BRAZILIAN ECONOMY

SPECIAL EDITION OF THE ECONOMIC REPORT

2019-2020

CNI

Brazilian National Confederation of Industry

THE FUTURE OF INDUSTRY

Brazilian National Confederation of Industry
THE FUTURE OF INDUSTRY

BRAZILIAN ECONOMY 2019-2020

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NEW ENVIRONMENT IN 2019, MORE GROWTH IN 2020

The year 2019 ends with the economy consolidating signs of recovery, including in the industrial sector. After some frustration with Brazil's economic performance in the first half of the year, the latest data point to consumption on the rise as a result of higher job creation and, consequently, rising household incomes, as well as falling interest rates. In addition, the effect of the injection of funds from the Government Severance Indemnity Fund for Employees (FGTS) into the economy provided an additional boost to demand.

Private investment has also been responding positively throughout the year, especially in the housing construction sector. The upturn in business confidence and the decline in interest on housing finance are the main causes of this recovery.

In the reform agenda, the analysis of the year is positive and shows that major progress has been made — especially as a result of the passage of the Pension Reform. But it also reveals significant challenges for ensuring sustained growth. **In short, for this new cycle to be consolidated, speeding up and promoting a more ambitious pro-competitiveness agenda with a focus on the Tax Reform is a must.**

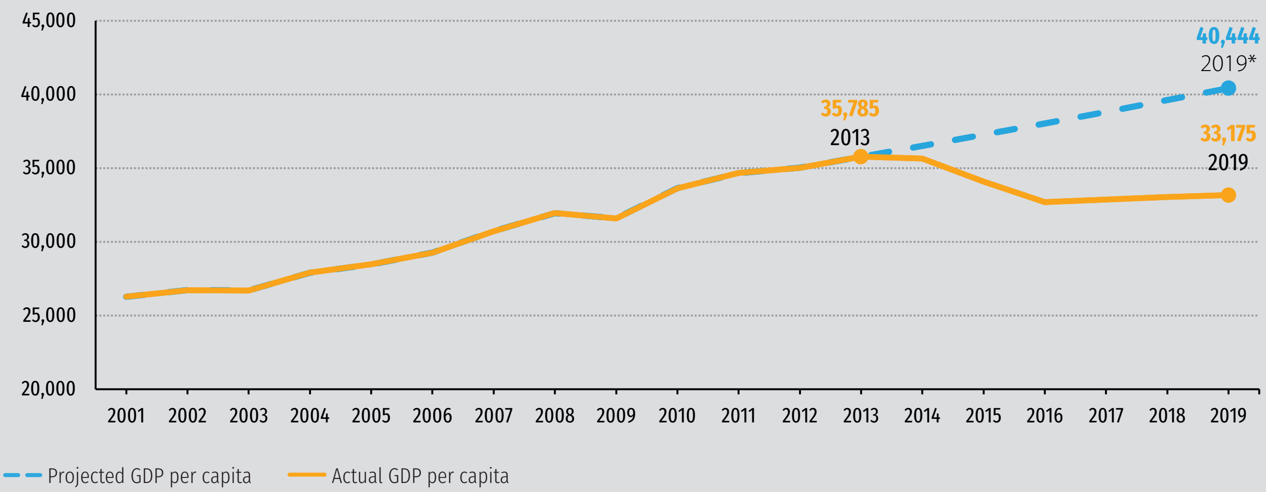
The lost decade: back to 2010

Despite the progress made on the fundamentals of the recovery process, economic growth in 2019 will still be modest and very close to that observed in 2018 and 2017 — CNI is projecting a GDP growth of 1.2% in the year.

This will be the third consecutive year in which GDP will grow by just over 1%, meaning that per capita GDP is still virtually stagnant. GDP per capita in 2019 is the same as in 2010, even considering the modest growth rate expected for this year.

Recession has set Brazil back a decade. If the economy had continued to grow at the average rate recorded in the last two decades (2.1% a year), GDP per capita in 2019 would have been about 22% higher than actually observed.

Graph 1 - GDP per capita could have been about 22% higher if the economy had continued to grow at the average rate seen in the last two decades
Gross Domestic Product (GDP) per capita
In 2018 reais (BRL)



*CNI Forecast
Source: Central Bank of Brazil, National Accounts (IBGE)
Prepared by: CNI

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The slow recovery process following the great recession has multiple causes. The first one is the magnitude of the imbalance in public accounts and its negative effects on economic stability: inflation and interest rates on the rise and high unemployment. This perverse combination has required a prolonged adjustment in the financial situation of private agents, businesses and families, resulting in lower confidence and responding capacity on their part.

Contrary to expectations of a more vigorous cyclical recovery, the second cause of the slow exit from the crisis lies in difficulties for securing the necessary political support in Congress for passing measures designed to adjust public accounts and implement reforms to reduce the so-called Brazil Cost.

Despite the approval of major adjustment measures in 2016 and 2017, it was only after the **2018 elections that a more favorable political environment emerged for reforms, which were given priority not only by the Executive Branch, but also by the majority in Congress.**

The Pension Reform is a milestone in the path of reforms and deserves special mention in 2019. The approval of this important change in the pension system made it possible to adapt our system to the demographic dynamics and to the longevity of our population. It is a historical reform and an example to be replicated.

The Pension Reform alone is not the solution to fiscal imbalance. Additional reforms need to be implemented to prevent public spending from increasing once and for all to meet the requirements of permanent fiscal equilibrium, which is the fundamental basis of a sustained growth cycle. This topic is likely to remain a priority on the 2020 agenda.

The low growth of the economy's productivity — the largest source of long-term growth — is the third cause of the slow recovery. The productivity gap is particularly reflected in the weak growth of manufacturing industry. Competitiveness difficulties, compounded by systemic cost barriers and the adversities faced by companies in the environment in which they have been operating, inhibit productive investment in the sector, mitigating productivity gains.

Private sector gains prominence

The most relevant aspect of the economic recovery being experienced today is that the economy resumed an upward path due to the strength of the private sector. The change in the economic strategy adopted back in 2015, focused on economic reforms and on the pursuit of long-term balance in public accounts, is beginning to show unequivocal results and growth has ceased to be boosted by public spending.

This shift makes it clear that for this new growth cycle to be consolidated it is indispensable to continue to remove obstacles that hinder private investment. The public sector lost its investment capacity by increasingly using its funds to cover current spending, especially on payroll, both for active and retired civil servants.

The change seen in the macroeconomic scenario is the second most important one in the year. Inflation has consistently remained below target and is likely to continue at this level. An environment favorable to keeping the Selic rate at a historically low level, with moderate exchange rate devaluation, is being consolidated. Lower spending and a partial recovery of tax revenues have been pushing the public deficit down, allowing for a new interest-exchange rate equation to materialize. This has unequivocally led to positive implications for the competitiveness of Brazilian products.

Greater and better growth in 2020

The combination of factors that characterized the second half of 2019 will likely be repeated in 2020. As a result, economic growth prospects are favorable. **CNI expects GDP to grow by 2.5% in 2020.**

It will also be a higher-quality growth. Gross fixed capital formation (investment) will be the leading component on the demand side, as it will grow by 6.5%, while household consumption will grow by 2.2% in the wake of rising income. On the supply side, growth will be led by industry, with a 2.8% growth, while manufacturing industry will grow by 2.3%. (See the section Economic Activity).

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This pace is still insufficient to make up for the poor performance seen in recent years and to reduce the gap that has widened in relation to the world and, in particular, to emerging countries, due to the great recession.

We need to be more ambitious in overcoming this challenge and to promote robust and urgent progress in the competitive transformation of the Brazilian economy. As reforms continue, we will have a clearer picture of how production and investment will respond next year and we will be able to begin to reap the benefits of a new, vigorous and sustained growth cycle.

The risks posed by the environment abroad

The world economy will not likely be a factor contributing positively to the recovery of the Brazilian economy. The continuation of the "trade war" between the two largest world economies — the United States and China — has been reducing international trade, with negative consequences for GDP growth rates in those countries and for global GDP growth. (See Special Topic on the International Scenario).

This conflict, which involves more than trade issues such as tariffs and market access, is unlikely to be settled in 2020. Although that trade conflict creates one-off opportunities for certain Brazilian export products, such as some agricultural products, it also puts negative pressure on manufactured products as competition with Chinese products intensifies both in third-party markets and in the domestic market itself.

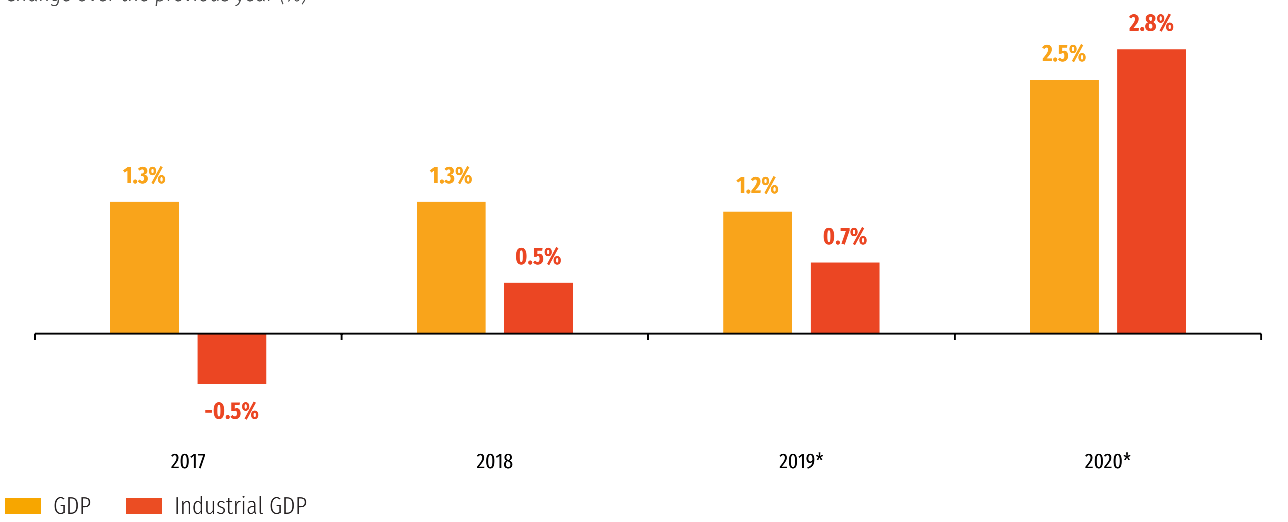
The US dollar is likely to remain strong as a result of growth pace differences between the US economy and those of the Eurozone and Japan. Lower global liquidity for emerging countries will also likely contribute to keeping the Brazilian currency at a more devalued level.

Still with regard to the scenario abroad, the evolution of the Argentine economy will be the main factor of uncertainty and risk for the Brazilian economy, as it is the third largest market for Brazilian exports. The newly elected government of that country is likely to make changes in its economic policy — which has not been clearly defined so far — with a potential impact on its economic performance. Argentine recession is likely to deepen, at least initially, with negative impacts on demand for Brazilian manufactured goods, particularly automobiles.

Graph 2 - Growth projected for industry in 2020 is the highest since 2011

Gross Domestic Product (GDP) and Industrial GDP

Change over the previous year (%)



*CNI Forecast

Source: National Accounts (IBGE)

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2020 Agenda: Focus on market rules

Entrepreneurs need a friendly business environment to invest and promote higher productivity. The entry into force of the "Law on Economic Freedom" provides an example of this paradigm that is now guiding the new strategy of economic expansion.

It is crucially important to continue on the path of reforms, and this applies not only to those related to the public sector, designed to foster efficiency and effectiveness in state actions, but especially to those intended to remove barriers affecting productive investment or hindering it altogether. This is the way to recover the confidence of economic agents (entrepreneurs and consumers) in order to resume normalcy in production, investment, and consumption processes.

It is imperative to build a better business environment to foster private investment, the engine of new growth. For this purpose, it is necessary to promote additional changes in legislation to eliminate distortions that have been compromising the competitiveness of the Brazilian economy.

There are many examples of distortions in the tax system that affect the ability of local companies to compete with foreign ones either on the international market when they export their products or on the domestic market when they compete with imported products. This environment makes resource allocation less efficient and attractive in Brazil as compared to several other countries.

The problems of our tax system include a defective debit-credit mechanism in the PIS/Cofins (Social Integration Program contribution/Contribution to Social Security Financing on fuel), IPI (Tax on Industrial Products), and ICMS (Turnover Tax), which is based on physical credit and leads to cumulative taxation. Because it is a cumulative tax with a very wide impact on services consumed by enterprises and families, the ISS (Tax on Services) also jeopardizes our competitiveness.

Therefore, we need to make timely progress on a comprehensive Tax Reform focused on improving the competitiveness of our products. **Delays in changing the Brazilian tax system can create uncertainty and inhibit investments.**

It is also indispensable to adapt regulatory frameworks to the needs of a market economy. It is essential to review and define regulatory frameworks, adapting regulations to the need to attract private funds to large investment projects that are essential for **financing the expansion and modernization of Brazilian infrastructure.**

Recovering the financial balance of enterprises is a critical factor. For borrowers, the reduction in the Selic rate has not yet materialized in interest rates comparable to those adopted in the international market. It is essential to reduce the cost of capital in order to adjust the financial cost of investments to the profitability of projects and make it possible for companies to operate competitively. The financial conditions of enterprises are deteriorating due to a combination of a major recession and still high interest rates on loans and credit constraints in the economy.

It is necessary to create conditions in the credit market that cater to the operational needs of companies. Reducing public sector borrowing needs and the Selic rate makes room for the private bond market to expand and for improved financing capacity in the new investment cycle.

The agenda is well known, and the challenge now is to move forward quickly based on a clear set of priorities. Making solid and timely progress on this agenda, we will be preparing Brazil for a decade of growth.

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1 OVERVIEW OF 2019

Frustrating start, gathering speed in the end

Industry has been keeping pace with demand growth in the second half of the year

The year 2019 was characterized by two distinct moments. The first half of the year was characterized by frustration over a very weak first quarter despite expectations of recovery with the change of government. In the second half of the year, the economy began to react and the year closed with moderate improvements.

Macroeconomic conditions evolved favorably throughout the year, with public spending under control and low inflation. In this environment, monetary policy was eased and the Selic rate hit its lowest historical level.

The foreign trade sector experienced turbulence and the Brazilian currency depreciated and dropped to a new level, but without generating destabilizing pressures on prices.

Growth in 2019 will still be small, but the economy continues to gather speed

GDP is expected to grow by 1.2% in 2019, at virtually the same rate observed in 2018, when it increased by 1.3%. Industry in particular is likely to grow by 0.7%, against 0.5% in 2018.

Since the second quarter of the year, demand has been on the rise, especially retail sales. More recently, improvements in industrial production have been observed. Industry is closing the year in "better health," with inventory levels close to planned and in a better financial situation than in recent years.

The response from investment is another positive aspect: Gross Fixed Capital Formation increased in the second and third quarters of the year, partially reversing a long period of decline.

Gradual improvement in the labor market

The labor market has shown a positive momentum in 2019, with more people employed and positive effects on the unemployment rate. The only reason why the effects of more people employed on the unemployment rate were not more significant is that the labor force (labor supply) has been increasing more intensely as a result of improved job prospects.

Employment was a determining factor in increasing total payroll, with effects on household consumption. Between January and October, the net balance of formal jobs in the country hit the mark of 842,000 (General Registry of Employed and Unemployed Persons - CAGED).

CNI predicts that the average unemployment rate in 2019 will amount to 11.9% of the workforce, 0.4 p.p. below that recorded in 2018. Despite this drop, the number of unemployed people is still very high: there are about 12.5 million jobless people in the country.

Inflation below the target center made it possible to reduce the Selic rate to 4.5%

Inflation performed quite well in 2019, remaining below the target center for most of the year. Even one-off pressures were not strong enough to compromise the positive dynamics of prices in general. CNI estimates that the Broad National Consumer Price Index (IPCA) will likely close 2019 at 3.78%, below the 4.25% target set for the year.

The Central Bank began a new cycle of interest rate reductions in July. This decision was based on the scenario of favorable inflation inertia, moderate pace of economic activity, and high idleness. The reduction was also based on the progress made on the policy agenda and on measures designed to promote macroeconomic stability in Brazil, especially in the fiscal area. With the Selic rate at 4.5% per year and inflation expected to remain at 3.9% over the next 12 months, the real interest rate is closing the year at around 0.6% a year.

Strong reduction in the primary deficit as a result of increased revenues

Revenue growth will be the main cause of the primary deficit decline in 2019. Spending is likely to increase by the end of the year, reversing the downward trend observed until October. In any case, the federal government's primary deficit will largely meet the target set for 2019.

The consolidated public sector is expected to record a primary deficit of 64.2 billion BRL in 2019 (0.89% of GDP as estimated by CNI), less than half the R$132 billion target set for the year.

The reduction in the primary deficit and the drop in nominal interest spending led to a reduction in the nominal deficit to 6.18% of GDP in 2019. This result will not be enough to stabilize the gross debt-to-GDP ratio, which will likely increase and close 2019 at 78.2%.

Uncertainty in the international scenario affects trade balance and exchange rate

The international scenario was quite turbulent in 2019, impacting Brazil's foreign accounts. US – China trade conflicts have not been settled, strengthening protectionism and stagnating world trade. In this environment, the US dollar has appreciated.

The impacts on the Brazilian currency were significant, leading it to drop to a new level. We are projecting an average exchange rate of 3.95BRL/1USD in 2019, which represents an 8% increase over last year's average (3.66BRL/1USD).

CNI estimates that exports will hit the mark of 223 billion USD in 2019, down by 6.8% compared to 2018. Imports are in turn likely to total 178 billion USD, down by 1.8% in relation to 2018. The cumulative trade balance will therefore amount to 45 billion USD, down by 22.5% (13 billion USD) from 2018.

The poor performance of the trade balance over the year has compromised balance of payment accounts and pushed the current account deficit up. The current account deficit will likely amount to 55 billion USD, about 3 percent of GDP.

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2 OUTLOOK FOR 2020

Reforms and improvements in the business environment have leveraged growth

Private investment and construction industry as engines of growth

The year 2020 will begin with prospects of faster growth, leveraged by private actors. Recent reforms in the economy, added to a macroeconomic scenario of inflation under control and a new ratio between the exchange rate and interest rates, will solidify an environment conducive to increased investment, production, and consumption.

This response from economic activity will be reflected in the labor market, leading to gradual improvements in employment and income and thus contributing to a sustained increase in purchasing power and to establishing a virtuous cycle of expansion.

The scenario of fiscal imbalance will likely improve gradually, despite an expected increase in the public deficit in relation to 2019. The rise in the deficit is explained not by increased spending, but by the sharp drop in revenues expected in 2020 resulting from the lack of extraordinary revenues generated by concession auctions held in 2019.

The contribution of the world economy will not be favorable. Trade conflicts between major economies will lead to the continuation of an adverse environment for our exports, which will also be affected by Argentina's weak economy.

Stronger growth of the economy and industry in 2020

As seen in 2019, the year 2020 will likely start with expectations on the rise. However, unlike observed in 2019, anchors that prevented a more robust resumption of economic activity have been largely dealt with**. We are projecting that GDP will grow by 2.5% of GDP in 2020.**

The construction sector will be the main engine for growth in 2020. Recovery in this sector tends to generate a large number of formal hires, supporting new progress on consumption. Manufacturing industry will likely start the year with a dynamic very similar to that observed in 2019, marked by difficulties in markets abroad and gradual improvements in the domestic market. The mining and quarrying industry is likely to continue as active as at the end of 2019. In this scenario, we are projecting that industrial GDP will grow by 2.8% in 2020.

We are projecting that investment will grow significantly in 2020, by 6.5%, and that household consumption will increase by 2.2%. As expectations of increased demand are confirmed, further increases in consumption will have an increasing effect on industrial production and on reducing idleness. This will lead to more decisive results in investment and employment, which in turn will provide new impetus to the continued recovery of the labor market.

More investment and jobs

Expectations for the labor market in 2020 are positive. Economic activity will continue to improve gradually, as will the conditions for a better business environment. This scenario is likely to lead to an increase in more formal jobs and to create higher-quality, higher-paying jobs, with positive effects on real average income in 2020.

Given this scenario, CNI estimates that real average income and real total payroll will grow by 1.6% and 3.4%, respectively, in 2020. The average unemployment rate will likely decline to 11.3% of the workforce.

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Inflation below the target for the fourth year in a row

Inflation will continue to perform well. The way the Central Bank has been conducting its monetary policy has anchored expectations, facilitating price convergence toward the targets set for the coming years. As a result, the IPCA index is likely to remain at a level of 3.7% per year, below the inflation target for the fourth consecutive year.

CNI believes that the monetary easing cycle came to an end in December. With inflation stable and the economy recovering at a moderate rate, we expect the Selic rate to remain at 4.5% per year throughout 2020.

There are expectations of continued growth in credit availability for both individuals and enterprises. The intensity of this shift will largely depend on making more significant progress on banking spread reduction policies and on their impact on the cost of capital.

Public deficit will grow again in 2020

The primary deficit of the consolidated public sector will likely increase and hit the mark of 97.5 billion USD (1.27% of GDP as estimated by CNI for 2020). However, it will still be 21.4 billion USD below the target of 118.9 billion USD set for the year. Albeit partially offset by the drop in nominal interest spending resulting from the reduction in the Selic rate, this increased primary deficit will once again push the nominal deficit up in 2020 to 6.40% of GDP.

Thus, despite the return of about R$30 billion by Brazil's Development Bank (BNDES) to the National Treasury, the gross debt-to-GDP ratio will increase to 79.3% in 2020.

It should be noted that the limit imposed by the public spending cap will be respected in 2020 due to a significant reduction in non-compulsory spending. However, there will no longer be room in coming years for further reductions in this spending and measures to ensure greater control of mandatory spending will be necessary.

Brazilian economic recovery tends to widen current account deficit

Foreign accounts and the exchange rate will be affected by the continued trade protectionism seen since mid-2018, which is likely to continue in 2020. In addition, other factors will likely impact foreign accounts in 2020, with effects on the exchange rate: the narrowing of the gap between Brazilian and foreign interest rates and the unfolding crisis in Argentina.

The recovery of the domestic economy, with increased investment and household consumption, will likely reduce the trade balance, with increased imports of consumer and intermediate goods. It has been estimated that the trade surplus will amount to 38 billion USD, representing 2% of CNI's projected GDP in 2020. The current account deficit is likely to increase to 55 billion USD in 2020. However, an improved domestic business environment will likely have a positive impact on the inflow of direct investment, contributing to balancing external accounts.

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3 SPECIAL TOPIC - INTERNATIONAL SCENARIO

Tariff barriers strengthened protectionism in global trade in 2019

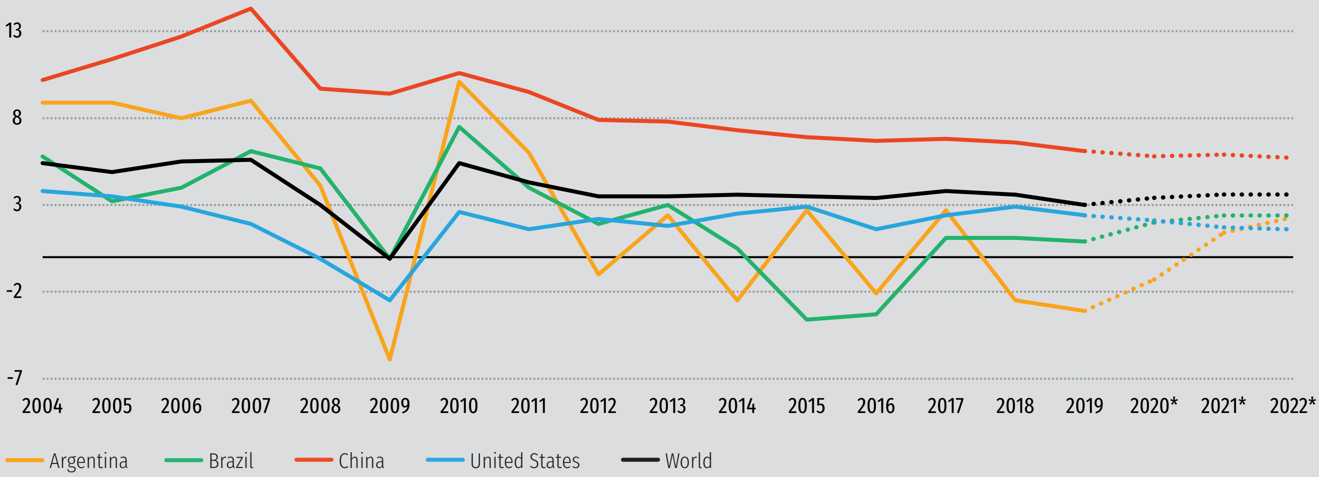
The tumultuous external scenario observed throughout 2019 led to successive downward revisions in world GDP growth, which according to the IMF is likely to close the year with a rise of only 3%, the lowest rate since the 2008 global financial crisis. This scenario is expected to continue in 2020.

The international conflicts seen in 2018 have not been settled. They are persisting and getting stronger, particularly Brexit in the European Union and the trade war between the United States and China, which has the greatest influence on the Brazilian economy. The IMF points out that **trade tensions between the two powers will account for a 0.8% reduction in global GDP growth in 2020.**

In parallel with trade issues, special mention should be made of the modest stimulus provided by expansionary monetary policies adopted in both advanced and emerging economies. Overall, the absence of inflationary pressures has allowed interest rates to fall in several markets, mitigating the negative effects of trade barriers. However, it led to currency devaluation in emerging countries and, due to uncertainties in global trade, failed to drive foreign investment.

Latin America is experiencing turmoil in some of its major economies: economic and financial crisis in Argentina, declining economic activity in Chile with recent political conflicts, and a serious humanitarian crisis in Venezuela. The Argentine economy is likely to close the year with a 3.1% drop in GDP and the forecast for 2020 is one of a further decline of 1.3% (IMF). These forecasts are worrisome for Brazil, as Argentines are major consumers of Brazilian manufactured goods.

Graph 3 - Trade barriers compromise global economic growth
World GDP and GDP of Brazil's main trading partners
Annual growth rate (%)



*IMF forecast
Source: IMF

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The share of manufactured goods in global trade remained undermined, with a significant decline in automotive and auto parts trade. This is a challenging scenario for Brazilian manufactured exports.

Although expectations for Brazilian GDP have improved, it will close the year with growth of 1.2% (according to CNI estimates). **Brazil will grow less than its peers:** an average 3.9% growth has been estimated for emerging countries in 2019 (IMF), with wide disparities among regions of the globe.

Tariff barriers were initially used in retaliation for trade conflicts. Trade tensions became more intense throughout the year and tariffs began to be used as a sectoral policy in a protectionist attempt by the US government to secure market power for certain sectors. **Conservatism has become a structural factor that international trade will have to deal with in the coming years. In this scenario, bilateral trade agreements have become more relevant** and powerful to ensure the international insertion of its members.

4 SPECIAL TOPIC - CREDIT MARKET

Agenda for improving the credit market

The monetary easing cycle in 2019 was a key step in recovering the economy. It made it possible for the Selic rate to be reduced to 4.5% per year, the lowest level since it was created back in 1999.

As the funding cost challenge has been overcome, **it is now necessary to address other elements that burden the final rates applied to credit operations**, undermining the feasibility of investment projects, thus making it difficult to increase competitiveness, economic growth, and new job creation.

Taking action to review components of the bank spread is necessary for reducing the triggers that have turned it into the second highest one in the world, behind only that charged in Madagascar. Among these components, special mention should be made of profit margins, provision for default, and compulsory deposits.

Regarding banks' net interest income, there is a need for stimulating instruments to encourage new players to enter the banking market to reduce the high concentration of credit under few financial institutions—according to a Central Bank report, the five largest banks in the country hold 85% of the credit stock.

In parallel, **it is necessary to foster the creation and/or growth of alternative credit markets** such as Fintechs, Credit Rights Investment Funds (FIDCs), Equity Investment Funds (FIPs), and Simple Credit Companies (ESC).

There is also significant scope for improving the instruments of the capital market by fostering the corporate debt niche, with receivables certificates and incentive debentures in infrastructure and industrial projects. It is also necessary to stimulate the expansion of the secondary private securities market and the securitization of receivables, which would increase the supply of credit.

Default is an element with a high impact on the cost of capital, as provisioning for it accounts for about 37% of the bank spread, according to a survey conducted by the Brazilian Central Bank.

Brazil has taken major steps for reducing information asymmetry with the aim of making it possible for financial institutions to mitigate risk perception and operating costs.

Among these actions, special mention should be made of the implementation of the Cadastro Positivo (credit worthiness list), which makes it possible to create a customer profile with the aim of reducing interest rates and providing better financing conditions for those who are well evaluated. Regulatory innovations such as the electronic trade bill and the centralized registration of collateralized receivables also have strong potential for mitigating credit risk. Another action under way is that of a public consultation carried out by the Central Bank of Brazil to regulate Open Banking, which will make it possible for information to be shared between credit institutions.

Other alternatives to reduce the banking spread and increase the availability of funds for enterprises and families include the **agenda for reducing banks' compulsory deposit rates.** Even after changes in the rules on reserve requirements over time deposits made by the Monetary Authority this year, Brazilian rates remain among the highest in the world. This leads to a decrease in credit supply and to an increase in the cost of capital for final borrowers.

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Special attention should be paid to the matter of guarantees. Credit guarantee systems are an efficient way to lower borrowing costs and increase companies' access to credit. In December, Complementary Law 169/2019 was approved, which authorized the creation of Mutual Guarantee Societies (MGSs) to act as guarantors of bank loans. This measure brought great expectation of leverage in access to credit for micro and small enterprises.

The regulation of a National Credit Guarantee System is still pending. The Law on the National Simplified Taxation System (Simples Nacional), which regulates a differentiated and favored treatment for micro and small enterprises, authorizes the establishment of this guarantee system as an element of the national financial system. This measure reduces risk and improves the quality of credit, giving greater efficiency to financial resources and promoting a greater multiplier effect on the economy, ensuring gains for companies and public and private financial entities.

Lastly, the current asset recovery system must be reviewed. Legal uncertainties regarding contract enforcement and judicial and extrajudicial debt recovery make access to the financial market even more difficult and increase the cost of credit.

According to the 2019 World Bank report, Brazil's credit recovery rate is one of only 14%. In Japan, for example, the rate is 92%, while in the United States it is 82%. In addition to the difficulties involved in recovering assets, financial institutions take an average of 4 years between when a debt recovery request is filed and the money owed by a company (or part of it) is repaid. This is a much longer period than the average recoded in other countries, such as in Japan (7 months) and in the United States (1 year).

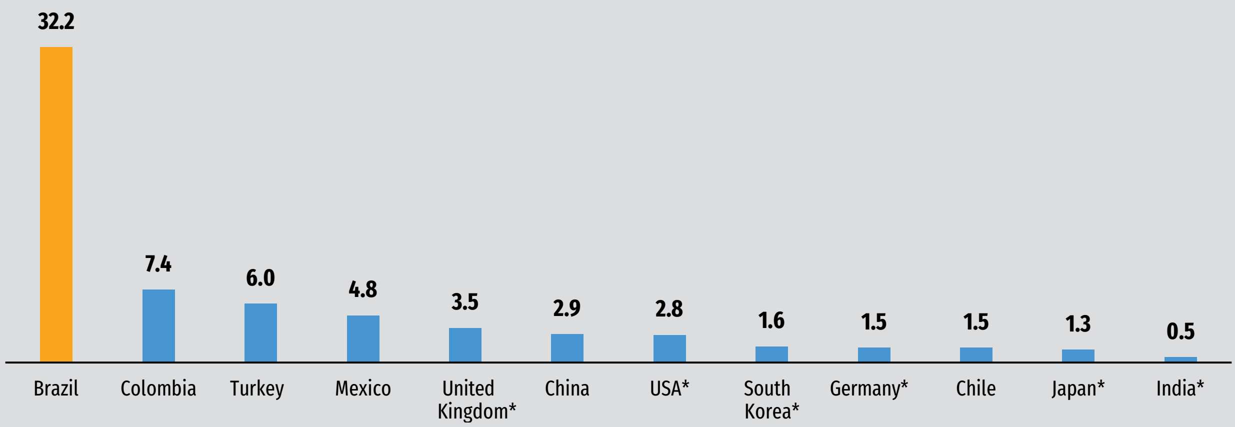
By making progress on this agenda, it will be possible to reduce the cost of credit in order to achieve international levels and increase the volume of credit in Brazil, which today amounts to 47% of GDP, much lower than the world average of 130% of GDP, according to a World Bank report.

Brazil will only resume robust levels of investment and growth if it takes action on all fronts that prevent the financial cost of investment from being adjusted to the profitability of business projects. It is necessary to make faster progress on this agenda to make it possible to increase the supply of finance, reduce capital costs, and extend financing terms.

Graph 4 - Brazil has the second largest banking spread in the world

International bank spread comparison - 2018

Percentage (%)



*Countries with data available until 2017

Source: IMD World Competitiveness Center

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5 ECONOMIC ACTIVITY

Faster growth in second half of 2019 heralds stronger growth in 2020

Industry will contribute 2.8% to this growth next year, the highest percentage since 2011

At first glance, it can be said that 2019 closely resembles 2018. As in 2018, early 2019 was marked by expectations about the reform agenda, rising confidence among economic agents, and optimism about economic activity. And, as in 2018, growth forecasts were then revised downward throughout the year. Finally, as in 2018, the end of 2019 renewed the confidence of entrepreneurs and consumers as the economy shows more signs of recovery, generating expectations of faster growth in the year to come.

The figures support this perception. GDP will likely grow by 1.2% in 2019, very close to the percentage recorded in 2018, 1.3%. Industry in particular is likely to grow by 0.7%, against 0.5% in 2018.

However, there are significant differences in the economic scenario between the end of 2018 and the end of 2019. Albeit high as at the end of 2018, confidence is no longer based almost exclusively on optimistic prospects, but also on the perception of improved business and economic conditions.

Demand is also on the rise, as observed in retail sales since the second quarter of 2019 and, more recently, also in industrial production. Finally, industry is closing the year in "healthier" conditions, with inventory levels close to planned and in a less weak, albeit far from ideal, financial situation.

In the 2018 report on the Brazilian Economy, we said that industry would recover on a more widespread basis as the broadly positive expectations of consumers and entrepreneurs translated into increased consumption and production, leading to increased use of installed capacity and investment. This only began to come true at the end of 2019. We also pointed out that a more robust growth rate would depend on the success of the agenda of reforms, which were gradually implemented throughout 2019.

Thus, the expectation is that in 2020 will see a consolidation of the recovery we began to experience in 2019. We expect GDP to grow by 2.5% in 2020.

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Confidence on the rise as current business conditions improve

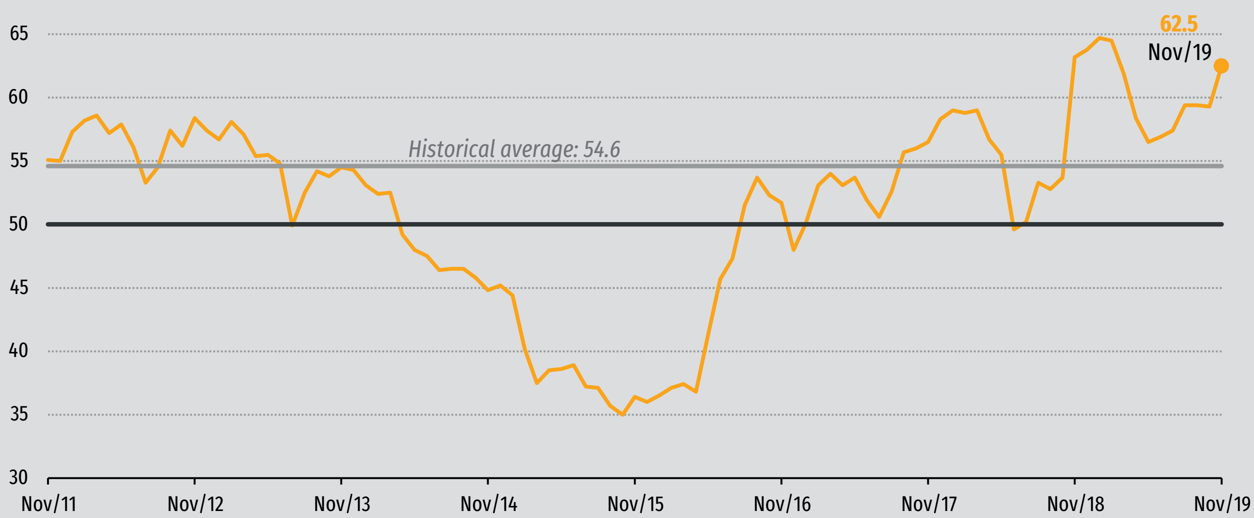
In November 2019, the Industrial Entrepreneur Confidence Index (ICEI/CNI) rose to 62.5 points, reinforcing the growth trend observed since June. Excluding the post-election period, between November 2018 and March 2019, the last time the ICEI had exceeded 60 points was in March 2011.

It should be noted that, at the end of 2018, the perception of improved current conditions was still incipient, and confidence was based on positive expectations, driven by the election of a new government. The high confidence level observed at the end of 2019 is based not only on expectations for the next six months, but also on the feeling that the economic situation is significantly better than in the last six months. In November 2019, the Current Conditions Index was the highest since October 2010.

In the case of consumers, however, there are no signs so far that their confidence has improved significantly. The latest available data from the National Consumer Expectation Index (INEC/CNI) showed a slight increase in consumer confidence in relation to the previous survey, carried out in June. Growth interrupted a sequence of two consecutive declines (in line with all other economic agents, who revised their expectations in the first half of the year). The next INEC survey (December) is likely to reveal a better scenario, albeit even less significantly so than that perceived by entrepreneurs. In any case, the INEC index is above its historical average and above the one recorded a year ago.

It should also be highlighted that consumer confidence could be higher had it not been for consumers' pessimistic assessment of inflation. The indices that measure the financial health of consumers (indebtedness and financial indices) have evolved positively. Thus, as in the case of entrepreneurs, improved confidence is supported not only by expectations, but also by an assessment of their current situation.

Graph 5 - Confidence closes 2019 at a very high level
Business Confidence Index (ICEI)
Percetage (%)



* Figures above 50 points indicate entrepreneurs are confident. The higher above 50 points, the greater and more widespread the confidence.
Source: ICEI/CNI

Manufacturing industry adjusts itself and production increases at the end of 2019

In the third quarter of 2019, GDP grew by 0.6% over the previous quarter in the seasonally adjusted series. Over the same period, industry grew by 0.8%, which came as a surprise. It should be noted, however, that the result among different industrial segments was very uneven. On one side, the mining and quarrying industry grew by 12% and the construction industry grew by 1.3% for the second time in a row. On the other side, manufacturing industry shrank by 1% as the electricity, gas and water supply industries and others decreased by 0.9%.

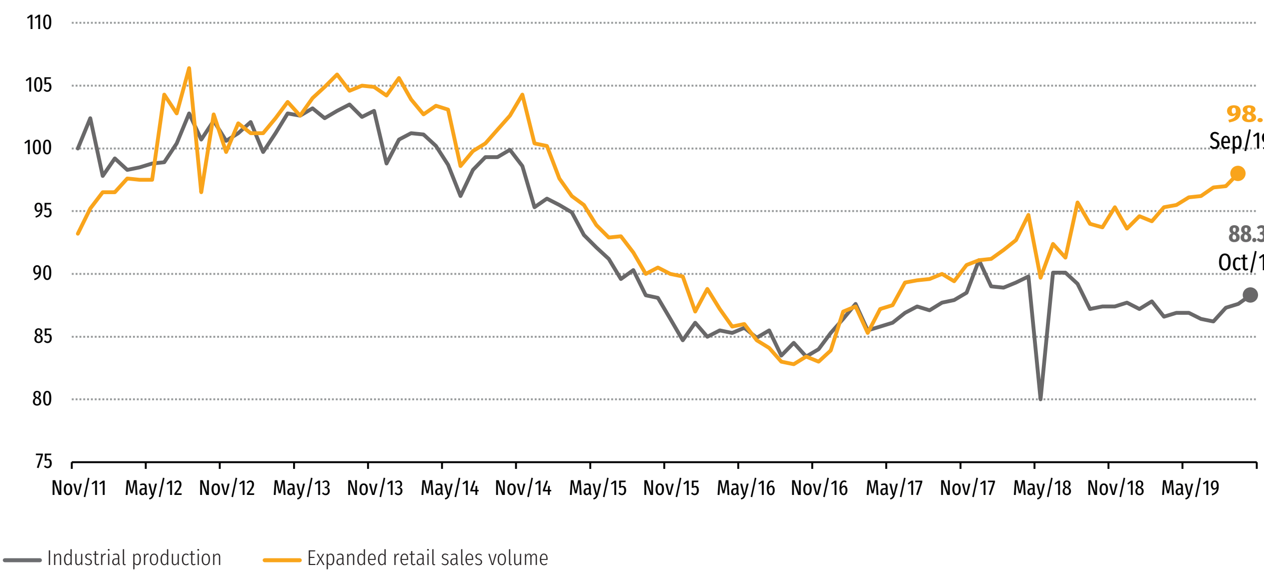
Manufacturing industry spent much of 2019 without consolidating a positive sequence. Any positive data were followed by negative ones in the following months. Thus, when comparing the year 2019 to October with the same period in 2018, IBGE (PIM-PF) data show an increase of only 0.1% in production, while CNI's Industrial Indicators survey reveal a decrease of 1, 1% in real revenues, of 0.3% in industrial employment, and of 0.4% in hours worked in production.

Data for manufacturing industry in September and especially for October suggest that the slow and at times erratic recovery in the sector may have gained a new momentum. Industrial production grew by 0.8% in October, rising for the third time in a row, something that had not been seen since 2017. Turnover grew in turn by 1.3%, rising for the fifth consecutive time, something that had not been observed since 2006.

It is also noteworthy that while industry has not shown consistent signs of recovery during most of the year, it managed to make major adjustments that help explain the improved activity data recorded at the end of 2019: improved financial situation and falling inventories.

The Industrial Survey (CNI) shows these two adjustments. The actual-planned inventory index, which measures the surplus of inventories of finished goods, has been falling since August after reaching its highest level since the truck drivers' strike in May 2018. The financial satisfaction index rose in turn in the third quarter of 2019 to the highest level recorded since the last quarter of 2017. Or, excluding the last quarter of 2017, to the highest level observed since the last quarter of 2013.

Graph 6 - Industry began to keep pace with retail trade growth at the end of 2019
Industrial production and expanded retail sales volume
Index Number - Base: 2012 average = 100



Source: PIM-PF and PMC (IBGE)
Prepared by: CNI

This recovery came too late to prevent manufacturing industry from closing 2019 without these variables on the decline, or at least most of them. For manufacturing industry, activity, production, and employment levels will change little in relation to the average recorded in 2018 and 2019. We are projecting that the GDP of manufacturing industry will grow by 0.5% in 2019, the same percentage recorded in 2018.

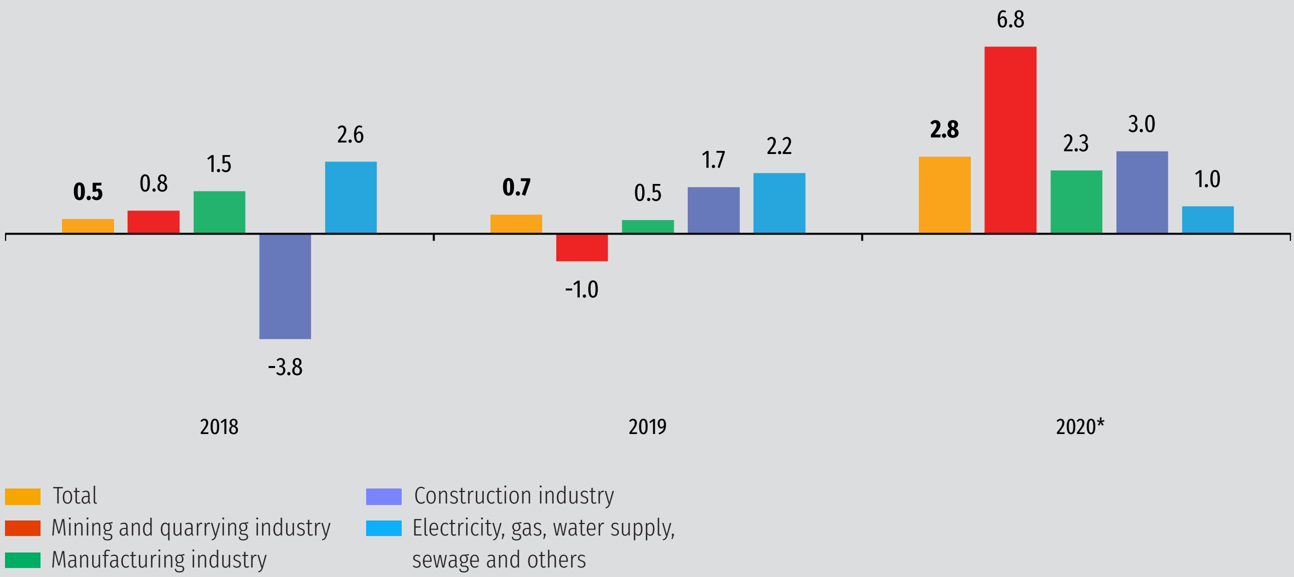
In the case of electricity, gas, water supply, sewage and others, the decline seen in the third quarter of 2019, of 0.9% over the previous quarter, was the second one in a row. Additionally, the decrease in the second quarter was revised upward from 0.7% to 1.1%. As a result, the carry-over effect (growth compared to 2018 without any change in the sector until the end of the year) dropped from 3.0% to 1.8%. This led us to revise the growth expected for 2019 downward from 3.0% to 1.7%.

Construction and mining and quarrying industries show recovery

The construction industry showed signs of recovery as early as in the second quarter of 2019, when it was up in relation to the same quarter last year—for the first time in twenty quarters. In the third quarter, the sector showed new growth: it had not recorded two quarterly highs in a row since 2013.

The activity indexes for the sector, calculated by the Construction Industry Survey (CNI), had been showing gradual improvement since the beginning of the year. More recent data, from October, consolidate this trend. Confidence and expectation—including intention to invest—are high. This better performance is mainly explained by the housing industry, whether as a result of renovation or new construction projects. We are therefore projecting that the construction industry will grow by 2.2% in 2019. It will be the first year in which it will grow since 2013.

Graph 7 - All segments of industry will grow in 2020
Industrial GDP
Variation compared to the previous year (%)



*CNI Forecast
Source: National Accounts (IBGE)
Prepared by: CNI

Table 1 - Estimate for GDP and its components in 2019
Projected variation (%)

	GDP COMPONENTS	Rate of change (%)
Demand side	Household consumption	1.9
	Government consumption	-0.2
	Gross fixed capital formation	2.8
	Exports	0.2
	(-) Imports	4.0
Supply side	Agriculture/livestock	1.7
	Industry	0.7
	Mining and quarrying industry	-1.0
	Manufacturing industry	0.5
	Construction industry	2.2
	Electricity, gas, water supply, sewage and others	1.7
	Services	1.4
	GDP	1.2

Prepared and projected by: CNI

The dynamics of the mining and quarrying industry in 2019 was in turn strongly affected by the dam collapse in Brumadinho, which had a negative impact on iron ore mining, especially in the first half of the year. In the third quarter, the sector experienced a significant recovery pace: it grew by 12% in relation to the previous quarter in the seasonally adjusted series, the highest quarterly increase observed since the fourth quarter of 2003. In addition to the resumption of iron ore mining, this result is also explained by an increase in oil and gas extraction in pre-salt rigs. Despite the strong recovery experienced in the third quarter and the expectation of very intense mining and quarrying activity in the last quarter, the result for the year will still be negative: a decline of 1.0%.

In this scenario, we are projecting that industrial GDP will grow by 0.7% in 2019, close to the 0.5% expansion observed in 2018.

Positive revisions of growth in agriculture/livestock and services

The agriculture/livestock industry grew by 1.3% in the third quarter of 2019, driven by positive cotton, orange, and corn harvests. The results for the first quarter of 2019 were also revised upwards. Our growth estimate for this industry in 2019 has been revised upward from 1.0% to 1.7%.

The service industry grew by 0.4% in the third quarter of 2019. Retail trade was the main source of this growth in services, mainly that of consumer goods. Data from the Monthly Retail Trade Survey (PMC/IBGE) show that the expanded retail sales volume (which includes vehicles and construction material in retail sales) grew for the eighth consecutive month, amassing a 5.2% increase over the period. Our estimate for growth in services in 2019 has been revised upward from 1.1% to 1.4%.

Higher consumption at end of 2019

Household consumption increased by 0.8% in the third quarter of 2019, influenced by the beginning of the release of funds from the Government Severance Indemnity Fund for Employees (FGTS) in September and by the growth in total payroll in the year (see the section Employment and Income). It was the fifth consecutive quarter in which it grew.

New growth is expected in the last quarter of the year. Improved household financial conditions, in a scenario of falling interest rates and credit expansion, supports new consumption growth, which will also be influenced by the additional release of FGTS funds throughout the fourth quarter. Our forecast is that it will grow by 1.9% in 2019 as compared to 2018.

Investment, as measured by Gross Fixed Capital Formation (GFCF), is also expected to continue to grow. Notwithstanding a significant share of imports, purchases of machinery and equipment have been on an upward trend since the beginning of 2019. For the remainder of the year, we expect the slow downturn in idleness in the industrial sector to boost new investment. In addition, further improvements in the construction industry will also impact investment in the last quarter of the year. We are therefore projecting a 2.8% increase in GFCF in 2019.

As for the foreign trade sector, imports have increased due to trade in capital goods and intermediate goods for use in agriculture. The improved industrial activity recorded at the end of 2019 is also already leading to an increase in imports of industrial intermediate goods. Brazilian exports, on the other hand, faced a challenging scenario abroad throughout the year, particularly due to the decline recorded in the volume of exports to Argentina.

Third quarter results will be revised because the official data announced by the Foreign Trade Secretariat (see the section Foreign Trade Sector) were miscalculated. Nevertheless, the contribution of foreign trade to GDP will certainly be significantly negative in 2019: we are anticipating a negative contribution of 0.6 percentage points. We are projecting a 0.2% increase in exports of non-factor goods and services and a 4% growth in imports of non-factor goods and services (exports and imports according to the National Accounts concept).

Outlook for 2020: Recovery in a new momentum

As in the previous year, 2020 is starting with rising expectations. Unlike observed in the previous year, most of the anchors that prevented a more robust resumption of economy activity have been overcome. Inventories have been adjusted, idleness is on the decline, albeit slowly, and the financial situation of economic agents is not as weak as before.

As expectations of increased demand are confirmed, further increases in consumption will have an increasing effect on industrial production and reduced idleness. This will lead to more decisive results in investment and employment, which in turn will provide further impetus for the continued moderate recovery of the labor market.

Consumer goods production is leading this recent growth process as 2019 turns into 2020, while the production of capital and intermediate goods has not been showing the same momentum. This recent dynamic is largely due to the resumption of consumption stimulated by the release of FGTS funds—demand for consumer goods is more susceptible to this kind of stimulus—and also by the reduction in interest rates and the greater availability of credit.

We are projecting that GDP will grow by 2.5% in 2020. Growth in 2020 is likely to gather speed as this surge in domestic demand spreads to other sectors engaged in the production of intermediate and capital goods.

This requires working on the productivity and competitiveness agendas of Brazilian industry as soon as possible, so that the positive effects of this boost on consumption can be more quickly and effectively translated into more employment—especially into better-quality employment—and into more investment.

Gradual recovery in industry

The construction sector will be the main engine for growth in 2020. Industry's recovery tends to generate a large number of formal hires, supporting new increases in consumption. Our expectation is that the performance of the real estate segment will continue to benefit from low interest rates and from the improved financial situation of households. We also expect the year to mark the start of a recovery in the infrastructure sector, which would give additional impetus to the construction industry. Although there is no fiscal space for public investment, the progress being made on the concession, bidding, and privatization agenda in a scenario of low uncertainty and favorable macroeconomic conditions will likely strengthen the sector. We are projecting that the sector will grow by 3% in 2020.

Manufacturing industry is in turn likely to experience a very similar dynamics early in 2020 to that observed at the end of the year, marked by difficulties in the foreign market and gradual improvements in the domestic market. No bumps along the way are expected, so the recovery trend is likely to continue and may even gather speed as it becomes more widespread among the different sectors of manufacturing industry. In this scenario, manufacturing industry will likely grow by 2.3% in 2020.

The mining and quarrying industry is likely to grow by 6.8% in 2020 due to the continued recovery of activity as iron ore mining is resumed at normal levels and oil and gas extraction is expanded.

In this scenario, we are projecting that industrial GDP will grow by 2.8% in 2020.

The expectation for the agricultural sector in 2020 is one of a record crop and strong growth of the meat sector, which would drive a 3% growth in the sector.

The service industry is likely to grow more evenly across its different segments in 2020. In addition to retail trade, services related to industrial activity (such as transportation) will likely grow at a faster pace, as well as services focused on meeting household demand. We are projecting a 2.1% growth for the sector.

Investment will increase more robustly in 2020

We are projecting a robust investment growth in 2020, of 6.5%. Companies will start the year in more favorable financial conditions, with lower interest rates and lower debt. In addition, idleness is showing the first signs of decline, while expectations remain optimistic. There are also prospects for progress on regulatory frameworks and reforms designed to make the environment more conducive to investing. CNI's survey entitled "Investments in Industry in 2019-2020," released in December 2019, shows that the percentage of companies intending to invest in 2020 is the highest in the last six years.

With regard to household consumption, income is likely to increase as a result of reduced idleness and more formal jobs becoming available. Coupled with a more controlled financial situation, high consumer confidence, and fear of unemployment on the decline, this increase in income will make it possible for consumption to continue to grow even without any additional stimulus such as the one provided by the release of FGTS funds. We are projecting that household consumption will increase by 2.2% in 2020.

The contribution of the foreign trade sector to GDP in 2020 will remain negative (-0.3 percentage points). On the one hand, it will reflect the increase in imports in response to higher household consumption and industrial production and, on the other, to a still quite challenging scenario abroad. We are projecting a 1.5% increase in exports and a 3.5% increase in imports of non-factor goods and services (exports and imports according to the National Accounts concept).

Table 2 - Estimate for GDP and its components in 2020
Projected variation (%)

	GDP COMPONENTS	Rate of change (%)
Demand side	Household consumption	2.2
	Government consumption	0.6
	Gross fixed capital formation	6.5
	Exports	1.5
	(-) Imports	3.5
Supply side	Agriculture/livestock	3.0
	Industry	2.8
	Mining and quarrying industry	6.8
	Manufacturing industry	2.3
	Construction industry	3.0
	Electricity, gas, water supply, sewage and others	1.0
	Services	2.1
	GDP	2.5

Prepared and projected by: CNI

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6 EMPLOYMENT AND INCOME

Labor market will continue to improve gradually in 2020

Progress made on making new jobs available ensures expansion of total payroll in 2019

Despite a slower than expected increase in economic activity (see the Economic Activity section), the labor market has been showing a positive momentum in 2019, as evinced mainly be the increase in the number of employed persons, with a positive impact on the unemployment rate. It is noteworthy that the only reason why the effects of improved employment on the decline seen in the unemployment rate were not more significant was that the workforce grew more strongly this year. In other words, the growth in job vacancies led part of the population of discouraged workers to look for a job again, slowing the pace of falling unemployment.

The increase in occupation played a particularly important role in increasing total payroll in 2019, since real average income between January and October was not significant. Therefore, employment was a determining factor in increasing total payroll, which was reflected in higher household consumption, one of the engines of the result calculated for GDP in the year (see the Economic Activity section).

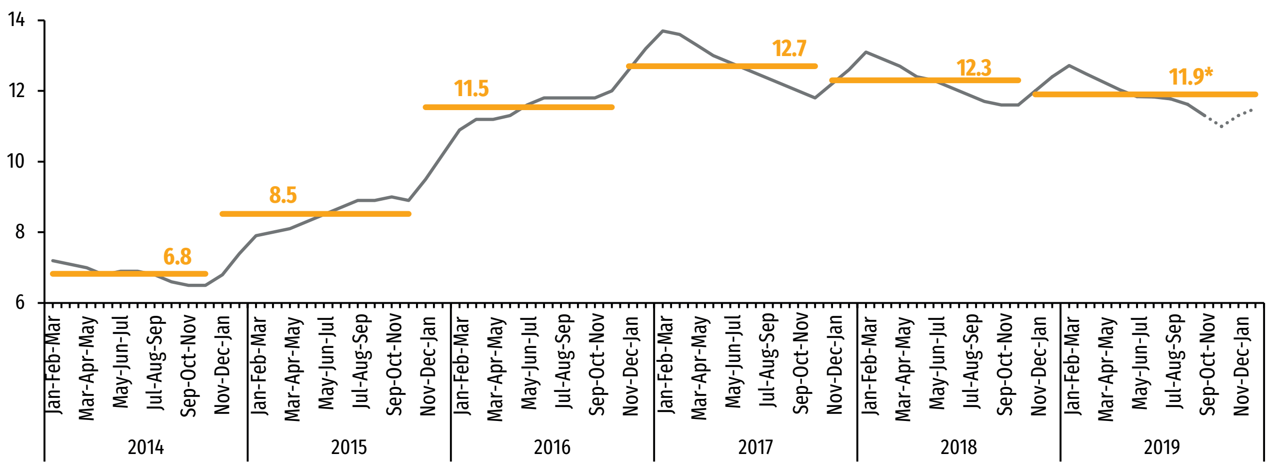
The outlook for the last two months of the year is one of continuity of this positive dynamics, with improved economic activity due to the year's end holidays. Nonetheless, the unemployment rate is likely to take an upturn from the moving quarter ended in December due to the seasonal behavior of layoffs of temporary workers at the end of each year.

As a result, CNI predicts that the average unemployment rate in 2019 will decrease to 11.9% of the workforce, 0.4 percentage points below that recorded in 2018. Despite this drop, the number of unemployed people is still very high: there are about 12.5 million people without a job in Brazil.

Graph 8 - Unemployment rate gradually improving

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

As a percentage of the workforce (%)



*CNI Forecast

Source: Monthly Continuous PNAD survey/IBGE

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Formal employment grows at a pace similar to that recorded in 2018

In 2019, the trajectory of formal employment, as measured by the General Registry of Employed and Unemployed Persons (CAGED/Ministry of Economy), was very similar to that observed in 2018. From January to October, the net balance of formal jobs in the country amounted to 842,000 vacancies.

All sectors of the economy recorded net job creation in the year, especially those of services (447,000 jobs) and industry (285,000).

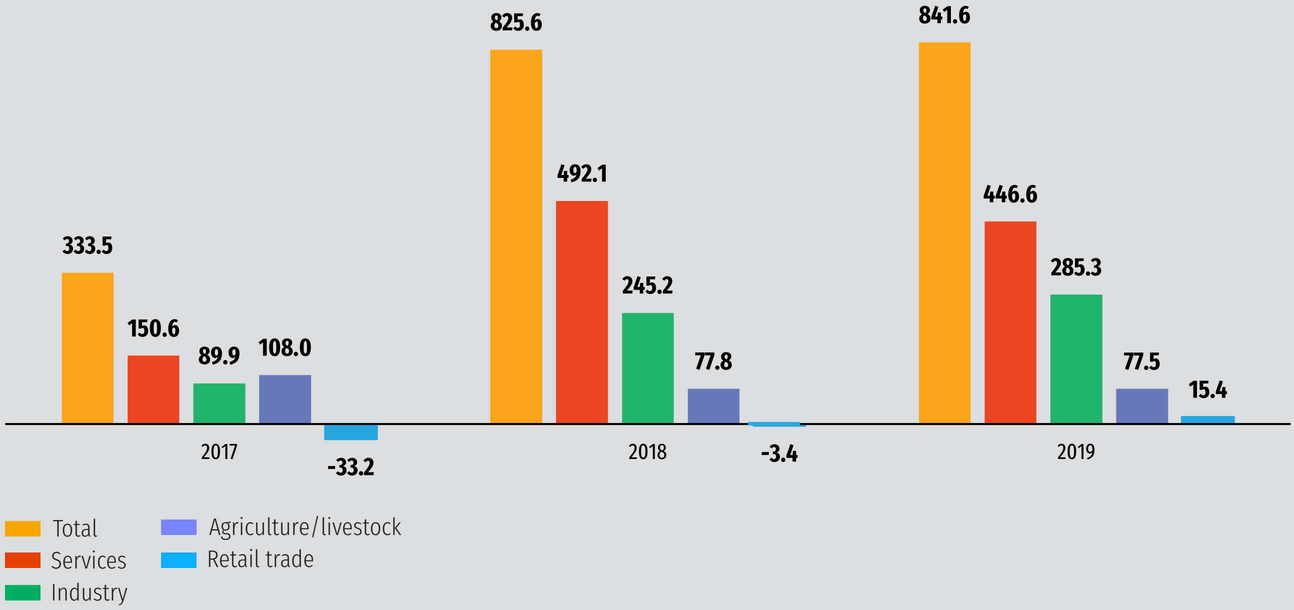
In the last two months of the year, a net loss of formal jobs is expected due to both seasonality in the agricultural sector and temporary layoffs in the industrial sector to meet stronger year-end demand. Brazil will likely close 2019 with a net job creation of around 500,000 jobs.

Methodological differences between the results of the CAGED and of the Continuous PNAD (National Household Sample Survey/IBGE), the two main labor market surveys carried out in Brazil, should be highlighted. These differences occur because CAGED produces monthly census data and covers only formal jobs governed by the Brazilian Consolidated Labor Laws, while the data produced by the Continuous PNAD survey data are sample data measured by moving averages that also take into account informal jobs.

Graph 9 - CAGED will likely record a net creation of more than 500,000 formal jobs for the second year in a row

Net balance of formal jobs - year to October*

Thousand jobs



*Includes information provided beyond deadline

Source: CAGED/Ministry of Economy

Employment supports total payroll growth

In 2019, average real income had a much less favorable dynamic than in 2018. As a result, growth in occupation became the engine for increasing total payroll in the year.

From January to October, the average real income usually earned by workers increased by only 0.3%, much less significantly than in 2018, when it grew by 1.7% in the same period of comparison.

Two reasons contributed to the downturn in average income: an increase in informal jobs, which usually pay lower wages than formal ones; and low generation of more qualified jobs, including due to difficulties in finding skilled professionals to fill these vacancies.

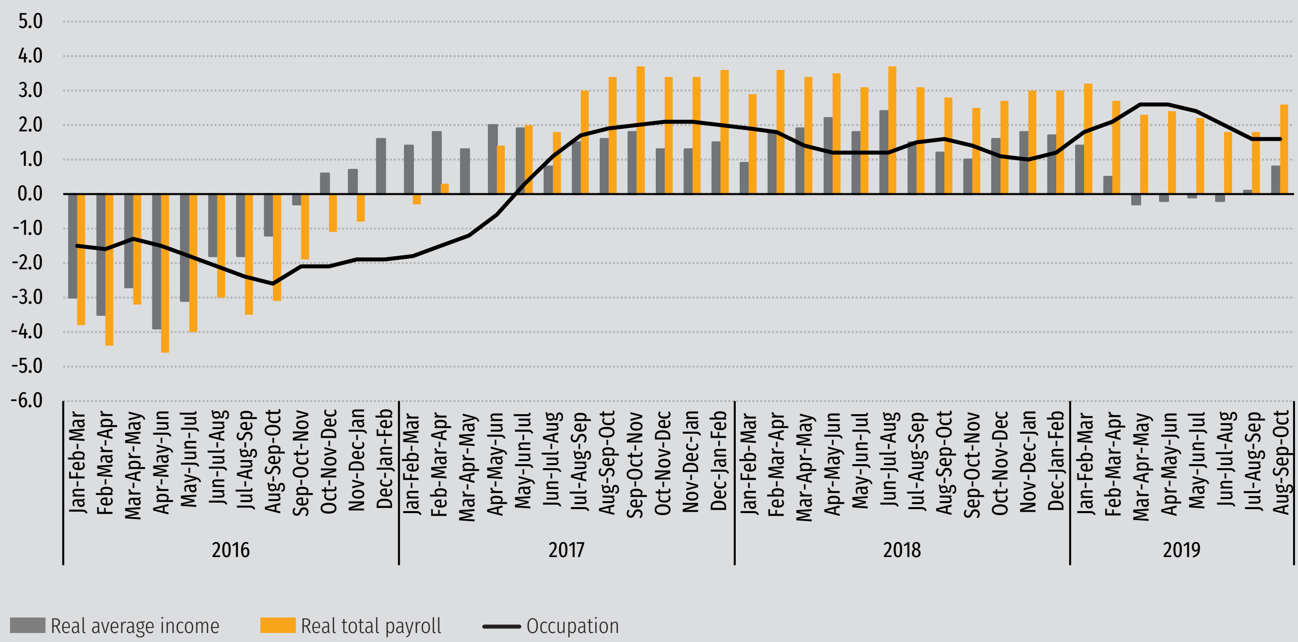
Occupation, on the other hand, grew by 2.1% on average from January to October, against 1.5% over the same period in 2018. This increase in the number of employed persons boosted real total payroll to 2.4% in 2019 from 3.3% in 2018 on the same basis of comparison.

In the last two months of the year, total payroll will likely continue to grow—albeit at a slower pace than that observed throughout the year, due to layoffs of temporary workers. As a result, CNI estimates that real total payroll will grow by 2.1%, 1 p.p. below the growth recorded in 2018.

Graph 10 - Employment growth ensures increase in total payroll in 2019

Real average income, real total payroll and occupation

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



Source: Monthly Continuous PNAD survey/IBGE

Outlook for 2020: Greater investment and more employment

Expectations for the labor market in 2020 are positive. Economic activity will continue to improve gradually, as will the conditions for a better business environment (see the section Economic Activity).

The passage of the Pension Reform led to prospects of a lower deficit in public accounts and of sustainable fiscal control, which will likely boost the confidence of both domestic and foreign economic agents. In addition, structural reforms, such as a tax reform, and microeconomic reforms, such as boosting the credit market and reducing excessive red tape, are likely to advance and to have an impact on competitiveness.

This expectation of progress on reforms is supported by an environment of continued inflationary control, with the Selic rate being kept at its current level (and perhaps even lower), and by prospects of growth in the credit market as a result of the actions contemplated in the BC# Agenda. The result is an environment conducive to increased investment, production, and employment.

This scenario will likely allow for a more robust growth in employment and for higher-quality, better-paying jobs to be created, with positive effects on real average income in 2020.

Given this scenario, CNI estimates that real average income and real total payroll will grow by 1.6% and 3.4%, respectively, in 2020. The average unemployment rate is likely to decline to 11.3% of the workforce in 2020, against the 11.9% rate estimated for 2019.

7 INFLATION, INTEREST RATES AND CREDIT

Monetary easing cycle makes it possible for the Selic rate to be reduced to the historical level of 4.5%

Inflation closed another year below the target center

The National Extended Consumer Price Index (IPCA) performed quite favorably in 2019, within the limits set by the National Monetary Council (CMN). Inflation remained under control due to both the performance of free prices, especially the lower inflation recorded for the Food group, and the decline in government-regulated prices.

Inflation in November, however, showed a less favorable dynamics, standing at 0.51%. This was the highest result for the month since 2015, when the IPCA index stood at 1.01%. This upturn was caused by pressures from the Food group (0.72%), derived mainly from a hike in beef prices, which had the largest individual impact on the IPCA in the month.

The result in November was also influenced by an increase in electricity rates resulting from a change in the tariff flag from October to November. In October, the yellow flag was applied, adding R$1.50 for each 100 kilowatt-hours of electricity consumed. In November, the level 1 red flag was applied, raising the rate from R$4.00 to R$4.169 for each 100 kilowatt-hours of electricity consumed.

As a result, the inflation rate, which had remained at 2.54% in the 12-month period to October, rose to 3.27% in November. For December, beef prices are expected to remain high, since the ones charged in November were defined before the pork crisis broke out, reflecting old prices. In addition, the devaluation of the Brazilian currency made it more attractive to export beef than to sell it domestically.

IPCA index will close 2019 below 4%

Among the four major groups that make up the IPCA index (Government-Regulated Prices, Food Prices, Industrial Prices, and Service Prices), that of government-regulated prices was the one with the sharpest variation. The group recorded growth of 6.08% in the year to November 2019, against 8.38% over the same period in 2018.

Prices in this group were influenced, on the one hand, by the downturn in gasoline and diesel oil prices driven by the decline in international fuel prices. In the opposite direction, government-regulated prices were pressured by the increase in electricity rates resulting from annual adjustments and from the tariff flag system. In the 12-month period to November, prices in this group rose by 4.98%, against 8.64% in the 12-month period to November 2018.

Food prices kept rising until April. From May to October, however, they experienced consecutive declines. Negative variations were influenced by seasonal factors, with oversupply of fresh products such as fruits, vegetables, and semi-processed and industrialized products in the period. In November, however, food prices took an upturn once again due to a strong growth in demand for beef from China as a result of an African swine fever epidemic that significantly reduced the herd worldwide. As a result, in the year to date, food prices recorded growth of 2.78%. In the last 12 months to November, food prices increased by 3.28%, against 4.41% in the 12-month to period to November 2018.

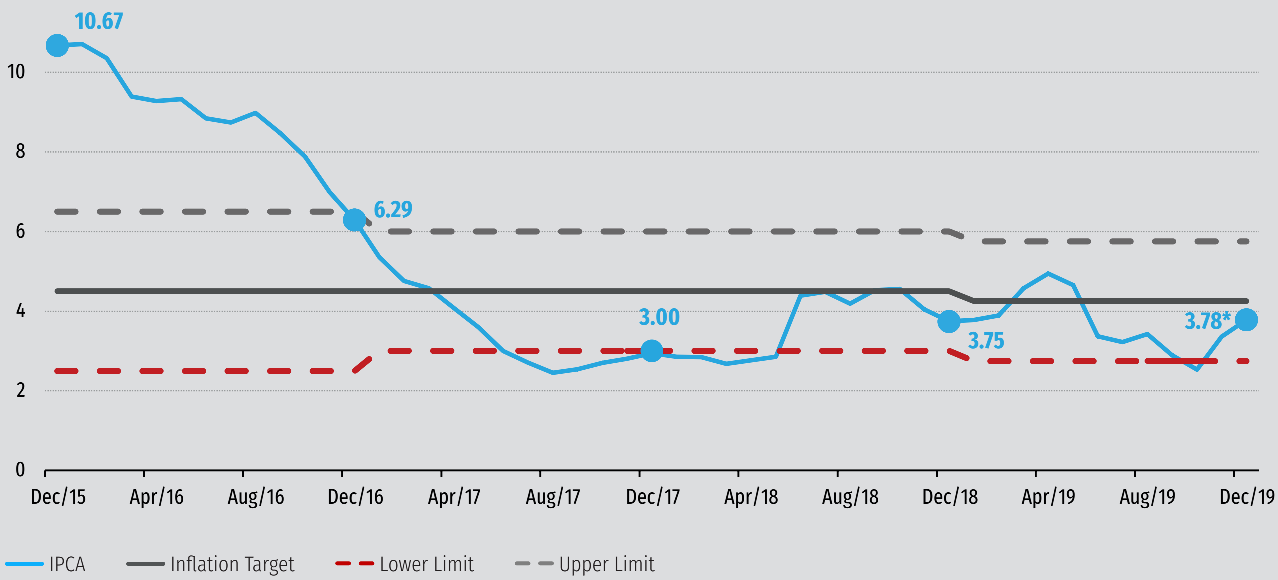
Service prices took a slight upturn in 2019, mainly due to an increase in airline tickets. But inflation in services remained well under control throughout most of the year. Service prices rose by 2.76% in the year to November. In the last 12 months, the group's inflation hit the mark of 3.40%, against 3.32% in the 12 months to November 2018.

Industrial product prices also took an upturn, but without any significant impact on the IPCA index. The group's weak effect on inflation is due to the slight variation in its prices, which rose from 0.6% in 12 months to November 2018 to 1.7% in the 12-month period to November 2019.

For the remainder of the year, inflation will likely continue to perform well, although a slightly faster rise is expected. This faster rise is likely to be particularly caused by food prices, due to the devalued exchange rate and to the "China effect" not only on beef prices, but also on other proteins such as pork, fish, and eggs.

As a result, we estimate the IPCA index to close 2019 at 3.78%, below the center of the 4.25% target set by the National Monetary Council (CMN).

Graph 11 - Inflation will close 2019 below the target center
National Expanded Consumer Price Index (IPCA)
12-month figure (%)



*CNI forecast
Source: National Monetary Council and Central Bank of Brazil

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Selic rate closes 2019 at a new historically low level

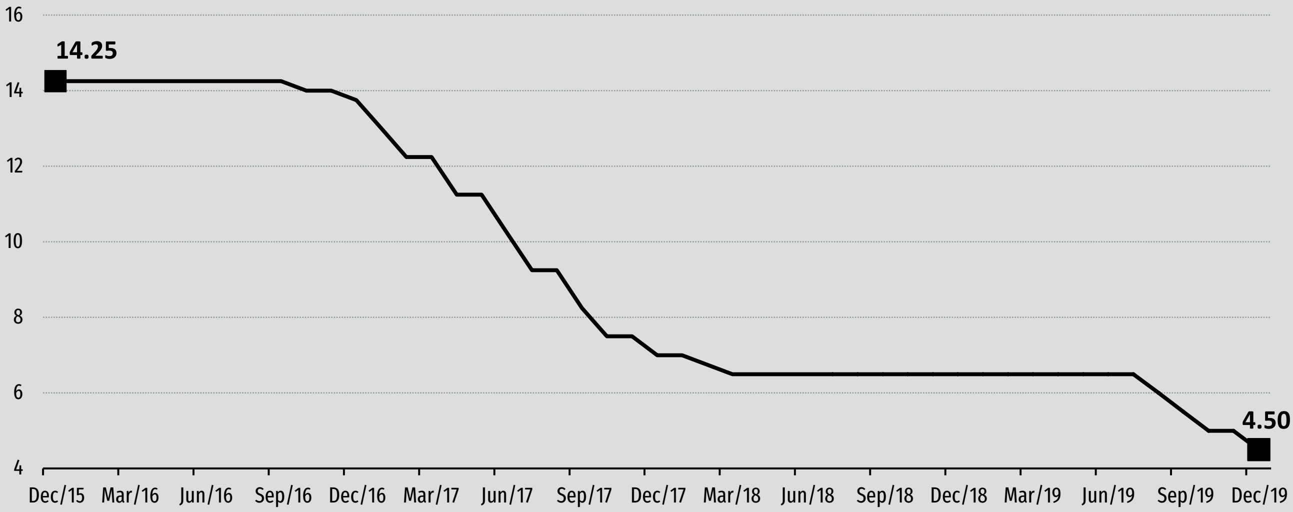
The Central Bank launched a new cycle of interest rate reductions at the Monetary Policy Committee (Copom) meeting held in late July. The decision was based on a favorable inflation inertia, with product and service prices behaving well, the economy growing at a moderate pace, and a high unemployment rate. The reduction was also based on the progress being made on the policy agenda and on measures being taken to promote macroeconomic stability in Brazil, particularly in the fiscal realm.

The decline in domestic interest rates also followed the trend seen in the rest of the world, as interest rates have been reduced in several emerging and developed countries. The cuts in international economies were intended to reduce the impacts of the slowdown in world economic activity.

At the Copom meeting in December, the Monetary Authority maintained its expansionary monetary policy, cutting the Selic rate by an additional 0.5 percentage points. As a result, the rate closed the year at 4.5% p.a., a new historical low.

With the Selic rate at 4.5% per year and inflation likely to remain at 3.9% over the next 12 months, according to BACEN's Focus survey, the real interest rate (ex-ante concept, which considers future inflation) stood at 0.6% p.a. in November.

Graph 12 - Selic rate closes 2019 at 4.50% per annum
Basic interest rate, Selic rate
Final rate for the period (% p.a.)



Source: Central Bank of Brazil

Credit continues on the rise

In 2019, lending continued on the rise year-on-year. In 12 months to October, total credit increased by 8.5% in relation to October 2018 in real terms. In October 2018, it had increased by 6.0% in relation to the same period in 2017.

Lending to individuals increased at a faster pace throughout the year: by 10.0% in 12 months to October 2019, against 5.8% in 2018. On the other hand, there was a slowdown in credit to companies: 6.5% increase in the 12-month period to October, down from 8.3% in 2018.

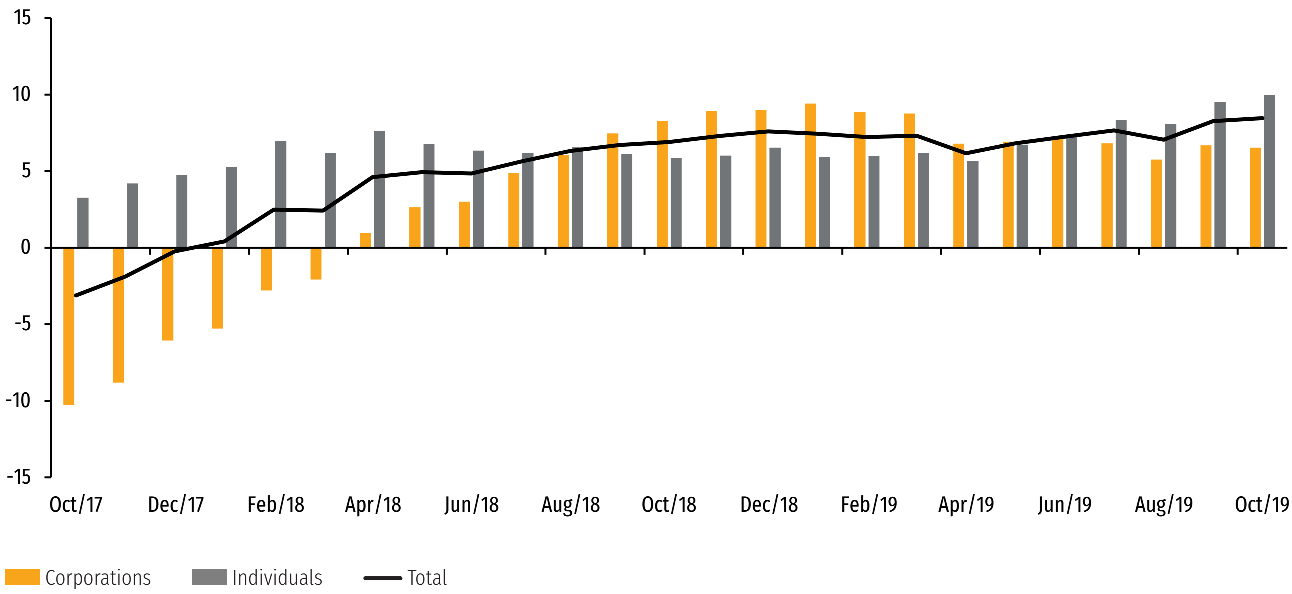
Lower financing costs were a major variable in increasing lending in the last two years. Interest rates on credit operations with non-earmarked funds dropped from 43.4% p.a. in October 2017 to 38.0% per annum in October 2018 and to 35.9% p.a. in October 2019.

The decline in interest rates on non-earmarked credit operations was mainly due to the expansionary monetary policy adopted by the Monetary Authority this year, which reduced the cost of borrowing, and to a lower average default rate. The percentage of the loan portfolio of the National Financial System with at least one installment overdue for over 90 days declined from 4.09% in October 2018 to 3.88% in October 2019.

Total credit stock, which had declined over the past three years, took an upturn in 2019 year-on-year. The indicator increased by 3.3% in October in real terms in relation to October 2018.

It should be mentioned that improvements recorded in total inventory were due to the balance of the individual loan portfolio. In October, this balance rose to 8.2%. On the other hand, the balance of the corporate loan portfolio has not yet recovered and has been on the decline since September 2015. In October, the balance for companies fell by 2.8% in relation to October 2018.

Graph 13 - Lending on a continued recovery path in 2019
Granting of credit, in real terms
Variation in 12 months (%)



Source: Central Bank of Brazil

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Outlook for 2020: Inflation below the target center for the fourth year in a row

Inflation's favorable performance will likely remain the same in 2020, despite the forecast of higher growth in economic activity (see the section Economic Activity). This is so because despite high idleness levels in the industrial park and prospects of a reduction in the number of unemployed people, they will still remain at levels that avoid great pressure on prices.

In addition, the way the Central Bank has been conducting its monetary policy has anchored expectations, facilitating price convergence toward the targets set for the coming years. As a result, the IPCA index will likely hit the mark of 3.7% per annum, below the inflation target set by the National Monetary Council (CMN) in 2020, of 4.0% p.a.

This forecast for the inflation rate in 2020 and the fact that inflation expectations are likely to remain at low levels in the following years—with targets set by the CMN at 3.75% p.a. in 2021 and at 3.50% p.a. in 2022—are likely to make it possible for the Selic rate to be kept at its current levels. CNI expects the monetary easing cycle to end in December and the Selic rate to remain at 4.5% per annum throughout 2020.

In the medium term, monetary policy is determined not only by the evolution of economic activity and prices, but also by how public accounts are managed toward fiscal balance.

The progress made on the macroeconomic agenda in 2019 with the passage of the pension reform and the prospect of other macro and microeconomic reforms in 2020 make it possible to predict a more favorable scenario, where low current inflation and anchored inflation expectations for the coming years may lead to additional cuts in Selic rate before 2020 is over.

Regarding the credit market, lending is likely to remain on the rise for both individuals and companies. The magnitude of this increase will depend, on the one hand, on the effect of the reduction in the Selic rate on interest rates on credit operations and, on the other, on more pronounced progress on policies designed to reduce bank spreads and the cost of capital.

8 FISCAL POLICY

Rising revenues will lead to a sharp reduction in the primary deficit

Compulsory spending on the rise continues to limit investment

Fiscal policy will become expansionary in the last months of 2019. Increased revenues will allow for spending that had been restricted for the federal government as for the states and municipalities. In any case, this will not prevent compliance with tax rules. Additional revenues from the onerous assignment of oil exploitation rights will make it possible for the federal government's primary deficit to be significantly reduced. In addition, the surplus of regional governments will help to reduce the public sector primary deficit, which will meet the primary result target with plenty of slack.

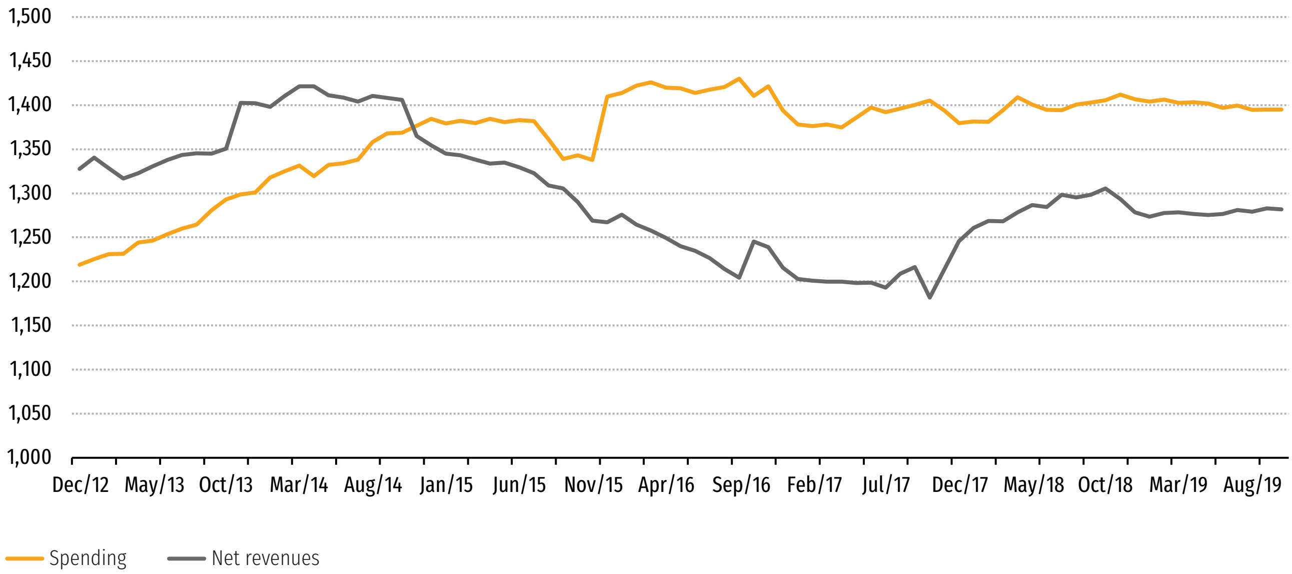
The approval of supplementary credits for covering current expenditures in mid-2019 will allow compliance with the golden rule, according to which any additional indebtedness of the federal government cannot exceed the annual amount of capital expenditure. Finally, the spending cap rule will also be met by curbing discretionary spending.

In 2020, compliance with the spending cap rule will depend on a sharp reduction in discretionary spending, including investments, to accommodate the pressure of increased mandatory spending, particularly on pensions. As in 2019, for the golden rule to be complied with, congressional approval of supplementary credits will be required to cover current budgeted expenses. However, the downturn in both the primary and nominal fiscal results of the public sector will further increase the public debt, despite the continued return of funds by the BNDES to the National Treasury.

Graph 14 - Federal government spending declines at a faster pace than revenue growth in 2019

Evolution of federal government primary spending and net revenues

12-month figure (billion BRL in October 2019)



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

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Federal government cuts expenditures despite higher spending on pensions and personnel

The federal government's net revenue increased by 0.3% in real terms (IPCA deflator) between January and October 2019 in relation to same period in the previous year. This result was mainly influenced by improvements in economic activity.

Revenues managed by the Brazilian Federal Internal Revenue Service (RFB) increased by 0.6% in real terms on the same basis of comparison. Special mention should be made of the increase recorded in revenues from the income tax and from the social contribution on net income (CLL) due to the increase in labor income and atypical tax revenues from corporate reorganizations. The increase in revenues managed by the RFB was not greater only because, albeit favored by improved economic activity, revenues from the PIS (Social Integration Program)/Cofins (Contribution to Social Security Financing) decreased due to the combined effect of a reduction in the tax rate on diesel oil, which became effective in June 2018, and in revenues from the PERT (Special Tax Recovery Program)/PRT (Tax Regularization Program), which were lower in 2019 than in 2018.

The collection for the General Social Security Scheme (RGPS) also had a positive influence on net revenue, with real growth of 2.9% in the year to October 2019, compared to the same period of the previous year. This result was mainly caused by a significant creation of formal jobs throughout the year.

On the spending side, there was a real decline of 1.0% in federal government expenditures in the first 10 months of 2019 as compared to the same period in 2018. This decrease was mainly due to a 17.0% reduction in discretionary spending. The decline in discretionary spending reflects the need to comply with the public spending growth cap rule in a scenario of continued increase in mandatory spending, such as on pensions and personnel. As a result, investment took a downturn once again in 2019, decreasing by 16.3% in real terms. This decrease reinforces the need to review mandatory spending and budgetary rigidity.

Among other mandatory expenditures, spending on pensions and personnel pushed expenditures up and they increased by 3.0% and 1.1% in real terms, respectively. In the case of pensions, the increase is explained by an increase in the number of pensioners and by the indexation of pensions. In the case of spending on personnel, the increase reflects wage increases granted to various categories of civil services.

Growth pace of spending of states and municipalities slows down

State and municipal spending increased moderately in 2019, at a slower pace than in 2017 and 2018, when their spending grew significantly.

Based on available data on state and municipal revenues and on the behavior of the primary outcome of states and municipalities, CNI estimates that regional government spending increased by 0.7% in real terms from January to October 2019, in relation to the same period in 2018. Over the period from January to October 2018, state and municipal spending grew by 6.0% in real terms.

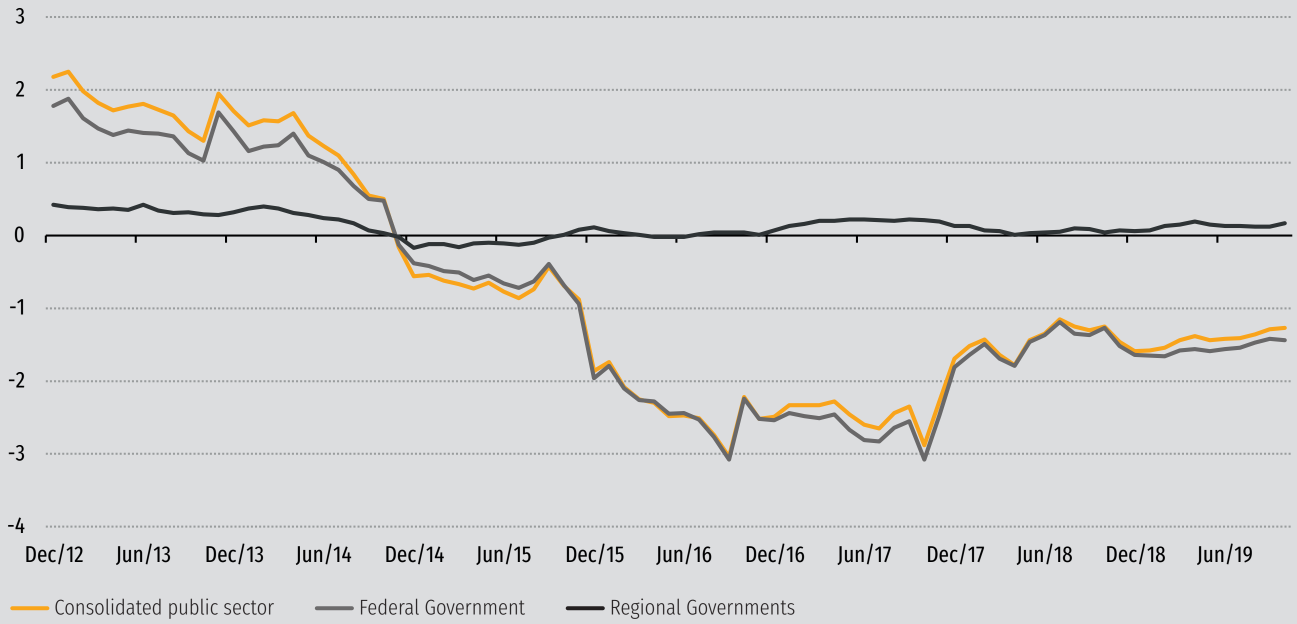
The revenues of these entities had in turn a real growth of 1.9% in the first 10 months of 2019 as compared to the same period in 2018. Revenues from the turnover tax (ICMS), the main source of funds for regional governments, had a real growth of 1.5% over that period and were mainly influenced by improvements in economic activity.

The improvement in the economy also led to higher revenues from taxes shared between the federal and regional governments. In the year to October 2019, transfers to states and municipalities grew by 4.5% in real terms. In addition to this increased transfer of tax revenues, an increase in financial compensation for mineral exploration also contributed to this result.

Graph 15 - Twelve-month public sector primary deficit on a downward path since October 2017

Consolidated public sector primary result and by levels of government

As a percentage of GDP (%)



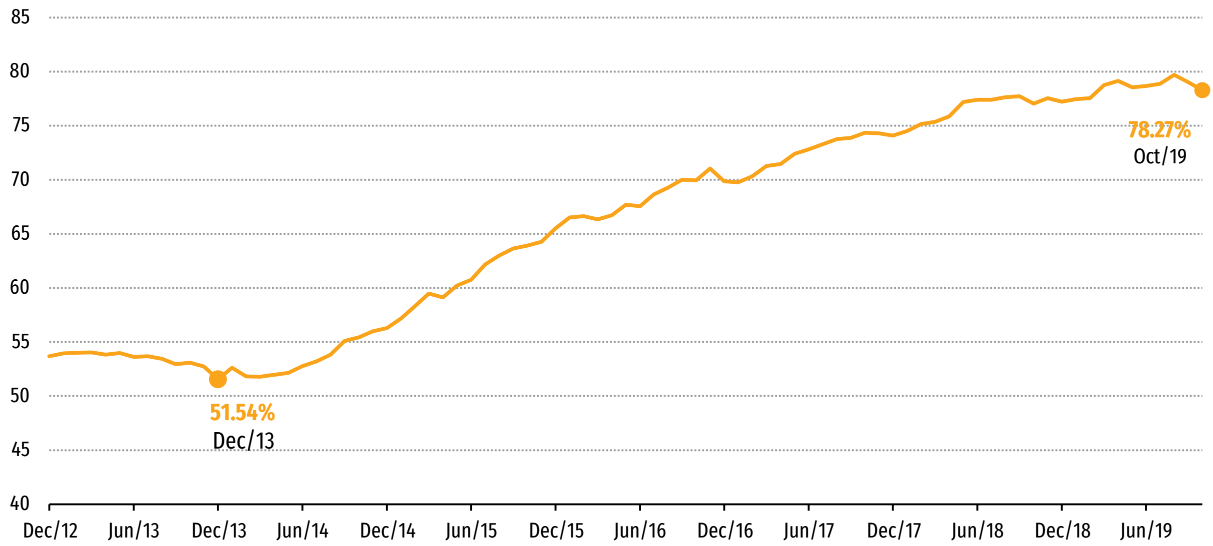
Source: Central Bank of Brazil
Prepared by: CNI

Public sector primary deficit remains on a downward path

Revenue growth in all spheres of government, combined with lower federal government spending, has been contributing to improve public accounts. As a result, the primary deficit of the consolidated public sector has remained on a downward path. In the last 12 months to October 2019, a deficit of 89.7 billion BRL (1.27% of GDP) in the consolidated public sector was recorded, lower than that observed in December 2018, when it hit the mark of 108.3 billion BRL (1.59% of GDP).

The fall in the primary deficit and the 0.4 percent of GDP reduction in interest spending led the 12-month nominal deficit to decline from 7.14% of GDP in December 2018 to 6.44%. in October 2019. In addition to this factor, the pace of increase in the public sector debt has also been mitigated by the return of funds to the National Treasury by BNDES, which until October 2019 amounted to R$100 billion. Still, public sector debt as expressed by the gross debt-to GDP ratio amounted to 78.2% of GDP in October 2019, up by 1.1 percentage points in relation to December 2018.

Graph 16 - Gross debt-to-GDP ratio rose by 26.7 percentage points between December 2013 and October 2019
Gross Public Sector Debt Trajectory in relation to GDP
As a percentage of GDP (%)



Source: Central Bank of Brazil

Revenue growth reduces primary deficit in 2019

The faster pace of increase in federal government revenues recorded in the last months of the year will be the main factor pushing the primary deficit down in 2019. Spending is in turn likely to increase until the end of the year, reversing the downward trend observed until October. In any case, the federal government's primary deficit will largely meet the primary outcome target set for 2019. In addition, surpluses are also likely to be recorded for both regional governments and for the federal administration, which will also contribute positively to reducing the consolidated public sector deficit, which is expected to close 2019 with a deficit close to half the target set for the year.

Federal government net revenue will likely close 2019 with real growth of 6.0% in relation to 2018, which represents a sharp upturn from the 0.3% increase observed until October 2019. This increase is mainly due to the auction for surplus onerous assignment held in November, which generated an additional 75 billion BRL in revenues not managed by Brazil's Federal Internal Revenue Service (RFB).

RFB-managed revenues are also likely to increase in 2019 and grow by 1.0% in real terms as compared to 2018. In addition to the faster economic growth pace observed in the second half of the year, the pace of increase in revenues managed by the RFB will be enhanced by the less intense effect of the reduction in the PIS/Cofins tax rate on diesel oil, effective from mid-2018 onward, on the annual comparison of the variable.

Federal government spending will in turn likely reverse the 1.0% real decline observed between January and October 2019 and close the year with a real increase of 1.7% in relation to 2018. This increase in spending can be largely explained by a full financial programming of the year's budget made possible by extraordinary revenues from oil auctions, especially from the auction for onerous assignment. It is also noteworthy that many ministries will not be able to spend all the funds released by the federal government at the end of the year. As a result, significant remnant payments by some ministries are expected, which would reduce the amount of remnants to be paid over the coming years.

Spending on personnel and pensions will continue to pressure federal government spending. Pension spending will likely increase by 3.7% in 2019 in real terms as compared to 2018, reflecting an increase in the number of pensioners and the indexation of pensions. Spending on personnel is in turn expected to increase by 2.5% in real terms on the same basis of comparison, mainly due to wage increases granted in early 2019.

With these results, and considering that federal state-owned companies will have a surplus of about 2.5 billion BRL, CNI estimates that the federal government and its state-owned enterprises will close 2019 with a deficit of 72.7 billion BRL (1.0% of GDP as estimated by CNI). If this estimate confirmed, this result will be significantly below the target of 142.5 billion BRL set for 2019.

For states and municipalities, the pace of revenue growth will likely increase until the end of 2019, as economic activity will continue to be favored by revenues from both the ICMS tax and from federal taxes shared between the federal and regional governments. In addition, states and municipalities are expected to receive, before 2019 is over, about 11.7 billion BRL from the onerous assignment of oil exploitation rights. However, as states and municipalities are being pressured to settle payments due, expenditures also tend to increase and the surplus is likely be one in the order 8.5 billion BRL until the end of 2019 (0.12% of GDP as estimated by CNI).

In this scenario, the consolidated public sector will likely record a deficit of 64.2 billion BRL in 2019 (0.89% of GDP as estimated by CNI), with a primary deficit below half the target of 132 billion BRL set for the year. This deficit is also significantly lower than that observed in 2018, when it amounted to 108.7 billion BRL (1.59% of GDP in 2018).

The reduction in the primary deficit, combined with a decline in nominal interest spending, will lead to a reduction in the nominal deficit from 7.14% of GDP in 2018 to 6.18% of GDP in 2019. In any case, this result, even adding the return of 123.0 billion BRL by BNDES to the National Treasury, will not be sufficient to stabilize the gross debt-to-GDP ratio, which will likely increase and close 2019 at 78.2%.

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Outlook for 2020: Primary deficit will grow again

The federal government's net revenue will likely decrease by 3.0% in real terms in 2020 in relation to 2019. This result is explained by a drop in revenues not managed by the RFB, which in 2019 had 75 billion BRL from the onerous assignment auction added to them. Disregarding this effect, federal government revenues would have grown by 1.7% in real terms in 2020 as compared to 2019.

Social security revenues will in turn contribute positively to federal government revenues in 2020, making it possible for them to grow by 2.8% in real terms in relation to 2019. Increased total payroll will be a determining factor for this result. In addition, due to the 2.5% growth forecast for the Brazilian economy, revenues managed by the RFB will have a real growth of 2.6% on the same basis of comparison.

A real 1.2 percent reduction in federal government primary spending is likely in 2020. Considering mandatory expenditures, spending on personnel will likely remain stable in 2020, as no further wage increases are expected for the year. Spending on pensions will likely grow by 2.5% in real terms due to an increase in the number of pensioners and to the annual indexation of pensions. The lower rate of increase in these expenditures as compared to 2019 is due to two factors. The first one is that the minimum wage will increase less next year and the second one is the impact of the Pension Reform, which according to government estimates will generate savings of 3.6 billion BRL in 2020.

However, for the public spending cap rule to be complied with, the rise in spending on pensions will have to be offset by a significant reduction in non-mandatory spending. Thus, a real reduction in spending on fixed costs and investments is likely, which together are expected to decrease by 6.8% in 2020 in relation to 2019.

In this scenario, the federal government and its state-owned enterprises will likely record a primary deficit of 106.5 billion BRL, below the 127.9 billion BRL target set for 2020. If confirmed, this result will reflect an increase in the federal government deficit over 2019.

The expected result for the consolidated public sector will in turn hit the mark of 97.5 billion BRL (1.27% of GDP as estimated by CNI for 2020), as regional governments are expected to meet the primary surplus target of 9.0 billion BRL set for 2020. Thus, the public sector primary deficit would amount to 21.4 billion BRL below the 118.9 billion BRL target set for 2020.

The increase in the primary deficit, albeit partially offset by the reduction in nominal interest spending driven by the decrease in the Selic rate, will push the nominal deficit up once again in 2020. Thus, the nominal deficit will likely amount to 6.40% of GDP and, despite the return of about 30 billion BRL by BNDES to the National Treasury, the gross debt-to-GDP ratio will take an upturn, hitting the mark of 79.3%.

In 2020, the limit imposed by the public spending cap rule will be met due to the significant reduction in discretionary spending. However, there will no longer be room in the coming years for further reductions in these expenditures and measures will be required to keep mandatory spending under stricter control.

9 FOREIGN TRADE SECTOR

Turbulent scenario abroad affects trade balance and the exchange rate

Balance of payments reveals current account deterioration

The international scenario remained turbulent in 2019, confirming the forecasts of a global economic slowdown, with a negative impact on Brazil's external accounts.

Conflicting issues have not been settled, but rather postponed, and this postponement undermined the confidence of economic agents, strengthening protectionism and the current stagnation of world trade. Global activity slowed down throughout the year due to unresolved trade conflicts, particularly between the United States and China. Protectionist behavior persisted throughout the year, causing retaliation and indicating that the trade barriers created in this process were no longer momentary, as they became structural.

The impact of the poor performance of international trade, especially for the Brazilian manufacturing industry, is clearly perceived in the indicators for import and export volumes of semi-manufactured and manufactured goods. The indices show a significant slowdown in trade flows in a period coinciding with the crisis in Argentina and consequent slowdown in trade between Brazil and Argentina.

The world economy has become adverse to Brazil's external accounts. Growth in exports to China was negatively offset by falling commodity prices in international trade. Imports in general grew faster than exports as a result of the gradual warming of the economy and increased investment. Consequently, the trade surplus recorded a decline.

Falling global interest rates and trade tensions contributed to increased demand for the US dollar as a risk-aversion move by economic agents. The US dollar appreciated against various currencies, especially against those of emerging countries.

However, in the Brazilian case, there is a divergence between the exchange rate series and the Country Risk (EMBI), suggesting that the influence of domestic factors on the exchange rate has weakened.

BThe balance of payments accounts reflected the devaluation of the Brazilian currency and trade barriers, reducing the trade surplus and widening the current account deficit. Direct investment continues to finance the negative current account balance with a good margin.

Scenario abroad contributes to depreciation of the real against the US dollar

The external scenario began to have more influence on the exchange rate this year, causing a continuous depreciation of the real, mainly from the second half of the year.

Until last year, the Country Risk (EMBI) and exchange rate series showed a similar, correlated behavior, indicating that the Country Risk was one of the factors with the highest impact on the behavior of the exchange rate. Since the beginning of this year, the series began to show a divergent behavior, suggesting that the impact of domestic factors that affected the Country Risk on the exchange rate volatility began to decrease. This shift became very clear from the second half of the year, when the Country Risk has been on a downward trend and the nominal exchange rate has been depreciating more sharply.

The Country Risk, which started 2019 at 275 points, showed a downward trend particularly from June. In December, it stands at 241 points. Oscillations in the series were more intense in the second half of the year, but did not generate significant effects on the exchange rate. In 2018, the indicator averaged 273 points, against an average of 243 points this year.

The real/US dollar exchange rate showed an upward trend that became more intense in the second half of the year. Devaluation of the real peaked in November, when the US dollar hit the mark of 4.26BRL/1USD (11/27/2019). Despite the persistent devaluation of the real throughout the year, volatility was lower as compared to past peaks, improving the predictability of trade contracts. Over the course of the year, the real depreciated by 8.26% against the US dollar (rate on 6/12/2019). In 2018, the real had depreciated by 18.5% against the US dollar.

The domestic factors that explain the devaluation of the Brazilian currency against the US dollar include a lower differential between interest rates in Brazil and abroad, reducing the gap between them. This reduction provided less incentive for agents to raise finance abroad and to invest in emerging countries, including Brazil. The resulting lower inflow of funds from abroad led to the devaluation of the Brazilian currency.

In addition to falling interest rates, the trade war between the United States and China, with a more aggressive protectionist stance on the part of the US government, reduced global trade and increased risk aversion, leading investors to prefer dollar investments, a phenomenon known as "escape to quality."

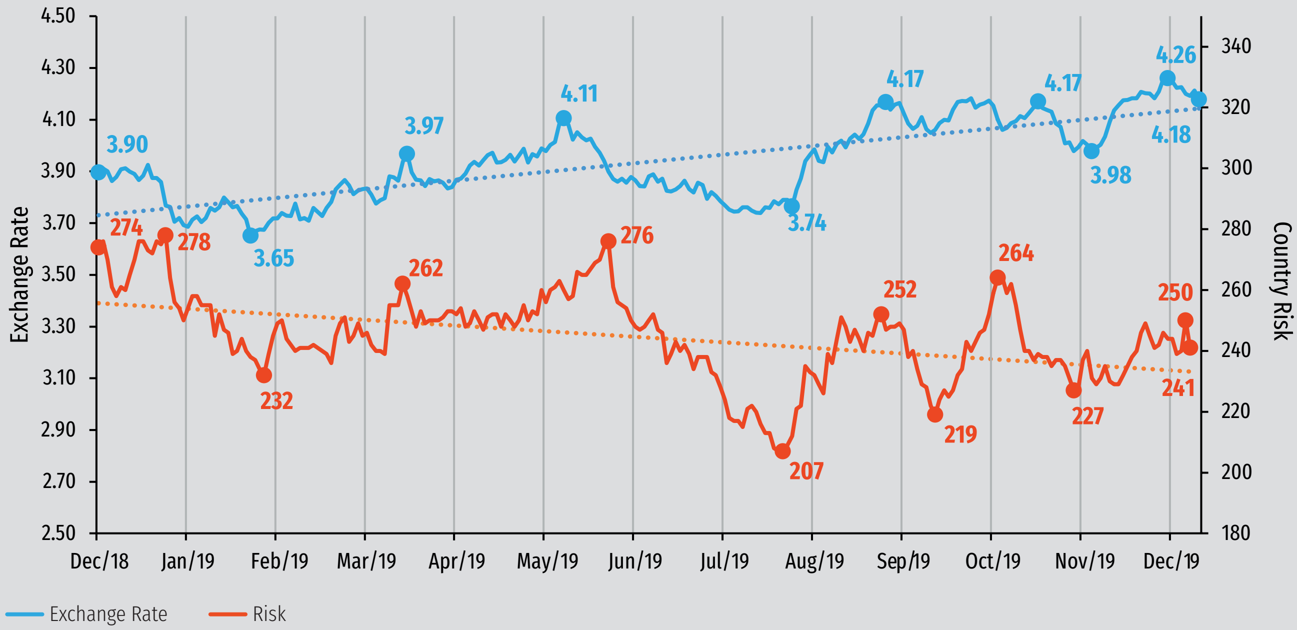
The auction of pre-salt oil fields in early November was another factor that contributed to the devaluation of the Brazilian currency. Its results thwarted expectations of economic agents, who expected to see a larger inflow of US dollars into the Brazilian economy and a consequent decline in the price of the US currency, which did not occur.

The US dollar will likely remain appreciated against the real in the end of the year, mainly due to the international environment. We expect an average exchange rate of 4.13BRL/1USD in December, up by 6.2% from the average recorded in December of last year (3.89BRL/1USD). For 2019, we are projecting an average exchange rate of 3.95BRL/1USD, up by 8% from the average recorded last year (3.66BRL/1USD).

Graph 17 - Divergent behavior in the Country Risk and exchange rate series: the impact of domestic factors on the exchange rate has weakened

Country Risk (EMBI) Daily Exchange Rate (Ptax Closing Rate)

Points/In R$/USD



Source: : Central Bank of Brazil

Scenario abroad contributes to the depreciation of the Brazilian currency against the US dollar

The trade balance shrank by 20.4% in relation to 2018 in the year to November. Two factors explain this decline: imports grew at a faster pace than exports, and exports lost market value, as their prices dropped more than the exchange rate devaluation. The annual trade balance has been on the decline since 2017.

Nevertheless, it has still been showing a surplus, with a positive balance of 41.1 billion USD in the year to November. Imports grew by 2.3% in the monthly average this year against 1.3% in 2018, totaling 164.8 billion USD in the year to November, 2.1% below the figure recorded in 2018. Exports decreased by 0.4% a month on average against an increase of 1.1% last year and amounted to 205.9 billion USD in the year to November, 6.4% less than in the same period in 2018.

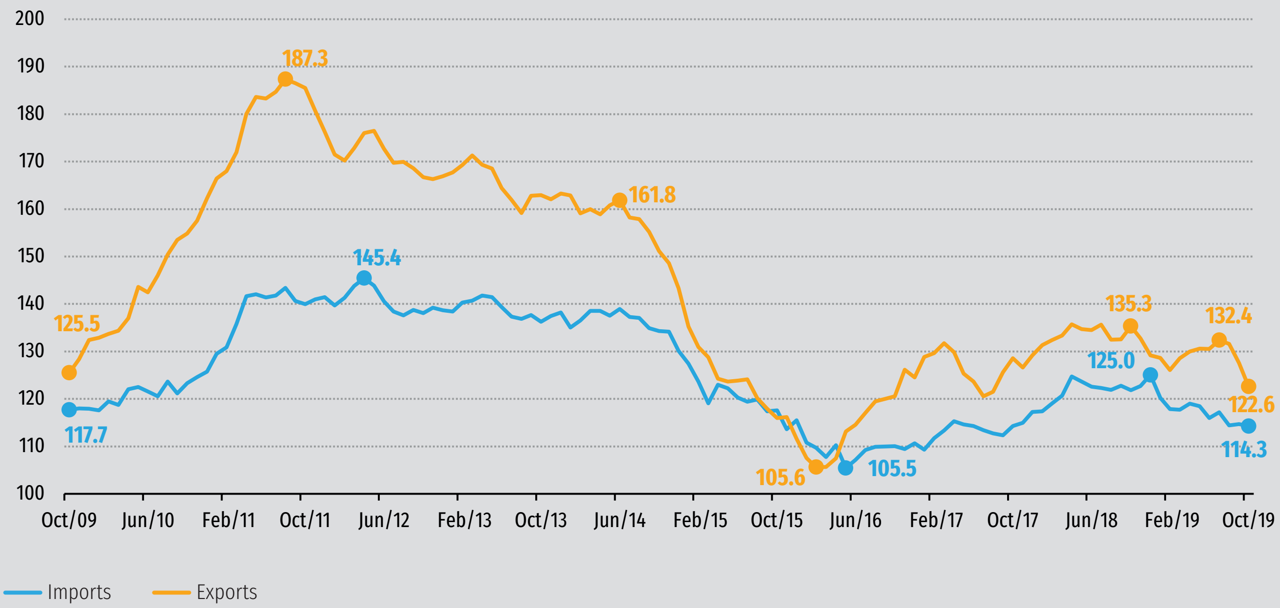
Export and import price indices, which take into account the US dollar prices of exported and imported products, show that the average prices of Brazilian exports fell while import prices remained virtually constant.

Between July and October, the export price index fell by 9.8 points while the one for imports decreased by 2.9 points over the same period.

Graph 18 - Decline in export prices reduces trade surplus

Price index for Brazilian imports and exports

Index Number - Base: 2006 average = 100



Source: Foreign Trade Studies Foundation (Funcex)
Prepared by: CNI

The scenario abroad has not been favoring the Brazilian trade balance since 2018 and adverse factors became stronger this year. Forecasts of a global economic slowdown came true, slowing down trade flows. Because of its low participation in global value chains, Brazil is more dependent on the economy of neighboring countries. As a result, the Argentine crisis and political conflicts in Latin American countries pushed the Brazilian trade balance further down.

In this scenario, exports of higher value-added manufactured products were more harmed than those of commodities. Commodities, for which China is the main destination, benefited from that country's growth. However, commodity prices declined in the international market, offsetting the positive effects of the increase in the exported volume.

According to the classification by aggregate factor, the value of exports for all product categories decreased in relation to last year. In the year to November, manufactured products showed the sharpest decrease compared to the same period in 2018, recording a 9.8% reduction in export value. Semi-manufactured and basic products experienced decreases of 5.5% and 1.2%, respectively, on the same basis of comparison.

Exports by major economic categories decreased year-over-year across all categories. With a significant decrease of 25.3%, capital goods were the least exported ones. Exports of fuels and lubricants declined by 8.93% and those of intermediate and consumer goods fell by 3.9% and 2.8%, respectively, on the same basis of comparison.

Despite decreases in accumulated values, the only drop recorded in the export quantum index was in exports of consumer durables and capital goods, from the second half of the year. This indicates that the products whose quantum increased—non-durable consumer goods, fuels, and intermediate goods—experienced a decrease in export profitability: their quantity exported increased while their accumulated value decreased. This shift nullified the positive effects of their increased export volumes on the trade balance.

The 2.1% decline in the value of imports (in the year to November) was driven by the 7.6% drop in imports of basic products in relation to the same period in 2018. Imports of manufactured products also decreased, by 1.7%, while imports of semi-manufactured goods recorded an increase of 2.4% on the same basis of comparison.

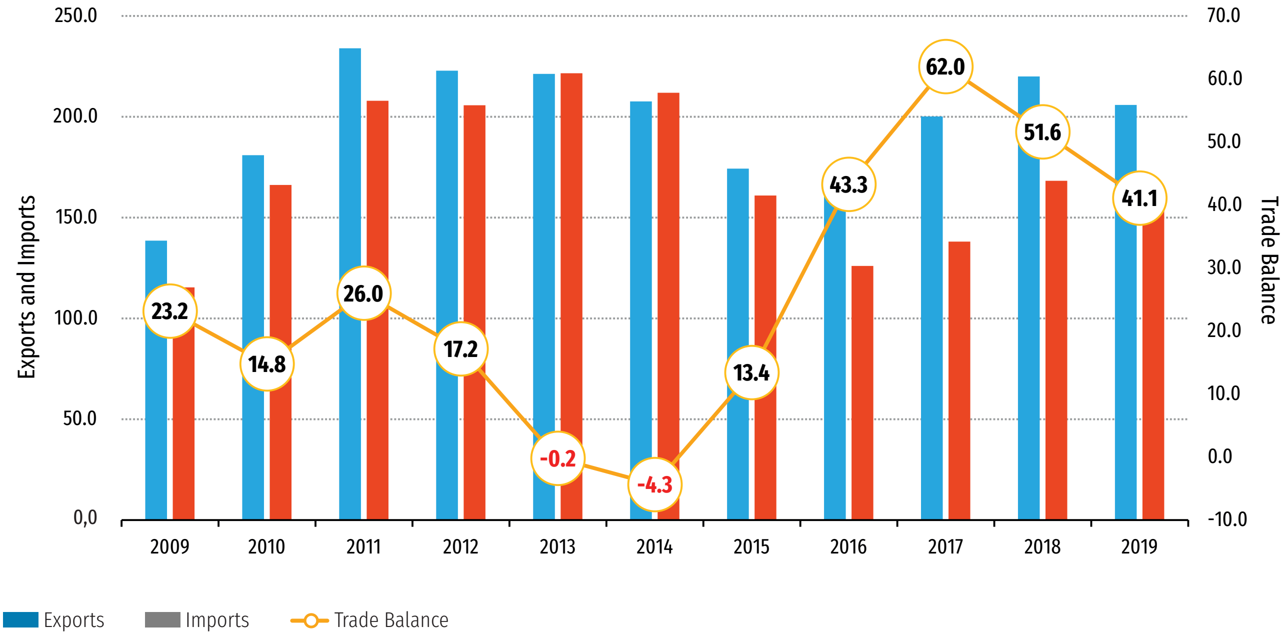
In the classification by major economic categories, fuels and lubricants were the most demanded products, as their imports increased by 16.44% in the year to November 2019 in relation to the same period in 2018. Imports of consumer goods remained virtually stable year-on-year. Imports of intermediate and capital goods declined by 9.73% and 54.22%, respectively, on the same comparison basis.

In addition to the year-on-year increase in the value of imports, the quantum index by broad economic categories increased for all groups, except for that of capital goods. Imports of other groups of products increased steadily from the second half of the year, when the economy started to show clearer signs of recovery.

Graph 19 - Weakening of global trade compromises Brazilian exports

Exports, imports and trade balance in the year to November

In billion USD



Source: SECEX/MDIC
Prepared by: CNI

There are steady signs of economic stability, such as low interest rates and inflation, increasing investor confidence and predictability. As a result, the trade surplus is likely to decrease at a faster pace as imports increase, as necessary for investments.

CNI estimates that exports will close 2019 at 223 billion USD, down by 6.8% in relation to 2018. Imports are in turn likely to total 178 billion USD, down by 1.8% from 2018. The cumulative trade balance is therefore likely to hit the mark of 45 billion USD, down by 22.5% (13 billion USD) in relation to 2018.

Performance of primary income and of the trade balance increases current deficit

The poor performance of the trade balance over the year has compromised balance of payments accounts and increased the current account deficit. However, changes in how primary income is calculated also had a negative effect on the current account.

In September, the Brazilian Central Bank (BC) changed its methodology for calculating trade balance profits. This data revision resulted in significant changes in the primary income series and in the current account balance since January 2018, increasing deficits. However, it should be noted that the new classification of profits does not change the final situation of the balance of payments as a whole, as it only changes its composition, increasing the current deficit.

In addition, the data transmitted to the Foreign Trade Secretariat (SECEX) had been miscalculated, causing exports to be underestimated in October and November 2019, reducing the trade balance. Until this report was being revised for publication, the correct data had not been released. Therefore, in the future, duly corrected official SECEX data will increase the trade balance, also impacting the current account balance.

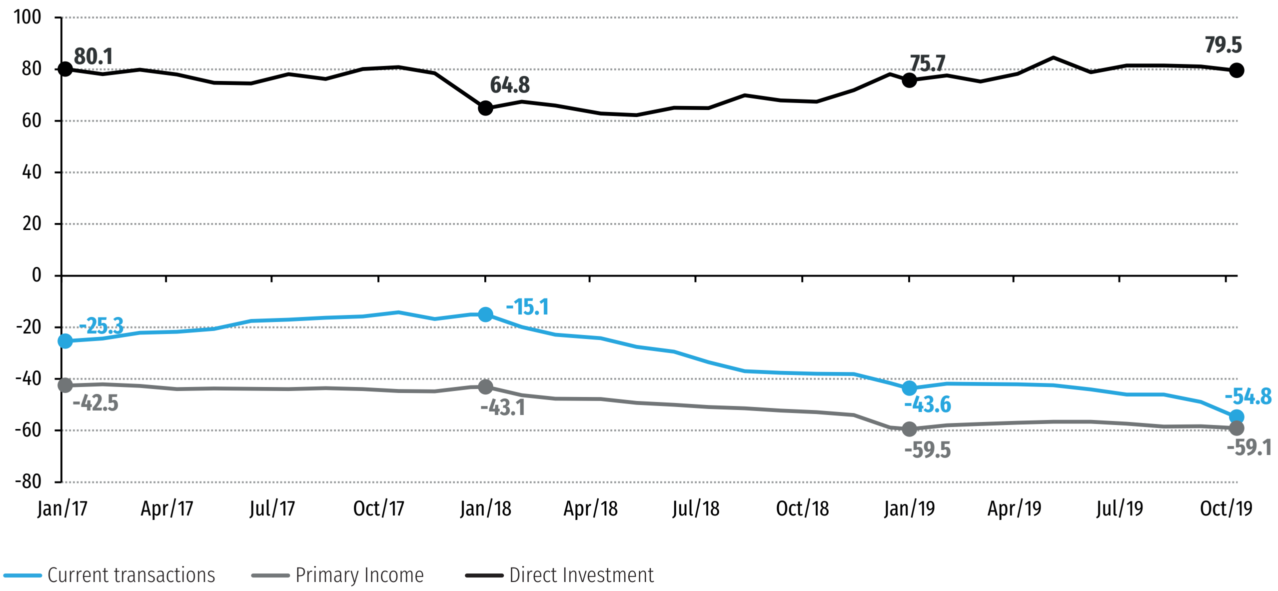
The balance of payments external accounts have been deteriorating since January 2018. The current account balance started 2019 with a deficit of 43.6 billion USD (in 12 months), almost three times the deficit recorded in January 2018. Throughout 2019, balance of payments accounts deteriorated further, mainly due to the performance of the trade balance. Until October, the current account deficit had increased by 25.6%, to 54.8 billion USD, from a deficit of 38.1 billion USD in October 2018, approximately 3% of GDP.

In addition to the decline in the trade balance, primary income was another factor that contributed to push the current balance down, but this was due to the methodological review, which had the greatest impact on the series in 2018. The current deficit started the year at 59.5 billion USD and in October it recorded a negative balance of 59.1 billion USD. Service accounts (travel, insurance, freight, government procurement) and secondary income (unilateral transfers) remained virtually stable throughout the year, with a negative balance of 36 billion USD and 1.5 billion USD, respectively, in October.

Graph 20 - Current account deficit on the rise in 2019

Balance of payments balances

12-month figure (billion USD)



Sorcee: Central Bank of Brazil

Year-to-date direct investment increased from 75.7 billion USD to 79.5 billion USD between January and October 2019 in relation to the same period in 2018, an increase of 5%. The amount is sufficient to finance the current account deficit. Direct investment in October was 1.5 times higher than the current account deficit.

The deterioration observed in the balance of payments accounts will likely persist in late 2019 due to the weak international scenario. Estimates suggest that the current account will hit the mark of 55 billion USD, approximately 3 percent of GDP as projected by CNI.

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Outlook for 2020: Brazilian economic recovery tends to widen current account deficit

The protectionist stance observed since mid-2018 will likely continue in 2020 and will be reflected in trade transactions in a more structural way.

In addition, other external and persistent factors will likely impact on foreign accounts in 2020, with effects on the exchange rate:

- The decreasing gap between Brazilian and foreign interest rates;
- The crisis in Argentina, which undermines exports of Brazilian manufactured goods;
- The political crisis in several Latin American countries, with depreciating effects on the exchange rate.

Domestically, interest rates will likely remain low as a result of strict inflation control. Given this scenario, which seems to be sustainable over the medium term, the exchange rate is likely to remain close to 4.05BRL/1USD in 2020.

The recovery of the domestic economy, with increased investment and household consumption (see the section Economic Activity), will likely have an impact on the trade balance, leading to increased purchases of consumer and intermediate goods. The trade surplus is likely to amount to 38 billion USD, representing 2% of GDP as projected by CNI in 2020.

Finally, the current account deficit will likely persist, hitting the mark of 55 billion USD in 2020. However, an improved domestic business environment is expected to have a positive impact on the inflow of direct investment, contributing to balancing external accounts.

	2017	2018	2019 (forecast)	2020 (forecast)
ECONOMIC ACTIVITY				
GDP (annual variation)	1.3%	1.3%	**1.2%**	**2.5%**
industrial GDP (annual variation)	-0.5%	0.5%	**0.7%**	**2.8%**
Household consumption (annual variation)	2.0%	2.1%	**1.9%**	**2.2%**
Gross formation of fixed capital (annual variation)	-2.6%	3.9%	**2.8%**	**6.5%**
Gross formation of fixed capital (annual average - % of the labor force)	12.7%	12.3%	**11.9%**	**11.3%**
INFLATION				
Inflation (IPCA index - annual variation)	2.95%	3.75%	**3.78%**	**3.70%**
INTEREST RATE				
Nominal interest rate				
(average rate in the year)	9.9%	6.6%	**6.0%**	**4.5%**
(end of year)	7.0%	6.5%	**4.5%**	**4.5%**
Real interest rate (annual average rate and deflated rate: IPCA)	6.2%	2.8%	**2.2%**	**0.8%**
PUBLIC ACCOUNTS				
Primary result (% of GDP)	-1.7%	-1.6%	**-0.9%**	**-1.3%**
Nominal result (% of GDP)	-7.8%	-7.1%	**-6.2%**	**-6.4%**
Gross public debt (% of GDP)	74.0%	77.2%	78.2%	**79.3%**
EXCHANGE RATE				
Nominal exchange rate - BRL/USD				
(December average)	3.29	3.89	**4.13**	**4.10**
(year average)	3.19	3.66	**3.95**	**4.05**
FOREIGN TRADE SECTOR				
Exports (billion USD)	217.7	239.3	**223.0**	**230.0**
Imports (billion USD)	150.7	181.2	**178.0**	**192.0**
Trade balance (billion USD)	67.0	58.0	**45.0**	**38.0**
Current account balance (billion USD)	-15.0	-41.5	**-55.0**	**-50.0**

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