

COMMENTS ON THE BRAZILIAN ECONOMY

Government seeks to spur growth in 2012

In brief...

The economy continues to shift into lower gear. The central bank indicates it will continue to ease monetary policy and the government plans to boost public investment. Inflation has come down, but it remains around the top of the target range. External borrowing recovers amid turbulent global markets. Capital markets remain on hold, but the market for M&A is active. President Dilma Rousseff's popularity is on the rise.

The economy continues to shift into lower gear...

After a peak in the first quarter of 2011, quarterly growth came to a standstill in the third quarter, with a 0.0% reading. All demand components but exports contracted. Initial data for the fourth quarter do not paint a much better picture: the central bank's GDP proxy IBC-BR fell 0.3% in October while Itaú's own proxy dropped 0.2%. Business confidence ticked up in December but remains 11% below a year ago. New hiring remained below an average of 90 thousand in the quarter to November, the lowest in two years.

...the central bank indicates it will continue to ease monetary policy...

In its quarterly inflation report, the central bank restated the view, expressed in the minutes, that by "promptly mitigating" the effects of a "more restrictive" global environment, a "moderate" adjustment in the Selic rate will make inflation converge to the target in 2012. However, the report was more cautious about the prospects for inflation convergence in 2013. We maintain our view that the CB will cut rates by an additional 200 bps, to 9%, but we recognize that this sign of greater conservatism may lead to a shorter cycle.

... and the government plans to boost investment spending in 2012.

Monthly budget results remain consistent with meeting the primary target balance of 3.15% of GDP. For 2012, however, the outlook is different. Treasury Secretary Arno Augustin said public investment will pick up in the first quarter. Amid a significant expansion in mandatory spending due to an increase in government transfers linked to the minimum wage, it will be hard to fully accommodate the pickup in federal investment. We expect a smaller primary surplus, at 2.5% of GDP.

Inflation is coming down and is now around the top of the target range...

December's mid-month consumer inflation was 6.56%, a tad above the 6.5% ceiling and more than 2 percentage points above the 4.5% mid-point. Pressure is more intense in the services sector, where prices grew 8.7%. Core inflation is at an average of 7.0%. We expect inflation to moderate to 5.2% this year.

... while external borrowing has recovered.

External borrowing bounced back in November, bringing the rollover ratio of the medium and long term debt to 446% from 72% a month earlier, a sign of strength in an unfriendly global environment. Foreign direct investment showed the usual vigor, amounting to 3.1% of GDP in 12 months, while

portfolio flows showed their usual weakness, at just 0.3%. The current account deficit, at 2.0% of GDP, remains easily financed by capital inflows. In the newly published census of foreign direct investment, the financial sector has the largest share of the stock, followed by beverages, oil & gas, and telecommunication. The census also ranks China for the first time among the 20 largest foreign investors.

Capital markets on hold, active M&A...

Equity offerings remained on standby in December, while M&A activity stayed strong. In a deal worth BRL 1.3 billion (USD 700 million), Kroton, a private school operator, acquired 100% of Unopar, the country's largest distance-learning university. The deal will be financed through a combination of debt and equity, including a capital increase, which could reach BRL 600 million. This was the largest-ever M&A deal in the Brazilian education sector and the second-largest in the education sector globally. Kroton also announced plans to migrate to the Novo Mercado in 2012 as a result of the acquisition. Brazil's regulatory authorities approved – with some restrictions – the merger of Chile's LAN Airlines and Brazil's TAM S.A., a deal that created the world's second-largest airline company. In a small but highly publicized deal, Penguin Group, the English publisher, bought 45% of Brazil's Companhia das Letras. This was Penguin's first investment in a non-English-speaking market. Its parent company, Pearson, had already moved into Brazil through the acquisition of SEB, an education company, in 2010. In the consumer goods sector, Hypermarchas sold its Etti food brand to Bunge and its Assolan cleaning products brand to Quimica Amparo, for a combined USD 172 million, while cookie- and pasta-maker M. Dias Branco bought Pelagio Participações and J. Brandao Comercio e Industria for USD 130 million.

Financial Markets...

Brazilian markets stood on the sidelines in December, rounding out a year of losses. The 5-year CDS ended at 161 bps over Libor, little changed from November but down from 111 bps a year ago. In dollar terms, the Ibovespa fell by 3.7% in December and by 27% in 2011. In local currency, it lost 0.2% in December but fell 18% in the year. The currency weakened to 1.88 reais per dollar, down 13% from a year ago.

Dilma's approval rating increases...

President Dilma's popularity rose to 56% according to an Ibope poll, five percentage points higher than in a September survey. Labor Minister Carlos Lupi (PDT) was the sixth to fall to corruption allegations last year. The government plans to adopt a flat, per-item tax (*ad rem*) on imported clothes, instead of the more usual *ad valorem* system, to prevent tax evasion via under-pricing of imports.

Furthermore...

A minor cabinet reshuffle is expected for January. In addition, the market is looking for signs of new government measures aimed at boosting growth. The monetary policy committee will meet on January 18.

ECONOMIC DATA

January 2, 2012

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Accumulated 3M	
													12M	Annualized
INFLATION (1) (2)														
2010 CPI (IPCA)	0.7	0.8	0.5	0.6	0.4	0.0	0.0	0.0	0.4	0.8	0.8	0.6	5.9	9.2
WPI	0.5	1.4	1.1	0.7	1.5	1.1	0.2	1.2	1.6	1.3	1.8	0.6	13.9	16.1
IGPM	0.6	1.2	0.9	0.8	1.2	0.9	0.2	0.8	1.2	1.0	1.4	0.7	11.3	13.3
2011 CPI (IPCA)	0.8	0.8	0.8	0.8	0.5	0.1	0.2	0.4	0.5	0.4	0.5	0.6	6.6	6.2
WPI	0.8	1.2	0.6	0.3	0.0	(0.4)	(0.2)	0.6	0.7	0.7	0.5	(0.5)	4.3	2.9
IGPM	0.8	1.0	0.6	0.4	0.4	(0.2)	(0.1)	0.4	0.6	0.5	0.5	(0.1)	5.1	3.7
MONEY AND CREDIT (1) (4)														
2010 M3	(0.5)	0.3	1.4	(0.3)	1.2	1.3	1.7	2.1	2.4	1.6	1.2	2.0	15.5	23.1
Bank credit	1.9	1.5	1.3	1.4	1.8	2.0	1.3	1.6	1.6	1.5	1.5	1.4	20.6	20.0
2011 M3	0.2	2.1	1.4	0.6	1.4	1.3	1.9	1.9	1.5	0.8	1.2		17.5	14.8
Bank credit	1.4	1.4	1.5	1.5	1.5	1.4	1.4	1.3	1.3	1.4	1.4		18.2	17.6
INTEREST RATES (5)														
2010 Overnight (Interbank rate in R\$)	8.7	8.7	8.7	9.4	9.4	10.2	10.7	10.7	10.7	10.7	10.7	10.7	9.9	10.7
Two-year interest rate (in R\$)	11.7	11.7	11.8	12.4	12.2	12.1	11.8	11.5	11.9	11.7	12.3	12.3	11.9	12.1
Two-year interest rate (in USD)	2.2	3.2	3.1	2.3	2.8	2.8	2.9	2.5	2.3	2.5	2.8	3.0	2.7	2.8
2011 Overnight (Interbank rate in R\$)	11.2	11.2	11.7	11.9	11.9	12.2	12.4	12.4	11.9	11.4	11.4	10.9	11.7	11.2
Two-year interest rate (in R\$)	12.9	12.7	12.8	12.7	12.5	12.7	12.8	11.1	10.6	10.5	9.8	10.5	11.8	10.3
Two-year interest rate (in USD)	2.4	2.7	3.3	4.6	4.0	3.5	2.7	3.6	3.7	3.3	3.9	3.2	3.4	3.5
STOCK MARKET														
IBOVESPA, São Paulo Stock Exchange Market Index														
2010 Traded Volume (daily average in US\$ mm.) (6)	3784	3626	3683	3875	4018	3022	2998	3140	3702	4519	3761	3732	3655	4004
Index Variation (end of month in US\$)	(11.2)	5.1	7.6	(1.4)	(10.9)	(2.5)	13.5	(3.4)	10.5	1.4	(5.0)	5.4	5.6	0.6
2011 Traded Volume (daily average in US\$ mm.) (6)	3756	4369	3861	4231	3768	3709	3644	4805	3597	4003	3195	3362	3858	3520
Index Variation (end of month in US\$)	(4.4)	2.0	3.8	(0.2)	(2.7)	(2.3)	(5.4)	(5.8)	(20.7)	22.4	(9.1)	(3.7)	(2.2)	3.2
EXCHANGE RATE														
<i>(End of month)</i>														
2010 (a) BRL/USD (7)	1.87	1.81	1.78	1.73	1.82	1.80	1.76	1.76	1.69	1.70	1.72	1.67	---	---
(b) % monthly change	7.4	(3.2)	(1.7)	(2.7)	4.8	(0.9)	(2.4)	(0.1)	(3.5)	0.4	0.9	(2.9)	(4.3)	(6.5)
(c) BRL/EUR (7)	2.63	2.46	2.41	2.31	2.24	2.21	2.29	2.23	2.30	2.37	2.23	2.22	---	---
(d) % monthly change	5.1	(6.3)	(2.2)	(3.9)	(3.1)	(1.5)	3.7	(2.8)	3.3	2.9	(5.7)	(0.4)	(11.1)	(12.9)
2011 (a) BRL/USD (7)	1.67	1.66	1.63	1.57	1.58	1.56	1.56	1.59	1.85	1.69	1.81	1.88	---	---
(b) % monthly change	0.4	(0.7)	(2.0)	(3.4)	0.4	(1.2)	(0.3)	2.0	16.8	(8.9)	7.3	3.6	12.6	4.7
(c) BRL/EUR (7)	2.28	2.30	2.31	2.33	2.27	2.27	2.24	2.29	2.49	2.36	2.44	2.43	---	---
(d) % monthly change	2.8	0.5	0.7	0.8	(2.5)	(0.3)	(1.2)	2.1	9.1	(5.3)	3.4	(0.3)	9.5	(9.2)
MAIN BRAZILIAN BONDS (%)														
2010 CDS 5-yr (8)	144.0	131.4	130.5	123.0	135.4	137.7	116.7	131.4	114.7	100.0	123.0	110.8		
BR 40 Spread over US Treasury (9)	171.4	146.5	121.8	128.3	186.2	174.7	143.3	154.8	127.8	104.4	107.7	106.8		
2011 CDS 5-yr (8)	118.9	118.0	111.0	105.3	104.3	110.0	113.6	142.6	202.4	140.3	163.1	160.8		
BR 40 Spread over US Treasury (9)	94.9	85.4	62.0	62.5	48.8	38.8	47.9	57.3	156.6	130.0	138.7	98.0		
<p>(1) End of month values. Percentage change over the previous period.</p> <p>(2) WPI (Wholesale Price Index) and IGPM (General Price Index, Market) from the Vargas Foundation; CPI (IPCA) (Consumer Price Index) from IBGE. The last figure for the CPI refers to the 30-day period ending on the 15th of this last month; previous figures refer to the full monthly period. Figures for the IGPM [a weighted average of Vargas Foundation's consumer price index (30%), WPI (60%), and national construction price index (10%)], always refer to the 30-day period ending on the 20th of each month.</p> <p>(3) Based on the average of the last three months, accumulated for 12 months.</p> <p>(4) M3 = currency outside banks plus demand deposits plus savings deposits plus CDs plus money market funds plus repurchase operations with federal securities. Bank credit = financial institutions' total credit to public and private sectors seasonally adjusted by Itaú-BBA</p> <p>(5) Annual yields, in percentage terms, gross of withholding tax on nominal income on nonbank operations. End of period values, except for the overnight rate, which is the cumulative value for the month. The USD rate is a swap rate and is deliverable in R\$.</p> <p>(6) Daily average = total monthly volume / business days.</p> <p>(7) Average of the offer rate of the last business day of the month.</p> <p>(8) CDS = premium in basis points, calculated over Libor, paid as a protection against Brazil's default over a 5y period.</p> <p>(9) Spread over US Treasury bond of equivalent duration, in basis points. BR 40 is callable on or anytime after 2015/08/17.</p>														

ECONOMIC DATA (Cont'd)

January 2, 2012

GDP (1)	2008		2009					2010					2011		
	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3
Index (1995 = 100)	144.1	147.0	141.7	144.5	148.1	151.7	146.5	154.6	157.1	158.6	159.8	157.5	161.1	162.2	162.2
% quarterly change	-4.2	5.2	-1.7	2.0	2.5	2.4	-0.3	1.9	1.6	1.0	0.8	7.5	0.8	0.7	0.0
ECONOMIC ACTIVITY												Year Average			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec			
2010 Industrial Production (2)	125.4	126.5	130.0	130.3	129.4	128.0	128.6	128.5	128.6	129.1	129.0	128.0	128.4		
Capacity Utilization (3)	83.8	84.0	84.3	85.1	84.9	85.5	85.1	84.9	85.0	85.2	84.5	84.9	84.8		
2011 Industrial Production (2)	128.5	131.1	132.4	129.2	130.8	129.2	129.5	129.4	126.9	126.1				129.3	
Capacity Utilization (3)	84.7	84.5	84.3	84.4	84.4	84.3	84.1	83.6	83.6	83.5	83.3	83.4	84.0		
2010 Retail Sales (4)	163.9	168.6	167.4	167.3	167.9	169.8	170.6	173.5	174.3	174.5	175.6	175.8	170.8		
Consumer Confidence Index (5)	112.6	110.5	111.6	115.8	116.8	119.3	120.8	121.8	122.9	120.7	124.2	121.7	118.2		
Business Confidence Index (6)	113.6	115.8	116.5	115.3	116.1	115.3	113.6	112.9	113.4	114.0	112.7	114.5	114.5		
2011 Retail Sales (4)	178.1	178.2	179.9	179.6	180.9	181.3	183.5	182.6	183.6	183.5				181.1	
Consumer Confidence Index (5)	121.6	122.6	120.1	118.2	115.4	118.0	124.4	118.7	114.7	115.2	119.0	119.6	119.0		
Business Confidence Index (6)	112.8	112.5	112.4	111.2	109.9	107.1	105	102.7	101.1	100.7	100.7	101.8	106.5		
EMPLOYMENT (%)												Year Average			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec			
2010 Unemployment Rate (7)	7.4	7.2	7.1	6.9	7.0	6.9	6.8	6.6	6.3	6.3	6.0	6.2	6.7		
Employment/Household Survey (8)	117.0	117.9	118.3	118.8	118.9	118.4	119.1	119.1	119.4	119.8	120.0	120.0	118.9		
Employment/Business Registry(9)	138.7	139.5	140.5	141.3	142.2	142.8	143.5	144.3	144.9	145.6	146.4	147.3	143.1		
2011 Unemployment Rate (7)	6.3	6.2	6.1	6.0	6.0	6.1	5.9	5.9	6.1	6.0	5.6	6.0			
Employment/Household Survey (8)	119.7	120.6	121.1	121.2	121.7	121.3	121.5	121.7	121.6	121.8	122.4	121.3			
Employment/Business Registry(9)	148.1	149.1	149.6	150.1	150.7	151.4	151.9	152.2	152.7	153.0	153.4	151.1			
PUBLIC SECTOR BUDGET (10)												Accumulated 12 months			
(% of GDP)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec			
2010 Overall Balance (11)	0.7	(1.6)	(3.1)	(1.8)	(2.5)	(2.8)	(3.1)	(3.1)	(2.3)	(2.3)	(2.5)	(2.5)	(2.4)		
Ex-interest Balance	5.7	3.4	2.2	3.4	2.7	2.4	2.1	2.0	2.8	2.8	2.7	2.7	3.3		
Gross Public Debt (12)	61.5	60.7	57.9	57.7	57.6	57.4	57.1	56.6	56.5	56.5	56.1	53.4			
Net Public Debt (13)	41.3	41.6	41.6	41.2	40.7	40.6	40.7	40.6	39.8	39.3	39.3	39.7			
2011 Overall Balance (11)	(0.5)	(2.0)	(2.0)	(1.6)	(2.2)	(2.1)	(2.0)	(2.4)	(2.4)	(2.3)	(2.4)	(2.4)			
Ex-interest Balance	5.5	4.0	4.1	4.4	3.9	3.9	3.9	3.6	3.4	3.5	3.4	3.3			
Gross Public Debt (12)	54.1	54.1	54.5	54.6	54.3	54.5	54.8	54.7	54.6	54.3	54.5				
Net Public Debt (13)	39.3	39.4	39.4	39.4	39.4	39.3	39.1	38.7	36.8	38.0	37.2				
BALANCE OF PAYMENTS												Acc Dec	last 12 months		
(US\$ billion)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec			
2010 Trade Balance	(0.2)	0.4	0.7	1.3	3.4	2.3	1.4	2.4	1.1	1.9	0.3	5.4	20.3	20.3	
Exports	11.3	12.2	15.7	15.2	17.7	17.1	17.7	19.2	18.8	18.4	17.7	20.9	201.9	201.9	
Imports	11.5	11.8	15.1	13.9	14.3	14.8	16.3	16.8	17.7	16.5	17.4	15.6	181.6	181.6	
Current Account	(3.8)	(3.3)	(5.1)	(4.6)	(2.0)	(5.3)	(4.6)	(2.9)	(3.9)	(3.8)	(4.7)	(3.5)	(47.5)		
Foreign Direct Investment (14)	0.6	2.8	2.1	2.2	3.6	0.8	2.6	2.4	5.4	6.8	3.7	15.4	48.5		
Other Capital Inflows (15)	2.2	9.4	11.0	9.4	9.0	10.8	6.4	8.4	16.9	14.3	3.5	7.9	109.1		
Brazilian Capital Outflows (16)	3.3	(7.8)	(4.4)	(3.5)	(6.2)	(2.8)	(3.1)	(3.0)	(6.6)	(8.2)	0.5	(17.1)	(58.9)		
Intl Reserves / Liquidity (17)	240.8	241.3	244.0	247.3	249.8	253.1	257.3	261.3	275.2	284.9	285.5	288.6			
Total External Debt (15)	200.9	203.0	211.5	211.6	218.3	228.6	235.3	235.4	247.8	254.1	247.1	256.8			
2011 Trade Balance	0.4	1.2	1.6	1.9	3.5	4.4	3.1	3.9	3.1	2.4	0.6	0.9	26.9	31.4	
Exports	15.2	16.7	19.3	20.2	23.2	23.7	22.3	26.2	23.3	22.1	21.8	16.4	250.3	254.8	
Imports	14.8	15.5	17.7	18.3	19.7	19.3	19.1	22.3	20.2	19.8	21.2	15.6	223.5	223.5	
Current Account	(5.5)	(3.4)	(5.6)	(3.5)	(4.1)	(3.3)	(3.5)	(4.8)	(2.2)	(3.1)	(6.8)	(49.3)			
Foreign Direct Investment (14)	3.0	7.8	6.8	5.5	4.0	5.5	6.0	5.6	6.3	5.6	4.1	75.4			
Other Capital Inflows (15)	7.8	0.0	9.7	11.1	9.8	3.1	11.3	5.8	1.2	0.7	7.6	75.9			
Brazilian Capital Outflows (16)	3.8	4.4	0.0	(7.0)	(4.9)	(1.9)	(6.3)	(0.6)	(4.2)	(3.3)	(4.2)	(41.3)			
International reserves (17)	297.7	307.5	317.1	328.1	333.0	335.8	346.1	353.4	349.7	353.0	350.7	351.3			
Total External Debt (15)	261.4	271.1	275.9	282.5	284.1	291.6	297.1	304.2	297.6	297.6	301.5				
(1) Seasonally adjusted IBGE data. (2) Seasonally adjusted IBGE index for Brazil, average 2002=100. (3) Seasonally adjusted FGV data for Brazil. (4) Seasonally adjusted IBGE nationwide index for inflation-adjusted retail sales, 2003=100. (5) FGV survey data on nationwide consumer expectations for their current and future economic conditions. Seasonally adjusted, September 2005 = 100. (6) FGV survey data on nationwide manufacturing industry expectations for their current and future conditions. Seasonally adjusted. (7) IBGE original household data for the six major Brazilian metropolitan regions, labor force with ten years of age or more, 30-day search period, seasonally adjusted by Itaú BBA. (8) IBGE household data (PME) on employed population for the six major Brazilian metropolitan regions, average 2003=100, seasonally adjusted by Itaú BBA. (9) Business registry data (CAGED) from the Labor Ministry, average 2003=100, including all employees with labor cards in the country, seasonally adjusted by Itaú BBA. (10) Accumulated flows in the year to date, except for net public debt which is an end-of-period stock. Includes federal, state and municipal governments, with respective non-financial enterprises (plus the Central Bank) and excludes Petrobras. (11) Net public sector borrowing requirements. (12) General Government gross debt. Does not include Central Bank, public enterprises and Social Security administration. (13) Gross debts less credits of the general government, plus net debts of Central Bank and public enterprises. (14) Includes intercompany loans. (15) Includes stocks, bonds, loans, suppliers' credits, asset transfers, and others (16) Includes direct investment and others (17) Includes, in addition to cash, stocks of repurchase lines and loans abroad.															