Executive summary

International financial markets have been experiencing strong pressure since September, as evidenced by the serious and widespread appreciation of the U.S. dollar against the currencies of major mature economies – except Japan – and emerging markets. In this respect, no less significant were the losses recorded in the indices of major stock exchanges and the sharp rise in risk aversion, that reflected in the historically high levels of bank credit spreads.

At September's quarter end, the pace of economic activity was strong, driven mainly by dynamism of the domestic demand. However, within this current environment characterized by the prospect of substantially reducing the growth of the global economy, the maintenance of sound macro-economic fundamentals in the Brazilian economy are not sufficient conditions to prevent the unfolding international crisis from spreading internally, for example, with repercussions on balance of payments and activity. Surely, the impact on the Brazilian economy will be smaller than what had been observed in other large economies, yet the prospects for the level of activity in the final quarters of 2008 and 2009 have been less favorable. This assessment is supported, for example, by reduced levels of confidence for consumers and businesses, and initial results from the fourth quarter, which show a cooling in industrial production and investment.

The sharp contraction of liquidity on a global scale has resulted in restricted access to external credit lines for banks and domestic companies, which in turn has led to a tightening of liquidity in the foreign currency market. This fact, boosted by growing risk aversion, contributed to a subsequent reduction of operations in the domestic inter-bank market. In this environment, the Central Bank has adopted several measures aiming to provide foreign currency liquidity at the time it promoted changes in the rules on reserve requirements and provided incentives to the trading of assets between financial institutions, aiming at a normalization of the domestic money market.

In this context, the strong credit expansion seen in recent quarters tends to an accommodation. This process must be led by a slowdown, already begun, in operations with individual borrowers, especially those related to payroll loans and car sales, that have been recording the most significant expansion in recent years. The cooling of these operations reflects a greater selectivity in concessions in the supply side and high interest rates and shorter terms in the demand side, along with a reduction in consumer optimism. Credit operations in the corporate segment, in turn, showed an increase in demand for funds from the banking system and have maintained robust growth, partly reflecting the scarcity of external funding and the loss of potency in the domestic capital market.

Tax revenues of federal and regional governments developed in line with the performance of the activity, and provided primary surpluses accumulated for the year and twelve-month period compatible with the target set for this year. By the other side, the prospect of slower growth next year and its impact on government revenues cannot be neglected, as much as the possible increase of expenditure on items such as unemployment insurance. The re-estimation of revenue and expenditure for next year, aimed at preserving the primary surplus, indicates the issue of coping, while maintaining fiscal responsibility and the goals of reducing the ratio of Net Public Sector Debt (DLSP) and Gross Domestic Product (GDP). Furthermore, it is plain that the composition of net public sector debt is comfortable compared to those reported in previous situations of stress in the international market, partly due to the significant volume of credits tied to the net exchange.

The performance of external accounts in the first ten months of the year suggests no difficulties in financing the balance of payments in 2008. In fact, net flows of Foreign Direct Investment (FDI) should exceed those recorded in 2007 and the rollover of private debt should remain above 100%. For 2009, restrictions on foreign credit and the reduced pace of international economic activity may determine the result of a worsening balance of payments. It should prevail, however, suitable conditions for their financing, which will still be favored by the level of international reserves and an anticipation of contracting made by the National Treasury. It is evident, however, that the private sector will face the most adverse conditions for the renewal of loans compared to those experienced in the last five years, with negative impacts on the time and cost of contracting.

The result of the current account in 2009 will be influenced, under the trade balance, by a possible reduction in exports – the extension will be linked to the behavior of prices of commodities and the magnitude and duration of the downturn in economic activity in the main markets for Brazilian products – as well as in imports, which should respond to the increase in prices resulting from currency depreciation and a slowdown in domestic economic activity. In relation to the services account, the deficit in transportation is likely to fall in line with the reduction of external trade, and the negative balance in international travel is expecting an expressive decline, mainly reflecting the depreciation of the exchange rate. Net income expenses will certainly be affected by the declining profitability of companies, the effects of a more depreciated exchange rate and a loss of foreign investors in equities, which will result in a reduction of inventory investments.

Inflation measured by the variation of the National Broad Consumer Price Index (IPCA) reached 5.61% for the year up to November, compared to 3.69% for the same period of 2007. Also, since January the cumulative rate has been positioned above the target center. In fact, twelve- month inflation through November stood at 6.39% versus 4.19% in November 2007. Moreover, also in the twelve-month period, both the prices of tradable goods as well as non-tradable items accelerated. This dynamic was largely due to the mismatch between the pace of domestic supply and demand. It is plausible that this imbalance is smoothed in this and the coming quarters, largely because of the unfolding international financial crisis and the lagged effects of monetary policy actions implemented in 2008. Still, it hasn't consolidated the process of reversing the trend away from inflation towards the target path, which had been observed since the end of 2007.

The central forecast linked to the benchmark scenario indicates inflation of 6.2% in 2008, a level 0.1 percentage points higher than projected in the *Report* in September, and markedly higher than the 4.5% target center set by the National Monetary Council (CMN). For 2009, the projection for the twelve-month inflation starts at 6.3% in the first quarter and reaches 4.7% in the last. For the fourth quarter of 2010, the projection is 4.2%. It should be noted that the decline in inflation forecast throughout 2009 and 2010 in the benchmark scenario, reflects mainly the effects of the increase in the Selic rate determined in 2008 and the fact that inflation expectations for 2009 and 2010 are expected to be at lower levels than expectations for 2008.

In the market scenario, the forecast of 6.2% for inflation in 2008 exceeds by 0.2 percentage points the one in the last *Report* and coincides with that associated with the benchmark scenario. The twelve-month inflation forecast falls to 6.1% in the first quarter of 2009, and continuing that trend, closes the year at 4.5%, matching the central value for the target set by the CMN. This trend partly reflects the expectations of appreciation of the exchange rate over 2009. Also, according to the market scenario, the projection for twelve-month inflation reaches 4.3% in the last quarter of 2010.

According to the benchmark scenario, GDP growth in 2008 rose to 5.6%, 0.6 p.p. higher than projected in September's *Inflation Report* and the forecast for 2009 is 3.2%.