A Newsletter from Brazilian Confederation of Industry

CNI

Economic Report

Year 23 - Number 2 - April/June 2007

Appreciation of the real restricts industrial output growth

In 2007, the Brazilian economy has been growing significantly. This growth, however, is marked by features which differentiate it from other moments of more vigorous expansion in the past. The main one is that the growth observed in domestic demand is not being accompanied by a similar increase in industrial output. On the contrary, the output growth rate in the manufacturing industry was little over half the GDP growth rate in a comparison between the first quarters of 2007 and 2006. The enhanced domestic demand is mainly met by increased imports. Imports of goods and services – as calculated in National Accounts – increased in the first quarter of 2007 at a pace six times faster than that of the industry.

Another feature of economic activity in 2007 is the heterogeneous growth of the industry. A significant growth in production was observed in certain sectors as a result of favorable foreign and domestic demands, while other sectors only experienced modest growth (most of them) or even a lower production.

The appreciation of the real affects industries in different ways, which largely explains the heterogeneous evolution of the manufacturing production. More labor-intensive sectors, those less capable of replacing domestic inputs with imported ones, and those which concentrate a more significant number of small enterprises are facing more difficulties to deal with the exchange rate appreciation.

The depreciation of the dollar is a global phenomenon, but it is intensified in Brazil by the vigorous entry of foreign currencies to the country, boosted by the higher interest rates prevailing in Brazil in relation to the rest of the world, by a favorable trade balance, and by the elimination of external restrictions which caused instability and seriously hindered growth in the past.

The main issue is that the Brazilian currency appreciated without substantive parallel advances in structural reforms which are necessary to foster competitiveness. Many of the specific difficulties faced by Brazilian corporations – which affect their competitiveness and were made up for by a depreciated exchange rate in the past – remain virtually unchanged. In other words, the appreciation of the real clearly revealed the high costs of producing in Brazil, as a result of the excessive tax load and the high cost of credit, among other no less important factors.

Therefore, it is imperative to face the distortions revealed by the exchange rate and not hesitate to adopt immediate measures to provide enterprises with the resources they need to compete in this new reality – such as, for example, compensatory tax breaks or special credit lines for the most affected sectors. Trade defense mechanisms must also be used in cases of abuse. In this regard, the measures adopted recently to fight the effects of the appreciation of the real are positive; although they are still insufficient, considering the magnitude and amplitude of the problems faced by affected segments.

Economic activity

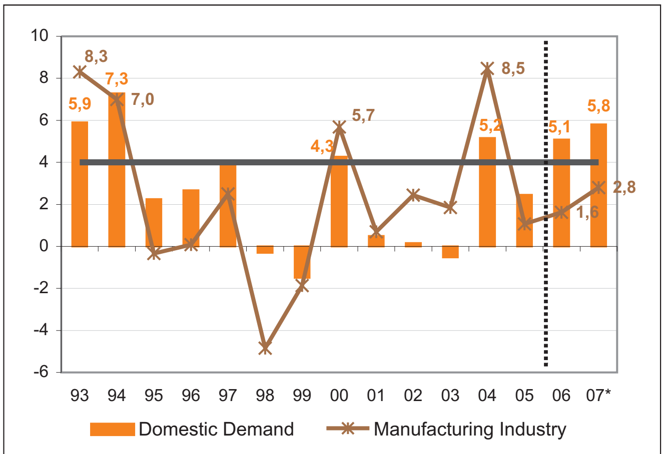
Domestic demand grows significantly, but industry doesn't keep pace with it

Domestic demand – made up of household and government consumption and gross formation of fixed capital – grew at a rate of 5.8% a year in 2007. This demand is being spurred by: a) higher income transfers from the government to the population; b) expansion of the real payroll; and, mainly, c) expansion of credit, resulting from the combination of lower interest rates and longer average debt financing deadlines.

Consumption is on the rise. Retail sales grew by 9.2% in the comparison between the averages registered in the first four months of 2007 and 2006. This growth in sales is shared by products which are more dependent on income, such as supermarket items (7.3% during this period) and products which are more dependent on credit, such as furniture items and household appliances (18.5%), IT equipment (21.6%) and vehicles and motorcycles (21.3%).

There are also clear signs of increased investments. The gross formation of fixed capital expanded by 7.2% in the first quarter of 2007, from the same period in 2006. The production of capital goods increased by 16.3% in the first five months of 2007 as compared to the same period in 2006. The growth pace observed in the production of capital goods for industrial purposes was even higher during this period, namely, 18.6%.

Domestic Demand and Manufacturing Industry:
(%) Annual Change



Source: National Accounts/IBGE. Prepared by: CNI

Historically, periods during which domestic demand grows coincide with periods in which the manufacturing industry leads economic growth. This is not, however, what is being observed in 2007. Production in the manufacturing industry grew by only 2.8% in the comparison between the first quarters of 2007 and 2006. Demand growth in Brazil is increasingly being met by imports of goods and services, which increased by 19.9% between the first quarters of 2007 and 2006.

The growth in imports at a pace six times faster than that of the manufacturing production shows that Brazilian products are losing competitiveness in the domestic market. Among the reasons leading to this loss of competitiveness on the part of the industry, special mention should be made of the appreciation of the real, which was particularly intense in the second quarter of 2007.

The appreciation of the real affected not only the result of the manufacturing production, but particularly the real revenue of industrial corporations. Turnover dropped by 0.9% in the comparison between the two-month period made up of April and May and the first quarter (CNI Industrial Indicators, seasonally adjusted data). This result reflects, on the one hand, the poorer performance of exporting firms – which are getting less reals for each dollar of exports – and, on the other hand, a higher pressure for lowering the prices of industrial products, as Brazilian corporations try and attenuate loss of market shares to imported products.

The figures for production and industrial turnover are marked by strong sectoral heterogeneity. In relation to physical production in the manufacturing industry, it was seen that five sectors – Machinery and equipment; Automotive vehicles; Food and beverages; Basic metallurgy; and IT equipment – concentrate three quarters of the growth registered in the manufacturing activity in 2007 (Monthly Industrial Survey/IBGE).

Among the sectors in which production decreased in 2007, Timber and Leather and footwear stand out for having experienced decreases in production for three years. In addition to these sectors, electronic materials and communication equipment industries have been suffering production drops for two years.

GDP is expected to grow by 4.5% in 2007

In 2007, GDP is expected to repeat the performance observed in 2006, that is, the industry will grow less than the economy as a whole in average and the foreign trade sector will contribute negatively to GDP growth.

In the previous newsletter, CNI estimated that GDP would grow by 4.2% in 2007. This rate is in tune with the GDP growth pace observed in the first quarter of this year. However, CNI expects economic activities to step up their pace in the coming quarters, and this is why GDP growth in 2007 has been reviewed upwards to 4.5%.

GDP: Projection for 2007

	GDP Components	2007 (%) Rate of change	2007 Contribution (p.p.)
Demand	Household consumption	5,8	3,1
	Government consumption	4,7	0,9
	GFCF	10,5	1,8
	Exports	5,0	0,7
	(-) Imports	21,0	2,3
Supply	Agriculture and livestock	4,5	0,2
	Industry	4,0	1,3
	Extractive (minerals)	5,7	0,2
	Manufacturing	3,7	0,7
	Construction	4,5	0,2
	Public utilities and services	4,2	0,2
	Services	4,2	2,7
	Taxes	6,8	4,5
	GDP (market prices)	**4,50**	

Source: CNI

This upward review was determined by prospects of a more intense growth in services and, mainly, in taxes – which have been increasing very significantly, particularly taxes on imported products. The estimated GDP growth at basic prices (net of taxes) in 2007 is 4.1%. Taxes on products are expected to increase by 6.8% this year, raising the GDP growth rate at market prices to 4.5%.

Concerning domestic demand components, CNI reviewed the growth in consumption (both household and government consumption) upwards. Household consumption is expected to grow by 5.8% in 2007, accounting for three quarters of economic growth as a whole, while government consumption should increase by 4.7% in 2007.

CNI maintains its previous estimate of a 10.5% growth in the gross fixed capital formation. This robust growth is associated with the downward trend of interest rates in the economy, higher capacity utilization, higher spending in infrastructure. The volume of exports of goods and services is expected to increase by 5.0% this year and that of imports by 21.0%. As a result, the net contribution of the foreign trade sector to GDP formation should be negative by 1.7 percentage points in 2007.

Industrial GDP is expected to grow by 4.0% in 2007, less than GDP. The manufacturing industry will grow by 3.7% and stand out negatively as the less dynamic of all industrial sectors. The agricultural/livestock production is expected to grow by 4.5% – boosted by both grain production and livestock – and services will grow by 4.2%.

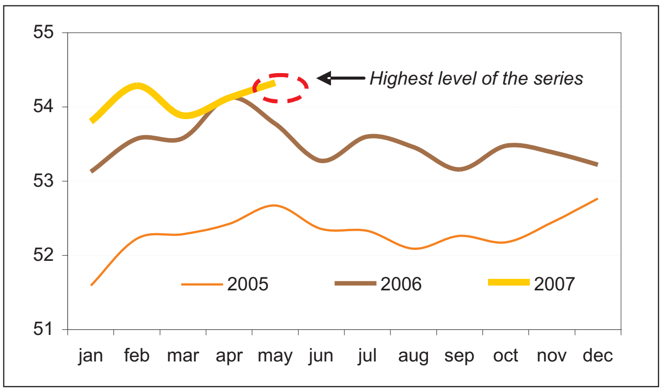
Formalization and increased total earnings are highlights

The metropolitan labor market was marked by a quantitative and qualitative increase in jobs. New jobs accumulated in twelve months amount to over 500,000, among which 75% are formal jobs. Jobs in the formal sector, where wages are higher than the global average, and inflation under control lead to a higher real payroll.

Occupation rates in the six metropolitan regions covered by the Monthly Job Survey (IBGE) point to a rather heterogeneous evolution. While jobs in the service sector grew by 9.9% in May from the same month in the previous year, the occupation rate in the public administration remained stable in the same sort of comparison. According to CNI Manufacturing Indicators, the occupation rate in the manufacturing industry grew by 3.5% during the same period.

The qualitative improvement observed in the labor market continues in 2007. In May, the formality index – which measures the ratio between formal jobs and total occupation – reached the highest level (54.3%) of the historical series. The increase of formal jobs in the private sector (3.9% in May, from the same month in the previous year) contrasts with the decrease observed in informal jobs. A large increase in self-employment (4.6% in May, from the same month in 2006), in turn, raises some concern: the persistence of this phenomenon can hinder advances in the formality index over the next few months.

Formality in metropolitan areas
(% of total occupation)

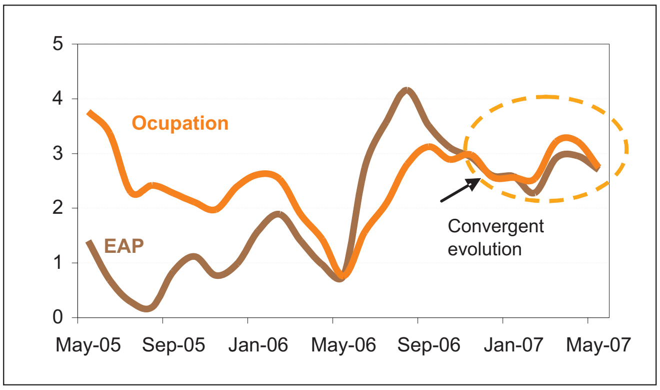


Source: Monthly Job Survey/IBGE   Prepared by: CNI

The unemployment rate was 10.1% in May – stable for three months in a row. In the comparison with May 2006, the rate also remained stable. This stability is explained by a synchronism between the expansion observed in the economically active population (EAP) and occupation rates over the past twelve months.

Occupation rates and EAP

(%) change from the same month in the previous year



Source: Monthly Job Survey/IBGE

Real total earnings grew by 5.6% in May from the same month in the previous year. The accumulated result from January to May of this year in relation to the same period in the previous year indicates that this indicator has grown even more significantly: 7.3%, according to data from the Monthly Job Survey.

The real total payroll in the manufacturing industry grew by 2.7% in May from the same month in 2006, according to CNI Manufacturing Indicators. Despite a somewhat slower growth pace in May, growth rates accumulated in the year are still quite high. In the accumulated result for the first five months of 2007 as compared to the same period in the previous year, there was a 5.5% increase.

Therefore, according to both the Monthly Job Survey (all sectors) and CNI (manufacturing industry), there are signs of a strong growth in the real total payroll, although this growth is relatively more modest in the industry.

INFLATION, INTEREST RATES AND CREDIT

Food and beverages push up inflation, but regulated prices help preserving a favorable scenario

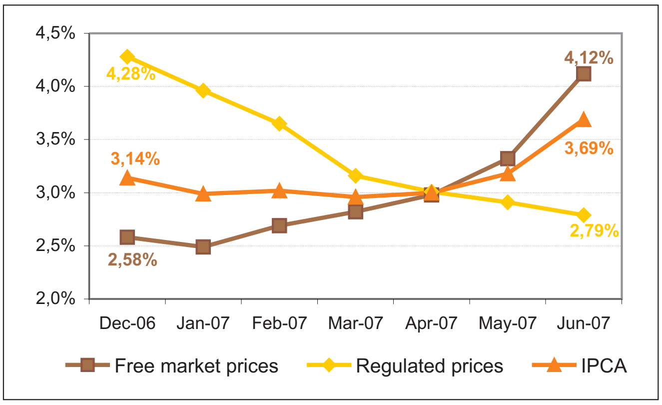
12-month inflation registered by IPCA (Expanded Consumer Price Index) rose from 2.96% at the end of the first quarter to 3.69% in June. The highest price increases, however, were concentrated in a small group of goods. From January to June, only three of nine categories covered by the index had variations exceeding those of the first half of 2006. Food and Beverages category registered the steepest increase this last semester: 3.93%, contrasting with a 1.31% drop in the first half of 2006.

The pressure on food prices was caused by both higher domestic consumption and larger international demand for commodities. In any case, the chances that prices in other sectors of the economy will behave in a similar way in 2007 are thin. Even after the inflation figures for June were announced, 2007 inflation estimates collected by the Central Bank pointed to a 3.68% rise of IPCA – just below CNI´s estimate (3.8%).

The behavior of regulated prices continues to favor inflation control. As they are based on past inflation, contractual readjustments end up reflecting – today – the favorable behavior of prices during the past four quarters. In 2007, regulated prices as a whole rose by 1.30% from January to June, less than half the 2.76% observed during the same period in 2006. Moreover, reductions in power (electricity) prices in various capitals, as announced early in July, suggest that regulated prices will remain on this relatively flatter trend over the next few months.

IPCA – Free market and regulated prices

(12-month % change)



Source: IBGE

Free-market prices, in turn, rose by 0.92% and 2.44% in the first halves of 2006 and 2007, respectively. A significant acceleration was registered for both tradable goods (from -0.17% to 1.62%) and non-tradable ones (from 2.19% to 3.20%) on the same comparison basis. As a result, market prices as a whole – which account for 70% of the IPCA – accumulated an inflation of 4.12% in the twelve-month period ending in June.

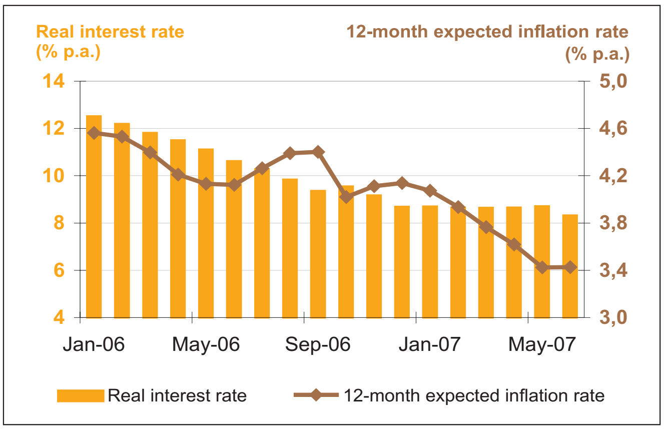
As for the General Price Index (IGP), which is more frequently adopted in real estate and financial markets, figures also suggest a low inflationary risk. The General Price Index-Internal Availability (IGP-DI) and its main component, the Wholesale Price Index-Internal Availability (IPA-DI), rose by 3.96% and 3.76%, respectively, in the twelve-month period ending in June. In the wholesale market, the prices of products of industrial origin (hike of 2.47% in twelve months) were contained by the exchange rate appreciation, which affects the competitiveness of domestic products both in domestic and foreign markets. Agricultural products, on the other hand, accumulated a variation of 8.07% in twelve months – following an international trend.

When the Wholesale Price Index (IPA) is broken into subcategories of different production stages, we see that prices of raw materials had a variation of 7.44% in twelve months, despite the drop in 2007, which hit the mark of 3.62% from January to June. Intermediate and final goods had more modest variations in twelve months: 2.73% and 2.63%, respectively.

Copom decisions become less predictable

In June, the Monetary Policy Committee (Copom) decided to speed up the pace of Selic rate reductions adopted in its three previous meetings, from 0.25% at 45-day intervals to 0.50%. As a result, the Overnight-Selic interest rate closed the half-year at 12% a year. Discounting the expected inflation for the next twelve-month period (3.54%), the real interest rate amounted to 8.17% a year in the beginning of this second semester – meaning that it remained practically stable in 2007.

Real interest rates and expected inflation



Source: Banco Central do Brasil

It has become increasingly difficult to predict what the Copom will do in the four meetings which are scheduled to be held in the second half of 2007. This is due to recent changes in the composition of the committee – involving the replacement of Central Bank directors – and ambiguities in the dissemination of the inflation target for 2009 (4.5%). Notwithstanding, we expect to see a new reduction of 0.5% in the Selic rate in July and three further reductions of 0.25% until December. The basic rate is therefore expected to close 2007 at 10.75% a year.

Loans and issuance grow at a fast pace

The balance of credit operations of the financial system hit the mark of 32% of GDP in May. The growth in relation to the 30.8% observed at the end of 2006 reflects a higher total credit outstanding with non-earmarked resources, which increased from 21% to 22.3% of GDP during the period. The average spread paid by enterprises in loans with non-earmarked resources was 12.8% a year in May, below the level of 14% – around which it had fluctuated for four years. Because the average interest rates paid by business in May amounted to 24.3% a year, the spread continues to account for over half (52%) of the cost actually borne by enterprises in bank credit operations.

The balance of operations with earmarked resources remained virtually stable as a percentage of GDP (9.8%), despite the increasing volume of resources disbursed by the BNDES (National Economic and Social Development Bank). In the comparison of accumulated volumes in twelve months until May 2007 and May 2006, the increase amounted to 26%. The reduction from 6.50 to 6.25% a year in the long-term interest rate (TJLP) – a level that will be maintained during all the third quarter – was welcomed by the production sector because of the need to step up investments in infrastructure projects, whose maturity is longer.

Finally, the increasing search for alternatives to bank loans through the capital market deserves special mention. Total issuance in the stock market – primary and secondary offerings – during the first six months of 2007 was R$ 25.2 billion, close to the figure for all 2006 (R$ 27 billion).

Fiscal Policy

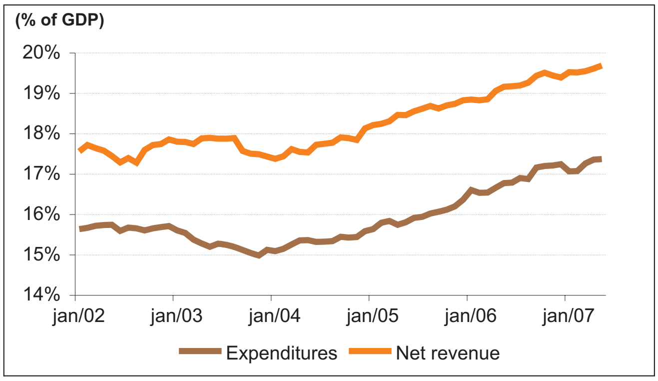
Higher tax revenues increases primary surplus

The significant increase observed in tax revenues has ensured a higher public-sector primary surplus, despite a marked increase in spending. Central government's primary surplus accumulated in the first five months of the year increased from 3.57% of GDP in 2006 to 3.86% of GDP in 2007. On the same comparison basis, regional governments increased their primary surplus from 1.11% to 1.62% of GDP.

In the case of central government, the increase observed in real tax collection amounted to 10.3%, basically as a result of a higher collection of income tax and social security contributions. In the first case, tax revenues grew due to the better results of enterprises (corporate income tax - IRPJ) and to the effects of higher total earnings on withheld individual income tax. The higher revenue from social security contributions was also largely determined by the increase observed in total earnings.

As for states and municipalities, the available data point to a real increase in tax revenues of 6.3% in the comparison between periods January-May of 2006 and 2007. Much of this expansion was determined by transfers from the central government, which grew 9.5% as a result of the higher tax revenue. The revenue from the Turnover Tax (ICMS) grew by only 3.2% on the same comparison basis.

Evolution of Expenditures and Revenues of the Central Government, 2002-2007



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

Revenues have been sufficient to make up for a higher public spending. In the first five months of 2007, we estimate that the primary expenditure of states and municipalities increased by 5.3% in real terms from the same period in the previous year.

During this period, the primary spending of the central government increased by 9.2% in real terms. All the main components of this spending increased significantly: social security benefits (9.6%), staff and contributions (8.9%) and fixed and capital expenses (8.9%).

The increase observed in the spending with social security benefits is explained by an increase in the number of benefits being paid and by significant raises in the minimum wage in 2006 (16.7%) and 2007 (8.6%). The spending with staff and contributions grew as a result of wage raises granted to civil servants in 2006.

Concerning fixed and capital expenses, the increase of 26.3% in investments of the central government in the first five months of 2007 in relation to the same period in 2006 should be highlighted. This expansion is particularly significant if we take into account the fact that 2006 was an election year, which tends to increase the volume of investments in the first months of the year.

Higher primary surplus brings nominal deficit and the debt/GDP ratio down

The consolidated public sector primary surplus increased from R$ 46.7 billion in the first five months of 2006 to R$ 60 billion in the same period this year. This behavior enhances the possibility that the primary surplus target set for the year will be achieved – R$ 91.3 billion, minus R$ 4.6 billion related to the Pilot Investment Project (PPI).

However, the results achieved by federal state enterprises so far suggest that it will be difficult for them to achieve the set target, which is R$ 18.1 billion (0.72% of GDP). During the past twelve months (up to May 2007), federal state enterprises had a primary surplus of 0.58% of GDP, the same percentage achieved up to December of last year. It is likely that the primary result to be achieved by the central government or, mainly, by regional governments will have to make up for the insufficient surplus of federal state enterprises.

As for broader fiscal indicators, the increase observed in the primary surplus brought the nominal deficit down from R$ 17.5 billion (1.92% of GDP) in the first five months of 2006 to R$ 7.9 billion (0.79% of GDP) during the same period in 2007. The debt/GDP remained in the same downward path and dropped from 44.9% of GDP in December of 2006 to 44.7% in May of this year.

Higher spending and less intense pace of expansion of revenues are expected to reduce the gap between the primary surplus and the target in the second half of the year. We expect the central government to have a primary surplus of 1.94% of GDP in 2007. Although the target will be achieved with this result, it represents a drop in relation to the surplus of 2.14% of GDP registered in 2006.

The projection of a 1.94% primary surplus considers that R$ 4.6 billion will be used in the PPI. The expansion of the PPI to R$ 11.2 billion was belated and expense authorization and settlement processes will put off most payments for next year. If expenses included in the changes made to the PPI are paid before this year is over, the actual primary surplus of the central government may be 1.68% of GDP.

Fiscal Results of the Consolidated Public Sector
(% of GDP)

Results	Jan-May/06	Jan-May/07	Jan-Dec/07*
Nominal deficit	1,92	0,79	2,05
Interest payments	7,04	6,79	5,79
Primary deficit	5,12	6,00	3,74
Net Debt/GDP	44,9 (dec/06)	44,7 (feb/07)	43,9 (dec/07)

Source: Banco Central do Brasil
(+) surplus (-) deficit
* CNI Estimate based on expenses of R$ 4.6 billion in the PPI.

If federal state enterprises and regional governments manage to achieve their primary surplus targets – 0.72% and 0.98% of GDP, respectively –, or if regional governments make up for the insufficient result of federal state enterprises, the public sector would have a primary surplus of 3.74% of GDP in the "below-the-line" concept, calculated by the Central Bank. In this case, there would be a drop in relation to the result in 2006 (3.88% of GDP).

Despite a lower primary surplus, a lower spending with interest payments and faster GDP growth are expected to make it possible for the nominal deficit and the debt/GDP ratio to close the year below the level registered in 2006. We expect the nominal deficit to drop from 3.01% to 2.05% of GDP. The debt/GDP ratio, in turn, is expected to drop from 44.9% to 43.4% of GDP.

Foreign Sector

Significant entry of dollars prevents the appreciation of the Real from being contained

A significant entry of dollars into Brazil is intensifying the appreciation of the real. In the first half of this year, the difference between the entry and exit of foreign currency was US$ 51.6 billion, a higher balance than the one observed at the end of last year.

Apart from the entry caused by large trade balance surplus and inflows of foreign direct investments, exporters advance revenues from their sales, invest those proceeds in the domestic financial market, and thus protect the value of their exports from future depreciations of the dollar. In 2007, exporters have already received US$ 19 billion in export revenue in advance.

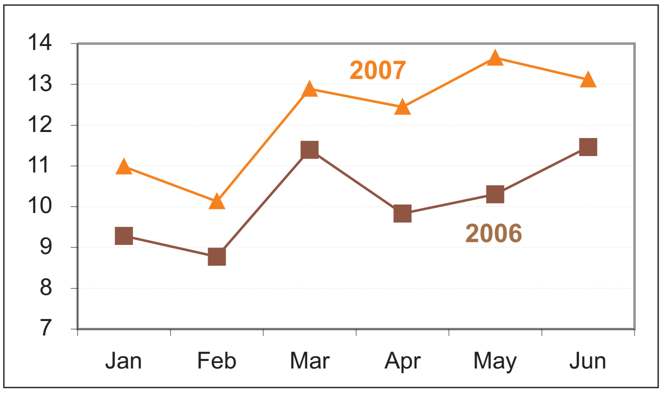
At the end of the first half of 2007, the real appreciated more intensely, as opposed to the gradual appreciation pace observed late in 2006 and early this year. Up to the second week of July 2007, the real had accumulated an appreciation of 11.3% in relation to the US dollar since December 2006 – the average exchange rate in June was R$ 1.93/ US$ 1.

In an attempt to contain the exchange rate depreciation, the Central Bank purchases dollars. Over the past twelve months, dollar purchase operations raised Brazil's international reserves from US$ 63 billion to US$ 147 billion. This is a high-cost strategy: on the one hand, the Central Bank accumulates an asset (the US currency) which continues to depreciate; on the other hand, it is forced to issue high-interest government bonds to reduce, at least in part, the liquidity generated by its exchange rate operations. As a result of operations in the future foreign exchange market alone, the losses of the institution this year have hit the mark of R$ 4.7 billion already.

Recent results of exports do not suggest that trend will be reverted

The foreign trade figures in the first half of 2007 seem to suggest that a new record trade balance is likely this year, but a more detailed analysis of the circumstances may point to a less certain scenario. In May, average daily exports grew by 32.4% in comparison with the same month in 2006, while in June they grew by 20% on the same comparison basis. However, in May and June 2006, a strike of auditors of Brazil's Internal Revenue Service distorted foreign trade figures, so the comparison is significantly favorable for the same months in 2007.

Monthly Exports – US$ billion



Source: Secex (Foreign Trade Secretariat)

Regardless of this distortion, one cannot deny that the performance of Brazilian exports continues to surprise positively, particularly if the path of the exchange rate is taken into account. Exports totaled US$ 73.2 billion in the first half of 2007, meaning that their result was 19.9% higher than the one registered in the same period in 2006.

By use category, it can be seen that basic products experienced the highest growth in the first half of the year: 31.3%. This performance can be attributed to hikes in commodity prices and to larger exported volumes as well. Exports of chicken, beef and pork stand out, as a result of the elimination of barriers and embargoes faced last year.

The growth rate of export prices hit the mark of 9% and the quantum grew by 11% between the first five months of 2007 and 2006. It should be mentioned that the quantum will be seen to have grown even more when the data for June is available, because of the above-mentioned strike. However, the trend is that prices will once again determine the increase of sales abroad throughout the year.

Therefore, the value of the exports is expected to total US$ 157 billion in 2007, an increase of 14% in the comparison with 2006, mainly sustained by price gains. For all products exported by Brazil, particularly for basic products, the loss of competitiveness abroad will be partly made up for by a large international demand.

Imported volumes grow in all categories

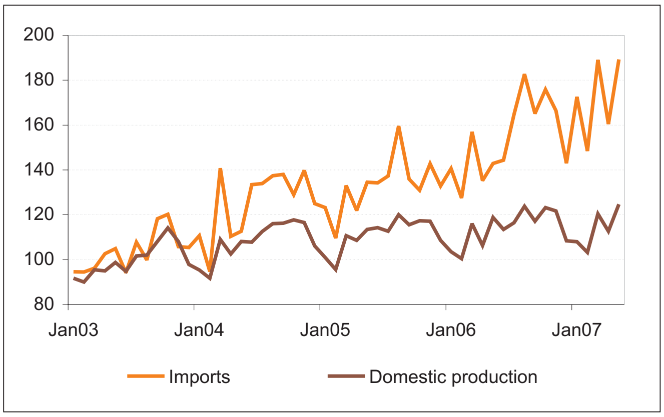
The more intense appreciation of the real in the first half of this year enhanced even more the purchasing power of the currency and stimulated the replacement of domestic goods with imported ones. Besides the appreciation of the real, domestic demand also grew significantly. Imports totaled US$ 52.5 billion in the first half of 2007, an increase of 26.6% in relation to the figure registered in the first half of 2006.

Imported volumes in all use categories have been growing strongly. Consumer goods account for most of this growth: imports of non-durable consumer goods increased by 36.7% between the first halves of 2007 and 2006, while those of durables grew by 31.8%.

Imports of capital goods also deserve special mention, as they grew by 24.3% in the comparison with 2006. The importance of this evolution should be stressed, as it suggests the presence of key investments to enable domestic supply to keep up with the strong increase in demand. Imports of industrial machines and their accessories account for over half of the growth observed in imports in this use category.

Imports of raw materials and intermediate goods grew by 29.4% in the comparison between the first halves of 2006 and 2007. It should be highlighted, however, that the growth observed in the imports of these goods is much higher than the growth pace of the manufacturing production, indicating that domestic inputs to production are being replaced by similar imported ones.

Imports of intermediate products and production in the manufacturing industry (2002 = 100)



Source: IBGE and Funcex Prepared by: CNI

The value of imports has been growing mainly as a result of larger quantities, and not so much due to changes in import prices. During the first five months of this year, imported volumes increased by 23% – according to Funcex data. Prices, in turn, rose by only 3%.

The stimuli to imports in the first half of 2007 should still be present during the second semester of this year. As a result, imports will once again grow as significantly as in 2006, hitting the mark of US$ 114 billion at the end of 2007, a growth of 25%. As opposed to exports, this growth is mostly due to the increase observed in imported volumes.

Therefore, a small reduction in the foreign trade balance is expected at the end of 2007, to about US$ 43 billion – which is still a robust balance, particularly if one takes into account the appreciation of the real.

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Available data until July 12, 2007.