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%.