

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, non earmarked 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*.