

## COMMENTS ON THE BRAZILIAN ECONOMY

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

Intense debate started on the alternatives for the exploration of large oil reserves discovered off Brazil's coast. Economic activity remained strong, but inflation dropped due to lower food prices. Weaker commodity prices and a stronger dollar brought local financial markets down. Lower profit remittances reduced the country's external deficit, while the government accounts remained healthy.

### **Debate over new oil wealth heats up...**

Last November, Petrobras announced to have found large oil reserves off Brazil's southern coast, to the tune of 5-8 billion barrels of light crude. Subsequently, speculation arose that around 80 billion worth of oil barrels might lie below a thick layer of salt under Brazil's sea bed, with the potential to convert the country in one of the top world's oil producers. According to some estimates, this new oil wealth will only begin to materialize by 2012, and will require some \$600 billion worth of investments, including on new technologies capable of bringing onshore oil lying 7km below sea level, 300km off Brazil's southern coast. However, except for a discussion on how to raise the capital of Petrobras--a government-controlled public corporation with 60% of its shares in the hands of private investors--to cope with the investment challenge, the debate last month centered mostly on the need of a new institutional framework to oversee the exploration of the new oil fields.

### **...which may lead to new rules on 'subsalt' oil exploration...**

Currently, the government auctions off the rights to oil blocks--most of them having been won by Petrobras in association with foreign companies--and obtains in return exploration rights, royalties and taxes amounting to some 40% of the sale proceeds (plus its share of Petrobras' dividends). Some 25% of the so-called subsalt oil fields have already been auctioned off according to this rule. Press reports are that for the remaining 75% the government favors a production-sharing model, in which a newly created government entity would remain as owner of the reserves, while contractors would bear all the exploration costs in return for an agreed share of production. Unsurprisingly, oil companies, including Petrobras, objected to these rumors, arguing that the current framework can be adapted to provide the government with a higher tax intake and more control over levels and destination of production, without the need of major legal changes that would require a lengthy investment-disturbing process of legislative approval and judicial consolidation. A ministerial-level commission is scheduled to submit its recommendations to President Lula by September 19, but the government may prefer to postpone a legislative debate on this topic until after the local elections taking place in all Brazilian municipalities next month.

### **Economic activity remains strong, while headline inflation drops...**

According to São Paulo industrial indicators, economic activity remained robust through July, with capacity utilization rates reaching record-high levels. The same healthy economic picture emerges from the July unemployment rate, which increased only slightly from the record-low levels of June, but otherwise remained well below previously published figures. A major drop of food prices led the wholesale price index to post a deflation of 0.7% in August. Consumer price inflation remained positive, but dropped to 0.4% from 0.6% in July. "Core" non-food prices, however, maintained their upward trend, suggesting that the Central Bank (CB) monetary committee might continue to tighten monetary policy in its forthcoming September 10<sup>th</sup> meeting.

### **Lower commodity prices and a stronger dollar hit local markets...**

Brazil's stock market, which is dominated by Petrobras, Vale, Gerdau, and other steelmakers, suffered from a softening of commodity prices and a stronger dollar, losing 10.1% in USD terms in August. Traded volumes sunk to their lowest levels in the year. After four months of uninterrupted appreciation, the *Real* depreciated 3.8% with respect to the USD. Brazil's risk as measured by the 5y CDS went up to 130bp over Libor, from 118bp in the previous month. The 2y local interest rate swap dropped to 14.4% from 14.7% in July, in the expectation of a shorter-lived interest-rate tightening cycle.

### **External accounts improve and government accounts remain healthy...**

A deceleration in the rhythm of profit remittances gave breath to the current account of the balance of payments. CB forecasts the current account turned negative in about \$1 billion in August, less than half of the \$2.1 billion deficit in July and the \$2.6 billion deficit in June. In the year to date, the current account deficit reached \$19.5 billion, whereas the CB forecast for the year as a whole, to be revised this month, is \$21 billion. Thanks to strong tax revenues, through July the overall public sector deficit was only 0.5% of GDP, which is less than the deficit of 0.9% of GDP in the same period last year despite higher debt payments. Separately, the Finance Minister announced that, starting probably next year, the government will be targeting the overall government balance and not only the ex-interest or primary balance, and aim at a near zero budget deficit by 2010. The proposed accounting changes may also split the cash-flow and investments of state-owned commercially-run enterprises from the public sector accounts (conveniently, this last move will allow Petrobras to disburse the huge sums needed for the development of the new oil fields without raising the government deficit.)

### **Furthermore...**

Market participants will be paying attention to the CB monetary committee meeting this September 10<sup>th</sup>, to evaluate if it feels the need for less monetary tightening than previously anticipated, in response to the better-than-expected recent inflation figures. The business community will consider carefully the recommendations of the government commission on the 'subsalt' oil fields if its report is indeed published this month. Politicians will focus on the elections for mayors and councilors in October, which means that only limited congressional activity will occur this month.

ECONOMIC DATA

September 01, 2008

		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	3.9
	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	6.5
	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	6.2
2008	CPI (IPCA)	0.7	0.6	0.2	0.6	0.6	0.9	0.6	0.4					6.3	7.8
	WPI	1.2	0.6	1.0	0.7	2.0	2.3	2.2	(0.7)					17.0	15.8
	IGPM	1.1	0.5	0.7	0.7	1.6	2.0	1.8	(0.3)					13.6	14.5
<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	17.1
	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	22.6
2008	M3	(0.0)	1.0	1.0	2.3	1.4	1.0	1.7						17.3	17.9
	Bank credit	1.0	1.5	3.5	2.5	2.6	2.2	1.7						32.7	29.3
<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	11.6
	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	11.2
	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	6.5
2008	Overnight (Interbank rate in R\$)	11.2	11.2	11.2	11.6	11.6	12.2	12.9	12.9					11.6	12.7
	Two-year interest rate (in R\$)	12.8	12.5	13.3	13.7	14.2	15.4	14.7	14.4					13.2	14.8
	Two-year interest rate (in USD)	3.9	4.3	3.8	3.7	4.7	5.0	5.0	4.6					4.8	4.8
<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	2020.2
	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	6.2
2008	Traded Volume (daily average in US\$ mm.)	3096	3135	2976	3121	3732	3452	3232	2604					3057.9	3095.8
	Index Variation (end of month in US\$)	(6.3)	11.6	(7.6)	15.4	10.8	(8.3)	(6.7)	(10.1)					24.5	(65.1)
<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)	7.0
2008	(a) R\$/US\$ (7)	1.76	1.68	1.75	1.69	1.63	1.59	1.57	1.63					---	---
	(b) % monthly change	(0.6)	(4.4)	3.9	(3.5)	(3.4)	(2.3)	(1.6)	3.8					(17.1)	(0.8)
<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	120.6	117.9	130.3						
	BR 40 Spread over US Treasury (9)	221.6	230.4	235.1	161.0	132.5	186.5	188.8	231.2						
<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)**

September 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
<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	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)	81.2	81.5	82.1	82.4	82.6	82.1	82.5	82.4	82.6	82.8	83.2	83.0		82.4	
2008 Industrial Production (2)	126.2	125.6	126.2	126.6	125.8	129.2								126.6	
Capacity Utilization (3)	82.9	83.0	83.0	83.1	82.5	83.3								83.0	
2007 Retail Sales (4)	128.0	129.2	129.6	131.0	131.9	132.2	132.9	134.5	136.2	136.2	138.7	139.1		133.3	
Consumer Confidence (5)	134.2	134.5	128.3	128.3	127.0	130.4	130.7	132.3	134.1	136.7	140.1			132.3	
2008 Retail Sales (4)	141.9	140.7	142.9	143.4	144.9	146.8								143.4	
Consumer Confidence (5)	142.8	147.3	147.9	149.0	147.6	142.9	131.5	137.5						143.3	
<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	9.3	9.2	9.0	8.8	8.5	8.7		9.3	
Employment Level (7)	115.1	115.4	116.0	115.8	115.6	116.5	116.8	117.3	117.6	118.0	118.6	118.4		116.8	
2008 Unemployment Rate (6)	8.4	8.5	8.1	8.1	7.6	7.7	7.9							8.1	
Employment Level (7)	119.3	119.5	120.1	120.8	121.0	121.7	121.5							120.5	
<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	44.4	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)	(0.5)							(1.9)	
Ex-interest Balance	8.3	6.3	6.5	6.9	6.6	6.2	6.0							4.4	
Net Public Debt (10)	41.9	42.2	41.2	40.9	40.7	40.4	40.6								
<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>Jul</b>	<b>Aug</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	24.0	27.5	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	87.3	102.4	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	63.3	74.9	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)	1.6	2.9	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	24.5	26.4	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	62.0	64.6	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)	(16.2)	(17.3)	(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	2.3					14.7	17.0	29.5
Exports	13.3	12.8	12.6	14.1	19.3	18.6	20.5	19.7					111.1	130.8	189.1
Imports	12.3	11.9	11.6	12.3	15.2	15.9	17.1	17.5					96.4	113.9	159.5
Current Account	(4.2)	(2.1)	(4.4)	(3.3)	(0.6)	(2.6)	(2.1)						(19.4)		(19.6)
Foreign Direct Investment (11)	4.8	0.9	3.1	3.9	1.3	2.7	3.2						19.9		30.1
Other Capital Inflows (12)	4.0	6.6	8.8	8.6	2.5	1.4	3.4						35.3		53.3
Brazilian Capital Outflows (13)	0.3	(1.7)	(6.1)	(3.8)	(0.1)	1.9	(2.4)						(12.0)		(21.3)
International Reserves	187.5	191.5	194.8	195.9	197.3	200.8	203.6	205.3							
Total External Debt (12)	196.2	198.1	201.6	200.2	203.0	205.3	208.5								
<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>															