

## **COMMENTS ON THE BRAZILIAN ECONOMY**

### **Rousseff widens lead over Serra, polls show**

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

Ms. Dilma Rousseff gained ground in the polls over the opposition candidate for President, Mr. José Serra. Concern about the U.S.'s economic recovery affected Brazil's financial markets. Local economic activity maintained a positive rhythm, with inflation under control. Fiscal accounts continued to disappoint, while the balance of payments remained stable. TAM, Brazil's largest airline, merged with the Chilean airline LAN to form the LATAM Airlines Group.

#### **President Lula's candidate does well in the polls...**

Successive public opinion polls published last month showed a continuously widening lead for Ms. Dilma Rousseff, President Lula's candidate for the presidency, over the opposition candidate, Mr. José Serra. According to the latest polls, Ms. Rousseff could win the elections for President on October 3 with a 50% majority, without the need for a run-off later in the month. Analysts agree that this reflects President Lula's huge popularity and a 'feel good factor' that favors political continuity. Ms. Rousseff is a high-level bureaucrat who has never been a candidate for a public post before. However, as President Lula's chief-of-staff until recently, she fully benefits from the President's huge popularity and his total immersion in the election campaign. If elected, she will be the first woman in the country's republican history to rise to the presidency.

#### **...but the opposition may hold ground in the two most populous states...**

According to the latest polls, Ms. Dilma Rousseff could beat Mr. José Serra in nearly all states of the Union. However, in São Paulo and Minas Gerais, the country's two most populous states, the candidates from the opposition Social Democrats (the party currently governs these two states) seem likely to win the local contests for governor. Moreover, the current governor of Minas Gerais state, Mr. Aécio Neves (who refused to become a candidate for vice-president on Mr. Serra's ticket) is poised to win his election for the national Senate with a very large majority, thus guaranteeing an alternate presidential candidate for the opposition in the future. Mr. Neves's strength in the Senate during the next Presidential term, however, will depend on the reelection of other senators from the opposition parties.

#### **Financial markets suffer from uncertainties on the U.S. economy...**

Worries about a 'double dip' in the U.S. negatively affected local markets. Brazil's currency remained firm, but the local stock market dropped 3.4% in the month, while the country's 5-year CDS spread over Libor widened to 131 bps from 117 bps the previous month. In contrast, and reflecting reduced concerns with monetary tightening locally, the 2-year interest rate swap shrank to 11.6% p.a. from 11.8% in the previous month (this rate peaked at 12.4% last May.)

### **Economic activity remains firm and inflation subdued...**

Industrial production grew modestly in July, after three consecutive monthly declines. In the same month, unemployment fell to a low 6.9%, while real wages jumped 2.1%. Supermarket sales rose 0.2% in July, a little slower than in June, but the 3-month trend was still strong at 0.4%. Consumer confidence rose again in August, but business confidence dropped for the third month in a row. Capacity utilization also shrank in August. The latest data for retail sales, employment and wages signal strong growth in consumption. We thus maintain our expectation that industrial activity will speed up in the months ahead. Second-quarter GDP will be announced later this week; we anticipate a non-annualized growth rate of 0.6%. For the third-quarter, our forecast is a GDP growth of around 1%. With the help of a continued decline in food prices, mid-month inflation for August was slightly negative. Given the strength of domestic demand, we anticipate that inflation will pick up in the next few months, requiring additional monetary tightening later in the year. Tonight, however, most likely the monetary committee of the Central Bank will leave the reference overnight rate unchanged at 10.75%.

### **Fiscal accounts deteriorate; external accounts remain under control...**

Brazil's fiscal budget continued to underperform in July. The R\$2.5 billion primary balance was lower than consensus, and the 3-month average surplus was the lowest it has been since 2002. Spending growth (especially investment) continued to offset the rebound in tax collection, creating risk to our 2010 primary surplus forecast of 3.0% of GDP (the government's target is 3.3%) The external accounts for July and their preview for August showed a picture of comfortable liquidity in the balance of payments, with an important recovery of foreign portfolio investments and robust external bond issuance. International reserves grew to US\$261 billion in August, up from US\$257 billion in July.

### **LATAM Airlines Group is created...**

A merger of TAM, Brazil's largest airline, with the Chilean airline LAN was announced, to form a new company – the LATAM Airlines Group – with the intent of competing globally. The deal structure was complex, to comply with Brazil's current regulation that requires Brazilians to hold 80% of the capital of airlines authorized to operate locally. The Brazilian Senate is voting a new regulation that will allow foreigners to own up to 49% of local airlines, but apparently with an escape clause that permits 100% foreign ownership if a reciprocity agreement with the country of origin is in place. Separately, Banco do Brasil and Bradesco announced a new partnership to operate jointly with Portugal's Banco do Espírito Santo in African countries.

### **Furthermore...**

The political campaign will dominate the scene this month as, on October 3, Brazilians will elect a new president, 27 new state governors, 2/3 of the federal Senate, and all members of federal and state-level parliaments. Outside of this, attention will focus on Petrobras's decision to launch a mega-stock offer.

ECONOMIC DATA

September 1, 2010

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	12-Month Period	
													Last	Proj. (3)
<b>INFLATION (1) (2)</b>														
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	3,0
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)	(7,4)
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)	(3,5)
2010 CPI (IPCA)	0,8	0,8	0,5	0,6	0,4	0,0	0,0	(0,1)					4,4	(0,2)
WPI	0,5	1,4	1,1	0,7	1,5	1,1	0,2	1,2					8,1	10,6
IGPM	0,6	1,2	0,9	0,8	1,2	0,9	0,2	0,8					7,0	7,3
<b>MONEY AND CREDIT (1) (4)</b>														
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	17,2
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	18,2
2010 M3	(0,5)	0,3	1,4	(0,3)	1,1	1,3	2,3						14,5	20,9
Bank credit	1,4	1,4	1,5	1,5	1,6	1,5	1,4						18,4	19,5
<b>INTEREST RATES (5)</b>														
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	8,8
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	10,6
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	3,1
2010 Overnight (Interbank rate in R\$)	8,7	8,7	8,7	9,4	9,4	10,2	10,7	10,7					9,2	10,5
Two-year interest rate (in R\$)	11,7	11,7	11,8	12,4	12,2	12,1	11,8	11,5					11,8	11,8
Two-year interest rate (in USD)	2,2	3,2	3,1	2,3	2,8	2,8	2,9	2,5					2,8	2,7
<b>STOCK MARKET</b>														
<b>IBOVESPA, São Paulo Stock Exchange Market Index</b>														
2009 Traded Volume (daily average in US\$ mm.) (6)	1581	1758	1737	2209	2588	2606	2566	3510	2977	4121	3645	3678	2748	2894
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	3,7
2010 Traded Volume (daily average in US\$ mm.) (6)	3784	3626	3683	3875	4018	3022	2998	3140					3547	3053
Index Variation (end of month in US\$)	(11,2)	5,1	7,6	(1,4)	(10,9)	(2,5)	13,5	(3,4)					2,1	2,5
<b>EXCHANGE RATE</b>														
<b>(End of month)</b>														
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)	(16,4)
2010 (a) R\$/US\$ (7)	1,87	1,81	1,78	1,73	1,82	1,80	1,76	1,76						
(b) % monthly change	7,4	(3,2)	(1,7)	(2,7)	4,8	(0,9)	(2,4)	(0,1)					(7,0)	(12,7)
<b>MAIN BRAZILIAN BONDS (%)</b>														
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	116,7	131,4						
BR 40 Spread over US Treasury (9)	171,4	146,5	121,8	128,3	186,2	174,7	143,3	154,8						
<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 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)

September 1, 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
<b>ECONOMIC ACTIVITY</b>													<b>Year Average</b>		
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)	125,1	126,8	131,2	130,0	129,8	128,3	128,9								128,6
Capacity Utilization (3)	83,8	84,0	84,3	85,1	84,9	85,5	85,1	84,9							84,7
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)	164,5	166,8	170,2	165,0	167,6	169,2									167,2
Consumer Confidence Index (5)	113,1	110,8	111,6	115,7	116,4	118,7	120,0	120,8							115,9
Business Confidence Index (6)	113,6	115,8	116,5	115,3	116,1	115,3	113,6	112,9							114,9
<b>EMPLOYMENT (%)</b>													<b>Year Average</b>		
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	7,0	6,9								7,1
Employment/Household Survey (8)	117,0	118,0	118,3	118,8	118,9	118,4	119,1								118,4
Employment/Business Registry(9)	138,7	139,5	140,6	141,4	142,2	142,9	143,5								141,3
<b>PUBLIC SECTOR BUDGET (10)</b>													<b>Last 12 months</b>		
(% of GDP)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec			
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)	(3,4)	(2,1)	(2,7)	(3,0)	(3,3)								(3,4)
Ex-interest Balance	5,9	3,2	2,0	3,3	2,7	2,4	2,1								2,0
Gross Public Debt (12)	63,5	62,7	59,9	60,0	60,1	60,1	60,1								
Net Public Debt (13)	41,5	41,8	42,0	41,8	41,4	41,4	41,7								
<b>BALANCE OF PAYMENTS</b>													<b>Acc Dec</b>	<b>Acc Jul</b>	<b>last 12 months</b>
(US\$ billion)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec			
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	16,9	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	84,1	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	67,2	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)	(8,7)	(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	14,0	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	21,3	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)	(11,5)	(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	1,4	2,4							11,7
Exports	11,3	12,2	15,7	15,2	17,7	17,1	17,7	19,2							106,9
Imports	11,5	11,8	15,1	13,9	14,3	14,8	16,3	16,8							114,4
Current Account	(3,8)	(3,3)	(5,1)	(4,6)	(2,0)	(5,2)	(4,5)								(28,4)
Foreign Direct Investment (14)	0,8	2,8	2,0	2,2	3,5	0,7	2,6								14,7
Other Capital Inflows (15)	2,7	9,8	9,0	8,9	7,5	6,0	9,3								53,1
Brazilian Capital Outflows (16)	2,6	(7,9)	(2,6)	(2,8)	(4,5)	0,9	(5,4)								(19,7)
Intl Reserves / Liquidity (17)	240,8	241,3	244,0	247,3	249,1	253,3	256,9	260,7							
Total External Debt (15)	200,9	203,0	206,5	211,6	218,3	225,2	235,3								

(1) Seasonally adjusted IBGE data.  
(2) Seasonally adjusted IBGE index for Brazil, average 2002=100.  
(3) Seasonally adjusted FGV data for Brazil.  
(4) Seasonally adjusted IBGE nationwide index for inflation-adjusted retail sales, 2003=100.  
(5) FGV survey data on nationwide consumer expectations for their current and future economic conditions. Seasonally adjusted, September 2005 = 100.  
(6) FGV survey data on nationwide manufacturing industry expectations for their current and future conditions. Seasonally adjusted.  
(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.  
(8) IBGE household data (PME) on employed population for the six major Brazilian metropolitan regions, average 2003=100, seasonally adjusted by Itaú BBA.  
(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.  
(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.  
(11) Net public sector borrowing requirements.  
(12) General Government gross debt. Does not include Central Bank, public enterprises and Social Security administration.  
(13) Gross debts less credits of the general government, plus net debts of Central Bank and public enterprises.  
(14) Includes intercompany loans.  
(15) Includes stocks, bonds, loans, suppliers' credits, asset transfers, and others  
(16) Includes direct investment and others  
(17) Includes, in addition to cash, stocks of repurchase lines and loans abroad.