prospects for the Brazilian economy

	2009	2010	2011 *previous projection Dec/10*	2011 *projection*
Economic activity				
GDP (annual variation)	-0.6%	7.5%	4.5%	**3.5%**
industrial GDP (annual variation)	-6.4%	10.1%	4.5%	**2.8%**
Household consumption (annual variation)	4.2%	7.0%	5.1%	**4.5%**
Gross fixed capital formation (annual variation)	-10.3%	21.9%	13.5%	**9.0%**
unemployment Rate (annual average - % of the labor force)	7.9%	6.7%	6.0%	**6.0%**
Inflation				
Inflation (IPCA - annual variation)	4.3%	5.9%	5.0%	**6.0%**
Interest rates				
Nominal interest rates				
(average rate in the year)	10.13%	9.90%	11.84%	**12.13%**
(year end)	8.75%	10.75%	12.00%	**12.50%**
Real interest rate (annual average and deflated rate: IPCA)	5.0%	4.6%	6.3%	**5.4%**
Public accounts*				
Nominal public deficit (% of GDP)	3.34%	2.55%	3.20%	**3.05%**
Public primary surplus (% of GDP)	2.03%	2.80%	2.20%	**2.70%**
Net public debt (% of GDP)	42.8%	40.2%	40.4%	**39.9%**
Exchange rate				
Nominal exchange rate - R$/US$				
(average in December)	1.75	1.69	1.70	**1.63**
(average in the year)	1.99	1.76	1.70	**1.63**
Foreign trade sector				
Exports (US$ billion)	153.0	201.9	228.0	**250.0**
imports (US$ billion)	127.6	181.6	224.0	**230.0**
Trade balance (US$ billion)	25.4	20.3	4.0	**20.0**
Current account balance (US$ billion)	-24.3	-47.5	-70.0	**-57.0**

* Excludes Petrobras Group's companies

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Brazilian economy in the first quarter of 2011

Inflation and exchange rate require new adjustment in fiscal policy

Rising inflation, a moderate economic growth rate and the continuity of a strong inflow of foreign resources have reshaped the economic scenario in the first quarter of 2011. As a result, there was a shift in economic policy focus, which must necessarily place greater emphasis on the path of inflation.

Inflationary memory in the Brazilian economy, as formalized in still-existing legal indexation instruments and in the practice of renegotiating contract prices, poses risks. Accepting that inflation will remain close to the top of its target for a long period revives this memory, resulting in higher future costs in terms of economic slowdown.

Industry is under pressure from relevant costs being pushed up not only by external shocks, such as rising commodity prices. In the past four years, the average industrial wage in dollars – a relevant cost for competitiveness comparisons – increased by 46%. A similar variation was observed in the minimum wage.

The strong growth of the Brazilian economy has translated into a full-employment economy, with a growing awareness that workers are lacking, particularly in professional categories requiring more skilled workers. This situation pushes wage costs up without a corresponding increase in productivity, with major repercussions in inflation (particularly for non-tradable services and products). Inflationary pressures are less intense on manufactured products owing to a fierce competition with imported goods, but they are also increasing.

Economic policy can and should be used to curb domestic pressures. Costs rising more than productivity cause inflation or reduce the profitability of investment projects. The consequence is loss of competitiveness – which is already threatened by an appreciated exchange rate – and economic slowdown. Experience shows that a virtuous growth cycle must be supported by higher productivity rates, which reflect a more efficient use of resources.

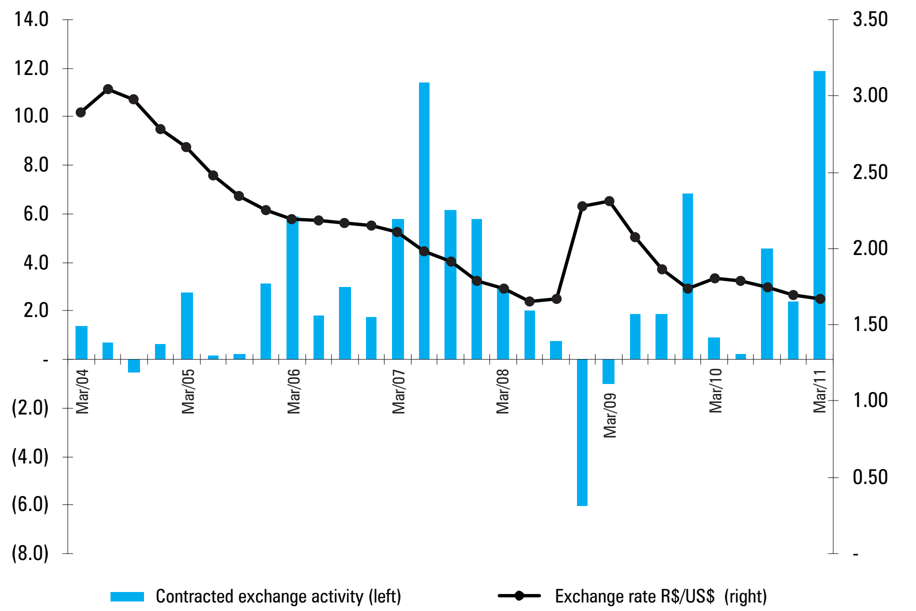
The current scenario of increasing cost pressures requires a tight fiscal stance, otherwise this role must be fully played by the monetary policy, appreciating the Brazilian currency even more and penalizing the production sector. Measures to restrict the inflow of foreign resources have been insufficient to curb the appreciation process.

For this reason, the main tool for inflation to remain within its target should be the fiscal policy. The commitment to stick to the fiscal target should be more explicit and consistent with these efforts, or else the burden will fall on the production sector. The fact that the GDP growth rate in 2011 will be less than half the one recorded in 2010 is a warning that should not be ignored.

Evolution of the exchange rate and exchange activity

Nominal exchange rate in R$/US$ and balance of exchange activity in US$ billion

Currency inflow in the 1st quarter of 2011 hits record-high



Source: Central Bank

economic activity

GDP growth in 2011 drops to half the one recorded in 2010

GDP is expected to grow by 3.5% in 2011, i.e. at a much lower rate than that observed in 2010 – 7.6%. Different signs of evolution in productive sectors were observed in the Brazilian economy early this year. While the service industry (including retail trade) continues to experience a dynamic trend, manufacturing is facing difficulties to grow.

This downward trend has been observed since the second half of 2010. Were it not for a 1.0% increase in the service GDP in relation to the previous quarter, the 0.7% GDP growth (National Accounts/IBGE) registered in the fourth quarter of 2010 would be even lower. The service industry was the only one to experience any growth in that period, while industry and agriculture/livestock dropped by 0.3% and 0.8%, respectively, on the same comparison basis.

In January 2011, seasonally-adjusted manufacturing production (PIM-PF/IBGE) rose by 0.2% in comparison with the previous month, even after dropping for two consecutive months. There was a marked increase (of 1.9%) in this indicator in February on the same comparison basis, contrasting with the performance of industry in recent months. The result for February should be analyzed cautiously because, even considering that there are more working days in the month, it is hard for any seasonal adjustment models to accurately account for the absence of carnival.

Real revenues in manufacturing (CNI Industrial Indicators) decreased by 1.2% (seasonally adjusted data) in January 2011 as compared to December 2010. In February, revenues rose by 6.9% in relation to the previous month. As with manufacturing production, the result for this indicator was influenced by the fact that carnival was not held in February.

While on the one hand the carnival effect boosted sales and manufacturing production in February, on the other the indicators are expected to fall in March for the same reason, reversing part of the increase observed in February. As a result, manufacturing activity is expected to have a moderate performance once again over the next few months.

Appreciated exchange rate creates gap between industrial sales and production

Sales grew more than manufacturing production as a result of a leakage of part of domestic demand to the foreign market. The strong growth observed in imports and the continuity of competitive pressures on Brazilians products in foreign markets, as well as in the domestic market, remain intense on account of a continued appreciation of the Brazilian currency.

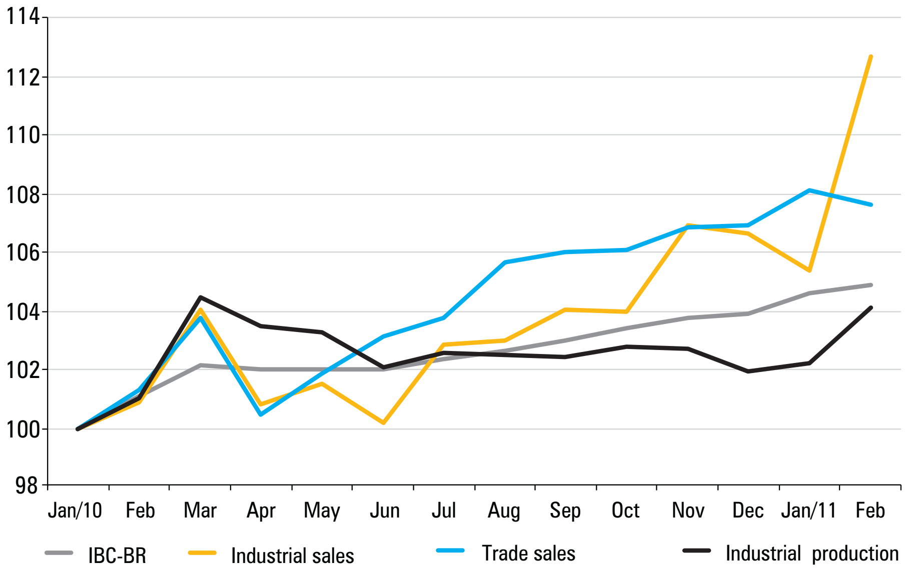
Since stocks of industrial products are relatively adjusted (CNI Industrial Survey - Manufacturing and Mining), the difference observed in the growth rate of the indicators for sales and production may have been caused by a greater share of imported products (inputs) in the production chain of domestic industry.

After growing by 11.6% in 2010, the construction industry has also lost momentum. According to data from the Construction Industry Survey (CNI), activity in this sector remained at usual levels for the month

Industrial production evolution, industrial sales, trade sales, and economic activity index (IBC-BR)

Base jan/10 = 100

Manufacturing production does not keep pace with the increase in sales in the sector



Source: CNI, Central Bank and IBGE

Prices, particularly commodity prices, will boost foreign sales to a certain extent, while the volume of manufactured products is likely to grow at an even slower pace. As a result, exports are expected to continue to increase, but at a slower pace than in 2010 and increasingly dependent on sales of basic product and price gains. At the end of the year, exports are likely to total US$ 250 billion, a 24% increase over 2010.

Increase in import prices pushes industrial costs up

Imports totaled US$ 48 billion in the first quarter of 2011, 23.3% more than in 2010. As opposed to last year, imports are growing at a rate below that of exports.

The increase in the value of foreign purchases resulted largely from an increase in imported volumes, which rose by 19% in the first two months of the year in relation to the same period in 2010 (by 35% in the 12-month accumulated figure). Imports of capital and intermediate goods have lost momentum as a result of the slowdown in manufacturing activity, while purchases of consumer goods remain on a strong upward trend.

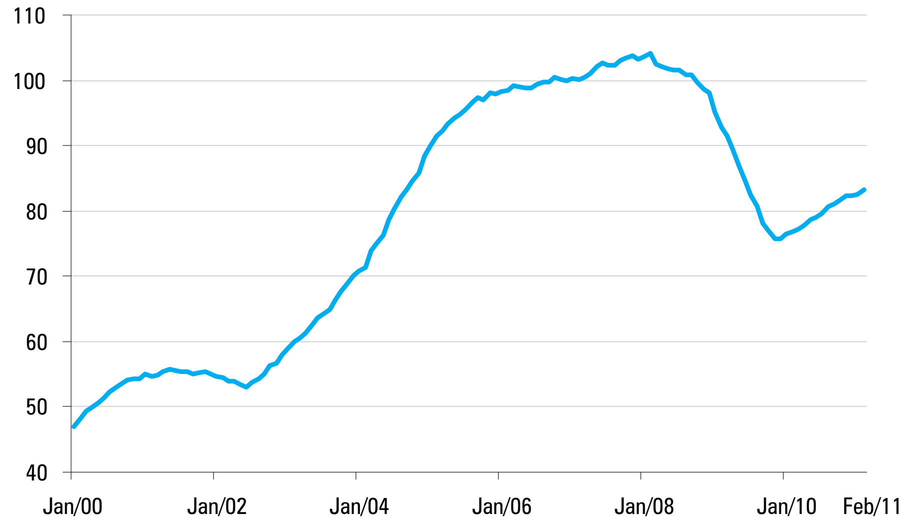
Special mention should be made of the increase observed in import prices. These increased by 10% in the comparison between the first quarters of 2010 and 2011. As compared to 2009, the increase stood at only 3% in 2010. The most significant price increases were registered in fuel prices (27%), but also in the prices of durable and intermediate products, which increased by 3% in the twelve-month period ending in February but have already accumulated a 9% variation in the two last months. This hike increases industrial production costs, mainly because it increases the prices of inputs used by industry.

Prices are likely to continue to increase more strongly than in 2010. A less intense manufacturing activity and lower household consumption will prevent imported volumes from increasing significantly in 2011. Albeit more moderately, imported volumes will continue to rise above the growth rate of exports. An appreciated exchange rate will keep boosting both foreign purchases and the replacement of domestic inputs with imported ones.

Quantum index of manufactured product exports

Twelve-month average (Base: 2006 Average = 100)

Total exported volume of manufactured products is close to 2004 levels



Source: Secex

As a result, we expect imports to grow by 27% in 2011, to US$ 230 billion. As a result, the trade surplus is expected to hit the mark of US$ 20 billion in 2011.

Higher service deficit will be financed by a greater inflow of foreign capital

A high domestic demand and an appreciated exchange rate are pushing imports up and creating a negative balance in services and income. As a result, the 12-month figure for current account deficit hit the mark of US$ 49.2 billion in February 2011, or 2.31% of GDP.

The higher trade balance registered early in 2011, coupled with a strong inflow of foreign direct investment, allowed for the current account deficit to remain stable after a strong upturn observed throughout 2010.

The service deficit is expected to grow at a slower pace, while the inflow of foreign direct investment is likely to remain strong.

Consequently, the current account deficit is projected to grow more moderately, remaining virtually constant in relation to GDP. CNI estimates this deficit at US$ 57 billion in 2011, about 2.35% of GDP.

foreign trade sector and exchange rate

Currency appreciation is unavoidable in a scenario of high liquidity and high interest rates

Trade balance is sustained by basic products' price gains

Whether in relation to the dollar or to the currency basket, the Brazilian real exchange rate is now at its most appreciated level since the Real was created. Since 1994, the Brazilian currency has appreciated by 39% in relation to the dollar and by 41% against a 13-currency basket. During the same period, the Funcex's export profitability index decreased by 20%. A set of measures was adopted to curb currency appreciation, but it has been ineffective so far, as the exchange rate remains on a downward path.

Brazil continues to attract high inflows of direct investments. In the first two months of the year, foreign direct investments (FDI) totaled US$ 10.7 billion, three times more than the accumulated figure in the same period in 2010.

The difference between domestic and international interest rates remains high – and is expected to increase as a result of further increases in interest rates in Brazil. Brazil will inevitably continue to attract foreign currencies for as long as it continues to keep its interest rates at one of the highest levels in the world in a period of high liquidity. As a result, the huge inflow of foreign currencies leads to currency appreciation. In the first quarter of the year, there was an inflow of US$ 35.2 billion in foreign currencies, 45% more than the accumulated figure in 2010.

Throughout the year, as the monetary policies adopted by developed countries become more restrictive and the government takes new measures (macroprudential measures or measures of another nature) to curb the currency appreciation, the appreciation pressure is likely to decrease. As a result, the real/dollar exchange rate may close the year close at its current level, at about R$ 1.60/US$ 1.

Real exchange rate index l

Deflator: IPA Base: Dez/2003 = 100

Real exchange rate is at its most appreciated level since the Real was created

Source: Central Bank

Exports of manufactured products lose momentum

In the first quarter, exports grew by 28.5% in relation to the same period in 2010. After a long period in which exports rose at a rate below that of imports on a year-on-year basis (almost throughout 2010, except for October and December), the situation was reversed in the first quarter of 2011.

The rise seen in the period is explained by exports of basic products, which accounted for 61% of the increase registered between the first quarters of 2011 and 2010.

This growth resulted from an increase in shipments, but mainly from price gains. Comparing the first two months of 2010 with 2011, the exported volumes of basic products increased by 12%, while prices rose by 42% in the same period. In February, the export prices of basic products hit their highest mark in the historical series of Funcex, initiated in 1977.

On the other hand, in the comparison with the first two months of 2010, the export prices of manufactured products grew by 12%, while exported volumes increased by only 7%. Total exported volumes of manufactured products grew with the end of the 2008-2009 economic crisis, but they are only now close to their levels in 2004.

(indicator of 50.1 points in February) for the first time since the beginning of the historical series, in December 2009. This behavior is different than that seen in the past, when the actual-usual activity indicator for the month remained systematically above 50 points – indicating activity above usual levels for the period.

Industrial GDP is expected to grow by only 2.8% in 2011

Taking the four industrial sectors together, CNI expects to see a slow growth rate throughout 2011, to such a point that the industrial GDP indicator will only exceed pre-crisis levels between the first and third quarters of the year. This means that industry lost more than two years as a result of the international crisis. In such a scenario, industrial GDP will grow by 2.8% in relation to 2010, representing a growth rate very close to the annual average figure registered over the past 10 years (2.9%).

Despite a moderate manufacturing activity, the Central Bank's economic activity index (IBC-BR) recorded a growth of 0.7% in January over December 2010. In February, the index grew by 0.3%, i.e. less than in the previous month. According to the scenario projected by CNI, economic activity will grow at a more moderate rate over the next few months, as household consumption is not expected to continue to rise as now.

The slowdown observed in the household consumption growth rate was influenced by macroprudential measures adopted by the Central Bank, which increased interest rates and the Tax on Financial Operations (IOF) from 1.5% to 3.0% per year for loans to individuals.

Besides, even though the performance of the labor market is still positive, workers are not being hired at the same pace, as investments are growing less strongly. For this reason, CNI estimates that household consumption will expand at a rate of 4.5% in 2011.

Gross fixed capital formation (National Accounts/IBGE) rose by 0.6% in the fourth quarter of 2010, meaning that the indicator is down for the fifth time in a row. Even if investments are more intensely resumed over the next quarters, CNI expects to see a 9.0% increase in 2011 in relation to the previous year.

Negative contribution of the foreign trade sector to GDP growth will be lower in 2011

GDP is likely to grow by 1.0%-1.2% in the first quarter of 2011 in relation to the previous quarter. Although the economy grew more in the first quarter of 2011 than in the fourth quarter of 2010, this pace will not be seen in coming quarters and, therefore, it will accumulate a growth of 3.5% of GDP against the year before.

With the slowdown in domestic demand, the negative contribution of the foreign trade sector to GDP growth (-1.3 percentage points) in 2011 is expected to be half the one recorded in 2010, as imports will decrease (growth estimate of 19.0%) more than exports (growth estimate of 9.2%).

GDP Estimate - Percentage variation and components' contribution to GDP growth

	GDP components	2011 Growth rate (%)	2011 Contribution (p.p.)
Demand side	Household consumption	4.5	2.7
	Government consumption	2.8	0.6
	Gross formation of fixed capital	9.0	1.7
	Exports	9.2	1.0
	(-) imports	19.0	-2.3
Supply side	Agriculture/livestock	3.8	0.2
	Industry	2.8	0.7
	Mining and quarrying	4.5	0.1
	Manufacturing	2.0	0.3
	Construction	3.5	0.2
	Public administration, health, and public education	4.0	0.1
	Services	3.8	2.6
	GDP	**3.5**	

employment and income

Labor market loses momentum

Average annual unemployment rate remains on a downward path

After a strong job creation pace in 2010, the labor market lost momentum on account of an economic slowdown. The positive aspect of this scenario is that job formalization continues on the rise, which coupled with higher-than-inflation wage settlements generates gains in workers' real total payroll.

In April 2010, metropolitan employment recorded its highest growth rate in six years (4.3%) as compared to the same month the year before. After this period, the indicator began to follow a downward trend. Jobs increased by 2.4% in February 2011 in relation to the same month in the previous year.

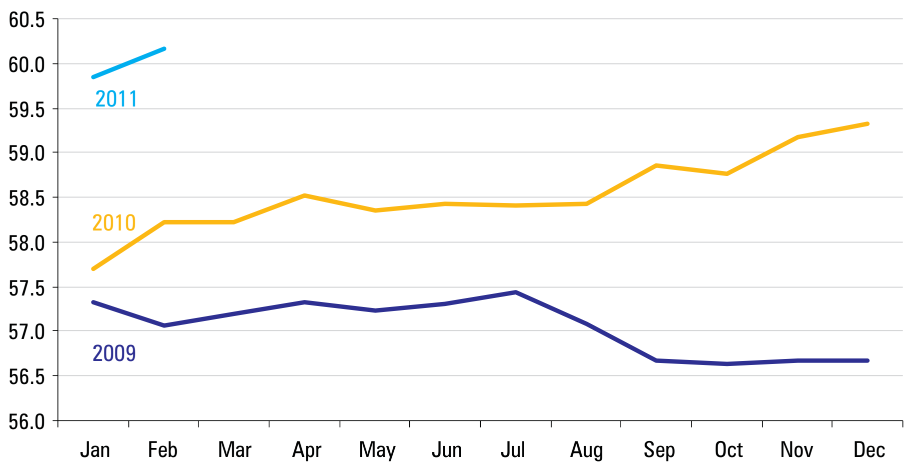
Employment grew the most in February in the business service industry (by 5.5% against the same month the year before), followed by manufacturing (3.2%) and public management (2.8%). The number of jobs in the trade sector rose by 0.5% during the same period.

Although manufacturing activity is facing difficulties to grow, the sector continues to hire workers. According to CNI Industrial Indicators, jobs in manufacturing fell only once in the last 19 months in relation to the previous month. A moderate growth rate (0.4%) was registered in February in relation December 2010 (seasonally adjusted data). Nevertheless, employment is up by 4.1% as compared to the same month last year.

Formality index

Percentage in relation to total jobs

Formal jobs continue to be generated at the same pace observed in 2010



Source: IBGE.

Formalization hits the mark of 60% of all jobs

In spite of a lower employment growth rate, formal metropolitan jobs increased their share in total employment. The formality index has been on the rise since January 2010. This indicator – which is calculated by the sum of all formal, military and statutory jobs divided by all occupations – remained above 60% in February 2011 for the first time in IBGE's historical series. The percentage of formal jobs in relation to the total number of occupations grew by 10 percentage points in the past 6 years.

The 12-month accumulated figure for formal employment rose by 2 million in February. Industry – taking into account mining and quarrying, manufacturing, construction, and public-utility services – accounted for 36% of all formal jobs created in Brazil over this period. It should be stressed that both total metropolitan jobs, as measured by the Monthly Job Survey/IBGE, and formal jobs, as measured by CAGED, grew at a lower rate.

Average annual unemployment rate to hit the mark of 6.0% in 2011

Even though employment has grown less strongly, the economically active population – or labour force – is following the same trend. In February, the labor force grew by

For regional governments and their enterprises, higher revenues also ensured a better primary result, which rose from 0.64% in December 2010 to 0.71% of GDP in the last twelve-month period ending in February of this year.

Federal Government's spending is likely to grow at a slower pace by year end

O The Federal Government's spending growth rate is likely to drop significantly over the year as compared to the first two months of 2011 and also to the figure registered in 2010. A financial programming of R$ 36 billion in discretionary spending and savings of R$ 14 billion in compulsory expenses – as no new civil servants will be hired, for example – point to a real growth of 2.6% in federal spending in 2011.

On the other hand, net revenues are also expected to grow at a slower pace. The strong real growth observed in the first two months in 2011 is likely to lose momentum throughout the year. This will occur because tax exemptions granted in 2010 and higher business profitability will cease to cause significant increases in relation to tax revenues in same period the year before. We are therefore projecting a real growth of 5.2% in the Federal Government's net revenue.

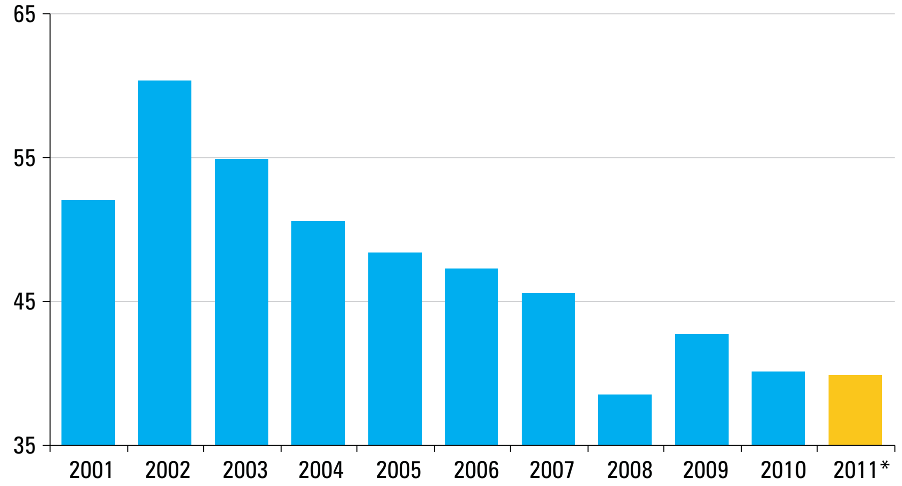
It should be emphasized that the effects of the Petrobras capitalization process in 2010 were not considered in these projections of higher spending and revenues.

In this scenario, the Federal Government's primary surplus is estimated to amount to R$ 70.5 billion, against a target of R$ 81.8 billion – without deducting costs contemplated in the Growth Acceleration Program (PAC). Therefore, to achieve the target without deductions, the Federal Government would need to promote a further

Evolution of the Public Sector Net Debt (DLSP)

Percentage of GDP

Increase of 0.5 percentage points of GDP in the nominal deficit did not prevent public debt from dropping slightly



Source: Central Bank *Elaboration and projection for 2011: CNI

financial programming of about R$ 11.0 billion in expenses.

However, we maintain our forecast of a surplus of R$ 70.5 billion, considering how difficult it is to promote the financial programming of R$ 11.0 billion, since budget expenses that can still be subject to financial programming amount to only R$ 52.0 billion. This is so because the original base of R$ 88.0 billion that could be subject to financial programming in the Annual Budget Law has been reduced by R$ 36.0 billion already.

Albeit difficult to implement, this new financial programming of the Federal Government would be a major step to enhance the contractionary nature of its fiscal policy, as it would cause real spending to grow by only 0.9% in 2011 in relation to 2010.

With respect to the other components of the primary result for the consolidated public sector, we believe that federal state-owned enterprises are likely to strike a balance between primary spending and revenues. As for regional governments, they will have to slow down the pace of their spending to achieve the primary surplus target of R$ 36.1 billion. While we cannot tell for sure what states and municipalities will do in relation to spending, we are still projecting that the target will be achieved. Therefore, the primary surplus for the consolidated public sector was estimated at R$ 106.6 billion (2.7% of GDP as projected by CNI) in 2011, below the R$ 117.9 billion (2.95% of GDP) target.

This expected result for the primary surplus is lower than the one registered in 2010 (2.8% of GDP). This decline, added to expectations of higher interest costs – which are likely to increase from 5.3% to 5.7% of GDP –, will significantly increase the nominal deficit from 2.55% in 2010 to 3.05% of GDP in 2011.

This higher nominal deficit will not, however, lead to an increase in the net debt/GDP ratio owing to an increase in the nominal GDP, boosted by a rising inflation. For this reason, we expect the net debt/GDP ratio to decline slightly, from 40.2% in December 2010 to 39.9% in December 2011.

fiscal policy

Federal Government reverses expansionary nature of the fiscal policy

But states and municipalities are spending more

The Federal Government's fiscal policy in 2011 is expected to contribute to control the economic growth rate, as spending is likely to grow less than the economy is projected to grow. CNI expects federal spending to increase by 2.6% in real terms, against a real GDP growth of 3.5% in 2011.

On the other hand, regional governments are likely to go in the opposite direction and keep increasing their spending at a rate way above GDP growth. It is therefore difficult to measure the contribution of the fiscal policy to controlling the economic growth rate and, consequently, the inflation rate.

Despite expectations of a lower primary federal spending, very high spending levels were observed in the first two months of the year. Federal Government's spending grew by 9.2% in real terms in January and February 2011 in relation to the same period in the previous year. Regional governments, which have maintained an expansionary fiscal policy, increased their spending by 10.8% on the same comparison basis.

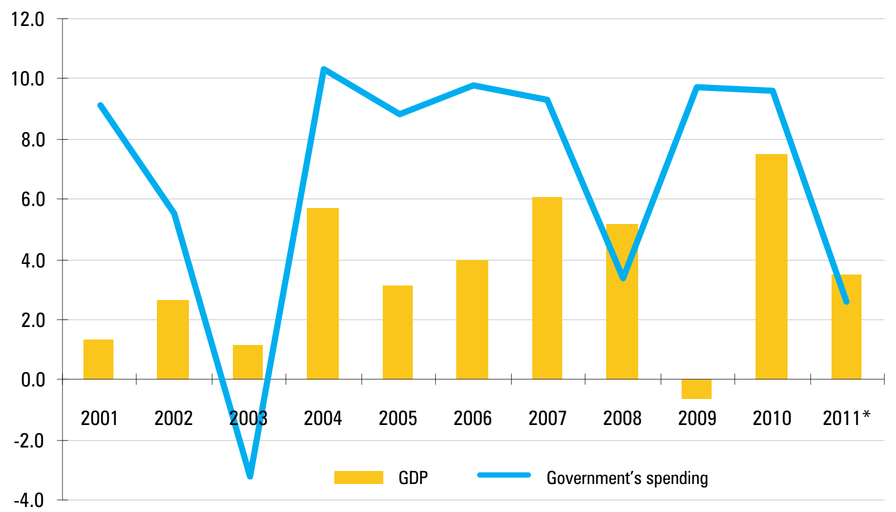
Defrayal and capital expenses were the ones that contributed most to this rise in federal spending. They grew at a rate of 16.6% in the first two months of 2011 as compared to the same period the year before.

Among the other items included in primary federal spending, social security expenditures rose by 5.8% in real terms in the first two months of 2011 in comparison with the same period in the previous year. Spending with staff, in turn, increased by 4.6% in real terms on the same comparison basis.

Real growth in Federal Government's spending and in GDP

Percentage of GDP

Federal Government's primary spending will grow less than GDP in real terms after two years of strong fiscal expansion



Source: National Treasury and IBGE - Elaboration and projection for 2011: CNI
Deflator: IPCA

This higher spending has not affected primary results significantly, but it continues to boost economic activity and make it difficult to control inflation. Primary results improved due to an increase in revenues, which more than made up for the rise in spending.

The Federal Government's net revenue increased by 11.1% in real terms in the first two months of 2011 in relation to the same period in 2010. This result denotes a faster growth rate than in 2010, when the net revenue rose by 10.1% – excluding the effects of the Petrobras capitalization process.

For states and municipalities, revenues are expected to grow by 13.7% in real terms by February as compared to the same period in 2010. This result can be mainly attributed to an increase in Federal Government transfers (25.6%).

This marked increase resulted mainly from revenues from the Tax on Industrial Products (IPI) on automobiles (after the end of temporary reductions in this tax which had been effective since March 2010) and from higher revenues from the Corporate Income Tax (IRPJ). A 7.9% increase in the Turnover Tax (ICMS) also contributed to these higher revenues.

Better fiscal results in the first two months of 2011

The evolution of revenues and expenses in the first two months of 2011 caused the primary surplus to rise from 2.14% until December 2010 to 2.20% of GDP (R$ 81.7 billion) in the 12-month accumulated figure (until February) for the Federal Government and its state enterprises.

1.3% in relation to the same month in the previous year, almost half the rate of employment growth. This gap will push the average annual unemployment rate down.

The increase observed in the unemployment rate between December 2010 (5.3%) and February 2011 (6.4%) is seasonal. This indicator is expected to keep oscillating above 6.0% until the second quarter of the year and then drop again to less than 5.0% in December 2011. If these estimates are confirmed, the average unemployment rate will amount to 6.0% in 2011.

The scenario projected by CNI of a lower average annual unemployment rate is based on the assumption that jobs will keep growing at a rate above that of people looking for a job entering the labor market. The labor force has grown at a lower rate than employment for more than three years.

Higher-than-inflation wage increases and more jobs boost real total payroll

Although real total payroll will grow less strongly in 2011, this variable will still increase at a significant rate. Total earnings usually received from the main job grew by 6.1% in February in relation to the same month in the previous year. This indicator has grown at a decreasing rate since October 2010, when it recorded a growth of 10.1% on the same comparison basis.

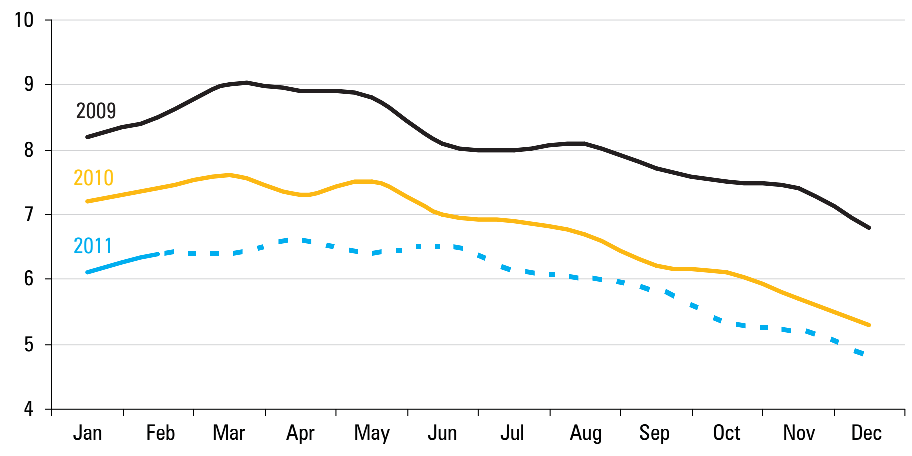
Despite a slowdown in its growth rate, total payroll is likely to keep rising at positive rates. According to data from Dieese, 89% of all salary adjustments in 700 bargaining units in the industrial, trade and service sectors remained above inflation in 2010, as measured by INPC/IBGE. This is the highest figure registered in the entire historical series of the survey, initiated 15 years ago.

Wage negotiations are expected to remain positive in 2011. Coupled with a backdrop of rising employment, they will ensure a positive performance of household consumption.

Unemployment rate

In % of the labor force

Lower job search will continue to push the unemployment rate down

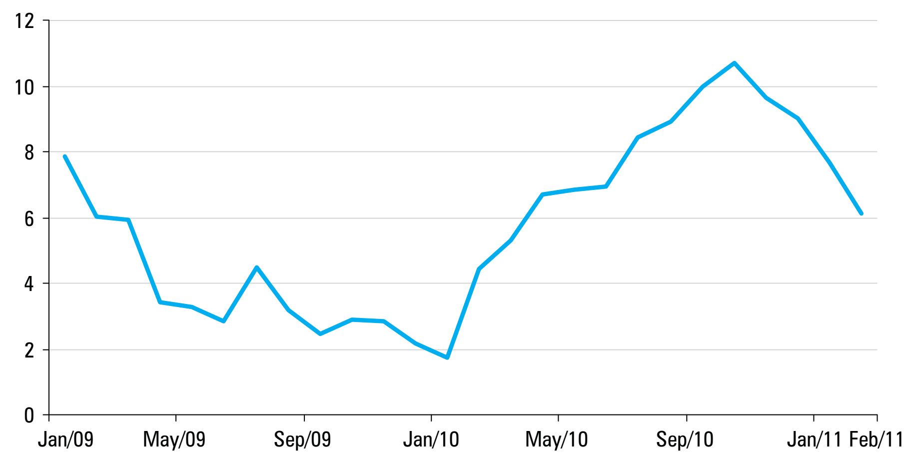


Source: IBGE. Projection: CNI

Real total earnings usually received from the main job

Variation in relation to the same month in the previous year

Despite losing momentum, total payroll is still rising above GDP growth



Source: IBGE.

inflation, interest rates and credit

Policy coordination will define inflation this year

Increase in service prices enhances inflationary scenario

The inflation scenario in 2011 has changed significantly in recent months. Price hikes were not seen as a problem until mid-2010. However, early in 2011 they prevented the inflation target of 4.5% a year from being achieved.

Regulated and industrial-product prices have contributed little to keeping the Extended Consumer Price Index (IPCA) (index on which the inflation target is calculated) at high levels. From June 2007 to March 2011, the average 12-month accumulated figure for regulated (3.3% per year) and industrial (3.1% per year) prices will remain below the 4.5% per year central target.

In recent years, the IPCA level was defined by the evolution of service prices and the volatility of the index was determined by variations in food prices.

The 12-month average figure for service prices stood at 6.3% per year (since June 2007). This accumulated figure varied little recently and kept the IPCA at high levels, as its weight in the IPCA is 25%.

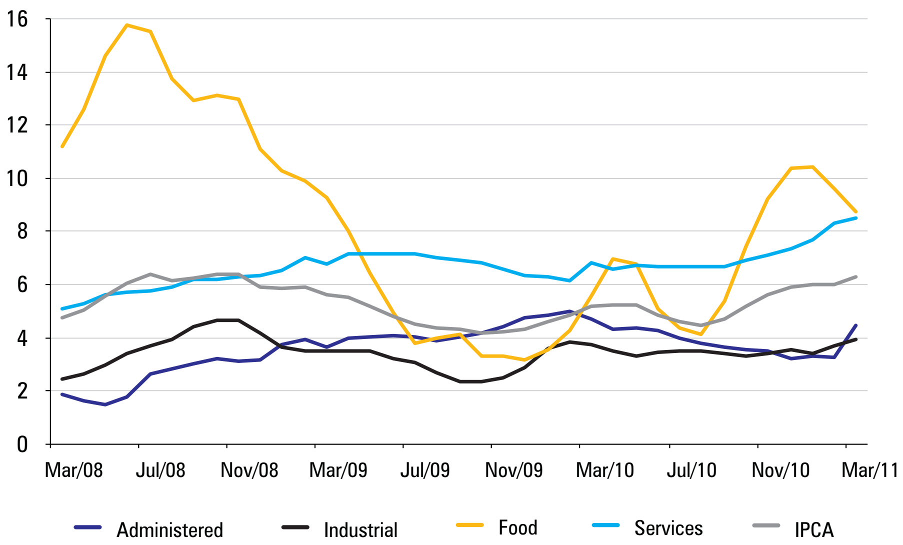
High volatility in food prices was registered in the period. While the 12-month average figure was calculated at 8.5% per year (since June 2007), this indicator hit the mark of 15.8% per year in June 2008 and then dropped to 3.2% a year in December 2009. Because its weight in the IPCA is 23.4%, it makes the total index volatile.

Food prices had been on an upward trend since late 2010. This trend resulted mainly from foreign demand conditions and from seasonal features that affected international commodity prices. But food prices began to decline between January and March 2011.

IPCA by groups

12-month accumulated percentage

Service prices on an upward trend early this year



Source: IBGE Elaboration: CNI

Both in January and February, the IPCA stood at about 6% per year, rising to 6.3% per year in March. However, an aspect of the movement observed in these months deserves special mention: the influence of food products, which are more volatile, on the index was replaced by an increase in the index for services. In March, service inflation stood at 8.5% per year, above its average level and equivalent to the accumulated figure for food products (8.7% per year).

Service prices increased as a result of three factors: (i) the positive performance of domestic demand; (ii) lack of skilled workers in the market, which led to an increase in the prices of services provided by these professionals; and (iii) the high number of inflation-indexed prices, such as rent (the General Market Price Index - IGP-M, which is used for rent adjustments, accumulated a 11.3% increase in 2010) and education. It takes time for this kind of increase to lose momentum, meaning that the IPCA is likely to remain at high levels for a long period.

Overall, industrial-product prices are expected to remain below the target, mainly as a result of the exchange rate anchor (an appreciated exchange rate makes imported products cheaper, increasing price competition with national goods) and of the capacity to increase the supply of these products (via investments). Producer prices (IPA-OG-M/FGV) have risen at a faster pace since mid-2010, but there was virtually no pass-through of these hikes to end products. The fast rise observed in this index lost momentum in recent months, a behavior that is likely to be followed by the share of industrial products in the IPCA.

Regulated prices are expected to grow more than in 2010 owing to a high indexation rate. Food prices are likely to keep growing over the year, but less strongly than in 2010. Service prices, in turn, will increase more significantly and persistently until year end. For this reason, CNI estimates that the IPCA will close 2011 at 6% per year.

Policy coordination should be given priority

The inflation estimated for the remaining months of this year does not reflect a benign scenario. Adjustment measures are a must, but they should not be based on controlling inflation by raising interest rates only.

The new federal administration has stressed the need and its intention to adopt alternative macroprudential measures. Some practical steps have already been taken, such as applying restrictions on credit through compulsory deposits and regulatory taxes (IOF), but their effects on the inflation path are not immediate and have barely been felt so far. It is crucial to make sure that the fiscal policy will contribute more to a macroeconomic policy that is less harmful to economic growth.

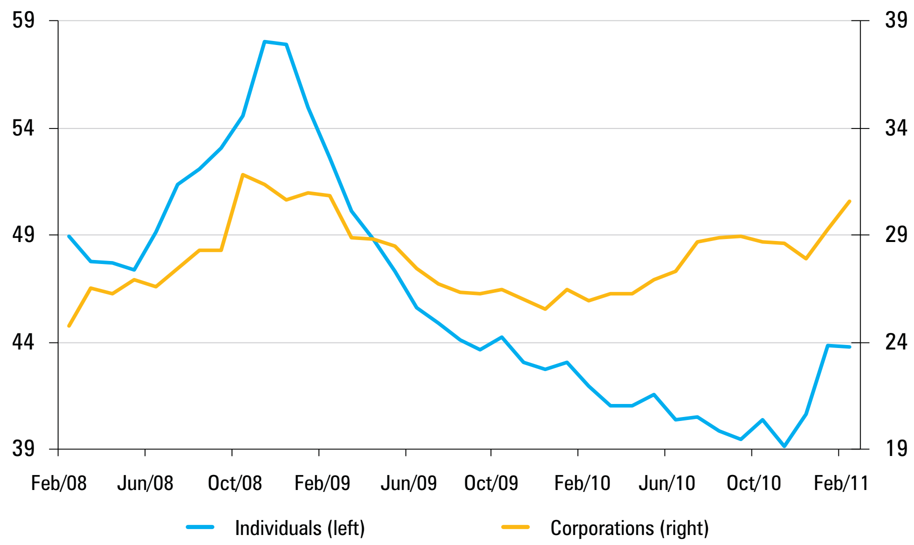
The most important measure for this purpose is reducing current government spending. Specific measures and cutting the budget as announced (by R$ 50 billion) can lead to a more favorable outlook for inflation. It is therefore necessary to ensure that this budget adjustment will be implemented in practice.

However, what is likely to happen in practice is that a less expansionary fiscal policy will be implemented that will be insufficient to adjust inflation within the target without raising the Selic rate. Given this scenario, CNI estimates that the Selic rate will close the year at 12.50% per year, with a real rate of 5.4% per year.

Interest rates for individuals and corporations

Percent per year

Rates are up in 2011 owing to measures to slow down credit



Source: Central Bank

Measures to restrict credit push interest rates up

The effects of the macroprudential measures that were taken to increase both capital requirements for loans to individuals and compulsory deposit requirements began to be felt in the credit market. While loans continue to be granted at a high rate – new loans to individual borrowers in February 2011 exceeded those registered in the same month last year by 22% and loans to corporations increased by almost 10% –, interest rates have risen already.

Rates on loans to corporations had been rising since early 2010, from 25.5% per year late in 2009 to 27.9 % per year in December 2010. However, in the first two months of 2011 alone, the increase was higher than that seen throughout 2010: in February, the rate hit the mark of 30.6% per year, a growth of 2.7 percentage points (p.p.).

The increase in rates on loans to individuals in 2011 reversed the downtrend observed throughout last year (interest rates dropped by 2.1 p.p. between December 2009 and 2010). From January to February 2011, interest rates increased by 3.2 p.p.

Over the next few months, this rise in interest rates is likely to reduce the rate at which loans are being granted right now. It takes time for the effects of these measures to be felt and they have not yet influenced general price levels directly. However, they tend to create a better scenario for fighting inflation without the need to increase basic interest rates significantly.