¿Y qué está pasando en Brasil?

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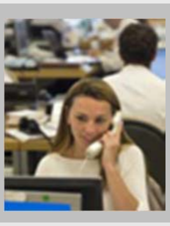


August, 2013

Summary

Itaú

- ✓ **Why has the Brazilian economy decelerated?**

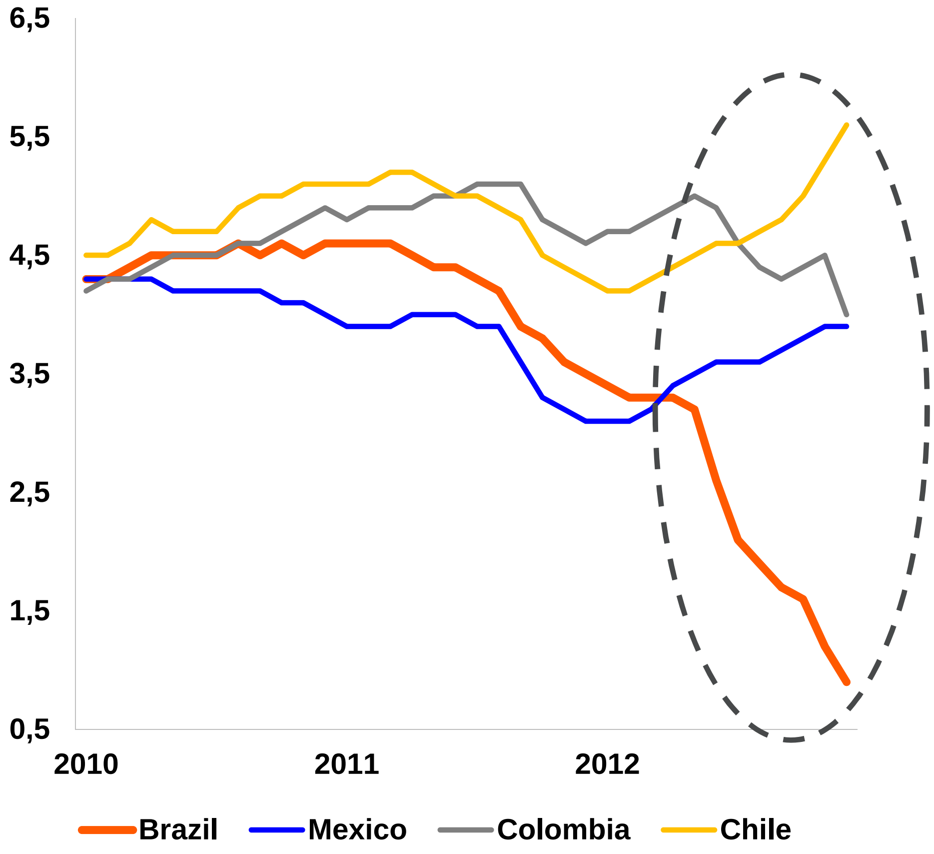
- ✓ **The low growth and full employment paradox (new middle class vs. high labor costs).**

- ✓ **Challenge: Brazil needs to invest more and increase productivity to grow sustainably.**

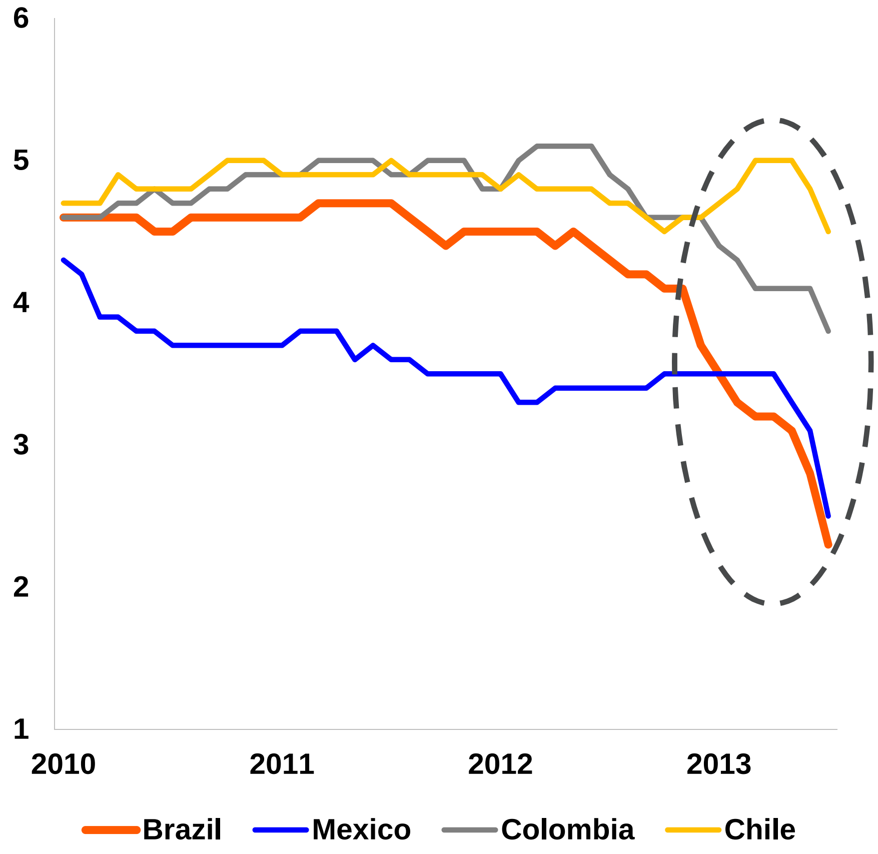
- ✓ **How can economic policy contribute to sustainable growth?**

Growth Disappointed First in Brazil, and Now in Other LatAm Countries

GDP Forecasts for 2012 (%)



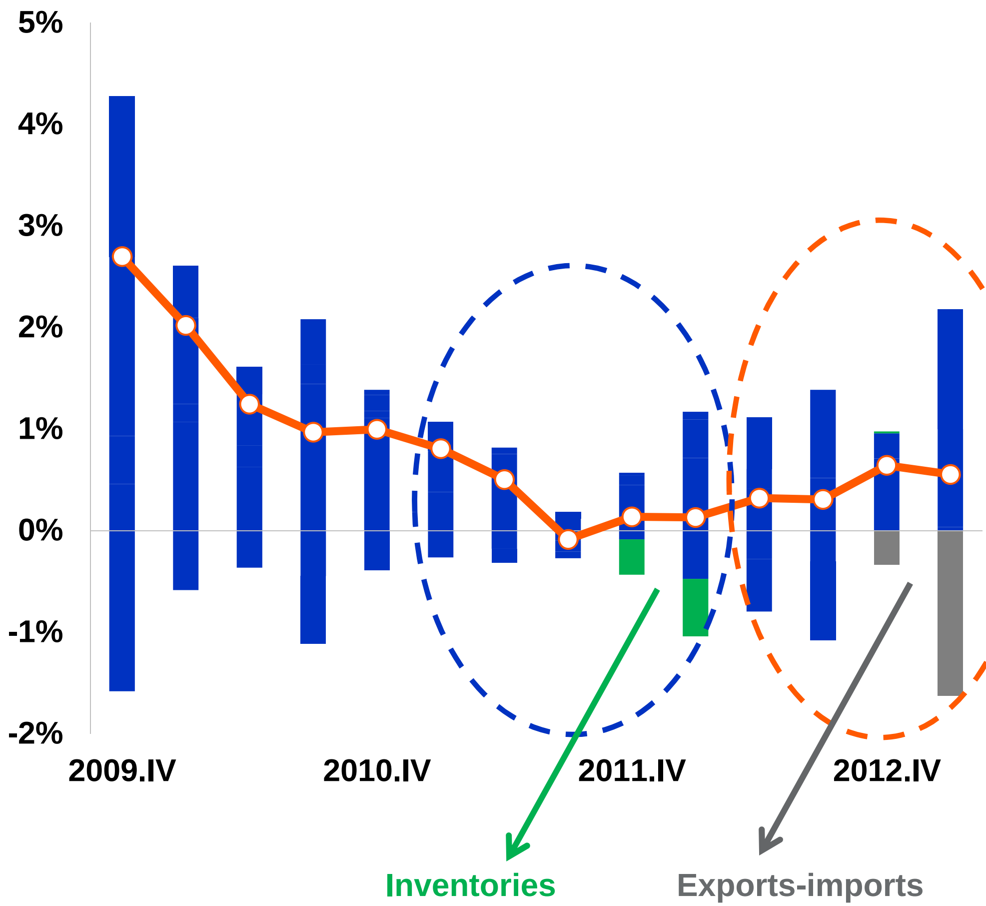
GDP Forecasts for 2013 (%)



Source: Itaú Unibanco, Latin Focus Consensus Forecasts

What Explains the Weak GDP in the Last Couple of Years?

GDP Growth
QoQ, SAAR



Deleveraging:

- ✓ Higher real interest rates (+150 bps)
- ✓ Macroprudential measures (reserve + capital requirements)
- ✓ Reduction in government current expenditure growth (to 0% from 10%-15%)
- ✓ Reduced BNDES disbursements
- ✓ Global risk aversion (VIX up to 40)
- ✓ High inventories, decelerating growth and imports

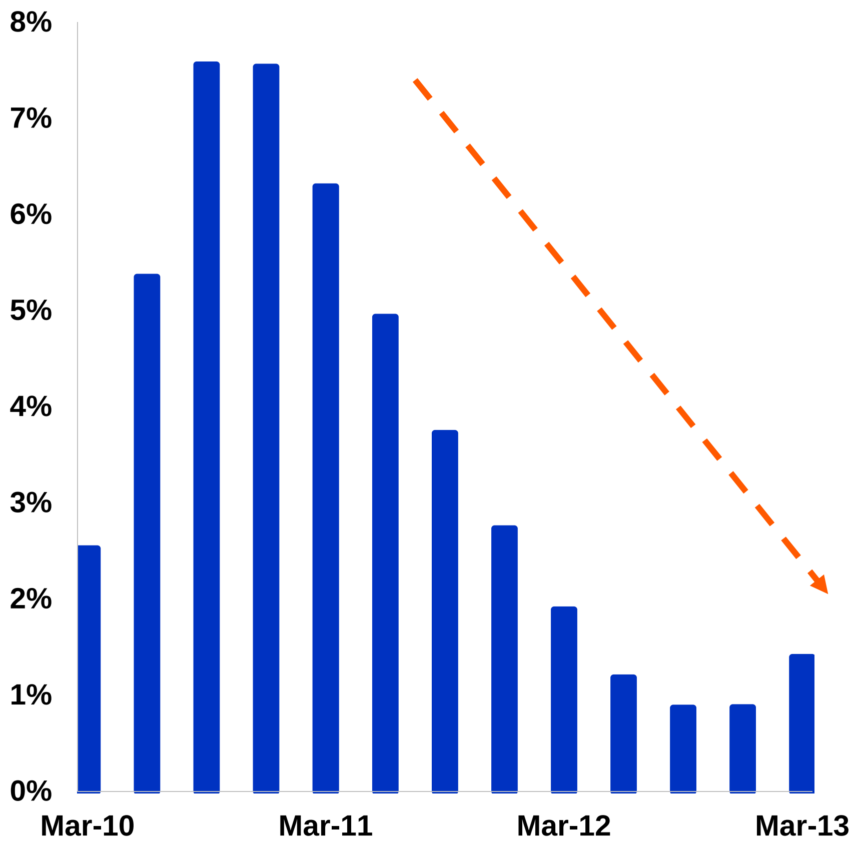
Supply Issues:

- ✓ Fiscal expansion and interest-rate cuts; economy reacts slowly
- ✓ Excessive interventionism creates higher economic-policy risk
- ✓ Productivity deceleration seems stronger than cyclical factors; lower potential growth
- ✓ With low productivity growth, rising wages reduce margins and become a limitation on investment
- ✓ Inflation accelerates, affecting real income and consumption
- ✓ Signs of growing net imports

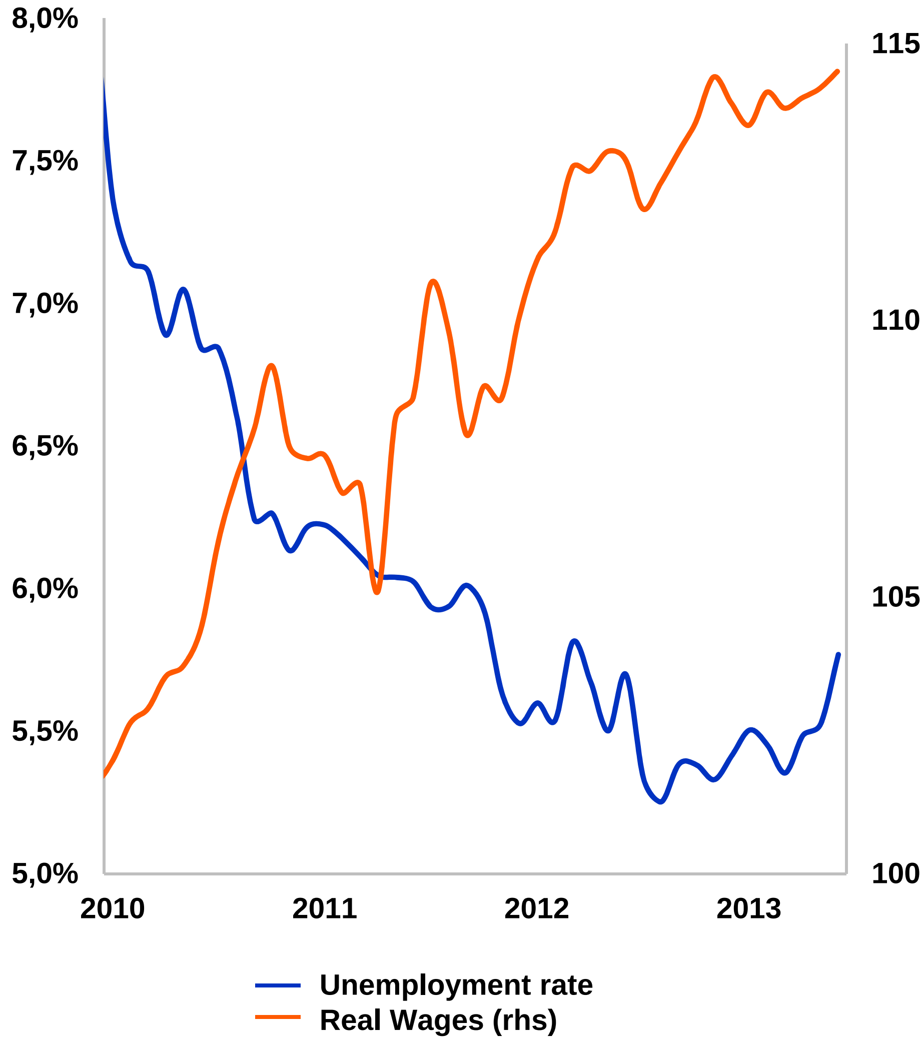
Source: Itaú Unibanco, IBGE

Low Growth, but Tight Labor Market

GDP Growth over 12 Months



Unemployment vs. Real Wages

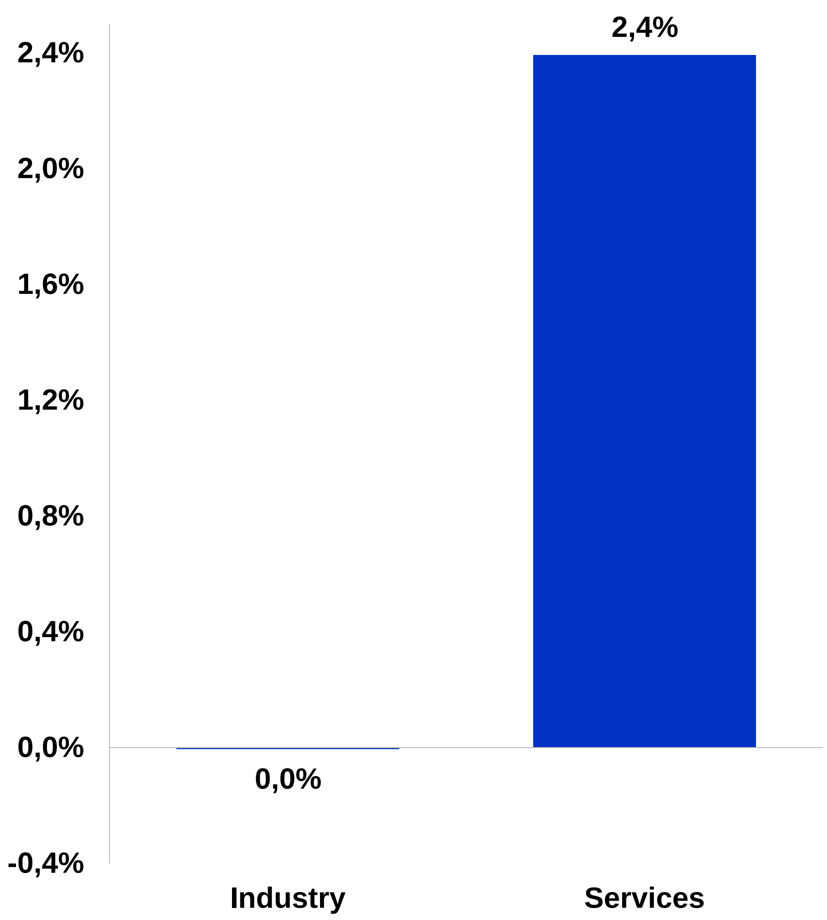


Source: Itaú Unibanco, IBGE

Demographics and Growth Composition Explain Tight Labor Market

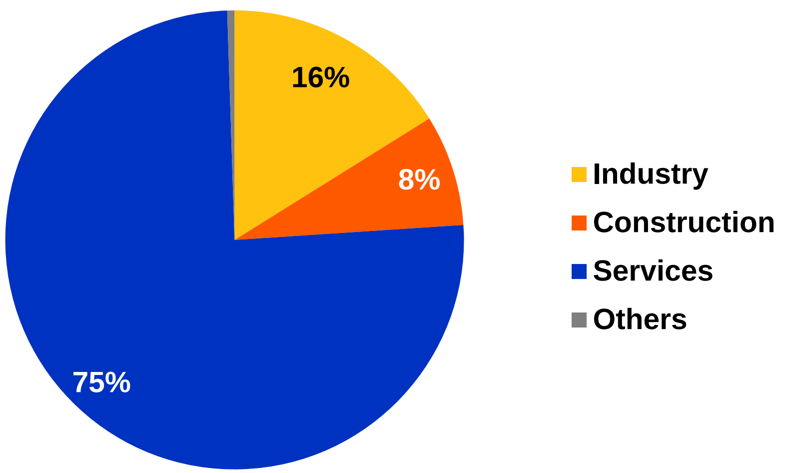
GDP – Industrial vs. Service

annualized average growth, 2010T2-2013Q1

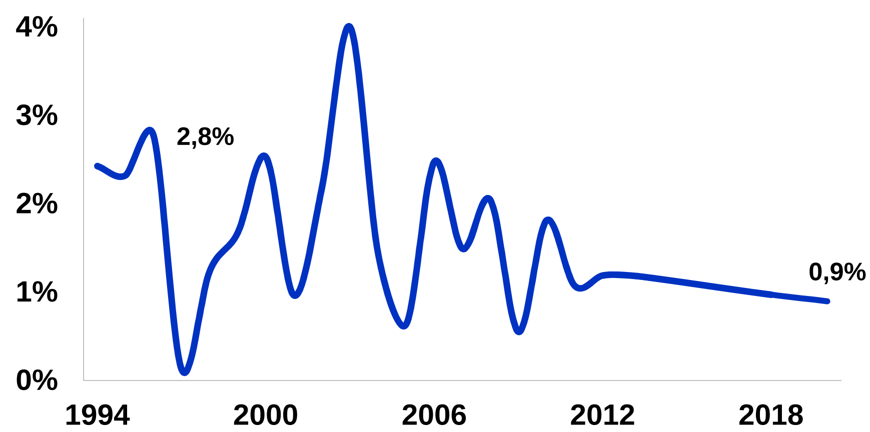


Employment by Sector

2012 average



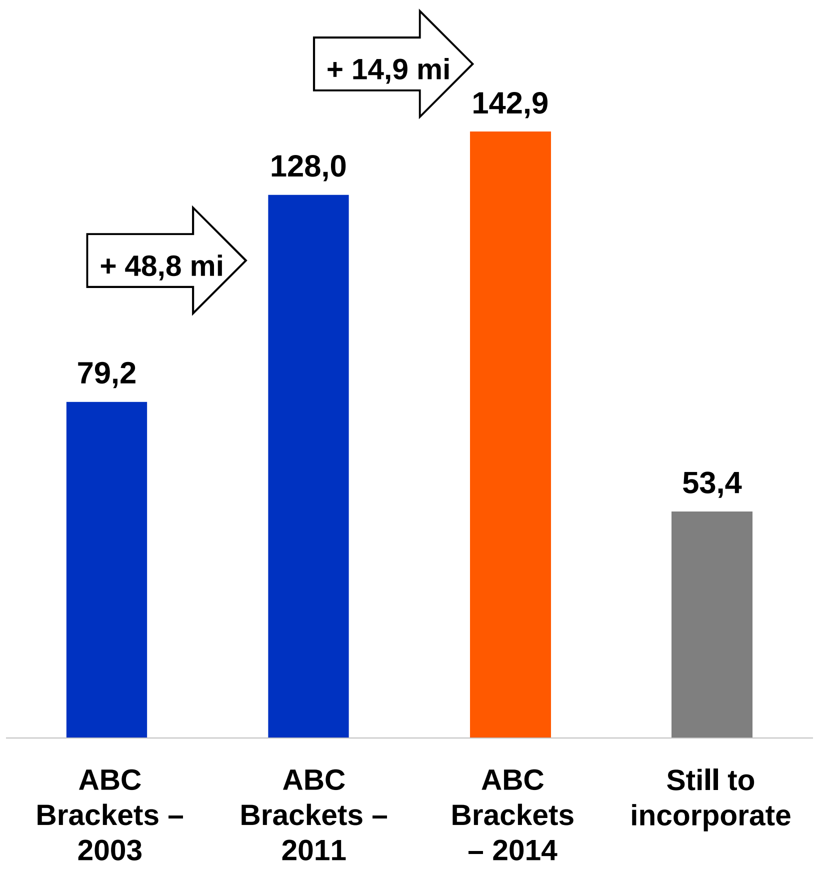
Growth in Economically Active Population



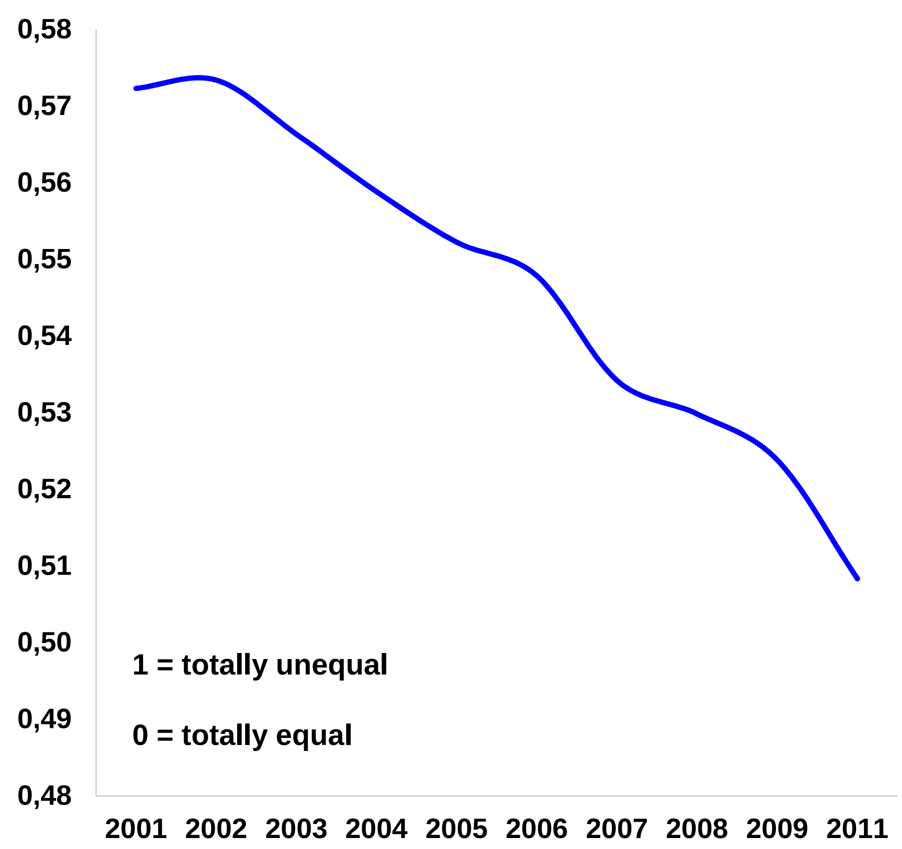
Source: Itaú Unibanco, IBGE

Lula´s Legacy: New Middle Class and Income Distribution

New Middle Class (Millions of People)



Gini Index



Source: Itaú Unibanco, FGV

Unemployment Simulations: Higher Productivity to Grow

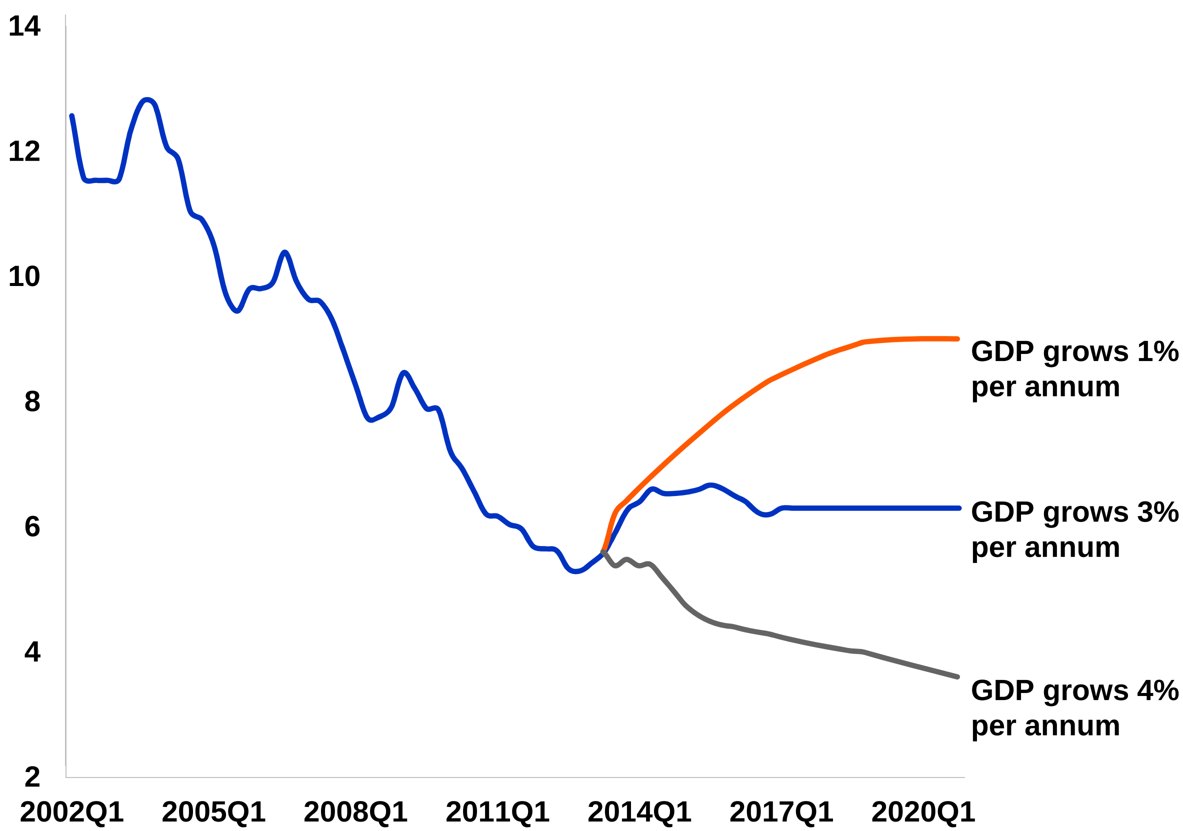
- ✓ Unemployment rate (u) dynamics determined by the equation:

$$u_t = 1 - \left[(1 - u_{t-1}) \frac{(1 + \Delta\% E_t)}{(1 + \Delta\% PEA_t)} \right]$$

E: Employment. Depends on GDP growth and long term wages

PEA (Labor force): labor supply Depends on demography

Unemployment Rate (%)

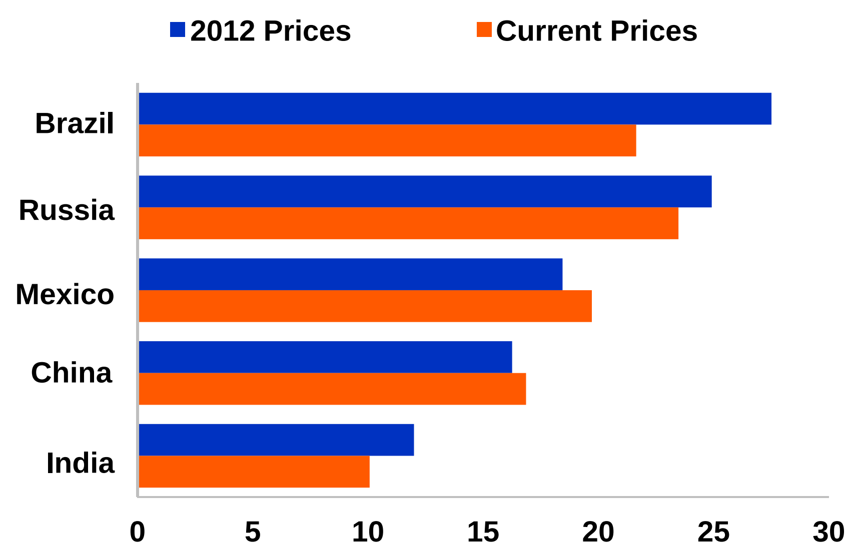


- ✓ Growth at around 3% maintains full employment.
- ✓ Higher growth would increase wages and inflation. Need higher productivity, or more investment in capital.

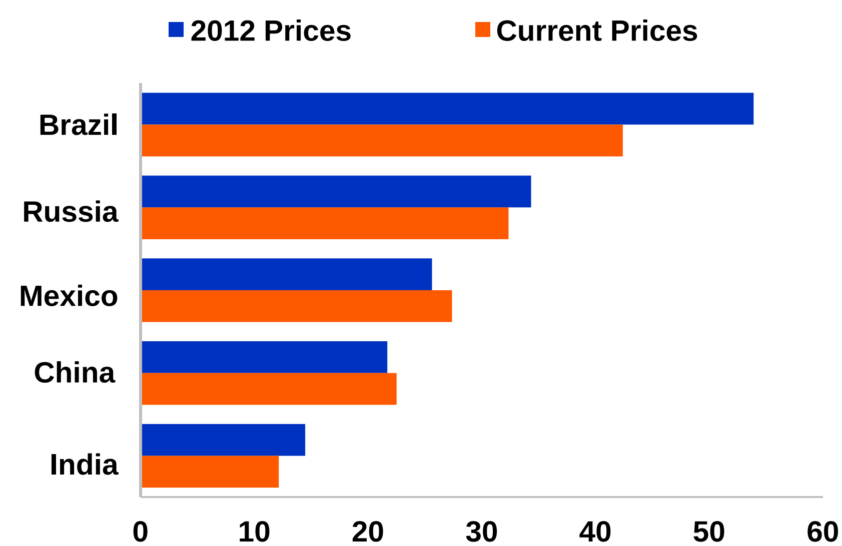
Source: Itaú Unibanco

High Costs Compared to Productivity Level

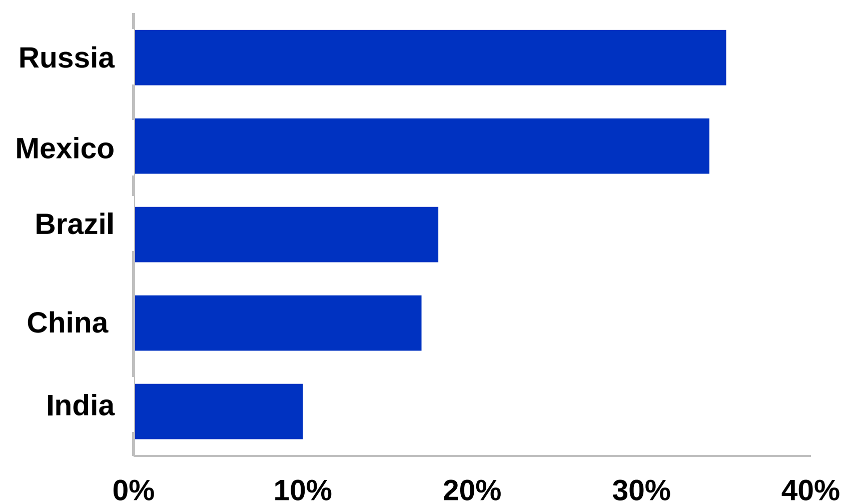
Wages (in Dollars)



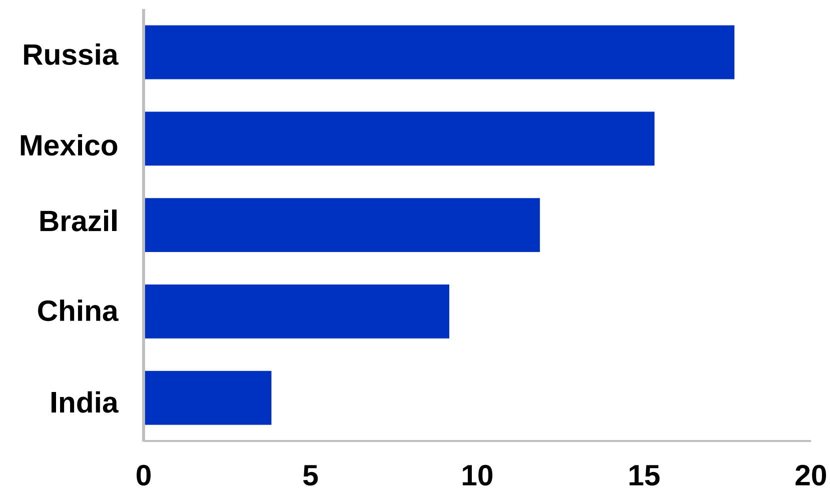
Wages + Labor Benefits (in Dollars)



Productivity (% of U.S.)



Per Capita GDP (PPP)

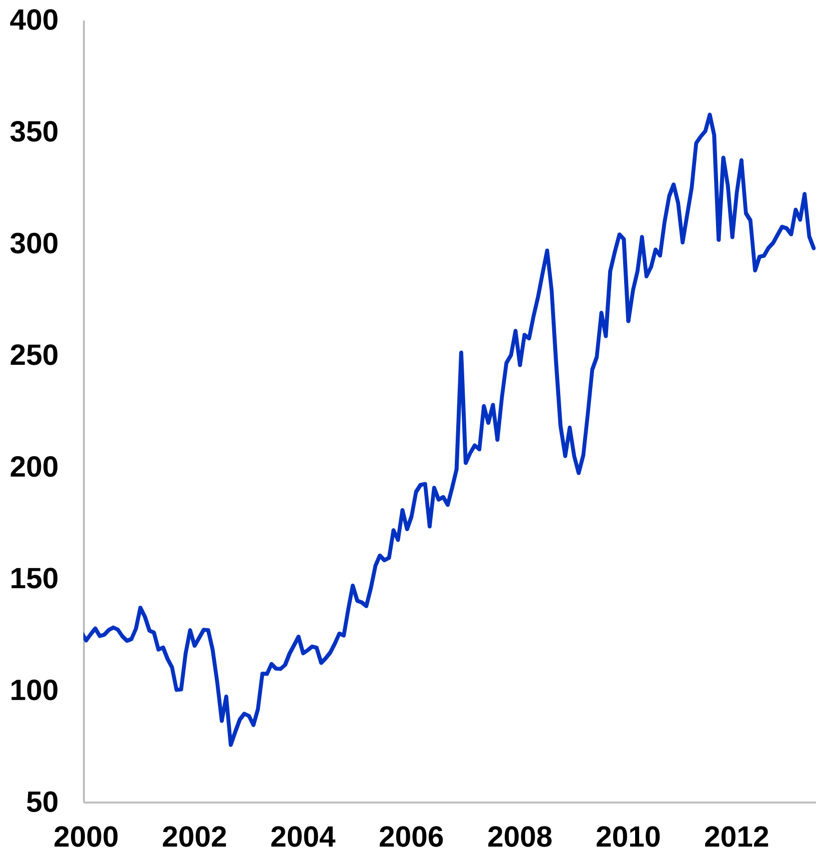


Source: Itaú Unibanco, KPMG, FMI, Conference Board

Wages Have Grown Compared to the Exchange Rate

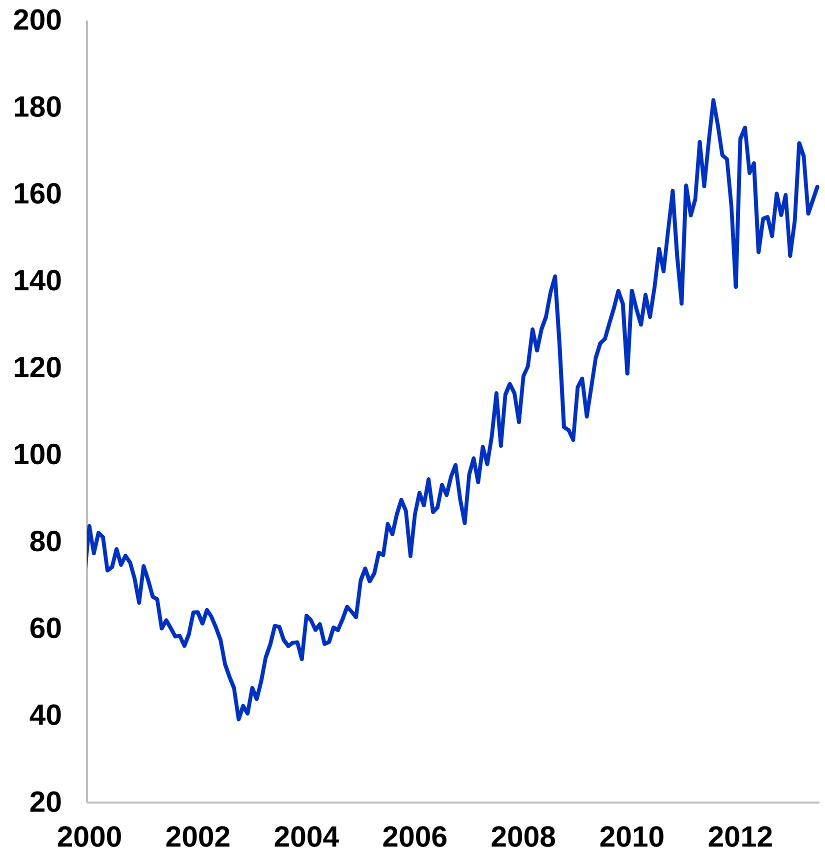
Wages/Exchange-Rate Ratio

Jun/1994=100



Unit Labor Cost

In Dollars, Jun/1994=100



Source: Itaú Unibanco, BCB

Prices in Brazil Remain High

Currency Appreciation (+) or Depreciation (-) Measures

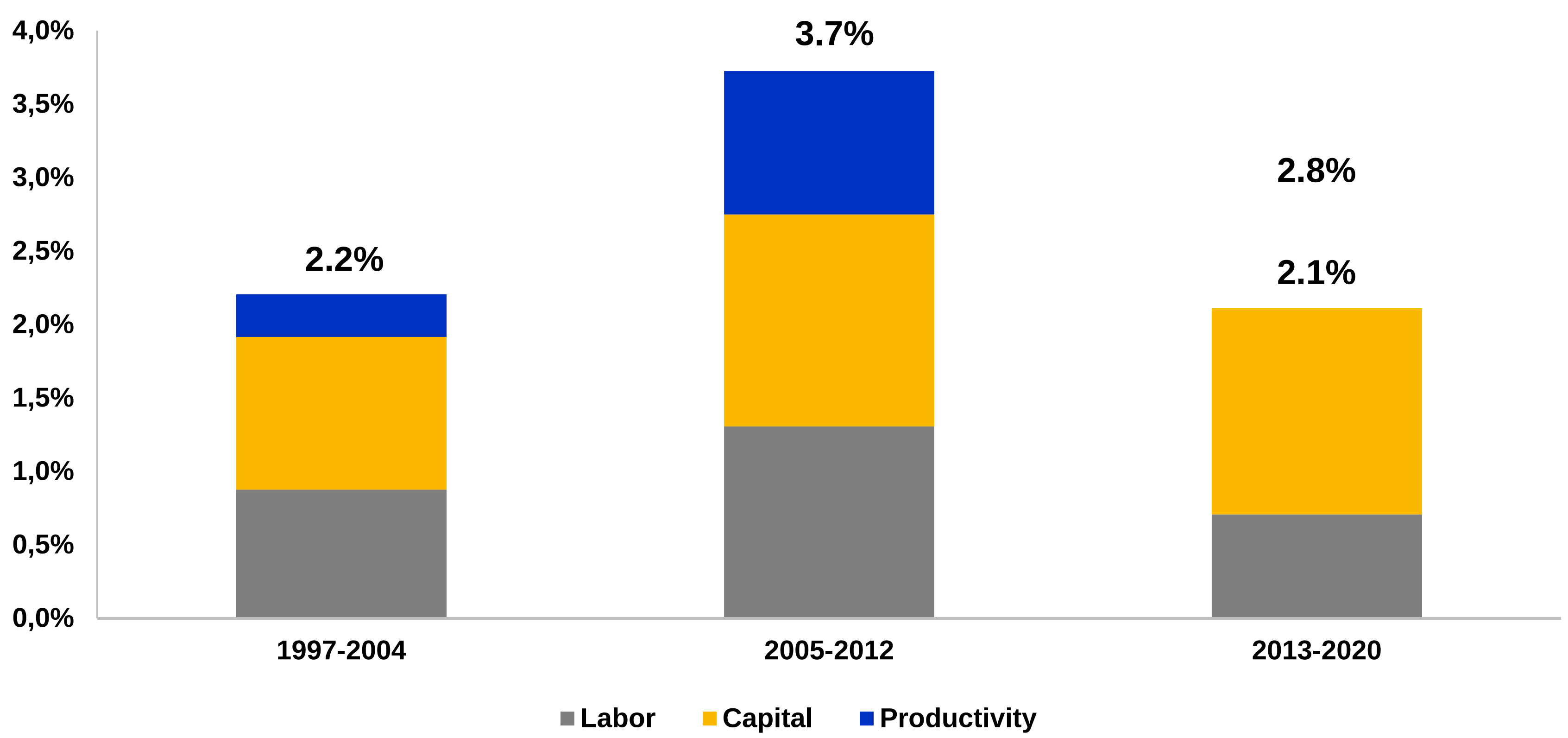
		Effective real exchange rate (Jun/13, against 04-11 average)	Big Mac Index (Jul/2013)	Prices in relation to the U.S. (PPP) in 2012
Emerging	South Africa	-16.6%	-60.0%	-34.0%
	South Korea	-9.2%	-24.6%	-28.0%
	India	-7.0%	-67.1%	-61.0%
	Mexico	-3.6%	-37.3%	-33.0%
	Chile	3.9%	-13.6%	-16.0%
	Brazil	7.9%	16.0%	2.0%
	Colombia	13.3%	-1.8%	-27.0%
	Russia	16.0%	-42.0%	-20.0%
	China	25.0%	-42.8%	-34.0%
Developed	Japan	-16.7%	-29.8%	29.0%
	United Kingdom	-10.4%	-11.8%	4.0%
	Eurozone	-6.1%	2.3%	9.0%
	Australia	10.3%	1.4%	59.0%

Source: Itaú Unibanco, FMI, The Economist, BIS

Growth in the Long Term Depends More on Productivity

- ✓ **We expect an average growth of 2.5 %– 3.0% throughout the decade.**
- ✓ **End of the boost given by the equilibrium unemployment rate reduction.**
- ✓ **Economically active population grows at a slower pace.**
- ✓ **If productivity fails to increase, potential GDP is likely to grow less.**

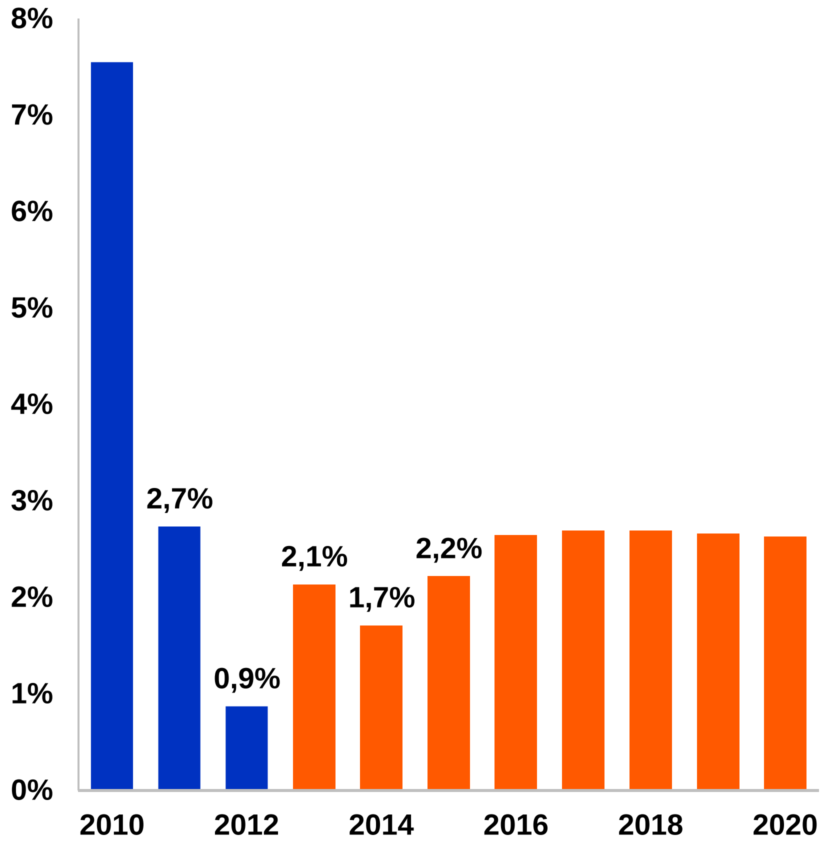
Potential GDP Growth (%)



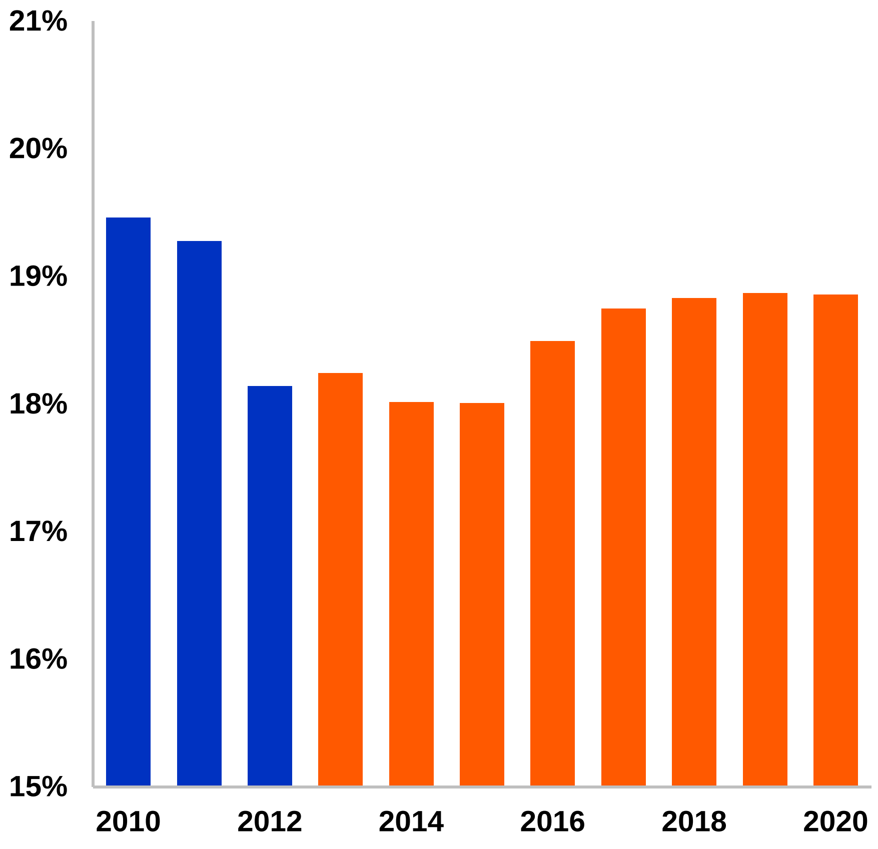
Source: Itaú Unibanco

Brazil Needs to Invest More to Grow Sustainably

GDP Growth



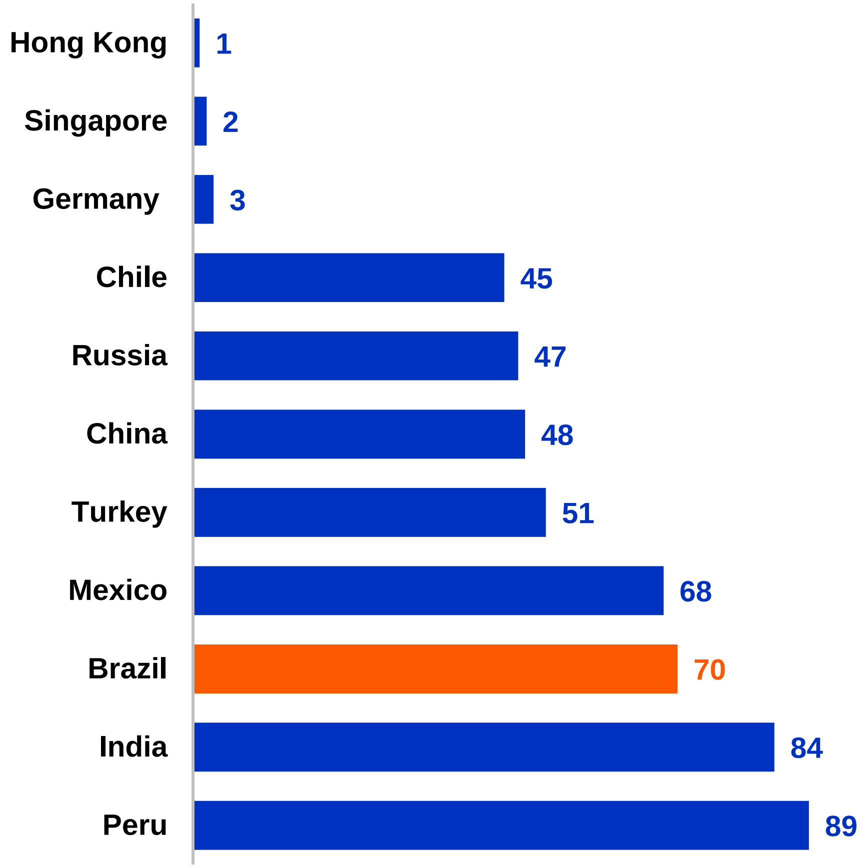
Investment Rate – % GDP



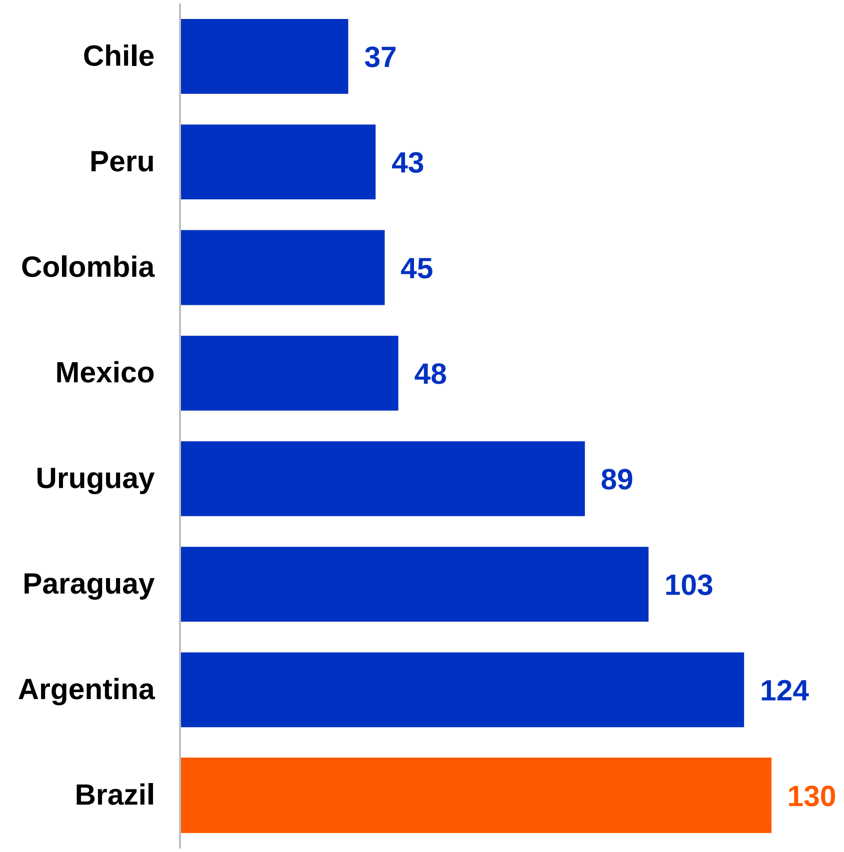
Source: Itaú Unibanco, BCB, IBGE

Challenges in Brazil: Infrastructure and Business Environment

Infrastructure Ranking (2011)
(*World Economic Forum,* 2010-11)



Ranking *Ease of Doing Business* – 2012



Source: Itaú Unibanco, OECD, U.S. Bureau of Labor Statistics, World Economic Forum

International Comparison: PISA Scores in Brazil Are Low

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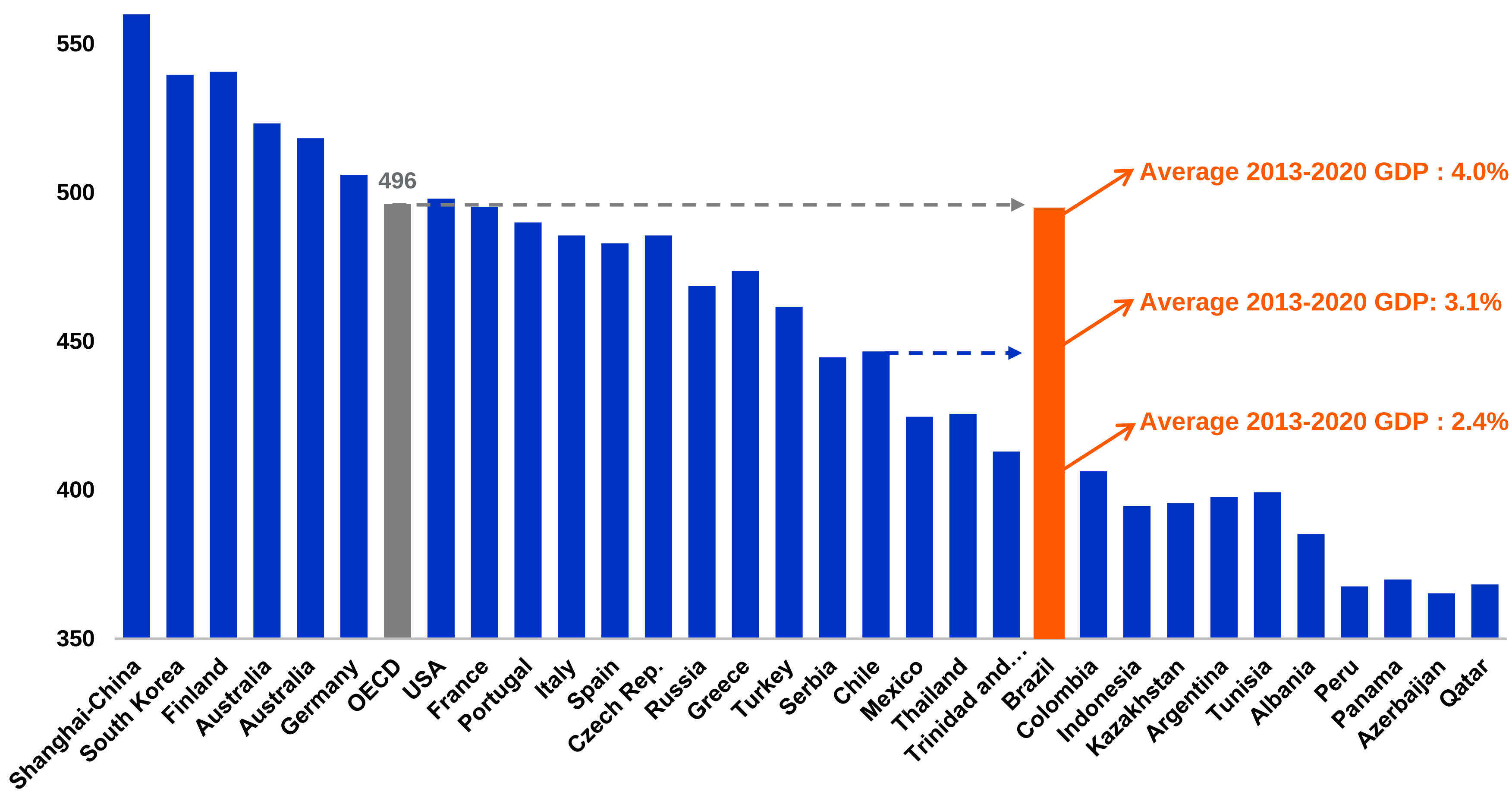
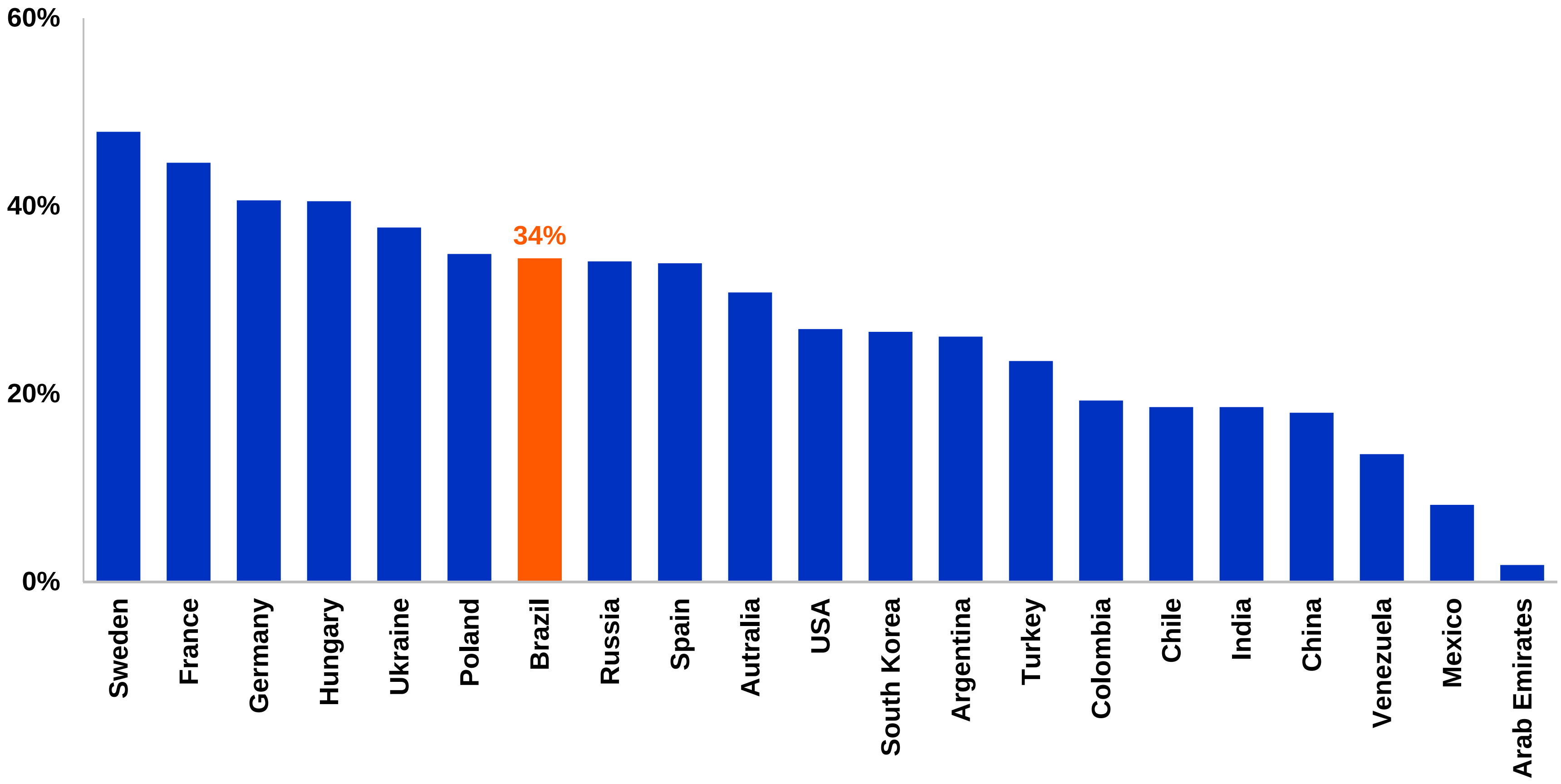
PISA 2009 – Average Test Score (Math, Science, Reading)



Source: CNI, OECD, Itaú Unibanco

Tax Burden Is Relatively High

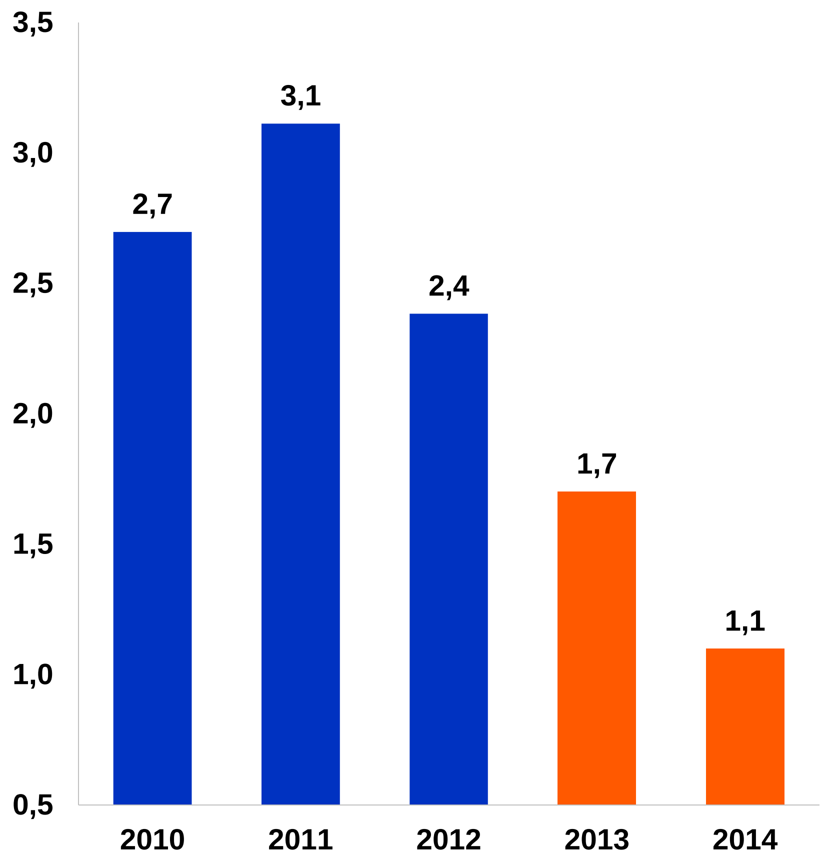
Tax Burden – % of GDP



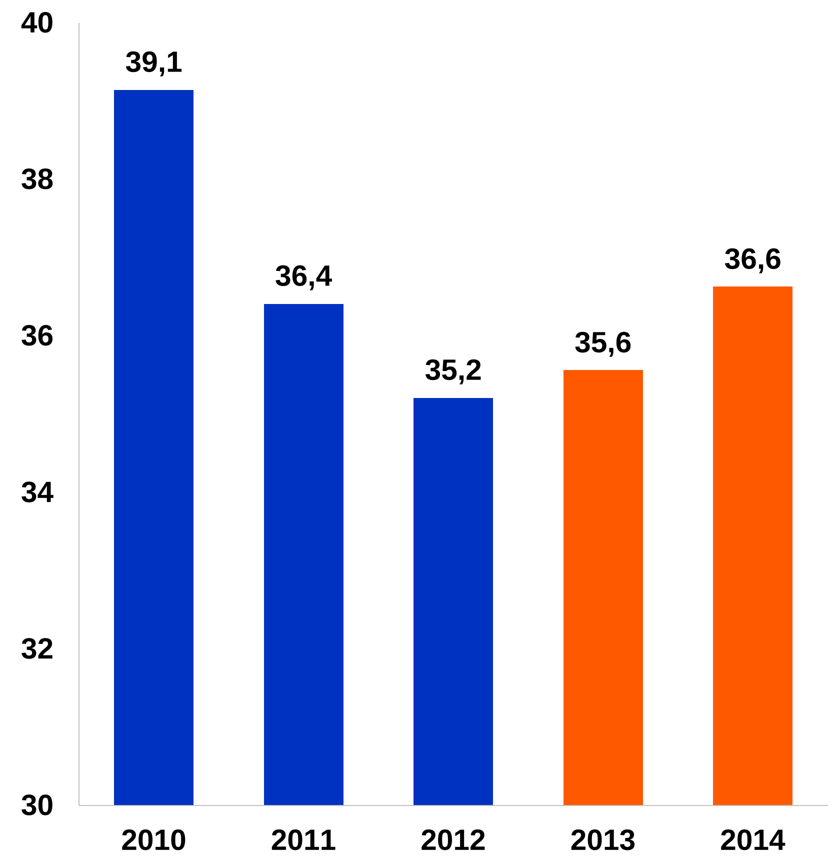
Source: Itaú Unibanco, OECD, U.S. Bureau of Labor Statistics, World Economic Forum

Less Room for Counter-Cyclical Fiscal Policy

Primary Surplus - % GDP



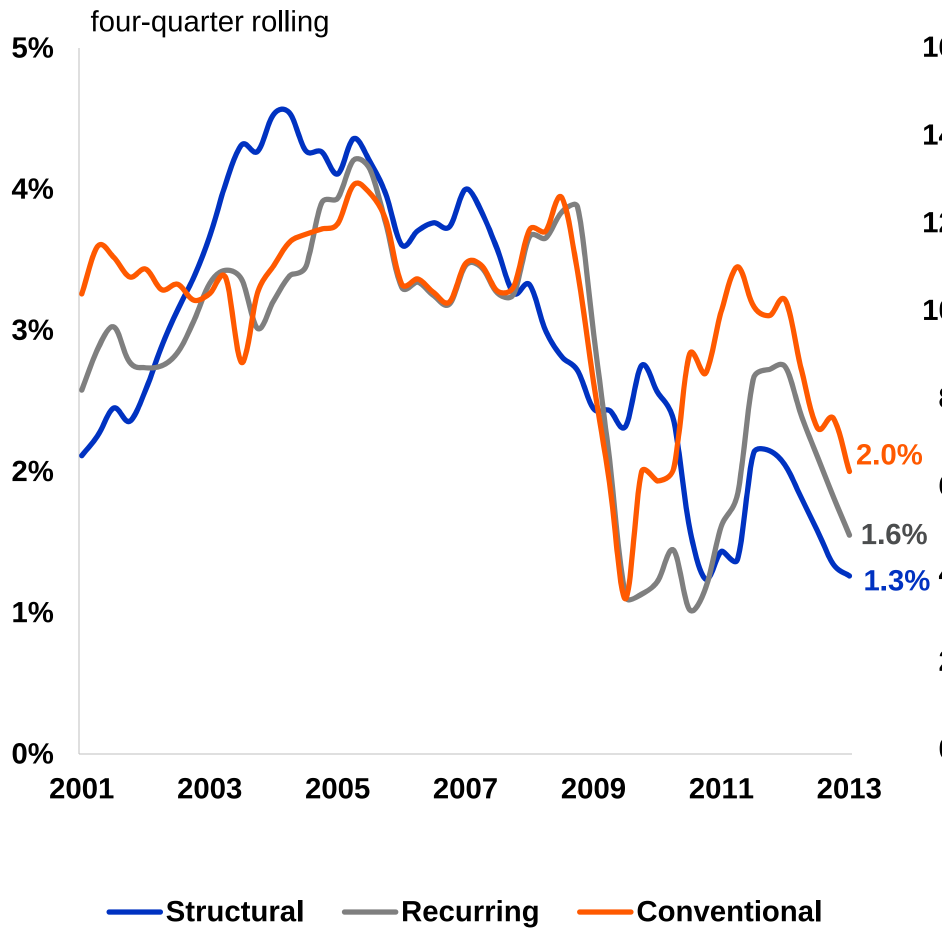
Net Debt - % GDP



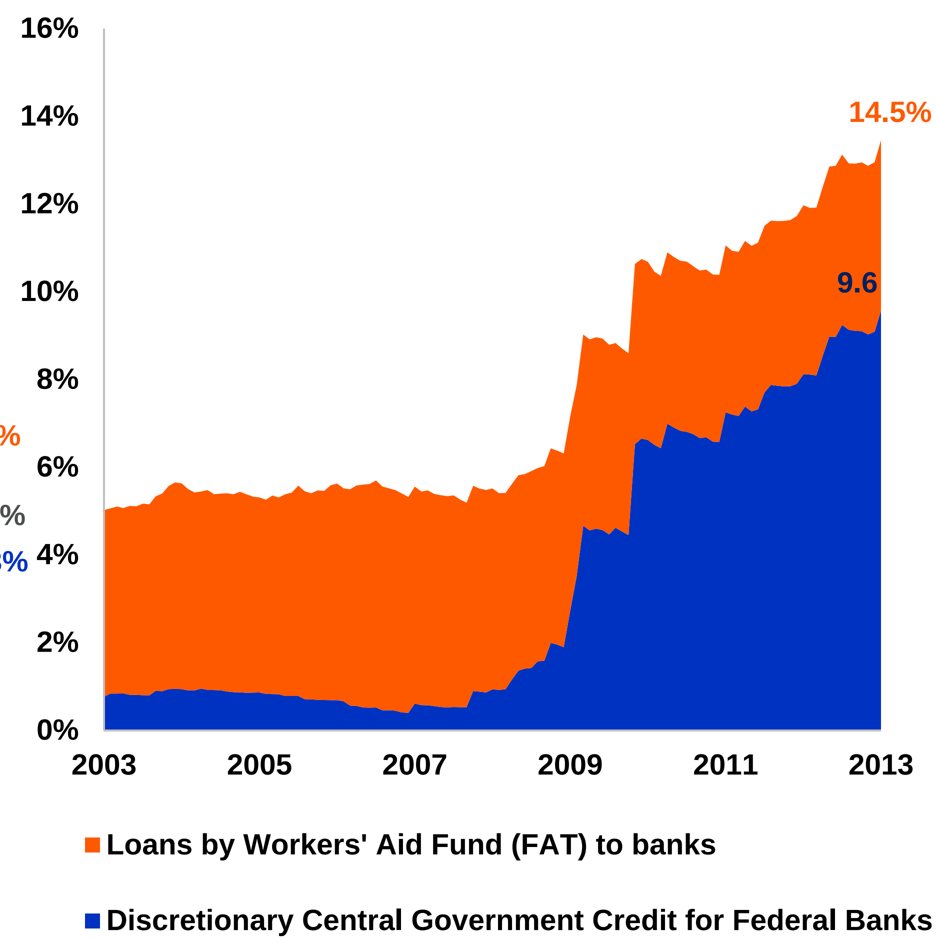
Source: Itaú Unibanco, BCB

Budgetary and Off-Budget Fiscal Stimulus Have Increased

Primary Fiscal Balance Measures (% GDP)



Quasi-Fiscal Stimuli via Govt. Credit (% GDP)

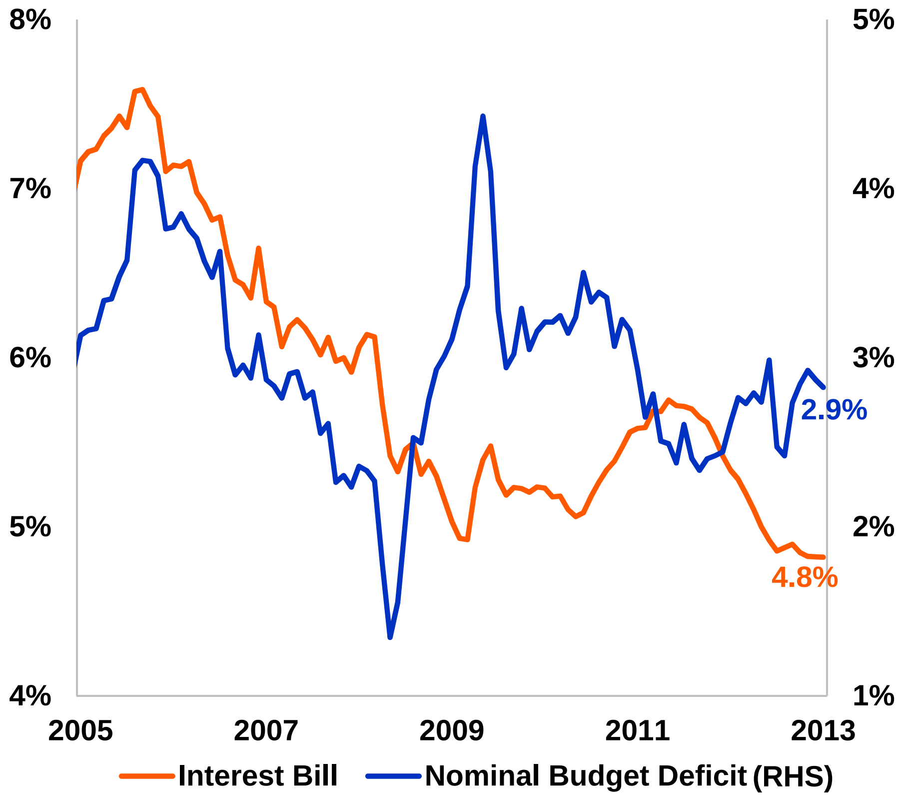


Source: Itaú Unibanco, Brazilian Central Bank

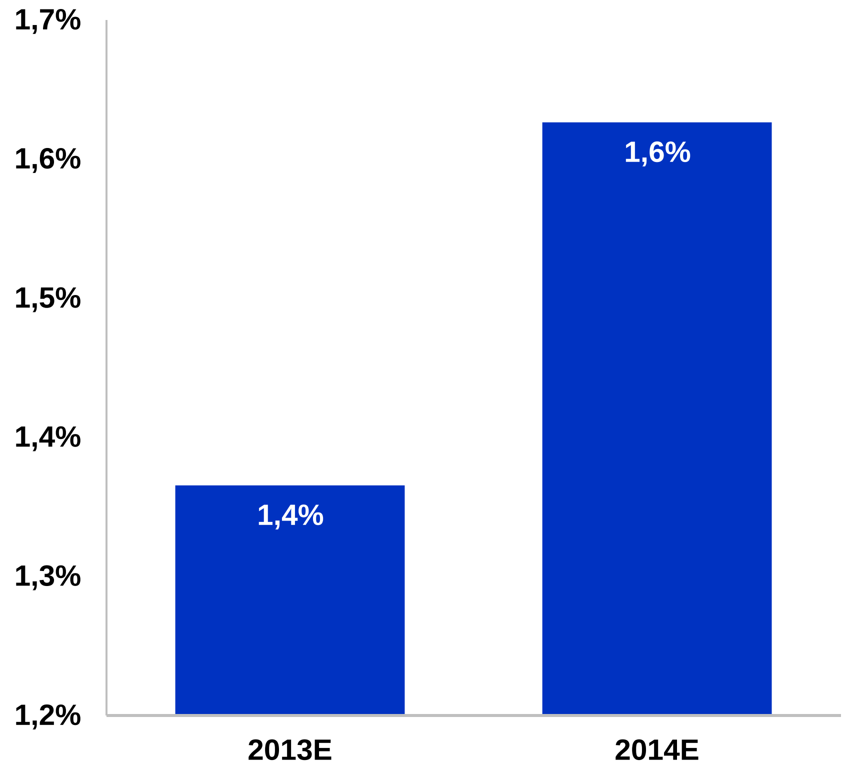
Fiscal: Lower Taxes or Higher Investment

- ✓ **Despite relevant budget rigities in the short run (due to earmarkings), which could only be addressed through reforms, Brazil could have a higher ratio of public investment...**
- ✓ ...but the choice was to use the fiscal leeway created by a lower interest burden (due to a strucutrally Lower Selic) to reduce taxes. If the amount of tax breaks had been used in public capital spending, federal investment could have doubled (from 1.4% of GDP today).

A Lower Interest Rate Burden (% GDP)



Incentives Through Tax Breaks (% GDP)



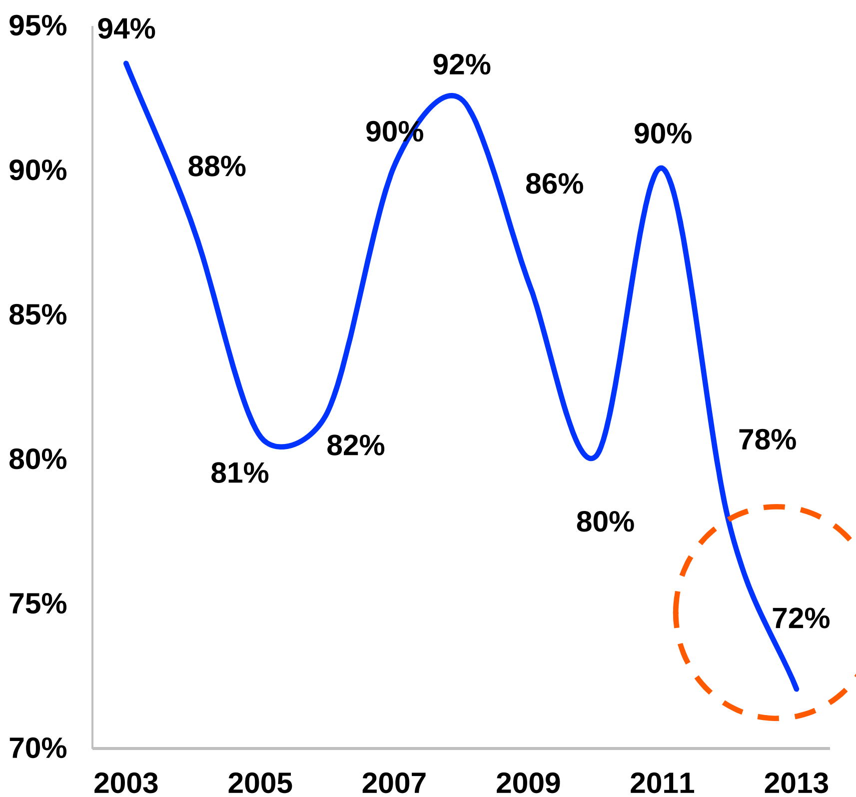
Source: Itaú Unibanco, Brazilian Central Bank, Ministry of Finance

Is There Political Room for Reforms?

- ✓ **Tax and labor reforms would boost GDP growth in the long term.**
- ✓ **However, with falling government support rates, it becomes harder to pass relevant reforms.**

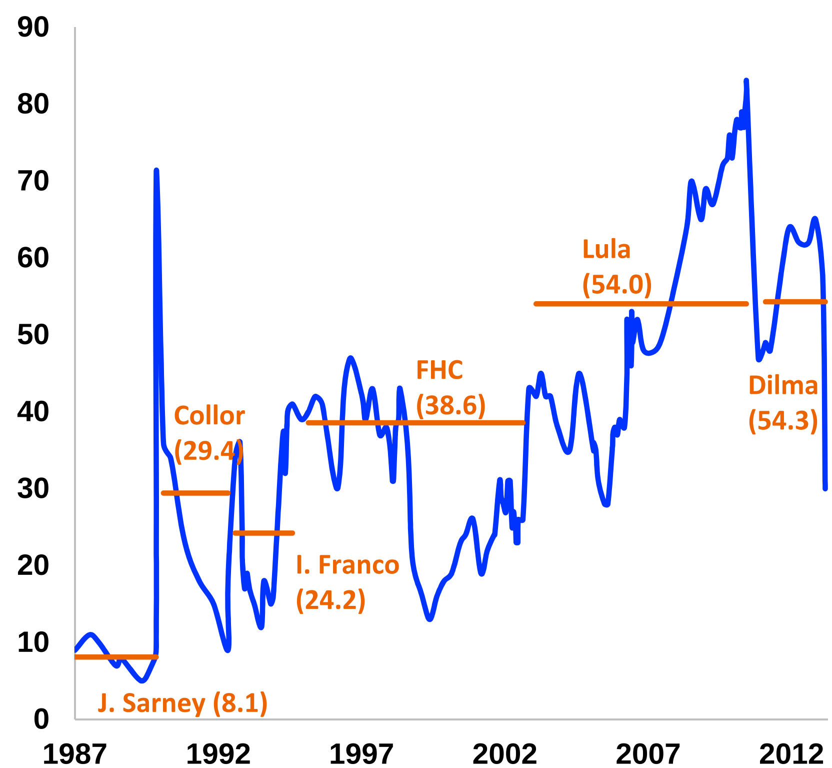
Coaliton Support Rate

Government Leader Support Lower House Votings



Government's Approval Rate

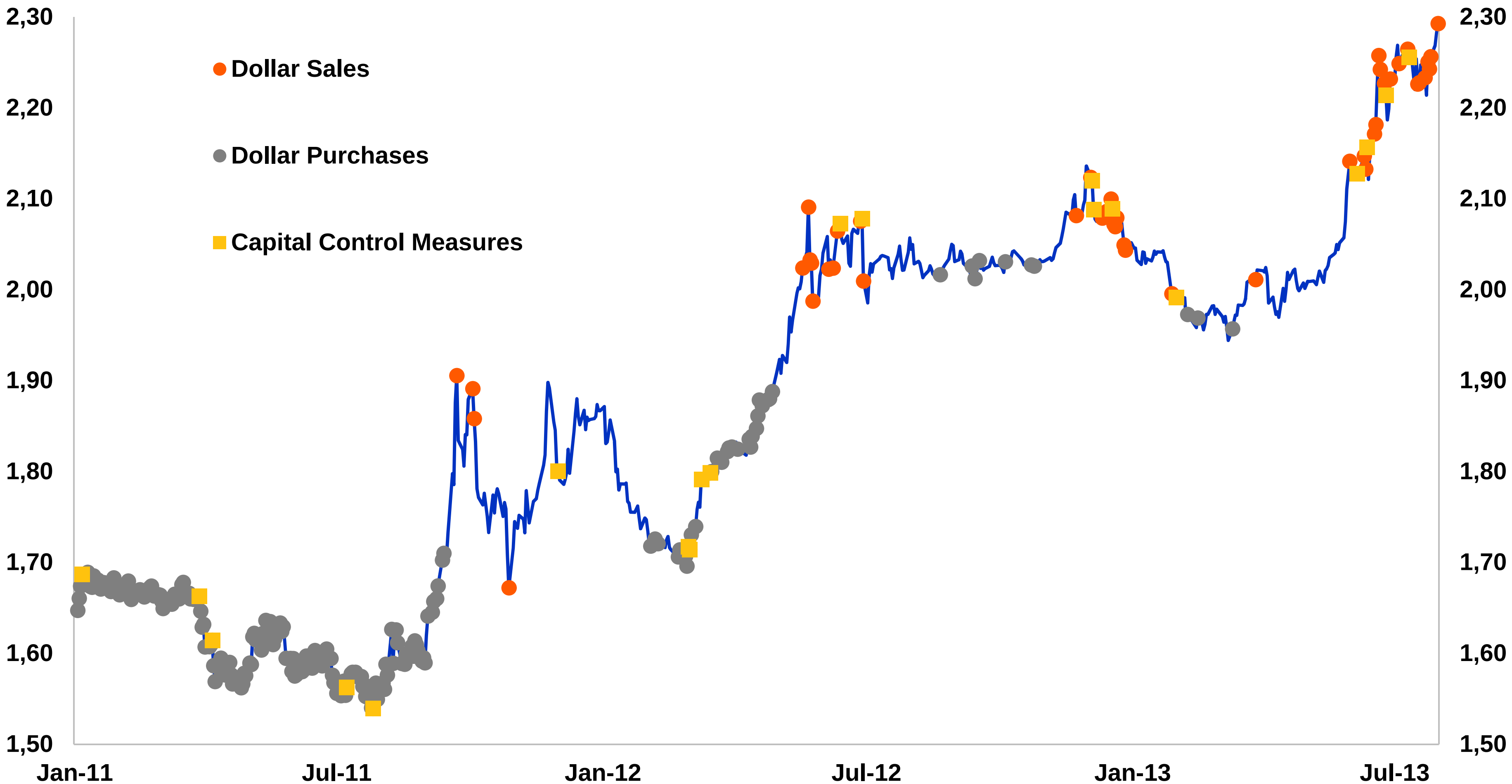
% of good or great



Source: Centro Brasileiro de Análise e Planejamento (Cebrap); Valor PRO, Datafolha

More Exchange-Rate Intervention in Brazil

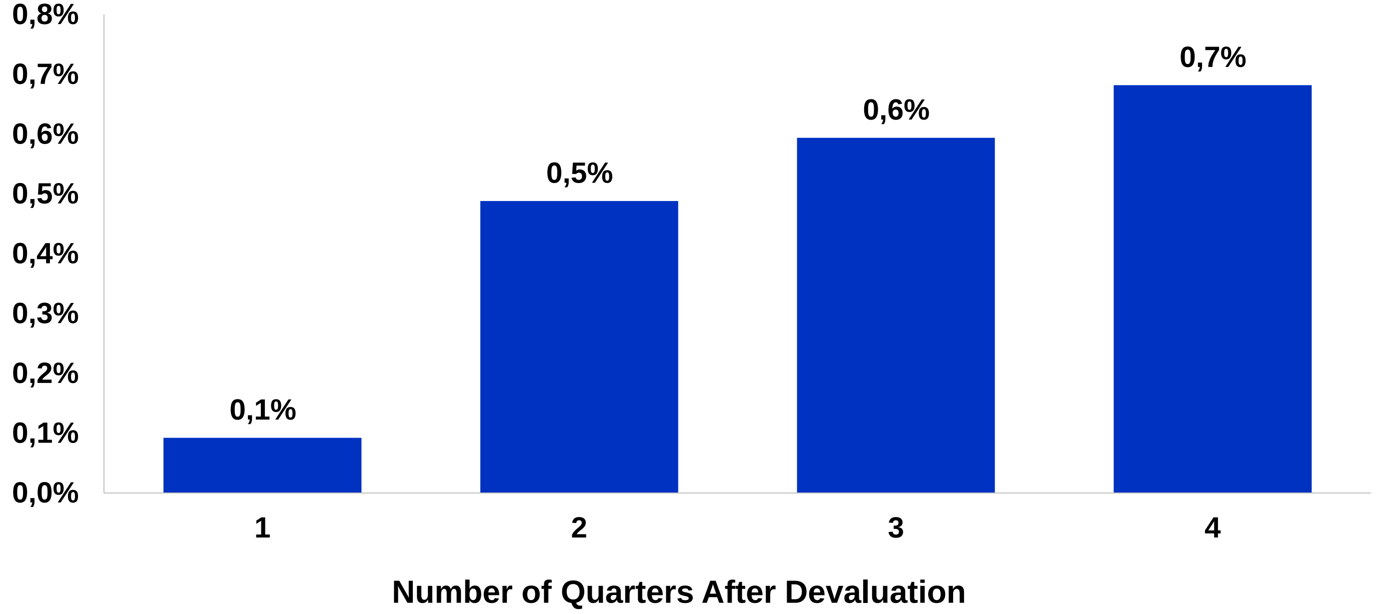
Exchange Rate – Reais per Dollar



Source: Itaú Unibanco, BCB, Bloomberg

The Impact of Exchange-Rate Pass-Through

Exchange Rate Pass-Through – 10% Devaluation of the Brazilian Real



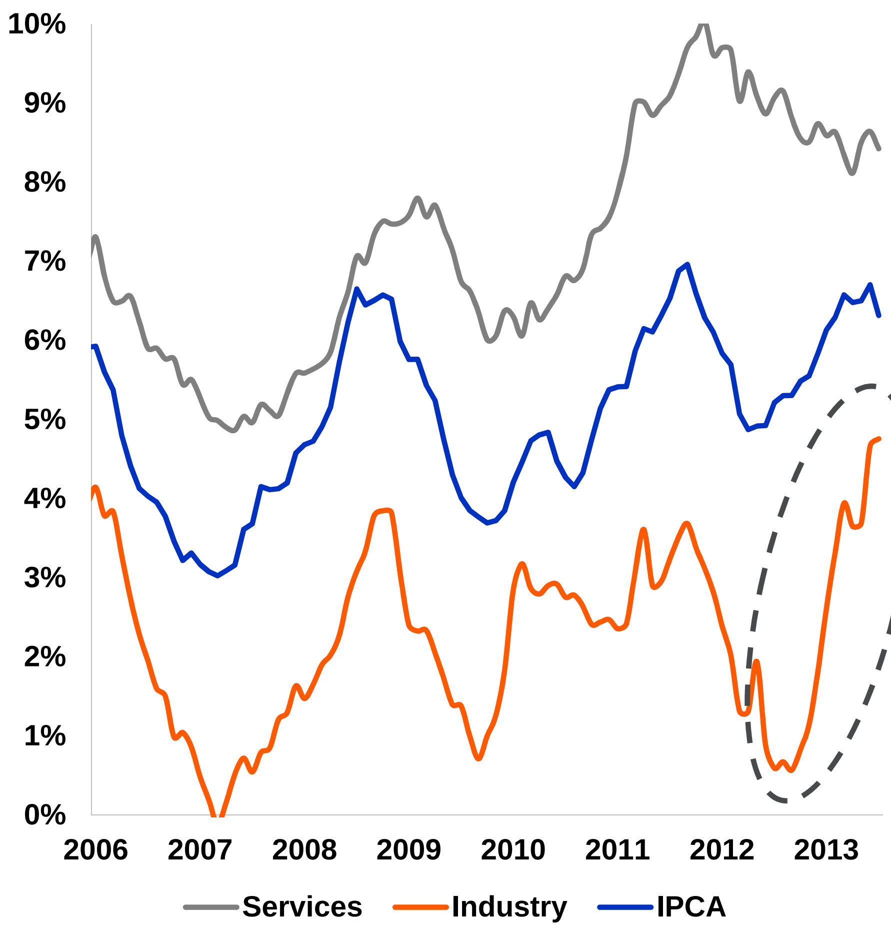
Exchange rate	Base case	10% devaluation	20% devaluation
IPCA 2013	5.9%	6.4%	6.9%
IPCA 2014	5.8%	6.0%	6.2%

Source: Itaú Unibanco

Dual Inflation in Brazil

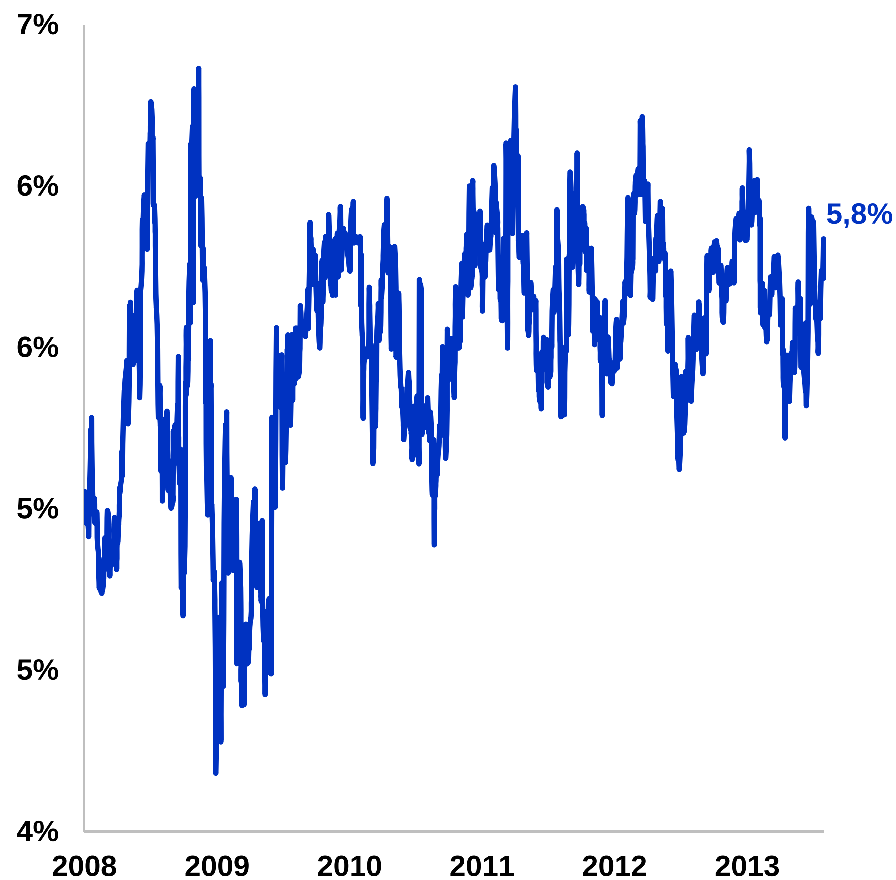
Inflation (IPCA) Breakdown

12-month inflation, seasonally adjusted



Break-Even Inflation, %

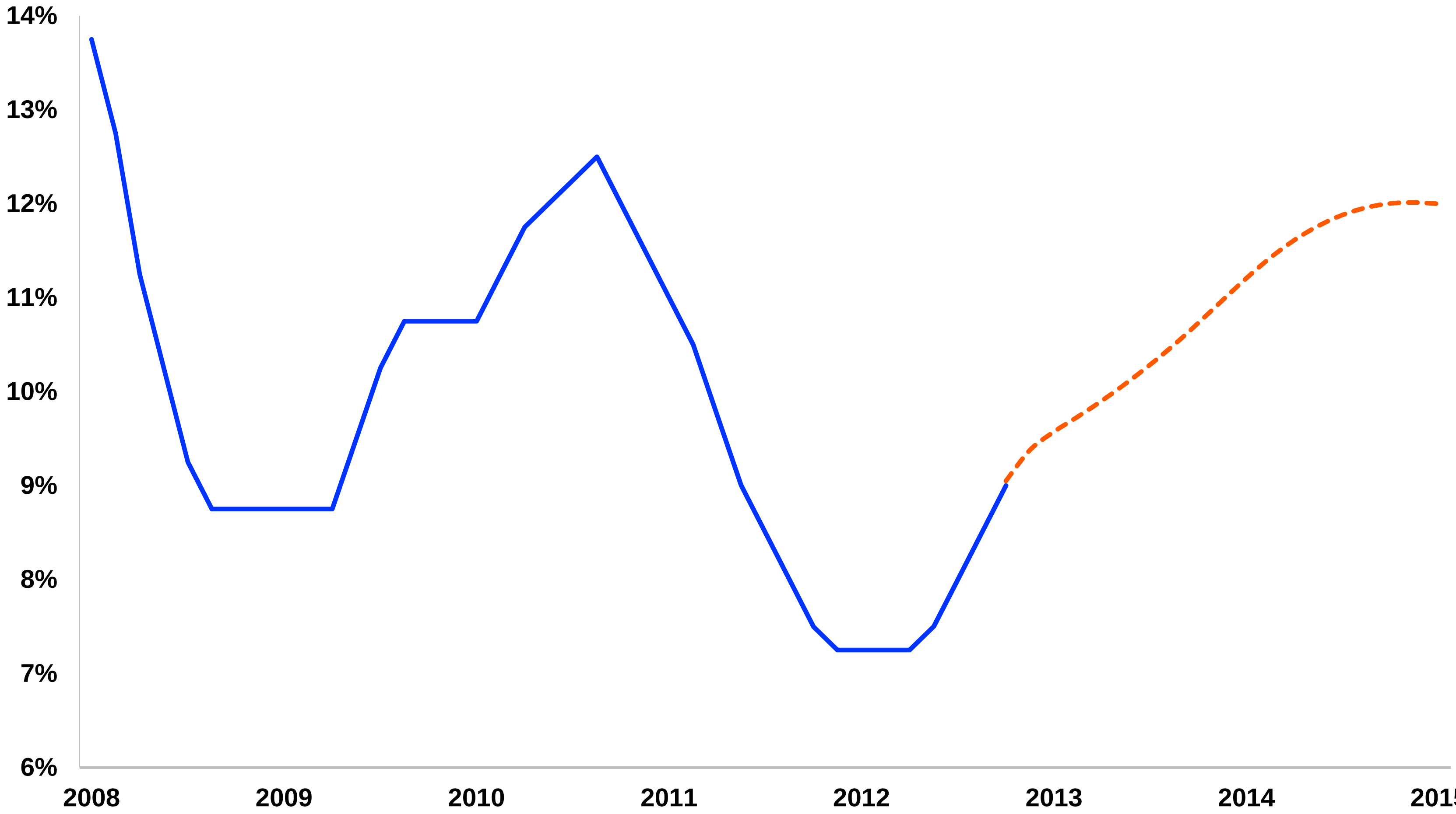
5-year bonds



Source: Bloomberg and Itaú Unibanco

Also Less Room for Counter-Cyclical Monetary Policy

Yield-Curve Pricing of Selic Rate



Source: Itaú Unibanco, Bloomberg

Conclusion

✓ Brazil: What explains the slower growth? Deleveraging in the economy; high costs reducing margins, production and investment.

✓ Despite the low GDP growth, the labor market remains tight due to demographic conditions and growth composition.

✓ There are challenges (more investment, better business conditions, education) which need to be adressed to enable sustainable long term growth.

✓ Fiscal policy: need more investment and efficiency.

✓ The Inca trail: no return for the middle class.

Appendix

Brazil: Our Expectations for the Short Term

	2012	2013	2014
Economic Activity			
GDP %	0.9	2.1	1.7
Inflation			
IPCA %	5.8	5.9	5.8
Monetary Policy			
Selic Rate %	7.25	9.75	9.75
Fiscal			
Primary Surplus	2.4	1.7	1.1
Balance of Payments			
Exchange Rate (eop)	2.08	2.30	2.40
Current Account (% GDP)	-2.4	-3.5	-2.9

Source: Itaú Unibanco and BCB

Long-Term Scenario

	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
World Economy											
World GDP growth	5.2%	4.0%	3.2%	2.8%	3.4%	3.7%	3.6%	3.5%	3.4%	3.4%	3.4%
USA	2.4%	1.8%	2.2%	1.9%	2.5%	2.9%	2.6%	2.2%	2.0%	2.0%	2.0%
Eurozone	2.0%	1.5%	-0.5%	-0.7%	0.7%	1.3%	1.8%	1.7%	1.5%	1.3%	1.1%
Japan	4.7%	-0.6%	1.9%	1.5%	1.3%	0.9%	1.0%	1.0%	1.0%	1.0%	1.0%
China	10.4%	9.3%	7.8%	7.5%	7.2%	7.0%	7.0%	7.0%	6.9%	6.6%	6.4%
CPI US	1.4%	3.0%	1.8%	1.5%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%
Brazil											
Balance of Payments											
BRL / USD nominal – eop	1.69	1.84	2.08	2.30	2.40	2.40	2.45	2.45	2.42	2.39	2.38
BRL / USD – year avg	1.76	1.68	1.95	2.16	2.35	2.40	2.43	2.45	2.43	2.41	2.38
Trade Balance – USD Bil.	20	30	19	(0)	10	10	21	30	40	52	64
Exports – USD Bil.	202	256	243	240	244	265	290	322	358	405	454
Imports – USD Bil.	182	226	223	240	234	255	269	292	318	352	390
Current Account – % GDP	-2.2%	-2.1%	-2.4%	-3.5%	-3.0%	-2.4%	-2.5%	-2.5%	-2.4%	-2.2%	-2.0%
Economic Activity											
Nominal GDP – BRL Bil.	3,770	4,143	4,403	4,781	5,120	5,531	6,022	6,553	7,129	7,751	8,423
Nominal GDP – USD Bil.	2,142	2,473	2,252	2,215	2,175	2,304	2,480	2,676	2,929	3,222	3,535
Real GDP Growth	7.5%	2.7%	0.9%	2.1%	1.7%	2.2%	2.6%	2.7%	2.6%	2.6%	2.5%
Inflation											
IPCA	5.9%	6.5%	5.8%	5.9%	5.8%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
INPC	6.5%	6.1%	6.2%	5.8%	6.0%	6.2%	6.0%	6.0%	6.0%	6.0%	6.0%
IGP-M	11.3%	5.1%	7.8%	4.7%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
IPA-M	13.9%	4.3%	8.6%	3.8%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Interest Rate											
Selic – eop	10.75%	11.00%	7.25%	9.75%	9.75%	9.75%	9.75%	9.75%	9.75%	9.00%	9.00%
Selic – year avg	10.00%	11.71%	8.45%	8.39%	9.75%	9.75%	9.75%	9.75%	9.75%	9.25%	9.00%
Real interest rate - eop	4.57%	4.22%	2.47%	2.34%	3.70%	3.54%	3.54%	3.54%	3.54%	3.07%	2.83%
CDI - % Acum.	9.75%	11.61%	8.51%	8.20%	9.70%	9.58%	9.62%	9.54%	9.58%	9.22%	8.87%
TJLP - % Dec	6.00%	6.00%	5.50%	5.00%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
Public Finance											
Primary Balance - % GDP	1.9%	3.1%	2.4%	1.8%	1.1%	1.5%	1.5%	1.4%	1.4%	1.4%	1.4%
Nominal Balance – % GDP	-3.3%	-2.6%	-2.5%	-3.6%	-3.9%	-3.6%	-2.9%	-3.1%	-3.3%	-3.1%	-3.1%
Net Public Debt – % GDP	39.2%	36.4%	35.2%	35.0%	35.9%	36.9%	36.4%	36.6%	37.1%	37.5%	37.7%

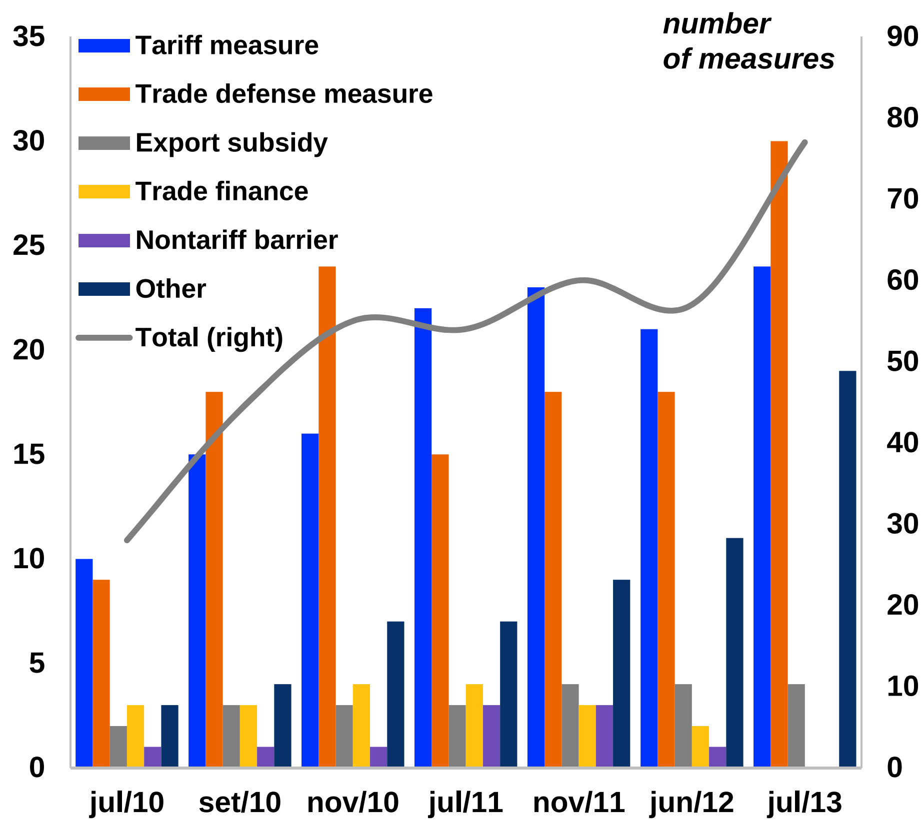
Source: Itaú Unibanco

More Trade Defense Measures Have Been Implemented

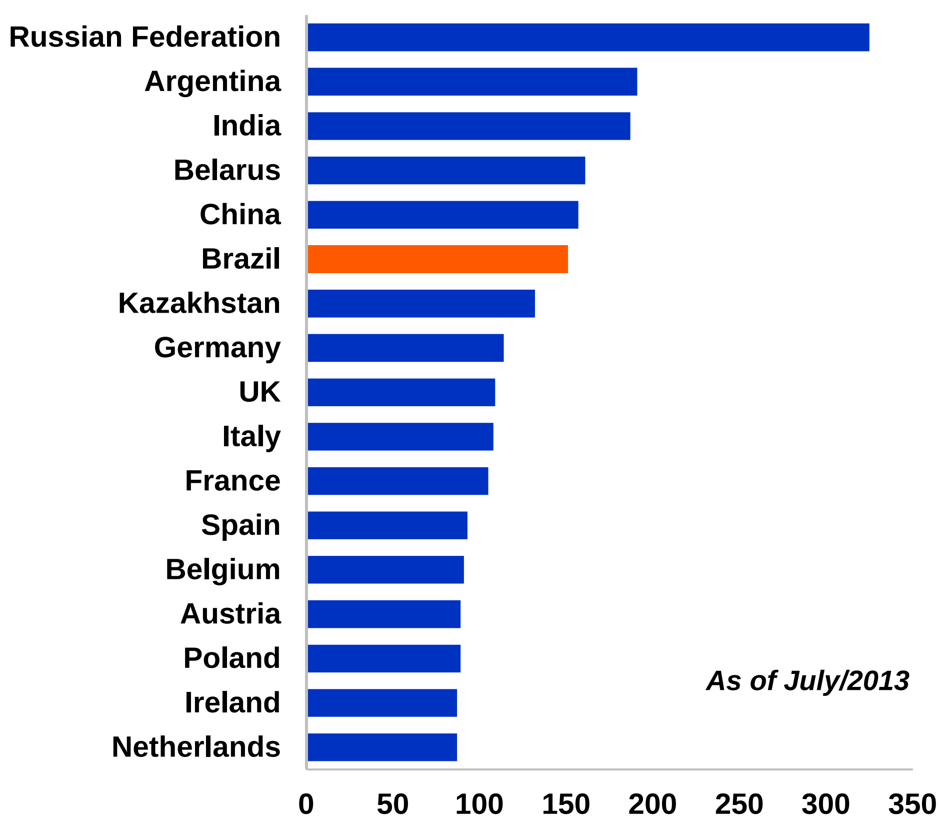
✓ **Since the Financial Crisis, Brazil has been increasing the number of trade protection measures.**

- In September 2012, 100 products, mostly manufacturing inputs, had their import tariff increased. Recently, with the currency weakening, they have been removed.
- Last month, a new anti-dumping legislation came in force, to quicken this kind of measure.

Trade Protection Measures



Implemented Trade Protection Measures



Source: Itaú Unibanco, Global Trade Alert