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Inflation Report

March 2011

Volume 13 | Number 1

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: Economic activity; Prices; Credit, monetary and fiscal policies; International economy; External sector and Inflation outlook. 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 perspectives of faster than expected recovery of the global economy and the smaller likelihood of this process to be reverted seem consolidated. However, the perception of strong growth asymmetry among countries still prevails. The consolidation of the economic recovery is particularly important in the United States, where the domestic demand has been showing some vigor, particularly household consumption, in an environment of decreasing uncertainties in the labor market. In the Euro Area, macroeconomic perspectives are still asymmetric. Although headline consumer price inflation indices have grown in the G3 countries (United States, Euro Area and Japan), core inflation indicators remain at moderate levels, despite the still strong fiscal and monetary stimuli. In the emerging markets, inflationary pressures have become more widespread.

In Brazil, macroprudential measures have been implemented late last year in order to ensure the stability of the financial system. Compared to the outlook at the cutoff date of the previous *Inflation Report* (December 2010), current available data indicate important changes in both prices and volume of resources traded in the credit market. Although at a more moderate pace, the credit market should continue contributing to the expansion of investment and consumption. As a matter of fact, credit operations with non-earmarked resources in the household credit market still register a positive performance, particularly the operations with payroll-deducted and auto loans.

The expansion of the Gross Domestic Product (GDP) in the last two quarters of 2010, coupled with recent industrial production indicators, corroborates the Central Bank assessment, expressed in the most recent *Inflation Reports*, that growth rates have converged to levels more consistent with long-term growth. The leveling off of the economic activity should continue in the coming quarters, reflecting, among other policy initiatives, the monetary policy stance, as well as high comparison basis.

Insofar as demand is concerned, retail sales continue growing, boosted by consumer confidence, positive labor market performance and somewhat moderate credit expansion. It should be highlighted that investments, which had been severely hit by the international financial crisis, have recovered fast and strongly and still post robust growth rates.

External trade flows have been expanding, thus adjusting to the differential between growth rates of domestic supply and demand. The expansion of imports has been contributing to attenuate the mismatch between aggregate demand and supply. The higher current account deficit in 2010 reflected the robust growth of the domestic economic activity. Remittance of profits and dividends – an important component of the overall deficit – also reflect the dynamism of business activities.

For 2011, the expansion of the current account deficit is expected to be moderate and should be mostly financed by net inflows of foreign direct investment (FDI). The FDI performance will depend upon the still abundant international liquidity and, to a great extent, on the growth prospects of the Brazilian economy. Foreign portfolio investment is expected to remain significant, notwithstanding the downturn of fixed-income foreign investment due to the increase of the IOF implemented in October 2010. In 2011, the rollover rate of medium and long-term external debt should reach 150%, thus increasing the debt share as a source of balance of payments financing. However, investments should continue to surpass the external debt in the composition of the Brazilian external liabilities.

In the beginning of 2011, consumer inflation rates were partially impacted by domestic seasonal factors, such as the increase in the price of perishable foodstuffs, public transportation fares and expenses with education. This unfavorable price dynamics was further reinforced by the effects of rising commodity prices in the international markets. Adding to these factors, there is the imbalance between the growth rate of domestic demand and the expansion of the aggregate supply. Such an imbalance was particularly reflected in the dynamics of the prices of services.

Regarding inflation projections, following the usual procedures, and taking into account the information set available up to the cutoff date of March 11, 2011, the baseline scenario, which assumes a constant exchange rate over the forecast horizon at R$1.65/US$, and the target for the basic interest rate (the Selic rate) at 11.75% p.a., projects inflation of 5.6% in 2011 and 4.6% in 2012. The projection for the first quarter of 2013 is 4.5%.

In the market scenario, which is based on data from the expectations survey undertaken by the Central Bank's Investor Relations and Special Studies Department (Gerin) with a significant group of institutions, the inflation projections are also 5.6% for 2011 and 4.6% for 2012. The projection for the first quarter of 2013 is also 4.5%.

In an alternative scenario, which assumes that the exchange rate remains unchanged over the relevant horizon at recently observed levels; and the target for the Selic rate based on data from the expectations survey carried out by Gerin, the inflation projection is 5.5% for 2011 and 4.4% for 2012. For the first quarter of 2013, the projection is 4.3%.

The Committee assesses that the balance of risks since the latest *Inflation Report* (December 2010), to a certain degree, has evolved more favorably to the realization of a benign scenario for inflation. In this regard, since then, monetary policy measures have been implemented, evidence of the effectiveness of macroprudential measures introduced in December 2010 has emerged, and important decisions have been taken and executed in the fiscal front. In addition, more recently, commodity prices have shown signs of moderation, despite unfavorable geopolitical developments.

In 2010, inflation surpassed the 4.5% midpoint target, an outcome that in part resulted from the first-round effects of negative supply shocks, in particular the acceleration of international commodity prices during the second half of 2010. For instance, the Commodities Brazil Index (IC-Br) increased by 41.1% between July 2010 and February 2011, and in the specific case of agricultural commodities, 60.2%, in the same period. It is estimated that the first-round effects of this extraordinary supply shock would alone lead to about 2.5 percentage point variation in headline inflation. Part of this variation already materialized in 2010, but estimates suggest that approximately one third of the inflationary impact of the commodity shock will affect consumer prices only this year.

The Committee assesses that the costs in terms of economic activity of preventing the first-round effects of the supply shock from moving the 2011 inflation away from the midpoint target of 4.5% would be excessively high. On the other hand, the domestic demand is expanding at a more modest pace, which, though uncertain, should still be impacted by the contractionary policy measures implemented so far. Additionally, the Committee assesses that the flexibility inherent to the inflation targeting regime allows the accommodation of the first-round effects of the supply shock. In other words, under the current circumstances the best practice recommends implementing a gradual convergence of inflation towards the target, similar to past strategy adopted by the Central Bank.

Therefore, the Committee highlights that the monetary policy strategy aims to curb the second round effects of the supply shock and ensure convergence of inflation towards the target in 2012. To this end, it is important to highlight that given the prospects of moderating domestic activity, as well as the complexity surrounding the international environment, among other factors, the monetary policy strategy may eventually be revaluated in terms of its intensity, temporal distribution or both.

According to the baseline scenario, the GDP growth projected for 2011 is 4.0%. The Committee assesses that the Brazilian economy has moved towards a trajectory which is more consistent with the long-run equilibrium. Such a trajectory is in line with the prospects of a declining mismatch between the growth of domestic absorption and the expansion of the aggregate supply.

Economic activity

1

The Brazilian economy, in a scenario of expanding employment, income and credit, and with high business and consumer confidence levels, registered in 2010 the highest annual growth since 1986. Throughout the second six months of the year, it was registered different growth rates between aggregate supply and aggregate demand, with splitting on the importations level and on the inflation's trajectory, especially in the services sector.

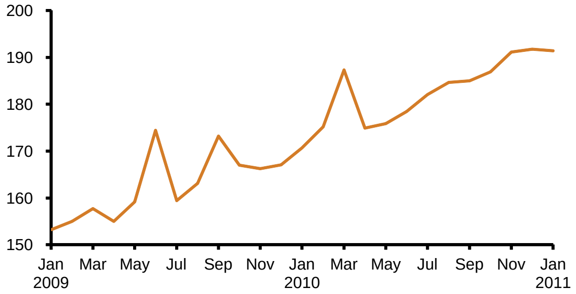
Early year's indicators still reflect fiscal and credit stimuli introduced in the 2010 final quarters. However, such effects are opposed by those of current macroprudential measures and basic interest rises, which tend to reduce the pace of demand expansion. In this scenario, more positive perspectives are outlined so as to maintain the Brazilian economic growth in a sustainable basis.

1.1 Trade

The expanded trade sales turned in strong performance in the second half of 2010 and some leveling off at the beginning of 2011. End-of-year sales performance surpassed the seasonal pattern of the period and helped the sector's annual growth to reach 12.2% according to the Brazilian Institute for Geography and Statistics (IBGE), second best result of the series initiated in 2003. This result reflected the expansion of sales of durable and semidurable goods, which are more sensitive to credit's conditions, and in a smaller scale, the evolution of nondurable goods consumption, mainly conditioned by an improved job market outlook.

Trade indicators continued to show a good performance in the beginning of 2011, consistent with consumers' high confidence level. In this context, expanded trade sales increased 3.2% in the quarter ended January, when compared to that ended October 2010, when they had increased 3.7% on the same comparison basis, considering

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



Source: IBGE

Table 1.1 – Sales volume index

	2010			2011
% change	Oct	Nov	Dec	Jan
In the month[1/]				
Retail sector	0.1	0.7	0.2	1.2
Fuel and lubricants	0.0	-0.1	1.3	0.3
Supermarkets	-0.2	0.0	-0.4	1.2
Fabrics, apparel and footwear	1.4	-3.6	3.1	0.5
Furniture and home appliances	2.5	2.4	1.8	2.7
Pharmac., medical, orthop. and perfumery articles	0.6	1.3	1.6	0.5
Books, newspaper, magazines,	2.5	10.1	2.2	-2.3
Office, comp./comunic. equip.	-12.1	11.5	2.8	-5.1
Other art. of personal use	-1.6	0.2	-0.3	-2.5
Broad trade sector	1.0	2.3	0.3	-0.2
Building materials	0.3	1.5	3.2	1.1
Automobiles, motorcycles, parts and spares	8.1	0.9	5.0	-7.1
3-Month Period/Previous 3-Month Period[1/]				
Retail sector	2.9	2.1	1.5	1.5
Fuel and lubricants	1.7	2.0	1.5	1.1
Supermarkets	1.4	0.4	-0.1	-0.1
Fabrics, apparel and footwear	3.6	1.3	0.6	-0.6
Furniture and home appliances	5.5	6.4	7.1	6.8
Pharmac., medical, orthop. and perfumery articles	4.5	3.6	2.9	2.9
Books, newspaper, magazines,	6.2	8.7	11.2	12.6
Office, comp./comunic. equip.	1.2	2.6	1.1	4.9
Other art. of personal use	3.5	1.8	-0.1	-1.3
Broad trade sector	3.7	3.3	3.3	3.2
Building materials	2.0	1.8	2.6	4.0
Automobiles, motorcycles, parts and spares	9.4	9.6	11.8	7.1
In the year				
Retail sector	11.1	11.0	10.9	8.2
Fuel and lubricants	6.6	6.6	6.6	6.3
Supermarkets	9.6	9.3	8.9	4.2
Fabrics, apparel and footwear	11.0	10.8	10.6	9.8
Furniture and home appliances	18.1	18.3	18.3	19.1
Pharmac., medical, orthop. and perfumery articles	11.5	11.6	11.9	12.7
Books, newspaper, magazines,	9.1	10.2	12.0	12.5
Office, comp./comunic. equip.	24.2	23.9	24.3	7.4
Other art. of personal use	8.7	8.9	9.1	4.9
Broad trade sector	11.4	11.9	12.2	11.2
Building materials	15.6	15.6	15.7	16.5
Automobiles, motorcycles, parts and spares	11.2	13.0	14.1	16.4

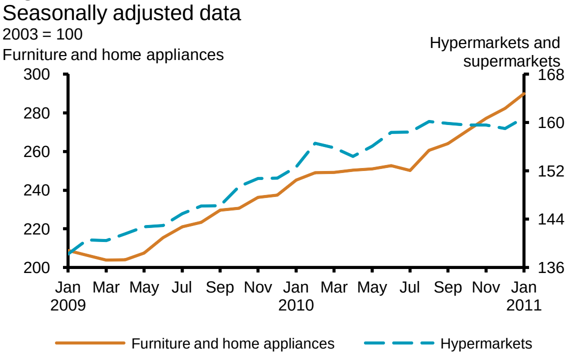
Source: IBGE

1/ Seasonally adjusted data.

Figure 1.2 – Retail sales

Seasonally adjusted data

2003 = 100



Source: IBGE

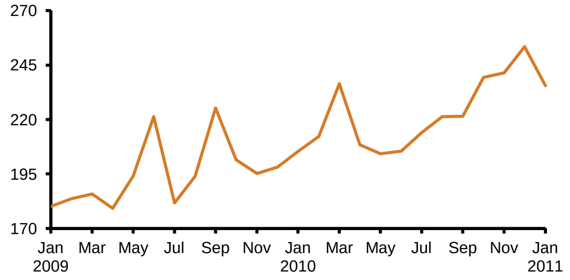
deseasonalized data from IBGE's Monthly Retail Trade Survey (PMC). The monthly data registered a 0.2% drop in January. In a quarterly comparison, it was registered growth in sales of seven of the ten segments surveyed, with emphasis on those related to books, newspapers, magazines and stationary, 12.6%; vehicles, motorcycles, parts and spares, 7.1%; and furniture and electrical appliances, 6.8%. On the other hand, there have been retractions in the segments of other personal and domestic goods, 1.3%; fabrics, clothing and footwear, 0.6%; and hypermarkets, supermarkets, food, beverages and tobacco, 0.1%; this last one was influenced by the rise in food prices, especially at the end of 2010.

Retail trade sales, which exclude the segments vehicles, motorcycles, parts and spares, as well as building material, increased 1.5% in the quarter, registering positive results in all regions of the country, pointing out those observed in the Central-West, 2.7%, and in the Southeast, 2.3%.

The most recent developments of other retail trade indicators also reveal, more moderate sales in segments related to food and a continued growth in the other segments in early 2011. Therefore, considering deseasonalized data, the real sales of the supermarket sector, segment with approximate weight of 32% in the PMC of IBGE and impacted by the recent increase of the food prices, dropped 2.5% in the quarter ended February, when compared to the one ended November, according to the Brazilian Association of Supermarkets (Abras). In addition, the Serasa Experian's Business Activity Index, with nationwide coverage, built from monthly consultations carried out by commercial establishments, increased 4% in the same comparison basis. In the same way, automotives' and light commercial vehicles' sales, published by National Federation of Motor Vehicles Distribution (Fenabrave), increased 1.5% in the quarter ended February compared with that ended November, with 8.5% increase in the same type of analysis, pointing out to growth continuity in the sector's sales.

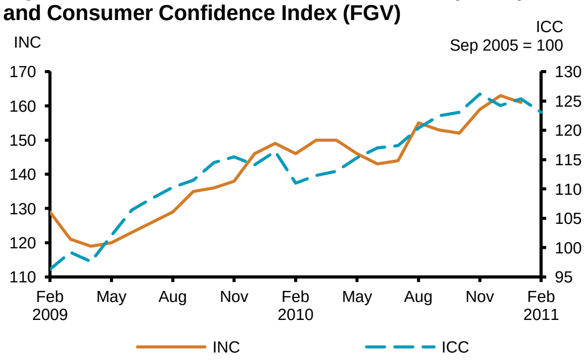
The ratio between the number of checks returned due to lack of funds and the total of checks cashed reached 5.8% in February, against 6% in the same period in the previous year, suggesting continuity of the indicator' steadiness in levels lower than observed in 2010. Default in São Paulo, measured by the São Paulo Trade Association (ACSP), reached 6.9% in February, against 6.3% in the same month in 2010, remaining at level compatible to the State's sales vigor.

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



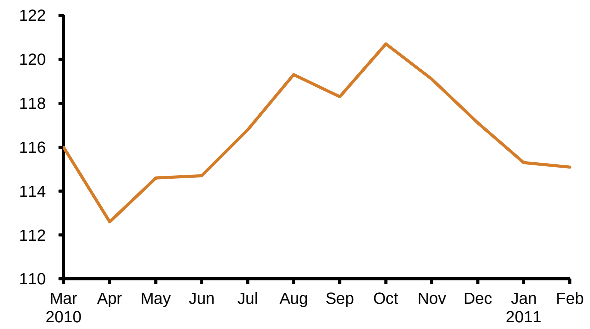
Source: IBGE

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



Sources: ACSP and FGV

Figure 1.5 – National Consumer Confidence Index
2001 = 100



Source: CNI

The Serasa Experian's Consumer Default Indicator[1] remained at a high level and registered in February a 2.3% monthly reduction and 25.9% annual rise. It should be emphasized the continuity of important arrears on financial enterprises, credit cards and nonfinancial companies' scope, which hold a participation of 36% in the general indicator.

The indicators targeted to evaluate consumers' expectations, after closing at record levels at the end of 2010, registered relative stability at high level in the beginning of 2011. Considering deseasonalized data, the Consumer Liability Index (ICC), of Getulio Vargas Foundation (FGV), reached 122.6 points in February 2011, a result 1.6 point lower than the record registered in November 2010, registering retreats in components of the Current Situation Index (ISA), 1.8 point, and the Expectations Index (IE), 1.4 points.

The National Confidence Index (INC), released by Ipsos Public Affairs for the ACSP, accounted for 157 points in February, dropping 2.5% compared with January and 3.7% compared with the December 2010 record, but increasing 7.5% compared with January 2011. The monthly result was a consequence of falloffs in the North/ Central-West regions, 15.2%, and Northeast, 8.9%, stability in the Southeast and rises of 4.8% in the South.

The National Consumer Expectation Index (Inec), published monthly as of March 2010 by the National Confederation of Industry (CNI), remained almost flat in February, interrupting the fall movement initiated in November 2010. The 0.2% decline compared with January reflected, especially, the in the components referring to personal income expectation, 2.2%, indebtedness, 2.1% and financial situation, 1.2%. On the opposite sense, one should note the monthly increase in the indices linked to expectations regarding unemployment, 2.5%; purchases of higher-value goods, 1.4% and expectations regarding inflation, 0.4%.

The ICC, published by the Trade Federation of the State of São Paulo (Fecomercio-SP) and restricted to the municipality of São Paulo, reached 162.2 points in February, increasing 1.4% in the month and remaining 2 points below the record registered in December of the previous year. The Consumer Expectations Index (IEC) calculated by the Trade Federation of the State of Rio de Janeiro (Fecomércio-RJ), for the metropolitan region of Rio de Janeiro, reached 120.9 points in February, retreating 2.2% compared with January and 5.2% compared with the record reached in December 2010.

1/ The indicator comprehends negative records from financial enterprises, credit cards, nonfinancial companies, banks, securities claimed and second devolution of checks uncashed due to lack of funds.

Table 1.2 – Industrial production

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

	2010			2011
	Oct	Nov	Dec	Jan
Industry	-0.2	0.1	-0.2	-0.4
By section				
Mining	2.6	2.6	0.7	0.6
Manufacturing	-0.8	-0.1	-0.1	0.4
By category of use				
Capital goods	-2.2	-1.3	0.2	2.4
Intermediate goods	-1.2	-0.6	-0.2	0.5
Consumer goods	0.4	1.2	0.1	0.2
Durables	0.3	1.5	2.2	3.3
Semi and nondurables	-0.1	0.5	-0.2	-0.5

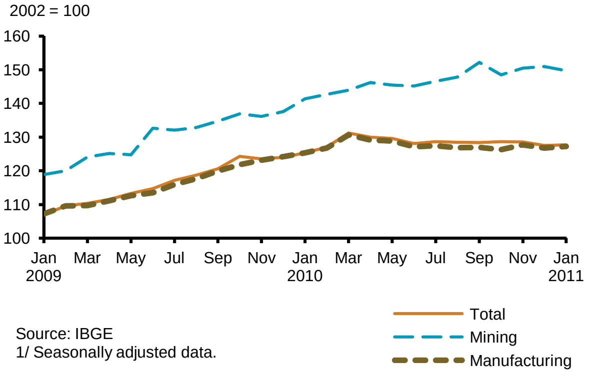
%

Source: IBGE

1/ Seasonally adjusted data.

Figure 1.6 – Industrial production[1/]

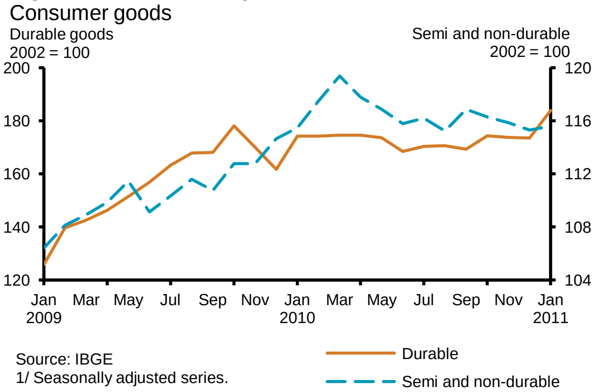
Total and sections



Source: IBGE
1/ Seasonally adjusted data.

Figure 1.7 – Industrial production[1/]

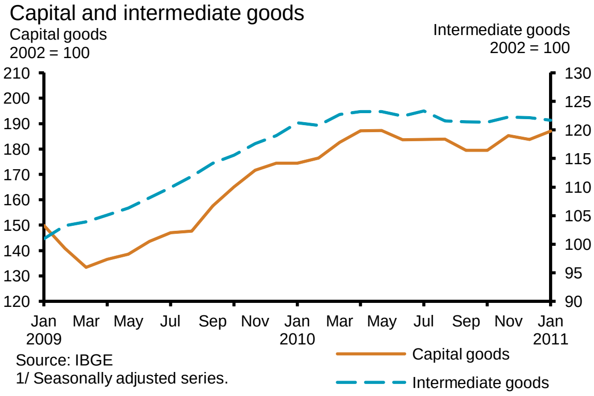
Consumer goods



Source: IBGE
1/ Seasonally adjusted series.

Figure 1.8 – Industrial production[1/]

Capital and intermediate goods



Source: IBGE
1/ Seasonally adjusted series.

1.2 Production

Industrial production

Industry's physical production retreated 0.4% in the quarter ended January, compared with the one ended October 2010, when it had decreased 0.2% in this type of analysis, according to IBGE'S Monthly Industrial Survey – Physical Production (PIM-PF) deseasonalized data. The sharpest retractions occurred in the activities footwear and leather, 4.1%; textile, 3.8%; and foodstuffs, 3.2%, contrasting with the rises in the industries of office machines and informatics equipments, 11.9%; machines, appliances and electric fittings, 6%; and furniture, 6%.

The analysis by use categories shows that the industry of consumer durables expanded 3.3%; capital goods, 2.4%; intermediate goods, 0.5%; while the industry of semidurable and nondurable consumer goods dropped 0.5% in the quarter.

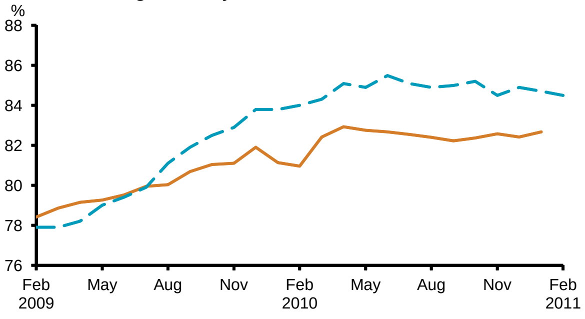
The index for salaried working population, considering deseasonalized data from IBGE's Monthly Industrial Survey – Employment and Salaries (Pimes), remained steady in the quarter ended January, compared with the one ended October, while the worker productivity, following growth in physical production, declined 0.5% within the period. The real payroll decreased 1% in the quarter ended January 2011, compared with the one ended October.

The Installed Capacity Utilization (UCI) of the manufacturing industry reached 84.5% in February in the series with seasonal adjustment, according to the Manufacturing Industry Survey (SIT) of FGV. The average UCI dropped 0.2 p.p. in the quarter ended February, compared with the one ended November 2010, considering deseasonalized data, due to 1.1 p.p. retraction in the consumer durables industry and 0.4 p.p. in the intermediate goods industry, stability in the nondurable consumer goods industry and 0.3 p.p. improvement in the capital goods industry.

The Industrial Confidence Index[2] (ICI), considering FGV's deseasonalized data, amounted to 112.5 points in February, above the balance level of one hundred points and indicating, therefore, satisfaction of the sector with the level of businesses and/or optimism regarding the future. This perception is shared by executives of all use categories identified by this research. The manufacturing industry average ICI dropped 0.1 p.p. in the quarter ended February,

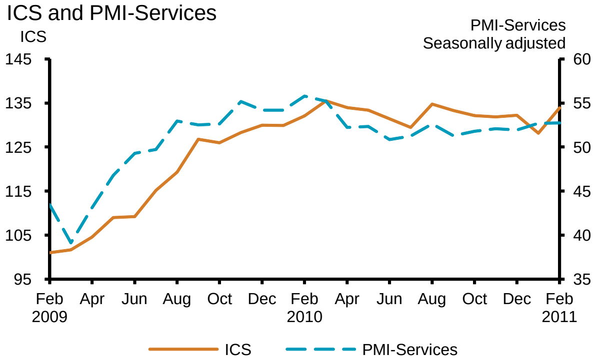
2/ Values above 100 points indicate a sentiment of optimism.

Figure 1.9 – Capacity utilization [1/]
Manufacturing industry



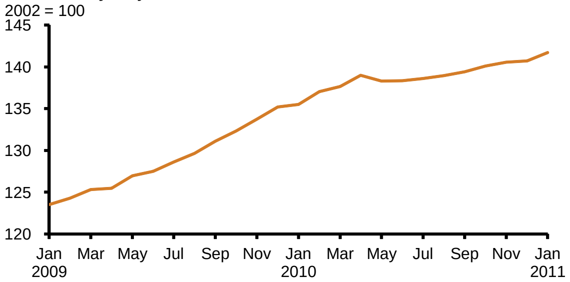
Sources: CNI and FGV
1/ Seasonally adjusted series.

Figure 1.10 – Service Confidence Index
ICS and PMI-Services



Sources: FGV and Markit

Figure 1.11 – Central Bank Index of Economic Activity – Brazil (IBC-Br)
Seasonally adjusted data



Source: IBGE

compared with the one ended November 2010, registering rise of 2 p.p. in the industry of nondurable consumer goods and reduction in those related to consumer durables, 4.9 per cent; capital goods, 2.5 p.p.; and intermediate goods, 1.8 per cent. The perception of the industrial businessmen with respect to economy is more optimistic under the point of view of Purchasing Managers' Index[3] (PMI) of Markit, which reached 54.6 points in February, the highest level since March of last year.

Service

The Services Confidence Index (ICS), portraying the continued business confidence of the service sector in a historically high level, reached 133.9 points in February, against 128.2 points in January and 132.1 points in the corresponding month of 2010. The ICS monthly evolution reflected the respective rises of 6.3% and 3% registered in the Current Situation Index (ISA-S) and the Expectations Index (IE-S).

The Purchasing Managers' Index (PMI-Services)[4], calculated by Markit and published by Hong Kong and Shanghai Banking Corporation (HSBC), suggesting the continued improving trend of the sector, reached 52.7 points in February, the highest level since April 2010, considering deseasonalized data.

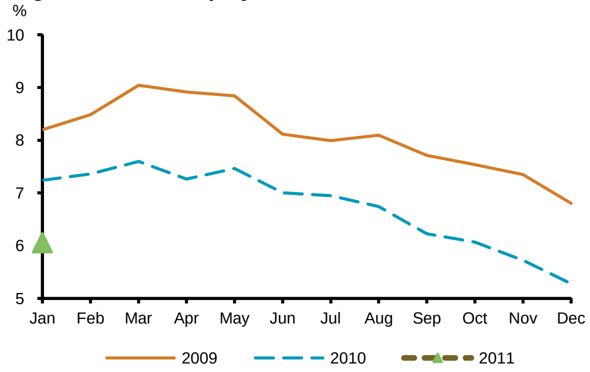
Central Bank Index of Economic Activity – Brazil (IBC-Br)

The Central Bank Index of Economic Activity – Brazil (IBC-Br), after 7.8% growth in 2010, registered a 1.1% rise in the quarter ended January, compared with the one ended October, when it increased 0.8% in the same type of comparison, considering deseasonalized data. In January the indicator registered monthly rise of 0.7%, reflecting the combination of positive temporary influences in the month, mostly originated from the primary sector.

3/ The PMI summarizes the monthly development of the indicators for new orders, production, employment, delivery time, and inventory of inputs. Values above 50 represent monthly expansion of activity.

4/ The index is constructed based on monthly responses sent by executives of about 400 private companies in the service sector, with the panel selected to replicate the actual structure of the sector, covering the activities of transportation and communication, financial intermediation, business services, personal services, computer and information technology, and hotels and restaurants. Values above 50 represent growth in activity.

Figure 1.12 – Unemployment rate



Source: IBGE

Table 1.3 – Formal employment

New jobs – In the year (1,000)

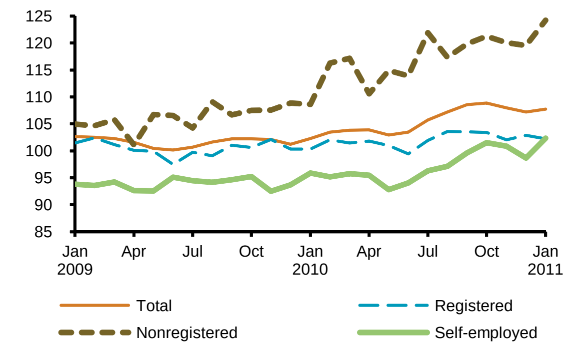
	2010			2011
	I H	II H	Year	Jan
Total	1473.3	663.6	2136.9	152.1
Manufacturing industry	394.1	90.9	485.0	53.2
Commerce	144.1	375.5	519.6	-18.1
Services	490.0	374.2	864.3	73.2
Building	230.0	24.2	254.2	33.4
Crop and livestock	175.1	-201.0	-25.9	8.3
Public utilities	9.9	8.0	17.9	1.6
Others[1/]	30.1	-8.1	22.0	0.5

Source: MTE

1/ Includes mining, public administration and others.

Figure 1.13 – Average real regular earnings

March 2002 = 100



Source: IBGE

1.3 Labor market

Employment

The unemployment rate, after remaining at 5.3% in December 2010, lowest level of the series initiated on March 2002, reached 6.1% in January, against 7.2% in the same period of the previous year, according to the Monthly Employment Survey (PME), performed by the IBGE in the six major metropolitan regions of the country. The average rate regarding the quarter ended January accounted for 5.7%, against 7.1% in the corresponding period of 2010. Considering deseasonalized data, the average unemployment rate reached 6.1% in the period, against 6.5% in the quarter ended October 2010, result of 0.3% increase in the working population and stability in the Overall labor Force (PEA).

According to the General File of Employed and Unemployed Persons (Caged), of the Ministry of Labor and Employment (MTE), 2,136.9 thousand jobs were created in 2010, the highest amount since the beginning of the series in 1985. Emphasizing the seasonality of the period, 117.2 thousand formal jobs were eliminated in the quarter ended January, with emphasis in the net dismissals registered in the rural sector, 141.6 thousand; manufacturing industry, 109 thousand; and in construction, 54.1 thousand. On the other hand, there were net declines in commerce, 127.6 thousand, as well as in the service sector, 77.2 thousand.

The real average income normally received by the main job, estimated by the PME in the six major metropolitan regions, increased 5.7% in the quarter ended January, compared with the corresponding period in the previous year, with emphasis in the 11.9% expansion registered in the segment of private-sector unregistered workers. By activity sector, the most expressive gains happened in the construction industry, 9.1%, and in the domestic help, 7.5%. The real overall wages expanded 8.8% during the period.

1.4 Gross Domestic Product

Gross Domestic Product (GDP) increased 7.5% in 2010, according to IBGE's Quarterly National Accounts, being registered, in the scope of demand, contributions of 10.3 p.p. from the domestic component and -2.8 p.p. from the external sector. From the supply side, there were annual rises in the added value of the three sectors of economy, amounting to

Table 1.4 – Gross Domestic Product
Accumulated in the year

% growth

	2009	2010			
	IV Q	I Q	II Q	III Q	IV Q
Crop and livestock	-4.6	5.4	8.1	7.8	6.5
Industry	-6.4	15.1	14.5	12.3	10.1
Mineral extraction	-1.1	14.7	15.6	16.0	15.7
Manufacturing	-8.2	17.3	15.6	12.5	9.7
Construction	-6.3	15.1	15.9	13.6	11.6
Public utilities	-2.6	8.4	9.2	8.8	7.8
Services	2.2	6.2	6.1	5.7	5.4
Commerce	-1.8	15.3	13.6	12.0	10.7
Transportation	-2.5	12.5	11.8	10.3	8.9
Communications	3.8	2.9	3.2	3.5	3.8
Financial institutions	7.1	9.6	9.9	10.4	10.7
Other services	3.5	3.4	3.8	3.5	3.6
Rents	1.9	1.6	1.7	1.6	1.7
Public administration	3.3	2.5	2.7	2.6	2.3
Value added at basic prices	-0.6	8.4	8.4	7.5	6.7
Taxes on products	-0.9	14.7	14.0	13.3	12.5
GDP at market prices	-0.6	9.3	9.2	8.4	7.5

Source: IBGE

Table 1.5 – Gross Domestic Product
Accumulated in the year

% growth

	2009	2010			
	IV Q	I Q	II Q	III Q	IV Q
GDP at market prices	-0.6	9.3	9.2	8.4	7.5
Households consumption	4.2	8.4	7.4	6.9	7.0
Government consumption	3.9	2.7	4.2	4.1	3.3
Gross fixed capital formation	-10.3	28.4	28.2	25.6	21.8
Exports	-10.2	14.7	10.6	10.8	11.5
Imports	-11.5	39.6	39.2	39.8	36.2

Source: IBGE

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

% growth

	2009	2010			
	IV Q	I Q	II Q	III Q	IV Q
GDP at market prices	2.5	2.2	1.6	0.4	0.7
Crop and livestock	5.1	2.6	1.4	-1.6	-0.8
Industry	3.8	1.7	3.6	-0.6	-0.3
Services	1.3	1.4	1.1	0.9	1.0
Households consumption	1.1	1.8	1.1	1.8	2.5
Government consumption	2.4	-0.2	1.8	-0.1	-0.3
Gross fixed capital formation	8.6	4.0	3.9	3.1	0.7
Exports	2.9	3.4	1.2	4.2	3.6
Imports	15.1	8.1	5.7	7.1	3.9

Source: IBGE

10.1% in the secondary sector, 6.5% in the primary sector and 5.4% in the service sector.

The rural sector result is consistent with the annual expansion of 11.6% of the grain harvest and with the respective rises of 8.5% and 3.8% in the slaughter of cattle, poultry and pork, within the first nine months of 2010, compared with the corresponding period of the previous year. The industrial sector's performance reflected, specially, increases in the mineral extraction industry, 15.7%; construction, 11.6%; and manufacturing industry, 9.7%. The services sector annual growth was mainly supported by the vigor of the segments commerce, 10.7%; transportation, storage and mailing, 8.9%; and financial intermediation, insurances, social security and related services, 10.7%, where the first two are related to the results of the industrial and farm sectors.

Considering the demand side, investments, in line with the performance of construction and purchase of capital goods, increased 21.8% in 2010, while the household consumption, reflecting the overall wages and credit operations increase, grew by 7%. The external sector negative contribution represented the annual rises registered in imports, 36.2%, and exports, 11.5%, a differential regarding the distinctive pace of growth of both international and Brazilian economies.

The analysis at the margin, considering deseasonalized data, reveals that GDP growth slowed down in the second half of 2010, when growth rates of 0.4% and 0.7% were registered in the third and fourth quarter of the year, respectively, against expansions of 2.2% in the quarter ended March and 1.6% in that ended June.

The aggregate's performance in the quarter ended December reflected the 1% growth observed in the service sector and farming and industry retractions of 0.8% and 0.3%, respectively. On the demand side, the household consumption grew by 2.5% in the quarter, while the gross fixed capital formation (FBCF), slowed down to 0.7%, but it still corresponded to the seventh positive result since the second quarter of 2009.

The GDP growth forecast for 2011 was reviewed from 4.5% to 4%, and is detailed in the box "Revision of GDP Forecast for 2011", on page 20 of this Report.

1.5 Investments

Investments, excluding stocks variations, increased 21.8% in 2010, according to the Quarterly National Accounts of IBGE, emphasizing that the average growth rate of this variable in the biennium ended 2010 reached 4.5%, against GDP's average rise of 3.3%, pointing out expansion of the economy's supply capacity within the period.

Table 1.7 – Industrial production

% change over the same period in previous year

	2010				2011
	I Q	II Q	III Q	IV Q	Jan
Building inputs	15.2	17.0	9.7	6.6	6.5
Capital goods	25.9	33.2	21.2	7.0	9.1
Typically industrialized	23.7	33.4	20.6	12.7	6.4
Agricultural	43.0	59.6	44.7	-3.4	-5.4
Agricultural parts	21.3	6.7	3.0	38.5	5.3
Building	212.4	169.1	92.1	27.6	23.6
Electricity	-3.3	0.9	2.4	-13.3	-2.8
Transportation equipment	19.4	33.2	35.4	17.4	8.3
Mixed	30.0	31.0	5.2	-2.9	9.8

Source: IBGE

At the margin, investments increased 0.7% in the quarter ended December, compared with that ended September, considering deseasonalized data. Such rise, the seventh in a row, represented a fall in this variable's growth, which had been 3.1% in the previous quarter. In the same type of comparison, investments' performance had been anticipated by GFCF monthly indicators trajectory. Thus, the construction inputs production registered a 2.4% rise in the quarter ended December, compared with that ended September, while the production, imports and exports of capital goods registered respective variations of 0.2%, -7.6% and 2.5%, determining a quarterly decline of 2.6% in the purchase of these goods.

The disbursements of BNDES – National Bank for Economic and Social Development (BNDES), Special Industrial Financing Agency (Finame) and BNDES Participações S.A. (BNDESpar) – accounted for R$168.4 billion in 2010, increasing 23.5% when compared with the previous year. The resources channeled to crop and livestock, manufacturing industry and to the commerce and service sector increased, respectively, 47.7%, 28.1% and 20.5%, while those targeted to the mineral extraction industry declined 53%.

Construction industry input production and capital goods purchases registered respective rises of 9.8% and 14.5% in January, compared with the same month in 2010, being registered respective variations of 9.1%, 25.3% and -4.6% in the production, imports and exports of capital goods. In addition, the production of trucks, farm machines and buses turned in respective variations of 13.2%, 8.1% and -5.6% in February, compared with the corresponding month in 2010, according to the National Association of Automotive Vehicle Manufacturers (Anfavea).

1.6 Conclusion

The country's current economic expansion cycle, as shown in the seven consecutive positive results of quarterly GDP, registered a relative slowdown in the last two quarters of 2010. Prospectively, the economic activity stabilizing trend must persist in the following months, reflecting the monetary policy and macro prudential measures, as well as the highest comparison basis after the strong recovery registered throughout 2010, constituting, therefore, a favorable scenario for sustainable growth.

Projection for the 2011 GDP

Gross Domestic Product (GDP) growth projection in 2011 was revised from 4.5%, in the last Inflation Report, to 4% mainly due to incorporation of preliminary data for the first quarter and updating of macroeconomic scenario for the following.

The supply analysis (Table 1) reveals that the crop and livestock sector may increase 1.9% in the year. This expansion, 1.4 p.p. higher than the previous estimate, reflects the projection, published by the Brazilian Institute of Geography and Statistics (IBGE), of 1.2% annual increase for the grain crop in 2011, against 2.5% drop considered in the last *Inflation Report*. In addition, the perspectives for cattle farming are still positive, supported by demand expansion and attractive prices for production.

Table 1 – Gross Domestic Product
Accumulated in the year

% growth

	2009	2010				2011
	IV Q	I Q	II Q	III Q	IV Q	IV Q[1/]
Crop and livestock	-4.6	5.4	8.1	7.8	6.5	1.9
Industry	-6.4	15.1	14.5	12.3	10.1	4.2
Mining	-1.1	14.7	15.6	16.0	15.7	5.6
Manufacturing	-8.2	17.3	15.6	12.5	9.7	3.6
Construction	-6.3	15.1	15.9	13.6	11.6	5.2
Public utilities	-2.6	8.4	9.2	8.8	7.8	4.5
Services	2.2	6.2	6.1	5.7	5.4	3.8
Commerce	-1.8	15.3	13.6	12.0	10.7	4.2
Transportation	-2.5	12.5	11.8	10.3	8.9	4.3
Communications	3.8	2.9	3.2	3.5	3.8	6.2
Financial institutions	7.1	9.6	9.9	10.4	10.7	6.1
Other services	3.5	3.4	3.8	3.5	3.6	4.9
Rents	1.9	1.6	1.7	1.6	1.7	2.3
Public administration	3.3	2.5	2.7	2.6	2.3	1.6
Value added at basic prices	-0.6	8.4	8.4	7.5	6.7	3.8
Taxes on products	-0.9	14.7	14.0	13.3	12.5	4.8
GDP at market prices	-0.6	9.3	9.2	8.4	7.5	4.0

Sources: IBGE and Banco Central
1/ Estimated.

It is estimated a 4.2% rise for the industrial sector in 2011, a result 1.2 p.p. lower than the previous projection. Mining industry may grow 5.6%, boosted by petroleum production, emphasizing that the 2.2 p.p. reduction, when compared to the previous estimate, reflects the preliminary results for the first quarter of the year. For the construction industry it is estimated 5.2% annual growth, against 6.6% in the previous report. This reevaluation comprehends, among others, reduction perspectives of governmental expenses, due to fiscal adjustment promoted by the federal government. Production and distribution of electricity, gas and water and the manufacturing industry may increase, respectively, 4.5% and 3.6%, against 5.2% and 4.9% in the previous forecast.

The service sector's output may increase 3.8% in the year, a projection 0.4 p.p. lower than the previous one, with emphasis on the reductions forecast for the segments of commerce and transportation, 0.8 p.p., and warehousing and mail, 0.9 p.p., which mainly reflect a drop in the industrial sector growth estimate. Growth estimates for the public administration, health and education segments, in response to the fiscal adjustment carried out by the federal government for 2011, dropped from 2.2% to 1.6%.

Table 2 – Gross Domestic Product
Accumulated in the year

% growth

	2009	2010				2011
	IV Q	I Q	II Q	III Q	IV Q	IV Q[1/]
GDP at market prices	-0.6	9.3	9.2	8.4	7.5	4.0
Households consumption	4.2	8.4	7.4	6.9	7.0	4.1
Government consumption	3.9	2.7	4.2	4.1	3.3	1.9
Gross fixed capital formation	-10.3	28.4	28.2	25.6	21.8	6.4
Exports	-10.2	14.7	10.6	10.8	11.5	9.6
Imports	-11.5	39.6	39.2	39.8	36.2	18.2

Sources: IBGE and Banco Central
1/ Estimated.

In the framework of demand (Table 2), the estimates related to household consumption, government consumption and to Gross fixed capital formation dropped 0.7 p.p., 0.5 p.p. and 1.0 p.p., respectively, in relation to the ones existing in the December report. These reductions reflect the impacts of the macroprudential measures carried out by the Central Bank, a new level of interest rates and the current fiscal consolidation. Once the rise in the estimate of stocks variation is incorporated, the domestic demand's contribution to the GDP reaches 5.1 p.p.

Annual exports and imports of goods and services may increase 9.6% and 18.2%, respectively, against 8.3% and 11.9% in the previous projection. The external sector, an adjustment factor between domestic demand and supply, may bring a negative contribution of 1.1 p.p. to GDP's variation in 2011.

Prices

2

The consumer prices indices accelerated in the quarter ended February 2011, compared with that ended November of the previous year. This movement was affected by seasonal pressures of perishable foodstuffs and tariff readjustments, especially public transportation, and the rise in education costs, among other factors.

It is important to emphasize that the recent price evolution, still expressed by the high level of the inflation cores in all the criteria used, mostly reflected the rise in service prices, which showed higher inflationary persistence. In this environment, in the following months, the inflation trajectory will be conditioned, among other factors, by the exhaustion of the mentioned seasonal pressures and by the rise of basic interest rates and macroprudential measures, in sharp contrast to the effects of high commodity price levels.

2.1 General indices

The General Price Index – Internal Supply (IGP-DI) variation, calculated by the FGV, reached 2.33% in the quarter ended February, against 3.75% in that ended November. This reduction, within scenario of consumer and civil construction prices rises, evinced the deceleration of the prices to the manufacturer, favored by agricultural prices moderation.

Table 2.1 – General price indices

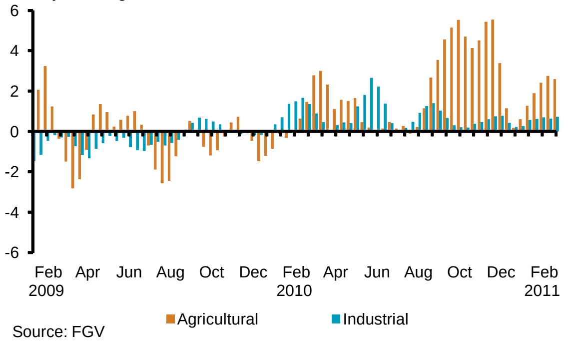
% monthly change

	2010			2011	
	Oct	Nov	Dec	Jan	Feb
IGP-DI	1.03	1.58	0.38	0.98	0.96
IPA	1.32	1.98	0.21	0.96	1.23
IPC-Br	0.59	1.00	0.72	1.27	0.49
INCC	0.20	0.37	0.67	0.41	0.28

Source: FGV

The Broad Producer Price Index (PPI), which weighs 60% in the composition of the IGP-DI, went up 2.42% in the quarter ended February, against 4.85% in the September – November 2010 period. The lesser rise was mainly related to the deceleration, from 15.58% to 4.74%, registered in the price variation of agricultural products, a movement consistent with the falloffs registered in the prices of beans, rice, potatoes, cattle, pork and soybeans. On the other hand, the prices of permanent crops posted an increase in the quarter, influenced by the rises in the items cocoa beans, banana, orange and coffee beans.

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



Source: FGV

Prices of industrial products rose 1.58% in the quarter ended February, against 1.45% in that ended November. This acceleration reflected the pressures exerted by the prices of the items metallic minerals, tobacco, textiles, clothing articles and petroleum derivatives. Agricultural prices registered twelve-month cumulative variation of 29.84% in February, against 23.86% in November, while the industrial prices increased, respectively, 8.65% and 9.90% in the same comparison bases.

Variations in the Consumer Prices Index (IPC) and in the National Cost of Construction Index (INCC), with respective weights of 30% and 10% in the composition of the IGP-DI, were 2.51% and 1.37%, respectively, in the quarter ended February, against 2.07% and 0.78% in that ended November 2010. The acceleration registered in the IPC derived from pressures from education and transportation, while that related to INCC evinced the rises of the items labor and goods and services.

The IGP-DI expanded 11.30% in 2010, the largest variation since 2004, against -1.43% in the previous year, registering acceleration in the annual variation of its three components. The IPA varied 13.85%, against -4.08% in 2009, while IPC and INCC increased 6.24% and 7.77%, respectively, against 3.95% and 3.25% in the previous year. The IPA variation in 2010 reflected rises of 25.61% in the prices of agricultural products and 10.13% in industrial prices.

2.2 Consumer price indices

Extended National Consumer Price Index

Table 2.2 – Consumer prices

% monthly change

	2010			2011	
	Oct	Nov	Dec	Jan	Feb
IPCA	0.75	0.83	0.63	0.83	0.80
Non regulated prices	0.94	1.04	0.78	0.79	0.93
Tradables	1.00	1.53	0.95	0.43	-0.02
Nontradables	0.88	0.60	0.63	1.10	1.78
Services	0.49	0.46	0.58	0.87	2.28
Regulated prices	0.30	0.33	0.26	0.94	0.47

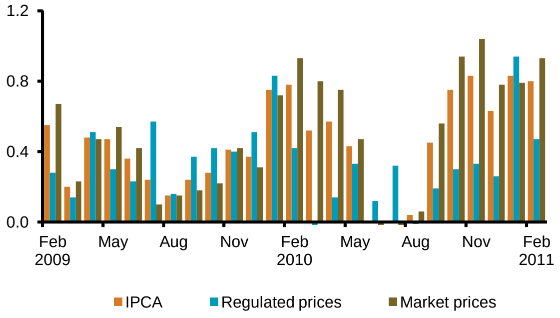
Sources: IBGE, Banco Central and FGV

The Extended National Consumer Price Index (IPCA), published by IBGE, increased 5.91% in 2010, against 4.31% in the previous year, registering rises of 3.13% in regulated prices of goods and services and 7.09% in non regulated prices, against 4.74% and 4.13% in 2009, respectively.

IPCA's variation amounted to 2.28% in the quarter ended February 2011, against 2.04% in that ended November 2010, pointing out that, excluding food and beverage's group, the indicator registered respective rises of 2.14% and 1.10% in the mentioned quarters.

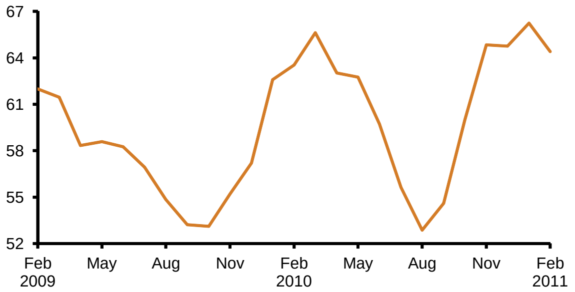
The general indicator's behavior in the quarter derived from the acceleration, from 0.82% to 1.68%, in regulated prices, and from the downturn, from 2.56% to 2.52%, in non-regulated prices. In this segment, there were respective

Figure 2.2 – IPCA
% monthly change



Source: IBGE

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



Source: IBGE

variations of 1.36% and 3.55% in the marketable and non-marketable prices, against 3.45% and 1.77% in the quarter ended November. It should be mentioned, in the non-marketable segment, increases of 10.54% in the prices of perishable foodstuffs and of 6.61% in the item courses. The deceleration observed in the scope of marketable goods was especially related to the lesser rises of apparel group prices and of items furniture and utensils, cattle, bakery goods, and sugars and sugar products.

Considering twelve-month periods, the IPCA accumulated a 6.01% variation on February, against 5.63% in November and, not including food, 4.96% against 4.59% in the same comparison bases. The seasonal pressure observed in the segments courses, public transportation and perishable foodstuffs tends to exhaust in the coming months, which may contribute to the IPCA deceleration.

The service prices, boosted by the rise of education prices, went up 3.77% in the quarter ended February, against 1.37% in that ended November 2010, while, considering twelve-month periods, respective variations of 8.39% and 7.36%were registered in the final months of the periods mentioned.

The diffusion index – indicator of the proportion of the items that indicated a positive IPCA variation, evincing spreading prices rises, registered an average of 64.41% in the quarter ended February, against 64.84% in that ended November, and 63.54% in the same period in 2010. In 2010, the index average reached 61.18%, against 57.53% in the previous year.

2.3 Regulated prices

The regulated prices increased 3.13% in 2010 and account for 0.92 point of IPCA's total variation in the year. The highest upward pressures derived from the items public transportation, 7.53%; notary, 5.19%; health insurance, 6.87%; and mail service, 6.35%; while, in the opposite way, registration and licensing services, vehicle gas and toll prices dropped 9.53%, 1.13% and 5.82%, respectively, in the year.

IPCA's group of free and regulated prices presented variations of 2.52% and 1.68%, respectively, in the quarter ended February, against 2.56% and 0.82% in that ended November. The regulated price' variation represented 0.49 point of IPCA's inflation of 2.28%, within this period.

Table 2.3 – IPCA

% monthly change

	Weights	2010			2011		
		Nov	Dec	Year	Jan	Feb	Year
IPCA	100.00	0.83	0.63	5.91	0.83	0.80	1.64
Market prices	71.10	1.04	0.78	7.09	0.78	0.93	1.73
Regulated prices	28.90	0.33	0.26	3.13	0.94	0.47	1.42
Main items							
Electricity	3.19	0.48	0.02	3.05	-0.38	0.09	-0.29
Natural gas vehicle	0.10	0.05	-1.60	-1.13	-1.95	-0.36	-2.30
Pipeline gas	0.10	-0.34	-0.03	1.48	6.21	1.13	7.41
Diesel fuel	0.08	-0.21	0.09	-0.11	0.71	0.65	1.36
Electricity	0.12	0.09	0.30	-5.82	0.15	0.02	0.17
Tolls	1.28	0.63	0.17	1.91	0.00	1.69	1.69
Water and sewage	1.60	0.00	0.03	3.38	0.07	0.42	0.49
Urban bus	3.77	0.30	0.07	7.53	4.13	1.30	5.48
Air ticket	0.36	-1.26	7.61	3.15	6.21	-11.43	-5.93
Gasoline	3.94	0.81	0.25	1.67	0.62	0.50	1.12
Bottled cooking gas	1.17	0.10	0.25	2.10	0.12	0.03	0.15
Medicine	2.80	0.09	0.11	3.36	-0.06	-0.22	-0.28
Health plans	3.48	0.58	0.58	6.87	0.59	0.59	1.18

Source: IBGE

Table 2.4 – Consumer prices and core inflation

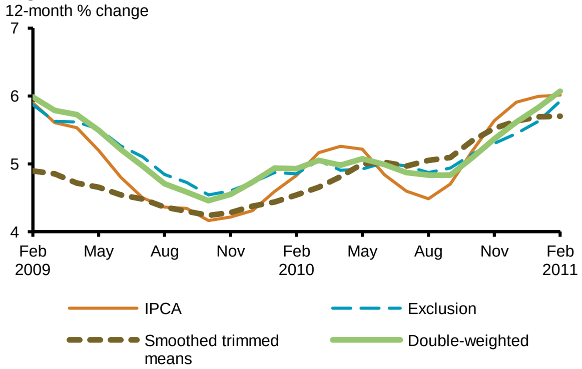
% monthly change

	2010			2011	
	Oct	Nov	Dec	Jan	Feb
IPCA	0.75	0.83	0.63	0.83	0.80
Exclusion	0.44	0.52	0.60	0.76	0.96
Smoothed trimmed means	0.55	0.56	0.52	0.54	0.40
Double-weighted	0.58	0.66	0.71	0.80	0.70
IPC-Br	0.59	1.00	0.72	1.27	0.49
Core IPC-Br	0.41	0.43	0.55	0.41	0.32

Sources: IBGE, Banco Central and FGV

Figure 2.4 – Core inflation

12-month % change



Sources: IBGE and Banco Central

Notary tariffs went up 5.35% in the quarter, following the expansions related to interstate bus, 4.14%; inter-municipal bus, 3.57%; and subway, 3.00%. In addition, public bus tariffs, evincing the rises registered in São Paulo, 11.11%; Recife, 8.13%; Salvador, 8.70%; Porto Alegre, 10.20%; and Belo Horizonte, 6.52%, increased 5.56% in the quarter ended February.

2.4 Inflation core

The 12-month variation of IPCA's inflation cores, considering the three measures calculated by the Central Bank, increased in the quarter ended February. The IPCA's core, by exclusion, increased 2.34% against 1.34% in the quarter ended November. In twelve months, the indicator growth amounted to 5.92% in February, against 5.30% in November.

The core calculated by smoothed trimmed means[5] increased 1.47%, against 1.55% in the quarter ended November. The indicator's twelve-month cumulative variation closed at 5.70% on February, against 5.52% in November.

The double-weighting[6] core registered growth of 2.23% in the quarter ended February, against 1.64% in that ended November. The twelve-month analysis reveals that the indicator variation moved from 5.37%, in November, to 6.07% in February.

The IPC inflation core, released by the FGV, calculated through the method of smoothed trimmed means, went up 1.29% against 1.37% in the quarter ended November. Considering twelve-month periods, the indicator registered rises of 5.02% on February and of 4.95% in November.

2.5 Market expectations

According to Focus Research – Market Readout of March 18, the medians of the forecasts related to the annual IPCA variations for 2011 and 2012 reached 5.88% and 4.8%, respectively, against 5.3% and 4.5%, at the end of 2010.

5/ The criterion used to calculate this indicator excludes the items whose monthly variation stays, in the distribution, above the percentile 80 or below the percentile 20, besides smoothing, throughout twelve months, the fluctuation of items whose variations are concentrated in few periods of the year.

6/ The criterion used to calculate this indicator consists in the re-weighting of the original weights – based on the importance of each item for the IPCA basket – by the respective degrees of relative volatility, a proceeding that reduces the importance of the more volatile components.

Figure 2.5 – IPCA
Medians

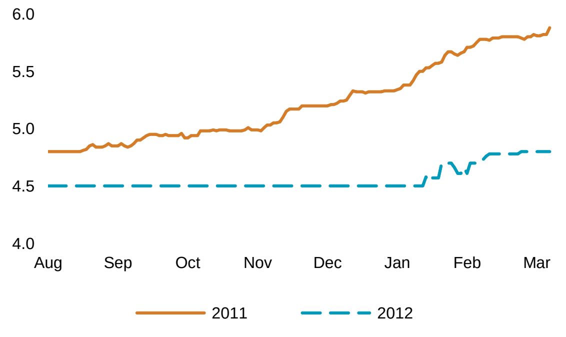


Figure 2.6 – IGP-M and IPA-DI
Medians 2011

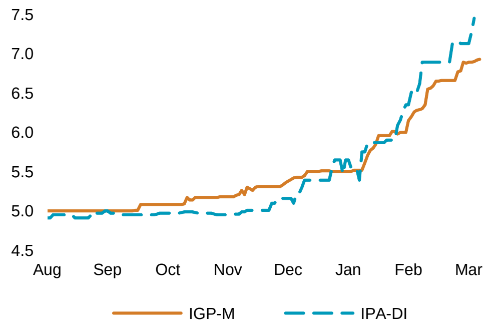


Figure 2.7 – Exchange rate
Medians 2011

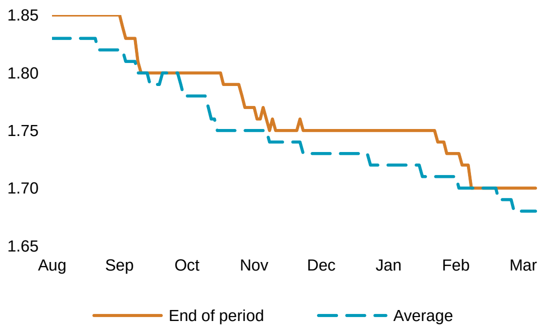


Table 2.5 – Summary of market expectations

	9.30.2010		12.31.2010		3.18.2011	
	2011	2012	2011	2012	2011	2012
IPCA	5.0	4.5	5.3	4.5	5.9	4.8
IGP-M	5.1	4.5	5.5	4.5	7.0	4.9
IPA-DI	5.0	4.5	5.4	4.5	7.5	4.7
Regulated Prices	4.7	4.5	4.5	4.5	4.5	4.5
Selic (end-of-period)	11.8	10.5	12.3	10.8	12.5	11.3
Selic (average)	11.5	10.9	12.1	11.3	12.2	11.9
Exchange rate (end-of-period)	1.8	1.9	1.8	1.8	1.7	1.8
Exchange rate (average)	1.8	1.9	1.7	1.8	1.7	1.7
GDP growth	4.5	4.5	4.5	4.5	4.0	4.4

The expectations median for the inflations twelve months ahead – mitigated – corresponded to 5.36%, smoothed above the level observed at the end of December.

The median regarding the General Price Index – Market (IGP-M) variation for 2011 increased from 5.5%, at the end of December, to 6.97% on March 18th, while that related to the Producer Price Index – Internal Supply (IPA-DI) moved from 5.4% to 7.45%. In the same period, the median referring to 2012 for the IGP-M increased from 4.5% to 4.89%, while for the IPA-DI, it moved from 4.5% to 4.72%.

The median of expectations regarding the 2011 and 2012 evolution of the government-set prices or prices regulated through contracts came to 4.5% on March 18, same level observed at the end of December.

The median of the exchange rate forecasted by the market for the end of 2011 was adjusted, from R$1.75/US$ to R$1.70/US$, between the end of December and March 18, while the forecast for the end of 2012 was reviewed from R$1.80/US$ to R$1.75/US$. The forecasts median for the average exchange rate related to 2011 dropped from R$1.72/US$, on December 31, to R$1.68/US$, on March 18th, while the median for 2012 decreased from R$1.79/US$ to R$1.74/US$, between both dates.

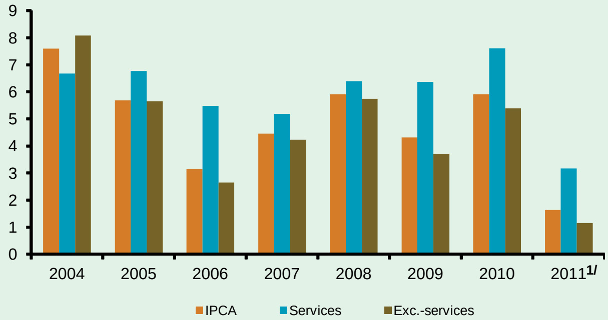
2.6 Conclusion

The consumer inflation rates in the beginning of 2011 reflected the impact of seasonal factors, as the rise of perishable foodstuff prices, of readjustments in public transportation tariffs and in education costs, and the mismatches between aggregate supply and demand, indicated, especially, in the service prices evolution. The inflation trajectory in the following months may reflect the impacts of the more restrictive stance adopted in the conduction of the monetary policy, macroprudential measures and depletion of seasonal factors. However, uncertainties originated from the external scenario, especially the evolution of commodity prices, still persisted.

Service Prices Dynamics: an analysis of the current experience

Services prices have been registering variations higher than those of the National Wide Consumer Price Index (IPCA) in the last years, in all the metropolitan regions researched, causing changes in the relative prices between the contents of the consumption basket. This box explores the services prices dynamics in national and regional scope, emphasizing the behavior of relative prices and the main contents of this segment.

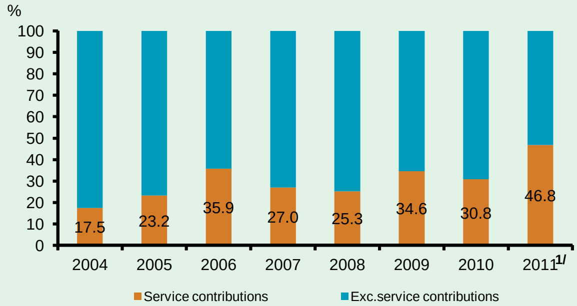
Figure 1 – IPCA services and excluding-services
Annual growth %



Source: IBGE, made by Central Bank.
1/ Until february.

The services inflation[1] overcame IPCA's variation in the last six years, according to Figure 1. From March 2004 to February 2011, the services prices mean annual variation reached 6.45% while the ones related to IPCA and to "IPCA excluding services" were 5.32% and 5.0%, respectively. Within the period considered, the services relative prices[2] increased 9.63% in relation to other IPCA segments.

Figure 2 – Relative contributions (estimates) of service prices at IPCA



Source: IBGE, made by Central Bank.
1/ Until february.

The service prices contributions for the aggregate index variation significantly overcame the weight[3] of the group in the IPCA basket, according to Figure 2, pointing out the results of 2006, 2009 and 2010, when services were responsible for, in this order, 35.9%, 34.6% and 30.8% of the annual IPCA variation. The retreat in 2010 is partly explained by the sharp rise of food prices, since the services inflation rose comparatively to the one registered in 2009. In the first two months of 2011, the services contribution reached 46.8%, mostly due to the

1/ For this work's objectives, until June 2006, 58 subitems were considered in the services prices composition, with approximate weight of 20%; since July 2006, when it was initiated the IPCA series with the current methodology, referenced in the Family Budget Research (POF) 2002-2003, 64 subitems were considered in the composition of services prices group, corresponding to around 24% in the general index weighing for Brazil.

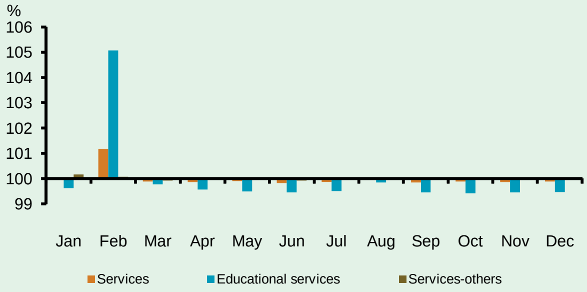
2/ It was considered the ratio between the geometric factor corresponding to the variation of services prices group and the one corresponding to the variation of other prices group, components of IPCA, for the period between March 2004 and February 2011.

3/ The seasonal factor average was calculated as, where the percentage variation in the "t" month of year "a"; and it is the percentage variation accumulated of year "a". Results lower than 100 represent negative seasonality and results higher than 100 represent positive seasonality for the month.

period's seasonality, which reflects the readjustments with respect to education.

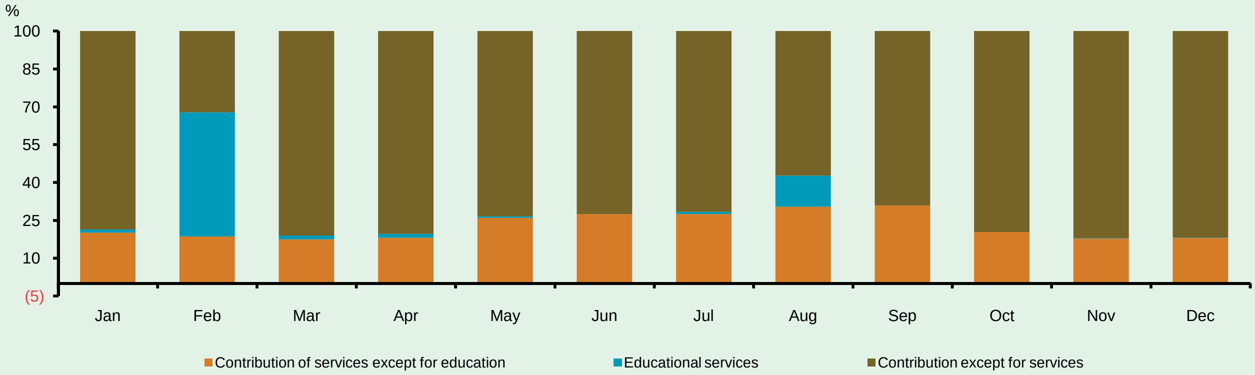
Given the generic nature of the services, it is appropriate to divide[4] it into subgroups according to the type of service to which they refer and, particularly, to isolate the services related to education. A preliminary analysis suggests that education follows seasonal pattern different from the other series, according to Figure 3. For the service prices group, the seasonal factor[5] regarding February represented, in average, 101.2% of each year's monthly mean variation. It showed to be more significant for educational services, to which it represented, in average, 105.1% of each year's monthly mean variation. Still regarding educational services, the seasonal factors related to August and March, despite lower than 100% in the period average, overcame this level in three and in two of the seven years analyzed, respectively. For services prices not related to education, the seasonal pattern seems less defined, with January and February being the months most distant from each year's mean variation.

Figure 3 – IPCA Services and componentes – Seasonal[1/]



Source: IBGE, made by Central Bank.
1/ Data lower than 100 mean a negative seasonality and data above 100 mean a positive seasonality in the month.

Figure 4 – Monthly average of relative contributions (estimated) of service prices, except for education and education-services for the IPCA[1/]



Source: IBGE, made by Central Bank.
1/ With the aim to avoid that outliers biased the averages, they have been estimated excluding those months in which the sum of payment contributions were within -0,1 and 0,1 (Jun/2005; Aug/2006; Jun/2010; Jul/2010; Aug/2010).

4/ Similar proceeding was carried out in the study "The evolution of goods and services prices in economic crises", presented in the Inflation Report published on June 2009.

5/ The seasonal factor average was calculated as, $\left\{\sum_{a=2004}^{2010}\left[\left(\frac{\pi_{t,a}}{100}+1\right)\Big/\left(\frac{\pi_a}{100}+1\right)^{1/12}\right]\right\}\frac{100}{7}$ where $\pi_{t,a}$ the percentage variation in the "t" month of year "a"; and π_a it is the percentage variation accumulated of year "a". Results lower than 100 represent negative seasonality and results higher than 100 represent positive seasonality for the month.

The services contribution for the IPCA present themselves relatively higher in February and August, due to readjustments related to education, according to Figure 4, while the highest contributions related to the other services are used to fall upon May to September.

Table 1 presents the services prices annual mean variations per subgroup, for each one of the metropolitan regions considered in IPCA's building. In Brazil, the expenses with education services and with the other services registered annual mean rises of 6.65% and 6.41%, respectively, from March 2004 to February 2011, while the annual mean variation of "IPCA exclusive services" reached 5.06%. The expenses with domestic servant registered the highest annual mean growth, 10%, exerting, in average, contribution of 21% to the services prices variation. In addition, important average rises occurred in the items vehicles maintenance, 6.89%; personal care, 6.88%; condominium, 6.27%; and health, 6.08%.

Table 1 – Subgroups of IPCA services by region

Annual average change – Mar/2004 to Feb/2011 (% a.y.)

Region[1/]	**Brasil**	BRA	GOI	RMB	RMBH	RMC	RMF	RMPA	RMR	RMRJ	RMS	RMSP
IPCA – Services	**6.45**	7.10	6.85	6.69	7.71	7.28	6.92	6.59	6.71	5.94	7.04	5.80
Subgroup refering to education	**6.65**	7.04	6.43	6.43	6.41	6.97	7.77	6.66	7.90	6.79	7.27	6.26
Formal education	**6.57**	6.64	6.06	6.33	6.46	6.99	8.04	6.55	8.01	6.68	7.23	6.14
Education others	**6.93**	8.86	9.25	6.33	6.21	6.88	4.78	7.17	7.20	6.37	7.25	6.78
Subgroup services-others	**6.41**	7.14	7.02	6.77	8.09	7.39	6.62	6.57	6.31	5.76	6.94	5.72
Rent	**5.03**	6.71	4.51	5.57	7.34	6.64	6.06	3.73	4.22	3.62	4.65	5.03
Condominium fee	**6.27**	8.38	6.91	7.09	7.77	7.34	5.41	7.15	8.20	8.41	8.13	3.67
House constrution and maintainance	**3.22**	3.31	4.11	4.98	3.35	3.77	2.48	3.06	4.02	2.81	1.10	3.36
Personal care	**6.88**	8.17	8.62	8.59	8.33	7.09	7.40	6.81	7.11	5.64	8.26	5.88
Domestic help	**10.00**	9.88	9.88	9.88	11.37	9.88	9.89	9.86	9.75	9.02	10.99	9.96
Leisure	**6.22**	5.70	5.63	4.59	9.00	7.14	4.57	6.32	8.00	4.50	5.35	5.73
Auto sevice	**6.89**	5.48	7.76	2.23	6.88	8.64	6.87	8.04	2.52	6.50	5.75	7.47
Labor[2/]	**7.87**	7.56	7.56	7.56	10.89	7.56	7.56	7.46	5.07	6.57	8.33	7.86
Health	**6.08**	6.72	7.19	6.42	6.37	6.36	6.00	5.20	4.88	6.34	6.48	6.03
Banking services	**2.06**	1.42	1.06	0.82	2.08	1.17	1.43	1.48	2.06	2.41	2.17	1.14
Transportation	**5.05**	4.20	7.32	10.63	7.34	7.44	0.54	6.93	4.77	2.29	10.59	4.09
Others	**3.63**	4.76	5.72	4.60	2.42	5.46	3.26	3.90	1.09	2.32	4.20	3.28

Source: IBGE, made by the Central Bank.

1/ BRA (Brasília), GOI (Goiânia), RMB (RM Belém), RMBH (RM Belo Horizonte), RMC (RM Curitiba), RMF (RM Fortaleza), RMPA (RM Porto Alegre), RMR (RM Recife), RMRJ (RM Rio de Janeiro), RMS (RM Salvador), RMSP (RM São Paulo).

2/ Statistics for labor have been calculated considering the initial July/2006 period, when the subgroup came into being.

The service inflation was higher than the respective general indices in all the regions researched, according to Table 2. The prices behavior was

Table 2 – Regional IPCA, services and ex-services

Annual average variation – Mar/2004 to Feb/2011 (% p.y.)

Region	IPCA	IPCA		Relative
		Services	Ex-services	prices 1/
RM Curitiba	5.14	7.28	4.52	2.64
Brasília	5.33	7.10	4.73	2.27
RM Fortaleza	5.05	6.92	4.69	2.13
RM Salvador	5.22	7.04	4.86	2.08
Goiânia	5.20	6.85	4.76	2.00
RM Belo Horizonte	6.06	7.71	5.69	1.91
RM Porto Alegre	5.21	6.59	4.86	1.66
RM Recife	5.40	6.71	5.21	1.43
Brasil	**5.32**	**6.45**	**5.06**	**1.32**
RM Belém	5.87	6.69	5.75	0.89
RM Rio de Janeiro	5.26	5.94	5.13	0.77
RM São Paulo	5.16	5.80	5.04	0.73

Source: IBGE, made by the Central Bank.

1/ Ratio between the geometric factor corresponding to the annual average variation of service prices altogether and that corresponding to the annual average variation of the set of the other prices forming the IPCA.

regionally heterogeneous and the relative prices change was lower in the metropolitan regions of São Paulo, Rio de Janeiro and Belem, and more relevant in Curitiba, Brasília, Fortaleza and Salvador.

The average services inflation was highest in Belo Horizonte, 7.71%, with emphasis on the rates related to the items domestic servant, 11.37%; leisure, 9%; and personal care, 8.33%. The expenses with education registered expressive annual average rises in the metropolitan regions of Recife, 7.9%; Fortaleza, 7.77%; and Salvador, 7.27%. Only São Paulo and Rio de Janeiro registered services prices average variations lower than the national average.

The divergences in the prices changes in each region may be decomposed, primarily, in price effect[6] and weight effect. The first comprehends the differences in the prices variations of the same service, due to local specificities and restrictions to mobility of factors. The weight effect corresponds to part of the differentials between the regional inflation rates due to the relative participation of several services of the index basket composition in each region.

Table 3 – Relative contribution (estimated) of the weight-effect and of the price-effect for the differential between the regional and national differences of the IPCA-services

Mar/2004 to Feb/2011

Region	Annual average variation	Difference (p.p.)	Weight-effect (%) 1/	Price-effect (%) 1/
Brasil	6.45			
RM Belo Horizonte	7.71	1.26	12.1	87.9
RM Curitiba	7.28	0.84	6.7	93.3
Brasília	7.10	0.66	26.4	73.6
RM Salvador	7.04	0.60	-3.4	103.4
RM Fortaleza	6.92	0.48	93.4	6.6
Goiânia	6.85	0.40	6.8	93.2
RM Recife	6.71	0.26	93.4	6.6
RM Belém	6.69	0.25	95.8	4.2
RM Porto Alegre	6.59	0.15	86.6	13.4
RM Rio de Janeiro	5.94	-0.50	-5.9	-94.1
RM São Paulo	5.80	-0.65	-34.1	-65.9

Source: IBGE, made by the Central Bank.

1/ Relative estimated contribution of the weight-effect and the price-effect to the differences between regional and national variation rates of the IPCA-services.

6/ Check the study "Differences between the Regional IPCAs in 2007", presented in the Regional Newsletter of the Central Bank of Brazil published on April 2008.

Focusing on services inflation, starting from subgroups' variations and adopting the national index[7] as reference, it was performed estimations of the differential decomposition between the services prices variations of each region and of the country in weight effect and price effect, according to Table 3. The price effect's importance replaced the weight effect one, e.g., it overcame 50% in module, in seven of the eleven regions researched, including four that registered the highest services inflations during the period (Belo Horizonte, Curitiba, Brasília and Salvador) and two with the lowest rates (São Paulo and Rio de Janeiro). These results point out to behaviors regionally different between similar services prices as the main elements of the spatial differences of services' IPCA. Only in Salvador both effects presented opposite pattern.

At last, the services mean inflation, with respect to the period from March 2004 to February 2011, overcame the IPCA variation in all the regions researched. This performance occurred heterogeneously, registering sharper variations in Belo Horizonte, Curitiba and Brasília, and lower variations in São Paulo and Rio de Janeiro. The regionally distinct behaviors between similar services prices (price effect) were responsible for the greatest part of the spatial differentials in the services' IPCA.

7/ It is observed that, since the national index consists of weighted average of regional indices, the differences between the regions' and the country's rates tend to, at first, be reduced in the regions with greater weight in the national index.

Real Estate Price Indices: methodology and use in the Brazilian economy

The repercussions of the Brazilian economy recent expansion on real estate demand and on the trajectory of prices applied in the real estate internal market has stimulated a growing interest for indicators of real estate prices in Brazil. In this context, this box discusses methodological aspects regarding the calculation of real estate price indices and presents some indicators recently produced in Brazil.

It is important to emphasize that the construction of such indices must take into account the underlying aspects of these assets. Thus, their own structural characteristics and the properties' unique location constitute a homogeneity problem. Furthermore, the restrictions imposed to these indices by the sporadicalness with which the transactions involving real estate occur and by the availability of data that enable to identify the transaction value, are evident.

According to the Statistical Office of the European Communities (Eurostat) (2011), there are four methods to calculate real estate price indices: stratification, repeat sales, evaluation, and hedonic regression. Clearly, each method incorporates relative advantages and the choice of the most appropriate one will depend on the index purpose and on data availability.

The repeat sales index is calculated only with properties that are sold at least for the second time, comparing sale price variation, but presents three main disadvantages. This method does not consider alterations in the real estate quality, due to renovations, and, therefore, even comparing the price of the same property, it is possible that the index may be impacted by changes in the property's characteristic and not only variations in prices.

Besides, this method rules out all the properties sold for the first time. Finally, this index may bring an important bias, if the most frequently transacted properties are not a representative sample of the overall properties on which the indicator's interest falls on.

The evaluation method, while considering real estate market quotes, enables to use all the properties of the sample, and not only those sold more than once, and its results may always be reviewed when new information is added. Although this method extends the sample used, its quality depends on the evaluations' strictness and still evinces the inability to grasp changes in the quality of real estate.

The stratification method divides the sample into strata according to the observed criteria, such as geographic region, number of rooms or bedrooms, property age, among others. From this division, measures of prices are calculated (usually average or median) that, when weighted, bring about an aggregate indicator. If the stratification incorporates relevant characteristics, the method allows identifying most part of the changes in the property's quality throughout time, being considered an acceptable index. The other advantage of the index is its ease to be used, while, on the contrary, the restricted stratification may provide small samples or even lack of observations in some strata.

The hedonic regression method requires data regarding real estate prices and information about its attributes, using, as from this basis, statistical techniques of regression. The prices are considered dependent variables and the attributes and dummies (binary variables) of a period, explanatory variables. Starting from these dummies it is possible to calculate a price index in which the property quality (which certainly depends on which other regressors are included in the model) remains constant[1]. Even though this method is, probably, the most efficient one, it requires information about attributes, reproduction difficulty and, depending on the technical specifications chosen, restrictions for the results revision.

1/ Check the study "Differences between the Regional IPCAs in 2007", presented in the Regional Newsletter of the Central Bank of Brazil published on April 2008.

While in several economies, especially the more developed ones, there are representative series of real estate price indices; its construction in Brazil is still beginning, encouraged by construction and real estate credit trajectories. The main indices of this nature in the country are those indicators elaborated by the Institute of Economic Research Foundation (Fipe) and by Getulio Vargas Foundation (FGV), both published on February 2011.

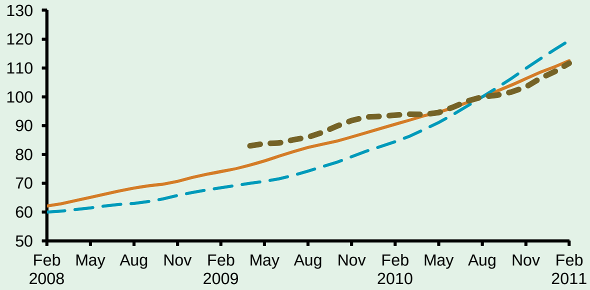
The Fipe Zap Index of Advertised Property Prices (Index Fipe Zap) is based on offer prices of apartments. Its data base is Zap records, a private company specialized in classified advertisements, and its calculation method is the stratification, which comprehends the apartment's location (region of the municipality) and the respective number of bedrooms. In each stratum, it is calculated the median of prices (in R$/m²) of the observations (offer advertising). In each city, the index (known as regional) corresponds to the weighted average of the price medians of the respective strata. The weighting variable used is the aggregate family income, per stratum, according to data from the 2000 Demographic Census, which provides a price index for the stock of apartments.

The Fipe uses the same weighting criteria for the calculation of indices regarding each class of number of bedrooms, as well as for the Fipe Zap Composite Index, the national aggregate as of seven metropolitan regions[2]. The main index qualities are the data base amplitude, which surpassed one thousand observations per month last December, enabling enough information in each stratum, and its timeliness – the indicator is published about one week after the end of the reference month. One disadvantage of the index is the use of the offer price and not the price of sale, emphasizing that, if this relation is relatively stable, such deficiency is no longer relevant for the analyses of relative evolution of real estate prices.

The first results turned in by Fipe support the perception that there has been a significant rise of real estate prices in the country. The indices referring to Rio de Janeiro and São Paulo presented increases of 99.3% and 81.3%, respectively, within the period

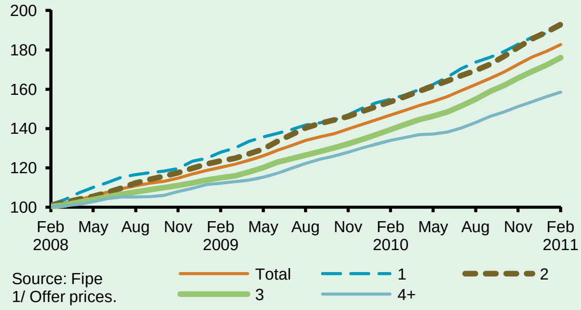
2/ São Paulo, Rio de Janeiro, Belo Horizonte, Federal District, Recife, Fortaleza and Salvador.

Figure 1 – FipeZap[1/] index
Selected regions
August 2010 = 100



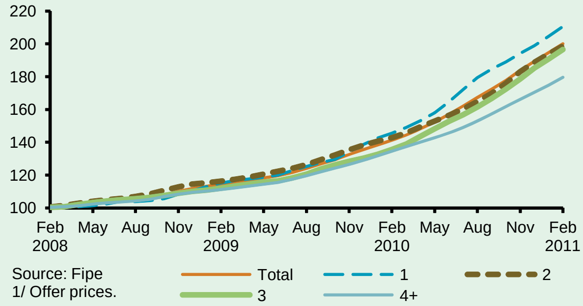
Source: Fipe
1/ Offer prices of apartamentos.

Figure 2 – FipeZap index by number of bedrooms[1/]
São Paulo
January 2008 = 100



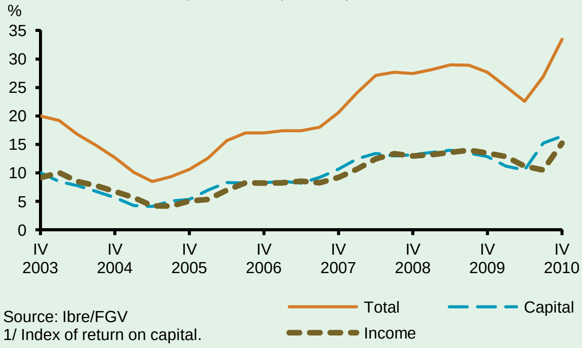
Source: Fipe
1/ Offer prices.

Figure 3 – FipeZap index by number of bedrooms[1/]
Rio de Janeiro
January 2008 = 100



Source: Fipe
1/ Offer prices.

Figure 4 – Total IGMI-C and components[1/]
Brasil
Variation over the same quarter of the previous year
%



Source: Ibre/FGV
1/ Index of return on capital.

of 36 months ended on February 2011, while the index referring to Belo Horizonte increased 29.7% within the period of 18 months ended in the same month, according to Figure 1. In the same figure it is still evident the recent acceleration of real estate prices growth rate in Rio Janeiro when compared to the other two capitals.

It must be pointed out that the prices of one and two-bedroom apartments increased more sharply than those with three and four bedrooms or more. In São Paulo, the biggest market analyzed, the indices regarding one and two-bedroom apartments increased 89.2% and 91.1%, respectively, within the period of 36 months ended on February 2011, while the prices of three and four-bedroom apartments expanded 75.4% and 58%, respectively (Figure 2). This trend has also been observed in Rio de Janeiro (Figure 3).

The General Real Estate Market Index – Commercial (IGMI-C) of FGV is a profitability indicator of the real estate business, displayed in two components – income return and capital return –, besides its aggregate form. The first one corresponds to the ratio between net operational revenue (total of business revenues minus operational expenditures) and the enterprise assessed value. The capital return is defined as the ratio between the real estate appreciation and its assessment in the previous period. The total return is just the addition of both. The basic information consolidated in IGMI-C is obtained from companies connected to the real estate sector, such as institutional investors, property developers, class entities, consultants, administrators and managers of property portfolios. The series periodicity, which could be retroactive to the first quarter of 2000, has a quarterly periodicity. In the last 2010 quarter, the sample comprehended 190 individual real estates, mostly formed by commercial offices concentrated in São Paulo (37%) and Rio de Janeiro (26%). The indicator growth is shown in Figure 4 and evinces a relevant rise in the last quarter, when the total return regarding the corresponding period of 2009 reached 33.5%, the highest variation of the series.

In general, it is possible to say, with the exceptions mentioned, that real estate price indices corroborate the perception regarding the real estate market acceleration in the country. It is important to consider that the indicator trajectory bears some limitation due to the low number of observations made, making it difficult to distinguish transactions related to the business cycle from those with a trendy nature.

Credit, monetary and fiscal policies

3

Table 3.1 – Credit operations

R$ billion

	2010		2011		% growth	
	Nov	Dec	Jan	Feb	3 months	12 months
Total	1 678.7	1 705.8	1 715.4	1 738.1	3.5	21.0
Nonearmarked	1 100.9	1 116.0	1 119.8	1 135.5	3.1	17.8
Earmarked	577.8	589.8	595.5	602.6	4.3	27.5
% participation:						
Total/ GDP	46.0	46.4	46.3	46.5		
Nonearmarked/GDP	30.2	30.4	30.2	30.4		
Earmarked/GDP	15.8	16.0	16.1	16.1		

Figure 3.1 – Credit by capital control of financial institutions

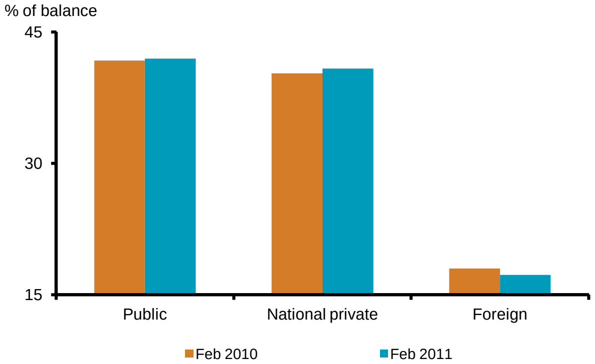
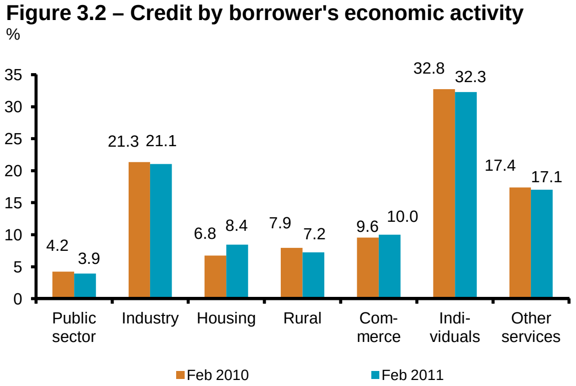


Figure 3.2 – Credit by borrower's economic activity



3.1 Credit

The credit evolution in the quarter ended in February was mainly conditioned by seasonal factors and the effects of macroprudential measures implemented in December. In the segment of corporations, the seasonal aspect prevailed, expressed in the expansion of demand for credit in the last months of 2010 followed by moderation in January and February. In the segment of individuals, the raise of interest rates on long-term hiring operations resulted in significant restriction of contractions as of December, notably in the financing of vehicles and in payroll-deducted loans.

Total bank loans, comprising both operations with earmarked and nonearmarked resources, reached R$1,738 billion in February, increasing 3.5% in the quarter and 21% in twelve months. The representativeness of national private institutions in the total financial system portfolio rose 0.2 point, to 40.8% in the quarter, while the participation of public banks and foreign institutions reached 41.9% and 17.3%, respectively. The credit/GDP ratio reached 46.5%, against 46% in November and 44.1% in February 2010.

Loans channeled to the private sector accounted for R$1,670 billion in February, increasing 3.6% in the quarter and 21.4% in twelve months. The quarterly result partly reflected the expansion in the segments of commerce, 3%, emphasizing concessions to department stores and supermarkets; other services, 2.9%, especially transportation, real estate and communications; and industry, 1.8%, emphasizing the demand of the automotive, food and energy sectors. Housing credits, including earmarked and nonearmarked resources, accounted for R$146.4 billion in February, increasing 9.6% in the quarter and 50.9% in twelve months.

Credit operations channeled to the public sector accounted for R$68.2 billion in February, increasing 1.7% in comparison with November and 12.3% in twelve months. It should be highlighted respective variations of 5.4% and 29.6% in state and municipal government bank debts, with emphasis on the resources targeted to direct state administration and basic sanitation projects.

The total volume of provisions set aside by the financial system reached R$96 billion in February, accounting for 5.5% of total financial system credit portfolio, against 5.8% in November. The volume of provisions decreased 1.8% in the quarter, a trajectory consistent with the decrease of 0.1 p.p. registered in the financial system's default rate in the period, 3.2%.

Credit operations with earmarked resources

In February, loans based on earmarked resources expanded 4.3% in the quarter and 27.5% in twelve months, reaching R$602.6 billion. BNDES operations accounted for R$363 billion, highlighting transfers of R$183.3 billion carried out by other financial institutions, for respective expansions of 4.6% and 40.5%. Housing financing with resources based on savings deposits and the Employment Guarantee Fund (FGTS) accounted for R$138.1 billion, up 9.1% and 49.6%, respectively. The rural credit portfolio, excluding operations contracted with BNDES, accounted for R$87.5 billion, expanding 3% and 9.4%, respectively.

BNDES disbursements carried out in the first two months of 2011 increased 7.3% when compared to the same period of the previous year, accounting for R$17.2 billion. The concessions to the segment of commerce and services increased 13.2%, emphasizing the electricity, gas and land transportation sectors, while the concessions to the industrial segment expanded 2.9%. Meanwhile, concessions to micro, small and medium enterprises increased 17.7%.

Credit operations with nonearmarked resources

The stock of credit operations carried out with nonearmarked resources reached R$1,136 billion in February, accounting for 65.3% of the total financial system portfolio, rising 3.1% in the quarter and 17.8% in twelve months. The loans to individuals accounted for R$573.1 billion, increasing 4.3% and 19.8%, respectively, while those targeted to corporations accounted for R$562.4 billion, rising 1.9% and 15.9% in the same comparison bases.

Table 3.2 – Earmarked credit operations

R$ billion

	2010		2011		% growth	
	Nov	Dec	Jan	Feb	3 months	12 months
Total	577.8	589.8	595.5	602.6	4.3	27.5
BNDES	353.3	357.8	359.9	363.0	2.8	25.4
Direct	178.0	178.0	178.1	179.7	1.0	13.0
Onlendings	175.3	179.8	181.8	183.3	4.6	40.5
Rural	85.0	86.8	87.1	87.5	3.0	9.4
Banks and agencies	80.1	81.9	81.9	82.5	3.1	8.8
Credit unions	4.9	4.9	5.1	5.0	1.8	20.7
Housing	126.6	131.4	134.8	138.1	9.1	49.6
Others	12.9	13.8	13.8	13.9	7.7	27.5

Table 3.3 – BNDES disbursements

R$ million

	Jan-Feb		% growth
	2010	2011	
Total	16 017	17 180	7.3
Industry	5 313	5 466	2.9
Mining	156	745	377.6
Food products	2 041	1 389	-31.9
Vehicle, towing truck and wagon	372	370	-0.5
Petroleum and alcohol refining	221	363	64.3
Chemical	182	274	50.5
Transportation equipment	163	130	-20.2
Commerce/services	9 017	10 205	13.2
Overland transportation	4 035	4 319	7.0
Electricity and gas	1 012	1 725	70.5
Commerce	1 590	1 539	-3.2
Auxiliary transportation activities	343	470	37.0
Construction	830	860	3.6
Telecommunication	69	53	-23.1
Crop and livestock	1 686	1 510	-10.4

Source: BNDES

Table 3.4 – Nonearmarked credit operations

R$ billion

	2010		2011		% growth	
	Nov	Dec	Jan	Feb	3 months	12 months
Total	1 100.9	1 116.0	1 119.8	1 135.5	3.1	17.8
Corporations	551.7	556.0	554.2	562.4	1.9	15.9
Reference credit[1/]	458.6	462.7	462.0	470.8	2.7	17.1
Domestic funding	406.3	413.9	411.4	419.0	3.1	21.1
External funding	52.3	48.9	50.6	51.8	-1.0	-7.7
Leasing[2/]	41.7	41.3	40.5	39.5	-5.4	-17.9
Rural[2/]	3.2	3.1	3.1	3.2	0.1	-18.2
Others[2/]	48.1	48.9	48.5	48.9	1.6	57.1
Individuals	549.3	560.0	565.7	573.1	4.3	19.8
Reference credit[1/]	413.6	417.3	428.1	437.0	5.7	30.0
Credit unions	24.8	25.3	25.7	26.1	5.5	19.9
Leasing	46.4	45.6	43.9	41.8	-9.9	-32.1
Others	64.5	71.8	68.0	68.2	5.7	15.7

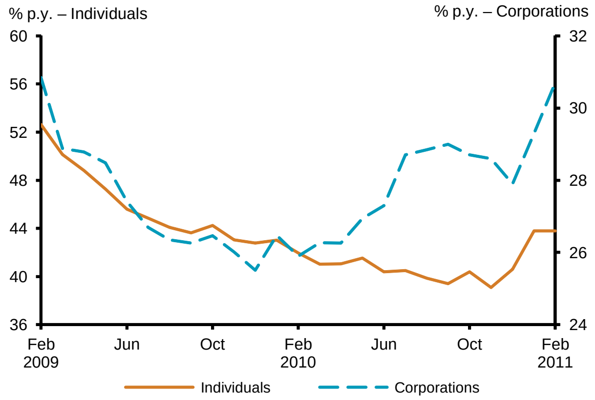
1/ Interest rate reference credit, defined according to Circular n. 2,957 dated 12.30.1999.
2/ Operations backed by domestic resources.

In the corporate segment, the performance of credit operations carried out with nonearmarked resources registered greater volume of concessions in the month of December and moderation in January and February. Thus, as a result of the typical seasonality of the period, total loans in the segment diminished 9.9% in the quarter. In December, it should be highlighted the resumption of operations involving advance exchange contracts (ACC), mostly conditioned by the reduction in the supply of other credit lines for the export activity.

In the framework of operations with individuals, the impacts of macroprudential measures were mostly felt on financing operations with terms over 24 months. This modality registered stability in the month of December, when the sales of vehicles usually increase, a significant decrease in January and partial recovery in February. In February, car loans decreased 25.7% in comparison to November, the month prior to the adoption of the macroprudential measures. Total credit granting related to the reference credit, which comprehends operations with individuals and corporations, diminished 8.9% in the quarter ended in February.

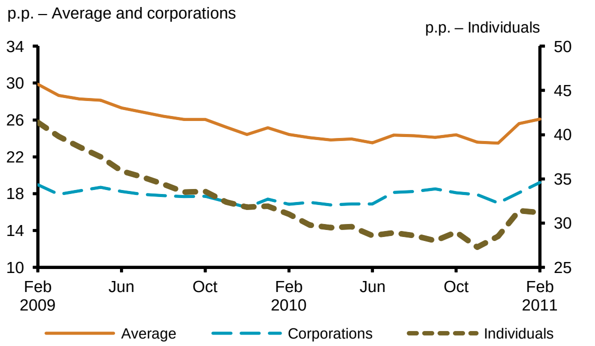
Interest rates and defaults

Figure 3.3 – Interest rates on nonearmarked credit



The average interest rate of reference credit operations reached 38.1% p.a. in February, increasing 3.3 p.p. in the quarter and 3.7 p.p. in twelve months. The quarterly trajectory mainly reflected the impact of the rise in compulsory collections and capital requirement on long-term operations with individuals, as well as the rise of the Selic rate target in January. The banking spread reached 26.1 p.p., up 2.5 p.p. in the quarter and 1.7 p.p. in twelve months.

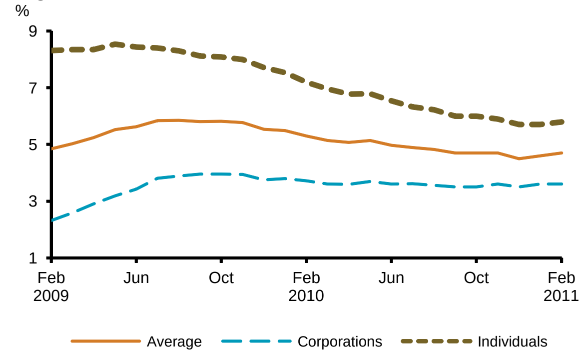
Figure 3.4 – Average spread on nonearmarked credit



The average interest rate closed at 43.8% in the segment of individuals, increasing by 4,7 p.p. in the quarter and 1.8 p.p. in twelve months. It should be stressed the quarterly growth under the modalities of personal credit, 6 p.p., and purchase of vehicles, 4,5 p.p. The average interest rate in the segment of corporations reached 30.7%, up 2.1 p.p. in the quarter and 4.8 p.p. in twelve months.

The default rate of the modalities that compose of the reference credit reached 4.7% in February, registering stability in the quarter and decrease of 0.6 p.p. in twelve months. The quarterly result reflected the 0.1 p.p. decrease in the segment of individuals and stability in the segment of corporations, 0.1 p.p.

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

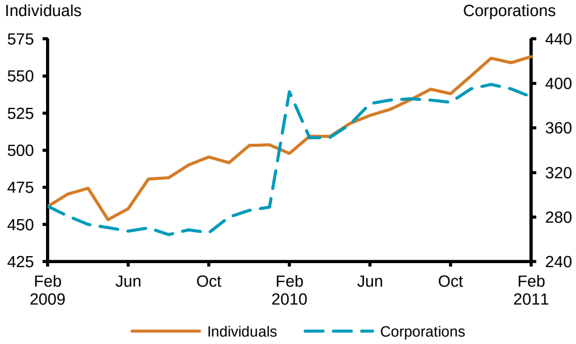


Figure 3.7 – Monetary base and M1 – Average daily balances

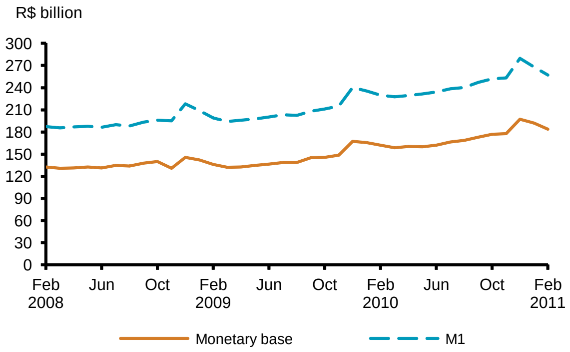
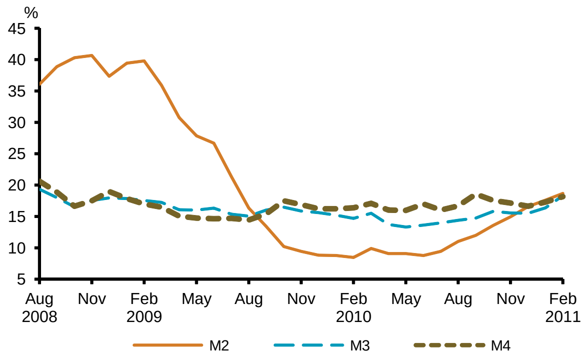


Figure 3.8 – Broad money supply
12-month growth



The average term of the reference credit portfolio reached 472 days in February, increasing 4 days in the quarter and 32 days in twelve months. Indicators referring to operations with individuals increased by 13 days, while indicators for corporations dropped by 7 days, closing at 563 and 388 days, respectively. It should be noted that, since the measures implemented in December raised the requirement of capital for longer terms loans to individuals, the portfolio's average term is expected to gradually decline in the following months.

3.2 Monetary aggregates

The daily average balance of the restricted money supply (M1) reached R$257.2 billion in February, increasing 1.6% in the quarter and 11.9% in twelve months. The average balances of currency outside the banks expanded 3.7% in the quarter and 12.9% in the year, while the demand deposits registered stability in the quarter and expanded 11.2% in the year. The average balance of the monetary base closed at R$183.9 billion, increasing 3.4% in the quarter and 13.6% in the year.

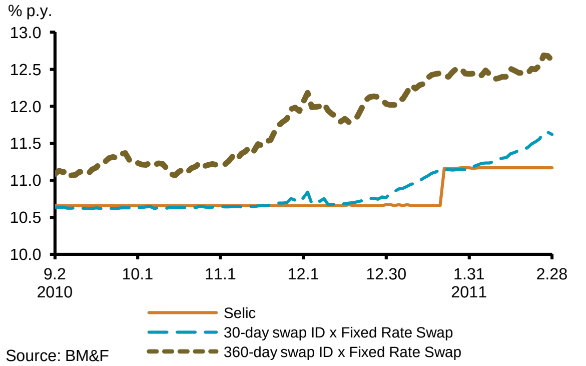
At the end of February, the monetary basis totaled R$185.6 billion. It should be noted that the quarterly expansion of R$7.1 billion mainly reflected net Central Bank foreign currency purchases of R$22 billion in the interbank exchange market and the contractionary impact of R$24.8 billion in National Treasury operations. The variation in compulsory collections totaled R$73.3 billion, reflecting increased rates on long-term resources and additional requirement on cash or long-term resources. Meanwhile, operations with federal public securities closed at R$70 billion.

The means of payment, in the M2 concept, increased 4.9% in the quarter and 18.7% in twelve months, adding up R$1.4 trillion. M3 closed at R$2.6 trillion, up 4.3% in the quarter and 18.3% in twelve months, while the M4 aggregate reached R$3.1 trillion, up 3.6% in the quarter and 18.1% in twelve months.

Real interest rates and market expectations

The curve of futures interest rates in DI x pre swap contracts, evincing expectations regarding the evolution of basic interest rate and the increase of risk premiums, registered raised inclination in all the vertices throughout the quarter. The DI x pre swap contracts of 360 days registered a 68 b.p. high in the quarter, reaching 12.62% per year in February.

Figure 3.9 – Interest rate



Source: BM&F

Figure 3.10 – Ex-ante real interest rate – Deflated by 12-month IPCA expectations

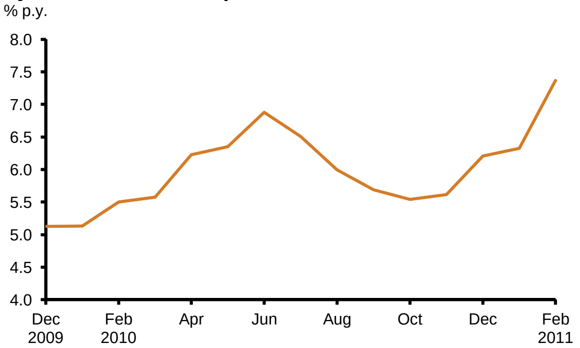
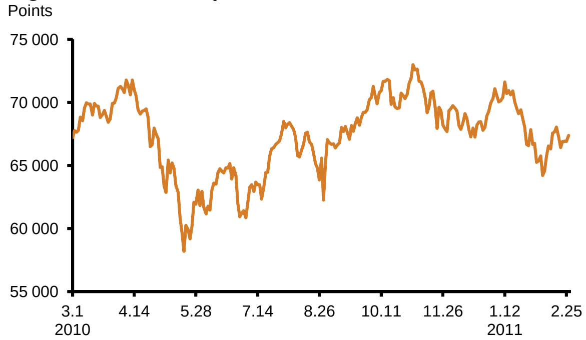
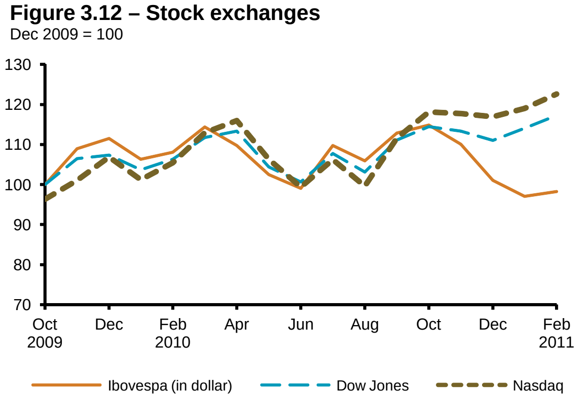


Figure 3.11 – Ibovespa



Source: Bovespa

Figure 3.12 – Stock exchanges



The real *ex-ante* Selic rate for the next twelve months, calculated by the Central Bank Market Report of February 28, stood at 74% per year, against 5.6% per year in November, with emphasis on the variation of 0.96 p.p. to 12.5% per year in the Selic rate expected for the next twelve months.

Capital market

After the upward trend followed up to December, the São Paulo Stock Exchange Index (Ibovespa) registered sharp volatility in February and closed the quarter at 67,383 points. In the period, the market value of the companies listed in the index and the daily average volume of transactions increased, in the order, 3.8% and 15.4%. The Ibovespa, evaluated in dollars, expanded 2.8% in the quarter, while the Dow Jones and the Nasdaq indices rose 11.1% and 11.4%, respectively.

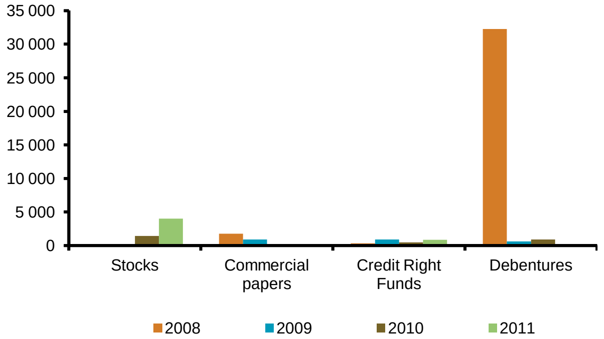
Business financing through capital market operations based on the issuance of stocks, debentures, promissory notes and placement of credit rights receivables, reached R$15.3 billion in the quarter ended in February, against R$127.2 billion in the quarter ended in November 2010, including issuance of R$120.2 billion in Petrobras stocks.

3.3 Fiscal policy

The Federal Government adopted a series of measures in order to enable the R$50.1 billion reduction in expenditures approved by the National Congress for 2011. This decision was partly stimulated by the R$19.1 billion reduction in the total primary revenues estimates, as compared to the forecast contained in the Annual Budget Law (LOA) 2011. It should be emphasized that the forecast for revenues administered by the federal revenue, except social security contributions, decreased R$22.3 billion, while non administered revenues rose R$3.2 billion.

The reduction of expenditures foresee in the scope of mandatory expenditures totals R$15.8 billion, while the reduction f discretionary expenditures amounts to R$32.7 billion. In addition, it should be mentioned an expansion of R$3.5 billion in extraordinary credits and reduction of R$1.6 billion in other expenditures. With regard to mandatory expenditures, it should be highlighted the reduction of R$8.9 billion in subsidies and economic subventions; R$3.5 billion personnel costs and social charges,; and R$3 billion in bonus and unemployment insurance. Concerning the discretionary expenditures, the

Figure 3.13 – Primary issues in the capital market
R$ million – Accumulated through February



Source: CVM

Table 3.5 – Public sector borrowing requirements – Primary result

Segment	2009		2010		Jan 2011[1/]	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Central Government	-42.4	-1.3	-78.7	-2.2	-79.0	-2.1
Sub-national governments	-21.0	-0.7	-20.6	-0.6	-22.4	-0.6
State companies	-1.3	-0.0	-2.3	-0.1	-1.9	-0.1
Total	-64.8	-2.0	-101.7	-2.8	-103.4	-2.8

1/ Twelve-month accumulated data up to january.

sharpest adjustments occurred in the Ministry of the Cities, R$8.6 billion; Ministry of Defense, R$4.4 billion; Ministry of Tourism, R$3.1 billion; Ministry of Transportation, R$2.4 billion; and in the Ministry of National Integration, R$1.8 billion.

It is important to mention that the new estimates take into account the achievement of the full target of R$81.8 billion defined for the central government primary surplus in 2011, excluding the PAC's investments eligible to be discounted.

The National Congress approved, in February, the rules for updating the minimum wage until 2015. The annual impact of 6.9% rise in the minimum wage on the Government's accounts in 2011 shall account for R$9.95 billion, including the wage adjustment carried out in January and February.

Public sector borrowing requirements

Evolution in 2010

The consolidated public sector primary surplus accounted for R$101.7 billion in 2010, representing 2.79% of GDP, against 2.03% of GDP in the previous year. This performance reflected the increased surplus of Central Government and state-owned companies, partially offset by the reduction of regional governments' result. Discounting PAC's investments, 0.6% of GDP, the adjusted surplus target for the year, 2.5% of GDP, was achieved. The target for 2011 was set in current values, for the first time, at R$117.9 billion.

Federal Government gross revenues closed at R$705.3 billion, for annual growth of 26.3% (1.83 p.p. of GDP). This expansion reflected the recovery of economic activity and the Petrobras collection of R$74.8 billion referring to onerous cession of oil exploitation. Excluding this item, the Federal Government revenue growth in 2010 reached 13.1%, down 0.2 p.p. of GDP in the year.

National Treasury expenditures accounted for R$442.2 billion in 2010, increasing 28.4% (1.3 p.p. of GDP) as compared to the previous year. Expenditures with personnel and charges rose 9.8%, while costing and capital expenditures increased 43.3%, with emphasis on the 38% expansion under investments and Federal Government expenditures with Petrobras capitalization carried out in September. Excluding the impact of Petrobras capitalization, National Treasury expenditures expanded 15.9% (0.13 p.p. GDP), while costing and capital expenditures rose by 20.9%.

Analysis of the Evolution of Nominal Interests Appropriation on the PSND

The evolution of the public indebtedness profile over the recent years mostly reflects the participation of fixed-income and indexed to price indices securities, as well as of the Worker Assistance Fund (FAT) assets, the Brazilian Development Bank (BNDES) loans and the international reserves. This box aims to analyze the major factors underlying the evolution of the Public Sector Net Debt (PSND) average cost.

While the Selic rate decreased 13.5 p.p. from 2003 to 2010, the implicit PSND rate decreased 2.6 p.p., emphasizing the distinction between the reduction of implicit credit rates, 7.9 p.p., and debit rates, 4.9 p.p. In the same comparison basis, the appropriation of nominal interests dropped by 3.2 p.p. of Gross Domestic Product (GDP). According to Table 1, since 2006 the PSND implicit interest rate has been higher than the Selic rate, evolution consistent with the changes in the indebtedness profile mentioned in the previous paragraph.

Table 1 – Selic, nominal interests and PSND implicit interest rate

% p.y.

Period	Selic average	Nominal interests (% GDP)	Implicit rate: Net debt total	Implicit rate: Credits	Implicit rate: Debts
2002	19.2	7.7	15.6	8.8	12.9
2003	23.3	8.5	17.5	12.2	15.0
2004	16.2	6.6	14.4	8.6	12.7
2005	19.0	7.4	17.2	6.7	14.0
2006	15.1	6.8	16.3	6.6	13.0
2007	11.8	6.1	15.1	5.9	11.7
2008	12.5	5.5	14.6	7.0	11.9
2009	9.9	5.4	14.5	2.9	9.9
2010	9.8	5.3	14.9	4.3	10.1

The analysis of PSND composition shows that the participation of fixed-rate securities increased from 9.8%, at the end of 2003, to 41.8% at the end of 2010. In a scenario of downward basic interest rates, this growth contributed for a less sharp reduction in the implicit rate of appropriation of nominal interests as compared to the Selic rate. The reason for this is that the rates defined for fixed-rate securities at the issue date prevail until their maturity. However, it should be stressed that the growing participation of fixed-rate securities provides greater predictability to the government financial commitments, reducing its exposure to market risks, among other benefits.

Another factor that contributes to explain the divergent trajectory of the implicit rate and the Selic

Table 2 – International reserves
Liquidity concept

Period	US$ billion	R$ billion	Exchange rate (R$/US$)
2002	37.8	133.6	3.53
2003	49.3	142.4	2.89
2004	52.9	140.5	2.65
2005	53.8	125.9	2.34
2006	85.8	183.5	2.14
2007	180.3	319.3	1.77
2008	193.8	452.7	2.34
2009	238.5	415.1	1.74
2010	288.6	480.6	1.67
2011 - Jan	297.7	497.9	1.67

Table 3 – PSND/GDP ratio
Selic impact

Period		Selic (% p.y.) (A)	Average elasticity Selic1/ (B)	Selic cost in the PSND/GDP2/ ratio (A*B)
2002	Sep	17.90		
2003	May	26.27		
	Change	8.37	0.25	2.11
2008	Sep	13.66		
2009	Jul	8.65		
	Change	(5.01)	0.26	(1.32)
	Total			3.43

1/ Change in the PSND/GDP ratio as a result of 1 p.p. increase and maintained for one year.
2/ In percentage points of GDP.

Table 4 – PSND/GDP ratio
Exchange impact

Period		Exchange rate R$/US$ (A)	Average elasticity exchange rate1/ (B)	Exchange cost in the PSND/GDP2/ ratio (A*B)
2002	Jan	2.42		
	Sep	3.89		
	Change	61.08	0.22	13.54
2008	Aug	1.63		
2009	Feb	2.38		
	Change	45.54	-0.10	-4.73
	Total			18.27

1/ Change in the PSND/GDP ratio as a result of 1% increase in the exchange rate.
2/ In percentage points of GDP.

rate is the accumulation of certain capital assets with nonfinancial purposes. For instance, it should be mentioned the growth of international reserves, from US$49.3 billion in 2003 to US$288.6 billion in 2010 (Table 2). As a matter of fact, it is important to emphasize that, in the absence of other factors impacting liquidity, the accumulation of reserves implies contracting open market operations aimed to neutralize the monetary expansion that it generates.

In 2006, with the accumulation of international reserves, the PSND started to register a net creditor position in foreign currency. Among other benefits, this introduced important degrees of freedom for the conduction of the economic policy. In the fiscal framework, this benefit in particular may be illustrated by the impact of the exchange and Selic rate variations during two stressful financial periods in the PSND/GDP ratio: the first, in 2002, when the volume of reserves was not appropriate in view of the uncertainties prevailing in the economic environment; and the second, in 2008, with the outbreak of the international crisis, when the stock of reserves seemed to fit better to the country's requirements.

In view of the international liquidity cushion, the Selic rate dropped 5 p.p. from September 2008 to July 2009[1]. On the other hand, from September 2002 until May 2003, the Selic rate increased 8.4 p.p. due to the excessive external vulnerability. Taken into account the elasticity of the PSND/GDP ratio to the Selic rate in both periods, the estimated gain reached 3.4 p.p. of GDP in the most recent episode. In addition, the 45.5% exchange rate depreciation accumulated from September 2008 to February 2009 led to the 4.7 p.p. drop in the PSND/GDP, given the net creditor position in dollars. On the other hand, the 61.1% exchange rate depreciation registered from January to September 2002 increased the PSND/GDP ratio by 13.5 p.p. of GDP. These figures are shown in Tables 3 and 4.

Regarding domestic assets, the credits linked to the Long-Term Interest Rate (TJLP) increased from 8.8% of PSND in 2003 to 26.4% in 2010. These assets are concentrated in constitutional funds

1/ Considering the daily average interest rate, yearly updated on the basis of 252 working days.

resources, FAT investments and credits held by federal financial institutions. This growth took place especially in recent years, as a consequence of the expansion of Federal Government loans granted to the BNDES by means of issues of public securities and creation of corresponding credits to the Federal Government, with no immediate impact on PSND or financing requirements. These operations provide the Federal Government with financial assets remunerated by the TJLP and financial liabilities indexed to marked-related costs. Table 5 shows the evolution of the volume of major public sector assets, highlighting the recent growth of loans granted to the BNDES and the Central Bank's net foreign credits.

Table 5 – Growth in the main public sector financial assets

R$ million

Breakdown	2002	2003	2004	2005	2006	2007	2008	2009	2010
FAT resources	-75 840	-88 053	-102 559	-116 890	-130 807	-138 392	-153 635	-159 633	-169 517
Hybrid instrument of capital and debt 1/	0	0	0	0	-2 389	-7 504	-7 633	-15 550	-19 879
Credit with the BNDES	-11 808	-13 622	-17 773	-16 814	-9 953	-6 645	-35 454	-129 237	-236 723
Federal government investments (Funds) 2/	-42 014	-60 865	-50 305	-57 718	-54 457	-59 175	-66 250	-78 627	-100 984
Central Bank's net external credits	-59 141	-58 490	-73 080	-125 238	-183 111	-319 216	-483 110	-408 188	-473 588
State government investments	-21 620	-20 854	-23 350	-23 578	-22 664	-28 050	-32 315	-34 025	-39 279
Federal state-owned credits	-31 098	-29 122	-31 928	-29 087	-27 047	-24 217	-19 475	-15 709	-12 760
Demand deposits	-4 893	-4 469	-4 516	-6 353	-6 099	-8 267	-9 156	-8 331	-8 116
Total	-246 415	-275 474	-303 512	-375 680	-436 527	-591 467	-807 028	-849 301	-1060 846

1/ Hybrid instruments of capital and debt – BNDES, CEF and BNB.
2/ Includes constitutional funds and other federal government funds and programs.
3/ The implicit rate of the net external debt does not include changes in the exchange rate.

Table 6 – PSND/GDP elasticity to index numbers
Impact on the PSND/GDP ratio

p.p. of GDP

Period	Interest rate 1/		Price indices 1/				Exchange 2/
	Selic	TJLP	IPCA	IGP-DI	IGP-M	Total	
2002	0.25	-0.05	0.01	0.02	0.03	0.03	0.17
2003	0.26	-0.05	0.01	0.02	0.03	0.03	0.12
2004	0.27	-0.05	0.01	0.01	0.04	0.04	0.08
2005	0.23	-0.05	0.03	0.01	0.03	0.07	0.03
2006	0.21	-0.06	0.06	0.01	0.02	0.07	-0.02
2007	0.23	-0.06	0.07	0.01	0.02	0.10	-0.08
2008	0.24	-0.06	0.09	0.01	0.02	0.12	-0.11
2009	0.26	-0.08	0.08	0.00	0.02	0.10	-0.11
2010	0.27	-0.11	0.09	0.00	0.02	0.11	-0.11

1/ Variation of 1 p.p. maintained for one year.
2/ Variation of 1% in the exchange rate.

Changes in the PSND composition have impacted the elasticity of the PSND/GDP ratio in relation to several indexing factors. Thus, the elasticity regarding the Selic rate increased from 0.26 p.p. of GDP, in 2003, to 0.27 p.p. of GDP in 2010, according to Table 6. In the same period, the elasticity regarding the TJLP increased from 0.05 p.p. of GDP to -0.11 p.p. of GDP; regarding the Extended National Consumer Price Index (IPCA), from 0.01 p.p. of GDP to 0.09 p.p. of GDP; and to the exchange rate variation, from 0.12 p.p. of GDP to -0.11 p.p.

Table 7, elaborated on the basis of information gathered by Gerin with a group of experts, concerning indicators such as the Selic and exchange rate, among others, shows the trajectory of the implicit rate and the evolution of PSND/GDP ratio until 2014. Even in 2011, when the market predicts an increase in

Table 7 – Projection of fiscal variables based on market parameters[1/]

% GDP

Period	PSND	Nominal result	Nominal interests	Implicit rate (% p.y.)
2011	38.0	1.9	4.8	14.3
2012	36.0	1.2	4.3	13.1
2013	33.6	0.7	3.8	12.2
2014	31.2	0.4	3.5	12.1

1/ The primary surplus forecasted in the LDO was defined for 2011 and a 3.1% surplus was adopted for the other years. Also, a real GDP growth rate of 4% was defined for 2011. For the other years, market projections were used.

the Selic average rate, the implicit rate tends to decrease in relation to the previous year, a trend that is expected to persist in the following years.

In short, the changes in the composition of the Brazilian public indebtedness observed recently have led to a mismatch between the paces of reduction of the Selic rate, the average cost of indebtedness and the appropriation of nominal interests. In the medium-term, one should expect a reduction in the average cost of indebtedness and appropriation of nominal interests in relation to GDP.

Figure 3.14 – National Treasury gross revenue
Jan-Dec

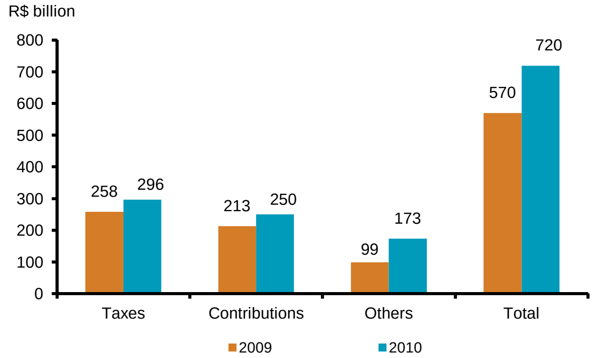


Table 3.6 – National Treasury expenditures
Jan-Dec

	2009		2010	
	R$ million	% GDP	R$ million	% GDP
Total	344 436	10.8	442 243	12.1
Personnel and payroll charges	151 653	4.8	166 486	4.6
Capital and current expenditures	191 604	6.0	274 514	7.5
Workers Support Fund	27 433	0.9	30 311	0.8
Subsidies and economic	5 190	0.9	7 846	0.8
subventions	5 190	0.2	7 846	0.2
Loas/RMV	18 496	0.6	22 234	0.6
Investment	34 137	1.1	47 107	1.3
Other capital expenditures	106 348	3.3	167 018	4.6
National Treasury transfers				
to the Central Bank	1 180	0.0	1 242	0.0

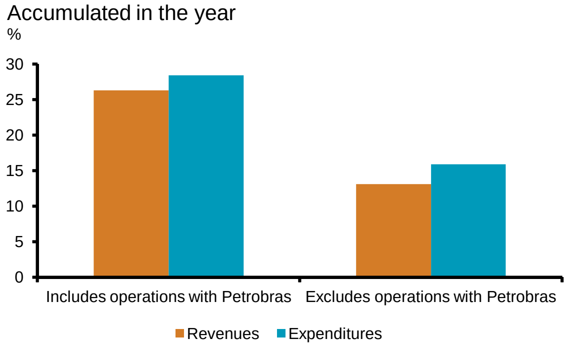
Source: Minifaz/STN

Table 3.7 – Social security primary result
Jan-Dec

R$ billion

	2009	2010	Var. %
Gross inflow	201.2	234.3	16.4
Cash refunds	-0.6	-0.7	33.3
Transfers to third parties	-18.6	-21.5	15.8
Net inflow	182.0	212.0	16.5
Social Security benefits	224.9	254.9	13.3
Primary result	-42.9	-42.9	0.1
Net inflow/GDP	5.7%	5.8%	
Social Security benefits/GDP	7.1%	7.0%	
Primary result/GDP	-1.3%	-1.2%	

Figure 3.15 – National Treasury income and expenditure growth rate
Accumulated in the year



The Social Security deficit accounted for R$42.9 billion in 2010, decreasing 0.17 p.p. of GDP as compared to the previous year. This evolution reflected, especially, the growth of overall wages in the period, which contributed to the 16.5% rise in net collection. Expenditures on social security benefits, reflecting respective rises of 8.8% and 3.2% in the average value of benefits and pensions and in the monthly average number of benefits paid, expanded 13.3%.

Revenues of the Central Government – National Treasury, Social Security and the Central Bank – increased 27.4% in 2010, while expenditures rose 22.4%.

The transfers to regional governments reached R$140.7 billion (3.85% of GDP), increasing 10.2% as compared to 2009. This performance is explained by the growth in the volume of resources transferred through the participation funds, as a consequence of greater collection of shared taxes; the expansion of transfers linked to petroleum and natural gas exploitation, consequent upon higher international oil prices; and the 14.2% growth in the transfers of the education-wage.

Revenues originating in the Tax on the Circulation of Goods and Services (ICMS), the most representative regional tax, and to the Tax on the Proprietorship of Automotive Vehicles (IPVA) increased 17.5% and 2.4%, respectively, in the year. The primary surplus of states and municipalities reached R$20.6 billion, decreasing 0.09 p.p. of GDP in comparison with the previous year, while the primary surplus of state-owned companies, concentrated in the federal sphere, accounted for 0.06 p.p. of GDP.

The appropriation of nominal interests accounted for R$195.4 billion, 5.35% of GDP, in 2010, decreasing 0.02 p.p. of GDP in comparison to the previous year. The public sector nominal deficit reached R$93.7 billion, decreasing 0.77 p.p. in the period. This deficit was financed through expansions of net banking debt, securities debt and other sources of internal financing, including the monetary base, partially offset by the reduction registered in net foreign financing.

Evolution in January 2011

The public sector primary surplus accounted for R$17.7 billion in January, against R$16.1 billion in the same period of 2010. In twelve months, the accumulated surplus reached 2.81% of GDP, against 2.29% of GDP in January 2010.

Figure 3.16 – Transfers to states and municipalities in 2010

Figure 3.17 – Regional governments: Cumulative 12-month primary surplus and net debt

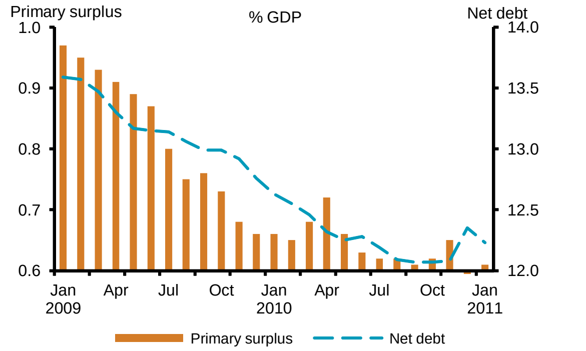
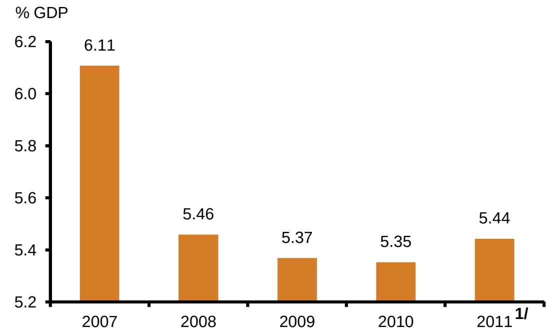


Figure 3.18 – Nominal interest



1/ Twelve-month accumulated up to January.

Table 3.8 – Public sector borrowing requirements

	2009		2010		Jan 2011	
	R$ billion	% GDP	R$ billion	% GDP	R$ billion	% GDP
Uses	106.2	3.3	93.7	2.6	1.5	0.5
Primary	-64.8	-2.0	-101.7	-2.8	-17.7	-5.7
Interest	171.0	5.4	195.4	5.4	19.3	6.2
Sources	106.2	3.3	93.7	2.6	1.5	0.5
Domestic financing	161.5	5.1	178.5	4.9	19.8	6.4
Securities financing	265.5	8.3	35.2	1.0	54.6	17.6
Bank financing	-123.2	-3.9	100.9	2.8	-23.0	-7.4
Others	19.3	0.6	42.5	1.2	-11.9	-3.8
External financing	-55.3	-1.7	-84.9	-2.3	-18.3	-5.9

The Central Government registered a surplus of R$13.8 billion in the month, against R$13.5 billion in January 2010, as a result of the greater impact of the reduction in the Social Security deficit as compared to the reduction in the Federal Government surplus. The National Treasury gross revenue increased 22.5% in the period, with emphasis on the performance of the collection of Legal Entity Income Tax (IRPJ) and of the Industrialized Products Tax (IPI). Meanwhile, expenditures increased 30%, emphasizing the 85% expansion under investments. In the framework of the Social Security, revenues rose 21.6%, while expenditures with benefits expanded 13.2%.

The appropriation of nominal interests, as a consequence of growth under the Selic rate and price indices, accounted for R$19.3 billion in the month, against R$14.1 billion in January 2010. The nominal deficit reached R$1.5 billion in the month, accumulating 2.64% of GDP in twelve months, against 2.57% of GDP in 2010.

Central Bank open market operations

National Treasury primary operations with federal public securities resulted in net redemptions of R$63.9 billion in the quarter ended in January, due to placements of R$81.2 billion and redemptions of R$145.1 billion. Swap operations, of which 82.6% were performed with National Treasury Notes – Series B (NTN-B), accounted for R$5.5 billion, while anticipated redemptions, concentrated in National Treasury Bills (LTN), added up R$1 billion.

The daily average balance of financing and go around operations performed by the Central Bank accounted for R$397.2 billion in January, decreasing 3.9% in comparison to October 2010. This performance reflected the reduction, from R$216.8 billion to R$141.1 billion, in operations with terms between two weeks and three months, and the increase in operations with six-month terms, from R$126.3 billion to R$144.8 billion, and in operations with terms lower than two weeks, from R$70.2 billion to R$111.4 billion.

Federal securities debt

The federal securities debt, evaluated by the portfolio position, stood at R$1,542.5 billion in January, 41.9% of the GDP, decreasing 1.3 p.p. of GDP as compared to October and 0.2 p.p. of GDP in twelve months. The quarterly reduction reflected net redemptions of R$61 billion carried out in the primary market, appropriation of nominal interests

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

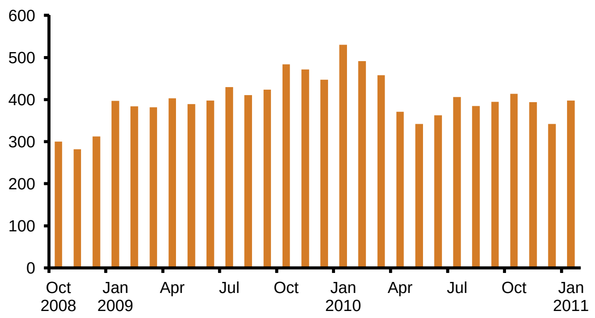


Figure 3.20 – Central Bank repo operations – Maturity – Average daily balances

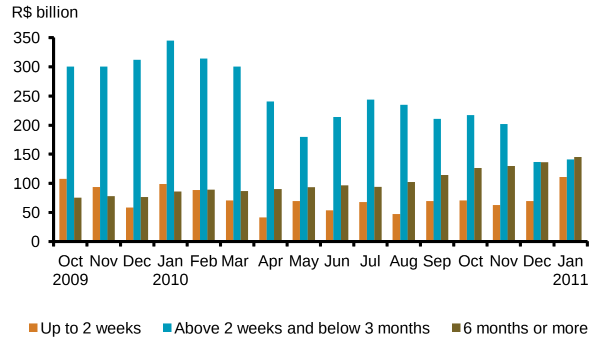
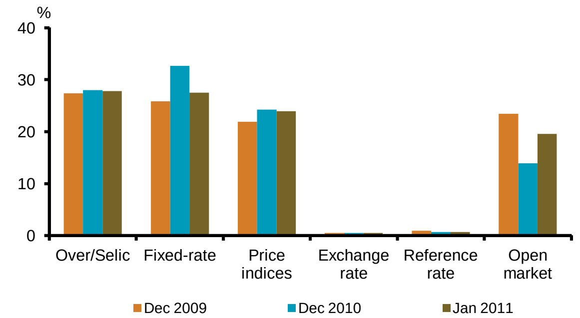
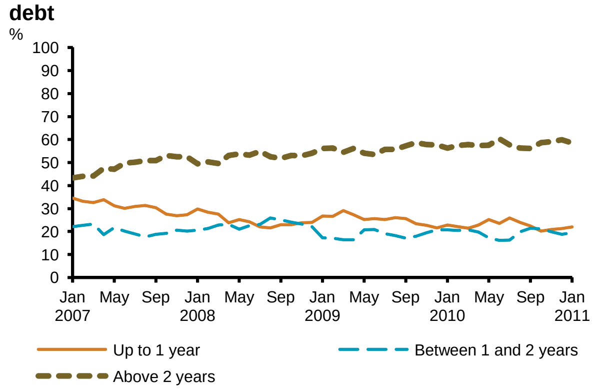


Figure 3.21 – Federal securities debt structure by indexing factor[1/]



1/ It does not include swap.

Figure 3.22 – Profile of maturities of the securities debt



of R$51 billion, and the impact of R$0.2 billion consequent upon the 1.7% exchange appreciation in the period.

The participation of securities linked to the over/Selic rate and to prices indices in the total federal securities debt registered respective quarterly increases of 1.1 p.p. and 1.3 p.p. in January, while the participation of fixed-rate securities and Central Bank financing through open market operations, reduced 1.9 p.p. and 0.5 p.p., respectively.

The amortization schedule of the securities debt on market, except financing operations, registered the following maturity structure in January: 16.2% of the total maturing in 2011; 19.5% in 2012; and 64.3% since January 2013. Securities with 12-month terms represented 22% of the total securities debt on the market, while the average term of the debt maturity reached 42.4 months, both within the respective intervals established by the Annual Financing Plan (PAF) 2011.

The Central Bank, after 18 months with zero net exposition, resumed swap exchange reverse operations in January. The stock of these operations at the end of the month reached R$5.8 billion and the result obtained, known as the difference between the DI's profitability and the exchange variation plus coupon, was favorable to the Central bank in R$12 million, considering the cash concept.

Public Sector Net Debt

The Public Sector Net Debt (PSND) totaled R$1,475.8 billion in 2010, 40.4% of GDP, decreasing 2.3 p.p. of GDP as compared to the previous year, with cutbacks in all public sector's segments, emphasizing the 1.8 p.p. drop in the framework of the Central Government. In January, the PSND reached R$1,476.1 billion, 40.1% of GDP.

The annual reduction of the PSND/GDP ratio mostly reflected the contribution of primary surplus, 2.8 p.p. of GDP; the current GDP growth, 5.4 p.p.; and the effect of privatizations, 0.1 p.p., compared to the effects consequent upon the appropriation of nominal interests, 5.4 p.p. of GDP; and the exchange appreciation of 4.31% registered in the period, 0.5 p.p. of GDP.

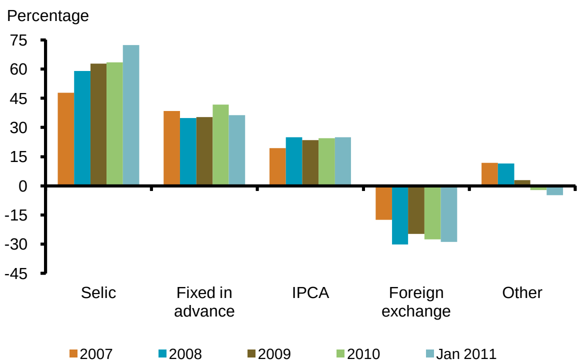
With respect to the PSND composition in 2010, it should be mentioned the 6.6 p.p. rise in the creditor position linked to the TJLP – as a result of the increase of Government assets with the BNDES, counterbalanced by the increase

Table 3.9 – Net debt growth
Conditioning factors

	2009		2010		Jan 2011	
	R$ million	% GDP	R$ million	% GDP	R$ million	% GDP
Total net debt – Balance	1362 711	42.8	1475 820	40.4	1476 105	40.1
Flows						
Net debt – Growth	194 472	4.3	113 109	-2.3	285	-0.4
Conditioning factors	194 472	6.1	113 109	3.1	285	0.0
PSBR	106 242	3.3	93 673	2.6	1 532	0.0
Primary	-64 769	-2.0	-101 696	-2.8	-17 748	-0.5
Interest	171 011	5.4	195 369	5.4	19 281	0.5
Exchange adjustment	80 886	2.5	17 677	0.5	-1 682	0.0
Domestic securities	-3 414	-0.1	1 513	0.0	- 143	0.0
debt[1/]	84 300	2.6	16 163	0.4	-1 539	0.0
External debt	10 907	0.3	1 533	0.0	604	0.0
Others[2/]	0	0.0	0	0.0	0	0.0
Skeletons	- 345	0.0	2 969	0.1	- 170	0.0
Privatizations	-3 217	-0.1	-2 742	-0.1	0	0.0
GDP growth effect		-1.9		-5.4		-0.4

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

Figure 3.23 – NPSD – Percentage share of indexator



in the federal securities debt – and of 6.5 p.p. referring to fixed-rate debts.

The General Government Gross Debt (GGGD) – Federal Government, National Social Security Institute (INSS), State and municipal governments – reached R$2,011.5 billion (55.1% of GDP) in 2010. The annual decrease of 6.8 p.p. of GDP mostly resulted of the reduction in the stock of repo operations, from 14.3% of GDP in 2009 to 7.9% in 2010. In January, the GGGB reached 55.9% of GDP.

3.4 Conclusion

In December 2010, the Central Bank introduced macroprudential measures aimed to increase the security of longer-term credit operations, especially in the modalities of acquisition of goods and personal credit, so as to mitigate the risks identified in the credit market. The impact of these measures, which are expected to raise interest rates and reduce the terms of new operations, shall reinforce the effects of the raise of the Selic rate target decided by Copom in January.

It is important to emphasize that the credit scenario continues to be favorable, as evinced by expanding credit operations, low default rates and interest rates at historically low levels. In this environment, the evolution of credit operations in 2011 should continue to stimulate consumption and investments, though at a more moderate pace.

The trajectories of GDP and primary surplus in 2010 contributed to lower the PSND/GDP rate, a trend that should persist in the following months, thus guaranteeing the sustainability of the fiscal policy.

4 International economy

Table 4.1 – Major developed countries

GDP components and other indicators

Anualised % rate

	2009				2010			
	I	II	III	IV	I	II	III	IV
GDP								
United States	-4.9	-0.7	1.6	5.0	3.7	1.7	2.6	2.8
Euro Area	-9.5	-0.6	1.6	0.7	1.6	4.0	1.4	1.1
United Kingdom	-8.6	-3.2	-1.1	1.9	1.3	4.2	2.8	-2.3
Japan	-20.0	10.7	-1.9	7.2	6.1	2.1	3.3	-1.3
Household consumption								
United States	-0.5	-1.6	2.0	0.9	1.9	2.2	2.4	4.1
Euro Area	-2.1	0.1	-0.8	1.0	1.4	0.7	0.6	1.7
United Kingdom	-5.4	-2.8	0.1	3.9	-0.1	1.9	0.2	-0.4
Japan[1/]	-7.4	5.2	0.4	3.9	2.1	-0.1	3.6	-3.2
Non-residencial investment								
United States	-35.2	-7.5	-1.7	-1.4	7.8	17.2	10.0	5.3
Euro Area[2/]	-19.4	-8.9	-4.7	-4.1	-0.6	8.6	-0.6	-2.4
United Kingdom	-31.1	-33.9	-14.3	-10.9	36.1	1.4	17.2	-9.5
Japan	-23.5	-18.2	-8.3	6.3	2.7	12.0	5.6	2.0
Residencial investment								
United States	-36.2	-19.7	10.6	-0.8	-12.3	25.6	-27.3	2.8
Euro Area[3/]	-3.0	-6.6	-6.8	-6.5	-6.1	3.1	-4.0	-6.5
United Kingdom	-44.0	-17.2	6.8	-10.6	5.9	33.8	16.9	nd
Japan	-23.6	-30.4	-27.9	-15.0	6.5	-1.3	7.5	12.3
Exports of goods and services								
United States	-27.8	-1.0	12.2	24.4	11.4	9.1	6.7	9.6
Euro Area	-30.6	-4.2	10.9	8.4	11.8	18.9	9.1	7.5
United Kingdom	-25.5	-6.9	3.5	15.5	-3.1	13.0	6.9	9.4
Japan	-68.4	45.1	40.1	28.1	29.3	22.9	6.3	-3.0
Imports of goods and services								
United States	-35.3	-10.6	21.9	4.9	11.2	33.5	16.8	-12.4
Euro Area	-24.8	-10.8	7.2	3.9	14.5	17.7	5.7	4.4
United Kingdom	-25.8	-8.8	4.4	17.7	9.2	7.8	6.7	12.3
Japan	-49.4	-19.7	24.0	4.1	12.7	16.8	12.0	-0.5
Government expenditures								
United States	-3.0	6.2	1.6	-1.4	-1.6	3.9	3.9	-1.5
Euro Area[4/]	2.8	2.4	2.0	-0.1	-0.1	0.7	1.6	0.5
United Kingdom	-3.1	0.6	-0.7	1.8	2.0	1.2	-1.3	2.8
Japan	5.8	11.2	2.7	4.6	-2.0	1.0	-0.3	-2.6
Manufacturing output								
United States	-21.0	-9.3	10.4	7.1	6.2	9.4	4.3	4.0
Euro Area	-31.6	-7.1	6.9	6.2	13.0	9.9	3.0	8.8
United Kingdom	-20.4	-0.9	-3.0	4.1	5.4	6.2	3.6	4.6
Japan	-59.5	29.4	22.8	26.1	30.9	6.1	-6.7	-6.4
Unemployment rate[5/]								
United States	8.6	9.5	9.8	9.9	9.7	9.5	9.6	9.4
Euro Area	9.1	9.5	9.8	9.9	9.9	10.0	10.0	10.0
United Kingdom	7.1	7.8	7.9	7.8	8.0	7.8	7.7	7.9
Japan	4.8	5.3	5.3	5.2	5.0	5.3	5.0	4.9

Sources: BEA, Thomson, Cabinet Office, Eurostat and own calculation.
1/ Private consumption.
2/ Includes residencial and public investment expenditures.
3/ Total construction expediture.
4/ Consumption expenditures exclusive.
5/ End of the quarter rate.

The global economy moves toward its recovery, registering improvements in the United States of America (USA) labor market, activity growth in the Euro Area, especially in Germany, and soundness of the Chinese internal demand, where the government has intensified liquidity restriction measures in order to to avoid increasing inflationary risks. This perspective is shared by the other emerging economies of Southeast Asia and Latin America, regions where the rise of commodities prices and product gap closure, among other factors, have been reflected as a rise in consumer prices indices. However, it is important to consider that the intensity of the global recovery is conditioned to the normalization of the US and Euro Area credit conditions and to impacts of the increasing geopolitical conflicts in Northern of Africa and the Middle East.

4.1 Economic activity

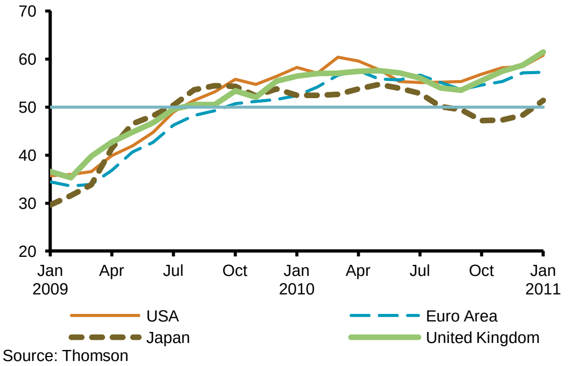
The U.S. and the Euro area GDPs annual growth reached 2.8% and 1.1%, respectively, in the quarter ended December, noticing that the expansion registered in the U.S. reflected, especially, a reduction in imports and a rise in private consumption. On the other hand, there were respective falloffs of 1.3% and 2.3% in Japan's and United Kingdom's GDPs, results derived from the exhaustion of incentives to the acquisition of consumer goods and of the international trade deceleration in Japan; and due to the severity of United Kingdom's winter in December.

The annual growth rate of household consumption increased for the fourth consecutive time in the U.S., reaching 4.1% in the final quarter of 2010, while the real available income went up 1.4% and the families' savings dropped 0.4 p.p., reaching 5.4% of the personal disposable income. In addition, the families' consumption registered annualized quarterly variations of -3.2% in Japan, 1.7% in the Euro area and -0.4% in the United Kingdom.

In the same period, business investments, despite being in deceleration for the second consecutive quarter, went up 5.3% in the U.S. and 2.0% in Japan, following the variations registered in the Euro area, -2.4%, and in United Kingdom, -9.5%. Property investments increased 12.3% in Japan and 2.8% in the U.S.

The external sector contributed 3.4 p.p. for U.S. annualized GDP variation in the quarter ended December, following the respective impacts of 1.2 p.p. and -0.4 p.p. registered in the Euro area and in Japan. Goods and services imports registered annual variation of -12.4% in the U.S., 4.4% in the Euro area, -0.5% in Japan and 12.3% in United Kingdom. Goods and services exportations of U.S., United Kingdom and Euro area presented respective rises of 9.6%, 9.4% and 7.5% within the period, while Japan's external sales dropped 3.0%.

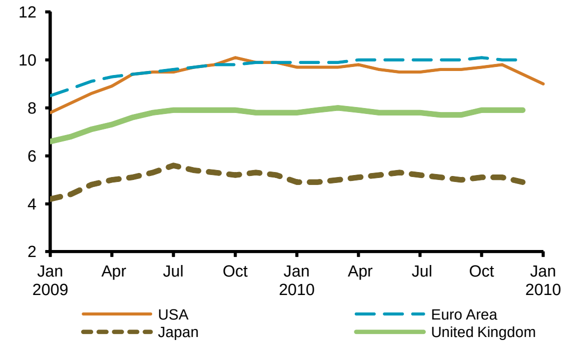
Figure 4.1 – Manufacuring PMI
Largest developed economies



Source: Thomson

United States' annualized growth rate of manufacturing output reached 4% in the quarter ended December, against 4.3% in that ended September, while Euro area and United Kingdom rates were, respectively, 8.8% and 4.6%, increasing 5.8 p.p. and 1.0 p.p. within the period. Japan's manufacturing output registered respective declines of 6.4% and 6.7% in the quarters mentioned. It must be pointed out that the PMI[7] regarding the manufacturing activity suggests the acceleration of the activity in the United States and the Euro area, respectively since August and October 2010, and growth in Japan since this year's January. In February, this indicator reached 61.4 p.p. in the U.S., 59.0 in the Euro Area, 52.9 in Japan and 61.5 in the United Kingdom, whereas the latter represented the highest value of the series for that country.

Figure 4.2 – Unemployment rate growth
Largest developed economies



Source: Bloomberg

The United State's labor market registered the generation of 457 thousand jobs in the private sector in the quarter ended February, against 380 thousand in that ended November. Within this context, in which the unemployment rate dropped to 8.9% in February, the consumer sentiment index reached 77.5 p.p. in February, the highest level of the last three years. Within the Euro area, the economic activity recovery favored the creation of 209 thousand jobs in the quarter ended December, against the loss of 29 thousand in that ended September, and the unemployment rate remained around 9.9% in January, the lowest level in 13 months. The unemployment rates in Japan and United Kingdom reached 4.9% and 7.9%, respectively, in January and December.

7/ The PMI referring to the Euro Area, the United Kingdom and Japan are calculated by Markit and that of USA, by the Institute for Supply Management (ISM).

Table 4.2 – China

GDP components and other indicators

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

	2009				2010			
	I	II	III	IV	I	II	III	IV
GDP	6.5	7.9	9.1	10.7	11.9	10.3	9.6	9.8
Retail sales	21.6	22.7	23.2	19.6	15.4	15.2	15.0	14.0
Vehicles sales[1/]	3.6	31.6	73.8	85.7	72.5	29.0	16.0	23.2
Investment in Fixed Assets (total)	30.3	41.2	38.2	25.8	23.2	20.5	18.3	16.8
Exports of Goods[2/]	-19.8	-23.5	-20.4	0.1	28.7	40.9	32.2	24.9
Imports of Goods[2/]	-31.0	-20.3	-11.7	22.8	65.1	43.6	27.1	29.4
Industrial production	5.1	9.0	12.3	17.9	19.6	16.0	13.5	13.3
Unemployment rate[2/]	4.3	4.3	4.3	4.3	4.2	4.2	4.1	4.1

Sources: Bloomberg, Thomson and own calculation.

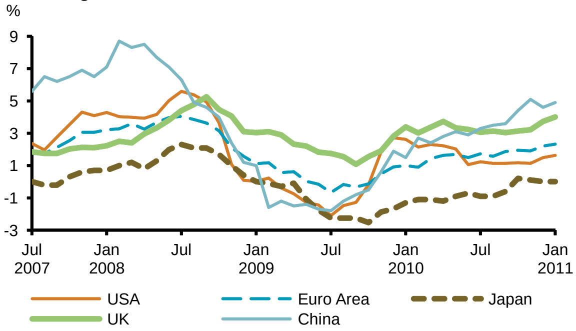
1/ Includes sales to enteprises.

2/ variations calculated in US$ current prices.

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

Figure 4.3 – Consumer inflation

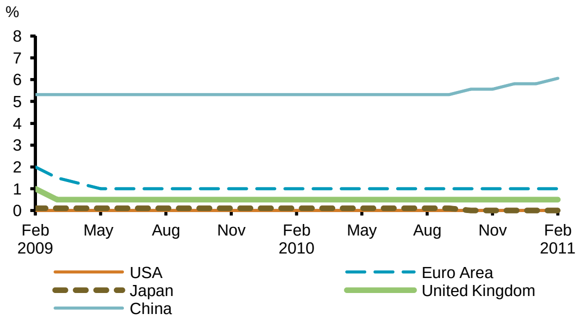
Annual growth



Sources: BLS, Eurostat, Bloomberg and ONS

Figure 4.4 – Official interest rates

Annual rates



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

In China, despite the governmental efforts to restrict credit, moderate the pace of growth and intensify the fight against inflation, the GDP annual growth rate reached 9.8% in the quarter ended December, against 9.6% in that ended September. December's result reflected, especially, the expressive performances of retail sales, 14%, and of investments in fixed assets, 16.8%.

4.2 Monetary policy and inflation

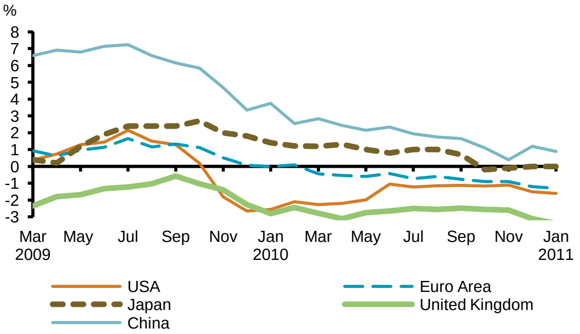
The rise of commodity prices, which intensified in the fourth quarter, has been putting considerable pressure on general prices indices, especially in emerging economies, with consequences on the level of respective basic interest rates. On the other hand, within the G3 economies, where the pace of activity is below the potential and unemployment rates remain high, the authorities kept the accommodative stance of the monetary policy.

The IPC's annual variation in the U.S., after ranging between 1.1% and 1.2% from June to November 2010, reached 1.6% in January. This growth has been related especially to the impact of petroleum prices rise on the annual variation of the energy price index, which amounted to 7.3% within the period. Despite this upward trend of high, the IPC center annual variation reached 0.95%, result compatible with the commodities prices rise transfer restrictions for the final consumer, within modest recovery environment of the economic activity and high unemployment rates.

Facing this scenario, and aiming to contain deflation risks, the Fed maintained unaltered, until February, the quantitative easing program II and the limits of the fluctuation band of the goal for the Fed funds, in 0% and 0.25%. In addition, in means of December, in response to the aggravation of the fiscal tensions in the peripheral economies of the Euro area, the Fed announced, in coordination with the central banks of England (BoE), Japan (BoJ), Europe (ECB), Canada (BoC) and Switzerland (BNS), the extension, until August 1 2011, of the validity of currency swap lines between the respective central banks.

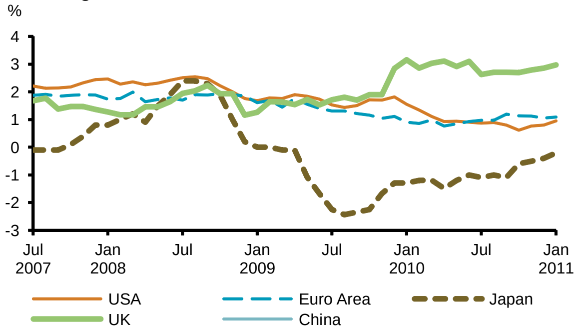
In Japan, there was an interruption in the deflation, measured by IPC variation, which registered zero variation in the annual index in January for the second consecutive month, against negative variation in the early nine months of 2010. This movement evinced the impact of energy and food price

Figure 4.5 – Real interest rates
Annual rates



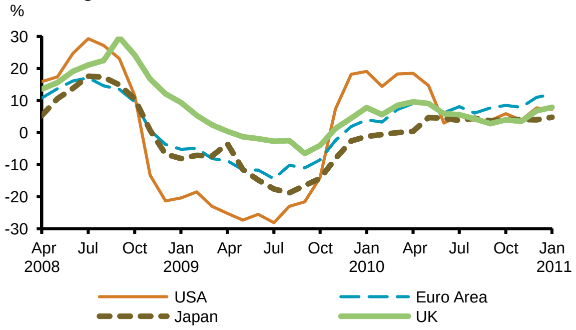
Sources: Fed, BCE, BoJ, BoE, BPC, BLS, Eurostat, ONS and Bloomberg

Figure 4.6 – Core consumer inflation
Annual growth



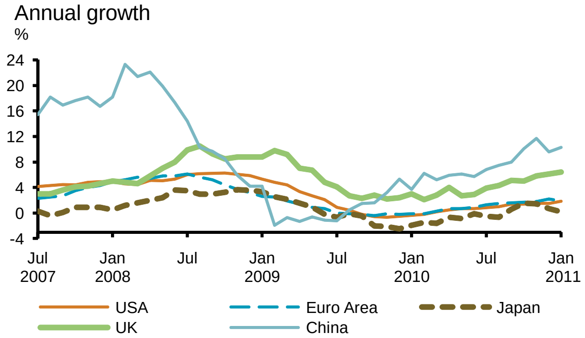
Sources: BLS, Eurostat, Bloomberg and ONS

Figure 4.7 – Energy inflation
Annual growth



Source: Thomson

Figure 4.8 – Food inflation[1/]
Annual growth



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

rises, respectively, from 4.8% to 0.2% in January. However, the fragile internal demand and the wide product gap did not benefit possible effects of second order, in a way that the measures of the core by exclusion of perishables and energy present negative variation since March 2009. Within this environment, the BoJ kept, on February, the fluctuation band for reference interest rate, an overnight call rate, within the range from 0.1% to 0%, bringing about real interests at zero level.

In the Euro Area the annual IPC variation amounted to 2.3% in January, which was above ECB's goal and the biggest increase since November 2008, with emphasis on the impact of the 12% annual rise in energy prices. Nevertheless, the inflation core annual variation, conditioned by the level of installed capacity's use, reached 1.1% in January and remains between 0.9% and 1.2% since March 2010. Despite the scenario that encloses a rise of inflationary risks, the ECB kept on February the basic interest rate at 1% per year. Moreover, due to fiscal difficulties faced by countries in this region, in coordination with the Fed, the ECB extended the unrestricted line of euro/dollar swap and announced, with the BoE, the creation of a temporary line of euro/pound swap of £10 billion.

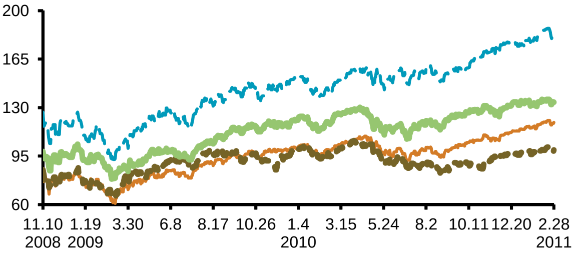
In the United Kingdom, the annual consumer price variation remains above the long-term goal since January 2010, coming to 4.0% in January 2011, the highest variation since November 2008. Although the perspective for the behavior of prices in the short-term is for higher prices – in January, the annual variation in energy and food prices closed at 7.9% and 6.4%, respectively, and that related to the core, 3% – the BoE kept, on February, the asset-purchasing program unaltered, at £200 billion, and the basic interest rate, at 0.5% p.y.

In China, where the domestic demand remains strong and the real estate market accelerated, the annual IPC variation reached 4.9% in January, with emphasis on the rise of 10.3% in food prices. In response to the inflationary process and the behavior of prices of real estate assets, the government has increased the measures of credit and liquidity restriction, as well as limited the access to property acquisition.

Thus, in December, the People's Bank of China (PBC) announced the extension, for three months, of the temporary increase in the reserve requirement rate applied to six banks in October and, in February, introduced a new tax rise for the entire banking system. In January, aiming at curbing prices in the real estate market, the PBC expanded from 50% to 60% the initial installment for the acquisition of the second residential property and introduced more severe fiscal restrictions on its resale. On February, repeating the measures taken in January, the BPC increased once again the basic interest rate, keeping it at 6.06% per year, the highest level since October 2008.

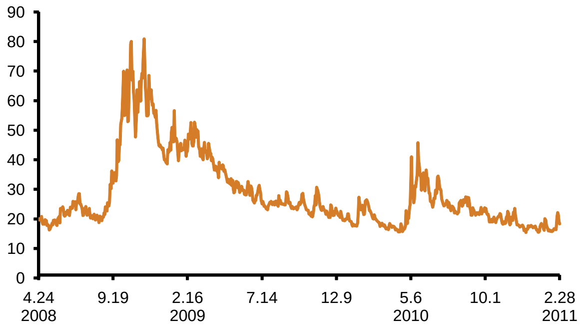
4.3 International financial markets

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



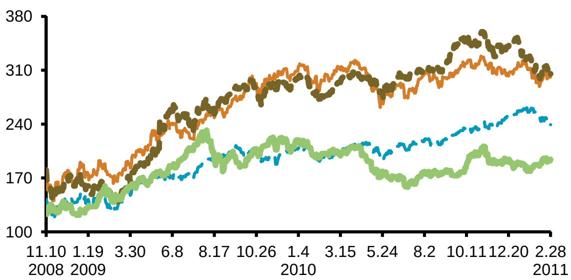
Source: Bloomberg

Figure 4.10 – VIX



Source: Thomson

Figure 4.11 – Stock exchanges: Emerging markets
12.31.2003 = 100



Source: Bloomberg

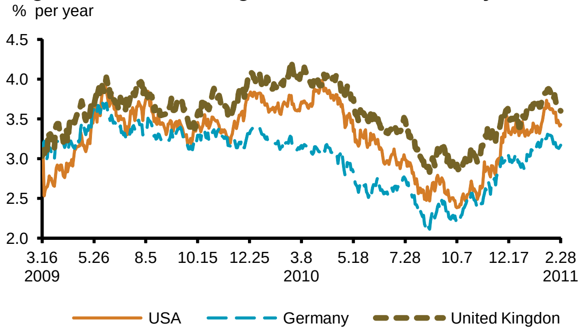
The increased optimism regarding the sustained recovery of the North American economy favored the continuity, in the quarter ended February, of the financial assets prices rise initiated in August 2010. This movement registered a relative reversal since mid-February, due to the aggravation of the geopolitical conflicts in the Middle East and North of Africa.

Standard and Poor's 500 (S&P 500) indices, of U.S.; Nikkei, of Japan; *Deutscher Aktienindex* (DAX), of Germany; and Financial Times Securities Exchange Index (FTSE 100), of the United Kingdom, accumulated respective gains of 12.4%, 8.7% and 6.9% in the quarter ended February, emphasizing that, except for the Japanese market, the stock exchanges of the more developed markets reached, in January, the highest quotation since August 29, 2008, period immediately prior to the collapse of the investment bank Lehman Brothers.

Within this scenario, the Chicago Board Options Exchange Volatility Index (VIX), which measures the short term implicit volatility of S&P 500 index, reached 15.5 p.p. on December 22, 2010, lowest daily close since July 2007. Despite of fears about the fiscal situation of European countries and the crisis in the Middle East has contributed to the indicator to account for 18.5 p.p. at the end of February, its average, evincing significant reduction of risk aversion, reached 17.3 p.p. in the quarter ended February, against 21 points in that ended November 2010.

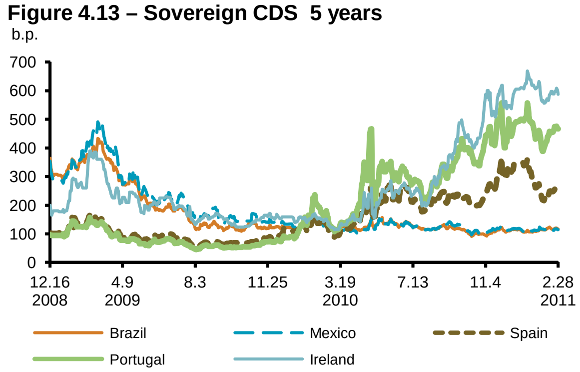
Most stock markets of the major emerging economies registered losses in the quarter ended February, a result consistent with the rise of the inflationary risks and with the withdrawal of the fiscal and monetary incentives adopted during the financial crisis. In addition, the rise of inflation expectations and/or the improvement in growth expectations of the mature economies provoked a rise of the respective long term interest rates, increasing the investments opportunity costs in portfolio investments in the emerging markets. In fact, the annual yield of ten-year securities of the mature economies kept the rising trajectory of began

Figure 4.12 – Yield on government bonds – 10 years



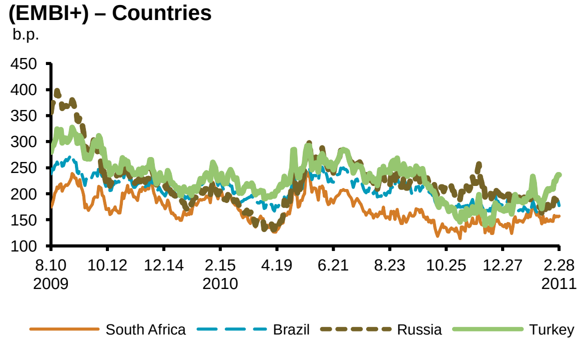
Source: Bloomberg

Figure 4.13 – Sovereign CDS 5 years



Source: Thomson

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



Source: Bloomberg

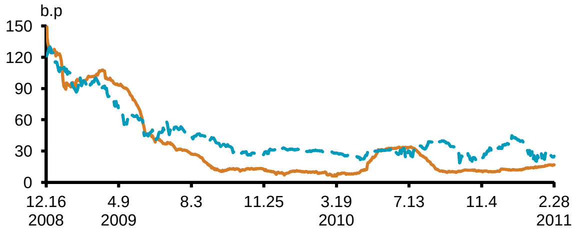
in the previous quarter. The Germany, the U.S. and United Kingdom securities presented, in this order, annual yields of 3.17%, 3.43% and 3.60% at the end of February. The indices Shanghai Composite, of China; Ibovespa, of Brazil; Istanbul Stock Exchange National 100 Index (XU100), of Turkey; and Bombay Stock Exchange Sensitive Index (Sensex), of India registered respective variations of 3.0%, -0.5%,-6.2% and -8.7% during the period.

Europe’s sovereign debt markets reflected the suspicions regarding the solvency of some economies in the region and the effectiveness of the European Stability Mechanism (ESM), which will replace the European Financial Stability Facility as of June 2013.Thus, the sovereign risk awards, measured through the Credit Default Swaps (CDS), of Ireland, Portugal and Spain after reaching, on January 10, 2011, historical maximums of 667 b.p., 557 b.p. and 361 b.p., closed February at 587 b.p., 467 b.p. and 252 b.p., respectively. The Emerging Markets Bonds Index Plus (Embi+) indicator of sovereign risk continues not very sensitive to events in Europe, dropping 6 b.p., to 272 b.p., in the quarter ended February.

The events in the debt market have affected the European interbank market performance. Therefore, the spread between Euribor (3 months) and European Overnight Index Swap (EONIA) rates, which reflects the risk of default in the interbank market, after reaching 45 b.p., on December 22 of last year, the highest value since July 2009, dropped to 25 b.p. at the end of February. In the U.S., the quarterly growth of the spread between Libor (3m) and Overnight Index Swap (OIS) rates registered lower volatility, expressed in the 6 b.p. variation registered by the indicator within the period.

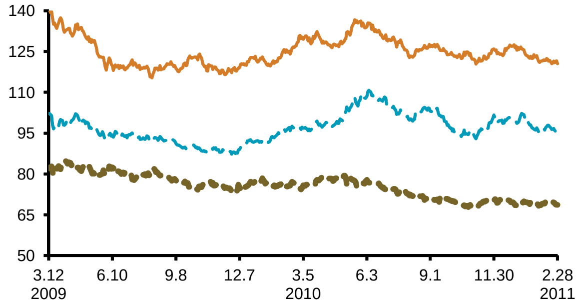
The U.S. dollar, reflecting the ongoing interest rate differential between the Federal Reserve (Fed) rate and those from the other central banks, in the quarter ended February registered a decrease in relation to the Euro, 6.0%; to the pound, 4.3%; and to the Yen, 2.3%. Regarding the emerging economies, the quotation of U.S.’s currency decreased when compared to the Russian ruble, 8.3%; to the real, 2.9%; to the South African rand, 1.9%; to the Indian rupee, 1.3%; and to the Chinese yuan, 1.4%.

Figure 4.15 – Spread interbank rate[1/]



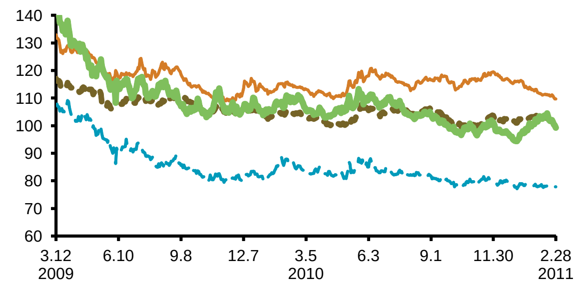
Source: Bloomberg
1/ OIS (Overnight Indexed Swap) and EONIA (European Overnight Indexed Swap) are interest rates swap transaction, where one party agrees to receive/pay a fixed rate to another party, against paying/receiving a floating rated.

Figure 4.16 – Dollar exchange rates
1.1.2007 = 100



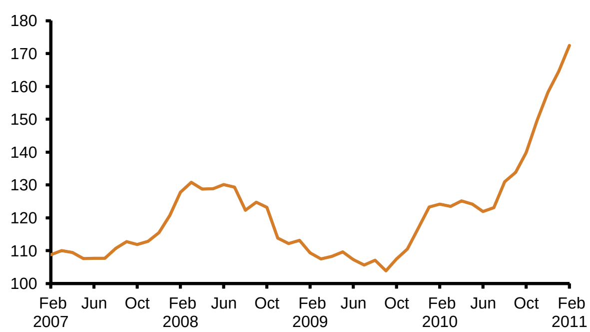
Source: Bloomberg

Figure 4.17 – Emerging markets currencies
1.1 2007 = 100



Source: Bloomberg

Figure 4.18 – Brazil Commodity Index (IC-Br)
Dec/2005 = 100 (monthly average – R$)



Source: BCB

4.4 Commodities

Interpreting the scenario of high international liquidity, optimism regarding growth in the main world economies and deteriorating supply of important agricultural products, international commodity prices remained high throughout the quarter ended February. This movement was identified by the Commodities Index – Brazil (IC-Br), calculated by the Central Bank of Brazil, which, considering monthly averages, went up 15.3% on February, when compared to November 2010, registering increases in the segments of farm commodities, 19.3%; metallic, 11.3%; and energy, 8.8%. The indicator presented the eighth consecutive monthly growth within the month, appreciating 41.4% since June 2010, with emphasis on the 60.2% rise in farm commodities.

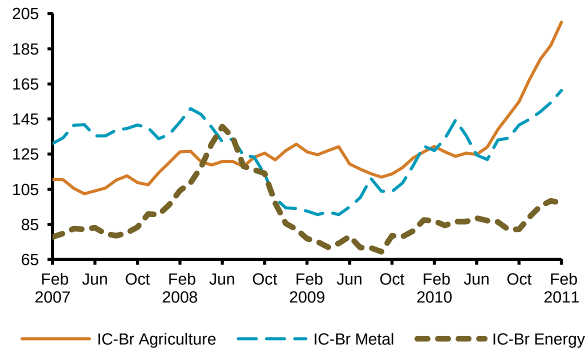
The quarterly evolution of the index related to farm commodities continued reflecting the outcome of the La Nina[8] phenomenon on the supply of this sector, within a context of strong expansion in consumption .in the emerging economies. Considering S&P and Goldman Sachs indices, there have been registered, in the period, average increases, in dollar terms, in the average prices of cotton, 40.9%; coffee, 26.3%; corn, 24%; wheat, 21.6%; soy, 11.6%; and sugar, 4.2%. It must be emphasized that in a situation of strong Asian demand, climatic adversities in important exporting regions and reduced global stocks, the average prices of cotton increased 143.9% from July 2010 to February 2011.

The behavior of metallic commodity prices was influenced, within the quarter, by the favorable performance of the global industrial activity, by expectations of a mismatch between supply and demand throughout 2011 and by supply restrictions related to the interruption of copper production in Chile and nickel in Canada. In this scenario, According to S&P and Goldman Sachs indices, there have been rises, in dollar terms, in the average monthly prices of nickel, 24.1%; copper, 16.9%; zinc, 8.1%; lead, 7.8%; and aluminum, 7.8%.

The average monthly price of iron ore of 63.5% content, evincing the strong demand of Chinese steel mills and the supply restrictions in the main exporters of this commodity, increased 17.1% in the Chinese spot market, in the quarter ended February 2011, according to the Metal Bulletin. Considering quarterly averages, the iron ore price increased 17.3% in the period ended February, when compared to that

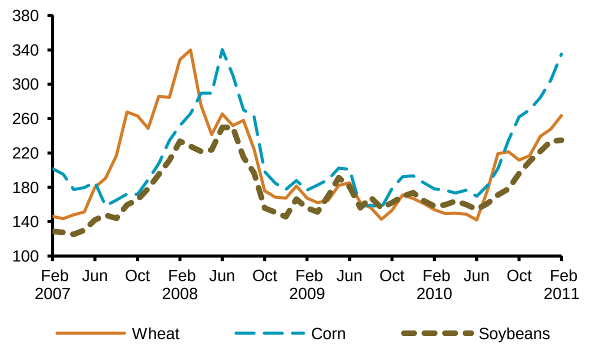
8/ According to the World Meteorology Organization, La Niña's influence on the climate in important producing regions must persist until the end of April or beginning of May, decreasing its strength progressively throughout this period.

Figure 4.19 – IC-Br segments
Dec/2005 = 100 (monthly average – R$)



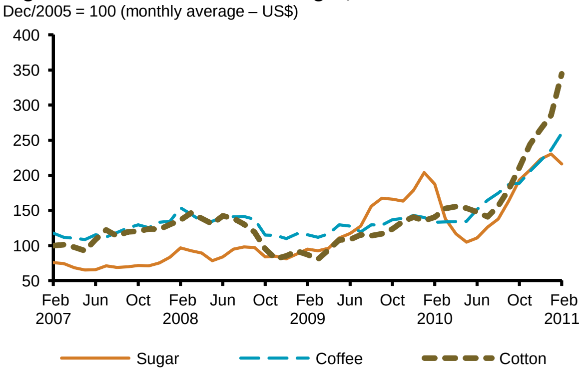
Source: BCB

Figure 4.20 – Commodities: wheat, corn and soybeans
Dec/2005 = 100 (monthly average – US$)



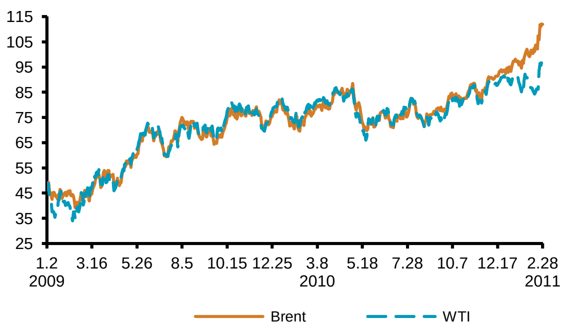
Source: S&P GSCI

Figure 4.21 – Commodities: sugar, coffee and cotton
Dec/2005 = 100 (monthly average – US$)



Source: S&P GSCI

Figure 4.22 – Oil – Spot market
US$ per barrel



Source: Bloomberg

ended November 2010, emphasizing that this percentage will be reference for the readjustment in the contractual value of the commodity in the second quarter of 2011.

The average quotation of Brent and WTI barrels of oil increased, respectively, from US$85.67 and US$84.24, in November 2010, to US$103.96 and US$89.53, on February 2011, evolution related to the winter harshnessin the Northern hemisphere and to the geopolitical conflicts in the North of Africa and the Middle East. It must be emphasized that the Brent barrel quotation reached US$111.94 at the end of February, registering monthly rise of 12.2%.

4.5 Conclusion

The ongoing divergences in the pace of growth enhanced the polarization in the central banks'performance of the emerging economies and of the G3, where, despite the improving signals of the activity, the product gap continues open and the unemployment rates high, thus contributing for the extension of the monetary easing period. In emerging economies, due to inflationary pressures arising from commodities price increases, especially agricultural and petroleum, and to a situation of more intense use of production factors, the withdrawal of monetary stimuli was heightened and, in some cases, the process of monetary crunch is already advanced.

It was observed, until mid-February, an increase in capital flows rise to the stock exchanges of more mature markets, which in the outset presented a better performance than the stocks of emerging markets.

Geopolitical tensions in the North of Africa and in the Middle East and the fiscal case in certain countries within Euro area represent risks for the strengthening of the global economic growth. In addition, the persistence of the oil barrel price above US$100 and a possible increase in fiscal restrictions in Europe, among other factors, increase the uncertainties in the financial markets and also may add to a frail recovery of the global economic growth.

External sector

5

The increase registered in the current account deficit in 2010 reflected, besides the impact of the recovery of domestic economic activity on the demand for imported goods, the effects of the global economic recovery on the country's exports. In addition, it must be emphasized the developments of the exchange rate trajectory and the salary mass on the services account net expenses, especially the accounts related to residents' international tourism.

For 2011, a lesser growth in the current account deficit is expected, essentially financed by net inflows of foreign direct investments (FDI). The behavior of these flows shall reflect the international liquidity and, mostly, the positive outlook regarding growth of the Brazilian economy. Portfolio investments in the country will remain significant, despite the reduction of the foreign investments in fixed income as a result of the increase in the Financial Operations Tax (IOF) last October. The rollover rate of the medium- and long-term external debt in 2011 shall remain around 150%, increasing the participation of the external indebtedness as financing source of the balance, without, however, changing the structure of the Brazilian external liabilities, with the investments taking over the debt.

The trajectory of the current account deficit may also be influenced by the maturing of investments in the sector of tradable goods and by the recovery of the foreign trade net incomes, in a setting of more favorable expectations for the world's economy.

In the beginning of 2011, a positive reaction of the trade balance was observed. The expansion projected for the deficit of the services' account considers the effects of rises in real income and employment, such as transportation and equipment rental. The profits and dividends shall present remittances higher than the ones observed in 2010, in line with the expansion of the foreign investment stock in the country and with an increase in the resident companies' profitability. The country risk, which in the beginning of

2010 was 191b.p., reached 251 b.p. in June on a trend that later reversed, reaching 189 b.p. at the end of December and 177 b.p. on February 28, 2011.

5.1 Exchange operations

Table 5.1 – Foreign exchange flows

US$ billion

	2010			2011	
	Feb	Jan-Feb	Year	Feb	Jan-Feb
Trade operations	-2.3	-2.4	-1.7	-0.5	0.6
Exports	10.1	20.8	176.6	14.7	29.7
Imports	12.4	23.2	178.2	15.2	29.2
Financial operations[1/]	1.9	3.1	26.0	7.9	22.4
Purchases	23.8	46.8	378.4	32.1	74.8
Sales	21.9	43.7	352.4	24.2	52.4
Net flows	-0.4	0.7	24.4	7.4	22.9

1/ Excluding interbank operations and Central Bank foreign operations.

Table 5.2 – Trade balance – FOB

US$ million

Period		Exports	Imports	Balance	Total trade
Jan-Feb	2011	31 947	30 325	1 622	62 272
Jan-Feb	2010	23 502	23 292	210	46 795
% change		35.9	30.2	672.4	33.1

Source: MDIC/Secex

The market of exchange transactions, after recording net inflows of US$24.4 billion in 2010, presented surplus of US$22.9 billion in the first two months of 2011, against US$676 million in the same period of the previous year. The trade surplus reached US$579 million, against deficit of US$2.4 billion in the same period in 2010, due to the respective rises of 42.9% and 25.5% in the export and import operations. The financial sector, evincing the external credit conditions, registered an increases of 59.7% in purchases and 19.9% in sales of foreign currencies, resulting in net inflows of US$22.4 billion, against US$3.1 billion in the first two-month period of 2010.

The interventions performed by the Central Bank throughout 2010 resulted in net purchases of US$42 billion, from which US$41.4 billion in the spot exchange market. In the first two months of 2011 interventions became more frequent, resulting in purchases of US$17 billion. The short position of banks, which reflects the operations with clients in the primary exchange market and the Central Bank's interventions, changed from US$16.8 billion, at the end of December 2010, to US$12.7 billion at the end of February 2011.

5.2 Trade in goods

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

US$ million

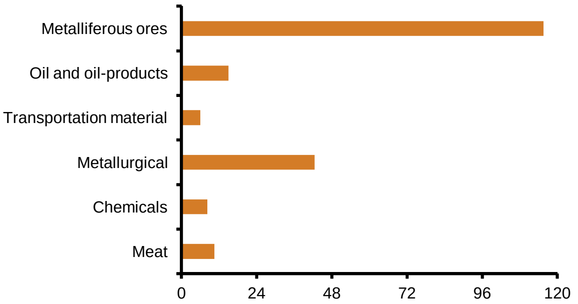
	2010	2011	% change
Total	618.5	779.2	26.0
Primary products	232.4	342.6	47.4
Industrial products	369.2	419.0	13.5
Semimanufactured goods	92.4	112.4	21.6
Manufactured goods	276.8	306.7	10.8
Special operations	16.9	17.5	3.9

Source: MDIC/Secex

The recent trend of a more balanced growth between the Brazilian exports and imports was maintained in the first two-month period of 2011, when exports accounted for US$31.9 billion and imports U$ 30.3 billion, rising 35.9% and 30.2%, respectively, when compared with the same period of 2010.

The daily average of exports in the first two months of this year increased 26% when compared to the same period in 2010 because of increases in all the categories of aggregate factors. The price evolution of several important commodities for the exports line helped the shipments of basic products and of semi-manufactured to increase in 47.4% and 21.6%, respectively, in the period. The participation of sales of basic products within total exports rose 6.4 p.p., to 44% in the period, contrasting with the decrease of 5.4 p.p., to 39.4%,

Figure 5.1 – Exports by major sectors
January-February – 2011/2010[1/] – % growth



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

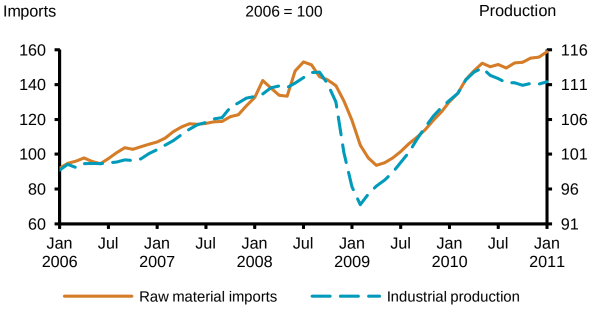
Table 5.4 – Imports by end-use category – FOB
Daily average – January-February

US$ million

	2010	2011	% change
Total	613.0	739.6	20.7
Capital goods	134.0	165.5	23.6
Raw materials	296.5	342.2	15.4
Consumer goods	103.6	135.7	31.0
Durable	59.2	80.3	35.5
Passenger vehicles	25.6	37.4	46.2
Nondurable	44.4	55.4	24.9
Fuels	78.8	96.2	22.0
Crude oil	40.3	15.3	-62.1

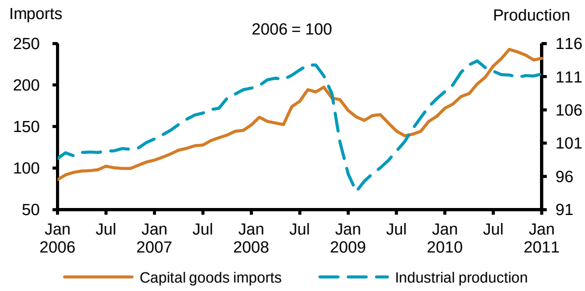
Source: MDIC/Secex

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



Sources: Funcex and IBGE

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



Sources: Funcex and IBGE

in manufactured products, whose external sales increased 10.8% within the period.

The daily average of imports increased 20.7% in the first two months of this year, when compared to the same period in 2010, with recorded rises in all final use categories. Imports of consumer durables rose 35.5% boosted by the increase of 46.2% in purchases of passenger vehicles, while those related to non-durable consumption goods and to capital goods grew 24.9% and 23.6%, respectively.

Trade with the main economic blocs and partner countries witnessed a broad increase in the period, emphasizing the rise in transactions with Eastern Europe, 33.2%; Asia, 32.2%; and Mercosur, 23.9%. In the exports scope, it shall be emphasized the rises in exports targeted to Asia, 40%, highlighting growth of 57.5% in shipments to China, to the Southern Common Market (Mercosur), 30.3%, and to the European Union, 19.9%. Regarding imports, it may be pointed out the rise in those from Eastern Europe, 62.4%, and USA, 27.4%.

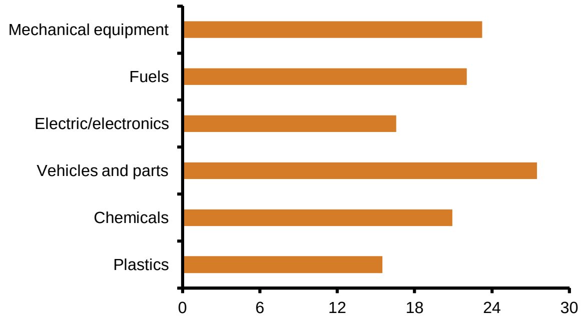
Growth in exports in the first two months of the year, when compared to the same period in 2010, resulted from the increases of 25.1% in prices and of 8.6% in the volume exported, according to the Foreign Trade Studies Center Foundation (Funcex). The prices of the basic products rose 42%, followed by the expansions in the semi-manufactured, 20.6%, and manufactured, 11.6%, categories while volume growth represented respective increases of 12.2%, 8.8% and 7.1%, in the mentioned categories.

Import growth, in the same basis of comparison, resulted from rises of 18.5% in the volume and of 10% in the prices of the acquired products. There was growth in the imported volume in all the use categories, though mainly in those related to consumer durables, 33.8%; non-durable consumer goods, 32.7%; and capital goods, 27%. The price trajectory reflected the rises applied to the categories of fuels and lubricants, 24.8%; consumer durables, 9.2%; intermediary goods, 10.9%; capital goods, 4.9% and non-durable consumer goods, 1.5%.

5.3 Services and income

The current account deficit amounted to US$47.5 billion in 2010, against US$24.3 billion in the previous year. In the first two months of 2011, the deficit reached US$8.8 billion, increasing 23.8% when compared to the same period of 2010.

Figure 5.4 – Imports by main products
January-February – 2011/2010 – % growth



Source: MDIC/Secex

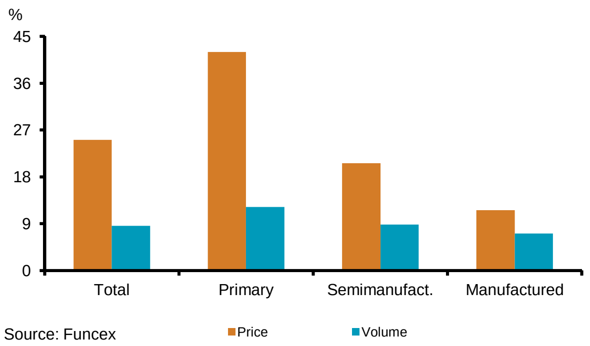
Table 5.5 – Exports and imports by area – FOB
Daily average – January-February

US$ million

	Exports			Imports			Balance	
	2010	2011	% change	2010	2011	% change	2010	2011
Total	618	779	26.0	613	740	20.7	6	40
L.A. and Caribe	154	185	20.4	109	128	17.4	45	58
Mercosur	70	91	30.3	59	69	16.5	10	22
Argentina	56	74	30.8	51	60	17.1	5	14
Other	13	17	28.2	9	10	12.4	5	8
Other	84	95	12.3	50	59	18.6	35	36
USA[1/]	71	82	14.9	88	113	27.4	-17	-31
EU	143	171	19.9	132	150	13.7	11	21
E. Europe	16	19	17.3	9	14	62.4	7	5
Asia	142	198	40.0	188	238	26.4	-47	-40
China	62	97	57.5	84	115	36.4	-23	-18
Other	142	101	-28.4	188	123	-34.8	-47	-21
Others	93	123	33.3	87	97	11.9	6	26

Source: MDIC/Secex
1/ Includes Puerto Rico.

Figure 5.5 – Exports – Price and volume index
January – February – 2011/2010



Source: Funcex

The deficit accumulated in 12 months totaled US$49.2 billion in February, which corresponds to 2.31% of the GDP.

The net service expenses accounted for US$4.5 billion, increasing 37.5% with respect to the first two months of 2010, with emphasis on the expansion of 66.7%, to US$1.9 billion, in the net expenses with international travel. Brazilians' expenses with international travel, remained in increasing trajectory, reached US$3.1 billion, and the incomes of foreign tourist's expenses totaled US$1.2 billion, representing growth of 38.5% and 8.6%, respectively.

Growth in imports and in Brazilians' travel abroad impacted on the expenses with freight and airline tickets, contributing to net expenses with transportation reaching US$865 million in the first two months, a 23.2% increase when compared to the same period in 2010. Net expenses with equipment rental amounted to US$2.2 billion, increasing 37.8% in the same comparison basis.

Net interest expenses dropped 22.8% in relation to the first two months of 2010 and totaled US$2 billion. Payments abroad totaled US$3.3 billion while revenues, reflecting the recent rise of the international interest rates, increased 55.8% to US$1.4 billion. Interest revenue originated from earnings on international reserves totaled US$4.5 billion in the twelve-month period ended in February. Net interest expenses came to US$9.1 billion.

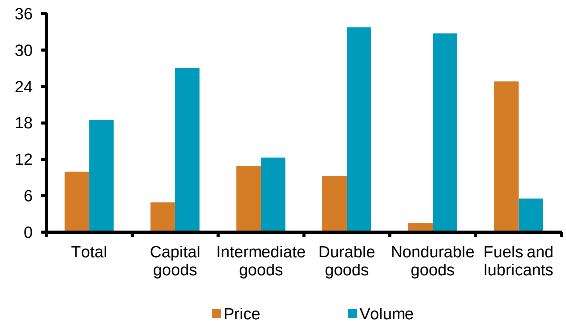
The net remittance of profits and dividends totaled US$4.7 billion in the first two months of the year, increasing 125.5% when compared to the same period of 2010. Companies of the industrial sector were responsible for the remittance of 54.6% of the gross remittances of profits and dividends of FDI in the period, especially the ones related to the automotive vehicles sector, 36.2%. Considering twelve-month periods, the net remittance of profits and dividends accounted for US$33 billion in February, of which US$25 billion referred to FDI.

The unilateral net transfers totaled US$673 million, increasing 33.8% when compared to the first two months of 2010. Inflows due to remittances for the maintenance of residents totaled US$336 million in the period.

5.4 Financial account

The financial account totaled a surplus of US$26.7 billion in the two-month period ended in February 2011, with

Figure 5.6 – Imports – Price and volume index
January-February – 2011/2010



Sources: MDIC and BCB

Table 5.6 – Current account

US$ billion

	2010			2011		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year1/
Current account	-3.3	-7.1	-47.5	-3.4	-8.8	-60.0
Trade balance	0.4	0.2	20.3	1.2	1.6	15.0
Exports	12.2	23.5	201.9	16.7	31.9	240.0
Imports	11.8	23.3	181.6	15.5	30.3	225.0
Services	-2.0	-3.3	-31.1	-2.2	-4.5	-34.8
Transportation	-0.4	-0.7	-6.4	-0.4	-0.9	-7.5
International travel	-0.5	-1.1	-10.5	-0.8	-1.9	-12.0
Computer and inform.	-0.2	-0.5	-3.3	-0.2	-0.6	-3.8
Operational leasing	-0.7	-1.6	-13.7	-1.2	-2.2	-14.5
Other	-0.2	0.7	2.8	0.4	1.1	3.0
Income	-1.8	-4.5	-39.6	-2.9	-6.6	-43.2
Interest	-0.6	-2.5	-9.7	-0.1	-2.0	-9.8
Profits and dividends	-1.3	-2.1	-30.4	-2.8	-4.7	-34.0
Compensation of employees	0.0	0.1	0.5	0.0	0.1	0.6
Current transfers	0.2	0.5	2.8	0.5	0.7	3.0

1/ Forecast.

Table 5.7 – Financial account

US$ billion

	2010			2011		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year1/
Financial account	4.6	10.7	99.0	12.8	26.7	89.4
Direct investments	-1.3	-2.1	37.0	9.8	19.1	50.0
Abroad	-4.2	-5.6	-11.5	2.1	8.4	-5.0
In Brazil	2.8	3.4	48.5	7.7	10.7	55.0
Equity capital	2.1	2.9	40.1	5.7	7.5	43.0
Intercompany loans	0.8	0.6	8.3	2.1	3.1	12.0
Portfolio investments	1.9	5.2	64.5	2.4	7.3	24.6
Assets	-0.1	-0.4	-3.3	1.3	2.9	-
Liabilities	2.0	5.7	67.8	1.1	4.5	24.6
Derivatives	0.0	0.0	-0.1	-0.1	-0.1	-
Other investments	4.1	7.6	-2.3	0.6	0.4	14.8
Assets	-3.8	0.7	-51.5	-3.6	-6.6	-23.3
Liabilities	7.9	6.9	49.2	4.2	7.0	38.2

1/ Forecast.

emphasis on the impact of foreign direct investments, of net loan amortizations received by headquarters of Brazilian companies from their branches abroad, and of private inflows of securities in the external market.

Brazilian direct investments abroad accumulated net assets of US$11.5 billion in 2010, reflecting the recovery of Brazilian companies' internationalization. In the first two–month period of 2011, the subsidiaries of Brazilian companies provided net returns of US$8.4 billion, as a result of amortizations of US$9.6 billion of intercompany loans and an increase of US$1.2 billion in the equity participation of subsidiary companies abroad.

Net FDI inflows US$10.7 billion in the first two months of the year, from which US$7.5 billion related to an increase in equity participation and US$3.1 billion regarding intercompany loans. The FDI accumulated in 12 months reached the historical record of US$55.7 billion in February, 2.62% of the GDP.

Net inflows concerning foreign portfolio investments totaled US$4.5 billion in the first two months of 2011, with net foreign investments in shares of Brazilian companies amounting to US$1.3 billion. Emphasizing the IOF growth impact, foreign investments in fixed-income securities negotiated in the country registered net outflows of US$524 million, constituting the fourth negative monthly result in a row.

The National Treasury, following the policy of extending the maturity profile of the public external indebtedness, anticipated bond repurchases of US$2.2 billion the first two months of 2011, with US$2 billion regarding the face value of the securities and US$185 million the premium of these operations.

The rollover rate of medium- and long-term securities negotiated abroad reached 970% in the two-month period ended in February, against 214% in 2010. The net disbursements of notes and commercial papers accounted for US$3.6 billion, as a result of disbursements of US$4 billion and amortizations of US$412 million. Short-term securities registered net disbursements of US$2.3 billion in the period.

The other Brazilian investments turned in net investment of assets abroad of US$6.6 billion in these two months, recording respective increases of US$1.8 billion and US$33 million in foreign deposits of Brazilian banks and of the non-financial sector. The net granting of loans abroad, including commercial credits, totaled US$4.3 billion in the first two months of 2011.

Table 5.8 – BP financing sources

Selected items

US$ billion

	2010			2011		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year[1/]
Medium and long-term funds	1.6	4.8	36.5	3.5	8.3	19.3
Public bonds	-	-	2.8	-	-	-
Private debt securities	1.1	3.2	23.0	1.0	4.0	7.8
Direct loans	0.5	1.6	10.7	2.6	4.3	11.5
Short-term loans (net)[2/]	4.6	3.8	21.7	1.9	5.0	10.0
Short-term sec. (net)	-0.1	-0.1	5.4	0.2	2.3	10.0
Portfolio in the country (net)	3.2	5.7	45.2	0.8	1.0	15.0
Roll-over rates[3/]						
Total	131%	261%	244%	538%	311%	150%
Debt securit.	94%	214%	248%	355%	970%	150%
Direct loans	614%	476%	237%	664%	190%	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.

Table 5.9 – Statement of international reserves

US$ billion

	2009	2010		2011	
	Year	Jan-Feb	Year	Jan-Feb	Year[1/]
Reserve position in previous period	193.8	238.5	238.5	288.6	288.6
Net Banco Central purchases	36.5	2.3	42.0	17.0	24.4
Forward	-	-	-	1.0	1.3
Spot	24.0	2.1	41.4	16.1	23.2
Repo lines of credit	8.3	-	-	-	-
Foreign currency loans	4.2	0.3	0.5	-	-
Debt servicing (net)	-2.2	-2.3	-5.2	-2.4	-0.4
Interest	0.7	-0.9	0.2	-0.4	2.4
Credit	4.8	0.6	4.1	1.0	6.0
Debit	-4.0	-1.5	-3.9	-1.4	-3.6
Amortization	-2.9	-1.4	-5.4	-2.0	-2.8
Disbursements	1.8	-	1.2	-	-
Multilateral organizations	-	-	-	-	-
Sovereign bonds	1.8	-	1.2	-	-
Others[2/]	1.7	-0.4	2.8	0.9	0.9
Treasury's purchases	7.0	2.9	9.3	3.4	6.4
Change in assets	44.7	2.6	50.1	18.9	31.3
Gross reserve position	238.5	241.1	288.6	307.5	319.9
Repo lines of credit position	-	-	-	-	-
Foreign currency loans position	0.5	0.3	-	-	-
Reserves position - liquidity	239.1	241.3	288.6	307.5	319.9

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

Other foreign investments, including direct loans with Banks and with international entities, commercial credits and deposits, registered net revenues of US$7 billion in the two-month period. The net inflows of long-term loans of the other sectors totaled US$2.4 billion, pointing out the net payments of direct loans, US$2 billion, indicating a rollover rate of 190% in the two-month period; of buyers, US$427 million; and of loans from agencies, US$123 million, while loans of entities turned in net amortizations of US$186 million. Short term loans totaled net payments of US$5 billion.

Brazil's international reserves totaled US$307.5 billion in February, increasing US$18.9 billion relative to December 2010. In the two-month period, Central Bank net purchases in the currency exchange market accounted for US$16.1 billion; the liquidation of long-term purchases, US$973 million; net interest expenses, US$383 million, result of US$1 billion income with earnings on reserves and of the expense of US$1.4 billion with the bonus interests; the amortization expenses, US$2 billion; and the other operations caused an impact of US$894 million on the rise of the reserve stock.

International reserves are expected to increase by US$31.3 billion in 2011, to US$319.9 billion. Including the events of the first two months of 2011, net expenses on external debt service are expected to be of US$404 million, result of the revenues from earnings on reserves of US$6 billion, forecasted interest expenses of US$3.6 billion and US$2.8 billion of amortizations. This calculation also includes liquidations of the purchases already carried out of US$24.4 billion by the Central Bank and of US$6.4 billion by the National Treasury in the domestic exchange market.

5.5 External sustainability indicators

Considering the estimated position of the external debt on February 2011, the external debt service and the exports showed respective rises of 4.1% and 4.2% with respect to December 2010, decreasing the ratio between these indicators from 23% to 22.9%.

The total debt increased 5.6%, the total net debt dropped 20.6%, and the GDP in dollars increased 1.7%, resulting in an increase from 12.3% to 12.8%, of the ratio total debt/GDP, and a reduction from -2.4% to -2.9% of the total net debt/GDP ratio.

Table 5.10 – Sustainability indicators[1/]

	2009		2010			2011
US$ billion	Jun	Dec	Jun	Sep	Dec	Feb[2/]
Exports of goods	177.2	153.0	172.2	186.1	201.9	210.4
Exports of goods and services	206.3	180.7	202.1	216.6	233.7	243.2
Debt service	38.7	43.6	46.5	47.7	46.3	48.2
Total external debt	199.0	198.2	228.6	247.8	256.8	271.1
Net external debt	-28.0	-61.8	-42.2	-44.9	-50.6	-61.1
International reserves						
Cash concept	201.5	238.5	253.1	275.2	288.6	307.5
Liquidity concept	208.4	239.1	253.1	275.2	288.6	307.5
GDP	1 462	1 598	1 998	2 074	2 090	2 126
Indicators						
Total external debt/GDP (%)	13.6	12.4	11.4	11.9	12.3	12.8
Net external debt/GDP (%)	-1.9	-3.9	-2.1	-2.2	-2.4	-2.9
Total external debt/exports	1.1	1.3	1.3	1.3	1.3	1.3
Total external debt/exports of goods and services	1.0	1.1	1.1	1.1	1.1	1.1
Net external debt/exports	-0.2	-0.4	-0.2	-0.2	-0.3	-0.3
Net external debt/exports of goods and services	-0.1	-0.3	-0.2	-0.2	-0.2	-0.3
Debt service/exports (%)	21.9	28.5	27.0	25.6	23.0	22.9
Debt service/exports of goods and services (%)	18.8	24.1	23.0	22.0	19.8	19.8
Reserves – cash concept/ total external debt (%)	101.2	120.3	110.7	111.1	112.4	113.4
Reserves – liquidity concept/ total external debt (%)	104.7	120.6	110.7	111.1	112.4	113.4

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

The ratio between total debt and net total debt (surplus) exports remained stable, respectively, in 1.3 and -0.3, in the period. In addition, the ratio between international reserves and the total external debt increased from 112.4% to 113.4%.

5.6 Conclusion

The perspective of a decreasing current account deficit in 2011, shown in the analysis carried out in this chapter and in the box Projections for the Balance of Payments, reflects the expectation of a reduced trade surplus and an increase in net expenses in the services and income accounts. The high international liquidity and, particularly, the favorable perspectives regarding the performance of the Brazilian economy, may ensure the comfortable financing of the projected deficit, maintaining the possibility of strengthening international reserves. It should be emphasized that the revision of the perspectives for net FDI inflows enables this modality of investments to account for even to the full financing of the deficit in the country's current account.

Balance of Payments Projections for 2011

This box presents a review of the projections for the 2011 balance of payments released in the December 2010 Inflation Report. This review comprehends recent statistics with respect to the commerce of goods and services, the country's foreign indebtedness and the debt service, Central Bank interventions in the domestic exchange market and National Treasury repurchase of sovereign debt in the months of January and February.

Exports are estimated at US$240 billion and imports at US$225 billion, respectively US$5 billion and US$1 billion more than the December estimates and 18.9% and 23.9% higher than registered in 2010. In this scenario, while the trade balance surplus should increase to US$15 billion, against US$11 billion in the previous forecast, estimated net services and income expenditures and unrequited transfers remain unchanged, thus leading to a deficit in current transactions estimated at US$60 billion, 2.57% of GDP.

The deficit in the service account decreased from US$35 billion, in December, to US$34.8 billion, 12.1% higher than observed in 2010. Net expenditures on equipment rentals, US$14.5 billion, and international travel, US$12 billion, remained unchanged, while the deficit in the transportation account, in line with of expectation of increased foreign trade volume, rose to US$7.5 billion.

Net expenditures on interests, US$900 million lower than the December forecast, are expected to increase US$100 million in relation to 2010, with emphasis on the expansion of US$1.7 billion under gross expenditures, US$300 million higher than the previous forecast and 10.8% higher than

Table 1 – Uses and sources

US$ billion

	2010			2011		
	Feb	Jan-Feb	Year	Feb	Jan-Feb	Year[1/]
Uses	-6.2	-11.9	-81.4	-5.3	-15.7	-89.0
Current account	-3.3	-7.1	-47.5	-3.4	-8.8	-60.0
Amortizations ML-term[2/]	-2.9	-4.8	-33.8	-1.9	-6.9	-29.0
Securities	-2.3	-3.1	-15.7	-0.6	-2.6	-8.2
Suppliers' credits	-0.2	-0.4	-2.6	-0.2	-0.4	-3.2
Direct loans[3/]	-0.4	-1.3	-15.5	-1.1	-3.9	-17.7
Sources	6.2	11.9	81.4	5.3	15.7	89.0
Capital account	0.1	0.1	1.1	0.1	0.1	1.0
FDI	2.8	3.4	48.5	7.7	10.7	55.0
Domestic securities[4/]	3.2	5.6	52.3	0.5	0.7	15.0
ML-term disbursem.[5/]	5.2	9.0	62.6	4.8	10.5	49.8
Securities	1.1	3.2	25.8	1.0	4.0	7.8
Supliers' credits	0.1	0.2	2.1	0.1	0.2	6.9
Loans[6/]	3.9	5.5	34.6	3.8	6.2	35.1
Brazilian assets abroad	-8.1	-5.3	-66.2	-0.2	4.7	-28.3
Other[7/]	3.7	1.9	32.2	1.9	7.1	27.0
Reserve assets	-0.7	-2.9	-49.1	-9.6	-18.1	-30.4

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 equity and debt securities traded in the domestic market.
5/ Excludes intercompany loans disbursements.
6/ Includes multilateral and bilateral financing and buyers' credits.
7/ Registers net values of bond swaps, short-term securities, short-term trade credit, financial derivatives, nonresident deposits, other liabilites and errors & omissions.

Table 2 – Balance of payments – Market

US$ billion

Itemization	2010 Feb	2010 Jan-Feb	2010 Year	2011 Feb	2011 Jan-Feb	2011 Year[1/]
Current account	-3.6	-7.7	-51.6	-3.9	-9.8	-66.0
Capital (net)	4.2	5.1	93.6	13.5	28.7	101.7
Foreign direct investment	2.8	3.4	48.5	7.7	10.7	55.0
Portfolio investment	3.2	5.6	51.1	0.5	0.8	15.0
ML-term loans	1.6	3.4	22.2	2.5	3.2	11.5
Trade credits – Short, medium and long term	4.7	4.0	33.8	2.6	5.9	26.1
Banks	5.3	4.7	26.5	2.4	5.5	15.4
Other	-0.6	-0.7	7.3	0.2	0.4	10.7
Brazilian invest. abroad	-7.9	-10.3	-66.5	0.3	6.6	-17.0
Other	-0.3	-1.2	4.6	-0.3	1.5	11.2
Financial gap	0.6	-2.6	42.0	9.5	18.9	35.7
Banco Central net interv.	-0.4	-2.3	-42.0	-9.0	-17.0	-24.4
Bank deposits	-0.2	5.0	0.0	-0.5	-1.9	-11.3

1/ Forecast.

in 2010, already including the debt stock registered on December 2010. Gross incomes are estimated at US$7.5 billion, 27.1% more than the 2010 result and US$1.2 billion higher than the December forecast, of which US$6 billion refer to earnings on international reserves and US$1.5 billion to income consequent upon private interests.

Estimates of net expenditures on profits and dividends, including remittances of US$4.7 billion performed in the first two months of the year, increased from US$33 billion to US$34 billion. It is important to mention that the stock of foreign investments in the BM&FBovespa S.A. – Securities, Commodities and Futures Exchange, which reached US$70.7 billion in February 2009, impacted by net capital outflows and exchange rate depreciation caused by the financial crisis of 2008/2009, accounted for US$254.2 billion at the end of December 2010. This increase may be partly explained by net capital inflows and the consequent exchange rate appreciation.

The financial account surplus, estimated at US$67.8 billion in the December forecast, should close at US$89.4 billion, emphasizing the increase from US$45 billion to US$55 billion in the forecast of net inflows of foreign direct investments (FDI), which are expected to reach 2.36% of Gross Domestic Product (GDP). The additional US$10 billion for net FDI inflows reflects respective expansions of US$8 billion and US$2 billion in the modalities of capital participation and intercompany loans, in addition to net inflows of US$10.7 billion registered in the first two months of 2011.

The forecast concerning net inflows of domestic stocks and shares decreased from US$40 billion, in December, to US$15 billion, compatible with the results obtained in the first two months of 2011.

The forecast for net Brazilian direct investments abroad decreased to US$5 billion, US$11 billion lower than the December forecast, explained by the trajectory observed in the first two months of 2011, with net returns of US$8.4 billion, even with the resumption of the process of internalization of Brazilian companies started in 2010.

Amortizations of medium and long-term foreign debt for 2011, considering the new foreign debt schedule of December 2010, increased US$100 million, to US$29 billion. Since payments are expected to surpass medium and long-term amortizations, the rolling rate forecast remained at 150%. Short-term inflows of foreign investments, including securities, commercial credits and loans, are estimated at US$27 billion.

According to these projections, the balance of payments financial gap is expected to remain positive, reaching US$35.7 billion, of which the Central Bank has already absorbed US$24.4 billion, while the assets of commercial banks abroad are expected to increase by US$11.3 billion.

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 December 2010. The chapter also presents the analysis of the inflation prospects up to the first quarter of 2013 and of the 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 11.75% per year over the forecasting horizon, the level defined by Copom at its most recent meeting on March 1 and 2, and the exchange rate will remain at R$1.65 per US dollar. The second scenario, named the market scenario, is based on the expected paths for the basic interest rate and for the exchange rate drawn from the survey carried out by the Central Bank's Investor Relations and Special Studies Department (Gerin) among independent analysts. For a third scenario, called alternative scenario, which assumes that the exchange rate remains unchanged over the relevant horizon at recently observed levels, and the target for the Selic rate based on data from the expectations survey carried out by Gerin, inflation projections are presented for the end of the years 2011 and 2012. It is important to stress that these scenarios are used only as support for monetary policy decisions and their assumptions should not be viewed as Copom forecasts of the future behavior of interest and exchange rates. The projections released here are based on the information set available up to the cutoff date of March 11, 2011.

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 that was present at the above mentioned cutoff date. Inflation projections depend not only on assumptions about 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, reaching 5.91%. In the first two months of 2011, the IPCA index increased by 0.83% in January and 0.80% in February. Thus, the twelve-month inflation reached 6.01% in February. The increase in inflation in the last twelve months was determined by the change in market prices. In fact, while regulated prices rose by 3.29% in the twelve months up to February, market prices increased by 7.17%. Within the set of market prices, stands out the price change for tradable goods (6.31%), influenced by the recent inflation dynamics of food items, as well as the price change recorded for non-tradable goods (7.91%). Reflecting the dynamism of domestic demand, services sector inflation has consistently remained higher than that of market prices. In the twelve months up to February, the change in services prices reached 8.39% (against 6.23% in the twelve-month period up to February 2010). In turn, the twelve-month change in regulated prices has positively contributed to the recent inflation dynamics as it has been below the center of the target since April 2010.

As with headline inflation, the three core inflation measures computed by the Central Bank show recent increase in the twelve-month accumulated indices and are above the center of the target. The exclusion core measure (IPCA-EX), which had moved from 5.72% in December 2008 to 4.73% in December 2009, rose to 5.45% in December 2010, and again to 5.63% and 5.92% in January and February 2011, respectively. 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 5.63% in December 2010 and increased to 5.69% and 5.70% in the two following months. Additionally, inflation measured by the double weighted core measure (IPCA-DP), which reached 6.06% in December 2008 and had decreased to 4.73% in December 2009, reached 5.62% in December 2010, and rose in the next two months to 5.83% and 6.07%. In February, the average monthly change of the three core measures remained stable, standing at 0.69%, against 0.70% in January.

The IPCA diffusion index stood at 61.72% in February 2011, the same figure recorded in February 2010. Although there has been decline in relation to the January 2011's level (69.27%), the diffusion index remains high, which supports the hypothesis of acceleration in prices.

After a sharp reduction in 2009 (-1.43% versus 9.10% in 2008), broad inflation, measured by the General Price Index (IGP-DI), reached 11.30% in 2010. In the first two months of 2011, the IGP-DI monthly changes were 0.98% (January) and 0.96% (February). Thus, twelve-month inflation remained at a high level, reaching 11.27% in January, and 11.12% in February 2011. The strong acceleration in broad inflation is mainly due to IPA-DI, the main component of the index, which increased 13.85% in twelve months up to December 2010, 13.85% up to January 2011, and 13.69% up to February. By origin and for the same periods, agricultural products changed by 25.59%, 28.39% and 29.83%, whereas industrial products, by 10.13%, 9.32% and 8.65%. According to the Consumer Price Index (IPC-DI), the second component of the IGP-DI, the twelve-month inflation reached 6.24% in December 2010, 6.21% in January 2011 and 6.02% in February 2011. In the same way, the accumulated variation of the National Cost of Construction Index (INCC), also a component of the IGP-DI, slightly declined in the first two months of 2011, after increasing in all months of 2010. According to this index, twelve-month inflation reached 7.77% in December, then dropped to 7.52% in January and then to 7.44% in February. Note that all components of the IGP-DI index continue to register significant inflation. As emphasized in previous *Reports*, the Committee evaluates that the effects of wholesale prices over consumer price inflation will depend on current and prospective demand conditions, as well as on price setters' expectations for the future path of inflation.

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 slowing down and reaching the minimum quarterly growth of 0.2% between June and August of 2010, the growth rate reached 1.0% between October and December 2010, relative to the previous quarter. In 2010, the IBC-Br index increased by 7.8% over the previous year. The Services Confidence Index (ICS), computed by Getulio Vargas Foundation (FGV), decreased by 3.0% in January 2011 compared to December 2010; by 1.3% compared to January 2010; and by 3.3% over the average index of 2010.

Industrial production increased 0.2% in January compared to December 2010, according to seasonally adjusted data by the Brazilian Institute of Geography and Statistics (IBGE), whereas the three-month moving average of industrial production fell by 0.2% between November 2010 and January 2011, the same rate registered in the last quarter of 2010. Based on rates of change in twelve months, industrial production exhibited expansion of 9.4% in January 2011, against 10.4% registered in December 2010. Comparing with December 2008, when industrial production registered the greatest decline during the 2008/2009 crisis, the recovery up to January 2011 amounted to 23.1%. The diffusion index, which measures the percentage of products that posted some increase in production, reached 56% in January, relative to the same month of the previous year, against 55.4% registered in December 2010, relative to the same basis of comparison.

Among the industry categories of use, and based on seasonally adjusted IBGE data, the production of durable consumer goods posted the greatest contribution to the change of the overall index in January 2011, relative to the previous month (6.0%). In the same period, the production of semi-durable and non-durable consumer goods expanded by 0.2%, whereas capital goods production increased by 1.8%. The production of intermediate goods decreased 0.4%. Considering the three-month moving average rates for January 2011, the durable consumer goods category grew by 1.8%, whereas capital goods production increased by 1.4% and the intermediate goods production registered growth of 0.1%. In turn, the production of semi durable and non-durable consumer goods contracted by 0.2%. Of notice, the production of capital goods increased 20.4% in the twelve-month period up to January 2011, the greatest expansion among the categories of use. This is an evidence of the robust investment activity, a relevant factor for economic recovery during the post-crisis period.

The rates of capacity utilization remain at high levels. The low idle capacity is a result of the recent expansion in economic activity, which has not been entirely met by maturing investments. In fact, the seasonally adjusted Level of Utilization of Installed Capacity (Nuci) computed by FGV reached 84.5% in February 2011, versus 84.7% in January. According to data from the National Confederation of Industry (CNI), seasonally adjusted by the Central Bank of Brazil, the Nuci remained stable at 82.8% in December 2010, against 82.7% in November. Regarding the twelve-month period up to January 2011, the absorption of capital goods showed a 26.1% increase. The production of inputs for civil construction rose by 11.5%, considering the same basis of comparison.

The seasonally adjusted inventory level indicator from the Manufacturing Industry Survey of FGV reached 101.3 in December 2010. In January 2011, this indicator decreased to 97.7, followed by a slight increase to 98.8 in February. In December 2010, 5.2% of the respondents expressed their inventory level as excessive, considering the seasonally adjusted series. This percentage reached 6.3% in January and 5.7% in February 2011. In summary, the data suggests that utilization rates remained high over the last months, signaling the small idle capacity in the manufacturing sector, despite the resumption of investment.

Unlike industrial production, the volume of expanded retail sales grew significantly at the margin by the end of 2010. In December 2010, expanded retail sales increased 14.8% relative to the same month of 2009, against 17.0% registered in November. It is worth noting that these rates are considerably higher than the 2.5% expansion of industrial production in December, relative to the same month of the previous year, as well as the 3.7% growth of IBC-Br on the same basis of comparison. Thus, the slowdown of industrial activity has not corresponded to moderation in retail sales, although this asynchrony tends to change in 2011. The expansion of retail sales is reflected, for example, in the imports of durable and non-durable consumer goods, which in December 2010 rose by 27.7% and 24.8%, respectively, relative to the same month of the previous year. In 2010, the volume of expanded retail sales increased by 12.2% with respect to the previous year, after posting growth rates of 6.8% in 2009 and 9.9% in 2008. For the next few quarters, retailing should continue to be bolstered by the growth of real wages, government transfers, credit expansion, though at a moderate pace, and consumer confidence.

After an increase of 5.2% in 2008 and a decline of 0.6% in 2009, the Brazilian economy expanded again in 2010, posting an expressive growth rate of 7.5% – the highest rate since 1986. According to seasonally adjusted IBGE data, compared to the immediately previous quarter, GDP exhibited high growth rates in the first and second quarters (2.2% and 1.6%, respectively). From the second semester on there was an economic slowdown, with growth rates of 0.4% in the third quarter of 2010, and 0.7% in the fourth quarter. The behavior of GDP suggests that the Brazilian economy resumed the expansion pattern prior to the financial crisis of 2008/2009 and, more recently, at a pace consistent with sustainable growth rates in the long-run. From the production viewpoint, the services sector, which exhibits less volatile growth rates, was the only sector to depict positive growth rate (1.0%) in the last quarter of 2010, the eighth consecutive increase, according to seasonally adjusted IBGE data. The agricultural production declined 0.8% in the fourth quarter of 2010, after falling 1.6% in the previous quarter. The industrial production also declined in the fourth quarter of 2010 (0.3%), against a decline of 0.6% in the previous quarter.

From the viewpoint of aggregate demand, the Gross Fixed Capital Formation (GFCF) increased 21.8% in 2010, after declining 10.3% in 2009. Compared to the immediately previous quarter, and based on seasonally adjusted IBGE data, GFCF registered expansion of 4.0%, 3.9%, 3.1% and 0.7% in the four quarters of 2010, respectively. Despite a low share in aggregate demand, compared to household consumption, the high growth rate of investment has contributed to sustain the level of economy in the post-crisis period. In addition, the perspective of new and large-scale investment projects coordinated by public sector, such as those in the oil (pre-salt layer) and infrastructure sectors, favors the expectations of economic agents and the fast pace of GFCF. Household consumption – the most important component of aggregate demand – increased by 1.8%, 1.1%, 1.8% and 2.5%, in the same periods and the same basis of comparison. Government expenditure grew only in the second quarter of 2010 (1.8%), and exhibited a decline of 0.2%, 0.1% and 0.3% in the first, third and fourth quarters. The external sector contributed negatively to GDP growth in 2010 (-2.8 p.p.) due to the growth of imports (36.2%), while exports rose 11.5% during the year. In sum, domestic demand, driven by the expansion of credit, employment and income, has been the main driving force of activity, and should continue to evolve positively in the coming quarters, although at a slower pace.

In fact, after having grown 9.1% in 2008 and 5.9% in 2009, real retail sales increased 10.9% in 2010, according to the IBGE, notably sales in the segment of “equipment, office supplies, computer and communication” (24.1%) and of “furniture and appliances” (18.3%). The expanded retail sales, which include sectors more sensitive to credit conditions, showed a robust performance in 2010, driven by sales of construction material, which grew by 15.6%, as well as by sales of cars and motorcycles, parts and accessories, which increased by 14.1%.

The labor market has played an important role in the current economic cycle. Unemployment, measured by the rate of unemployment in the six metropolitan areas covered by the monthly survey of IBGE, has been falling in the last years, reaching a historic low of 6% in November 2010, considering the seasonally adjusted series. Afterwards, it increased to

6.3% in January 2011. Based on the non-seasonally adjusted series, the unemployment rate reached 6.1% in January 2011 – the lowest rate for the month of January since the beginning of the unemployment series under the current methodology (March 2002). Relative to the same month of 2010, the unemployment rate declined 1.1 p.p. It is worth noting that this fall took place in all the six areas covered by the survey. Also according to IBGE, the average real earnings usually received by the employed population increased 5.3% in January 2011, with respect to the same month of 2010. The total number of persons working in the six regions reached 22.1 million in January 2011, against 21.6 million in January 2010. Concerning the evolution of formal employment, after falling sharply at the end of 2008 and beginning of 2009, job creation returned to expand quite robustly in 2010. According to figures released by the Ministry of Labor and Employment (MTE), a total of 2.47 million jobs were created between February 2010 and January 2011. Thus real payroll expanded 7.7% compared with the same month of 2010, 9.5%, compared to 2009, 18.1%, compared to 2008, and 26% compared to January 2007.

In addition to the rising payrolls, the availability of credit to households – largely determined by macroeconomic stability and institutional reforms in recent years – was an important driving force of the growth in household consumption. After being adversely affected by the crisis of 2008/2009, credit conditions return to more favorable patterns, thus boosting lending volumes. The stock of credit to households with non-earmarked resources grew 19.1% in January 2011, compared to the same month of the previous year. In the same period, housing loans, whose operations are mainly based on earmarked resources, grew 50.2%. Despite this performance, it is expected some moderation in 2011 with regard to credit for individuals and corporations, in part due to the recently adopted macro prudential measures. In general, delinquency rates have remained at levels consistent with the phase of the cycle. In fact, the share in total outstanding credit with earmarked and non-earmarked funds of loans that is 90 or more days past due moved from 5.5% in January 2010 to 4.6% in January 2011.

The total volume of credit to corporations grew by 18.8% in January 2011, compared to the same month of 2010, considering non-earmarked and earmarked resources, and totaled R$927.5 billion. Credit expansion was boosted by loans and financing with resources from The Brazilian Development Bank (BNDES), which amounted to R$359.4 billion in January 2011, an increase of 24.6% over the same period in 2010. Regarding the capital market, the volume of primary issues of shares registered in the Securities and Exchange Commission (CVM) reached R$145.2 billion in 2010, including the issue of R$120.2 billion by Petrobras in September 2010, the highest ever recorded in the Brazilian stock exchange. In turn, bond issuance (excluding emissions by leasing companies), totaled R$15.6 billion in 2010, after reaching R$11.1 billion in 2009.

Regarding the external sector, the twelve-month trade balance has been rising since the previous *Report* and reached US$21.7 billion in February 2011. This performance includes exports of US$210.4 billion and imports of US$188.7 billion. These values are 33.9% and 42.0% higher than those recorded in twelve months ending in February 2010, respectively. The recovery of external demand has contributed to the growth of exports. In fact, the quantum of exports increased 9.7% in the twelve months ending in January 2011, against the previous twelve months. In the same period, the average price of exports rose by 21.7%. In turn, the quantum of imports increased 37.5% during this period, in part reflecting the strength of domestic demand. The average price of imports rose by 4.3% in the twelve months up to January 2011.

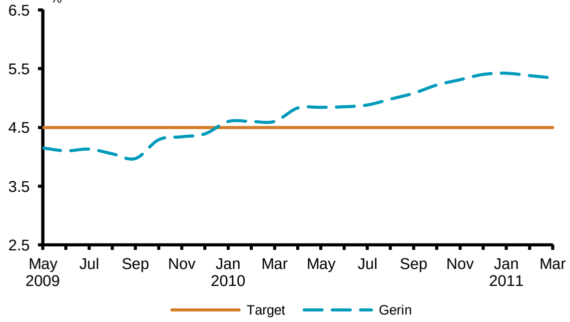
The twelve-month current account deficit increased from US$47.5 billion in December 2010 to US$49.1 billion in January 2011, equivalent to 2.35% of GDP. Remittances of profits and dividends have been an important component of this deficit, reaching US$31.4 billion in the same period. In turn, foreign direct investment amounted to US$50.8 billion in the twelve months up to January 2011, equivalent to 2.43% of GDP, and surpassing the external financing requirement.

In international financial markets, volatility and risk aversion have risen since the previous *Report*, fueled by very high levels of global liquidity and geopolitical uncertainty in the Middle East and North Africa. Although the perception of systemic risk has fallen significantly in recent months, concerns about the effects of recent high oil prices on economic activity of developed economies have increased recently. There is also uncertainty about the sustainability of debt levels in some European countries, the possibility of a slowdown in China, as well as the effects of the massive earthquake and tsunami in the afternoon of March 11 in Japan.

As far as the pace of global economic activity is concerned, the outlook of a faster than expected recovery has strengthened. The likelihood of a reversal has lowered, but reins the view that will be a marked growth asymmetry across countries. Recovery is consolidating worldwide, and particularly in the United States, whose domestic demand has been exhibiting some vigor, especially with respect to household consumption, within an environment of declining uncertainties about the labor market. The macroeconomic perspective for the Euro Area remains asymmetric, with Germany expanding quite strongly. Although headline inflation rates of consumer prices have increased in the G3 countries (United States, Euro Area and Japan), the respective core inflation rates in those countries remained at moderate levels – despite the still strong fiscal and monetary stimuli. In emerging markets, inflationary pressures have become widespread. Since the release of the last *Report*, it is worth noting the interest rate hikes promoted by the central banks of Chile, China, Colombia, India, Indonesia, Peru and Russia, as well as the successive increases in reserve requirements in China.

Brent oil prices surpassed again the level of US$110/barrel. Although the hike in the last weeks has been driven by elevated political instability in some countries of the Middle East and, especially, in North Africa, this price acceleration is consistent with the strengthening of global demand. As far as the considerable uncertainty regarding oil price projections is concerned, the main scenario adopted by Copom assumes unchanged domestic gasoline prices in 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, as well as the expectations channel. Among the remaining commodities, there was a sharp rise in international food prices since the release of the latest *Report*. The food price index, calculated by the Food and Agriculture Organization (FAO) of the United Nations, increased by 11.1% in the last three months, and by 34.2% over the twelve-month period up to February 2011. In turn, the commodity price index of the Commodity Research Bureau (CRB), based on twenty two commodities, reached new record on the first week of March. At the cutoff date of March 11, the index increased 11.2% in the three-month period and 29.1% in the twelve-month period. The behavior of commodity and asset prices still embodies great uncertainty, reflecting the volatility in financial and currency markets.

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



The median of market expectations for the 2011 GDP growth rate declined since the release of the previous *Report*, from 4.50% at December 10, 2010 to 4.10% at March 11, 2011. During this period, the median expectation for inflation in 2011 moved from 5.21% to 5.82%, and in 2012, from 4.50% to 4.80%. The dispersion of inflation expectations for the

Figure 6.2 – Dispersion of inflation expectations for 2011

Relative frequency

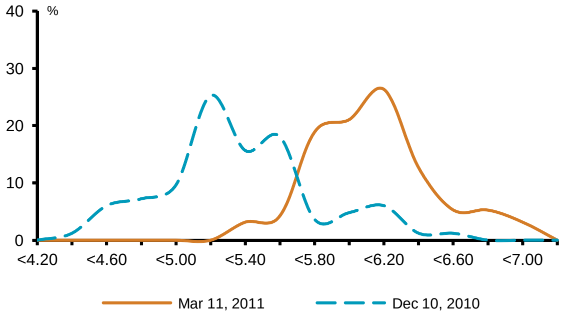


Figure 6.3 – Median market expectations by segment for 2011 IPCA-inflation

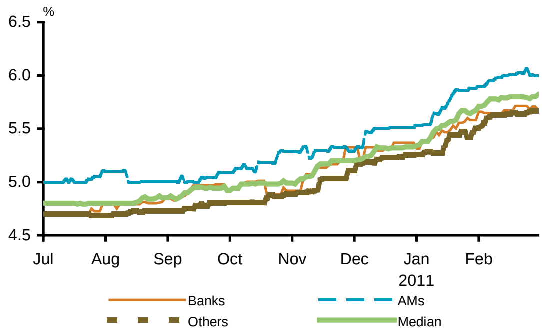
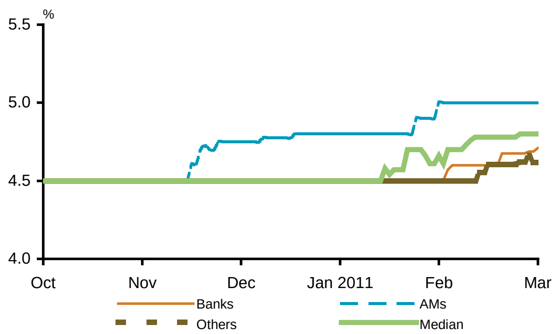


Figure 6.4 – Median market expectations by segment for 2012 IPCA-inflation



twelve months ahead decreased slightly, with the standard deviation moving from 0.46% to 0.44%.

Overall, since the release of the previous *Report*, there was a reduction in dispersion around the central tendency measures of inflation expectations for 2011, and an increase for 2012, as illustrated in Figure 6.2. In this sense, according to economic theory, the presence of heterogeneous agents in a survey of expectations, by itself, would lead to the dispersion of beliefs within the sample. One approach to tackle this issue relates the heterogeneous beliefs to underlying economic incentives. Alternatively, the existence of different loss-functions among agents is also used for explaining the dispersion of beliefs.

The international evidence on surveys of expectations, in general, suggests significant degree of information dispersion, both for consumers and professional market analysts. In fact, in the case of Brazil, the breakdown of market participants of the survey carried out by Gerin into three groups – banks, asset managers (AMs) and other institutions (nonfinancial companies, brokers, consulting companies and professional entities), reveals that agents have different views on the inflation outlook. Thus, for each group, time series of median inflation expectations were built, as illustrated in Figures 6.3 and 6.4, which suggest distinct behavior among segments, particularly in the case of the AMs group.

At the cutoff date of March 11, the median inflation expectations for 2011 of banks, AMs and other institutions are 5.68%, 6.00% and 5.67%, respectively. For 2012, these figures are 4.71%, 5.00% and 4.62%, respectively. In order to reduce information asymmetries among market participants, from this *Report* onwards the Central Bank will systematically release inflation expectations of each referred segment, without any loss regarding the release of the median for the whole sample.

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, on the external side, the tendency of consolidation of the recovery of the global economy and some dissemination of inflationary pressures, mostly in emerging economies. On the domestic side, the prospective scenario involves moderation in economic activity, and some advances in the balance of risks for inflation, although the inflation projections for 2011 are less favorable that those in the last Inflation *Report*.

On the external front, the main inflationary risk comes from commodity prices behavior. Since the last *Report*, the prospect for international commodity prices, including oil, remains shrouded in uncertainty. For example, it depends on the repercussions of the recent earthquake in Japan; on geopolitical factors in North African and Middle Eastern countries; on the evolution of demand, in the context of asymmetric global recovery; on the possibility of a slowdown in China; and on the volatility in international financial markets. During this period, the chances for new unconventional monetary measures abroad have lowered; and these measures have been seen as supporting elements for the recent surge in international commodity prices.

The recent increase in domestic wholesale prices is closely linked with soaring commodity prices in international markets. In particular, agricultural commodities witnessed a strong acceleration in prices between August 2010 and February 2011, with total change of 24.3%. However, to a significant extent, the commodity price increase has already been incorporated into consumer prices. In fact, the food and beverages group has accumulated 8.15% increase between August 2010 and February 2011. Even so, pressure arising from commodity markets may be persistent and, without compensation from movements in the opposite direction in domestic assets, could result in additional inflationary pressures – which in fact have occurred in recent episodes.

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 price setting process. Second, they reduce demand for domestic input markets, contributing to the weakening of cost pressures and, by consequence, of its pass-through to consumer prices.

In relation to the recovery of the global economy, the baseline scenario continues to contemplate the hypothesis of an ongoing recovery of activity, still with marked asymmetry between economic blocs, and with a lower probability of reversion.

On the domestic front, the Committee evaluates the main risk is that the recent increase in inflation – in the context of tight spare capacity in factor markets, most notably the labor market – be transmitted to the prospective scenario. This important risk factor could be worsened by mechanisms favoring inflation persistence. It is worth noting that inflation in the previous months reflected the strong negative influence from food price dynamics, which is in part explained by external and domestic supply shocks; seasonal factors characteristics of the first two months of the year; and unusual readjustments of administered prices in the same period. These price increases have occurred in the context of ongoing imbalance between growth of domestic absorption and supply expansion capacity; but there are signs the imbalance will ease off.

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, and rates have converged in the last quarter of 2010. As a result, the investment rate – the share of GFCF in GDP – is recovering vigorously, although it remains below the levels 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 2010.

The high GDP growth rate in 2010, 7.5%, reflects in part 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, despite the ongoing moderation, at an uncertain pace, of domestic demand expansion. This assessment is underpinned, among others, by the indications that the expansion of credit supply will persist – although at a more moderate pace after the recent adoption of macroprudential 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 moderation at the margin. The strength of labor markets, the remaining effects of the fiscal stimulus and of the policies of public banks and 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). There are, however, some signs of moderation in employment growth. In this sense, real average earnings, after growing vigorously in 2010, show evidence of moderation, in part, due to higher inflation. 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, something which has been occurring. In a strong demand environment, such wage increases tend to be passed on to consumer prices. 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 thus increase the "starting point" of the inflation rate during upturns, thus raising the inflation risks for the prospective scenario. In fact, this years' inflation rate will incorporate the high starting point from 2010.

The risks related to indexation mechanisms are particularly important in 2011. Indeed, inflation in the previous year was well above the target path, and particularly so for the last quarter's annualized rate. Moreover, the 12-month inflation rate for the next two quarters tends to remain close to or above the current ones. In part, this is explained by inertia from 2010 and by inflation projections for June to August close to the historical pattern, in contrast to the verified in the same period of the previous year.

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 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 unfavorable dynamics 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 dynamics more persistent.

Regarding fiscal policy, the Copom understands that the generation of primary surpluses in line with the assumptions considered for inflation projections, besides contributing to the reduction in the mismatches between supply and demand growth rates, will strengthen the reduction trend in the public debt-to-GPD ratio. The Copom reaffirms that the inflation main scenario considers the materialization of the trajectories regarding fiscal and quasi-fiscal variables. In this sense, significant decisions have been taken and implemented by the government to restrain expenditure, which support the vision that, at the beginning of this year, a fiscal consolidation process has begun.

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 macroprudential 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, may have contributed to the amplification of the power of monetary policy in Brazil. On the other hand, we should stress that the policy towards international reserve accumulation seeks to purchase the flows in the medium and long run, but, in spite of that, part of the resources have been gone to the credit market. In this sense, the excess of external inflows may weak the credit channel, smooth its contribution to the aggregate demand moderation, as well as cause distortions in the price of domestic assets.

Nevertheless, the Copom understands that the moderation in the expansion of the credit market constitutes an important element to the materialization of its main scenario. In this connection, it considers appropriate the implementation of initiatives aiming to restrain subsidies through credit operations. 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 general. Incidentally, available information showed significant changes both in prices and quantities transacted in the credit market since the introduction of macroprudential initiatives. The Committee highlights the near equivalence between macroprudential measures and conventional monetary policy measures, in spite of the focus on systemic stability of the former. In this sense, it reaffirms its view that monetary policy strategy cannot be disentangled from macroprudential developments.

Summing up, the Copom recognizes above normal uncertainty in the economic environment and identifies high risks to the achievement of a benign scenario where inflation would timely converge to the target. Since the last *Report*, in the external outlook, stimulus factors and asset price spillovers have lowered the probability of reversion in the recovery process experience by G3 economies. From another point of view, they still reveal the ambiguous influence of the international outlook over domestic inflation behavior. Regarding the domestic outlook, both macroprudential measures – a fast and potent instrument to contain local pressures on demand – and conventional monetary policy measures have been implemented, and in both cases their effects will still be incorporated to price dynamics.

Despite no clear identification of the degree of permanence of recent pressures – due to uncertainties surrounding the global and, to a lesser extent, the domestic scenario –, the Committee assesses that the balance of risks since the last *Report* has shown to be, to some degree, more favorable to the achievement of a benign scenario. Since then, monetary policy measures have been implemented, evidences of the effectiveness of macroprudential measures introduced in December 2010 have emerged, and important decisions have been taken and executed in the fiscal front. In addition, more recently, commodity price dynamics show signs of moderation, despite unfavorable geopolitical developments, such as the crisis in North Africa and the Middle East.

The Copom unanimously decided to increase the target for the Selic rate from 10.75% to 11.25% and 11.75% p.a., without bias, in the January and March meetings, respectively.

In 2010, inflation surpassed the 4.5% midpoint target, an outcome that in part resulted from the first-round effects of negative supply shocks (see the exercise presented in a box in this *Report*), in particular the acceleration of international commodity prices. As regards the timing, however, the commodity shock was concentrated in the second half of 2010 and in the initial months of 2011. For instance, from July 2010 to February 2011, the Commodities Brazil Index (IC-Br) increased by 41.4%, and in the specific case of agricultural commodities, 60.2%, in the same period. It is estimated that the first-round effects of this extraordinary supply shock would alone increase the IPCA by around 2.5 p.p. Part of this variation already materialized in 2010, but estimates suggest that still approximately one third of the inflationary impact of the commodity shock will affect consumer prices this year.

In circumstances such as the present one, it is natural to discuss how monetary policy should be conducted in the presence of supply shocks. According to economic theory, optimal monetary policy should accommodate first-round effects from negative supply shocks. However, active policy should minimize the possibility of supply related, sector specific price increases to be further propagated into nominal wages, medium- and long-run inflation expectations, and other prices (second-round effects). International experiences support this view, and there is consensus among policymakers that first-round effects of supply shocks represent relative price changes, which, in the presence of wage and price rigidity, leads to aggregate price increases. At the same time, it is consensual that central banks should restrain the propagation of the supply shock, in order to lower the risks of wage and price setting dynamics following suit, that is, to lower the risk of a persistent upward movement in inflation.

The Committee assesses that the costs in terms of economic activity of preventing the first-round effects of the supply shock from moving the 2011 inflation away from the midpoint target of 4.5% would be excessively high. On the other hand, the domestic demand is expanding at a more modest pace, which, though uncertain, should still be impacted by the contractionary policy measures implemented so far. Additionally, the Committee assesses that the flexibility inherent to the inflation targeting regime allows the accommodation of the first-round effects of the supply shock. In other words, under the current circumstances the best practice recommends implementing a more gradual convergence of inflation towards the target, similar to past strategy adopted by the Central Bank.

In this context, therefore, the Committee emphasizes that monetary policy strategy will be implemented in order to restrain second-round effects of the supply shock and assure inflation convergence towards the midpoint target in 2012. For this purpose, it is worth highlighting that, considering the prospective domestic activity slowdown, the complexity of the international environment, and other factors, monetary policy strategy may be reevaluated, with respect to its intensity, to its temporal distribution, or both.

6.3 Inflation forecasts

According to traditionally adopted procedures, and taking into account the available information up to the cutoff date of March 11, 2011, the baseline scenario assumes the exchange rate remains unchanged over the forecast horizon at R$1.65/US$, and the target for the Selic rate stays at 11.75% p.a. – the level set by the March Copom meeting – against R$1.70/US$ and 10.75% p.a. considered in the December *Inflation Report*. The projection in the baseline scenario for the change, in 2011, of the set of regulated and monitored prices is of 4.0%, the same value considered in the last *Report*. This projection is based on the hypotheses of stable prices for gasoline and bottled gas; increase of 2.8% for electricity rates; and of 2.9% 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 4.4% for 2012, the same value considered in the December 2010 *Report*, while for 2013 the projection is 4.3%.

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 December *Inflation Report*. For the last quarter of 2011, these expectations moved from R$1.75/US$ to R$1.70/US$, and for the last quarter of 2012, from R$1.80/US$ to R$1.75/US$. For the first quarter of 2013, survey expectations project an average exchange rate of R$1.76/US$. The expectation about the average Selic rate increased in comparison to the values presented in the last *Report*. For the last quarter of 2011, it moved from 12.25% to 12.50% p.a., while for the last quarter of 2012, it moved from 10.92% to 11.33% p.a. For the first quarter of 2013, the projection for the average Selic rate is 11.13% 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 (11.75% p.a.), of 116 b.p. and -6 b.p., in the last quarter of 2011 and 2012, respectively. Additionally, the market scenario assumes changes for the group of regulated and administered prices of 4.1% in 2011, and of 4.5% in 2012 and 2013.

With regard to fiscal policy, the projections presented in this *Report* are based on the working hypothesis of accomplishment of the primary surplus target of R$117.9 billion (or roughly 2.9% of GDP) in 2011, without any adjustment (according to the Budget Guidelines Law – LDO 2011). Moreover, the primary surplus in 2012 is assumed to remain at the level of 3.1% of GDP.

In addition, the projections presented in this *Report* incorporated the estimated effects of the reserve requirements measures announced in December 2010.

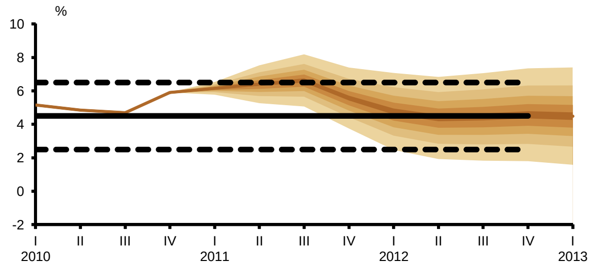
Based on the above assumptions and using the information set until the cutoff date (March 11, 2011), projections were constructed for the IPCA inflation accumulated over four quarters, consistent with the interest and exchange rate paths of the baseline and market scenarios.

The central projection associated with the baseline scenario shows inflation of 5.6% in 2011, an increase of 0.6 p.p. in comparison to the projection presented in the December *Report*. As can be seen on Figure 6.5, in the baseline scenario, the projection for twelve-month accumulated inflation stays above the central value of 4.5% for the target determined by the National Monetary Council (CMN) until the first quarter of 2012, when it reaches 4.8%, moving to figures close to the central target in the following quarters. According to data shown on Table 6.1, the projection for twelve-month accumulated inflation moves from 6.2% in the first quarter of 2011, reaches 6.6% in the third quarter, but decreases and ends the year at 5.6%. In this scenario, the associated projection for the first quarter of 2012 is of 4.8%, decreases to 4.4% in the second and third quarters and ends the year at 4.6%. The decrease of the inflation projections along the first semester of 2012, in comparison to 2011, partially reflects the effects of the Selic rate increase determined by Copom on its last two meetings, as well as the changes in reserve requirements announced last December. The projection for the first quarter of 2013 is 4.5%.

According to the baseline scenario, the estimated probability that inflation for 2011 will breach the upper tolerance level of the target is 20%. For 2012, this probability is close to 13%.

Figure 6.5 – Projected IPCA-inflation with interest rate constant at 11.75% p.a. (Baseline scenario)

Inflation fan chart



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

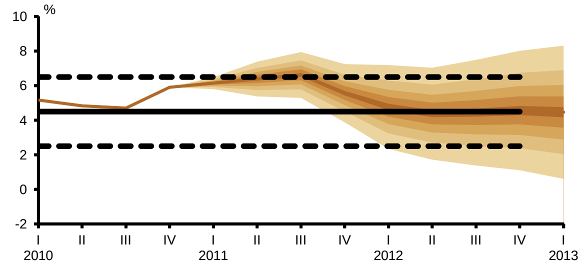
Table 6.1 – Projected IPCA-inflation with interest rate constant at 11.75% p.a.
(Baseline scenario)

Year	Q	Probability Interval 50%	30%	10%				Central projection
2011	1	6.0	6.1	6.1	6.2	6.2	6.3	6.2
2011	2	5.9	6.1	6.3	6.5	6.7	6.9	6.4
2011	3	6.0	6.3	6.5	6.7	7.0	7.3	6.6
2011	4	4.8	5.1	5.4	5.7	6.0	6.3	5.6
2012	1	3.8	4.2	4.6	4.9	5.3	5.7	4.8
2012	2	3.4	3.8	4.2	4.6	5.0	5.4	4.4
2012	3	3.4	3.8	4.2	4.6	5.1	5.5	4.4
2012	4	3.4	3.9	4.4	4.8	5.2	5.7	4.6
2013	1	3.3	3.8	4.3	4.7	5.2	5.7	4.5

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

Figure 6.6 – Projected IPCA-inflation with market interest and exchange rates expectations

Inflation fan chart



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

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

Year	Q	Probability Interval						Central projection
		50%						
			30%					
				10%				
2011	1	6.0	6.1	6.1	6.2	6.2	6.3	6.2
2011	2	6.0	6.2	6.3	6.5	6.6	6.8	6.4
2011	3	6.1	6.3	6.5	6.7	6.9	7.2	6.6
2011	4	4.9	5.2	5.4	5.7	6.0	6.3	5.6
2012	1	3.8	4.2	4.6	5.0	5.3	5.8	4.8
2012	2	3.3	3.8	4.2	4.6	5.0	5.5	4.4
2012	3	3.2	3.7	4.2	4.7	5.2	5.7	4.4
2012	4	3.1	3.8	4.3	4.8	5.4	6.0	4.6
2013	1	2.9	3.6	4.2	4.8	5.4	6.0	4.5

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

1/ According to Gerin.

Table 6.3 – December 2010 *Inflation Report* projections

Period	Baseline scenario	Market scenario
2010 IV	5.9	5.9
2011 I	5.7	5.7
2011 II	5.7	5.7
2011 III	5.8	5.8
2011 IV	5.0	4.8
2012 I	4.5	4.4
2012 II	4.3	4.1
2012 III	4.6	4.4
2012 IV	4.8	4.5

In the market scenario, the inflation projection for 2011 is 5.6%, equal to the respective baseline scenario projection, representing an increase of 0.8 p.p. in comparison to the projection presented in the last *Report*. As can be seen on Figure 6.6 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 first quarter of 2012. Within this scenario, the projection for the first quarter of 2011 is of 6.2%, moves to 6.6% in the third quarter and ends the year at 5.6%. In the same scenario, the projection for the first quarter of 2012 is of 4.8%, recedes to 4.4% in the second and third quarters and ends the year at 4.6%. The projection for the first quarter of 2013 is 4.5%.

According to the market scenario, the estimated probability that inflation for 2011 will breach the upper tolerance level of the target is 18%. For 2012, this probability is close to 18%.

As it was shown in the last *Report*, the projected dynamics for both scenarios are close to each other along 2011 and 2012, given that the effect of the difference between the interest rate trajectories is offset, to some extent, by the respective exchange rate paths. It is worth noting that, in general, inflation projections increased in comparison to figures presented 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 can be seen that there was an increase of the projections along 2011, partially reflecting higher inflation rates in recent months than the corresponding projections presented in the last *Report*. The trajectory for 2012 reflects, to some extent, higher inflation expectations. In the market scenario, the projection changes also reflect these movements. Regarding the second semester of 2012, it is shown a decrease in the inflation projections in the baseline scenario, and relative stability in the market scenario, in respect to figures presented in the December 2010 *Report*.

Figure 6.7 shows the path of twelve-month accumulated inflation, according to the baseline and market scenarios, up to the first quarter of 2013, as well as the target trajectory. The figures are actual twelve-month inflation until February 2011, and, from March on, projections according to the two scenarios. The projections fluctuate, in both scenarios, above the target along 2011. In both scenarios, the trajectory indicates decrease of the twelve-month accumulated inflation in the fourth quarter of 2011, and tends to near the central

Figure 6.7 – Projections and target path for twelve-month cummulative inflation

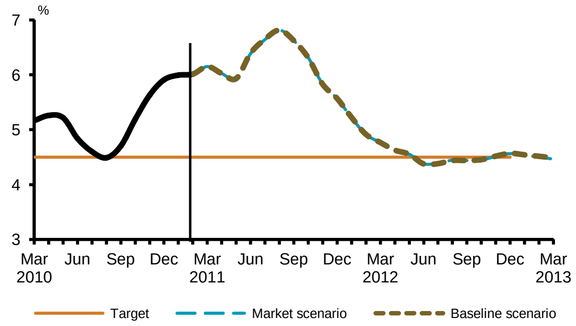
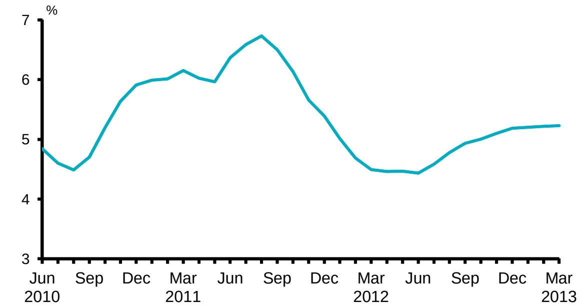


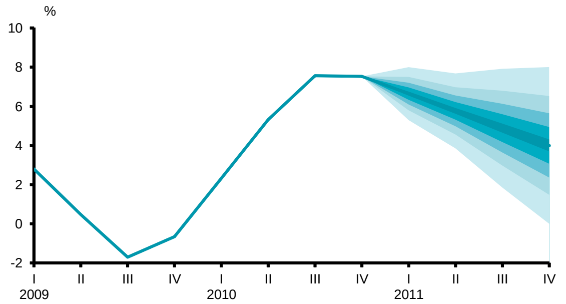
Figure 6.8 – Inflation forecast: VAR models



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

Figure 6.9 – Projected GDP growth with interest rate constant at 11.75% p.a. (Baseline scenario)

Output fan chart



target along the first and second quarters of 2012, fluctuating around this value until the end of the projection horizon.

In an alternative scenario, which assumes the exchange rate remains unchanged, over the relevant horizon, at recently observed levels; and the target for the Selic rate based on data from the survey carried out by Gerin, the inflation projection for 2011 is 5.5%, and 4.4% for 2012. For the first quarter of 2013, the projection is 4.3%.

The average forecast generated by the Vector Autoregression models (VAR) for the twelve-month accumulated inflation is presented in Figure 6.8. Up to February 2011, the values are actual twelve-month inflation and, as of March, refer to the average forecast of the VAR models. Compared to the projections presented in the last *Report*, as well as the projections generated in the baseline and market scenarios, the VAR models forecasts for twelve-month accumulated inflation increased along 2011. Regarding 2012, the forecasts, in general, decrease in comparison to those presented in the December 2010 *Report*, but close the year with higher levels. The VAR models forecasts decrease along the first and second quarters of 2012, in comparison to 2011, but increase in the third and fourth quarters and tend to the unconditional average of inflation by the end of the forecast horizon.

Figure 6.9 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 2011 is 4.0%, a decrease of 0.5 p.p. in comparison to the projection presented in the December 2010 *Inflation Report*.

Breakdown of 2010 Inflation

Following the procedure adopted in previous years, this box presents estimates, based on projection models used by the Banco Central do Brasil, of the various contributing factors for inflation in 2010. In this regard, the variation in the Broad National Consumer Price Index (IPCA) is broken down into six components: i) exchange rate variation; ii) inertia associated with the portion of inflation that exceeded the target, accumulated from the last quarter of the previous year; iii) difference between agents' inflation expectations and the inflation target; iv) supply shock; v) inflation of market prices, excluding the effects of the four preceding items; and vi) inflation of contractually administered and monitored prices, removing the effects of items "i)" and "ii)".[1] It is worth highlighting that the estimates presented in this breakdown process are approximations, based on models, and are therefore subject to uncertainties inherent to the modeling process.

In comparison to what was presented in previous years, the methodology adopted in this box differs by including the item (iv), supply shock. The supply shock was identified in two steps: in the first step, the one-step-ahead prediction error was calculated from the *Phillips* curve of market prices. This prediction error includes a component that can be identified as supply shock, which impacts the inflation of market prices. In the second step, the prediction error was projected in the space generated by innovations in commodity price indexes in *reais* – measured by the Commodity Research Bureau (CRB) index

1/ The basic procedure is described in Freitas, Minella and Riella (2002), "Methodology for Calculating Inflationary Inertia and Shock Effects of administered prices," Technical Note of the Central Bank of Brazil, n. 22. In this box, in addition to what is described in the basic procedure, the component "supply shock" was estimated.

and the Brazil Commodity Index (IC-Br)[2] –, in the international price of oil in *reais*, and by the mismatch between domestic wholesale and retail price indices. These variables work as instruments to identify the supply shock used in the breakdown.

Before presenting the estimates of the inflation breakdown, it is worth to present a brief background on supply shocks.

Supply shocks are defined as surprises that directly affect production conditions, such as agricultural crop failures, shortages of energy, increases in productivity of firms, terms of trade improvements, among others, and they may be positive or negative. Although their definitions are quite straightforward, generally the identification of the shocks is complex, because many times the shocks are not easily classified or may embed elements of supply and demand, making the process uncertain and dependent on the use of economic models.

For the purpose of monetary policy implementation, the relevance of a shock depends on its magnitude and persistence, as well as on structural features of the economy. For example, persistent exchange rate movements tend to be further transferred to prices. Or still, economies with high share of food in the consumption basket of families tend to be more strongly affected when these prices increase in international markets. From another perspective, since the magnitude of the shock, in general, is revealed over time, a commonly accepted rule in central banks suggests calibrating the policy response as the effects are unveiled overtime (Blinder (1998)).[3]

In the specific case of supply shock, monetary policy may face a trade-off between stabilizing output and controlling inflation. If the shock is positive – such as productivity gains – the situation is not conflicting, because the shock contributes to increase the aggregate supply and aligns with monetary policy efforts to keep prices stable. If it

2/ CRB is the commodity index produced by the Commodity Research Bureau and IC-Br is the Brazil Commodity Index presented in the box "Transfer of Commodity Prices for the IPCA and Brazil Commodity Index (IC-Br)" in the December 2010 *Inflation Report*.

3/ "Step 1: Estimate how much you need to tighten or loosen monetary policy to "get it right". Then do less. Step 2: Watch developments. Step 3a: If things work out about as expected, increase your tightening or loosening toward where you thought it should be in the first place. Step 3b: If the economy seems to be evolving differently from what you expected, adjust policy accordingly." (Blinder, 1998, pp. 17-18).

is negative – such as an electrical blackout, crop failures or oil price increases – it contracts the supply and pushes inflation up. Theory[4] recommends that, in the presence of negative supply shocks, the optimal monetary policy does not react to the first order effects (primary effects). Such policy should prevent the so-called second-order effects, that is, those effects of localized increases in prices – stemming from sectors where supply shocks originated – to propagate for nominal wages, medium and long term inflation expectations and prices not directly affected by the cost variations.

Figure 1 – CRB and IC-Br Commodity Price indices

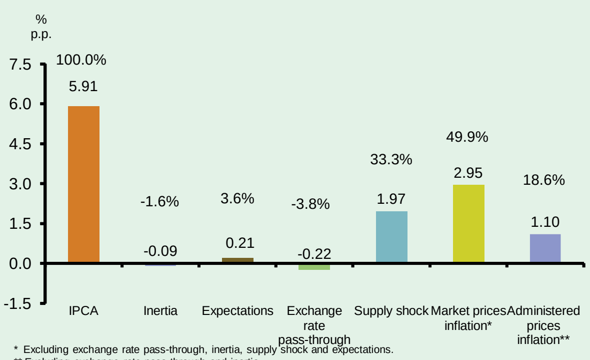
In 2010, as shown in Figure 1, the prices of commodities in *reais* rose significantly. This process, a result, at least in part, of supply shocks, quickly reflected in the dynamics of consumer prices, so that inflation measured by the IPCA reached 5.91% in December 2010, from 4.31% in the previous year. Considering the two major price groups that make up the IPCA, inflation of market prices closed the year at 7.08% and the one of administered prices at 3.13%.

Table 1 – Inflation decomposition from 2003 to 2010 (in p.p.)

Component	2003	2004	2005	2006	2007	2008	2009	2010
IPCA (percentage variation)	9.30	7.60	5.69	3.14	4.46	5.90	4.31	5.91
Inertia	5.92	0.28	0.77	0.47	0.01	0.23	0.00	-0.09
Expectations	1.71	0.37	0.27	-0.13	-0.43	0.22	-0.10	0.21
Exchange rate pass-through	-1.11	-0.34	-2.06	-0.55	-1.12	0.63	-0.24	-0.22
Supply shock	1.24	3.52	-0.88	0.18	2.12	1.52	-0.25	1.97
Market prices inflation*	-0.12	0.83	4.29	1.58	2.91	2.25	3.72	2.95
Administered prices inflation**	1.66	2.93	3.31	1.60	0.96	1.05	1.18	1.10

* Excluding the effects of exchange rate pass-through, inertia, expectations and supply shock.
** Excluding the effects of exchange rate pass-through and inertia.

Figure 2 – Breakdown of 2010 inflation



* Excluding exchange rate pass-through, inertia, supply shock and expectations.
** Excluding exchange rate pass-through and inertia.

According to Table 1, controlling for the effects of the exchange rate pass-through, inertia, expectations and supply shocks, the major part of the variation of the IPCA, in recent years, was due to the behavior of market prices, followed by the one of the supply shock. In 2007 and 2008, the supply shock contributed with 47.6% and 25.8%, respectively, of total inflation. In 2009, it presented itself as disinflationary.

In 2010, according to Figure 2 and Table 1, discounting the effects of the exchange rate

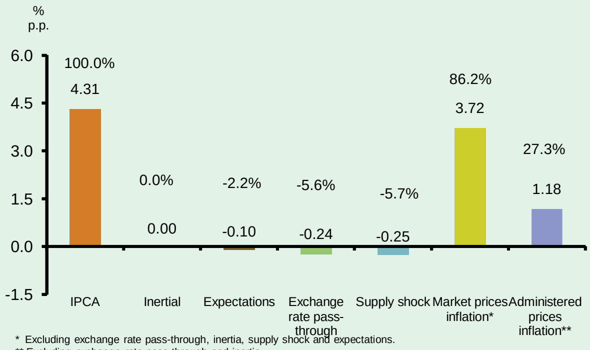
4/ See, for example, the dynamic stochastic general equilibrium models of Aoki (2001) and Bodenstein *et al* (2008).

pass-through, inertia, expectations and supply shock, market prices contributed with 2.95 percentage points (p.p.) of inflation and administered prices with 1.10 p.p.

In relative terms, the effects of market and administered prices on inflation reached 49.9% and 18.6% respectively in 2010 (Figure 2). In relation to the set of items described in "(i)", "(ii)", "(iii)" and "(iv)", it was estimated that, in the aggregate, they increased the IPCA by 1.87 p.p. (31.5%), contrasting to what happened in 2009, when they reduced inflation by 0.59 p.p., but in line with what happened in 2007 and 2008, years in which the inflation was strongly influenced by supply shocks.

Figure 2 and Table 1 indicate that the variation of the exchange rate helped reduce the inflation rate in 2010, repeating what has been observed since 2003, except for 2008. In fact, the variation of the exchange rate was responsible for a reduction of 0.22 p.p. in the IPCA, equivalent to 3.8% of total inflation. The inertia also contributed to the decrease in the IPCA of 0.09 p.p., equivalent to 1.6% in overall inflation in 2010. In turn, the contributions of the supply shock and of the component given by the difference between inflation expectations and the inflation target were positive in 2010, increasing the IPCA by 1.97 p.p. and 0.21 p.p., respectively, equivalent to 33.3% and 3.6% of the inflation.

Figure 3 – Breakdown of 2009 inflation



* Excluding exchange rate pass-through, inertia, supply shock and expectations.
** Excluding exchange rate pass-through and inertia.

In comparison to the previous year, Figure 3 illustrates that the inflation of market prices (excluding the effects of exchange rate pass-through, inertia, expectations and supply shock) and the inflation of administered prices (excluding the effects of exchange rate pass-through and inertia) accounted for most of the inflation in 2009.

In summary, in 2004, 2007, 2008 and 2010, the component "supply shock" explained over 25% of observed inflation, approaching one half in some episodes. Specifically in 2010, the contribution of the supply shock was approximately one third. It should be noted that this shock is associated, in large part, with the dynamics of commodity prices in the second half of 2010. In fact, the rise in commodity prices was reflected, with a short lag, in the inflation indices, especially in the food and beverages group – the variation of the prices in this group in just four months (September-December 2010) reached 6.67%. Finally, it is important to note that, as recommended by theory, in line with the international experience, monetary policy should accommodate the first-order effects of the supply shock and remain vigilant to contain its propagation and attempts of relative price recomposition (the second-order effects).

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The Output Gap – Recent Estimations

The output gap, defined as the difference between actual and potential output, is an important variable to indicate inflationary pressures in the economy. Positive values of the output gap indicate that actual output is above potential and suggests the possibility of a future rise in price levels, and vice versa. By functioning as an indicator of economic fluctuations, the output gap, among other variables, gives policymakers the ability to anticipate potential demand pressures on prices.

But since the output gap cannot be directly measured, ie, an unobservable variable, it must be estimated, involving a high degree of uncertainty.[1] There is no consensus regarding the most appropriate method for the estimation of the potential output and, hence, the output gap. Thus, the Banco Central do Brasil, similar to what occurs in most major economies, uses several methods to measure the output gap: i) the extraction of a linear trend (LT); ii) the Hodrick-Prescott filter (HP); iii) the production function approach (PF);[2] iv) the Kalman filter (KF).[3] Methods i) and ii) are univariate, while (ii) and (iv) are multivariate.

The objective of this box is to assess the recent evolution of the different measures of the output gap calculated by the Banco Central, updating the estimates presented in the Inflation Report of March

1/ In the literature on the methodology for estimating the output gap, there are basically two components. One is based on simpler models, in general univariate, which employs statistical filters to extract potential output, and the output gap as a residual. Another, more complex, makes use of multivariate models that seek greater economic fundamentals for estimating the output gap. The advantage of the first approach is the simplicity of the estimation process, while the multivariate lies on the imposition of economic relations or economic characteristics.

2/ Calculated with data on unemployment rate and data on Installed Capacity Utilization (UCI), using either the UCI prepared by the Confederation of Industry (PF-CNI) as well as the UCI from the Getulio Vargas Foundation (PF-FGV).

3/ The estimation methods based on the extraction of a linear trend and on the HP filter are described in the *Inflation Report* of September 1999. The method was associated with the production function approach is described in the December 2000 and December 2003 *Inflation Reports*, and have been refined in recent years with changes in methodology and variables. The method that uses the Kalman filter with restrictions arising from economic theory was presented in the *Inflation Report* of December 2007.

Figure 1 – Output Gap Dynamics – 2007-II to 2010-IV

Production Function, Linear Trend, HP Filter, Kalman Filter

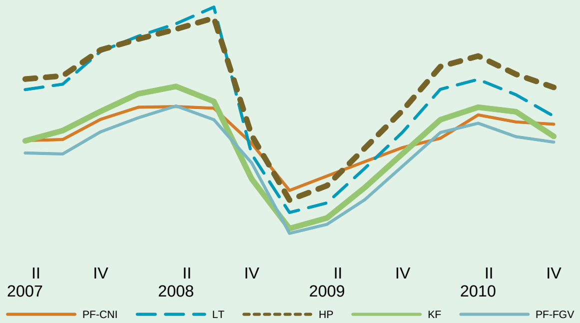
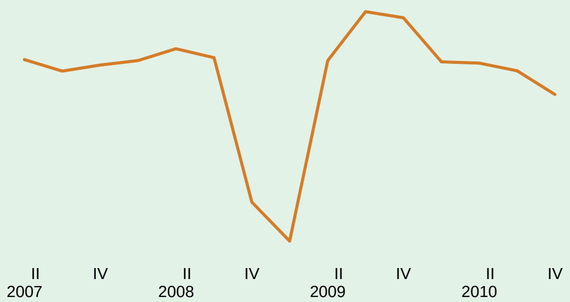


Figure 2 – Gross Fixed Capital Formation – 2007-II to 2010-IV

Quarterly growth rate



2010. Additionally, we present recent developments in the Gross Fixed Capital Formation (GFCF) of the Brazilian economy.

Using the sample that goes from the second quarter of 2007 to the fourth quarter of 2010, as seen in Figure 1, the various output gap measures are quite correlated, although they differ in level. The different levels mainly reflect the different economic models used at Banco Central for forecasting inflation.[4]

Regarding the recent evolution of the different measures of output gap, the strong fall between the third quarter of 2008 and the first of 2009 is due to the 2008/2009 financial crisis. It's important to point out that this reduction of the output gap was not restricted to the Brazilian economy, but also occurred in other emerging economies, as well as in developed economies.[5] As shown in Figure 1, from the second quarter of 2009 on, all output gap measures gradually increase. This movement goes until the second quarter of 2010 and is compatible with the observed increase in the utilization of production factors in the economy. Finally, in the third and fourth quarters of 2010, all measures of output gap begin to decline.

Each measure of the output gap generates a corresponding measure for the potential output of the Brazilian economy. By the way, in the exercises presented here, despite the fact that information on aggregate investment is not directly used in the calculation of the potential output, there is a correlation between the growth rate of potential output and the growth rate of the GFCF. Figure 2 shows the growth rate of the Brazilian GFCF. After achieving growth of around 4.5% in the third quarter of 2008, its rate fell to -10.6% and -14.6% in the next two quarters, reflecting a sharp decline caused by the 2008/2009 financial crisis. The GFCF starts to recover around the second quarter of 2009, posting a 9.3% growth rate in the third quarter of 2009. Since then, as with many other economic indicators, the change in GFCF has cooled down, ranging from 3.1% in the third quarter of 2010 and 0.7% in the

4/ Considering the different Phillips curves based on the different measures of output gap, the measure calculated by the production function approach does not imply inflation projections that are consistently lower, or higher, than the projections obtained with the other measures.

5/ See, for example, IMF (2010) and Cardenas and Levy-Yeyati (2010).

fourth quarter. It is plausible to conjecture that over the same period, the growth rates of potential output have depicted similar trajectory.

To sum up, good practice in the conduct of monetary policy requires adequate measurements of the output gap. In this regard, it is important to monitor indicators produced by different methodologies, as well as closely monitor the consistency of the data. It is also important to improve constantly the methodologies used, given the inherent difficulties in the estimation process of the output gap. In a sense, when different methodologies for computing the output gap end up producing similar trajectories, this tends to give more confidence to the analysis of economic fluctuations.

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Fiscal Multiplier, Output and Inflation

Due to the international financial crisis of 2008/2009, many countries implemented accommodative monetary policies to offset the sharp drop of output that was then observed. The policy mix involved interest rate cuts, in some cases to values close to the zero lower bound, the use of unconventional instruments such as direct liquidity injection in domestic currency (quantitative easing), and, at times, in foreign currency as well; and even the change of the balance sheets of central banks (qualitative easing).

Given the magnitude and intensity of the impact of the financial crisis on the economic activity, as well as the natural limits of the monetary stimuli, several developed and emerging economies also adopted strongly expansionary fiscal policies, by reducing taxes and/or increasing spending. In the specific case of Latin American economies, the countercyclical policies contributed to a relatively quick economic recovery. Still, in some of these economies, the fiscal stimuli have not yet fully reversed.[1]

This box has two goals. First, it puts the issue into perspective by presenting a brief review of the theory and empirical evidence on the fiscal multiplier. Second, it assesses the expected impact of fiscal policy on inflation in Brazil.

Fiscal Multiplier: Theory and Evidence

The effect on aggregate demand of the change in government spending and/or taxes is proportional to the size of the fiscal stimulus and this coefficient of proportionality is known as the “fiscal multiplier”. For the fiscal authority, knowing the size of the

1/ See, for example, Cárdenas and Levy-Yeyati (2010).

multiplier is important in order to choose the right policy mix (expenditures, taxes and/or transfers), as well as to gauge the magnitude and duration of the stimulus. For the monetary authority, knowing the multiplier is relevant for assessing the impact of the fiscal stimulus on the output gap and, thus, on inflation.

Macroeconomic models, even the simplest, suggest that the size and signal of the fiscal multiplier result from a non-trivial combination of several factors – for example, openness of economy, exchange rate regime, and monetary policy stance, among others. These models suggest that fiscal policy tends to be more potent in closed economies, in situations similar to that of the liquidity trap in which monetary policy remains accommodative and, therefore, does not counterbalance part of the stimulus; and in open economies with fixed exchange rates. In general, traditional Keynesian models generate a fiscal multiplier greater than 1. In extreme cases of a closed economy with marginal propensity to consume between 0.5 and 0.9 (and Auberbach Gorodnichenko, 2010) and relatively flat LM curve, the multiplier could reach values between 2 and 10.

Dynamic stochastic general equilibrium (DSGE) models, even those with Keynesian features, such as sticky prices and wages, generate multipliers less than 1. Two aspects help explain the differences between DSGE models and purely Keynesian models. First, DSGE models combine some rational (or forward-looking) expectations and some dose of Ricardian equivalence. Under this framework, consumers anticipate that a persistent reduction in public spending from today will require lower tax burden in the future, which may induce them to consume more today and generate inflationary pressures.[2] Second, given that fiscal restraint contributes to reducing inflation, the monetary authority can respond by lowering the nominal interest rates, if this is determined by some rule (e.g., the Taylor rule). With prices relatively rigid in the short-run, inflation responds with some lag to economic activity and the real interest rate falls, thus stimulating consumption and investment.

2/ Including non-Ricardian features into DSGE models – for example, agents that consume all their current income (hand-to-mouth households) – tends to weaken the Ricardian equivalence.

This reaction cancels part of the desired effect by the tax authority and, ultimately, fiscal restraint causes only a redistribution of aggregate demand among its various components, not a reduction of its level. However, there is at least one important exception to the rule: when the nominal interest rate remains close to zero at the relevant horizon, the multipliers of DSGE models reach 2 or more (Christiano *et al.* (2009), Hall (2009), Woodford (2010), among others).

Coenen *et al.* (2010) simulate the impact of fiscal stimuli in the United States of America (USA) and in the Euro Zone using seven structural models, including DSGE models.[3] Table 1 illustrates the estimated effects on U.S. inflation and output, caused by an increase in government consumption equivalent to one percentage point (p.p.) of the Gross Domestic Product (GDP). The second and third columns contain the multipliers for each scenario, while the last two columns show the maximum effect on inflation. Note that the longer the fiscal stimulus and the more accommodative the monetary policy, the greater the effects on output and inflation. As, in general, the models are linear, the effect of a reduction in government spending would be symmetrical.

Table 1 – Effect of a Fiscal Stimulus on Inflation and Output

Increase in the USA Government Consumption-to-GDP Ratio by 1p.p.

Monetary Policy	Effect on GDP PIB (%)		Maximum Effect on Inflation (p.p.)	
Stance	1-year stimulus	2-year stimulus	1-year stimulus	2-year stimulus
No accomodation	0.8 a 1.3	0.6 a 1.4	0.2	0.4
1-year accomodation	0.9 a 1.5	0.6 a 1.9	0.4	1.0
2-year accomodation	1.0 a 1.5	0.9 a 2.6	0.6	2.0

Original source: Coenen *et al*. (2010).

Based on semi-structural and DSGE models, Hemming et al. (2002) gather evidence for the U.S. and other economies of the Organization for Economic Cooperation and Development (OECD). Some of the semi-structural models generate short-term multipliers between 0.6 and 1.4 when the fiscal instrument is government consumption, and between 0.3 and 0.8 in the case of taxes.

3/ European Commission (QUEST), International Monetary Fund (GIMF), Federal Reserve (FRB-US and SIGMA), Bank of Canada (BoC-GEM), European Central Bank (NAWM) and Organization for Economic Cooperation and Development (OECD Fiscal).

And what do purely statistical models have to say about fiscal multipliers? Much of the evidence is based on econometric techniques using vector auto-regression (VARs) and focuses on the U.S. economy during the second half of the twentieth century, following the seminal work of Blanchard and Perotti (2002). The range of available estimates is wide, but they tend to point to multipliers of government spending between 0.5 and 1.0.[4] Given that these econometric exercises identify the average behavior of the economy during the sample period – not in specific events like the Great Depression or the 2007/2010 crisis – Auberback and Gorodnichenko (2010) try to overcome this limitation. They use a structural VAR with a regime change (regime-switching SVAR) that is capable of distinguishing the multipliers during recessions and expansions. The results for the U.S. economy support the conjectures of Christiano *et al.* (2009) and others in the context of DSGE models: the estimated multipliers are higher in periods of recessions than in expansions.

To some researchers, the traditional econometric techniques have identification problems, which would reduce the degree of confidence in the estimates. To deal with this problem, Ramey (2009) uses the so-called narrative approach, which would be less subject to problems of identification. By applying this unconventional methodology to the United States, during the period of 1939-2008, the author finds multipliers between 0.6 and 1.1. Therefore, VAR models – using conventional identification techniques or the narrative approach – point to relatively modest magnitudes for the multipliers, which are closer to those suggested by DSGE models with non-accommodative monetary policy than to those suggested by purely Keynesian models.

Regarding emerging economies, the evidence is scarce, because of data limitations, macroeconomic instability and/or difficulty in identifying fiscal shocks, among other factors. The literature suggests that fiscal multipliers are lower in emerging than in mature economies. For example, Ilzetzki and Vegh (2008) estimate a maximum multiplier of 0.6 for a sample of developing countries, compared

4/ Limitations imposed by the data and identification problems have not ruled out the possibility that the multipliers are greater than 1 (Hall, 2009).

with 0.91 for a sample of developed countries. According to this study, on average, fiscal policy would be pro-cyclical in emerging economies, while it would be counter-cyclical or a-cyclical in industrialized countries. Thus, fiscal policy would tend to amplify rather than mitigate the business cycles in developing countries.[5]

In turn, Ilzetzki *et al*. (2010) use a sample of 44 countries – 20 developed and 24 developing countries, including Brazil – covering the period of 1960-2007 and applying structural VARs (SVARs). Their results suggest that the spending multiplier is greater in closed economies, in open economies with fixed exchange rate regimes, as well as in mature economies. In particular, the authors estimate that in mature economies, the multiplier of government consumption varies from 0.37, on impact, and 0.80 in the long run. On the other hand, in developing economies, the multiplier is negative on impact (-0.21) and 0.18 in the long run.

What does the literature says about Brazil? The estimates of Ilzetzki *et al*. (2010) capture the average multiplier for two groups of countries, but are uninformative on individual economies. Although included in the sample, the study does not provide estimates of the fiscal multiplier for the Brazilian economy. There is also little evidence regarding the impact of fiscal shocks in Brazil using the DSGE methodology.[6] Some features of the Brazilian economy, however, suggest that the fiscal multiplier in Brazil would probably be higher than in other emerging economies with similar level of development. First, the Brazilian economy is relatively closed, which tends to reduce external leaking. Second, the average propensity to save is relatively low. Finally, the relevant part of fiscal stimulus in Brazil refers to current spending, as well as transfers for groups with low savings rate/high propensity to consume.

5/ For Levy-Yeyati (2010) and others, the current round of fiscal expansion in Latin America, which during the international crisis of 2008/2009 played a countercyclical role, would be too prolonged and exacerbate the economic cycle.

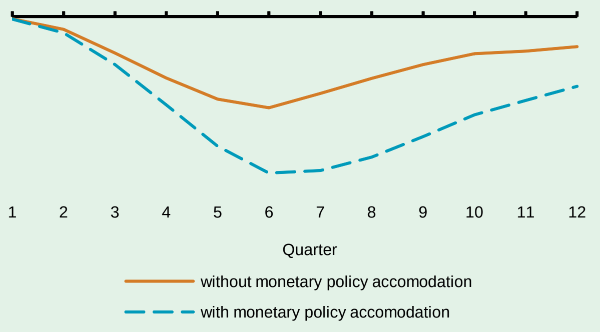
6/ However, there is already some evidence available based on DSGE models. For example, Valli and Carvalho (2010) calibrate a large-scale DSGE model for the Brazilian economy and find that an increase of 1 p.p. in the fiscal surplus-to-GDP ratio would lead to a fall in the output gap by 1 p.p. on impact.

In a study carried out by the Department of Investor Relations and Special Studies (Gerin),[7] market participants responded that a fiscal effort for a year, equivalent to 1% of GDP, combined with accommodative monetary policy in the first year, would lead to an average decline of 0.34 p.p. in inflation (maximum of 0.8 p.p.). The wide range of responses by market participants about the expected effects, captured by the survey, indicates that considerable uncertainty surrounds the estimates for the fiscal multiplier in Brazil, as happens with the international empirical evidence.

Simulations for Brazil

The simulations follow the line adopted by Coenen *et al.* (2010); however, it utilizes a semi-structural medium-sized model[8], which has the advantage of being an intermediary tool between DSGE models and purely econometric models such as the VARs. The fiscal stimulus is modeled exogenously, being described by a cut in government spending equivalent to 1% of GDP for four consecutive quarters. Two scenarios for monetary policy were considered: (1) the policy interest rate reacts to the fiscal effort according to the Taylor rule estimated in the model (non-accommodative monetary policy), and (2) the policy interest rate remains constant in the first year of the simulation, reacting according to the Taylor rule from the second year onwards (accommodative monetary policy).

Figure 1 – Effect on Inflation of a Fiscal Effort of 1% of GDP, for one year



In Figure 1, the solid line shows the effects on inflation of a 1 p.p. reduction in the government spending-to-GDP ratio (for this simulation, the fiscal multiplier is estimated at around 0.9), lasting one year and without monetary accommodation. The exercise suggests that fiscal restraint impacts inflation relatively quickly and the effects are significant and long-lasting. The maximum effect on inflation occurs about six quarters after the beginning of the fiscal effort. The dotted line shows the response of inflation in the case of accommodative monetary policy (constant nominal interest rates), which, coupled

7/ Available at the Central Bank's website on <http://www.bcb.gov.br/Pre/ASIMP/bcimprensa/2774-Pesquisa 20sobre%%% 20Política 20Monetária.pdf>.

8/ See Minella and Souza-Sobrinho (2009). In order to make the simulations more representative, two modifications were made in the original model: (i) inflation expectations are a weighted average of model-consistent expectations and the inflation target and (ii) the Taylor rule also responds to the output gap.

with the fall in expected inflation causes a greater increase in the real interest rate than that suggested by the previous exercise. As a consequence, the effects on inflation are amplified – the maximum effect also occurs around the sixth quarter.

In both exercises, the transmission of fiscal policy to prices materializes primarily via the aggregate demand channel (or, equivalently, by reducing the output gap). In line with the results found by Coenen *et al.* (2010), the second simulation indicates that the effects on the output gap and inflation may be amplified if monetary policy remains temporarily accommodative. This magnifying effect occurs because the fiscal effort, when combined with temporary monetary accommodation, leads to a higher increase in real interest rates, a key variable for consumption and investment decisions.

In summary, despite the uncertainties surrounding the estimates of the fiscal multiplier, the simulations presented in this box indicate that a fiscal contraction may have important effects on inflation dynamics in Brazil, even when the fiscal effort is short-lived. It is reasonable to claim that long-lasting changes in the fiscal regime would have significant implications for the sustainability of the public debt in the medium and long run as well as for aggregate savings. Therefore, persistent changes in the fiscal regime would certainly have even more important effects on the entire price system.

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Annex

Minutes of the 156th Meeting of the Monetary Policy Committee (Copom)

Date: January 18th, 2011 from 4:15PM to 18:30PM, and January 19th, from 4:32PM to 8:08PM
Place: BCB Headquarters meeting rooms – 8th floor on January 18th and 20th floor on January 19th – Brasília – DF

In attendance:
Members of the Committee
Alexandre Antonio Tombini – Governor
Aldo Luiz Mendes
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 January 18th)
Adriana Soares Sales – Research Department (also present on January 19th)
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 and Special Studies Department

Other participants (present on January 18th)
Alexandre Pundek Rocha – Advisor to the Board
André Minella – Advisor to the Research Department
Emanuel Di Stefano Bezerra Freire – Advisor to the Board
Eugênio Pacceli Ribeiro – Advisor to the Economic Department
Fabio Araujo – Advisor to the Research Department
Gustavo Paul Kurrle – Press Officer

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 0.83% in November, reached 0.63% in December. As a consequence, 2010 inflation reached 5.91%, 1.60 p.p. above the one observed in 2009 and 1.41 p.p. above the midpoint target. The inflation increase in 2010 reflects the behavior of market prices, which increased 7.09% and contributed with 5.0 p.p. of the 5.91 p.p. total. In fact, regulated prices increased 3.13%, compared to 4.74% in 2009, contributing with just 0.91 p.p. for 2010 inflation. Regarding market prices, it bears emphasizing that the change in the prices of tradable goods reached 6.87%, and the one relative to the prices of non-tradable goods, 7.28% in 2010. The change in the prices of services, whose dynamics tends to show more persistence than that of the prices of goods, continues in high levels, reaching 7.62% in 2010. In short, the set of available information suggests that prices acceleration in 2010, process lead by market prices, may show some persistence, in part because services inflation continues at high levels.

2. Food prices trajectory performed relevant role for 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%. In the last four-month period, monthly inflation recorded high values in all months, with food and beverages increasing by 6.67%. It bears highlighting that twelve-month household food price inflation moved from 6.67% in April 2010, to 2.29%, in August, and reached 10.69% in December. According to the same comparison basis, the IPCA reached 5.26%, 4.49% and 5.91%, 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 and global demand increase.

3. In line with the evolution of headline inflation, each one of the three main underlying inflation measures calculated by the BCB has recorded high values. The smoothed trimmed means core inflation moved from 0.55% in October to 0.56% in November and 0.52% in December, averaging 0.46% in 2010. In the same months, the double weight core inflation increased 0.58%, 0.66% and 0.71%, also averaging 0.46% in 2010. The core inflation by exclusion rose 0.44%, 0.52% and 0.60%, in the same months, averaging 0.44% in 2010. In 2010, the smoothed trimmed means core inflation, double weight core inflation and the core inflation by exclusion increased 5.45%, 5.63% and 5.62%, respectively. The IPCA diffusion index, which had reached 64.8% in October, increased to 67.2% in November and decreased to 62.2% in December. With the diffusion index at this level, evidences support hypothesis of prices acceleration.

4. The General Price Index (IGP-DI) inflation recorded 0.38% in December, value below the one registered in November (1.58%). In 2010, inflation reached 11.30%, above the level recorded in 2009 (-1.43%). Inflation measured by its main component, the Wholesale Price Index (IPA-DI), reached 13.85% in the year (-4.08% in 2009), reflecting the increase of 10.13% in the industrial IPA and 25.61% in the agricultural IPA. Inflation measured by the Consumer Price Index (IPC-DI), another component of the IGP-DI, recorded 6.24% in 2010, above the 3.95% registered in the previous year. According to the same comparison basis, inflation measured by the Civil Construction National Index (INCC), component with the lowest weight in the IGP-DI, increased 7.77%, above the 3.25% recorded in 2009. 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. Considering seasonally adjusted data, the IBC-Br, which had been showing relative stability, with 0.1% increase between April and August 2010, resumed significant growth in September (0.4%), October (0.5%) and November (0.4%), suggesting that the period of most intense cooling of economic activity may have finished.

6. Industrial activity has not still shown consistent signs of a new expansion cycle. According to data seasonally adjusted by the IBGE, industrial output retreaded by 0.1% in November 2010, after a 0.3% increase in October, month-on-month, and a 0.8% decrease between April and November. The three-month moving average growth rate reached 0.1% in the period between August and November, unchanged relative to the rate registered in the three-month period ended in October. Year-over-year, output increased 5.3% in November and 1.8% in October. On a twelve-month trailing basis, industrial output expanded for the eighth consecutive month, recording 11.7% in November, unchanged relative to October. Compared to December 2008, a record low for industrial production level registered during the 2008/2009 crisis period, recovery up to November 2010 totaled 24.1%. 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 November, month-on-month, stemmed from capital goods production, which increased by 3.2%. Consumer and intermediate goods production rates were also positive, recording 0.4% and 1.0%, respectively. Considering the three-month moving average ended in November, all categories increased. Capital goods production increased 0.2%, while consumer and intermediate goods production grew by 0.3%. It bears highlighting that increase in the capital goods industry activity is the highest among the use categories, not only according to a month-on-month comparison basis, but also according to the average until November 2010, which expanded by 22.7%, compared to the same period of 2009. Such behavior 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 6.1% in October to 5.7% in November, lower than the 7.4% observed in November 2009, according to observed data. After reaching 9.0% in March 2009, the observed rate not only retreated significantly until November, but reached a historical record low for the series begun in March 2002. According to the seasonally adjusted series, the rate in November also reached a new record low for the series (6.0%). Employment, measured by the number of employed workers in the metropolitan regions, increased by 3.9% in October and 3.7% in November, year-over-year. Data from the Ministry of Labor and Employment (MTE) indicated growth in formal employment in all months of 2010, except for December. In December, 407.5 thousand jobs were eliminated, compared to the elimination of 415.2 thousand jobs in December 2009. In November 2010, 138.2 thousand jobs were created (246.7 thousand jobs in November 2009). In the year, 2.14 million jobs were created (2.52 million according to the criterion that considers delayed data delivered by the companies), a 114.7% expansion relative to 2009, which represents the best yearly result since the start of the series. The key driver for employment retreat in December 2010 was industry, which contributed with 37.5% for the monthly reduction. In 2010, the services sector was the main driver, with 40.4% of job creation in the year. Real average earnings in November retreated by 0.8% compared to the historical record registered in October and increased 5.7% year-over-year. As a consequence, real payroll, considering real average earnings earned in the six metropolitan regions, expanded by 9.6% in November, 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 17.0% in November, 11.1% in October and 6.0% in September, year-over-year. According to the seasonally adjusted series, sales increased 1.4% in November, after growing in the six previous months. The average of sales increased 3.4% in the quarter ended in November, compared to the quarter ended in August. Out of the ten sectors surveyed, eight sectors performed positively month-on-month in November. The key driver was “office material and equipment” once again, with 10.5% growth. In the upcoming months, the retail sales trajectory should continue to be benefited by governmental transfers, real payroll growth, moderate credit expansion and consumer confidence.

10. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by FGV, without seasonal adjustment, reached 85.3% in December, down from 86.1% in November, 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 84.9% in December, up from 84.5% in the previous month. The four use categories retreated. Consumer goods industry utilization rate retreated 0.8 p.p. reaching 85.0%, and, for capital goods industry, 0.3 p.p., reaching 84.5%. Both in the construction inputs and in the intermediate goods industries the reduction was lower: 0.1 p.p. 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. Therefore, the installed capacity utilization rates have been stable at high levels. The high occupation level reflects the recent expansion in economic activity, whose effects have not been totally offset by

the maturity of investment projects. In this sense, the absorption of capital goods resumed growth in November (4.4%), month-on-month, and grew by 16.4% year-over-year. The average index through November increased by 28.0%, year-over-year. The production of construction inputs increased 1.4% month-on-month and 7.6% year-over-year, in November. 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.

11. The 2010 trade balance result totaled US$20.3 billion, US$5.0 billion below the observed in 2009. This result stemmed from US$201.9 billion in exports and US$181.6 billion in imports, equivalent to 32.0% and 42.2% changes, respectively, compared to 2009. In fact, the greater dynamism of domestic demand relative to external demand explains most of the reduction of the trade surplus. The behavior of remittances of profits and dividends, which also reflects the growth differential between the Brazilian economy and other economies, has been contributing to elevate the current account deficit. The 12-month period deficit increased from US$48.0 billion in October to US$49.4 billion in November, equivalent to 2.43% of GDP. On its turn, foreign direct investment reached US$38.2 billion in the last twelve months through November, equivalent to 1.88% of GDP, resulting in a need of foreign funding equivalent to 0.55% of GDP.

12. Since the last Copom meeting, some tendency of global economy recovery has been observed, mainly in the US, whose domestic demand shows some dynamism, especially in household consumption. The leading indicator published by the Organization for Economic Co-operation and Development (OECD) – often used for inferences of future behavior of global industrial production –, for instance, registered, in November, the third consecutive monthly increase. The disaggregated indicators by country suggest acceleration on the growth pace in the US and France, and expectation of continued growth in the other G7 countries, except for Japan. The Euro Area prospects, in particular, show quite asymmetrical, as uncertainties regarding the solvency of some peripheral economies persist, at the same time that the expansion pace remains strong in Germany. Inflation rates have been very low in G3 countries (US, Euro Area and Japan), in spite of extremely expansionist economic policy actions, both in fiscal and monetary sides. In the twelve months ended in November, core inflation rates – which excludes food and energy products – reached only 0.8% in the US, 1.1% in the Euro Area and -0.8% in Japan. Since the last meeting, there was monetary tightening in several economies, as in China. The People´s Bank of China announced, in January this year, the fourth increase in reserve requirements since November last year.

13. Brent oil prices increased substantially since the last Copom meeting, reaching a level close to U$100. This acceleration is consistent with apparent strengthening in the global demand framework – given that empiric evidences suggest that international oil prices, in the last two decades, have been determined more due to the global demand conditions than by the supply side. However, it bears highlighting oil prices volatility, a result of low predictability of some global demand components, of dependency of supply growth on the maturity pace of risky investment projects and of geopolitical complexity that is typical to the sector. The main scenario adopted by the Copom assumes unchanged domestic gasoline prices in 2011. Regarding the prices of other commodities, it is noteworthy the increase in the agricultural international prices. The food price index, calculated by the Food and Agriculture Organization of the United Nations (FAO), and which considers 55 items, reached its peak in December 2010. This movement was leveraged, among other factors, by the increase in the international prices of sugar, cereals and vegetable oils. In recent past, the high volatility observed in commodities prices seems to have been strongly impacted by the abundant global liquidity, in a context where financial markets adjust to new expectations of demand growth and to the remarkable volatility in FX markets.

Assessment of inflation trends

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

a) the projected adjustments for gasoline an bottled gas prices in 2011 were kept unchanged at 0%, the same considered at the December Copom meeting;

b) the projected adjustments for fixed telephone and electricity rates in 2011 were kept at 2.9% and 2.8%, respectively;

c) the projection for regulated prices inflation in 2011, based on individual items, according to the benchmark scenario, was kept at 4.0%, unchanged relative to the December meeting. This set of prices, according to data released by the IBGE, accounted for 29.00% of the total December IPCA;

d) the projection for regulated prices inflation in 2012, according to the benchmark scenario, was kept at 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 13 bps and 62 bps spreads in the fourth quarters of 2011 and 2012, respectively.

15. Regarding fiscal policy, projections assume the achievement of a public sector primary surplus target of 3.0% of GDP, without adjustments, in 2011 (according to parameters contained in the Budget Guidelines Law). Moreover, a primary surplus of 3.1% is considered for 2012.

16. The set of projections incorporated the estimated effects of the reserve requirements measures announced in December.

17. Since the last Copom meeting, the median of the expectations compiled by the BCB's Investor Relations Group (Gerin) for the 2011 IPCA increased from 5.20% to 5.42%. For 2012, the median of inflation expectations remained unchanged at 4.50%.

18. 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 2011 inflation increased relative to the figure considered at the December Copom meeting, and it stands 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 2011 also increased and stands above the inflation midpoint target. For 2012, the projection stands above the midpoint target in the benchmark scenario and around the target in the market scenario.

Monetary policy decision

19. 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 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.

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 strategy adopted by the Copom aims to ensure the convergence of inflation towards the targets path in 2011 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 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 seven years, at the same time that real interest rates have reduced. Progress in the financial markets structure, the FX and the inflationary risk premiums reduction, among other factors, seem to have determined 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. 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, volatility and risk aversion have remained high since the last Copom meeting, partially fueled by the extraordinary levels of global liquidity and by the prospects that this process can eventually accentuate. Concerns about European countries` sovereign and banking debts and the possible deceleration in China have remained high, at the same time that the confidence in the sustainability of the US economy recovery increased. Prices of relevant commodities grew, without movements, in the opposite direction, of domestic assets and, in general, the prospects for external funding of Brazilian economy remain favorable. Meanwhile, the trajectory of prices indices shows the increase of inflationary pressures in some relevant economies, whereas concerns regarding the prospects of deflation in other economies tend to deplete.

23. The Copom evaluates that domestic economy activity prospects are favorable in this and in the upcoming quarters. This assessment is supported by signs that the expansion of credit supply tends to persist, despite at a 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, mirrored in the historical low unemployment rates and substantial growth of real wages, particularly in the public sector.

24. The Copom evaluates that the development of the inflation prospective scenario developed unfavorably since the last meeting. In fact, in the last quarter of 2010, inflation was strongly and negatively impacted by the dynamics 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 Committee in its inflation forecasts, as well as market analysts projections. The Committee considers relevant the risks derived from the persistence of the mismatch between supply and demand growth rates. It is also noteworthy the narrow margin in production factors idleness, especially in labor force. Under such circumstances, a relevant risk is posed by the possibility of concession of nominal wages increase incompatible with productivity growth. The prospective scenario considers the seasonal aspect of inflation in the first quarter, as well as the atypical concentration of regulated prices adjustments foreseen to be implemented in

this period, although, for the year as a whole, the behavior of these items tend to be relatively benign. The benchmark scenario also considers the potential negative impact stemming from extremely adverse weather conditions observed in the beginning of this year in some regions of the country, although it attributes significant probability to the hypotheses that, at least in part, this process may be reverted during the year.

25. The Copom reaffirms that the inflation main scenario considers the materialization of its trajectories regarding fiscal variables. It bears highlighting that the generation of primary surpluses in line with the hypotheses considered for inflation projections, besides contributing to reduce the mismatches between supply and demand growth rates, will strengthen the reduction trend in the public debt/GPD ratio.

26. The Copom highlights that its main scenario for inflation also considers moderation in credit expansion, for which the macroprudential actions recently adopted contribute. The Committee considers that, in part, such regulatory changes should materialize as an element of aggregate demand constraint through the credit channel, as well as by the reduction of incentives to the adoption of strategies such as the simple broadening of contract tenures, among others. The available information confirm this opinion, by evidencing relevant impacts both in prices and in volume of goods traded in the credit market. Additionally, it is plausible to affirm that the current regulatory framework, compared to the previous one, tends to heighten the impacts of conventional monetary policy actions.

27. In short, the Copom recognizes an economic environment in which an above-than-usual uncertainty level prevails, and identifies increasing risks to the materialization of a scenario where inflation promptly converges to the midpoint target. Since the last Copom meeting, at the external outlook, the extraordinary liquidity levels, the introduction of new fiscal stimuli in the US and respective asset price spillovers have pointed to lower probability of reversion in the recovery process experienced by the G3 economies. From another point-of-view, they reveal the still ambiguous influence of the international outlook over domestic inflation behavior. Regarding the domestic outlook, the recently announced macroprudential actions, a fast and powerful tool to contain local demand pressures, will still have their effects incorporated to price dynamics. Since the last meeting, the materialization of short term risks which the Copom considered at that opportunity has also continued. Although uncertainties that surround the global outlook and, at a minor magnitude, the domestic one, do not allow the clear identification the degree of permanence of recent pressures, the Committee evaluates that the inflation prospective scenario evolved unfavorably.

28. In this context, the Copom unanimously decided to increase the Selic rate to 11.25% p.a., without bias, starting a process of adjustment of the basic interest rate, whose effects, combined to those stemming from macroprudential actions, will contribute to inflation convergence towards the target path.

29. 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 activity expansion and, hence, for the maintenance of the idleness level of factors at low levels. The effects of these stimuli, however, are counterbalanced by the effects of the reversal of initiatives taken during the recent 2008/2009 financial crisis, by the not yet very favorable prospects for global economy and, mainly, by recent macroprudential actions. These elements and the developments in the fiscal outlook 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.

30. At the end of the meeting it was announced that the Committee will reconvene on March 1st, 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

31. The IPCA rose 0.63% in December, down from 0.83% in November, totaling 5.91% in 2010, the highest annual rate since 2004 and 1.60 p.p. above the 2009 level. Market prices inflation retreated from 1.04% in November to 0.78% in December, with emphasis in the reduction from 1.53% to 0.95% in tradable products, favored by the deceleration of the increases in the prices of meat. Non-tradable products prices increased 0.63%, up from 0.60% in November, with highlights for the prices of services. Regulated prices increased by 0.26%, down from 0.33% in November. The diffusion index reached 62.24%, down from 67.19% in November, averaging 61.18% in 2010, up from 57.53% in the previous year.

32. Market prices increased 7.09% in 2010, up from 4.13% in 2009, while regulated prices recorded 3.13% and 4.74%, respectively. Market prices performance reflected the increased in tradable items, from 2.63% to 6.87% and non-tradable, from 5.53% to 7.28%, driven by the 10.39% increase in the prices of food and beverage, which had reached 3.17% in 2009. Services inflation increased 7.62%, up from 6.37% in the previous year.

33. The smoothed trimmed-means core IPCA inflation increased 0.52% in December, down from 0.56% in November, totaling 5.63% in the year, compared to 4.38% in 2009. The core inflation by exclusion that excludes ten items of household food and vehicles fuels rose 0.60% in December, up from 0.52% in November, totaling 5.45% in the year, up from 4.73% in 2009. The core inflation by exclusion that excludes the whole food and beverages group grew 0.42% in the month, compared to 0.41% in November, reaching 4.61% in the year, down from 4.65% in 2009, highlighting that this stability indicates the impact caused by the food group in the IPCA acceleration in 2010. The double weight core inflation rose 0.71% in December, up from 0.66% in November, reaching 5.62% in the year, up from 4.73% in 2009.

34. The IGP-DI increased 0.38% in December, down from 1.58% in November, reaching 11.30% in the year, compared to a 1.43% reduction in 2009, highlighting that the monthly rate resulted from a slowdown in the IPA and in the IPC rates and acceleration in the INCC rate. The IPA rose 0.21% in the month, down from 1.98% in November, mainly influenced by the monthly downward change from 5.56% to 0.18% in agricultural prices, driven by the reduction of 22.01% and 4.80% in the prices of beans and cattle, respectively, and by the deceleration in the price increase of soybeans, corn and cotton. The industrial products prices decreased from 0.75% to 0.22%, driven by the retreat in the prices of meat, meat products and fish. The IPA grew 13.85% in 2010, up from -4.08% in 2009, due to the increases of 25.61% in agricultural products and 10.13% in industrial products. The IPC, favored by the deceleration in the prices increase of food, mainly meat, increased 0.72% in December, down from 1.00% in November, reaching 6.24% in the year, up from 3.95% in 2009. The INCC grew 0.67% in December, up from 0.37% in November, highlighting that the 7.77% increase in the index, compared to 3.25% in 2009, was especially related to the 10.41% increase in labor force cost.

Economic activity

35. The IBC-Br increased 0.4% in November, the sixth consecutive monthly rise, according to seasonally adjusted data. For the quarter ended in November, the IBC-Br increased by 1.1%, relative to the quarter ended in August, which had recorded 0.3% according to the same comparison basis. According to the observed series, the IBC-Br increased 6.5% in November, year-over-year, accumulating 8.1% in the year and 8.3% in the last twelve months.

36. Expanded retail sales increased 1.4% in November, month-on-month, according to data seasonally adjusted by the IBGE's monthly survey (PMC), contributing to the 3.4% increase in the average of the quarter ended in November compared to the quarter ended in August. Retail sales grew 1.1% in the month and 2.2% in the quarter. Sales increased in eight of the ten sectors surveyed, with highlights for sales of office equipment and material (10.5%) and books, newspapers, magazines and stationery (6.6%). On the other hand, the sales of fabric, clothing and shoes reduced by 3.6%.

37. Expanded retail sales grew 17% in November, year-over-year, accumulating increases of 11.9% in the year and 12.1% in the last twelve months. Interannual evolution stemmed from sales in all segments considered in the PMC, with highlights for vehicles and motorcycles, parts and pieces (30.3%), books, newspapers, magazines and stationery (23.2%), and furniture and appliances (20.5%). The retail sales path in the first eleven months of the year was equally due to the increase in all considered activities, especially the ones related to office equipment and material (23.8%), furniture and appliances (18.3%), construction inputs (15.6%). The expanded sales in the twelve months through November showed general growth in sales by activity, highlighting office equipment and material (21.3%), furniture and appliances (17.7%), construction inputs (14.9%) and vehicles and motorcycles, parts and pieces (14%).

38. Automobile sales by dealers, including cars, light commercial vehicles, trucks and buses, increased 0.3% in December, month-on-month, according to Fenabrave (Brazilian Federation of Automotive Vehicles Distribution) data, seasonally adjusted by the BCB, totaling 5.2% in the quarter ended in December, quarter-on-quarter. Automobile sales increased 11.9% in the year, with emphasis on the sales of trucks (44.2%), light commercial vehicles (27.8%) and buses (25.3%).

39. Capital goods imports increased 5% in November, month-on-month, according to the Funcex quantum index, seasonally adjusted by the BCB. Year-over-year, the indicator rose 47.8%, while in the year through November and on a twelve-month trailing basis, it increased 42.8% and 37.9%, respectively, compared to the same periods of the previous year.

40. Capital goods production increased 3.2% in November, but decreased 1.4% in the quarter compared to the quarter ended in August, according to data seasonally adjusted from the Monthly Industrial Survey (PIM) by IBGE. The monthly increase reflected, in part, rises in the production of capital goods for serial industrial purposes (4.6%), for construction (4.2%), and for mixed use (4%), in opposition to reduction in the production of capital goods for non-serial industrial purposes production (16%) and capital goods for agricultural production (7.2%). Capital goods production increased 22.3% in the first eleven months of the year, compared to the same period of 2009, highlighting the 107.9% increase in the segment of goods for the construction sector.

41. Construction inputs production increased 1.4% in November, equal to the rate recorded for the quarter ended in the month, compared to the quarter ended in August, according to seasonally adjusted data. The industry grew 7.6% year-over-year, accumulating increases of 12.3% and 12.5% in the year through November and in the last 12 months, compared to the same periods of 2009.

42. Disbursements granted by the BNDES reached R$153.6 billion in the year through November, increasing by 30.8% year-over-year, with emphasis in the 48.2% expansion in the agriculture and livestock sector. The disbursements share to the industrial sector totaled 47% of the total, followed by infrastructure (31%), trade and services (16%) and agriculture and the livestock (6%) sectors.

43. Industrial production decreased 0.1% in November, month-on-month, according to seasonally adjusted data from the PIM-PF, while the average of the quarter ended in November increased 0.3% compared to the average recorded in the quarter ended in August, when it had decreased 1.3%, according to the same comparison basis. By use categories, capital goods production increased 3.2% in the month, followed by changes in the production of intermediate goods (1%), durable consumer goods (-0.7%), and semi-durable and non-durable goods (-0.5%), highlighting that from the 26 industry activities, fourteen posted monthly increase. Quarterly evolution partially reflected increases in publishing, printing and reproduction (9.9%), furniture (7.7%) and office machines and computing equipment (7.6%), and, in contrast, the retreats in electronic material and communication equipment (14.2%), shoes and leather (5.8%) and basic metallurgy (4.2%) production.

44. Industrial production increased 5.3%, year-over-year, with highlights to the expansion of capital goods production (9%), followed by the production of intermediate goods (5.8%),

durable goods (4.6%) and semi- and non-durable consumer goods (3.1%). On a twelve-month trailing basis, general industry grew 11.7% in November, year-over-year, with highlights to the increases in the production of capital goods (22.4%), durable consumer goods (13.3%), and intermediate goods (12.9%).

45. The Nuci in the manufacturing industry, calculated by FGV, reached 85.3% in December, compared to 86.1% in November and 84.2% in the same month of 2009. The monthly reduction was driven by the retreat in all categories, highlighting the 1.00 p.p. decrease in the consumer goods industry. The Nuci in the capital goods, construction material and intermediate goods industries reduced 0.4 p.p., 0.4 p.p. and 0.3 p.p., respectively, in the period. The increase year-over-year was driven by increases in construction material (4.1 p.p.), capital goods (3.6 p.p.) and intermediate goods (1.9 p.p.) industries and reduction in the consumer goods segment (0.8 p.p.).

46. Vehicles production reached 302 thousand units in December, increasing 1.1% month-on-month, according to data released by the Anfavea and seasonally adjusted by the BCB. The sector production expanded 19.5% year-over-year, totaling a 14.9% increase in the year through November, compared to the same period of 2009.

47. Vehicles sales increased 6.4% in December month-on-month, and 31.5% year-over-year. The month-on-month change was due to the 19.8% increase in domestic sales and -22.7% in exports, while the interannual result stemmed from changes of 41.8% and -8.6%, respectively, in the same indicators. The sector sales increased 16.1% in 2010, as domestic sales increased 8.2% and exports, 61.1%.

48. The third prognosis carried out by the IBGE in December for the 2011 harvest estimated 145.8 million tons of cereals, legumes e oilseed, 2.5% below the one recorded in 2010, with emphasis in the estimated reduction in the South region. Rice and beans harvests are expected to grow by 12.6% and 10.2% and wheat, corn and soybeans are expected to reduce by 18.3%, 7.4% and 0.8%. Total harvest should increase by 1.8%, to 47.4 million ha.

Surveys and expectations

49. The Consumer Confidence Index (ICC) from FGV decreased 2.1% in December, month-on-month, reaching 122.5 points, considering seasonally adjusted data, but still stands at a high level. There were declines in the Expectation Index (IE), by 3.4% and in the Current Situation Index (ISA), by 0.4%. The ICC increased 8.9% year-over- year, due to the increases of 21.2% in the ISA and of 1.4% in the IE.

50. The Industry Confidence Index (ICI) from FGV increased 1.6% in December, month-on-month, reaching 114.5 points, equal to the 2010 average level. The IE increased 1.9% and the ISA, 1.3%. The ICI grew 1% year-over- year, due to the 3.9% increase in the ISA and the 1.9% decrease in the IE.

51. The Services Confidence Index (ICS) from FGV increased 0.3% in December month-on-month, reflecting the increase of 5.7% in the ISA, and the fall of 4.4% in the IE. The ICS grew 1.7%, year-over-year, recording a 7.8% increase in the ISA and a 3.5% decrease in the IE.

Labor market

52. According to the General Record of Employment and Unemployment (Caged) of the Ministry of Labor and Employment (MTE), 407.5 thousand formal jobs were eliminated in December, being 153 thousand in manufacturing industry, 92.2 thousand in agriculture, 79.6 thousand in civil construction and 75.2 thousand in the services sector, while commerce was responsible for the net creation of 14.4 thousand jobs. In 2010, 2,136.9 thousand jobs were created, a record high since the beginning of the series in 1985, with emphasis in hirings in the services sector (864.3 thousand), commerce (519.6 thousand), manufacturing industry (485 thousand) and civil construction (254.2 thousand), representing employment increase of 5.7%, 6.1%, 6.3% and 13.8%, respectively, compared to 2009.

53. According to the IBGE employment survey (PME), carried out in the six main metropolitan regions of the country, the unemployment rate reached 5.7% in November, a historical record low for the series begun in April 2002. The monthly reduction, the sixth

consecutive retreat according to this comparison basis, reached 0.4 p.p., while on a twelve-month trailing basis, the decrease totaled 1.7 p.p. In seasonally adjusted terms, the unemployment rate reached 6% in November, down from 6.3% in the previous month, as a result of the 0.1% increase in occupation and 0.2% reduction in the Economically Active Population (PEA). Average real earnings usually earned by workers reduced by 0.8% in November, interrupting the sequence of five consecutive monthly increases, but increased 3.6% in the year through November, while payroll changed -0.6% and 7.3%, according to the same comparison bases.

Credit and delinquency rates

54. Outstanding credit in the financial system reached R$1,678 billion in November, equivalent to 46.3% of GDP, increasing by 2% in the month, 18.6% in the year and 20.8% in twelve months. Non-earmarked credit operations increased by 2%, 15.4% and 16.5%, respectively, according to the same comparison bases, reflecting the increases of 2.1%, 16.8% and 18% for credit operations to individuals and 1.8%, 14% and 15% for credit operations to corporate, according to the same comparison bases. Earmarked credit operations increased 2% in the month, 25.3% in the year and 30.2% in twelve months, with highlights for the rises of 3.4%, 44.9% and 53.6% recorded in housing credit and of 1.9%, 39.3% and 46% recorded in BNDES disbursements, according to the same comparison bases.

55. The average interest rate on non-earmarked credit operations decreased 0.6 p.p. in November, reaching 34.8%. The average annual rates on credit for individuals reached 39.1% and for corporate, 28.6%, which represented respective reductions of 1.3 p.p. and 0.1 p.p.

56. The average tenure on non-earmarked credit operations increased from 456 days in October to 469 days in November, representing an increase of thirteen and twelve days for tenures related to individuals and corporate segments, which reached 551 days and 395 days, respectively.

57. 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 November. Delinquency rates for credit operations with individuals reduced 0.1 p.p., to 5.9%, and the one relative to corporate increased by 0.1 p.p., to 3.6%.

External environment

58. Although the prospects for developed economies to enter new short-term recessive period have strongly decreased since the last Copom meeting, the risks associated to the evolution of a benign scenario for the global economic activity remain relevant, in special those associated to the fiscal crisis in some Euro Area economies. In the US, the current prospects consider better domestic demand development, mainly consumption, in an environment of reduction of uncertainties associated to employment and income. The recent extension of tax cuts' fiscal law in the US, which included reduction in taxes levied on payroll, contributes for this favorable prospect.

59. Commodities international prices registered strong increase in the last months of 2010, in some cases exceeding the record highs reached in 2008. Heightened by investors' actions in financial markets, the occurrence of adverse weather conditions and consumption strengthening worldwide were the main drivers of that behavior. In special, the performance of agricultural commodities prices trend was highly impacted by the deterioration of supply conditions in several regions, reflecting the climate impact caused by La Niña phenomena. In the financial markets, the main stock market indices have registered gains since the last Copom meeting, influenced by economic agents' optimism, in an environment of abundant liquidity.

60. December inflation indices captured the trajectory of commodities prices increase. Annual CPI in the US, Euro Area, Chile, Mexico, Indonesia and Russia reached 1.50%, 2.20%, 3.00%, 4.40%, 7.00% and 8.80%, respectively, in December, compared to 1.10%, 1.90%, 2,50%, 4.30%, 6.30% and 8.10%, respectively, in November. This trend reflects, in emerging markets, increases in the prices of agricultural commodities, domestic demand strengthening and product gap reduction in their

economies, while in the US and in the Euro Area, December hikes are mainly associated to increases in energy prices. It bears emphasizing that, in these economies, evidencing the scenario of low level installed capacity utilization and high unemployment rates, inflationary pressures continue to be contained, registering, in December, 0.80% and 1.10% CPI core annual changes, respectively, in the US and in the Euro Area.

61. In this context, the central banks in the US and Euro Area maintained the accommodative stance of their policies, choosing by keeping their respective basic interest rates unchanged, being followed by the UK and Japan central banks. It bears highlighting that, since the last Copom meeting, several central banks, among which the ones from Chile, Peru, Hungary, Sweden, China, Korea and Thailand, have increased their respective basic interest rates. On January 14th the People´s Bank of China (PBOC) announced new increase in reserve requirements, the fourth rise since November last year.

Foreign trade and international reserves

62. The Brazilian trade surplus reached US$5.4 billion in December, the highest monthly surplus in the year, contributing for the annual result of US$20.3 billion. Exports reached new monthly historical high of US$20.9 billion and imports totaled US$15.6 billion. On a daily average basis, the trade surplus fell by 20.1%, year-over-year, recording growth of 41.6% in imports and 31.4% in exports.

63. International reserves reached US$288.6 billion in December, increasing US$3.1 billion compared to November and US$50.1 billion in the year. The monetary authority’s interventions accounted for net purchases of US$2.1 billion in the domestic market, in the month, accumulating US$41.4 billion in the year.

Money market and open market operations

64. Since the last Copom meeting, in December, the futures interest rate yield curve shifted upwards for all tenors. This movement was influenced by several factors, among which the release of high current inflation indices, including different core measures; the upward trajectory of commodities prices in the international market; and uncertainties related to the implementation of the fiscal adjustment announced by the government. Moreover, for the short term tenures, the market agents’ prospects regarding the start of a new cycle of basic interest rate increase also contributed for the upward movement in the rates. Between December 6th 2010 and January 17th 2011, one-, three- and six-month interest rates increased 0.38 p.p., 0.49 p.p. and 0.47 p.p., respectively. One-, two- and three-year interest rates increased 0.43 p.p., 0.41 p.p. and 0.45 p.p., respectively. Real interest rates, measured by the differential between the one-year forward nominal interest rate and the smoothed twelve-month-ahead inflation expectations, increased from 6.30% on December 6th 2010 to 6.61% on January 17th 2011.

65. On January 14th, the Central Bank carried out reverse exchange rate swap auctions, in which it assumed long FX position and short interest rate position. This operation totaled the equivalent to US$987.9 million.

66. In its open market operations, the BCB carried out, between December 7th 2010 and January 17th 2011, repo operations borrowing R$41.5 billion for a six-month period. As a consequence, the average daily balance of the long operations reached R$138.9 billion. In the same period, the BCB also borrowed money through repo operations with tenures between thirteen and thirty working days, increasing the average daily balance of short-term borrowing operations to R$129.9 billion. The BCB also borrowed money through 31 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$89.7 billion in the period, borrowing. The average daily balance of the total stock of repurchase agreements of the Central Bank decreased from R$395.4 billion between October 19th and December 6th to R$358.5 billion, between December 7th 2010 and January 17th 2011. Considering the daily balance of operations for the most recent period, there was an increase in the daily balance of repurchase agreements totaling R$23.1 billion, elevating the total stock from R$373.6 billion on December 6th

2010 to R$396.7 billion on January 17th. The main driver of liquidity expansion in the period was the net redemption of securities by the National Treasury.

67. Between December 7th 2010 and January 17th 2011, the National Treasury issuance regarding the traditional auctions raised a total of R$35.2 billion. The sale of fixed-rate securities reached R$19.8 billion, with R$18.1 billion via issuance of LTNs maturing in 2011, 2012, 2013 and 2015, and R$1.7 billion via NTN-Fs maturing in 2015, 2017 and 2021. Issuance of LFTs totaled R$11.5 billion, for securities maturing in 2015 and 2017. Issuance of inflation-linked NTN-Bs reached R$3.9 billion, for securities maturing in 2014, 2016, 2020, 2030, 2040 and 2050.

Minutes of the 157th Meeting of the Monetary Policy Committee (Copom)

Date: March 1st, 2011, from 4:15PM to 6:45PM, and March 2nd, from 4:35PM to 8:10PM
Place: BCB Headquarters meeting rooms – 8th floor on March 1st and 20th floor on March 2nd – Brasília – DF

In attendance:
Members of the Committee
Alexandre Antonio Tombini – Governor
Aldo Luiz Mendes
Altamir Lopes (present only on March 2nd)
Alvir Alberto Hoffmann (present only on March 1st)
Anthero de Moraes Meirelles
Antonio Gustavo Matos do Vale (present only on March 1st)
Carlos Hamilton Vasconcelos Araújo
Luiz Awazu Pereira da Silva
Sidnei Corrêa Marques (present only on March 2nd)

Department Heads (present on March 1st)
Adriana Soares Sales – Research Department (also present on March 2nd)
João Henrique de Paula Freitas Simão – Open Market Operations Department
Márcio Barreira de Ayrosa Moreira – International Reserves Operations Department
Renato Jansson Rosek – Investor Relations and Special Studies Department
Rodrigo Collares Arantes – Department of Banking Operations and Payments System
Tulio José Lenti Maciel – Economic Department

Other participants (present on March 1st)
Other participants (present on March 1st)
Alexandre Pundek Rocha – Advisor to the Board
Eduardo José Araújo Lima – Advisor to the Research Department
Emanuel Di Stefano Bezerra Freire – Advisor to the Board
Gustavo Paul Kurrle – Press Officer
Katherine Hennings – Advisor to the Board
Nelson Ferreira Souza Sobrinho – Senior 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. After recording 0.63% in December 2010, monthly inflation measured by IPCA reached 0.83% in January 2011. As a consequence, twelve-month trailing inflation reached 5.99%, 1.40 p.p. above inflation registered in the twelve months through January 2010. The inflation increase in this period reflected, basically, the behavior of market prices, which increased 7.17% and contributed 5.0 p.p. of the 5.99 p.p. total variation. In fact, the increase in regulated prices in the last twelve months through January 2011 (3.24%) was below the one recorded for the twelve months ended in January 2010 (4.82%), contributing only 1.0 p.p. for the 5.99% headline inflation. Regarding market prices, it bears highlighting that tradable goods inflation reached 6.61% and the non-tradable goods increased 7.65%, in the last twelve months through January 2011.

Services price inflation continues at high levels and, in the twelve-month period through January 2011, it reached 7.89%. In short, the set of available information suggests that prices acceleration observed in 2010, process lead by market prices, may show some persistence, in part because services inflation remains at high levels.

2. The food prices trajectory continues to perform relevant role in recent acceleration of headline inflation. In the last three months, the IPCA recorded 2.31%, up from 1.24% observed in the last three months through October 2010 and 0.44% in the three months ended in July 2010. In the same periods, prices of food and beverages changed 4.77%, 2.74% and -1.38%, respectively. In the last twelve months, household food price inflation changed from 2.53%, in July 2010, to 6.89% in October, and reached 10.68% in January 2011. At the same time, IPCA inflation stood at 4.60%, 5.20% and 5.99%, respectively. The recent elevation in food prices reflects, in part, supply shocks, domestic and external, heightened by the high liquidity environment in international financial markets and by global demand increase.

3. In line with the evolution of headline inflation, each one of the three main underlying inflation measures calculated by the BCB increased in January this year. The smoothed trimmed means core inflation moved from 0.52% in December 2010 to 0.54% in January 2011. In the same months, the double weight core inflation increased from 0.71% to 0.80%, while the core inflation by exclusion increased from 0.60% to 0.76%. In the last twelve months through January 2011, the three core inflation measures reached 5.69%, 5.83% and 5.63%, respectively. The IPCA diffusion index, which had reached 62.2% in December, increased to 69.3% in January, evidencing higher of prices acceleration dissemination.

4. The General Price Index (IGP-DI) inflation recorded 0.98% in January 2011, value above the one registered in December 2010 (0.38%). In the last twelve months, inflation reached 11.27%, above the level recorded in the last twelve months through January 2010 (-0.45%). Inflation measured by its main component, the Wholesale Price Index (IPA-DI), reached 13.85% in the twelve months through January 2011 (-2.84%, according to the same comparison basis), reflecting the increase of 9.32% in the industrial IPA and 28.40% in the agricultural IPA. Inflation measured by the Consumer Price Index (IPC-DI), another component of the IGP-DI, recorded 6.21% in the twelve months through January 2011, above the 4.42% recorded until January 2010. According to the same comparison basis, the Civil Construction National Index (INCC), component with the lowest weight in the IGP-DI, increased 7.52%, above the 3.56% recorded in the previous period. 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 Economic Activity Index 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. Considering seasonally adjusted data, the IBC-Br performed positively in every month in the second half of 2010, but showed relative stability in December 2010 (0.1%). Year-over-year, the index showed 3.7% growth in December and, comparing to the 2010 average, the it increased 7.8%. The Services Confidence Index (ICS), from FGV, reduced 3.0% in January 2011, month-on-month; 1.3%, year-over-year; and 3.3% compared to the 2010 average index.

6. Industrial activity has not shown consistent signs of entering a new expansion cycle yet. According to data seasonally adjusted by the IBGE, industrial output increased by 0.2% in January, after a 0.8% retreat in December, and 0.1% in November, month-on-month. January output is still 2.6% below the record high observed in March 2010. On the other hand, the three-month moving average growth rate reached -0.2% in the period between October and January – the same rate observed in the last quarter of 2010. Year-over-year, output increased 2.5% in January. In the last twelve months, output increased 9.4% in January, down from 10.4% in December, continuing the process of growth cooling. The diffusion index,

which measures the percentage of products that registered output increase year-over-year, reached 56% in January, compared to 55.4% in December. Compared to December 2008, month that recorded the lowest output during the 2008/2009 crisis, growth pace moderation through January reached 23.1%. The recovery dynamics was partially supported by the growth of industrial activity financed by public financial institutions.

7. Among the industry use categories, according to data seasonally adjusted by the IBGE, durable consumer goods production grew 6% in January, month-on-month, while non-durable and semi durable consumer goods expanded 0.2%. In the same period, capital goods production increased 1.8%, while intermediate goods production reduced 0.4%. Considering the three-month moving average ended in January, durable consumer goods production increased 1.8%, while non-durable and semidurable consumer goods reduced 0.2%. Under the same criterion, capital goods production increased 1.4%, while intermediate goods expanded by 0.1%. It bears highlighting, however, that the capital goods industry activity growth, accumulated in twelve months, is the highest among the use categories, with a 20.4% increase. Such behavior evidences the investment robustness, 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), according to observed data, increased from 5.3% in December 2010 to 6.1% in January 2011, below the 7.2% level registered in January 2010. After reaching 9.0% in March 2009, the observed data not only significantly reduced until January, but reached a record low for the month since the start of the series in March 2002. The seasonally adjusted rate registered 6.3% in January, a 0.1 p.p. increase compared to December. Employment, measured by the number of employed workers in the metropolitan regions, year-over-year, increased 2.9% in December 2010 and 2.2% in January 2011. Data from the Ministry of Labor and Employment (MTE) indicate growth in formal employment in eleven out of the twelve last months. In January, 152.1 thousand jobs were created (181.4 thousand in January 2010), while in December 2010, 407.5 thousand jobs were eliminated (415.2 thousand reduction in December 2009). In the last twelve months through January, 2.11 million jobs were created (2.47 million according to the criterion that considers data delivered with delay by the companies). Services was the sector that most contributed for the formal employment increase in January, accounting for 48.1% of the increase in the month. The services sector also was the main driver for the increase in the last twelve months, being responsible for 41.7% of job creation in the period. Real average earnings observed in January increased 0.5% month-on-month and 5.3% year-over-year. As a consequence, real payroll, considering real average earnings in the six metropolitan regions, expanded 7.7% in January, year-over-year, continuing to constitute a key driver for the maintenance of domestic demand growth, although there is evidence that the growth rate of this indicator may decrease in the upcoming months.

9. According to the retail monthly survey (PMC) from the IBGE, expanded retail sales has been increasing since May 2009, year-over-year. Growth was 14.8% in December 2010, 17.0% in November and 11.1% in October. According to the seasonally adjusted series, expanded retail sales increased for the eighth consecutive month, 2.3% in December, up from 0.4% in November and 2.2% in October. Therefore, average sales in the quarter ended in December increased 4.2%, quarter-over-quarter. It also bears noticing that eight out of the ten sectors surveyed performed positively month-on-month in December, with highlights for vehicles and motorcycles, parts and pieces (4.7%) and fabric, clothing and shoes (3.4%). In the next months, the retail trajectory will continue to be benefited by governmental transfers, real payroll growth, moderate credit expansion and consumer confidence.

10. The installed capacity utilization rate (Nuci) in the manufacturing industry, calculated by FGV, without seasonal adjustment, changed from 83.1% in January to 83.7% in February. These values are close to the observed in the same period of 2010. According to the seasonally adjusted monthly series calculated by FGV, the Nuci reduced from 84.7% in January to 84.5% in February. Two out of the four use categories retreated in February, month-on-month. The Nuci in the intermediate goods industry reduced 0.8 p.p.,

while in the consumer goods industry, it decreased by 0.2 p.p. For the construction inputs industry, the Nuci increased from 89.5% in January to 89.9% in February, according to seasonally adjusted data, while in the capital goods industry, it increased from 84.2% to 84.8% in the same period. According to CNI data seasonally adjusted by the BCB, the Nuci in December reached 82.8% in December, up from 82.7% in November. Therefore, installed capacity utilization rates have shown relative stability, at high levels. The high occupation level reflects the recent expansion in economic activity, whose effects have not been totally offset by the maturity of investment projects. In this sense, the absorption of capital goods grew 26.1% in 2010, year-over-year. Construction inputs production increased 11.9%. 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.

11. The trade balance result in the last twelve months increased from US$20.9 billion in January to US$21.7 billion in February. This result stemmed from US$210.4 billion in exports and US$188.7 billion in imports, equivalent to 33.9% and 42.0% changes, respectively, compared to the twelve month period ended in February 2010. Current account deficit accumulated in twelve months increased from US$47.5 billion in December to US$49.1 billion in January, equivalent to 2.35% of GDP. On its turn, foreign direct investment reached US$ 50.8 billion in the last twelve months through January, equivalent to 2.43% of GDP, exceeding the need for foreign funding.

12. Since the last Copom meeting, the trend of global economy recovery has persisted, mainly in the US economy, whose domestic demand shows some dynamism, especially in household consumption, in spite of continued uncertainties regarding labor market. The leading indicator published by the Organization for Economic Co-operation and Development (OECD) – often used for inferences regarding the future behavior of global industrial production –, for instance, registered, in December, the fourth consecutive monthly increase. The indicators disaggregated by country suggest acceleration in growth pace or continued growth in all G7 countries, except Italy. The Euro Area macroeconomic prospects, in particular, are asymmetrical, as uncertainties regarding the solvency of some peripheral economies persist, at the same time that the expansion pace remains strong in Germany. Inflation rate cores are still at moderate levels in the G3 group (US, Euro Area and Japan), in spite of extremely expansionist economic policy actions, both in fiscal and monetary sides. On its turn, headline consumer inflation rates reached 1.6% in the US and 2.3% in the Euro Area, in the twelve months through January 2011, mainly due to the hikes in energy prices. In the emerging countries, there are inflationary pressures in Latin America, Asia and Eastern Europe. Since the last meeting there was a moderate monetary tightening in several economies – among them, China and India. The People’s Bank of China announced the fifth increase in reserve requirements, since November last year.

13. Brent oil prices have increased since the last Copom meeting, surpassing the US$100 level. This price acceleration is consistent with a framework of apparent strengthening in the global demand framework – given that empiric evidences suggest that international oil prices, in the last two decades, have been determined more by global demand conditions than by the supply side – as well as with political instability in some countries of the Middle East and, especially, in North Africa. It bears highlighting that geopolitical complexity that involves the oil sector tends to heighten price volatility, which is also a reflex of the low predictability of some global demand components and of the dependency of supply growth on long term risky investment projects. The main scenario adopted by the Copom assumes unchanged domestic gasoline prices in 2011. It is also noteworthy the continuous increase in the prices of international agricultural and metallic commodities prices. In this sense, the current quarterly readjustment system for iron ore price reinforces future price increase expectations. The food price index, calculated by the Food and Agriculture Organization of the United Nations (FAO), which considers 55 items, reached a new record high in January 2011, resulting in 28.4% increase in twelve months. This movement was leveraged, among other factors, by the increase in international prices of sugar, cereals

and vegetable oils. In recent past, the high volatility observed in commodities prices seems to have been strongly impacted by the abundant global liquidity, in a context where financial markets adjust to new expectations of demand growth and to FX markets volatility.

Assessment of inflation trends

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

a) the projected adjustments for gasoline an bottled gas prices in 2011 were kept unchanged at 0%, the same considered at the January Copom meeting;

b) the projected adjustments for fixed telephone and electricity rates in 2011 were kept at 2.9% and 2.8%, respectively;

c) the projection for regulated prices inflation in 2011, based on individual items, according to the benchmark scenario, was kept at 4.0%, unchanged relative to the January meeting. This set of prices, according to data released by the IBGE, accounted for 28.90% of the total January IPCA;

d) the projection for regulated prices inflation in 2012, according to the benchmark scenario, was reduced to 4.3%, down from 4.4% considered in the January meeting. 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 29 bps and 46 bps spreads in the fourth quarters of 2011 and 2012, respectively.

15. Regarding fiscal policy, projections assume the achievement of a public sector primary surplus target of 3.0% of GDP, without adjustments, in 2011 (according to parameters contained in the Budget Guidelines Law – 2011). Moreover, a primary surplus of 3.1% is considered for 2012.

16. The set of projections incorporated the estimated effects of the reserve requirements measures announced in December.

17. Since the last Copom meeting, the median of the expectations compiled by the BCB's Investor Relations and Special Studies Department (Gerin) for the 2011 IPCA increased from 5.42% to 5.80%. For 2012, the median of inflation expectations moved from 4.50% to 4.78%.

18. The benchmark scenario assumes the maintenance of the exchange rate at R$1.65/US$1.00 and the Selic rate at 11.25% p.a. during the forecast period. Under this scenario, the projection for the 2011 inflation increased relative to the figure considered at the January Copom meeting, and it stands 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 2011 also increased and stands above the inflation midpoint target. For 2012, the projection reduced in the benchmark scenario, but still stands above the midpoint target, while, in the market scenario, it stands around the midpoint target.

Monetary policy decision

19. The Copom evaluates 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 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.

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 companies. 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 originate any lasting results for economic and employment growth; 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 2011 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 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 seven years, at the same time that real interest rates have reduced. Progress in the financial markets structure, the FX and the inflationary risk premiums reduction, among other factors, seem to have determined significant reduction in the neutral rate. The generation of primary surpluses consistent with the maintenance of the 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. 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, volatility and risk aversion have increased since the last Copom meeting, partially fueled by the extraordinary levels of global liquidity, although the chances of adoption of a new set of unconventional monetary actions and adverse geopolitical developments have diminished. While concerns about European countries` sovereign and banking debts and the possible deceleration in China have remained high, the confidence in the sustainability of the US economy recovery has increased. Prices of relevant commodities grew, without movements, in the opposite direction, of domestic assets and, in general, the prospects for external funding of Brazilian economy remain favorable. Meanwhile, the trajectory of prices indexes shows some dissemination of inflationary pressures in the main economies.

23. The Copom evaluates that, although moderation of domestic demand growth is observed, yet in uncertain pace, prospects for economic activity are favorable. This assessment is supported by signs that point to the fact that the expansion of credit supply tends to persist, both for individuals and corporate, despite showing some cooling, 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, mirrored in historically low unemployment rates and substantial growth of real wages, particularly in the public sector.

24. The Copom evaluates that the inflation prospective scenario has not developed favorably since the last meeting. In fact, in the last quarter of 2010 and at the beginning of this year, inflation was strongly and negatively impacted by the dynamics of food prices, which in part reflected domestic and external supply shocks. Evidences suggest that consumer prices

have already incorporated substantial part of these shocks' effects, and have also absorbed the seasonal effects typical from the first two months of the year. The localized effects stemming from atypical concentration of regulated prices readjustments in the same period were also relevant, although, for the year as a whole, the behavior of these items tends to be relatively benign. The Committee considers that these effects should still impact consumer prices dynamics, among other mechanisms, through inertia. At the same time, it evaluates, as relevant, risks derived from the persistence of the mismatch between supply and demand growth rates, despite the signs that this mismatch tends to retreat. Moreover, it highlights the narrow idleness margin of the production factors, specially labor force, and analysis that, in such circumstances, an important risk stems from the possibility of concession of nominal wages increases incompatible with productivity gains. It is also noteworthy to mention the risks associated to commodities prices trajectory in international markets, which has been surrounded by great uncertainty.

25. The Copom considers two distinct moments for inflation trajectory, according to the 2011 main scenario. In this quarter and in the following two, inflation accumulated in twelve months tends to remain at levels similar or even above the current one. This, in part, is explained by the high inertia that stemmed from 2010 and by the fact that the projections, in contrast with what was observed in 2010, point to inflation rates close to the historical standard in the quarter ending in August 2011. However, from the fourth quarter on, the main scenario indicates a downward trend for the inflation accumulated in twelve months, moving to the target direction.

26. The Copom reaffirms that the inflation main scenario considers the materialization of its trajectories regarding fiscal variables. It bears highlighting that the generation of primary surpluses in line with the hypotheses considered for inflation projections, besides contributing to reduce the mismatches between supply and demand growth rates, will strengthen the reduction trend in the public debt/GPD ratio. It bears highlighting that since the last Committee meeting, important decisions have been taken and implemented, which support the vision that, in the beginning of this year, a fiscal consolidation process began.

27. The Copom highlights that its main scenario for inflation also considers moderation in credit expansion, for which the macro prudential actions recently adopted contribute. The Committee considers that, although such regulatory changes target primarily the financial system stability, they should also materialize as an element of aggregate demand constraint through the credit channel, as well as through the reduction of incentives to the adoption of strategies such as the simple extension of contract tenures, among others. The available information confirm this opinion, by evidencing relevant impacts both in the prices and in the volumes negotiated in the credit market. Additionally, it is plausible to affirm that the current regulatory framework, compared to the previous one, tends to intensify the impacts of conventional monetary policy actions.

28. In short, the Copom recognizes an economic environment in which an above-than-usual uncertainty level prevails, and identifies increasing risks to the materialization of a scenario where inflation promptly converges to the midpoint target. Since the last Copom meeting, at the external outlook, stimuli factors and assets prices spillovers have pointed to lower probability of reversion in the recovery process experienced by the G3 economies. From another point-of-view, they still reveal the ambiguous influence of the international outlook over domestic inflation behavior. Regarding the domestic outlook, the recently announced macro prudential actions – a fast and powerful tool to contain local demand pressures –, and conventional monetary policy actions will still have their effects incorporated to price dynamics. Although uncertainties that surround the global outlook and, at a minor magnitude, the domestic one, do not allow the clear identification of the degree of permanence of recent pressures, the Committee evaluates that the inflation prospective scenario has not evolved favorably.

29. In this context, continuing the process of monetary conditions adjustment, the Copom unanimously decided to increase the Selic rate to 11.75%, without bias.

30. Domestic demand is robust, largely due to the effects of stimulus factors, such as income growth and credit expansion. Moreover, although recent initiatives point to some constraint in public sector expenditures, fiscal and credit incentives provided to the economy in the last quarters should still contribute for the activity expansion and, hence, for the maintenance of the idleness level of factors at low levels. The effects of these stimuli, however, are counterbalanced by the effects of the reversal of initiatives taken during the recent 2008/2009 financial crisis and, especially, by macro prudential and conventional monetary policy actions recently taken. These elements and the fiscal and quasi fiscal developments 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.

31. In an alternative scenario, which takes in consideration the maintenance of the foreign exchange rate, in the relevant horizon, at levels similar to the observed in the recent past, and the interest rate path collected by Gerin, projected inflation is above the target rate in 2011 and slightly below it in 2012. Considering this alternative scenario and prospects of domestic activity slowdown, as well as the current complexity of the international environment, among other factors, the introduction of macro prudential actions may create opportunities for the reassessment of monetary policy strategy.

32. At the end of the meeting it was announced that the Committee will reconvene on April 19th, 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-15 rose 0.97% in February, up from 0.76% in January and 0.69% in December, totaling 1.74% in the year and 6.08% in twelve months, according to IBGE data. Market prices inflation rose from 0.85% in January to 1.08% in February, reflecting the increase from 1.02% to 1.97% in the prices of non-tradable products, influenced, mainly, by the increase in the prices of services, from 0.88% to 2.34%. The prices of tradable goods retreated from 0.66% in January to 0.06% in February. Regulated prices increased 0.69%, up from 0.53% in January. The group education registered the higher contribution for the index in the month, 0.42 p.p., followed by transportation, 0.19 p.p. The diffusion index reached 66.41% in the month, down from 68.23% in January. The diffusion index, excluding beverages and food, rose from 58.67% in January to 70.22% in February.

34. Market prices increased 7.26% in the last twelve months through February, up from 7.22% in January, while regulated prices increased 3.30% and 3.31%, respectively. Market prices change reflected the acceleration from 7.48% to 7.86% in the prices of non-tradable products, mainly services, and the retreat from 6.87% to 6.52% in the prices of tradable products.

35. All core inflation measures presented higher rates in the last twelve months through February, while on a month-on-month basis, the smoothed trimmed-means inflation core retreated. The IPCA-15 core, considering the smoothed trimmed-means inflation core, increased 0.45% in February, down from 0.59% in January, accumulating 5.76% in twelve months through February, up from 5.72% in January. Core inflation by exclusion, which excludes ten items of household food and fuels, grew 1.08% in February, compared to 0.69% in January, reaching 5.86% in twelve months through February, up from 5.58% in January. The double weight core inflation rose 0.82% in February, up from 0.74% in January, reaching 6.01% in the last twelve months, up from 5.78% in twelve months through January.

36. According to FGV, the IGP-M, increased 1.00% in February, up from 0.79% in January, accumulating 1.80% in 2011 and 11.30% in the last twelve months. In February, the IPA-M and the INCC-M accelerated and the IPC-M reduced.

37. The IPA-M increased 1.20% month-on-month, up from 0.76% in January, accumulating 1.97% in the first two months of the year and 13.93% in twelve months. Agricultural prices increased 2.75% in February, up from 1.27% in January, accumulating

4.05% in the year and 29.68% in twelve months. Industrial products prices increased 0.64% in February, up from 0.57% in January, accumulating 1.22% in the year and 9.03% in twelve months. Regarding agricultural prices, the 2.75% change reflected, mainly, the 18.40% and 9.84% increases in the prices of cotton and corn, respectively, and the deceleration in the prices of pork, beans and rice.

38. IPC-M increased 0.67% in February, accumulating 1.76% in the year and 5.96% in the last twelve months, with slowdown in five out of the seven groups surveyed. Considering the contribution to the monthly result, the main drivers were transportation (1.82% in February, down from 1.94% in January, 0.22 p.p. of the IPC-M), housing (0.51%, up from 0.22%, 0.15 p.p.) and instruction, reading and leisure (1.63%, down from 2.75%, 0.14 p.p.). The INCC-M increased 0.39%, up from 0.37% in January, accumulating 0.76% in the year and 7.46% in the last twelve months. The February result reflected, mainly, the increase in the prices of material, equipment and services, 0.65%, up from 0.42% in January, and labor force, 0.12%, down from 0.32% in the previous month. Accumulated increases in the year and in twelve months reached, respectively, 1.07% and 5.60% for the prices of material, equipment and services, and 0.44% and 9.49% for labor costs, according to the same comparison bases.

39. The commodities index Brazil (IC-Br) grew in February, for the eighth consecutive month, increasing 4.7% in the month, driven by changes of 7%, 4.5% and -1.3% in the agricultural, metal and energy segments.

Economic activity

40. The IBC-Br increased 0.1% in December, month-on-month, according to seasonally adjusted data. For the last quarter of 2010, the IBC-Br increased by 1%, quarter-over-quarter, which it had recorded 0.3% according to the same comparison basis. According to the observed series, the IBC-Br increased 3.7% in December, year-over-year, accumulating 7.8% in 2010.

41. Expanded retail sales increased 2.3% in December, month-on-month, according to data seasonally adjusted by the IBGE's monthly survey (PMC), driving the fourth-quarter result to exceed by 4.2% the third quarter result. Retail sales remained stable in the month and grew 1.5% in the quarter. Sales increased in eight out of the ten sectors surveyed, with highlights for vehicles and motorcycles, parts and pieces (4.7%), fabric, clothing and shoes, (3.4%), and construction input, (3.2%). On the other hand, the sales of items of other personal and domestic use, and hyper-, supermarkets and food prices reduced, respectively, by 1% and 0.3%.

42. Expanded retail sales grew 14.8% in December, year-over-year, accumulating increases of 12.2% in 2010. Interannual evolution stemmed from sales in all segments, with highlights for books, newspapers, magazines and stationery (26.6%), vehicles and motorcycles, parts and pieces (25.6%), and office equipment and material (25.5%). Expanded retail sales in 2010 also reflected the increase in all considered activities, especially in those related to office equipment and material (24.1%), furniture and appliances (18.3%), and construction inputs (15.6%).

43. Automobile sales by dealers, including cars, light commercial vehicles, trucks and buses, retreated by 1.7% in January, month-on-month, according to Fenabrave (Brazilian Federation of Automotive Vehicles Distribution) data, seasonally adjusted by the BCB, totaling 4.8% increase in the quarter ended in January, quarter-over-quarter. Automobile sales increased 12.3% in the last twelve months, compared to the same period of the previous year, with emphasis on the growth of sales related to trucks (42.1%), light commercial vehicles (26.8%) and buses (25.5%).

44. Capital goods imports decreased 1.7% in January, month-on-month, according to the Funcex quantum index, seasonally adjusted by the BCB. Year-over-year, the indicator rose 25.3% and on a twelve-month trailing basis, it increased by 43.2%, compared to the same periods of the previous year.

45. Capital goods production increased 1.8% in January and 2.4% in the quarter ended in the month, compared to the quarter ended in October, according to data seasonally adjusted from the Monthly Industrial Survey (PIM) by IBGE. The monthly increase reflected, in part, rises in the production of

capital goods for agricultural production (7.5%) and for mixed use (5.5%), in opposition to the retreats in the production of equipment for transportation (7%), and for non-serial industrial purposes (6.6%). Capital goods production increased 9.1% year-over-year, accumulating 20.4% in the last twelve months.

46. Construction inputs production increased by 0.1% in January, and 1.9% in the quarter ended in the month, compared to the quarter ended in October, according to seasonally adjusted data. The industry grew 6.5% year-over-year, increasing by 11.5% in the last 12 months.

47. Disbursements granted by the Brazilian Development Bank (BNDES) reached R$168.4 billion in 2010, increasing by 23.5% year-over-year, with emphasis in the expansions of 47.7% in the agriculture and livestock sector and 28.1% in the industrial sector. In the year, the disbursements share to the trade and services sector totaled 47.2%, while industry accounted for 45.9%, and agriculture and livestock, 6%. Extractive industry accounted for 0.9% of total disbursements.

48. Industrial production increased 0.2% in January, month-on-month, according to seasonally adjusted data from the PIM-PF. Year-over-year, industrial production grew 2.5%, with emphasis in the production of capital goods (9.1%) and durable consumer goods (6.1%). On a twelve-month trailing basis, industrial production increased by 9.4%, compared to the previous period, with highlights for the 20.4% production for capital goods.

49. The Nuci in the manufacturing industry, calculated by FGV, reached 84.5% in February, compared to 84.7% in January, according to seasonally adjusted data. The monthly reduction was driven by the retreats in the production of consumer goods (-0.2 p.p.) and, mainly, intermediate goods (-0.8 p.p.).Capital goods and construction inputs industries grew by 0.6 p.p. and 0.4 p.p., respectively, in the same period. Considering observed data, the Nuci reached 83.7% in February, up from 83.1% in the same month 2010. The growth reflected increases in the industries of construction inputs (3.1 p.p.), capital goods (2.3 p.p.) and intermediate goods (1.4 p.p.), and the reduction in the consumer goods industry (1.1 p.p.).

50. Vehicles production reached 261.8 thousand units in January, decreasing 2.8% month-on-month, according to data released by the Anfavea and seasonally adjusted by the BCB. In the quarter ended in January, vehicles production increased by 0.3%, quarter-over-quarter. Production expanded by 6.4% year-over-year, and 12.9% in the last twelve months.

51. Vehicles sales decreased 9.6% in January, month-on-month, and increased 2.1% year-over-year. The monthly change reflected the 11.3% reduction in domestic sales and the 24.2% increase in exports, while the interannual result stemmed from respective changes of -0.1% and 10.7%, in the same indicators. In twelve months, sales increased by 13.5%, resulting from growth of 6.1% and 53.9% in domestic sales and exports, respectively.

52. The last projection for the 2011 national harvest of cereals, legumes e oilseed, carried out by the IBGE, estimated the production of 146.8 million tons, a 1.8% decline relative to the 2010 harvest, with emphasis in the 8.8% projected reduction in the South region, the most important grain producer of the country. Estimates point to the increases of cotton seed (53.9%), beans (19%) and rice (13.5%). On the other hand, wheat, corn and soybeans are expected to reduce by 18.3%, 7.1% and 1.2%, respectively.

Surveys and expectations

53. The Consumer Confidence Index (ICC), increased by 0.8% in February, reaching 122.6 points, after two consecutive monthly retreats, considering nationwide seasonally adjusted data from the Consumer Expectations Survey (FGV). The result was driven by the increases in the Expectations Index (IE), by 1.2%, and in the Current Situation Index (ISA), by 0.3%. The ICC increased 10.9% year-over- year, due to the increases of 17% in the ISA and of 7.1% in the IE.

54. The Industry Confidence Index (ICI) reduced by 0.3% in February, reaching 112.5 points, considering seasonally adjusted data from the Survey of Manufacturing Industry (SCIT-FGV). The result was driven by the increase of 0.8% in the IE and the stability of the ISA. The ICC retreated by 2.3% year-over- year, due to the decreases of 1.2% in the ISA and 3.6% in the IE.

55. The Services Confidence Index (ICS) from FGV reduced 3% in January, month-on-month, impacted by unfavorable assessment of the current moment. The ISA retreated by 12.2%, while the IE increased 5.6%. The ICS decreased 1.3%, year-over-year, recording a 2.5% increase in the ISA and a 4.2% decrease in the IE.

Labor market

56. According to the General Record of Employment and Unemployment (Caged) of the Ministry of Labor and Employment (MTE), 152.1 thousand formal jobs were created in January, being 73.2 thousand in the services sector, 53.2 thousand in the manufacturing industry, 33.4 thousand in civil construction and 8.3 thousand in agriculture, while the commerce sector eliminated 18.1 thousand jobs. In twelve months, 2,107 thousand jobs were created, with emphasis in the services sector (879.5 thousand), in commerce (508.3 thousand), in the manufacturing industry (469.3 thousand) and in civil construction (233.2 thousand).

57. According to the IBGE employment survey (PME), carried out in the six main metropolitan regions of the country, the unemployment rate reached 6.1% in January, a historical record low for the month since the start of the series. The rate increased 0.8 p.p. month-on-month, and reduced 1.1 p.p. year-over-year. Considering seasonally adjusted data, the unemployment rate reached 6.3% in January, up from 6.2% in the previous month, as a result of the 0.1% decrease in occupation and stability in the Economically Active Population (PEA). Average real earnings usually earned by workers grew by 0.5% month-on-month and 5.3 year-over-year, while payroll changed -1.2% and 7.7%, respectively, according to the same comparison bases.

Credit and delinquency rates

58. Outstanding credit in the financial system reached R$1,714.5 billion in January, equivalent to 46.5% of GDP, increasing by 0.5% in the month and 20.3% in twelve months. Non-earmarked credit operations increased by 0.3% and 17.1%, respectively, according to the same comparison bases, reflecting the increases of 1% and 19.1% for credit operations to individuals and -0.3% and 15.1% for credit operations to corporate, according to the same comparison bases. Earmarked credit operations increased 0.9% in the month and 27% in twelve months, with highlights for the rises of 2.5% and 50.2% recorded in housing credit and of 0.8% and 40.9% recorded in BNDES disbursements, according to the same comparison bases.

59. The average interest rate on non-earmarked credit operations increased 2.4 p.p. in January, reaching 37.4%. The average annual rates on credit for individuals reached 43.8% and for corporate, 29.3%, which represented respective increases of 3.2 p.p. and 1.4 p.p.

60. The average tenure on non-earmarked credit operations decreased from 476 days in December to 474 days in January, representing decreases of three and four days for tenures related to individuals and corporate segments, which reached 559 days and 395 days, respectively.

61. The delinquency rate in the financial system (non-earmarked loans used as reference for interest rates, in arrears for more than ninety days) increased 0.1 p.p., reaching 4.6% in January. The delinquency rate for credit operations with individuals was stable at 5.7% and the one relative to corporate increased by 0.1 p.p., to 3.6%.

External environment

62. Economic activity accelerated for the second consecutive quarter in the US, reaching quarterly annualized increase of 2.8% in the fourth quarter of 2010, up from 2.6% in the previous one. The result reflected, among other factors, household consumption growth and imports contraction. The labor market has continued to recover in the US. Personal available income grew in January, for the fourth consecutive month. In the Euro Area, the strong winter contributed to the deceleration of GDP growth from 1.4% to 1.2%; while in Japan, 2010 fourth quarter GDP contracted by 1.1%. In the same period, China GDP interannual growth accelerated to 9.8% from 9.6%, in the previous quarter. Recent consumer, corporate and manufacturing activity confidence indicators showed acceleration in the economic activity at the start of the year in the

G3 economies. The purchase management index (PMI) for the global manufacturing industry activity grew for the ninth consecutive month in January, showing increase in its expansion pace. The February index, specific for the Euro Area, reached a record high since June 2000. Although most recent data suggest resumption of economic activity in the main economies, it is important highlight that this favorable scenario depends on the crisis development in North Africa and the Middle East.

63. Commodities international prices have registered new increase since the last Copom meeting, although they have presented higher volatility in the last weeks, due to the geopolitical tension. The prices of agricultural commodities continue to be quite impacted by the deterioration of supply conditions in several regions, by consumption increase, mainly in emerging markets, and by low global inventories, when compared to consumption. Oil prices increased substantially reflecting, on the one hand, uncertainties related to possible supply shock due to geopolitical tensions and, on the other hand, the impact over demand resulting from favorable prospects for economic activity. In the financial markets, despite the recent volatility increase, the prospects for developed economies growth have favorably impacted stock market in these countries, compared to those related to emerging economies.

64. In January, annual CPI increased in the US, Euro Area, UK and China, among others, reaching 1.6%, 2.3%, 4.0% and 4.9%, compared to 1.5%, 2.2%, 3.7% and 4.6%, in December, respectively. While in the US energy annual prices grew 7.3% in January, in China, the 10.3% increase in food prices was the main driver of the CPI. Despite recent increases in inflation indexes, inflationary pressures are contained in the main developed economies, except in the UK. Considering core inflation measures, annual growth in January reached 1.0%, 1.1% and 3.0%, respectively, in the US, Euro Area and in the UK. Among emerging economies, in addition to China, food prices increases have contributed for inflationary pressures. In January, annual CPI reached 9.6% in Russia and 7% in Indonesia.

65. In the context of contained inflationary pressures, the Federal Reserve and the European Central Bank maintained their accommodative monetary policy stances, unchanging their basic interest rates, decision followed by the Bank of England. In the opposite direction, since the last Copom meeting, central banks of several emerging countries have increased their respective basic interest rates, among them, Chile, China, South Korea, Russia and Thailand. In February, the People´s Bank of China (PBOC) announced new increase in the reserve requirements in 2011, the second in the year.

Foreign trade and international reserves

66. The Brazilian trade surplus reached US$1.2 billion in February. Exports reached US$16.7 billion and imports, US$15.5 billion. In the year, the trade surplus was US$1.6 billion, 615.9% above the registered in 2010, according to the daily average criterion, reflecting expansions of 26% in exports and 20.7% in imports. Total trade grew 23.3% in the year, totaling US$62.3 billion in 2011, compared to US$46.8 billion in the same period of 2010.

67. International reserves reached US$307.5 billion in February, increasing US$9.8 billion compared to January. The monetary authority's interventions accounted for net purchases of US$8.1 billion in the domestic market until February 25th.

Money market and open market operations

68. Since the last Copom meeting, in January, the futures interest rate yield curve reduced its slope, moving upwards short term rates and keeping tenors higher than a year relatively stable. In the short term, the main drivers of the movement were the worsening of inflation expectations and the release of still high current inflation indexes and prices collected data. Between January 17th and February 28th, one-, three- and six-month interest rates increased 0.52 p.p., 0.44 p.p. and 0.36 p.p., respectively. One-year interest rate increased 0.19 p.p., while two- and three-year rates reduced 0.02 p.p. Real interest rates, measured by the rate between the one-year forward nominal interest rate and the smoothed twelve-month-ahead inflation expectations, increased from 6.61% on January 17th to 6.90% on February 28th.

69. Between January 18th and February 28th, the Central Bank carried out reverse exchange rate swap auctions, in which it assumed long FX position and short interest rate position. This operation totaled the equivalent to US$8.5 billion in notional value.

70. In its open market operations, the BCB carried out, between January 18th and February 28th, repo operations borrowing R$39.0 billion for a six-month period. As a consequence, the average daily balance of the long operations reached R$148.5 billion. In the same period, the BCB also borrowed money through repo operations with tenures between thirteen and thirty working days, increasing the average daily balance of short-term borrowing operations to R$129.9 billion. The BCB also borrowed money through 31 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$95.4 billion in the period, borrowing. The average daily balance of the total stock of repurchase agreements of the Central Bank increased from R$358.5 billion between December 7th and January 17th to R$ 387.1 billion, between January 18th and February 28th. Considering the daily balance of operations for the most recent period, there was a reduction in the daily balance of repurchase agreements totaling R$37.2 billion, reducing the total stock from R$396.7 billion on January 17th to R$359.5 billion on February 28th. The main drivers of liquidity contraction in the period were the net revenues of the Central Government and the issuance of net securities by the National Treasury.

71. Between January 18th and February 28th, the National Treasury issuance regarding the traditional auctions raised a total of R$45.4 billion. The sale of fixed-rate securities reached R$27.9 billion, with R$24.0 billion via issuance of LTNs maturing in 2011, 2012, 2013 and 2015, and R$ 3.9 billion via NTN-Fs maturing in 2017 and 2021. Issuance of LFTs totaled R$9.6 billion, for securities maturing in 2015 and 2017. Issuance of inflation-linked NTN-Bs reached R$7.9 billion, for securities maturing in 2014, 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

Alexandre Antonio Tombini
Governor

Aldo Luiz Mendes
Deputy Governor

Altamir Lopes
Deputy Governor

Anthero de Moraes Meirelles
Deputy Governor

Carlos Hamilton Vasconcelos Araújo
Deputy Governor

Luiz Awazu Pereira da Silva
Deputy Governor

Sidnei Correa Marques
Deputy Governor

Members of the Monetary Policy Committee (Copom)

Voting members

Alexandre Antonio Tombini
Governor

Aldo Luiz Mendes
Deputy Governor

Altamir Lopes
Deputy Governor

Anthero de Moraes Meirelles
Deputy Governor

Carlos Hamilton Vasconcelos Araújo
Deputy Governor

Luiz Awazu Pereira da Silva
Deputy Governor

Sidnei Correa Marques
Deputy Governor

Non-voting members

Tulio José Lenti Maciel
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
AMs	Asset managers
Anfavea	National Association of Automotive Vehicle Manufacturers
b.p.	basis points
BNDES	Brazilian Development Bank
BNDESpar	BNDES Participações S.A.
BoC	Bank of Canada
BoE	Bank of England
BoJ	Bank of Japan
Caged	General File of Employed and Unemployed Persons
CCI	Consumer Confidence Index
CDS	Credit default swap
CMN	National Monetary Council
CNI	National Confederation of Industry
Copom	Monetary Policy Committee
CSI	Current Situation Index
CVM	Securities and Exchange Commission
DAX	Deutscher Aktienindex
ECB	European Central Bank
EI	Expectations Index
Embi+	Emerging Markets Bond Index Plus
EONIA	European Overnight Index Swap
ESM	European Stability Mechanism
Eurostat	Statistical Office of the European Communities
FAO	United Nations Food and Agriculture Organization
FAT	Worker Support Fund
FDI	Foreign Direct Investments
Fecomercio SP	Trade Federation of the State of São Paulo
Fecomércio-RJ	Trade Federation of the State of Rio de Janeiro
Fed	Federal Reserve Bank of New York
Fenabrave	National Federation of Automotive Vehicle Distribution
FGTS	Employment Compensation Fund
FGV	Getulio Vargas Foundation
Finame	Special Industrial Financing Agency
Fipe	Institute of Economic Research Foundation
FTSE 100	Financial Times Securities Exchange Index
Funcex	Foreign Trade Studies Center Foundation

GDP	Gross Domestic Product
Gerin	Investor Relations and Special Studies Department
GFCF	Gross Fixed Capital Formation
GGGD	Gross General Government Debt
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
Ibre	Brazilian Institute of Economics
IC-Br	Commodities Index – Brazil
ICI	Industrial Confidence Index
ICMS	Tax on the Circulation of Merchandises and Services
ICS	Services Confidence Index
IEC	Consumer Expectations Index
IGMI-C	General Real Estate Market Index – Commercial
IGP	General Price Index
IGP-DI	General Price Index - Domestic Supply
IGP-M	General Price Index – Market
INC	National Confidence Index
INCC	National Cost of Construction Index
Inec	National Consumer Expectations Index
INSS	National Social Security Institute
IOF	Financial Operations Tax
IPA-DI	Producer Price Index – Domestic Supply
IPC	Consumer Price Index
IPCA	Extended National Consumer Price Index
IPC-DI	Consumer Price Index – Domestic Supply
IPI	lndustrialized Products Tax
IPVA	Tax on Automotive Vehicle Proprietorship
IRPJ	Corporate Income Tax
ISP	Investment Support Program
LOA	Annual Budget Law
LTN	National Treasury Bills
Mercosur	Southern Common Market
MTE	Ministry of Labor and Employment
NTN-B	National Treasury Note – Series B
Nuci	Installed Capacity Utilization Level
OIS	Overnight Index Swap
p.p.	percentage points
p.y.	Per year
PAC	Growth Incentive Program
PAF	Annual Financing Plan
PBC	People's Bank of China
PEA	Overall Labor Force
Petrobras	Brazilian Petroleum Company
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

POF	Consumer Expenditure Survey
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
SIT	Manufacturing Industry Survey
SNB	Swiss National Bank
TJLP	Long-Term Interest Rate
UCI	Installed Capacity Utilization
USA	United States of America
VaR	Value at Risk
VIX	Chicago Board Options Exchange Volatility Index
XU100	Istanbul Stock Exchange National 100 Index