

## COMMENTS ON THE BRAZILIAN ECONOMY Government Battles Inflation

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

Inflation remained on the rise. Brazil's Central Bank indicated that it will continue to raise interest rates, and the government announced a R\$50 billion fiscal austerity plan. President Dilma's proposal for a moderate minimum wage increase was approved by a wide margin in congress, which indicates some commitment to hold down spending and her ability to mobilize lawmakers. Unrest in North Africa, as well as doubts over domestic economic conditions, have caused market volatility. Capital inflows to Brazil were still robust, despite a slowdown in fixed income inflows. Capital markets have been busy, despite unfavorable trends in global flows.

### **Manufacturing disappoints, but elsewhere growth is still robust...**

Manufacturing production fell 0.7% in December and has been roughly at the same level since June. The strong Brazilian real weighs on margins and on market shares, with import-sensitive sectors suffering the most. Elsewhere, strong demand still rules. Passenger traffic at airports rose by 16.4% year over year in January, according to the National Aviation Agency. A consumer confidence index from the Getulio Vargas Foundation rose 0.8% in February. Retail sales were up 10.9% in 2010. Formal jobs were still being created at a solid pace in January. Unemployment rose slightly, to 6.3% (in our seasonally-adjusted estimate), but remains close to recent record lows. Our monthly GDP proxy rose 0.6% in December, rounding off a very strong fourth quarter and suggesting final 2010 GDP growth of 7.4%.

### **... and inflationary pressures remain high.**

In February, the mid-month IPCA-15 consumer inflation index reached 6.1% over a year ago, with average core inflation at 6.0%. Both are above the Central Bank's 4.5% mid-point target. Rapidly increasing commodity prices weigh on an overheated economy, this time without the buffer of an appreciating exchange rate. Service inflation is also a major source of pressure. Market consensus points to a 5.8% IPCA in 2011, and 4.8% in 2012.

### **Monetary conditions will probably continue to be tightened...**

We expect the Selic benchmark rate to rise from 11.25% now to at least 12.50% by June. At the same time, the macro-prudential measures introduced in December had a noticeable impact on bank lending. "Core" new loans (ex overdraft and credit cards) fell 4.7% in January, following a 6.5% decline in December. Auto sales, which depend heavily on credit, fell a seasonally adjusted 6% in January.

### **... and fiscal policy should also help...**

The government promised to trim R\$50 billion from the 2011 budget, a substantial cut. The minimum wage of R\$545 per month was approved by a wide margin in congress. In its first congressional battle, the new administration was able to secure significant support from its allies.

### **...but doubts remain on the fiscal outlook.**

After a surprisingly sharp increase in spending in January, doubt over the feasibility of the fiscal plan has yet to be quelled. Skepticism also stemmed from a new round of capitalization at BNDES, the national development bank, and at Caixa, the state savings bank. BNDES took R\$6.4 billion, and Caixa received R\$2.2 billion. Their combined lending power rose by R\$130 billion.

### **Financial markets responded to global geopolitical risk...**

Local financial markets ended up practically stable through January. After large swings, the Ibovespa rose 2.0% in February, in dollar terms. The Brazilian real appreciated marginally, to R\$ 1.66 to the dollar, from 1.67 in January. Brazil's five-year CDS spread over Libor fell slightly to 118 from 119 in January.

### **... and foreign fixed income flows declined.**

Fixed income capital flows were in the red for the second month in a row in January. Flows reversed rapidly following the two increases in the IOF tax last October. Foreign direct investment was strong, at US\$3.0 billion, and the current account deficit was US\$5.4 billion in January. Over the last 12 months through January, FDI, at US\$50.8 billion, roughly matched the current account deficit of US\$49.1 billion.

### **Capital markets maintained a busy deal schedule, despite unfavorable global flows.**

Inflation concerns, and a somewhat better U.S. outlook, continued to move global funds away from emerging markets and back to developed markets in February. While investors were more selective and many deals were priced at less than planned, a total of three IPOs and three follow-ons were concluded in the beginning of the month. Despite volatile market conditions, close to 15 deals are expected to occur by the end of April.

### **Power outages in the Northeast and in São Paulo.**

Problems in transmission lines left eight Northeastern states in the dark for more than three hours. Heavy rains also caused brown-outs in São Paulo. For 13 minutes on February 8, the Congonhas airport had to turn to its own generators for energy.

### **Furthermore...**

Markets will closely follow the implementation of the fiscal austerity plan and the government's efforts to guide the economy toward slower, more sustainable growth. Watch out for possible protectionist measures to check competition from manufactured imports.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Accumulated	
													12M	3M Annualized
<b>INFLATION (1) (2)</b>														
2010 CPI (IPCA)	0.7	0.8	0.5	0.6	0.4	0.0	0.0	0.4	0.8	0.8	0.6		5.9	7.9
WPI	0.5	1.4	1.1	0.7	1.5	1.1	0.2	1.2	1.6	1.3	1.8	0.6	13.9	5.8
IGPM	0.6	1.2	0.9	0.8	1.2	0.9	0.2	0.8	1.2	1.0	1.4	0.7	11.3	6.3
2011 CPI (IPCA)	0.8	1.0											6.2	10.2
WPI	0.8	1.2											13.9	10.9
IGPM	0.8	1.0											11.3	10.4
<b>MONEY AND CREDIT (1) (4)</b>														
2010 M3	(0.5)	0.3	1.4	(0.3)	1.2	1.3	1.7	2.1	2.4	1.6	1.1	1.6	14.9	12.1
Bank credit	1.5	1.5	1.5	1.5	1.6	1.7	1.7	1.7	1.7	1.6	1.5	1.4	20.7	17.6
2011 M3	0.3												15.8	12.6
Bank credit	1.3												20.6	18.2
<b>INTEREST RATES (5)</b>														
2010 Overnight (Interbank rate in R\$)	8.7	8.7	8.7	9.4	9.4	10.2	10.7	10.7	10.7	10.7	10.7	10.7	9.9	8.6
Two-year interest rate (in R\$)	11.7	11.7	11.8	12.4	12.2	12.1	11.8	11.5	11.9	11.7	12.3	12.3	11.9	11.8
Two-year interest rate (in USD)	2.2	3.2	3.1	2.3	2.8	2.8	2.9	2.5	2.3	2.5	2.8	3.0	2.7	2.8
2011 Overnight (Interbank rate in R\$)	11.2	11.2											10.3	11.0
Two-year interest rate (in R\$)	12.9	12.7											12.1	12.6
Two-year interest rate (in USD)	2.4	2.7											2.7	2.7
<b>STOCK MARKET</b>														
<b>IBOVESPA, São Paulo Stock Exchange Market Index</b>														
2010 Traded Volume (daily average in US\$ mm.) (6)	3784	3626	3683	3875	4018	3022	2998	3140	3702	4519	3761	3732	3655	3696
Index Variation (end of month in US\$)	(11.2)	5.1	7.6	(1.4)	(10.9)	(2.5)	13.5	(3.4)	10.5	1.4	(5.0)	5.4	5.6	(1.1)
2011 Traded Volume (daily average in US\$ mm.) (6)	3756	4369											3715	3952
Index Variation (end of month in US\$)	(4.4)	2.0											1.1	1.0
<b>EXCHANGE RATE (End of month)</b>														
2010 (a) BRL/USD (7)	1.87	1.81	1.78	1.73	1.82	1.80	1.76	1.76	1.69	1.70	1.72	1.67	---	---
(b) % monthly change	7.4	(3.2)	(1.7)	(2.7)	4.8	(0.9)	(2.4)	(0.1)	(3.5)	0.4	0.9	(2.9)	(4.3)	14.5
(c) BRL/EUR (7)	2.63	2.46	2.41	2.31	2.24	2.21	2.29	2.23	2.30	2.37	2.23	2.22	---	---
(d) % monthly change	5.1	(6.3)	(2.2)	(3.9)	(3.1)	(1.5)	3.7	(2.8)	3.3	2.9	(5.7)	(0.4)	(11.1)	(23.6)
2011 (a) BRL/USD (7)	1.67	1.66											---	---
(b) % monthly change	0.4	(0.7)											(8.3)	(12.2)
(c) BRL/EUR (7)	2.28	2.30											---	---
(d) % monthly change	2.8	0.5											(6.7)	12.1
<b>MAIN BRAZILIAN BONDS (%)</b>														
2010 CDS 5-yr (8)	144.0	131.4	130.5	123.0	135.4	137.7	116.7	131.4	114.7	100.0	123.0	110.8		
BR 40 Spread over US Treasury (9)	171.4	146.5	121.8	128.3	186.2	174.7	143.3	154.8	127.8	104.4	107.7	106.8		
2011 CDS 5-yr (8)	118.9	118.0												
BR 40 Spread over US Treasury (9)	94.9	85.4												
<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)

March 1, 2011

GDP (1)	2007		2008					2009					2010			
	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	
Index (1995 = 100)	142.9	139.7	145.4	148.1	150.4	143.9	146.9	141.2	144.0	147.8	150.9	146.0	154.4	157.1	157.9	
% quarterly change	1.7	6.1	1.8	1.9	1.6	-4.4	5.2	-1.9	2.0	2.6	2.1	-0.6	2.3	1.8	0.5	
<b>ECONOMIC ACTIVITY</b>												<b>Year Average</b>				
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec				
2010 Industrial Production (2)	125.4	127.0	131.2	129.9	129.6	128.1	128.6	128.5	128.4	128.7	128.5	127.7	128.5			
Capacity Utilization (3)	83.8	84.0	84.3	85.1	84.9	85.5	85.1	84.9	85.0	85.2	84.5	84.9	84.8			
2011 Industrial Production (2)													-			
Capacity Utilization (3)	84.7	84.5													84.6	
2010 Retail Sales (4)	164.4	166.6	170.5	165.2	167.8	169.5	170.6	173.8	174.4	174.6	175.9	175.9	170.7			
Consumer Confidence Index (5)	112.6	110.5	111.6	115.8	116.8	119.3	120.8	121.8	122.9	120.7	124.2	121.7	118.2			
Business Confidence Index (6)	113.6	115.8	116.5	115.3	116.1	115.3	113.6	112.9	113.4	114.0	112.7	114.5	114.5			
2011 Retail Sales (4)													-			
Consumer Confidence Index (5)	121.6	122.6													122.1	
Business Confidence Index (6)	112.8	112.5													112.7	
<b>EMPLOYMENT (%)</b>												<b>Year Average</b>				
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec				
2010 Unemployment Rate (7)	7.4	7.2	7.1	6.8	7.0	6.9	6.8	6.6	6.4	6.4	6.0	6.2	6.7			
Employment/Household Survey (8)	117.1	118.0	118.3	118.8	118.9	118.4	119.1	119.1	119.4	119.8	119.9	119.9	118.9			
Employment/Business Registry(9)	138.6	139.5	140.5	141.3	142.2	142.9	143.5	144.3	144.9	145.6	146.4	147.2	143.1			
2011 Unemployment Rate (7)													6.3			
Employment/Household Survey (8)	119.7													119.7		
Employment/Business Registry(9)	148.1													148.1		
<b>PUBLIC SECTOR BUDGET (10)</b>												<b>Accumulated 12 months</b>				
(% of GDP)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec				
2010 Overall Balance (11)	0.7	(1.7)	(3.1)	(1.8)	(2.5)	(2.9)	(3.2)	(3.2)	(2.4)	(2.4)	(2.6)	(2.6)				
Ex-interest Balance	5.8	3.5	2.3	3.5	2.8	2.4	2.1	2.1	2.9	2.9	2.7	2.8				
Gross Public Debt (12)	62.6	61.8	59.0	58.9	58.8	58.6	58.4	57.9	57.9	58.1	57.8	55.1				
Net Public Debt (13)	42.1	42.4	42.4	42.1	41.6	41.5	41.7	41.5	40.7	40.4	40.5	41.0				
2011 Overall Balance (11)	(0.5)												(2.6)			
Ex-interest Balance	5.7												2.8			
Gross Public Debt (12)	55.9															
Net Public Debt (13)	40.6															
<b>BALANCE OF PAYMENTS</b>																
(US\$ billion)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Acc Feb	last 12 months		
2010 Trade Balance	(0.2)	0.4	0.7	1.3	3.4	2.3	1.4	2.4	1.1	1.9	0.3	5.4	0.2	20.3		
Exports	11.3	12.2	15.7	15.2	17.7	17.1	17.7	19.2	18.8	18.4	17.7	20.9	23.5	201.9		
Imports	11.5	11.8	15.1	13.9	14.3	14.8	16.3	16.8	17.7	16.5	17.4	15.6	23.3	181.6		
Current Account	(3.8)	(3.3)	(5.1)	(4.6)	(2.0)	(5.3)	(4.6)	(2.9)	(3.9)	(3.8)	(4.7)	(3.5)		(47.5)		
Foreign Direct Investment (14)	0.6	2.8	2.1	2.2	3.6	0.8	2.6	2.4	5.4	6.8	3.7	15.4		48.5		
Other Capital Inflows (15)	2.7	9.9	11.4	9.9	10.1	11.9	7.6	9.2	17.4	14.8	4.5	7.5		117.0		
Brazilian Capital Outflows (16)	2.8	(8.1)	(4.7)	(4.1)	(7.3)	(3.9)	(4.4)	(3.8)	(7.2)	(8.6)	(0.5)	(16.4)		(66.3)		
Intl Reserves / Liquidity (17)	238.5	240.5	241.1	243.8	247.3	249.8	253.1	257.3	261.3	275.2	284.9	288.6				
Total External Debt (15)	200.9	203.0	211.5	211.6	218.3	228.6	235.3	235.4	247.8	254.1	247.1	255.2				
2011 Trade Balance	0.4	1.2													1.6	21.7
Exports	15.2	16.7													31.9	210.4
Imports	14.8	15.5													30.3	188.7
Current Account	(5.4)													(49.1)		
Foreign Direct Investment (14)	3.0													50.8		
Other Capital Inflows (15)	6.1													120.4		
Brazilian Capital Outflows (16)	4.9													(64.2)		
Intl Reserves / Liquidity (17)	297.7	305.8														
Total External Debt (15)	261.4															
<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. 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>																