

COMMENTS ON THE BRAZILIAN ECONOMY AMID CONTINUED EXTERNAL VOLATILITY, BRAZIL MARCHES ON

In brief...

Brazil's GDP grew very strongly in the first quarter, but slowed down in the second quarter. The Central Bank (CB) again raised the basic interest rate while still projecting inflation above the 2011 target. Local financial markets fluctuated in response to continued worldwide volatility. Fiscal accounts deteriorated and the external accounts offered no surprises. Action in the capital markets was tepid. President Lula's candidate pulled ahead in the polls.

Economic activity is vigorous...

Brazil's GDP grew by a healthy 2.7% in the first quarter on a non-annualized seasonally-adjusted basis. Domestic demand was very strong, particularly capital formation which expanded by 7.4%, thus completing three consecutive quarters with an annualized growth rate of over 30%. Economic growth slowed down in the second quarter, and GDP may have expanded by less than 1.0%, according to our estimates. In the Vargas Foundation reports for June, consumer confidence continued to increase, while business confidence dipped a little. Industrial capacity utilization, which had dropped in May, increased again in June to reach its highest level since August 2008. For the year as a whole, in line with our own expectations, the recently released CB Quarterly Inflation Report raised its GDP growth estimate to 7.3%, up from 5.8% in the previous report.

Central Bank tightens monetary policy...

For the second time in a row, the CB monetary policy committee raised the basic interest rate by 75 bps, setting it at 10.25%. Thanks mostly to easing pressure from food prices, inflation slowed down somewhat in June. For the months ahead, however, core indexes continue to point to a higher-than-targeted rate of inflation. Moreover, under the assumption of constant interest and exchange rates, the CB anticipates that inflation will remain above target through 2011. For this reason, we believe that the CB will raise the basic interest rate by an additional 150 bps before the October elections. Separately, to compensate for a reduction in the volume of rural credit supply requirements, the CB increased the required volume of bank reserves for demand deposits. Meanwhile, total bank credit continued to expand strongly throughout June.

Markets stay volatile...

In response to continued uncertainty about the pace of world economic recovery, local markets remained volatile. With trading volume slackening somewhat because of the World Cup, the Ibovespa closed June with a drop of 2.5% in dollar terms. The Brazilian *real* appreciated marginally, to R\$1.80 to the dollar, down from R\$1.82 the previous month. Brazil's 5-year CDS spread over Libor widened to 138 bps from 135 bps in May.

Fiscal policy remains expansionary...

Despite ample tax receipts, the primary (or ex-interest) public sector surplus remained stable at relatively low levels because of vigorous growth in spending. The composition of government spending is improving, with a growth of capital expenditures of 63% in real terms for the three months ending in May, relative to the same period last year. But other spending – on maintenance, social security and civil servants' salaries – is also increasing faster than GDP. Given legal restrictions on the budget, in effect from this July because of the October elections, spending growth is likely to slow down in the second half of the year. Separately, President Lula vetoed a congressional bill that revoked an automatic mechanism that raises the minimum retirement age in accordance with the country's population longevity. He agreed, though, to increase pensions by a sizable 7.7% (rather than the 6.1% of his original proposal to Congress).

Two-way international investment flows resume...

Foreign direct investment in Brazil was a strong US\$3.5 billion in May, but, at US\$2.4 billion, Brazilian direct investment abroad was also strong. The trade balance had a solid US\$2.3 billion surplus in June. We're now projecting that the trade surplus will reach US\$13 billion for the full year, which compares favorably with the US\$9 billion in our previous forecast. International reserves continued to expand, reaching US\$253 billion in June.

Capital markets are tepid...

Due to a delay in the assessment of the value of the sub-salt oil reserves that the federal government will transfer to it, Petrobras postponed until September its mega-stock offering. The senate approved most of the new bills for sub-salt oil exploration, but the package returned to the House, which is expected to hold a final vote in July. Banco do Brasil went ahead with a large share offering that reached R\$9.8 billion (US\$5.4 billion).

President Lula's candidate takes the lead...

Ms. Dilma Rousseff, President Lula's former chief of staff and his candidate for the presidency in the forthcoming October elections, jumped ahead of the opposition candidate, former São Paulo state governor José Serra, in the polls. She is clearly benefiting from the immense popularity of President Lula, as well as from the country's economic upswing. Separately, the regional electoral courts started putting into practice a new law that prevents individuals found guilty of legal transgressions from being candidates for electoral posts. The federal electoral court still has to rule on this legislation, which according to some estimates could affect some 5,000 would-be candidates for local councils, state and federal legislatures, and state governments.

Furthermore...

After the World Cup ends this July 11, the electoral season will start in earnest. The government hopes that congress will pass the new oil bills before effectively closing for business until the end of October. Other than that, market participants will divide their attention between the financial turbulence abroad and the CB's interest rate decision on July 21.

ECONOMIC DATA

July 01, 2010

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12-Month Period	
														Last	Proj. (3)
INFLATION (1) (2)															
2009	CPI (IPCA)	0,5	0,6	0,2	0,5	0,5	0,4	0,2	0,2	0,2	0,3	0,4	0,4	4,3	5,4
	WPI	(1,0)	0,2	(1,2)	(0,4)	(0,3)	(0,5)	(0,9)	(0,6)	0,5	0,0	0,1	(0,5)	(4,4)	(4,7)
	IGPM	(0,4)	0,3	(0,7)	(0,2)	(0,1)	(0,1)	(0,4)	(0,4)	0,4	0,1	0,1	(0,3)	(1,7)	(1,3)
2010	CPI (IPCA)	0,8	0,8	0,5	0,6	0,4	0,2							5,0	4,9
	WPI	0,5	1,4	1,1	0,7	1,5	1,1							5,1	14,0
	IGPM	0,6	1,2	0,9	0,8	1,2	0,9							5,2	11,8
MONEY AND CREDIT (1) (4)															
2009	M3	(0,1)	0,8	0,7	1,3	1,6	1,0	1,4	1,7	2,1	0,7	1,4	2,0	15,5	15,1
	Bank credit	1,0	0,8	0,8	0,9	1,2	1,4	1,6	1,5	1,4	1,2	1,3	1,3	15,4	12,2
2010	M3	(0,5)	0,3	1,4	(0,3)	1,0								12,9	8,6
	Bank credit	1,4	1,4	1,4	1,5	1,6								18,5	19,6
INTEREST RATES (5)															
2009	Overnight (Interbank rate in R\$)	12,7	12,7	11,2	10,2	10,2	9,2	8,7	8,7	8,7	8,7	8,7	8,6	9,8	9,8
	Two-year interest rate (in R\$)	11,5	11,0	10,4	10,8	10,1	10,6	10,5	10,7	11,3	11,5	11,7	11,9	11,0	10,5
	Two-year interest rate (in USD)	3,8	4,1	3,3	2,6	2,9	3,3	3,0	3,0	3,0	2,8	3,2	2,9	3,1	2,9
2010	Overnight (Interbank rate in R\$)	8,7	8,7	8,7	9,4	9,4	10,2							8,9	9,7
	Two-year interest rate (in R\$)	11,7	11,7	11,8	12,4	12,2	12,1							11,6	12,2
	Two-year interest rate (in USD)	2,2	3,2	3,1	2,3	2,8	2,8							2,9	2,6
STOCK MARKET															
IBOVESPA, São Paulo Stock Exchange Market Index															
2009	Traded Volume (daily average in US\$ mm.) (6)	1581	1758	1737	2209	2588	2606	2566	3510	2977	4121	3645	3678	2748	2468
	Index Variation (end of month in US\$)	5,6	(5,4)	10,1	22,3	24,7	(2,2)	10,9	2,4	15,5	2,0	8,5	2,8	145,0	14,9
2010	Traded Volume (daily average in US\$ mm.) (6)	3784	3626	3683	3875	4018	3022							3542	3638
	Index Variation (end of month in US\$)	(11,2)	5,1	7,6	(1,4)	(10,9)	(2,5)							2,4	-4,9
EXCHANGE RATE															
(End of month)															
2009	(a) R\$/US\$ (7)	2,32	2,38	2,32	2,18	1,97	1,95	1,87	1,89	1,78	1,74	1,75	1,74	---	---
	(b) % monthly change	31,6	2,7	(2,7)	(5,9)	(9,4)	(1,1)	(4,1)	0,8	(5,7)	(1,9)	0,3	(0,5)	(24,8)	(49,5)
2010	(a) R\$/US\$ (7)	1,87	1,81	1,78	1,73	1,82	1,80								
	(b) % monthly change	7,4	(3,2)	(1,7)	(2,7)	4,8	(0,9)							(7,8)	4,6
MAIN BRAZILIAN BONDS (%)															
2009	CDS 5-yr (8)	345,0	400,6	325,3	274,1	191,0	176,4	133,8	137,8	126,6	137,5	129,1	122,5		
	BR 40 Spread over US Treasury (9)	394,3	407,0	367,0	302,5	197,1	212,0	194,7	193,9	177,9	168,6	153,0	133,9		
2010	CDS 5-yr (8)	144,0	131,4	130,5	123,0	135,4	137,7								
	BR 40 Spread over US Treasury (9)	171,4	146,5	121,8	128,3	186,2	174,7								
<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 seasonally adjusted by Itaú-BBA</p> <p>(5) Annual yields, in percentage terms, gross of 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)

July 01, 2010

GDP (1)	2007				2008					2009				2010	
	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1
Index (1995 = 100)	138,4	140,2	143,5	139,7	145,6	147,4	149,8	144,9	146,9	142,7	144,8	147,9	151,3	146,7	155,4
% quarterly change	1,2	1,3	2,4	6,1	1,5	1,2	1,6	(3,3)	5,1	(1,5)	1,5	2,1	2,3	(0,2)	2,7
ECONOMIC ACTIVITY															
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year Average		
2009 Industrial Production (2)	106,9	109,6	110,5	111,9	113,5	114,3	117,2	118,6	120,6	124,4	123,6	123,6	116,2		
Capacity Utilization (3)	78,4	77,9	77,9	78,2	79,0	79,4	79,9	81,1	81,9	82,5	82,9	83,8	80,2		
2010 Industrial Production (2)	125,2	126,9	131,3	130,3	130,2								128,8		
Capacity Utilization (3)	83,8	84,0	84,3	85,1	84,9	85,5							84,6		
2009 Retail Sales (4)	148,3	149,9	149,5	149,7	150,5	153,3	154,1	155,4	156,6	159,2	161,1	160,1	154,0		
Consumer Confidence Index (5)	96,9	95,9	98,3	100,0	102,9	108,2	111,3	111,0	111,0	113,4	115,1	112,3	106,4		
Business Confidence Index (6)	75,1	76,2	78,0	82,6	87,0	90,6	95,7	100,2	103,6	107,0	109,6	113,4	93,3		
2010 Retail Sales (4)	164,3	166,6	170,2	165,1									166,6		
Consumer Confidence Index (5)	113,0	110,7	111,5	115,6	116,3	118,5							114,3		
Business Confidence Index (6)	113,6	115,8	116,5	115,3	116,1	115,3							115,4		
EMPLOYMENT (%)															
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year Average		
2009 Unemployment Rate (7)	8,6	8,2	8,4	8,3	8,3	8,0	8,0	7,9	7,8	7,8	7,8	7,8	8,1		
Employment/Household Survey (8)	114,6	114,2	114,1	114,0	114,2	114,4	115,4	115,3	115,2	115,2	115,6	116,5	114,9		
Employment/Business Registry(9)	133,0	132,9	132,9	132,9	133,0	133,2	133,6	134,3	134,9	135,7	136,9	137,7	134,2		
2010 Unemployment Rate (7)	7,5	7,2	7,1	6,8	7,1								7,1		
Employment/Household Survey (8)	117,0	118,0	118,4	118,9	119,0								118,2		
Employment/Business Registry(9)	138,7	139,6	140,6	141,4	142,3								140,5		
PUBLIC SECTOR BUDGET (10)															
(% of GDP)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Last 12 months		
2009 Overall Balance (11)	(3,1)	(3,1)	(2,9)	(2,3)	(2,7)	(2,9)	(3,2)	(3,2)	(3,8)	(3,4)	(3,2)	(3,3)			
Ex-interest Balance	3,1	2,3	2,6	3,2	2,6	2,4	2,2	2,1	1,6	2,0	2,3	2,1			
Gross Public Debt (12)	58,9	59,4	59,8	59,2	59,6	60,9	62,5	63,7	63,9	64,7	64,2	62,8			
Net Public Debt (13)	38,9	39,0	39,1	39,8	40,9	41,2	42,0	42,1	43,2	43,4	43,1	42,8			
2010 Overall Balance (11)	0,8	(2,1)	(3,5)	(2,1)	(2,7)								(3,3)		
Ex-interest Balance	6,2	3,3	2,1	3,4	2,7								2,1		
Gross Public Debt (12)	63,5	62,7	59,9	60,0	60,1										
Net Public Debt (13)	41,5	41,8	42,0	41,8	41,4										
BALANCE OF PAYMENTS															
(US\$ billion)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Acc Dec	Acc May	last 12 months
2009 Trade Balance	(0,5)	1,8	1,8	3,7	2,6	4,6	2,9	3,1	1,3	1,3	0,6	2,2	25,4	9,4	25,4
Exports	9,8	9,6	11,8	12,3	12,0	14,5	14,1	13,8	13,9	14,1	12,7	14,5	153,0	55,5	153,0
Imports	10,3	7,8	10,0	8,6	9,3	9,8	11,2	10,8	12,5	12,8	12,0	12,3	127,6	46,1	127,6
Current Account	(2,8)	(0,6)	(1,6)	0,1	(1,7)	(0,5)	(1,7)	(0,8)	(2,3)	(2,9)	(3,3)	(5,9)	(24,0)	(6,5)	(24,0)
Foreign Direct Investment (14)	1,9	2,0	1,4	3,4	2,5	1,5	1,3	1,9	1,8	1,6	1,6	5,1	26,0	11,2	26,0
Other Capital Inflows (15)	(3,2)	(2,2)	3,1	4,1	7,2	7,8	4,6	8,7	10,4	15,5	2,7	1,7	60,2	8,9	60,2
Brazilian Capital Outflows (16)	1,4	0,3	(1,6)	(4,7)	(5,9)	(0,9)	(0,1)	(2,2)	(6,0)	(4,7)	1,7	6,5	(16,2)	(10,5)	(16,2)
Intl Reserves / Liquidity (17)	200,8	199,4	202,5	201,3	205,6	208,4	211,9	219,1	224,2	232,9	238,0	239,1			
Total External Debt (15)	199,6	195,8	192,6	193,1	194,0	199,0	195,9	204,0	201,7	204,7	205,5	198,2			
2010 Trade Balance	(0,2)	0,4	0,7	1,3	3,4	2,3								7,9	21,7
Exports	11,3	12,2	15,7	15,2	17,7	17,1								89,2	169,6
Imports	11,5	11,8	15,1	13,9	14,3	14,8								81,3	147,9
Current Account	(3,8)	(3,3)	(5,1)	(4,6)	(2,0)									(18,7)	(36,2)
Foreign Direct Investment (14)	0,8	2,8	2,0	2,2	3,5									11,4	26,1
Other Capital Inflows (15)	2,7	9,8	9,0	8,9	7,5									37,8	89,2
Brazilian Capital Outflows (16)	2,6	(7,9)	(2,6)	(2,8)	(4,5)									(15,2)	(20,9)
Intl Reserves / Liquidity (17)	240,8	241,3	244,0	247,3	249,1	253,3									
Total External Debt (15)	200,9	203,0	206,5	211,6	218,3										
<p>(1) Seasonally adjusted IBGE data.</p> <p>(2) Seasonally adjusted IBGE index for Brazil, average 2002=100.</p> <p>(3) Seasonally adjusted FGV data for Brazil.</p> <p>(4) Seasonally adjusted IBGE nationwide index for inflation-adjusted retail sales, 2003=100.</p> <p>(5) FGV survey data on nationwide consumer expectations for their current and future economic conditions. Seasonally adjusted, September 2005 = 100.</p> <p>(6) FGV survey data on nationwide manufacturing industry expectations for their current and future conditions. Seasonally adjusted.</p> <p>(7) 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>(8) IBGE household data (PME) on employed population for the six major Brazilian metropolitan regions, average 2003=100, seasonally adjusted by Itaú BBA.</p> <p>(9) Business registry data (CAGED) from the Labor Ministry, average 2003=100, including all employees with labor cards in the country, seasonally adjusted by Itaú BBA.</p> <p>(10) 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) and excludes Petrobras.</p> <p>(11) Net public sector borrowing requirements.</p> <p>(12) General Government gross debt. Does not include Central Bank, public enterprises and Social Security administration.</p> <p>(13) Gross debts less credits of the general government, plus net debts of Central Bank and public enterprises.</p> <p>(14) Includes intercompany loans.</p> <p>(15) Includes stocks, bonds, loans, suppliers' credits, asset transfers, and others</p> <p>(16) Includes direct investment and others</p> <p>(17) Includes, in addition to cash, stocks of repurchase lines and loans abroad.</p>															