# 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.