

COMMENTS ON THE BRAZILIAN ECONOMY

In brief...

The Central Bank (CB) accelerated the rhythm of monetary tightening. Economic activity remained strong while inflation gave some signs of abating. Fiscal and external accounts offered no surprises. The stock market plunged 6.7% in the month. Brazil's currency sustained its appreciation with respect to the US dollar. Capital markets' activity was very weak. Infrastructure investment regulation continued to provoke active debate. Local election campaigns started gaining shape.

Central Bank tightens the screw...

The CB took most analysts by surprise and raised the overnight rate to 13% from 12.25% previously. The 75bp move contrasts with the expectation that the CB would keep the rhythm of monetary tightening at 50bp per meeting. The minutes of the CB meeting reveal that it wants inflation to converge to the 4.5% target by the end of 2009 (it is currently running at 6.3% on a 12-month basis), and that it was concerned that monetary policy, if kept at its previous rhythm, would not produce this result. Analysts interpreted this as meaning that 75bp is the new *status quo*, at least until signs are clearer that demand growth is abating and inflation expectations (currently at 5.0% for 2009, in the CB's weekly market analysts' survey) are falling. The anticipation of a stronger but shorter tightening cycle contributed to reduce the 2y interest rate to 14.7% yesterday, from 15.4% the previous month.

Economic activity and inflation stay strong...

Consumer price inflation dropped to 0.6% in July from 0.9% in June, but wholesale prices gained the same 2.2% as in June. With the help of weaker commodity prices abroad, food prices domestically seem to be under less pressure than before, and as a consequence analysts are projecting lower inflation figures for this month. Economic activity, as measured by industrial production and employment, remains strong. Consumer and business confidence indexes are, however, anticipating less demand pressure going forward. The deficit of the balance of payments in current account was \$2.6 billion in June, larger than expected by the CB due to the strength of profit remittances. In July, the trade surplus was \$3.3 billion, with exports expanding at the margin only on account of higher prices as quantities remain sluggish. Through June, the public sector consolidated deficit was 1.9% of GDP, in line with market's expectations.

Financial markets remain volatile...

Reflecting negative trends in US markets, but also affected by the impact of weaker commodity prices on its leading firms, Brazil's stock market lost 6.7% in USD terms last month. With the help of higher domestic interest rates, the local currency maintained its tendency to appreciate and ended the month at R\$1.56 per US dollar (down from R\$1.59 in June). Country risk, as measured by the 5y

CDS spread over Libor, declined a little—to 118bp from 121bp the previous month.

...and capital markets show little activity...

Outside of a global stock offer by Vale, which raised \$11.4 billion (less than the \$14 billion that it reportedly aimed for), there was no other offer in the Brazilian stock market last month. The big news in M&A was the acquisition for \$52 billion of the American beer-maker icon Anheuser-Busch by the Belgian-located and Brazilian-run Inbev.

Controversy surrounds power supply sources...

Aneel, the power industry regulator, validated the winning bid of a consortium headed by the French-Belgian Suez for the construction of a mega-power plant in the Amazon region. According to newspaper reports, the Brazilian construction giant Odebrecht that lost the auction intends to contest this decision. This caused government officials to worry about delays in critical power generation investments. Separately, Ibama, the environment-protection regulator, gave a conditional green light for the construction of a third nuclear power plant in Angra dos Reis, in Rio de Janeiro state.

...as well as other infrastructure regulation...

According to newspaper reports, the government will arbitrate a dispute on private ports' rights by issuing a decree to authorize them to freely carry third-parties' cargo, provided that their license to operate is won in a public auction. Controversy also surrounds a bill currently in the Senate establishing new rights to natural gas distribution, which would break the existing monopoly of state-level private concessionaries of this service.

Local election campaigns starts...

On October 5, local elections will be held in all Brazilian municipalities. As a preview of the 2010 presidential elections, the most interesting ones are those in São Paulo city and Belo Horizonte, as they involve three potential presidential candidates: governors José Serra and Aécio Neves, of the main opposition party, who are supporting mayoral candidates; and ruling party São Paulo mayoral candidate Marta Suplicy. Other elections that will help shaping the political party landscape for 2010 are those in Rio de Janeiro, Porto Alegre, Curitiba, Salvador, Recife and Fortaleza.

Furthermore...

July ended with the sad note of the international community's failure to conclude the Doha round of trade liberalization. August, without a meeting of the CB's monetary committee and with politicians focused on local elections, should be a month with attention centered on inflation and economic activity, plus whatever news that manages to flow from the holidays in the Northern Hemisphere.

ECONOMIC DATA

August 01, 2008

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12-Month Period	
														Last	Proj. (3)
INFLATION RATE (1)(2)															
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	0.6						6.3	8.7
	WPI	1.2	0.6	1.0	0.7	2.0	2.3	2.2						19.4	29.2
	IGPM	1.1	0.5	0.7	0.7	1.6	2.0	1.8						15.1	23.6
MONEY AND CREDIT (1) (4)															
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	1.4	1.0							16.8	20.3
	Bank credit	1.0	1.5	3.5	2.5	2.6	2.1							33.4	33.4
INTEREST RATES (5)															
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	12.9						11.5	12.2
	Two-year interest rate (in R\$)	12.8	12.5	13.3	13.7	14.2	15.4	14.7						13.0	14.8
	Two-year interest rate (in USD)	3.9	4.3	3.8	3.7	4.7	5.0	5.0						5.0	4.9
STOCK MARKET															
IBOVESPA, São Paulo Stock Exchange Market Index															
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	3452	3232						3019.2	3472.1
	Index Variation (end of month in US\$)	(6.3)	11.6	(7.6)	15.4	10.8	(8.3)	(6.7)						32.0	(19.6)
EXCHANGE RATE															
(End of month)															
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)	(27.4)
2008	(a) R\$/US\$ (7)	1.76	1.68	1.75	1.69	1.63	1.59	1.56						---	---
	(b) % monthly change	(0.6)	(4.4)	3.9	(3.5)	(3.4)	(2.3)	(1.9)						(16.8)	(26.5)
MAIN BRAZILIAN BONDS (%)															
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	120.6	117.9							
	BR 40 Spread over US Treasury (9)	221.6	230.4	235.1	161.0	132.5	186.5	188.8							
<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>															

ECONOMIC DATA (Cont'd)

August 01, 2008

GDP (1)	2005				2006					2007				2008	
	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1
<i>Index (1995 = 100)</i>	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
<i>% quarterly change</i>	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
ECONOMIC ACTIVITY													Year		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Average	
2007 Industrial Production (2)	117.0	118.1	119.6	119.6	121.5	121.5	121.9	123.6	122.9	127.2	124.7	123.9		121.8	
Capacity Utilization (3)	81.5	81.6	82.0	82.1	82.3	82.4	82.5	82.6	82.8	82.9	83.0	82.8		82.4	
2008 Industrial Production (2)	126.2	125.6	126.2	126.6	125.8	129.2								126.6	
Capacity Utilization (3)	82.8	83.0	82.9	82.9	82.8									82.9	
2007 Retail Sales (4)	127.9	129.2	129.4	130.8	131.9	132.4	133.0	134.6	136.3	136.2	138.8	139.0		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)	141.7	140.6	142.7	143.1	143.9									142.4	
Consumer Confidence (5)	142.8	147.3	147.9	149.0	147.6	142.9	131.5							144.1	
EMPLOYMENT (%)													Year		
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	Average	
2007 Unemployment Rate (6)	9.8	9.6	9.6	9.5	9.9	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	115.6	116.5	116.8	117.3	117.5	118.0	118.6	118.4		116.8	
2008 Unemployment Rate (6)	8.4	8.4	8.1	8.0	7.7	7.7								8.1	
Employment Level (7)	119.3	119.5	120.1	120.9	121.0	121.7								120.4	
PUBLIC SECTOR BUDGET (8)													last		
(% of GDP)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	last	12 months	
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	44.4	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	(0.1)								(1.9)	
Ex-interest Balance	8.3	6.3	6.5	6.9	6.5	6.2								4.3	
Net Public Debt (10)	41.9	42.2	41.2	40.9	40.6	40.4									
BALANCE OF PAYMENTS													Acc	last	
(US\$ billion)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Acc	Jul	12 months
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	20.6	24.0	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	73.2	87.3	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	52.6	63.3	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)	2.4	1.6	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	20.9	24.5	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	55.7	62.0	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)	(16.0)	(16.2)	(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	3.3						11.4	14.7	30.8
Exports	13.3	12.8	12.6	14.1	19.3	18.6	20.5						90.6	111.1	184.4
Imports	12.3	11.9	11.6	12.3	15.2	15.9	17.1						79.3	96.4	153.6
Current Account	(4.2)	(2.1)	(4.4)	(3.3)	(0.6)	(2.6)							(17.3)		(18.3)
Foreign Direct Investment (11)	4.8	0.9	3.1	3.9	1.3	2.7							16.7		30.4
Other Capital Inflows (12)	4.0	6.6	8.8	8.6	2.5	1.4							31.8		56.2
Brazilian Capital Outflows (13)	0.3	(1.7)	(6.1)	(3.8)	(0.1)	1.9							(9.6)		(19.1)
International Reserves	187.5	191.5	194.8	195.9	197.3	200.8	203.6								
Total External Debt (12)	196.2	198.1	201.6	200.2	203.0	205.3									

(1) Seasonally adjusted IBGE data.

(2) Seasonally adjusted IBGE index for Brazil, average 2002=100.

(3) Seasonally adjusted CNI index for Brazil.

(4) Seasonally adjusted IBGE data. Nationwide index for inflation-adjusted retail sales, 2003=100.

(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).

(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.

(7) IBGE original household data on employed population for the six major Brazilian metropolitan regions, average 2002=100, seasonally adjusted by Itaú BBA.

(8) Accumulated flows in the year to date, except for net public debt which is an end-of-period stock.

Includes federal, state and municipal governments, with respective non-financial enterprises (plus the Central Bank).