Highlights of Brazil*

2007 - 2008 Edition

*connectedthinking

PRICEWATERHOUSECOOPERS

1 Robust Demand Expansion in 2007

After two decades of near stagnation and high instability, the pattern of growth in Brazil has changed for the better since 2004: the economy has grown moderately for four years in a row (an average of 4.4% per year, against 2.4% in the previous two decades). The macroeconomic adjustments made back in 1999, which in time reduced dramatically the country's external vulnerability, and the boom of the world economy in the last five years are the main reasons for that improvement. In 2007, growth jumped to over 5%, driven by a strong increase in domestic demand. Personal consumption grew near 6%, as a function of the increase in both employment and real wages and the vigorous expansion of consumer credit. Private investment went up 13% in the year, responding to the record high levels of capacity utilization, especially in industry. On top of that expansionary thrust, the Lula administration has maintained a very expansive fiscal policy since 2005, increasing primary government expenditures at the rate of 8% per year, in real terms.

The industrial sector, with estimated output growth of 6.3%, led the expansion in 2007. Some segments of industry, such as consumer durables (+10.5%) and machinery and equipment (+19%), grew much above average. Car sales, for example, went up by one third, the best result in the industry's history. Residential construction, stimulated by lower real interest rates and more abundant credit, overcame the protracted situation prior to 2004 and entered a period of rapid expansion.

On the other hand, net external demand contributed negatively to growth. Although exports expanded 17%, favored by the exceptional expansion of international trade, imports grew 32%, reflecting the vigor of domestic demand. As a result, the trade surplus fell to US$40 billion, down from more than US$46 billion in 2006, but still a very comfortable situation. In fact, the expansion of imports has been instrumental in supplementing domestic supply in many sectors and mitigating inflationary pressures.

Monetary policy was partially responsible for the demand expansion, insofar as the Central Bank interest rate was driven to the lowest level in recent history (6.5% in real terms currently). Although still high by international standards, real rates of one digit, prevailing since 2006, stimulated borrowing by consumers and explain the boom in the durable goods and housing sectors. However, in the final months of the year, it was clear that no room existed for further cuts in interest rates, as inflation hit the government target rate for the year (4.5%, up from 3.1% in 2006) and threatens to increase further in 2008 if demand keeps expanding at the current rate. An indicator of the inflationary pressures embedded in the economy is the general price index (IGP), with a 7.8% rise in the year.

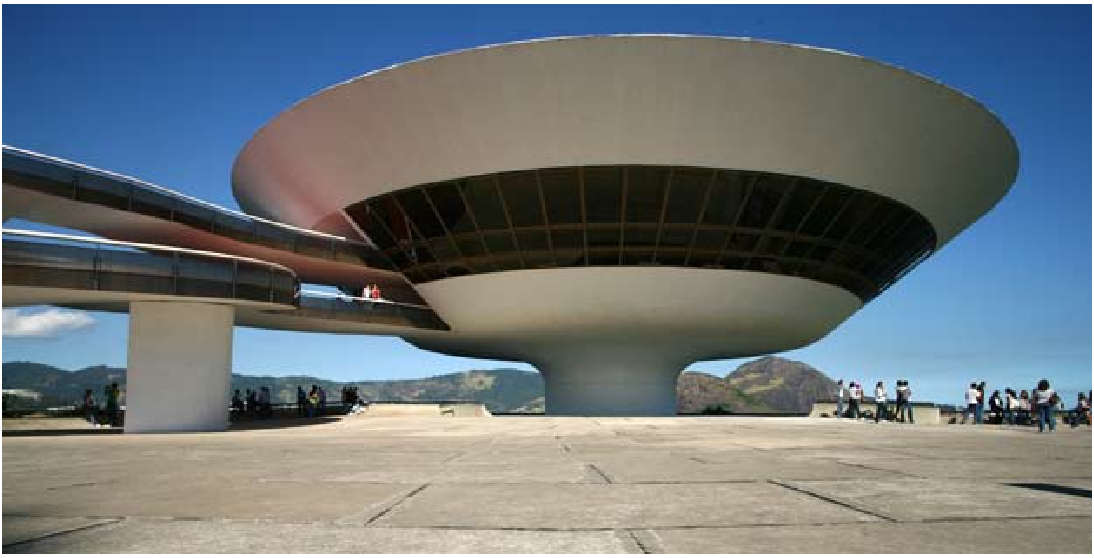
Real estate and stock prices responded vigorously to the expansion of the economy and the lower real interest rates. The Bovespa stock exchange index, for instance, accumulated an appreciation of 43.5% in the year, reflecting both the higher profitability of Brazilian companies and the expectations of continuing economic expansion in 2008.

The exchange rate decreased an additional 18%, as the result of the still large trade surplus and the massive capital inflow, despite Central Bank purchases of more than US$ 90 billion along the year. Foreign direct investment reached the all-time high of US$ 36 billion, and (net) foreign portfolio investments exceeded US$ 40 billion.

It should be noted that the Brazilian net foreign debt (gross debt minus reserves; see table in section 3) is negligible today. The Brazilian real is clearly overvalued and has only stayed at this artificial level, without severely hurting the country's exports, because of the increase in the dollar prices of commodities in the world market and the massive inflow of capital in the country. On the other hand, the decline in of the exchange rate has been a very important factor in keeping domestic inflation in line with the government target.

The crisis in the mortgage market in the US, initiated in July, has not so far affected the Brazilian economy through the financial channel, given the country's strong balance of payments position, as commented above. The negative effects of the crisis will certainly be felt in Brazil if the US economy enters into a recession in 2008, with the consequent weakening of the world economy and international trade.

On the political front, the year has been characterized by very little congressional activity, with no major legislation coming to light and a long list of failures, like the reforms of the tax, social security and political systems, which were in last year's agenda. The Congress, especially the Senate, was engulfed by scandals of corruption involving some of its members, and spent much of the year dealing with the problem. At the end of the year there was a heated debate over the extension of the CPMF (the tax on bank debits) until 2011 proposed by the Lula administration, resulting in the rejection of the proposal by the Senate. The loss of revenue, estimated at roughly R$ 40 billion in 2008, is to be compensated partially by an increase in two other federal taxes, the IOF (tax on financial, insurance and foreign exchange operations) and the CSLL on financial institutions (a corporate income tax). But even if the Congress approves the proposed tax increases, the federal administration will need some expenditure cuts along the year to preserve the primary surplus and the declining trend of the public debt/GDP ratio.
It can be said that the failure to extend the CPMF reflected the resistance of public opinion to the high tax burden in Brazil: around 37% of GDP, almost double the tax burden of most emerging market economies. In the end, the extinction of this exotic tax removes one of the many distortions of the Brazilian tax structure and may turn out to be a healthy means to impose more stringent fiscal discipline on the government.



2 Perspectives for 2008

The period of high economic instability in Brazil seems to have been overcome. The challenge now is to keep the economy growing around the current level of 5% per year while keeping inflation within the government target of 4.5%. For 2008, the scenario is one of continuing growth, probably in the same range as 2007, again based on the expansion of domestic demand. At present, business expectations are optimistic and a substantial increase in private investment is forthcoming to cope with demand expansion. As is known, gross investment in Brazil has been quite low (in the range of 17% of GDP) and a substantial increase in this rate is necessary to sustain the desired growth figure.

A small deficit in the current account of the balance of payments is expected, after five years of surplus, as the trade balance deteriorates. However, the balance of payments is not a threat to growth as it was in the past. The worsening of the current account may imply some devaluation of the real along the year, which could be seen as a beneficial movement to improve the competitiveness of the export sector, especially in the context of a less buoyant world economy.

There are some potential problems that should be considered. First, it is not clear at this point the extent of the damage to the world economy that will follow from the financial stress suffered by the financial sector due to the crisis in the mortgage market in the US. A large part of Brazil's good performance is due to the boom in the world economy, and the future scenario will naturally be poorer if the world enters a period of low expansion.

Second, there is a possibility that inflation may eventually exceed the government target (4.5%), requiring a tightening of monetary policy by the Central Bank, with its negative impact on domestic demand. The management of monetary policy in 2008 will be a delicate matter: to keep inflation stable while not spoiling the optimistic business environment and the confidence of consumers.

Third and more important, it has been said that Brazil is experiencing a virtual down break of the country's infra-structure, as attested by the acute crisis in air travel in 2007. New investments in these areas have been sluggish and take a long time to mature. So far the Lula administration has not increased public investment in critical sectors and failed to create a reliable regulatory environment for private investment in infra-structure. In particular, the risk of a shortage of electric energy in the next few years can be a major factor in inhibiting private investments, as occurred during the rationing of 2001. Sustaining growth at the rate of 5% per year is clearly not feasible unless a decisive change in public policies for infra-structure occurs very soon.

3 Principal Economic Indicators

	2007[1]	2006	2005	2004	2003
GDP (US$ bi. at year-average exchange rate)[2]	1300.0	1067.0	880.0	664.0	552.0
Real GDP growth (% per year)	5.3	3.7	2.9	5.7	1.1
Unemployment rate (% of labor force)	9.5	10.0	9.8	9.6	10.9
General price index - IGP-DI (% per year)	7.8	3.8	1.2	12.4	7.7
Consumer price index - IPCA (% per year)	4.5	3.1	5.7	7.6	9.3
Exchange rate at year-end (R$/US$)	1.79	2.15	2.29	2.72	2.93
Exchange rate change (% per year)	(18.2)	(6.1)	(15.8)	(7.2)	(19.3)
Public sector deficit (% of GDP)	2.1	2.9	3.0	2.4	4.6
Public sector debt (% of GDP)	43.0	44.9	46.5	47.0	52.3
(in US$ Billion)					
Merchandise exports	160.6	137.5	118.3	96.5	73.1
Merchandise imports	120.6	91.4	73.6	62.8	48.2
Trade balance	40.0	46.1	44.7	33.7	24.9
Current-account balance	4.8	12.9	14.3	11.7	4.1
International reserves	177.1	85.8	53.8	52.9	49.3
Foreign direct investment[3]	36.0	18.8	15.1	18.1	10.1
Total foreign debt	196.2	172.5	168.9	220.1	235.4

[1] *Some 2007 figures are estimates.*

[2] *The GDP series was revised upward by IBGE in 2007.*

[3] *Inclusive of intercompany loans.*

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