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Inflation on the rise slows down economic growth pace

Higher primary surplus target is expected to reduce the intensity of the rise in interest rates

Inflation on the rise is the main economic highlight in the first half of this year. The figures of the economy still point a solid economic growth as a result of inertial forces, originating mainly in domestic demand. Therefore, GDP is projected to grow by 4.7% in 2008. However, economic policy measures designed to curb the inflationary pressure – particularly the resumption of a restrictive monetary policy – will cool the economy down. GDP data for the second quarter which have not been disseminated yet will reveal an inflection in the current growth cycle, but its effects will be more intensely felt in the second half of this year, and mainly in 2009.

Although the main primary sources of inflation are external – resulting from the continued rise in commodity prices –, the combination of a strong pressure from the inflation in food products and the expansion of credit and income are creating conditions for a more widespread contamination of prices domestically. The inflation rate accumulated in 12 months (IPCA) hit the mark of 5.6% in May, after increasing for seven months in a row. Inflation forecasts for 2008 rose considerably and CNI believes that the annual inflation will rise to 6.4% in December – virtually the highest limit of the inflation target.

Real total payroll continues to grow at a fast pace. This movement is being caused by a strong growth in jobs, since the real income is already dropping somewhat as a result of the higher inflation. However, given the gap between the GDP expansion cycle and the evolution observed in jobs, positive results will continue to be registered in the labor market throughout the year. CNI projects an unemployment rate of 6.7% in December, accumulating an annual average of about 8%.

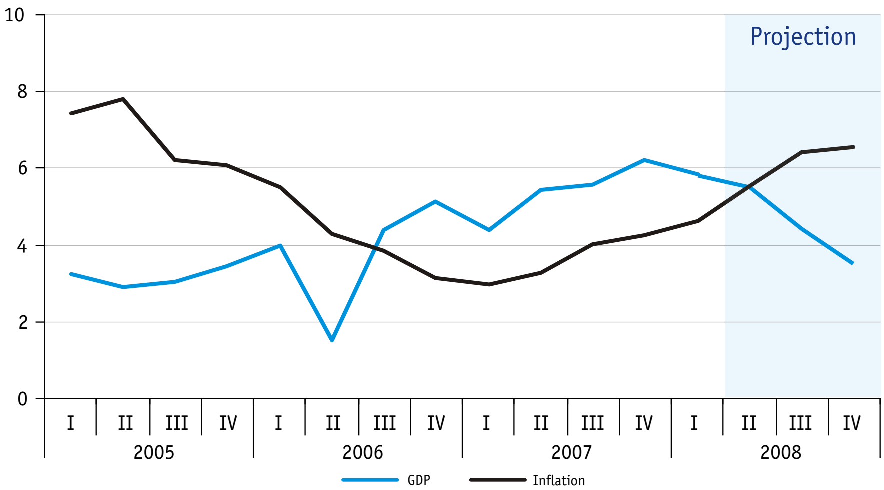
The response of the economic policy is clear in fighting the inflation hike and the challenge lies in controlling it while affecting economic growth as little as possible. The new fact is the greater harmony observed between the fiscal and the monetary policy, as revealed by the announcement of a higher primary surplus target, namely, 4.3% of GDP. The fiscal commitment assumed by the Executive Branch plays a major role in curbing domestic demand and it shares the burden of fighting inflation with the Central Bank, limiting the intensity of an increase in interest rates. Nevertheless, the Selic rate may hit the mark of 14.25% late this year if interest rates continue to rise at the current pace.

The fact that Brazil was awarded with an investment grade rating and a higher interest rate differential led to a further appreciation of the real during the quarter. The impact of this appreciation on trade flows is significant and, as a result, the trade balance is expected to decrease by almost half its current level in 2008, closing the year at about US$ 20 billion.

GDP growth and the inflation rate

Variation (%) in the comparison with the same quarter in the previous year

Inflation hike slows down economic growth



Source: IBGE - Projection: CNI

the Brazilian economy in the second quarter of 2008

economic activity

Signs of inflection in the economic growth path

Economy loses dynamism as inflation and interest rates rise

The Brazilian GDP grew twice as fast in the past two years: from 3.0% a year in the second quarter of 2006 to 5.8% in the first quarter of 2008 (variation accumulated in four quarters in relation to the average registered in the four previous quarters). The second quarter of 2008 will be marked by an inflection in the GDP growth rate, which might decrease even more intensely in the second half of the year.

There are signs already that the manufacturing activity is cooling off. The average production in April and May remained virtually stable as compared to the average observed in the first quarter (0.1% growth, seasonally adjusted). During 2007, its growth rates exceeded 1.5% per quarter. The industry's real revenue has been growing at a lower pace as well: it grew by 0.2% in April and May (as compared to the first quarter, after seasonal adjustments), against an average growth of 2% per quarter in the past four quarters.

The inflection in the economic growth pace is largely associated to the effects of a rising inflation on the income of the population and of a tighter monetary policy on consumption and investments, which today are the main determinants of the economy's dynamism.

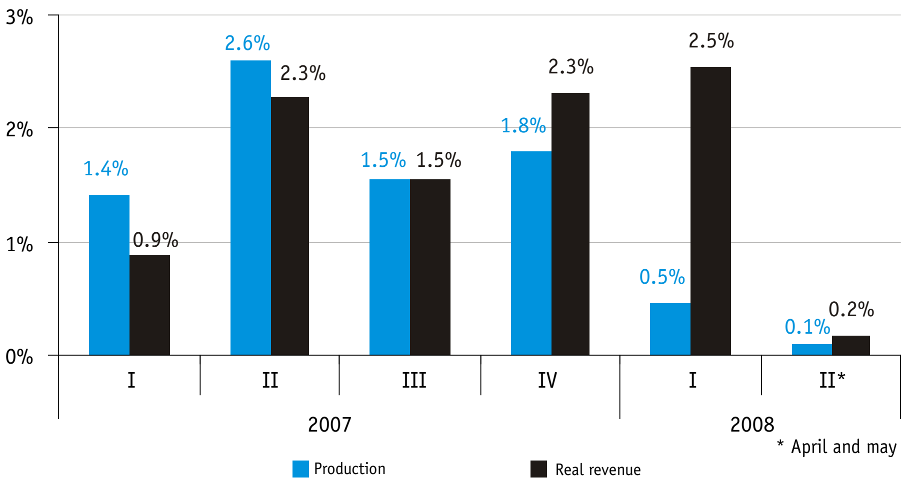
Household consumption grew by 6.7% in the last four-quarter period ending in the first quarter of 2008 and it accounted for 4 percentage points of the GDP growth. Such a significant increase in household consumption had not been registered since 1997. This increase is mainly due to three factors: a) a higher real payroll; b) an increase in government cash transfers in the form of social benefits; and c) greater credit availability.

The real payroll, which has been growing less intensely as a result of the inflation hike, is expected to remain on a downward path due to the negative effects of higher interest rates on jobs.

Industrial production and real revenue

Seasonally adjusted variation (%) between the quarterly average and the one observed in the previous quarter

Manufacturing activity cools off in the second quarter



Source: PIM-PF/IBGE (Production) and CNI Industrial Indicators/CNI (Real revenue)

Government cash transfers will not continue at the same pace observed in 2007. There are exceptions, such as the benefits provided under the Bolsa Família (family grant) program, whose amount was adjusted twice in the past twelve months.

> Second quarter will mark an inflection in the GDP growth rate

The expansion of credit is the main factor leading to a higher consumption of greater value-added goods, such as durables (personal automotive vehicles and furniture items) and capital goods (civil construction, computers, trucks). Although higher interest rates affect credit directly, as they increase the cost of raising funds and require more selectivity for granting credit, another (indirect) effect is also relevant. Higher interest rates cool off the economy, with negative impacts on jobs and income, thereby limiting the expansion of credit. The more the monetary squeeze is intense and lasting, the more intense this restriction will be.

The rise in interest rates can also reduce the growth pace of investments. The gross formation of fixed capital accumulated a growth of 14.9% in the last four-quarter period ending in the 1st quarter of 2008 as compared to the four previous quarters. This is the highest growth rate registered since the 3rd quarter of 1995 on the same comparison basis. The participation of gross formation of fixed capital in GDP amounted to 18.3% in the first quarter of 2008, resuming the level observed in 1995, in the early stages of the post-Real Plan productive restructuring process. This scenario can change in the second half of this year if the economic cool-off affects the optimistic expectations of entrepreneurs in relation to future demand.

GDP is expected to grow 4.7% in 2008

CNI revised the estimated GDP growth to 4.7% in 2008, as opposed to the 5.0% growth projected in the previous survey. This lower GDP growth projection was based on forecasts that the monetary squeeze will be maintained throughout the year. The impacts of rising interest rates on the economic activity are expected to be more pronounced in the second half of this year, particularly in the fourth quarter. In this scenario, GDP would close 2008 with a growth pace of almost 3.5% (comparison between the four quarters of 2008 and 2007).

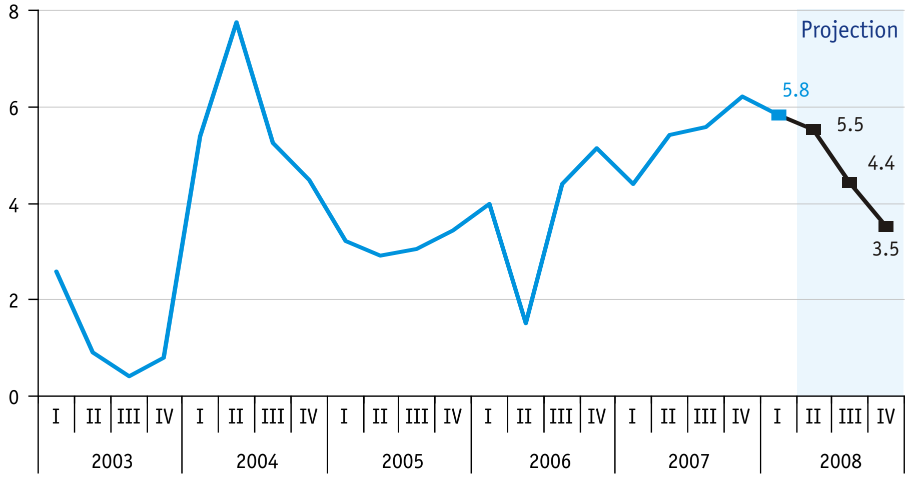
Household consumption is projected to increase by 5.5% in 2008, less than the 7.5% increase projected in the previous survey. This downward revision was mainly determined by the lower consumption observed back in the first quarter. The higher inflation (mainly of food products) reduced the income of the poorest segments of the population, whose propensity to consume is quite high. Consumption is also projected to decrease as a result of the expected effects of higher interest rates on income and credit.

Gross formation of fixed capital is expected to grow by 10.5% in 2008, accumulating three consecutive years marked by two-digit variation rates. However, this scenario of decreased economy activity can affect the predisposition of entrepreneurs to invest.

GDP Evolution

GDP: Variation (%) in relation to the same quarter in the previous year

GDP growth pace is projected to slow down in 2008



Source: National Accounts/IBGE and CNI (projection)

The persistent appreciation of the real causes major changes on the foreign demand contribution side in GDP. Exports of goods and services are expected to remain stable this year in relation to 2007, interrupting an eleven-year growth trend. Imports are projected to increase by 18.0%. As a result, the net contribution of the foreign trade sector to GDP formation will be negative by 2.2 percentage points.

Agricultural/livestock production will increase by 4.5%. Rising agricultural commodity prices will be an incentive to increasing the planted area and the harvest in 2008. The service industry is also expected to grow by 4.5%. CNI maintains the estimate of an industrial output growth of 5.0% in 2008, a level close to the one registered in 2007. Taxes continue to outpace GDP growth and are expected to increase by 5.7%.

GDP: Projections for 2008

	GDP Components	2008 Rate of change (%)	2008 Contribuition (p.p.)
Demand	Household consumption	5.5	3.3
	Government consumption	5.0	1.0
	GFCF	10.5	2.5
	Exports	0.0	0.0
	(-) Imports	18.0	2.2
Suppy	Agriculture and livestock	4.5	0.3
	Industry	5.0	1.4
	Services	4.5	2.9
	Taxes	5.7	
	GDP - market prices	**4.7**	

jobs and income

Jobs grow intensively

Unemployment rate in 2008 is the lowest one in six years

Jobs in Brazil's six largest metropolitan regions (Monthly Job Survey/IBGE) grew by 4.6% in the 12-month period ending in May. It is the highest growth pace in the last six years.

The dynamism observed in the labor market is not only due to the number of new jobs being created, but also to the quality of these jobs. Registered jobs have been growing at a fast pace and absorbing an increasing number of workers. Registered jobs in the private sector grew by 9.5% in May as compared to the same month in the previous year. At the same time, not registered jobs have been decreasing: in May, they dropped by 0.9% in the same comparison.

The persistence of this movement – registered jobs in the private sector growing at a faster pace than the variation of not registered jobs for 40 months in a row – increased the formality index in the labor market. As measured by the ratio between registered, statutory and military jobs and total occupations, this indicator hit the mark of 56.4% in May, repeating the level registered in April, the highest one of the Monthly Job Survey.

The trend toward job formalization is not restricted to metropolitan regions. In the first five months of 2008, one million registered jobs were created throughout the national territory (Caged/MTE), meaning a job flow 15% higher than the one registered in the same period in 2007 – when the highest flow ever was observed. During the 12-month period ending in May, 1.75 million registered jobs were created.

The industry created 389,000 jobs in the past 12 months (Caged/MTE). Given the robust growth observed in the manufacturing activity, the participation of new jobs in this sector as a whole increased from 13.4% in January 2006 to 22.2% in May 2008, reaching a level close to the one registered for jobs in the commerce sector. In industrial sectors, the creation of a significant number of jobs in the civil construction industry, which have been growing at a significant pace, deserves special mention: their participation in all new jobs rose from 8% in January 2006 to 14.6% in May 2008.

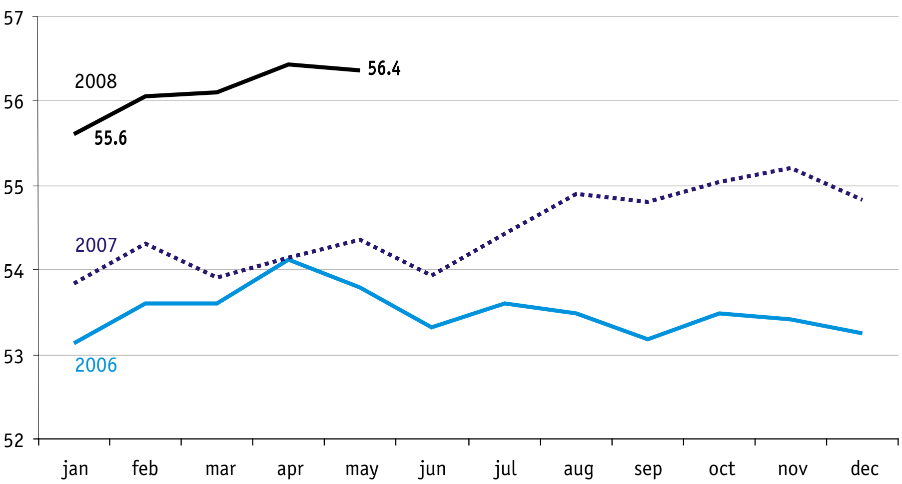
> During the last 12-month period ending in May, 1.75 million formal jobs were created in Brazil

It should be stressed that the enhanced dynamism of the labor market was caused by an increase in occupations (954,000 new jobs in the last 12-month period) at twice the pace of the growth observed in the number of people looking for new work opportunities (the economically active population – EAP – grew by 482,000 people during the same period). This combination has been systematically reducing the number of unemployed people: in May 2007, there were 2.3 million unemployed individuals in the six metropolitan regions, while in May 2008 this figure dropped to 1.8 million.

Metropolitan formality index

Participation (%) of formal, military and statutory jobs in occupations as a whole

Steady increase in formal jobs as a result of the drop in informal jobs continues to formalize occupations



Source: IBGE, calculations: CNI

The unemployment rate dropped to the lowest level in the series, as a result of which early 2008 was characterized as the best year for the labor market since 2002.

It is expected, however, that the difference between a higher occupation rate and the expansion of the labor force will drop over the next few months, slowing down the decreasing pace of the unemployment rate as of 2009.

The labor market is expected to lose dynamism in the number of new jobs being generated and not in the quality of these jobs

However, the rising inflation has already affected the purchasing power of workers. With inflation on the rise, wage negotiations in 2008 may not be as advantageous as in 2007, when 88% of the negotiations ensured wage raises above the inflation rate (Dieese).

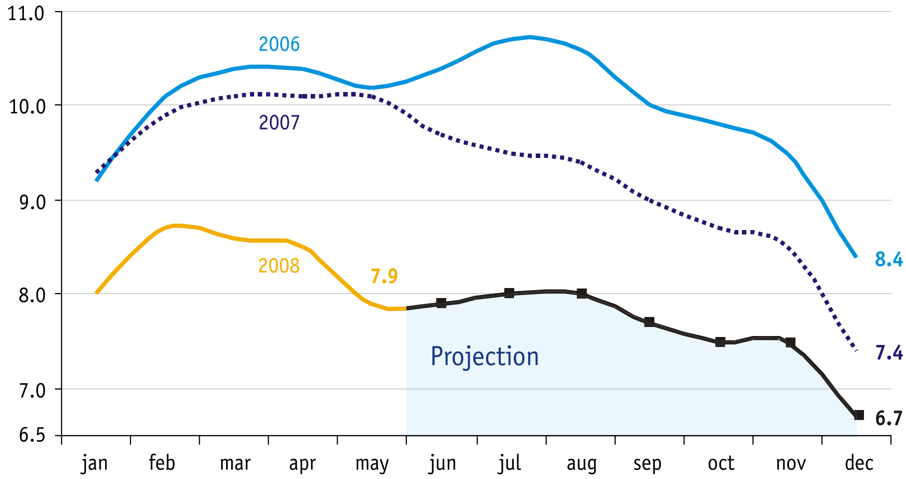
The growth observed in the actually earned real income (Monthly Job Survey/IBGE) became less intense. The variation rate of 2.4% in April 2008 in the comparison with the same month in the previous year, is almost half the one registered in April 2007, when this indicator increased at a rate of 4.5% in the same comparison.

Despite the slower growth of real income, total earnings are still growing at a fast pace. In April 2008 (last data available), total earnings grew by 8.0% in relation to the same month in the previous year. This movement

Unemployment rate

In (%)

Average unemployment rate in 2008 of about 8%



Source: MONTHLY JOB SURVEY/IBGE

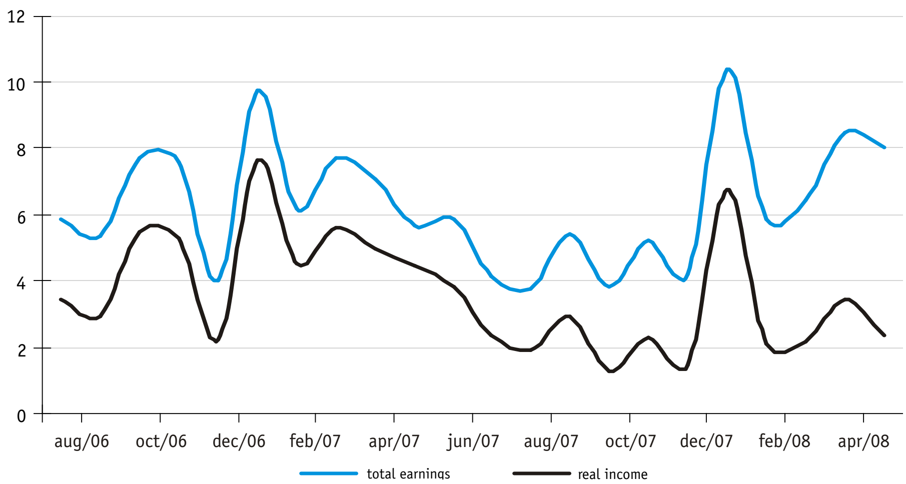
is being spurred by the solid growth observed in jobs, since real earnings are dropping somewhat.

In sum, given the gap between the impact of the GDP growth cycle and that of the evolution of jobs, positive results in the labor market are expected throughout the year. However, the loss of momentum will be felt in the amount of jobs being created and not in the quality of new jobs. CNI projects an unemployment rate of 6.7% in December of this year, accumulating an annual average of about 8%.

Total earnings and average real income of workers

Variation (%) in relation to the same month in the previous year

Real total payroll grows as a result of an intense increase of jobs



Source: MONTHLY JOB SURVEY/IBGE

inflation, interest rates and credit

Inflation is expected to reach the upper target limit

There are signs that core inflation is spreading

The rise in the inflation rate in 2008 led the IPCA (expanded consumer price index) to hit the mark of 5.6% in the 12-month period ending in May – already above the inflation target center, 4.5%.

This higher inflation is being caused by a hike in the prices of food products mainly: this group accounts for 54% of the whole inflation rate in the last 12 months. It should be stressed that this phenomenon is not a problem being faced by Brazil only, but worldwide. Considering only Latin America, 12 countries have been facing two-digit inflation rates, more than twice the Brazilian inflation.

However, the steady rise in the international oil price, which has not influenced fuel prices in Brazil yet but is automatically transferred to the petrochemical industry, which brings impact on the prices of other products, such as cleaning products and fertilizers (essential products for the agricultural sector).

The combination between these factors and the expansion of credit and income in Brazil led to widespread price hikes. The core inflation calculated with the exclusion of food products and IPCA monitored prices hit the mark of 5.0% in the 12-month period ending in May (from 3,0% in May 2007). The spread index, also excluding food products – which reveals the percentage of IPCA-covered items whose prices increased –, rose to 65% in the movable quarterly average ending in May (in May of last year, the index was 59%). As a result of this scenario, the IPCA service group, whose evolution was more inelastic in 2007, also began to move upward, increasing to 6.4% in the same period (one year ago, this indicator increased by 4.9%).

Pressures for transferring prices from the wholesale to the retail market were also felt. The General Price Index (IGP)-DI rose in the last seven consecutive months to 12.1% in the indicator accumulated in the 12-month period ending in May – very influenced by the 15.4% hike in the IPA. Gross raw materials continue to cause the highest price hikes in the wholesale market which are already pushing industrial production costs up. The industrial IPA-DI accumulated in 12 months rose from 3.5% in May 2007 to 9.6% in May of this year.

Hikes in the prices of services will become an additional source of inflationary pressure

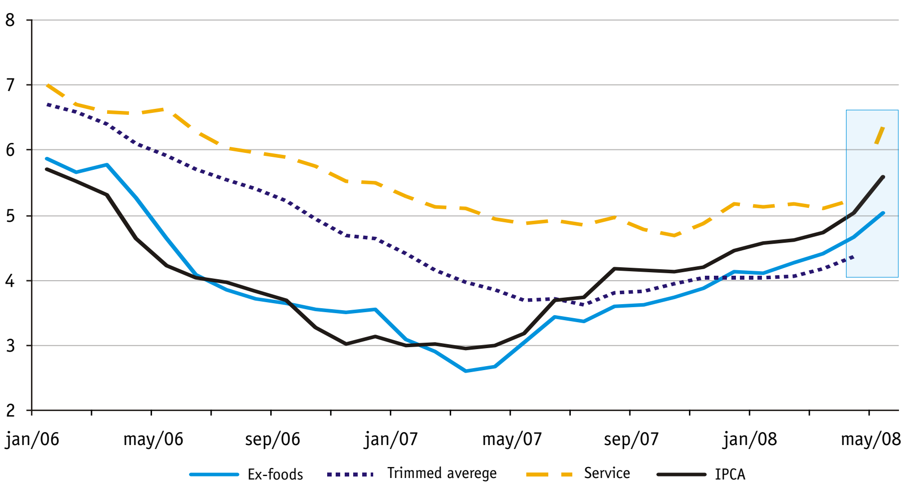
The continued rise in the inflation in the wholesale market (IPAs) can cause inflation inertia through the transfer of prices in the service group (among others), since they follow price adjustments according to the IGPs, as in the case of rental contracts. Therefore, people will reallocate an increasing percentage of their income to the consumption of food products and services, reducing the percentage used for consuming other goods, including industrial goods.

CNI projects a rising inflation as measured by the IPCA up to the mid-second half of this year, when it will begin to

IPCA evolution, core and service group

Variation (%) in 12 months

In May, the core inflation increased significantly



Source: Central Bank of Brazil and IBGE

show a desaceleration process, closing 2008 at 6.4% – close to the upper limit of the inflation target. This movement will be led by continued hikes in the prices of food products and by the transfer of higher costs in the wholesale market to consumers. The inflation projected for the next 12 months – 5.3% (Focus/BC) – is also expected to continue to rise until current inflation begins to lose momentum.

Signs of greater harmony between the fiscal and monetary policies

As a result of a scenario of rising inflation, the Central Bank increased interest rates in June for the second consecutive time at a pace of 0.5 percentage points, to 12.25% a year. The possibility of greater harmony between the fiscal and monetary policies – given the commitment already assumed by the government to increase the primary surplus to 4.3% of GDP – helps to reduce domestic demand in major ways, thus

> The combination of the greater weight of the prices of food products for consumers and a more costly credit will slow down household consumption

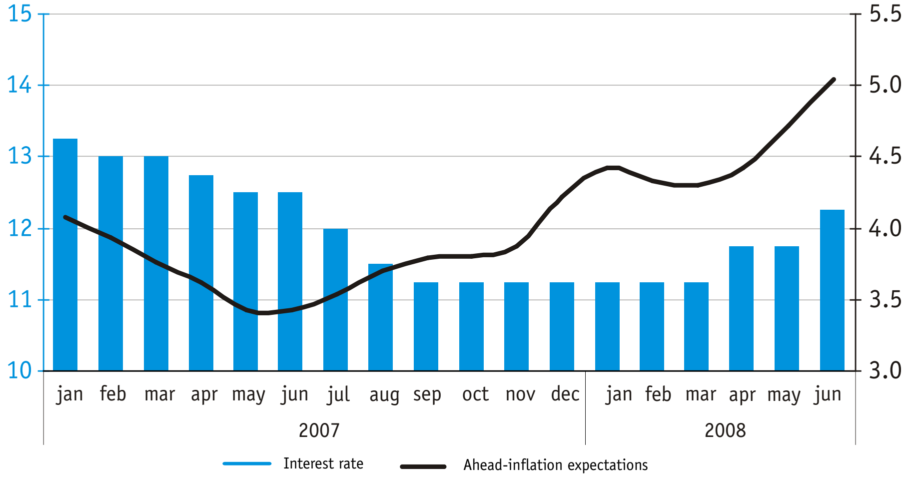
creating better conditions to bring the inflation down.

As a result of gaps in the monetary policy transmission mechanism, it is expected that interest rates will continue to rise at the current pace – but not any faster – and the Selic rate may hit the mark of 14.25% at the end of the year.

Evolution of the Selic rate and expected inflation 12 months ahead

In %

Greater harmony between the fiscal and monetary policies will contribute to reduce ahead-inflation expectations



Source: Central Bank of Brazil and Federal Reserve

Therefore, the average Selic rate in 2008 (12.50%) will be very close to the one registered in 2007 (12.13%). In a scenario of a higher inflation, the average real interest rate in 2008 (6.3%) will be lower than the 8.2% rate registered last year.

Because the IOF (tax on financial operations) is not being charged, leasing has become the fastest-growing credit modality.

Total credit available in the financial system increased by 32.4% in May – to R$ 1.04 million – as compared to the same month in the previous year, hitting the mark of 36.5% of GDP. This ratio is 4.6 percentage points higher than the one registered in May 2007. This performance was led by credit with non-earmarked resources, which increased by 36.1% during the same period, while consigned credit, under the modality of BNDES transfers, grew at a rate of 27.3% in the same comparison.

Credit with non-earmarked resources to legal persons continued to expand, reaching the pace of 39.8% in May. Credit granted to natural persons grew less in May (32.1% as compared to 34% in April) in the comparison with the same month in the previous year.

Leasing – which increased by 89.9% for legal persons and by 128% for natural persons in May in the comparison with the same month in the previous year – has increased the availability of credit more than any other factor, given the benefit of not charging the IOF.

The rising path of interest rates is expected to slow down the expansion of credit in the second half of this year as a result of higher costs for taking loans. At the same time, the tighter budget of families – since a higher percentage of the income is being used to buy food products – will make it more difficult to repay debts incurred in the past. This may increase default rates, which are currently at 1.8% for legal persons and at 7.3% for natural persons (indicators for May).

fiscal policy

Central Government coordinates the fiscal and monetary policies

Primary surplus target increases from 3.8% to 4.3% of GDP

The remarkable results of public accounts in the first five months of this year, the significant financial programming of expenditures in the 2008 budget – R$ 14.8 billion in the first two decrees – and the increase in the primary surplus target suggest a change in posture in the fiscal policy, away from the expansionism observed in the last four years.

The consolidated public sector primary surplus hit the mark of R$ 75.0 billion (6.55% of GDP) in the first five months of 2008, against R$ 60.0 billion (5.9% of GDP) in the same period last year. The increase from R$ 38.6 billion to R$ 53.6 billion in the bottom line of the Central Government accounted for this increase in the total primary surplus.

The increase registered in the net revenue – 10.0% in real terms –, which was largely brought about by a higher tax collection, contributed decisively to this result. In addition, even after the Provisional Contribution on Financial Transactions (CPMF) was abolished, the tax revenue exceeded, in nominal terms, the one registered in the first five months of 2007.

The primary spending of the Central Government also contributed positively to this higher primary surplus in relation to the same period last year. In the first five months of 2008, total spending increased by 4.1%, against 10.0% in the same period in 2007.

Higher primary surplus target will help to control inflation

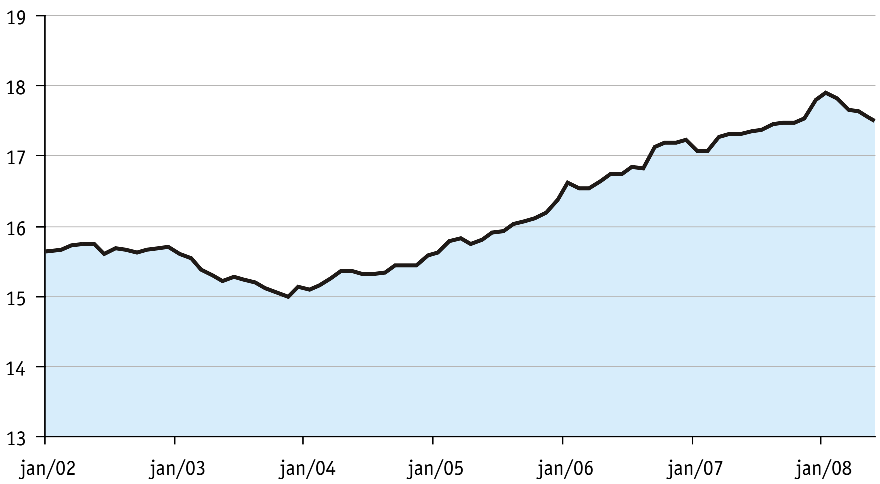
The Federal Government announced an increase in the primary surplus to be pursued in 2008: from 3.8% to 4.3% of GDP. This is a positive initiative, mainly because it will strengthen the monetary policy for controlling inflation. For reaching this target, the Federal Government pledged to achieve a primary surplus of 2.7% of GDP without changing the targets set for federal state enterprises (0.65% of GDP) and for states and municipalities (0.95% of GDP).

For this new target to be reached, a cut in expenditures amounting to R$ 8.2 billion was announced. However, the higher target requires a combination of a lower spending and/or an increase of R$ 14.2 billion in the revenue. In its efforts to ensure this amount, the government relies on additional revenue from dividends and financial compensations amounting to R$ 6.6 billion, which would also be sufficient to make up for higher expenditures resulting from adjustments in the cash transfers made under the Bolsa Família (family grant) Program – about R$ 500 million in 2008. For this estimate to be confirmed, the tax revenue not managed by Brazil's Internal Revenue Service must grow, in nominal terms, by 33.6% as compared to 2007.

Evolution of the Primary Spending of the Central Government

As a percentage of GDP

After increasing for four years, the primary spending of the Central Government began to drop in relation to GDP



Source: STN/Ministry of Finance and Central Bank of Brazil

Higher expenditures of states and municipalities contrast with the trend observed in the Central Government

In opposition to the fiscal policy of the Central Government, we estimate that the primary spending of state and municipal governments increased, in real terms, by 17.3% in the first four months of the year in relation to the same period in 2007. On the same comparison basis, it is estimated that revenues increased by 13.6%, in real terms. Although the election calendar already indicated that the expenditures of regional governments would increase in 2008, its fast growth pace deserves special mention.

For a higher target to be reached, a combination of a lower spending and/or an increase of R$ 14.2 billion in the revenue is necessary

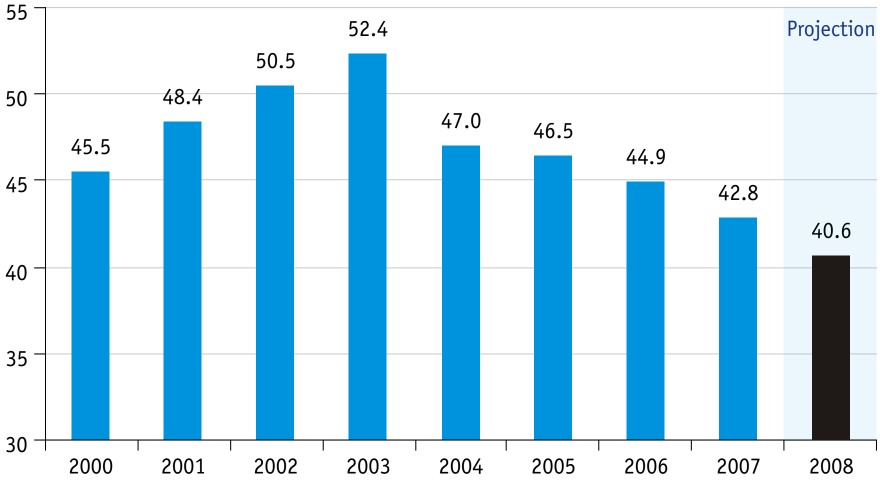
Primary surplus will reach the 4.3% of GDP target

Expenditures will rise at a faster pace in the next few months. In all the main components of primary spending, expansion factors can be identified. For social security spending, the data only include two months with the effects of the adjustment in the minimum wage and of benefits exceeding the minimum wage. As for the spending with fixed expenses and capital – in addition to the impacts of the minimum wage on unemployment insurance, wage bonuses, and LOAS (organic social assistance law) benefits –, other expenditures with fixed expenses and investments usually increase in the last months of any year. Finally, spending with staff will increase at a faster pace as a result of wage adjustments granted recently, which increased projected expenditures by R$ 7.1 billion in 2008. Therefore, our projection is that the Federal Government primary spending will increase, in nominal terms, by 10.6% in 2008 as compared to 2007 – against the nominal 9.2% registered in a comparison with the first five months of last year. However, as inflation is expected to rise at a faster pace, real growth will remain at 4.0%.

Evolution of the Public Sector Net Debt/GDP ratio

As a percentage of GDP

GDP growth and a higher primary surplus sped up the downward path of the public debt



Source: Central Bank of Brazil
2008 Projection: CNI

On the revenue side, we estimate that the net revenue will grow, in real terms, by 6.1% – a nominal increase of 12.9%. In this scenario, the Central Government will achieve its new primary surplus target, namely, 2.7% of GDP.

Primary surplus will hit the mark of 4.3% of GDP, despite the need to improve the bottom line of federal state enterprises

Considering the behavior of the spending of states and municipalities, and despite the positive behavior of revenues, the primary surplus of regional governments is likely to remain closer to the target than in previous years, when it exceeded the target by a large margin. However, we still expect states and municipalities to contribute more than 0.95% of GDP to the primary surplus.

For this reason, we believe that the public sector will achieve the primary surplus target of 4.3% of GDP despite the need to improve the bottom line of federal state enterprises. In the last 12-month period ending in May, they had a surplus of 0.48% of GDP, against a target of 0.65% for 2008.

A higher primary surplus is not positive only because of the coordination it will make possible between the fiscal and monetary policies. It will also ensure a reduction in the nominal deficit, despite a scenario of a rising Selic rate. Our estimate is that the nominal deficit will close the year at about 1.7% of GDP, against 2.3% in 2007. As a result, and taking into account the positive growth pace of the economy, the debt/GDP ratio would drop from 42.8% to 40.6% of GDP.

foreign trade sector and the exchange rate

Enhanced trade flows and a lower trade surplus

Investments and interest rates keep the real at an appreciated level

New factors led the continued appreciation of the real in relation to the currencies of Brazil's main trade partners. In real terms, (IPA deflator, Funcex indicator), the appreciation trend of the Brazilian currency in relation to other currencies has become more intense. This is so because inflation is on the rise in most countries due to the hike in the prices of petroleum and food products, while in Brazil inflation rose below the level registered in most emerging countries. In addition, international rating agencies awarded Brazil an investment grade rating, leading to a more intense flow of foreign capital to the country. The real appreciation of the Brazilian currency in relation to a set of currencies of its main trade partners amounted to 16% in the 12-month period ending in May.

However, the Fed is worried about inflation in the United States and this may lead to higher interest rates in the US in the fourth or even in the third quarter, according to the evolution of inflation and of the economic activity. In this case, the current path of appreciation of the real could be interrupted or even reverted in the second half of this year. In any case, there is not much room for the real to continue to appreciate, considering that the trade balance is dropping and the current account gap is higher than anticipated initially.

Export growth is not threatened

In the first half of 2008, exports grew by 24.8% as compared to the same period in 2007. This growth is more intense than the one observed in the same period in 2007 in relation to 2006, which was 19.9%.

Exported value kept growing early this year only as a result of price gains

However, the exported value only continued to grow early this year as a result of price gains. In the first five months of the year, prices rose by 23% in relation to the same period in 2007, while exported volumes dropped by 3%. Exported volumes began to drop in the first two months of the year, but this drop became more intense after a strike of customs inspectors between March and May.

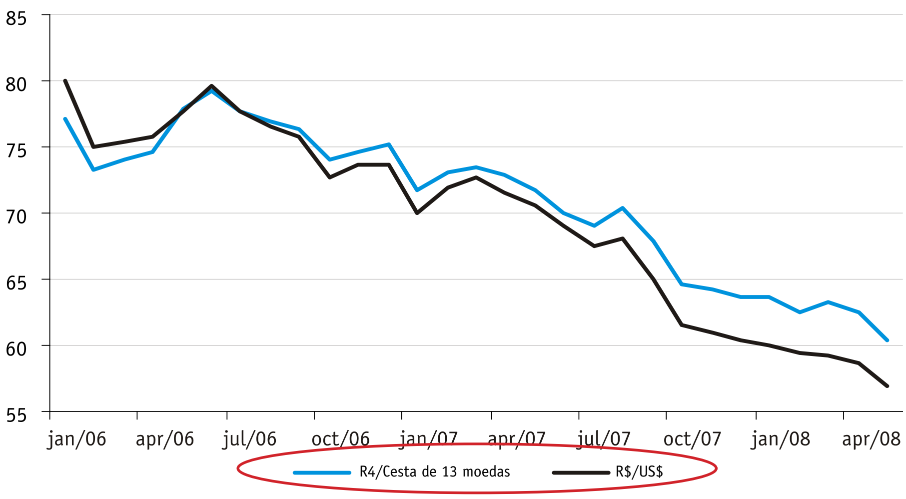
The growth observed in exports – in terms of value – is not under threat. In 2008, exports totaled US$ 190 billion. Prices will continue on the rise as a result of a still strong international demand, albeit at a lower growth pace than in recent years. The effects of more restrictive monetary policies that several countries are expected to adopt pose a risk to this scenario. Depending on the intensity of these policies, their effects on international demand may be felt this year.

Price hikes also impact imports

The appreciation of the real, combined with enhanced economic activity and

Real exchange rate index (R$/US$)
Deflators: IPA-DI (Brazil) and US-Wholesale Prices (US)
Base: December 2003 = 100

Trend toward appreciation of the Brazilian currency becomes stronger



Source: Funcex

domestic demand, continues to drive imports up strongly. The import growth registered in the first half of 2008 amounted to 51.8% as compared to the same period in 2007.

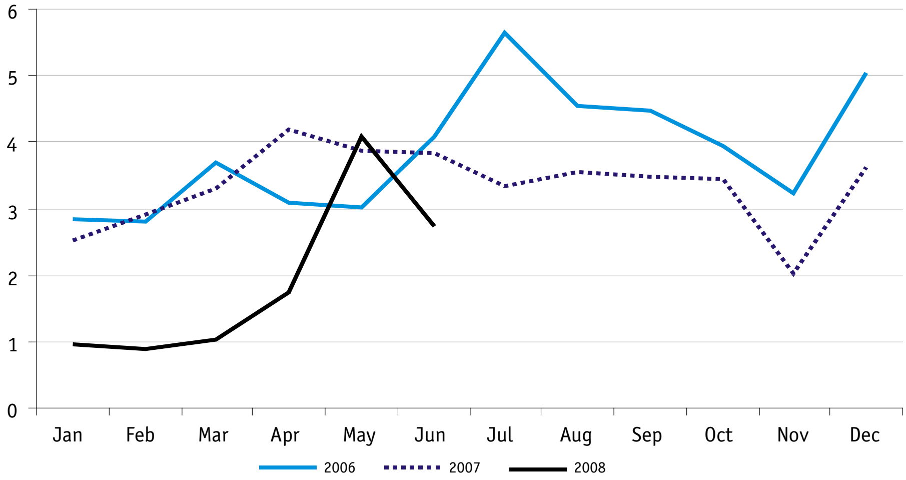
In the first five months of 2008, the growth observed in the imported quantum amounted to 20%. Differently from the situation in 2007, special mention should also be made of an increase in import prices, which hit the mark of 21% in the same comparison – between 2007 and 2006, the increase in prices amounted to only 8%. The increase in prices is mainly explained by the hike in the prices of fuels, but also by widespread price hike in the global market, as it is not restricted only to commodities anymore.

In the rest of the year, we expect imports to grow at a less intense pace than in May and June, after trade flows were resumed once the strike of customs inspectors came to an end. However, imports will continue to grow at a fast pace, totaling US$ 170 billion at the end of 2008, a growth in excess of 40%. The hikes registered in international prices above the initially expected level made this revision imperative.

Trade balance

Monthly figures - US$ billion FOB

The trade surplus accumulated in the first six months of this year dropped by 44.3% in relation to 2007



Source: Secex

Current account deficit is back

The increasing difference between trade flows led the trade surplus accumulated in the first six months of this year to drop by almost half: it dropped by 44.3% in relation to 2007. The fact that the flows of both exports and imports are back to normal will not reduce the gap between their growth pace, and therefore we expect to see, at the end of the year, a balance of US$ 20 billion, 50% less than in 2007.

Another major consequence of the exchange rate appreciation is a higher deficit in the income and service accounts. The deficit in the income and service account increased by US$ 8.4 billion in the comparison between the first five months of 2008 and 2007. The current account deficit accumulated in the year hit the mark of US$ 14.7 billion already, while in the same period last year a surplus of US$ 1.9 billion was registered.

> Higher current account gap is financed by direct investments

It should be highlighted, however, that significant improvements were observed in May as compared to March and April. First, the impact of the trade balance should be considered, which in these months amounted to US$ 1 billion, while in May it amounted US$ 4 billion. There was also a reduction in the remittances of profits and dividends: a significant percentage of the remittances of profits and dividends from multinational companies to their headquarters were made early this year. The current account gap, however, is financed by direct investments, which are still significantly high.

Therefore, we expect the growth pace of the current account deficit, which was intense early this year, to slow down. On the other hand, the fact that the real remains at an appreciated level will continue to push the deficit up. Therefore, we believe that the current account deficit will amount to US$ 20 billion in 2008 – after registering positive balances since 2003.

Prospects for the Brazilian economy in 2007-2008

	2006	2007	2008 *estimate*	2008 *Earlier projection mar/08*
Economic activity				
GDP (annual change)	3.8%	5.3%	**4.7%**	5.0%
Industrial GDP (annual change)	2.9%	4.9%	**5.0%**	5.0%
Household Consumption (annual change)	4.6%	6.5%	**5.5%**	7.5%
Gross Fixed Capital Formation (annual change)	10.0%	13.4%	**10.5%**	14.0%
Unemployment Rate (annual average- % of EAP)	10.0%	9.3%	**8.0%**	8.4%
Inflation				
Inflation (IPCA - annual change)	3.1%	4.2%	**6.4%**	4.7%
Interest rates				
Nominal Interest Rate				
(average annual rate)	15.40%	12.13%	**12.50%**	11.25%
(end of period)	13.25%	11.25%	**14.25%**	11.25%
Real Interest Rate (average annual rate and IPCA)	10.7%	8.2%	**6.3%**	6.3%
Public accounts				
Nominal Public Deficit (% of GDP)	3.0	2.3	**1.7**	2.0
Primary Public Surplus (% of GDP)	3.9	4.0	**4.3**	3.6
Net Public Debt (% of GDP)	44.9	42.8	**40.6**	41.0
Exchange rate				
Exchenge Rate - R$/US$				
(average annual rate)	2.14	1.78	**1.67**	1.76
(end of period)	2.18	1.95	**1.67**	1.72
Foreign sector				
Exports (Billion US$)	137.5	160.0	**190.0**	190.0
Imports (Billion US$)	91.4	120.0	**170.0**	165.0
Trade balance (Billion US$)	46.1	40.0	**20.0**	25.0
Current Account Balance (Billion US$)	13.6	4.5	**-20.0**	-15.0

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