CNI Newsletter
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ECONOMIC REPORT

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

Uncertainty increases as growth slows

Addressing the fiscal deficit is the biggest challenge facing the next government

The increased uncertainty observed in recent months has reduced economic growth expectations for Brazil. This scenario of uncertainty over the country's future as a result of the upcoming general elections, the future economic policy and the consequences of the recent crisis in road haulage services has led CNI to reduce its expected GDP growth to 1.6% in 2018.

The causes behind a lower recovery intensity, however, go beyond domestic uncertainties. Changes in the international scenario have also contributed to a less robust growth rate. Albeit moderate, the upward trend in US interest rates reduces international liquidity and leads to devaluation and volatility in the exchange rates of emerging countries. A less favorable environment raises the risk of these countries, thus driving up long-term interest rates and impacting growth.

Still on the international scene, the new protectionist wave – with intensified trade tensions between the main countries and the U.S. trade war with Europe and China – is another disturbing element in the scenario. The reduced trade flows between developed countries will likely increase the availability of industrial goods on the world market and encourage the penetration of Chinese products into emerging markets.

Apart from the scenario of uncertainties, the fact that the decline in the benchmark interest rate is not being reflected in a proportional improvement in domestic liquidity conditions has limited a stronger economic recovery. Interest rates on loans to enterprises and households remain high in real terms, limiting consumption growth and thus the economy's ability to recover and the decline in the unemployment rate.

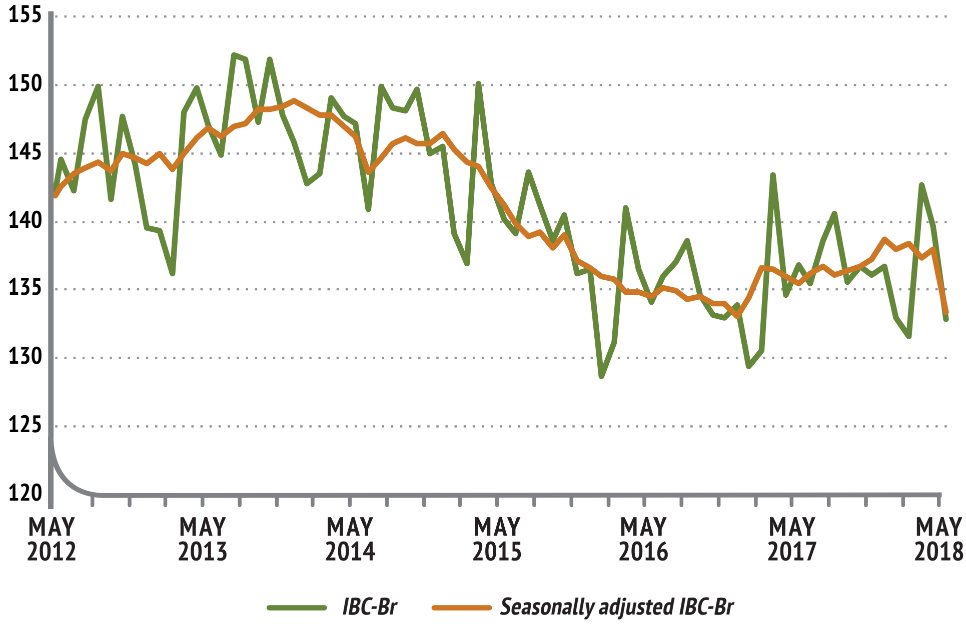
The shutdown of road haulage services had an impact on economic activity and on business confidence indices in

(continued on the next page)

The Brazilian economy in the second quarter 2018

Truck drivers' strike affects second-quarter GDP negatively

Economic Activity Index of the Central Bank (IBC-Br)
2002 base = 100



Source: Central Bank of Brazil (BACEN)

May. With respect to activity, the most significant and representative result is the 3.34% decline in the IBC-Br (Indicator prepared by the Central Bank that anticipates the GDP result) from April to May. While much of the negative effects are reversible with normalization of haulage services, the second-quarter GDP has been negatively affected.

The strike has also had an impact on the prices of some products, particularly food, thus driving up inflation in June and July. As a result of this and the pressures caused by the exchange rate devaluation and the rise in international oil prices, the expected inflation for the year is now closer to the central inflation target. Under this scenario, the benchmark interest rate is expected to hold steady at current levels (6.5%) in the medium term.

The intervention established by the new legislation that determines the creation of a minimum rate freight table brings about legal uncertainty and, if implemented, will increase economic costs. The disregard for market laws and free enterprise also discourages businesses and investments, which are not restricted to the freight market, thus hindering economic recovery.

However, the main source of uncertainty limiting economic growth is the electoral scenario and its implications for the country's future economic policy. The main challenge is balancing the public deficit, which has remained around 2% of GDP since 2015. Over the past four years, the public sector gross debt has grown by more than 20 percentage points of GDP, reaching 77% of GDP in May 2018. These figures express the magnitude of the efforts required to reverse the upward trend in public debt over the next four years, which requires measures focused on turning the primary deficit into a surplus.

The social security reform is crucial to this effort, but it alone is not enough. Additional measures are required to rein in the increase in mandatory expenditures, such as spending on personnel and other programs, with the aim of complying with constitutional fiscal targets – i.e. the public spending cap and the golden rule – and with the primary result target.

Therefore, the definition of the electoral scenario – and the clear proposition of a credible and effective economic adjustment program – is the only factor that will generate positive expectations about the performance of Brazilian economy beyond 2018.

ECONOMIC ACTIVITY

Truck drivers' strike slows down economic recovery

Economic agents' confidence has also been affected

The shutdown of road haulage services at the end of May affected economic activity and changed industry's recovery trend. May's data were largely negative. In industry, the indicators of production, sales, hours worked and capacity utilization are all down, while unwanted inventories increased and financial indicators worsened. These effects were not limited to industrial activity, as commerce and services also experienced a decline.

Business expectations have also been affected, with a decline in both confidence and investment and increased pessimism about hiring new staff. Consumers were impacted by product shortages and price hikes. Their confidence, which was already low, also worsened.

Leading indicators and the data already available for June show that the reversal of May's decline – after the supply of goods was fully normalized – has been faster than previously anticipated. Yet, the increase in business and consumer pessimism may not be temporary and could thus affect the performance of activity for a longer period. The deterioration of financial conditions in industry can also limit recovery.

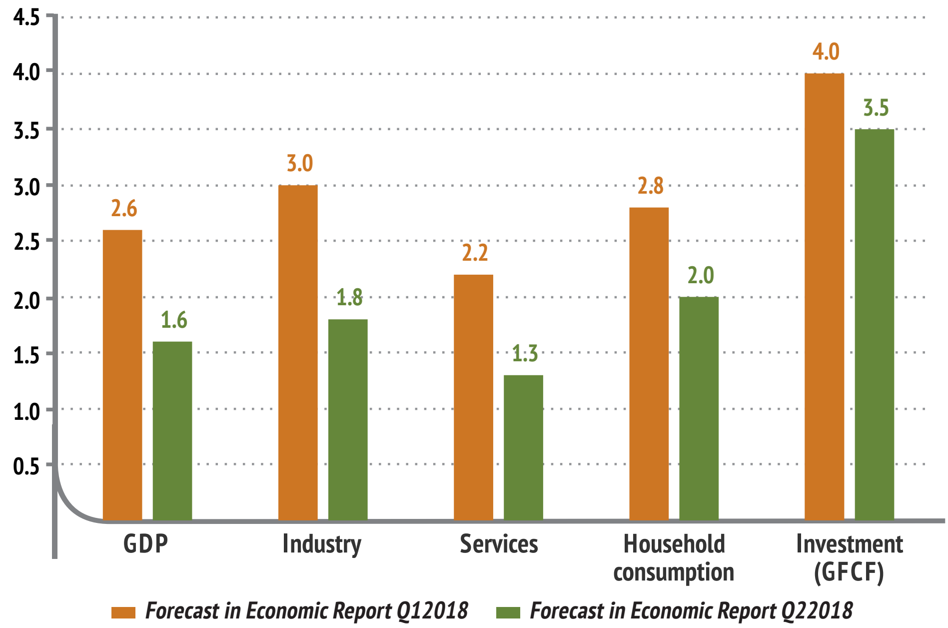
Despite the negative shock, inflation will remain at a low level (albeit higher than before), with the interest rate staying at its historical low. However, unemployment, which plays a major role in the recovery of consumption and activity, has been falling at a slower than expected pace. Thus, activity is estimated to recover at a rate lower than initially expected in the second half of the year. We are therefore expecting GDP to increase by 1.6% in 2018.

HIGHER UNCERTAINTY AND LOWER CONFIDENCE

The Business Confidence Index (ICEI/CNI) fell sharply in June, after the truck drivers' strike (-5.9 points, reaching 49.6 points), and rebounded slightly in July (+0.6 points to 50.2 points). The index had been above 50 points since January, meaning that it showed confidence among industrial entrepreneurs. The ICEI fell not only because of a deterioration in current business conditions, but also because of worsening

Negative impact on economic activity

Forecasts for GDP and its components in 2018
Percentage change from the previous year (%)



Estimated and prepared by: CNI

expectations. Despite the decline in the ICEI, expectations about individual companies remain positive, but those about the Brazilian economy have become negative.

Consumer expectations, which had already been hovering below their historical average, have worsened. The Consumer Confidence Index (INEC/CNI) dropped by 3.8 points between May and June to 98.3 points, reaching its lowest level since April 2016, when it stood at 97.5 points.

Economic agents' confidence may improve in the second half of 2018. However, it will take some time for business confidence to return to the level observed before the May shutdown, particularly due to the lack of definition of minimum freight rates, a solution considered inappropriate by the productive sector. As a result, production, hiring and investment decisions will be affected. Consumer confidence, which was already low before the truck drivers' strike, will likely take longer to reach a level capable of boosting consumption more strongly. This could happen as a result of the decline in uncertainty at the end of the electoral period and of the confidence that is usually placed at the beginning of a new administration.

RECOVERY WILL BE MORE MODERATE

Data from the June issue of CNI's Industrial Indicators survey reflected the effects of the shutdown of transportation services on the manufacturing industry. All indicators recorded declines, some of which were pronounced (see the infographic to the right). It is worth noting that sales and capacity utilization fell to the lowest levels in their historical series started in 2003. In addition, CNI's Industrial Survey showed an accumulation of unwanted inventories in manufacturing, particularly among large companies, and deteriorated financial indicators.

Preliminary data for June indicate that activity has been recovering faster than initially anticipated. CNI's Industrial Survey showed a decline in inventories and an increase in industrial activity in June on a month-over-month basis. Therefore, while part of the losses observed in May are irreversible owing to the disposal of products and to inventory accumulation, industry will likely resume an upward trend.

This uptrend, however, is expected to be less intense than initially predicted. This is because the most enduring effect on activity will probably not come from the strike itself, but from the way the government responded to it. The measures taken by the government brought about uncertainties and distortions in the economy and imposed more sacrifices on the industrial sector, since they pushed up costs and reduced programs that mitigated the distortions of the current Brazilian tax system, such as the Reintegra program.

For this reason, industrial activity will surely recover at a moderate pace in the second half of 2018. Consequently, we have revised our estimate for industrial GDP growth in 2018, down from 3% to 1.8%.

Impacts on activity and confidence

Activity indicators (manufacturing)
Seasonally adjusted data

CHANGE BETWEEN APRIL AND MAY 2018

REAL SALES
Down by 16.7%

HOURS WORKED IN PRODUCTION
Down by 2.4%

PRODUCTION
Down by 12.2%

EMPLOYMENT
Down by 0.6%

CAPACITY UTILIZATION
Down by 2.2 percentage points

CHANGE BETWEEN MAY AND JUNE 2018

BUSINESS CONFIDENCE
Down by 5.9 points

CONSUMER CONFIDENCE
Down by 3.8%

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

In 2018, the agricultural harvest will only fall behind last year's record result. However, the sector was severely impacted by the disruption of road haulage services, with losses that are not immediately recoverable. Thus, we have revised the increase in agricultural GDP downward from 2% to 1% in 2018.

The services sector was also affected by the truck drivers' strike, falling by 3.8% in May as compared to April (Monthly Survey of Services - PMS /IBGE). This was the biggest decline ever recorded in the historical series started in 2011. In the year to May, the sector shows a 1.3% drop from the same period the year before. All activity indicators are down, with emphasis on those related to the transportation sector.

Retail sales in turn dropped at a lower rate in May, down by 0.6% as compared to the previous month (Monthly Survey of Trade - PMC/IBGE, seasonally adjusted). All trade activities experienced losses in May, except for hypermarkets and supermarkets. Considering the extended retail trade, which includes sales of vehicles and construction materials, the decline reached 4.9%.

The deterioration in consumer confidence and the interruption of industry's recovery may also affect growth over the next few months. Under this scenario, CNI estimates that the services sector will grow by 1.3% in 2018.

Estimates for GDP and its components for 2018

Estimated percentage change

	GDP COMPONENTS	Percentage change (%)
Demand side	Household consumption	2.0
	Government consumption	0.0
	Gross fixed capital formation	3.5
	Exports	6.0
	(-) Imports	7.0
Supply side	Agriculture/livestock	1.0
	Industry	1.8
	Mining and quarrying	1.5
	Manufacturing	2.5
	Construction	0.0
	Public utility industrial services	2.6
	Services	1.3
GDP		**1.6**

Projected by: CNI

CONSUMPTION TO GROW LESS THAN ANTICIPATED

Part of the factors that boosted demand in the first quarter of 2018 will likely continue in place in the second half of 2018. Inflation will remain below the target, while the Selic rate is at an all-time low and is not projected to increase in 2018.

However, the unemployment rate has been falling at a slower than expected pace, remaining above 12%. In addition, the deterioration in consumer confidence after the truck drivers' strike can last longer and affect consumer decisions. We have revised our growth projection downward from 2.8% to 2.0% in 2018.

The Investment Survey (CNI) and the Investment Intentions Index (Industrial Survey/CNI) indicated a recovery of investments in 2018. In fact, imports of capital goods posted a strong growth, particularly in the first months of 2018. However, the rise in uncertainties and the decline in business confidence have already had an impact on the investment intentions index, especially in the manufacturing industry. A high idle capacity and a weak outlook for the construction sector are expected to limit the recovery of Gross Fixed Capital Formation (GFCF). We are thus expecting GFCF to rise by 3.5% in 2018.

The strong import volumes observed in the first half of the year, particularly of capital goods, are expected to slow down in the second half. One of the reasons is the more depreciated exchange rate, which has even stimulated a frontloading of imports so as to obtain a more favorable exchange rate.

Meanwhile, the pace of exports is likely to speed up with a more devalued exchange rate. Despite the intensification of trade tensions around the world, the world economy continues to grow at a favorable rate and the trade war is not yet widespread.

We project a 7% increase in imports of goods and services and a 6% increase in exports of goods and services (both based on IBGE's National Accounts concept). Thus, after three years of positive contributions, the external contribution to GDP will be negative in 2018.

EMPLOYMENT AND INCOME

Labor market improves, but difficulties linger

Lower activity recovery hinders a more significant employment recovery

In 2018, the labor market has been recovering more slowly than expected, with formal employment rebounding weakly. This behavior is explained by frustrations over the resumption of activity, which fell short of the projection for the year. The indicators' response depends directly on the robustness and consistency of economic growth and also on the time required for idle resources in the productive sector to even out.

Yet, the unemployment rate has been showing positive results and has declined in the last two three-month periods ended in April and May. These declines were expected, as they reflect the typical seasonality for the period. The indicator usually accelerates in the first quarter, when temporary work contracts for the holiday season come to an end, and begins to fall again in the second quarter of each year.

Real average earnings and total payroll also remain on a positive trend. The indicators started 2018 with a strong year-on-year increase and continue to post growth, albeit at a lower rate than that observed in the first two months of the year.

As a result, CNI has revised its expectations for the labor market and predicts that the average unemployment rate will reach 12.4% of the labor force in 2018.

UNEMPLOYMENT RATE FALLS SLIGHTLY IN MAY

According to the National Household Sample Survey (Continuous PNAD survey/IBGE), the unemployment rate experienced a slight decline in the three-month period to May, reaching 12.7% of the labor force. The rate was 0.2 percentage points lower than that registered in the quarter ended in April and 0.6 percentage points lower than the figure observed in the same quarter of 2017.

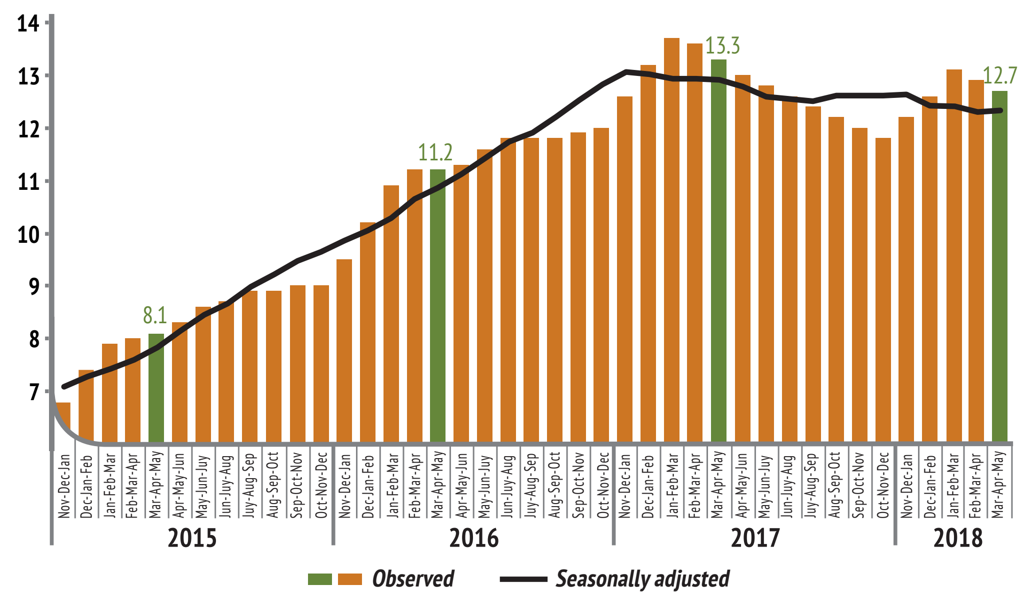
It should be stressed that the improvement in the unemployment rate has been made possible by the increase in informal employment and that the seasonally adjusted indicator – prepared by CNI – held steady in May as compared to April at 12.3%

Frustrations over the resumption of economic growth have been the main reason for a lower than expected recovery of the labor market. CNI has revised its estimate for GDP growth in 2018 downward from 2.6% to 1.6% (see the section Economic Activity).

Under this scenario of frustrations over a more robust recovery of activity, coupled with high

Unemployment rate remains at high level

Unemployment rate, as a percentage (%) of the labor force – three-month moving average



Source: Monthly Continuous PNAD survey/IBGE
Prepared by: CNI

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idle capacity levels, CNI has revised its estimated average unemployment rate for 2018, which is expected to reach 12.4% of the labor force, down by 0.3 percentage points from 2017's levels, when the indicator hit the mark of 12.7%.

It should be stressed that unemployment also has impacts on economic recovery. The large number of unemployed and discouraged workers, which has already exceeded the mark of 20 million people, limits the growth of household consumption, which accounts for 67% of GDP, and thus the pace of activity recovery and the opportunity to create new jobs.

Finally, it is worth noting that that the outlook for employment is not favorable. CNI's indicators – calculated in the Industrial and Construction Industry surveys – show an expected decline or stability in employment over the next months. In addition, the Fear of Unemployment Index (IMD) edged up by 4.2 points in June as compared to March. At 67.9 points, the index reached its highest point in the historical series started in May 1996. The Fear of Unemployment Index is 18.3 points above its 49.6-point historical average.

FORMAL JOBS ARE RECOVERING

Formal employment, as measured by the General Register of Employed and Unemployed Persons of the Ministry of Labor and Employment of Brazil (CAGED/MTE), recorded a net creation of 392,500 jobs in the first six months of 2018.

The service and industry sectors accounted for the highest share of jobs created in the year to June, with a net creation of 279,100 and 124,300 jobs respectively. The agriculture/livestock sector created 70,300 jobs during the same period.

The trade sector, on the other hand, continues to struggle and has already accumulated a net loss of 94,800 formal jobs in the first half of the year. The biggest responsible for the negative result of this sector was the segment Retail trade of new unspecified products and used products, which lost 66,900 jobs in the period.

It is worth noting that June was the first month of the year to post a negative net balance, with the loss of 661 jobs. Trade and industry were the sectors for which the worst job losses were recorded: -20,900 and -20,400 jobs respectively.

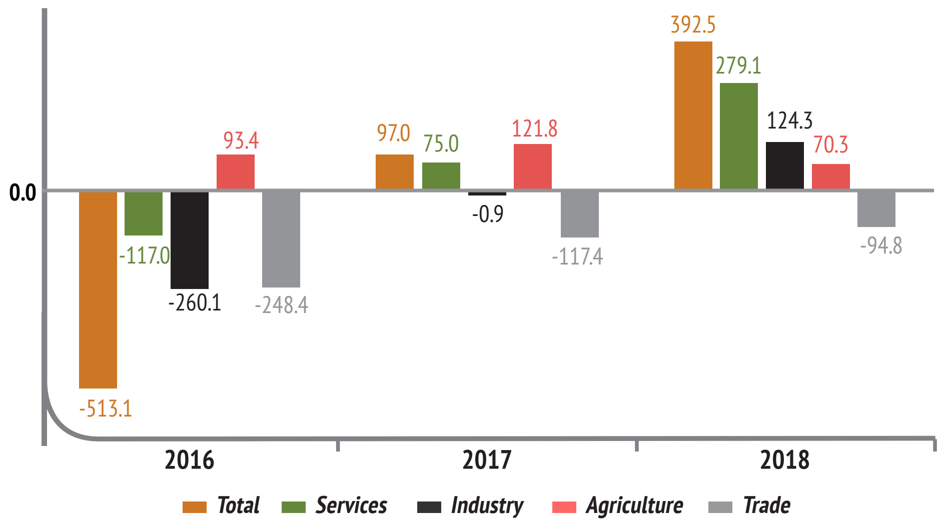
REAL TOTAL PAYROLL KEEPS INCREASING

The growth rate of real total payroll accelerated in the first five months of 2018 as compared to 2017. According to IBGE's Continuous PNAD survey, the indicator edged up by 2.3% in the three-month period ending in May as compared to the corresponding period in 2017. On the same comparison basis, the indicator had increased by 1.0% between 2017 and 2016.

The most pronounced increase in the indicator was driven by the behavior of employment, which grew by 1.3% in the quarter through May. In the same period of 2017, jobs had fallen by 1.3%.

Services and industry drive recovery of formal employment in 2018

Net balance of formal jobs in the year to June*
In thousands



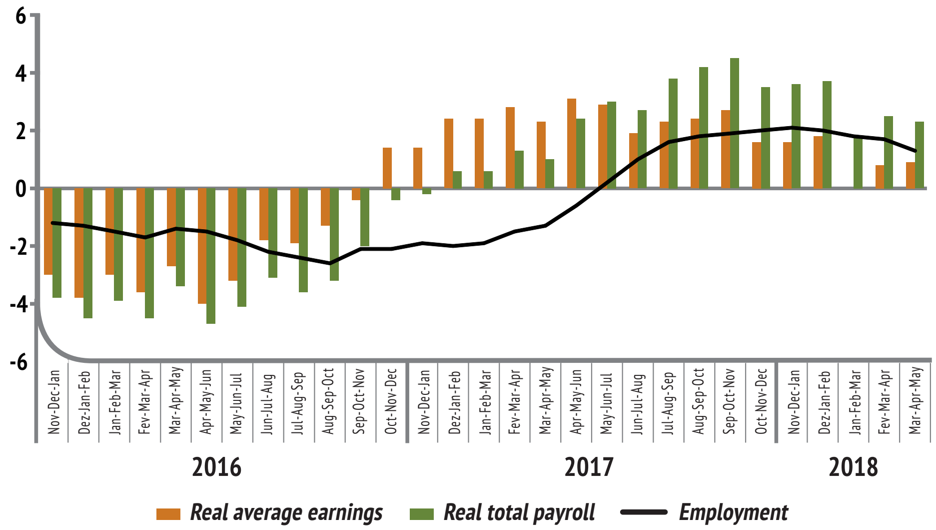
Source: CAGED/MTE
** Includes information reported after the deadline*

Meanwhile, real average earnings usually received by workers grew at a less significant rate (+0.9%) in 2018 than in 2017 (+2.3%).

Total payroll was expected to increase in 2018, mainly on account of a projected greater increase in jobs in the year. The less pronounced increase in employment, however, has impacted the indicator's growth rate. In addition, the increase in employment has been driven by informal jobs, according to data from the Continuous PNAD survey. While informal jobs in the private sector (excluding domestic workers) grew by 5.7% in the quarter ended in May, formal private sector employment fell by 1.5% on the same basis of comparison. This trend has an impact on real average earnings, as informal workers are often paid less than formal workers and have lower job security. Consequently, the expected increase in real total payroll in 2018 was also downwardly revised to 2.2%, down by 0.2 percentage points from the growth rate of 2017, which stood at 2.4%.

Real total payroll accelerates its growth rate in 2018

Real average earnings, real total payroll and employment
Percentage change (%) from the same three-month period in the previous year



Source: Monthly Continuous PNAD survey/IBGE

INFLATION, INTEREST RATES AND CREDIT

Inflation to remain below central target in 2018

Truck drivers' strike drives up IPCA index in June

In June, the inflation rate was higher than usual for the month owing to the effects of the truck drivers' strike. The Extended National Consumer Price Index (IPCA) increased by 1.26% in the month, up from a 0.40% increase in May and a 0.23% decline in June 2017.

As a result, the diffusion index calculated by the Central Bank of Brazil (BACEN), which measures the proportion of IPCA sub-items that posted positive changes in the month, rose from 55.3% in May to 65.5% in June. The result reflects a widespread rise in prices in the last month.

With the acceleration, the IPCA grew by 4.39% in the twelve-month period to June, up from 2.86% in the year to May. In the same month of 2017, inflation had reached 3.00% on a 12-month basis. Despite the acceleration, the index remains below the central target set by the National Monetary Council (CMN), currently set at 4.5%.

The food group showed the highest increase in June.[1] The group's intense contribution toward the increase in the IPCA in the month was a direct consequence of the truck drivers' strike, on account of the perishability of many products

1 The highest contributions to the 1.26% increase in the IPCA in June came from the Food and beverages (0.50 percentage points), Housing (0.39 percentage points) and Transportation (0.29 percentage points) groups.

and shortages. The group's prices, which recorded a decline of 6.3% in the 12 months through September 2017, fell by 0.4% in the year to June.

The services group continues to show a slowdown in prices. The group's trend has been driven by the slow recovery of the labor market and the slower pace of economic activity growth. The group's inflation went from an increase of 7.4% in the 12 months to June 2017 to a 3.5% growth in the same period of 2018.

The group of government-regulated prices has also generated inflationary pressure, mainly due to the increase in gasoline prices and to increases in electricity rates. Energy prices rose by 7.9% in June, reflecting the effect of the red flag level 2 tariff base, which was implemented at the beginning of the month (additional charge of R$ 5.00 per 100 kilowatt-hours consumed). As a result, the group's prices rose by 13.8% in the twelve-month period to June.

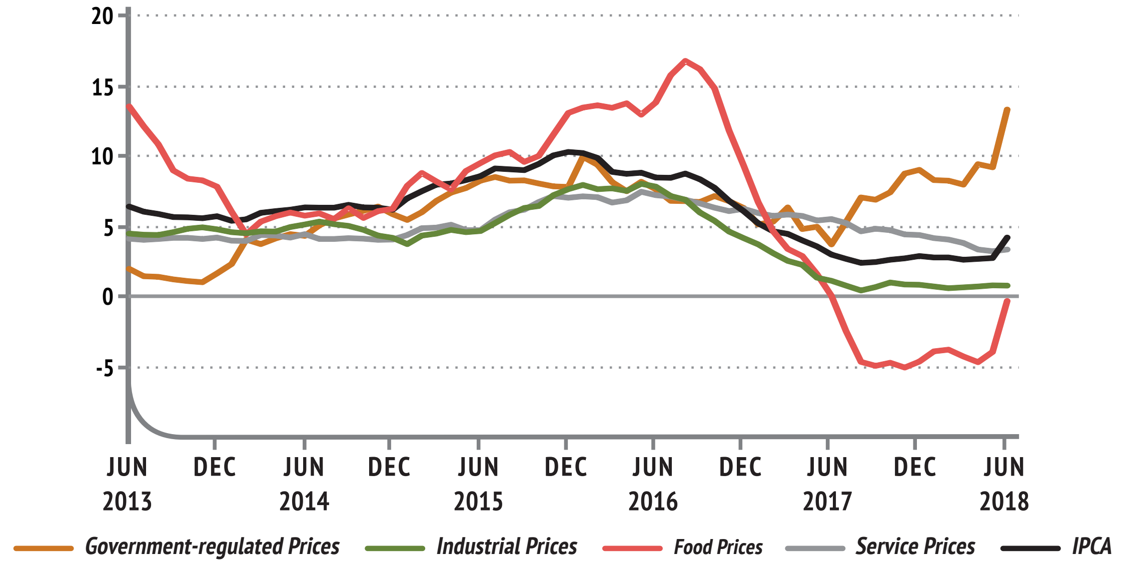
Despite the atypical increase in June and possible future inflationary impacts on account of the implementation of the freight rate table – a measure taken by the government to end the truck drivers' strike – inflation is expected to remain at low levels. CNI estimates that the IPCA will accelerate to 4.21%, still below the central target for 2018.

INTEREST RATES TO REMAIN UNCHANGED BY THE END OF 2018

The still favorable behavior of inflation and uncertainties regarding the impacts of the truck

Inflation remains below central target

Seasonally adjusted IPCA by group – 12-month rate
As a percentage (%)



Source: IBGE
Prepared by: CNI

National Monetary Council sets inflation target for 2021

With the aim of strengthening the monetary authority's commitment to stabilizing the purchasing power of the Brazilian currency, the National Monetary Council (CMN) has set the inflation target for 2021 at 3.75%, with a tolerance margin of 1.5 percentage points. The Council has also confirmed the targets previously set for 2018, 2019 and 2020 at 4.50%, 4.25% and 4.00%, respectively.

The fact that the targets have been set at gradually lower levels contributes to keeping inflation under control, as it anchors inflationary expectations at low levels. Furthermore, the reduction of the targets signals a gradual convergence to international standards.

This is the first change made since 2005, when the target was set at 4.5% per year. It should be noted that this decision is partly explained by the recent performance of the indicator. When the targets were set in May, inflation had been below the lower limit of 3.0% set by BACEN for 11 months.

drivers' strike and the implementation of the freight rate table on prices over the coming months led the Central Bank's Monetary Policy Committee (COPOM) to keep the benchmark interest rate (Selic) unchanged at 6.5% per year at the last meeting held in June. The decision also considered a lower than expected economic recovery, high spare capacity levels, and a still high unemployment rate.

The Selic rate, which started 2018 at 7.0%, reached 6.5% in March, following two consecutive cuts of 0.25 percentage points made by COPOM at the February and March meetings. The current expectations are that the interest rate reduction cycle is over and that the benchmark interest rate will close the year at that level, even though an additional drop would be important to boost consumption and investment and thus enable a more robust economic recovery.

It is worth highlighting that in order to keep the interest rate at a low level without driving up inflation, public accounts should be balanced, otherwise the Central Bank will likely reverse the downward trend observed so far.

While the Selic rate is at its lowest level since its inception in 1986, interest rates remain, at the international level, higher than those observed in countries with a development profile similar to that of Brazil, such as Chile (2.5%), and much higher than in developed countries like the United States (2.0%) and Canada (1.5%).

In addition, the final capital cost for households and companies remains high on account of the high spreads charged by the banking system and on the limited Brazilian capital market. While access to the capital market increased significantly in 2017, the Central Bank's Inflation Report for March 2018 shows that the volume of financing through private bonds is still marginal.

CREDIT MARKET RESPONDS TO REDUCED INTEREST RATE

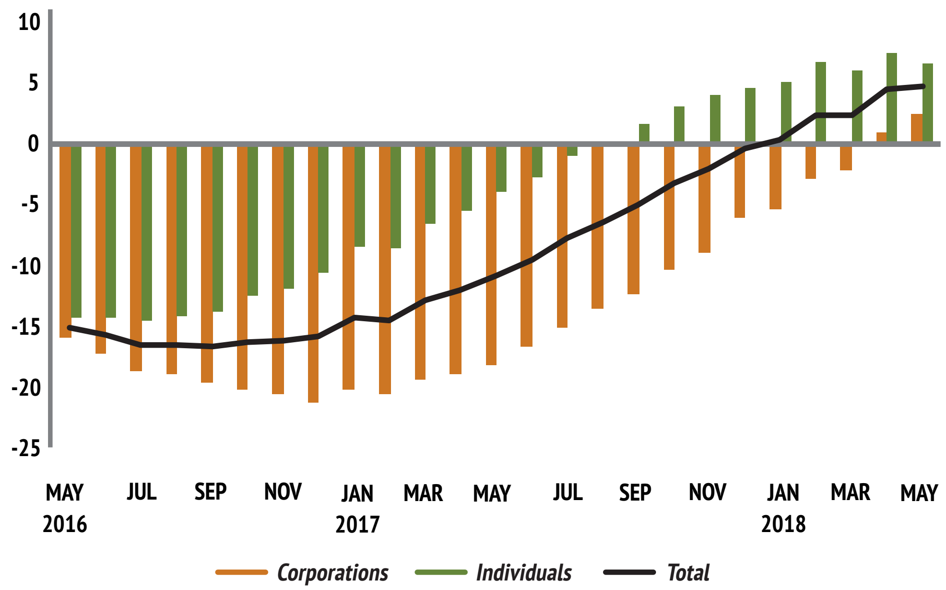
The credit market has been responding moderately to the stimulus from expansionary monetary policy since the beginning of the year: loans have been growing steadily and the interest rates charged are lower.

In the 12 months to May 2018, total lending grew by 5.0% in real terms from the corresponding period in 2017. On the same comparison basis, total lending had dropped by 10.7% between 2017 and 2016. The increase was more significant for loans to individuals, which posted growth of 6.8% on the same comparison basis. Loans to corporations in turn grew by only 2.7%.

Interest rates on loans granted with non-earmarked funds dropped from 47.3% per year in May 2017 to 39.2% per year in May 2018. The decrease was

Lending is up in 2018

Lending, in real terms
12-month change



Source: Central Bank of Brazil

sharper for individuals, whose average financing costs decreased from 64.6% per year to 53.8% per year. For corporations, these costs fell from 26.1% per year to 20.6% per year.

The downward trend in the total credit stock in real terms, which started in 2016, has been slowing down. In May 2018, the credit stock fell by 1.4%, compared to a 6.4% decline in May 2017. The drop was driven by a 6.5% reduction in the real stock of lending to corporations, as the real credit balance for individuals increased by 3.4%.

For the remainder of the year, the credit market is expected to continue to recover gradually, given the positive results of the current benchmark interest rate and the resumption – albeit modest – of Brazilian economy.

FISCAL POLICY

Primary deficit to remain below target as revenues grow

Fiscal policy becomes expansionary again

The increase in revenues led to an improvement in some fiscal indicators in the first months of 2018. On the other hand, the fiscal space opened by this growth drove up the federal government's expenditures and caused regional governments' spending to increase at an accelerated pace. As the federal government's revenue increased more than its spending, the downward trend in the public sector primary deficit started in the last months of 2017 has remained in place so far.

This scenario will likely change in the second half of the year, mainly because some factors that contributed to driving up revenues (installment payments of debts with the Brazilian Internal Revenue Service and increase in the rates of the PIS/COFINS taxes levied on fuels) will not be repeated. On the spending side, the impact of prepayments of court-ordered deposits and settlements will disappear at the start of the second half of the year, while expenses are expected to grow at a slower pace by the end of the year. Regional governments will likely show the same behavior and are not expected to keep growing at the same rate as in the first five months of 2018.

Under this scenario, the primary public sector deficit is projected to rise by the end of 2018, even though both the primary result target and the spending growth ceiling will likely be somewhat easily achieved. Nevertheless, the primary deficit in 2018 is expected to be higher than that registered in 2017, meaning it will not be enough to reverse the upward trend in public sector indebtedness.

FEDERAL GOVERNMENT'S NET REVENUE GROWS STRONGLY

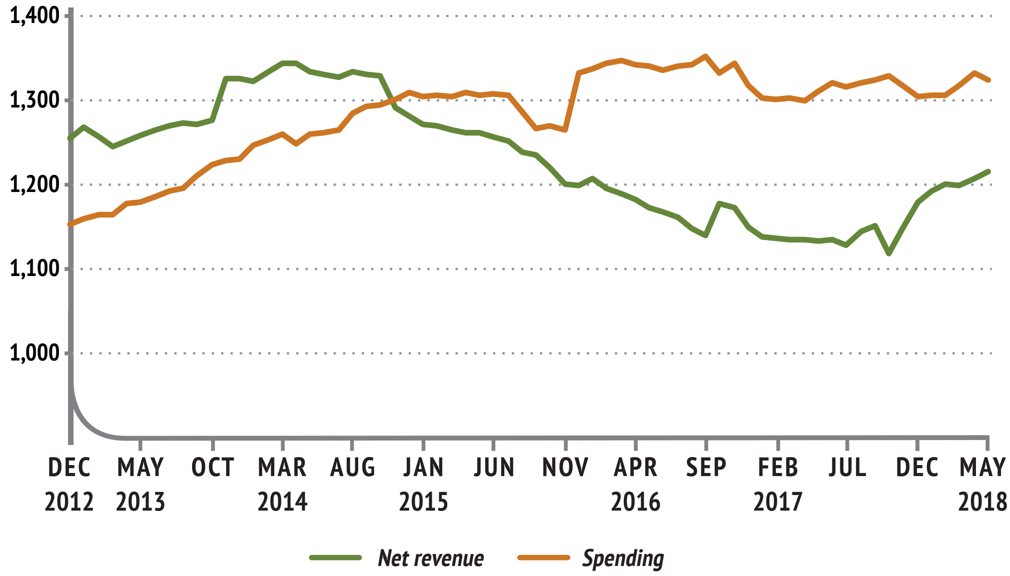
The federal government's net revenue posted real growth (IPCA deflator) of 7.9% in the first five months of 2018 on a year-on-year basis. Three factors explain this favorable behavior. The main reason is the economic recovery, with positive impacts on the collection of PIS/COFINS and IPI taxes.

In addition, two non-recurring factors have favored an increase in net revenue: the new installment payments of debts with the federal government (Special Tax Regularization Program - PERT and installment payments of outstanding debts) and the increase in the PIS/COFINS taxes levied on fuels. In both cases, the effects began to be felt – or intensified – in the second half of 2017. Therefore, the impacts on the increase in net revenue in 2018 on a year-on-year basis will begin to lose momentum in coming months.

All of these factors affect mainly revenues managed by the Brazilian IRS, which are thus up by 9.2% in real terms in the first five months of 2018 as compared to the corresponding period in 2017. Revenues not managed by the Brazilian IRS were another component of net revenue that experienced a pronounced increase of 14.9% from January to May 2018 from the same period a year ago. In this case, the increase is explained by the rise in financial compensation

12-month figure for federal government's net revenue posted a real increase of 8.8% between November 2017 and May 2018

Evolution of federal government's primary spending and net revenue in 12 months (R$ billion in May 2018)



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

for the exploitation of natural resources, which has benefited from the increase in oil production and prices, and by the dividends received by the federal government.

Finally, social security revenues rose by 1.7% in real terms in the first five months of 2018 over the corresponding period the year before. This increase was driven by the improvement in the labor market, which has led to a real increase in total payroll, and, to a lesser extent, by revenues from debt installment payment programs.

On the spending side, one can see that the government has been somewhat less effective in keeping expenditures under control. Spending experienced a real increase of 3.8% in the first five months of 2018 as compared to the same period the year before. Even excluding the effect of prepayments of court-ordered deposits and settlements in 2018 as compared to the 2017 schedule, expenditures are up by 1.7% in real terms on that comparison basis.

All spending components increased in the first five months of 2018 from the same period in 2017, even excluding the effects of prepayments of court-ordered deposits and settlements. Social security expenses rose by 2.9% due to the increase in pensions – due to adjustments made in January – and to the increase in the number of pensioners.

Spending on personnel posted real growth of 1.9%. This increase in personnel spending could have been lower if the Federal Supreme Court had not suspended the Provisional Presidential Decree that postponed the wage increase for public servants in late 2017.

Even non-compulsory expenditures, in which the federal government controls the amount spent, recorded a real increase of 5.6% in the first five months of 2018 as compared to the same months of 2017. In this case, the increase is not influenced by the payment schedule for court-ordered deposits and settlements (which are compulsory expenses) and shows that the federal government has struggled to keep spending under control in the same way it did in 2017, when these expenditures dropped by 14% in real terms as compared to 2016.

In the opposite direction are other compulsory expenses (excluding personnel and social security). Disregarding the effect of prepayments of court-ordered deposits and settlements, compulsory spending dropped by 6.4% in real terms in the first five months of 2018 from the corresponding period the year before. This drop is explained mainly by a decline in spending on subsidies and unemployment insurance.

STATES AND MUNICIPALITIES' EXPENDITURE KEEPS GROWING

Regional governments continued to increase their spending in early 2018. These public entities had already recorded an increase in expenditure in 2017. The difference now is that their expenditures have grown faster than revenues, thus driving down the primary surplus of all states and municipalities.

Based on available data on state and municipal revenues and on the behavior of the primary result for all these public entities, CNI estimates that regional governments' spending grew by 7.7% in real terms in the first five months of 2018 as compared to the corresponding period in the previous year.

As for revenues, the available data indicate a real increase of 5.3% in the first months of 2018 on a year-on-year basis. Revenues from the turnover tax (ICMS), which is the main source of revenue for regional governments, posted real growth of 4.1% on the same comparison basis. The increase in revenues from the ICMS tax is explained by the recovery of economic activity and by tax increases promoted by several state governments.

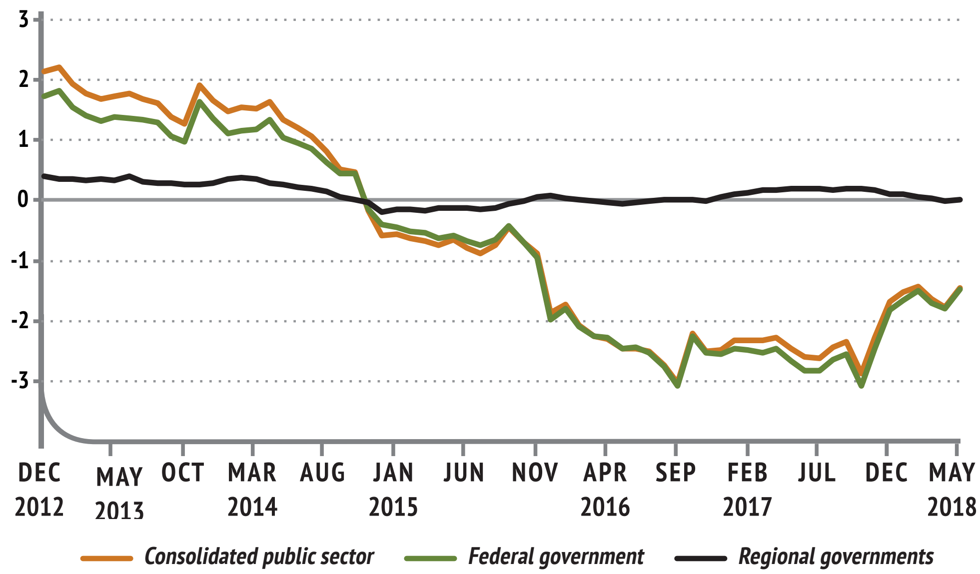
The second most important source of funds – transfers received from the federal government – increased by 7.6% in real terms in the first five months of 2018 over the same period the year before. In addition to the effect of economic recovery, which has a positive impact on the collection of federal taxes shared with states and municipalities, transfers have been growing as a result of the increase in oil production and prices, which has led to a rise in transfers of financial compensation for the exploitation of natural resources.

PRIMARY DEFICIT FALLS IN EARLY 2018

The sharp increase in revenues, both in the federal government and in regional governments, has more than offset the increase in expenditures at all levels of government and has caused the public sector primary result to continue in 2018 on the downward trend started in late 2017. The public sector recorded a primary deficit of R$ 95.9 billion (1.44% of GDP) in the 12 months to May 2018. Thus, the deficit remains on a downtrend as compared to October 2017, when it amounted to R$ 187.2 billion (2.87% of GDP).

12-month figure for public sector's primary deficit fell by 1.44 percentage points of GDP between October 2017 and May 2018

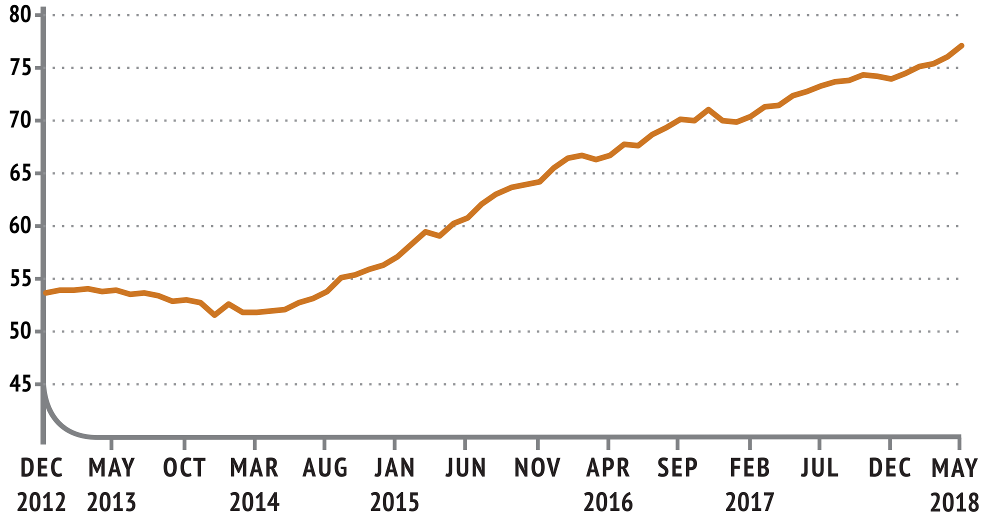
Primary result of the consolidated public sector and by levels of government
Percentage (%) of GDP



Source: Central Bank of Brazil
Prepared by: CNI

Gross debt-to-GDP ratio rose by 3.0 percentage points between December 2017 and May 2018

Trajectory of the Public Sector's Gross Debt as a percentage (%) of GDP



Source: Central Bank of Brazil

Coupled with the reduction of 0.34 percentage points of GDP in nominal interest spending, the decline in the primary deficit led the 12-month nominal deficit to fall from 7.8% in December 2017 to 7.21% of GDP in May 2018. Yet, this nominal deficit is not enough to stabilize the increase in the gross debt-to-GDP ratio, which rose from 74% in December 2017 to 77% in May 2018.

PRIMARY DEFICIT TO RISE IN 2018 AS REVENEUS GROW AT SLOWER PACE

The decline in the federal government's primary deficit is expected to be reversed by the end of 2018. The main factor behind this reversal will be the slowdown in the growth rate of net revenue. On the expenditure side, compulsory expenditure will exert a lower pressure on account of the unwinding of the effects of the payment schedule for court-ordered deposits and settlements. The primary surplus of regional governments in turn is not projected to change significantly toward the end of the year. This will lead to an increase in the primary deficit of the consolidated public sector in coming months.

The federal government's net revenue will likely close 2018 with a 3.4% real increase as compared to 2017. The slowdown in the growth rate of revenues by the end of 2018 is explained by two main factors. First, the revenues collected from federal tax debt installment payment programs will not be repeated in coming months, and second, the PIS/COFINS taxes will be increased. In addition, revenues not managed by the Brazilian IRS will likely not include the return to the public coffers of judicial deposits not withdrawn by beneficiaries occurred in 2017. It is worth noting that this forecast does not include the R$ 12.2 billion that would come from the privatization of Eletrobras.

Federal government's spending in turn is expected to close 2018 with a 3.8% real increase – the same growth rate observed until May. Social security expenditures are expected to close the year slightly higher than the figure recorded until May, notably due to the effect of the payment schedule for court-ordered deposits and settlements. Personnel, financing and capital expenses, on the other hand, are likely to grow at an accelerated pace by December. As for financing and capital expenditures, the acceleration would be largely explained by the payment of subsidies for diesel prices.

Under this scenario, CNI estimates that the federal government and its state-owned enterprises would close the year with a primary deficit of R$ 142.1 billion (2.05% of GDP as estimated by CNI). While this result falls within the target of R$ 162.5 billion set for 2018, it would be significantly higher than the primary deficit of R$ 119.4 billion (1.82% of GDP) registered in 2017.

For regional governments and their state-owned enterprises, the growth rate of revenues is expected to remain unchanged owing to the continued economic recovery and the continued impact on transfers from the federal government associated with oil prices and production.

On the other hand, expenditures will also likely continue to experience significant increases. One of the reasons for this is the increase in revenues, as the restrictions imposed by the Fiscal Responsibility Law and by the debt renegotiation agreements with the federal administration tend to link the increase in spending to the behavior of revenues. Another reason is the impact of the debt renegotiation agreement with the state of Rio de Janeiro, which could lead to an increase in primary spending in the state due to the suspension of the need to use a percentage of revenue to pay interest to the federal government. Thus, the primary surplus of these entities is expected to decline and close 2018 at about R$ 2.5 billion (0.04% of GDP as estimated by CNI).

As a result, the consolidated public sector would post a primary deficit of R$ 139.6 billion (2.0% of GDP as estimated by CNI) in 2018. Even though the deficit shows a gap of R$ 21.7 billion as compared to the R$ 161.3 billion target set for 2018, it will increase due to the negative result of R$ 110.6 billion observed in 2017.

This increase in the primary deficit in relation to 2017 will probably be more than offset by the decline of 0.6 percentage points of GDP in nominal interest spending. The nominal deficit is thus set to fall slightly from 7.80% in 2017 to 7.48% of GDP in 2018. This level of nominal deficit and a nominal GDP growth of only 5.7% will lead to a further increase in the gross debt-to-GDP ratio. Despite the fact that the National Bank for Economic and Social Development (BNDES) will return R$ 130 billion to the National Treasury in order to comply with the Golden Rule (according to which public indebtedness cannot exceed the amount spent on capital expenditures), the gross debt-to-GDP ratio is set to close 2018 at 76.3%.

FOREIGN TRADE SECTOR

Downward trend in current account deficit comes to halt

Changing environment leads to devaluation and increased volatility of Brazilian currency

The downward trend in the current account deficit that started in 2015 has come to a halt. The deficit accumulated in the 12 months to May reached US$ 13 billion, representing a 45% increase as compared to December 2017 (US$ 9.8 billion). The deficit, however, remains at a historically low level and in line with the volume of foreign direct investment in the country, which despite the decline observed during the year, is more than enough to cover this deficit.

In the first half of 2018, the trade balance recorded its second-highest surplus in the historical series: US$ 29.9 billion. Imports, however, are growing more strongly than exports, influenced by both the reduced comparison basis and by the rebound – albeit slow – of domestic demand.

CNI estimates that the trade balance will reach US$ 62.0 billion in 2018, with exports growing by 6.5% (US$ 232 billion) and imports rising by 12.8% (US$ 170 billion). Regarding the current account balance, we expect the deficit to increase by the end of the year to US$ 20 billion, or 1% of GDP as estimated by CNI.

FURTHER DEPRECIATION OF BRAZILIAN CURRENCY

The second quarter was marked by increased uncertainties, influenced by both the external scenario and by the country's domestic conditions. The devaluation of the real started in late January 2018 has intensified in recent months, despite the intervention by the Central Bank, which increased the supply of currency swaps. The average exchange rate for July (up to the 23rd) stood at R$ 3.87 per US dollar, up by 17.5% from the average for December 2017 (R$ 3.29 per US$).

In the external environment, the higher than expected increase in US interest rates contributed toward the devaluation of other currencies against

Exchange rate rises back to June 2016 levels

Daily exchange rate (Ptax Closing Rate) in R$ per US$*

Source: Central Bank of Brazil
** The Closing Ptax rate is the arithmetic average of bid and offer rates published in daily bulletins.*

the US dollar and led to capital flight, particularly in emerging countries. The US Federal Reserve (FED) raised interest rates again in June and signaled two more hikes for the second half. In addition, President Trump's protectionist measures, such as the imposition of higher tariffs on some imported products, raise the risk of a trade war. These measures affect the dollar supply negatively, also contributing to the current strengthening of the US currency.

At the domestic level, the uncertainties are mostly linked to the electoral scenario, as the risk exists that the country will not approve the reforms required to balance public accounts in the medium and long run. The economic agents' perception of risks about the economic and political environment has been aggravated by the truck drivers' strike in May. With an increased risk, the real decline in the economy's interest rates makes investing in the country less attractive, leading to a further devaluation of the Brazilian currency.

This scenario of domestic uncertainties, coupled with the gradual downward trend in the interest rate differential between Brazil and the US, has caused the real to depreciate and thus brought about positive effects on the trade balance. However, the election of a new president willing to implement the structural reforms required to put Brazil on a sustainable growth path may contribute toward greater stability of the real.

We therefore estimate that the Brazilian real-US dollar exchange rate will hit the mark of R$ 3.80 per US$ by the end of 2018 – slightly below current levels. Over the coming months, however, we expect to see an increased volatility, mainly due to an unclear political scenario.

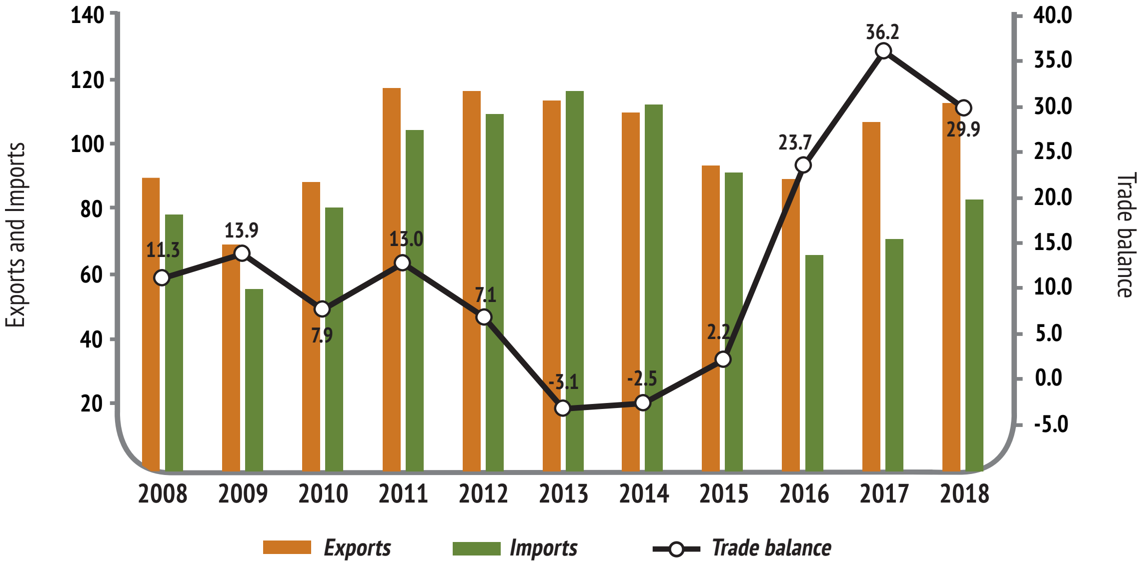
SIGNIFICANT TRADE SURPLUS

In the first half of 2018, the trade balance recorded a surplus of US$ 29.9 billion. This result was only surpassed by the figure observed last year (US$ 36.2 billion). However, imports are growing at a rate three times higher than that of exports, influenced both by the frontloading of imports to obtain a more favorable exchange rate and by the gradual economic recovery. Imports totaled US$ 83.8 billion in the year to June 2018, up by 17.2% over the same period the year before. Exports in turn reached US$ 113.7 billion, representing a 5.6% increase on the same comparison basis.

In the classification of exports by aggregate factor, all product groups increased in the first quarter of 2018 as compared to the same period a year ago: manufactured goods (9.1%), basic products (4.4%), and semi-manufactured goods (0.5%).

Despite increase in imports, trade surplus remains high

Exports, imports, and trade balance in the year to June 2018
In billion US$



Source: SECEX/MDIC
Prepared by: CNI

Imports increased in three of the four major economic categories: capital goods (33.8%), consumer goods (20.8%), and intermediate goods (13.2%). Meanwhile, fuels and lubricants posted a decline of 7.7%. The significant increase in imports of capital goods indicates a recovery – albeit gradual – of economic activity.

It is worth noting that the transportation shutdown caused by the truck drivers' strike affected the trade balance results in late May and early June. The daily average of both exports and imports experienced a decline during the period. In the second week of June, the daily figures returned to the levels observed before the truck drivers' strike.

As imports have grown at a faster pace than exports, we estimate that the trade surplus for 2018 will be lower than last year's. However, this growth rate difference will likely decrease over the second half of the year as a result of an appreciation of the Brazilian currency and a lower than expected economic growth. According to CNI calculations, the trade balance will reach US$ 62.0 billion, with exports growing by 6.5% (US$ 232 billion) and imports increasing by 12.8% (US$ 170 billion).

CURRENT ACCOUNT DEFICIT RISES

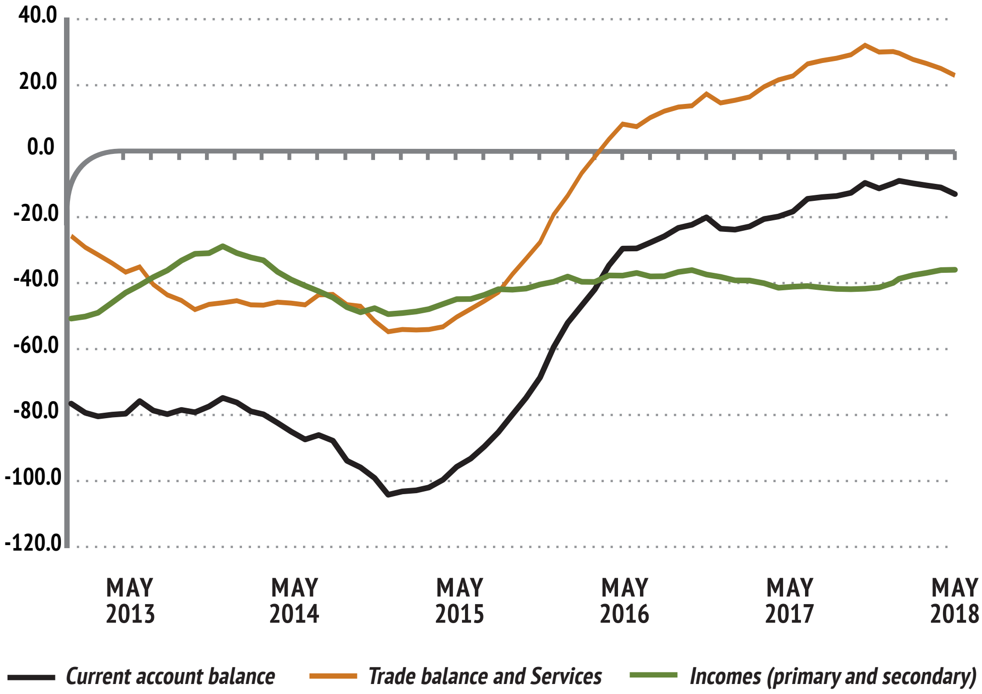
The current account deficit accumulated over the last 12 months has reversed its downward trend in recent months. The 12-month deficit reached US$ 13 billion in the year to May, representing a 32.7% increase as compared to December 2017 (US$ 9.8 billion). Despite the recent increase, the current account deficit remains at a low level, as it is down by 29% from May 2017 (US$ 18.3 billion).

The increase in the current account deficit is explained by a deterioration in the goods and services balance, which has fallen by 24% since the beginning of the year, down from a 12-month surplus of US$ 30.2 billion in December 2017 to US$ 22.9 billion in May. This reduction is driven mainly by the economic recovery – albeit modest – observed in the first months of 2018, contributing to an increase in imports.

The primary income deficit has fallen at a slower pace in recent months. The deficit fell from US$ 42.6 billion in the twelve-month period ending in May to US$ 38.8 billion in December 2017, representing an 8.9% reduction. Finally, foreign direct investment in Brazil edged up from US$ 2.6 billion to US$ 2.8 billion on the same basis of comparison.

Goods and services balance surplus falls

12-month current account balance
In billion US$



Source: Central Bank of Brazil
Prepared by: CNI

Direct investment, which had been declining since October last year, has stabilized. In the last twelve months to May, investments totaled US$ 61.8 billion – enough to cover the current account deficit. However, monthly average investments accumulated in 12 months remain lower than in 2017, when average investments reached 4.25% of GDP, up from 3.14% in the year to May 2018.

We estimate that the current account deficit will increase to US$ 20 billion – 1% of GDP as projected by CNI – at the end of 2018. This rise will likely be driven by an increased growth rate of imports on account of the recovery of domestic economic activity.

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2016	2017	2018 previous forecast (Brazilian Economy - April 2018)	2018 current forecast
ECONOMIC ACTIVITY				
GDP (annual change)	-3.5%	1.0%	2.6%	**1.6%**
Industrial GDP (annual change)	-4.0%	0.0%	3.0%	**1.8%**
Household consumption (annual change)	-4.3%	1.0%	2.8%	**2.0%**
Gross fixed capital formation (annual change)	-10.3%	-1.8%	4.0%	**3.5%**
Unemployment rate (annual average - % of the labor force)	11.5%	12.7%	11.8%	**12.4%**
INFLATION				
Inflation (IPCA index - annual change)	6.3%	2.9%	3.7%	**4.2%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	14.18%	9.92%	6.40%	**6.58%**
(year's end)	13.75%	7.00%	6.25%	**6.50%**
Real interest rate *(ex-post - average annual rate and deflation: IPCA)*	5.0%	6.2%	3.0%	**3.4%**
PUBLIC ACCOUNTS				
Primary result (% of GDP)	-2.5%	-1.7%	-2.2%	**-2.0%**
Nominal result (% of GDP)	-9.0%	-7.8%	-7.2%	**-7.5%**
Public sector's gross debt (% of GDP)	69.9%	74.0%	73.7%	**76.3%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average for December)	3.35	3.29	3.40	**3.80**
(average for the year)	3.48	3.19	3.35	**3.63**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	185.2	217.7	230.0	**232.0**
Imports (US$ billion)	137.5	150.7	172.0	**170.0**
Trade balance (US$ billion)	47.7	67.0	58.0	**62.0**
Current account balance (US$ billion)	-23.5	-9.8	-25.0	**-20.0**

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