CNI Newsletter
ISSN 1676-5486 • Year 34 • Number 4 • December 2018

BRAZILIAN ECONOMY

Special edition of the Economic Report

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

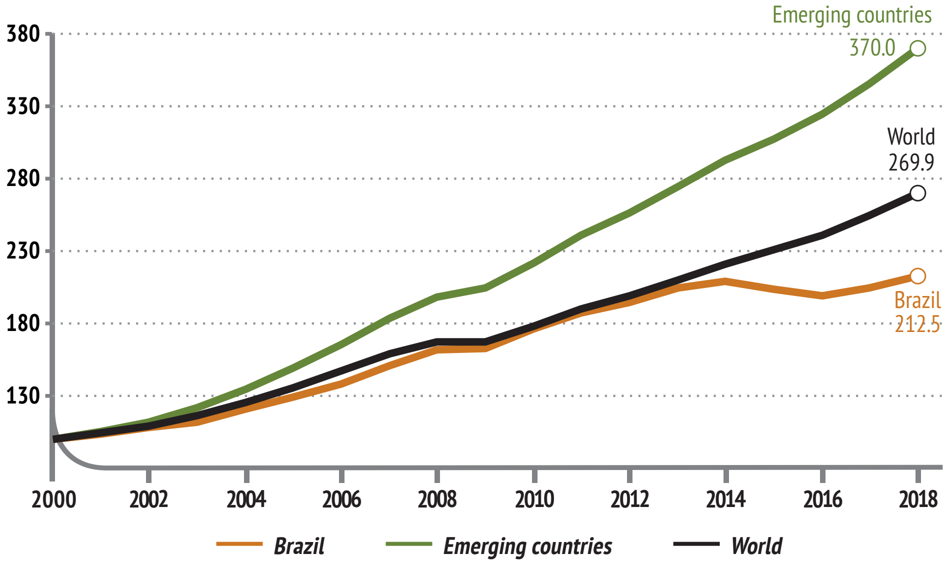
Frustration in 2018, optimism about 2019

In 2018, the performance of the Brazilian economy thwarted expectations. GDP growth left much to be desired at the beginning of the year, when the economy was expected to continue to recover at the same pace seen in the second half of 2017. Instead of the 2.6% growth predicted by CNI in December of last year, GDP will likely grow by only 1.3% in 2018. Industrial GDP will probably increase by only 1.3% instead of 3%, as expected early this year.

The gap between Brazil and advanced and emerging economies continues to widen

GDP trajectory (in international dollars and purchasing power parity)

Fixed base rate (2000 = 100)



Source: IMF.
Prepared by: CNI.

SECTIONS

These results are far from the average growth of 3.7% predicted for the world economy. Therefore, the gap between Brazil and advanced and emerging economies continues to increase.

Economic agents, especially those of the productive sector, expect the newly elected federal administration to implement reforms intended to boost production and investment, so as to ensure the feasibility of a new cycle of economic growth and thus reduce this gap.

This optimism was reflected in an upward shift in industrial entrepreneurs' confidence, especially after the results of the recent elections were announced. The Business Confidence Index, calculated by CNI, returned to a level similar to that observed in the period of greatest economic growth in the last decade, with a significant improvement in the expectations component for the coming months.

FRUSTRATION WITH 2018

There are many reasons for the frustration of expectations in 2018, almost all of which were influenced by the political scenario. Difficulties mounted as uncertainties associated with the electoral process - and its consequences for the economic agenda of whoever was elected - increased, leading economic agents to adopt a cautious behavior, with negative impacts on consumer and business confidence. As a result, consumption growth has slowed down (consumption will probably grow by only 2.1% against 2.8%, as anticipated in late 2017) and investment has been on hold (it increased by 5.1% after falling by 32.8% since 2014).

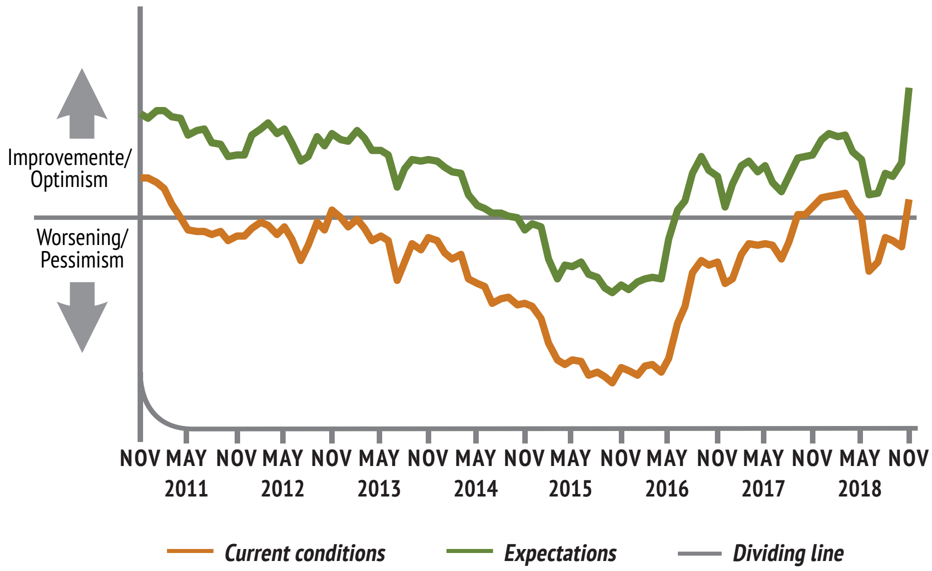
Postponed discussions about the Pension Reform bill mark the beginning of a downward shift in the recovery trend of the economy. After a federal intervention in Rio de Janeiro state was approved in February, the legislature stalled out. It became clear that structural changes, such as those proposed by reforms of this nature, would be put off until after the October general elections.

The confidence of economic agents was further shaken by a truck drivers' strike in May, which brought productive activity to a virtual halt and had a major impact on GDP in the second quarter. In this case, it became clear that the strike had been politically motivated, as it only ended after the government approved subsidies for truck drivers and a list of minimum freight prices, generating additional problems that are yet to be addressed. Intervening in the market is a practice contrary to the principles of free enterprise and to the policy of removing obstacles to a sound business environment, and it brought even more uncertainties.

Improved expectations and a more positive assessment of business conditions have boosted entrepreneurs' confidence

Components of the Business Confidence Index (ICEI)

Diffusion index (0-100 points)



Source: ICEI/CNI

Note: Figures above 50 points indicate improved current conditions or optimistic expectations.

Reforms made room for improvements in the business environment in which companies operate and contributed to recovering confidence in the Brazilian economy. It is necessary to continue to implement reforms and to increase their scopes

These events prevented the emergence of a benign macroeconomic environment and higher economic growth rates. Inflation remained low and will close the year at 3.8%, below the target center. Basic interest rates have been kept at 6.5% since April, their lowest historical level. The fiscal issue has evolved favorably, leading to a gradual reduction in the public deficit to 1.76% of GDP, below the target set for 2018. These factors alone would justify a better GDP performance.

The positive potential of endogenous effects, which feedback into economic recovery and are usually observed in cyclical recovery processes after a strong recession, was also limited. On the one hand, the fact that the number of unemployed and discouraged workers remains high reduced the response of household consumption due to the loss of income observed in this group. On the other hand, the fall in basic interest rates was not passed on to the interest rates paid by borrowers due to the prevalence of banking spreads that are still very high and to a previous scenario of excessive borrowing by consumers and companies.

The combination of weakening dynamics and political constraints has therefore reduced the pace of economic growth, postponing the resumption of a new growth cycle in the Brazilian economy.

HOW CAN BRAZIL RESUME A GROWTH PATH?

We have a well-known sustained growth agenda without any magic formula: it contemplates fiscal consolidation and a long-term adjustment of public accounts - by carrying out the pension reform and implementing other fiscal adjustment measures - with the aim of reversing the growth path of public debt and preserving economic stability.

Implementing the pension reform is key, as the current system is unsustainable. Without changing the current beneficiary eligibility criteria - by setting a minimum age for eligibility to avoid the early retirements allowed under the current regime - the system will collapse. These changes must also correct distortions and eliminate privileges enjoyed by certain groups in society with the aim of promoting a socially fairer system.

Besides fiscal and social security adjustments, it is also necessary to promote ongoing improvements in the business environment, which is a key measure to bring private investment back into Brazil and to increase our productivity.

A relevant set of reforms was carried out in Brazil over the last two years: a labor reform, which made labor contracts more flexible without removing workers' rights, the passage of a law on outsourcing, the passage of a constitutional amendment on a spending cap (EC 95/2016), and advances in privatization and in improving the governance of companies. These reforms improved the business environment in which companies operate and contributed to recovering confidence in the Brazilian economy. These reforms should be continued and deepened, as the gap between the quality of the Brazilian business environment and that of other developed countries, even emerging ones, is still very large.

However, this agenda has not been fully implemented. Some reforms are yet to be carried out, such as the pension reform (the consideration of which in Congress has been suspended) and other measures to control government staff costs. These measures are under discussion at the National Congress and may return to the priority agenda of discussions. Without them, the mandatory adjustment provided for in constitutional amendment EC 95/2016 will not materialize as efficiently as it should.

Little progress has been made in Congress in relation to the tax reform, which is part of a very important agenda on competitiveness. However, it has been increasingly discussed in society as a consensus is gradually built on its necessity and design, but based on the fundamental premise of not increasing the tax burden.

In our opinion, this reform should be focused on adopting a unified tax on the circulation of goods and services – a Value-Added Tax (VAT) - designed to eliminate cumulative taxation, simplify the tax system, and reduce ancillary obligations for taxpayers. However, simplifying the system does not mean pursuing simplistic solutions that are attractive at first sight but are clearly inappropriate for a complex economy such as ours.

The objective to be pursued should be that of promoting a rational and more efficient tax system, with positive effects for the allocation of funds and for promoting the competitiveness of our products, reducing tax compliance costs for companies. This would increase the efficiency and focus of government on allocating appropriate funds to reducing social inequalities through spending policies focused on lower-income individuals. As a result, it will be possible to reconcile the objectives of social equity and competitiveness.

SCENARIOS AND RISKS FOR 2019

Expectations for 2019 are positive – GDP is expected to grow by 2.7%, with a stronger contribution from industry (3.0% growth) and investment (6.5% increase). The performance of household consumption will also improve, making it possible for it to rise by 2.9%. The contribution of the external sector will once again be negative, with imports increasing more (7%) than exports (5%), according to the goods and services concept of the national accounts methodology adopted by the Brazilian Institute for Geography and Statistics (IBGE).

There is room for greater and sustained growth. This requires a well-defined agenda - with focus, political determination, and perseverance. **If substantial progress is made in the transformation agenda and in the proposed reforms, the response of economic agents may be faster and boost growth.** Consumers will be more confident in their consuming decisions and entrepreneurs will be more willing to invest and hire workers.

In this favorable scenario, the annualized GDP growth rate may hit the mark of 3% or more in the second half of the year. As a result, the Brazilian economy could record GDP and employment growth rates as high as in the past decade.

The risks for this virtuous scenario are fundamentally domestic, although there are uncertainties associated with the international scenario. The deceleration of the world economy as interest rates rise gradually in the United States and the US dollar appreciates is a scenario anticipated by economic agents whose effects are already being felt in most emerging countries. The position of Brazil's external accounts - and the level of its international reserves - provides a protective shield strong enough to ward off such risks for Brazil. The US-China trade war could eventually lead to destabilization by pushing commodity prices down if it causes a more significant slowdown in Chinese GDP growth.

Domestic risks are more significant. Limited or incomplete reforms constitute a hindrance to sustained growth. They affect both the perception of permanent balance in public accounts - and the process of controlling public debt growth - and of an improved business environment and increasing productivity. If expectations related to the reform agenda are thwarted, the confidence of economic agents, consumers, and investors may be affected, leading to a situation of semi-stagnation of the economy, which will show growth rates similar to those seen in 2017-2018.

Not addressing this agenda or postponing it would be even more detrimental. Such a situation could have a devastating impact on the confidence of economic agents, leading to a rapid deterioration of indicators for the so-called Brazil risk, financial assets, and the exchange rate, with effects on the domestic interest rate. This scenario could even lead to a comeback of the recession experienced in the middle of this decade.

SPECIAL TOPIC

International scenario: slower growth of the world economy

Trade tensions affect trade flows

During 2018, the international scenario pointed to changes in the relationship between several countries that affected global trade and reduced the prospects for global economic growth. The main events included, particularly, the following ones:

- The "trade war" waged by the United States against its main trading partners, especially China;
- Rising interest rates in the US, heating its economy; and
- AThe discussions on the agreement for the United Kingdom to leave the European Union *(Brexit)*.

Early in 2018, world growth forecasts pointed to a rate of about 4% (OECD, IMF). As trade tensions mounted, projections were adjusted and now these organizations expect world output to grow by about 3.7% this year and by 3.5% over the next two years. These forecasts assume that global tensions will not worsen, otherwise the growth rate is likely to be closer to 3% (OECD).

Throughout the year, international trade was affected by the United States' decision to impose surcharges on imports of certain products. In July 2018, the US government declared a trade war with China that was later extended to the European Union, Turkey, Canada, and Mexico, among other countries.

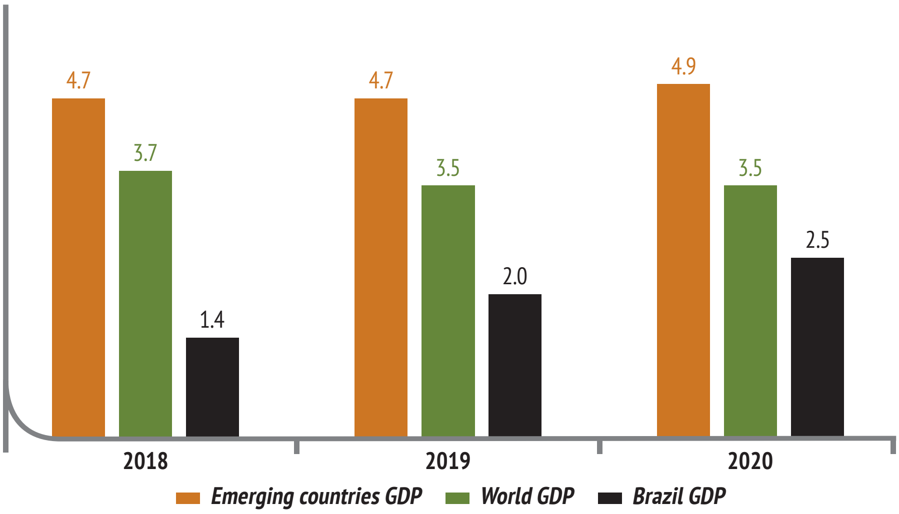
The tightening of trade restrictions between the two largest economies in the world has already been leading to a significant slowdown in the growth rate of trade flows both in regions directly affected by the surcharges imposed by the US and in others indirectly affected by them. If these tensions increase, they can reduce world trade substantially by 2020, leading to a decline in global output.

In the year to September, Asian countries were the ones marked by the sharpest slowdown in international trade. During this period, Asia's trade flow grew by 3.8% in relation to 2017, when the group recorded a 28.0% growth as compared to 2016. Currently, countries such as India, China, and other *commodity* exporters contribute significantly to international trade.

Global growth will likely slow down over the next two years

GDP growth projections

Fixed base rate (2000 = 100)



Source: IMF

Declining growth rates in emerging markets tend to jeopardize the global supply chain

RISING INTEREST RATES IN THE US AFFECT EMERGING COUNTRIES

China and India are likely to grow at a slower pace as a result of tariff measures. Generally speaking, a decline in the growth of these countries tends to jeopardize the global supply chain, leading to imbalance between supply and demand, changes in relative prices and, consequently, inflationary pressures.

Europe recorded a 0.5% loss in its cumulative trade flow up to September in relation to 2017, when it grew by 10.8% compared to the previous year. The European Union has been directly affected by the US import surcharge. In addition, the United Kingdom's exit from the economic bloc compromised capital flows, which accounted for approximately half of the region's GDP. *Brexit* will impose tariff barriers that could further hamper UK industry, creating uncertainties that have undermined investment.

The US government has been signaling that it will take measures to protect itself from inflationary pressures, which tend to increase as a result of import tariffs. The Federal Reserve has been pursuing a contractionary monetary policy throughout the year: interest rates rose from 1.75% a year in January of this year to 2.5% a year in December. Strong GPD growth in the US and the fact that unemployment is close to its natural rate in the country corroborate its decision to continue to pursue a contractionary monetary policy. These factors contribute to the maintenance of a conservative stance in relation to monetary policy and as a result interest rates are likely to hit the mark of 3.5% a year by 2020, according to some projections.

Given this scenario, the effects of US monetary policy tend to be stronger. Gradual and successive increases in interest rates put financial pressures on emerging markets and reduce the effectiveness of monetary policy in those countries.

The rise in interest rates in the US had a major impact on countries with a high foreign debt-to-GDP ratio. With the devaluation of their currencies against the US dollar, they experienced consecutive increases in their debt and interest rates, affecting the balance of their external accounts and leading to a downturn in their financial position. This is the case of Argentina and Turkey, for example, but not of Brazil, which has managed to keep balanced external accounts, partly due to its high trade surpluses.

In the short term, import barriers have had a positive effect on Brazilian exports. However, while exports of *commodities* and agricultural products increased, those of industrial products decreased (see the section on the Foreign Trade Sector). Nevertheless, the slowdown in world growth and international trade tends to compromise the current balance of Brazil's external accounts due to its effect on *commodity* prices.

In the first week of December, the US and Chinese governments committed to a 90-day truce on tariff barriers at a G20 meeting. In the face of so much tension and uncertainties, a temporary truce may not be enough to reverse the unfavorable projections for international trade prevailing today.

If these trade tensions are not eased, uncertainties tend to increase, restricting investments. This may worsen the situation of emerging countries, which are more dependent on external investment flows. It should be noted that economic growth is particularly slower in countries facing financial constraints and uncertainties regarding future structural reforms, as is the case in Brazil.

OVERVIEW IN 2018

Less intense recovery

Recovery in economic activity became less intense throughout 2018. Despite a benign macroeconomic scenario, marked by low inflation and interest rates at historical levels, the upturn in consumption was limited by a weaker than expected response from the labor market and by difficulties related to credit costs and availability.

Domestic uncertainties caused by difficulties to have Congress approve the Pension Reform and by a truck drivers' strike interrupted the upward trend of the confidence of economic agents throughout the year. As a result, CNI's forecast for GDP growth in 2018 has been revised downward to 1.3% from 2.6% at the beginning of the year.

In addition, electoral uncertainties made it difficult for the Brazilian economy to recover at a faster pace, mainly due to doubts related to the continuity of the reform agenda. The tax issue is still worrying and addressing it will require controlling compulsory spending, with emphasis on reducing pension and government staff costs. The Gross Debt-to-GDP ratio will likely close 2018 at 77.1%, up by 3.1 percentage points (p.p.) in relation to 2017.

LOWER GROWTH THAN EXPECTED

According to CNI estimates, GDP will likely grow by 1.3% in 2018 compared to the previous year. This figure is half that predicted at the beginning of the year. Albeit far from its potential, household consumption was the main driver of growth in 2018, with a projected growth of 2.1%. This positive shift reflects the improved financial situation of households, a gradual decline in unemployment, and Brazil's greater macroeconomic stability. Industrial GDP will in turn grow by 1.3%, interrupting a four-year downward trend (see the section on Economic Activity).

IMPROVEMENTS IN THE LABOR MARKET

The labor market recovered during 2018, albeit at a slower rate than expected. There was an increase in employment and the unemployment rate fell, while income and wages increased in real terms. CNI estimates that the average unemployment rate will close 2018 at 12.2% of the workforce, 0.5 p.p. below the rate registered in 2017 (see the section on Employment and Income).

INFLATION BELOW THE TARGET CENTER AND INTEREST RATES AT A NEW HISTORICAL LOW

The inflation rate remained below the target center during most of the year. CNI estimates that the Expanded Consumer Price Index (IPCA) will remain at 3.8% for the year, below the 4.5% a year target set by the National Monetary Council.

In 2018, the Central Bank continued to pursue an expansionary monetary policy, approving reductions of 0.25 p.p. in the first two meetings held this year and bringing the Selic rate down to 6.5% in March. After that, the Selic rate remained unchanged, reflecting an environment of macroeconomic stability where inflation has remained consistent with its target and economic activity has been recovering at a moderate rate. The Central Bank will likely keep the Selic rate at the same level in its last meeting in 2018. (see the section on Inflation, Interest Rates and Credit).

INCREASED REVENUES CONTRIBUTED TO REDUCE THE PRIMARY DEFICIT

Despite the expansionary fiscal policy adopted in 2018, with increased spending by the federal government and by states and municipalities, increased revenues of both the federal and regional governments will play a key role in achieving the primary result of the consolidated public sector. CNI estimates that the deficit will close 2018 at R$120.6 billion (1.76% of GDP as estimated by CNI), about R$40 billion below the target (R$161.3 billion). Despite this reduction, this result will be lower than the one recorded in 2017, of R$110.6 billion (1.69% of GDP) (see the section on Fiscal Policy).

EXCHANGE RATE VOLATILITY AND TRADE-RELATED TENSIONS

The year 2018 was marked by strong exchange rate volatility, fluctuations in the perception of Brazil's risk premium, and worsening of the trade balance and of the balance of current transactions. A turbulent international scenario contributed to contaminate Brazil's external accounts, even though the country is enjoying a much more favorable situation in the external landscape than some emerging countries. It is estimated that the current account deficit will hit the mark of US$15.0 billion, approximately 0.80% of GDP as projected by CNI (see the section on Foreign Trade).

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OUTLOOK FOR 2019

Newly elected government renews business and consumer confidence

The turn of the year will bring greater optimism about the future dynamics of the Brazilian economy. This positive feeling is mainly based on the expectation that the newly elected government will manage to implement an economic agenda favorable to business and to creating jobs, which requires structural reforms such as the pension and tax reforms, among other measures.

If the new federal administration truly manages to make progress on these reforms, Brazil will likely experience the beginning of a new cycle of economic growth. In response to this shift, the inflation rate is expected to rise modestly compared to 2018, but still remaining close to the target center. A similar shift is expected in the basic interest rate (Selic rate), which will likely rise moderately. In line with the pace of economic activity, the labor market is likely to recover more strongly, with more jobs being created and higher real wages.

The fiscal issue will in turn remain critical and will continue to be a potential source of uncertainties. The external scenario will also deserve more attention as it tends to become less favorable as a result of the US-led tariff war and of the upward trend of interest rates in that country.

INDUSTRY LEADING GROWTH

Economic activity as a whole will likely intensify throughout 2019, overcoming oscillations and consolidating a clearer growth trajectory. In this scenario, we estimate that GDP will grow by 2.7% in the coming year, with consumption increasing by 2.9% and investment by 6.5%.

On the supply side, special mention should be made of the 3% increase projected for industrial GDP, meaning that it will grow more than GDP for the first time since 2011. The service industry is also likely to grow significantly (by 2.5%). The agriculture-livestock sector is in turn expected to increase by 2% (see the section on Economic Activity).

UNEMPLOYMENT ON THE DECLINE

The labor market tends to follow the performance of economic activity, so net job creation is likely to increase next year. Therefore, CNI expects the average unemployment rate, as measured by the continuous PNAD (National Household Sampling Survey), to decrease in 2019 in relation to 2018, hitting the mark of 11.4% of the workforce (see the section on Employment and Income).

INFLATION REMAINS UNDER CONTROL

The inflation rate will likely increase moderately in 2019 as a result of a more intense growth of economic activity. However, it will still remain below the target center (which will be 4.25%). Thus, CNI predicts that the IPCA index in 2019 will amount to 4.1%.

Despite the expected growth in economic activity, low current inflation and market expectations will likely make it possible for the Selic rate to rise only marginally over the next year, reaching 7.5% in December. (see the section on Inflation, Interest Rates and Credit).

SPENDING CAP WILL LIMIT EXPENDITURES

Federal government primary spending is likely to increase by 1.0% in 2019 in real terms, in line with the rules of the cap imposed on public spending. As for revenues, a real growth of 2.6% is expected next year as economic activity improves.

In this scenario, the primary result of the consolidated public sector will likely be negative by R$115.4 billion (1.57% of GDP), exceeding the target set for 2019 (R$132.0 billion) by R$16.6 billion.

However, the decline in the primary deficit forecast for 2019 will likely be more than offset by the increased nominal interest spending resulting from increases in interest rates. As a result, the nominal deficit would increase to 7.8% of GDP, leading to a further increase in the public debt ratio, which may close 2019 at 79.5% of GDP (see the section on Fiscal Policy).

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EXTERNAL ACCOUNTS NOT UNDER THREAT

There is consensus regarding the slowdown in global GDP in 2019 as a result of trade-related tensions. The pace of GDP growth is expected to increase in the US, with a positive impact for Brazil, as the United States is a major trading partner of the country. In addition, the tendency is for the US to continue to pursue a contractionary monetary policy, raising the value of the US dollar against other currencies. Thus, the average exchange rate will likely amount to R$1/US$3.78 in 2019.

In this scenario, CNI projects a surplus of US$45 billion in the trade balance for 2019, lower than the figure estimated for 2018 (US$53 billion). Current account results are also expected to worsen, from US$-15.0 billion in 2018 to US$-22.0 billion in 2019. However, this deficit is not likely to threaten the external balance, as it will be lower than the inflow of funds via direct investment (see the section on the Foreign Trade Sector).

ECONOMIC ACTIVITY

Disappointing growth in 2018

Industry closes the year with limited advances

The year 2018 was disappointing and difficult with regard to economic activity. Not by chance, macroeconomic forecasts for the year have been repeatedly revised downward. At the end of 2017, CNI predicted that GDP would grow by 2.6% in 2018 in the wake of the improved confidence and financial position of economic agents, declining unemployment, and return of investment. Our forecast at the end of 2018 is that GDP will grow by only 1.3% - half of the figure predicted early this year. In the case of industrial GDP, the figure was revised downward from 3% to 1.3%.

The data for the first quarter of 2018 were positive, but they already showed that economic activity was recovering at a slower pace than expected, challenging more optimistic projections for the year. Growth in industry was only modest.

The truck drivers' strike in May changed this scenario. Its impacts on economic activity in that month were severe and the recovery recorded in the following months, albeit significant, left much to be desired. In addition, consumer confidence and, above all, business confidence took a downturn once again. Expectations worsened and investment intentions, which had been improving, also declined. Uncertainties increased both in the domestic market, due to political unpredictability, and in the international market.

In November, after the results of the elections were announced, business and consumer confidence took a sharp upturn. The data for economic activity in October - the most recent ones available when this report was being prepared - show that industry is still faltering and needs a stronger stimulus from household consumption to recover more decisively. For the remainder of the fourth quarter, we expect to see more positive data resulting from increased household consumption and economic activity.

GDP estimate for 2018

Projected change (%)

	GDP COMPONENTS	Rate of change (%)
Demand side	Household consumption	2.1
	Government consumption	0.2
	Gross fixed capital formation	5.1
	Exports	3.0
	(-) Imports	10.0
Supply side	Agriculture/livestock	0.4
	Industry	1.3
	Mining and quarrying industry	0.5
	Manufacturing industry	2.1
	Construction industry	-0.5
	Public utility industrial services	1.5
	Services	2.5
	GDP	**1.3**

Prepared and projected by: CNI

In sum, industry is closing 2018 with advances, albeit limited, compared to 2017. As a result, it is still very far from the levels recorded before the four years of industrial activity between 2014 and 2017 - in terms of revenue, production, and employment. Idle installed capacity also remains high.

A more widespread and intense recovery of industry is expected next year as today's broadly positive expectations translate into increased consumption, production, and occupation of idle capacity. Intensifying and maintaining this growth rate will depend on the degree of success of the newly elected federal administration in implementing its reform agenda, which would lead to a more effective investment response.

CONFIDENCE OF ECONOMIC AGENTS ON THE RISE

After the results of the elections were announced, business and consumer confidence rose to their highest levels in years.

Business confidence increased remarkably, according to the Business Confidence Index (ICEI/CNI). Between October and November, confidence rose by 9.5 points, the highest increase between two consecutive months since the beginning of the monthly series in 2010. The highest monthly growth before this one was 4.5 points, recorded between April and May 2016. As a result, ICEI reached 63.2 points in November 2018, the highest figure recorded for the index since September 2010, when it amounted to 63.3 points. The last time the index exceeded 60 points was in March 2011.

The ICEI index in November is 6.7 points higher than the one recorded in November of last year and 9.0 points above its historical average. Confidence increased in a widespread fashion, among companies of all sizes and all activity sectors.

In should be noted that the increase in business confidence is due to both improved expectations and to a more positive assessment of current business conditions.

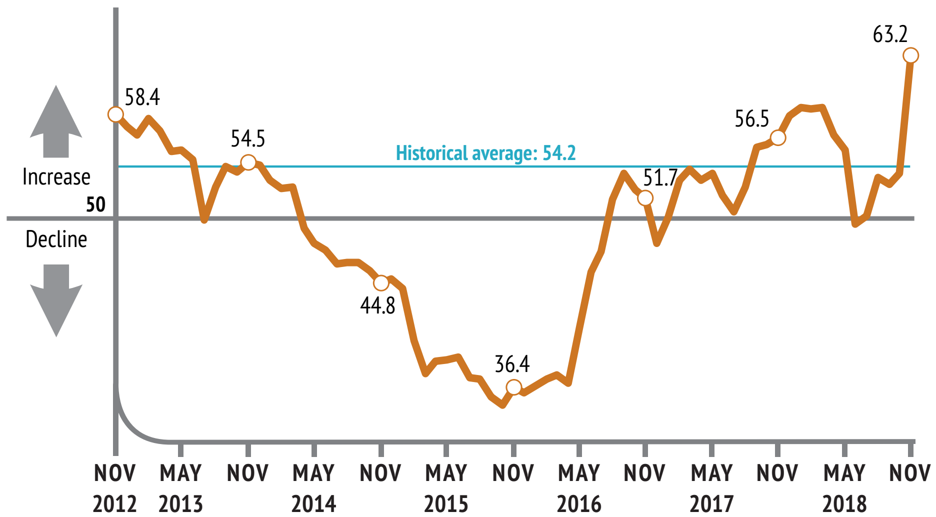
In the case of consumer confidence, its upward trend had been detected back in October already. The prospect of lower political uncertainty led the Consumer Confidence Index (INEC/CNI-Ibope) to increase by 4.4%, reaching its highest figure in four years. There was a further increase in November (the fifth consecutive one), this time of 2.7%. The INEC index hit the mark of 113.6 points, 5.8% higher than the historical average of 107.8 points and the highest figure recorded since January 2014.

It should be mentioned that the INEC index rose not only as a result of a significant improvement in expectations, but also due to a more positive assessment of the financial situation of consumers and to lower debt levels among them. As the financial situation of consumers improves, the increase in consumer confidence will translate into greater consuming power, especially of goods

Business confidence is at the highest level in eight years

Business Confidence Index (ICEI/CNI)

Diffusion index (0-100 points)



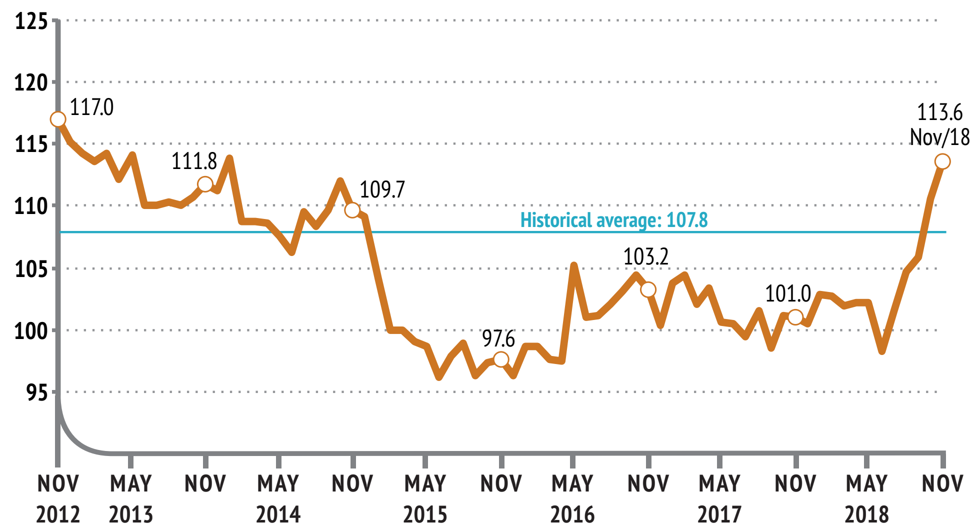
Source: ICEI/CNI

Note: Figures above 50 points indicate confidence on the part of businesses. The higher above 50 points, the greater and more widespread the confidence.

Consumers are even more optimistic than in November

Consumer Confidence Index (INEC)

Fixed base rate. 2001 average = 100



Source: INEC/CNI

of higher value, which tend to eat up most of the income of families and require a more meticulous planning. The INEC index does not yet indicate improved expectations of buying goods of this type, but it is likely to do so in the coming months.

In short, the optimism of entrepreneurs and consumers increased substantially not only due to their improved expectations, but also to the influence of the current conditions of both of them. For confidence to remain at such high level in the medium term, beyond the typical "honeymoon" period observed after elections, the reform agenda must be effectively pursued and the economy must show clearer signs of improvement.

A LONG RECOVERY PATH

In December 2017, CNI estimated that industry would in that year interrupt a sequence of three years of negative results, during which it shrank by 10.9%. Back then, we expected industrial GDP to grow by 0.2%. However, as results at the end of the year proved to be less positive than previously assumed and after GDP data were revised (see box), it is now likely that industry will only finally interrupt its sequence of declines in 2018. Industrial GDP growth projected by CNI in 2018 is one of 1.3%.

AComparing 2018 to October with the same period in 2017, average capacity utilization (Industrial Indicators/CNI) grew by 0.3 p.p. (from 77.3% to 77.6%), while industrial production (PIM-PF/IBGE) increased by 2% on the same comparison basis. Real sales (Industrial Indicators/CNI) increased more significantly on this basis of comparison (4.8%). In this case, however, the exchange rate also had a bearing on the scenario, as it increased the value of exports in Reals (the Brazilian currency depreciated by 14% comparing the average recorded in 2018 to October against the average observed in the same period in 2017).

The crisis faced by industry was more pronounced than expecteda

Revised GDP data for 2017 and 2016, which were released in November, confirm the size of the disaster faced by industry between 2014 and 2017. Industry had already declined by 1.5% in 2014 and by 5.8% in 2015. Its decline in 2016 was revised upward from 4% to 4.6%, while the result in 2017, before the return of a stable environment, was revised downward for a fourth decline in a row, of 0.5%. Thus, industrial production decreased by 12% - losing more than one-tenth of its full value - in four years.

In 2018, it is projected to grow by only 1.3%. At this pace, it would take another eight years for industrial production to return to the levels recorded in 2013. That is, industrial losses during this period would only be recovered in 2026.

It should be noted, however, that much of the growth recorded in 2018 is due to its statistical effect over the past year. Earnings declined over the course of the current year, especially in the third quarter, and virtually all the data for manufacturing industry were negative, as can be seen in the table.

The mining and quarrying industry did not grow very significantly in 2018. In the year to October, it grew by only 0.5%, even though production in this industrial segment in October (PIM/PF-IBGE) increased by 3.1%, recovering the decline observed in the previous two months.

The construction industry continues in turn to face serious difficulties. Demand for this industry has been low throughout the year. With respect to building construction works, it was only at the end of the year that uncertainties subsided, the financial situation of families became more balanced, and confidence rose; therefore, no significant shift in demand has been perceived in that sector. As for infrastructure works, the serious fiscal situation faced by the federal administration and by state and municipal governments, apart from restrictions imposed by the electoral year, made new projects virtually unfeasible.

EVEN WITH LIMITATIONS, CONSUMPTION EXPLAINS GROWTH IN 2018

We are projecting a 2.1% increase in household consumption in 2018, which is the main reason for GDP growth from the perspective of spending. The improved financial situation of households resulting from the drop in unemployment and inflation and from low interest rates contributed to boosting consumption.

This recovery could have been more pronounced had it not been for the slow decline in unemployment, with a still high number of unemployed and discouraged workers and a strong contribution of informal employment. High banking spreads are another factor limiting the pace of recovery of consumption, as they limit the pass-through of the decline in basic interest rates to households. Finally, the high uncertainty that prevailed for most of the year prevented confidence - and purchases - from rising more strongly.

We are projecting a 5.1% increase in Gross Fixed Capital Formation (GFCF) in 2018. This will be the first increase after four years of reductions - which led to an impressive total drop of 32.8%. This growth, which is small compared to the magnitude of the total drop recorded in recent years, must be viewed with caution. This expansion is partly due to a change in the REPETRO regime, which grants special tax treatment to oil and gas investments. This change has been generating significant flows of “imports” of oil rigs that are merely of an accounting nature, impacting GFCF.

The contribution of foreign trade to GDP will be strongly negative in 2018. The change in the REPETRO regime affects foreign trade statistics, partly explaining the significant increase observed in imports. On the other hand, exports are being affected by the crisis in Argentina, the main destination of Brazilian manufactured goods, and also by increasing uncertainties about the trade war and the rise of interest rates in the United States (for more details, see the section on the Foreign Trade Sector). We are predicting a 3% increase in exports and a 10% increase in imports.

In the last quarter of the year, industry is at levels close to those recorded in late 2017

Industrial activity indicators (seasonally adjusted)

Variation between December 2017 and October 2018

REAL SALES
Stable

HOURS WORKED IN PRODUCTION
Drop of 2.1%

PRODUCTION
Drop of 3.5%

EMPLOYMENT
Drop of 1.0%

CAPACITY UTILIZATION
Fall of 0.6 percentage points

Source: Industrial Indicators/CNI and PIM-PF/IBGE
Prepared by: CNI

OUTLOOK

OPTIMISM AND RISKS

With confidence, expectations, and purchases on the rise at the end of 2018, a larger number of temporary workers will likely be hired and industrial activity may become more intense in early 2019 than in recent years, leading to the replenishing of inventories.

Throughout the year, without interruptions for hosting the World Cup or uncertainties associated with the electoral process (or with an unexpected crisis in the transportation sector, as seen in 2018), the economy is likely to recover on a more widespread basis. Confidence will likely remain on the rise as expectations, now largely positive, improve in relation to employment and income. Consequently, it is expected that idle capacity will be gradually occupied and that investment will rise. In this scenario, we are projecting a 2.7% GDP growth in 2019.

The risk - both positive and negative - for this dynamic lies in the pace at which reforms are implemented. In an optimistic scenario, government manages to secure a stable majority in Congress capable of soothing the fierce political atmosphere prevailing today. In this scenario, positive and broad reforms are approved with clear prospects of being continued and deepened in the coming years. Thus, additional improvements in the business environment will likely lead to a more robust recovery of the economy, which may close 2019 at an annualized growth rate in excess of 3%.

In a pessimistic scenario, only reforms with a limited scope and/or effectiveness are approved. If this happens, expectations, especially those of entrepreneurs, could be quickly reversed and lead them to resume a cautious stance in relation to hiring workers and investing. In this case, recovery could once again become erratic, or even interrupted altogether, jeopardizing growth prospects for 2019 and subsequent years. In an even more pessimistic scenario, failure to pursue this reform agenda would lead to rapid deterioration of risk and confidence indicators, with impacts even on the current macroeconomic balance. In this case, we could even face a new recession.

Another risk to the base scenario lies in the foreign trade sector. If trade tensions escalate, we may experience additional impacts on trade flows and investments, new increases in interest rates in the US, and further declines in global output growth (see the section on the Special Topic "International Scenario: lower growth of the world economy").

CONSUMPTION AND INVESTMENT ON THE RISE

In the base scenario, with low interest rates and inflation, financial recovery of households, low uncertainty, and confidence on the rise, household consumption will likely continue to increase in 2019. Over the course of the year, we expect to see a further drop in unemployment and more formal jobs becoming available, which will sustain - or even speed up - growth in the second half. As a result, we are projecting a 2.9% growth in household consumption in 2019.

Even though it is still restricted by the strong need for fiscal adjustment, we are projecting a marginal increase in government consumption in 2019, even as economic activity expands: 0.5%.

GDP estimate for 2019

Projected change (%)

	GDP COMPONENTS	Rate of change (%)
Demand side	Household consumption	2.9
	Government consumption	0.5
	Gross fixed capital formation	6.5
	Exports	5.0
	(-) Imports	7.0
Supply side	Agriculture/livestock	2.0
	Industry	3.0
	Mining and quarrying industry	2.2
	Manufacturing industry	4.8
	Construction industry	0.3
	Public utility industrial services	1.8
	Services	2.5
	GDP	**2.7**

Prepared and projected by: CNI

We are projecting a 6.5% growth in Gross Fixed Capital Formation (GFCF) in 2019. Although idleness in production will still be high in early 2019, the prospects of more intense and, above all, lasting growth coupled with more favorable financial conditions will likely lead to increased investment. The investment indicators for the manufacturing and mining and quarrying industries (Industrial Survey/ CNI) and for the construction industry (Construction Industry Survey) are already indicating an upward trend in investment intentions at the end of 2018.

This investment dynamic is particularly vulnerable to the risks already mentioned in the Outlook part of this section, including both domestic and external risks. In addition, the impacts of the REPETRO regime have increased, affecting investment statistics.

The contribution of foreign trade to GDP will likely be negative in 2019 once again. Imports are likely to remain on the rise, as increased economic activity tends to stimulate imports of inputs, consumer goods, and capital. Exports are in turn are more subject to this less favorable and volatile scenario abroad. We expect imports of goods and services to grow by 7% in 2019 and exports of goods and services to increase by 5% (both according to IBGE's National Accounts concept).

INDUSTRY WILL GROW MORE STRONGLY IN 2019

Inventories in manufacturing industry will be replenished early in 2019 as a result of sales higher than expected in 2018. Throughout the year, industrial production will likely remain on the rise in the wake of higher domestic consumption and higher investment. This increase will be more pronounced in the manufacturing industry, while the mining and quarrying industry, which is more subject to the scenario abroad, may show more moderate growth rates.

We also expect the year to mark the beginning of the recovery of the construction industry. The sector will likely have a positive result in 2019, after shrinking for five years in a row. Nevertheless, the result of the sector will still be limited by the critical fiscal situation faced by the Union and states, especially with regard to infrastructure projects.

In this scenario, we are projecting a 3% growth for industrial GDP in 2019, greater than that predicted for GDP.

The service sector will likely growth by 2.5%. As in 2018, this growth will not be restricted to retail, as it will comprise transportation and services provided to households. The agricultural sector is likely to increase by 2% as a result of a greater grain harvest and more favorable climatic conditions for agribusiness. It is also expected that progress will be made on the sector's regulatory agenda. On the other hand, this result can also be affected by a more adverse scenario abroad.

EMPLOYMENT AND INCOME

Labor market improves less than expected

Low growth, high idleness, and uncertainties prevent more significant improvements in employment in the year

The Brazilian labor market improved moderately in 2018. There was an increase in employment and the unemployment rate declined, and both average income and total earnings took an upturn. But this recovery was less intense than CNI expected.

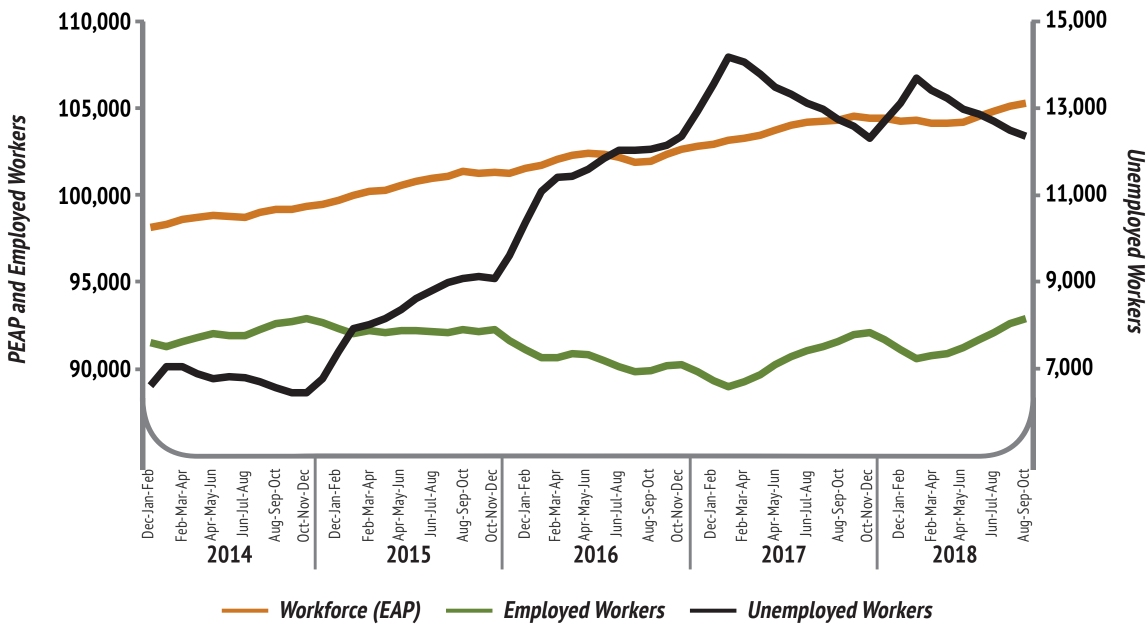
The low growth rate of economic activity in the year was the main reason for this frustration. At the end of last year, CNI had projected a growth of 2.6% for GDP in 2018, but this forecast has been revised downward to 1.3%. Structural barriers, such as the failure to approve the Pension Reform, as well as barriers, such as the truck drivers' strike, also contributed to this slower growth (see the section on Economic Activity).

The lack of greater incentives for investment - due to low confidence levels, high idle capacity, and high financial capital costs - also contributed to the weaker employment dynamics.

The number of unemployed people in Brazil doubled in 2018 compared to the period before the economic crisis in 2014

Workforce (EAP), employed workers, and unemployed workers

In thousands of people



Source: Continuous Monthly PNAD survey/IBGE

These factors prevented a more robust growth in employment despite improvements in the normative environment for labor relations resulting from the modernization of labor laws in 2017.

In this scenario, CNI predicts that the average unemployment rate in 2018 will hit the mark of 12.2% of the workforce, which is still a very high rate, as it represents almost 13 million people without jobs.

UNEMPLOYMENT RATE DECLINES AT A SLOW PACE

In 2018, the unemployment rate as measured by the National Continuous Household Sampling Survey (Continuous PNAD/IBGE) once again recorded a seasonal upward trend early in the year - due to the layoff of temporary workers at the end of each year - followed by a downward path from the second quarter.

Despite following the expected trajectory, the magnitude of the decline in the indicator was modest. More significant improvements in employment were expected. However, a reduction in employment growth was observed over the year.

The decline observed in formal employment was also frustrating. The drop in the unemployment rate was supported by an increase in informal jobs. Informal employment in the private sector (excluding domestic workers) increased by 5.9% in the quarter ended in October compared to the same period in 2017, while formal employment in the private sector declined by 1.1% on the same basis of comparison.

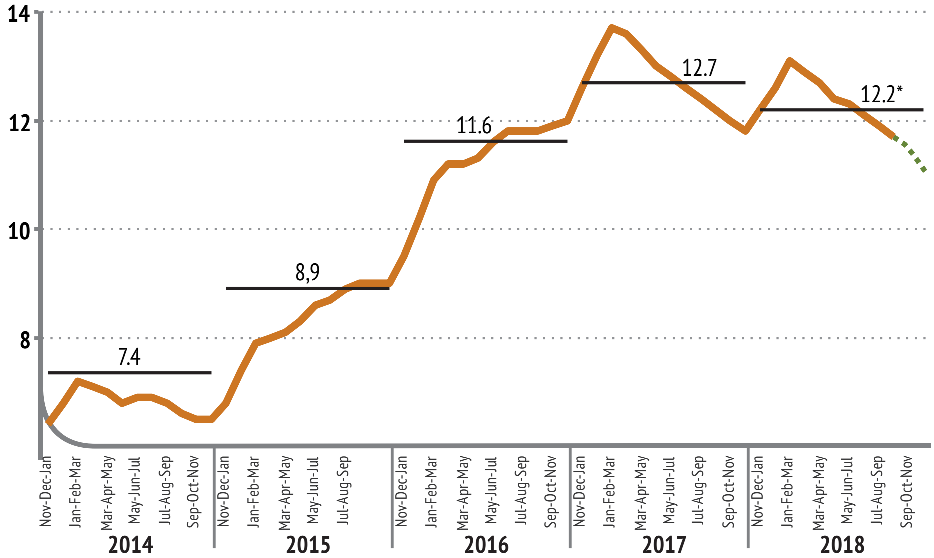
Considering that informality increased in all categories (private sector, domestic workers, helping hand in the family, public sector, employers, and independent workers), informal employment already accounts for 44% of the labor market.

CNI projects that the average unemployment rate in 2018 will hit the mark of 12.2% of the workforce, 0.5 percentage points below the rate recorded in 2017.

Moderate decline in the unemployment rate in 2018

Unemployment rate (quarterly moving average) and average annual unemployment rate

As a percentage of the workforce (%)



Source: Continuous Monthly PNAD survey/IBGE
*CNI forecast

FORMAL EMPLOYMENT AS MEASURED BY CAGED TO RECOVER IN 2018

Formal jobs, as measured by the General Registry of Employed and Unemployed Persons (CAGED/MTE), took an upturn in 2018. Between January and October, the net balance of formal jobs reached 790,600 vacancies. Net job creation was recorded in almost all sectors of the economy in the year. The only exception was the retail sector, in which 10,300 jobs were lost during that period.

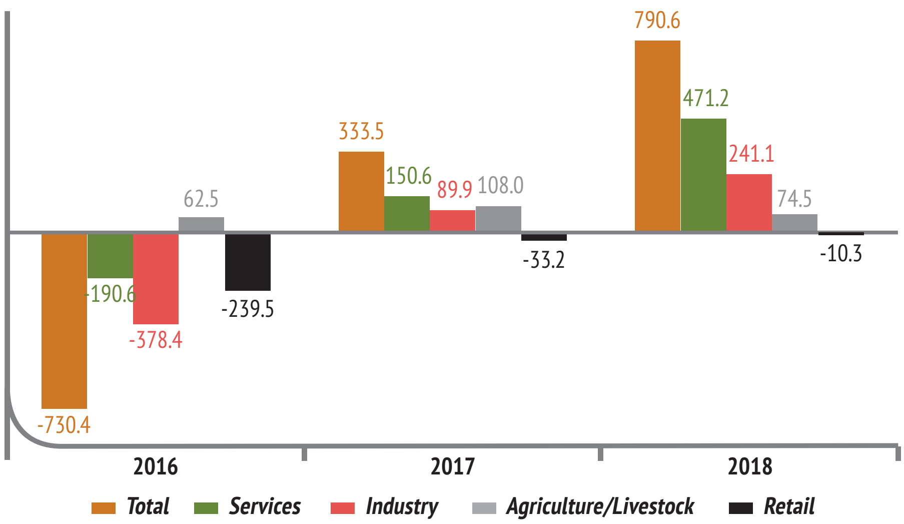
In the 12-month period to October, 444,500 net jobs were created, with the service sector accounting for 361,400 new jobs during that period.

It should be noted that unlike the Continuous PNAD survey/IBGE, which produces information based on sample data and on the moving average methodology, the data collected by CAGED/MTE are monthly census data exclusively focused on shifts in waged employment governed by the Consolidated Labor Laws (CLT).

Formal employment as measured by CAGED will likely stop decreasing in 2018

*Net balance of formal jobs - in the year to October**

In thousands



Source: CAGED/TEM

In the last two months of the year, loss of net formal jobs is expected due to both the seasonality of the agricultural sector and layoffs of temporary workers in the industrial sector, who were hired to meet the stronger demand it faces at the end of the year.

Despite the decline observed over the last two months, Brazil is likely to close 2018 with net formal job creation, against a drop of 12,600 in 2017. This will interrupt a sequence of a negative net formal job balance for three years in a row, when more than 3.5 million formal jobs were lost in the economy.

TOTAL EARNINGS GROW WITH THE RISE IN INFORMAL JOBS

In 2018, average real income grew at much lower rates than in 2017 in the year-on-year comparison. A somewhat higher inflation and the rise in informal jobs, which pay lower wages than formal ones, contributed to this slowdown.

However, the increased number of employed workers led to a significant increase in real total earnings. In the comparison between the moving quarter ended in October with the same quarter in 2017, the indicator recorded a variation of 1.9%. This growth resulted from a 0.4% increase in the average real income usually earned by workers and from a 1.5% increase in jobs, which represented the creation of 1.4 million jobs in the economy during the period.

The increase in total earnings and the reduction in the basic interest rate in the year should have contributed to a more robust growth of household consumption and thus of economic activity at large.

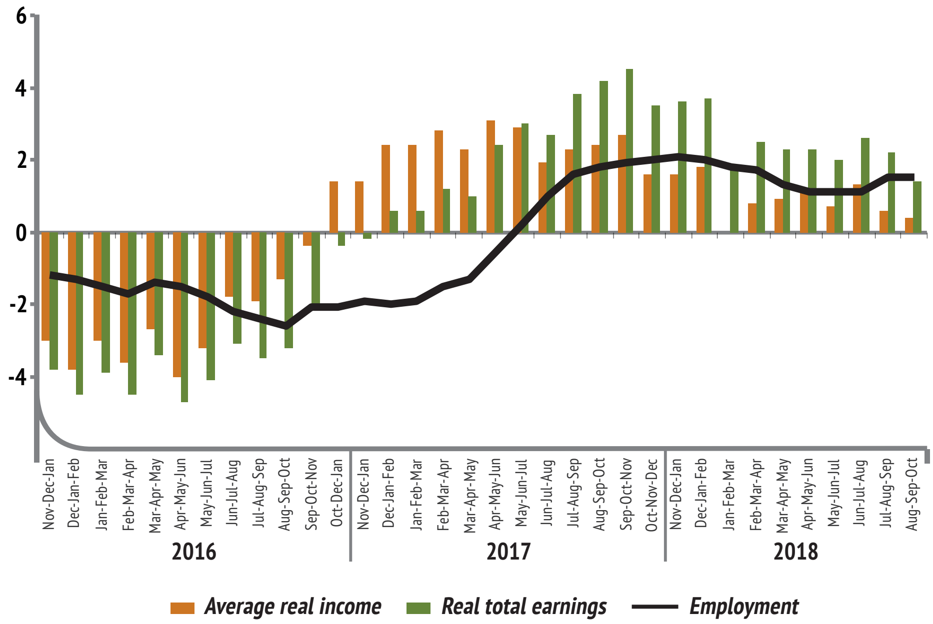
However, a scenario of high unemployment rate, low consumer confidence, and costly financial capital due to high banking spreads limited the effect of the increase in total earnings on household consumption, which will likely grow by 2.1% this year as predicted by CNI (see the section on Economic Activity).

In the two last months of the year, total earnings are expected to remain on the rise - albeit at a lower rate than during the course of the year - as a result of temporary hiring, especially in the retail sector, and of the increase in average real income. As a result, CNI estimates that total earnings will grow by 2.1%, 0.6 percentage points (p.p.) less than in 2017.

Real total earnings continue to grow in 2018

Average real income, real total earnings and employment

Variation as compared to the same moving quarter the year before (%)



Source: Continuous Monthly PNAD survey/IBGE

CNI

OUTLOOK

EMPLOYMENT LIKELY TO INCREASE MORE IN 2019

With the new Government, progress on structural reforms such as the Pension Reform is expected in 2019. Other short- and medium-term fiscal adjustment measures will likely contribute to fix public accounts, which will in turn boost the confidence of economic agents (see the section on Fiscal Policy).

Further growth in economic activity with inflation under control as now is also expected. This favorable environment signals more significant improvements in employment next year compared to 2018.

It should be noted, however, that the cost of credit is likely to rise as a result of an expected increase in the Selic rate of up to 1 p.p. (see the section on Inflation, Interest Rates and Credit). However, a more favorable economic environment will likely make up for this increase and prevent negative effects on investment and consumption intentions in the year and, consequently, on employment.

In view of these effects, the recovery of the labor market - and in particular unemployment reduction - may become somewhat more intense than this year. CNI estimates that the average unemployment rate will reach 11.4% of the workforce by 2019 against the 12.2% rate estimated for 2018.

INFLATION, INTEREST RATES AND CREDIT

Inflation remains under control

IPCA index will close 2018 below 4%

In 2018, the strong disinflation process observed in 2017 was not repeated, but inflation is still under control and will remain below the target center. Last year, the National Extended Consumer Price Index (IPCA) dropped to its lowest level since 1998 (2.9%), mainly as a result of record agricultural harvests. The resulting oversupply pushed food prices down and led to a series of negative shifts in this group.

This year, a partial recuperation of food prices and adjustments in government-regulated prices led the indicator to rise more sharply. Despite this shift, the inflation rate remained below the target center for practically the whole year, except in September and October.

Inflation was kept under control mainly by the behavior of free prices, which continue to surprise positively as inflation in services remains on a downward path and food prices rise less than expected, even after the agricultural harvest returned to usual levels.

Service prices, which are usually influenced by the inertia caused by their indexation to past inflation and to the minimum wage, decreased significantly. Prices in this group dropped from a 4.6% hike in 12 months to November 2017 to 2.9% over the same period in 2018.

Food prices, which had been increasing moderately, rose more sharply in June due to the truck drivers' strike. However, in the following months they returned to the positive behavior seen previously, clearly showing that the effect of the shock had been a one-off event. Prices in this group went from a 5.2% drop in 12 months to November 2017 to a 4.0% increase in 12 months to November 2018.

In the case of industrial products, their prices continued to behave favorably, as had been observed last year. Prices in this group rose from 0.9% in 12 months to November 2017 to 1.5% in 12 months to November 2018.

The greatest pressure on the IPCA index, especially from the second half of the year on, came from government-regulated prices. These prices increased due to the exchange rate devaluation and to the rise in international oil prices and in the cost of electricity during this period, as water levels in the reservoirs of hydroelectric plants dropped and distributors rose their prices sharply. Prices in this group increased by 9.9% in the 12-month period to November.

For December, the inflation scenario remains favorable. The negative variation in fuel prices seen in November will likely be repeated, albeit less intensely, as a result of the drop in oil prices.

Electricity prices, which decreased from level two of the red flag rate to the yellow flag rate in November, will be charged at the green flag rate in December. Although water levels in some reservoirs are quite low, the rainy season will likely continue to increase the capacity of hydroelectric plants to generate electricity and to reduce the hydrological risk factor.

As a result, the IPCA has been estimated to rise by 0.19% in December, leading the inflation rate to close the year at 3.8%, below the 4.5% a year target set by the National Monetary Council.

SELIC RATE LIKELY TO CLOSE 2018 AT A HISTORICAL LOW

Throughout 2018, the IPCA suffered certain pressures that led the monetary authority to remain on the alert: the devaluation and volatility of the exchange rate, as a result of a more challenging international scenario and uncertainties associated with the presidential elections; and the truck drivers' strike, which occurred at the end of May. These factors of pressure, however, were addressed over the months and did not prevent the inflation target from being met.

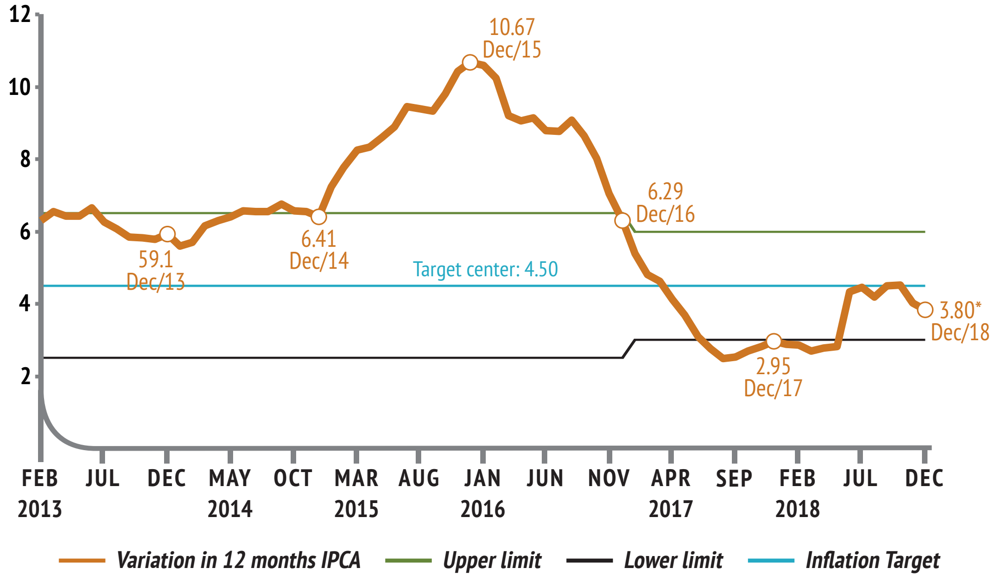
In this scenario, and considering the anchored expectations for inflation in the coming years, it was possible to keep the Selic rate at its lowest level since 1999.

The basic interest rate started the year at 7.0% and, after being reduced by 0.25 p.p. twice, it hit the mark of 6.5% in March. At its last meeting held on October 31 the Monetary Policy Committee (Copom) kept - for the fifth time in a row - the Selic rate at 6.5%. The rate is likely to kept at the same level at the last meeting of the Copom, which is scheduled to held on December 12.

Inflation will likely close the year at 3.8%

IPCA and the target set by COPOM

12-month figure (%)

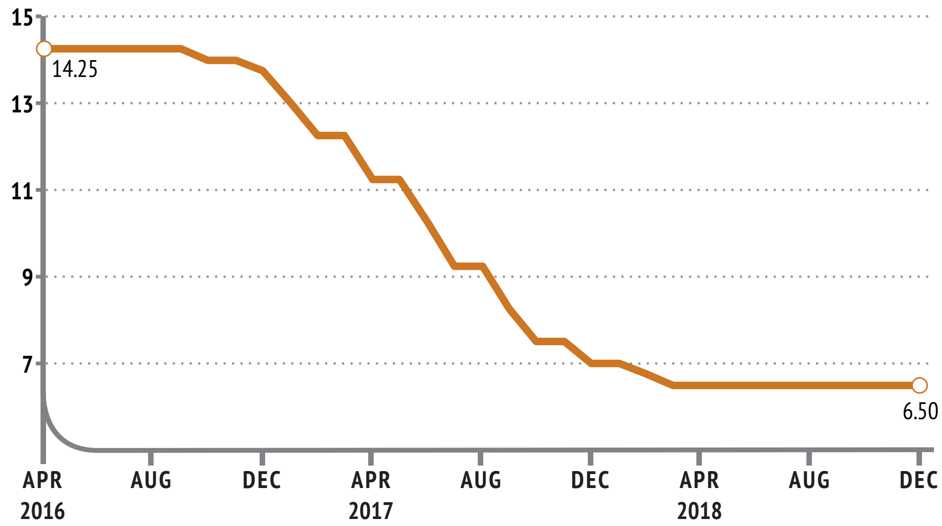


Source: IBGE
*CNI forecast

Selic rate hits the mark of 6.5% a year

Basic interest rate - Selic rate target set by Copom

Final rate for the period (% a year)



Source: Central Bank of Brazil

CREDIT ON THE RISE IN 2018

The year of 2018 marked a shift in credit granting, which had been registering negative variations since 2014. Total loans increased by 6.6% in real terms between the 12-month period to October 2018 and the same period in 2017. On the same basis of comparison between 2017 and 2016, total loans had decreased by 3.1%.

This increase in loans to companies was slightly higher than the one recorded for individuals, as rates of 7.9% and 5.6% were observed for the two, respectively, on the same basis of comparison. In operations with non-earmarked funds, the performance of the portfolios of companies and individuals was similar in the period, with variations of 10.9% and 6.3%, respectively.

A reduction in financing costs in the year, both for individuals and corporations, was an important variable for this shift. Interest rates on loans granted with non-earmarked funds dropped from 43.6% a year in October 2017 to 38% a year in October 2018.

The decrease in interest rates on credit operations with non-earmarked funds was more significant for households, whose average loan cost decreased by 7.4 percentage points, from 59.3% to 51.9% a year, while that of companies declined by 2.9 percentage points, from 23.3% to 20.4% a year, on the same comparison basis.

This reduction was mainly due to the decline in the basic interest rate and to a lower rate of default on credit repayment. The percentage of the credit portfolio of the National Financial System with at least one installment in arrears for more than 90 days fell from 3.63% in October 2017 to 3% in October 2018.

On the other hand, the total balance of credit operations is still on the decline, albeit at decreasing rates. The total average balance in the last 12 months to October in real terms was -2.1% in 2018, against -6.7% in 2017.

For individuals, there was an increase of 2.8% in 2018 compared to a drop of 0.4% in 2017. The credit balance for legal entities recorded in turn a -7.3% shift against -12.6% on the same basis of comparison.

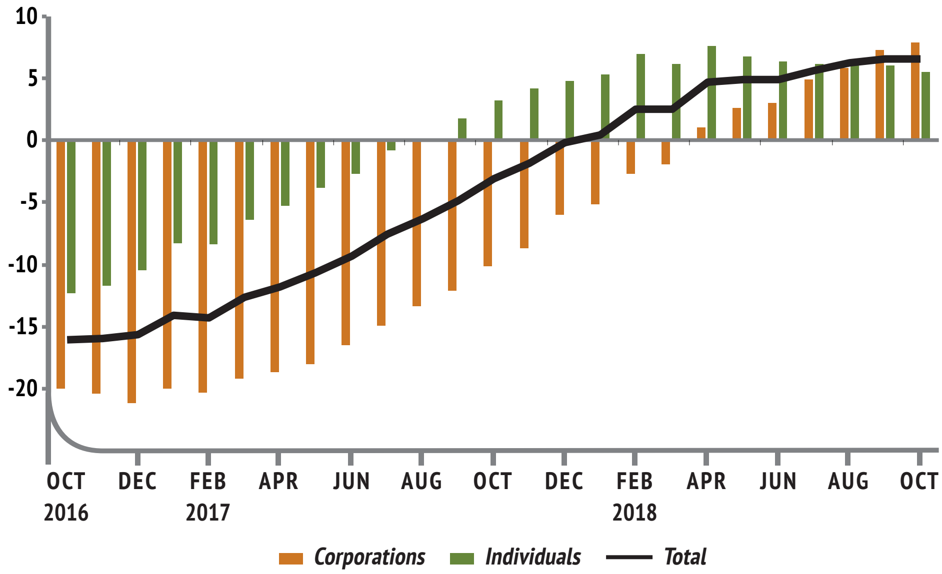
Despite the upward trend observed in the credit market, the current level of the basic interest rate should have led to a much more significant improvement in the indicators. However, on the supply side of credit, the collateral requirements imposed by banks and high banking spreads still make it difficult for borrowers to access financing lines. On the demand side, the low business and consumer confidence rates recorded throughout the year and a high unemployment rate, added to the moderate recovery of economic activity, ended up discouraging potential borrowers from seeking loans.

These difficulties are reflected in the country's credit-to-GDP ratio, which in October amounted to 46.3%. It is the lowest rate in October since 2011, when it recorded 45.3%. It should be noted that this performance is well below the world average of 130% (World Bank, 2018).

Granting of credit on the rise in 2018

Granting of credit, in real terms

Variation in 12 months (%)



Source: Central Bank of Brazil

OUTLOOK

INFLATION BELOW THE TARGET FOR THREE YEARS IN A ROW

Inflation will likely continue to show a positive behavior in 2019 due to a still high idleness in the economy and a high unemployment rate. In addition, the fact that the Central Bank adopted a more credible monetary policy has anchored expectations, facilitating the convergence of prices toward the target. However, because economic activity is likely to grow at a faster pace, the IPCA index is expected to rise to 4.1% a year, still below the inflation target set by the National Monetary Council, of 4.25% per year.

This expected moderate rise in the IPCA index and the prospects that it will remain at low levels in the coming years - within the target set by the Copom of 4.00% a year in 2020 and of 3.75% a year in 2021 - will likely allow for the basic interest rate to rise only marginally, even considering the increased economic growth rate expected for the year. CNI expects the Selic rate to increase by up to 1 percentage point from the second half of 2019, closing the year at 7.5% p.a.

It should be stressed that, in the medium term, monetary policy will be determined not only by the evolution of economic activity and prices, but also by whether reforms are actually carried out to some degree or not - especially the Pension Fund - and by the trajectory of public accounts toward fiscal balance.

Therefore, considering that progress will likely be made on these agendas from 2019 on, despite the higher growth rate expected for the economy, current inflation at a low level and anchored expectations for the coming years are likely to make it possible for the monetary authority to resume an expansionary policy as early as in 2020.

In relation to the credit market, the forecasts of stronger growth in 2019 will likely contribute to making more credit available. The magnitude of this increase will depend, on the one hand, on the effect of the *Selic* rate on credit operations and, on the other, on the adoption of policies designed to reduce banking *spreads*. The approval of the Cadastro Positivo (positive credit record) will represent a major advancement on this agenda, since this measure will allow financial agents to have more information about borrowers, making it possible to reduce banking *spreads* in Brazil.

FISCAL POLICY

Expansion of compulsory spending challenges the spending cap rule

Defrayal and investment spending at very low levels in 2019

Fiscal policy was expansionary in 2018, with increased spending on the part of the federal administration and of states and municipalities. However, this will not prevent compliance with tax rules this year. Different factors will play a key role in meeting each of these rules. Increasing the revenues of both the federal administration and regional governments will be decisive for achieving the primary result target. The spending cap rule imposed on the federal government will be observed without major difficulties due to the margin to grow left by cuts in spending in 2017, the first year in which the rule became effective. Finally, the golden rule, according to which additional debt contracted by the federal government cannot exceed its annual capital spending, will be met with the help of BNDES funds to be returned to the National Treasury.

Nevertheless, the fiscal situation remains worrying. Compliance with the spending cap in 2019 will depend on reducing non-compulsory spending once again, including investment. In the case of the golden rule, it will be necessary to rely on the option provided for in the Constitution and approve additional credits in Congress to cover current expenditures contemplated in the budget. However, both primary and nominal fiscal results in 2019 will not be sufficient to prevent a further increase in public sector debt.

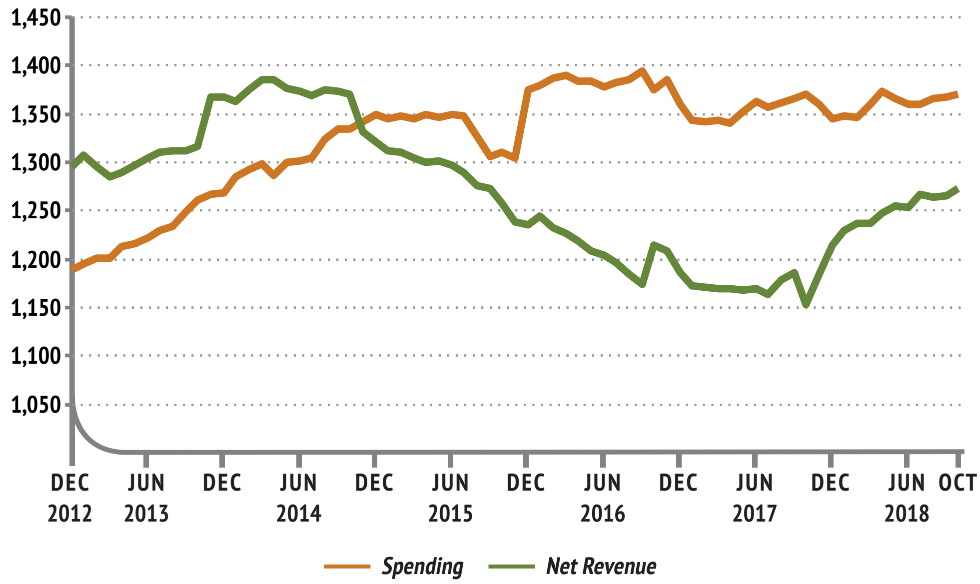
IMPROVED ECONOMIC ACTIVITY CONTRIBUTED TO INCREASE FEDERAL GOVERNMENT REVENUES

The net revenues of the federal government recorded a real increase (IPCA deflator) of 6.0% between January and October 2018 compared to the same period in the previous year. This result is mainly due to improvements in economic activity and in some non-recurring revenues.

Net revenue grows at a faster pace than that of federal government spending

Evolution of primary spending and net revenue of the federal government

In 12 months (R$ billion in October 18)



Source: National Treasury Secretariat/Ministry of Finance.
Prepared by: CNI

Revenues managed by the Brazilian Internal Revenue Service (RFB) grew by 5.8% in real terms in the first 10 months of 2018 in relation to the same period in 2017. The main factors with a bearing on this performance include the collection of tax debts with the federal government in installments, the increase in the PIS/COFINS taxes on fuel, the increase in the sales of goods and services, and the increase recorded in industrial production.

Another major contribution came from revenues not managed by the RFB, which grew by 21.5% in real terms in 2018 to October in relation to the same period in the previous year. This growth is mainly explained by increases in financial compensation for natural resources exploitation resulting from the exchange rate devaluation and the rise in international oil prices, as well as from revenues from concessions derived from the 15th round of oil and gas concessions and from the 4th round of auctions of fields in the pre-salt layer.

In relation to spending, federal government expenditures increased by 2.3% in real terms in the year to October in relation to the same period the year before. This behavior is due to a 0.8% growth in compulsory spending and to a 10.0% increase in non-compulsory expenditures.

Among mandatory expenditures, the most intense upward pressures came from spending on pensions and personnel, which increased by 1.6% and 1.0% in real terms, respectively, on the same basis of comparison. However, these pressures were partly offset by a decrease in other compulsory expenditures, such as with subsidies, salary bonuses, and unemployment insurance.

The significant increase recorded in non-compulsory spending reflects in turn difficulties to curb it as in 2017, when it declined by 14.0% in real terms compared to 2016. However, it should be stressed that investments (capital expenditures minus subsidies for the Minha Casa Minha Vida [my home, my life] program) showed real growth of 18.9% between January and October 2018 against the same period in the previous year. In 2017, investments decreased by 28.5% in real terms compared to 2016.

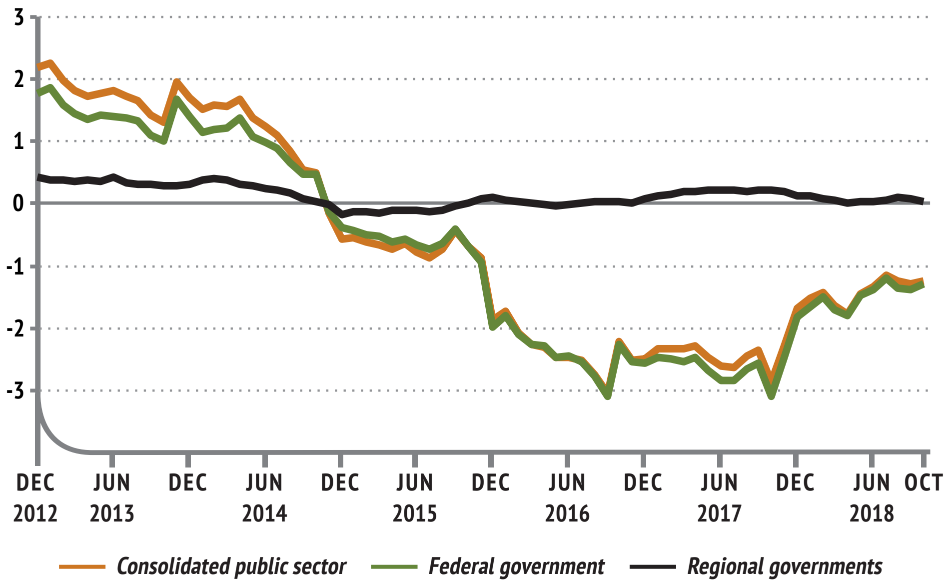
SPENDING OF STATES AND MUNICIPALITIES REMAINS ON THE RISE

The spending of states and municipalities increased significantly in 2018 and at a faster pace than in 2017, when it took an upturn once again after being kept under strict control for two years.

Primary deficit of the public sector in 12 months on a downward path since October 2017

Primary result of the consolidated public sector and by levels of government

As a percentage of GDP (%)



Source: Central Bank of Brazil
Prepared by: CNI

Based on the available data for the revenues of states and municipalities and on the behavior of the primary result of these units of the federation, CNI estimates that the spending of regional governments rose by 6.0% in real terms between January and September 2018 in relation to the same period in 2017.

The available data indicate that these revenues increased by 5.0% in real terms in the first nine months of 2018 against the same period in 2017. Revenues from the ICMS tax, the main source of revenue for regional governments, showed real growth of 4.1% on the same comparison basis. These revenues were favored by the resumption of economic growth and increases in the ICMS tax approved by several state governments.

The improved economic environment, which had a positive effect on revenues from federal taxes shared with states and municipalities, as well as the increased financial compensation for mineral exploration, led transfers from the federal administration to increase by 7.5% in real terms in the first nine months of 2018 in relation to the same period in 2017.

SIGNIFICANT REDUCTION IN THE PUBLIC SECTOR PRIMARY DEFICIT

The strong revenue growth experienced by the federal government and by regional governments has more than offset increased spending in all spheres of government. As a result, in 2018 the public sector primary deficit remained on the downward path that began to be observed in October 2017. In the last 12 months to October 2018, the primary deficit of the public sector hit the mark of R$84.8 billion (1.24% of GDP), down by 54.7% compared to October 2017, when the deficit amounted to R$187.2 billion (2.87% of GDP).

This reduction in the primary deficit, combined with a decline of 0.6 percentage points of GDP in spending on nominal interest, led the 12-month nominal deficit to drop from 7.8% in December 2017 to 6.8 % in October 2018. Despite the reduction in the nominal deficit and the return of R$130 billion from the BNDES to the National Treasury, public sector debt (Gross Debt-to-GDP ratio) increased by 2.5 points in the comparison between October 2018 (76.5%) and December 2017 (74.0%).

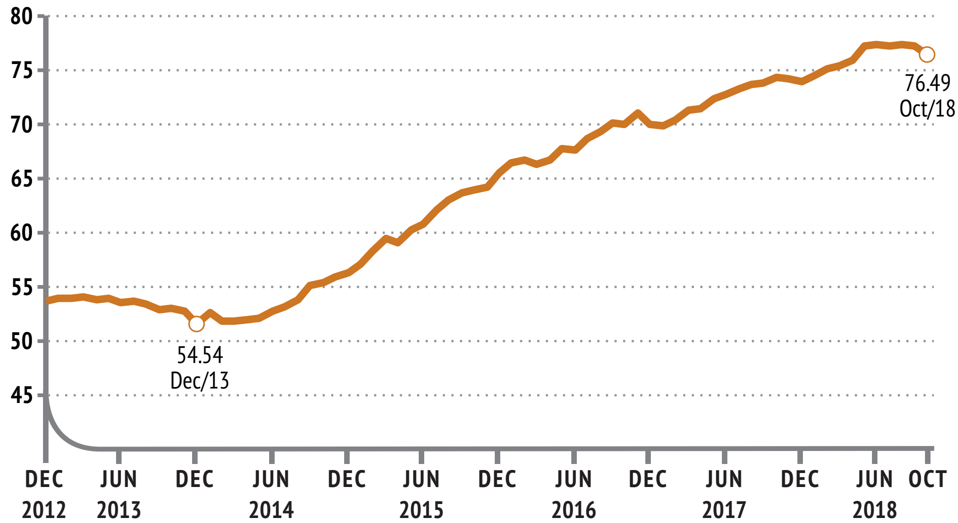
PRIMARY DEFICIT LIKELY TO CLOSE 2018 BELOW THE TARGET

The increase in federal government revenues, the main factor leading to the fall in the primary deficit in the first ten months of 2018, is likely to be less intense in the two last months of the year. However, as the pace of spending growth will not likely change significantly until the end of the year, the federal government's primary deficit is expected to close 2018 well below the primary result target. Because the primary surplus of regional governments will likely exceed its target and federal state-owned companies are

Gross Debt-to-GDP ratio increased by 2.5 percentage points between December 2017 and October 2018

Path of the Gross Debt of the Public Sector in relation to GDP

As a percentage of GDP (%)



Source: Central Bank of Brazil

Federal government spending is likely to increase at a faster pace in the two last months of the year as a result of a more intense growth of spending on personnel and pensions

also expected to show positive results, the primary deficit of the consolidated public sector is likely to close 2018 at about R$40 billion below the target.

The net revenue of the federal government is likely to grow, in real terms, by 2.4% in 2018 in relation to 2017. Although this level is considerably lower than that observed in the first ten months of 2018, it still represents a very significant increase, given that the economy will probably grow by 1.3% in real terms. A slowdown in the growth rate of net revenue in relation to the 6.0% increase observed until October will likely lead to a less intense increase in revenues not managed by the Internal Revenue Service. We also expect to see a slower increase in revenues managed by the Internal Revenue Service. First, because revenues generated by a program on debt repayment in installments implemented during the same period in 2017 will not be repeated in the two last months of the year. Second, because the PIS/Cofins contributions on fuels will not be raised at the same pace as in the first half of 2018, as their increase was already in force in the second half of 2017, thus increasing the comparison basis.

Regarding federal government spending, it will likely rise at a faster pace in the two last months of the year, closing 2008 at 2.8%, against the 2.3% growth observed until October. This shift will probably be triggered by a more intense increase in spending on personnel and pensions. Spending on personnel will continue to reflect wage increases granted in early 2018 and will likely close the year with a real growth of 1.9%. Social security expenditures are expected to close the year with a real increase of 2.1% due to increases in the number of pensioners and in the value of pensions.

In this scenario, and since federal state-owned companies will likely have a primary surplus of about R$6 billion, CNI estimates that the federal government and its state-owned companies are likely to close the year with a primary deficit of R$126.1 billion (1.84% of GDP as estimated by CNI). If confirmed, this result will be well below the R$162.5 billion target set for 2018 and close to the R$119.4 billion primary deficit (1.82% of GDP) observed in 2017.

In states and municipalities, revenues will likely continue to grow at the same pace in the two last months of 2018. Apart from increasing revenues from the ICMS tax, the continued resumption of economic activity increased the revenue from federal taxes shared with regional governments.

On the side of primary spending, the resumption of full repayment in installments of the debt of states with the federal administration from July 2018 will likely continue to slow down the growth pace. Thus, the primary surplus of states is likely to increase and reach R$5.5 billion in 2018 (0.08% of GDP as estimated by the CNI).

As a result, the consolidated public sector is expected to record a primary deficit of R$120.6 billion (1.76% of GDP as estimated by CNI) in 2018. The target set for the deficit in 2018 (R$161.3 billion) will likely be exceeded by more than R$40.0 billion. This result, however, will probably be slightly higher than the R$110.6 billion deficit (1.69% of GDP) observed in 2017.

The increase in the primary deficit in relation to 2017 will be more than offset by the reduction in spending on nominal interest. Thus, the nominal deficit will probably decrease slightly, from 7.80% of GDP in 2017 to 7.69% in 2018. This level, however, is still well above the required nominal deficit to stabilize the Gross Debt-to-GDP ratio. Despite the return of R$130 billion from the BNDES to the National Treasury in compliance with the so-called Golden Rule, the Gross Debt-to-GDP ratio will likely close 2018 at 77.1%.

OUTLOOK

COMPLIANCE WITH THE SPENDING CAP IN 2019 RESTRICTS NON-COMPULSORY SPENDING

Primary spending of the federal government is expected to grow by 1.0% in real terms in 2019, in line with the cap on public spending growth, which was largely observed in 2018. However, the composition of this spending deserves special attention. To offset the further real growth in compulsory spending, non-compulsory spending is expected to be strongly curbed. Thus, planned investments amount to only R$27.4 billion, against R$31.1 billion in 2018 and R$33.1 billion in 2017. The same will occur with non-compulsory defrayal of costs.

Among compulsory expenditures, the real growth of 4.6% in spending on personnel is noteworthy. This projection contemplates the cost of R$1.4 billion for the federal government alone resulting from the salary raise approved for justices of the

Federal Supreme Court (STF). It also includes an additional cost of R$4.7 billion resulting from an expected salary raise for federal civil servants if Provisional Measure (MP) 849/2018, which postpones the wage increase to 2020, is not approved or is ruled unconstitutional by the STF, as occurred with a provisional measure that postponed the wage increase granted in 2018.

Spending on pensions, which is expected to increase by 2.4% in 2019, will be another source of pressure from compulsory spending. In addition to the effects of a real increase in the minimum wage that has been approved, social security spending will continue to be impacted by the increase in the number of pensioners.

On the revenue side, a real growth of 2.6% is expected in 2019. This growth will likely be brought about by revenues managed by the Internal Revenue Service, which are expected to grow by 4.2%, and by the revenues of the social security system, which are projected to increase by 3.0%. Revenues managed by the Internal Revenue Service will likely be boosted by the faster growth pace of the economy, while social security revenues will be favored by the increase in total payroll.

In this scenario, the federal government is expected to record a primary deficit of R$125.9 billion, below the R$ 142.5 billion target set for 2019. If confirmed, this result will reverse the upward trajectory observed in the primary deficit in 2018. The result expected for the consolidated public sector will likely be even lower, as regional governments are expected to achieve the primary surplus target of R$10.5 billion set for 2019. Thus, the public sector primary deficit would amount to R$115.4 billion (1.57% of GDP as projected by CNI) in 2019 and would exceed the R$132.0 billion target set for the year by R$16.6 billion.

However, the decline in the primary deficit projected for 2019 is likely to be significantly exceeded by the expected increase in spending on nominal interest, which will be brought about by a likely increase in the Selic rate. As a result, the nominal deficit would increase to 7.82% of GDP, leading to a new increase in the Gross Debt-to-GDP ratio, which would close 2019 at 79.5%.

The main challenge for public accounts in 2019 and in the coming years will therefore be that of controlling compulsory spending to ensure compliance with the spending cap rule and, mainly, to prevent public sector debt from rising further.

FOREIGN TRADE SECTOR

Lower trade surplus increases the deficit in current transactions

Exchange rate volatility and trade-related tensions mark the year 2018

In 2018, the performance of external accounts was not as positive as in the previous year. The year was marked by strong exchange rate volatility, fluctuations in risk perception, a lower trade surplus, and a higher deficit in current transactions. A turbulent international scenario contributed to contaminate external accounts, mainly those of emerging countries. In the case of Brazil, this effect was intensified by electoral uncertainties that prevailed until October.

While the results of the election were uncertain, Brazil's risk rating (EMBI) soared, affecting the exchange rate. The US dollar started the year rated at R$3.22/US$1. Before the elections, it rose to R$4.19/US$1 and after its results were announced it dropped to R$3.64/US$1. From November onward, it began to show an upward trend that is likely to continue due to the strengthening of the US dollar as interest rates rise in the US.

This year, Brazil's trade balance surplus, which had been on an upward trend, took a downturn despite a favorable exchange rate for exports. This result is explained by a strong growth in imports in the wake of improved economic activity. In addition, the truck drivers' strike in May and June of this year and the crisis in Argentina affected exports of *commodities* and manufactured goods, which grew at a slower pace than in 2017. Nonetheless, the trade surplus in the year to November amounted to US$51.7 billion, the second highest figure in its history for the period.

As the trade surplus declined, the 12-month cumulative current account deficit, which had been falling over the last three years, rose once again from US$5.7 billion in January of this year to US$15.4 billion in October. On the other hand, direct investment in the country increased by 16.4% on the same basis of comparison, hitting the mark of US$75.0 billion. Despite the slight deterioration in Brazil's external accounts, its trade balance *surplus* and high levels of direct investment will continue to ensure the soundness of its external accounts.

EXCHANGE RATE DEVALUATION AND VOLATILITY THROUGHOUT 2018

In 2018, the domestic scenario was marked by political uncertainties that affected Brazil's investments abroad and the value of the Brazilian currency. The exchange rate was also strongly affected by events abroad, especially in the second half of the year, as a result of the protectionist trade policy and monetary policy adopted by the US, which appreciated the dollar against other currencies, mainly those of emerging countries.

Exchange rate fluctuations have a negative effect on the business environment, as they affect the predictability of prices, turnover and, consequently, of business contracts. An unstable and high country risk rating as of the second half of the year affected investments and the appreciation of Brazil's assets.

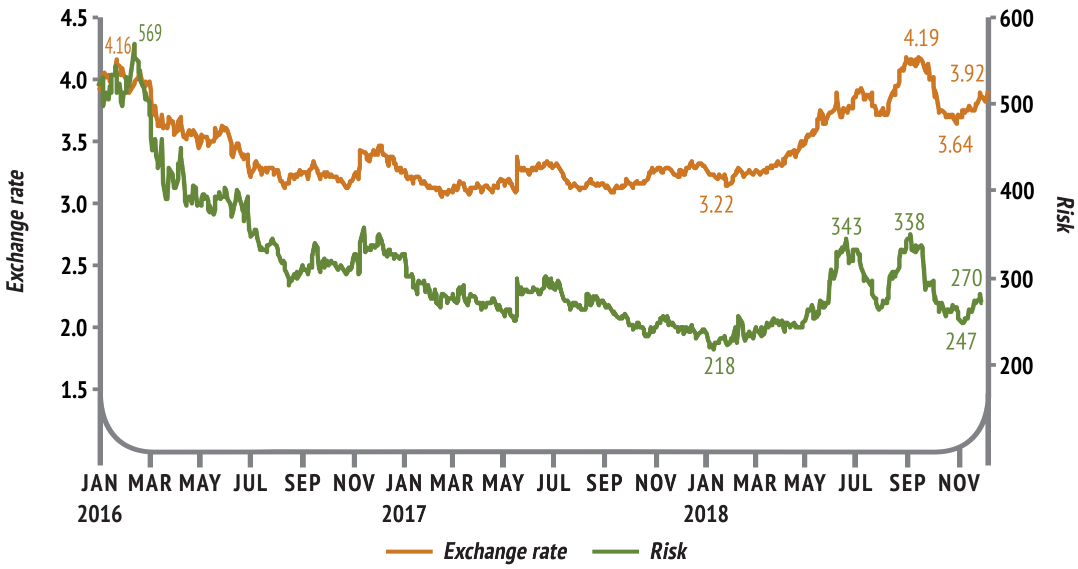
Brazil's country risk rating started the year at 218 points, then it spiked and fluctuated between May and October, reaching 343 points, and closed November at 270 points. The risk perception of economic agents, as measured by this indicator, increased during the period leading up to the elections. Fluctuations in risk also contributed to the exchange rate volatility recorded over the same period. Despite this turbulent domestic scenario, Brazil's country risk rating registered an average of 271 points this year against 276 last year.

The US dollar exchange rate spiked during the period preceding the October elections, when it soared to R$4.19/US$1 (on September 14). After the results of the elections were announced, the Brazilian currency appreciated against the US dollar, as its exchange rate dropped to R$3.64/US$1 on October 29. From then on, the US dollar appreciated gradually to R$3.90/US$1 in early December, possibly influenced by the rise in interest rates in the US. Since interest rates in Brazil are at a historically low of 6.5% a year,

Brazil's country risk swings contributed to exchange rate volatility

Daily exchange rate (Ptax closing rate) and EMBI risk*

In R$/US$ (exchange rate) and points (country risk rating)



Source: Central Bank of Brazil and JP Morgan
Prepared by: CNI
* The closing Ptax rate is the arithmetic average of bid and offer rates published in daily bulletins.

higher interest rates in the US reduce the gap between the remuneration of Brazilian and foreign bonds, making American bonds relatively more attractive and reducing the demand for Brazilian bonds.

Poward the end of the year, the US dollar will likely remain appreciated, particularly due to the monetary policy adopted by the Federal Reserve of the United States. According to our projections, the average exchange rate in December will be R$3.80/US$1, 15.5% higher than the average recorded in December of last year, R$3.29/US$1. As the average for the year, we are projecting an exchange rate of R$3.64/ US$1, up by 14.1% over last year's average of R$3.19/US$1.

TRADE SURPLUS DECLINES IN 2018

Brazil's trade balance recorded a surplus throughout 2018, with a positive result of US$51.7 billion in the year to November. However, the surplus was 16.7% lower than in the same period in 2017. Imports grew at higher rates than exports. While imports grew at a monthly average rate of 3.4%, exports increased by 2.6% a month on average, despite a relatively high exchange rate. In the year to November, the import balance amounted to US$168.3 billion, up by 21.8% in relation to the same period in 2017, and exports totaled US$ 220.0 billion, up by 9,9% in the annual comparison.

Since 2014, the trade surplus had been growing at significant rates. In 2018, the result of the trade balance shows a reversal in this growth trajectory due to a turbulent scenario domestically and abroad and also to the resuming of economic growth, which led to an increase in imports. In the domestic scenario, the truck drivers' strike between May and June of this year jeopardized trade flows, leading the trade balance to fall by 33.3% between June and July. Imports recovered rapidly, but exports remained low until October.

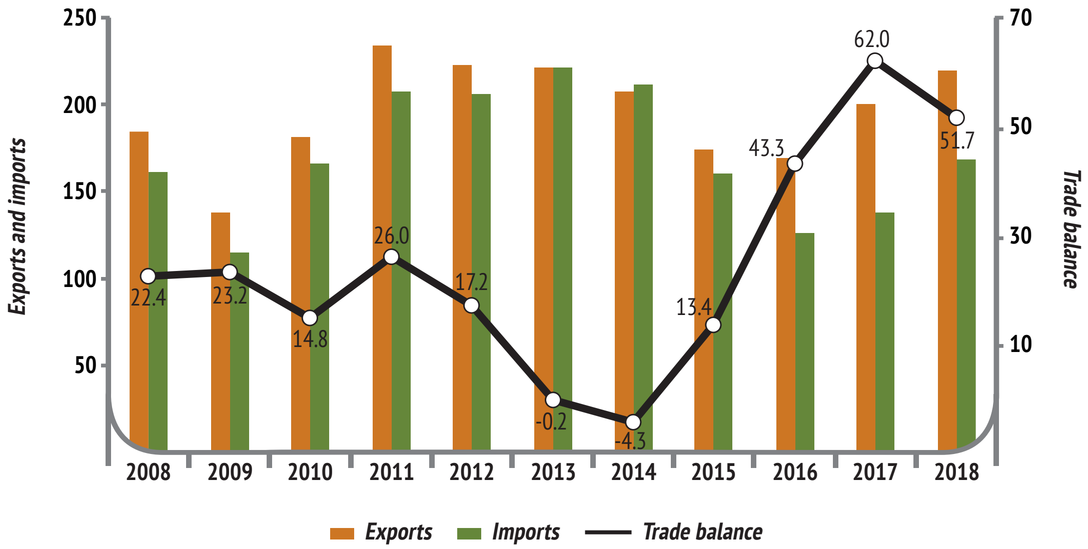
In the international scenario, the US trade war, and the contractionary monetary policy adopted by the US government (see the analysis of the Special Topic) affected the exchange rate, investments, and trade relations in general. Exports of Brazilian manufactured goods, which had been losing share in the global market already, failed to recover. Exports of basic products and commodities increased in turn as a result of the friction between the United States and China.

Exports of basic products were the ones that contributed the most to the trade surplus, while those of manufactured and semi-manufactured products were the ones that contributed the least to it. By aggregate factor, exports of basic products and manufactured goods grew by 16.3% and 8.9%, respectively, while those

Growth in imports explains lower trade balance

Exports, imports and trade balance in the year to November

In billion US$



Source: SECEX/MDIC
Prepared by: CNI

of semi-manufactured products decreased by 3.1% in the year to November against the same period in 2017. Imports of manufactured and semi-manufactured products were the ones that grew the most, by 22.3% and 25% respectively, while those of basic products increased by 17% on the same basis of comparison.

Exports by major economic categories show that fuels and lubricants were the most exported group of products, while that of durable and semi-durable consumer goods was the least exported compared to last year. The crisis in Argentina affected automobile exports, which decreased by 13.2% from January to November 2018 against the same period the year before. This year, exports of durable consumer goods declined by 10.6% in the quantum index compared to last year. In the year to date, exports of fuels and lubricants increased by 48.8%, those of capital goods rose by 27.2%, and those of intermediate goods grew by 6.5%, while those of consumer goods declined by 8.3%.

In relation to imports, those of capital goods stood out, while consumer goods were the least imported products. In the annual comparison to November, imports of capital goods increased by 84.3%, those of fuels and lubricants rose by 24.6%, those of intermediate goods grew by 13.0%, and those of consumer goods increased by 12.1%. It should be mentioned that trade balance data will be affected, until 2019, by accounting distortions caused by the REPETRO-Sped special customs regime. This year, a significant percentage of the trade deficit resulted from so-called fictitious imports, which refer to purchases of equipment for the oil and gas industry that was not actually imported and did not enter the country, but was traded between a resident and a non-resident. These imports are partly only an accounting device due to the nationalization of such equipment by subsidiaries in Brazil.

CNI estimates that exports will close 2018 at US$228 billion, up by 4.7% compared to 2017. Imports are in turn likely to total US$175 billion, up by 16.0% on the same basis of comparison. Total trade balance is therefore expected to amount to US$53 billion, down by 14.5% compared to 2017.

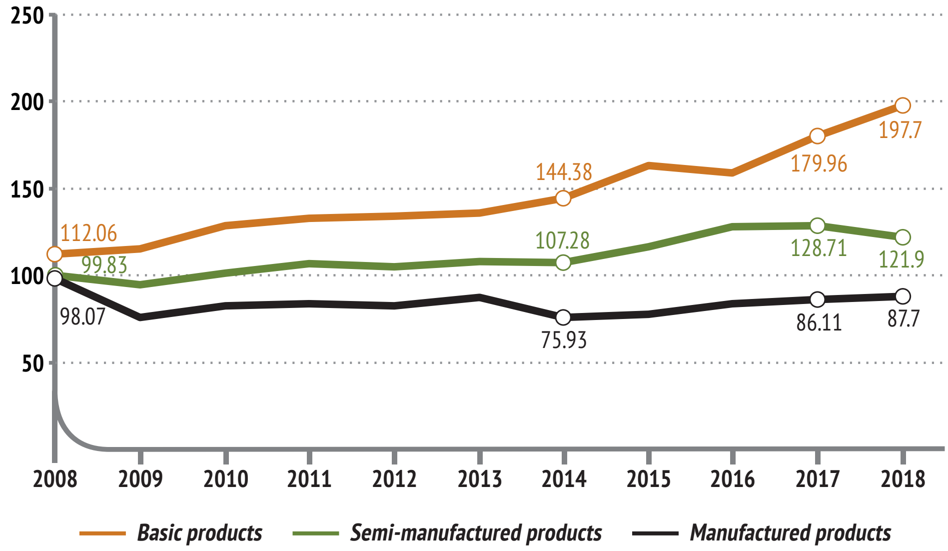
CURRENT TRANSACTION DEFICIT ON THE RISE

In early 2018, external accounts were very favorable, but they worsened throughout the year. At the beginning of the year, the current transaction balance was negative by US$5.7 billion (in 12 months), the lowest deficit in 10 years, equivalent to 0.28% of GDP. In October, this balance had decreased by 171.3%, resulting in a deficit of US$15.4 billion or of 0.8% of GDP.

Exports of basic products rise in 2018

Annual export quantum index by product class

In billion US$



Source: FUNCEX and SECEX/MDIC
Prepared by: CNI

The worsening of current account results was caused by a sharp reduction in the trade balance that began to be observed in October of last year. The improvement in the primary income balance - which includes payments of wages, profits and dividends, and interest - was more than offset by the fall in the trade balance. Results in 12 months show that while the primary income balance increased by US$7.5 billion (17.5%), improving from a deficit of US$42.6 billion in October 2017 to one of US$35.1 billion in October of this year, the trade balance recorded a loss of US$11.5 billion (17%) on the same basis of comparison, from US$67.6 billion to US$56.1 billion.

Service and secondary income accounts remained virtually stable over the last 12 months. The balance of services recorded a decrease of 6.0%, corresponding to a loss of US$2 billion in 12 months. The deficit rose again from US$32.8 billion in October of last year to US$34.8 billion until October of this year in the 12-month figure. On the other hand, the secondary income account - transfers between resident and non-resident individuals - increased by 13.7%, corresponding to US$0.3 billion in 12 months, hitting the mark of US$2.8 billion in October of this year against US$2.5 billion twelve months ago.

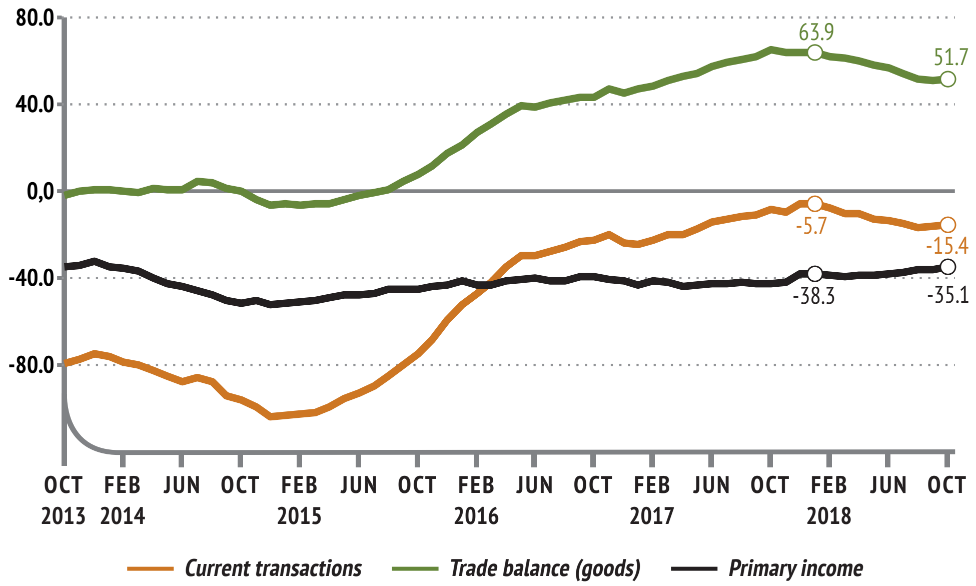
Foreign Direct Investment (IDP) dropped by 5.7% in 12 months to October 2018. FDI balance in 12 months reached US$75.0 billion in October, corresponding to 3.9% of GDP, more than enough to cover the current account deficit of US$15.4 billion.

Late in 2018, external accounts are expected to remain stagnant due to the international tensions that affected world GDP, investment, and trade relations between countries. The current account deficit is likely to amount to US$15.0 billion, approximately 0.80% of GDP as projected by CNI.

Current account deficit rises in 2018

Balances of payments (in 12 months) until October

In billions US$



Source: Central Bank of Brazil

OUTLOOK

CURRENT TRANSACTION DEFICIT MAY INCREASE AGAIN

The international scenario has been affected by tensions in trade relations that make forecasts for 2019 difficult. However, there is consensus that the world economy will grow at a slower paced in the next two years as a result of these tensions (see the analysis of the Special Topic). Emerging countries are likely to grow more than the world average, but China and India tend to grow less than expected, affecting Brazil's trade relations. US GDP will in turn continue to grow, but at lower rates.

The US central bank, the Federal Reserve, will likely continue to pursue a contractionary monetary policy, corroborating expectations of rising interest rates in the US. As a result, the average exchange rate will likely be close to R$3.78/US$1 in 2019.

An appreciated US dollar favors exports, but there are other factors that tend to contribute to slowing down Brazilian exports. The reduction in global GDP and trade tensions have been leading to uncertainties and to a cautious stance that could reduce demand for our products. Nonetheless, a trade surplus of US$45 billion is expected, representing 2.3% of GDP as projected by CNI for 2019.

Current account results are also predicted to worsen from US$15.0 billion in 2018 to US$22.0 billion in 2019. However, this deficit is not likely to threaten the external balance, as it will be smaller than the inflow of funds through direct investment.

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2016	2017	2018 (estimates)	2019 (estimates)
ECONOMIC ACTIVITY				
GDP (annual change)	-3.5%	1.0%	1.3%	**2.7%**
Industrial GDP (annual change)	-4.6%	-0.5%	1.3%	**3.0%**
Household consumption (annual change)	-3.9%	1.4%	2.1%	**2.9%**
Gross fixed capital formation (annual change)	-12.1%	-2.5%	5.1%	**6.5%**
Unemployment Rate (annual average - % of the labor force)	11.5%	12.7%	12.2%	**11.4%**
INFLATION				
Inflation (IPCA index - annual change)	6.3%	2.9%	3.8%	**4.1%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	14.18%	9.92%	6.54%	**6.83%**
(year's end)	13.75%	7.00%	6.50%	**7.50%**
Real interest rate (average annual rate and deflation: IPCA)	5.0%	6.2%	2.7%	**3.0%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	-2.49%	-1.69%	-1.76%	**-1.57%**
Public sector primary surplus (% of GDP)	-8.99%	-7.80%	-7.69%	**-7.82%**
Net public debt (% of GDP)	69.9%	74.0%	77.1%	**79.5%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	3.35	3.29	3.80	**3.80**
(average in the year)	3.48	3.19	3.64	**3.78**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	185.2	217.7	228.0	**235.0**
Imports (US$ billion)	137.5	150.8	175.0	**190.0**
Trade balance (US$ billion)	47.7	67.0	53.0	**45.0**
Current account balance (US$ billion)	-23.7	-5.5	-15.0	**-22.0**

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