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Overcoming the current low-growth scenario requires coordinated policies and a focus on investment

The second half of the year began with less positive expectations for the Brazilian economy. Changes in both the domestic and international economic environment may determine an unsatisfactory performance in 2013, marked by low growth and high inflation. CNI estimates a GDP growth of 2.0%; and a 1.0% growth for industrial GDP (against 3.2% and 2.6% projected in April). Inflation will in turn remain at 6%, higher than last year.

The economy is struggling to overcome this low-growth scenario. Economic fundamentals are showing signs of deterioration: inflation on the rise, a high current-account gap, and worsening fiscal accounts. This situation is aggravated by adverse changes in the world economy, such as signs of reversal in the US monetary policy and lower growth rates in China. These trends make it difficult to capture resources abroad and have caused the Brazilian currency to depreciate.

This depreciation will have a positive impact on competitiveness in the short run. However, it creates immediate pressure on inflation, pushing interest rates up and making it more difficult to resume growth. Thus, to prevent a cycle of rising interest rates from being particularly intense, ambiguities must be eliminated from the macroeconomic policy and fiscal and monetary policies must be aligned, with the aim of reversing the expansionary nature of the fiscal policy.

Possible solutions will necessarily entail stepping up competitiveness (cost reductions) and resuming investment, as the model that sustained economic growth in the previous cycle, based on greater consumption, shows signs of exhaustion. The rise in investment observed this year is still modest and insufficient to raise the current rate of investment to a level above 20% of GDP.

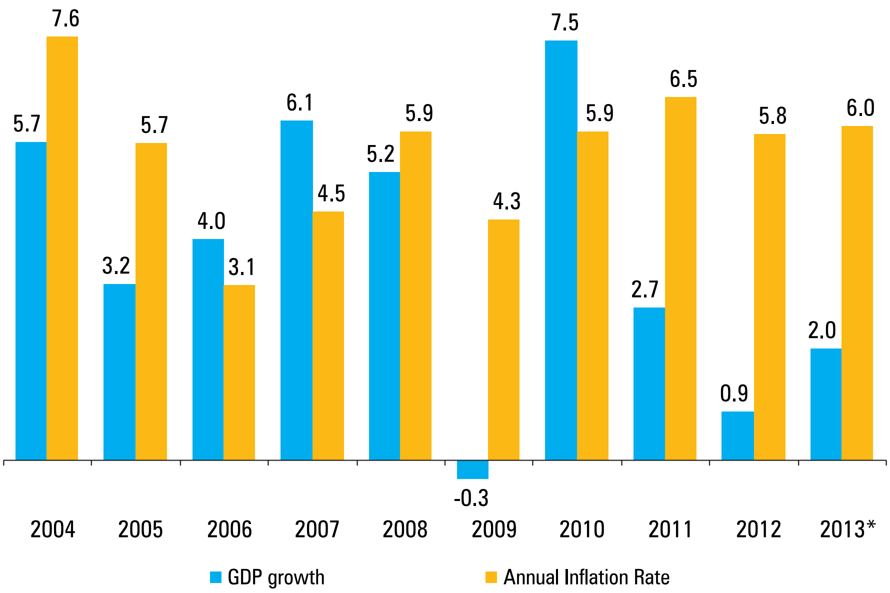
The weak response to investment is due to difficulties faced by the Brazilian economy in the realm of competitiveness. The productivity drop seen in recent years, rising real wages, distortions in the tax system, and spending associated with a deficient infrastructure have created cost pressures that enterprises haven't been able to cope with.

For investment to be unlocked, actions are required in two dimensions. On the one hand, the economic policy should provide more incentives to industry, as these have not been strong enough to reverse a steady increase in domestic costs. On the other, as far as infrastructure is concerned, it's taking too long for major projects to be implemented and important regulatory milestones to be defined. In the medium term, chances of resuming growth are associated with effective and coordinated actions in the area of infrastructure.

Without acting timely and with determination to eliminate adversities that have been restricting investment and hindering competitiveness, the growth potential of the Brazilian economy will remain low, and the poor results seen in recent years will be repeated.

GDP and inflation - Annual variation (%)

Lower growth and prices on the rise characterize the economic scenario in recent years



Source: IBGE *Estimate: CNI

Brazilian economy in the second quarter of 2013

economy activity

Exhaustion of the consumption-oriented growth model

Investment should lead growth

The Brazilian economy is expected to grow by only 2.0% in 2013. Estimates for GDP growth have worsened as new short-term indicators suggest that industrial activity will be slow to recover. At the end of the first quarter, CNI was projecting a GDP growth of 3.2% this year.

Because it is not supported by investment, the emphasis on household consumption to boost economic growth has been contributing less and less to growth in recent years. The model has become unsustainable.

The effects of weak economic activity are already evident in the labor market, as jobs are not being created at the same pace as in recent years. Earnings have been growing less against a backdrop of higher household debt, hindering increases in domestic consumption. In the first quarter of 2013, household consumption remained virtually stagnated: increased 0.1% in relation to the previous quarter. CNI's projected increase in household consumption has been reduced from 3.5% to 2.3%.

After decreasing almost throughout 2012, investment grew by 4.6% in the first quarter of 2013 against the quarter before. The apparent good result observed for investment should be analyzed with caution, as there are no signs that this trend will continue. The growth registered in the first quarter was brought about by two factors:

i) Investments grew against a low comparison basis, resulting is a very positive statistical carry-over effect (above 4.0%) that ensured a more intense growth for this GDP component than for household consumption in 2013.

ii) investment was largely concentrated in transportation equipment (up by 25.2% in the first quarter of 2013 compared to the same period last year), as a result of the positive performance of agriculture and of amendments to the Proconve P7 (Euro 5) legislation last year, which impacted sales in that period - both of which are one-off factors that will not be repeated in coming quarters.

Industry will grow by only 1.0%

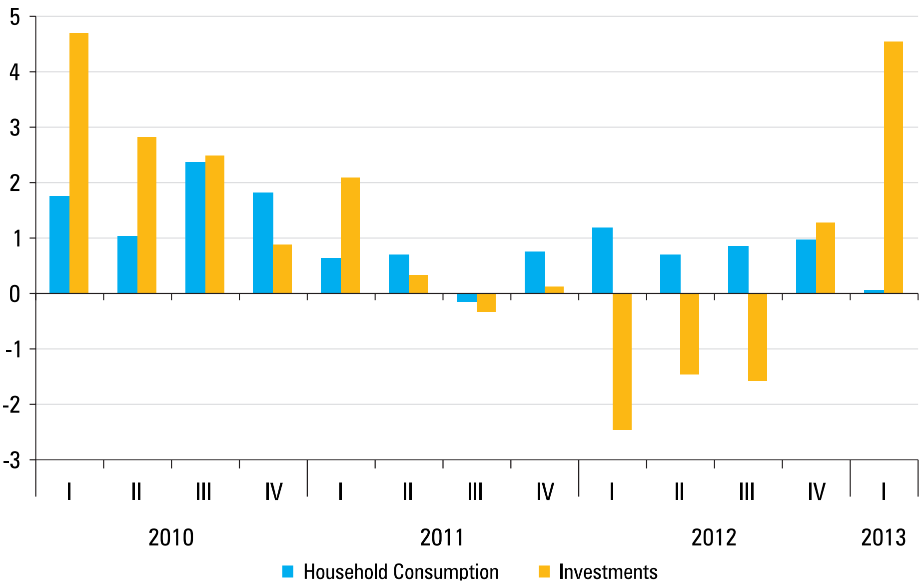
The situation on the supply side is worrying. Total industry started the year down by 0.3% against the last quarter of 2012. Despite the fact that physical production increased by 1.7% in the first quarter, the manufacturing industry's GDP grew by only 0.3% over the same period. The manufacturing industry was the only segment of industry to record positive growth in the first quarter.

After growing significantly for two months – in March and April –

Variation in household consumption and investment (GFCF)

Variation (%) in the quarter from the previous quarter – seasonally adjusted

Imbalance between consumption and investment growth



Source: IBGE

industrial production fell again in May. The seasonally adjusted indicator recorded a drop of 2.0% in May in relation to the previous month. In the year to May, industrial production increased by 1.7%.

Idleness in industry has been decreasing gradually, a situation that does not encourage investments in the sector. In April, capacity utilization (seasonally adjusted) stood at 83.3% (CNI Industrial Indicators). This indicator is still more than 1.0 percentage points below its historical peak.

Industrial business confidence as measured by the BCI calculated by CNI has been on a downward path since March. The BCI has decreased by 0.7 points to 58.4 points in June. This is the lowest industrial business confidence level recorded since August 2012.

The downward trend in industrial business confidence is due to competitiveness difficulties faced by industry in the business environment, raising doubts about whether industrial activity will recover more strongly. CNI estimates that the industrial GDP will increase by only 1.0% in 2013.

Outlook

The outlook for the second half is less optimistic. The cycle of rising interest rates to curb inflation will result in weaker economic performance. The manufacturing industry has been on a recovery path with interruptions, showing that it is facing difficulties to resume growth at a more robust pace (growth estimated at 1.5% in 2013).

The mining and quarrying industry is not expected to grow in 2013. The 2.1% drop recorded in this segment's GDP in the first quarter against the quarter before was the fourth drop in the past five quarters. With a carry-over effect of -2.2% and even considering that this sector might grow at a slow pace in coming quarters, the mining and quarrying industry is likely to experience a drop close to 1.0% in 2013.

The construction industry also shrank in the past two quarters as compared to previous quarters. CNI's Construction Industry Survey shows that activity in the sector has decreased every month in 2013. CNI estimates that this sector's GDP will increase by only 1.0% in 2013. This sector might not grow at all this year.

As investment grows at twice the pace of GDP growth, the share of investment in GDP will rise to 18.7% in 2013.

Difficulties in the macroeconomic scenario are greater than the chances of positive surprises. Changes expected in the FED's monetary policy, possibly with rising interest rates, have led to more uncertainties and impacts on risk aversion and on the exchange rate.

The foreign sector is likely to contribute negatively to GDP growth by 0.8 percentage points in 2013. Exports (according to the National Accounts/IBGE concept) are expected to drop by 1.0% – despite the depreciation of the Brazilian currency – and imports to grow by 5.0% this year.

CNI's estimate for GDP

Percentage variation and contribution of GDP components

		2013	
	GDP components	Growth rate (%)	Contribution (p.p.)
Demand side	Household consumption	2.3	1.4
	Government consumption	2.0	0.4
	Gross formation of fixed capital	5.1	0.9
	Exports	-1.0	-0.1
	(-) imports	5.0	-0.7
Supply side	Agriculture/livestock	9.0	0.5
	Industry	1.0	0.3
	Mining and quarrying	-1.3	-0.1
	Manufacturing	1.5	0.2
	Construction	1.0	0.1
	Public administration, health and public education	1.9	0.1
	Services	2.2	1.5
	GDP	**2.0**	

jobs and income

Labor market loses momentum

Pace of job growth slows down to 2009 levels

There are clear signs of less intense activity in the labor market in 2013, interrupting a period of job growth for two years in a row in a scenario of weak economic activity.

A lower increase in jobs and average real earnings rising at increasingly modest rates have reduced the growth rate of household consumption. Consumer spending barely grew in the first quarter of 2013 – only 0.1% from the previous quarter.

Lower employment in all job categories

In all the first five months of 2013, jobs in metropolitan areas (Monthly Job Survey/IBGE) grew at decreasing rates before hitting the mark of 0.1% in May against the same month the year before. It was the lowest annual growth in employment since October 2009. In the first five months of 2013, employment grew by 1.3% over the same period last year.

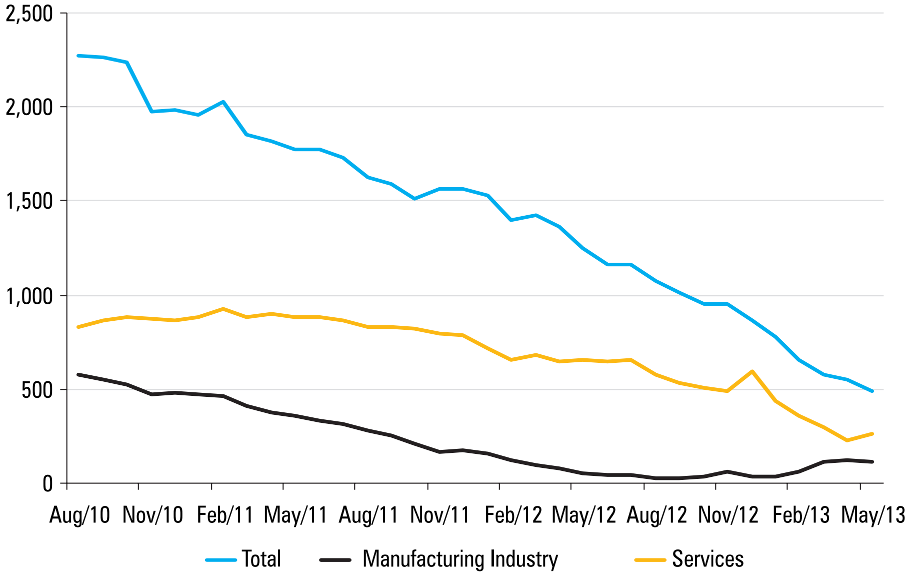
Formal employment has been slowing down at the same pace, but is still growing more than other occupation categories. In the year to May, formal employment in the private sector increased by 1.8% as compared to the same period last year (Monthly Job Survey/IBGE). The number of civil and military staff – which also fall under the formal employment category – increased by 0.1% over the same period.

Informal jobs decreased by 4.9% and self-employment grew by only 0.6% in the first five months of the year against the same period last year.

Net creation of formal jobs

In thousands (in 12 months to now)

Steady reduction in the pace of job creation



Source: CAGED/MTE

The same downward trend has been observed in new jobs in the manufacturing industry and in the service sector. In the manufacturing industry, however, where only 25,000 jobs were created in the twelve-month period ending in August 2012, a greater hiring pace has been recorded: the number of new jobs in it increased to 117,000 over the twelve-month period ending in May 2013.

In the service sector, the downward trend in job creation observed since March 2011 (when nearly a million jobs were created) continues. Job creation in that sector declined gradually since then and hit the mark of 259,000 in the twelve-month period to May 2013 – a figure three times lower than those recorded in 2010 and 2011.

CNI estimates that this low employment growth rate will continue in coming months, but it rules out any decline in occupations in 2013, despite the projected reduction in GDP growth this year.

Full employment can give rise to difficulties in the future

Despite the loss of momentum in job creation, the unemployment rate remains at a historically low level. The reasons for this phenomenon range from a lower population growth to the retention of labor by enterprises – particularly industrial enterprises.

In the first case, a scenario of lower population growth, as a result of which the number of people looking for a job decreases in relation to the pace of job creation, reduces the pressure on the unemployment rate.

The second case is related to the lack of skilled workers and costs arising from the strict laws governing the Brazilian labor market, as a result of which retention of labor by enterprises is encouraged.

A scenario of full employment in the labor market – or one very close to it – amidst weak economic activity raises concerns in relation to the possibility of a more intense GDP growth. There will be pressure for further increases in wages. Given the current cost structure of industry, it will be difficult for this sector to absorb this process, a situation that will further exacerbate its competitiveness problems.

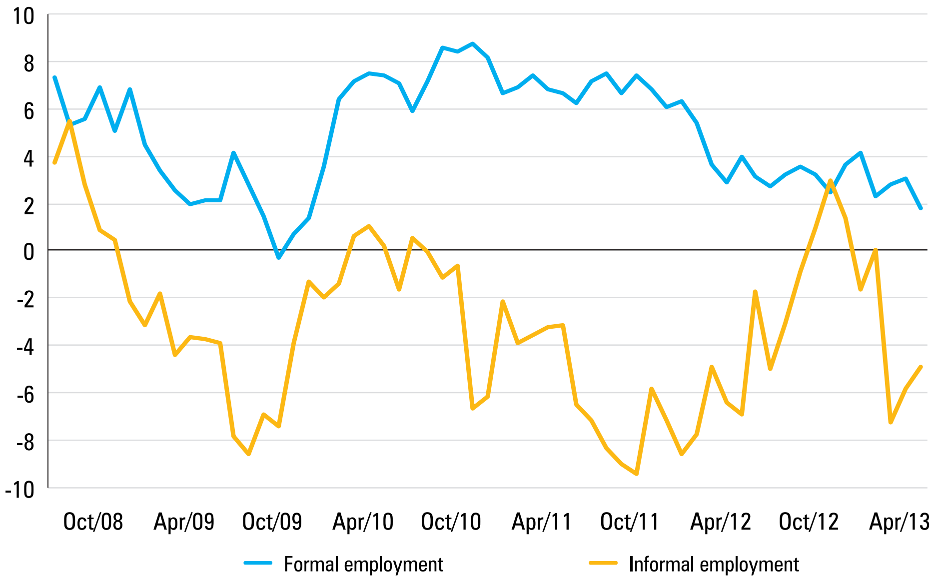
Stepping up productivity is the solution to avoid the cost pressure. However, this process also has limitations due to the lack of skilled workers. CNI's Polls and Surveys show that this problem is among the most pressing ones faced by industrial enterprises.

Data on variations in productivity are not encouraging. CNI has built a productivity index using the ratio between industrial production (PIM-PF/IBGE) and employment (CNI's Industrial Indicators) in the manufacturing industry. In 2004-2008, industry's productivity grew by 4.5%. Between 2008 and 2012 – when industry started to face great difficulties to grow – productivity decreased by 4%.

Employment by position in the occupation

Variation (%) compared to the same month last year

Formal employment grows to the detriment of informal jobs

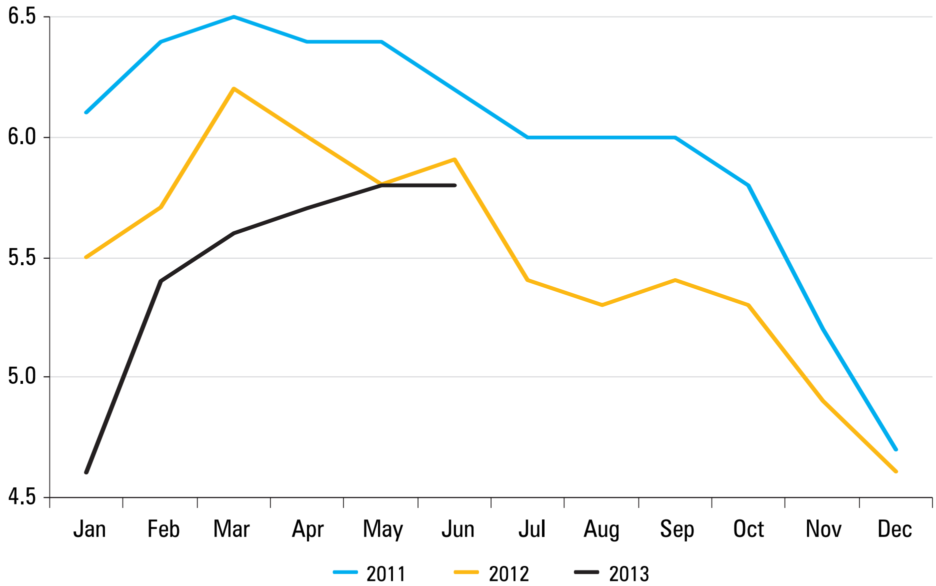


Source: PME/IBGE

Unemployment rate

In (%) of the labor force

Downward trend in the coming months is seasonal



Source: PME/IBGE

inflation, interest rates and credit

Inflationary pressures trigger rise in interest rates

Exchange rate depreciation pushes inflation up

Rising inflation in Brazil is worrying. In May, the 12-month IPCA (Expanded Consumer Price Index) reached the target ceiling (6.5%) and, based on June data, this limit is likely to be exceeded. This scenario led the Monetary Policy Committee to resume a cycle of rising interest rates.

Toward the end of 2013, the IPCA is likely to remain within the target, but some circumstantial factors will determine the inflation level this year. Despite the monetary policy response, the inflation level will depend on the pass-through of the exchange rate depreciation to final prices, on the impact of the reduction in public transportation fares, and on the resilience of the economy.

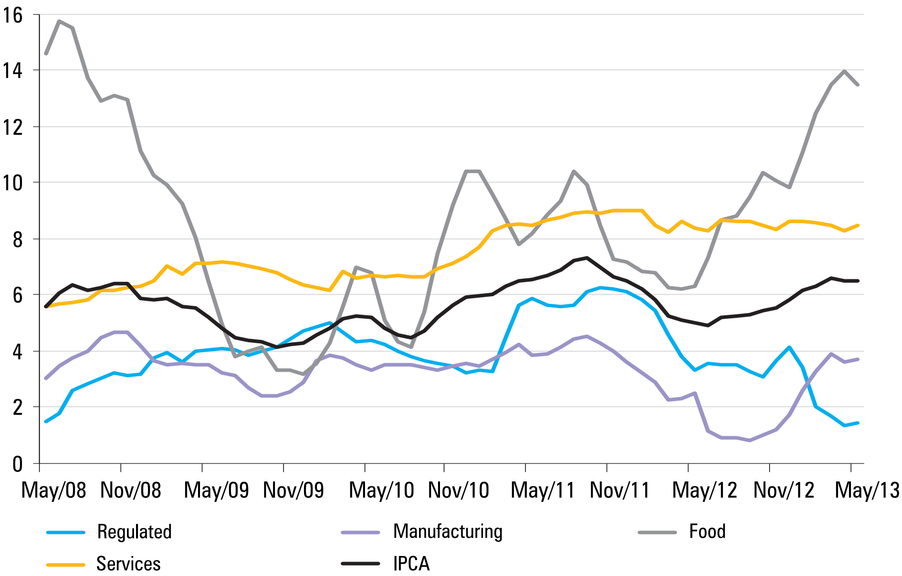
Among the four major price groups making up the IPCA index (reguated prices and the prices of industrial products, food products and services), food prices are the ones that continue to push inflation up the most. The 12-month to May increase for this group hit the mark of 13.5%.

But food prices are likely to trend downward, mainly due to increases below those registered in late 2012, as already observed in May. On the other hand, the exchange rate depreciation tends to reduce the expected effect of this likely downward trend to levels below those estimated before. Food prices tend to close 2013 with an accumulated increase of more than 10.0%.

Up till May, the prices of industrial products were putting little pressure on the aggregate IPCA. The 12-month index stands at 3.7% – below the target center.

IPCA by groups
12-month figure (%)

Specific tax cuts slow down regulated-price inflation



Source: IBGE Preparation: CNI

However, these prices might rise in the coming months.

In June 2012, they dropped by about 1.0% due to a reduction in the IPI (Tax on Industrial Products) charged on car sales. Because of a shift from this drop to a rise in June of this year (albeit mild), the 12-month increase will be close to 5.0%. This level is likely to hold until the end of the year, also due to possible increases in the prices of imported products as a result of the exchange rate pass-through to them.

Inflation in services remains at a high level due to its inertia and to real increases in the minimum wage. In the 12-month period to May, service prices rose by 8.5%, contributing to put more pressure on consumer prices. They are expected to decrease slightly by the end of the year as a result of lower economic activity. Service prices will nevertheless close the year with a 12-month figure close to 8.0%.

The behavior of regulated prices has been unusual, due to tax cuts applied to some of them. A reduction in electricity prices has played a major role in slowing down regulated price increases. The figure for the 12-month period to May was 1.5%, meaning that regulated prices were the ones that contributed less to the current inflation.

A freeze and, in some cases, even reduction in public transportation fares are likely to slow down regulated price hikes even more. The 12-month figure is not likely to exceed 1.0%, and it is a key component for the inflation target for the year to be achieved. It should be stressed that this slowdown is not widespread and that it will only contribute to put less pressure on inflation in 2013.

In such a scenario, the IPCA will remain above the central target of 4.5% for the fourth year in a row. CNI estimates an inflation of 6.0% in 2013, higher than in 2012 and with no prospect of convergence to the central target.

Rising interest rates is the choice to curb inflationary pressure

Stronger-than-expected inflationary pressures in the first months of the year and a more negative inflation outlook in coming months have led the Monetary Policy Committee (COPOM) to review its stable interest rate policy. COPOM's perception was that the lack of a more incisive policy would pose a risk to achieving the inflation target ceiling.

COPOM made the first increase in the basic interest rate (Selic) in May, rising it from 7.25% to 8.00% per year. The decision to raise interest rates steams from the burden of using an expansionary fiscal policy as an alternative to boost the economy.

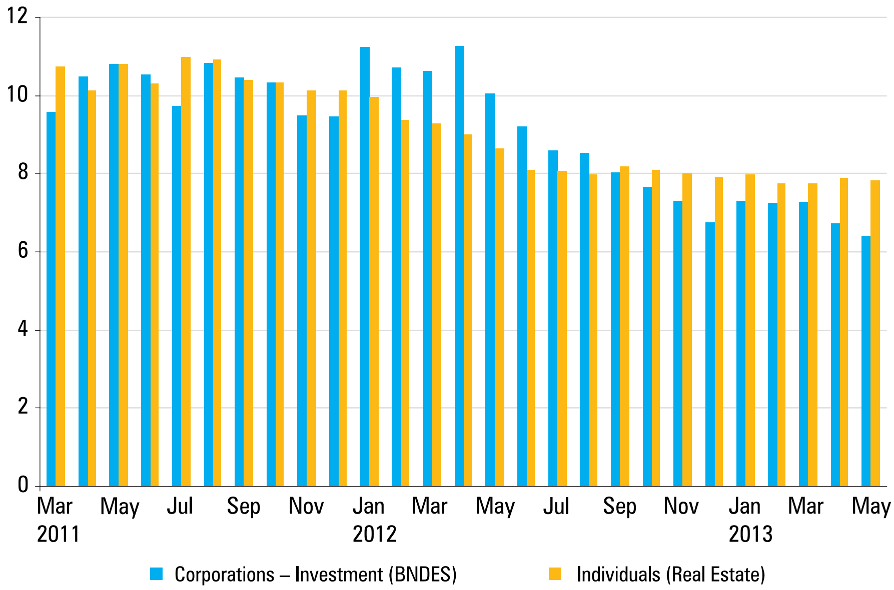
As it usually takes some time for the monetary policy effects on inflation to be seen, the impact on price levels will occur gradually, thus stimulating expectations of further increases in the Selic rate. This scenario becomes even more likely in light of the pressure that devaluation tends to exert on inflation.

In this regard, CNI estimates that new increases will be made in future meetings, leading to an additional increase of 1.5 p.p. in the basic interest rate, with Selic ending the year at 9.50% per year. Still, the average real interest rate is expected to fall once again in 2013, standing at 1.7%.

Long-term financing interest rates

Annual percentage

Long-term interest rates down in the year



Fonte: Central Bank of Brazil

Increase in Selic has not affected bank interest rates yet

The upward trend in the basic interest rate has not yet affected the interest rates on loans. Central Bank indicators show that interest rates are at their lowest levels in the new series initiated in March 2011.

In May (latest data available), the average interest rate for corporations amounted to 13.5% per year. As a comparison, this rate stood at 16.2% per year in May last year. For individuals, it declined by 3.6 percentage points over the same period, from 27.6% to 24.0% per year in May 2013.

This decrease was observed in every type of lending, both in loans with non-earmarked resources (usually short-term) and in earmarked financing (mainly loans granted by BNDES to businesses, and mortgages and rural loans to individuals).

The average interest rate for BNDES's investment financing fell to 6.4% per year in May. As a comparison, this rate totaled 11.3% per year in April 2012. For individuals, the average interest rate for mortgages was 7.8% per year in May – in July 2011, it amounted to as high as 11.0% per year.

This trend will likely reverse in coming months. Interest rates, especially for non-earmarked resources (freely traded in the banking market), are expected to grow in line with the new cycle of high interest rates.

From the lending standpoint, this increase is negative. An increase in interest rates, coupled with existing default levels, contributes toward further slowing down the growth of bank credit balance, which is essential to sustain consumer financing.

fiscal policy

Deterioration in public accounts intensifies

Stable revenues and increased spending lead to lower primary surplus

The slow pace of economic growth continues to contribute to the deterioration of the public sector's fiscal results. On the one hand, it has led the Federal Government to maintain a strongly expansionary fiscal policy, with increased expenditures and tax cuts. On the other hand, it has caused revenues to remain almost unchanged as compared to 2012 levels. The fiscal results for state and local governments, in turn, have been most affected by a weak revenue performance, as expenses grow at a slower rate than at the federal level.

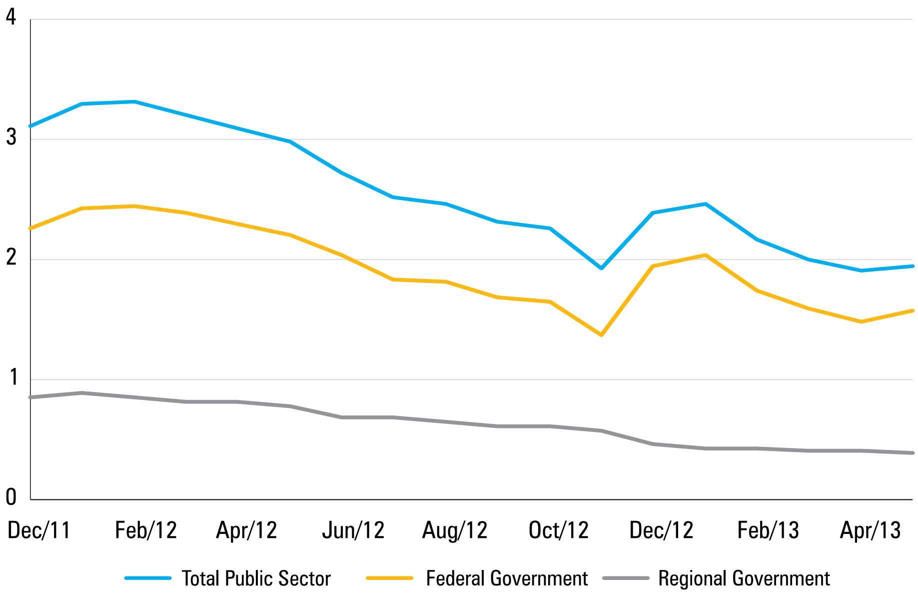
In the Federal Government, total spending recorded real growth of 6.0% in the first five months of 2013 as compared to the same period the year before. The strong real increase in discretionary spending – the item 'other defrayal and capital expenses' grew by 9.8% on this comparison basis – indicates the Federal Government's intention to use fiscal policy to prevent the economic growth pace from declining even further.

Instead of focusing on investments, however, this action by the Federal Government has prioritized the increase in defrayal spending. Within the item 'other defrayal and capital expenses', defrayal spending experienced an increase of 10.3% in the first five months of 2013. Investments (SIAFIS's GND 4) grew by 8.4% in real terms on the same comparison basis. Thus, as the Federal Government is willing to accept the risks inherent in the deterioration of fiscal results, it would be better if the composition of expenditure growth was changed so as to focus on investments.

Primary surplus for the consolidated public sector and by government levels

In relation to GDP in the last 12 months (%)

Public sector's primary result down by more than 0.4 percentage points of GDP between December 2012 and May 2013



Source: Central Bank of Brazil Preparation: CNI

For states and municipalities, CNI estimates that expenditures have grown much less than for the Federal Government, with a real growth of 2.3% in the first four months of 2013 from the same period last year. This growth rate, which is well below that recorded in 2012 (5.4%), is being restrained by weak revenue performance. While they have accelerated slightly in recent months, revenues in states and municipalities grew by only 0.6% in real terms between January and April 2013.

Tax results significantly down

As with states and municipalities, the Federal Government's net revenues has also advanced slowly, with a net increase of only 0.8% between January and May 2013 from the same period in 2012. Yet, this growth was only achieved on account of the collection of R$ 4.0 billion in extra revenues in May. Without these funds, the net revenue would be slightly down in real terms.

The increase in spending, especially in the Federal Government, coupled with low revenue growth led to a strong drop in the primary surplus, which was calculated as structural primary surplus. This calculation excludes atypical factors that affected the primary result in late 2012, i.e., the withdrawal of R$ 12.4 billion from the Brazilian Sovereign Fund and anticipation of R$ 7.0 billion in dividends from BNDES and Brazilian federal bank Caixa Econômica Federal that were accounted for as Federal Government revenue in December 2012.

The Federal Government's 12-month structural primary result fell from 1.5% in

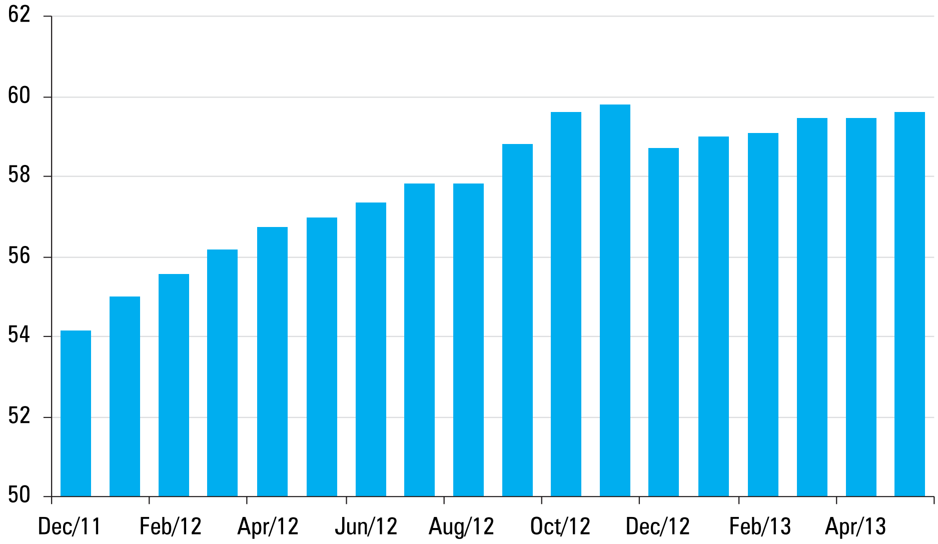
December 2012 to 1.2% of GDP in May 2013. For states and municipalities, the primary surplus dropped from 0.45% to 0.38% of GDP on the same comparison basis. As a result, the structural primary surplus for the consolidated public sector edged down from 1.9% in December 2012 to 1.5% of GDP in May 2013.

The decline in the primary surplus brought about a sharp rise in the nominal deficit, whose 12-month figure increased from 2.9% in December 2012 to 3.3% of GDP in May in 2013, as adjusted to the structural primary surplus. However, the increase in the nominal deficit was not reflected in increased net public debt-to-GDP ratio, as the exchange rate devaluation led the adjustment in domestic and foreign debts to cause the net debt/GDP ratio to fall from 35.2% in December 2012 to 34.8% in May 2013. The gross debt-to-GDP ratio in turn remains on the rise and hit the mark of 59.6% of GDP in May 2013, against 58.7% observed in December 2012.

Evolution of Public Sector's Gross Debt

In relation to GDP (%)

Gross Debt/GDP ratio accumulating increase of almost 1.0 percentage points of GDP in 2013



Source: Central Bank of Brazil

Expenses and revenues on the increase in coming months

The Federal Government's spending growth rate is expected to trend upward over the coming months. CNI's expectation that the Federal Government would make a financial programming of about R$ 35.0 billion for discretionary spending was not confirmed and restrictions imposed on expenditures authorized in the budget totaled only R$ 23.0 billion. Thus, if this financial programming is not made, CNI projects that the Federal Government spending will grow by 8.1% in real terms in 2013.

And the Federal Government net revenues are expected to accelerate even more than expenditures. CNI is estimating to see a real growth of 4.9% in 2013. This acceleration will likely be driven by tax revenues, as a result of the end of some tax reductions (such as in the Tax on Industrialized Products - IPI), and by revenues not administered by the Brazilian Federal Revenue Service.

Under this scenario, the primary surplus for the Federal Government and its state-owned companies is estimated to hit the mark of R$ 54.0 billion (1.1% of GDP as projected by CNI) in 2013. This result would fall R$ 9.0 billion short of the target set by the Federal Government, which announced that it would use only R$ 45.0 billion in deductions for investment costs and tax exemptions authorized by the Budget Guidelines Law for 2013.

For regional governments, the primary result is expected to improve slightly by the end of the year and reach R$ 19.0 billion (0.4% of GDP). However, the impact of the cancellation of certain adjustments to regulated prices can lead to an inferior result. Anyway, the primary surplus in regional governments will likely remain well below the R$ 47.8 billion target set by the Federal Government.

As a result, CNI is projecting that the primary surplus for the consolidated public sector will amount to R$ 73.0 billion (1.5% of GDP) in 2013. This result would fall short of both the adjusted target (R$ 110.9 billion) and the structural result observed in 2012 (1.9% of GDP).

The expected fall in the primary surplus and the small increase estimated in interest expenses are likely to bring the nominal deficit up to 3.4% of GDP. This rise, however, is not expected to translate into an increased net debt/GDP ratio, as it will probably be more than offset by the effects of the exchange rate devaluation in exchange adjustments to domestic and foreign debts. Thus, the Net Debt/GDP ratio is projected to close 2013 at 34.9% of GDP, compared to 35.2% recorded in 2012.

foreign trade sector and exchange rate

Current account deficit remains high

Foreign direct investment is lower than deficit

Brazilian currency is unstable at a more depreciated level

In early 2013, the exchange rate followed a managed float band, albeit not overtly. In late May, however, a significant devaluation in the Brazilian currency began to be noticed. The dollar quickly exceeded the R$ 2.10 / US$ "ceiling", surpassing the mark of R$ 2.25 / US$ at closing on some days in the last half of June.

It should be stressed that this depreciation, which was far beyond the fluctuation band, has not alleviated concerns over the trajectory of prices. The Central Bank intervened in the market in an attempt to contain the rise of the dollar by selling the U.S. currency in the derivatives market. It also discarded policies that had been adopted in the past to stimulate the depreciation of the real, such as the Tax on Financial Transactions (IOF) levied on "sold" foreign exchange position and on fixed income investments to foreign investors, and changed compulsory deposit requirements for banks. The measures contribute toward slightly increasing capital inflows, but are not enough to reverse the depreciation.

The depreciation in the Brazilian currency results from domestic and foreign factors. On the domestic side, the Brazilian foreign accounts have deteriorated (see more later in this section). On the foreign side, the possibility of faster economic growth in the United States generates expectations of higher interest rates in that economy, which has led to a strengthening of the U.S. dollar in the world. It should be noted that it is still difficult to estimate the impact on the Brazilian currency, thus making the exchange rate quotation very unstable.

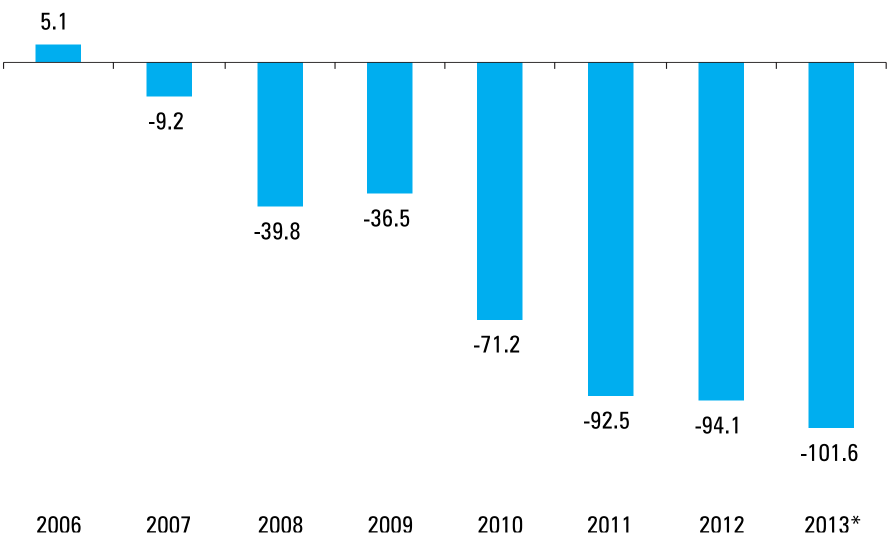
The two factors behind the depreciation of the real will continue in place by the end of 2013. Thus, CNI estimates that the average exchange rate for 2013 will stand at about R$ 2.10 / US$.

Furthermore, two important aspects must be considered. First, the increasingly less favorable evaluation of the Brazilian economy by foreign investors and, particularly, rating agencies. Second, the cycle of rising interest rates, which leads to greater profitability of Brazilian securities and can stimulate capital inflows.

Brazilian trade balance of manufactured goods

In US$ billion

Manufactured goods trade deficit continues to expand



Source: Funcex *over the 12-month period ended in May

Manufactured goods trade deficit exceeds $ 100 billion in 12 months

In the first quarter of 2013, the Brazilian trade balance posted a record trade deficit for the period. A recovery began to be seen in May, but it was not sufficient to prevent this balance from remaining negative in the 12-month figure. At the end of the first half of 2013, the trade balance is negative at US$ 3 billion. In 2012, a US$ 7.2 billion surplus was recorded in the year-to-June figure.

The 12-month trade surplus decreased from US$ 27.5 billion in May 2012 to US$ 7.7 billion in May 2013. In the same period, the deficit in oil and oil products increased by US$ 8 billion. In other words, 41% of the drop of almost US$ 20 billion in the trade surplus in the last twelve months can be explained by the increase in the account deficit in oil and oil products.

Although oil and oil products account for a significant share of the deficit, it is important to note that this group of products was not the only one to show a poor performance. The 12-month deficit in the balance of manufactured goods increased by 4.1% between May 2012 and 2013, reaching US$ 101.6 billion or 4.5% of GDP. Commodities have also shown a weaker performance owing to the slowdown in China, the main trading partner for this kind of product.

Oil exports are expected to recover somewhat in the second half, thus reducing the first impact to some extent. The fall in the trade balance of other products (mainly the increase in the deficit in manufactured goods) steams from a competitiveness problem facing the Brazilian industry that is amplified by a drop in demand for these products, especially in developed countries.

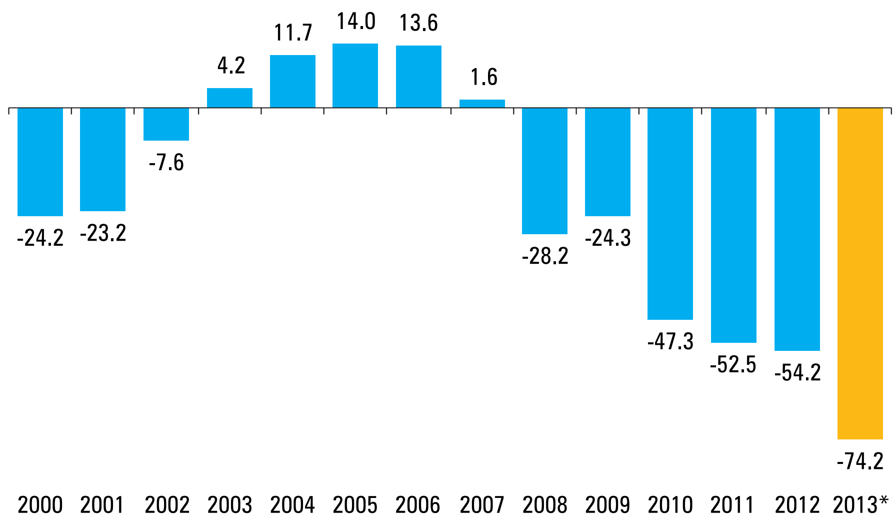
The competitiveness issues and an adverse international scenario will not be reversed in the short run. As a result, exports are unlikely to show signs of recovery by the end of the year – it will only react if the Brazilian currency remains depreciated for some time. Exports are thus expected to rise slightly, reaching US$ 249.3 billion, similar to the 2012 figure.

Imports remain on the rise, but will likely reduce their growth rate by the end of the year. A less favorable exchange rate coupled with the economic slowdown is expected to affect mainly imports of intermediate goods and raw materials – which account for most Brazilian imports.

Current account deficit

In US$ billion

Deficit to hit record high in 2013



Source: Central Bank of Brazil *Estimates: CNI

Imports will reach US$ 240.1 billion by the end of 2013, up by 7.6% from 2012. As a result, the trade balance will amount to only US$ 9.2 billion, almost half the level recorded in 2012.

Low trade balance contributes to increasing current account deficit

In the 12 months to May 2013, the current account deficit totaled US$ 72.9 billion, against US$ 50.7 billion in the twelve months ending in May 2012 (43.8% growth). During the period, the external deficit rose from 2.13% to 3.20% of GDP. Almost all (88.9%) of this increase can be explained by the drop in the trade surplus over the period. The rest is explained by an increased deficit in services, which is up by 10.6% and stood at US$ 43.7 billion in the twelve-month period to May.

During the same period, foreign direct investment (FDI) held virtually steady. FDI reached US$ 64.2 billion at the end of May 2013, an increase of only 1.1% over the previous 12 months. The 12-month FDI has been lower than the current account deficit in the same period since March – and this difference is growing.

For the remainder of the year, the current account deficit is expected to slow down its growth pace. Both the service account and the trade balance are unlikely to sustain the strong deterioration observed in early 2013. An unstable and depreciated exchange rate will partly contain the service deficit. Nevertheless, we estimate that the current account deficit will hit a record high: US$ 74.2 billion, an increase of 36.6%.

prospects for the Brazilian economy

	2011	2012	2013 *previous projection March/13*	2013 *projection*
Economic activity				
GDP (annual variation)	2.7%	0.9%	3.2%	**2.0%**
industrial GDP (annual variation)	1.6%	-0.8%	2.6%	**1.0%**
Household consumption (annual variation)	4.1%	3.1%	3.5%	**2.3%**
Gross fixed capital formation (annual variation)	4.7%	-4.0%	4.0%	**5.1%**
unemployment Rate (annual average - % of the labor force)	6.0%	5.5%	5.4%	**5.3%**
Inflation				
Inflation (IPCA - annual variation)	6.5%	5.8%	5.7%	**6.0%**
Interest rates				
Nominal interest rates				
(average rate in the year)	11.76%	8.63%	7.25%	**8.25%**
(year end)	11.00%	7.25%	7.25%	**9.50%**
Real interest rate (annual average and deflated rate: IPCA)	4.8%	3.1%	0.9%	**1.7%**
Public accounts				
Nominal public deficit (% of GDP)	2.61%	2.47%	3.20%	**3.40%**
Public primary surplus (% of GDP)	3.11%	2.38%	1.70%	**1.50%**
Net public debt (% of GDP)	36.4%	35.2%	35.4%	**34.9%**
Exchange rate				
Nominal exchange rate - R$/US$				
(average in December)	1.83	2.08	2.00	**2.18**
(average in the year)	1.67	1.95	1.98	**2.10**
Foreign trade sector				
Exports (US$ billion)	256.0	242.6	253.4	**249.3**
imports (US$ billion)	226.2	223.2	242.1	**240.1**
Trade balance (US$ billion)	29.8	19.4	11.3	**9.2**
Current account balance (US$ billion)	-52.5	-54.2	-68.1	**-74.3**

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