

Inflation trended downward in the quarter ended in May (compared to February quarter end) expressed both in a decelerated performance in consumer prices as well as the more pronounced downfall experienced by the general indices. This is primarily evident in the impact of the reduced level of global economic activity on wholesale prices of both farm and industrial goods.

The deceleration recorded in the change in consumer prices mainly reflected the cooling of pressure from the food and beverages segments, with an emphasis on the decline in prices of semi-manufactured products, as well as education, which was favored by an exhaustion of the impact of annual increases in school fees. The rate of consumer inflation in the following accumulated twelve months showed a downward trend and displayed a slow convergence to the annual target set by the CMN in the framework of inflation targeting system, a development particularly related to the deceleration in the prices of durable goods, which reflected reduced demand and the impacts of tax unburdening measures, in contrast to the acceleration in prices of services and regulated goods

2.1 General indices

The General Price Index (IGP-DI) from FGV ranged -0.62% for May quarter end, compared to -0.55% in February, an outcome from recorded reductions in wholesale prices, agricultural and industrial, as well as a deceleration in consumer prices. In a 12-month period, the IGP-DI accumulated growth of 2.99% in May – the lowest rate since August 2006 when the index recorded an increase of 2.78% against 7.50% in February, registering a general slowdown in the variations of the three components of the indicator.

The drop of the Producer Price Index (IPA-DI) reached 1.65% for the quarter ended May, up from 1.51% in February

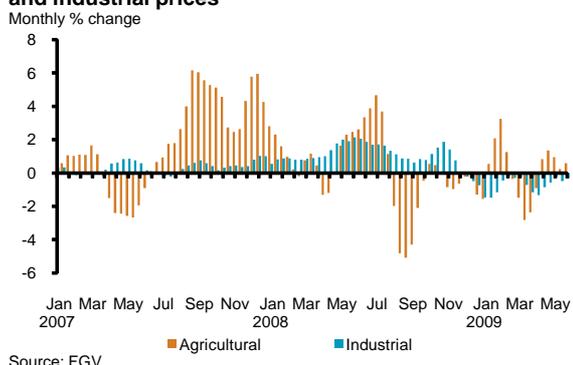
Table 2.1 – General price indices

	Monthly % change				
	2009	Jan	Feb	Mar	Apr
IGP-DI	0.01	-0.13	-0.84	0.04	0.18
IPA	-0.33	-0.31	-1.46	-0.10	-0.10
IPC-Br	0.83	0.21	0.61	0.47	0.39
INCC	0.33	0.27	-0.25	-0.04	1.39

Source: FGV

quarter end. Agricultural prices fell by 0.47% in the period, compared to an increase of 0.37% in the quarter ended in February, with an emphasis on variations in items such as beans -27.21%, permanent crops -5.92%; and rice, 17.95%. Industrial prices recorded decreases of 2.04% and 2.16% in the quarters considered, a move particularly associated with the larger impact of the reductions observed in the segments of basic metallurgy 7.81%; chemicals 5.05%; and non-metallic minerals products 2.79%, compared to increases experienced by cigarette items 24.55%, dairy products 7.98%, and pharmaceuticals 5.40%. The accumulated variation of the IPA-DI in 12 months was 1.18% in May, against 7.39% in February.

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



The change in the Consumer Price Index – Brazil (IPC-Br), showing, mostly, the cooling of pressure from the Education and Transportation groups decelerated, going from 1.57% in the quarter ended in February to 1.48%. As periods of 12 months, the indicator had respective highs of 6.15% and 5.55% in February and May.

The National Cost of Construction (INCC), after registering a growth of 0.77% in the quarter ended in February, rose 1.09% in the month ending in May. This result reflected an increase of 4.19% in the prices of labor, in contrast to a reduction of 1.52% observed in the prices of materials and services, favored by both lower demand and temporary tax relief measures. Considering a 12 month period, the INCC had elevations of 11.67% in February and 8.98% in May.

2.2 Consumer price indices

The IPCA, released by the IBGE, grew 1.15% in the quarter ended in May, compared to 1.32% in the previous quarter, emphasized by a reduction from 1.39% to 0.89% in the prices of food and beverages. The segmentation of IPCA shows that the quarterly performance indicator reflecting deceleration in the variations of market prices, from 1.31% to 1.24%, and regulated prices, from 1.32% to 0.95%, translating into decreases observed in the prices of items such as gasoline, 1.69%, and airfares of 2.31%, which had increased in the order of 0.29% and 3.03% in the quarter ended in February.

The trajectory of market prices reflected a more accentuated reduction, from 2.46% to 1.03%, in the variation in the prices of nontradable goods and services, in relation to increases of 0.08% to 1.47% in that concerning prices of tradable goods and services. The quarterly performance of prices of nontradable items was mainly associated to

Figure 2.2 – IPCA

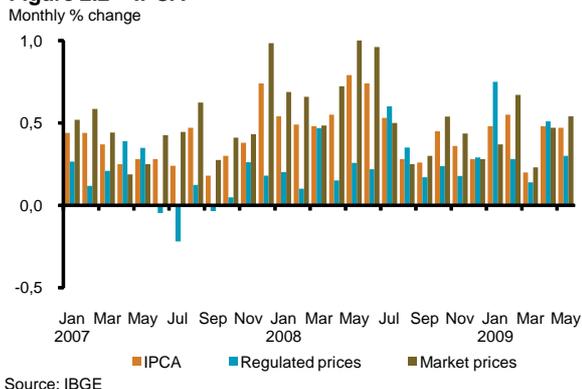


Figure 2.3 – IPCA – Food

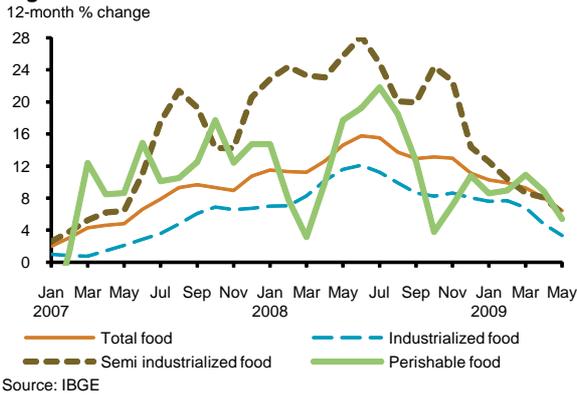
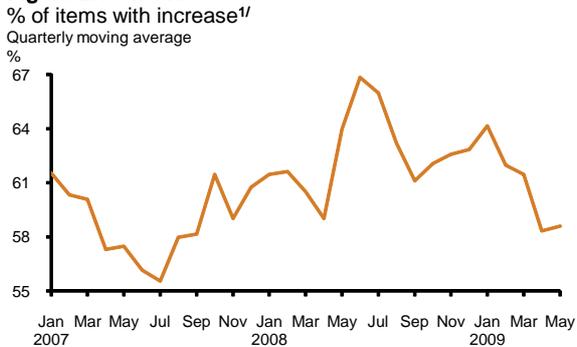
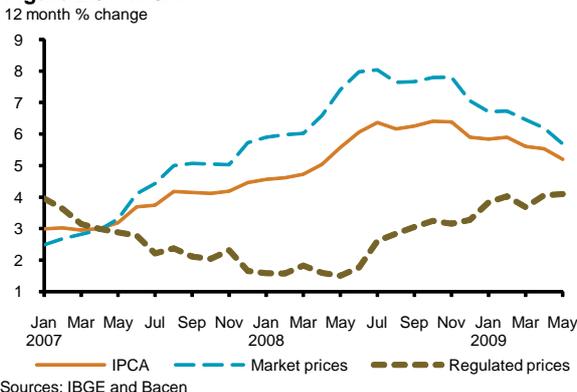


Figure 2.4 – IPCA



1/ The IPCA is formed by 384 sub-items.

Figure 2.5 – IPCA



the seasonal nature of prices in the segments in perishable foods and education.

Considering 12-month periods, the IPCA, highlighting the convergence process towards the goal set by the CMN, registered an increase of 5.20% in May, up from 5.90% in February, a result of an increase from 4.02% to 4.09% in prices, and a slowdown of 6.71% to 5.68% in market prices.

It should be noted that the trajectory of market prices shows the recent reduction experienced by the prices of goods, particularly durable goods, in response to the environment of decreasing demand, contrasting with the recurring increases in the twelve month variation of service prices, which reached 7.23% in May, up from 7.09% in February, the highest percentage since November 2003. This trend reflects both the relative lag in these prices in relation to the evolution of economic activity as the contributions of accumulated changes in 12 months of items such as domestic help and personal services, which moved, in that order, from 10.38% and 7.61% in February to 12.30% and 9.46% in May.

The diffusion index, which shows the proportion of the number of components of the IPCA price index, which has registered a positive growth in a certain period, has increased positively over time, reaching an average of 58.59% in the quarter ended in May, against 61.98% from February and 63.98% from the same period last year, a performance consistent with a slowdown in prices in the period.

2.3 Regulated prices

Regulated prices increased 0.95% in the quarter ended in May, accounting for 0.28 percentage points of variation from 1.15% recorded by the IPCA in the period. The greatest pressure came from 4.64% in the adjustments in medicines, 1.42% in electricity, pressured by marked increases in Fortaleza 10.13%, Salvador 8.19%, Porto Alegre 5.49%, and Belo Horizonte of 4.59%; 1.96% in water and sewage fees, highlighting the highs seen in Salvador of 17.97%, Brasilia 6.24%, and in Porto Alegre of 3, 93%; and 1.47% in health insurance.

The accumulated variation in 12 months of regulated prices reached 4.09% in the quarter ended in May, compared to 4.02% in February, constituting the highest rate since December 2006. In the first five months of the year, regulated prices accumulated an increase of 1.99% against 1.18% in the same period last year.

Table 2.2 – IPCA

	Weights	% change					
		2009					
		Jan	Feb	Mar	Apr	May	Year
IPCA	100.00	0.48	0.55	0.20	0.48	0.47	2.20
Market prices	70.36	0.37	0.67	0.23	0.47	0.54	2.29
Regulated prices	29.64	0.75	0.28	0.14	0.51	0.30	1.99
Main items							
Electricity	3.24	-0.14	-0.36	-0.27	0.87	0.82	0.92
Natural gas vehicle	0.13	4.13	-1.12	-0.92	-2.32	-1.61	-1.95
Pipeline gas	0.10	4.47	-1.10	-0.15	0.00	-1.17	1.96
Diesel fuel	0.09	0.33	-0.34	-0.03	0.35	-0.23	0.08
Electricity	0.14	0.94	0.05	0.00	0.00	0.00	0.99
Tolls	1.35	0.00	0.13	0.10	0.17	0.00	0.40
Water and sewage	1.62	0.00	0.00	0.00	0.61	1.34	1.96
Urban bus	3.77	3.24	1.03	0.11	0.14	0.41	4.99
Air ticket	0.30	0.87	0.82	0.00	-1.13	-1.19	-0.65
Gasoline	4.20	0.42	-0.04	-0.34	-0.46	-0.90	-1.32
Bottled cooking gas	1.11	0.13	-0.41	1.73	2.41	0.64	4.55
Medicine	2.83	0.61	0.34	0.37	2.89	1.33	5.64
Health plans	3.38	0.47	0.48	0.47	0.48	0.51	2.43

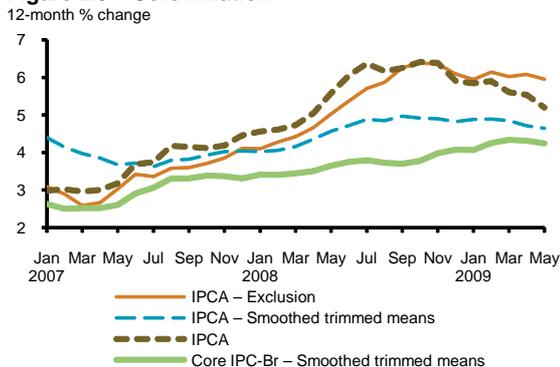
Source: IBGE

Table 2.3 – Consumer prices and core inflation

	Monthly % change				
	2009				
	Jan	Feb	Mar	Apr	May
IPCA	0.48	0.55	0.20	0.48	0.47
Exclusion	0.27	0.88	0.25	0.58	0.56
Trimmed means					
Smoothed	0.42	0.29	0.35	0.35	0.44
Non smoothed	0.44	0.27	0.21	0.27	0.39
IPC-Br	0.83	0.21	0.61	0.47	0.39
Core IPC-Br	0.35	0.33	0.39	0.36	0.37

Source: IBGE, Bacen and FGV

Figure 2.6 – Core inflation



Source: IBGE, Bacen and FGV

2.4 Inflation core

The calculated core measure, excluding regulated prices and home food prices, registered a growth of 1.40% for the quarter ended May, up from 1.49% in that ended in February, reaching its variations 5.96% and 6.14% in 12 months.

The core smoothed trimmed means increased 1.14% compared to 1.04% in the quarter ended in February, totaling 12-month respective increases of 4.65% and 4.89%. The quarterly changes of the core by smoothed trimmed means attained, in the same period, 0.87% and 1.04% respectively, while those accumulated in 12 months stood, in order, 4.34% and 4.85%.

The core CPI inflation-Br FGV, as calculated by the trimmed mean, rose 1.12% in the quarter ended in May, compared to 1.02% that ended in February.

2.5 Market expectations

Since March quarter end, inflation expectations for 2009, collected by the Investor Relations and Special Studies Department (Gerin), have stayed slightly below the annual target of 4.5% established by CMN for IPCA. On June 5, the median of forecasted projected an annual range of 4.3% for the indicator for both 2009 and 2010, compared to 4.3% and 4.5% in late March. The median of expectations for inflation in the twelve months ahead – smoothed – fell to 4.0% in the period.

The medians for the IGP-M and IPA-DI for 2009 decreased, respectively, from 2.7% and 2.4% at the end of March, to 1.5% and 0.5% on June 5, while those for 2010 also remained at 4.5%.

The median related to expectations regarding the evolution of prices administered or regulated by contracts in 2009 and 2010 reached, in order, 4.3% and 4.0% on June 5, in view of 4.5%, at the end of March.

Forecasts for the exchange rate fell sharply in recent months. The medians of forecasts on exchange rates from the end of 2009 and 2010 moved from R\$2.30/US\$ at the end of March, to R\$2.00/US\$ and R\$2.10/US\$, respectively, on June 5. The median of forecasts for the average exchange rates for 2009 and 2010 decreased in the order of US\$2.30/US\$ and R\$2.28/US\$ at the end of March to R\$2.10/US\$ on June 5.

Figure 2.7 – IPCA



Figure 2.8 – IGP-M e IPA-DI

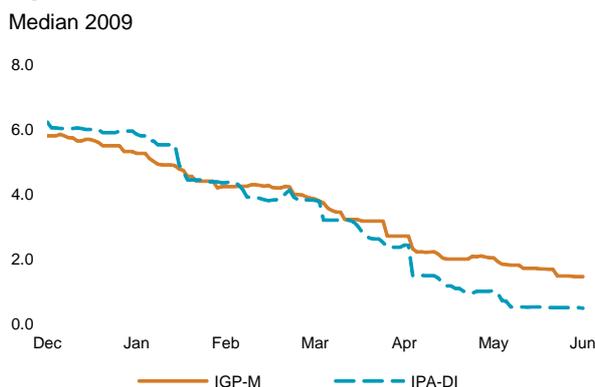


Figure 2.9 – Exchange

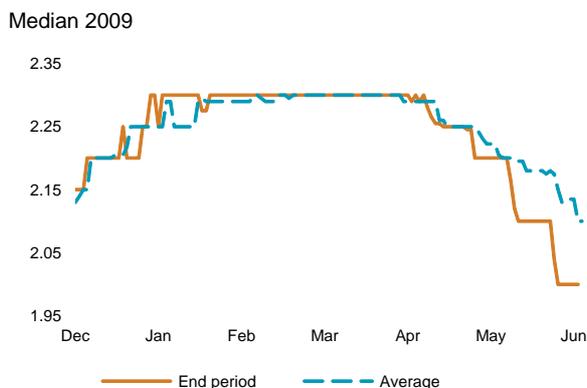


Table 2.4 – Summary of market expectations

	12.31.2008		3.31.2009		6.5.2009	
	2009	2010	2009	2010	2009	2010
IPCA	5.0	4.5	4.3	4.5	4.3	4.3
IGP-M	5.3	4.5	2.7	4.5	1.5	4.5
IPA-DI	6.0	4.7	2.4	4.5	0.5	4.5
Regulated Prices	5.1	4.5	4.5	4.5	4.3	4.0
Selic (end-of-period)	12.0	11.5	9.3	9.5	9.0	9.2
Selic (average)	12.4	12.0	10.1	9.5	10.0	9.2
Exchange rate (end-of-period)	2.30	2.25	2.30	2.30	2.00	2.10
Exchange rate (average)	2.25	2.22	2.30	2.28	2.10	2.10
GDP growth	2.4	3.9	0.0	3.5	-0.7	3.5

The median forecast for GDP growth in 2009 was revised downwards from 0% at the end of March to -0.7% in the first week of June, while remaining at 3.5% in 2010.

In this scenario of a slowdown in prices and economic activity, the research participants posted higher projection of the cuts benchmark interest rate. In this sense, the median rate on the Special Settlement and Custody (Selic) for the end of 2009 decreased to 9.25% per year at the end of March to 9% per year in the first week of June, while 2010 increased from 9.5% per year to 9.15% per year.

2.6 Conclusion

The behavior of the relatively favorable prices in recent months mainly reflected the depletion of seasonal pressures related to the education group, especially in courses, and a continuing decline of prices of semi-industrialized foodstuffs. It should be noted, additionally, the downward trend of inflation in 12 months, even in a scenario of upward pressures recorded during the first months of 2009, associated with the behavior of prices of services and some regulated items.

The outlook for the coming months incorporates the continuity, possibly at a faster rate, of convergence of the IPCA to the goal set by the CMN. This performance has been favored both by the impact on the exchange rate derived from the resumption of inflows of external resources in the country and by the persistence of the environment of recession in the major mature economies. Conversely, possible impacts of the pickup in domestic demand in a recovery scenario in the domestic economy during the second half of the year should be considered, as well as possible impacts of increased prices of raw materials.

The Evolution of Prices of Goods and Services in Economic Crisis

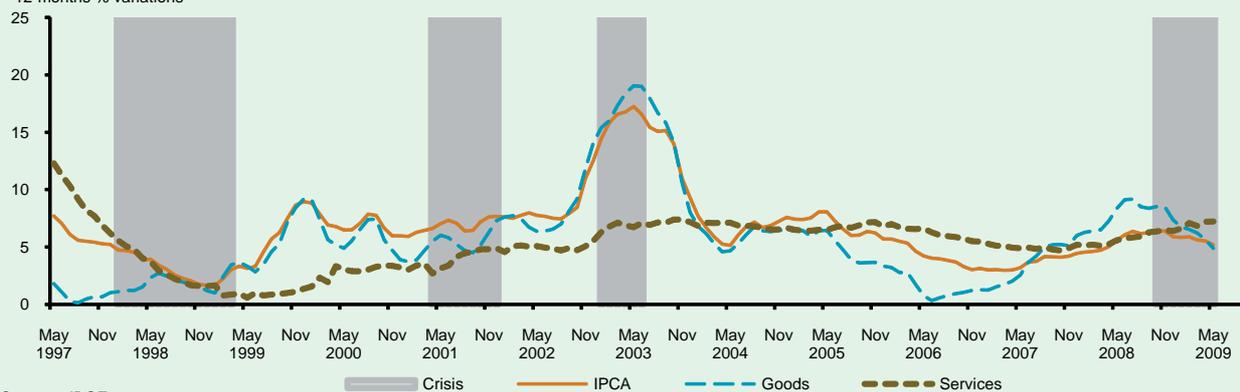
The analysis of changes in relative prices in periods of crisis makes it possible to assess the behavior of the relevant mechanisms of transmission, such as the impacts of the downturn in the economic activity, movements of exchange rate pass-through and the presence of inertial components of inflation. In general, prices of items of services, vis-à-vis those of other products, tend to respond with greater delay and lower intensity and volatility to marked temporary changes that are typical of periods of crisis. This aspect is partly explained by the greater influence of the rigidity of contracts and the lower mobility of factors in this segment.

According to the Economic Cycles Dating Committee (Codace), an entity linked to the Getulio Vargas Foundation (FGV), the current economic crisis was preceded by three other recessive cycles over the past thirteen years: in 1998, when the maintenance of the exchange rate prevailed and there was also the coping with the Russian crisis; in 2001, due to the supply shock caused by energy restriction; and in 2003 in response to the crisis of investors' confidence due to the uncertainty surrounding the presidential election. In all these periods, prices of services followed the behavior of prices of goods, but with less volatility, as illustrated in Figure 1. This behavior, however, has not been observed in the present moment, which shows the trajectory of relative detachment groups.¹ In this scenario, this box assesses the determinants of this change in pattern, drawing parallels between the current crisis and the other recession periods.

1/ The price breakdown in this box regards the items of the IPCA nonemarked price segment, weighting 23.80% in the case of services and 46.65% in the case of goods.

Figure 1 – IPCA – Goods and Services

12-months % variations

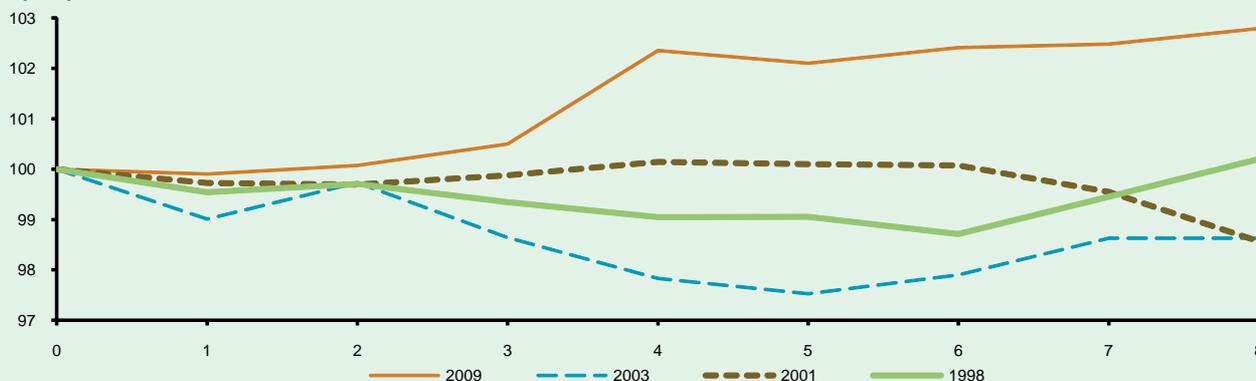


Source: IBGE

The separate behavior of relative prices in the current period is shown in Figure 2, which shows the evolution of the parity price of services and goods in the various crises. In the recent situation, parity evolves all the time above the base level (100) and, –reflecting the rise in prices of items in the service sector and the cooling of prices of other products –increases the level from the sixth month. This trajectory is markedly different from those observed in the crises of 2003 and 1998. In the first case, it was due to the sharp exchange depreciation in the period, and, in the second, due to the impact of the long periods of recession on prices. The evolution of parity in 2001 initially displays a behavior similar to the current crisis, reflecting, as expected, the lagged impact of lower activity on the deceleration of prices of services, which is six months in that specific case. In the seventh and eighth months, however, the behavior differs in the two crises, with the relative price of services slowing in 2001 and continuing to increase in the current crisis.

Figure 2 – Relative prices in economic crisis – Services/Goods

Beginning of the crisis = 100



Source: IBGE

The recent downturn in the prices of goods, in which case twelve-month cumulative variation decreased from 8.37%, in September 2008, to 4.89%, in May 2009, mainly reflected the impact of recession in major developed economies on international prices, which, in other recession periods, recorded a significant acceleration in response to processes of exchange depreciation observed on those occasions. According to the same basis of comparison, the prices of services have accelerated from 6.27% to 7.23%. This development is associated partially to the lagged adjustment of the segment to the variation in the economic activity, to the minimum wage real increase, and to the impact of high inflation during the period preceding the crisis – the 12-month change of the General Price Index – Market (IGP-M) reached 12.3 % in September 2008 – on the adjustments in various services, also highlighting the presence of indexation mechanisms.

The opening of the group of services, as shown in Table 1, favors the identification of the mechanisms underlying the behavior of prices in that segment. It is worth mentioning that only on the item personal service that responds more readily to the activity level a sharp deceleration in prices was recorded in the current crisis, as demonstrated by the reduction of their cumulative 12-month change, from 7.14% in September 2008, to 5.24% in May 2009. These

Table 1 – IPCA – goods, services and regulated – and IGP-M

Itemization	Weights May-2009	12-month variation							
		Period prior to the outset of the crisis				Eight months after the outset of the crisis			
		Crisis I Dec-1997	Crisis II Mar-2001	Crisis III Dec-2002	Crisis IV Sep-2008	Crisis I Aug-1998	Crisis II Nov-2001	Crisis III Aug-2003	Crisis IV May-2009
IPCA	100.0	5.2	6.4	12.5	6.3	2.6	7.6	15.1	5.2
Goods	46.6	1.0	4.7	14.1	8.4	2.2	6.2	16.7	4.9
Services	23.8	6.2	3.6	5.5	6.3	2.2	4.8	7.1	7.2
Repairs	1.3	-1.7	6.2	8.5	5.4	0.0	5.9	7.3	8.8
Domestic help	3.3	7.1	11.0	8.7	10.2	8.3	8.1	8.3	12.3
Personal	2.1	0.9	2.6	5.4	7.1	-0.1	1.7	6.6	5.2
Health	1.6	6.3	0.2	4.3	6.7	3.0	1.5	6.0	6.6
Education	6.1	12.1	5.5	7.9	4.9	7.0	6.4	10.0	5.7
Housing	4.8	8.8	-0.7	1.9	5.8	1.4	2.9	4.3	6.8
Transportation	2.2	6.0	3.8	5.6	6.5	1.1	4.5	8.6	8.5
Leisure	2.5	5.1	4.8	6.9	5.1	2.7	6.1	7.8	5.6
Regulated	29.6	18.3	12.7	15.3	3.0	4.4	12.8	18.4	4.1
IGP-M	100.0	7.7	9.6	25.3	12.3	4.0	10.8	22.9	3.6

Sources: IBGE and FGV

prices displayed a similar performance in other crises, except for the 2003 crisis when, in general, all price indicators showed acceleration.

The segments of domestic help and repairs and alterations, with joint participation of 19% in the group showed accelerations, respectively, from 3.38 p.p. and 2.10 p.p. on the same basis of comparison. This movement reflected, in particular, the impact of minimum wage increase and the maintenance of purchasing power due to the process of reducing inflation. The transmission channel of real income to the prices in the two segments mentioned had exerted a corresponding effect in previous crises.

In the case of the spending on education and housing, accounting for 46% in the service sector, prevails the effect of high inflation prevails in the period preceding the crisis, which serves as a reference for indexing contracts, particularly in residential rents and school fees, usually based on the IGP-M. The remaining segments, health services, leisure and transportation, which accounts for 26% of the service sector, are more dependent on movements in demand but they tend to react with some lag to changes in economic activity.

In broader terms, inflation in services presents relative rigidity and responds with a lag to the pace of activity and to the process of slowing inflation. Moreover, key segments such as education, have annual adjustments rules that are the transmission mechanism of inflation recorded in prior periods. In this scenario, the perspective is that the prices of services remain at a relatively high level in 2009, particularly when considering the 12-month variations. However, such prices outline a gradual cooling throughout this year and even more intensely in 2010. The explanation for the difference in the behavior of relative prices of services in this episode of contraction is probably due, on one hand, to the warming of the labor market in the period prior to the crisis and, on the other, to the effect of the global economic downturn on prices of tradable goods.