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Lower GDP growth due to new drop in industry

The first half ended on a frustrating note as a result of poor economic performance and a downward revision of estimated GDP growth to just 1.0% in 2014. Industrial GDP in turn is expected to drop 0.5% in the year.

In fact, the seasonally adjusted indicator of industrial GDP is set to drop for the fourth time in a row in the second quarter. Many issues have led to this sharp slowdown in industrial activity – and they are more related to the domestic environment than to the world economy.

A persistently high inflation – which has been testing the upper inflation target limits – has led to an increase in interest rates and, therefore, to a reduction in loans granted by private banks. A reduced liquidity results in a progressive weakening of both household consumption and corporate investment.

The macroeconomic policy environment – monetary contraction and fiscal expansion – has not shown positive results to sustain demand as in the years following the global financial crisis. Fiscal expansion has led to a continued deterioration in public accounts: the structural primary surplus for the Federal Government fell to only 0.5% of GDP. The impacts on fiscal accounts would be even greater were it not for extraordinary tax collection mechanisms, which will not be afforded in the future.

Investment is the key variable behind the difficulties faced by the Brazilian economy. Gross fixed capital formation, which measures investment in the National Accounts, will likely fall for the fourth straight quarter in June – as will industry. Business confidence must be restored if this negative scenario is to be reversed, as shown in the graph.

The lack of business confidence reflects the current difficulties faced by industry and results not only from weak demand expectations, but mainly from a decreased profitability of projects as production costs continue to increase more than industrial prices. This reduces entrepreneurs' willingness to invest, further aggravating the slowdown.

Although key to breaking this cycle, investment recovery is also hampered by uncertainties on the evolution of economic policy in 2015 surrounding the elections. This is to say that we will hardly witness an improvement in the scenario in the second half.

Brazilian economy in the second quarter of 2014

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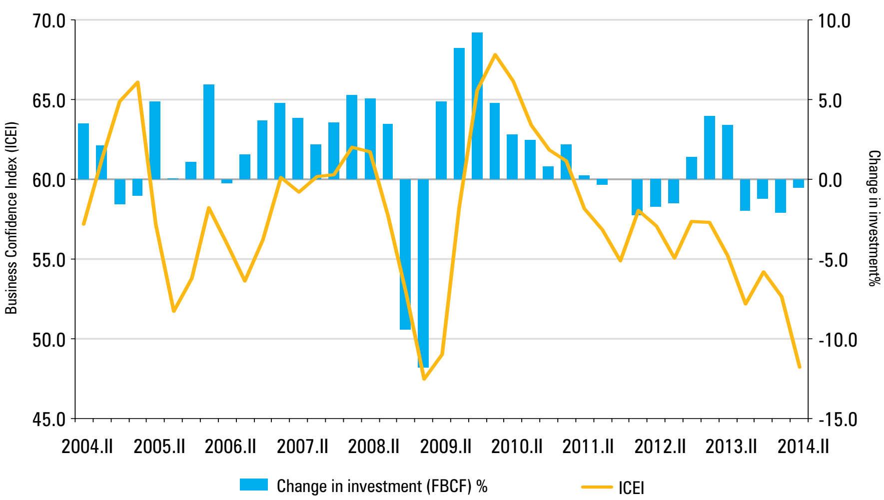
Confidence and Investment

Quarterly average figure for the Business Confidence Index and quarterly investment growth rate (seasonally adjusted)

Restoring confidence is key to recovering investment



Source: CNI and IBGE
Note: The investment growth rate for the second quarter of 2014 is a projection made by CNI.

economic activity

Industrial downturn in 2014

Low confidence and reduced investment are the main barriers to recovery

Recent indicators show that Brazilian industry is still struggling to step up its activity levels. This is clear when we look at production results, which fell for the third consecutive month in May and accumulates a 1.6% decrease in the first five months of 2014 over the same period last year (PIM-PF/IBGE).

The scenario is even more negative when we restrict the analysis to manufacturing. Manufacturing production also declined by 2.4% in the year to May, with emphasis on capital goods, which fell by 5.8% (PIM-PF/IBGE).

Furthermore, capacity utilization dropped and unwanted inventories piled up. Actual-usual capacity utilization fell to 36.6 points in June, hitting a record low since 2009, and actual-planned inventories rose to 51.1 points in the same month, remaining higher among large firms (54.8 points). These results suggest idleness in the industrial park and excess inventories, respectively (Industrial Survey/CNI).

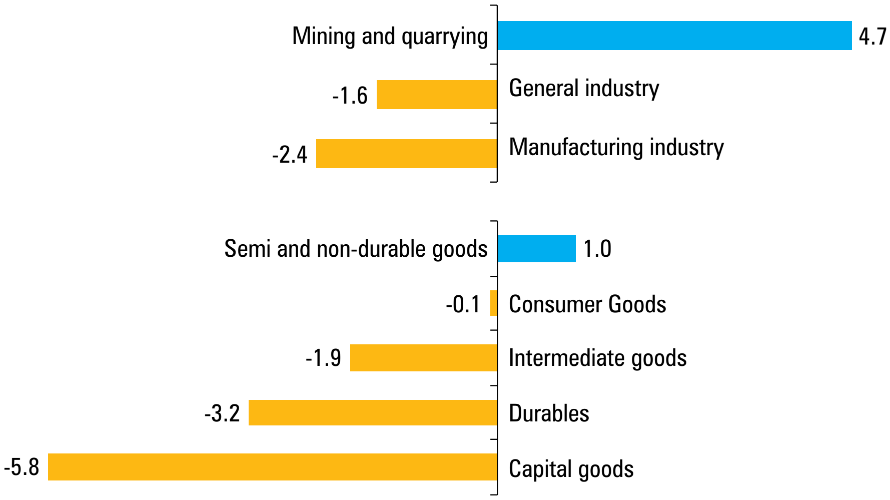
The labor market is already feeling the impacts of weak industrial activity. In May, both the indicators of employment and real average earnings of industrial workers (Industrial Indicators/CNI) edged down for the third month in a row.

The industrial slowdown is explained by several factors, the most important of which is the lack of competitiveness of Brazilian companies. However, this is a structural factor that cannot solely and fully explain the decline in industrial activity in 2014. The downward trend is also driven by short-term issues,

Industrial production by activity and use category

Average figure in the January-May 2014 period compared the same period last year (%)

Decline in production of capital goods reflects the low rate of investment in industry



Source: IBGE

including weak domestic demand, lower exports to Argentina, increased working capital costs, higher electricity costs (caused mainly by the water deficit) and lack of business confidence.

Business confidence must be restored for current negative scenario to be reversed

While some steps have been taken recently to address this scenario – reestablishment of the export support program REINTEGRA, renewal of the BNDES Investment Maintenance Program (PIS/BNDES), extension of the reduced Tax on Industrial Products (IPI) on cars, and permanent extension of payroll tax breaks to sectors already covered by the new system –, entrepreneurs' expectations remain negative, making it more difficult for investment to be recovered. The Business Confidence Index (ICEI/CNI) amounted to 46.4 points in July, the lowest level in its entire series, which started in 1999.

In any case, it is worth stressing that the above-mentioned measures are considered positive by industry, particularly the long-term ones, as they indicate the government's intention to boost industry's competitiveness on a permanent basis.

In this scenario of slowdown and lack of confidence, industry is expected to fall by 0.5% in 2014. This drop will be led mainly by manufacturing and construction industries, with the former dropping by 1.0% and the latter by 1.7%. Mining and quarrying in turn recorded positive results in the first months of this year and is likely to rebound from 2013 levels, growing by 1.5% this year.

Services are expected to growth at a slower pace. This segment expanded by 2.2% in 2013 and is set to post growth of 1.5% in 2014. This lower growth rate can be explained by both a slowdown in household consumption and trade and by a drop in industry.

As for agriculture/livestock, the sector is estimated to grow by 2.3% in 2014: albeit lower than last year (7.3%), this growth rate is higher than that expected for industry and services in 2014.

Reduced investment to limit economic growth

Investment is still a critical variable on the demand side. In the first quarter, the Gross Fixed Capital Formation fell by 2.1% as compared to the last quarter a year ago – the third drop in a row on this comparison basis – and this result is unlikely to be reversed in 2014.

Lack of business confidence, an expected weakening of household consumption and the decline in construction industry (which makes up more than half the Gross Fixed Capital Formation) will probably lead to a 2.0% drop in investment this year.

As a result, the investment rate (Gross Fixed Capital Formation to GDP ratio) will stand at 17.6%, down by 0.6 percentage points from the 2013 figure.

Household consumption is also down in the first quarter (0.1%), the first drop since the third quarter of 2011. In 2014, household consumption is projected to grow by only 1.5%, marking the fourth consecutive year of slowdown. This reduced growth is mainly a result of adverse conditions to access credit (more expensive and restricted), deteriorating expectations about the labor market, and a persistently high inflation rate.

With respect to government consumption, the indicator is set to grow at a slightly lower rate, down from 2.0% in 2013 to 1.9% in 2014.

Owing to the slowdown in household consumption and investment and to the decline in industry, imports are projected to grow by 1.2% this year, significantly less than in 2013 (8.3%).

Exports are also likely to grow less as compared to last year's result. CNI estimates that exports of goods and services will rise by 0.8% in 2014, after increasing by 2.5% in 2013. This behavior is driven primarily by a lower increase in exports of manufactured goods, as industry is still struggling to compete internationally in 2014 and suffering from a reduced demand from Argentina.

For this reason, CNI expects GDP to grow by 1.0% in 2014, a result significantly lower than that observed last year, when the Brazilian economy grew moderately (2.5%).

CNI estimate for GDP

Percentage variation and contribution of GDP components

	GDP components	2014 Growth rate (%)	2014 Contribution (p.p.)
Demand side	Household consumption	1.5	0.9
	Government consumption	1.9	0.4
	Gross formation of fixed capital	-2.0	-0.4
	Exports	0.8	0.1
	(-) imports	1.2	0.2
Supply side	Agriculture/livestock	2.3	0.1
	Industry	-0.5	-0.1
	Mining and quarrying	1.5	0.1
	Manufacturing	-1.0	-0.1
	Construction	-1.7	-0.1
	Public administration, health and public education	2.0	0.0
	Services	1.4	1.0
	GDP	**1.0**	

employment and income

Sluggish labor market

Real income growth pushes costs up

Despite a weak economic activity in 2014, the labor market continues to show low unemployment rates. This trend is even more contradictory when considering the recent slowdown in job creation.

Metropolitan employment (PME/IBGE) remained virtually stagnant in the first four months of 2014. In January, the numbers of jobs created fell by 0.1% from the same month last year (30,900 fewer jobs). In both February and March, job growth was close to zero. In April (latest data available), employment rose by 0.1%, representing an increase of only 34,300 new jobs in the period.

Data from the General Register of Employed Persons (CAGED) of the Ministry of Labor and Employment confirm the poor performance observed in recent months. In June, the CAGED recorded only 25,400 new jobs, a decrease of 79.5% compared to the same month last year, when 123,800 formal jobs were created.

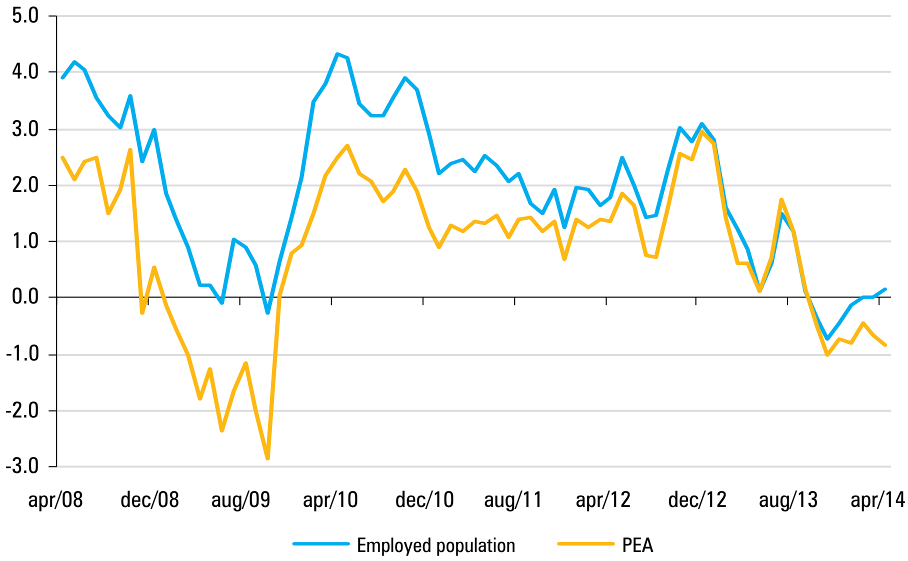
This means that unemployment rates remain low due to the poor performance of the labor force, which has been shrinking since October last year. In April, the labor force fell by 0.8% on a year-on-year basis, representing 206,000 fewer people. That was the sharpest decline in the labor force in the year.

As a result of this downtrend in the labor force, the unemployment rate reached 4.9% in April in all the six Brazilian metropolitan regions surveyed by the Brazilian Institute of Geography and Statistics (IBGE). This is the lowest rate

Employed population and labor force

Year-on-year variation (%)

Strong reduction in labor force causes unemployment rate to fall below 5% in April



Source: PME/IBGE

for April in the entire series, which began to be conducted in 2002. In the same period a year ago, unemployment was at 5.8% of the labor force.

The decline in the labor force can be partly explained by the behavior of the labor force participation rate – the ratio of the labor force to the working-age population –, which has been falling significantly: down from 58.1% in November 2012 to 55.7% in April this year.

The decline is even stronger among people in the 18-24 age group: the labor force participation rate fell by 6.2 percentage points, from 70.4% to 64.2%. This is to say that the Brazilian population appears to be entering the labor market increasingly later in life. This result can be confirmed by the labor force participation rate among adults in the 25-49 age bracket, which fell by 1.1 percentage points during the same period.

For this reason, even if the job market continues to slow down on account of low economic activity, the labor force will keep trending downward, albeit more moderately. As a result, we expect to see a low average unemployment rate average in 2014: 5.6% of the labor force. However, it should be stressed that the 2013 unemployment rate was lower than that expected for 2014: 5.4% of the labor force.

Labor market formalization still underway

After dropping slightly in February and March, the labor formalization index is back to the level recorded early this year, indicating that formal employment started an uptrend in April. On the other hand, informal employment keeps falling in the six largest metropolitan regions in Brazil (PME/IBGE). On a year-on-year basis, formal private sector jobs increased by 2.2% in April. Informal jobs in turn experienced a 13.3% drop on the same comparison basis – actually, they have been falling for 14 straight months on a year-on-year basis.

Consequently, the share of formal employment (all formal, military and statutory jobs) in total employment hit the mark of 63.4% in April – this is the second highest share of formal employment since the labor force time series began to be conducted in March 2002.

Real average earnings remain on the rise

Real average earnings usually earned by workers (PME/IBGE) slowed down in the first four months of 2014. The year-on-year growth rate fell from 3.7% in January to 2.7% in April.

While, on the one hand, earnings are still on the rise – due in part to formal jobs rising quicker than total employment, which pushes wages up, as formal jobs pay above average wages – on the other hand, they have been growing at lower rates, influenced by a recent slowdown in job creation.

Considering that employment will continue to fall, albeit more moderately, and that the labor force will increase slightly due to inflationary pressures on workers' purchasing power, which will lead to increased demand for work, real average earnings are expected to grow by an average of 1.6% in 2014, marginally below the figure recorded in 2013 (1.8%).

Industry is the sector losing the most jobs

The scenario of weak economic activity, coupled with increased average earnings of workers, has led to a slowdown in the industrial labor market.

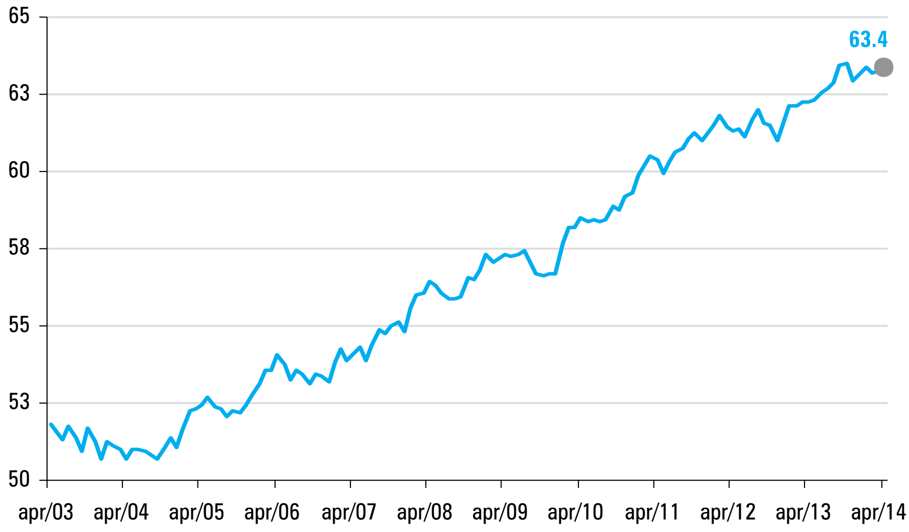
In the 12 months ending in April, industry (comprising three segments: mining and quarrying, manufacturing, and industrial utilities) was the sector that lost the most jobs in the metropolitan regions: 72,900 jobs in the period, down by 2.0% from April 2013. Confirming this result, the CNI Industrial Indicators survey showed that jobs fell for the third month in a row in May.

Construction industry was also badly hit, with a reduction of 54,300 jobs (down by 3.1% year on year). Trade was another sector for which significant losses were observed in the period: reduction of 48,000 jobs (-1.1%). Two sectors experienced growth in job numbers in the last 12 months to April: services (1.3%) and public administration (0.8%), with the creation of 49,800 and 29,300 new jobs, respectively.

Labor market formalization

Percentage share (%)

Share of formal employment in total employment grows in April



Source: IBGE

inflation, interest rate and credit

Inflation target ceiling may be exceeded

Lower economic activity avoids more adverse inflationary scenario

Inflation continued to rise in the second quarter of 2014. The 12-month IPCA (Extended Consumer Price Index) hit the mark of 6.52% in June, marking the fifth consecutive monthly increase in this indicator. As a result, inflation exceeded the target ceiling (6.5%) again, as it did in June 2013. Prices of industrial products and services were the main drivers behind the increase in the indicator in June.

The 12-month figure for industrial product prices reached 5.5% in June, the highest level in the recent history of the IPCA. The acceleration in June resulted mainly from seasonal effects of ethanol prices, which fell by 3.4% in June 2014, a significantly lower drop than that observed in June last year (5.3%).

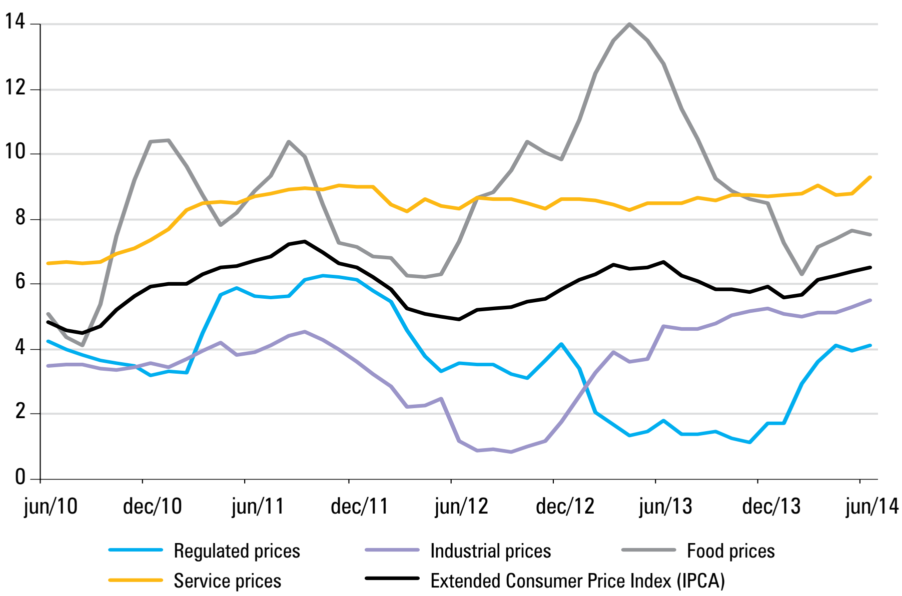
Despite the recent increase, the effects of reduced economic activity and lower household consumption growth will likely impact the group by the end of the year. Thus, the group's accumulated prices are expected to close the year at 4.9%.

Service prices are still a key contributing factor to the high level of the IPCA. In June, the 12-month figure for the group stood at 9.3%, also a record high in the recent history of the IPCA. This group has a strong inertial component linked to inflation-based adjustments and to minimum wage changes.

IPCA by groups

12-month figure (%)

Prices of industrial products and services speed up in June



Source: IBGE – Prepared by: CNI

As with industrial products, however, the effects of lower economic activity tend to cool down demand for services. The group's prices will likely experience a slight deceleration by the end of the year, closing 2014 at around 8.7%.

Food prices are up by 7.5% in the 12 months ending in June. As a result of the fall in the prices of these products in the month, the 12-month figure edged down – in May, the group's index totaled 7.7%.

Yet, the indicator for this group is set to accelerate again by the end of the year. The drop in prices recorded in June will likely be mitigated in coming months due to the inter-harvest season and to a lower growth in agricultural supply in 2014 as compared to 2013. This group is therefore expected to close the year with an accumulated inflation of approximately 8.6%.

Regulated prices increased to 4.1% in the year to June, significantly up from the level observed early this year (1.7% in January). This rise was driven by a reversal of the effects of electricity tax cuts, which have been fully incorporated into the index.

New increases in public transportation and electricity will likely be seen in the remaining months of 2014, as a result of which the group would close the year with an accumulated figure of about 4.3%.

The low growth rate projected for the year contributes to a less perverse inflation dynamics, but this will not translate into a comfortable result:

there is a high risk that the inflation target (6.5%) will not be attained.

The IPCA is expected to accelerate further in coming months, amounting to about 6.8% and only falling again in December. Considering these effects, CNI is projecting that the IPCA will stand at 6.6% in December, slightly above the target ceiling.

Low growth rate postpones changes in Selic rate

The Brazilian basic interest rate (Selic rate) was maintained at 11.00% per year at the COPOM meeting held on July 15 and 16. It was the second consecutive meeting at which the basic interest rate was kept unchanged. This occurred despite a recent acceleration of inflation, with the IPCA growing from 5.68% in 12 months ending in February to 6.52% in June.

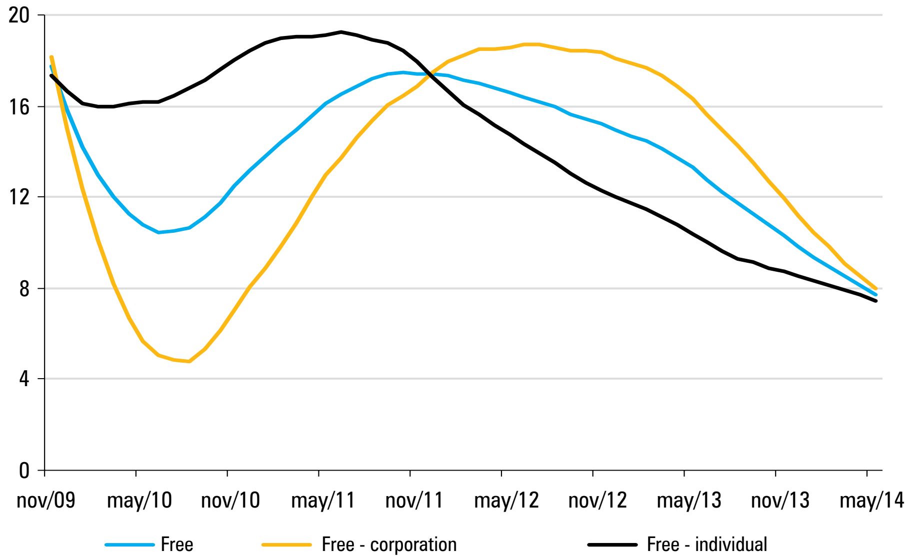
The perception is that COPOM will stick to this strategy on account of an adverse macroeconomic scenario and the lagged effects of the recent high interest rate cycle (the Selic rate went up from 7.25% per year to 11.00% per year since April 2013), as it understands that keeping interest rates at the current level is the best thing to do "at this time." The announcement of the last decision is ambiguous and leaves room for further changes in the near future – both for increases, due to a negative inflation environment, and decreases, due to a worsening of the already negative economic situation.

Given the current turbulent economic environment and imminent changes in the US monetary policy (with a reduction in asset purchases and a possible interest rate hike in the near future), the Monetary Policy Committee will likely wait a little longer to eventually change the Selic rate.

Total balance of credit operations with non-earmarked resources

12-month figure compared to the previous 12-month figure (%)

Non-earmarked loans continue to slow down



Source: Central Bank of Brazil

From this perspective, CNI estimates that the Selic rate will only be changed next year, with the rate closing 2014 at the current level of 11.00% per year. This forecast, combined with the estimated IPCA figure, means that the average real interest rate would amount to 4.2% per year in 2014 (compared to 2.0% last year).

Credit slows down as a result of reduced demand and low willingness to lend

Loans have experienced a sharp slowdown in recent months, both for individuals and corporations. This downturn is driven primarily by non-earmarked resources (those without a specific purpose, such as short-term loans) rather than by earmarked resources (mainly housing loans to individuals and BNDES loans to corporations).

The growth rate of total non-earmarked resources (average figure for the last 12 months as compared to the 12 previous months) amounted to a significant 17.5% in mid-2011, but has since then been slowing down – in May (latest data available), this indicator stood at only 7.7%.

This situation can be explained by a reduction in both credit demand and supply. The lower demand resulted from a recent hike in interest rates (especially non-earmarked resources), lower economic activity, and low business confidence (which is reflected in lower investment).

On the supply side, the uncertain economic environment has made banks become more reluctant to lend. In fact, industrialists have found more difficult to obtain financing. In the second quarter, the indicator of difficulty to access credit, as measured in CNI's Industrial Survey, hit a record low since the 2009 crisis.

fiscal policy

Further deterioration in public accounts

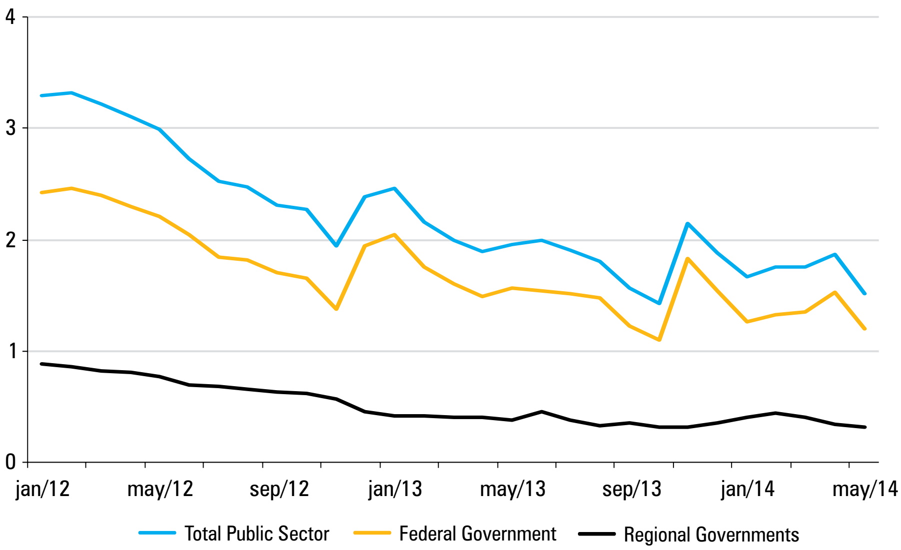
Expenditure grow faster than GDP

An expansionary fiscal policy continues to lead to a deterioration in public accounts. Spending by both the federal and regional governments rose at a pace much faster than that of revenues and economic activity. As a consequence, the primary surplus for the public sector declined significantly, which has impacted, albeit moderately, indebtedness levels.

Primary surplus for the consolidated public sector and by government levels

In relation to GDP in the last 12 months (%)

Public sector primary surplus fell by 0.4 percentage points of GDP between December 2013 and May 2014



Source: Central Bank of Brazil – Preparation: CNI

Federal expenditures grew by 4.8% in real terms in the first five months of 2014 over the same period a year earlier. Discretionary, defrayal and investment expenses rose by 15.4% on the same comparison basis and account for almost all the increase in Federal Government's spending.

The rise in defrayal expenses was led by a R$ 4.0 billion increase in compensation paid by the Treasury to INSS (Brazilian Social Security) and by a R$ 8.5 billion increase in spending in the Ministries of Health and Education. Investments posted real growth of 36.8% in the first five months of 2014. Much of this increase was driven by a rise in expenditures between January and February, probably due to late payments from the end of 2013.

The increase in federal spending could be even higher were it not for the postponement of expenditures on other items. Social security spending decreased by 0.6% in real terms from January to May 2014 on a year-on-year basis. While the small 1.0% real increase in the minimum wage has contributed to downward pressure on expenditure growth, the postponement of court-ordered payments totaling R$ 3.0 billion was the main factor behind the drop. Staff expenditures, which grew by 0.6% in the first five months of the year, also recorded a drop in court-ordered payments, which in recent years have been made primarily in the early months of the year.

Only R$ 900 million worth of court-ordered payments were made by May 2014, against R$ 3.7 billion during the same period of 2013. About R$ 2.7 billion will still be paid in the second half.

The Federal Government's net revenue posted real growth of only 0.5% in the first five months of 2014 from the same period in the previous year. The difference between the growth rate of net revenues (0.5%) and total revenues (1.9%) can be explained by the fact that transfers to regional governments planned for 2013 have been postponed to 2014. Expenditures grew much more quickly than net revenues and this led to a drop in the Federal Government primary surplus, which stood at 1.2% of GDP in the last 12 months ending in May 2014, compared to 1.5% in the 12 months to December 2013. Excluding extraordinary revenues of R$ 35.4 billion from debt repayments in instalments and the Libra oilfield auction, the primary result would total 0.5% in the last twelve-month period.

Spending in states and municipalities grow strongly

The growth rate of regional government expenditures was also high. Spending rose by 5.4% in the first five months of 2014 from the same period in 2013. However, revenues performed better in regional governments than in the Federal Government, as they grew by 4.2% in real terms between January and May 2014.

This result was driven mainly by an 8.8% growth in transfers from the Federal Government. As a result, the 12-month primary surplus of states and municipalities fell slightly from 0.34% in December 2013 to 0.32% of GDP in May 2014.

The drop in the Federal Government surplus was a major factor that caused the 12-month primary result for the consolidated public sector to fall from 1.9% in December 2013 to 1.5% of GDP in May 2014. As a result, the 12-month nominal deficit rose from 3.25% to 3.5% of GDP during the same period. This increase occurred in spite of a reduction in interest payments in the last twelve-month period, from 5.1% in December 2013 to 5.0% of GDP in May 2014.

Finally, the increase in nominal deficit and exchange rate adjustments to domestic and foreign debts led to a rise in the Net Debt/GDP ratio: up from 33.6% in December 2013 to 34.6% of GDP in May 2014.

The Gross Debt/GDP ratio in turn grew even stronger: up from 56.7% in late 2013 to 58% in May 2014.

Primary surplus target unlikely to be achieved in 2014

The Federal Government spending growth rate is set to fall in coming months. The budget appropriations available to cover defray and investment expenses and the high amount of payments made in the first months of the year show that these items will likely play a key role in slowing down the upward trend in spending observed in the year to May. Staff and social security expenditures, on the other hand, are expected to edge up due to an increase in court-ordered payments. For this reason, Federal Government spending is projected to close 2014 with a year-on-year real growth of 2.7%.

On the other hand, the Federal Government's net revenue is expected to close the year at a higher level than that recorded by May, mainly as a result of a lower increase in transfers to regional governments. Moreover, the drop in tax revenues will likely be softened by the renewed possibility of paying tax debts in installments. Net revenues are thus projected to grow by 1.1% in real terms in 2014.

Under this scenario, the Federal Government's primary surplus would total R$ 64.0 billion in 2014 (1.2% of GDP as projected by CNI). This result is estimated to fall below the set target, which is R$ 80.8 billion. For this target to be achieved, the Federal Government would need to make a financial programming of an additional R$ 17 billion in discretionary spending.

In regional governments, the revenue growth rate is expected to slow down due to reduced transfers from the Federal Government. The slowdown in expenditures will probably not be enough to accommodate a lower revenue growth rate. As a consequence, the primary surplus is estimated to fall slightly from May's level and stand at around R$ 16 billion (0.3% of GDP) in 2014 – below the target set by the Federal Government (R$ 18.2 billion).

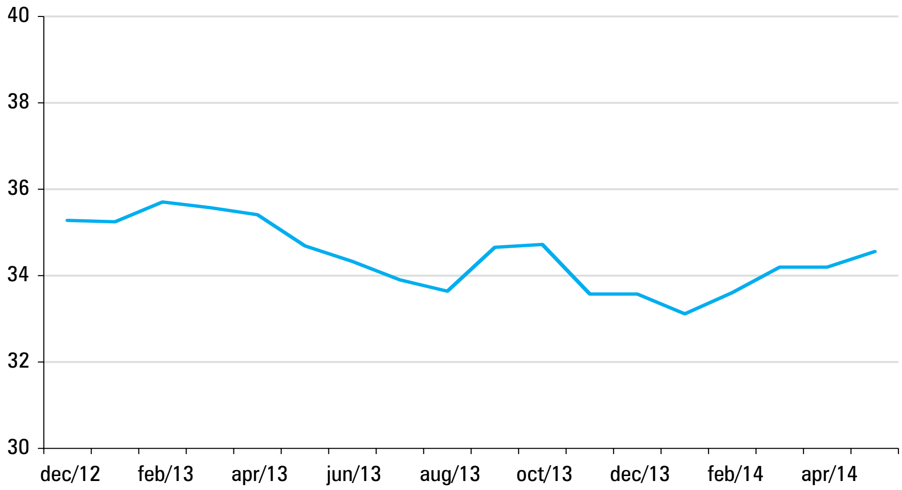
The primary surplus for the consolidated public sector is expected to amount to R$ 80.0 billion (1.5% of GDP), falling below the R$ 99.0- billion target.

The decline from last year's primary surplus of 1.9%, coupled with stable interest expenses – 5.15% of GDP in 2014 –, will likely push the nominal deficit up to 3.65% of GDP. This rise would be the main driver behind the increase in the Net Debt/GDP ratio from 33.6% in December 2013 to 35% in December 2014.

Evolution of the Public Sector Net Debt

In relation to GDP (%)

Increased nominal deficit and appreciated exchange rate have led to a rise in the Net Debt/GDP ratio in recent months



Source: Central Bank of Brazil

foreign sector and exchange rate

Trade deficit still lingers despite lower imports

Exchange rate holding steady for three months

The real/US dollar exchange rate has held steady between R$ 2.20-2.30/US$ since April. In early June, the exchange rate almost hit the mark of R$ 2.30/US$, but then it dropped and started to fluctuate below R$ 2.25/US$.

The reduction in US monetary stimulus and in the US Central Bank's program is gradually pushing for the appreciation of the dollar in international markets. As a result, in early June the Central Bank of Brazil extended its exchange rate intervention program, which would expire at the end of the same month, after two days on which the exchange rate almost reached the R$ 2.30/US$ mark. At the same time, the government also announced the end of the Financial Transaction Tax (IOF) on foreign funding transactions. These measures reduced the pressure for the depreciation of the Brazilian currency and stabilized the exchange rate.

It seems very clear that the government is "comfortable" with the current exchange rate range. A weaker real (i.e. a more depreciated exchange rate) would increase the risk of the upper inflation target limit being exceeded, as prices of tradable products (goods that can be imported or exported) would tend to rise. On the other hand, a stronger real would have an even more negative impact on export activities.

The exchange rate is set to experience some volatility by the end of the year due to the electoral calendar, particularly as compared to the level observed in recent months. This oscillation will likely be accompanied by an exchange rate depreciation. Great efforts will likely be made to avoid a more significant devaluation. CNI is therefore projecting that the average exchange rate in December will total around R$ 2.40/US$, but that the annual average will be lower.

The annual average would stand at R$ 2.30/US$, a depreciation of 6.0% as compared to the 2013 average figure.

Daily exchange rate

Closing Quotations (R$/US$)

Exchange rate fluctuates between US$ 2.20-2.25/US$ as a result of Central Bank interventions

Source: Central Bank of Brazil

Trade flows to drop in 2014

Exports totaled US$ 110.5 billion in the first half of 2014, down by 3.4% from the same period in 2013. Imports amounted to US$ 113 billion during the same period, a 3.8% drop on the same comparison basis. As a result, the trade balance recorded a deficit of US$ 2.5 billion, against a deficit of US$ 3.0 billion in the first half of 2013.

The fall in exports was driven exclusively by a reduction in shipments of manufactured products. Despite prospects for increased growth in world trade volumes (up from 3.0% in 2013 to 4.3% in 2014, according to the IMF), Brazilian exports of semi-manufactured goods fell at a rate of 9.3%, while sales of manufactured products dropped by 11.0%. This decline can be largely explained by the difficulties faced by Argentina, a major consumer market for Brazilian manufactured products. Moreover, an oil rig was exported in June 2013, which was not seen again in June 2014. Exports of basic goods in turn grew by 3.3%.

This difference between the performance of manufactured and basic products had led to a steady decline in the share of manufactured goods in Brazilian exports. The share of basic products grew from 47.5% of total exports to 50.8% in the first half of 2014 as compared to the same period the year before. On the other hand, the share of semi-manufactured goods fell from 12.8% to 12.0%, while that of manufactured products shrank from 37.4% to 34.4%.

Imports in turn dropped mainly as a result of the economic activity slowdown, which has reduced the growth rate of household consumption, production and investment. In the year to date, imports of capital goods fell by 9.2%, of fuels by 6.6%, of durable consumer goods by 6.1%, of non-durable consumer products by 2.3% and of intermediate goods by 1.2%.

Sales of manufactured goods are expected to remain weak by the end of 2014. In the second half, the Brazilian currency will not fall below the level observed in the same period last year and the crisis in Argentina will likely continue, as will the difficulties faced by Brazilian industry.

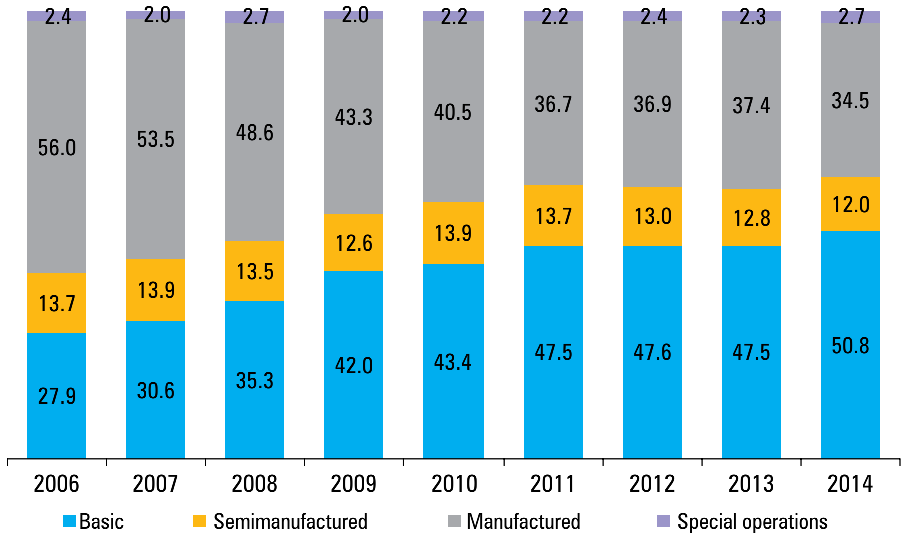
On the other hand, the expected export of oil rigs will boost exports to some extent, even though the total value is lower than in 2013. For this reason, CNI is expecting to see a drop of 2.0% in exports, which are set to hit the mark of US$ 237 billion.

In principle, imports will benefit from a more stable and overvalued exchange rate as compared to the second half of 2013. However, the exchange rate can

Composition of Brazilian exports (first half)

Share in total exports (%)

Share of manufactured goods keeps falling



Source: MDIC/Secex

only minimize the downward trend in imports. As a result, imports are likely to fall by 1.7% in 2014, standing at US$ 235.5 billion. In this scenario, trade surplus will total US$ 1.5 billion. Nevertheless, it is worth stressing that we cannot rule out the possibility of a lower trade surplus or even a small deficit.

Foreign direct investment to be lower than current account deficit

The 12-month current account deficit totaled US$ 81.8 billion in May 2014, up by 12.6% from the level recorded in the 12 months to May 2013. The figure represents 3.6% of GDP, up from 3.2% in May 2013. As a proportion of GDP, the current account deficit has been close to 3.6% of GDP since August 2013.

The deficit in services and income in the 12 months through May hit the mark of US$ 87.6 billion, a five-percentage point increase over the same month of 2013. Foreign Direct Investments (FDIs) in turn amounted to US$ 66.5 billion in the 12 months to May, up by only 3.6% from the figure recorded in the previous twelve-month period. A reduced global liquidity and an increasingly negative outlook for economic growth in Brazil explain the fall in FDIs.

The decline in activity is expected to slow down the growth rate of the deficit in services and income. Yet, this change will not be enough to prevent the current account deficit from hitting a new record high, as it is projected to amount to US$ 86 billion.

This figure means a small increase in the current account balance/GDP ratio, which will likely reach 3.7% of GDP for 2014 as projected by CNI.

prospects for the Brazilian economy

	2012	2013	2014 *previous projection mar/14*	2014 *projection*
Economic activity				
GDP (annual variation)	1.0%	2.5%	1.8%	**1.0%**
industrial GDP (annual variation)	-0.8%	1.7%	1.7%	**-0.5%**
Household consumption (annual variation)	3.2%	2.6%	1.7%	**1.5%**
Gross fixed capital formation (annual variation)	-4.0%	5.2%	2.5%	**-2.0%**
unemployment Rate (annual average - % of the labor force)	5.5%	5.4%	5.7%	**5.6%**
Inflation				
Inflation (IPCA - annual variation)	5.8%	5.9%	6.4%	**6.6%**
Interest rates				
Nominal interest rates				
(average rate in the year)	8.63%	8.29%	11.03%	**10.88%**
(year end)	7.25%	10.00%	11.25%	**11.00%**
Real interest rate (annual average and deflated rate: IPCA)	3.1%	2.0%	4.4%	**4.2%**
Public accounts				
Nominal public deficit (% of GDP)	2.48%	3.28%	3.50%	**3.65%**
Public primary surplus (% of GDP)	2.39%	1.90%	1.80%	**1.50%**
Net public debt (% of GDP)	35.1%	33.6%	33.8%	**35.0%**
Exchange rate				
Nominal exchange rate - R$/US$				
(average in December)	2.08	2.35	2.45	**2.40**
(average in the year)	1.95	2.15	2.35	**2.30**
Foreign trade sector				
Exports (US$ billion)	242.6	242.2	240.0	**237.0**
imports (US$ billion)	223.2	239.6	238.5	**235.5**
Trade balance (US$ billion)	19.4	2.6	1.5	**1.5**
Current account balance (US$ billion)	-52.4	-81.4	-88.0	**-86.0**

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