copom's forecasts about future behavior of interest and foreign exchange rates.

Inflation and GDP growth forecasts mentioned in this *Report* are not point estimates; they specify probability intervals which evince the degree of uncertainty prevailing in the above-mentioned cutoff date. The inflation forecasts do not depend only on the assumptions about interest and foreign exchange rate, but also on a set of assumptions about the behavior of exogenous variables. The most likely set of assumptions considered by Copom is used to construct the scenarios to which the Committee attaches the greatest weight on making the interest rate decision. By exposing them, the Committee seeks to foster transparency to monetary policy decisions, contributing to its effectiveness in controlling inflation, which is its primary target.

6.1 Inflation determinants

The IPCA measured inflation reached 2.88% over the year up to May, against 1.79% in the same period of 2007. Since January, the twelve-month rate stands higher than the target's center, with an increasing deviation since then. In fact, the twelve-month inflation up to May stands at 5.58% (against 4.56% in January and 3.18% in May 2007). In this way, the consumer inflation continues to follow the upward trend initiated in 2007, thereby changing the benign scenario existing in the previous year. Behind these increases there are structural factors which tend to be persistent, such as the major demand by big Asian countries – China and India – and the displacement of some crop productions, as maize, in favor of the biofuel production.

Additionally, transitory factors, such as weather conditions, also put pressure on food prices, as well as tariff and nontariff restrictions on the trading of specific products by several countries in the latest months. Recently, a more intensive increase of petroleum prices and high readjustments on prices of some nonagricultural commodities, for example, iron ore joined up with the above factors. Another important difference in the inflation dynamics, compared to the usual pattern, arises from the behavior the administered prices, which, in 2007, for the first time since the inception of the Inflation Targeting System in 1999, registered increases lower than that of market prices, a trend which persists in 2008. In fact, while the market prices grew 3.62% over the year up to May and the administered and monitored prices grew 1.18%. The behavior of nontradable prices indicates that the demand pressure continues to have a relevant impact on the inflation behavior. Therefore, market prices and nontradables increased 7.70% in twelve months up to May, while the increase in prices of tradable goods also stood higher than the target's center (7.90% in twelve months up to May). In the first five months of the year, market prices continued rising, while monitored prices stood contained. In the aggregated, however, the IPCA registered an important growth.

The GDP at market prices grew 5.8% in the first quarter of 2008 in relation to the same quarter of the previous year and, according to IBGE's seasonally adjusted data, 0.7%, in relation to the last quarter of 2007, when it grew

1.6% against the previous quarter. From the production viewpoint, one should note the industrial sector growth, of 6.9% compared to the same period of the previous year, while the agricultural sector and the services sector reached, 2.4% and 5.0% respectively. Concerning demand, highlighted was the gross fixed capital formation, which expanded 15.2%, against the same quarter of the previous year, followed by household and government consumption, expansions of 6.6% and 5.8% respectively, compared to the same quarter of the previous year. Just as occurred since the first quarter of 2006, the growth was dictated exclusively by domestic market. In fact, domestic demand contributed with -2.6 percentage points (p.p.) to GDP expansion of 5.8 p.p. in the first quarter of this year, the lowest value since the fourth quarter of 1996. Copom considers that, even with the weakening prospects of global economy compared to the situation depicted in the last *Report*, the current behavior of domestic demand activity should continue, with some moderation, in the next months, favored by several sustaining factors that still impact on economic activity, such as credit and employment expansion. Taking into account, additionally, the narrowing in the factor market observed in the latest quarters, the Committee assesses that the pace of demand expansion remains a dominant element in the balance of risks affecting the inflation behavior.

At a moment when the confidence in the pace of global economy expansion decreases, the dynamics in household consumption activity has contributed importantly for sustaining the domestic demand. In fact, in the first quarter of 2008, household consumption reached 6.6% as compared to the same period of the previous year. This robust performance may also be seen, and anticipated, by data related to retail sales. Retail sales grew 12.0% in the first quarter of 2008 and 10.2% in the last twelve months up to March. One should highlighted the increase in furniture and appliances sales (17.3%), favored by the continued growth of the total payroll and by improved credit conditions, as well as in sales of fabrics, clothing and footwear (13.3%). Additionally, sales of vehicles, motorcycles, auto parts and accessories, which are included only in the expanded sales index, increased a significant 21.4% in the first quarter.

Expansion of economic activity has produced positive effects on the labor market. The employed population, according to the PME, increased 4.3% as compared to April 2007, while the real average earnings usually received grew 2.8%, causing the total real payroll to reach 7.2%. On the other hand, also in April, the manufacturing industry employment level registered a 4.0% growth as compared to the same period in 2007, according to CNI data. Referring to formal jobs, data released by MTE indicated its growth intensification in 2008, with the creation of 849 thousand job positions up to April, more than a half of the number of positions created in 2007, when it registered the highest annual balance in Caged's historic series. In percentage terms, formal employment expansion in 2008 up to April was led by the construction industry (16.3%), trading (6.5%), manufacturing industry (6.4%) and services (5.5%). The favorable developments on the labor market, strengthened the perception, expressed by the Copom in previous *Reports*, that the total payroll will continue to be one of the pillars for sustaining aggregated demand. Among other reasons to this, there is the fact that the positive performance of the labor market has contributed to maintain consumer confidence indices at high levels.

The availability of household credit, favored by macroeconomic stability and institutional advances, notwithstanding the increase of funding costs by financial institutions, has been another important element of consumption incentive. In twelve months up to April, financing system's credit (with free resources) to individuals increased 34.1%, with emphasis to the expansion of leasing operations (124.1%). One should still mention that the credit expansion has been accompanied by the lengthening of the average term of the credit operations and by the stabilization in delinquency rates. Concerning the prospective scenario, market analysts and banking sector agents expect credit will continue to increase in 2008, however with some moderation, mainly in some segments, such as the real estate credit. This assessment finds support, for instance, in the labor market formalization process, in the increase of population's bankarization and improvements of the institutional environment, which have sustained personal credit growth in 2008.

Investment has proven to be the most dynamic component of domestic demand. After the growing 10% in 2006 and 13.4% in 2007, the Gross Fixed Capital Formation (GFCF) increased, in real terms, by 15.2% in the first quarter of 2008, against the same period of the previous year. As a GDP share, the GFCF moved from 17.4%, in the first quarter of 2007, to 20.0%, in the first quarter of 2008. The investment upturn mirrors the heating of activity in an environment of economic stability and increases of companies' earnings.

There is evidence that credit expansion would be helping sustain investment expansion. In fact, free resource credit to companies grew 35.7% in twelve months up to April, 10.3% only in this year. However, loan disbursements and financing through the BNDES system grew 45.4% in the first quarter of 2008 compared to the same period of the previous year. Besides, on the capital market, the volume of public offer (US$5.3 billion up to May) as well as the placement of debentures (R$1.6 billion up to May 2008, excluding issuances carried out by leasing companies) contributed to finance the investment in practically all sectors. In view of this, there are signs that capital market activity will be intensified in the second half of the year. On the one hand, the appreciation of the real also favored investment growth, in an important way, by reducing the cost of imported capital goods. On the other hand, the enhancement of PAC implementation process must expand public investments in infrastructure. In short, even in context of a moderate slowdown of world economy this year and greater volatility in the world markets since mid-2007, the combination of earnings and high confidence, linked to favorable financing conditions, should contribute to the continuity of an investment positive performance.

According to IBGE, government consumption grew 5.8% in the first quarter of 2008, in relation to the same period of 2007; this development was accompanied by strong increase in public revenues. In fact, despite not counting anymore on inflows from the Provisional Tax on Financial Operations (CPMF), the Central Government’s revenues grew 18.1% up to April compared to the same period of the previous year. On the other hand, ICMS collection, the main state tax, increased 7.6%. Faced with the current budget-earmarking framework in the country and public policy guidelines, it is expected that growth of government consumption will continue in the next quarters, even with the downturn in the pace observed at the beginning of the year.

Regarding the external sector, after registering surplus of US$40 billion in 2007, balance of trade showed surplus of US$8.7 billion in the first five months of 2008, 48.4% lower than that observed in the same period of previous year. This result is due to an amount of US$72.1 billion in exports and imports of US$63.4 billion. Besides the relative reduction in the performance of exports, one should note that the partial results of this year were negatively affected by important facts such as the strike of Federal Revenue auditors, the delays in grain harvest and the lockout of farming products in Argentina. Actually, these factors were absent or very attenuated in May, apparently with immediate effects on the month’s balance of trade, with surplus of US$4.1 billion. In this way, even if the balance of trade shows a new cutback in

2008, it is worth noting that forecasts based on extrapolations of recent balance of trade performance may overestimate the observed retraction in the year.

Still concerning external trade, after growing 5.5% in 2007 (against 3.3% in the previous year), the exports rose 6.9% in the first quarter, the first contraction since 2003, on this basis of comparison, reflecting external demand slowdown and the absorption of part of the previously exported production, by the domestic market. On the other hand, after expanding 22% in 2007 (against 16.1% in 2006), the imports expanded 18.4% in the first four months of the year. The fall in exports was partially offset by increases in export prices, which, even after rising 12.5% in 2006 and 10.5% in 2007, moved up a significant 22.1% in the first four months of the year. The import prices, which grew 8.2% in 2007 (against 6.9% in 2006), also strongly increased in the first four months of the year (21.3%). In this context, still anticipating for 2008 balance of trade lower figures than those observed in 2007 (strictly, partial results have already been registered), Copom does not foresee abrupt reversal in the balance of trade in the short term.

It is important to observe that the high growth in imports reflects, largely, the significant increase in external purchases of capital goods, which, after growing 32.1% in 2007, continues to accelerate on the margin. In fact, the growth in the first four months topped 33.6%. Partially mirroring these developments, net exports contribution to aggregate demand growth was negative by 2.6 p.p. in the first quarter of 2008, as occurred in previous years (-1.4 p.p. in 2006 and 2007). The evolution of net inflows mirrors the effects of domestic economic activity acceleration *vis-à-vis* the situation of our trade partners, as well as the strengthening of Brazilian assets prices, especially of the foreign exchange rate. Despite its relevance to mitigate inflationary pressures, evidence shows that net exports became less effective as an auxiliary instrument in the maintenance of price stability. On the other hand, still negatively biased by the mentioned factors in the penultimate paragraph, the Committee recognizes that, concerning current transfers, the most plausible scenario is that which considers an assumption of deficit for 2008. In fact, in the first four months, current transfers showed deficit of US$14.1 billion, which corresponded to 3.1% of GDP, against surplus of 2% registered in the same period of the previous year. In the last twelve months, deficit topped US$14.7 billion, meaning 1.08% of GDP, while direct foreign investments net inflows totaled an equivalent 2.75% of GDP.

Future paths of external accounts and of net external demand will not only depend on domestic economy developments, but also, in an important way, on the global economic context. Therefore, one should note that the external scenario remains characterized by a tendency of modest slowdown in activity, now accompanied by the renewed intensification of inflationary pressures.

The United States economy seems to go through a stagnation period since the final quarter of 2007, and continues to suffer the impact of the real estate crisis, with effects on the weakening labor market, which, coupled with high prices of petroleum derivatives, affects consumers' confidence, and contributes importantly to depress outlays. Though the influence of monetary and fiscal incentives may limit the risk of significant contraction in activity, the dominant scenario seems to indicate a more consistent recovery only in 2009. Even after significant strengthening of relevant financial institutions' assets, uncertainty remains about the extension and magnitude of the American mortgage crisis development within the USA and Europe banking system, as well as the impact they will have on the credit access conditions by companies and households. Therefore, doubts persist over the capacity of the monetary and fiscal policy measures implemented by USA authorities to soften in a timely manner the weaknesses of economy, against persistent financial system difficulties. Notwithstanding some reduction in systemic risk perception since mid-March, such difficulties might be aggravated by cyclic deterioration of credit quality, which would reinforce the already existing contractive tendency of financial conditions, which would increase the risk of slowdown intensification. Prospects on activity in Europe – notwithstanding favorable indicators in Germany – and in Japan also continue pointing to a negative direction, although, up to the moment, existing concerns are not as high as those with the USA economy.

One should observe that, notwithstanding the prospects of continuing slowdown in central economies, global inflationary pressures have intensified. Somehow, this mirrors the strong growth shown by emerging economies, which, up to now, apparently were barely affected by the USA mortgage crisis, counteracting the effects of slowdown in mature economies. Even in these economies, however, inflationary pressures have been intensified. The inflation up to May in the USA, United Kingdom and Euro Area, stood, respectively, at 1.5 p.p., 0.8 p.p. and 1.8 p.p. higher than the observed values in the same month of previous year. In the case of Japan, twelve-month inflation up to April stood at 0.8 p.p. higher than the one registered in the same period of 2007. In emerging economies, inflation slowdown has been even more significant. For example, the twelve months inflation up to May in Chile, Peru and South Africa stood, respectively, at 5.5 p.p., 4.5 p.p. and 4.1 p.p. higher than the value registered in the same period of the previous year. Depending on the region, these developments mirror, to a higher or lower extent, pressures from the demand growth relative to the availability of production factors and the tendency of price increase of raw materials.

Given this situation, tendency, in emerging economies, is one of continued contractionary monetary policy. In mature economies, inflation acceleration, which in some cases also starts to have effects on medium-term inflationary expectations, led to substantial change in the stance and communication by monetary authorities, who started to emphasize their respective worries about inflation. Despite the remainder risks of USA credit crisis, and the need for consolidating the systematic risk cutback, apparently limit the prospects for more incisive actions against inflation pressures in mature economies, also in these cases the general tendency must be one of gradual adoption of restrictive measures.

The volatility and risk-aversion indicators in international financial markets stood at relatively high levels since the last *Inflation Report*. However, the re-evaluation of the Brazilian sovereign risk to investment grade by important rating agencies tends to reduce the sensitivity of Brazilian assets prices to the international scenario, and contributes to mitigate, but not eliminate, the difficulties experienced by global economy on economic activity in Brazil, whose dynamics has been sustained essentially by domestic demand. In summary, since the release of the last *Inflation Report*, the central prospective scenario for the world economic activity continues pointing to a moderate slowdown, accompanied by important rises of inflationary pressures and by monetary policy reorientation towards containing price upsurges.

In this way, the prospects for the behavior of prices of the Brazilian main export products – especially of commodities – continue shrouded in considerable uncertainties. Generally, however, prices of commodities still remain at historically high levels; being subject to corrections as consequence of possible cutbacks in global demand, especially from the USA and Europe, despite the demand arisen from important emerging economies contributes to cool off this movement. On the other hand, interest rates at relatively low levels in mature economies, and the rising concern about inflation, may introduce a renewed search for commodities as a tool for anti-inflationary protection. While there is some controversy about the speculative role in recent behavior of commodities prices, the price trends of raw materials, not negotiated on the stock market, such as iron ore, indicates the underlying importance of supply and demand fundamentals.

In relation to aggregate supply, the three sectors showed positive performance in the first quarter of 2008. Industry was strongly accelerated, with growth rate (6.9%) markedly higher than the one observed in the previous year (4.9%). In fact, industrial production expansion, against the same period of the previous year, was the highest since the first quarter of 2005. The services sector also showed positive result, with increase of 5% (4.7% in 2007). On the other hand, the poorest performance was in the farm sector, which grew 2.4% (5.3% in 2007), which is due to some extent to the postponed harvest of some important crops.

After a sharp increase of 6% in 2007 – the highest rate in the latest three years and the second highest since 2001 – industrial production accelerated and expanded 7.3% in the first four months of 2008, the highest rate since 1996. In these months, manufacturing industries grew 7.4% and the mining sector, 5.9%. While the former still shows signs of increase on the margin, the latter suggests a stabilization pace. One should highlight in the recent behavior in industrial production – more common in recent years – the manufacturing industry has grown more than the mining sector, a position which is aligned to the greater domestic demand upturn. Data already released in the latest months point to the continuity of the industrial growth cycle, even at a pace conditioned by occasional limitations to the supply expansion.

While from a supply viewpoint GDP grew 5.8% in the first quarter, compared to the same period of previous year, from the demand side – excluding inventory variation – growth reached 5.2%. From the restricted viewpoint of the industrial sector, FGV´s May Outlook Survey shows that, after remaining for more than four months above 100 since last October, – a level higher than that in which a number of companies assesses that inventories are insufficient surpasses that which evaluates that they are oversupplied – the inventory level indicators is again around 100 since February, which suggests that stocks would have returned to the level planned by the surveyed companies. On the other hand, to CNI, at the end of March, inventories of final goods remained at a level higher than the one registered in the same period of 2007. Besides, the difference between observed and planned inventories, which had dropped to lower than 50 in the last quarter of 2007 – level which shows that the effective demand is higher than that anticipated – returned to a level higher than 50 (50.2) in the first quarter of 2008. Thus, there seems to have been the adjustment in inventory levels at the beginning of the year, which was forecasted in the last *Report*.

The Nuci (capacity utilization rate) average in the manufacturing industry stood at 82.2% in the first four months of 2008, according to CNI data, a level 1.3 p.p. higher than that verified in the same period of the previous year. One should note that, after reaching the maximum in April and November 2007 (1.8 p.p.), the difference has been decreasing marginally. On the other hand, according to FGV, the Nuci in the five first months of 2008 reached 85% on average, a level 1.3 p.p. higher than that observed in the same period of the previous year.

Generally, the high level of capacity utilization is due to the acceleration of economic activity and is expressed in several sectors, notwithstanding the substantial growth of the investment volume. The FGV's Outlook Survey of the manufacturing industry indicates that, between January and April, there was an increase of 4 p.p. in the number of companies which mentioned facing limitations in production growth (36% against 40%, respectively). As concerns the capacity expansion, the capital goods absorption, which was already showing high growth rates (5.1% in 2005, 13.9% in 2006 and 19.6% in 2007), accelerated at the beginning of this year, registering sharp growth of 22% in the first four months, in relation to the corresponding period of the previous year. This development reflects not only the vigorous increase in capital goods imports (33.6% in volume), but also in their production (20.5%). One should also mention the 10.0% increase in production of inputs for the construction industry, the best four-month period since 1995. On the other hand, in view of the recent behavior of capacity use rates, the timely maturity of investment projects is a fundamental factor in avoiding the important deepening unbalance verified in the evolution of aggregated of supply and demand in the latest quarters, which has exacerbated the risk for the inflation dynamics. In general terms, however, against recent evidence it is plausible to assume that the sustainment of a more intense pace of economic activity also implies the increase of interest rates.

The National Cost of Construction Index – Domestic Availability (INCC-DI) showed increase in production costs linked to this sector. The INCC's accumulated growth up to May reached 4.40% against 2.56% registered in the same period of the previous year. On the other hand, the increase in the last twelve months topped 8.06% in May, a value 2.9 p.p. higher than the one verified in the corresponding period of 2007. These developments have been raising worries about the emergence of possible supply restrictions in this segment, which, given its production structure, would hardly be alleviated by imports. In addition, the construction industry seems to suffer cost pressures given the apparent lack of specialized labor force. Remaining prospects of demand expansion in an environment where financing conditions remain unfavorable reinforces concerns with price evolution in the construction industry.

With the overcoming of the "encourage" effect, typical of initial phases of expansion cycles, the growth in the economically active population (PEA) has been decreasing. In twelve months up to April this growth reached 2%, against 2.8% registered in the same period of the previous year. This movement, linked to the acceleration of economic activity pace and the consequent expansion of employment, caused faster drops in unemployment rates. Actually, in April, unemployment rate stood at 8.5% against 10.61% and 10.4% in the same periods of 2007 and 2006. Consequently, average unemployment rate in the first four months of the year stood, on average, 1.4 p.p. lower than the one verified in the corresponding period of the previous year and, on margin, the difference has been increasing. When the average rate is analyzed in twelve months, it is observed that April registered its tenth consecutive cutback in this metrics. In the presence of strong upturn in demand for labor force, once the remaining trends for PEA are maintained, unemployment rates should maintain a declining trend in the next quarters, which could enable the emergence of pressures for more significant rise in wages, possibly higher than the growth of labor productivity.

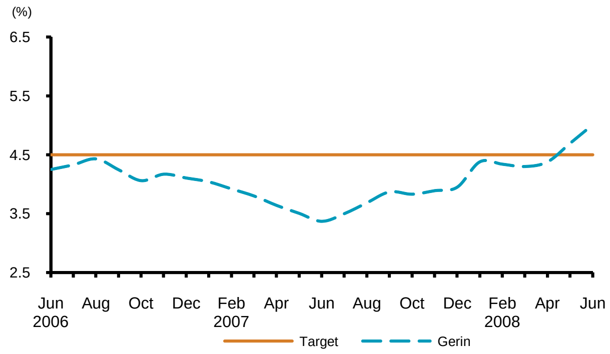
On the other hand, petroleum prices, systematic source of uncertainty in the external scenario, have been rising since the release of the last *Inflation Report* and continue highly volatile. This behavior is due to structural changes in the world energy market, which have hindered the traditionally observed recovery of stock levels, and generated geopolitical tensions. One should note that the impact of international prices of petroleum on domestic inflation is not exclusively transferred by fuel prices, but also, for example, by the petrochemical sector's supply chain and by consumers' and entrepreneurs' expectations. The volatility of other important commodities prices continues equally high and with a general rising tendency, an effect of increased uncertainty in the prospects for world demand growth, and of major turbulence in the global financial markets.

After more than doubling in 2007 (7.89% against 3.79% in 2006), the broad inflation – measured by the IGP-DI – continued accelerating in 2008. Up to May, the IGP-DI grew 5.16%, against 1.19% in the corresponding period of the previous year, and in twelve months, 12.14%, a percentage 7.76 p.p. higher than the one verified in the same months of 2007. The strong acceleration of the index was due especially to the behavior of IPA-DI, which increased 15.36% in the last twelve months, against 4.29% in 2006. On the other hand, on the same basis of comparison, the IPC-Br and the INCC increased 5.59% and 8.06%, respectively, against 3.12% and 5.18% in the previous year. Still referring to the wholesale price index (IPA), one should note that the rising industrial prices, a process which began in the second half of 2007, was intensified in the latest months. In fact, between January and May 2008, the industrial IPA accumulated growth of 6.67%, against 1.61% in the same period of 2007. As a result, the twelve-month inflation of industrial prices grew from 4.42% in December 2007 to 9.63% in May 2008. As verified in previous *Reports*, Copom assesses that effects of the behavior of wholesale prices on consumer inflation will depend on the actual and future conditions of demand and price-setters expectations with regard to the future inflation trend.

The benign scenario for consumer prices, which was intensely materialized in 2006, began to decline in 2007 and showed even higher deterioration at the beginning of this year. These developments were referred to in the risk balance conducted by the Committee in previous *Reports*, which forecasted that the twelve-month inflation could accelerate this year. Similarly to what occurred in 2007, market prices this year have risen more than the monitored and administered ones, with the latter mitigating, at least for one more year, the IPCA acceleration. While market prices grew 3.62% in the first five months of 2008 (7.14% in twelve months), administered prices increased only 1.18% (1.50% in twelve months). In the set of market prices, nontradable goods topped 3.89% up to May (7.70% in twelve months), while tradable goods grew 3.33% (7.09% in 2007).

The three measures of core inflation calculated by the Central Bank registered, up to May, values higher than the ones verified in the same period of the previous year. Besides, with exception of the non-smoothed trimmed mean core, the twelve months inflation stands higher than the target's center. In fact, in the accumulated in the year up to May the core that excludes monitored prices and food at home prices registers inflation of 2.70% (1.80% in the same period of 2007), the smoothed trimmed mean core stands at 2.03% (1.52% in the same period of 2007) and the and the non-smoothed trimmed mean core shows inflation of 2.15%. In twelve months, the values are 5.03%, 4.56% and 4.39%, respectively.

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



As mentioned in the last *Inflation Report*, inflation expectations for 2008 continues rising and actually stands at 5.80%, against 4.40% in March. For 2009, expectations also deteriorated, increasing from 4.30%, in March, to 4.63%. For 2010, the expectations rate moved from 4.40%, where it stood for a long time, to 4.50%. In the Committee's assessment, these developments, as well as the inflation acceleration in 2007 and in the first five months of the year, indicate that the convergence of the Brazilian inflation to the target, even against inflationary pressures in global scale, requires a timely action by the monetary authority, through adjustments to the basic interest rate.

6.2. Main scenario: associated risks and monetary policy implementation

The forecasts considered by the Copom are based on a set of assumptions about the behavior of the main macroeconomic variables. This set of assumptions, as well as the risks associated to it, make up the main prospective scenario based on which the Committee makes decisions.

In general terms, this scenario considers a slow down on the pace of expansion of the global economy, on the external side, followed by slight downturn in the expansion of the Brazilian economy, on the domestic side. Forecasts considered in this scenario will be presented in the following section. The scenario also encompasses the deterioration of the current and expected inflation dynamics due to rising inflation risks, both on the domestic and external sides. In this context, the main challenge of monetary policy is to prevent the current deterioration of inflation from spreading and consolidating.

The main scenario for the external sector incorporates a worse deceleration of the North-America economy than assessed in the last *Inflation Report*. Besides the impact caused by the USA economic deceleration to the global economy, one must consider the potential negative effects of this deceleration on mature economies in Europe and Asia, and the consequent deepening of the current negative growth trend. On the other side, equally important, there are increasing concerns about the evolution of inflation, in various regions. To some extent, it reflects the direct and secondary effects (due to rising inflation expectations) of increases in the prices of energy and foodstuffs. In this sense, some economies already face a situation that combines economic deceleration with significant inflationary pressures. The distribution of the external risks impacts on economic activity and inflation around this main scenario, as assessed by the Committee, changed since the release of the last *Inflation Report*. Monetary policy decisions taken by the central banks of mature economies, followed by fiscal incentives in the case of USA, seem to have been successful in limiting the risk of economic downturn, but the period of deceleration may extend into 2009. To the extent that the size and allocation of losses derived from the North-American real estate crisis among the financial institutions from mature economies are not fully known, and important segments of the financial market in these economies have not yet resumed normal liquidity conditions, the perception of systemic risk persists. However, this perception is less intensive than it was at the beginning of this year.

While the process of recapitalization of financial institutions proceeds, the credit supply conditions remain restrictive, which tends to feed back into the dynamics of demand deceleration. Note, however, that the ongoing deceleration of the global economy does not seem to be sufficient to contain the inflationary pressures that started off by the behavior of the raw materials prices but are now, apparently, intensifying and spreading. Considering all that, the main risks coming from the external sector tend to more balanced. On the one hand, there is a possible intensification of the contractive trends of the economic activity, which predominated up to March, and on the other, the deterioration of the global inflationary outlook seems to be worse in the latest months.

Copom reaffirms its assessment that the possible scenario of more intensive and generalized world deceleration would have an ambiguous impact on domestic inflation. Besides, by reducing net exports, a stronger world deceleration helps to contract aggregated demand. On the one hand, the potential cooling off of prices of some important commodities could contribute to lower domestic inflation. On the other, the above-mentioned possible scenario could impact unfavorably the prospects of inflation by means of two mechanisms. In the case of deceleration of mature economies, which are the center of the global financial market, the risk aversion could rise, thereby reducing the demand for Brazilian assets and depreciating their respective prices. However, the higher evaluations of the Brazilian sovereign risk by important rating agencies tends to reduce the sensitivity of the prices of Brazilian assets in face the international scenario.

This contributes to mitigate the effects of the global economy slowdown on the economic activity in Brazil, whose dynamics has been sustained essentially by domestic demand. The second mechanism is a similar, but medium run impact, of a possible reduction in net exports on the sustainability of some Brazilian asset prices that would probably have repercussions on the inflationary dynamics. In this context, even though the Brazilian economy has shown repeated signs of greater resistance to the international financial markets moods, it is possible that the capacity of external sector to help mitigating the inflationary risks ends up being limited.

As indicated above, under the current circumstances, this additional alternative scenario of an intensification of the global inflationary pressures should be considered. As registered in the March *Report*, Copom assesses that the behavior of international petroleum prices may pose some risks on the inflation trajectory. The rising prices of oil is an inflation risk factor associated to the domestic prices of fuels and to the potential impact over the domestic price of other by-products, especially those utilized during the productive chain of the petrochemical sector. Also, further impact may occur due to the rise in the prices of fertilizers over the cost structure of the agricultural sector. One cannot disregard, either, that the excessive volatility of oil prices generate even further uncertainties, which may influence negatively the evolution of economic agents' expectations, in general, and of the price setters, in particular. In summary, under the current situation, additional increases in oil prices or even their maintenance at the current levels may be transmitted to domestic prices, either via an increase in fuel prices or in the prices of other by-products that are part of the productive chain. The prices of other commodities, such as grains and minerals continue, with few exceptions, to rise over the year, despite the increasing pessimism involving the growth prospects for the world economy.

Apart from all this, the Brazilian economic growth has been relatively little dependent of the external trade and, therefore, its economic cycle has little synchronization with the mature economies, and has been led by the vigorous expansion of the domestic demand. Nevertheless, lately, the external sector has played an important role in maintaining inflation within a trajectory that is consistent with the targets set in advance by the CMN.

This has occurred, mainly, by means of the discipline imposed over the prices of tradable goods and via the expansion of investments in an environment of heated demand. However, the consistent increase in global inflation, which has been registered since the end of last year, has led to further rises in the price of imports, reducing the external sector´s contribution for inflation control. One should highlight that the rising of import prices is not restricted to fuels and other raw materials. For instance, the prices of imported capital goods climbed 6.2% in the twelve months period ended in May, against 5.3% up to March and 0.6% up to May 2007 (Funcex data, for total imports shows that the respective variations are 15.2%, 12.2% and 5.3%).

Despite the intensification of external inflationary pressures, Copom maintains the assessment that the main inflationary risk comes from internal factors. The central scenario indicates a relative accommodation during the year, against the expansion of 5.4% observed in 2007. However, it is expected that domestic demand continues growing at vigorous rates. In fact, the robustness of the domestic demand has exerted pressure on the supply capacity of basically all sectors of the economy, especially on those not exposed to external competition. This assessment becomes more certain upon the analysis of the data related to economic activity, such as, the high level of capacity utilization and the sustained growth of retail sales. In addition, it is worth considering that the performance of payroll, credit, as well as the fiscal impulses expected for 2008, although less intense than previously anticipated, constitute an additional strength to boost domestic demand, which already grows at robust rates. In this context, in line with the assessment made by Copom in previous documents, the uncertainty regarding the future dynamics of consumer inflation remains high. This assessment is supported by the deterioration of expectations, the reduction of the idle capacity, and also by the pressures on the wholesale market prices, among others.

Beyond the risk derived from the unbalance between the pace of expansion of domestic demand and supply, it is also important to consider the risks derived from the movements of wholesale prices and their possible effects on the consumer price index. Considering the magnitude and persistence of these increases in the wholesale prices, the chances that they are going to be translated into a significant increase in the consumer price index has expanded since the last *Report*. The wholesale agricultural prices still exert considerable pressure, and prospects for their accommodation should be analyzed in the light of the trends of world increase of food demand and the relative scarcity, especially in mature economies, of resources for food production. The worse risk, however, comes from the industrial prices because it is closer to the stages of final consumption and, therefore, it disseminates more rapidly toward consumer prices. Also, industrial prices usually demonstrate greater persistence.

Additionally, these prices are exactly the ones constantly accelerating since the second half of 2007, reflecting both the afore-mentioned external inflationary pressures and the strong economic activity in Brazil. If we consider that the significant growth in wholesale prices happens in an environment of exchange rate appreciation, the role which economic activity has played in the dynamics of prices becomes very clear.

Evidence shows that, in Brazil, there is a high pass-through from wholesale prices to consumer prices and with at a relative small time lag. The Committee understands that the impact of the variation of wholesale prices over consumer prices will depend essentially on the prospective conditions of supply and demand and, in a critical manner, on expectations from the price setters in relation to the future trajectory of inflation. In any case, regarding the scenario prevailing in March, the probability that inflationary pressures will materialize is high. These pressures that were initially limited, will end up being a risk for the domestic inflation trajectory because the upturn in demand and in the factor market, as well as the possibility of sectoral supply restrictions may lead to an increase of the pass-through to consumer prices. Actually, the behavior of the consumer price index in the latest months is, in part, due to the materialization of this risk. It was already mentioned in previous *Reports* and now it calls for monetary policy reaction.

Despite the recent rise in general price indices, for the short-term horizon, there is a contrast between the negative risks that outline the dynamics of free prices and the benign scenario that is still foreseen for the evolution of administered prices. In fact, in 2008 the administered prices may sustain its contribution to mitigate the pressures on the full index, however, less intensively than it did in 2007. Specifically, regarding energy, specialists assess that the tariffs should be well behaved again in 2008, even if there are concerns in some segments as to the prospects for expansion of supply in the medium term. Therefore, it should not be the case that substantial negative immediate risks will come from the performance of administered prices. The important exception, though, refers specifically to the price of gasoline, as highlighted before. Specialists are concerned with the magnitude of the impact of the increase in the general price indices, observed this year, on the set of administered prices, in 2009. Nevertheless, this impact is associated to contracts ruling the readjustments of some administered prices, so it is worth noting that the direct contribution of the overall inflation in the indexation of monitored prices is limited. Inflation being a monetary phenomenon, it is expected that, on the medium run, the variation of administered prices converges towards the average variation of free prices and, therefore, ceases to contribute to the pressures overall inflation.

Despite the inflationary acceleration observed since the end of 2007, the annual comparison of the average real income growth has been robust. Besides, partly due to macroeconomic stability, employment expansion has supported and tends to sustain the growth in real payroll at a good pace. In fact, the deceleration in the pace of the labor force growth, associated to the continued expansion of employment, will result in reduced unemployment, which could lead to acceleration of wage gains, with potential impact both on domestic demand and on the costs in various sectors.

In these circumstances, the behavior of wages, given the growth of labor productivity, should be carefully monitored. On the other hand, the more consistent growth of inflation in the latest months became an important factor of reduction in the real labor income gains. This tends to cause pressure on nominal earnings, which would end up feeding back into inflation. If part of the firms readjusts wages decoupled from productivity growth, it would reinforce inflation acceleration increasing the risks for the prospective scenario.

The expansion of credit has been another important factor supporting aggregated demand. In principle, the rise in credit operations interest rates verified since the beginning of the year, as well as in the costs of funding by financial institutions, should act to cool off the growth of credit during the next quarters. Besides, the growth of especially dynamic modalities, such as payroll-deducted loans, could be facing natural limitations. However, the significant increase of income and employment, and the prospects of continuity of this process, in an environment in which banks seek to preserve their market shares, has worked as an important driving force of credit expansion. In addition, one cannot disregard that the introduction of institutional changes aimed at stimulating credit market competition should keep credit concessions at a strong pace. So far, the expansionist efforts have prevailed in determining the credit dynamics. From now on, taking into account the above-mentioned factors, some moderation in the pace of credit expansion is expected.

The possibility that changes in inflation dynamics, which in a preliminary assessment seems transitory, may have effects on the agents' expectations on medium and long run inflation prospects constitutes a permanent risk for monetary policy implementation. Taking into account the inflation performance in the recent past, Copom considers that there is a significant probability that inflationary pressures, which were initially localized, may pose risks to the domestic inflation trajectory. Actually, this assessment is supported by the recent inflation behavior. The Committee understands that this risk tends to become higher in moments such as the current one, when domestic demand is heated and exposed to expansionist impulses, and the production factor market is clearly tight. Evidence shows that the inflation acceleration episodes are not uniformly distributed among the different components of the price indices. To some extent, the behavior of cores, diffusion indices of IPCA and of the prices of services and of industrial wholesale prices in the latest months confirms the view that inflationary pressures, initially limited, would be disseminating. It is up to monetary policy, therefore, to be alert in order to prevent this scenario from materializing. In particular, one should be aware to the dissemination of second round effects, since significant variations in relative prices that validate the high inflation indices tend to generate reactions to recompose agents' real income, which, in turn, feeds back the inflationary process. The international experience, as well as the very history of inflation in our country, recommends that the monetary authority, by means of the adjustment of the basic interest rates, should counteract potential secondary effects. Note, also, that increases in prices of items, such as energy and foodstuffs, which have high visibility but not a high weight at the inflation index, tend to have a more than proportional effect on how agents form inflation expectations.

In this regard, Copom's assesses that the prospects of inflation has deteriorate and are surrounded by great uncertainty, since the last *Report*. Additionally, the risk of materialization of a less benign inflation scenario, in the medium run, has risen since then.

Considering the whole picture of the robust domestic demand, as confirmed by the 2008 first quarter national accounts, and the increase on inflation expectations, there are relevant risks that the positive results in terms of inflation observed in recent years will not be sustained. In fact, inflation expectations for 2008 increased significantly in the last quarter, followed by an undesirable growth in expectations for 2009 and for 2010. This behavior is an important indication that the factors underlying the recent acceleration of inflation may have a more persistent character than anticipated, in line with the concerns expressed in the latest *Reports*. Differently from that registered in the March *Report*, the expectations for 2008 and 2009 are above the central level of the target and, even if there is no additional deterioration, this upturn represents a risk for the prospective scenario, meriting attention and response on the part of monetary authorities.

In summary, the Committee assesses that, since the release of the last *Report*, the balance of risks for the expected inflation trajectory became less favorable, both from the viewpoint of external factors, and mainly, from the internal ones. In the external context, the developments of the recent quarters suggest that the contribution of imports for the maintenance of a benign inflation scenario became less effective. In the domestic context, the accelerated pace of demand growth continues to be an important source of risk for inflation dynamics, despite the robust behavior of investment, restrictions to the expansion of supply could be emerging. From another perspective, the additional increases in the rate of aggregated demand growth could be conditioned to rises of the rate of investment, a process undoubtedly slow. In this context, Copom assesses that the reduction consistent with the unbalance between the pace of expansion of supply of goods and services and of demand continues to be a central element in the assessment of the different possibilities, which are presented to the monetary policy.

Inflation rates consistent with the inflation target trajectory, which result from the consolidation of a sustained and stable macroeconomic scenario, will contribute for the continuity of the process of progressive reduction of the perception of macroeconomic risk, which has been occurring in the latest years. In order to turn this in concrete results, however, it is necessary for the prospective inflation indicators, in particular the trajectory of aggregated demand and supply, to evolve in a harmoniously. Copom assesses that the persistence of a careful and timely action of the monetary policy has been fundamental to increase the probability that inflation continues evolve according to the target trajectory.

Copom considers fundamental to highlight, once more, that there are important lags between the implementation of monetary policy and its effects over the level of activity and over inflation. Therefore, the assessment of alternative decisions of monetary policy should be concentrated, necessarily, on the analysis of the prospective scenario for inflation and on the risks associated to it, instead of prioritizing the current values observed for this variable.

By the way, during the next quarters, the expansion of payroll and of credit will continue to drive the aggregated demand. Besides these factors, the effects of the government transfers on the expanded domestic demand, which are still mitigated, should be added. Besides this scenario, within the set of information considered by the Committee, it is also considered the evidence that the domestic demand is already heated and the fact that the current decision of the monetary policy will have concentrated impacts on the second half of 2008 and in 2009.

In the light of these considerations, Copom decided to raise the Selic rate by 0.5 p.p. in its meetings of April and June, setting it at 12.25%.

Aiming to consolidate an environment of stability and predictability, the Committee adopts a strategy that seeks to avoid a volatile inflation trajectory. Such a strategy takes into account the lags of the transmission mechanism. It has proved to be the most adequate way to deal with the uncertainty inherent to the process of formulation and implementation of the monetary policy, and will have its results evidenced over time. That is the reason for the importance attached to the forecasts of inflation, to the balance of risks associated to the prospective scenario and, in a fundamental way, to the preventive action in the decision making process of Copom. Prudence plays an even more important role in this process, in moments such as the current one, characterized by deterioration of the current and expected inflation dynamics. In the current circumstances, there is a risk that the economic agents give a high probability to the fact that increases in inflation may persist, which would reduce the efficacy of the monetary policy. Therefore, in the Committee's assessment, supported by international experience, monetary policy actions tend to be more effective when it is consolidated. It is up to the monetary policy to act so that the impacts, initially limited to the price indices, do not carry on through the worsening of inflation expectations to a persistent deterioration of inflation dynamics. Copom understands that the current monetary policy stance, to be maintained while it is necessary, will ensure the convergence of actual inflation to the inflation target trajectory. Evidently, in the event of alteration of the risks profile that implies changes of the basic prospective scenario forecasted for inflation by the Committee at this moment, the monetary policy strategy will be promptly adequate to the circumstances.

6.3 Inflation forecasts

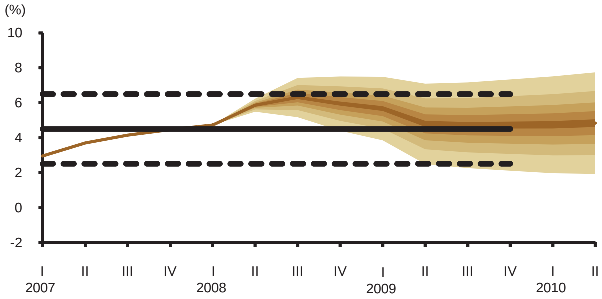
According to the traditionally adopted procedures, and taking into account the available information up to the cutoff date of June 13, 2008, the benchmark scenario assumes the exchange rate constant over the forecast horizon at R$1.65/US$, and the target for the Selic rate at 12.25% – set on the Copom meeting of June – against R$1.70/US$ and 11.25% considered in last March *Inflation Report*. The projection for the variation, in 2008, of the set of regulated and administered prices was maintained at 4.0%. This projection is based on the hypotheses of nil variation in gasoline and bottled gas prices, for the accumulated in 2008 (adjusted by the effects of changes in specific taxes); of 1.1% in prices of electricity; and of 3.5% in the fixed telephone prices. The items for which more information is available price changes were estimated individually, whereas, for the others, the projections are based on models of endogenous determination of regulated and administered prices, which considers seasonal components, exchange rate variations, market price inflation and General Price Index (IGP) inflation. According to these models, the readjustment projection of the regulated and administered prices for 2009 and 2010 stands at 4.5%, which is the same level used in the March *Report*.

The market scenario, on the other hand, is based on data from the survey carried out by Gerin with a representative group of institutions up to the cutoff date. In this scenario, the evolution of the average exchange rate expectations decreased in comparison to the values released in the March *Inflation Report*. For the last quarter of 2008, these expectations moved from R$1.74 to R$1.68, and for the last quarter of 2009, from R$1.84 to R$1.77. For the second quarter of 2010, average survey expectations project an exchange rate of R$1.81. The average expectations about the Selic rate evolution significantly increased compared to the values registered in the last *Report*. For the last quarter of 2008, it moved from 11.25% to 13.66%, while for the last quarter of 2009 it went from 10.61% to 12.94%. For the second quarter of 2010, the projection for the average Selic rate is 12.13%. In the market scenario, the pre-DI swap of twelve months model – used in replacement of the Vector Autoregression (VAR) model, based on levels of the Selic rate and of the pre-DI swap of six months – projects a pre-DI swap of twelve months spread of 264 b.p., 136 b.p. and 58 b.p., considering the current Selic rate, in the last quarter of 2008 and 2009, and in the second quarter of 2010, respectively. Additionally, reflecting especially the effects of the expected depreciation of the nominal exchange rate, the market scenario assumes variation of 4.1% for the group of regulated and administered prices in 2008, and of 4.9% and 5.0%, in 2009 and 2010, respectively.

With regard to the fiscal policy, the projections presented in this *Report* are based on the working hypothesis of a primary surplus of 3.8% of GDP in 2008 and 2009, increased by 0.5 p.p.

Figure 6.2 – Forecasted IPCA-inflation with interest rate constant at 12,25% p.a. (Benchmark scenario)

Inflation fan chart



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

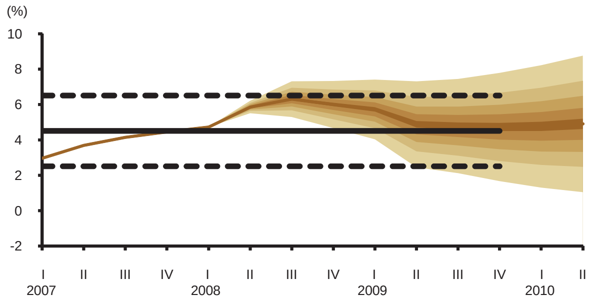
Table 6.1 – IPCA-inflation with interest rate constant at 12.25% p.a.
(Baseline scenario)

Year	Q	Probability Interval						Central
		50%						
			30%					
				10%				projection
2010	1	5.7	5.8	5.8	5.9	5.9	6.0	5.9
2010	2	5.8	6.0	6.2	6.4	6.6	6.8	6.3
2010	3	5.3	5.6	5.8	6.1	6.3	6.6	6.0
2010	4	4.9	5.2	5.5	5.8	6.1	6.4	5.7
2011	1	3.8	4.3	4.6	5.0	5.3	5.7	4.8
2011	2	3.7	4.1	4.5	4.9	5.3	5.7	4.7
2011	3	3.7	4.1	4.5	4.9	5.3	5.8	4.7
2011	4	3.6	4.1	4.5	5.0	5.4	5.9	4.7
2012	1	3.6	4.2	4.6	5.1	5.5	6.0	4.8

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

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

Inflation fan chart



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

Based on the above assumptions and using the information set until the cutoff date (June 13, 2008), projections were constructed for four quarters of the accumulated IPCA inflation, given the benchmark and market scenarios interest and exchange rates trajectories.

The central projection associated with the benchmark scenario indicates inflation of 6.0% in 2008, increase of 1.4 p.p. in comparison to the projection presented in the March *Report*, and higher than the central value of 4.5% for the target established by the CMN. According to the data shown on Table 6.1, the twelve-month accumulated inflation moves from 5.9% in the second quarter of 2008, reaches 6.3% in the third one and slows down to 6.0% in the last quarter of 2008. For 2009, the projected twelve-month accumulated inflation moves from 5.7% in the first quarter and ends the year at 4.7%. In this scenario, the initial projection for the first quarter of 2010 remains at 4.7% and for the second one reaches 4.8%. One should highlight that the decline of inflation projection throughout 2009 essentially reflects the fact that inflation expectations, both for 2009 and for 2010, are below the respective expectations for the current year.

Data on Table 6.1 indicates, for 2008, an increase of 0.4 p.p. in the twelve-month accumulated inflation in the third quarter, compared to the second quarter; and a decrease of 0.3 p.p. in the fourth quarter, when compared to the third one. In the first case, the movement reflects a projection for the inflation of regulated and administered prices, for the third quarter of 2008, higher than the inflation observed for these prices in the same period of 2007. In the second case, the decrease reflects a lower projection for market price inflation in the fourth quarter of 2008, when compared to the observed inflation in the same quarter of 2007, which is more than sufficient to offset the effects of the projected regulated and administered price inflation, also for the fourth quarter of 2008, and higher than the observed one in the same period of 2007. According to the confidence interval illustrated on Table 6.1, which is based on the benchmark scenario, the estimated probability of the inflation surpassing the upper limit (6.5%) of the target in 2008 stands around 25%.

In the market scenario, the inflation projection of 2008 (6.0%) is 1.3 p.p. higher than that registered in the last *Report*. As can be seen on Figure 6.3 and on Table 6.2, the projections indicate an increase in the inflation accumulated in twelve months in the third quarter of 2008 and a slight decrease in the last quarter, but still ending the year at 6.0%, quite higher than the central value of 4.5% for the inflation target. When

Table 6.2 – Projected IPCA-Inflation with market interest and exchange rates expectations[1/]

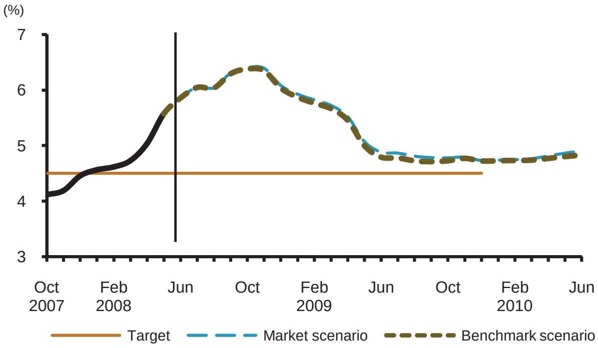
Year	O	Probability Interval 50%	30%	10%	10%	30%	50%	Central projection
2010	1	5.7	5.8	5.8	5.9	5.9	6.0	5.9
2010	2	5.9	6.1	6.2	6.4	6.5	6.7	6.3
2010	3	5.5	5.7	5.9	6.1	6.3	6.5	6.0
2010	4	5.0	5.3	5.6	5.9	6.1	6.4	5.7
2011	1	3.9	4.3	4.7	5.1	5.5	5.9	4.9
2011	2	3.7	4.2	4.6	5.0	5.4	5.9	4.8
2011	3	3.5	4.0	4.5	5.0	5.4	6.0	4.7
2011	4	3.3	4.0	4.5	5.0	5.6	6.2	4.8
2012	1	3.3	4.0	4.6	5.2	5.8	6.5	4.9

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

Table 6.3 – March 2008 *Inflation Report* forecasts

Period	Benchmark scenario	Market scenario
2008 I	4.6	4.6
2008 II	4.7	4.7
2008 III	4.9	4.9
2008 IV	4.6	4.7
2009 I	4.3	4.5
2009 II	4.5	4.8
2009 III	4.4	4.9
2009 IV	4.4	4.8
2010 I	4.3	4.7

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

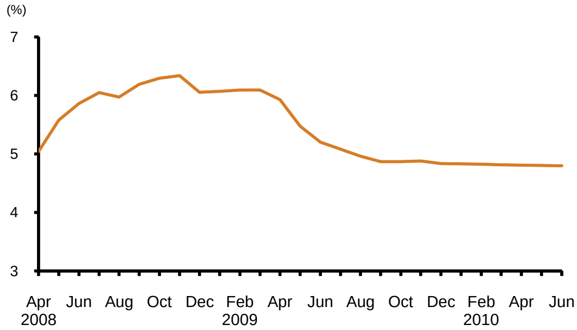


comparing this projection with that of the benchmark scenario (6.0%), which after rounding are equivalent, it should be noted that in the market scenario there is essentially a balance of effects over the inflation projections, regarding the devaluation of real against the US dollar and the increase of Selic rate, according to analysts' expectations. Still according to the market scenario, the projection of the accumulated inflation in twelve months decreases during 2009 and ends the year at 4.7%, therefore, higher than the central value of 4.5% for the target determined by CMN. For the second quarter of 2010, the projection for the twelve-month accumulated inflation stands at 4.9%. This slight increase in comparison to the projected value for the end of 2009 basically comes from the combination of expectations of exchange rate depreciation and of reduction in Selic rate. According to the confidence interval presented on Table 6.2, the estimated probability of the inflation surpassing the upper limit of the target in 2008 also stands at a level close to 25%.

Comparing the trajectories shown in this *Report* with those released in the previous *Report*, which projections are reproduced on Table 6.3, indicates that there was an increase of the projections, in both scenarios, for 2008. In these two scenarios, the inflation projection stands at 6.0%, a value 1.4 p.p. higher than the one presented in the last *Report*, in the benchmark scenario, and 1.3 p.p., in that of market scenario. Besides incorporating the effects of the inflation rates for the recent months higher than the projections prevailing on occasion of release of the last *Report*, the current projections reflect the effects of significant increase of inflation expectations for 2008 and 2009, despite the maintenance of the regulated and administered prices inflation projection for 2008 (4.0%). For 2009, in comparison to the ones presented in the previous *Report*, it is noted an increase of 0.3 p.p. in the projection associated to the benchmark scenario and a relative stability in the market scenario.

Figure 6.4 shows the evolution of twelve-month accumulated inflation, according to the benchmark and market scenarios, up to the second quarter of 2010, as well as the target trajectory up to the end of 2009. By May 2008, the values are related to inflation occurred in twelve months and, after June, the trajectories consider the projections according to the two scenarios. In both scenarios, the projections rise up to the final months of 2008, slow down during 2009 and turn to increase in the first quarter of 2010. In the two scenarios, projections remain higher than the current central target (4.5%) up to the end of the forecast horizon.

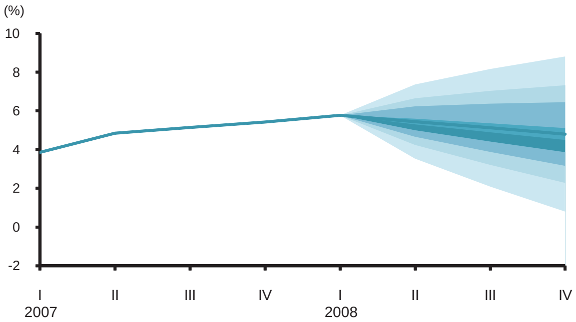
Figure 6.5 – Inflation Forecast: VAR Models



Note: accumulated inflation in 12 month (% p.a.). Average forecast generated by the VAR models.

Figure 6.6 – GDP growth with interest rate constant at 12.25% p.a. Benchmark scenario

Output fan chart



The forecast generated by the VAR models, incorporated as of this *Inflation Report*, follows the methodology discussed in the box "Vector Autoregression Models" presented in the last *Report*, where it is registered that these models exhibit better performance in shorter horizons. Up to May 2008, the values refer to inflation occurred in twelve months and, as of June, refer to the average forecast of the VAR models. According to Figure 6.5, the VAR models indicate an increase of inflation up to the third quarter of 2008, since when a decrease trend is forecasted. Nonetheless, the forecast for the twelve-month accumulated inflation remains above the current central target (4.5%) up to the end of the forecast horizon.

Figure 6.6 illustrates the output growth fan chart built on the benchmark scenario assumptions. Considering that the model which generates GDP growth projections uses two variables not directly observable, potential output and output gap, the forecast errors associated to these projections are considerably higher than the errors related to the inflation projections. According to this scenario, the GDP growth projected for 2008 remains at 4.8%, the same value projected in the March *Inflation Report*.

Preemptive Action and Inflation Fighting

There is consensus that the choice of timing for implementing monetary policy actions is a crucial step in the monetary policy framework. One reason that makes this choice hard is the existence of relevant lags in the monetary transmission mechanism. Evidence suggests that in mature economies a change in the monetary policy instrument may take up to two years to significantly affect the path of inflation and real output. The evidence for Brazil does not differ much from the international experience, though the lags are shorter. Another reason is that the monetary action directly depends on the nature of the shocks (demand versus supply shocks) and on their persistence (transitory or permanent). In this context, the measurement of lags and the precise identification of the shocks determine, to a large extent, the effectiveness and the cost of implementing monetary policy[1]. For example, inflationary pressures arising from excess demand tend to be more easily controlled at its early stages, before having long-lasting effects over agents' expectations and on wage and price decisions. In such circumstances, a preemptive monetary policy action is potentially more effective in terms of controlling inflation and less costly in terms of real output loss [2].

Preemptive policy actions have been successful in both mature and emerging economies. The goal of this box is to identify stylized facts associated with the international experience. Therefore, we analyzed episodes of monetary policy tightening implemented by 26 central banks, since the adoption of their inflation targeting regimes – New Zealand (1990),

1/ This is not a trivial task. "… economies rarely evolve as expected. Surprises are the norm, not the exception, and they would induce the central bank to alter its expected path in obvious ways." (Blinder, 1998, pp. 16-17).

2/ See Mishkin (1997) for a discussion about the advantages and disadvantages of preemptive monetary policy actions.

Chile (1990), Canada (1991), England (1992), Israel (1992), Sweden (1993), Australia (1993), Czech Republic (1998), South Korea (1998), Poland (1998), Euro Area (1999), Mexico (1999), Brazil (1999), Switzerland (2000), South Africa (2000), Thailand (2000), Iceland (2001), Norway (2001), Hungary (2001), Philippines (2002), Peru (2002), Slovakia (2005), Indonesia (2005), Romania (2005), Guatemala (2006) and Turkey (2006). The sample also includes data from the U.S. economy (which for some analysts has an implicit inflation target of 2%) since the beginning of the Greenspan era (1987).

The main goal of this analysis is to verify whether there exist significant differences between preemptive and reactive actions. To this goal, we first identified those tightening cycles related to inflationary pressures, therefore excluding episodes associated with financial crises or other shocks that did not significantly affect the path of inflation. Moreover, we also discarded very short cycles, under the assumption that only relatively long tightening cycles significantly affect the inflation dynamics. Therefore, the resulting sample includes only those tightening cycles that lasted at least eight months. Finally, we define preemptive actions as those implemented before the average inflation in the six months prior to its implementation exceeded the center of the target[3]. Altogether, we identified 50 tightening cycles, of which 22 we considered preemptive and 28 reactive[4].

On Table 1, $\Delta\pi_0$ denotes the mean deviation of inflation from the target in the six months before the start of monetary tightening cycle. Moreover, in order to compare preemptive and reactive policies, we selected the following four variables:

(1) Cycle duration – it measures both the duration of the tightening cycle (the period of increase in the policy interest rate) and the period required to bring inflation close to the target (for each country in the sample, T_r represents the time required to increase the policy interest rate, while T_π denotes the average time required to control inflation, both in months);

3/ Alternatively, we could have used the target range instead of the target center. However, some central banks pursue inflation targets without fluctuation bands. For those countries whose targets are the ranges themselves we considered the midpoint of the range as the center of the implicit target.

4/ It is important to mention that a country may have implemented the two policies on different occasions.

(2) Mean deviation from the target of the 12-month inflation – for each country and episode, according to:

$$\Delta\pi = \frac{1}{T_\pi}\sum_{t=1}^{T_\pi}\left(\frac{\pi_t - \overline{\pi}_t}{\overline{\pi}_t}\right)$$

where, Δπ represents the variation of the inflation rate and denotes the inflation target.

(3) Magnitude of the increase in the policy rate – for each country and episode, the magnitude of the tightening cycle was defined as the difference between the peak of the policy interest rate (r_{max}) and the rate prevailing in the month immediately preceding the beginning of the cycle (month 0), according to:

$$\Delta r = \frac{r_{max} - r_0}{r_0}$$

where, r_0 is the policy interest rate prevailing in month 0.

(4) Economic activity indicator – for each country and episode we measured the acceleration or deceleration of the average growth rate of industrial production during the period required to control the inflation, as below:

$$\Delta y = \frac{1}{T_\pi}\sum_{t=1}^{T_\pi}\left(y_t - \overline{y}_0\right)$$

where y_t denotes the 12-month growth rate of industrial production and denotes the average growth rate of industrial production in the semester immediately before the start of the monetary tightening.

The last variable is taken as an indicator of the cost of fighting inflationary pressures. We opted for the industrial production, rather than the unemployment rate or the growth rate of Gross Domestic Product (GDP), because the indicators of industrial production tend to be more homogeneous across countries, and are available on a monthly basis.

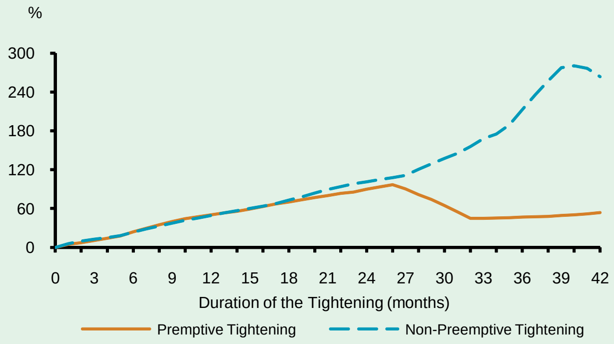
Table 1 shows the average (across countries) of the variables of interest for both preemptive and reactive cycles. The table highlights: (1) countries that have acted preemptively initiated the tightening cycle when the average level of inflation in the semester preceding the cycle was 26% *lower* than the target, while countries that have only reacted to the surge in inflation began their tightening cycle when the average level of inflation in the semester proceeding the cycle was 36% *higher* than the target; (2) the average duration of preemptive cycles was approximately four months lower than that of reactive cycles and, in addition, the time required to control inflation was much smaller in the first case; (3) the average increase in the policy interest rate required to control inflation was substantially smaller in the countries that acted preemptively; (4) despite implementing a tighter monetary policy, for having acted with delay, the reactive countries experienced larger deviations of inflation from the target during the tightening cycle; and (5) real output reduced only in the reactive cycles.

Table 1 – Preemptive and Non-Preemptive Interest Rate Cycles (mean values)

Features	Symbol	Preemptive Tightening	Non-Preemptive Tightening
Number of episodes		22.0	28.0
Deviation of inflation from target prior to the tightening	$\Delta\pi_0$	-26.5%	36.3%
Duration of the tightening (in months)	T_r	17.3	21.5
Time required for inflation to converge to target (in months)	T_π	20.4	26.4
Accumulated change in the interest rate over the tightening	Δr	68.6%	91.8%
Deviation of inflation from target after the tightening	$\Delta\pi$	24.6%	52.3%
Dynamics of industrial production	Δy	0.79%	-0.12%

Banco Central do Brasil. Original sources: central banks, *Global Financial Data* and IMF.

Figure 1 – Change in the Interest Rate
Accumulated



Complementing Table 1, Figures 1, 2 and 3 show, respectively, the paths of the average values of the cumulated interest rate increase (Δr), inflation deviation from the target ($\Delta\pi$) and the variation in industrial output (Δy), in the three cases, considering six-month moving averages. Figure 1 indicates that despite the average increase in the interest rate being identical in the first half of the cycle for both preemptive and reactive countries, monetary policy started to ease first in the preemptive ones. In turn, Figure 2 shows that the inflation deviations from the target were systematically higher in the reactive cycles. Finally, Figure 3 suggests that the cost of fighting inflation was higher in the reactive cycles.

The above analysis does not identify the nature of the inflationary pressures, that is, whether they were caused by demand or supply shocks. Despite this caveat, overall, this boxe presents

Figure 2 – Deviation of Inflation from Target

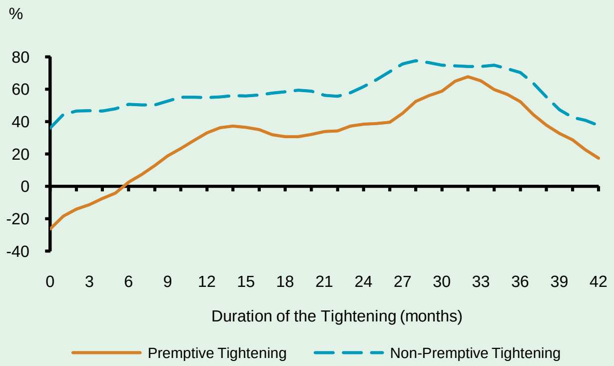
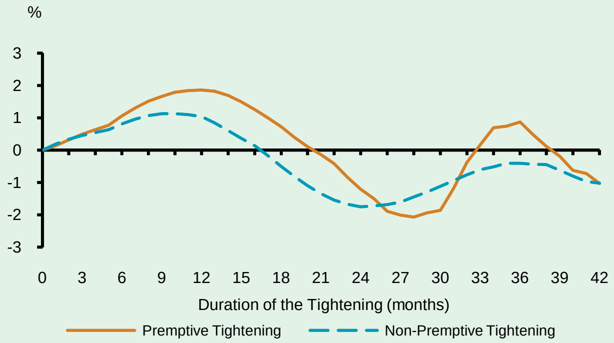


Figure 3 - Change in the Growth Rate of Industrial Production



evidence that preemptive monetary actions are shorter, milder, more effective and less costly than the reactive ones. Therefore, in line with the theory, the international experience suggests that, in inflation-targeting economies, preemptive policies seem to be more effective in terms of controlling inflation and imply fewer costs in terms of output. These considerations reflect the available empirical evidence, but do not represent, nor should they be interpreted as forecasts by the Monetary Policy Committee about the ongoing monetary adjustment.

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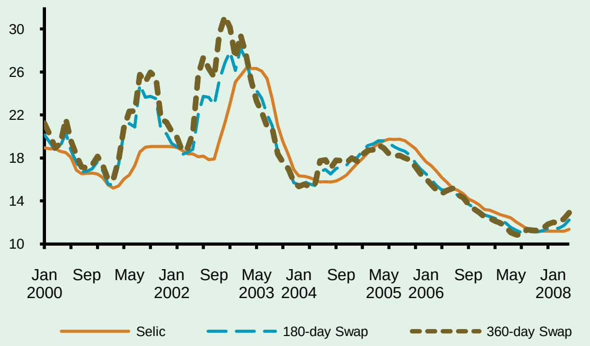
The Impacts of the Interest Rate Term Structure on the Economy

The boxes “Interest Rate, Cost of Credit and Economic Activity” and “The Term Structure of Interest Rates and the Cost of Credit”, published in the September 2003 and March 2005 Inflation Reports respectively, examined the impact of the interest rate term structure on the cost of credit, and this on the demand level of the Brazilian economy. This box revisits the theme, showing some of the graphics then presented, and updating the analysis in the light of recent developments in monetary policy.

In summary, the points raised in those boxes were: (a) the monetary authority only determines the nominal short-term interest rate (overnight rate or base rate) and, thus, even atrelatively short tenors, other rates may deviate from the short-term rate, as when the market players anticipate changes in the monetary policy stance, (b) the term structure of interest rates determines the nominal cost of credit for the different contractual instruments and terms, (c) the decisions of consumption and private investment are affected by, among other factors, the real expected cost of credit , and (d) there are lags in the transmission mechanism of monetary policy, so that changes in the base rate does not instantly affect the real cost of credit and, therefore, the actual demand.

In the September 2003 box there was evidence of economic activity recovery, in response to falling long-term interest rates from March of that year on, which in turn was due to the anticipation by private agents of the monetary easing started in June of that year by the Copom. Indeed, the market yield curve became negatively tilted in the second quarter of 2003. This created conditions for the reduction of the interest rate applied in credit operations, boosting the resumption of economic activity from the third quarter of that year on. It was noted in the March 2005 Box that the long-term rates anticipated, some months before, the process of monetary tightening initiated by the Central Bank in mid-2004. However, there was a rapid return to a negative slope of the yield curve in the second half of 2005, which was followed, thereafter, by the reduction of the spread between long-term rates and the short-term rate, ushering in a strong economic growth driven by credit expansion, which had reached around 34.7% of Gross Domestic Product (GDP) in the end of 2007.

Figure 1 – Over Selic, 180-day and 360-day swap rates (%)

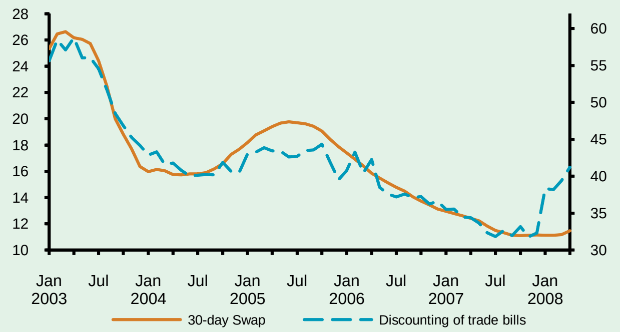


As occurred in previous years, the recent movements in the term structure of interest rates and lending rates are consistent with the stance of the monetary policy currently under way, and do not constitute an abnormal situation. Regarding the term structure, Figure 1 shows that from the end of 2007 on, the market long-term interest rates once again diverged from the base rate, anticipating the process of monetary contraction initiated by the Central Bank in last April.

The recent evolution of the term structure, besides not representing a completely new behavior, does not indicate a loss of effectiveness of the monetary policy. Indeed, what has happened since the end of last year is a process similar to that seen in early 2001, and in the second halves of 2002 and 2004. On the other hand, it is opposite to what was seen in the second quarter of 2003, and during the period from March 2005 to mid-2007, when the market interest rates anticipated the easing of the monetary policy due to a better environment concerning inflation.

Figure 2 – Market interest rates and credit cost (%)

Discounting of trade bills



With respect to the movement of lending rates and, therefore, the banking spread, one must distinguish between changes of medium and long term and short-term changes. In the former case, it is known that the banking spread has followed a downward trend in recent years. This downward trend has been favored by several factors, all of them acting in the same direction. For example, there has been rapid growth of credit supply, as well as innovations in the credit sector, with the beginning of new forms of loans to individuals (payroll loans). The latter helped to reduce the average spread, because they involved lower credit risk. It should also be mentioned the scenario of greater confidence of economic agents in

Figure 3 – Market interest rates and credit cost (%)

Vendor

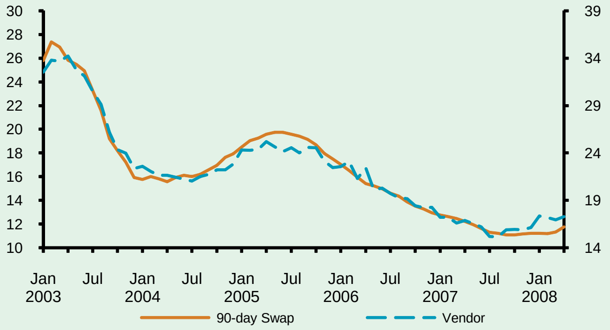


Figure 4 – Market interest rates and credit cost (%)

Personal credit

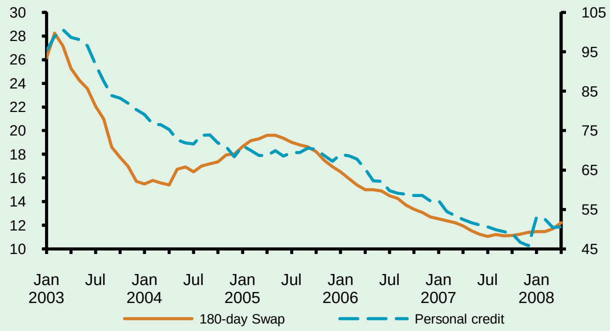


Figure 5 – Market interest rates and credit cost (%)

Auto loans

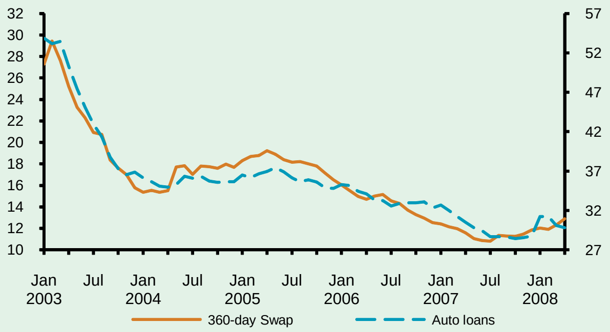
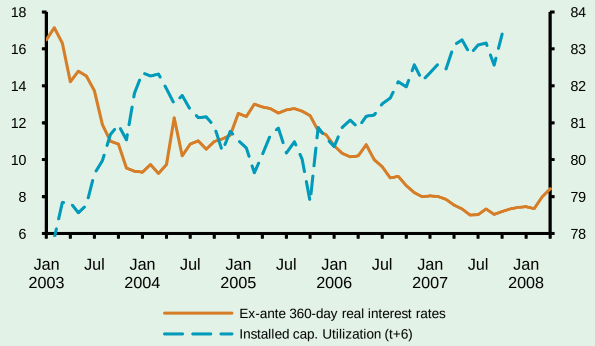


Figure 6 – Market interest rates and credit cost (%)

360-day real interest rates and installed capacity utilization



the performance of the economy, which allowed an increase in the average maturity of credit operations.

On the other hand, the movements of short-term lending rates are more closely related to the monetary policy instance and especially to the behavior of the market interest rates. Figures 2, 3, 4 and 5 illustrate the links between market interest rates for different maturities, with the cost of credit to the borrower in specific modalities. The graphs show clearly that there is a close correlation between the various curves specified, although there was an increase in Financial Operations Tax (IOF) at the beginning of the year (Decree No. 6339 of 3 January 2008) to compensate for the end of the Provisional Contribution on Financial Transactions (CPMF), which contributed significantly to explain the recent increase in loan interest rates.

These figures show, in the first quarter of 2008, that there has been a more pronounced impact of the IOF increase on the discounting of trade bills and vendor costs of operations. The reason is that this tax is proportionately greater for shorter maturity operations and the interest swaps for these maturities have changed little in the period. On the other hand, for longer operations such as personal credit and vehicles finance, it is clear the effect of the anticipated increase in long-term rates, in response to the prospect of a raising Selic.

Finally, in relation to the response of economic activity to monetary policy stimuli, there is no evidence to support any pattern of abnormality in the recent past. As shown in Figure 6, which presents a comparison between the 360-day real interest rate (deflated by expected inflation) and the seasonally adjusted installed capacity utilization (ICU), lagged six months and measured by the National Confederation of Industry (CNI), it is noted that the monetary policy implemented in recent years has allowed to adjust the output growth at the rate of expansion of productive capacity.

Annex

Minutes of the 134th Meeting of the Monetary Policy Committee (Copom)

Date: April 15th, from 4:50PM to 6:50PM, and April 16th, from 4:50PM to 7:40PM
Place: BCB Headquarters meeting rooms – 8th floor on April 15th and 20th floor on April 16th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Alexandre Antonio Tombini
Alvir Alberto Hoffmann
Anthero de Moraes Meirelles
Antonio Gustavo Matos do Vale
Maria Celina Berardinelli Arraes
Mário Gomes Torós
Mário Magalhães Carvalho Mesquita

Department Heads (present on April 15th)
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on April 16th)
Luiz Donizete Felício – Open Market Operations Department
Luiz Fernando Cardoso Maciel – Department of Banking Operations and Payments System
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on April 14th)
Adriana Soares Sales – Deputy Head of the Research Department
Alexandre Pinheiro de Moraes Rego – Press Secretary
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo – Advisor to the Board
Katherine Hennings – Advisor to the Board
Sergio Almeida de Souza Lima – Executive Secretary

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

Recent economic developments

1. IPCA inflation remained virtually unchanged in March (0.48%) relative to 0.49% in February. As a consequence, inflation reached 1.52% in the first quarter of 2008, up from 1.26% in the same period of 2007. Twelve-month trailing inflation continued to accelerate. After reaching 4.56% in January, it totaled 4.61% in February and 4.73% in March (2.96% in March 2007). Under this comparison basis, the acceleration of consumer price inflation essentially mirrors the behavior of market prices, which increased more rapidly than regulated prices. In fact, market prices and regulated prices increased 6.03% and 1.83%, respectively, in the twelve months through March, compared to 2.82% and 3.15% in the twelve months through March 2007. Moreover, despite the BRL appreciation, the prices of tradable goods accelerated, reaching 5.33% (compared to 1.10% in March 2007), according to the same comparison basis. Regarding non-tradable goods, greatly pressured by the behavior in the prices of

perishable food and services, twelve-month trailing inflation was even higher (6.67%). The recent behavior of IPCA inflation has been remarkably less benign than that observed in previous quarters, so that since the end of 2007 inflation has signaled that it could be diverging from the targets path, reaching 2.97% in the last six months.

2. The three main underlying inflation measures calculated by the BCB showed divergent behavior in the first three months of the year. The core inflation by exclusion of household food items and regulated prices increased from 0.40% in January to 0.69% in February (under the impact of seasonal elevation of education costs), but retreated to 0.36% in March. The smoothed and non-smoothed trimmed means core inflation measures varied from 0.37% and 0.41% in January 2008, to 0.27% and 0.36% in February, and 0.39% and 0.41% in March, respectively. Similarly to headline inflation, the three core inflation measures remarkably accelerated in the first quarter of the year, in comparison to the same period of 2007, with increases from 1.17%, 0.92% and 0.81% to 1.46%, 1.03% and 1.18% for the core inflation by exclusion, smoothed and non-smoothed trimmed means core inflation, respectively. On a twelve-month trailing basis, the three core inflation measures accelerated, following the behavior of headline inflation. Core inflation by exclusion of household food items and regulated prices increased significantly, to 4.41% in March 2008, up from 4.27% in February and 4.09% in January. Smoothed trimmed means core inflation showed similar behavior (4.16% in March, up from 4.05% in February and 4.02% in January), while the non-smoothed trimmed means core inflation, which tends to present less inertial behavior, increased to 4.01% in March, up from 3.83% in February and 3.68% in January. Still on a twelve-month trailing basis, inflation core measures, despite remaining below the central target, currently stand at levels significantly higher than the record lows reached in 2007.

3. The General Price Index (IGP-DI) inflation retreated to 0.38% in February, down from 0.99% in January, but accelerated to 0.70% in March. On a twelve-month trailing basis, IGP-DI inflation accelerated to 9.18% in March, up from 8.65% in February and 8.49% in January (compared to 4.49% in March 2007). In the twelve months through March, the IGP-DI increase reflected both the behavior of the Consumer Price Index-Brazil (IPC-Br), which totaled 4.52% (2.69% in March 2007), and also of the IPA-DI (Wholesale Price Index), whose variation totaled 11.39% (5.09% in March 2007). According to the same comparison basis, the Civil Construction National Index (INCC) increased 6.69% (5.25% in March 2007). Regarding agricultural IPA, inflation reached 24.68% (12.83% in the twelve months through March 2007). It bears emphasizing the acceleration of industrial prices, which began in the second half of 2007 and seems to have intensified lately. In the first quarter of 2008, the industrial IPA increased 2.63%, up from 0.18% in the same period of 2007. In the last twelve months, wholesale industrial price inflation increased to 6.98% in March, up from 6.20% in February, 5.26% in January and 4.42% in December 2007. As highlighted in previous Copom Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend on current and prospective demand conditions and price-setters' expectations for the future inflation path.

4. After the last Copom meeting, the IBGE released GDP data for the fourth quarter of 2007, as well as the results for the whole year. The data showed significant acceleration of growth in the last quarter of 2007, according both to the accumulated change in the year (5.4%, up from 5.1% in the third quarter), and to the year-over-year change (6.2%, up from 5.6% in the previous quarter). On the aggregate demand side, it bears highlighting the acceleration of gross fixed capital formation, which grew 16% year-over-year and, especially the change in the expansion pace of domestic consumption, which tends to be less volatile than investment throughout the cycle, to 8.6% up from 6.0%, according to the same comparison basis. On the aggregate supply side, it bears noticing the acceleration of the services sector, with 5.3% year-over-year expansion, up from 4.6% in the previous quarter.

5. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output increased 0.2% in February, after retreating 0.3% in the previous month. Still considering the seasonally adjusted series, after the 1.7% month-on-month expansion observed in January, industrial output reduced 0.5% in February, partially as a result

of the technical interruptions in the pharmaceutical sector. It bears mentioning that general industrial output and manufacturing output grew 9.2% in the year. On a year-over-year basis, industrial output shows consistent growth acceleration: 9.7% in February, up from 8.5% in January and 6.3% in December 2007. The data already released for 2008 point, in short, to the continuity of the industrial production expansion cycle, which will continue to be favored by several incentive factors that influence economic activity, such as credit, employment and income expansion, the fiscal impulse and, in some sectors, the recovery of inventory levels.

6. Among the use categories, according to data seasonally adjusted by the IBGE, capital goods production increased significantly in February (3.1%), after stability observed in January. Regarding other use categories, it bears emphasizing the production of durable consumer goods, which increased by 0.9% (5.9% in January). The scenario of solid expansion of capital goods production observed in 2007, mainly driven by the consolidation of positive prospects for the continuity of economic growth, underpinned by the perception of macroeconomic stability consolidation, seems to persist in this year. On its turn, the dynamism of durable consumer goods production reflects, predominantly, the remarkable improvement in credit conditions, when compared to historical patterns. It should be highlighted that the appearance of signs pointing to pressure over the availability of production factors, as suggested in some industrial surveys, indicates that possible reductions in the pace of industrial activity expansion could be associated to productive capacity restrictions.

7. Labor market continues to present quite favorable performance. The unemployment rate in the six metropolitan regions covered by the Monthly Labor Survey (PME) increased, according to the seasonal pattern, to 8.7% in February (a record low for the month in the historical series), up from 8.0% in January and 7.4% in December). As a result, the average unemployment rate in the first two months of the year was 1.2 p.p. below that observed in the same period of 2007. According to data seasonally adjusted by the BCB, the unemployment rate increased to 8.6% in February, up from 8.5% in January, remaining in levels close to the record low of the historical series. In February, average real earnings increased 1.1% month-on-month and 2.5% year-over-year. As a consequence, real payrolls expanded by 6.2% in February, in year-over-year terms (and by 7.1% in January 2008, according to the same comparison basis), and continue to constitute a key driver for sustained aggregate demand growth. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment reduced by 0.1% in February (+0.8% in January). In year-over-year terms, employment grew 4.9%, totaling 4.0% growth in the last twelve months. Still regarding employment, data from the Ministry of Labor and Employment (MTE) indicate the continuity of strong expansion in formal employment at the start of the year, with the creation of 205 thousand jobs in February (up from 142.9 thousand in January), a record high for the month and for the first two-month period of the year. Formal employment grew by 0.5% in the month, seasonally adjusted. Observed data point to a 6.1% expansion in formal employment in February, year-over-year, the highest rate recorded since April 2005, according to this comparison basis, an evidence of strong dynamism in the labor market. The services sector presented the highest hiring rate, with the creation of 74.4 thousand new jobs, followed by the manufacturing industry (46.8 thousand), the best performance of the series for the month, and civil construction (27.6 thousand). The retail sector recorded 13.8 thousand new jobs. The agricultural sector created 25.2 thousand new jobs, a record high for the period, due to the activities related to sugar cane plantations in the Mid-South region and to the soybean plantations.

8. In line with the positive developments in labor market and with credit expansion, retail sales continue to record positive performance, indicating that the pace of domestic demand growth remains robust, and signs of cooling cannot be perceived. Despite the 1.5% decrease month-on-month in February, according to data seasonally adjusted by the IBGE, retail sales grew 12.2% year-over-year, showing acceleration at the margin. It bears highlighting the 22.3% expansion in the sales of “furniture and domestic appliances”. The steady growth of retail sales has reflected the performance of both the sectors more sensitive to income and

employment expansions and those more sensitive to credit conditions. The expanded retail sales, which also include the sales of "vehicles, motorcycles, parts and pieces" and "construction material", increased 1% in February, month-on-month, according to series seasonally adjusted by the IBGE, and 18.1% year-over-year. For the next quarters, the continuity of the current expanding cycle is expected, and will continue to be underpinned by employment and income growth, credit expansion and the maintenance of consumer confidence at high levels. Sector indicators, for example, relative to automobile sales in the first quarter of the year, corroborate this assessment.

9. The installed capacity utilization rate (Nuci) in the manufacturing industry reached 83.2% in February, unchanged relative to January, according to CNI data seasonally adjusted by the BCB, and remained close to the record high of the series. According to data seasonally adjusted by the CNI, the Nuci in the manufacturing industry reached 82.9%, down from the 83.3% record high observed in November. Without the seasonal adjustment, the Nuci in February stood 1.5 p.p. above the level registered in the same month of 2007. Thus, the average rate of the first two-month period of the year was 1.6 p.p. above the level observed in the same period of 2007. The quarterly Nuci calculated by Fundação Getulio Vargas (FGV) reached 85.2% in March, according to the observed series, 2.1 p.p. above the level registered in March 2007. For the consumer goods, capital goods and civil construction material sectors, the utilization rates in March were 4.3, 4.4 and 3.4 p.p. above those observed in the same month of 2007, respectively. The reduction of idle capacity, in relation to the margins usually observed, occurs in several sectors despite the significant increase of investment. Indeed, in February 2008, according to seasonally adjusted data, the absorption of capital goods increased firmly (1.8%), due to the vigorous growth of capital goods imports (6.8% in volume) and capital goods production (3.1%). Furthermore, the production of civil construction inputs increased 1.2% in the same period, showing robust performance. Recent data indicate that, although investment has been contributing to soften the increasing trend of capacity utilization rates, it has not been sufficient to contain this process. In this context, the timely maturation of investment projects will be crucial to limit mismatches regarding the evolution of aggregate supply and domestic demand in the relevant forecast period for monetary policy. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments related to the expansion of supply of goods and services, to adequately meet demand conditions.

10. The trade balance continues to present robust performance, compared to historical patterns, despite the already expected deceleration at the margin, in line with assessments present in Inflation Reports and previous Copom Minutes about important structural changes in Brazilian foreign trade. In the last twelve months through March the trade surplus reached US$34.1 billion (25.5% below March 2007). Exports and imports totaled US$165.3 billion and US$131.2 billion, equivalent to 16.1% and 36.0% growth, respectively, year-over-year. As highlighted in previous Copom Minutes, imports have been growing faster than exports, both due to the strengthening of the BRL and to the robust economic activity in the country, despite the increases in the prices of several commodities included in the Brazilian export basket. The decrease in trade surplus contributed to the US$4.9 billion current account deficit registered in the twelve months through February 2008, equivalent to 0.4% of GDP. Foreign direct investment reached US$36.5 billion in the same period, equivalent to 2.8% of GDP.

11. Regarding the external scenario, the process of economic deceleration in the US has consolidated, as evidenced by the economic activity data in the last quarter of 2007 and first quarter of 2008, but uncertainties regarding its magnitude and duration still remain. More recent data about the housing market and consumer goods demand, as well as confidence indices and other leading indicators, point to a significant slowdown. Uncertainties still remain about the length and amplitude of the effects of the US subprime mortgages market crisis over US and European financial institutions and over credit conditions for households and corporate. Despite the dominant opinion still seems to point out to a transitory, but possibly intense deceleration, the negative assessments have become more disseminated.

These assessments reflect, to some extent, uncertainties about the capacity of the monetary policy stance implemented by the central bank in the US, to which fiscal incentives will be added, to smooth in a timely manner the US economic weakening, in light of persistent difficulties in the financial system. Despite the reduction of systemic risk perception, due to the Federal Reserve stance and the recapitalization of important institutions, such difficulties, on their turn, could be worsened by a cyclic deterioration in credit quality, which would reinforce the already evident trend to financial contraction, increasing the risk of slowdown intensification. Prospects for economic activity in Europe and Japan, notwithstanding some favorable indicators in Germany, have also deteriorated, despite not provoking the same degree of concerns that surround the US economic activity. On the other hand, strong economic growth in main Asian emerging economies, which so far have been apparently little affected by the US mortgage crisis, has offset the effects of economic deceleration in mature economies. In fact, pressures over production factors availability have triggered inflationary pressures in many emerging economies, many of which are consequently in the midst of monetary tightening cycles. For mature economies, prospects for monetary policy are more diverse. Economies presenting more moderate inflationary pressures and more evident credit contraction tend to present additional monetary policy easing. On the other hand, in economies where inflation rates are at high levels relative to their respective targets, the scope for reaction to the contraction caused by the credit crisis seems more limited. In this context, volatility and risk aversion indicators in international financial markets have remained at quite high levels since the last Copom meeting, although showing some contraction at the margin. Even if the prices of Brazilian assets present, at different magnitudes, sensitivity to the international scenario, Brazilian economic activity does not seem to have been significantly impacted by the persistent deterioration on global financial markets confidence, and, despite not decoupled from external economic developments, Brazilian economy should sustain its growth trajectory, essentially driven by domestic demand.

12. Oil prices, systematic source of uncertainty stemming from the international scenario, once more increased substantially since the last Copom meeting and continue highly volatile. This behavior reflects structural changes in global energy markets, which have blocked the recovery of inventory levels traditionally observed, in addition to recurrent geopolitical tensions. Despite significant uncertainties inherent to oil prices forecasts, the main scenario considered by the Copom forecasts unchanged domestic gasoline prices in 2008, despite the probability of materialization of an alternative scenario has increased. However, apart from the behavior of domestic gasoline prices, one should recognize that the elevation of international oil prices impacts domestic economy both through productive chains, such as the petrochemical, as well as through the deterioration of inflation expectations. The prices of other commodities, especially grains, which have also increased significantly since the last Copom meeting, despite more pessimism about the prospects for global economic growth and the turmoil on global financial markets, decreased last weeks, but continue to record significant increases in the year.

Assessment of inflation trends

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

a) Compared to the assumptions considered in the March Copom meeting, projected adjustments for gasoline and bottled gas prices were both maintained at 0% for 2008;

b) Compared to the assumptions considered in the March Copom meeting, the projections for electricity price adjustments in 2008 were set at 0.1% down from 1.1%, while projections for fixed telephone prices were maintained at 3.5%;

c) The projection for regulated prices inflation, based on individual items, was maintained at 4.0% for 2008. This set of prices, according to data released by the IBGE, corresponded to 30.09% of the total March IPCA;

d) The projection for regulated prices inflation in 2009 was maintained at 4.5%. This projection is based on the endogenous determination model for regulated prices, which computes seasonal components, exchange rate changes, market prices inflation and the IGP (General Price Index) variation;

e) The projection for the spreads over the Selic rate, using a Vector Autoregressive model based on the 360-day swap rates – replacing the model based on the Selic and 180-day swap rates, estimates a 83bps spread in the fourth quarter of 2008, under the benchmark scenario. The swap rate trajectory points to a 55bps spread in the last quarter of 2009. The identified shocks and their impacts were reassessed according to newly available information.

14. Regarding fiscal policy, the projections assume the achievement of 3.8% of GDP for the consolidated public sector primary surplus in 2008 and 2009, adjusted by the possibility of a 0.45 p.p. reduction in this percentage, due to the implementation of the PPI (Investment Pilot Program). The related assumptions considered in the previous meeting were maintained.

15. Since the March Copom meeting, median IPCA inflation expectations for 2008, compiled by the BCB's Investor Relations Group (Gerin), increased significantly to 4.66%, up from 4.41%. Twelve-month ahead inflation expectations increased to 4.38%, from 4.30%, considering the composition of median monthly inflation market expectations. For 2009, inflation expectations increased to 4.40% up from 4.30%.

16. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the Selic rate at 11.25% and the exchange rate at R$1.70/US$ during the forecast period – the projection for the 2008 IPCA significantly increased compared to the value considered at the March Copom meeting, above the 4.5% target established by the National Monetary Council (CMN) for the year. According to the forecast based on the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – IPCA inflation forecast for 2008 also increased compared to the value considered at the March Copom meeting, and is also above the central target for the year. The projection for 2009 based on the benchmark scenario increased relative to the March Copom meeting, whilst the projection based on the market scenario decreased – in both cases, projections are above the 4.5% target.

Monetary policy decision

17. The Copom evaluates that monetary policy should contribute for the consolidation of a favorable long-term macroeconomic environment. Economic activity data indicate that the intensity of demand expansion continues quite robust, showing acceleration in some segments and regions in the first quarter of 2008, and is responsible, at least partially, for the inflationary pressures observed in the short-run, despite strong imports growth and the benign investment behavior. Even in the context of moderate deceleration of global growth this year and the higher volatility observed in global markets since mid-2007, the Committee believes, according to available information, that the balance of payments should not represent imminent risk to the inflationary scenario. On the other hand, there are signs that relevant inflationary pressures are intensifying both in mature and emerging economies, evidencing the existence of inflationary risks on the global outlook. The Copom reaffirms the view, stated in previous minutes, that an alternative scenario of more intense and generalized global deceleration represents an ambiguous risk factor for the Brazilian inflation. On the one hand, by reducing net exports it would act as a factor to restrain aggregate demand. Moreover, the potential decrease of some important commodities prices could contribute to a lower domestic inflation. On the other hand, the above-mentioned alternative scenario could unfavorably impact inflation prospects through two mechanisms. In the case of deceleration in the mature economies that comprise the global financial markets center, risk aversion could increase, resulting in decreased demand for Brazilian assets and depreciation of their prices. In addition, in the medium run, a possible reduction of net exports could similarly affect the price sustainability of certain Brazilian assets. Due to the deterioration of inflation prospects, in a more uncertain scenario, the Committee evaluates that the risk of materialization of a less benign inflationary scenario increased. The Copom emphasizes that the main challenge of monetary policy in this context is to guarantee the maintenance of positive results reached

in the last years. Particularly, monetary policy should act so that impacts initially focused on price indices do not result in persistent deterioration of inflation dynamics through a worsening in expectations.

18. The Copom considers that the probability that emerging local inflationary pressures will represent risks to the domestic inflation trajectory has increased, because the heated demand and market of factors, in addition to the possibility of existence of supply restrictions in some sectors, can increase the pass-through of wholesale prices over consumer price inflation. The Committee understands that the prospects for this pass-through, as well as for the generalization of the local pressures initially focused on consumer price inflation, depend in a critical manner on inflation expectations, which increased significantly in the recent weeks, and continue to be carefully monitored. Additionally, it is worth noticing that although the external sector can restrain the inflationary pressures in the tradable sector, heated domestic demand can trigger inflationary pressures in the non-tradable sector, for instance, such as in the services sector. In this context, the Copom will continue to manage the monetary policy stance so that the gains obtained in inflation control in recent years become permanent. In this respect, the Copom will continue to carefully monitor the evolution of inflation and the several core inflation measures, as well as inflation expectations within the forecast period, promptly adjusting the monetary policy stance in order to avoid the consolidation of a scenario where one-off adjustments become persistent or generalized price increases.

19. The preservation of inflation rates in line with the targets path and the consequent consolidation of a long-lasting stable macroeconomic scenario will contribute to the continuous progressive reduction of macroeconomic risk perception that has occurred in the last years. The Copom evaluates that the persistence of a cautious and timely monetary policy stance has been critical to increase the probability that inflation will continue to evolve according to the targets path. For this to materialize, however, it is important that forward-looking inflation indicators, in particular the expected dynamic of aggregate supply and demand, converge during the relevant time for monetary policy.

20. The Committee emphasizes, once again, that there are important time lags in the transmission of monetary policy stance to economic activity and inflation. Therefore, the evaluation of alternative monetary policy stances should necessarily focus on the forward-looking inflation scenario and its risks, instead of current inflation indicators.

21. During the coming months, credit growth and real payroll expansion should continue to bolster economic activity. As mentioned in recent Copom Minutes, the effects of governmental transfers and other fiscal impulses expected for this and the next quarters should also add up to the factors that will sustain demand. These issues become even more relevant considering the clear signs of heated aggregate demand, and the fact that the monetary policy decisions will have concentrated effects in the second half of 2008 and in 2009.

22. The Copom recognizes the important contribution of investment to expand productive capacity. This factor, together with the external sector, has helped to mitigate inflationary pressures, which would be even more intense in their absence. However, the Copom evaluates that the pace of domestic demand expansion, which should continue to be sustained, among other factors, by fiscal transfers and by income and credit growth, continues to present risks to inflationary dynamics. In this context, the consistent reduction of the mismatch between the rhythm of expansion of supply of goods and services and the increase of demand is even more relevant to the assessment of different possibilities of monetary policy stance.

23. Aiming at consolidating a stable and predictable environment, the Copom adopts a strategy to avoid a volatile inflationary trajectory. This strategy takes into consideration the time lags in the transmission mechanisms and has proved to be the most adequate to deal with the uncertainty inherent to the process of monetary policy formulation and implementation. That is the reason why variables such as inflation projections, the balance of risks associated to the forward-looking scenario and especially the preventive stance in the decision-making process of the Copom are so important. At the current moment, characterized by the deterioration in current and

expected inflationary dynamics, prudence assumes an even more important role in this process. In the current circumstances, there is the risk is that economic agents start to attribute higher probability that inflation increases will become persistent, which would reduce the efficacy of the monetary policy. Therefore, the Copom's assessment, backed by international experience, is that the performance of monetary policy tends to be more effective to reach their goals more quickly, when the deterioration of inflationary dynamics is in its early stages, rather than when it is consolidated.

24. The Copom evaluates that, in light of signals of economy heating, as illustrated by the acceleration of some wholesale prices and the evolution of core inflation measures, and by the fast increase in inflation expectations, the risks for the concretization of a benign inflationary scenario, in which IPCA would remain consistent with the targets path, are relevant. In fact, the deterioration of the forward-looking scenario is already present in the Committee's inflation projections. The Copom also considers that the persistence of the mismatch between the paces of expansion of aggregate supply and demand tends to increase the probability of such scenario to materialize. In these circumstances, monetary policy should act through the adjustment of the basic interest rate in order to, on the one hand, contribute to the convergence between the paces of expansion of aggregate supply and demand, and on the other hand, avoid that inflationary pressures initially focused on price indices lead to persistent deterioration of expectations and of the inflation forward-looking scenario. By remaining ready to act as the balance of risks to inflation dynamics so requests, the Committee believes that it is, in fact, helping to sustain economic growth, which requires stability, predictability and consequent extension of the planning horizon for businesses and families, as well as to protect the substantial increases in real income of workers observed in recent years.

25. In this context, evaluating the evolution of the macroeconomic scenario and inflation prospects, the Committee unanimously decided to raise the Selic target rate to 11.75% p.a., without bias. The Committee understands that the decision to promptly implement significant part of the adjustment in the basic interest rate will contribute to the timely reduction in the risks for the inflation scenario, reducing, therefore, the magnitude of the total adjustment to be implemented.

26. Under the inflation-targeting regime, the Copom decides according to inflation prospects, the analysis of several alternative scenarios for the evolution of the main variables that determine prospective price dynamics and the balance of risks associated to its projections. Domestic demand continues to expand vigorously, backing-up economic activity dynamism, including sectors little exposed to external competition, at a time when the effects of important incentive factors are still perceived. On its turn, the contribution of the external sector to a benign inflationary scenario, in light of robust domestic demand growth, seems to become less effective, at a moment when the effects of investment over productive capacity of the economy still need to consolidate. In such environment, the monetary authority should act so that to avoid that short-term uncertainties contaminate longer time horizons. If the risk profile deteriorates in a matter that implies shifts in the basic inflation prospective scenario, the Committee will promptly adjust monetary policy stance to the circumstances.

27. At the conclusion of the meeting, it was announced that the Copom would reconvene on June 3rd 2008, for technical presentations, and on the following day, to discuss the monetary policy decision, as established in Communiqué 16,051 of September 3rd, 2007.

Summary of data analyzed by the Copom

Inflation

28. IPCA inflation increased 0.48% in March, up from 0.49% in February and 0.37% in March 2007. In the first quarter of the year, IPCA inflation reached 1.52%, up from 1.26% year-over-year. On a twelve-month trailing basis, the IPCA increased 4.73% in March, up from 4.61% in February.

29. Food prices increased 0.89% in March, up from 0.60% in previous month, contributing 0.2 p.p. to the monthly IPCA result. Housing and transportation, which increased by 0.65% and 0.42%, respectively,

contributed both 0.09 p.p. to the IPCA monthly result. Market prices decelerated, increasing 0.48%, down from 0.66% in February, while regulated prices registered inverse trend, with a 0.47% increase, up from 0.10% in the previous month. On a twelve-month trailing basis through March, market prices expanded by 6.03% and regulated prices, 1.83%, up from 5.98% and 1.57%, respectively, in the previous month. Amongst market prices, in the last twelve months, the prices of tradable goods increased to 5.33% in March, up from 5.00% in February, while the prices of non-tradable goods decelerated, to 6.67%, down from 6.89%, following the same trend of the prices of services, which increased 5.11% in March, down from 5.19% in February, according to the same comparison basis.

30. Trimmed means core inflation measures accelerated and, for seasonal reasons, the core excluding household food and regulated prices decelerated in March, while on a twelve-month trailing basis the three measures increased, compared to February. The core excluding household food and regulated prices increased 0.36% in March, down from 0.69% in February, totaling 4.41% in the last twelve months (the highest rate since May 2006) and up from 4.27% in the previous month. The smoothed trimmed means core increased 0.39% in March, up from 0.27% in February, totaling 4.16% in the last twelve months. The non-smoothed trimmed means core increased 0.41% in March, up from 0.36% in February, accumulating 4.01% in the last twelve months, also the highest rate since May 2006.

31. IGP-DI inflation increased 0.70% in March, up from 0.38% in February, accumulating 2.08% in the first quarter of the year and 9.18% in the last twelve months. The three index components accelerated in the month, with highlights to food prices, both at wholesale and consumer levels. IPA-DI inflation increased 0.80%, up from 0.52% in the previous month, totaling 11.39% in the last twelve months. IPC-Br inflation increased 0.45% in March, after stability in February, accumulating 4.52% in twelve months. INCC inflation increased 0.66% in March, up from 0.40% in February, reaching 6.69% in twelve months.

32. The IPC-Br acceleration reflected the behavior of five out of the seven groups, with highlights to food (0.62% up from -0.38%) and housing (0.47% up from 0.09%). At the wholesale level, both agricultural and industrial prices increased in March, highlighting the elevations in the prices of tomato, composed fertilizers, bovines, iron ore, in natura milk, while soybean, manioc, coffee, corn and poultry were the main negative drivers.

Economic activity

33. According to IBGE's monthly survey (PMC), retail sales increased 12.2% in February 2008, year-over-year, with generalized growth sales in all segments, mainly driven by office, computing and communication equipment and material (38.9%); other items for domestic and personal use (27.5%); furniture and home appliances (22.3%); books, newspapers, magazines and stationery (17.9%); and pharmaceutical, medical, orthopedic and perfumery items (14.1%). Expanded retail sales, which include the activities vehicles, motorcycles, parts and pieces, and construction material, increased 18.1%, influenced by the expansions of 30.5% in the automotive sector and 19.0% in construction material.

34. Retail sales declined 1.5% in February, month-on-month seasonally adjusted, recording 12.4% growth in the sales of office, computing, and communication material and equipment, and declines in fabric, clothing and shoes (4%); hyper- and supermarkets sales, food products, beverages and tobacco (3.8%); and fabric, pharmaceutical, medical, orthopedic and perfumery items (2.8%). Expanded retail sales increased 1% in February, month-on-month seasonally adjusted, as a result of increases in the sales of vehicles and motorcycles (5.2%) and construction material (3.6%).

35. According to São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, the consultations to the Usecheque system and database consultations for credit sales in March increased, respectively, 4.5% and 1.1% month-on-month. Year-over-year, there were respective increases of 3.2% and 3.5%. In the first quarter of 2008, these indicators increased 6.5% and 6.3%, respectively, compared to the same period of 2007.

36. Regarding investment indicators, the production of construction inputs and domestic production of capital goods increased by 1.2% and 3.1% in February, month-on-month seasonally adjusted. These indicators grew 12.9% and 25.0%, respectively, year-over-year. Still according to this comparison basis, the positive evolution of capital goods production reflects mainly the good performances in the following sectors: agricultural equipment (57.5%), equipment linked to investment in infrastructure, such as transportation equipment (35.3%), construction (26.3%) and energy (19.9%).

37. Capital goods imports increased month-on-month 6.8% in February, according to data from Fundação Centro de Estudos do Comércio Exterior (Funcex), seasonally adjusted by the BCB. Confirming the expansionist trajectory of investments in Brazilian economy, capital goods imports increased 55.3% year-over-year.

38. CNI indicators, seasonally adjusted by the BCB, showed expansion of industrial activity in February, month-on-month, with increases of 1.0% in industrial real revenues and 0.6% in hours worked in production. Compared to February and the first two months of 2007, industrial real revenues increased 11.5% and 10.9%, respectively, and hours worked in production, 8.8% and 7.8%, in the same order. Installed capacity utilization (Nuci) reached 83.2% in February, remaining relatively stable month-on-month seasonally adjusted, and increased 1.5 p.p. year-over-year, according to the observed series.

39. According to IBGE's Monthly Industrial Survey (PIM), on a month-on-month basis, industrial production decreased 0.5% in February, while the three-month moving average remained stable. These results were influenced by the 33.2% decline in monthly pharmaceutical production, which responds for approximately 4.3% of industrial production, reflecting the effects of technical interruptions in an important company in the sector. Fourteen out of the twenty seven activities surveyed recorded production increase in February and, by use categories, the production of capital goods and durable consumer goods increased by 3.1% and 0.9%, respectively. The production of intermediated goods showed relative stability (-0.2%), after two consecutive months of positive results, expanding by 2.2%. The production of semi-durable and non-durable consumer goods declined 3.9%, mainly reflecting the interruption in the pharmaceutical industry previously mentioned. Year-over-year, industrial activity increased 9.7%, with expansion in all use categories, with highlights to the increases of 25% in capital goods production and 20.7% in durable consumer goods production. In the first two months of 2008, these rates reached 9.2%, 19.9% and 18.1%, respectively, year-over-year. In the same period, the production of intermediate goods and semi- and non-durable consumer goods expanded by 9.2% and 3.5%, respectively. On a twelve-month trailing basis, industrial output expanded 6.8% in February, up from 6.3% in January, showing acceleration at the margin, contrary to month-on-month and the three-month moving average seasonally adjusted data comparisons.

40. Vehicles production reached 280.6 thousand units in March, according to Anfavea, increasing 13.4% year-over-year. Total sales of vehicles increased 9.8%, with a 17.1% expansion in domestic sales and an 8.8% contraction in exports relative to March 2007. Considering seasonally adjusted data, the production of vehicles increased 2.5% month-on-month, with expansions in the production of automobiles and light commercial vehicles (1.9%) and trucks (1.7%), and a 1.5% decrease in the production of buses. Year-over-year, the production of the same items changed 13.3%, 21.5%, and -0.6%, respectively. Considering seasonally adjusted data, the production of agricultural machinery decreased by 6% month-on-month, but expanded by 33.2% relative to March 2007and by 56.2% in the first quarter, year-over-year.

41. According to the survey carried out by the IBGE in March, the grains harvest should reach 140.5 million tons in 2008, increasing 5.6% year-over-year. Planted area was estimated at about 46.5 million hectares, a 2.5% increase relative to March 2007, being the plantations of corn and soybean responsible for 76% of the total. Good weather conditions have been contributing to the confirmation of the expected favorable results, with highlights for the growth in the productions of rice and soybean (8.1% and 3.4%, respectively) and in the first harvest of corn (7.5%). The survey also estimated a 7.9% increase in sugar cane

production, with an 8.0% expansion in planted area, and a 22.9% increase in coffee production.

Surveys and expectations

42. The Fecomercio-SP survey showed a 0.4% month-on-month elevation in the Consumer Confidence Index (ICC) in March, reflecting the 0.7% increase in the Consumer Expectations Index (IEC), while the Current Economic Conditions Index (Icea) remained stable. The ICC grew by 15.2% year-over-year, due to expansions of 15.7% and 14.9% in the Icea and IEC, respectively.

43. According to the FGV survey, the ICC grew 3.5% in March, month-on-month. This result reflected a 5.2% increase in the Current Situations Index (ISA) and a 2.6% elevation in the Expectations Index (IE), which computes 6-month ahead expectations. The survey registered increases of 12.1%, 25.7% and 5.6% in the ICC, ISA and IE, respectively, year-over-year.

44. Still according to the FGV, the Industry Confidence Index (ICI) increased 5.8% in March, month-on-month. The same index increased by 4.5% in March, up from 3.7% registered in February, both in year-over-year terms, after four consecutive months of deceleration. The IE expanded by 8.3% and the ISA grew by 3.8%, month-on-month, and 4.4% and 4.7%, respectively, in year-over-year terms. Amongst the IE components, it is noteworthy the monthly nine-point growth of the six-month ahead business conditions, approaching the record of the series, occurred in July 2000. According to the same comparison basis, expected employment and output both increased eleven points, showing the continuation of favorable expectations of businessmen for the near future.

45. According to the FGV Manufacturing Industry Survey, installed capacity utilization (Nuci) reached 85.2% in March, standing 0.5 p.p. above the February level and 2.1 p.p. year-over-year. The Nuci reached 89.9% in capital goods industry, a 4.4 p.p. growth relative to March 2007, reaching a record high. Nuci also grew 1.4 p.p. in the consumer goods industry and 0.4 p.p. in intermediate goods industry, but retreated 1.3 p.p. in the construction inputs industry, according to the same comparison basis. The same survey showed that, based on either planning or investment decisions already approved by their boards, firms expect a 11% expansion in manufacturing installed capacity, on average, for 2008 and 22% for the 2008-2010 period, the highest rates in five years. According to the same firms, the current level of the domestic demand and the expected returns of new investments were the key drivers for investment decisions.

Labor market

46. According to the Ministry of Labor and Employment, 205 thousand new formal jobs were created in February 2008, totaling 347.9 thousand year-to-date, a record high for the month and for the two-month period. Employment level increased by 0.5% month-on-month in seasonally adjusted terms, expanding in all sectors, with highlights to the 1.6% expansion in the construction sector and the creation of 74.4 thousand new jobs in the services sector. In the first two-month period, year-over-year, employment expanded by 6%, with highlights to the 15.5% expansion in the construction sector.

47. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate reached 8.7% of economically active population (PEA) in February, a record low for the month in the historical series. Considering seasonally adjusted data, the rate remained almost stable, recording 8.6% against 8.5% in January. Year-over-year, the unemployment rate reduced 1.2 p.p., reflecting a 3.6% increase in the number of employed workers, 732 thousand, and a 2.3% expansion in the PEA. Formal workers in the private sector increased 8.4%, according to the same comparison basis, representing 722 thousand jobs, while the number of informal workers decreased 3.4%, with the reduction of 96 thousand jobs. The number of self-employed workers grew by 1.9% in the same period.

48. The same survey showed that average real earnings of occupied workers grew 1.1% in February month-on-month and 2.5% year-over-year, reaching the highest value since December 2002. Real payrolls increased 0.6% in February month-on-month and 6.2% year-over-year.

49. According to CNI data seasonally adjusted by the BCB, employment in manufacturing industry retreated 0.1% in February, month-on-month, and increased 0.5%, year-over-year. In the first two-month period of 2007, employment and real payroll in the manufacturing industry increased by 5.0% and 13.0%, respectively.

Credit and delinquency rates

50. Credit operations in the financial system expanded by 1.1% in February, expanding by 27.9% on a twelve-month trailing basis. According to the same comparison bases, non-earmarked credit operations increased 1.3% and 32.8% respectively, while earmarked credit operations elevated 0.6% and 17.4%, respectively. Among the non-earmarked operations, leasing operations remained strong, with expansions of 120.8% and 78.9% for credit to individuals and to corporate, respectively, in the last twelve months. Regarding earmarked credit, it bears highlighting the 24.1% and 17.7% increases in operations related to housing and the agricultural sector, respectively, according to the same comparison basis. Considering other sectors, loans to industry increased 1% month-on-month and 30.6% in twelve months, in February, while credit to commerce expanded by 0.8% and 26.8%, according to the same comparison bases.

51. The average interest rate on non-earmarked credit operations, used as reference for interest rates, reached 37.4% p.a. in February, standing 0.1 p.p. above the January result. The average rate on credit for individuals reached 49.0% p.a., up from 48.8% p.a. in the previous month. The average rate on corporate credit increased 0.1 p.p. in the month, reaching 24.8% p.a.

52. The average tenure of non-earmarked credit operations, used as reference for interest rates, reached 369 days in February, compared to 371 in January and 302 in the same month of the previous year. The average tenure of corporate credit operations decreased 4 days in February, reaching 303 days, while the average tenure for credit operations to individuals totaled 447 days, up from 376 days in February 2007.

53. Delinquency rates in the financial system (non-earmarked loans in arrears for more than ninety days) reached 4.3% in February, a 0.7 p.p. decrease relative to the same month of 2007. Delinquency rates for credit operations with corporate and individuals reached 2.0% and 7.1%, respectively, decreasing by 0.8 p.p. and 0.2 p.p. in the period.

54. Net delinquency rate for retail credit, measured by the ACSP, reached 7.6% in March, up from 7.1% in the same month of 2007.

External environment

55. The perception of a longer and more severe deceleration in the US economic activity has increased and negative spillovers on global economic performance have been expected. The Federal Reserve recognizes a slight recession in the first semester in the US economy, followed by a modest recovery in the second half of the year.

56. In Europe, the fears regarding the UK real estate market increased. After several banks had adopted more restrictive policies to mortgage grants, real estate prices fell 2.5% in March, the greatest retraction of the last sixteen years. Economic growth in the Euro Area cooled in the last three months of 2007, as government and consumer expenditures reduced. According final data released, GDP in the thirteen countries that adopted the Euro increased 0.4% in the fourth quarter, quarter-over-quarter, and 2.2%, year-over-year.

57. At the beginning of 2008, it is important to notice, the persistent characteristic of inflation, even in light of global deceleration. Food and energy remain driving inflation, which spreads worldwide. In addition to increases in large economies, it bears emphasizing inflation rises in Hong Kong (6.3%), India (6.11%) and Saudi Arabia (8.7%, the highest rise in 27 years). Similar situation concern the central banks in Latin America, Russia and Philippines, among others.

58. In China, inflation reached a record high in twelve years, 8.7% p.a. in February, mainly driven by food prices, which increased 23.3% only in February. In the US, activity cooling has offset inflationary pressures stemming from food and energy prices, added to the effect of the devaluated exchange rate.

Foreign trade and international reserves

59. In March 2008, Brazilian trade surplus reached US$1 billion, totaling surpluses of US$ 2.8 billion in the year and US$ 34.1 billion in the last twelve months. In the first quarter of the year, exports reached US$38.7 billion, and imports, US$35.9 billion, growing by 13.8% and 41.8%, year-over-year.

60. In March, exports totaled US$12.6 billion, reaching a US$630.7 million daily average, a 7.6% growth year-over-year. Imports totaled US$11.6 billion in March, with a US$580.1 million daily average, a 33.2% increase year-over-year. Imports, both in value and in daily average terms reached record highs for the month.

61. International reserves totaled US$195.2 billion in March, with increases of US$2.3 billion in the month and US$14.9 billion, compared to the end of 2007.

Money market and open market operations

62. In the period between the March and the April Copom meetings, the yield curve shifted upwards in all extension, with a slope increase. This movement was mainly driven by the economic agent's perception about the March Copom Minutes and the Quarterly Inflation Report, the release data for inflation above market expectations, the increase of inflation expectations and the worsening of the external outlook. Between March 3rd and April 14th, one-, three-, and six-month rates went up by 31 bps, 50 bps and 70 bps, respectively. Moreover, one-, two- and three-year rates increased by 95 bps, 88 bps and 90 bps, respectively. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectations, increased to 8.07% on April 14th, up from 7.31% on March 3rd.

63. On March 26th, the BCB carried out reverse FX swap auctions amounting US$2.0 billion, with the total rollover of the April 1st redemptions.

64. In its open market operations, the BCB carried out, from March 4th to April 14th, weekly five-and seven-month fixed rate repo operations, borrowing. The average daily balance of these operations reached R$84.6 billion, of which R$59.0 billion were seven-month operations. In the same period, the BCB conducted 30 overnight repo-borrowing operations. The BCB also conducted daily liquidity management operations with tenures up to two working days. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R$29.1 billion, borrowing. In addition, on March 6th, 17th and 26th and on April 1st, the BCB conducted borrowing operations with tenure of 29, 9, 16 and 12 working days, respectively, amounting R$83.8 billion, R$8.9 billion, R$19.9 billion and R$29.2 billion. These operations totaled R$108.6 billion on a daily average basis.

65. Between March 4th and April 14th, the National Treasury raised a total of R$28.2 billion, of which R$13.1 billion in fixed-rate securities: R$9.7 billion via issuance of LTNs maturing in 2008, 2009 and 2010, and R$3.4 billion in NTN-Fs maturing in 2012, 2014 and 2017. Issuance of LFTs totaled R$9.7 billion, for securities maturing in 2012 and 2014. Issuance of inflation-linked NTN-Bs reached R$5.4 billion, for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045.

66. In the same period, the Treasury conducted auctions to sell LTNs maturing in October 2008, and April and July 2009 and bought LTNs maturing in April and July 2008, totaling R$2.8 billion. Issuance of inflation-linked NTN-Bs for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045, settled in other National Treasury securities, totaled R$4.9 billion. The Treasury also conducted sales auctions of LFTs maturing in 2012 and 2014, which totaled R$2.2 billion, receiving LFTs maturing in 2008 as payment, and purchase auctions to buy LTNs and NTN-Bs, totaling R$2.0 billion and R$0.3 billion, respectively.

Minutes of the 135th Meeting of the Monetary Policy Committee (Copom)

Date: June 3rd, from 4:50PM to 7:10PM, and June 4th, from 5:30PM to 7:00PM
Place: BCB Headquarters meeting rooms – 8th floor on June 3rd and 20th floor on June 4th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Alexandre Antonio Tombini
Alvir Alberto Hoffmann
Anthero de Moraes Meirelles
Antonio Gustavo Matos do Vale
Maria Celina Berardinelli Arraes
Mário Gomes Torós
Mário Magalhães Carvalho Mesquita

Department Heads (present on June 3rd)
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on June 4th)
João Henrique de Paula Freitas Simão – Open Market Operations Department
José Antônio Marciano – Department of Banking Operations and Payments System
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on June 3rd)
Adriana Soares Sales – Deputy Head of the Research Department
Alexandre Pinheiro de Moraes Rego – Press Secretary
Alexandre Pundek Rocha – Advisor to the Board
Flávio Pinheiro de Melo – Advisor to the Board
Katherine Hennings – Advisor to the Board
Sergio Almeida de Souza Lima – Executive Secretary

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

Recent economic developments

1. IPCA inflation accelerated in April (0.55%) relative to 0.48% in March and 0.49% in February. As a consequence, inflation reached 2.08% in the first four months of 2008, up from 1.51% in the same period of 2007. Twelve-month trailing inflation continued to accelerate. In fact, after reaching 4.61% in February and 4.73% in March, it totaled 5.04% in April (3.00% in April 2007). Under this comparison basis, the acceleration of consumer price inflation essentially mirrors the behavior of market prices, which increased more rapidly than regulated prices. In fact, market prices and regulated prices increased 6.59% and 1.59%, respectively, in the twelve months through April, compared to 2.97% and 2.99% in the twelve months through April 2007. Moreover, despite the BRL appreciation, the prices of tradable goods accelerated, reaching 6.15% (compared to 1.53% in April 2007), according to the same comparison basis. Regarding the prices of non-tradable goods, greatly pressured by the behavior in the prices of perishable food and services, twelve-month trailing inflation was even higher (6.99%), evidencing the influence of domestic prices over inflation. Preliminary data for May point to the continuity of inflation acceleration. The recent behavior of IPCA inflation has been remarkably less benign than that observed in previous quarters, so that since the end of 2007, inflation has signaled that it could be diverging from the targets path, reaching 3.22% in the last six months.

2. Two out of the three main underlying inflation measures calculated by the BCB followed the inflation acceleration in the headline index in April. The core inflation by exclusion of household food items and regulated prices and the smoothed trimmed means core inflation measures increased from 0.36% and 0.39% in March to 0.53% and 0.48% in April, respectively. On the other hand, the non-smoothed trimmed means core inflation measure increased 0.41% in April, unchanged relative to March. Similarly to headline inflation, the three core inflation measures remarkably accelerated in the first four months of the year, compared to the same period of 2007, with increases from 1.46%, 1.21% and 1.09% to 1.99%, 1.52% and 1.60% for the core inflation by exclusion, smoothed and non-smoothed trimmed means core inflation, respectively. On a twelve-month trailing basis, the three core inflation measures continued to accelerate substantially, following the behavior of headline inflation. Core inflation by exclusion of household food items and regulated prices continued to increase significantly, to 4.65% in April, up from 4.41% in March and 4.27% in February. Smoothed trimmed means core inflation showed similar behavior (4.36% in April, up from 4.16% in March), while the non-smoothed trimmed means core inflation increased to 4.14% in April, up from 4.01% in March, and 3.83% in February. Moreover, it bears emphasizing that the behavior of diffusion indices suggests increased dissemination of inflation acceleration, confirming the analysis present in previous Copom Minutes.

3. The General Price Index (IGP-DI) inflation increased to 1.12% in April, up from 0.70% in March and 0.38% in February. On a twelve-month trailing basis, IGP-DI inflation accelerated to 10.24% in April, up from 9.18% in March and 8.65% in February (compared to 4.61% in April 2007). In the twelve months through April, the IGP-DI increase reflected both the behavior of the Consumer Price Index-Brazil (IPC-Br), which totaled 4.95% (2.67% in April 2007), and also of the IPA-DI (Wholesale Price Index), whose variation totaled 12.82% (5.27% in April 2007). According to the same comparison basis, the Civil Construction National Index (INCC) increased 7.13% (5.35% in April 2007). Regarding agricultural IPA, inflation reached 27.90% (11.04% in the twelve months through April 2007). It bears highlighting the acceleration of industrial prices, which began in the second half of 2007 and seems to have intensified lately. In the first four months of 2008, the industrial IPA increased 4.44%, up from 1.02% in the same period of 2007. In the last twelve months, wholesale industrial price inflation increased to 7.97% in April, up from 4.42% in December 2007. As mentioned in previous Copom Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend on current and prospective demand conditions and price-setters' expectations for the future inflation path.

4. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output increased 0.1% in April, after growing by 0.7% in the previous month. Still considering the seasonally adjusted series, after the 0.6% month-on-month expansion observed in March, industrial output increased 0.2% in April. It bears noticing that general industrial output grew 7.3% in the year, with respective increases of 7.4% and 5.9% in manufacturing and in mining output. In a year-over-year basis, industrial output showed remarkable volatility in March and April, with changes of 1.4% and 10.1%, respectively, mainly driven by the unusual number of working days recently observed. The data already released for the last months point, in short, to the continuity of the industrial production expansion cycle, despite at a pace dependent of possible limits to supply expansion.

5. Among the use categories, according to data seasonally adjusted by the IBGE, capital goods production increased significantly in April (1.6%), up from 1.3% in March. The other use categories showed declines at the margin, totaling -0.2% for intermediate goods, -1.9% for durable consumer goods and -1.5% for semi- and non-durable consumer goods. Among industrial production categories, capital goods production leads the expansion, with a 20.5% increase, followed by the 15.9% elevation in durable consumer goods production. The scenario of solid expansion of capital goods production observed since 2007, mainly driven by the consolidation of positive prospects for the continuity of economic growth, underpinned by the perception of macroeconomic stability consolidation, seems to persist in this year. On its turn, the dynamism of durable consumer

goods production reflects, predominantly, the remarkable improvement in credit conditions, when compared to historical patterns. It should be highlighted that the emergency of signs pointing to pressure over the availability of production factors, as suggested in some industrial surveys, indicates that accommodation in the pace of industrial activity expansion could be greatly associated to productive capacity restrictions.

6. Labor market continues to present quite favorable performance. The unemployment rate in the six metropolitan regions covered by the Monthly Labor Survey (PME) decreased to 8.5% in April, down from 8.6% in March and 8.7% in February. As a result, the average unemployment rate in the first four months of the year was 1.4 p.p. below that observed in the same period of 2007. According to data seasonally adjusted by the BCB, the unemployment rate decreased to 8.1% in April, a record low for the month since the start of the historical series in 2002, down from 8.2% in March and 8.5% in February. In March, average real earnings fell 0.6% month-on-month and increased 2.0% year-over-year. On the other hand, in April, average real earnings increased 1.0% month-on-month and 2.8% year-over-year. As a consequence, real payrolls expanded by 6.5% in April, up from 6.3% in the previous month, and 7.2% in year-over-year terms, continuing to constitute a key driver for sustained aggregate demand growth. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment reduced by 0.04% in April (+0.2% in March). In year-over-year terms, employment grew 4.0%, totaling 4.2% growth in the last twelve months. Still regarding employment, data from the Ministry of Labor and Employment (MTE) indicate the continuity of strong expansion in formal employment this year, with the creation of 294.5 thousand jobs in April (up from 206.6 thousand in March and 205.0 thousand in February). In the first four months of the year, employment reached a record high of 849 thousand hires. Formal employment grew by 0.5% in April, seasonally adjusted. Observed data point to a 5.6% expansion in formal employment in the last twelve months, an evidence of strong dynamism in the labor market. The services sector presented the highest hiring rate in April, with the creation of 97.4 thousand new jobs, followed by the manufacturing industry (82.7 thousand), and by civil construction (32.1 thousand), a record high for the period. The retail sector recorded 34.7 thousand new jobs. The agricultural sector created 38.6 thousand new jobs, due to the activities related to sugar cane plantations in the Mid-South region.

7. In line with the positive developments in the labor market and with the credit expansion, retail sales continue to record positive performance, indicating that the pace of domestic demand growth remains robust, and signs of cooling cannot be perceived. According to data seasonally adjusted by the IBGE, expanded retail sales grew by 1.4% in March, up from the 1.2% in February, growing 12.1% year-over-year. As a consequence of the March result, expanded retail sales growth averaged 3.8% in the first quarter of the year, quarter-on-quarter. Month-on-month, according to data seasonally adjusted, it should be highlighted the expansion in the sales of fabric, clothing and shoes (6.1%), hyper- and supermarket sales, food products, beverages and tobacco (3.3%, despite the rise of food prices) and fuels and lubricants (1.7%). In 2008, accumulated growth was more significant in “office, computing and communication material and equipment” (31.3%), “other personal and domestic articles” (23.9%) and “vehicles, motorcycles, parts and pieces” (23.4%). The steady growth of retail sales has reflected the performance of both the sectors more sensitive to income and employment expansions and those more sensitive to credit conditions. For the next quarters, the continuity of the current cycle of retail sales expansion is expected, and will continue to be underpinned by employment and income growth, credit expansion and the maintenance of consumer confidence at high levels. Sector indicators, for example, relative to automobile sales in April and May, corroborate this assessment.

8. The installed capacity utilization rate (Nuci) in the manufacturing industry reached 83.4% in April, up from the 82.4% observed in March, according to CNI data seasonally adjusted by the BCB, a record high for the series. According to data seasonally adjusted by CNI, the Nuci in the manufacturing industry reached 83.2%, down from the 83.3% record high observed in November. Without the seasonal adjustment, the Nuci in April stood 1.5 p.p. above the level registered in the same month of 2007. As a consequence, the

average rate of the first quarter of 2008 was 1.3 p.p. above the level observed in the same period of 2007. The quarterly Nuci calculated by Fundação Getulio Vargas (FGV) reached 85.5% in April, according to the seasonally adjusted series, above the 85.3% level registered in January. For the consumer goods and capital goods sectors, the utilization rates in April reached 86.0% and 88.3%, respectively, in both cases a record high for the series. The maintenance of high installed capacity utilization rates, with some reduction of idle capacity at the margin, occurs in several sectors despite the significant increase in investment. Indeed, in April 2008, according to seasonally adjusted data, the absorption of capital goods firmly increased (6.2%), due to the vigorous growth of capital goods imports (10.7% in volume) and capital goods production (1.6%). Furthermore, the production of civil construction inputs decreased 3.4% in the same period, after a 2.6% increase in March. Recent data indicate that, although investment has been contributing to soften the increasing trend of capacity utilization rates, it has not been sufficient to contain this process. In this context, the timely maturation of investment projects will be crucial to limit mismatches regarding the evolution of aggregate supply and domestic demand in the relevant forecast period for monetary policy. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments related to the expansion of supply of goods and services, to adequately meet demand conditions.

9. The trade balance continues to present deceleration at the margin, which was already expected, and is in line with assessments present in Inflation Reports and previous Copom Minutes. In the last twelve months through May the trade surplus reached US$31.9 billion (33% below May 2007). Exports and imports totaled US$172.6 billion and US$140.7 billion, equivalent to 16.4% and 39.9% growth, respectively, in the last twelve months, in comparison to the same period ended in May 2007. As highlighted in previous Copom Minutes, imports have been growing faster than exports, both due to the strengthening of the BRL and to the robust economic activity in the country, notwithstanding the increases in the prices of several commodities included in the Brazilian export basket. The decrease in trade surplus contributed to the US$14.7 billion current account deficit registered in the twelve months through April 2008, equivalent to 1.1% of GDP. Foreign direct investment reached US$37.2 billion in the same period, equivalent to 2.8% of GDP.

10. Regarding the external scenario, the US economy seems to have entered a process of economic stagnation since the last quarter of 2007, and still suffers the impact of the crisis in the real estate sector, with spillover effects on the labor market, whose weakening, in combination with higher oil prices, affects consumer confidence, contributing importantly to depress consumption. Even if the influence of monetary and fiscal stimulus can reduce the risk of a significant contraction in activity, the dominant scenario seems to point to a more consistent recover only from 2009. Even after significant strengthening of capital basis of relevant financial institutions, uncertainties still remain about the length and amplitude of the effects of the US subprime mortgages market crisis over US and European banking system and over credit conditions for households and corporate. Therefore, uncertainties persist about the capability of monetary and fiscal policy measures implemented by the US authorities to smooth the weakening of the US economy in a timely manner, in light of the ongoing difficulties of the financial system. Despite the reduction of systemic risk perception, since mid-March, such difficulties could be worsened by a cyclic deterioration in the quality of credit, which would reinforce the already evident trend to financial contraction, increasing the risk of slowdown intensification. Prospects for economic activity in Europe and Japan, in spite of some favorable indicators in Germany, have also deteriorated, despite not provoking the same degree of concerns that surround the US economic activity. It should be highlighted that despite the prospects of continuity of slowdown for mature economies, global inflationary pressures have intensified. This has partially reflected strong economic growth in many emerging economies, which so far have been apparently little affected by the US mortgage crisis, offsetting the effects of economic deceleration in mature economies. In fact, in light of pressures over production factors availability, which have triggered inflationary pressures in many emerging economies, the trend seems to point to the continuity of monetary tightening cycles. For mature economies,

prospects for monetary policy are more diverse, notwithstanding the fact that inflation acceleration, which in some cases starts to deteriorate mid-term inflation expectations, seems to limit the scope for additional monetary policy easing, even if the risks to activity stemming from the credit crisis remain. In this context, volatility and risk aversion indicators in international financial markets have remained at quite high levels since the last Copom meeting, although showing some contraction at the margin. The elevation of Brazilian sovereign risk assessment by major rating agencies tends to reduce the sensitivity that Brazilian assets prices show relative to the international scenario, contributing to mitigate, but not to eliminate, the effects of difficulties experienced by the global economy over Brazilian economic activity, essentially driven by domestic demand.

11. Oil prices, systematic source of uncertainty stemming from the international scenario, once more increased substantially since the last Copom meeting and continue highly volatile. This behavior reflects structural changes in global energy markets, which have blocked the recovery of inventory levels traditionally observed, in addition to recurrent geopolitical tensions. Despite significant uncertainties inherent to oil prices forecasts, the main scenario considered by the Copom forecasts unchanged domestic gasoline prices in 2008, despite the probability of materialization of an alternative scenario is relevant. However, apart from the behavior of domestic gasoline prices, one should recognize that the elevation of international oil prices impacts domestic economy both through productive chains, such as the petrochemical, as well as through the deterioration of inflation expectations. The prices of other commodities, especially grains, which have also increased significantly since the last Copom meeting, despite more pessimism about the prospects for global economic growth and the turmoil on global financial markets, showed heterogeneous performance in the last weeks, but continue, with few exceptions, to record significant increases in the year.

Assessment of inflation trends

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

a) Compared to the assumptions considered in the April Copom meeting, projected adjustments for gasoline and bottled gas prices didn't change, once adjusted according to the effects stemming from specific taxes, and so were maintained at 0% for 2008;

b) Compared to the assumptions considered in the April Copom meeting, the projections for fixed telephone prices were maintained at 3.5% in 2008, while the projections for electricity price adjustments were changed to 1.1%, up from 0.1%;

c) The projection for regulated prices inflation, based on individual items, was maintained at 4.0% for 2008. This set of prices, according to data released by the IBGE, corresponded to 30.09% of the total April IPCA;

d) The projection for regulated prices inflation in 2008 was maintained at 4.5%. This projection is based on the endogenous determination model for regulated prices, which computes seasonal components, foreign exchange rate changes, market prices inflation and the IGP (General Price Index) variation;

e) The projection for the spreads over the Selic rate based on the 360-day swap rates estimates a 133bps spread in the fourth quarter of 2008 and 84bps spread in the last quarter of 2009. The identified shocks and their impacts were reassessed according to newly available information.

13. Regarding fiscal policy, the projections assume the achievement of the public sector primary surplus target of 3.8% of GDP in 2008 and 2009, increased by 0.5 p.p. The related assumptions considered in the previous meeting were maintained.

14. Since the April Copom meeting, median IPCA inflation expectations for 2008, compiled by the BCB's Investor Relations Group (Gerin), increased significantly to 5.48%, up from 4.66%. Twelve-month ahead inflation expectations increased as well from 4.38% to 5.01%, considering the composition of median monthly inflation market expectations. For 2009, inflation expectations increased to 4.60% up from 4.40%.

15. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the Selic

rate at 11.75% and the exchange rate at R$1.65/US$ during the forecast period – the projection for the 2008 IPCA increased compared to the value considered at the April Copom meeting, remaining above the 4.5% target established by the National Monetary Council (CMN) for the year. According to the forecast based on the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – IPCA inflation forecast for 2008 also increased compared to the value considered at the last Copom meeting, and is also above the central target for the year. The projection for 2009 based on the benchmark scenario increased relative to the April Copom meeting, whilst the projection based on the market scenario remained stable – in both cases, projections are above the 4.5% target.

Monetary policy decision

16. The Copom evaluates that monetary policy should contribute for the consolidation of a favorable long-term macroeconomic environment. Economic activity data indicate that the intensity of domestic demand expansion continues quite robust, showing acceleration in some segments and regions in the first quarter of 2008, and is responsible, at least partially, for the inflationary pressures observed in the short-run, despite strong imports growth and the benign investment behavior. Even in the context of moderate deceleration of global growth this year and the higher volatility observed in global markets since mid-2007, the Committee believes, according to information available at the moment, that the balance of payments should not represent imminent risk to the inflationary scenario, evaluation corroborated by the recent upgrade to investment grade of Brazilian sovereign debt bonds. On the other hand, there are signs that relevant inflationary pressures are intensifying both in mature and emerging economies, evidencing the existence of inflationary risks on the global outlook. The Copom reaffirms the view, stated in previous Minutes, that an alternative scenario of more intense and generalized global deceleration represents an ambiguous risk factor for the Brazilian inflation. On the one hand, by reducing net exports it would act as a factor to restrain aggregate demand. Moreover, the potential decrease of some important commodities prices could contribute to a lower domestic inflation. On the other hand, the above-mentioned alternative scenario could unfavorably impact inflation prospects through two mechanisms. In the case of deceleration in the mature economies that comprise the global financial markets center, risk aversion could increase, resulting in decreased demand for Brazilian assets and depreciation of their prices. In addition, in the medium run, a possible reduction of net exports could similarly affect the price sustainability of certain Brazilian assets. In light of the deterioration of inflation prospects, in a more uncertain scenario, the Committee evaluates that the risk of materialization of a less benign inflationary scenario continues to be high. The Copom emphasizes that the main challenge of monetary policy in this context is to guarantee the maintenance of positive results reached in the last years. Particularly, monetary policy should act so that impacts initially focused on price indices, partially derived from relative prices adjustments that occur in global scale, do not result in persistent deterioration of inflation dynamics through the worsening in expectations. The Copom understands that the maintenance of monetary stability is a necessary condition so that the relative prices system continues to signal efficiently the adjustments requested for ongoing consumption and production patterns in the economy.

17. The Copom considers that the probability that emerging local inflationary pressures will represent risks to the domestic inflation trajectory remain high, because the heated domestic demand and market of factors, in addition to the possibility of emergency of supply restrictions in some sectors, can increase the pass-through of wholesale prices over consumer price inflation. The Committee understands that the prospects for this pass-through, as well as for the generalization of the local pressures initially focused on consumer price inflation, depend in a critical manner on inflation expectations, which increased significantly in the recent weeks, and continue to be carefully monitored. Additionally, it is worth noticing that although the external sector can restrain the inflationary pressures in the tradable sector, heated domestic demand can trigger intense inflationary pressures in the non-tradable sector, for instance, such as in the services sector. In this context, the Copom will continue to manage the monetary policy stance so that the gains obtained in inflation control

in recent years become permanent. In this respect, the Copom will continue to carefully monitor the evolution of inflation and the several core inflation measures, as well as inflation expectations within the forecast period, promptly adjusting the monetary policy stance in order to avoid the consolidation of a scenario where one-off adjustments become persistent or generalized price increases.

18. The preservation of inflation rates in line with the targets path and the consequent consolidation of a long-lasting stable macroeconomic scenario will contribute to the continuous progressive reduction of macroeconomic risk perception that has occurred in the last years. The Copom evaluates that the persistence of a cautious and timely monetary policy stance has been critical to increase the probability that inflation will continue to evolve according to the targets path, even in light of global inflationary pressures. For this to materialize, however, it is important that forward-looking inflation indicators, in particular the expected dynamic of aggregate supply and demand, converge throughout relevant period for the monetary policy.

19. The Committee emphasizes, once again, that there are important time lags between the implementation of monetary policy and its effects over economic activity and inflation. Therefore, the evaluation of alternative monetary policy stances should necessarily focus on the forward-looking inflation scenario and its risks, instead of current inflation indicators.

20. During the coming months, credit growth, despite more moderate due to an increase in funding costs, and real payroll expansion should continue to bolster economic activity. The effects of governmental transfers expected for this and the next quarters should also add up to the factors that will sustain demand, but with less intensity than previously anticipated. These considerations become even more relevant considering the clear signs of heated aggregate demand, the dissemination of pressures resulting from adjustments in relative prices, and the fact that the monetary policy decisions will have concentrated effects in the second half of 2008 and in 2009.

21. The Copom recognizes the important contribution of investment to expand productive capacity. This factor, together with the external sector, has helped to mitigate inflationary pressures. However, the Copom evaluates that the pace of domestic demand expansion, which should continue to be sustained, among other factors, by income and credit growth, continues to present significant risks to inflationary dynamics. In this context, the consistent reduction of the mismatch between the rhythm of expansion of supply of goods and services and the increase of demand continue to be vital to the assessment of different possibilities of monetary policy stance.

22. Aiming at consolidating a stable and predictable environment, the Copom adopts a strategy to avoid a volatile inflationary trajectory. This strategy takes into consideration the time lags in the transmission mechanisms and has proved to be the most adequate to deal with the uncertainty inherent to the process of monetary policy formulation and implementation. That is the reason why variables such as inflation projections, the balance of risks associated to the forward-looking scenario and, especially, the preventive stance in the decision-making process of the Copom are so important. At the current moment, characterized by the deterioration in current and expected inflationary dynamics, prudence assumes an even more important role in this process. In the current circumstances, there is the risk is that economic agents start to attribute higher probability that inflation increases will become persistent, which would reduce the efficacy of the monetary policy. Therefore, the Copom's assessment, backed by international experience, is that the performance of monetary policy tends to be more effective, when the deterioration of inflationary dynamics is in its early stages, rather than when it is consolidated. The Committee believes that the present monetary policy stance, which will be kept while it is necessary, will assure the convergence of inflation towards the targets path. Evidently, if the risk profile deteriorates in a matter that implies shifts in the basic inflation prospective scenario considered at the present moment, the Committee will promptly adjust the monetary policy stance to the circumstances.

23. The Copom evaluates that, in light of signals of economy heating, as illustrated by the acceleration of some wholesale prices and the evolution of core inflation measures, and by the fast increase in inflation

expectations, the risks for the concretization of a benign inflationary scenario, in which IPCA would remain in line with the targets path, are relevant. In fact, the deterioration of the forward-looking scenario is already present in the Committee's inflation projections. The Copom also considers that the persistence of significant mismatch between the paces of expansion of aggregate supply and demand tends to increase the risk for the inflationary dynamics. In these circumstances, monetary policy should act through the adjustment of the basic interest rate in order to, on the one hand, contribute to the convergence between the paces of expansion of aggregate supply and demand and, on the other hand, avoid that inflationary pressures initially focused on price indices lead to persistent deterioration of expectations and of the inflation forward-looking scenario. By acting as the balance of risks to inflation dynamics so requests, the Committee understands that it is, in fact, contributing to sustain economic growth, which requires stability, predictability and consequent extension of the planning horizon for businesses and families, as well as to protect the substantial increases in real income of workers observed in recent years. Therefore, the Copom ratifies that the decisions of monetary policy necessarily take into consideration the time lags of the transmission mechanism, and that they are part of a dynamic strategy, whose results will become evident throughout time.

24. In this context, continuing the process of adjustment of the basic interest rate initiated in the April's meeting, the Committee unanimously decided to raise the Selic target rate to 12.25% p.a., without bias.

25. Under the inflation-targeting regime, the Copom decides according to inflation prospects, the analysis of several alternative scenarios for the evolution of the main variables that determine the prospective price dynamics and the balance of risks associated to its projections. Domestic demand continues to expand vigorously, backing-up economic activity dynamism, including sectors little exposed to external competition, at a time when the effects of important incentive factors are still perceived. On its turn, the contribution of the external sector to a benign inflationary scenario, in light of robust domestic demand growth and the increase of global inflationary pressures, seems to become less effective, at a moment when the effects of investment over productive capacity of the economy still need to consolidate. In such environment, the monetary authority should act in order to avoid that short-term uncertainties contaminate longer time horizons.

26. At the conclusion of the meeting, it was announced that the Copom would reconvene on July 22nd 2008, for technical presentations, and on the following day, to discuss the monetary policy decision, as established in Communiqué 16,051 of September 3rd, 2007.

Summary of data analyzed by the Copom

Inflation

27. IPCA-15 inflation increased 0.56% in May, down from 0.59% in April. Food and beverages prices increased 1.26%, contributing 0.28 p.p. to the monthly index result, unchanged relative to April, showing the resilience of the price increases in this group. The second main driver of the IPCA-15 in May, contributing 0.09 p.p., came from the 0.93% increase in personal outlays, which accelerated relative to April (0.49%). Market prices increased 0.74% in May, up from 0.68% in the previous month, with price elevations in tradable goods (1.11%) and non-tradable goods (1.41%). Regulated prices increased 0.15%, down from 0.38% in April. The diffusion index reached 67.19% in May, the highest level since January 2007, with a 62.29% average in 2008, up from 59.22% in the same period of 2007. In the last twelve months through May, IPCA-15 increased 5.25%, against 4.94% in April, due to elevations of 6.98% in market prices and 1.41% in regulated prices.

28. The IPCA-15 core inflation measures accelerated both on month-on-month and 12-month trailing bases. The core excluding household food and regulated prices increased 0.55% in May, up from 0.44% in April, totaling 4.84% in twelve months (the highest rate since April 2006), up from 4.59% in April. The non-smoothed trimmed means core evolved from 0.39% in April to 0.40% in May, accumulating 4.06% in the last twelve months, also

the highest rate since April 2006. The smoothed trimmed means core increased 0.41% in May, up from 0.39% in April, totaling 4.28% in the last twelve months (the highest rate observed since January 2007), against 4.15% in April.

29. IGP-M inflation increased 1.61% in May, up from 0.69% in April, accumulating 11.53% in the last twelve months. Among the index components, only the IPC-M decelerated month-on-month (0.68% against 0.76% in April), reaching 5.25% in twelve months. IPA-M inflation increased 2.01%, up from 0.65% in April, totaling 14.53% in twelve months. INCC inflation increased 1.10% in May, up from 0.82% in April, reaching 7.64% in the last twelve months.

30. The lower IPC-M change in May reflected inflation deceleration in five out of seven groups that compose the index, with highlights for the cooling in housing prices, which changed 0.02% in the month, down from 0.38% in April. The change in food prices in May remained the highest for the index (1.77%), although barely the same as the 1.76% rate of the previous month and according the same trend captured by IPCA-15.

31. The higher increase in the IPA-M inflation rate in May reflected the behavior of both agricultural and industrial prices. Agricultural prices increased 2.29% in May, reversing the 1.19% decrease in April, totaling 33.32% in the last twelve months. The industrial IPA increased 1.91%, up from 1.37% in April, accumulating 8.58% in twelve months. The IPA also accelerated in May considering all processing stages, mainly in the prices of gross raw materials, which increased 3.38%, after decreasing 0.13% in April. The prices of final goods increased 1.11%, up from -0.01% in April, while the prices of intermediate goods increased 1.79%, up from 1.72%, in the same period.

Economic activity

32. According to seasonally adjusted data from the IBGE's monthly survey (PMC), retail sales increased 1.4% in March, month-on-month, considering the expanded retail sales concept, which includes construction material and vehicles and motorcycles, parts and pieces. It bears emphasizing the increases of 6.1% in the sales of fabric, clothing and shoes, and 3.3% in hyper- and supermarkets, food products, beverages and tobacco, while the sales of office, computing and communication material and equipment decreased 5.6%.

33. Under the same concept, the volume of sales in the commerce increased 14.8% in the first quarter of 2008, recording a generalized growth in all segments, with emphasis to office, computing and communication material and equipment, 29.2%; other personal and domestic items, 26.9%; vehicles, motorcycles, parts and pieces, 21.4%; furniture and home appliances, 17.2%; and fabric, clothing and shoes, 13.3%. The results of retail sales evidenced the increase of payrolls, favorable credit conditions, impacts of income transfer programs, and higher agricultural income.

34. According to São Paulo Trade Association (ACSP) data, related to the city of São Paulo and seasonally adjusted by the BCB, database consultations for credit sales increased 0.3% in April while the consultations to the Usecheque system decreased 0.3%, month-on-month. Compared to April 2007, there were respective increases of 12.6% and 12.9%.

35. Regarding investment indicators, domestic production of capital goods increased 1.6% in April, month-on-month seasonally adjusted, while the production of construction inputs decreased 3.4%. Compared to April 2007, these indicators increased 30% and 11%, respectively. Still according to this comparison basis, the positive evolution of capital goods production reflects mainly the expansion of agricultural equipment (37.3%) and transportation equipment (42.2%).

36. Capital goods imports increased month-on-month 10.7% in April, according to Fundação Centro de Estudos do Comércio Exterior (Funcex) data, seasonally adjusted by the BCB. Confirming the expansionist trajectory of investments in Brazilian economy, capital goods imports increased 32.6% year-over-year.

37. CNI indicators, seasonally adjusted by the BCB, showed expansion of industrial activity in April, with increases of 0.6% in industrial real revenues

and 0.4% in hours worked in production. Compared to April and the first four months of 2007, industrial real revenues increased 6.5% and 7.6%, respectively, and hours worked in production, 5.3% and 5.8%, in the same order. Installed capacity utilization (Nuci) reached 83.4% in April, a record high for the series and 1 p.p. above the March level, considering seasonally adjusted data, and 1.5 p.p. above the April 2007 level, according to the observed series.

38. According to IBGE's Monthly Industrial Survey (PIM), industrial production increased 0.2% in April month-on-month, while the three-month moving average remained almost stable (0.1%). Sixteen out of the twenty-seven activities surveyed recorded production increase in April and, by use categories, only the production of capital goods increased (1.6%). The production of intermediate goods showed relative stability (-0.2%), while the production of semi-durable and non-durable consumer goods declined 1.5%, after a 2.6% increase in the previous month. Durable goods production decreased 1.9%, after three consecutive increases (accumulating a 9% increase). Year-over-year, industrial activity increased 10.1%, with expansion in all use categories, highlighting the increases of 30.0% in capital goods production and 22.4% in durable consumer goods production. In the first four months of 2008, compared to the same period of 2007, these rates reached 7.3%, 20.5% and 14.5%, respectively. In the same period, the production of intermediate goods and semi- and non-durable consumer goods expanded by 6% and 2.2%, respectively. On a twelve-month trailing basis, industrial output expanded 7.0% in April, up from 6.6% in March, showing acceleration at the margin, in contrast to month-on-month and the three-month moving average seasonally adjusted data comparisons.

39. Vehicles production reached 300.6 thousand units in April, according to Anfavea, increasing 34.4% year-over-year. Considering seasonally adjusted data, the production of vehicles increased 6.8% month-on-month, with expansions in the production of automobiles (6.9%), buses (4.1%), and trucks (1.3%). Considering seasonally adjusted data, and the same comparison basis, the production of agricultural machinery increased by 5%. In the first four months of the year, the production of vehicles and agricultural machinery increased 23.9% and 46.9%, respectively, compared to the same period of 2007. In the same period, total vehicles sales increased 21.8%, with expansion of 30.5% in domestic sales and decrease of 0.2% in exports.

40. According to the survey carried out by the IBGE in April, planted area was estimated at about 46.8 million hectares, a 3.2% increase relative to April 2007. The grains harvest should reach 142.6 million tons in 2008, increasing 7.2% year-over-year. This result encompasses increases of 8.6%, 11.4% and 2.6% in rice, corn and soybean productions, respectively, which are responsible for 90% of total grains production and occupy 82% of total planted area. The survey also estimated an 8.2% increase in sugar cane production, with an 8.0% expansion in planted area, and a 26.3% increase in coffee production, an effect of the biannual cyclic recovery in productivity.

Surveys and expectations

41. The Fecomercio-SP survey showed a 1% month-on-month decrease in the Consumer Confidence Index (ICC) in May, reflecting the 1.4% and 0.7% retractions in Current Economic Conditions Index (Icea) and in Consumer Expectations Index (IEC), respectively. The ICC grew by 16.2% year-over-year, due to expansions of 12.9% and 18.7% in the Icea and IEC, respectively.

42. According to the FGV survey, the ICC grew 2% in May, month-on-month. This result reflected a 2.6% increase in the Current Situations Index (ISA) and a 1.6% elevation in the Expectations Index (IE), which computes 6-month ahead expectations. The survey registered increases of 5.6%, 15.5% and 0.7% in the ICC, ISA and IE, respectively, year-over-year.

43. Still according to the FGV, the Industry Confidence Index (ICI) reached 119.9 points in May, up from 120.3 in April. The indicator stayed 1.7 p.p. above the level registered in the same month of 2007, reflecting the elevations of 2.9 p.p. in the ISA and 0.5 p.p. in the IE.

44. According to the FGV Manufacturing Industry Survey, installed capacity utilization (Nuci) reached

85.6% in May, standing 0.5 p.p. above the April level and 1.2 p.p. year-over-year. The Nuci decreased 0.7 p.p. in intermediate goods segment, and increased 5.3 p.p., 3.2 p.p. and 2.7 p.p. in construction material, consumer and capital goods segments, respectively.

Labor market

45. According to the Ministry of Labor and Employment, 294.5 thousand new formal jobs were created in April 2008, totaling 849 thousand in the first four months of the year. Employment level increased by 0.5% month-on-month in seasonally adjusted terms, expanding in all sectors, with highlights to the 1.0% expansion in the construction sector and the creation of 97 thousand new jobs in the services sector.

46. According to the IBGE employment survey (PME) in the six main metropolitan areas of the country, the unemployment rate reached 8.5% of economically active population (PEA) in April, compared to 8.6% in the previous month and 10.1% in April 2007. The stability of the unemployment rate between March and April reflected the increase of 105 thousand employed workers, compared to 102 thousand who entered the labor market. Year-over-year, occupation increased 4.3%, while the PEA increased 2.5%. Formal workers in the private sector increased 1.5% between April and March, representing 139 thousand jobs, and the number of self-employed and informal workers decreased 2.4% and 1.3%, respectively (96 thousand and 35 thousand jobs). Compared to April 2007, formal workers in the private sector leaded the occupation growth (9.9% increase), the number of self-employed workers increased 1.8% and the number of informal workers decreased 4.7%.

47. The same survey showed that average real earnings of occupied workers grew 1% in April month-on-month and 2.8% year-over-year. Real payrolls increased 1.5% in April month-on-month, 6.5% in the year, and 7.2% year-over-year.

48. According to CNI data seasonally adjusted by the BCB, employment in manufacturing industry and real payroll increased 4% and 5.3% in April, year-over-year. In the first four months of 2008, employment and real payroll in the manufacturing industry increased by 4.7% and 6.2%, respectively, compared to the same period of 2007.

Credit and delinquency rates

49. Credit operations in the financial system expanded by 2.5% in April, expanding by 30.9% on a twelve-month trailing basis. According to the same comparison bases, non-earmarked credit operations increased 2.8% and 35.0%, respectively, while earmarked credit operations elevated 1.7% and 21.8%, respectively. Among the non-earmarked operations, leasing operations remained strong, with expansions of 124.1% and 87.6% for credit to individuals and to corporate, respectively, in the last twelve months. Regarding earmarked credit, it bears highlighting the 24.9% and 21.5% increases in operations related to housing and the agricultural sector, respectively, according to the same comparison basis. Considering other sectors, loans to industry increased 3% month-on-month and 35.5% in twelve months.

50. The average interest rate on non-earmarked credit operations, used as reference for interest rates, reached 37.4% p.a. in April, standing 0.2 p.p. below the previous month result. The average rate on credit for individuals reached 47.7% p.a., compared to 47.8% p.a. in the previous month, while the average rate on corporate credit increased 26.3% p.a., compared to 26.5% p.a. in the previous month.

51. The average tenure on non-earmarked credit operations, used as reference for interest rates for individuals reached 370 days in April, remaining almost stable since January, when it breached, for the first time, the one-year record. The average tenure of corporate credit operations reached 298 days, while the average tenure for credit operations to individuals totaled 457 days, up from 241 days and 389 days, respectively, in April 2007.

52. Delinquency rates in the financial system for non-earmarked loans (used as reference for interest rates in arrears for more than ninety days) reached 4.2% in April, a 0.6 p.p. decrease relative to the same month of 2007. Delinquency rates for credit

operations with corporate and individuals reached 1.8% and 7.0%, respectively, compared to 2.7% and 7.0% in April 2007.

53. Net delinquency rate for retail credit, measured by the ACSP, reached 8.6% in April, up from 8.1% year-over-year. According to the seasonal adjusted series, net delinquency rate stood at 6.0% in April, up from 5.7% month-on-month.

External environment

54. There are evidences that the financial market turmoil and the worst of the liquidity crises have already finished, although still the risks to the global economic outlook stemming from the real estate markets remain. In the US, signals of deterioration in the commercial real estate mortgage market arose and tend to sharpen due to the less favorable conjuncture and the financial institution conservatism in credit analysis. Moreover, in European countries such as Spain, Ireland and the United Kingdom, there are signals of saturation of their mortgage markets, with a downward trend, mirroring the adverse effects of the crisis in credit and the weakening of economies. The prices of real estate in the UK recorded the sharpest monthly fall in May.

55. The inflationary outlook and, more important, inflation expectations continues to deteriorate. Despite the deceleration observed in great part of economies, global inflation index reached a record high for the last nine years. This fact can be perceived because the reduction of the purchase power is still not effective and also because inflation has been pressured mostly by more inelastic consumer goods. Therefore, the inflationary process remains resilient to fall, keeping the central banks under strict surveillance.

56. Oil prices have reached record highs systematically, and the cycle of commodities prices rises in the international market continues to pressure domestic inflation in several countries. Several factors explain the cycle of commodities prices rises, such as the new development standard reached by emerging economies; prices transmissions among different commodities and inventories at historically low levels.

Foreign trade and international reserves

57. In May 2008, Brazilian trade surplus reached US$4.1 billion, totaling surpluses of US$8.7 billion in the year and US$ 31.9 billion in the last twelve months. In the year through May, exports reached US$72.1 billion, and imports, US$63.4 billion, growing by 22.2% and 49.2%, compared to the same period of 2007.

58. In May, exports totaled US$19.3 billion, reaching a US$965.3 million daily average, a 55.6% growth year-over-year. Imports totaled US$15.2 billion in May, with a US$761.5 million daily average, a 71% increase year-over-year. Imports and exports reached record highs for both series, impacted by the regularization of the exports registers, which had been harmed by the strike of the Brazilian state tax agency auditors between March 18 and May 12.

59. International reserves totaled US$195.8 billion in April, with increases of US$535 million in the month and US$15.4 billion, compared to the end of 2007.

Money market and open market operations

60. In the period between the April and the May Copom meetings, the yield curve shifted upwards in all extension, and sharpened in its intermediate tenure. This move was mainly driven by the release of above-than-expected inflation indicators and by the increase of inflation expectations. The long-tenure future interest rates recorded momentary relief twice after the grant of investment grade level to Brazilian sovereign debt by two risk agencies: on April 30 and May 29. Between April 14 and June 2, one-, three-, and six-month rates went up by 65 bps, 70 bps and 87 bps, respectively. Moreover, both one- and two-year rates increased by 103 bps, and the three-year rate, by 85 bps. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month ahead inflation expectations, increased to 8.66% on June 2, up from 8.07% on April 14.

61. On April 25 and May 28, the BCB carried out reverse FX swap auctions amounting US$1.8 billion and US$2.4 billion, respectively, with the rollover of the May and June redemptions.

62. In its open market operations, the BCB carried out, from April 15 to June 2, weekly five- and seven-month fixed rate repo operations, borrowing. The average daily balance of these operations reached R$79.4 billion, of which R$50.8 billion were seven-month operations. In the same period, the BCB conducted 38 overnight repo-borrowing operations. The BCB also conducted daily liquidity management operations with tenures up to two working days. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R$29.4 billion, borrowing. In addition, on April 17 the BCB conducted borrowing operations with tenures of 32 and 10 working days, respectively, and on May 16, operations with tenures of 13 working days, amounting R$110.9 billion, R$31.1 billion, and R$19.7 billion, respectively. These operations totaled R$129.6 billion on a daily average basis.

63. Between April 15 and June 2, the National Treasury raised a total of R$30.6 billion, of which R$10.6 billion in fixed-rate securities: R$7.2 billion via issuance of LTNs maturing in 2008, 2009 and 2010, and R$3.4 billion in NTN-Fs maturing in 2012, 2014 and 2017. Issuance of L=R$15.7 billion, for securities maturing in 2012 and 2014. Issuance of inflation-linked NTN-Bs reached R$4.3 billion, for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045.

64. In the same period, the Treasury conducted auctions to sell LTNs maturing in April and July 2009 and bought LTNs maturing in July 2008, totaling R$0.9 billion. Issuance of inflation-linked NTN-Bs for securities maturing in 2011, 2013, 2017, 2024, 2035 and 2045, settled in other National Treasury securities, totaled R$3.2 billion. The Treasury also conducted sales auctions of LFTs maturing in 2012 and 2014, which totaled R$5.9 billion, receiving LFTs maturing in 2008 as payment, and purchase auctions to buy LTNs and NTN-Bs, totaling R$0.6 billion and R$0.1 billion, respectively.

Appendix

Banco Central do Brasil Management

Members of the Monetary Policy Committee (Copom)

Banco Central do Brasil Management

Board

Henrique de Campos Meirelles
Governor

Alexandre Antonio Tombini
Deputy Governor

Alvir Alberto Hoffmann
Deputy Governor

Anthero de Moraes Meirelles
Deputy Governor

Antonio Gustavo Matos do Vale
Deputy Governor

Maria Celina Berardinelli Arraes
Deputy Governor

Mario Gomes Torós
Deputy Governor

Mário Magalhães Carvalho Mesquita
Deputy Governor

Members of the Monetary Policy Committee (Copom)

Voting members

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Deputy Governor

Mario Gomes Torós
Deputy Governor

Mário Magalhães Carvalho Mesquita
Deputy Governor

Non-voting members

Altamir Lopes
Head of the Departament of Economics (Depec)

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

João Henrique de Paula Freitas Simão
Head of the Departament of Open Market Operations (Demab)

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

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

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

Acronyms

ACSP	São Paulo Trade Association
Aladi	Latin American Integration Association
Anef	National Association of Automakers Financing Companies
Anfavea	National Association of Automotive Vehicle Manufacturers
BNDES	National Bank of Economic and Social Development
BoC	Bank of Canada
BoE	Bank of England
Caged	General File of Employed and Unemployed Persons
CDC	Direct Consumer Loans
CDS	Credit default swap
Cide	Contribution on Intervention in the Economic Domain
CMN	National Monetary Council
CMN	National Monetary Council
CNI	National Confederation of Industry
Cofins	Contribution to Social Security Financing
CPMF	Provisional Contribution on Financial Operations
CRB	Commodity Research Bureau
CSI	Current Situation Index
CSLL	Social Contribution on Net Corporate Profits
DAX	Deutscher Aktienindex
ECB	European Central Bank
EI	Expectations Index
Embi+	Emerging Markets Bond Index Plus
EU	European Union
FAO	United Nations Food and Agriculture
FAT	Worker Support Fund
FDI	Foreign Direct Investments
Fecomercio SP	Trade Federation of the State of São Paulo
Fed	Federal Reserve
Fenabrave	National Federation of Automotive Vehicle Distribution
FGTS	Employment Compensation Fund
FGV	Getulio Vargas Foundation
FMP-FGTS	Mutual Privatization Funds – FGTS
FMP-FGTS-CL	Mutual Privatization Funds – FGTS – Free Portfolio
FOMC	Federal Open Market Committee
FTSE 100	Financial Times Securities Exchange Index
Funcex	Foreign Trade Studies Center Foundation
GDP	Gross Domestic Product
Gerin	Executive Investor Relations Group

GFCF	Gross Fixed Capital Formation
GRV	Guaranteed Residual Value
IBGE	Brazilian Institute of Geography and Statistics
Ibovespa	São Paulo Stock Exchange Index/ Bovespa Index
ICC	Consumer Confidence Index
Icea	Current Economic Conditions Index
ICI	Industrial Confidence Index
ICMS	Tax on the Circulation of Merchandise and Services
ID	Interbank Deposit
IEC	Consumer Expectations Index
IGP	General Price Index
IGP-DI	General Price Index
IMF	International Monetary Fund
INC	National Confidence Index
INCC	National Cost of Construction Index
INCC-DI	National Market Cost of Construction Index
Inec	National Consumer Expectations Index
INSS	National Social Security Institute
IOF	Financial Operations Tax
IPA-DI	Wholesale Price Index
IPC	Consumer Price Index
IPCA	Extended National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPI	lndustrialized Products Tax
Ipsos	Ipsos Public Affairs
IRPJ	Corporate Income Tax
LFT	Treasury Financing Bills
Loas	Social Assistance Law
LSPA	Systematic Farm Production Survey
LTN	National Treasury Bills
Mercosur	Southern Common Market
MTE	Ministry of Labor and Employment
Nuci	Installed Capacity Utilization Level
Opec	Organization of Petroleum Exporting Countries
p.a	per annum
p.p.	Percentage points
p.y.	Per year
PAC	Growth Incentive Program
PBC	People's Bank of China
PDCF	Primary Dealer Credit Facility
PEA	Overall Labor Force
PIM-PF	Monthly Industrial Survey – Physical Production
PIS	Social Integration Program
PMC	Monthly Retail Trade Survey
PME	Monthly Employment Survey
PPI	Broad Producer Price Index
PSND	Public Sector Net Debt
Recap	Special Capital Goods Acquisition System for Exporting Companies
Reporto	Tax System for Incentives to Port Structure Modernization and Expansion
RMV	Lifetime Monthly Income

S&P	Standard & Poor’s
S&P 500	Standard and Poor’s 500
SCPC	Credit Protection Service Center
Selic	Special System of Clearance and Custody
SFH	Housing Financing System
SLS	Special Liquidity Scheme
SNB	Swiss National Bank
TAF	Term Auction Facility
TN	National Treasury
TPRA	Term Purchase and Resale Agreements
TSLF	Term Securities Lending Facility
UN	United Nations
USA	United States of America
USDA	US Department of Agriculture
VAR	Autoregressive Vector
VIX	Chicago Board Options Exchange's Volatility Index
WTI	West Texas Intermediate
XU100	Istanbul Stock Exchange National 100 Index