CNI Newsletter
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ECONOMIC REPORT

CNI
National Confederation of Industry
Brazil
CNI. THE STRENGTH OF THE BRAZILIAN INDUSTRY

Growth requires effort beyond fiscal consolidation

Adjustments must also include competitiveness-enhancing measures

Data for 2014 provide a clear picture of the extent of Brazil's macroeconomic imbalance. Public accounts deteriorated much more significantly than anticipated, inflation remained artificially at the upper limit of the target range due to the freezing of public rates, and foreign accounts posted a large deficit. On the production side, GDP growth was null and industry experienced a fall.

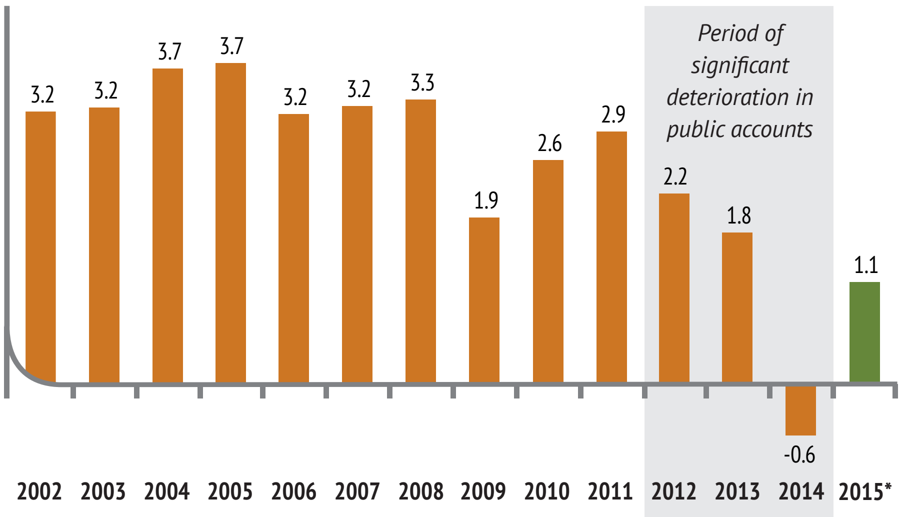
The first quarter of 2015 was marked by a strong decline in industrial confidence, with the Business Confidence Index (Índice de confiança do empresário industrial, ICEI) falling to an all-time low of 37.5 points. Regaining confidence is crucial to recover investment, so we will hardly see an economic rebound later this year.

(continues)

Primary balance target likely to be achieved in 2015

Primary balance of the consolidated public sector

As a share of GDP (%)



Source: Central Bank of Brazil and IBGE – Prepared by CNI
* The figure for 2015 is projected by CNI based on a primary balance of R$ 66.3 billion.

Brazilian economy in the first quarter 2015

Albeit necessary, the economic adjustment measures that are being implemented will immediately aggravate the situation – with public spending cuts, higher taxes, monetary tightening, and the so-called tariff realism. The delay in implementing these adjustments made them even more expensive.

Investment and industrial production are the main contributors to the decline in GDP in 2015

In 2015, GDP will likely drop by 1.2%, with industry falling by 3.4% and investment shrinking by 6.2%. Inflation will remain above 8% throughout the year, the average unemployment rate is expected to rise to 6.7%, and household consumption is estimated to experience a decline (0.6%) for the first time since 2003.

Non-economic factors aggravate the situation and pose risks to short-term economic recovery. On the one hand, issues related to the corruption scandals affecting Petrobras and other major companies have adverse effects on investment; on the other, a weaker government coalition in Congress hinders the adoption of structural measures required to create a better economic environment.

Consolidating a new fiscal framework by achieving primary surpluses and keeping the public debt-to-GDP ratio under control is a prerequisite to restore macroeconomic balance and reverse the current outlook for the Brazilian economy.

The expected achievement of the primary surplus target in 2015 through adjustments based on spending cuts (as shown in the Fiscal Policy section) clearly indicates a change in the previous trend. However, overcoming the recessionary cycle requires implementing a broader agenda designed to enhance competitiveness and investment attractiveness.

A positive aspect is the change in the exchange rate level, which should provide better conditions for Brazilian manufactured goods, particularly abroad. However, two remarks must be made. First, the volatility that has characterized the foreign exchange market hinders the consolidation of a stable level that would allow for companies to make more lasting decisions about their export strategy. Second, foreign trade deadlines are longer due to contracts and customer relations, meaning that the effects of the exchange rate change will not be immediately apparent.

ECONOMIC ACTIVITY

Brazilian economy to fall by 1.2% in 2015

Negative results, previously restricted to industry, are now affecting services and consumption

The bleak outlook for economic activity seen late last year became even gloomier at the end of the first quarter of 2015. The fiscal and monetary adjustments required to restore the country's macroeconomic stability have not been accompanied by competitiveness-enhancing measures, thereby further deteriorating activity and possibly hindering economic recovery. As a result, we are now expecting GDP to decline by 1.2% in 2015.

On the supply side, industry is the main responsible for the negative performance of economic activity. Recent industrial production results suggest that the difficulties seen last year will be even more pronounced. In January and February 2015 alone, industrial production edged down by 7.1% as compared to 2014 (Monthly Industrial Survey - Physical Production - PIM-PF/IBGE).

The scenario is even worse when we restrict the analysis to manufacturing industry. Production in this segment is also down by 9.3% in the first two months of the year, with emphasis on capital goods, which experienced a 13.5% drop. Furthermore, the widespread negative results across the sectors deserve special mention: only one out of the twenty-five sectors considered in the survey recorded growth in production by February (PIM-PF / IBGE).

The drop in production is accompanied by a fall in real sales in industry in the first two months of 2015: down by 8.8% from the corresponding period last year (Industrial Indicators/CNI).

The slowdown in industrial activity is also reflected in the indicators of inventory and capacity utilization. The indicator of actual-planned inventories for large companies went up to 55.3 points in February, drifting away from the 50-point dividing line and indicating an increase in unwanted inventories in industry (Industrial Survey – Manufacturing and mining/CNI).

Companies have reduced the use of their production facilities in response to rising inventories and slowing demand. In February, average capacity utilization in manufacturing stood at 79.7%, the lowest level since early 2009 (Industrial Indicators/CNI).

Issues such as unwanted inventories, idle manufacturing facilities, reduced sales and weak demand expectations have led to recurrent job losses in industry. Comparing the first two months of 2015 with the same period a year earlier, one can see a 3.4% reduction in employment levels in manufacturing (Industrial Indicators/CNI). This trend will likely continue throughout 2015.

Based on this information, the current situation of manufacturing industry can be briefly defined as follows: lower production, accumulated inventories, idleness, reduced sales and layoffs.

The reality in the construction industry is quite the same. According to data from CNI's Construction Industry Survey, companies in this segment have experienced successive declines in activity levels, reductions in new developments and services, low operation capacity utilization levels and lower number of employees.

Another industrial segment that is expected to face difficulties in 2015 is the sector of Public Utility Industrial Services (*Serviços Industriais de Utilidade Pública, SIUP*), which includes, among other activities, electricity production and distribution and water collection, treatment and distribution services. As a result of current water and energy deficits, we believe that SIUP will decline in 2015, just as it did last year.

In contrast, the mining and quarrying industry is estimated to report a positive performance this year, even though its expected growth rate will be lower than that registered in 2014. This continued growth stems mainly from an increase in oil production.

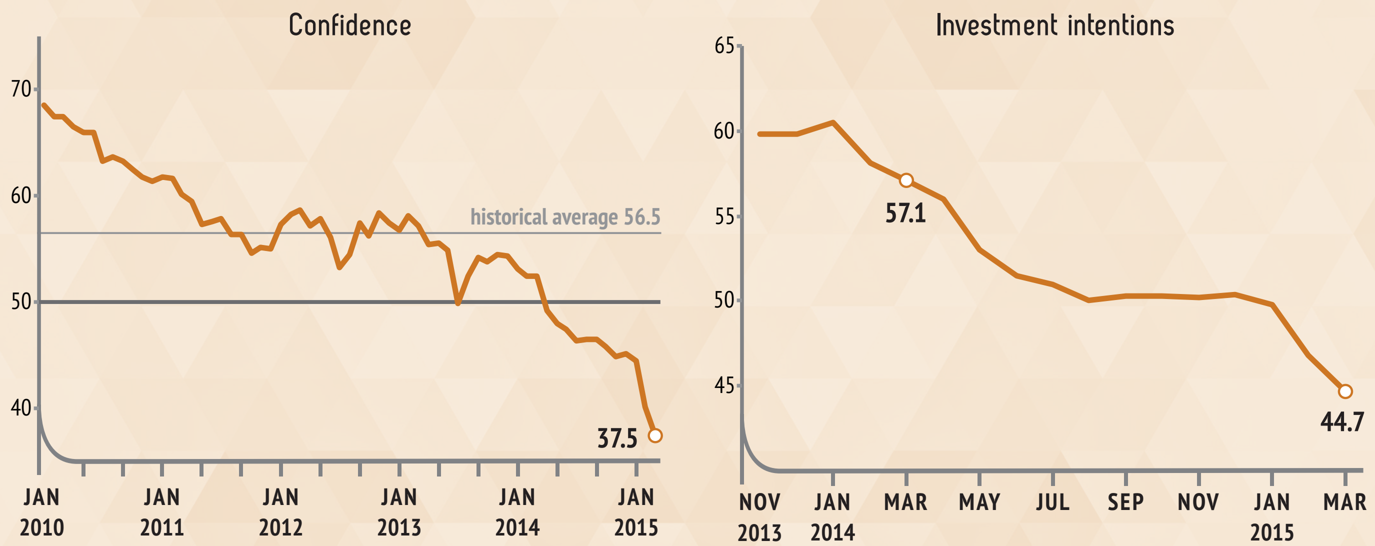
Considering the above-mentioned results, the Business Confidence Index (ICEI/CNI) edged down in the first three months of 2015 and stood at 37.5 points in March, an all-time low in its historical series initiated in 1999. This result indicates that lack of confidence remains a widespread issue across industry and has become even more intense.

With no prospects of a short-term reversal in this adverse scenario, industrial entrepreneurs have been reluctant to invest. The Investment Intentions Index (released by CNI this year) experienced a 12.4-point drop between March 2015 and March 2014.

Confidence must be restored if industry is to invest and grow again

Business Confidence Index (ICEI) and Investment Intentions Index

In points



Source: CNI
Both indices refer to total industry (manufacturing, mining and quarrying, and construction).
The ICEI ranges from 0 to 100 points. Figures above 50 points indicate that entrepreneurs are confident.
The Investment Intentions Index ranges from 0 to 100 points. The higher the index, the more likely industry is to invest.

Considering the overall picture of the segments analyzed so far, we expect industrial GDP to fall by 3.4% in 2015, marking the second consecutive annual decline. This drop will likely be driven by manufacturing (down by 4.4%), construction (5.5% drop) and SIUP (fall of 2.8%). Mining and quarrying, on the other hand, is projected to grow at a rate of 2.3% in 2015.

The decline in industry, coupled with reduced household purchasing power, is expected to lead to a 0.4% drop in the service sector this year. The last drop in this sector, which had been recently driving economic growth, was over 20 years ago.

The first signs of decline in the service sector have already been seen in the retail trade results for January, as the sales volumes recorded this month was 4.9% lower than those observed in January 2014 according to the Monthly Trade Sector Survey (*Pesquisa Mensal do Comércio/IBGE*). Vehicle registration data released by Anfavea support this scenario, with the number of registered vehicles down by 15.3% in the first quarter of this year on a year-over-year basis.

GDP estimate for 2015

Percentage change in GDP components

	GDP COMPONENTS	Growth rate (%)
Demand	Household consumption	-0.6
	Government consumption	0.9
	GFCF	-6.2
	Exports	-1.2
	(-) Imports	-3.2
Supply	Agriculture	0.5
	Industry	-3.4
	Mining and quarrying	2.3
	Manufacturing industry	-4.4
	Construction industry	-5.5
	SIUP*	-2.8
	Services	-0.4
	GDP	**-1.2**

* Public Utility Industrial Services (Serviços Industriais de Utilidade Pública, SIUP)

Household consumption and investment will likely fall in 2015. We expect to see a 0.6% drop for the former and a 6.2% decline for the latter

Agriculture/livestock will probably be the only productive sector to experience growth in 2015, albeit only moderately. We forecast a growth rate of 0.5%, up slightly from the figure recorded in 2014 (0.4%).

On the demand side, household consumption, which had been slowing down considerably in recent years, is estimated to fall in 2015. CNI expects to see a 0.6% drop in this component. If confirmed, this will be the worst result since 2003.

The downward trend can be explained by a restrictive monetary policy, less favorable labor market conditions, higher household debt-to-income ratios, stubbornly high inflation rates, difficulties to access credit and the current fiscal tightening.

Investment (Gross Fixed Capital Formation - GFCF), a key component to accelerating sustainable growth, will likely edge down once again in 2015. The estimated decline of 6.2% will be driven mainly by a decline in manufacturing industry, a major consumer of machinery and equipment, and by a shrinking in the construction industry, which accounts for over half of gross fixed capital formation in Brazil. As a result, investment rates (GFCF as a share of GDP) would fall from 19.7% in 2014 to 18.7% in 2015.

The most significant factors behind this decline in investment include industrial idleness, higher brazilian interest rate – reducing demand expectations and increasing opportunity costs of capital –, developments in the Petrobras exposure and an uncertain environment.

Given the current fiscal environment in Brazil, CNI expects government consumption to grow at a lower rate in 2015 (0.9%).

Despite the significant depreciation in the Brazilian currency in the first quarter of the year, exports are expected to decrease by 1.2% in 2015. The more favorable exchange rate has not yet been translated into higher export profitability, as prices (in dollars) of tradable goods have trended downward. This downtrend in prices, coupled with a still unstable foreign consumer market, has limited advances in Brazilian exports, particularly of manufactured goods.

Imports are also estimated to drop in 2015. As a result of an increased exchange rate, a sharp slowdown in household consumption and the decline in manufacturing, we estimate that imports will experience a 3.2% drop this year.

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Employment and income affected by weak economic activity

Average unemployment rate to grow to 6.7% in 2015 as layoffs increase

The economy's unemployment rate, which had been at record low levels until late 2014, has shown the first signs of a reversal in this trend early in the year. In January, the indicator amounted to 5.3% of the labor force. In February, the latest data available, the indicator edged up to 5.9%, representing a 0.8-percentage point increase over the same period last year (PME/IBGE).

The increase in the unemployment rate in the first two months of 2015 was driven mainly by job losses, with industry being hardest hit. According to data from the General Register of Employed and Unemployed Persons of the Ministry of Labor and Employment (CAGED/MTE), the industrial sector lost 470,000 jobs in the 12 months ending in February.

In the Brazilian manufacturing sector alone, 231,600 jobs were destroyed in the last twelve-month period. The construction industry has also accumulated a significant decline: 240,000 jobs lost in the 12 months to February.

The net job creation rate in the other economic sectors has slowed down in 2015. The domestic trade and service sectors recorded drop of 68.7% and 49.8%, respectively, as compared to the number of jobs created in the 12 months ending in February 2014.

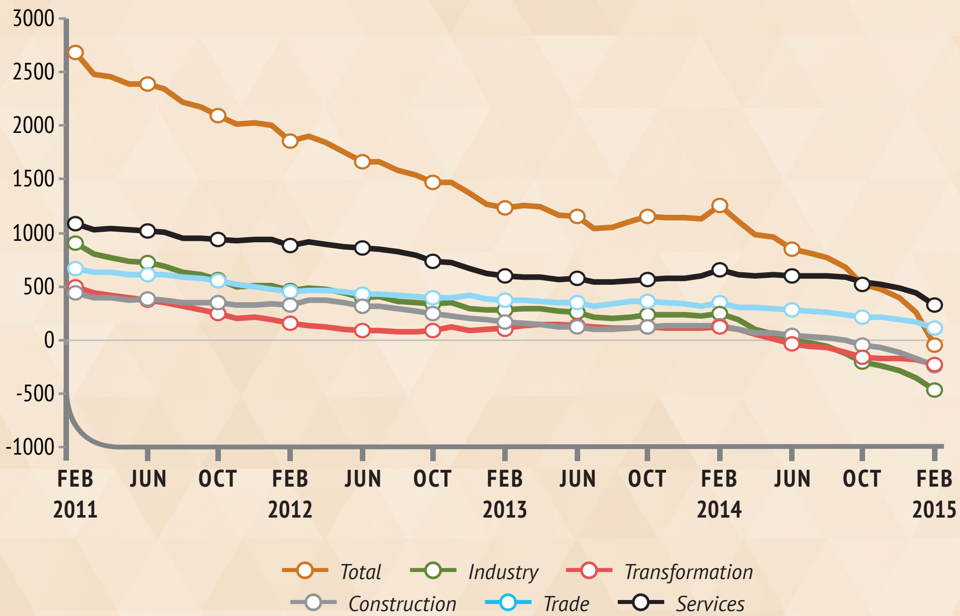
Labor force is another relevant fact in 2015 because, as opposed to last year, it is no longer offsetting the effect of job losses on the unemployment rate. In January this year, the labor force increased by 0.1% from the same month the year before and fell by 0.1% in February (-0.1%) on the same comparison basis.

The labor force is expected to keep trending upward in 2015, particularly on account of a contraction in economic activity and its impact on real average household income. The economic downturn and the new rules for receiving unemployment insurance benefits will increase the labor supply of unemployed persons so as to re-

Employment falls across all economic sectors

Net creation of formal jobs

In thousands (in 12 months)



Source: CAGED/MTE

store average household income. Furthermore, restrictions placed on the Student Financing Program (Fundo de Financiamento ao Estudante de Ensino Superior, FIES) should have an impact on the labor supply of people in the 15-24 age group.

Considering this expected increase in the labor force and the slowdown in economic activity, we estimate that the average unemployment rate for 2015 will return to 2010 levels, when it stood at 6.7%.

The share of formal jobs – which is the sum of all formal, military and statutory jobs divided by total employment – has stopped growing. The indicator, which had been above 63% of the labor force since September 2013, fell to 62.4% in January 2015 (PME/IBGE).

In February, the formalization index increased slightly to 63.1%. This increase, however, was driven exclusively by an increase in military and statutory jobs, as the other formal employment categories are down once again.

The number of formal jobs in the private sector shrank in the first two months of the year. In January, the figure dropped by 1.9% as compared to the same period in 2014, representing 224,200 jobs lost in this twelve-month period. In February, the figure fell by 1%, corresponding to 115,100 formal job losses on the same comparison basis.

Informal jobs have also declined, but to a lesser extent. A total of 43,500 informal jobs were lost in February over the same month of 2014, down by 2.2% in 12 months. Compared to January, the figure fell by 1.4%, meaning that 28,000 jobs were lost.

Real average earnings usually received by metropolitan workers (PME/IBGE), which had not declined since October 2011, fell last February (by 0.5% on a year-on-year basis). This was the worst result since May 2005, when the indicator edged down by 0.7%.

Average earnings are expected to grow only moderately in 2015. The decline in formal employment has a negative bearing on the indicator, as formal workers usually receive higher wages than informal workers.

Furthermore, the reduction in employment levels is expected to push up labor supply, thus exerting further pressure on workers' average earnings.

In this scenario, CNI estimates a 0.5% increase in real average earnings, significantly down from last year's figure of 2.7%.

The reduction in the labor force and the lower growth rate of average earnings caused total payroll to drop by 1.4% in February over the same period in 2014. Compared to January, total payroll is down by 2.4%.

Considering that the labor market will likely continue to deteriorate, CNI predicts that real total payroll will post near-zero growth in 2015. This result is significantly lower than the 2.6% growth rate recorded in 2014.

PNAD Contínua survey confirms trend of rising unemployment and reduced income in 2015

In the three-month period ending in February 2015, the unemployment rate as measured by the PNAD Contínua (PNAD-C) survey – which, unlike the Monthly Employment Survey, covers the entire national territory – was estimated at 7.4% of the labor force, up by 0.7 percentage points from the same period the year before.

With respect to real average earnings usually received by workers, the results of the PNAD-C survey are also in line with those found by the Monthly Employment Survey, pointing to a downward trend in this indicator.

Real average earnings stood at R$ 1,816.99 in the three months to February 2015, representing an increase of only 1.1% over the same period last year (R$ 1,797.92), when the indicator grew by 3.3% from the three-month period ending in February 2013.

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INFLATION, INTEREST RATE, AND CREDIT

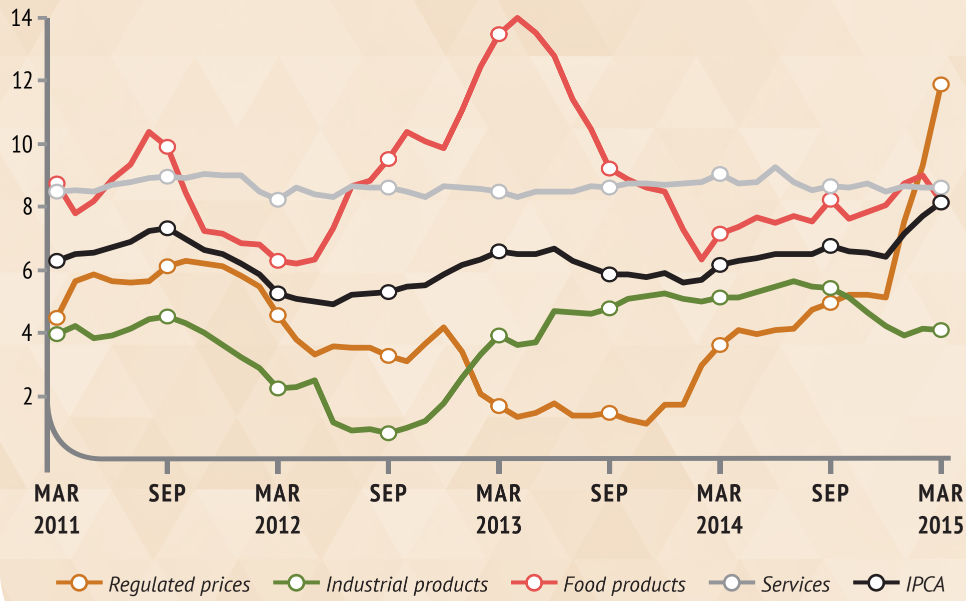
Regulated prices strongly impact inflation in the first quarter

IPCA to surpass the target ceiling in 2015 despite weak activity

Regulated prices accelerate in the first quarter

IPCA by groups

In 12 months (%)



Source: IBGE – Prepared by CNI

Since January, inflation has been hovering near the 6.5 percent upper limit of the target range set by the inflation targeting program. The Extended National Consumer Price Index (*Índice Nacional de Preços ao Consumidor Amplo, IPCA*), the system's base index, edged up by 3.8% in the January-March period and by 8.1% in 12 months. This upward trend in the first months of the year has been led mainly by adjustments in regulated prices, by seasonal effects on food and services, and by the significant devaluation of the real against the US dollar. CNI estimates that prices will rise by 8.1% by the end of the year.

The group of regulated prices was the main source of inflationary pressure in the first quarter. This group accumulated growth of 6.7% between January and March, hitting the mark of 11.9% in 12 months. The implementation of the so-called "tariff flags" system in January has resulted in higher electricity prices for consumers depending on electricity generation conditions in each region. In March, cost adjustments in the tariff flags and exceptional electricity rate revisions brought about greater inflationary pressure. As a result, electricity prices increased by 36.3% in the first three months of the year and accounted for a 4.6-percentage point increase in the group, corresponding to a 1.2-percentage point growth in the IPCA in the quarter.

Adjustments in public transportation prices and the increase in the PIS/COFINS rate levied on gasoline and diesel prices are two other factors that contributed toward the significant increase in regulated prices. Tariff adjustments are expected to take place only in the first quarter, with the group's prices slowing down in subsequent months. We are therefore expecting regulated prices to grow by 11.8% by the end of 2015.

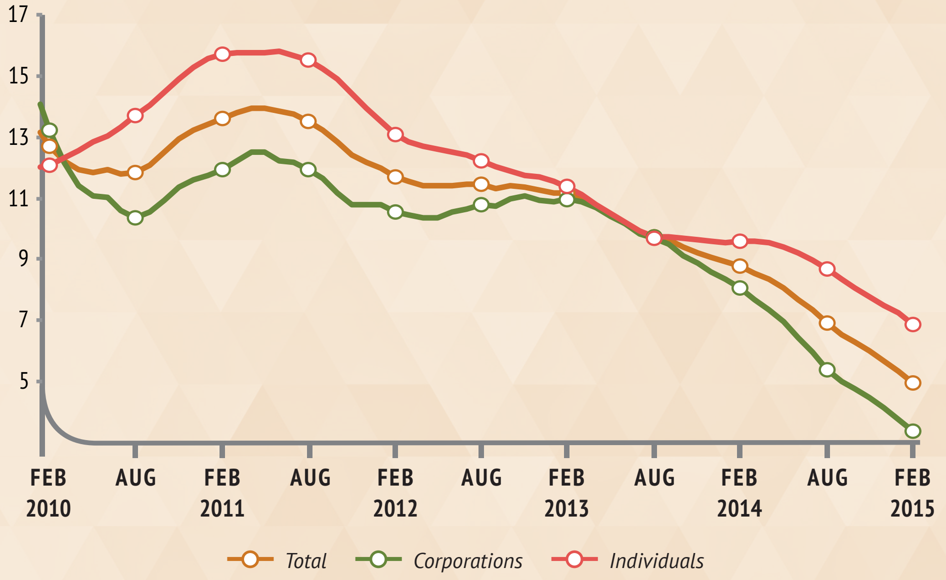
The food group accumulated a 3.5% growth in the quarter ending in March, hitting the mark of 8.2% in 12 months. This behavior is normal for this period of the year, when the food group is affected by seasonal effects. CNI estimates that food prices will finish the year with 8.0% growth.

Prices of industrial products accumulated an increase of 1.5% in the first three months of the year. In the 12 months to March,

Credit keeps slowing down

Balance of credit operations

Real variation in 12 months over the previous 12 months (%), deflated by the IPCA



Source: Central Bank of Brazil

these prices are up by 4.1%. This increase can be partly explained by the reinstatement of the Tax on Industrialized Goods (*Imposto sobre Produtos Industrializados, IPI*) levied on cars. Furthermore, the exchange rate depreciation had an impact on the group's prices. This impact, however, has been mitigated by a downward trend in commodity prices and by a weak economic performance. For this reason, industrial product prices are estimated to experience a 4.6% growth by the end of 2015.

The service group, commonly affected by school fee adjustments at this time of the year, grew by 3.6% in the first quarter. The 12-month rate reached 8.6% in March. The characteristic inertia in the group, whose prices are directly influenced by adjustments indexed to past inflation and to the minimum wage, has prevented a significant slowdown in service prices. Nevertheless, the group's prices are expected to decelerate slightly as a result of the anticipated deterioration in labor market conditions and its impact on real household earnings. For this reason, this group is estimated to grow by 8.0% by the end of the year.

Early this year, the Brazilian Central Bank decided to continue the cycle of interest rate hikes initiated last October. As a result, it increased Brazil's basic interest rate (the Selic rate) to 12.75% – 0.50 percentage points at each of the meetings, held in January and March. Ever since the monetary tightening cycle was resumed, this interest rate has increased by 1.75 percentage points.

Special mention should be made of the following factors behind the current stance of the Brazilian monetary authority: higher-than-expected increases in regulated prices, strong depreciation of the Brazilian currency and the consequent increase in inflation expectations.

In CNI's opinion, the government's statement that the goal is to anchor expectations and drive inflation toward the central target in 2016 suggests possible further increases in the Selic rate in coming months. Given the current economic environment, however, we do not expect the cycle to be extended over a very long period of time. The Selic rate would therefore close the year at 13.50%.

The successive increases in the Selic rate coupled with the rise in the long-term interest rate (TJLP), from 5.0% to 5.5% in January and then to 6.0% in April, resulted in higher interest rates for borrowers.

According to the Brazilian Central Bank data, average interest rates for non-earmarked loans to individuals amounted to 54.3% in February, up by 6.4 percentage points from the same month in 2014.

Credit availability has grown at an increasingly lower rate. Comparing the average figure for the last 12 months with that for the previous 12 months, the amount of credit available slowed down from a real growth of 8.8% in February 2014 to 5.0% in February this year. The same analysis for individuals shows that the

CNI estimates that credit availability will continue to slow down in 2015

figure edged down from 9.6% to 6.8%. On the same comparison basis, credit availability to corporations decelerated to 3.4% from 8.1%.

Several factors have contributed to the credit slowdown. Among these we can mention the increase in total financing costs, which, in the specific case of individuals, was driven by higher interest rates and by an increase in the Tax on financial Transactions (*Imposto sobre Operações de Crédito, IOF*) from 1.5% to 3.0%. A second factor is the lack of confidence in the economy on the part of both consumers and entrepreneurs, which ends up postponing consumption and investment and thus discouraging the search for new financing mechanisms.

In parallel, financial institutions have adopted a more cautious lending stance. Also, the government has signaled that it will moderate Brazilian Devolpment Bank (Banco Nacional de Desenvolvimento Econômico e Social, BNDES) disbursements, which could lead to a further decline in earmarked loans.

Given that the economic environment is not expected to change over the short term, CNI estimates that credit availability will continue to slow down in 2015.

FISCAL POLICY

Reversal of tax policy to ensure achievement of primary surplus target

Expenditure containment measures amount to 72.5% of proposed fiscal adjustment

The expansionary fiscal policy observed in recent years is being reversed in 2015. The deterioration in public accounts led by fiscal expansion has forced the government to make significant adjustments, including measures designed to reduce spending and increase revenue. State and municipal governments are expected to follow in the same direction and bring primary balance back to 2013 levels.

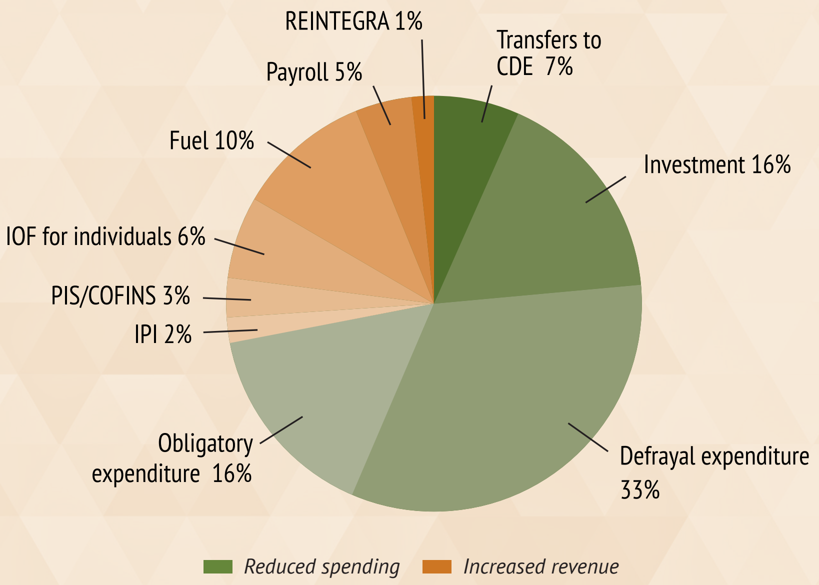
The set of tax measures announced by the federal government is now close to R$ 115 billion in spending cuts and increased revenues. The aim is to ensure the achievement of the R$ 66 billion primary surplus target for the public sector in 2015. The magnitude of this set of measures is justified by the need to reverse 2014's primary deficit of R$ 32.5 billion.

It is worth noting that, although some measures will increase the tax load and undermine the com-

Financial Programming Decree provides for a R$ 57.5 billion reduction in non-obligatory expenditure in 2015

Composition of the fiscal adjustment proposed by the government

In percentage (%)



Prepared by CNI

petitiveness of Brazilian firms, the fiscal adjustment is based mostly on spending cuts. The set of measures focused on reining in public spending amount to about R$ 83 billion, accounting for 72.5% of the total adjustment. Measures designed to increase revenues in turn totaled R$ 31.5 billion, corresponding to 27.5% of the total adjustment. These figures take into account estimates released by the Ministry of Finance and do not include any future changes in the measures awaiting approval in the Brazilian Congress.

Primary expenditure of the federal government is no longer growing at the fast pace observed in the 2012-2014 period. After growing by 6.1% in 2014, federal spending did not experience a real increase (IPCA deflator) in January and February 2015 as compared to the corresponding months the year before.

The cost-cutting effort has so far focused on non-obligatory expenditures, as there has not been enough time to verify the results of measures intended to rein in mandatory spending such as unemployment insurance benefits and salary bonuses. Non-obligatory expenditures, including investment or defrayal expenditures, edged down by 6.4% in real terms in the first two months of 2014 over the same period in 2013.

This reduction in non-obligatory expenditures was made possible by a 33.5% real decline in investments in the federal government (GND-4) in the first two months of 2015 as compared to the same period a year earlier. Although the fiscal adjustment is not ideal in that it fails to protect investments, at least it has curbed the growth of non-obligatory defrayal expenditures. While these expenditures posted real growth of 11.6% in 2014, they held steady in real terms in the first two months of 2015 from the same period the year before.

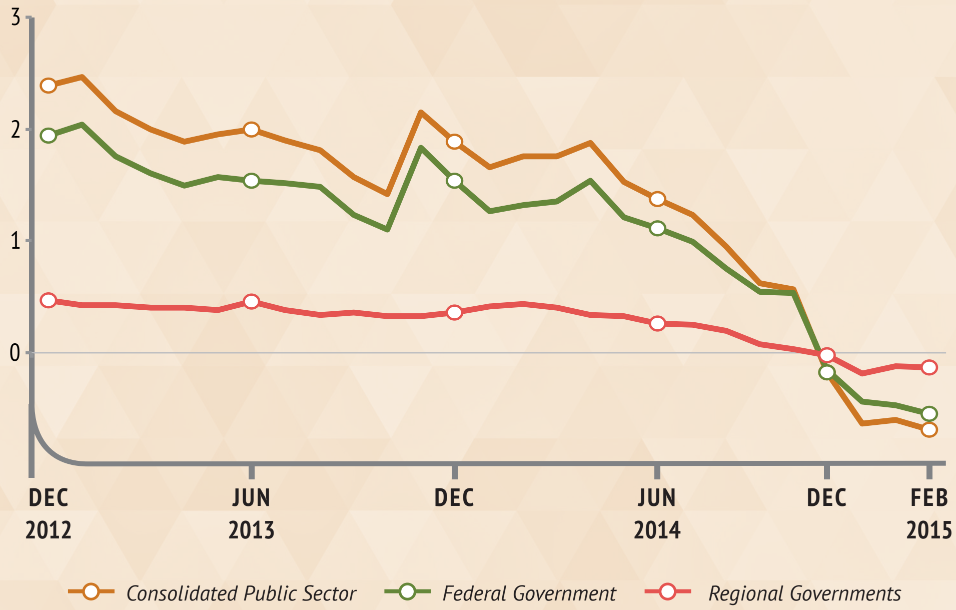
As opposed to non-obligatory expenditure, some mandatory expenses are up in the first two months of 2015. Among these, special mention should be made of expenditures impacted by the increase in the minimum wage that took effect in January, such as social security expenditures and welfare benefits, which grew, respectively, by 5.2% and 11% in real terms. The 50.8% real growth in expenditures on subsidies and grants in the first two months of 2015 also deserves special mention. A significant portion of this increase can probably be explained by the fact that expenditures that should have been made in previous years have been brought into line.

The deterioration in economic activity caused the federal government's net revenue to fall even further in the first two months of 2015 as compared to the figure recorded in late 2014. Comparing the first two months of 2015 with the corresponding period in 2014, the federal government's net revenue is down by 4.1% in real terms. In 2014, net revenues experienced a real decline of 3.7% from 2013's figure.

12-month primary deficit up by R$ 3.3 billion in the first two months of 2015

Evolution of public sector's primary balance

In 12 months (% of GDP)



Source: Central Bank of Brazil - Prepared by CNI
These results are based on GDP calculations using the methodology of the System of National Accounts - reference 2000.

This behavior of net revenue can be mainly explained by a poorer performance of social security expenses and revenues not administered by the Department of Federal Revenue of Brazil. Brazilian Social security revenues fell by 1.1% in real terms in the first quarter of 2015, down from 2014's 1.3% real growth. The slowdown in payroll growth is the main reason behind this deterioration in social security revenues. Revenues not administered by the Department of Federal Revenue of Brazil in turn, which experienced a real decline of 10.2% in 2014, fell by 21% in real terms in the first two months of 2015. This deterioration can be mainly explained by the fact that the federal government received lower dividend payments and financial compensations for oil exploration activities.

As with the federal government, regional governments are also showing signs of significant spending cuts in 2015. The available data allow us to estimate that states and municipalities reduced their expenditure by 7.9% in January and February 2015 as compared to last year's corresponding period.

As a result of this behavior, the primary surplus has already shown the first signs of recovery despite a 5.5% decline in revenues of states and municipalities in the first quarter of 2015 over the same period in 2014. The downturn in economic activity, with negative impacts on revenue from the Tax on Circulation of Goods and Services (Imposto sobre Circulação de Mercadorias e Serviços, ICMS), was the main contributor to this drop in revenues. This has also led to reduced transfers from the federal government.

In spite of spending cuts at the federal and regional level, the decline in revenues caused the primary surplus to continue to deteriorate in the first months of 2015. In the 12 months to February, the consolidated public sector recorded a primary deficit of R$ 35.8 billion (0.69% of GDP).

At the end of 2014, the primary deficit stood at R$ 35.5 billion (0.64% of GDP).

A higher primary deficit, coupled with an increase of 0.57 percentage points of GDP in interest expenses, led the 12-month nominal deficit to stand at 7.3% of GDP in February 2015.

The increased nominal deficit has not translated into a rise in the net debt-to-GDP ratio, which fell by 0.5 percentage points of GDP between December 2014 and February 2015. This behavior was determined by the effects of the exchange rate devaluation on both domestic and foreign debt.

The gross debt-to-GDP ratio in turn edged up by 2 percentage points of GDP on the same comparison basis, which can be explained by the fact that, in this case, the calculation does not deduct public sector credits, whose value increases with a depreciated exchange rate, as is the case with international reserves of the Brazilian Central Bank.

The effects of fiscal adjustment measures will be intensified in coming months and fiscal results are expected to improve significantly by the end of 2015. The impacts of some measures are still dependent on the Brazilian Congress approval and on how they will eventually be passed. Under the current scenario, however, the fiscal adjustment proposed by the federal government will likely require a financial programming not much higher than the limit on non-obligatory expenditures imposed by the financial programming for the first four months of the year. If extended through the end of 2015, the limit imposed by this decree would represent a R$ 57.5 billion cut in non-obligatory expenditures authorized in the budget. According to CNI's projections for the central government's revenue and expenditure and for regional governments' primary balance, a R$ 67.5 billion financial programming would be required to achieve the R$ 66.3 billion primary balance target set for the public sector.

Primary balance target of R$ 66.3 billion likely to be achieved

Considering that the programmable base in the 2015 budget is probably at about R$ 200 billion – given the Brazilian Ministry of Finance's commitment to meeting the target – a higher financial programming could possibly be required to offset minor impacts caused by the adjustment measures approved in Brazilian Congress or frustrations over the results expected from states and municipalities.

If the financial programming amounts to R$ 67.5 billion and the fiscal adjustment measures are not significantly altered in Brazilian Congress, central government's expenditure will likely fall by 4% in real terms by the end of 2015.

On the revenue side, should the tax-raising measures be approved in Congress, CNI expects revenues to post real growth of 3.5% in 2015. Considering this scenario of revenue and expenditure, CNI projects that the federal government and its state-owned enterprises will close the year with a primary surplus of R$ 60.3 billion (1.03% of GDP as estimated by CNI).

Regional governments in turn are expected to continue to rein in costs and reverse the decline in revenue. The improvement expected in revenue collection is explained mainly by the ICMS tax levied on electricity and fuels, which experienced significant price hikes and account for a major share of the total revenue collected from the tax. States and municipalities are therefore estimated to post a primary surplus of about R$ 6.0 billion (0.1% of GDP) in 2015.

As a result, the primary balance of the consolidated public sector would amount to R$ 66.3 billion (1.13% of GDP). The improved primary result should more than offset the increase in interest expenses, with nominal deficit falling to 5.0% in 2015 from 6.2% in 2014. Despite this decline, a still significantly high nominal deficit and a low nominal GDP growth are likely to cause the net debt-to-GDP ratio to rise from 34.1% in 2014 to 35.7% in 2015.

FOREIGN SECTOR

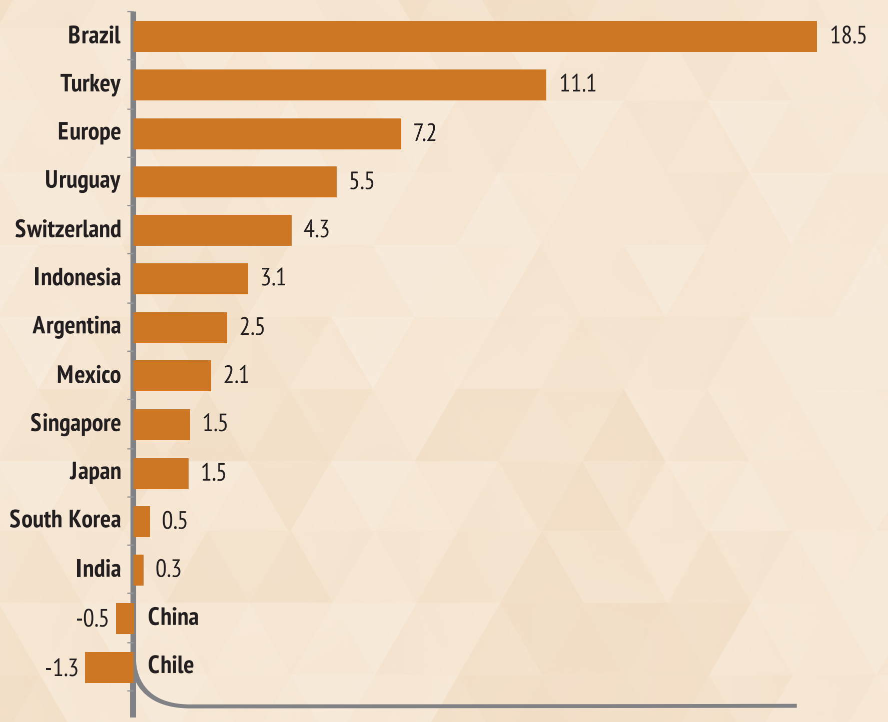
Unstable exchange rate as uncertainties linger

Exports and imports down early in the year

Brazilian real was the currency that weakened the most against the dollar

Exchange rate variation in 2015 (January/April)

In percentage (%)



Fonte: Bloomberg

The beginning of this year has been characterized by strong exchange rate volatility. The real-dollar exchange rate (monthly average) appreciated by 0.35% in January on a month-over-month basis, but depreciated by 19% in the two subsequent months, exceeding the mark of R$ 3.20 per US dollar. In early April, this depreciation was partly offset. Considering the first two weeks of the month, the average exchange rate is down to R$ 3.10 per US dollar.

The decline in the Brazilian currency is not an isolated fact, as the dollar has appreciated against most world currencies. The US economy has grown more than other developed economies and is once again attracting investment, thus making US assets more attractive. Another factor contributing to this behavior is the expected increase in the US interest rate later this year.

Basic goods prices and manufactured goods volumes push exports down

Changes in export prices and volumes

(January-February 2015 versus January-February 2014, in %)

Source: FUNCEX

Uncertainties to fade away over the year and exchange rate to become less unstable

In particular, the real was the currency that experienced the sharpest depreciation against the dollar in the first quarter of 2015. It is worth noting that, unlike other countries (such as Turkey and the Eurozone), Brazil is experiencing a cycle of rising interest rates, which was supposed to contribute toward an appreciation in the currency or a lower depreciation.

This additional depreciation and instability can be mostly explained by the uncertain environment that has characterized the Brazilian economy. External deficit, which increased in 2014, is another major issue.

Uncertainties will likely fade away throughout the year with the approval of adjustment measures. Furthermore, the current account deficit is also expected to fall (see more information on this later in this section). For this reason, the Brazilian currency is estimated to become less unstable and fall to about R$ 3.10 per US dollar by December, slightly below the average exchange rate recorded in March (R$ 3.13/US$).

The first quarter closed with a negative trade balance of US$ 5.6 billion, slightly up from the figure observed in the same period in 2014 (US$ 6.1 billion deficit).

Exports hit the mark of US$ 42.7 billion in the first quarter of 2015, representing a decline of 13.7% from the corresponding period a year earlier. Exports of basic goods stand out negatively with a 21.2% decline on the same comparison basis, driven mainly by a fall in commodity prices. Exports of iron ore, the number one product exported by Brazil, recorded a decline of 45.5% in value terms on the same basis of comparison. The price index for exports of basic goods, calculated by Funcex, shows a 28% drop in the first two months of 2015 over the same period a year ago. The quantum index shows a 6% increase in export volumes.

Manufactured goods are also down by 10% in value terms in the quarter. Almost a third (32%) of this fall is attributed to the decline in fuel oil sales. The price and quantum indices of manufactured goods edged down by 6% and 15%, respectively, in the first two months of 2015.

Imports in turn reached US$ 48.3 billion in the first quarter, down by 13.2% from the figure observed in 2014. The drop in imports is widespread. Imports of fuels and lubricants shrank by 26.5%, while those of durable consumer goods experienced a 19.5% decline. Oil imports alone fell by 53.4%, accounting for 25% of the drop in total imports during the period.

Comparing the first two months of 2015 with the same period in 2014, the price and quantum indices calculated by Funcex decreased, respectively, by 7% and 10%. Imports of capital goods and durable consumer goods experienced the sharpest declines in volume: down by 18% and 17%, respectively. Fuels in turn recorded the steepest fall in prices: 25%.

The exchange rate depreciation will boost sales abroad for the remainder of the year. Other factors, however, will prevent exports from increasing in value in 2015. Prices of basic goods will remain significantly below those recorded in 2014 and the increase in export volumes will not be able to offset the decline in export values. Manufactured products, which would in principle benefit more from the exchange rate depreciation, will also continue to experience a downtrend in prices by the end of the year. Moreover, a still weak demand from major trading partners, particularly Argentina, is preventing export volumes from rebounding fully. Exports are therefore expected to edge down by 7.5% in 2015, standing at US$ 208 billion.

With regard to imports, the exchange rate devaluation and the sharp slowdown point to a significant decline in foreign purchases. A drop was observed not only in fuels, but also in the prices for all categories of use. For this reason, imports are likely to fall by 9.7% in 2015, totaling US$ 207 billion. The trade balance for the year would be a positive US$ 1 billion, compared to a U$ 3.9 billion deficit in 2014.

The 12-month current account deficit reached US$ 89.8 billion in February 2015, up by 9.2% from the figure recorded in February 2014. This increased deficit stems mainly from the trade balance deterioration and the higher deficit in the services account, with emphasis on the increase in the equipment rental deficit.

Considering only the first two months of 2015 and 2014, the result is the opposite: decline of 7.2% in the deficit. This drop can be attributed both to a lower deficit in the trade balance (down by 2.9%) and in the services and capital accounts (down by 5.3% and 15.5%, respectively) and to a 25.1% decline in transfers account.

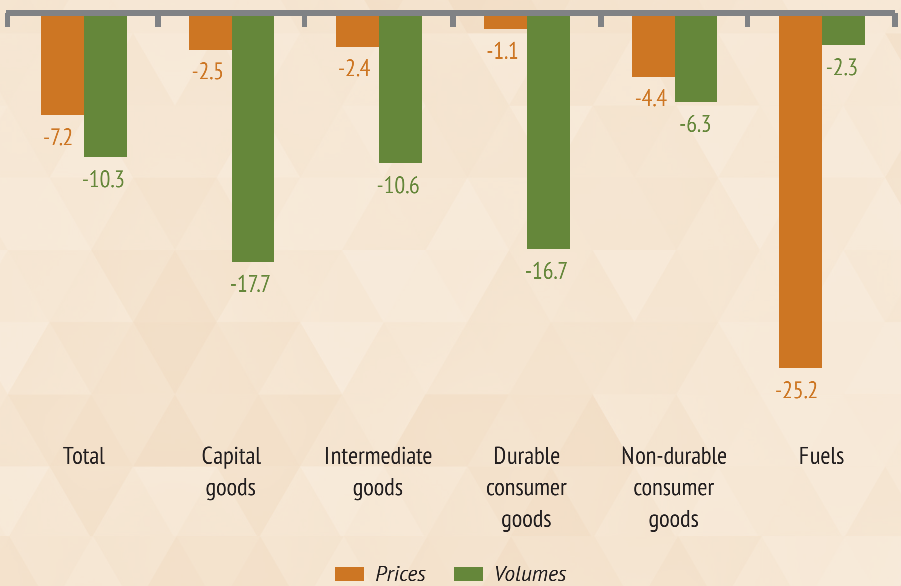
This downtrend in the current account deficit is expected to continue through the end of the year on account of the exchange rate depreciation and the pronounced decline in domestic absorption. The deficit in services and income will keep falling, mainly as a result of the reduction in international travel spending and in profit and dividend remittances. Moreover, the trade balance will become positive later in the year. The current account deficit is thus expected to close 2015 at US$ 70 billion. This figure corresponds to 3.67% of GDP for 2015 as projected by CNI.

Current account deficit to continue to trend downward through 2015

Import volumes fall for all categories of use

Changes in import prices and volumes

(January-February 2015 versus January-February 2014, in %)



Source: FUNCEX

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2013	2014	2015 previous forecast (Dec / 14)	2015 current projection
ECONOMIC ACTIVITY				
GDP (annual change)	2.7%	0.1%	1.0%	**-1.2%**
Industrial GDP (annual change)	1.8%	-1.2%	1.0%	**-3.4%**
Household consumption (annual change)	2.9%	0.9%	0.7%	**-0.6%**
Gross fixed capital formation (annual change)	6.1%	-4.4%	0.0%	**-6.2%**
Unemployment Rate (annual average - % of the labor force)	5.4%	4.8%	5.2%	**6.7%**
INFLATION				
Inflation (IPCA index - annual change)	5.9%	6.4%	6.2%	**8.1%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	8.29%	10.96%	12.39%	**13.12%**
(year's end)	10.00%	11.75%	12.50%	**13.50%**
Real interest rate (average annual rate and deflation: IPCA)	2.0%	4.3%	5.8%	**4.7%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	-3.05%	-6.23%	-3.97%	**-4.97%**
Public sector primary surplus (% of GDP)	1.77%	-0.59%	1.13%	**1.13%**
Net public debt (% of GDP)	31.5%	34.1%	35.5%	**35.7%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.35	2.64	2.70	**3.10**
(average in the year)	2.15	2.35	2.60	**3.10**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	242.2	225.1	219.5	**208.0**
Imports (US$ billion)	239.0	229.0	212.0	**207.0**
Trade balance (US$ billion)	2.6	-4.0	7.5	**1.0**
Current account balance (US$ billion)	-81.4	-91.3	-78.0	**-70.0**

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