

## COMMENTS ON THE BRAZILIAN ECONOMY

### **In brief...**

Inflation accelerated and the Central Bank raised the overnight rate once more. The economy gave signs to be slowing down. Ibovespa lost 8.3% in USD terms. An oil company made a strong debut in the stock market, and mergers and acquisitions maintained their rhythm. Controversy surrounded upcoming government rules on telecom mergers, port operations, and offshore oil digging. Fiscal and external accounts remained in order.

### **Inflation accelerates, and the Central Bank reacts...**

The monthly consumer price index (CPI) reached 0.9% last month, to close the year's first half at an annual rate of 7.8%, above the 6.5% upper limit of the government's inflation target range (which is 4.5% plus or minus 2%). More worrisome still, the wholesale price index gained 2.3% last month, closing the year's first half at an annual rate of nearly 14.1%. In yesterday's weekly Central Bank survey of market analysts, CPI expectations jumped to 6.3% for this year and to 4.8% for 2009, respectively from 5.5% and 4.6% one month ago. The Central Bank raised its target overnight rate to 12.75% from 11.75% previously, and clearly stated its intent to keep tightening monetary policy as long as required to bring inflation back to 4.5% over the medium term.

### **...but economic activity remains positive...**

GDP grew at a seasonally adjusted annual rate of 2.9% in the 1<sup>st</sup> quarter, the lower since the 2<sup>nd</sup> quarter of 2006. Monthly industrial production and capacity utilization rates grew only marginally through May, and consumer confidence declined for the 2<sup>nd</sup> month in a row in June. Other indicators, however, suggest that economic activity remains healthy: retail sales grew handsomely through April and urban employment continued to expand, with the unemployment rate falling to 7.7% in May, the lowest since the new series started in 2002. Bank credit [*see this new series in the Economic Data, sharing space with the broad-money concept of M3*] grew strongly through May, but apparently less so in June.

### **Global equity sell-off is felt in Brazil...**

In sympathy with major international exchanges, Ibovespa closed the month down 8.3% in USD terms, while Brazil's currency appreciated 2.3%, to end the month at just below R\$1.60 to the USD, its strongest level since January 1999. Increased risk aversion abroad widened the 5y Brazil's CDS spread over Libor to 121bp from 85bp the previous month. Domestically, inflation fears raised the 2y interest rate swap to 15.4% from 14.2% in May.

### **...while capital markets favor big tickets...**

Eike Batista's oil digging company OGX made a strong debut, raising R\$6.7 billion (\$4.2bn) in its initial public offer, the largest in Brazil's market to date. Other than this, however, the market only absorbed an additional offer of R\$380 million (\$238m) by commodity producer SLC Agrícola. Vale announced a primary worldwide offer that may reach \$14 billion, apparently designed to



strengthen its acquisition capacity. Brazil's biggest real estate developer Cyrella paid R\$1.5 billion (\$938m) to acquire Agra, a developer with a strong presence in the northeast region. Finally, the Belgian-located and Brazilian-run beer producer InBev is reportedly launching a hostile bid for Anheuser-Busch, following on the latter's refusal of its \$46 billion bid.

### **Controversy surrounds new rules for infrastructure...**

Anatel, the telecoms regulator, issued tentative new rules that will permit Oi/Telebrás to acquire Brasil Telecom; thus forming a "national champion" in the telecoms sector, but it required--to Oi's objections--that fixed line telephony and broad band be split into two separate business entities. The Minister of Mines and Energy said that he favors a new model to explore the apparently huge new deep-water oil fields in southern Brazil, involving a new 100% government-owned firm that would operate according to a shared production model, rather than using the current auction-based concession mechanism. Petrobrás and private oil-digging companies raised strong objections and the theme continues under discussion. Controversy also rages on new rules for the operation of private ports, which would allow these to serve third parties freely. Private operators of public ports objected that this would be unfair competition, and the topic also continues under discussion. Separately, the power regulator Aneel promoted the largest auction of power transmission lines to date, for a total for 1.9 thousand miles, from which there will result investments of the order of R\$2.9 billion (\$1.8bn).

### **External and fiscal accounts remain in order...**

June's trade flows continued to reflect the end of an auditors' strike in March and April, but at \$2.7 billion the trade surplus was lower than the surprisingly strong \$4.1 billion of May. International reserves surpassed the \$200 billion mark, although growing more slowly than last year because of a more relaxed attitude of the Central Bank toward the *Real's* appreciation with respect to the US dollar. The public sector had a R\$3 billion (\$1.9bn) overall deficit in May, but accumulates a surplus of R\$3.9 billion (\$2.4bn) in the year. The net public sector debt closed May at 40.8% of GDP, with a reduction of 1.9pp from December last year.

### **Furthermore...**

After an eventful June, July may witness less activity because of a recess in Congress and the beginning of summer holidays in the Northern Hemisphere. Politics will dominate the year's 2<sup>nd</sup> half because of local elections that will be held in all Brazilian municipalities on October 5. Markets, that remain worried about inflation, will follow attentively the local price indexes and economic activity indicators; as well the unsteady financial and economic signs coming from the US.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12-Month Period	
													Last	Proj. (3)
<b>INFLATION RATE (1)(2)</b>														
2007 CPI (IPCA)	0.4	0.4	0.4	0.3	0.3	0.3	0.2	0.4	0.3	0.2	0.2	0.7	4.3	3.3
WPI	0.4	0.2	0.3	(0.1)	(0.1)	0.0	0.3	1.3	1.8	1.4	1.0	2.4	9.2	(0.9)
IGPM	0.5	0.3	0.3	0.0	0.0	0.3	0.3	1.0	1.3	1.1	0.7	1.8	7.7	1.4
2008 CPI (IPCA)	0.7	0.6	0.2	0.6	0.6	0.9							5.9	8.5
WPI	1.2	0.6	1.0	0.7	2.0	2.3							17.1	21.6
IGPM	1.1	0.5	0.7	0.7	1.6	2.0							13.4	18.5
<b>MONEY AND CREDIT (1) (4)</b>														
2007 M3	1.0	1.1	0.5	1.9	1.2	1.4	1.4	0.7	2.4	1.6	1.0	2.0	17.4	15.8
Bank credit	0.8	1.4	1.2	2.6	1.5	1.4	2.2	3.0	1.8	2.8	3.3	2.8	27.8	23.4
2008 M3	(0.0)	1.0	1.0	2.3	1.5								17.4	20.7
Bank credit	1.0	1.5	3.5	2.5	2.6								32.4	40.3
<b>INTEREST RATES (5)</b>														
2007 Overnight (Interbank rate in R\$)	12.9	12.9	12.7	12.4	12.4	11.9	11.4	11.4	11.2	11.2	11.2	11.2	11.9	12.3
Two-year interest rate (in R\$)	12.2	11.9	11.6	10.9	10.5	10.6	11.0	11.8	11.4	11.5	12.1	12.8	11.5	10.7
Two-year interest rate (in USD)	5.7	6.0	5.7	5.5	6.1	6.3	6.4	6.8	5.9	5.3	6.3	4.8	5.9	6.0
2008 Overnight (Interbank rate in R\$)	11.2	11.2	11.2	11.6	11.6	12.2							11.4	11.8
Two-year interest rate (in R\$)	12.8	12.5	13.3	13.7	14.2	15.4							12.7	14.4
Two-year interest rate (in USD)	3.9	4.3	3.8	3.7	4.7	5.0							5.1	4.5
<b>STOCK MARKET</b>														
<b>IBOVESPA, São Paulo Stock Exchange Market Index</b>														
2007 Traded Volume (daily average in US\$ mm.) (6)	1215	1641	1437	1674	1699	2005	1917	2139	2213	2916	3169	3050	2089.5	1792.5
Index Variation (end of month in US\$)	1.0	(1.4)	7.8	7.7	12.6	4.2	2.2	(4.7)	19.5	13.9	(5.7)	2.1	73.4	155.3
2008 Traded Volume (daily average in US\$ mm.)	3096	3135	2976	3121	3732	3169							2886.1	3340.8
Index Variation (end of month in US\$)	(6.3)	11.6	(7.6)	15.4	10.8	(8.3)							44.6	88.5
<b>EXCHANGE RATE</b>														
<b>(End of month)</b>														
2007 (a) R\$/US\$ (7)	2.12	2.12	2.05	2.03	1.93	1.93	1.88	1.96	1.84	1.74	1.78	1.77	---	---
(b) % monthly change	(0.6)	(0.3)	(3.2)	(0.8)	(5.2)	(0.1)	(2.5)	4.5	(6.3)	(5.2)	2.3	(0.7)	(17.2)	(22.1)
2008 (a) R\$/US\$ (7)	1.76	1.68	1.75	1.69	1.63	1.59							---	---
(b) % monthly change	(0.6)	(4.4)	3.9	(3.5)	(3.4)	(2.3)							(17.4)	(31.4)
<b>MAIN BRAZILIAN BONDS (%)</b>														
2007 CDS 5-yr (8)	98.0	95.9	83.3	72.0	62.1	75.8	130.3	104.5	85.1	81.3	98.4	103.0		
BR 40 Spread over US Treasury (9)	134.0	136.0	109.0	97.0	85.4	106.0	153.3	144.0	116.5	116.0	175.3	170.4		
2008 CDS 5-yr (8)	135.7	152.4	177.7	108.3	85.2	121.0								
BR 40 Spread over US Treasury (9)	221.6	230.4	235.1	161.0	132.5	186.5								
<p>(1) End of month values. Percentage change over the previous period.</p> <p>(2) WPI (Wholesale Price Index) and IGPM (General Price Index, Market) from the Vargas Foundation; CPI (IPCA) (Consumer Price Index) from IBGE. The last figure for the CPI refers to the 30-day period ending on the 15th of this last month; previous figures refer to the full monthly period. Figures for the IGPM [a weighted average of Vargas Foundation's consumer price index (30%), WPI (60%), and national construction price index (10%)], always refer to the 30-day period ending on the 20th of each month.</p> <p>(3) Based on the average of the last three months, accumulated for 12 months.</p> <p>(4) M3 = currency outside banks plus demand deposits plus savings deposits plus CDs plus money market funds plus repurchase operations with federal securities. Bank credit = financial institutions' total credit to public and private sectors.</p> <p>(5) Annual yields, in percentage terms, gross of 20% withholding tax on nominal income on nonbank operations. End of period values, except for the overnight rate, which is the cumulative value for the month. The USD rate is a swap rate and is deliverable in R\$.</p> <p>(6) Daily average = total monthly volume / business days.</p> <p>(7) Average of the offer rate of the last business day of the month.</p> <p>(8) CDS = premium in basis points, calculated over Libor, paid as a protection against Brazil's default over a 5y period.</p> <p>(9) Spread over US Treasury bond of equivalent duration, in basis points. BR 40 is callable on or anytime after 2015/08/17.</p>														

GDP (1)	2005				2006					2007					2008			
	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1			
Index (1995 = 100)	127.8	126.7	127.6	126.7	129.5	130.0	132.3	133.9	131.4	135.2	137.3	139.8	142.0	138.6	143.0			
% quarterly change	2.4	(0.8)	0.7	3.2	1.5	0.3	1.8	1.2	3.7	1.0	1.5	1.8	1.6	5.4	0.7			
<b>ECONOMIC ACTIVITY</b>														<b>Year</b>				
	<b>Jan</b>	<b>Feb</b>	<b>Mar</b>	<b>Apr</b>	<b>May</b>	<b>Jun</b>	<b>Jul</b>	<b>Aug</b>	<b>Sep</b>	<b>Oct</b>	<b>Nov</b>	<b>Dec</b>	<b>Average</b>					
2007 Industrial Production (2)	117.0	117.9	119.4	119.5	121.2	122.4	122.1	123.7	123.0	127.2	124.7	123.7	121.8					
Capacity Utilization (3)	81.3	81.7	82.0	82.4	82.6	82.1	82.5	82.4	82.7	82.9	83.3	83.1	82.4					
2008 Industrial Production (2)	126.0	125.5	126.2	126.5										126.0				
Capacity Utilization (3)	83.0	83.0	83.1	83.2										83.1				
2007 Retail Sales (4)	127.9	129.1	129.4	130.8	131.9	132.3	133.0	134.6	136.3	136.2	138.8	139.1	133.3					
Consumer Confidence (5)	134.2	134.5	128.3	128.3	127.0	130.4	130.4	130.7	132.3	134.1	136.7	140.1	132.3					
2008 Retail Sales (4)	141.8	140.6	142.7	143.1										142.0				
Consumer Confidence (5)	142.8	147.3	147.9	149.0	147.6	142.9										146.2		
<b>EMPLOYMENT (%)</b>														<b>Year</b>				
	<b>Jan</b>	<b>Feb</b>	<b>Mar</b>	<b>Apr</b>	<b>May</b>	<b>Jun</b>	<b>Jul</b>	<b>Aug</b>	<b>Sep</b>	<b>Oct</b>	<b>Nov</b>	<b>Dec</b>	<b>Average</b>					
2007 Unemployment Rate (6)	9.8	9.6	9.6	9.6	9.7	9.5	9.4	9.2	9.0	8.8	8.5	8.6	9.3					
Employment Level (7)	115.1	115.4	116.0	115.8	115.5	116.5	116.8	117.3	117.6	118.1	118.6	118.4	116.8					
2008 Unemployment Rate (6)	8.4	8.5	8.1	8.0	7.7										8.1			
Employment Level (7)	119.3	119.5	120.0	120.8	120.9										120.1			
<b>PUBLIC SECTOR BUDGET (8)</b>														<b>last</b>				
<b>(% of GDP)</b>	<b>Jan</b>	<b>Feb</b>	<b>Mar</b>	<b>Apr</b>	<b>May</b>	<b>Jun</b>	<b>Jul</b>	<b>Aug</b>	<b>Sep</b>	<b>Oct</b>	<b>Nov</b>	<b>Dec</b>	<b>12 months</b>					
2007 Overall Balance (9)	(0.2)	(1.2)	(1.9)	(0.1)	(0.8)	(0.6)	(0.9)	(1.0)	(1.5)	(1.4)	(1.5)	(2.3)	(2.3)					
Ex-interest Balance	6.7	5.1	4.6	6.3	5.9	5.8	5.5	5.3	4.9	5.1	4.9	4.0	4.0					
Net Public Debt (10)	44.4	44.5	44.6	43.9	44.3	43.9	43.7	42.7	43.2	43.1	42.3	42.7						
2008 Overall Balance (9)	2.5	(0.2)	0.5	0.8	0.3										(1.7)			
Ex-interest Balance	8.2	6.2	6.4	6.8	6.6										4.3			
Net Public Debt (10)	41.9	42.0	41.1	41.0	40.8													
<b>BALANCE OF PAYMENTS</b>														<b>Acc</b>	<b>last</b>			
<b>(US\$ billion)</b>	<b>Jan</b>	<b>Feb</b>	<b>Mar</b>	<b>Apr</b>	<b>May</b>	<b>Jun</b>	<b>Jul</b>	<b>Aug</b>	<b>Sep</b>	<b>Oct</b>	<b>Nov</b>	<b>Dec</b>	<b>May</b>	<b>Jun</b>	<b>12 months</b>			
2007 Trade Balance	2.5	2.9	3.3	4.2	3.9	3.8	3.3	3.5	3.5	3.4	2.0	3.6	16.8	20.6	40.1			
Exports	11.0	10.1	12.9	12.4	13.6	13.1	14.1	15.1	14.2	15.8	14.1	14.2	60.1	73.2	160.7			
Imports	8.5	7.2	9.5	8.3	9.8	9.3	10.8	11.6	10.7	12.3	12.0	10.6	43.3	52.6	120.6			
Current Account	(0.4)	0.4	0.2	1.8	(0.2)	0.5	(0.8)	1.3	0.4	(0.2)	(1.3)	(0.4)	1.9	2.4	1.5			
Foreign Direct Investment (11)	2.4	1.4	2.8	3.5	0.5	10.3	3.6	2.0	1.5	3.2	2.5	0.9	10.5	20.9	34.6			
Other Capital Inflows (12)	1.1	9.4	10.9	10.3	17.6	6.3	6.4	2.6	0.9	5.8	4.7	4.0	49.3	55.7	80.0			
Brazilian Capital Outflows (13)	2.6	(1.2)	(4.8)	(4.2)	(2.3)	(6.1)	(0.3)	(1.0)	(3.6)	(4.6)	0.9	(1.0)	(9.9)	(16.0)	(25.5)			
International Reserves	91.1	101.1	109.5	121.8	136.4	147.1	155.9	161.1	163.0	167.9	175.6	179.8						
Total External Debt (12)	163.3	170.0	175.9	182.1	184.3	191.4	195.4	194.3	195.4	194.6	196.2	193.6						
2008 Trade Balance	0.9	0.9	1.0	1.7	4.1	2.7										8.7	11.4	30.8
Exports	13.3	12.8	12.6	14.1	19.3	18.6										90.6	90.6	178.1
Imports	12.3	11.9	11.6	12.3	15.2	15.9										79.3	79.3	147.3
Current Account	(4.2)	(2.1)	(4.4)	(3.3)	(0.6)										(14.7)	(14.7)	(15.2)	
Foreign Direct Investment (11)	4.8	0.9	3.1	3.9	1.3										14.0	14.0	38.0	
Other Capital Inflows (12)	1.7	4.9	8.8	8.6	2.5										26.5	26.5	57.1	
Brazilian Capital Outflows (13)	1.0	(1.7)	(6.1)	(3.8)	(0.1)										(10.8)	(10.8)	(26.4)	
International Reserves	187.5	191.5	194.8	195.9	197.3	200.7												
Total External Debt (12)	196.2	198.1	202.6	200.2	201.6													
<p>(1) Seasonally adjusted IBGE data. (2) Seasonally adjusted IBGE index for Brazil, average 2002=100.</p> <p>(3) Seasonally adjusted CNI index for Brazil.</p> <p>(4) Seasonally adjusted IBGE data. Nationwide index for inflation-adjusted retail sales, 2003=100.</p> <p>(5) FCESP survey data on São Paulo (metropolitan region) consumer expectations for their current and future economic conditions, with a range from 0 (absolute pessimism) to 200 (absolute optimism).</p> <p>(6) IBGE original household data for the six major Brazilian metropolitan regions, labor force with ten years of age or more, 30-day search period, seasonally adjusted by Itaú BBA.</p> <p>(7) IBGE original household data on employed population for the six major Brazilian metropolitan regions, average 2002=100, seasonally adjusted by Itaú BBA.</p> <p>(8) Accumulated flows in the year to date, except for net public debt which is an end-of-period stock.</p> <p>Includes federal, state and municipal governments, with respective non-financial enterprises (plus the Central Bank).</p> <p>(9) Net public sector borrowing requirements, computed according to the IMF standards, i.e., excluding the capital losses/gains resulting from exchange rate changes.</p> <p>(10) Gross debts less credits of the general government, plus net debts of Central Bank and public enterprises.</p> <p>(11) Includes intercompany loans.</p> <p>(12) Includes stocks, bonds, loans, suppliers' credits, asset transfers, and others</p> <p>(13) Includes direct investment and others</p>																		