Economic Report
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ECONOMIC REPORT

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

Political uncertainty deepens recession

Lack of fiscal adjustment has been preventing the positive effects of the economic adjustment from materializing

The prevalence of an uncertain political environment - which has been generating economic instability and low confidence among economic agents - kept the Brazilian economy in severe recession in the early months of 2016. The focus on political issues makes it impossible to overcome structural problems that have been preventing the economy from recovering and leading to a postponement of necessary actions to correct its course.

Economic activity continues on a sharp downturn that has been strongly affecting the labor market, aggravating the scenario of rising unemployment rates that will likely characterize the first half of the year. The loss of jobs and income reduces the purchasing power of households (already affected by high inflation and credit difficulties), further contracting consumption. On the other hand, uncertainties and high idle capacity in industry as a whole have been hindering investment.

Without prospects of changes in this scenario, the recessionary cycle lingers on. CNI estimates that GDP is likely to drop by about 3.1% in 2016, as it did in the previous year. We expect Industrial GDP to decrease by 5%. After a third consecutive year of decline, industry will suffer a drop of 12% in three years. If the sharp deterioration in the financial conditions of companies is not reversed, the scenario might worsen and cause further declines.

Some signs of adjustments can be seen in the economy that should not be disregarded. The foreign trade sector has been showing signs of recovery in the wake of changes in the exchange rate and of a slowdown in domestic demand, with increased trade surplus and a reduction in the current account deficit. Inflation began to give signs of cooling that can be more clearly perceived in segments with government-regulated prices - including energy - and in the service industry, in response to

(to be continued)

The Brazilian economy in the first quarter 2016

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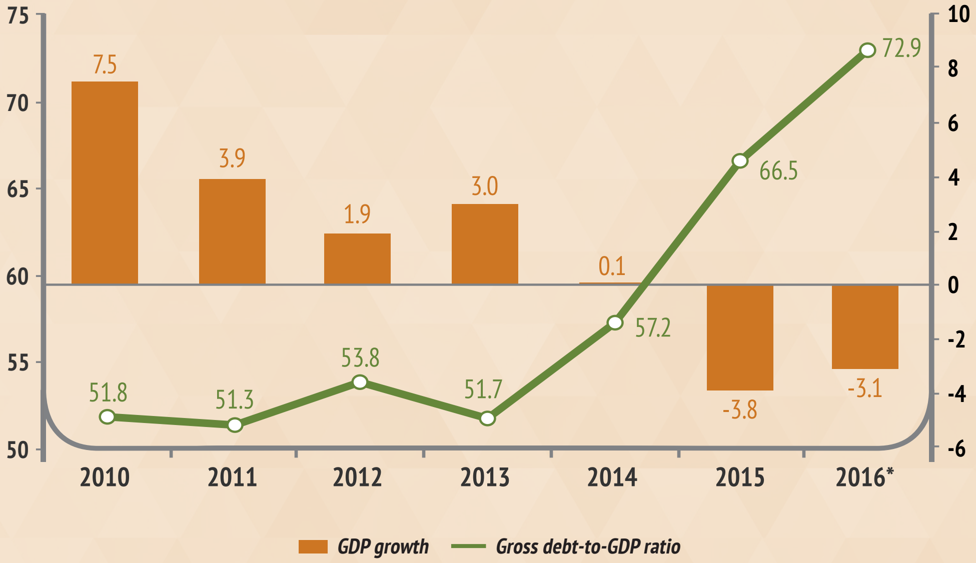
Activity and public accounts deterioration

GDP growth and Gross debt-to-GDP ratio

Percentage and share of GDP (%)



Source: IBGE and Central Bank of Brazil

*CNI projection

the sharp drop in demand. On average, companies are adjusting their inventories to planned levels. Although they remain high in some segments, the adjustment indicates that production can react positively if consumer demand recovers.

One question remains unanswered: has the economy hit "rock bottom" in the first half of the year or is it possible that difficulties will worsen over the year? Recovery factors brought about by adjustments in relative prices, particularly in the exchange rate and the damping of inflation are likely to be gradually experienced in the second half of the year.

Some difficulties remain unresolved, preventing the positive effects of the economic adjustment from materializing. The fiscal imbalance is severe and is the main hurdle to overcome. There are strong indications that a new "mega primary deficit" - amounting to R$100 billion - will be recorded in 2016. The magnitude of the deficits recorded over the past two years, coupled with a heavy debt service burden and recession, is pushing the debt/GDP ratio up, which is worrying. This is the main factor of economic instability that has been preventing the economy from resuming its normal path and restricting the necessary flexibility for easing the monetary policy.

Uncertainties around the fiscal adjustment are due to the reduced likelihood of its actual implementation under the environment of low governability prevailing today. Necessary adjustment measures to control spending growth, which largely depend on a strong commitment on the part of the executive branch and on approval from the legislative branch, are simply not advancing. Recent changes in the fiscal target and the resumption of policies that led to the economic problems faced now suggest that the government has shifted its focus from adjusting public accounts to promoting economic stabilization in the short term. This is evidenced by the resumption of an expansionary fiscal policy early this year, which reinforced fears of loss of control over public accounts. Projections for the debt/GDP ratio suggest that it will exceed 70% before 2016 is over.

It is crucial to reverse the current recession. For this purpose, it is indispensable to address the fiscal crisis head-on by adopting permanent adjustment measures and signaling a commitment to balancing public accounts in the long term. Simultaneously, it is urgently necessary to implement the agenda of transformation of the economy, including measures to restore the confidence of economic agents. Without this coordinated action, the crisis will linger for an intolerable period for companies and society.

ECONOMIC ACTIVITY

Brazilian economy in severe recession

No improvement in the political and economic environment in the first quarter of the year

After the Brazilian GDP declined by 3.8% in 2015, the first figures for 2016 point to continued downturn in the Brazilian economy. CNI estimates suggest that GDP will likely drop by a further 3.1% in 2016. This will be the second consecutive annual decline in GDP, something that had not been recorded before in the current historical series of the National Accounts/IBGE started in 1996. Industry will continue on a downward path, despite the stimulus provided to exports by the appreciation of the Brazilian currency and the improved competitiveness of domestic products in relation to imported ones. Industrial GDP is likely to decrease by 5.0% in 2016, according to CNI estimates.

ECONOMIC RECESSION LIKELY TO LINGER THROUGH 2016

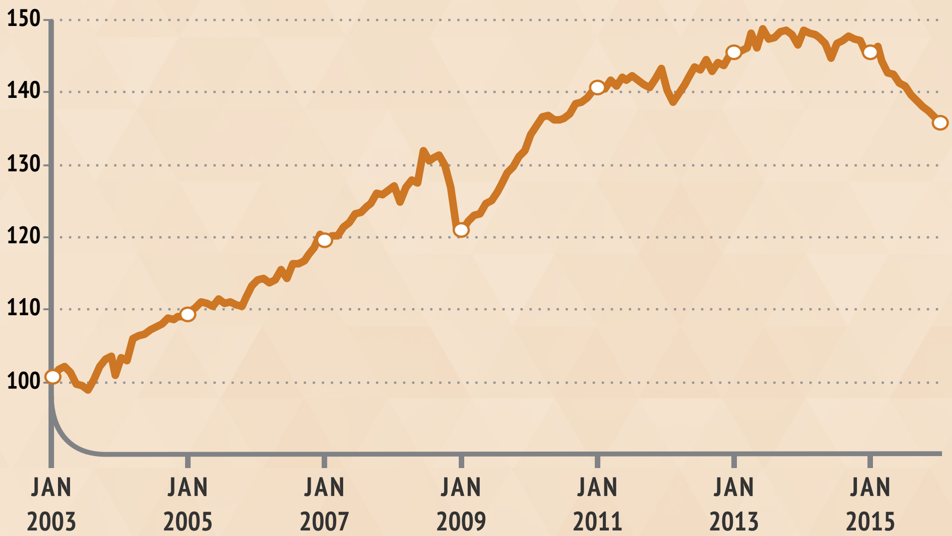
Preliminary data for 2016 suggest continued economic recession. The economic activity rate published by the Central Bank of Brazil (IBC-Br) dropped by 0.6% in January in relation to December in the seasonally adjusted series; the decline in relation to January 2015 was 6.7%. Even though consolidated statistics on economic activity in the first quarter of the year are not available yet, that leading indicator suggests continued economic crisis.

Industry has also been suffering the effects of the economic recession and the available physical production indicators are not encouraging. According to the Monthly Industrial Survey of Physical Production (PIM-PF/IBGE), industrial production experienced an accumulated drop of 11.8% in the first quarter of 2016 as compared to the same period in 2015. Among industrial sectors, declines in production were recorded in 23 of the 26 surveyed sectors, among which the one with the most negative impact on this undesirable result is that of Motor vehicles, which suffered a drop of 30.1%. On the other hand, the Pulp, paper and paper products and Tobacco products sectors accounted for the most positive impacts, as they grew by 3.3% and 49.8%, respectively, in the year. Among the main economic categories, the results for the first quarter of 2016 show a sharp drop of 30.8% in capital goods and of 29.0% in consumer durables.

Indicators for 2016 suggest continued recession

Economic Activity Index of the Central Bank - Brazil (IBC-Br), seasonally adjusted

Fixed base index number: 2002 average = 100



Source: Central Bank of Brazil.

According to data from the Industrial Indicators/CNI survey, increases of 0.8% and of 1.6% were recorded in real turnover between December and January and from January to February, respectively. Despite this marginal improvement, the indicator accumulated a decrease of 12.3% over the first two months of 2016 in relation to the same period in 2015. A reduction has been observed in all the indicators of the survey: decreases of 10% in worked hours, of 9.5% in employment, of 11.1% in real wages, and of 1.8% in the average real income of workers.

The results of the Industrial Survey/CNI also illustrate the impacts of the crisis on industry. In February, Capacity Utilization (CU) recorded a 62% rate for the third month in a row, the lowest one in the monthly series initiated in 2011. Indicators for production and number of employees continue on a downward trend.

On the positive side, the Industrial Survey/CNI reveals that after a long period of excess inventories, industry managed to bring its inventories down to planned levels in late 2015 and to keep them adjusted in the first quarter of 2016. This fact indicates that, in the event of improvements in the economy, industry is prepared to increase its production to meet demand and replenish inventories. In addition, according to the results of the Business Confidence Index (ICEI)/CNI survey carried out in March, lack of confidence is intense and widespread among industrial entrepreneurs. The bright side is that this lack of confidence interrupted a trajectory of worsened expectations. In other words, pessimism stopped increasing.

CNI estimates reveal that the Brazilian economic crisis is worsening. In the absence of a new fact capable of changing the Brazilian economic situation substantially, negative results are being recorded month after month and becoming even more negative in some cases. CNI estimates that Brazil's GDP will drop by 3.1% in 2016.

On the supply side, it is estimated that agriculture will grow by 2.3% and that services will decrease by 2.7%. Industry is likely to decrease by 5.0% due to reductions of 6.5% in manufacturing, of 8.1% in construction and of 1.1% in Industrial Public Utility Services (SIUP) and to a growth of 7.2% in mining and quarrying.

On the demand side, CNI estimates that the following elements will experience a drop: household consumption (4.4%), government consumption (2.0%) and GFCF (13.5%). Exports will likely increase by 10.3%, while imports are expected to drop by 8.1%. The decrease in GDP would be even more pronounced were it not for the positive contribution of 2.5% of the foreign trade sector, considering that domestic demand is likely to decline by 5.6% in 2016.

Three facts deserve attention in early 2016. First, the continued deterioration in the labor market (see Employment and Income for details) tends to be ac-

Pessimism remains high among entrepreneurs

Business confidence index (ICEI/CNI)

The ICEI ranges from 0 to 100 points. Readings below 50 points indicate lack of confidence. The lower the index, the higher and more widespread the lack of confidence in industry.

Source: ICEI/CNI

GDP estimate for 2016

Percentage variation in GDP components

	GDP COMPONENTS	Variation rate (%)
Demand	Household consumption	-4.4
	Government consumption	-2.0
	Gross Fixed Capital Formation	-13.5
	Exports	10.3
	(-) Imports	-8.1
Supply	Agriculture/livestock	2.3
	Industry	-5.0
	Mining and quarrying	7.2
	Manufacturing industry	-6.5
	Construction industry	-8.1
	Industrial Public Utility Services	-1.1
	Services	-2.7
	GDP	**-3.1**

companied by reductions in major GDP components both on the demand side (household consumption) and on the supply side (services). As a result, household consumption and services are likely to drop more sharply in 2016 than they did in 2015. This fact may intensify recession throughout the year.

Second, no intention to resume investment has been observed in the private or the public sector. In the private sector, this is due to the recession itself and to an uncertain environment. In the public sector, it is due to government budget constraints (see Fiscal Policy for more details) and to political instability. These facts justify the estimate of a further drop in investment in 2016, which would be the third consecutive annual drop.

Third, an expected increase in exports and the substitution of imports due to the depreciation of the real have not materialized yet to offset losses in the domestic market (see Foreign Trade Sector for more details). Thus, according to CNI estimates, despite the positive contribution of the foreign trade sector, the Brazilian economy will continue on a downward trend in 2016.

EMPLOYMENT AND INCOME

Sharp deterioration in the labor market in early 2016

Unemployment will hit double-digit rates

The economic crisis of 2015 changed the dynamics of the Brazilian labor market, and these changes will continue to be felt throughout this year. CNI estimates that unemployment will exceed double-digit rates in the first quarter and will continue to rise until the end of the year. As a result, the annual average unemployment rate is likely to hit the mark of 11.5% of the labor force in 2016.

The drop in jobs in industry, especially in the manufacturing and construction industries, will continue to push the unemployment rate up. The intensity of this drop, however, is expected to be lower because of major adjustments in employment in these sectors in 2015. Nevertheless, the impact of the economic crisis on demand and investment will lead to more layoffs in 2016. The effects of the reinstatement of certain payroll taxes and contributions, which became effective in January, will also influence dismissals.

In addition, there will be more layoffs in the trade and service sectors this year than in 2015. It should be noted that, combined, these sectors employ more than 70% of the workforce in Brazil. The drop in employment in these activities in 2016 was caused by deteriorating household consumption due to the impact of inflation on purchasing power, a high expenditure-to-income ratio and high indebtedness.

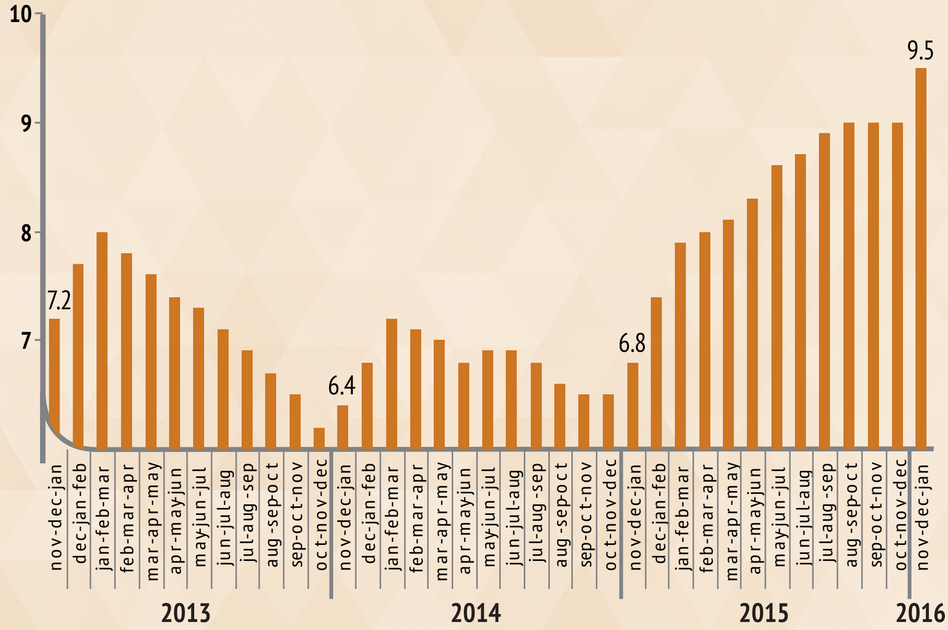
UNEMPLOYMENT AT THE HIGHEST RATE SINCE 2012

In the quarter ending in January 2016 (latest data available), the unemployment rate reached 9.5% of the labor force. This result constitutes an in-

Unemployment rate at its highest level since the start of the series in 2012

Unemployment rate

As a proportion of the labor force (%)



Source: Pnad Contínua/IBGE

crease of 2.7 percentage points in relation to the same period in 2015, when the unemployment rate was 6.8%.

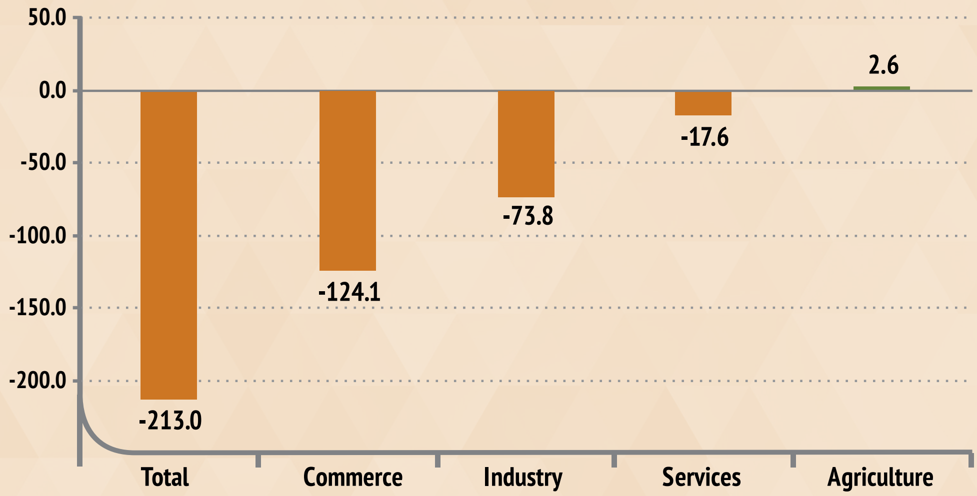
The drop in employment has been a determining factor in pushing the unemployment rate up, and the volume and speed of job destruction in Brazil are alarming. According to the General Registry of Employed and Unemployed Persons (CAGED/MTE), 1.65 million formal jobs have been lost in the economy in the 12-month period ending in February.

In the first two months of 2016, 213,000 jobs were destroyed in the Brazilian economy, against a net balance of -79.6 thousand jobs in the same period in 2015 and the creation of 285,000 ones in 2014. Trade was the sector that lost more formal jobs in the first two months of 2016, namely, 124,100 jobs. Industry ranked second in the same period, with a reduction of 73,800 jobs. Among industrial segments, manufacturing and construction were the most affected ones in the first two months of 2016, with a loss of 45.8 and 22.6 thousand formal jobs, respectively. Over the same period, the mi-

Commerce accounted for 58% of all jobs lost in the first two months of 2016

Net balance of formal jobs

In thousands (accumulated figure in the first two months of 2016)



Source: CAGED/MTE
Note: The graph considers information reported after the set deadline.

ning and quarrying industry and Industrial Public Utility Services (SIUP) cut 3.5 and 1.8 thousand jobs, respectively. The service sector recorded a loss of 17,600 jobs. Agriculture was the only sector that hired more people than it fired: it created 2,600 jobs.

RETRACTION OF TOTAL WAGES WILL REDUCE HOUSELHOLD CONSUMPTION EVEN MORE IN 2016

The year 2016 is also likely to be marked by a sharp fall in the average real income of workers. Inflation will continue to reduce workers' purchasing power, albeit less intensely than in 2015.

Another influencing factor will be the continued retraction of employment and the growth of the labor force - to make up for the loss of income among households that lost jobs in 2015. These factors reduce the bargaining power of workers in collective wage negotiations and are conducive to lower pay for new hires.

This dynamic is evidenced by the lower ratio between the average wage of newly hired employees and of those laid off in times of recession, as seen in 2009. This indicates that workers are hired with lower salaries than those of dismissed employees. This pressure is being caused not only by the increase in the number of people looking for a job, with consequent loss of bargaining power, but also by the need to adjust the production costs of companies to the slowdown in economic activity.

This ratio, however, rises when the labor market heats up, creating pressure for higher wages. The graph below shows the new downward trend of this ratio as of 2014, clearly indicating the weakening of wages since that period.

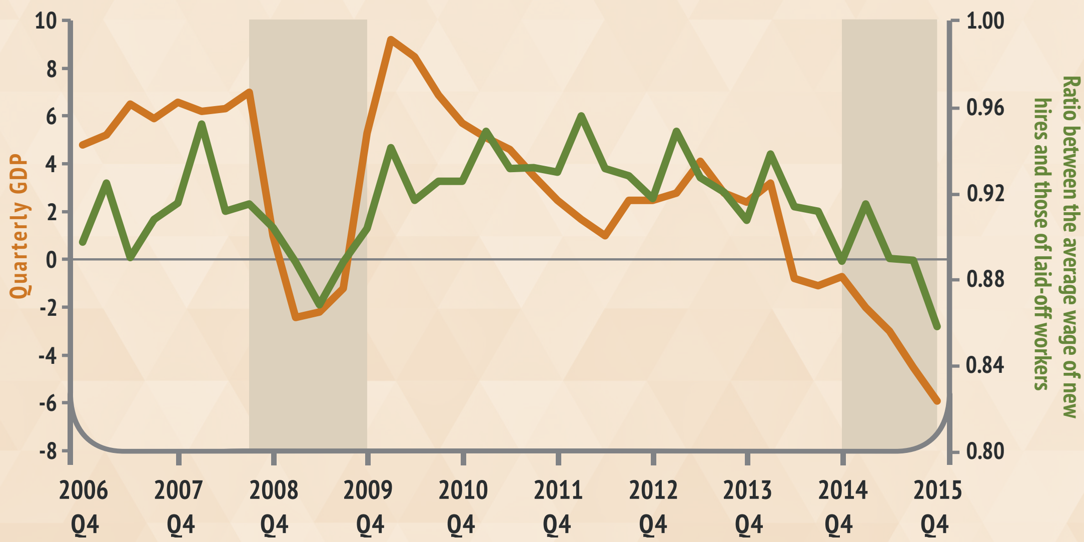
Average real income has been showing signs of deterioration since October of last year. In the mobile quarter ending in January, average real income dropped by 2.4% as compared to the same period last year. This decline occurred despite an increase of 11.7% in the minimum wage granted early in the year. In the quarter ending in January 2015, average real income had grown by 2.8% on the same comparison basis.

With the downturn in jobs and in average real income, real wages recorded the sharpest drop in the series, initiated in 2012, in the quarter ended in January: -3.1% in relation to the same period in 2015. In the quarter ending in January 2015, average real income had grown by 3.7% on the same comparison basis. Given the prospect of continued downturn in real wages in the coming months, household consumption will likely drop further in 2016 (see the Economic Activity section for more details).

In times of economic recession, the wages of new hires are relatively lower than those of laid-off workers

Quarterly GDP and ratio between the average wage of new hires and those of laid-off workers (quarterly average)

As a percentage (%)



Source: Central Bank of Brazil and CAGED/MTE

INFLATION, INTEREST RATES AND CREDIT

Inflation slows down in 2016

Interest rates are likely to fall in the second half of the year

Inflation in early 2016 is well above the target set under the inflation targeting regime. In March, the IPCA index had an accumulated variation of 2.6% in the quarter and of 9.4% in 12 months. The upward trend in prices observed early in the year was mainly determined by increases in federal and state taxes and by unusually strong seasonal climatic effects that pushed food prices up. On the other hand, there was a significant slowdown in regulated prices, which accounted for most of the inflationary pressure recorded in 2015.

The food group was the one that pushed inflation up the most in the first three months of the year. Prices varied by 5.9% in the quarter and by 15.3% in the 12-month period to March. This increase was mainly due to climatic effects that had an impact on food supply, particularly in natura food supply. CNI estimates that food prices will have increased by 12.2% by the end of the year.

Regulated prices increased by 1.8% in the first quarter and by 10.8% in 12 months. In January, food prices were pressured by a hike in fuel prices and by traditional adjustments in public transportation fares. In contrast, energy prices dropped in February and March as a result of better power generation conditions. This fact made it possible to reduce the red-flag tariff charged on electricity bills in February and to apply the lower yellow-flag tariff in March. This contributed to a lower increase in regulated prices early this year in relation to the same period in 2015, when an accumulated hike of 8.5% was recorded.

In 2016, regulated prices will likely exert less pressure on the IPCA index than in 2015. This will mainly occur due to the more positive behavior of energy prices resulting from the suspension of the additional charge tariff from April on. Thus, the group is likely to close 2016 with an accumulated increase of 6.3%.

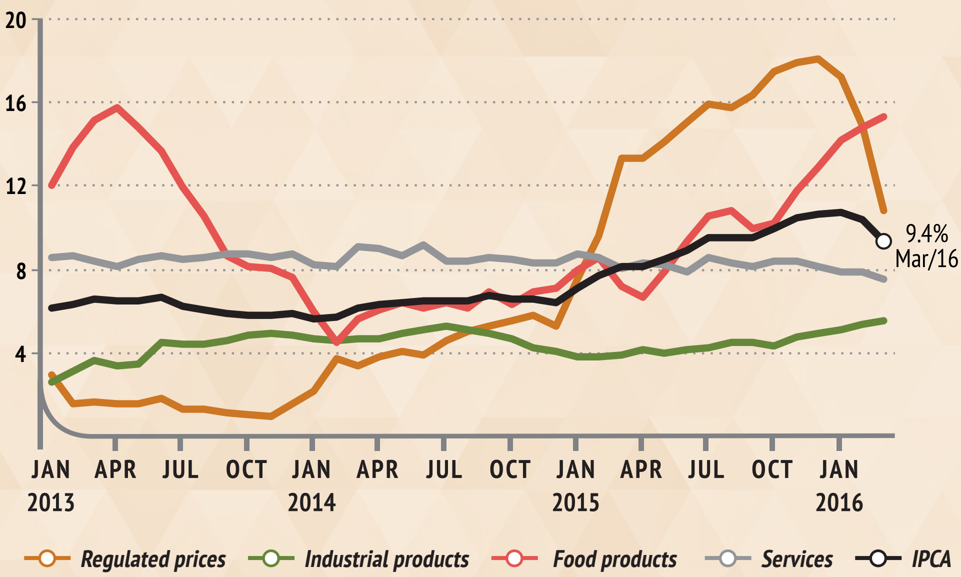
The prices of industrial products rose by 1.7% in the first quarter and by 5.5% in the 12-month period ending in March.

Despite the recent appreciation of the real recorded at the beginning of the year, it is estimated that the average exchange rate (R$/US$) in 2016

Regulated prices slow down early in the year

IPCA by groups

12-month figure (%)

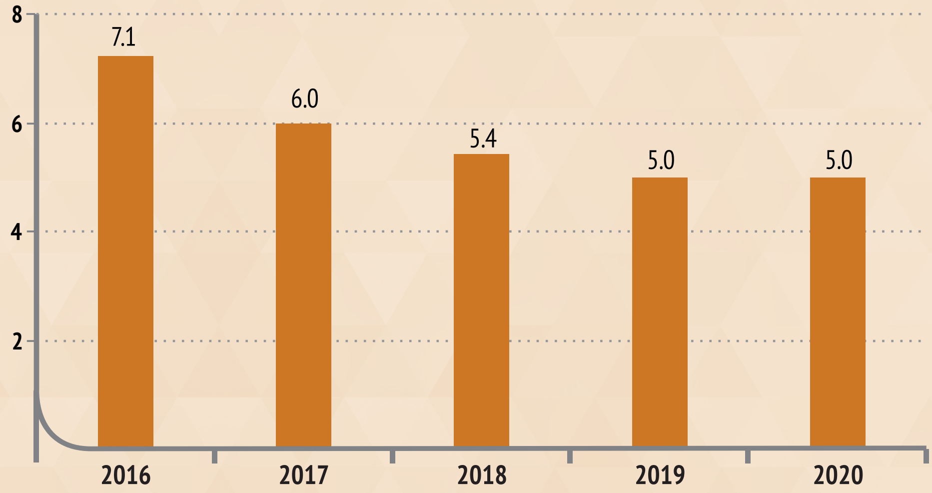


Note: Weighting of IPCA groups: Regulated prices = 24%; Industrial prices = 24%; Food prices = 17%; Service prices = 35%.
Source: IBGE
Prepared by: CNI

Unanchored inflation expectations until 2020

Expected inflation according to the Focus - Central Bank survey

Expectation for the year (%) on 04/08/2016



Source: Central Bank of Brazil

will be higher than in 2015. This fact will likely put additional pressure on the prices of this group, which is expected to be mitigated by the ongoing crisis and its negative impact on the output gap and on the real income of households. CNI estimates that these prices will rise by 5.1% in 2016.

Service prices rose by 2.0% in the quarter and by 7.5% in the 12-month period to March. The characteristic rigidity of prices in this group, caused by indexation to past inflation and to the minimum wage, has been mitigated by a marked recession and labor market deterioration. This trend can be clearly perceived in adjustments in the prices of regular courses, which are traditionally made in February. This year, these prices increased by 7.4%, at a rate lower than inflation in 2015, suggesting difficulties to pass past inflation through to current prices. In 2016, CNI estimates that prices in this group will increase by 6.3%.

In short, a lower inflationary pressure than the one recorded in 2015 is expected in 2016. The lower increase in regulated prices, particularly in energy prices, and the decline in activity and in real household income will contribute to a slowdown in inflation. Nevertheless, the IPCA index will likely remain above the 4.5% target set by the National Monetary Council. CNI estimates that the inflation rate will close the year at 7.1%, against 10.7% in 2015.

INFLATION ABOVE THE TARGET IN COMING YEARS

The first meeting of the Monetary Policy Committee (Copom) in 2016, held in January, surprised economic agents with its announcement that the Selic rate would be kept at 14.25%. Communications from members of the Central Bank and from the institution itself led the market to believe that the Selic rate would be raised. Since then, representatives of the institution have indicated that the Selic rate will be kept at its current level.

In addition, the high current inflation and unanchored expectations have been leading to projections of inflation on the rise in the coming years. Official estimates of the Central Bank, as contained in the inflation report of March, as well as those of market analysts disseminated in the Focus survey for April 8, are above the target set under the inflation targeting regime. According to those analysts, inflation is likely to remain above the target center until 2020, the latest available datum, as shown in the graph above.

The strong recession and its impacts on demand, however, contribute to the most significant slowdown in inflation recorded since the middle of the year. If the constant interest rate remains at its current level, the inflation slowdown will push the real interest rate up, thus leading to a more restrictive monetary policy. This will reduce the Selic rate without affecting current inflation and expectations negatively. It is estimated that a reduction of 0.25 percentage points will be approved in each of the two last meetings of the Monetary Policy Committee in 2016, which will be held in October and November. Thus, the Selic rate would close the year at 13.75%.

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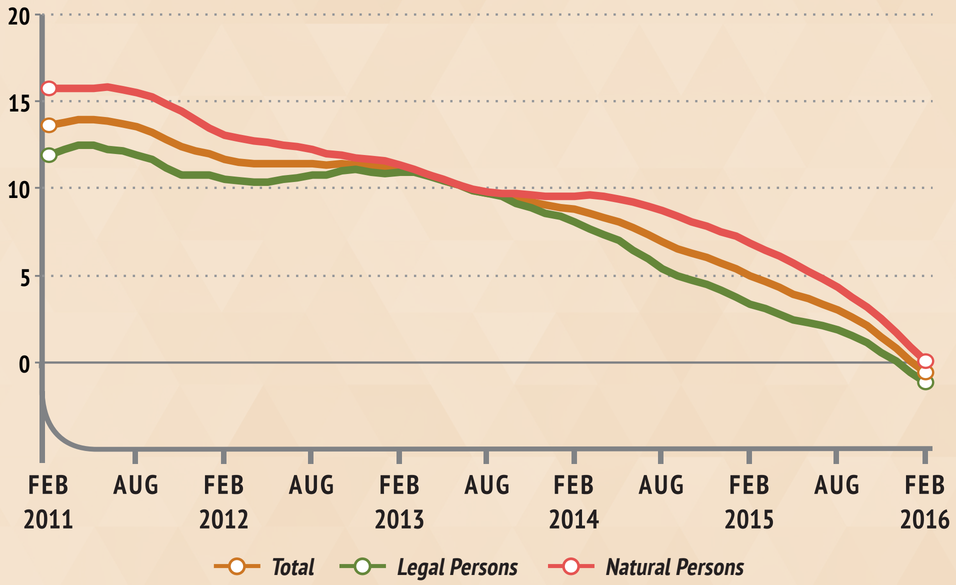
Credit on a continued downward trend

Balance of credit operations

12-month variation in the Brazilian currency against the previous 12 months (%), as deflated by the IPCA index



Source: Central Bank of Brazil

REAL CREDIT BALANCE DROPS FOR THE FIRST TIME SINCE 2007

The credit balance fell in real terms early in the year. According to Central Bank data, the total balance dropped by 0.6% in a comparison between the average recorded in the last 12-month period ending in February and that observed in the previous 12 months. On the same comparison basis, the average balance decreased by 1.2% for legal persons and remained virtually stable for individuals, with a positive variation of 0.1%.

Several factors contributed to this downward trend in credit. On the side of demand for funds, these factors include high capital costs, downturn in economic activity, labor market deterioration and lack of confidence on the part of entrepreneurs and consumers, which ended up postponing consumption and investment and thus discouraging demand for new financings.

On the supply side, the fear of rising default rates led banks to take a more conservative and selective stance in granting credit, making it more difficult for companies and consumers to access credit lines.

Measures to stimulate credit recently announced by the government - by raising the financing limits imposed on loans granted by Caixa Economica Federal (Brazil's federal savings bank) for buying used property and by increasing the offer of credit by the BNDES at subsidized rates for infrastructure concessions - may mitigate the current downward trend in credit. However, they will not be enough to cause drastic changes in its trajectory. Thus, a lower credit balance is likely in 2016.

FISCAL POLICY

Reviews of the primary result target suggest that fiscal policy has been reversed

Primary deficit is likely to exceed US$100 billion

Fiscal policy has once again assumed an expansionary character in 2016. Before the end of the first quarter of the year, the Federal Government proposed a second fiscal adjustment which, once ratified by Congress, will make it possible for the primary surplus target to be achieved even if the primary deficit amounts to R$96.6 billion. In practice, this change will allow the federal government not to make any new financial programming of expenditures, as projections suggest that the previous target (deficit of R$60.2 billion) would not be achieved without additional cuts in spending.

A similar situation is likely to be seen in state governments if an agreement to refinance their debts with the federal government, as proposed in March, is actually approved. In addition to extending the debt repayment period, the agreement provides for a reduction in the percentage of state revenues that must be paid to the Federal Government. The Ministry of Finance estimates that if all states agree to the conditions set out in the agreement by the Federal Government, the amount to be released for primary spending, which will very likely increase, will be R$3.5 billion.

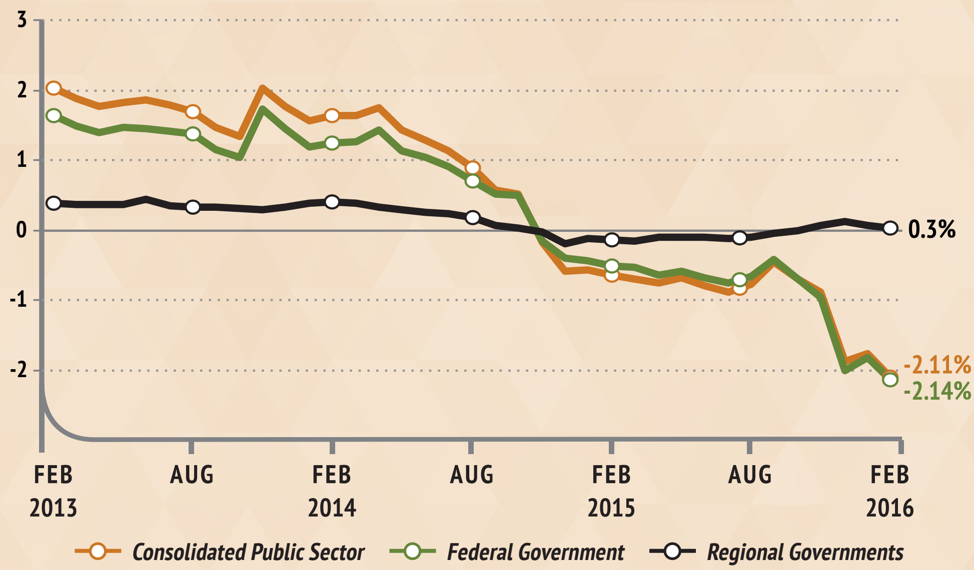
FEDERAL SPENDING INCREASES IN THE FIRST TWO MONTHS OF 2016

The reversal of fiscal policy at federal level can already be felt in the behavior of spending in the first two months of 2016. Federal Government spending has increased, in real terms (IPCA deflator), by 5.7% in the first two months of 2016 in relation to the same period last year. In 2015, expenditures recorded a real decrease of 3.9% as compared to 2014, when R$72.4 billion paid in obligations that should have been settled in previous years are deducted, an operation referred to as "tax pedaling" (delaying bank transfers to misrepresent balances).

The increase in spending was mainly due to expenditures related to social security, operating costs and capital. In the case of social security, the 3.7% rise was due to a nominal increase of 11.7% in the minimum wage and to a similar increase approved for benefits exceeding the amount of the minimum wage.

Between operating costs and capital expenditures, spending on salary bonuses and unemploy-

12-month primary deficit increased by 0.23 percentage points of GDP in the first two months of 2016



Evolution of the primary result of the Public Sector

Accumulated in 12 months (% of GDP)

Source: Central Bank of Brazil

ment insurance and on subsidies and subventions were the ones that pushed expenditures up the most. The real increase of 63.4% in salary bonuses and unemployment insurance was mainly due to a review of the schedule for paying salary bonuses in 2015. That schedule, which concentrated these payments in the second half of the year, extended them throughout the year. While on the one hand that review contributed to reducing expenditures in 2015, its effect in 2016 has been the opposite. The rise in unemployment and, once again, the increase in the minimum wage also had an impact on this scenario.

An increase of R$11billion in spending on subsidies and subventions was mainly due to the payment of subsidies under the Investment Support Program (PSI), which exceeded the amount recorded in the first two months of 2015 by approximately R$6 billion.

Finally, in relation to operating costs and capital expenditures, it is worth mentioning that the investments made under the Growth Acceleration Program (PAC), excluding subsidies granted under the Minha Casa, Minha Vida program (government housing program), have increased by 9.5% in real terms. After a 39.7% decrease in 2015, this expansion is an important indication of reversal in fiscal policy.

FEDERAL GOVERNMENT REVENUES ARE DROPPING LESS SHARPLY

Some tax increases approved by the Federal Government during 2015 have eased the pace of decline in net revenues, which recorded a real drop of 1.4% in the first two months of 2016 as compared to the same period last year. In 2015, net revenues dropped by 6.3% in relation to 2014.

The effect of increases in tax rates for taxes becomes evident when one compares the real decrease of 1.4% in net revenue with the 8.1% drop in economic activity in January 2016 in relation to the same month in 2015, according to the IBC-BR of the Central Bank.

FISCAL RESULTS WORSEN IN 2016

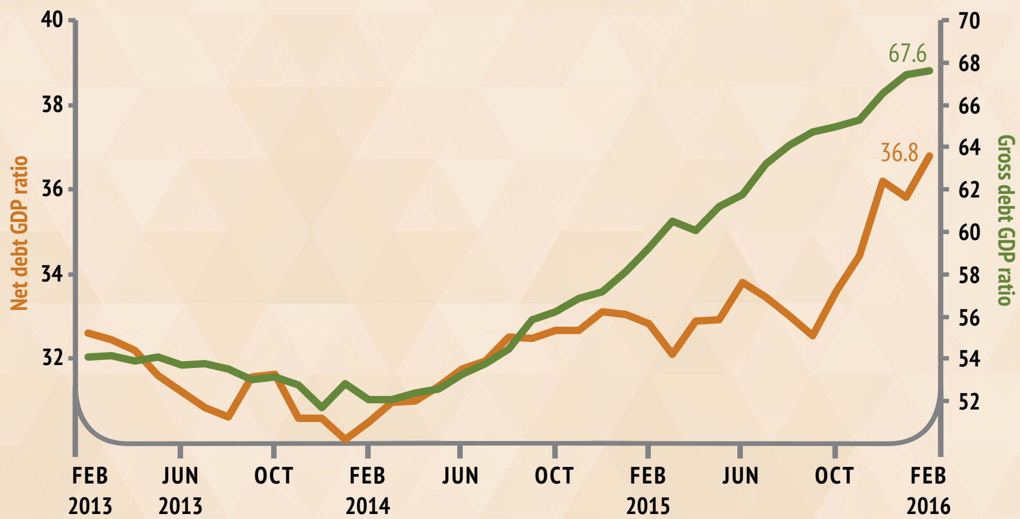
Spending on the rise and continued decline in net revenues have caused the primary result of the Federal Government to worsen in relation to that recorded at the end of 2015. In the 12-month period to February 2016, the primary deficit of the Federal Government reached 2.1% of GDP, against 2.0% in December 2015.

The primary balance of regional governments also deteriorated in the early months of 2016. In this case, a reversal can be observed in improvements seen in 2015, when states and municipalities recorded a primary surplus of 0.12% of GDP, against a deficit of 0.18% of GDP in 2014. This result was achieved with the incorporation of judicial deposits

The Gross Debt/GDP ratio in February 2016 was 1.1 percentage points higher than that recorded in December 2015

Evolution of the Net Debt and Gross Debt of the Public Sector

In relation to GDP (%)



Source: Central Bank of Brazil

Consolidated public sector will likely record a primary deficit of 1.73% of GDP in 2016. While this result is lower than the deficit of 1.88% of GDP seen in 2015, it is actually indicative of deep deterioration

These movements in the Federal Government and in regional governments have led to deterioration in the primary result of the consolidated public sector. In the 12-month period to February 2016, the primary deficit hit the mark of 2.1%, against 1.9% in late 2015.

The rise in the primary deficit and the increase of 0.14 percentage points of GDP in interest spending led the 12-month nominal deficit to reach 10.75% of GDP in February 2016. The higher nominal deficit was reflected in the Gross Debt/GDP ratio, which rose from 66.5% of GDP in December 2015 to 67.6% of GDP in February 2016.

NEW PRIMARY SURPLUS TARGET NOT LIKELY BE ACHIEVED

The Federal Government proposed an amendment to the Budget Guidelines Law of 2016 to Congress that will make it possible for the primary result target to be achieved despite a deficit of about R$96.6 billion. This will be possible because up to R$120.6 billion will be allowed to be deducted from the R$24 billion primary surplus target due to revenue estimates that did not materialize and to certain increases in spending on health care, investment and public security. As a result, no new financial programming of costs is expected and spending may even increase in certain areas.

Therefore, Federal Government spending will likely close 2016 with a real increase of 3.8%. This rise is likely be determined by increased spending on social security (3.7%), operating costs and capital (3.0%). Even spending on personnel, which in the first quarter dropped by 2.6% in real terms, will likely decrease at a lower rate and close the year with a real drop of 1.6%. This is due to a wage increase scheduled to be granted to federal civil servants in the second half of the year.

Revenues are in turn likely to drop at a slower pace and close 2016 with a real decrease of 0.8%. This projection takes into account both the negative effects of the real GDP contraction estimated by CNI (-3.1%) and the continued positive effects of tax increases approved in 2015 and 2016 on tax revenues.

Still, the Federal Government will likely not achieve the primary result target even if Congress approves further deductions. Without carrying out a new financial programming of costs, the federal government will likely close 2016 with a deficit of R$102 billion (1.63% of GDP, as estimated by CNI).

States and municipalities are likely to see continued deterioration in their primary result, which will drop from surplus to a deficit of R$6 billion at the end of 2016. This reversal is due to a decrease in judicial deposits that could be collected by the states and by the release of R$3.5 billion to finance primary spending under a new debt refinancing agreement with the Federal Administration. This amount had been previously earmarked for interest payments.

As a result, the consolidated public sector will likely record a primary deficit of R$108 billion (1.73% of GDP) in 2016. While this result is lower than the deficit of 1.88% of GDP seen in 2015, it is actually indicative of deep deterioration, considering that the result in 2015 carried over R$72.4 billion in spending that should have been accounted for in previous years.

Because of this lower primary deficit than in 2015 and of the reduction in interest spending - from 8.5% of GDP in 2015 to 8.0% in 2016 - the nominal deficit is expected to be lower in 2016. The decrease in interest spending is explained by the reduction in the Selic rate in the last quarter of 2016 and by a lower exchange rate devaluation, which leads to lower currency swap costs. CNI estimates a nominal deficit of 9.8% of GDP in 2016, against 10.4% in 2015.

Albeit lower, this nominal deficit will likely continue to push the debt of the public sector up and, given the low nominal GDP growth (decline in real GDP), lead the Gross Debt/GDP ratio to exceed the mark of 70% of GDP. According to CNI projections, the gross public sector debt will rise from 66.5% of GDP in 2015 to 72.9% at the end of 2016.

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FOREIGN TRADE SECTOR

Significant adjustments in foreign trade accounts

Political uncertainty has a major influence on the exchange rate

After a period of relative stability in the fourth quarter of 2015, the exchange rate between the real and the US dollar resumed a downward trend, particularly in March. The average exchange rate in March stood at R$3.70/US$, up by 4% in relation to the average in December 2015. The exchange rate closed March at R$3.55/US$, the lowest rate since Standard and Poor's downgraded the Brazilian credit ratings in September 2015.

The country risk rating has been playing a major role in explaining exchange rate variations, but in March this role was decisive. In March, the country risk fell and reversed all increases recorded since November of last year.

External pressures also led to the recent exchange rate changes. There are once again doubts as to the pace of normalization of US monetary policy, which may prevent further increases in interest rates in the near future. Europe, in turn, continues to adopt an expansionary monetary policy. These factors have caused the currencies of emerging countries (and not only the Brazilian currency) to appreciate.

In the coming months, particularly until the end of the first half of the year, the risk component will influence the path of the exchange rate significantly. By the end of the year, we expect to see a reversal in the appreciation recorded in March and the real-US dollar exchange rate to return to the level of R$4.00/US$1.

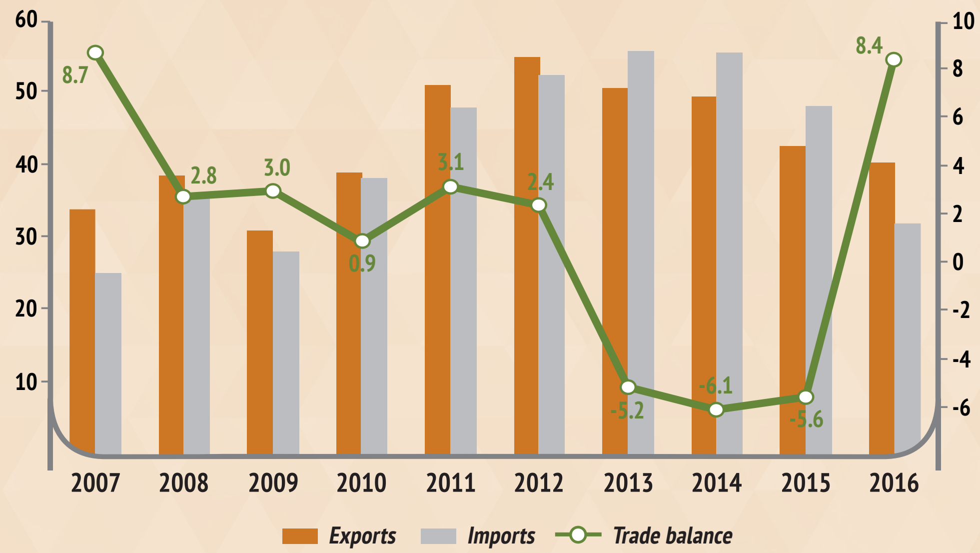
TRADE BALANCE IN THE QUARTER IS THE HIGHEST IN NINE YEARS

The Brazilian foreign accounts reveal a significant adjustment in the first quarter of 2016, when a trade surplus of US$8.4 billion was recorded against a deficit of US$5.6 billion in the same period in 2015. This is the highest trade surplus recorded in such period since 2007. This positive trade balance resulted from a reduction in foreign trade marked by a strong decline in imports and a less pronounced drop in exports, as occurred in 2015.

Exports and imports are declining

First quarter exports, imports and trade balance

In US$ billion



Source: MDIC/SECEX

In the first quarter of 2016, exports totaled US$40.6 billion, 5.1% less than recorded in the same period in 2015. In the same comparison, a decrease was recorded in the value of exports of basic goods (-5.4%), of semi-manufactured goods (-8.5%) and of manufactured goods (-2.0%). The drop in export value was exclusively due to prices. In the first two months of 2016, prices fell by 20% in relation to the same period in 2015, while volumes increased by 19.6%. The same dynamic was observed for basic, semi-manufactured and manufactured goods.

The depreciation of the Brazilian currency (37% between the first quarters of 2016 and 2015) greatly influenced the increase in export volumes. This change made it possible for exporters to reduce their prices in foreign markets and thus to increase their shipments abroad. In the case of basic goods, international commodity prices have also dropped on the same comparison basis, especially those of iron ore, oil and coffee.

Imports, in turn, totaled US$32.2 billion in the first quarter, 33.4% less than in 2015. The decline in imports is intense in all categories of use: fuels and lubricants (-52.4%), intermediate goods (-32%), capital goods (-27%) and consumer goods (-26.9%).

The decrease in the value of imports is due to a drop in prices (11.4% in the first quarter of 2016 as compared to the same period in 2015) and, mainly, to a reduction in import volumes: drop of 26.9% on the same comparison basis. The drop recorded in the import volumes of durable consumer goods (50.4%) deserves special mention. The decline in import volumes is due to the exchange rate and to the strong economic slowdown, which had an impact on consumption, production and investment.

In the remainder of the year, the currency is likely to depreciate again, reinforcing the current dynamics of exports, marked by drops in prices and increases in quantities sold. Global growth will remain modest, inhibiting significant increases in commodity prices. Thus, exports will likely show a slower rate of decline in the annual comparison. At the end of 2016, exports are expected to total an amount close to the one recorded in 2015: US$192 billion.

As for imports, the currency depreciation and, mainly, the strong economic slowdown will cause the value of imports to continue to record a significant decrease throughout the year. Thus, imports will likely drop by 12.5% in 2016, to US$150 billion. The trade balance is expected to be positive by US$42 billion in 2016, against a surplus of US$19.7 billion in 2015.

Export volumes on the rise

Variation in prices and export volumes - average recorded in January-February 2016/2015

As a percentage (%)

Source: Funcex

CURRENT ACCOUNT DEFICIT APPROACHING ZERO

The 12-month current account deficit amounted to US$46.3 billion in February 2016, less than half the deficit recorded in the 12-month period to February 2015 (US$102.8 billion). This strong adjustment in the current account balance resulted both from an increasingly more positive trade balance and from a reduction in the negative balance of services and income. Both were impacted by a more depreciated currency and by the slowdown in economic activity in Brazil.

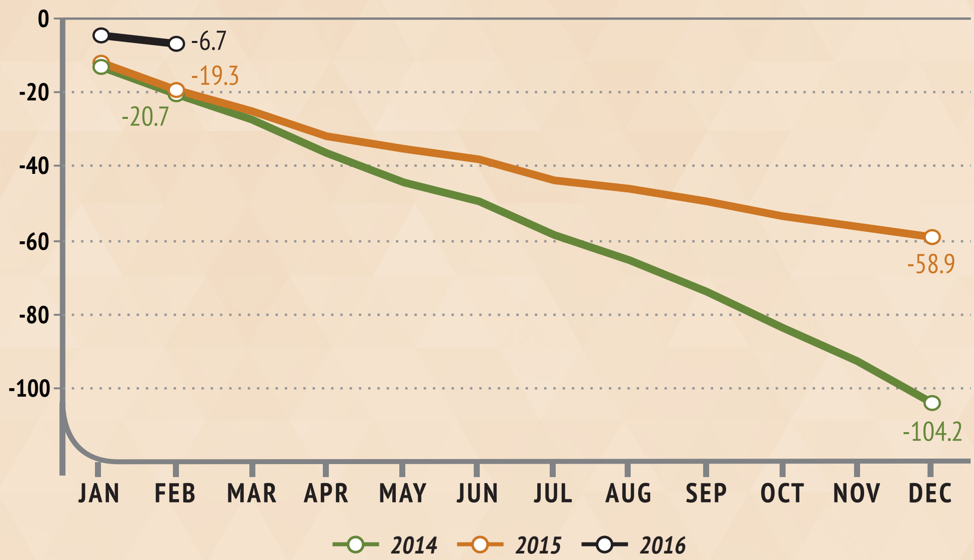
In relation to the deficit in services and income, special mention should be made of a sharp drop of 39% (US$10 billion) in spending on international travel and of 33% (US$6 billion) in net remittances of profits and dividends, both in the comparison between the 12-month period to February and the previous 12 months. The 31% reduction (US $4.4 billion) recorded in spending on transportation is also significant, because of declining trade flows.

This downward trend in the current account deficit is expected to continue until the end of 2016 due to the expectation that the exchange rate will remain at its current level and that economic activity will continue to slow down. Thus, the current account deficit will likely close 2016 at US$20 billion. This amount represents a deficit of 1.2% of GDP as projected by CNI in 2016, against a deficit of 3.3% of GDP recorded in 2015.

Current account deficit drops quickly

Current account balance

In US$ billion



Source: Central Bank of Brazil.
Prepared by: CNI

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2014	2015	2016 previous forecast (Brazilian Economy)	2016 current projection (04/11/16)
ECONOMIC ACTIVITY				
GDP (annual change)	0.1%	-3.8%	-2.6%	**-3.1%**
Industrial GDP (annual change)	-1.2%	-6.2%	-4.5%	**-5.0%**
Household consumption (annual change)	0.9%	-4.0%	-3.3%	**-4.4%**
Gross fixed capital formation (annual change)	-4.4%	-0.1%	-12.3%	**-13.5%**
Unemployment Rate (annual average - % of the labor force)	6.8%	8.3%	11.0%	**11.5%**
INFLATION				
Inflation (IPCA index - annual change)	6.4%	10.7%	6.8%	**7.1%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	10.96%	13.47%	14.25%	**14.18%**
(year's end)	11.75%	14.25%	14.25%	**13.75%**
Real interest rate (average annual rate and deflation: IPCA)	4.3%	4.2%	5.6%	**5.2%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	-6.23%	-10.40%	-9.40%	**-9.80%**
Public sector primary surplus (% of GDP)	-0.59%	-1.88%	-0.80%	**-1.73%**
Net public debt (% of GDP)	57.2%	66.5%	70.6%	**72.9%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.64	3.87	4.40	**4.00**
(average in the year)	2.35	3.33	4.20	**3.80**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	225.1	191.1	198.0	**192.0**
Imports (US$ billion)	229.0	171.5	161.0	**150.0**
Trade balance (US$ billion)	-3.9	19.7	37.0	**42.0**
Current account balance (US$ billion)	-104.2	-58.9	-39.0	**-20.0**

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