

Executive summary

The economic outlook for the global economy has deteriorated substantially since the last Inflation Report. Growth forecasts for the main economic blocks have been broadly and significantly revised downwards, given the escalation of the fiscal crisis in Europe and similar tensions in the United States of America (USA), which, among other developments, have negatively affected businesses and consumers' expectations. The constraints to the international economic environment tend to persist over a longer than anticipated period of time and imply a disinflationary bias for both the world and the domestic economy. In such a context, the increase in risk aversion translated into strong volatility of financial markets.

In Brazil, there has been moderation in the pace of economic activity, which, nonetheless, will continue to be favored by the domestic demand, in face of the strong labor market and the credit expansion, despite some deceleration at the margin. On the other hand, it is necessary to take into account the effects of the deteriorating global economic outlook on businesses and consumers' expectations, international trade and investments.

The dynamics of credit operations and monetary aggregates has been consistent with the monetary policy actions implemented at the end of last year and beginning of the current year. Regarding credit to households, housing financing is still expanding, in part because of the institutional changes that took place in this market.

The instability of the international scenario has negatively affected the domestic capital markets, leading to a fall of stock prices and restraining primary issuance of financial instruments.

Favorable performance of tax revenue together with management of expenditure has improved the dynamics of the fiscal accounts. In this regards, it is worth mentioning the increase of the primary surplus target for 2011.

The expansion of imports of goods and services and the growth of net remittances to abroad in recent months have been counterbalanced by the good performance of exports, favored by better terms of trade. As a result, the twelve-month current account deficit has remained stable at 2.2% of GDP for the third consecutive quarter.

Despite the high degree of risk aversion in the international markets, the favorable outlook of the Brazilian economy keeps attracting capital inflows, especially foreign direct investments. As a consequence, international reserves increased by US\$64.8 billion in the first eight months of 2011, thus reaching a stronger position than before.

Indicators of consumer price inflation, overall, have decelerated during the quarter ended in August relative to the quarter ended in May. In line with headline inflation dynamics, the measures of core inflation calculated by the Central Bank of Brazil have also decelerated over the same period.

Regarding inflation projections, following the usual procedures, and taking into account the information set available up to the cutoff date of September 9, 2011, the baseline scenario – which assumes constant exchange rate over the projection horizon at R\$1.65/US\$ and target for the Selic interest rate at 12.00% p.a. – projects inflation of 6.4% in 2011, 4.7% in 2012, and 4.5% in the third quarter of 2013.

In the market scenario – which is based on data from 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 6.4% for 2011, 5.0% for 2012, and 5.1% for the third quarter of 2013.

In an alternative scenario, built and analyzed from the perspective of a medium-sized dynamic stochastic general equilibrium model, and also taking into account projections from other models, the inflation projection is 6.4% for 2011, 4.7% for 2012, and 4.8% for 2013.

The Committee recognizes an economic environment in which prevails an increasing and above-than-usual level of uncertainty; the Committee also identifies decreasing risks to the materialization of a scenario where inflation timely converges to the midpoint target. Additionally, the Committee foresees that the twelve-month inflation upward cycle ends this quarter. From the fourth quarter on, the main scenario indicates downward trend for the twelve-month inflation,

which will start to move toward the target. In other words, the Committee evaluates that the prospective scenario has shown favorable signs since the last Report, to a great extent because of the substantial deterioration in the international environment.

The Committee understands that, by promptly mitigating the effects stemming from a more restrictive global environment, moderate adjustments of the basic interest rate are consistent with the scenario of convergence of inflation to the target in 2012.

According to the baseline scenario, the GDP growth rate projected for 2011 is 3.5%, 0.5 percentage point lower than the projection of the June 2011 Inflation Report. This revision takes into account the policy actions implemented since the end of last year and, more importantly, the ongoing deterioration of the international scenario, which has led to generalized and significant reduction in growth projections for the main economic blocks.