ISSN 1517-7289

Inflation Report

March 2009

Volume 11 | Number 1

BANCO CENTRAL DO BRASIL

BANCO CENTRAL DO BRASIL

Inflation Report

March 2009

Volume 11 | Number 1

ISSN 1517-7289
CGC 00.038.166/0001-05

Inflation Report	Brasília	v. 11	n. 1	Mar	2009	p. 1-168

Inflation Report

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

The following departments are responsible for the English version of the text and the respective tables and graphs:

Department of Economics (Depec)
(e-mail: depec@bcb.gov.br);

Research Department (Depep)
(e-mail: conep.depep@bcb.gov.br); and

Investor Relations Group (Gerin)
(e-mail: gerin@bcb.gov.br).

General Control of Publications

Banco Central do Brasil
Secre/Surel/Cogiv
SBS – Quadra 3 – Bloco B – Edifício-Sede – 1º andar
Caixa Postal 8.670
70074-900 Brasília – DF – Brazil
Phones: (5561) 3414-3710 and 3414-3565
Fax: (5561) 3414-3626
E-mail: editor@bcb.gov.br

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.

Banco Central do Brasil Information Bureau

Address: Secre/Surel/Diate
SBS – Quadra 3 – Bloco B – Edifício-Sede – 2º subsolo
70074-900 Brasília – DF – Brazil
DDG: 0800 9792345
Fax: (5561) 3414-2553
Internet: http://www.bcb.gov.br
E-mail: cap.secre@bcb.gov.br

Contents

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 prospect of a sharp decline in global economic growth, anticipated in the previous *Inflation Report*, was confirmed. The world's economic scenario of the latest months was characterized by the intensification of the impacts of a worsening international financial crisis, in mid-September, on the domestic demands of main mature and emerging economies, with effects to the levels of employment and international trade flows. In this environment, the paths of deceleration or contraction in activity level observed in the leading economies, evident in marginal reduction of Gross Domestic Product (GDP) of the world's economy in the final quarter of 2008, should persist during 2009.

The Brazilian economy, in line with global developments, registered GDP reduction in the fourth quarter of 2008, as compared to the previous quarter, interrupting the series of twelve positive observations. This marginal movement, consistent with the scenario of obstruction of credit channels in the international financial markets, was associated, to a large extent, to the effects on the productive chain, of the adjustment of the stock levels; to the deterioration of entrepreneurs and consumers' expectations; and to the reduction of external trade flows.

Just as observed in the leading mature and emerging markets, deterioration of credit in Brazil, as well as consumers' and entrepreneurs' confidence translated in downturn of the internal demand dynamics. In this sense, sales of durable goods of greater aggregate value, therefore more sensitive to the credit conditions, suffered the most, as evident in the reduction, on the margin, of 20.2% in the sales of vehicles, motorcycles, parts and spares, in the quarter ended in December 2008. Investments, which, in general, depend strongly on credit, dropped 9.8% in the same period.

The reduction of the industrial output reflected on the utilization level of the sector's installed capacity, which was under pressure up to September 2008. The labor market, which in general reacts with delay to the cooling off of activity, also reflected the effects of deceleration in the pace of economy, with rises in unemployment rates. On the other hand, there was growth of real income, in part due to inflation reduction. These income gains have contributed toward sustaining retail trade sales, especially in the segments of semi and nondurable goods.

The significant contraction in liquidity, observed in the international financial markets in the latest months of 2008, continues to be a conditioning factor in the evolution of domestic credit market. In this sense, although the expansionist credit trajectory remained at a high level in the quarter ended in October 2008, it showed a tendency to gradual deceleration, associated, especially, to the observed deceleration in personal credit operations. The greater dynamics of the credit operations in the corporate segment reveals the increased demand in this segment for banking system resources, in line with restrictions to external credit and to capital market operations.

The impact of reduced demand for greater value added goods – more dependent on operations in the segment of personal credit and, therefore, more susceptible to the experienced restrictions, both in terms of supply and demand – on industrial sales, anticipated the process of stocks' adjustment suffered by companies at the end of 2008 and beginning of 2009, with developments to the level of domestic activity and to the demand for personal credit. An assessment of the recent behavior of stocks in the Brazilian industry and of the meaning of its fluctuations in periods of alternating economic cycles is made in the box on "Stocks and Economic Cycle".

In this scenario, although the total stock of credit registered expansion in the quarter ended in January, favored by the growth of financing backed by earmarked resources, which expanded its contribution to the supply of capital needs for the financing of entrepreneurial investment projects, the indicators related to the credit market began to register a cooling off, on the margin. Although the large-scale companies have increased their demand for domestic credit market resources, in view of the retraction of capital markets and of external financing sources, nonearmarked credit to corporate entities declined in January. In the same way, the expansion of portfolios channeled to private individuals shows deceleration, with a reduced pace of new contracts. The contraction of credit demand, despite seasonal factors, reflects the uncertainties associated to the evolution of the activity level and, particularly, of employment and income. The behavior of these indicators will determine the conditions for recovery of the credit market in the next months.

It should be highlighted that a better understanding of the evolution of the credit market is expected to occur after the improvement in the calculation of the average rate of the National Financial System (SFN), since the inclusion of the rates practiced in credit operations modalities currently not considered in the calculation of the aggregated rate. Details of this discussion are found in box “Average Interest Rate in SFN Credit Operations”, where estimates are shown, which besides being more representative of the credit market scenario, they demonstrate that the SFN effective average interest rates differ significantly from those currently disclosed, considering the credit modalities with earmarked resources.

The evolution of public accounts in 2008 propitiated, once more, the compliance with the primary surplus target and the maintenance of the downward trajectory of the ratio between the Public Sector Net Debt (DLSP) and GDP. The observed downward path, in the latest months, in the revenue growth rates, constitute a movement consistent with the cooling off of economic activity and an indication that the fiscal conditions in 2009 should differ from the pattern registered in the previous year.

In this environment, the conditioning of expenditures indicated in the year’s budget plan reveals itself compatible with the pledge of fiscal austerity assumed by the government. One should highlight that the 2009 Budget Guidelines Law contemplates the possibility that the resources expended with the Investment Pilot Project (PPI), foreseen at 0.5% of GDP, may be deducted from the year´s primary surplus target. Although this possibility already existed in previous years and was not utilized, it represents a means of maintaining fiscal responsibility in a scenario of greater economic difficulty, while guaranteeing productive investments for the country.

One should also highlight that the current composition of public sector net debt reveals itself favorable in view of the turbulence scenario in the international financial market, above all due to the creditor share associated to foreign exchange and to the continuous lengthening of the maturities of federal securities.

In this same direction, the favorable results registered by the external sector during the latest years made possible the strengthening of the country’s external position and the introduction of important modifications in its external liabilities. Worth mentioning here are the strengthening of international reserves, and their stability, six months after the intensification of the crisis in the international financial markets; and the reduction in the participation of the external debt in the total of the country's liabilities, favoring direct and portfolio investments which, in general, are pro-cyclical. In this way, the process of strengthening of the balance of payments and, consequently, the external sector´s resilience to the global financial crisis, were maintained.

The prospects for evolution of the world's economy continue undefined and the uncertainties amidst the international environment may impact the scenarios forecasted for capital inflows and for the expansion of exports and world output, as well as for international prices of commodities – the impact of international prices of commodities on the Brazilian external trading terms is discussed in box "Correlation between Trading Terms and International Prices of Commodities". The expectations concerning economy in the United States of America (USA) and other industrialized countries were revised downwards after the disclosure of revised statistics for the fourth quarter. More recent indicators show significant contraction of consumers' expenses, reduction of companies' stocks and sudden decline of exports, with the consequent impacts on production and employment.

In this environment, the expectations for 2009 consider the maintenance of financing conditions of the balance of payments and the reduction of the deficit in current transactions. This result, impacted, on the one hand, by the reduction of the trade surplus and, on the other, by the reduction of net remittances of services and revenues, should be financed with net inflows of the financial account, with emphasis on the Direct Foreign Investments (IED). The forecasts for the 2009 balance of payments are detailed in the box "Balance of Payments Forecasts".

In relation to the evolution of prices, the climbing of consumer inflation rates, registered at the beginning of 2009, reflected the readjustments in public transportation tariffs, the annual increase of costs with education, and seasonal factors, evident in the behavior of prices of in natura foodstuffs. The forecasted reductions in the wholesale prices of relevant industrial goods of the productive chain and the exhaustion of the influence of seasonal factors should favorably impact the evolution of consumer prices, lending more visible contours to the expectations that the Expanded Consumer Price Index (IPCA) will meet the inflation target established by the National Monetary Council (CMN).

The central forecast associated to the referred scenario indicates an inflation of 4% in 2009, a level 0.7 p.p. smaller than that forecasted in the December *Report*, therefore, lower than the central value of 4.5% target set by CMN. For 2010, forecast for 12-month accumulated inflation starts from 4.3% in the first quarter and reaches 4% in the last quarter. For the first quarter of 2011, forecast stands at 3.9%. It should be highlighted that the cutback in the inflation forecast during 2009 and 2010 reflects, fundamentally, the effects of increase of slack capacity observed in the fourth quarter of 2008, which surpass the effects of reduction of basic interest rate determined by Copom in its last two meetings.

On the market scenario, the forecast of 4.1% for inflation in 2009 is 0.1 p.p. higher than that associated to the reference scenario and 0.4 p.p. lower than that contained in the last *Report*. The twelve-month accumulated inflation forecast moves up to 4.4% in the first quarter 2010, the same level at which it closes the year, therefore, below the central value for the target established by the CMN. The rising of inflation forecast for 2010, compared to the forecast for 2009, is partly due to the market analysts' expectations of continuity in the process of reduction of basic interest rate started by Copom in its January meeting. Still according to the market scenario, twelve-month accumulated inflation forecast remains at 4.4% in the first quarter of 2011.

In accordance with the reference scenario, as explained in the box "Revision of the Forecast for GDP in 2009", GDP growth foreseen for 2009 was revised to 1.2%, against the 3.2% contained on last December *Inflation Report*.

1 Economic activity

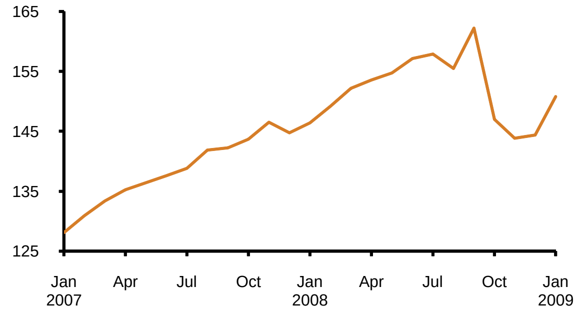
The Gross Domestic Product (GDP) showed a sharp reduction in the quarter ended in December, as compared to the previous quarter, thereby interrupting a cycle of twelve consecutive positive observations, in the same type of comparison. This margin movement, anticipated in the previous inflation report and consistent with the scenario of obstruction of credit channels in the international financial markets, has been associated, to a large extent, to the slowdown of the industrial sector; to the deterioration of entrepreneurs and consumers' expectations; to the reduction of external trade flows; and to the effects, over the productive chain, of the adjustments on the level of stocks.

Just as observed in the leading mature and emerging economies, deterioration of credit conditions and of consumers and entrepreneurs' confidence translated in reduction in the dynamics of domestic demand. In this sense, sales of durable goods of greater aggregated value and, therefore, more sensitive to the credit conditions, were more affected, as indicated in the margin reduction, of 20.2%, in the sales of vehicles, motorcycles, parts and spares in the quarter ended in December 2008, while, in the same direction, investments were cut back by 9.8%, in the same period.

Reduction of the industrial output reflected on the level of utilization of the industry's installed capacity, which was under pressure, up to September, by the expansionist cycleregistered, up to that moment, by the Brazilian economy. Labor market conditions, which tend to react with some delay to the reductions in activity levels, turned to demonstrate some worsening in unemployment rate, followed by significant growth of real earnings, an evolution derived, in part, from inflation reduction. These income gains have been sustained by the retail trade sales, in particular in the segments of semi and nondurable goods, and should favor an upward movement of confidence and growth in the medium term. One should highlight, however, that although some favorable signs can be anticipated in relation to the Brazilian economic growth in the next months, prospects for the GDP growth in 2009 continue to be revised upward.

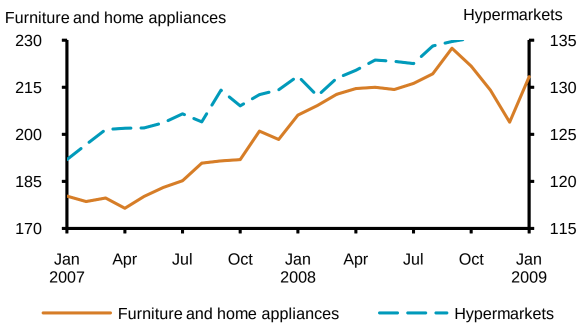
1.1 Trade

Figure 1.1 – Broad trade sales volume index
Seasonally adjusted data
2003 = 100



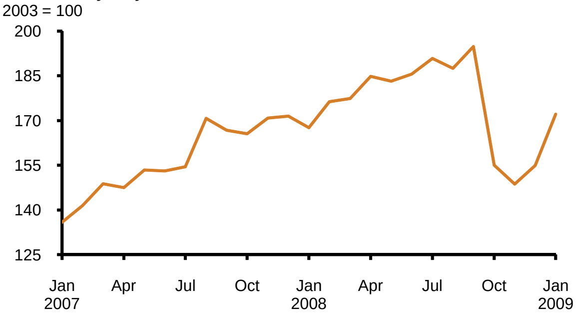
Source: IBGE

Figure 1.2 – Retail sales
Seasonally adjusted data
2003 = 100



Source: IBGE

Figure 1.3 – Sales volume index (automobiles, motorcycles, parts and spares)
Seasonally adjusted data
2003 = 100



Source: IBGE

Expanded trade sales, after showing a marked dynamics in the first nine months of the year, registered a drop of 8.7%, according to the Trade Monthly Survey (PMC) released by the Institute of Geography and Statistics (IBGE), in the quarter ended in December, as compared to that ended in September, considering seasonally adjusted data.

One should highlight that thisfalloff, particularly associated to the negative performance of the segments more sensitive to credit conditions, interrupted a sequence of twenty-eight positive results, in this type of comparison. In the period, sale reductions were registered in six of the ten segments surveyed, with emphasis on those related to automobiles, motorcycles, parts and spares, 20.2%; and construction material, 7%; and books, newspapers, magazines and stationery, 2.9%.

Even with this margin cutback, expanded trade grew 9.9% in the year, a rate only lower than the 13.6% that was registered in 2007. This performance reflected the dynamics shown by the sector in the first nine months of the year, when, in an environment of continued improvement in the labor and credit markets, sales soared by 13.8%, as compared to equivalent period of the previous year.

More recent results reflecting, particularly, the incentives to sales of automobiles and the continuity of gains in overall wages, suggest a recovery of the expanded trade sales. In this sense, accumulated sales in the quarter ended in January dropped 5.5% compared to that ended in October, 3.2 percentage points (p.p.) below that registered, on the same type of comparison, in December. This evolution becomes more significant if considering that the January sales recorded monthly rise of 4.4%, with emphasis on the 11.1% expansion observed in the segment of vehicles, motorcycles, parts and spares.

Segmented by geographical regions and by units of the Federation, retail sales registered generalized annual expansion in 2008. Considered by region, noteworthy are the expansions, above the country's average, observed in the Center-West, 11.35; Southeast, 10.8%; and South, 10%, followed by those registered in the Northeast, 9.2%;

Table 1.1 – Sales volume index

% change	2008			2009
	Oct	Nov	Dec	Jan
In the month1/				
Retail sector	-1.0	-1.1	-0.4	1.4
Fuel and lubricants	-0.8	-1.2	-1.1	-0.7
Supermarkets	0.2	0.3	0.6	0.3
Fabrics, apparel and footwear	-6.0	-5.2	0.9	2.2
Furniture and home appliances	-2.5	-3.5	-4.8	7.1
Pharmac., medical, orthop. and perfumery articles	-1.0	1.6	-0.9	0.8
Books, newspaper, magazines,	-0.1	1.9	2.9	7.6
Office, comp./comunic. equip.	-2.4	-8.3	8.9	-12.5
Other art. of personal use	-1.0	-2.0	-3.5	5.8
Broad trade sector	-9.4	-2.2	0.4	4.4
Building materials	-2.7	-2.7	-5.9	-2.8
Automobiles, motorcycles, parts and spares	-20.4	-4.0	4.2	11.1
3-Month Period/Previous 3-Month Period1/				
Retail sector	1.9	0.9	-0.6	-1.1
Fuel and lubricants	0.7	-0.9	-2.0	-2.7
Supermarkets	1.6	1.5	1.4	1.1
Fabrics, apparel and footwear	-1.4	-3.3	-6.8	-6.8
Furniture and home appliances	3.6	2.1	-3.5	-4.8
Pharmac., medical, orthop. and perfumery articles	4.3	4.8	2.6	1.8
Books, newspaper, magazines,	1.0	2.5	3.9	7.6
Office, comp./comunic. equip.	12.4	9.2	2.3	-5.5
Other art. of personal use	1.2	0.0	-3.2	-2.8
Broad trade sector	-1.1	-3.7	-8.5	-5.5
Building materials	-2.2	-4.5	-7.0	-9.0
Automobiles, motorcycles, parts and spares	-4.0	-11.6	-20.0	-11.4
In the year				
Retail sector	10.3	9.8	9.1	6.0
Fuel and lubricants	10.1	9.6	9.3	3.8
Supermarkets	5.7	5.7	5.5	7.0
Fabrics, apparel and footwear	9.1	7.1	4.8	-4.7
Furniture and home appliances	18.0	16.6	15.1	6.3
Pharmac., medical, orthop. and perfumery articles	13.1	13.2	13.3	8.9
Books, newspaper, magazines,	10.7	10.7	11.1	23.9
Office, comp./comunic. equip.	34.7	33.1	33.5	15.4
Other art. of personal use	19.2	17.8	15.6	5.0
Broad trade sector	12.6	11.0	9.9	2.8
Building materials	10.6	8.8	7.8	-12.5
Automobiles, motorcycles, parts and spares	17.4	13.5	11.9	-0.3

Source: IBGE

1/ Seasonally adjusted data.

Table 1.2 – Retail sales
2008, December

% accumulated growth in 2008	Nominal revenue	Volume	Price
Retail sector	15.1	9.1	5.5
Fuel and lubricants	9.6	9.3	0.3
Supermarkets	17.2	5.5	11.1
Fabrics, apparel and footwear	10.7	4.9	5.5
Furniture and home appliances	11.3	15.1	-3.3
Pharmac., medical, orthop. and perfumery articles	16.1	13.3	2.5
Office, comp./comunic. equip.	16.2	33.5	-13.0
Books, newspaper, magazines	13.0	11.1	1.7
Other art. of personal use	21.7	15.6	5.3
Broad retail sector	15.1	9.9	4.7
Automobiles, motorcycles, parts and spares	14.3	11.9	2.1
Building materials	18.1	7.8	9.6

Source: IBGE

and North, 7.6%. Considering the Federation units, the most outstanding have been expansions in Rondônia, 19%; Espírito Santo, 17.2%; Mato Grosso, 15.2%; Goiás, 14%; and Mato Grosso do Sul, 13.7%, contrasting with the less significant performances registered in Distrito Federal, 0.7%; Pará, 3.1%; and Amazonas, 5.7%.

The nominal revenues from expanded trade registered average annual increase of 15.1% in 2008, result of rises of 9.9% in the volume of sales and of 4.7% in prices, highlighting that, in all of the ten segments considered in the IBGE survey, the nominal revenues growth rates situated on levels superior to the average variation of 4.7% registered by the Extended National Consumer Price Index (IPCA), in the period. The most important rises occurred in the year were in the segments of other items of personal and household usage, 21.7%; construction materials, 18.1%; hypermarkets, supermarkets, foodstuffs, beverages and tobacco, 17%, while that related to the sector of automobiles, motorcycles, parts and spares, after reaching 23.8% in the first nine months of the year, increased by 14.3% in the year, a trajectory in line with the negative result obtained by the sector in the last quarter.

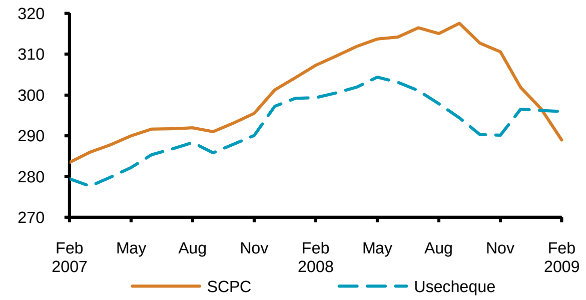
Sales in the automotive vehicles trade, favored by the incentive measures for the sector expressed in the reduction of the Industrialized Products Tax (IPI) and improvement of financing conditions, have shown a relative recovery at the beginning of 2009. In this sense, seasonally adjusted statistics from the National Federation of Automotive Vehicle Distribution (Fenabrave) reveal that sales of automobiles and light-weight commercial vehicles, after growing 39.7% in January, compared to the previous year, increased 4% in February, in the same type of comparison. Additionally, according to the National Association of Automotive Vehicle Manufacturers (Anfavea), sales of national automotive vehicles in the domestic market increased, in the order, 59.7% and 3%, in the considered periods.

At the beginning of 2009, São Paulo State trade indicators signaled the continuity of the cooling off observed in the retail trade sales of the final quarter of 2008. According to seasonally adjusted data from the São Paulo Trade Association (ACSP), the number of consultations to the Credit Protection Service Center (SCPC), an indicator related to sales of durable goods, dropped 7% in the quarter ended in February, compared to that ended in November, while consultations to Usecheque, indicator of cash purchases and therefore related to the performance of sales of nondurable goods, registered rise of 2% in the period.

Figure 1.4 – Retail sales indicators

Seasonally adjusted data – Quarterly moving average

1992 = 100



Source: ACSP

Table 1.3 – Default rates

Itemization	2008			2009		%
	Oct	Nov	Dec	Jan	Feb	Year[1/]
Returned checks[2/]						
Brasil	6.5	6.4	6.2	7.0	6.9	7.0
Northern region	10.4	9.3	8.4	9.2	9.2	9.2
Northeast region	10.4	9.6	9.2	9.7	10.0	9.9
Southeast region	5.7	5.7	5.5	6.3	6.2	6.2
Center-western region	7.7	7.8	7.7	8.6	8.3	8.4
Southern region	6.3	6.3	6.0	6.9	7.0	6.9
SCPC (SP)[3/]	6.4	6.4	3.6	7.7	7.8	7.7

Sources: Banco Central do Brasil and ACSP

1/ Annual average.

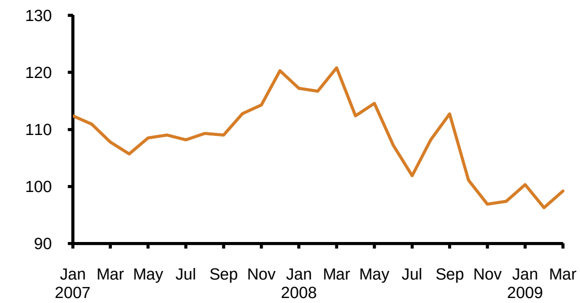
2/ Returned checks/cleared checks.

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

Figure 1.5 – Consumer Confidence Index (FGV)

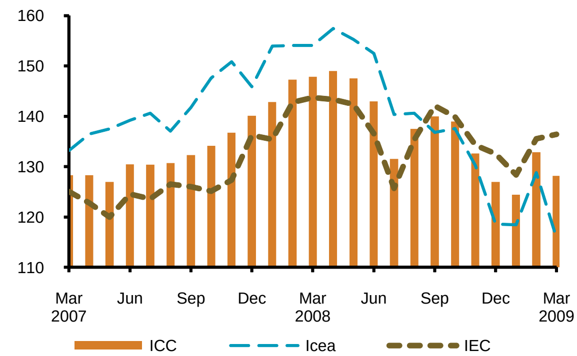
ICC

Sep 2005 = 100



Source: FGV

Figure 1.6 – Consumer Confidence Index



Source: Fecomercio SP

Default indicators, translating, in particular, a more restrictive stance of the financial institutions in relation to credit grant and the increase of interest rates, showed a rising trajectory since the final quarter of 2008. In this sense, the ratio between the number of checks returned for lack of funds and the total of checks cleared reached 6.9% in February 2009, against 6.5% in equivalent period of the previous year, with emphasis on the increase of 1.1 p.p., to 8.3%, registered in the Center-West region.

According to ACSP, in the State of São Paulo, default shows a pattern similar to that observed in the national indicators, reaching 7.8% in February, against 6.4% in equivalent period of the previous year.

The surveys aimed at assessing the expectations demonstrate that consumers began considering the developments of the aggravation of the international financial crisis. The Consumer Confidence Index (ICC), of Getulio Vargas Foundation (FGV), closed at, in February, the lowest level of the series initiated in September of 2005, registering drops of 4% in relation to January and of 17.5% compared to the same month of 2008. The monthly drop reflected reductions of 3.2% in the Expectations Index (IE) and of 5.6% in the Current Situation Index (ISP), which registered, in the order, cutbacks of 18.6% and 15.5% in twelve months.

The National Consumer Expectation Index (Inec), released on a quarterly basis, by the National Confederation of Industry (CNI), based on a survey carried out between the 5th and 8th of December, dropped 5% in relation to the September index. This result translated in general deterioration of the indicator components, with emphasis on the reductions registered in the expectations related to unemployment, 18.5%, and to inflation, 9%.

The ICC, released by Trade Federation of the State of São Paulo (Fecomercio/SP) and restricted to the metropolitan region of São Paulo, after registering a 6.8% rise in February, which occurred after a sequence of four negative monthly results, turned to fall in March. The monthly contraction of 3.5% observed in the month reflected the impact of the 10.1% reduction registered in the Current Economic Conditions Index (Icea), in part attenuated by the increase of 0.6% registered in the Consumer Expectations Index (IEC), a component representing 60% of the general index. In March, the ICC stood at a level 13.3% lower than registered in the same period of 2008.

1.2 Production

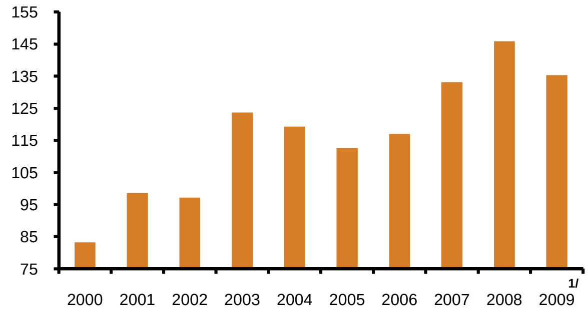
Crop/livestock output

According to the Quarterly National Accounts released by IBGE, crop and livestock output grew 2.2% in the final quarter of 2008, in relation to the same period of 2007, accumulating a 5.8% increase in the year.

Crops

The grain harvest totaled 145.9 million tons in 2008. The annual growth of 9.6%, consequent upon the elevations of 5.3% in productivity and of 4.1% in the harvested area, was favored by the performance of the crops of wheat, with expansion of 47.5%; coffee, 25%; sugar cane, 19.2%;corn, 13.3%; rice, 9.7%; beans, 5%; and soybeans, 3.4%, while, in contrast, registered reduction of 2.4% in the production of herbaceous cotton.

Figure 1.7 – Grain production
In million tons



Source: IBGE
1/ Estimate.

The Systematic Farm Production Survey (LSPA) estimate for the 2009 grain harvest came to 135.3 million tons. The forecasted annual cutback of 7.3% incorporates reduction expectations of 7.6% in the average productivity and growth of 0.3% in the area under cultivation.

Soybean production should total 57.6 million tons in 2009, for a contraction of 3.9% in the year – the first since 2004, when the harvest posted an annual fall of 4.6%. This result, due to the increase of 1.2% in the area under cultivation and decrease of 5% in the average yield, will be impacted by the drought occurred in the South region and in the state of Mato Grosso do Sul, in the periods of crop planting and development.

Table 1.4 – Farm production

In 1,000 tons

	Production		% change
	2008	2009 1/	2009/2008
Grain production	145 850	135 261	-7.3
Cotton (seed)	2 436	2 017	-17.2
Rice	12 114	12 558	3.7
Beans	3 408	3 785	11.1
Corn	58 741	51 288	-12.7
Soybean	59 920	57 594	-3.9
Wheat	6 031	5 097	-15.5
Others	3 199	2 922	-8.7

Source: IBGE
1/ Estimate.

Corn crop was estimated at 51.3 million tons, a drop of 12.7% in the year. One should highlight the prospect of contraction above 10% in yield of this crop, an evolution consistent both with the occurrence of unfavorable climatic conditions in the principal corn producing regions, and with the combination of high production costs and the low prices of the commodity.

Harvests of beans and of herbaceous cottonseed should reach 3.8 million and 2 million tons, respectively, in 2009, registering, in the order, a rise of 11.1% and fall of 17.2%, as compared to the previous year. Additionally, rice production was estimated at 12.6 million tons, 3.7% above that of 2008, registering increases both in average yield, 2.3%, and in planted area, 1.3%, prospects associated, to a large extent, to favorable climatic conditions for the crops of the main producing regions.

Sugar cane production should reach 660.7 million tons, a volume 1.1% higher than the previous harvest. This result, marking the continuity of the significant upturn of 19.2% observed in 2008, incorporates an increase of 2.4% in the area under cultivation and a decrease of 1.2% in average yield.

Coffee harvest, estimated at 2.4 million tons, should post a decrease of 16% in the year, mirroring a falloff of 2.7% in the area under cultivation and of 13.6% in average yield. The annual output reflects both a year of lesser production in the coffee crop biannual cycleand a disincentive of its production, as a result of high prices of agricultural supplies.

Table 1.5 – Livestock production

Total slaughters

% accumulated growth in the year

Itemization	2007	2008					
		Apr	May	Jun	Jul	Aug	Sep
Cattle	2.4	-6.7	-6.9	-5.8	-5.5	-5.9	-5.6
Swine	7.9	-3.9	-4.3	-3.2	-2.8	-3.4	-3.0
Poultry	10.1	7.1	5.7	6.1	6.6	5.5	6.0

Source: IBGE

Livestock

According to the Quarterly Survey on Animal Slaughter, released by IBGE, beef production reached 1.7 million tons in the third quarter of the year, falling 5.4% in relation to the same period of 2007. Using the same basis of comparison, production of poultry and swine reached 2.6 million and 0.7 million tons, for increases of 14.9% and 5.6%, respectively.

Beef and pork exports of totaled, in the order, 1 million and 467.6 thousand tons in 2008, falling 20.5% and 15.3%, respectively, in relation to the previous year, while those related to poultry expanded 8.7%, in the period, standing at 3.3 million tons.

Table 1.6 – Industrial production

% change

	2008			2009
	Oct	Nov	Dec	Jan
Industry (total)				
In the month1/	-1.4	-7.1	-12.7	2.3
3-Month Period/Previous 3-Month Period1/	0.9	-2.4	-9.5	-14.8
Same month of the previous year	1.1	-6.4	-14.8	-17.2
Accumulated in the year	5.8	4.6	3.1	-17.2
Accumulated in 12 months	5.9	4.8	3.1	1.0
Manufacturing industry				
In the month1/	-2.8	-5.0	-12.5	2.2
3-Month Period/Previous 3-Month Period1/	0.6	-2.2	-9.2	-13.5
Same month of the previous year	0.7	-6.5	-14.3	-17.2
Accumulated in the year	5.7	4.5	3.1	-17.2
Accumulated in 12 months	5.9	4.7	3.1	1.0
Mining				
In the month1/	-0.2	-10.9	-11.1	1.4
3-Month Period/Previous 3-Month Period1/	2.0	-2.6	-10.4	-17.1
Same month of the previous year	7.2	-4.6	-21.2	-18.4
Accumulated in the year	7.4	6.2	3.8	-18.4
Accumulated in 12 months	7.3	6.6	3.8	1.5

Source: IBGE

1/ Seasonally adjusted data.

Industrial production

Industrial production, confirming the trajectory followedby the business' expectations indices in the previous *Inflation Report*, declined in the quarter ended in January, as compared to that ended in October. In this environment, high decreases in the levels of utilization of installed capacity and industrial employment, maintenance of the declining trend of confidence indices, and reversal, in relation to the result registered in the quarter ended in October, of the performance of capital goods production, more susceptible to credit conditions and to the planning horizon.

Table 1.7 – Industrial production by category of use

% change

	2008			2009
	Oct	Nov	Dec	Jan
In the month[1/]				
Industrial production	-1.4	-7.1	-12.7	2.3
Capital goods	-0.3	-3.9	-23.3	8.4
Intermediate goods	-3.1	-4.0	-12.4	0.8
Consumer goods	-3.5	-5.0	-9.3	3.6
Durables	-4.1	-21.0	-32.9	38.6
Semi and nondurables	-2.3	-1.0	-3.9	-0.6
Quarter/previous quarter[1/]				
Industrial production	0.9	-2.4	-9.5	-14.8
Capital goods	4.9	1.5	-8.7	-16.1
Intermediate goods	-2.1	-4.9	-10.5	-13.6
Consumer goods	0.6	-1.8	-8.1	-11.2
Durables	-0.5	-9.6	-25.3	-33.4
Semi and nondurables	0.2	-0.4	-3.2	-4.7
In the year				
Industrial production	5.8	5.4	3.4	-17.2
Capital goods	18.5	18.6	16.1	-13.3
Intermediate goods	4.4	3.4	1.2	-20.4
Consumer goods	4.2	4.2	2.7	-13.7
Durables	10.6	8.7	3.8	-30.9
Semi and nondurables	2.2	2.8	2.4	-8.3

Source: IBGE
1/ Seasonally adjusted data.

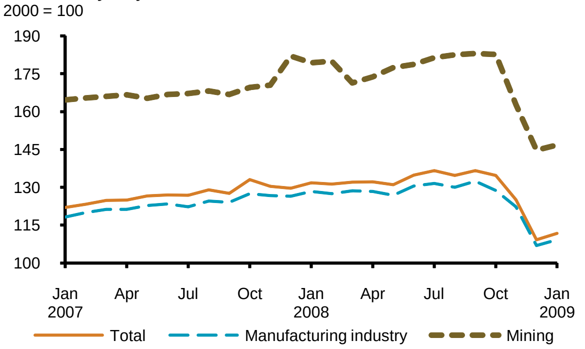
The physical production index of the IBGE´s Monthly Industrial Survey's (PIM-PF) showed reduction of 14.8% in the quarter ended in January, in relation to the one ended in October, when it had expanded 0.9%, on the same comparison basis, considering seasonally adjusted data. In the quarter, reductions of 13.5% in manufacturing industry and of 17.1% in the mineral extraction industry were registered.

The manufacturing industry's performance reflected the occurrence of falloffs in 21 of the 26 activities included in the IBGE's survey, with emphasis on those registered in the sectors of automotive vehicles, 38%; electronic material, apparatuses and communication equipment, 36.2%; machinery and equipment, 23.9%; iron and steel, 23.6%; and rubber and plastic, 21.9%. Reversely, the production of other transportation equipment, under the impact of the construction and assembly of aircrafts, increased 18.4% in the quarter.

Broken down by use categories, industrial production registered a generalized reduction in the quarter ended in January, in relation to that ended in October, with highlights to cutbacks observed in the categories of consumer durables, 33.4%; and of capital goods, 16.1%. The production of intermediate goods and of semi and nondurable consumer goods registered respectively falls of 13.6% and 4.7%, in the period.

The analysis of the capital goods production by end-use reveals a general negative performance in the segments under analysis. The contraction registered in the quarter ended in January, in relation to that ended in October, occurred in the production of goods targeted to construction, 38%; goods for serial industrial use, 25.6%; agricultural spares, 24.9%; and multipurpose use goods, 23.7%, considering seasonally adjusted data.

Figure 1.8 – Industrial production
Seasonally adjusted data

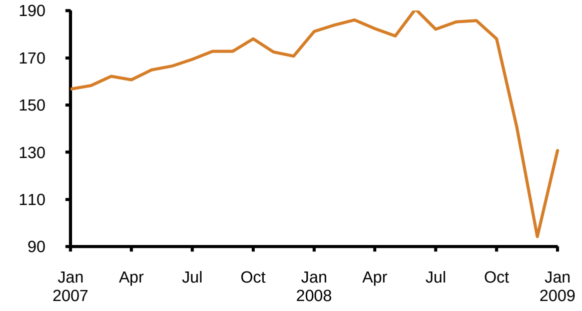


Source: IBGE

The production of typical construction inputs fell by 9.2% in the quarter ended in January, in relation to that ended in October, when it registered fall of 0.4%, in the same type of comparison, according to seasonally adjusted data.

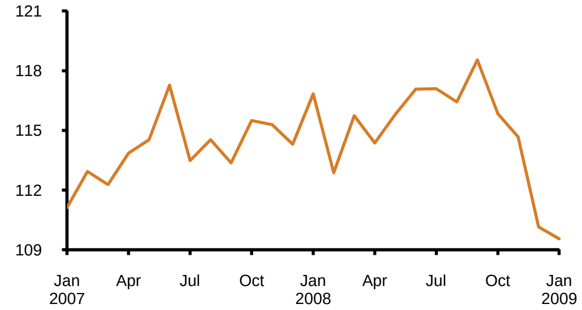
In the quarter ended in January, industrial physical production dropped in the surveyed thirteen units of the Federation, considering seasonally adjusted data, with emphasis in the reductions registered in Espírito Santo, 27.5%; and Minas Gerais, 24.4%. Production of the São Paulo industry, responsible, in 2006, for 39.2% of the Value of Industrial Manufacturing, fell by 13.1% in the period.

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



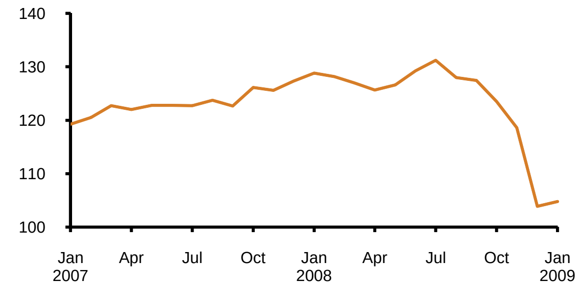
Source: IBGE

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



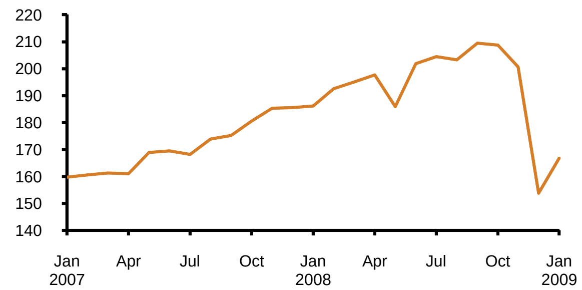
Source: IBGE

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

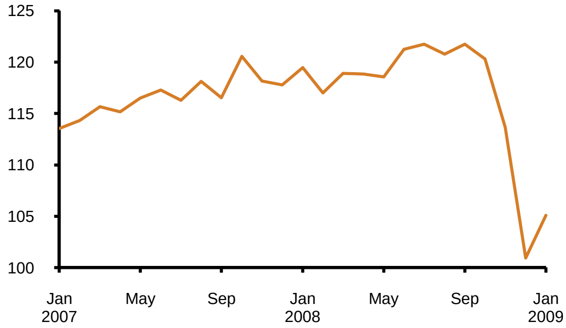
Production of farm machinery decreased 12.7% in the quarter ended in January, compared to the one ended in October, while production of automotive vehicles, demonstrating a significant reduction experienced by the sector in the November-Decembertwo-month period, fell 38.5%, considering seasonally adjusted statistics by Anfavea. One should highlight that the production of automotive vehicles showed a relative recovery in January and February, a movement stimulated by more favorable conditions for retail sales in the sector.

The downturn in industrial activity affected the evolution of employment indicators of the sector. According to seasonally adjusted data of the Monthly Industrial Survey – Employment and Wages (PIMES), of IBGE, the index of personnel occupied in industry fell 2.3% in the quarter ended in January, in relation to the one ended in October – the largest reduction, in this type of comparison, since the inception of the series, in January 2003. In addition, the indices related to the number of hours paid for by the industry and to the Real Payroll (FPR) dropped, in the order, 3.3% and 2.5%, on the same comparison basis.

Labor productivity – ratio between the physical production indices and the number of hours paid – decreased 11.9% in the quarter ended in January, compared to that ended in October, when it had increased 0.4% on the same type of comparison. The Unit Labor Cost (ULC) of industry, estimated by the ratio between the nominal payroll and physical production, has registered expansion rates above that of industrial prices, compressing, therefore, the sector's profit margin. Average CUT related to the quarter ended in January rose 26.2%, as compared to the corresponding period of 2008, for respective increases, on the same type of comparison, of 6.9% and 8.5% in the quarters ended in July and October.

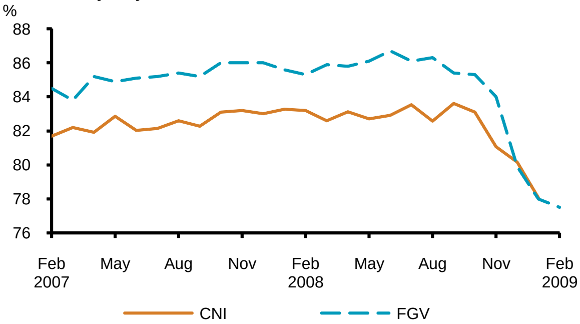
The Installed Capacity Utilization Level (Nuci) in industry reached 77.5% in February, the lowest since 1995, against 84% in November, according to the FGV'seasonally adjusted data. Manufacturing Industry Survey (SCIT). The 6.5 p.p. reduction registered in the period reflected the occurrence of cutbacks in Nuci related to all use categories, with emphasis on the falloffs observed in the capital goods industries, 13.5 p.p., and of consumer goods, 10.7 p.p. The level of occupation in the category of intermediate goods reached 77%, smallest value of the series, initiated in April 1995. Seasonally adjusted CNI data indicates, equally, reduction in the level of installed capacity utilization, which reached, on average, 79.6% in the quarter ended in January, against 82.7%, in the one ended in October.

Figure 1.13 – Labor productivity
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

Table 1.8 – Industry Confidence Index[1/]

	2008			2009	
	Feb	Nov	Dec	Jan	Feb
Industry Confidence Index	113.7	83.9	74.7	75.3	76.3
By component:					
Current Situation Index	117.0	85.3	76.1	78.1	77.4
Global demand level	115.7	75.2	66.6	72.0	67.7
Inventory level	97.6	84.3	80.4	78.2	81.6
Business situation	123.3	84.5	69.9	72.9	71.3
Expectations Index	110.5	82.5	73.3	72.5	75.2
Business situation	149.7	95.6	87.7	77.0	85.7
Employment	118.4	95.6	83.0	82.6	83.4
Physical production	129.3	102.7	90.9	98.3	99.3

Source: FGV
1/ The average of the last ten years is equal to one hundred. Seasonally adjusted

The Industrial Confidence Index (ICI) reached 76.3 points in February, falling 7.6 points in relation to November, according to FGV's SCIT seasonally adjusted data, with emphasis on the reductions registered in the categories of capital goods, 33.3 points, and intermediate goods, 18.7 points.

The ICI quarterly growth translated generalized reductions in its components. In this sense, the Current Situation Index (ISA) decreased 7.9 points in the period, with highlights on the falloffs observed in the headings current business situation, 13.2 points, and global demand level, 7.5 points, while the IE, situation at the smallest level of the series, started in April 1995, came down 7.3 points, a movement determined by the reduction of 9.9 points in the heading foreseen physical production, which reached, equally, the lowest level of the series.

The capital goods industry, which had shown sharp activity in the quarter ended in October, started to reflect, in the latest months, the new economic environment. The international financial crisis, as anticipated in the previous report, has been imposing heterogeneous effects over the performance of the Brazilian industry, taking into account that the uncertainties underlying this process and the reduced credit supply tend to impact more strongly the categories of consumer durables and capital goods, favored, in the recent scenario, by the expansion of the planning horizon and by the improvement of credit conditions. The reversal of this environment and the intensification of business uncertainties in relation to the demand level in the coming monthscaused, therefore, the reduction of investments by companies and, as a consequence, in a contractive demand for machinery and equipment.

The automotive sector production, a relevant segment of the country's industrial structure, turned in a sharp reduction in December, during which the majority of the vehicle assembling plants granted employees group holidays, aiming at readjusting their respective stocks. This movement had a negative impact on the production of sectors representing the categories of durable and intermediate consumer goods. It should be highlighted that the recent increase of stock levels reflects, in particular, the inconsistency amidst the investments carried out in 2008, aiming at expanding the installed capacity, and the process of reducing domestic and external demand.

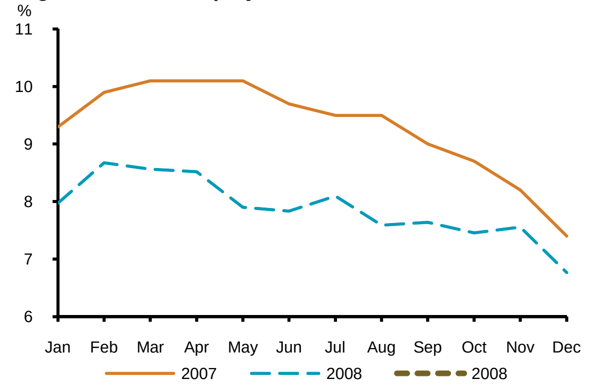
1.3 Labor market

Employment

The lesser dynamics of economic activity has been reflecting, on margin, the job market indicators. The average unemployment rate, measured by IBGE's Monthly Employment Survey (PME), reached 7.5% in the quarter ended in January, the lower level for that period, since the beginning of the survey, as against 7.6% in the quarter ended in October and 7.9% in the same period of 2008. At the margin, however, the indicator turned to demonstrate the impact of reduction in the activity level, standing at 8.2% in January, against 8% in equivalent period of 2008, emphasizing that since January 2007 there had not been any increase in employment in this type of comparison.

The increase of 0.2 p.p. registered by the unemployment rate, in the annual comparison, reflected expansions of 1.9% in the level of occupation and of 2.1% in the Overall Labor Force (PEA), representing growth of 4.6% in the number of the unemployed.

Figure 1.15 – Unemployment rate



A breakdown in unemployment rate by job categories reveals that the slowdown registered at the beginning of the year translated similar growth in the segments considered. In this sense, after respective annual variations of 7.4% and -0.4% in 2008, formal and unregistered employment, in the order, posted variations of 4.5% and -3.2% in January, compared to equal period of 2008. In this scenario, the rate of employment formalization, defined as the ratio between the number of registered workers in the private sector and the total number of occupied persons, reached 44.9% in January, the highest percentage of the series initiated in March 2002.

Table 1.9 – Formal employment

	2008				2009
	Jan/Jun	Jul/Sep	Oct/Dec	Year	Jan
Total	1 361.4	725.2	-634.4	1 452.2	-101.7
Manufacturing industry	317.9	206.1	-345.3	178.7	-55.1
Commerce	132.1	132.7	117.4	382.2	-50.8
Services	438.8	251.1	-41.7	648.3	2.5
Building	197.2	103.7	-103.0	197.9	11.3
Crop and livestock	227.0	14.6	-223.4	18.2	-12.1
Public utilities	7.3	3.3	-2.6	8.0	0.7
Others[1/]	41.1	13.6	-35.7	19.0	1.8

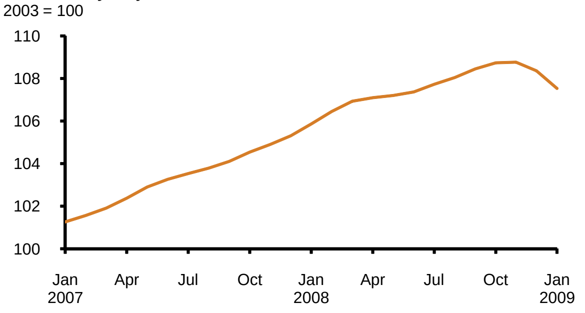
Source: MTE

1/ Includes mining, public administration and others.

According to the General File of Employed and Unemployed Persons (Caged), of the Ministry of Labor and Employment (MTE), 1,452 thousand new job positions were created in 2008, a result only smaller than that registered in 2007, when 1,617 thousand new formal job positions were created. The annual increase of 6.4% in the number of registered workers translated the respective expansions of 6.7%, 6% and 5.6% recorded in the segments of trade, services and manufacturing industry. In the construction industry, where high rates have been registered since 2005, the annual increase reached 17.4%.

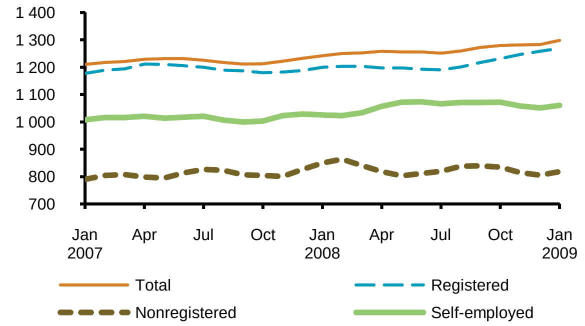
As of November, Caged statistics turned to incorporate the developments of the international financial crisis, registering, in the quarter ended in January, the elimination of 798

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



Source: CNI

Figure 1.17 – Average real regular earnings[1/]
In R$ of January 2009, deflated by INPC



Source: IBGE
1/ Quarterly moving average.

thousand job positions, of which 51% in the manufacturing industry. In the corresponding 2008 period, 52 thousand formal job positions had been eliminated.

According to CNI, considering statistics related to twelve units of the Federation, industrial employment grew 4% in 2008. One should point out that in the first ten months of the year the accumulated expansion had reached 4.3%, contrasting with the increase of 2.4% registered in the final two-month period of the year, an evolution which showed, just as did other surveys, the deterioration of the job market conditions at the margin.

Income

The average real income usually received by occupied persons in the six metropolitan regions encompassed by PME increased 3.4% in 2008, with emphasis to the acceleration observed in the second half of the year, when expansion reached 4.5% in relation to equal period of 2007. The average earnings reached R$1,318.70 in January 2009, the highest value of the series, initiated in March 2002. For this month, a rise of 5.9% in relation to the same period of 2008, a movement which, in an environment of elimination of job positions, suggests the occurrence of cutbacks in the lower salary bracket. The overall wages, a product of the average real income habitually received by the number of those employed, after rising 6.9% in 2008, expanded 7.8% in January, as compared to January 2007.

1.4 Gross Domestic Product

In spite of showing a reduction, at the margin, GDP registered a cumulative 5.1% growth in the final quarter of 2008. This result, which reflected, in particular, the dynamics experienced by the economic activity in the first nine months of the year, translated, once again, the positive contribution of domestic demand, with emphasis in investment acceleration registered in the period prior to the intensification of the crisis in the international financial markets.

GDP fell by 3.6% in the quarter ended in December, as compared to the one ended in September, according to seasonally adjusted date from the Quarterly National Accounts System, of IBGE. This movement, representing the interruption of a cycle of 12 sequential positive results, in this type of comparison, was associated, in particular, to the developments of deteriorating expectations of credit

Table 1.10 – Gross Domestic Product at market prices

% growth

	2007	2008			
	IV Q	I Q	II Q	III Q	IV Q
Accumulated in the year	5.7	6.1	6.2	6.4	5.1
Accumulated in 4 quarters	5.7	5.9	6.0	6.3	5.1
Quarter/same quarter of the previous year	6.1	6.1	6.2	6.8	1.3
Quarter/previous quarter 1/	1.8	1.6	1.6	1.7	-3.6
Crop and livestock	2.4	-1.3	3.0	1.3	-0.5
Industry	1.4	2.4	-0.2	3.6	-7.4
Services	2.7	1.4	0.9	0.8	-0.4

Source: IBGE
1/ Seasonally adjusted data.

Table 1.11 – Gross Domestic Product

% growth

	2007	2008			
	IV Q	I Q	II Q	III Q	IV Q
GDP at market prices	5.7	6.1	6.2	6.4	5.1
Households consumption	6.3	6.3	6.1	6.5	5.4
Government consumption	4.7	6.5	5.3	5.7	5.6
Gross fixed capital formation	13.5	15.4	16.0	17.3	13.8
Exports	6.7	-2.3	1.4	1.6	-0.6
Imports	20.8	18.8	22.5	22.6	18.5

Source: IBGE
1/ Estimated.

Table 1.12 – Gross Domestic Product

% growth

	2007	2008			
	IV Q	I Q	II Q	III Q	IV Q
Crop and livestock	5.9	3.8	6.7	6.7	5.8
Industry	4.7	6.9	6.2	6.5	4.3
Mining	2.8	3.6	4.5	5.6	4.3
Manufacturing	4.7	7.4	6.2	6.1	3.2
Construction	5.0	8.9	9.3	10.2	8.0
Public utilities	5.9	5.4	4.6	4.9	4.5
Services	5.4	5.2	5.3	5.5	4.8
Commerce	7.1	7.9	8.1	8.6	6.1
Transportation	5.3	4.3	4.7	5.0	3.2
Communications	7.0	8.0	8.1	8.8	8.9
Financial institutions	14.5	13.2	11.7	10.7	9.1
Other services	2.7	3.3	4.1	4.7	4.5
Rents	4.1	3.8	3.5	3.3	3.0
Public administration	2.4	1.4	1.7	2.0	2.3
Value added at basic prices	5.2	5.6	5.8	5.9	4.7
Taxes on products	8.4	9.1	8.6	9.1	7.4
GDP at market prices	5.7	6.1	6.2	6.4	5.1

Source: IBGE

conditions over the performance of industry, which carried out a strong reduction of stocks and of investments.

The analysis of GDP growth at the margin, from the production perspective, reveals a reduction of 7.4% in industrial production, following the cutbacks registered in the sectors ofcrop and livestock, 0.5%, and services, 0.4%, demonstrating the lesser dynamics of the segments of trade and transportation. In relation to the demand components, one should highlight the quarterly fall of 9.8% in the Gross of Fixed Capital Formation (FBCF). Additionally, government consumption expanded 0.5% on margin, while the imports, exports and household consumption fell off, in the order, 8.2%, 2.9% and 2%.

GDP performance in 2008 reflected, from the production perspective, the occurrence of positive results in all of the output components, while from the demand perspective, repeating the pattern initiated in 2006, the dynamics of domestic demand offset the negative contribution exerted by the external sector.

The domestic demand, therefore, continued sustaining the process of growth of economic activity. The annual contribution of 6.8 p.p. for GDP growth was associated, in particular, to the growth of 13.8% registered by the GFCF – the highest rate since 1995, followed by the performances of government consumption, 5.6%, and of households, 5.4%.

As far as the external sector is concerned, exports dropped 0.6% in the year and imports, 18.5%, determining a negative contribution of 2.3 p.p. to the GDP growth in the period. This result, which reflects, to a great extent, the dynamics of domestic demand in the period prior to the aggravation of the international crisis, favored the process of expansion of the industrial capacity.

Viewed from the production perspective, annual expansions of 5.8% in farming, 4.8% in services and 4.3% in industry, were registered. The increase of the crop and livestock output translated, in particular, the annual rise of 9.6% in grain harvest, boosted by the respective increases of 47.5%, 13.3% and 9.7% observed in the harvests of wheat, corn and rice. It was also verified expansions of 25% in coffee harvest, favored by the biannual nature of the crop, and of 19.2% in the sugar cane. harvest. The crops, favored by adequate climatic conditions, have shown, on average, yield gains of 5.4%. In relation to animal raising, according to IBGE's Quarterly Survey on Animal Slaughter, production of bovines fell off 5.6% in the first nine months of 2008,

Gross Domestic Product – 2009 Forecast Revision

Brazil's Gross Domestic Product (GDP) growth forecast for 2009 was revised from 3.2%, as shown in the last *Inflation Report*, to 1.2%, a cutback consistent with the evolution at the margin of the principal indicators of the Brazilian economy's activity level and with the deteriorating expectations, as registered early this year.

The new forecast considers, from the supply viewpoint, overall reductions in the farming, industrial and service sectors. Farming should drop 0.1% in 2009, against expansion of 2.2% in the previous forecast, a reversal associated, especially, to the impacts expected of the reduced external demand for agricultural commodities and for animal products.

Industrial production, the sector most hit by deteriorating expectations, should grow 0.1%, against 3.6% in the previous forecast, reflecting reduction in growth forecasts in all the industrial segments. The mineral extraction industry should grow 2.4%, against 5.2% in the previous forecast, a cutback associated mainly to the forecasted reduction in the production of iron ore. The manufacturing industry production should register a reduction of 1.6% in 2009, when compared to the 3.1% expansion forecast of the previous report, a movement consistent with the performance observed at the outset of the year, lower than foreseen. Expansion of the construction industry, which should remain favored by the new lines of real estate financing, by the government's program of subsidy to popular housing construction and by investments in the context of the Growth Incentive Program (PAC), is forecasted at 2.7%, a cutback of 1.6 p.p. in relation to the previous forecast. The expansion forecast for the industrial services of public utilities, reflecting the performance of the

Table 1– Gross Domestic Product

	2008	2007	2008				2009[1/]
	Weights	IV Q	I Q	II Q	III Q	IV Q[1/]	
Crop and livestock	5.7	5.9	3.8	6.7	6.7	5.8	-0.1
Industry	23.6	4.7	6.9	6.2	6.5	4.3	0.1
Mineral extraction	3.0	2.8	3.6	4.5	5.6	4.3	2.4
Manufacturing	13.5	4.7	7.4	6.2	6.1	3.2	-1.6
Construction	4.3	5.0	8.9	9.3	10.2	8.0	2.7
Public utilities	2.7	5.9	5.4	4.6	4.9	4.5	2.1
Services	55.2	5.4	5.2	5.3	5.5	4.8	1.7
Commerce	10.3	7.1	7.9	8.1	8.6	6.1	-0.4
Transportation	4.6	5.3	4.3	4.7	5.0	3.2	-0.5
Communications	3.0	7.0	8.0	8.1	8.8	8.9	4.9
Financial institutions	5.7	14.5	13.2	11.7	10.7	9.1	3.2
Other services	11.4	2.7	3.3	4.1	4.7	4.5	1.8
Rents	7.3	4.1	3.8	3.5	3.3	3.0	2.1
Public administration	12.9	2.4	1.4	1.7	2.0	2.3	2.6
Value added at basic prices	84.5	5.2	5.6	5.8	5.9	4.7	1.2
Taxes on products	15.5	8.4	9.1	8.6	9.1	7.4	1.5
GDP at market prices	100.0	5.7	6.1	6.2	6.4	5.1	1.2

Sources: IBGE and Banco Central

1/ Estimated.

other segments of the economy, was curtailed from 3.8% to 2.1%.

The expansion forecast for the services sector was revised from 3.1% to 1.7%, with emphasis on the respective cutbacks of 4.6 p.p. and of 3.6 p.p. in the segments of trade and transportation, more intensively impacted by the reduction of total supply of goods and services. The segment of public administration is the only one to register a rise in the expected growth rate in the current forecast, 0.8 p.p.

From the demand perspective, the most important revision occurred in the forecast for Gross Fixed Capital Formation (FBCF), a component more sensitive to the expectations and output evolution, moving from 4.4% to 0.7%. Although it shows a significant cutback, maintenance of the positive variation of this component considers the contribution of PAC's infrastructural works and the government measures aimed at stimulating works in the context of popular housing; of the credit lines from the National Bank of Economic and Social Development (BNDES) to guarantee investment resources; and continued investments on specific sectors, like petroleum and natural gas prospection.

The expansion forecast of household consumption also a cutback, from 3.9% to 1.6%. This movement, less strong than that registered in the GFCF, incorporates the persistence of a favorable impact in maintaining real income gains stimulated by both the cooling off of inflation and by the increases in the minimum wage and the impact of the federal government's social assistance programs.

The forecast related to the government's consumption expanded from 2.2% to 2.4%, an evolution consistent with the anti-cyclical behavior expected for this year.

The dynamics recently registered by the external trade flows will be impacted by the negative performance of the Brazilian economy and the country's main trading partners. In this environment, sharp reductions in exports and imports, in spite of the likely interruption of the three-year sequence of external sector's positive contribution to GDP, the annual expansion of the Brazilian economy will remain dependent on the dynamics of domestic demand.

Table 2 – Gross Domestic Product – Demand side

%

Period	GDP at market price	Private consumption	Government consumption	Total consumption	Gross Fixed Capital Formation	Exports	Imports
2002	2.7	1.9	4.7	2.6	-5.2	7.4	-11.8
2003	1.1	-0.8	1.2	-0.3	-4.6	10.4	-1.6
2004	5.7	3.8	4.1	3.9	9.1	15.3	13.3
2005	3.2	4.5	2.3	3.9	3.6	9.3	8.5
2006	4.0	5.2	2.6	4.5	9.8	5.0	18.4
2007	5.7	6.3	4.7	5.9	13.5	6.7	20.8
Contribution (p.p.)		3.8	0.9	4.7	2.2	1.0	-2.4
2008	5.1	5.4	5.6	5.4	13.8	-0.6	18.5
Contribution (p.p.)		3.3	1.1	4.4	2.4	-0.1	-2.2
2009 (estimated)	1.2	1.6	2.4	1.8	0.7	-6.6	-6.4
Contribution (p.p.)		1.0	0.5	1.4	0.1	-1.0	0.9

Sources: IBGE and Banco Central

Table 1.13 – Gross Domestic Product
Quarter/previous quarter
Seasonally adjusted

% growth

	2007	2008			
	IV Q	I Q	II Q	III Q	IV Q
GDP at market prices	1.8	1.6	1.6	1.7	-3.6
Crop and livestock	2.4	-1.3	3.0	1.3	-0.5
Industry	1.4	2.4	-0.2	3.6	-7.4
Services	2.7	1.4	0.9	0.8	-0.4
Households consumption	2.7	1.5	0.7	2.1	-2.0
Government consumption	0.6	4.1	-0.2	1.6	0.5
Gross fixed capital formation	3.8	2.8	3.4	8.4	-9.8
Exports	6.1	-6.2	3.9	-1.4	-2.9
Imports	5.5	1.3	8.6	6.4	-8.2

Source: IBGE

against the same period of 2007, while that related to swine and poultry registered respective increases of 15.9% and 4.7%, in the period.

The annual increase of 4.8% experienced by the services sector, in 2008, reflected the occurrence of generally positive results in its components, with emphasis on the performance of the segments of financial intermediation, insurances, complementary social security and related services, 9.1%; information services, 8.9%; and trade, 6.1%.

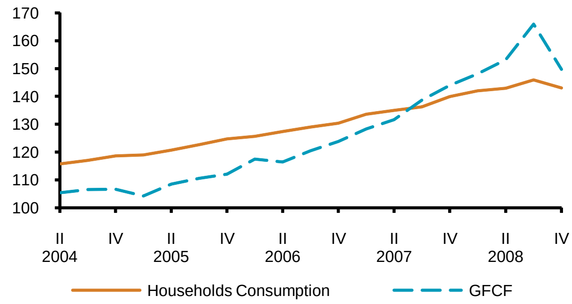
The expansion of industrial activity mirrored, in part, the increases registered in the activity of construction, 8%, a result consistent with the increased destination of resources to real estate financing and with the intensification of infrastructural works in the context of the Growth Incentive Program (PAC); and in production and distribution of electricity, gas and water, 4.5%. The mineral extraction industry, translating increases in the productions of petroleum (crude oil and Liquefied Natural Gas (LGN), 3.8%, and of iron ore, 1.9%, expanded 4.3% in the year, while the manufacturing industry, favored by the dynamics of the segments other transportation equipment, 42.2%, and automotive vehicles, 8.1%, registered expansion of 3.2%.

Estimates for the GDP growth in 2009 are explained in the Box Revised Forecasts for GDP 2009 (page 23).

1.5 Investments

According to IBGE's Quarterly National Accounts System, investments, excluding the stock variations, increased 13.8% in 2008, the greatest annual variation since 1995. The GFCF increased 3.8% in the fourth quarter of 2008, as compared to the same period in 2007, by contrast to the reduction of 9.8% registered in relation to the quarter ended in September, considering seasonally adjusted data.

Figure 1.18 – Households Consumption and Gross Fixed Capital Formation[1/]
1995 = 100



Source: IBGE
1/ Seasonally adjusted data.

Reduction of investments at the margin, interrupting a sequence of nine positive results, in this type of comparison, was signaled by the evolution of leading GFCF monthly indicators. In this sense, the production of inputs for construction showed contraction of 6.7% in the period, while the production and imports of capital goods registered respective decreases of 8.7% and 4.7%, which determined a reduction of 5.8% in the absorption of this category of goods.

The margin analysis of the evolution in the segments of capital goods production demonstrates a general reduction in the components of this industry, highlighting the contraction observed in the segments of farm machinery parts, 27.4%; typically manufactured capital good, 16.5%; and multiuse capital goods, 16.4%.

1.6 Conclusion

In this scenario of declining activity, improvement in inflation prospects allowed the Central Bank to initiate a process of monetary easing, which, coupled with other government policies, will have anticyclical results. Thus, one should highlight, besides the process of reduction in the economy's basic interest rate, the introduction of mechanisms aimed at guaranteeing the dynamics of exports and the normalization of foreign currency liquidity, as well as the increase of expenses, in particular, those related to investments in infrastructure. Also noteworthy are measures aimed at releasing resources to increase liquidity of the national financial system, in a way as to foster growth in domestic financing. Although there is the persistent issue of the scope of the mentioned measures and the effective extent of the worldwide crisis, recent results show a relative recovery, at the margin, of the Brazilian economy.

Stocks and Economic Cycle

The impact of the intensification of the international financial markets crisis on credit supply and on the deterioration of consumers' expectations reflected on sharp reduction of sales and, at a second moment, on the interruption of purchase orders and, as a consequence, on accumulation of stocks. This Box aims to assess the recent behavior of stocks in the Brazilian industry and the significance of their fluctuations in periods of alternating economic cycles. The analysis will consider theoretical aspects related to the formation and maintenance of stocks and the evolution of specific indicators related to the country's industry.

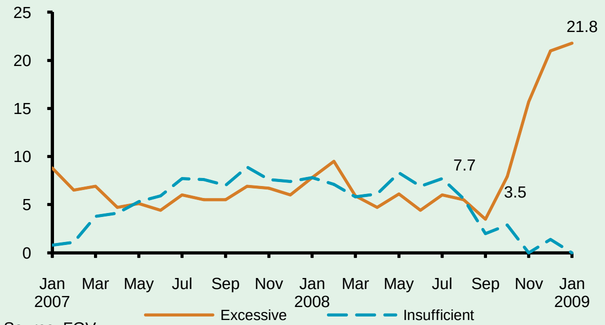
The concern with the impact of stocks over the cycles of production, sales and employment is not unheard of. During the 1940's, Metzler (1941) demonstrated the pro-cyclical role of stocks in Keynesian models. Abramovitz (1950) registered the relevant role of stock variations in the variation of gross domestic product. More recently, Blinder and Maccini (1991) argued that in a typical recession the stock reduction represents the most important part of the gross domestic product reduction.

Horstein (1998) established some stylized facts of the stocks accumulation and its relation with the economic cycle using data from the United States in the period from 1960 to 1995. The gross domestic product was subdivided into final sales and investment on stocks and each of these variables was submitted to a breakdown into a cyclical component and an irregular component. Horstein (1998) registered that the variance of stocks represented 28.6% of the total variance of the domestic product in the period. This participation, however, depended strongly on which series components have been used. When cyclical components of the three series have been considered, the participation of the variance of stocks in the variance of the domestic product restricted to only 5.8%; when irregular components have been considered, this participation reached 48.1%. Apparently, the investment on stocks is more important for the short-term fluctuations than for variances of domestic product during the economic cycle. In this sense, sharp falls and rises in the stocks may hold little information about the cycle stage in which the economy stands.

Another important aspect of the behavior of stocks is their relation with the final sales. Investments in stocks and final sales are not, in principle, correlated. When considered their cyclical and irregular components, however, the situation is different. One may examine that investments in stock are positively correlated to the final sales when the respective cyclical components are considered. Conversely, investment in stocks and final sales are negatively correlated when their irregular components are considered. Thus, apparently, during the economic cycle there is a relatively stable ratio of proportion between sales and stocks, which tend to be maintained at a higher level in periods of more significant sales, whereas, in the opposite sense, the irregular component translates unexpected stock variations.

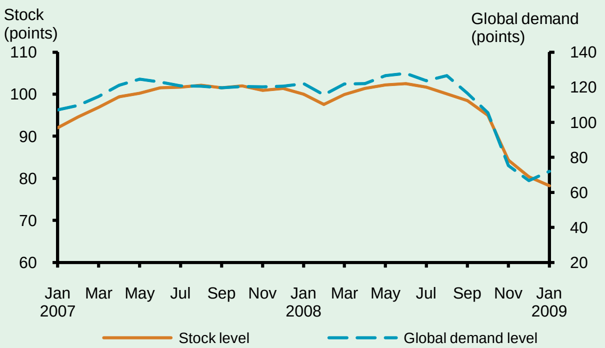
Just as released for the American economy, there are no quantitative and comprehensive statistics on stocks for the Brazilian economy, which hinders, for example, to ascertain if the stylized facts registered by Horstein (1998) for the American economy are observed or not in Brazil. There is, however, qualitative evidence. The Getulio Vargas Foundation (FGV) Manufacturing Industry Survey (SCIT) verifies whether a number of companies in the manufacturing industry have, in a given month, excessive, normal or insufficient stocks, based on an analysis of a sample of businessmen interviewed. The stock level indicator consists in the difference (percentage points) between the participation of companies that stated having insufficient stocks and of those which stated having excessive stocks added by 100. Thus, the indicator may vary from 200, in the extreme case that all of the companies consider that they have insufficient stocks, to zero, situation in which all the companies assess their stocks as excessive.

Figure 1 – Stock level Indicator[1/]



Source: FGV.
1/ Seasonally adjusted series.

Figure 2 – Stock level and Global demand[1/]



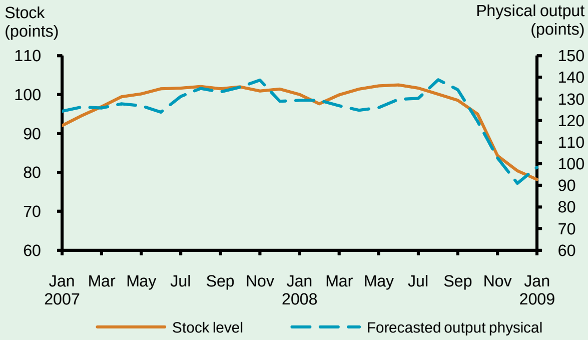
Source: FGV.
1/ Seasonally adjusted series.

The recent behavior of this indicator, registered in Figure 1, reveals that the number of companies which demonstrated having insufficient stocks in relation to the universe of companies surveyed remained between 5% and 10% from May 2007 to August 2008, period characterized by expansion of sales and production. With the aggravation of the international economic crisis, in September, this figure was reduced to 2%, until it reached zero in November, and, again, in January. The participation of a number of companies which reported excessive stocks, after remaining below 10% in the period of November 2006 to October 2008, reached 15.7% in November and 21.8% in January 2009.

Between April 2007 and September 2008, the balance between the number of companies with insufficient and with excessive stocks was known by the permanence of the indicator of stock level around the equilibrium level of 100 points, suggesting that the trajectory of expansion of sales and of production occurred at a pace which made it possible to adequately adjust the stocks. The same did not occur in the last quarter of the year, when the aggravation of the world crisis, as of September, was not anticipated by the companies and manifested itself in sharp reduction of industry's sales and in accumulation of excessive stocks. This process is shown on Figure 2, where one may observe that while global demand remained stable, the stocks were balanced and that after their non-anticipated, sharp decline, stocks piled in a similar proportion.

The relevance of the stock level as a determinant of physical production may be understood by the analysis of Figure 3, which shows that the indicator of physical production volume foreseen for the next three months, also contained in the FGV's Survey, remained above 120 points in the period from November 2006 to September 2009, revealing that there were more companies planning to expand production than the other way around. One should highlight that, in line with the trajectory of gradual expansion of production in this period, the stock indicator remained near the equilibrium. The sudden reduction of demand and the consequent accumulation of excessive stocks in the last quarter of 2008 led to a similar reduction in the volume of physical production foreseen for the three following

Figure 3 – Stock level and physical output[1/]



Sources: IBGE and FGV.
1/ Seasonally adjusted series.

months. The foreseen physical production indicator reduced from 134.2 points, in September, to 90.9 points, in December – the lowest value since April 1995. Again, it is observed that, if on the one hand, the stock level indicator was not helpful to signal the stage of the economic cycle, it unambiguously indicated an unforeseen shock on sales and on foreseen physical production.

SCIT statistics also allow the analysis of the manufacturing industry's stock level evolution broken down by use categories and segments. The monthly evolution of the aggregated stock level indicator, as registered on Figure 1, translated similar movements in three of the use categories and nine of the considered segments (Table 1), evincing, therefore, the widespread 0stock growth in the latest months.

It should be highlighted that the prospect of possible shortage of raw materials observed in the period prior to September 2008 has been an additional important element in the recent process of stock accumulation. In this sense, companies that accumulated excessive stocks of intermediate products and, especially, of raw materials in order to guarantee the continuity of their activities under the risk of supply exhaustion of these products became overstocked, subjecting their suppliers to more intensive stock expansions. It is worth noting that this type of defensive behavior, leading to the monopolization of stocks of raw materials and intermediate products, was not restricted to Brazil, but was observed in other mature and emerging economies as well, like China.

The recent expansion of stocks in the manufacturing industry occurred with sharp intensity in the automobile sector, which after registering relevant and constant rises in domestic sales and in production, began to reflect restrictions to credit and consumers' deteriorating expectations.

According to data from the National Association of Automotive Vehicle Manufacturers (Anfavea), the stock of vehicles at the assembling lines and at the car dealerships reached 305 thousand units in November, after registering average of 174 thousand units from January 2007 to October 2008. This movement, intuitively classified as an irregular component, translated into generalized interruption

Table 1 – Stock level[1/]

Itemization	2008				2009	Difference between Jan/2009 and		
	Sep	Oct	Nov	Dec	Jan	Dec/2008	Sep/2008	Average[2]
Manufacturing industry	98.5	95.0	84.3	80.4	78.2	-2.2	-20.3	-10.3
By use categories								
Consumer goods	99.1	99.8	84.1	81.1	75.5	-5.6	-23.6	-9.1
Capital goods	107.1	96.8	84.1	80.1	83.5	3.4	-23.6	4.9
Building material	97.4	94.4	92.8	90.2	81.3	-8.9	-16.1	-8.3
Intermediate goods	99.9	97.6	91.2	79.6	78.8	-0.8	-21.1	-14.5
By type								
Non-metallic minerals	86.9	90.1	81.8	70.9	60.1	-10.8	-26.8	-21.5
Metallurgy	100.1	92.3	86.4	73.0	69.3	-3.7	-30.8	-25.7
Mechanic	106.5	99.3	80.3	72.0	73.7	1.7	-32.8	-12.7
Electric fittings	100.0	101.2	88.4	66.1	63.9	-2.2	-36.1	-19.2
Transportation material	100.0	99.8	72.5	60.7	67.5	6.8	-32.5	-11.1
Furniture	90.4	84.2	86.2	85.5	77.5	-8.0	-12.9	-9.6
Cellulose and paper	99.5	90.5	87.8	72.6	72.5	-0.1	-27.0	-13.6
Chemical	101.5	99.2	97.1	86.3	92.9	6.6	-8.6	-4.5
Pharmaceutical	86.9	86.7	93.5	77.0	87.2	10.2	0.3	1.1
Plastics	90.4	93.5	87.8	85.9	91.4	5.5	1.0	3.0
Textiles	87.6	87.4	82.0	95.4	71.4	-24.0	-16.2	-5.5
Apparel and footwear	93.7	96.5	83.2	75.4	72.3	-3.1	-21.4	-8.2
Food products	98.9	93.8	92.5	94.1	90.0	-4.1	-8.9	-3.1
Other products	98.7	99.1	97.2	91.5	82.0	-9.5	-16.7	-13.6

Source: FGV / Manufacturing Industry Survey (SCIT).

1/ Segment of respondents which described their stocks as insufficient deducted from the segment which described them as excessive; measured in percentage points; seasonally adjusted series.

2/ Average of the series since April 1995.

of activities of the sector, with negative effects on distinct segments of the productive chain. In this scenario, and considering the unpredictable nature of this stock movement, the Federal Government opted for reducing the Industrialized Products Tax (IPI) levied upon the sales of automobiles, favoring the resumption of sales and production both in the sector and in the principal links of this productive chain.

As a result, there was rapid reduction of the stock level in the sector, to some 27 days of sales, below the historical average of 34 days.

Prices

2

Consumer price index variation showed acceleration in the quarter ended in February 2009, impacted by seasonal pressures over the prices of unprocessed foodstuffs and by tariff readjustment, especially public transportation and by the hike in education-related costs.

Conversely, variation of general price indices registered a downturn in the period, evincing, essentially, the falloff in wholesale industrial prices, which had grown sharply in the quarter ended in November. Farming prices, translating the recovery of international prices of the principal *commodities*, expanded in the period, mirroring the behavior observed, specifically, in January.

One should also highlight the inconsistency between the behavior of the diffusion index, which registered the strengthening of the dissemination process of price increases, and the performance of inflation core measures, which registered, in general, smaller price variations in the quarter ended in February, as compared to that ended in November 2008. In this environment, considering the exhaustion, in the next months, of seasonal pressures observed at the beginning of the year, variation of consumer prices is forecasted to gradually converge towards the target established by the National Monetary Council (CMN).

2.1 General indices

Accumulated variation of the FGV's General Price Index – Internal Availability (IGP-DI) reached -0.55% in the quarter ended in February, against 1.53% in the quarter ended in November. This behavior reflected both the cutback registered in wholesale prices, in line with the price reduction of industrial products, and the lesser variation of construction prices.

Table 2.1 – General price indices

Monthly % change

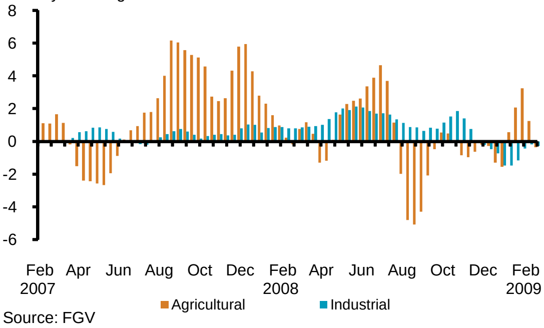
	2008			2009	
	Oct	Nov	Dec	Jan	Feb
IGP-DI	1.09	0.07	-0.44	0.01	-0.13
IPA	1.36	-0.17	-0.88	-0.33	-0.31
IPC-Br	0.47	0.56	0.52	0.83	0.21
INCC	0.77	0.50	0.17	0.33	0.27

Source: FGV

The Wholesale Price Index (IPA-DI), weighting 60% in IGP-DI, fell off by 1.51% in the quarter ended in February, against a 1.63% increase in the period from September to November 2008. The reduction was associated, fundamentally, with the deceleration, from 2.63% to -2.16%, registered in the variation of prices of industrial products, a movement consistent with the cutbacks registered in the prices of metallic and non-metallic minerals, leather and footwear, cellulose, chemicals, iron and steel and petroleum derivatives. The twelve-month cumulative industrial price variation reached 9.49% in February, 14.93% in November, a development which tends to exert a benign effect over the evolution of the consumer prices in the following months.

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

Monthly % change



Source: FGV

Farming prices expanded by 0.37% in the quarter ended in February, against -1.12% in the quarter ended in November. This acceleration reflected the pressures exerted by the prices of products originated from seasonal crops, such as corn, wheat, soybeans, potatoes and pineapple, as well as by the prices of those originating in permanent crops such s cocoa, banana, coffee and orange. Prices related to livestock continued to drop, in the quarter.

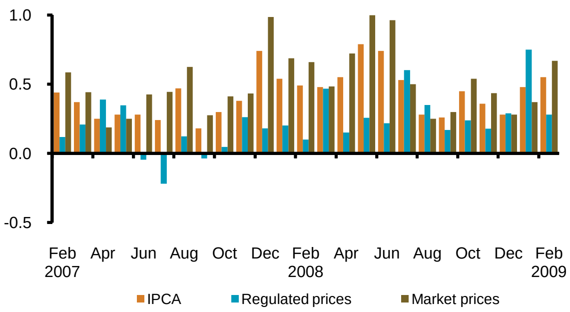
Variations in the Consumer Price Index – Brazil (IPC-Br) and in the National Cost of Construction Index (INCC), with respective weights of 30% and 10% in IGP-DI, in the order, stood at 1.57% and 0.77%, in the quarter ended in February, against 0.94% and 2.24%, in the quarter ended in November 2008. The acceleration registered by IPC-Br resulted in pressures associated to the items education, recreation and food, while the smallest variation of INCC translated the lower pressures exerted by the items labor and materials and services.

IGP-DI expanded 9.10% in 2008, against 7.89% in the previous year, registering acceleration in the annual variation of its three components. IPA-DI varied 9.80%, against 9.44% in 2007, while IPC-Br and INCC rose by 6.07% and 11.87%, respectively, against 4.60% and 6.15%, in the previous year. One should highlight that the variation of IPA-DI in 2008 reflected rises of 1.64% in the prices of farming products and of 12.96% in the prices of industrial products.

2.2 Consumer price indices

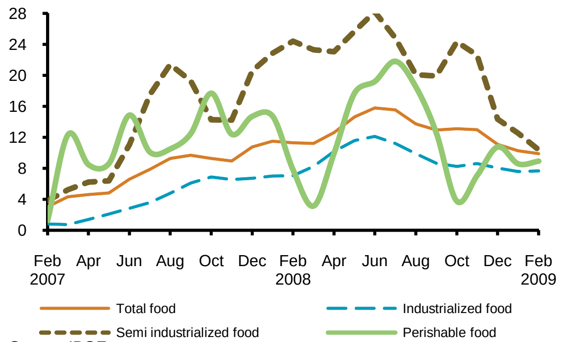
Changes in consumer price indices, impacted by seasonal pressures on the prices of perishable foodstuffs, increases in city bus fees and education-related costs, accelerated in the quarter ended in February, compared to that ended in November 2008.

Figure 2.2 – IPCA
Monthly % change



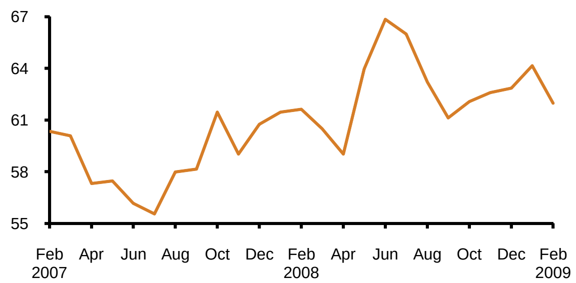
Source: IBGE

Figure 2.3 – IPCA – Food
12-month % change



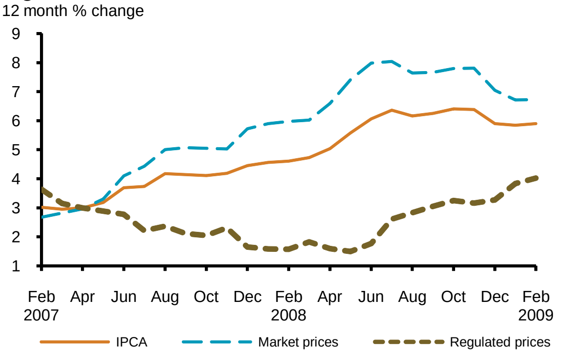
Source: IBGE

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



Sources: IBGE and Bacen

Figure 2.5 – IPCA
12 month % change



Sources: IBGE and Bacen

IPCA, released by IBGE, expanded 5.90% in 2008, against 4.46% in the previous year, registering rises of 3.27% in prices of government-regulated goods and services and of 7.05% in free prices, against 1.65% and 5.73%, respectively, in the previous year.

IPCA variation reached 1.32% in the quarter ended in February 2009, against 1.07% in that ended in November, a result of an upturn from 0.59% to 1.32%, in regulated prices, and from 1.28% to 1.31% in free prices. This behavior, consistent with the seasonality of the period and with the less vigorous domestic demand, reflected, to a large extent, price elevations of city bus fees, recreation, health plans, meals, *in natura* foodstuffs and training courses.

The prices of services, driven by the impact of education, expanded 2.96% in the quarter up to February, the greatest hike since February 2004, when expansion reached 3% in the same type of comparison. Considering twelve-month periods, the prices of services rose 7.09%, against 6.48% in November. It should be highlighted that the process of price formation in this segment is based on readjustment rules which incorporate past inflation, thus turning the inflationary trajectory of services more persistent and less sensitive to fluctuations of aggregated demand at the margin. In summary, prices of this segment should account for the lag in the pace of activity, showing gradual deceleration during the second half of the year.

The diffusion index – an indicator of the proportion of the number of items which displayed a positive variation in the IPCA, evincing the continuity of dissemination of price increases, registered an average of 61.98% in the quarter ended in February, against 62.59% in that ended in November.

The seasonal pressure over the price indices by the segment of courses tends to exhaust in the next months. This factor and the cutback in prices of important segments of the industrial sector should contribute to the deceleration of IPCA variation. One should highlight, however, that this movement may be partially neutralized by the effects on consumer prices of the increases observed in the prices of wholesale farming products in the latest months.

2.3 Regulated prices

The regulated prices rose by 3.27% in 2008, and accounted for 0.98 p.p. of the total IPCA variation in the

Table 2.2 – IPCA

% change

	Weights	2008			2009	
		Nov	Dec	Year	Jan	Feb
IPCA	100.00	0.36	0.28	5.90	0.48	0.55
Market prices	70.36	0.44	0.28	7.05	0.37	0.67
Regulated prices	29.64	0.18	0.29	3.27	0.75	0.28
Main items						
Electricity	3.24	0.16	0.14	0.97	-0.14	-0.36
Natural gas vehicle	0.13	2.43	1.69	21.39	4.13	-1.12
Pipeline gas	0.10	-2.26	-0.18	14.17	4.47	-1.10
Diesel fuel	0.09	0.12	-0.21	13.19	0.33	-0.34
Electricity	0.14	0.12	1.87	9.82	0.94	0.05
Tolls	1.35	0.00	0.00	-2.82	0.00	0.13
Water and sewage	1.62	0.00	0.00	7.09	0.00	0.00
Urban bus	3.77	0.00	0.89	2.16	3.24	1.03
Air ticket	0.30	0.73	1.31	10.73	0.87	0.82
Gasoline	4.20	0.21	-0.09	-0.17	0.42	-0.04
Bottled cooking gas	1.11	0.23	-0.18	2.61	0.13	-0.41
Medicine	2.83	0.15	-0.11	4.09	0.61	0.34
Health plans	3.38	0.48	0.48	5.66	0.47	0.48

Source: IBGE

Table 2.3 – Consumer prices and core inflation

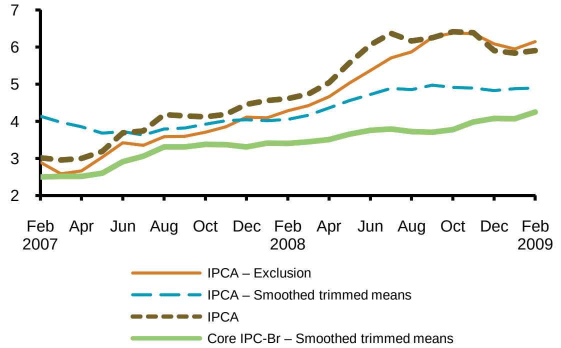
Monthly % change

	2008			2009	
	Oct	Nov	Dec	Jan	Feb
IPCA	0.45	0.36	0.28	0.48	0.55
Exclusion	0.51	0.36	0.33	0.27	0.88
Trimmed means					
Smoothed	0.37	0.35	0.33	0.42	0.29
Non smoothed	0.32	0.28	0.33	0.44	0.27
IPC-Br	0.47	0.56	0.52	0.83	0.21
Core IPC-Br	0.31	0.45	0.34	0.35	0.33

Source: IBGE, Bacen and FGV

Figure 2.6 – Core inflation

12-month % change



Source: IBGE, Bacen and FGV

year. The greatest rising pressures occurred in the items vehicle fuel gas, 23.44%; piped gas, 13.96%; diesel oil, 12.95%; air fares, 12.18%, the latter reflecting the behavior of the prices of energy *commodities* ; and toll, 11.88%; while, conversely, the mobile phone fees fell off 2.82% and the price of gasoline, 0.26%.

The groups of IPCA free and regulated prices showed variations of 1.31% and 1.32%, respectively, in the quarter ended in February, against 1.28% and 0.59% in that ended in November. Variation of regulated prices represented 0.39 p.p. of the 1.32% IPCA inflation, in this period.

The intermunicipal bus fees expanded 5.97% in the quarter, while those of urban buses, translating rises registered in Curitiba, 15.80%; Belém, 13.33%; Salvador, 10%; Belo Horizonte, 9.53%; Porto Alegre, 7.62%; and Rio de Janeiro, 4.76%, expanded 5.23%. The prices of medicines rose 0.84% in the quarter, contrasting with the cutback of 0.36% registered in the item electric energy.

2.4 Inflation core

The inflation core measures showed, on average, less intensive variation in the quarter ended in February than in that ended in November 2008, registering cutbacks in the respective variations in twelve months, which, however, stand above the central value for the inflation target.

IPCA core, calculated by the exclusion of regulated prices and foodstuffs in the household, grew 1.49% in the quarter ended in February, same variation registered in that ended in November. The twelve-month variation of the indicator, moved from 6.36%, in November, to 6.14% in February.

The core, calculated by smoothed trimmed averages showed an increase of 1.04%, against 1.18% in the September to November 2008 period, accumulating, 12-month expansions of 4.89% in February and 4.90% in November. The quarterly variation of inflation core by trimmed averages without smoothing reached 1.04%, against 1.02% in the quarter ended in November, accumulating 12-month variation of 4.85% in February, against 5.05% in November.

The inflation core for FGV's IPC-Br, calculated by the method of trimmed averages, showed a rising trend in the quarter ended in February, expanding 1.02%, against 0.98% in the quarter ended in November.

2.5 Market expectations

Figure 2.7 – IPCA
Median

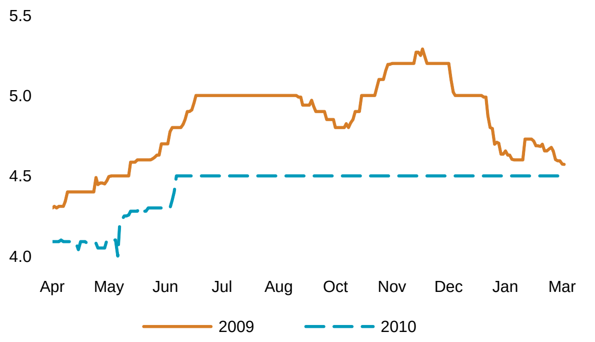


Figure 2.8 – IGP-M e IPA-DI
Median 2009

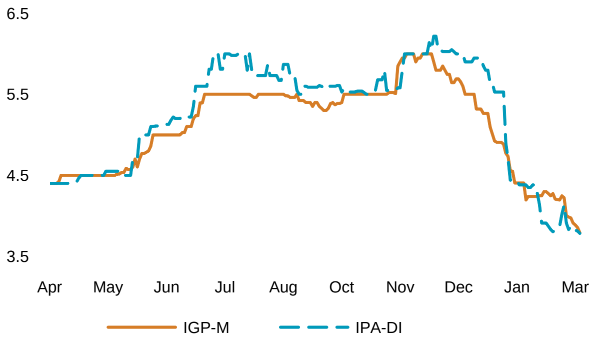


Figure 2.9 – Exchange
Median 2009

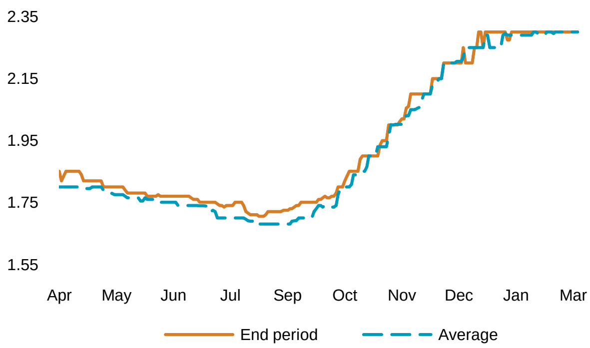


Table 2.4 – Summary of market expectations

	9.30.2008		12.31.2008		3.6.2009	
	2009	2010	2009	2010	2009	2010
IPCA	4.9	4.5	5.0	4.5	4.6	4.5
IGP-M	5.4	4.5	5.3	4.5	3.8	4.5
IPA-DI	5.6	4.7	6.0	4.7	3.8	4.6
Regulated Prices	5.1	4.5	5.1	4.5	4.7	4.5
Selic (end-of-period)*	13.8	12.0	12.0	11.5	10.3	10.3
Selic (average)*	14.2	12.4	12.4	12.0	10.8	10.2
Exchange rate (end-of-period)	1.80	1.89	2.30	2.25	2.30	2.28
Exchange rate (average)	1.78	1.85	2.25	2.22	2.30	2.25
GDP growth	3.5	4.2	2.4	3.9	1.2	3.5

The 2009 inflation expectations, gathered by the Executive Investors Relations Group (Gerin), retroactive to the end of the final quarter of 2008, situated near the official target of 4.5%, established by the National Monetary Council (CMN) for the IPCA. On March 6, the median of forecasts estimated a 4.6% variation for the IPCA in 2009, against 5% at the end of 2008. For 2010, inflation expectations remained anchored at the target center of 4.50%. The median of inflation expectations for twelve months ahead – smoothed – reached 4.50% in the first week of March, as compared to 5% at the end of December.

The medians related to General Price Index – Market (IGP-M) and to IPA-DI for 2009 fell back to 3.80% in the first week of March, against 5.30% and 6%, at the end of December, in the same order. For 2010, the forecasted median for IGP-M remained at 4.50%, while that related to IPA-DI was revised from 4.70% to 4.60%.

The median of expectations of regulated price variation for 2009 was reduced from 5.10%, at the end of December, to 4.70%, at the beginning of March, remaining unaltered at 4.50% for 2010.

In spite of intense volatility and risk aversion experienced by the international markets in the latest months, the median of the forecasted exchange rate for the market to end of this year remained stable at R$2.30 since the end of December 2008, reproducing somehow the behavior observed in the latest months in the spot market. The median for the foreseen average rate of exchange for 2009 moved from R$2.25/US$, at the end of December, to R$2.30/US$, at the beginning of March, while those related to the average and end of period rates for 2010 rose, respectively, from R$2.22/US$ to R$2.25/US$, and from R$2.25/US$ to R$2.28/US$, in the considered periods.

The worsening of the economic crisis resulted in strong adjustments in the growth forecasts for the Brazilian economy in 2009. In the first week of March, the median of forecasts for the GDP growth in the year reached 1.2%, against 2.4% at the end of 2008. The median of forecasts for GDP growth in 2010 was reduced, though in a less intense fashion, falling from 3.9%, at the end of December, to 3.5%

With the economic slowdown, the expectations survey participants started forecasting, also, a greater cutback in the basic interest rate. In this sense, the median related to Selic rate forecasted for the end of 2009 moved from 12% p.y., at the end of December, to 10.25% p.y., in the first week of March. For 2010, the median related to 2010 retroacted from 11.5% p.y. to 10.25% p.y., in the period.

2.6 Conclusion

The rise in consumer inflation rates at the beginning of 2009 reflected the readjustments in public transportation fees, the annual increase of education costs, and seasonal factors, such as the rise in the prices of perishable foodstuffs. The behavior of these prices should start reflecting, in the coming months, the cutbacks in the wholesale prices of relevant industrial prices in the productive chain. In this scenario, the expectation, that the annual IPCA variation will meet the inflation target established by CMN, assumes neater contours.

Credit, monetary and fiscal policies

3

3.1 Credit

The National Financial System's credit operations trajectory, after reflecting, in the quarter ended in November, both the impact of the worsening crisis in the international financial markets concerning the external financing conditions, and, in the domestic scenario, the process of reduction of maturities and greater selectivity in credit granting, started to mirror, in the quarter ended in February 2009, the scenario of deceleration of economic activity, partly linked to the restriction of credit channels. In this scenario, the unfavorable evolution of expectations as regards employment conditions, income and production negatively affected the demand for resources on the part of households and the productive sector. Outstanding in the framework of uncertainties associated to the persistence of the international financial crisis, was the performance of operations backed by earmarked resources, mainly aimed at investments in infrastructure and housing.

The balance of credit operations reached R$1, 230.9 billion in February, expanding 1.9% in the quarter and 28.3% in twelve months, turning to represent 41.6% of GDP, the greatest value of the historical series initiated in July 1994. The balance of operations in national private bank portfolios came to 42.3% of the total, in the period, followed by those related to government-owned banks, 37.1%, and to the banks with foreign capital control, 20.6%.

Viewed by activity sector, loans to the private sector summed up R$1,203 billion, 97.7% of the total, and those channeled to the public sector, R$27.9 billion. One should highlight that, in the period, the expansion of 3.1% in credit granted to industry, with emphasis to the sectors of chemicals, automotive vehicles, foodstuffs and aeronautics, contrasting with the cutbacks registered in the loans granted to trade, 4.4%, reflecting seasonal factors; and to the segment of other services, 1.4%. Credit operations contracted by the public sector grew 14.3% in relation to November, boosted by the 35.3% expansion in financing channeled to the federal

Table 3.1 – Credit operations

R$ billion

Itemization	2008				% growth	
	Jul	Aug	Sep	Oct	3 months	12 months
Total	1 085.9	1 110.3	1 152.8	1 186.6	9.3	34.6
Nonearmarked	778.4	798.4	829.2	850.3	9.2	37.3
Earmarked	307.5	311.9	323.6	336.3	9.3	28.2
% participation:						
Total/ GDP	37.1	38.0	39.2	40.2		
Nonearmarked/GDP	26.6	27.3	28.2	28.8		
Earmarked/GDP	10.5	10.7	11.0	11.4		

Figure 3.1 – Credit by capital control of financial institutions

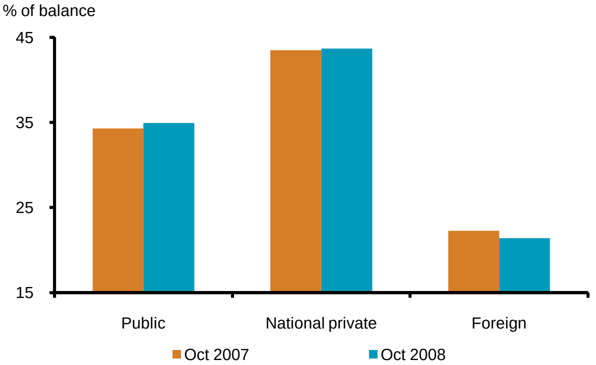


Figure 3.2 – Credit by borrower's economic activity – National private institutions

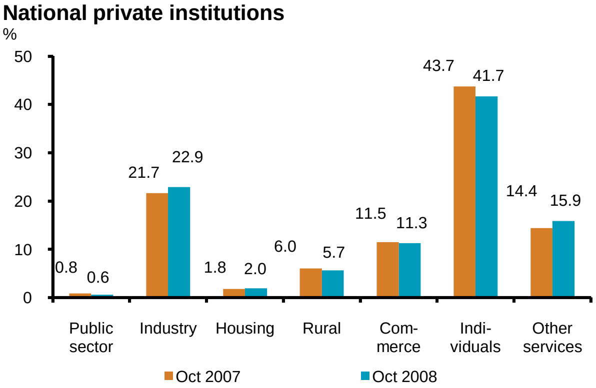


Figure 3.3 – Credit by borrower's economic activity – Public institutions

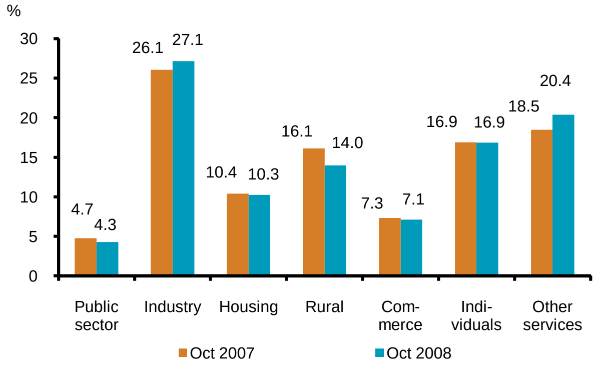


Figure 3.4 – Credit by borrower's economic activity – Foreign institutions

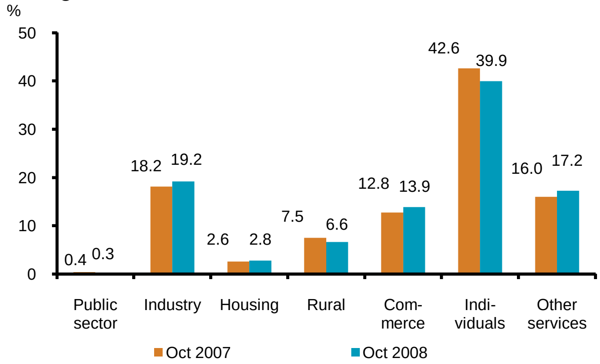


Figure 3.5 – Provisions of total financial system credit

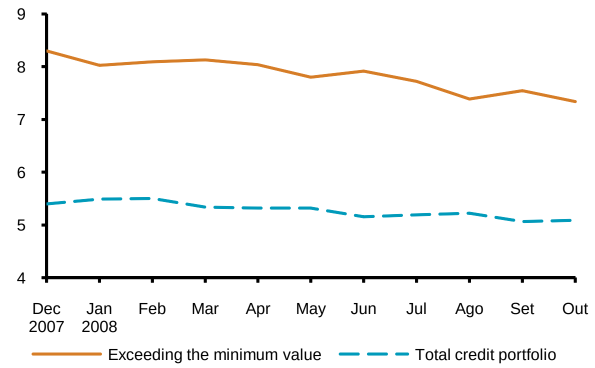


Table 3.2 – Earmarked credit operations

R$ billion

	2008				% growth	
	Jul	Ago	Set	Out	3 months	12 months
Total	307.5	311.9	323.6	336.3	9.3	28.2
BNDES	176.1	177.8	185.1	195.1	10.8	28.3
Direct	84.1	86.9	91.3	98.2	16.7	34.5
Onlendings	91.9	90.8	93.8	96.9	5.4	22.6
Rural	72.4	73.1	75.3	76.1	5.2	23.9
Banks and agencies	68.5	69.0	70.5	71.0	3.8	22.1
Credit unions	3.9	4.1	4.8	5.1	29.8	54.2
Housing	51.2	53.0	55.0	56.5	10.4	36.0
Others	7.9	8.1	8.2	8.6	8.6	19.1

government, with highlights to the outflows related to the petroleum segment.

Provisions constituted by the financial system totaled R$79.2 billion in February, rising 24.8% in the quarter. The ratio between the values provisioned and the total credit portfolio stood at 6.4%, against 5.3% in November, while total default of the financial system's credit operations, considering installments in arrears for over ninety days, moved from 3% to 3.4%, in the period.

Earmarked credit

Loans with earmarked resources totaled R$361.9 billion in the quarter ended in February, registering increases of 4.7% in relation to November and of 29.5% in twelve months. This performance was driven, especially, by loans granted by the National Bank of Economic and Social Development (BNDES) and by credits granted to the housing segment.

Loans granted by BNDES totaled R$212.6 billion in February, representing 58.8% of earmarked credit. The 5.4% expansion in relation to November resulted from increases of 7.3% in direct operations and of 3.5% in transfers to the financial system. Disbursements totaled R$90.9 billion in 2008, a volume 40% higher than in 2007, with emphasis to growth of 47.5% in credits channeled to industry, with the sectors of foodstuffs and beverages taking the lead. Credit granting to trade and services expanded 38.3%, with highlights on the demand from the sectors of land transportation and telecommunications.

The balance of loans to the rural sector came to R$77.6 billion in February, rising 0.5% in relation to November 2008. The current expenditures operations concerning the 2008/2009 harvest expanded 2.7%, while operations with investment on machinery and equipment grew 2.2%. Credits targeted to agricultural marketing registered growth of 3.2% in the quarter. The relative participation of these modalities in the total amount of rural credit began representing 42.2%, 9.4% and 48.4%, respectively.

Housing loans, which encompass the financing for acquisition and construction of dwellings, summed up R$62.6 billion, registering increases of 7.3% in relation to November 2008 and of 40.3% in twelve months. Savings-backed credit granting, which account for the most significant share of this balance, expanded 58.7% in 2008, reaching R$28 billion, with highlights to the operations aimed at

Table 3.3 – BNDES disbursements

R$ million

Itemization	Jan-Oct		% growth
	2007	2008	
Total	49 818	70 164	40.8
Industry	20 896	28 942	38.5
Mining	788	2 177	176.3
Food products	3 812	7 309	91.7
Vehicle, towing truch and wagon	2 069	3 697	78.7
Petroleum and alcohol refining	1 415	2 371	67.6
Commerce/Services	24 937	36 892	47.9
Overland transportation	9 337	14 647	56.9
Electricity and gas	4 273	6 765	58.3
Construction	2 231	3 079	38.0
Telecommunication	3 031	5 220	72.2
Crop and livestock	3 985	4 329	8.6

Source: BNDES

Figure 3.6 – Credit to housing with resources from saving deposits – January-September

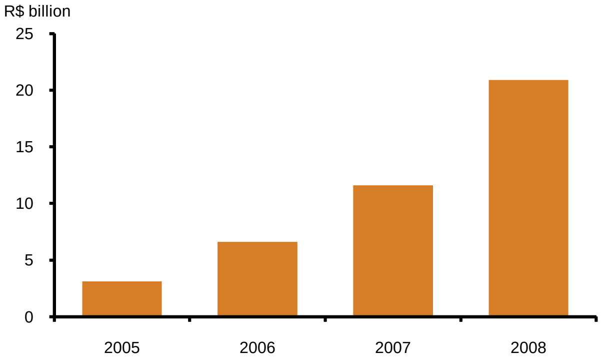


Table 3.4 – Nonearmarked credit operations

R$ billion

Itemization	2008				% growth	
	Jul	Aug	Sep	Oct	3 months	12 months
Total	778.4	798.4	829.2	850.3	9.2	37.3
Corporations	408.9	423.2	444.8	458.4	12.1	45.9
Reference credit1/	338.8	349.3	368.5	379.1	11.9	46.2
Domestic funding	265.8	274.7	284.5	290.9	9.5	49.6
External funding	73.0	74.6	84.0	88.2	20.8	36.1
Leasing2/	48.0	50.8	53.7	54.4	13.3	71.9
Rural2/	2.3	2.5	2.8	3.2	37.4	70.3
Others2/	19.8	20.5	19.8	21.7	9.8	1.6
Individuals	369.5	375.2	384.3	391.9	6.1	28.4
Reference credit1/	266.2	268.5	270.5	273.4	2.7	16.5
Credit unions	14.8	15.4	16.0	16.5	11.6	37.5
Leasing	49.0	51.3	54.3	55.7	13.6	116.3
Others	39.4	40.1	43.5	46.3	17.4	41.3

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

acquisition of dwellings. The contracting of resources from the Employment Compensation Fund (FGTS) totaled R$6.3 billion, increasing 7.2% in the year.

Nonearmarked credit

Credit operations with nonearmarked resources came to R$868.9 billion in February, registering rises of 0.7% in relation to November and of 27.8% in twelve months. The participation of these loans in the entire financial system's credit balance stood at 70.6%. Operations carried out with corporate entities represented a cutback of 1.4% in the quarter and an upturn of 32.9% in twelve months, reaching R$464.9 billion, while those carried out with individual persons registered respective increases of 3.3% and of 22.3%, totaling R$404.1 billion.

In the context of credit to corporate entities, it is worth highlighting the performance of working capital loans, translating the increased demand of large-sized companies and the exporting segment in an environment of restricted liquidity in foreign markets and downturn in capital markets. Conversely, trade-related credit lines posted a decline, evincing a lower seasonal balance of transactions at the beginning of the year and the downturn of economic activity.

Financing with external resources totaled R$88.6 billion in February, registering a cutback of 4.5% in relation to November and expansion of 24.5% in twelve months. The scarcity of these lines, as of September 2008, was progressively offset by the supply of foreign currency in auctions carried out by the Central Bank of Brazil (BCB), which benefited, especially from operations of Advances on Exchange Contracts (ACC).

The deceleration observed in credit modalities to individual persons, as of the beginning of 2008, sharpened in the latest months of the year. Personal credit loans, revealing adjustment, registered expansions of 2.1% in the quarter and of 22.1% in twelve months, with emphasis to the reduction, from 56.3%, in February 2008, to 54.4%, of the participation of guaranteed credit in this portfolio.

Credit channeled to acquisition of vehicles, incorporating the operations of mercantile leasing and the traditional loans, expanded 4%, in the quarter, as a consequence of a 12.8% increase in leasing operations to individual persons and a cutback of 2% in the other financing modalities. The balance of the modalities overdraft check and credit card showed

Average Interest Rate of the National Financial System's Credit Operations

The current structure for monitoring the evolution of interest rates and spreads of the National Financial System (SFN) credit operations originated in 1999, with the project “Interest and Banking Spread”, which comprises the release of the annual report “Banking Economy and Credit”[1]. Several studies based on this project enabled a better understanding about the composition of spreads and thus contributed directly or indirectly to the adoption of measures aimed at the reduction of credit associated costs. Among these studies, it should be mentioned the regulation of payroll-deducted loans, the creation of the Banking Credit Note (CCB), the Bankruptcy Act, the dissemination of the instruments of fiduciary alienation, and the legislation on assets affected by public interest in real estate undertakings.

The “Interest and Banking Spread” project was regulated by Circular n. 2,957, dated December 30, 1999. This Circular stipulated that financial institutions should provide detailed information on the most relevant credit operations at the time, which would constitute the reference credit for interest rates. Since available information on SFN’s credit operations is restricted to the modalities that compose the subset of the reference credit, the effective average interest rate of the financial system generally differ from that currently released by the Central Bank.

The goal of this box is to analyze how the inclusion of those modalities of credit operations not currently taken into account affects the SFN’s average rate. For this, the calculation basis of the SFN’s average interest rate will be expanded so as to incorporate a

1/ Available on http://www.bcb.gov.br/?SPREAD broader set of credit modalities, by utilizing reference values for the rates practiced in the modalities not previously taken into consideration. The calculation basis will now incorporate the interest rates related to operations carried out by leasing companies and credit unions, as well as those granted with earmarked resources, which encompass the National Bank of Economic and Social Development (BNDES) financing, as well as rural and housing loans[2].

With regard to the interest rates of the new modalities classified as nonearmarked credit operations, the effective monthly rates of similar modalities during the period under analysis were utilized as proxies[3]. Therefore, for corporate and individuals' leasing operations, the latter channeled particularly to the acquisition of vehicles, the rates utilized refer to the modalities of purchase of goods – corporations and purchase of goods – vehicles, which correspond, respectively, to 19% p.y. and 36.5% p.y., in December 2008[4]. For mutual loan operations, granted by credit unions, the interest rate utilized is of 30.8% p.y., which corresponds to the average interest rate of payroll-deducted loans, while the interest rate related to credit card, based on market research, was calculated at 248.2% p.y. in December.

In the segment of credit operations with earmarked resources, the interest rate of housing loans was estimated at 12.2% p.y., calculated on the basis of a mix of lending rates practiced in the framework of the Brazilian System of Savings and Loans (SBPE) and the Employment Compensation Fund (FGTS). The interest rate for the rural loans granted with monitored resources was stipulated at 6.9% p.y. This constitutes the lowest rate practiced by the SFN, taking as parameter the average rate of the operations with resources from demand deposits and rural savings accounts, foreseen in the Rural Credit Manual (MCR)[5].

Table 1 – Reference parameters for calculating SFN interest rates in December 2008

Modality	Interest rate – % p.y.	Reference
Nonearmarked credit		
Leasing (individuals)	33.38	Credit for vehicle acquisition
Borrower by co-op	30.80	Payrol-deducted loans
Credit card	248.20	Market survey
Leasing (corporation)	17.91	Goods acquisition – Corporations
Earmarked credit		
Rural	6.92	Rural credit manual
Housing	12.22	Average weighted rate in SFH financing
BNDES – Direct	8.05	TJLP + 1.8% p.y.
BNDES – Onlending	12.39	BNDES direct + 4.34% p.y.

2/ It should be observed that the regular calculation of an interest rate that could represent the total of credit operations would require the enhancement of the normative and operational credit monitoring apparatus by means of which the financial system would supply information on the rates of earmarked operations and the share of nonearmarked credit that are not currently included in the reference credit for the calculation of interest rates.

3/ It should be highlighted that the estimated series took into account the effective monthly rates of the period under analysis, from March 2003 to December 2008. December 2008 rates are based on the Central Bank's Monetary Policy and Credit Operations Press Release, available at http://www.bcb.gov.br/?ECOIMPOM.

4/ Rates were adjusted to effective tax differences.

5/ Chapter 2 – Basic conditions, Section 4 – Expenditures, item 3, paragraph a. There are several exceptions to this interest rate. In 2006, interest rates varied from 1% p.y. (Pronaf – Semi-Árido – Resolution n. 3,206/2004 (MCR-10-8)), and 12.34% p.y. (Finame Agrícola Especial – Resolution n. 3,215/2004).

The interest rate of direct BNDES loans is composed of the financial cost, related to the funding of resources, by the rate of credit risk, and by the BNDES interest earnings. Taking as reference the Long-Term Interest Rate (TJLP)[6], 6.25% p.y., and adding 1.8% p.y. which refers to the interest earnings and credit risk rate, the final rate reaches 8.05% p.y. As for indirect loans, carried out through transfers to financial institutions, it should be added, to the TJLP and the BNDES interest earnings, the intermediation rate, limited to 0.8% p.y., as well as the earnings of the authorized financial institution. If the authorized financial institution utilizes the Competitive Enhancement Guaranty Fund (FGPC), which guarantees up to 80% of the operation's risk, this share of the cost is limited to the ceiling of 4% p.y. The costs associated to the last two factors analyzed totals 4.34%, thus resulting in a final rate of 12.39% p.y.

Based on these parameters, as observed on Figure 1, the SFN's average rate, comprising 86.3%[7] of the country's total credit operations, would fall to 30.9% p.y. in December 2008, compared to 43.2% p.y. in compliance with the current methodology. Over the last two months, the expanded average rate increased by 5.3 p.p., as compared to 9.4 p.p. according to the current rate calculation. In general, it may be observed that the new series register a smoother evolution, since the response of earmarked credit operations to alterations in the monetary policy is not so intense as that of nonearmarked credit operations (Figure 2). With the inclusion of the aforementioned operations, the banking spread, in the month of December, would drop from 30.6 p.p. to 20.2 p.p. per year.

Moreover, changes in the calculation basis would increase the participation of credit operations with individuals, including the housing credit operations,

Figure 1 – Credit operations

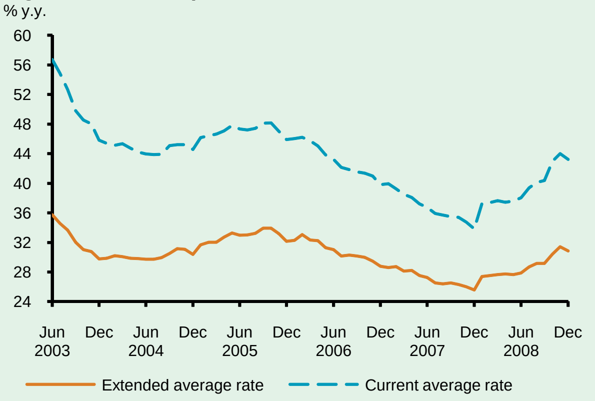
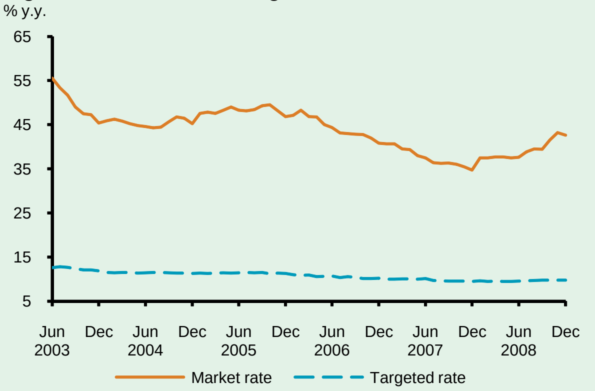


Figure 2 – Extended average rate



6/ Other indexing factors not taken into account include the National Extended Price Index (IPCA) and the Exchange variation.7/Rates were adjusted to effective tax differences.

7/ The calculation of the expanded interest rate does not include operations classified as "sundry" in the segment of corporations and individuals (anticipation of deposits, pledge), since their rates are excessively volatile and not homogeneous. In addition, in some operations classified as fixed-rate operations it is impossible to identify the indexing factor and thus the exact operation cost estimate. Finally, for some earmarked credit operations carried out with constitutional funds by fostering agencies and development banks, there are no available information on rates.

Figure 3 – Credit operations – Corporations

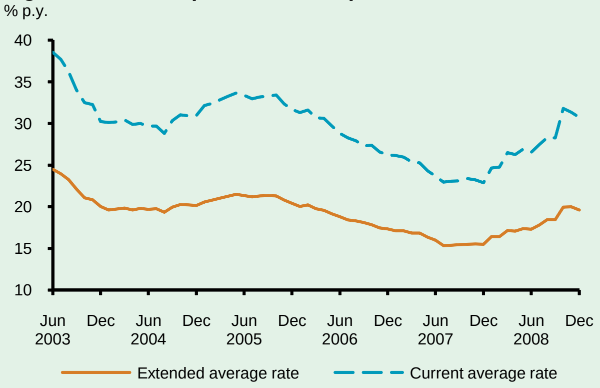


Figure 4 – Credit operations – Individuals

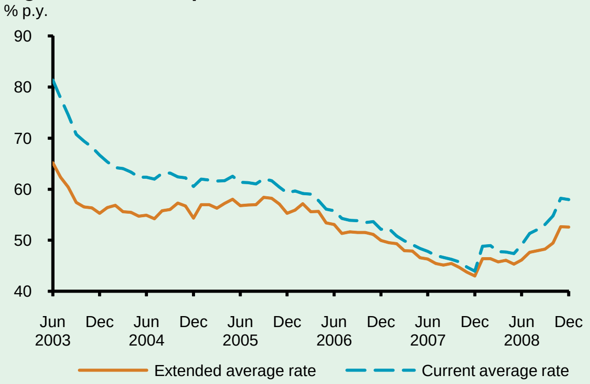


Table 2 – Interest rates and banking spread

December 2008

	Individuals	Corporations
Scope[1/] (%)	89.3	84.6
Interest rate – Current methodology (%)	58.0	30.7
Interest rate – Alternative methodology (%)	52.6	19.6
Spread – Current methodology (p.p.)	45.1	18.3
Spread – Alternative methodology (p.p.)	39.8	8.5

1/ Refers to the SFN total balance of credit.

to 89.3%. The interest rate in this segment would fall from 58% p.y., according to the current sample, to 52.6% p.y, while the spread would fall from 45.1 p.p. to 39.8 p.p. With regard to corporate credit operations, participation would increase to 84.6%, and average interest rate and spread would fall, respectively, from 30.7% p.y. to 19.6% p.y., and from 18.3 p.p. to 8.5 p.p.

It is interesting to highlight that, as shown by Figures 3 and 4, the expanded average interest rate in the segment of corporations also remain lower in the period under analysis, while, in the segment of individuals, the rates are convergent. The behavior of the rates for individuals reflects, to a large extent, the inclusion of credit card operations, which rates are higher than the average, as opposed to the housing loans rates. As for operations with corporations, it should be highlighted the effect of the inclusion of longer-term loan operations, particularly with earmarked resources, with emphasis on the long-term BNDES loans. Finally, the reduction of the interest rates practiced in the framework of the productive sector evinces the significant difference still observed between the rates associated to earmarked and nonearmarked credit operations.

The forecasts shown in this box not only constitute a more comprehensive description of the credit market but also demonstrate that the SFN's effective average interest rates differ significantly from that currently released if earmarked credit operations are also taken into account. Therefore, the improvement of statistics, as well as the institutional framework that underlie its elaboration, would make it possible to achieve a more comprehensive and accurate view of the evolution of credit operations.

Figure 3.7 – Interest rates on nonearmarked credit

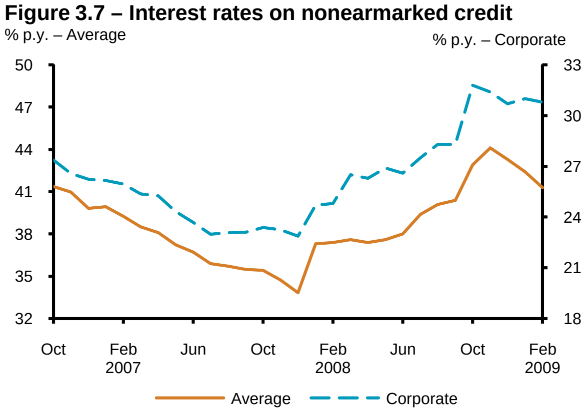


Figure 3.8 – Interest rates on fixed rate credit – Individuals

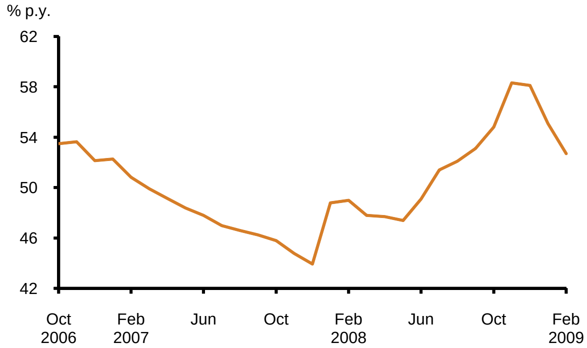


Figure 3.9 – Average spread on nonearmarked credit

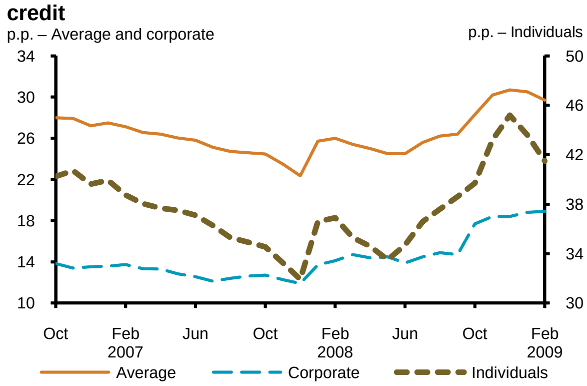
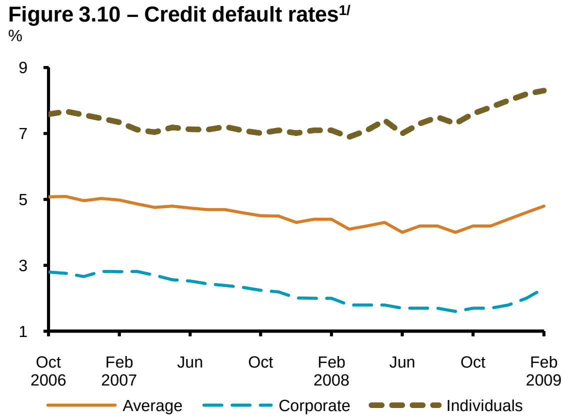


Figure 3.10 – Credit default rates[1/]



significant advances, a movement which, coupled with the accommodation of personal credit, tends to alter the profile of household' indebtedness, with greater participation of credit lines with higher costs and shorter maturities.

The average interest rate levied on referential credit operations reached 41.3% p.y. in February, registering a quarterly cutback of 2.8 p.p. and increase of 3.9 p.p. in twelve months. By segment, the average rates carried out in operations with corporate entities and individuals stood, in the order, at 30.8% p.y. and 52.7% p.y., registering expansions of 6 p.p. and 3.7 p.p. when compared to February 2008. Although, at the margin, the rate registered a cutback, its annual evolution was associated, especially, to the hike observed in October, in response to the increases of funding costs and to the restrictions of financial institutions to granting of new loans, after the aggravation of the crisis on the international financial markets.

In this context, the banking spread reached 29.7 p.p. in February, with contraction of 0.5 p.p. in the quarter and expansion of 3.7 p.p. in twelve months. The quarterly evolution reflected a cutback of 1.7 p.p., to 41.5 p.p., in loans contracted by households, and expansion of 0.5 p.p., to 18.9 p.p. in those contracted with the corporate segment.

Default from reference credit, considering operations in arrears above ninety days, reached 4.8% in February, registering increases of 0.6 p.p. in three months and of 0.4 p.p. in twelve months. Considering the operations with corporate entities, the indicator reached 2.3%, with expansions of 0.6 p.p. in the quarter and of 0.3 p.p. in twelve months, while in loans contracted by households, default reached 8.3%, rising, in the order, 0.5 p.p. and 1.2 p.p. on the same basis of comparison.

The average maturity of the referential credit portfolio reached 380 days in February, rising by two days in the quarter and eleven days in twelve months. The quarterly evolution reflected the occurrences of increase of 15 days in the average maturity of operations in the segment of individuals and reduction of 10 days in those referring to corporate entities, which stood, in the order, at 498 and at 294 days.

3.2 Monetary aggregates

The average daily balance of money supply (M1) reached R$198.9 billion in February, showing expansions of 1.9% in relation to November and of 6.2% in twelve months, period in

Figure 3.11 – Average term for credit operations – Calendar day

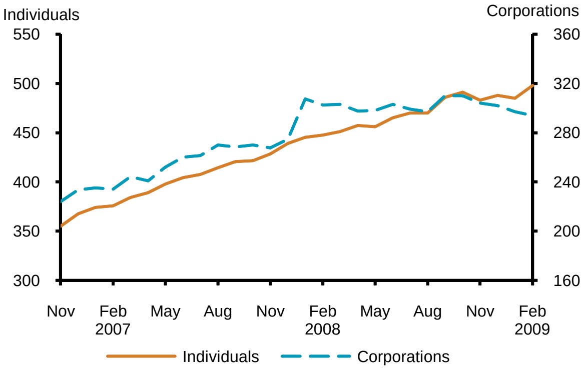


Figure 3.12 – Monetary base and M1 – Average daily balances

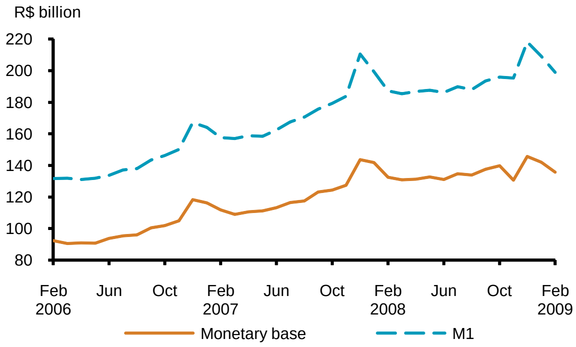
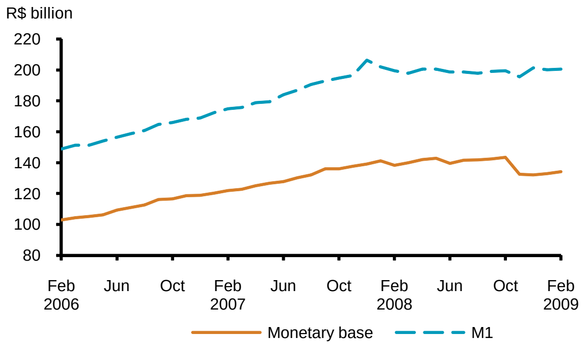
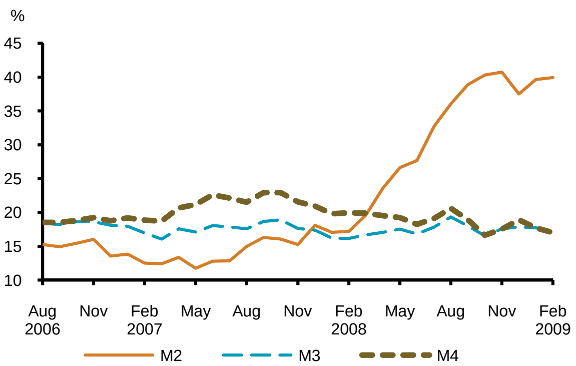


Figure 3.13 – Monetary base and M1 at February 2009 prices seasonally adjusted1/



1/ Deflated by: IPCA.

Figure 3.14 – Broad money supply 12-month growth



which the average balances of currency held by the public and of demand deposits registered respective increases of 14.6% and 0.8%. Considering seasonally adjusted data deflated by IPCA, M1 grew 2.6% in the quarter ended in February.

The monetary base assessed by the average of daily balances, reached R$135.9 billion in February, showing elevations of 4% in the quarter and of 2.5% compared to February 2008. The average balance of currency issued expanded by 14.4% in twelve months, while the banking reserves fell by 23.7%, reflecting the reduction, from 45% to 42%, of the rate of reserve requirements over demand resources, as of October 29, in addition to deductions resulting from contributions anticipated by the financial institutions to the Credit Guarantee Fund (FGC).

With reference to the sources of primary currency issuance, one should highlight, in the quarter ended in February, the expansionary impact underlying the reserve requirements over time deposits, R$4.1 billion, and the additional requirement over deposits, R$42.1 billion, in which case the compliance started to be carried out with public federal securities as of December 2008. Conversely, the reserve requirements over deposits in savings accounts and net sales of foreign exchange by the Central Bank on the interbank exchange market caused a contractionist effects of R$966 million and R$9.6 billion, respectively. The impact of these factors, associated to the net placements of R$31.8 billion in National Treasury bonds, resulted in expansion of R$3.9 billion in the monetary base in the quarter, considering the end-of-period balance.

Complementary to the alterations over the rules of reserve requirements, the Central Bank reduced, from 5% to 4%, the rate of the additional requirement over the time resources, effective as from January 19.At the same time, Circular 3,427, of December 19, 2008, reduced the in-kind share of collections over time deposits from 70% to 60%, included the interfinancial deposits gathered from leasing companies among the values subject to collection of time resources and extended, up to March 31, 2009, the time period required for acquisitions of assets and investments on interfinancial deposits among financial institutions, with the benefit of deduction of reserve requirements.

Expanded money supply, in the M2 concept, increased 2.6% in the quarter ended in February, reaching R$1 trillion. Savings deposit grew 3.9%, totaling R$274.5 billion, favored by the December seasonality, while the private bonds, following the behavior of time deposits, expanded 3.4%.

With reference to the M3 concept, which aggregates to the M2, the investment fund quotas and public federal securities which back up the net financing position in repo operations, and money supply rose by 2.9%, in the quarter, totaling R$1.9 trillion. The M4 concept expanded 3.2%, totaling R$2.3 trillion.

Federal public securities and Central Bank open market operations

In the quarter ended in February, the National Treasury primary operations with public federal securities resulted in an expansionist monetary impact of R$39.1 billion, registering placements of R$79.1 billion, maturities of R$116 billion and anticipated purchases and redemptions of R$2.2 billion. Swap operations came to R$12.8 billion. The Central Bank's open market net financing position, based on the average of daily balances, rose by 36.4% in the quarter, totaling R$383.9 billion.

The Central Bank's financing and very short-term go-round operations, carried out with the aim of adjusting the financial system's liquidity conditions, expanded from R$86.6 billion, in November, to R$101.8, in February. The operations with maturities of two weeks up to three months and of five months showed respective increases from R$150.7 billion to R$240.7 billion, and from R$12.8 billion to R$15.1 billion, while those with seven months maturity decreased from R$31.8 billion to R$26.3 billion.

Real interest rates and market expectations

The future interest rate curve of the ID x Fixed-rate swaps showed, in February, an inclination reduction for all vertices relative to November. This movement, evincing the expectations of basic interest rate reduction in 2009, revealed itself sharper in the vertices with maturity less than one year. The 360-day swap DI x pre suffered a contraction of 381 b.p. in relation to the previous quarter, reaching 10.62% p.y. at the end of the period, the lower value of the series.

The real ex-ante Selic rate for the next twelve months, based on the on the Market Report survey, dated February 27, conducted by the Central Bank, reached 5.8% p.y., against 7.8% p.y., in November. This reduction reflected, especially, the cutback from 13.73% p.y. to 10.69% p.y., in the expectations for the 12-month Selic rate.

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

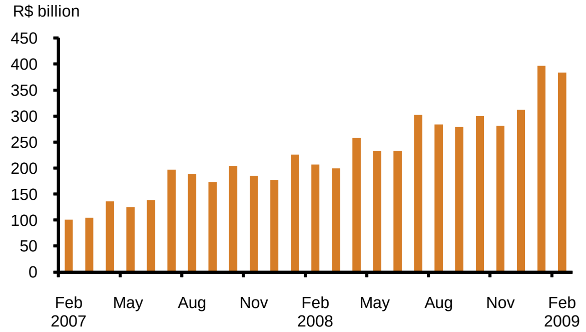


Figure 3.16 – Central Bank repo operations – Maturity – Aveage daily balances

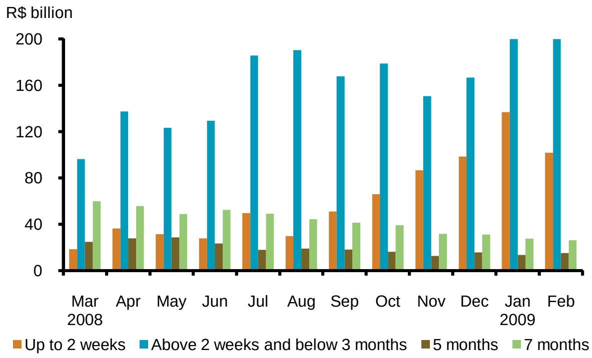
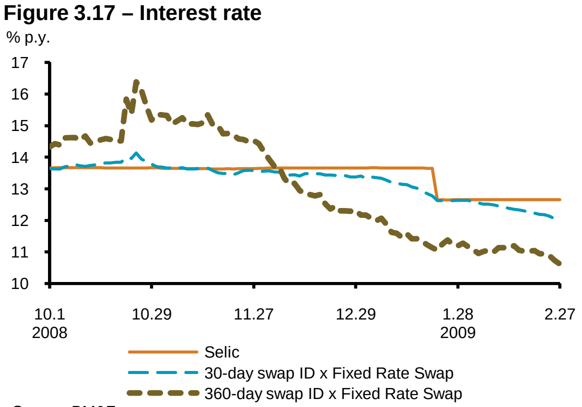


Figure 3.17 – Interest rate



Source: BM&F

Figure 3.18 – Ex-ante real interest rate – Deflated by 12-month IPCA expectations
% p.y.

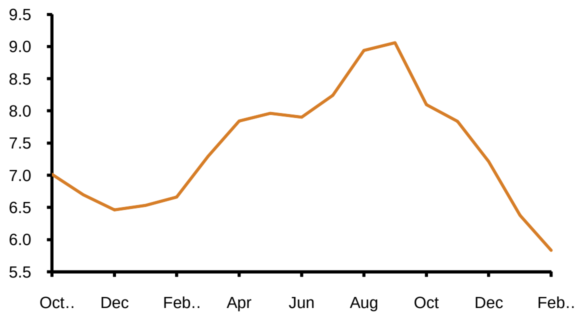
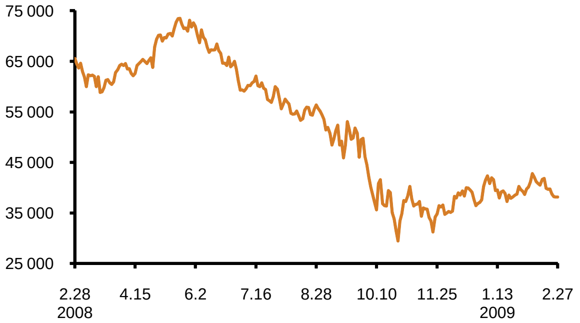


Figure 3.19 – Ibovespa
Points



Source: Bovespa

Figure 3.20 – Stock exchanges
January 2008 = 100

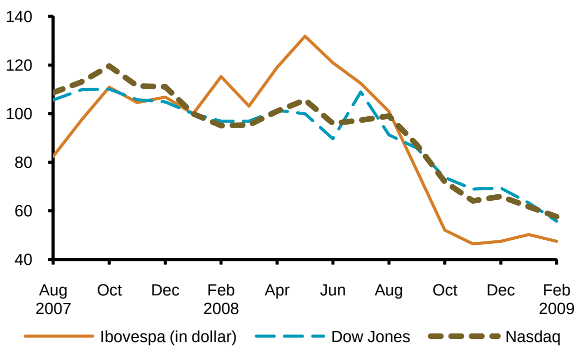
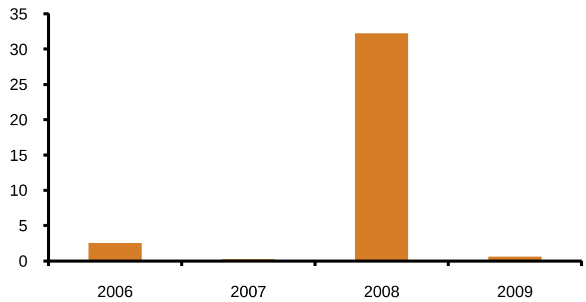


Figure 3.21 – Debenture primary issues in the capital market
R$ billion – Accumulated through February



Source: CVM

Capital market

The São Paulo Stock Exchange Index (Ibovespa), after undergoing sharp losses during the second half of 2008, showed relative recovery in the quarter ended in February, rising 4.3% against the quarter ended in November, coming to 38,183 points. The market value of companies listed in the index, after successive reductions, increased by 4.6% in the quarter, coming to R$1.42 trillion at the end of February, against R$2.42 trillion in the same period of 2008. The average daily balance of Bovespa transactions, following the reduction in liquidity observed in stock exchanges of leading economies, stood at R$3.8 billion in the quarter, a balance of 22% lower than that verified in the quarter ended in November.

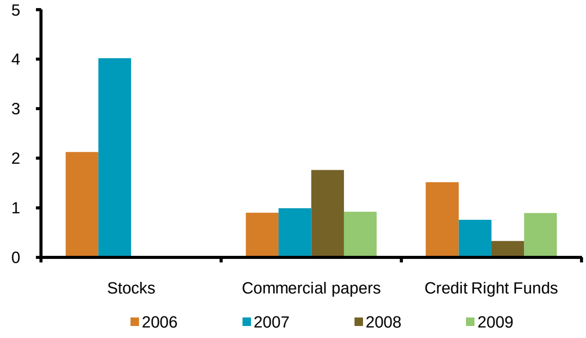
When assessed in dollar value, Ibovespa moved up 2.4% in relation to the quarter ended in November, a movement associated, in part, to the effect of depreciation of the Real against the dollar. In the same period, the Dow Jones and NASDAQ indices registered cutbacks of 19.1% and 10.1%, respectively, returning to the 2003 level.

The funding of companies in the capital market, by means of issuance of shares, debentures, promissory notes and placement of receivables of credit rights, reached R$2.4 billion in February 2009, against R$34.4 billion in the same period of 2008, with emphasis on the contraction of R$31.6 billion, to R$610 million, registered in the issuance of debentures. The primary issuance of promissory notes totaled R$918 million, against R$1.8 billion in February of the previous year.

3.3 Fiscal policy

The intensification of the effects of the international financial crisis on the internal expectations and, consequently, on the level of aggregated demand, has incentivated the government to adopt expansionist fiscal measures which contributed to the reversal of the process of activity level slowdown. Thus, in December 2008 tax cuts were introduced which favored the credit market conditions and propitiated expansion of consumers' available income. In this sense, noteworthy is the adjustment of the progressive income tax table to the growth of nominal wages of the economy; the reductions of IPI rates levied on the purchase of new vehicles and trucks, and of the Financial Operations Tax (IOF) levied on loans granted to individuals; the creation of two intermediate rates, of 7.5% and 22.5%, of the table of the Individual

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



Source: CVM

Income Tax (IRPF), reducing in up to 50% the tax levied on lower income bracket. These adjustments should cause an expansionist impact of R$8.4 billion on the 2009 fiscal year.

The government has also published a provisional measure with the aim of reducing the tax-related disputes in the administrative and judicial context. Among these provisions, one should highlight the installment payment of debts matured up to December 31, 2005, the value of which is not higher than R$10 thousand, with reductions of up to 100% of the fines and legal charges and up to 30% of interests. The debts of taxes with consolidated total value of up to R$10 thousand, which, on December 31, 2007 had been matured five years ago or longer, were forgiven. The measure also encourages the conclusion of judicial and administrative disputes consequent upon special conditions of payment of questioned debts.

In December 2008, a law was enacted creating Brazil's Sovereign Fund (FSB), which has the aim to foster investments in assets both in Brazil and abroad, in order to form public savings and reduce the effects of economic cycles and foster projects of interest to the country. The law states that the Fund´s resources will be constituted by allocations set aside in the annual budget, including those derived from issuance of public debt securities; from shares of federal mixed capital company, in excess to the maintenance of its control by the Union, or other rights with asset value; and from results of financial investments on its account.

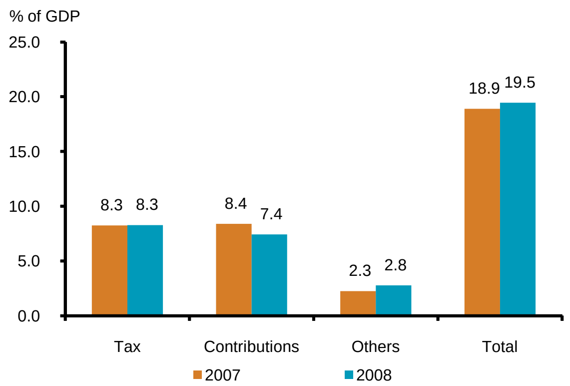
In January, the Government published a decree dealing with the budgetary and financial planning and setting up the monthly schedule of disbursements by the Executive Power for the 2009 fiscal year. Due to the uncertainties as to the performance of the economic activity and the performance of tax collection, the Government carried out, in a preventive manner, the conditioning of R$37.2 billion in expenditures of the Executive Power, of which R$22.6 billion in current expenditures and R$14.6 billion in investments. One should highlight that the revenue estimates for 2009 took into account GDP's real growth rate of 4%.

Also in January, aiming to face the uncertainties related to liquidity conditions, a provisional measure was published assuring to BNDES the additional allocation of resources valued at R$100 billion, in 2009. Credit granting may be carried out by means of issuance, by the Federal Government, in the form of direct placement in favor of BNDES, of bonds from the Internal Federal Public Securities Debt bonds, the

Table 3.5 – Public sector borrowing requirements – Primary result

Segment	2007		2008		Jan 2009	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central Government	-59.4	-2.3	-71.3	-2.5	-4.8	-2.0
Sub-national governments	-29.9	-1.2	-30.6	-1.1	-2.4	-1.0
State companies	-12.2	-0.5	-16.2	-0.6	2.0	0.8
Total	-101.6	-3.9	-118.0	-4.1	-5.2	-2.1

Figure 3.23 – National Treasury gross revenue



nature of which are defined by the State Minister of Finance, or by the utilization of the Federal Government's financial surplus in the fiscal year 2008.

Public sector borrowing requirements

Evolution in 2008

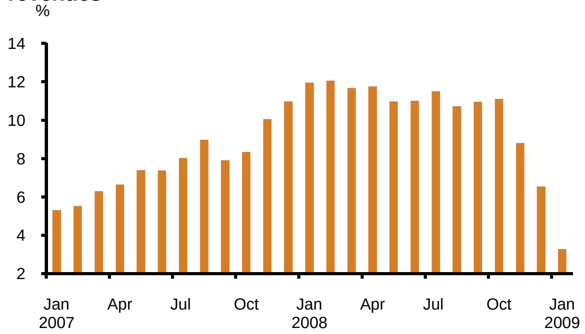
The non-financial public sector's primary surplus reached R$118 billion in 2008, representing 4.06% of GDP. The annual increased of 0.15 p.p. of GDP reflected rises in Central Government surpluses, 0.17 p.p., and of government-owned companies, 0.09 p.p., contrasting with a cutback of 0.1 p.p. verified in the context of the regional governments. One should highlight that the 2008 result was impacted by the issuance of bonds of the Brazil's Sovereign Fund (FSB), occurred at the end of the year, valued at R$14.2 billion, equivalent to 0.5% of GDP.

The Central Government's revenues, evincing the positive performance of the Treasury and of Social Security, expanded 0.82 p.p. of GDP in 2008, reaching R$716.6 billion. This evolution, which mirrored, in particular, the dynamics of the economy during the preceding period to the aggravation of the international financial crisis, also reflected administrative actions carried out by the Federal Revenue and by the General Prosecutor of the National Treasury aiming at the recovery of debts in arrears and the maintenance of regular tax collection flows.

The Treasury's revenues totaled R$551.3 billion in 2008. The annual growth of 15.5% was associated to expansions registered in the collections of Corporate Income Tax (RFPJ), 21%, and of the Social Contribution on Net Corporate Profits (CSLL), 27.4%, an evolution consistent with the increase observed in the companies' profitability, during the period. It is worth highlighting, additionally the expansions of revenues related to the Contribution to Social Security Financing (Cofins), to PIS/Pasep, to the Financial Operations Tax (IOF), to Income Tax(IR) derived from labor income and to the Import Tax (II). One should highlight that, in line with the crimp in economic activity, the annual cumulative rate of real growth of Treasury's revenues, taking IPCA as a deflator, fell from 11.4%, in September, to 6.5%, in December.

The Central Government's primary expenditures totaled R$497.9 billion in 2008, rising 9.3% in the year and turning to represent 17.2% of GDP, against 17.6% in 2007. The National Treasury's expenditures reached R$295.9 billion, followed

Figure 3.24 – 12-month real growth rate of Treasury revenues[1/]



1/ Updated by IPCA.

Figure 3.25 – Central Government expenditures

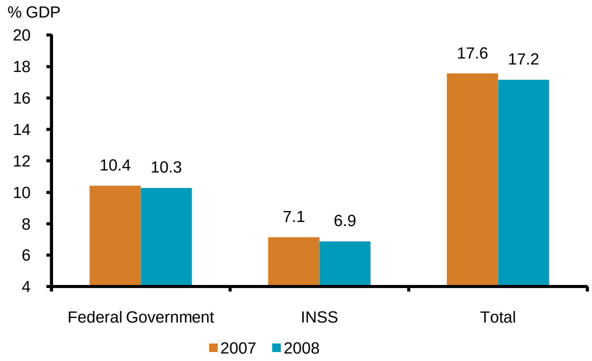
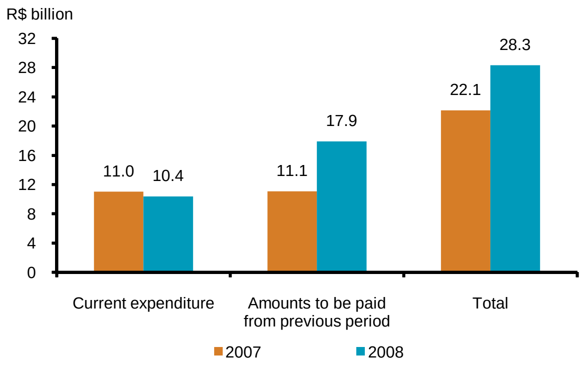


Table 3.6 – National Treasury Expenditures

Itemization	2007		2008	
	R$ million	% GDP	R$ million	% GDP
Total	268 186	10.3	295 933	10.2
Personnel and payroll charges	116 372	4.5	130 829	4.5
Capital and current expenditures	151 293	5.8	164 061	5.6
Workers Support Fund	18 472	0.7	21 026	0.7
Subsidies and economic subventions	10 021	0.4	6 006	0.2
Loas/RMV	14 192	0.5	16 036	0.6
Investment	22 109	0.9	28 269	1.0
Other capital expenditures	86 499	3.3	92 724	3.2
National Treasury transfers to the Central Bank	521	0.0	1 043	0.0

Source: Minifaz/STN

Figure 3.26 – Federal Government: investment expenditures paid



by those under the responsibility of Social Security, R$199.6 billion; and those of the Central Bank, R$2.4 billion.

Disbursements with personnel and social charges, including expenses of R$3.4 billion with the judicially mandated payment, moved from R$116.4 billion, 4.48% of GDP, in 2007, to R$130.8 billion, 4.51% of GDP in 2008. The Executive Power's expenditures, reflecting the impact of the restructuring of civil and military servants' careers and the natural growth of the payroll, expanded R$10.1 billion in the year.

The current and capital expenditures reached R$164.1 billion in 2008, reducing its participation in GDP from 5.82%, in 2007, to 5.65%, result of the reduction of 0.29 p.p. of GDP in current expenditures and the increase of 0.12 p.p. of GDP in those related to investments. Investments made increased 27.9%, to R$28.3 billion, in the year, with emphasis on allocations from the Ministry of Transport, R$6 billion, and of the Ministry of the Cities, R$4.9 billion.

One should highlight the budget operations of the Investment Pilot Project – expenditure liable to be deducted from the primary surplus target – reached R$7.8 billion in 2008, against R$5.1 billion in 2007.

A breakdown of current expenditures reveals the occurrence of a 0.18 p.p annual cutback of GDP in expenditures with subsidies, economic subventions and restructuring of liabilities. The main determinants of this reduction are based on contractions in the expenditures related to the National Development Fund (FND), R$1.9 billion; to the securitization of the farm debt, R$1.4 billion; to the Land Fund/Incra, R$559 million; and to the Program of Guarantee and Price Maintenance, R$245 million.

Social Security revenues expanded 16.3% in 2008, to R$163.4 billion, turning to represent 5.63% of GDP, against 5.41% in the previous year. The annual expansion of this collection evinced the expansion of the formal labor market and the rise in overall wages. The payment of Social Security benefits rose by 7.7% in the period, totaling R$199.6 billion, 6.88% of GDP, against 7.14% of GDP in 2007. In this scenario, the Social Security deficit dropped from 1.73% of GDP, in 2007, to 1.25% of GDP, in 2008, the second consecutive annual cutback.

The primary surplus of the regional governments topped R$30.6 billion in 2008. The annual reduction of 0.10 p.p. of GDP reflected the impact of the acceleration registered in expenditures, higher than the respective expansions of

Figure 3.27 – Basic Investment Plan (PPI) expenditures

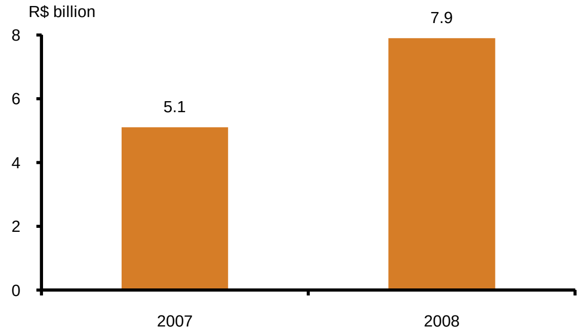


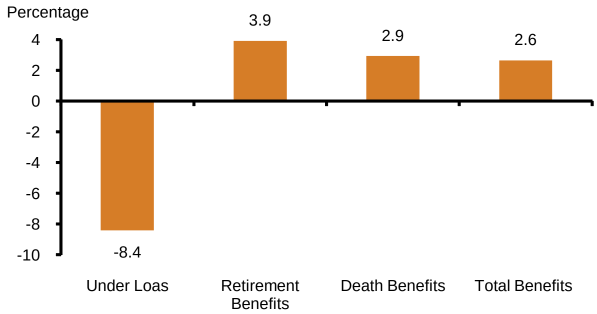
Table 3.7 – Social security primary result

January-December

R$ billion

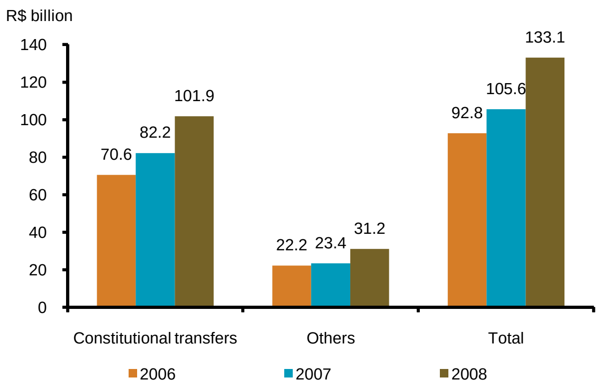
Itemization	2007	2008	Var. %
Gross inflow	154.6	180.9	17.0
Cash refunds	-0.5	-0.5	0.0
Transfers to third parties	-13.7	-17.0	24.1
Net inflow	140.4	163.4	16.4
Social Security benefits	185.3	199.6	7.7
Primary result	-44.9	-36.2	-19.4
Net inflow/GDP	5.41%	5.63%	
Social Security benefits/GDP	7.14%	6.88%	
Primary result/GDP	-1.73%	-1.25%	

Figure 3.28 – Growth in the number of benefits issued by Social Security (Jan-Oct 2008 average/Jan-Oct 2007 average)



Source: STN

Figure 3.29 – Transfers to states and municipalities



0.44 p.p. of GDP and 0.51 p.p. of GDP verified in collection of the Tax on the Circulation of Merchandise and Services (ICMS) and on the constitutional transfers, two main sources of resources from the state and municipal governments. The surplus reduction was concentrated on state governments.

The state-owned companies, mirroring improvements in the federal and state level spheres, produced a primary surplus of R$16.2 billion in 2008, a 0.09 p.p. GDP result higher than that observed in the previous year.

Nominal interests appropriated by competency came to R$162.3 billion in 2008. The annual reduction of 0.55 p.p. of GDP was impacted both by the result of exchange swap operations carried out by the Central Bank – favorable to the Institution by R$4.8 billion, against negative result of R$8.8 billion in 2007 –, and by the effects, over the domestic assets tied to exchange depreciation of 32% observed in the year.

The non-financial public sector nominal deficit came to R$44.3 billion in 2008, 1.53% of GDP, the lowest annual deficit, as proportion of output, since the beginning of the series, in 1991.This result was financed by expansions of R$171 billion in securities debt and of R$4.3 billion in other sources of domestic financing, partly offset by reductions in net banking debt, R$82.3 billion, and by the sources of external funding, R$48.8 billion.

Evolution in January 2009

The public sector primary surplus totaled R$5.2 billion in January, against R$18.7 billion in the same period of the previous year, as a result of across the board reductions in all spheres of the public sector. The twelve-month cumulative surplus came to 3.58% of GDP in January, showing respective cutbacks of 0.48 p.p. and of 0.50 p.p. of GDP as compared to the results achieved in December and in January 2008.

The Central Government's surplus summed up R$4.8 billion in January. The reduction of R$11.9 billion observed in relation to the same period of the previous year reflected the combination of increased expenditures and reduced nominal revenues. The Treasury's revenues totaled R$50.9 billion, reducing 4.9% in the period. Outstanding among the determinants of this movement were:

a) anticipation of the IRPJ collection and of Social Contribution on Corporate Net Profits (CSLL), in January 2008, related to profit obtained by the companies, in 2007;

Figure 3.30 – ICMS and IPVA inflow

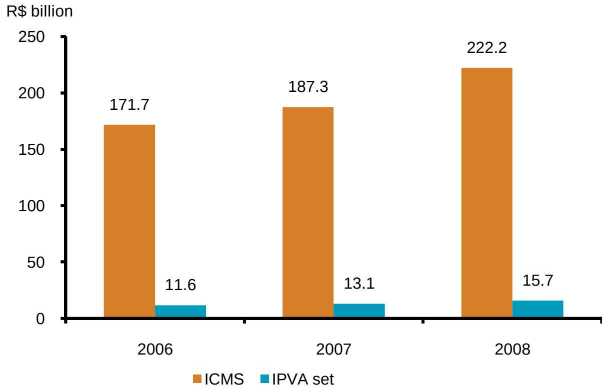


Figure 3.31 – Regional governments: Cumulative 12-month primary surplus and net debt

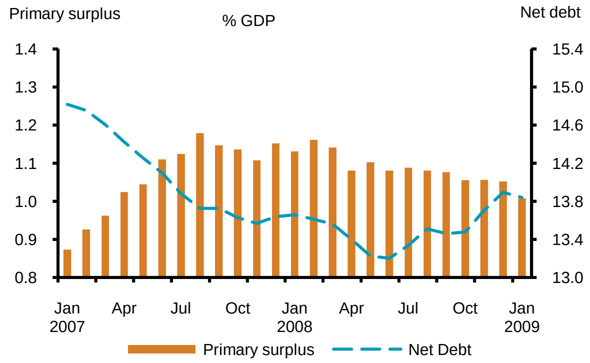
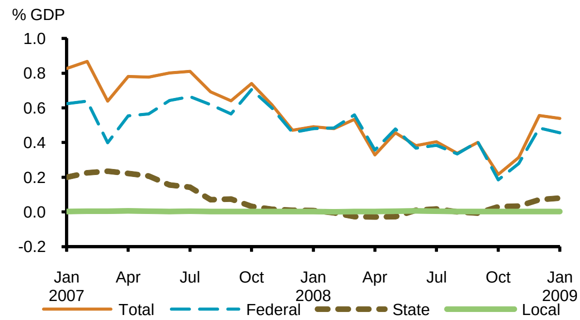
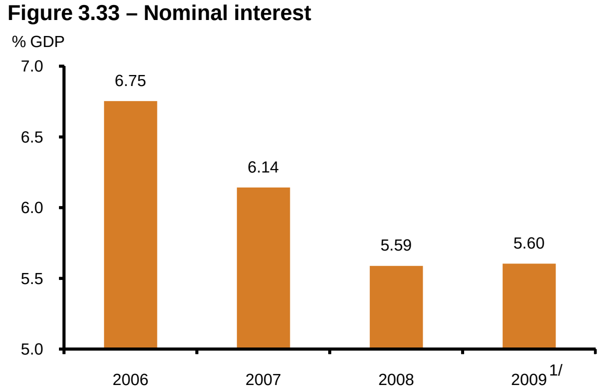


Figure 3.32 – Primary surplus of public enterprises
12-month cumulative data



(+) Surplus (-) Deficit

Figure 3.33 – Nominal interest



1/ Twelve-month accumulated up to january.

b) impact on IPI collection derived from the reduction of 14.5% in industrial production of December 2008, as compared to December 2007;
c) clearance, in January 2009, of debits of Cofins and PIS/Pasep, valued at R$811 million;
d) alteration in the table of IPI levying on automobiles on triggering events from January to March 2009, and establishment of mechanism which allowed the new table to be also applied to the stock of vehicles still not negotiated up to December 12, 2008;
e) extension, up to February 2009, of the expiry date of payment of the Integrated System of Micro and Small Business Tax and Contributions (Simples Nacional), in relation to generating facts occurred in December 2008;
f) losses of revenues originating in dividends, R$700 million; and of petroleum royalties, R$625 million.

The rate of real growth of National Treasury's (TN) twelve-month cumulative revenues, which had reached 6.5% in December 2008, closed at 3.3% in January, keeping its downward trajectory observed in the final quarter of the year.

TN's expenditures climbed from R$22.5 billion, in January 2008, to R$29.6 billion, registering in the period:
a) rise of R$1.9 billion in the payment of judiciary bonds and judicial sentences related to current expenditures and personnel;
b) financial impact of the restructuring of servants' careers and salaries; and
c) increase of R$2.7 billion in discretionary expenditures, with emphasis on the budget operations in the context of the Ministry of Health.

The Social Security's deficit came to R$6.3 billion in January 2009, rising R$1.2 billion in relation to January 2008. In the period, 7.4% increases were registered in net inflows, translating growth in overall wages and 12.7% in expenditures, driven by the minimum wage increase and by the observed increases in the volume of benefits paid, 3.3%, and in the value of judicially mandated payments, 25.3%.

The appropriated nominal interests topped R$14.4 billion in January, against R$13.1 billion in the same period of 2008, an increase associated, in particular, to the evolution of Selic rate. Viewing accumulated twelve month figures, appropriated nominal interests represented 5.6% of GDP, in January, the same level registered in December 2008.

The public sector nominal deficit totaled R$9.3 billion in January, contrasting with the nominal surplus of

R$5.5 billion indicated in the same month of 2008, accumulating 2.02% of GDP in twelve months.

Table 3.8 – Public sector borrowing requirements

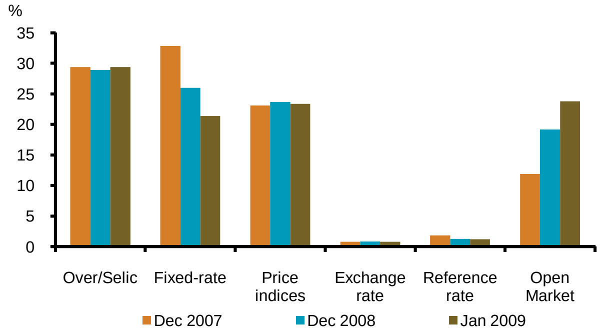
Itemization	2007		2008		Jan 2009	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Uses	57.9	2.2	44.3	1.5	9.3	3.8
Primary	-101.6	-3.9	-118.0	-4.1	-5.2	-2.1
Interest	159.5	6.1	162.3	5.6	14.4	6.0
Sources	57.9	2.2	44.3	1.5	9.3	3.8
Domestic financing	266.6	10.3	93.1	3.2	2.1	0.9
Securities financing	239.4	9.2	171.1	5.9	37.2	15.3
Bank financing	-2.2	-0.1	-82.3	-2.8	-25.2	-10.4
Others	29.3	1.1	4.3	0.1	-9.9	-4.1
External financing	-208.6	-8.0	-48.8	-1.7	7.2	2.9

Federal securities debt

The federal securities debt, assessed by the portfolio position, totaled 40.9% of GDP in January 2009, registering an increase of 0.2 p.p. of GDP in relation to October 2008 and a reduction of 2.7 p.p. of GDP in the last twelve months. The quarterly growth mirrored contractive impacts related to the occurrence of net redemptions carried out in the primary market; to the financial effects arising from the exchange depreciation of 9.5% observed in the quarter; and the incorporation of R$37 billion for purposes of nominal interests.

The participation of securities tied to price indices and fixed-rate bonds in the total of the federal securities debt registered reduction in January, compared to October 2008, contrasting with increased representativeness of the Selic-indexed securities. Additionally, the participations of bonds linked to exchange and Reference Rate (RT) maintained stable, while that related to financing taken by the Central Bank by means of open market operations increased 4.3 p.p., to 23.8%.

Figure 3.34 – Federal securities debt structure by indexing factor[1/]



1/ It does not include swap.

The revision of the Annual Financing Plan (PAF) 2008, in August of that year, established that fixed-rate securities in the federal securities debt should fluctuate between 29% and 32%, and that related to Selic-indexed bonds, between 31% and 34%. These alterations, which represent an extension of the limits of participation of the Selic-indexed securities and a reduction in that concerning the fixed-rate securities, aim to prevent short-term transitory fluctuations from raising the costs of medium and long-term financing. In December, the mentioned participations reached, in the order, 26% and 28.9%.

The 2009 PAF established that the participation limits, to be reached up to the end of the year, become 24% and 31%, for fixed-rate securities, and 32% and 38%, for those linked to the Special System of Settlement and Custody (Selic). In January, such participations stood, in the order, at 21.4% and 29.4%.

Table 3.9 – Repo operations – Open market
Balances and percentage share

R$ million

Period		Up to 1 month		More than 1 month		Total
		Balance	%	Balance	%	Balance
2003	Dec	43 742	78.5	11 975	21.5	55 717
2004	Dec	7 797	16.5	39 410	83.5	47 207
2005	Dec	-24 430	-106.9	47 286	206.9	22 856
2006	Dec	5 800	9.7	54 231	90.3	60 030
2007	Mar	41 656	39.3	64 281	60.7	105 937
	Jun	10 198	7.5	126 562	92.5	136 760
	Sep	7 561	4.3	168 525	95.7	176 086
	Dec	-1 460	-0.9	167 274	100.9	165 813
2008	Mar	37 349	18.2	167 643	81.8	204 991
	Jun	42 818	18.4	190 311	81.6	233 129
	Sep	87 261	30.9	195 107	69.1	282 368
	Dec	88 303	29.4	212 188	70.6	300 491
2009	Jan	132 202	34.7	249 018	65.3	381 220

The repo operations carried out in the open market, which represented very short-term and short-term financing, reached R$406.2 billion in January, against R$321.7 billion in October, evincing securities net sales of R$73.8 billion and incorporation of interests of R$10.7 billion.

Figure 3.35 – Profile of maturities of the securities debt

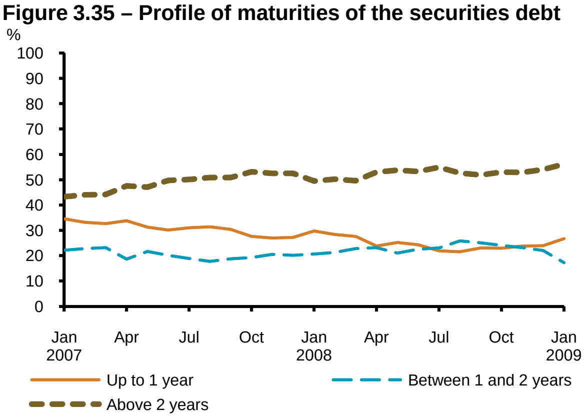


Figure 3.36 – Swap and open market position

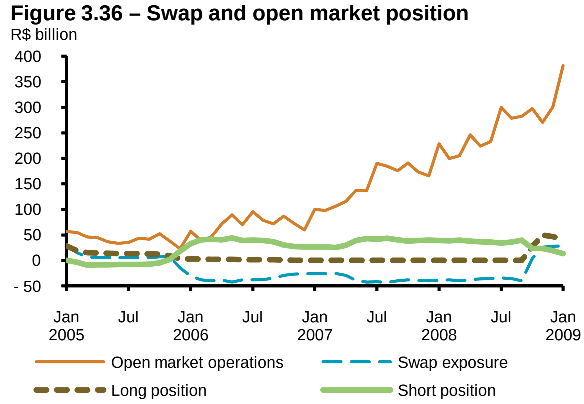


Table 3.10 – Net debt growth

Conditioning factors

Itemization	2007		2008		Jan 2009	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1150 357	42.0	1069 579	35.8	1091 439	36.6
Flows	**Accumulated in the year**					
Net debt – Growth	82 994	-2.0	-80 778	-6.2	21 859	0.8
Conditioning factors	82 994	3.0	-80 778	-2.7	21 859	0.7
PSBR	57 926	2.1	44 307	1.5	9 250	0.3
Primary	-101 606	-3.7	-118 037	-4.0	-5 188	-0.2
Interest	159 532	5.8	162 344	5.4	14 438	0.5
Exchange adjustment	29 268	1.1	-98 217	-3.3	3 673	0.1
Domestic securities debt[1/]	-2 432	-0.1	3 180	0.1	- 120	0.0
External debt	31 701	1.2	-101 397	-3.4	3 792	0.1
Others[2/]	-2 305	-0.1	-26 236	-0.9	8 601	0.3
Skeletons	- 630	0.0	135	0.0	336	0.0
Privatizations	-1265	0.0	-767	0.0	0	0.0
GDP growth effect		-5.0		-3.5		0.0

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

The structure of the securities debt maturities on market, except for financing operations, was as follows, in January: 19.3% of the total, in 2009; 23%, in 2010; and 57.7%, as of January 2011. This schedule, in line with the Annual Financing Plan (PAF) objectives, represents an extension of the debt maturity, compared to the same period of 2008, when 23.9% of the total would expire in that year, 20.9% in the following year, and 55.2% as of the second year. The average maturity of the debt reached 3.44 years, respecting the limits, of 3.4 and 3.7 years, specified in the 2009 PAF.

Securities expiring in twelve months represented, in January, 26.7% of the total of the securities debt on market, standing at the gap from 25% and 29%, established by the 2009 PAF.

The foreign exchange swap operations registered a debtor position of R$28.5 billion in January, reversing the creditor position by R$40 billion, observed in September 2008. This movement proved consistent with the Central Bank actions in view of the significant demand for exchange hedge which came after the aggravation of the crisis in the international financial markets.

On the cash basis, the result of exchange swap operations, defined as the difference between the profitability of the Interfinancial Deposit (DI) and the exchange variation plus coupon, was favorable to the Central Bank by R$158 million, in the quarter ended in January. The accumulated result since 2002, when these operations were initiated, was favorable to the Central Bank by R$5.7 billion.

Gross and net public sector debt

The Public Sector Net Debt (PSND) totaled R$1,069.6 billion at the end of 2008, representing 35.8% of GDP, against 42% of GDP, in December 2007, reflecting the fifth consecutive reduction and the least percentage since August 1998. PSND showed monthly increase of 0.8 p.p. of GDP, in January.

The annual reduction of the ratio between PSND and GDP in 2008 reflected the contributions of the primary surplus verified in the period, 4 p.p. of GDP; of the effects of valued GDP, 3.5 p.p. of GDP; of the exchange depreciation of 32% occurred in the year, 3.3 p.p. of GDP; and of the parity adjustment of the basket of currencies which form the net external debt, 0.9 p.p. of GDP. The incorporation of nominal interests acted in the opposite sense, thus contributing to raise the ratio by 5.4 p.p. of GDP. The increase of the PSND/GDP registered in January mirrored, especially, the performance of the primary surplus.

Figure 3.37 – NPSD – Percentage share of indexator

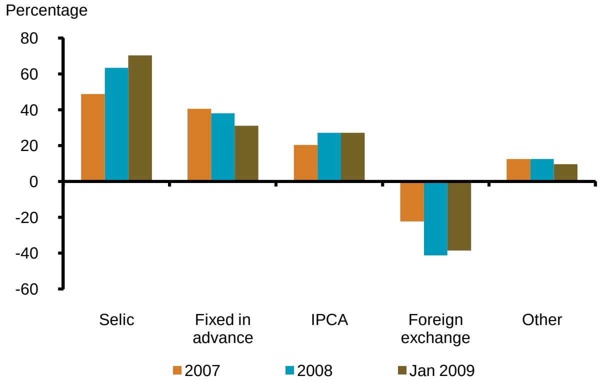


Table 3.10 – Net debt growth
Conditioning factors

Itemization	2007		2008		Jan 2009	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1150 357	42.0	1069 579	35.8	1091 439	36.6
Flows	**Accumulated in the year**					
Net debt – Growth	82 994	-2.0	-80 778	-6.2	21 859	0.8
Conditioning factors	82 994	3.0	-80 778	-2.7	21 859	0.7
PSBR	57 926	2.1	44 307	1.5	9 250	0.3
Primary	-101 606	-3.7	-118 037	-4.0	-5 188	-0.2
Interest	159 532	5.8	162 344	5.4	14 438	0.5
Exchange adjustment	29 268	1.1	-98 217	-3.3	3 673	0.1
Domestic securities debt[1/]	-2 432	-0.1	3 180	0.1	- 120	0.0
External debt	31 701	1.2	-101 397	-3.4	3 792	0.1
Others[2/]	-2 305	-0.1	-26 236	-0.9	8 601	0.3
Skeletons	- 630	0.0	135	0.0	336	0.0
Privatizations	-1265	0.0	-767	0.0	0	0.0
GDP growth effect		-5.0		-3.5		0.0

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

The evolution of the PSND composition during 2008 reflected, especially, the growth of issuance of Selic-indexed securities and the effect of exchange depreciation on the creditor share linked to exchange. The representativeness of the Selic-indexed net debt moved from 48.7%, at the end of 2007, to 63.4%, at the end of 2008, maintaining an upward trajectory in January 2009, when it reached 70.5%. The exchange-indexed creditor share, after growing 18.8 p.p., to 410.2%, in 2008, dropped to 38.5%, in January.

The Gross General Government Debt (GGGD), represented by debts of the Federal Government, Social Security and regional governments, reached R$1,740.9 billion in December 2008, 58.3% of GDP, rising to 1.9 p.p. of GDP compared to 2007. GGGD showed monthly increase equivalent to 1.2 p.p. of GDP, in January.

The increase indicated in the GGGD/GDP ratio in 2008 reflected the more intense impact of the incorporation of nominal interests and the effect of exchange depreciation, in relation to that propitiated by the net redemptions of debt and by the GDP nominal growth. One should highlight that the effect of exchange depreciation over GGGD is opposite to that observed in relation to PSND, considering that, in the latter case, the share suffering the impact of depreciation is a creditor one. In January, the growth of the GGGD/GDP ratio was associated to the incorporation of nominal interests and to the net issuance of debt.

3.4 Conclusion

The sharp contraction of liquidity observed in the international financial markets in the final months in 2008 continues conditioning the evolution of the domestic credit market. In this sense, as emphasized in the previous report, although the expansionist trajectory of credit remained at a high level in the quarter ended in October 2008, it showed a downward trend, associated, especially, to the deceleration registered in operations with individuals. The greater dynamics of credit operations in the corporate segment revealed the increase in demand by this segment for resources with the banking system, in line with the restrictions in external credit lines and with the internal economic activity level.

The impact of the reduced demand for goods with higher aggregate value – more dependent on the contracting of credit operations in the segment of individual persons and, therefore, more susceptible, to restrictions that occurred, both on the supply side and that of demand, for this market and on industrial sales anticipated the process of adjustment of stocks to which the companies submitted themselves at the end of 2008 and early 2009, with effects over the level of internal activity and over the demand for credit in the segment of corporate entities.

In this scenario, although the total credit stock registered expansion in the quarter ended in January, favored by growth in loan operations backed by targeted resources, which expanded their contribution to the supply of capital requirements in investment projects of the entrepreneurial sector, indicators related to the credit market began registering a downturn, at the margin. Although large-scale companies have increased their demand for resources on the domestic credit market, in view of the drop in the capital markets and external financing sources, free credit to corporate entities declined in January. In much the same way, expansion of the portfolios channeled to individuals evince deceleration, with a reduced pace of new hiring. The drop in credit demand, despite seasonal factors, reflects the uncertainties associated to the evolution of the activity level and, in particular, of employment and income. The performance of these indicators will determine the conditions for a recovery of the credit markets in the coming months.

The evolution of public accounts in 2008 propitiated, once again, the compliance with the primary surplus target and the maintenance of the declining trajectory of the DLSP/GDP ratio. The downward trend observed, in the latest months, in the growth rates of revenues generates a movement consistent with the downturn in economic activity and a sign that the fiscal scenario in 2009 will differ significantly from the pattern registered in the previous year.

In this environment, the conditioning of expenditures indicated in the budget program of the year reveals itself compatible with the fiscal austerity pledge assumed by the government. One should highlight that the Budget Guidelines Law (LDO) of 2009 foresees the possibility that the resources expended with the Investment Pilot Project, forecasted at 0.5% of GDP, may be deducted from the year's primary surplus target. Although this possibility existed in previous years and has not been used, it represents an efficient way of maintaining fiscal responsibility in a scenario of greater economic hardship, while guaranteeing productive investments for the country.

Also, it should be highlighted that the current composition of the public sector's net indebtedness reveals favorable vis-à-vis the scenario of turmoil in the international financial market, above all as a consequence of the creditor's share linked to foreign exchange and of the continuous lengthening of maturities of federal securities.

International economy

4

The consolidation of the prospects of an accentuated reduction in the growth of global economy, anticipated in the previous inflation report, was confirmed in the course of the quarter ended in February. Thus, the world's economic scenario over the recent months was marked by the intensification of the international financial crisis began as of mid-September. The crisis hit severely the domestic demand of the leading mature and emerging economies, impacting both the levels of employment and international trade flows. In this environment, the trajectories of deceleration or contraction in the activity level in the leading economies, evinced by the reduction, at the margin, of the world's economy GDP in the fourth quarter of 2008, is expected to persist throughout 2009.

Between mid-September and October 2008, the liquidity squeeze experienced by the leading international financial markets showed some accommodation, reflected in important improvements in the functioning of specific markets in the USA and in Western Europe. Notwithstanding, the deterioration of economic expansion perspectives in the largest developed economies, coupled with the effects of international credit restrictions on emerging markets, especially from Central and Eastern Europe, intensified the negative interaction between the economic real variables and the financial system.

In this scenario, the estimates of the financial sector's potential losses were revised upwards, thus reinforcing the general perception of a probable high systemic banking risk in major economies, at the same time that stimulated the rearrangement and reshaping of the monetary and fiscal policies in an attempt to fight against it.

4.1 Economic activity

As of the final months of 2008, the leading developed economies, in an environment of scarcity of credit channels

Table 4.1 – Major developed countries

GDP components and other indicators

% rate (anualised)

	2007			2008			
	II	III	IV	I	II	III	IV
GDP							
United States	4.8	4.8	-0.2	0.9	2.8	-0.5	-6.2
Euro Area	1.8	2.4	1.7	2.8	-1.0	-1.0	-5.8
United Kingdon	3.5	3.2	2.2	1.6	-0.1	-2.8	-6.0
Japan	-0.5	0.9	4.5	0.6	-3.6	-2.3	-12.7
Household consumption							
United States	2.0	2.0	1.0	0.9	1.2	- 3.8	- 4.3
Euro Area	2.6	2.0	1.1	0.7	-0.5	0.6	-3.4
United Kingdon	4.3	5.6	0.9	3.8	-1.0	- 0.8	- 2.8
Japan	1.6	- 0.4	1.2	2.8	- 2.8	1.2	- 1.6
Non-residencial investment							
United States	10.3	8.7	3.4	2.4	2.5	- 1.7	- 21.1
Euro Area[1/]	0.7	3.8	4.0	5.0	- 4.5	- 2.4	- 10.4
United Kingdon[1/]	- 2.1	7.8	5.6	-11.0	-5.0	- 13.8	- 8.9
Japan	- 13.6	5.7	9.1	- 2.4	- 8.9	- 12.9	- 19.6
Residencial investment							
United States	- 11.5	- 20.6	- 27.0	- 25.1	- 13.3	- 16.0	- 22.2
Euro Area[2/]	- 3.9	- 0.4	3.6	10.8	- 7.3	- 5.4	- 6.9
United Kingdon	4.6	1.9	4.1	4.1	- 2.5	- 1.4	- 4.3
Japan	- 11.1	- 29.3	- 36.4	19.7	- 7.4	17.0	24.8
Exports							
United States	8.8	23.0	4.4	5.1	12.3	3.0	- 23.6
Euro Area	4.3	8.1	3.0	7.6	- 0.2	0.1	- 26.0
United Kingdon	3.4	9.5	- 1.0	2.9	- 4.2	2.1	- 20.2
Japan	8.7	10.0	12.6	12.6	- 8.9	2.4	- 45.0
Imports							
United States	- 3.7	3.0	- 2.3	- 0.8	- 7.3	- 3.5	- 16.0
Euro Area	3.2	8.6	0.5	5.7	- 1.3	5.6	- 20.3
United Kingdon	- 1.9	20.9	- 0.7	-1.5	- 4.4	1.1	- 21.6
Japan	4.5	- 1.2	1.6	6.1	- 11.8	7.0	12.1
Unemployment rate[3/]							
United States	4.6	4.7	4.9	5.1	5.6	6.2	7.2
Euro Area	7.5	7.4	7.3	7.3	7.5	7.6	8.1
United Kingdon	5.4	5.3	5.2	5.2	5.4	5.8	6.3
Japan	3.7	4.0	3.7	3.8	4.1	4.0	4.3

Sources: BEA, Cabinet Office, Eurostat

1/ Includes residencial and public investment expenditures.

2/ Total construction expediture.

3/ End of the quarter rate.

and reduction in household wealth, registered a sharp contraction on the final demand for goods and services. This movement was evinced by both the sharp downturn of consumption and, particularly, private investment – a trend anticipated in the third quarter of 2008, as well as the reversal of the upward trajectory of real exports. Thus, in the quarter ended in December, GDP registered accentuated contractions in Japan, 12.7%; United Kingdom, 6%; USA, 6.2%; and Euro Area, 5.8%, with unfavorable developments for the job markets, especially in the USA, where the unemployment rat reached 8.1% in February, 0.9 p.p. higher than that registered at the end of 2008.

The reduction of domestic demand and the restrictive credit market conditions were fundamental for the contraction of imports of goods and services observed in developed economies; thus functioning as an important channel of transmission of the recessive trend towards other economies. In annualized terms, imports from the United Kingdom, the Euro Area and USA dropped, in the order, 21.6%, 20.3% and 16% in the quarter ended in December, as compared to that ended in September. In Japan, despite the annualized reduction of 1.2% in domestic demand, imports expanded at an annualized rate of 12%, in contrast with the 45% falloff in exports. In this scenario, the net exports accounted for 90% of GDP contraction registered in that country in the period under analysis.

Foreign sales of emerging countries – especially Asia, which are concentrated on durable goods and, as a consequence, are more vulnerable to the credit conditions and the economic cycle – also began to reflect the impacts of the worsened world's economic scenario. Seasonally adjusted South Korean exports registered annualized real reduction of 31.9% in the quarter ended in December, while the external sales from China and Taiwan registered respective variations of 4.4% and -19.7%, as compared to the quarter ended in December 2007. Exports from India, concentrated on the sales of services, expanded 11.4%, on the same basis of comparison.

Similarly to the foreign trade trajectory, the behavior of household consumption and gross fixed capital formation contributed decisively for the contraction and deceleration of the activity level in Asian countries, except in China. In this environment, South Korean GDP registered annualized reduction of 20.8% in the quarter ended in December, while, in terms of 12-month variations, Taiwan GDP fell by 8.4% and those related to China and India, revealing a significant deceleration, expanded, in the order, 6.8% and 4.5%, in December 2008.

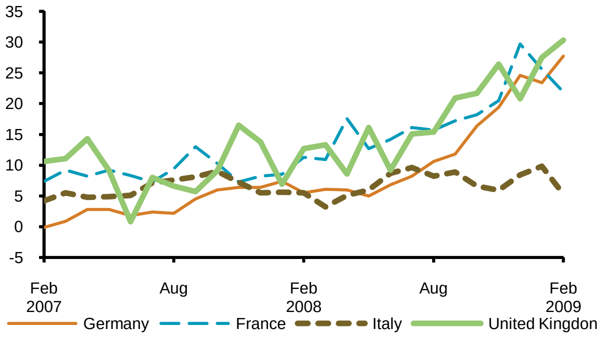
Table 4.2 – Emerging economies
GDP components and other indicators

% rate [(Q)/(Q-4)]

	2007			2008			
	II	III	IV	I	II	III	IV
GDP							
South Koreia[1/]	7.1	6.0	6.4	3.3	3.4	2.1	-20.8
China	14.0	13.0	12.0	10.6	10.1	9.0	6.8
India	9.1	8.9	9.1	8.8	8.1	7.7	4.5
Taiwan	5.5	7.0	6.4	6.2	4.6	-1.0	-8.4
Household consumption							
South Koreia[1/]	3.7	5.1	3.2	1.76	-0.6	0.2	- 17.9
China[2/]	24.3	19.1	16.8	14.7	16.6	22.1	23.8
India	8.4	7.5	8.9	8.3	7.7	6.9	5.4
Taiwan	2.2	3.1	1.6	2.1	0.5	- 2.1	- 1.7
Gross Fixed Capital Formation							
South Koreia[1/]	0.2	- 1.8	6.5	-3.45	0.2	3.0	-30.7
China	26.6	31.8	25.8	19.5	16.3	16.7	22.5
India	12.9	16.2	13.7	11.2	10.1	15.1	5.3
Taiwan	4.7	3.8	- 0.8	3.7	- 8.0	- 11.8	- 23.2
Exports							
South Koreia[1/]	16.2	5.2	30.9	-2.74	17.6	-4.5	-31.9
China	23.8	24.8	18.3	17.2	17.1	18.3	4.4
India	- 4.0	- 4.8	6.1	10.1	23.2	10.6	11.4
Taiwan	5.2	11.6	12.9	12.7	9.9	-0.6	-19.8
Imports							
South Koreia[1/]	19.7	- 7.1	40.4	-8.73	18.2	-6.66	- 42.2
China	11.8	21.2	22.1	15.6	17.1	10.6	-2.1
India	- 0.7	- 3.6	6.7	9.6	30.3	26.0	20.6
Taiwan	2.6	7.3	5.8	9.6	0.2	-2.6	-22.6
Unemployment rate[3/]							
South Koreia[1/]	3.3	3.2	3.1	3.1	3.2	3.2	3.3
China[4/]	4.1	4.0	4.0	4.0	4.0	4.0	nd
India	nd	nd	nd	nd	nd	nd	nd
Taiwan	3.9	4.0	3.9	3.9	3.9	4.3	5.0

Source: Thomson Financial
1/ QoQ annual rate.
2/ Retail sales growth rate.
3/ End of the quarter rate.
4/ Urban unemployment

Figure 4.1 – Uneasiness Indicator for inventory level
European countries



Source: European Union

The scenario of reduced internal and external demand resulted in the accumulation of undesired stocks, both of final and intermediate products, thus leading to significant cutbacks in production as well as in the orders for intermediate goods and raw materials. Indicators of discomfort with the stock levels, evincing the persistent downturn of demand, remain, however, on a high level, suggesting the continuity of low levels of production and employment, affecting negatively the performance of world's GDP in the early months of 2009.

4.2 Monetary policy and inflation

The recent slowdown of the world economic activity favored the downward trajectory for the prices of energy and commodities, leading to significant reductions in inflation rates. In this environment, fears concerning the likelihood of a deflationary process were revived, particularly in mature economies and in China. Thus, the deepening of credit restrictions and the worsening of the crisis in the financial systems stimulated the central banks of mature and emerging economies to expand the accommodation posture of their monetary policies and inject a larger volume of resources in their financial systems.

Likewise, this same posture started being adopted in Latin America, where the central banks of Colombia, Chile, Mexico, Brazil and Peru inaugurated, during the quarter ended in February, a cycle of interest rate reduction. The same occurred in Hungary, where the central bank cut the basic interest rate by 25 b.p. Conversely, the central bank of Russia, pressured by the evolution of prices, exchange, balance of payments or swap terms, maintained the upward trajectory for interest rates. One should highlight that, in parallel to the relaxation of monetary policies, several countries, especially from the G3 and the United Kingdom, have been adopting expansionist fiscal policies in an attempt to mitigate the negative interaction between the economic activity and the deterioration of their financial systems.

In the USA, the behavior of prices, which was deemed benign up to the end of the quarter ended in September 208, started to indicate a progressive probability of a deflationary process. The increase in the output gap and the deceleration in the prices of foodstuffs and energy contributed to the -1.7% inflation rate registered in November, the greatest monthly negative rate in 60 years, and -8.4%, in annualized terms, in the quarter ended in January. Considering 12-month

Figure 4.2 – Inventories/Sales ratio
USA and Japan

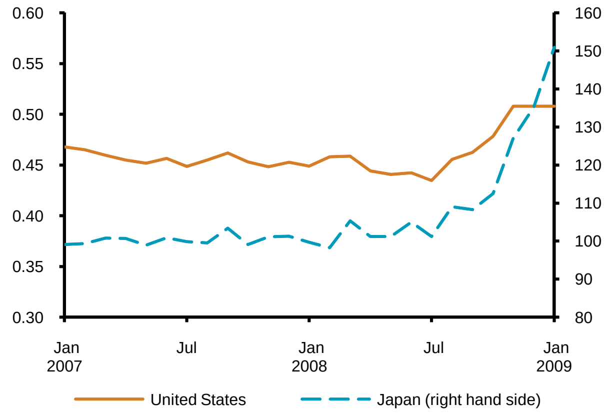


Figure 4.3 – China PMI
Final goods inventories PMI – Subindex

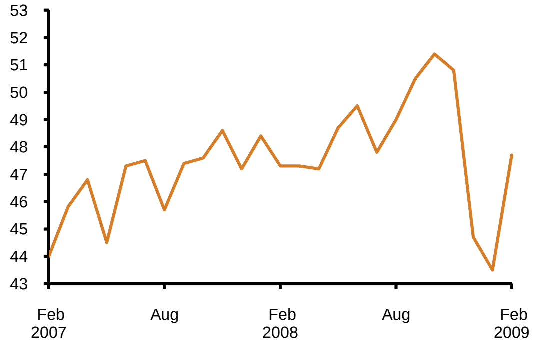
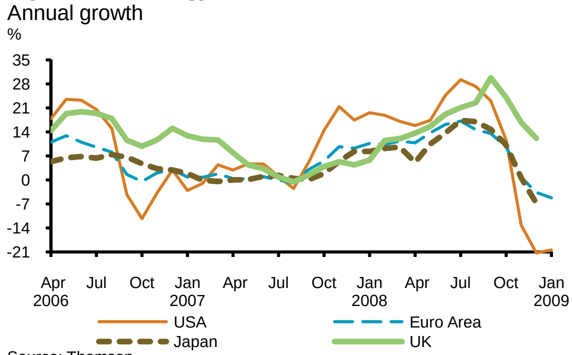
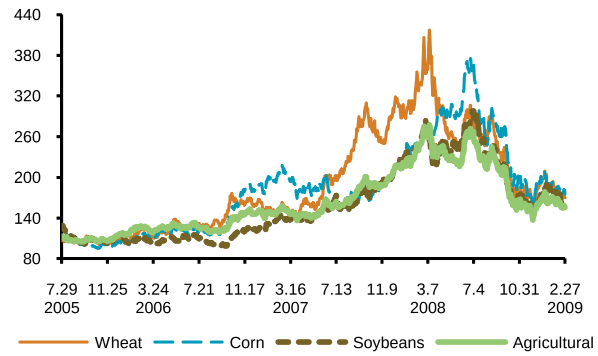


Figure 4.4 – Energy inflation
Annual growth



Source: Thomson

Figure 4.5 – Agricultural Index
12.31.2004 = 100



Source: Thomson

periods, inflation dropped from 5.6% in July 2008 – the highest rate in seventeen years, to 0.03% in January 2009.

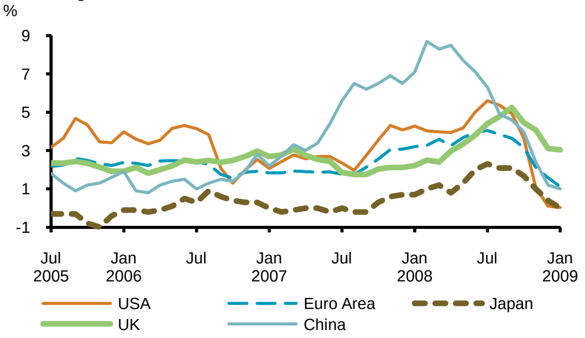
In view of this scenario and the need for adjusting the Fed funds target to the effective rate, the Fed carried out, in December, a new reduction in the target for basic interest rates, deciding for a fluctuation band, with limits of 0% and 0.25%. In addition, against the backdrop of the deteriorating credit scenario and restrictive financial markets, the Fed expanded one more time the scope of its liquidity assistance programs and increased the broadened its monetary policy, making a significant amount of resources available to the financial system.

With this goal, several measures were introduced or extended for regularizing the consumption, the real estate market, the financial market, and the offshore currencies market. With a view to reactivating consumption, the Fed created the Term Asset-Backed Securities Loan Facility (TALF), a program initially worth US$200 billion that was lately expanded to US$1 trillion by the new Treasury Financial Stabilization Plan. Through this program, the Fed will grant non-recourse loans to banks holding AAA papers collateralized by students' credits, auto loans credits, small entrepreneurs' credits, as well as loans granted by means of credit cards.

With the purpose of expanding liquidity to the mortgage market, the Fed started buying mortgage-backed securities (MBS) from the agencies Freddie Mac and Fannie Mae, a program that had already been announced in November 2008. In order to reestablish the normal functioning of financial markets and guarantee liquidity to primary dealers, the Fed also announced the extension, from April 30 to the end of October, of the maturity of all its liquidity assistance programs. In addition, with the objective of guaranteeing the offshore dollar supply, together with the central banks of Australia, Brazil, Canada, South Korea, Denmark, Europe, England, Japan, Mexico, Norway, New Zealand, Singapore, Sweden and Switzerland, the Fed extended, up to October 31, the currency swap lines.

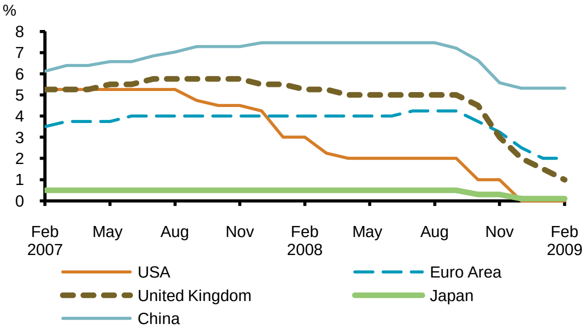
On February 10, in order to provide additional support to the economic activity, the North-American government announced the basic guidelines of a new Financial Stability Plan, based on three pillars: creation of the Financial Stability Trust (FST) fund to allocate resources to the financial institutions which, after a comprehensive analysis of their balance sheet and the prospects for stabilization of lending activities (stress test), prove to require the allocation of resources. Resources will be allocated through the Capital

Figure 4.6 – Consumer inflation
Annual growth



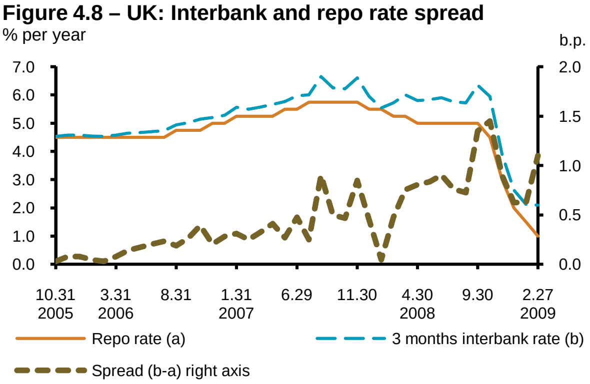
Source: BLS, Eurostat, Bloomberg and ONS

Figure 4.7 – Official interest rates
Annual rates



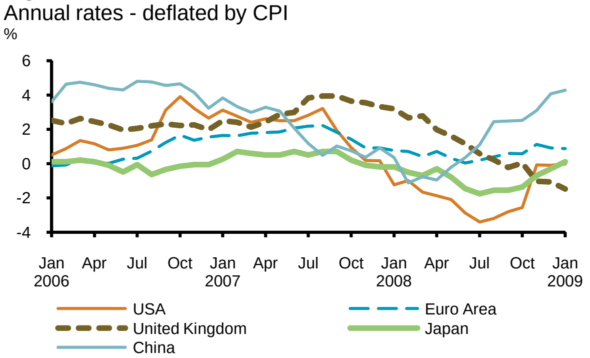
Sources: Fed, ECB, BoJ, Bank of England and The People`s Bank of China

Figure 4.8 – UK: Interbank and repo rate spread
% per year



Source: Thomson

Figure 4.9 – Real interest rates
Annual rates - deflated by CPI



Sources: Fed, BCE, BoJ, BoE, BPC, BLS, Eurostat, ONS and Bloomberg.

Assistance Program. Eligible institutions must demonstrate how they intend to utilize the resources so as to achieve a level of credit concession higher than that achieved without the government assistance:

- a coordinated action among the Fed, FDIC, the private sector, and the Treasury for the establishment of a Public-Private Investment Fund ("bad bank"), which should, at first, rely upon resources in the order of US$500 billion, but which may reach US$1 trillion; and
- joint Treasury/Fed action aiming to revitalize the secondary market of loans targeted to consumption and small entrepreneurs. Resources offered may reach US$1 trillion, partly represented by the Troubled Asset Relief Program (TARP).

Still in the framework of fiscal interventions, the Congress approved, on February 11, an incentive package worth US$787 billion, including direct government expenses, estimated at US$35 billion in 2009 and US$111 billion in 2010; and tax reductions and respective transfers of US$150 billion and US$289 billion in the years mentioned. One should highlight that, also in February, was approved the borrowers' rescue plan, worth US$75 billion, aimed to contain foreclosures and refinance mortgages.

In the United Kingdom, the financial and economic environment deteriorated rapidly with the worsening of the international crisis. This was clearly demonstrated by the increase in the interbank spread, the depreciation of the Sterling Pound, the economic activity slowdown, and higher unemployment rates. According to the Bank of England (BoE), this is a recessive economic scenario. Therefore, the monetary authority decided to reduce the basic interest rates from 5% p.y., in September 2008, to 0.5% p.y. at the beginning of March 2009, the lowest level ever recorded. The BoE is concerned with the probability that, over the medium term, annual inflation would stand below the target of 2%. Annual inflation dropped from 5.2% in September 2008 to 3% in January 2009, an evolution that may be explained by the more intense effect of the cutback in the prices of energy and foodstuffs, temporary reduction of the value added tax (VAT), and the expansion of idle capacity in comparison to the impact of the depreciation of the Pound Sterling.

In this framework, expectations in relation to the measures to be adopted by the BoE included the maintenance of the repo rate near to zero and the intensification of the policy aimed at increasing the supply of currency and credit. Thus, on January 19, the BoE announced the extension of maturities of rediscount operations, from 30 days up to one year, and established the Asset Purchase Facility (APF), a fund worth £50 billion financed through the issue of treasury notes with the goal to increase the liquidity to the corporate credit segment. In addition, the Monetary Policy Committee (MPC) announced the start of purchase of private assets with investment grade[1]. In March, backed by the APF and by Treasury authorization, the MPC announced the start of direct purchase, at an initial value of £75 billion, and for an initial term of three months, of the referred private corporate bonds, as well as of medium and long-term public bonds (gilts) on the secondary market. Purchases should be financed through the issue of banking reserves. In parallel to this, the Special Liquidity Scheme continues to operate, in spite of the closing of its access term. Through this program, the Treasury lent £185 billion in public securities, with maturities of up to 3 years, in exchange for MBS. Finally, with the goal of guaranteeing the supply of dollars in the English market, the BoE renewed, from the end of April up to the end of October 2009, the unlimited line of currency swap established with the Fed.

In the Euro Area, the annual variation of consumer price indices reached 1.1% in January 2009, the smallest rate since July 1999, with emphasis on the negative variations registered by transportation, 3.2%, and energy, 5.3%. In this scenario, in which inflation persists below the target of 2% and the economic activity continues to give signs of a sharp reduction, the European Central Bank (ECB) opted for additional cutbacks in the basic interest rate, by fixing it at 1.5% p.y. at the beginning of March 2009. In the context of financial markets needs, the ECB maintained the liquidity lines available during 2008 and, in relation to dollar supply in the European market; it renewed the unlimited line of swap currencies established with the Fed.

In Japan, the deepening of recession is confirmed by both the deterioration of the trade balance and the reduction of domestic absorption. In this context, the increase of the output gap and the strong cutback in the prices of commodities were responsible for the drop in the 12-month accumulated consumer price index from 2.3%, in July – the highest rate since the middle of the nineties – to 0% in January, a trajectory similar to that registered by the inflation core index.

In this environment, in which the Bank of Japan (BoJ) takes in to account the possibility of a deflationary process over

1/ Securities issued in the framework of the government credit guarantee program, corporate bonds, commercial papers, syndicated loans, and several asset-backed securities (ABS).

the medium term, the Japanese government introduced a new fiscal incentive package, involving ¥23 trillion, aimed at stimulating the household consumption and recapitalizing the financial system. The monetary authority decided for a new reduction in the target for the overnight call rate, from 0.3% to 0.1%, the second cutback observed over the last six years. Also, it resumed the practice of quantitative slackening, the major monetary policy instrument utilized from 2001 to 2006. In this sense, aiming to ensure minimum liquidity levels in the local markets, the BoJ:

- reduced from A to BBB- the minimum requirement for acceptance of corporate bonds as collaterals;
- announced the increase of direct purchase of government bonds (JGB) from ¥1.2 trillion to ¥1.4 trillion, including, 30-year bonds;
- started, with the purpose of reducing the deflationary pressures on the market of corporate bonds, the purchase of corporate bonds rated A or higher and maturity below or equal to one year;
- extended, until the end of September, the term for direct purchase of commercial papers and the list of eligible collaterals; and,
- in coordination with the Fed, renewed the unlimited dollar/yen currency swap up to October 2009.

In China, despite the passage of the Lunar New Year – a period in which is normal to occur pressures on food prices, the deflation process did not lose momentum. The 12-month accumulated inflation dropped to 1% in January, registering variations of 4.2% in the item foodstuffs and of -0.6% in the non-food segment, the first deflation in six years. In this scenario, in which global recession is reflected in significant loss in the balance of trade, hitting severely the level of local production, the government continued to stimulate measures to strengthen the private sector, while the People's Bank of China (PBC) decided for a new reduction in the basic interest rate, fixing it at 5.31% p.y. since December 2009.

4.3 International financial markets

Since the last inflation report, banks, stock brokerage companies, insurance companies, and the so-called government sponsored enterprises (GSE) announced additional losses and write-offs in the order of US$161 billion, accumulating US$1,116 billion since the beginning of 2007[2]. These same companies from the financial sector

Table 4.3 – Bank writedowns & credit losses x capital raise

US$ billion

	Accumulated since 2007		Accumulated since 10.1.08[1/]	
	Writedowns & credit losses	Capital raised	Writedowns & credit losses	Capital raised
Worldwide	1116.3	996.0	200.7	534.8
Banks	824.5	860.1	172.2	461.3
Insurers	177.4	99.5	28.5	59.7
GSEs [2/]	114.4	36.4	0	13.8
Americas	762	558.0	148.7	312.1
Banks	494.7	448.1	125.6	245.1
Insurers	152.9	87.3	23.1	53.2
GSEs [2/]	114.4	22.6	0	13.8
Europe	323.9	355.8	51.4	179.6
Banks	300.9	343.7	46	173
Insurers	23	12.1	5.4	6.6
Asia	30.3	68.3	0.6	43.2
Banks	28.9	68.3	0.6	43.2
Insurers	1.4	-	-	-

Source: Bloomberg
1/ Updated on February 26th, 2009.
2/ Government Sponsored Enterprises – Fannie Mae and Freddie Mac.

2/ According to Bloomberg data of February 26, 2009.

raised, during the same period, US$172 billion in new capital, adding up US$996 billion since the beginning of 2007. The banking segment, which also includes the stock brokerage companies, still concentrates 74% of the total losses and 86% of the raised capital.

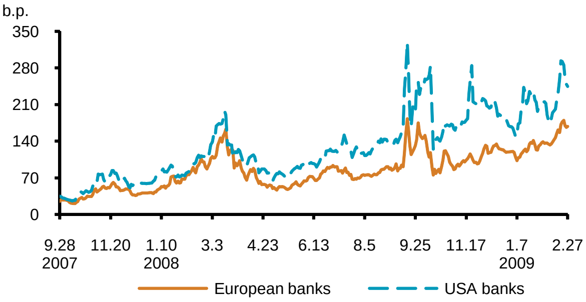
The persistent deterioration of global economic outlook continues to affect negatively the banks' financial conditions, especially in the USA and in Europe. The average CDS premiums – which measure the cost of guarantee against default – of five important North-American banks and of five important European banks kept on the upward trend initiated in mid-2007, moving, respectively, from 214 and 97 b.p., at the end of November, to 245 and 169 b.p. on February 27, with the maximum values close to those registered on September 17, after the bankruptcy of the Lehman Brothers bank.

The ongoing sharp contraction in the G3 economies, as well as the significant deceleration of emerging economies, led to the reduction in the demand for credit by the corporate segment. Meanwhile, the banks, in an attempt to prevent their balance sheets from further deterioration, have adopted a restrictive posture in their credit analyses. In Europe, the iTraxx Crossover, which represents the premium required to guarantee loans borrowed by high risk companies, moved from 890 b.p., on November 30, to 1,082 b.p., on February 27. The iTraxx IG, which represents the premium required by the companies classified as investment grade, climbed, in the same period, from 170 b.p. to 181 b.p.

The cutbacks in basic interest rates and the granting of credit by the government to the financial sector in the leading world's economies did not necessarily reflected in the reduction of the annual earnings of their respective long-term papers. These papers were partially affected by the deterioration of public finance, stimulating the BoE and the BoJ to carry out direct purchase of government papers and the Fed to announce, in the minute of its January meeting, the discussion of this practice. Between the end of November and the end of February, the annual earnings on long-term papers rose from 2.92% to 3.04% in the USA, while in Germany, in the United Kingdom and in Japan, it moved, in the order, from 3.26%, 3.77% and 3.40%, to 3.11%, 3.62%, and 1.28%.

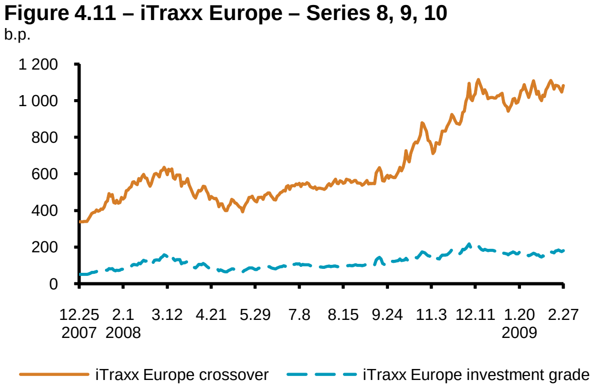
The Chicago Board Options Exchange (VIX), which measures the Standard & Poor's (S&P) short-term implicit volatility, although still signaling the prevalence of high wariness to risk on the North-American stock market, registered an average of 47.5 points in the quarter ended

Figure 4.10 – 5 year CDS premiums of major banks1/



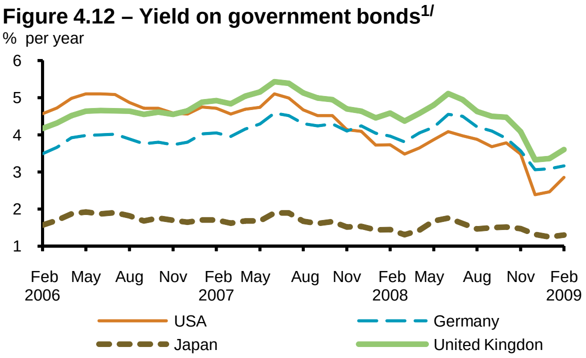
Source: Thomson
1/ Aritmethic average of 5-year CDS premiums for major European and USA banks. Since it's not a random sample, it may not reflect the behavior of the financial system as a whole.

Figure 4.11 – iTraxx Europe – Series 8, 9, 10



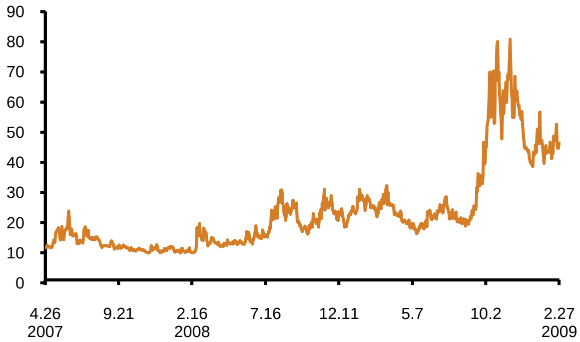
Source: Thomson

Figure 4.12 – Yield on government bonds1/



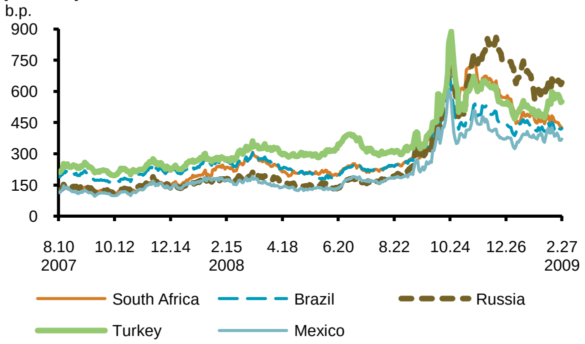
Source: Bloomberg
1/ Monthly average of nominal yields on 10-year bonds, up to February 27, 2009.

Figure 4.13 – VIX



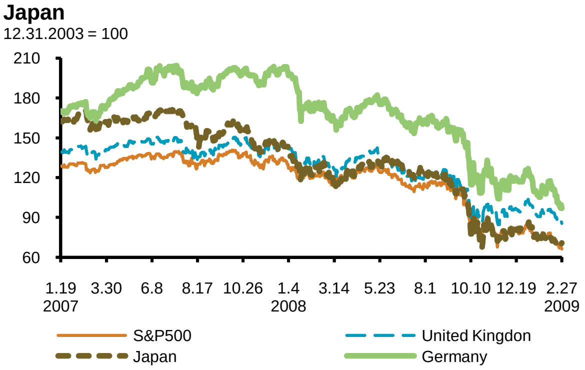
Source: Thomson

Figure 4.14 – Emerging Markets Bond Index Plus (EMBI+) – Countries



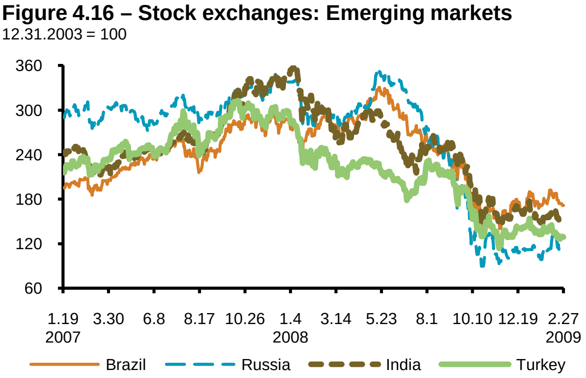
Source: Bloomberg

Figure 4.15 – Stock exchanges: USA, Europe and Japan



Source: Bloomberg

Figure 4.16 – Stock exchanges: Emerging markets



Source: Bloomberg

in February, against 50.9 points in the quarter ended in November. The indicator, after registering a fluctuation from 39 to 69 points in the quarter, reached 46.4 points at the end of February, against the record of 80.9 points observed on November 20, 2008.

The Emerging Market Bond Index Plus (Embi+), a risk indicator associated to emerging markets, reached 639 points at the end of February, against 707 points at the end of November, an evolution associated to respective reductions of 195, 88, 72, 68, and 59 points registered in the South Africa, Russia, Mexico, Brazil, and Turkey indicators. Conversely, the Embi+ associated to Argentina and Venezuela expanded, in the order, 5 and 110 points, in the period.

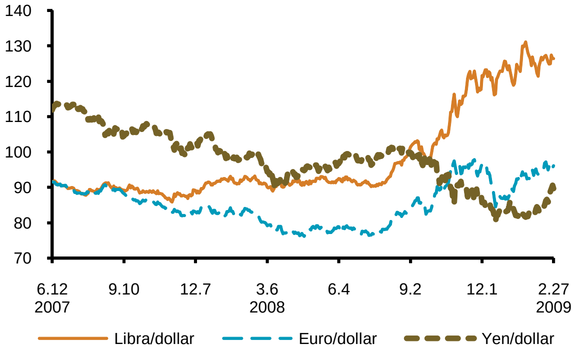
The stock market indicators of mature economies continue to reflect the unfavorable corporate results and the financial sector losses. The USA's S&P500 reached, on February 27, the lowest value in more than twelve years, while that of Germany's DAX went back, on the same date, to the level of September 2004. The United Kingdom's FTSE 100 continues close to the minimum level of the last five years, registered in mid-November 2008. Meanwhile, Japan's Nikkei stands at a level slightly higher than that of 1982. In the quarter ended in February, the S&P500 and DAX fell by 18%, while the FTSE 100 and Nikkei accumulated losses of 11%.

Stock markets in the emerging economies registered an heterogeneous behavior in the quarter ended in February, expressed in respective gains of 4.3% and 6.2% in the Brazilian Ibovespa and Russian RTS, and respective losses of 2.2% and 6.6% in the Indian Sensex and Turkish XU100.

The worsening of the economic-financial crisis continues to benefit the strengthening of the US dollar. In the quarter ended in February, the dollar appreciated against the Pound, 7.4%; the Yen, 2.1%; and the Euro, 0.2%. It should be observed that, in the first two months of 2009, these variations reached, in the order, 1.9%, 7.6% and 10.3%. With regard to the Euro and the Yen, these movements reflected the negative performances of Euro Zone and Japan economies as well as the poor performance of their exporting sectors. The appreciation of the Pound reflects, to a large extent, the reduction of the differential between the basic interest rates adopted by the BoE and the Fed. The Pound, which, on January 23, reached the smallest value against the US dollar, accumulates, since June 2001, a depreciation of 32%, considering the record quotation of November 2007 and that of February 27.

Figure 4.17 – Dollar exchange rates

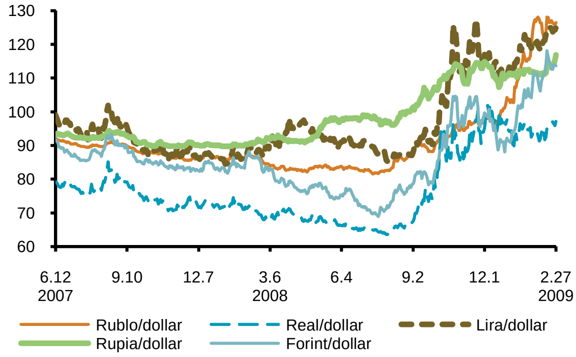
6.1. 2005 = 100



Source: Bloomberg

Figure 4.18 – Emerging markets currencies

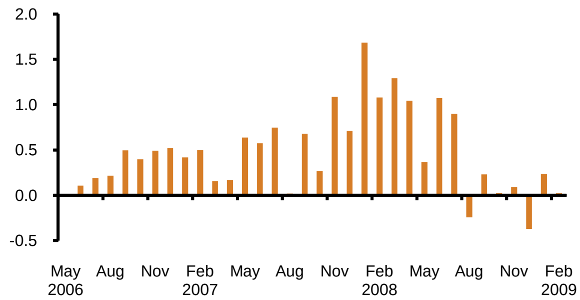
6.1 2005 = 100



Source: Bloomberg

Figure 4.19 – Renminbi/dollar exchange rate
Monthly valuation – average[1/]

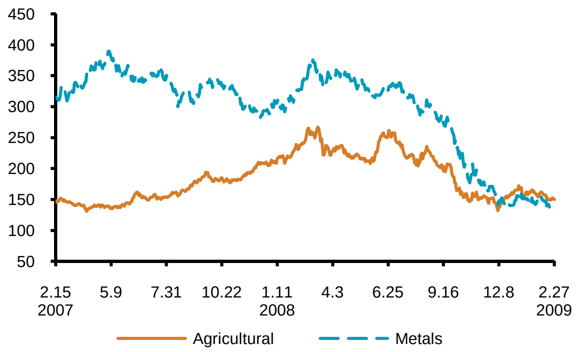
%



Fonte: Bloomberg
1/ Up to February 27, 2009.

Figure 4.20 – Commodity price index

Jan/2003 = 100



Source: S&P GSCI

The dollar appreciation trajectory was also observed vis-à-vis the emerging economies' currencies. In the quarter under analysis, the dollar appreciated 2.1%, 3.5%, 8.7%, 15.9%, and 28.6% against the Indian Rupee, the Real, the Turkish Lira, the Hungarian Forint, and the Russian Rublo. In Hungary, despite the agreement signed with the International Monetary Fund (IMF), high uncertainties about the evolution of domestic economy and the high costs associated to the foreign currency debt have put additional pressure on the local currency. In Russia, the interest rate raise was not enough to offset the adverse effects represented by the strong drop in the price of petroleum and the reduction in the country's international reserves.

In China, the renmimbi, which interrupted, since July 2008, the gradual appreciation trajectory against the US dollar, continues to register low volatility, reflected on the depreciation of 0.1% observed in the quarter ended in February.

4.4 Commodities

International quotations of commodities, interrupting the downward trajectory initiated in July, began to show relative stability as of December. According to the Commodity Research Bureau (CRB), the average index increased 4.3% between December 5, the smallest level in the quarter, and the end of February. On this date, the CRB registered respective reductions of 35.3% in relation to the maximum value, observed on July 2, 2008, and of 32.5% in comparison to the level observed at the end of February of that year.

With regard to the Standard & Poor's (S&P's) GSCI commodity index, in partnership with Goldman Sachs, the variation in the prices of commodities reached 5.7% between December 5 and the end of February, reflecting expansions of 2.5% and 13.5% in the segments of metallic and agricultural products.

The evolution in the prices of metallic commodities in the period, in an environment of relative accommodation of financial markets turbulence, was associated to the deceleration in the pace of growth in the stocks of most metals. According to the London Metal Exchange (LME), the quotations of copper and nickel increased by 11% and 6.5% in the period, as opposed to cutbacks observed in the quotations of aluminum, 10.8%, and zinc, 1.9%.

Insofar as the iron ore market is concerned, the relative recovery in the iron and steel activity in China, in the

December-January period, and the less intense downturn of the USA and European Union steel production are expected to provide mining companies with some negotiation power, amidst a scenario of expected falloff in the price of iron ore in the contractual negotiations for 2009. In addition, the reduction of almost 80% in the cost of sea freight, as compared to the level of the first half of 2008, may attenuate the pressure for reduction in the price paid to producers.

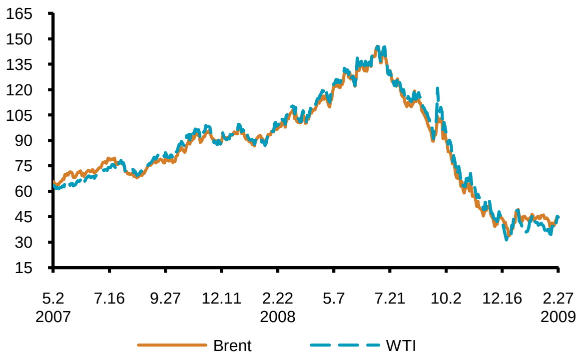
The trajectory of quotations of agricultural commodities incorporates the recent cutoffs on the forecasts of world grain production, in line with the climatic adversities observed in Latin America. Considering the futures contracts for first delivery, generalized expansions in the quotations of major agricultural commodities were observed between December 5 and the end of February, with emphasis on wheat, 11.5%; maize, 19.5%; and soybean, 11.6%, at the Chicago Board of Trade; and coffee, 7.7%; and sugar, 36%, at the New York Intercontinental Exchange, the latter boosted by the harvest break in India.

4.4.1 Petroleum

In line with the deceleration observed in the activity level of the world economy, the average prices per barrel of WTI and Brent-type petroleum dropped from US$57.29 and US$53.24, respectively, on November 2008, to US$39.15 and US$43.24, in February. The price per barrel of Brent-type petroleum moved from US$51.73, at the end of November, to US$44.91 on February 27, for a 13.2% reduction. January and February International Energy Agency (IEA) estimates confirm the downward trend of world's consumption of petroleum for the first half of 2009. This trend, in a scenario of growing stocks in the importing countries, reinforces the expectation of a relative stability in the prices per barrel of petroleum over the next months.

Figure 4.21 – Oil – Spot market

US$ per barrel



Source: Bloomberg

4.5 Conclusion

Expectations in relation to the evolution of the world economy continue to depend on the improvement of entrepreneurs and household confidence as well as on the reestablishment of the credit channels. Even though some recent indicators point, as of December, to a relative deceleration in the pace of deterioration of industrial activities and services, a concrete evidence of stabilization of private demand for goods and services is not foreseen.

In this environment, in which the accumulation of undesired stocks imply cuts in the production of intermediate goods and raw materials, the maintenance of the level of commodity prices registered as of December is conditioned to the trajectory of global demand over the next months.

This process will depend on the impacts of credit restriction over the economy's real activity as well as on the way entrepreneurs and customers form their expectations. In 2009, an the governments and monetary authorities of leading mature and emerging economies may give an important contribution, since, in the framework of the perspectives for the deterioration of the current disinflation scenario, they have been intensifying the adoption of expansionist fiscal and monetary policies.

External sector

5

The Brazilian economy's main external indicators, even evincing the importance of macroeconomic adjustment achieved in the latest years, especially the strengthening of the country's external position, with the objective to meet the turmoil in the international markets, moved on to reflect the adverse conditions of the world economy.

The country-risk which, in early 2008, closed at 221 b.p., reached 179 b.p. at the beginning of June, the lowest level in the year, turning to represent a growing trajectory as of the third quarter. After reaching the maximum level, in the year, from 688 b.p. on October 23, the indicator started reflecting the relative accommodation on the markets, closing 2008 at 428 b.p., a level similar to the one registered in mid-March 2009.

The foreign exchange domestic market, following the US$17.2 billion surplus verified during the three first quarters, began making explicit the external liquidity restriction and the foreign investors' necessity to cover losses incurred in other economies. The sharp remittances registered in the last quarter of the year conditioned, therefore, the exchange deficit of US$983 million observed in 2008.

Even with the deterioration occurred in the last quarter, the balance of payments showed, in 2008, the eighth consecutive positive result, registering surpluses of external financing, defined as the sum of the result in current transactions and of the net inflows of Foreign Direct Investments (FDI), of US$16.8 billion in the year, against US$36.1 billion, in 2007.

The current transactions, after registering surpluses for five consecutive years, turned to show deficits in 2008. This reversal, initiated in mid-2007, evinced the impact of the expansion trajectory of the Brazilian economy on the growth in imports, at a level significantly higher than that of exports, and the increase in the net remittances of services and income, mainly those related to profits and dividends.

The performance of the financial account of the balance of payments continued translating significant net IED inflows, which achieved a record level in 2008, contrasting with the outflows of foreign capital in portfolio investments, especially shares; short-term loans; and reduction in the medium and long-term external debt rollover rate;

The international reserves, following the process of strengthening of the Brazilian external position, registered continuous growth up to September 2008, period in which the external public debt showed a downward trajectory. The strategy of accumulation of reserves and of improvement in the public debt profile proved to be an efficient tool to confront the external crisis, ensuring that its impacts on the external accounts were less intense than those events observed in the recent past.

In this environment, expectations for 2009 consider the maintenance of financing conditions of the balance of payments and the reduced deficit in current transactions. The alterations registered in the forecasts for the year, in relation to the previous Inflation Report, detailed in the specific box, incorporate the new international scenario; the results observed up to February, including net interventions on the market carried out by the Central Bank; and the new position of external indebtedness, related to last December.

5.1 Exchange operations

The foreign exchange market, after registering record net inflows of US$87.5 billion in 2007, showed net outflows of US$983 million in 2008, the first negative result since 2002. The net inflows in the trading sector, reflecting respective expansions of 1.7% and 29.7% in contracting export and import contracting operations, reached US$47.9 billion, dropping 37.6% in the year. The financial sector registered net outflows of US$48.9 billion, against net inflows of US$10.7 billion in 2007, reflecting increases of 21% in purchases, and of 39.3% in sales of foreign currency.

The shortage of external financing to foreign trade, as of the fourth quarter of 2008, translated in the reduction of funding for ACC lines, which began experiencing, as of October, negative variation rates in relation to equal periods of the previous year. In this scenario, the Central Bank began to offer loans in foreign currency, aimed at financing export lines, highlighting that this modality was responsible, from October 2008 to February 2009, for 74.5% of the contracting of exports supported by ACC operations.

Table 5.1 – Foreign exchange flows

US& billion

Itemization	2008			2009	
	Feb	Jan-Feb	Ano	Feb	Jan-Feb
Trade operations	2.7	6.8	47.9	2.9	3.4
Exports	12.3	27.7	188.0	10.5	20.7
Imports	9.7	20.8	140.1	7.6	17.3
Financial operations[1/]	0.6	-5.9	-48.9	-2.0	-5.6
Purchases	28.7	61.3	421.2	16.4	34.8
Sales	28.1	67.2	470.1	18.4	40.4
Net flows	3.2	0.9	-1.0	0.8	-2.2

1/ Excluding interbank operations and Central Bank foreign operations.

The foreign exchange market, if the wariness to risk persists on the part of investors on the international financial market, registered net outflows of US$2.2 billion in the first two-month period of 2009, against net inflows of US$889 million in the same period of the previous year. The trading segment registered a surplus of US$3.4 billion, against US$6.8 billion in the first two months of 2008, result of respective reductions of 25% and 16.7% in the contracting for exports and imports, while the financial segment accumulated net outflows of US$5.6 billion, against -US$5.9 billion in the equivalent period of the previous year, evincing reductions in the purchases (43.2%) and in sales (40%) of foreign currency.

Central Bank's interventions in the domestic exchange market, in 2008, resulted in net purchases of US$6.7 billion, against US$78.6 billion in 2007. The results of the exchange market, added with net interventions from the Central Bank determined the reduction of US$6.3 billion in the banks' short position, which topped US$1 billion at the end of 2008. At the end of February, the banks held short position at a level similar to that of the closure of the previous year, US$954 million.

5.2 Trade in goods

In the first two months of 2009, the balance of trade results confirmed the effects of the international crisis on the international trade flows. In this sense, the Brazilian exports reached US$19.4 billion and imports, US$18.1 billion, falling, in the order, 25.7% and 25.4%, in relation to the same period of 2008. The trade surplus and the current trade registered respective reductions of 29.9% and 25.6%, in the period.

Table 5.2 – Trade balance – FOB

US$ million

Period		Exports	Imports	Balance	Total trade
Jan-Feb	2009	19 368	18 127	1 242	37 495
Jan-Feb	2008	26 077	24 306	1 771	50 382
% change		-25.7	-25.4	-29.9	-25.6

Source: MDIC/Secex

The monthly analysis reveals that the average daily value of imports fell off 30.9% in February, as compared to the same month of 2008 while in the context of exports, the cutback reached 20.9%. In this scenario, although there is sharp drop in the current trade, the trade surplus in the month, totaling US$1.8 billion, revealed 119.4% above that registered in the same period of 2008.

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

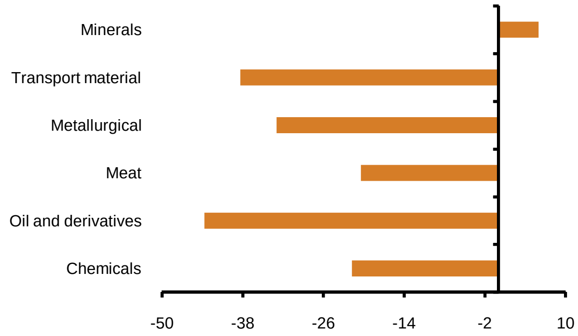
US$ million

Itemization	2008	2009	% change
Total	636.0	496.6	-21.9
Primary products	189.9	180.7	-4.8
Industrial products	426.7	305.6	-28.4
Semimanufactured goods	96.1	76.0	-20.9
Manufactured goods	330.6	229.6	-30.5
Special operations	19.5	10.3	-47.1

Source: MDIC/Secex

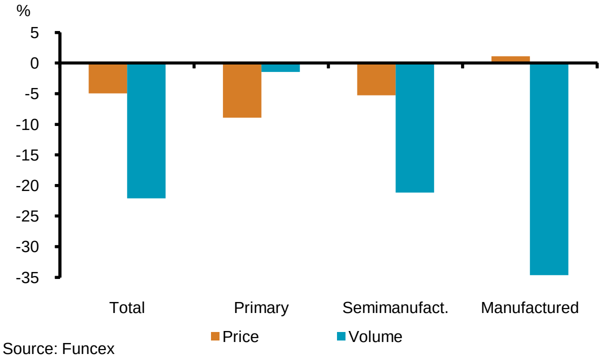
The evolution of external sales in the first two months of the year, in relation to the same period of 2008, derived from reductions in the daily averages exported in all of the categories of aggregated factor, with emphasis on the decrease observed in the segments of manufactured goods, 30.5%, and semi-manufactured goods, 20.9%. The shipping of basic products reduced by 4.8%, in the period, causing an

Figure 5.1 – Main exports
January-February – 2009/2008 – % growth



Source: MDIC/Secex

Figure 5.2 – Exports – Price and volume index
January - February – 2009/2008



Source: Funcex

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

US$ million

Itemization	2008	2009	% change
Total	592.8	464.8	-21.6
Capital goods	127.9	114.2	-10.7
Raw materials	304.6	221.2	-27.4
Naphtha	11.3	3.0	-73.7
Consumer goods	73.1	70.8	-3.1
Durable	38.7	35.9	-7.4
Passenger vehicles	13.9	13.0	-6.4
Nondurable	34.4	34.9	1.7
Fuels	87.3	58.6	-32.8
Crude oil	49.6	27.3	-44.9

Source: MDIC/Secex

increase of 6.5 p.p. of its participation in the total exported, whereas those of manufactured goods decreased from 52% to 46.2% and those of semi-manufactured remained stable, at 15.3%.

With reference to basic products, one should highlight, in the two month-period, the declines observed in the average daily sales of beef, 39.9%; petroleum, 28.7%; and chicken 17.2%, contrasting with respective increases of 24.4% and 12.9% registered in the exports of soybeans and iron ore. The cutback in the shipping of semi-manufactured goods was associated, in part, to the reductions in exports of leather and furs, 57%; semi-manufactured products of iron and steel, 53.8%; and cast iron, 12.7%; while those of sugar and aluminum registered respective increases of 98% and 18.8%. Concerning manufactured items, one should highlight the reductions in the sales of fuel oils, 53.3%; automobiles, 46.9%; and automotive spares, 43.3%.

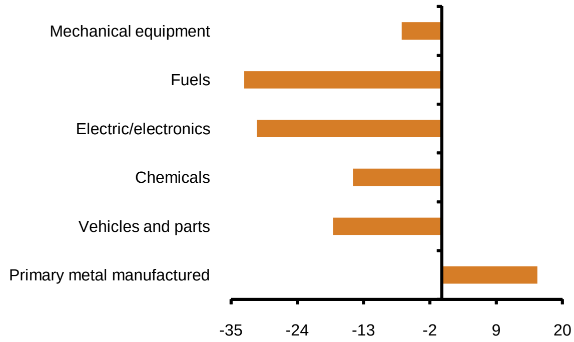
The external sales of the six major industrial sectors represented 53.8% of the total exported in the two-month period ended in February. The 27.6% downturn in relation to the same period of 2008 reflected cutbacks in exports of petroleum and derivatives, 43.7%; transportation materials, 38.4%; iron and steel, 33%; chemicals, 21.8%; and meats, 20.4%. The external sales of ores, stimulated by the ongoing demand from China, expanded 6% in the two-month period.

According to the Foreign Trade Studies Center Foundation (Funcex), the cutback of 25.7% registered by exports in the first two-month period, compared to equivalent period of 2008 translated, in particular, the decrease of 22.1% observed in the quantities exported; resultant from an overall decline in all aggregated factor categories, reaching 34.7% in manufactured goods, 21.2% in semi-manufactured goods, and 1.5% in basic products. Exports prices dropped 5% in the period, registering respective decreases of 8.9% and of 5.3% in those of basic and semi-manufactured goods, and an increase of 1.1% in the segment of manufactured goods.

The process of deceleration of imports, initiated in September 2008, was intensified in the two-month period ended in February, when the daily average of external purchases dropped 21.6% in relation to the same period of 2008. This movement reflected the occurrence of generalized reductions in acquisitions of all use categories, excepting that related to nondurable consumer goods, which registered expansion of 1.7%, in the period.

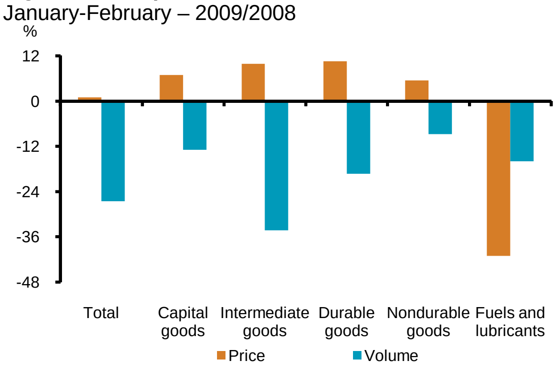
The imports of fuels and lubricants decreased 32.8% in the two-month period, reflecting, particularly, the evolution of

Figure 5.3 – Imports by main products
January-February – 2009/2008 – % change



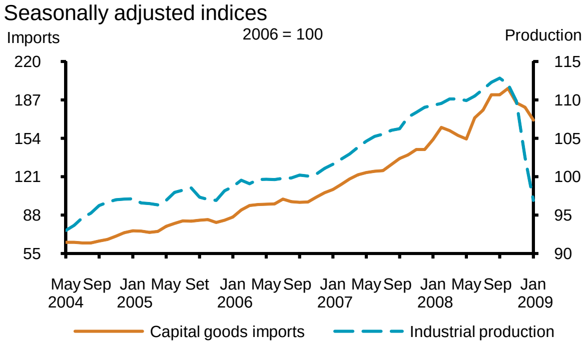
Source: MDIC/Secex

Figure 5.4 – Imports – Price and volume index
January-February – 2009/2008



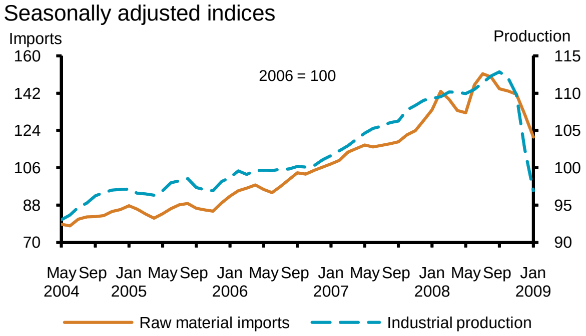
Source: Funcex

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



Sources: Funcex and IBGE

international petroleum prices, which led to the reduction of 44.9% in their imported value.

The purchases of raw materials and intermediate products, representing 47.6% of the total imported, dropped 27.4%, impacted by the retractions in imports of chemical and pharmaceutical goods, 15.6%; transportation equipment accessories, 14%; mining products, which include fertilizers and naphtha, 34.5%; parts and spares of intermediate products, 27.9%; and non-food farming products, 25.3%. The behavior of external purchases of this category is closely correlated to the industrial output level, which registered, equally, a significant decline in the period.

The average daily acquisitions of capital goods dropped 10.7% in the two-month period, with emphasis on reductions of purchases of machinery and office and scientific service apparatuses, 27.7%; parts and spares for industrial capital goods, 27,9%; and industrial machinery accessories, 4.2%. Conversely, there has been an expansion of 65.9% on imports of movable transportation equipment, due to planned imports of two aircrafts, by a national air carrier.

The cutback, in the two-month period, of 7.4% registered in the external purchases of consumer durables, reflected the decreases in the acquisitions of machinery and household appliances, 26.8%, and of automobiles, 6.4%, the latter accounting for 36.2% of imports of the category. The purchases of articles of personal adornment expanded 6.2% in the two-month period ended in February, as compared to equal period of 2008.

The acquisition from the six principal importing sectors dropped 18.9% in the two-month period ended in February, compared to the same period in 2008, representing 61.6% of imports in the period. Reductions in purchases of five sectors: fuels and lubricants, 32.8%; electric and electronic products, 30.8%; automotive vehicles and parts, 18.1%; organic and inorganic chemicals, 14.7%; and mechanical equipment, 6.7%, contrasting with the expansion of 15.8% in imports of steel products.

According to Funcex, the reduction of 25.4% observed in the value of imports in the two first months of 2009, in relation to the same period of the previous year reflected, especially, the downturn of 26.6% registered in the volume of imports, with an average increase of 1% registered in prices. Considering use categories, the imports of fuels and lubricants registered respective reductions of 16% in the volume and of 41% in prices. In the other categories, there has been reductions in volume and an increase in prices, reaching, in the order, 12.9% and 6.9% in capital goods; 34.3% and 9.9% in raw materials and intermediate products; 19.3% and 10.5% in durable consumer goods; and 8.7 and 5.5% in nondurable consumer goods. The impact of the recent evolution on the prices of intermediate commodities has shown to be more representative on the structure of export prices than on the Brazilian imports, reducing, therefore, the swap terms for the country, which registered, in February 2009, accumulated reduction of 11.4% since the peak reached in October 2008.

The country's current trade, considering the daily average flows, registered reduction of 21.8% in the first two months of 2009, as compared to the same period of the previous year, result of generalized falloffs in the trade relations among the leading blocs and regions.

The European Union was the largest bloc to purchase Brazilian products in the two-month period, absorbing 24% of the country's total exports, followed by Latin America and the Caribbean, 22.8%. The USA, destination of 12% of the Brazilian external sales, against 15% in the first two-month period of 2008, remained as the leading individual buyer. Sales to Asia expanded 8.2% in the period, boosted by the expansion of 23.3% in the shipping directed to China, which purchased 8.6% of Brazilian exports, becoming the second main individual buyer. The daily average of exports to Mercosur dropped 44.1%, with emphasis on the reduction of 46.5% registered in sales to Argentina, which, in the period, received 6.9% of Brazilian sales.

Table 5.5 – Exports and imports by area – FOB

Daily average – January-february

US$ million

Itemization	Exports			Imports			Balance	
	2008	2009	% change	2008	2009	% change	2008	2009
Total	636	497	-21.9	593	465	-21.6	43	32
L.A. and Caribe	173	113	-34.4	108	70	-35.0	65	43
Mercosur	78	43	-44.1	63	38	-38.6	15	5
Argentina	64	34	-46.5	55	33	-41.1	8	2
Other	14	9	-32.8	7	6	-19.4	7	3
Other	95	70	-26.4	45	32	-30.1	50	38
USA[1/]	96	59	-38.0	88	91	3.4	8	-32
EU	155	119	-23.1	131	100	-23.3	24	19
E. Europe	15	11	-27.3	16	5	-66.6	-1	5
Asia	99	107	8.2	159	139	-12.6	-60	-32
China	34	43	23.3	70	61	-12.4	-35	-19
Other	64	64	0.1	89	78	-12.8	-25	-14
Others	99	87	-12.1	91	59	-35.1	8	28

Source: MDIC/Secex

1/ Includes Puerto Rico.

Brazilian imports originating in the principal blocs and regions registered significant reduction in the first two-month period of 2009, highlighting the cutbacks observed in the purchases from Eastern Europe, 66.6%; Latin America and the Caribbean, 35%; and European Union, 23.3%. The acquisition of products from the USA, Brazil's leading supplier, expanded 3.4% in the period, turning to represent 19.5% of Brazilian external purchases. Asia has consolidated its position as the major regional supplier to Brazil, with an expansion of 3.1 p.p. on the market-share, which reached 29.9% of the total, followed by the European Union, 21.6%, and Latin America and the Caribbean, 15.1%.

5.3 Services and income

Current transactions registered a US$3.3 billion a deficit in the two-month period ended in February, against US$5.9 billion in the same period of 2008. The net expenses of the income account reached US$3.7 billion; net remittances of the service account, US$1.4 billion; and the trade surplus, US$1.2 billion, representing respective reductions of 38.6%, 35.9% and 29.9%, in the period. The unilateral transfers registered net revenues of US$585 million, 9.3% lower than those registered in the first two months of 2008.

The current transactions deficit topped US$25.7 billion in the twelve- month period ended in February, reverting the trajectory of deterioration since mid-2007, with a peak of US$28.3 billion in December 2008. The net expenditures of the income account totaled US$38.2 billion and the net remittances on the service account, US$15.9 billion, representing respective reductions of US$2.3 billion and US$806 million in relation to the deficits observed in the twelve-month period ended in December. The trade surplus came to US$24.2 billion and unilateral transfers, US$4.1 billion

In 2008, the international travel account showed the highest annual values of the historical series, since records begun 0in 1947, related to revenues, expenses and deficit, an evolution consistent with the environment of increase of available income and appreciation of the real observed up to the aggravation of the international crisis, in the final quarter of the year. Considering periods of twelve months, the account showed net outflows of US$4.9 billion in February, registering cutbacks of 6.3% in relation to December and of 16.6% compared to the peak of the series, in September. Net outflows reached US$371 million in the first two months of the year, dropping 46.7%, when compared to the same 2008 period.

The transportation account, which responds to the performance of the trade balance and the international travel account, registered cumulative net outflows of US$4.7 billion in the twelve-month period ended in February, a result 5.8% lower than in 2008. N-et expenditures with transportation reached US$335 million in the two-month period ended in February, dropping 46.3% in relation to the same period of the previous year.

Net remittances related to equipment lease, accumulated in twelve months, totaled US$8 billion in February, expanding 3.1% in relation to December, a result which confirms the lesser capacity of response of that heading to the international scenario, as a consequence of the rigidity of prevailing contracts. In the two-month period ended in February, the net expenditures associated to this account summed up US$1.2 billion, rising 23.9% in relation to the corresponding period of 2008.

Net payments abroad related to royalties and licenses, a heading which includes technology supply services, copyrights, licenses and registries for use of trademarks and of exploration of patents, franchises, among others, reached US$2.1 billion in the twelve-month period ended in February. Net outflows came to US$255 million in the two-month period ended in February, falling 32.7% in relation the same period in 2008.

Table 5.6 – Current account

US$ billion

Itemization	2008			2009		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year[1/]
Current account	-1.9	-5.9	-28.3	-0.6	-3.3	-16.0
Trade balance	0.8	1.8	24.7	1.8	1.2	17.0
Exports	12.8	26.1	197.9	9.6	19.4	158.0
Imports	12.0	24.3	173.2	7.8	18.1	141.0
Services	-1.2	-2.2	-16.7	-0.9	-1.4	-13.4
Transportation	-0.3	-0.6	-4.9	-0.2	-0.3	-4.5
International travel	-0.3	-0.7	-5.2	-0.1	-0.4	-2.5
Computer and informat.	-0.3	-0.5	-2.6	-0.1	-0.3	-2.7
Operational leasing	-0.4	-1.0	-7.8	-0.6	-1.2	-7.7
Other	0.2	0.6	3.9	0.2	0.8	4.1
Income	-1.8	-6.1	-40.6	-1.7	-3.7	-22.6
Interest	-0.6	-1.8	-7.2	-0.7	-2.0	-8.2
Profits and dividends	-1.3	-4.3	-33.9	-1.1	-1.8	-15.0
Compensation of employees	0.0	0.1	0.5	0.1	0.1	0.6
Current transfers	0.3	0.6	4.2	0.3	0.6	3.0

1/ Forecast.

The income account deficit accumulated in the twelve-month period ended in February reached US$38.2 billion. As observed since 2006, the result of this account has been significantly impacted by the remittances of income from direct investment. Additionally, as a consequence of the reduction in external indebtedness, the net remittances of profits and dividends surpassed the net expenses with interests for the third consecutive year. This behavior reflects the alterations in the country’s total external liabilities, in which the stocks of direct and portfolio foreign investments began to predominate.

In this scenario, net remittances of profits and dividends totaled US$31.4 billion in the twelve-month period ended in February. The cutback of US$2.5 billion compared to the result observed in 2008 evinces the celerity of the adjustment derived from the deceleration of the domestic growth and of exchange depreciation – these net remittances reached US$1.8 billion, in the two-month period, reducing by 58.3% in relation to the same period of 2008.

Net remittances of interests totaled US$7.4 billion in the twelve-month period ended in February, showing stability in relation to the result accumulated from January to December 2008. Expenditures with payments of interests abroad fell by 2.2%, to US$17.1 billion, while interest revenues dropped 5.9%, to US$9.6 billion. One should highlight that interest earnings on reserves, the main determinant of interest revenues, has been conditioned, in the latest months, to the measures of monetary easing adopted by the leading industrialized economies, as a response to the international crisis. In this scenario, the revenues with reserve remuneration, accumulated in twelve months, after showing an upward trajectory up to July 2008, when they summed up the record value of US$7.5 billion, totaled US$6.9 billion in February. One should highlight that the net remittances of interests reached US$2 billion in the two-month period ended in February, rising 11.7%, in relation to the same period of 2008, with emphasis on the 32.7% reduction registered in revenues.

Net remittances of direct investment income accumulated in twelve months up to February came to US$25.1 billion. The net expenditures with profits and dividends reduced by 7.3%, compared to the corresponding period of 2008, while the net remittances related to interests of intercompany loans expanded 14.8%, totaling, in that order, US$23.5 billion and US$1.6 billion. Net remittances related to portfolio investment income totaled US$7.9 billion, falling 6.3% in the period, with highlight to the drop of 7.7% in the remittances of profits and dividends.

Income from other investments, which includes interests on suppliers' credits, loans, deposits and other assets and liabilities, totaled net remittances of US$5.8 billion in the twelve-month period ended in February, reducing by 2.1% in relation to the level registered in December 2008.

The companies of the industrial sector and those from the services sector accounted for, in the order, the remittance of 66.2% and 31.5% of the gross remittances of profits and FDI dividends in 2008, highlighting the representativeness of the relative remittances related to the segments manufacturing and assembling of automotive vehicles, 21.6%; iron and steel, 14.7%; and financial intermediation, 11.8%.

The unilateral transfers summed up net inflows of US$4.1 billion in the twelve-month period ended in February, practically stable in relation to the accumulated result in 2008. In the first two months of the year, the unilateral transfers made possible net inflows of US$585 million, 9.3% lower than that registered in the same period of 2008.

5.4 Financial account

The capital and financial accounts indicated a positive result of US$1.1 billion in the two-month period ended in February, registering twelve month accumulated surplus of US$19.3 billion. The performance of the financial account continues to show the significant net inflows of FDI, which reached a record volume in 2008, contrasting with the recent outflows of external capital related to portfolio investments, especially in shares; short-term loans; and with the reduction, as of the last quarter of 2008, on the rollover rate of the medium and long-term external debt.

The financial account of the balance of payments accumulated net inflows of US$18.1 billion in the twelve-month period ended in February, against US$87.3 billion in the same period of 2008, a reduction associated, to a large extent,

Table 5.7 – Financial account

US$ billion

Itemization	2008			2009		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year[1/]
Capital account	5.5	14.6	31.9	0.5	0.8	27.7
Direct investments	-0.1	3.4	24.6	2.6	4.6	25.0
Abroad	-1.0	-2.4	-20.5	0.7	0.7	0.0
In Brazil	0.9	5.7	45.1	2.0	3.9	25.0
Equity capital	0.6	4.3	30.1	1.0	1.9	25.0
Intercompany loans	0.3	1.4	15.0	1.0	2.0	0.0
Portfolio investments	2.2	0.5	1.1	-1.9	-4.3	-14.5
Assets	-0.4	-0.4	1.9	-0.2	-0.2	0.0
Liabilities	2.6	0.8	-0.8	-1.7	-4.0	-14.5
Derivatives	-0.2	-0.2	-0.3	0.1	0.2	0.0
Other investments	3.6	11.0	6.5	-0.4	0.3	17.2
Assets	-0.3	1.2	-4.2	-1.9	-2.0	12.9
Liabilities	4.0	9.7	10.6	1.5	2.3	4.2

1/ Forecast.

to the reversals observed in the flows related to portfolio investments, of net inflows of US$20.8 billion to net outflows of US$4.2 billion. The financial account of the balance of payments showed net inflows of US$842 million in the two-month period ended in February, against US$14.6 billion in the corresponding period of 2008.

The adverse condition on the international financial markets impacted the flows of Brazilian direct investments abroad at the beginning of the year, which, after summing up US$20.5 billion in 2008, totaled returns of US$682 million in the two-month period ended in February.

Net inflows of FDI totaled US$43.2 billion in the twelve-month period ended in February, against US$36.5 billion in the same period of 2008. In the two-month period ended in February, FDI inflows totaled US$3.9 billion, 31.8% lower than the result of the same period in the previous year.

Foreign portfolio investments totaled net outflows of US$5.6 billion in the twelve-month period ended in February, against net inflows of US$43.6 billion in the same period of 2008. Net foreign investments in stock of Brazilian companies reduced from net inflows of US$19.1 billion, down to net outflows of US$8.3 billion, on the same basis of comparison.

Foreign investments in fixed-income securities totaled net outflows of US$527 million, in the twelve-month period ended in February, against net inflows of US$23.4 billion in equivalent period of 2008, with emphasis on the reduction, from US$23.7 billion to US$8.2 billion, in the net inflows of securities negotiated in the country.

The sovereign bond market registered net remittances of US$1.7 billion in the twelve-month period ended in February, a result not only of the original schedule of maturities, but mainly, in view of the anticipated debt redemptions, which totaled US$3.3 billion. In the period, the new issuances summed up US$1.6 billion, of which US$1 billion related to the launch, in January, of the Global 19N bonds, and US$525 million related to the reopening of Global 17 bonds. Considering the two-month period ended in February, there have been net outflows of US$789 million in this segment.

Operations with notes and commercial papers showed net amortizations of US$3.2 billion in the twelve-month period ended in February, against net disbursements of US$5.4 billion in the corresponding period of 2008. The short-term securities registered net amortizations of US$3.8 billion

Table 5.8 – BP financing sources
Selected items

US$ billion

Itemization	2008			2009		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year 1/
Medium and long-term funds	1.0	4.2	13.5	0.3	1.9	10.7
Public bonds	0.0	1.2	0.5	0.0	1.0	1.0
Private debt securities	0.6	2.5	7.3	0.1	0.4	5.8
Direct loans	0.5	0.5	5.7	0.2	0.5	3.9
Short-term loans (net) 2/	1.1	7.0	-6.0	-0.2	-0.3	0.0
Short-term sec. (net)	0.0	0.8	-3.9	-0.3	-0.7	0.0
Portfolio (net)	2.8	1.4	4.4	-1.1	-3.2	-10.0
Roll-over rates (%)						
Private sector:	156%	299%	109%	63%	54%	75%
Debt securit.	104%	230%	83%	32%	33%	75%
Direct loans	410%	688%	183%	96%	120%	75%

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

Table 5.9 – Statement of international reserves

US$ billion

Itemization	2008		2009	
	Jan-Feb	Year	Jan-Feb	Year 1/
Reserve position in previous period	180.3	180.3	193.8	193.8
Net Banco Central purchases	5.5	-5.4	-2.9	7.6
Spot	5.5	7.6	-3.4	-3.4
Repo lines of credit	-	-8.3	2.7	8.3
Foreign currency loans	-	-4.7	-2.2	2.7
Debt servicing (net)	-0.6	-0.4	-0.6	-0.7
Interest	-0.2	2.8	-0.4	1.3
Credit	1.3	7.2	1.0	5.2
Debit	-1.5	-4.4	-1.4	-3.9
Amortization	-0.4	-3.2	-0.2	-2.0
Disbursements	-	1.3	-	-
Multilateral organizations	-	0.8	-	-
Sovereign bonds	-	0.5	-	-
Others 2/	5.8	10.4	-4.9	-4.9
Treasury's purchases	1.8	7.6	1.6	5.9
Change in assets	12.6	13.4	-6.9	7.9
Gross reserve position	192.9	193.8	186.9	201.7
Repo lines of credit position	-	8.3	5.7	-
Foreign currency loans position	-	4.7	6.8	2.0
Reserves position - liquidity	192.9	206.8	199.4	203.7

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.

and net inflows of US$1.9 billion in the periods under consideration, an inversion deriving, especially, from the decline of 62.9% registered in gross inflows, mirroring the credit restrictions on the international market.

The other investments, encompassing direct loans with banks and with international organizations, commercial credits and constitution of assets in the form of deposits, registered net outflows of US$4.2 billion in the twelve-month period ended in February, against net disbursements of US$20.8 billion in the same period of 2008. The other Brazilian investments, demonstrating net granting of medium and long-term loans of US$4.4 billion, showed net outflows of US$7.4 billion, against US$15.5 billion in the twelve-month period ended in February 2008. Other foreign investments registered respective net inflows of US$3.2 billion and US$36.3 billion, in the same periods. In the two-month period ended in February, the other foreign investments were positive by US$2.3 billion, basically as consequence of the performance of short-term commercial credits.

The rollover of the medium and long-term external debt of the private sector, the rate of which reflects new disbursements in relation to observed amortizations, stood at 111% in 2008, when the percentages related to the rollover of bonuses and direct medium and long-term loans were, respectively, at 85% and 193%. One should highlight that this rate was affected, in the final quarter of 2008, by the escalation of the economic crisis, coming down to percentages lower than 50%. The rollover rate of the private sector medium and long-term external debt, still mirroring the international market credit squeeze, came down to 58% in the two-month period ended in February.

The international reserves, in the liquidity concept, which include lines with repurchase and foreign currency loan operations, dropped by US$7.4 billion in the first two-month period of 2009, totaling US$199.4 billion. In the period, there were US$2.9 billion net sales by the Central Bank on the exchange market, result of cash sales of US$3.4 billion; repurchases of lines sales of US$2.7 billion; and US$2.2 billion outflows related to loan operations in foreign currency. Interest earnings on reserves accumulated US$950 million. The other operations reduced their stock by US$4.9 billion. The stock of foreign currency sales operations with repurchase commitment totaled US$5.7 billion, and that related to foreign currency loan operations, US$6.8 billion. At the end of February, the international reserves, on the cash basis, reached US$186.9 billion, falling off US$6.9 billion, when compared to December 2008.

It is estimated that the international reserves total US$203.7 billion, in the liquidity concept, at the end of 2009, falling by US$3.1 billion in the year. Including in the first two months of the year, sales liquidations are foreseen. already occurred, of US$3.4 billion in the spot market; purchases of US$8.3 billion in repurchase lines;; and purchases of US$2.7 billion in foreign currency loan operations. Additionally, interest earnings on reserves should accumulate US$5.2 billion in the year.

5.5 External sustainability indicators

Most indicators of the country's external sustainability evinced the deterioration of the international financial markets, when comparing the results of February 2009 to those of December 2008. There were reductions in exports, in GDP denominated in dollars, in international reserves and in the surplus position of the total net external debt, besides the increase of the external debt service. Even so, it is worth highlighting the changes observed, albeit modest in view of the serious international crisis; attest to the increased resilience of the Brazilian economy's external position.

In the period in question, the external debt service expanded US$0.2 billion, while the exports decreased US$6.7 billion, raising the participation of the debt service in exports from 19% to 19.8%. In this same sense, the total external debt total dropped 1.3%, while the surplus position of the total net external debt reduced from -US$27.6 billion to -US$22.7 billion. Incorporating the of 5.2% registered at the nominal GDP, measured in dollars, the ratio between total debt and GDP increased from 12.6% to 13.1%, while the surplus ratio between the total net debt and GDP moved from -1.8% to -1.5%.

The coefficient of total debt over exports remained at 1, while the ratio total net debt over exports maintained its surplus position at -0.1. Both indicators remained at the best historical level, since the beginning of the series, in 1970.

Still in the same period, international reserves in the liquidity concept decreased by US$7.4 billion, coming to US$199.4 billion. Taking into account the reduction of US$2.5 billion registered by the total external debt, the ratio between international reserves/total external debt dropped 2.4 p.p., to 101.8%.

Table 5.10 – Sustainability indicators[1/]

US$ billion

Itemization	2006	2007	2008			2009
	Dec	Dec	Jun	Sep	Dec	Feb[2/]
Exports of goods	137.8	160.6	178.1	194.9	197.9	191.2
Exports of goods and services	157.3	184.6	205.1	224.3	228.4	221.5
Debt service	56.9	52.0	40.5	38.9	37.6	37.8
Total external debt	172.6	193.2	205.5	211.4	198.4	195.8
Net external debt	74.8	-11.9	-19.2	-20.6	-27.6	-22.7
International reserves						
Cash concept	85.8	180.3	200.8	206.5	193.8	186.9
Liquidity concept	85.8	180.3	200.8	206.5	206.8	199.4
GDP	1 089	1 334	1 458	1 526	1 573	1 491
Indicators						
Total external debt/GDP (%)	15.8	14.5	14.1	13.9	12.6	13.1
Net external debt/GDP (%)	6.9	-0.9	-1.3	-1.4	-1.8	-1.5
Total external debt/exports	1.3	1.2	1.2	1.1	1.0	1.0
Total external debt/exports of goods and services	1.1	1.0	1.0	0.9	0.9	0.9
Net external debt/exports	0.5	-0.1	-0.1	-0.1	-0.1	-0.1
Net external debt/exports of goods and services	0.5	-0.1	-0.1	-0.1	-0.1	-0.1
Debt service/exports (%)	41.3	32.4	22.8	19.9	19.0	19.8
Debt service/exports of goods and services (%)	36.2	28.2	19.8	17.3	16.5	17.1
Reserves – cash concept/ total external debt (%)	49.7	93.3	97.7	97.7	97.7	95.4
Reserves – liquidity concept/ total external debt (%)	49.7	93.3	97.7	97.7	104.3	101.8

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

5.6 Conclusion

The positive results registered by the external sector during the latest years reinforced the country's external position and the introduction of important modifications in its external liabilities. In this sense, noteworthy is the strengthening of international reserves and their stability, six months after the aggravation of the international financial market crisis; and the reduction in participation of the external debt in the total of the country's liabilities, on behalf of investments, both direct and portfolio, which respond to the economic cycle. In this way, the process of strengthening of the balance of payments has been maintained and, consequently, the external sector's resilience to the global financial crisis.

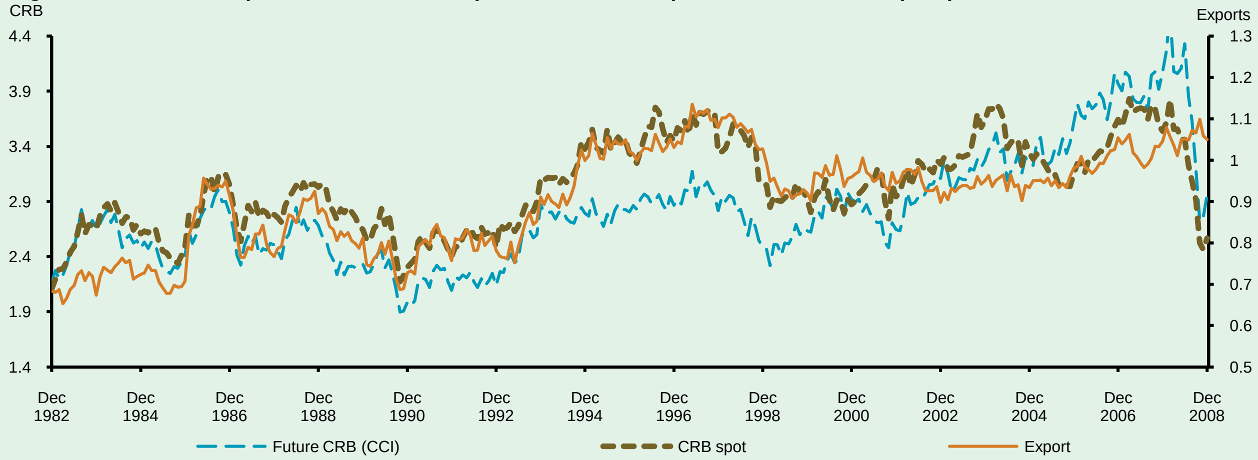
The prospects for growth in the world economy continue unclear, with the uncertainties in the international environment, which may impact the forecasted outlook concerning commodities international prices, capital flows and growth rates of exports and world outputs. Expectations on the US economy and other industrialized countries were revised downwards after the release of new statistics for the fourth quarter. More recent indicators show consumers' expenses in significant decrease, companies reducing their stocks and exports declining abruptly, with the consequent impacts on production and employment.

The year 2009 should register reduction in the current transactions deficit, mirroring the adjustment of the Brazilian economy to the international crisis. This result, impacted by the reduced balance of trade and of net remittances of services and income, should be financed with net inflows of the financial account, with emphasis to the FDI flows.

Correlation between the Terms of Trade and the International Prices of Commodities

In foreign trade, terms of trade are defined as the ratio between the prices of exports and imports of a given country. The improvement in the terms of trade means more favorable conditions for imports, stimulating the domestic production of goods to be exported. To this real effect it should be added the positive monetary effect that increases the balance of trade, even if the quantum of traded goods remains unchanged. In addition, changes in the terms of trade generate potentially important income-effects in producing regions or countries. In the case of Brazil, evidence shows a decisive impact of international prices of commodities on the terms of trade. This box analyses the terms of trade in view of its importance for the balance of trade and the allocation of resources in the economy. In addition, the box also examines the likely effects of the sharp reduction in the international prices of commodities occurred in the final quarter of 2008.

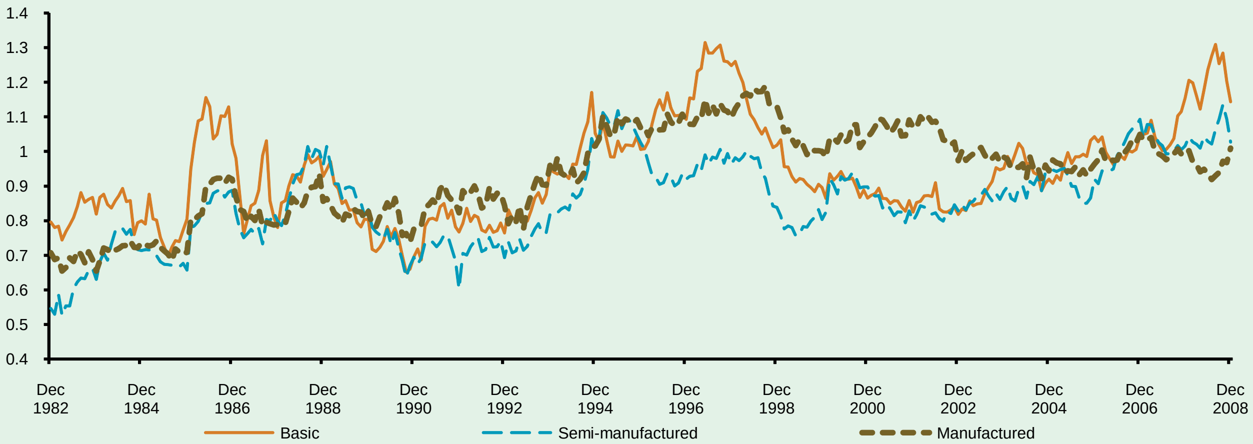
Figure 1 – Indices of export and commodities prices, both in comparison to Brazilian import prices



The dynamic ratio between the Brazilian export prices and the international prices of commodities, both expressed in terms of prices for imported goods, is shown on Figure 1, with monthly data from January 1982 to December 2008. The prices of commodities are based on the Commodity Research Bureau's (CRB) indices, while the prices of Brazilian exports and imports are based on the Foreign Trade Studies Center Foundation (Funcex) indices. By analogy to the terms of trade, the ratio of these indicators and prices of imports is a measure of the incentives for an economy to specialize in commodities.

By analyzing Figure 1, it may be observed that the selected price indices present a series of cyclical movements, especially when longer periods are taken into account. By taking the most recent cyclical movement, which refers to the commodities boom initiated in 2002, more significant impacts on the terms of trade seem to have occurred only after 2006. Notwithstanding this could question whether the empirical correlation between the variables is relevant, the breakdown of export prices by aggregated factor, as illustrated on Figure 2, reveals a significant improvement in the terms of trade for basic and semimanufactured goods. And, at least up to 2006, this trend is smoothened by the manufactured goods only. This points to a greater concentration, over the latest years, of the real and nominal effects of the terms of trade of basic and semimanufactured goods.

Figure 2 – Export price indices by aggregating factor, all in comparison to Brazilian import prices



As shown in Figures 1 and 2, evidence points to the improvement in all indicators of the terms of trade and relative commodity prices in the period under analysis. In fact, despite occasional downward movements, the upward trend prevails on average. Formally, in all series there is a component responsible for the consistent

Table 1 – Average growth rate of price indices
Annual rate, 1982-2008

Indice	%
Brazilian exports	
Total	1.54
Basic	1.60
Semi-manufactured	1.63
Manufactured	1.25
Commodities	
CRB spot	1.60
CRB future	1.99

1/ Price indices related to Brazilian import prices.

improvement in the Brazilian terms of trade in the last quarter of the century. Table 1 quantifies the constant tendency through the average rate of annual growth of the variables. The relative decrease in the price of imports reflects structural changes – initiated in response to the external debt crisis of the 1980's, complemented by the opening of the economy in the 1990's and deepened by the search for petroleum self-sufficiency –, which tend to align the economy with its comparative advantages.

Therefore, this is the most relevant trend for the variables in the long-term. Thus, the forecast should be careful with regard to the level of the most recent figures, impacted by the shorter cycle. This is especially relevant for the analysis of the recent period, in which a sharp contraction of the international prices of commodities was observed at the end of 2008. Since these indicators generally reflect the markets in which commodities are negotiated as financial assets, it is reasonable to assume that the strong shock may result from high volatility and overshooting. Therefore, the price level relevant for carrying out extrapolations of the trend may not be as low as that observed at the end of last year. By comparison, the Brazilian terms of trade are more dependent on the price rigidity in the commodity market, which minimizes the transmission of shocks from the asset market and indicates a long-term trend that starts from a not so unfavorable level.

The analysis of the correlation between the terms of trade and the international commodity prices took into consideration the medium and long-term cyclical

Figure 3 – Export price indices in comparison to import prices; medium and long-term cyclical components

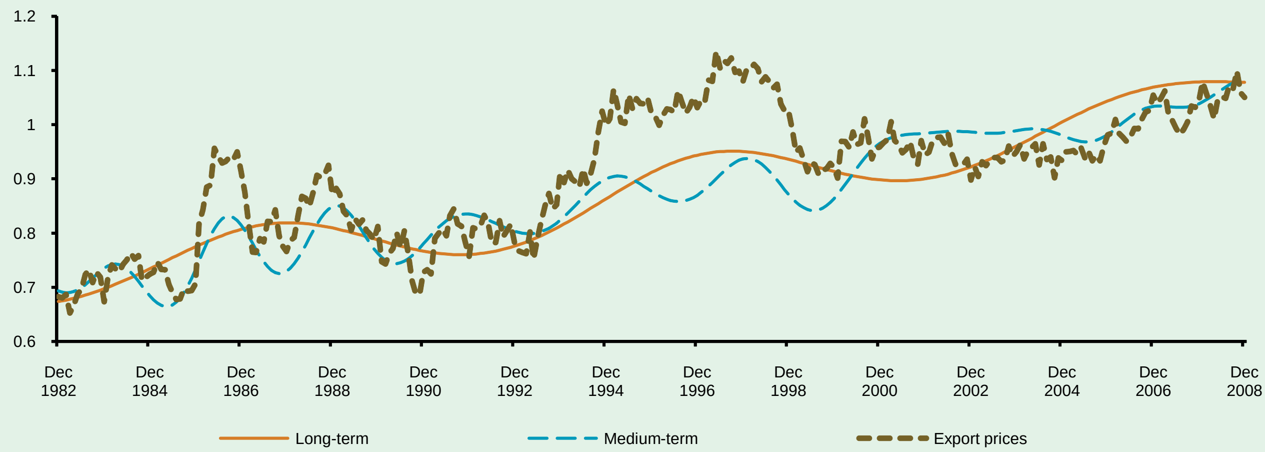


Figure 4 – Commodities current prices (CRB spot) in comparison to import prices: medium and long-term cyclical components

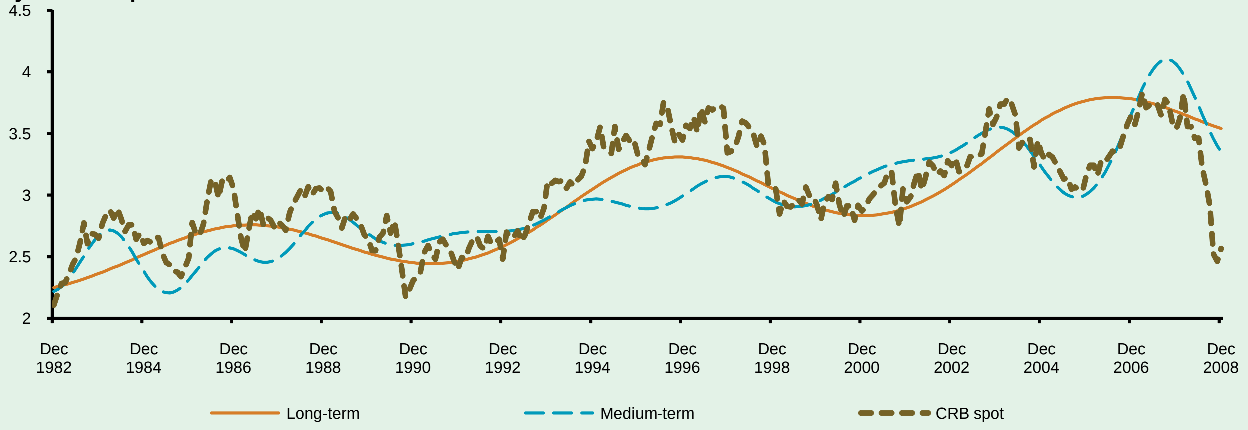
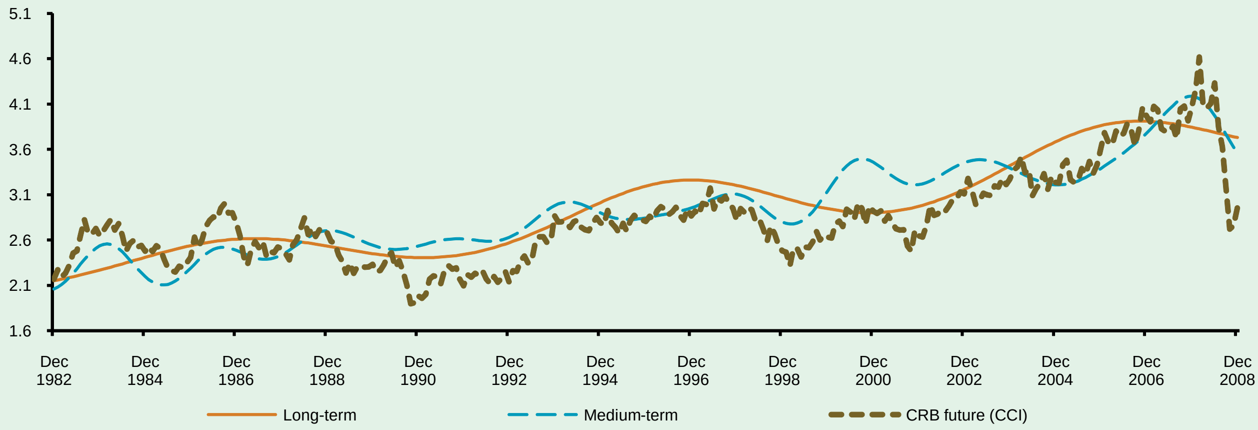


Figure 5 – Commodities future prices (CCI) in comparison to import prices: medium and long-term cyclical components



components, revolving around the growth trend[1]. The breakdown of the series in cyclical movements of different periodicities is appropriate to the context, since it permits to associate the index movements to commodity booms or business cycles in the world economy. The breakdown of terms of trade and commodity prices according to their cyclical components is shown on Figures 3, 4 and 5. Medium-term cycles may be understood as those with periods from 2 to 8 years for its conclusion, and long-term cycles, those with periods from 8 to 12 years.

In all figures, the long-term cycles sustained commodity booms starting around 1982, 1992, and 2002. With regard to the most recent cycle, evidence

1/ A formal definition of correlation between cyclical components may be found in Croux, Forni & Reichlin, 2001, A Measure of Comovement for Economic Variables: Theory and Empirics, The Review of Economics and Statistics, 83-2. The medium and long-term components were extracted by a band pass filter approximately optimum in finite samples. Formal definition may be found in Christian & Fitzgerald, 2003. The Band Pass Filter. International Economic Review, 44-2.

shows that the peak was reached in 2006, despite the break in the two following years due to the medium-term business cycle. In a broader sense, the business cycles are responsible for the fluctuations of the series around the curve drawn by the long-term cycles, and their quantitative influence is more accentuated at the beginning and at the end of the sample. The breakdown does not attribute to the medium and long-term components the sudden drop in the commodity indices, which are better adjusted to a shorter-term development. Therefore, this reinforces the argument that the reduction in international prices, at the levels currently observed, should not be permanent.

Table 2 – Correlation between commodities price indices and export price indices[1/] for medium and long-term cycles[2/]

Commodities prices	cycle	Brazil's export prices			
		Total	Basic	Semi-manufactured	Manufactured
CRB spot	medium	0.54	0.47	0.57	0.36
	long	0.88	0.93	0.89	0.77
CRB future – CCI	medium	0.51	0.45	0.58	0.27
	long	0.86	0.92	0.87	0.73
CRB future – CCI (-3)	medium	0.57	0.48	0.67	0.34
	long	0.92	0.97	0.92	0.81
CRB future – CCI (-9)	medium	0.25	0.11	0.41	0.17
	long	0.97	0.98	0.97	0.92

1/ Price indices referring to Brazil's export prices.
2/ The expected duration of medium cycles is from 2 to 8 years and of long cycles is from 8 to 12 years.

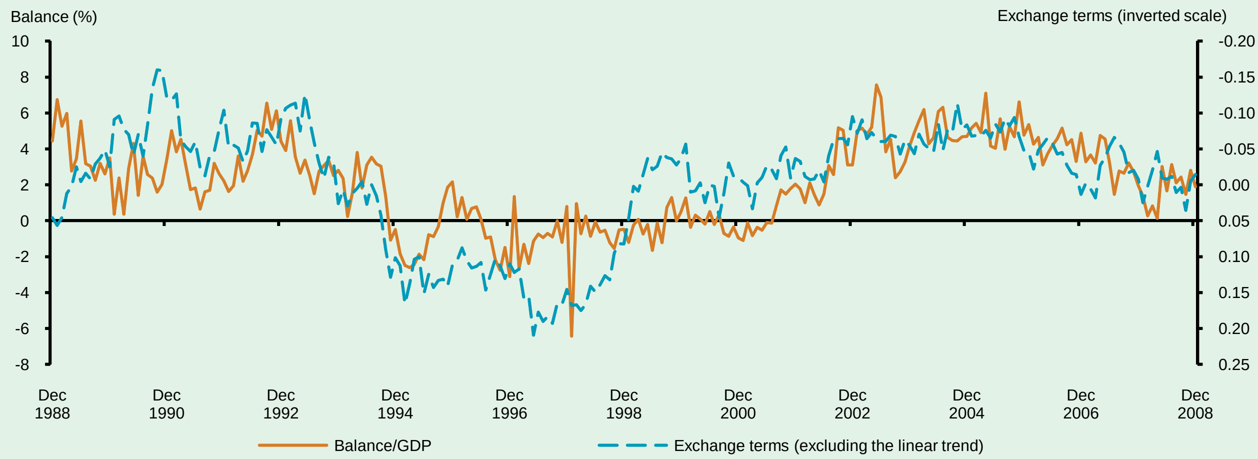
The dynamic correlation of the series, that is, the correlation between the respective cyclical components, is shown on Table 2. The first lines of the table report to the contemporary correlation, in which case the current and future commodity indices do not show significant differences. In both cases, it may be observed a greater correlation for the long-term cycles. The terms of trade for manufactured goods show the lowest correlation with the relative price of commodities in all the periodicities, while the semimanufactured goods exhibit the greatest correlation registered for the medium-term cycles. With regard to the basics, they are more relevant in the long-term, periodicity in which they show greater correlation with commodity indices.

In order to examine the potential of the commodity indices as leading indicators of terms of trade, correlations were calculated for up to twelve months in advance. The current prices index, CRB spot, does not show any correlation improvement with any antecedent. In the comparison, the future prices index, future CRB (CCI), shows a significant improvement, thus showing a good antecedent indicator. In fact, the greater correlation of future CRB with the export prices occurs, in the medium cycle, in the 3-month period; and, in the long cycle, in the nine-month period. It may be observed that the improvement over contemporary correlation is more important for long cycles. Extrapolating the information of the future CBR for the terms of trade, one may expect the beginning of recovery, in relation to recent floors, of the long-term cycle by the end of 2010 and, of the medium term, in 2009.

In addition to the information contained in the historic series of relative prices, the foundations of the commodity markets also indicate a downward cycle, with later recovery at levels lower than those observed in 2008. In fact, a World Bank study[2] identifies as the origin of the last commodity boom a strong positive demand shock, especially in emerging countries, reinforced by favorable international liquidity conditions. Moreover, the study points to the lack of investments on petroleum prospecting and metal extractive industries as a limiting factor to the capacity of supply to respond to the demand shock. The hike in the prices of agricultural inputs, strongly affected by petroleum, coupled with the increased demand for foodstuffs and alternative energy sources, also contributed to the increase in the prices of agricultural commodities, especially in the last two years. Currently, the scenario is completely diverse. On the one hand, demand pressures have been completely reversed by the international liquidity crisis and, on the other, maturing of productive investments and technological initiatives consequent upon higher prices, expanded the supply response capacity. In this framework, expectation point to a scenario of slow recovery in the prices of commodities.

Both medium and long-term trends have relevant consequences on the trade balance. The immediate impact is the negative incentive to produce goods to be exported, which tends to reduce prices and,

Figure 6 – Exchange terms and the account trade balance in comparison to GDP



2/ World Bank Global Economic Prospects 2009: Commodities at the Crossroads. http://go.worldbank.org/TYAM73LY40.

Figure 7 – Exchange terms and effective real exchange rate

consequently, the aggregated income. However, the negative income shock and the release of productive inputs by the exporting sector tend to appreciate the imported goods in relation to nontradable goods, negatively stimulating imports. The total effect on the balance of trade depends on the relative dimension of the opposite channels of exports and imports. As illustrated on Figure 6, the negative correlation of terms of trade and balance of trade suggests the predominance of the imports channel. In fact, Figure 7 shows the negative correlation between the terms of trade and the price of importable goods, measured by the effective real exchange rate, a condition necessary to affect imports[3]. Therefore, in the absence of other impacts on the real exchange rate and imports, the forecasted reduction in the terms of trade tends to improve the balance of trade when it is measured in relation to the aggregated product. Thus, it is possible that the reduction in comparison to that observed in the previous year is not so significant as the median of the market forecasts for the latest months.

3/ Notes about the variables shown in the graphs: (i) the terms of trade exclude the growth trend; (ii) the trade balance was calculated by dividing the annual product by 12: (iii) the real exchange rate is an approximate indicator for the relative price of imported goods.

Balance of Payments Forecasts

The impacts of the crisis endured by the world economy on the financial markets and on the international trade flows, have been more accentuated as of the final quarter of last year, are reflected on the recent performance of several accounts of Brazil's balance of payments. These adjustments, caused both by the world recession and the external credit restriction, result in sharp reduction of the current trade and of the net remittances of profits and dividends, indicating a declining trajectory of the deficit in current transactions as well as of net inflows of the financial account, with lesser FDI flows and net outflows related to the external debt service. Notwithstanding the intensity of the crisis and its effects, the conditions for financing the country's balance of payments remain adequate.

This box shows the forecasts for the 2009 balance of payments, which have been revised in relation to those shown in the December Inflation Report. Besides the impacts of the aggravating economic crisis, this new forecast considers the results observed in the latest months, the modifications to the external debt service consistent with its stock in December, the Central Bank's interventions in the exchange market already carried out and the repurchases of the sovereign external debt by the National Treasury, carried out up to February.

The deficit in current transactions for 2009 was revised from US$25 billion, in the previous report, to US$16 billion. The forecast for the trade surplus was upgraded by US$3 billion, totaling US$17 billion, reflecting respective reductions of 20.2% and 18.6% in the export and import forecasts, which came to total, in the order, US$158 billion and US$17 billion, in the year. These alterations are consistent with the

Table 1 – Uses and sources

US$ billion

	2008			2009		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year[1/]
Uses	-3.1	-8.5	-50.7	-1.7	-6.4	-40.6
Current account	-1.9	-5.9	-28.3	-0.6	-3.3	-16.0
Amortizations ML-term[2/]	-1.2	-2.6	-22.4	-1.1	-3.0	-24.6
Securities	-0.8	-1.6	-12.4	-0.3	-1.4	-11.3
Paid	-0.8	-1.6	-12.4	-0.3	-1.4	-11.3
FDI conversions	0.0	0.0	0.0	0.0	0.0	-0,0
Suppliers' credits	-0.1	-0.2	-1.7	-0.2	-0.4	-1.1
Direct loans[3/]	-0.3	-0.7	-8.3	-0.5	-1.2	-12.2
Sources	3.1	8.5	50.7	1.7	6.4	40.6
Capital account	0.1	0.1	1.1	0.1	0.2	1.0
FDI	0.9	5.7	45.1	2.0	3.9	25.0
Domestic securities[4/]	1.8	-0.2	6.3	-0.8	-2.5	-10.0
ML-term disbursem.[5/]	2.7	5.9	31.6	1.2	3.4	24.4
Securities	0.6	2.0	7.8	0.1	1.4	6.8
Supliers' credits	0.2	0.5	2.2	0.1	0.3	3.2
Loans[6/]	1.9	3.4	21.6	1.0	1.7	14.3
Brazilian assets abroad	-1.9	-1.6	-22.4	-1.3	-1.3	12.9
Other[7/]	3.1	5.6	-8.0	0.6	0.6	0.0
Reserve assets	-3.6	-6.9	-3.0	-0.1	2.1	-12.7

1/ Forecast.
2/ Registers amortization of medium and long-term suppliers' credit, loans and securities placed abroad minus refinancing and discounts. Excludes amortization referring to loans to IMF and intercompany loans.
3/ Registers amortizations of loans from foreign banks, buyers, bilateral agencies and multilateral organizations.
4/ Includes foreign investment in equity and debt securities traded in the domestic market.
5/ Excludes disbursements of intercompany loans.
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, deposits of non-residents, other liabilites and errors & omissions.

prospects of economic recession in the country's main trading partners, to the performance of commodity prices and to the deceleration of Brazil's GDP growth.

The service account should display a US$13.4 billion deficit in 2009, against the US$13 billion previous forecast, with emphasis on increases on net outflows under international travel, US$1 billion; other services, US$1 billion; and equipment lease, US$0.9 billion, partly offset by the improvement of US$2.5 billion forecasted for the transportation account. The new forecast for the annual deficit in services represent a reduction of US$3.3 billion compared to the previous year, as a result, especially, of cutbacks in deficits of international travel accounts, US$2.7 billion, and transportation, US$0.4 billion.

The forecast for net expenditures with interests reaches US$8.2 billion, against US$9 billion in the previous report. Estimated gross expenditures, based on the debt stock position in December and including the impact of declining international interest rates (Libor) on the share of the debt with floating charges, were lowered by US$0.8 billion, to US$15.3 billion, while revenues remained at US$7.1 billion, including US$5.2 billion related to the interest earnings on the country's international reserves.

Estimates on net remittances of profits and dividends, reflecting a scenario of declining companies' profitability in the country, exchange depreciation and reduction of the foreign investors' portfolio stocks, were revised from US$20 billion to US$15 billion. One should highlight that the stock of foreign investments at Bovespa dropped from the record level of US$200.9 billion, in May 2008, to US$70.6 billion, in November of that year, the end of 2009, closing at US$82.6 billion in the end of 2009.

The unilateral transfers were raised to US$3 billion, from a previous US$2.5 billion, estimated in December, a movement consistent with the account's performance in the latest months.

The forecast for a financial account surplus, estimated at US$42.3 billion, in December, was reduced to US$27.7 billion in this report. The performance of this account reflects, especially, the reduction of US$5 billion, in relation to the previous forecast, in the net inflows of Foreign Direct Investments (FDI), which after reaching the historical record of US$45.1 billion in 2008, should total US$25 billion in 2009.

The amortizations of the medium and long-term external debt, added with the expected amortizations of the new scheme of the external debt in December 2008, were reduced, from US$26.9 billion, in the previous forecast, to US$24.6 billion. For 2009, the forecast for the 75% rollover rate for the private sector's medium and long-term indebtedness has been maintained, highlighting that this forecast, at a level above the percentage observed in the latest months, considers a more stable scenario in the international financial markets in the second half-year.

The hypothesis that the process of internationalization of Brazilian companies should be impacted by the effects of the international crisis has been maintained. In this context, after registering a US$28.2 billion record in 2006, and US$20.5 billion in 2008, the Brazilian Direct Investments Abroad (BDIA) should face stability this year, with no modification imposed to this heading of last December Inflation Report. As a consequence, the net result between the FDI and IDB should top US$25 billion this year, against US$24.6 billion in 2008.

For 2009, observing the trajectory of the latest months, an increase is forecasted in the net remittances of foreign portfolio investments in the country, from US$3 billion, in the last forecast, to US$10 billion in this Report.

The cutback in the assets of the banking sector abroad, which translates the behavior of the FDI and in portfolio and of the balance foreseen for the current transactions, evincing the banking sector performance as a supplier of foreign currency to the nonfinancial private sector, is forecasted at US$13.8 billion in 2009, against US$16.1 billion in the previous forecast. One should highlight that these returns on banking assets abroad are impacted by the repurchases of already contracted lines, which sum up to US$10.7 billion from April to December this year.

With reference to international reserves, considered in the concept of liquidity, their position at the end

Table 2 – Balance of payments – Market

US$ billion

Itemization	2008			2009		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year[1/]
Current account	-2.5	-7.2	-35.4	-1.5	-4.8	-21.2
Capital (net)	4.4	9.9	24.7	2.9	4.0	15.0
Foreign direct investment	0.9	5.7	45.1	2.0	3.9	25.0
Portfolio investment	1.8	-0.2	6.3	-0.8	-2.5	-10.0
Med. and long term loans	0.9	2.1	1.6	0.1	0.1	-4.4
Trade credits – Short, medium and long term	2.7	8.0	5.0	1.1	2.2	4.1
Banks	1.6	4.2	0.5	0.0	0.1	2.0
Other	1.1	3.8	4.5	1.2	2.1	2.1
Brazilian invest. abroad	-2.9	-4.4	-27.7	0.5	0.8	-0.9
Other	1.2	-1.2	-5.6	0.1	-0.5	1.1
Financial gap	2.0	2.8	-10.7	1.4	-0.8	-6.2
Banco Central net interv.	-3.0	-5.5	5.4	0.4	2.9	-7.6
Bank deposits	1.1	2.8	5.3	-1.8	-2.1	13.8

1/ Forecast.

of 2009 should show a cutback of US$3.1 billion, compared to the previous year, coming to US$203.7 billion, against US$212 billion in the previous report. The principal alterations in the forecast result from the incorporation of cash sales, US$3.4 billion, from the performance of the heading "other", formed mainly by variations of prices and parities, – US$4.9 billion. In 2009, the forecast for interest revenues of US$5.2 billion as function of interest earnings on reserves is maintained, without any further interventions being forecasted. The international reserves on the cash basis, which disregard the stock of repurchase lines and foreign currency loans, should post expansion this year, US$7.9 billion, among other factors, given the returns on these lines. Thus, international reserves, on the cash basis, should close 2009 at US$201.7 billion.

Inflation outlook

6

This Chapter of the *Inflation Report* presents the assessment made by the Monetary Policy Committee (Copom) about the behavior of the Brazilian economy and of the international scenario since the release of the last *Report*, in December 2008, as well as the analysis of inflation prospects up to the first quarter of 2011 and GDP growth up to the end of 2009. The inflation forecasts are presented in two main scenarios. The first, named benchmark scenario, supposes unaltered Selic rate during the forecast horizon, at 11.25% p.a., value decided by Copom in its last meeting held on March 10 and 11, and that the foreign exchange rate will remain at R$2.35/US$ along the same period. The second scenario, denominated market scenario, uses the trajectories for Selic rate and for the exchange rate which are included in the survey carried out by Central Bank of Brazil's Gerin with the private sector analysts. It is important to highlight that these scenarios only serve as an input to the monetary policy decisions, and their hypotheses do not constitute and should not be seen as Copom's forecasts on the future behavior of interest and exchange rates. One must take into account that the forecasts released herewith utilize the set of available information up to the cutoff date of March 13, 2009.

The prospects of inflation and of GDP growth released in this *Report* are not punctual. They explicitly present probability intervals, which highlight the degree of uncertainty present in the above-mentioned cutoff date. The inflation forecasts depend not only on the hypotheses about the interest and foreign exchange rates, but also on a set of assumptions on the behavior of exogenous variables. The set of hypotheses considered more likely by Copom is utilized to construct the scenarios to which the Committee attaches greater weight in decision making on the interest rate. On presenting them, Copom seeks to attach greater transparency to the monetary policy decisions, thereby contributing to their efficacy in terms of inflation control, which is its primary objective.

6.1 Determinants of inflation

After exceeding the center of the target in January 2008 and growing monotonically up to July, inflation measured by the twelve-month change in IPCA cooled off in the second half of the year, despite the exchange depreciation occurred in the period. This dynamics was impacted, at a first moment, by the fall in the price of important commodities and, on a second occasion, by the slowing down of economy. In this way, twelve-month inflation, which reached 6.37% in July, came down to 5.90% at the end of 2008. Even so, inflation was 1.44 p.p. greater than that verified in 2007 (4.46%), and remain on this level in the first bimester of the current year. In 2008, the government-monitored prices accumulated variation of 3.27%, while the market prices rose 7.05%. Within the set of market prices, the most important developments were similar variations in prices of tradable and non-tradable goods of 6.99%, and of 7.10% respectively, in spite of the movement in the foreign exchange rate. There was a replay of what occurred in 2007, in which, for the first time since inception of the inflation targeting system, in 1999, monitored prices increased less than market prices. This dynamics was impacted by the behavior of the exchange rate, given its appreciation, in the latest years. In this context, given the exchange depreciation occurred in the second half of 2008; one cannot discard an acceleration of monitored prices in 2009, even if not necessarily with the same intensity observed in previous situations. In summary, in spite of a scenario less favorable to inflationary pressures and the expectation of inflation falloff in 2009, it is expected that it shows some resistance to the demand conditions.

GDP, at market prices, dropped 3.6% in the final quarter of 2008, as compared to the previous quarter, according to seasonally adjusted data from IBGE. This result interrupted the sequence of twelve quarters of growth, the most extensive period of growth of the series under this comparison criterion. Even so, GDP grew 5.1% in 2008, a rate only 0.5 p.p. lower than that observed in 2007 and well above the average of the latest twenty years. In comparison with the same period of 2007, GDP expanded 1.3% in the fourth quarter, against expansion of 6.8% in the third. The slowing down of activity reflects the contractionary effects of the global economic crisis on the Brazilian economy.

From the production viewpoint, after sustaining a highlight position in the third quarter, the industrial sector registered contraction of 7.4% in the fourth quarter, as compared to the third quarter, according to IBGE-seasonally adjusted data, the largest cutback since the fourth quarter of 1996.

The performance of this sector was markedly impacted by the process of reduction in inventories. For its part, the farm sector and that of services had contractions of 0.5% and 0.4%, respectively, on the same comparison basis. Compared to the same period of last year, these sectors registered growth of 2.2% and 2.5%, respectively, while the industrial sector dropped by 2.1%.

Regarding demand, the negative performance is due to the Gross Fixed Capital Formation (GFCF), which fell 9.8% compared to the previous quarter in terms of seasonally adjusted data, this is the greatest fall since the beginning of the new series in 1996. In this way, the expansion against the same quarter of the previous year, which had reached 19.7% on the third quarter – greatest expansion of the new series – moved to 3.8%. On the other hand, household consumption dropped 2% against the previous quarter, whereas the government consumption rose 0.5%, according to seasonally adjusted data. In the comparison with the same period of the previous year, both expanded: 2.2% and 5.5%, respectively. Just as what is happening since the first quarter of 2006, GDP growth was dictated solely by the dynamics of domestic demand in 2008, which contributed with 7.3 p.p. for the expansion of 5.1% of GDP in 2008, while the external sector registered negative contribution of 2.3 p.p. Copom assesses that, given the domestic demand will remain the key factor for sustaining the economic activity given the substantial deterioration in the prospects of global economic growth since the release of last *Report*.

At a moment in which the downturn of global economic activity continues surprising by its intensity and magnitude, the resilience of domestic demand depicts an element of stabilization of the Brazilian economy during the next quarters. Data related to the retail sales – discrepant from production data – seem to corroborate this assessment. Incidentally, one should note that, in 2008, household consumption expanded 5.4%, and that of government, 5.6%, in both cases with expansion higher than that of GDP. After falling three consecutive months, seasonal adjusted retail sales increased 1.4% in January compared with the previous month. In the comparison with the same month of the previous year, the increase topped 6%, a level well above that verified in December (3.8%). Although the twelve month expansion has reduced from 10.3% in October to 8.7% in January, the pace of growth still remains high. One should highlight that the rise in sales in the segments “books, newspapers, magazines and school supplies”, the expansion of which reached 7.6% in January against the previous month, and in furniture and house appliances (7.1%), in the first case, which are very dependent on income components, and in the second, dependent on credit supply conditions. The good performance of sales extended to the expanded retail sales – which includes vehicles, motorcycles, parts and spares and construction material, segments more vulnerable to credit conditions – of which the growth reached 4.4% in January compared with the previous month, according to seasonally adjusted data. In general terms, although the production data suggest a sharp deceleration of the economic activity level, the retail sales data suggest that an important part of this movement was due to inventories adjustments. In this way, the Committee assesses that, despite having to show lesser dynamics than in the recent past, retail sales should continue registering positive results throughout next quarters.

The dynamics of economic activity produced consistent improvements in the labor market in the latest years. According to PME, the average unemployment rate, which stood at 10% in 2006, moved to 9.3% in 2007 and to 7.9% in 2008. This situation reflected on the labor income, with the average real income usually received by the occupied population increasing 3.4% in 2008, after increment of 3.2% in 2007 and of 4% in 2006. On the other hand, the number of persons occupied increased by 3% in 2008 after expansion of 2.6% in 2007. As a consequence, the overall real wages – an important boosting factor of aggregated demand in the latest years – advance 6.9% in 2008, after increment of 5.8% in 2007. As per CNI data, the average employment level in the manufacturing industry expanded by 3.9% in 2008. However, there were significant changes in the industrial labor market in the latest months. When compared to equal month of the previous year, one verifies that the increase in December reduced to 1.4% and, in January, a contraction of 0.1% was observed. This deterioration in employment level reflects, to a large extent, the fall of industrial production in the latest months. As with the evolution of formal (CLT) employment, MTE-released data shows that after the closing of 655 thousand job positions in December, there was a new reduction in January (102 thousand job positions).

In combination with increased overall payroll, credit availability to households, favored by the macroeconomic stability and by institutional advances, had been an important element in the propulsion of private consumption and, therefore, of aggregated demand. Notwithstanding, not only did financing conditions deteriorate since the worsening of the global crisis (either through higher rates or shorter maturities), but also the economic agents have shown to be more reluctant in taking loans in an environment of greater macroeconomic uncertainty and of a weakening labor market. In twelve months up to January, credit with no earmarked resources of the financial system to individual persons expanded 23.2% (28.2% up to October), with highlights to the expansion of leasing operations (84.1%, against 116.3% up to October). It is important to highlight that credit expansion has been characterized by the increase, up to this moment a modest one, of delinquency. Regarding the prospective scenario, expectations by market analysts and banking sector representatives indicate that credit will continue to expand in 2009, although there should be deceleration in relation to 2008, partly due to the effects of the global crisis. These effects, however, tend to be attenuated by the impacts of the liquidity management measures and monetary policies adopted by the Central Bank.

Investment, which had shown to be the most dynamic component of domestic demand, presented the greatest adjustment in the fourth quarter of 2008, in line with a stylized fact long before identified. After expansion of 8.4% in the third quarter, against the previous quarter, GFCF fell 9.8% in the fourth quarter, interrupting a sequence of nine quarters of growth. In relation to the same quarter of the previous year, variation moved from 19.7% in the third quarter to 3.9% in the last quarter. Even so, after increment of 9.8% in 2006 and of 13.5% in 2007, GFCF expanded 13.7% in 2008. Note, however, that as percentage of GDP, the GFCF moved from 17.5% in 2007 to 19% in 2008. However, the aggravation of the world's financial crisis led to the deterioration of the scenario for investments. Besides the revaluation of the investment plans, in part due to worsening prospects for growth of demand and of greater macroeconomic uncertainty, the companies confront deterioration of the financing conditions, as it comes to credit maturities and cost. Also, due to the fall in prices of shares, the option for financing via capital market lost attractiveness. Finally, one should note that the depreciation of Real may have determined an increase in the costs of imported capital goods, with adverse impact on the volume of investments. In this context, Copom foresees deceleration of investments on the Brazilian economy in 2009, compared to what was observed in previous years, despite it considers that the situation may evolve toward a more benign scenario in which domestic demand experiences recovery.

The volume of credit with no earmarked resources to corporate entities expanded 37.2% in twelve months up to January (45.9% up to October) and showed a 1.4% contraction in the month to month comparison. In addition, the intensification of the international financial crisis also affected the dynamics of the capital market. In fact, after significant volumes of initial public offerings of shares verified in the first half of 2008, the amount remained practically constant since August (R$32.1 billion in the year in 2008, against R$31.7 billion, up to August, and R$33.2 billion in 2007). Similarly, the issuance of debentures (excluding the issuance carried out by leasing companies) showed to be stable (R$6.3 billion in 2008, strictly, the value observed up to October). However, it is plausible to assume that the easing of the monetary policy leads to the recovery of the domestic capital market, especially regarding the fixed-income operations, during the next quarters. On the other hand, the disbursements of loans and BNDES – System financing expanded 1.2% in January, compared to January 2008.

With reference to the external sector, after registering surplus of US$40 billion in 2007, a favorable balance of trade topped US$24.7 billion in 2008. Despite this decrease, in 2008 the exports reached the record of US$197.9 billion (an increase of 23.3% over 2007), as well as imports, of US$173.2 billion (increase of 43.6% over 2007). The decreasing trend of the trade surplus continued in the first two months of 2009. Indeed, up to February the balance of trade reached US$1.2 billion, a value 29.9% lower than obtained in the same period of 2008. The effects of the global economic crisis over the international trade – both due to the smaller level of global economic activity, and by the fall in prices, particularly of commodities – allow anticipating a decrease in the balance of exports in 2009, a fact which does not occur since 1999, despite the expansionist effects deriving from the alignment of relative prices due to foreign exchange depreciation. On the other hand, the slowing in the pace of domestic activity also allows foreseeing a less robust performance of imports, which may experience a cutback in relation to 2008.

After expanding 5.5% in 2007, exports decreased 2.5% in 2008, in part reflecting the effects of deceleration of external demand and of the re-direction of the share of production previously channeled to the external market, to the domestic market (for instance, in the iron and steel sector). Notwithstanding, the cutback in the export volume was more than offset by the increase of 26.3% of prices in 2008, even after increments of 12.5% in 2006 and of 10.5% in 2007. On the other hand, after expansion of 22% in 2007, imports increased 17.7% in 2008, reflecting, to a good extent, the expansion of external acquisitions of capital goods, as well as the greater level of economic activity. Imports prices, which rose 8.2% in 2007 (against 6.9% in 2006), strongly appreciated in 2008 (22%).

The global economic crisis, which had already intensified at the time of the last *Inflation Report*, does not yet show signs of cooling off. Besides, its magnitude has shown to be more comprehensive than initially foreseen, especially with reference to the impact on the emerging markets. The net effect of the exchange rate depreciation occurred since September 2008, coupled with the intense fall in price of commodities, which was a factor of great uncertainty in the prospective inflation scenario when the last *Report* was released, has shown, up to this moment, to be more benign than that was anticipated. As with current transactions, the deficit in 2008 reached US$28.3 billion, or 1.8% of GDP. One should highlight that it was fully financed by the net inflow of foreign direct investment, which totaled US$45.1 billion and corresponded to 2.8% of GDP.

After more than one year since its inception, the subprime crisis – which originated in the North-American real estate market, spread itself to the financial and credit markets of the US and other mature economies – continues surprising negatively, especially regarding the impacts on the dynamics of emerging market economies, including the Brazilian one, which, up to the third quarter of 2008, had been showing substantial resilience. In fact, partly as a result of the adjustment in inventories occurred in the latest months, the contraction of domestic economic activity has been intensive. In this context, despite the diverse measures implemented by the Fed and other central banks, including the fixing of targets for basic interest rates close to zero, the adoption of monetary policy strategies based on quantitative expansion and, in some cases, aggressive fiscal measures, there are no convincing signs, up to now, of economic recovery. Note, in particular, that credit conditions remain very restricted in the international financial market, since the impacts of these measures may take some time to come up. In summary, the prospects for global economy have been deteriorated further since the publication of the last *Report*, and so does the balance of risks, with a bias still negative for activity. As consequence, the most likely scenario indicates that the global economic recovery, which for many analysts would come in the second half of 2009, will only take place in 2010.

With regard to the aggregate supply, the three sectors of economy experienced a cutback in the fourth quarter of 2008 against the previous quarter, after having registered strong growth during 2008 and, in particular, in the third quarter. According to the national accounts, the worst performance derived from the industrial sector, the one which had shown the highest growth in the previous quarter. While industrial production fell by 7.4% against the third quarter, the sectors of services and farming retroacted, respectively, 0.4% and 0.5%, according to seasonally adjusted data. When comparing with the same period of the previous year, the contraction of the textile sector reaches 2.1%. Note, however, that on the same basis of comparison, the services sector registered a 2.5% expansion, while the farm sector grew 2.2%. In 2008, the growth of the three sectors reached 4.3%, 4.8% and 5.8%, respectively.

In 2008, industrial production expanded 3.1%, reflecting the growth of 3.8% in the mining industry and of 3.1% of the manufacturing industry. Similarly to what was observed in national accounts, industrial production registered strong deceleration in the last quarter of 2008, after spending a good part of the year growing at twelve-month rates above 6%. The effects of the worsening in the global economic crisis started to be mirrored on statistics related to the fourth quarter of 2008, especially in more credit-dependent sectors, such as automotive and construction, also petrochemical and iron and steel industries. In fact, the monthly comparison based on seasonally adjusted data indicates that industrial production fell 7.1% in November and 12.7% in December, a performance impacted, to a large extent, by the fall in production of the automotive industry and in its productive chain. It is compelling to recognize that this result partially derived from the adjustment in the industrial inventories, as well as from the increase in sales and production of automobiles in January and February. Even so, there is a high uncertainty over the magnitude and persistence of the crisis effects on the industry and economy in general.

From the demand perspective, GDP expanded 7.5% in 2008, with the external sector showing a negative contribution of 2.3 p.p. On the other hand, after falling under 100 in August – implying that the number of companies considering inventories as excessive exceeds that of those which assess that they are insufficient – the inventories indicator of the FGV's Outlook Survey persisted on this tendency, signaling that the companies may have been surprised by the intensity of the deceleration of industrial demand which came up after the intensification of the international financial crisis. Notwithstanding, after reaching the level of 81 in December and in January – smallest level since July 2003 – the inventories indicator rose to 84 in February, suggesting that the recovery in inventories could be initiating. On the other hand, the indicator's low level shows that this process may take some time. It is worth stating that, at least in part, the industrial growth observed in the three first quarters of 2008 had been the result of preemptive formation of inventories of raw materials and inputs on the part of the companies.

Such behavior probably accounts for the intensification of growth of the sector of intermediate goods in 2008 and, consequently, for its deceleration since the fourth quarter of last year.

The monthly Nuci (capacity mutilization rate) without seasonal adjustment, calculated by FGV, reached 79.6% in February, showing a cutback of 7.8 p.p. compared with same month of the previous year. As regards the expansion of capacity, the absorption of capital goods, which showed robust growth in the latest years (5.1% in 2005, 13.5% in 2006 and 19.3% in 2007), increased 17.7% in 2008, despite the contraction in the final months of the year. In January 2009, the absorption of capital goods contracted by 19.6% compared to the same month of 2008, being strongly affected by the falls of 12.4% of capital goods imports and of 13.3% in the production of these goods. One should also note that, on the same basis of comparison, the production of construction inputs also fell sharply in January (-9.7%). Despite the great increase of inactivity, the recent numbers of industrial production, coupled with the numbers of sales of automobiles and on retail, suggest a recovery of the textile activity, even if it is difficult to foresee its extension and intensity. In fact, the FGV's Outlook Survey indicator of global demand for the manufacturing industry shows that, after the sharp fall in the level from 121 in September to 65 in January, the indicator rose to 70 in February, returning to the December level.

After a long period of acceleration in construction sector prices the National Construction Cost Index – Internal Availability (INCC-DI) started to show signs of cooling off in December, although still at a modest pace. After reaching the peak in November (12.34%), the INCC twelve-month variation fell to 11.67% in February. Even so, this level is well superior to that observed in the same period of 2008 (6.28%). Furthermore, inflationary pressures would hardly be reduced in a substantial way by imports given the production structure of the construction sector.

After falling to 9.3% in 2007 (10% in 2006), the average unemployment rate plummeted in 2008 (to 7.9%). Notwithstanding, the rate of unemployment tends to experience a climb in this and next quarters, reflecting both seasonal patterns and the effects of the world's economic crisis over domestic economy. In fact, employment rate stood at 8.2% in January, 0.2 p.p. above that registered in the same month of the previous year, the first increase after twenty-three consecutive falls. In reality, the adverse effects on the labor market clearly demonstrate the numbers of formal jobs as well as on the industrial employment statistics. Up to this moment, however, temporary layoffs, plus the reduction in working hours and other emergency measures have mitigated the expansion of unemployment rates. However, even if there is a marginal recovery on of industrial production and despite the more stimulating numbers of retail sales, the reduction of the activity level may lead to increases of unemployment rates during the next months.

The petroleum price, a systematic source of uncertainty derived from the international scenario, remains on levels lower than those prevailing up to the middle of last year. After reaching almost US$150 in mid-2008, the price of a barrel of petroleum fell to levels around US$40-50 and has remained around this level, although with high volatility. This fall reflects not only the smaller global demand, due to the economic deceleration in course, but also, above all, uncertainties regarding the size and length of the current contractionary cycle, besides the effects of the deleverage on speculative positions in the markets of commodities. Despite considerable uncertainty inherent to forecasts over the path of petroleum prices, the baseline scenario adopted by Copom, which foresees unaltered domestic prices of gasoline for 2009, remains plausible, but, if the current situation in the petroleum market remains, one must not discard the occurrence of reductions in prices during the year. It is also worth noting that the impact of international petroleum prices over domestic inflation is not transmitted exclusively by prices of fuels, which, for the time being, have been stable, but, also, by other channels, such as the productive chain of the petrochemical sector, as well as the of consumers and entrepreneurs. The strong reduction petroleum prices between the middle and end of last year extended to agricultural and metallic commodities, whose quotations of also reflected the deterioration of prospects for global growth. It is worth registering, however, that since the beginning of the year the prices of commodities have shown some elevation, notably regarding precious metals and part of the energy sector.

After more than doubling in 2007 (7.89%, against 3.79% in 2006), and continuing to rise in 2008, when it reached 9.10%, broad inflation – measured by IGP-DI – starts giving consistent signs of cooling off. Since August 2008, IGP-DI registered monthly deflation on three occasions and, in four months up to February, it shows negative variation of 0.49%. Therefore, twelve-month inflation, which reached 14.81% in July 2008, reduced to practically half (7.50%) in February. The index deceleration, essentially due to the behavior of IPA-DI which the twelve-month change moved from 18.91% in July to 7.39% in February, despite the exchange depreciation occurred in the recent past. In fact, in this period, twelve-month inflation measured by INCC expanded from 10.38% to 11.67%, while inflation measured by IPC-Br showed a slight reduction (from 6.23% to 6.15%). The dynamics of IPA-DI is explained, to a great extent, by the change in behavior of farm products, the variation of which in twelve months moved from 37.91% in June 2008 to only 1.94% in February of this year, after registering six monthly deflations in seven months up to February. Additionally, the industrial prices, which showed strength during most of 2008, started falling off in November, and accumulated deflation of 2.17% in four months up to February. As consequence, the twelve month variation of Industrial IPA moved from 15.41% in October to 9.49% in February. As pointed out in previous *Reports*, Copom assesses that the effects of wholesale price behavior over consumer inflation will depend on current and prospective demand conditions and on expectations of price makers in relation to future inflationary path.

The deterioration in the scenario of consumer prices, present since mid-2007 and intensified during 2008, started to show a reversal at the end of last year. Although the consumer inflation cutback has been modest up to this moment (contrary to broad inflation), it has been happening despite the exchange depreciation occurred in the second half of 2008. The prevailing fears at the time of writing the December *Report*, with regard to the magnitude of the foreign exchange pass-through to the prices of final goods and services have not confirmed, up to this moment, as consequence both of the behavior of prices in foreign currency of imports, and of the deceleration of economic activity. Although the macroeconomic scenario has been characterized by a high degree of uncertainty, the general and intensive fall in the commodity prices, along with the pessimistic expectations concerning the growth of the world economy and the deceleration of domestic growth, suggest that the inflationary cycle observed in the latest quarters tend to be surpassed. In any case, the Committee reaffirms that it will continue to conduct its actions in order to ensure that the gains obtained in combating inflation in recent years could be permanent.

The three core inflation measures calculated by the Central Bank show a slight reduction in the twelve-month changes, evidence similar to that observed for the headline inflation. The core by exclusion of regulated and administered prices and food at home prices registers inflation of 6.14% in twelve months up to February, after having reached

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

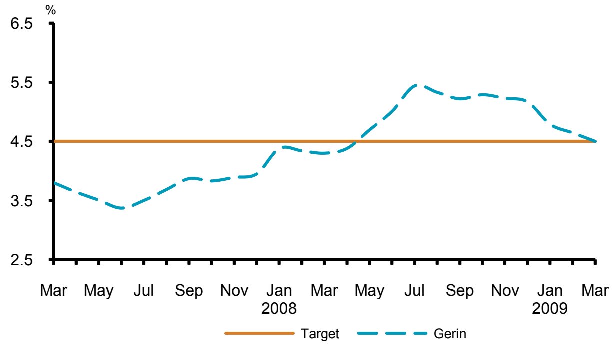
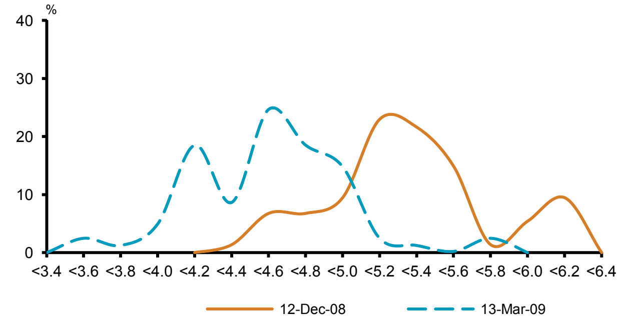


Figure 6.2 – Dispersion of inflation expectations for 2009

Relative frequency



6.38% in October, while inflation measured by the core by non-smoothed trimmed mean reduced from 5.15% to 4.85% on the same basis of comparison. On the other hand, inflation measured by the core by the smoothed trimmed mean show virtual stability (4.89% in February against 4.97% in September). Therefore, all core measures still find themselves above the center of the target.

Inflation expectations for 2009 dropped significantly since the release of the last *Report* and, at the cutoff date of March 13, they reach 4.52%, against 5.20% on December 12. On the other hand, expectations for 2010 remain anchored at 4.50%. As illustrated by Figure 6.2, it is compelling to highlight the increase, since the release of the last *Report*, of the dispersion around the central tendency of inflation expectations, mainly for 2009, which matches with the assessment that the prospective scenario for inflation became more uncertain since the release of the last *Report*.

6.2 Main scenario: associated risks and monetary policy implementation

The forecasts presented at the Copom meetings consider a set of hypotheses on 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, the current prospective scenario considers the continuity of global contraction, on the external side, the slowdown of economic activity and the reduction of inflationary pressures, on the domestic side. The forecasts, used in the current prospective scenario, will be presented in the following section. In particular, from the viewpoint of the balance of risks related to inflation prospects, the main risks associated to the main scenario stem from the duration, the magnitude, and the impact of the developments of the world crisis over the trajectory of the domestic economic activity. Some risk associated to the exchange transfer due to the depreciation of the national currency observed in the last months of 2008 still remains. However, the assessment of this kind of risk is now reduced when compared with that in the last *Report*.

The external scenario considers the world's economic downturn continues to impact both at the developed and the emerging countries. Even though, recently, the financial markets have reacted positively to the initiatives of the American authorities to deal with the issues affecting their banking system, there is still considerable uncertainty is left about the future developments of the financial crisis. Actually, since the publication of the last *Inflation Report*, the financial markets have been over continued stress. Although, originating in the USA and Europe, the financial crisis repercussions over emerging economies remain significant. In particular, despite unpublished actions of American and European authorities, aiming at ensuring the minimum functioning and liquidity conditions to the assets markets, the perception of systemic risk continues at a high level. The lack of international liquidity continued to foster the unleveraging of resource administrators who also had to face a low level trend of asset prices. In an economic environment where there is increased wariness to risk and shorter capital flows, the volatility of the currencies of emerging economies persist, and there is no apparent trend so far.

Regarding the global macroeconomic scenario, slowdown tendencies prevail and inflationary pressures cool off. The currently dominant view points to the slowdown of the world's economy in 2009, and the recovery only in 2010. The consensual forecasts indicate activity slowdown in the USA, Europe and Japan, will not be totally offset by the existing dynamics among the emerging markets economies, mainly in Asia. There is evidence that the more pronounced frailty of economic activity in Europe and in parts of Asia was, to an important extent, due to the negative shock on swap terms. This shock was caused by the hike in commodities prices in the first half of 2008, but reverted in the second half of the same year, allowing for increments of available income in these regions. On the other hand, the cyclical deterioration in the credit quality, centered in the USA and in Europe, helps to intensify the problems of the international financial system worsening financial conditions and consequently increasing the risks a deeper recession. In mature economies, where inflation expectations have been successfully anchored and the economic growth has been weak for a long time, inflationary pressures have shown rapid reduction. In emerging economies, inflationary pressures have also lessened, although in many cases, it still displays strong persistence. In these economies, there were secondary effects of the rise in the prices of raw materials on the consumer prices, and a more intensive pressure from heated demand on the capacity to increase production. Also, exchange rate has depreciated in these countries. In this context, while monetary policies were very expansionist in mature economies, in emerging economies, the expansionist stance of policy makers have been more moderate. In mature economies, the authorities have been announcing a series of important initiatives aimed at sustaining activity by means of fiscal incentives, which may contribute towards a gradual upward movement. Developed countries authorities have announced a series of fiscal incentives with the purpose of sustaining economic activity. These were important policy decisions that may contribute towards a gradual recovery. On the other hand, increasing estimates of the fiscal expenditures with these macroeconomic incentive packages and with those aimed at supporting the financial sector deteriorating the risk classification of diverse sovereign credits, even for advanced economies.

As highlighted in the latest *Reports*, the world crisis effects on Brazilian inflation is, a priori, ambiguous. On the one hand, reduction of exports contributes to limit aggregated demand expansion, and the cutback in prices of commodities helps to mitigate the domestic inflationary pressures. On the other, increased risk wariness and the repatriation of capitals towards mature economies reduced the demand for assets from emerging economies, leading to a sharp depreciation of various national currencies against the North-American dollar. Depreciation, in turn, ended up pushing up the prices in these economies. In this context, even if the Brazilian economy were to be less vulnerable to changes of the international financial markets, the capacity of the external sector to mitigate inflationary risks has been jeopardized.

However, the net effect of global deceleration on domestic inflation path has been mostly benign. This is a consequence of the dominant impact of the international crisis on domestic demand that prevailed over the pressures stemming from the exchange rate market. Note that the reduced external demand induced by the world crisis is not the only impact on the level of activity of the Brazilian economy. The restriction of external financing sources has had an indirect but important effect over the domestic financial conditions. Also, increasing uncertainty has led the agents to postpone important consumption and investment-related decisions. More specifically, the duration of the world crisis is one of the main components of uncertainty and risk on the external side. In case the crisis persists for a longer period of time, extending into 2010, the effects of deceleration over domestic economy would last for the whole forecast horizon. If recovery occurs more rapidly than currently anticipated, the restoration of financial and confidence conditions coupled with the upturn of the commodities prices will cause inflationary risk to increase.

Also, it is worth mentioning that the recent expansion of both the public indebtedness and the monetary aggregates in the mature economies, compared to the crisis, may lead to changes in the behavior of asset prices and in the time structure of interest rates. This could lead to potentially relevant implications for the external financing of the Brazilian economy in the future, within the forecast horizon.

Regarding the behavior of commodities prices, the scenario remains benign, as described in the last *Report*. Although still volatile, in general, these prices are close to those verified in the previous quarter. Taking into account the global economic growth deceleration, the prospect is that both the price of petroleum and of other commodities will contribute to restrain domestic inflation. However, as mentioned in the previous *Reports*, the analysis of the possible deflationary effects of recent trends of the prices of raw materials cannot be decoupled from the implications on the prices of Brazilian assets.

In this context, it is convenient to do a careful assessment of the possible effects of the national currency depreciation, verified since September of the last year, on inflation. Evolution of prices has been monitored and, so far, it does not show significant effects of exchange rate depreciation on inflation, as pointed out in the last *Report*. At first, the increasing credibility of the inflation targeting system tends to mitigate the exchange rate pass-through. One should also highlight that the current economic environment is fairly different from that verified, for instance, in 2002. On that occasion, the agents considered even the possibility of a change of the monetary system, which exacerbated the inflationary expectations, and potentially the exchange rate pass-through. A second aspect is that the cutback of commodities prices in international currency terms, to a certain extent, counterbalanced the impact of exchange rate depreciation and contained the impact on domestic prices. In fact, the CRB index, measured in domestic currency, decreased in the latest months. On the other hand, one should acknowledge that commodities represent a small share in the basked of imported goods. The price index of imports in dollar, calculated by Funcex, fell only 12% between August 2008 and January 2009, meanwhile exchange rate depreciation reached 43%. Also, domestic economic activity fell since the final quarter of last year. There is empirical evidence that the magnitude of the exchange pass-through depends on the economic cycle tending to be higher when the economy is heated. Lastly, one should consider the initial conditions in terms of the real exchange rate. When the nominal exchange variation represents, to a large extent, an adjustment of the real exchange rate toward a historic average value, the transfer tends to be smaller. Also, it is possible that the exchange rate appreciation, verified in previous years and in the first half of 2008, was not completed incorporated on the price level, allowing for a smaller pass-through of the current exchange rate depreciation. On the other hand, it is necessary to take into account that the current exchange rate depreciation was substantial. Therefore, the potential inflationary effect might be significant even with small pass-through coefficient.

It is important to highlight the existence of risk associated to the lag between the exchange rate variation and its impacts on the consumer prices. This is because there is a chain which goes from the import price in national currency at the customs house, through transportation, through the wholesaler and finally gets to the final consumer. Secondly, the high volatility of the exchange rate during the final months of 2008 generated uncertainty over the level at which this rate would converge. Therefore, it might be the case that price setters decided to wait for a more stable scenario before defining price readjustment. In principle, the latest movements of wholesale prices have pointed to a scenario of limited pass-through in the short-run. However, in the event that levels of exchange rate previously seen as transitory turn to be assessed as permanent, the probability of a higher pass-through increases. In this case, monetary policy should prevent such price movements stemming from exchange depreciation from passing to inflation expectations or from generating second round effects due to the attempt to realign prices, including salaries, to previous levels of the exchange rate depreciation episode. Considering all these arguments, the developments of both consumer and wholesale prices indicate a decline of the risks associated with exchange rate pass-through since the assessment in the last *Inflation Report*.

Another risk is related to the prospects of economic growth for the Brazilian economy. In fact, the GDP contraction in the final quarter of 2008 confirms the prognosis in the last *Report*. Up to the third quarter of last year, the strong GDP expansion was led by the vigorous growth in domestic demand, which exceeded supply expansion and caused, at least in part, both the divergence of inflation relative to its target and deterioration of the current account balance. However, in spite of the greater resistance of the Brazilian economy to external shocks, the global crisis seems to be affecting, more than anticipated, the domestic economic activity. The contraction of the economic activity in the final quarter of 2008, with effects over the performance of the economy in the current year was a result of the following developments: in an environment of greater uncertainty, consumption and investment decisions were postponed; more restrictive conditions of internal and external credit; reduction of world's demand and exchange rate depreciation, which, in turn, made imported investment goods more expensive. The slowdown of economic activities is confirmed by other preceding and effective activity indicators that are released with greater frequency than those of the national accounts. Examples are sales, industrial production, sales on the retail trade, the confidence indices, and the degree of idle capacity.

In fact, data on the performance of the economy by the end of 2008 led to a reassessment of the prospect for the economic growth this year. The magnitude of deceleration, however, is still enshrouded in high degree of uncertainty as indicated by the great dispersion of market expectations for 2009 GDP growth, collected by Gerin. Actually, the variation the coefficient of expectations, measured by the ratio between the standard deviation and the average of forecasts, reached, in March 2009, values four times greater than the maximum value verified until then in this series (considering the forecasts made in March of each year). As a result, inflation forecasts were also affected by greater uncertainty.

On the fiscal side, uncertainty about GDP growth mirrors the uncertainty on the future fiscal balance, especially because of governmental expenditures rigidity, which transmits itself to the evolution of the consolidated public sector's primary surplus. Nevertheless, Copom assesses, with the information so far available, that there should not be significant and consistent change of the trend in the reduction of the ratio debt-output.

The assessment of the macroeconomic outlook becomes more complex because economy sectors tend to be affected in a heterogeneous manner by the international financial crisis. At least in the very beginning, the most credit dependent is the good the most affected it is. In particular, goods whose purchase implies greater income commitment by the households, either in terms of the size of the budget share or in terms of the period of commitment, tend to be more affected because in an environment of uncertainty the agents postpone more significant purchasing decisions. On the other hand, the prospects for the minimum wage and overall income, which is in part sustained by the social transfers, may act favorably to cushion the impact of external turbulences over the level of activity in the short term.

Even disregarding the stock adjustment verified in recent months, the effects of the economic activity contraction in the last quarter, which was concentrated in the month of December, tend to spread to the following quarters. As pointed out in the last *Report*, some feedback mechanisms tend to be effective over time. Restrictive credit conditions and greater uncertainty generates postponement of consumption and investment decisions is translated into effective economic dampening. The resulting reduction of overall real income, in turn, strengthens the initial driving forces in the process. On the other hand, the domestic agents should realize there is no reason to behave preemptively once the worse moments of the international financial crisis are overcome and their attention turn the to the solid foundations of the Brazilian economy. As a result, the economy may gradually resume its positive growth trend. In this context, the government's policy decisions, such as the recently announced housing program, will also be a contributing factor.

Additionally, observe that the expectation of reduction of the agricultural harvest in 2009 adds up uncertainty to the prospective scenario. On the one hand, such development would reinforce the contractive movement of the industrial sector. On the other, the reduction of the farming supply would raise pressures over the prices of foodstuffs, with potential inflationary consequences.

The Committee assesses that the Brazilian economy may face the global crisis without ruptures. Actually, the situation does not require a change of the country's economic policy regime, differently from what occurred at the beginning of 1999. The basic framework of the economic policy, based on the tripod inflation targets, fiscal adjustment and floating exchange rate is consolidated and combines resilience and flexibility. Besides, the solid external financial position, with the significant volume of international reserves, the trade surpluses and the external financing based mainly on direct investment reinforce the assessment that the current turbulences may be overcome without ruptures.

The domestic economic deceleration must also be analyzed under the prism of the external financing conditions. In fact, the accelerated growth pace of the Brazilian economy, up to the third quarter of last year, was, in part, sustained by a growing worldwide demand for exports and by a boom in the prices of raw materials, which made feasible the high expansion of imports. Thereby, the inflationary pressures derived from the domestic demand which expands at a pace incompatible with the capacity of expansion of domestic supply were mitigated. In reality, the external sector, in the latest years, had been playing an important role in the maintenance of inflation in a trajectory consistent with the targets established by CMN. This occurred, especially, by means of the discipline imposed over the prices of tradable goods and by means of the expansion of investments. The external conditions, however, changed substantially in the latest quarters, with reduction of demand for exports and fall in price of the commodities. Thus, the pace of domestic absorption should adjust itself to the changes in the external conditions.

Upon breaking down the IPCA into free prices and monitored prices, one observes that the monitored prices will probably cease to play the role of cooling off the inflationary pressures, verified in the last two years. In fact, for 2009, the main scenario considers that variations in the monitored prices should be higher than the inflation target. As the monitored prices respond mainly to movements beyond the level of prices and are not very sensitive to the economic cycle, the still high levels of the twelve-month accumulated inflation tend to result in still significant variation in this group of prices. In any case, it would be reasonable to expect, at any moment, the variation of monitored prices to converge toward the average variation of free prices and, thereby, ceased to contribute to mitigating pressures over full the inflation rate. On the other hand, although the central work scenario adopted by Copom foresees domestic prices of gasoline unaltered in 2009, if the current status of the petroleum market persists, it does not seem prudent to discard completely the hypothesis of a reduction of these prices.

Up to the third quarter of last year, employment expansion, in part backed by macroeconomic stability, had sustained the growth of overall real wages at a robust pace. The latest months show signs of contraction of the job market, which eventually may intensify, considering that in general this market reacts with some delay to the level of activity. This stronger downturn may even expand initial deceleration movements of demand, but, in contrast, they may function as a mitigator of possible inflationary pressures.

Credit growth that was an important element to sustain aggregated demand has now played a central role for the deceleration. The expansion of banking spreads, even in view of the reduction of the cost of banks' funding, coupled with the shortening of the contractual term and of conditionality for credit cession, should, if persistent, contribute to contain the aggregated demand. On the other hand, the recovery of credit or, in more general terms, of the financial conditions in general, including the capital market, may enable a quicker resumption of economic activity, than is currently anticipated.

The possibility that alterations in the inflation dynamics, which in a preliminary assessment seem transitory, may have effects over the agents' expectations as to the inflationary trajectory in the medium and long term constitutes a perennial risk for the implementation of the monetary policy and, therefore, merits continuous monitoring. In principle, short-term concentrated effects of the exchange rate pass-through may lead to dissemination of the second round effects. This happens because significant variations in relative prices, which substantiate in high inflation indices, tend to generate reactions by recomposition of real income by the agents, 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 stance of the monetary authority remain cautious in order to face potential second-round effects.

However, Copom assesses that the probability that initial inflationary pressures may pose risks to the inflation trajectory continues to diminish. In fact, in comparison with the previous *Inflation Report*, the committee states that the risk of materialization of a benign inflationary scenario has expanded. The contraction in economic activity has limited the inflationary impact of the adjustment on the balance of payments. Actually, the economy had been, up to the third quarter of 2008, showing substantial gap between the expansion of goods and services supply and that of demand, which caused inflationary pressures at that moment and prospectively. In this sense, the demand contraction acted towards the elimination of this gap. Incidentally, this evolution of the prospective scenario is expressed in the inflation forecasts considered by the Committee. However, the duration and magnitude of the economic deceleration still remains surrounded by uncertainty. In these circumstances, the monetary policy should remain cautious, aiming to ensure the convergence of inflation of inflation toward the targeted trajectory.

Remember that inflation ended 2008 near the upper limit of the tolerance interval for the inflation target. The strategy adopted by Copom aims to bring inflation back to the central target of 4.4%, established by the CMN, in 2009, and keep it at a level consistent with the trajectory of targets in 2010. Such a strategy, which shows it's results over time, takes into account the transmission mechanisms gaps and is the most appropriate way to deal with the uncertainty inherent to the process of formulation and implementation of the monetary policy. The Committee understands that the downturn of demand, motivated by the squeeze of financial conditions, by the deterioration of the agents' confidence and by the contraction of global economic activity, created an important amount of idle capacity of production factors. This development should contribute to contain the inflationary pressures, even in the face of the consequences of the adjustment process of the balance of payments and in the presence of inflationary feedback mechanisms in the economy, making way to relax the monetary policy. On the other hand, besides the fact that the changes of the basic interest rate have effects on the activity and inflation that accumulate over time, Copom's assessment about the room for additional monetary easing also takes into account aspects resulting from the long period of high inflation, which subsist in the institutional framework of the national financial system.

In the light of these considerations, Copom decided to reduce the Selic rate from13.75% p.a. to 12.75% and 11.25% in its January and March meetings, respectively. This adjustment of the basic interest rate will have delayed and cumulative effects on the economic activity and inflation.

6.3 Inflation forecasts

According to the traditionally adopted procedures, and taking into account the set of available information up to March 13, 2009 (cutoff date), the benchmark scenario assumes the exchange rate constant over the forecasting horizon at R$2.35/US$, and the target for the Selic rate at 11.25% p.a. – set on the Copom meeting of March – against R$2.40/US$ and 13.75% considered in the *Inflation Report* of December 2008. In the benchmark scenario, the projection for variation, in 2009, of the set of administered prices was maintained at 5.5%, as considered in the last *Report*. This forecast is based on hypotheses, for the accumulated of 2009, of nil variation for the prices of gasoline and of cooking gas; of 7.6% in prices of electricity; and of 5% in the fixed telephone tariffs. The items for which more information is available were projected individually. For the others, projections are based on models of endogenous determination of administered prices, which consider seasonal components, exchange variations, market prices inflation and General Price Index (IGP) inflation, among other variables. According to these models, the readjustment projections of administered prices for 2010 is 4.8%, the same presented the December *Report*, and for 2011 it stands at 4.5%.

The market scenario, on the other hand, incorporates data from the survey carried out by Gerin with market analysts up to the cutoff date. In this scenario, the evolution of exchange rate expectations increased in the comparison with the values released in the December *Inflation Report*.

For the last quarters of 2009 and of 2010, these expectations moved from R$2.20 to R$2.30. For the first quarter of 2011, the expectations forecast a exchange rate of R$ 2.30. The Selic interest rate expectation suffered a significant reduction regarding the values of the last *Report*. For the last quarter of 2009, the average went from 13% to 9.75% p.a., whereas, for the last quarter of 2010, it moved from 11.83% to 9.61%. For the first quarter of 2011, expectations point to an average Selic rate of 9.79%. This trajectory is consistent with spreads for the pre-DI swap for 360 days of -123 b.p. and -117 b.p., regarding the current Selic rate, the last quarter of 2009 and of 2010, respectively. Additionally, the market scenario assumes variations of 5.5% and of 4.8% for the set of administered prices in 2009 and in 2010, respectively. According to the market scenario, for 2011, the forecast stands at 4.5%.

With regard to the fiscal policy, the forecasts presented in this *Report* are based on the working hypothesis of one primary surplus of 3.3% of GDP in 2009, which takes into account the implementation of the Investment Pilot Project (PPI), and 3.8% of GDP in 2010 and 2011.

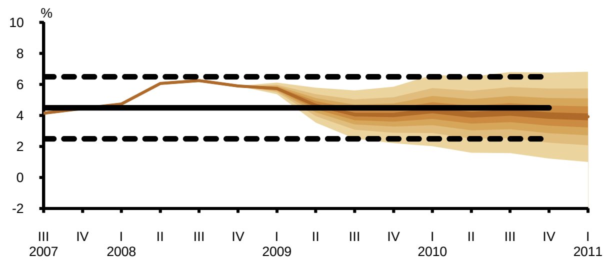
Based on above assumptions and using the information set available, forecasts were constructed for the four quarter accumulated IPCA, given the benchmark and the market scenarios interests and exchange rate trajectories.

The central forecast associated with the benchmark scenario indicates inflation of 4% in 2009, a level 0.7 p.p. lower than forecasted in the December *Report*, therefore, below the central value of 4.5% for the target established by the CMN. As illustrated in Figure 6.3, the four quarter accumulated inflation tends to stabilize around 4%, as of the second semester of 2009. This reflects, mainly, the effects of the rising of production factor idle observed in the fourth quarter of 2008, which in a way, surpass the effects of reduction in the basic interest rates determined by Copom in its last two meetings. Twelve month accumulated inflation starts from 5.7% in the first quarter of 2009, reaches 4% in the fourth quarter of 2009 and remains around this value during the forecast horizon.

Data on Table 6.1 indicates, for 2009, a decrease of 1 p.p. in the accumulated inflation of the last twelve months in the second quarter, regarding to the first; and of 0.6 p.p. in the third quarter, when compared to the second. The movement reflects a forecast of free price inflation, both for the second and the third quarter of 2009, well below the inflation observed in the same period of 2008, considering that in the

Figure 6.3 – Forecasted IPCA-inflation with interest rate constant at 11.25% p.a. (Benchmark scenario)

Inflation fan chart



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

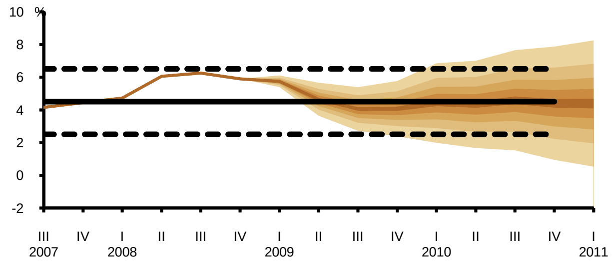
Table 6.1 – IPCA-inflation with interest rate constant at 11.25% p.a.
(Benchmark scenario)

Year	Q	Probability Interval 50%	30%	10%		30%	50%	Central projection
2009	1	5.6	5.7	5.7	5.8	5.8	5.9	5.7
2009	2	4.2	4.4	4.6	4.7	4.9	5.1	4.7
2009	3	3.4	3.7	3.9	4.2	4.4	4.7	4.1
2009	4	3.3	3.6	3.9	4.2	4.5	4.8	4.0
2010	1	3.4	3.8	4.1	4.5	4.9	5.3	4.3
2010	2	3.0	3.5	3.9	4.2	4.6	5.1	4.0
2010	3	3.1	3.6	4.0	4.4	4.8	5.3	4.2
2010	4	2.9	3.3	3.8	4.2	4.6	5.1	4.0
2011	1	2.7	3.2	3.7	4.1	4.6	5.1	3.9

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

Figure 6.4 – Forecasted IPCA-inflation with market expected interest and exchange rates

Inflation fan chart



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

Table 6.2 – IPCA-inflation with market expected interest and exchange rates [1]

Year Q	Probability Interval 50%	30%	10%				Central projection
2009 1	5.6	5.7	5.7	5.8	5.8	5.9	5.7
2009 2	4.2	4.4	4.6	4.7	4.9	5.1	4.6
2009 3	3.5	3.7	4.0	4.2	4.4	4.6	4.1
2009 4	3.4	3.7	3.9	4.2	4.5	4.8	4.1
2010 1	3.4	3.8	4.2	4.6	5.0	5.4	4.4
2010 2	3.2	3.7	4.1	4.5	5.0	5.4	4.3
2010 3	3.3	3.9	4.4	4.8	5.3	5.8	4.6
2010 4	3.0	3.6	4.1	4.7	5.2	5.8	4.4
2011 1	2.8	3.5	4.1	4.7	5.3	6.0	4.4

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

Table 6.3 – December 2008 *Inflation Report* forecasts

Period	Benchmark scenario	Market scenario
2008 IV	6.2	6.2
2009 I	6.3	6.1
2009 II	5.2	5.0
2009 III	5.1	4.9
2009 IV	4.7	4.5
2010 I	4.7	4.5
2010 II	4.5	4.5
2010 III	4.3	4.3
2010 IV	4.2	4.3

case of administered prices, the contrary occurs. According to data shown on Table 6.1, the estimated probability that inflation will surpass the upper limit of the target for 2009, according the benchmark scenario stands at around 1%.

In the market scenario, the forecast for inflation of 2009 (4.1%) is 0.1 p.p. higher than that associated to the benchmark scenario, and 0.4 p.p. lower than that registered in the last *Report*. This cutback in the forecast, to a large extent, is explained by the rise of idle capacity verified as of the fourth quarter of 2008, which in a way surpass the joint effects of the monetary relaxation occurred and expected by the market participants. As can be inferred from Figure 6.4 and from Table 6.2, forecasts indicate a twelve-month accumulated inflation drop during 2009, from 5.7% in the first quarter to 4.1% in the year closure, therefore, below the central value of 4.5% for the target. In the comparison with the benchmark scenario, the slight upturn of the inflation forecast for 2009 is explained, basically, by the expectation, on the part of the market analysts, of continuity in the process of reduction of the basic interest rate initiated by Copom in the January meeting. In the market scenario, as well as in the benchmark scenario, the estimated probability that inflation will surpass the upper limit of the target for 2009 also stands at around 1%. Still according to market scenario, the twelve month accumulated inflation forecast rises in the first quarter of 2010, when it reaches a level near the central value of 4.5% for the target established by CMN. The forecast fluctuates around this value up to the first quarter of 2011. The forecast for both the last quarter of 2010 and the first of 2011 is influenced by the fact that inflation expectations for 2011 are positioned at 4.5%.

Comparing the trajectories shown in this *Report* with those released in the previous *Report*, which forecasts are reproduced in Table 6.3, indicates that there was a significant reduction in the forecasts, in the benchmark scenario, for 2009. In the market scenario, although there was also reduction in inflation forecasts for 2009, the movement was smoother. In part, in both cases, the cutback in the forecasts is explained by the fact that inflation rates for recent months have been below the expectations prevailing at the release of the last *Report*. For 2010, in the benchmark scenario, the inflation forecast falls regarding the value contained in the last *Report*, with the opposite happening to the market scenario. It is worth registering that the monetary policy decisions will have effects increasingly concentrated at the end of 2009 and, particularly, in 2010.

Figure 6.5 illustrates the evolution of twelve-month accumulated inflation, according to the benchmark and

Figure 6.5 – Forecasts and target path for twelve-month cummulative inflation

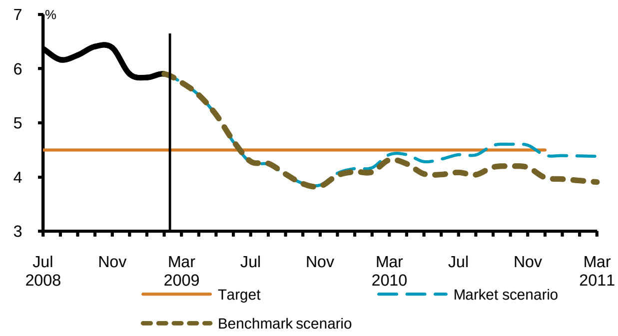
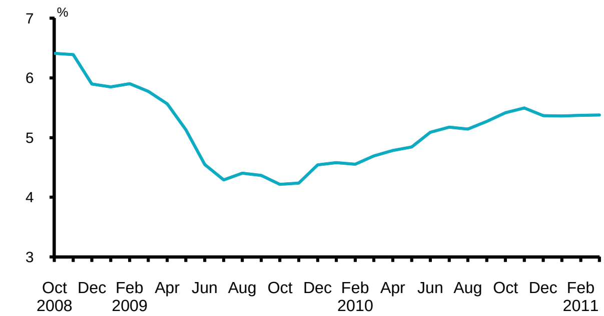


Figure 6.6 – Inflation Forecast: VAR Models

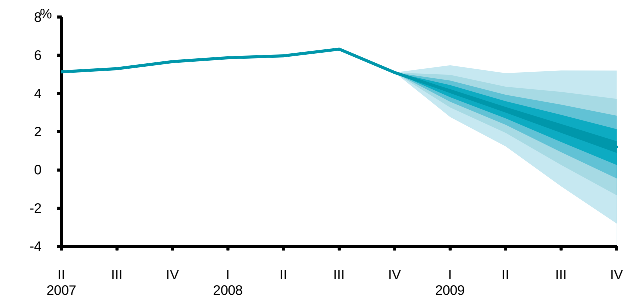


Note: accumulated inflation in 12 month (% p.a.).

Average forecast generated by the VAR models.

Figure 6.7 – GDP growth with interest rate constant at 11.25% p.a. Benchmark scenario

Output fan chart



market scenarios, jointly with the target trajectory, up to the first quarter of 2011. Up to February 2009, the values refer to inflation occurred in twelve months and as of March the accumulated values trajectories consider the forecasts of the respective scenarios. The forecasts in the benchmark scenario are below the central value of the target (4.5%) over the forecast horizon. The forecasts under the market scenario, however, are below the central target during 2009, but converge toward the central value in 2010, and in the first quarter of 2011.

The average forecasts generated by the Vector Autoregressive models (VAR) for twelve-month accumulated inflation is shown on Figure 6.6. Up to February 2009, the values refer to inflation occurred and, as of March, to forecasts. The models indicate the downward trend of the twelve-month accumulated inflation up to the third quarter and stability around the central value of the target until the beginning of 2010. From that point the forecast rises practically over all considered horizon, reaching values near 5%. Note that, for the period up to mid-2010, the average of the forecasts generated by the VAR models was reduced when compared to the one presented in the last *Report*.

Figure 6.7 shows the output growth fan chart, built on the hypotheses of the benchmark scenario. Taking into account that the forecasts of GDP growth consider two variables which are not directly observable, potential output and output gap, the forecast errors associated here are considerably greater than the errors contained in the inflation forecasts. According to this scenario, forecasted GDP growth for 2009 is 1.2%, 2 p.p. below that presented in the December 2008 *Inflation Report*. This reflects, in part, the fall in economic activity in the last quarter of 2008, more intensive than projected; besides the signs that the recovery will occur in a gradual manner along the year.

Impact of Imported Goods Inflation in Brazil

The Central Bank of Brazil (BCB) uses several structural models with the aim of identifying and assessing the transmission mechanisms of the monetary policy. In this sense, the Phillips curve performs a relevant role in relating current inflation to variables of concern – for instance, measurements of imbalance in real economy, past inflation, inflation expectations, and foreign inflation. Regarding the last variable, it is worth mentioning the significant volatility, observed in the latest quarters, of the U.S. Producer Price Index (PPI), the international prices of the main commodities and the nominal exchange rate. Given the importance and contemporariness of the subject, this Box assesses the recent behavior of foreign inflation and their potential effects on inflation dynamics in Brazil.

According to Batini & Haldane (1999), a Phillips curve for an open economy may be represented by means of the following reduced form:

$$\begin{aligned}\boldsymbol{\pi_t} &= \boldsymbol{\chi_0 E_t(\pi_{t+1}) + (1-\chi_0)\pi_{t-1} + \chi_1(y_t + y_{t-1})} \\ &\boldsymbol{+\mu[(1-\chi_0)\Delta c_t - \chi_0 E_t(\Delta c_{t+1})] + \varepsilon_t}\end{aligned} \tag{1}$$

where $\boldsymbol{\pi_t}$ represents the domestic inflation rate; $\boldsymbol{E_t}$ represents the expectation operator; $\boldsymbol{y_t}$ is the real output; $\boldsymbol{\Delta}$ is the difference operator; $\boldsymbol{c_t \stackrel{\text{def}}{=} e_t + p_t^* - p_t}$ is the real exchange rate; $\boldsymbol{e_t}$ is the nominal exchange rate; $\boldsymbol{p_t^*}$ is the price level of imported goods expressed in foreign currency; $\boldsymbol{p_t}$ is the domestic price level, and $\boldsymbol{\varepsilon_t}$ represents a supply shock. In addition, note that all the variables are considered as (logarithm) deviations from the respective equilibrium values. Theoretically, this specification can be justified by means of a micro-founded framework, such as the neo-Keynesian Phillips curve proposed by Woodford (2003) for an open economy with full capital mobility.

In addition, one theoretical feature usually incorporated into the Phillips curve is the long-term verticality, which implies neutrality of the monetary policy on this time horizon. In practice, the adoption of this restriction in empirical investigations generally leads to more stable parameters of the Phillips curve, as well as to more intuitive specifications. In Batiti & Haldane (1999), where foreign inflation is transmitted to domestic inflation through a real exchange measure, the verticality restriction can be easily interpreted in terms of inflation. To do so, one can isolate the domestic prices term and rearrange the Phillips curve in order to obtain inflation as a function of the foreign inflation.

Regarding the Phillips curve specifications estimated by BCB, it is worth mentioning that, in most cases, market prices inflation is considered as a dependent variable[1], following the general form below:

$$\pi_t^{livres} = \sum_{k>0} \alpha_k \pi_{t-k} + \sum_{k>0} \beta_k \, E_t(\pi_{t+1}) +$$

$$+\left(1 - \sum_{k>0} \alpha_k - \sum_{k>0} \beta_k - \sum_{k>0} \gamma_k\right)\left(\Delta e_t + \pi_t^*\right) +$$

$$+ \textstyle\sum_{k>0} \gamma_k \left(\Delta e_{t-k} + \pi_{t-k}^*\right) + \sum_{k>0} \theta_k \, h_{t-i} + \varepsilon_t \qquad (2)$$

where all the variables are in logarithm form, π_t^{livres} representing market prices inflation; π_t is the headline inflation measured by IPCA; π_t^* is inflation of imported goods measured in foreign currency, and h_t is the output gap. Estimations for the pass-through coefficient in Equation (2) suggest that the impact of foreign inflation on domestic inflation has diminished in the last years, period in which the credibility of the Brazilian inflation targeting system has been consolidated.

In this sense, the evolution of the pass-through coefficient can also be inferred from Figure 1, for the period 2002-2008, which presents the two components of foreign inflation: the U.S. Producer Price Index related to all commodities – PPI-all commodities – and the nominal exchange rate R$/US$. It should be mentioned that both the PPI-all commodities and the nominal exchange rate

1/ Regulated prices inflation is separately modeled due to its particular features.

Figure 1 – Nominal exchange rate (R$/US$) and PPI *all commodities*

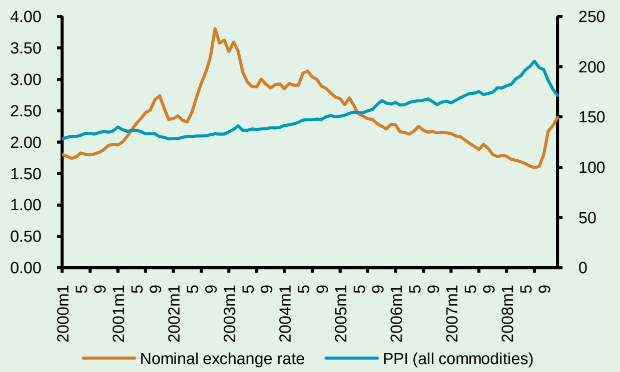
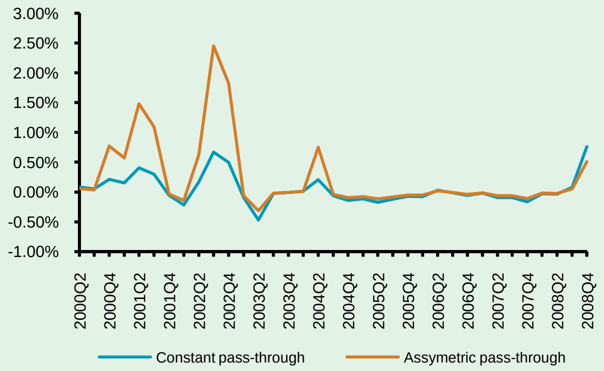


Figure 2 – Evolution of pass-through



constitute proxies, respectively, for the imported goods inflation, in terms of foreign currency, and for the exchange rate, which effectively impact CPI inflation in Brazil. Based on Figure 1, the dynamics of PPI-all commodities has apparently been important in attenuating the effects of exchange rate variations on inflation and *vis-a-vis*. In particular, since mid-2002, these two series exhibit opposite movements, with correlation equal to -0.92. In fact, from the third quarter of 2002 up to the third of 2008, the average quarterly change of nominal exchange rate and PPI-all commodities reached, respectively, -1.63% and 1.71%, which leads to a net impact of only 0.08%.

Nonetheless, from the point of view of the impact of foreign inflation on domestic inflation, besides the movements of PPI-all commodities and nominal exchange rate, one must also consider the dynamics of the pass-through coefficient. In order to assess how the interaction of these three effects (changes in nominal exchange rate, the dynamics of the imported goods inflation in foreign currency and the evolution of the pass-through coefficient) could have impacted the domestic inflation in recent years, the following exercise is conducted: Following Correa & Minella (2006), an asymmetric pass-through coefficient is adopted, with differentiated regimes for periods of exchange rate appreciation/depreciation. As depicted in Figure 2, the mechanism of asymmetry is expressed in a more pronounced manner in periods of high exchange rate volatility, such as in 2002.

Therefore, the exchange rate dynamics observed in the latest years, in a certain way counterbalanced by the movements of imported goods inflation (in terms of foreign currency), gives support to the hypothesis of impact attenuation of the foreign inflation on domestic inflation.

References

Batini, N., Haldane, A.G. (1999). "Forward-Looking Rules for Monetary Policy". Bank of England. Working Paper n. 91.

Correa, A.S., Minella, A. (2006). "Nonlinear Mechanisms of the Exchange Rate Pass-through: a Phillips Curve Model with Threshold for Brazil". Working Paper n. 122. Banco Central do Brasil.

Razin, A., Yuen, C.W. (2002). “The ‘New Keynesian’ Phillips Curve: Closed Economy Versus Open Economy”. Economics Letters, 75, 1-9.

Woodford, M. (2003). “Optimizing Models with Nominal Rigidities”, Chapter 3 of Interest and Prices: Foundations of a Theory of Monetary Policy, Princeton University.

Inflation Expectations Collected by the Central Bank of Brazil

Inflation expectations play a fundamental role in the inflation formation process. However, since these variables cannot be directly observed, some proxies are usually adopted by central banks, such as: (i) expectations extracted from financial market data; and (ii) survey-based expectations. In 1999, the Central Bank of Brazil implemented a daily survey as part of the transition to the inflation targeting system. Nowadays, the Market Expectations System collects information – on several variables, among which inflation rate – from roughly one hundred financial and non-financial institutions. Because of the importance of the subject for monetary policy, this Box aims to identify the main features of survey-based inflation expectations collected by the Central Bank of Brazil, as well as to map the driving forces behind the expectation formation process.

Overall, by comparing the time series of short and medium-term expectations (Table 1), and of long-term expectations (Table 2) with the respective monthly percentage change of the National Consumer Price Index – extended (IPCA), it can be noticed that the average and median values of the expectations approach the observed inflation rate as long as the

Table 1 – Descriptive Statistics (series in % month)

	IPCA (% p.m.)	*Top5* Short h=1 month	Median h=1 month	*Top5* Average h=3 months	Median h=3 months	*Top5Average* h=6 months	Median h=6 months
mean	0.55	0.50	0.48	0.44	0.43	0.43	0.43
median	0.46	0.45	0.45	0.4	0.4	0.4	0.4
maximum	3.02	1.88	1.49	1.72	1.4	1.3	1.4
minimum	-0.21	0.10	0.10	0.15	0.16	0.2	0.21
standard deviation	0.48	0.29	0.22	0.20	0.17	0.17	0.17
correl (IPCA , .)	1.0	0.78	0.69	0.18	0.2	(0.08)	(0.08)

Nota: *Top5* expectations refer to median series of Top 5 (short or medium term), while expectations denominated Median represent the medians of all surveyed institutions in a certain time period. The Sample is from 2002m05 to 2008m12 (80 observations).

Table 2 – Descriptive Statistics (series in % 12 months)

	IPCA (% 12 months)	Median (h=12 months)
mean	7.1	5.57
median	6.1	4.92
maximum	17.2	13.18
minimum	3.0	3.37
standard deviation	3.9	2.01
correl (IPCA , .)	1.0	0.17

Note: sample from 200m1 to 2008m12 (74 observations)

forecast horizon diminishes, whereas the correlation between the inflation rate and the expectations increases, approaching the unit value.

A relevant issue to be investigated regarding any inflation expectations series is the existence of bias. To do so, first consider the following regression:

$$\pi_t = C_1 + C_2\pi^e_{t,t-h} + \varepsilon_t , \qquad (1)$$

where π_t represents the observed inflation rate; $\pi^e_{t,t-h}$ is the respective inflation expectation, formed with a forecast horizon of h periods; and ε_t is a random residual. According to Grant & Thomas (1999), the existence of bias, or a "weak" form of rationality[1], can be verified through the following joint null hypothesis Ho: $(c_1;c_2) = (0;1)$[2]. Tables 3 and 4 show the bias test results for the survey-based inflation expectations in Brazil.

Table 3 – Bias Test H_0: $(C_1; C_2) = (0; 1)$

Sample 2002m05 – 2008m12	*Top5* Short h=1 month	Median h=1 month	*Top5* mean h=3 month	Median h=3 month	*Top5* mean h=6 month	Median h=6 months	Median h=12 months
C_1	(0.11)	(0.15)	0.37	0.32	0.66	0.65	5.22
standard deviation	0.07	0.13	0.21	0.24	0.22	0.22	1.88
C_2	1.31	1.47	0.41	0.55	(0.23)	(0.21)	0.34
standard deviation	0.17	0.35	0.51	0.61	0.35	0.35	0.24
P Value	0.19	0.36	0.09	0.15	0.00	0.00	0.02

Nota: o teste de hipótese utilizou a correção de Newey & West (1987). Para a regressão da Mediana (h=12 meses), adota-se como variável dependente IPCA (%12 meses), com uma amostra de 2002m11 até 2008m12.

Table 4 – Bias Test H_0: $(C_1; C_2) = (0; 1)$

Sample 2002m05 – 2008m12	*Top5* Short h=1 month	Median h=1 month	*Top5* mean h=3 month	Median h=3 month	*Top5* mean h=6 month	Median h=6 months	Median h=12 months
C_1	0.04	0.04	0.16	0.10	0.16	0.18	1.74
standard deviation	0.09	0.09	0.12	0.15	0.17	0.19	1.80
C_2	0.94	0.95	0.70	0.86	0.70	0.65	0.70
standard deviation	0.16	0.17	0.25	0.35	0.39	0.48	0.35
P Value	0.91	0.77	0.36	0.48	0.55	0.47	0.56

Notes: the hyphotesis test used Newey & West (1987). For the regression of the median (h=12 months), we adopt as dependent variable IPCA (%12 months). In this case, for a sample from 2005m01 até 2008m12, we obtain a p-value of 0.56

1/ According to the authors, the "strong" form of rationality requires the forecast errors to be uncorrelated to any relevant available economic information.
2/ Obstfeld and Rogoff (1996, p. 79) argue that rational expectation is a mathematical expectation conditional on the available information set. In other words, the rational expectations hypothesis does not require the forecasts to be strictly correct in all periods but, instead, requires the forecast errors to be unbiased and uncorrelated with any information in which the forecast is conditioned. See also Clements (2005, p 5) for further details.

Notice from Table 3 that the null hypothesis is rejected at a 5% confidence level only for longer forecast horizons (6 and 12 months), whereas for 1 and 3 months the results suggest the inexistence of a forecast bias. However, the results based on more recent samples suggest the inexistence of bias for all the considered forecast horizons (Table 4). Such results support the "weak" form of rationality of market agents researched by the Central Bank's survey, reflecting in some way the degree of sophistication of the models used in the expectations formation process[3].

A more in-depth investigation reveals some factors that help explaining the dynamics of inflation expectations in Brazil. Tables 5 and 6 show some specifications for the inflation expectations, based on the following regressors: autoregressive term, inflation target (for the next 12 months), inflation and Selic rates (both in percentage over 12 months), nominal exchange rate, industrial production, the Emerging Markets Bond Index Plus Brazil (Embi+Br) and industrial capacity utilization(UCI)[4].

Table 5 – Estimation of inflation expectations for the next 12 months

Regressors	I	II	III	IV
expectation (t+11,t-1)	**0.723**	**0.720**	**0.684**	**0.709**
	(0.000)	(0,000)	(0,000)	(0,000)
Inflation target (t+12,t)	**0.207**	**0.210**	(0.005)	(-4.1)
	(0.000)	(0,001)	(0,977)	(0.229)
IPCA (t)	**0.155**	**0.161**	**0.133**	**0.142**
	(0.000)	(0,000)	(0,004)	(0.002)
selic (t)	**(0.071)**	**(0.074)**	**(0.068)**	**(0.051)**
	(0.000)	(0.000)	(0.000)	(0.045)
exchange rate (t)	**0.007**	**0.007**	0.004	**0.008**
	(0.043)	(0.032)	(0.173)	(0.033)
Δ(industrial production)(t)		0.014		
		(0.130)		
embi+Br (t)			0.002	
			(0.211)	
capacity utilization (t)				0.043
				(0.208)
R^2	0.936	0.939	0.936	0.938
Adjusted R^2	0.931	0.933	0.933	0.932
LM Test (p-value)	0.117	0.094	0.172	0.116

3/ The formation of expectations of some US surveys is analyzed by Mankiw et al (2003), in which the authors investigate the hypotheses of adaptive, rational or "sticky-information" expectations.

4/ All variables are in log terms, excepting IPCA, Selic, inflation target and expectation, which are used in log (1 + rate/100). None of the regressions has intercept, since inflation target is constant in the adopted sample period.

According to Table 5, the autoregressive coefficient (around 0.70) indicates quite a significant persistence of inflation expectations. In addition, as expected, the expectations are positively related to the inflation target, as well as to the current inflation and nominal exchange rates. On the other hand, the results also suggest a negative coefficient for the Selic short-term interest rate, revealing the due reaction of the long-term inflation expectations *vis-à-vis* the changes in monetary policy, also reflecting the credibility of monetary authority, according to market agents.

Table 6 – Estimation of inflation expectations for the next 3 months

Regressores	I	II	III	IV
expectation (t+11,t-1)	**0.535**	**0.534**	**0.499**	**0.547**
	(0.000)	(0.000)	(0.000)	(0.000)
Inflation target (t+12,t)	**0.033**	**0.033**	(0.059)	(-3.41)
	(0.361)	(0.366)	(0.554)	(0.397)
IPCA (t)	**0.071**	**0.071**	**0.058**	**0.053**
	(0.015)	(0.016)	(0.093)	(0,133)
selic (t)	**0.001**	**0.001**	**(0.002)**	**0.019**
	(0.939)	(0.939)	(0.853)	(0.446)
exchange rate (t)	**0.166**	**0.165**	0.132	**0.223**
	(0001)	(0.028)	(0.003)	(0.016)
Δ(industrial production)(t)		0.000		
		(0.987)		
embi+Br (t)			0.001	
			(0.317)	
capacity utilization (t)				0.031
				(0.392)
R^2	0.654	0.654	0.660	0.660
Adjusted R^2	0.629	0.622	0.629	0.629
LM Test (p value)	0.901	0.904	0.514	0.806

Notes: all specifications use Newey & West (1987). Sample from 2004m01 to 2008m12 (60 observations). The significant coefficients at 5% are marked in black, with respective p-values below the estimated coeficients in the parentesis. In Table 5, inflation expectations (median of expectations of all economic agents surveyed) are measured in 12 months, with forecast horizon of h=12 meses. In Table 6, inflation expectations (mediam of medium term forecasts of *Top5*) are measured quartely, with forecast horizon of h=3 meses. The exchange rate volatility refers to the average (of the last 3 months) of the volatility of the monthly nominal exchange rate.

Table 6 presents the behavior of inflation expectations, in quarterly rates, with a three-month forecast horizon. First, a lower persistence of expectations is obtained in comparison to the results of Table 5, probably due to the higher frequency of the inflation expectation rate. In addition, the coefficient for inflation is again positive, but the responses to the inflation target and Selic seem to be not significant. These results are not surprising, taking into account the short-term horizon of the considered expectations.

On the other hand, the results of Table 6 suggest that the past exchange rate volatility has a positive impact on inflation expectations.

In summary, these exercises suggest that the factors explaining the formation of inflation expectations vary with the considered forecast horizon. In particular, the analysis presented herein corroborates the notion that both the inflation target and Selic interest rate play an important role on the formation of inflationary expectations in the relevant horizon for the monetary policy.

References

Clements, M.P. (2005). "Evaluating Econometric Forecasts of Economic and Financial Variables". Palgrave Mcmillan, 1st edition.

Grant, A.P., Thomas, L.B. (1999). "Inflationary Expectations and Rationality Revisited". Economics Letters 62 (1999) 331-338.

Mankiw, N. G., Reis, R., Wolfers, J. (2003). "Disagreement about Inflation Expectations". NBER Working Paper n. 9796.

Newey, W.K., West, K.D. (1987). "A Simple, Positive Semi-Definite, Heteroskedasticity and Autocorrelation Consistent Covariance Matrix". Econometrica 55, 703-708.

Obstfeld, M., Rogoff, K. (1996). "Foundations of International Macroeconomics". The MIT Press.

Breakdown of 2008 Inflation

Following the procedure adopted in previous years, this Box examines the behavior of inflation rate in 2008 and shows the estimates of the major factors contributing to explain its dynamics. The procedure consists in decomposing total variation of the Broad National Consumer Price Index (IPCA) for the calendar-year into the following components: (i) exchange rate variation; (ii) inertia from the difference between previous year's target and actual inflation ; (iii) difference between inflation expectations of agents and inflation target; (iv) market prices inflation, excluding the impacts of the three previous items; and (v) inflation of contractually administered and regulated prices, excluding the impacts of the models of items "(i)" and "(ii)". It is worth highlighting that these estimates are approximations, based on models, and are subject to the uncertainties inherent in the process.

IPCA inflation reached 5.90% in 2008, thus registering an increase compared to 4.46% observed in the previous year. Considering the two large groups of prices which make up the IPCA, market prices inflation closed the year at 7.05%, and the variation of the regulated prices reached 3.27%. Thus, as it occurred in the four previous years (Table 1), excluding the combined impact of pass-through, inertia, and expectations, the major contribution to IPCA's variation was due to the behavior of market prices and regulated prices. In fact, considering the above exclusions, market prices contributed with 3.77 p.p. to the 2008 inflation, and the regulated ones, with 1.05 p.p. In relative terms, the effect of market prices and the regulated prices on inflation reached 63.9% and 17.8%, respectively (Figure 1).

Component	2002	2003	2004	2005	2006	2007	2008
IPCA inflation (variation %)	12.53	9.30	7.60	5.69	3.14	4.46	5.90
Inertia	0.93	5.92	0.28	0.77	0.47	0.01	0.23
Expectations	1.65	1.71	0.37	0.27	-0.13	-0.43	0.22
Pass-through	5.82	-1.11	-0.34	-2.06	-0.55	-1.12	0.63
Market prices inflation*	2.28	1.12	4.35	3.41	1.76	5.03	3.77
Administered prices inflations**	1.85	1.66	2.93	3.31	1.60	0.96	1.05

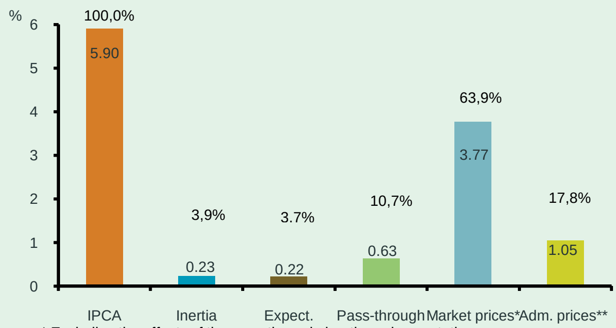
Table 1 – Inflation decomposition: 2002 – 2008 (p.p.)

* Excluding the effects of the pass-through, inertia and expectations.

** Excluding the effects of the pass-through and inertia.

With an opposite effect, the set of items described in "(i)", "(ii)", and "(iii)", is estimated to have contributed to an increase of 1.08 p.p. in IPCA, differently from what occurred in the previous three, when the estimated contribution of these three components was negative – a variation basically due to the impact of pass-through.

Figure 1 – Inflation decomposition: 2008

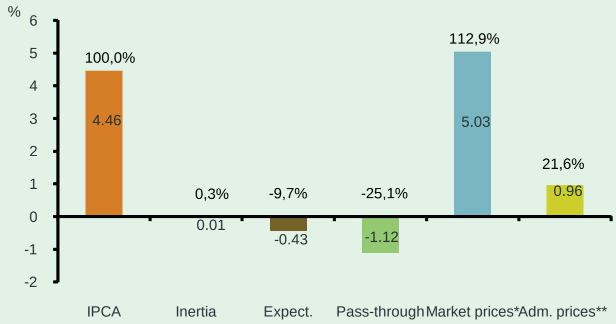


* Excluding the effects of the pass-through, inertia and expectations.

** Excluding the effects of the pass-through and inertia.

According to Figure 1 and to data on Table 1, it is noted that, in contrast with that verified in the five previous years, in 2008 the variation of the exchange rate would have contributed to raising inflation rate, but on a scale considerably lower than that observed in 2002, for instance. Specifically, in 2008 the variation of the exchange rate was accountable for 0.63 p.p. of the IPCA increase, equivalent to 10.7% of total inflation – in 2002 the pass through had accounted for 46.4% of total inflation. On the other and, despite the deterioration in expectations, notably since the second quarter of 2008, the contribution of the component, given by the difference between the inflation expectations of agents and the target, was relatively small, though positive. Even in view of the strong uncertainty derived from the global markets and exchange rate depreciation observed in 2008, the relatively modest impact of these components on inflation may be associated, at least in part, to the policy of strengthening of economic defenses against external shocks – for instance, via accumulation of reserves –, as well as to the agents' confidence in the management of the monetary policy, focused on the objective of maintaining inflation at levels compatible with the targets' trajectory, and which has rapidly adjusted during the year to the changes in the prospective scenario for the inflationary dynamics. This assessment finds support in the fact that the inflation expectations for longer horizons have remained well anchored.

Figure 2 – Inflation decomposition: 2007



* Excluding the effects of the pass-through, inertia and expectations.
** Excluding the effects of the pass-through and inertia.

Finally, the analysis of Figures 1 and 2 indicates that the component associated to the inertia contributed to inflation in a less intensive manner than verified in 2007. It is worth highlighting that, from total inertia estimated for 2008, 71% corresponds to the inertia of market prices, an item with greater contribution (63.9%) in the 2008 inflation.

Annex

Minutes of the 140th Meeting of the Monetary Policy Committee (Copom)

Date: January 20th, from 4:55PM to 6:50PM, and January 21st, from 4:20PM to 6:40PM
Place: BCB Headquarters meeting rooms – 8th floor on January 20th and 20th floor on January 21st – 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 January 20th)
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on January 21st)
João Henrique de Paula Freitas Simão – Open Market Operations Department
José Antônio Marciano – Department of Banking Operations and Payments System
Ariosto Revoredo de Carvalho – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on January 20th)
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
Valderez Caetano Paes de Almeida – Press 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 decelerated from 0.36% in November to 0.28% in December. It bears noticing that, in contrast to previous quarters, inflation in the last quarter of 2008 totaled 1.09%, quite lower than that registered in the same period of 2007 (1.43%). As a consequence, inflation reached 5.90% in 2008 – the highest change recorded since 2005 – up from 4.46% in 2007 and 6.39% in the last twelve months through November 2008. The acceleration of twelve-month consumer price trailing inflation mirrors the behavior of both regulated prices and market prices. Indeed, market prices and regulated prices increased 7.05% and 3.27%, respectively, up from 5.73% and 1.65% in 2007. Moreover, both prices of tradable goods and non-tradable goods accelerated on a twelve-month trailing basis, reaching 6.99% and 7.09%, respectively (compared to 4.75% and 6.65% in 2007). The price of services, whose dynamics tends to show more persistence than the prices of goods, increased 6.39% in the twelve months through December 2008, compared to 6.48% in November and 5.19% in December 2007. Preliminary data for January point to consumer inflation index above that observed in December. Considering broader intervals, twelve-month IPCA trailing inflation trended upwards since

the second quarter of 2007, reached levels close to the upper limit of the tolerance interval after June 2008 and has reduced since October (when it reached 6.41%) – market prices, under this comparison basis, which started to accelerate more intensely from the second quarter of 2007 on, started to cool down in the third quarter of 2008. In the case of regulated prices, whose behavior incorporates more intensely past inflation developments, twelve-month trailing inflation continued to trend upwards. In short, information available suggest that the inflationary cycle observed in the last quarters tends to be gradually overcome by a process that should be led by the behavior of market prices, while regulated price inflation should show more persistence.

2. The three main underlying inflation measures calculated by the BCB showed divergent behavior in the last months, but converged in December. The core inflation by exclusion of household food items and regulated prices decreased from 0.51% in October to 0.36% in November and 0.33% in December. Smoothed and non-smoothed trimmed means core inflation measures showed relative stability, recording 0.37% and 0.32% in October, 0.35% and 0.28% in November and 0.33% in December, respectively. Similarly to the headline inflation, the three core inflation measures remarkably accelerated in 2008, compared to 2007, with increases from 4.11%, 4.04% and 3.62% to 6.09%, 4.82% and 4.92%, for the core inflation by exclusion, smoothed and non-smoothed trimmed means core inflation, respectively. Also in line with headline inflation, twelve-month trailing core inflation measures seem to have reached record highs in September (smoothed and non-smoothed trimmed means core inflation measures) or in October (core inflation by exclusion of household food items and regulated prices), reducing afterwards, despite to levels above the midpoint of the target. Moreover, it bears emphasizing that the behavior of the IPCA diffusion index, which remarkably increased in November and continued to point to an inflationary process relatively disseminated, reduced in December (from 64.58 to 61.72, compared to 61.98 in December 2007).

3. The General Price Index (IGP-DI) inflation changed from 0.07% in November to -0.44% in December. On a twelve-month trailing basis, IGP-DI inflation increased 9.10% in December, down from 11.20% in November, compared to 7.89% in December 2007. The acceleration of IGP-DI in 2008 reflected the behavior of its three main components. The Consumer Price Index-Brazil (IPC-Br) increased 6.07% (4.60% in 2007), while the Wholesale Price Index (IPA-DI) totaled 9.80% (9.44% in 2007). According to the same comparison basis, the Civil Construction National Index (INCC) increased 11.87% (6.15% in 2007). Regarding IPA-DI, the inflationary acceleration, under this comparison basis, derives basically from the behavior of industrial prices. The agricultural IPA reached 1.64% (24.82% in 2007), while the elevation of wholesale industrial prices reached 12.96% (4.42% in 2007). It bears noticing that, despite the exchange rate depreciation occurred since August, both wholesale agricultural and industrial prices have showed deflation at the margin. 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 decreased 2.1% in November, after falling by 0.8% in the previous month. Still considering the seasonally adjusted series, after the 2.8% retreat observed in October, industrial output decreased by 5.2% in November, month-on-month (with less three working days than the previous month). Moreover, it bears emphasizing that the severe climatic conditions observed in the South of the country also influenced the industrial performance in November. As a consequence, industrial output grew 4.7% in the year through November, with respective increases of 4.6% and 6.2% in manufacturing and in mining output. On a year-over-year basis comparison, industrial output retreated by 6.2% in November, with respective falls of 4.6% and 6.3% in mining and manufacturing industries. Data already released for the last months point, in short, to the interruption of the industrial production expansion cycle in the last quarter of 2008. Industrial activity has been influenced by the international crisis, both due to its effects over credit conditions, and over business and households' expectations. In this context,

several industrial segments have been led to adjust inventories and reduce production, with highlights to the sectors of transportation, especially vehicles, mining, ironworks and petrochemical.

5. Among the use categories, according to data seasonally adjusted by the IBGE, the production of capital goods decreased by 4.0% in November. Regarding the other use categories, intermediate goods production decreased 3.9%, semi-durable consumer goods production retreated by 0.7%, and the production of durable goods production, strongly influenced by the automotive sector, reduced by 20.4%. In the year, capital goods production leads the expansion, with a 16.9% increase, followed by the 7.3% elevation in durable consumer goods production. The recent slowdown in capital goods production reflects the persistence of the international financial turmoil and its consequences over business confidence. On its turn, the cooling in the pace of expansion of durable goods production reflects, predominantly, the tightening of credit conditions, the deterioration of consumer expectations and the process of inventories' reduction mentioned above. Such developments should continue to be evidenced by the December data.

6. Labor market started to record ambiguous indicators, combining positive aspects with significant accommodation of formal job creation at the margin. The unemployment rate in the six metropolitan regions covered by the Monthly Labor Survey (PME) increased from 7.5% in October to 7.6% in November, down from 8.3% in November 2007. As a result, the average unemployment rate in the first eleven months of the year was 1.5 p.p. below that observed in the same period of 2007. According to data seasonally adjusted by the BCB, the unemployment rate stood at 7.8% in November, above the 7.6% observed in October, remaining, however, at a historically low level. In November, average earnings increased 11.4% year-over-year (12% in October), totaling increases of 9.9% in the year and 9.6% in the last twelve months. In November, average real earnings increased 0.9% month-on-month and 4.0% year-over-year. In the year through November, average real earnings increased by 3.4%, while employment expanded by 3.8%. As a consequence, real payroll increased 7.4% (6.9% expansion in November, in year-over-year terms), continuing to constitute a key driver for domestic demand growth. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment retreated by 0.6% in November, after increasing by 0.1% in October, resulting in a 0.8% growth in the quarter ended in November, quarter-on-quarter. In year-over-year terms, employment grew 2.9%, totaling 4.2% growth in the last twelve months. According to data seasonally adjusted by the IBGE, manufacturing employment fell 0.6% in November (after falling 0.1% in October and increasing by 0.1% in September), totaling increases of 2.5% in the last twelve months and 0.4% year-over-year. Still regarding employment, data from the Ministry of Labor and Employment (MTE) indicate significant loss of dynamism in the generation of formal employment at the end of 2008. In December, 654,946 jobs were dismissed (compared to the negative result of 40,821 in November), approximately two fold the historical average for the month. On the other hand, employment reached the third best result for the yearly historical series, reaching 1,452 thousand hires for the period, only below the results for 2007 (1,617 thousand jobs) and 2004 (1,523 thousand jobs). Formal employment reduced by 0.2% in December, seasonally adjusted, and observed data point to a 6.4% expansion in the last twelve months. The manufacturing industry recorded the highest dismissal rate, with the reduction of 273,240 jobs (-1.1% seasonally adjusted change), followed by the agricultural and the services sector, which dismissed 134,487 and 117,128 workers, respectively. The civil construction sector dismissed 82,432 workers (-0.7%). The retail sector dismissed 15,092 workers (0.2%). The services sector recorded the highest hiring rate in the year (648,259 jobs, or 6% growth), a historical record high for the sector. The retail sector recorded the second most important growth (382,218 jobs; 6.7%); followed by the civil construction (197,868 jobs; 17.4%) – a record high for the series; and the manufacturing industry (178,675 jobs, or 5.6%).

7. According to data seasonally adjusted by the IBGE, expanded retail sales decreased by 3.4% in November, after decreasing 8.3% in October. On a year-over-year basis, it reduced by 4.1% and grew 11% in the year through November. The three-month

moving average of expanded retail sales decreased 3.7% in the quarter ended in November, compared to the quarter ended in August, according to seasonally adjusted data. On a month-on-month basis, according to seasonally adjusted data, it bears emphasizing the expansion in the sales of "pharmaceutical, medical, orthopedic and perfumery products" (1.6%), "books, newspapers, magazines and stationary" (1.3%) and "hyper- and supermarket and food products" (0.7%). The negative key drivers were "vehicles and motorcycles, part and pieces" (-7.0%) and "office material and equipment" (-9.8%), sectors more sensitive to the credit supply conditions. In the year through November, cumulative growth was more significant in "office material and equipment" (33.2%) and "other personal and domestic articles" (17.8%). Similar to the observed in October and November, expanded retail sales data for December should also evidence the effects of credit supply restrictions and the deterioration of consumer confidence over vehicle sales, already captured by the data from the National Federation of Distribution of Automotive Vehicles (Fenabrave) for this month. However, preliminary evidence for January points to some recovery in the sales of vehicles, partially in response to sectoral incentives granted by the government. The steady growth of retail sales had been reflecting, in short, 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 retail sales trajectory will continue to be sustained by fiscal transfers, as well as by real payroll growth, whose evolution may be favored by inflation reduction, but it will also be affected by the changes in the access to credit supply and by the deterioration of consumer confidence.

8. The installed capacity utilization rate (Nuci) in the manufacturing industry reached 81.3% in November, below the level observed in October, according to CNI data seasonally adjusted by the BCB. According to data seasonally adjusted by CNI, the Nuci in the manufacturing industry also showed reduction, reaching 81.6% in November, down from 82.6% in October. Without the seasonal adjustment, the Nuci stood 2.0 p.p. below the level registered in November 2007. As a consequence, the average rate in the year through November was 0.5 p.p. above the level observed in the same period of 2007. The monthly non-seasonally adjusted Nuci calculated by Fundação Getúlio Vargas (FGV) retreated strongly in December to 80.6%, standing 6.10 p.p. below the level registered in the same month of 2007. The reduction in the Nuci in December 2008, year-over-year, is also observed in the production of consumer goods (-9.5 p.p.), intermediate goods (-6.0 p.p.), capital goods (-2.6 p.p.) and civil construction inputs (-4.9 p.p.). The reduction on Nuci calculated by CNI and FGV seems to be a result of a combination between the maturity of investment projects and accommodation on economic activity, and points to significant increase of the idle capacity level of the manufacturing industry. On the other hand, recent data about the absorption of capital goods show contraction at the margin, despite continuing to show expansion, compared to the same periods of 2007. The absorption of capital goods decreased 7.7% in November, according to seasonally adjusted data, and expanded by 21.8% in 2008, according to observed data. On its turn, the production of civil construction inputs retreated 4.6% at the margin in November, after showing stability in October, accumulating a 9.7% growth in 2008. In short, evidences so far suggest an ongoing process of reduction in demand pressures on the productive capacity level of the manufacturing industry. 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 register deceleration at the margin, an already anticipated trend, and which is in line with assessments present in previous Inflation Reports and Copom Minutes. In 2008 the trade surplus reached US$24.7 billion (38.2% below 2007). Exports and imports totaled, respectively, US$197.9 billion and US$173.2 billion, equivalent to 23.2% and 43.6% growth, over 2007. The reversal on the appreciation trend of the BRL and the accommodation on the pace of expansion of domestic demand may contribute to the recovery of the trade surplus, while the reduction on price levels of exports acts on the opposite direction. The decrease in the trade surpluses contributed to the US$26.3 billion current account deficit registered in the twelve months through November 2008, equivalent to 1.7% of GDP. On its turn, foreign direct investment reached

US$37.8 billion in the twelve months through November, equivalent to 2.4% of GDP.

10. The period since the last Copom meeting was marked by the continuity of stress on international financial markets, which originated in the US and Europe, but whose impact on emerging economies has continued being significant. The increased risk aversion, observed since mid-September, after the bankruptcy of an important US financial institution, led the authorities in the US, Europe and Oceania to intervene in an unprecedentedly way in their financial systems, using wide range of instruments, in order to ensure minimum conditions of operation and liquidity in money markets. Systemic risk perception, which has shown some moderation, intensified in the last weeks. The international liquidity contraction has been contributing to a deleverage process by asset managers, which, in turn, has been pressuring down the prices of financial assets. In an environment of increased risk aversion and shortage of capital flows, the volatility of emerging economies' currencies continues present, despite not showing the generalized trend of depreciation against the US dollar observed in the last months of 2008.

11. Regarding the global macroeconomic scenario, contraction trends prevail over inflationary pressures. The dominant view still points to the expansion, despite at quite modest pace, of global economic activity in 2009, but data released in the last weeks indicate a more intense and generalized cooling of activity in mature economies and also in several emerging economies. There are evidences that the deeper weakening of economic activity in Europe and parts of Asia was in a significant manner due to the negative shock in the terms of trade caused by the elevation of commodities prices, which is being reverted. On the other hand, the problems in the financial system have been aggravated by a cyclical deterioration in the quality of credit, which tends to reinforce the contraction in financial conditions and, as a consequence, the risk of intensification of deceleration. The US economy, in particular, has been in recession since the end of 2007 and still continues to suffer the impacts of the housing sector crisis, with spillover effects on the labor market, whose weakening, together with the negative wealth effect associated to the fall in the prices of financial assets, has affected consumers' confidence, significantly contributing for depressing expenditure. Moreover, the prevailing interpretation is that the activity in Europe and Japan should continue to lose dynamism in the next months. In mature economies, where inflation expectations are better anchored and economic activity is decelerating considerably, inflationary pressures have reduced fast. In emerging economies, where the secondary effects of raw materials price increases over consumer prices and the heated demand pressures over the supply expansion capacity had been more intense, inflationary pressures have also been declining, although they show, in many cases, more persistence. In this context, the monetary policy stance is mainly expansionist in mature economies, whereas in emerging economies, which have been affected by the exchange rate depreciation trend, in addition to the facts already mentioned, the reaction seems to be more heterogeneous, but expansionist bias also prevails. In mature economies, the authorities have been announcing a series of initiatives aimed at sustaining economic activity, particularly through fiscal incentives, which could contribute to a gradual economic recovery. On the other hand, estimates on the fiscal costs for packages of macroeconomic stimulus and support to the financial sector have been increasing, which has caused pressures on the assessment of risk on many sovereign credits, even in advanced economies.

12. Oil prices remain highly volatile, despite currently being close to the levels observed at the last Copom meeting. Future markets quotations have also shown high volatility, without a defined trend. Uncertainty concerning these quotations remains high, as the prospective scenario depends on the evolution of demand, especially in emerging countries, on the supply's reaction to stimuli stemming from previous changes on relative prices and on the geopolitical issues that affect the price of this commodity. Nonetheless, despite the great uncertainty inherent to the projections of oil prices' trajectory, the main scenario adopted by the Copom, which assumes unchanged gasoline prices in 2009, remains plausible, but with the persistence of the current scenario in the oil market, it does not seem prudent to completely disregard the hypothesis of oil price reductions in 2009. However, it bears highlighting that, regardless of the behavior of domestic gasoline prices, the reduction in international oil prices observed in the second half of 2008 can eventually affect domestic

prices both through productive chains, such as the petrochemical, as well as through the potential effect over inflation expectations. Conversely, prices of agricultural commodities such as wheat, soybeans and corn, which impact particularly the evolution of food costs, have remarkably increased since the last Copom meeting, reacting both to weather problems in important production regions, as well as to the apparent exhaustion of investment repositioning by non-traditional investors that had been allocating resources to these markets.

Assessment of inflation trends

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

a) the projected adjustment for 2009 for both gasoline and bottled gas prices were maintained at 0%;

b) the projected adjustment for 2009 for fixed telephone and electricity prices were kept at 5.0% and 8.1%, respectively, unchanged relative to the values considered in the December Copom meeting;

c) the projection for regulated prices inflation in 2009, based on individual items, was maintained unchanged at 5.5%, relative to the December Copom meeting. This set of prices, according to data released by the IGBE, corresponded to 29.56% of the total December IPCA;

d) the projection of regulated prices inflation for 2010 stood at 4.8%. This projection is based on the endogenous determination model for regulated prices, which computes, among other factors, seasonal components, foreign exchange rate changes, market prices inflation and the IGP (General Price Index) variation; and;

e) the projection for the spreads over the Selic rate, on the benchmark scenario, based on the 360-day swap rates, estimates a 5 bps spread in the fourth quarter of 2009 and 22 bps in the last quarter of 2010. The identified shocks and their impacts were reassessed according to newly available information.

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

15. Since the last Copom meeting, according to the median IPCA inflation expectations compiled by the BCB's Investor Relations Group (Gerin), the 2009 IPCA variation noticeably reduced to 4.80% from 5.20%. For 2010, inflation expectations stand at 4.50%.

16. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the exchange rate at R$2,35/US$1.00 and the Selic rate at 13.75% during the forecast period – the projection for the 2009 IPCA inflation decreased relative to the figure considered in the December Copom meeting, and remains below the 4.5% target established by the National Monetary Council (CMN). 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 2009 slightly decreased compared to the figure considered in the previous Copom meeting, but remained around the central target for the year. Inflation projection for 2010, based on the benchmark scenario, reduced compared to the figure considered in the December "Inflation Report" and is considerably below the 4.5% central target for that year. On the other hand, considering the market scenario, the inflation projection slightly increased, staying around the 4.50% central target.

Monetary policy decision

17. The Copom evaluates that the monetary policy should contribute for the consolidation of a favorable long-term macroeconomic environment. Economic activity data indicate that the pace of domestic demand expansion, which continued quite robust until the third quarter of 2008, and was at least partially responsible for the inflationary pressures, has considerably lost momentum since then. This deceleration is partly a result of a substantial and generalized cooling of economy activity on both emerging and G-8 economies. On its turn, the increase in risk aversion and

the unprecedentedly constraints observed in liquidity conditions in the international markets continue to impose adjustments in the balance of payments. In general terms, the influence of the external scenario on the future trajectory of Brazilian inflation continues to be subject to contradictory effects, which can act with distinct intensity throughout time and surrounded by significant uncertainty. On the one hand, the economic cooling has caused an increase in risk aversion, impacting the demand for Brazilian assets, and consequently, depreciating their prices. On the other hand, the more generalized economic deceleration in the last months, which may persist in the upcoming quarters, has caused the cooling of both commodities prices and external demand, and has also negatively impacted local financial conditions. Moreover, the trajectory of price indices evidences the reduction of inflationary external pressures, especially in mature economies, but also in some emerging economies. As a consequence, the net effect of the global deceleration over the inflation trajectory seems to be, so far, predominantly benign. The Copom emphasizes that the main challenge of monetary policy in this context is to guarantee the maintenance of favorable results achieved in the last years.

18. The Copom evaluates that the probability that initially localized inflationary pressures may cause risks to domestic inflation trajectory diminished. The evidences of accommodation of domestic demand, and reduction of inflationary pressures over the market of factors, despite remaining surrounded by uncertainty, may mitigate the risk of pass-through of wholesale prices (which have been showing deflation in the last months) upward pressures to consumer price inflation. The Committee evaluates that the materialization of this pass-through, as well as the generalization of pressures initially localized on consumer prices, depend critically on economic agents' inflation expectations for 2009. The 2009 inflation expectations remain in levels above the inflation target, despite having remarkably decreased since the last Copom meeting and continue to be carefully monitored. Additionally, it is worth noticing that, according to data available, domestic demand should exert lesser pressures over the prices of non-tradable items, such as services, in the upcoming quarters. In this context, the Copom reaffirms that it will continue to conduct its actions in order to ensure that the gains obtained in inflation control in recent years become permanent.

19. Copom emphasizes, once again, that there are important time lags between the implementation of monetary policy and its effects on economic activity and inflation. Therefore, the evaluation of alternative options for monetary policy should necessarily focus on the forward-looking inflation scenario and its risks, instead of current inflation indices. This point of view is even more important in periods of higher uncertainty.

20. Prospects for the evolution of economic activity have continued to deteriorate since the last Copom meeting, despite the fact that industrial activity data have been partially reflecting a process of inventory retreat, which tends to exhaust. It is particularly important to notice, the effects of the international crisis over domestic financial conditions have resulted in severe decline of the credit contribution to support domestic demand. Additionally, the intensification of the international crisis has caused a negative effect on consumers and businessmen confidence. If this situation persists, the strength of economic activity will increasingly depend on payroll expansion and on the effects of governmental transfers expected for 2009. These considerations become even more relevant considering the fact that the monetary policy decisions will have concentrated impacts in the upcoming quarters.

21. The Copom evaluates that the loss of strength on domestic demand should result in reduction of inflationary pressures. On the other hand, the remaining risks for the inflationary dynamics derive from the trajectory of Brazilian assets prices, amidst a process of decreasing external sources of funding and mechanisms of price adjustments that contribute to prolong inflationary pressures observed last year. The balance of those influences over the prospective trajectory of inflation will be crucial to the assessment of the various alternatives available for the monetary policy stance.

22. International evidence, as well as the Brazilian experience, indicates that high inflation rates leads to increase in risk premiums, shortening of planning horizons and, consequently, to lower potential economic growth, besides having regressive effects

over income distribution. Therefore, the Copom's strategy aims to bring inflation back to the midpoint target of 4.5% during 2009, as already established by the CMN, and keep it in a consistent level relative to the target path during 2010. Such strategy, which should have its results evidenced throughout time, takes into account the time lags in the transmission mechanisms and is the most adequate to deal with uncertainties inherent to the process of monetary policy formulation and implementation.

23. The Copom evaluates that, in light of signs of economic activity slowdown, evidenced since the last meeting regarding, for instance, the industrial production indicators – exacerbated by an inventory cycle –, some available data on labor market and industrial capacity utilization rates, as well as on consumers and businessmen confidence, together with lower inflation expectations for relevant horizons, the risks of non-materialization of a benign inflation scenario, in which IPCA would resume evolution in line with the targets path, have been markedly reduced. Indeed, the evolution of the prospective scenario is reflected on inflation projections considered by the Committee. The Copom also understands that demand deceleration has reduced the pressure over supply conditions observed in most of 2008, which should significantly contribute to deflate the economy. Still, monetary policy should be cautiously conducted, aiming to assure the convergence of inflation to the targets path, despite some scope for an easing process.

24. The Committee believes that the consolidation of restrictive financial conditions for a longer period should exert in significant contraction effect over demand and, throughout time, a relevant deflation pressure. Under such circumstances, the majority of the Copom members, taking into account the balance of risks for economic activity and, consequently, for the prospective inflation scenario, as well as the absence of clear evidence of effects over inflation stemming from the depreciation of the exchange rate, in an environment of global reduction of inflationary pressures, has decided, at this moment, to reduce the Selic rate by 100 bps.

25. Other Copom members evaluate that, in light of the presence of inflationary feedback mechanisms in the economy, as well as the consequences of the balance of payments adjusting process, a more moderate reduction of the Selic rate would represent a more consistent signal of the prospective trend of inflation convergence to the targets path and would be more adequate to an optimal pace of the easing process.

26. In such context, taking into account inflation prospects, the Copom has decided, at this moment, to reduce the Selic rate to 12.75% p.a., without bias. Five votes were in favor of this monetary policy action while three were in favor of reducing the Selic rate by 75bps. With such action, the Committee has initiates a process of monetary policy easing, immediately accomplishing significant part of the Selic rate movement, without harming the commitment to the inflation target.

27. Under the inflation targeting regime, the Committee guides its decisions according to projected inflation, analysis of several alternative scenarios for the evolution of the main variables that determine the forward-looking prices dynamics, and the balance of risks associated to their projections. There are signs that, after a long expansion period, domestic demand has started to have a contraction influence over economic activity, despite persistence of incentive factors, such as income growth. Additionally, it is worth noticing that inflation expectations for 2009 have substantially decreased since the last Committee meeting. On the other hand, the strong global economy deceleration has resulted in downward pressures over wholesale prices, despite the exchange rate adjustment. In such environment, monetary policy can be more flexible without putting at risk inflation convergence to the targets path. Evidently, if deterioration on the risk profile implies shifts to the inflation prospective basic scenario, considered by the Committee at this moment, the monetary policy stance will be promptly adjusted to the circumstances.

28. At the end of the meeting, it was announced that the Committee would reconvene on March 10th, 2009, for technical presentations, and on the following day, to discuss the monetary policy decision, as established in Communiqué 17.327 of August 27th, 2008.

Summary of data analyzed by the Copom

Inflation

29. The IPCA changed 0.28% in December, showing a decrease in inflation compared to the December IPCA-15 result (0.29%) and to the November IPCA (0.36%). In 2008, the IPCA accumulated a 5.90% increase, compared to 6.39% in the twelve months through November, and 4.46% in 2007, representing the highest annual change since 2005. The 2008 result showed increases of 7.05% in market prices and of 3.27% in regulated prices, compared to 5.73% and 1.65%, respectively, in 2007. The household food group contributed 2.42 p.p. for the 2008 index, representing 41% of the annual IPCA change.

30. Market prices decelerated in December, increasing 0.28% compared to 0.44% in November, as a result of the increases of 0.17% in the prices of tradable goods and of 0.36% in the prices of non-tradable goods, compared to 0.60% and 0.29%, respectively, in November. Regulated prices changed 0.29% compared to 0.18% in the previous month. The diffusion index reached 61.72%, down from 64.58% in November, with a 62.83% average in 2008, surpassing the 2007 average, 58.79%.

31. Core excluding household food items and regulated prices increased 0.33% in December, down from 0.36% in November, accumulating a 6.09% increase in the last twelve months, compared to 6.36% in the previous month. For the third consecutive month, the smoothed trimmed means core change declined, reducing to 0.33% in December down from 0.35% in November and, in twelve months, to 4.82% down from 4.90%. The non-smoothed trimmed means core change reached 0.33% in December, compared to 0.28% in the previous month, accumulating 4.92% in the last twelve months through December, down from 5.05% through November.

32 The IGP-DI decreased 0.44% in December, compared to a 0.07% increase in November, accumulating a 9.10% increase in 2008, compared to an 11.20% twelve-month trailing change in November. The IPA decreased 0.88%, reflecting the fifth consecutive fall in the prices of agricultural products, of 1.30%, and a 0.73% decrease in the prices of industrial products. The prices of industrial products reached a record low in the series for the period after June 2003. In 2008, the IPA increased 9.80%, with increases of 12.96% in the prices of industrial products and of 1.64% in the prices of agricultural products. It is worth highlighting the IPA significant deceleration, considering the twelve-month accumulated changes ended in October and November, of 14.72% and 12.88%, respectively. The agricultural IPA behavior strongly contributed to this scenario. The IPC-Br slightly decelerated to 0.52% in December, down from 0.56% in November, increasing by 6.07% increase in 2008. The INCC changed 0.17% in December, down from 0.50% in November, and totaled 11.87% in 2008. The IPC-Br core totaled 0.34%, compared to 0.45% in the previous month, accumulating a 4.07% change in 2008.

33. By stages of processing,the IPA in December, decreased in all its components: 0.36% in the prices of final goods, 1.35% in the prices of intermediate goods, and 0.74% in the prices of gross raw materials prices. In 2008, considering the IPA by stages of processing, there were increases of 4.19%, 14.83% and 9.23%, respectively.

34. The IPC-S increased from 0.52% in the last week of December to 0.68% in the first week of January 2009 and 0.69% in the second week.

Economic activity

35. According to data seasonally adjusted from the IBGE's monthly survey (PMC), expanded retail sales, which include construction material and vehicles and motorcycles, parts and pieces, decreased 3.4% in November, month-on-month, after an 8.3% decrease in October. Among the ten segments surveyed by the IBGE, only three expanded, with highlights for the 1.6% growth in the sales of pharmaceutical, medical, orthopedic, perfumery and cosmetic products and the 1.3% growth in the sales of books, newspapers, magazines and stationery. Among the negative drivers, it is worth highlighting the 7% decline in the sales of vehicles, motorcycles, parts and pieces.

36. Considering the comparisons between identical periods of 2008 and 2007, expanded retail sales decreased 4.1% in November. From January to November 2008, sales increased 11%, compared to the same period of last year, with expansion in all commerce sectors, as well as in all Federal units, except for Amazonas.

37. According to São Paulo Trade Association (ACSP) data, seasonally adjusted by the BCB, database consultations for credit sales (SCPC) related to the city of São Paulo decreased by 3.2% in December, month-on-month, while consultations to the Usecheque system expanded by 1.4%. In 2008, these indicators increased by 6.4% and 4.3%, respectively, compared to 2007.

38. Regarding investment indicators, capital goods production declined 4% in November, while the production of construction typical inputs decreased 4.6%, month-on-month, considering the seasonally adjusted series. All sub-sectors of capital goods production decreased in the period, with highlights to the production of construction capital goods (-17.3%) and agricultural capital goods (-11.6%). Capital goods and construction typical inputs production increased 3.6% and 1.6%, respectively, year-over-year. In the year through November, these indicators increased 16.9% and 9.7%, respectively, compared to the same period of 2007.

39. Capital goods imports declined 4% in November, month-on-month, according to the quantum indices from Funcex, seasonally adjusted by the BCB. The November indicator expanded by 22.3% year-over-year, standing below the cumulative change in the year through November (37.3%), and the cumulative change in twelve months (36.9%), signaling the significant loss of dynamism.

40. CNI indicators showed deceleration in the pace of industrial activity in November, with decreases of 0.6% in employment, 2.1% in installed capacity utilization and 1% in hours worked, according to data seasonally adjusted by the BCB. Seasonally adjusted real revenues decreased by 4.8%, month-on-month. Compared to the same periods of 2007, real revenues decreased by 7% in November, with a 6.4% increase in the first eleven months of the year, while hours worked increased by 1.4% and 5.6%, respectively, according to the same comparison bases. Installed capacity utilization (Nuci) reached 81.3% in November, 1.7 p.p. below the October level, considering seasonally adjusted data, and 2.4% below the November 2007 level.

41. According to IBGE's Monthly Industrial Survey (PIM), industrial production decreased in November, for the second consecutive month, intensifying the monthly decrease to 5.2%, compared to 2.8% in October, according to the seasonally adjusted series. In November, industrial production recorded a record low for the series since May 1995. As a consequence, the production of the quarter ended in November stood 2.4% below that of the quarter ended in August. Considering seasonally adjusted data, the four use categories presented negative results, with highlights to the 20.4% decrease in durable consumer goods production, a record low for the series since December 1997. In addition to the weak performance of automotive production, the retractions in the production of audio and video equipments (17.3%), and kitchen appliances (5.1%) also contributed to the decrease. The production of semi- and non-durable consumer goods, whose consumption is more dependent on the payrolls, presented the lowest decrease among the use categories (0.7%). Capital and intermediate goods declined 4% and 3.9%, respectively, in November, month-on-month.

42. Industrial production decreased 6.2% in November, year-over-year, a record low for the series since December 2001. Only five out of the twenty six manufacturing industry activities surveyed expanded in November according to the same comparison basis, with highlights to the production of other transportation equipment, which increased 73%, backed up by the production of airplanes and the production of pharmaceuticals, with a 16.6% increase in the month. According to the same comparison basis, the most important negative drivers were office machines and IT equipment (-29.6%), electronic material and communication equipment (-20.5%), shoes and leather (-18.8%), furniture (-18.7%), and vehicles (-18.3%). Considering the use categories, the production of durable consumer goods, intermediate goods and semi- and non-durable consumer goods

declined 22.1%, 7.5% and 2.7%, respectively, year-over-year, while the production of capital goods expanded by 3.6%.

43. In the year through November, industrial production growth reached 4.7%, with highlights to the expansions of capital goods (16.9%) and durable consumer goods (7.3%). In the same period, the growth of production of intermediate and semi- and non-durable consumer goods reached 3.3% and 1.7%, respectively. Industrial production increased 4.8% in the last twelve months through November, compared to 5.9% in October and 6.8% in September, indicating significant deceleration at the margin.

44. Vehicles production reached 102.1 thousand units in December, according to Anfavea, decreasing 53.8% year-over-year. Considering data seasonally adjusted by the BCB, the production of vehicles fell 34.3% in December, month-on-month, while the last quarter averaged 32.5% less than in the previous quarter. In 2008, the production of vehicles and agricultural machinery increased by 8.2% and 30.7%, respectively, year-over-year. Domestic vehicles sales decreased 7.2% in December 2008, compared to December 2007, and increased 13.9% in the year, compared to 2007. According to the same comparison bases, vehicles exports decreased 26.1% and 7.7%, respectively.

45. The LSPA survey carried out by the IBGE in December pointed to the production of 145.8 million tons in the year, a 9.5% increase over 2007, up from the 145.7 million tons November estimate. For 2009, the third estimate for the grains harvest points to a 5.9% fall in production, which should reach 137.3 million tons. Declines of 10.5% and 1.9% in the production of corn and soybean, respectively, were also projected.

Surveys and expectations

46. According to the Fecomercio SP survey, the Consumer Confidence Index (ICC) decreased 2% in January, month-on-month, reflecting the reduction of 3.1% in the Consumer Expectations Index (IEC). The Current Economic Conditions Index (Icea) was kept virtually stable. The ICC declined 12.9% year-over-year.

47. The National Consumer Expectations Index (Inec), quarterly surveyed by CNI, declined 5% in December, quarter-on-quarter. Among its components, the indices related to the expectations of unemployment and inflation presented declines of 18.5% and 9%, respectively, registering record lows since March 2002 and November 2001, respectively.

48. According to the FGV survey, the ICC increased 0.5% in December, month-on-month, favored by the increase of 6.8% in the Current Situation Index (ISP), while the Expectations Index (IE) declined 2.8%, reaching a record low for the series started in September 2005. Relative to December 2007, the survey also registered decreases of 19% in the ICC, 13.9% in the ISP and 21.9% in the IE.

49. Still according to the FGV, businessmen confidence in the industrial sector declined in December, similarly to the observed in the previous three months. The Industry Confidence Index (ICI) reached 74.7 points in December, seasonally adjusted, falling by 9.2 points month-on-month and 40.3 points relative to September. The index reached a record low since October 1998, emphasizing the pessimistic businessmen expectations about industrial activity, already captured in the November survey. Among its components, and also in seasonally adjusted terms, the Current Situation Index (ISA) leveled at 76.1 points, 9.2 points below the November outcome. The Expectations Index (IE) declined by the same magnitude, reaching 73.3 points, a record low for the series started in April 1995.

50. In accordance with the FGV Manufacturing Industry Survey, installed capacity utilization (Nuci) reached 80.6% in December, 6.1 p.p. below December 2007, and 79.9% in the seasonally adjusted series, 4.1 p.p. below the previous month, when these changes registered 2 p.p. and 1.3 p.p. declines, respectively. The seasonally adjusted index for December was close to the 80% average of the last 20 years. In December 2008, all use categories registered year-over-year declines, with the sharpest retraction for consumer goods (-9.5%). Considering industrial segments, only pharmaceuticals and veterinary products expanded, 3.6 p.p., year-over-year. Among the negative drivers, it bears highlighting transportation material (-14.4 p.p.), metallurgy (-13.6 p.p.), and mechanics (-10.5 p.p.), according to the same comparison basis.

Labor market

51. According to the Ministry of Labor and Employment (MTE), 654.9 thousand formal jobs were eliminated in December 2008, result that ratifies the loss of dynamism in the labor market, outlined since October. Employment level decreased by 0.2% month-on-month in seasonally adjusted terms. Manufacturing industry was the sector that recorded the higher number of dismissals, 273.2 thousand, followed by agriculture and services, which eliminated 134.5 and 117.1 thousand jobs, respectively. In 2008, 1,452,204 new jobs were created, compared to the creation of 1.617.392 jobs in 2007. Moreover, the level of formal jobs grew 6.4% in 2008. By sectors, the level of employment in the construction sector registered the higher increase in the year, 17.4%, followed by the retail sector, 6.7%, services, 6%, and manufacturing industry, 5.6%.

52. According to the IBGE employment survey (PME), carried out in the six main metropolitan areas of the country, the unemployment rate stood at 7.6% of the economically active population (PEA) in November, returning to the August and September levels, after a 0.1 p.p. decline in October. Compared to November 2007, unemployment declined 0.6 p.p. Despite the slight increase, the unemployment rate recorded the lowest level for November months since the beginning of the new PME series, started in March 2002. The relative stability of the unemployment rate in November, month-on-month, reflected the dismissal of 76 thousand workers from the labor market and the elimination of 95 thousand jobs. In seasonally adjusted terms, unemployment reached 7.8%, up from 7.6% registered in October. Compared to November 2007, occupation increased 2.9%, diverging from the annual average of 3.9% recorded until October. The PEA expanded 2.1%, year-over-year, and 2.2% in the year through November. The number of formal workers slightly decreased by 0.2% in November, month-on-month, corresponding to the elimination of 22 thousand jobs, while the total number of informal workers reduced by 38 thousand jobs, corresponding to a 1.3% decline in the number of this type of workers. In the year through November, formal workers in the private sector grew by 7.9%, while informal job creation expanded by 0.2%.

53. The same survey pointed that average real earnings of occupied workers increased by 0.9% in November, month-on-month, and expanded by 4%, year-over-year, representing the second consecutive month of deceleration according to this comparison basis. Real payrolls increased by 0.4% in November, month-on-month, and by 6.9% year-over-year.

Credit and delinquency rates

54. Outstanding credit in the financial system reached R$1,209 billion in November, increasing by 2% in monthly terms and 32.8% on a twelve-month trailing basis. This volume corresponded to 40.3% of GDP, compared to the 2007 figures of October (39.6%) and November (33.6%). According to the same comparison basis, non-earmarked credit operations increased 1.7% and 34.5%, respectively. Non-earmarked operations, with a share of 71.4% in the total of financial system, registered the cooling in the dynamism of operations with individuals, both in the arrangements that includes credit used as reference to the interest rate and in the operations to rental markets, which increased 98.6% in twelve months, but only 0.1% in November. Earmarked credit operations increased 3% month-on-month and 28.6% on a twelve-month trailing basis, as result of increases of 4.2% in credit operations performed by the BNDES (Brazilian Development Bank) and 3.3% in housing loans and transfers. Considering the segmentation by economic activity, it is worth mentioning loans to industry, which increased 4.3% in November and 41.8% in the last twelve months.

55. The average interest rate on non-earmarked credit operations, used as reference for interest rates, reached 44.1% p.a. in November, up from 42.9% p.a. in October and 34.7% p.a. in November 2007. The average rate on credit for individuals increased 3.8 p.p. in November, month-on-month, reaching 58.7% p.a., while the average rate on corporate credit declined by 0.4 p.p., reaching 31.2% p.a. In November 2007, the average rate on credit to individuals and credit to corporate stood at 44.8% p.a. and 23.3% p.a., respectively.

56. The average tenure on non-earmarked credit operations, used as reference for interest rates for individuals, reached 378 days in November,

compared to 385 days in October and 343 days in November 2007. The average tenure of corporate credit operations reached 305 days, while the average tenure for credit operations to individuals totaled 482 days, up from 268 days and 429 days, respectively, in November 2007.

57. Delinquency rates in the financial system (non-earmarked loans, used as reference for interest rates, in arrears for more than ninety days) stood at 4.2% in November, a 0.3 p.p. decrease year-over-year. Delinquency rates for credit operations with corporate and individuals reached 1.7% and 7.8%, respectively, compared to 2.2% and 7.1% in November 2007.

58. Net delinquency rate for retail credit, measured by the ACSP, reached 3.6% in December, up from -1.9% in the same month of 2007. In 2008, the average delinquency rate stood at 6.5%, up from 5.4% in 2007.

External environment

59. Since September, the global macroeconomic scenario has reflected the deepening of the crisis. The current economic and financial conditions have implied a decline in consumption and deterioration of business and consumer expectations, impacting negatively production, investment and real GDP, outlining the most severe economic reversal since 1929. The recession in United States, Japan, United Kingdom, Germany, Italy and Australia, among others; the dramatic decline in the installed capacity utilization verified globally; and the retraction in international trade are responsible for the deepening in the decline in the prices of commodities, oil in particular. This picture, which progressively contaminates emerging economies, both through the fall in the imports of developed countries and through the growing difficulty of external funding, exposes the fragility of the decoupling thesis and translates into estimates of global GDP contraction of approximately 4.1% in the fourth quarter of 2008, which should be added up to the 2.6% contraction in the first quarter of 2009.

60. The domestic demand collapse and its effects over the international trade, among credit restrictions, have provoked the increase in the unemployment rate, which reached 7.2% in December in the US economy. This fact, added up to the deepening of the non-functionality in the financial systems, has evidenced the need of anti-cyclical fiscal policies. In this sense, new packages of fiscal stimulus, preferentially directed to expenditures in infrastructure and tax reduction, were released in the US, Japan, China, Germany, Spain, France and UK, among others.

61. In light of the magnitude of reversal of the inflationary process and the weakening of the economic activity, initially occurred in the developed economies, but progressively reaching emerging economies, a continuous monetary policy easing process can be observed in global terms, even in the Latin America, where the central banks of Colombia, Chile and Mexico started a process of interest rate reduction between December 2008 and January 2009. In Japan and in the US, where the interest rates are almost zero, the central banks changed the focus of monetary policy, acting under the outlook of quantitative easing and therefore widening their balance sheets (Fed balance sheets increased to US$2.3 trillion in mid- December up from US$900 billion in September). In the UK, the repo rate stood at 1.5%, the lowest level since the foundation of the bank, more than 300 years ago.

Foreign trade and international reserves

62. Brazilian trade surplus reached US$2.3 billion in December, totaling US$24.7 billion in 2008. In the year, exports reached US$197.9 billion, and imports, US$173.2 billion, growing by 21.8% and 41.9%, respectively, year-over-year, on a daily average basis. Total external trade recorded US$371.1 billion in 2008, a 30.4% increase related to 2007, on a daily average basis.

63. Despite the favorable balance in December, exports and imports reduced by 11.7% and 1.2%, respectively, on a daily average basis, compared to December 2007, signaling the cooling of 2009 total external trade.

64. Based on the liquidity concept, international reserves totaled US$206.8 billion in December, with increases of US$429 million in the month and

US$26.5 billion relative to the end of 2007. Under the cash concept, international reserves totaled US$193.8 billion, recording a US$885 million decrease month-on-month.

Money market and open market operations

65. After the last Copom meeting in December, the future yield curve shifted sharply downward in the whole extension. This behavior was mainly driven by the fall in the current and expected inflation and by the released indicators that signaled the reduction of the expansion pace of economic activity, negatively impacting in the labor market. In the external outlook, the Federal Open Market Committee (FOMC) decision to adopt, on the December 16 meeting, a reference range from zero to 0.25% to the Fed funds, also contributed to this movement. Between December 8 and January 19, one-, three-, and six-month rates decreased by 51 bps, 87 bps and 141 bps, respectively. Moreover, one-, two- and three-year rates decreased by 180 bps, 209 bps, and 211 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, decreased to 6.25% on January 19, down from 7.38% on December 8.

66. In the period between December 9 and January 19, the BCB carried out traditional FX swap auctions, in which assumed a long position in domestic interest rate and a short position in FX. These operations totaled US$12.1 billion, rolling contracts due on January 2 and February 2.

67. In its open market operations, the BCB carried out, from December 9 to January 19, weekly five- and seven-month fixed rate repo operations, borrowing. The average daily balance of these operations reached R$45.0 billion, of which R$30.0 billion were seven-month operations. In the same period, the BCB borrowed money through 32 overnight repo operations. The BCB also conducted daily, at the end of day, two-working-day-tenure liquidity management operations. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R$114.3 billion, on a daily basis, borrowing. In addition, the BCB conducted borrowing operations with tenures of 28 and 15 working days on December 11; of 24 and 11 working days on December 17; of 14 working days on January 2; and of 11 working days on January 7. These operations draw from the market the following amounts: R$163.5 billion, R$10.4 billion, R$3.6 billion, R$2.0 billion, R$33.4 billion and R$12.4 billion, respectively. These operations averaged R$190.8 billion.

68. Between December 9 and January 19, the National Treasury raised a total of R$28.8 billion, of which R$11.6 billion in fixed-rate securities: R$10.9 billion via issuance of LTNs maturing in 2009, 2010 and 2011, and R$0.7 billion in NTN-Fs maturing in 2012, 2013, 2014 and 2017. Issuance of LFTs totaled R$15.1 billion, for securities maturing in 2011, 2012 and 2013. Issuance of inflation-linked NTN-Bs reached R$2.1 billion, for securities maturing in 2011, 2013, 2014, 2017, 2020, 2024, 2035 and 2045.

69. In the same period, the Treasury conducted auctions to sell LTNs maturing in July and October 2009 and bought LTNs maturing in January and April 2009, totaling R$1.3 billion; and conducted auctions to sell LFTs maturing in March and December 2011, and September 2013, against the purchase of LFTs maturing in December 2008 and January 2009, totaling R$2.0 billion. The sales of NTN-Bs settled in other National Treasury securities maturing 2011, 2013, 2014, 2020, 2024, 2035 and 2045 totaled R$2.2 billion. The Treasury also conducted purchase auctions of LTNs and NTN-Bs totaling R$1.0 billion and R$0.2 billion, respectively.

Minutes of the 141st Meeting of the Monetary Policy Committee (Copom)

Date: March 10th, from 4:00PM to 18:00PM, and March 11th, from 17:00PM to 18:50PM
Place: BCB Headquarters meeting rooms – 8th floor on March 10th and 20th floor on March 11th – 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 March 10th)
Adriana Soares Sales – Department of Banking Operations and Payments System
Altamir Lopes – Economic Department
Carlos Hamilton Vasconcelos Araújo – Research Department (also present on March 11th)
João Henrique de Paula Freitas Simão – Open Market Operations Department
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on March 10th)
Alexandre Pundek Rocha – Advisor to the Board
Eduardo José Araújo Lima – Advisor to the Research Department
Flávio Pinheiro de Melo – Advisor to the Board
Katherine Hennings – Advisor to the Board
Valderez Caetano Paes de Almeida – Press Secretary

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

Recent economic developments

1. IPCA inflation accelerated from 0.28% in December to 0.48% in January and 0.55% in February. As a consequence, inflation accumulated in the first two months of 2009 reached 1.03%, level equivalent to the registered in the same period of the previous year. In the last twelve months, after declining from 5.90% in December to 5.84% in January, inflation increased again to 5.90% in February (4.61% in February 2008). The acceleration of twelve-month consumer price trailing inflation mirrors the behavior of regulated prices, as there was no change in market prices. Both prices of tradable goods and non-tradable goods cooled on a twelve-month trailing basis, reaching 6.51% and 6.90%, respectively, down from 6.99% and 7.10% in December 2008, despite the acceleration relative to the levels observed in the same month of the previous year. According to the same comparison basis, the prices of services, whose dynamics tends to show more persistence than that of the prices of goods, as evidenced by the intense increase in the prices of education in February 2009, increased from 6.39% in December to 6.63% in January and 7.09% in February (5.19% in February 2008). Preliminary data for March point to consumer inflation below that observed in February. In short, information available suggest that the inflationary cycle observed in the last quarters tends to be gradually overcome by a process that should be led by the behavior of market prices, while regulated price inflation should show more persistence.

2. The three main underlying inflation measures calculated by the BCB showed divergent behavior in the first months of the year. The core inflation by exclusion of household food items and regulated prices decreased from 0.33% in December to 0.27% in January and then increased to 0.88% in February, reflecting seasonal factors. Smoothed and non-smoothed trimmed means core inflation measures showed lower variation, recording 0.33% in December, 0.42% and 0.44% in January, and 0.29% and 0.27% in February, respectively. The twelve-

month trailing inflation measures changed from 6.09%, 4.82% and 4.92% in December to 6.14%, 4.89% and 4.85% in February, for the core inflation by exclusion, smoothed and non-smoothed trimmed means core inflation, respectively, remaining in levels above the midpoint of the target. Moreover, it bears emphasizing that the behavior of the IPCA diffusion index, which remarkably increased in January, on a month-on-month basis, and continued to point to an inflationary process relatively disseminated, reduced in February (from 66.2% in January to 58.1% in February, compared to 56.5% in February 2008).

3. The General Price Index (IGP-DI) inflation changed 0.01% in January and -0.13% in February up from -0.44% in December. On a twelve-month trailing basis, the IGP-DI inflation decreased from 9.10% in December to 8.05% in January and 7.50% in February, compared to 8.65% in February 2008. The slowdown of the IGP-DI has reflected the behavior of its main component, the Wholesale Price Index (IPA-DI), which decreased from 9.80% in December to 7.39% in February, on a twelve-month trailing basis (10.62% in February 2008). On its turn, the Consumer Price Index-Brazil (IPC-Br) increased 6.15% (4.55% in February 2008) and, according to the same comparison basis, the Civil Construction National Index (INCC) increased 11.67% (6.28% in February 2008). Regarding IPA-DI, the inflationary acceleration, under this comparison basis, derives basically from the behavior of agricultural prices. The agricultural IPA increased 1.94% (23.89% in February 2008), while the elevation of wholesale industrial prices reached 9.49% (6.20% in February 2008). It bears noticing that, despite the effects of the exchange rate depreciation that has occurred since the third quarter of last year, wholesale industrial prices have showed deflation at the margin. 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. The IBGE (Statistics and Geography Brazilian Institute) released information about 2008 fourth quarter GDP. The data showed a slowdown in growth, both for accumulated results in the year (5.1% down from 6.4% accumulated in the first three quarters) and for year-over-year results (1.3%, down from 6.8% in the previous quarter). On the aggregate demand side, the expansion was led by public administration consumption, which increased 5.5% in the fourth quarter, year-over-year. The gross fixed capital formation (FBCF) increased 3.8% and household consumption growth grew 2.2%, according to the same comparison basis, sustained by the increase in real payroll. The contribution of domestic absorption to the GDP growth totaled 3.2 p.p. in the fourth quarter of 2008, year-over-year, overweighting the 1.9 p.p. negative impact exerted by the external sector. On the aggregate supply side, still according to the same basis, the services sector presented the best performance, growing by 2.5%, followed by agriculture (2.2%) and industry, which decreased 2.1% relative to the same period of 2007. The GDP deflator under market prices, on a year-over-year basis, changed from 6.8% in the third quarter of 2008 to 7.4% in the fourth quarter.

5. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output decreased 6.2% in January, after falling by 6.9% in the previous month. Still considering the seasonally adjusted series, according to the month-to-month comparison, after the 12.7%% retreat observed in December, industrial output increased by 2.3% in January. On a year-over-year basis, industrial output retreated by 17.2% in January, with respective falls of 18.4% and 17.2% in mining and manufacturing industries. Data released for the last months point, in short, to the interruption of the industrial production expansion cycle since the last quarter of 2008. The industrial activity has been influenced by the international crisis, due to its effects both over exports and credit conditions, and over business and households' expectations. In this context, several industrial segments have been led to adjust inventories and reduce production, a process that has recently been particularly evident in the intermediate goods industry.

6. Among the use categories, according to data seasonally adjusted by the IBGE, the production of capital goods decreased by 23.3% in December, but increased 8.4% in January. Regarding the other use categories, intermediate goods production decreased 12.4% in December and increased 0.8% in January;

semi-durable consumer goods production decreased 3.9% in December and 0.6% in January; and the production of durable goods, strongly influenced by the automotive sector, reduced by 32.9% in December, and increased by 38.6% in January. The recent slowdown in capital goods production reflects the persistence of the international financial turmoil and its consequences over business confidence. On its turn, the cooling in the pace of expansion of durable goods production reflects, predominantly, the tightening in credit conditions, the deterioration of consumer expectations and the process of inventories' reduction mentioned above. Such developments should continue to be evidenced by the data relative to the first months of the current year, despite with some recovery at the margin.

7. Labor market started to record ambiguous indicators, combining positive aspects with significant accommodation of formal job creation at the margin. The unemployment rate in the six metropolitan regions covered by the Monthly Labor Survey (PME) changed from 7.6% in November to 6.8% in December (record low in the historical series), but increased to 8.2% in January, up from 8.0% in January 2008. According to the seasonally adjusted series, the unemployment rate stood stable around 7.8%, between November and December, but increased to 8.6% in January. Average real earnings increased by 3.6% in December, in year-over-year terms, but increased 5.9% in January, according to the same comparison basis, resuming acceleration after three months of slowdown in the growth rate. Employment, on its turn, expanded by 3.0% in December and 1.9% in January, in year-over-year terms. As a consequence, real payroll increased 6.7% in December and 7.8% in January, continuing to constitute a key driver for domestic demand growth. According to the National Industry Confederation (CNI) data seasonally adjusted by the BCB, manufacturing employment retreated by 1.1% in January, after decreasing by 0.5% in December and 0.7% in November. In year-over-year terms, employment declined 0.1%. According to data seasonally adjusted by the IBGE, manufacturing employment fell 1.9% in December (after falling 0.6% in November and 0.1% in October), totaling a 2.1% increase in 2008 and a 1.2% decline year-over-year. Still regarding labor market, data from the Ministry of Labor and Employment (MTE) indicate significant loss of dynamism in the generation of formal employment since the end of 2008. In January, 101,748 jobs were dismissed (compared to the negative result of 654,946 in December). The manufacturing industry recorded the highest dismissal rate, with the reduction of 55,130 jobs, followed by the commerce sector, which habitually dismisses in this period of the year, with the reduction of 50,781 positions. On the other hand, the civil construction sector and the services sector hired workers in the month: 11,324 and 2,452 jobs, respectively.

8. According to data seasonally adjusted by the IBGE, expanded retail sales decreased by 1,0% in December, after decreasing 3.1% in November. On a year-over-year basis, the indicator increased by 1.3%, resulting in 9.9% growth in the year. The three-month moving average of expanded retail sales decreased 8.7% in December, quarter-over-quarter, according to seasonally adjusted data. On a month-on-month basis, according to seasonally adjusted data, it bears emphasizing the expansion in the sales of "office material and equipment" (11.9%) and "vehicles, motorcycles, parts and pieces" (3.5%). The negative key drivers were "civil construction" (-7.3%) and "furniture and appliances" (-3.7%). In the year, cumulative growth was more significant in "office material and equipment" (33.5%) and "other personal and domestic articles" (15.6%). After falls in October, November and December, expanded retail sales data for January and February should evidence a recovery influenced mainly by the increase in the sales of vehicles, in response to the sector incentives granted by the government. This recovery was captured by the data from the National Federation of Distribution of Automotive Vehicles (Fenabrave). For the next quarters, the retail sales trajectory will continue to be sustained by fiscal transfers, as well as by real payroll growth, whose evolution should be favored by the reduction of inflation, but it will also be affected by the evolution in the access to credit supply and by the behavior of consumer confidence.

9. The installed capacity utilization rate (Nuci) in the manufacturing industry reached 78.07% in January, below the level observed in December, according to CNI data seasonally adjusted by the BCB. According to data seasonally adjusted by CNI, the Nuci in the

manufacturing industry also reduced, reaching 78.4% in January, down from 79.4% in December. Without the seasonal adjustment, in January the Nuci stood 5.1 p.p. below the level registered in the same month 2008. On its turn, the monthly non-seasonally adjusted Nuci calculated by Fundação Getulio Vargas (FGV) retreated strongly in February, to 76.9%, standing 7.8 p.p. below the level registered in the same month of 2008. The reduction in the Nuci, year-over-year, is also observed in the production of consumer goods (-4.7 p.p.), intermediate goods (-9.7 p.p.), capital goods (-15.2 p.p.) and civil construction inputs (-5.9 p.p.). The reduction on Nuci calculated by CNI and FGV seems to be a result of a combination between the maturity of investment projects and accommodation of economic activity, and points to significant increase of the idle capacity level of the manufacturing industry. On the other hand, recent data about the absorption of capital goods indicate continuity in the slowdown of investments. The absorption of capital goods decreased 1% in January, according to seasonally adjusted data, and by 19.6% in year-over-year terms, according to observed data. In its turn, the production of civil construction inputs increased 0.8% at the margin in January, after decreasing 5.8% in December, falling 9.7% year-over-year. In short, evidences so far suggest an ongoing process of reduction in demand pressures over the productive capacity level of the manufacturing industry. 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 twelve-month accumulated trade balance has been showing stability at the margin. Under this criterion, the trade surplus reached US$24.7 billion in December, decreased to US$23.3 billion in January and increased to US$24.2 billion in February. This total resulted from US$191.2 billion in exports and US$167.0 billion in imports, equivalent to 15.5% and 29.2% growth, respectively, year-over-year. The adjustment in relative prices and the accommodation in the pace of expansion of domestic demand contribute to the recovery of the trade surplus, but the deterioration in the terms of trade acts on the opposite direction. The reduction in remittances of profits and dividends has acted to limit the current account deficit, which reached US$28.3 billion in December 2008, decreasing to US$27.0 billion in January, equivalent to 1.8% of GDP. On its turn, foreign direct investment reached US$42.2 billion in the twelve months through January, equivalent to 2.7% of GDP.

11. The period since the last Copom meeting was marked by the continuity of stress on international financial markets, which originated in the US and Europe, but whose impact on emerging economies has continued to be significant. Despite the unprecedented actions taken by the authorities in the US and Europe, using wide range of instruments, in order to ensure minimum conditions of operation and liquidity in money markets, systemic risk perception is still in evidence. The contraction of international liquidity has continued to contribute to a process of deleverage by asset managers, which, in turn, has been pressuring down the prices of financial assets. In an environment of increased risk aversion and shortage of capital flows, the volatility of emerging economies' currencies remains present, despite not showing the generalized trend of depreciation against the US dollar observed in the last months of 2008.

12. Regarding the global macroeconomic scenario, contraction trends prevail over inflationary pressures. The predominant view points to the contraction of global economic activity in 2009, recovering just in 2010. The consensual projections point to an intense retraction of activity in US, Europe and Japan, which wouldn't be totally offset by the economic dynamism of some emerging economies, especially in Asia. There are evidences that the deeper weakening of economic activity in Europe and parts of Asia was in a significant manner due to the negative shock in the terms of trade caused by the elevation of commodities prices in 2008, which was reverted, allowing an increase in available income in these regions. On the other hand, the problems in the international financial system have continued to be aggravated by a cyclical deterioration in the quality of credit, focused on the US and Europe, which tends to reinforce the contraction in financial conditions and, as a consequence, the risk of intensification in the deceleration. In mature economies, where inflation expectations are better anchored and economic activity has considerably decelerated, inflationary pressures have reduced rapidly. In emerging economies, where the secondary

effects of raw materials price increases over consumer prices and the heated demand pressures over the supply expansion capacity had been more intense, inflationary pressures have also been declining, although they show, in many cases, more persistence. In this context, while the monetary policy stance is mainly expansionist in mature economies, in emerging economies, which, in addition to the facts already mentioned, have been affected by the exchange rate depreciation trend, the expansionist stance has been more moderate. At the same time, the authorities in US, Western Europe and Asia have been announcing a series of initiatives aimed at sustaining economic activity through fiscal incentives, which could contribute to a gradual economic recovery. However, the estimates on the fiscal costs for packages of macroeconomic stimulus and support to the financial sector have been increasing, which has caused pressures on the assessment of risk on many sovereign credits, even in advanced economies.

13. Oil prices remain volatile, despite currently being close to the levels observed at the last Copom meeting. Future markets quotations have also shown volatility, without a defined trend. Uncertainty concerning these quotations remains high, as the prospective scenario depends on the evolution of demand, especially in emerging countries, on the prospects for evolution of global supply, in a scenario of uncertainties regarding the implementation and maturation of investments in the sector, in addition to the geopolitical issues that affect the price of this commodity. Nonetheless, the main scenario adopted by the Copom, which assumes unchanged gasoline prices in 2009, remains plausible. However, with the persistence of the current scenario in the oil market, it does not seem prudent to completely disregard the hypothesis of price reductions in 2009. However, it bears highlighting that, regardless of the behavior of domestic gasoline prices, the reduction in international oil prices observed since the second half of 2008 can eventually affect domestic prices both through productive chains, such as the petrochemical, as well as through the potential effect over inflation expectations. Conversely, the prices of agricultural commodities such as wheat, soybeans and corn, have reduced since the last Copom meeting, reacting both to the perspectives of reduction in demand and to the accumulation of inventorie.

Assessment of inflation trends

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

a) similarly to the January Copom meeting, the projected adjustment for 2009 for both gasoline and bottled gas prices stood at 0%;

b) the projected adjustment for fixed telephone for 2009 was kept unchanged at 5.0% (the same value considered in the January Copom meeting), while the expected adjustment for electricity prices was reduced to 7.6%;

c) the projection for regulated prices inflation in 2009, based on individual items, was maintained unchanged at 5.5%, compared to the January Copom meeting. This set of prices, according to data released by IBGE, corresponded to 29.64% of the total February IPCA;

d) the projection of regulated prices inflation for 2010 remained unchanged at 4.8%, compared to the January Copom meeting. Such projection is based on the endogenous determination model for regulated prices, which computes, among other factors, seasonal components, foreign exchange rate changes, market prices inflation and the IGP (General Price Index) variation; and

e) the projection for the spreads over the Selic rate, on the benchmark scenario, based on the 360-day swap rates, estimates a 29 bps spread in the fourth quarter of 2009 and 37 bps in the last quarter of 2010. The identified shocks and their impacts were reassessed according to newly available information.

15. Regarding fiscal policy, the projections assume the achievement of the public sector primary surplus target of 3.8% of GDP in 2009. The additional assumptions considered in the previous meeting remained unchanged.

16. Since the last Copom meeting, according to the median IPCA inflation expectations compiled by the BCB’s Investor Relations Group (Gerin), the 2009

IPCA change reduced to 4.57% down from 4.80%. For 2010, inflation expectations stood at 4.50%, the same projection observed in the January meeting.

17. Considering the hypotheses under the benchmark scenario – which assumes the maintenance of the exchange rate at R$/US$2.40 and the Selic rate at 12.75% p.a. during the forecast period – the projection for the 2009 IPCA decreased relative to the figure considered at the January Copom meeting and remains below the 4.5% target established by the National Monetary Council (CMN). 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 2009 also decreased compared to the figure considered in the previous Copom meeting and is below the central target. Inflation projection for 2010, based on the benchmark scenario, slightly decreased compared to the figure considered in the last Copom meeting and is significantly below the 4.5% central target, while on the market scenario, it has also decreased, staying below the 4.5% central target.

Monetary policy decision

18. The Copom evaluates that the monetary policy should contribute to the consolidation of a favorable long-term macroeconomic environment. Economic activity available data indicate that the pace of domestic demand expansion has significantly cooled since the last months of 2008, amidst a significant generalized economic activity deceleration in other economies, developed and emerging. On its turn, the increase in risk aversion and the unprecedented constraints observed in liquidity conditions in the international markets, unseen over the last few decades, continue to impose adjustments in the balance of payments. Therefore, in general terms, the influence of the external scenario over the future path of Brazilian inflation continues to be subject to apparently contradictory effects, which can act with distinct intensity throughout time, surrounded by significant uncertainty. On the one hand, the economic cooling has caused an increase in risk aversion, impacting the demand for Brazilian assets and consequently, depreciating their prices. On the other hand, the more generalized economic deceleration observed in the last months which, despite not permanent, may persist in the upcoming quarters, has caused the cooling of both commodities prices and external demand, also negatively impacting local financial conditions. Moreover, the trajectory of price indices evidences the reduction of external inflationary pressures, especially in mature economies, but also in some emerging economies. As a consequence, the net effect of the global deceleration over domestic inflation path seems to be, so far, predominantly benign. Copom emphasizes that the main challenge of monetary policy in this context is to guarantee the maintenance of favorable results achieved in the last years, when inflation targets were systematically met.

19. The Copom evaluates that the probability that initially localized inflationary pressures may cause risk to domestic inflation trajectory continues to diminish. Evidences of substantial accommodation of domestic demand and moderation of pressures over the market of factors, despite remaining subject to uncertainty, should reduce the risk of pass-through of upward pressures, observed through the end of 2008, of wholesale prices (which have been showing deflation over the last few months) to consumer prices. The Committee evaluates that the materialization of this pass-through, as well as the generalization of pressures initially localized on consumer prices, still depends critically on economic agents' inflation expectations. In particular, inflation expectations for 2009 remain in levels above the inflation target, in spite of some reduction since the last Copom meeting, and continue to be closely monitored. Additionally, it is worth noticing that, according to available data, the behavior of domestic demand should exert lesser pressures over the prices of non-tradable items, such as services, in the upcoming quarters. Anyhow, the Committee reaffirms that it will continue to conduct its actions in order to ensure that the gains obtained in inflation control in recent years become permanent.

20. The Copom emphasizes, once again, that there are important time lags between the implementation of monetary policy and its effects on economic activity and inflation. Therefore, the evaluation of alternative options for monetary policy should necessarily focus on the forward-looking inflation

scenario and its risks, instead of current inflation indices. This point of view is even more important in periods surrounded by heightened uncertainty.

21. Prospects for the evolution of economic activity have continued to deteriorate since the last Copom meeting, although industrial activity data have been partially reflecting a process of inventory retreat, which tends to fade over time. It is particularly important to notice that the effects of the international crisis over domestic financial conditions have resulted in severe decline of the credit contribution to domestic demand support. Additionally, the intensification of the international crisis has caused negative effect on consumers and businessmen confidence. Under such circumstances, the economic activity dynamism tends to increasingly rely on payroll expansion and on the effects of the possibly enhanced governmental transfers that should occur in 2009. On the other hand, the contracting effects of the international financial crisis over the domestic economy dynamism and, consequently, over the context of monetary policy, despite not permanent, may become persistent. These considerations become even more relevant considering the fact that the current monetary policy decisions will have concentrated impacts over the upcoming quarters.

22. The Copom evaluates that the loss of domestic demand dynamism should result in the reduction of inflationary pressures. On its turn, the remaining risks for the inflationary dynamics derive from the trajectory of Brazilian asset prices, amidst a process of decreasing external sources of funding and mechanisms of price adjustments that contribute to prolong inflationary pressures observed in the past, as evidenced by the behavior of the prices of services and regulated items during the beginning of 2009. The balance of those influences over the prospective trajectory of inflation will be crucial to the assessment of the various alternatives available for the monetary policy stance.

23. International evidence, as well as the Brazilian experience, indicates that high inflation rates leads to increase in risk premiums, both for private and public funding, to the shortening of planning horizons and, consequently, to lower potential economic growth, besides having regressive effects over income distribution. Therefore, the Copom strategy aims to ensure that inflation resumes the 4.5% midpoint target path in 2009, as established by the CMN, and to keep it in level consistent with the targets path for 2010. Such strategy, which should have its results evidenced throughout time, takes into account the time lags in the transmission mechanisms and is the most adequate to deal with uncertainties inherent to the process of monetary policy formulation and implementation.

24. The Copom evaluates that, in light of signs of economic activity slowdown, regarding, for instance, industrial production indicators (exacerbated by an inventory cycle), certain available data on labor market and industrial capacity utilization rates, as well as on businessmen and consumers confidence, and of lower inflation expectations for relevant horizons, the prospects for the materialization of a benign inflation scenario, in which IPCA would resume evolution in line with target path, have been increasing. Indeed, the evolution of the prospective scenario is reflected on inflation projections considered by the Committee. Nevertheless, despite there is still some scope for an easing process, monetary policy should be cautiously conducted, aiming to assure the convergence of inflation to the targets path.

25. The Committee believes that the demand slowdown, stemming from the tightening of financial conditions, the deterioration of agents' confidence and global economic activity contraction, has created significant idleness margin of production factors. Such development should contribute to restrain inflationary pressures, even in light of the consequences of the adjustment process of the balance of payments and the presence of mechanisms of inflation feedback in the economy, making room for a monetary policy easing process. On the other hand, in addition to the fact that changes on the basic interest rate have effects over activity and inflation that accumulate over time, the Copom's evaluation about the scope for some additional monetary policy easing also takes into account aspects resulting from the long periods of high inflation, still embedded within the financial system institutional framework.

26. In such context, taking into account the macroeconomic scenario, Copom has unanimously

decided, at the moment, to reduce the Selic rate to 11.25% p.a., without bias. The Committee will monitor the evolution of the inflation forward-looking scenario until its next meeting, considering the magnitude and speed of the basic interest rate adjustment already implemented and its cumulative effects, in order to define the next steps of its monetary policy strategy.

27. Under the inflation targeting regime, the Copom guides its decisions according to projected inflation, the analysis of several alternative scenarios for the evolution of the main variables that determine the forward-looking prices dynamics, and the balance of risks associated to the projections. There are signs that, after a long period of expansion, domestic demand has started to have a contractionist influence over economic activity, despite persistence of stimulus factors, such as income growth. Additionally, it is worth noticing that inflationary expectations for 2009 have decreased since the last Committee meeting. On the other hand, the deceleration of global economy has generated downturn pressures over wholesale prices, despite the exchange rate adjustment. Under such environment, monetary policy can be more flexible without putting at risk inflation convergence to the targets path. Evidently, if deterioration on the risk profile implies shifts to the inflation prospective basic scenario considered by the Committee at this moment, the monetary policy stance will be promptly adjusted to the circumstances.

28. At the end of the meeting, it was announced that the Committee would reconvene on April 28th, 2009, for technical presentations and on the following day, to discuss monetary policy decision, as established in Communiqué 17.327 of August 27th, 2008.

Summary of data analyzed by the Copom

Inflation

29. The IPCA increased 0.55% in February, decelerating relative to the February IPCA-15 (0.63%), and accelerating relative to the January IPCA (0.48%). In the last twelve months through February, the IPCA reached 5.9%, up from 5.84% observed in January, reaching 1.03% in 2009. The February result was influenced by the increase in the costs of education (4.77%), which contributed 0.33 p.p., representing 60% of IPCA change in February, as a result of the typical readjustments of this group at the start of the year.

30. Market prices accelerated, reflecting the increase in education costs, reaching 0.67% in February, up from 0.37% in January, while regulated prices reached 0.28%, down from 0.75% in the same period. On a twelve-month trailing basis, market prices increased 6.71% in February (the same change observed in January), while regulated prices reached 4.02%, up from 3.83% over the previous month. The diffusion index reached 58.07%, down from 66.15% in January, the lowest level recorded since March 2008.

31. The core excluding household food items and regulated prices increased 0.88% in February, up from 0.27% in January, reaching 6.14% over twelve months, compared to 5.95% in the previous month. The smoothed trimmed means core reached 0.29% relative to 0.42% in January, increasing by 4.89% over the last twelve months (4.88% in the previous month). The non-smoothed trimmed means core increased 0.27% in February, down from 0.44% and reached 4.85% in twelve months (4.95% in the previous month).

32. The IGP-DI decreased 0.13% in February, compared to a 0.01% increase in January, accumulating a 0.11% decrease over the year and a 7.5% increase in the last twelve months. The IPA (Wholesale Price Index) decreased 0.31% in February, reflecting lower prices on both agricultural products (-0.36%) and on industrial products (-0.29%). On a twelve-month basis, the IPA increased 7.39%, with a 9.49% increase in industrial prices and 1.94% in agricultural prices. It bears highlighting IPA's significant deceleration in the twelve months through October, November, December and January: 14.72%, 12.88%; 9.80% and 8.27%, respectively. The IPC-Br decelerated, decelerating from 0.83% in January to 0.21% in February, reaching 6.15% in twelve months. The INCC increased 0.27% in February, down from 0.33% in January, reaching 11.67% in the last twelve months. The IPC-Br core reached 0.33% in February, down from 0.35% in January, reaching 4.25% in twelve months.

33. Analyzing the IPA by stages of processing, the prices of final goods increased 0.85% in February, while the prices of intermediate goods and gross raw material decreased 1.03% and 0.55%, respectively. In the last twelve months through February, these three segments increased 4.78%, 9.05% and 8.02%, respectively.

34. The IPC-S (Weekly Consumer Price Index) increased 0.35% over the first week of March, compared to 0.21% in February.

Economic activity

35. According to seasonally adjusted data from the IBGE's monthly survey (PMC), expanded retail sales, which include construction supplies and vehicles and motorcycles, parts and pieces, decreased 1% in December, after decreasing 3.1% in November and 8.4% in October. Four out of the ten segments surveyed by the IBGE expanded in December, with highlights to office material and equipment (11.9%) and vehicles, motorcycles, parts and pieces (3.5%), which benefitted from the IPI (Industrialized Products Tax) reduction. In October and November, automobile industry sales decreased by 18.8% and 7.1%, month-on-month, respectively. Among the segments that declined relative to December, it bears noticing the performance of construction material (-7.3%, month-on-month), deepening the contraction observed in the two previous months.

36. Considering the comparisons between identical periods of 2008 and 2007, expanded retail sales increased 1.3% in December, growing by 9.9% year-over-year in 2008. In December, it bears emphasizing a decrease in sales of fabric, clothing and shoes (6.3%); vehicles, motorcycles, parts and pieces (4.5%); and construction material (3.6%), according to the same comparison basis. Among the sectors with sales increases, office material and equipment presented the best performance, with a 35.6% increase year-over-year. In 2008 all sectors grew, with highlights, once again, for office material and equipment, which grew 33.5% compared to 2007.

37. According to São Paulo Trade Association (ACSP) data, seasonally adjusted by the BCB, database consultations for credit sales (SCPC) related to the city of São Paulo decreased by 3.3% in February, month-on-month. On the other hand, consultations to Usecheque system expanded by 2.8%. In addition, those indicators decreased 12.8% and 5.5%, respectively, year-over-year. In the first two months of 2009, those indicators decreased 9.2% and 5.3%, respectively, compared to the same period of 2008.

38. Automobile sales by dealers, which take into account light commercial vehicles, trucks and buses, declined 0.8% in February, year-over-year, according to Fenabrave. However, February data hit the second highest volume of sales in the historical series. According to seasonally adjusted data, February sales increased 4% month-on-month, after a 36.5% increase in January, according to the same comparison basis. In the quarter ended in February, sales decreased 4.6%, quarter-over-quarter.

39. Regarding investment indicators, capital goods production increased 8.4% in January, while the production of construction typical inputs increased 0.8%, month-on-month, considering the seasonally adjusted series. Relative to January 2008, those indicators decreased 13.3% and 9.7%, respectively. The positive margin increase on capital goods production reflected basically the expansion of segments of transportation equipment (9.6%) and for mixed use (7.8%).

40. According the industrial survey conducted by CNI, 89% of industrial companies plan to invest in 2009 (although in a lesser proportion than 2008), although 67% of entrepreneurs responded that their productive capacity is adequate to the expected demand for 2009. The planned investments seek to improve quality and expand production, with focus on the domestic market.

41. Capital goods imports declined 18.4% in January, month-on-month, according to the Funcex quantum indices, seasonally adjusted by the BCB. The January indicator decreased by 12.4% year-over-year, down from the twelve-month cumulative change (28.5%), signaling the significant downturn in the performance recently observed.

42. According to IBGE's Monthly Industrial Survey (PIM), industrial production increased 2.3% in January, month-on-month, after three consecutive months of decline, according to the seasonally adjusted series. Twelve of the 27 activities surveyed reported monthly decline in production, with highlights to the negative performance in the sectors of machinery, appliances and electrical materials (-9.5%), and miscellaneous (-10.7%). By use categories, still considering seasonally adjusted data, only the production of semi- and non-durable consumer goods presented negative result (-0.6%). Capital goods, intermediate goods and durable consumer goods production increased, respectively, 8.4%, 0.8% and 38.6% in January, month-on-month.

43. Industrial production decreased 17.2% in January, year-over-year, a record low for the series since its start in November 1991. All the use categories declined year-over-year: capital goods (-13.3%), intermediate goods (-20.4%), durable consumer goods (-30.9%) and semi- and non-durable consumer goods (-8.3%). The 12-month cumulative industrial production expanded by 3.1% in December and 1% in January, evidencing deceleration at the margin.

44. Vehicles production reached 201.7 thousand units in February, according to Anfavea, decreasing 20.6% year-over-year. Considering data seasonally adjusted by the BCB, the production of vehicles increased 7.2% in February, month-on-month, while the production in the last quarter stood 27.8% below than the observed in the quarter ended in November. The cumulative production of vehicles and agricultural machinery increased by 0.9% and 16.1%, respectively, in the last twelve months through February. The sales of domestic vehicles decreased 13.2% in February 2009, year-over-year, but increased 4.1% in twelve months. According to the same comparison bases, vehicles exports decreased 52.3% and 15.5%, respectively.

45. CNI indicators continued to show deceleration in the pace of industrial activity in January, with decreases of 3.5% in real revenues and 2.1 p.p. in the installed capacity utilization, according to data seasonally adjusted by the BCB. The hours worked was the only indicator that grew month-on-month. Compared to January 2008, all indicators decreased: real revenues (-13.4%), hours worked (-6.5%) and installed capacity utilization (-5.1 p.p.).

46. The LSPA survey carried out by the IBGE in February pointed to the production of 135.3 million tons in 2009, up from 134.7 million tons estimated in January. The new estimate represents a 7.3% decrease relative to the 2008 production. Declines of 12.7% and 3.9% in the production of corn and soybean, respectively, were also projected. Products directly related to the basic food basket, such as rice and beans, should have their production expanded by 3.7% and 11.1%, respectively.

47. The IBGE released information on the GDP performance of the fourth quarter of 2008. The data show a slowdown both for accumulated changes in the year (5.1%, down from 6.4% in the previous quarter), and for year-over-year results (1.3%, down from the 6.8% in the previous quarter). According to data seasonally adjusted, the GDP in the last quarter of 2008 decreased by 3.6%, quarter-on-quarter. On the supply side, according to the year-over-year comparison, only the industry activity fell (-2.1%). Agriculture and services grew, respectively, 2.2% and 2.5%. On the demand side, household and government consumption and gross fixed capital formation increased 2.2%, 5.5% and 3.8%, respectively. Additionally, exports retreated 7% and imports increased 7.6%, resulting in the twelfth consecutive quarter of growth driven exclusively by the domestic market. The domestic demand contributed 3.2 p.p. for the 1.3% increase of GDP in the last quarter of 2008 (year-over-year), while the external sector contributed -1.9 p.p..

Surveys and expectations

48. According to the Fecomercio-SP survey, the Consumer Confidence Index (ICC) decreased 3.5% in March, month-on-month, reflecting the reduction of 10.1% in the Current Economic Conditions Index (Icea) and the rise of 0.6% in the Consumer Expectations Index (IEC). The ICC declined 13.3% year-over-year, mainly due to the retraction of 24.8% in the Icea.

49. According to the FGV survey, the ICC decreased 4% in February, month-on-month, reaching a record

low for the series started in September 2005. This negative result was driven by the 5.6% decrease in the Current Situation Index (ISP) and by the 3.2% decline in the Expectations Index (IE). The survey also registered decreases of 17.5% in the ICC, resulting in falls of 15.5% in the ISP and 18.6% in the IE, year-over-year.

50. Still according to the FGV, businessmen confidence in the industrial sector was kept virtually unchanged the first two months of 2009, after falling in the last quarter of 2008, remaining at a level below 80 points. The Industry Confidence Index (ICI) reached 76.3 points in February, seasonally adjusted, increasing by 1 point month-on-month. For the second consecutive month, the seasonally adjusted index recorded growth, emphasizing the recovery of optimistic businessmen expectations about industrial activity. Among its components, and also in seasonally adjusted terms, the Current Situation Index (ISA) leveled at 77.4 points, 0.9% below the January outcome, while the Expectations Index (IE) increased 3.7%, reaching 75.2 points. By use categories, all indicators increased in the month, but stood below 100 points. Consumer goods outperformed for being the use category with greatest confidence level and greatest level of recovery in the month, increasing 12.9 points, up from 4.1 points recorded by the general industry. By industrial segments, the segment of transportation material registered the most significant recovery in ICI, 34.1 points, reaching 83 points in February. The sectors of mechanics, cellulose and paper and other products reached a record low for the historical series. Year-over-year, food products and pharmaceuticals showed the slightest fall in the confidence index, of 11.3 points and 14.3 points, respectively, while the general industry retracted 24.6 points.

51. According to the FGV Manufacturing Industry Survey, installed capacity utilization (Nuci) reached 76.9% in February, 7.8 p.p. below February 2008, and 77.5% in the seasonally adjusted series, 0.5 p.p. below the previous month, having reached, according to this criterion, a record low for the historical series. All use categories registered year-over-year declines, with highlights for the retraction in capital goods (-15.2%). Considering the industrial segments, only food products and pharmaceuticals and veterinary products expanded, respectively, 0.6 p.p. and 0.4 p.p., year-over-year. Among the negative drivers, it bears highlighting metallurgy (-25.6 p.p.), and mechanics (-20.4 p.p.), according to the same comparison basis.

Labor market

52. According to the Ministry of Labor and Employment (MTE), 101.7 thousand formal jobs were eliminated in January 2009. Employment decreased by 0.2% month-on-month, in seasonally adjusted terms. Among economic activities, manufacturing industry recorded the highest number of dismissals, 55.1 thousand, followed by the retail sector, which eliminated 50.8 thousand jobs. The services and the construction sectors increased employment level by 0.08% and 0.06%, respectively, in seasonally adjusted terms. In the last twelve months through January, employment increased 4.1%, led by the construction sector (10.8%), and followed by the retail sector (5.4%) and the services sector (5.2%).

53. According to the IBGE employment survey (PME), carried out in the six main metropolitan areas of the country, the unemployment rate reached 8.2% of the economically active population (PEA) in January, increasing 1.4 p.p. month-on-month. The unemployment rate increased 0.2 p.p. year-over-year, first increase according to this comparison basis since October 2006. In seasonally adjusted terms, the unemployment reached 8.6% in January 2009, up from 7.8% in December, reflecting decreases of 1.6% in occupation and 0.1% in the PEA.

54. Occupation expanded by 1.9% in January 2009, year-over-year, decelerating from the 3.4% average growth observed last year. The PEA expanded by 2.1%, according to the same comparison basis, slightly above the 1.8% average growth observed last year. Formal employment decreased by 1.3% in January, month-on-month, corresponding to the elimination of 129 thousand jobs, while the total number of informal workers and self-employed workers reduced by 127 thousand jobs (-4.5%) and 88 thousand jobs (-2.2%), respectively.

55. The same survey pointed out that average real earnings of occupied workers increased by 2.2%

in January, month-on-month, and expanded by 5.9%, year-over-year. Real payrolls increased by 0.5% in January, month-on-month, and by 7.8%, year-over-year.

56. According to CNI data seasonally adjusted by the BCB, employment in the manufacturing industry fell 1.1% in January, after decreasing 0.5% in December, resulting in a 1.1% decrease in the quarter ended in January, quarter-on-quarter. Year-over-year, employment in the manufacturing industry decreased by 0.1%, while industrial real payroll increased by 2.1%.

Credit and delinquency rates

57. Outstanding credit in the financial system reached R$1,230 billion in January, increasing by 0.2% in monthly terms and 30.1% on a twelve-month trailing basis. This volume corresponded to 41.2% of GDP, compared to the 2008 figures of January (34.2%) and December (41.1%). Non-earmarked credit operations decreased 0.2% month-on-month and increased 30.4% in the last twelve months. Among the non-earmarked operations, which represent a share of 70.8% in the total of the financial system, credit operations to individuals increased 1.3% month-on-month and 23.2% in the last twelve months. Non-earmarked credit operations to corporate reduced by 1.4% month-on-month, expanding by 37.2% year-over-year. Earmarked credit operations increased 1.1% month-on-month and 29.5% on a twelve-month trailing basis, with highlights to the monthly increases of 1.9% in housing loans and transfers and 1.2% in credit operations performed by the BNDES (Brazilian Development Bank).

58. The leasing operations in the individuals segment continue losing momentum at the margin. On a twelve-month trailing basis, the expansion declined to 84.1% in January, down from 116.3% in October. Considering the segmentation by economic activity, the loans to industry decreased 0.8% month-on-month and expanded 36.5% in the last twelve months.

59. The average interest rate on non-earmarked credit operations, used as reference for interest rates, reached 42.4% p.a. in January, down from 43.3% p.a. in December and 37.3% p.a. in January 2008. The average rate on credit for individuals decreased 3 p.p. in January, month-on-month, reaching 55.1% p.a.. The average rate on corporate credit increased by 0.3 p.p., month-on-month, reaching 31% p.a., but still below the levels observed in October and November, of 31.8% and 31.4%, respectively. In January 2008, the average rate on credit to individuals and credit to corporate stood at 48.8% p.a. and 24.7% p.a., respectively.

60. The average tenure on non-earmarked credit operations, used as reference for interest rates for individuals, reached 375 days in January, compared to 379 days in December and 371 days in January 2008. The average tenure of corporate credit operations reached 297 days, while the average tenure for credit operations to individuals totaled 484 days, up from 308 days and 445 days, respectively, in January 2008.

61. Delinquency rates in the financial system (non-earmarked loans, used as reference for interest rates, in arrears for more than ninety days) stood at 4.6% in January, a 0.2 p.p. increase year-over-year. Delinquency rates for credit operations with corporate and individuals reached 2% and 8.3%, respectively, compared to 2% and 7.1% in January 2008.

62. Net delinquency rate for retail credit, measured by the ACSP, reached 7.8% in February, up from 6.4% in the same month of 2008.

External environment

63. The global macroeconomic scenario continues to reflect the deepening of the international financial crisis, with impacts over the global credit and economic activity. In this context, recent economic data have pointed to the contraction in consumption and private investment, worsening the loss of dynamism in international trade, increasing unemployment rates and widening the product gap. The weakness of aggregate demand in mature economies also began to contaminate the emerging economies that still showed some resilience. The current lack of liquidity conditions and further deterioration of growth prospects are set to be the most likely scenario for the short and medium term, which contributes for the global financial system to remain under severe stress.

64. As a result of the global recession outlook, energy and commodities prices have remained low, which resulted in significant reductions in inflation rates. In the US, despite the slight rise at the margin, the decrease in energy prices continued to contribute to the decline in inflation, which recorded 0.03% in the last twelve months through January, down from 5.6% in the twelve months through July 2008. In other mature economies, the declines in are not less significant. For the same period, inflation retreated to 0%, down from 2.3% in Japan, to 1.1%, down from 4.0% in the Euro Area and to 3.0%, down from 5.2% in the UK (in this last case, between September and January).

65. Considering the deepening of credit restrictions, the crisis in financial systems and the current behavior of inflation, central banks, both in the mature economies and in the emerging economies were urged to increase the amount of resources injected into their financial systems and further the monetary policy easing in order to mitigate the risk of deflation, especially in mature economies and in China. Such easing is also noticeable in Latin America, where the central banks in Colombia, Chile, Mexico, Brazil and Peru have continued the cycle of interest rate reduction. It bears highlighting that in the United States, Japan, UK, Canada, Sweden and Switzerland, where interest rates are very close to zero, central banks have begun considering or have already started to directly purchase long-term public or private securities. Additionally, several measures of fiscal and monetary stimulus were edited or prorogated in order to reestablish the normality of private consumption, the housing market and the global financial markets. For example, the US authorities have announced or launched loans programs for banks to encourage private consumption and activity of small companies, which adds up to new plans adopted based both on fiscal stimulus and also on support to the financial system.

Foreign trade and international reserves

66. The Brazilian trade surplus reached US$1.8 billion in February, totaling US$1.2 billion in the first two months of 2009. In the month, exports reached US$9.6 billion, and imports, US$7.8 billion, decreasing by 20.9% and 30.9%, respectively, year-over-year, on a daily average basis. Total external trade recorded US$17.4 billion in February, a 25.8% decrease year-over-year, on a daily average basis.

67. The decline of 21.9% in exports and 21.6% in imports in the first two months signal the cooling of global and domestic economic activity, which exceeds initial predictions, creating concerns about the performance of total external trade for 2009.

68. Based on the liquidity concept, international reserves totaled US$199.4 billion in February, recording a US$1.4 billion decrease month-on-month. Under the cash concept, international reserves totaled US$186.9 billion, recording a US$1.2 billion decrease month-on-month.

Money market and open market operations

69. Between the January Copom meeting and the start of March, the future yield curve for tenures up to one year shifted sharply downward in the whole extension. This behavior was domestically mainly driven by the released indicators signaling strong retraction in economic activity and weakening of labor market, as well as by the improvement of current inflation rates and expectations. The long-term rates ended the period showing less intensive reduction, mainly influenced by the maintenance of uncertainty regarding the direction of global economy. Between January 19 and March 9, one-, three-, and six-month rates decreased by 143 bps, 154 bps and 148 bps, respectively. Moreover, one-, two- and three-year rates decreased by 116 bps, 88 bps, and 45 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, decreased to 5.51% on March 9, down from 6.25% on January 19.

70. In its open market operations, the BCB carried out, between January 20 and March 9, weekly five- and seven-month fixed rate repo operations, borrowing. The average daily balance of these operations reached R$41.1 billion, of which R$26.2 billion were seven-month operations. In addition, the BCB conducted borrowing operations with tenures of 33 and 16 working days on January 22; of 26 working days on February 2; of 21 working days on February 9; and of 16 working days on February

16. These operations draw from the market the following amounts: R$207.1 billion, R$23.9 billion, R$2.5 billion, R$11.4 billion and R$20.9 billion, respectively. These operations averaged R$237.9 billion. In the same period, the BCB borrowed money through 33 overnight repo operations. The BCB also conducted daily, at the end of day, one- and two-working-day-tenure liquidity management operations. Operations with tenors less than thirty days, including daily liquidity management operations, averaged R$105.3 billion, on a daily basis, borrowing.

71. In the period between January 20 and March 9, the BCB carried out traditional FX swap auctions, in which assumed a long position in domestic interest rate and a short position in FX. These operations totaled US$13.8 billion, rolling contracts due on February 2 and March 2.

72. Between January 20 and March 9, the National Treasury raised a total of R$37.4 billion, of which R$20 billion in fixed-rate securities: R$19 billion via issuance of LTNs maturing in 2009, 2010 and 2011, and R$1 billion in NTN-Fs maturing in 2013 and 2017. Issuance of LFTs totaled R$14.3 billion, for securities maturing in 2012, 2013 and 2015. Issuance of inflation-linked NTN-Bs reached R$3.1 billion, for securities maturing in 2011, 2014, 2020, 2024, 2035 and 2045.

73. In the same period, the Treasury conducted auctions to sell LTNs maturing in October 2009 and April 2010 and bought LTNs maturing in April 2009, totaling R$1.5 billion; and conducted auctions to sell LFTs maturing in September 2013, against the purchase of LFTs maturing in March and June 2009, totaling R$1.0 billion. The sales of NTN-Bs settled in other National Treasury securities maturing in 2011, 2014, 2020, 2024, 2035 and 2045 totaled R$3.4 billion. The Treasury also conducted purchase auctions of LTNs, NTN-Bs and NTN-Fs totaling R$1.0 billion, R$0.4 billion and R$83 thousand, 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

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

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

ACC	Advance on Exchange Contracts
ACSP	São Paulo Trade Association
Anfavea	National Association of Automotive Vehicle Manufacturers
APF	Asset Purchase Facility
BNDES	Brazilian Development Bank
BoE	Bank of England
BoJ	Bank of Japan
Caged	General File of Employed and Unemployed Persons
CMN	National Monetary Council
CMN	National Monetary Council
CNI	National Confederation of Industry
Cofins	Contribution to Social Security Financing
Copom	Monetary Policy Committee
CRB	Commodity Research Bureau
CRB	Commodity Research Bureau
CSI	Current Situation Index
CSLL	Social Contribution on Net Corporate Profits
ECB	European Central Bank
EI	Expectations Index
Embi+	Emerging Markets Bond Index Plus
FDI	Foreign Direct Investments
FDI	Foreign Direct Investments
Fecomercio SP	Trade Federation of the State of São Paulo
Fenabrave	National Federation of Automotive Vehicle Distribution
FGC	Credit Guaranty Fund
FGTS	Employment Compensation Fund
FGV	Getulio Vargas Foundation
FPR	Real Payroll
FST	Financial Stability Trust
Funcex	Foreign Trade Studies Center Foundation
GDP	Gross Domestic Product
GDP	Gross Domestic Product
Gerin	Executive Investor Relations Group
GFCF	Gross Fixed Capital Formation
GGGD	Gross General Government Debt
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
IEA	International Energy Agency
IEC	Consumer Expectations Index
IGP-DI	General Price Index
IMF	International Monetary Fund
INCC	National Cost of Construction Index
INCC-DI	National Cost of Construction Index – Domestic Supply
Inec	National Consumer Expectations Index
IOF	Financial Operations Tax
IPA-DI	Producer Price Index
IPCA	Extended National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPI	lndustrialized Products Tax
IRPJ	Corporate Income Tax
ISP	Current Situation Index
LME	London Metal Exchange
LNG	Liquified Natural Gas
LSPA	Systematic Farm Production Survey
M1	Currency outside banks + demand deposits
MTE	Ministry of Labor and Employment
Nuci	Installed Capacity Utilization Level
PAC	Annual Trade Survey
PAF	Annual Financing Plan
Pasep	Civil Service Asset Formation Program
PBC	People's Bank of China
PEA	Overall Labor Force
Pimes	Monthly Industrial Survey – Employment and Wages
PIM-PF	Monthly Industrial Survey – Physical Production
PIS	Social Integration Program
PMC	Monthly Retail Trade Survey
PME	Monthly Employment Survey
PSND	Public Sector Net Debt
PSND	Public Sector Net Debt
SCIT	Manufacturing Industry Survey
SCPC	Credit Protection Service Center
Selic	Special System of Clearance and Custody
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
TN	National Treasury
TR	Reference Rate
ULC	Unit Labor Cost
USA	United States of America
VAR	Autoregressive Vector
VAT	Value Added Tax