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Inflation Report

December 2010

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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 ou **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 emerging economies remain in the front line of the world economic recovery. For the most part, this lead has been sustained by domestic demand and, in some cases, by the exporting sector. The activity level continues expanding in the United States and Europe, albeit at a more moderate pace than previously anticipated. In the developed economies, in which there are significant idle production factors and the unemployment rates remain high, this process tends to show distinctive features in comparison to those prevailing in the emerging economies. In the latter case, these economies are generally enjoying a new expansion cycle, which affects the inflation dynamics, reinforced by the recent increases in commodity prices, particularly farm commodities.

In Brazil, the credit market continues to positively contribute to the expansion of investments and consumption, especially in the modality of earmarked credit. In fact, it should be highlighted the important role played by the Brazilian Development Bank (BNDES) as a supplier of resources for infrastructural projects and for the acquisition of machines and equipments for small and medium-sized companies, and the fast pace of expansion observed for housing credit operations. Also, credit operations with non-earmarked resources still show a sound performance in household operations, particularly in the case of payroll-deducted loans and auto loans.

In this scenario, the National Monetary Council (CMN) and the Central Bank have adopted macroprudential measures that consisted in increasing the reserve requirements and discouraging those operations which might jeopardize the financial household balance or the balance between the volumes contracted and collateral values.

The Gross Domestic Product (GDP) growth registered in the third quarter of the year and the recent outcome of the industrial activity have corroborated the Central Bank assessment – released in the last *Inflation Report* – that growth rates are edging closer to levels more consistent with long-term growth.

Insofar as demand is concerned, retail sales have maintained the pace of growth, boosted by consumer confidence, a positive performance of the job market and expanded credit operations. Foreign trade has also expanded, thus adjusting to the differential between growth rates of domestic supply and demand. It should also be highlighted that investments continue to show significant growth rates.

The difference between the pace of growth of the Brazilian economy and its major commercial partners is reflected in the performance of the country's current account, which registered a US$38.8 billion deficit in the first ten months of the year, as compared to US$15.1 billion in the same period of 2009. In 2011, this trend is expected to decelerate, in line with more modest projections for the GDP growth rate. Viewed on a different perspective, the current account dynamics reflects the expansion of net expenses on services and on profits and dividends. In 2011, the current account deficit tends to be financed by the expansion of net inflows of Foreign Direct investments (FDI) and the roll-over of public and private foreign liabilities, though at lower rates in comparison to 2010.

With regard to inflation trend, the acceleration observed in the 3-month period ended in November was influenced both by seasonal internal factors – related to food supply – and the external outlook of rising prices observed for major commodities. It should also be taken into consideration, among other factors, the persistent imbalance between demand and supply growth rates.

Regarding inflation forecasts, following the usual procedures, and taking into account the information set available up to the cutoff date of December 10, 2010, the Monetary Policy Committee (Copom)'s central forecast associated with the baseline scenario, which assumes a constant exchange rate over the forecast horizon at R$1.70/US$, and the target for the basic interest rate (the Selic rate) at 10.75% p.a. – the level set by the Copom meeting of December 7 and 8, 2010, shows inflation of 5.9% in 2010. Under this scenario, twelve-month inflation projection stays above the midpoint of the target until the end of 2011, ending the year at 5.0%, and hovers around the target in the following quarters, reaching 4.8% in the last quarter of 2012.

The market scenario, which is based on data from the expectations survey undertaken by the Central Bank's Investor Relations Group (Gerin) with a significant group of institutions, the inflation projection for 2010 is 5.9%, equal to the projection of the baseline scenario. In this case, twelve-month inflation projections, following a similar pattern of the baseline scenario, hover above the midpoint of the target until the end of 2011, reaching 4.8%, but decrease along 2012, ending the year at 4.5%.

The Committee assesses that the balance of risks associated with the inflation outlook has evolved unfavorably since the release of last *Report*. Under the baseline scenario, as well as under the market scenario, the projections have already incorporated the estimated impact of the recently announced increase in the reserve requirements and the primary surplus effort. Nevertheless, in both cases, the projected values stand above the midpoint target of 4.5% established by the National Monetary Council (CMN) for inflation in 2011. It is worth noting that, under the inflation targeting regime, deviations in projected inflation from the target of such magnitude suggest the need for implementation, in the short-run, of an adjustment in the basic interest rate, in order to control the growth pace mismatch between the domestic demand and the productive capacity of the Brazilian economy, as well as to reinforce the anchorage of inflation expectations.

According to the baseline scenario, GDP growth projected for 2010 should reach 7.3%; the same projection presented in the September 2010 *Inflation Report*. This projection partially reflects a carry-over statistical effect due to the growth rates observed along the second semester of 2009. The Copom assesses that Brazilian economy has been changed towards a GDP growth rate which is consistent with its long-run equilibrium and, therefore, projects a growth rate for 2011 of 4.5%.

Economic activity

1

Table 1.1 – Sales volume index

	2010			% change
	Jul	Aug	Sep	Oct
In the month[1/]				
Retail sector	0.9	1.7	0.3	0.4
Fuel and lubricants	0.0	1.5	1.0	-0.2
Supermarkets	0.1	1.2	-0.1	-0.2
Fabrics, apparel and footwear	1.0	2.1	0.1	1.4
Furniture and home appliances	-0.2	3.4	1.5	2.3
Pharmac., medical, orthop. and perfumery articles	2.6	2.6	-0.4	1.7
Books, newspaper, magazines,	4.3	3.8	-0.4	4.7
Office, comp./comunic. equip.	-4.6	1.8	8.0	-10.0
Other art. of personal use	1.1	0.2	2.6	-2.0
Broad trade sector	2.0	2.4	0.2	2.1
Building materials	1.1	1.8	-0.4	0.0
Automobiles, motorcycles, parts and spares	3.8	3.9	1.5	6.8
3-Month Period/Previous 3-Month Period[1/]				
Retail sector	1.1	2.3	3.4	3.0
Fuel and lubricants	1.0	0.2	1.2	1.7
Supermarkets	1.3	2.4	2.2	1.6
Fabrics, apparel and footwear	-0.1	1.1	2.1	3.8
Furniture and home appliances	-0.1	1.3	2.8	5.2
Pharmac., medical, orthop. and perfumery articles	0.7	2.0	3.8	4.3
Books, newspaper, magazines,	1.9	3.2	6.0	7.4
Office, comp./comunic. equip.	2.4	1.1	2.3	1.9
Other art. of personal use	4.1	6.1	5.3	3.9
Broad trade sector	-1.4	0.4	4.6	4.9
Building materials	1.8	1.0	1.9	1.8
Automobiles, motorcycles, parts and spares	-6.2	-2.6	7.8	10.2
In the year				
Retail sector	11.4	11.3	11.4	11.1
Fuel and lubricants	5.9	6.3	6.8	6.6
Supermarkets	10.5	10.1	10.0	9.6
Fabrics, apparel and footwear	10.5	10.9	11.1	10.9
Furniture and home appliances	19.3	18.9	18.4	18.1
Pharmac., medical, orthop. and perfumery articles	11.6	11.7	11.7	11.5
Books, newspaper, magazines,	8.0	8.6	8.8	9.4
Office, comp./comunic. equip.	24.8	24.8	25.8	24.4
Other art. of personal use	7.0	7.6	8.5	8.7
Broad trade sector	11.9	12.2	11.4	11.4
Building materials	15.8	16.4	16.5	15.6
Automobiles, motorcycles, parts and spares	12.1	13.1	10.7	11.3

Source: IBGE

1/ Seasonally adjusted data.

GDP growth in the third quarter and recent results from industrial activity confirm the assessment of the Central Bank, expressed in the last Inflation Report, that growth rates are moving to levels considered to be sustainable. It is noteworthy that, while remaining at a high level, as of April these indicators began to show less pronounced positive interannual variations and relative stability when considering the margin analysis.

There can be seen, however, continuity in the pace of growth of trade sales, driven by the level of consumer confidence, the performance of the labor market and the expansion of credit, emphasizing the importance of foreign trade as an adjustment mechanism between aggregated supply and demand. Moreover in the domestic arena, it is worth mentioning that investment spending continues to show robust growth rates.

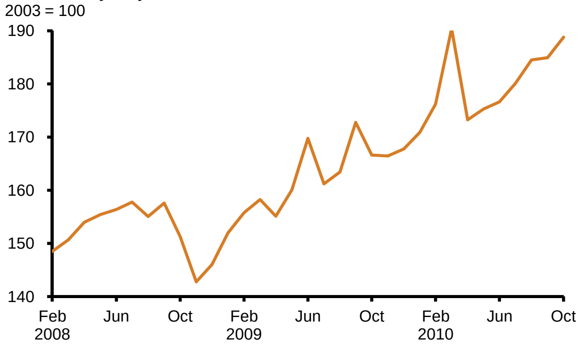
1.1 Retail sales

Expanded trade sales grew 4.9% in the quarter ending October, in relation to that ending July, when they had fallen 1.4%, in this comparison measure, based on seasonally adjusted data from the Monthly Retail Trade Survey (PMC), published by the Brazilian Institute of Geography and Statistics (IBGE). There were increases in sales in all ten sectors surveyed, with emphasis on those relating to vehicles, motorcycles, parts and accessories, 10.2%; books, newspapers, magazines and stationery, 7.4%; and furniture and domestic electrical appliances, 5.2%.

Sales in retail trade, a concept that does not include the segments of vehicles, motorcycles, parts and accessories, or building materials, increased by 3% in the quarter, registering positive results in all regions of the country, highlighting the expansion of 5.4% observed in the North.

Figure 1.1 – Extended retail sales

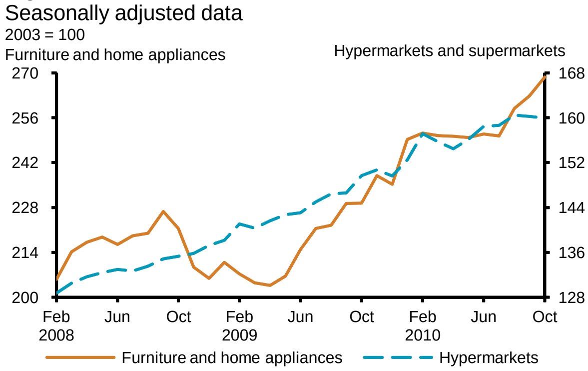
Seasonally adjusted data



Source: IBGE

Figure 1.2 – Retail sales

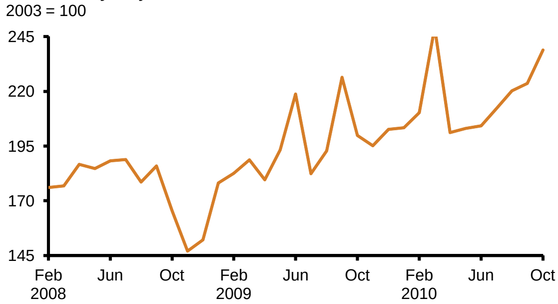
Seasonally adjusted data



Source: IBGE

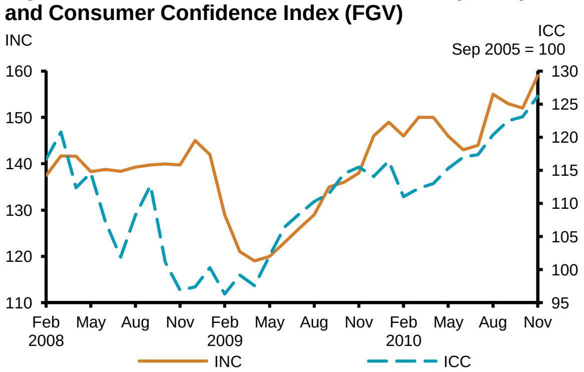
Figure 1.3 – Sales volume index (automobiles, motorcycles, parts and spares)

Seasonally adjusted data



Source: IBGE

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



Sources: ACSP and FGV

More recent statistics suggest a continued expansion in sales in the close of this year. Thus, considering seasonally adjusted data, real sales of the supermarket sector, a segment which accounts for approximately 32% of the IBGE's PMC, grew 1.7% in the 3-month period ending in October, compared to that ending in July, according to the Brazilian Association of Supermarkets (Abras). Additionally, the Sears Experian Index of Trade Activity, with national coverage, constructed from monthly research conducted by businesses, grew 1.6% on the same comparison base, while sales of cars and light commercial vehicles, announced by the National Federation of Automotive Vehicle Distribution (Fenabrave) increased by 8.8% in the 3-month period ending in November, compared to that ending in August.

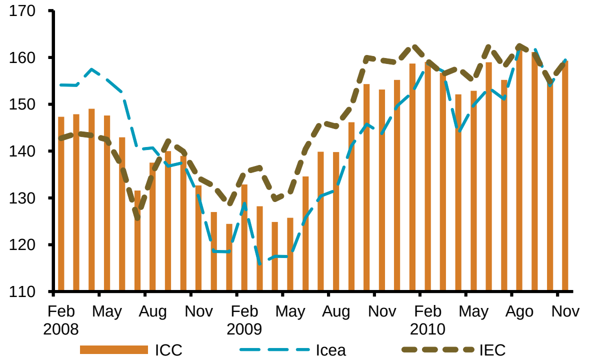
The comparison ratio between the number of checks returned for insufficient funds and the total number of checks cleared measured 5.6% in October, the same percentage as July, up 6.4% on the same period in 2009. In the same vein, default in the state of São Paulo, measured by the São Paulo Trade Association (ACSP), and stood at 4.2% in November from 5.8% in August and 4.2% in the same month of 2009.

The Serasa Experian Consumer Default Indicator, which includes negative entries concerning the financial enterprises, credit cards, non-financial companies, banks, protested securities, the second return of checks refused for insufficient funds, in October recorded increases of 1.8% over the previous month and 16.9% in 12 months. These were fundamentally due to the continuing delays registered in the context of financial enterprises, credit cards and non-financial companies, which comprise 36% of the overall indicator. Thus, as in previous months, the other components of the indicator reported falls in the two comparison bases mentioned.

The main indicators designed to assess consumer expectations remained at a high level. Considering seasonally adjusted data, the Consumer Confidence Index (CCI) of the Getulio Vargas Foundation (FGV), registered a monthly increase of 2.7% in November, the ninth consecutive positive result in this comparison measure, reaching 125.4 points, the highest value in the historical series started in September 2005. The Current Situation Index (CSI) component rose 4.5% in the period, registering a record 147.5 points, while the Expectations Index (EI) rose 1.5% to 113.6 points, a level 5.3 points below the series record in December 2007.

The National Confidence Index (INC), calculated by Ipsos Public Affairs for the ACSP, measured 159 points in

Figure 1.5 – Consumer Confidence Index



Source: Fecomercio SP

Table 1.2 – Industrial production

3-Month Period/Previous 3-Month Period[1/]

%

	2010			
	Jul	Aug	Sep	Oct
Industry	-0.3	-1.3	-0.4	0.0
By section				
Mining	1.0	1.1	2.4	3.0
Manufacturing	-0.7	-1.8	-0.9	-0.7
By category of use				
Capital goods	1.5	-1.2	-2.2	-2.4
Intermediate goods	0.6	-0.5	-0.7	-1.3
Consumer goods	-1.4	-2.0	-0.4	0.2
Durables	-2.0	-2.8	-1.6	-0.2
Semi and nondurables	-1.7	-1.8	-0.5	0.1

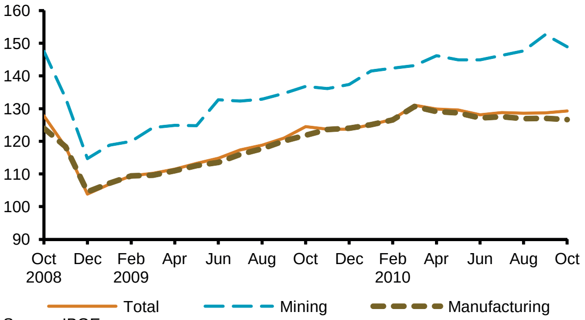
Source: IBGE

1/ Seasonally adjusted data.

Figure 1.6 – Industrial production[1/]

Total and sections

Average(2002)=100



Source: IBGE

1/ Seasonally adjusted data.

November, a record for the series which started in April 2005, marking growth of 4.6% in the month and 15.2% in twelve months. The monthly result showed increases recorded in the South region, 21.3%, and Southeast region, 6.2%, and falls seen in the North/Central-West region, 8.2%, and the Northeast region, 4.6%.

The National Consumer Expectations Index (Inec), released monthly from March 2010 by the National Confederation of Industry (CNI), reached 119.1 points in November, falling 1.3% compared to October, with emphasis on falloffs registered in consumer expectations regarding inflation and unemployment. It is noteworthy that all components of INEC are at historically high levels.

The ICC, published by the Trade Federation of the State of São Paulo (Fecomercio SP) and restricted to the municipality of São Paulo, reached 159.3 points in November, rising 3.1% in the month and 4% in twelve months. The Current Economic Conditions Index (Icea) reached 159.5 points and the Consumer Expectations Index (IEC), 159.2 points. The Consumer Expectation Index (IEC) calculated by Fecomercio RJ for the region of Metropolitan Rio de Janeiro, reached a record 124.8 points in October, rising 0.6% over the previous month, the fifth consecutive rise in this comparison base, and 3.2% in twelve months.

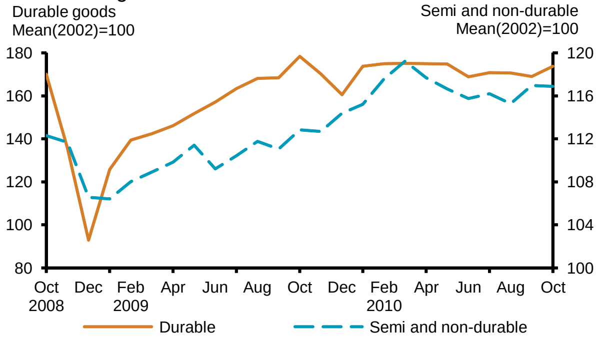
Another indicator calculated by Fecomercio RJ, the ICC, through research conducted in the State of Rio de Janeiro with approximately 2,450 traders spread over twenty-six sectors, noted, like the consumer targeted research, high optimism among traders in Rio state. Accordingly, in October, the ICC reached the record of the series initiated in July 2003, marking growth of 4.2% over the previous month and of 1% in twelve months.

1.2 Output

Industrial output

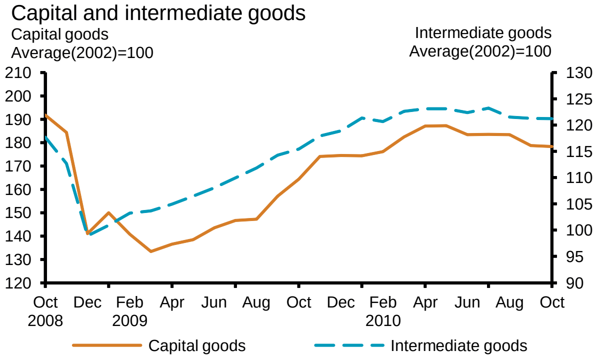
Physical production of industry was stable in the quarter ending October, in relation to that completed in July, when it had fallen 0.3% in the same comparison base, according to seasonally adjusted data from the Monthly Industrial Survey – Physical Production (PIM-PF) of the IBGE. Mining grew by 3% and manufacturing fell by 0.7%, registering significant quarterly declines in the segments of electronic materials and equipment for communications, 14.5%; machinery, appliances and electrical equipment, 6.5%; and

Figure 1.7 – Industrial production[1/]
Consumer goods



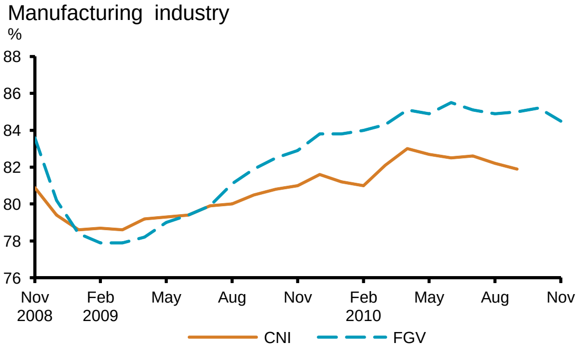
Source: IBGE

Figure 1.8 – Industrial production[1/]
Capital and intermediate goods



Source: IBGE

Figure 1.9 – Capacity utilization[1/]
Manufacturing industry



Sources: CNI and FGV
1/ Seasonally adjusted series.

basic metallurgy, 6.1% and sharp increases in the industries of publishing, printing and reproducing, 8%; and equipment for medical hospital instrumentation, 6.5%.

Analysis by use categories shows that the production of capital goods, impacted by reductions in the sectors of capital goods for mixed use, 6.9% and of serial industrial purposes, 1.9%, registered a quarterly decline of 2.4%. In the same period, the industries of intermediate goods, consumer durables, and semi- and non-durable consumer goods experienced respective variations of -1.3%, -0.2% and 0.1%.

The index of salaried employed persons, seasonally adjusted data drawn from the Monthly Industrial Survey – Employment and Wages (Pimes) of IBGE, grew 0.4% in the quarter ending October, compared to that ending July, when it had grown 1.4% in the same comparison base. The combination of this result with the stability of physical production resulted in a reduction of 0.4% in the productivity of the industrial worker.

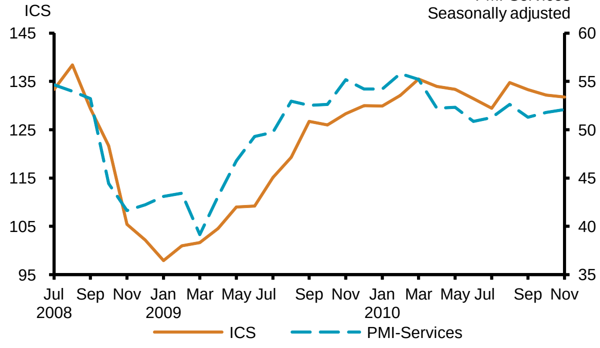
The manufacturing industry Nuci reached 84.5% in November, dropping 0.7 p.p. in the month, according to seasonally adjusted data from the Manufacturing Industry Survey (SIT) of FGV. Based on quarterly averages, the index reached 84.9% in November, from 84.6% in August, registering a reduction of 1.3 p.p. in the construction materials industry and increases in those relating to capital goods, 0.9 p.p.; consumer goods, 0.5 p.p. and intermediate goods, 0.1 p.p.

The Industrial Confidence Index[1] (ICI), based on seasonally adjusted data from FGV, reached 112.7 points in November, the lowest level of the last twelve months, dropping 0.2 points compared to August. Although all components of the indicator are at optimistic levels, the period registered significant decreases in the assessment of the current business situation, 5.3 points, and for the next six months, 6 points. The most significant quarterly improvement was reported in the assessment of expectations of physical production, 6.2 points. The Purchasing Managers Index[2] (PMI), considered the seasonally adjusted series calculated by Markit, reached 49.9 points in November.

1/ Values above 100 points indicate a sense of optimism.

2/ The PMI summarizes the monthly change in the indicators for new orders, production, employment, delivery time and supply of raw materials. Values above 50 represent a monthly growth in activity.

Figure 1.10 – Service Confidence Index
ICS and PMI-Services



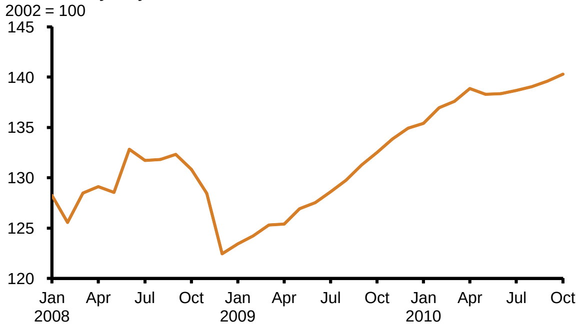
Sources: FGV and HSBC/Markit

Services

Business confidence in the service sector remains at a high level, expressed by the development of the Services Confidence Index (ICS), which reached 132.2 points in October against 133.3 points in September and 126 points in the same month of 2009. The monthly development of the ICS reflected a 3.7% increase recorded in the ISA-S and the 4.6% decline experienced by the IE-S component, while the 4.9% growth recorded in the twelve months resulted from the increase of 13.3% in the ISA-S and the decrease of 1.6% in IE-S.

The PMI-Services[3] calculated by Markit and published by HSBC Bank Brazil (HSBC), reached 52.1 points in November, from 51.8 points in October and 51.3 points in September, based on seasonally adjusted data. The indicator, without seasonal adjustment, measured 52.7 points in November from 56.5 points in November 2009 and indicates high activity in the sector, but at slower rate than in the same period of the previous year.

Figure 1.11 – Central Bank Index of Economic Activity – Brazil
Seasonally adjusted data

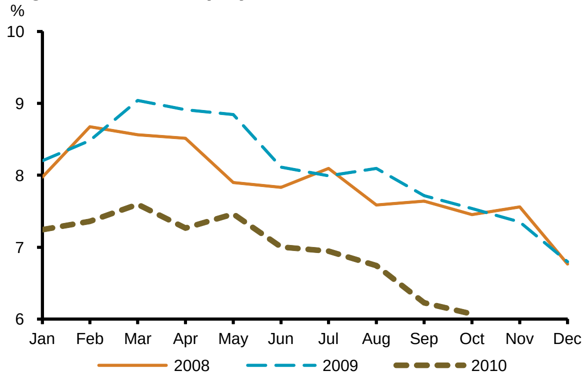


Source: IBGE

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

The IBC-Br registered growth of 0.9% in the quarter ending October, in relation to that ending July, when it had risen 0.5% in the same comparison measure, based on seasonally adjusted data. The monthly analysis indicates the resumption of activity growth in September after four months of relative stability, stressing that this movement, although less than that registered in the early months of the year, seems compatible with the estimated growth of 7.3 % of GDP in 2010.

Figure 1.12 – Unemployment rate



Source: IBGE

1.3 Labor market

Employment

The unemployment rate, based on the Monthly Employment Survey (PME) conducted by the IBGE in the six main metropolitan areas, reached 6.1% in October, the lowest value of the series started in March 2002, falling 0.1 p.p. compared to September and 1.4 p.p. in twelve months. The analysis of seasonally adjusted data shows that the unemployment rate reached, on average, 6.4% in the quarter

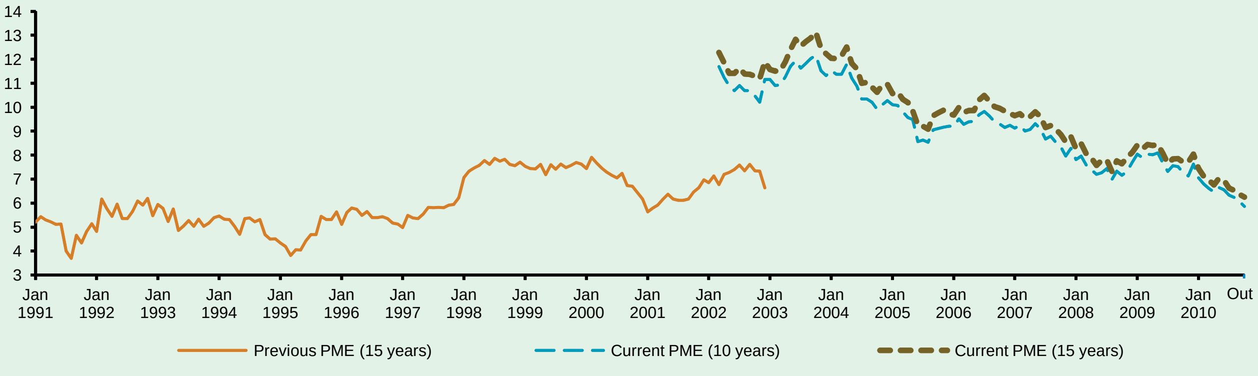
3/ The indicator is constructed based on monthly replies sent to executives of some 400 private businesses in the services sector, with the panel selected in order to replicate the actual structure of the industry, covering the activities of transportation and communication, financial intermediation, business services, personal services, computing and information technology, and hotels and restaurants. Values above 50 represent growth in activity.

Open Unemployment in Brazil: contributions of supply and demand for labor

The open unemployment rate (OUR)[1] has trended downward since mid-2004 in response to the cycle of economic expansion experienced by the Brazilian economy since late 2003. This process cooled in the period following the aggravation of the international financial crisis (seen in Figure 1), which shows the OUR trajectory as from January 1991, considering the seasonally adjusted series of former and current and current adjusted population[2] methodologies.

The series showed a growth tendency in the OUR, particularly in the 90's, and a reversal of this process in the current decade. As expected, there is a good adhesion between the development of OURs calculated using the current methodology and actual adjusted population.

Figure 1 – Open unemployment rate
Seasonally adjusted data



1/ The indicator is released by the Monthly Employment Survey of the Brazilian Institute of Geography and Statistics (PME/IBGE), covering the formal and informal sectors of the metropolitan areas of Recife, Salvador, Belo Horizonte, Rio de Janeiro, Sao Paulo and Porto Alegre.

2/ The methodology for calculating the unemployment rate was changed from the beginning of 2002, and the series using the old methodology is available until early 2003. Considering that one of the amendments to the current methodology consisted of the incorporation of individuals from 10 to 14 years of age in the population target of research, an alternative series has been created – called the current population-adjusted methodology – which counts in the calculation, from the current methodology, of only the population of persons aged equal to or more than 15 years, pursuant the former methodology.

The behavior of the OUR can be better understood as of the segmentation of the impacts of the contributions of changes in the demand for labor corresponding to the level of employment, and of the labor supply corresponding to the workforce. The exercise uses the current series and breaks down the change in the OUR from two components: (i) the labor supply effect, understood as the impact on the OUR for the change in the Overall Labor Force (PEA), keeping the employed population (EP) constant; (ii) the demand for labor effect, defined as the contribution to the OUR variation resulting from changes in EP, with the EAP unchanged.

Considering,

$$u_t = \frac{PEA_t - EP_t}{PEA_t};$$

$$o_t = \frac{EP_t}{PEA_t};$$

$$s_t = \frac{PEA_t}{PEA_{t-1}};$$

$$d_t = \frac{EP_t}{EP_{t-1}};$$

Where:
u = open unemployment rate;
o = occupation rate;
s = growth rate of PEA; and
d = growth rate of EP.

The breakdown of the OUR can be expressed through:

$$\Delta u_t = \Delta s_t - \Delta d_t + r_t$$

$$\Delta u_t = \underbrace{o_{t-1}\left(\frac{s_t - 1}{s_t}\right)}_{\text{labor supply variation}} - \underbrace{o_{t-1}(d_t - 1)}_{\text{demand for labor variation}} + \underbrace{o_{t-1}\left(\frac{s_t d_t - s_t - d_t + 1}{s_t}\right)}_{\text{residual variation}}$$

Table 1 shows the annual variations of the OUR in percentage points for five periods. In the first, from November 2003 to August 2005, the average annualized contraction of the OUR reached 1.97 percentage points, with an emphasis on the impact of 2.89 percentage points inherent to the expansion of a demand for labor.

Table 1 – Breakdown of annualized variations of the Open Unemployment Rate

p.p.

Outlook	Period	Δu	Δs	Δd	r
Downward trend	Nov/2003-Aug/2005	-1.97	0.86	2.89	0.06
Bullish labor market	Sep/2005-Jul/2006	1.41	3.10	1.68	-0.01
Downward trend	Aug/2006-Aug/2008	-1.36	1.47	2.86	0.04
International crisis	Sep/2008-May/2009	1.49	1.54	0.05	0.01
Downward trend	Jun/2009-Oct/2010	-1.58	1.62	3.26	0.06

The second period considered, from September 2005 to July 2006, is characterized by a reversal of the downward movement of the OUR, a change fundamentally associated to a significant annualized increase of 3.1 p.p. recorded in the labor supply. This largely reflected the stimulation of the rising income of labor, as discussed in the Box titled Recent Developments in Employment and Unemployment: Metropolitan Areas and Interior released in the September 2006 Inflation Report. Similarly, when the effects of the international financial crisis was most intense from September 2008 to May 2009, the OUR posted an average annualized increase of 1.5 percentage points, highlighting the weak growth of 0.05 p.p. in labor demand.

The third period, from August 2006 to August 2008, and the fifth period, from June 2009 to October 2010, characterized by the retraction of the OUR, registered in both average rates a major expansion in the demand and supply of labor, with a predominance of the former.

In general terms, the labor supply, to the extent that it reflects the expansion of the EAP, has grown in all analyzed periods and has thereby contributed to growth in the OUR, highlighting the more intense impact during "labor exuberance" due to the stimulus provided by rising wage gains in that period (impetus effect). In turn, the contributions of labor demand for a reduction of OUR were recurring, except for the "international crisis" period.

It bears emphasizing that the continuity of the current process of economic growth tends to increase the demand for labor, with likely developments on the levels of OUR. In contrast, the possible existence of hidden unemployment tends to favor an increase in labor supply, a process that would be stimulated by investments in human capital and the incentives represented by increases in earnings and formalization.

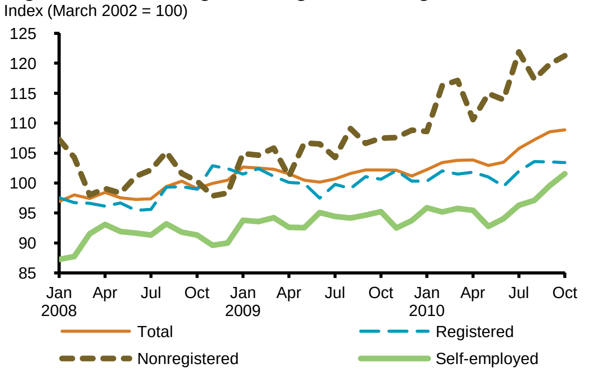
Table 1.3 – Formal employment

				New jobs – In the year (1,000)
	2009	2010		
	Year	I H	III Q	Oct
Total	995.1	1 473.3	728.1	2 406.2
Manufacturing industry	10.9	394.1	206.1	647.2
Commerce	297.2	144.1	148.4	373.9
Services	500.2	490.0	284.0	860.3
Building	177.2	230.0	100.2	341.6
Crop and livestock	-13.6	175.1	-26.4	124.0
Public utilities	5.0	9.9	4.9	16.1
Others1/	18.3	30.1	10.8	43.1

Source: MTE

1/ Includes mining, public administration and others.

Figure 1.13 – Average real regular earnings



Source: IBGE

Table 1.4 – Gross Domestic Product
Accumulated in the year

					% growth
	2009		2010		
	III Q	IV Q	I Q	II Q	III Q
Crop and livestock	-5.3	-4.6	5.4	8.1	7.8
Industry	-9.8	-6.4	15.1	14.5	12.3
Mining	-3.4	-1.1	14.7	15.6	16.0
Manufacturing	-12.4	-8.2	17.3	15.6	12.5
Construction	-9.2	-6.3	15.1	15.9	13.6
Public utilities	-3.6	-2.6	8.4	9.2	8.8
Services	1.1	2.2	6.2	6.1	5.7
Commerce	-4.9	-1.8	15.3	13.6	12.0
Transportation	-5.0	-2.5	12.5	11.8	10.3
Communications	4.8	3.8	2.9	3.2	3.5
Financial institutions	6.0	7.1	9.6	9.9	10.4
Other services	2.8	3.5	3.4	3.8	3.5
Rents	1.5	1.9	1.6	1.7	1.6
Public administration	3.1	3.3	2.5	2.7	2.6
Value added at basic prices	-2.4	-0.6	8.4	8.4	7.5
Taxes on products	-3.3	-0.9	14.7	14.0	13.3
GDP at market prices	-2.5	-0.6	9.3	9.2	8.4

Source: IBGE

ending October, from 6.9% in that ending July, the result of the stability of the Overall Labor Force (PEA) and the rise of 0.5% in the number of employed.

According to the General File of Employed and Unemployed Persons (Caged), of the Ministry of Labor and Employment (MTE), 24,062,000 formal jobs were created in the first ten months of the year, the highest result for the period since the series began in 1985. Of note, in the period, the net hiring registered in the services sector, 8,603,000; in the manufacturing sector, 6,472,000; in trade, 3,739,000, and in construction, 3,416,000.

Income

According to the PME, the average real earnings typically received in the main job, in the six major metropolitan regions, increased 6.1% in the quarter ending October when compared to the same period in 2009, recording real gains of 10.9% and 3.2% respectively in the segments of unregistered and registered private sector employees. Among the main sectors of activity, the biggest gains were seen in household services, 9.1% and in construction, 8.8%. Real overall wages, a product of the number of employed and the typical average real income grew 9.9% in the period.

1.4 Gross Domestic Product

According to the Quarterly National Accounts of the IBGE, the GDP grew 6.7% in the third quarter of 2010 compared to same period of the previous year, using the same comparison measure, respective rises of 9.3% and 9 2% for the quarters ending in March and June.

Considering the supply side, agriculture and livestock grew 7% in the period, from 10.4% in the quarter ending June, a result associated with the modest performance of those crops with greater weight in the third quarter, such as beans, cassava and orange. The industrial sector expanded 8.3%, compared to 14.1% in the second quarter of the year, highlighting the deceleration in growth rates of the manufacturing industries, from 14.1% to 7.1% and construction, from 16.6% to 9.6%. The expansion of the service sector fell by 1.1 p.p. to 4.9%, a change which, in part, reflects the impact of the performance of agriculture and livestock and industry on the trade and transportation segments.

GDP Estimates: 2010 and 2011

The estimated growth of Gross Domestic Product (GDP) for 2010 remains at 7.3%, the same as shared in the last two Inflation Reports. Adjustments have been introduced, at the margin, in the growth rates of the components of supply and demand, consistent with the revised results for 2009, with data from the first three quarters of 2010 and with the outlook for the remainder of this year.

The growth of agriculture and livestock is expected to come to 7.5%, rising 1.5 p.p. from the estimate of the previous report, highlighting the impact of the increase of 7.8% for the sector, up to the third quarter. Besides, one should note the favorable adjustments in the estimates of the Systematic Farm Production Survey (LSPA), conducted by the Brazilian Institute of Geography and Statistics (IBGE), for important crops in 2010, such as coffee, from 14.8% to 18.6%, wheat from 8.1% to 15.3%, and sugar cane, from 1.4% to 6%.

Industry is predicted to grow 10.2%, a projection 0.8 p.p. lower than that made in September, reflecting the revision from 11% to 9.8% for the expansion of the manufacturing industry, motivated as much by the results presented up to October, as by the prospects for the remainder of the year.

For the service sector there is a projected high of 5.4%, from 5.2%, including the 2.1 p.p. rises in the estimated growth of the segment of financial intermediation, insurance, complementary pensions and related services, owing to the performance of the sector up to the third quarter, benefiting from the strong credit expansion. It may safely be said that the recently announced macro-prudential measures are bound to impact the segment throughout 2011.

Table 1 – Gross Domestic Product
Accumulated in the year

% growth

	2009	2010				2011
	IV Q	I Q	II Q	III Q	IV Q[1/]	IV Q[1/]
Crop and livestock	-4.6	5.4	8.1	7.8	7.5	0.5
Industry	-6.4	15.1	14.5	12.3	10.2	5.4
Mineral extration	-1.1	14.7	15.6	16.0	14.6	7.8
Manufacturing	-8.2	17.3	15.6	12.5	9.8	4.9
Construction	-6.3	15.1	15.9	13.6	11.5	6.6
Public utilities	-2.6	8.4	9.2	8.8	8.0	5.2
Services	2.2	6.2	6.1	5.7	5.4	4.2
Commerce	-1.8	15.3	13.6	12.0	10.3	5.0
Transportation	-2.5	12.5	11.8	10.3	8.8	5.2
Communications	3.8	2.9	3.2	3.5	4.1	7.9
Financial institutions	7.1	9.6	9.9	10.4	10.4	6.1
Other services	3.5	3.4	3.8	3.5	3.5	4.9
Real estate and rent	1.9	1.6	1.7	1.6	1.5	2.3
Public adminisitration, health and education	3.3	2.5	2.7	2.6	2.6	2.2
Value added to basic prices	-0.6	8.4	8.4	7.5	6.7	4.3
Taxes on products	-0.9	14.7	14.0	13.3	11.3	5.2
GDP at market prices	-0.6	9.3	9.2	8.4	7.3	4.5

Sources: IBGE and Banco Central
1/ Estimate.

From the demand perspective, it should be noted a 3.4 p.p. increase in the growth estimate of the gross fixed capital formation, which, due to the performance of investment in the third quarter, is expected to rise to 20.9% in 2010, higher than previously projected. Thus, the contribution of domestic demand is estimated at 10.1 p.p. of annual GDP growth in 2010, from 9.8 p.p. in the previous estimate, in contrast to the negative impact of 2.7 p.p. exerted by the external sector.

First GDP estimate for 2011

The estimate for GDP growth in 2011 totaled 4.5%, underpinned by the performance of domestic demand. As in 2010, it predicts an overall expansion in all the sectors of the economy.

The crop and livestock sector should grow 0.5%, a development consistent with the prospect of an annual fall of 2.5% for the grain harvest, according to the IBGE's forecast, in collaboration with the National Supply Company (Conab), offset by expansion of other crops and livestock production, this helped by the market expansion and by attractive prices.

Regarding the industrial sector, expansion of 5.4% is forecasted, highlighting the increase of 7.8% in the mining industry, driven in particular by increased oil production. The construction industry is expected to grow by 6.6%, helped by the continuation of government works, such as the Growth Incentive Program (PAC), and the continued expansion of real estate credit. The production and distribution of electricity, gas and water is expected to increase 5.2% across the year, and the manufacturing industry, 4.9%.

For the service sector, the forecast is for growth of 4.2%, highlighting the growth forecast for information services, 7.9%, helped mainly by improved access for classes "D" and "E "to mobile and internet services; financial intermediation, insurance, complementary pensions and related services, 6.1%, lower than the rate recorded in the past five years, reflecting in part the effects of the macro-prudential measures on credit; transportation, storage and postal services, 5.2%; and trade, 5%, the latter two directly influenced

Table 2 – Gross Domestic Product
Accumulated in the year

	2009	2010				2011
	IV Q	I Q	II Q	III Q	IV Q[1/]	IV Q[1/]
GDP at market prices	-0.6	9.3	9.2	8.4	7.3	4.5
Households consumption	4.2	8.4	7.4	6.9	6.8	4.8
Government consumption	3.9	2.7	4.2	4.1	3.9	2.4
Gross fixed capital formation	-10.3	28.4	28.2	25.6	20.9	7.4
Exports	-10.2	14.7	10.6	10.8	10.3	8.3
Imports	-11.5	39.6	39.2	39.8	34.3	11.9

% growth

Sources: IBGE and Banco Central
1/ Estimated.

by the performance of crop and livestock and industrial activities. Standing out among other sectors are the forecasts related to other services, 4.9%; real estate and rent, 2.3%; and administration, health and education, 2.2%.

In relation to demand indicators, there are projected increases of 4.8% and 2.4% respectively for household consumption and government consumption, whilst gross fixed capital formation is expected to increase by 7.4%. The development of domestic demand is expected to continue reflecting the favorable development of the credit and labor markets, such that its contribution to GDP growth in 2011 is estimated at 4.9 p.p.

Exports and imports of goods and services are expected to increase 8.3% and 11.9% respectively in 2011. This trajectory, whilst implicit in the 0.4 p.p. negative contribution of the external sector to GDP in 2011, constituted a significant factor for the balance between aggregated supply and demand.

Table 1.5 – Gross Domestic Product
Accumulated in the year

% growth

	2009		2010		
	III Q	IV Q	I Q	II Q	III Q
GDP at market prices	-2.5	-0.6	9.3	9.2	8.4
Households consumption	3.2	4.2	8.4	7.4	6.9
Government consumption	2.9	3.9	2.7	4.2	4.1
Gross fixed capital formation	-15.3	-10.3	28.4	28.2	25.6
Exports	-11.9	-10.2	14.7	10.6	10.8
Imports	-16.3	-11.5	39.6	39.2	39.8

Source: IBGE

Table 1.6 – Gross Domestic Product
Quarter/previous quarter
Seasonally adjusted

% growth

	2009		2010		
	III Q	IV Q	I Q	II Q	III Q
GDP at market prices	2.6	2.1	2.3	1.8	0.5
Crop and livestock	0.3	3.8	3.2	2.1	-1.5
Industry	3.8	3.9	3.6	2.0	-1.3
Services	2.0	1.2	1.5	1.2	1.0
Household consumption	2.1	1.7	1.6	0.9	1.6
Government consumption	1.1	2.1	0.0	1.9	0.0
Gross fixed capital formation	10.1	7.5	4.0	4.3	3.9
Exports	-1.5	1.4	6.9	0.1	2.4
Imports	5.6	14.1	8.8	5.8	7.4

Source: IBGE

From the demand perspective, the growth rate of Gross Fixed Capital Formation (GFCF), although slowing 6.9 p.p., reached 21.2% in the quarter. Household consumption and government consumption increased 5.9% and 4.1% respectively, compared with growth of 6.4% and 5.6% in the quarter ending June, whilst exports and imports reported respective rises of 11.3% and 40.9%. In this scenario, domestic demand and the external sector made contributions of 10.1 p.p. and -3.4 p.p. for the 6.7% increase registered by GDP in the third quarter of 2010.

The GDP grew 0.5% in relation to the second quarter, when it had expanded 1.8% in the same comparison measure, based on seasonally adjusted data. The deceleration registered at the margin reflected respective decreases of 1.5% and 1.3% seen in agriculture and livestock and industry and a 1% increase in the service sector, compared with variations of 2.1%, 2% and 1.2% in the quarter ending in June. The negative result of agriculture and livestock was linked in part to the high comparison basis in the second quarter, when there was a good performance of the soybean crop, whilst the industrial sector's loss of dynamism in the third quarter was evidenced by a contraction in the manufacturing industry. Analysis by domestic demand components reveals rises in household consumption, 1.6% and GFCF, 3.9%, and stability in government consumption, while in the external sector there were increases of 2.4% in exports and 7.4% in imports.

GDP registered growth of 8.4% in the first three quarters of the year, changes consistent with the annual growth forecast of 7.3% for the aggregate in 2010. The first forecast for GDP in 2011, detailed in a specific section in this report, is 4.5%.

1.5 Investments

GFCF, defined as investments minus changes in stocks, rose 21.2% in the third quarter according to the Quarterly National Reports, compared to the corresponding period in 2009, from, by the same comparison measure, respective expansions of 28.4% and 28.1% in the quarters ending June and March. At the margin, the GFCF increased by 3.9% in relation to the second quarter, this being the sixth consecutive positive growth.

The production of raw materials for construction increased 9.7% in the third quarter, compared to the same period of 2009, while the absorption of capital goods,

Table 1.7 – Industrial production

% change over the same period in previous year

	2010			
	I Q	II Q	III Q	Oct
Building inputs	15.4	17.2	9.7	5.2
Capital goods	25.9	33.2	21.2	6.0
Typically industrialized	23.7	33.4	20.6	25.3
Agricultural	43.0	59.6	44.7	19.4
Agricultural parts	21.3	6.7	3.0	17.6
Building	212.4	169.1	92.1	29.0
Electricity	-3.3	0.9	2.4	-25.3
Transportation equipment	19.4	33.2	35.4	15.8
Mixed	30.0	31.0	5.1	-6.5

Source: IBGE

showing respective increases of 21.2%, 75.8% and 27.3% in production, exports and imports of these goods, rose 34%. Segmentation of the production of capital goods showed widespread growth in the quarter, highlighting the increases in the industries of goods targeted to construction, 92.1%; at the agricultural sector, 44.7%; at transportation equipment, 35.4%; and serial industrial goods, 24.2%, according to the IBGE.

According to October statistics, production of raw materials for construction and the absorption of capital goods recorded respective increases of 5.2% and 9.6% compared to the same month in 2009. By the same comparison base, manufacturing of buses, trucks and agricultural machinery increased 32.1%, 24.6% and 16.3% respectively, according to the National Association of Automotive Vehicle Manufacturers (Anfavea).

Disbursements from the BNDES system – Brazilian Development Bank (BNDES), Special Industrial Financing Agency (Finame) and BNDES Participacoes SA (BNDESpar) – totaled R$140.9 billion in the first ten months of the year, increasing 32.3% in relation to the same period in 2009. Funding for agriculture and livestock, the manufacturing industry and the trade and services sector increased, in order, 50.4%, 35.8% and 29.6%, while that for mining decreased by 39.6%.

1.6 Conclusion

As expected, the Brazilian economy registered, in the third quarter of 2010, some cooling, especially in the industrial sector. Conversely, favorable changes in the labor and credit market continued to drive household consumption, whilst the favorable business expectations regarding continuing economic growth and increased agricultural income should ensure the sustainability of the current investment cycle.

Prices

2

Inflation rates rose in the quarter ending November, after registering a downward trend in the quarter ending August, both episodes largely due to the impact of changing food prices.

Developments over recent months of the general and consumer indices, core inflation and the diffusion index of the Extended National Consumer Price Index (IPCA) resulted from a combination of both domestic and external pressures. Domestically, apart from the exceptionally unfavorable seasonal contribution of agricultural prices, causing significant rises in food prices, there were important pressures from the service sector, reflecting the imbalance between the growth rates of supply and of demand for goods and services.

On the external front, it is worth noting the pressure associated with rising international prices of the principal agricultural and metallic commodities.

2.1 General indices

Table 2.1 – General price indices

% monthly variation

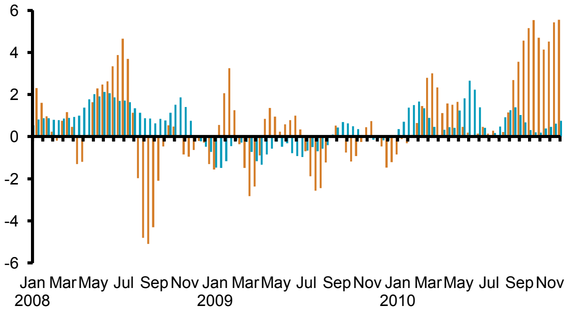
	2010				
	Jul	Aug	Sep	Oct	Nov
IGP-DI	0.22	1.10	1.10	1.03	1.58
IPA	0.34	1.70	1.47	1.32	1.98
IPC-Br	-0.21	-0.08	0.46	0.59	1.00
INCC	0.44	0.14	0.21	0.20	0.37

Source: FGV

The FGV's General Price Index – Domestic Supply (IGP-DI),, increased 3.75% in the quarter ending November, compared to 1.67% for that ending August. The increase registered in the period reflected the impact of rises in the levels of the Broad Producer Price Index (PPI), of 2.49% to 4.85% and the Consumer Price Index (IPC) of -0.50 % to 2.07%, offset in part by a slowdown, of 1.68%, to 0.78%, seen in the variable of the National Cost of Construction Index (INCC).

The changes in IPA resulted, in particular, in growth of 3.05% to 15.58% – the highest quarterly rate since November 2002 – registered in the level of agricultural prices, with emphasis on rises in the prices of corn, wheat, beans, soybeans, white potatoes, tomatoes, sugar cane, cattle, pork and poultry. The

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



Source: FGV

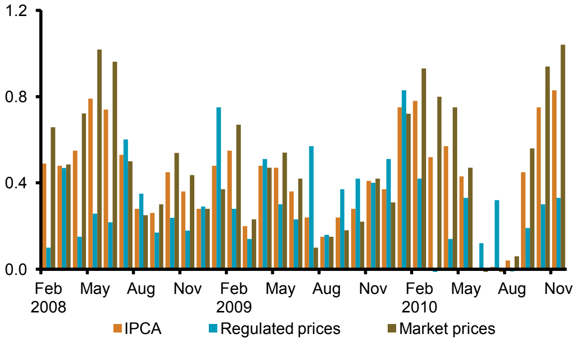
Table 2.2 – Consumer prices

% monthly change

	2010				
	Jul	Aug	Sep	Oct	Nov
IPCA	0.01	0.04	0.45	0.75	0.83
Non-regulated prices	-0.12	0.06	0.56	0.94	1.04
Tradables	-0.21	0.12	0.88	1.00	1.53
Nontradables	-0.04	0.01	0.28	0.88	0.60
Services	0.35	0.41	0.41	0.49	0.46
Regulated prices	0.32	-0.01	0.19	0.30	0.33

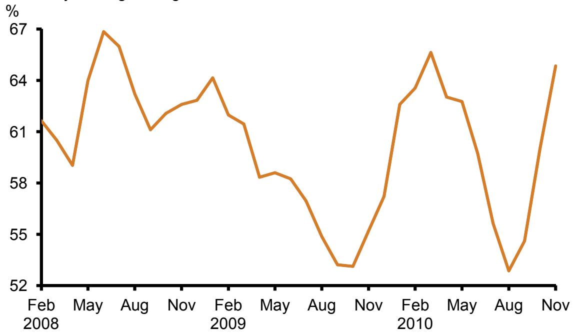
Sources: IBGE, Banco Central and FGV

Figure 2.2 – IPCA
% monthly change



Source: IBGE

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



Source: IBGE

quarterly variation of industrial prices reached 1.45%, down from 2.31% in the quarter ending August, a slowdown partly associated to falls in the prices of metallic minerals, base metallurgy and computer equipment.

CPI growth principally reflected price increases in food, 4.55%, and clothing, 2.61%. In turn, the slowdown in the INCC was favored by slower variations of materials and services, of 1.57% to 0.78% and manpower, of 1.80% to 0.76%.

2.2 Consumer price indices

Extended National Consumer Price Index

The IPCA rose 2.04% in the quarter ending November, compared to 0.05% in that ending August, a result of market price contributions, 1.82 p.p. and regulated prices, 0.22 p.p.

The variable of market prices recorded a reversal of -0.11% to 2.56% in the period, the result of respective increases of 3.45% and 1.77% in the segments of tradables and nontradables, which had experienced decreases of 0.18% and 0.04% respectively in the quarter ending August. It is worth mentioning, in the segment of nontradables, increases in the prices of perishable foodstuff items, 1.45%, and domestic help, 3.13%, which had varied -16.78% and 1.02% in the quarter ending August. The acceleration observed in tradables was attributed, in particular, to increased prices of apparel and items such as wheat flour, beef, processed meats and farmed fish, poultry, bakery goods, oil and fats and alcohol.

The IPCA with the exclusion of food and beverages recorded a high of 1.10% in the quarter from 0.63% in the quarter ending August. The cumulative variation of this indicator, over 12 months, remained stable, reaching 4.59% in November from 4.60% in August.

Considering all market prices together, those referring to the food group rose 5.28% in the quarter ending November, with emphasis on rises in the segments of semi-processed products, 11.87%; processed products, 4.33%; and perishable foodstuffs, 1.45%, compared to respective reductions of 1.76%, 1.11% and 16.78% for the quarter ending August. Moreover, the variation in service prices, reflecting increased pressure from domestic help, increased from 1.17% to 1.37% in the period. Market prices excluding the group food and beverages varied 1.26% against 0.75% in the quarter ending August, while

Table 2.3 – IPCA

% monthly change

	Weights 2010	Jul	Aug	Sep	Oct	Nov	Year
IPCA	100.00	0.01	0.04	0.45	0.75	0.83	5.25
Market prices	70.85	-0.12	0.06	0.55	0.93	1.04	6.24
Regulated prices	29.15	0.32	-0.01	0.20	0.30	0.33	2.89
Main items							
Electricity	3.22	1.17	0.11	-0.06	0.13	0.48	3.03
Natural gas vehicle	0.10	-0.43	-0.03	0.53	0.07	0.05	0.47
Pipeline gas	0.10	-0.01	0.36	0.04	0.00	-0.34	1.51
Diesel fuel	0.08	0.04	-0.01	0.04	0.03	-0.21	-0.20
Electricity	0.12	2.47	0.52	0.23	0.06	0.09	-6.10
Tolls	1.29	0.00	0.03	0.05	0.71	0.63	1.74
Water and sewage	1.62	0.13	0.23	0.70	0.52	0.00	3.34
Urban bus	3.81	0.38	-0.38	0.00	0.00	0.30	7.46
Air ticket	0.35	9.15	-10.32	7.58	3.69	-1.26	-4.14
Gasoline	3.96	-0.13	0.75	-0.14	1.13	0.81	1.42
Bottled cooking gas	1.19	-0.04	-0.16	0.20	0.23	0.10	1.84
Medicine	2.83	-0.16	0.07	0.15	-0.44	0.09	3.25
Health plans	3.49	0.53	0.62	0.58	0.59	0.58	6.25

Source: IBGE

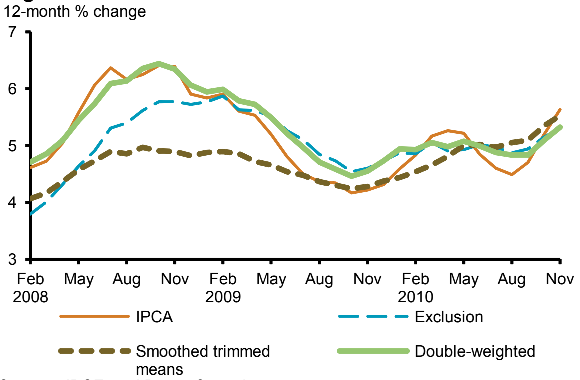
Table 2.4 – Consumer prices and core inflation

% monthly change

	2010 Jul	Aug	Sep	Oct	Nov
IPCA	0.01	0.04	0.45	0.75	0.83
Exclusion	0.24	0.12	0.37	0.44	0.52
Smoothed trimmed means	0.25	0.33	0.43	0.55	0.56
Double-weighted	0.20	0.19	0.39	0.58	0.66
IPC-Br	-0.21	-0.08	0.46	0.59	1.00
Core IPC-Br	0.28	0.26	0.52	0.41	0.43

Sources: IBGE, Banco Central and FGV

Figure 2.4 – Core inflation



Sources: IBGE and Banco Central

the variation over 12 months was 5.33%, rising 0.22 p.p. in the period.

The IPCA diffusion index, demonstrating dissemination of price increases, reached an average of 64.84% in the quarter ending November, compared to 52.86% in that ending August and 55.21% in the same period in 2009. Excluding food and beverages, the index reached 61.19% compared to 54.67% and 57.33% respectively for the quarters ending August 2010 and November 2009.

The IPCA rose 5.25% in the first eleven months of the year, against 3.93% in the corresponding period of 2009. This acceleration was a result of the greater impact of the 2.45 p.p. rise, to 6.26% in the variation of market prices, over that caused by a 1.34 p.p. reduction to 2.86% in regulated prices. Considering the 12-month period, the IPCA rose 5.63% in November compared to 4.49% in August.

2.3 Regulated prices

The regulated price variable reached 0.82% in the quarter ending November, compared to 0.43% for that ending August, changes attributed in particular to price increases in airfares, 10.14%; gasoline, 1.81%, and rates for water and sewage, 1.22%. The cumulative 12-month change in regulated prices reached 3.39% in November, from 3.77% in August, whilst considering the first eleven months of the year, there were increases of 2.86% in 2010 and 4.21% in the previous year.

2.4 Core inflation

The core of the IPCA by exclusion registered a variation of 1.30% in the quarter ending November, compared to 0.72% for that ending August. Considering the twelve month period, the variation of the index reached 5.26% in November compared to 4.87% in August.

The core calculated by smoothed trimmed means[4] grew 1.55% from 0.98% in the quarter ending August. The variation of the indicator over the last twelve months was 5.52% in November compared to 5.05% in August.

4/ The criterion used to calculate this indicator excluded those items whose monthly variation places them in the distribution above the 80th percentile or below the 20th percentile, and smoothed over twelve months the fluctuation of items whose variations are concentrated in short periods of the years.

The double weighting core[5] registered a variation of 1.64% in the quarter ending November, compared to 0.68% for that ending August. The twelve month analysis reveals that the variance of the indicator accelerated from 4.83% in August to 5.37% in November.

Core inflation of the FGV's Consumer Price Index – Brazil (IPC-Br), calculated by the method of smoothed trimmed means and rose 1.37% against 0.91% in the quarter ending August. Considering the twelve-month periods, the index registered increases of 4.95% in November and 4.36% in August.

Figure 2.5 – IPCA

Median

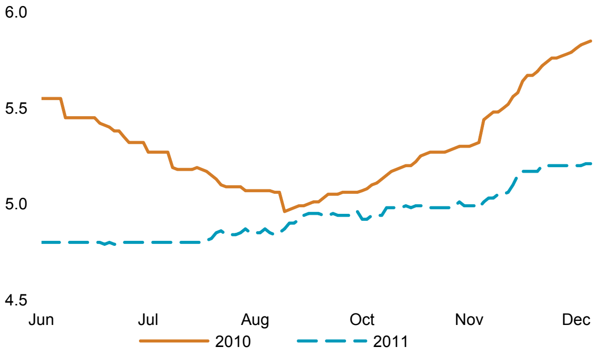


Figure 2.6 – IGP-M and IPA-DI

Median 2010

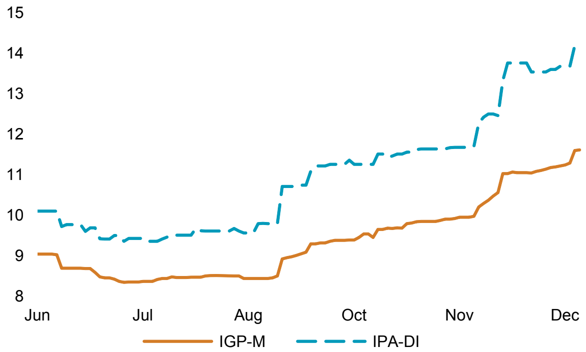
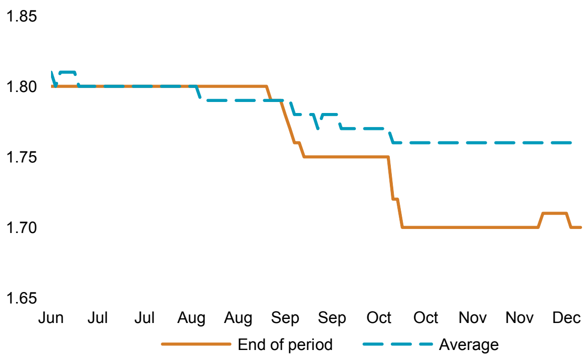


Figure 2.7 – Exchange

Median 2010



2.5 Market expectations

According to the Research Focus – Market Report for December 10th, the median forecasts for the IPCA's annual variations for 2010 and 2011 reached 5.85% and 5.21% respectively, compared to 5.1% and 5% at the end of September. The median expectations for the inflation twelve months ahead – smoothed – closed at 5.38% against 5.14% at the end of September.

The median with respect to the variation of the General Price Index – Market (IGP-M) for 2010 increased from 9.4% at the end of September to 11.43% at December 10th, whilst that for 2011 increased from 5 1% to 5.5%. In the same period, the medians associated with the variations of the Broad Producer Price Index – Domestic Availability (IPA-DI) for 2010 and 2011 registered, respectively, increases from of 11.4% to 14.18% and 5% to 5.16%.

The median of expectations concerning the 2010 developments of regulated prices remained unchanged at 3.5%, whilst for 2011; they fell from 4.7% to 4.5%.

The median exchange rate projected by the market towards the end of 2010 was adjusted from R$1.75/US$1.00 to R$1.70/US$1.00, between late September and December 10th, whilst the projection for the end of 2011 was revised from R$1.80/US$1.00 to R$1.75/US$1.00, in the same period. In the same interval, the medians of the projections for the average exchange rate for 2010 and 2011 decreased in order, from R$1.77/US$1.00 to R$1.76/US$1.00, and R$1.79/US$1.00 to R$1.73/US$1.00.

5/ The criterion used to calculate this indicator is the reweighting of the original weights – based on the importance of each item to the IPCA basket – by their respective relative degrees of volatility, a procedure that reduces the importance of the more volatile components.

Table 2.5 – Summary of market expectations

	6.30.2010		9.30.2010		12.10.2010	
	2010	2011	2010	2011	2010	2011
IPCA	5.6	4.8	5.1	5.0	5.9	5.2
IGP-M	9.0	5.0	9.4	5.1	11.4	5.5
IPA-DI	10.1	5.0	11.4	5.0	14.2	5.2
Regulated Prices	3.6	4.8	3.5	4.7	3.5	4.5
Selic (end-of-period)*	12.0	11.8	10.8	11.8		12.3
Selic (average)*	10.5	12.1	10.0	11.5		12.1
Exchange rate (end-of-period)	1.8	1.9	1.8	1.8	1.7	1.8
Exchange rate (average)	1.8	1.8	1.8	1.8	1.8	1.7
GDP growth	7.2	4.5	7.6	4.5	7.6	4.5

2.6 Conclusion

The rise in inflation in the quarter ending November was, largely, influenced as much by domestic seasonal factors, and related to food supply, especially of perishable foodstuffs, as by external factors relating to the supply of some agricultural commodities.

Credit, monetary and fiscal policies

3

3.1 Credit

The expansion of financial system credit transactions in the quarter ended October reflected a persistent economic activity dynamics and the seasonal impact of the end of year sales. Financing granted with earmarked funds continued to be more robust, especially transactions contracted with the BNDES and housing financing. As for the nonearmarked credit portfolio, it is worth mentioning the performance of car loans.

The stock of financial system credit transactions totaled R$1,645 billion in October 2010, increasing 6.3% in the quarter and 20.3% in twelve months, representing 47.2% of GDP, compared to 45.5% in July and 44.6% in the same period of the previous year. The participation of public banks in total credit operations reached 41.9%, against 42.2% in July and 40.7% in the same period of 2009, whereas the share of private national institutions and foreign banks reached 40.6% and 17.5%, respectively, compared to 40.1% and 17.6% in July, and 40.6% and 18.7% in the same period of 2009.

Credit to the private sector totaled R$1,578 billion in October, accounting for 96% of the national financial system total credit operations, for a 6.5% increase in the quarter and 20.3% in twelve months. It should be highlighted that the quarterly change reflected, in particular, the increase of 7.7% in the industrial segment. Housing credit transactions, which exerts an important effect on the performance of the construction sector, increased 11.2% in the quarter and 51.5% in twelve months. Of the stock of R$129.1 billion registered in October, 94.8% referred to transactions with savings deposits and the Employment Compensation Fund (FGTS).

The balance of the public sector financing reached R$66.4 billion, increasing 1.7% in the quarter and 19.6% in twelve months, with emphasis on the respective expansions of 5.3% and 37.7% on the regional level.

Table 3.1 – Credit operations

R$ billion

Itemization	2010				% growth	
	Jul	Aug	Sep	Oct	3 months	12 months
Total	1 547.9	1 584.5	1 613.6	1 644.8	6.3	20.3
Nonearmarked	1 025.0	1 042.2	1 061.6	1 078.9	5.3	15.7
Earmarked	523.0	542.2	552.0	565.9	8.2	30.0
% participation:						
Total/ GDP	45.5	46.2	46.7	47.2		
Nonearmarked/ GDP	30.1	30.4	30.7	31.0		
Earmarked/GDP	15.4	15.8	16.0	16.3		

Figure 3.1 – Credit by capital control of financial institutions

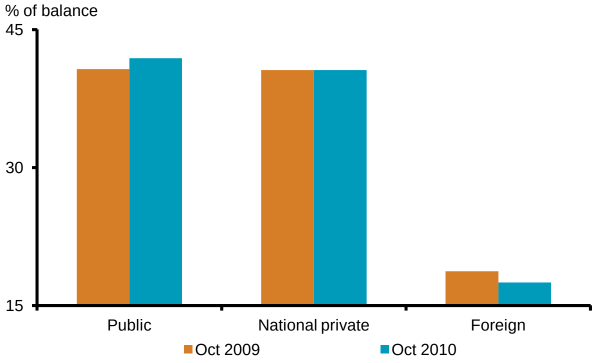
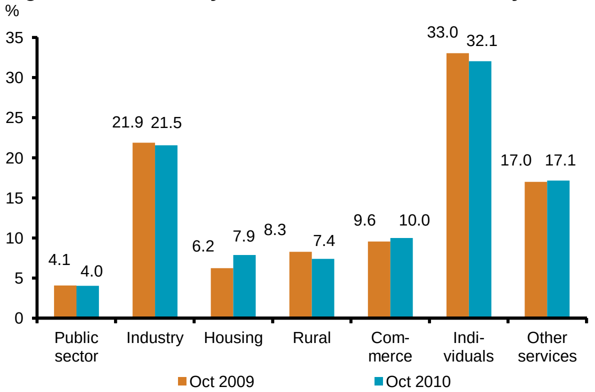


Figure 3.2 – Credit by borrower's economic activity



Provisions set aside by the financial system totaled R$96.4 billion in October, for respective changes of 1.1% in the quarter and -2.7% in twelve months. The ratio between the amounts set aside and the total credit portfolio reached 5.9%, compared to 6.2% in July, whilst the total financial system default, based on those transactions overdue by more than ninety days, fell 0.2 p.p. in the period, to 3.4%.

With the goal to strengthen prudential regulation and the sustainability of the credit market, the Circular no. 3,515, dated December 3, outlined the increase in capital requirements applicable to credit transactions and commercial lease financing to individuals where the contractual terms exceed 24 months. Accordingly, the Risk Weighting Factor (FPR) for transactions entered into from December 6, 2010 went from 100% to 150%, representing an increase from 11% to 16.5% in the capital requirement. This increase does not apply to the following transactions: i) payroll-deducted loans with contractual period lower than 36 months; ii) rural credit; iii) housing credit; iv) financing or commercial leasing of vehicles with terms between 24 and 36 months, provided that the contract value does not exceed 80% of the vehicle value; v) financing or commercial leasing of vehicles with terms between 36 and 48 months, providing that the contract value does not exceed 70% of the vehicle value; vi) Financing or commercial leasing of vehicles with terms between 48 and 60 months, providing that the contract value does not exceed 60% of the vehicle value; vii) financing or commercial leasing of haulage vehicles; and viii) financing with funds derived from Federal Government funding transfers or special programs.

Earmarked credit

Earmarked credit operations totaled R$565.9 billion in the quarter ended October, rising 8.2% in relation to July and 30% in twelve months, with emphasis on the trajectories of BNDES transactions and housing financing, which registered, on the same comparison basis, respective increases of 7.6% and 10.9%, and 32.4% and 51.1%.

BNDES disbursements reached R$140.9 billion in the first ten months of the year, up 32.3% in comparison to the same period in 2009. Financing to industry, driven by demand from the segments of food and coke, oil and fuel, rose by 33%, while that granted for the segments of trade and services increased 29.6%, with emphasis on the branches of land transportation and trade. Financing to micro, small and medium enterprises, representing 26.4% of total disbursements, grew 105% on the same comparison basis.

Table 3.2 – Earmarked credit operations

R$ billion

	2010				% growth	
	Jul	Aug	Sep	Oct	3 months	12 months
Total	523.0	542.2	552.0	565.9	8.2	30.0
BNDES	322.3	334.9	337.8	347.0	7.6	32.4
Direct	168.9	172.1	171.2	175.2	3.7	20.2
Onlendings	153.4	162.8	166.7	171.8	12.0	47.7
Rural	78.4	80.1	82.3	83.6	6.7	1.9
Banks and agencies	74.6	75.8	77.8	78.9	5.8	1.1
Credit unions	3.8	4.3	4.4	4.7	24.3	17.7
Housing	110.4	114.7	119.0	122.5	10.9	51.1
Others	11.9	12.4	12.9	12.8	7.8	27.5

Table 3.3 – BNDES disbursements

R$ million

	Jan-Oct		
	2009	2010[1/]	% growth
Total	106 486	140 921	32.3
Industry	52 572	69 908	33.0
Mining	1 960	1 183	-39.6
Food products	4 312	11 258	161.1
Vehicle, towing truck and wagon	5 678	5 207	-8.3
Petroleum and alcohol refining	22 519	27 884	23.8
Cellulose and paper	3 228	1 397	-56.7
Transportation equipment	2 403	3 128	30.2
Commerce/services	48 522	62 904	29.6
Overland transportation	19 003	23 326	22.7
Electricity and gas	10 672	9 749	-8.6
Commerce	3 990	8 638	116.5
Auxiliary transportation activities	1 828	2 673	46.2
Construction	4 743	5 339	12.6
Telecommunication	1 992	1 981	-0.5
Crop and livestock	5 393	8 110	50.4

Source: BNDES

Consultations with the BNDES, a leading indicator of productive sector investments, totaled R$224 billion in the first ten months of the year, increasing 21.3% compared to the same period of the previous year, highlighting the growth of 34.2% in trade applications, including services. Industrial sector consultations grew 6.8%, highlighting the demand of the sectors of transportation equipment, food products and coke, oil and fuel.

Rural credit transactions, excluding those contracted by the BNDES, increased 6.7% in the quarter, reaching R$83.6 billion, with emphasis on the rise of 8.1% recorded in those aimed at costs, which accounted for 43.9% of the total, whilst the shares for investment and marketing reached 51.5% and 4.6%, respectively.

In relation to the housing loans portfolio, disbursements based upon savings accounts funds totaled R$23.9 billion in the first eight months of the year, up 59.5% in relation to the same period in 2009, while the total number of house units financed grew by 34.5%.

Nonearmarked credits

The balance of nonearmarked credit operations reached R$1,079 billion in October, for a 5.3% increase in the quarter and 15.7% in twelve months. The proportion of these transactions in the financial system portfolio fell from 68.2% in October 2009 to 65.6%.

Table 3.4 – Nonearmarked credit operations

R$ billion

	2010				% growth	
	Jul	Aug	Sep	Oct	3 months	12 months
Total	1 025.0	1 042.2	1 061.6	1 078.9	5.3	15.7
Corporations	514.0	521.2	532.9	541.5	5.3	14.3
Reference credit[1/]	425.1	430.6	442.0	449.6	5.8	15.3
Domestic funding	374.0	378.2	390.4	397.4	6.2	20.5
External funding	51.0	52.3	51.6	52.2	2.4	-12.9
Leasing[2/]	44.2	44.3	43.1	41.9	-5.1	-16.0
Rural[2/]	2.9	3.2	3.3	3.1	6.6	-21.6
Others[2/]	41.8	43.1	44.4	46.8	11.9	56.7
Individuals	511.0	521.1	528.7	537.4	5.2	17.1
Reference credit[1/]	376.6	384.2	393.7	402.7	6.9	26.6
Credit unions	23.0	23.4	23.8	24.4	5.9	18.7
Leasing	53.5	51.9	50.5	49.3	-7.9	-23.2
Others	57.9	61.4	60.8	61.1	5.5	9.0

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

Transactions carried out in the segment of individuals, which closed at R$537.4 billion, increased 5.2% in the quarter and 17.1% in twelve months. In the framework of reduced interest rates and lengthened average terms, it should be highlighted the respective expansions of 10.7% and 44.4% recorded in the segment of vehicle financing. Payroll-deducted loans, accounting for 60.4% of personal credit portfolio, grew 6.3% in the quarter and 28.7% in twelve months.

The balance of corporate transactions reached R$541.5 billion in October, rising 5.3% in the quarter and 14.3% in twelve months, with emphasis on the respective expansions of 6.4% and 23.6% recorded by working capital. Loans backed by external funds, reflecting the performance of contracting under Advance on Exchange Contracts (ACC) varied 2.4% in the quarter and -12.9% in twelve months.

Figure 3.3 – Interest rates on nonearmarked credit

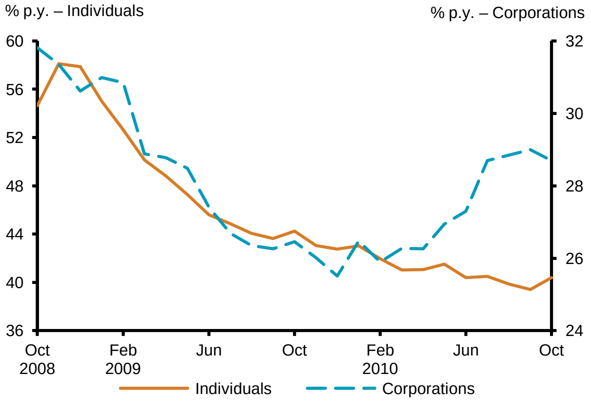


Figure 3.4 – Average spread on nonearmarked credit

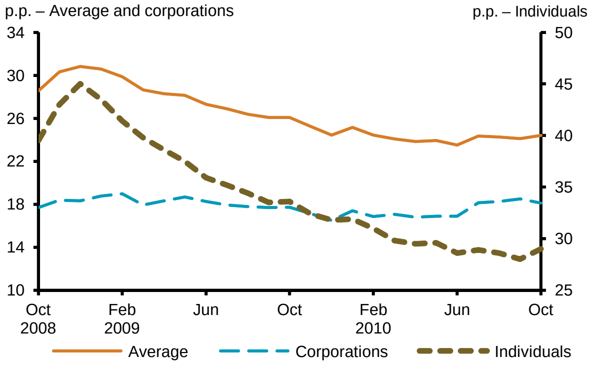
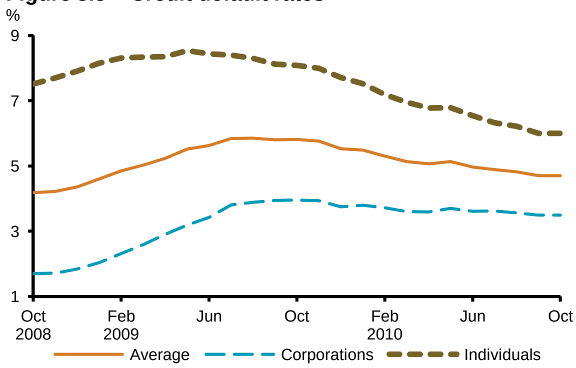
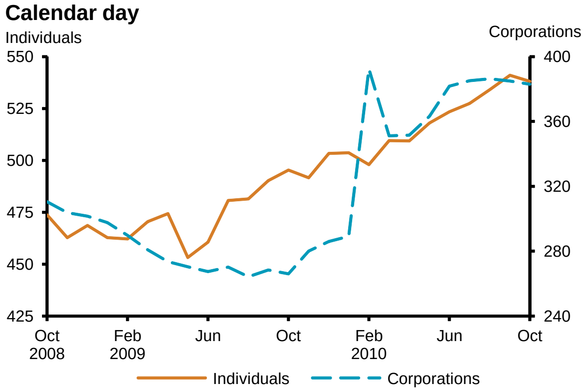


Figure 3.5 – Credit default rates[1/]



1/ Nonearmarked credit in arrears of more than 90 days.

Figure 3.6 – Average term for credit operations – Calendar day



Interest rates and default

The average interest rate for reference credit operations reached 35.4% p.a. in October, registering stability in the quarter and a drop of 0.2 p.p. compared to the same month of 2009. The banking spread totaled 24.4 p.p. in October, for respective changes of 0.1 p.p. in the quarter and -1.6 p.p. in twelve months.

The average cost of transactions carried out in the individual segment reached 40.4% in October, dropping 0.1 p.p. in the quarter and 3.8% in twelve months, emphasizing the annual falloffs in the rates for personal loans and purchase of vehicles. The average rate for transactions contracted in the corporate segment closed at 28.7%, registering stability in the quarter and increasing by 2.2% in twelve months.

The default rate of reference credit modalities, which have followed a downward trend since mid 2009, reached 4.7% in October. The quarterly fall of 0.2 p.p. resulted from respective decreases of 0.3 p.p. and 0.1 p.p. in the segments of individuals and corporations.

The average term of the reference credit portfolio reached 456 days in October, rising 4 days in the quarter and 87 days in twelve months. In the quarter under analysis, the average term of household loans increased by 11 days in s, influenced by the segment of vehicle purchase, and decreased by 2 days in the corporate segment.

3.2 Monetary aggregates

The average daily balance of the restricted money supply (M1) totaled R$250.9 billion in October, expanding by 5.2% in the quarter and 18.8% in twelve months. The monetary base totaled R$176.9 billion, rising 6.4% and 21.6% in the same comparison bases.

Considering the end-period balances, the monetary base stood at R$177.4 billion in October. The quarterly growth of R$14.9 billion reflected, in particular, the impact of R$38.8 billion in net Central Bank currency purchases on the interbank foreign exchange market, partly offset by the impact of the National Treasury transactions, R$7.3 billion, and compulsory reserve requirements, R$6.8 billion.

The money supply, in the M2 concept, increased 5.4% in the quarter and 13.3% in twelve months, totaling R$1.3 trillion. The M3 reached R$2.5 trillion, rising 6.2% and 15.6%,

Figure 3.7 – Monetary base and M1 – Average daily balances
R$ billion

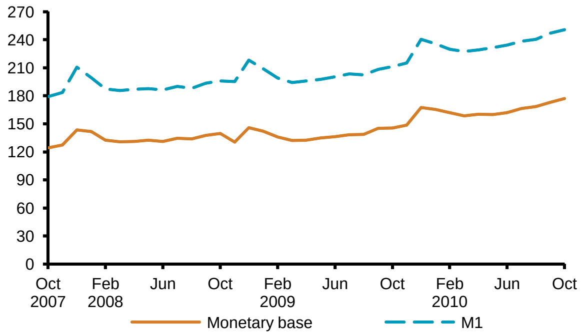


Figure 3.8 – Broad money supply
12-month % growth
%

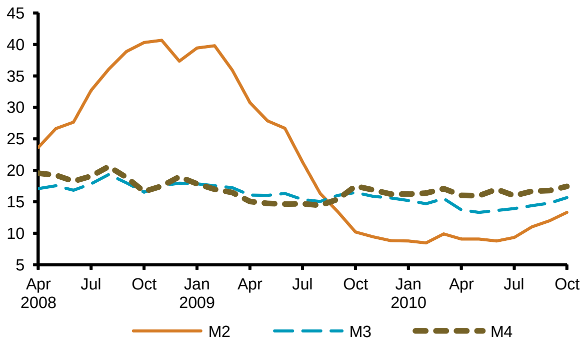
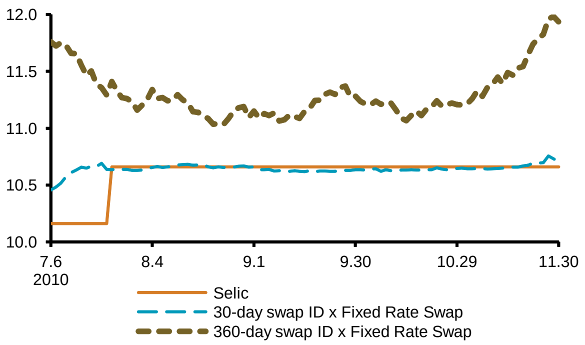
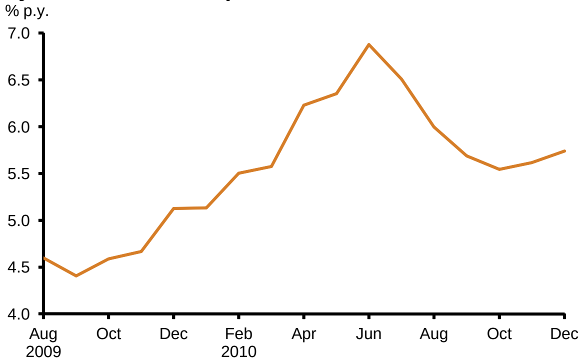


Figure 3.9 – Interest rate
% p.y.



Source: BM&F

Figure 3.10 – Ex-ante real interest rate – Deflated by 12-month IPCA expectations
% p.y.



respectively, while the M4 aggregate totaled R$3 trillion, growing by 6.5% and 17.5%.

With the goal of maintaining the process of gradual withdrawal of incentives introduced in response to the worsening of the international financial crisis and seeking to ease liquidity conditions in the prospective scenario, the Central Bank issued, on December 3, 2010, the Circular no. 3,513, which raised the percentage of reserve requirements on fixed-term deposits from 15% to 20%. Deduction limits were raised as follows: from R$2 billion to R$3 billion for financial institutions with reference assets lower than R$2 billion: and from R$1.5 billion to R$2.5 billion for those with reference assets exceeding R$2 billion and lower than R$5billion. The maximum deduction limit for amounts related to the acquisition of securities and interbank deposits was reduced from 45% to 36%. Issues of Financing Bills remained exempt from reserve requirements.

Issued on the same date, the Circular no. 3,514 increased the rate of additional liability on demand and fixed-term deposits from 8% to 12%. The deduction limits increased from R$2 billion to R$2.5 billion for institutions with reference assets lower than R$2 billion and R$1.5 billion to R$2 billion for those with assets between R$2 billion and R$5 billion. These measures became effective as of the calculation period beginning December 6, 2010 with an estimated monetary impact of R$61 billion.

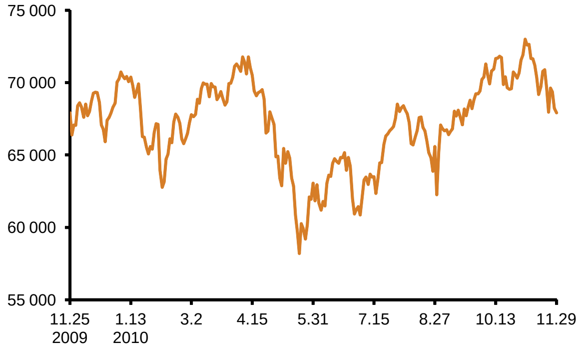
Additionally, the CMN, through Resolution no. 3,931, dated December 3, 2010, raised the maximum guarantee value of deposits and loans secured by the Credit Guarantee Fund (FGC), from R$60,000 to R$70,000, and defined the gradual reduction of the limit for raising Fixed-term Deposits with Special FGC Guarantee (DPGE) at a rate of 20 p.p. per year, beginning on January 1, 2012, up to 2016.

Real interest rates and market expectations

The curve of future interest rates for ID X pre swap contracts, demonstrating expectations for the trend of the basic interest rate and rises in risk premiums, showed, in late November, an increase in slope for all vertices. The 360-day ID x pre swap contracts rose by 84 b.p. in the quarter, to 11.94% p.a.

The real *ex-ante* Selic rate for the next twelve months, calculated by the Market Report survey dated December, 10, reached 5.7% p.a., compared to 6% p.a. in August. This reduction reflected, in particular, the rise, from 4.9% to 5.2%, of 12-month IPCA expectations.

Figure 3.11 – Ibovespa
Points



Source: Bovespa

Figure 3.12 – Stock exchanges
Sep 2009 = 100

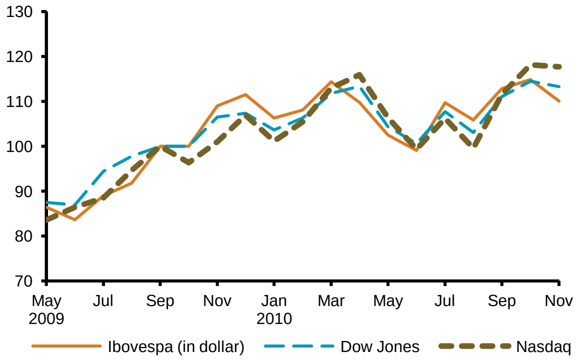
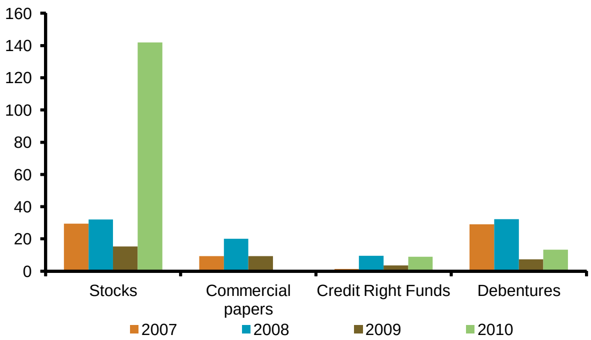


Figure 3.13 – Primary issues in the capital market
R$ billion – Accumulated through November



Source: CVM

Table 3.5 – Public sector borrowing requirements – Primary result

Segment	2008		2009		Oct 2010[1/]	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central Government	-71.3	-2.4	-42.4	-1.4	-74.2	-2.1
Sub-national governments	-30.6	-1.0	-21.0	-0.7	-22.2	-0.6
State companies	-1.7	-0.1	-1.3	-0.0	-2.7	-0.1
Total	-103.6	-3.4	-64.8	-2.1	-99.1	-2.8

1/ Twelve-month accumulated data up to october.

Capital markets

The São Paulo Stock Exchange Index (Ibovespa), following an upward trend up to mid-November, when it again exceeded the threshold of 70,000 points, started to show accentuated volatility, closing the quarter at 67,705 points. The market value of the index listed companies grew 11% in the quarter, reaching R$2.5 trillion at the end of November, while the average daily trading volume increased by 24.8%.

Measured in dollars, Ibovespa rose 6.3% in the quarter. In the same period, the Dow Jones and Nasdaq indices rose 9.9% and 18.9%, respectively.

Business financing in the capital market through issues of shares, debentures, promissory notes and placement of receivables-backed, totaled R$164.4 billion in the first eleven months of 2010, compared to R$36.5 billion in the same period of 2009, with emphasis on the primary issues of R$120.2 billion of Petrobras shares, a record volume in the Brazilian stock exchange.

3.3 Fiscal Policy

In November, the government submitted to the National Congress a bill proposing the exclusion of the results of the Eletrobras Group companies from the public sector primary surplus and, hence, the amendment of the goals stated in the Budget Guidelines Law (LDO) for 2010, of 3.3% of GDP to 3.1% of GDP, and for 2011, of R$125.5 billion to R$117.9 billion.

Fiscal statistics released by the Central Bank began to exclude the Eletrobras group companies, as prescribed by Decree no. 7,368, dated November 26, 2010, which deals with the Federal Government budget and financial programming.

Public sector borrowing requirements

The consolidated public sector primary surplus totaled R$86.7 billion, 2.99% of GDP, in the first ten months of the year, rising 0.95 p.p. of GDP compared to the same period in 2009. This performance reflected the impact of increased surpluses registered by the Central Government and state enterprises, and the fall of those relating to regional

Figure 3.14 – National Treasury gross revenue
Jan-Oct

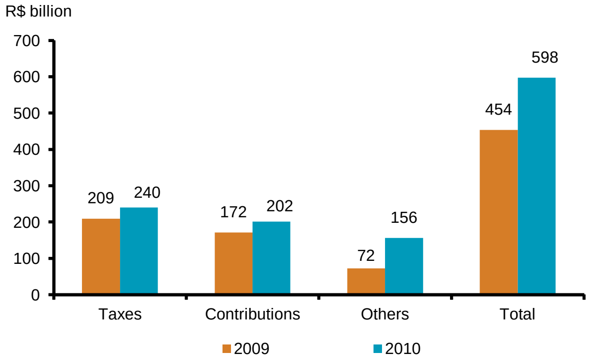


Table 3.6 – National Treasury expenditures
Jan-Oct

	2009		2010	
	R$ million	% GDP	R$ million	% GDP
Total	273 623	10.7	368 142	12.7
Personnel and payroll charges	121 383	4.7	132 788	4.6
Capital and current expenditures	151 306	5.9	234 357	8.1
Workers Support Fund	23 180	0.9	25 185	0.9
Subsidies and economic	3 898	0.9	7 586	0.9
subventions	3 898	0.2	7 586	0.3
Loas/RMV	15 671	0.6	18 431	0.6
Investment	23 940	0.9	36 104	1.2
Other capital expenditures	84 617	3.3	147 050	5.1
National Treasury transfers				
to the Central Bank	934	0.0	997	0.0

Source: Minifaz/STN

Table 3.7 – Social security primary result
Jan-Oct

R$ billion

	2009	2010	Var. %
Gross inflow	155.6	181.9	16.9
Cash refunds	-0.4	-0.5	14.4
Transfers to third parties	-15.5	-17.9	15.2
Net inflow	139.6	163.5	17.1
Social Security benefits	181.1	205.5	13.4
Primary result	-41.5	-41.9	1.0
Net inflow/GDP	5.4%	5.6%	
Social Security benefits/GDP	7.1%	7.1%	
Primary result/GDP	-1.6%	-1.4%	

governments. The accumulated surplus in twelve months reached 2.85% of GDP.

Federal Government gross revenues totaled R$597.8 billion in the first ten months of 2010, rising 31.8% compared to the same period in the previous year. This expansion, equivalent to 2.9 p.p. of GDP, reflected the favorable impact of the economic performance on income tax, as the levy of R$74.8 billion on the onerous assignment of petroleum exploration registered in September. Excluding the mentioned sale, the Federal Government revenues increased by 15.3%, equivalent to 0.3 p.p. of GDP in the period.

National Treasury expenditures totaled R$368.1 billion in the first ten months of 2010, increasing 34.5% compared to the same period in the previous year. It should be noted that this growth, accounting for 2 p.p. of GDP, reflected in particular the capitalization of Petrobras in September (R$42.9 billion). Excluding this contribution, the increase in Treasury expenditures reached 16.7% in the period, 0.5 p.p. of GDP. Spending on personnel and taxes grew 9.4%, and that relating to costs and capital expenditures, excluding capitalization, 26.5%, with emphasis on the 51% expansion in investments. Expenditures related to the Growth Incentive Program (PAC), which can be deducted from the primary surplus, amounted to 0.69% of GDP in the 12-month period ended in October.

The Social Security deficit reached R$41.9 billion in the first ten months of the year, falling 0.17 p.p. of GDP compared to the same period in 2009. Net income tax, reflecting the growth in wages, increased 17.1%, whilst expenditure on social security benefits, reflecting respective increases of 8.8% and 3.1% in the average value of pensions and welfare as well as the average monthly amount of benefits paid, increased by 13.4%.

The total Central Government – National Treasury, Social Security and Central Bank – revenues rose 28.2% on the same comparison basis, while spending grew by 26.1%. Excluding onerous assignment transactions of subsalt and the capitalization of Petrobras, which are atypical transactions, without correspondence in the previous year, central government revenues grew less than expenditures, for respective changes of 15.5% and 16.6%.

Transfers to regional governments totaled R$111.3 billion in the first ten months of the year, rising 9.6% compared to the same period in the previous year. This trajectory reflected the expansion of resources transferred through equity funds, in response to the favorable performance of shared taxes; transfers related to the exploration of oil and natural gas, influenced by rising international market prices; and transfers related to the Contribution on Intervention in the Economic Domain (Cide), resulting from the rise in rates effective as of June 2009.

The primary surplus of states and municipalities, and state enterprises experienced respective variations of -0.05 p.p. of GDP and 0.04 p.p. of GDP compared to that recorded in the first ten months of 2009.

Income relating to the Tax on the Circulation of Merchandise and Services (ICMS), the most dynamic regional tax, and Vehicle Excise Duty (IVPA) registered respective increases of 19.6% and 3.8% in the first nine months the year, compared to the same period in 2009.

Nominal appropriated interests totaled R$157.3 billion in the first ten months of the year. The nominal public sector deficit, which includes the primary result and the nominal appropriated rates, reached R$70.6 billion, equivalent to 2.44% of GDP, registering a reduction of 1.04 p.p. of GDP compared to the same period of 2009. The financing of this deficit occurred through expansion of net banking debt, debt securities and other domestic funding sources, including the monetary base, partly offset by the drop in net foreign financing.

Central Bank open market operations

National Treasury primary transactions with federal public securities led to a monetary contraction of R$7.2 billion in the quarter ended October, as a result of placements of R$129.4 billion and redemptions of R$122.2 billion. Exchange transactions totaled R$8.9 billion, of which 73.5% referring to National Treasury Notes – Series B (NTN-B). Anticipated redemptions totaled R$4.9 billion, of which 99.3% referring to NTN-B.

The average daily balance of Central Bank financing and go-around transactions totaled R$413.4 billion in October. The quarterly growth of 1.9% reflected the impact of rises registered in six month transactions, from R$94.2 billion in July to R$126.3 billion in October; for those with terms lower than two weeks, from of R$67.6 billion to R$70.2 billion; and the reduction, from R$243.8 billion to R$216.8 billion, of those with terms from two weeks to three months.

Table 3.8 – Public sector borrowing requirements
Jan-Oct

	2008		2009		2010	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Uses	11.7	0.5	89.0	3.5	70.6	2.4
Primary	-125.5	-5.0	-52.3	-2.0	-86.7	-3.0
Interest	137.2	5.5	141.4	5.5	157.3	5.4
Sources	11.7	0.5	89.0	3.5	70.6	2.4
Domestic financing	51.7	2.1	132.3	5.2	147.4	5.1
Securities financing	132.4	5.3	276.2	10.8	116.6	4.0
Bank financing	-68.7	-2.8	-144.7	-5.6	17.6	0.6
Others	-12.0	-0.5	0.9	0.0	13.1	0.5
External financing	-40.0	-1.6	-43.3	-1.7	-76.8	-2.6

Figure 3.19 – Net financing position of the federal public securities – Daily average

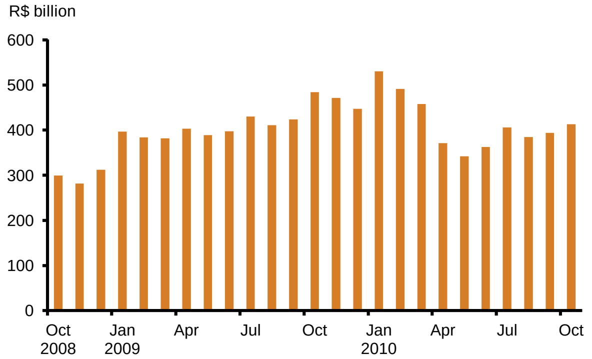


Figure 3.20 – Central Bank repo operations – Maturity – Aveage daily balances

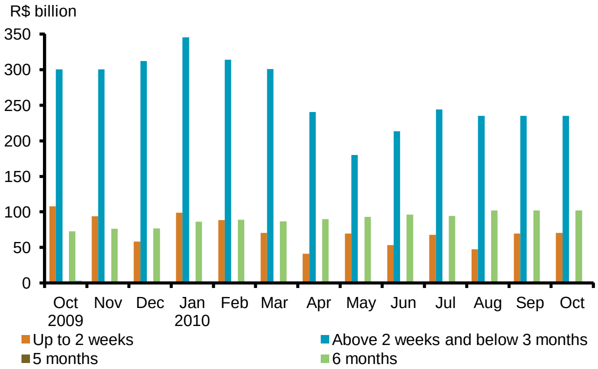
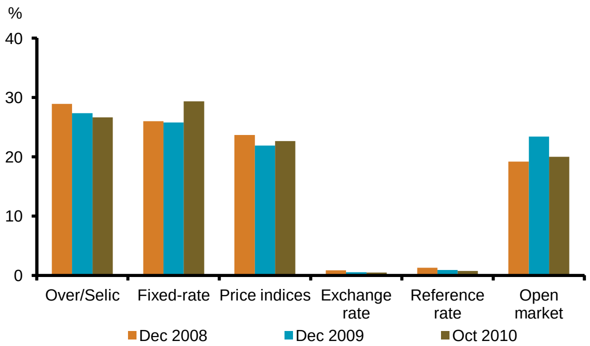


Figure 3.21 – Federal securities debt structure by indexing factor[1/]



1/ It does not include swap.

Federal securities debt

The federal debt measured by the portfolio position totaled R$1,552.7 billion in October, 44.6% of GDP, registering variations of 0.2 p.p. of GDP compared to July and -0.1 p.p. of GDP in twelve months. The quarterly increase reflected the impact of net primary market issues, R$2.9 billion, and the incorporation of nominal interests, R$41 billion, partly offset by the effect of the exchange rate appreciation registered in the quarter, 3.2%.

Of the total federal debt, the participation of securities indexed to the over/Selic rate and to price indices posted quarterly decreases of 0.8 p.p. and 1.3 p.p. in October, contrasting with expansions in fixed-rate securities, 2.01 p.p., and Central Bank financing through open market transactions, 0.1 p.p.

The repayment schedule of debt securities on the market, with the exception of financing transactions, registered the following maturity schedule in October: 1.1% of the total maturing in 2010; 21.5% in 2011; and 77.4% as of January 2012. Securities maturing in 12 months accounted for 20.2% of the total securities debt on the market, slightly lower than the percentage range of 24% to 28% established by the PAF in 2010. The average debt maturity reached 41.2 months.

Public sector net debt

The public sector net debt (PSND) totaled R$1,436.3 billion in October, 41.3% of GDP, falling 2.1 p.p. of GDP compared to December 2009. This decline reflected the contributions of the primary surplus, 2.5 p.p. of GDP, current GDP growth, 4.2 p.p., and the privatizations and acknowledgement of debts, both 0.1 p.p., partly offset by expansions associated with the appropriation of nominal interest rates, 4.5 p.p. of GDP, and the impact of currency exchange appreciation, 0.3 p.p. of GDP.

The PSND registered, in particular, growth in creditor installments linked to Long Term Interest Rates (TJLP) – due to the increase of Federal Government assets with the BNDES through issue of federal securities – and the Selic rate.

The Gross General Government Debt, which comprises the Federal Government, INSS, state governments and municipal governments – reached R$2,087.8 billion, 60% of GDP, in October, falling 2.8 p.p. of GDP compared to December 2009.

Figure 3.22 – Profile of maturities of the securities debt

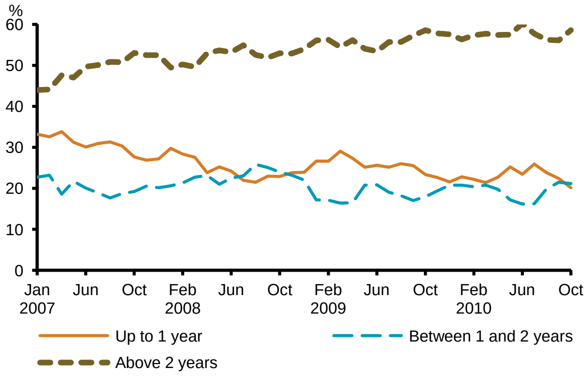


Figure 3.23 – NPSD – Percentage share of indexator

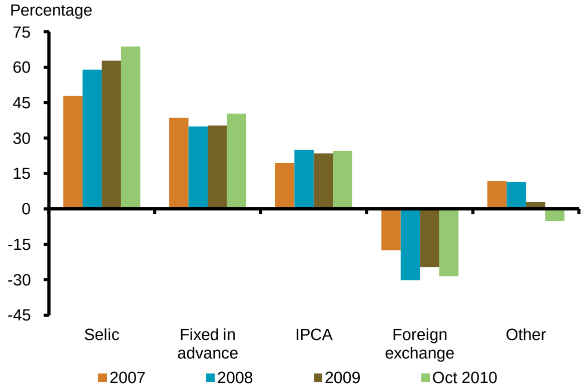


Table 3.9 – Net debt growth

Conditioning factors

	2008		2009		Oct 2010	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1168 238	38.9	1362 711	43.4	1436 288	41.3
Flows	**Accumulated in the year**					
Net debt – Growth	-43 524	-6.7	194 472	4.5	73 577	-2.1
Conditioning factors	-43 524	-1.4	194 472	6.2	73 577	2.1
PSBR	61 927	2.1	106 242	3.4	70 632	2.0
Primary	-103 584	-3.4	-64 769	-2.1	-86 677	-2.5
Interest	165 511	5.5	171 011	5.4	157 309	4.5
Exchange adjustment	-78 426	-2.6	80 886	2.6	9 367	0.3
Domestic securities	3 180	0.1	-3 414	-0.1	809	0.0
debt[1/]	-81 606	-2.7	84 300	2.7	8 557	0.2
External debt	-26 394	-0.9	10 907	0.3	-1 591	0.0
Others[2/]	0	0.0	0	0.0	0	0.0
Skeletons	135	0.0	- 345	0.0	-2 088	-0.1
Privatizations	- 767	0.0	-3 217	-0.1	-2 742	-0.1
GDP growth effect		-5.2		-1.7		-4.2

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

3.4 Conclusion

Economic activity is still being sustained by high domestic demand growth rates. Accordingly, the credit market continues to give a significant contribution in the financing of investment and aggregate consumption. Earmarked operations have been boosted by the significant role played by the BNDES in providing funds for infrastructure projects and the purchase of machinery and equipment for small and medium enterprises, in addition to the acceleration of housing credit growth. Meanwhile, nonearmarked credit loans continue to show a robust performance in the area of household transactions, with emphasis on payroll-deducted and auto loans.

The credit market has been also benefited from declining interest rates for loans to individuals, which reached historic lows. The stability of default rates at low levels also contributed to the scenario of credit expansion.

Although the pace of economic activity has decelerated in recent months, retail sales continued to show strong dynamism, a development associated with both the performance of the labor market and of the credit market, the latter stimulated by positive expectations and favorable supply conditions. In this scenario, the CMN and the Central Bank adopted macro-prudential measures aimed at adjusting the financial system liquidity levels through the rise in reserve requirements and the discouragement of transactions potentially harmful to financial institution's household balance sheets or the balance between contracted volumes and guarantee values. These measures improved credit market regulatory instruments with the goal to ensure its stability and prevent the emergence of risks that could jeopardize the economic activity.

The expansion of the public sector primary surplus in the first ten months of the year was due to a significant revenue growth as compared to expenditures, highlighting the reversal of this relationship when excluding the impact of atypical transactions with no parallel in the previous year, such as the onerous assignment of subsalt and the capitalization of Petrobras. The PSND/GDP ratio remains on a downward trajectory, emphasizing this trend is reinforced by the fiscal policy objectives defined in the budget law.

Capital Structure of Public Companies in Brazil

The aim of this Box is to examine the financial structure of public companies in Brazil during the 2005-2009 periods, with emphasis on the development of debt and the trend of the composition of ordinary sources of funding.

It is based on a sample of publicly traded companies with shares traded at BM&FBOVESPA S.A. – Securities, Commodities and Futures Exchange (BM&FBOVESPA), over the five-year period ending 2009[1]. The filters used for the construction of the sample mentioned prioritized non-financial companies that reported net operating revenues exceeding R$30 million in the 2009 fiscal year, a total of 147[2] that jointly registered sales of R$287.4 billion in December 2009. These companies are spread across 20 segments of the economic sector classification as suggested by Economática.

Capital structure by maturity, seen in Table 1, shows that short-term liabilities (up to one year), represented by current liabilities of the sample companies, reported relative stability in the five-year period, accounting, on average, for 19.6% of the total of funds in the period. Long-term bonds (over one year), represented by non-current liabilities, comprised, on average, 29.6% of the total, registering a significant increase in the last two years.

Table 1 – Equity structure by maturity

% share

	2005	2006	2007	2008	2009	Average
Third party captital	48.4	47.4	45.9	52.7	51.6	49.2
Current liabilities	19.4	19.7	19.0	20.5	19.4	19.6
Non-current liabilities	29.0	27.7	26.9	32.2	32.2	29.6
Shareholder's equity	51.6	52.6	54.1	47.3	48.4	50.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

Debt accounted, on average, for 49.2% of funds raised over the five-year period, while the proportion of shareholder capital, after experiencing a sharp annual fall of 6.8 p.p. in 2008, reached 50.8%. It

1/ Considering that the data analyzed is extracted from the financial statements of companies registered in the Economática system, the analysis will focus on the situation as of December 31 of each year, with 2009 being the latest fiscal year available.
2/ Not including Petrobras and Vale do Rio Doce, which have too great a size discrepancy in relation to other companies.

Table 2 – Equity structure

% annual growth

	2006	2007	2008	2009
Third party captital	6.0	6.9	36.1	11.3
Current liabilities	10.0	6.5	27.9	8.0
Non-current liabilities	3.3	7.2	41.9	13.4
Shareholder's equity	10.2	13.7	3.8	16.6
Total resources	8.1	10.5	18.5	13.8

Table 3 – Financial and non-financial liabilities to third parties

% share

	2005	2006	2007	2008	2009	Average
Financial	47.4	48.3	46.9	53.1	49.6	49.1
Non-financial	52.6	51.7	53.1	46.9	50.4	50.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Table 4 – Financial debt by modalities and terms

% share

	2005	2006	2007	2008	2009	Average
Short-term debt	23.1	24.1	20.4	22.6	23.5	22.7
Financing	20.1	19.3	19.1	20.7	21.2	20.0
Debentures	3.0	4.8	1.3	1.9	2.3	2.7
Long-term debt	76.9	75.9	79.6	77.4	76.5	77.3
Financing	62.5	59.5	61.4	63.8	63.7	62.2
Debentures	14.4	16.4	18.2	13.6	12.8	15.1
Total	100.0	100.0	100.0	100.0	100.0	100.0

Table 5 – Partiicipation of supplier's credit

%

	2005	2006	2007	2008	2009	Average
Suppliers/current liabilities	24.8	26.7	26.8	26.2	23.7	25.6
Suppliers/total resources	4.8	5.3	5.1	5.4	4.6	5.0

is worth emphasizing that this decline reflected, in particular, the impact of the intensifying global crisis in the second half of 2008 on the aggregate net profit of the companies considered, which fell 12% in that year. The resumption of activity in 2009 supported a reversal of this movement, expressed in a 29% annual rise in net profit. The annual trends of debt capital and aggregated shareholder capital are shown in Table 2, highlighting the contrast between the annual growth rates seen in 2008 in debt capital, 36.1%, and in shareholder capital, 3.8%.

Debt capital is composed of non-financial debt, such as supplier credit, various operational credits for payments (salaries, social charges, taxes, services, etc.), and typical financial debts such as loans, financing and debentures. This breakdown, as seen in Table 3, shows the relative stability of the proportions of the two modes in the debt capital total, only registering statistical change in 2008, also associated with the impact of the global crisis.

Table 4 records the breakdown of financial debt by financing and debentures, segmented by length of maturity. On average, short and long-term financing accounted for 82.2% of debt in the period. Regarding debentures – the predominant fundraising instrument within large companies – it is worth mentioning the proportion of long-term transactions.

In parallel, it is worth highlighting the 25.6% average proportion of supplier's credit – a mechanism with no explicit cost – in current liabilities and 5% in the total of resources used for financing, both of which registering relative stability in the recording period (Table 5).

In summary, equity accounted for an average of 50.8% of the funds used for business financing that form the sample over the five-year period ending in 2009, and debt capital make up 49.2%. Specifically with respect to the last segment, the proportion of long-term (non current) and short-term liabilities (current) reached, on average, 60.2% and 39.8% in the period, suggesting a comfortable capital structure with relatively low risk.

The breakdown of debt capital shows that financing debts comprised, on average, 49.1% of these liabilities, over five years. Additionally, it is worth emphasizing the stability of its share during the period and its concentration in loans and long-term financing.

The worsening of the global financial crisis has created short-lived effects, mostly in 2008, on the capital structure of companies, with emphasis on increased indebtedness, reflecting the expansion of debt and/or the decline in net profits. Additionally, it is important to emphasize that the low risk of financial leverage of the publicly traded companies is an indication that there would be enough room for funding, in relation to new investment opportunities, within a framework of sustainable expansion in the Brazilian economy. The challenge is to ensure a consistent supply of appropriate financing, both in terms of cost and maturity.

Credit transactions in the Automotive Sector and Connected Activities

Credit transactions targeted to the purchase of automotive vehicles have grown significantly in recent years, contributing to sustain the activity level in the automotive industry and in the economy as a whole. With the aim of contributing to the analysis of the sector's economic performance, this Box evaluates the trajectory of credit transactions for the acquisition of vehicles, the production and marketing of cars, trucks, buses, motorcycles and agricultural machinery as well as auto parts, components and accessories.

Favorable credit market conditions, expressed by reduced interest rates and lengthened maturities, in addition to macroeconomic stability and positive trajectory of employment and income indicators led to the expansion of financing and commercial leasing operations for vehicles and agricultural machinery.

Thu, the stock of the sector's credit operations, taken into account both transactions with individuals and corporations, as shown in Table 1, totaled R$217 billion in September 2010, increasing by 232.1% in comparison to the same period in 2005. Credits targeted to individuals, encompassing direct consumer loans (CDC) and leasing operations, totaled R$176 billion, up 230.2% in the period. Meanwhile, corporate credit operations expanded 240.5%, to R$41 billion, of which R$25.2 billion involving nonearmarked resources and R$15.8 billion involving earmarked resources. It should be noted that earmarked credit operations, reflecting the relevant contribution of the Special Industrial Financing Agency (Finame) administered by the National Bank of Economic and Social Development (BNDES), grew 368.7% in the period.

Over the last five years, the supply of credit with lengthened terms and decreasing costs boosted the demand for motor vehicles and, therefore, contributed to the expansion of the segment's level of production and sales. The total output of the automotive sector – including cars, light commercial vehicles, trucks, buses and motorcycles – reached 4.6 million units in the first ten months of 2010, up 47.3% in comparison to 2005. Parallel to this, domestic sales reached 3.9 million units, compared to 2.3 million units from January to October 2005.

Financing for the production of vehicles, parts and accessories (FV) totaled R$17.6 billion in September 2010, rising 22.3% in the period, as seen in Table 1. It should be noted that the proportion of credit allocated to the automotive industry in total FV fell from 68.1% in September 2005 to 42.4%. In this segment, 70% of loans were channeled to the production of cars, 24.7% to buses, trucks and tractors and 5.3% to motorcycles. In September 2010, loans for the production of parts, spares and accessories, which now represent 57.6% of the FV, focused on contracts related to the manufacturing of engines, chassis, bodywork and other components, corresponding to 52.7% of total credit operations in this segment.

The balance of loans for the marketing of cars and auto-parts reached R$29.9 billion in September 2010, increasing 192.4% in comparison to September 2005. Of this total, 68.6% referred to loans for the marketing of new and used cars and 31.4% for the financing of auto-parts dealers.

Table 1 – Credit to the automotive sector

R$ million

Period		Output			Trade			Acquisition				Total
		Vehicles	Parts	Total	Vehicles	Parts	Total	Corporations	Individuals			
									CDC	Leasing	Total	
2005	Sep	9 808	4 588	14 396	7 096	3 124	10 220	12 053	46 218	7 080	53 298	89 966
	Dec	9 691	4 788	14 479	7 384	3 342	10 726	12 768	50 685	8 427	59 112	97 085
2006	Dec	7 435	5 219	12 654	9 427	3 980	13 407	14 251	63 475	13 877	77 352	117 664
2007	Dec	5 762	6 234	11 996	11 834	5 248	17 082	17 909	81 481	30 136	111 617	158 604
2008	Dec	7 632	6 965	14 597	17 477	7 051	24 528	20 424	82 433	56 712	139 145	198 694
2009	Dec	6 497	7 774	14 271	18 602	8 080	26 682	28 967	94 133	63 159	157 292	227 213
2010	Sep	7 458	10 142	17 600	20 490	9 391	29 882	41 038	125 515	50 456	175 971	264 491

Taken together, the balance of credit operations for the production and marketing activities of automotive vehicles and auto parts and the purchase of automotive vehicles reached R$264.5 billion in September 2010 (Table 1), rising 16.4% in comparison to the end of 2009 and 194% in comparison to September 2005. It should be noted that financing for the acquisition of vehicles accounted for 82% of this total, while the proportion of loans for the marketing and production of vehicles and auto parts totaled 11.3% and 6.7%, respectively.

Table 2 – Participation of credit to the automotive sector

R$ million

Period		Total credit to the automotive sector (a)	Total SFN credit (b)	Participation of the automotive sector (a)/(b)	Participation of the credit to the automotive sector no GDP
2005	Sep	89 966	564 357	15.9	4.3
	Dec	97 085	607 023	16.0	4.5
2006	Dec	117 664	732 590	16.1	5.0
2007	Dec	158 604	935 973	16.9	6.0
2008	Dec	198 694	1 227 294	16.2	6.6
2009	Dec	227 213	1 414 344	16.1	7.2
2010	Sep	264 491	1 613 631	16.4	7.7

Analysis of Table 2 shows that the participation of these credit operations in the total national financial system credit operations reached 16.4%, rising 0.5 p.p. over the past five years. This expansion becomes even more relevant in view of the upward trend of the ratio between the National Financial System (SFN) credit stocks and the Gross Domestic Product (GDP). Accordingly, the share of credit operations targeted to the automotive sector in the GDP moved upward from 4.3% to 7.7% in the period.

It is plausible to suppose that this trend shall be affected by the effects of Circular no. 3,515, dated December 3, 2010, on the contracting of transactions with maturities greater than 24 months. This macroprudential measure regulates, among other credit modalities, the financing and commercial leasing of vehicles whose maturity terms may jeopardize the balance between the contracted volumes and the value of vehicles constituting the guarantees for theses operations. The increase in the required capitalization of financial institutions that carry out such transactions through greater risk-weighting factor could, in principle, restrict longer-term loans, thus encouraging contracts with shorter maturities or with greater down payments. The restriction of operations with longer maturities, although could represent an eventual disincentive for credit transactions in the automotive industry, is seen as an important mechanism for maintaining the sustainable development of the credit market in the country.

International economy 4

Table 4.1 – Major developed countries

GDP components and other indicators

Anualised % rate

	2008	2009				2010		
	IV	I	II	III	IV	I	II	III
GDP								
United States	-6.8	-4.9	-0.7	1.6	5.0	3.7	1.7	2.5
Euro Area	-7.0	-9.6	-0.6	1.6	0.8	1.5	4.0	1.5
United Kingdom	-8.1	-9.0	-3.1	-1.2	1.4	1.8	4.7	3.1
Japan	-11.9	-19.9	11.3	-1.2	5.7	6.8	3.0	4.5
Household consumption								
United States	-3.3	-0.5	-1.6	2.0	0.9	1.9	2.2	2.8
Euro Area	-1.9	-2.3	0.1	-0.7	1.2	1.0	0.9	1.0
United Kingdom	-6.0	-5.4	-2.9	-0.5	3.4	-0.1	2.7	1.0
Japan	-5.6	-7.7	6.1	0.9	2.4	2.4	1.2	4.9
Non-residencial investment								
United States	-22.7	-35.2	-7.5	-1.7	-1.4	7.8	17.2	10.3
Euro Area[1/]	-14.2	-19.2	-9.3	-4.4	-4.7	-1.0	7.1	0.1
United Kingdom	-5.0	-29.4	-37.2	-10.5	-13.5	35.6	2.8	-0.9
Japan	-22.9	-23.1	-18.7	-8.3	6.3	3.5	11.1	5.3
Residencial investment								
United States	-32.6	-36.2	-19.7	10.6	-0.8	-12.3	25.6	-27.5
Euro Area[2/]	-7.3	-2.8	-6.9	-6.9	-6.6	-6.5	3.2	-2.5
United Kingdom	-20.2	-45.8	-26.3	16.7	-18.7	1.7	53.6	nd
Japan	10.0	-23.4	-31.0	-29.0	-12.9	7.5	-3.1	5.0
Exports of goods and services								
United States	-21.9	-27.8	-1.0	12.2	24.4	11.4	9.1	6.3
Euro Area	-25.4	-28.4	-5.0	9.6	8.4	11.0	18.4	7.8
United Kingdom	-15.5	-29.4	-6.0	3.7	15.5	-2.8	9.4	9.3
Japan	-47.2	-68.1	46.8	43.2	21.1	32.0	24.6	10.2
Imports of goods and services								
United States	-22.9	-35.3	-10.6	21.9	4.9	11.2	33.5	16.8
Euro Area	-16.8	-27.0	-10.4	8.6	5.1	18.2	17.7	7.0
United Kingdom	-19.9	-26.6	-9.8	4.9	19.3	8.1	9.9	3.0
Japan	9.3	-49.2	-19.3	24.5	2.8	13.5	18.0	12.5
Government expenditures								
United States	1.5	-3.0	6.2	1.6	-1.4	-1.6	3.9	4.0
Euro Area[3/]	3.1	2.6	2.4	1.9	-0.3	0.3	0.5	1.5
United Kingdom	6.8	-0.8	1.8	2.1	3.8	2.5	-0.4	nd
Japan	3.2	5.6	11.7	3.4	3.3	-1.9	1.3	0.1
Manufacturing output								
United States	-18.3	-20.9	-8.5	10.9	7.2	7.1	9.9	4.6
Euro Area	-24.6	-32.2	-6.9	11.3	5.5	9.7	9.4	3.3
United Kingdom	-16.2	-19.3	-0.9	-4.1	1.4	6.6	5.0	1.6
Japan	-38.0	-59.5	29.4	22.8	26.1	30.9	6.1	-6.7
Unemployment rate[4/]								
United States	7.4	8.6	9.5	9.8	10.0	9.7	9.5	9.6
Euro Area	8.2	9.1	9.5	9.8	9.9	9.9	10.0	10.0
United Kingdom	6.4	7.1	7.8	7.9	7.8	8.0	7.8	7.7
Japan	4.4	4.8	5.3	5.3	5.2	5.0	5.3	5.0

Sources: BEA, Cabinet Office and Eurostat

1/ Includes residencial and public investment expenditures.

2/ Total construction expediture.

3/ Consumption expenditures exclusive

4/ End of the quarter rate.

Improvements in the activity indicators of the United States of America (USA) economy and the prospects for continued dynamism in the Chinese economy may, in the coming months, lead to the continuing recovery process of world economic growth. This process tends to be show in developed economies which record significant idle production factors and high unemployment rates, distinct characteristics to those that must be measured in emerging markets, where recent high prices for agricultural commodities have, in general, have fueled inflation in the economies that are undergoing a new expansion cycle. In this scenario, the central banks of the main developed economies have opted for maintaining the accommodating nature of monetary policy, and the monetary authorities of an increasing group of emerging economies have accelerated the process of normalization of the monetary policy.

It should be further noted that uncertainties about the development of the European fiscal crisis and the beginning of a new process of monetary easing in the USA favored the depreciation of the dollar and the overall increase in commodity prices, with implications for the volatility in international financial markets.

4.1 Economic Activity

The risk of entering into a new recession in major developed economies lessened. Accordingly, showing labor market recovery and continued expansion of private consumption, the annualized growth rate of Japan's GDP reached 4.5% in the quarter ending September, following marked expansions in the UK 3.1%; USA 2.5%; and in the Euro Area, 1.5%.

In the USA, the annualized growth rate of household consumption rose for the third consecutive time, reaching 2.8% in the quarter ending September. The growth of real disposable income reached 0.9%, contributing to the fall in the rate of household savings of 0.4 p.p. In the same period, the annualized growth rate of household consumption reached 1% in the Euro Area and United Kingdom and 4.9% in Japan, this showing the impact of introducing income transfer measures and the extension of incentives for durable goods consumption.

USA business investment, whilst slowing, grew by 10.3% in the quarter ending September, in line with the changes seen in Japan, 5.3%; the Euro Area, 0.1%; and the United Kingdom, -0.9%. Residential investments measured, respectively, 5% and -27.5% in Japan and the USA, in this case reflecting the lagged effect of suppressing, in April, government incentives for first home purchase.

In the USA, the external sector contributed -1.8 p.p. in annualized GDP growth for the quarter ending September, contrasting with impacts of 1.5 p.p., 0.3 p.p. and zero registered respectively in the United Kingdom, the Euro Area and Japan. Imports of goods and services registered a 16.8% annualized increase in the USA, in line with the expansions seen in Japan, 12.5%; the Euro Area, 7%; and the United Kingdom, 3%, highlighting that exports of goods and services in these economies experienced an annualized expansion of 6.3%, 10.2%, 7.8% and 9.3% respectively in the period.

Growth of USA manufacturing production registered an annualized rise of 4.6% in the quarter ending September, compared to 9.9% for that ending June. Rates for the Euro Area, Japan and the United Kingdom fell, in order, 9.4%, 6.1% and 5% to 3.3% -6.7% and 1.6% in the period. It should be noted, conversely, that, with the exception of Japan, the PMI for manufacturing activity[6] in November suggested an acceleration of activity in the sector, reaching 56.6 points in the USA, 55.3 points in the Euro Area, 58 points in the United Kingdom and 47.3 points in Japan.

In the USA, excluding federal government contracts[7], 269,000 jobs were created in the quarter ending November, compared to 239,000 for that ending August, and the unemployment rate rose to 9.8% in November. In the Euro Area, the recovery of economic activity generated 277,000 new jobs in the quarter ending September, against 253,000 in the quarter ending June. After six months of stability, the unemployment rate in this economy rose 0.1 p.p. to 10.1% in October. In Japan and the United Kingdom unemployment

Figure 4.1 – Manufacuring PMI
Largest developed economies

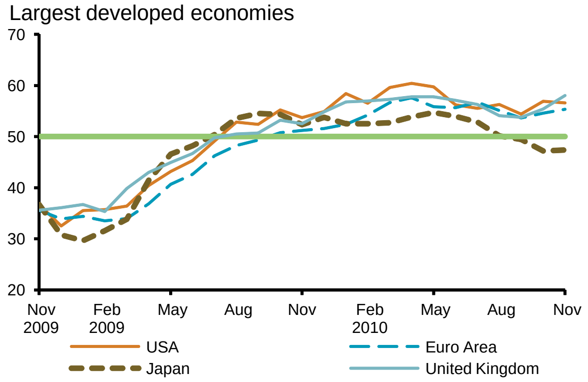
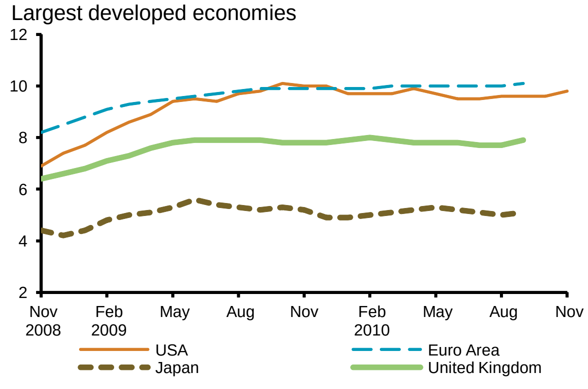


Figure 4.2 – Unemployment rate growth
Largest developed economies



6/ In the Euro Area, UK and Japan, the PMI is calculated by Markit and in the USA, by the Institute for Supply Management (ISM).

7/ A function of the effect of temporary hiring for census research conducted in 2010, the measure of the number of employed people excluding federal government is an alternative method for assessing the behavior of the labor market.

Table 4.2 – China

GDP components and other indicators

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

	2008	2009				2010		
	IV	I	II	III	IV	I	II	III
GDP	6.8	6.5	7.9	9.1	10.7	11.9	10.3	9.6
Retail sales	17.6	15.7	16.8	16.8	15.7	15.3	17.5	18.4
Vehicles sales[1/]	-8.2	3.6	31.6	73.8	85.7	72.5	29.0	15.9
Gross Fixed Capital Formation	25.3	38.8	50.2	47.4	29.8	22.8	20.1	20.6
Exports of Goods	4.4	-10.9	-9.1	-5.5	13.9	30.2	28.8	15.1
Imports of Goods	-2.4	-3.9	18.4	29.0	25.9	19.4	-1.4	-5.3
Industrial production	6.4	5.6	9.0	12.4	18.0	19.6	15.9	13.5
Unemployment rate[2/]	4.2	4.3	4.3	4.3	4.3	4.2	4.2	nd

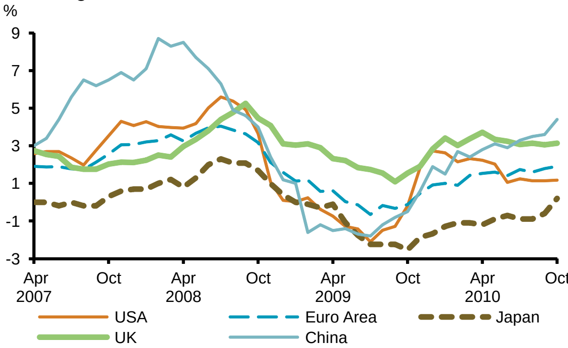
Source: Thomson

1/ Includes sales to enteprises.

2/ Urban unemployment rate at the end of the quarter.

Figure 4.3 – Consumer inflation

Annual growth



Sources: BLS, Eurostat, Bloomberg and ONS

rates stood at 5.1% and 7.9% in October, dropping 0.2 p.p. and advancing 0.1 p.p. respectively, compared to June.

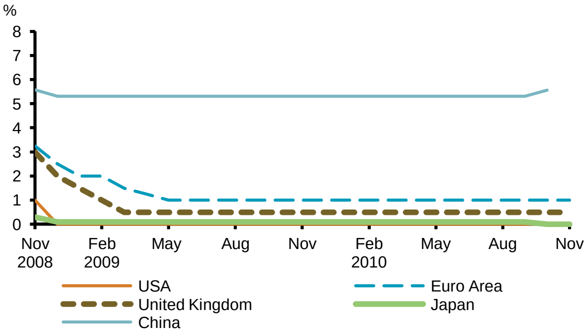
In China, GDP growth over twelve months amounted to 9.6% in the quarter ending September, against 10.3% for that ending June. Real retail sales, accelerating for the second consecutive quarter, rose 18.4% compared to 17.5% in the quarter ending June, despite the downturn from 29% to 15.9% in the rate of growth of vehicle sales. Gross fixed capital formation grew by 20.6% compared to 20.1% in the quarter ending June, whilst industrial production increased by 13.5% and 15.9% in the periods mentioned. Chinese exports grew by 15.1% in the quarter, while imports, in the same period in 2009, fell 5.3%, showing the impact of the policy of building up commodity stocks.

4.2 Monetary policy and inflation

The low capacity utilization rate and high unemployment rates favored maintaining the adjusting nature of monetary policy in developed economies. In the USA, where there are still risks of deflation, the Federal Reserve (Fed) began a new program of monetary easing (quantitative easing II), resulting in depreciation of the dollar and rising international commodity prices. In emerging economies, these high prices, together with the strengthening of domestic demand and the reduced output gap have led to price pressures. In China, the monetary authority intensified the suspension of the incentives introduced during the financial crisis of 2008/2009, and the outlook is for normalization of monetary conditions and securing of inflationary expectations.

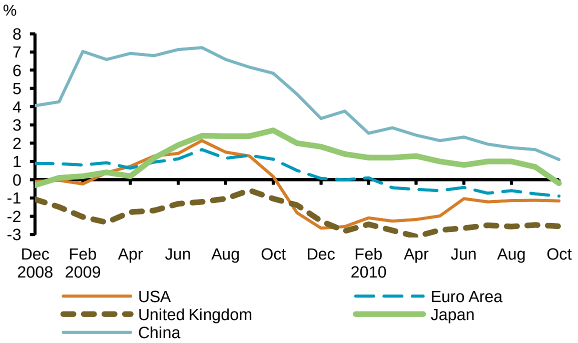
In the USA, the annual index of the IPC remained at a level of 1.2% in October, registering respective increases of 1.4% and 5.9% in food and energy prices. The annual core IPC variation, which excludes these segments, amounted to 0.6%, the lowest of the historical series which started in 1957, an inflationary trend associated with the still fragile recovery in economic activity, the shortage of credit and the high level of idleness in factors of production. Given this scenario, in November, the Fed held the limits of the fluctuation band for the Fed Funds target at 0% to 0.25%, but, recognizing that core inflation remains below the level considered ideal, and that labor and real estate markets remain depressed, the Federal Open Market Committee (FOMC), on November 3rd, decided on further expansion in the volume of assets on its balance sheet. In the new program of quantitative easing (quantitative easing II), to be completed by mid 2011, the

Figure 4.4 – Official interest rates
Annual rates



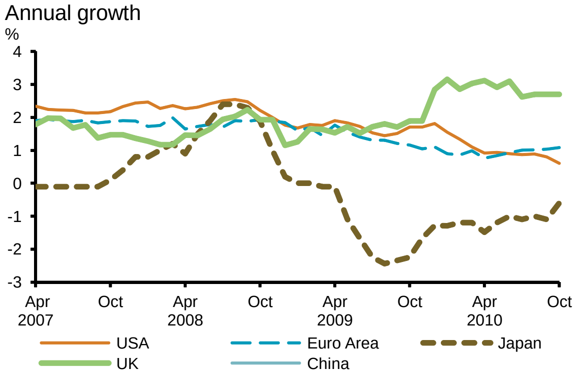
Sources: Fed, ECB, BoJ, Bank of England and The People`s Bank of China

Figure 4.5 – Real interest rates
Annual rates



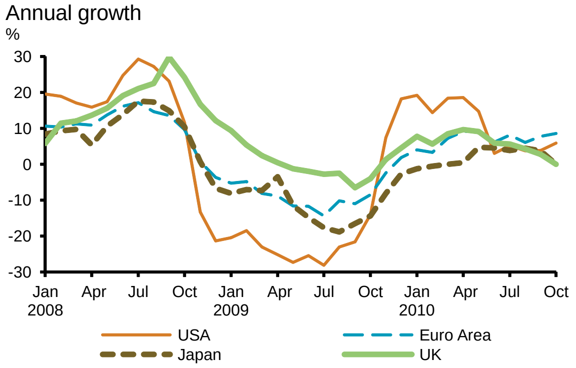
Sources: Fed, BCE, BoJ, BoE, BPC, BLS, Eurostat, ONS and Bloomberg

Figure 4.6 – Core consumer inflation
Annual growth



Sources: BLS, Eurostat, Bloomberg and ONS

Figure 4.7 – Energy inflation
Annual growth



Source: Thomson

Fed will buy another US$600 billion in long-term treasuries, thereby looking to increase inflationary expectations, reduce real interest rates and stimulate the local economy.

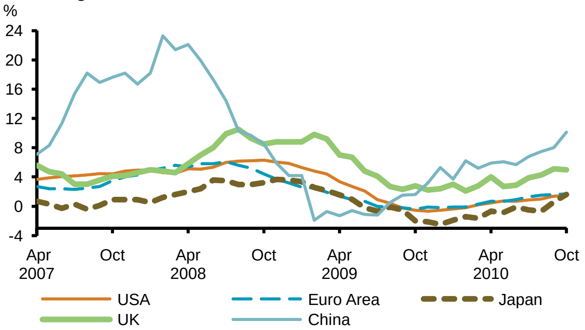
In Japan, although the annual variation of the IPC amounted to 0.2% in October, in a scenario of tax hikes and increasing perishable food prices, the development of core inflation continues to show the persistent deflationary process underway in the country. In this environment, aiming to give greater support to the economy, on October 5th the Bank of Japan (BoJ) announced a reduction in the benchmark interest rate of 0.1 % p.a. by the interval of 0.1% to 0%. Additionally, at the same time, it increased liquidity by creating an acquisition program of financial assets totaling ¥5 trillion, in addition to a ¥30 trillion program that provides funds for the banking sector, amounting to a single fund of ¥35 trillion. Among the assets eligible for purchase, within the 12-month interval, are long-term government securities, treasury bills, commercial papers and corporate bonds, including high-risk assets (high yields).

In the Euro Area, the annual IPC variation closed at 1.9% in October, driven by a rise of 8.5% in the price of energy. Although high, the IPC still falls within the comfort zone of the European Central Bank (ECB) of 1% to 2%. The annual IPC core variation hit 1.1% in October, remaining at around 1% since mid-2010. In this benign inflationary background and considering the recent recovery, albeit modest, of growth in credit and money supply, the ECB held the basic interest rate at 1% p.a. in November.

Unlike in the G3 economies, the United Kingdom inflation remains above the ceiling of the long-term inflation targeting, with the annual IPC variation coming to 3.2% in October, particularly impacted by service prices. Despite the prospects of rising short-term prices, especially due to the impact of the 2.5% rise on value-added tax, effective as of next January, the Bank of England (BoE) has kept unchanged the asset-purchasing program at £200 billion, and the basic interest rate at 0.5% p.a. This decision was based on the assumption that the IPC should drop into the target limits within a two-year horizon.

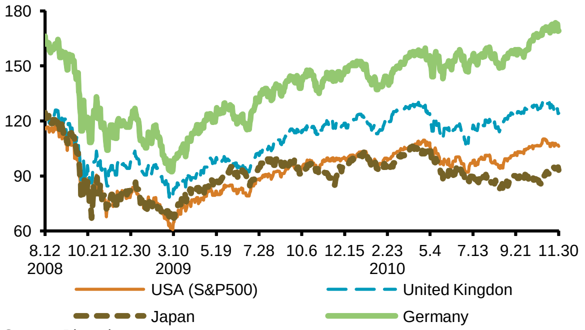
In China, the annual IPC variation, in an upward trajectory, came to 4.4% in October, with emphasis on the 10.1% increase in food prices. Pressured by the new monetary easing undertaken by the Fed, the recovery in domestic demand, the strong growth of credit and increasing prices of real estate assets and by the heightened inflationary expectations, the People’s Bank of China (PBC) intensified

Figure 4.8 – Food inflation[1/]
Annual growth



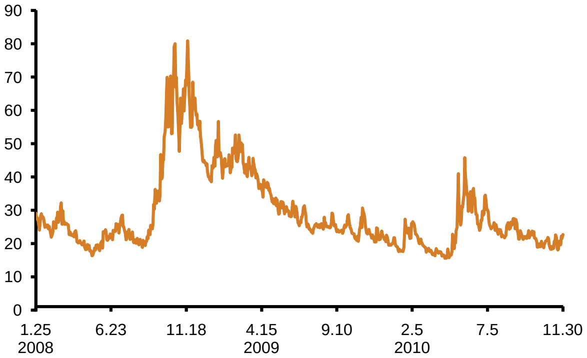
Source: Thomson
1/ For Euro Area and United Kingdom, data includes alcohol & tobacco.

Figure 4.9 – Stock exchanges: USA, Europe and Japan
12.31.2003 = 100



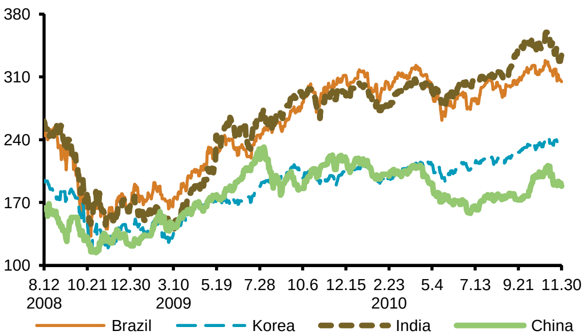
Source: Bloomberg

Figure 4.10 – VIX



Source: Thomson

Figure 4.11 – Stock exchanges: emerging markets
12.31.2003 = 100



Source: Bloomberg

its monetary policy normalization process. Thus, on October 19, the first rise in the basic interest rate since December 2007 was introduced, from 5.31% p.a. to 5.56%, and, on December 10, the sixth 0.5 p.p. increase in the year for the rate of reserve requirements.

4.3 International Financial Markets

The international financial markets, amid increased optimism about the recovery of the North American economy and the continuing dynamism of the Chinese economy, registered a reduction of volatility and recovery of asset prices in the quarter ending November. From mid-November on, however, the worsening fiscal situation in European countries started to influence the behavior of these markets and, thus, increase risk aversion and uncertainty regarding the trajectory of financial asset prices, particularly in the Euro Area.

Stock markets, still benefiting from the impact of good corporate results and the announcement of quantitative easing II in the USA, experienced significant recovery in the quarter ending November. The German Deutscher Aktienindex (DAX); Japanese Nikkei; USA's Standard and Poor's 500 (S&P 500); and the United Kingdom's Financial Times Securities Exchange Index (FTSE 100), accumulated respective gains of 13.2%, 12.6%, 12.5% and 6.5% in the period. It is worth noting that, after reaching the highest value of the year on October 5, the English, American and German indices fell respectively by 5%, 4% and 1% by the end of the quarter.

The Chicago Board Options Exchange Volatility Index (VIX) – which measures the implicit short-term volatility S&P 500 index – measured 22.7 points at the end of November, compared to 26 points at the end of August. The average value of the indicator was 21 points in the quarter ending November against 26.9 points in the quarter ending August.

The stock markets of the leading emerging economies also reported gains for the quarter ending November. The Korea Composite Stock Price Index (Kospi) of South Korea; Bombay Stock Exchange Sensitive Index (Sensex) of India; Shanghai Composite of China; and Ibovespa of Brazil accumulated respective highs of 9.3%, 8, 6%, 6.9% and 4.1% in the period, but, constrained by the factors that influenced the stock markets in the USA and Europe, fell from mid-November.

Figure 4.12 – Yield on government bonds – 10 years

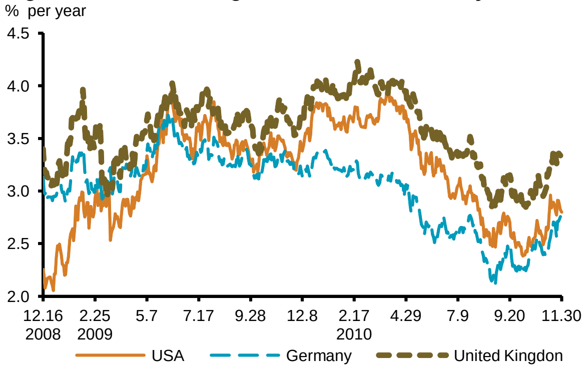
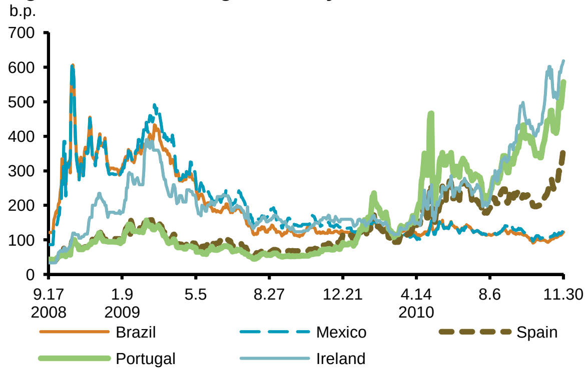
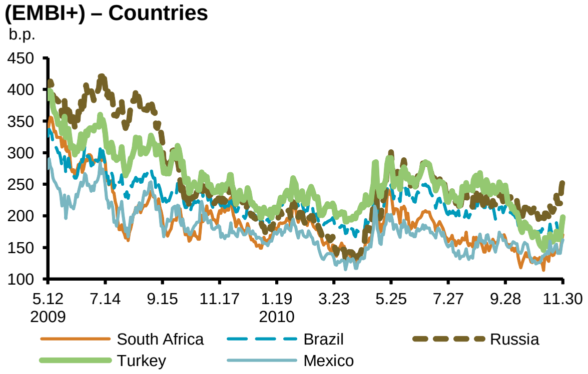


Figure 4.13 – Sovereign CDS 5 years



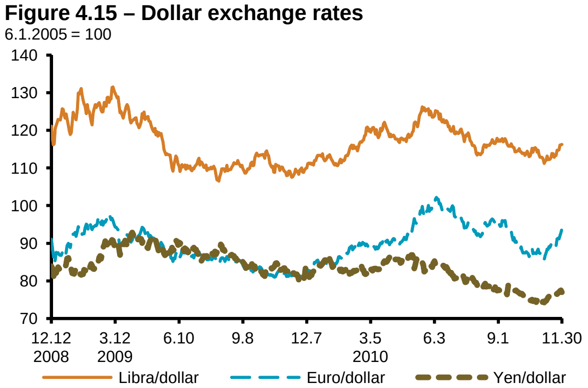
Source: Thomson

Figure 4.14 – Emerging Markets Bond Index Plus (EMBI+) – Countries



Source: Bloomberg

Figure 4.15 – Dollar exchange rates



Source: Bloomberg

Influenced by greater optimism about the US economy and the deterioration of the debt market in Europe, the annual income of ten-year securities of the developed economies rose in the quarter ending November, with securities of the USA, Germany and the United Kingdom achieving annual incomes of 2.8%, 2.7% and 3.3% respectively.

The worsening fiscal situation in some European countries once again became the focus of attention during the period. Despite the aid package from the IMF and the European Union to the Irish government, in the order of €85 billion, to capitalize the banking system and avoid the risk of sovereign default in the short-term, sovereign risk premiums, measured by the Credit Default Swaps (CDS), of Ireland, Portugal and Spain at the end of November hit 608 b.p., 532 b.p. and 343 b.p. respectively, the highest values of the historical series. In the same period, Brazil's sovereign CDS fell 13 b.p. to 119 b.p. Despite the worsening fiscal crisis of Europe, the Emerging Markets Bond Index Plus (Embi+), the sovereign risk indicator, fell 25 b.p. to 278 b.p., for the quarter ending November, emphasizing that the index concerning Brazil fell 35 b.p. to 198 b.p., despite the increase in the margin from the middle of that month.

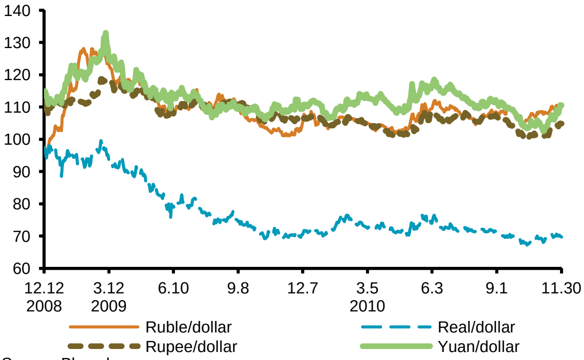
In the quarter, the US dollar registered depreciation against the euro of 2.3%; against the pound sterling, 1.4%; and the yen, 0.6%. For the emerging economies there were decreases in the price of the US currency against the Indian Rupee, 2.5%; the Real, 2.4%; and the Turkish Lira 1.5%; compared with an appreciation of 2.2% registered against the Russian Ruble.

4.4 Commodities

The Commodity Research Bureau Index (CRB), a measure of the behavior of commodity prices, recorded an increase of 6.4% in the quarter ending November, a result of dollar depreciation, improvement in indicators of consumption in many economies and the effects of adverse weather on agricultural product supply. It stands out that in a scenario of fears about the effects of monetary tightening in China, the fiscal sustainability of some European countries and profits in financial markets, commodity prices showed a strong correction in November. Still, taken as quarterly averages, in the quarter ending November, the CRB index registered respective increases of 12.2% and 25% compared to the quarters ending August 2010 and November 2009.

Figure 4.16 – Emerging markets currencies

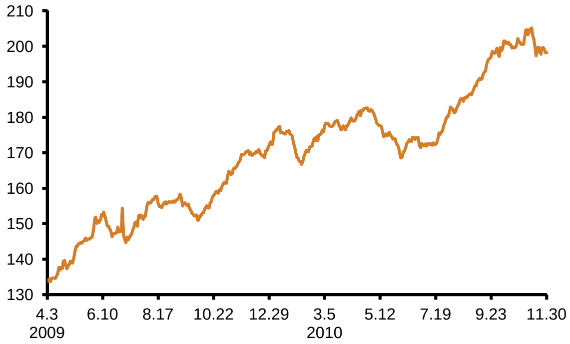
6.1 2005 = 100



Source: Bloomberg

Figure 4.17 – CRB index

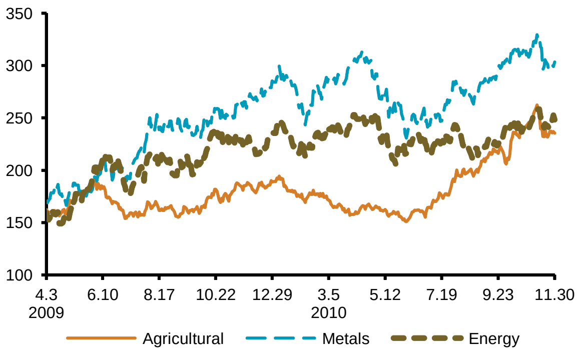
Jan/2003 = 100



Source: Commodity Research Bureau

Figure 4.18 – Commodity price index

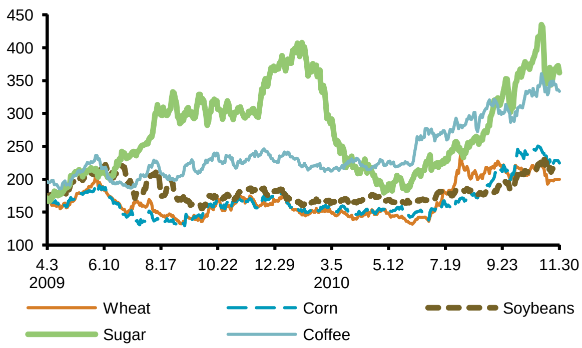
Jan/2003 = 100



Source: S&P GSCI

Figure 4.19 – Agricultural commodities

Jan/2003 = 100



Sources: NYB-ICE and Chicago Board of Trade

According to the index Goldman Sachs Commodity Index (GSCI), comprising Standard & Poor's together with the Goldman Sachs, commodity prices appreciated 15.4% in the quarter, reflecting respective variations of 18.9%, 10.8% and 15.8% in the segment indices of agricultural, metallic and energy commodities.

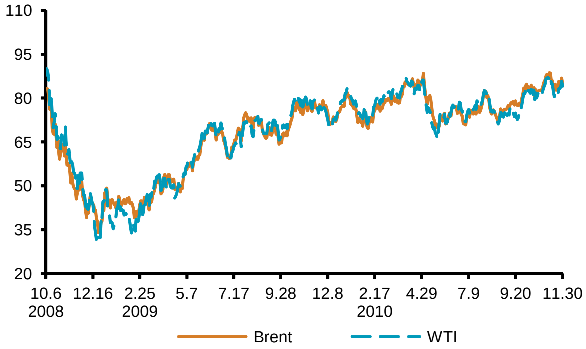
Prices of agricultural commodities maintained an upward trend that began in July, amid adverse climatic impacts on supply and the expansion of global liquidity. Concerns about damage to crops, which in July and August focused on Russia, have moved to the USA, where productivity fell to a lower than expected level, and to South America, where unfavorable weather conditions affected prospects for a successful crop outcome.

After accumulating a 40.4% rise between late June and late August, the futures contract for the first delivery of wheat traded on the Chicago Board of Trade (CBT), fell 0.3% in the quarter ending November. Also on the Chicago exchange, first delivery futures contracts of soybeans and corn showed respective rises of 23.3% and 24.9% in the quarter, reflecting in particular the low productivity of the North American harvest. The futures contracts for first delivery of sugar and coffee, traded on the New York Intercontinental Exchange (ICE), registered respective highs of 39.5% and 13.7% in the quarter. This development has been influenced by reduced world supply and the adverse weather in major exporters, especially in Brazil.

The metallic commodities segment registered, according to the London Metal Exchange (LME), increases in the prices of tin, 16.5%; copper, 13.3%; nickel 11.4%; aluminum, 10.4 %; and lead 8.3% in the quarter ending November. The price of 63.5% content iron ore increased 11.8% in the Chinese spot market in the period, according to Metal Bulletin, a development arising from problems in supply of the commodity by India and by the accumulation of stocks in Chinese steelworks, due to the low fixed price contract for the last quarter of 2010.

The average oil barrel price of Brent and WTI rose, respectively, from US$77.79 and US$75.26 in September to US$85.67 and US$84.19 in November. With a more favorable outlook concerning development of the global economy, particularly in the USA, the Department of Energy (DOE) of the US government increased its estimate for average prices of WTI barrel for the fourth quarter of 2010 and for 2011, from US$77.00 and US$82.00 respectively in September to US$82.63 and US$85.17 in November.

Figure 4.20 – Oil – Spot market
US$ per barrel



Source: Bloomberg

4.5 Conclusion

Emerging economies have shown faster growth rates than developed economies, but have needed to cope with inflationary pressures stemming from high commodity prices, the strengthening of domestic demand and the closing of the output gap. These factors altogether have influenced the withdrawal of monetary and fiscal stimulus introduced during the international financial crisis.

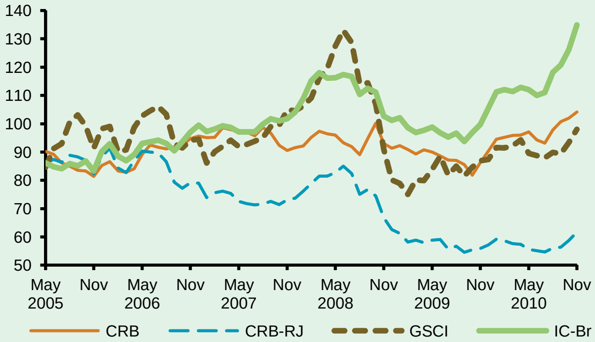
Conversely, the return to activity in the main developed economies, particularly in the USA, is taking place in an environment of idle production factors that, at least partly offsets the impact of increases in commodity prices on inflation indices and favors the maintenance of the accommodative stance of the monetary policy.

Transfer of Commodity Prices to the IPCA and Commodities Index-Brazil

Knowledge of the dynamics of commodity prices in the international markets has gained importance in recent years, given its potential impact on the dynamics of consumer prices in Brazil and, consequently, its impact on future prospects. In this context, this box presents the Commodities Index-Brazil (IC-Br)[1], which aims to identify the portion of commodity price variations in international markets that is relevant to the dynamics of domestic inflation. Furthermore, we present illustrations of how variations in the IC-Br are passed on to consumer prices.

Figure 1 shows the development of the IC-Br, as well as other commodity indices that are often referenced in macroeconomic analysis.

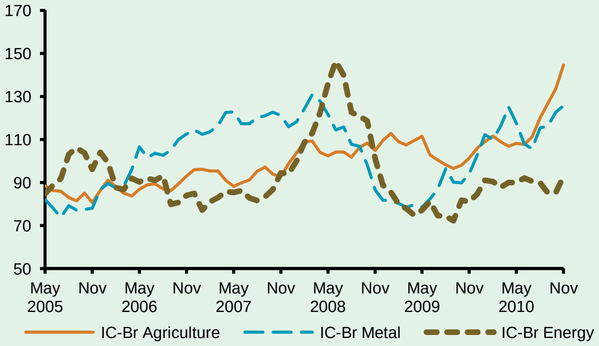
Figure 1 – IC-Br and other indices (R$)
Mar/2005 = 100



Sources: Commodity Research Bureau, Thomson Reuters, S&P GSCI and BCB.

In the basket that comprises the IC-Br, weightings were obtained from Autoregressive Vector models (VAR), constructed to estimate the transfer effect of each commodity price on inflation. Thus, it was possible to construct the IC-Br, and segment it into three sub-indices, IC-Br Agriculture, IC-Br Metal and IC-Br Energy, as seen in Figure 2.

Figure 2 – IC-Br segments (R$)
Mar/2005 = 100



Source: BCB

To estimate the transfer effect of the IC-Br on the Extended National Consumer Price Index (IPCA), VAR methodology was again looked to. Monthly data from the last five years was used, including; average monthly commodity prices in reais; the IC-Br, as a measure of economic activity; the Special System of Clearance and Custody (Selic) rate, as a monetary policy measure; the average monthly exchange rate variation; and inflation as measured by the IPCA. As such, it seeks to identify not just the direct impacts of

1/ The IC-Br aggregates the indicators regarding the segments of Crop and Livestock, Metal and Energy. The calculation of the Crop and Livestock index was based on the commodities beef, cotton, soybean oil, wheat, sugar, corn, coffee and pork. The Metal segment encompasses aluminum, iron ore, copper, tin, zinc, lead and nickel, whilst the Energy segment includes Brent oil, natural gas and coal.

Table 1 – Commodity price indexes

(changes % – measured in R$)

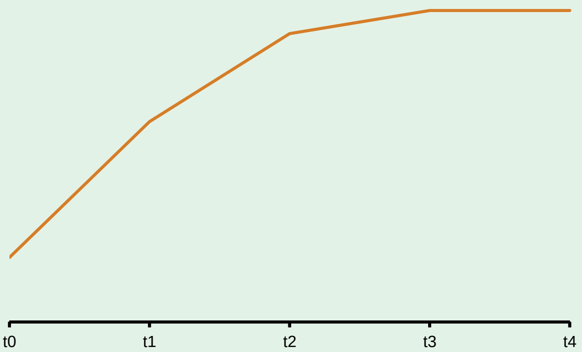
	2006	2007	2008	2009	2010[1]	Δ 12m[2]	Δ 3m[2]	Oct/2010	Nov/2010
IC-Br	6.2	7.4	-4.4	6.4	23.7	29.2	14.7	8.0	1.5
IC-Br Agriculture	8.0	3.7	10.5	-3.5	31.3	35.7	18.5	11.1	0.4
IC-Br Metal	28.0	1.7	-29.6	30.0	17.9	25.8	8.8	4.5	0.8
IC-Br Energy	-23.5	21.9	-11.9	2.3	8.1	12.7	11.3	3.9	5.2
S&P GSCI Composite	-8.1	17.2	-25.6	13.3	7.9	9.7	12.6	4.0	3.0
S&P GSCI Agriculture	18.6	17.6	4.5	-13.5	22.4	22.1	16.1	15.1	-3.2
S&P GSCI Industrial Metals	38.6	-25.6	-33.0	44.1	4.8	12.2	8.1	2.7	-0.6
S&P GSCI Energy	-16.5	26.9	-34.3	22.4	3.6	5.8	13.1	2.0	4.5
CRB	9.4	-4.9	-0.9	0.7	12.9	14.0	3.8	1.3	-0.4
CRB – Reuters Jefferies	-15.3	-2.7	-16.8	-6.9	4.5	6.1	11.4	5.5	1.1

Sources: Commodity Research Bureau, Thomson Reuters, S&P GSCI and BCB
1/ November/2010 compared to Dezember/2009.
2/ Until November/2010.

Figure 3 – Pass-through from IC-Br to IPCA

Source: BCB

Figure 4 – Pass-through from IC-Br to IPCA (accumulated)



Source: BCB

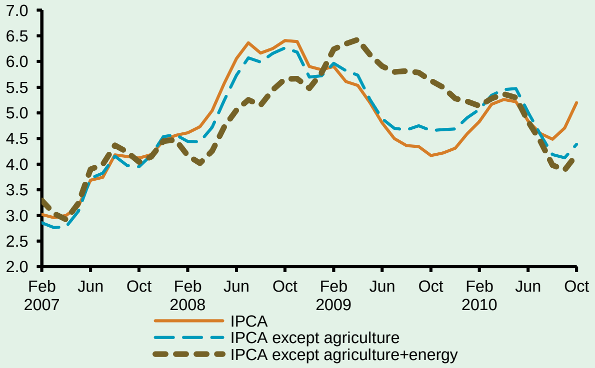
the increased production costs of finished goods, but also the secondary effects, namely the passing on of increased prices of some goods or services to others.

The estimated transfer effects of a price shock in the basket of commodities that makes up the IC-Br to the IPCA have been calculated based on responses to the impulse generated by the model. Figures 3 and 4 show the results obtained, considering the month-by-month development of the transfer effect of a price shock that occurred in t_0 (Figure 3) and the accumulated transfer effect (Figure 4).

Data indicate that the transfer effect of a IC-Br shock to the IPCA starts right in the first month in which the average price of the basket rises, reaches a peak in the following month, and levels to almost zero after the fifth month. Based on the estimated transfer effect, it was also possible to calculate the IPCA variation, excluding total or partial effects of IC-Br variation. It should be noted that this exclusion tends to identify a significant proportion of the secondary effects of shocks in commodity prices and is not simply a case of removing the components as is typically done in the calculation of measures of core inflation.

Recent developments in headline inflation, as well as the IPCA variation excluding the estimated effects of variation in the IC-Br sub-index for Crop and Livestock and the addition of this to the IC-Br Energy, are shown in Figure 5. Note that, after registering variations similar to the IPCA during 2007, the measures of exclusion showed less variation in 2008, when there was high growth

Figure 5 – IPCA ex-commodities



Sources: IBGE and BCB

in commodity prices in international markets. The decline in these prices, which followed the worsening of the global crisis, is seen in the third period, ending mid-2010, when the variation of the measures of exclusion was higher than the IPCA. A fourth period, starting in the second half of 2010, sees the IPCA variation more pronounced than that of the exclusion measures, a trend consistent with the rise in the international market of the prices of major agricultural and metallic commodities.

In summary, this box shows the IC-Br, the most useful indicator of commodity prices to understand the process of transfer effects of these prices on Brazil's inflation. The recent trajectory of the indicator confirms the view that there was a significant impact, in recent months, on the acceleration of the IPCA from rising commodity prices. Data also suggests that the transfer effect is exhausted by around the fifth month.

External sector

5

The faster growth rate of the Brazilian economy in comparison to other countries continued to influence the performance of current transactions, which registered a deficit of R$43.5 billion in the first eleven months of the year, as against R$18.4 billion in the same period of 2009.

Notwithstanding, net flows of FDI and stocks are expected to exceed the level registered in the previous year, at the same time that the rollover rates of medium and long-term debts are expected to reach 230%. Thus, since long-term capital has been the main source of balance of payments financing, favorable conditions persist for continued accumulation of international reserves and for the strengthening of the foreign balance.

The projections for the 2011 balance of payments, shown on a specific box, reflect the prospects for moderate recovery in the global economy and the persistence of net inflows of foreign investments in Brazil.

5.1 Exchange

Table 5.1 – Foreign exchange flows

US$ billion

	2009			2010	
	Nov	Jan-nov	Year	Nov	Jan-nov
Trade operations	1.5	11.1	9.9	0.5	-2.2
Exports	13.1	131.1	144.7	17.3	158.3
Imports	11.7	120.1	134.7	16.8	160.4
Financial operations[1/]	2.4	15.7	18.8	1.7	28.4
Purchases	24.9	297.1	336.3	27.3	325.2
Sales	22.4	281.4	317.4	25.6	296.8
Net flows	3.9	26.7	28.7	2.2	26.3

1/ Excluding interbank operations and Central Bank foreign operations.

The contracts carried out in the foreign exchange market registered a surplus of US$26.3 billion in the first eleven months of the year, compared to US$26.7 billion in the same period of the previous year. In the financial segment, reflecting the foreign credit scenario and the attractiveness of the Brazilian economy, foreign currency purchases increased by 9.5% and sales expanded 5.5%, resulting in a net inflow of US$28.4 billion, compared to US$15.7 billion in the first eleven months of 2009. Conversely, the balance of the trade exchange registered a deficit of US$2.2 billion, compared to a surplus of US$11.1 billion in the corresponding period of 2009. This turnaround was due to respective increases of 20.7% and 33.6% in export and import contracts.

Net Central Bank foreign currency purchases on the exchange spot market totaled US$39.3 billion in the year up to November. The position of banks on the spot exchange market, reflecting their clients' transactions and Central Bank interventions, changed from a long position at US$3.4 billion at the end of 2009 to short position at US$12.7 billion at the end November 2010.

Table 5.2 – Trade balance – FOB

US$ million

Period		Exports	Imports	Balance	Total trade
Jan-Nov	2010	180 998	166 059	14 939	347 057
Jan-Nov	2009	138 532	115 426	23 106	253 958
% change		30.7	43.9	-35.3	36.7

Source: MDIC/Secex

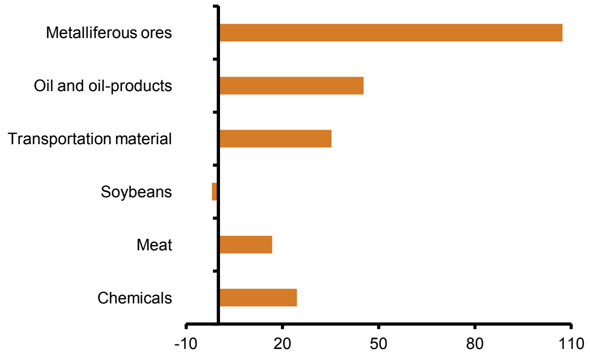
Table 5.3 – Exports by aggregate factor – FOB
Daily average – January-November

US$ million

	2009	2010	% change
Total	607.6	793.8	30.7
Primary products	251.0	352.5	40.4
Industrial products	343.9	425.2	23.6
Semimanufactured goods	81.2	112.0	38.0
Manufactured goods	262.8	313.3	19.2
Special operations	12.7	16.1	27.0

Source: MDIC/Secex

Figure 5.1 – Exports by major sectors
January-November – 2010/2009 – % growth



Source: MDIC/Secex

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

US$ million

	2009	2010	% change
Total	506.3	728.3	43.9
Capital goods	118.1	163.2	38.1
Raw materials	238.3	336.3	41.2
Naphtha	7.0	14.7	109.5
Consumer goods	84.4	124.9	48.0
Durable	45.1	73.8	63.4
Passenger vehicles	21.0	33.4	59.2
Nondurable	39.2	51.1	30.3
Fuels	65.5	103.9	58.7
Crude oil	35.9	40.9	13.8

Source: MDIC/Secex

5.2 Trade in goods

The trade balance figures continued to show the enhanced Brazilian economy dynamics, especially in the first half of the year, compared to the country's major foreign trading partners. Exports totaled US$181 billion and imports US$166 billion in the first eleven months of 2010, rising 30.7% and 43.9%, respectively, in comparison to the same period of the previous year.

Average daily exports grew 30.7% in the first eleven months of the year, compared to the corresponding period of the previous year, registering foreign sales expansion in all aggregate factor categories. The value of shipments of commodities and semi-manufactured products, driven by the recovery of commodity prices, increased by 40.4% and 38%, respectively, while that for manufactured products rose 19.2% on the same comparison basis. The share of commodity exports in the total of foreign sales increased by 3.1 p.p. to 44.4% in the period, contrasting with a fall of 3.8 p.p. to 39.5% in that for manufactured goods. It is important to note that this dynamic is essentially due to price movements, since in both cases the exported volume registered expansion.

Average daily imports increased 43.9% over the same period, reflecting expansion in purchases in all end use categories, with emphasis on those related to durable consumer goods, 63.4%, and fuels and lubricants, 58.7 %, reflecting respective increases of 13.8% and 113.4% in purchases of oil and other products in the category. The increase in Brazilian imports reflected greater purchases from China, 62%; Eastern Europe, 50.7%; and other Latin America and Caribbean countries, 47.8%.

The country's daily average trade reported widespread growth from January to November 2010, compared to the same period of the previous year, with emphasis on the respective growth rates of 47.2%, 43.8% and 39.4% in trade with Asia, Eastern Europe and the Mercosur. Regarding exports, it should be highlighted sales expansion to Asia, 38.5%, and to Latin America and the Caribbean countries, 35.9%.

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

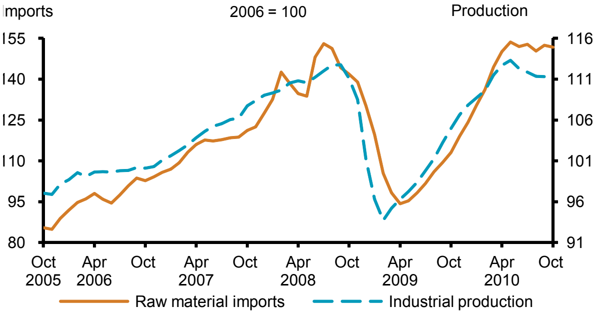
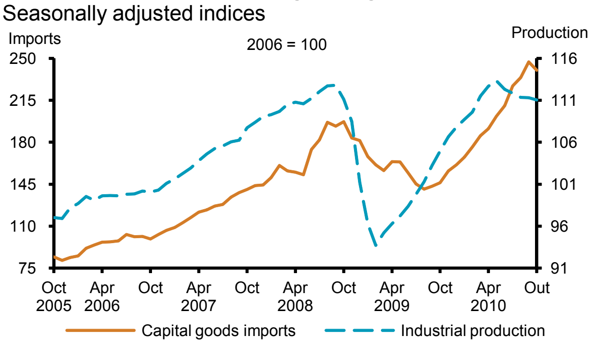
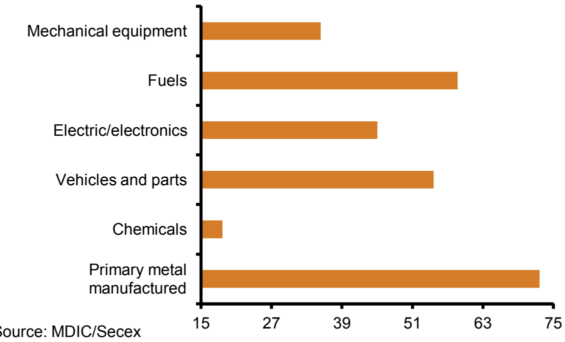


Figure 5.3 – Capital goods imports x industrial production – 3-month moving average
Seasonally adjusted indices



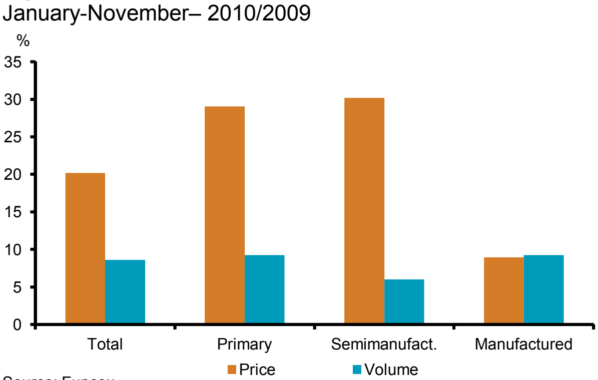
Sources: Funcex and IBGE

Figure 5.4 – Imports by major sectors
January-November – 2010/2009[1/] – % growth



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

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



Source: Funcex

According to the Foreign Trade Studies Center Foundation (Funcex), the 30.7% rise in exports from January to November 2010, compared to the same period of the previous year, resulted from increases of 20.2% in prices and 8.6% in exported volume. The price of semi-manufactured goods increased by 30.2%, followed by commodities, 29%, and manufactured goods, 8.9%, while exported volume in the categories mentioned increased, in the order, 6%, 9.2% and 9.3%.

The growth of 43.9% under imports in the period mainly reflected the 40.2% increase in the volume imported, with emphasis on the performance of consumer durables, 56.8%; capital goods, 44.2%; and raw materials and intermediate goods, 37.8%. Prices of imported goods in U.S. dollars rose 2.6% in the first eleven months of the year, highlighting increases observed in the categories of fuels and lubricants, 22.5%, nondurable consumer goods, 11.6%, contrasting with the decrease of 4.1% in the price of capital goods.

5.3 Services and income

The current account deficit totaled US$43.4 billion in the first eleven months of the year, compared to US$18.4 billion in the same period of 2009, due to the drop in the trade balance and the increase in net spending on services and income. In twelve months, the current account deficit totaled US$49.4 billion in November, equivalent to 2.43% of GDP.

Net remittances in the service account rose 63.3% in the period, to US$28.2 billion, with emphasis on the increase of 91.1% in net expenditures on international travel, which, driven by income gains and exchange rate appreciation in the period, reached US$9.4 billion. Net expenditures on equipment rental increased 42.1% to a total of US$12.3 billion.

Net income account expenditures increased by 20.4%, to US$32.8 billion, while net expenditures on interests rose 3.9%, totaling US$8.2 billion. It should be emphasized the 16.3% falloff in revenues, which, in an environment of low international interest rates, totaled US$5.1 billion.

Net remittances of profits and dividends totaled US$25 billion, for a 25.8% increase in the period. The sectors of industry and services accounted for respective 57.5% and 40.2% of gross remittances of FDI profits and dividends, highlighting those associated with the automotive, financial services and chemical products sectors.

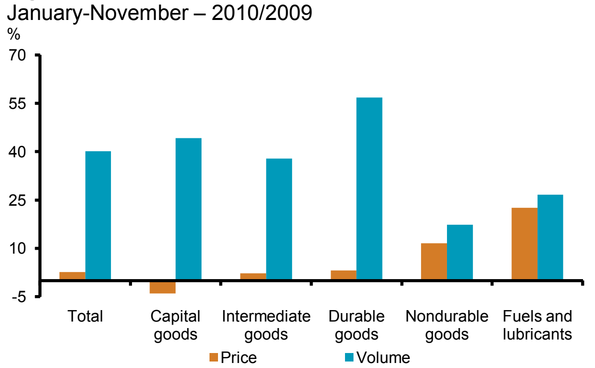
Table 5.5 – Exports and imports by area – FOB
Daily average – January-November

US$ million

	Exports			Imports			Balance	
	2009	2010	% change	2009	2010	% change	2009	2010
Total	608	794	30.7	506	728	43.9	101	66
L.A. and Caribe	137	186	35.9	89	122	36.6	48	64
Mercosur	59	88	49.1	51	66	28.3	8	22
Argentina	47	72	52.4	44	57	30.0	3	15
Other	12	16	35.7	7	9	18.0	5	8
Other	78	98	25.9	38	56	47.8	40	42
USA[1/]	63	75	19.3	81	110	35.5	-18	-35
EU	136	169	24.0	115	156	35.5	21	13
E. Europe	14	19	39.7	8	12	50.7	5	7
Asia	162	225	38.5	144	226	56.9	18	-1
China	87	124	41.6	63	103	62.0	24	21
Other	75	101	34.8	81	123	52.9	-5	-22
Others	95	120	25.6	68	102	49.0	27	18

Source: MDIC/Secex
1/ Includes Puerto Rico.

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



Sources: MDIC and BCB

Table 5.6 – Current account

US$ billion

	2009			2010			2011
	Nov	Jan-nov	Year	Nov	Jan-nov	Year[1/]	Year[1/]
Current account	-3.3	-18.4	-24.3	-4.7	-43.4	-49.0	-64.0
Trade balance	0.6	23.1	25.3	0.3	14.9	17.0	11.0
Exports	12.7	138.5	153.0	17.7	181.0	198.0	235.0
Imports	12.0	115.4	127.7	17.4	166.1	181.0	224.0
Services	-1.8	-17.3	-19.2	-2.8	-28.2	-31.1	-35.0
Transportation	-0.4	-3.5	-3.9	-0.6	-6.0	-6.5	-7.2
International travel	-0.5	-4.9	-5.6	-1.0	-9.4	-10.5	-12.0
Computer and inform.	-0.2	-2.3	-2.6	-0.3	-2.9	-3.3	-3.8
Operational leasing	-0.8	-8.6	-9.4	-1.2	-12.3	-13.5	-14.5
Other	0.1	2.1	2.3	0.3	2.4	2.6	2.5
Income	-2.3	-27.2	-33.7	-2.5	-32.8	-37.6	-43.0
Interest	-0.4	-7.9	-9.1	-0.6	-8.2	-9.5	-10.6
Profits and dividends	-2.0	-19.9	-25.2	-1.9	-25.0	-28.7	-33.0
Compensation of employees	0.0	0.5	0.6	0.0	0.4	0.6	0.6
Current transfers	0.2	3.1	3.3	0.2	2.6	2.7	3.0

1/ Forecast.

Net unilateral transfers reached US$2.6 billion in the first eleven months of 2010, compared to US$3.1 billion in the same period of the previous year. Net inflows of remittances for maintenance of residents totaled US$1.2 billion, compared to US$1.4 billion in the same period in 2009.

5.4 Financial Account

The capital and financial account registered a surplus of US$90.7 billion in the first eleven months of the year.

Brazilian direct investments abroad accumulated net investments of US$6.5 billion in the first eleven months of 2010. Brazilian companies have resumed their internationalization process, with net investments of US$20.3 billion under the equity participation modality. Net repayments of loans to foreign subsidiaries totaled US$13.8 billion.

Net FDI inflows amounted to US$33.1 billion in the period, compared to US$20.8 billion in the first eleven months of 2009. This performance signals that, in spite of the persistent sub-potential growth in major economies and its effect on the ability of their companies to carry out investments, the favorable medium and long-term economic outlook in Brazil continued to attract significant flows of investment. Net inflows of equity capital totaled US$26.8 billion, for growth of 74.3% in the period, while intercompany loans registered disbursements of US$6.4 billion. In twelve months, FDI totaled US$38.2 billion up to October, accounting for 1.88% of GDP.

Net inflows of foreign portfolio investments totaled US$61.7 billion from January to November 2010, compared to US$43.1 billion in the same period in 2009. Foreign investments in shares of Brazilian companies totaled net inflows of US$35.7 billion, compared to US$33.6 billion in the equivalent period of 2009. Meanwhile, fixed income securities traded in the country registered net inflows of US$14.8 billion, compared to US$9.2 billion in the previous period. National Treasury securities traded abroad registered net repayments of US$3.1 billion in the period, including disbursements related to the issue of Global 21, US$788 million; at its reopening, US$825 million; and reopenings of Global 41, US$550 million, and Global BRL28, US$655 million. The National Treasury, proceeding with the policy aimed at improving the profile of the foreign public debt, carried out anticipated redemptions of US$3.8 billion in the period, of which US$2.9 billion referring to the face value of bonds and US$869 million to premiums.

Table 5.7 – Financial account

US$ billion

	2009			2010			2011
	Nov	Jan-nov	Year	Nov	Jan-nov	Year 1/	Year 1/
Capital account	6.0	56.9	70.2	7.7	89.7	93.9	67.8
Direct investments	2.4	26.7	36.0	4.8	26.6	30.5	29.0
Abroad	0.8	5.8	10.1	1.1	-6.5	-7.5	-16.0
In Brazil	1.6	20.8	25.9	3.7	33.1	38.0	45.0
Equity capital	1.0	15.4	19.9	2.4	26.8	29.8	35.0
Intercompany loans	0.6	5.5	6.0	1.4	6.4	8.2	10.0
Portfolio investments	3.6	42.5	50.3	3.0	64.2	64.6	41.0
Assets	0.4	-0.5	4.1	1.3	2.5	2.0	-
Liabilities	3.3	43.1	46.2	1.7	61.7	63.1	41.0
Derivatives	0.0	0.2	0.2	0.0	-0.1	-	-
Other investments	0.0	-12.5	-16.3	-0.1	-1.0	-1.2	-2.2
Assets	0.5	-28.0	-30.4	-3.0	-47.5	-52.6	-18.0
Liabilities	-0.5	15.5	14.1	2.9	46.4	51.4	15.8

1/ Forecast.

Table 5.8 – BP financing sources

Selected items

US$ billion

	2009			2010			2011
	Nov	Jan-nov	Year	Nov	Jan-nov	Year 1/	Year 1/
Medium and long-term funds	1.2	13.9	15.7	1.7	31.4	36.1	19.9
Public bonds	0.0	3.6	4.1	0.0	2.8	2.8	-
Private debt securities	0.9	7.6	8.5	0.8	18.7	22.1	8.6
Direct loans	0.3	2.7	3.1	0.9	9.9	11.2	11.3
Short-term loans (net) 2/	-1.6	-0.6	-2.2	1.0	22.1	23.5	-
Short-term sec. (net)	0.0	-0.6	-0.6	0.1	4.1	4.1	-
Portfolio in the country (net)	2.8	37.9	42.2	2.0	43.3	51.3	40.0
Roll-over rates 3/							
Total	262%	95%	88%	367%	239%	230%	150%
Debt securit.	517%	105%	95%	290%	223%	220%	150%
Direct loans	99%	75%	72%	472%	274%	250%	150%

1/ Forecast.
2/ Includes direct loans and trade credits transferred by banks.
3/ Corresponds to the ratio between direct loans and medium-and long-term amortizations. Excludes amortizations resulting from debt/equity conversion.

The rollover rate of medium and long-term loans to businesses traded abroad reached 239% in the year up to November, compared to 95% in the equivalent period of 2009. Net inflows of notes and commercial papers totaled US$10.3 billion, with disbursements of US$18.7 billion and repayments of US$8.4 billion, for a rollover rate of 223% in the period. Short-term securities showed net disbursements of US$4.1 billion.

Other Brazilian investments registered net increases in foreign assets of US$47.5 billion in the year up to November, while Brazilian banks deposits abroad fell by US$302 million and those held by the nonfinancial sector increased by US$5.8 billion. Net foreign loan disbursements, including commercial credits, totaled US$41.2 billion in the period.

Other foreign investments, including operations with international bodies and agencies, direct bank loans, commercial credits and deposits, showed net disbursements of US$46.4 billion in the first eleven months of the year, compared with US$15.5 billion in the same period in 2009. Net inflows of long-term loans totaled US$15.8 billion, highlighting the net loans granted by agencies, US$3.8 billion, and by buyers, US$3.7 billion. Direct mid and long-term loans registered net disbursements of US$6.2 billion, for a rollover rate of 274%, while short-term loans totaled US$22.1 billion.

In November, international reserves totaled US$285.5 billion, up US$46.9 billion compared to December 2009. Central Bank net purchases on the foreign exchange market amounted to US$39.8 billion in the year, of which US$39.3 billion referring to spot market operations and US$535 million to the amortization of the remaining balance of foreign currency loans. In addition, it should be mentioned the impacts of issues of sovereign bonds, US$1.2 billion; earnings on international reserves, US$3.6 billion; and other operations, US$2.3 billion.

5.5 External sustainability indicators

External sustainability indicators showed divergent trends during the period from December 2009 to November 2010, a trajectory consistent with the accentuated increase in the level of international reserves, 19.7%; of GDP evaluated in US dollars, 27.2%; in exports of goods, 27.8%; in total foreign debt, 24.7%, and its respective service, 10.5%. The creditor position of total net foreign debt fell by US$3.4 billion in the period to US$58.3 billion.

Table 5.9 – Statement of international reserves

US$ billion

	2009		2010		2011
	Jan-Nov	Year	Jan-Nov	Year[1/]	Year[1/]
Reserve position in previous period	193.8	193.8	238.5	238.5	285.8
Net Banco Central purchases	32.2	36.5	39.8	39.8	-
Spot	20.6	24.0	39.3	39.3	-
Repo lines of credit	8.3	8.3	-	-	-
Foreign currency loans	3.3	4.2	0.5	0.5	-
Debt servicing (net)	-2.4	-2.2	-5.3	-5.3	-0.6
Interest	0.4	0.7	-0.2	0.1	1.2
Credit	4.4	4.8	3.6	4.0	4.8
Debit	-4.0	-4.0	-3.9	-3.9	-3.6
Amortization	-2.8	-2.9	-5.1	-5.4	-1.9
Disbursements	1.8	1.8	1.2	1.2	-
Multilateral organizations	-	-	-	-	-
Sovereign bonds	1.8	1.8	1.2	1.2	-
Others[2/]	4.4	1.7	2.3	2.3	-
Treasury's purchases	6.8	7.0	8.9	9.3	5.4
Change in assets	42.9	44.7	46.9	47.3	4.8
Gross reserve position	236.7	238.5	285.5	285.8	290.6
Repo lines of credit position	-	-	-	-	-
Foreign currency loans position	1.3	0.5	-	-	-
Reserves position – liquidity	238.0	239.1	285.5	285.8	290.6

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.

The ratio of total foreign debt/GDP fell from 12.4% in December 2009 to 12.2%, while the ratio between the total net foreign debt to GDP moved from -3.9% to -2.9%.

The increase in foreign debt service at a level below that of exports contributed to the decrease in the debt service/total exports ratio by 3.8 p.p. to 24.6% in November. The total debt/exports ratio stood at 1.3, while the total net debt/exports moved from -0.4 to -0.3. In the same period, the international reserves/total foreign debt ratio fell from 120.6% to 115.5%.

5.6 Conclusion

In 2010, financial flows do not only permit the balance of payments financing, but also the accumulation of reserves. Forecasts for the balance of payments in 2011 reflect expectations of a slower recovery in the global economy and the maintenance of the expansion cycle of the Brazilian economy. Thus, the current account deficit should increase, driven by expanded demand for imports of goods and services and the prospect of greater net remittances of services as well as of profits and dividends.

However, it should be mentioned that the expected trajectory for current account transactions does not imply restrictions to the balance of payments financing. As demonstrated by the projections shown in a separate Box, the prospects point out for an increase in net flows of foreign direct investments with no obstacles to the rollover of public and private external liabilities, albeit at lower rates than 2010.

Table 5.10 – Sustainability indicators[1/]

US$ billion

	2009		2010			
	Jun	Dec	Mar	Jun	Sep	Nov[2/]
Exports of goods	158.9	153.0	161.0	172.2	186.1	195.5
Exports of goods						
and services	186.6	180.7	189.8	202.1	216.6	226.5
Debt service	41.3	43.6	47.4	47.0	48.3	48.1
Total external debt	204.9	198.2	211.5	228.6	247.8	247.1
Net external debt	-37.8	-61.8	-49.5	-42.2	-44.9	-58.3
International reserves						
Cash concept	221.6	238.5	243.8	253.1	275.2	285.5
Liquidity concept	224.2	239.1	244.0	253.1	275.2	285.5
GDP	1 489	1 598	1 798	1 971	2 033	2 033
Indicators						
Total external debt/GDP (%)	13.8	12.4	11.8	11.6	12.2	12.2
Net external debt/GDP (%)	-2.5	-3.9	-2.8	-2.1	-2.2	-2.9
Total external debt/exports	1.3	1.3	1.3	1.3	1.3	1.3
Total external debt/exports						
of goods and services	1.1	1.1	1.1	1.1	1.1	1.1
Net external debt/exports	-0.2	-0.4	-0.3	-0.2	-0.2	-0.3
Net external debt/exports						
of goods and services	-0.2	-0.3	-0.3	-0.2	-0.2	-0.3
Debt service/exports (%)	26.0	28.5	29.4	27.3	26.0	24.6
Debt service/exports of						
goods and services (%)	22.1	24.1	25.0	23.2	22.3	21.3
Reserves – cash concept/						
total external debt (%)	108.1	120.3	115.2	110.7	111.1	115.5
Reserves – liquidity concept/						
total external debt (%)	109.4	120.6	115.3	110.7	111.1	115.5

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

Balance of Payment Projections

This box introduces a review of projections for the balance of payments in 2010 and 2011. Reviews looked at data gathered since the Inflation Report of last September, current updates regarding trends in the global and national economic outlook, the most recent statistics regarding the stock of national foreign indebtedness and its servicing, and repurchases of sovereign debt by the National Treasury.

The projection for the current account deficit remained at US$49 billion, a level that has remained constant since the March Inflation Report. There was, however, a rise in the projection for trade surplus and a reduction in expected net remittances of profits and dividends, at the same time as an expansion in the services account deficit and a decrease in net revenue with unilateral transfers.

The trade balance in 2010 rose from US$15 billion, estimated in the previous Inflation Report, to US$17 billion, already accumulating US$16.7 billion by the third week of December. This change occurred due to an increase in exports forecast for the year, from US$192 billion to US$198 billion, boosted by the favorable international scenario for price increases of Brazilian products abroad. The forecast for imports increased from US$177 billion to US$181 billion, due to the faster expansion of import volume.

The deficit in the category of services increased from US$26.7 billion in the previous Inflation Report, to US$31.1 billion, mainly due to the revision of net expenditures in accounts for equipment rental, transportation and international travel. The dynamism of the domestic economy and investments were reflected in an increase of US$2.5 billion in the forecast for net remittances of equipment rental,

Table 1 – Uses and sources

US$ billion

	2009			2010			2011
	Nov	Jan-nov	Year	Nov	Jan-nov	Year[1/]	Year[1/]
Uses	-5.4	-43.0	-54.4	-7.4	-74.2	-82.7	-92.9
Current account	-3.3	-18.4	-24.3	-4.7	-43.5	-49.0	-64.0
Amortizations ML-term[2/]	-2.1	-24.7	-30.1	-2.7	-30.8	-33.7	-28.9
Securities	-0.5	-10.3	-13.0	-1.1	-14.4	-15.6	-7.6
Suppliers' credits	-0.3	-3.4	-3.8	-0.2	-3.7	-3.8	-3.6
Direct loans[3/]	-1.4	-10.9	-13.3	-1.3	-12.7	-14.3	-17.8
Sources	5.4	43.0	54.4	7.4	74.2	82.7	92.9
Capital account	0.1	1.0	1.1	0.1	1.0	1.1	1.0
FDI	1.6	20.8	25.9	3.7	33.1	38.0	45.0
Domestic securities	2.8	42.8	47.1	2.0	50.4	51.3	40.0
and equities[4/]	2.9	27.9	35.8	3.5	52.9	58.3	45.8
ML-term disbursem.[5/]	0.9	11.2	12.6	0.8	21.5	23.3	8.6
Securities	0.2	2.3	2.7	0.2	2.9	4.7	6.9
Supliers' credits	1.9	14.5	20.5	2.5	28.5	30.3	30.3
Loans[6/]	1.7	-22.4	-15.8	-0.6	-51.4	-58.6	-34.0
Brazilian assets abroad	0.1	15.0	6.9	1.6	34.4	39.3	-
Other[7/]	-3.9	-42.2	-46.7	-3.0	-46.3	-46.7	-4.8
Reserve assets							

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 and omissions.

which totaled US$13.5 billion. Expansion of trade flow was largely responsible for the increase of US$1.5 billion in the forecast for net payments abroad for transportation, which should total US$6.5 billion in the year. Net spending on international travel increased from US$10 billion to US$10.5 billion.

Net interest expenses increased by US$0.1 billion to US$9.5 billion, while those relating to profits and dividends were reduced from US$32 billion to US$28.7 billion, representing growth of 13.8% compared to 2009. Still reflecting the impacts of the international crisis on the labor market of developed countries, the projection for unilateral transfers, consisting mainly of remittances for resident maintenance, dropped to US$2.7 billion this year.

The estimated surplus for the financial account was raised to US$93.9 billion, a reduction in the projection for net Brazilian direct investment abroad and increases in net inflows of Foreign Direct Investment (FDI), in portfolio investments and in rollover rates. The projection for Brazilian direct investment was reduced from US$12 billion to US$7.5 billion, while that for FDI increased from US$30 billion to US$38 billion, returning to the value forecast in the June Inflation Report, due to the acceleration of these investments in recent months.

Among portfolio investments, it is worth noting the increase in the projection for net inflows of foreign investment in shares and fixed-income in the country. With the conclusion of recent share offerings, this projection has moved from US$38 billion to US$51.3 billion.

Likewise, the typical access of resident corporations to international financial markets is materialized in disbursements more than sufficient to meet the depreciation in the period. Accordingly, the projection for the rollover rate for national foreign debt, which reached 239% by November, was revised upward from 175% to 230%. Thus, disbursements in the year were increased from US$11.9 billion to US$58.3 billion.

Finally, the projection for inflows of foreign short-term investments, including securities, commercial credits and loans, moved from US$32 billion to US$39.3 billion.

Table 2 – Balance of payments – Market

US$ billion

	2009			2010			2011
	Nov	Jan-nov	Year	Nov	Jan-nov	Year[1/]	Year[1/]
Current account	-3.6	-22.8	-29.1	-5.1	-47.1	-53.0	-68.8
Capital (net)	8.5	60.2	67.5	6.9	87.5	93.4	74.9
Foreign direct investment	1.6	20.8	25.9	3.7	33.1	38.0	45.0
Portfolio investment	2.8	42.6	46.7	2.0	49.3	49.7	38.0
ML-term loans	0.3	-0.4	1.0	1.1	17.7	19.1	8.4
Trade credits – Short, medium and long-term	-1.0	10.0	5.8	2.1	34.4	37.8	8.4
Banks	-1.0	2.5	1.7	1.3	25.8	26.0	5.2
Other	0.1	7.5	4.1	0.8	8.6	11.9	3.3
Brazilian invest. abroad	3.1	-17.2	-14.0	-1.1	-50.8	-58.0	-28.0
Other	1.7	4.4	1.9	-0.9	3.9	6.8	3.0
Financial gap	4.9	37.4	38.4	1.8	40.4	40.4	6.0
Banco Central net interv.	-3.4	-32.2	-36.5	-2.4	-39.8	-39.8	-
Bank assets	-1.4	-5.2	-1.9	0.6	-0.6	-0.6	-6.0

1/ Forecast.

In this scenario, the financing gap for the balance of payments in the market is expected to reach a total surplus of US$40.4 billion, compared with US$19.5 billion in the previous projection. Of this total, the Central Bank will absorb, based only on transactions carried out up to November, US$39.8 billion, while the banking sector will expand assets abroad by US$0.6 billion.

Regarding 2011, there was an increase in the deficit projection for current transactions compared to the previous report, from US$60 billion to US$64 billion, equivalent to 2.85% of Gross Domestic Product (GDP). The trade surplus was maintained at US$11 billion, with increases in the values of exports and imports to US$235 billion and US$224 billion, respectively.

The deficit in the services account expanded from US$30.1 billion to US$35 billion, with increases in net expenditures on equipment rental, travel and transportation ofUS$14.5 billion, US$12 billion and US$7.2 billion, in that order.

Additionally, there were reductions both in net remittances of profits and dividends, from US$36 billion to US$33 billion, and inflows of unilateral transfers, from US$4 billion to US$3 billion. In both cases, such revisions in projections were due to a lower than expected performance, maintained in the prospects for the next year.

Projections for direct investments, both Brazilian investments abroad, and foreign investment in the country, remained unchanged at US$16 billion and US$45 billion respectively. The rollover rate also remained steady at 150%. Investments in domestic securities and shares have increased from US$36 billion, in the September projection, to US$40 billion.

In this scenario, the financial gap in the balance of payments of the market should again be a surplus, totaling US$6 billion in 2011.

Inflation Outlook

6

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 September 2010. The chapter also presents the analysis of the inflation prospects up to the fourth quarter of 2012 and of Gross Domestic Product (GDP) growth up to the end of 2011. Inflation projections are presented in two major scenarios. The first scenario, called the baseline scenario, assumes that the Selic rate will remain unchanged at 10.75% per year over the forecasting horizon, the level defined by Copom at its most recent meeting, held on December 7 and 8, and that the exchange rate will remain at R$1.70 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 the Central Bank's Investor Relations 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 December 10, 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 change in the Broad National Consumer Price Index (IPCA), after reaching 4.31% in 2009, 1.59 percentage points (p.p.) lower than in 2008, rose again in 2010. In the year up to November, the IPCA index increased by 5.25%, a rate 1.32 p.p. above that recorded in the same period last year. Twelve-month inflation increased from 4.22% in November 2009 to 4.49% in August, and 5.63% in November this year, above the center of the inflation target (4.5%). Thus, although inflation receded from June to August, inflation dynamics showed significant deterioration in recent months.

The increase in inflation in 2010 was determined by the change in market prices. In fact, while regulated prices rose 3.39% in the twelve months up to November, market prices increased by 6.59%. Within the set of market prices, the price change for tradable goods (6.04%) stand out, influenced by the recent inflation dynamics of food items, and whose level is close to the inflation observed in non-tradable items (7.09%). Showing the dynamism of domestic demand, service sector inflation has remained at a level higher than that for market prices. In fact, in the twelve months up to November, the change in service prices reached 7.36% (against 6.42% in the same period of 2009). In turn, the change in regulated prices has contributed positively to the inflation dynamics in 2010, for it has been bellow the center of the target since April.

As with headline inflation, the three core inflation measures computed by the Central Bank show a rise in inflation in 2010 and, in particular, have increased in the last three months. In twelve months, the exclusion core measure (IPCA-EX), which had moved from 5.72% in December 2008 to 4.73% in December 2009, rose to 5.30% in November 2010. Similarly, the change in the core by smoothed trimmed mean (IPCA-MS), which had reached 4.82% in December 2008 and had been reduced to 4.38% in December 2009, reached 5.52% in the twelve months up to November. Additionally, inflation measured by double weight core measure (IPCA-DP), which reached 6.06% in December 2008 and had fallen to 4.73% twelve months later, reached 5.32% in November. It should be noted that the three core measures are above the center of the target and have presented less favorable dynamic in the recent past.

Additionally, it should be noted that after reaching 58.85% in November 2009, the IPCA diffusion index advanced to 67.19% in November 2010 – still bellow January 2010

(68.75%). Note that, with the diffusion index at that level, the evidence supports the hypothesis of acceleration of prices.

After a sharp reduction in 2009 (-1.43% versus 9.10% in 2008), broad inflation, measured by the General Price Index (IGP-DI), has reached 10.88% in the year up to November 2010. Similarly, twelve-month IGP-DI inflation attained 10.75% in November 2010, after receding -1.76% in the same period of 2009. The strong acceleration in broad inflation in 2010 is mainly due to IPA-DI, the main component of the index, which registered 13.29% change in twelve months up to November. By origin, agricultural products registered 23.86% change, and industrial products 9.90%. The two other components of IGP-DI, the Consumer Price Index (IPC-DI) and the National Cost of Construction Index (INCC) changed 5.73% and 7.16%, respectively, in the same base of comparison. With respect to the change in twelve months, the INCC recorded increase in all eleven months in 2010 up to November, standing out the 5.48% variation of materials, equipments and services, and 9.01% of labor cost. Therefore, all components of the IGP-DI record significant inflation. As emphasized in previous *Reports*, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend, among other factors, on the current and prospective demand conditions, the exposure of each sector to external and domestic competition, as well as on the price setters' expectations for the future inflation path.

The Index of Economic Activity of the Central Bank (IBC-Br) includes estimates for monthly production of the three sectors of the economy, as well as taxes on products, and therefore it is an important coincident indicator of economic activity. After registering growth for all months from January 2009 to April 2010, IBC-Br remained stable from May to August (with only a 0.2% change), but has resumed its growth with 0.7% change in September, evidencing the period of more intense receding of economic activity has been exhausted.

Industrial production increased 0.4% in October compared to September according to seasonally adjusted data by the Brazilian Institute of Geography and Statistics (IBGE). The three month moving average of industrial production registered growth of 0.1% from July to October, close to the rate registered from June to September (0.2%). The reduced growth rates indicate somewhat slower industrial activity in the recent past. This contrasts with the rates of change in twelve months. In fact, in this base of comparison, industrial production in October exhibited expansion for the seventh consecutive time (11.8% versus 11.2% in September). Comparing with December 2008, when industrial production registered the greatest decline after the 2008/2009 crisis, the recovery up to October summed up to 24.5%. Among the industry categories of use, in accordance with seasonally adjusted IBGE data, the greatest contribution for the change in October relative to the previous month was the 2.8% change in the production of durable consumer goods – against the slight decline in the production of semi-durable and non-durable consumer goods, intermediate goods and capital goods (-0.1%, -0.1% and -0.2%, respectively). Considering the three month moving average rates, only the consumer goods category registered growth in October, of 0.2% (0.6% in the durable sector and 0.2% in the semi-durable and non-durable sector), with reduction of 0.9% in capital goods and of 0.5% in intermediate goods. Of notice, although the indicator for activity in the capital goods industry has showed a reduction at the margin, growth in the year up to October has reached 24.0% relative to the same period in the previous year, the greatest expansion among categories of use. This attests robust investment activity, a relevant factor for economic recovery during the post-crisis period.

The rates of capacity utilization show slight decline, but remain at high levels. The low idle capacity is a result of the recent expansion in economic activity, expansion still not offset by maturing investments. In fact, the seasonally adjusted Level of Utilization of Installed Capacity (Nuci) computed by Fundação Getulio Vargas (FGV) reached 84.5% in November, versus 85.2% in October. According to data from the National Confederation of Industry (CNI), seasonally adjusted by the Central Bank of Brazil, the Nuci remained stable in October at 82.2%, versus 81.9% in September and 82.1% in August. The absorption of capital goods showed a 5.8% decrease in October with respect to the previous month. Regarding the year up to October, the increase of 29.4% evidences a slowdown in the absorption of capital goods. To a great extent, this slowdown is being determined by the external sector variables. While imports have grown 7.4% in the third quarter relative to the previous quarter (1.2 p.p. bellow its average growth rate in the four previous quarters, in accordance with seasonally adjusted IBGE data), exports have grown 0.6 p.p. above its average growth rate in the four previous quarters. The production of inputs for civil construction registered a small increase in October, 0.8% over the previous month, and 12.2% considering the twelve months up to October. The seasonally adjusted inventory level indicator from FGV reached 78.9 in January 2009, the lowest level since July 2003 (78.0). During the economic recovery, the indicator reached 103.0 in June, and receded in September (100.1) and October (99.3), remaining somewhat stable in November (101.2). In summary, the data suggests utilization rates receded a little, but remained in high levels over the last months, evidencing the small margin of idleness of industry, despite the resumption of investment.

Unlike industrial production, expanded retail sales volume presented significant growth at the margin throughout 2010. Expanded retail sales volume registered positive growth in the four months from May to August 2010, totaling 4.8% growth in the period. On the other hand, during the same period, industrial production receded 0.9% and the IBC-Br showed some stability. Thus, the slowdown of industrial activity had no parallel in retail sales; the latter's dynamism is reflected, for example, in the import of non-durable goods, up 8.1% in volume between the second and quadrimester (seasonally adjusted data by the Central Bank). For the next few quarters, retailing should continue to be bolstered by the growth of real wages, credit expansion and consumer confidence.

The latest information on GDP showed the economy growing at a slower pace than seen earlier in the year. In comparison with the same quarter in the previous year, growth in the first quarters of 2010 was 9.3%, 9.2% and 6.7%, respectively. In accordance with seasonally adjusted IBGE data, GDP increased 2.3%, 1.8% and 0.5% in the first three quarters of 2010, respectively, compared to the immediately previous quarter. On the same basis of comparison, industry grew 3.6% and 2.0% in the first two quarters, and decreased by 1.3% in the third. Similarly, agricultural production had, respectively, rates of 3.2%, 2.1% and -1.5%. The service sector was more stable, with rates of 1.5%, 1.2% and 1.0%, respectively, for the first three quarters. From the viewpoint of aggregate demand, the external sector contributed negatively to GDP growth in 2010 due to the strong growth of imports, ranging 8.8%, 5.9% and 7.4%, while exports rose 6.9%, 0.1% and 2.4%, compared to the immediately previous quarter. Among the contributions of other components of demand to GDP growth in 2010, it is noteworthy the contribution of household consumption – with greater participation in the total and growth of 1.6%, 0.9% and 1.6% – and to the Gross Fixed Capital Formation (GFCF), which increased 4.0%, 4.3% and 3.9% respectively. In sum, domestic demand, driven by credit expansion, employment and income, has been the main factor sustaining activity, and should continue to evolve positively in the coming quarters.

In fact, after having grown 9.1% in 2008 and 5.9% in 2009, real retail sales increased substantially in 2010 (11.1%) – in the year to October, according to the IBGE, in comparison with the same period last year. In the twelve months through October, sales increased 10.7%, with sharp increase in sales in the “equipment, office supplies, computer and communication” segment, (21.3%) and “furniture and appliances” (17.2%).The expanded retail sales, which includes “vehicles, motorcycles, parts and spares” and “construction material”, sectors more sensitive to credit conditions, also show strong performance. It has expanded 12.0% in the twelve months through October, driven by sales of cars and motorcycles, parts and accessories, which reached 14.1% growth, and by sales of construction material, which increased 13.9%.

The labor market has played an important role in the current cycle of the economy. Unemployment, measured by the rate of unemployment in the six metropolitan areas covered by the monthly survey by IBGE, has been receding in the last eight years. In October 2003 it was 13.0%, and in the same month of the following years, until 2010, it stood at: 10.5% 9.6% 9.8% 8.7% 7.5 %, 7.5% and 6.1%. The last rate registered in 2010, 6.1% in October, represents a historic low for the series started in March 2002. In the regional analysis, five of the six regions surveyed showed unemployment at record low in September or October this year. Also according to IBGE, the average real earnings usually received by the employed population, which was R$763.02 in October 2002, also showed favorable momentum in the last eight years, reaching record high of R$1,515.40 in October 2010, valued at 2010 prices. The total number of persons working in the six regions also showed robust growth since the beginning of the series, up from 18.1 million in October 2002 to 22.3 million in October 2010. Concerning the evolution of formal employment, after intense falls at the end of 2008 and the beginning of 2009, job creation returned to expand quite robustly in 2010. According to figures released by the Ministry of Labor and Employment (MTE), it were created 2.41 million jobs in the year to October, a growth of 107% over the same period in 2009, the largest accumulated surplus from January to October for the historical series. Thus payroll, in real terms, reached a new record in October, expanding 10.7% compared with the same month of 2009, 13.9%, compared to 2008, and 34.2%, compared to 2002.

In addition to the increased payrolls, the availability of credit to households – largely determined by macroeconomic stability and institutional advances achieved in recent years – was an important element for sustaining growth in household consumption. After being adversely affected by the crisis of 2008/2009, credit conditions return to more favorable patterns and thus boosted the volume of lending in 2010. In the year to October, the stock of credit to households with non-earmarked resources grew 14.4%.

In the same period, housing loans, whose operations are mainly based on earmarked resources, grew 40.2%. In general, delinquency indicators have remained at levels consistent with the phase of the cycle. In fact, the share of outstanding balance with arrears of more than 90 days on the total balance of credit with non-earmarked resources and interest rate reference dropped from 5.8% in October 2009 to 4.7% in October 2010.

Despite its low share in aggregate demand when compared to consumption, high investment growth has contributed to sustain economic activity in post-crisis period. It is worth noting that from the third quarter of 2009 to the third quarter of 2010, GFCF expanded by 10.1%, 7.5%, 4.0%, 4.3% and 3.9%, respectively, in comparison with the previous quarter, in accordance to seasonally adjusted data by the IBGE. Additionally, the prospect of new large scale investment projects coordinated by the public sector, as in the oil sector (pre-salt) and infrastructure, promotes agents' favorable expectations and the continued high growth in GFCF.

The total volume of credit to corporations grew by 20.9% in October 2010, compared to the same month last year, considering non-earmarked and earmarked resources, and totaled R$901.3 billion. Credit expansion was helped by loans and financing with resources from BNDES, which amounted to R$347 billion in October 2010, an increase of 32.4% over the same period in 2009. Regarding the capital market, the volume of primary issues of shares registered in the Securities and Exchange Commission (CVM) reached R$142.6 billion in the twelve months ending in November, with the highlight of the issue of R$120.3 billion of Petrobras in September, the highest ever recorded in the Brazilian stock exchange. In turn, bond issuance (excluding emissions by leasing companies), after reaching R$6.3 billion in 2008 and R$11.1 billion in 2009, attained R$16.3 billion from December 2009 to November 2010.

As regards the external sector, the trade balance accumulated in twelve months, after presenting stability in 2009, fell in 2010, recording US$17.1 billion in November, down 33% compared with the same period the previous year, reflecting import growth has outpaced export growth.

After decreasing 2.5% in 2008 – the first drop since 1996 – and 10.7% in 2009, quantum of exports grew again in 2010, 6.2% in October 2010 over the same period last year. Foreign demand recovery, while slow and gradual, had a positive impact on the average price of exported goods, which rose 23.3% on the same basis of comparison, after declining

13.4% in 2009. In turn, quantum of imports rose 24.9% in October 2010 over the same period last year after contracting 17.4% in 2009. The average price of imported good, after falling 10.5% in 2009, increased 3.8% in October, compared with the same month of 2009.

The behavior of remittances of profits and dividends, of US$23.1 billion in the year to October, has contributed to raise the current account deficit. The accumulated deficit in twelve months increased from US$47.3 billion in September to US$48.0 billion in October, equivalent to 2.4% of GDP. In turn, foreign direct investment amounted to US$36.1 billion in twelve months to October, the equivalent of 1.8% of GDP, which resulted in external financing requirement of 0.6% of GDP.

In international financial markets, volatility and risk aversion remained high, partly fueled by increased global liquidity and the prospect that this process may eventually become more pronounced. Although the perception of systemic risk has decreased, concerns about sovereign debt of European countries and the possibility of a slowdown in China have increased and, at the same time, doubts remained about the sustainability of the recovery of the U.S. economy. Regarding commodity prices the index of the Commodity Research Bureau (CRB) is at a high level and has recently shown some stability.

As far as the pace of global economic activity is concerned, the outlook remains of a relatively slow recovery, but with a lower chance of reversal and with marked asymmetry among countries with respect to growth rate. The recovery has been led by a group of emerging countries for which the rate of expansion is anchored primarily on domestic demand growth and, in specific cases, on the export sector. The economic recovery also continued in the United States and Europe, albeit gradually and with strong regional variations. The Euro Area in particular has different situations, since doubts continue over the solvency of peripheral economies, while the pace of expansion in Germany remains quite strong. Ireland has concluded negotiations for a financial assistance package from the European Union, the International Monetary Fund (IMF) and bilateral sources, totaling 85 billion Euros. Inflation rates have remained at low levels in the G3 countries, despite economic policy actions of highly expansionist character, both on the fiscal side and on the monetary side. Since the last *Report*, United States and Japan announced new programs for monetary easing. In emerging markets, in a way, inflationary pressures have become widespread. Noteworthy was the interest rate hikes promoted by the Chinese central bank, after a long period of stability, as well as the increase in compulsory deposits requirements.

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

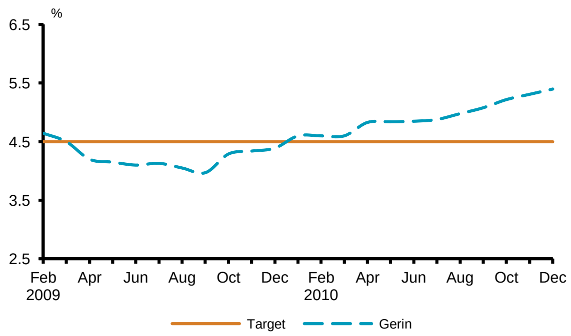
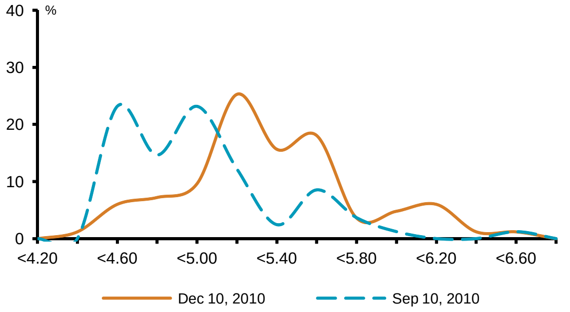


Figure 6.2 – Dispersion of inflation expectations for 2011

Relative frequency



Oil prices returned to levels above US$80. Despite the significant uncertainties inherent to forecasts over the path for oil prices, the baseline scenario adopted by Copom foresees domestic gasoline prices unchanged for 2011. It should be noted that the influence of international oil prices on domestic inflation is not transmitted exclusively through the local price of gasoline, but also via the production chain of the petrochemical industry, or the expectations channel. Among other commodities, there was sharp rise in metal prices since the last *Report*. While there is still great uncertainty about the behavior of commodities prices and assets prices in the context of volatility in financial markets and in currencies, the recent dynamics of international commodity prices may put pressure on domestic inflation in the short term.

Between September 10 and December 10, 2010, the median of market expectations for GDP growth rate this year rose from 7.42% to 7.61%. The median expectation for inflation moved from 4.97% to 5.85% (2010) and from 4.90% to 5.21% (2011). For 2012, it positions itself at 4.50%. There was also a slight increase in the dispersion of inflation expectations for twelve months ahead, with the standard deviation increasing from 0.43% to 0.46%. Overall, since the release of the last *Report*, there was less dispersion around the central tendency indicators of inflation expectations for 2010, and more dispersion for 2011, as shown in Figure 6.2.

6.2 Main scenario: associated risks and monetary policy implementation

The projections used by the 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 them, make up the main prospective scenario based on which the Committee makes policy decisions. On the whole, the prospective scenario envisages a slow recovery of the global economy, with a smaller possibility of reversion, and a moderate domestic expansion. The balance of risks associated with the prospective scenario for inflation has developed in an unfavorable way since the publication of the last *Report*. This development can be seen, for instance, in the increase in inflation forecasts that market analysts report to the Central Bank, as well as on the inflation forecasts that are presented in the next section.

On the external front, the main inflationary risk comes from commodity prices. This risk has exacerbated since the last *Report* due to the still ongoing process of increase in global liquidity.

The recent increase in wholesale prices is directly associated with the surge in commodity prices in the international market. Especially agricultural commodities witnessed a strong acceleration in prices in the September/November quarter – which changed the scenario that was presented in the last *Report* in an adverse way. To a certain extent this change had been anticipated by the Committee and, in fact, a substantial part of the increase in commodity prices has already been incorporated into consumer prices. Even so, the risk is that the pressures that are arising from the commodity markets may persist, without compensation from movements in the opposite direction in domestic assets – which in fact was what occurred in the recent episode.

The outlook for the evolution of commodity prices, including oil, continues to be very uncertain, hinging on the evolution of demand, in a context of an uneven recovery of the global economy and substantial volatility in international financial markets. Specifically for agricultural commodities, the outlook is for rising prices, given the indications that a contraction in supply may occur.

The purchase of external goods tends to diminish domestic inflationary pressures through two channels. First, these products compete with goods that are produced domestically imposing greater discipline to the process of price increases. Second, they reduce the demand in domestic input markets contributing to the weakening of cost pressures and, by consequence, of an eventual pass-through to consumer prices.

In relation to the recovery of the global economy, the baseline scenario continues to contemplate the hypothesis of a relatively slow recovery of activity, with marked asymmetry between economic blocs, but with a smaller probability of reversion.

Internally, the Committee judges that the risks of an imbalance between the growth of domestic absorption and the capacity of supply expansion persist, even though a less pronounced pace of demand expansion and a stronger increase in imports have been noted. The factor markets – most notably the labor market – are operating on tight spare capacity, which is an important risk factor that could be worsened by the presence of mechanisms that favor inflation persistence in the economy. Furthermore, there is the risk that the considerable price increases that were recently seen in the wholesale markets will continue to reverberate to consumer prices. In this context, another relevant risk is that the recent increase in inflation – that was affected in a strong and negative way by the dynamics of food inflation, which in turn was caused by domestic and external supply shocks – be transmitted to the prospective scenario.

After the pronounced drop in the last quarter of 2008 and the first quarter of 2009, investments have been expanding systematically above the growth rate of GDP. As a result, the investment rate – the share of fixed capital formation in GDP – has been recovering in a vigorous way, even though it still remains below the levels that were observed before the 2008/2009 crisis. The combination of less pronounced growth in aggregate demand with the rebound in investment has led to more stable readings of industrial capacity utilization levels – which had been going through a process of continuous growth during 2009 and the beginning of this year.

The high GDP growth rates of this year will be partly reflecting the statistical carry-over effect that results from the growth rates that were recorded in the second half of 2009. In general, however, the outlook for the evolution of domestic economic activity remains favorable, at a more moderate pace than what was observed at the beginning of the year. This assessment is underpinned, among others, by the indications that the expansion of credit supply will persist – if at a more moderate pace after the recent adoption of macro-prudential measures – both, for individuals and for corporations; by the fact that the confidence levels of consumers and entrepreneurs remain at historically high levels – in spite of marginal accommodations; and by the recent behavior of inventory levels in some industrial sectors. The strength of labor markets, the remaining effects of the fiscal stimulus and of the policies of public banks and, to a lesser extent, the recovery of the global economy are also noteworthy.

An important source of risk comes from the labor market. The employment level has increased in a vigorous manner and led to the lowest unemployment rate readings since the beginning of the computation of the time series with the methodology that is currently employed (in March 2002). Real average earnings have been growing since the beginning of the year, after oscillating in 2009, in particular in the public sector. A crucial aspect in such situations is the possibility that the level of activity in the labor market leads to nominal wage increases at rates that are not compatible with productivity growth, which in a strong demand environment, are passed on to price increases. In this respect, the theory, which is backed by international experience, establishes that wage moderation is a key element for guaranteeing a macroeconomic environment with price stability.

The Committee assesses that there are important mechanisms making the Brazilian inflation downward rigid. In particular, the presence of regular and almost automatic mechanisms of price adjustment, either *de jure* and/or *de facto*, has contributed to the persistence of inflationary pressures coming from the past. It is well known that the existence (even informally) of price indexation mechanisms reduces the sensitivity of inflation to demand conditions. Overall, 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.

The potential effects of recent increases in wholesale market prices on consumer prices should also be monitored. The evidence suggests time lags between price variations in the wholesale market and their eventual pass-through to consumer prices – as highlighted in a box in the March 2010 *Inflation Report*. This implies that, presumably, a share of the effects of the recent spike in producer prices will still be transmitted to consumer prices. As noted in previous *Reports*, the Copom understands that the effects of the development of prices in the wholesale market on consumer inflation will depend, among others, on current conditions and the outlook for demand, on the exposure of each sector to external and internal competition, and on expectations of price setters regarding the future evolution of inflation.

Another source of concern lies in the evolution of inflation expectations – which have followed an unfavorable dynamic during the last months. More specifically, the associated risk lies in the possibility that the recent increase in inflation will influence even further the expectations of price increases, making this dynamic more persistent.

Regarding fiscal policy, the recovery of economic activity, led by the expansion of domestic demand and the reversion of a substantial portion of the tax breaks that had been introduced to fight the economic crisis create an outlook that is favorable to the substantiation of a scenario of recovery of fiscal accounts. In this context, the Copom understands that, based on the available information, the origination of primary surpluses that are compatible with the working hypotheses of the inflation forecasts that are presented in the next section, on top of diminishing the imbalance between the rates of growth of demand and supply, will solidify the trend of reduction in the public debt to GDP ratio. On this point, it is important to clarify that the Committee reaffirms that its main prospective scenario is conditioned on the materialization of the trajectories with which it works for fiscal and quasi-fiscal variables.

The dynamics of the credit market also deserves attention, be it for its potential impact on aggregate demand and, as a consequence, on inflation, or for the macro-prudential risks that it may represent. The dynamism of the credit market in Brazil has been intense and has meant a persistent growth in the credit to GDP ratio. As highlighted in the box "The Potency of Monetary Policy in Brazil", in the June 2010 *Report*, this deepening of credit markets, among other factors, must have contributed to amplify the power of monetary policy in Brazil. On the other hand, the Copom understands that the moderation in the expansion of the credit market, in particular of the earmarked operations, constitutes an important element to the materialization of its main scenario. Compared to the situation that prevailed at the time of the last *Report*, the view that prevails is that there has been a substantial increase in the probability of the hypothesis of moderation in the expansion of the credit market in face of the introduction of macro-prudential initiatives.

Regarding macro-prudential risks, it is important to note that the expansion of credit has taken place in an environment in which there are declining delinquency rates – which in their turn are partly a consequence of the position of the economy in the cycle.

The Committee understands that the macro-prudential actions that were recently adopted contribute favorably to the outlook and that they are part of a broader process that aims, among others, at the phasing out of the stimuli introduced to counteract the effects of the 2008/2009 crisis on the Brazilian economy. Together with other initiatives, they constitute a sequence aimed at adapting the domestic financial conditions to the post-crisis environment, which is characterized by contrasting outlooks for the main economic blocs. The Committee notes that, to a certain extent, there is an equivalence between macro-prudential and conventional monetary policy actions and that the importance of this link is going to increase with the deepening of credit markets – a phenomenon that has been observed in Brazil during the last years. However, the Committee notes that there is no backing for the view that these two sets of instruments be viewed as perfect substitutes as they diverge, among other aspects, in their outreach and transmission mechanisms. In sharing the view that the behavior of banks with respect to risk taking is one of the transmission mechanisms of monetary policy, the Committee understands that, under the conditions that prevailed in the beginning of December, macro-prudential actions should precede conventional actions of monetary policy. Furthermore, it should be noted that even when the scenario requires the use of both types of instruments, good practice recommends that the former should precede the latter.

Summing up, since the last *Report*, on the external front, extraordinary liquidity injections and their almost immediate and generalized effects on asset prices, especially commodities, point to a smaller probability of reversion of the still slow process of adjustment in which the G3 economies find themselves in. On the other hand, they reveal an ambiguous influence of the international scenario on the evolution of domestic inflation. Internally, the remaining effects of the adjustment of the Selic rate have not yet been entirely incorporated into the price dynamics. Additionally, the macro-prudential measures that were recently announced – a fast and potent instrument to contain local pressures on demand – will have their effects incorporated in the evolution of prices. Against the background of these recent developments, there was the materialization of short-run risks with which the Copom had been working, but in a scale that was larger than had been anticipated. Even though the uncertainties that surround the global scenario and, to a lesser extent the domestic scenario, do not allow to identify with certainty the persistence of recent pressures, the current balance of risks is much less favorable to a benign scenario for inflation, in which the inflation rate would consistently converge to its target, when compared to the last *Report*.

In this context, the Committee unanimously decided to keep the Selic rate at 10.75% p.a., without bias, in its October and December meetings.

6.3 Inflation forecasts

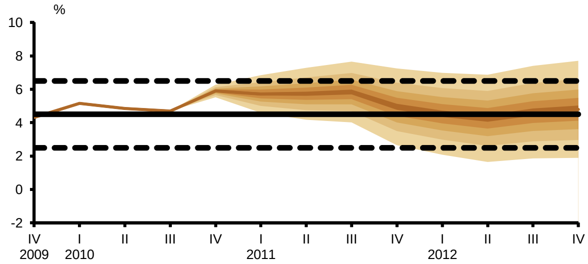
According to traditionally adopted procedures, and taking into account the available information up to the cutoff date of December 10, 2010, the baseline scenario assumes the exchange rate remains unchanged over the forecast horizon at R$1.70/US$, and the target for the Selic rate stays at 10.75% p.a. – the level set by the December Copom meeting

– against R$1.75/US$ and 10.75% p.a. considered in the September *Inflation Report*. The projection in the baseline scenario for the change, in 2010, of the set of regulated and monitored prices is of 3.4%, a decrease of 0.2 p.p. in comparison to the value considered in the last *Report*. This projection is based on the hypotheses of an increase of 1.6% in prices for gasoline; of 1.7% in prices for bottled gas; of 2.8% for electricity rates; and of 0.4% 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, in the baseline scenario, is at 4.0% for 2011 and 4.4% for 2012 – against 4.4% and 4.5% considered in the September 2010 *Report*.

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 decreased in comparison to the values released in the September *Inflation Report*. For the last quarter of 2010, these expectations moved from R$1.77/US$ to R$1.70/US$, and for the last quarter of 2011, from R$1.81/US$ to R$1.75/US$. For the last quarter of 2012, survey expectations project an average exchange rate of R$1.80/US$. The expectation about the average Selic rate, in general, increased in comparison to the values presented in the last *Report*. For the last quarter of 2010, it was kept at 10.75% p.a., while for the last quarter of 2011, it moved from 11.75% to 12.25% p.a. For the fourth quarter of 2012, the projection for the average Selic rate is 10.92% p.a. This trajectory of the Selic rate is consistent with a twelve-month pre-DI swap spread, with respect to the current target for the Selic rate (10.75% p.a.), of 81 b.p., 161 b.p. and 80 b.p., in the last quarter of 2010, 2011 and 2012, respectively. Additionally, the market scenario assumes changes for the group of regulated and administered prices of 3.4% in 2010, of 4.1% in 2011, 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 3.1% of GDP in 2010, which could be reduced by up to 0.90 b.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 levels of 3.0% (according to the project of the Budgetary Guidelines Law – LDO) and of 3.1% of GDP, respectively, without any adjustment.

Figure 6.3 – Projected IPCA-inflation with interest rate constant at 10.75% p.a. (Baseline scenario)
Inflation fan chart



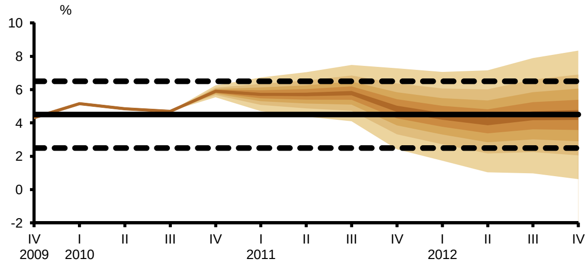
Note: accumulated inflation in 12 months (% p.a.).

Table 6.1 – Projected IPCA-inflation with interest rate constant at 10.75% p.a.
(Baseline scenario)

Year	Q	Probability Interval						Central
		50%						
			30%					
				10%				projection
2010	4	5.7	5.8	5.9	5.9	6.0	6.1	5.9
2011	1	5.3	5.5	5.6	5.8	6.0	6.2	5.7
2011	2	5.1	5.4	5.6	5.9	6.1	6.4	5.7
2011	3	5.1	5.4	5.7	6.0	6.3	6.6	5.8
2011	4	4.0	4.4	4.8	5.1	5.5	5.9	5.0
2012	1	3.5	4.0	4.3	4.7	5.1	5.5	4.5
2012	2	3.2	3.6	4.1	4.5	4.9	5.3	4.3
2012	3	3.5	4.0	4.4	4.8	5.3	5.8	4.6
2012	4	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.).

Moreover, the projections presented in this *Report* incorporate the estimated impact of the recently announced changes in the rules of reserve requirements.

Based on the above assumptions and using the information set until the cutoff date (December 10, 2010), projections were constructed for the IPCA inflation accumulated over four quarters, consistent with the interest and exchange paths of the baseline and market scenarios.

The central projection associated with the baseline scenario shows inflation of 5.9% in 2010, an increase of 0.9 p.p. in comparison to the projection presented in the September *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 until the last quarter of 2011, when reaches 5.0%, and fluctuates around the central target in the following quarters. According to data shown on Table 6.1, the projection for twelve-month accumulated inflation in the last quarter of 2010 is of 5.9%. The respective projections for 2011 moves from 5.7% in the first quarter, reaches 5.8% in the third quarter, but decreases and ends the year at 5.0%. In this scenario, the associated projection for the first quarter of 2012 is of 4.5%, decreases to 4.3% in the second quarter and ends the year at 4.8%. The decrease of the inflation projections for 2011 and 2012, 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, as well as the recovery of the primary surplus and the estimated impact of the changes in the rules of reserve requirement. According to the baseline scenario, the estimated probability that inflation for 2010 will breach the upper tolerance level of the target is negligible. For 2011, this probability is close to 13%.

In the market scenario, the inflation projection for 2010 is 5.9%, equal to the respective baseline scenario projection, representing an increase of 0.9 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, following a similar pattern of the baseline scenario, fluctuate above the central value of the target until the end of 2011, when stands at 4.8%, but recede along 2012, finishing the year at 4.5%. The projection for the last quarter of 2010, within this scenario, is 5.9%, decreases to 4.8% in the fourth quarter of 2011 and reaches 4.5% in the last quarter of 2012. According to the market scenario, as well as in the baseline scenario, the estimated probability that inflation for 2010 will breach the upper

Table 6.2 – Projected IPCA-inflation with market interest and exchange rates expectations [1/]

Year Q	50%	30%	10%		30%	50%	Central projection
2010 4	5.8	5.8	5.9	5.9	6.0	6.0	5.9
2011 1	5.3	5.5	5.6	5.8	6.0	6.1	5.7
2011 2	5.2	5.4	5.6	5.8	6.0	6.3	5.7
2011 3	5.1	5.4	5.7	5.9	6.2	6.5	5.8
2011 4	3.9	4.3	4.7	5.0	5.4	5.8	4.8
2012 1	3.3	3.8	4.2	4.6	5.0	5.5	4.4
2012 2	2.8	3.4	3.9	4.3	4.8	5.4	4.1
2012 3	3.0	3.6	4.2	4.7	5.2	5.8	4.4
2012 4	2.9	3.6	4.2	4.8	5.4	6.1	4.5

Probability Interval

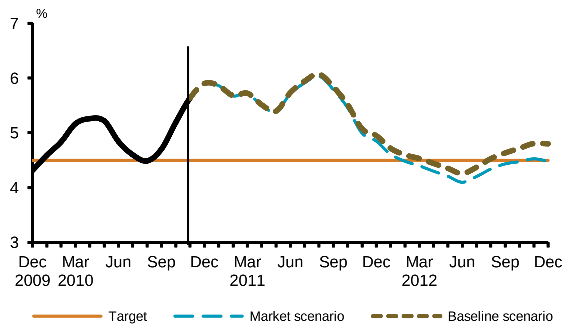
Note: accumulated inflation in 12 months (% p.a.).

1/ According to Gerin.

Table 6.3 – September 2010 *Inflation Report* projections

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

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



tolerance level of the target is negligible. For 2011, this probability is close to 13%.

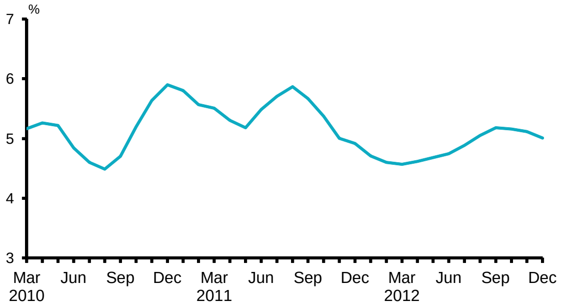
As it was shown in the last *Report*, the projected dynamics for both scenarios are close to each other along 2011, as long as the effect of the difference between the interest rate trajectories is almost entirely offset by the respective exchange rate paths. For 2012, it is worth noting the increasing distance between the projection paths toward the end of the considered horizon. This departure is essentially caused by the lagged effect, due to the monetary policy transmission mechanisms, of expected hike in the Selic rate considered in the market scenario. Another aspect to highlight is that, in general, inflation projections increased in comparison to figures in the last *Report*, but nevertheless are close to the central target by the end of the considered horizon.

Comparing the trajectories shown in this *Report* with those released in the previous *Report*, whose projections are shown on Table 6.3, in the baseline scenario, it is apparent that there was an increase of the projections in the last quarter of 2010 and along 2011, partially reflecting the increase of inflation expectations for the current year and 2011, and higher inflation rates in recent months than the respective projections presented in the September *Report*. In the market scenario, the projection changes also reflect these movements. Regarding 2012, in both scenarios, it is also shown a decrease in the inflation projections, in respect to those presented in the September 2010 *Report*, for the first and second quarters of 2012, and a slight increase in the projections for the third quarter of 2012.

Figure 6.5 shows the path of twelve-month accumulated inflation, according to the baseline and market scenarios, up to the fourth quarter of 2012, as well as the target trajectory. The figures are actual twelve-month inflation until November 2010, and, from December on, projections according to the two scenarios. The projections fluctuate, in both scenarios, above the target in 2011. In the baseline scenario, the trajectory indicates decrease of the twelve-month accumulated inflation along the first semester of 2012, and a slight increase in the second semester, whereas in the market scenario, after a decrease until the third quarter of 2012, the trajectory tends to figures close to the central target by the end of the projection horizon.

The average forecast generated by the Vector Autoregression models (VAR) for the twelve-month accumulated inflation is presented in Figure 6.6. By November 2010, the values are actual twelve-month inflation and, as of December, refer to

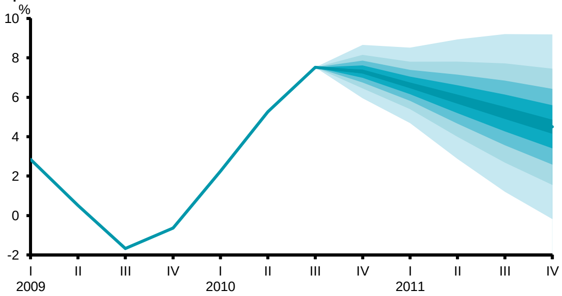
Figure 6.6 – Inflation forecast: VAR models



Note: accumulated inflation in 12 month (% p.a.).
Average forecast generated by the VAR models.

Figure 6.7 – Projected GDP growth with interest rate constant at 10.75% p.a. (Baseline scenario)

Output fan chart



the average forecast of the VAR models. As well as in the projections generated in the baseline and market scenarios, the VAR models forecasts for twelve-month accumulated inflation increased along 2011, in comparison to those presented in last *Report*. Regarding the first semester of 2012, the forecasts decrease in comparison to those presented in the September 2010 *Report*, and increase again in the third quarter of 2012. The VAR models forecasts decrease along the first quarter of 2012, in comparison to 2011, but increase in the second and third quarters and tend to inflation unconditional average, below the 2010 inflation.

In short, under the baseline scenario, as well as under the market scenario, the projections have already incorporated the estimated impact of the recently announced increase in the reserve requirements and the primary surplus effort. Nevertheless, in both cases, the projected values stand above the midpoint target of 4.5% established by the CMN for inflation in 2011. It is worth noting that, under the inflation targeting regime, deviations in projected inflation from the target of such magnitude suggest the need for implementation, in the short-run, of an adjustment in the basic interest rate, in order to control the growth pace mismatch between the domestic demand and the productive capacity of the Brazilian economy, as well as to reinforce the anchorage of inflation expectations.

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%; the same projection presented in the September 2010 Inflation Report. This projection essentially reflects a carry-over statistical effect due to the growth rates observed along the second semester of 2009. Copom assesses that Brazilian economy has been changed towards a GDP growth rate which is consistent with its long-run equilibrium and, therefore, projects a growth rate for 2011 of 4.5%.

Administered Projections Prices

For the purposes of inflation analysis and forecasting, the Broad National Consumer Price Index (IPCA) is usually divided into market prices and prices that are administered or regulated by contract ("administered prices"). For this and other purposes, administered prices are those established by contract by a public or regulatory agency, and are generally less sensitive to supply and demand conditions. Currently, the set of administered prices comprises 28 items that represent about 30% of the total IPCA bundle, as reported in Table 1[1].

Given the importance of such prices for the conduction of monetary policy, and in order to provide updated information on the models currently used by the Central Bank, the objective of this box is to describe the strategy for projecting administered prices, which is subject to constant updates. It should be emphasized that, beyond the models described here, expert judgment is also taken into account in the construction of scenarios for the future behavior of administered prices, especially for the short term. The projections of this set of prices, along with the information generated by other econometric tools, constitute important inputs for the decision making process of the Monetary Policy Committee (Copom).

Figure 1 – Twelve-month change for market and administered prices

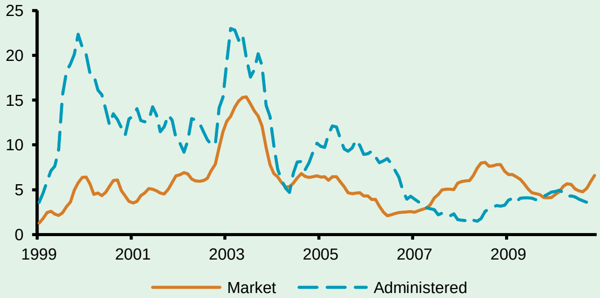


Figure 1 shows the twelve-month percentage change of market and administered prices since January 1999. After the period between 1999 and early 2007, in which the changes in administered prices were

1/ As explained on the boxes "Change in the Composition of the IPCA Group of Administered Prices by Contracts and Monitored" and "**IPCA** Administered Prices by Contracts and Monitored: Update on the Consumer Expenditure Survey", published in the Inflation Report of December 2005 and March 2006, respectively, the classification of administered prices can be modified by the Monetary Policy Committee (Copom) for analytical or economic policy reasons. In 2006, for example, the composition of administered prices has changed, with the inclusion of pharmaceuticals, vehicular gas and traffic fines, and the exclusion of ethanol, property tax and public transportation – ship.

Table 1 – Administered Prices Composition

Items	IPCA weights (%)*	Administered weights (%)	Price adjustment frequency**	Regulatory authority***
Petroleum Products	5.49%	18.77%		
Gasoline	3.94%	13.47%	Irregular	ANP
Bottled Gas	1.19%	4.07%	Irregular	ANP
Vehicular Gas	0.10%	0.36%	Irregular	ANP
Piped Gas	0.10%	0.33%	Irregular	States
Diesel	0.08%	0.27%	Irregular	ANP
Motor Oil	0.08%	0.26%	Irregular	ANP
Public Transportation and Bus	6.57%	22.44%		
Urban Bus	3.84%	13.10%	Irregular	Municipalities
Intercity Bus	1.20%	4.08%	Irregular	States
Insterstate Bus	0.37%	1.27%	Annual	ANTT
Taxi Cab	0.32%	1.10%	Irregular	Municipalities
Plan 1/	0.34%	1.15%	Irregular	–
Subway	0.26%	0.90%	Irregular	Municipalities
Train	0.10%	0.36%	Irregular	Municipalities
Ferry-Boat	0.01%	0.04%	Irregular	Municipalities
Ship	0.00%	0.01%	Irregular	Municipalities
Toll	0.12%	0.43%	Annual	States
Electricity	3.24%	11.06%	Annual	Aneel
Water	1.63%	5.56%	Annual	Municipalities
Health	6.36%	21.73%		
Health Plans 2/	3.50%	11.94%	Annual	ANS
Pharmaceuticals	2.87%	9.79%	Annual	CMED
Communication	4.82%	16.45%		
Fixed Telephone	3.25%	11.09%	Annual	Anatel
Mobile Telephone	1.29%	4.42%	Annual	Anatel
Public Telephone	0.23%	0.80%	Annual	Anatel
Post Mail	0.04%	0.15%	Irregular	Federal Government
Other	1.17%	4.00%		
Vehicle Licensing	0.72%	2.45%	Irregular	States
Lottery	0.38%	1.30%	Irregular	Federal Government
Traffic Fines	0.07%	0.24%	Irregular	Contran
Legal services	0.00%	0.01%	Irregular	States
	29.28%	100.00%		

Source: Banco Central do Brasil and IBGE

* Weights for October 2010.

** Approximate frequency for recent years.

***It should be noted that the nature of regulation concerning the adjustment price rates varies between different agencies. Some, like the ANS and Anatel, determine the percentage adjustment to be applied to most goods and services regulated by them, while the ANP role is to ensure competition in the market.

1/ The prices of airline tickets are free but are included in the category given because the air transport in Brazil's public concession.
2/ The annual adjustment is distributed throughout the year to calculate the variation of the IPCA item.
Anatel – National Telecommunications Agency
Aneel – National Energy Agency
ANP – National Agency of Petroleum
ANS – National Health Agency
ANTT – National Agency of Terrestrial Transportation
CMED – Chamber of Market Regulation on Pharmaceutical Prices
Contran – National Council of Traffic

higher than that of market prices[2], in recent years the latter have been, generally, growing slightly faster than the former. For example, administered prices grew 2.87% in 2010 up to November, while market prices rose by 6.25% in the same period.

Administered prices, as mentioned earlier, are less sensitive to supply and demand forces than market prices are and, in general, their adjustments are determined by contractual rules. Roughly speaking, these rules usually seek to compensate variations in costs and productivity gains across sectors and are set by regulatory agencies in each sector and the indices used to update the value of the contracts vary with each item.

The price of fixed telephone services, for example, was adjusted based on the change of the General Price Index – Internal Availability (IGP-DI) until 2005. Currently, the readjustments follow the change in the Telecommunication Services Index (IST), which is mainly composed by IPCA (weight of 47.6%) and the Broad Producer Price Index – Global Supply/ Machinery and Equipment (IPA-OG/Machines, weight of 32.5%). Price of pharmaceuticals, in turn, have been adjusted, since 2003, according to a price cap model that combines the IPCA with factors of productivity and relative price adjustment between and within sectors. Regarding electricity, the annual adjustment rate considers explicitly the variation in the General Price Index – Market (IGP-M), as well as the influence of other factors, including the evolution of the exchange rate and the incidence of taxes and fees on the final consumer. The consumer price of gasoline, although depends on factors such as price of ethanol and the competition among the distributors, tends to reflect the pricing policy pursued by Petrobras. This, in turn, is influenced by the exchange rate, international oil prices and the Contribution of Intervention in the Economic Domain (Cide).

In summary, besides the IPCA and the general price indexes, the variation in administered prices are influenced by other variables, such as exchange

2/ Between January 1999 and December 2006, administered prices rose 147%, compared to an increase of 61% of market prices. The Working Paper No. 59, (2002), “Administered Prices and Inflation in Brazil,” discusses the causes of the distinct behavior of market-based and administered prices between 1996 and 2002.

rate and international prices. Moreover, as there are defined rules regarding the frequency and period of readjustment, seasonal pattern exists for certain items, such as the fixed telephone tariffs and prices of pharmaceuticals.

In this context, the identification of the indexes and the variables that influence the administered prices, in addition to seasonal patterns, are the starting point for modeling. Two different strategies are used for projecting the administered prices. Under the first one, which is purely econometric, different models comprising two-stage least squares regressions and Vector Autoregression techniques (VAR) are estimated for the aggregate of administered prices. Under the second, known as hybrid modeling, there is a mix of econometric models with "accounting" procedures. With the goal of projecting individual items of administered prices, the "accounting" procedures use information from the contracts between the public agency and the service provider, together with price adjustment rules and methodologies used by the Brazilian Institute of Geography and Statistics (IBGE) to incorporate price variations of specific IPCA components.

In the "accounting" procedures, there are items whose annual adjustments are set nationally and delimited by a specific index or set of indexes as in the cases of fixed telephone services and pharmaceuticals. Other items are defined in state and municipal[3] levels and show no regular intervals in the adjustment, such as urban bus fares – in some cities the readjustment of the tariff has been occurring annually in the same month of the year, while in others the rate remains unadjusted for periods exceeding three years. In such cases, the "accounting" procedures would be difficult to deal with because, in addition to estimating the magnitude of price adjustments, one would have to anticipate when they would be implemented. Thus, for items where the "accounting" procedures are inadequate, prices are modeled by econometric techniques in the aggregate, i.e., for the remainder of the administered prices bundle not included in the "accounting" approach. To summarize, in the hybrid modeling a portion of administered prices

3/ The IPCA is calculated for nine metropolitan regions (Rio de Janeiro, Sao Paulo, Belo Horizonte, Belem, Fortaleza, Salvador, Recife, Curitiba and Porto Alegre), plus the cities of Goiânia and Brasília.

Table 2 – Summary of model specifications for administered prices

Approach	Dependent variable	Method	Explanatory variables*
Econometric	Administered prices (aggregate)	Ordinary least squares	Market prices, PPI, Exchange rate
		Vector autoregressive (VAR)	Endogenous: prices of bottled gas, gasoline, electricity and urban bus
			Exogenous: Exchange rate and market prices
		Vector autoregressive (VAR)	Endogenous: IGP-DI and market prices
			Exogenous: PPI and Exchange rate
Hybrid	Individual items**	"Accounting"	IPCA, IGP-DI, IGP-M
	Other administered prices (aggregate)	Two-stage least squares	IGP-DI, PPI, Exchange rate
		Ordinary least squares	Market prices, PPI, Exchange rate
		Vector autoregressive (VAR)	Endogenous: IGP-DI and market prices
			Exogenouss: PPI and Exchange rate

* For the "accounting" approach, the indexes are explicitly indicated in the contracts or those that allow more closely replicate the pattern of recent adjustment.

** Fixed telephone, public telephone,interestate bus, water supply, bottled gas, toll, health plan, pharmaceuticals, vehicle licensing.

PPI – U.S. Producer Price Index
IGP-DI – General Price Index – Internal Availability
IGP-M – General Price Index – Market Prices

is projected individually using the "accounting" approach, while the rest is projected collectively by econometric models. The final projections of the hybrid models are obtained, then, by the weighted average of these two sets[4].

Table 2 summarizes the model specifications for the two strategies. Note that the future path of the explanatory variables used in econometric models and the indexes used in the accounting procedures, in the market scenario, are given by the median aggregate projections for the corresponding series from the Market Report – *Focus* produced by the Central Bank's Investor Relations Group (Gerin).

Figure 2 – Twelve-month forecasts for administered prices

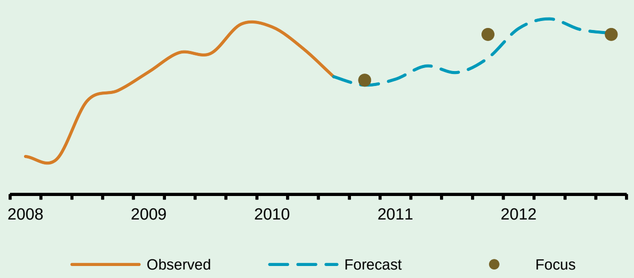


Figure 2 shows the projections of administered prices from the fourth quarter of 2010 through the fourth quarter of 2012 and the estimates provided by the *Focus* Report for the end of each year[5].

To conclude, this box presented the modeling process used by the Central Bank to project administered prices. Therefore, by providing additional information about the set of projections considered by the Copom, it helps to foster transparency in the decision making, one of the pillars of the inflation targeting system .

4/ Nearly 44% of the administered prices are modeled using the "accounting" approach.
5/ The projections through the end of 2011 are based on analysis of experts, while the others are from the models described in Table 2.

Annex

Minutes of the 154th Meeting of the Monetary Policy Committee (Copom)

Date: October 19th, from 4:50PM to 6:40PM, and October 20th, from 5:40PM to 8:00PM
Place: BCB Headquarters meeting rooms – 8th floor on October 19th and 20th floor on October 20th – 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

Department Heads (present on October 19th)
Adriana Soares Sales – Research Department (also present on October 20th)
Altamir Lopes – Economic Department
César Viana Antunes de Oliveira – Investor Relations Group
Daso Maranhão Coimbra – Department of Banking Operations and Payments System
João Henrique de Paula Freitas Simão – Open Market Operations Department
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department

Other participants (present on October 19th)
Alexandre Pundek Rocha – Advisor to the Board
Eduardo José Araújo Lima – Deputy-Head of the Research Department
Emanuel Di Stefano Bezerra Freire – Advisor to the Board
Francisco Leopoldo Carvalho de Mendonça Filho – Press Secretary
Wagner Piazza Gaglianone – Advisor to the Research Department

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 recording 0% and 0.01% in June and July, respectively, remained close to zero in August (0.04%), and increased in September to 0.45%. As a consequence, inflation accumulated in the first nine months of 2010 reached 3.60%, 0.39 p.p. above the one observed in the same period of 2009. Inflation increase in 2010 reflects, basically, the behavior of market prices, which increased by 4.19% in the year through September and contributed with 2.90% of the 3.60% recorded in the year. On its turn, regulated prices, which increased 2.03% in the year through July, decelerated and totaled 2.22% in the year through September, compared to 3.36% in the same period of 2009, contributing only 0.7% to cumulative inflation in the year through September. Regarding market prices, it bears emphasizing that while the prices of tradable goods reached 3.25% in the year through September (3.92% in twelve months), the prices of non-tradable goods reached 5.05% (6.31% in twelve months). The change in the

prices of services, whose dynamics tends to show more persistence than that of the prices of goods, shows some stability, and reached 5.98% in the year through September and 6.90% in twelve months. The increase in the monthly IPCA index in September is greatly due to the elevation in the prices of food and beverages. In short, information available evidences deterioration of the inflationary dynamics at the margin, restricted to some groups, a movement that was anticipated by the Committee.

2. The volatility of food prices performed a fundamental role in the behavior of 2010 headline inflation. In fact, due to accentuated swings in these prices, the IPCA dynamics showed two distinct moments: pronounced rise in the first four-month period, when food and beverages prices changed 5.19%; and relative stability in the following period, when they retreated 1.61%. It also bears emphasizing that twelve-month trailing household food price inflation increased from 0.88%, in December 2009, to 6.67%, in April 2010, and returned to 2.29%, in August; at the same time, twelve-month trailing IPCA inflation reached 4.31%, 5.26% and 4.49%, respectively. This behavior of food price inflation partially mirrored domestic and external supply shocks, whose impacts were possibly heightened by the high volatility environment in international financial markets. For the last four-month period, the most likely scenario indicates the continuity of this dynamics, with elevation of the headline inflation mainly determined by the increase in food prices.

3. In line with the evolution of headline inflation, the three main underlying inflation measures calculated by the BCB increased between August and September. The smoothed trimmed means core inflation increased from 0.33% in August to 0.43% in September. In the same period, the double weight core inflation measure increased from 0.19% to 0.39%, and the core inflation by exclusion rose from 0.12% to 0.37%. In the year through September, the smoothed trimmed means core inflation increased 3.93%, up from 3.21% recorded in the same period of 2009. According to the same comparison basis, double weight core inflation measure increased to 3.59%, up from 3.48%, while the core inflation by exclusion reached 3.82%, up from 3.62%. Twelve-month trailing inflation measures, on its turn, reached, in September, 4.94%, 5.09% and 4.83% for the core inflation by exclusion, smoothed trimmed means and double weight core inflation measures, respectively, standing, therefore, above the midpoint of the inflation target. The IPCA diffusion index, which had retreated to 48.7% in July, reached 52.6% in August and 62.5% in September.

4. The General Price Index (IGP-DI) inflation recorded 1.10% in September, the same change observed in August, but above the rate registered in July (0.22%). In the year through September, the IGP-DI inflation reached 8.04%, above the level recorded in the same period of 2009 (-1.35%). According to the same comparison basis, inflation measured by its main component, the Wholesale Price Index (IPA-DI), rose 9.95%, reflecting the increases of 8.6% and 14.1%, respectively, in industrial and agricultural prices. The 2010 IPA-DI inflation change is, therefore, above the change recorded in the same period of 2009 (-3.69%). Inflation measured by the Consumer Price Index (IPC-DI), another component of the IGP-DI, increased 3.82% in the year through September, above the 3.41% recorded in the same period of 2009. Under the same criterion, inflation measured by the Civil Construction National Index (INCC), component with the lowest weight in the IGP-DI, increased 6.45%, also above the rate recorded in the same period of 2009 (2.78%). As emphasized in previous Copom Meeting Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend, among other factors, on the current and prospective demand conditions, the exposure of each sector to external and domestic competition, as well as on the price setters' expectations for the future inflation path.

5. The IBGE (Statistics and Geography Brazilian Institute) released information about 2010Q2 GDP. The data showed expansion in activity, which increased 8.8% in the second quarter, year-over-year, and a 1.2% increase quarter-over-quarter. GDP growth reflected, to great extent, statistical carry over, which, in general, was observed in the demand components and supply subsectors. On the aggregate demand side, household consumption and public administration consumption increased, respectively, 6.7% and 5.1%, year-over-year. Gross fixed capital formation (FBCF) increased 26.5%, imports grew 38.8%, and exports

increased 7.3%, according to the same comparison basis. Still on a year-over-year basis, the contribution of domestic demand to the Q2 GDP growth was positive (12.4 p.p.), the most remarkable one since 1995, offsetting the 3.6 p.p. negative contribution stemming from the external sector. On the aggregate supply side, still according to the same comparison basis, the services sector grew by 5.6%, while industry grew by 13.8% and agriculture, 11.4%.

6. The Index of Economic Activity of the BCB (IBC-Br) incorporates estimates for the monthly production of the three sectors of the economy, as well as for products taxes and, therefore, it constitutes an important coincident indicator of economic activity. After registering positive growth rates in all months of 2009 until April 2010, the IBC-Br has shown stability in the last months. In August, the IBC-Br remained stable, and changed 0.1% in July after recording stability in the previous month, suggesting, therefore, a less intense pace of economic activity than previously expected, in contrast to the fast pace observed in the first quarter of 2010.

7. After strong retreat due to the 2008/2009 crisis, industrial output recovered, but it has shown some accommodation at levels similar to those observed in the pre-crisis period. According to data seasonally adjusted by the IBGE, industrial output recorded -0.1% in August, after increasing 0.6% in July, month-on-month. The three-month moving average growth rate reached -0.2%, considering the three-month period ended in August, equal to the rate recorded in the three-month period ended in July, and above the one registered between March and June (-0.7%). Year-over-year, the production increased 8.9% in August 2010, similar to the rate recorded in July (8.8%), according to the same comparison basis. On a twelve-month trailing basis, industrial production expanded by 9.8% in August, above the July rate (8.3%). Compared to December 2008, a record low for industrial production level registered during the 2008/2009 crisis period, recovery up to August totaled 24.2%. Industrial activity has partially been supported by the growth of industrial activity financing by public financial institutions.

8. Among the industry use categories, according to data seasonally adjusted by the IBGE, the most important driver in August, month-on-month, was capital goods production, which increased by 1.4%. Consumer goods and intermediate goods production were negative, recording -0.2% and -1.5%, respectively. On a three-month moving average basis, the production for the three categories retreated: -0.1% for capital goods, -0.5% for intermediate goods and -0.4% for consumer goods. It bears highlighting that capital goods production expanded by 28.3% in the year through August, year-over-year, the most remarkable expansion among the use categories, evidencing the growth in capital goods investment as a relevant factor in the economic recovery of the post-crisis period. The future behavior of industrial production will also depend on the evolution of consumer and businessmen confidence, which should continue to be additional source of dynamism.

9. The unemployment rate in the six metropolitan regions covered by the IBGE Monthly Labor Survey (PME) decreased from 6.9% in July to 6.7% in August, lower than the 8.1% observed in August 2009, according to observed data. After reaching 9.0% in March 2009, the rate not only retreated significantly until August, but it reached a historical record low (6.7%) considering the last nine years of the series, which methodology was extensively revised in 2001. Also according to the seasonally adjusted series, the rate retreated in August, month-on-month, reaching a record low for the series (6.7%). Employment, measured by the number of employed workers in the metropolitan regions, increased by 3.2% in August and also in July 2010, compared to 3.5% in June, year-over-year. Data from the Ministry of Labor and Employment (MTE) indicate that formal employment continues to present strong growth, although September data do not suggest acceleration. In September, 246.9 thousand jobs were created, compared to 252.6 thousand jobs registered in September 2009. In the first nine months of 2010, 2.20 million jobs were created, a 136% expansion relative to the same period of 2009 and the best result for the period since 1985, when the series began. Among the sectors, manufacturing industry outperformed, contributing with 38% of job creation in the month. In the year, services contributed the most (35% of total job creation). Real average earnings also increased month-on-month (1.4% in August relative to 2.2% in July). As a

consequence, real payroll expanded by 8.9% in August, year-over-year, continuing to constitute a key driver for the maintenance of domestic demand growth.

10. According to data seasonally adjusted by the IBGE, expanded retail sales increased 2.1% in August, 1.7% in July and 0.8% in June, month-on-month. As a consequence, the average of sales increased 0.3% in the quarter ended in August, compared to the quarter ended in May, also seasonally adjusted. The three-month moving average of expanded retail sales increased 1.5% in August. On a year-over-year basis, expanded retail sales increased 14.0% in August, 12.6% in July and 3.3% in June. All ten sectors surveyed increased month-on-month in August. The two key drivers were "books, newspapers, magazines and stationary", with 3.5% growth and "furniture and appliances", which increased 2.9%. In the next months it is expected that the retail sales trajectory continues to be benefited by governmental transfers, by real payroll growth, by credit expansion and by consumer confidence.

11. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by FGV, without seasonal adjustment, reached 85.9% in September, up from 85.4% in August, standing close to the levels registered prior to the 2008/2009 crisis. According to the seasonally adjusted monthly series calculated by FGV, the Nuci reached 85.0% in September (84.9% in the previous month). Among the four use categories, the Nuci in construction inputs industry was the only one to reduce (1.4 p.p.), month-on-month, reaching 89.6%, the highest among the use categories. On the other hand, the Nuci for capital goods (84.1%) increased 0.1 p.p. The Nuci for the intermediate goods industry increased 0.3 p.p., while the Nuci for consumer goods industry increased 0.4 p.p., totaling 86.6% and 85.3%, respectively. According to the CNI series seasonally adjusted by the BCB, the Nuci decreased to 82.2% in August, after reaching 82.3% in July and 82.7% in June. Therefore, evidence suggests that the utilization rates have accommodated at high levels, and that the maintenance of the reduced idleness margin is the result of the recent economic activity expansion, still not totally offset by the maturity of completed and ongoing investment projects. It bears noticing that the absorption of capital goods increased 3.3% in August month-on-month, and 40.0% year-over-year. The production of construction inputs also increased in August (1.1% month-on-month and 10.8% year-over-year). On a twelve month trailing basis, expansion totaled 9.7%. 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.

12. The twelve-month cumulative trade balance, after reaching a US$17.1 billion surplus in August, totaled US$ 16.9 billion in September, US$9.6 billion lower than the obtained in the same period last year. This total resulted from US$186.1 billion in exports and US$169.3 billion in imports, equivalent to 17.1% and 27.8% changes, respectively, year-over-year. In fact, the greater dynamism of domestic demand relative to external demand is relevant for the reduction in the trade surplus. The behavior of remittances of profits and dividends, which also reflects the growth differential between the Brazilian economy and the economy in other countries, has contributed to elevate the twelve-month trailing current account deficit, which reached US$45.8 billion in August, equivalent to 2.3% of GDP, up from US$43.8 billion in July. On its turn, foreign direct investment reached US$27.2 billion in the last twelve months through August, equivalent to 1.4% of GDP, resulting in an additional need of foreign funding equivalent to 0.9% of GDP.

13. The global economy recovery continues to be led by a group of emerging countries, whose steady pace of economic expansion is anchored mainly by domestic demand. Regarding the G3 economies (US, Euro Zone and Japan), there are evidences that the recovery process may be slower than anticipated in the first half of the year. The possibility of eventual reversion in this recovery process cannot be completely discarded, though. The US economic activity data indicate a scenario of gradual recovery from the crisis, but at a more moderate pace of growth than that recorded in the first quarter. Consumer confidence in the US reached a new record low and the signs of relevant idleness margin persist, not only in the American economy, but also in the Euro Area and in Japan. In the US, the unemployment rate remained at 9.6% of the labor force in September. In

the Euro Area, the unemployment rate remained at 10.1% in August, with increasing dispersion among the regions: while in Germany the rate reduced to 6.8% – a record low since 1992 –, in Spain it increased to 20.5%. Regarding inflation rates, they have remained at very low levels in the G3 countries, despite the extremely expansionist economic policy actions, both at the fiscal and at the monetary sides. In Japan, its short term interest rate was reduced to an interval between zero and 0.1%, returning to the zero interest rate monetary policy, ended in July 2006. The monetary authority in Japan also announced a new policy of assets purchase. Finally, the possibility that also the US adopts new expansionist monetary policy actions has contributed for the acceleration of the devaluation process of the US dollar that had been observed in the last months. Among emerging markets, it bears highlighting that the Chinese central bank increased its interest rate after a long period of stability. Since the last Copom meeting, monetary policy tightening has also been observed in Chile, although in a magnitude lower than previously practiced, in India and in Israel, whereas monetary policy easing has been observed in South Africa.

14. For the first time in five months, oil prices, in spot and futures markets, increased to levels above U$80. The low predictability of the asymmetric rebound of global economy, the dependence of supply growth on the maturity pace of risky investment projects and the geopolitical complexity of the sector add uncertainty to oil prices forecasts. Nonetheless, the main scenario adopted by the Copom assumes unchanged domestic gasoline prices in 2010. However, it bears highlighting that, regardless of the behavior of domestic gasoline prices, oil prices swings might affect the domestic economy, for example, through the petrochemical sector or through expectations chains. Regarding agricultural commodities, their prices continued to record increases, with highlights for sugar, cotton and corn. Industrial commodities prices have also increased. These price increases may be explained by price movements of important currencies and commodities global demand growth. Although the recent performance of G3 economies, which represent little more than 60% of global GDP, continues modest, the demand for commodities by emerging economies has increased in a robust pace, contributing, therefore, for the prices hikes. On its turn, the volatility observed in commodities prices results from a context where financial markets adjust to new expectations of demand growth and FX markets volatility is high.

Assessment of inflation trends

15. 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 adjustment for fixed telephone for 2010 reduced to 0.8%, down from 1.6%, which was considered in the August/ September meeting, while the projected adjustment for electricity prices for 2010 reduced to 3.6%, down from 3.7%;

c) the projection for regulated prices inflation for 2010, based on individual items, was kept unchanged relative to the August/ September meeting at 3.6%, according to the benchmark scenario. This set of prices, according to data released by the IBGE, accounted for 29.35% of the total September IPCA;

d) the projection for regulated prices inflation for 2011 was reduced to 4.3%, down from 4.4% considered in the August/ September meeting, according to the benchmark scenario. Such projection is based on endogenous determination models for regulated prices, which compute, 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 97 bps and 25 bps spreads in the fourth quarters of 2010 and 2011, respectively.

16. 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 0.90 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 in 2011 and 2012. The additional assumptions considered in the previous meeting remained unchanged.

17. 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 5.07% to 5.20%. For 2011, the median of inflation expectations increased from 4.87% to 4.99%.

18. The benchmark scenario assumes the maintenance of the exchange rate at R$1.65/US$1.00 and the Selic rate at 10.75% p.a. during the forecast period. Under this scenario, the projection for the 2010 inflation increased relative to the figure considered at the August/ September Copom meeting, and is considerably 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 at the period immediately prior to the Copom meeting – IPCA inflation forecast for 2010 also increased, and it stands considerably above the inflation midpoint target. For 2011, under both the benchmark and the market scenarios, the projection increased relative to the figure considered at the August/ September Copom meeting, but it remains around the inflation midpoint target. Regarding the third quarter of 2012, in both scenarios, the projection is around the inflation midpoint target.

Monetary policy decision

19. The Copom evaluates that the monetary policy should contribute to the consolidation of a favorable longer-term macroeconomic environment. In this respect, the Copom reassures that, under the inflation-targeting regime, it guides its decisions according to projected inflation and based on the analysis of several alternative scenarios for the evolution of the main variables that determine the price dynamics. The Committee also understands that low risks for the underlying inflation in the short run tend to reduce uncertainties regarding the future behavior of headline inflation, facilitate the assessment of scenarios by the monetary authority, and help the process of coordination of economic agents' expectations, mainly price setters'. It is additionally noteworthy that low risks for the underlying inflation in the short run tend to reinforce the effects of monetary policy actions, enabling them to affect in a more long-lasting manner the dynamics of headline inflation in the future. Although the Copom recognizes that other actions of macroeconomic policy may influence the price trajectory, it reaffirms its view that it is the responsibility of the monetary policy to remain especially vigilant to guarantee that pressures detected in shorter horizons do not spread to longer horizons.

20. International evidence, ratified by the Brazilian experience, indicates that high inflation rates lead to the increase in 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.

21. As a consequence of the stabilization and correction of unbalances, which determined important structural changes, the process of maturing of the inflation targets stands at advanced stage, and it reflects favorably in the dynamics of neutral interest rate and in the power of monetary policy. Evidences under this respect can be observed, among other factors, through the accomplishment of inflation targets in the last six years, at the same time that real interest rates have reduced. Progress in the financial markets structure, the FX and inflationary risk premium reduction, among other factors, seem to have resulted in significant reduction of the neutral rate. The generation of primary surpluses consistent with the maintenance of decreasing trend for the

public debt/GDP ratio also contributed for it. From another point-of-view, some of these developments, combined to others, such as the extension of contract tenures, also suggest that the power of monetary policy in Brazil has increased in the last years. Despite the substantial uncertainty that surrounds the calculation of non-observable variables, it should be emphasized that this perception is supported by estimates generated by macroeconometric models used by the Copom. In addition, it is also noteworthy that, according to half of the analysts who responded to the consultation carried out by the BCB, the neutral rate in Brazil would currently be at levels equal to or lower than 6.50%. The Committee also considers that there are evidences that the traction of monetary policy increased in the recent past and, compared to what was observed some years ago, currently inflationary pressures are contained with more efficiency by monetary policy actions.

22. In international markets, risk aversion and volatility have remained high since the last Copom meeting, with higher prospects for the increase of global liquidity. Concerns about European countries sovereign debt and the deceleration in China remain elevated, as well as about the sustainability of the US economy recovery. Even so, the prices of some commodities and Brazilian assets increased and, overall, prospects for external funding for the Brazilian economy remain favorable. Meanwhile, the trajectory of price indices evidences the cooling of inflationary pressures in some relevant economies, whereas concerns regarding the prospects of deflation in other economies remain. In this context, the probability of some influence of external disinflation over domestic inflation remains high, although uncertainty about the behavior of asset and commodities prices persists in a context of substantial volatility in international financial markets. Regardless of how these aspects of the international outlook evolve, the Copom reaffirms its view that the main challenge of monetary policy is to ensure that the favorable results obtained over the last years are preserved.

23. Although the accommodation observed in the last two quarters has been more intense than expected at the start of the year, as evidenced, among others, by data on inventories and industrial production, the prospects for the evolution of domestic economic activity remain favorable. This assessment is supported, among other factors, by signs that the expansion of credit supply tends to persist, despite at a more moderate pace, both for individuals and corporate, and by the fact that consumers and businessmen confidence stands at historically high levels, notwithstanding some accommodation at the margin. The Copom considers, additionally, that the dynamism of domestic activity will continue to be benefited by the vigor of labor market, despite the cooling in the generation of jobs in specific segments.

24. The Copom emphasizes, once more, that there are time lags between the implementation of monetary policy and its effects on both economic activity and inflation. Therefore, the assessment of alternative stances 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 substantially deteriorated early this year, but this dynamic has reversed, greatly mirroring less favorable prospects for global activity and the monetary policy actions implemented this year. Since the last meeting, however, the short-term scenario was negatively influenced by the dynamics of food prices, which partially reflects supply shocks. Despite the difficulty in identifying the nature of these shocks, and their intensity, duration and the possibility of reversal, monetary policy should act to prevent its propagation, the so-called second-order effects.

25. The high contribution of food prices to headline inflation, when compared to historical standards, suggests the ongoing materialization of short-term risks that had been identified and taken into account in the balance of risks assessed at the last Copom meeting. However, the prevailing view is that the convergence of inflation to the midpoint target tends to materialize. For that, the Copom finds support in the pertinent considerations that monetary policy acts with time lags over activity and inflation, and that the effects of the adjustment process in the base interest rate initiated in April 2010 haven't completely materialized yet. Moreover, it is worth noticing that this hypothesis of convergence is subject to the materialization of the trajectories regarding fiscal and credit variables which the Committee considers. Anyway, the Committee ensures that, in case this scenario does not promptly materialize, the monetary

policy stance should be adjusted in order to guarantee the convergence between the pace of demand and supply expansions. From another point-of-view, in case inflation does not promptly converge to the midpoint target established by the CMN, monetary policy will act in order to redirect price dynamics and, therefore, ensure the target to be fulfilled.

26. The intensity and frequency of shocks that both the global and Brazilian economies have undergone in recent years impose additional challenges to the analysis of the prospective scenario. Evidence in this respect are manifested, for example, in the bimodal character of analysts' view polled by the BCB, as some participants perceive a benign inflation scenario, in which the Selic rate would remain stable in the relevant horizon, while other participants show skepticism and advocate the base rate. On its turn, the Committee recognizes an economic environment in which the uncertainty level prevails above the usual, where the remaining risks for the consolidation of a benign inflationary scenario stem from the domestic outlook. For instance, it bears highlighting those deriving from domestic demand expansion, in a context of narrow idleness margin in the use of production factors. Regarding this point, it is important to highlight that some stability has been recently observed in the capacity utilization rate at high levels, as well as some moderation in the dynamism of the labor market (exception for public administration). In this context, it seems plausible to affirm that the factors that support these domestic risks have decelerated. Moreover, there are signs that the economy has moved towards a trajectory closer to long-term equilibrium and, therefore, the effects of demand pressures and of the high level of utilization of factors over the balance of risks for inflation tend to cool down.

27. In short, since the last meeting, the short-term risks considered by the Copom at that time have materialized. Still, the current balance of risks still points to the accomplishment of a benign scenario, in which inflation would remain consistent with the inflation targets path, which is largely due to the adjustment of the base rate implemented since April. Also contributing to this scenario is the new information released since then, indicating an improvement in the balance of risks related to the regulated prices dynamics, as well as that the slowdown of economic activity in the last two quarters was more intense than the projected at the start of the year. Regarding the external outlook, the probability of deceleration, and even reversion, of the already slow process of recovery of G3 economies remains high. As a consequence, the influence of the international scenario over domestic inflation behavior shows some disinflationary bias.

28. Under these considerations, evaluating the macroeconomic outlook and the inflation prospects, the Copom unanimously decided to maintain the Selic rate at 10.75% p.a., without bias.

29. Domestic demand is robust, largely due to the effects of stimulus factors, such as income growth and credit expansion. Moreover, although they tend to cool down, fiscal and credit incentives have been provided to the economy in recent quarters, and should still contribute for the consolidation of activity expansion and, hence, for the maintenance of the idleness margin of factors at low levels. The effects of these stimuli, however, are counterbalanced by the effects of the reversal of substantial share of the initiatives taken during the recent 2008/2009 international financial crisis, by those referring to the worsening of the global economy prospects and especially by those stemming from the change in the monetary policy stance. 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.

30. At the end of the meeting it was announced that the Committee will reconvene on December 7th, 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

31. The IPCA rose 0.45% in September, up from 0.04% in August and 0.01% in July. The index increased by 3.60% in the year and 4.70% in twelve months, compared to 4.49% recorded in the year through August.

32. The IPCA acceleration in September reflected especially the greater variation in market prices, which reached 0.56% in the month, up from 0.06% in August. The change in regulated prices also contributed to a higher IPCA rate in the month, reaching 0.19%, compared to -0.01% in August. The behavior of market prices reflected mainly the acceleration of the prices of tradable goods, whose rate increased from 0.12% in August to 0.88% in September. Similarly, the prices of non-tradable goods increased from 0.01% to 0.28%, despite the stability in the change of services prices, 0.41% in August and September. Considering the behavior of the IPCA by groups, it is worth noticing the increase of 1.08% in the prices of food and beverages, group that had been the main driver of the relative price stability in the two preceding months, contributing 0.24 p.p. to the IPCA change in September. The diffusion index reached 62.5%, up from 52.6% in August and 48.7% in July.

33. The changes in the three IPCA core inflation measures have accelerated in September month-on-month. The smoothed trimmed-means core inflation increased 0.43%, up from 0.33% in the previous month, totaling 5.09% in twelve months, compared to 5.05% in August. Core inflation by exclusion, which excludes ten items of household food and the items related to vehicle fuel, rose 0.37% in September, up from 0.12% in August, accumulating 4.94% in twelve months, up from 4.87% in the previous month. The double weight core inflation increased 0.39% in September, up from 0.19% in August, accumulating 4.83% in twelve months, unchanged relative to the previous month.

34. The IGP-DI increased 1.10% in September, unchanged relative to August, totaling an 8.04% increase in the year and 7.95% in twelve months. The Wholesale Price Index (IPA) increased by 1.47% in September, down from 1.70% in August, influenced exclusively by the acceleration of agricultural prices, from 2.68% to 5.15%, considering the slowdown in the change of industrial prices, from 1.40% to 0.31%. In the last twelve months through September, the IPA increased 9.51%, due to increases of 12.48% and 8.56% in the prices of agricultural and industrial products, respectively. The main drivers of wholesale prices were corn, contributing 0.34 p.p.; cattle, 0.22 p.p.; and poultry 0.17 p.p. The IPC-DI increased by 0.46% in September, up from -0.08% in August, totaling 4.36% in twelve months. The INCC rose 0.21% in September, up from 0.14% in August, reaching 6.94% in the last twelve months.

Economic activity

35. The IBC-Br showed stability in August, after increasing by 0.1% in July, considering seasonally adjusted data. For the quarter ended in August, the IBC-Br also showed stability (0.01%), compared to the quarter ended in May. The indicator increased 9.2% in the year through August and 7.4% in twelve months.

36. Expanded retail sales recorded growth at the margin for the fourth consecutive month, increasing by 2.1% in August, month-on-month, after increasing 1.7% in July and 0.8% in June, according to data seasonally adjusted by the IBGE's monthly survey (PMC). According to month-on-month seasonally adjusted data, sales increased in all ten segments surveyed, with highlights for the increases recorded by books, newspapers, magazines and stationery (3.5%); furniture and appliances (2.9%); pharmaceutical and medical articles (2.6%); and vehicles, motorcycles, parts and pieces (2.4%). For the quarter ended in August, retail sales grew 0.3%, quarter-on-quarter.

37. Expanded retail sales grew 14% in August, year-over-year, accumulating increases of 12.2% in the year and 12.3% in the last twelve months. All segments increased year-over-year, with highlights for office material and equipment (24.7%); construction inputs (19.9%); and vehicles, motorcycles, parts and pieces (19.3%). In the year, sales also increased for all segments, especially those regarding office material and equipment (24.8%); furniture and appliances (18.9%); and construction inputs (16.4%). Expanded retail sales in the last twelve months through August, compared to the same previous period, also shows generalized increase by activity, with highlights to the rise in office material and equipment (18%) and vehicles, motorcycles, parts and pieces (16.8%); and furniture and appliances (15.1%).

38. Automobile sales by dealers, including cars, light commercial vehicles, trucks and buses, reduced 1.8% in September, month-on-month, according

to Fenabrave (Brazilian Federation of Automotive Vehicles Distribution) data, seasonally adjusted by the BCB. It bears highlighting the 10.4% fall in the sales of trucks. Total sales decreased 0.5%, year-over-year, a result influenced by the 6.1% decrease in automobile sales. The other categories – trucks, buses and light commercial vehicles – showed significant increases of 31.3%, 21.2% and 21.1%, respectively, year-over-year. In the year and in the last twelve months through September, automobile sales increased respectively 8.7% and 14.7%, reflecting stronger sales in all segments.

39. Capital goods imports increased 2.2% in August, month-on-month, according to the Funcex quantum index, seasonally adjusted by the BCB. Year-over-year, the indicator rose 88.2%, while in the year and on a twelve-month trailing basis, it increased 38.2% and 17.9%, respectively, compared to the same periods of the previous year.

40. Capital goods production increased 1.4% in August, month on month, resulting in a decrease of 0.5% in the quarter ended in August, quarter-on-quarter, according to data from the Monthly Industrial Survey (PIM) by IBGE. Major advances in production in August, month-on-month, were recorded in the segments of capital goods for construction (5.9%), capital goods for the power sector (5.4%); and capital goods for non-serial industrial purposes (4.5%). Among the sectors that recorded declines in production, it bears highlighting capital goods for agriculture (-4.4%). For the year, capital goods production increased 28.3%, with an emphasis on the production for construction, which increased by 155.6%.

41. Industrial production decreased 0.1% in August, month-on-month, after changing 0.6% in July, according to seasonally adjusted data from the PIM-PF. By use categories, capital goods production outperformed, while other categories declined, with emphasis on the decrease of 1.5% in intermediate goods. Considering industry activities, the major changes were observed in machines and equipment (5.6%), medical equipment (5%), other transport equipment (4.5%) and publishing, printing and reproduction (4.1%). The main negative drivers were electronic material and communication equipment (-6.5%), basic metallurgy (-5.8%), tobacco (-5.6%) and pharmaceutical products (-5.5%).

42. Industrial production increased 8.9%, year-over-year, with special emphasis on the production of capital goods (28%), intermediate goods (8.7%), durable consumer goods (4.7%) and semi- and non-durable consumer goods (4.3%). On a twelve-month trailing basis, general industry grew 9.8% in August, year-over-year, with highlights to the increases in the production of durable consumer goods (15.5%), capital goods (14.2%) and intermediate goods (10.9%).

43. The Nuci in the manufacturing industry, calculated by FGV, reached 85.9% in September, corresponding to 85% seasonally adjusted, a 0.1 p.p. increase relative to the previous month, seasonally adjusted, and a 3.1 p.p. increase year-over-year. The increase in the installed capacity utilization rate was observed in all use categories for both comparison bases, except for construction material: durable consumer goods (0.4 p.p. and 1.2 p.p.), intermediate goods (0.3 p.p. and 3.5 p.p.), capital goods (0.1 p.p. and 7.2 p.p.) and construction material (-1.4 p.p. and 0.7 p.p.).

44. Vehicles production reached 308.1 thousand units in September, according to data released by the Anfavea and seasonally adjusted by BCB, representing a downfall of 1.5% relative to August. The sector production expanded by 12.7% year-over-year, by 17.3% in the year and by 23.1% in the last twelve months through September.

45. Vehicles sales decreased 1% in September, month-on-month, exclusively influenced by a 2.1% fall in domestic market sales, while exports expanded by 2.5%. In the year and in the last twelve months, domestic sales increased by 5.8% and 15%, respectively, while exports expanded by 76.3% and 48.6%.

46. The LSPA survey carried out by the IBGE in September projected an 11.1% annual expansion for grains in 2010, representing 148.9 million tons, 2% above the 2008 record high. Compared to 2009, the growth projection for the year reflected especially the upward movements of corn (8.5%), soybeans (20.6%) and wheat (10%).

Surveys and expectations

47. According to the Consumer Expectations Survey carried out by the FGV nationwide, the Consumer Confidence Index (ICC) increased 0.7% in September, month-on-month seasonally adjusted, reaching 121.7 points. The result was influenced by the 3.5% increase in the Current Situation Index (ISA), which reached a historical record high for the sixth consecutive month, while the Expectation Index (IE) decreased by 1.1%. Year-over-year, the ICC increased 9.9%, reflecting increases of 22.9% in ISA and of 2.5% in IE.

48. The Industry Confidence Index (ICI) from FGV increased 0.4% in September, reaching 113.4 points, considering seasonally adjusted data, as a result of the 1.3% increase in the IE, whereas the ISA decreased 0.3%. Year-over-year, the ICI grew 9%, reflecting increases of 10.6% in the ISA and of 7.3% in the IE. In the last two months, there was decrease in optimism about the industry at present and recovery in relation to the future situation.

49. The Services Confidence Index (ICS) from FGV reduced 1.1% in September month-on-month, after increasing by 4.1% in the previous month, influenced by the falls of 1% in the Current Situation Index (ISA-S) and 1.2% in the Expectation Index (IE-S). However, the September ICS stood at 0.6% above the 2010 average and 5.2% above the September 2009 index. The quarter ended in September showed a 0.3% decrease in the ICS, quarter-on-quarter.

50. The Consumer Confidence Index (ICC) from Fecomercio SP reduced 4.1% in October month-on-month, influenced by the falls of 4.9% in the Index of Current Economic Conditions (ICEA) and 3 6% in the Consumer Expectation Index (IEC). In the year through October, the ICC increased 16.3%.

Labor market

51. According to the General Record of Employment and Unemployment (Caged) of the Ministry of Labor and Employment (MTE), 246.9 thousand formal jobs were created in September, increasing 0.3% month-on-month, considered seasonally adjusted data. In the year through September, 2,201.4 thousand jobs were created, a record high for the series, which started in January 1985. According to the same comparison basis, hiring registered a record in expansion in the services sector (774.1 thousand), in manufacturing industry (600.3 thousand), in civil construction (330.2 thousand) and in commerce (292.5 thousand). The net creation of formal employment exceeds by 136% the figure recorded in the same period of 2009, while formal employment increased by 6% in the same period, according the same comparison basis. Regarding the activity sectors mentioned above, formal employment increased 5.5%, 6%, 14.1% and 6.2%, respectively. In September, it bears highlighting the hiring in the service sector (94.2 thousand), in the manufacturing industry (94.2 thousand) and in commerce (55.1 thousand). In the last twelve months through September, 2,263.9 thousand formal jobs were created in the country.

52. According to the IBGE employment survey (PME), carried out in the six main metropolitan regions of the country, the unemployment rate declined for the third consecutive month, reaching 6.7% in August, a historical record low, declining 0.2 p.p. month-on-month and 1.4 p.p. year-over-year. In seasonally adjusted terms, the unemployment rate also reached 6.7% in August, declining 0.2 p.p month-on-month, as a result of falls from 0.3% in the Economically Active Population (PEA) and 0.1% in occupation. According to the same survey, average real earnings usually earned by workers increased 1.4% month-on-month and 2.6% in the year through August, contributing for payroll growth, 1.9% and 6.2%, according the same comparison bases.

Credit and delinquency rates

53. Outstanding credit in the financial system reached R$1,583 billion in August, equivalent to 46.2% of GDP, increasing by 2.2% in the month, 11.9% in the year and 19.2% in twelve months. Non-earmarked credit operations increased by 1.7%, 9.1% and 14.5%, according to the same comparison bases. Among non-earmarked operations, credit operations to individuals increased 1.7% in the month and 10.7% in the year and 17.1% in twelve months, while those relative to corporate increased 1.7%, 7.6% and 11.9%, according to the same comparison bases.

Earmarked credit operations increased 3.3% in the month, 17.7% in the year and 29.6% in twelve months, with highlights for the rises of 3.9%, 31.2% and 51.1% recorded in housing credit and of 6%, 30.1% and 50.5% recorded in BNDES disbursements, according to the same comparison bases.

54. The average interest rate on non-earmarked credit operations, used as reference for interest rates, decreased 0.2 p.p. in August, reaching 35.2%. The average annual rate on credit for individuals reached 39.9% in August, decreasing by 0.6 p.p. relative to July. The average rate on corporate credit totaled 28.9% in August, increasing by 0.2 p.p. relative to July.

55. The average tenure on non-earmarked credit operations, used as reference for interest rates, increased in August, reaching 457 days, up from 452 days in July. This expansion mirrored the rises in the average tenure of credit for individuals and corporate (9 days and 1 day, respectively), which totaled 536 days and 386 days, following the same order.

56. Delinquency rates in the financial system (non-earmarked loans used as reference for interest rates, in arrears for more than ninety days) reduced 0.1 p.p. in August, reaching 4.8%. After reaching the 5.9% record high in August 2009, the delinquency rate has been showing a consistent declining path. Delinquency rates for credit operations with corporate remained stable at 3.6%, while those regarding credit to individuals declined 0.1 p.p., reaching 6.2% in August.

External environment

57. According to International Monetary Fund (IMF) projections released at the start of October, global economy should grow by 4.8% in 2010 and 4.2% in 2011, revising the July estimates, which signaled 4.6% and 4.3%, respectively. According to the observed since the beginning of the financial crisis, the global economic dynamics has remained driven mainly by the emerging economies, which are expected to grow by 7.1% this year, while among developed economies, growth is expected to reach 2.7%. In the US, despite the consumption increase, considering that the labor market still remains weak, 2010 GDP growth should reach 2.6%, compared to the previous forecast of 3.3%. The 2011 projection has also been reviewed, retreating to 2.3%, down from 2.9%.

58. In the commodities market, agricultural prices hiked, increasing 15.7% in dollar terms since the last Copom meeting, mainly as a result of the dollar depreciation, the strengthening of Chinese demand and adverse weather conditions. Similarly, the metallic and energy commodities rose 12.1% and 9.8% in the period. Despite this bias, as the mature economies continue to present significant output gap, price indices are tamed. In the US, driven by the declining path of inflationary cores, the Federal Reserve (Fed) concerns intensified, imposing to the monetary authority to manifest regarding that the current prices level is incompatible with its maximum employment and price stability mandate.

59. In this context, the central banks of G4 economies maintained the accommodative stance of their policies, with the Bank of Japan (BoJ) announcing a new stage of quantitative easing and the reintroduction of the zero interest rate policy (ZIRP). In the emerging economies, despite some basic interest rate rises, as occurred in Peru, Chile and India, the monetary policy stance continues to support economic growth, as central banks have maintained the basic interest rates below the levels observed prior to the beginning of the crisis, with the perception that it will be necessary to continue to delay the withdrawal of monetary stimuli introduced during that period. The evaluation is partially due to the perception of the likely deepening of the accommodative stance adopted by the Fed, which has implied in persistent dollar devaluation, to the demand increase of 10-year government securities relative to mature economies, whose yields remain in a low path, and to the frequent interventions in the FX market, especially in emerging economies (Colombia, Peru, Malaysia, Thailand, India, South Africa and Turkey, among others).

60. It is important to highlight that since the last Copom meeting, the financial markets have been characterized by deep dollar devaluation, lower risk aversion, the stock market valuation and volatility reduction, according to the VIX

index. The VIX index retreated to twenty-point level, standing close to the values recorded at the end of April, before the fiscal crisis deepening in European countries.

Foreign trade and international reserves

61. The Brazilian trade surplus reached US$1.1 billion in September, accumulating US$12.8 billion in the first nine months of the year. In the month, exports totaled US$18.8 billion, and imports, US$17.7 billion. On a daily average basis, the trade surplus fell by 40% year-over-year, mirroring a 45.1% growth in imports and a 28.9% growth in exports. Total external trade accumulated US$277.1 billion in the year, growing by 36.2% relative to the first nine months of 2009.

62. International reserves reached US$275.2 billion in September, recording a US$13.9 billion growth month-on-month and a US$36.7 billion growth in the year. The monetary authority's interventions accounted for net purchases of US$10.8 billion in the domestic market, in the month, accumulating US$ 29.4 billion in the first nine months of 2010.

Money market and open market operations

63. Since the September Copom meeting, the futures interest rate yield curve shifted upwards for longer-term tenors (above one year), mainly driven by the release of more-pressured inflation indices; by the increase of Focus survey inflationary expectations and by the release of robust data for activity, employment and credit. Between August 30th and September 29th, one-, two- and three-year rates increased by 0.08 p.p., 0.28 p.p. and 0.29 p.p., respectively. However, from September 29th, these rates started a declining trajectory, mirrored by the release of below-than-expected domestic activity indicators; by the signals of low recovery of US economy and by the expectation of new monetary easing measures in developed economies. Therefore, on October 18th, the domestic interest rate yield curve stood almost at the same level recorded at the end of August. Between August 30th and October 18th, one-, three- and six-month rates decreased by 0.03 p.p., 0.04 p.p. and 0.05 p.p., respectively. The one- and three-year rates decreased by 0.08 p.p., and 0.01 p.p., respectively, while the two-year rate increased by 0.03 p.p. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month-ahead inflation expectations, fell from 5.89% on August 30th to 5.68% on October 18th.

64. In its open market operations, the BCB carried out, between August 31st and October 18th, repo operations borrowing R$47.7 billion for a six-month period. As a consequence, the average daily balance of the long operations reached R$117.7 billion. In the same period, the BCB also borrowed money through repo operations with tenures between 12 and 33 working days, increasing the average daily balance of short-term borrowing operations to US$218.4 billion. The BCB also borrowed money through 33 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$65.9 billion in the period, borrowing. The average daily balance of the total stock of repurchase agreement of the Central Bank increased from R$387.3 billion between July 20th and August 30th to R$402.0 billion, between August 31st and October 18th. Considering the daily balance of operations for the most recent period, there was a rise in the repurchase agreements totaling R$ 53.5 billion, elevating the total stock from R$ 369.5 billion on August 30th to R$422.9 billion on October 18th. The main drivers of liquidity expansion in the period were the BCB interventions in the FX market, the net expenses of the Union and the net redemption of federal public securities.

65. Between August 31st and October 18th, the National Treasury issuance regarding the traditional auctions raised a total of R$64.8 billion. The issuance of fixed-rate securities reached R$43.2 billion, with R$33.2 billion via issuance of LTNs maturing in 2011 and 2013, and R$10.0 billion via NTN-Fs maturing in 2015, 2017 and 2021. Issuance of LFTs totaled R$12.1 billion, for securities maturing in 2014, 2015, 2016 and 2017. Issuance of inflation-linked NTN-Bs reached R$9.5 billion, for securities maturing in 2013, 2015, 2020, 2040 and 2050.

Minutes of the 155th Meeting of the Monetary Policy Committee (Copom)

Date: December 7th, 2010, from 4:30PM to 6:50PM, and December 8th, from 4:55PM to 7:40PM
Place: BCB Headquarters meeting rooms – 8th floor on December 7th and 20th floor on December 8th – 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 December 7th)
Adriana Soares Sales – Research Department (also present on December 8th)
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – Department of Banking Operations and Payments System
João Henrique de Paula Freitas Simão – Open Market Operations Department
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations Group

Other participants (present on December 7th)
Alexandre Pundek Rocha – Advisor to the Board
André Minella – Advisor to the Research Department
Emanuel Di Stefano Bezerra Freire – Advisor to the Board
Francisco Leopoldo Carvalho de Mendonça Filho – Press Secretary
Katherine Hennings – Advisor to the Board
Wagner Piazza Gaglianone – Advisor to the Research Department

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 recording 0.45% and 0.75% in September and October, respectively, increased again in November, to 0.83%. As a consequence, inflation accumulated in the first eleven months of 2010 reached 5.25%, 1.32 p.p. above the one observed in the same period of 2009. Inflation increase in 2010 reflects the behavior of market prices, which increased by 6.26% in the year through November and contributed 4.4 p.p. of the 5.25% recorded in the year. In fact, regulated prices decelerated year-over-year and total 2.86% in the year through November, down from 4.21% in the same period of last year, contributing only 0.8 p.p. to cumulative inflation in the year through November. Regarding market prices, it bears emphasizing that tradable goods inflation reached 5.87% in the year through November, while the non-tradable goods inflation reached 6.61%. The change in the prices of services, whose dynamics tends to show more persistence than that of the prices of goods, shows some stability, and reached 6.99% in the year through November. The acceleration in prices in September, October and November was greatly due to the elevation in the prices of food and beverages.

2. The deviations in food prices trajectory have continued to perform relevant role in the behavior of 2010 headline inflation. In fact, in the first four-month period, the IPCA showed sharp rise, when the prices of food and beverages increased 5.19%, while in the second four-month period there was relative stability, when the prices of food and beverages retreated 1.61%. The monthly IPCA recorded consecutive price increases in the first three months of the last four-month period, with food and beverages prices increasing by 5.28%. It bears emphasizing that twelve-month trailing household food price inflation changed from 6.67%, in April 2010, to 2.29%, in August, and increased again, to 9.39%, in November; at the same time, according to the same comparison basis, IPCA inflation reached 5.26%, 4.49% and 5.64%, respectively. The recent elevation in food price inflation has partially mirrored domestic and external supply shocks, heightened by the high liquidity environment in international financial markets.

3. In line with the evolution of headline inflation, the three main underlying inflation measures calculated by the BCB increased between September and November. The smoothed trimmed means core inflation increased from 0.43% in September to 0.55% in October and 0.56% in November. In the same period, the double weight core inflation increased from 0.39% to 0.58% and 0.62%, and the core inflation by exclusion rose from 0.37% to 0.44% and 0.52%. In the year through November, the smoothed trimmed means core inflation, double weight core inflation and the core inflation by exclusion increased 5.52%, 5.32% and 5.30%, respectively. The IPCA diffusion index, which had already reached 62.5% in September, increased again to 64.8% in October and to 67.2% in November.

4. The General Price Index (IGP-DI) inflation recorded 1.03% in October, close to the change observed in September (1.10%). In the year through October, the IGP-DI inflation reached 9.16%, above the level recorded in the same period of 2009 (-1.40%). According to the same comparison basis, inflation measured by its main component, the Wholesale Price Index (IPA-DI), rose 11.40%, reflecting the increases of 9.07% and 18.78%, respectively, in industrial and agricultural prices. The 2010 IPA-DI inflation change is, therefore, above the change recorded in the same period of 2009 (-3.77%). Inflation measured by the Consumer Price Index (IPC-DI), another component of the IGP-DI, increased 4.43% in the year through October, above the 3.41% recorded in the same period of 2009. Under the same criterion, inflation measured by the Civil Construction National Index (INCC), component with the lowest weight in the IGP-DI, increased 6.66%, also above the rate recorded in the same period of 2009 (2.85%). As emphasized in previous Copom Meeting Minutes, the Copom evaluates that the effects of wholesale prices over consumer price inflation will depend, among other factors, on the current and prospective demand conditions, the exposure of each sector to external and domestic competition, as well as on the price setters' expectations for the future inflation path.

5. The Index of Economic Activity of the BCB (IBC-Br) incorporates estimates for the monthly production of the three sectors of the economy, as well as for products taxes and, therefore, it constitutes an important coincident indicator of economic activity. After registering positive growth rates in all months of 2009 until April 2010, the IBC-Br, which had been showing stability, growing by 0.2% between May and August this year, resumed growth (0.7% in September), suggesting that the period of most intense cooling activity has finished.

6. After strong retreat due to the 2008/2009 crisis, industrial activity recovered, but has shown some accommodation at levels similar to those observed in the pre-crisis period. According to data seasonally adjusted by the IBGE, industrial output grew by 0.4% in October, and 0.1% in September, month-on-month. The three-month moving average growth rate reached 0.1%, in the period between July and October, close to that registered in the June-September period (0.2%). Year-over-year, the production increased 2.1% in October 2010 and 6.6% in September. On a twelve-month trailing basis, industrial production expanded for the seventh consecutive time, by 11.8% in October, up from 11.2% in September. Compared to December 2008, a record low for industrial production level registered during the 2008/2009 crisis period, recovery up to October totaled 24.5%. This recovery has partially been supported by the growth of industrial activity financing by public financial institutions.

7. Among the industry use categories, according to data seasonally adjusted by the IBGE, the most important driver in October, month-on-month, was durable goods production, which increased by 2.8%. Semi-durable and non-durable consumer goods production, intermediate goods production and capital goods production were negative, recording -0.1%, -0.1% and -0.2%, respectively. On a three-month moving average basis, only consumer goods production increased, reaching 0.2% (0.6% for durable goods production and 0.2% for semi- and non-durable consumer goods production). Capital goods production retreated 0.9%, while intermediate goods production reduced by 0.5%. It bears highlighting that, although capital goods production decreased at the margin, the expansion in the year through October reached 24.0%, year-over-year, the most remarkable expansion among the use categories. This evidences the robustness in capital goods investment, a relevant factor for economic recovery in the post-crisis period.

8. The unemployment rate in the six metropolitan regions covered by the IBGE Monthly Labor Survey (PME) decreased from 6.2% in September to 6.1% in October, lower than the 7.5% observed in October 2009, according to observed data. After reaching 9.0% in March 2009, the observed rate not only retreated significantly until October, but reached a historical record low for the series begun in March 2002 (6.1%). Also according to the seasonally adjusted series, the rate in October reached a new record low for the series (6.3%). Employment, measured by the number of employed workers in the metropolitan regions, increased by 3.5% in September and 3.9% in October, year-over-year. Data from the Ministry of Labor and Employment (MTE) indicate that formal employment continues to grow, although October data do not suggest acceleration. In October, 204.8 thousand jobs were created, compared to 231.0 thousand jobs registered in October 2009. In the year through October, 2.41 million jobs were created, a 107% expansion relative to the same period of 2009 and the best result for the period since the start of the series. The driver for employment in October and in 2010 was services, which contributed with 42% and 36% for job creation in the month and in the year, respectively. Real average earnings also reached a record high in October (0.3% month-on-month and 6.5% year-over-year). As a consequence, real payroll, considering the main earnings, expanded by 10.7% in October, year-over-year, continuing to constitute a key driver for the maintenance of domestic demand growth.

9. According to the retail monthly survey from the IBGE, expanded retail sales increased 5.9% in September, 14.0% in August and 12.6% in July, year-over-year. According to the seasonally adjusted series, sales retreated by 0.9% in September, after growing in the four previous months. As a consequence, the average of sales increased 3.5% in the third quarter, quarter-over-quarter. Out of the ten sectors surveyed, four sectors performed positively month-on-month in September. The most important driver was "office material and equipment", with 5.6% growth. In the next months the retail sales trajectory should continue to be benefited by governmental transfers, by real payroll growth, by credit expansion and by consumer confidence.

10. Expanded retail sales performed positively in all months of the second four-month period of 2010, totaling 4.8%. On the other hand, in the same period, activity recorded 0.9% reduction, according to the industrial output index, and some stability, according to the IBC-Br. Therefore, industrial activity accommodation did not have a correspondence in retail sales, whose dynamism reflects both the evolution of non-durable consumer goods imports, with 8.1% increase in volume between the first and the second four-month period, according to data seasonally adjusted by the BCB, and the evolution of final products inventories, which, throughout the six first months of the year stood below companies' forecasts, according to the industrial survey carried out by the National Industry Confederation (CNI).

11. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by FGV, without seasonal adjustment, reached 86.1% in November, down from 86.4% in October, standing close to the levels registered prior to the 2008/2009 crisis. According to the seasonally adjusted monthly series calculated by FGV, the Nuci reached 84.5% in November, down from 85.2% in the previous month. Among the four use categories, only intermediate goods industry had a retreating Nuci (0.5 p.p.), month-on-month, reaching 86.0%. On the other hand, the Nuci in capital goods industry increased by 1.2 p.p., reaching 84.8%. No monthly change was observed for the Nuci for the construction inputs industry and for the consumer goods industry in November. According to the CNI series seasonally adjusted by the BCB, the Nuci remained stable at 82.2% in October, after reaching 82.1% in September and 82.2% in August. The installed capacity utilization rates, despite at high levels, showed slight decline. The reduced idleness margin is the result of the recent economic activity expansion, still not totally offset by the maturity of investment projects. It bears noticing that the absorption of capital goods decreased 5.8% in October month-on-month, but increased 9.6% year-over-year. In the year through October, growth reached 29.4% year-over-year, evidencing deceleration in capital goods absorption. The production of construction inputs increased 0.8% month-on-month and 5.2% year-over-year, in October. On a twelve-month trailing basis, expansion totaled 12.2%. 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.

12. The twelve-month cumulative trade balance result totaled US$ 17.1 billion in November, US$8.3 billion below the observed in the same period last year. This result stemmed from US$195.5 billion in exports and US$178.4 billion in imports, equivalent to 28.3% and 40.5% changes, respectively, year-over-year. In fact, the greater dynamism of domestic demand relative to external demand is relevant for the reduction in the trade surplus. The behavior of remittances of profits and dividends, which also reflects the growth differential between the Brazilian economy and the economy in other countries, has been contributing to elevate the current account deficit, which reached US$48 billion in October, equivalent to 2.4% of GDP, up from US$47.3 billion in September. On its turn, foreign direct investment reached US$36.1 billion in the last twelve months through October, equivalent to 1.8% of GDP, resulting in a need of foreign funding equivalent to 0.6% of GDP.

13. The global economy recovery continues to be led by a group of emerging countries, whose steady pace of economic expansion is anchored mainly by domestic demand and, in specific cases, by the export sector. Economic recovery has also continued in the US and Europe, despite at a more gradual pace than previously anticipated. The Euro Area, in particular, faces different situations, once persistent uncertainties regarding the solvency of some peripheral economies remain, while the pace of expansion continues quite strong in Germany. Business confidence reached, in November, a record high since the unification of that country. Ireland, on its turn, concluded negotiations on a joint financial assistance package from the European Community, the International Monetary Fund (IMF) and bilateral sources, totaling €85 billion. Regarding inflation rates, they have remained at very low levels in the G3 countries (US, Euro Area and Japan), despite the extremely expansionist economic policy actions, both at the fiscal and at the monetary sides. In a new effort in this direction, the US announced a $600 billion expansion of the monetary easing program and there is greater chance for an extension of fiscal incentives. Among emerging markets, it bears highlighting that the People’s Bank of China has raised the reserve requirements twice since the last Copom meeting. Tightening monetary policy actions were also observed in Chile, South Korea, Hungary and India, whereas further easing was recorded in South Africa.

14. Oil prices, in spot and futures markets, remained near U$80. The low predictability of the asymmetric rebound of global economy, the dependence of supply growth on the maturity pace of risky investment projects and the geopolitical complexity of the sector add uncertainty to oil prices forecasts. The main scenario adopted by the Copom assumes unchanged domestic gasoline prices in 2011. However, it bears highlighting that, regardless of the behavior of local gasoline prices, oil prices swings might affect the domestic economy, for example, through the petrochemical sector or through the expectations channel. Regarding the prices of other commodities, it is noteworthy that the price index based on 22 commodities, published by the Commodity Research Bureau (CRB), has varied in recent weeks, around record levels. One factor that seems to contribute to the sharp elevations is the rebalancing of global demand from developed countries to emerging countries, where consumption tends to be more intensive in commodities. It also bears noticing that, in the recent past, the movement of commodity prices seems to have been strongly influenced by wide global liquidity. In recent weeks, however, there was some cooling in upward pressures, especially for agricultural commodities. The high volatility observed in commodities prices results from a context where financial markets adjust to new expectations of demand growth and to the remarkable volatility in FX markets.

Assessment of inflation trends

15. The identified shocks and their impacts were reassessed according to new set of available information. The scenario considered in the simulations was based on the following assumptions:
a) the projected adjustments for gasoline in 2010 increased from 0%, considered at the October Copom meeting, to 1.6%, and for bottled gas prices, increased from 0% to 1.7%, for the same period. For 2011, the projected adjustments for gasoline and bottled gas prices stand at 0%;

b) the projected adjustments for fixed telephone in 2010 reduced to 0.4%, down from 0.8%, considered at the October meeting, and for electricity prices in 2010, reduced to 2.8%, down from 3.6%. For 2011, the projected adjustments for fixed telephone and electricity rates stand at 2.9% and 2.8%, respectively;

c) the projection for regulated prices inflation in 2010, based on individual items, according to the benchmark scenario, reduced to 3.4%, down from 3.6%, considered at the October meeting. For 2011, the projection reduced to 4%, down from 4.3%. This set of prices, according to data released by the IBGE, accounted for 29.15% of the total November IPCA;

d) the projection for regulated prices inflation in 2012, according to the benchmark scenario, reached 4.4%. Such projection is based on endogenous determination models for regulated prices, which compute, 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 82 bps and 12 bps spreads in the fourth quarters of 2010 and 2011, respectively. For the third quarter of 2012, the estimate is 65 bps spread.

16. Regarding fiscal policy, projections assume the achievement of a public sector primary surplus target of 3.1% of GDP in 2010. This percentage can be reduced by up to 0.90 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% of GDP (according to parameters contained in the Budget Guidelines Law) and to 3.1% in 2012.

17. The set of projections incorporated the estimated effects of the reserve requirements recently announced.

18. 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 5.20% to 5.78%. For 2011, the median of inflation expectations increased from 4.99% to 5.20% and for 2012, it stands at 4.5%.

19. The benchmark scenario assumes the maintenance of the exchange rate at R$1.70/US$1.00 and the Selic rate at 10.75% p.a. during the forecast period. Under this scenario, the projection for the 2010 inflation increased relative to the figure considered at the October Copom meeting, and it is remarkably 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 at the period immediately prior to the Copom meeting – IPCA inflation forecast for 2010 also increased, and it stands considerably above the inflation midpoint target. For 2011, under the benchmark scenario, the projection increased relative to the figure considered at the October Copom meeting and stands above the inflation midpoint target, whereas according to the market scenario, the projection remained stable. Regarding the third quarter of 2012, the projections increased in both scenarios, but remained around the inflation midpoint target.

Monetary policy decision

20. The Copom`s assessment is that monetary policy should contribute to the consolidation of a favorable longer-term macroeconomic environment. In this respect, the Copom reassures that, under the inflation-targeting regime, it guides its decisions according to projected inflation and based on the analysis of several alternative scenarios for the evolution of the main variables that determine prices dynamics. The Committee also understands that low risks for the underlying inflation in the short run tend to reduce uncertainties regarding the future behavior of headline inflation, facilitate the assessment of scenarios by the monetary authority, as well as help the process of coordination of economic agents' expectations, mainly price setters'. It is additionally noteworthy that low risks for the underlying inflation in the short run tend to reinforce the effects of monetary policy actions, enabling them to affect in a more long-lasting manner the dynamics of headline inflation in the future. Although the Copom recognizes that other actions of macroeconomic policy may influence the price trajectory, it reaffirms

its view that it is the responsibility of the monetary policy to remain especially vigilant to guarantee that pressures detected in shorter horizons do not spread to longer horizons.

21. International evidence, ratified by the Brazilian experience, indicates that high inflation rates lead to the increase in 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 strategy adopted by the Copom 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.

22. As a consequence of the stabilization and correction of unbalances, which determined important structural changes, the process of maturing of the inflation target regime stands at an advanced stage, and it reflects favorably in the dynamics of neutral interest rate and in the power of monetary policy. Evidences under this respect can be observed, among other factors, through the accomplishment of inflation targets in the last six years, at the same time that real interest rates have reduced. Progress in the financial markets structure, the FX and inflationary risk premium reduction, among other factors, seem to have resulted in significant reduction of the neutral rate. The generation of primary surpluses consistent with the maintenance of decreasing trend for the public debt/GDP ratio also contributed for it. From another point-of-view, some of these developments, combined to others, such as the extension of contract tenures, also suggest that the power of monetary policy in Brazil has increased in the last years. Despite the substantial uncertainty that surrounds the calculation of non-observable variables, it should be emphasized that this perception is supported by estimates generated by the macroeconometric models used by the Copom. In addition, it is also noteworthy that, according to 49% of the analysts who responded to the consultation carried out by the BCB, the neutral rate in Brazil would currently be at levels equal to or lower than 6.50%. The Committee also considers that there are evidences that the traction of monetary policy increased in the recent past and, compared to what was observed some years ago, currently inflationary pressures are contained with more efficiency by monetary policy actions.

23. In international markets, volatility and risk aversion have remained high since the last Copom meeting, partially fueled by the increase of global liquidity and by the prospects that this process can eventually accentuate. Concerns about European countries` sovereign debts and the possible deceleration in China have also grown, at the same time that doubs regarding the sustainability of the US economy recovery have persisted. The prices of some commodities and Brazilian assets remained relatively stable and, overall, prospects for external funding for the Brazilian economy remain favorable. Meanwhile, the trajectory of price indices evidences the increase of inflationary pressures in some relevant economies, whereas concerns regarding the prospects of deflation in other economies cooled down. In this context, the probability of some influence of external disinflation over domestic inflation retreated, although uncertainty about the behavior of asset and commodities prices persists in a context of substantial volatility in international financial markets. Regardless of how these aspects of the international outlook evolve, the Copom reaffirms its view that the main challenge of monetary policy is to ensure that the favorable results obtained over the last years be preserved.

24. Although the accommodation observed in the last two quarters has been more intense than the expected at the start of the year, as evidenced, among others, by data on inventories and industrial production, the prospects for the evolution of domestic economic activity remain favorable. This assessment is supported, among other factors, by signs that the expansion of credit supply tends to persist, despite at a more moderate pace, both for individuals and corporate, and by the fact that consumers and businessmen confidence stands

at historically high levels, notwithstanding some accommodation at the margin. The Copom considers, additionally, that the dynamism of domestic activity will continue to be benefited by the vigor of labor market, despite the cooling in the generation of jobs in specific segments.

25. The Copom emphasizes, once more, that there are time lags between the implementation of monetary policy and its effects on both economic activity and inflation. Therefore, the assessment of alternative stances for monetary policy should necessarily focus on the forward-looking inflationary scenario and its risks, instead of current and past inflation figures. Since the August/September meeting, inflation was strong and negatively influenced by the dynamic of food prices, which in part reflected domestic and external supply shocks. These developments tend to be transmitted to the prospective scenario, among other mechanisms, through inertia, as pointed by the figures considered by the BCB in its inflation forecasts. It also bears highlighting the persistence of the mismatch between supply and demand growth rates. In this context, the Committee identifies risks to the materialization of a scenario in which inflation promptly converges to the midpoint target.

26. The Copom evaluates, on the other hand, that the effects of the adjustment process in the base interest rate, interrupted in July 2010, haven't completely materialized yet to price dynamics, and, at the same time, reaffirms that the main scenario is subject to the materialization of the trajectories regarding fiscal and parafiscal variables which the Committee considers. The main scenario also incorporates moderation in the credit pace. Regarding this last aspect, since the last meeting, the view of a substantial increase in the probability of materializing this hypothesis prevails, in light of the introduction of macroprudential initiatives.

27. The Copom emphasizes that there is some equivalence among macroprudential and conventional monetary policy actions and that the importance of this link tends to grow with the deepening of the credit market, a phenomenon already observed in Brazil in the last years. However, these two sets of instruments cannot be seen as perfect substitutes, once they diverge, among other aspects, regarding scope and transmission mechanisms. The macroprudential actions recently announced are inserted in a wider process, which includes, among other aims, the reversion of stimuli introduced to outweigh the effects of the 2008/2009 crisis over the Brazilian economy. Together with other measures, they constitute a sequence of initiatives that aim to adequate domestic financial conditions to the after-crisis scenario, characterized by intense contrast among the prospective scenarios for the main economic blocks. Regarding this point, once the Copom shares the view that the banks` attitude regarding risk taking is one of the monetary policy transmission channels, macroprudential actions may precede conventional monetary policy actions.

28. The intensity and frequency of shocks that both the global and Brazilian economies have undergone in the last years impose additional challenges to the analysis of the prospective scenario. The Committee recognizes an economic environment in which the uncertainty level prevails above the usual, where the risks for the consolidation of a benign inflationary scenario essentially stem from the domestic outlook. Among these risks, it bears mentioning those deriving from domestic demand expansion, in a context of narrow idleness margin in the use of production factors, although, in a recent past, a slight decline in the capacity utilization rate and a certain moderation in the dynamism of labor market (except for public administration) have been observed.

29. In short, since the last Copom meeting, in the foreign outlook, extraordinary liquidity eases and their impact, in a certain way, immediate and generalized over assets prices, specially commodities, point to lower probability of reversion of the still slow recovery process in which G3 economies stand. On the other hand, these liquidity eases evidence the ambiguous influence of the international scenario over domestic inflation behavior. Regarding the domestic outlook, the effects of Selic rate adjustments have not been totally incorporated into price dynamics. Additionally, recently announced macroprudential measures, a quick and powerful instrument to contain localized demand pressures, will still have their effects incorporated to price dynamics. Still, since the last Copom meeting, the materialization of short-run risks which the Copom considered at that opportunity has continued, but it revealed to be at a magnitude higher than previously

anticipated. Although the uncertainties that surround the global scenario, and at a lower scale, the domestic scenario, do not allow the clear identification of the lastingness of the recent pressures, the current balance of risks is less favorable to the materialization of a benign scenario, in which inflation would consistently follow the targets trajectory.

30. In this context, after having considered the macroeconomic context and inflation prospects, the Copom unanimously decided to maintain the Selic rate at 10.75% p.a., without bias. In light of a less favorable prospective scenario than that observed in the last meeting, but considering that, due to credit and liquidity conditions, the BCB recently introduced macroprudential measures, among the Committee members prevailed the understanding that additional time will be necessary in order to better measure the effect of these initiatives over monetary conditions. In this sense, the Committee understood it is not opportune to reevaluate monetary policy strategy at this meeting and will attentively follow the evolution of the macroeconomic scenario until its next meeting, to then define the next steps in its monetary policy strategy.

31. Domestic demand is robust, largely due to the effects of stimulus factors, such as income growth and credit expansion. Moreover, although tending to cool down, fiscal and credit incentives have been provided to the economy in the last quarters, and should still contribute for the consolidation of activity expansion and, hence, for the maintenance of the idleness margin of factors at low levels. The effects of these stimuli, however, are counterbalanced by the effects of the reversal of substantial share of the initiatives taken during the recent 2008/2009 financial crisis and by recent macroprudential initiatives. These elements are an important part of the context in which future monetary policy decisions will be taken, aiming to ensure the timely convergence of inflation to the targets path.

32. At the end of the meeting it was announced that the Committee will reconvene on January 18th, 2011 for technical presentations and, on the following day, to discuss the monetary policy decision, as established in Communiqué 20,223 of October 15th, 2010.

Summary of data analyzed by the copom

Inflation

33. The IPCA rose 0.83% in November, showing acceleration relative to the October result, 0.75%, but a reduction relative to the IPCA-15 result in November, 0.86%. The index increased by 5.25% in the year and by 5.64% in the last twelve months through November. Market prices increased by 1.04% in the month, up from 0.94% in October, as result of the increases of 1.53% in the prices of tradable goods and of 0.60% in the prices of non-tradable goods. Regulated prices increased by 0.33%, up from 0.30% in October. The diffusion index reached 67.19% in November and an average of 61.08% in 2010.

34. Monthly and twelve-month IPCA core inflation rates accelerated in November. The smoothed trimmed-means core inflation increased 0.56%, up from 0.55% in the previous month, accumulating 5.52% in twelve months, up from 5.35% in October. Core inflation by exclusion, which excludes ten items of household food and items related to vehicles fuel, grew 0.52% in November, up from 0.44% in October, totaling 5.30% and 5.15% in the last twelve months through November and through October, respectively. The double weight core inflation measure increased by 0.62% in November, up from 0.58% in October, totaling 5,32% in twelve months, up from 5.09% in the previous month.

35. The IGP-M increased 1.45% in November, totaling 10.56% in the year and 10.27% in twelve months. In November, all three components accelerated. The IPA rose 1.84%, up from 1.30% in October, mainly influenced by the high increase observed in the prices of bovines items and meat, meat and fish products, which jointly contributed 0.79 p.p. for the result. In the last twelve months through November, the IPA rose 12.62%, reflecting respective increases of 22.05% and 9.59% observed in the prices of agricultural and industrial products. The IPC increased 0.81% in November, up from 0.56% in October, with acceleration in four out of the seven surveyed groups, especially in food prices. In the year through October, and in the last twelve months, the IPC increased by 5.13% and 5.34%, respectively. The INCC increased 0.36% in November, up from 0.15%

in October, reaching 6.95% in the year and 7.16% in the last twelve months.

Economic activity

36. The IBC-Br increased 0.7% in September, after five months of relative stability, according to seasonally adjusted data. For the quarter ended in September, the IBC-Br increased by 0.3%, relative to the quarter ended in June. According to the observed series, the IBC-Br increased 8.9% in the year and 8% in the last twelve months.

37. After four consecutive months of growth at the margin, expanded retail sales decreased 0.9% in September, month-on-month, according to data seasonally adjusted by the IBGE's monthly survey (PMC). Nevertheless, retail sales continued to grow in the period, with a 0.4% increase for the fifth consecutive month. According to month-on-month seasonally adjusted data, sales increased in four of the ten sectors surveyed, with highlights for the following positive drivers: sales of office equipment and material (5.6%) and other items of personal and domestic use (2.8%). Among the negative drivers, it bears highlighting the retreats of 1.2% in pharmaceutical and medical articles and 0.8% in vehicles and motorcycles, parts and pieces. The average of expanded retail sales in the third quarter showed a 3.5% increase, quarter-over-quarter.

38. Expanded retail sales grew 5.9% in September, year-over-year, accumulating increases of 11.4% in the year and 12% in the last twelve months. The sales of vehicles, motorcycles, parts and pieces were the only ones that decreased year-over-year (-4%). Among sectors that expanded, it bears highlighting the sales of office equipment and material (28.5%), construction inputs (16.8%) and other items of personal and domestic use (15.8%). The sales of all ten sectors increased in the year, especially those relative to office equipment and material (25.3%), furniture and appliances (18.4%) and construction inputs (16.4%). The expanded sales in the last twelve months through September, year-over-year, also increased by each sector, with highlights to office equipment and material (20.4%), furniture and appliances (16.1%) and vehicles, motorcycles, parts and pieces (14.4%).

39. Automobile sales by dealers, including cars, light commercial vehicles, trucks and buses, increased 4.8% in November, month-on-month, according to Fenabrave (Brazilian Federation of Automotive Vehicles Distribution) data, seasonally adjusted by the BCB, with generalized increases in all categories. In the quarter ended in November, sales increased 8.3%, relative to the quarter ended in July, a performance mainly driven by automobile sales (10.0%). In the year and in the last twelve months through November, automobile sales increased 10% and 12.6%, respectively, reflecting increases in all categories, with emphasis on light commercial vehicles, trucks and buses.

40. Capital goods imports decreased 13.2% in October, month-on-month, according to the Funcex quantum index, seasonally adjusted by the BCB. Year-over-year, the indicator rose 32.7%, while in the year and on a twelve-month trailing basis, it increased 42.1% and 33.2%, respectively, compared to the same periods of the previous year.

41. Capital goods production decreased 0.2% in October, resulting in a 2.4% decrease in the quarter ended in October, quarter-on-quarter, according to data from the Monthly Industrial Survey (PIM) by IBGE. Among the sectors, the major production decreases recorded in October, month-on-month, stemmed from the segments of capital goods for the power sector (4.2%), capital goods for non-serial industrial purposes (3.1%) and capital goods for agricultural production (2.5%). Among the sectors that recorded increase in production, it bears highlighting transport equipment (4%) and capital goods for serial industrial purposes (3.9%). In the year, capital goods production grew 24%, with emphasis on the production for construction, which increased by 120.8%.

42. Construction inputs increased 0.8% in October, month-on-month, according to data seasonally adjusted by the Central Bank, totaling 0.2% growth in the quarter. Year-over-year, production increased 5.2%, whereas in the year through October and in the last twelve months it expanded by 12.9% and 12.2%, respectively.

43. Disbursements from granted by the BNDES reached R$ 140.9 billion in the year through October,

with a 31% increase year-over-year. The industrial sector was the largest recipient of disbursements, with participation of 50% of the total released in the period, followed by the infrastructure sector (29%), trade and services (15%) and agriculture and the livestock sector (6%).

44. Industrial production increased 0.4% in October, month-on-month, after changing 0.1% in September, according to seasonally adjusted data from the PIM-PF. As a consequence, average production quarter-on-quarter was unchanged. By use categories, it bears highlighting that durable consumer goods outperformed (2.8% increase), while other categories declined. Considering the 26 industry activities, twelve showed monthly increases. In the quarter ended in October, the major changes were observed in publishing, printing and reproduction (8%), medical equipment (6.5%), and other transport equipment (3.8%). The main negative drivers were electronic material and communication equipment (-14.5%), capital goods for the electricity sector (-6.5%), and basic metallurgy (-6.1%).

45. Industrial production increased 2.1%, year-over-year, with special emphasis on the production of capital goods (6%), followed by the production of intermediate goods (3.2%) and semi- and non-durable consumer goods (1.5%), while the production of durable consumer goods decreased (4.9%). On a twelve-month trailing basis, general industry grew 11.8% in October, year-over-year, with highlights to the increases in the production of capital goods (21.1%), durable consumer goods (15.4%), and intermediate goods (12.8%).

46. The Nuci in the manufacturing industry, calculated by FGV, reached 84.5% in November, corresponding to a 0.7 p.p. decrease month-on-month and a 1.6 p.p. increase year-over-year. According to the last comparison basis, the increase in installed capacity utilization rate mainly reflects the one relative to capital goods, which increased from 77.9% to 84.8% in November this year. The intermediate goods and construction material industries increased 2 p.p. and 1.9 p.p., respectively, while the consumer goods industry decreased by 0.7 p.p. Month-on-month, capital goods increased 1.2 p.p., consumer goods and construction material were stable, whereas intermediate goods decreased by 0.5 p.p.

47. Vehicles production reached 321.1 thousand units in November, according to data released by the Anfavea and seasonally adjusted by BCB, representing a 0.1% increase month-on-month. The sector production expanded 10.2% year-over-year, 14.6% in the year and 19.2% in the last twelve months through November.

48. Vehicles sales increased 1.7% in November month-on-month, and 14.6% year-over-year, according to seasonally adjusted data. In the year and in the last twelve months through November, sales increased by 14.3% and 17.2%, respectively, influenced both by the domestic market expansion (4.3% and 7.8%, respectively) and by exports vehicles growth (73% and 68.4%, following the same order).

49. The LSPA survey carried out by the IBGE in October projected a 2.8% annual decrease for grains in 2011, relative to 2010, representing 144.5 million tons. It bears highlighting that, in this projection, corn and soybeans average yields, which follow last years' averages, are below 2010 levels, historical record highs for these products. The total area projected increased 1.7%, to 47.4 million ha.

Surveys and expectations

50. According to the Consumer Expectations Survey carried out by the FGV nationwide, the Consumer Confidence Index (ICC) increased 2.7% in November, month-on-month seasonally adjusted, reaching 125.4 points, new historical record high. The result was influenced by the 4.5% increase in the Current Situation Index (ISA) and 1.5% in the Expectation Index (IE). Year-over-year, the ICC increased 9.3%, reflecting increases of 19.8% in ISA and of 3% in IE.

51. The Industry Confidence Index (ICI) from FGV decreased 1.1% in November, month-on-month, reaching 112.7 points, considering seasonally adjusted data, a record low since November 2009. The index behavior reflected, with greater intensity, lower optimism regarding the coming months. The IE decreased 1.9% and the ISA declined 0.3%. The ICI grew 2.9% year-over- year, due to the 5.8% increase in the ISA and the 0.3% decrease in the IE.

52. The Services Confidence Index (ICS) from FGV reduced 0.3% in November month-on-month, after retreating by 0.9% in the previous month, reflecting the fall of 2.5% in the Current Situation Index (ISA-S), smoothed by the 1.8% increase in the Expectation Index (IE-S). The ICS grew 2.7%, year-over-year, and 0.4% in the quarter ended in November, quarter-over-quarter.

Labor market

53. According to the General Record of Employment and Unemployment (Caged) of the Ministry of Labor and Employment (MTE), 204.8 thousand formal jobs were created in October, representing a 0.4% increase month-on-month, considering seasonally adjusted data. In the year through October, 2,406.2 thousand jobs were created, a record high for the ten first months of the year, since the start of the series, in January 1985. According to the same comparison basis, hiring registered a record in expansion in the services sector (860.3 thousand), in manufacturing industry (647.2 thousand), in commerce (373.9 thousand) and in civil construction (341.6 thousand). Regarding the activity sectors mentioned above, formal employment increased 5.6%, 6.1%, 6.2% and 14%, respectively. In October, it bears highlighting the hiring in the service sector (86.2 thousand); and in commerce (81.3 thousand). In the last twelve months through October, 2,237.7 thousand formal jobs were created in the country.

54. According to the IBGE employment survey (PME), carried out in the six main metropolitan regions of the country, the unemployment rate declined for the fifth consecutive month, reaching 6.1% in October, a historical record low, declining 0.1 p.p. month-on-month and 1.4 p.p. year-over-year. In seasonally adjusted terms, the unemployment rate also reached 6.3% in October, declining 0.1 p.p., month-on-month, as a result of increases of 0.3% in the Economically Active Population (PEA) and 0.4% in occupation. According to the same survey, average real earnings usually earned by workers reached a record high for the series, increasing 0.3% month-on-month and 3.4% in the year through October, contributing for the expansions of 1.4% and 7.1% in payroll growth, according to the same comparison bases.

Credit and delinquency rates

55. Outstanding credit in the financial system reached R$1,645 billion in October, equivalent to 47.2% of GDP, increasing by 1.9% in the month, 16.3% in the year and 20.3% in twelve months. Non-earmarked credit operations increased by 1.6%, 13% and 15.7%, respectively, according to the same comparison bases, reflecting the increases of 1.6% in the month and 14.4% in the year and 17.1% in twelve months for credit operations to individuals and 1.6%, 11.7% and 14.3%, according to the same comparison bases, for credit operations to corporate. Earmarked credit operations increased 2.5% in the month, 23.1% in the year and 30% in twelve months, with highlights for the rises of 2.9%, 40.2% and 51.1% recorded in housing credit and of 2.7%, 22.6% and 32.4% recorded in BNDES disbursements, according to the same comparison bases.

56. The average interest rate on non-earmarked credit operations increased 0.3 p.p. in October, reaching 35.4%. The average annual rate on credit for individuals reached 40.4% in October, increasing by 1 p.p. relative to September. The average rate on corporate credit totaled 28.7% in October, decreasing by 0.3 p.p. relative to September.

57. The average tenure on non-earmarked credit operations decreased in October, reaching 456 days, down from 458 days in September. This contraction mirrored the falls in the average tenure of credit for individuals and corporate (3 days and 2 days, respectively), which totaled 538 days and 383 days, following the same order.

58. Delinquency rates in the financial system (non-earmarked loans used as reference for interest rates, in arrears for more than ninety days) remained stable at 4.7% in October, reducing 1.1 p.p. in twelve months, a record low since January 2009. Delinquency rates for credit operations with corporate and to individuals remained stable at 6% and 3.5%, respectively.

External environment

59. In the third quarter, economic activity accelerated in the US and in Japan and cooled in the Euro Area

and in UK. Regarding the US and Japan, GDP acceleration was positively influenced by the expansion in household consumption, although in Japan this demand component has been benefited by governmental incentives, already extinct for the automotive sector, but still in vigor until the end of the year for some certain durable goods. In the US, the last *Beige Book* reported evidence of better performance of retail sales in several Districts, but it continues to signal a depressed housing real state market. In the same period, the interannual Chinese GDP growth rate decelerated to 9.6%, down from 10.3% in the previous quarter. Regarding manufacturing industry, the PMI index (purchase managers index) advanced in global manufacturing production in November, with highlights for the growth in the employment and new orders indices.

60. The assets prices in the financial and commodity markets shifted upwards and downwards. The upward movement, among the resumption of liquidity ease in the US, was due to the improvement in consumption indicators in several economies and to the effects of adverse weather conditions over supply (in the specific case of agricultural commodities). The downward movement reflected the surge of fears regarding the monetary tightening in China and the fiscal sustainability of some European countries, whose uncertainties remain even after the agreement settled by Ireland, the European Union and the IMF. In this sense, the US dollar, which had been depreciating in face of other currencies, started to appreciate in response to the growth of risk perception by financial agents.

61. Less exposed to swings in food prices, due to the composition of the consumption baskets, the consumer price indices (IPC) of the mature economies maintained more stable behavior than those of the emerging economies. The annual IPC change reached, in October, 1.2% in the US, 1.9% in the Euro Zone, 3.2% in the UK and 0.2% in Japan, the first positive change since February 2009. It bears highlighting that in the US, the annual IPC core change stood at 0.6%, a record low for the series, began in 1957. Among the emerging countries, also in October, the annual IPC increased in Russia, to 7.5%, in China, to 4,4%, in Korea, to 4.1%, and in Mexico, to 4%, while it reduced in Turkey, to 8.6%.

62. In this context, the central banks in the US, Euro Area, UK and Japan maintained the accommodative stance of their policies, having the Fed announced, on November 3rd, a new quantitative easing, by deciding on the purchase, until the end of the second quarter of 2001, of more than US$600 billion in long-term Treasuries, at a pace of US$75 billion per month. It bears highlighting that, since the last Copom meeting, several central banks, among which the ones from Chile and India, have increased their basic interest rates.

Foreign trade and international reserves

63. The Brazilian trade surplus reached US$312 million in November, as a result of US$17.7 billion in exports and US$17.4 billion in imports. As a consequence, the trade surplus accumulated in the year reached US$14.9 billion. On a daily average basis, the trade surplus fell by 35.4% year-over-year, mirroring a 43.9% growth in imports and a 30.7% growth in exports. Total external trade grew by 36.7% in the year, increasing to US$347.1 billion in the year, up from US$254 billion in 2009.

64. International reserves reached US$285.5 billion in November, recording a US$531 million growth month-on-month and a US$46.9 billion growth in the year. The monetary authority's interventions accounted for net purchases of US$2.4 billion in the domestic market, in the month, accumulating US$39.3 billion in the first eleven months of 2010.

Money market and open market operations

65. Since the October Copom meeting, the futures interest rate yield curve shifted upwards for all tenors, mainly driven by the release of above-than-expected current inflation indices; by the increase of inflationary expectations and by the uncertainties related to the conduction of fiscal policy by the next government. On the external outlook, the increase in the US Treasuries rates also contributed to pressure the long-term domestic interest rates. However, from December 3rd, this upward movement of the interest rate was partially reverted, due to the announcement, by the BCB, of macroprudential measures involving the increase of reserve requirements and increase of capital requirements for credit operations. Therefore,

between October 18th and December 6th, one-, three- and six-month rates increased by 0.08 p.p., 0.31 p.p. and 0.76 p.p., respectively. The one-, two- and three-year rates increased by 0.88 p.p., 0.76 p.p. and 0.70 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 5.68% on October 18th to 6.30% on December 6th.

66. In its open market operations, the BCB carried out, between October 19th and December 6th, repo operations borrowing R$28.3 billion for a six-month period. As a consequence, the average daily balance of the long operations reached R$ 129.2 billion. In the same period, the BCB also borrowed money through repo operations with tenures between 13 and 33 working days, increasing the average daily balance of short-term borrowing operations to US$201.0 billion. The BCB also borrowed money through 34 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$65.2 billion in the period, borrowing. The average daily balance of the total stock of repurchase agreements of the Central Bank decreased from R$402.0 billion between August 31st and October 18th to R$395.4 billion, between October 19th and December 6th. Considering the daily balance of operations for the most recent period, there was a reduction in the daily balance of repurchase agreements totaling R$49.3 billion, elevating the total stock from R$422.9 billion on October 18th to R$373.6 billion on December 6th. The main drivers of liquidity retreat in the period were the net issuance of National Treasury securities, the net revenues of the Union and the demand for currency by the public.

67. Between October 19th and December 6th, the National Treasury issuance regarding the traditional auctions raised a total of R$39.2 billion. The sale of fixed-rate securities reached R$23.5 billion, with R$21.8 billion via issuance of LTNs maturing in 2011 and 2013, and R$1.7 billion via NTN-Fs maturing in 2015, 2017 and 2021. Issuance of LFTs totaled R$11.2 billion, for securities maturing in 2015 and 2017. Issuance of inflation-linked NTN-Bs reached R$4.5 billion, for securities maturing in 2013, 2014, 2015, 2016, 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)

Voting members

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

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)

Daso Maranhão Coimbra
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
Caged	General File of Employed and Unemployed Persons
CBT	Chicago Board of Trade
CCI	Consumer Confidence Index
CDC	Direct Consumer Loans
CDS	Credit default swap
Cide	Contribution on Intervention in the Economic Domain
CMN	National Monetary Council
CNI	National Confederation of Industry
Conab	National Supply Company
Copom	Monetary Policy Committee
CRB	Commodity Research Bureau
CSI	Current Situation Index
CVM	Securities and Exchange Commission
DAX	Deutscher Aktienindex
DOE	U.S. Department of Energy
DPGE	Deposits with Special Guarantee
ECB	European Central Bank
EI	Expectations Index
Embi+	Emerging Markets Bond Index Plus
EP	Employed Population
FDI	Foreign Direct Investments
Fed	Federal Reserve
Fenabrave	National Federation of Automotive Vehicle Distribution
FGTS	Employment Compensation Fund
FGV	Getulio Vargas Foundation
Finame	Special Industrial Financing Agency
FOMC	Federal Open Market Committee
FPR	Risk Weighting Factor
FTSE 100	Financial Times Securities Exchange Index

FV	Production of vehicles, parts and accessories
GDP	Gross Domestic Product
Gerin	Investor Relations and Special Studies Department
GFCF	Gross Fixed Capital Formation
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
IC-Br	Commodities Index – Brazil
ICE	New York Intercontinental Exchange
Icea	Current Economic Conditions Index
ICI	Industrial Confidence Index
ICMS	Tax on the Circulation of Merchandises and Services
ICS	Services Confidence Index
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
INSS	National Social Security Institute
IPA-DI	Producer Price Index – Domestic Supply
IPC	Consumer Price Index
IPCA	Extended National Consumer Price Index
IPC-Br	Consumer Price Index – Brazil
IPC-DI	Consumer Price Index – Domestic Supply
IPVA	Tax on Automotive Vehicle Proprietorship
ISM	Institute for Supply Management
Kospi	Korea Composite Stock Price Index
LDO	Budget Guidelines Law
LME	London Metal Exchange
LSPA	Systematic Farm Production Survey
MTE	Ministry of Labor and Employment
NTN-B	National Treasury Note – Series B
Nuci	Installed Capacity Utilization Level
OUR	Open unemployment rate (OUR)
p.p.	percentage points
p.y.	Per year
PAC	Growth Incentive Program
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
PPI	Broad Producer Price Index
PSND	Public Sector Net Debt

S&P 500	Standard and Poor's 500
Selic	Special System for Clearance and Custody
Sensex	Bombay Stock Exchange Sensitive Index
SFN	National Financial System
SIT	Manufacturing Industry Survey
TCI	Trade Confidence Index
TJLP	Long-Term Interest Rate
USA	United States of America
VAR	Autoregressive Vector
VIX	Chicago Board Options Exchange Volatility Index
WTI	West Texas Intermediate