ECONOMIC REPORT

2ND QUARTER OF 2022

Brazilian National Confederation of Industry

THE FUTURE OF INDUSTRY

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Exceeding expectations

The economy is driven by improvements in the labor market and an increase in demand for services

CNI forecasts a growth rate of 1.4% for Brazil's GDP in 2022. After a better-than-expected first half mainly driven by continuous improvement in the labor market and demand for services, the expected economic expansion now overcomes the 1.2% growth considered in December 2021.

At the end of the first quarter of 2022, CNI's expectations for the year worsened, having general GDP and industrial GDP revised downward. The main reasons for these revisions were the thwarted expectations for the normalization of supplies, the effects of the Russia-Ukraine conflict, and production stoppages in China, **as supply chains faced further disruptions and cost pressures increased.** The Russia-Ukraine conflict and the stoppages in Chinese production impacted—and still do—the supply of inputs, regarding availability and especially, the prices. Thus, the normalization of supply chains, expected for the first half of this year, has been pushed back.

Inflation around the world was a negative surprise for most of the year. In Brazil, even considering the significant impact of ICMS tax reduction on fuels (gasoline, diesel, and ethanol), electricity, telecommunications, and public transport, we revised the inflation forecast (IPCA) upwards for 2022 from 6.3% p.a. to 7.6% p.a. As a result, the Selic interest rate has increased beyond our expectations for the first quarter (13% p.a.), and we are still forecasting another increase in August, which would raise the rate as high as 13.75% p.a. by the end of 2022.

However, the first half of 2022 has shown a strong performance in economic activities in Brazil. In the first quarter, the Services sector surprised positively and has been leading a more favorable performance. The industrial sector saw moderate increases in production during the first quarter, slightly above expectations, with greater dynamism in commodities-related sectors. **So far, the available second quarter data allow us to believe this good performance will continue to do well into this year.**

Several drivers help to explain the more favorable performance of economic activities in the first half of 2022. Labor market recovery continues, with employment on the rise since 2020, totaling 97.5 million employed people, the highest employment rate since the beginning of the series in 2012. Real average income has also been rising, despite high inflation. We revised our expectations downward for the average unemployment rate for the year, from 12.9% to 10.8%, and upward for the real wage bill, from 1.4% to 1.6%.

Furthermore, **some transitory drivers also impacted this performance.** Measures such as the advance of the Christmas bonus for INSS retirees and pensioners; authorization for FGTS withdrawals; resumption of the compensation bonus; and the increase in direct income transfers are noteworthy.

As a result, we have reviewed the GDP forecasts for Services and Industry. In addition to the drivers mentioned above, the services sector is benefiting from post-pandemic normalization of mobility-related services, and the forecast increased accordingly, from 1.2% to 1.8% in 2022. Industry, in turn, continues to face difficulties, but the industrial GDP projection went from a drop of 0.2% to a rise of 0.2% in 2022. On the other hand, it went the other way around for Agriculture. Therefore, we decided to forecast stability levels due to a high of 1.3%, as the effects of adverse weather at the beginning of the year were more extensive than expected for soybeans.

Due to these revisions and further activities in the first half of 2022, especially in the first quarter, we revised our GDP forecast for the year. We forecast a GDP growth of 1.4%, compared to the expected growth of 0.9% in the previous edition of the Conjuncture Report.

1 ECONOMIC ACTIVITY

The first quarter exceeded the expectations

A recovery in the labor market, the dynamics of sectors linked to commodities, and the process of normalization of services support a better forecast for GDP in 2022

By early 2022, CNI revised heavily down the forecasts for the quarter. The main reasons for these revisions were the thwarted expectations for the normalization of supplies, the effects of the Russia-Ukraine conflict, and production stoppages in China.

However, the first quarter brought a positive surprise, although the scenario remained very difficult for the industry with more pressure on costs. Despite this, the industrial sector saw moderate increases in production during the first quarter, slightly above expectations, with greater dynamism in commodities-related sectors.

Available data up to the second quarter indicate that this more positive performance will continue in the quarter, especially with industry showing some additional impetus due to demand growth. For the second half of 2022, however, we expect economic activity to lose strength due to the impact of high-interest rates.

This more robust activity in the first half of 2022, especially in the first quarter, implies a revision of projections for the year. We currently forecast a GDP growth of 1.4%, compared to the growth of 0.9% in the previous edition of the Conjuncture Report.

Table 1 - GDP for 2022 should return to its level by 2021 end of the year.

GDP Estimate and its components for 2022

Projected percentage change (%)

	PIB components	Variation Percentage (%)
DEMAND	Household consumption	1.6
	Government consumption	0.6
	Gross fixed capital formation	-2.0
	Exports	3.9
	(-) Imports	0.2
OFFER	Agriculture	0.0
	Industry	0.2
	Mining and quarrying	2.3
	Manufacturing	-1.5
	Construction	2.0
	Electricity and gas, water, sewage, and waste management	1.2
	Services	1.8
	GDP	**1.4**

Preparation and forecasting: CNI

Manufacturing surprises positively at the beginning of 2022

Manufacturing GDP grew by 1.4% in the first quarter of 2022. It was the first rise after four consecutive quarters of drop. Opportunities for exports and even those in the domestic market, replacing struggling foreign suppliers, were more favorable than expected, resulting in the first quarter with production advances—and not stability, or even decline, as feared.

The industry continues to face restrictions on production. The availability of inputs and raw materials became somewhat more restricted in early 2022. Additionally, pressures on cost, not only on inputs but also on freight and energy, have been harming the production and flow of industry products. The CNI Industrial Survey continues to point out the lack and high cost of inputs as the main problem faced by the industry and shows that entrepreneurs have been noticing an acceleration in the prices of inputs. The CNI Special Survey on the subject shows that expectations for normalization, previously concentrated in 2022, have greatly moved to 2023.

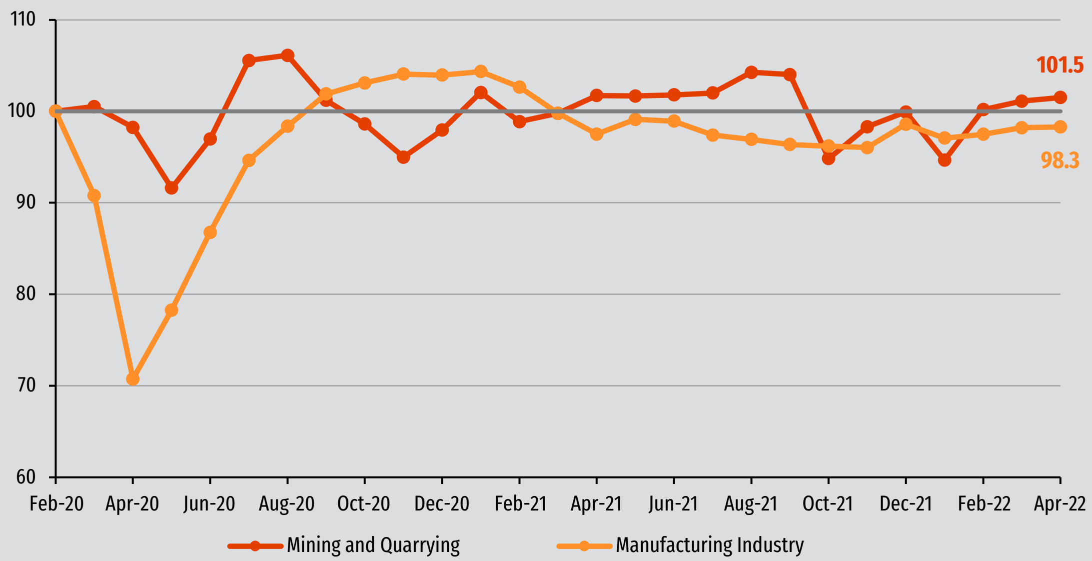
It is noteworthy that exports have been a determining factor for manufacturing, showing an increase in the volume exported (7% cumulative over the year up to May, as compared to the same period in 2021). Possibly, China's production difficulties are generating some business opportunities. These same difficulties also open up some opportunities in the domestic market.

In the domestic market, the labor market recovery should also be noted (learn more in the next section, Employment and Income), in addition to the economic stimulus measures, which are helping consumption. On the other

Chart 1 – Production of manufacturing remains below the pre-pandemic levels

The physical production of mining and quarrying, and processing industries

Index Number (Base: Feb/2020 = 100) – Seasonally adjusted



Source: PIM-PF/IBGE.
Prepared by: CNI

hand, the rising interest rate continues to limit consumption, especially of consumer durables and, consequently, the production of these goods.

For the second quarter of 2022, we still expect growth in manufacturing. The stimulus to demand present in the first semester will be smaller in the second half, while the lagged effects of interest rate hikes will also be felt more strongly. On the other hand, the expected continuity of the labor market recovery will sustain demand.

As a result, we revised our forecast for the manufacturing GDP from a 2.0% drop to a 1.5% drop.

High in mining and quarrying in 2022

Unlike manufacturing, in the first quarter of 2022, mining and quarrying GDP totaled 3.4% compared to the last quarter of 2021, the third consecutive drop.

We have already pointed out that mining and quarrying should suffer from the ambiguous effects from the Russia-Ukraine conflict. On the one hand, a positive effect due to the increase in commodity prices, especially iron ore and oil. On the other hand, the efficiency of maritime transport was compromised in light of trade sanctions and raised freight prices due to increases in fuel.

Iron ore exports fell in the first quarter, a movement related to the closing of cities in China that brought the country's economic activities to a halt in the last two months. The expectation is for normalization of external sales given the resumption of these activities and the economic package announced by China (more about this in the External Sector section).

Thus, we revised our growth expectation for the sector from 2% to 2.3% in 2022.

Construction is losing momentum

The construction industry has continued to grow in the first quarter of 2022, the seventh in a row. However, it is worth noting that growth in the first quarter fell short of previous quarters, showing gradual exhaustion of the last growth cycle.

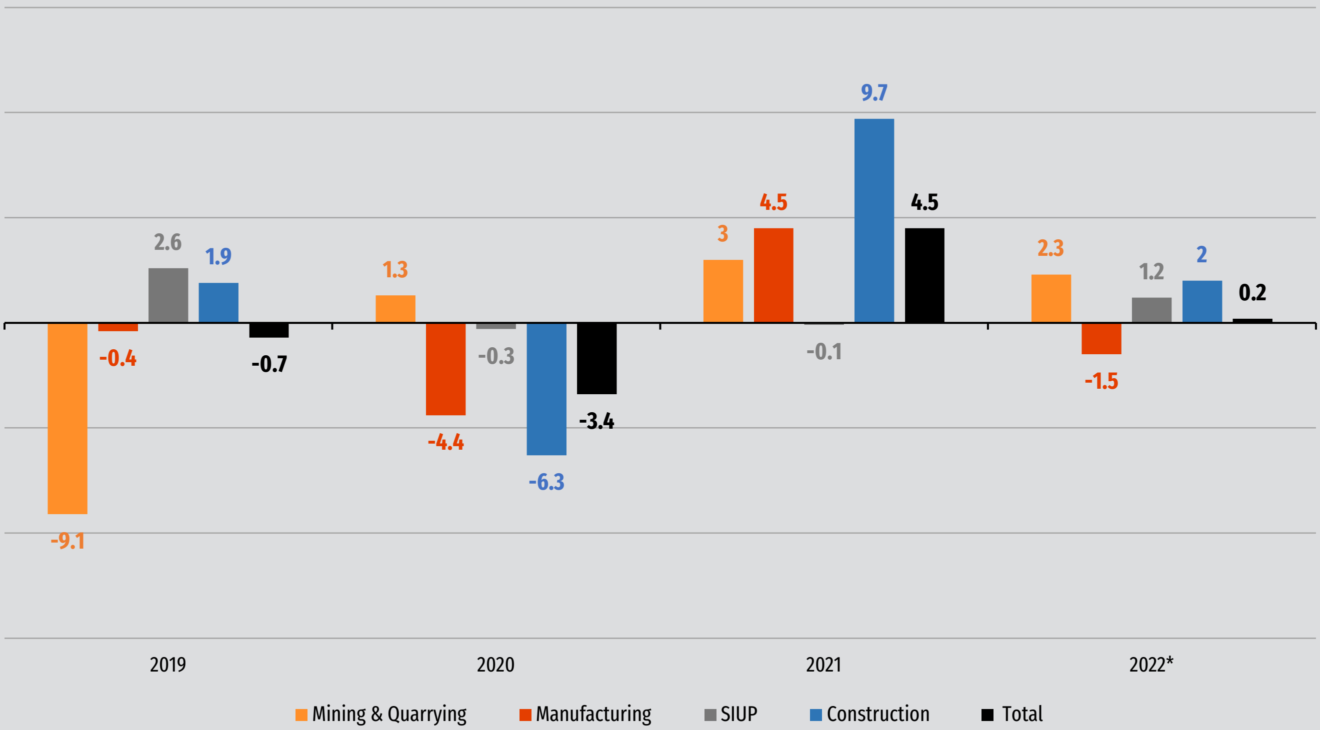
The Construction Industry Survey shows that the Infrastructure Construction sector continues to experience considerable difficulties, while the Construction of Buildings sector remains positive but losing strength.

The combination of high input costs and rising interest rates hamper a new growth cycle, so the sector should move towards more modest results in the coming quarters. Even so, we maintain the high projected for the sector at 2.0% in 2022.

Strong growth in Public Utilities Industrial Services in early 2022

In the case of Public Utilities Industrial Services (SIUP), there was a growth of 6.6% in the first quarter of 2022 compared to the previous quarter. The growth is explained by the rapid increase in electricity production and distribution, with the normalization of rainfall and a reduction in energy generation via thermoelectric plants. This rise has led us to revise the industry's projected growth from 0.6% to 1.2% in 2022.

Chart 2 – Expectation of uneven development of the industry for another year
Annual GDP growth rate
Percentage (%)



Source: Quarterly Accounts System – IBGE.
Preparation and forecasting: CNI.
*Projection.

New negative review for agriculture

The GDP of agricultural production fell 0.9% in the first quarter of 2022 after increasing by 6.0% in the last quarter of 2021.

Data from the Systematic Survey of Agricultural Production (LSPA) by IBGE show significant harvests for a series of grains. However, the forecast for the harvest of soybeans, the most relevant product for the added value of agricultural production, worsened compared to the previous forecasting. The soybean harvest was affected by the lack of rains at the beginning of the year. As a result, we have reduced our GDP growth forecast for the sector from 1.3% to 0.0% in 2022.

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Services will continue to lead growth in 2022

The service sector increased by 1.0% in the 1st quarter of 2022 compared to the previous quarter, a stronger-than-expected result. The sector had a streak of seven consecutive quarters with gains, the last drop in the 2nd quarter of 2020, when it registered a fall of 8.9% due to the pandemic.

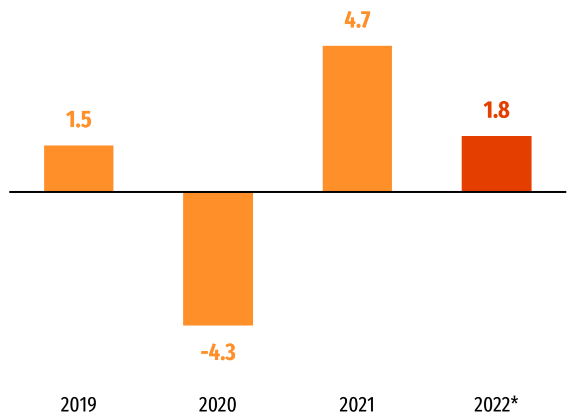
The sector continues to benefit from the normalization of its post-pandemic activities, especially those linked to people's mobility, and continues to have room to continue growing. Services provided to families showed a rise of 60.8% compared to April 2021. Despite this, it is the only category of services that is below the pre-pandemic level (-9.6%).

What is also noteworthy is the growth in digitization during the pandemic, which keeps the search for technology and information services high (above the pre-pandemic).

The expectation is that this movement of resumption of demand for household and transport services will continue. At the same time, we also project high levels of demand for technology and information services to be maintained.

Due to these factors, in view of the stronger-than-expected first quarter, we revised our forecast for the sector's growth in 2022 from 1.2% to 1.8%.

Chart 3 – Growth in services above GDP in 2022
Services GDP annual growth rate
Percentage (%)



Source: Quarterly Accounts System – IBGE.
Preparation and forecasting: CNI.
*Projection.

Lower investment in 2022

Gross Fixed Capital Formation (GFCF) recorded a strong recovery in 2021 but started the year with a drop (-3.5% compared to the previous quarter). The basis of comparison[1] can explain part of the drop in the first quarter of 2022, and the effect is what appears to be the end of the current cycle of construction expansion and underperformance of the industry.

There is the influence of interest rates, which make investment more expensive. There is also cost pressure, which reduces disposable income considering the relevant participation of own resources in investment plans funding. The CNI Investments in Industry Survey and the Industrial Survey showed that entrepreneurs are more cautious in their investment plans.

Although the sectors linked to commodities should promote some increase in investment, the expectation is for a fall in GFCF in 2022.

1 Last year's results were influenced by imports of machinery and equipment recorded merely for accounting purposes ('fictional imports'), related to Repetro (as explained in CNI's Economic Note 17, of January 2021)

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Consumption advances in the first quarter of 2022, supporting GDP performance

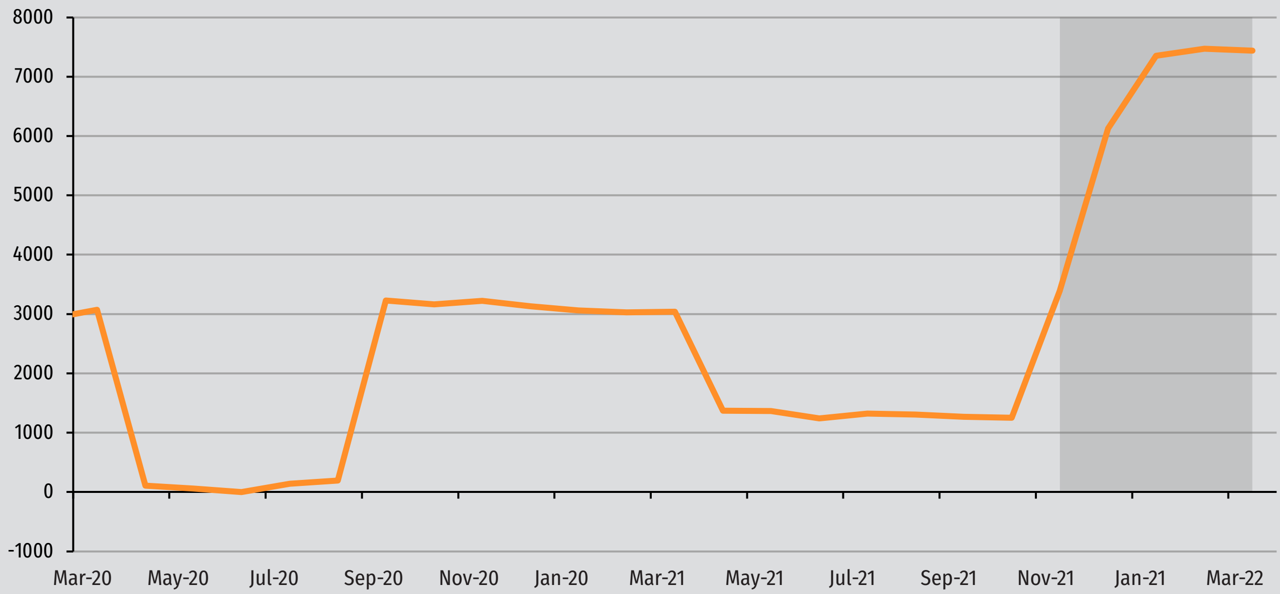
Household consumption grew 0.7% in the first quarter of 2022, the third consecutive increase. The increase is 2.2% compared to 2021 Q1.

Consumption has been responding to the recovery of employment and the recomposition, albeit partial, of the real average income (see the Employment and Income section for more details). The increase in pension spending and the Continuous Cash Benefit (*Benefício de Prestação Continuada* – BPC) is also noteworthy.

Furthermore, it was also boosted by measures such as the advance of the Christmas bonus for INSS retirees and pensioners; authorization for FGTS withdrawals; resumption of the compensation bonus; and the increase in direct income transfers are noteworthy.

The 'Auxílio Brasil' program, since November 2021, replacing the 'Bolsa Família' program, increased the amount transferred considerably. In the first quarter of 2022, the amount transferred by the 'Auxílio Brasil' program was 144.1% higher than the amount transferred by the 'Bolsa Família' program in the first quarter of 2021. The first quarter of 2022 also featured the Salary Bonus, released between February and March.

Chart 4 – 'Auxílio Brasil' program influenced consumption growth in early 2022
Amount transferred via 'Bolsa Família' and 'Auxílio Brasil' programs
In thousand Reais (BRL)



Source: National Treasure.
Prepared by: CNI

In April 2022, the new round of extra FGTS withdrawals began. According to the CEF Bank forecast, the bank expects a BRL 30 billion withdrawal from at least 42 million workers. The impact of the extra FGTS withdrawal on consumption should be more intensely observed in the second quarter of 2022 and may also influence the beginning of the third quarter.

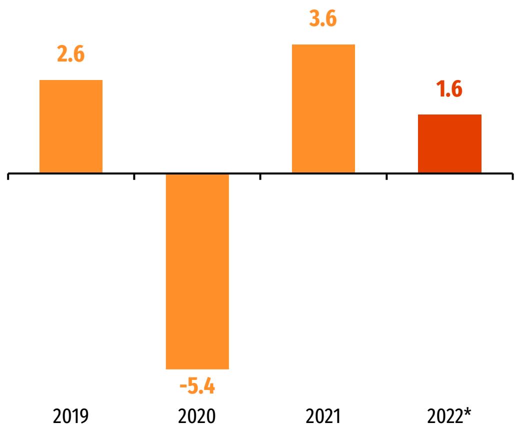
Besides the additional withdrawal, from April to June, there was an anticipation of the Christmas bonus for INSS beneficiaries. According to the Federal Government, the measure injected BRL 56.7 billion into the economy, covering 30.5 million beneficiaries. The impact of income anticipation on consumption is focused in the second quarter, with moderate effects on the third quarter performance.

The projected scenario for the second semester includes a slowdown in the labor market, deceleration of the inflationary process, and the maintenance of high interest rates. Even considering the measures of the Proposed Amendment to the Constitution (PEC) 1/2022, which increases the amount and number of beneficiaries of the 'Auxílio-Brasil' program, and creates aid for truck drivers, among other measures (see the Fiscal Policy section for more details) the resource flows to households in the second half will not be so massive as in the first semester.

The flow of resources reduction added to the high interest rate will make the labor market performance critical for sustaining consumption in the second half of the year. Thus, consumption should decelerate in the second semester, following a more moderate increase in employment and income.

In this scenario, consumption will end 2022 with more limited growth than in 2021, when the recovery from the previous year led to a 3.6% growth. The projection for 2022 is up 1.6% compared to 2021.

Chart 5 – After the recovery process in 2021, consumption should grow less in 2022
Household consumption GDP annual growth rate
Percentage (%)



Source: Quarterly Accounts System – IBGE.
Preparation and forecasting: CNI.
*Projection.

Government consumption will grow less in 2022

Government consumption grew by 0.1% in the first quarter of 2022, after a number of increases around 1%, which reflected the normalization of the supply of public goods and services, such as public education. While it will remain restrained by fiscal constraints, government consumption should maintain moderate growth, in line with post-pandemic normalization. The projection is for growth of 0.6% in 2022, compared to a high of 2% in 2021.

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External contribution to GDP should be positive

Brazilian trade flows have been increasing a lot in value, but the expansions, for both exports and imports, are due much more to the increase in prices than the volume of transactions.

Exports benefited from a strong demand for commodities, solutions presented due to the Russia-Ukraine conflict, and, above all, the problems faced by China during the lockdowns. As a result, we project exports of goods and services to expand by 3.5%.

The world's largest economies are at a greater risk of recession due to the need to control inflation and the relevant increase in interest rates and stimulus withdrawal. At the same time, there is a significant stimulus package announced for the Chinese economy. The balance of these contrary factors in 2022 is uncertain, making the future scenario more volatile.

With regard to imports, data from the last few months show significant increases, but much of this is due to the normalization of operations delayed by a civil servants' strike, which affected customs clearance. There is also the normalization of pent-up acquisition demand from China. We expect less investments and lower imports of capital goods; a more volatile exchange rate, containing purchases of consumer goods; and industrial activity without major expansion, limiting the purchase of inputs for the rest of the year.

We forecast a small growth (+0.2%) in imports of goods and services in 2022. Thus, the external contribution to GDP would be positive by 0.7 percentage point.

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2 EMPLOYMENT AND INCOME

Employment should maintain an upward trend in 2022, with a deceleration in the second half of the year

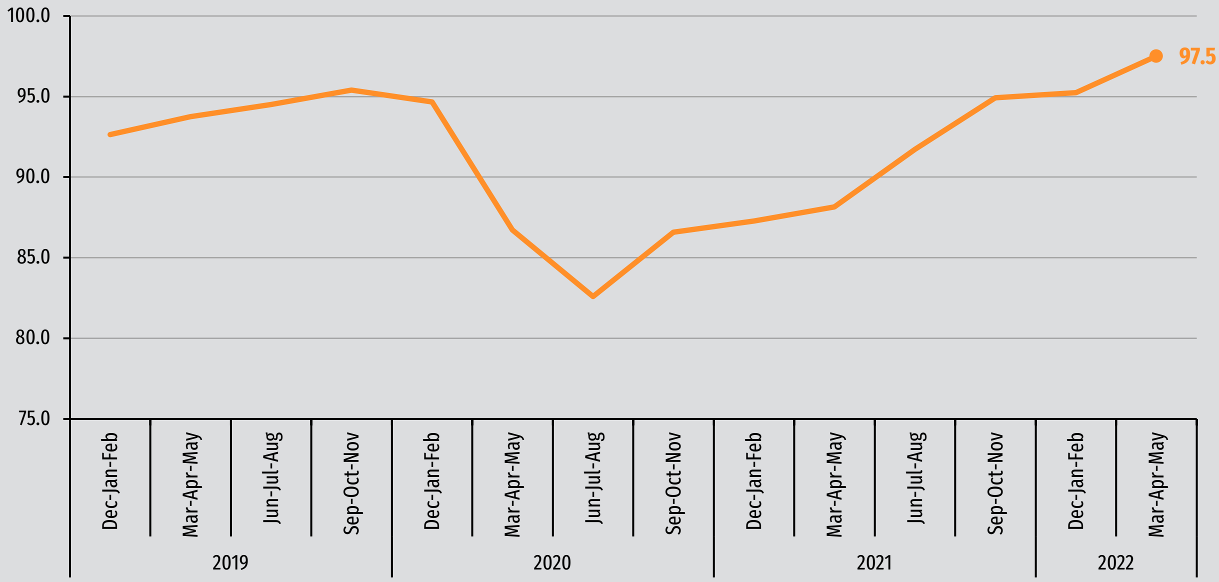
Further increases in actual yield for the second half will depend on a slowdown of inflation.

Employment follows an upward trend in 2022, with a growth of 2.4% in the quarter that ended in May compared to the quarter ended in February 2022, according to IBGE data. There were 2.3 million new jobs in the period. The observed movement was led by the expansion of employment in the services segment. It is noteworthy that 981 thousand of the new positions are formal jobs.

Data from Caged indicated the creation of 1.1 million new formal jobs between January and May 2022. The recovery rate in the formal sector has been responsible for the drop in the informality rate, which reached 40.1% in the quarter that ended in May. This value is below the pre-pandemic average[2] of 40.5%.

In view of the expansion of employment, the unemployment rate continued to fall, reaching 9.8% in the quarter that ended in May. This percentage places the unemployment rate at a level that is not only below pre-pandemic levels, but the unemployment rate has not reached

Chart 6 – Employment surpasses the pre-pandemic level
Employed population
Trailing quarter



Source: PNADC–IBGE.
Prepared by: CNI

2 Reference is made to the years 2018 and 2019.

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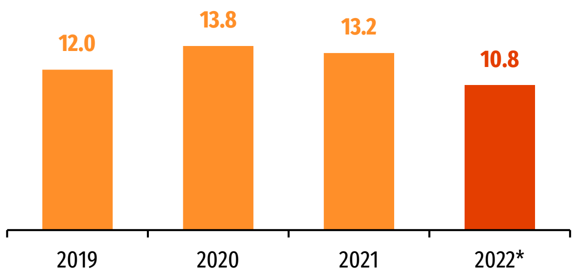
a value below 10% since the quarter ended in November 2015, when it accounted for 9.1% of the unemployment in the available workforce.

The process of recovering the labor market is expected to continue, with the unemployment rate reaching a value below that recorded in the pre-pandemic period. The drop in the unemployment rate should be driven by the positive evolution of positions, considering that the entry of new individuals into the labor market should follow a stable trajectory.

In the second quarter, employment should show a consistent evolution. In the second semester, a deceleration is expected as the economic activity should be less heated in this period (see the Activity section for more details). As a result, **the average unemployment rate for 2022 should be 10.8%.**

Chart 7 – Unemployment rate expected to be lower than the pre-pandemic level in 2022
Annual average unemployment rate
Percentage (%)



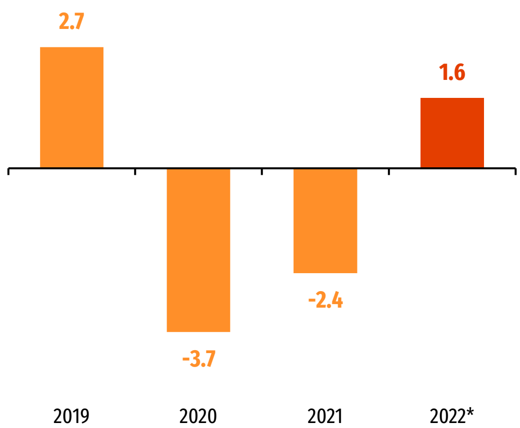
Source: IBGE and CNI.
Preparation and forecasting: CNI
*Projection.

The wage bill should show a slow recovery without achieving the pre-pandemic level

According to IBGE data, the real wage bill increased by 3.2% in the quarter that ended in May 2022, while the real median income remained stable for the second consecutive quarter after six quarters of drop, a phase in which it dropped by 13.5%. Therefore, the growth in employment has contributed to the wage bill increase in the period.

Despite remaining below the pre-pandemic level, the recent growth in the wage bill allowed considerable recovery, registering a drop of 4.2% compared to the quarter that ended in February 2020 (it even fell 7.8% in this comparison). The drop is 7.2% compared to the quarter that ended in February 2020, considering the real median income.

Chart 8 – The wage bill is expected to increase after two consecutive years of decline
Rate of change in real wage bill
Percentage (%)



Source: IBGE and CNI.
Preparation and forecasting: CNI
*Projection.

The number of unemployed people is still high compared to the total workforce. Thus, the increase in employment still does not exert sufficient pressure to promote improved increases in wages, helping to explain the more moderate recovery in income. But, above all, high inflation continues to weigh negatively on the recovery of real average income.

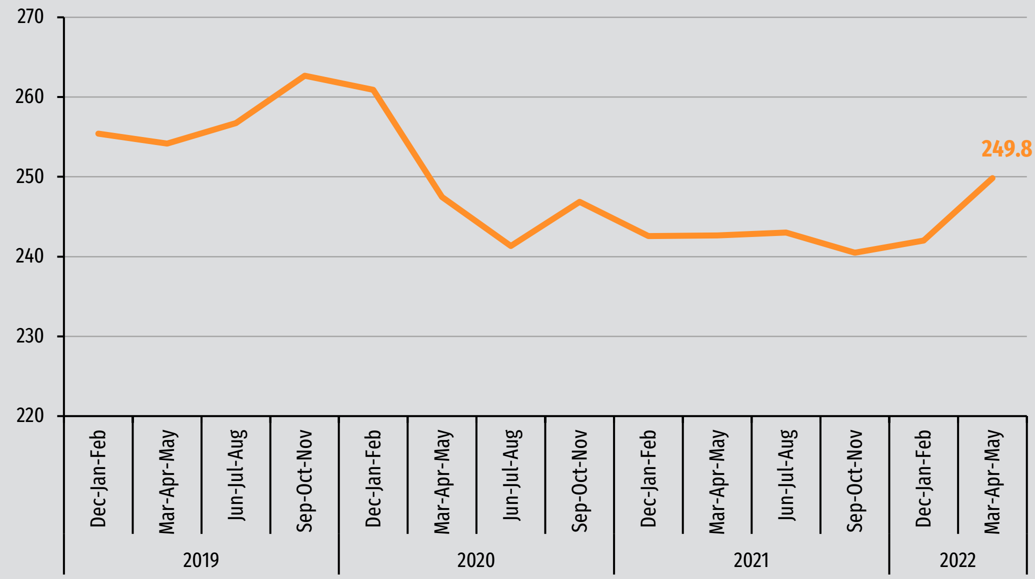
The perspective of consistent gains in real median income and wage bill over 2022 depends on two factors. Firstly, the expected deceleration of inflation for the second half of the year (see the section Inflation, interest, and credit). Additionally, collective bargaining should advance throughout 2022 and will restore part of the wage purchasing power.

According to the Salariômetro[3] data, the median of the adjustments agreed in 2022 has followed the National Consumer Price Index (INPC).

The drop in informality is another factor contributing to the recovery of income. The average income from formal employment in the private sector is 77% higher than the income from informal jobs.

As a result, income should grow slowly in light of the inflation deceleration expected for the second semester and the increase in employment, which should be consistent in the second quarter and discreet in the second half of the year.

Chart 9 – Mass of income advanced in 2022
Real wage bill
In millions of reais (BRL) as of April 2022, the trailing quarter



Source: PNADC–IBGE.
Prepared by: CNI

3 'Salariômetro' is a database on the labor market provided by Fipe. The database collects data agreement and collective agreement texts from the MTP Mediator archives to monitor collective bargaining.

3 INFLATION, INTEREST RATES AND CREDIT

Inflation should slow down in the second semester of 2022

The high Selic rate explains part of this trend

Inflation measured by the National Consumer Price Index (IPCA) is at a high rate, 11.7%, cumulative over a 12-month period up to May. It is worth noting that the index experienced a decline in May, however modest, which should intensify in the coming months.

The main reasons for the fall in the IPCA are the lagged effects of the basic interest rate, Selic; the reduction of taxes; and the cyclical downturn in food prices. As a result, the IPCA should end 2022 at 7.6%.

In this scenario, the Central Bank of Brazil (BCB) could end the Selic high cycle in August 2022, with a final increase of 0.50 percentage point. Thus, the Selic rate is expected to reach 13.75% per year (p.a.) in August and remain at that level for the rest of the year.

Business credit is expected to grow by 7.5% in 2022 in nominal terms. It is considered a moderate growth rate compared to 2021 when credit expansion was 13.4%. Higher interest rates and fewer opportunities for productive investments due to the economic slowdown reduced growth this year.

IPCA should end 2022 at 7.6%

Inflation, measured by the IPCA, was 11.7% in the 12-month period ended in May. The first sign of a drop in the index occurred during the month, however modest, due to the Administered and Industrial price groups, which should slowdown in the second half of the year more strongly. The Food price group, which showed price acceleration between January and May, should experience a deceleration course in the coming months. The Services price group, which accelerated prices between December 2021 and May 2022, is expected to continue at a high pace of increases for the rest of the year.

Prices of the Industrials group reached a high of 13.9% in the 12-month period up to May 2022. The prices of this group began to slow down in May, mainly due to the lagged effects of the high Selic rate. The rise discourages the purchase of durable and semi-durable consumer goods, with an impact on the prices of these goods—a movement that should remain in the coming months. The IPI tax reduction and the more appreciated exchange rate are leading to a deceleration of industrial goods prices.

The sharper deceleration of the Broad Producer Price Index (IPA), which went from 19.1% over the 12-month period ended in January to 10.5% over the 12 months ended in May, shows that the industry has already reduced the rhythm of price increase in its sales to the wholesale trade. The expectation is that this movement will impact the deceleration of prices in the IPCA Industrial group in the coming months.

In addition, the reduction in fuel and electricity tariffs, just as the slow-down of industrial activity compared to last year, should add to bring down industrial prices, especially in the second semester.

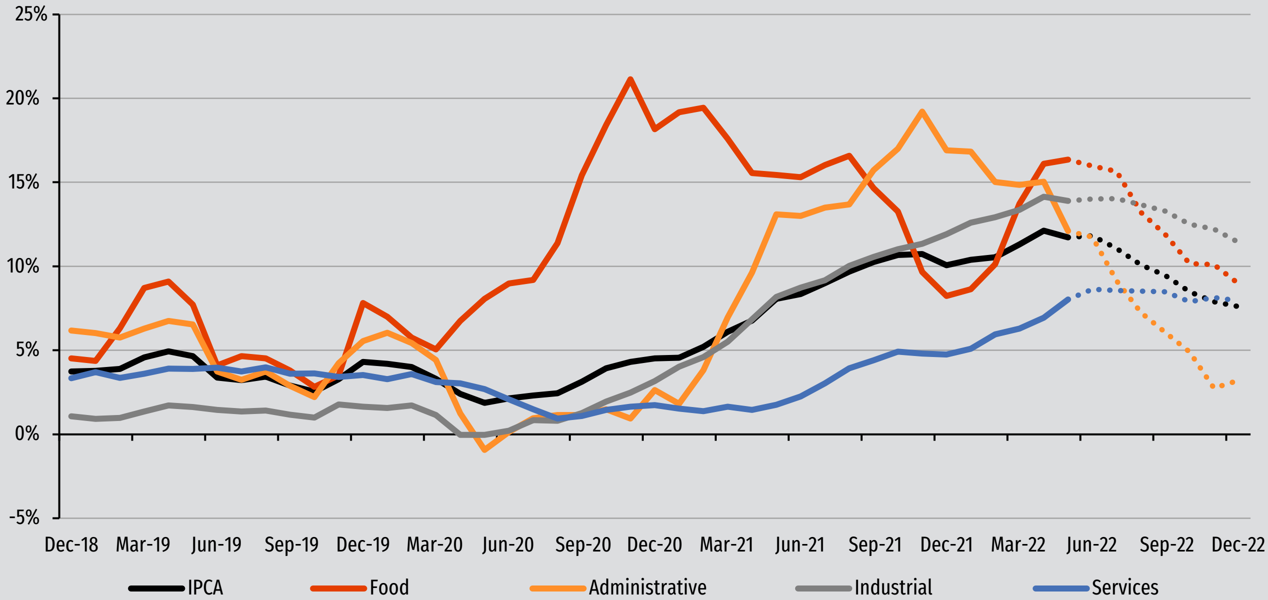
There is, however, a risk of rising costs in the industry due to higher prices of imported inputs. As a result of the lockdown in China, there may be pressures on prices in the Industrials group in the coming months, so the expected deceleration for this group should be milder.

The prices of the Managed price group, in turn, increased by 12.1%, cumulative in a 12-month period up to May 2022. The rise concentrates on prices related to oil and pharmaceuticals. On the other hand, the price of the residential electricity tariff experienced a sharper drop due to the green tariff flag.

For the following months until the end of 2022, the prices of the Managed price group should register a significant deceleration, mainly due to the tax reduction of fuel (gasoline, diesel, and ethanol), electricity, and fixed telephony tariffs promoted by Complementary Law 194/2022[4] (More details on the effects of this Law can be found in the Fiscal Policy section). This deceleration depends on the pass-through of tax reductions to consumer prices, and there are risks of this pass-through being lower than estimated.

As the Russia-Ukraine conflict continues, oil prices are expected to stabilize above $100 a barrel. Thus, despite the current high level of oil prices, new rises are not expected, at least not as extreme as the rises observed in the first half of the year.

Chart 10 – Inflation should drop significantly in the second half
IPCA inflation and IPCA groups
Cumulative over a 12-month period (in %)



Source: IBGE.
Preparation and forecasting: CNI.

4 The ICMS tax reduction related to telecommunications affects the Administered price group, which includes fixed telephony, and the Services group, which covers mobile telephony. Public transport, which also had its maximum ICMS rate set by law, already had a rate close to the standard (internal rate) in most states and, therefore, means we should not expect an additional reduction, which should not reflect in lower prices.

The prices of the Food group reached a high of 16.4% in a 12-month period up to May 2022. At the beginning of the year, the perspective of deceleration in these prices was interrupted due to the Russia-Ukraine conflict. As the conflict has not escalated, and no more countries are involved, in addition to Brazil harvesting its largest-ever grain crop—according to the National Supply Company (Conab)—a cyclical deceleration of Food prices should occur throughout the second half of the year.

Finally, the prices of the Services group reached a high of 8.0% in a 12-month period up to May 2022. Despite the increase in interest rates and the deceleration of prices in the other groups, this group should continue to be under pressure, as the Services activity shows some heating up since measures to restrict human mobility were withdrawn or relaxed. Furthermore, prices of the Services group are too low compared to the other groups. Nevertheless, the rate of increase should remain near this level of 8.0% p.a.

Given the expected dynamics for the IPCA groups, CNI expects 2022 inflation to be 7.6% p.a. However, it is worth noting that this inflation scenario depends on the pass-through of subsidies to prices of fuel, electricity, and telecommunications exemptions. Thus, there are risks of higher-than-expected inflation if the pass-through of subsidies is insufficient.

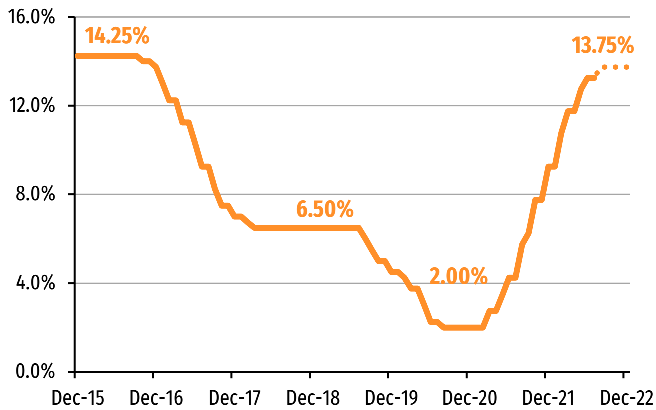
Central Bank to end Selic increase cycle in August 2022

Since March 2021, the BCB has been raising the Selic rate, which has already seen a rise of 11.25 percentage points until the last Copom (Monetary Policy Committee) meeting held in June 2022. In the same period, inflation rose by more than 5 percentage points due to the various shocks (in fuel, energy, and food, for example). In addition, inflation expectations for 2022 and 2023 have risen considerably.

It is critical to highlight that the ex-ante real interest rate, measured by the current Selic rate minus the inflation forecast for the next 12 months, is above 7% p.a. This means a tight monetary policy that may restrict economic activity and bring down inflation in the coming months.

In any case, we believe the BCB should still raise the Selic one last time at the Copom meeting in August 2022. As a result, the rate will reach 13.75% p.a. , a level that could be sustained up to the end of the year. Thus, the real interest rate should end in 2022 at 5.7% p.a.

Chart 11 – Selic rate should reach 13.75% p.a. and remain at that level for the remainder of 2022
Basic interest rate (Selic)
% p.a.



Source: Brazilian Central Bank.
Preparation and forecasting: CNI.

4 FISCAL POLICY

The public sector should return to deficit in 2022

Measures that increase expenses and reduce revenues worsen the federal government's primary result

The consolidated public sector fiscal position—which encompasses the federal government, regional governments, and state-owned companies—should end 2022 with a primary deficit of 0.2% of GDP. This result stems from the increase in the primary deficit expected for the federal government, estimated at 0.9% of GDP, partially offset by the primary surplus of regional governments of 0.6% of GDP.

The approval of the Proposed Amendment to the Constitution (PEC) 1/2022 will be one of the causes of the growth in federal government expenditures in 2022, with an estimated impact of BRL 41.3 billion[5]. PEC 1/2022 increases the benefit amount and the number of beneficiaries of the Auxílio-Brasil program, it also creates assistance for autonomous truck and taxi drivers, extends the reach of the gas voucher and the Alimenta Brasil program, in addition to transferring resources from the federal government to regional governments, as an effort to offset the free public transport for senior citizens and tax credits to ethanol producers and distributors.

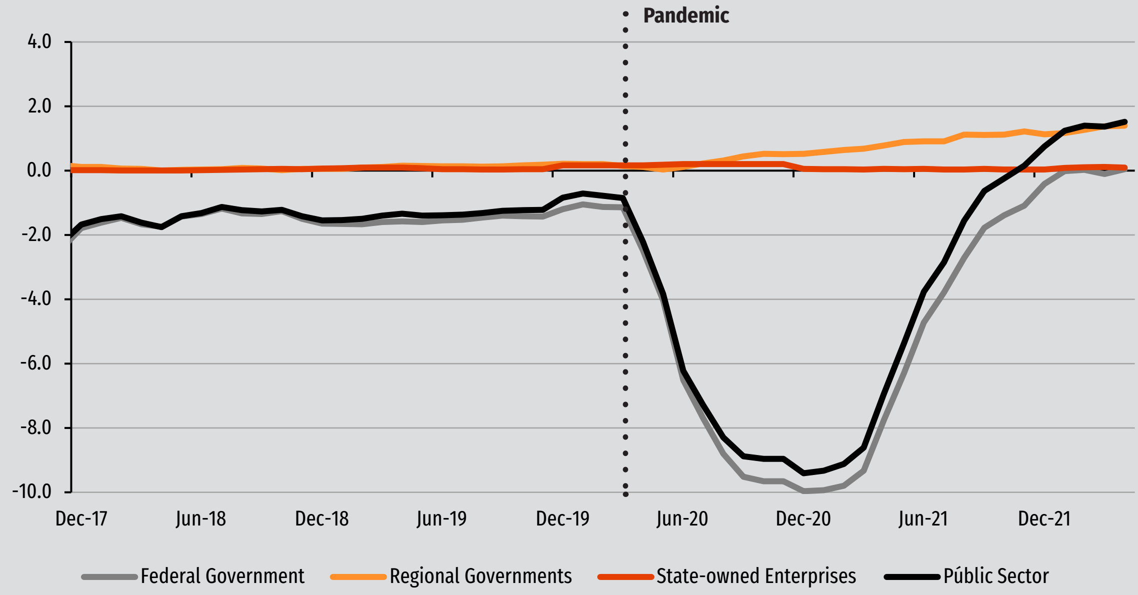
In addition to the measures which increased expenses, several initiatives led to a reduction in tax collection in 2022 by the federal and regional governments. Among these measures, the following stand out: the limitation of the ICMS rate for fuels, electricity, telecommunications, and public transport[6], which could generate a drop in collection of BRL 40 billion for regional governments; and the reduction to zero of the PIS/Cofins rate on fuels[7], which should represent a drop in a BRL 35 billion drop in tax collection for the federal government. There is also a reduction in the IPI rate[8], which should lead to a BRL 17 billion reduction in revenue, shared between the federal government (BRL 7 billion) and regional governments (BRL 10 billion).

Despite the relevant fiscal impact, which may exceed BRL 90 billion, or 0.9% of GDP, the federal and regional governments (states and municipalities) expect increased collections in 2022. However, in the case of the federal government, the revenue growth will not be enough to offset the increase in expenditures and will lead to a worsening of the primary result compared to 2021.

Concerning regional governments, measures that reduce collections will offset the growth in transfers received from the federal government and the increase in tax collection related to goods and services not addressed by the legislative change. If compared to 2022, the expenses of these entities should have significant growth, mainly due to the readjustment of civil servants' salaries and the increase in investments. Nevertheless, regional governments will register a primary surplus of 0.6% of GDP in 2022.

5 Considering the version approved by Brazil's Senate on June 30, 2022.
6 Complementary Law (CL) 194/2022 now lists fuel, electricity, telecommunications, and public transport as essential goods. As a result, these goods are subject to the standard internal ICMS tax rate limit of the relevant state, which, at the moment, is between 17% and 18%, depending on the state. It is worth noting that this is a permanent measure.
7 The CL 192/2022 has determined the reduction to zero of the PIS/Cofins rates, levied on diesel oil, biodiesel, aviation kerosene, and liquefied petroleum gas (LPG), as of March 2022. The CL 194/2022, in turn, has determined the reduction to zero of PIS/Cofins rates on gasoline and ethanol and of 'Cide-Combustíveis' on gasoline. Both measures are valid through December 2022.
8 Established by Decree 10.979/2022 and later by Decree 11.055/2022.

Chart 12 – Primary result of the consolidated public sector should return to a deficit in 2022
Primary result by government level
Cumulative over a 12-month period (in % PIB).



Source: Brazilian Central Bank.
Prepared by: CNI.

Federal government revenue continues to surprise positively

The federal government collection had a real growth (adjusted for the IPCA) of 10.9%, cumulative from January to May 2022, as compared to the same period in 2021. It is worth noting the 8.8% real growth in revenues managed by the Federal Revenue Service, driven mainly by the strong growth in the collection of the Corporate Income Tax (IRPJ) and the Social Contribution on Net Profits (CSLL).

Also noteworthy was the real growth of 25.8% in revenues not managed by the Federal Revenue Service, mainly due to the collection related to the exploitation of natural resources leading to oil price increase.

The growth in collections, particularly from managed revenues, can be largely explained by the growth in economic activity in the first months of 2022, compared to the beginning of 2021. In addition, it is important to note that the collection at the beginning of 2021 still reflected the negative impacts of the pandemic on economic activity, lowering the basis for comparison. Finally, inflation also helps to explain part of this process since the prices of some goods and services with high participation in the total collection had grown above the average inflation of the period.

Over the year, the slowdown in the pace of economic growth, the start of new tax cuts and the decrease of inflation should reduce the rate of expansion of federal government revenues. As a result, the net revenue of the federal government by the end of 2022 should show real growth of 0.6% compared to 2021.

Regarding federal government expenditures, there was a real growth of 5.9%, cumulative between January and May 2022, compared to the same period in 2021. This growth is due mainly to the resumption of the payment of the compensation bonus not paid in 2021[9]; increase in cash transfers under the 'Auxílio Brasil' program, compared to the 'Auxilio Emergencial' and 'Bolsa Família', both paid in 2021; and the first payments of the Christmas bonus, which started in April, in 2022, and only in May, in 2021. Additionally, the delay in the budget approval in 2021 was another reason to postpone some expenses which also reduced the basis for comparison.

It is worth noting that some economic stimulus measures do not represent an increase in federal government spending. As for the anticipation of the Christmas bonus, there is only a change in the payment schedule. The authorization to withdraw up to BRL 1,000.00 from the FGTS[10] does not represent an expense since is it just a release of resources from the fund.

For 2022, expenses should end the year with real growth of 2.6% compared to 2021. However, for the year, the explanations for the growth in spending are different from those observed until May. Particularly, two sources of expenditure are worth mentioning.

The first comes from PEC 1/2022, implying an increase in expenses of about BRL 41.3 billion in the second half of 2022, as detailed above. These expenses are extraordinary credits, and they will not be accounted for the spending limit imposed by the Spending Ceiling.

The second additional source of expenses in the second semester is related to the Campo de Marte dispute[11]. The Federal Government and the city of São Paulo agreed to reimburse the city for the possession and use of part of Campo de Marte, and as a result, the Federal Government shall cancel the city debt of BRL 23.9 billion. Therefore, this amount will be recorded as a primary expense by the Federal Government and as financial revenue for the municipality, which will have a neutral result in debt, even though it will worsen the federal government's primary result. In any case, since the transaction is settled through "offsetting of accounts", this expense will not be accounted for the federal government's Spending Ceiling.

If these two expenses—PEC 1/2022 and the Campo de Marte dispute—did not occur, our projection for the variation in the federal government's primary expenses in 2022 would be a drop of 1.1% (instead of real growth of 2.6%).

As the PEC 1/2022 is expected to be approved, the federal government will end 2022 with a primary deficit of BRL 75.9 billion (0.9% of GDP), against a deficit of BRL 36.2 billion (0.4% of GDP) in 2021.

9 In 2022, the payment of the compensation bonus was concentrated in February and March. It is noteworthy that in 2021 there was no payment of the compensation bonus, due to the change in the Workers Support Fund (FAT for its acronym in Portuguese)payment schedule.
10 Both actions were also taken in 2021.
11 Campo de Marte is a Brazilian airport located in the north of the City of São Paulo. The airport area was the subject of a litigation in 1958 when the municipality filed a repossession action against the Federal Government.

Table 2 - Federal Government Result
In Billion BRL

	2021	2022*	Variation (%)	Variation % (actual)**
TOTAL REVENUE	**1,932.2**	**2,200.9**	**13.9**	**3.4**
Managed revenue	1.195,7	1.345,4	12.5	2.1
Social security revenue	462.2	541.9	17.2	6.4
Unmanaged revenue	274.3	313.5	14.3	3.8
(-) Transfers	- 354.3	- 452.6	27.8	16.0
NET REVENUE	**1,577.9**	**1,748.2**	**7.0**	**0.6**
TOTAL EXPENSE	**1,613.5**	**1,824.9**	**10.4**	**2.6**
Social security expenses	709.5	786.5	10.9	0.6
Personnel expenses	330.1	341.3	3.4	-6.1
Other expenses	574.5	671.5	14.0	5.9
Primary result	-36.2	-75.9	-	-
PRIMARY RESULT	**-35.6**	**-64.7**	**-**	**-**

Source: National Treasury Secretariat/Ministry of Economy.
Prepared by: CNI.
*CNI Estimate.
**Taking into account the average inflation for the year (IPCA).

Regional governments should register a primary surplus in 2022 even with ICMS revenue losses

Between January and April 2022, the growth rate in regional government revenues has more than offset the growth in spending by these entities. The growth in revenues continues to be influenced by the expansion in economic activity, inflation, and increased transfers from the federal government. On the other hand, the expansion in expenses is mainly due to the concession of adjustments to public employees. Between January and April 2022, regional governments accumulate a primary surplus of BRL 62.3 billion.

However, by the end of the year this favorable scenario should be mitigated by two factors. The first of these, as already mentioned, is the approval of CL 194/2022[12], which may represent less BRL 40 billion in revenues for regional governments in 2022 alone. In any case, the increase in transfers from the Union and in revenues related to the taxation of other goods, other than those listed in CL 194/2022, will cause the revenues of these entities to grow, albeit at a slower pace, in 2022.

The other factor that will lead to a reduction in the surplus of the regional governments in 2022 is the increase in expenses, especially with personnel, which will be reflected significantly in the primary result of these entities during the year. It is worth noting that the favorable cash flow and the presidential election year should also influence the increase in investment spending by regional governments throughout the year. As a result, the regional governments should end 2022 with a surplus of BRL 55.0 billion, 0.6% of GDP, compared to a BRL 97.7 billion surplus, 1.1% of GDP, in 2021.

12 CL 194/2022 establishes that the Federal Government must compensate the states that have lost revenue by reducing the debt service of the respective states with the Federal Government. Compensation, however, is restricted to the year 2022 only.

In this context, it is noteworthy that CL 194/2022 provides for a permanent cut in revenue for regional governments at a time when all states have contracted a permanent increase in their expenses, which is the adjustment of civil servants. In the first quarter of this year, two states already exceeded the limit established by the Lei de Responsabilidade Fiscal (LRF) for the ratio between the Executive Branch's total spending on personnel and Net Current Revenue (RCL), even before the CL 194/2022 came into effect. These data serve as an alert for the fiscal situation of the states in the coming years.

Public debt continues to fall

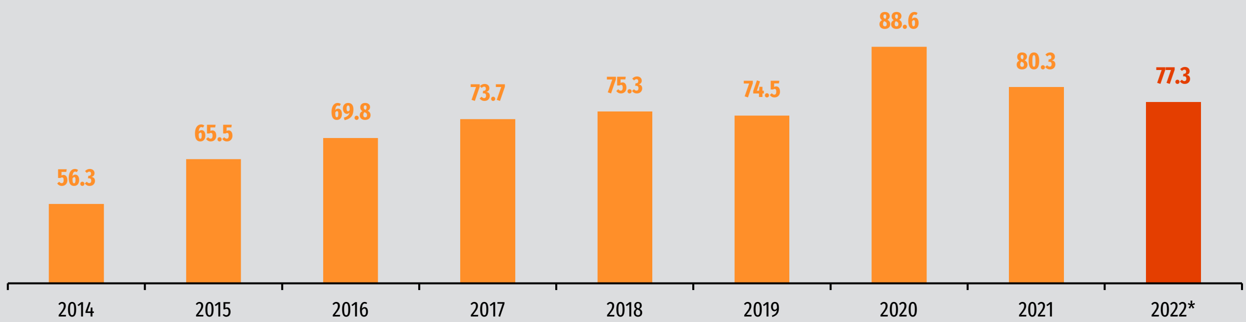
The public debt, measured by the Gross Debt/GDP ratio, is expected to go from 80.3% in 2021 to 77.3% in 2022. This is expected as the worsening of the nominal result—consisting of the primary result and interest expenses—will be more than offset by the growth of nominal GDP and the return of BRL 30 billion by BNDES to the National Treasury.

The worsening of the nominal result is explained by the public sector's primary deficit and the increase in interest expenses. The growth in interest expenses, in turn, continues to be influenced by the Selic rate increase and the average cost of issuing public debt. This expense is expected to grow by 1.2 percentage points of GDP in 2022, compared to 2021. As a result, the nominal result of the consolidated public sector should end 2022 with a deficit of BRL 617.9 billion (6.55% of GDP), against a deficit of BRL 383.5 billion (4.42% of GDP) in 2021.

Even with the expected improvement in indebtedness (Gross Debt/GDP) in 2022, it is necessary to further the discussions about fiscal adjustment. Initiatives that imply expenditure increases, even if temporary, such as PEC 1/2022, cast doubt on the federal government's commitment to the fiscal rules in force and worsen the market's perception of the sustainability of the public debt.

There is also the risk of converting temporary measures into permanent ones, increasing the level of mandatory spending and further worsening the country's fiscal situation in terms of public debt sustainability. In this scenario, the interest rates demanded by the market to finance the public debt will become even higher, and the primary surpluses needed to stabilize the public debt increasingly large and difficult to achieve. The proximity of the election reinforces the importance of the debate regarding the commitment to the current fiscal rules, especially the Spending Ceiling.

Chart 13 – Gross Debt/GDP ratio should fall again in 2022
Public Sector Gross Debt Trajectory
Percentage (%) of GDP



Source: Brazilian Central Bank.
Preparation and forecasting: CNI.
*Projection.

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5 FOREIGN TRADE SECTOR

Foreign trade sector shows positive performance in the second quarter

Increase in commodity prices, lockdown *in China, and higher interest rates impact the external scenario in the first half of the year*

Exchange rate to end 2022 at BRL 5.00/US$

Compared to the end of 2021, when the exchange rate reached BRL 5.65/US$, the exchange rate appreciated and reached values below BRL 5.00/US$ at times. Reasons for this were the rising commodity prices and the demand for risky assets away from the Russia-Ukraine conflict, which attracted international investors until the end of the first quarter of 2022. However, in June, the exchange rate resumed a devaluation cycle and has already surpassed the BRL 5.20/US$ mark.

Although it is not possible to access more up-to-date data on the financial flow[12], it is possible to note that the growth in net income, seen in the first two months, has reversed its flow. The monetary authorities in the US and Europe have signaled that they will use monetary policy to contain inflation, which creates expectations of interest rate rises in these countries throughout the year. In June, specifically, the U.S. Federal Reserve (FED) raised the interest rate target to a range between 1.5% and 1.75%, the highest level since 2008, in response to the accumulated inflation over 12 months, which reached 8.6% in May, the highest level since 1981.

In addition, fiscal uncertainties, deriving from measures that result in increased spending by the federal government, are contributing to maintaining the Real at a more devalued level.

Despite these factors, there is still a cycle of rising commodity prices, which makes Brazilian assets relatively cheap to foreign investors. In this scenario, CNI projects that the exchange rate will become more stable as of November and will end 2022 at BRL 5.00/USD.

12 The latest data released by the Central Bank of Brazil was from February 2022. The delay in disclosing foreign trade sector data is due to a civil servants' strike.

Positive performance of exports and imports is mainly due to price increases

In the second quarter of 2022, the external sector was affected by the economic consequences of the Russia-Ukraine conflict and the strict lockdowns in China.

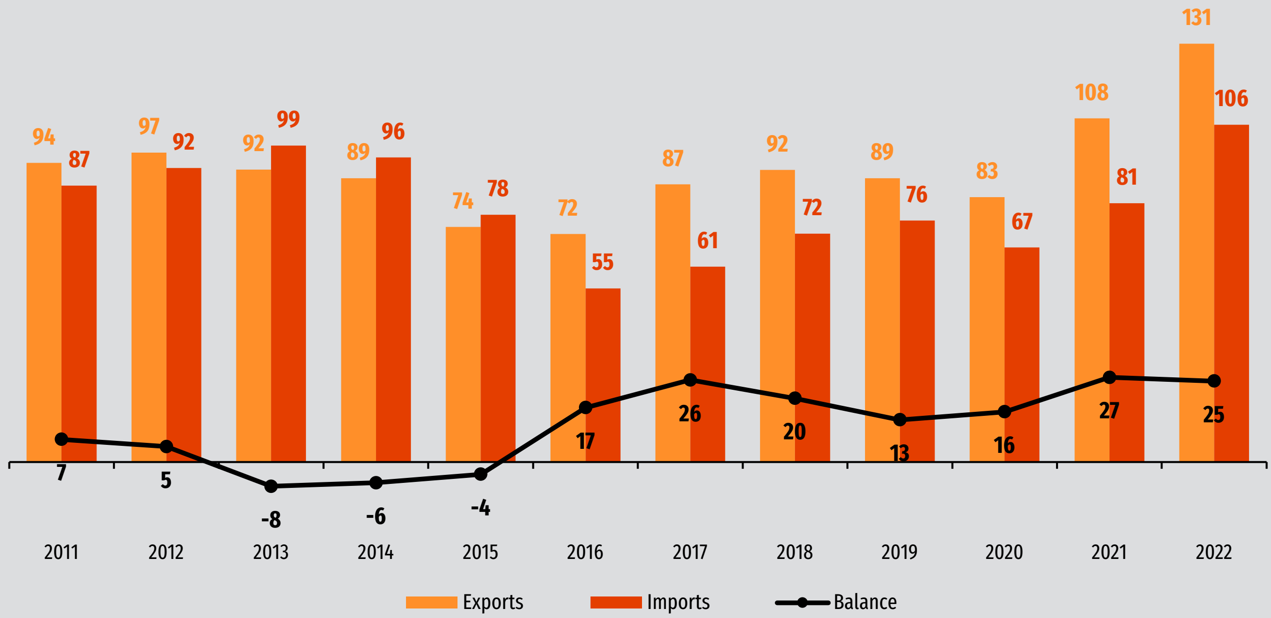
These events have contributed to the increase in the price of different products, mainly commodities, and to the disruption of global value chains, which were not yet completely restructured since the pandemic's onset. These events have also substantially impacted the inflationary process worldwide, requiring even more efforts by governments to contain its acceleration, resulting in rising interest rates everywhere.

The external accounts in Brazil until May 2022 totaled approximately US$ 131 billion for exports and US$ 106 billion for imports. When comparing cumulative results between January and May 2022 with the same period in 2021, exports increased by 21.7% and imports by 30.3%. These are high figures, driven by price increases, both from exports and imports.

It is worth noting that although the increases in export prices are at high levels, the increases in import prices have been even more significant. Therefore, caution is needed when analyzing the changing conditions. When comparing cumulative results from January–May 2022 and 2021, the trade balance dropped from $27 billion to $25 billion.

Brazilian exports were boosted by rising prices in all economic segments: agriculture, manufacturing, and mining & quarrying.

Chart 14 – Positive performance of exports and imports
Exports, imports, and trade balance––cumulative from January to May
Value in billions of dollars



Source: Ministry of Economy.
Prepared by: CNI.

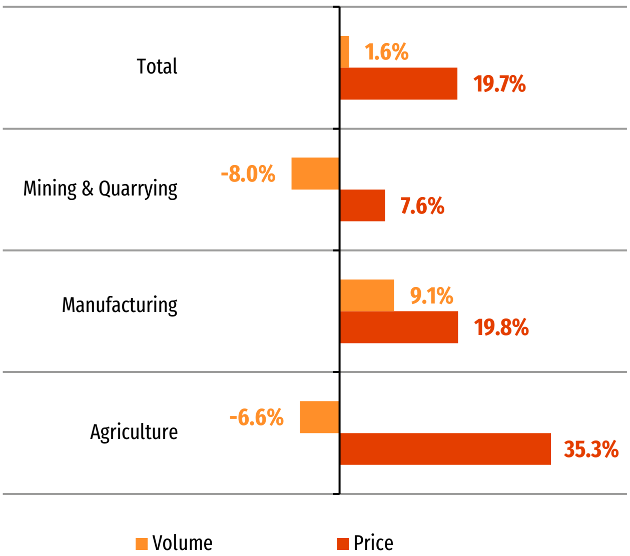
The lockdown in China impacts Brazilian exports during the quarter

There was an increase in volume only for the manufacturing industry (+9.1%), in the cumulative variation from January to May 2022 compared to the same period in 2021. In the other export categories, the volume decreased.

Price increases were already occurring due to the impacts of the pandemic on international trade, which generated imbalances in global value chains, freight increases, insurance, and cost pass-through.

In 2022, this was strongly affected by increases that stemmed from the war

Chart 15 – Exports driven by increases in prices
Price and volume of Brazilian exports by economic activity
Percentage variation between the average indices (price and volume) of January-May 2022 and 2021



Source: Ministry of Economy.
Prepared by: CNI.

between Russia and Ukraine. As for agricultural commodities, there has been a significant reduction in Ukrainian food exports. The war has also fostered a movement toward food protectionism, which has led to more countries imposing restrictions on food exports in response to escalating prices.

Even before the invasion of Ukraine, the world oil supply could not keep up with demand in the resumption of economic activity as the restrictive measures against Covid-19 were relaxed. But the sanctions imposed on Russia—a major oil and gas exporter—are affecting the country's energy supply to the rest of the world.

Thus, until the end of 2022, the scenario is that prices will remain high. The pressures on commodities prices will continue, the economic barriers to food exports by some countries will remain in place, and the cost pressures will keep industrial goods prices high.

As for the exported volume, it is noteworthy that recently the Chinese government launched the Package of Policy Measures to Stabilize the Economy, estimated at more than ¥ 35 trillion[13] (or more than US$ 5 trillion), containing 33 stimulus measures to boost its economy. The expectation is that the economic plan will be implemented throughout the second semester, improving Brazil's export volume forecasts due to the increase in demand for commodities.

In short, in terms of values, exports will tend to end 2022 at higher levels than in recent years, mainly as a result of the persistent rise in commodity prices. The Brazilian export agenda is composed mainly of commodities, therefore we

13 Value estimated by BLOOMBERG NEWS on May 19, 2022 https://www.bloomberg.com/news/articles/2022-05-19/china-s-stimulus-tops-5-trillion-as-covid-zero-batters-

are projecting exports of US$ 336.6 billion, 19.9% more than in 2021.

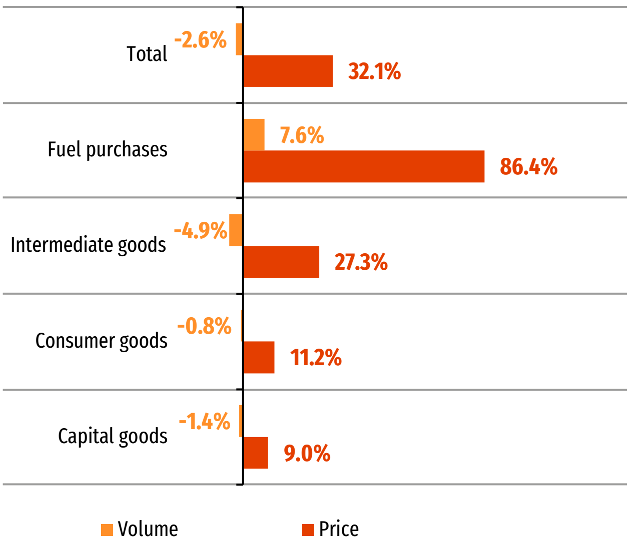
Brazilian imports, cumulative from January to May 2022, had price increases in all economic categories. In mining and quarrying, fuel purchases stood out since it was the only category that registered an increase in prices (86.4%) and quantities (7.6%) in the period.

Imports of intermediate goods stand out in the quarter

Concerning prices, this growth is also a consequence of the war between Russia and Ukraine. The growth in the amounts imported is related to the increase in the production of national refineries, which reported cumulative growth rates compared to the previous month in all months of 2022.

The import volume is being affected by the lockdowns in China. The country is Brazil's largest supplier of capital goods, intermediate goods, and consumer goods. Analyzing imports by major economic categories, in April 2022, while several Chinese provinces were in lockdown, Brazil saw a 51% drop in imports of consumer goods from China, a 38% drop in imports of intermediate goods, and an 8% drop in imports of capital goods.

Chart 16 – Imports show an increase in prices
Price and volume of Brazilian imports by large economic categories
Percentage variation between the average indices (price and volume) of January-May 2022 and 2021



Source: Ministry of Economy.
Prepared by: CNI.

In May, with the gradual improvement in the mobility of people and goods in China, the imports of Chinese consumer goods and intermediate goods grew by 12% and 17%, respectively.

Capital goods, however, dropped 7% in the period, reflecting the outlook for further moderation in investment (see Activity section for more details).

With the recent announcements of the relaxation of the Zero Covid policy and the gradual improvement in Chinese production, no further disruptions in the flow of imports should occur. At the same time, the volume of imports for industrialized products should increase in the next quarter due to the growth, albeit moderate, of Brazilian industrial production. The figures will continue to be driven by prices.

Thus, the forecast for 2022 is that imports will reach US$ 254.9 billion, 16.2% more than in 2021. Therefore, the trade balance will remain in surplus, with a balance of US$ 81.7 billion.

Chart 17 – Imports of products from China by major economic categories
Monthly variation of imports in dollars (FOB)
Percentage (%)

Source: Ministry of Economy.
Prepared by: CNI.

Balance in current account should remain in deficit

The current account deficit cumulative over a 12-month period up to February 2022 was $26.1 billion (1.59% of GDP), an increase of about 24% compared to the same period in 2021. This result was mainly due to the deficit balance of primary income[14] in the period.

The net inflow of direct investment into the country, responsible for financing the current account deficit, reported a cumulative result of $50.7 billion over a 12-month period up to February. This result exceeded the current account deficit by US$ 27.2 billion, with no need for external financing in this period.

New inflows of direct investment are expected throughout the year, taking advantage of opportunities generated by the privatization and concession agenda, especially in the energy and telecommunications sectors. We maintain the first quarter forecast for the current account at the end of 2022, a deficit of around $20 billion.

14 Primary income indicates the amounts payable or receivable in exchange for the temporary use of financial resources, labor, or non-produced non-financial assets, namely workers' compensation, investment income, and other primary incomes. The first includes compensation of salaried labor (wages and salaries); the second, direct investment income, portfolio investment income, other investment income, and income from reserve assets; and the third includes taxes on production and imports, subsidies, and rents.

6 OUTLOOK FOR THE BRAZILIAN ECONOMY

	2020	2021	2022 (forecast)
ECONOMIC ACTIVITY			
GDP (annual variation)	-3.9%	4.6%	**1.4%**
Industrial GDP (annual variation)	-3.4%	4.5%	**0.2%**
Manufacturing GDP (annual variation)	-4.4%	4.5%	**-1.5%**
Mining and Quarrying GDP (annual variation)	1.3%	3.0%	**2.3%**
Construction GDP (annual variation)	-6.3%	9.7%	**2.0%**
Unemployment rate (annual average - % of PEA)	13.8%	13.2%	**10.8%**
INFLATION			
Inflation (IPCA - annual variation)	4.5%	10.1%	**7.6%**
INTEREST RATE			
Nominal interest rate (average rate for the year)	2.9%	4.5%	**12.6%**
Nominal interest rate (end of the year)	2.0%	9.25%	**13.75%**
Real interest rate (end of year rate and defl: IPCA)	-2.4%	-0.7%	**5.7%**
PUBLIC ACCOUNTS			
Primary result (% of GDP)	-9.4%	0.7%	**-0.2%**
Nominal result (% of GDP)	-13.6%	-4.4%	**-6.6%**
Gross Public Debt (% of GDP)	88.6%	80.3%	**77.3%**
EXCHANGE RATE			
Nominal exchange rate - BRL/US$ (December average)	5.14	5.65	**5.00**
Nominal exchange rate - BRL/US$ (average of the year)	5.16	5.40	**5.13**
EXTERNAL SECTOR			
Exports (US$ billion)	209.2	280.8	**336.6**
Imports (US$ billion)	158.8	219.4	**254.9**
Trade balance (US$ billion)	50.4	61.4	**81.7**
Current account balance (US$ billion)	-23.3	-27.9	**-20.0**

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