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Inflation Report

June 2010

Volume 12 | Number 2

BANCO CENTRAL DO BRASIL

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Inflation Report

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Statistical Conventions

...	data not available.
-	nil or non-existence of the event considered.
0 or **0.0**	less than half the final digit shown on the right.
*****	preliminary data.

Hiphen between years indicates the years covered, including the first and the last year.
A bar (/) between years (1970/1975) indicates the average of the years covered, including the first and the last year or even crop or agreement year, when mentioned in the text.

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Foreword

Inflation Report is a quarterly publication of the Banco Central do Brasil with the objective of evaluating the performance of the inflation targeting system and providing a prospective scenario for inflation. The national and international economic conditions underlying decisions taken by the Monetary Policy Committee (Copom) concerning the monetary policy management are presented.

The *Report* is divided into six chapters: Activity level; Prices; Credit, monetary and fiscal policies; International economy; Foreign sector and Prospects for inflation. With regard to the activity level, growth in retail sales, inventories, output, labor market and investments are investigated. In the following chapter, price analysis focuses on the results obtained in the quarter as a consequence of monetary policy decisions and the real conditions of the economy outside the realm of government action. The chapter referring to the credit, monetary and fiscal policies, the analysis is centered on the behavior of credit, financial and budget operations. In the chapter dealing with the international economy, the *Report* presents an analysis of the world's major economies and seeks to identify those conditions capable of impacting the Brazilian balance of payments. Insofar as the foreign sector chapter is concerned, analysis is targeted at economic-financial relations with the international community, with emphasis on trade results and foreign financing conditions. Finally, prospects on inflation growth are analyzed.

Executive summary

The robust growth rate of the Brazilian economy in the first quarter of 2010, (9% growth rate of the Gross Domestic Product (GDP), in comparison to the same period of the previous year), makes evident the consolidation of the current expansion cycle. In this context, the slackness observed in industrial activity and in retail sales in April is not a deviation from the growth trend, which should be sustained by the performance of the labor market, by the high business and consumer confidence indices, and by the expansion of credit.

Economic activity remains driven essentially by domestic demand, with emphasis on the upswing of investments, in line with the high levels of business confidence and of capacity utilization. Furthermore, the dynamism of household consumption has been led by consumer confidence, as well as recurrent increases in payrolls and by improvements in the conditions of the credit market. The external sector still shows a negative contribution to GDP growth, a performance consistent with the mismatch between the growth rates of the Brazilian economy and of its trading partners.

The labor market indicators presents continued gains in real income, despite the acceleration of price indices in the beginning of this year, whose effects have been more than compensated by the decreasing in unemployment rate and by the gains of nominal wages. The improvement in quality of created jobs, depicted in the substitution of informal for formal jobs, should be underscored.

Credit remained in an expansion path, in an environment of retreats of interest rates, of spreads and of defaults, in the February to April period, thus functioning as an important source for household consumption and investments. The expansion of credit has been led by the earmarked resources segment, with emphasis on the Brazilian Development Bank (BNDES) operations and housing loans, whereas credit with non-earmarked resources were pushed by the performance of households loans, with emphasis on the increased share of payroll deducted loans and automotive vehicles financing. The relative slowing in domestic corporate credit could be interpreted, at least in part, as a result of greater corporate demand for funding in capital markets, domestic and international, , specially by bigger companies.

The fiscal result accumulated this year, more favorable than the one registered in the same period in 2009, reflects the impact of the recovery of economic activity on revenues. The persistence of this process along the year should be sustained, among other elements, by the reversal of part of the tax reliefs introduced amid the international crisis. As regards expenditures, the increase in investments should be highlighted. This path, taken into account the fiscal targets established for the year, should be counterweighted by limiting current expenditures.

The impact of the current growth cycle on the demand for imported goods and services has been reflected in the increase of the current account deficit. In this scenario, although exports have registered important growth, mostly due to the increase in prices, the trade surplus shrank 39.6% during the first five months of 2010, compared to the same period in the previous year. Moreover, it should be taken under consideration the expected increase of the deficits in the services and income accounts, the latter due to the increase of profit net remittances, driven by the expansion of foreign investments in the country and of the improved profitability of resident enterprises.

In regard to the financial account, the net inflows of foreign direct investments, investments in debt securities and in equity securities remain at a level in excess of the current account deficit. Furthermore, the improvement of the structure of external liabilities, with investment liabilities outpacing debt, has been an enduring process.

The main emerging market economies remain on a stronger recovery pace than the mature economies. Although greater risk aversion due to the fiscal crisis that some European economies are undergoing may represent a risk factor to the net inflow of external resources in those economies, with negative impacts on the prices of their assets, until now these effects have been limited.

Regarding inflation forecasts, following the usual procedures, and taking into account the information set available up to the cutoff date of June 18, 2010, the baseline scenario considered by the Copom assumes a constant exchange rate over the forecast horizon at R$1.80/US$, and that the target for the

Selic rate stays at 10.25% p.a. – the level set by the June Copom meeting. The projection for the change, in 2010, of the set of regulated and monitored prices stands at 3.6%, and moves to 4.4% and 4.5% in 2011 and 2012, respectively.

The market scenario, on the other hand, is based on data from the expectations survey undertaken by the Investor Relations Group (Gerin) of the Central Bank of Brazil until the cutoff date (June 18, 2010). In this scenario, average exchange rate expectations slightly changed in comparison to the values released in the March 2010 *Inflation Report*. The average expectations about the Selic rate increased in comparison to those presented in the last *Report*. Additionally, the market scenario assumes changes of 3.6% and 4.6% for the set of regulated prices in 2010 and 2011, respectively, and of 4.5% in 2012.

The forecasts presented in this *Inflation Report* are based on working assumptions about fiscal policy, namely a primary surplus of 3.3% of GDP in 2010, reduced by up to 1.12 b.p. thanks to implementation of the Government's Growth Acceleration Program (PAC). Moreover, the working assumptions are that the primary surpluses in 2011 and 2012 will return to the level of 3.3% of GDP, without adjustment factors.

Based on the above assumptions, the Copom's central forecast associated with the baseline scenario shows inflation of 5.4% in 2010, 0.2 p.p. higher than in the March 2010 *Report*. In this scenario, twelve-month inflation projections stay above the midpoint of the target for the entire relevant horizon.

In the market scenario, the inflation projection for 2010 is 5.3%, 0.1 p.p. lower than the projection of the baseline scenario, and 0.1 p.p. higher than in the last *Report*. In this case, twelve-month inflation projections hover above the midpoint of the target along 2010, and decline along 2011, ending the year at 4.6%, around the target midpoint. The projection for the second quarter of 2012 is 4.3%.

Regarding the balance of risks associated with the projections, the main domestic risk to the inflation outlook stems from the possibility that actual and projected inflation may persistently remain above the target due to the increasing utilization of production factors and/or the expansion of the domestic demand. An additional risk to the inflation outlook is related to the behavior of inflation expectations, which, nonetheless, have remained contained in the latest weeks.

On the foreign sector, the main risks are associated with the potential developments of the European crisis, whose dynamics has become less favorable since the release of the latest *Inflation Report*. This has introduced some caution in the analysis of the prospective scenario given that the uncertainties surrounding those developments have increased lately.

According to the baseline scenario, GDP growth should reach 7.3% in 2010, against 5.8% considered in the March 2010 *Inflation Report*.

Economic activity

1

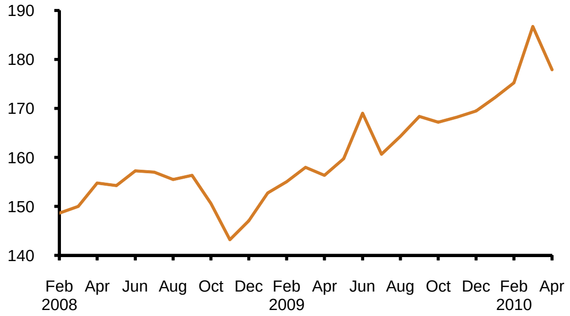
The vigorous GDP growth registered in the first quarter demonstrates the consolidation of the current cycle of expansion of the Brazilian economy. It should be noted that the April stabilization in industrial activity and retail sales is not indicative of change in the growth trend, which should continue, sustained by the favorable trajectories of the labor market and confidence indices of businesses and consumers, and the upswing of credit operations.

Internal activity continues to show the dynamism of domestic demand, pointing to the sharp growth in investments consistent with high levels of confidence in the business community and a scenario of increased capacity utilization. Additionally, the upturn of household consumption continues, boosted by high consumer confidence, recurring increases in payroll, and by the improved conditions in the credit market. The external sector continues to contribute negatively to GDP growth, a performance consistent with the negative impact exerted by the Brazilian trade balance, the significant differential between the pace of recovery of the Brazilian and global economies.

1.1 Retail sales

After registering a sharp rise in the first quarter, commerce indicators settled in the month of April. This movement is largely a reflection of the effects of purchases in anticipation of the end of tax incentives and of Easter, which this year occurred at the beginning of April. The favorable performance of the job market and consumer expectations, and the positive effect of the World Cup suggest a continuing trend of growth in retail business in the coming months.

Figure 1.1 – Extended retail sales
Seasonally adjusted data
2003 = 100



Source: IBGE

Extended trade sales increased by 5.9% in the quarter ending in April, in relation to the one that ended in January, considering seasonally adjusted data from the Monthly Retail Trade Survey (PMC), published by the Brazilian Institute

Table 1.1 – Sales volume index

% change

	2010			
	Jan	Feb	Mar	Apr
In the month[1/]				
Retail sector	2.8	1.4	2.1	-3.0
Fuel and lubricants	0.0	0.7	2.1	-2.0
Supermarkets	1.9	3.2	-1.1	-0.7
Fabrics, apparel and footwear	1.1	3.4	1.7	2.2
Furniture and home appliances	8.9	1.0	-0.3	0.0
Pharmac., medical, orthop. and perfumery articles	2.5	3.4	-0.3	-0.9
Books, newspaper, magazines,	2.8	-2.4	-0.2	-0.2
Office, comp./comunic. equip.	5.8	-0.6	10.9	-10.5
Other art. of personal use	1.8	1.2	0.8	2.5
Broad trade sector	1.6	1.7	6.6	-4.7
Building materials	2.3	2.7	2.6	-0.9
Automobiles, motorcycles, parts and spares	0.4	2.2	12.7	-11.7
3-Month Period/Previous 3-Month Period[1/]				
Retail sector	2.9	2.9	4.4	3.5
Fuel and lubricants	3.6	2.6	2.1	1.8
Supermarkets	2.2	2.8	3.5	3.3
Fabrics, apparel and footwear	3.1	3.5	4.6	6.4
Furniture and home appliances	6.1	5.6	8.3	5.3
Pharmac., medical, orthop. and perfumery articles	2.5	3.2	4.2	4.2
Books, newspaper, magazines,	2.8	2.7	1.9	-0.3
Office, comp./comunic. equip.	8.5	6.8	10.7	7.0
Other art. of personal use	-0.3	0.3	1.9	3.5
Broad trade sector	2.0	2.6	5.8	5.9
Building materials	4.9	5.5	6.6	6.1
Automobiles, motorcycles, parts and spares	1.1	1.7	7.8	7.7
In the year				
Retail sector	10.4	11.2	12.8	11.8
Fuel and lubricants	4.8	4.8	5.5	5.3
Supermarkets	10.2	10.9	12.4	10.6
Fabrics, apparel and footwear	2.3	6.3	9.5	11.5
Furniture and home appliances	17.7	19.7	21.6	21.8
Pharmac., medical, orthop. and perfumery articles	10.3	12.4	13.3	12.7
Books, newspaper, magazines,	7.0	8.4	8.3	8.4
Office, comp./comunic. equip.	32.2	26.6	30.0	23.2
Other art. of personal use	6.0	5.4	6.3	6.1
Broad trade sector	10.3	11.9	15.6	14.9
Building materials	9.5	12.1	15.0	16.0
Automobiles, motorcycles, parts and spares	10.3	13.1	20.8	20.3

Source: IBGE
1/ Seasonally adjusted data.

of Geography and Statistics (IBGE). In the period, positive results were registered in nine of the ten segments surveyed, with emphasis on the marked expansion in sales of vehicles, motorcycles, parts and accessories, 7.7%; equipment and office supplies, computers, and communication, 7%; textiles, clothing, and footwear, 6.4% construction materials, 6.1%; and furniture and appliances, 5.3%.

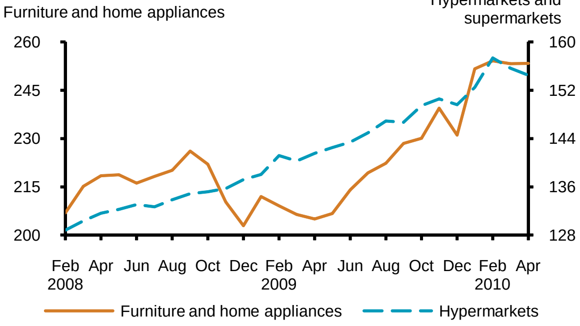
Retail trade sales, a concept that excludes the segments of vehicles, motorcycles, parts and accessories, and building materials increased 3.5% over the same period, with emphasis on increases observed in the North, 8%, and Northeast, 5.7%.

Nominal revenue for the extended market increased 13.2% in April, in relation to the same period in 2009, resulting from increases of 9.1% in sales volume and 3.8% in prices. Nine of the ten segments surveyed showed nominal revenue growth higher than the average variation of 5.3% in the period, registered by the Extended National Consumer Price Index (IPCA) and released by the IBGE, emphasizing the marked increases in the furniture and house appliance segments, 24.2%; construction materials, 23.7%; textiles, clothing, and footwear, 22.7%; and vehicles, motorcycles, parts and accessories, 21%.

The upward trend of retail sales, as evidenced in surveys by the IBGE, is corroborated by the development of other indicators. In this respect, the Serasa Experian Commerce Activity index, of national scope, built from monthly consultations carried out by shops, grew by 2.7% in the quarter ending in May, in relation to the one that ended in February, considering seasonally adjusted data. Sales of automobiles and light commercial vehicles, released by the National Federation of Automotive Vehicle Distributors (Fenabrave) increased 10.7% over the same period, emphasizing that the end of tax incentives for sales in the sector tends to contribute to its stabilization, at a higher level in the months to follow. Conversely, real sales of the supermarket sector, a segment whose weight is approximately 32% of the IBGE's PMC, dropped 1.1% in the quarter ended in May, as compared to the one closed in February, according to seasonally adjusted data from the Brazilian Association of Supermarkets (Abras).

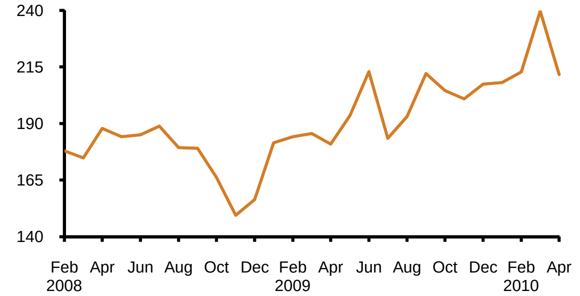
The continued improvement of job market conditions continues to favor the trajectory of default rate indices. The ratio between the number of checks returned for insufficient funds and the total number of checks cleared reached 5.6% in May, against 6.9% in same period of the previous year,

Figure 1.2 – Retail sales
Seasonally adjusted data
2003 = 100



Source: IBGE

Figure 1.3 – Sales volume index (automobiles, motorcycles, parts and spares)
Seasonally adjusted data
2003 = 100



Source: IBGE

Table 1.2 – Retail sales
2010, April

% accumulated growth in 2010

	Nominal revenue	Volume	Price
Retail sector	15.0	11.8	2.9
Fuel and lubricants	8.9	5.4	3.3
Supermarkets	14.2	10.6	3.3
Fabrics, apparel and footwear	17.5	11.5	5.4
Furniture and home appliances	21.7	21.8	-0.1
Pharmac., medical, orthop. and perfumery articles	17.3	12.7	4.1
Office, comp./comunic. equip.	15.2	23.2	-6.5
Books, newspaper, magazines	13.0	8.4	4.2
Other art. of personal use	14.4	6.1	7.8
Broad retail sector	17.0	14.9	1.8
Automobiles, motorcycles, parts and spares	20.3	20.4	-0.1
Building materials	20.3	16.0	3.7

Source: IBGE

emphasizing that this retraction reflects the occurrence of decreases in all of the country's regions, with emphasis on those with 1.8 p.p. and 1.7 p.p. marked by the Northeast and Central-West regions, respectively.

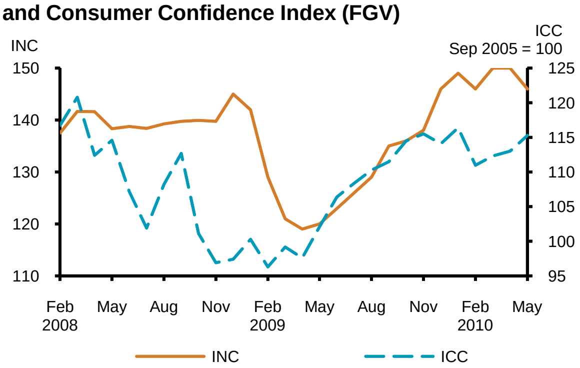
The Serasa Experian Consumer Default Indicator, which includes debt payments overdue by a minimum of 90 days, together with credit companies, credit cards, non financial companies, banks, unpaid obligations, and second return of unpaid checks due to insufficient funds registered a 4.3% increase in May in relation to the previous month and 1.9% compared to the same month in 2009. This high is concentrated in credit card operations, and is consistent with the increase of transactions in this segment. In São Paulo state, defaults, as measured by the Sao Paulo Trade Association (ACSP), reached 6.6% in May, up 9.7% in same period in 2009.

The main indicators for measuring consumer expectations continue at high levels. The Consumer Confidence Index (ICC), by the Getulio Vargas Foundation (FGV), registered a monthly increase of 0.6% in May, seasonally adjusted data considered, and reached 116.1 points, the third highest historical value in the series, which initiated in September 2005. The Current Situation Index (CSI) increased by 2.3% in the period, reaching the record level of 128.4 points, while the Expectations Index (EI) fell 0.4%. The ICC registered an increase of 12.9% compared to May 2009.

The National Consumer Expectations Index (Inec), published monthly since March 2010 by the National Industry Confederation of Industry (CNI), registered monthly changes of -3% in April and 1.8% in May. Worth noting is that this month, all of the indicator's components, except the one that evaluates expected higher value purchases, reported positive results, with emphasis on expectations related to unemployment expectations, personal income, and indebtedness. Although changes in the periodicity to release the indicator moved from three-monthly to monthly, comparisons between periods in 2010 and the previous year are not permitted, and it should be emphasized that Inec lies at a level above its historical average.

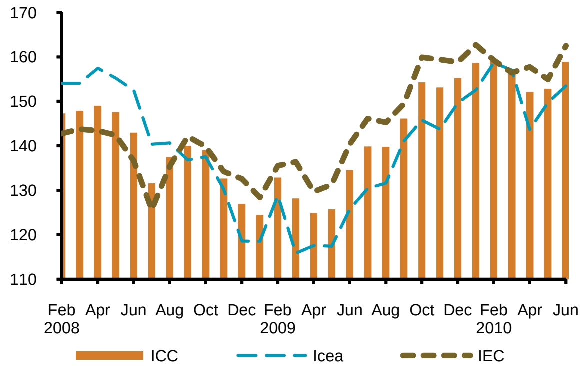
The National Confidence Index (INC), prepared for the ACSP by Ipsos Public Affairs, after reaching a record 150 points in April, showed a monthly decline of 2.7% in May, but remained at a level 21.7% higher than in the same 2009 period. The monthly decline reflected the falloffs recorded in the South, 19.3%, and Northeast, 6.3%, neutralized in part by increases in the Southeast, 5.4%, and North/Central-West, 3%.

Figure 1.4 – National Consumer Confidence (ACSP) and Consumer Confidence Index (FGV)



Sources: ACSP and FGV

Figure 1.5 – Consumer Confidence Index



Source: Fecomercio SP

The inter-annual development of the indicator resulted from widespread regional growth, with emphasis on observed increases in the North/Central-West, 34.4%, and the Northeast, 31.7%.

The ICC, which is released by the São Paulo Trade Federation (Fecomercio SP) and restricted to São Paulo only, attained 159 points in February, a historical record for the series, which was initiated in June of 1994. It went on to register monthly changes of -1.5% in March, -2.9% in April, 0.5% in May, and 4% in June, positioning itself at 158.9 points, the second best result for the historical series. The ICC components showed growth in May, with the Consumer Expectations Index (IEC) varying by 4.9% and the Index of Current Economic Conditions (Icea), 2.5%. The ICC continues at a high level – the indicator's average in the first six months of the year stands at a level 21.8% higher than in the same period in 2009, a reflection of the expansions observed in the Icea, 26.4%, and the IEC, 18.9%. Similarly, the IEC, as measured by the Rio de Janeiro Trade Federation of the State of Rio de Janeiro (Fecomércio- RJ), after hitting a record 121.4 points in January 2010, fell in the three months that followed and recorded a high of 0.4 % in May, reaching 118.2 points, considering seasonally adjusted data.

1.2 Output

Crop and livestock output

Table 1.3 – Farm production

In 1,000 tons

	Production		% change
	2009	2010[1/]	2010/2009
Grain production	133 986	145 800	8.8
Cotton (seed)	1 785	1 879	5.3
Rice	12 605	11 249	-10.8
Beans	3 523	3 329	-5.5
Corn	51 232	53 147	3.7
Soybean	56 961	68 131	19.6
Wheat	4 965	5 154	3.8
Others	2 916	2 911	-0.2

Source: IBGE

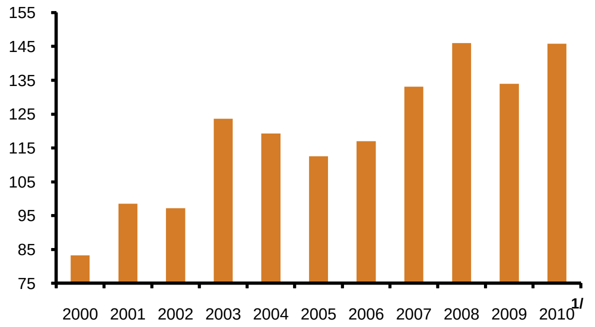
1/ Estimate.

Production of the crop/livestock sector increased by 5.1% in the first quarter of 2010, in relation to the same period last year, according to the National Quarterly Accounts, released by the IBGE. This performance reflected, in particular, the impact of weather conditions suitable for the production of major crops such as upland cotton, corn, soybean, and coffee.

Grain production estimates total 145.8 million tons in 2010, registering an annual growth of 8.8%, according to the May Systematic Farm Production Survey (LSPA), published by the IBGE. A 0.9% drop is projected for the harvested area and an increase of 9.9% for the average yield.

The soybean crop is expected to grow 19.6% this year, with an emphasis on an 11.6% increase for the average yield, due to suitable weather conditions in the major production regions. Similarly, growth projections are indicated for the production of coffee, 12.9% upland cottonseed, 5.3%, wheat

Figure 1.6 – Grain production
In million tons



Source: IBGE
1/ Estimate.

Table 1.4 – Livestock production
Total slaughters

% accumulated growth in the year

Itemization	2009						
	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Cattle	-7.0	-5.7	-4.6	-3.6	-2.4	-1.2	0.3
Swine	11.8	13.3	13.5	12.9	12.1	11.7	10.9
Poultry	-5.2	-4.7	-3.7	-3.1	-3.1	-3.0	-2.7

Source: IBGE

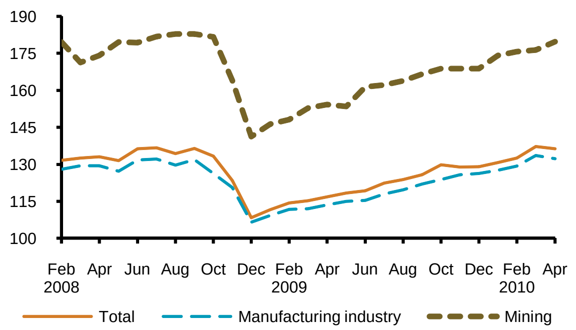
Table 1.5 – Industrial production
3-Month Period/Previous 3-Month Period 1/

%

	2010			
	Jan	Feb	Mar	Apr
Industry	2.4	2.0	3.2	4.5
By section				
Mining	2.5	2.8	3.9	3.9
Manufacturing	3.9	3.1	3.9	4.1
By category of use				
Capital goods	11.9	6.5	4.5	4.9
Intermediate goods	5.1	4.2	3.8	2.6
Consumer goods	1.1	1.2	3.0	4.0
Durables	-1.6	-1.1	3.0	4.4
Semi and nondurables	2.2	3.2	3.5	3.5

Source: IBGE
1/ Seasonally adjusted data.

Figure 1.7 – Industrial production
Seasonally adjusted data
2000 = 100



Source: IBGE

3.8%, corn 3.7%, and sugarcane, 1.1%. Conversely, rice and bean crops should decrease by 10.8% and 5.5% respectively.

According to the Quarterly Survey on Animal Slaughter, published by the IBGE, the production of poultry, cattle, and pork totaled, in order, 9.9 million, 6.6 million, and 2.9 million tons in 2009, registering annual variations of -2.7%, 0.3%, and 10.9% respectively.

Beef exports totaled 300,000 tons in the first three months of the year, increasing 3.5% over the same period in 2009, as compared with respective decreases of 8.5% and 1.2% in external sales of pork and poultry, which amounted to, in order, 151.5 and 1.1 million tons.

Industrial output

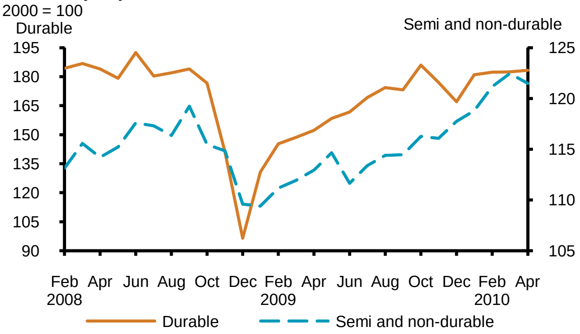
The recovery of industrial activity, facilitated by dynamic domestic demand, has enabled the production of the manufacturing sector to overcome in March, the level registered in the pre-crisis period. Industrial employment, after shrinking in 2009, shows signs of sustainable recovery, while the evolution of business expectations indicates the continuing growth process in the sector, with emphasis on the performance of the capital goods and construction material segments.

Industrial output grew 4.5% in the quarter ended in April, compared to the one ended in January, when it had expanded 2.4% in the same type of comparison, according to seasonally adjusted data from the IBGE's Monthly Industrial Survey – Physical Production (PIM -PF), with the processing industry growing 4.1% and quarrying, 3.9%. It is worth mentioning that the quarterly growth verified in industry reflected the occurrence of positive results in all thirteen federal units surveyed, emphasizing growth reported in Pernambuco, 11.9%, and Goiás, 11.4%.

Analysis of the industrial growth by use categories reveals widespread growth in the period, with emphasis on the expansion of 4.9% in the capital goods segment. The production of durable consumer goods rose 4.4%, followed by the performance of industries of semi-durable and non-durable goods, 3.5%, and intermediate goods, 2.6%.

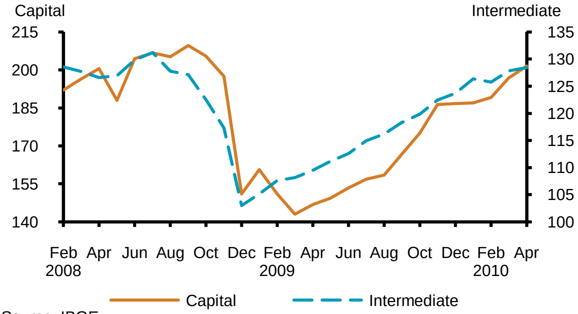
The upswing in the production of capital goods reflected, in part, the quarterly increases registered in the segments of construction goods, 10.8%; mixed-use, 8.6% and electricity, 7.7%, segments.

Figure 1.8 – Industrial production
Durable, semi and non-durable goods
Seasonally adjusted data
2000 = 100



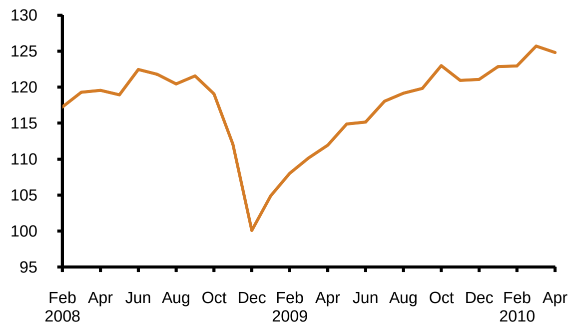
Source: IBGE

Figure 1.9 – Industrial production
Capital and intermediate goods
Seasonally adjusted data
2000 = 100



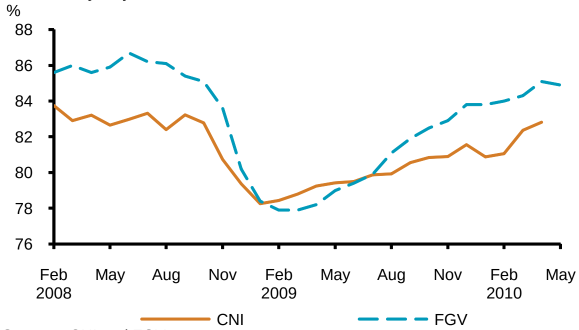
Source: IBGE

Figure 1.10 – Labor productivity
Seasonally adjusted data
2002 = 100



Source: IBGE

Figure 1.11 – Utilization of installed capacity in the manufacturing industry
Seasonally adjusted data
%



Sources: CNI and FGV

The production of automotive vehicles increased 5.8% in the trimester ended in May, compared to the one ended in February, when it had registered an increase of 0.1% in this type of comparison, according to statistics from the National Association of Automotive Vehicle Manufacturers (Anfavea), seasonally adjusted by the Central Bank. The automobile and light commercial vehicle industry grew 5.4% in the period, while production of trucks and buses posted respective expansions of 7.9% and 10.2%. The farm machinery industry increased 10.3% in the quarter, with an emphasis on the increase of 14.7% observed in the production of wheeled tractors.

The rate of employed persons released by the IBGE's Monthly Industrial Survey – Employment and Wages (Pimes), shows an ongoing recovery of industrial employment, which, considering seasonally adjusted data, increased 1.2% in the quarter ended in April, as compared to the one ended in January, the third consecutive positive result, in this type of comparison. Similarly, the number of hours paid in production, which had shown respective elevations of 1.6% and 1.3% for the quarters ending in January 2010 and October of the previous year, increased by 2.1%.

Labor productivity, estimated by the ratio between the physical production and number of hours paid indices, registered an average increase of 2.4% in the quarter ended in April, compared to the one ended in January, when it had grown 0.8%, considering seasonally adjusted data.

The Installed Capacity Utilization Level (Nuci) reached 84.9% in May, according to seasonally adjusted statistics from the FGV's Manufacturing Industry Survey (SIT), rising 0.9 percentage points in relation to February and standing 2.6 p.p. above the average for the series, which was initiated in April 1995. Analysis by use categories shows that the construction materials industry Nuci increased by 5 p.p. in the quarter, reaching a record 91.6%, while for the intermediate goods industry, it grew by 2.3 p.p. to 86.5%. Indicators referring to the consumer and capital goods industries registered stability in the quarter, standing in order at 85.4% and 82.8%, and 1.7 p.p. and 6.8 p.p. below their respective maximum values.

The prospect of continuing industrial expansion is corroborated by the development of businesspeople sentiment surveys. The Industrial Business Confidence Index[1] (Icei), released by the CNI, reached 66.3 points in May, compared to 67.8 points in February, with components

1/ Values above 50 points indicate optimism.

Service Sector Survey

Table 1 – GDP composition by sectors[1/]

%

Sector	2004	2005	2006	2007	2008	2009
Crop/livestock	5.9	4.9	4.7	4.8	5.0	5.2
Industry	25.8	25.1	24.7	23.9	23.3	21.8
Services	54.1	55.8	56.5	57.3	56.8	58.9
Net taxes	14.2	14.2	14.1	14.0	14.9	14.0

Source: IBGE

1/ Values at current prices.

The growing participation of the service sector in the country's Gross Domestic Product (GDP) – it accounted for 58.9% in 2009, as compared to 54.1% in 2004, as shown in Table 1 – evinces the need for monitoring the short-term trends of this sector's segments. In this context, the Getulio Vargas Foundation, in partnership with the Central Bank, developed the Service Sector Survey.

Among other things, this survey aims to generate indicators to predict economic trends within the sector. It consists of a monthly national survey of over 2,000 companies with one or more employees. The coverage of the service sector activities is similar to that of the Annual Service Survey (PAS) of the Brazilian Institute of Geography and Statistics (IBGE), which covers the entire service sector, with the exception of the government, the health sector, part of educational, financial and trade activities.

Thus, the results are disclosed to the service sector as a whole, divided according to scale (small, medium, and large), and by seven segments:

– household services (housing; food; recreational and cultural activities; personal services and continuing educational activities);
– information services (telecommunications; computer activities; audiovisual services; news agencies and journalism services);
– business services (legal, accounting, and business consultancy activities; architecture and engineering services; materials testing and product quality analysis; advertising, selection, management, and leasing of temporary labor; investigative services; security, surveillance, and transportation of

valuables; home and building cleaning services and other business services);

- transportation, auxiliary transportation services and mail (rail and subway transport; road transport; water transport; air transport; travel agencies and tour operators; and other mail delivery activities);
- real estate activities and rental of movable and immovable property (incorporation, purchase and selling of real estate; management, brokerage, and real estate rental to third parties; and rental of vehicles, machinery, and personal and household objects);
- maintenance and repair services (vehicle maintenance and repair; maintenance and repair of personal and household objects; and maintenance and repair of office machinery and computers);
- other service activities (ancillary services related to agriculture; trade agents and commercial representation; ancillary; financial; insurance and pension funds; and urban sanitation and sewage services).

These segments were defined according to the IBGE National Classification of Economic Activities, version 1.0 (CNAE 1.0). The result for each segment is obtained by aggregating the estimated proportions for the three scales, weighted according to the total number of persons employed by each company on the basis of data compiled by the Ministry of Labor’s Annual List of Social Information (RAIS). The result for the service sector is derived from the aggregation of estimated proportions for 31 segments, according to the segment’s value added, based on the IBGE PAS, with the exception of items related to employment, which are weighted by the total number of employed persons disclosed by the PAS.

Answer options for proposed questions are mostly qualitative, thus making it easier to carry out an immediate assessment of the sector’s cyclical state. One of the research key attributes is the quickness with which data is collected, processed, and disclosed, without the need for further revisions. Data thus obtained provide for signals in the three to six month time horizon as of the disclosure’s reference month.

Assessments on the current scenario refer to the variable’s level or situation at the time of research (good, normal or bad situation). Predictions for the future and observations on the recent past are made in a comparative manner (situation expected to improve, remain unchanged, or worsen). Some questions are addressed to the company as a whole, such as the items related to employment standards, factors that limit the business improvement, and credit conditions, while others are related to the level of services offered. When the company supplies more than one relevant line of services, answers are provided for each of these lines. The Survey’s questions are related to the following items:

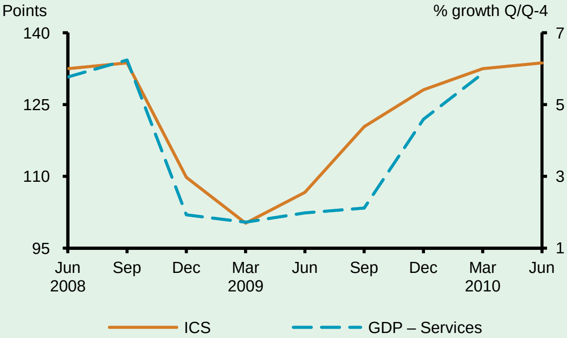
– current state of business: the study seeks to capture the company’s sentiment in relation to the general state of business. Typically, when evaluating the state of business, companies take into consideration microeconomic factors, such as profit and revenue margins, and macroeconomic factors that affect their performance, such as interest and exchange rates, as well as tax burden. As for the timeframe, the state of business is evaluated in relation to the moment the survey is being conducted;
– business trends: companies should evaluate, disregarding seasonal effects, if the state of business over the next six months will improve, remain unchanged, or worsen;
– forecast employment: the objective is to prospect for the next three months the company’s contingent manpower in relation to the survey’s reference month;
– volume of current demand: the purpose is to assess the current level of demand for the company’s services at the survey’s reference month;
– expected demand: the company should estimate, disregarding seasonal effects, how the volume of demand for its services would evolve over the next three months;
– sales forecast: the objective is to measure the prospects for the next three months in relation to the survey’s reference quarter;
– price: evaluates the outlook for the company’s prices during the quarter following the survey’s reference month;
– credit conditions: seeks to assess the degree of difficulty in acquiring credit in the banking system in the survey’s reference month;

– limiting factors to improving the state of business: if they exist, the company should select the most important factors among six suggested factors, or specify a factor not included in the survey.

For each of the survey's items, a summary indicator is created, based on the proportion of favorable responses to the question minus the proportion of unfavorable responses, plus 100. Thus, if the proportion of favorable responses is equal to the proportion of unfavorable responses, the indicator remains at 100 points, denominated the zone of indifference. Values above 100 indicate optimism and values below 100, pessimism.

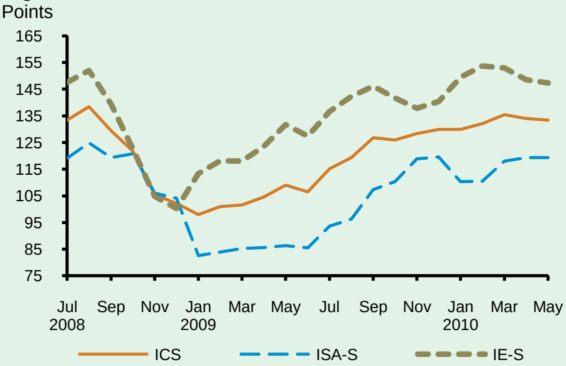
The Service Confidence Index (ICS), the survey's summary index, represents the arithmetic mean of two indicators: the Current Situation Index (ISA-S) and the Expectations Index (IE-S). The ISA-S is calculated by the arithmetic mean of current state of the business situation and the volume of current demand items. Similarly, the IE-S is equal to the arithmetic mean of the business trends and the expected demand items.

Figure 1 – Services Confidence Index (ICS) and GDP services



Sources: IBGE and FGV

Figure 2 – Service Confidence Index



Sources: IBRE/FGV and BCB

The ICS trajectory, according to the historical series begun in June 2008, seems consistent with the recent service sector developments. Accordingly, after increasing in the first three months, the ICS started to drop as of August of 2008, reaching the minimum value in January 2009, coinciding with the worsening of the world financial crisis. It is worth highlighting the good adherence of the ICS quarterly average to the GDP service sector indicator released on a quarterly basis by the IBGE, as shown in Figure 1. The ICS mean observed in the early months of the second quarter of 2010 suggests the persistence of service sector activity growth, which shall reflect on the next GDP results.

The analysis at the margin, shown in Figure 2, reveals that the index fell 1.1% in April, in relation to the previous month, reaching 134 points, lower than in the previous month, 135.5 points, and in August 2008, 138.4 points, only. At the margin, ISA-S increased 1.2% in the month, to 119.4 points, the highest value since October 2008, and IE-S, in spite of a 2.9% drop, to 148.6 points, remained at a high level.

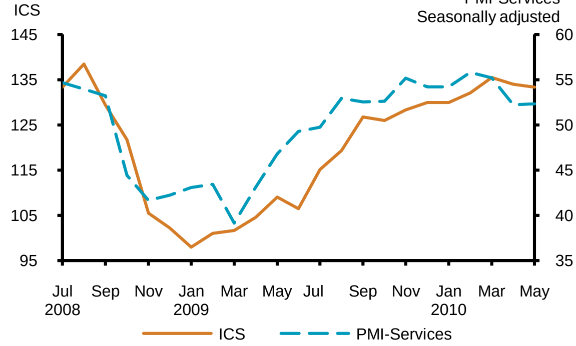
Table 1.6 – Industry Confidence Index[1/]

	2010				
	Jan	Feb	Mar	Apr	May
Industry Confidence Index	113.6	115.8	116.5	115.3	116.1
By component:					
Current Situation Index	112.6	113.4	117.3	120.0	119.2
Global demand level	114.3	112.3	117.6	119.7	120.8
Inventory level	96.9	99.7	99.4	101.3	100.5
Business situation	123.5	124.9	131.8	136.2	133.3
Expectations Index	114.5	118.3	115.7	110.5	113.0
Business situation	162.2	169.6	163.7	158.7	160.3
Employment	120.8	128.3	125.2	123.0	126.2
Physical production	139.2	137.9	137.2	125.2	129.2

Source: FGV

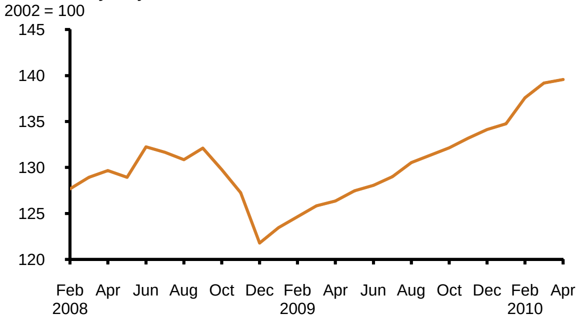
1/ The average of the last ten years is equal to one hundred.
Seasonally adjusted series.

Figure 1.12 – Services Confidence Index
ICS and PMI-Services



Sources: FGV and HSBC/Markit

Figure 1.13 – Central Bank Index of Economic Activity – Brazil
Seasonally adjusted data



Source: IBGE

that assess the current situation and expectations for the next six months, closing at 61 and 69.1 points in the same order. The FGV's Industrial Confidence Index[2] (ICI), recorded a quarterly increase of 0.3 p.p. and hit 116.1 points, reflecting marked increases in the components of business perception relating to the level of demand, 8.5 points, and current state of businesses, 8.4 points, partly offset by the 5.3 points drop in relation to expectations. By use categories, one should note the 18.6 points quarterly increase observed in the construction materials segment indicator.

The Purchasing Managers Index (PMI), calculated by Markit and published by HSBC Bank Brazil (HSBC), reached 52.4 points in May[3], compared with 55.8 points in February, considering seasonally adjusted data. This deceleration resulted from a reduction in all of the index components, with emphasis on the new orders indicator, which fell by 5.4 points to 51.9 in the period.

Services

The Services Confidence Index (ICS), developed by the FGV in partnership with the Central Bank, aims to map the activity level and business expectations of the service sector, the most representative of the Brazilian economy[4]. After reaching 135.5 points in March, the second largest value in the series, which began in June 2008, the indicator recorded monthly variations of -1.1% in April and -0.4% in May, resulting from the stability in the ISA-S and a decrease of 0.8% in IE-S, but remained at a level of optimism. Similarly, the PMI-Services[5], which is calculated by Markit and released by HSBC, reached 52.3 points in May, down from 55.8 in February, when seasonally adjusted data are considered. The indicator, without seasonal adjustment, reached 54.1 points in May, up from 48.6 points in the same period last year.

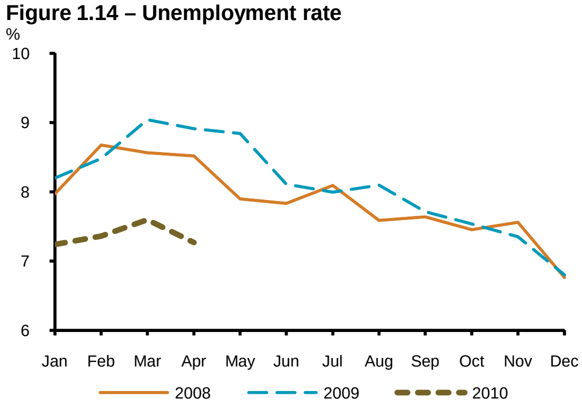
Central Bank Index of Economic Activity – Brazil (IBC-Br)

The IBC-Br[6] registered 2.4% growth in the quarter ended in April, compared to the one closed in January, when it had

2/ Values above 100 points indicate a sentiment of optimism.
3/ The PMI summarizes the monthly development of the indicators for new orders, production, employment, delivery time, and inventory of inputs. Values above 50 represent monthly expansion of activity.
4/ The methodology for calculating the indicator can be found in the Box: Survey of the Service Sector, on page 18 of this Report.
5/ The index is constructed based on monthly responses sent by executives of about 400 private companies in the service sector, with the panel selected to replicate the actual structure of the sector, covering the activities of transportation and communication, financial intermediation, business services, personal services, computer and information technology, and hotels and restaurants. Values above 50 represent growth in activity.
6/ The indicator's mothodology may be found in the box "Central Bank Index of Economic Activity" on page 24 of the march 2010 Inflation Report.

risen 2.8% in the same type of comparison, considering seasonally adjusted data. The monthly analysis reveals that the indicator increased 0.3% in April, the sixteenth consecutive increase in this type of comparison. The quarterly moving average of the IBC-Br increased 0.8% in April, compared to 0.9% in March and 0.7% in February, a shift that reinforces the prospects for continuing the cycle of expansion that the economy finds itself in. The index grew 11.8% in April, compared to the same month last year, accumulating a 10.5% expansion on the year and 4.1% in 12 months.

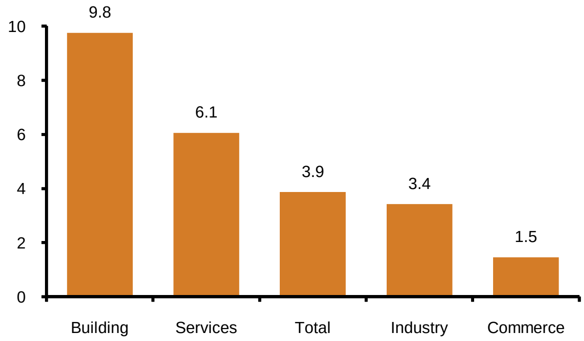
Figure 1.14 – Unemployment rate



Source: IBGE

Figure 1.15 – Occupied people

Quarter over the same-quarter of the previous year – April



Source: IBGE

Table 1.7 – Formal employment

New jobs – in the year (1,000)

	2009	2010			
	Year	Jan	Feb	Mar	Apr
Total	995.1	181.4	390.8	657.3	962.3
Manufacturing industry	10.9	68.9	131.9	204.4	287.4
Commerce	297.2	-6.8	3.9	33.3	74.0
Services	500.2	57.9	143.5	249.9	346.5
Building	177.2	54.3	89.1	127.7	166.1
Crop and livestock	-13.6	4.1	8.1	18.5	57.4
Public utilities	5.0	2.5	4.4	6.0	7.8
Others[1/]	18.3	0.4	10.0	17.5	23.1

Source: MTE

1/ Includes mining, public administration and others.

1.3 Labor market

Employment

Growth in job market indicators has been consistent with the dynamism of economic activity, registering a decline in the unemployment rate and qualitative improvements in the generation of jobs, expressed by the substitution of informal jobs for those with registered documentation. Real labor income, although negatively impacted due to the acceleration of price indices in the recent past, continues to grow.

Considering the IBGE's Monthly Employment Survey (PME) that was conducted in the country's six major metropolitan areas, the unemployment rate reached 7.3% in April, constituting – as observed in the seven previous months – the lowest rate for the month.

Using seasonally adjusted data, the unemployment rate reached an average of 7% in the quarter ended in April, compared to 7.7% in the quarter that ended in January, representing the largest quarterly decline and the lowest level in the historical series, which began in March of 2002. This movement reflected the marked increase in employment, 1.9%, the highest quarterly growth since April 2003, partly offset by the 1.1% expansion registered in the Overall Labor Force (PEA).

The unemployment rate fell 1.4 p.p. in the quarter ended in April, compared to the same period last year, pointing to the 3.9% increase observed in employment, which revealed, in particular, expansions in construction, 9.8%, in services, excluding domestic services, 6.1%, and in industry, 3.4%. Additionally, it should be noted that formal job openings and the number of informal jobs showed respective variations of 6.8% and -0.1% in the quarter ended in April, resulting in an increase of 1.4 p.p. in the ratio of formalization – defined as

Extended Payroll and Available Extended Payroll: improving the concept and recent comparative development

Overall Earnings (MSA)[1] is defined as an aggregate that incorporates overall labor income and security benefits and welfare and social programs of the government. It is worth noting that this concept was often mentioned after the escalation of the global financial crisis, in an environment of reduced liquidity, as well as deterioration of expectations and to a lesser extent, the conditions of the labor market, since its dynamics has contributed to sustain the dynamism of domestic demand[2]. Given the relevance of the MSA concept in better understanding the evolution of private consumption, this Box introduces a methodological improvement, expressed in the creation of the concept of Available Extended Payroll (MSAD).

Income from work considered in the Monthly Employment Survey (PME) and the Household Sampling National Survey (PNAD) of the Brazilian Institute of Geography and Statistics (IBGE), used in calculating the MSA, does not exclude discounts corresponding to social security payments and to income tax levying at source, which can reduce its explanatory power, for example, in times of changing tax and/or social security legislation. Therefore, in this sense, the MSAD calculation uses gross income, but excludes the burden of taxes and social security contributions.

MSAD = MRB – (IR + CP) + BPS + BP;

Where MRB = N x RMB such that MRD = MRB – (IR + CP).

1/ See Box – Overall Earnings: Concept and Recent Developments, published in the September 2009 Inflation Report.

2/ See Box – Determinants of the Recent Evolution of Private Consumption, published in the September 2009 Inflation Report.

Where:
MRB = Overall gross labor income;
IR = Income tax;
CP = social security contributions;
BPS = social protection benefits;
BP = social security benefits;
N = number of employed personnel in the country;
RMB = average gross income;

It is worth noting that in constructing the MSAD, the methodology adopted in the calculation of the MSA is followed, including additionally the IR component that incorporates the resources from work income[3] withheld at the source, and the quota- adjustment declarations of salaried workers, and the CP component that includes contributions to the General Social Security System (RGPS), to the Civil Servant Social Security (RPSP), and to Closed Entities of Complementary Social Security (pension funds)[4].

Table 1 shows the real variation of MSAD in the five-year period ending in 2009 and the participation of its components that year. The MRB, indicating the positive trajectory of the labor market, expressed as an increase in the formalization rate and in recurrent real gains, registered an average actual increase of 5.6% in the period, while inflows regarding income tax and social security contributions increased 6.8%. The most pronounced average increase of these inflows, when compared to those registered in MRB, was reflected in the performance of the overall income from available work (MRD), which marked an average growth of 5.4% in the five years ending in 2009. It is worth mentioning that the other MSAD components registered an average real growth of 7.9% in the period, with emphasis on the 18.2% increase in spending on the federal government social protection programs.

The participation of MRB in MSA reached 75.1% in 2009, and of the other components (BPS and BP), 24.9%. The introduction of the concept of availability in the overall income from work and in extended

3/ Include revenue from social security benefits.
4/ Contributions to the RGPS include individual payments as well as those carried out by companies and entities alike; those targeted to the RPSP include contributions to maintain the military personnel pensions as well as those channeled to the active civil service personnel, retired civil servants and pensioners.

Table 1 – Available overal real earnings
Cumulative data

	Share 2009	2005	2006	2007	2008	2009	Average 2009/2004	% variation 2010 (until March)
Gross overall labor earnings (MRB)[1/]	100.0	5.5	6.0	5.2	7.8	3.3	5.6	5.7
Income tax and social security contributions[2/]	10.2	3.7	13.9	3.7	11.1	1.5	6.8	5.4
IRRF-labor and IR-wage earner	5.4	7.5	7.6	4.8	14.1	-2.3	6.4	4.6
RGPS contributions	3.5	13.3	16.7	9.2	6.8	6.1	10.4	7.1
RPSP contributions	0.8	29.2	14.1	8.0	9.7	8.2	13.8	6.2
Pension funds contributions	0.5	4.4	4.0	3.8	12.5	3.1	5.6	1.9
Disposable overall labor earnings (MRD)[3/]	73.0	5.7	5.2	5.3	7.4	3.6	5.4	4.4
Others	27.0	8.7	10.0	8.2	3.3	9.3	7.9	10.1
Social security programs	3.6	25.7	21.5	15.1	9.4	19.0	18.2	10.4
Family allowance	0.9	42.1	28.1	14.4	11.1	11.3	21.4	19.4
Benefits of Continuous Support (BPC)	1.2	22.2	25.2	14.1	12.0	16.5	18.0	16.8
Unemployment insurance and professional qualification	1.4	18.0	13.8	16.5	5.9	26.5	16.1	-1.4
Social security benefits	23.5	7.3	8.7	7.3	2.5	8.0	6.8	10.1
RGPS	16.7	9.9	9.9	7.4	1.1	7.3	7.1	10.0
RPSP	5.1	0.5	6.2	7.9	7.4	8.6	6.1	10.2
Pension funds	1.7	2.0	4.8	4.8	2.3	13.4	5.5	10.9
Available overall real earnings	100.0	6.4	6.4	6.1	6.3	5.1	6.0	5.9

Sources: IBGE, MDS, RFB, STN, MPS and SPC.
1/ Product of the working population by the effective income in the PME. (djusted by the effective income in the PNAD).
2/ 2009 participation in the total IRRF and salaried IR: 52.8%; RGPS contributions: 34.4%; RPSP contributions: 8.3%; and Pension funds contributions: 4.5%.
3/ Gross overall labor income less income tax and social security contributions.

payroll, excluding inflows related to income tax and social security contributions changed the ratio between components and the aggregate total, with MRBD representing 73% of MSAD.

Figure 1 – Available overall real earnings and selected components

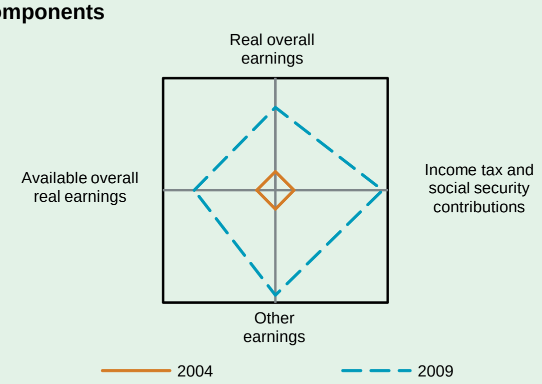
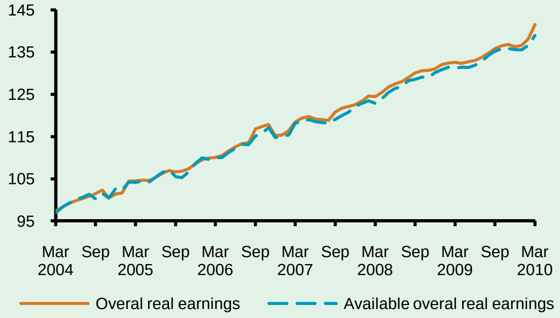


Figure 1 illustrates the development of the payroll concepts covered in this box and the impact of the average real increases indicated in other income and other inflows regarding income tax and social security contributions. In this respect, the diamond, which represents the indices referring to the mentioned variables with base 100 in 2004, becomes asymmetric toward the axis representing income tax and social security contributions and to the one related to other earnings. The real MSA and the real MSAD display uniform standards of development and relatively lower growth in the period.

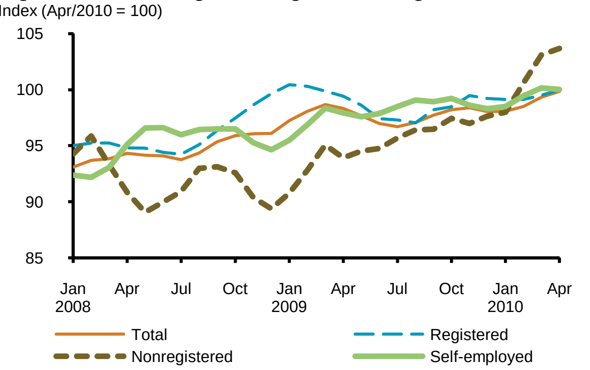
Figure 2 – Overal real earnings and available overal real earnings
Seasonally adjusted data quartely moving average
2004 = 100



In fact, the trajectories of the real quarterly moving averages MSA and MSAD, shown in Figure 2, show good adhesion, as expected.

In summary, although the general exclusion of IR and CP does not significantly alter the seasonal and cyclical component of the series, the concept of MSAD is quite useful at specific times. In this respect, it complements the MAS explanatory power.

Figure 1.16 – Average real regular earnings



Source: IBGE

the ratio between the number of documented workers and the total number of employed people – which hit a record 50.9% in the period.

According to the General Register of the Employed and Unemployed (Caged), from the Ministry of Labor and Employment (MTE), 962.3 thousand formal jobs were created in the first four months of 2010, the most significant result in the period since the series began, in January of 1985. In this four-month period, net formal employment openings were registered in record numbers in all segments of the economy, reaching 346.5 thousand in the service sector, 287.4 thousand in manufacturing, 166.1 thousand in construction, and 74 thousand in commerce.

Income

The average real income commonly earned by employed persons in the six metropolitan areas covered by the PME, increased 1.5% in the quarter ended in April, compared to the same period of the previous year, reaching the highest level for the quarter in the series, which was initiated in March of 2002. Real earnings increased 10.4% in the informal segment and 0.6% in the segment of registered workers, while in relation to the main economic sectors, relevant increases were registered in construction, 12.4%, in commerce 5.1%, and domestic services, 4.4%.Real overall wages, a product of the average real earnings commonly earned by the number of employed, grew by 5.5% in the quarter.

1.4 Gross Domestic Product

Table 1.8 – Gross Domestic Product

Quarter/previous quarter

Seasonally adjusted

% growth

	2009				2010
	I Q	II Q	III Q	IV Q	I Q
GDP at market prices	-1.5	1.5	2.2	2.3	2.7
Crop and livestock	-5.9	1.8	-0.5	0.2	2.7
Industry	-4.5	1.5	3.3	4.0	4.2
Services	0.9	1.4	1.6	0.7	1.9
Household consumption	0.0	2.9	2.5	2.1	1.5
Government consumption	4.5	-0.2	0.5	0.6	0.9
Gross fixed capital formation	-12.0	2.1	7.5	7.1	7.4
Exports	-14.9	9.0	0.0	3.3	1.7
Imports	-17.6	5.8	3.4	13.3	13.1

Source: IBGE

The GDP grew 2.7% in the first quarter of 2010, compared to the fourth quarter of the previous year, according to seasonally adjusted data from the IBGE's Quarterly National Accounts, increasing 9% over the same period in 2009. The favorable trends in the job market, real income, investments, and indicators of business and consumer confidence are important signs that the current cycle of the Brazilian economy should be sustainable over the medium-term.

The evolution of GDP at margin, which corresponds to the fourth consecutive aggregate increase in this type of comparison, reflected increases in industry, 4.2%, agriculture and livestock, 2.7%, and the service sector, 1.9%. In relation to demand components, continued growth in Gross Fixed Capital Formation (GFCF) was emphasized, at 7.4%, while household and government consumption increased by 1.5%

Table 1.9 – Gross Domestic Product at market prices

% growth

	2009				2010
	I Q	II Q	III Q	IV Q	I Q
Accumulated in the year	-2.1	-1.9	-1.7	-0.2	9.0
Accumulated in 4 quarters	3.0	1.0	-1.0	-0.2	2.4
Quarter/same quarter of the previous year	-2.1	-1.6	-1.2	4.3	9.0
Quarter/previous quarter 1/	-1.5	1.5	2.2	2.3	2.7
Crop and livestock	-5.9	1.8	-0.5	0.2	2.7
Industry	-4.5	1.5	3.3	4.0	4.2
Services	0.9	1.4	1.6	0.7	1.9

Source: IBGE

1/ Seasonally adjusted data.

Table 1.10 – Gross Domestic Product
Quarter/same quarter of the previous year

% growth

	2009				2010
	I Q	II Q	III Q	IV Q	I Q
GDP at market prices	-2.1	-1.6	-1.2	4.3	9.0
Households consumption	1.5	3.0	3.9	7.7	9.3
Government consumption	4.3	3.9	1.6	4.9	2.0
Gross fixed capital formation	-14.2	-16.0	-12.5	3.6	26.0
Exports	-15.4	-11.4	-10.1	-4.5	14.5
Imports	-15.8	-16.5	-15.8	2.5	39.5

Source: IBGE

1/ Estimated.

Table 1.11 – Gross Domestic Product
Quarter/same quarter of the previous year

% growth

	2009				2010
	I Q	II Q	III Q	IV Q	I Q
Crop and livestock	-2.8	-4.4	-9.0	-4.6	5.1
Industry	-10.4	-8.6	-6.9	4.0	14.6
Mining	-2.6	-1.8	-2.0	5.6	13.6
Manufacturing	-14.0	-10.8	-7.9	4.7	17.2
Construction	-9.6	-9.3	-8.4	2.5	14.9
Public utilities	-4.2	-3.8	-3.3	1.4	8.1
Services	1.7	2.0	2.1	4.6	5.9
Commerce	-6.0	-3.8	-2.8	8.1	15.2
Transportation	-6.2	-5.4	-2.9	5.4	12.4
Communications	6.4	6.8	4.5	2.1	2.6
Financial institutions	6.2	5.0	6.1	8.5	9.0
Other services	5.8	6.2	4.9	3.5	2.4
Rents	1.3	1.4	1.4	1.5	1.8
Public administration	3.4	2.9	3.2	3.2	2.3
Value added at basic prices	-1.8	-1.3	-1.1	3.9	8.0
Taxes on products	-4.2	-3.5	-2.0	6.2	14.9
GDP at market prices	-2.1	-1.6	-1.2	4.3	9.0

Source: IBGE

and 0.9% respectively in the period. Exports grew by 1.7% and imports, in line with growth of domestic demand, expanded 13.1%.

GDP performance over the first quarter of 2009 showed the consolidation of buoyant domestic demand, accounting for the 11.8 p.p. growth during the quarter, compared with the contribution of -2.9 percentage points of the external sector.

Considering the demand perspective in a scenario of increased real payroll, employment and credit and steady consumer confidence at a high level, household consumption increased 9.3% in the period, representing the twentieth-sixth positive result in this type of comparison. The GFCF, reflecting the trajectory of the indexes of business confidence and performance of the construction and capital goods industries, increased 26% in the period, while government consumption expanded by 2%. The negative contribution of the external sector, consistent with the soundness of domestic demand and the less buoyant global economy, reflected increases in exports, 14.5%, and imports, 39.5%.

Concerning the supply components, the inter-annual performance of GDP reflected increases in production in the industrial, 14.6%, services, 5.9%, and agriculture and livestock, 5.1%, sectors.

The industry’s overall performance was boosted by a strong manufacturing sector, 17.2%, and construction, 14.9%, the latter favored by the increase in resources targeted to mortgages and infrastructure works in the PAC framework. Electricity output and distribution of electricity, gas, and water increased 8.1% in the period, while mining activity, with emphsasis on the performance of the iron ore segment, grew 13.6%.

The agriculture and livestock sector grew by 5.1% in the first quarter of 2010, in comparison with the same period of the previous year, with emphasis on results of cotton, corn, and soybean crops.

Highlighting the stronger domestic demand, the service sector grew by 5.9% in the period, highlighting the expansion of the commerce, 15.2%, and the transport, warehouse, and postal service, 12.4%, segments, reflecting in part, the performance of the agriculture, livestock and industrial sectors. The financial intermediation sector, insurance, complementary social security, and related services grew by 9%, followed by expansions recorded in the information services, 2.6%; other services, 2.4%; administration, public health and education, 2.3%; and the segments of real estate and rent, 1.8%.

GDP growth forecasts for 2010 are detailed in the Box: GDP Projection for 2010, on page 30 of this report.

1.5 Investments

Investments, excluding variations in stocks, increased by 26% in the first quarter of 2010, in relation to the same period in 2009, according to the Quarterly National Accounts, released by the IBGE. Margin analysis, considering seasonally adjusted data, confirms the upward trend of investments, which increased 7.4% in relation to the fourth quarter of 2009, and is an important signal that the current cycle of economic expansion will be sustainable.

The performance of investments at margin had been anticipated by the trend of the monthly indicators of GFCF. Following the same line, the production of inputs for construction registered a 3.9% expansion in the first quarter of 2010, compared to the quarter ended in the last December, while production, import, and export of capital goods reported respective increases of 4.5%, 13.1%, and 2.9%, resulting in growth of 5.9% in the consumption of these goods.

Growth in production of capital goods reflected a widespread sectoral expansion, with emphasis on the performance in the segments of goods for agricultural parts, 33.2%, industrialized goods, 13.6%, goods produced for the agricultural sector, 7.4%, transportation equipment, 7.3%; goods for the construction industry, 5%, and goods for the electricity sector, 3.3%.

Disbursements from the BNDES system, – BNDES the Special Agency for Industrial Financing (Finame), and BNDES Participações S.A. (BNDESpar) totaled R$25.5 billion in the first quarter of 2010, rising 42.5% over the same period in 2009. Resources intended for agriculture and livestock grew 129.9% and those intended for the commerce and services sectors, 70.5%. Disbursements for the processing industry, representing 29.4% of the resources provided by BNDES in the quarter, fell by 2.7% over the same period in 2009.

Revision of the GDP Projection

Table 1 – Gross Domestic Product
Accumulated in the year

% growth

	2009				2010	2010
	I Q	II Q	III Q	IV Q	I Q	IV Q[1/]
Crop and livestock	-2.8	-3.7	-5.3	-5.2	5.1	5.4
Industry	-10.4	-9.5	-8.6	-5.5	14.6	11.6
Mining	-2.6	-2.2	-2.1	-0.2	13.6	9.4
Manufacturing	-14.0	-12.3	-10.7	-7.0	17.2	12.3
Construction	-9.6	-9.5	-9.1	-6.3	14.9	13.3
Public utilities	-4.2	-4.0	-3.7	-2.4	8.1	7.4
Services	1.7	1.9	1.9	2.6	5.9	5.3
Commerce	-6.0	-4.9	-4.2	-1.2	15.2	9.0
Transportation	-6.2	-5.8	-4.8	-2.3	12.4	9.4
Communications	6.4	6.6	5.9	4.9	2.6	4.8
Financial institutions	6.2	5.6	5.8	6.5	9.0	6.3
Other services	5.8	6.0	5.6	5.1	2.4	4.8
Rents	1.3	1.4	1.4	1.4	1.8	2.4
Public administration	3.4	3.2	3.2	3.2	2.3	3.0
Value added at basic prices	-1.8	-1.5	-1.4	-0.1	8.0	6.9
Taxes on products	-4.2	-3.8	-3.2	-0.8	14.9	9.8
GDP at market prices	-2.1	-1.9	-1.7	-0.2	9.0	7.3

Source: IBGE
1/ Estimated.

The estimated growth of Gross Domestic Product (GDP) for 2010 was revised from the 5.8% showing in the two last inflation reports to 7.3%. This increase in the projection is in line with results disclosed in the first half-year and reflects general improvement in the activity indicators, whether by the perspective of production or demand.

The crop and livestock sector should grow 5.4%, an increase of 0.1 p.p. compared to the projection made in the March report, consistent with the changes forecasted in the Systematic Farm Production Survey (LSPA), by the Brazilian Institute of Geography and Statistics (IBGE). The increases in yields of soybean, wheat, and coffee crops are estimated at 19.2%, 13.1%, and 10.9% respectively.

The projected expansion of the industrial sector went from 8.3% to 11.6%, with emphasis on the revised estimate, from 10.1% to 13.3%, for the construction industry, which reflects the dynamism of the sector in the early months of the year along with its very favorable outlook for the second half. Growth estimates for the manufacturing industry went from 8.2% to 12.3%; the mining industry, from 6.1% to 9.4%; and the production and distribution of electricity, gas, and water, 7.3% to 7.4%.

The service sector should grow 5.3%, compared to 4.7% in an earlier projection. This increase was mainly determined by the respective expansions of 2.4 p.p. and 2.9 p.p. in the growth estimates for the commerce and transportation subsectors, and the warehousing and postal subsectors, directly influenced by the performance of agriculture and livestock, and industry.

Table 2 – Gross Domestic Product
Accumulated in the year

% growth

	2009				2010	
	I Q	II Q	III Q	IV Q	I Q	IV Q[1/]
GDP at market prices	-2.1	-1.9	-1.7	-0.2	9.0	7.3
Household consumption	1.5	2.3	2.8	4.1	9.3	7.2
Government consumption	4.3	4.1	3.3	3.7	2.0	3.2
Gross fixed capital formation	-14.2	-15.1	-14.2	-9.9	26.0	17.1
Exports	-15.4	-13.2	-12.1	-10.3	14.5	12.6
Imports	-15.8	-16.2	-16.0	-11.4	39.5	27.8

Source: IBGE
1/ Estimated.

Considering the demand perspective, the estimate for household consumption increased from 6.1% to 7.2%, a consistent evolution with prospects of continued improvement in employment and income; while the estimate for government consumption grew 0.3 p.p. to 3.2%, after adjustments ahead of the last quarterly results. Gross Fixed Capital Formation (FBCF) is expected to grow 17.1% compared to 15.7% in the previous forecast, an increase consistent with the high level of business confidence and increasing capacity utilization. This framework should be strengthened by projects related to the oil sector (sub-salt) and infrastructure, led in large part by the public sector. Furthermore, these projects, along with the execution of events like the World Cup and the Olympics, generate many externalities for the economy as a whole and should encourage the expansion of private investment this year and in the years to come. The contribution of domestic demand to GDP results is expected to reach 9 p.p.

Exports are expected to increase 12.6% and imports, 27.8%, compared to respective increases of 12% and 20.4% in the previous estimate. The prospect of a more intense growth of imports reflects the fact that the economy is going through a new cycle of expansion, driven by domestic demand. On the other hand, the relatively modest performance of exports reflects the unfavorable prospects for growth of some of Brazil's important trading partners. These trajectories should reflect the negative contribution of 1.7 p.p. by the external sector to GDP in 2010.

Statistics for April reinforces the investment growth trajectory. In this respect, production, imports, and exports of capital goods increased, in order, by 2.6%, 0.9%, and 3.4% compared to March, resulting in expansion of 2.2% in the consumption of these goods, while the production of inputs for construction indicated a 1.4% monthly increase.

1.6 Conclusion

The economy is undergoing a new cycle of expansion, as shown by the national accounts concerning the first quarter of 2010, an impressive result in quantitative terms – the quarterly GDP grew 9% in relation to the same period last year – and, especially in qualitative terms, in view of the significant contribution of investments.

Domestic demand remains the essential fuel for the pace of economic growth, with emphasis on investment recovery, which confirms the scenario of sustainable, in the medium term, of economic expansion. This view gains additional support in the evolution of reliable of business and consumer confidence indicators; of the credit market conditions, which recorded an increase in the volume of loans and declining interest rates, spreads, and defaults; and in the job market, expressed in real salary gains and the increase in the rate of formal employment.

Household consumption should continue to be driven by the willingness of workers to commit future income in a scenario of high confidence and credit availability, while the recovery of investments, indicating the favorable expectations of business, the increase of capacity utilization, and the behavior of the construction industry tend to consolidate.

The favorable outlook regarding the development of economic activity in the coming quarters should incorporate, however, the negative impact of the effect of anticipated purchases in the first quarter of the year, in response to the end of tax relief programs in the segments of automobiles and other durable goods, which occurred in the early months of the second quarter.

Prices

2

Inflation, measured by variations in producer price indices, pressured by rising agricultural and industrial prices, registered acceleration in the quarter ended in May, compared to the one finalized in February.

The change in consumer prices remains at a high level, despite the lesser pressure associated with the annual rise of monthly school fees and the cooling down of prices of perishable food and regulated prices. Inflation associated with market prices, highlighting in particular the pressure exerted by services, recorded acceleration at the margin, partly due to rising labor costs.

Pressures in the scope of consumer pricing should be observed in the coming months due to the pass-through of wholesale price increases. In this scenario, where twelve-month cumulative inflation rates indicate a growth tendency, there are risks of decoupling from the goal established by the National Monetary Council (CMN).

2.1 General indices

The Consumer Price Index – Internal Availability (IGP-DI), published by the FGV, registered a variation of 2.95% in the quarter ended in May, up from 2.00% in the one that ended in February. The growth reflected the impact of accelerations recorded in producer prices and construction costs, the latter indicating the increase in manpower. In contrast, there was a slowdown of 0.38 p.p., to 1.84%, in the Consumer Price Index (IPC) variation. In 12-month periods, the IGP-DI posted a 4.38% growth rate in May, against 0.77% in February, the highest result in this type of comparison, since the 4.74% growth in April 2009. An upward trend in price variations of the three indicator components was registered.

Table 2.1 – General price indices

Monthly % change

	2010				
	Jan	Feb	Mar	Apr	May
IGP-DI	1.01	1.09	0.63	0.72	1.57
IPA	0.96	1.38	0.52	0.68	2.06
IPC-Br	1.29	0.68	0.86	0.76	0.21
INCC	0.64	0.36	0.75	0.84	1.81

Source: FGV

The Broad Producer Price Index (IPA) grew 3.29% in the quarter ended in May, up from 2.06% in the one ended in

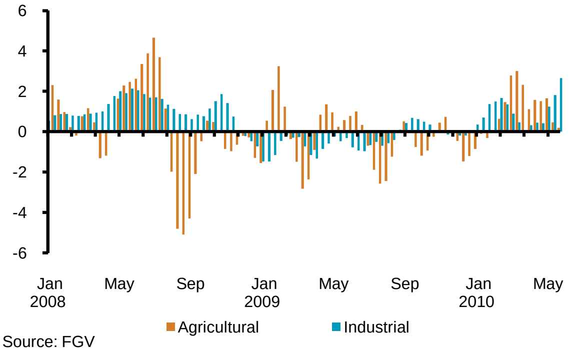
February. Agricultural prices rose 4.08% in the period, compared with a drop of 0.08% in the quarter ended in February, with emphasis on variations in beans, 67.26%; white potatoes, 39.96%; unprocessed milk, 25.52%; tomatoes, 15.81%; cotton, 11.81%; pork, 11.53%, sugarcane, 6.26%, and cattle, 6.09%. Industrial prices registered respective variations of 3.04% and 2.75% in the quarters in question, associated with acceleration, in particular, of the impact of increased prices of the metallic minerals segment, 61.16%; dairy products, 6.88%; basic metallurgy, 6.79%; and tobacco products, 5.29%, partly offset by downturns in the prices of alcohol, 26.04%, food products and beverages, 3.17%, and electronic material, a 1.75%. The cumulative IPA variation over 12 months was 3.77% in May, compared to -1.19% in February.

The quarterly IPC slowdown reflected, in particular, the 0.44% falloff in Transport group prices, contrasting with the marked 5.57% expansion in the quarter ended in February. Considering 12-month periods, the indicator presented respective increases of 5.28% and 4.91% in May and February.

The National Cost of Construction Index (INCC), after registering growth of 1.10% for the quarter ended in February, increased by 3.44% in the one ended in May. This result reflected respective increases of 5.33% and 1.72% registered in the prices of labor and materials and services. Considering 12-month periods, the INCC varied 6.07% in May compared to 3.66% in February.

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

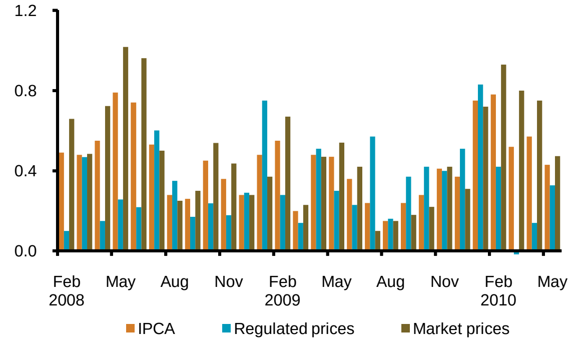
Monthly % change



Source: FGV

Figure 2.2 – IPCA

Monthly % change



Source: IBGE

Table 2.2 – Consumer prices

Monthly % change

	2010				
	Jan	Feb	Mar	Apr	May
IPCA	0.75	0.78	0.52	0.57	0.43
Non regulated prices	0.72	0.93	0.80	0.75	0.47
Tradables	0.68	0.26	0.53	0.61	0.42
Nontradables	0.75	1.54	1.03	0.87	0.52
Services	0.61	1.81	0.72	0.50	0.62
Regulated prices	0.83	0.42	-0.14	0.14	0.33

Sources: IBGE, Banco Central and FGV

2.2 Consumer price indices

The IPCA, released by the IBGE, grew 1.53% in the quarter ended in May, compared to 1.91% in the one ended in February. This evolution was associated, in particular, with the slowdown of regulated prices from 1.77% to 0.32%, with emphasis on the decrease in the prices of air fares, 11.94%, and gasoline, 2.49%, which had increased 31.77% and 2.45% respectively in the quarter ended in February.

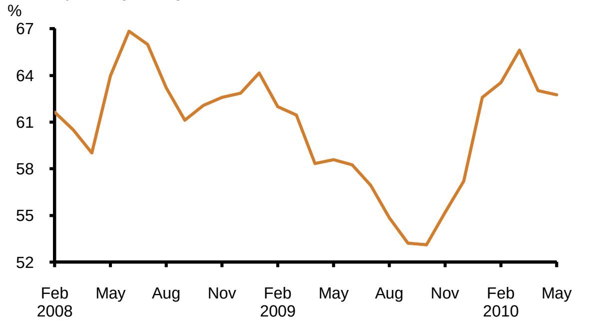
The variation in market prices reached 2.03%, compared to 1.97% in the quarter ended in February, a movement resulting from the larger impact of the 1.10% to 1.58% variation in prices of tradable goods, in relation to the reduction from 2.76% to 2.44% in those prices of non-tradable goods and services. It is worth mentioning that the quarterly performance in the prices of tradable goods reflected primarily the higher prices of beef, dairy products, apparel, and new cars.

Considering periods of 12 months, the IPCA registered a variation of 5.22% in May, up from 4.83% in February, a result of the increase from 4.77% to 5.60% in market prices, and decrease from 4.97% to 4.31% with reference to regulated prices.

The trajectory of market prices shows the recent high experienced particularly in the prices of durable and nondurable consumer goods. In this respect, the impact of increased service prices is highlighted, which, when considering a twelve-month periods, rose 6.78% in May, up from 6.23% in February, a trajectory due in large part to the accelerated prices of items domestic help and education service, which increased, respectively, by 0.84 p.p. and 1.17 p.p. over the period.

The diffusion index reached an average of 62.76% for the quarter ended in May, compared to 63.54% in the one ended in February, and 58.59% in the same period last year.

Figure 2.3 – IPCA
% of items with increase
Quarterly moving average



Source: IBGE

2.3 Regulated prices

Regulated prices increased 0.32% in the quarter ended in May, contributing 0.09 p.p. to the 1.53% IPCA variation in the period. The highest pressures originated in adjustments of items medicines, 3.45%; health insurance, 1.61%; and water and sewage charges, 1.67%, the latter pressured by marked increases in Salvador, 9.29%, Goiânia, 5.29%; Brasília, 4.38%, and Belo Horizonte, 3.96%.

The cumulative change in regulated prices over 12 months reached 4.31% in May, down from 4.97% in February, while, considering the first five months of the year, there were increases of 1.58% in 2010 and 1.99% in 2009.

Table 2.3 – IPCA

% change

	Weights	2010					
		Jan	Feb	Mar	Apr	May	Year
IPCA	100.00	0.75	0.78	0.52	0.57	0.43	3.09
Market prices	70.73	0.72	0.93	0.80	0.75	0.47	3.72
Regulated prices	29.27	0.83	0.42	-0.14	0.14	0.33	1.59
Main items							
Electricity	3.19	0.07	0.10	-0.11	-0.13	1.23	1.16
Natural gas vehicle	0.11	-0.39	0.24	0.53	-0.39	0.57	0.56
Pipeline gas	0.10	0.18	0.34	0.04	0.00	1.04	1.61
Diesel fuel	0.08	0.26	0.00	-0.10	-0.30	0.03	-0.11
Electricity	0.12	-3.83	-5.57	0.00	0.00	0.00	-9.19
Tolls	1.30	0.00	0.00	0.31	0.00	0.00	0.31
Water and sewage	1.61	0.00	0.00	0.74	0.08	0.84	1.67
Urban bus	3.87	3.90	2.50	0.60	0.00	0.00	7.14
Air ticket	0.29	-4.00	-6.57	-6.35	-5.12	-0.90	-21.02
Gasoline	3.99	1.33	0.97	-1.95	-0.56	0.01	-0.23
Bottled cooking gas	1.20	0.66	0.20	0.29	0.38	-0.25	1.28
Medicine	2.84	0.06	-0.43	0.04	2.22	1.16	3.06
Health plans	3.43	0.53	0.53	0.53	0.53	0.54	2.69

Source: IBGE

2.4 Inflation core

The core of the IPCA, by exclusion, registered equal variations of 0.42% in both March and April, and 0.56% in May, totaling 1.41% for the quarter that ended in May, compared to 1.74% in the one that ended in February. The indicator variation, accumulated over 12 months, reached 4.93% in May, compared to 4.86% in February.

The core, calculated by smoothed trimmed-means, registered variations of 0.46% in March, 0.50% in April, and 0.62% in May, accumulating a total of 1.59% in the quarter. The

Table 2.4 – Consumer prices and core inflation

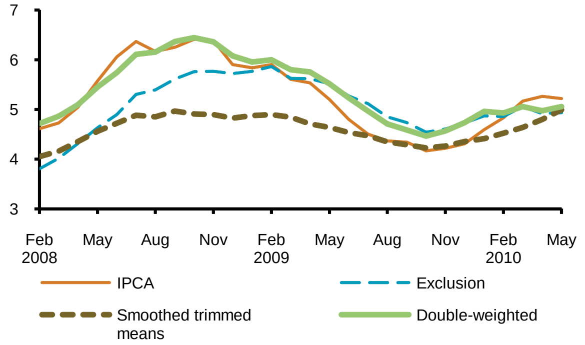
Monthly % change

	2010				
	Jan	Feb	Mar	Apr	May
IPCA	0.75	0.78	0.52	0.57	0.43
Exclusion	0.59	0.68	0.42	0.42	0.56
Smoothed trimmed means	0.48	0.39	0.46	0.50	0.62
Double-weighted	0.60	0.47	0.40	0.42	0.56
IPC-Br	1.29	0.68	0.86	0.76	0.21
Core IPC-Br	0.47	0.41	0.42	0.47	0.47

Sources: IBGE, Banco Central and FGV

Figure 2.4 – Core inflation

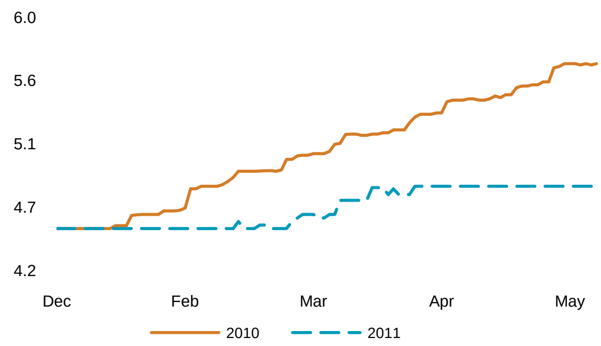
12-month % change



Sources: IBGE and Banco Central

Figure 2.5 – IPCA

Median



criteria used to calculate this indicator excludes items in which monthly variation lies, in distribution, above the 80th percentile or below the 20th percentile, along with smoothing over twelve months the fluctuation of items whose variations are concentrated in a few periods of the year. The indicator's variation, accumulated over twelve months, was 4.99% in May, compared to 4.52% in February.

The double weighting core showed variations of 0.40% in March, 0.42% in April, and 0.56% in May, totaling 1.39% in the quarter ended in May, down from 1.55% in the quarter ended in February. Accumulated over twelve months, the indicator's variation totaled 5.06% in May, compared to 4.93% in February. This nucleus is calculated putting the original weights – based on the importance of each item to the IPCA basket – by respective degrees of relative volatility, a procedure that reduces the importance of the more volatile components.

The core inflation of the Consumer Price Index – Brazil (IPC-Br), by the FGV, calculated by the smoothed trimmed-means method, showed variations of 0.42% in March and 0.47% in April and May, totaling an increase of 1.37% in the quarter, compared to 1.21% in the one ended in February. Considering 12-month cumulative variations, the index recorded an increase of 4.16% in May, up from 3.91% in February.

2.5 Market expectations

According to the Focus Survey – Market Report from May 28, the median estimates of the annual IPCA variations for 2010 and 2011 reached 5.7% and 4.8% as compared to 4.9% and 4.5% respectively, at the end of February. The median expectation for inflation twelve months ahead – and smoothed – stood at 4.8%, compared to 4.5% at the end of February.

The medians regarding the changes in the General Price Index – Market (IGP-M) and the Producer Price Index – Domestic Supply (IPA-DI) for 2010 increased in the order of 5.9% and 5.3% at the end of February, to 8.8% and 9.5% on May 28, while those with reference to 2011 equally came to 5%, compared to 4.5% on February 26.

The median of expectations regarding growth in administered or regulated prices by contracts in 2010 has not changed since the end of February, remaining at 3.6% on May 28, while the one referring to 2011 increased from 4.5% to 4.7%.

Figure 2.6 – IGP-M and IPA-DI

Median 2010

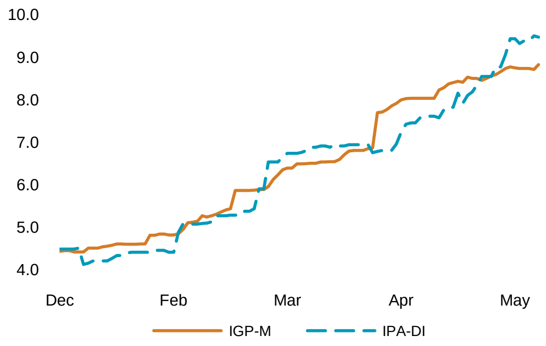


Figure 2.7 – Exchange

Median 2010

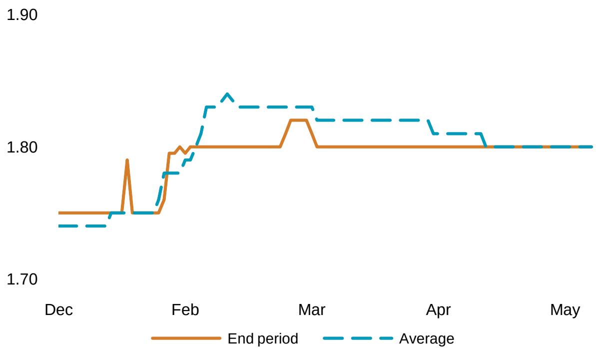


Table 2.5 – Summary of market expectations

	12.31.2009		2.26.2010		5.28.2010	
	2010	2011	2010	2011	2010	2011
IPCA	4.5	4.5	4.9	4.5	5.7	4.8
IGP-M	4.4	4.5	5.9	4.5	8.8	5.0
IPA-DI	4.5	4.5	5.3	4.5	9.5	5.0
Regulated Prices	3.5	4.5	3.6	4.5	3.6	4.7
Selic (end-of-period)*	10.8	10.9	11.3	11.3	11.8	11.5
Selic (average)*	9.9	10.6	10.1	11.3	10.4	11.8
Exchange rate (end-of-period)	1.8	1.8	1.8	1.9	1.8	1.9
Exchange rate (average)	1.7	1.8	1.8	1.8	1.8	1.8
GDP growth	5.2	4.5	5.5	4.5	6.5	4.5

The exchange rate median projected by the market for the end of 2010 remained unchanged, at R$1.80/US$, while the projection for 2011 was revised from R$1.87/ US$ at the end of February to R$1.85/US$ on May 28. The median forecast for the average exchange rate regarding 2010 decreased from R$1.83/ US$ at the end of February, to R$1.80/ US$, while the median for 2011 has not changed, remaining at R$1.84/US$ between the 2 dates.

2.6 Conclusion

The recent evolution in consumer prices primarily reflected the depletion of seasonal pressures regarding the education group, especially the item courses, and the lesser variation of regulated prices. It is worth noting that the slowdown at the margin registered contrasts with the opposite movement in the twelve-month cumulative period, particularly with regard to the behavior of prices of tradable goods and services.

The inflation outlook in the coming months should reflect the strong performance of domestic demand, in a scenario of expanding domestic economy throughout the year, as well as likely impacts of price hikes of raw materials and labor.

Credit, monetary and fiscal policies

3

Table 3.1 – Credit operations

R$ billion

Itemization	2010				% growth	
	Jan	Feb	Mar	Apr	3 months	12 months
Total	1 424.6	1 435.9	1 452.0	1 468.2	3.1	17.6
Nonearmarked	956.2	963.7	972.5	981.2	2.6	11.7
Earmarked	468.4	472.2	479.5	487.0	4.0	31.6
% share:						
Total/ GDP	45.0	45.0	45.0	45.2		
Nonearmarked/ GDP	30.2	30.2	30.2	30.2		
Earmarked/GDP	14.8	14.8	14.9	15.0		

Figure 3.1 – Credit by capital control of financial institutions

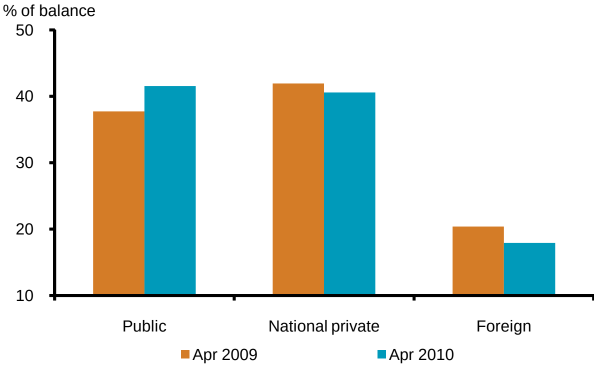
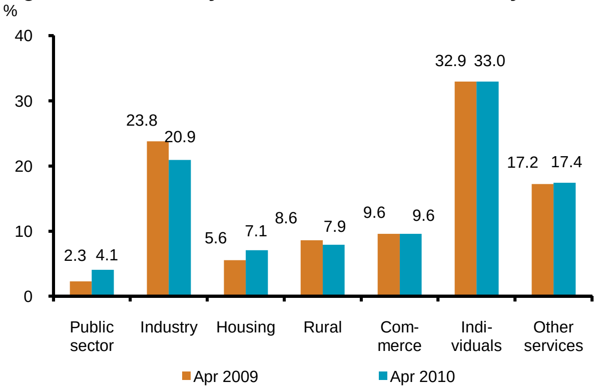


Figure 3.2 – Credit by borrower's economic activity



3.1 Credit

Financial system credit operations maintained the growth trajectory in the 3-month period ended in April, a performance consistent with the pace of economic expansion, improvements in the labor market, and maintenance of consumer and business expectations at high levels. Portfolios based on earmarked resources continued registering greater dynamism, driven by housing credit operations and financing granted by the BNDES.

Loans with nonearmarked resources also continued to grow, with emphasis on the household segment, especially auto loans and personal credit operations, the latter with increased participation of payroll-deducted credit transactions. Operations with nonearmarked in the corporate segment continued to evolve at a moderate pace, with significant settlements of contracts backed by external resources. It should be observed that the reduced dynamics of corporate credit operations, in contrast with the intense pace of economic activity, is due to the expansion of business funding based on foreign resources and on the capital markets.

The total financial system credit operations amounted to R$1,468 billion in April, rising 3.1% in the 3-month period and 17.6% in twelve months, equivalent to 45.2% of GDP, compared to 45% in January and 41.1% in the same period of the previous year. The share of public banks in total credit operations, after expanding significantly in 2009, declined 0.1 p.p., to 41.5%, in the 3-month period ended in April, while those for private national institutions and foreign banks reported respective variations of 0.4 p.p. and -0.3 p.p., reaching, in the order, 40.6% and 17.9%.

The volume of credit targeted to the private sector totaled R$1,409 billion in April, increasing 3.3% in the 3-month period and 15.4% in twelve months. Funding for trade operations increased 3.7% in the 3-month period up to April, totaling R$140.9 billion, emphasizing the expansion observed in the segments of automotive vehicles and food and beverages. The volume of credit operations with the segment of other services increased 3.5%, to R$256.1 billion, driven by increases in the energy, metallurgy, and transportation industries. Meanwhile, credit to the industry grew 0.8%, for total stocks of R$307.5 billion, with emphasis on operations in the segments of energy, agribusiness, and mining.

The balance of credit operations targeted to the public sector totaled R$59.6 billion in April, decreasing by 2.9% in the 3-month period, but expanding 110.5% in twelve months. The evolution at the margin evinced the impact of the 8.9% reduction in funding channeled to the federal government – consistent with the effect of exchange rate appreciation in contracts for state-owned oil and gas companies, in contrast with the 5.5% increase registered in the resources channeled to states and municipalities.

Total provisions set aside by the financial system amounted to R$95.9 billion in April, representing 6.5% of the total national financial system credit operations. The total volume registered a 2% reduction in the 3-month period up to April, consistent with the decrease of 0.3 p.p., to 3.9%, in the financial system default rates when delays of more than 90 days are taken into consideration.

Earmarked credit

Table 3.2 – Earmarked credit operations

R$ billion

	2010				% growth	
	Jan	Feb	Mar	Apr	3 months	12 months
Total	468.4	472.2	479.5	487.0	4.0	31.6
BNDES	288.5	289.5	291.9	295.6	2.5	36.6
Direct	159.9	159.0	158.9	159.6	-0.2	41.9
Onlendings	128.6	130.5	133.0	136.1	5.8	30.9
Rural	79.6	79.5	80.4	80.9	1.6	3.0
Banks and agencies	75.6	75.6	76.2	76.6	1.4	4.3
Credit unions	4.0	3.8	4.1	4.3	6.6	-15.7
Housing	89.7	92.3	95.9	99.0	10.3	50.5
Others	10.7	10.9	11.3	11.5	7.8	22.3

Credit operations with earmarked resources totaled R$487 billion in April, increasing by 4% in the 3-month period and 31.6% in twelve months. This evolution reflected the persistent growth of housing loans backed by funds from savings accounts and the Employment Guarantee Fund (FGTS), which totaled R$99 billion, for respective increases of 10.3% and 50,5% in the period under analyses. Disbursements with savings funds totaled R$9.6 billion in the quarter ended in March, rising 64.7% over the same period of the previous year.

The BNDES financing portfolio totaled R$295.6 billion in April, increasing 2.5% in the 3-month period and 36.6% in twelve months. Disbursements accumulated in the year reached R$35.7 billion, expanding 39.4% over the same period of 2009. Emphasis should be given to resources channeled for the segments of commerce and services, industry, crop and livestock, which totaled, in the order, R$21.7 billion, R$10.6 billion, and R$3.5 billion, for respective changes of 65.7%, -2.2%, and 100.3%, on the same comparison basis. It should be noted that financing for

Table 3.3 – BNDES disbursements

	2009	2010[1/]	% growth
			R$ million
Total	25 606	35 696	39.4
Industry	10 792	10 557	-2.2
Mining	822	317	-61.4
Food products	1 294	3 091	138.9
Vehicle, towing truck and wagon	726	957	31.8
Petroleum and alcohol refining	1 647	777	-52.8
Cellulose and paper	2 640	339	-87.2
Transportation equipments	624	556	-10.9
Commerce/services	13 085	21 677	65.7
Overland transportation	4 638	8 290	78.7
Electricity and gas	4 029	3 199	-20.6
Auxiliary transportation activities	493	1 078	118.7
Construction	1 755	2 491	41.9
Telecommunication	303	287	-5.2
Crop and livestock	1 729	3 463	100.3

1/ Refers to April.
Source: BNDES

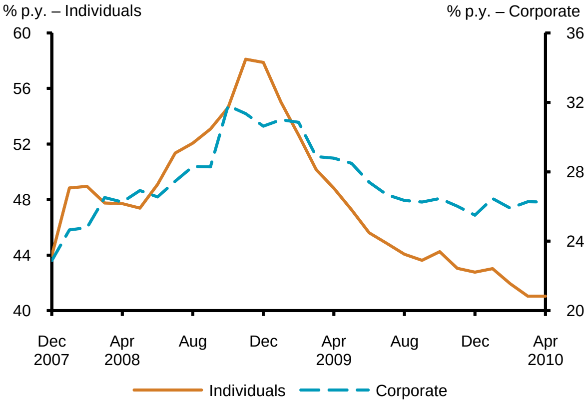
Table 3.4 – Nonearmarked credit operations

R$ billion

	2010				% growth	
	Jan	Feb	Mar	Apr	3 months	12 months
Total	956.2	963.7	972.5	981.2	2.6	11.7
Corporations	481.7	485.4	485.9	488.6	1.4	5.8
Reference credit[1/]	396.9	402.1	403.5	405.4	2.2	5.0
Domestic funding	340.9	346.0	350.6	354.4	4.0	16.5
External funding	56.0	56.1	52.9	51.1	-8.8	-37.7
Leasing[2/]	47.4	46.9	46.5	46.3	-2.1	-6.6
Rural[2/]	4.0	4.1	3.9	3.8	-4.6	0.0
Others[2/]	33.4	32.3	32.0	33.0	-1.3	48.3
Individuals	474.5	478.3	486.5	492.6	3.8	18.2
Reference credit[1/]	329.8	336.1	344.5	352.6	6.9	21.7
Credit unions	21.5	21.8	22.2	22.6	5.1	24.5
Leasing	63.4	62.4	61.2	58.9	-7.1	-8.2
Others	59.8	58.0	58.7	58.5	-2.2	30.5

1/ Interest rate reference credit, defined according to Circular n. 2,957 dated 12.30.1999.
2/ Operations backed by domestic resources.

Figure 3.3 – Interest rates on nonearmarked credit



micro, small, and medium enterprises, accounting for 37.6% of the disbursements made in the 4-month period, increased by 120% in relation to the same period in 2009.

Rural credit operations totaled R$80.9 billion in April, expanding 1.6% when compared to January. This trajectory, in a scenario of seasonal reduction in the employment of funding credit, reflected, in particular, the 2.8% increase observed in fund transfers and official investment programs.

Nonearmarked credit

The balance of nonearmarked credit operations reached R$981.2 billion in April, rising 2.6% in the 3-month period and 11.7% in twelve months, accounting for 66.8% of the financial system's portfolio, compared to 70.4% in same period of 2009. The performance in the 3-month period reflected the enhanced dynamics of household consumption, in an environment of reduced interest rates, strengthened payment deadlines, and lower default rates. Moreover, it should be also mentioned the largest corporate demand for loans backed by domestic resources as of February.

Loans to individuals totaled R$492.6 billion in April. The expansions registered in the 3-month period, 3.8%, and in twelve months, 18.2%, reflected, in particular, the performance of personal credit and financing for the purchase of vehicles, in both cases benefiting from reduced interest rates and increased consumer confidence. The volume of payroll-deducted loans totaled R$118.8 billion, rising 8.2% in the 3-month period and 37.7% in twelve months, accounting for 60% of the personal credit portfolio, compared to 54.2% in the same month of the previous year. Financing for the purchase of vehicles, driven primarily by the end of the IPI reduction period for vehicles in March, grew 9.8% and 29.3% in the period under analysis.

Operations contracted in the corporate segment totaled R$488.6 billion in April, rising 1.4% in the 3-month period and 5.8% in twelve months. In the framework of operations contracted with domestic resources, the modalities of working capital and guaranteed account registered respective expansions of 4.6% and 5.6% in the 3-month period, highlighting the demand from small companies. Conversely, as a result of the impact of exchange rate appreciation observed during the period and the reduction of renewals of advances on exchange contracts (ACC), loans backed by external funds fell by 8.8% in the 3-month period and 37.7% in twelve months.

Figure 3.4 – Average spread on nonearmarked credit

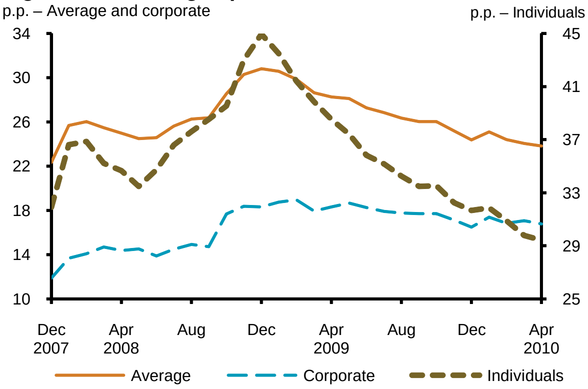
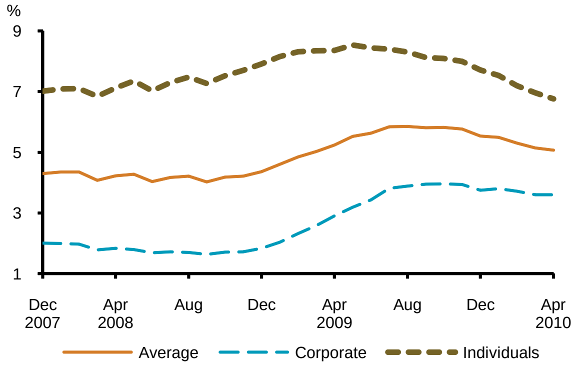
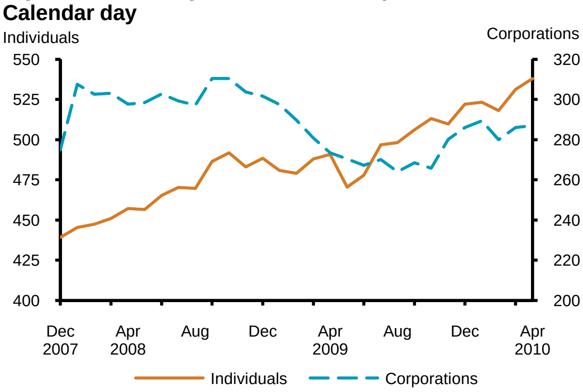


Figure 3.5 – Credit default rates[1/]



1/ Nonearmarked credit in arrears of more than ninety days.

Figure 3.6 – Average term for credit operations – Calendar day



Interest rates on credit operations continue to follow a declining trend, despite increasing funding costs observed since August of 2009. As a consequence, bank spreads have decreased significantly, particularly in the modalities related to credit operations with individuals, which reached the lowest level of the series begun in June 2000.

Insofar as reference credit operations are concerned, the average interest rate closed at 34.3% p.a. in April, decreasing by 0.8 p.p. in the 3-month period and 4.3 p.p. in twelve months. The rate observed in the segment of individuals reached 41.1% p.a., falling by 1.9 p.p. and 7.7 p.p., respectively, in the same comparison basis. Meanwhile, the rate for corporate reference credit operations reached 26.3% p.a., decreasing by 0.2 p.p. and 2.5 p.p., respectively, in the 3-month and 12-month periods.

The banking spread reached 23.8 p.p. in April, decreasing by 1.3 p.p. in the 3-month period and 4.4 p.p. in twelve months. The spread closed at 29.5 p.p. in the segment of individuals and 16.8 p.p. in the segment of corporations, decreasing, in the order, by 2.3 p.p. and 0.6 p.p. in the 3-month period up to April, and by 9 p.p. and 1.5 p.p., respectively, in 12 months.

Default rates for the modalities that compose of the referential credit operations – taken into consideration delays of more than ninety days – continued to follow the downward trend begun in mid-2009, declining by 0.5 p.p. to 5% in the 3-month period up to April. The rate reached 6.8% in the segment of individuals and 3.6% in the segment of corporations, decreasing by 0.7 p.p. and 0.2 p.p., respectively, in the 3-month period under analyses.

The average payment term of the reference credit portfolio, highlighting the enhanced dynamics of housing financing and auto loans, reached 404 days in April, increasing 8 days in the 3-month period and 38 days in twelve months. The average payment terms for individuals and corporations reached 538 days and 287 days, respectively, compared to 523 days and 289 days in the month of January.

3.2 Monetary aggregates

The average daily balance of the restricted money supply (M1) reached R$229.1 billion in April, dropping 2.8% in the 3-month period, and rising 16.9% over twelve months. Considering seasonally adjusted data deflated by the IPCA, M1 grew 2.6% in the 3-month period and 11% in twelve months, a trajectory consistent with the evolution of economic activity.

Figure 3.7 – Monetary base and M1 – Average daily balances

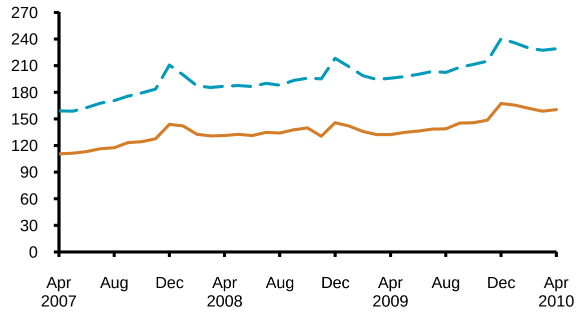
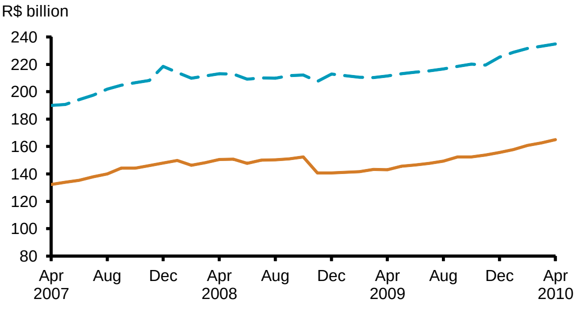


Figure 3.8 – Monetary base and M1 at April 2010 prices seasonally adjusted[1/]



1/ Deflated by: IPCA.

Figure 3.9 – Broad money supply
12-month growth

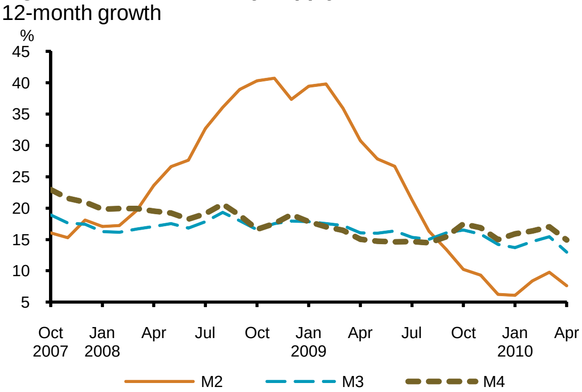
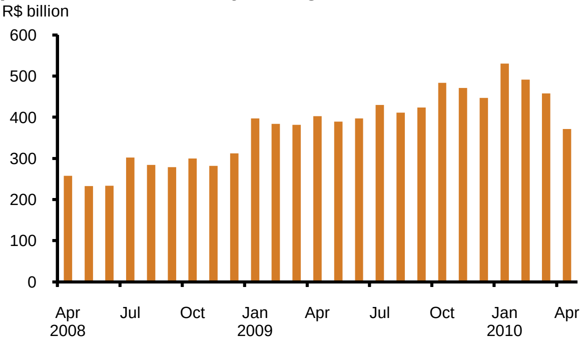


Figure 3.10 – Net financing position of the federal public securities – Daily average



The monetary base, as assessed by average daily balances, totaled R$160.3 billion in April, for a reduction of 3.1% in the 3-month period up to April and growth of 21.1% in twelve months, as a consequence of respective increases of 17.6% and 32.7% in the average balances of currency issued and bank reserves.

Considering the end-of-period balances, the monetary base totaled R$154.6 billion in April. The contraction of R$1 billion in the period reflected, in part, Central Bank inflows of additional liabilities on deposits, R$90.4 billion, and mandatory deposits on time deposits, R$59.6 billion, which once again had to be complied entirely with in cash as of March 22 and April 9, respectively. Similarly, the National Treasury single account exerted a contractionary impact of R$18.8 billion, contrasting with the expansion associated with net redemptions of R$156.4 billion in National Treasury bills and Central Bank net purchases of R$11.4 billion on the interbank currency exchange market.

The M2 concept, which aggregates to M1 the investment deposits, savings accounts deposits, and bonds issued by financial institutions, declined by 0.3% in the 3-month period and expanded 7.6% in twelve months, totaling R$1.1 trillion. M2 components behaved distinctly in the 3-month period: while the stock of private securities decreased by 1.8%, to R$581 billion, savings account deposits grew by 2.5%, to R$331.8 billion.

M3, which aggregates to M2 the shares of fixed income funds and federal securities that back the net position of repo operations between the public and the financial sector, reached R$2.2 trillion, rising 0.8% in the 3-month period and 13% in twelve months. The M4 aggregate, which includes M3 plus federal securities held by the nonfinancial public, totaled R$2.6 trillion, growing by 1.3% in the 3-month period and 14.9% in twelve months.

Federal public securities and Central Bank open market operations

Primary National Treasury operations with federal securities resulted in a monetary contraction of R$27.5 billion in the 3-month period ended in April, corresponding to placements of R$103.6 billion and redemptions of R$76.1 billion. Swap operations totaled R$6.1 billion, of which 49% involving

Figure 3.11 – Central Bank repo operations – Maturity – Average daily balances

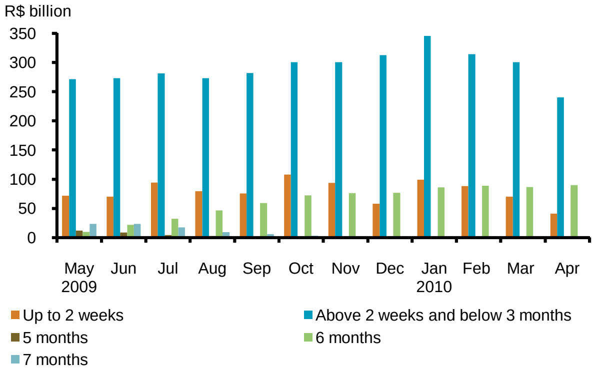
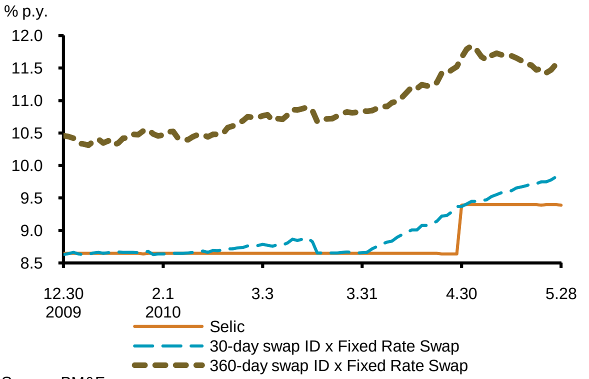


Figure 3.12 – Interest rate



Source: BM&F

Figure 3.13 – Ex-ante real interest rate – Deflated by 12-month IPCA expectations

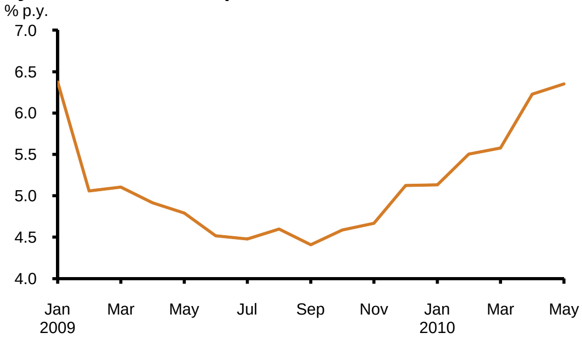
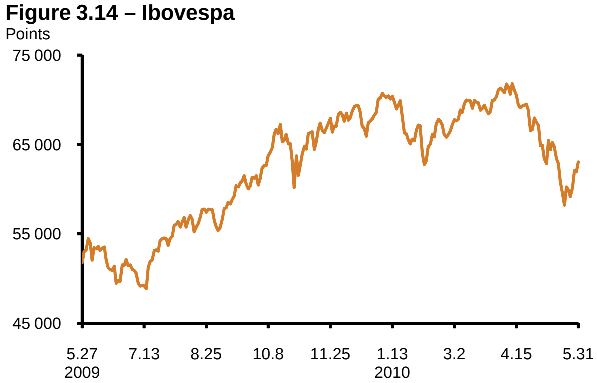


Figure 3.14 – Ibovespa



Source: Bovespa

National Treasury Bills (LTN), and anticipated redemptions totaled R$18 million.

The average daily balance of Central Bank financing and go-around operations totaled R$371.2 billion in April. The 30% decline observed in the 3-month period reflected the impact of reductions in operations with 2-week to 3-month terms, from R$345.3 billion in January to R$240.3 billion in April, as well as in operations with terms shorter than two weeks, from R$99.1 billion to R$41.2 billion, partly offset by an increase from R$86 billion to R$89.6 billion in transactions with 6-month terms.

Real interest rates and market expectations

The curve of future interest rates for Interfinancial Deposits (DI) X pre contracts previewed a slope increase for all vertices in the 3-month period ended in May. It should be stressed that this movement occurred more intensely for the vertices with payment terms lower than one year. The rate for contracts with maturities of 360 days increased by 82 b.p. in the period, reaching 11.57% p.a.

The real *ex-ante* Selic rate for the next twelve months, estimated from Central Bank's Market Report research dated May 28, reached 6.4% p.a. in May, compared to 5.5% p.a. in February, with emphasis on the increase of 1.26 p.p., to 11.5% p.a., registered in the 12-month expectations for the Selic rate.

Capital market

The São Paulo Stock Exchange Index (Ibovespa), after recovering in the second half of 2009, declined in January and recovered significantly in February and March. Increased volatility in international markets, associated with instability originated in European countries, contributed to the 5.2% index retreat registered in the 3-month period ending in May, to 63,046 points. The market value of companies listed in the index, also reflecting the consequences of European instability, fell 5.7% in the 3-month period up to May, closing at R$2.14 trillion. The volume traded in the Bovespa reached a daily average of R$6.8 billion, increasing 3.4% in the 3-month period under analysis.

In dollars, the Ibovespa fell 5.5% in the 3-month period ended in May, while the Dow Jones and Nasdaq posted respective variations of -1.8% and 0.8%.

Figure 3.15 – Stock exchanges
March 2009 = 100

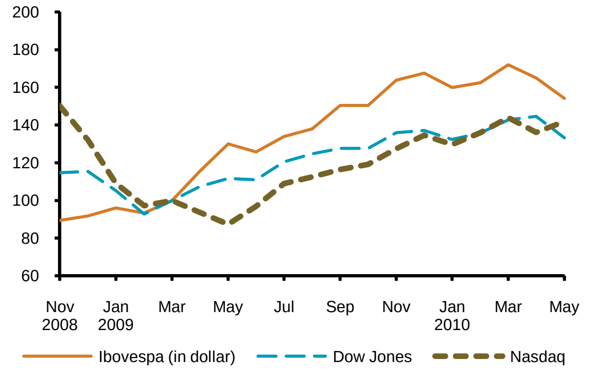
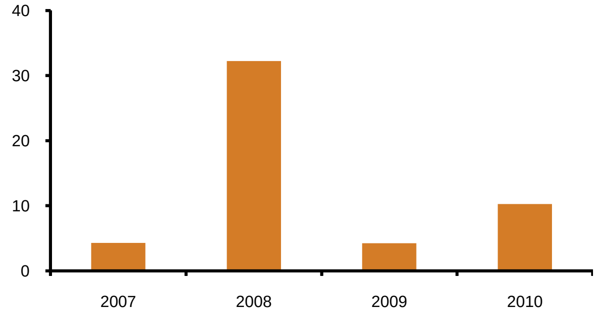
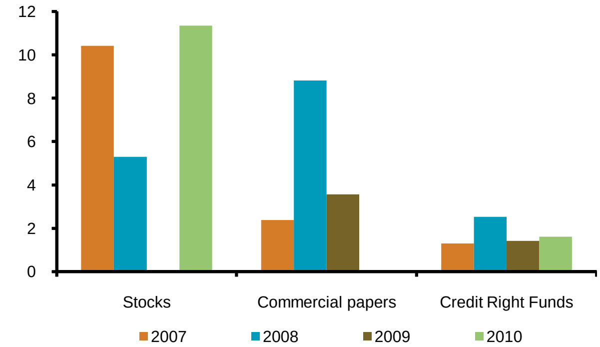


Figure 3.16 – Debenture primary issues in the capital market
R$ billion – Accumulated through May



Source: CVM

Figure 3.17 – Primary issues in the capital market
R$ billion – Accumulated through May



Source: CVM

Table 3.5 – Public sector borrowing requirements – Primary result

Segment	2008		2009		Apr 2010[1/]	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central Government	-71.3	-2.4	-42.4	-1.4	-45.5	-1.4
Sub-national governments	-30.6	-1.0	-21.0	-0.7	-24.2	-0.7
State companies	-4.5	-0.2	-1.1	-0.0	-0.6	-0.0
Total	-106.4	-3.5	-64.5	-2.1	-70.4	-2.2

1/ Twelve-month cumulative data up to January.

Business financing in the capital markets through the issue of shares, debentures, promissory notes, and placement of receivables totaled R$23.2 billion in the first five months of 2010, compared to R$9.2 billion in the same period of 2009, with emphasis on issues of shares, which totaled R$11.3 billion.

3.3 Fiscal policy

In May, the Ministry of Planning, Budget and Management (MPOG) announced a report updating the macroeconomic parameters and re-estimating Central Government revenues for the year 2010. Aiming to preserve the primary surplus target, representing 2.4% of GDP, in a scenario of R$9.4 billion revenue reduction in relation to March's forecast, the federal government issued a decree determining a R$10 billion cut in National Treasury annual expenditures, of which R$7.6 billion referring to expenditures of discretionary nature while R$2.4 billion referring to obligatory expenditures.

It should be noted that, in March, following the disclosure of the primary result for the first two months of the year, the Government had promoted a R$15.7 billion cut in central government expenditures, accumulating, in the exercise, a contingency of R$25.7 billion.

Public sector borrowing requirements

The consolidated public sector primary surplus totaled R$36.6 billion in the first four months of 2010, equivalent to 3.41% of GDP, for a 0.23 p.p. of GDP increase over the same period in 2009. This performance reflected the greater Central Government and regional governments surpluses, partly offset by the increased state-owned enterprises deficit. The 12-month accumulated primary result amounted to R$70.4 billion in April, 2.17% of GDP, below the target set for the year, 3.3% of GDP. It is noteworthy that this goal can be reduced by up to 1.12 p.p., depending on discounts provided in the Budget Guidelines Law of 2010 with regard to PAC expenditures.

The Federal Government surplus, favored by the 19.7% growth under gross revenues, increased by 0.09 p.p. of GDP in the 4-month period. It should be highlighted that collections grew 22.9% in April, in relation to the corresponding month in 2009.

Figure 3.18 – Public sector primary surplus
12-month cumulative data

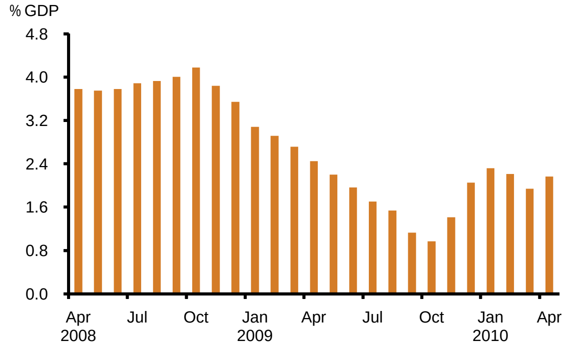


Figure 3.19 – National Treasury gross revenues
Jan-Apr

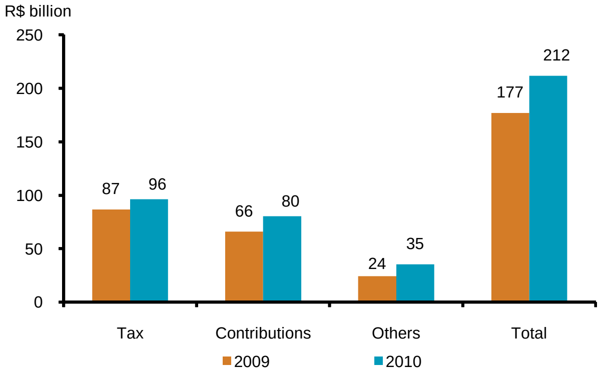
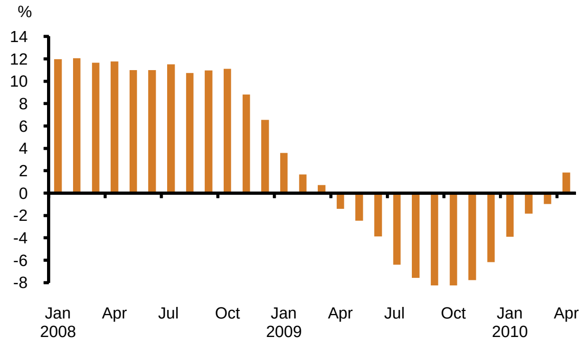


Figure 3.20 – 12-month real growth rate of Treasury revenues[1/]



1/ Updated by IPCA.

Table 3.6 – National Treasury Expenditures
Jan-Apr

Itemization	2009		2010	
	R$ million	% GDP	R$ million	% GDP
Total	102 095	10.6	123 583	11.5
Personnel and payroll charges	49 921	5.2	53 494	5.0
Capital and current expenditures	51 819	5.4	69 702	6.5
Workers Support Fund	6 790	0.7	7 279	0.7
Subsidies and economic	680	0.7	3 474	0.7
subventions	680	0.1	3 474	0.3
Loas/RMV	6 051	0.6	7 231	0.7
Investment	6 761	0.7	12 803	1.2
Other capital expenditures	31 537	3.3	38 916	3.6
National Treasury transfers				
to the Central Bank	354	0.0	388	0.0

Source: Minifaz/STN

Inflows of Cofins, driven by increased sales, rose 26.8% in the first four months of the year, compared to the same period in 2009, totaling R$43.4 billion, while that associated with IPI, reflecting the expansion of industrial production and vehicle sales, grew 22.8% to R$11.4 billion. Additionally, other Treasury revenues, reflecting the impact of rising international petroleum prices over the collection of quota-share and the increases in the collection of dividends and of revenues originating in installment payments of tax debts, increased 46.3%, to R$35.4 billion.

Considering 12-month periods, Treasury revenue real growth rates, deflated by the IPCA, reached 1.8% in April, the first positive result since March 2009 on this basis of comparison. It is important to emphasize, however, that this trajectory, although reflecting the impact of economic recovery on the level of collection, is largely due to the depressed revenue base in the period that followed the worsening of the international crisis. In this framework, the maintenance of collection recovery shall depend upon the pace of economic growth, benefiting from the reversal of tax cuts introduced to strengthen domestic demand after the intensification of the international crisis, which represented an estimated impact of R$24.9 billion over the 2009 collection.

National Treasury expenditures amounted to R$123.6 billion in the first four months of 2010, increasing 21% over the same period of the previous year. Expenditures on personnel and liabilities increased by 7.2%, despite the reduction in the payment of judicial claims and current and capital expenditures, 34.5%, with emphasis on the expansion of 89.4% under investments.

The Social Security deficit reached R$17.2 billion, rising by 0.04 p.p. of GDP, compared to that recorded from January to April 2009. The collection growth consequent upon payroll increase grew 14.9%, and expenditures on social security benefits, reflecting in particular the average growth of 9.1% in the value of pensions and benefits, increased 14.7%.

It is worth mentioning that the R$47.2 billion projected deficit in 2010 in the MPOG report aforementioned incorporates the original readjustment forecast of 6.14% for benefits above the floor. Under these conditions, that projection should take into consideration the effects regarding the 7.7% increase for benefits above the floor recently approved by the National Congress.

Transfers to regional governments totaled R$44.2 billion in the first four months of 2010, increasing 13.6% over the same period of 2009, with emphasis on the increases

Figure 3.21 – Federal Government: investment expenditures paid
Jan-Apr

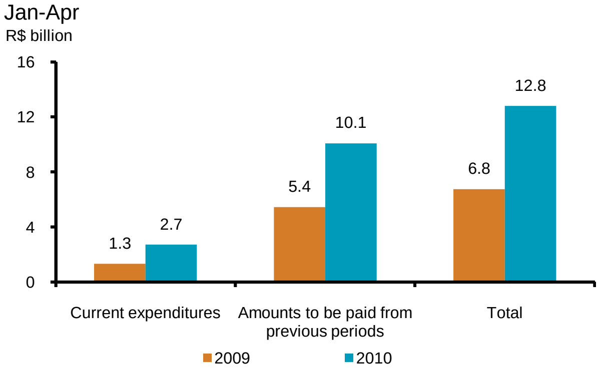


Figure 3.22 – Transfers to states and municipalities
Jan-Apr

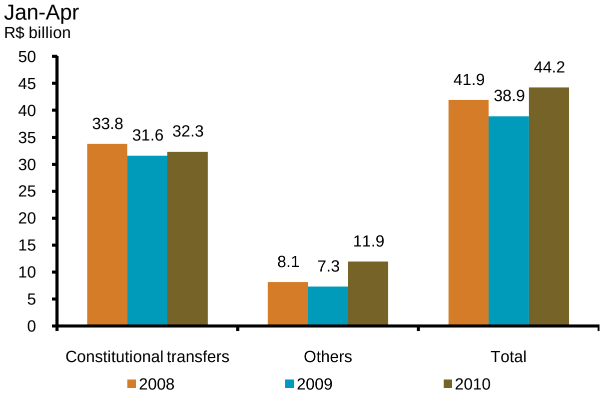
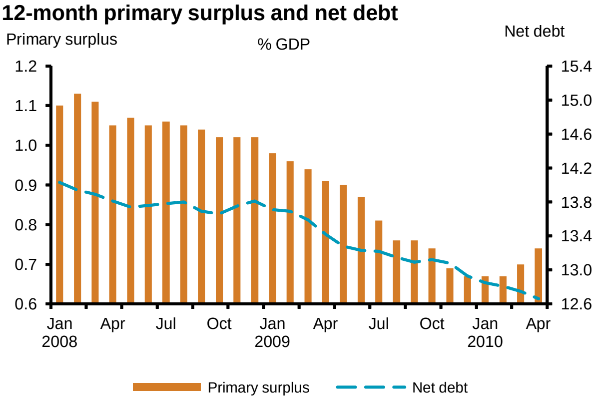


Table 3.7 – Social security primary result
Jan-Apr

R$ billion

Itemization	2009	2010	Var. %
Gross inflow	60.4	69.2	14.7
Cash refunds	-0.2	-0.2	11.3
Transfers to third parties	-6.7	-7.5	12.6
Net inflow	53.5	61.5	14.9
Social Security benefits	68.7	78.7	14.7
Primary result	-15.2	-17.2	13.7
Net inflow/GDP	5.5%	5.7%	
Social Security benefits/GDP	7.1%	7.3%	
Primary result/GDP	-1.6%	-1.6%	

Figure 3.23 – Regional governments: cumulative 12-month primary surplus and net debt



of petroleum and natural gas transfers; transfers from the Contribution of Intervention in the Economic Domain (Cide) and the Fund for Maintenance and Development of Basic Education and Enhancement of Education Professionals (Fundeb); and transfers referring to financial support to states and municipalities.

Tax collections for the Tax on the Circulation of Goods and Services (ICMS), the most significant regional tax, and the Motor Vehicle Ownership Tax (IPVA) registered respective increases of 17.2% and 16% in the quarter ended in March, compared to the same period in 2009.

The regional governments' primary surplus reached R$12.8 billion in the first four months of the year, increasing by 0.2 p.p. of GDP in relation to the same period in 2009, contributing significantly to the decline of 0.3 p.p. of GDP in regional government's net debt for 2010.

State-owned companies registered a primary deficit of 0.15% of GDP in the period, compared to 0.12% of GDP between January and April 2009. In particular, this trajectory reflects the impact of investment programs implemented by federal state-owned companies.

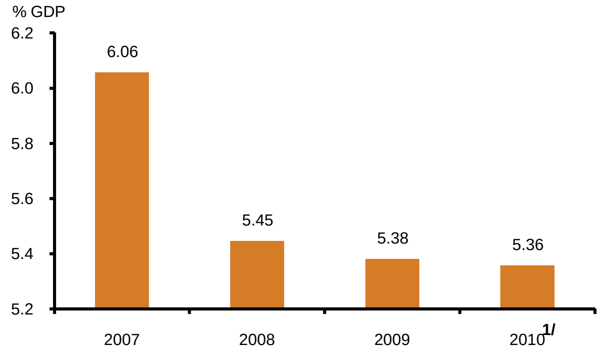
Appropriated nominal interest totaled R$59.5 billion in the first four months of the year, increasing by 0.07 p.p. of GDP over the same period in 2009. This movement reflected both the growth of 0.92 p.p. observed in the accumulated IPCA variation in the period and the reversal of the favorable result of foreign exchange swap operations recorded in first four months of 2009.

The public sector nominal deficit, which includes the primary result and appropriated nominal interests, totaled R$22.8 billion in the first four months of the year, equivalent to 2.13% of GDP, falling by 0.16 p.p. of GDP in relation to the same period in 2009. This deficit was financed through expansions of net banking debt and securities debt, partly offset by reductions in net foreign financing and other sources of domestic financing, including the monetary base.

Federal securities debt

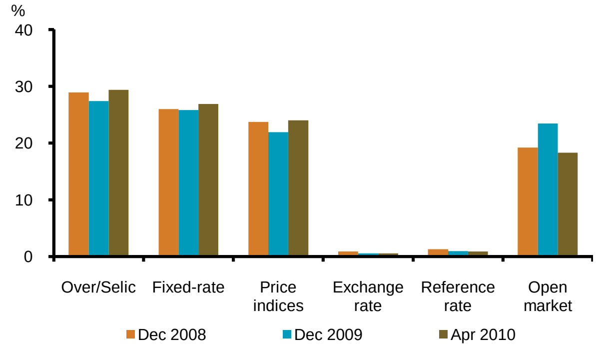
The domestic federal securities debt, evaluated by the portfolio position, totaled R$1,492.9 billion in April, 44.6% of GDP, increasing by 2.3 p.p. of GDP compared to January and 3 p.p. of GDP in twelve months. This trajectory reflected the impacts of expansions under net primary market

Figure 3.24 – Nominal interest



1/ Twelve-month cumulative data up to April.

Figure 3.25 – Federal securities debt structure by indexing factor[1/]



1/ It does not include swap.

Figure 3.26 – Profile of maturities of the securities debt

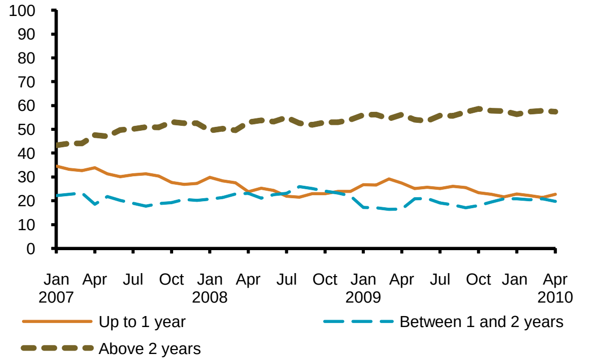


Table 3.8 – Public sector borrowing requirements

Jan-Apr

Itemization	2008		2009		2010	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Uses	-7.4	-0.8	22.1	2.3	22.8	2.1
Primary	-62.9	-6.7	-30.8	-3.2	-36.6	-3.4
Interest	55.5	5.9	52.8	5.5	59.5	5.5
Sources	-7.4	-0.8	22.1	2.3	22.8	2.1
Domestic financing	21.2	2.3	19.7	2.0	44.0	4.1
Securities financing	75.0	8.0	68.7	7.1	2.0	0.2
Bank financing	-31.9	-3.4	-48.1	-5.0	53.3	5.0
Others	-21.9	-2.3	-0.9	-0.1	-11.2	-1.0
External financing	-28.6	-3.1	2.4	0.2	-21.2	-2.0

issues, R$98 billion; and appropriation of nominal interests, R$40 billion, contrasting with the contractionary impact of R$0.8 billion due to the effects of the 7.7% currency appreciation in the period.

In the February-April period, the participation in the domestic federal securities debt of fixed-rate securities and securities indexed to price indices and the Selic rate registered, in the order, expansions of 5.4 p.p., 2.0 p.p., and 1.6 p.p., while Central Bank financing through open market operations declined by 9 p.p.

The 2010 Federal Public Debt Annual Financing Plan (PAF) defined the following minimum and maximum limits to be pursued, until the end of the year, for the participation of public debt indexing factors: fixed-rate securities, 31% and 37%, price indices, 24% and 28%; Selic rate, 30% and 34%; exchange rate, 5% and 8%. In April, these percentages reached 26.9%, 24%, 29.4% and 0.5%, respectively.

Open market repo operations, which represent short and very short-term financing, reached R$362.1 billion in April, compared to R$535.7 billion in January, with Central Bank net purchases of securities totaling R$182.8 billion and incorporation of interests, R$9.2 billion.

The amortization schedule of the securities debt on the market, except for financing operations, registered the following maturity structure in April: 14.3% of total maturing in 2010, 20.3% in 2011, and 65.4% as of January 2012. Securities maturing in 12 months represent 22.8% of total securities debt on the market, slightly below the lower limit of 24% set by the PAF 2010. The average debt maturity reached 41.1 months, within the range set in the PAF 2010.

Net and gross debt

The Public Sector Net Debt (PSND) closed at R$1,370.7 billion in April, 42.2% of GDP, falling 0.6 p.p. of GDP in comparison to December 2009. The PSND/GDP ratio dropped in all spheres of the public sector in the period, except for state-owned companies, which remained stable.

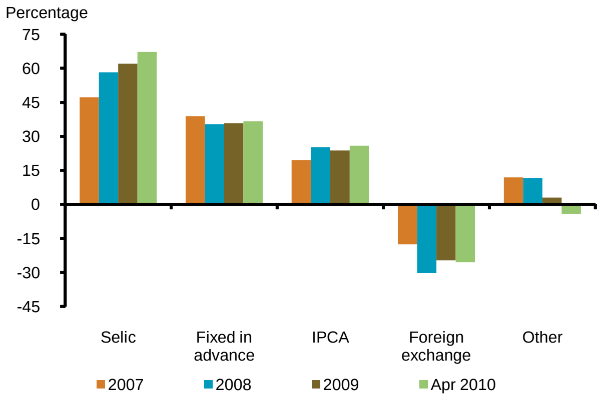
The decline recorded in PSND/GDP ratio in the four-month period under analysis reflected the primary surplus decrease, -1.1 p.p. of GDP, and current GDP growth, -1.4 p.p., partly offset by the impacts of 1.8 p.p. of GDP related to the appropriation of nominal interests, 0.1 p.p. of GDP related to

Table 3.9 – Repo operations – Open market
Balances and percentage share

R$ million

Period		Up to 1 month		More than 1 month		Total
		Balance	%	Balance	%	Balance
2003	Dec	43 742	78.5	11 975	21.5	55 717
2004	Dec	7 797	16.5	39 410	83.5	47 207
2005	Dec	-24 430	-106.9	47 286	206.9	22 856
2006	Dec	5 800	9.7	54 231	90.3	60 030
2007	Mar	41 656	39.3	64 281	60.7	105 937
	Jun	10 198	7.5	126 562	92.5	136 760
	Sep	7 561	4.3	168 525	95.7	176 086
	Dec	-1 460	-0.9	167 274	100.9	165 813
2008	Mar	37 349	18.2	167 643	81.8	204 991
	Jun	42 818	18.4	190 311	81.6	233 129
	Sep	87 261	30.9	195 107	69.1	282 368
	Dec	88 303	29.4	212 188	70.6	300 491
2009	Mar	124 877	33.7	246 066	66.3	370 943
	Jun	68 826	17.8	316 797	82.2	385 624
	Sep	60 179	14.0	369 497	86.0	429 676
	Dec	31 846	7.4	396 029	92.6	427 874
	Mar	92 320	22.8	312 448	77.2	404 767
	Apr	84 761	25.3	250 089	74.7	334 849

Figure 3.27 – NPSD – Percentage share of indexator



exchange rate appreciation of 0.6%, and the parity variation of the parity of the basket of currencies that composes of the net debt.

The trajectory of PSND composition throughout 2010 reflected, in particular, the growth of the debt share indexed to the Selic rate and the creditor portion linked to the Long Term Interest Rate (TJLP), the latter associated with the increase in federal government assets held by the BNDES through the issue of federal securities on the domestic market. It should be also highlighted the growth of the portion linked to IPCA, in line with this inflation index acceleration throughout the year.

The General Government Gross Debt (GGGD), represented by the Federal Government, Social Security, and regional government debts totaled R$1,968.2 billion, 60.6% of GDP in April, falling 2.2 p.p. in the year. Contributed to this trend the drop in repo operations, associated with the recent increase in the rate of compulsory deposits, and GDP growth, partly offset by the incorporation of nominal interests and the issues of National Treasury securities.

3.4 Conclusion

In an environment of decreasing interest rates, spreads, and default, credit operations continued to follow an upward trajectory in the 3-month period ending in April, thus contributing to the favorable performance of consumption and, more significantly, investments. The expansion of loans occurred with greater intensity in the segment of earmarked resources, especially in BNDES credit operations and housing financing. Insofar as nonearmarked credit are concerned, the volume of operations were less pronounced, being boosted by the performance of individuals' portfolios, with emphasis on the growing participation of payroll-deducted and auto loans. It is worth emphasizing that the relative slowdown observed in the corporate segment partly reflected the increased access of companies, especially large ones, to the capital market and foreign resources.

Fiscal results accumulated in the year, more favorable in relation to those registered in the same 2009 period, appear to be consistent with the impact of economic activity recovery on the revenue levels. The maintenance of tax collection recovery should be sustained by the impact of the end of tax cuts and the outlook for persistent economic expansion. With regard to public expenditures, it should be emphasized the significant expansion observed under investments.

Table 3.10 – Net debt growth
Conditioning factors

	2008		2009		Apr 2010	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1153 631	38.4	1345 325	42.8	1370 705	42.2
Flows	**Accumulated in the year**					
Net debt – Growth	-47 168	-6.7	191 694	4.4	25 380	-0.6
Conditioning factors	-47 168	-1.6	191 694	6.1	25 380	0.8
PSBR	57 240	1.9	104 622	3.3	22 847	0.7
Primary	-106 420	-3.5	-64 517	-2.1	-36 617	-1.1
Interest	163 660	5.4	169 139	5.4	59 464	1.8
Exchange adjustment	-77 373	-2.6	79 754	2.5	2 519	0.1
Domestic securities	3 180	0.1	-3 414	-0.1	214	0.0
debt1/	-80 553	-2.7	83 168	2.6	2 305	0.1
External debt	-26 404	-0.9	10 880	0.3	2 272	0.1
Others2/	0	0.0	0	0.0	0	0.0
Skeletons	135	0.0	- 345	0.0	- 908	0.0
Privatizations	- 767	0.0	-3 217	-0.1	-1 351	0.0
GDP growth effect		-5.2		-1.7		-1.4

1/ Domestic dollar – Indexed securities.
2/ Parity of the basket of currencies in the net external debt.

Table 3.11 – General government gross debt
Conditioning factors

Itemization	2008		2009		Apr 2010	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
GGGD – Balance	1 740 888	57.9	1 973 424	62.8	1 968 165	60.6
Flows	**Accumulated in the year**					
GGGD – Growth	198 036	0.0	232 536	4.9	-5 259	-2.2
Conditioning factors	198 036	6.6	232 536	7.4	-5 259	-0.2
GGGD borrowing requirements	158 976	5.3	265 777	8.5	-6 186	-0.2
GGGD net issues	-41 963	-1.4	74 329	2.4	-73 825	-2.3
Interest	200 938	6.7	191 448	6.1	67 639	2.1
Exchange adjustment	38 473	1.3	-41 212	-1.3	- 606	0.0
Indexed internal securities debt1/	3 180	0.1	-3 414	-0.1	- 58	0.0
External debt	35 293	1.2	-37 798	-1.2	- 548	0.0
Others2/	-2 662	-0.1	6 070	0.2	1 503	0.0
Skeletons	3 250	0.1	1 902	0.1	30	0.0
Privatizations	0	0.0	0	0.0	0	0.0
GDP growth effect		-6.6		-2.5		-2.1

1/ Domestic dollar – Indexed securities.
2/ Parity of the basket of currencies in the external debt.

In view of fiscal targets established for the year, this trajectory should be counterbalanced by the slowdown in the growth rate of current expenditures.

International economy

4

The recent evolution of global economic activity has corroborated the outlook, as highlighted in previous editions of the Inflation Report, of the different paces of the recovery process in major mature economies. In fact, the recovery, supported by the greater dynamism of domestic demand and by the normalization of the labor market, has occurred with less intensity in the Euro Area, which has been negatively impacted by the worsening fiscal conditions in some economies, particularly in Greece.

Tensions in the international financial markets intensified in May due to concerns over sovereign debt of European countries, negatively impacting the indexes of major stock exchanges and commodity prices. Thus, the perception of risk increased, as evinced, for example, in the volatility of foreign exchange markets in general, particularly in those of European economies.

4.1 Economic activity

The four largest developed economies, reflecting the unequal recovery of their respective domestic demands, especially in household consumption and business investments, registered distinct growth rates in the first quarter of the year. The annualized rates of GDP growth in Japan and the United States of America (USA) amounted, in that order, 5.0% and 3% in the quarter, while those relative to the United Kingdom and the Euro Area reached 1.2% and 0.8%, respectively.

In the U.S., in a scenario of stabilization of real disposable income and a reduction in personal savings, household consumption registered an annualized increase of 3.5% in the quarter ended in March. Considering the same basis of comparison, the gradual exhaustion of the effects of incentives towards the purchase of cars combined with the harsh winter have contributed to the marked contraction of 0.4% in household consumption in the Euro Area. At

Table 4.1 – Major developed countries

GDP components and other indicators

% rate anualised

	2008			2009				2010
	II	III	IV	I	II	III	IV	I
GDP								
United States	1.5	-2.7	-5.4	-6.4	-0.7	2.2	5.6	3.0
Euro Area	-1.4	-1.9	-7.4	-9.6	-0.4	1.6	0.5	0.8
United Kingdom	-0.4	-3.7	-7.0	-10.0	-2.7	-1.2	2.0	1.2
Japan	-4.0	-4.3	-9.6	-15.8	6.9	0.4	4.6	5.0
Household consumption								
United States	0.1	-3.5	-3.1	0.6	-0.9	2.8	1.6	3.5
Euro Area	-1.7	-0.1	-2.4	-2.5	0.3	-0.7	0.8	-0.4
United Kingdom	-1.0	-1.2	-4.5	-6.2	-3.4	0.0	1.5	0.1
Japan	-6.6	-0.5	-3.4	-4.6	4.0	2.6	2.8	1.3
Non-residencial investment								
United States	1.4	-6.1	-19.5	-39.2	-9.6	-5.9	5.3	3.1
Euro Area 1/	-5.6	-4.8	-15.2	-19.0	-6.7	-3.9	-5.2	-4.3
United Kingdom 1/	1.0	-13.7	-9.4	-26.3	-25.9	11.8	-10.3	6.3
Japan	-3.3	-13.5	-24.9	-34.0	-14.1	-7.9	5.1	4.2
Residencial investment								
United States	-15.8	-15.9	-23.2	-38.2	-23.3	18.9	3.8	-10.7
Euro Area 2/	-8.0	-6.3	-7.9	-5.1	-4.1	-5.0	-4.7	n.d.
United Kingdom	-17.6	-24.5	-23.4	-27.8	-19.4	9.6	-19.3	n.d.
Japan	-0.8	18.8	12.6	-25.5	-33.8	-26.2	-10.4	1.6
Exports of goods and services								
United States	12.1	-3.6	-19.5	-29.9	-4.1	17.8	22.8	7.2
Euro Area	-1.9	-4.6	-26.1	-29.5	-4.3	11.6	7.2	10.4
United Kingdom	1.2	-2.2	-16.8	-25.7	-6.8	2.4	16.0	0.2
Japan	-4.3	-1.9	-45.8	-68.0	46.8	39.1	25.2	30.5
Imports of goods and services								
United States	-5.0	-2.2	-16.7	-36.4	-14.7	21.3	15.8	10.4
Euro Area	-4.2	0.3	-17.6	-28.7	-10.2	11.5	5.0	17.1
United Kingdom	-3.0	-4.5	-22.1	-23.6	-11.1	4.9	20.0	5.7
Japan	-10.0	11.6	2.0	-54.8	-14.0	24.2	6.3	9.6
Government expenditures								
United States	3.6	4.8	1.2	-2.6	6.7	2.6	-1.3	-1.9
Euro Area 3/	3.2	1.9	3.4	2.9	2.9	2.7	-0.2	2.6
United Kingdom 3/	4.1	4.4	4.7	1.7	0.4	7.9	5.0	n.d.
Japan	-7.2	-0.5	4.0	5.2	5.6	-0.4	1.5	0.5
Manufacturing output								
United States	-5.4	-9.2	-18.2	-21.9	-8.9	8.4	5.6	6.2
Euro Area	-9.8	-13.0	-21.0	-27.4	-10.9	3.7	9.1	17.2
United Kingdom	-6.0	-8.8	-19.7	-19.8	-1.2	-1.1	3.8	5.3
Japan	-7.4	-11.6	-37.3	-57.1	21.8	24.8	25.6	32.9
Unemployment rate 4/								
United States	5.5	6.2	7.4	8.6	9.5	9.8	10.0	9.7
Euro Area	7.5	7.7	8.2	9.1	9.4	9.8	9.9	10.0
United Kingdom	5.4	5.9	6.4	7.1	7.8	7.8	7.8	8.0
Japan	5.4	5.9	6.4	7.1	5.3	5.3	5.2	8.0

Sources: BEA, Cabinet Office and Eurostat

1/ Includes residencial and public investment expenditures.

2/ Total construction expeditures.

3/ Consumption expenditures exclusive

4/ End-of-quarter rate.

the same time, demand in Japan, showing the stimulus for automobiles and durable goods acquisition, registered an expansion of 1.3%, and in the United Kingdom it was marked by stability.

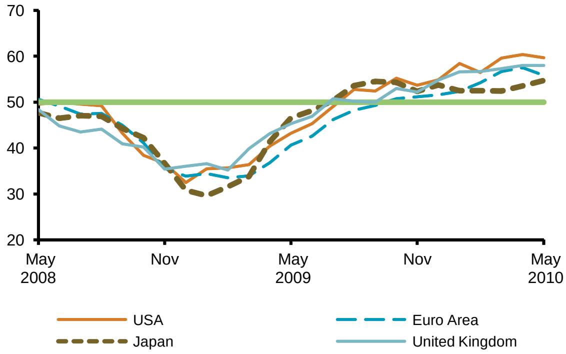
Business investments, following the recovery that began in the December 2009 quarter, showed quarterly annualized increases of 4.2% in Japan and 3.1% in the USA, while residential investments experienced respective variations of 1.6%, the first expansion since the last quarter of 2008, and -10.7%. It is noteworthy that this decline resulted in large part, the impact of the termination of tax incentives offered by the U.S, government for first home purchases. Gross fixed capital formation recorded an annualized increase of 6.3% in the UK and a 4.3% contraction in the Euro Area, the eighth consecutive decline in this type of comparison.

The net external demand exerted a contribution of 2.7 p.p. to the annualized growth of Japanese GDP in the first quarter of the year, contrasting with the negative impacts of 2.2 p.p., 1.3 p.p. and 0.7 p.p. highlighted in the Euro Area, the UK, and the USA. Exports of goods and services in a scenario of recovery of global demand and depletion of the adjustment process in stocks, registered, in the first quarter of the year, annualized growth in Japan, 30.5%; in the Euro Area, 10.4%; and the USA, 7.2%, while in the UK, highlighting the lower dynamism of the Euro Area's economy, they remained stable. Imports from the Euro Area, partly reflecting the reduced stock levels in the region, had an annualized increase of 17.1% in the quarter, while Japan and the USA, reflecting the recovery in domestic demand of these countries, increased 10.4% and 9.6% in the order. Foreign UK purchases increased 5.7% in the period.

The contribution of stock variation to the annualized GDP growth in the quarter ended in March of 2010 reached 3.4 p.p. in the Euro Area, 1.6 p.p. in the US, 1.5 p.p. in the UK, and 0.8 p.p. in Japan. This performance, combined with the expansion of exports and, in the US and Japan, also the positive evolution of household consumption, boosted growth in manufacturing output, which recorded in the quarter, annualized rates of 32.9% in Japan, 17.2% in the Euro Area, 6.2% in the US, and 5.3% in the UK.

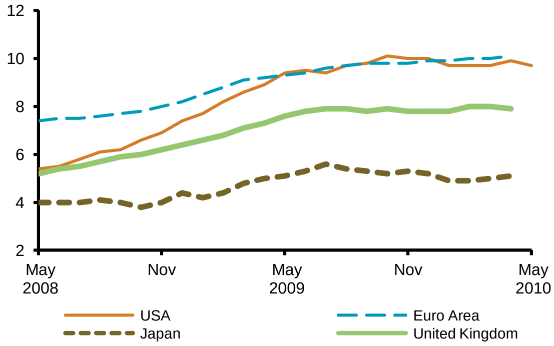
It is important to stress that in the Euro Area, despite the uncertainties surrounding the unfolding fiscal crisis affecting several countries in the region, recent developments of the PMI relative to manufacturing activity suggests the continuing recovery of the sector. Incidentally, in May, the indicators for the US, UK, Euro Area, and Japan stood at,

Figure 4.1 – Manufacturing PMI
Largest developed economies



Source: Bloomberg

Figure 4.2 – Unemployment rate evolution
Largest developed economies



Source: Bloomberg

Table 4.2 – China
GDP components and other indicators

% rate [(Q)/(Q-4)]

	2008			2009				2010
	II	III	IV	I	II	III	IV	I
GDP	10.1	9.0	6.8	6.2	7.9	9.1	10.7	11.9
Retail sales	13.4	17.1	17.6	15.7	16.8	16.8	15.7	21.1
Vehicles sales[1/]	15.4	-1.9	-8.2	3.6	31.6	73.8	85.7	72.5
Gross Fixed Capital Formation	20.1	20.2	25.3	38.8	50.1	47.4	29.9	22.8
Exports of Goods	17.3	18.5	4.4	-10.9	-9.1	-5.5	13.9	30.2
Imports of Goods	17.1	10.6	-2.4	-3.8	18.1	28.7	25.9	19.2
Industrial production	15.9	12.9	6.4	5.6	9.0	12.4	18.0	19.6
Unemployment rate[2/]	4.0	4.0	4.2	4.3	4.3	4.3	4.3	4.2

Source: Thomson
1/ Includes sales to enteprises.
2/ Urban unemployment rate at the end of the quarter.

in order 59.7, 58, 55.8, and 54.7, all of them at levels higher than the dividing level 50[7].

The resumption of economic activity led to favorable developments in the labor market in the US. In the first quarter of this year, 261,000 urban jobs were generated, the first positive result since the quarter that ended in December 2007[8], followed by the creation of 721 thousand jobs registered in the two–month period ending in May, of which 477 thousand were of a temporary nature, for the census of 2010. In the Euro Area, 89 thousand jobs were eliminated in the first quarter of 2010, compared to respective extinctions of 643 thousand and 278 thousand jobs in the quarters ending in September and December of 2009.

In the US, the unemployment rate reached 9.7% in May, compared to 10% in December, while in April, those regarding Japan, the Euro Area, and the United Kingdom remained in that order in 5.1 %, 10.1%, and 7.9%, registering respective variations of -0.1 p.p., 0.2 p.p., and 0.1 p.p. compared to rates at the end of 2009.

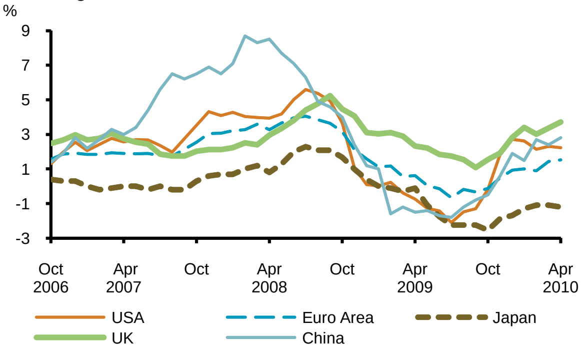
In China, the annualized GDP growth rate reached 11.9% in the first quarter of this year, the highest since the second 2007 quarter, emphasizing the contribution of domestic consumption and exports, in an environment of slowing growth in the gross fixed capital formation. The performance of consumption was stimulated by the recovery of the labor market and the maintenance of government incentives for the acquisition of consumer durables, which favored respective increases of 19.6%, 21.1%, and 72.5% recorded in the period, in industrial production, retail, and vehicle sales. Chinese exports grew 30.2% in the quarter ending in March, compared to the same period in 2009, while imports increased 19.2%, benefiting growth in economic activity in Southeast Asian countries, in Japan, and in raw material exporting countries.

4.2 Monetary policy and inflation

The pace of economic recovery did not reflect significant changes in inflationary expectations in the major mature economies, therefore carrying on the accommodative nature of monetary policies adopted by the respective monetary authorities. In the most important emerging economies, where the resumption of activity was faster and more

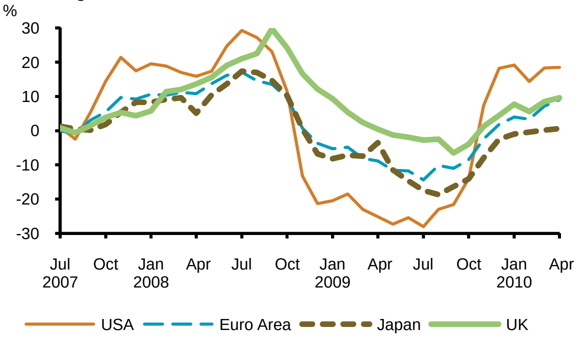
7/ PMIs for the Euro Area, UK, and Japan are provided by Markit; for the USA, by the Institute for Supply Management (ISM).
8/ In the quarters that ended between December of 2007 and 2009, 8.4 million jobs were eliminated in the USA.

Figure 4.3 – Consumer inflation
Annual growth



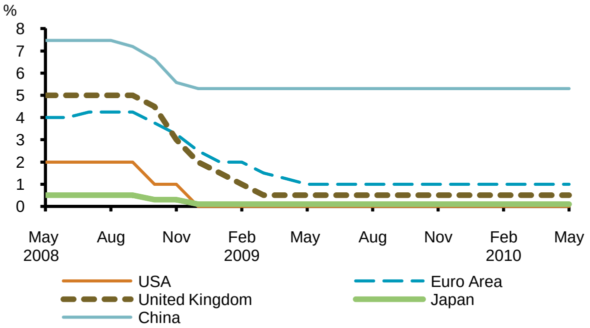
Sources: BLS, Eurostat, Bloomberg and ONS

Figure 4.4 – Energy inflation
Annual growth



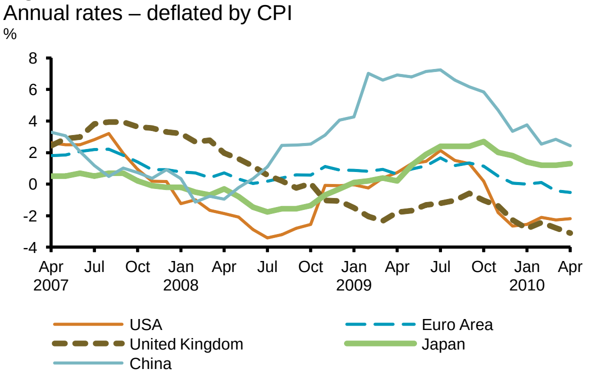
Source: Thomson

Figure 4.5 – Official interest rates
Annual rates



Sources: Fed, ECB, BoJ, Bank of England and The People`s Bank of China

Figure 4.6 – Real interest rates
Annual rates – deflated by CPI



Sources: Fed, BCE, BoJ, BoE, BPC, BLS, Eurostat, ONS and Bloomberg

intense, the emergence of inflationary pressures reinforces the expectation of change in the monetary policy stance.

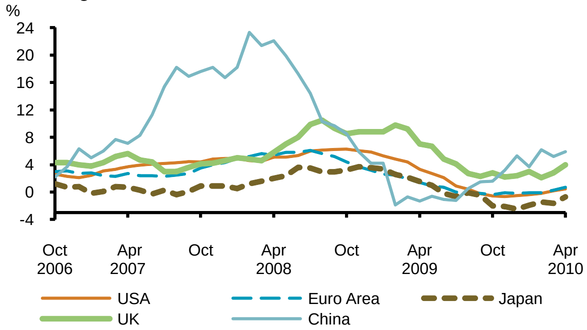
In the USA, the IPC cumulative variation over twelve months fell from 2.6% in January to 2.2% in April. Excluding energy and food items, which had respective increases of 18.5% and 0.5% in April, the accumulated twelve-month variation of the core CPI amounted to 0.9% in April, the lowest level since 1966, and certainly contributed to the Federal Reserve (Fed) maintaining, in April, its limits to the target fluctuation band for *Fed funds* at 0% and 0.25%. In a scenario of aggravated financial markets tensions in May, the Fed reinstated currency swap lines effective until January 2011 with the central banks of England, Canada, Japan, Switzerland, and the Euro Area, which had been closed last February.

In the UK, despite the high idleness of production factors, the IPC variation accumulated in twelve months, in an upward trend since September of 2009, amounted to 3.7% in April, its highest value in the last seventeen months. The core index posted annual growth of 3.1%, a level observed since the beginning of the year and significantly higher than reported throughout the decade. The Bank of England (BoE), considering that the main determinants of inflation underway in the country's economy – changes in commodity prices, depreciation of the pound, and rise in value-added tax – constitute transient elements and that inflationary expectations remain anchored, maintained the basic interest rate at 0.5% p.y. at the May meeting.

In the Euro Area, the cumulative CPI variance in twelve months amounted to 1.5% in April, the highest level since December of 2008, while that regarding its core reached 0.8%, the lowest level since the series has begun. In this scenario, the European Central Bank (ECB) decided to maintain the basic interest rate at 1% p.a. at its May meeting. Additionally, in May, the ECB suspended the minimum rating limit for the acceptance of Greek sovereign debt bonds, as collateral for refinancing operations and announced the start of purchases – which will be sterilized through auctions of term deposits – of public and private securities issued in countries that use the common currency (Securities Markets Program).

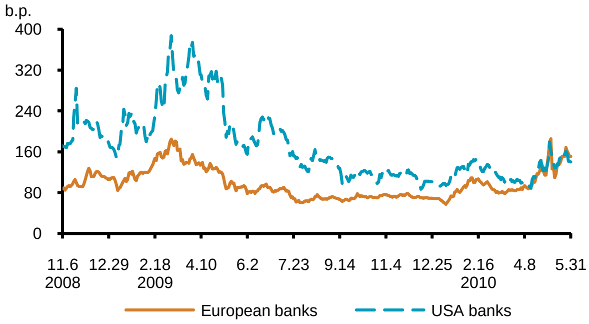
In Japan, the annual variation in IPC was negative for the fifteenth consecutive month, and reached -1.2% in April, with food prices falling 0.7%. The Bank of Japan (BoJ), after announcing in mid-March the duplication to ¥20 trillion of resources offered to the financial system through three-month term operations, at the fixed rate of 0.1%, maintained at its May meeting, the basic rate at 0.1% p.a.

Figure 4.7 – Food inflation[1/]
Annual growth



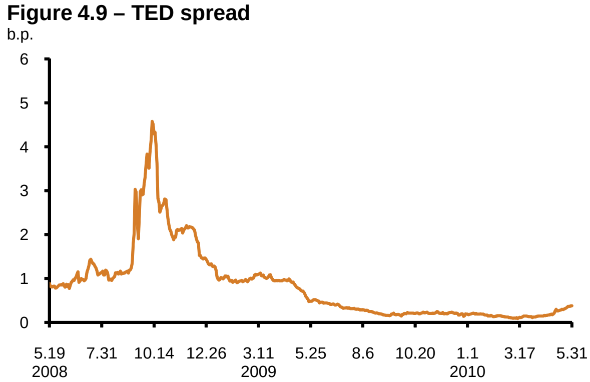
Source: Thomson
1/ For Euro Area and United Kingdom, data includes alcohol & tobacco.

Figure 4.8 – 5-year CDS premiums of major banks[1/]



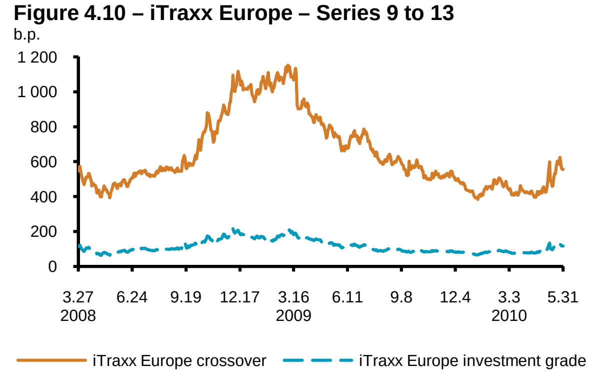
Source: Thomson
1/ Aritmethic average of 5-year CDS premiums for major European and USA banks. Since it's not a random sample, it may not reflect the behavior of the financial system as a whole.

Figure 4.9 – TED spread



Source: Thomson

Figure 4.10 – iTraxx Europe – Series 9 to 13



Source: Thomson

In China, the annual inflation rates for consumers and producers hit respective levels of 2.8% and 6.8% in April, the highest levels since, October and September 2008. In this scenario, although inflation expectations continued growing and bank credit remained high, the People's Bank of China (PBC) maintained the basic interest rate in May at 5.31% p.a. for the seventeenth consecutive month. The monetary authority, however, turned to make quantitative restrictions aiming at curbing liquidity and cut back prices increases of real estate assets. Accordingly, in April, the PBC sold securities with maturities of three years and in May, increased for the third time in 2010, the reserve requirements over demand deposits, fixed at 17% for large banks and 15% for smaller institutions.

4.3 International financial markets

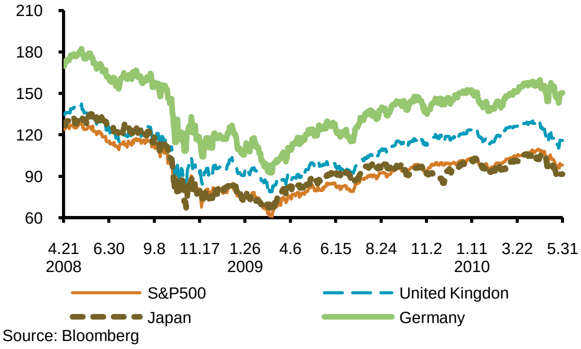
Uncertainties arising from the fiscal deterioration observed particularly in Greece, Spain, and Portugal, led to rising risk aversion in financial markets during the quarter that ended in May. In this scenario, increased volatility in stock markets, in the sovereign risk of European countries, and in the demand for low-risk government bonds, along with the euro depreciation were registered.

The escalation of sovereign risk and regulatory uncertainties were reflected in the evolution of risk premiums implicit in contracts for Credit Default Swaps (CDS) of the banking sector, particularly in Europe. The average premium for the five largest American banks, selected by the criterion of market capitalization, rose 6 basis points in the quarter ending in May, and reached 140 b.p. at the end of the period, while for the five largest in European banks, selected by the same criterion; it grew 53 b.p. and reached 151 b.p. It should be noted that the trajectory of the risk premiums associated with European banks showed the largest exposure of the region's banking sector, especially French and German banks, to markets with higher sovereign default risk. Additionally, the German ban on short selling shares of German financial firms as well as sovereign CDS from countries in the Euro Area, in mid-May, fueled fears about the continent's banking system.

The environment of greater risk aversion has resulted in the reduction of liquidity in the North American interbank market. The TED Spread – the difference between the 3-month Treasury Bill, considered a short-term risk-free

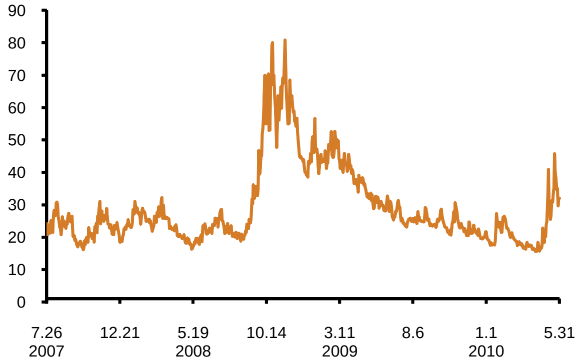
Figure 4.11 – Stock exchanges: USA, Europe and Japan

12.31.2003 = 100



Source: Bloomberg

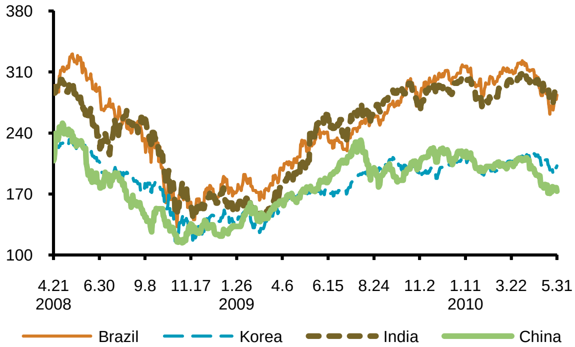
Figure 4.12 – VIX



Source: Thomson

Figure 4.13 – Stock exchanges: emerging markets

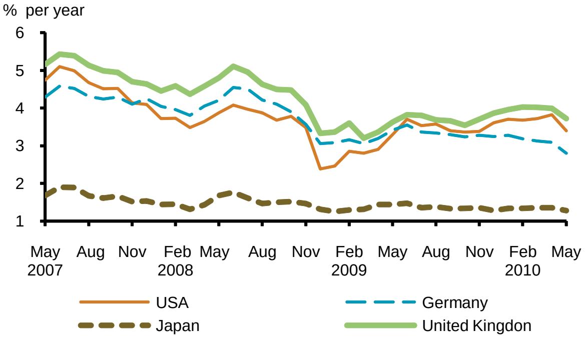
12.31.2003 = 100



Source: Bloomberg

Figure 4.14 – Yield on government bonds[1/]

% per year



Source: Bloomberg

1/ Monthly average of nominal yields on 10-year bonds, up to May 31, 2010.

rate, and the libor in dollar of the same term – reversed the narrowing trend observed in the past three Inflation Reports and reached 37 b.p. at the end of May, compared to 12 b.p. basis points at the end of February. It is worth mentioning that the new level is below those observed prior to September 2008.

Similarly, business financing conditions, especially those considered to be of greater risk, have become more restrictive. The iTraxx Crossover, which represents the risk premium required to guarantee loans to European companies considered high risk, reached 459 b.p. at the end of May, rising by 58 b.p. in relation to the end of February. The iTraxx IG, which represents the premium required for European companies considered to be investment grade, reached 113 b.p. at the end of May, moving up 29 b.p. in the period.

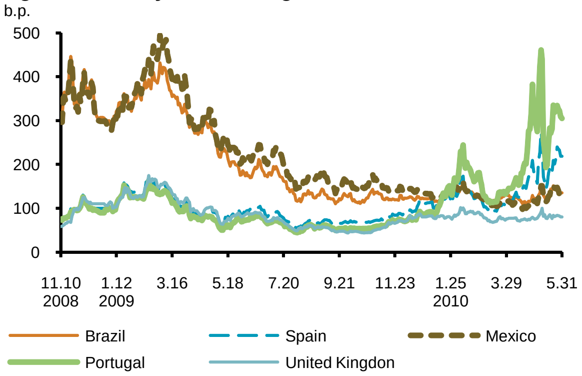
Growing uncertainties ascribed, in addition, losses on major stock exchanges. The Nikkei index of Japan; Financial Times Securities Exchange Index (FTSE 100), of the United Kingdom; and Standard and Poor's 500 (S&P 500), of the US., posted respective drops of 3.5%, 3.1%, and 1.4% for the quarter ended in May, compared with the appreciation of 6.5% recorded on the Deutscher Aktienindex (DAX), of Germany. Considering only May, when the uncertainties about the evolution of the fiscal crisis in Europe deepened, the mentioned indicators declined, in sequence, 11.7%, 6.6%, 8.2%, and 2.8%.

The Chicago Board Options Exchange Volatility Index (VIX) – which measures the short-term implied volatility of the S&P 500 and which is an important indicator of risk aversion – hit 45.8 points on May 20, compared to 19.5 points at the end of February, the highest value in 14 months, but fell to 32 points at the end of the month.

Stock markets in emerging economies, despite the stronger economic recovery observed in these countries, registered losses in May. The Shanghai Composite index, of China; Sensex, of India; Kospi of South Korea; and Bovespa of Brazil, retreated, in order, 9.7%, 3.5%, 5.7%, and 6.6% in the month, and accumulated respected variations of -15.1%, 3.1%, 2.9% and -5.1% in the quarter ended in May.

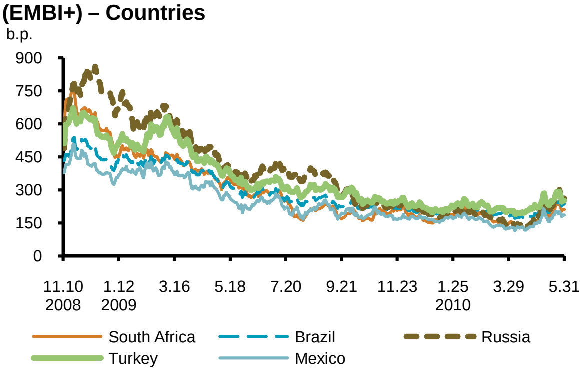
Increased demand for better rated sovereign bonds resulted in a trajectory of average annual income of ten-year securities from the UK, USA, Germany, and Japan, which fell, in order, by 4%, 3.72%, 3.13%, and 1.35% in March, to 3.20%, 2.93%, 2.42% and 1.1% in May.

Figure 4.15 – 5-year sovereign CDS



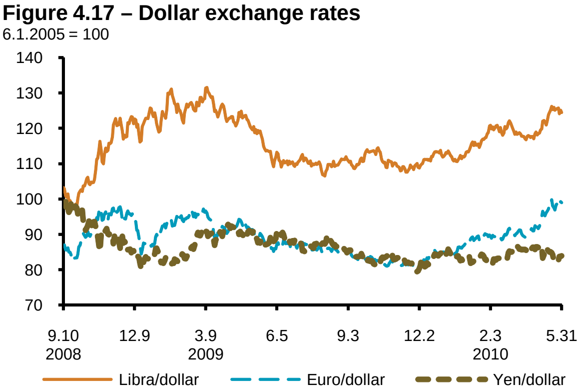
Source: Thomson

Figure 4.16 – Emerging Markets Bond Index Plus (EMBI+) – Countries



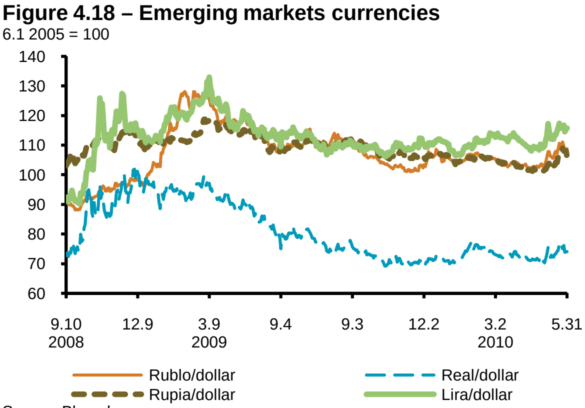
Source: Bloomberg

Figure 4.17 – Dollar exchange rates



Source: Bloomberg

Figure 4.18 – Emerging markets currencies



Source: Bloomberg

Sovereign risk premiums in Greece, Portugal, and Spain, as measured by their 5-year CDS, rose in order, by 364 b.p., 164 b.p., and 130 b.p. at the end of February to 941 b.p., 461 b.p., and 275 b.p., on May 6 – the highest values of their respective series. At the end of the month, reflecting the favorable expectations regarding the effects of assistance measures by the European Union (EU) and the International Monetary Fund (IMF) to Greece[9], among other initiatives, the mentioned indicators fell to 663 b.p., 305 b.p., and 219 b.p., respectively.

The increase in risk aversion impacted, in addition, the demand for lower quality assets. The sovereign risk indicator, Emerging Markets Bonds Index Plus (Embi+) reached 317 b.p. at the end of May, compared with 292 b.p. at the end of February, highlighting that the indices regarding Russia, Mexico, Brazil, and Turkey registered respective increases of 61 b.p., 21 b.p., 20 b.p., and 11 p.b. in the period.

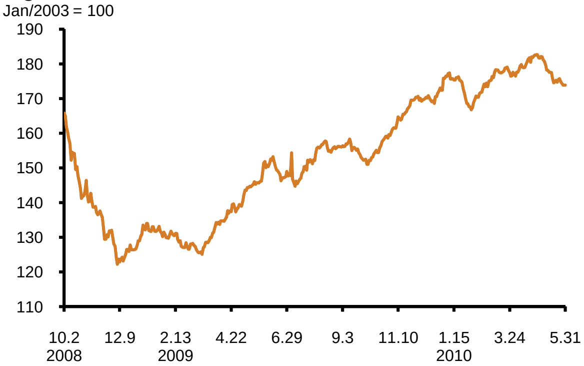
The deterioration of expectations concerning the fiscal situation and the sustainability of economic growth in the Euro Area intensified the process of depreciation of the single European currency in relation to the US dollar, which experienced respective variations of 10.8% and 4.8% in relation to the euro and pound sterling, in the quarter ended in May. In an environment of lower inclination to risk and reduced capital flows to emerging markets, over the same period the dollar also appreciated against the Russian ruble, 3.2%; the Turkish lira 1.8%, the Brazilian real, 0 7%, and the Indian rupee, 0.6%.

4.4 Commodities

The Commodity Research Bureau (CRB) index, after registering a 4.1% appreciation in the March-April period, in an environment of stronger global economic recovery than originally expected, especially in China – an important consumer of commodities, and the US, fell 0.6% in the quarter ended in May. The reversal in the index behavior reflected unfavorable expectations regarding the fiscal sustainability of some European countries, the effects of possible regulatory changes in the financial systems of developed countries, and the measures adopted in China to reduce liquidity in that country. When considering quarterly averages, the CRB registered, for the quarter ended in May,

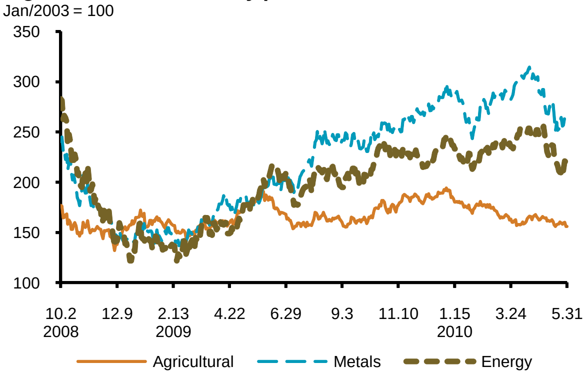
9/ The European Union and the IMF agreed to a total aid package to Greece of €110 billion over the next three years, with the first disbursement on May 19, in the value of €14.5 billion. Additionally, with the approval on May 10 of the European Stabilization Mechanism, the EU will have resources of about €500 billion, reaching € 750 billion with an additional contribution of funds from the IMF. Also highlighted is the beginning of the purchases by the ECB and other central banks in the region of sovereign bonds issued by EU countries with the objective of increasing liquidity in the financial markets in the region.

Figure 4.19 – CRB index



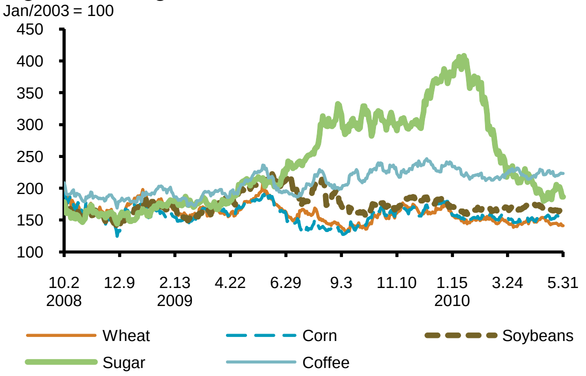
Source: Commodity Research Bureau

Figure 4.20 – Commodity price index



Source: S&P GSCI

Figure 4.21 – Agricultural commodities



Sources: NYB-ICE and Chicago Board of Trade

respective increases of 3.5% and 31.3% for the quarters ending in February 2010 and May 2009.

According to the Goldman Sachs Commodity Index (GSCI), by Standard & Poor's (S&P) together with Goldman Sachs, commodity prices fell on average 5.7% in the quarter ended in May, compared to the one that ended in February, a result of the marked shrinkage in segments of agricultural, 12.3%; energy, 5.7%; and metal, 4.7% commodities.

The reduction in prices of agricultural commodities reflected both a level above the originally forecast for crops in South America, as well as favorable prospects for the recovery of world sugar production, after two seasons hampered by bad weather in India. Considering future contracts for first delivery, quarterly reductions were registered in the prices of wheat, 9.6%; corn, 5%; and soybean, 1.4%, negotiated on the Chicago Board of Trade (CBT); and of sugar, 41.2%, traded on the New York Intercontinental Exchange (ICE). The contract for coffee, also traded on the ICE, reported 4% appreciation in the period, showing reduced levels of world stock and prospects of crop failure yields in important exporting countries.

The recent decline in prices of metal commodities, even in a scenario of relative recovery in global demand and reductions in inventories, led to the prospect that the reduction of liquidity in China and fiscal issues in Europe constitute restrictions to consolidating a global economic recovery, with adverse developments on the demand in this product segment. According to the London Metal Exchange (LME) quarterly decreases in May were registered in the prices of lead, 14.8%; zinc, 12.3%; aluminum, 4.2%; and copper 3.6 %, in contrast to the elevations observed in respect to tin, 4.7%; and nickel 0.9%.

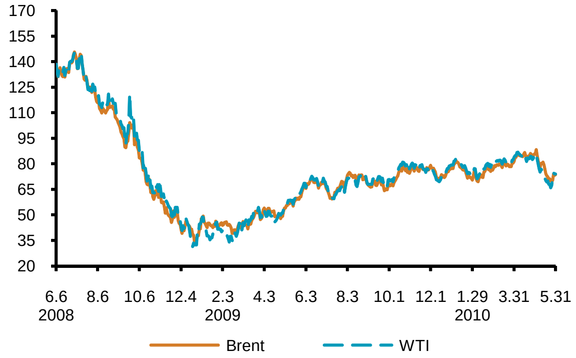
As of the beginning of April, when the readjustment of the price of iron ore – reflecting in large measure, the strong Chinese demand driven by investments in infrastructure, construction, and production of durable goods – reached about 100% in relation to that in 2009, the world's biggest mining companies have adopted new pricing system for that commodity, replacing annual negotiations for quarterly reviews[10]. According to the Metal Bulletin, the price of iron ore, after accumulating an increase of 21.3% in April, up to the 22nd day, began to show depreciation, closing May at a level lower than the 5.4% reported at the end of March. This reversal reflected in part the impact of measures taken

10/ Under the new methodology, in every quarter, prices for iron ore will be determined by the average spot price in the three months preceding the final month of the quarter in question.

by the Chinese government to curb the housing boom[11], which tends to affect construction and therefore demand for the commodity.

4.4.1 Petroleum

Figure 4.22 – Oil – Spot market
US$ per barrel



Source: Bloomberg

Average barrel prices of WTI and Brent petroleum rose from US$76.30 and US$74.31 respectively, in February, to US$73.72 and US$76.53, in May. May report of the US Department of Energy (DOE), incorporating the perspectives of more consistent world economic recovery, considers that the average price for a WTI barrel is expected to reach US$84.00 by the end of the second half of this year and US$87.00 at the close of 2011.

4.5 Conclusion

Recent developments in the global economy have been characterized by a disparate pace of recovery in major developed countries. The process of recovery in these economies becomes clearer in a scenario of strengthening their respective domestic demands, as indicated by growth of consumer spending and investment, and in the recovery of the labor market. The worsening fiscal conditions in European countries and the increased risk aversion in international financial markets are, however, restrictive elements to the process mentioned.

The recent drop in oil prices, the idleness of production factors, the return of stress in the financial markets, and maintenance of the indices of core inflation at historically low levels suggest that the G-3 central banks will continue to maintain an accommodative stance and will continue to promote, if and when necessary, liquidity adjustments in their markets.

The major emerging economies maintained the pace of economic activity more intensely than those in mature economies. It is noteworthy that although the increased risk aversion recently verified can somehow contain the net inflow of foreign capital to these economies, with likely repercussions on their respective exchange rates, stock exchanges, and sovereign risk indicators, the perception regarding the continuity of their growth should stimulate incoming capital flows.

11/ Measures to reduce liquidity and impose restrictions on the purchase of properties in large cities.

External sector

5

The trajectory of the current account deficit appears to be compatible with the unfolding consolidation of Brazil's economy current growth cycle in the demand for imported goods and services. In this scenario, while exports registered substantial growth, aided by the rising prices of exported products, the trade balance surplus fell 39.6% in the five early months of 2010 in relation to the same period in the previous year, a trajectory that, reflecting disparate growth rates between the Brazilian and global economies, should persist throughout the year. Additionally, the prospect of increases in the deficit of the service account should be noted, driven by increases in imports of services and net remittances of profits and dividends, the latter encouraged by expansion of the stock of foreign investments in the country and the increasing profitability of residing companies.

Within the financial account, net inflows of direct foreign investments, fixed income securities, and stocks remain sufficient to finance current transactions and strengthen the momentum of improvement in the structure of external liabilities, with growth in the share of investments at the expense of the debt component.

Projections for the balance of payments, as shown in the box Review of Projections for the Balance of Payments, on page 73 of this Report, consider the maintenance of appropriate financing conditions for external accounts in the year. The changes recorded in these projections resulted from the incorporation of results that occurred until May, including net interventions made by the Central Bank in the market, and the new external indebtedness position, regarding March.

Table 5.1 – Foreign exchange flows

US$ billion

Itemization	2009			2010	
	May	Jan-May	Ano	May	Jan-May
Trade operations	1.6	13.0	9.9	2.7	2.0
Exports	12.4	59.1	144.7	16.3	66.1
Imports	10.8	46.2	134.7	13.6	64.1
Financial operations[1/]	1.6	-11.4	18.8	-0.1	5.6
Purchases	27.5	105.6	336.3	30.5	133.1
Sales	26.0	117.0	317.4	30.6	127.4
Net flows	3.1	1.6	28.7	2.6	7.6

1/ Excluding interbank operations and Central Bank foreign operations.

5.1 Exchange operations

The foreign exchange market contracted a surplus of US$7.6 billion in the first five months of 2010, when compared to US$1.6 billion in the same period of the previous year. The foreign exchange trade surplus for the period closed at US$2 billion, against US$13 billion in the equivalent period of 2009, reflecting respective expansions of 38.8% and 11.7% in contracting import and export operations.

The financial segment, indicating more favorable external financing conditions, registered 26% increases in purchases and 8.9% in sales of foreign currency, resulting in net inflows of US$5.6 billion, compared to net outflows of US$11.4 billion in the first five months of 2009.

Net foreign currency purchases by the Central Bank in the foreign exchange spot market totaled US$12.1 billion in the period. The position of banks, which reflects transactions with customers in the primary exchange market and Central Bank interventions, went from a long position of US$3.4 billion at the end of December 2009, to short position of US$3.3 billion at the end of May.

Table 5.2 – Trade balance – FOB

US$ million

Period	Exports	Imports	Balance	Total trade
Jan-May 2010	72 094	66 474	5 619	138 568
Jan-May 2009	55 484	46 180	9 304	101 663
% change	29.9	43.9	-39.6	36.3

Source: MDIC/Secex

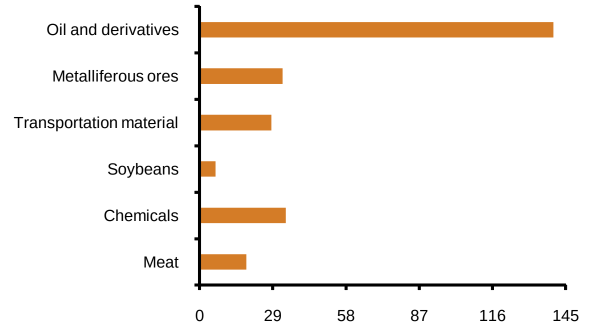
Table 5.3 – Exports by aggregate factor – FOB
Daily average – January-May

US$ million

	2009	2010	% change
Total	549.3	706.8	28.7
Primary products	223.9	304.5	36.0
Industrial products	314.2	386.7	23.1
Semimanufactured goods	71.0	96.4	35.8
Manufactured goods	243.2	290.3	19.4
Special operations	11.3	15.6	38.5

Source: MDIC/Secex

Figure 5.1 – Main exports
January-May – 2010/2009[1/] – % growth



Source: MDIC/Secex
1/ Change in value over the same period of the previous year.

5.2 Trade in goods

Exports totaled US$72.1 billion and imports, US$66.5 billion in the first five months of 2010, results 29.9% and 43.9% higher than those that occurred in the same period a year earlier, resulting in a decrease of 39.6% in the trade surplus for the period, which reached US$5.6 billion. Growth in the Brazilian economy and the recovery of activity with trading partners was reflected in the 36.3% increase in trade flow in the period.

Exports of basic products registered a daily average of US$304.5 million in the first five months of 2010, rising 36% over the same period in 2009, with emphasis on the expansion of foreign sales of crude oil, 208%; copper ore, 145%; beef, 44.2%; and iron ore, 28.3%. Conversely, shipments of grain corn and tobacco leaves were reduced 25.3% and 9.5% respectively.

Shipments of semi-manufactured goods totaled a daily average of US$96.4 million, noting that the increase of 35.8% in the period reflected, in part, increases in foreign sales of hides and skins, 77%; iron alloys, 58.4%; raw sugar, 57.9%; and cellulose, 55.6%. Exports of manufactured items, which amounted to a daily average of US$290.3 million in the five early months of the year, rising 19.4% over the same period in 2009 were boosted in particular by growth in shipments of fuel oil, 122.7%; cargo vehicles, 74.4%;

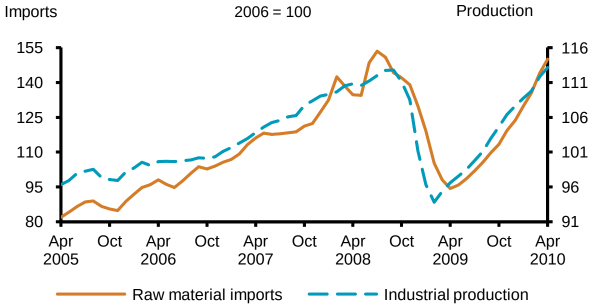
Table 5.4 – Imports by end-use category – FOB
Daily average – January-May

US$ million

Itemization	2009	2010	% change
Total	457.2	651.7	42.5
Capital goods	115.9	140.8	21.5
Raw materials	209.8	307.2	46.4
Naphtha	5.5	17.5	218.2
Consumer goods	74.9	110.5	47.5
Durables	37.0	62.6	69.1
Passenger vehicles	16.0	28.0	75.1
Nondurable	37.9	47.9	26.3
Fuels	56.6	93.2	64.7
Crude oil	28.0	41.8	49.5

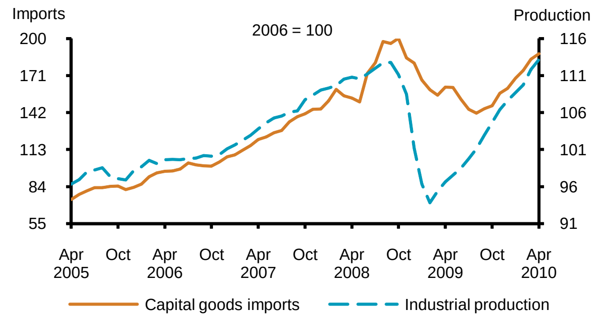
Source: MDIC/Secex

Figure 5.2 – Raw material imports x industrial production – 3-month moving average
Seasonally adjusted indices



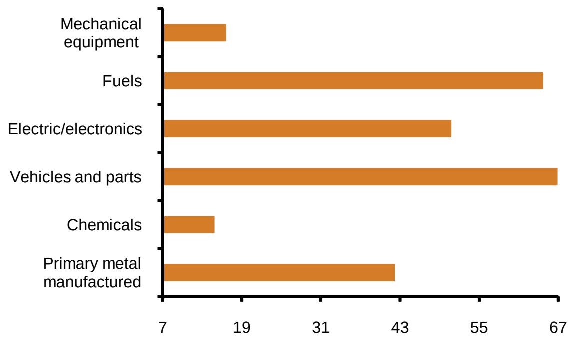
Sources: Funcex and IBGE

Figure 5.3 – Capital goods imports x industrial production – 3-month moving average
Seasonally adjusted indices



Sources: Funcex and IBGE

Figure 5.4 – Imports by main products
January-May – 2010/2009[1/] – % growth



Source: MDIC/Secex
1/ Change in value over the same period of the previous

aluminum oxides and hydroxides, 71.9%; passenger cars, 46.9%; and auto parts, 44.6%.

Breaking down by sector the country's exports, it was observed that the six major sectors accounted for 59.5% of the average daily shipments in the first five months of 2010, compared to 55.4% in the same period of the previous year, totaling US$420.2 million. Foreign sales of petroleum and oil-derived products – those relating to crude oil accounted for 71.1% of the total – rose by 140.1%, followed by increases in exports of chemical products, 34.2%; minerals, 33% – of which 91.5% related to iron ore; transportation equipment, 28.5%; meats, 18.6%; and soybean, 6.4%.

The accession of the Brazilian economy into a new expansion cycle, as evidenced in the 9% GDP growth experienced in the first quarter of the year compared to the corresponding period of 2009, continues reflecting in the import trajectory. Accordingly, the daily average of foreign acquisitions increased 42.5% in the first five months of the year, compared to the same period last year, with increases in purchases in all use categories.

Average daily imports of raw materials and intermediate goods, representing 47.1% of foreign purchases in the period, increased 46.4%, driven by increases in purchases of mineral products, 78.5%; non-food agricultural/livestock products, 59.6%; and parts and accessories for intermediate products, 47.1%.

Average daily purchases of capital goods accounted for 21.6% of the total imported in the first five months of the year, stressing that the increase of 21.5% over the same period in 2009 reflected, in part, increases in imports of office and scientific machines and appliances, 51.5%; accessories for industrial machinery, 37.8%; and parts and accessories for industrial capital goods, 28.7%. Imports of industrial machinery, the most representative item under this category, grew by 1.8% in the period, and now represent 30.5% of the purchases of capital goods.

The average daily purchases of fuels and lubricants rose by 64.7% in the first five months of the year, accounting for 14.3% of imports in the period, 44.9% of which 44.9% were related to petroleum.

The participation in the average daily purchases of durable and non-durable consumer goods in the total Brazilian imports reached, in order, 9.6% and 7.3% in the first five months of the year. Imports of durables, which rose 69.1% in relation to

Table 5.5 – Exports and imports by area – FOB

Daily average – January-May

US$ million

Itemization	Exports			Imports			Balance	
	2009	2010	% change	2009	2010	% change	2009	2010
Total	549	707	28.7	457	652	42.5	92	55
L.A. and Caribe	117	171	47.2	81	112	37.9	35	60
Mercosur	49	77	58.6	45	61	34.4	4	16
Argentina	39	62	60.5	39	53	35.8	-0	9
Other	10	15	51.1	6	8	25.8	4	7
Other	68	94	39.0	36	51	42.4	32	43
USA[1/]	59	72	20.6	82	98	19.4	-22	-26
EU	127	154	21.8	106	140	32.6	21	14
E. Europe	12	21	73.4	4	10	145.9	8	11
Asia	142	188	32.2	128	198	54.7	14	-10
China	77	104	35.0	56	86	52.7	21	18
Other	65	84	28.7	72	112	56.2	-7	-29
Others	92	101	8.8	57	94	66.1	36	6

Source: MDIC/Secex

1/ Includes Puerto Rico.

the corresponding period in 2009, were sustained by increases in the purchases of machinery and household appliances, 135.9%; furniture and other home equipment, 84.4%; and automobiles, 75.1%, while the average daily increase of 26.3% registered in the non-durable consumption category reflected, in particular, growth in purchases of food products, 42.1%; toiletries, 39.3%; and pharmaceuticals, 21.6%.

Bilateral trade with major blocs and countries registered a general expansion in the first five months of the year, compared to the same period in 2009, with emphasis on the respective increases of 43.4% and 42.8% reported in foreign exchanges with Latin America and the Caribbean, and Asia. Additionally, commercial transactions with other countries, with the EU, and the US registered respective increases of 30.6%, 26.7%, and 19.9% in the period.

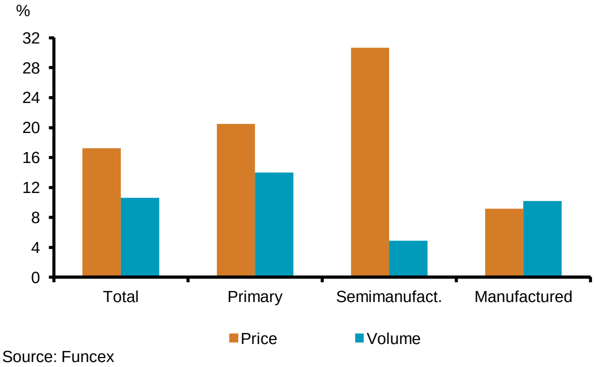
Trade with the Asian bloc, the country’s largest trading partner, resulted in an average daily deficit of US$10 million in the first five months of the year, compared to a surplus of US$14 million in the corresponding period in 2009. Exports to the region accounted for 26.6% of Brazilian external sales, of which 55.5% were targeted to China, while Asian products accounted for 30.4% of foreign purchases of the country, 43.4% originated in China.

Commercial exchange with the EU provided an average daily surplus of US$14 million. The observed of 32.2% drop over the same period in 2009 reflected increases in exports, 21.8%, and imports, 32.6%, which represented 21.8% and 21.5% respectively, of the total country’s external sales and purchases.

Commercial operations with Latin America and the Caribbean contributed an average daily surplus of US$60 million in the first five months of the year, of which 27.6% was relative to the Southern Common Market (Mercosul). The expansion of 68.2% in relation to the same period of 2009 was a result of growing exports, 47.2%, and imports, 37.9% that accounted for, in order, 24.3% and 17.2% the total exported and imported by Brazil in that period.

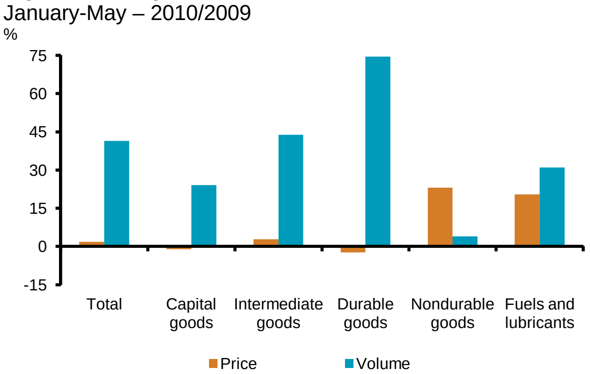
The average daily deficit observed in bilateral trade with the US grew from US$22 million, from January to May 2009, to US$26 million, a variation arising from increases of 20.6% in exports and 19.4% in imports, which registered respective daily averages of US$72 million and US$98 million, and accounted for, in order, 10.1% and 15% of total shipments and purchases by the country in the period.

Figure 5.5 – Exports – Price and volume index
January-May – 2010/2009



Source: Funcex

Figure 5.6 – Imports – Price and volume index
January-May – 2010/2009



Sources: Funcex and BCB

Table 5.6 – Current account

US$ billion

Itemization	2009			2010		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Current account	-1.8	-6.6	-24.3	-2.0	-18.7	-49.0
Trade balance	2.6	9.3	25.3	3.4	5.6	13.0
Exports	12.0	55.5	153.0	17.7	72.1	185.0
Imports	9.4	46.2	127.7	14.3	66.5	172.0
Services	-1.7	-6.2	-19.2	-2.6	-11.3	-24.7
Transportation	-0.4	-1.3	-3.9	-0.5	-2.3	-5.0
International travel	-0.4	-1.3	-5.6	-0.7	-3.2	-8.0
Computer and inform.	-0.2	-1.0	-2.6	-0.2	-1.2	-3.0
Operational leasing	-0.7	-3.6	-9.4	-1.1	-5.0	-11.0
Other	0.0	1.0	2.3	0.0	0.5	2.3
Income	-2.9	-11.1	-33.7	-3.2	-14.6	-40.8
Interest	-0.4	-3.6	-9.1	-0.4	-4.0	-9.4
Profits and dividends	-2.6	-7.8	-25.2	-2.9	-10.8	-32.0
Compensation of employees	0.1	0.3	0.6	0.0	0.2	0.6
Current transfers	0.2	1.4	3.3	0.4	1.5	3.5

1/ Forecast.

The average daily surplus registered in trade with other countries posted reduction of 82.1% in the first five months of the year, as a result of 8.8% expansion on foreign sales and 66.1% on foreign purchases, which totaled respective daily averages of US$101 million and US$94 million. This result reflected, in particular, increases in petroleum imports from Nigeria, Algeria, Angola, and Iraq, countries which together accounted for 26.3% of trade flows and 41.2% of imports within the framework of 'other countries' group, in the first five months of the year.

According to Foreign Trade Studies Center Foundation (Funcex), the 29.9% growth registered in exports from January to May 2010, in relation to the same period in the previous year, resulted from increases of 17.2% in prices and 10.6% in quantum exported. The price index trajectory showed expansions of 30.6% in semi-manufactured product prices, 20.5% in basics, and 9.2% in manufactured products; while amounts exported increased, in the same order, by 4.9%, 14%, and 10.2% in the period.

The 43.9% expansion in imports, in relation to the first five months of 2009, revealed in particular, an increase of 41.5% in imported volume, while prices rose by 1.8%. A segmented analysis reveals that the imported quantum of durable consumer goods grew 74.5%, followed by increases in the categories of raw materials and intermediate goods, 43.9%; fuels and lubricants, 31%; capital goods, 24%; and non-durable consumer goods, 3.9%. In relation to the price index of imports, highlights were the increases in the categories of non-durable consumer goods, 23.1%, and fuels and lubricants, 20.5%, followed by variations for raw materials and intermediate goods, 2.8%; capital goods, -1.1%; and consumer durables, -2.3%.

5.3 Services and income

The deficit in current account reached US$18.7 billion in the first five months of 2010, compared with US$6.6 billion in the same period last year, evolving from the reduction in the trade balance and from increases in net expenditures on services and income account deficit. Considering twelve-month periods, the current account deficit totaled US$36.4 billion in May, equivalent to 1.94% of GDP.

Net remittances in the service account reached US$11.3 billion, increasing 82.7% over the outcome of the first five months of 2009, highlighting the variation of 145.7%, to US$3.2 billion, in net expenditures for international travel. Expenditures of Brazilians abroad resumed its upward trend and hit US$5.7 billion, while revenues from spending by foreign tourists in Brazil totaled US$2.5 billion, respective increases of 65.1% and 16.7%, in the same basis of comparison.

The performance of imports and international travel expenses contributed to net expenditures on transportation reaching US$2.3 billion from January to May, an increase of 81.8% over the same period in 2009. Net spending on equipment rentals totaled US$5 billion, increasing 41.3%, while net payments of royalties and licenses, including the provision of technology services, copyright, licenses and registrations for trademark use and exploitation of patents, franchises, and others, grew 31.6%, totaling US$1 billion. Government services as well as computing and information services registered net expenditures of US$1.3 billion and US$1.2 billion, increasing 139.1% and 23% respectively.

Net expenditures of the income account totaled US$14.6 billion in the first five months of the year, rising 31% over the same period last year. Net interest expenditures increased 11.4% in the period and hit US$4 billion, with emphasis on the 33.1% decline in revenues, which totaled US$2.1 billion in an environment of declining international interest rates.

Net remittances of profits and dividends totaled US$10.8 billion, increasing 38.1% in the period. The industrial and service sectors were responsible, respectively, for 52.1% and 45.5% of the gross remittances of profits and dividends from foreign direct investments (FDI) in the period, with emphasis on financial services, automobiles, and metallurgy.

Net unilateral transfers totaled US$1.5 billion in the first five months of 2010, increasing 6.1% over the same period last year. Net inflows stemming from remittances to maintain residents, reflecting the lower economic activity in major destination countries for Brazilian migrants, totaled US$606 million, dropping 18% in the period.

5.4 Financial account

The capital and financial account registered a surplus of US$34.4 billion in the first five months of the year, highlighting that the recent increase in risk aversion in international financial markets caused a limited impact on the financing of the country’s foreign accounts.

Table 5.7 – Financial account

US$ billion

Itemization	2009 May	2009 Jan-May	2009 Year	2010 May	2010 Jan-May	2010 Year[1/]
Capital account	3.7	9.8	70.2	6.6	34.0	64.7
Direct investments	3.9	10.3	36.0	1.2	3.5	26.0
Abroad	1.5	-0.9	10.1	-2.4	-7.9	-12.0
In Brazil	2.5	11.2	25.9	3.5	11.4	38.0
Equity capital	1.8	6.3	19.9	3.2	10.7	31.0
Intercompany loans	0.7	5.0	6.0	0.3	0.7	7.0
Portfolio investments	2.3	-0.7	50.3	3.7	19.8	33.6
Assets	-1.4	-1.1	4.1	0.1	-0.4	0.0
Liabilities	3.7	0.5	46.2	3.5	20.2	33.6
Derivatives	0.0	0.2	0.2	0.0	0.0	0.0
Other investments	-2.5	-0.1	-16.3	1.7	10.8	5.1
Assets	-6.0	-8.4	-30.4	-2.3	-6.9	-4.4
Liabilities	3.4	8.4	14.1	4.0	17.7	9.5

1/ Forecast.

Table 5.8 – BP financing sources

Selected items

US$ billion

Itemization	2009 May	2009 Jan-May	2009 Year	2010 May	2010 Jan-May	2010 Year[1/]
Medium and long-term funds	1.3	4.8	15.7	3.1	15.2	16.8
Public bonds	0.8	1.8	4.1	-	0.8	0.8
Private debt securities	0.4	2.2	8.5	2.1	10.5	11.7
Direct loans	0.2	0.8	3.1	1.1	3.9	4.3
Short-term loans (net)[2/]	1.2	-2.2	-2.2	0.5	5.1	-
Short-term sec. (net)	-0.1	-1.5	-0.6	0.1	0.0	-
Portfolio in the country (net)	3.5	2.5	42.2	-1.2	13.1	32.0
Roll-over rates (%)[3/]						
Total	35%	55%	88%	664%	261%	125%
Debt securit.	49%	58%	95%	1354%	240%	125%
Direct loans	22%	48%	72%	332%	337%	125%

1/ Forecast.
2/ Includes direct loans and trade credits transferred by banks.
3/ It is equivalent to the ratio between medium-and long-term disbursements and amortizations, excluding amortizations resulting from debt-equity conversion.

Direct Brazilian investments abroad totaled net investments of US$7.9 billion in the first five months of 2010. Brazilian companies resumed investments in foreign markets, amounting to a net US$11.2 billion in the form of equity. Net amortizations of loans to foreign subsidiaries totaled US$3.2 billion.

Net inflows of FDI amounted to US$11.4 billion in the first five months of the year, compared with US$11.2 billion in same period in 2009. Net inflows in capital participation totaled US$10.7 billion and those relating to intercompany loans, US$734 million, marking respective variations of 70.8% and -85.3% in the period. Considering periods of twelve months, FDI reached US$26.1 billion in May, 1.39% of GDP.

Net inflows of foreign portfolio investments totaled US$20.2 billion from January to May, compared with US$462 million in same period in 2009. Net inflows of foreign investment in shares of Brazilian companies totaled US$8.1 billion, compared to US$3.1 million in the equivalent period in 2009, while those referring to fixed income securities traded in the country reached, in that order, net inflows of US$7.9 billion and net outflows of US$621 million.

Bonds traded abroad showed net outflows of US$1.9 billion in the first five months of the year, including the disbursement of US$788 million relative to the issue of the Global 21. The National Treasury, in a policy of improvement of the foreign debt profile of the Public Sector, redeemed in advance US$1.5 billion of rebates in advance during the period, of which US$1.2 billion referred to the face value of the securities and US$283 million, to the premium on these operations.

The rollover rate of medium and long term securities negotiated abroad reached 240% in the five month period ended in May, up from 58% in the equivalent period in 2009. Net inflows of notes and commercial papers totaled US$6.1 billion, resulting from disbursements of US$10.5 billion and amortizations of US$4.4 billion. Short-term securities recorded net disbursements of US$15 million in the period.

Other Brazilian investments showed a net increase in assets abroad of US$6.9 billion in the year through May, while deposits abroad by Brazilian banks fell US$8 billion and those held by the non-financial sector increased by US$2.5 billion. Net disbursements of foreign loans, including commercial credits, totaled US$12.5 billion in the period.

Table 5.9 – Statement of international reserves

US$ billion

Itemization	2008 Year	2009 Jan-May	2009 Year	2010 Jan-May	2010 Year[1/]
Reserve position in previous period	180.3	193.8	193.8	238.5	238.5
Net Banco Central purchases	-5.4	2.0	36.5	12.7	12.7
Spot	7.6	-0.7	24.0	12.1	12.1
Repo lines of credit	-8.3	4.8	8.3	-	-
Foreign currency loans	-4.7	-2.0	4.2	0.5	0.5
Debt servicing (net)	-0.4	-0.3	-2.2	-2.9	-3.3
Interest	2.8	0.4	0.7	-0.5	0.2
Credit	7.2	2.4	4.8	1.5	4.0
Debit	-4.4	-2.0	-4.0	-2.0	-3.8
Amortization	-3.2	-0.6	-2.9	-2.4	-3.5
Disbursements	1.3	-	1.8	-	-
Multilateral organizations	0.8	-	-	-	-
Sovereign bonds	0.5	-	1.8	-	-
Others[2/]	10.4	-2.9	1.7	-2.8	-2.8
Treasury's purchases	7.6	2.6	7.0	4.4	7.3
Change in assets	13.4	1.5	44.7	11.3	13.8
Gross reserve position	193.8	195.3	238.5	249.8	252.4
Repo credit lines position	8.3	3.6	-	-	-
Foreign currency loans position	4.7	6.7	0.5	-	-
Reserve position – Liquidity	206.8	205.6	239.1	249.8	252.4

1/ Forecast.
2/ Includes payments/receipts in the framework of the Reciprocal Credits and Payments Agreement (CCR), fluctuations in prices of securities, exchange parities and price of gold, discounts and premiums, duty fees, release of collaterals and SDRs allocations.

Other foreign investments, which include direct loans to banks, international organizations and agencies, commercial credits and deposits, registered net disbursements of US$17.7 billion in the first five months of the year, compared to US$8.4 billion in same period in 2009. Net inflows of long-term loans amounted to US$8 billion, highlighting net loans granted by agencies, US$3.9 billion. Direct medium and long-term loans presented net disbursements of US$2.8 billion, resulting in a rollover rate of 337%. Short-term loans totaled net disbursements of US$5.1 billion.

The May position of the international reserves registered a convergence between the two concepts, cash and liquidity, due to the total liquidation of the remaining balance of loan operations in foreign currencies granted during the 2008/2009 crisis. Thus, international reserves totaled US$249.8 billion in May, rising US$10.8 billion compared to December 2009, in the liquidity concept, and US$11.3 billion in the cash concept.

Net purchases by the Central Bank in the foreign exchange market amounted to US$12.7 billion in the same period, of which US$12.1 billion occurred in the spot market and the remaining US$535 million in lending transaction returns in foreign currencies. Still during the analyzed period, the remuneration of reserves generated revenues of US$1.5 billion and the other operations reduced the stock of reserves by US$2.8 billion.

5.5 External sustainability indicators

Debt indicators maintained positive trajectory in the first five months of 2010, except for growth of 10.2% of the estimated total external debt position and 5.4% increase in its service. It should be noted that, incorporating growth of 18.9% of GDP in dollars, the total external debt/GDP ratio decreased by 0.9 p.p. in relation to December 2009, to 11.6%. The increase of total external debt reduced the creditor position of the total net external debt, from -US$61.8 billion to -US$48.6 billion in the period, contributing to the change of the total net external debt/GDP ratio from -3.9% to -2.6%.

The rise in external debt service, associated with the 10.9% increase in exports, contributed to the ratio between debt service and total exports was reduced to 1.4 p.p., to 27.1%, in the year up to May. The coefficient total debt/exports remained at 1.3 and the total net debt/exports ratio dropped from -0.4 to -0.3.

Table 5.10 – Sustainability indicators[1/]

US$ billion

Itemization	2008		2009			2010
	Jun	Dec	Jun	Sep	Dec	May[2/]
Exports of goods	178.1	197.9	177.2	158.9	153.0	169.6
Exports of goods and services	205.1	228.4	206.3	186.6	180.7	199.2
Debt service	40.5	37.6	38.7	41.3	43.6	45.9
Total external debt	205.5	198.3	199.0	204.9	198.2	218.3
Net external debt	-19.2	-27.7	-28.0	-37.8	-61.8	-48.6
International reserves						
Cash concept	200.8	193.8	201.5	221.6	238.5	249.8
Liquidity concept	200.8	206.8	208.4	224.2	239.1	249.8
GDP	1 513	1 636	1 449	1 475	1 577	1 876
Indicators						
Total external debt/GDP (%)	13.6	12.1	13.7	13.9	12.6	11.6
Net external debt/GDP (%)	-1.3	-1.7	-1.9	-2.6	-3.9	-2.6
Total external debt/exports	1.2	1.0	1.1	1.3	1.3	1.3
Total external debt/exports of goods and services	1.0	0.9	1.0	1.1	1.1	1.1
Net external debt/exports	-0.1	-0.1	-0.2	-0.2	-0.4	-0.3
Net external debt/exports of goods and services	-0.1	-0.1	-0.1	-0.2	-0.3	-0.2
Debt service/exports (%)	22.8	19.0	21.9	26.0	28.5	27.1
Debt service/exports of goods and services (%)	19.8	16.5	18.8	22.1	24.1	23.0
Reserves – cash concept/ total external debt (%)	97.7	97.7	101.2	108.1	120.3	114.4
Reserves – liquidity concept/ total external debt (%)	97.7	104.3	104.7	109.4	120.6	114.4

1/ Excludes stock of principal, amortizations and interests concerning intercompany loans.
2/ Estimated data.

International reserves rose 4.5% in the liquidity concept, contributing to their impact in the total external debt receding from 120.6% in December to 114.4% in April.

5.6 Conclusion

The evolution of the external sector remains conditioned to the need to bridge the gap produced by growth of domestic demand at a rate exceeding the capacity of supply expansion. The deficit projection for short-term transactions, detailed in this chapter and in the box Projections for the Balance of Payments, was maintained in relation to the previous Report, with improvement in the trade balance being offset by the increase in net expenditures of services and income. In this scenario, the projections mentioned indicate that the current account deficit must be wholly financed by net investment inflows in both direct and portfolio, and with rollover rates from external debt, estimated at 125%.

Revision of Projections for the Balance of Payments

This box brings the revised projections for the balance of payments in 2010. As such, both the latest information on the global economy as well as the reassessment of domestic economic activity are considered. Also considered are changes in external debt service consistent with its stock in March, recent Central Bank interventions in the foreign exchange market, and buybacks of sovereign external debt by the National Treasury, carried out up to May.

Table 1 – Uses and sources

US$ billion

	2009			2010		
	May	Jan-May	Year	May	Jan-May	Year[1/]
Uses	-4.3	-16.5	-54.4	-3.6	-32.0	-77.6
Current account	-1.8	-6.6	-24.3	-2.0	-18.7	-49.0
Amortizations ML-term[2/]	-2.5	-9.9	-30.1	-1.6	-13.2	-28.6
Securities	-0.8	-4.5	-13.0	-0.3	-7.1	-13.1
Suppliers' credits	-0.3	-1.2	-3.8	-0.3	-1.4	-2.4
Direct loans[3/]	-1.4	-4.2	-13.3	-1.0	-4.7	-13.1
Sources	4.3	16.5	54.4	3.6	32.0	77.6
Capital account	0.1	0.5	1.1	0.1	0.4	1.0
FDI	2.5	11.2	25.9	3.5	11.4	38.0
Domestic securities and equities[4/]	3.5	2.5	47.1	1.7	16.0	35.0
ML-term disbursem.[5/]	2.9	10.7	35.8	4.6	24.9	36.6
Securities	1.2	4.0	12.6	2.1	11.3	11.7
Supliers' credits	0.2	1.1	2.7	0.2	0.9	4.1
Loans[6/]	1.5	5.6	20.5	2.4	12.7	20.9
Brazilian assets abroad	-5.9	-10.2	-15.8	-4.5	-15.1	-16.4
Other[7/]	5.0	6.2	6.9	2.7	8.6	-
Reserve assets	-3.7	-4.4	-46.7	-4.6	-14.2	-16.7

1/ Forecast.
2/ Registers amortization of medium and long-term supliers' credit, loans and securities placed abroad minus refinancing and discounts. Excludes amortizations referring to loans to IMF and intercompany loans.
3/ Registers amortizations loans borrowed from foreign banks, buyers, agencies and multilateral organizations.
4/ Includes foreign investment in debt securities traded in the domestic market and in equities traded in domestic market and abroad.
5/ Excludes intercompany loans disbursements.
6/ Includes multilateral and bilateral financing and buyers' credits.
7/ Registers net values of bond swaps, short-term securities, short-term trade credit, financial derivatives, nonresident deposits, other liabilites and errors & omissions.

The updated balance of payments projection maintains the expected current account deficit unchanged, at US$49 billion, with the increased trade surplus being offset by rising deficit in service and income accounts. Direct investment flows, for both Brazilians abroad and foreigners in the country, have been reduced due to the negative developments of the international environment, in particular, the fiscal crisis that is affecting some European economies. Despite a deteriorating world outlook, rollover rates and portfolio inflows in the country were maintained.

Revised projections for the trade balance include expansion of trade flows, with an increase both in exports, from US$173 billion to US$185 billion, and imports, from US$163 billion to US$172 billion. Thus, the projected 2010 trade surplus rose from US$10 billion to US$13 billion. The estimates are consistent with the results observed by mid-June, with the perspectives for the global and Brazilian economies, and with the maintenance of the terms of trade at high levels.

The revision raised the projected deficit in the service account by US$1.8 billion, in comparison with the March Inflation Report, which should reach US$24.7 billion in the year, 28.3% higher than observed in the previous year. This revision reflects increases of US$1billion in net expenditures forecast with equipment rentals, to US$11 billion in the year; US$500 million for the projected deficit in international travel, which should reach US$8 billion; and US$500 million in deficit on the transportation account, in line with the expected increase in trade of goods.

The projection for net interest expenditures grew US$1.1 billion, in comparison with the previous report, to US$9.4 billion. This growth resulted, primarily, from the reduction of US$1.1 billion in gross revenue projections, given the perspective of maintaining low international interest rates. A US$4 billion revenue is estimated with earnings on international reserves, a decrease of US$1.1 billion compared to the previous forecast, and US$1.8 billion in private interest income. Gross expenditures, forecast as of the stock of external debt in March 2010, were maintained at US$15.2 billion.

The estimate for net remittances of profits and dividends remained at US$32 billion, an increase of 26.9% compared to 2009. It is worth mentioning that the stock of foreign investments in BM&FBOVESPA, S.A. – Securities, Commodities and Futures Exchange increased to US$210.5 billion at end of March, from US$70.7 billion in February 2009. Unilateral transfers projected for 2010 were maintained at US$3.5 billion, a level similar to that seen in 2009.

The estimated surplus for the financial account rose from US$55.1 billion in the previous forecast, to US$64.6 billion. Highlighted is a reversal in the estimate of the external position of Brazilian banks, from an increase in investments of US$6.7 billion to a reduction of US$5.6 billion. Additionally projected is the increase of US$3.6 billion in net disbursements of medium and long-term loans, which should reach US$7.8 billion.

The projection for net inflows of foreign direct investments (FDI) was reduced from US$45 billion to US$38 billion, considering the results already shown in the first five months of the year and estimates from the United Nations Conference on Trade and

Table 2 – Balance of payments – Market

US$ billion

Itemization	2009 May	2009 Jan-May	2009 Year	2010 May	2010 Jan-May	2010 Year[1/]
Current account	-2.2	-9.0	-29.1	-2.3	-20.2	-53.0
Capital (net)	8.8	12.8	67.5	3.7	25.0	60.0
Foreign direct investment	2.5	11.2	25.9	3.5	11.4	38.0
Portfolio investment	3.4	3.1	46.7	1.3	15.1	35.0
ML-term loans	-0.4	-0.4	1.0	2.9	10.6	4.7
Trade credits – Short, medium and long term	3.9	8.0	5.8	2.9	11.8	3.3
Banks	2.0	-0.8	1.7	0.8	6.7	1.6
Other	1.9	8.9	4.1	2.1	5.1	1.7
Brazilian invest. abroad	-2.6	-8.5	-14.0	-7.3	-23.0	-22.0
Other	1.9	-0.6	1.9	0.4	-0.8	1.0
Financial gap	6.5	3.8	38.4	1.4	4.8	7.0
Banco Central net interv.	-3.2	-2.0	-36.5	-4.2	-12.7	-12.7
Bank assets	-3.3	-1.8	-1.9	2.8	7.9	5.6

1/ Forecast.

Development (UNCTAD) on global flows of FDI in 2010. Net flows of Brazilian direct investments abroad were reduced by US$3 billion to US$12 billion.

Projections for net inflows of foreign investment in long-term domestic bonds in the country were maintained at US$35 billion.

Amortizations of medium and long-term external debt for the year, considering the new external debt scheme positioned in March 2010, increased by US$2 billion to US$28.6 billion. The projection for the rollover rate was maintained at 125%.

In this scenario, the financing gap in the balance of payments in the market will remain at a surplus of US$7 billion. The Central Bank, considering only the transactions carried out up to May, will absorb US$12.7 billion of that amount, while the assets of commercial banks abroad should reduce US$5.6 billion.

6 Inflation outlook

This chapter of the *Inflation Report* presents the Monetary Policy Committee's (Copom) assessment of the behavior of the Brazilian economy and of the international scenario since the release of the previous *Report* in March 2010. The chapter also presents the analysis of the inflation prospects up to the second quarter of 2012 and of Gross Domestic Product (GDP) growth up to the end of 2010. Inflation projections are presented in two major scenarios. The first scenario, called the baseline scenario, assumes that the Selic rate will remain unchanged at 10.25% per year over the forecasting horizon, the level defined by Copom at its most recent meeting, held on June 8 and 9, and that the rate of exchange will remain at R$1.80 per US dollar. The second scenario, named the market scenario, is based on the expected paths for basic interest and exchange rates drawn from the survey carried by Brazilian Central Bank's Investors Relation Group (Gerin) among independent analysts. It is important to stress that these scenarios are used only as support for monetary policy decisions and should not be viewed as Copom forecasts of the future behavior of interest and exchange rates. The projections released here utilize the set of information available up to the cutoff date of June 18, 2010.

The projections for inflation and of GDP growth released in this *Report* are not point estimates. They consist of probability intervals which embody the degree of uncertainty present at the above mentioned cutoff date. Inflation forecasts depend not only on the assumptions over the interest and exchange rates, but also on a set of assumptions on the behavior of exogenous variables. The most likely set of assumptions considered by the Copom is used to build the scenarios to which the Committee attaches the greatest weight on making its interest rate decisions. On setting out these assumptions, the Copom seeks to foster transparency to the monetary policy, thereby contributing to effectiveness of policy decisions in controlling inflation, which is its primary objective.

6.1 Inflation determinants

Inflation measured by the Broad National Consumer Price Index (IPCA), after reaching 4.31% in 2009 (rate 1.59 p.p. lower than that seen in 2008), returned to increase in 2010 in line with the robust growth pace of domestic demand. IPCA posted inflation of 3.09% over the first five months of 2010, the highest rate for the period since 2006 and 0.89 p.p. above that recorded in the same period last year. Twelve-month inflation up to May reached 5.22%, a rate close to that observed in the same period of 2009 (5.20%) and higher than the center of the target (4.5%). Thus, although at a slower pace in the second quarter, inflation dynamics presented important deterioration in the first months of the year.

Regulated prices rose 4.31% in twelve months up to May whereas market prices rose 5.60%. Within the set of market prices, it stands out that the price change for nontradable goods (7.24%) was much higher than that for tradable goods (3.79%). This behavior stems in part from the asymmetric effects of the world economic crisis on the domestic economy whose the most intense effects were observed in manufacturing sector while the service sector was very resilient as well as the strong expansion of the domestic demand. The gap between twelve-month inflation of regulated prices and market prices which had been declining consistently, increased again in the last three months. Actually, the gap, which was -6.21 p.p. in June 2008, reversed completely in October 2009 (0.16 p.p.) and it has again increased since March, reaching -1.29 in May. Showing the strength of the domestic demand, service sector inflation has remained at a level higher than that of market prices. In fact, the change in service prices reached to 6.78% in twelve months up to May (against 7.23% in the same period of 2009).

After growing 5.1% in 2008% and receding slightly in 2009 (0.2%), GDP at market prices grew by 2.7% in the first quarter of 2010 compared to the previous quarter according to seasonally adjusted data by the Brazilian Institute of Geography and Statistics (IBGE), after increases of 2.2% and 2.3% in the two previous quarters. Thus, the Brazilian economy is in a new cycle of growth resuming to the growth rates seen before the escalation of the world crisis in September 2008. From the supply side viewpoint, manufacturing sector increased by 4.2% in the first quarter (after increasing by 3.3% and 4.0% in the previous two quarters) on a quarterly basis with seasonal adjusted data partially, due to the effects of monetary, credit and fiscal stimulus used to mitigate the consequences of the crisis of 2008. The service sector, whose growth rates are less volatile, expanded 1.9% in the first quarter following increases of 1.6% and 0.7% in the two previous quarters. Agriculture production, which had recorded contraction of 0.5% in the third quarter of 2009 and expansion of only 0.2% the following quarter reflecting the lower level of global activity and the consequent fall in prices of agricultural commodities, registered recovery with growth rate of 2.7% in the first quarter of 2010. In general, the strength of domestic demand – based on credit and employment expansion – was important for the rapid recovery of the economy and continues to contribute to the current cycle of economic expansion.

From the viewpoint of agregate demand, after suffering strong reductions in the last quarter of 2008 and in the first quarter of 2009 (-9.7% and -12.0% respectively against the previous quarter), the Gross Fixed Capital Formation (GFCF) grew 7.4% in the first quarter against the previous quarter according to seasonal adjusted IBGE data, after rising more than 7.0% in the two previous quarters (7.5% and 7.1% respectively). This behavior supports the positive scenario regarding the strength of the economy's expansion. Household spending – the most important component of aggregate demand – rose 1.5% in the first quarter in same basis of comparison, a rate lower than those prevailing in the two previous quarters (2.5% and 2.1% respectively). With four consecutive quarterly increases, household spending has made solid contributions to sustain domestic demand. Government spending registered increase of 0.9%, after growing 0.5% and 0.6% in the last two quarters of 2009 respectively. On the other hand, the external sector contributed negatively to GDP growth in first quarter (-2.9 p.p.), with imports increasing by 13.1% (contribution of -4.5 p.p.) and exports by 1.7% (contribution of 1.6 p.p.). Based on recent developments, a plausible scenario includes the negative contribution of the external sector to GDP growth in the following quarters.

The resilience of domestic demand has again been the key element for sustaining the Brazilian economy. This assessment is supported by the performance of retail sales. Indeed, after they had grown 9.1% in 2008 and receded 5.9% in 2009 due to the effects of the crisis of 2008, real retail sales rose in 2010 (11.8% over the year up to April) according to IBGE. In twelve months up to April, sales increased 8.2% highlighting the sharp increase of sales in the "supermarkets, food, beverages and tobacco" segment (9.7%) and in "furniture and appliances" (9.1%). The expanded retail sales – which includes "vehicles, motorcycles, parts and spares” and “construction material”, sectors more sensitive to credit conditions – has also presented strong performance, growing 10.7% in twelve months up to April, driven by sales of “vehicles, motorcycles, parts and spares”, which posted growth of 17.3%. Actually, car sales have already surpassed the pre-crisis level. The Copom assesses that retail sales should continue to display positive results over the coming quarters, driven, among others factors, by the expanding employment and by the household credit dynamism.

The average unemployment rate, which had been consistently falling (10.0% in 2006, 9.3% in 2007 and 7.9% in 2008), increased to 8.1% in 2009 and returned to recede in 2010. In fact, the average rate stood at 7.4% up to April, 1.3 p.p. lower than that observed in the same period of 2009. In April, the seasonally adjusted unemployment rate by IBGE reached 6.8%, the lowest level in the new series. According to IBGE, the average real earnings – which grew 3.2% in 2007, 3.4% in 2008 and 3.2% in 2009 despite the effects of economic crisis – continue to increase in 2010 with an expansion of 1.1% up to April. In turn, the average number of persons working, which had increased 2.6% in 2007, 3.4% in 2008, and slowed in 2009 (0.7%), increased again in 2010, an increase of 3.4% in the first four months of the year. Thus, real wage bill – important factor driving aggregate demand in recent years – continues to expand in 2010. After growing by 5.8% in 2007, by 6.9% in 2008 and by 3.9% in 2009, it increased by 4.5% in April mainly due to the job creation. As per National Confederation of Industry (CNI) data, with regard specifically to industrial sector, the most heavily affected by the crisis of 2008, employment in manufacturing, which grew 3.7% in 2007 and 3.9% in 2008, receded in 2009 (-3.3%). In 2010, it has grown by 3% up to April, a rate higher than those observed before the global crisis. Concerning the evolution of formal employment, after intense falls at the end of 2008 and the beginning of 2009, job creation has presented a strong pace according to Ministry of Labor and Employment (MTE) data, with the creation of 962,000 positions this year up to April. Service sector, manufacturing and construction industry and commerce created, respectively, 346,000, 287,000, 166,000 and 74,000 new positions this year up to April. In twelve months up to April, the aggregate expansion reaches 1.9 million positions.

In addition to increased payrolls, credit availability to households – largely determined by macroeconomic stability and institutional improvements achieved in recent years – had been a key element to increase private spending. After being negatively affected by the crisis of 2008, the financing conditions and credit volume returned to more favorable patterns position. Financial system nonearmarked credit to households grew by 18.2% in April compared with the same month last year. In the same period, credit to housing, whose operations are mainly based on earmarked resources, grew 49.7%. Overall, credit expansion to households has occurred in a context of reduction of how performing loans. Moreover, expectations of market analysts and banking sector representatives point to expansion of credit volume – less vigorously than that observed before the crisis, despite recent adjusts in reserve requirements and changes of monetary policy stance.

After being severely affected by the crisis of 2008, investment performance has been significantly positive since the second half of 2009. Actually, the rapid recovery of the domestic economy – partly due to the appropriate and timely adoption of monetary, fiscal and credit measures with countercyclical effects – and the abandonement of pessimistic scenarios for the world economy led to a reduction in the degree of uncertainty and risk aversion. This also improved the credit conditions and made entrepreneurs to resume business investment plans that had been interrupted or even abandoned during the crisis. Consequently, according to seasonally adjusted data by IBGE, the GFCF grew by 7.5%, 7.1% and 7.4% in the last three quarters compared to the previous quarter. Additionally, it is likely that the current expansion of the Brazilian economy will be boosted by several projects related to oil sector (pre-salt oil reserves), infrastructure, largely led by public sector.

The volume of credit with nonearmarked resources to corporate entities grew 15.7% in April, compared to same month the previous year, reaching R$795.7 billion in April. Such behavior was favored by loan and financing done through the National Bank of Economic and Social Development (BNDES) system, which totaled R$35.7 billion up to April, an increase of 39.4% over the same period in 2009. In the twelve months up to April, these outlays increased 36.6% and totaled R$295.6 billion. Concerning capital market, the volume of initial public offerings of shares registered in the Securities and Exchange Commission (CVM) reached R$27.2 billion in twelve months up to May. In the secondary market, the issuances amounted to R$17.2 billion in the same period, especially for operations in the financial sector that occurred in 2009, including an issuance of R$14.1 billion in depositary receipts. In 2010, the issuances concentrated on real estate companies and construction, showing the sector recovery. Additionally, the issuance of debentures (excluding operations involving leasing companies), after reaching R$6.3 billion in 2008 and

R$11.1 billion in 2009, reached R$17.1 billion in the June 2009 to May 2010.

Regarding the external sector, the trade balance showed virtual stability in 2009 (US$25.3 billion from US$24.9 billion in 2008), but decreased in 2010. Up to May, the trade balance reached US$5.6 billion against US$9.3 billion for the same period last year, a decrease of 39.6%. This result comes from exports amounting US$72.0 billion and imports equal to US$66.5 billion, values respectively, 29.9%% and 43.9% higher than those recorded in the same period of 2009. In this context, the drop in the trade balance comes mainly from the stronger increase in imports related to exports, in line with the fact that the domestic economy is expanding at rates higher than those observed in mostly of our business partners. It is noticeable, however, that export revenues can be positively impacted over the year, among others factors, by the expected increase in the price of iron ore.

After decreasing 2.5% in 2008 – the first drop since 1996 – and 10.7% in 2009, quantum of exports grew again in 2010 (8.5% up to April), with the gradual recovery in external demand. The resumption of external demand also positively impacted the average price of exports, which rose 15.2% over the year up to April, after declining 13.4% in 2009. In turn, after contracting 17.4% in 2009, quantum of imports increased by 41.2% up to April, reflecting the acceleration in domestic activity, particularly in the manufacturing sector, which has higher propensity to import. On the other hand, the average price of imports, after falling 10.5% in 2009, showed stability up to April (0.5%)

The remittances of profits and dividends contributed to increase the twelve-month current account deficit, that moved from US$25.4 billion in January to US$36.2 billion in April (2.0% of GDP). Twelve-month foreign direct investments amounted to US$25.1 billion (1.4% of GDP) up to April 2010.

Signs of slow and uneven recovery in the global economy have continued to build up since the last *Report*. Unlike the mature economies, whose recovery has occurred in a markedly heterogeneous way, economic activity in many emerging economies continues in expansion pace, in some cases with magnitude and speed greater than those expected. Initially, these facts were reflected in commodity prices and especially in oil prices, which recently came to surpass the barrier of US$85. Since the last *Report*, however, concerns about the effects of sovereign debt crisis in European countries have intensified, which increased the uncertainty about the sustainability and pace of recovery in mature economies. As a result, prices of various commodities were reduced since the last *Report*. Under these conditions of heterogeneous and gradual improvement in global economic scenario and some recovery in demand for risky assets, there was appreciation of the currencies of major emerging economies and of US dollar. However, it should be noted that perception of systemic risk in international financial markets apparently reappeared. Despite recent developments in the Euro area, the prospects for the global economy have not deteriorated since the release of the last *Report*. It is plausible to assume that the current situation will stabilize or even improve over the coming quarters, even though the current situation is deemed to be shrouded in more uncertainty than the prevalent when the release of the last *Report*.

Regarding aggregate supply, after displaying sharp contraction in the fourth quarter of 2008 and first quarter of 2009 (7.6% and 4.5%), the manufacturing sector grew steadily since then. In the last three quarters up to the first quarter of 2010, there were expansions of 3.3%, 4.0% and 4.2%, according to seasonally adjusted IBGE data. This recovery was reflected in the agricultural sector, which grew 2.7% in the first quarter of 2010, after stagnation in the two previous quarters (-0.5% and 0.2%). In turn, after contraction of 1.9% in the fourth quarter of 2008, the service sector recorded the fifth consecutive quarter of expansion in the first quarter of 2010 (1.9%), which shows a consistent recovery.

Industrial production decreased 0.7% in April compared to March according to seasonally adjusted IBGE data, which is partly explained by anticipation of production to meet anticipated consumption due to the withdrawal of tax incentives for the purchase of durable goods. In general, however, industrial production shows robust expansion in 2010, even after growing the first ten months of last year. This year up to April, industrial production expanded 18.0%, and grew 2.3% in twelve months, the first positive rate in this metric since January 2009. Manufacturing and mining industries grew by 18.0% and 18.5% up to April, respectively, and 2.4% and 1.1% in the last twelve months. The sectors most dependent on credit such as automotive and construction, and consequently the most affected by the global economic crisis, show expansion and for some cases they already exceed production levels prevailing before the crisis.

From the demand viewpoint, the GDP – net of inventory adjustments of -1.2 p.p. – grew 7.7% in the first quarter of 2010 compared to the same quarter last year, with the external sector presenting a negative contribution of 2.9 p.p. The inventory level indicator from FGV, which had receded to 78.9 in January 2009, the lowest level since August 2003, has been rising consistently since then. In April and May, the indicator reached 101.3 and 100.5 respectively, according to seasonally adjusted data, showing that the process of adjusting inventory levels in manufacturing ended. Actually, the rebuilding of inventories has contributed to the consistent recovery of activity level. Copom assesses that industrial production should continue to grow robustly, with positive effects on employment and income level.

After reaching 86.7% in June 2008, the seasonally adjusted Level of Utilization of Installed Capacity (Nuci) computed by the Getulio Vargas Foundation (FGV) moved down to 77.9% in February and March 2009 due to the 2008 crisis. This indicator has consistently risen since then and it reached 85.1% and 84.9% in April and May respectively, levels close to those prevailing before the crisis of 2008. Regarding the expansion of capacity, after robust growth of 23.8% in 2007 and 20.1% in 2008, the absorption of capital goods contracted by 13.4% in 2009. In 2010, however, the absorption has increased and there was an expansion of 28.2% up to April. This growth is due to the increase of 13.8% in imports and only 3.2% in exports of capital goods, and of 28.7% in the domestic production of these goods. It is also worth noting the production of inputs for the construction industry increased 16.1% in the same basis of comparison. Industrial production indicators and retail sales figures show a robust expansion of activity. Actually, after moving from 125.9 in June 2008 to 71.1 in December 2008, the seasonal adjusted FGV´s Economic Outlook Survey indicator of global demand for the manufacturing industry surpassed the 100-point threshold in September 2009 and reached 120.8 in May 2010. Thus, an increasing number of companies qualify the demand for its products as strong and, in turn, decreases the amount of those that judges the demand as weak. In summary, the data points out the utilization rate has been rising through the last months showing virtual exhaustion of the idleness margin of the industry, despite the resumption of investment.

With the worsening of the world crisis, the National Cost of Construction Index (INCC) began to show signs of cooling off in the last quarter of 2008. However, there was a reversion of this trend since the end of 2010 Actually, after peaking in November 2008 (12.33%), the twelve-month change in INCC moved down to 3.25% in December 2009 and has been steadily increasing since then, having reached 6.07% in May. The medium term scenario for construction sector prices – sector in which the use of imported inputs is limited – continue pointing out the continuation of this process. This is due to the intensity of activity in this sector, which must be supported by public policies, the expansion of the labor market and the expansion of housing credit markets. It should be noted that there are expectations by market analysts of increases in steel prices.

Despite rising in 2009 (8.1%), after two consecutive years of reduction (from 10.0% in 2006 to 9.3% in 2007 and then to 7.9% in 2008), the average unemployment rate have persistently receded since the end of 2009. Rigorously, not only the unemployment rate has been reduced since November 2009 compared to the same period of last year (7.2%, 7.4%, 7.6% and 7.3% in the last four months up to April against 8.2%, 8.5%, 9.0% and 8.9% in the last year) but it has also been standing at historically low levels in recent months (7.5%, 7.1%, 7.0% and 6.8% according to seasonal adjusted IBGE data). The strength in the labor market is confirmed when analyzing the numbers of formal employment and industrial employment – the most affected by the crisis, as well as the growth rates of wages. The prospects for the coming quarters continue to indicate the continuity of this dynamic.

After surpassing the threshold of US$85 in May 2010, oil prices – a systematic source of international market uncertainty – receded to a level close to US$75 in the latest weeks due to increasing concerns about the impact on global growth of the fiscal crisis in European countries. Despite considerable uncertainty inherent to forecasts over the path of oil prices, the baseline scenario adopted by Copom, which foresees unaltered domestic prices of gasoline for 2010, remains plausible. It is also worth noting that the impact of international oil prices over domestic inflation is not transmitted exclusively through fuel prices but also, through other channels, such as the productive chain of the petrochemical sector, as well as the expectations of consumers and entrepreneurs. It is also appropriate to note the strong increase in the price of iron ore and other metals due to the recovery of world economy especially for emerging countries. On the other hand, agricultural commodity prices have been very volatile and consistent signs of recovery cannot yet be clearly identified.

After a sharp reduction in 2009 (-1.43% against 9.10% in 2008), broad inflation – measured by the General Price Index (IGP-DI) – has been rising through 2010. Twelve-month IGP-DI inflation, which had reached 14.82% in July 2008, had receded to -1.76% in October and November of 2009 has returned to the positive territory in 2010. IGP-DI grew 5.12% over the year up to May, 5.86 p.p. higher than that observed in the same period of 2009, and the twelve-month rate reached 4.38%.

The sharp acceleration in the index in 2010 is mainly due to IPA-DI and INCC whose changes up to May reached 5.72% and 4.48% respectively against -2.29% and 1.70% for the same period of previous year. Additionally, IPC-Br grew by 3.86%. The sharp IPA-DI increase is partly due either to the change in the agricultural prices, for which the twelve-month change reached 5.26% and to manufacturing prices with an increase of 5.86%. As pointed out in previous *Reports*, the Copom assesses that the effects of wholesale price behavior over consumer inflation will depend on current and prospective demand conditions and on expectations of price makers in relation to the path of future inflation.

As for headline inflation, the three core measures computed by the Central Bank show an inflation increase in 2010. The twelve-month change in the core by exclusion (IPCA-EX), which had moved from 5.71% in December 2008 to 4.73% in December 2009, rose to 4.93% in May 2010. The other two measures of core inflation have displayed the same pattern. The change in the core by smoothed trimmed mean (IPCA-MS), which had reached 4.82% in December 2008 and had been reduced to 4.24% in October 2009, increased again to 4.99% in May. Finally, inflation measured by double weighted core measure (IPCA-DP), which had reached 6.08% in December 2008 and had reduced to 4.74% twelve months later, increased again to 5.06% in May 2010. It should be noted that all core measures are above the center of the target. Additionally, after reaching 68.75% in January 2010 (against 66.15% in January 2009) the IPCA diffusion index receded to 60.94% in May 2010 (against 58.9% in May 2009), but its level continue to indicate the spread of the inflation acceleration process.

The expectations for GDP growth in 2010 have changed a lot since the release of last *Report*, moving from 5.50% to 7.06%, partly due to the release of the national accounts figures for the first quarter. Inflation expectations have also increased since the release of the last *Inflation Report* and they registered 5.61%, and 4.80% for 2010 and 2011 respectively at the cutoff date of June 18, 2010 compared to 5.10% and 4.70% for 2010 and 2011 at March 19, 2010. Broadly speaking, however, there has been a reduction of the dispersion around the central tendency of inflation expectations for 2010 since the release of the last *Report*.

Figure 6.1 – Inflation target path and market expectations for twelve-month ahead inflation

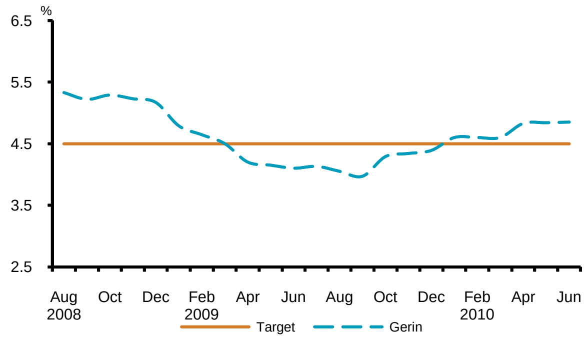


Figure 6.2 – Dispersion of inflation expectations for 2010

Relative frequency

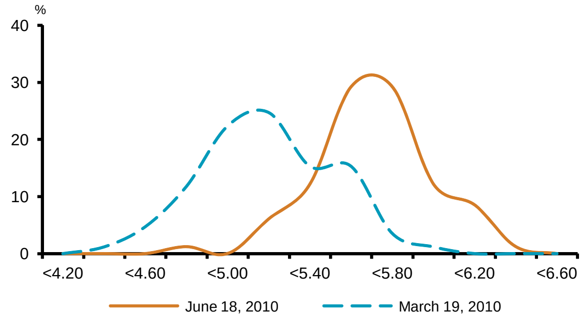


Figure 6.2 shows that the prospective scenario for inflation in 2010 has become less uncertain since the release of the last *Report*.

6.2 Main scenario: associated risks and monetary policy implementation

The projections used by Copom are based on a set of assumptions about the behavior of the main macroeconomic variables. This set of assumptions, as well as the risks associated with it, make up the main prospective scenario based on which the Committee makes policy decisions. In general terms, the prospective scenario – whose corresponding projections are presented in the following section – envisages the recovery of the global economy, though uneven across countries and surrounded by uncertainties, and robust expansion of the domestic economic activity, combined with increase in the inflation projections relative to the previous *Inflation Report*.

The balance of risks related to the inflation prospects has worsened since the previous quarter, and the Committee assesses that the risks to a benign scenario for inflation are concentrated in the domestic front. The current inflationary pressures – stemming from increasing resource utilization and from the imbalances between the growths of domestic absorption and the aggregate supply – have already materialized in actual twelve-month inflation rates above the target, and the inflation projections point to inflation rates well above the target in 2010, and that difference recedes in 2011. An important risk arises from the possibility that actual and expected inflation may persistently remain above the target or even drift away from it because of the rising utilization of the production factors and/or demand expansion. The behavior of inflation expectations is an additional risk to the inflation outlook. Even though inflation expectations have remained contained in the latest weeks, the Committee is closely monitoring the developments of the expectations and other indicators as to prevent the materialization of an unfavorable scenario. In fact, if such a less benign scenario for inflation indeed materializes, the costs associated with bringing inflation back to its target may be significant. We should stress that, despite the disinflationary effects from the domestic economic downturn that was trigged by the global financial crisis, the Brazilian inflation has shown important resilience – the trough of the twelve-month inflation was 4.17% in October 2009. Therefore, to avoid that the society incur these costs, it is recommendable the adoption of adequate and timely monetary policy measures.

On the external front, there are two main risks to be monitored, even though, in the Committee's main scenario, these risks do not pose an important threat to the materialization of a benign inflation scenario. The first risk – which has tilted to downside in the short run since the previous *Inflation Report* – is related to the recovery of commodity prices, especially if such a recovery is not offset by changes of the nominal exchange rate in the opposite direction. The second is associated with the ongoing crisis in some European countries, and the resulting worsening of the international financial conditions, which could deteriorate further. The possibility that this second risk materializes is related to the perception of systemic risk that resurfaced on the wake of the crisis. Such perception is based on the view that there is a close connection between a possible fiscal consolidation in the countries currently facing fiscal hurdles and the balance sheets of financial institutions. This scenario would likely bring about relevant movements in the price of some domestic assets.

The main scenario for the external front considers that the world economy will continue to recover in 2010, although there is more uncertainty than in the previous *Report*. Under this scenario, the global economic recovery is led by the emerging market economies, and the G3 economies (United States, Europe and Japan) regain some dynamism, though unevenly across regions. The US economic recovery is proceeding at a moderate pace, as illustrated by the fact that restocking of inventories is over, with positive effects on the performance of manufacturing production and retail sales, although the economic indicators in general are volatile and often present divergent signs. Consumer confidence is improving, even though it is well below its level prior to the 2008 crisis, and the labor market is showing signs of a rebound. The Japanese economy is also gradually recovering, led by exports directed mainly to East Asia, but its domestic demand remains weak. The economic recovery of the Euro Zone is likely to be slower and more unequal across its members given the current fiscal strains, the stagnation of household consumption and the latest indicators from the manufacturing and services sectors. In short, since the previous *Inflation Report*, there has been higher uncertainty surrounding the sustainability and the pace of the recovery of mature economies, mainly in Europe, in a context in which policy stimuli are withdrawn or even replaced by contractionary measures and prospects for credit expansion are moderate. On the other hand, several emerging market economies continue to expand robustly, to the point of overheating in the goods, services, factors and asset markets, in some cases. As a matter of fact, there is increasing concern about the behavior of inflation in important emerging markets. Against this background, monetary policy in many countries is still in pause mode after a period of aggressive easing, but in the countries less affected by the global crisis – where recovery is faster and more intense – monetary policy is already being tightened.

The fiscal imbalances, due to or aggravated by the global crisis, constitute an important issue that the mature economies have to deal with. The implementation of fiscal stimuli by these economies and the fall of their tax revenues because of the economic contraction led to an unprecedented peacetime growth of their public debts. Projections of different experts suggest that the government debt will rise substantially if relevant measures aiming at fiscal adjustment are not implemented. Dealing with the fiscal imbalances poses a big challenge for the advanced economies because the fiscal stimuli still in place are relevant for the economic recovery. Despite this fact, many countries have already started to implement tighter fiscal policies in order to improve the financial position of the public sector and conduct stress tests for their banking systems.

In face of the significant uncertainty regarding the speed and magnitude of the global economic recovery, two alternative scenarios are considered here. In the first, the world economy recovers slowly, and market participants remain overly cautious about the solvency of some European countries, so that the contractionary effects on the domestic economy would persist over the entire projection horizon. The Committee assesses that the materialization of such a scenario would have ambiguous effects on the domestic inflation. On one hand, the global downturn would help to contain the domestic aggregate demand through the fall of Brazilian net exports. Furthermore, the contraction could cool off the prices of important commodities and thus could help to keep the domestic inflation low. On the other hand, the outlook for the domestic inflation could worsen for two reasons. First, the global deceleration could increase risk aversion and reduce the demand for Brazilian assets, depreciating their prices. Second, a possible reduction of net exports in the medium term could reinforce the depreciation of Brazilian asset prices and so put upward pressure on inflation. In the second scenario, the global economic upturn is faster than expected, accompanied by full restoration of financial conditions and confidence, together with the recovery of commodity prices. In principle, as in the first alternative scenario, the impacts on domestic inflation would be ambiguous.

Commodity prices have not shown any clear upward trend throughout this year, with quite heterogeneous behavior within the group. In the case of iron ore, for example, a key input in the production chain of the manufacturing sector, its price has been increasing significantly over the last months. On the other hand, in the case of sugar, in part as a result of weather conditions in India, the downward trend for its prices prevails. Overall, however, the outlook for commodity prices – including oil prices – remains surrounded by considerable uncertainty. It depends on how the demand will behave in a context of asymmetric recovery of the global economy, on the uncertainties regarding the European fiscal situation as well as on the trajectory of the world supply. In any case, it is expected that these prices are more likely to rise than to remain stable in the medium and long term as the world economy recovers. It is important to remember that the analysis of the potential inflationary effects coming from the prices of raw materials must also take into account the implications for Brazilian asset prices. For instance, in the past few years, there has been a negative correlation between the international price of commodities and the exchange rate in Brazil. Nonetheless, considering a prospective scenario in which the current account worsens, that negative correlation may become weaker in the medium run.

The main domestic risk, as stressed in the beginning of this section, is associated with rising resource utilization together with the imbalance between the growths of domestic absorption and the aggregate supply. As highlighted in previous *Inflation Reports*, the increasing utilization of production factors – both the capital stock and the labor force – was taking place when the twelve-month inflation was already close to the target. Against this background, isolated inflationary pressures could quickly turn into higher overall inflation and a less benign scenario. In fact, since the first quarter of 2010, both current inflation and Copom projections point to values well above the target for 2010, but with a less challenging scenario for 2011. The economic downturn of the last quarter of 2008 and first quarter of 2009 led to an abrupt interruption of a cycle of strong economic growth and mitigated existing inflationary pressures. Nevertheless, in spite of the magnitude of the downturn – in large part mitigated by government policies implemented during the crisis and earlier – the existence of mechanisms turning the Brazilian inflation rigid downward reduces the scope for accommodative stances. Additionally, it is important to mention that the lagged effects of the fiscal and credit stimuli implemented throughout 2009 and beginning of 2010 have not completely materialized yet. Therefore, it is natural to expect that, against this background of virtual scarcity of resources and increasing demand, price increases are more widespread.

The behavior of the GDP in the first quarter of 2010 confirmed the fast growth of the domestic economic activity. In particular, investment – the more volatile component of aggregate demand and, not coincidentally, most affected by the crisis – continues to grow robustly. For the first time since the beginning of the crisis, the gross formation of fixed capital (GFFC) surpassed its pre-crisis level of the third quarter of 2008. As a result, the investment rate – the GFFC-to-GDP ratio – is recovering, reaching 18% in the first quarter of 2010. Such a solid recovery will contribute to a more sustained economic growth in the medium run, once the current investment is translated into higher productive capacity in the future. However, there is still the risk that the growth of the capital stock may not be enough to ensure that aggregate supply meets the expected strong growth of the aggregate demand without pressures on consumer prices. The strong growth of imports during the fourth quarter of 2009 and the first quarter of 2010 – 13.3% and 13.1%, respectively (q-o-q after seasonal adjustment) – as well as the strong increase in the import volume in April 2010 are in line with the robust growth of the aggregate demand. In comparison, the growth of export volume is still weak because of the slow global recovery, especially in the developed economies. However, the rebound in the prices of raw materials and semi-manufactured products is partially offsetting the slow pace of export volume. The outlook for the external sector is largely conditioned by the necessity of filling the gap of resources resulting from the strong growth domestic demand.

The ongoing expansion of the domestic economy and its growth prospects are based on four elements. First, and in contrast to previous shocks to the Brazilian economy, this time there was no balance-of-payment crisis, deterioration of public sector finances, increase in inflation or concern about policy regime change. In short, as stressed in other Copom texts, the Brazilian economy became more resilient to external shocks. Second, the fiscal and credit stimuli are still adding to the domestic expansion. Third, and possibly more importantly, household consumption – which accounts for the largest share of the aggregate demand – has been quite resistant. The expansion of consumption is associated, in large extent, with the resumption of credit and better-than expected performance of the labor market, which has positive effects on payroll. The expansion of labor market formalization also contributes positively since employees feel less insecure to make consumption decisions and makes easier the access to the credit market. Fourth, investment has recovered vigorously, and the prospects are very positive, given the rising confidence of consumers and entrepreneurs and the capacity utilization indices. This scenario will be reinforced by projects related to the oil sector (pre-salt) and infrastructure, in large extent, led by the public sector. We should stress that those projects, as well as the realization of events such as World Cup in 2014 and the Olympic Games in 2016, generate several externalities for the economy as a whole and should stimulate private investment expansion in the following years.

The Committee judges that there are important mechanisms making the Brazilian inflation downward rigid. In particular, the presence of regular and almost automatic mechanisms of adjustment, either *de jure* and/or *de facto*, has contributed to the persistence of inflationary pressures coming from the past. This phenomenon took place recently as inflation, in spite of the strong economic activity reduction, stood at 4.31%, close to the target of 4.5% in 2009, with price of services growing by 6.37%. It is well known that the existence (even informally) of price indexation mechanisms reduces the sensitivity of inflation to demand conditions. Even though inflation rates have been relatively low in recent years, by Brazilian standards, they still encourage feedback mechanisms as they do not correspond to the usual concept of price stability. In general, indexation mechanisms tend to prevent the economy from disinflating during downturns and increase the "starting point" of the inflation rate during upturns, thus raising the inflation risks for the prospective scenario in moments like this.

On the fiscal front, the economic recovery led by the expansion of domestic demand, as well as the phasing out of tax breaks implemented during the crisis have improved the fiscal accounts. Based on the information available so far, and provided that the primary surplus continues to rise according to the assumptions used in the inflation projections presented in the next section, the Committee assesses that is unlikely to occur any significant and consistent reversion of the trend towards a reduction of the debt-to-output ratio. The Committee also recognizes that the realization of these assumptions would contribute in a relevant way to the correction of the imbalance between the growths of domestic absorption and aggregate supply.

Breaking down the IPCA into free and regulated prices reveals that in 2009 the latter exerted larger pressure on overall inflation than the former, differently from the previous two years. However, the scenario for regulated prices in the medium term is relatively benign. In fact, the prospective scenario considers that the regulated price inflation will be lower than the free price inflation in 2010. In particular, the domestic prices of gasoline are unlikely to rise in the short run.

The recent trend of wholesale prices of manufactured goods displayed an important shift. After falling by 4.43% in 2009 – with negative changes in nine months of the year – the IPA for manufactured goods grew 5.86% in the first five months of 2010. In May 2010, this set of prices increased by 2.66%, the largest change since December 2002, when there was a confidence crisis and large exchange rate depreciation. Differently from last year, the wholesale price index of farming products has also increased quite a lot in 2010, going from a deflation of 3.16% in 2009 to an inflation of 5.26% in the first five months of the current year. In fact, the behavior of the wholesale prices of manufactured and farming products during the first five months of 2010 is similar to that observed in the same period of 2008. Given the evidence that changes in wholesale prices have lagged effects on consumer prices, as highlighted in a box of the March 2010 *Inflation Report*, the ongoing increase of wholesale prices is likely to affect headline inflation in the coming months.

In short, some sectoral or disaggregated price indices, as well as wholesale price indices, point to a less benign scenario for inflation: i) the services sector still remains as an important source of inflationary pressures; and ii) the wholesale prices of manufactured and, to a less extent, of farming goods are on the rise and will have lagged effects on consumer price indices.

The labor market is experiencing strong expansion. The unemployment rate reached its lowest level since the beginning of the new labor market survey in March 2002. The underlying risk from such tight labor market conditions is that nominal wages start to grow faster than labor productivity, which, in an environment of buoyant demand, tends to be transmitted to consumer prices. We should stress that the theory, supported by international evidence, recommends that wage moderation plays a key role in reaching price stability.

The credit market continues to expand at a strong pace. The main scenario involves the maintenance of the expansion of the domestic credit market and of the favorable conditions for Brazilian companies to access external credit. The development of the credit market in Brazil has brought the profile of that market closer to those of economies with similar levels of economic development. However, the sustainability of the strong credit expansion must be – and has been – closely monitored given the potential side effects on inflation and prudential risks.

The possibility that unexpected changes in the inflation dynamics may have long-lasting effects on agents' inflation expectations constitutes a perennial risk for monetary policy implementation and, therefore, must be monitored continuously. In principle, short-run inflationary pressures may lead to the dissemination of second-round effects. This happens because large changes in relative prices that result in high inflation rates are followed by agents' desire to restore their real income, which, in turn, feeds back into the inflationary process. Such a risk is higher when factor markets and demand are overheated, and the evidence suggests that such is the situation the Brazilian economy is currently experiencing. The international experience, as well as the own history of inflation in Brazil, recommends that the monetary authority remains cautious in order to fight potential second-round effects.

The strategy adopted by Copom aims to ensure the convergence of inflation to its target in the current and in the next years. This requires that deviations of inflation from its target must be readily corrected. Such a strategy takes into account the lags in the transmission mechanisms and is the most appropriate way to deal with the uncertainty inherent to the process of formulating and implementing monetary policy.

The Committee evaluates that the Brazilian economy is in a new expansion cycle. This assessment is corroborated by the information released since the previous *Inflation Report*, even though there is still some uncertainty about the pace of the ongoing expansion. There are signs of overheating coming from core inflation measures, inflation expectations, tight labor market conditions and rising cost of raw materials. In fact, the Committee's inflation projections have indicated some deterioration of the prospective scenario. The Committee understands that this deterioration should be contained and, for that reason, it is necessary to reverse the signs of imbalances between the growth pace of aggregate demand and aggregate supply, which ultimately tend to increase the inflation risks. In such circumstances, monetary policy must be adjusted to eliminate those imbalances and at the same time prevent that isolated inflationary pressures result in persistent deterioration of the prospective scenario.

The Committee understand that, despite the fact that a substantial part of the policy stimuli implemented during the international financial crisis have been unwound – such as the rise of banks' reserve requirements and the reversion of tax breaks – the risks to a more benign scenario for inflation, in which inflation would consistently converge to its target, have tilted to the upside. On the other hand, the latest developments on the external front have raised some caution about the assessment of the prospective scenario. In any case, the Committee members' prevailing understanding is that monetary policy must act in a timely fashion in order to prevent that short-run uncertainties propagate to longer horizons.

In light of these considerations, proceeding with the adjustment of the monetary conditions to the prospective scenario, in order to ensure the convergence of inflation to its target, the Committee unanimously decided to increase the Selic rate from 8.75% p.a. to 9.5% and 10.25%, without bias, in the meetings of April and June, respectively.

6.3 Inflation forecasts

According to traditionally adopted procedures, and taking into account the available information up to the cutoff date[1] of June 18, 2010, the baseline scenario assumes the exchange rate remains unchanged over the forecast horizon at R$1.80/US$, and the target for the Selic rate stays at 10.25% p.a. – the level set by the June Copom meeting – against R$1.80/US$ and 8.75% p.a. considered in the March *Inflation Report*. The projection for the change, in 2010, of the set of regulated and monitored prices stands at 3.6%, against 4.0% considered in the last *Report*. This projection is based on the hypotheses of stable prices for gasoline and bottled gas; increase of 1.5% for electricity rates; and of 1.6% in the fixed telephone rates. Regarding items for which more information is available, price changes were estimated individually, whereas for the others, the projections are based on models of endogenous determination of regulated prices, which consider seasonal components, exchange rate variations, market price inflation and General Price Index (IGP) inflation, among others. According to those models, projection of the regulated and administered prices for 2011 stands at 4.4%, above the value used in the March 2010 *Report* (4.3%), and of 4.5% for 2012.

1/ The only exception is the inflation target for 2012, set at 4.5% through the Resolution CMN nº 3.880, of June 22, 2010. The figures and tables presented in this section already incorporate the target for 2012.

The market scenario, on the other hand, is based on data from the expectations survey carried out by Gerin with a representative group of institutions up to the cutoff date. In this scenario, average exchange rate expectations slightly changed in comparison to the values released in the March *Inflation Report*. For the last quarter of 2010, these expectations moved from R$1.83/US$ to R$1.81/US$, and for the last quarter of 2011, were kept at R$1.86/US$. For the second quarter of 2012, average survey expectations project an exchange rate of R$1.89/US$. The average expectation about the Selic rate increased in comparison to the values presented in the last *Report*. For the last quarter of 2010, it moved from 11.14% to 11.81% p.a., while for the last quarter of 2011, it went from 11.14% to 11.75% p.a. For the second quarter of 2012, the projection for the average Selic rate is 11.33%. This trajectory of the Selic rate is consistent with a pre-DI swap of twelve months spread, with respect to the current target for the Selic rate (10.25% p.a.), of 260 b.p. and 175 b.p., in the last quarter of 2010 and 2011, respectively. Additionally, the market scenario assumes changes of 3.6% and 4.6% for the group of regulated prices in 2010 and 2011, respectively, and of 4.5% in 2012.

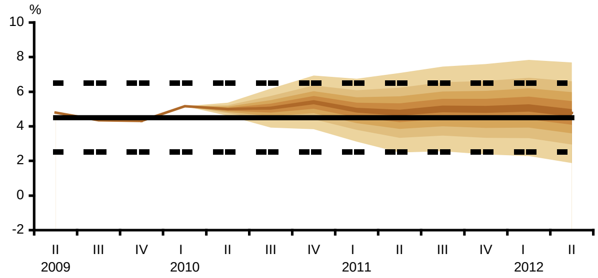
With regard to fiscal policy, the projections presented in this *Report* are based on the working hypothesis of a primary surplus of 3.3% of GDP in 2010. In this case, the surplus is adjusted by the possibility of reduction of 1.12 p.p. due to the implementation of projects belonging to the Growth Acceleration Program (PAC). Moreover, the primary surplus in 2011 and 2012 is assumed to remain at the level of 3.3% of GDP without any adjustment.

Based on the above assumptions and using the information set until the cutoff date (June 18, 2010), projections were constructed for the IPCA inflation accumulated over four quarters, consistent with the baseline and market scenarios interest and exchange rate paths.

The central projection associated with the baseline scenario shows inflation of 5.4% in 2010, an increase of 0.2 p.p. in comparison to the projection presented in the March *Report*, therefore, above the central value of 4.5% for the target determined by the National Monetary Council (CMN). As can be seen on Figure 6.3, in the baseline scenario, the projection for twelve months inflation stays above the central target for the entire relevant horizon. According to data shown on Table 6.1, the projection for twelve-month accumulated inflation moves from 5.0%, in the second quarter of 2010, to 5.1% in the third quarter and reaches 5.4% in the last quarter of 2010. The respective projections

Figure 6.3 – Projected IPCA-inflation with interest rate constant at 10.25% p.a. (Baseline scenario)

Inflation fan chart



Note: accumulated inflation in 12 months (% p.a.).

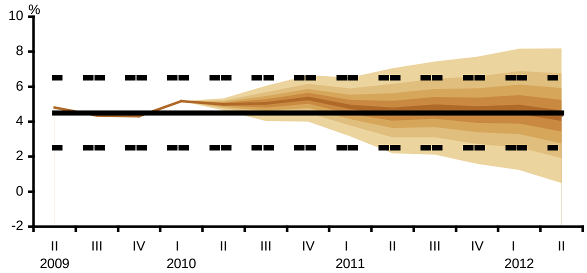
Table 6.1 – Projected IPCA-inflation with interest rate constant at 10.25% p.a. (Baseline scenario)

Year	Q	Probability Interval 50%	30%	10%				Central projection
2010	2	4.8	4.9	5.0	5.0	5.1	5.1	5.0
2010	3	4.6	4.8	5.0	5.1	5.3	5.5	5.1
2010	4	4.8	5.0	5.3	5.5	5.8	6.0	5.4
2011	1	4.2	4.5	4.8	5.1	5.4	5.7	4.9
2011	2	3.8	4.2	4.6	5.0	5.3	5.7	4.8
2011	3	4.0	4.4	4.8	5.2	5.6	6.0	5.0
2011	4	3.9	4.4	4.8	5.2	5.6	6.1	5.0
2012	1	3.9	4.4	4.8	5.3	5.7	6.2	5.1
2012	2	3.6	4.1	4.6	5.0	5.5	6.0	4.8

Note: accumulated inflation in 12 months (% p.a.).

Figure 6.4 – Projected IPCA-Inflation with market interest and exchange rates expectations

Inflation fan chart



Note: accumulated inflation in 12 months (% p.a.).

Table 6.2 – Projected IPCA-Inflation with market interest and exchange rates expectations 1/

Year Q	Probability Interval 50%	30%	10%		30%	50%	Central projection
2010 2	4.8	4.9	5.0	5.0	5.1	5.1	5.0
2010 3	4.6	4.8	5.0	5.1	5.3	5.5	5.0
2010 4	4.8	5.0	5.2	5.4	5.6	5.9	5.3
2011 1	4.1	4.4	4.7	5.0	5.2	5.5	4.8
2011 2	3.6	4.1	4.4	4.8	5.2	5.6	4.6
2011 3	3.7	4.2	4.6	5.0	5.4	5.9	4.8
2011 4	3.4	3.9	4.4	4.9	5.4	5.9	4.6
2012 1	3.3	3.9	4.4	5.0	5.5	6.1	4.7
2012 2	2.8	3.4	4.0	4.6	5.2	5.9	4.3

Note: accumulated inflation in 12 months (% p.a.).

1/ According to Gerin.

Table 6.3 – March 2010 *Inflation Report* projections

Period	Baseline scenario	Market scenario
2010 I	5.1	5.1
2010 II	4.9	4.9
2010 III	5.0	5.1
2010 IV	5.2	5.2
2011 I	4.7	4.5
2011 II	4.4	4.2
2011 III	4.7	4.3
2011 IV	4.9	4.4
2012 I	5.1	4.6

for 2011 moves from 4.9% in the first quarter, fluctuates around this value in the following quarters and ends the year at 5.0%. In this scenario, the associated projection for the first quarter of 2012 is 5.1% whereas for the second quarter is 4.8%. It is worth mentioning that the decrease of the inflation projections for 2011, in comparison to 2010, partially reflects the fact that inflation expectations, for both 2011 and 2012, are lower than the ones for the current year. According to the baseline scenario, the estimated probability that inflation for 2010 will breach the upper tolerance level of the target is close to 12%. For 2011, this probability is close to 17%.

In the market scenario, the inflation projection for 2010 is 5.3%, 0.1 p.p. lower than the respective projection of the baseline scenario, representing an increase of 0.1 p.p. in comparison to the projection presented in the last *Report*. As can be seen on Figure 6.4 and on Table 6.2, projections for inflation accumulated in twelve months fluctuate above the central value of the target along 2010, and recede along 2011, finishing the year at 4.6%, around the central value of the target. The projection for the first quarter of 2012, within this scenario, is of 4.7%, but in the second quarter moves to 4.3%, therefore, below the central value of 4.5% for the target. According to the market scenario, the estimated probability that inflation for 2010 will breach the upper tolerance level of the target is 7%. For 2011, this probability is close to 16%.

As it was shown in the last *Report*, the projected dynamics for both scenarios depart from each other along 2011, reflecting the effect of the expected increase in the Selic interest rate, which brings inflation back to inferior levels on the market scenario. Along 2010 this difference is quite smaller mainly due to the lags of the transmission mechanism of monetary policy to prices. Another aspect to highlight is that, in general, inflation projections have risen in comparison to figures in the last *Report*; however, there are indications that this movement is being reversed, at the margin.

Comparing the trajectories shown in this *Report* with those released in the previous *Report*, whose projections are shown on Table 6.3, it is apparent that there was an increase of the projections along 2010 in the baseline scenario, partially reflecting the increase of inflation expectations for the current year and inflation rates in recent months higher than the respective projections presented in the March *Report*. Regarding the market scenario changes in projections also reflect these movements. In respect to 2011, it is also shown an increase in the inflation projections, for both scenarios, in respect to those presented in the March 2010 *Report*.

For the first quarter of 2012, there is a relative stability in projections comparison.

Figure 6.5 – Projections and target path for twelve-month cummulative inflation

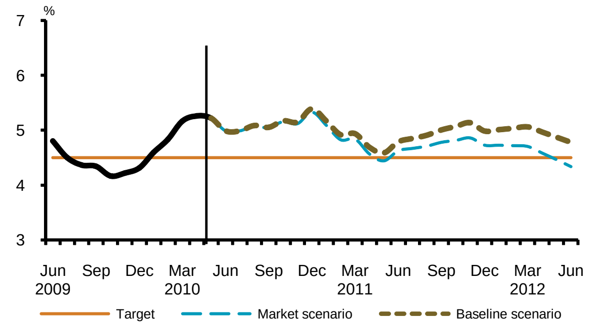
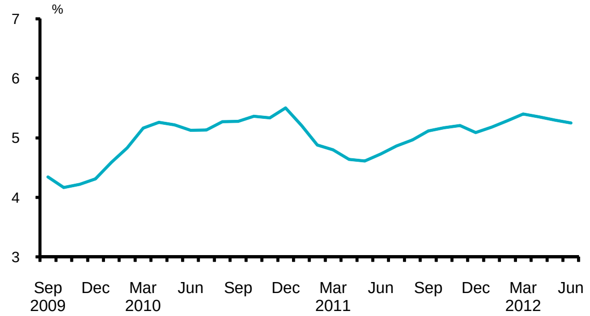


Figure 6.5 shows the path of twelve-month accumulated inflation, according to the baseline and market scenarios, up to the second quarter of 2012, as well as the target trajectory. The figures are actual twelve-month inflation until May 2010, and, from June on, projections according to the two scenarios. The projections fluctuate, in both scenarios, above the target along 2010. However, it is worth noting the increasing distance between the projection paths toward the end of the considered horizon. This departure is essentially due to the expected change in the Selic rate in the market scenario.

Figure 6.6 – Inflation forecast: VAR models



Note: accumulated inflation in 12 month (% p.a.).

Average forecast generated by the VAR models.

The average forecast generated by the Vector Autoregression models (VAR) for the twelve-month accumulated inflation is presented in Figure 6.6. By May 2010, the values are actual twelve-month inflation and, as of June, refer to the average forecast of the VAR models. As well as in the projections generated in the baseline and market scenarios, the VAR models forecasts increased along the entire horizon, in comparison to those presented in last *Report*. Along 2010, the forecasts are in levels quite above the target, but tend to converge to the central target along the first semester of 2011, although afterward returning to the unconditional average of the observed inflation.

Figure 6.7 – Projected GDP growth with interest rate constant at 10.25% p.a. (Baseline scenario)

Output fan chart

Figure 6.7 illustrates the output growth fan chart built under baseline scenario assumptions. Considering that the model which generates GDP growth projections uses two variables that are not directly observable, potential output and the output gap, the forecast errors associated to these projections are considerably higher than the errors related to the inflation projections. According to this scenario, the GDP growth projected for 2010 is 7.3%, an increase of 1.5 p.p. in comparison to the projection presented in the March 2010 *Inflation Report*.

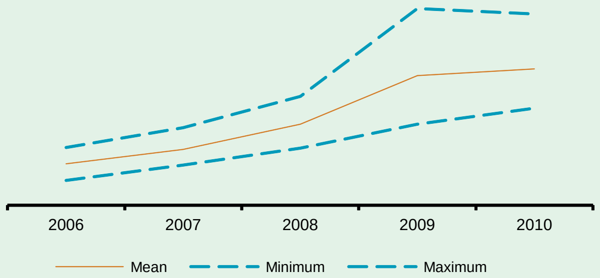
The Power of Monetary Policy in Brazil

With inflation targeting implemented in Brazil for over a decade[1] and the macroeconomic stability achieved in recent years, issues related to monetary policy fine-tuning take greater relevance in the context of its execution. Among issues to be considered, the discussion about the power of monetary policy, quantifying the sensitivity of inflation rate to the policy interest rate (Selic rate), emerges as a relevant issue. Positive changes in the power of monetary policy over time can be understood, among others, as a reflection of higher credibility achieved by the central banks[2] and, in a feedback mechanism, may influence the actual monetary policy execution.

The aim of this box is to present evidence that the power of monetary policy has increased in recent years in Brazil, from small structural models used by the Central Bank and economic indicators usually associated with greater power of monetary policy, which are: expansion of credit to Gross Domestic Product (GDP) ratio and its average maturity; lower share of government debt indexed to the Selic rate; and increase of the average maturity of government debt.

The small structural models used by the Central Bank show, among others, an equation for aggregate demand (IS curve) and an equation for aggregate supply (Phillips curve). Thus, the power of monetary policy (short-term) can be defined by the product of the sum of the real interest rate coefficients in the IS curve by the sum of the output gap coefficients in the Phillips Curve[3]. Figure 1 shows the path of

Figure 1 – Power of monetary policy (short-term)



Source: BCB

1/ Decree 3.088, June, 21,1999.

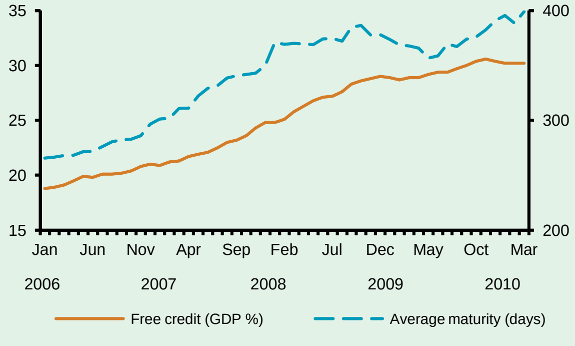
2/ The credibility of the inflation targeting regime was the subject of box in *Inflation Report* of December 2007.

3/ These models differ regarding the output gap estimation method. Its variants have been discussed most recently in Inflation Report of March 2010, which includes several references to earlier boxes.

the power of monetary policy regarding the various models used by the Central Bank, standardized by the average of the models in 2006 (base year). According to this measure, notice that the power of monetary policy increased in recent years, regarding not only the average of the models, but also maximum and minimum values. Indeed, this analysis is supported by credit markets and government debt evolution, as discussed below.

The literature and international experience recognize the amount of credit in the economy[4] as one of the drivers of the power of monetary policy. In principle, a change in policy interest rate can be quickly transmitted to credit market interest rates. With higher interest rates, households resist rising debt, which can negatively impact consumption; and companies become more reluctant to initiate new investment projects in response to higher funding costs and the prospects of decline in household consumption. Notice also that an increase in credit to GDP ratio shows that a higher share of consumption and investment depends on credit markets[5]. Regarding this, the greater the credit to GDP ratio, the greater should be the expected effect of monetary policy on inflation. Furthermore, if there is, for example, an increase in interest rates, the marked to market value of banks' loan portfolio may be more affected because of longer-term loans and, therefore, hinder or even prevent a credit expansion.

Figure 2 – Free credit and average maturity



Source: BCB

Figure 2 shows a consistent and persistent upward trend of credit to GDP ratio considering bank's free resources in this period. Moreover, the figure shows an increase in the average maturity of free resources credit. In January 2006 free resources credit to GDP was 18.8% with an average maturity of 266 days. In March 2010 that ratio rose to 30.2% and the average maturity to 399 days. Regarding this, literature suggests that the Selic rate, since somehow it is benchmark for all credit operations, has more influence on economic activity and inflation than it had a few years ago.

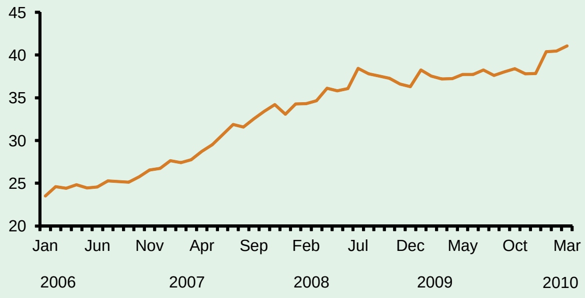
4/ Credit growth in Brazil in several segments, was the subject of previous boxes in *Inflation Reports* of June and September 2008 and of March 2010.

5/ A learning material about the transmission mechanisms of monetary policy can be found at "The transmission mechanism of monetary policy", in the Bank of England (http://www.bankofengland.co.uk/publications/other/ monetary/montrans.pdf).

Figure 3 – Share of Selic indexed government bonds

Source: BCB

Figure 4 – Average maturity of government bonds issued through public offering (months)



Source: BCB

Another issue that needs some analysis is the share of government debt indexed by the Selic rate. Indeed, when there is an increase in the Selic rate, there is negative wealth effect on the holders of fixed rate government bonds, which should help containing demand pressures in the economy. With bonds indexed by the Selic, however, the opposite occurs, and an increase in the Selic rate generates positive wealth effect, which should help to raise aggregate demand and, thus, reduce the power of monetary policy. Figure 3 shows that the share of government bonds indexed by the Selic presents a downward trend over recent years, from 47.9% in January 2006 to 39.9% in March 2010, which suggests a greater power of monetary policy.

From another perspective, average maturity of government debt also contributes to the magnitude of the negative wealth effect. Thus, a larger average maturity tends to increase the power of monetary policy. Figure 4 shows that there is an upward trend in the average maturity of Brazilian government debt, considering the total bonds issued by the Treasury through public offering, which increased from 23.5 months in January 2006 to 41.1 months in March 2010.

In summary, the evidence presented in this box, based on small structural models of the Central Bank and other economic indicators, suggest that the power of monetary policy in Brazil has increased over recent years. This, on one hand, shows that inflationary pressures can be contained more efficiently and, secondly, suggests higher credibility in the conduct and execution of monetary policy in Brazil.

Vector Autoregressive Models (VAR)

The vector autoregressive models (VAR) are systems of simultaneous equations that capture the existence of interdependence relations among variables, and allow to assess the impact of stochastic shocks on a specific system variable. As mentioned in the literature, despite limitations such as the absence of any structural or economic relations and the relatively high number of parameters to be estimated, VAR models are important instruments of analysis and forecasting, especially for short and medium term horizons.

The Central Bank, like the vast majority of its international peers, uses VAR models as an analytical tool and, especially, for inflation forecasting since the implementation of the inflation targeting framework, in June 1999. The information provided by the VAR models, along with the ones generated by other econometric tools, are important inputs to the decision-making process of the Monetary Policy Committee (Copom). Thus, considering that the economic system is dynamic, the models used in the Central Bank's inflation forecasts are constantly subject to improvements. The box "Autoregressive vector models" in the March 2008 *Inflation Report*, presented the VAR models used at the time. Considering recent developments, the aim of this box is to provide updated information on the set of VAR models currently in use by the Central Bank.

According to the well-known World's theorem, all stationary time series have a moving average representation[1], which can be approximated by an initial condition and an accumulation of new events, i.e., by an autoregressive representation. Unlike simple autoregressive models, autoregressive vectors have more explained variables (one per equation).

1/ For more details, see Diebold (1998).

In the system of equations that defines the VAR, the variables are treated symmetrically and, for each variable considered, includes an equation containing its lags and also lags of the other system variables. Sims (1980) introduced the autoregressive vectors as an alternative to structural macroeconomic models, which were formed mostly by a large amount of equations with theoretical restrictions difficult to be tested and that resulted in inaccurate forecasts. Having simple operation and well-evaluated forecasts, VAR models had good acceptance in the academic world as well as in central banks.

VAR models examine the relations among the variables by imposing few restrictions on the structure of the economy, which are, basically, the choice of variables and lags. All other characteristics of the models are determined, generally, by the sample considered. In fact, in general, the choice of lags is based on statistical tests. Currently, the VAR models used by the Central Bank are divided into two big groups: VARs with economic fundamentals and purely statistical VARs. In both cases, the VAR models generate inflation forecasts for free prices. Inflation forecasts for the full National Consumer Price Index (IPCA) are obtained by combining the inflation forecasts of free prices from the VARs with projections of administered prices inflation, estimated independently. These projections, together with information from small and medium size structural models, are intended to assist the decision-making of the Monetary Policy Committee.

VARs with economic fundamentals

VARs with economic fundamentals are, in turn, divided into two subgroups: (1) models estimated with monthly data and (2) models estimated with quarterly data. In each of the subgroups seven models are estimated: three traditional VARs, three Bayesian VARs with the Minnesota prior and a VECM (Vector Error Correction model, a way to estimate non-stationary series). The aggregate inflation forecast of each of the subgroups is given by the median forecast of the models within that subgroup. Except for the variables present in the VECM estimation, all endogenous variables are considered in first difference.

The monthly models, with a larger number of observations, are estimated from the beginning of 2000, avoiding a series of structural breaks, especially the transition of the Real Plan and the introduction of the inflation targeting framework. The nominal interest rate is given by the Selic rate held in the month, whereas the real interest rate discounts the inflation rate measured by the IGP-DI. The monetary aggregate is measured by the end-of-period M1. To select the number of lags the *Akaike* (AIC), *Schwarz* (SC) and *Hannan-Quinn* (HC) information criteria are used. Table 1 shows the set of models estimated with monthly data.

Table 1 – Monthly models

Denomination	Endogenous variables	Seasonal adjustment	Lags
VAR I	free prices, administered prices, exchange rate and real interest rate	yes	2
VAR II	free prices, administered prices, exchange rate, nominal interest rate, industrial production and money	yes	6
VAR III	free prices, nominal interest rate, exchange rate and industrial production	no	1
BVAR I	free prices, administered prices, exchange rate, nominal interest rate, industrial production and money	no	6
BVAR II	free prices, administered prices, exchange rate, nominal interest rate, industrial production and money	yes	6
BVAR III	free prices, administered prices, exchange rate and real interest rate	yes	2
VECM	free prices, nominal interest rate, exchange rate, industrial production and error correction	no	1

Table 2 – Quarterly models

Denomination	Endogenous variables	Seasonal adjustment	Lags
VART I	free prices, administered prices, real interest rate and exchange rate	yes	2
VART II	free prices, administered prices, nominal interest rate, exchange rate, industrial production and money	yes	1
VART III	free prices, administered prices, real interest rate, industrial production and risk premium	yes	1
BVART I	free prices, administered prices, real interest rate and exchange rate	yes	1
BVART II	free prices, administered prices, nominal interest rate, exchange rate, industrial production and money	yes	2
BVART III	free prices, administered prices, real interest rate and exchange rate	yes	1
VECMT	free prices, nominal interest rate, industrial production, exchange rate and error correction	no	2

Table 2 presents the set of models estimated with quarterly data[2]. To avoid small sample problems, these specifications use data beginning in late 1994 and trend *dummies* for the period immediately after the Real Plan. Except for the VECMT and some variables used in the VART III and BVART III models, all endogenous variables are considered in first

2/ The “T” after each acronym indicates that the model is estimated with quarterly data.

difference. In VART III, the risk premium, measured by the Emerging Markets Bond Index (EMBI + Br) as such as the real interest rate variable used in BVART III are treated in level. As in the monthly models, the nominal interest rate is given by the Selic rate held in the month, whereas the real interest rate discounts the inflation rate measured by the IGP-DI from the Selic rate. The monetary aggregate is measured by the end-of-period M1. As in the monthly VARs, the number of lags is chosen based on the *Akaike* (AIC), *Schwarz* (SC) and *Hannan-Quinn* (HQ) information criteria.

Statistical VARs

The statistical VARs do not have structural restrictions (of economic order) either in the short or long term, and use a large number of variables and different lags. The variables are divided into six groups of distinct indicators (economic activity, external sector, financial, pricing, monetary and shocks). An important criterion for the choice of these variables was their correlation with inflation indexes.

The Statistical VARs are estimated with monthly data and divided into two classes, each one estimated with a different approach. In each model of the first class, principal components are extracted from variables from all different groups of indicators, totalling 1,536 different models. In the second class, the models use principal components and selected variables. In this class, only three sets of indicators are used at a time, totalling 1,440 models. The aggregate inflation projection in each class is simply the median of the projections within the class. Table 3 presents the variables used in the estimations.

In the first class, the models use the principal components extracted from each group of indicators based on variables of different subgroups of indicators. For example, in the group of economic activity, two main components of energy are obtained (first and second components), taken from the three indices of electricity energy use, and two principal components of production, extracted from the capacity utilization, real GDP and industrial production. In the second class, models are formed from selected variables and convex combinations between the first two principal components of each group of indicators used.

Table 3 – Statistical models

Group of indicators	Selected variables
Economic activity	retail sales, three electricity use indicators, monthly industrial production, real GDP, capacity utilization, unemployment
External sector	VIX, Embi, exchange rate, U.S. PPI (all commodities), export price index, import price index, export *quantum* index, import *quantum* index
Financial	Selic rate, real Selic rate calculated in four ways (deflated by IGP and IPCA, with 3 and 12-month expectations), spreads over Selic, calculated for individuals, corporations, total and for credits with BNDES interest rate
Prices	administered prices, IGP-DI, IPC-BR, IPC-FIPE, free prices
Money	M1, M2, M3, M4, currency held by the public, monetary base and demand deposits
Shocks	CRB commodities index, electricity, gasoline, IPA-IPC, motor oil and petroleum

Composition of the projection

The final composition of the projections of all VAR models (economic and statistical) is a simple arithmetic average of the following six elements: (1) median of the monthly VAR and VECM models, (2) median of the monthly Bayesian VAR models, (3) median of the quarterly VAR and VECM models, (4) median of the quarterly BVAR models, (5) median of the first class of statistical VARs, and (6) median of the second class of statistical VARs.

Finally, this box shows how VAR models are being incorporated into the decision-making process of the Copom and presents a new class of VAR models, the statistical, indicating that the Central Bank models are under constant updates. In this sense, it contributes to increasing the transparency of the decision-making process and, therefore, the credibility of monetary policy.

References

DIEBOLD, Francis X. (1998). *Elements of Forecasting*. Ed.South-Western College Publishing.

SIMS, Christopher A. (1980). Macroeconomics and reality. *Econometrica* 48, p.1-48.

Annex

Minutes of the 150th Meeting of the Monetary Policy Committee (Copom)

Date: April 27th, from 4:15PM to 6:15PM
Place: BCB Headquarters meeting rooms – 8th floor on April 27th and 20th floor on April 28th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Aldo Luiz Mendes
Alexandre Antonio Tombini
Alvir Alberto Hoffmann
Anthero de Moraes Meirelles
Antonio Gustavo Matos do Vale
Carlos Hamilton Vasconcelos Araújo
Luiz Awazu Pereira da Silva

Department Heads (present on April 27th)
Adriana Soares Sales – Research Department (also present on April 28th)
Altamir Lopes – Economic Department
João Henrique de Paula Freitas Simão – Open Market Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
Leonardo Martins Nogueira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on April 27th)
Eduardo José Araújo Lima – Deputy-Head of the Research Department
Fabio Araujo – Advisor to the Research Department
Ricardo Franco Moura – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and the prospects for the Brazilian economy and for the international economy, under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

Recent economic developments

1. IPCA inflation, after moving from 0.75% in January to 0.78% in February, reduced to 0.52% in March. As a consequence, inflation accumulated in the first quarter of 2010 reached 2.06%, 0.8 p.p. above the level registered in the same period of the previous year. The rise in inflation in 2010 mirrors the behavior of both market prices, which increased by 2.47% in the year through March, and regulated prices. Focusing on market prices, both prices of tradable goods and non-tradable goods accelerated in the first quarter, reaching 1.48% and 3.36%, respectively, up from 0.05% and 2.39% year-over-year. On its turn, regulated prices increased by 1.11% in the first three months of the year, compared to 1.17% in the same period of 2009. The change in the prices of services, whose dynamics tends to show more persistence than that of the prices of goods, reached 3.17% until March and 6.92% in twelve months. Preliminary data for April point to consumer inflation above that observed in March. In short, information available suggests deterioration of inflation dynamics at the margin.

2. The three main underlying inflation measures calculated by the BCB showed divergent behavior

between February and March. The smoothed trimmed means core inflation increased from 0.39% in February to 0.46% in March, while the core inflation by exclusion and double weight core inflation measures reduced (from 0.68% and 0.47% in February, to 0.42% and 0.40% in March, respectively). In the year through March, the core inflation by exclusion increased by 1.70%, while smoothed trimmed means and double weight core inflation measures increased 1.33% and 1.48%, respectively. These changes are, respectively, 0.32 p.p., 0.27 p.p. and 0.31 p.p. above the rates prevailing in the same period in 2009. The twelve-month trailing inflation measures changed from 4.73%, 4.36% and 4.74% in December 2009, for the core inflation by exclusion, smoothed trimmed means and double weight core inflation measures, to 5.06%, 4.64% and 5.06% in March, respectively. It is important highlighting that all core inflation measures continued to increase on a twelve-month basis, and are above the midpoint of inflation target. Moreover, it bears emphasizing that the behavior of the IPCA diffusion index increased from 61.7% in February to 66.4% in March (compared to 60.2% in March 2009). From another perspective, the diffusion indices suggest dissemination in the inflation acceleration process.

3. The General Price Index (IGP-DI) inflation decreased from 1.09% in February to 0.63% in March. In the year through March, the IGP-DI inflation reached 2.76% (-0.96% in the first quarter of 2009). Under this comparison basis, the acceleration of the IGP-DI reflected the behavior of its three components. The Wholesale Price Index (IPA-DI) increased 2.88% in the first quarter of 2010 (-2.09% in 2009Q1). On its turn, the Consumer Price Index-Brazil (IPC-Br) increased 2.86% in the same period (1.66% in 2009Q1). Still according to the same comparison basis, the Civil Construction National Index (INCC) increased 1.76% (0.35% in 2009Q1). The IPA-DI inflation acceleration, under this comparison basis, derived mainly from the behavior of agricultural prices. While the industrial IPA increased 2.69% (-2.59% in 2009Q1), the elevation of wholesale agricultural prices reached 3.50% (-0.71% in 2009Q1). As mentioned in previous Copom Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend on current and prospective demand conditions, as well as on price setters' expectations for the future inflation path.

4. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output moved from 0.1% in January to 0.8% in February. Still considering the seasonally adjusted series, on a month-on-month basis, after expanding by 1.2% in January, industrial output increased by 1.5% in February. On a year-over-year basis, industrial output increased by 18.4% in February, up from 16.1% in January. On a twelve-month trailing basis, decline in industrial production is still observed (-2.6%), but it has been reduced (-7.4% in December and -5.0% in January). The behavior of IBGE industrial output series, and its components, shows that industrial production expands at a pace that continues to be influenced by the international outlook, by business and households expectations, as well as by domestic financial conditions. This process is supported not only by traditional sources of credit, but also by the recovery of capital markets and the performance of public financial institutions.

5. Among the use categories, according to data seasonally adjusted by the IBGE, in February it bears highlighting the expansion of 1.6% in capital goods production, and especially, in non-durable and semi-durable consumer goods production, which increased 2.4%. Durable consumer goods production increased 0.7%. Intermediate goods production declined 0.4% after rising 0.9% and 2.0% in December and January, respectively. It bears highlighting that capital goods productions expanded by 6.4% in the quarter ended in February, the most remarkable expansion among the use categories. The recovery in industrial production dynamism was initially led by the production of durable goods, but it has become even more widespread than before, reflecting tax exemption measures, in advanced process of reversion, as well as the easing in financial conditions and the income expansion. The future behavior of industrial production, which should not be uniform over time, will also depend on the evolution of consumer and businessmen confidence, which should continue to be sources of dynamism, to which will be added the recovery of external demand.

6. Labor market continues to show favorable behavior. The unemployment rate in the six metropolitan regions covered by the IBGE Monthly Labor Survey (PME) increased from 7.2% in January to 7.4% in February, 1.1 p.p. lower than that observed in the same month of last year. According to the seasonally adjusted series, the unemployment rate reached 7.2% in February, down from 7.5% in the previous month. Average real earnings increased 1.8% in February, month-on-month, after increasing by 2.2% in January. Employment, on its turn, increased by 2.1% in January and 3.5% in February, year-over-year. As a consequence, real payroll expanded by 4.4% in February, year-over-year, continuing to constitute a key driver for domestic demand growth. Still regarding the labor market, data from the Ministry of Labor and Employment (MTE) indicate that formal employment has continued to recover. In fact, 266 thousand jobs were created in March and, 657 thousand, in the first quarter of 2010, both record highs for the historical series. The manufacturing industry, services and civil construction recorded, for the third consecutive month, record highs for the month and, therefore, registered the best first quarter for the historical series (204 thousand, 250 thousand and 128 thousand, respectively). The most dynamic sector continues to be civil construction, where employment recorded a 12.3% increase in the first quarter of the year, year-over-year.

7. According to data seasonally adjusted by the IBGE, expanded retail sales increased by 2.1% in February, after increasing by 1.3% in January. On a year-over-year basis, the indicator increased 13.6% in February. The three-month moving average of expanded retail sales reached 1.4% in February, according to seasonally adjusted data, after reaching 0.8% in January. On a month-on-month basis, according to seasonally adjusted data, it bears emphasizing the expansion in the sales of pharmaceuticals and medical articles (3.9%) and fabric, clothing and shoes (3.4%). Expanded retail sales data have been evidencing growth, mainly influenced by the increase in the sales of durable goods, in response to the improvement in the access to credit supply, income expansion and temporary sector incentives granted by the government. The retail sector continues to register positive performance and indicates that the pace of domestic demand growth remains robust, showing no signs of cooling. For the next quarters, the retail sales trajectory will be benefited by fiscal transfers, by real payroll growth, by the recovery in the access to credit and by the evolution of consumer confidence.

8. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by FGV, without seasonal adjustment, reached 83.5% in March, 6.4 p.p. above the level registered in the same month of 2009. According to the CNI series seasonally adjusted by the BCB, the Nuci showed stability in February (80.7%). According to the seasonally adjusted monthly series calculated by FGV, the Nuci reached 84.3% in March (84.0% in the previous month), above the average observed in the last five years. Similarly, the Nuci in the consumer goods, construction material and capital goods industries in March stood, in the same order, 5.0 p.p., 7.7 p.p. and 5.3 p.p. above the respective averages for the historical series, started in 1995. On its turn, the intermediate goods industry (-1.1 p.p.) is slightly below the historical average. The reduction in the idle capacity is a result of economic activity expansion, not totally offset by the maturity of investment projects. Data regarding the absorption of capital goods showed recovery compared to the same periods of 2009 and increase in February month-on-month. The absorption of capital goods increased 5.4% in February, according to seasonally adjusted data, a 31.6% increase in year-over-year terms, but an 8.7% decrease in the last twelve months. On its turn, the production of construction inputs expanded by 1% at the margin in February, after recording stability in January. According to observed data, it increased 15.1% in February, year-over-year, accumulating a 2.7% fall in the last twelve months. In short, evidences suggest that the utilization rates have recorded upward trajectory in the last months, showing reduction in any remaining idle margin of the industry, despite the recovery of investments. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments related to the expansion of supply of goods and services to adequately meet demand conditions.

9. The twelve-month cumulative trade balance retreated at the margin, reaching a US$23.2 billion surplus in March, US$2 billion lower than the one obtained in the same period last year. This

total resulted from US$161 billion in exports and US$137.9 billion in imports, equivalent to -15.4% and -16.6% changes, respectively, year-over-year. In fact, the greater dynamism of domestic demand relative to the external demand contributes to the narrowing of the trade surplus. The increase in remittances of profits and dividends contributes to elevate the twelve-month trailing current account deficit, which reached US$31.5 billion in March, up from US$28 billion in February, equivalent to 1.8% of GDP. On its turn, foreign direct investment reached US$26.3 billion in the last twelve months through March, equivalent to 1.5% of GDP.

10. The period since the last Copom meeting was initially marked by the continuity in the process of normalization of activity in international financial markets and, more recently, by some increase in the volatility of asset prices, although the perception of systemic risk remains limited. These developments can be attributed to fiscal concerns in mature economies, notably in Europe. Under these conditions, there was some moderation in the demand for risky assets, as evidenced by the behavior of international financial markets. Moreover, given the fiscal concerns in the Euro Area, the emphasis in the currency market remained the depreciation of the euro.

11. Regarding the global macroeconomic scenario, the current predominant view points to the recovery in 2010 and acceleration in 2011, in a process where the US, Europe and Japan (G3) would recover some dynamism, but which would continue to be led by emerging economies. The US economy shows signs of gradual recovery, due to the improvement of conditions in labor market and industrial activity. On its turn, the economic activity in Japan continues to suggest a slow recovery, led by exports, especially to Asia. In the Euro Area, where fiscal concerns persist and where household consumption shows no signs of reaction, the economic recovery has been slower and uneven. In short, uncertainty regarding the sustainability of consumption expansion in mature economies still remains, mainly in Europe, in a scenario of withdrawal of economic policy stimuli and modest prospects for credit expansion, but the recovery shows some consolidation. On the other hand, in many emerging economies, economic activity seems to have embarked on a consistent path of expansion, showing, in some cases, evidence of heat in the markets of goods, services, production factors and assets. Therefore, inflation troughs in mature economies and major emerging economies have been exceeded. In this context, after a period of aggressive monetary policy easing, in several countries, monetary policy continues a phase of stability, whereas those economies that were less impacted by the international crisis and recover more quickly and intensely tend to adopt more restrictive monetary policy stance. Australia and India, for instance, recently raised the basic interest rate.

12. Oil prices increased, both for spot and future markets, despite with reduced volatility, since the last Copom meeting. Uncertainty concerning these quotations remains high, as the prospective scenario depends on the evolution of demand, in a context of global economic recovery, on the prospects for the evolution of global supply, subject to the pace of investment maturation in the sector, in addition to the geopolitical issues that affect the price of this commodity. Nonetheless, the main scenario adopted by the Copom assumes unchanged domestic gasoline prices in 2010. However, it bears highlighting that, regardless the behavior of domestic gasoline prices, the evolution of international oil prices can eventually affect domestic prices both through production chains, such as the petrochemical, and through the potential effect over inflation expectations. It bears emphasizing that agricultural commodity prices, which have particularly important impact on the evolution of food costs, have presented stability since the previous Copom meeting, while the industrial commodities prices have registered slight increase, except for nickel and iron ore, which have notably increased since the last Copom meeting.

Assessment of inflation trends

13. The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations was based on the following assumptions:

a) the projected adjustments for gasoline and bottle gas prices for 2010 were kept unchanged at 0%;

b) the projected adjustments for fixed telephone was kept at 1.6% for 2010, while the projections for electricity prices adjustments was reduced to 0.7% for 2010, down from 3.3% considered in the March meeting;

c) the projection for regulated prices inflation for 2010, based on individual items, reduced to 3.6%, down from 4.0% considered in the March meeting, according to the benchmark scenario. This set of prices, according to data released by IBGE, accounted for 29.60% of the total March IPCA;

d) the projection for regulated prices inflation for 2011 was maintained at 4.4%, on the benchmark scenario. Such projection is based on the endogenous determination model for regulated prices, which computes, among other factors, seasonal components, foreign exchange rate changes, market prices inflation and the IGP (General Price Index) change; and

e) the projection for the spreads over the Selic rate, based on the 360-day swap rates, on the benchmark scenario, estimates 88 bps and 23 bps spreads in the fourth quarters of 2010 and 2011, respectively.

14. Regarding fiscal policy, projections assume the achievement of a public sector primary surplus target of 3.3% of GDP in 2010. This percentage can be reduced by up to 1.12 p.p., due to the implementation of the projects linked to the Growth Acceleration Program (PAC), of which 0.44 p.p. refer to amounts to be paid from 2009. Moreover, it is expected that the primary surplus in 2011 would return, without adjustments, to 3.3% of GDP. The additional assumptions considered in the previous meeting remained unchanged.

15. Since the last Copom meeting, the median of the expectations compiled by the BCB's Investor Relations Group (Gerin) for the 2010 IPCA increased from 5.03% to 5.41%. For 2011, the median of inflation expectations also increased, from 4.60% to 4.80%.

16.The benchmark scenario assumes the maintenance of the exchange rate at R$1.75/US$1.00 and the Selic rate at 8.75% p.a. during the forecast period. Under this scenario, the projection for the 2010 inflation increased relative to the figure considered in the March Copom meeting, and continues to be significantly above the 4.50% midpoint target established by the National Monetary Council (CMN). According to the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – IPCA inflation forecast for 2010 also increased, standing significantly above the inflation midpoint target. For 2011, under the benchmark scenario, the projection increased relative to the figure considered in the March Copom meeting, and is significantly above the inflation midpoint target. Under the market scenario, the projection also increased, however it stands around the midpoint target.

Monetary policy decision

17. The Copom evaluates that the monetary policy should contribute to the consolidation of a favorable longer-term macroeconomic environment. In international markets, risk aversion has improved since the last Copom meeting, despite the intensification of volatility in these markets in recent weeks, largely due to concerns about the sovereign debt of European countries. Indeed, there is a context of abundant liquidity, so that the prospects for external funding for the Brazilian economy remain favorable. In line with these developments, both the prices of Brazilian assets and of some selected commodities have continued to rise. On the other hand, the trajectory of price indices evidences the resumption of inflationary pressures in relevant economies. Consequently, the benign impact of the international scenario over the domestic inflation path could come to an end, despite the persistence of uncertainty regarding the behavior of asset and commodities prices in the context of gradual normalization of international financial conditions. On the other hand, this scenario may be quickly reversed, depending on the dynamics that derives from the market distrust regarding the solvency of some European economies. Regardless of how these aspects of the international outlook evolve, the Copom reaffirms that the main challenge of monetary policy is to ensure that the favorable results obtained over the last years are preserved.

18. The Copom believes that the indicators released since the last meeting reinforce the perception

about the existence of pressures over the market of factors, increasing the probability that initially localized inflationary episodes pose risks to the inflation trajectory. In this context, the risk of pass-through of upward costs pressures to wholesale price inflation, and from the last to consumer price inflation, increases as well. The Committee states that the materialization of this pass-through, as well as the spread of initially localized pressures over consumer prices, continues to depend critically on the economic agents' expectations for inflation and on the idleness degree of the economy, among other factors. Therefore, these and other variables are part of the information set that is taken into account in the generation of inflation forecasts of the BCB, which constitute a key element in the Committee's assessment on the prospective inflation scenario. Additionally, it should be noted that the behavior of domestic demand has exerted some pressure over the prices of non-tradable items, such as services, which, considering the perspective for the evolution of the main factors sustaining aggregate demand, tends to be observed again in this and in the upcoming quarters. In any event, the Committee reaffirms the commitment that it will continue to conduct its actions in order to ensure that the gains obtained in inflation control in recent years become permanent.

19. The Copom considers important to emphasize, once more, that there are important time lags between the implementation of monetary policy and its effects on both economic activity and inflation. Therefore, the assessment of alternative options for monetary policy should necessarily focus on the forward-looking inflationary scenario and its risks, instead of current inflation figures. The prospective scenario, indeed, suffered some deterioration at the start of 2010, a dynamic that has become even more evident since the last meeting. This occurred despite specific moves of some domestic assets, which are only relevant for monetary policy if they impact the forward-looking inflationary path.

20. Prospects for the evolution of domestic economic activity remain favorable, as evidenced by data on trade, manufacturing capacity utilization and the labor market. This assessment is also supported by signs of continued expansion of credit supply, both for individuals and corporate; by the fact that consumers and businessmen confidence stands at historically high levels; and by income growth. The continuity and intensification of this outlook depends significantly upon the effects of fiscal stimulus measures and the additional governmental transfers that will occur in the upcoming months and, to a lesser extent, upon the pace of recovery in global activity. The dynamism of domestic activity should also be benefited by the easing of financial conditions, favored, among other factors, by the policies of official banks. Considering the Brazilian economy's new cycle of expansion, these considerations become even more relevant when one takes into account that there are lags between the implementation of monetary policy and its effects over the activity level and inflation.

21. The Copom believes that the main risks to the consolidation of a benign inflationary scenario stem, regarding the external environment, from additional rises in commodities prices and, regarding the domestic scenario, from the fiscal and credit impulse over the evolution of domestic demand, in the context of virtual exhaustion of the idleness margin in the use of production factors. Indeed, these developments may exacerbate an outlook that already evidences the presence of mismatch between the growth of domestic absorption and capacity of supply expansion.

22. International evidence, ratified by the Brazilian experience, indicates that high inflation rates lead to the increase of risk premium, both for private and public funding, and to the shortening of planning horizons, both for households and corporate. Consequently, high inflation rates reduce investment and the economic growth potential, in addition to presenting regressive effects on income distribution. Otherwise, high inflation rates do not result in any lasting results for economic growth and employment level; on the contrary, they create permanent damage to these variables in the medium and long term. Therefore, the Copom strategy aims to ensure the convergence of inflation towards the targets path in 2010 and in the next years, which requires that possible deviations from the target path be promptly corrected. Such strategy takes into account the time lags in the transmission mechanism and is the most adequate to deal with the uncertainty inherent

to the process of monetary policy formulation and implementation.

23. The Committee believes that the economy is in a new expansion cycle, and this assessment is corroborated by data released since its last meeting, although uncertainty about the pace of this process – which should be resolved over time – still persists. Signs of overheat in the economy are evidenced, for example, in core inflation trajectories, in the rise of inflation expectations, in the evidence of workers shortage for some sectors and in the rising inputs costs. In particular, during this period, the inflation projections considered by the Committee showed some deterioration in the prospective scenario. The Copom believes that this deterioration should be contained and, therefore, the signs of persistent mismatch between the pace of aggregate demand expansion and aggregate supply, which, ultimately, tend to increase the risk for inflation dynamics, must be reversed. In such circumstances, the monetary policy stance should be adjusted, on the one hand, because it contributes to the convergence between the pace of demand expansion and supply and, on the other hand, because it prevents that originally localized price pressures determine a persistent deterioration of the inflation prospective scenario.

24. In short, despite the withdrawal of substantial share of the stimuli introduced during the recent international financial crisis, since the last meeting, the risks for the achievement of a benign inflationary scenario, in which inflation would remain consistent with the inflation targets, have increased. In light of this outlook, the prevailing opinion among the Committee members was that monetary policy must act incisively in order to avoid that the greater uncertainty detected in shorter horizons spread to longer horizons.

25. Under these considerations, continuing the adjustment process of monetary conditions to the prospective scenario of the economy, in order to ensure the convergence of inflation to the targets path, the Copom unanimously decided to increase the Selic rate to 9.50% p.a., without bias.

26. Under the inflation-targeting regime, the Copom guides its decisions according to projected inflation, the analysis of several alternative scenarios for the evolution of the main variables that determine the forward-looking dynamics for prices, and the balance of risks associated to the projections. After a brief contraction, domestic demand recovered, largely due to the effects of stimulus factors, such as income growth and credit resumption. On its turn, important fiscal and credit incentives have been provided to the economy in recent quarters, and should contribute for the consolidation of activity expansion and, hence, for the reduction of any residual idleness margin of productive factors. The effects of these stimuli, as well the reversal of substantial share of the initiatives taken during the recent international financial crisis, and a possible deepening of the fiscal crisis that several European countries face, are an important part of the context in which future monetary policy decisions will be taken, aiming to ensure a timely convergence of inflation to the targets path.

27. In addition, it bears noticing that there was consensus among the Committee members about the need to adapt the pace of adjustment of the basic interest rate to the developments in the prospective inflation scenario, as well as to the corresponding balance of risks, in order to limit the impacts caused by the behavior of current inflation over the underlying prices dynamics.

28. At the end of the meeting it was announced that the Committee will reconvene on June 8th, 2010 for technical presentations and, on the following day, to discuss the monetary policy decision, as established in Communiqué 18,927 of October 9th, 2009.

Summary of data analyzed by the Copom

Inflation

29. The IPCA increased 0.52% in March, down from 0.78% in February, accumulating a 2.06% increase in the year through March. In the last twelve months, the index increased 5.17% in March, up from 4.83% in February. The behavior of food and beverages prices constituted the key driver of inflation in March, contributing 0.35 p.p. to the result, in particular due to the change in tubers, roots and vegetables, pasteurized milk, refined sugar and fruit, which

jointly contributed 0.23 p.p. to the March IPCA result. Despite the pressure stemming from food and beverages, the IPCA cooled in March, mainly favored by the depletion of the impacts caused by school fees readjustment, which had pressured the index in February.

30. The deceleration in market price inflation, from 0.93% in February to 0.80% in March, reflected the slowdown in non-tradable goods inflation, which reached 1.03% in March, down from 1.54% in February, while the prices of tradable goods rose 0.53% in March, up from 0.26% in the previous month. Regulated prices fell 0.14% in the month, after rising 0.42% in February, reflecting mainly the 1.95% decrease in the price of gasoline. In the last twelve months through March, market prices rose 5.37%, the highest change since May 2009, up from 4.77% through February, while regulated prices increased 4.67%, against 4.97% for the same periods, respectively. The diffusion index stood at 66.4% in March, up from 61.7% the previous month, confirming the dissemination process of price adjustments.

31. The IPCAEX core, which excludes all fuel items and ten items of household food, decelerated in March to 0.42%, down from 0.68% in February. In twelve months, it accelerated, reaching 5.06% in March, up from 4.86% in February. The smoothed trimmed-means core measure accelerated, both for the monthly rate, increasing 0.46% in March up from 0.39% in February, and for a twelve-month trailing basis, reaching 4.64%, compared to 4.52% in the previous month. The double weight core increased by 0.40% in the month, down from 0.47% in February, increasing 5.06% on a twelve-month trailing basis, up from 4.93% in February.

32. The IGP-DI decelerated in March, increasing by 0.63%, down from 1.09% in February, favored by the cooling in wholesale price inflation, whose impact overweighed the resurgence of highs in consumer price inflation and construction prices. The IGP-DI expanded by 2.76% in the year through March and 2.26% in the last twelve months. The IPA-DI increased 0.52% in March, down from 1.38% in February, registering increase for agricultural prices (2.33%) and decrease for industrial prices (-0.05%). In the year through March, the IPA-DI increased 2.88% and in the last twelve months, it rose 0.79%. The IPC-Br grew 0.86% in March, up from 0.68% in February, accumulating 2.86% in the year and 5.17% in twelve months. In the month, three of the seven groups that compose the IPC-Br accelerated, with emphasis on food expenses, accounting for 0.74 p.p. in the composition of the monthly change, especially fruit and vegetables, which contributed 0.44 p.p.. The INCC-DI increased 0.75% in March, up from 0.36% in the previous month, with highlights to the greatest change in the prices of the labor force, which increased 1.05%, up from 0.21% in February. In the year through March and in the last twelve months, the index expanded by 1.76% and 4.71%, respectively.

33. Partial results of price indices indicated continuity in the process of inflation deceleration in April, reflecting, among other factors, the depletion of seasonal impacts responsible, in part, for the increase in inflation at the start of the year. The IPCA-15 increased 0.48%, up from 0.55% in the previous month, mainly reflecting the behavior in the prices of alcohol, which decreased 13.64% in the period, also influencing the 2.12% decline in the price of gasoline. The food and beverages group continued to be the key driver for inflationary pressure, contributing 0.39 p.p. to the monthly IPCA-15. Considering wholesale price indices, there are also less intense highs, due to the cooling in the prices of final and intermediate goods, followed by fall in the prices of raw materials.

Economic activity

34. Expanded retail sales increased 2.1% in February, month-on-month, after rising 1.3% in January and 0.9% in December, according to seasonally adjusted data by the IBGE’s monthly survey (PMC). The average sales for the quarter ended in February rose 1.3%, compared to the quarter ended in November. Year-over-year, growth reached 13.6%, accumulating increases of 11.9% in the first two months of 2010 and 8.3% in the last twelve months through February. The month-on-month result recorded rise in sales in eight of the ten sectors surveyed, with emphasis on pharmaceuticals and medical articles (3.9%), and fabric, clothing and shoes (3.4%).

35. Year-over-year, all commerce segments expanded in February 2010, with highlights to the increases

in the sales of furniture and appliances (22.2%), office material and equipment (18.8%), and vehicles and motorcycles, parts and pieces (16%). In the last twelve months, there were increases in eight of the ten sectors surveyed, with emphasis on the growth in vehicles and motorcycles, parts and pieces (13.1%), office material and equipment (12.3%) and pharmaceutical and medical articles (12.1%). Among the segments that presented negative performance, according to the same comparison basis, it bears noticing construction materials (-3.2%), and fabric, clothing and shoes (-1.2%).

36. Signs of continued expansion in retail activity were released by the São Paulo Trade Association (ACSP), covering the state capital, showing increases of 2.4% in the number of consultations to the Central Credit Protection Service (SCPC) and 0.6% to the Usecheque system, in March, according to the month-on-month seasonally adjusted series. In 2010Q1, these indicators increased 6.6% and 6.4%, respectively, relative to the same period last year.

37. Automobile sales by dealers, including cars, light commercial vehicles, trucks and buses, rose 15.6% in March, month-on-month, according to Fenabrave (Brazilian Federation of Automotive Vehicles Distribution) data, seasonally adjusted by the BCB. The increase in the month reflected the significant growth in sales of trucks and buses, both recording 27.2% in the period, in addition to the expansion of car sales (13.3%) and light commercial vehicles (6.9%). It should be noticed that the end in the reduction of industrialized products tax (IPI), to which flex-fuel vehicles were subject in March, favorably impacted the performance of vehicles sales in the month. Total sales increased 30.3% in March year-over-year and 14.8% in the last twelve months through March.

38. Capital goods imports decreased 1% in March, month-on-month, according to the Funcex quantum index, seasonally adjusted by the BCB. The March indicator increased 17.1% year-over-year and 16% in the year through March, but it declined 9.8% in the last twelve months through March, compared to the same period last year.

39. Capital goods production increased 1.6% in February, month-on-month seasonally adjusted, and expanded 26.2% and 19.1% compared to February and the first two months of 2009, respectively, according to the IBGE. Considering the result by destination of products, there was monthly decline only for serial industrial use (3.3%), while there were expansions in production of agricultural pieces (20.9%), capital goods for construction (14.4%), and for mixed use (7.1%). Compared to February 2009, it bears noticing the production of capital goods for construction, which increased 196.9%, followed by agricultural parts and capital goods for agricultural production, with increases of 76.3% and 51.7%, respectively. The production of construction inputs expanded 1% month-on-month, according seasonally adjusted data, and 15.1% year-over-year.

40. Disbursements from granted by the BNDES reached R$ 144.3 billion in the last twelve months through March, with a 53% increase over the same previous period. The industrial sector was the largest recipient of disbursements, with participation of 44% of the total released in the period, followed by the infrastructure sector, with 36%. In the first quarter of 2010, disbursements expanded by 42%, compared to same period in 2009, with emphasis on the infrastructure sector, which recorded a 40% share in the total released, followed by industry (30%), trade and services (20%) and agriculture (10%). The March result reported slowdown in disbursements by the institution, and a 12.5% increase compared to March 2009.

41. Industrial production increased 1.5% in February, month-on-month, when it registered 1.1% expansion, seasonally adjusted, according to IBGE’s Monthly Industrial Survey – Physical Production (PIM-PF). Year-over-year, industrial output grew by 18.4% in February and 17.2% in the first two months, still recording negative result in the last twelve months (-2.6%), over the same previous period. Month-on-month, the category of semi- and non-durable consumer goods outperformed in February (2.4% growth), followed by capital goods (1.7%) and durable consumer goods (0.7%), while intermediate goods production decreased 0.4%. Year-over-year, all use categories expanded, with emphasis on the increases of 26.2% in capital goods and of 25.2% in durable consumer goods. On a twelve-month trailing basis, the production of capital

goods and intermediate goods decreased 12.7% and 3.1%, respectively, while the production of durable consumer goods and semi and non-durable consumer goods increased 1.5% and 0.5%, respectively.

42. Real earnings in the manufacturing industry increased 1.5% in February month-on-month, while in January it declined by 1.5%, according to data released by the CNI, seasonally adjusted. Hours worked and employment rose by 1.3% and 1%, respectively, in the same period. Year-over-year, these indicators increased by 11.4%, 5.3% and 2.8%, respectively. On a twelve-month trailing basis, the three indicators reduced by 1.3%, 5.8% and 2.9%, respectively.

43. According to CNI, the Nuci remained unchanged at 78.6% in February, relative to January, 2.1 p.p. higher than the level observed in the same month of 2009. Considering the seasonally adjusted series, the Nuci stood at 80.7% in February, compared to 80.6% in January, and accumulated a decline of 0.2% in the quarter ended in February. In eleven out of the nineteen segments of the manufacturing industry, the Nuci presented positive performance month-on-month. According to data from FGV, the Nuci reached 84.3% in March, seasonally adjusted, with increases of 0.3 p.p. in the month and 0.5 p.p. over the last three months.

44. According to Anfavea, vehicles production reached 331 thousand units in March, increasing by 20.3% year-over-year. According to data seasonally adjusted, vehicles production increased 5.3% in March, month-on-month. In the year and in the last twelve months through March, the production of vehicles increased 24.4% and 8.3%, respectively. The monthly increase in vehicles sales was exclusively due to the performance of domestic market, with a 14.5% increase in March, month-on-month, while exports fell 0.2%. In the year and twelve months through March, domestic sales increased 14.7% and 13.9%, respectively, while exports expanded by 82.7% in the year and decreased by 14.7% in the last twelve months.

45. The LSPA survey carried out by the IBGE in March estimated the production of 145.2 million tons in 2010, up from 133.8 million tons in 2009. The new estimate represents an 8.5% increase relative to 2009, remaining virtually unchanged relative to the forecast in February. The projected expansions for the production of soybeans and corn were changed to 18.1% and 3%, respectively. For products directly related to the basic basket, such as rice, beans and wheat, the new survey projected changes of -9.6%, 2.3% and 9.4%, respectively.

Surveys and expectations

46. According to the Fecomercio-SP survey, the Consumer Confidence Index (ICC) decreased in April for the second consecutive month. The ICC fell 2.9% in April, compared to March, when it had fallen 1.5% compared to February, the month when it reached a record high for the series. This result reflected the fall of 8.5% in the Current Economic Conditions Index (Icea), considering that the Consumer Expectations Index (IEC) increased 0.8% in the period. Year-over-year, the ICC increased 21.8%.

47. According to the Consumer Expectations Survey carried out by the FGV nationwide, the ICC increased 0.6% in March, month-on-month seasonally adjusted, reaching 110.9 points. In the month, the Current Situation Index (ISA) decreased for the second consecutive month, from 123.4 to 121.5 points, while the Expectations Index (IE) increased from 103.2 to 105.4 points, after three consecutive months of decline. Year-over-year, the ICC increased 13.2%, reflecting increases of 21.4% in the ISA and of 8.7% in the IE.

48. The Industry Confidence Index (ICI) from FGV reached 116.5 points in March, standing 0.6% above the level observed in February, according to seasonally adjusted data and 49% higher than the level observed in March 2009. Considering the components, the ISA increased 3.4%, and the IE decreased 2.2%, seasonally adjusted. Year-over-year, the same indicators expanded by 47.2% and 50.8%, respectively.

49. According to the CNI survey, the industrial businessmen confidence remained virtually unchanged in March, compared to the previous month, as evidenced by the Industrial Businessmen Confidence Index (Icei), which stood at 67.7 points, compared to 67.8 points registered in February. The component relative to current conditions fell by

0.3 point compared to the previous month, while that relative to expectations increased by 0.1 point.

Labor market

50. According to the General Record of Employment and Unemployment (Caged) of the Ministry of Labor and Employment (MTE), 266.4 thousand formal jobs were created in March, the best result for the month, surpassing by 19% the previous record in March 2008. In the last twelve months through March, 1,710.1 thousand hires were created, nearly two-fold the number recorded in the same period of 2009. Considering seasonally adjusted data, employment level expanded by 0.6% month-on-month. The manufacturing industry recorded 72.4 thousand new jobs, recording increases of 0.9% in employment in the month, considering seasonally adjusted data, and 3.5% year-over-year. The service sector created 106.4 thousand jobs in March, with increases of 0.6% month-on-month in the employment level and 4.6% in the year. The construction sector was responsible for the supply of 38.6 thousand jobs during the month, representing a 1.2% growth in the level of employment month-on-month and a 12.3% increase in the year, performing as the sector with the highest growth rate according to both comparison bases.

51. According to the IBGE employment survey (PME), carried out in the six main metropolitan regions of the country, the unemployment rate reached 7.4% in February, increasing 0.2 p.p. month-on-month and declining 1.1 p.p. year-over-year. The increase in unemployment in the month resulted from an increase of 63 thousand jobs, lower than the increase of 98 thousand people in the Economically Active Population (PEA). In seasonally adjusted terms, the unemployment rate fell by 0.3 p.p. in the month and reached 7.2%. According to the survey, average real earnings usually earned by workers increased 1.2% month-on-month, after increasing 1.1% in January. Payroll grew 1.5% month-on-month and 4.4% year-over-year.

Credit and delinquency rates

52. Outstanding credit in the financial system reached R$1,452 billion in March, equivalent to 45% of GDP, with increases of 1.1% in the month and of 16.8% in the last twelve months. Non-earmarked credit operations increased 1.1% in the month and 11.2% in the last twelve months. Among the non-earmarked operations, credit operations to individuals increased 2% in the month and 18.6% in twelve months, while non-earmarked credit operations to corporate increased 0.2% and 4.6%, according to the same comparison bases. Earmarked credit operations increased 1.1% in March and 30.2% in twelve months.

53. The average interest rate on non-earmarked credit operations, used as reference for interest rates, decreased 0.1 p.p. in March, month-on-month, reaching 34.2%. The average annual rate on credit for individuals reached 41% in the month, 0.9 p.p. below that recorded in February, and the average rate on corporate credit reached 26.3%, 0.4 p.p. above the level registered in the previous month.

54. The average tenure on non-earmarked credit operations, used as reference for interest rates, increased in March, reaching 396 days, up from 388 days in February. The average tenure of corporate credit operations reached 287 days, up from 280 days in February, while the average tenure for credit operations to individuals totaled 526 days, eight more than the previous month.

55. Delinquency rates in the financial system (non-earmarked loans used as reference for interest rates, in arrears for more than ninety days) reduced from 5.3% in February to 5.2% in March. Delinquency rates for credit operations with corporate declined 0.1 p.p., reaching 3.6%, and with individuals, declined 0.3 p.p., reaching 7%.

External environment

56. Economic indicators released since the last Copom meeting have highlighted the continuing process of global economic expansion, driven primarily by emerging economies, especially in Southeast Asia. Recent projections by the IMF revised 2010 global growth to 4.2% and maintained their expectation for the performance of 2011, at 4.3%. Growth estimates for 2010 related to the US and Japan increased, respectively, to 3.1% and 1.9%, while for the Euro Area, UK and China projections remained unchanged

at 1%, 1.3% and 10%, respectively. For world trade, the IMF raised its forecast for expansion this year to 7%, 1.2 p.p. above the last forecast, released in January.

57. In the US, expectations indicators showed continued rise in consumer confidence, while labor market indicators showed positive development, reflecting the net creation of jobs in the first quarter of the year. The disposable income, in contraction, suggests that consumption growth in the period had as counterpart a reduction in the savings rate. In the Euro Area, where the resumption of activity continues contained, the most recent data evidenced that consumer spending has not shown significant recovery yet and economic activity in the region continues to be driven mainly by the external sector.

58. In larger advanced economies, although the costs to producers respond to the rise in commodities prices, the relatively low installed capacity utilization (UCI) and the high unemployment rates result in the maintenance of reduced consumer price indices (IPC), which, in the last twelve months through March, reached 2.3% in the US, 1.4% in the Euro Area and 3.4% in the UK. Among emerging economies, the CPI annual changes recorded in March 9.6% in Turkey, 5.0% in Mexico, and 2.4% in China. In light of this outlook, the central banks of major mature economies kept the basic interest rates unchanged and were involved in the management of liquidity. Moreover, among emerging economies, signs of reduction of accommodative stance for monetary policy prevail, with recent high in the interest rate in India and restrictions to credit in China.

59. As highlighted in the last Copom meeting, in face of the fiscal deterioration, especially in the European Union, tensions in the international economy remained high. The five-year CDS spreads in Greece and Portugal have recently increased, despite the statement of financial support to Greece signed in mid-April by the countries that comprise the Euro Area. The Greek long-term debt was downgraded by a rating agency, and the Greek government formalized, with the countries that comprise the Euro Area and the IMF, the request for activation of the loan scheme. However, lack of details regarding its implementation maintained the CDS in Greece at record highs.

Foreign trade and international reserves

60. The Brazilian trade surplus reached US$668 million in March, accumulating US$892 million in the first quarter of the year, compared to US$3 billion in the same period of 2009. In twelve months, the surplus reached US$23.2 billion, decreasing 7.5% year-over-year. In the month, exports totaled US$15.7 billion, and imports, US$15.1 billion, both record highs for the month of March, growing by 27.4% and 43.3%, respectively, year-over-year, on a daily average basis. External trade reached US$77.6 billion in the first quarter, growing by 30.7% relative to the same period of 2009.

61. Based on the liquidity concept, which encompasses the balance of borrowing operations in foreign currencies, international reserves reached US$244 billion in March, recording a US$2.6 billion growth month-on-month. Under the cash concept, international reserves totaled US$243.8 billion, recording a US$2.7 billion increase, according to the same comparison basis. The monetary authority’s interventions accounted for net purchases of US$3 billion in the domestic market, in March.

Money market and open market operations

62. Since the March Copom meeting, the slope of the yield curve has increased throughout its length. The persistent rise in inflationary expectations, the slow deceleration of current inflation indices and the disclosure of activity and employment data suggesting consistent recovery of economic activity were key drivers of this movement. Between March 15th and April 26th, one- three- and six-month rates increased by 0.35 p.p., 0.52 p.p. and 0.58 p.p., respectively. The one- two- and three-year rates increased by 0.55 p.p., 0.62 p.p. and 0.69 p.p., respectively. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month-ahead inflation expectations, increased from 6.05% on March 15th to 6.36% on April 26th.

63. In its open market operations, the BCB carried out, between March 16th and April 26th, repo operations borrowing R$24.1 billion for a six-month

period. As a consequence, the average daily balance of the long operations reached R$87.8 billion. In the same period, the BCB also borrowed money through repo operations with tenures between 12 and 28 working days, increasing the average daily balance of short-term borrowing operations to US$262.8 billion. The BCB also borrowed money through 28 overnight repo operations and conducted daily, at the end of day, two-working-day tenure liquidity management operations. The very short-term operations, including the two-working-day tenure liquidity management operations, averaged a daily balance of R$56.1 billion in the period, borrowing. The average daily balance of the total stock of repurchase agreement of the Central Bank decreased from R$487.9 billion between January 26th and March 15th to R$406.7 billion, between March 16th and April 26th. Considering the daily balance of operations for the most recent period, there was a fall in the repurchase agreements totaling R$139.2 billion, with a decrease in total stock from R$473.3 billion on March 15th to R$334.1 billion on April 26th. The main driver of liquidity contraction in the period was the adjustment promoted by reserve requirements.

64. Between March 16th and April 26th, the National Treasury issuance regarding the traditional auctions raised a total of R$37.4 billion. The issuance of fixed-rate securities reached R$20.1 billion, with R$13.4 billion via issuance of LTNs maturing in 2010, 2011 and 2012, and R$6.7 billion via NTN-Fs maturing in 2014 and 2021. Issuance of LFTs totaled R$10.7 billion, for securities maturing in 2013, 2014, 2015 and 2016. Issuance of inflation-linked NTN-Bs reached R$6.6 billion, for securities maturing in 2013, 2015, 2020, 2030, 2040 and 2050.

Minutes of the 151st Meeting of the Monetary Policy Committee (Copom)

Date: June 8th, from 4:15PM to 6:00PM, and June 9th, from 4:45PM to 7:40PM
Place: BCB Headquarters meeting rooms – 8th floor from June 8th and 20th floor on June 9th – Brasília – DF

In attendance:
Members of the Committee
Henrique de Campos Meirelles – Governor
Aldo Luiz Mendes
Alexandre Antonio Tombini
Alvir Alberto Hoffmann
Anthero de Moraes Meirelles
Antonio Gustavo Matos do Vale
Carlos Hamilton Vasconcelos Araújo
Luiz Awazu Pereira da Silva

Department Heads (present on June 8th)
Adriana Soares Sales – Research Department (also present on June 9th)
Altamir Lopes – Economic Department
Ariosto Revoredo de Carvalho – International Reserves Operations Department
João Henrique de Paula Freitas Simão – Open Market Operations Department
José Antonio Marciano – Department of Banking Operations and Payments System
Renato Jansson Rosek – Investor Relations Group

Other participants (present on June 8th)
Alexandre Pundek Rocha – Advisor to the Board
Eduardo José Araújo Lima – Deputy-Head of the Research Department
Ricardo Franco Moura – Advisor to the Board

The members of the Monetary Policy Committee analyzed the recent performance of and the prospects for the Brazilian economy and for the international economy, under the monetary policy framework, which is designed to comply with the inflation targets established by the government.

Recent economic developments

1. IPCA inflation, after moving from 0.52% in March to 0.57% in April, reduced to 0.43% in May.

As a consequence, inflation accumulated in the first five months of 2010 reached 3.09%, 0.89 p.p. above the level registered in the same period of the previous year. The rise in inflation in 2010 mirrors the behavior of market prices, which increased by 3.72% in the year through May. Focusing on market prices, both prices of tradable goods and non-tradable goods accelerated in the first five months of the year, reaching 2.52% and 4.80%, respectively, up from 1.38% and 3.12% in the same period of 2009. On its turn, regulated prices increased by 1.59% in the first five months of the year, compared to 1.99% in the same period of 2009. The change in the prices of services, whose dynamics tends to show more persistence than that of the prices of goods, reached 4.33% until May and 6.78% in twelve months. In short, information available suggests continued deterioration of inflation dynamics at the margin, although at a slower pace.

2. The three main underlying inflation measures calculated by the BCB showed convergent behavior between April and May. The smoothed trimmed means core inflation increased from 0.50% in April to 0.62% in May, as well as the double weight core inflation (from 0.42% to 0.56%) and core inflation by exclusion (from 0.42% to 0.56%), respectively. In the year through May, the core inflation by exclusion increased by 2.71%, while smoothed trimmed means and double weight core inflation measures increased 2.47% and 2.48%, respectively. These changes are, respectively, 0.20 p.p., 0.62 p.p. and 0.31 p.p. above the rates prevailing in the same period in 2009. The twelve-month trailing inflation measures changed from 4.73%, 4.36% and 4.74% in December 2009, for the core inflation by exclusion, smoothed trimmed means and double weight core inflation measures, to 4.93%, 4.99% and 5.06% in May, respectively. It is important highlighting that all core inflation measures, on a twelve-month basis, are above the midpoint of inflation target. Moreover, it bears emphasizing that, despite the IPCA diffusion index remained unchanged compared to April (60.9%), its level continues to suggest dissemination in the inflation acceleration process (58.9% in the same month of 2009).

3. The General Price Index (IGP-DI) inflation increased from 0.72% in April to 1.57% in May. In the year through May, the IGP-DI inflation reached 5.12% (-0.74% in the same period of 2009). Under this comparison basis, the acceleration of the IGP-DI reflected the behavior of its three components. The Wholesale Price Index (IPA-DI) increased 5.72% in the year through May (-2.29% in the same period of 2009). On its turn, the Consumer Price Index – Brazil (IPC-Br) increased 3.86% in the same period (2.54% in 2009). Still according to the same comparison basis, the Civil Construction National Index (INCC) increased 4.48% (1.70% in 2009). The IPA-DI inflation acceleration, under this comparison basis, derived both from the behavior of agricultural and industrial prices. While the industrial IPA increased 5.86% (-3.46% in the same period of 2009), the elevation of wholesale agricultural prices reached 5.25% (1.23% in 2009). As mentioned in previous Copom Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend on current and prospective demand conditions, as well as on price setters' expectations for the future inflation path.

4. The IBGE (Statistics and Geography Brazilian Institute) released information about 2010Q1 GDP. The data showed expansion in activity, which increased 9.0% in the first quarter, year-over-year, and a 2.7% increase quarter-over-quarter, according to seasonally adjusted data. On the aggregate demand side, household consumption and public administration consumption increased, respectively, 9.3% and 2.0%, year-over-year. Gross fixed capital formation (FBCF) increased 26.0% and imports grew 39.5%, according to the same comparison basis, whereas exports increased 14.5%. The positive contribution of domestic absorption to the Q1 GDP growth totaled 11.8 p.p., year-over-year, overweighting the 2.9 p.p. negative contribution of the external sector. On the aggregate supply side, still according to the same comparison basis, the services sector presented a positive performance, growing by 5.9%, while industry grew by 14.6% and agriculture, 5.1%.

5. On a three-month moving average basis, according to data seasonally adjusted by the IBGE, industrial output increased 2.1% in March and 1.4% in April. Still considering the seasonally adjusted series, on a month-on-month basis, after expanding by 3.4% in

March (revised from 2.8%, an increase of 0.5 pp in the observed data), industrial output decreased by 0.7% in April. On a year-over-year basis, industrial output increased by 17.4% in April, compared to 20.2% in March. On a twelve-month trailing basis, the industrial production growth expanded in April (2.3%), after consecutive declines since February 2009. Despite the decrease on a month-on-month basis, the behavior of IBGE industrial output series, and its components, shows that industrial production expands, returning to pre-crisis levels of 2008, at a pace that continues to be influenced by the international outlook, by business and households expectations, as well as by domestic financial conditions. This process is supported not only by traditional sources of credit, but also by the recovery of capital markets and the performance of public financial institutions.

6. Among the use categories, according to data seasonally adjusted by the IBGE, in April it bears highlighting the expansions of 2.4% in capital goods production, and 0.5% in durable consumer goods production. Intermediate goods production increased 0.4%. On its turn, semi-durable consumer goods production decreased 0.8%, contributing to the 1.5% decline in the consumer goods production in the month, after rising 1.4%, 2.2% and 2.5% in January, February and March, respectively. Considering the quarterly series, all categories showed growth: capital goods, 4.9%, durable consumer goods, 4.4%, non-durable and semi-durable consumer goods, 3.5% and intermediate goods, 2.6 %. It bears highlighting that capital goods productions expanded by 28.7% in the year through April, the most remarkable expansion among the use categories, demonstrating the consistent recovery of the domestic economy. The recovery in industrial production dynamism was initially led by the production of durable goods, but it has become even more widespread than before, reflecting tax exemption measures, in advanced process of reversion, as well as the easing in financial conditions and the income expansion. The future behavior of industrial production, which should not be uniform over time, will also depend on the evolution of consumer and businessmen confidence, which should continue to be sources of dynamism, to which shall be added the gradual recovery of external demand.

7. Labor market continues to show vigor in clear process of expansion in the economic cycle. The unemployment rate in the six metropolitan regions covered by the IBGE Monthly Labor Survey (PME) decreased from 7.6% in March to 7.3% in April, 1.6 p.p. lower than that observed in the same month of last year. According to the seasonally adjusted series, the unemployment rate reached 6.8% in April, down from 7.0% in the previous month. Average real earnings were stable (0.1%) in April, month-on-month, after increasing by 0.4% in March. Employment, on its turn, increased by 3.8% in March and 4.3% in April, year-over-year. As a consequence, real payroll expanded by 6.7% in April, year-over-year, continuing to constitute a key driver for domestic demand growth. Still regarding the labor market, data from the Ministry of Labor and Employment (MTE) indicate that formal employment has continued to recover. In fact, 305 thousand jobs were created in April and 962 thousand in the year through April. In the latter case, the expansion of the period was a record high for the historical series, begun in 1985. Similarly, the manufacturing industry, trade, services and civil construction registered the largest balances accumulated since 1985. The most dynamic sector continues to be civil construction, where employment recorded a 12.9% increase in the first four months of the year, year-over-year.

8. According to data seasonally adjusted by the IBGE, expanded retail sales increased by 5.0% in March, after increasing by 2.2% in February. On a year-over-year basis, the indicator increased 22.0% in March. The three-month moving average of expanded retail sales reached 3.0% in March, according to seasonally adjusted data, after reaching 1.6% in February. On a month-on-month basis, according to seasonally adjusted data, it bears emphasizing the expansion in the sales of "vehicles, motorcycles, parts and pieces" (10.3%) and "office material and equipment" (8.6%). Expanded retail sales data have been evidencing growth, mainly influenced by the increase in the sales of durable goods, in response to the improvement in the access to credit, income expansion and temporary sector incentives granted by the government. The retail sector continues to register positive performance and indicates that the pace of domestic demand growth remains robust, but might, however, show

some signs of cooling. For the next months, it is expected that the retail sales trajectory continues to be benefited by fiscal transfers, by real payroll growth, by the recovery in the access to credit and by the evolution of consumer confidence.

9. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by FGV, without seasonal adjustment, reached 84.6% in May, 5.9 p.p. above the level registered in the same month of 2009. According to the CNI series seasonally adjusted by the BCB, the Nuci reached 82.8 in April (up from 82.4% in March). According to the seasonally adjusted monthly series calculated by FGV, the Nuci reached 84.9% in May (85.1% in the previous month), the first decline since February 2009. Among the four use categories, the Nuci in construction material (91.6% versus 89.4% in the previous month) and in intermediate goods industry (86.5% versus 85.7% in the previous month) increased on a month-on-month basis, with the former reaching a new historical record for the series, while the latter is slightly above the historical average. On its turn, the industries of consumer goods (85.4% versus 86.3% in the previous month) and capital goods (82.8% versus 83.4% in the previous month) have shown little reduction compared to the previous month. The trend of reduction in the idle capacity is the result of economic activity expansion, not totally offset by the maturity of investment projects. Data regarding the absorption of capital goods show recovery compared to the same periods of 2009. Despite the decline of 0.3% in April compared to the previous month, the absorption of capital goods increased 30.9%, year-over-year, and 28.2% in the year through April. On its turn, the production of construction inputs recorded virtual stability (-0.1%) at the margin in April, after a strong increase of 4.0% in March. According to observed data, it increased 18.2% in April, year-over-year, accumulating 1.7% growth in twelve months. In short, evidences suggest that the utilization rates have recorded upward trajectory in the last months, showing reduction in any remaining idle margin of the industry, despite the recovery of investments. As stressed in previous Copom Minutes, the inflation trajectory is closely linked to current and prospective developments related to the expansion of supply of goods and services to adequately meet demand conditions.

10. The twelve-month cumulative trade balance retreated at the margin, reaching a US$21.6 billion surplus in May, US$4.1 billion lower than the obtained in the same period last year. This total resulted from US$169.6 billion in exports and US$148.0 billion in imports, equivalent to -6.5% and -4.9% changes, respectively, year-over-year. In fact, the greater dynamism of domestic demand relative to the external demand contributes to the narrowing of the trade surplus. The increase in remittances of profits and dividends contributed to elevate the twelve-month trailing current account deficit, which reached US$36.2 billion in April, equivalent to 2.0% of GDP, up from US$31.5 billion in March. On its turn, foreign direct investment reached US$25.1 billion in the last twelve months through April, equivalent to 1.4% of GDP.

11. The period since the last Copom meeting was marked by deterioration in the process of normalization of activity in international financial markets, following the intensification of the effects of fiscal crisis in many European countries, with impact on the volatility of asset prices. Apparently, the perception of systemic risk resurfaced, fueled by the view that there would be interdependence between a possible fiscal consolidation in economies that are facing difficulties in this area and the balance sheets of financial institutions. However, until now, the possibility of realization of a stress scenario seems limited, but, anyway, there was some moderation in demand for risky assets in international financial markets.

12. The global economy continues to show recovery in 2010, whose intensity might accelerate in 2011, in a scenario in which the economies of the US, Europe and Japan (G3) recover some dynamism, but with considerable discrepancy between the regions, and with the recovery process being led by emerging economies. The US economy shows signs of recovery, as can be seen, for example, at the end of the process of rebuilding of inventories, with positive impact on industrial activity and retail sales, although these indicators show some volatility. The levels of consumer confidence also advanced, although remaining at levels well below those prevailing before the crisis of 2008. Moreover, the labor market begins to show signs of recovery. On its turn, the

economic activity in Japan continues to suggest a slow recovery, led by exports. In the Euro Area, fiscal concerns turn the recovery more uncertain, the household consumption shows no consistent signs of reaction, and the economic recovery tends to be slower and uneven. In short, since the last Copom meeting, the uncertainty regarding the sustainability and pace of consumption expansion in mature economies increased, mainly in Europe, in a scenario where economic policy stimuli are replaced by contractionary measures, and prospects for credit expansion are modest. On the other hand, in many emerging economies, economic activity remains in a path of expansion, showing, in some cases, evidence of heat in the markets of goods, services, production factors and assets. In fact, there is already concern about the dynamics of inflation in major emerging economies. In this context, after a period of aggressive monetary policy easing, monetary policy continues unchanged in several countries, and in those economies that were less impacted by the international crisis, which had recovered more quickly and intensely, the adoption of more restrictive monetary policy has started.

13. Since the last Copom meeting, oil prices showed some cooling, both in spot and future markets, despite the high volatility. In fact, the uncertainty concerning these quotations remains high, as the prospective scenario depends on the evolution of demand, in a context of asymmetric global economic recovery, on major uncertainties about the recovery of the European economy, on the prospects for the evolution of global supply, subject to the pace of investment maturation in the sector, in addition to the geopolitical issues that affect the price of this commodity. Nonetheless, the main scenario adopted by the Copom assumes unchanged domestic gasoline prices in 2010. However, it bears highlighting that, regardless the behavior of domestic gasoline prices, the evolution of international oil prices might affect domestic prices both through production chains, such as the petrochemical, and through the potential effect over inflation expectations. Furthermore, measures to reduce liquidity in China may have an effect on commodity prices. It bears emphasizing that agricultural commodity prices, which have particularly important impact on the evolution of food costs, have presented some reduction since the previous Copom meeting. On the other hand, iron ore, an important input in the production chain of the industrial sector, has shown significant increase in price, although there was a reduction in May. Market players expect another price change in the contracts.

Assessment of inflation trends

14. The identified shocks and their impacts were reassessed according to newly available information. The scenario considered in the simulations was based on the following assumptions:

a) the projected adjustments for gasoline and bottle gas prices for 2010 were kept unchanged at 0%;

b) the projected adjustments for fixed telephone was kept at 1.6% for 2010, while the projections for electricity prices adjustments rose to 1.5% for 2010, up from 0.7% considered in the April meeting;

c) the projection for regulated prices inflation for 2010, based on individual items, was maintained at 3.6%, the same projection considered at the April meeting, according to the benchmark scenario. This set of prices, according to data released by IBGE, accounted for 29.27% of the total May IPCA;

d) the projection for regulated prices inflation for 2011 was maintained at 4.4%, on the benchmark scenario. Such projection is based on the endogenous determination model for regulated prices, which computes, among other factors, seasonal components, foreign exchange rate changes, market prices inflation and the IGP (General Price Index) change; and

e) the projection for the spreads over the Selic rate, based on the 360-day swap rates, on the benchmark scenario, estimates 86 bps and 25 bps spreads in the fourth quarters of 2010 and 2011, respectively.

15. Regarding fiscal policy, projections assume the achievement of a public sector primary surplus target of 3.3% of GDP in 2010. This percentage can be reduced by up to 1.12 p.p., due to the implementation of the projects linked to the Growth Acceleration Program (PAC), of which 0.44 p.p. refers to amounts to be paid from 2009. Moreover, it is expected that the primary surplus in 2011 would return, without

adjustments, to 3.3% of GDP. The additional assumptions considered in the previous meeting remained unchanged.

16. Since the last Copom meeting, the median of the expectations compiled by the BCB's Investor Relations Group (Gerin) for the 2010 IPCA increased from 5.41% to 5.64%. For 2011, the median of inflation expectations remained at 4.80%.

17. The benchmark scenario assumes the maintenance of the exchange rate at R$1.85/US$1.00 and the Selic rate at 9.50% p.a. during the forecast period. Under this scenario, the projection for the 2010 inflation increased relative to the figure considered at the April Copom meeting, and continues to be significantly above the 4.50% midpoint target established by the National Monetary Council (CMN). According to the market scenario – which incorporates the consensus exchange and Selic rates trajectories collected by Gerin on the eve of the Copom meeting – IPCA inflation forecast for 2010 also increased, standing significantly above the inflation midpoint target. For 2011, under the benchmark scenario, the projection decreased relative to the figure considered at the April Copom meeting, but remains significantly above the inflation midpoint target. Under the market scenario, the projection increased, and is positioned above the midpoint target.

Monetary policy decision

18. The Copom evaluates that the monetary policy should contribute to the consolidation of a favorable longer-term macroeconomic environment. In international markets, risk aversion has increased since the last Copom meeting, largely due to concerns about the sovereign debt of European countries. Although liquidity in international markets reduced, the prospects for external funding for the Brazilian economy remain favorable. In line with greater risk aversion and more scarce liquidity, the prices of some selected commodities and Brazilian assets decreased. On another front, the trajectory of price indices evidences inflationary pressures in relevant economies. In this context, the influence of the international scenario over the domestic inflation path is more ambiguous, although uncertainty persists about the behavior of asset prices and commodities in the context of the worsening international financial conditions. The Copom assesses that this scenario can deteriorate, depending on the dynamics that derives from the market distrust regarding the solvency of some European economies, but, on the other hand, recognizes that this is not the baseline scenario considered. Regardless of how these aspects of the international outlook evolve, the Copom reaffirms that the main challenge of monetary policy is to ensure that the favorable results obtained over the last years are preserved.

19. The Copom believes that the indicators released since the last meeting reinforce the perception about the existence of pressures over the market of factors, increasing the probability that initially localized inflationary episodes pose risks to the inflation trajectory. In this context, the risk of pass-through of upward costs pressures to wholesale price inflation, and from these to consumer price inflation, increases as well. The Committee states that the materialization of these pass-throughs, as well as the spread of initially localized pressures over consumer prices, continues to depend critically on the economic agents' expectations for inflation and on the idleness degree of the economy, among other factors. Therefore, these and other variables are part of the information set that is taken into account in the generation of inflation forecasts by the BCB, which constitute a key element in the Committee's assessment on the prospective inflation scenario. Additionally, it should be noted that the behavior of domestic demand has exerted some pressure over the prices of non-tradable items, such as services, which, considering the prospects for the evolution of the main factors sustaining aggregate demand, may continue. In any event, the Committee reaffirms the commitment that it will continue to conduct its actions in order to ensure that the gains obtained in inflation control in recent years become permanent.

20. The Copom considers important to emphasize, once more, that there are important time lags between the implementation of monetary policy and its effects on both economic activity and inflation. Therefore, the assessment of alternative options for monetary policy should necessarily focus on the forward-looking inflationary scenario and its risks, instead of current and past inflation figures.

The prospective scenario, indeed, suffered some deterioration earlier this year, a dynamic that has continued since the last meeting, in spite of seasonal and occasional contributions to the rise in consumer prices as well as of price movements of certain domestic assets.

21. Prospects for the evolution of domestic economic activity remain favorable, as evidenced by data on trade, manufacturing capacity utilization and the labor market. This assessment is also supported by signs of continued expansion of credit supply, both for individuals and corporate; by the fact that consumers and businessmen confidence stands at historically high levels; and by income growth. The dynamism of domestic activity should also be benefited, among other factors, by fiscal impulses, the policies of official banks and, to a lesser extent, the pace of recovery in global activity. Considering the Brazilian economy's new cycle of expansion, these considerations become even more relevant when one takes into account that there are lags between the implementation of monetary policy and its effects over the activity level and inflation.

22. The Copom believes that the risks to the consolidation of a benign inflationary scenario stem mainly from the domestic side, for example, those resulting from the expansion of domestic demand in the context of virtual exhaustion of the idleness margin in the use of production factors. Incidentally, evidences of narrowing of the market factors are the acceleration of real wage gains in the recent past in some segments and higher producer price pressures. Indeed, these developments may exacerbate an outlook that already evidences the presence of mismatch between the growth of domestic absorption and capacity of supply expansion.

23. International evidence, ratified by the Brazilian experience, indicates that high inflation rates lead to the increase of risk premium, both for private and public funding, and to the shortening of planning horizons, both for households and corporate. Consequently, high inflation rates reduce investment and the economic growth potential, in addition to presenting regressive effects on income distribution. Moreover, high inflation rates do not result in any lasting results for economic growth and employment level; on the contrary, they create permanent damage to these variables in the medium and long terms. Therefore, the Copom strategy aims to ensure the convergence of inflation towards the targets path in 2010 and in the next years, which requires that possible deviations from the target path be promptly corrected. Such strategy takes into account the time lags in the transmission mechanism and is the most adequate to deal with the uncertainty inherent to the process of monetary policy formulation and implementation.

24. The Committee believes that the economy is in a new expansion cycle, and this assessment is corroborated by data released since its last meeting, although uncertainty about the pace of this process – which should be resolved over time – still persists. Signs of overheat in the economy are evidenced, for example, in core inflation trajectories, in the behavior of inflation expectations, in the evidence of workers shortage and in the rising inputs costs. In particular, during this period, the inflation projections considered by the Committee showed slight deterioration in the prospective scenario. The Copom believes that this deterioration should be contained and, therefore, the signs of persistent mismatch between the pace of aggregate demand expansion and aggregate supply, which, ultimately, tend to increase the risk for inflation dynamics, must be reversed. In such circumstances, the monetary policy stance should be adjusted, on the one hand, because it contributes to the convergence between the pace of demand expansion and supply and, on the other hand, because it prevents that originally localized price pressures determine a persistent deterioration of the inflation prospective scenario.

25. In short, despite the withdrawal of substantial share of the stimuli introduced during the recent international financial crisis, since the last meeting the risks for the achievement of a benign inflationary scenario, in which inflation would remain consistent with the inflation targets remained elevated. On the other hand, it is worth noting that in that same period, external developments have introduced a certain amount of caution in the analysis of the prospective scenario. Anyway, the prevailing opinion among the Committee members was that monetary policy should be adjusted incisively in order to avoid that

the greater uncertainty detected in shorter horizons spread to longer horizons.

26. Under these considerations, continuing the adjustment process of monetary conditions to the prospective scenario of the economy, in order to ensure the convergence of inflation to the targets path, the Copom unanimously decided to increase the Selic rate to 10.25% p.a., without bias.

27. Under the inflation-targeting regime, the Copom guides its decisions according to projected inflation, the analysis of several alternative scenarios for the evolution of the main variables that determine the forward-looking dynamics for prices, and the balance of risks associated to the projections. Domestic demand appears robust, largely due to the effects of stimulus factors, such as income growth and credit resumption. Moreover, fiscal and credit incentives have been provided to the economy in recent quarters, and should contribute for the consolidation of activity expansion and, hence, for the reduction of any residual idleness margin of productive factors. The effects of these stimuli, however, counter the effects of the reversal of substantial share of the initiatives taken during the recent international financial crisis, and a possible deepening of the fiscal crisis that several European countries face. These elements are an important part of the context in which future monetary policy decisions will be taken, aiming to ensure a timely convergence of inflation to the targets path.

28. In addition, it bears noticing that there was consensus among the Committee members about the need to adapt the pace of adjustment of the basic interest rate to the developments in the prospective inflation scenario, as well as to the corresponding balance of risks, in order to limit the impacts caused by the behavior of current inflation over the underlying prices dynamics.

29. At the end of the meeting it was announced that the Committee will reconvene on July 20th, 2010 for technical presentations and, on the following day, to discuss the monetary policy decision, as established in Communiqué 18,927 of October 9th, 2009.

Summary of data analyzed by the Copom

Inflation

30. The IPCA increased 0.43% in May, compared to 0.57% in April, recording the lowest monthly growth since December 2009. The accumulated variation of the index reached 3.09% in the first five months of the year, compared to 2.20% in the same period of 2009, while, considering periods of twelve months, the index rose 5.22% in May, compared to 5.26 % in April.

31. The deceleration recorded in the monthly IPCA reflected the larger impact of the downturn, from 0.75% to 0.47%, observed in market prices, compared to that provided by the acceleration of 0.14% to 0.33% registered in the variation of regulated prices. The segmentation of IPCA shows that its monthly change in May resulted, in large part, from the increases observed in the groups housing (0.10 p.p.); personal expenses (0.08 pp); and health and personal care (0.08 p.p.). The diffusion index reached 60.94%, recording stability compared to April and standing above 60% since November 2009.

32. The variations of the three core measures accelerated, in May, month-on-month and year-over-year. The smoothed trimmed-means core monthly values increased 0.62% from 0.50% in April, accumulating, in order, 4.99% and 4.80% for a twelve-month trailing basis ending in May and in previous month. Core by exclusion, which excludes ten items of food and fuel varied 0.56% in May, up from 0.42% in April, totaling in twelve month increases of 4.93% and 4.91% respectively. The core of double weighting grew 0.56% in May, up from 0.42% in April, totaling 5.06% and 4.98% for on a twelve-month trailing basis ending in May and in the previous month.

33. The IGP-DI increased 1.57% in May, up from 0.72% in April, accumulating 5.12% in the year and 4.38% in twelve months. The Producer Price Index Broad (IPA) changed by 2.06% in May, reflecting the increases in agricultural products prices (0.19%) and industrial prices (2.66%), whereas, considered

the period of twelve months ended in May, rose 3.77%, reflecting respective increases of 4.79% and 0.71% observed in the prices of industrial goods and agricultural products. The IPC-Br showed deceleration of 0.76% in April to 0.21% in May, totaling 5.28% in twelve months. The INCC increased 1.81% in May, up from 0.84% in April, accumulating 6.07% in twelve months. The core IPC-Br, repeating the monthly evolution observed in April, rose 0.47% in May, totaling 4.16% in twelve months.

Economic activity

34. GDP grew 2.7% in the first quarter of 2010, compared to the previous quarter, up from the 2.3% increase registered in the last quarter of 2009 on the same basis of comparison, according to seasonally adjusted data from the Quarterly National Accounts of the IBGE. The result reflected respective expansions of 2.7%, 4.2% and 1.9% observed in agriculture, industry and service sectors. From the demand viewpoint, it can be emphasized the quarterly growth of 7.4% recorded in investment, while households and government consumptions have grown, in order, 1.5% and 0.9%, confirming the importance of domestic demand for the resumption of economic activity. Exports and imports increased, respectively, 1.7% and 13.1% in the quarter. Considered accumulated changes in four quarters, GDP grew 2.4% in the period, breaking a sequence of two negative results, in this type of comparison.

35. Expanded retail sales, after registering monthly growth of 1.7% in January and 2.2% in February, rose on the same basis of comparison, 5% in March, according to seasonally adjusted data by the IBGE’s monthly survey (PMC). There were increases in sales in seven of the ten sectors surveyed, with emphasis on vehicles, motorcycles, parts and pieces - influenced by the impact of the last month’s validity of the reduction of the Industrialized Product Tax (IPI) on the sector (10.3%), and office supplies and equipment (8.6%). Conversely, sales for the hypermarkets, supermarkets, food products, beverages and tobacco reported monthly decline of 0.8% in March. The average sales for the quarter ended in March rose 5.5% compared to the previous quarter.

36. Considered the observed data, March sales grew 22% year-over-year, accumulating increases of 15.5% in the year and 9.6% in the last twelve months. The year-over-year expansion was due to widespread increases in sales across all sectors addressed in the survey, with emphasis on equipment and office supplies, 35.4%; vehicles, motorcycles, parts and pieces (32.4%), and furniture and appliances (25.7%). Likewise, the accumulated growth in the quarter resulted from generalized sector increase in sales, emphasizing those registered in equipment and office supplies (29.9%); furniture and appliances (21.6%); and vehicles, motorcycles, parts and pieces (20.7%). The analysis of the evolution of retail trade in the periods of twelve months ending in March 2010 and March 2009 shows that only the sales of building materials fell (-1.5%), contrasting with the increases observed in vehicles, motorcycles, parts and parts (14.6%); equipment and office supplies (14%); pharmaceutical and medical articles (12.1%) and hypermarkets, supermarkets and food products (10.4%).

37. The number of consultations to the Central Credit Protection Service (SCPC) and to the Usecheque System registered declines of 2.1% and 0.4% in April, month-on-month, according to seasonally adjusted data from the Commercial Association of Sao Paulo (ACSP), covering the state capital. Considered the observed data, these indicators recorded respective increases of 7.7% and 6.6% in the first four months of the year relative to the same period of last year, and respective variations of -4% and 4,5% in the period of twelve months ended in April, year-over-year.

38. Automobile sales by dealers, including cars, light commercial vehicles, trucks and buses, declined 1.5% in May, month-on-month, according to Brazilian Federation of Automotive Vehicles Distribution (Fenabrave) data, seasonally adjusted by the BCB. In the month were recorded downturns in sales of buses (19.4%), and automobiles (4.1%), while those related to trucks and light commercial vehicles recorded respective increases of 4.1% and 4%. Total sales in May reported respective increases of 1.6%, 14.6% and 17.4% year-over-year, accumulated during the year and in the last twelve months ended in May.

39. Capital goods imports decreased 2.5% in April, month-on-month, according to the Funcex quantum index, seasonally adjusted by the BCB. Considering periods of twelve months, the indicator rose 7.9% in April, registering sharp deceleration compared to the results observed in March (17%) and February (25.7%). Also in April, imports of capital goods increased 13.8% in twelve months and fell 9.9% in the year, in relation to the same periods in 2009.

40. Capital goods production increased 2.4% in April, month-on-month, according to seasonally adjusted data from Monthly Industrial Survey (PIM) by IBGE, with emphasis on the expansions observed in the segments of capital goods for serial industrial use (6.2%), transport equipment (5.2%) and equipment for the electricity sector (3.2%). The remaining segments recorded decline in the month, emphasizing the agriculture pieces (15%), and capital goods for non-serial industrial use (7.3%). The production of capital goods increased 36.3% compared to April 2009, highlighting the increases in the segments of capital goods for construction (208.5%), agricultural goods (46.5%), and goods for serial industrial use (42.9%). The production of construction inputs recorded a drop of 0.1% month-on-month and a 18.2% year-over-year growth. The production of capital goods grew 28.7% in the first four months of 2010 compared to the same period in 2009, with emphasis on the 211.3% increase in the segment of goods for the construction sector.

41. Disbursements granted by the BNDES reached R$146.5 billion in the last twelve months ended in April, with a 58% increase over the same period of last year. In the first four months of the year, disbursements mentioned expanded by 34%, compared to same period in 2009, with emphasis on the infrastructure sector, which recorded a 39% share in the total released in this four months period, industry (30%), trade and services (21%) and agriculture (10%).

42. The industrial production declined 0.7% in April, month-on-month, according to seasonally adjusted data from the PIM, by IBGE. This movement is associated, in particular, to the 0.8% decrease observed in the industry of semi- and non-durable consumer goods, affected by the 10.9% decrease experienced by the beverage industry. The other categories of use reported favorable results in the month, with highlights for the performance of the industry of capital goods, quoted above. Industrial production increased 17.4% year-over-year, reflecting in particular the performance of the categories of capital goods (36.3%), durable consumer goods (20.9%) and intermediate goods (17.8%). On twelve-month periods, the industry showed a 2.3% expansion in April year-over-year, due to the increases of 8.8%, 2.2% and 2% observed, respectively, in the durable consumer goods industry, intermediate goods and semi- and non-durable goods, offset in part by the decrease of 3.7% recorded in the production of capital goods.

43. Real earnings in the manufacturing industry decreased 0.4% in April, month-on-month, while in March it increased by 2.8%, according to data released by the CNI, seasonally adjusted by the Economic Department of BCB (Depec). Hours worked and employment showed relative stability in the same period. Year-over-year, these indicators increased by 12.7%, 5.4% and 8.3%, respectively.

44. Still according to CNI, the Nuci reached 82.4% in April, 3.6 p.p. higher than the level observed in the same month of 2009. Considering the seasonally adjusted series, the April Nuci recorded a monthly increase of 0.5 p.p., while the average quarterly NUCI recorded a growth of 1 p.p. in the quarter ended in April compared to the quarter ended in January.

45. Vehicles production reached 309.6 thousand units in May, increasing by 0.5% month-on-month, according to data released by the Anfavea, seasonally adjusted by BCB. In the year and in the last twelve months through May, the production of vehicles increased 20.7% and 13.7%, respectively. The monthly decrease of 5.3% in May vehicles sales reflected the performance of domestic market sales, with a 13.4% decrease, and the 23.5% increase in exports. In the year and in the twelve months through May, domestic sales increased 7.4% and 14.2%, respectively, while exports expanded by 78.6% and 2.5%.

46. The LSPA survey carried out by the IBGE in May estimated the production of 145.8 million tons of grains in 2010, representing an 8.8% increase

relative to 2009. The increase projected for the year incorporates the estimated expansions for the production of soybeans (+19.6%), wheat (+3.8%) and corn (+3.7%), as opposed to the estimated retractions for rice (-10.8 %) and beans (- 5.5%).

Surveys and expectations

47. According to the Fecomercio-SP survey, the Consumer Confidence Index (ICC) increased 0.5% in May, after two consecutive months of decline, reaching 152.9 points. The monthly trajectory of the ICC in May reflected the larger impact of the 4.3% increase observed in the Current Economic Conditions Index (Icea), relative to the shrinkage of 1.8% recorded in the Consumer Expectations Index (IEC). Year-over-year, the ICC increased 21.6%.

48. According to the Consumer Expectations Survey carried out by the FGV nationwide, the ICC increased 0.6% in May, month-on-month seasonally adjusted, reaching 116.1 points. In the month, the Current Situation Index (ISA) increased 2.9 points, to 128.4 points, while the Expectations Index (IE) decreased 0.4 points to 109.6 points. Year-over-year, the ICC increased 12.9%, reflecting increases of 26.4% in the ISA and 5.8% in the IE.

49. The Industry Confidence Index (ICI) from FGV reached 116.1 points in May, standing 0.7% above the level observed in April, third highest result of the series according to seasonally adjusted data and 33.5% higher than the level observed in May 2009. Considering the components, the ISA decreased 0.7%, and the IE increased 2.3%, seasonally adjusted. Year-over-year, the same indicators expanded by 34% and 33.1%, respectively. According to the same survey, the seasonally adjusted Nuci reached 84.9% in May, a level 0.2 p.p. lower than in April and 1.1 p.p. higher than in January.

Labor market

50. According to the General Record of Employment and Unemployment (Caged) of the Ministry of Labor and Employment (MTE), 305.1 thousand formal jobs were created in April, totaling 962.3 thousand formal jobs in the first four months of 2010, the most expressive result for the period since the series began in January 1985. For the year through April, net generation of formal employment registered record highs for all segments of the economy, reaching 346.5 thousand jobs in the service sector, 287.4 thousand in the manufacturing industry, 166.1 thousand in civil construction and 74 thousand in commerce. The monthly analysis shows that the service sector recorded the creation of 96.6 thousand jobs in April, followed by the manufacturing industry, 83.1 thousand; and civil construction, 38.4 thousand. Additionally, 1,909 thousand jobs were created during the twelve months ended in April, 2.7% higher than the results reported in the same period of 2009.

51. According to the IBGE employment survey (PME), carried out in the six main metropolitan regions of the country, the unemployment rate reached 7.3% in April, declining 0.3 p.p. month-on-month and 1.6 p.p. year-over-year. The monthly decrease in unemployment reflected the 0.4% increase in the occupation and a 0.2% expansion in the Economically Active Population (PEA), while the annual decline was due to respective increases of 3.4% and 2% in the mentioned variables. In seasonally adjusted terms, the unemployment rate fell by 0.2 p.p. in the month and reached 6.8%, representing the fourth consecutive monthly decline and the lowest percentage for the series. According to the same survey, average real earnings usually earned by workers increased 0.1% month-on-month and 2.3% in twelve months. Payroll grew 0.4% month-on-month and 6.7% in twelve months.

Credit and delinquency rates

52. Outstanding credit in the financial system reached R$1,468 billion in April, equivalent to 45.2% of GDP, with increases of 1.1% in the month and 17.6% in the last twelve months. Non-earmarked credit operations increased 0.9% in the month and 11.7% in the last twelve months. Among the non-earmarked operations, credit operations to individuals increased 1.2% in the month and 18.2% in twelve months, while non-earmarked credit operations to corporate increased 0.6% and 5.8%, according to the same comparison bases. Earmarked credit operations increased 1.6% in April, month-on-month, and 31.6% in twelve months, with highlights for the respective expansions of 3.2% and 50.5% recorded in housing finance.

53. The average interest rate on non-earmarked credit operations, used as reference for interest rates, increased 0.1 p.p. in April, month-on-month, reaching 34.3%. The average annual rate on credit for individuals reached 41.1% in the month, 0.1 p.p. below that recorded in March, and the average rate on corporate credit reached 26.3%, showing stability relative the level registered in the previous month.

54. The average tenure on non-earmarked credit operations, used as reference for interest rates, increased in April, reaching 404 days, up from 399 days in March. The average tenure of corporate credit operations reached 287 days, one day up from the average observed in March, while the average tenure for credit operations to individuals totaled 538 days, seven days more than in the previous month.

55. Delinquency rates in the financial system (non-earmarked loans used as reference for interest rates, in arrears for more than ninety days) reduced from 5.1% in March to 5% in April. Delinquency rates for credit operations with corporate remained stable, at 3.6%, while declined from 7% in March to 6.8% in April with individuals.

External environment

56. Since the last Copom meeting, strains in international financial markets amounted. Apparently the adoption of a broad set of measures to restore financial stability in Europe was not sufficient to calm market participants. Risk aversion has increased, rates of stock exchanges in several countries retreated and the euro reached the lowest value against the US dollar in the last four years. In contrast, the movement of investment in assets perceived as less risky reduced the government securities yields of major mature economies.

57. Available data suggest the continuing process of global economic expansion, driven primarily by the US, Asia and Latin America, however, in an environment of high uncertainty. Among the G3 countries, the US and Japan reported annualized quarterly growth rates of, respectively, 3% and 4.9% in the 1Q 2010, while the euro area grew 0.8%. In the US, the most recent indicators for retail sales, industrial production and the net creation of jobs remained pointing to a positive performance. In the euro area, domestic consumption remains fragile, and the expansion of economic activity over the first quarter was due to the positive contribution of inventories. In China, although the Purchasing Managers Index (PMI) for Manufacturing activity in May has indicated deceleration, the main economic indicators continue to point the maintenance of high economic growth in the country.

58. Inflation remains at modest levels in the US and in the Euro Area – the consumer price index (CPI) annual changes in April reached 2.2% in the US and 1.5% in the Euro Area. In Japan, the CPI remains in deflation for fifteen months, having recorded, in April, annual change of -1.2%. In this context, the central banks of G3 retained the accommodative monetary policies stance. The persistence of high unemployment and idle production factors in conjunction with anchored inflation expectations should help to maintain this accommodative stance for a longer period of time than had been anticipated. Among expansionary emerging economies, the price pressures have already appeared: the CPI annual changes recorded in April 2.8%, 4.3% and 10.2%, respectively, in China, Mexico and Turkey. Like China, India and Malaysia (Asia), and Brazil and Peru (Latin America), the monetary authorities in emerging economies should change, even in 2010, the stance of their monetary policies.

Foreign trade and international reserves

59. The Brazilian trade surplus reached US$3.4 billion in May, a monthly record high since June 2009 accumulating US$5.6 billion in the year through May. It should be noted that this performance, 39.6% lower than that reported in the same period of last year, seems consistent with the process of recovery of strong activity observed in the Brazilian economy. In the month, exports totaled US$17.7 billion, and imports, US$14.3 billion, growing by 47.7% and 52.3%, respectively, year-over-year. In the year through May, exports and imports grew, respectively, 29.9% and 44% relative to the same period of 2009.

60. Based both on the liquidity concept and on the cash concept, international reserves

reached US$249.8 billion in May, recording respectively US$10.8 billion and US$11.3 growths month-on-month. The two concepts were equal due to the full payment of borrowing operations in foreign currencies in May. In 2010 through May, the monetary authority's interventions accounted for net purchases of US$12.1 billion in the domestic market.

Money market and open market operations

61. Since the April Copom meeting, the slope of the domestic yield curve has decreased throughout its length. The short-term rates increased influenced by the disclosure of activity data suggesting consistent recovery of the Brazilian economy and expectations of inflation above the targeted path. The resume of crisis in Europe and greater pessimism about the recovery of the global economy, moreover, were key drivers in the decline of long rates. Between April 26th and June 7th, one- three- six-month and one-year rates increased by 0.82 p.p., 0.70 p.p., 0.40 p.p. and 0.05 p.p., respectively. The two- and three-year rates decreased by 0.40 p.p. and 0.66 p.p., respectively. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month-ahead inflation expectations, increased from 6.36% on April 26th to 6.46% on June 7th.

62. In its open market operations, the BCB carried out, between April 27th and June 7th, repo operations borrowing R$21.4 billion for a six-month period. As a consequence, the average daily balance of the long operations reached R$92.9 billion. In the same period, the BCB also borrowed money through repo operations with tenures between 12 and 29 working days, resulting in the average daily balance of short-term borrowing operations of US$183.6 billion. The BCB also borrowed money through 28 overnight repo operations and conducted daily one- and two-working-day tenure liquidity management operations. The very short-term operations, including the one- and two-working-day tenure liquidity management operations, averaged a daily balance of R$64.1 billion in the period, borrowing. The average daily balance of the total stock of repurchase agreement of the Central Bank decreased from US$406.7 billion, between March 16th and April 26th to US$340.6 billion between April 27th and June 7th. Considering the daily balance of operations for the most recent period, there was an increase in the repurchase agreements totaling R$26.1 billion, with a increase in total stock from R$334.1 billion on April 26th to R$360.1 billion on June 7th. The net redemption of securities by the National Treasury was the main driver of liquidity expansion in the period.

63. Between April 27th and June 7th, the National Treasury issuance regarding the traditional auctions raised a total of R$27.7 billion. The issuance of fixed-rate securities reached R$19.5 billion, with R$16.6 billion via issuance of LTNs maturing in 2010, 2011 and 2012, and R$2.9 billion via NTN-Fs maturing in 2014 and 2021. Issuance of LFTs totaled R$5 billion, for securities maturing in 2014 and 2016. Issuance of inflation-linked NTN-Bs reached R$3.2 billion, for securities maturing in 2013, 2015, 2020, 2030, 2040 and 2050.

Appendix

Banco Central do Brasil Management

Members of the Monetary Policy Committee (Copom)

Banco Central do Brasil Management

Board

Henrique de Campos Meirelles
Governor

Aldo Luiz Mendes
Deputy Governor

Alexandre Antonio Tombini
Deputy Governor

Alvir Alberto Hoffmann
Deputy Governor

Anthero de Moraes Meirelles
Deputy Governor

Antonio Gustavo Matos do Vale
Deputy Governor

Carlos Hamilton Vasconcelos Araújo
Deputy Governor

Luiz Awazu Pereira da Silva
Deputy Governor

Members of the Monetary Policy Committee (Copom)

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Alvir Alberto Hoffmann
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Anthero de Moraes Meirelles
Deputy Governor

Antonio Gustavo Matos do Vale
Deputy Governor

Carlos Hamilton Vasconcelos Araújo
Deputy Governor

Luiz Awazu Pereira da Silva
Deputy Governor

Non-voting members

Altamir Lopes
Head of the Departament of Economics (Depec)

Adriana Soares Sales
Head of the Research Departament (Depep)

João Henrique de Paula Freitas Simão
Head of the Departament of Open Market Operations (Demab)

José Antônio Marciano
Head of the Departament of Banking Operations and Payments System (Deban)

Márcio Barreira de Ayrosa Moreira
Head of the Departament of International Reserve Operations (Depin)

Renato Jansson Rosek
Head of the Investor Relations Group (Gerin)

Acronyms

Abras	Brazilian Association of Supermarkets
ACC	Advance on Exchange Contracts
ACSP	São Paulo Trade Association
Anfavea	National Association of Automotive Vehicle Manufacturers
b.p.	Basis points
BM&FBOVESPA	Securities, Commodities and Futures Exchange
BNDES	Brazilian Development Bank
BNDESpar	BNDES Participações S.A.
BoE	Bank of England
BoJ	Bank of Japan
BP	Social security benefits
BPS	Social Protection Benefits
Caged	General File of Employed and Unemployed Persons
CBT	Chicago Board of Trade
CCI	Consumer Confidence Index
CDS	Credit default swap
Cide	Contribution on Intervention in the Economic Domain
CMN	National Monetary Council
CNI	National Confederation of Industry
Copom	Monetary Policy Committee
CP	Social security contributions
CRB	Commodity Research Bureau
CSI	Current Situation Index
CVM	Securities and Exchange Commission
DAX	Deutscher Aktienindex
DOE	U.S. Department of Energy
ECB	European Central Bank
EI	Expectations Index
Embi+	Emerging Markets Bond Index Plus
EU	European Union
FDI	Foreign Direct Investments
Fecomercio SP	Trade Federation of the State of São Paulo
Fecomércio-RJ	Trade Federation of the State of Rio de Janeiro
Fed	Federal Reserve
Fenabrave	National Federation of Automotive Vehicle Distribution
FGTS	Employment Compensation Fund
FGV	Getulio Vargas Foundation
Finame	Special Industrial Financing Agency
FTSE 100	Financial Times Securities Exchange Index

Funcex	Foreign Trade Studies Center Foundation
Fundeb	Fund for Maintenance and Development of Basic Education and Enhancement of Education Professionals
GDP	Gross Domestic Product
Gerin	Investor Relations and Special Studies Department
GFCF	Gross Fixed Capital Formation
GGGD	Gross General Government Debt
GSCI	Goldman Sachs Commodity Index
HSBC	HSBC Bank Brasil
IBC-Br	Central Bank Index of Economic Activity – Brazil
IBGE	Brazilian Institute of Geography and Statistics
Ibovespa	São Paulo Stock Exchange Index/ Bovespa Index
ICE	New York Intercontinental Exchange
Icea	Current Economic Conditions Index
Icei	Industrial Business Confidence Index
ICI	Industrial Confidence Index
ICMS	Tax on the Circulation of Merchandises and Services
ICS	Services Confidence Index
ID	Interbank Deposit
IEC	Consumer Expectations Index
IGP	General Price Index
IGP-DI	General Price Index - Domestic Supply
IGP-M	General Price Index – Market
IMF	International Monetary Fund
INC	National Confidence Index
INCC	National Cost of Construction Index
INCC-DI	National Cost of Construction Index – Domestic Supply
IPA-DI	Producer Price Index – Domestic Supply
IPC	Consumer Price Index
IPCA	Extended National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPVA	Tax on Automotive Vehicle Proprietorship
IR	Income Tax
Kospi	Korea Composite Stock Price Index
LME	London Metal Exchange
LSPA	Systematic Farm Production Survey
LTN	National Treasury Bills
Mercosur	Southern Common Market
MPOG	Ministry of Planning, Budget and Management
MRB	Gross overall labor earnings
MRD	Disposable overall labor earnings
MSA	Overall Earnings
MSAD	Available Expanded Payroll
MTE	Ministry of Labor and Employment
N	Working Population in the Country
NCEA	National Classification of Economic Activities
Nuci	Installed Capacity Utilization Level
p.p.	Percentage points
p.y.	Per year
PAC	Growth Incentive Program

PAF	Annual Financing Plan
PAS	Annual Survey of Services
PBC	People's Bank of China
PEA	Overall Labor Force
Pimes	Monthly Industrial Survey – Employment and Wages
PIM-PF	Monthly Industrial Survey – Physical Production
PMC	Monthly Retail Trade Survey
PME	Monthly Employment Survey
PMI	Purchasing Managers Index
PNAD	Household Sampling National Survey
PPI	Broad Producer Price Index
PSND	Public Sector Net Debt
Rais	Annual Social Information Listing
RGPS	General Social Security System
RMB	Average gross income
RPSP	Civil Servant Social Security System
S&P 500	Standard and Poor's 500
Selic	Special System of Clearance and Custody
Sensex	Bombay Stock Exchange Sensitive Index
SIT	Manufacturing Industry Survey
TJLP	Long-Term Interest Rate
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
VAR	Autoregressive Vector
VIX	Chicago Board Options Exchange Volatility Index
WTI	West Texas Intermediate