CNI Newsletter
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BRAZILIAN ECONOMY

Special edition of the Economic Report

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

Double challenge to grow more

BRAZIL FACES A DOUBLE CHALLENGE IN 2015: restoring macroeconomic fundamentals and enhancing competitiveness. There is no choice between these two objectives. Achieving both is crucial for Brazil to resume sustained growth and favorable conditions should be ensured for them to be achieved simultaneously.

The interaction between short- and medium-term agendas is fundamental for the success of the program. Restoring economic fundamentals is a must to bring credibility back, remove uncertainties, and expand the horizons of agents.

The economic adjustment will increase the predictability of the economy if it is properly combined with a growth strategy focused on boosting competitiveness and reducing costs. Defining a microeconomic agenda capable of bringing about significant impacts on business costs and of improving the business environment is crucial. Investor confidence will be restored, promoting favorable conditions to resume a virtuous cycle of investment, production, employment, and consumption.

RESULTS IN 2014 WERE FRUSTRATING FOR THE INDUSTRIAL SECTOR

The economy remained stagnant and GDP grew by only 0.3%, while industry experienced a drop of 1.5%. Investment decreased by 6.7%.

Besides difficulties in the global economy, this situation can be mainly attributed to loss of competitiveness, deteriorating domestic fundamentals, and uncertainties about the best strategy to address these difficulties. The slower pace of economic growth can be clearly felt in the slowdown registered in household consumption.

OUTLOOK FOR 2015 IS MODEST

Given the required economic adjustment, the economy should not be expected to grow by more than 1.0%. The contributions from industry, which grew by 1.0%, and of exports, which are likely to rise by 2.5%, are expected to support this result.

Risks are predominantly domestic, even though the global scenario deserves attention as well. If the domestic adjustment is successful, with convergence of inflation and control of fiscal accounts, the economy may show signs of recovery in the second half of the year. Resistance from some sectors and difficulties to implement the required adjustment will delay the recovery of domestic and international confidence in the Brazilian economy. The result will be continued stagnation over a longer period.

SECTIONS

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The economic adjustment and growth agenda

The necessary adjustment to restore macroeconomic fundamentals requires immediate action in three areas. Restoring the fiscal balance is a must, with consistent fiscal surpluses and public debt dynamics control. Inflationary expectations must be broken and the inflation target must be achieved, without resorting to mechanisms to keep prices artificially low. External accounts must be rebalanced by reducing the current account deficit and recovering the competitiveness of Brazilian products.

The economic growth agenda has a broader horizon and can be grouped into two blocks. On the one hand, actions and policies designed to promote a recovery in investment capacity must be implemented. On the other, an agenda designed to promote competitiveness and structural changes in the economy must be resumed, with a focus on efficiency and productivity.

Increasing investment rates in the economy is a must for expanding supply and fostering sustained growth. The drop observed in domestic savings recently is at the root of Brazil's low investment rate. Increasing domestic savings even if gradually – both public and private – is critical to ensure higher investment rates without pressuring foreign accounts in a global environment marked by capital costs on the rise. The proposed agenda should include promoting mechanisms to stimulate private savings and enhance the public sector's investment capacity, while keeping any increases in current spending under control.

The growth strategy should be supported by private investment as the engine of the economy. Paying attention to the microeconomic agenda is crucial for improving the business environment and expanding private investment projects. A high-growth economy requires the development of an institutional environment that combines an efficient state, economic policy credibility, adequate regulation, and legal certainty. The adaptation and modernization of institutions and the certainty and predictability of rules is the result of this combination, which leads to an environment that is conducive to investment and production.

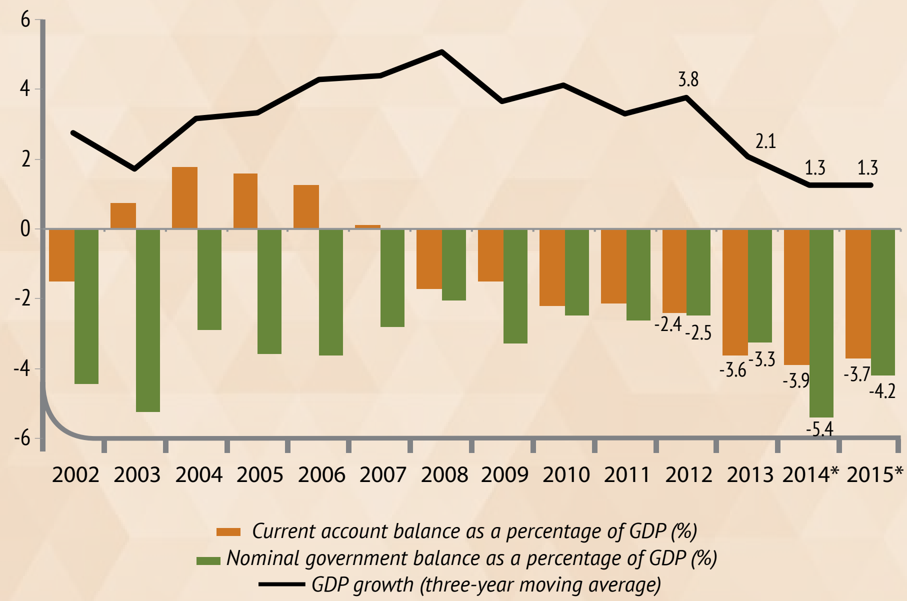
Industry should be at the heart of this strategy. Priority should be given to the commitment to promote advances in the competitiveness agenda, adjusting production costs to productivity growth. This agenda includes resuming structural reforms in the tax system, with red tape simplification and reduction, building long-term funding mechanisms, modernizing labor relations, and reducing investment costs.

Ensuring consistency between the two agendas will lead to a synergistic environment. Macroeconomic rebalancing consolidates confidence, while the competitiveness agenda reinforces profitability prospects for investment projects. Both are essential for investment to be resumed, which is the key to sustained growth.

Deficits prevented advances in the economy

Current account balance, nominal government balance, and GDP growth

As a percentage of GDP and rate of change (%)



Source: Central Bank of Brazil - * CNI Projection

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OVERVIEW 2014

Economic difficulties are not restricted to low growth

The year's results so far are sufficient for evaluating Brazil's economic performance in 2014 as negative. Activity was markedly weak on both the demand and supply sides, especially in the areas of investment and industry. In response to this weak activity, there was a significant slowdown in job creation, although the unemployment rate remained low.

The economic scenario in 2014 is still marked by a combination of inflation under pressure, deteriorating public accounts, a negative trade balance, and an increasing current account deficit. This evaluation shows that the Brazilian economy's problems go beyond a low GDP growth, suggesting the need for adjustments in the country's macroeconomic policy and the urgent need to implement the pro-competitiveness agenda.

● SHRINKAGE IN INVESTMENT AND INDUSTRY

The weak performance of the economy in 2014 is mainly reflected in a shrinkage in industry and investment: CNI estimated this shrinkage at 1.5% and 6.7%, respectively. A slowdown in services and household consumption are two other results that also deserve special mention. The service sector is expected to grow by 0.9% in 2014, against 2.2% in 2013, while consumption growth slowed down from 2.6% in 2013 to 1.4% in 2014.

Aggregating these statistics, one sees that GDP is likely to grow at a very modest rate as compared to 2013, i.e. by only 0.3%.

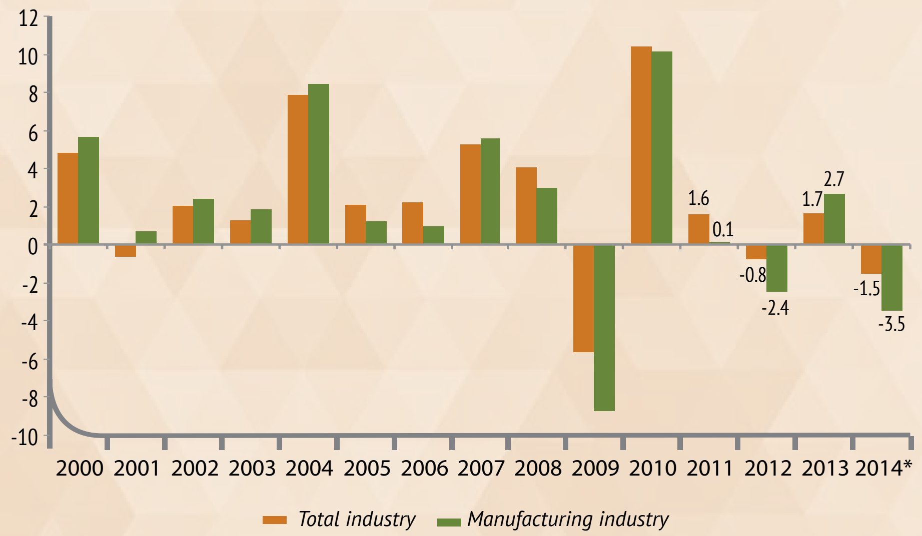
Among the main reasons that explain this virtual stagnation, the following ones stand out: less favorable conditions in the labor market, a higher household debt-to-income ratio, a persistently high inflation rate, adverse conditions for accessing credit, the effects of high interest rates, and low business confidence. (See the section Economic activity).

While conditions in the labor market are less favorable – marked by a sharp slowdown in job creation – the unemployment rate remained at the same level until September and is expected to close the year at 4.8% (PME-Monthly Job Survey/IBGE-Brazilian Institute for Geography and Statistics), at the lowest rate in the time series that began in 2003. (See the section Employment and income).

Industry has not managed to maintain a steady growth path

GDP of total industry and manufacturing industry

Annual change (%)



Source: IBGE - * CNI Projection

Rising food prices, inertia of service prices, partial adjustments in regulated prices, and a readjustment of relative prices were the main sources of inflationary pressure in 2014.

● INFLATION CONTINUES UNDER PRESSURE

Inflation remained at high levels throughout the year, exceeding the upper limit of the target in some months during the last 12-month period. CNI estimates the IPCA (Consumer Price Index) at 6.4% this year. Rising food prices, inertia of service prices, partial adjustments in regulated prices, and a readjustment of relative prices – caused by the exchange rate depreciation – were the main sources of inflationary pressure in 2014.

Given this situation, monetary policy varied over the year. Between January and April, interest rates were gradually raised – as had been done since 2013 – leading the Selic rate to 11.00% in April. From May to September, the monetary tightening was interrupted until its delayed effects on economic activity and, consequently, on inflation could be felt. Because the monetary tightening was not sufficient to keep inflation at least below the upper boundary of the target, the Central Bank rose interest rates again in October and December, resuming and intensifying the cycle of interest rate increase. As a result, the nominal interest rate will close the year at 11.75%. (See the section Inflation, interest rates, and credit).

● TRADE BALANCE WILL HAVE THE WORST RESULT IN 16 YEARS

A consolidated deficit in the trade balance is a hallmark of 2014. Exports totaled US$207.6 billion in the year to November, 6.2% less than in the same period in 2013. Imports also declined, albeit at a slower pace: by 4.3% on the same comparison basis.

As no major changes are expected in December, the trade deficit is likely to close 2014 at US$4.5 billion – the first deficit on an annual basis since 2000 and the highest one since 1998.

Foreign Direct Investment (FDI) amounted to US$66 billion in the 12-month period to October 2014 (2.91% of GDP), showing some stability in relation to 2013.

We estimate that the current account deficit will close 2014 at about US$86 billion, 3.9% of CNI's projected GDP for the year.

As for the exchange rate, special mention should be made of significant fluctuations observed in recent months, with a sharp depreciation in November that led the exchange rate to its highest level since 2005. The average exchange rate in December will be R$2.55/US$1, with an annual average of R$2.35/US$1. (See the section Foreign trade sector).

● HIGHLY EXPANSIONARY FISCAL POLICY

Fiscal policy in 2014 became even more expansionist than in the last few years. On the spending side, the growth pace recorded in 2013 continued. The growth rate of revenues, in turn, dropped significantly for regional governments and is likely to decline in real terms for the Federal Government.

This mismatch between revenue and spending led to a further deterioration in fiscal indicators in 2014, as indicated by the primary balance of the consolidated public sector, which is likely to record a deficit of R$5.5 billion (0.1% of GDP). On a recurring basis, the primary deficit of the consolidated public sector is likely to close the year at 0.3% of GDP.w

Given the deterioration of the primary balance and higher interest spending, CNI estimates that the nominal deficit is likely to rise from 3.25% in 2013 to 5.4% in 2014. The impact of a higher nominal deficit will probably be stronger than the effects of the increase in nominal GDP and of exchange rate adjustments for the domestic and foreign debt, leading the Net Debt/GDP ratio to rise from 33.6% in 2013 to 36.3% in 2014. (See the section Fiscal Policy).

OUTLOOK FOR 2015

Path will be difficult, but with prospects of improvements

The outlook for the performance of the Brazilian economy in 2015 is rather modest, albeit better than the one recorded this year. GDP is expected to grow by about 1.0%, a rate similar to that of industrial GDP. Agriculture will grow by 2.4% and the slowdown in the service sector will continue, recording an increase of only 0.7%.

GRADUAL IMPROVEMENTS OVER THE YEAR

Recovering the credibility of the economic policy, particularly in relation to meeting the fiscal target, as well as realigning prices and the exchange rate will restore necessary market signals to increase the confidence of productive agents. We thus project that industrial production and investment will begin to recover gradually in the second half of the year.

It should be noticed that robust GDP growth rates were only registered in periods in which investment and industry recorded significant increases. Reestablishing conditions for this conjunction is therefore a key requirement for ensuring a new cycle of more robust growth rates for the Brazilian economy (See the box on the right on potential GDP).

However, the first months of the year are likely to be marked by greater difficulties resulting from necessary adjustments designed to reverse the deterioration of macroeconomic fundamentals. A new cycle of interest rate increase, which has begun already, and the effects of fiscal contraction throughout the year will curb household demand and investment, particularly in the first half of the year. In the year's average, we expect household consumption to grow by only 0.7% and Gross Fixed Capital Formation to stagnate. Government consumption will increase by 1.2%, a rate that is also lower than the one recorded in 2014.

A higher net foreign demand, resulting from the exchange rate devaluation and the recovery of some markets for manufactured products, will be a positive counterpoint for resuming growth in 2015. Exports are likely to grow by 2.5%, while imports are expected to drop by 0.3% (both on the basis of the National Accounts concept). Thus, the contribution of foreign demand to GDP will be positive by 0.4 percentage points.

Potential GDP

Brazil experienced a significant potential GDP growth between 2000 and 2008, with an average rate of 3.2% per year. Much of this increase is associated with a growth in the labor force, a reduction in the unemployment rate, and a sharp increase in the investment rate – which rose from 16.8% in 2000 to 19.1% in 2008.

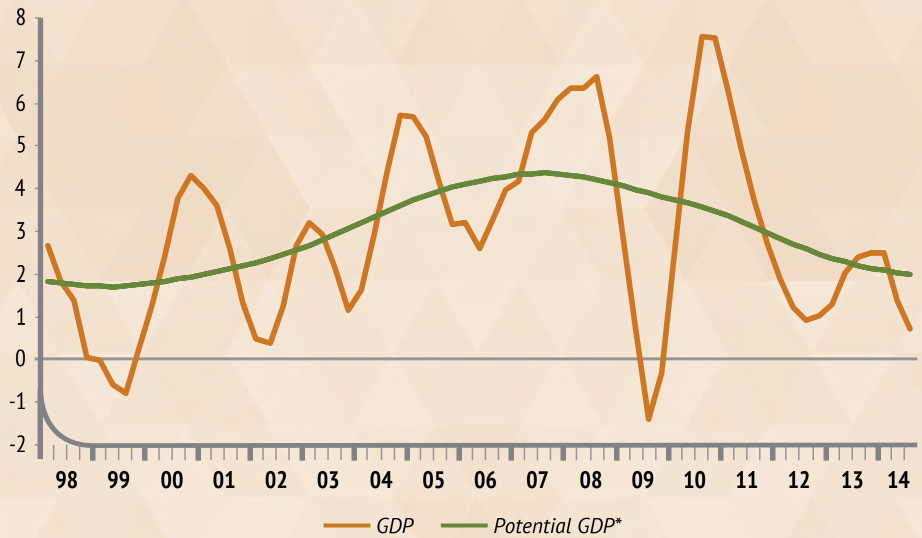
However, the economy has clearly experienced a reduction in its potential to grow since 2009, particularly in more recent years, when potential GDP dropped to below 3.0% – 2012 (2.5%) and 2013 (2.1%). Up to the third quarter of 2014, it was estimated at 2.0%.

This scenario can only be changed by giving priority to the competitiveness agenda, thereby increasing investment rates and labor productivity.

The growth potential of the Brazilian economy is shrinking

GDP and potential GDP

Last 4 quarters against the previous 4 quarters (%)



Source: IBGE - Prepared by: CNI
* Estimated by HP statistical filter

MODERATE RECOVERY OF INDUSTRY WITH CHANGES IN RELATIVE PRICES

Manufacturing activity is projected to grow by 0.8% in 2015 after dropping sharply in 2014. Positive developments are expected to begin in sectors associated with tradables of the manufacturing industry, which were affected by the loss of competitiveness brought about by an appreciated exchange rate and increases in domestic costs. Price adjustments are also expected to maximize the positive effects of measures already adopted, such as payroll exemptions.

In other industrial segments, we expect to see a growth of 2.5% in mining and quarrying, largely as a result of a stepped-up oil production, and of 1.7% in Public Utility Industrial Services. The construction industry will, in turn, show zero growth as a result of the stagnation in investment (See the section Economic activity).

Low GDP growth for two years will reflect on the labor market. We expect to see continuing job losses in the industrial segment and a slowdown in new hires in the non-tradable sectors, such as in the service sector. As a result of a likely increase in the economically active population looking for a job, the unemployment rate (PME/IBGE) is expected to rise slightly to 5.2% (See the section Employment and income).

ADJUSTMENTS IN THE COURSE OF ECONOMIC POLICY

Incompatibility between the two components of macroeconomic policy will be eliminated in 2015. Both will be focused on recovering fundamentals and stability in the short-term. The primary surplus target of 1.2% is likely to be achieved through a combination of cost containment measures (with the financial programming of the federal budget) and a partial recovery of revenues as a result of the end of some tax exemptions.

A higher primary surplus is likely to bring the nominal deficit down from 5.4% in 2014 to 4.2% of GDP in 2015, despite the increase in interest spending. The Net Debt/GDP ratio will still be high, closing 2015 at 37.6% of GDP (See the section Fiscal policy).

The synergy with fiscal policy will lend greater efficiency to monetary policy. The cycle of interest rate hikes is expected to end in March with the Selic rate at 12.50%, high enough to begin to cool down inflation in the second quarter of 2015 despite the realignment of relative prices. The slowdown in demand for non-tradables will be a crucial factor for breaking the inflation inertia for this group of products. However, inflation will still remain close to the upper boundary of the target, at 6.2%, albeit lower than in 2014 (See the section Inflation, interest rates and credit).

NEW EXCHANGE RATE LEVEL IS LIKELY TO CONSOLIDATE

The depreciation trend of the Brazilian currency against the US dollar is likely to continue in 2015, consolidating a new level for the exchange rate. We estimate that the exchange rate will hit the mark of R$2.70/US$ in December 2015, with an annual average of about R$2.60/US$.

The normalization of US monetary policy is the main driver of this shift. Two other factors can also have an impact on the exchange rate dynamics in 2015: the possible end of the Central Bank's swap program and a possible change in the sovereign rating by rating agencies if the Brazilian economic adjustment program is unsuccessful.

Despite this improvement, the value of exports is likely to decline by 2% to US$219.5 billion due to the drop in commodity prices. Imports are expected to drop by 7%, at a stronger pace in 2015, to US$212 billion. As a result, the trade surplus will once again be positive in 2015, amounting to about US$7.5 billion.

The current account deficit will be lower in 2015 as a result of a positive trade balance. The amount of US$78 billion accounts for 3.7% of CNI's projected GDP for 2015 (See the section Foreign trade sector).

THE RISK OF A LESS FAVORABLE SCENARIO

The international scenario deserves attention. US interest rates are certain to rise, albeit moderately, pushing the US dollar up against the Brazilian real. However, the recovery of the US economy may not be sufficient to boost global trade, which is already suffering the effects of the slowdown in China and of the economic difficulties faced in Europe and Japan. Even the realignment of oil prices may impose additional limitations on emerging countries, with impacts on capital flows. All of these risks are beyond our control.

The risks on the domestic side can be more dramatic. Difficulties to implement the economic adjustment, leading to frustration with the targets or excessive tolerance with macroeconomic and price imbalance, may prevent the necessary improvements in confidence to ensure a gradual recovery of the economy and industry. In this case, we might face a scenario of stagnation similar to the one observed in 2014.

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ECONOMIC ACTIVITY

Industry downturn limited economic growth in 2014

Drop in investment and a slowdown in consumption are also negative results deserving special mention

With the main economic indicators announced for at least three quarters of the year, it is possible to say that Brazilian GDP growth in 2014 will be frustrating. According CNI estimates, Brazil's economy is likely to grow by only 0.3% – significantly below the global average, estimated by the IMF at 3.3%.

On the supply side, this weak performance is mainly attributed to industry. Despite its increase in the third quarter, industrial GDP recorded a negative result for the year: it is down by 1.4% in the comparison between the first three quarters of 2014 and the same period in 2013 (National Accounts/IBGE).

The results for production reinforce this negative assessment of industry. In the first ten months of the year, the production indicator decreased by 3.0% (PIM-PF/IBGE). The picture is even worse when the assessment is restricted to the manufacturing industry. The decrease in production in this sector amounted to 4.0% altogether between January and October, and for capital goods a drop of 8.8% was recorded. In addition, the fact that these negative results were widespread among all sectors deserves special mention: of the 25 surveyed sectors, only five experienced an increase in production in the year to October (PIM-PF/IBGE).

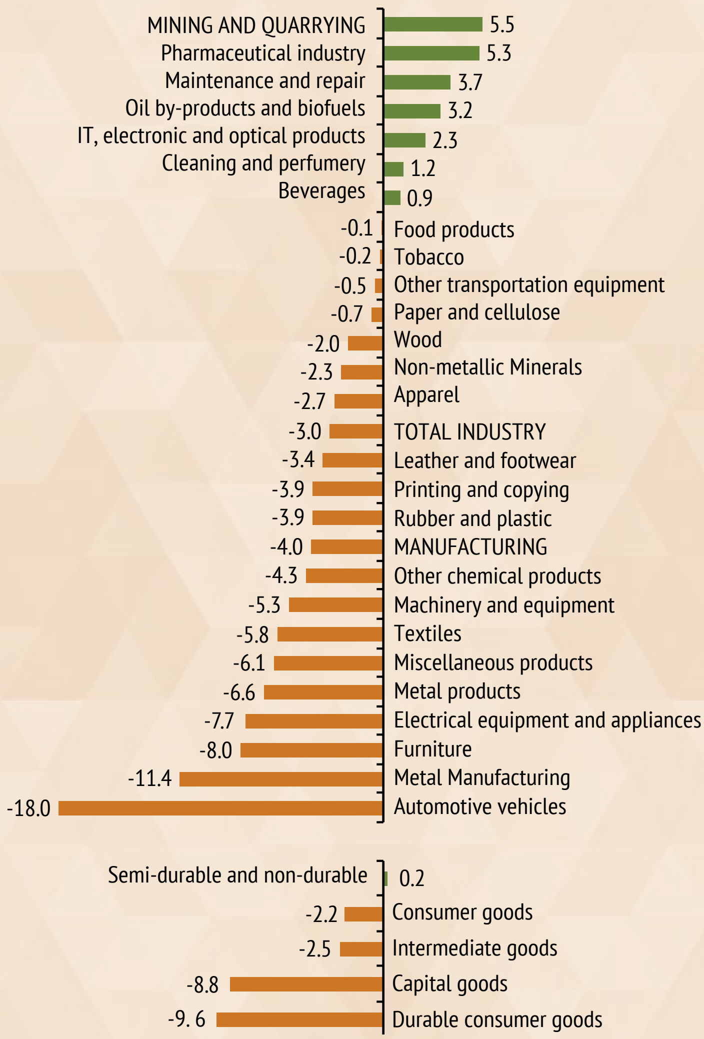
The slowdown in industrial activity can also be felt in the path of inventories and capacity utilization. The indicator for actual versus planned inventories levels among large companies rose to 53.8 points in October, remaining above the 50-point dividing line, indicating unwanted stocks in industry (Industrial Survey/CNI).

The Brazilian economy is likely to grow by only 0.3% in 2014, significantly below the global average, estimated by the IMF at 3.3%

Drop in production is widespread among all industrial sectors

Industrial production by sector and category of use

Average from January to October 2014 as compared to the same period the year before (%)



Source: IBGE

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In response to high inventories levels and demand slowdown, industrial companies have reduced the use of their facilities. This trend becomes evident when one compares the average capacity utilization in 2014 (January-October) with averages recorded in previous years (over the same ten-month period). According to CNI's Industrial Indicators, the current average (81.3%) is the lowest one in the last five years – including 2012 (82.2%), when a decrease in industrial GDP was recorded.

With unwanted inventories levels, idle manufacturing facilities, and production on the decline, layoffs in industry became inevitable. October saw the eighth consecutive monthly drop in the employment indicator for the manufacturing industry (Industrial Indicators/CNI). If there is no significant shift in this downward trend in the last two months of the year, the number of industrial workers will decrease in 2014. This fact was observed for the last time in 2009, the year in which Brazil's GDP decreased by 0.3% and industry shrank by 5.6%.

For the construction industry, the situation is even worse. The Construction Industry Survey/CNI showed a strong deterioration in indicators this year, as all of them were below the 50-point line, including those that capture prospects for the next six months. The indicator of activity level, for example, recorded 42.7 points in October, indicating a continuing slowdown in the sector.

Given the results mentioned above, the Business Confidence Index (ICEI/CNI) has been below the 50-point dividing line for nine months in a row, suggesting lack of confidence. The ICEI hit the mark of 45.2 points in December (11.8 p.p. below its historical average).

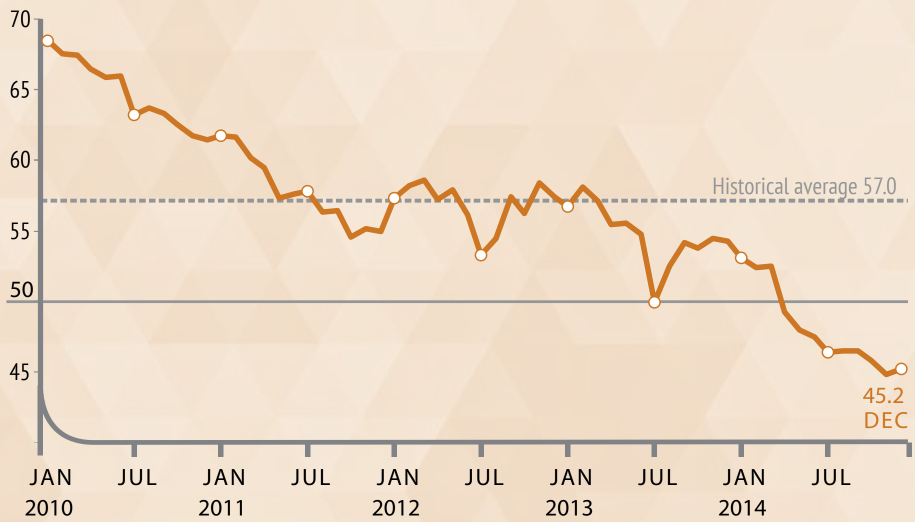
In this scenario of low activity and lack of confidence, industrial GDP is expected to drop by 1.5% in 2014. This decline is mainly led by the manufacturing and construction industries: they have slowed down by 3.2% and 4.7%, respectively. The mining and quarrying industry, in turn, recorded positive results in the first ten months of the year and is expected to recover from the drop recorded in 2013, as it grew by 6.2% in 2014.

The negative indicators for industrial activity coupled with a slowdown in consumption and trade are likely to reduce the growth pace of the service sector from 2.2% in 2013 to 0.9% in 2014. Sales in the extended retail trade (which includes automotive vehicles and construction materials) provide a good picture of this slowdown, as they declined in half of the surveyed months and accumulated a drop of 1.5% until October (PMC/IBGE).

On the demand side, investment continues to be a critical variable. After four consecutive drops, Gross Fixed Capital Formation (GFCF) rose again in the third quarter, but not enough to prevent the variable from closing the year with a negative result (National Accounts/IBGE).

Resuming confidence is key for industry to grow again

Business Confidence Index (ICEI)
In points



Source: CNI
The ICEI varies in the 0-100 interval. Figures above 50 indicate that entrepreneurs are confident.

A scenario of lack of confidence among industrial entrepreneurs, household consumption on the decline, and a downturn in the construction industry (which accounts for more than half of GFCF) is likely to lead investment to drop by 6.7% in 2014.

Thus, the investment rate (GFCF as a share of GDP) is expected to decrease from 18.2% in 2013 to 17.0% in 2014, remaining below the rates reported by several emerging countries. This low investment rate is in part associated with a low domestic savings rate, which recorded only 12.8% in the third quarter of this year – as calculated based on the average registered in the last four quarters.

Loss of momentum in household consumption is a hallmark of 2014. After a moderate recovery in the second quarter, consumption fell again in the third quarter and there are no signs of change in the year's scenario in this regard (National Accounts/IBGE). Thus, household consumption is expected to grow by only 1.4% in the year – the lowest rate since 2003 – marking a four-year consecutive slowdown. This accommodation is justified by adverse conditions to access credit (more expensive and restricted credit), deterioration in expectations about the labor market, and high inflation.

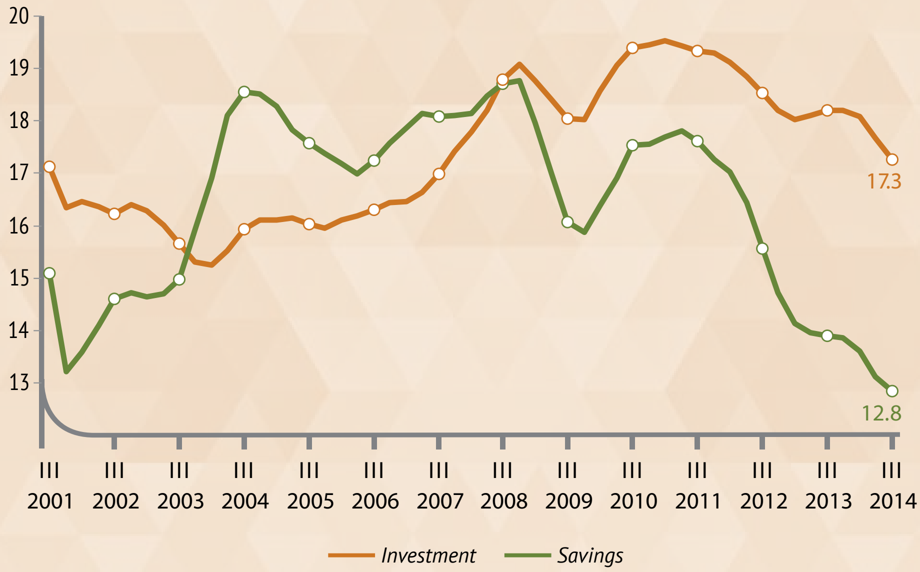
With regard to government consumption, we project a slight reduction in its growth, with its rate falling from 2.0% in 2013 to 1.9% in 2014.

Given the slowdown in household consumption, in investment, and in industrial activity, we estimate that imports of goods and services will grow by only 0.2% this year. This rate is far below the one registered last year, 8.3%.

Increasing of investment rate demands higher saving rate

Investment rate and savings rate – quarterly averages

Gross Fixed Capital Formation and Gross Domestic Savings, both as a share of GDP (%); four-quarter moving average



Source: IBGE

The investment rate is likely to drop from 18.2% in 2013 to 17.0% in 2014, remaining below the rates reported by several emerging countries

Exports also grew less intensely as compared to 2013, when they recorded a 2.5% increase. As a result of a lower contribution from manufactured products, CNI estimates that exports of goods and services will increase by 1.8% in 2014. It should be emphasized that without the contribution from the foreign trade sector GDP would grow by only 0.1% in 2014.

GDP estimate for 2014

Percentage change in GDP components

	GDP COMPONENTS	Growth rate (%)
Demand	Household consumption	1.4
	Government consumption	1.9
	GFCF	-6.7
	Exports	1.8
	(-) Imports	0.2
Supply	Agriculture	1.2
	Industry	-1.5
	Mining and quarrying	6.2
	Manufacturing industry	-3.2
	Construction industry	-4.7
	Public Utility Industrial	1.7
	Services	0.9
	GDP	**0.3**

OUTLOOK

ECONOMIC SLOWDOWN IS LIKELY TO CONTINUE IN 2015

The scenario in 2015 is not expected to be much different from the one seen in 2014. The Brazilian economy is likely to continue to face difficulties to grow at a faster pace, since most hurdles preventing this from happening cannot be easily removed in the short term. The economic adjustment, including measures such as extending and intensifying the cycle of interest rate increase and securing a fiscal surplus, creates additional complications for economic activity in the short term. If these adjustments are successfully implemented in the first half of 2015, we believe that the confidence of economic agents will improve in the second half, leading to increased economic activity. We thus project GDP to grow by 1.0% next year, more than the rate estimated for 2014.

On the supply side, the big difference between the two years can be attributed to industry, which is likely to resume growth in 2015 – albeit at moderate rates. The main reason for this partial recovery will be the depreciated exchange rate, which will create a more favorable environment both for exports, particularly of manufactured products, and for competition with imports.

Provided that the contribution from the foreign trade sector offsets the difficulties created by the deterioration of domestic demand, CNI predicts that manufacturing industry will grow by 0.8% in 2015.

The mining and quarrying industry is also likely to have a positive performance next year, growing by 2.5%. This likely result is mainly based on the expected increase in oil production.

The outlook for the construction industry is different, and less positive. The indicator for expectations of the sector does not suggest that there will be any major shift in its current downward trend (Construction Industry Survey/CNI). We therefore believe that the construction industry will record zero growth in 2015.

After analyzing the situation in all of these segments, we estimate that industrial GDP as a whole will grow by 1.0% next year. This result is seen as positive, given the current economic scenario, but still insufficient to make it possible for industry to resume its role as the growth engine of the national economy.

Due to a weak demand and low industry growth, services are expected to grow in 2015 at a lower rate than that estimated for 2014: 0.7% and 0.9%, respectively.

According to our estimates, agriculture will grow more in 2015 (2.4%) than expected in 2014 (1.2%).

On the demand side, household consumption is likely to continue on a downward path. CNI predicts that it will grow by 0.7% in 2015, half of the rate expected in 2014. This low growth is explained by the effects of a more restrictive monetary policy, less favorable conditions in the labor market, a higher household debt-to-income ratio, a persistently high inflation rate, adverse conditions to access to credit, and a likely fiscal tightening.

Investment (Gross Fixed Capital Formation), as well as construction industry, are likely to record zero growth next year. With a higher interest rate, expectations about demand – which is already losing momentum – are lower and, in addition, the cost of capital opportunity increases, making investment projects less attractive.

The only factor preventing the result for investment in 2015 from being even worse is that manufacturing industry is expected to resume growth. This is so because as manufacturing companies win market shares based on a more competitive exchange rate, they are likely to resume their investment projects.

Given the current fiscal scenario in the country, CNI estimates that government spending will grow less in 2015, by 1.2%.

The foreign trade sector is likely to provide a positive contribution to GDP growth next year. This result is explained by a more rapid pace of export growth, 2.5%, and by a slight drop in imports, 0.3%. The expected upward trend for exports is mainly justified by a higher oil production and the exchange rate effect, especially for manufactured products. On the other hand, imports are expected to fall in response to the slowdown in consumption.

GDP estimate for 2015

Percentage change in GDP components

	GDP COMPONENTS	Growth rate (%)
Demand	Household consumption	0.7
	Government consumption	1.2
	GFCF	0.0
	Exports	2.5
	(-) Imports	-0.3
Supply	Agriculture	2.4
	Industry	1.0
	Mining and quarrying	2.5
	Manufacturing industry	0.8
	Construction industry	0.0
	Public Utility Industrial	1.7
	Services	0.7
	GDP	**1.0**

EMPLOYMENT AND WAGES

Weak performance of the economy is reflected in industry employment

Manufacturing industry is the one more likely to close the year with more layoffs than hires

The labor market in industry is sluggish. All four segments of industry experienced a slowdown in net job creation in 2014. According to data from the Ministry of Labor and Employment (CAGED-General Register of Employed and Unemployed Persons/MTE) for the 12-month period to October 2014, considering information reported beyond the required deadline, a decrease of 190,777 jobs was registered in industry. This result represents a 140% decrease in the number of jobs created in the 12-month period to October 2013.

Manufacturing industry was the one that recorded the sharpest drop in job creation: the figure for the 12-month period to October 2014 shows a reduction of 157,213 jobs, while in the same period in 2013 this figure was positive, as 259,505 jobs were created.

Employment is on the decline as a result of the negative result recorded for industrial activity – industry's GDP will fall by 1.5% in 2014, according to CNI's projections. It should be stressed that the forecast is even more negative for the manufacturing industry: -3.2%.

According to the Industrial Indicators/CNI survey, industrial employment fell by 0.3% up to October 2014 compared to the same period of the previous year. The dynamism of different manufacturing activity sectors is heterogeneous: employment decreased in half of the 22 sectors considered in the survey. The Petroleum products and biofuels sector had the worst performance in terms of job creation and fell by 5.0% from January to October 2014 as compared to the same period in 2013. On the other hand, the Pharmaceutical and Food sectors recorded the highest growth rates on the same comparison basis: 3.67% and 3.65%, respectively.

UNEMPLOYMENT RATE REMAINS LOW

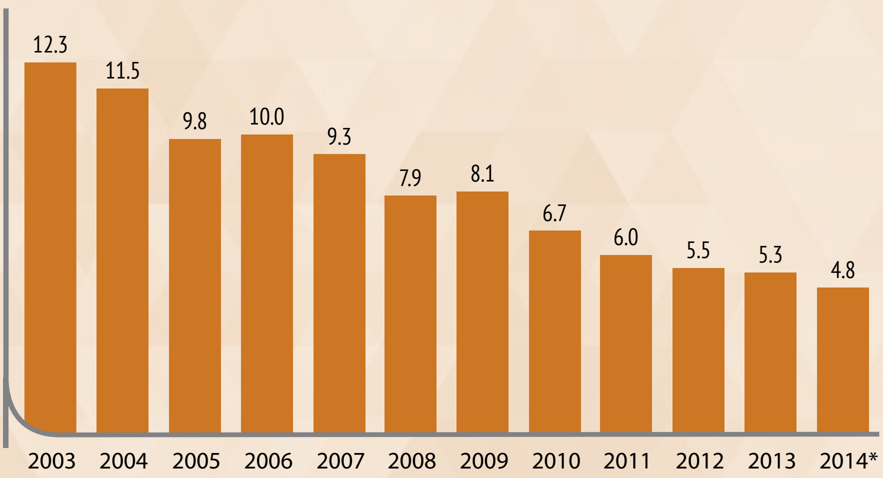
Despite a scenario of weak economic activity, the unemployment rate remains low. October saw the lowest unemployment rate in the time series for the month, hitting the mark of 4.7% of the labor force. The index is likely to drop further at the end of the year due to the seasonal effect of temporary job creation during that period. We estimate that unemployment rates will be close to 4.5% in November and December. Thus, the average projected for 2014 will be the lowest one in the time series, closing the year at about 4.8%.

The behavior of the labor force is the most influential factor explaining the continued low unemployment rate, as its growth rate has been slowing down since 2013, with a lower increase in the number of people looking for a job. This potential labor force group is not part of the unemployed population and neither of the labor force, but it affects more strongly the numerator of the unemployment rate, pushing it down.

Unemployment rate will reach its lowest level in 2014

Unemployment rate

As a percentage of the labor force

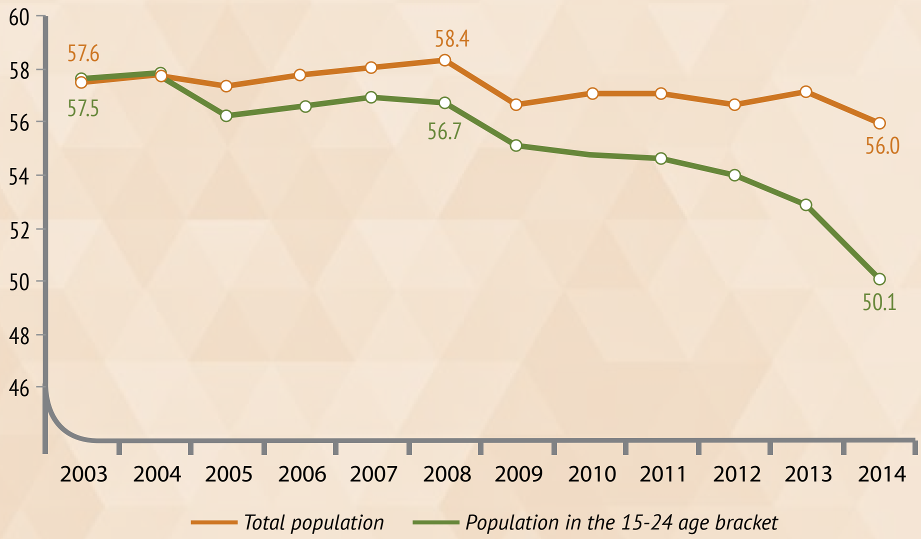


Source: IBGE - *CNI Projection

Reduction in the rate of participation is remarkable in 2014

Participation rate

Labor force in relation to the active-age population,% – average until October of each year



Source: IBGE

The behavior of the participation rate of the population draws attention in 2014. The labor force participation in terms of the Active-Age Population recorded the lowest rate since 2003 – when the series started – as compared to the averages recorded from January to October of each year. It should be noted, however, that the share of the population that most influenced this result is made up of people in the 15-24 age bracket. This result suggests that the Brazilian population is entering the labor market at increasingly older ages.

Thus, the unemployment rate remains low despite the weak performance of the economy, marked by lower job creation and a rising layoff rate. Up till October 2014, net job creation amounted to 933,533 jobs (CAGED/MTE), corresponding to a 37% decrease in job creation as compared to the same period in 2013.

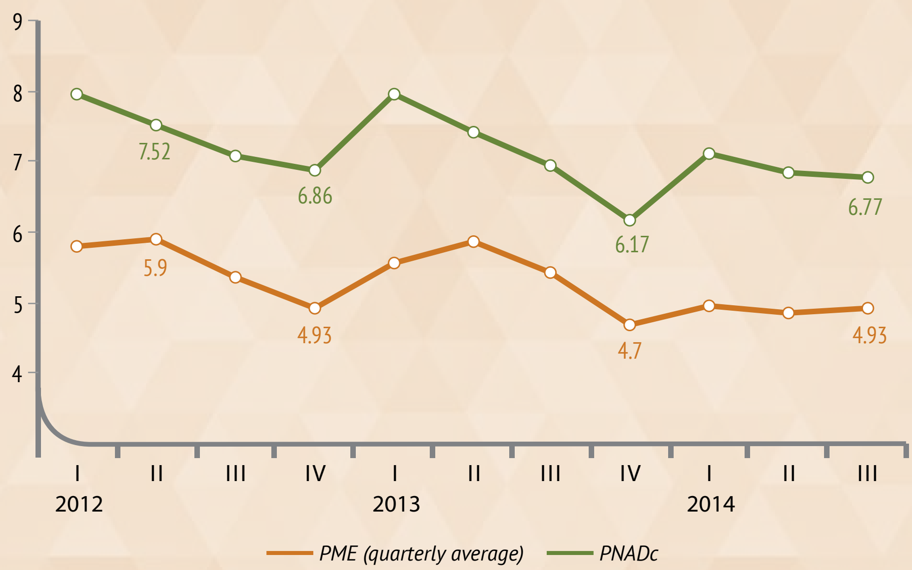
Continuous PNAD

Unlike the Monthly Employment Survey (PME), which only covers six major metropolitan areas, the Continuous PNAD (National Household Sample Survey) covers the entire national territory (including, therefore, all rural areas of the country). In the third quarter of 2014, the Continuous PNAD showed an unemployment rate of 6.77%, while the one presented by the PME amounted to 4.93%, a difference of about 1.8 percentage points. Despite the magnitude of the difference between the results of the two surveys, the trend indicated by the Continuous PNAD survey confirms the downward trend of the unemployment rate in the six metropolitan regions covered by the PME.

The Continuous PNAD survey is in line with the PME survey

Unemployment rate

As a percentage of the labor force (%)



Source: IBGE

AVERAGE REAL EARNINGS RISES MORE QUICKLY IN 2014

Despite a slowdown in job creation, the average real earnings were 2.8% higher in the first ten months of 2014 than in 2013. This is a reversal in the behavior of the average interannual growth rate of usual earnings (PME/IBGE), which had been slowing down since 2013, when real earnings grew by 1.8% on average.

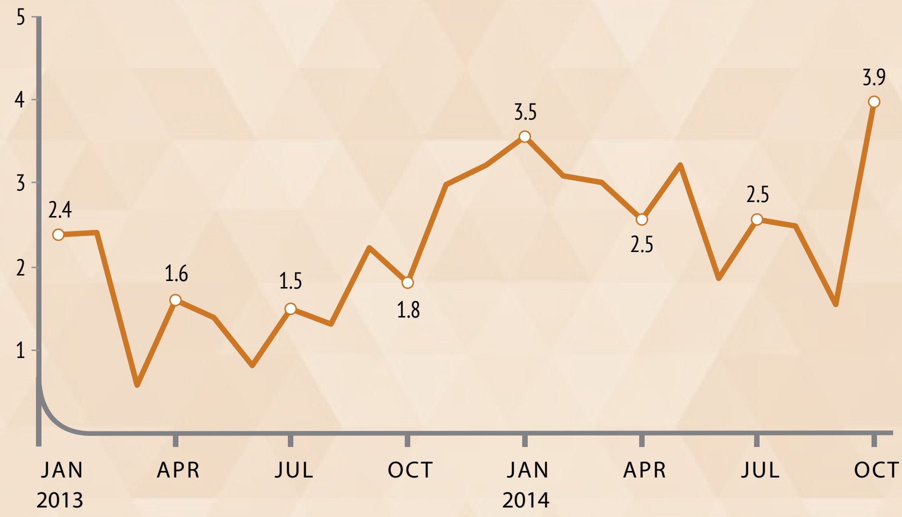
In October of this year, the real average wage of employed persons hit the mark of R$2,122.10 – the highest figure in the historical series started in March 2002. As compared to the same month the year before, wage had a positive change of approximately 4.0%.

The rise in formal jobs can partly explain this more rapid increase in earnings as compared to previous periods. The rate of participation of formal jobs – the sum of registered workers, the military, and public-sector workers at all levels of government – accounted for 63.3% of the employed population in 2014 on average until October, while the figure recorded in 2013 was 62.7%. Because wages are above average in this type of occupation, its growth pushes income levels up. The monthly wage of registered workers in the private sector amounted to R$1,886.30 in 2014 on average, while informal workers had an average monthly income of R$1,477.20. Although the jobs of registered workers do not represent the integrity of formal jobs, this result suggests that the average income earned in formal jobs is higher than the one earned in informal ones.

Earnings rises more quickly in 2014

Average usual real earnings

Year-over-year change (%)



Source: IBGE

OUTLOOK

MODERATE INCREASE IN THE UNEMPLOYMENT RATE

CNI predicts a lower increase in average earnings in 2015. An increasing gap between the wages of newly hired workers and laid-off ones can be observed already. That is, during 2014 the wages of new hires became increasingly lower as compared to those of laid-off workers. The average wage difference between these groups from January to October 2014 was almost three times higher than the difference observed in the same period in 2013, according to CAGED/MTE data.

A persistently high inflation and the fact that the wages of new hires are lower may force more members of the same household to work. These factors are likely to lead people outside the labor force to look for a job. The weak economic activity expected for 2015, albeit stronger than the one recorded in 2014, will continue to generate few jobs and constitutes another element contributing to a scenario that justifies the expected rise in the unemployment rate.

For these reasons, our projections indicate that the average unemployment rate in 2015 will be slightly higher than the one recorded in 2014, about 5.2%.

INFLATION, INTEREST RATES AND CREDIT

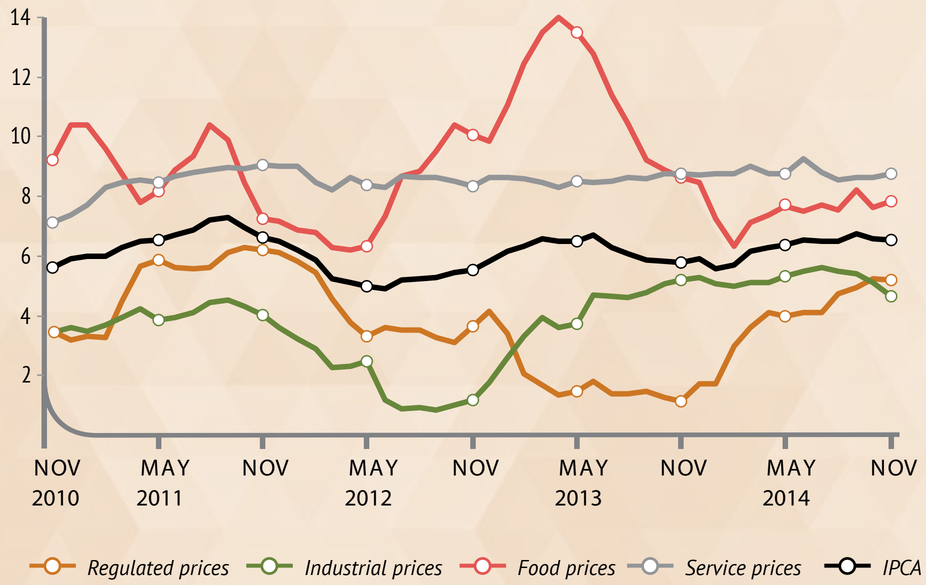
Inflation pressured by food prices and a realignment of relative prices

Partial reestablishment of regulated prices also contributed to push the IPCA index up

Regulated prices rise more quickly in 2014

IPCA by groups

12-month accumulated figure (%)



Source: IBGE - Prepared by: CNI

Inflation has, since July, remained above the mark of 6.50%, the upper limit of the band set for the inflation targeting system. The IPCA, which is the base index of the system, closed November with a 12-month accumulated change of 6.56%. For the last month of the year we estimate a lower change than the one seen in December 2013, when gasoline and diesel oil prices were major factors pushing the index up.

Several factors contributed to the behavior of inflation during 2014. The cycle of rising interest rates, which had been interrupted in April and was resumed in October, limited to some extent the economic activity and, consequently, price hikes. Similarly, a significant drop in commodity prices resulting from the economic slowdown in China also prevented inflation from rising more sharply. However, an expansionary fiscal policy and the adjustment of regulated prices, albeit partial, pushed prices upward during the year. An increase in exchange rate, which impacted the prices of tradable goods, was another factor that contributed to a higher inflation in 2014.

Regulated prices were one of the main factors that influenced the behavior of inflation in 2014, as they increased by 5.22% in the 12-month period to November, against 1.12% in the same period in 2013. This shift was caused by a flexibilization of the policy of keeping regulated prices artificially low, even though such flexibilization was modest. In the 12-month period to December, regulated prices are likely to rise by 4.76%.

Services inflation peaked in June, when consumption was boosted by the World Cup and led the cumulative 12-month rate to rise by 9.27%. Significant decelerations in service prices are not very common due to the inertia that characterizes this group, in which prices are adjusted by past inflation and minimum wage increase. However, a deceleration was recorded in the group over the past few months, which was mainly due to the weak performance of domestic demand. As a result, it is expected to close the year at a rate of 8.76%.

Regulated prices were one of the main factors influencing the behavior of inflation in 2014, as they rose by 5.22% in the 12-month period to November

Food prices rose less this year than in the previous year. The 12-month rate to November dropped from 8.63% in 2013 to 7.83% in 2014. This year, the upward pressure on prices in March and April brought about by a prolonged drought and a rise in average temperature was partly offset by deflation in June, July and August. Thus, CNI estimates a rate of 7.88% at year's end.

The prices of industrial products recorded a cumulative 12-month change of 4.66% until November, against 5.18% in 2013. Although the exchange rate depreciation pushed the prices of industrial products up, the postponement of the lifting of the IPI tax exemption for some durable goods, coupled with a weak economic performance, made it possible for this group to exert less pressure on inflation. This group is thus likely to close December at a 12-month accumulated rate of 4.38%. An assessment from another perspective, separating tradable and non-tradable goods, suggests that the devaluation of the Brazilian currency, which increased by 67.25% altogether since its peak in mid-2011 and by 9.55% in 2014, has been pressuring the prices of tradable products. These started the year with a 12-month accumulated change of 5.64%, rising to 6.02% in November.

The bottom line is that the 12-month accumulated inflation has remained above the target ceiling in the last few months due to the pressure from a food supply shock and relative price adjustments. CNI estimates that the year's accumulated inflation (IPCA) will hit the mark of 6.40%, settling slightly below the upper band limit set by the government.

CYCLE OF INTEREST RATE HIKES IS RESUMED

In April of this year, the Central Bank had interrupted the monetary tightening initiated in April 2013. In total, the cycle had accumulated a hike of 3.75 percentage points in the Selic rate when it rose to 11.00%. This interruption was justified by the lagged effect of monetary policy on prices. However, with inflation persistently at the target ceiling and unanchored inflation expectations, the Central Bank decided to resume the cycle of rising interest rates.

Considering a Selic rate at 11.75% and CNI's projected inflation of 6.40% in 2014, the average real interest rate is likely to close the year at 4.3%, against 2.0% in 2013.

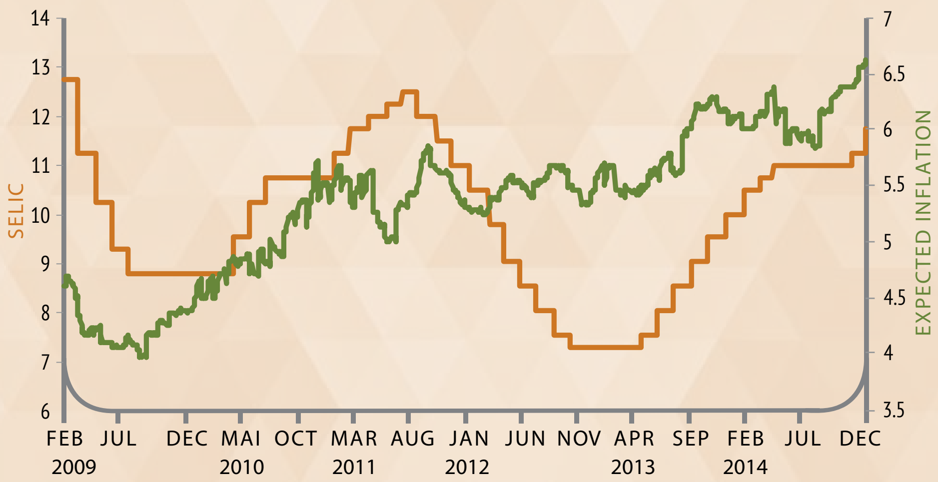
ADVERSE CONDITIONS TO ACCESS CREDIT

The tightening of monetary policy and the economic slowdown led to a scenario in which conditions were not favorable for the credit market in 2014. According to data from the Central Bank, the credit balance rose at increasingly lower rates throughout the year. Comparing the average balance in the last 12 months with the average balance in the previous 12-month period, one sees that there was a shift in the increase in the stock of credit from 15.71% in January to 13.03% in October of this year. If the same analysis is made for individuals, one sees that the rate dropped from 16.49% in January to 14.86% in October. On the same comparison basis, the credit balance for corporations decelerated from 15.06% to 11.48%.

Selic rate rises due to the expectations of high inflation

Expected inflation (IPCA) and Selic rate

Expected accumulated inflation in the next 12 months and annual Selic rate (% p.a.)



Source: FOCUS/Central Bank of Brazil - Prepared by: CNI
Note: Weekly figures

What the Copom said

According to the minutes of the October meeting of the Monetary Policy Committee (COPOM), "the fact that inflation currently stands at high levels reflects, in part, the occurrence of two important relative prices adjustments processes now underway in the economy - the realignment of domestic prices relative to international prices and the realignment of regulated prices relative to market prices. The Committee recognizes that these adjustments in relative prices have direct impacts on inflation and reaffirms its view that monetary policy can and should contain the second order effects arising from them."

According to the minutes, the exchange rate depreciation and the adjustments applied to regulated prices, among other factors, led the officers of the Central Bank to decide to resume the process of rising interest rates from October. Uncertainties about the magnitude and persistence of these adjustments were stronger than the effects of a weak economic activity and of a significant drop in commodity prices. Thus, the Central Bank decided to intensify the cycle of interest rate hikes at its December meeting and raised the rate by 0.50 percentage points to 11.75%.

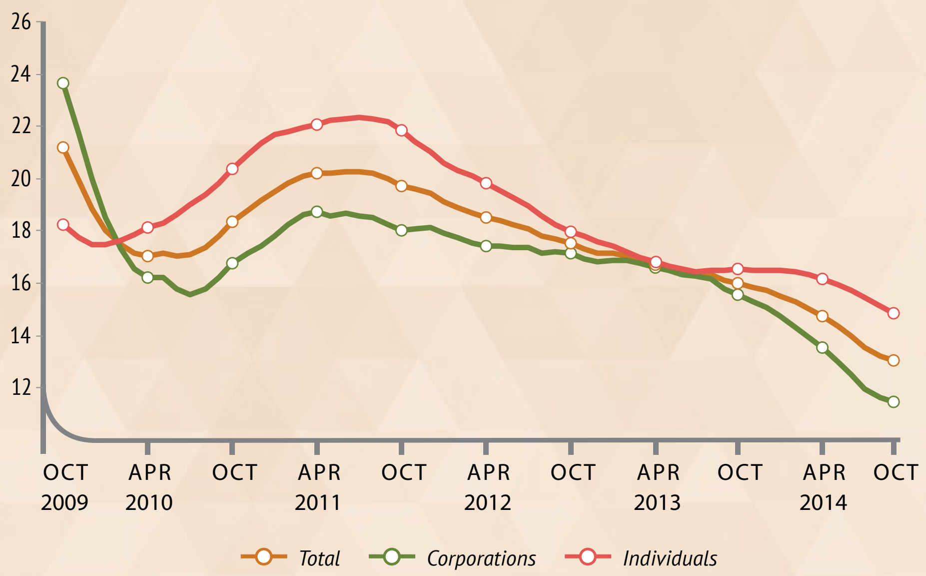
Financing with BNDES funds for corporations also followed a path similar to that of other funding schemes. The growth rate of the average 12-month balance as compared to the growth rate of the average balance in the previous 12 months dropped from 16.39% in January to 13.94% in October.

In the case of individuals, a high household debt-to-income ratio contributed to the credit slowdown by restricting the granting of new loans. On the producer's side, uncertainties about economic policy and a weak domestic demand discouraged producers from looking for new financing sources.

Credit continues to slow down

Balance of credit operations

12-month accumulated change against the previous 12 months (%)



Source: Central Bank of Brazil

In addition, financial institutions have taken a more conservative and selective stance. Data from the Industrial Survey/CNI show that industrial companies continue to face great difficulties to access credit. Despite some stability in the average interest rate for loans to individuals and legal entities, the banking spread – the difference between the interest rate charged to borrowers and the rate that the bank pays to depositors – recorded an increase during the year, reflecting a less favorable situation for lending. Between January and October, spreads in loans with non-earmarked resources for individuals rose from 27.44% to 32.14%. The same was true for corporations, for which the spread increased from 11.65% to 12.27%.

For the remainder of the year, CNI projects that credit balance will continue to decline, as no changes are expected in the economic scenario in the short term and the benchmark interest rate is likely to rise.

OUTLOOK

INFLATION WILL DECELERATE MODESTLY IN 2015

The adoption of a stricter macroeconomic policy and certainly more restrictive than the one adopted this year is likely to slow down demand in 2015 even more, slightly reducing the pressure on market prices in the second half of the year.

From a monetary point of view, the tightening that began in October and was intensified in December 2014 is expected to continue. Contemplating further increases of 0.50 p.p. at the January meeting and of 0.25 p.p. at the meeting in March, the benchmark interest rate will rise from the current 11.75% to 12.50%. For better appreciating the lagged effects of monetary policy on prices and the outcome of a tighter fiscal policy, we project that the COPOM will keep the Selic rate at this level until the end of 2015. On the other hand, the normalization of US monetary policy and uncertainties about the domestic economy will pressure the Brazilian exchange rate upward even more in 2015. This additional depreciation is likely to impact on tradable products. Another element that is expected to affect inflation in 2015 is a likely reversal of certain tax exemptions, such as the IPI tax exemption on cars and furniture.

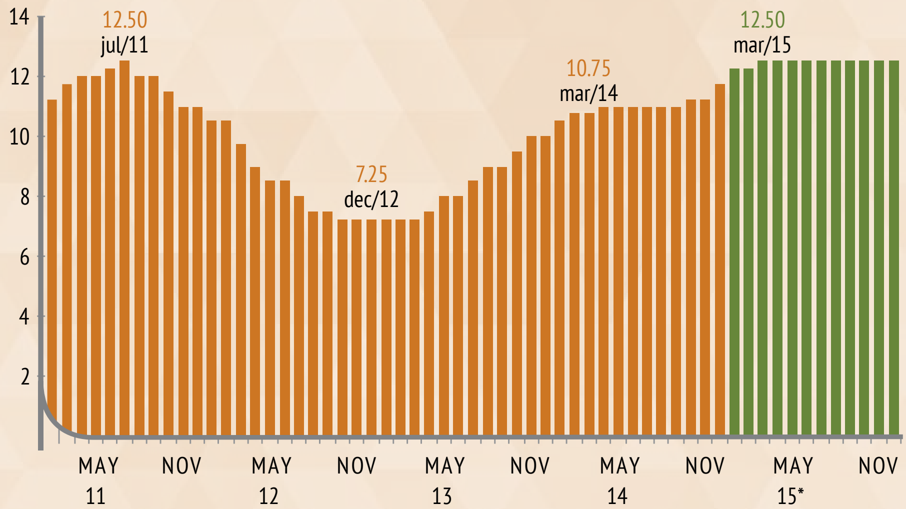
We also estimate that inflation of regulated prices will increase significantly. The recent hike in gasoline prices, which had been kept under control in recent years, is one of the causes of this higher inflation. Other factors tend to influence the increase in regulated prices, such as a higher adjustment of transportation fares as a result of its postponement in recent years and a faster increase in electricity prices, caused by a pass-through to customers of part of the costs of using thermoelectric plants.

Given the forecasts mentioned above, the IPCA index is likely to continue to oscillate at a high level in 2015. However, it is expected to decline slightly during the year as a result of deteriorated demand caused by the adoption of restrictive policies. Thus, CNI projects an inflation rate of 6.20% at the end of 2015, against 6.40% in 2014.

Cycle of interest rate hikes is resumed

Nominal Selic rate

Percentage per year (% p.a.)



Source: Central Bank of Brazil - *CNI Projection

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FISCAL POLICY

Strong fiscal expansion deteriorates public accounts

Primary outcome is likely to record its first deficit since 1997

Fiscal policy in 2014 reinforced the expansionary nature that characterized it in recent years. On the spending side, the growth rate recorded in 2013 continued. The growth rate of revenues, in turn, decreased significantly for regional governments and is likely to experience a real decline for the Federal Government.

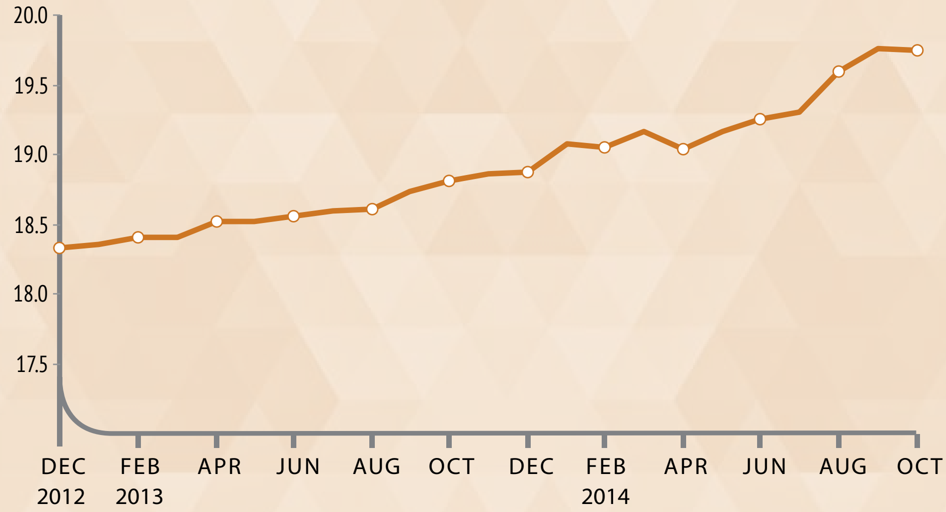
The highly expansionist nature of fiscal policy sped up the deterioration observed in fiscal indicators since 2012. Regarding the primary outcome, the Federal Government is very likely to experience a deficit for the first time since 1997. A late change made to the Budget Guidelines Law (LDO) will make it possible for the Federal Government to meet the fiscal target set for 2014 despite this deficit. The outcome of states and municipalities is in turn expected to be the worst one since 1998, when regional governments experienced a primary deficit, and will be very far from meeting the target set by the Federal Government.

A reversal of this situation is expected in 2015, mainly in what regards the Federal Government. For the primary surplus target established in the revised version of the LDO for 2015 submitted to Congress in December to be achieved, the spending growth rate must be substantially reduced. On the other hand, revenues are likely to grow again in real terms due to the end of some tax exemptions, to the expansion of the economy, and to an increase in revenues not managed by the Federal Revenue Service (dividends, concessions, etc.).

Federal Government primary spending is getting close to 20% of GDP

Federal Government primary spending

Accumulated in 12 months (% of GDP)



Source: STN/MF and Central Bank of Brazil - Prepared by: CNI

FEDERAL SPENDING CONTINUED TO INCREASE AT A FAST RATE

Federal Government primary spending kept increasing in real terms at a fast pace in 2014. After increasing by 6.9% in 2013, federal spending recorded a real increase (IPCA deflator) of 5.9% between January and October 2014 in relation to the same period the year before.

The use of fiscal policy to contain the slowdown in economic activity is evident when one considers the increase recorded in non-compulsory spending. This type of spending increased by 13.4% in real terms between January and October 2014 in relation to the same period in 2013. The stronger expansionist character of fiscal policy can be more clearly noticed when one considers that this growth occurred on top of a rather pronounced previous growth in 2013, when non-compulsory spending had already had a real increase of 9.6% in relation to 2012.

Federal Government primary spending kept increasing in real terms at a fast pace in 2014. After increasing by 6.9% in 2013, federal spending recorded a real increase (IPCA adjusted) of 5.9% between January and October 2014 in relation to the same period the year before

It should be stressed that although far from ideal, the composition of the growth of non-compulsory spending in 2014 was more favorable than in 2013, when Federal Government investments recorded a real decline and operating expenses were the only ones that increased. In 2014, Federal Government investments (GND-4) grew by 23.2% in real terms in the first ten months in relation to the same ten months the year before. Operating expenses, in turn, recorded a real increase of 11.2% on the same comparison basis.

The growth pace of the main items of mandatory spending was well below that observed for non-mandatory spending. The moderate growth observed in mandatory spending was largely due to the lower pressure from the minimum wage hike, whose real increase remained below 1.0% in 2014 against 2.6% in 2013. As a result, pension costs recorded a real increase of 2.3% between January and October 2014 in relation to the same period in 2013 – although in this case the postponement of payments of judiciary bonds until the last months of the year also contributed to reducing their increase. Spending items affected by the minimum wage hike include in particular a significant real growth of 16.1% in expenses with wages and unemployment insurance on the same comparison basis.

Another important item of compulsory spending, personnel costs and charges, recorded a real increase of 1.1% between January and October 2014 in relation to January-October 2013. Thus, spending with personnel remained at about 4.2% of GDP despite the economy's low growth.

• NO REAL INCREASE IN NET FEDERAL GOVERNMENT REVENUES

Net revenues of the Federal Government remained stagnant in real terms between January and October 2014 and the same period in 2013. A real decrease of 0.9% in revenues from taxes and contributions is the main factor that explains this behavior. This drop was brought about by the effect of low economic activity on tax collection and it was recorded in spite of revenues amounting to R$10.4 billion from programs designed to enable taxpayers to pay tax debts in installments. In addition, tax exemptions such as one applied to a basic set of food items that did not affect the entire year of 2013 and a court decision to exclude the ICMS (VAT tax) from the calculation basis of the PIS/COFINS (Social Integration Program/Contribution for Social Security Financing) for imports influenced results negatively.

Social security revenues increased in turn by 4.0% in real terms between January and October 2014 in relation to the same period in 2013. This growth was partly explained by a real increase of 2.2% in total payroll of formal and informal private-sector employees and self-employed individuals between December 2013 and September 2014 as compared to December 2012 and September 2013.

As for revenues not managed by the Brazilian Federal Revenue Service, they recorded a real growth of 2.4% between January and October 2014 and the same period in 2013. This increase is largely due to a growth in dividends and financial compensations for oil exploitation received by the Federal Administration.

• STATES AND MUNICIPAL REVENUES INCREASED AT A LOWER PACE

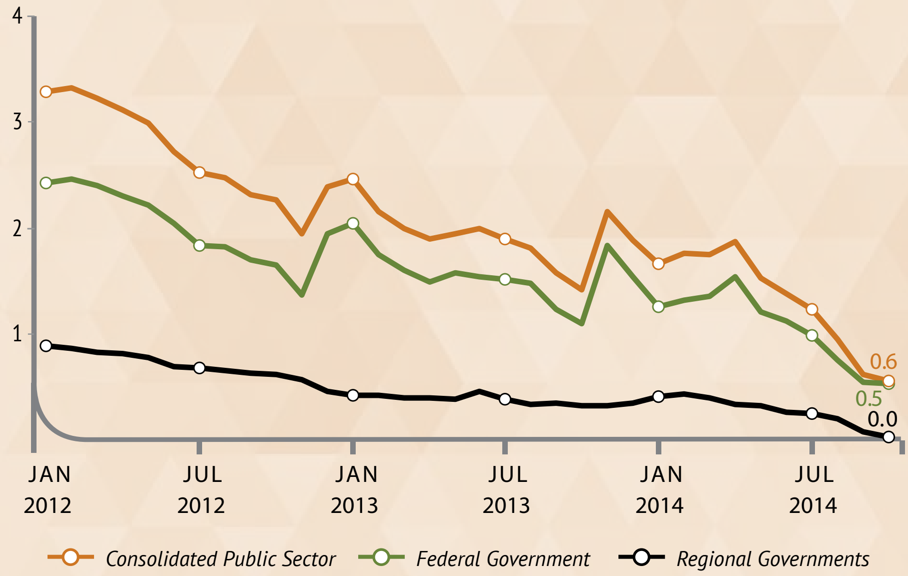
The growth rate of the revenues of regional governments was significantly lower in 2014. The data available on the revenues of states and municipalities show that they grew by 1.0% in real terms between January and September 2014 in relation to the same period in 2013. In the comparison between 2013 and 2012, revenues recorded a real growth of 3.5%.

The slowdown in economic activity, which led to a decrease in the ICMS tax collection, accounted for most of this decline in the revenue growth rate. In the first seven months of 2014 against the same period in 2013, the ICMS collection had a real decline of 1.4%. The only reason that the impact on total revenue of regional governments was not stronger was because transfers from the Federal Government to them increased by 4.4% and revenues from other taxes directly collected by state and municipal revenue services grew by 4.3%.

Primary surplus drops by 1.3 percentage points of GDP between December 2013 and October 2014

Public Sector primary surplus

Accumulated in 12 months (% of GDP)



Source: Central Bank of Brazil

In the case of transfers from the Federal Administration, two factors explain much of this growth. The first one was the transfer, only in 2014, of about R$2.0 billion that should have been transferred in 2013. The second one was an increase in the participation fund of states (FPE) and municipalities (FPM) resulting from the collection of R$20.0 billion in debt installments by the Federal Government in late 2013.

Despite the small increase in revenues, CNI estimates that spending by regional governments increased by 3.9% between January and September 2014 in relation to the same period the year before. Despite the deceleration as compared to the real growth of 4.8% recorded in 2013, spending continued to increase much more than revenues, as had happened in 2013 already. The increase in spending by states and municipalities should be matched with increased revenues in compliance with restrictions imposed by the Fiscal Responsibility Law and debt refinancing agreements. This disparity between the growth rates of revenues and spending by states and municipalities is explained by the expansion of Federal Government guarantees for them to contract new loans.

HIGHER NOMINAL DEFICIT PRESSURES PUBLIC DEBT

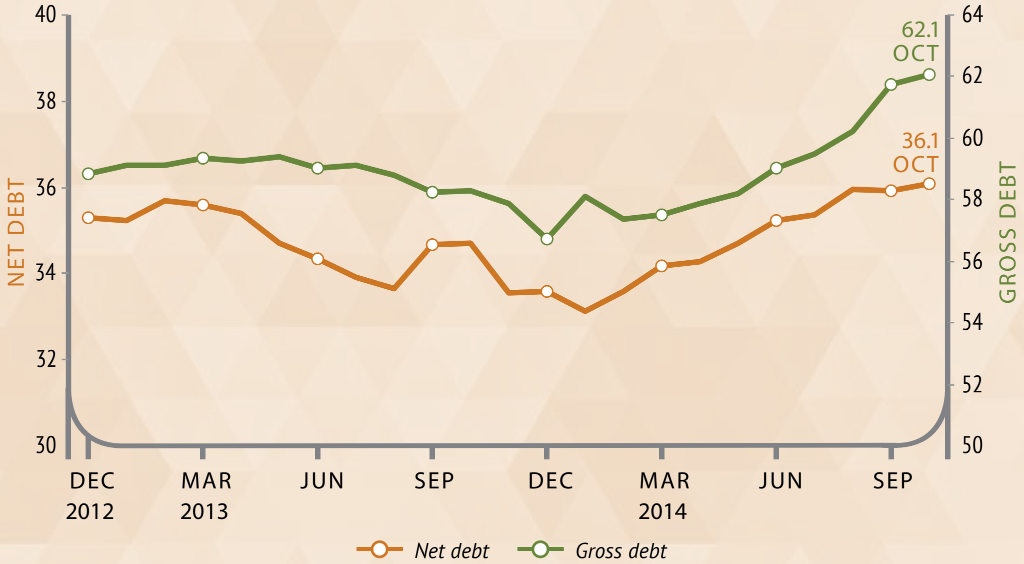
The combination of a marked increase in spending and revenues on the decline led to a sharp decrease in the primary surplus in 2014. Over the past 12 months to October, the public sector recorded a primary surplus of R$28.6 billion (0.6% of GDP). If non-recurring revenue were excluded from the calculation, the primary result would record a deficit of R$10.0 billion (0.2% of GDP). In both cases a marked decrease was recorded as compared to 2013, when the public sector primary surplus amounted to 1.9% of GDP and the recurring result was positive by 1.2% of GDP.

With the decrease in the primary surplus, combined with an increase of 0.5 percentage points in interest spending, the 12-month nominal deficit increased from 3.25% in December 2013 to 5.0% of GDP in October 2014. Thus, the Net Debt/GDP ratio rose from 33.6% in December 2013 to 36.1% in October 2014. The Gross Debt/GDP ratio also recorded a significant increase, from 56.7% in December 2013 to 62.1% in October 2014.

Public sector gross debt increases by 5.4 percentage points of GDP in the first ten months of 2014

Public Sector Net and Gross Debt

In relation to GDP (%)



Source: Central Bank of Brazil

● FISCAL RESULTS ARE LIKELY TO DETERIORATE BY LATE 2014

The fiscal results of the Federal Government are likely to deteriorate significantly in the last two months of 2014, reflecting on the indicators of the consolidated public sector. Federal government spending is expected to grow even more, from the 5.9% figure recorded until October to 6.6% by December.

Social security spending is likely be the main factor driving this increase, mainly as a result of court-ordered payments that should have been made in the first half of the year. In addition, the forecast for operating expenses and investments was inflated by R$10.0 billion through the 5th Expenditure and Revenue Assessment Report issued in November. This was possible due to a change made to the 2014 Budget Guidelines Law, the purpose of which was to deduct all investments in the Growth Acceleration Program (PAC) and tax exemptions from the primary goal to keep the figures within the fiscal target. This amount totaled R$136.0 billion until October and it already exceeds the fiscal target of R$116.1 billion set for the Federal Government.

The net revenue of the Federal Government is likely to lose the stability seen in the comparison between January and October 2014 and the same period in 2013 and record a real decrease of 2.6% when the last two months of the year are included in the calculations. This shift is likely due to the continued impacts of weak economic activity on tax collection and to the fact that R$35.4 billion in extraordinary revenues recorded in November 2013 will not be available this time.

Given this scenario for spending and revenues, and because the 5th Expenditure and Revenue Assessment Report does not contemplate any additional use of resources remaining in the Sovereign Fund in 2014, CNI estimates that the Federal Government and its state enterprises will close the year with a primary deficit of R$10.7 billion (0.2% of CNI's estimated GDP). The recurring primary result is in turn likely to be negative by 0.4% of GDP in 2014.

For regional governments, the growth pace of expenses is expected to continue to decrease in the last months of the year, mainly due to the end of the election period. In addition, the growth pace of revenues is likely to increase with the resumption of regular transfers from the Federal Government. It should be recalled that transfers amounting to R$2.0 billion to make up for tax reliefs on exports were postponed in the last months of 2013. Thus, the surplus of states and municipalities is likely to rise slightly until the end of 2014 and amount to approximately R$5.0 billion (0.1% of GDP), well below the R$51.3 billion target.

As a result, the primary balance of the consolidated public sector is likely to be negative by R$5.5 billion (0.1% of GDP). On a recurring basis, the primary deficit of the consolidated public sector is expected to hit the mark of 0.3% of GDP. The deterioration in the primary balance and the rise in interest spending will probably lead to an increase in the nominal deficit from 3.25% in 2013 to 5.4% in 2014. The impact of a higher nominal deficit is expected to exceed the effects of a higher nominal GDP and of exchange rate adjustments for the domestic and foreign debt and lead to an increase in the Net Debt/GDP ratio from 33.6% in 2013 to 36.3% in 2014.

OUTLOOK

FISCAL POLICY IS LIKELY TO EXPERIENCE A REVERSAL IN 2015

It is likely that fiscal policy will no longer be expansionary in 2015 and that the new fiscal target set in the revised 2015 LDO will be achieved as a result of necessary cuts in spending by the Federal Government. CNI estimates that a financial programming of R$50 billion would be necessary for non-mandatory spending provided for in the current Draft Annual Budget Law (PLOA) for 2015. Although it is a significant amount, it is feasible, since the basis for financial reprogramming of spending contemplated in the PLOA is in the order of R$180 billion. Thus, CNI estimates that operating and capital costs will record a real decrease of 5.5% in 2015 in relation to 2014. It is noteworthy that these expenses grew by 40.5% in real terms in the last four years.

On the other hand, federal spending will be pressured by expenditures with social security and personnel. In the case of personnel costs and charges, wage hikes already agreed upon, and new hires contemplated in the PLOA suggest a real increase of 2.6% in 2015 in relation to 2014. Spending with social security will in turn be pressured by a real hike in the minimum wage that will be higher than in 2014, amounting to 6.4% in real terms in 2015 in relation to the year before.

In this scenario, CNI estimates that total spending of the Federal Government will increase by only 0.8% in real terms in 2015, a percentage that is close to the expected GDP growth.

Regarding the net revenue of the Federal Government, CNI projects a real growth of 7.2% in 2015 in relation to 2014. Three factors explain this significant growth in net revenues. The first one is that revenues from taxes and contributions are likely to resume a growth path and increase by 2.1% in real terms. An increased pace of economic growth, the non-extension of some tax exemptions, and monthly debt installment payments under specific programs are likely to ensure this growth.

The second factor is a forecast in the PLOA of a real increase of 24.3% in revenues not managed by the Brazilian Internal Revenue Service. Finally, the third factor is the lower increase in transfers from the Federal Administration to states and municipalities, despite an increase in the percentage of the Municipalities' Participation Fund. The postponement of transfers from 2013 to 2014 increased the amount transferred in 2014, something that is not likely to be repeated in 2015.

Based on these projections for revenues and spending, CNI estimates the primary surplus of the Federal Government at R$55.3 billion (1.0% of GDP) in 2015.

States and municipalities are also expected to record an increase in their primary surplus in 2015 in relation to 2014. The revenues of regional governments will likely be favored by the impact of a more intense economic activity on the ICMS tax collection. Spending will in turn increase at more moderate rates, considering that 2015 is not an election year. Thus, CNI estimates a primary surplus of R$11.0 billion (0.21% of GDP) for states, municipalities, and their enterprises. The primary balance of the consolidated public sector in 2015 is therefore likely to amount to R$66.3 billion (1.2% of GDP), in line with the targets set by the Federal Government in the revised 2015 LDO.

The increase in the primary result is expected to cause the nominal deficit to drop to 4.2% of GDP, despite an increase of 0.1 percentage points of GDP in interest spending as a result of a higher Selic rate. This improvement in primary and nominal results will not be sufficient to stabilize the Net Debt/GDP ratio, which is expected to close 2015 at 37.6% of GDP.

The primary balance of the consolidated public sector in 2015 is projected to amount to R$66.3 billion (1.2% of GDP), in line with the targets set by the Federal Government in the revised 2015 budget guidelines law

FOREIGN TRADE SECTOR

Brazil will record the first trade deficit in more than a decade

Devaluation of the Brazilian currency in the second half of 2014 failed to prevent a negative trade balance

A deficit in the trade balance is a hallmark of 2014. Exports totaled US$ 207.6 billion up to November, 6.2% less than in the same period in 2013. Imports also declined, but at a slower pace: 4.3% on the same comparison basis. As a result, the trade balance recorded a deficit: US$4.2 billion in the year. The 12-month accumulated balance in November was negative by US$1.6 billion. This is the first time since September 2001 that a 12-month deficit is recorded.

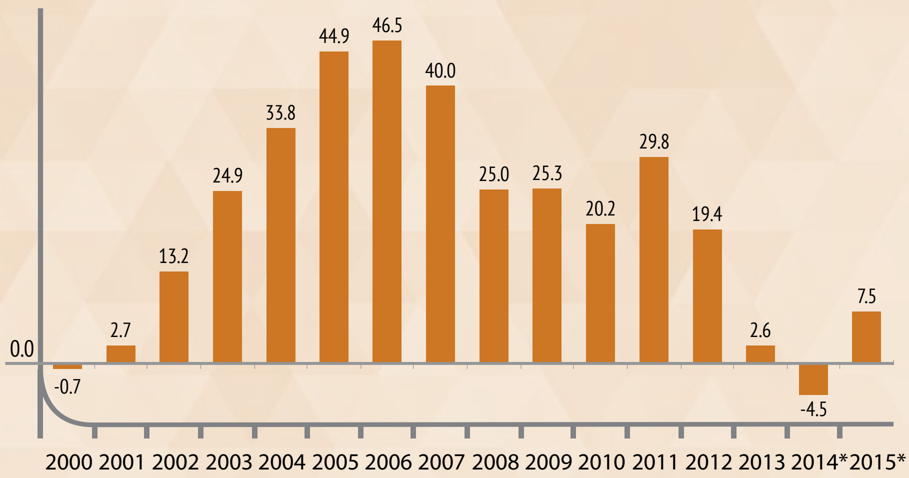
The main reasons for the trade deficit include the low growth registered among Brazil's main trading partners (importers of not only commodities, such as China, but also industrialized products, such as Argentina) and a deficit in the trade balance for oil and its products. These effects were stronger than the factors that led to a decline in imports: lower activity in Brazilian industry (reducing purchases of intermediate and capital goods) and a slowdown in household consumption (which impacted imports of consumer durables particularly).

This scenario is not expected to change in December, so exports are likely to amount to US$224.3 billion, down by 7.4% in relation to 2013. Imports will decrease less, by 4.5%, totaling US$228.8 billion. Thus, 2014 is likely to see a US$4.5 billion deficit – the first trade deficit on an annual basis since 2000 and the highest one since 1998.

Trade balance will be positive in 2015 due to the exchange rate

Trade balance

In US$ billion



Source: Secex/MDIC - * CNI Projection

• DEFICIT IN CURRENT ACCOUNTS IS LIKELY TO AMOUNT TO 3.9% OF GDP

The current account deficit amounted to US$84.4 billion in the 12-month period to October 2014, equivalent to 3.73% of GDP. In the same month in 2013, the 12-month deficit was US$82.0 billion, 3.65% of GDP. The deficit grew mainly as a result of the trade balance, which was much more negative in 2014. Equipment rental and international travel also contributed to push the deficit up.

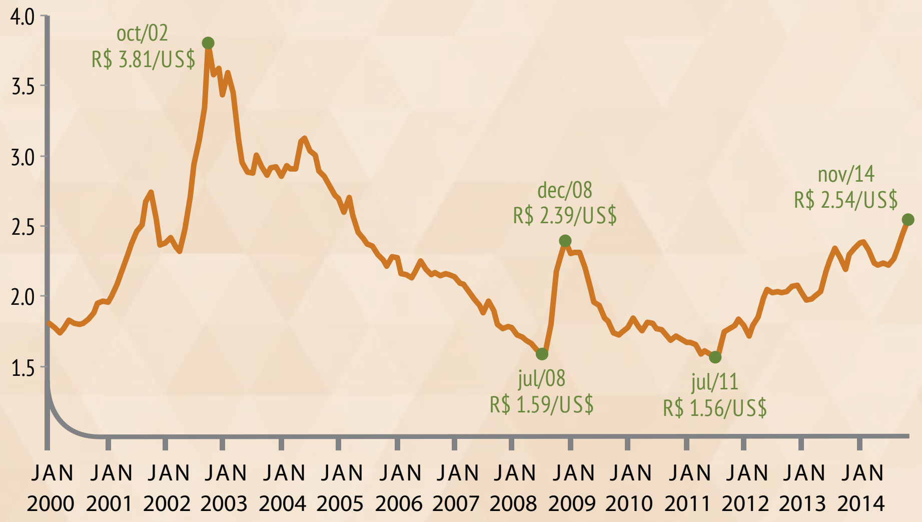
Foreign direct investment (FDI) remained stable in turn. It totaled US$66 billion in the 12-month period to October 2014 (2.91% of GDP) and remained at a level of about US$65 billion in the last two years, with few exceptions. It is likely to end the year close to this figure.

In November and December, the 12-month current account deficit is expected to edge up, particularly because oil platforms exported late in 2013 will no longer be accounted for. This trend can already be observed in the trade balance in November (the trade balance in November 2013 was positive by US$1.7 billion, while in 2014 it recorded a deficit of US$2.3 billion). Therefore, the current account deficit is expected to end 2014 at around US$86 billion, 3.9% of CNI's projected GDP for the year.

Exchange rate reaches the highest level in the last ten years

Monthly exchange rate

Average Ptax price (R$/US$)



Source: Central Bank of Brazil

● NOMINAL EXCHANGE RATE REACHES THE HIGHEST LEVEL SINCE 2005

The exchange rate between the real and other currencies has been highly volatile since November mainly due to the lack of a clear definition of the macroeconomic adjustment to be applied in Brazil in the near future. Apart from its instability, which is decreasing, the Brazilian currency has also been rapidly depreciating against other currencies of emerging countries.

The real/US dollar exchange rate in particular has been above R$2.50/US$1 since October, after oscillating between R$ 2.20/US$1 and R$2.30/US$1 in April to September. The real is still on a devaluation path. The US currency has appreciated due to the more favorable performance of the US economy, especially as compared to those of other developed economies. The euro area and Japan recorded low growth, while China is experiencing an economic slowdown.

The downward trend of the Brazilian currency is being partly offset by the Central Bank's policy of selling swaps to provide a better hedge against the devaluation of the real. The inventory of swaps offered exceeds US$100 billion (4.5% of GDP).

No change in the exchange rate level is expected until the end of the year. We expect the average exchange rate in December to remain at about R$2.55/US$1. Thus, the annual average will be US$2.35/US$1.

OUTLOOK

● EXCHANGE RATE WILL CONTINUE TO DEPRECIATE

During 2015, the difference between the recovery rate of the European and Japanese economies on the one hand and of the US economy on the other is likely to lead to different movements in their monetary policies. While the US is expected to adopt a more restrictive monetary policy, the euro area and Japan are likely to loosen it and to opt for a more expansionary policy.

This difference will enhance the trend of capital flowing back to the US with a reduction mainly for more vulnerable emerging countries. Thus, the US dollar will probably continue to appreciate against the real.

At the same time, the Chinese economy is likely to slow down, reflecting on commodity prices and, consequently, on dollar inflows to Brazil, enhancing the depreciation trend of the real.

Thus, we project that the exchange rate will continue to depreciate, hitting the mark of R$2.70/US$1 in December 2015. The average for the year would be close to R$2.60/US$1.

Two other factors may have an impact on the dynamics of the exchange rate in 2015: the possible end of the Central Bank's currency swap program and a downgrade in Brazil's sovereign rating by rating agencies.

It is not certain whether the Central Bank's intervention program will continue. Concerns about the inflationary impact of a rapid and significant depreciation, as well as an extension of a higher exchange rate volatility, may postpone the end of the program. This, with a reversal of swap inventories, is not likely to occur abruptly and its effect on the exchange rate (devaluation of the real) will be gradual.

Tthe risk of a downgrading of Brazil's risk rating is inversely proportional to the adoption of an austere fiscal policy. If the fiscal measures are insufficient, such downgrading is possible, but without Brazil losing investment grade. Anyway, this would only happen in the second half of the year.

Only the absence of a contractionary fiscal strategy, which seems unlikely, could result in Brazil's loss of investment grade and hence in a major devaluation of the real.

● TRADE BALANCE WILL ONCE AGAIN BE POSITIVE IN 2015

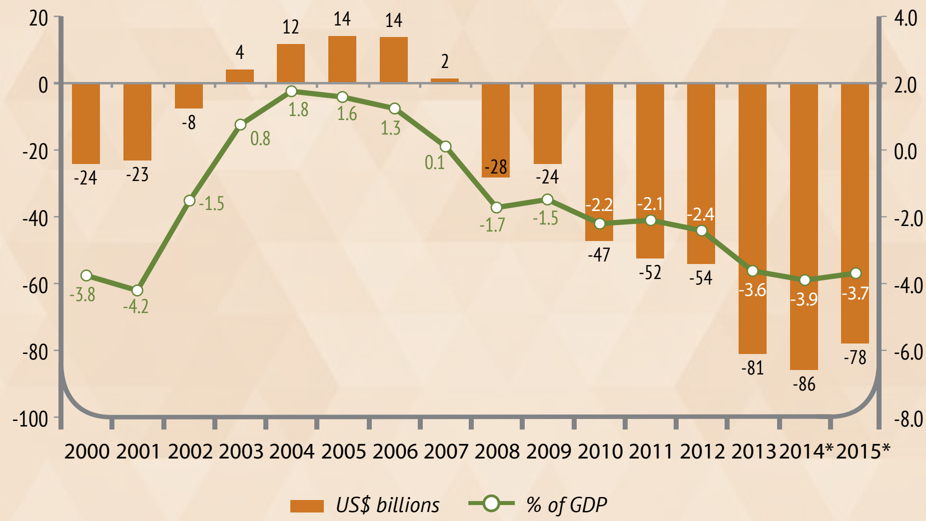
Exports are expected to keep declining in 2015 on account of export prices, which are likely to remain on a downward path (especially commodity prices). Even iron ore prices, which recorded a significant drop in 2014, are likely to decline further in 2015.

In principle, export volumes will probably be favored and increase due to a more depreciated exchange rate and a better economic situation in countries that import Brazilian industrialized products. Nevertheless, the drop in prices is likely to exceed the increase in export volumes and, as a result, exports may drop by 2% in 2015 to US$219.5 billion.

Deficit in current accounts is likely to decrease in 2015 after hitting a record high the year before

Current account result

(US$ billion and % of GDP)



Source: Central Bank of Brazil - *CNI Projection

Imports will decrease at a faster pace in 2015. The exchange rate will depreciated further, especially in relation to the first half of 2014. In addition, imports of oil and oil products are expected to decline. The growth rate of the economy, albeit higher than the one recorded in 2014, will remain low and will not stimulate any significant increase in foreign purchases. Imports are likely to drop by 7%, more than exports, totaling US$212 billion. Thus, the trade surplus will once again be positive in 2015, amounting to approximately US$7.5 billion.

● DEFICIT IN CURRENT ACCOUNTS WILL BE LOWER IN 2015

The current account deficit will be lower in 2015. The main reason is the trade balance, which will shift from a US$4.5 billion deficit to a surplus of US$7.5 billion – a difference of US$12 billion.

This increase will be partly offset by an increase in the services deficit. Although the deficit in international travel will probably decline (due to a lower household consumption and to the exchange rate devaluation), spending on transportation and, above all, on equipment rental (on account of investments in the oil production chain) is expected to continue on a growth path. The current account deficit is likely to close 2015 at US$78 billion. This amount represents 3.7% of CNI's projected GDP for 2015.

FDI is also expected to decrease. Lower expectations of economic growth in Brazil over the next few years are reducing the attractiveness of investments, while the rise in US interest rates will reduce liquidity and increase the opportunity cost of investing in Brazil. We estimate that FDI will amount to US$55 billion in 2015. Thus, the need for external financing, given the difference between the current account balance and foreign direct investment, will increase from US$20 billion in 2014 to US$23 billion in 2015.

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2012	2013	2014 (projection)	2015 (projection)
ECONOMIC ACTIVITY				
GDP (annual change)	1.0%	2.5%	0.3%	**1.0%**
Industrial GDP (annual change)	-0.8%	1.7%	-1.5%	**1.0%**
Household consumption (annual change)	3.2%	2.6%	1.4%	**0.7%**
Gross fixed capital formation (annual change)	-4.0%	5.2%	-6.7%	**0.0%**
Unemployment Rate (annual average - % of the labor force)	5.5%	5.4%	4.8%	**5.2%**
INFLATION				
Inflation (IPCA index - annual change)	5.8%	5.9%	6.4%	**6.2%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	8.63%	8.29%	10.93%	**12.39%**
(year's end)	7.25%	10.00%	11.75%	**12.50%**
Real interest rate (average annual rate and deflation: IPCA)	3.1%	2.0%	4.3%	**5.8%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	2.47%	3.25%	5.40%	**4.20%**
Public sector primary surplus (% of GDP)	2.39%	1.88%	-0.10%	**1.20%**
Net public debt (% of GDP)	35.2%	33.6%	36.3%	**37.60%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.08	2.35	2,55	**2.70**
(average in the year)	1.95	2.15	2,35	**2.60**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	242.6	242.2	224.3	**219.5**
Imports (US$ billion)	223.2	239.6	228.8	**212.0**
Trade balance (US$ billion)	19.4	2.6	-4.5	**7.5**
Current account balance (US$ billion)	-54.2	-81.4	86.0	**78.0**

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