The International Economy

World economic activity was marked by two distinct phases in 2007. In the first six months, positive performances occurred in the three major economic regions and in most of the emerging economies. In the United States, on the other hand, the ongoing drop in home investments that began in mid-2006 resulted in a gradual process of economic deceleration. The positive results registered in the Euro Area and Japan were driven by investments.

Nonetheless, in the second half of the year, the overall balance of risks to global growth worsened as a result of growing defaults on the United States subprime market, with serious repercussions on the balance sheets of financial institutions. Defaults on financial products backed by securities generated repercussions on the world credit market, leading major central banks to coordinate their efforts to maintain international financial system liquidity at adequate levels, in order to mitigate the macroeconomic impact of financial sector difficulties.

Although the measures taken attenuated liquidity restrictions, markets were unable to return to their pre-crisis conditions. Liquidity restrictions prevailed on forward interbank markets during the entire second half of the year, resulting in revisions of economic activity and world inflation forecasts.

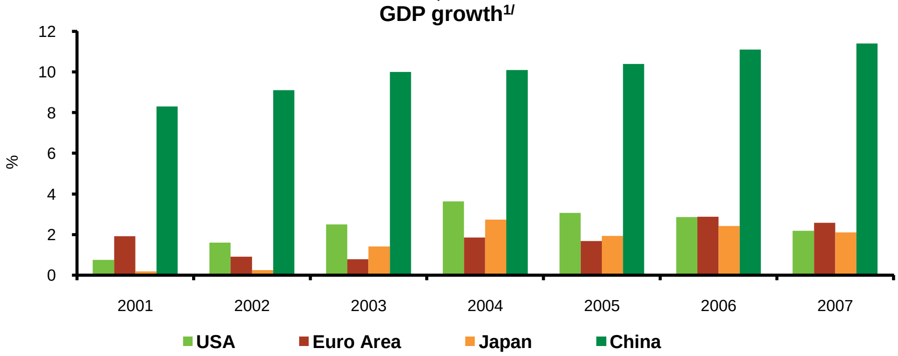
Economic activity

Over the course of 2007, economic activity in the USA was conditioned to real estate market evolution. The scenario of a gradual deceleration that had marked the first half of the year was progressively replaced by much more pessimistic expectations regarding economic growth. Starting in the third quarter of the year, the increase in defaults was reflected in additional restrictions on credit, despite the efforts made by the Federal Reserve to curtail interbank market tensions.

Even in this environment, however, reflecting strong growth in the job market, consumer spending continued expanding, closing 2007 with real growth of 2.9% compared to 3.1% in 2006. As a result, GDP in the USA rose 2.2% in 2007, compared to 2.9% in the previous year. Impacted by the falloff in home investments, private investments declined 4.9% in the year, compared to expansion of 2.7% in 2006. Domestic demand, which had expanded 3% in 2006, increased 1.6% in 2007.

Net exports contributed 0.6 p.p. to annual GDP growth. This result, representing the first positive contributions since 1995, reflected the impacts of domestic demand and depreciation of the dollar on imports, which expanded 1.9% in the year, compared to 5.9% in 2006. Parallel to this, one should stress the impact of real export growth, which came to more than 8% for the second consecutive year, reflecting the evolution of exchange rate, continued expansion of emerging economies and growth in Europe and Japan.

Graph 6.1
GDP growth[1/]



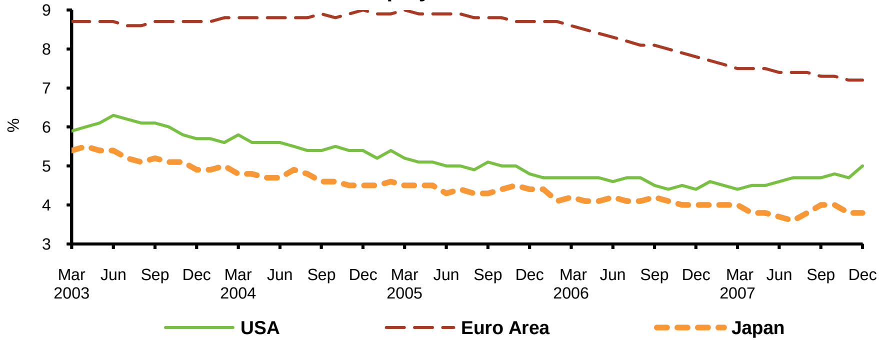
Source: Bureau of Economic Analysis, Eurostat, Economic and Social Research Institute, Bloomberg
1/ Annual growth.

Particularly in the first six months of the year, economic growth in the Euro Area was driven by domestic demand, as a result of rising private investments generated by an environment of corporate recovery and positive labor market growth. In the second half of the year, despite positive labor market evolution and rising corporate investments, credit market tensions, increasing energy prices, the impact of appreciation of the euro and declining United States economic activity reduced the dynamics of the region. In this framework, GDP expanded 2.6% in the year, against 2.9% in 2006.

To a great extent, 2.1% Japanese GDP growth in 2007, against 2.4% in the previous year, resulted from the performance of exports to the Asian continent, deceleration of import growth and rising government spending. Taken together, these factors partially offset the impacts of decelerating consumption growth and private investment. One should note that high levels of profitability, positive business expectations and evolving external demand made it possible for growth in private sector investments (2.4%) to surpass GDP expansion.

Reflecting both external demand and intensification of domestic consumption, the Chinese economy expanded at quarterly rates of 11% in 2007, compared to the corresponding periods of previous years. To some extent, the dynamics of this growth offsets relative deceleration in the United States and Euro Area economies and, to a lesser degree, similar performances in various emerging economies which, despite the uncertainties rooted in the United States financial crisis, continued expanding at a robust pace, revealing the reduced importance of channels of contamination from the United States economy to those of other nations.

Graph 6.2
Unemployment rates



Sources: Bureau of Labor Statistics, Eurostat, Ministry of Internal Affairs and Communications

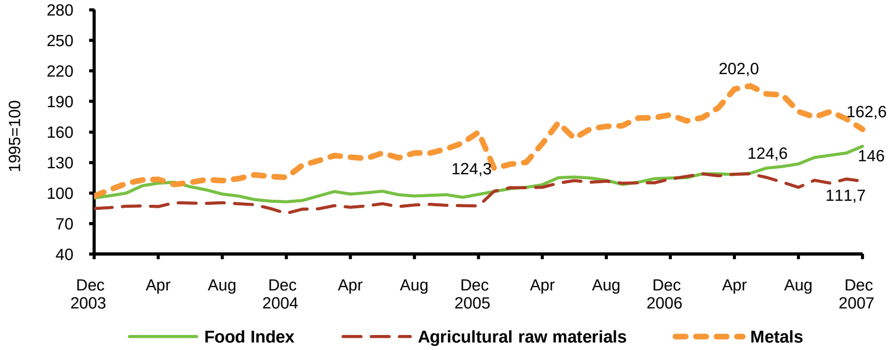
The economies of the major Latin American countries have mainly been sustained by strong domestic demand and, consequently, have not been impacted seriously by the United States crisis. Given this, economic growth in the region is expected to close 2007 at 5.6%, according to the Economic Commission for Latin America and the Caribbean (Cepal).

It should be noted that the economies of the emerging countries have mostly become less dependent on the performance of the more mature economies. The fact of the matter is that, in recent years, China's contribution to world growth has been significantly greater than that generated by the USA and the Euro Area countries. This is considered, to a certain degree, a result of that country's inclusion in the WTO in mid-2001, which altered the relevance of the major economic blocs in international flows of goods and services. Inter-regional trade, particularly in Asia, but also in Latin America, has played a role of increasing importance in this scenario.

In this environment, globalization of world trade has favored reductions in the correlation between the emerging economies and the central economies, particularly in relation to those nations that produce commodities since, in this case, their economies were leveraged by growing demand in that market.

Rising commodity prices in 2007 reflected the lag between growth in supply and demand, in the latter case driven by strong growth in emerging market consumption, and their enhanced attractiveness as an alternative asset and hedge option in a global scenario marked by depreciation of the dollar, declining short-term interest rates and rising inflation.

Graph 6.3
Commodity price index in terms of U.S. Dollars



Source: IMF

Reflecting an annual average increase of 56.6% in the segment of grains, the prices of the major farm commodities expanded in 2007 at a higher rate than in previous years. Here, particular mention should be made of the annual increase in the prices of wheat, 76.7%; soybeans, 75.4%; cocoa, 24.5%; cotton, 21.1%; and corn, with 16.7%. In the opposite direction, international sugar prices dropped 7.91% as a result of excess of world output.

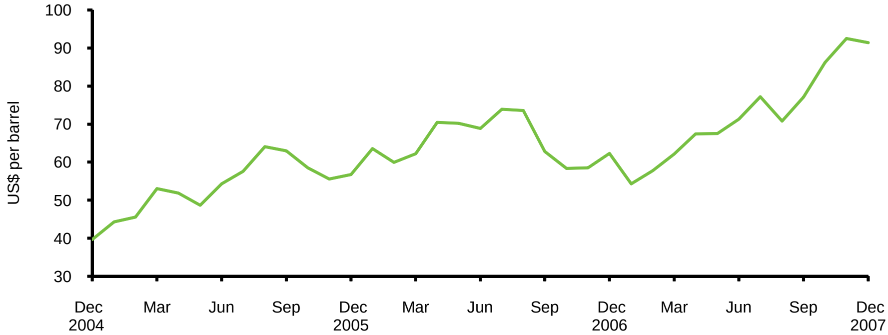
The increase in farm commodity prices not only revealed the existence of low stock levels, but also resulted from such factors as the impact of higher oil prices on the cost of inputs used in the production of the major crops. In the same context, increased demand for meat and dairy products in such countries as China and India has also impacted the prices of grains used as animal feed. At the same time, emphasis should be given to the impact of rising demand for unprocessed matter for the production of biofuels, which, according to the World Bank, accounted for 20% of corn production in the United States and 68% of vegetable oils in the European Union.

Following a period of strong growth in early 2007, the prices of metallic commodities moved into a downward trajectory starting in the month of May and, compared to the previous year, accumulated an annual average drop of 12.1%. To a great extent, this result reflected the reduction that occurred in the prices of zinc, 44.8%; nickel, 22.7%; and aluminum, 14.4%, impacted by the crisis that hit the United States real estate market. Moving in the opposite direction, the price of lead rose 55.6% in the year, as a result of increased activities in the segments of chemicals, munitions, medical-hospital equipment and electric equipment.

Reflecting greater investor demand at a time of depreciation of the dollar, the price of gold rose 28.5% in the year, generating pressures on prices in the segment of precious metals, which expanded by an average of 25.9%.

Oil prices showed considerable volatility in 2007, generated by pressures caused by the negative ratio between supply and demand. This factor reflected output difficulties in Nigeria in the first half of the year, together with OPEC's reluctance to raise the oil cartel's output; a weakened dollar against the world's major currencies; intensification of operations in speculative investment funds; and geopolitical factors rooted in the Middle East.

Graph 6.4
U.K. Brent oil – Spot market



Source: Bloomberg

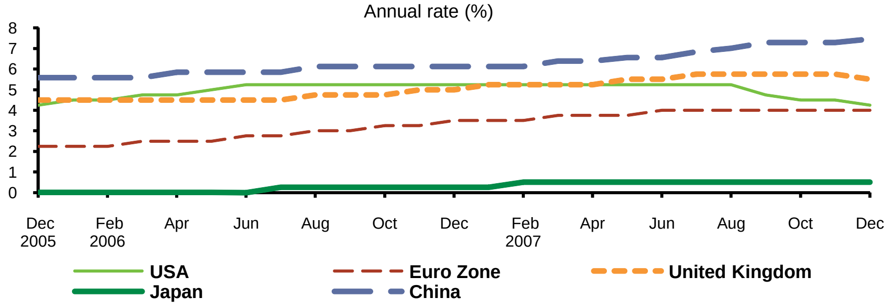
In this context, the average per barrel price of WTI hit US$72.23 in 2007, against US$66.09 in the previous year, setting successive records during the course of the year and registering an historic high of US$98.88 on November 20. The price of Brent type oil accompanied the prices of WTI and reached its highest value of US$95.81 on November 23.

Monetary policy and inflation

Monetary policy was implemented by the major central banks in a manner compatible with evolving expectations of world economic activity. The year under analysis can be divided into two distinct stages. In the first six months, prices remained relatively stable, particularly in the period prior to the outbreak of the international financial crisis, as central banks tended to maintain the cycle of monetary restrictions, with the exception of the Federal Reserve, which did not alter its Fed fund target.

Starting in mid-August, however, this scenario was radically altered. On the one hand, unemployment declined, utilization of installed industrial output capacity remained high and commodity prices increased as a result of supply shocks, expanding global demand for foodstuffs and geopolitical tensions in oil-producing areas. At the same time, growing perceptions that investments in mortgage-backed assets would generate losses of still unknown magnitude further aggravated uncertainties and worsened liquidity problems on short-term financing markets, initially in the United States and, soon afterwards, on global markets. Thus, paying attention to growing financial market tensions, central banks, with the exception of China, were forced to expand their open market operations, alleviate the restricted character of their monetary policies and avoid occurrences of short-term rates above predetermined targets.

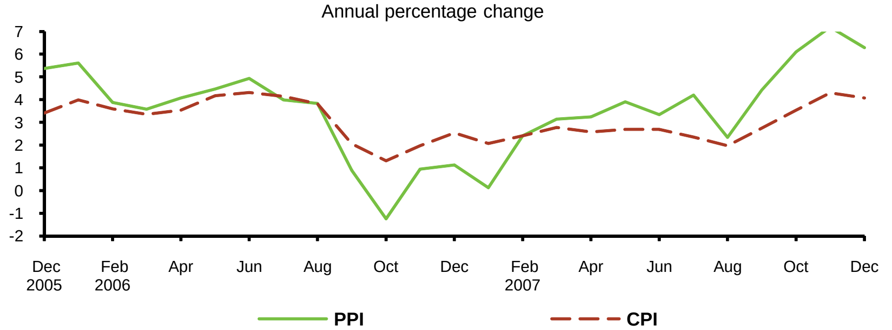
Graph 6.5
Official interest rates[1/]
Annual rate (%)



Source: USA – Fed, Euro Area – ECB, United Kingdom – BoE, Japan – BoJ and China – PBoC
1/ USA – Fed funds, Euro Area – minimum bid rate, United Kingdom – Securities repurchase, Japan – Overnight call rate and China – 1-year working capital.

In the USA, though inflation increased in the second quarter of the year – cumulative 12-month growth in the consumer price index reached 4.3% in November, after remaining below 3% in the first half of the year – the Federal Reserve opted to reverse the cycle of monetary tightening, in light of the worsening of the subprime mortgage market crisis and its repercussions on the financial market. This decision was reflected in reductions in the discount window rate and in cutbacks in the Fed fund target, which was lowered from a 5.25% per year in August to 4.25% per year in December.

Graph 6.6
USA: Inflation[1/]
Annual percentage change



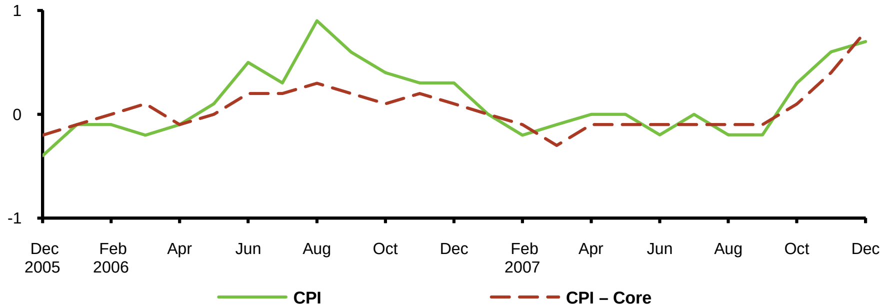
Source: Bureau of Labor Statistics
1/ Producer and consumer prices.

In a second front designed to combat reductions in the credit flow, the Fed coordinated global efforts aimed at injecting financial resources through forward auctions in which, in the USA as well as the Euro Area, Switzerland, England and Canada, loans were made at rates below those available through discount window operations, at the same time in which maturities and types of collateral guaranties accepted were also broadened. Aside from the Term Auction Facility (TAF), the name given to these auctions in the United States, the Fed established currency swap lines with the European Central Bank (ECB) and the National Bank of Switzerland in order to reduce pressures on the eurodollar.

In Japan, the general price level remained on a downward or stable trajectory in the first half of the year. Free of external restrictions, the Bank of Japan (BoJ) continued the process of eliminating its very flexible monetary policy, raising the overnight call rate to 0.50% per year in the month of February.

In the second half of the year, considering the outlook for a global economic downturn and appreciation of the yen, the BoJ interrupted the process of monetary normalization despite the fact that, in the fourth quarter, upward movement in international commodity prices had neutralized deflationary pressures. In this way, Japan did not accompany the other mature economies in their joint efforts to aid the international financial system. In this context, in which cumulative growth in the consumer price index and its core reached 0.70% and 0.80%, respectively, the real rate of interest closed the year with a negative result.

Graph 6.7
Japan: Inflation[1/]
Annual percentage change

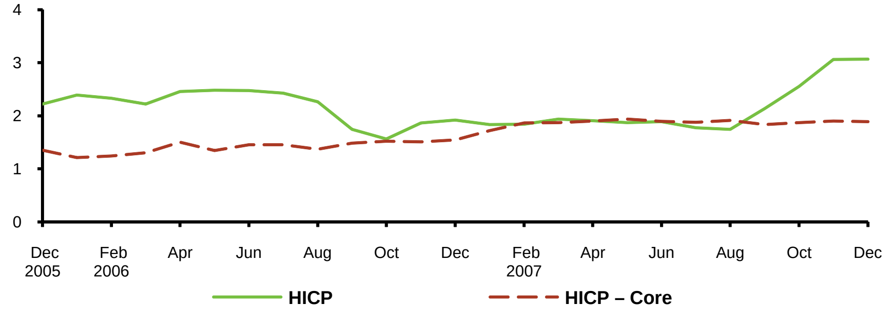


Source: Bloomberg
1/ Consumer prices.

In the Euro Area, despite the fact that the general price index remained below the 2% target through August, the ECB perceived a growing risk of higher inflation and acted with the objective of anchoring medium and long-term inflation expectations. Thus, in a scenario of vigorous growth in the money and credit supply and intense utilization of production factors, the ECB continued its cycle of monetary squeeze begun in December 2005, raising the refi rate to 4% per year in June.

In mid-August, with the first signs of a possible financial system crisis, the ECB took steps on the local market to inject the equivalent of US$250 billion through forward open market operations. Although the evolution of price indices since September showed imminent risk of higher inflation – cumulative 12-month growth in the consumer price index reached 3.1% in December – deteriorating financial conditions and banking system reluctance to provide resources to final consumers, coupled with the Fed's increasingly flexible monetary policy and, finally, persistent appreciation in the value of the euro, locked the ECB into a dilemma between reacting to the inflation rise or injecting liquidity into the financial system. In this framework, basic interest rates were held at 4% per year through December.

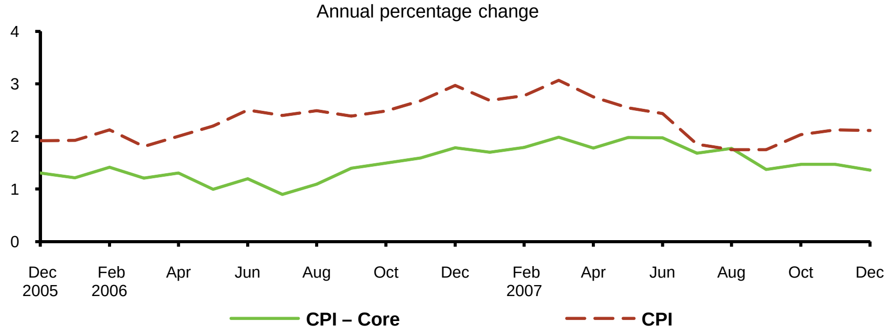
Graph 6.8
Euro Area: Inflation[1/]
Annual percentage change



Source: Bloomberg
1/ Consumer prices.

In the United Kingdom, the sharp rise in prices, particularly education and food products, brought added pressures to bear on annual consumer inflation, which closed March at 3.1%. In response to this, the Bank of England (BoE) continued its restrictive monetary policy begun in August 2006, raising the basic rate of interest – repo rate – twice, to a level of 5.75% per year in July. In the second half of the year, reflecting the outbreak of the global financial crisis which literally slammed the Northern Rock Bank, restrictions on the flow of credit and the outlook for declining economic activity in 2008, the BoE opted to reduce the repo rate for the first time in more than two years, closing the period at a level of 5.5% per year.

Graph 6.9
United Kingdom: Inflation[1/]
Annual percentage change

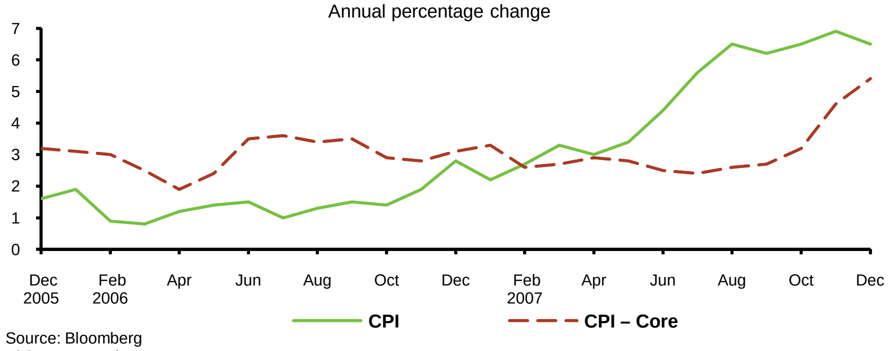


Source: Bloomberg
1/ Consumer prices.

Inflation in China rose persistently over the course of 2007. Responding to the pressures brought to bear by food prices, cumulative 12-month growth in the consumer price index increased from less than 3% in the first two months of the year to approximately 7% in the fourth quarter, the highest level of the last 10 years.

In a scenario of overheated economic activity and recurrent trade surplus records, which closed the year at US$262 billion, with repercussions on growth in domestic liquidity, the People's Bank of China implemented monetary restrictions once again. In this context, the basic interest rate was lifted 135 b.p. over the course of 2007, closing December at 7.47% per year, while reserve requirements were raised 550 b.p. to a level of 14.5%. Aside from continuing the guided currency sterilization policy, in the fourth quarter of the year, the government of Beijing opted to implement new administrative measures, including a temporary freeze on some energy and food sector prices, coupled with utilization of government meat stocks and reductions in taxes on grain imports.

Graph 6.10
China: Inflation[1/]
Annual percentage change



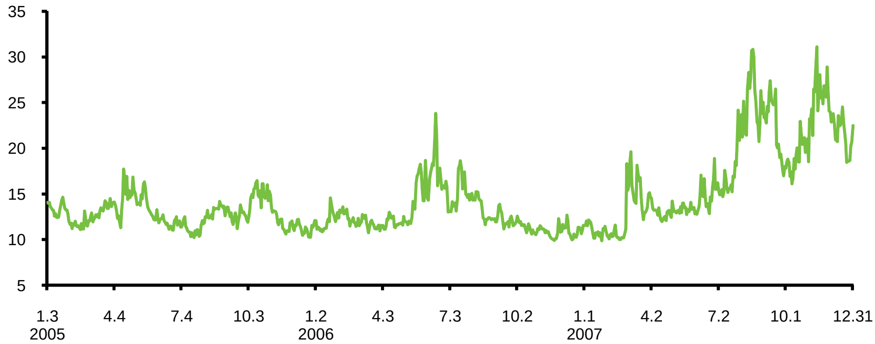
Source: Bloomberg
1/ Consumer prices.

International financial market

In 2007, two distinct dynamics predominated on international financial markets. The first, which lasted through mid-July, was marked by ample international liquidity and low risk aversion. Starting in that month, the sequence of negative results on the subprime market contaminated other areas of United States financial and capital markets, with repercussions on liquidity levels, volatility and risk aversion. In this framework, dissemination of the financial turmoil, which was initially concentrated in a specific segment of the United States financial market, impacted the real sector of important economies, setting off a process of steady deterioration in expectations regarding the effects, breadth and depth of the crisis on the world economy.

The sharp increase in defaults in the subprime market triggered a process of repricing assets that resulted in equity losses to a variety of United States and European financial institutions, further worsening capital market volatility. In this scenario, the average of the Chicago Board Options Exchange Volatility Index (VIX) index, which measures the implicit short-term volatility of Standard & Poor's 500 (S&P500) index and is considered an important indicator of risk aversion, closed the second half of 2007 at 21.8 points, after reaching a maximum of 31.1 points on November 12. These results should be compared to averages in the range of 13 points both in the previous half-year period and in the 2005/2006 period, when the maximum value of the indicator reached 23.8 points. The level in the second half of 2007 had only been reached previously during the crises in

Graph 6.11
VIX



Source: Bloomberg

Asia and Russia, the collapse of the Long-Term Capital Management (LTCM) fund, bursting of the high tech stock bubble, the September 11, 2001 terrorist attack and the outbreak of the Iraqi war.

In this environment of growing uncertainty and deteriorating confidence regarding domestic financial systems, the central banks of the United States and United Kingdom adopted measures aimed at reducing short-term interest rates, while the central banks of the Euro Area and Japan opted for stability.

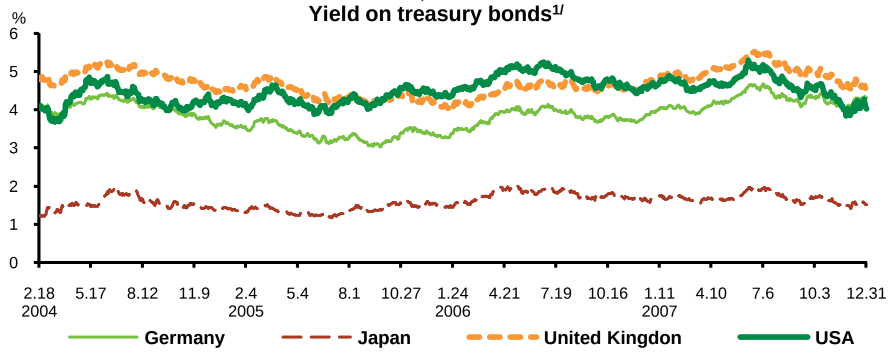
These movements aided in reducing long-term interest rates in the second half of the year, a trend further stimulated by rising demand for these securities, keeping step with growing risk aversion among investors. This downward movement – following the upturn in the first half of the year in interest rates on 10-year government bonds in the United States, Germany and the United Kingdom, when monetary policies were implemented with the aim of curtailing inflationary pressures – resulted in greater horizontalization of the forward interest rate curve in those countries and a reversal of the inverted interest curve, which had existed in the USA and United Kingdom since 2006.

Average annual earnings on 10-year United States Treasury Bonds reached 4.62% in 2007, against 4.78% in 2006, while earnings on similar papers in Japan closed at 1.68% and 1.75%, in the same order. In the opposite sense, the average annual rate on 10-year bonds in Germany and the United Kingdom increased from 3.78% and 4.5%, respectively, in 2006, to 4.23% and 5%.

With the exception of Japan, the major stock markets posted positive results in 2007, despite intense volatility during the course of the year. This performance reflected the repercussions of the subprime market crisis, particularly announced and the potential book losses at important financial institutions, expectations regarding reductions in corporate profits and the outlook for a downturn in the level of world economic activity.

Graph 6.12

Yield on treasury bonds[1/]



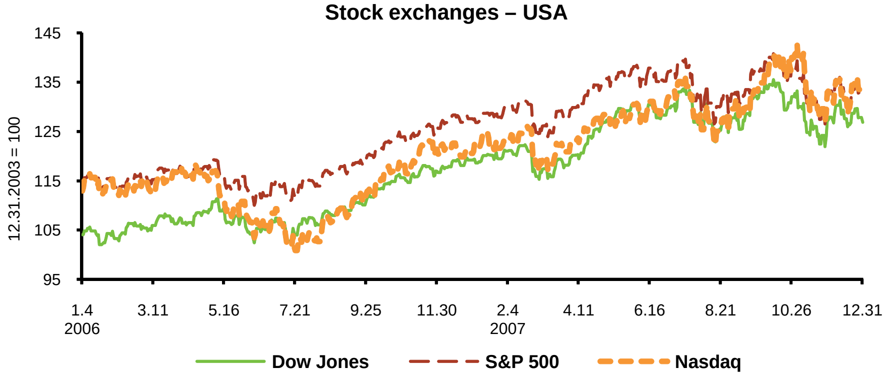
Source: Bloomberg
1/ 10 year treasury nominal yields.

Annual growth in the United States Dow Jones index, the British Financial Times Securities Exchange Index (FTSE 100) and the German Deutscher Aktienindex (DAX) closed at levels of approximately 6.4%, 3.8% and 22.3% in 2007, against 16.3%, 10.7% and 22%, respectively, in the previous year, while the Japanese Nikkei index dropped 11.1%, compared to a 6.9% increase in 2006 and 40.2% in 2005.

The evolution of these stock exchanges can be broken down into different stages during the year, particularly in the final six months. Reflecting the crisis in the Chinese stock exchange toward the end of February, the Dow Jones, FTSE 100, DAX and Nikkei dropped 4.6%, 5.8%, 7% and 8.6% between February 27 and March 5, followed by a period of recovery through July 23, the eve of the outbreak of the subprime crisis, when indices closed with growth of 15.7%, 9.3%, 21.6% and 7.9%. From July 24 to August 16, a period in which the dimensions of the financial crisis became considerably clearer, the same indices dropped 7.9%, 11.6%, 8.5% and 15%, respectively. These indicators which had shown recovery of the previous year's losses through the end of October posted additional losses in the final two months of the year, reflecting more restrictive credit conditions, new and significant book losses in the balance sheets of financial institutions, diminishing demand in light of increased possibilities of lesser growth in the income of borrowers, coupled with rising unemployment.

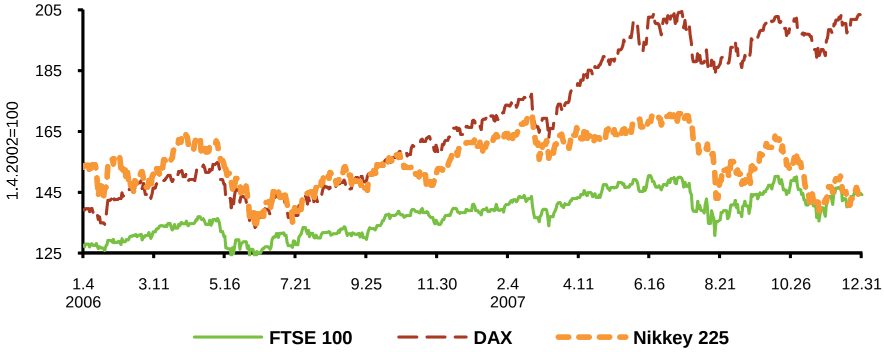
Graph 6.13

Stock exchanges – USA



Source: Bloomberg

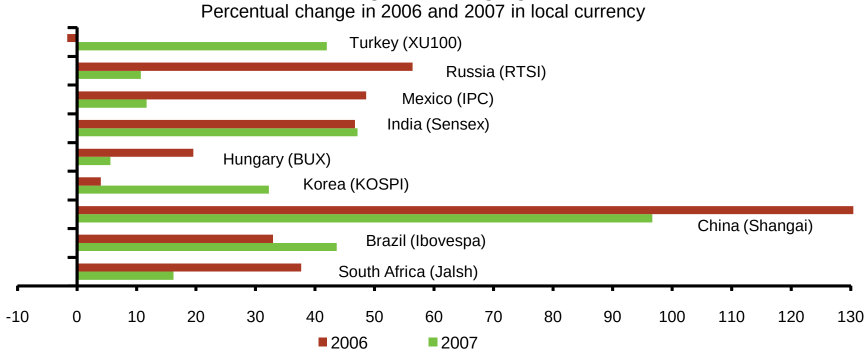
Graph 6.14
Stock exchanges – Europe and Japan



Source: Bloomberg

The stock exchanges of the major emerging countries posted positive results in 2007, with 43.6%, 32.3% and 42% in Brazil, South Korea and Turkey, against 32.9%, 4% and a 1.7% drop, respectively, in 2006. The Indian stock market posted positive growth of 46.7%, matching the 2006 result, while the Chinese stock market expanded 96.7%, against 130.4% in the previous year, even in a framework of intensification of restrictive monetary and credit policies. Parallel to this, the stock exchanges of South Africa, Mexico and Russia posted respective growth figures of 16.2%, 11.7% and 10.1% in 2007, against 37.7%, 48.6% and 56.4% in the previous year, in the same order. These results are indicative of the financial turbulence that broke out in the mature economies, but that tended to impact the emerging economies with less intensity than in previous episodes.

Graph 6.15
Stock exchanges – Emerging markets
Percentual change in 2006 and 2007 in local currency



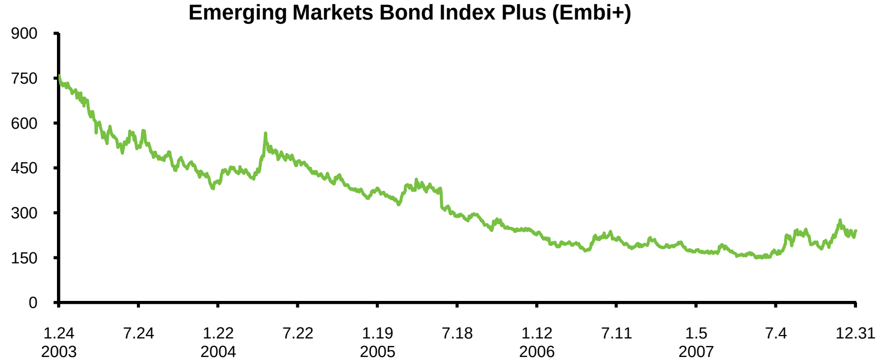
Source: Bloomberg

Revealing generalized sales of higher risk assets, mainly for purposes of paying debts and covering positions, as well as profit-taking, it is important to stress that the stock markets of the emerging countries posted more accentuated losses than the markets of developed nations in the period extending from July 24 to August 16. In that time frame, the Mexican *Índice de Precios y Cotizaciones* (IPC), the Argentine *Mercado de Valores de Buenos Aires* (Merval), the South African JSE All Share Index (Jalsh), Turkey's Istanbul Stock Exchange National 100 Index (XU100) and Brazil's Ibovespa posted respective declines of 13.6%, 20.4%, 13%, 20% and 17.3%.

The spreads practiced on international credit markets remained at historically low levels in 2007. The Emerging Markets Bond Index Plus (Embi+), considered an indicator for emerging markets, registered an average of 190 points in the year, compared to 199 points in 2006. This result was compatible with the reduction in external exposure, growth in the international reserve position and the dynamics and stability found in many of these economies. It should be stressed that, despite occurring at a moment of greater adversity for the world economy, the increase in this indicator was not significant, as demonstrated by the average of 166 points through July 23 and 219 points during the remainder of the year. The Embi+ for Brazil registered an average of 181 points during the year, closing below the general indicator for the first time.

When one looks at the final 2007 position and that of the previous year, the general indicator and the Embi+ for Brazil, Mexico, Russia and Turkey increased 42%, 15.1%, 52%, 53.1% and 15.5%, respectively.

Graph 6.16
Emerging Markets Bond Index Plus (Embi+)

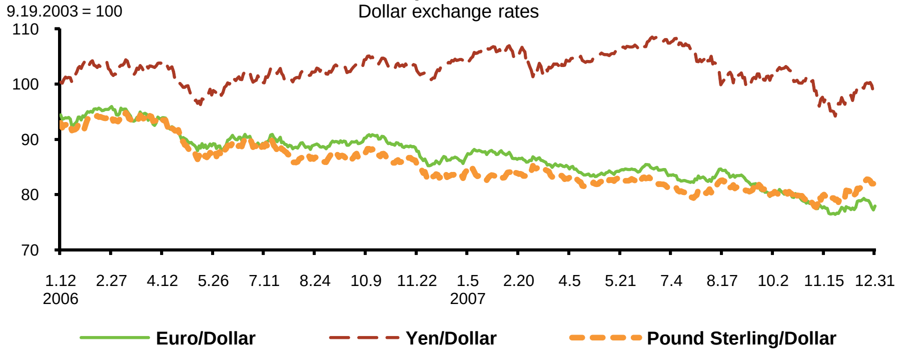


Source: Bloomberg

Expectations of deceleration in the level of economic activity and continued high current account deficits in the United States, coupled with the more flexible monetary policy adopted by the Federal Reserve compared to other important central banks and lessening of the earnings differential along the interest curve aided in reinforcing the tendency toward long-term depreciation of the dollar against the other major currencies.

In this environment, the United States currency registered annual depreciation of 9.5% against the euro; 6.2% against the yen; and 1.3% against the pound sterling. With the exception of the pound sterling, this process was more intense in the second half of the year. Worsening financial turbulence, with evident impacts on risk aversion among investors, stimulated settlements of higher risk operations, such as carry trade operations – funding taken on the Japanese market for investment in assets denominated in dollars – thus provoking appreciation of the yen against the dollar and pound sterling, and its depreciation against the euro.

Graph 6.17
Developed countries
Dollar exchange rates

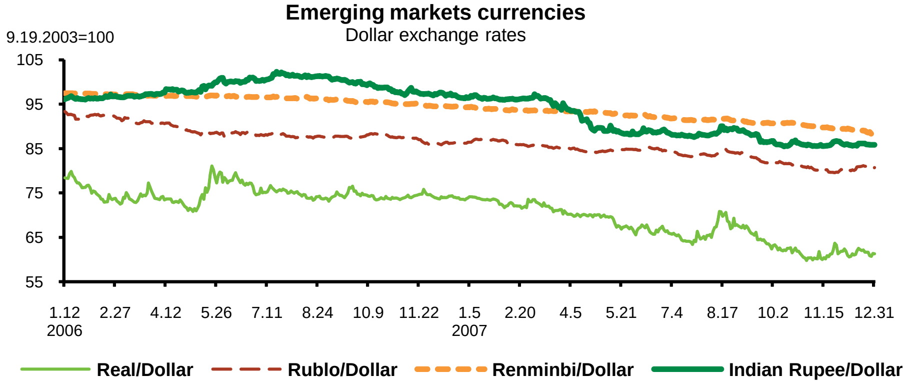


Source: Bloomberg

In much the same way, the dollar devalued against the currencies of the major emerging economies, following a trajectory that mirrored improvement in the macroeconomic fundamentals of those countries, solidity in their external accounts and the interest rates practiced on their markets. Depreciation of the United States currency against the real reached 16.7% in 2007, followed by a 10.9% drop against the Indian rupee, 6.5% against the Chinese renminbi; and 6.4% against the Russian ruble. In China, despite the fact that the daily limit on fluctuations of the renminbi against the dollar remained at 0.5%, appreciation of the currency reflected the combined impact of rate cutbacks on Fed funds and increases in the domestic basic interest rate.

Parallel to this, one should stress that even the currencies of emerging countries that registered high current account deficits, such as Turkey, South Africa and Hungary, appreciated against the dollar in 2007. These currencies posted appreciation of 17.3%, 8.9% and 2% in that order during the year, mainly reflecting improvement in the financing conditions of their current account deficits.

Graph 6.18
Emerging markets currencies
Dollar exchange rates

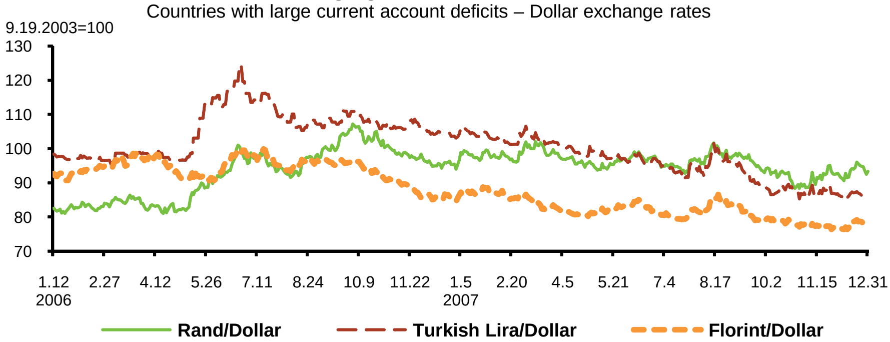


Source: Bloomberg

Graph 6.19

Emerging markets currencies

Countries with large current account deficits – Dollar exchange rates



Source: Bloomberg