Executive summary

The trajectory of the world economy in the quarter ended in May, although revealing the continuous process of reduced production and employment, also showed that the coordination of counter-cyclical measures are translating into an improvement in indicators related to consumer and business confidence. Despite these movements exerting a favorable impact, on the margin, over the development of the real sector indicators, it should be noted that, in the environment of conditionalities for the effective stabilization of world economic activity, it still lacks the conclusion of the cycle of inventory adjustment and the consolidation of the process of sustaining consumption levels, especially in major developed economies.

The Brazilian economy is showing signs of a gradual recovery in relation to the deterioration marked by the intensification of the crisis in international financial markets since last September. Although the performance of the industrial sector, especially in those segments that are more dependent on investment and international trade, still displayed signs of weakness, recent monthly indicators generally suggest that the cycle of economic slowdown in the country may be less pronounced than in several other economies. The sustained economic resumption activity in coming months, and its intensification, will benefit by maintaining the trend of less stress in international financial markets, expressed as a reduction of restrictions in the credit market, the return of external capital flows to the country, the perspective of return of firms to capital markets, as well as the lagged and cumulative effects of monetary easing promoted since January.
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The unfavorable development of investments reflects the worsening business environment and, in the coming months, its recovery will depend on the improvement of the context of prevailing uncertainties in the current economic scenario. Household consumption, favored by the preservation of purchasing power caused by controlled inflation, the intensification of income transfer programs, as well as the reduction in credit constraints and temporary tax relief measures, recorded a positive performance in recent months.

In quarter ended in April, interest rates in the credit market remained on a downward trend, especially in loans to individuals, a segment with relativly stable default records. This situation, however, contrasts with the conditions prevalent in the corporate segment, where the reduction in the cost of borrowing was less expressive and defaults, though at a moderate level, showed an upward trend since the beginning of the year. In any event, the prospect of observing a declining trend in interest rates to the borrower, consistent with the reversal of the default and the loosening of monetary conditions, is expected to strengthen the credit market, which had decisive role in sustaining domestic demand in recent years.

The dynamics of fiscal accounts in the first four months of the year reflected both the impact of reduced activity on government revenues as well as the impact on costs associated with tax cuts and public investment policy adopted in order to promote the recovery aggregate demand. It should be noted that the impact of these counter-cyclical actions on the reducing trend of the Public Sector Net Debt (DLSP) as a proportion of Gross Domestic Product (GDP), even in the scenario of decline in primary surplus targets, will be offset by the effects of a reduction of the Selic rate, which reduces the cost of financing the domestic public debt.

The performance of the country's external accounts during the year has been more favorable than suggested by the macroeconomic environment that followed the intensification of the crisis in financial markets, thereby contradicting pessimistic predictions. The stability of international reserves and the reduction of the relative share of external debt in total external liabilities of the country, in favor of direct investments and portfolio, reinforce the perception of solidity of the balance of payments and also the perception of the resistance of the economy to shocks. The latest scenario, while still incorporating a high degree of uncertainty, reveals more favorable external accounts and anticipates positive developments on the flows of foreign investment. Incidentally, the current account deficit for 2009 is shown below the previous year´s and should be fully financed by net inflows of Foreign Direct Investment (FDI). In this scenario, the resumption of cash purchases by the Central Bank in the currency market was possible – maintaining the policy of not setting floors or ceilings for the rate – aimed at strengthening the country's international reserves.

The prospects related to the behavior of prices in the coming months incorporates the continuity, possibly at a faster rate, of the convergence of the Broad National Consumer Price Index (IPCA) to the target set by the National Monetary Council (CMN). This dynamic was favored, in part, by the decrease of activity occurred in the last two quarters. On the other hand, the potential impacts of a pickup in domestic demand in a recovery scenario in the domestic economy during the second half of the year must be considered, as well as possible impacts of increased prices of raw materials.

The central forecast associated with the baseline scenario indicates inflation of 4.1% in 2009, a level 0.1 percentage point higher than what had been projected in the March *Inflation Report*. From the third quarter of 2009 on, four-quarters inflation is positioned below the 4.5% target for 2009 and 2010. This fundamentally reflects the lagged effects of higher idle production factors verified since the fourth quarter of 2008. Note, however, that this impact was partly offset by reductions in the Selic rate and the fiscal impulses implemented this semester. Twelve-month inflation starts at 4.7% in the second quarter of 2009 and reaches 4.1% in the last quarter. In 2010, it reaches 3.9% and then stays around 4.0% in the first and second quarters of 2011.

In the market scenario, the forecast of 4.2% for inflation in 2009 is 0.1 percentage point higher than the value associated to the baseline scenario, and to the last Inflation Report. The projections indicate a continued decline in twelve-month inflation in 2009, with 5.6% recorded in the first quarter, moving to 4.7% in the second, 4.4% in the third, and ending (closing?) the year at 4.2%, below the 4.5% target. For 2010, the market scenario projects, in the first semester, a drop in twelve-month inflation, which, however, will return to the level of 4.2% in the fourth quarter, but still below the 4.5% target set by the National Monetary Council. In the first two quarters of 2011, the twelve-month inflation projection will stay around this value. As in the baseline scenario, the estimated probability of inflation exceeding the upper limit of the tolerance range of the target in 2009 in the market scenario is residual.

According to the baseline scenario, GDP growth forecast for 2009 was revised to 0.8%, compared to 1.2% contained in the March *Inflation Report*.