Executive summary

The robust growth rate of the Brazilian economy in the first quarter of 2010, (9% growth rate of the Gross Domestic Product (GDP), in comparison to the same period of the previous year), makes evident the consolidation of the current expansion cycle. In this context, the slackness observed in industrial activity and in retail sales in April is not a deviation from the growth trend, which should be sustained by the performance of the labor market, by the high business and consumer confidence indices, and by the expansion of credit.

Economic activity remains driven essentially by domestic demand, with emphasis on the upswing of investments, in line with the high levels of business confidence and of capacity utilization. Furthermore, the dynamism of household consumption has been led by consumer confidence, as well as recurrent increases in payrolls and by improvements in the conditions of the credit market. The external sector still shows a negative contribution to GDP growth, a performance consistent with the mismatch between the growth rates of the Brazilian economy and of its trading partners.

The labor market indicators presents continued gains in real income, despite the acceleration of price indices in the beginning of this year, whose effects have been more than compensated by the decreasing in unemployment rate and by the gains of nominal wages. The improvement in quality of created jobs, depicted in the substitution of informal for formal jobs, should be underscored.

Credit remained in an expansion path, in an environment of retreats of interest rates, of spreads and of defaults, in the February to April period, thus functioning as an important source for household consumption and investments. The expansion of credit has been led by the earmarked resources segment, with emphasis on the Brazilian Development Bank (BNDES) operations and housing loans, whereas credit with non-earmarked resources were pushed by the performance of households loans, with emphasis on the increased share of payroll deducted loans and automotive vehicles financing. The relative slowing in domestic corporate credit could be interpreted, at least in part, as a result of greater corporate demand for funding in capital markets, domestic and international, , specially by bigger companies.

The fiscal result accumulated this year, more favorable than the one registered in the same period in 2009, reflects the impact of the recovery of economic activity on revenues. The persistence of this process along the year should be sustained, among other elements, by the reversal of part of the tax reliefs introduced amid the international crisis. As regards expenditures, the increase in investments should be highlighted. This path, taken into account the fiscal targets established for the year, should be counterweighted by limiting current expenditures.

The impact of the current growth cycle on the demand for imported goods and services has been reflected in the increase of the current account deficit. In this scenario, although exports have registered important growth, mostly due to the increase in prices, the trade surplus shrank 39.6% during the first five months of 2010, compared to the same period in the previous year. Moreover, it should be taken under consideration the expected increase of the deficits in the services and income accounts, the latter due to the increase of profit net remittances, driven by the expansion of foreign investments in the country and of the improved profitability of resident enterprises.

In regard to the financial account, the net inflows of foreign direct investments, investments in debt securities and in equity securities remain at a level in excess of the current account deficit. Furthermore, the improvement of the structure of external liabilities, with investment liabilities outpacing debt, has been an enduring process.

The main emerging market economies remain on a stronger recovery pace than the mature economies. Although greater risk aversion due to the fiscal crisis that some European economies are undergoing may represent a risk factor to the net inflow of external resources in those economies, with negative impacts on the prices of their assets, until now these effects have been limited.

Regarding inflation forecasts, following the usual procedures, and taking into account the information set available up to the cutoff date of June 18, 2010, the baseline scenario considered by the Copom assumes a constant exchange rate over the forecast horizon at R$1.80/US$, and that the target for the

Selic rate stays at 10.25% p.a. – the level set by the June Copom meeting. The projection for the change, in 2010, of the set of regulated and monitored prices stands at 3.6%, and moves to 4.4% and 4.5% in 2011 and 2012, respectively.

The market scenario, on the other hand, is based on data from the expectations survey undertaken by the Investor Relations Group (Gerin) of the Central Bank of Brazil until the cutoff date (June 18, 2010). In this scenario, average exchange rate expectations slightly changed in comparison to the values released in the March 2010 *Inflation Report*. The average expectations about the Selic rate increased in comparison to those presented in the last *Report*. Additionally, the market scenario assumes changes of 3.6% and 4.6% for the set of regulated prices in 2010 and 2011, respectively, and of 4.5% in 2012.

The forecasts presented in this *Inflation Report* are based on working assumptions about fiscal policy, namely a primary surplus of 3.3% of GDP in 2010, reduced by up to 1.12 b.p. thanks to implementation of the Government's Growth Acceleration Program (PAC). Moreover, the working assumptions are that the primary surpluses in 2011 and 2012 will return to the level of 3.3% of GDP, without adjustment factors.

Based on the above assumptions, the Copom's central forecast associated with the baseline scenario shows inflation of 5.4% in 2010, 0.2 p.p. higher than in the March 2010 *Report*. In this scenario, twelve-month inflation projections stay above the midpoint of the target for the entire relevant horizon.

In the market scenario, the inflation projection for 2010 is 5.3%, 0.1 p.p. lower than the projection of the baseline scenario, and 0.1 p.p. higher than in the last *Report*. In this case, twelve-month inflation projections hover above the midpoint of the target along 2010, and decline along 2011, ending the year at 4.6%, around the target midpoint. The projection for the second quarter of 2012 is 4.3%.

Regarding the balance of risks associated with the projections, the main domestic risk to the inflation outlook stems from the possibility that actual and projected inflation may persistently remain above the target due to the increasing utilization of production factors and/or the expansion of the domestic demand. An additional risk to the inflation outlook is related to the behavior of inflation expectations, which, nonetheless, have remained contained in the latest weeks.

On the foreign sector, the main risks are associated with the potential developments of the European crisis, whose dynamics has become less favorable since the release of the latest *Inflation Report*. This has introduced some caution in the analysis of the prospective scenario given that the uncertainties surrounding those developments have increased lately.

According to the baseline scenario, GDP growth should reach 7.3% in 2010, against 5.8% considered in the March 2010 *Inflation Report*.