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CNI

Disappointing growth pace

This was another year in which the Brazilian economy registered a modest growth. In 2006, GDP will grow by 2.7%, frustrating more positive expectations early this year. Once again, Brazil's economic performance contrasts with a favorable environment abroad, marked by strong demand, high export prices, and abundant liquidity.

The fact that Brazil grew little in 2006 despite lower basic interest rates shows that there are other elements preventing the Country from embarking on a high-growth path. Investment rates – which are close to 20% of GDP – are insufficient to foster sustained GDP growth beyond 3.5% a year.

Other problems are also hindering growth in the short run: appreciated exchange rates and public spending continually on the rise. The level of the exchange rate reflects, to a certain extent, successful efforts to overcome external fragilities. But the appreciated exchange rate restricts investment opportunities for the external market, which boosted the economy in the first half of the decade.

The biggest obstacle to fast growth, however, is a strong and continuous increase in current public spending. In 2006, public spending increased over twofold more than GDP, without any increase in public investments – which are key to ensuring higher investment rates. This higher current spending leads to a higher taxation and reduces the investing capacity of the public sector and the economy's productivity. Excessive and poor-quality taxation reduces the investing capacity of the private sector and jeopardizes the competitiveness of domestic products.

Turning Brazil into a high-growth economy is the challenge. This task entails a complex and multi-faceted agenda which makes it imperative to complete the cycle of institutional reforms, improve the environment for private investments, and restrain any further increase in public spending. This is the only way to increase the potential GDP growth rate, a key condition to ensure lasting growth.

OUTLOOK 2007: modestly sped-up growth 3

The outlook for 2007 is better than the current performance of the economy; nevertheless, it does not justify any remarkable optimism.

THE BRAZILIAN ECONOMY IN 2006

Overview of the economy in 2006

A pattern keeps repeating itself: for eleven years in a row, Brazil has been growing less than the world average

Once again, the year ends with a strong feeling of frustration. In 2006, the estimates indicate that GDP will grow by 2.7%, only 0.5 percentage points above the average over the past ten years. The modest growth of the Brazilian GDP contrasts with the marked expansion observed in the world economy. The International Monetary Fund estimates a growth of 5.1% in the world GDP this year.

Economic growth in Brazil is frustrating not only because we have been growing less than the world for eleven years in a row, but also because the difference between the Brazilian and the world growth pace remains high. In 2006, as in 2005, the world GDP grew at double the pace of the Brazilian GDP.

The economic activity in 2006 was led – in Brazil – by an expanded consumption, which is basically associated with two factors: a) greater credit availability, the participation of which in GDP rose to the highest level in nine years; b) and a higher real household income. These two events were registered in the wake of inflation control measures. With inflation rates below the target, interest rates could be reduced, with an impact on the demand for credit. At the same time, the purchasing power of salaries was preserved, with a favorable impact on household income.

In part, the higher household income (and higher demand) was brought about by a higher government spending. An enhanced income transfer by the government encouraged consumption and generated jobs, particularly in the north and northeast regions of the Country.

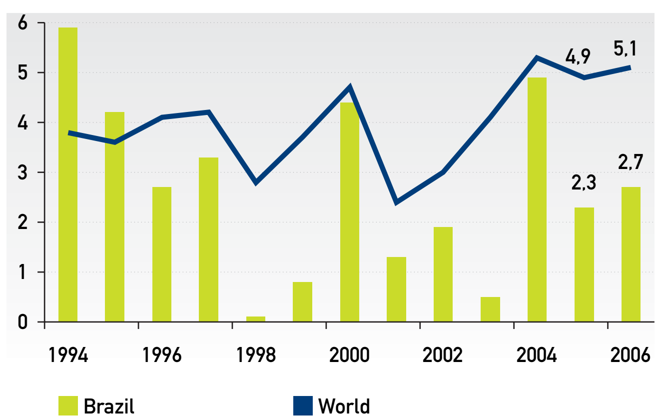
In 2006, as in 2005, the difference between the Brazilian and the world growth pace was sharp.

This higher consumption, however, had a low impact on the manufacturing production. The expanded consumption was mainly met by imported products, which are cheaper now as a result of the appreciation of the real. In 2006, domestic products were replaced by imported products, and this is true both for consumption goods and intermediate goods.

The appreciated exchange rate, however, did not reduce the trade balance in 2006. The robust growth observed in the foreign demand for commodities ensured a sufficient trade balance to generate a current account surplus and a strong inflow of foreign currency. This led to a paradoxical situation: while the foreign sector is doing well, most manufacturing exporting companies are facing tough times.

Brazilian and world GDPs

ANNUAL VARIATION (%)

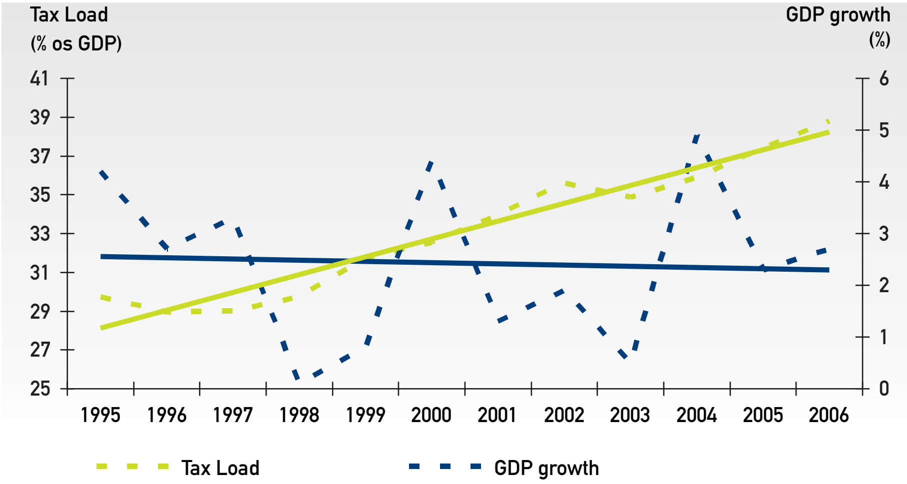


Sources: IBGE (Brazilian Institute for Geography and Statistics) / National Accounts and International Monetary Fund

While, on the one hand, the expansionist fiscal policy contributed to enhance the domestic demand in 2006, on the other hand it prevented any marked improvements in public accounts. Apart from preventing a more pronounced drop in interest rates, the higher expenditures of the government – particularly on current expenditures –, were accompanied by a higher tax load which inhibits private investments.

Continuous increase in the tax load prevents a higher GDP growth

GDP growth in Brazil and the Tax Load



Sources: IBGE / National Accounts and the Brazilian Internal Revenue Service
* the figures for 2006 and 2007 were estimated by CNI

OUTLOOK 2007

The scenario

Modestly enhanced growth pace, but no guarantee of high growth

The trends for 2007 point to a slightly enhanced economic growth pace in Brazil. The economy is expected to perform better than in 2006, but without any guarantee that it will embark on a high-growth path. In our scenario, GDP will grow by 3.4%, inside the expansion range of the economy's potential output in recent years.

This only moderate growth pace is explained by the fact that no effective action has been taken to remove obstacles which have been hindering Brazil's economic growth in recent decades. In other words, without structural changes designed to enhance the growth rate of the country's potential output – higher investment and productivity growth rates – a significantly higher growth pace in the short run is unlikely.

International scenario remains favorable

The world scenario will remain as favorable as in recent years:

(i) both the United States and emerging countries, led by China, will continue to grow at high rates, leading the pace of the world trade;

(ii) commodity prices will stabilize at a still high level;

(iii) the world liquidity will remain comfortable as a result of the end of the cycle of high interest rates in the US;

(iv) the risk perception of emerging countries will continue on a downward trend.

Continuity scenario: few changes in economic policy

The economic policy will not be managed in any sharply different way as compared to 2006. In fact, it is likely that the "relative success" observed during the past two years – low inflation, better image abroad, and higher consumption among the population – will lead to a certain inertia in the economic policy, which tends to "test the limits of the current framework."

Interest rates will continue to decrease, albeit at a slower pace than in 2006. A scenario of inflation under control will make it possible to further reduce the Selic rate, which is expected to close 2007 at 11.5%. As for the annual average, the drop in the rate will be significant, with real interest rates decreasing to 7.9% in 2007, from 11.6% in 2006.

However, the constraints imposed by a still low credit volume and high capital costs for borrowers – the reduction in banking spreads has not been very significant – are factors which will continue to hinder fast growth.

No substantial changes are expected in the fiscal policy either. Ensuring the primary surplus will continue to be the main fiscal target, supplemented by some effort to reduce current spending. However, spending decisions in 2006 – such as a high real raise in the minimum wage, more liberal salary readjustments, and expanded social benefits – leave little room for more substantial progress in 2007.

The actual primary surplus should remain at 4.06% of GDP, within the target of 4.25%, provided that the Pilot Investment Project – PPI (0.21% of GDP) mechanism is used. The poor quality of the fiscal adjustment will continue to hinder economic growth, and the spending of the Federal Administration will once again increase. The nominal result will be negative by 2.5% of GDP, a lower percentage than the one registered in 2006, which is expected to hit the mark of 3.3% of GDP. This drop will be caused by a lower nominal spending on interests.

The modestly enhanced economic growth and the favorable evolution of the nominal result will result in a small drop in the net public debt as a percentage of GDP, which will decrease to 49.5% from 50.6% of GDP in 2006.

GDP will grow, led by the industry

The result of this continuity scenario is a GDP growth of 3.4% in 2007. On the demand side, the domestic absorption will once again be the growth engine. Household consumption will increase by 3.7% and investments will play a more decisive role in promoting economic growth – with capital formation increasing by 9.2%.

Because of a marked increase in imports, the contribution of the foreign sector to economic growth will once again be negative by 1.2 percentage points. Exports will continue to increase, but at a rate that is insufficient to revert this scenario.

On the supply side, we will see improvements in the performance of the manufacturing industry – which

GDP growth forecast for 2007

Demand	(%) Growth rate	Contribution (in p.p.)
Household consumption	3,7	2,1
Government consumption	1,9	0,4
GFCF	9,2	1,9
Exports	5,7	1,0
(-) Imports	15,2	2,2
Net Exports		-1,2
GDP		**3,4**

Supply	(%) Growth rate	Contribution (in p.p.)
Agricultural and Live Stock Production	4,0	0,3
Industry	4,2	1,7
Mining	7,6	0,4
Manufacturing	3,3	0,8
Construction	5,0	0,4
Public Utilities	3,2	0,1
Services	2,4	1,4
GDP (at basic prices, before taxes)		3,1
Taxes	5,0	
GDP (market prices)		**3,4**

Source: CNI

GDP is expected to rise 3.4% in 2007, due to expansion of both household consumption and gross formation of fixed capital

will grow by 4.2%. The mining and construction industries will lead this growth, with the manufacturing industry growing at a moderate pace as a result of lingering difficulties, such as the appreciated exchange rate and a decreasing competitiveness with foreign products.

Inflation below the target and stable real exchange rate

The annual inflation rate – 4% as measured by the IPCA – will increase by about one percentage point in relation to 2006; however, for the second consecutive year, the annual inflation will remain below the center of the target zone.

The marked appreciation of the real in 2006 – current account surplus and comfortable liquidity worldwide – will continue, but not as strongly. The exchange rate will therefore remain relatively stable. Late in 2007, the exchange rate will hit the mark of US$ 1/R$ 2.25, against the expected rate of US$ 1/R$ 2.15 in December 2006.

Lower trade balance, exports losing pace

Exports will grow less in 2007, but they will hit the record value of US$ 150 billion. On the one hand, the unfavorable exchange rate will constitute the main difficulty for exporters of manufactured products; on the other hand, a strong world demand will ensure good prices and a market for commodities. High domestic demand and appreciated exchange rate will foster imports, which may hit the mark of US$ 107 billion – a growth of 15% in relation to 2006.

The trade balance – US$ 43 billion – will be only slightly lower than in 2006. As a result, the current account surplus – savings remitted abroad – will be marginally reduced to US$ 10 billion or about 1% of GDP. However, this is still a very high figure for our economy and it runs counter the need to attract external resources to increase investment rates.

How can growth be sped up?

Overcoming the low-growth situation is a must for enhancing the potential output growth rate

During the past ten years, economic growth in Brazil oscillated around 2.2% a year. The years of more intense growth reflected a combination of a favorable international environment – as in 2000 and 2004 – and a certain degree of domestic stability. These conditions, however, were not sufficient for the Brazilian economy to become a high-growth one.

One of the important lessons learned in 2006 is that we have grown little, despite a drop in basic interest rates. It doesn't mean that interest rate levels are irrelevant, much on the contrary. But it clearly shows that, apart from a high capital cost, there are other restrictions preventing Brazil from embarking on a sustainable growth path.

One fact is unquestionable: the current potential output growth– that is, the growth rate of the economy in the long run – is low. This growth is mainly determined by the level of investment rates (accumulation of physical capital) and by the evolution of the economy's average productivity. Productivity, in turn, besides depending on the accumulation of physical capital, depends on the incorporation of new technologies, on a favorable business environment, and on the accumulation of human capital through education, which constitutes a project spanning generations.

The question is: what can be done now to increase the potential output growth rate and to leave this modest growth situation behind?

In the medium term, investments are the crucial variable. A more robust – and sustained – growth will only materialize if there is a substantial increase in investment rates. Not only because investments constitute a means for incorporating new technologies, but also because they increase the productive capacity directly.

To increase investments, actions are required in two directions: actions to induce private corporations to engage in new business lines; and actions to increase the investing capacity, that is, to expand savings – the non-consumed portion of the income which is available for investments.

A better business environment ensures more efficient markets and, therefore, encourages private investments (which follow the logic of profits and opportunities). These are actions which can leverage private investments and generate new business opportunities: red tape reduction; creation of modern regulations – including labor market regulations – and of appropriate environmental laws; lower capital cost and less inefficiency in the financial market; and a better taxation. Defining regulatory frameworks is especially important to attract private capital both for large investment projects, such as infrastructure projects, and for industrial segments requiring specific policies to be clearly defined.

For domestic savings to increase, the saving capacity of the public sector should be recovered

Increasing the domestic saving capacity and attracting more foreign savings are, in turn, macroeconomic issues. Increasing private savings will not be problem – it will happen naturally as a result of the emergence of opportunities – provided that an institutional environment favoring investments is built. However, for domestic savings to increase, the saving capacity of the public sector must be recovered.

Public savings are indispensable for public investments to be made, particularly in infrastructure. In cases where the return on investments is not sufficient to attract private capital, investing is essentially a duty of the State. In other cases, the participation of private capital in infrastructure projects – such as in the PPPs (public-private partnerships) – is possible and desirable.

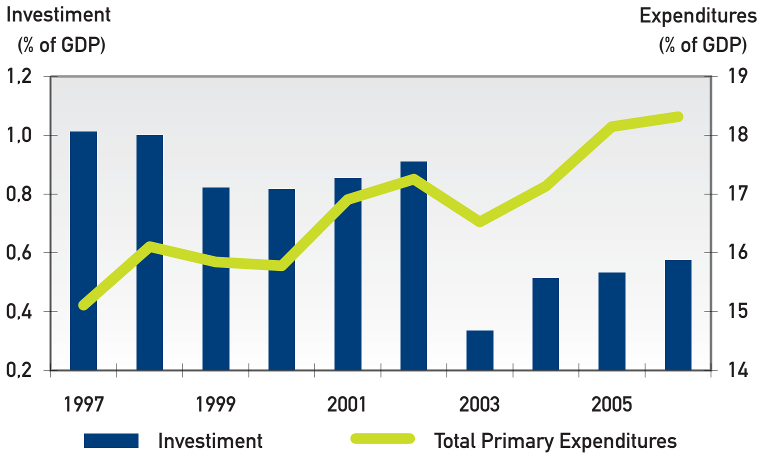
For public savings to increase, deep fiscal adjustments must be made which imply a reduction in public spending as a percentage of GDP. These adjustments require strict measures to curb current spending – such as reforming the social security system, setting limits to public spending, improving the public administration (through measures such as a review of the so-called linked revenues and compulsory expenses, and an evaluation of programs based on physical goals achieved), lower taxes on investments and reduction of the tax load. That is, they require an effective fiscal plan, including constitutional reforms and structural changes.

Essentially, what is required is a cultural change in relation to the role of the State and the reach of public spending. Opting between current spending and investments is choosing between preserving the past or building the future.

The high-growth agenda is clear: improving the efficiency of the State and stimulating private investments

The high-growth agenda is clear: the efficiency of the State must be improved – with a reduction in current spending and a lower tax load – and private investments must be stimulated. This is the only way to create favorable conditions for increasing investment rates and the global productivity of the economy. If they are implemented at the required speed, these adjustments will pave the way for Brazil to embark on a high-growth path in the medium term. Otherwise, the potential output growth pace will not increase substantially, and the mediocre growth rates observed in recent years will continue in the long run.

Federal government: Investments and primary spending



Source: SIAFI and National Treasury Secretariat
Prepared by: CNI

Higher current expenses reduce the space for stepping up public investments

Level of Economic Activity

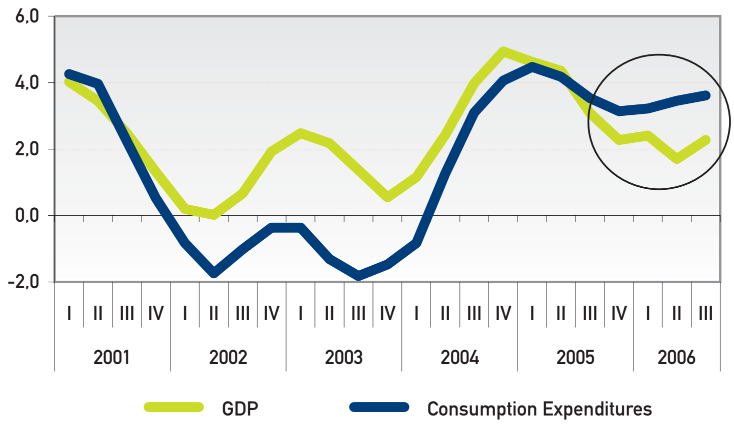
Another frustrating year: the Brazilian economy is expected to grow by only 2.7% in 2006

The economic activity in 2006 was less intense than anticipated early this year. Growth projections have been reviewed downward as it became clear that the effects of relaxing the monetary policy on the economic activity, particularly on the manufacturing production, were not very significant.

There is no record of another period in this decade in which household consumption grew at a significantly higher pace than GDP

GDP and Household Consumption

ANNUAL VARIATION (%) – FOUR-QUARTER MOVING AVERAGE



Source: National Accounts

The estimated GDP growth in 2006 was reviewed downward to 2.7% from 3.7% early this year. Nevertheless, for the growth estimate of 2.7% in 2006 to be maintained, the economic activity must be recovered in the fourth quarter. In this scenario, GDP must grow 1.3% in the fourth quarter in relation to the third quarter, after seasonal adjustments. For this purpose, the growth pace in the fourth quarter should be almost three times higher than the one observed in the second and third quarters. This greater dynamism late in 2006 is justified by positive prospects in terms of sales during the Christmas season, which will be boosted by a higher household income and the greater availability of credit.

2006 was a year marked by a unique growth pattern, almost exclusively based on household consumption and with a negative contribution from the foreign sector

GDP grew by only 2.5% in the first three quarters of 2006 as compared to the same period in 2005. Modest growth is not a new phenomenon: what is different in the economic growth registered in 2006 is its composition, which is almost exclusively based on consumption. Household consumption grew by 3.7% during the same period, totaling a contribution of 2.0 percentage points to GDP growth (or 80% of the growth registered this year).

Consumption-led growth is not a usual fact either. There is no record of another period in this decade in which household consumption grew at a significantly higher pace than GDP. Consumption usually increases in response to enhanced economic growth and to a higher productivity and salaries, feeding back into a virtuous growth cycle.

In 2006, consumption grew, but the domestic production did not respond – at least not with the same intensity – to this higher consumption. While the retail trade (PMC/IBGE) increased its sales by 5.9% in the comparison between the averages in the first ten months of 2006 and 2005, the physical production (PIM/IBGE) and the real revenue of the manufacturing industry (CNI) grew by 2.9% and 1.4% over the same period, respectively.

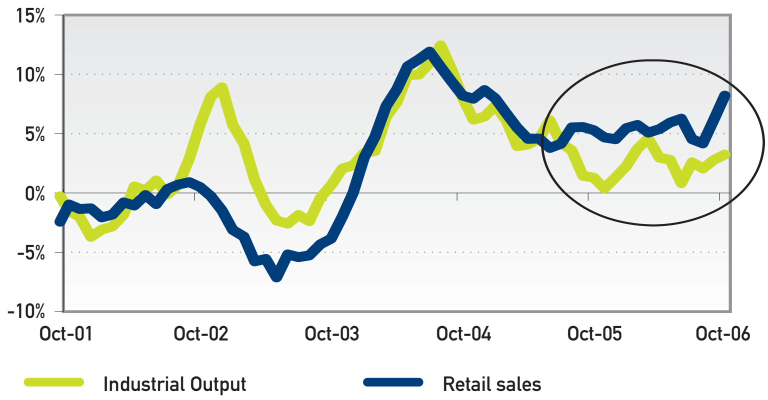
As a result of an increasing demand for consumption goods, there was a strong penetration of imported products. Enhanced imports are also a result of the appreciation of the real, which has stimulated the replacement of domestic products with imported products. It should be highlighted that these substitutions are not restricted to consumption goods, as they also involve inputs used by companies.

In CNI's Special Survey of June 2006, it was seen that 28% of the companies which used imported inputs had plans to step up their use, to the detriment of domestically produced inputs.

Retail sales increased, but the domestic production did not respond to this higher domestic consumption

Retail trade and manufacturing production

ANNUAL VARIATION (%) – FOUR-QUARTER MOVING AVERAGE

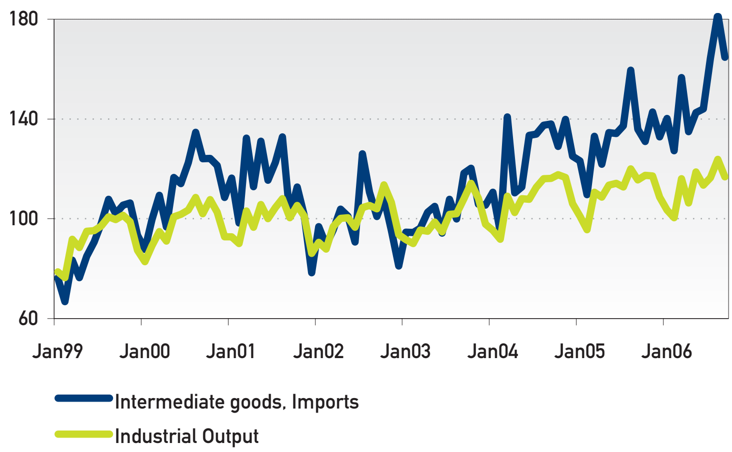


Source: PIM-PF/IBGE and PMC/IBGE

Evidence of the replacement of domestic inputs with imported ones: imports of intermediate goods increased much more than the manufacturing production

Manufacturing production and imports of intermediate goods

AVERAGE FOR 2002 = 100



Source: PIM-PF/IBGE and Funcex

Among companies which did not use imported inputs, 10.6% had plans to use them in 2006. Another piece of evidence of the replacement of domestic inputs by imported ones is the marked increase observed in the import of intermediate goods in relation to production in the manufacturing industry. In 2006, imports of intermediate goods increased at a pace that was six times faster than that of the manufacturing production.

As a result of the appreciation of the real, products manufactured abroad have become more competitive. Therefore, while imports grew, the growth pace of exports is slowing down. The consequence is that the net contribution of the foreign sector to GDP growth has become negative – which is an unprecedented situation in this decade. Between 2001 and 2005, the foreign sector contributed, in average, 1.5 percentage points to GDP growth each year. In 2006, the situation was inverted: the foreign sector has been contributing to reduce GDP by 1.1 percentage points.

One of the strengths of GDP in 2006 was an increase of 6.0% in the gross formation of fixed capital (in the comparison between the three first quarters of 2006 and 2005). This growth reflects the positive moment experienced by the civil construction industry, which has been growing at a pace of 5.0% a year and is sustained by: a) a higher volume of budget funds earmarked for housing – FGTS (Warranty Fund for Severance Pay) funds for housing increased by 56.6% in 2006 in relation to 2005; b) lower interest on housing loans – which encouraged people to purchase and renovate real property; c) higher spending on infrastructure – as usual in election years.

Contribution of components in GDP formation (expenditure approach)

IN PERCENTAGE POINTS

Expenditure components	2001/ 2005 average	2005	2006 (Up to 3rd quarter)
Consumption	0,9	2,0	2,4
Household consumption	0,7	1,7	2,0
Government consumption	0,2	0,3	0,4
Investiment	-0,1	-0,6	1,2
Gross form. of fixed capital	0,1	0,3	1,2
Change in stocks	-0,3	-0,9	0,0
External Sector	1,5	0,8	-1,1
Exports	1,7	2,1	0,9
Imports	-0,3	-1,3	-2,0
GDP	2,2	2,3	2,5

Source: National Accounts

In 2006, the foreign sector has been contributing to reduce GDP growth rate by 1.1 p.p.

Investments in machinery and equipment, in turn, increased less than expected early this year, despite the availability of lower interest rates and the higher household consumption. In 2006, for example, only 36% of the companies made their investments as planned (CNI's Special Survey – November 2006). Investments were not more dynamic because businesspersons did not perceive the higher consumption as a permanent phenomenon, as it was largely sustained by governmental income transfer schemes – which are short-lived by nature; and, second, because industrial companies operated in 2006 with some idle capacity – average of 81.8%, lower than the levels observed in the two previous years.

In 2006, however, average industrial performance should be considered carefully, as they disguise an unequal behavior among different industrial sectors. The manufacturing production, for example, was concentrated in three sectors – IT equipment; extractive industry; electric machines, appliances and materials – which together accounted for almost half of the industrial output growth. On the other hand, the production of timber products, clothing, and shoes actually dropped in 2006.

In 2007, GDP is expected to increase by 3.4% and, as in 2006, this increase will be led by the domestic demand

GDP is expected to increase by 3.4% in 2007. As in 2006, the domestic demand will lead economic growth. Household consumption is estimated to grow by 3.7% both in 2006 and 2007, contributing 2.1 percentage points to GDP growth in each of these years.

The gross formation of fixed capital should grow by 6.7% in 2006, as opposed to only 1.6% in 2005. In 2007, a greater increase is anticipated, namely, 9.2%. This more robust growth is associated with the continuing downward path of long-term interest rates and with expectations of a more dynamic industrial activity, particularly in the civil construction industry.

Exports of goods and services (as measured according to the National Accounts methodology) are expected to increase by 6.0% in 2006 – the lowest rate since 1999, when the floating exchange rate regime was adopted. In 2007, the growth pace is expected to remain close to the one observed in 2006 (an estimated 5.7%), since no additional appreciation of the real is anticipated. Both in 2006 and 2007, exports will contribute 1.0 percentage points to GDP formation. In 2004 and 2005, the contribution of exports to GDP formation exceeded 2 percentage points.

It is estimated, on the other hand, that the imports of goods and services (as measured according to the National Accounts methodology) will hit the mark of 18.3% in 2006. Since imports have been growing three times faster than exports, the net contribution of the foreign sector should be negative in 2006. As in 2006, imports are expected to increase very much in 2007 (about 15.2%). This growth is a little less intense than in 2006 because: a) the comparison basis is higher; b) the exchange rate (R$/US$) will be more stable in 2007.

The estimated Industrial GDP growth of 3.0% in 2006 is frustrating, considering the 4.5% rate projected early this year. The slowdown was more pronounced in the manufacturing industry, which is expected to increase by only 1.7%, or at a pace very close to the ones observed in 2003 and 2005. In 2007, the scenario is more positive, following the behavior registered in the fourth quarter of 2006. The projections for 2007 suggest a growth of 4.2% in the Industrial GDP and of 3.3% in the manufacturing industry.

The agriculture/livestock sector is expected to grow by 3.0%, recovering from a no-growth situation in 2005 caused by harvest losses. For 2007, prospects are even better, as the growth rate is expected to hit the mark of 4.0%. Services, which are the most stable GDP component, are expected to increase by 2.2% in 2006 and by 2.4% in 2007.

Jobs and wages

Job formalization and higher real wage growth rates were major achievements in the labor market in 2006

The number of formally registered employees increased by 4.8% in the comparison between the averages registered in the first ten months of 2006 and 2005 (data from the Monthly Job Survey/IBGE). This growth pace is particularly strong not only because of the rather high comparison basis that was used to measure it – the number of registered workers had already grown by 5.9% in 2005 – but also because it contrasts with the drop of 0.9% observed in the number of workers without a formal registration this year.

Job formalization has become a trend during the past two years: while the number of formally registered workers – formal workers in the labor market and statutory civil servants – grew 11% in the 2005-2006 period, the number of informal workers – workers without a formal registration and self-employed individuals – remained virtually stable during that period.

The number of formal jobs increased by 1.24 million units during the twelve-month period ending in October 2006, or 4.7% (data from the General Register of Employed and Unemployed Individuals of the Ministry of Labor). Jobs in the services sector deserve special mention, as 547,000 of them were created – a growth of 5.1% – and, particularly, in the technical-professional sector, where 210,000 new jobs were created (7.3%). These services mostly include jobs in large companies which were outsourced.

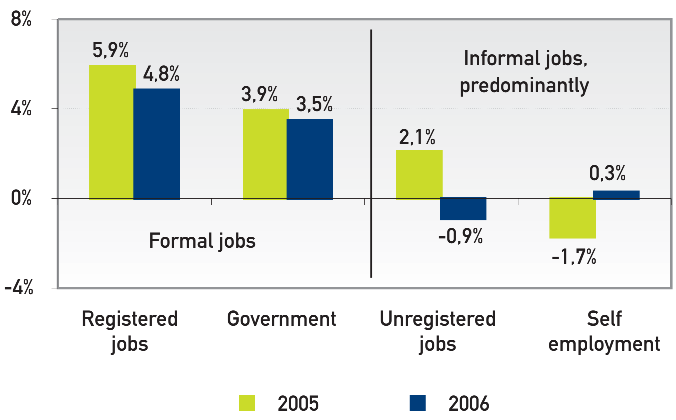
Besides the formalization of jobs, the Brazilian labor market has other unique features, such as:

a) greater participation of female labor – almost two-thirds of all jobs generated in metropolitan regions in 2006 were taken by women;

Job formalization: the majority of jobs generated in 2006 were formally registered

Occupied population, status of the occupation

ANNUAL VARIATION (%)



Source: PME/IBGE

b) migration of jobs to more schooled individuals – between October 2005 and October 2006, the number of jobs taken by individuals with 11 years of schooling or more increased by 661,000, against a drop of 92,000 in the ones taken by less schooled workers;

c) more jobs taken by individuals in older age brackets – jobs for the population aged 50 and over increased by 4.7% between October 2006 and October 2005, almost twice the figure registered for the occupied population as a whole.

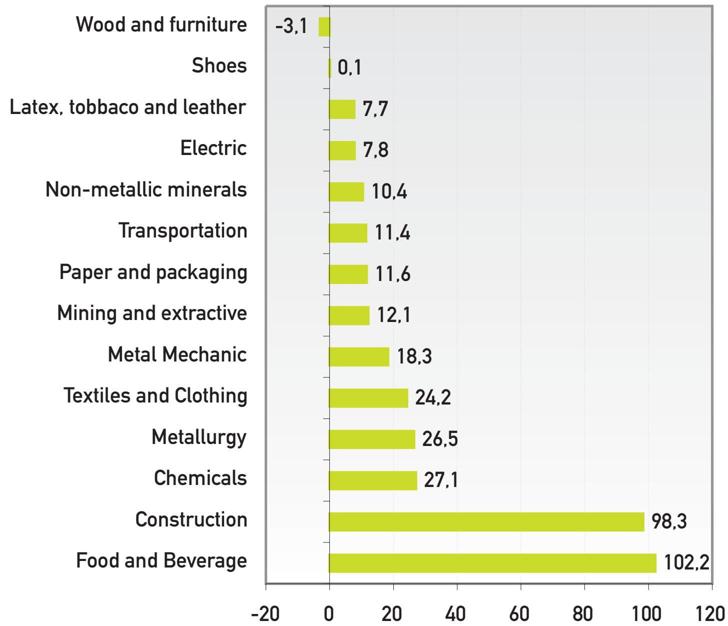
The evolution of jobs in the manufacturing industry was marked by heterogeneity. While the food and civil construction industries generated 102,000 and 98,000 jobs, respectively, during the twelve-month period ending in October 2006 (totaling growth rates of 6.9% and 8.2%, respectively), the timber and furniture industries downsized their staff.

In regional terms, clear differences can be observed in the behavior of jobs: less jobs in the south region and more jobs in the north, mid-west and southeast regions, according to PIMES/IBGE. More individuals were dismissed by companies in the state of Rio Grande do Sul than hired in the southeast region. The state of Rio Grande do Sul has accounted for most industrial jobs that were lost for the second year in a row.

Heterogeneity marked industrial jobs in 2006

Industrial jobs

ABSOLUTE VARIATION IN THE TWELVE-MONTH PERIOD ENDING IN OCTOBER 2006 (IN THOUSAND UNITS)



Source: Caged/ MTE

The unemployment rate increased in 2006, despite the greater availability of jobs. In October, 9.8% of the economically active population did not have a job. This higher unemployment rate is associated with changes in the labor force growth pace. The labor force increased by 2.4% in the average of the ten first months of 2006 in relation to the same period in 2005. In the second half of 2006, the pace became faster, hitting the mark of 3.6%. This faster pace contrasts with the one observed in 2005, when the labor force grew at an average rate of 1.1%.

There are three factors which, as a rule, stimulate growth in the labor force. A lower household income is the first factor, as it leads secondary members of the family (those who are not heads of the household) to look for a job as a means to complement the household income. This was what led to an increase in the labor force in 2003, but it does not seem to have caused an increase in the labor force in 2006. The household income is high now, as a result of increases in the real payroll – 6.4% in average in the first ten months of 2006 in relation to the same period in 2005 – and in benefits paid by the government.

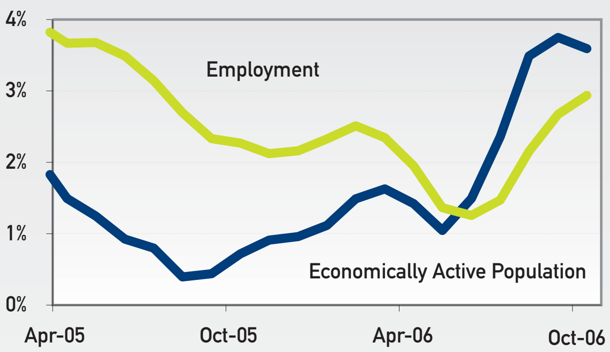
The second factor is the perception of workers that the labor market is more favorable and, as a result, their higher chances of being successful in their search for a job. This behavior is typically observed when the economic activity is picking-up.

Higher real wages constitute the third factor which stimulates growth in the labor force. When salaries rise, the opportunity cost of staying out of the labor market increases. This year, the real average income of workers grew by 4.1% (comparison between averages in the first ten months of 2006 and 2005) in the wake of economic growth, albeit modest, and particularly, of measures to keep the inflation under control.

Next year, these two factors will still be present, meaning that the real income of workers will continue to rise. As for jobs, the prospects are less optimistic. In CNI's Industrial Survey in the 4th quarter of 2006, businesspersons said that job stability is expected in the next six months. The unemployment rate, in turn, is expected to remain at about 10% in 2007 – as in 2006 – or even a little higher, because the labor force growth is expected to continue to outpace job creation.

Occupied population and the labor force

PERCENTAGE VARIATION IN RELATION TO THE SAME MONTH IN THE PREVIOUS YEAR – QUARTERLY MOVING AVERAGE

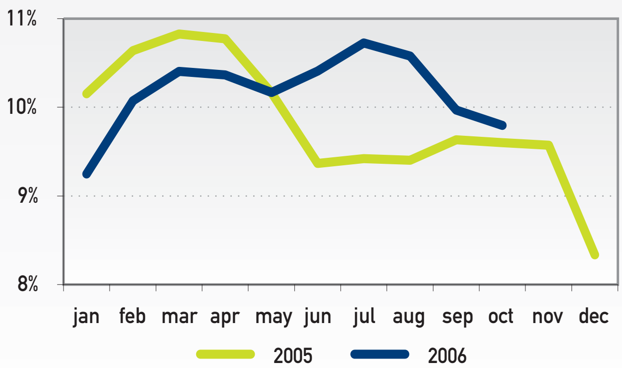


Source: PME/IBGE

In the 2nd half of 2006, the labor force outpaced jobs...

Unemployment rate

% OF THE LABOR FORCE



Source: PME/IBGE

... increasing the unemployment rate

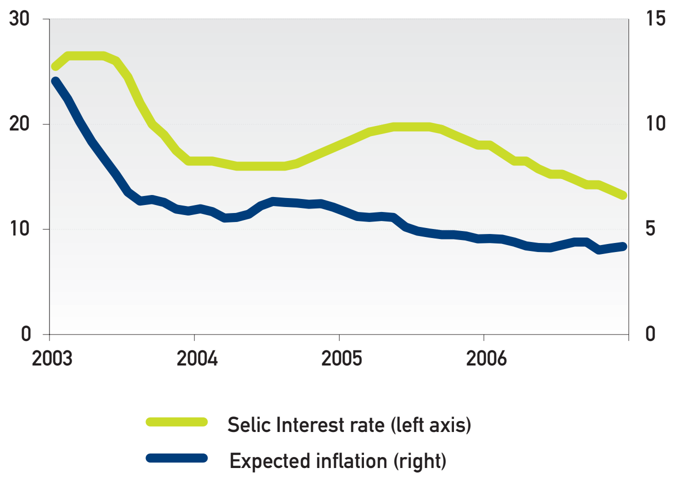
Inflation, Interest Rates and Credit

Slow reduction in interest rates in 2006 results in inflation rate close to the lower limit of the target.

The monetary policy in 2006 was based on extremely cautious reductions in the Selic rate. This strategy, which was much more conservative than the one adopted in 2003, resulted in a current inflation close to the lower limit of its flotation range. Although excessively strict, the rigor with which the inflation target system has been managed contributed to avoiding the typical turbulence of election years – which can be felt at four-year intervals in Brazil. Brazil will close the third year in a row with the inflation within the targeted range and with good chances of keeping it very close to the target in 2007.

The Selic rate was 18% a year early in 2006, then it was subjected to three successive reductions of 0.75% and, from May on, it began to be reduced by 0.50% at 45-day intervals– closing the year at 13.25%. Long-term interest rates, which are used as a benchmark for BNDES (National Economic and Social Development Bank) operations, were also cautiously reduced throughout the year: they dropped from 9% a year in January to 6.85% in the last quarter of 2006.

BASIC INTEREST RATES (% A YEAR) AND MEDIAN OF TWELVE-MONTH INFLATION EXPECTATIONS (%):



Source: Central Bank of Brazil (BCB).

Drop in the Selic rate is much slower than in 2003.

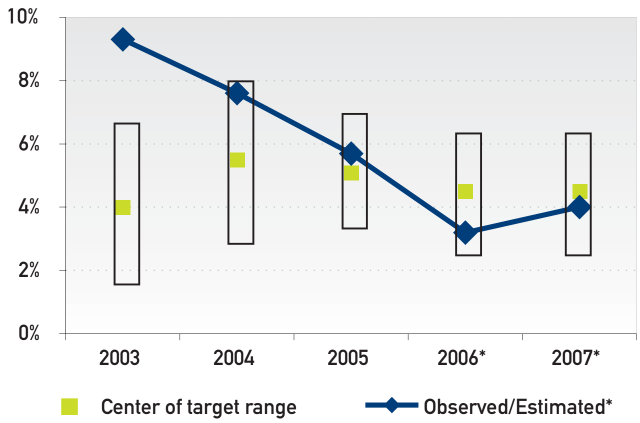
The monetary policy was relaxed in a fairly foreseeable way and largely as a result of two exceptionally favorable factors: a null variation in the IPCA (Expanded Consumer Price Index) in the second quarter of the year and the fact that, since May already, the estimated IPCA variation in 2006 was below the central point of the target (4.5%) – with a clear downward trend. In its weekly survey, the Central Bank even measured, in October, an average estimate below 3% for the inflation in 2006.

In November, however, seasonal pressures were felt on the prices of food products in the retail market, as well as a recovery in wholesale prices of agricultural products – the latter in response to a higher demand for commodities in the international market. These factors ended up interrupting a sequence of (downward) reviews of inflation estimates both for the final months of 2006 and for 2007 as a whole.

A modest rise in inflation expectations, the (moderately) faster pace of economic activity, and the relative stability of the exchange rate in recent months – supported by the purchase of almost US$ 4 billion a month by

2007 will be the second year marked by an inflation rate below the center of the target zone pursued by Copom (Monetary Policy Council).

Inflation targets and annual IPCA variation



Source: BCB (Central Bank of Brazil).
(*) 2006 and 2007: Estimates

the Central Bank – contributed to this scenario. Given these signs, some Copom members even voted in favor of reducing the pace of reductions in the Selic rate during the last meeting of the council in 2006. They did not win, but the dissent ended up consolidating a scenario of enhanced parsimony in the way the monetary policy will be managed in 2007.

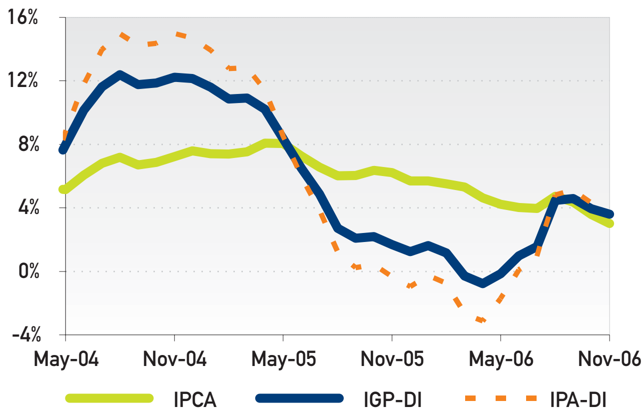
Convergence of the main inflation indices at the end of 2006

Late in November, the variation in the IPCA accumulated in twelve months hit the mark of 3.02%, almost 1.5 p.p. below the target set for 2006. The fact that variations in (both) market and monitored prices were below 4% is as significant as this behavior of the "full" index: 2.54% and 3.96%, respectively, in the twelve-month period ending in November. As for the indices based on subcategories of tradable and non-tradable goods, the former had a variation of 1.13% in twelve months, while the latter rose by 4.15% – until November.

Recovery in wholesale prices and stable consumer prices foster convergence

Inflation indices

(%) VARIATION IN TWELVE MONTHS



Source: IBGE and FGV (Getúlio Vargas Foundation)

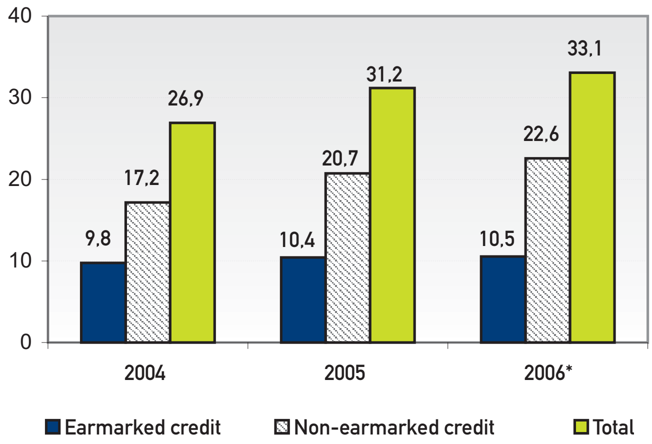
During the same period, the IGP-DI (General Price Index - Internal Availability) and its main component, the IPA-DI (Wholesale Price Index - Internal Availability), rose by 3.59% and 4.04%, respectively. As for the subcategories of IPA associated with different production stages, the prices of raw materials had accumulated a hike of 9.80% in twelve months late in November, while much lower variations were registered for intermediate and final goods: 2.17% and 2.49%, respectively. Considering the origin of the goods, it could be seen that the recovery in wholesale prices was mainly concentrated in agricultural products, the prices of which rose by 8.28% in the twelve-month period ending in November. The prices of industrial goods increased by only 2.71% during the same period.

Thus, the convergence of the main inflation indices late in 2006 can be explained not only by the favorable behavior of consumer prices throughout the year, but also by the quick recovery observed in the prices of raw materials and agricultural products in the wholesale market since May.

Credit on the rise, interest rates dropping, but banking spreads remain at practically the same level.

The balance of credit operations of the financial system hit the mark of 33.1% of GDP in October – a relatively high level for the Brazilian economy, but still lower than the one registered in other emerging countries. The volume of credit with so-called non-earmarked resources exceeded 20.7% of GDP in January and rose to 22.6% in October, while the balance of operations with earmarked resources remained stable at about 10% of GDP. The participation of the industry in the

Earmarked and non-earmarked credit (% of GDP)



* Up to November.
Source: BCB

Credit expansion in relation to GDP is due to an increase in operations with non-earmarked resources.

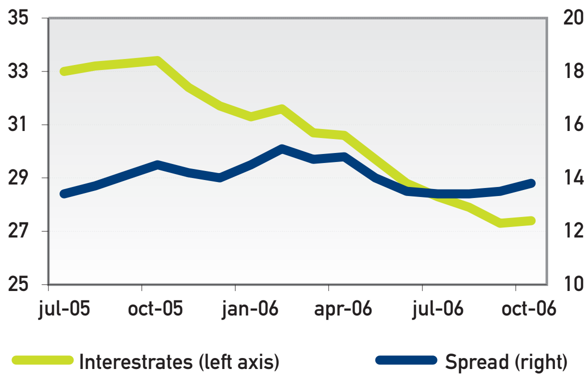
total balance of credit operations decreased a little during 2006, dropping from 22.9% in December of last year to 22% in October of this year.

The volume of non-earmarked resources for operations with individual borrowers continues to grow at a faster pace than for operations with corporations: the average expansion rates are 1.6% and 1% a month, respectively. As a result, the share of the balance of operations with individuals in the total volume of credit increased from 31.1% to 32.7% during the past ten months.

Since the Selic rate reducing cycle began, in September 2005, the average interest paid by corporations for operations with non-earmarked resources decreased from 33.3% to 27.1% a year (October). During the same period, the average spread – which is the difference between the average interest a bank charges a borrower and the interest a

Interest rates for corporations and spread

(MONTHLY AVERAGES, % A YEAR.)



Source: BCB.

Cost of bank intermediation does not respond to reductions in interest rates.

bank pays a depositor – remained stable at about 14%. It can thus be seen that the measures announced by the government in September of this year to reduce the banking spread have not generated any palpable result so far.

Inflation under control and greater liquidity favor long-term financing

Inflation under control, decreasing interest rates, ample international liquidity, and a still very high banking spread: this combination of favorable factors is expected to continue to make the capital market grow in 2007. From 2004 to 2005, debenture issues grew 300%, increasing from R$ 9.6 billion to R$ 41.5 billion. In 2006, share issues more than doubled, from R$ 11.3 billion in 2005 to R$ 26 billion early in December. As a result, the total amount of resources intermediated by the capital market reached the record volume of R$ 107 billion in December 2006.

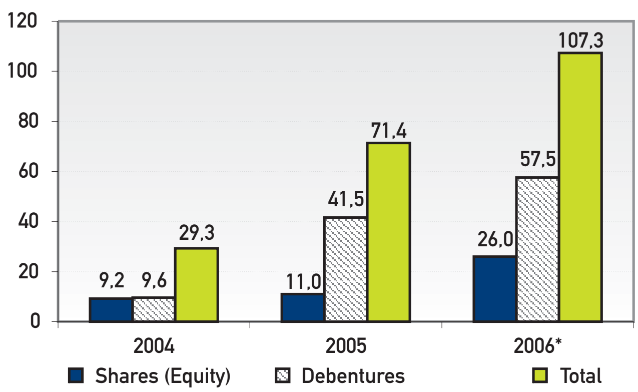
The expansion observed in the capital market in 2006 contrasts with the modest increase registered in the total disbursements of Brazil's main long-term investor, the BNDES (National Economic and Social Development Bank). This growth totaled only 5% in the comparison between the first eleven months of 2006 and 2005. By all appearances, it would be easier for Brazil to finance key investments in infrastructure – either via capital market or using funds of the state-owned Bank – were it not for the fact that little priority has been attached to the regulatory framework.

Outlook for 2007

Our projections for next year point to a scenario of continued conservative management of the monetary policy and of efforts to consolidate economic stability. The Selic rate is expected to decrease at a slower pace than in 2006, dropping from the current 13.25% a year to 11.5% a year over the next twelve months. This greater parsimony will translate into an inflation of 3.2% at the end of 2006 and of 4% in 2007, as measured by the IPCA, both of which are below the center of the target set by CMN - National Monetary Council (4.5%). As a result, the real Over-Selic interest rate (*ex post* annual averages, minus IPCA variations) is expected to decrease from 11.6% in 2006 to 7.9% in 2007. The magnitude of this reduction, 3.7 percentage points, is explained not only by the accumulated effect of previous reductions, but also by the fact that we are projecting a slightly higher inflation in 2007. The IGPs – as well as the IPCA itself – will continue to register annual variations below 4.5%.

It should be highlighted that the production sector continues to wait, at the end of 2006, for a provisional measure to be issued to regulate the operation and use of the positive credit record. This measure, which was announced in September of this year, is still under technical studies. It is believed that this tool could correct one of the greatest anomalies in the Brazilian financial market: the fact that good and bad debtors incur practically identical costs in their credit operations and that the only differences applied between them, if any, are related to the deadlines and amounts involved in their operations.
The time has also come for the Central Bank to review the extremely tight requirements imposed on banks in terms of compulsory deposits, so as to increase the availability of resources for private funding purposes. The guidelines of this policy, which were established in a period of great instability, are not justified any longer.

Capital Market: Total issues registered with CVM - Securities and Exchange Commission of Brazil (R$ billion)



Source: CVM. * Up to November.

While 2005 was the year of debentures, 2006 was the year in which stock issues stood out.

Fiscal Policy

Fiscal policy remains the same in 2006: marked increase in current spending financed by a higher tax load.

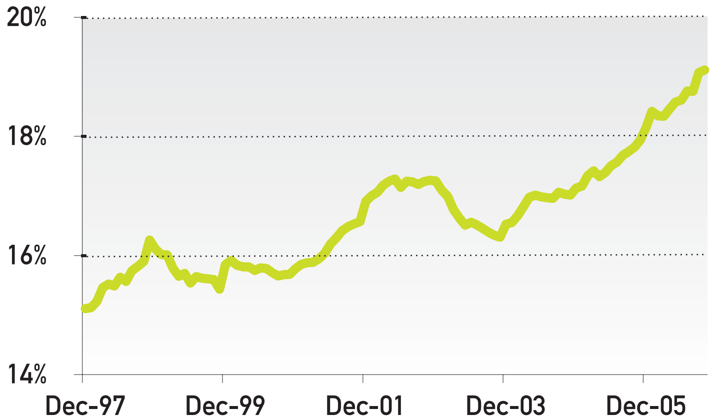
The fiscal adjustment process in 2006 was characterized by the usual bad quality, that is, higher spending financed by a higher tax load.

Total primary expenditures were increased by 1.3 p.p. of GDP in 2006 – 3.0 p.p. in the past three years.

The achievement of fiscal targets has contributed to preserving a stable economic environment and, therefore, to promoting economic growth. However, the fiscal adjustment should be improved in such a way as to enhance the GDP growth pace. For this purpose, current public spending in relation to GDP should be reduced, paving the way for a lower tax load and more public and private investments.

Evolution of total primary expenditures of the Federal Government

TWELVE-MONTH AGGREGATES (% OF GDP)



Source: STN - National Treasury Secretariat/MF - Ministry of Finance

The total spending of the Federal Government will close 2006 at 19.6% of GDP, against 18.2% in 2005. In the first ten months of this year, expenditures grew mainly as a result of a higher current spending. As compared to the same period in 2005, this spending increased by 1.05 percentage points of GDP. Investments grew by 0.2 percentage points.

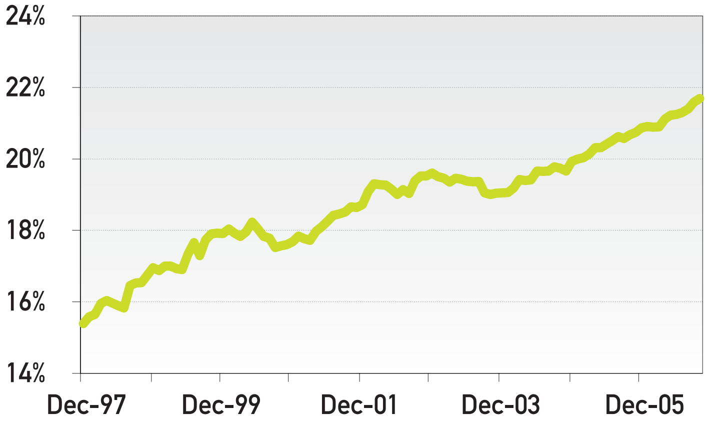
By the end of 2006, the net revenue of the Federal Government will also have increased sharply, from 20.9% of GDP in 2005 to 22.1% in 2006.

Of the total growth of 1.2 p.p. of GDP, the net collection of taxes and contributions is expected to contribute 0.4 p. p. The rest will come from the social security revenue (0.4 p.p.), as a result of the increase in formal jobs and in the income of workers, and of "other revenues" (0.3 p.p.), particularly those derived from dividends paid by state-owned financial enterprises.

The bad quality of the fiscal adjustment is also felt in state and municipal governments. The revenue from the main sources of these entities of the federation increased from 13.21% of GDP in the first ten months of 2005 to

Evolution of the net revenue of the Federal Government

TWELVE-MONTH AGGREGATES (% OF GDP)



Source: STN - National Treasury Secretariat/MF - Ministry of Finance

To finance increasing expenditures, the net tax collection by the Federal Government has been rising, as % of GDP.

13.53% during the same period in 2006. Given the primary result achieved up to October, expenditures might have grown by approximately 0.5 p.p. of GDP under the same comparison basis.

The target set for the primary surplus in 2006 was exceeded due to extraordinary revenues

Albeit not ideal, the fiscal policy management in 2006 is expected to ensure a primary surplus of 4.32% of GDP, exceeding the target of 4.25% set for the year. As compared to 2005, when the primary surplus hit the mark of 4.83% of GDP, the expansionist nature of the fiscal policy throughout the year can be clearly perceived.
With regard to the favorable difference between the projected primary surplus and the target, it should be stressed that it will be generated by regional governments and their state enterprises, for which positive results corresponding to 1.18% of GDP are expected. That is, 0.08 p.p. above the target of 1.10% of GDP defined in the 6th Budget Evaluation Report.

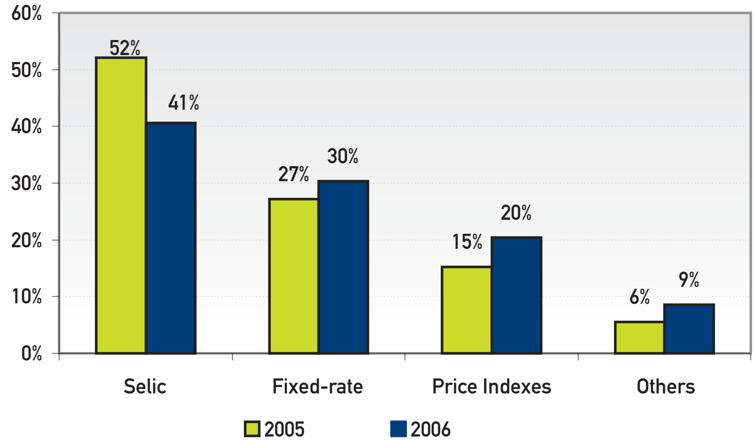
The primary surplus of state government enterprises will provide a decisive contribution to this positive difference in relation to the target. We estimate that the surplus will amount to 0.27% of GDP in 2006. In this case, there will be an increase of 0.11 p.p. of GDP in relation to the result in 2005. However, it should be mentioned that this increase was brought about by shares issued by Cesp (Electricity Company of São Paulo), which had a positive impact of R$ 2.75 billion on the primary result of state government enterprises.

At the federal level, the primary result of the National Treasury and of the social security system will be positive by 2.53% of GDP, exceeding the target of 2.34% set for the year in the 6th Budget Evaluation Report. This way, it will make up for the primary surplus of federal government enterprises, which should amount to 0.62% of GDP – below the 0.81% of GDP target. Therefore, the federal contribution to the primary surplus (3.15% of GDP) will remain within the target set for 2006 as a result of the collection of taxes in arrears (0.1 p.p.) made possible by a new scheme for tax debts to be paid in instalments.

As a result of a lower primary surplus, despite a lower spending with interest rates, the nominal deficit is not expected to decrease in relation to 2005, but rather to remain stable at 3.3% of GDP. The continuity of the process of reducing the Over-Selic interest rate – indexer of 40.6% of the federal debt in bonds – will play a key role in ensuring this stability. As a result of a lower nominal deficit and economic growth, the public debt in relation to GDP is expected to fall from 51.5% last year to 50.6% in 2006.

Composition of the Brazilian Federal Bond Debt, by indexer

During 2006, improvements were registered in the public debt profile: ratios of fixed-rate bonds and inflation-indexed bonds grow.



Source: BCB

Primary surplus in 2007 may fall short of the target

In 2007, although the Federal Administration is considering a variety of fiscal measures, we do not expect to see any of the improvements we deem necessary in terms of fiscal adjustment. This realization stems from the nature of the budget bill submitted to Congress. In general lines, the Annual Budget Bill (PLOA) contemplates a new increase in spending and is based on an overly optimistic revenue projection. While the PLOA is based on a real GDP growth of 4.75%, our revenue projections are based on a real GDP increase of 3.4% in 2007.

We expect the collection of taxes and contributions by the Federal Government, as well as the social security revenue, to have a real growth similar to the one experienced by GDP. In this regard, one should remember that some tax reductions have been planned for next year, such as, for example, those provided for in the General Law for Micro and Small Enterprises.

Based on these assumptions, our projections indicate that the net revenue of the Federal Government will remain at a level of 22.1% of GDP in 2007.

As for the primary spending of the Federal Government, we expect to see it grow by 0.32 p.p. of GDP, which would raise it to 19.96% of GDP. The expectations for the main components of the primary spending of the Federal Government are as follows:

- Staff: total spending of R$ 117.9 billion, according to the PLOA, which would increase its participation in GDP from 5.2% to 5.3% between 2006 and 2007. Besides the impact of salary readjustments granted in 2006 to be implemented in 2007, new civil servants will be hired and positions filled – totaling 46.6 thousand.

- Social Security: the real readjustment of the minimum wage below the levels registered in 2006 will lead to a lower increase in the social security spending, which will increase from 8.1% of GDP in 2006 to 8.2% in 2007.

- Fixed and Capital Costs: expenditures would increase from 6.3% to 6.4% of GDP between 2006 and 2007. Besides the effects of the readjustment of the minimum wage on expenditures with unemployment insurance and social security benefits, the PLOA provides for a nominal raise of 7.8% in “other fixed and capital expenses” (OCC).

The anticipated nominal growth of current expenditures (7.6%) in relation to other fixed and capital expenses is lower than the growth of investments, as in 2007 it will exceed the R$ 16.2 billion earmarked in the 2006 PLOA by 8.6% (totaling R$ 17.6 billion). Of the amount anticipated for 2007, R$ 4.6 billion (0.21% of GDP) are part of the Pilot Investment Project (PPI) and may be excluded from the primary surplus calculation for the purpose of ensuring compliance with the target of 4.25% of GDP.

Given the projections for revenues and expenditures, we estimate that the Federal Government will have a primary surplus of 2.26% of GDP. In this case, compliance with the primary surplus target would be conditioned to the exclusion of PPI expenses from the calculation, which would reduce it from 2.45% to 2.24% of GDP.

For this not to be necessary, the actual OCC expenditures would have to be shortened of R$ 4.5 billion. This figure is feasible, given the R$ 97.0 billion earmarked for these expenses in 2007. However, the cut may very well end up being much larger, as Congress is expected to raise revenue and budget spending forecasts.

Because the Federal Government has been inclined to increase investments and they account for a considerable percentage of programmable expenses, it is more likely that expenses will be excluded from the PPI. Therefore, we reiterate the forecast of a primary surplus of 2.26% of GDP for the Federal Government.

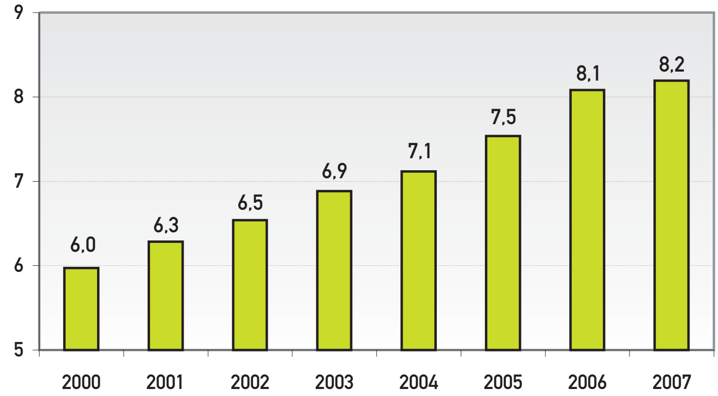
As for the other components of the primary result of the consolidated public sector, that is, federal state enterprises and regional governments with their state enterprises, we believe that the targets of a surplus of 0.7% and 1.10% of GDP, respectively, are feasible. A consolidated public sector primary surplus of 4.06% of GDP is anticipated for 2007.

Therefore, given the expected reduction in expenditures with interest payments, there would be a deficit in the nominal result of 2.5% of GDP. As a result of a lower nominal deficit and the expected GDP growth, the debt/GDP ratio is expected to decrease to 49.5% of GDP.

The spending with social security benefits has been growing steadily in relation to GDP, and in 2006 it will exceed the spending with interest payments – which is something not seen since 1997.

Evolution of the spending with social security benefits

(% OF GDP)

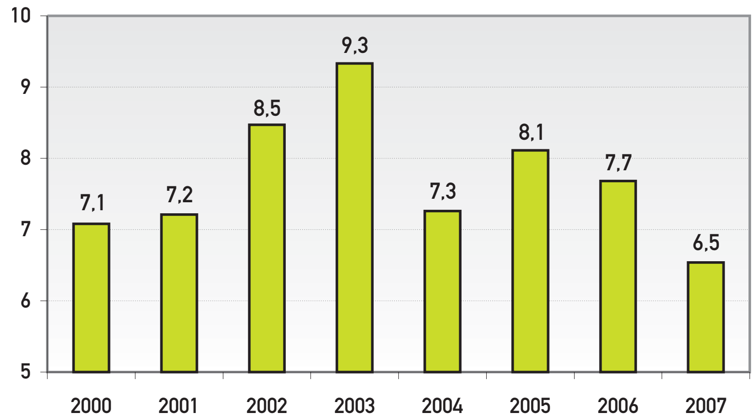


Source: STN - National Treasury Secretariat/MF - Ministry of Finance

Note: The figures for 2006 and 2007 were estimated by CNI.

Evolution of the public spending with interest payments

(% OF GDP)



Source: BCB

Note: The figures for 2006 and 2007 were estimated by CNI.

Interest payments by the public sector in relation to GDP are expected to drop for the second consecutive year in 2007.

Foreign Sector and Exchange rate

Devaluation of the US dollar is a worldwide trend; its effects in Brazil are more intense because of the country's high interest rates and large trade surplus

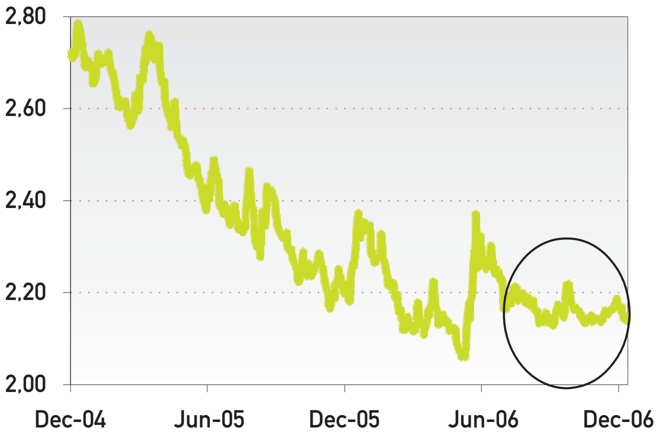
The average exchange rate in the period between January and November was R$ 2.178 / US$ 1, which constitutes an appreciation of 11% in relation to the same period in 2005. However, this trend seems to have lost momentum in the last months of the year, although there are no signs that it will be actually reverted. As a matter of fact, the exchange rate between the real and the US dollar has remained virtually stable during the past four months.

The appreciation of the Real is not very likely to be reverted over the next few months. The deceleration of the US economy and the persistence of high trade deficits have been pushing the US dollar down throughout the world. The only reason why the effect of this phenomenon is not more intense is that various economies have been buying dollars in large volumes, including Brazil (the country's international reserves grew from US$ 53.8 billion in 2005 to US$ 78.2 billion in 2006 until October). Here, the devaluation of the US currency in 2006 was even higher than in the rest of the world as a result of two domestic stimuli: high real interest rates and high trade balances. We expect to see a small additional appreciation in 2006, with the year closing at R$ 2.15 / US$ 1 (monthly average for December). The average in 2006 would be R$ 2.18 / US$ 1, constituting an appreciation of 10.6% in relation to the average in 2005.

Appreciation of the real loses momentum in the second semester of 2006

Exchange rate R$/US$

AVERAGE DAILY QUOTES



Source: Central Bank

In 2007, the US currency could devaluate even further in the world if economies which accumulated high reserves in US dollars – particularly China – sell part of their dollars and decide to use another reserve currency. On the other hand, the domestic stimuli for the Real to appreciate will be less intense next year (lower trade balance, albeit not much lower, and decreasing real interest rates).

Therefore, we do not believe that the current appreciation trend will be significantly reverted, but rather that there will be a small devaluation throughout the year, leading the exchange rate to hit the mark of R$ 2.25 / US$ 1 by the end of 2007.

Higher export prices account for 70% of the increase observed in exports in 2006

The exported value this year (January-November) exceeded US$ 125 billion and our projections are that the exported value in 2006 will amount to US$ 137.5 billion, 16% higher than in 2005.

Exports continued to grow despite the appreciation of the real. The prices of sales abroad explain these record export figures, as they helped keeping the profitability of sales abroad stable.

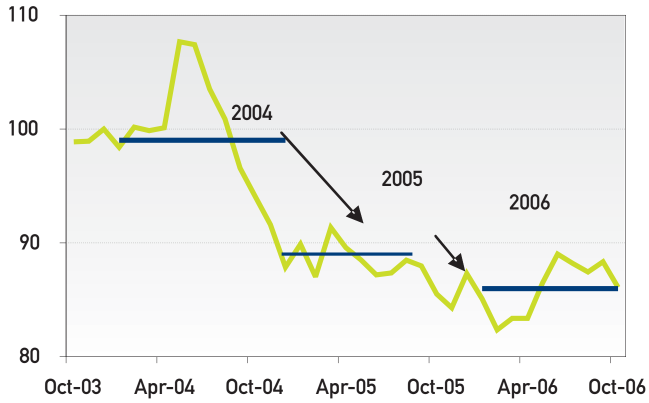
In the 12 month-period ending in October, prices increased by 12.4% – accounting for 72% of the increase registered in the exported value during that period. On the other hand, the total exported quantum grew at a much lower pace than the one observed in previous years. The growth accumulated in the 12-month period ending in October 2006 was limited to 5.3%; in the same month in 2005, the growth rate was 11.6%, and in 2004 it was 17.6%.

A strong asymmetry among the different sectors of the economy can also be observed. In 10 of the 26 sectors surveyed by Funcex,

Profitability stabilized at a low level

Evolution of the Export Profitability Index

(AUGUST 1994 = 100)

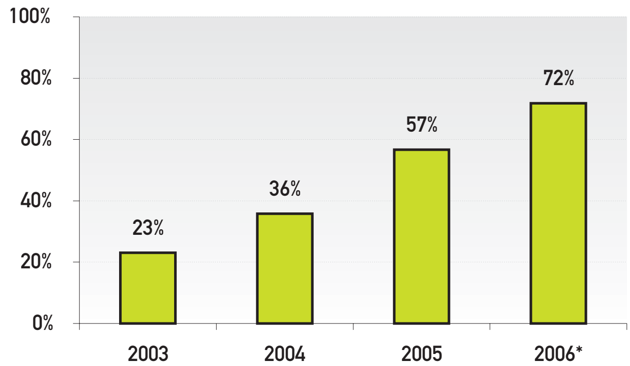


Source: Funcex

Price gains are the main factor which led exports to grow in 2006

Participation of Export Price Gains

PERCENTAGE OF TOTAL VALUE GROWTH REGISTERED IN THE YEAR



* until October
Source: Funcex

exported volumes dropped in a comparison among the three first quarters of 2006 and 2005. The effect was not stronger in total exports statistics because in seven of these sectors price gains were higher than the reduction in terms of quantities.

Additionally, the effects of the appreciation process which pose risks to maintaining the current growth pace of Brazilian exports in the future have become more evident:

a) sectors suffering a decreasing profitability account for 59% of the total exported value (in 12 months up to October of this year);

b) the quantum of exports to major markets, such as the United States, the European Union, and Mexico decreased in the comparison between the 4 last quarters and the 4 previous ones;

c) the number of exporting companies dropped 10 % (1,715 fewer exporting companies) between 2004 and 2006 (figures accumulated until October of each year);

d) the expansion of sales abroad is increasingly concentrated in a few products. The sales of petroleum and its by-products, gross sugar, iron ore, alcohol, and soybeans account for practically half of the growth registered in exports in 2006 (data up to October). In 2005, twelve products accounted for 50% of this growth in the comparison with 2004. In 2004, they were 25 products.

Imports have been growing in response to the appreciation of the real and to a higher domestic consumption

In 2007, the trend toward a lower growth rate of the export quantum is expected to continue. Economic growth in the world at large is still expected to preserve price gains, which in turn will contribute toward ensuring positive results in Brazilian sales abroad. Although the world growth anticipated for 2007 is a little lower than in 2006 (particularly because of the US economy), the scenario is still favorable. As a result, exports in 2007 may grow by about 8%, totaling US$ 150 billion by the end of the year.

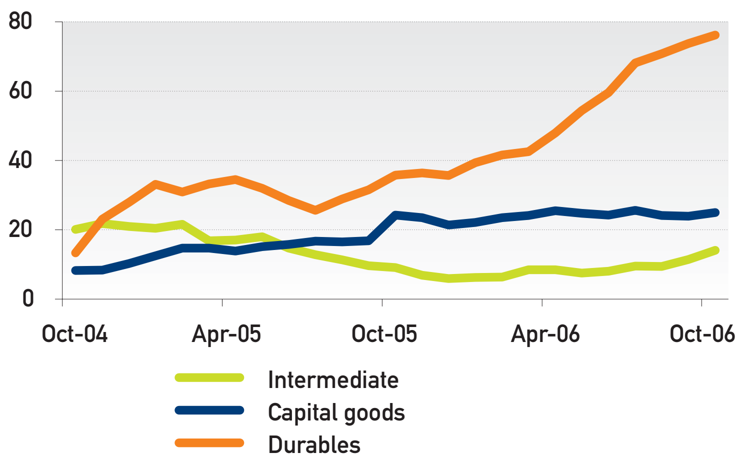
Brazilian imports grew at a high pace in 2006. Average daily imports have been growing since May. From January to November, imports totaled US$ 84.1 billion. We expect to see a total of US$ 92 billion by the end of 2006, which represent a growth of 25% in relation to the figure registered in 2005.

The growth observed in imports is, to a large extent, determined by the increase registered in imported volumes. Taking into account the growth rate in the 12-month period ending in October, the quantum grew 14.4%, while prices

Imports of durables are the main – but not the only – category fostering purchases abroad

Quantum of Brazilian Imports

MONTHLY GROWTH RATE OF TWELVE-MONTH AGGREGATES (%)



Source: Funcex

increased by only 7.5%. This growth in imported volumes is mostly explained by the higher purchasing power associated with the appreciation of the real.

The increase in imported volumes could be felt in all categories, but it is particularly intense in durables. Between January and October of this year, the growth rate registered for these goods hit the mark of 76.2% as compared to the same period in 2005. This strong growth is also explained by the appreciation of the real, but it was enhanced by the higher purchasing power of households as a result of the recovery of their income.

Imports of capital goods in 2006 grew by 28% until October and those of intermediate goods stood out in the second semester.

In this case, purchases increased from 11.8% in the first half of the year (in the comparison with the first half of 2005) to 22.8% in the period between July and October.

In 2007, the likely continuation of an appreciated exchange rate and greater economic growth will continue to foster Brazilian purchases abroad. As a result, we expect imports to increase by 15% in 2007, which would lead total purchases to US$ 107 billion.

Positive trade balance does not prevent deterioration of Current Account balance

The trade balance accumulated in the 12-month period ending in November dropped in relation to the previous month: from US$ 46.3 billion in October to US$ 45.4 billion in November. We expect the trade balance accumulated in 2006 to total US$ 45.5 billion – only 2% higher than in 2005.

Since the trade balance has been growing at a low rate, its contribution to the current account surplus is not sufficient to curb the deterioration observed in the Services and Income account – which registered a deficit 9%larger than in 2005 (January-October aggregates).

As a result, the current account surplus (accumulated until October) is US$ 11.6 billion, a figure 2% lower than the one registered in the same period in 2005. We expect 2006 to close with a balance of US$ 13 billion, or 1.38% of GDP.

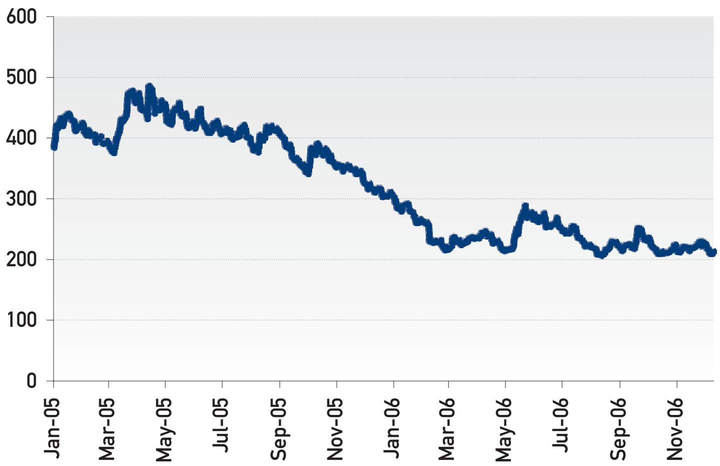
Despite the higher deficit in the services and income account, the perception is that Brazil's external vulnerabilities will decrease. The country risk spread oscillated between 300 and 200 points during the year and the average in 2006, 237 points (until the third week of December), is 40% lower than the average registered in 2005.

Based on the assumption of a vigorous growth in imports, above the pace of exports, and with the real remaining close to its current level in 2007, the trade balance is expected to drop to US$ 43 billion and the current account balance to about US$ 10 billion.

After a sharp reduction in 2005, country risk stabilizes at 300-200 points.

EMBI + SPREAD

BASE POINTS



Source: JP Morgan

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PROSPECTS FOR THE BRAZILIAN ECONOMY IN 2006 - 2007

	2004	2005	2006 (estimate)	2007 (projection)
Economic Activity				
GDP (annual variation)	4.9%	2.3%	2.7%	3.4%
Industrial GDP (annual variation)	6.2%	2.5%	3.0%	4.2%
Household Consumption (annual variation)	4.1%	3.1%	3.7%	3.7%
Gross formation of fixed capital (annual variation)	10.9%	1.6%	6.7%	9.2%
Unemployment Rate (annual average - % of EAP)	11.5%	9.8%	10.0%	10.0%
Foreign Sector				
Exports (billion US$)	96.5	118.3	137.5	150.0
Imports (billion US$)	62.8	73.6	92.0	107.0
Trade balance (billion US$)	33.7	44.7	45.5	43.0
Current account balance (billion US$)	11.7	14.2	13.0	10.0
Inflation				
Inflation (IPCA – annual variation)	7.60%	5.69%	3.20%	4.0%
Public Accounts				
Nominal public deficit (% of GDP)	2.7	3.3	3.3	2.5
Primary public surplus (% of GDP)	4.6	4.8	4.3	4.1
Net public debt (% of GDP)	51.7	51.5	50.6	49.5
Interest Rates				
Nominal interest rate				
(average annual rate)	16.2%	19.1%	15.2%	12.2%
(end of year)	17.8%	18.0%	13.3%	11.5%
Real interest rate (average annual rate and defl: IPCA)	8.0%	12.7%	11.6%	7.9%
Ex change Rate				
Nominal Exchange Rate - R$/US$				
(average in December)	2.71	2.28	2.15	2.25
(average for the year)	2.92	2.43	2.18	2.22