



Monthly Report
October

Government adopts measures against financial crisis

THE INTERNATIONAL FINANCIAL CRISIS, WHICH STARTED IN THE U.S. REAL ESTATE MARKET, HAS GOTTEN WORSE SINCE THE SECOND FORTNIGHT IN SEPTEMBER WITH THE DECISION TAKEN BY THE FEDERAL RESERVE NOT TO GRANT CREDIT TO LEHMAN BROTHERS, CAUSING IT TO APPEAL TO THE BANKRUPTCY ACT ON SEPTEMBER 15. THE SIGNAL WAS DIFFERENT FROM THAT WHICH FED HAD PASSED IN MARCH, WHEN IT GRANTED US\$ 30 BILLION CREDIT TO JP MORGAN CHASE TO ACQUIRE BANCO BEAR STERNS, AND CONTRIBUTED TO WORSEN THE TRUST CRISIS IN THE INTERNATIONAL FINANCIAL MARKET AND RESULTED IN THE NATIONALIZATION, CONSOLIDATION OR CLOSING OF IMPORTANT FINANCIAL INSTITUTIONS IN THE MAIN DEVELOPED MARKETS, EVOKING IMMEDIATE AND COORDINATE ACTION BY THE GOVERNMENT OF MANY COUNTRIES. IN ADDITION TO SIGNIFICANT IMPACTS TO THE STOCK EXCHANGE AND INTEREST MARKETS, THIS BANKING TRUST CRISIS MORE IMMEDIATELY RESULTED IN CREDIT CONTRACTING, CHANNEL BY MEANS OF WHICH BRAZIL WAS ALSO AFFECTED. EVEN WITH ECONOMY PRESENTING MORE SOLID MACROECONOMIC FOUNDATIONS COMPARED TO PREVIOUS CRISIS, THE NEW ECONOMIC ENVIRONMENT HAS BEEN REQUIRING THE BRAZILIAN GOVERNMENT TO ADOPT MANY MEASURES IN ORDER TO PROVIDE LIQUIDITY – ESPECIALLY VIA RELEASE OF COMPULSORY COLLECTIONS – AND INCREASE THE DOLLAR OFFER, AS WELL AS TO THE MORE PUNCTUAL MANAGEMENT OF PUBLIC DEBT, INCLUDING THE TEMPORARY SUSPENSION OF THE TRADITIONAL AUCTION OF GOVERNMENT BONDS.



International crisis effect

Significant crisis impacts could be observed in all segments of the financial market. The Stock Exchanges, which generally anticipate trends and present higher volatility, recorded expressive losses, especially on the first fortnight of October. In the case of Ibovespa, which over the past years had presented successive highs, higher than those of other countries, except for China, the decrease in October was 24.80%, accumulating a 41.68% fall in the year. This move caused the circuit breaker, which had not been used for ten years, to be activated six times in October, whenever the daily loss of the index exceeded 10%. In addition to the decrease in the trust level, a significant part of this performance can also be attributed to the decrease in commodity prices, market in which the largest companies listed in Ibovespa participate. The main international Stock Exchanges also presented expressive decreases, reflecting the financial crisis of the global markets and the expectation of retraction in economy.

The trust crisis and the narrowing of credit channels also influenced the expressive reduction of ACC – Exchange Contract Anticipation – lines, and, consequently, the volume of contracted foreign exchange for export. The financial segment, in turn, filed net outflow of foreign exchange of US\$6.1 billion up to the 24th. Thus, in the exchange market, the negative capital flow, combined with an expectation of loss of momentum in exports, either by reducing the credit or the actual growth worldwide, has caused the dollar, which was quoted at US\$1.63 at the end of August, to be traded at \$2.52 as early as the opening of the market on the 23rd October. Therefore, also in Brazil, there was a trend of recovery in the U.S. currency compared to local currency, which ultimately reflects the search by the agents for a value reserve, which now exposes the recognition of the dollar as a strong currency. Except for the yen, several currencies have weakened against the dollar, including euro and pounds.

However, after several initiatives of the Central Bank in order to expand the dollar supply in the financial and commercial segments, the U.S. currency depreciated, closing the month quoted at US\$ 2.12. Still, the devaluation accumulated over the past two months reached 29.42%, which led some exporting companies – which carried out operations in the futures market in order to protect against the movement of foreign exchange recovery observed in previous months – to record significant financial losses, reducing the trust and available credit in the economy even more.



Please note that the dollar appreciation has occurred in spite of the center of the crisis relying on the United States economy and the significant reduction of interest rates paid by the U.S. Treasury bonds within less than five years, found between the beginning of September and the end of October. In addition to reflecting both 0.5% cuts in the basic interest rate promoted by Fed in October, this move may also reflect an increased demand by the agents for those securities in the search for greater safety.

Even after obtaining the investment grade in April, the Brazil risk also experienced significant increase as from September, reaching 449 points at the end of October and accumulating 87% increase over the past two months. However, this progress was lower than the average index composed of the risk of emerging countries.

With regard to interest rate market, the level of uncertainty caused by the financial crisis and the sharp currency devaluation also contributed to the increase in rates of public and private securities in all maturities. The evolution of the forward interest rate structure from September shows that in a first moment, the uncertainty in the international scenario caused by the bankruptcy of Lehman Brothers Bank resulted in a slight adjustment upward in the curve in relation to the level observed earlier that month, especially in shorter maturities. This movement got more and more accentuated up to the beginning of October when, in the penultimate week of the month, with worse expectations in the domestic scenario, the curve reached its highest level on the 24th, partly decreasing in the last week.

One of the main effects of the trust crisis in the financial market was the hold of bank liquidity. The reduction in volume of DI operations led the Central Bank to increase the value of its daily operations in the money market and to adopt various measures for the expansion of liquidity, mainly through the reduction of required compulsory fund collection.

Due to high interest rates observed in the market, the National Treasury has substantially reduced the primary placement of securities, canceling, in a few weeks, its traditional auction, replacing it with a simultaneous purchase and sale of NTN-F aiming at setting a switch to the long-term interest curve.

This instable environment was reflected in the behavior of the IMA and its sub-indices, which showed extreme volatility over the period, with expressive daily variations, especially in portfolios of longer duration. The profitability of the IMA-B5 + (NTN-B portfolio of over five years) recorded negative variation of



approximately 8.17% in October, which shows investors' aversion to take positions in long-term scenario of uncertainty.

The crisis worsening and the behavior of the different segments of the financial market also reflected in the allocation of assets by investors. While almost all classes of investment funds recorded negative net fund raising – especially those with a significant portion of variable-income asset portfolio or higher risk –, the CBD – Banking Deposit Certificates – continued being the main destination of resources for investors, yet in a volume lower than that observed in previous months.

Measures adopted by governments

Facing the crisis, governments of various countries were mobilized to find solutions aimed at restoring the players' confidence in the markets and the economy. In the United States, even with some political difficulties, the Congress approved a US\$850 billion dollar package, with US\$700 billion for asset repurchase related to subprime credit and the remaining portion for subsidies or tax incentives. In Europe, the measures were taken towards the temporary acquisition by the State of shareholding in financial institutions with liquidity problems. Moreover, there was a decrease in the basic interest rate coordinated between the central banks of developed countries in early October and a new round at the end of the month. IMF loans were also required for some emerging countries and for Iceland.

With stronger economic fundamentals in comparison to previous crises, particularly because it eliminated the dollar-pegged public debt, it became a creditor in U.S. dollars and relied on international reserves of around US\$200 billion, Brazil did not need international aid. However, to address the reduction in credit lines and the hold in commercial bank liquidity seen as from the worsening of international crisis, the Central Bank has adopted a series of measures over the past two months (see next page).

With regard to the exchange market, the measures aimed at meeting the reduction observed in lines of export financing and increasing the dollar supply into the economy in order to reduce the pressure on the exchange rate, as the US\$30 billion swap, which could be achieved between the Central Bank and the Fed. There was also a reduction from 1.5% to zero in the IOF (tax on financial operations) rate levied on the settlement of exchange operation for the entry of



foreign investors to the country's financial and capital markets, and from 0.38% to zero in the case of entrance and exit of funds for loans and financing.

As to the money market, the objective was to provide liquidity through the release of funds from compulsory collection, especially for credit operations and for small-sized financial institutions. The issue, on the 22nd, of Provisional Measure 443, allowing Banco do Brasil and Caixa Econômica Federal to acquire financial institutions in the country, however, contributed to the investors' mood worsening, since it raised doubts about the magnitude of liquidity problems faced by the Brazilian Financial System. This scenario led the Ibovespa, on this day, to decrease 10.18%, the dollar to appreciate 6.44%, the country-risk to have a significant 26.29% increase and the interest rate curve to significantly increase, especially at the longer edge.

Although the IPCA (Broad Consumer Price Index) accumulated in the year and in 12 months is still above the center of the inflation target and being observed a significant pressure on the exchange rate, Copom decided not to change the target for the Selic rate at 13.75% per year, at its last meeting, ended on the 29th, after four consecutive increases, which represented a 2.75% accumulated increase per year since April. Apparently, the risk of slowdown in the Brazilian economy in the forthcoming months due to the international crisis weighed more than the risk of inflation. In this scenario, the reduction of activity could help the monetary policy control the price level.

The IGP-M (General Market Price Index), however, showed a significant increase in October, recording a 0.98% increase from 0.11% in September, accumulating a 9.53% increase in the year, and 12.23% in 12 months. This behavior weighed on the performance of IPA-M (Wholesale Price Index), which increased from 0.04% to 1.24%, mainly influenced by the increase of 2.09% in raw materials. The IPC-M (Consumer Price Index), which had decreased 0.06% in September, increased 0.25% in October and INCC (Brazilian Construction Cost Index) decelerated from 0.95% in September to 0.85% in October.

Issues to be faced

In the forthcoming months, the society's most immediate challenge facing this financial crisis is the restoration of credit and trust among financial institutions, businesses, investors and consumers. The expectation of a slower world growth or even economic slowdown in some countries – the U.S. GDP had already gotten



down 0.3% in the third quarter – but almost certainly it will be an significant obstacle to achieve this goal.

In Brazil, despite the most favorable conditions for foreign accounts, the loss of momentum in the global economy, it seems, could reduce the rate of expansion of the country. Although it has increased foreign sector participation in the economy in recent years, the dynamism of the internal market should play an important role for growth in the level of activity in the coming years. Despite the likely slowdown of world trade and rising of protectionism, maintenance and attraction of new markets, in turn, continue to pose new challenges and opportunities for Brazilian companies.

Finally, the issue that should dominate worldwide debate in the forthcoming months with respect to financial rules and model to be adopted, based on the lessons of the current financial crisis. The choice between the adoption of models more or less regulated will certainly be at the center of these discussions. Another important debate concerns the appropriate level of risk exposure and supervision to which the banks must undergo. Whatever the chosen model is, the goal should be to ensure that the financial system offers the best alternative for the allocation of capital without however compromising investors' safety and confidence. Accordingly, the review of multilateral agencies' work scope may also bring an important contribution.

Main measures adopted by the Brazilian government

Liquidity increase:

- Increases from R\$100 million to R\$1 billion the deduction to be made on the additional enforceability of the compulsory collection on time deposits (Circular Letters 3405 and 3410).

- Postpones the schedule of increased compulsory collection rates on DI – leasing operations (Circular Letter 3405).

- Increases from US\$300 million to US\$2 billion the amount to be deducted by the financial institutions when calculating the compulsory collection of time deposits made in public securities (Circular Letter 3408).

- Reduces from 8% to 5% the rates used to calculate the additional enforceability on cash deposits and time deposits of financial institutions (Circular Letters 3408 and 3410).

- Establishes program for full release of compulsory collections on time deposits, on interfinancial deposits and on the additional enforceability of cash and time



deposits in the total of R\$100 billion. (Note to Press – corresponding rule has not been issued.)

- Reduces the rate of compulsory fund collection on cash funds from 45% to 42% (Circular Letter 3413).

- Includes the DI of institutions that are not under the same control to the operations/assets reducing the value of the compulsory collection of time funds (Circular Letter 3417).

- Reduces from 100% to 30% the percentage of completion of compulsoriness on time funds that can be met with federal public securities, the rest being in cash, without remuneration. This portion may be deducted from the value of acquisitions and interfinancial deposits (Circular Letter 3417).

- Authorizes the FIs to cut from the enforceability of compulsoriness on time deposits the value of acquired credits and of the interfinancial deposit, the latter being included in the limit of 20% per institution (Circular Letter 3417).

Credit and financing operations:

- Authorizes the FIs to cut, in up to 70% of the enforceability of compulsory collection on time deposits, an amount equivalent to the acquisition of credit operations from originating banking institutions not members of the same conglomerate with up to R\$7 billion of the PR – Reference Net Worth, made until December 31, 2008, co-obligation admitted to the assignor and repurchase prohibited. The deduction is limited to 20% for acquisition of credits from just one institution (Circular Letters 3407, 3411 and 3414).

- Authorizes the Brazilian Monetary Council – CMN to establish criteria for evaluation and acceptance of assets received by the Central Bank in the rediscount operations in domestic currency, or guarantee of loan operations in foreign currency; and remove, for a specific period, demands for regular tax, including the discharge of federal taxes and FGTS – Severance Fund, in the the rediscount and loan operations made by the Central Bank (Provisional Measure 442).

- It allows leasing companies to issue LAM – Leasing Bill, a credit instrument representing payment commitment in cash, registered, endorsable and freely traded. Does not constitute transaction or advance, neither is it deemed to be security (Provisional Measure 442).

- Raises the call for application in rural credit from FIs, with resources required for the period from completion of November 1, 2008 to June 30, 2009, from 25% to 30% (Resolution 3623).

- Increases from 65% to 70% the enforceability for investing resources of rural savings and reduces the mandatory (compulsory) grip of rural savings deposits



from 20% to 15%. The measures are valid from November 1, 2008 to June 30, 2009 (Resolution 3625).

- It states that at least 60% of the required resources are targeted exclusively at rural credit operations, with up to 40% for the acquisition of CPR (Rural Product Note), marketing, processing or industrialization of agricultural products (Resolution 3625).

- Authorizes the hiring of new credit operations in a total of up to R\$8 billion destined to Petrobras, which must be recorded in Cadip by financial institutions (Resolution 3628).

Acquisition of ownership in financial institutions:

- Authorizes Banco do Brasil and Caixa Econômica Federal, directly or through their subsidiaries, to acquire interest in financial institutions, public or private, headquartered in Brazil, including companies from the security branches, welfare, capitalization, among others, with or without the control of the capital stock (Provisional Measure 443).

- Waive of the auction to the sale of shareholding in financial and public institutions and the public for the BB and Caixa (Provisional Measure 443).

Foreign, credit to export and foreign investment market:

- Authorizes the Central Bank, for lending operations, to release the value of the transaction in the same foreign currency denominated or referred to the guarantee. If there is default, the Central Bank could sell in a public offering, the assets received (Provisional Measure 442).

- It authorizes FIs to deduct from the completion of call for compulsory collection of DI resources of leasing operations the values of transactions to acquire foreign currency in the BC. These operations are carried out with a reselling agreement of the FIs in conjunction with the repurchase agreement by the Central Bank (Circular Letter 3412).

- Regulates the exchange of currencies between the Central Bank and the Federal Reserve and provides that the limit for the swap will be US\$30 billion and operations can be performed until April 30, 2009. (Resolution 3631).

- Allows the Central Bank to determine that the resources obtained from the operations of foreign currency loans are directed to operations of foreign trade (Resolution 3634).

- The Central Bank announced a program of sales of foreign exchange swaps worth up to US\$ 50 billion. Sales will be made according to the needs of market liquidity (Note the press).

- Reduces to zero the IOF tax rate levied on the settlement of transactions on foreign exchange related to transfers from and to abroad, including by means of



simultaneous operations, carried out by foreign investors, for investment in financial and capital markets, as regulated by CMN (it was 1.5%), and for resources extracted from October 23, 2008 as loans and foreign financing (it was 0.38%) (Decree 6613).

- On loan operations in foreign currencies, the Central Bank could receive as collateral Brazilian sovereign bonds in dollars or of other countries, provided they hold minimum rating A. Operations of ACC, ACE, financing to the import and loan operations between residents and non-residents will be also accepted as collateral. The cost will be Libor plus an additional to be further defined by the Central Bank (Resolution 3622).