

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.