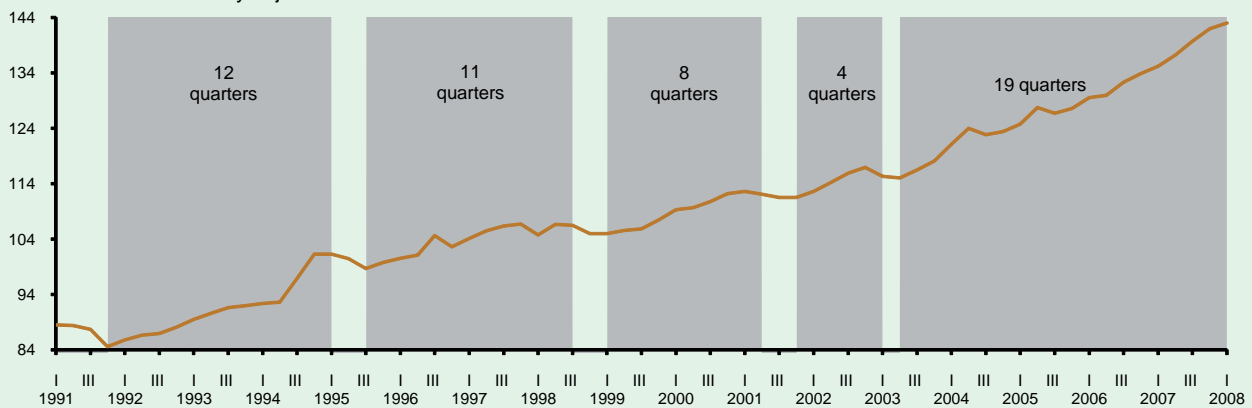


The Brazilian Economy – Growth Cycles and Constraints

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 identify, 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 reductions in the seasonally adjusted series of the quarterly 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.

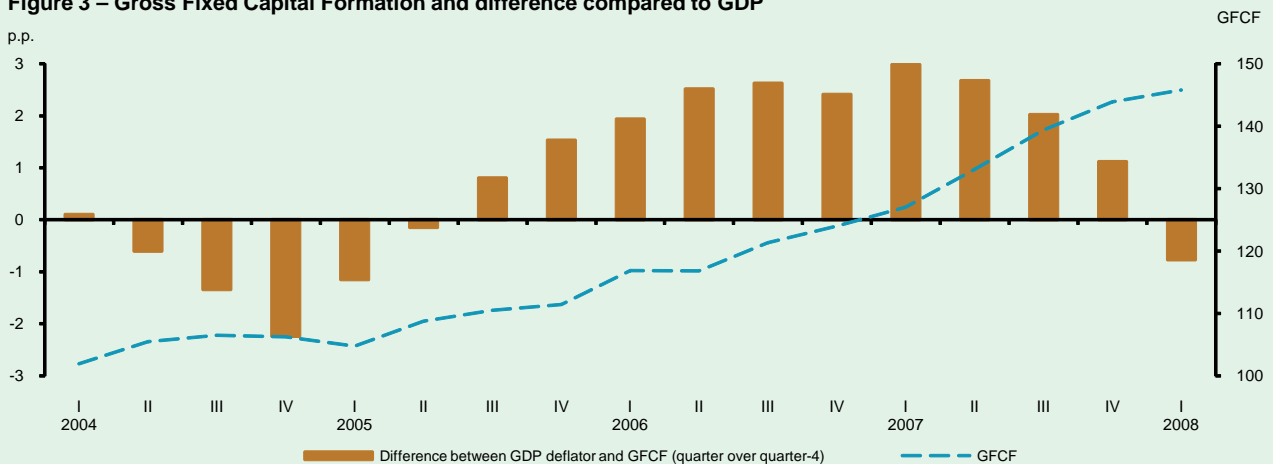
The evolution to investment level is an indicator of the soundness of the cycles of economic expansion. Although – excepting to the short-term cycle registered in the four quarters of 2002, when the investors' confidence still reflected the restriction imposed by the energy rationing, – in all the cycles 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.