Introduction

In early 2007, the Central Bank Monetary Policy Committee (Copom) maintained its strategy of following a more flexible monetary policy. In the ordinary meetings held in the early part of the year, the Committee introduced successive cuts of 25 b.p. in the Selic rate target. Though it could be considered relatively conservative compared to the previous year's trajectory – cutbacks of 75 b.p. in each of the three initial meetings, followed by five consecutive reductions of 50 b.p. – the pace adopted by the Committee was, in fact, the most appropriate position, particularly when viewed against the scenario of more rapid growth in price indices since the end of 2006.

The early months of 2007 reflected a price behavior influenced by the impact of foreign market prices of major commodities as well as the effects of expanding levels of employment and income, credit, government transfers and other sources of fiscal momentum that marked 2006 and were expected to continue in 2007. An additional element to be taken into consideration is the delayed impact of the 650 b.p. reduction observed in the Selic rate in 2006.

In this context, the reductions introduced by Copom in the first three meetings of 2007 revealed the Committee's perception that the short-term rise in prices was basically caused by factors of a transitory nature. Despite the outlook for consolidation of a global environment of reduced liquidity, generated by the impacts of rising interest rates in the industrialized economies and increased global market volatility, the external scenario remained favorable, particularly as regards financing for the Brazilian economy.

In the two following meetings held in June and July, Copom concluded that the evolution of inflation was consistent with the specified targets, in contrast to the relatively high rates that had persisted since the end of 2006. At the same time, the Committee judged that the contribution of the external sector to consolidation of a benign inflationary scenario was greater than originally thought, particularly as a result of the discipline imposed on the prices of tradable goods and the measures taken to expand investments. In this environment, growth in aggregate demand and domestic supply moved once again toward a state of equilibrium within a timeframe appropriate to monetary policy decisions, without in any way jeopardizing convergence toward the inflation target

path. Consequently, a decision was made to increase the pace of cutbacks in the Selic rate target, reflected in successive reductions of 50 b.p.

In the final three meetings of the year, Copom took the position that evolution of the world economic scenario and more rapid growth in the domestic economy justified a reduction in monetary incentives. In the month of September, though a decision not to alter interest rates at that meeting could have been justified by several factors, the Committee decided that the balance of the risks to the prospective trajectory of inflation still called for an additional monetary stimulus in the form of a 25 b.p. cutback in the Selic rate. Starting in the month of October, as it became clearer that initially localized inflationary pressures could endanger the trajectory of domestic inflation, particularly when one considers that the favorable impact of the external sector on inflation in the segment of tradable goods could be neutralized by the upward pressures generated by rising domestic demand on the sector of nontradables, in an environment of expanding credit and real overall wages, Copom opted to hold the Selic rate target at 11.25% per year.

The continued effectiveness of the monetary policy allowed the country to absorb the external financial market turbulence of the second half of the year without any significant trauma, while avoiding deterioration of internal expectations in response to the sharp rise in agricultural prices. As a result, annual growth in the IPCA – the third lowest rate since the series was first calculated in 1980 – remained well within the parameters defined by the CMN in the framework of the inflation targeting system. Furthermore, price evolution reflected the positive impact of austere public accounts management, as is evident in the downward slide of the proportion between net public sector debt and GDP, which closed 2007 at 42.7%, the lowest level since 1998.

In this framework of persistent gains consequent upon the process of macroeconomic stability, the dynamics of internal demand, evident both in the sharp rise in the volume of investments and in the steady expansion under household consumption were once again responsible for acceleration in the pace of Brazilian economic growth. Annual GDP expansion hit 5.4% in 2007, the third best result of the last twenty years, as the current cycle of sustained Brazilian economic expansion closed at eighteen quarters at the end of the year with favorable perspectives into the future.

Consolidation of internal demand as the driving force underlying this economic growth cycle, therefore, reflected both consumption and investment decisions. Based on the optimism shown in both consumer and business expectations, these decisions were stimulated by improved credit market conditions, evident in the downward trajectory of interest rates and longer maturities in lending operations. Thus, boosted by improved labor market conditions, credit operations registered sharp growth in the year, with particular emphasis on operations targeted to the financing of household consumption, particularly in the form of personal loans for purposes of vehicle acquisitions, a segment

in which leasing operations have played a growing role. In much the same way, loans granted to the business sector also expanded sharply, particularly under the headings of disbursements for working capital and investment operations, despite the fact that many companies, particularly larger enterprises, have pursued alternative long-term sources of financing.

Demand growth has generated positive impacts on labor market conditions. In this environment, formal labor market hirings have grown steadily and become almost commonplace in various sectors of the economy; unemployment has dropped to the lowest levels in the historical statistical series, at the same time in which skilled labor shortages have appeared in specific sectors of the economy.

Evolution of consumption and investment levels has contributed to lesser trade balance surpluses. This movement – which has not been reflected in balance of payments financing restrictions due to a continued inflow of longer-term capital generated by growing confidence among international investors regarding the consistency of Brazil's macroeconomic fundamentals – has been driven by increased imports of capital and consumer goods, thus favoring short-term equilibrium between supply and demand, with positive impacts on price stability and, over the medium term, adjustments in utilization of installed industrial capacity.

The balance of payments registered an overall surplus for the seventh consecutive year, closing with an annual record of US$87.5 billion. The positive results of the country's external accounts has made it possible to adopt a consistent policy for managing net external liabilities, now in a creditor position as a result of sharp growth in foreign reserves and significant reductions in the external debt stock. Maintenance of the strategy of reducing public sector exchange exposure and rebuilding reserves adopted since 2003 has created a more solid external accounts position, while enhancing the resilience of the economy to external adversities. This became patently clear in the only marginal impact on the country's economy of the outbreak of international credit market turbulence that followed upon the subprime crisis in the USA.

Net inflows of US$87.5 billion on the domestic exchange market in 2007 created the conditions needed for the Central Bank to increase its exchange purchases on the spot market, with settlement of US$78.6 billion, of which US$57 billion in the first half of the year. Only in the month of September, with the worsening of the international financial market turbulence, the monetary authority did not make any foreign exchange acquisitions on the spot market. Consequently, international reserves more than doubled during the year, shifting from US$85.8 billion at the end of 2006 to US$180.3 billion in 2007. It is important to recall that, just as in previous years, continued application of this policy by the Central Bank reflected a constant process of adjustment to changing market conditions, in such a way as to avoid increased exchange market volatility, without assuming any commitment as regards the level of exchange rates.

Aside from this, the National Treasury continued applying its strategy of acquiring exchange market resources to pay the external debt service and carry out anticipated sovereign bond buyback operations, thus further strengthening the temporal profile of the nation's debt.

Over the course of 2007, the performance of external sustainability indicators produced a highly favorable external Brazilian accounts situation. The positive evolution of risk premiums, viewed in the international context, was consistent throughout the year, as the Brazil risk closed at 138 points in mid-June, the lowest level since the series was first calculated in 1994. In the second half of the year, the risk level rose to a maximum of 254 points toward the end of November as a result of the international financial volatility generated by the subprime market crisis, only to settle back into a downward trajectory, closing the year at 221 points.

Improvements in macroeconomic fundamentals, the record level of international reserves, expanding trade flows, unprecedented inflows of international capital, improvement in sustainability indicators, elimination of exposure in internal and external public debt linked to exchange rate variations, among other factors, generated the conditions required for the major international risk rating agencies – Standard & Poor's, Fitch and Moody's – to raise the country's sovereign risk ratings to just one level below investment grade. It should be noted that Moody's rating was issued in the month of August and thus incorporates the impact of intense international financial market volatility, clearly bearing witness to the robustness of Brazil's economic fundamentals.