CNI Newsletter
ISSN 1983-621X • Year 33 • Number 3 • July/September 2017

ECONOMIC REPORT

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

Consumption leverages recovery of the economy

Progress in fiscal adjustment is a key condition for consolidating economic growth

The Brazilian economy has been gradually showing more solid signs of recovery. With the contribution of agriculture and consumption on the rise, GDP has grown for two quarters in a row, technically signaling the end of recession. The scenario abroad remains favorable, with abundant liquidity, high prices for commodities, and consistent growth in the world economy. As a result, CNI's estimate for GDP growth was revised upward to 0.7% in 2017, with industrial GDP increasing by 0.8%. Inflation will remain at a rate of 3.1%, close to the lower limit of the target, and the Selic rate will close the current downward cycle at 7.0% per year.

Despite these improvements in the recent scenario, they still raise a number of questions. What is the extent and intensity of this recovery? What will this new growth cycle look like? Will it be broad and widespread and in the economy? How will industry behave?

There are reasons to believe that the current recovery trend will continue. While one-off factors have been playing a major role in bringing about these positive developments (such as the release of funds from the Government Severance Indemnity Fund - FGTS - to workers), the upturn in consumption is actually explained by a set of favorable conjunctural elements (strong disinflation process, interest rates and unemployment on a downward path).

This recovery after a strong recession is seen as an effect of adjustments made by households and companies, especially in relation to a very high indebtedness amassed during the previous cycle, which continue to be favored by declining interest rates.

This reaction can already be felt even in the labor market, where unemployment is on the decline. Improvements in the labor market coupled with falling inflation have led to a recovery in purchasing power and to better prospects for economic recovery, as fear of unemployment tends to decrease and help restore

(continued on the next page)

The Brazilian economy in the third quarter 2017

consumer confidence, favoring the consuming decisions of households.

The significant drop in inflation deserve special mention. Disinflation was mainly caused by a drop in food prices and by lower inflation inertia in the non-tradable segments of the economy, especially in the service sector. The current inflation rate has even fallen below the lower limit of the inflation target, hitting the mark of 2.5% in September.

In industry, a gradual recovery in household consumption will pave the way for production to be stepped up in a more widespread fashion. Inventories have been adjusted to planned levels and demand growth is likely to be reflected in production. Some fluctuations in industrial activity may still be seen in the coming months. However, negative variations will become gradually milder, while positive ones will become more intense.

The high idleness in industry allows for growth in the short term without pushing inflation up. However, sustaining economic growth in 2018 will depend on the investment response, which so far has not been felt. In this regard, resuming investment, especially in infrastructure, is important not only to generate new jobs, but also to improve the efficiency and productivity of the economy. For this reason, positive conditions must be created for investments to be resumed by reducing costs and uncertainties for entrepreneurs and leveraging their confidence.

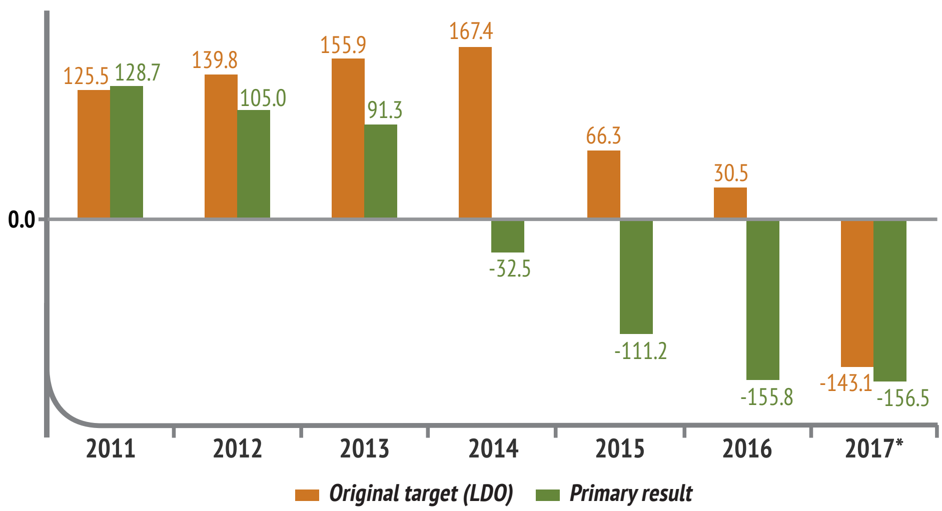
There are structural signs that contribute to overcoming the crisis and to promoting the resumption of investments in the future. The passage of the new labor law, advances in the privatization process, and new concessions consolidate a shift in the growth model strategy, which is now under the leadership of the private sector and focused on economic efficiency. The gap here is in the lack of an explicit tax reform strategy.

Fiscal consolidation remains the critical issue for actually resuming economic growth and ensuring balanced public accounts on a permanent basis. The fiscal adjustment process is being implemented at a slow pace and a recent revision of fiscal targets for this year and next year is a warning sign. For controlling the public debt, which is crucial to lasting stability, these deficits must be reversed. The imposition of a “spending cap” alone is not sufficient to ensure such reversal, as it requires the adoption of additional mechanisms to control spending growth.

Albeit positive, the current pace of growth may be limited in scope. Optimism with the process under way should not slow down the efforts being made to pass structuring reforms in Congress and to ensure fiscal consolidation, as these are key elements to ensure the continuity of the current recovery process. The pension reform, which is the main item on the fiscal agenda, is essential and urgent. Its passage in 2017 could be the landmark for a new cycle of economic growth.

Original target provided for in the Budget Law (LDO) has not been met since 2012

Original fiscal target provided for in the LDO and primary result achieved - Consolidated public sector
In R$ billion



Source: Ministry of Planning, Budget and Management (MPOG) and Central Bank of Brazil
**Note: The primary result for 2017 is a CNI forecast*

ISSN 1983-621X • Year 33 • Number 3 • July/September 2017

ECONOMIC ACTIVITY

Recovery under way

Consumption leads growth

A 0.2% increase in GDP recorded in the second quarter of 2017 met the market's highest expectations and was above the increase projected by CNI. This growth shows that the recession experienced in Brazil recently - one of the longest and deepest in the country's history - is over. This increase was the second one in a row and it confirms that the economy is recovering. What remains to be seen is how intense and lasting this recovery process will be.

The increase in GDP in the second quarter of 2017 is largely explained by an increase recorded in household consumption and its impact on trade. The 1.0% increase in the first quarter was driven by the outstanding performance of agriculture and livestock.

When industry is analyzed, however, it can be seen recovery was not recorded in all its segments. On the one hand, the manufacturing and mining and quarrying industries experienced a growth of 0.1% and 0.4% in the second quarter, respectively. In the case of manufacturing industry, it is worth noting that the growth recorded in the second quarter followed a 1.1% increase in the first quarter. On the other hand, the construction and public-utility industrial services industries (electricity generation and transmission, sanitation, etc.) have experienced a drop of 2.0% and 1.3%, respectively. The construction industry has been on the decline for six quarters in a row.

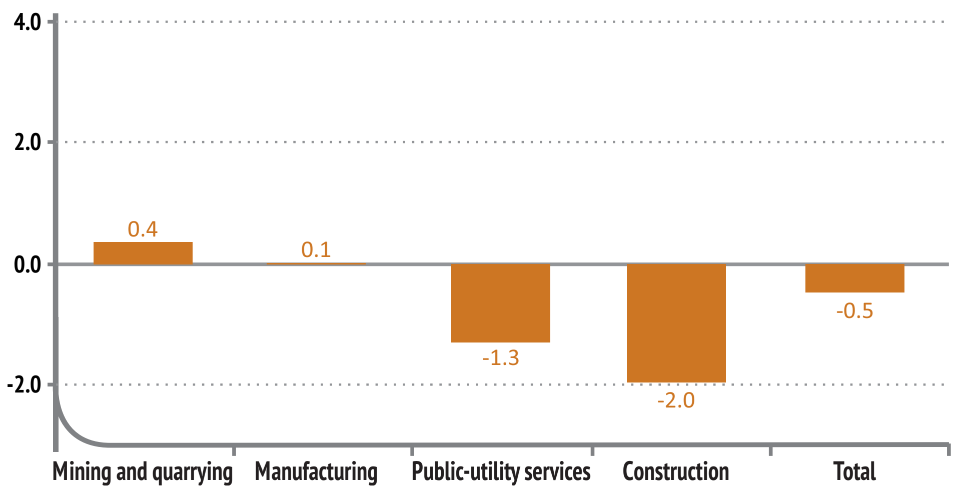
MANUFACTURING INDUSTRY RECOVERS

Among industrial segments, manufacturing industry is the one showing more consistent signs of recovery. However, activity data for that sector are still fluctuating and have not been sustaining continuous growth. While CNI's Industrial Indicators survey for July revealed very positive data for manufacturing industry, the August survey suggests that its recovery lost some pace. Comparing the quarter ended in August with the immediately previous one, that is, the one ended in May, its actual turnover rose by 1.4%, but small decreases of 0.3% and 0.4% were still recorded in employment and hours worked, respectively.

Data for production (PIM-PF/IBGE) are more positive. Production in the manufacturing industry remained stable in August, after having remained at the same levels for five months in a row in the monthly comparison. Comparing the three-month period to August with the previous three months, production increased by 1.7%.

Part of industry showed no growth

Components of Industrial GDP
Variation in the second quarter of 2017 compared to the previous quarter - seasonally adjusted (%)



Source: National Accounts/IBGE

Significant improvements were recorded in the mining and quarrying industry in relation to 2016: it grew by 7.1% in the year to August. This difference is influenced by a low base of comparison, affected by the rupture of a dam in the municipality of Mariana. However, the sector's performance has not been positive recently. In the monthly comparison, a decrease of 1.1% was recorded in August after a 1.4% decline in the previous month. Comparing the quarter ended in August with the previous one, production in the mining and quarrying industry decreased by 0.3%.

The construction industry continues to experience a period of declining activity levels, whose effects are being felt in employment. Surprisingly, CNI's Construction Industry Survey in August revealed that the sector's entrepreneurs were optimistic about the coming months, but the indices for current activity levels and the labor market in the segment continue to suggest declines - albeit gradually lower ones.

Confidence indices have been pointing to a better outlook for the coming months. The Industrial Entrepreneur Confidence Index (ICEI) for all industry segments (manufacturing, mining and quarrying, and construction) posted strong growth in September and has risen to a new confidence level. The indices have not only risen above 50 points (the dividing line separating confidence from lack of confidence) but they have also exceeded their respective historical averages in the manufacturing and construction industries. Confidence levels have increased due to improved expectations, particularly for the mining and quarrying and construction industries. In the manufacturing industry, there is also a perception of improved current business conditions.

During the rest of the year, manufacturing industry will register growth, stimulated by the recovery of household consumption (more on this later in this section). The mining and quarrying industry is likely to continue to grow in relation to last year, albeit at a slower pace at the end of the year.

The construction industry will in turn continue to face difficulties that are not likely to be removed in 2017. The government continues to contain spending, limiting investments in infrastructure and housing. In addition, consumer confidence remains low, restricting the sector's demand, particularly because it involves high amounts, long terms, and financing.

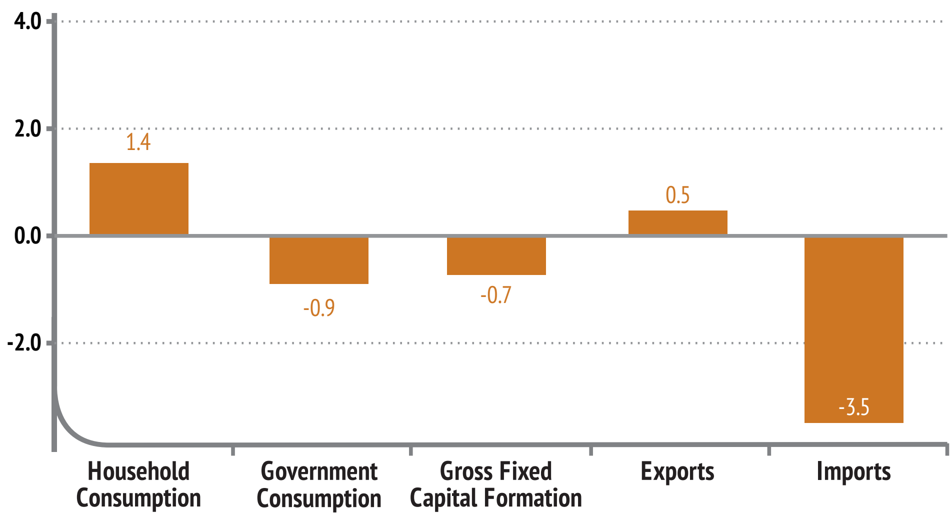
In this scenario, we are projecting a year-on-year increase of 0.8% in industrial GDP, the first positive result since 2013. This increase will be brought about by the growth of the mining and quarrying industry, of 7.2%, and of the manufacturing industry, of 1.4%. The construction industry, on the other hand, is likely to decrease by 2.3% in 2017.

CONSUMPTION-LED GROWTH

Household consumption increased by 1.4% in the second quarter of 2017 as compared to the previous quarter, which is the best result since the

Consumption improves results in Q2

Demand components in GDP
Variation in the second quarter of 2017 compared to the previous quarter - seasonally adjusted (%)



Source: National Accounts/IBGE

first quarter of 2014. Withdrawals from inactive accounts of the Workers' Severance Fund (FGTS) gave an additional impulse to the recovery of consumption - about R$40 billion were injected into the economy. In addition, consumption was favored by an increase in real income resulting from a slowdown in inflation, from the resumption of net job creation, and from an increase in credit availability.

Consumption will continue to drive the recovery of the economy. By the end of the year, the one-off stimulus to the economy provided by the withdrawals from the FGTS will likely weaken, but a new, albeit less intense stimulus may be provided with the approval of early withdrawals of funds from the PIS/Pasep social program for the elderly - which are expected to inject an additional R$16 billion into the economy.

In addition, the fall in food prices, which has increased disposable income, will continue to favor consumption. Further improvements are also likely in the credit market for individuals, as well as a further decrease in household indebtedness (see Inflation, Interest Rates and Credit). In this scenario, we are projecting a 0.8% increase in household consumption in 2017.

INVESTMENT CONTINUES ON A DOWNWARD PATH

Gross Fixed Capital Formation (GFCF) has been on a virtually steady decline for 15 quarters in a row (except for the second quarter of 2016, when it grew by 0.4%) in the series free of seasonal effects. Investment, as measured by GFCF, accounted for only 15.5% of GDP in the second quarter of 2017, while that percentage was about 20% before the crisis. Despite the drop in interest rates and improved confidence, investment continues to be discouraged by high idleness rates - it is only natural that new investments will only be made after machines and equipment are fully back in operation. Political uncertainties are also leading to the postponement of major investment decisions.

It is worth noting that the construction industry accounts for more than half of GFCF. And activity and willingness to invest remain very low in this industry. The investment intention index for the construction industry (Construction Industry Survey/CNI) stands at only 29.8 points on a scale of 0-100 points (the higher the index, the greater the willingness to invest). Willingness to invest is higher in the mining and quarrying and manufacturing industries (Industrial Survey/CNI): indices of 53.3 and 49.2 points, respectively.

We are therefore predicting a further reduction about 4% in GFCF in 2017. The low investment rate is worrying, but it is not likely to limit the recovery of economic activity for the time being. Installed production capacity is more than enough to meet expected demand over a long period of time. In the future, however, investments will be required to increase production capacity and respond to a rise in demand without growth being limited by inflation.

SCENARIO ABROAD WILL FAVOR GROWTH

The scenario abroad remains favorable, with high international liquidity and increased global trade and commodity prices (see the Foreign Sector section), which will ensure robust growth in sales abroad. We are projecting a growth of 8.0% in exports of goods and services in 2017.

Imports of intermediate products have been on the rise already in recent months, in response to increased industrial activity. Imports of consumer goods have also been increasing with the rise in household consumption and even imports of capital goods have been growing in recent months. This pace of improvement is lower than that recorded for exports, but the gap is narrowing. Our projections suggest that this scenario will continue and that imports of goods and services will increase by 1.2% this year.

Estimates for GDP and its components for 2017

Percentage change in GDP and its components

	GDP COMPONENTS	Percentage change (%)
Demand side	Household consumption	0.8
	Government consumption	-2.3
	Gross fixed capital formation	-4.0
	Exports	8.0
	(-) Imports	1.2
Supply side	Agriculture/livestock	11.0
	Industry	0.8
	Mining and quarrying	7.2
	Manufacturing	1.4
	Construction	-2.3
	Public utility industrial services	2.1
	Services	0.0
GDP		0.7

Prepared and estimated by: CNI

EMPLOYMENT AND INCOME

Labor market showing greater dynamism

Long path to recovery

After a long period of employment and real income on the decline, there are signs of improvement in the labor market and of a more intense recovery than expected.

Expectations in the first months of the year pointed to a modest upturn in employment due to the likelihood of weak economic activity. However, more significant progress in economic activity indicators, combined with a reduction in the basic interest rate and inflation control, created a favorable environment for unemployment to decrease and for real average income to increase from the second quarter.

The outlook for the last four months of 2017 remains positive due to the upturn in economic activity and increased confidence of entrepreneurs. In addition, changes to come into effect as a result of the Labor Reform can lead to an increase in temporary work contracts as early as by year's end as a result of the adoption of more flexible rules, which will make the labor market more dynamic and efficient.

It should be noted, however, that the economy is still suffering from the effects of the recession experienced by Brazil in recent years. The unemployed population amounts to over 13 million people and employment has been recovering through informal jobs - which are usually lower quality and less stable jobs.

In this scenario, CNI estimates that the average unemployment rate in 2017 will amount to 12.9% of the workforce, 1.4 percentage points (p.p.) above the average in 2016, when the rate was 11.5%.

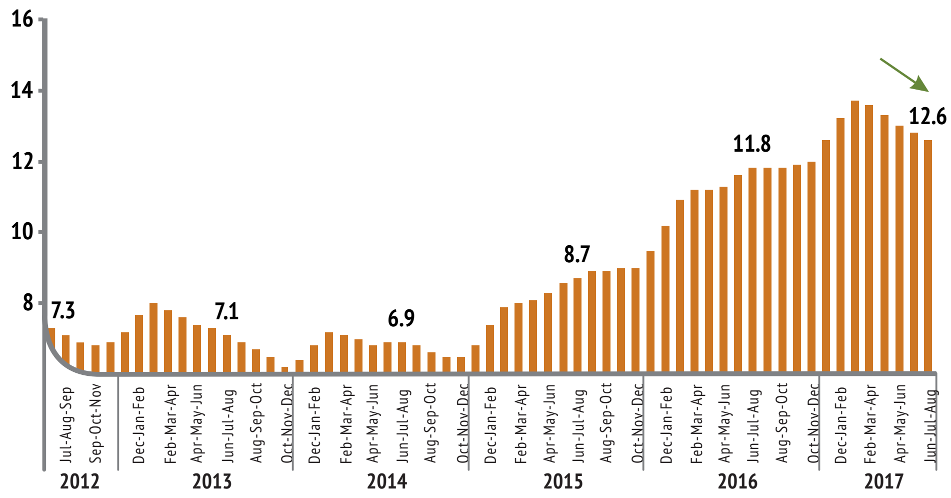
UNEMPLOYMENT REMAINS ON A DOWNWARD PATH, BUT RATE IS STILL HIGH

In 2017, the unemployment rate resumed its usual decline from the second quarter of each year - a behavior interrupted by the economic crisis of 2014 - due to the seasonal effects and a more significant increase in economic activity. From April, when it began to fall, until the third mobile quarter ended in August, the indicator declined by 1.1 percentage points.

Nonetheless, the unemployment rate hit the mark of 12.6% in the quarter ended in August, the highest rate in the series of the monthly National Continuous Household Survey (Continuous PNAD/IBGE), which began to be carried out in 2012.

Unemployment rate on a downward trend since April

Unemployment rate - annual average
As a proportion of the workforce (%)



Source: PNAD Contínua Mensal (Monthly Continuous PNAD)/IBGE

The change in the behavior of the employed population has been a key factor for reversing the unemployment rate. Between March and August, the employed population grew by 2.1 million people - from 89.9 million to 91.1 million people.

It should be highlighted that the result of the unemployment rate has been mainly determined by an increase in informal jobs. From March to August, the number of informal workers increased by 576,000 (from 10.2 million to 10.7 million people). At the same time, the number of formal workers increased by only 6,000.

The labor force - another component of the unemployment rate - continues to grow. The better performance of economic activity made it possible for more people who had stopped looking for a job - those discouraged with finding a job – to return to the labor market in search of a job.

CAGED RECORDS NET JOB CREATION ONCE AGAIN

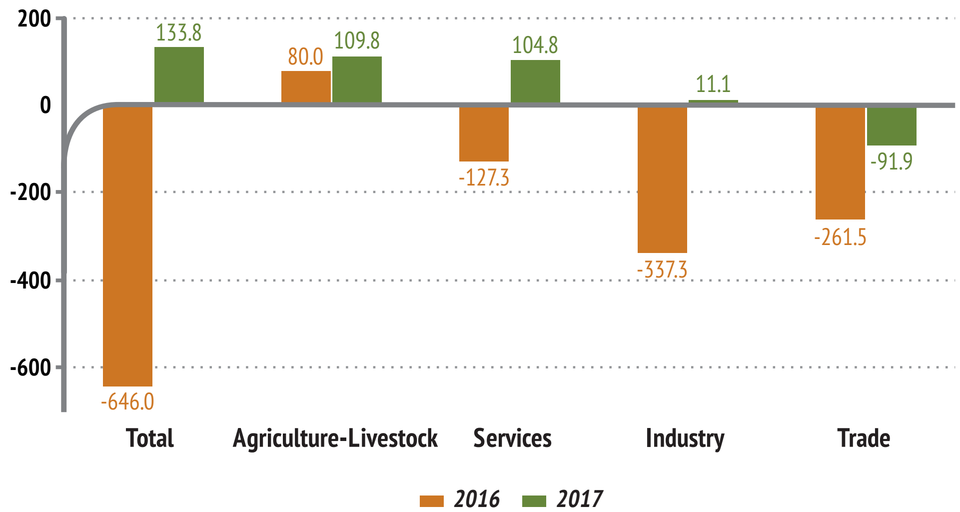
According to the General Register of Employed and Unemployed Individuals (CAGED/Ministry of Labor and Employment [MTE]), conditions in the formal labor market improved in 2017. In the year to August, Brazil recorded a net creation of 134,000 formal jobs, against a net loss of 646,000 jobs over the same period in 2016.

Agriculture and Services accounted for the net creation of 110,000 and 105,000 jobs, respectively, the best result of the year. At the same time, 92,000 jobs were lost in the Trade sector over the same period.

The contribution of Industry was positive, but it amounted to only 11,000 jobs. On the one hand, this result was influenced by the manufacturing industry, where 54,000 jobs were created in the year to August; on the other hand, it was influenced by the construction industry, in which 41,000 jobs were lost during the same period.

Economy continues to record net job creation in 2017

Net balance of formal jobs by economic activity
In 1,000 (from January to August)



Source: CAGED/MTE

INFLATION ON THE DECLINE LEADS TO AN UPTURN IN INCOME

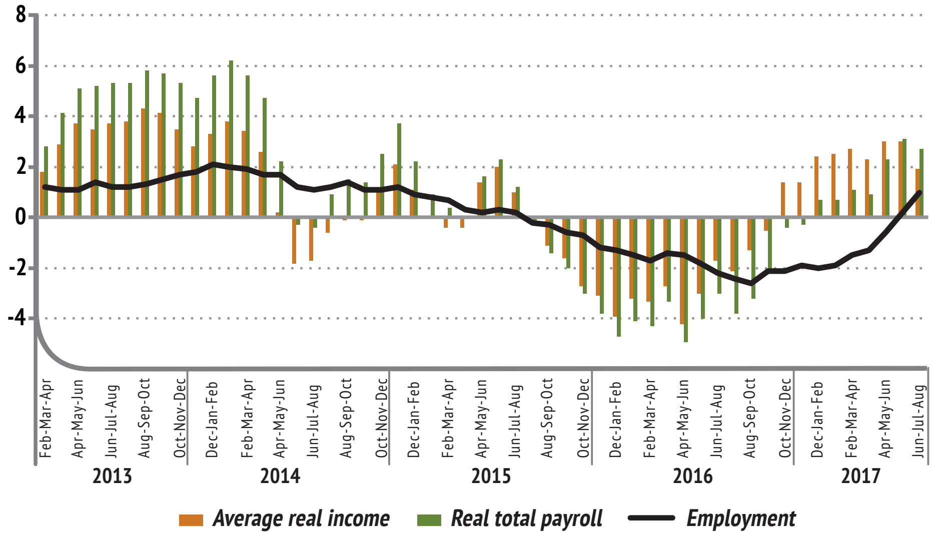
After shrinking throughout 2016 - except in December - real average income took an upturn in 2017. In the quarter ended in August, average real income increased by 1.9% compared to the same period the year before. This result was mainly possible due to the strong disinflation recorded during the year (see the section Inflation, Interest Rates and Credit), which made it possible for wages to be indexed above inflation, as measured by the National Consumer Price Index (INPC).

The increase in income and employment had an impact on real total payroll, which recorded an increase of 2.7% in the quarter ended in August in relation to the same quarter in the previous year. The increase in real total payroll is fundamental for the recovery of household consumption, which declined by 4.2% in 2016 in relation to 2015.

Considering that inflation will remain on a downward path and employment will continue to rise until the end of the year, CNI estimates that real total payroll will grow by 2.0% in 2017, after decreasing by 3.5% in 2016.

Increase in total payroll signals a better outlook for consumption

Average real income, real total payroll and employment
Variation as compared to the same mobile quarter the year before (%)



Source: Monthly Continuous PNAD/IBGE

INFLATION, INTEREST RATES AND CREDIT

Inflation on the decline continues to surprise

Favorable behavior of prices paves the way for the Selic rate to be further reduced to 7%

The current process of disinflation has been surprising economic agents for its duration and intensity. The Extended National Consumer Price Index (IPCA) posted a variation of 2.5% in the 12-month period to September, remaining below the lower band of the target set by the National Monetary Council (CMN), 3% currently.

The unexpected performance of the indicator was mainly explained by the favorable behavior of food prices, which fluctuated well below the usual figures recorded in such period due to a record crop harvest. After rising by 16.1% in 12 months to September 2016, food prices dropped by 5.3% in the 12-month period ended in the same month in 2017.

Moreover, the effects of the strong recession on demand have influenced price formation and contributed to the widespread disinflation observed among the IPCA components.

The diffusion index disseminated by the Central Bank of Brazil (BACEN), which measures the percentage of IPCA sub-items with a positive variation in a month, recorded an average of 46.7% in the quarter ended in September 2017. In the same period the year before, the index was 60.0%.

The disinflation process can be felt even in service prices, which are less sensitive to monetary policy. Service prices, which are usually marked by strong inertia, experienced a rather sharp drop. The 12-month rate declined from 7.0% in September 2016 to 5.0% in September 2017.

A rise in fuel prices resulting from an increase in the rates of the Social Integration Program (PIS)/ Contribution to Social Security Financing (COFINS) pushed government-regulated prices up more intensively in July and August. The most significant variations recorded in these two months pushed the 12-month rate up to 6.1% in September, as a result of which government-regulated prices have been pressuring inflation up the most. However, the rate of this price group is still below that observed in the 12-month period ended in September 2016, when it hit the mark of 7.9%.

The favorable behavior of inflation is expected to continue during the remainder of the year, despite a moderate increase in the inflation rate in the last quarter due to the seasonal behavior of food prices. As a result, the IPCA index will likely close 2017 at 3.1%, 1.4 percentage points (p.p.) below the 4.5% target set by the CMN for this year.

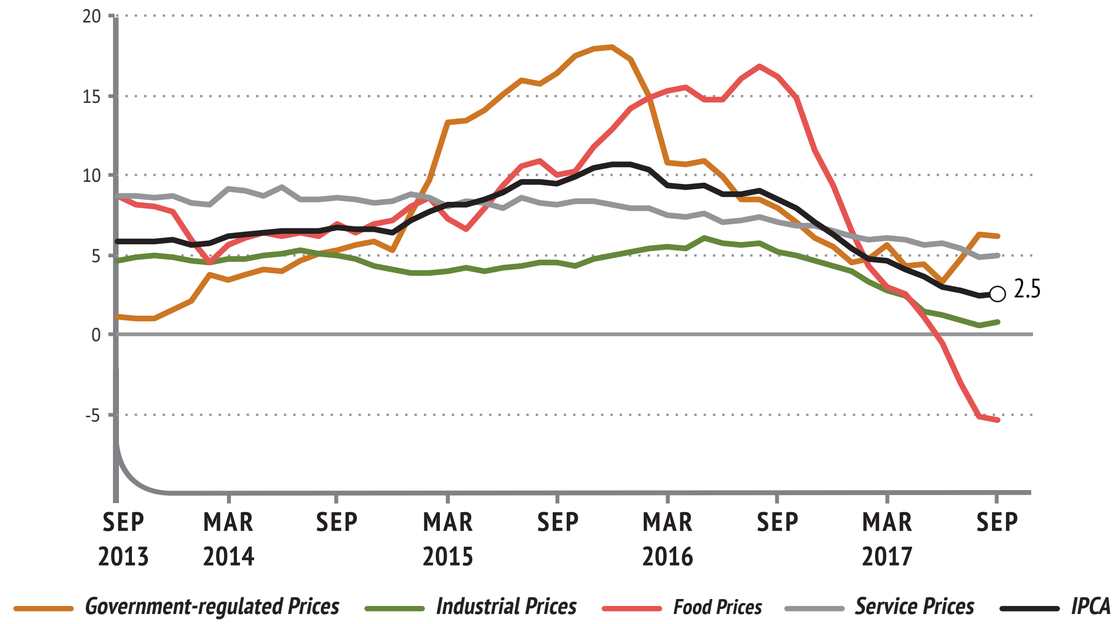
SELIC RATE LIKELY TO DROP TO 7% IN LATE 2017

The recent political turmoil in Brazil has not affected the orientation of monetary policy as initially suggested. The Monetary Policy Committee (Copom) reduced the Selic rate by 4 percentage points in its last four meetings, mainly based on the significant downturn in the IPCA index and on expectations that inflation will remain below the target set for 2018. The basic interest rate was thus reduced to 8.25% in early September, reaching its lowest level since 2013.

The still high rate of idleness in the economy and anchored inflation expectations made it possible for the Central Bank to adopt a strongly expansionist monetary policy based on interest rates below the neutral rate with the aim of promoting economic recovery. However, taking into account the current stage of the monetary easing cycle, the pace of interest rate reductions is likely to be gradually reduced.

Disinflation process remains strong

IPCA by groups - 12-month rate
As a percentage (%)



Source: IBGE - Prepared by CNI

ISSN 1983-621X • Year 33 • Number 3 • July/September 2017

We are therefore projecting reductions of 0.75 and 0.5 percentage points in the Selic rate in the last two meetings of the Copom to be held this year. As a result, the rate will likely close 2017 at 7% per year.

COST OF CREDIT CONTINUES ON A DOWNWARD TREND

Successive reductions in the Selic rate have made it possible to reduce financing costs for companies and households, although they are still far from ideal.

Interest rates on non-earmarked loans fell from 53.0% a year in August 2016 to 45.6% a year in the same month in 2017. The drop was sharper for individuals, whose average financing costs decreased from 72.4% to 62.3% a year during the same period, while for companies they increased from 30.5% to 24.4% a year.

The behavior of concessions, however, is different for individuals and companies. For the former, they increased by 3.6% in real terms in the comparison between the year to August and the same period in 2016, while for the former they dropped by 6.8% on the same comparison basis.

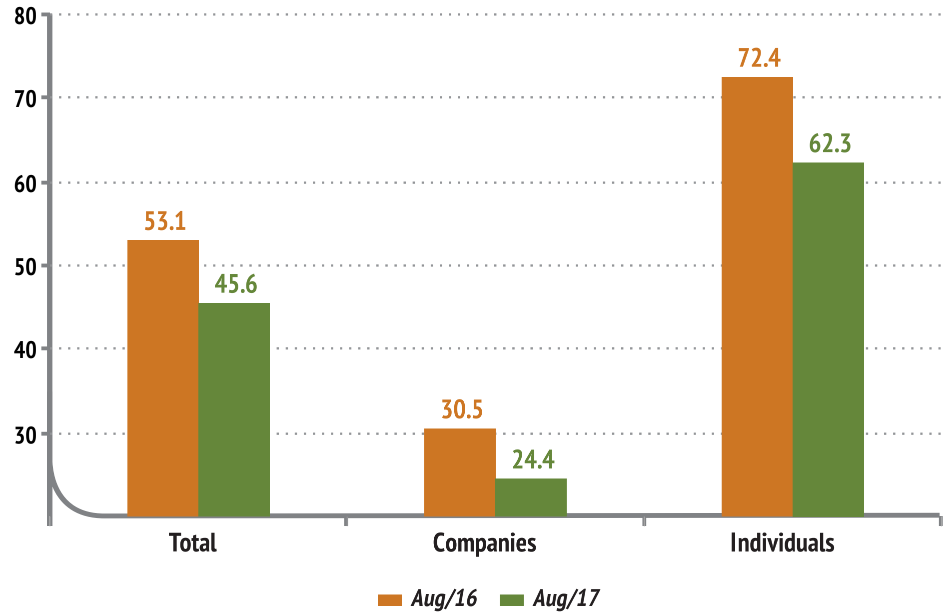
The reduction in household indebtedness and increase in real income caused by the sharp drop in inflation made it possible for households to resume consumption gradually.

Companies, however, remain highly indebted and with idle capacity, which are factors that inhibit demand for investment financing.

The process of financial deleveraging of companies and households is likely to continue in the coming months. The pace of decrease in balances, however, will likely be slower than the one observed so far, due to the positive results of expected additional reductions in the basic interest rate and of the resumption of economic activity.

Reduction of the average cost of financing

Average interest rate on credit operations with non-earmarked funds
As a percentage per annum (% p.a.)



Source: Central Bank of Brazil

CNI

New interest rate on long-term financing: TLP will replace TJLP

In September, Law No. 13,483 of 2017 was enacted, which created the Long-Term Rate (TLP) to gradually replace the Long-Term Interest Rate (TJLP) currently applied to loans granted by the National Economic and Social Development Bank (BNDES).

The TLP, which will come into effect on January 1, 2018, will be composed of two factors: i) a prefixed rate, based on the National Treasury Bill - B Series (NTN-B) with a five-year maturity; and ii) the inflation rate, as measured by the National Consumer Price Index (IPCA). All the details about this calculation were defined in BACEN's Resolution 4,600.

The TLP will be stable, in real terms, during the entire period of the financial operation, meaning that the fixed rate will be defined at the beginning of the contract and will remain constant throughout the operation. The nominal rate, the one actually paid by the borrower, will in turn vary monthly according to the inflation rate (IPCA).

The TJLP will not be replaced by the TLP immediately. It will take five years for the transition to be completed and for loans to be exclusively determined by the TLP. Among the implications of this change, special mention should be made of a likely increase in the financing cost of BNDES contracts. In addition, the rate's instability caused by the inflation component may interrupt or prevent investment projects, making it difficult for the economy to recover.

Those who drew up the proposal, however, believe that this change will reduce the cost of implicit subsidies in BNDES credit operations and thus contribute to controlling the public debt. In addition, they argue that the TLP improves the effectiveness of the country's monetary policy by increasing the acting power of the basic interest rate, reducing the average interest rate in the economy.

It should be noted, however, that for these expectations to materialize the authorities must be committed to the goals of fiscal and monetary policies, so that inflation may be kept at low levels and pressures on the perception of country risk may be avoided. In addition, changes will be required in BNDES funding and measures must be taken to boost the private long-term financing market.

FISCAL POLICY

Lifting of budget spending restrictions increase public spending in 2017

Increased revenues enable the federal administration to meet the fiscal target

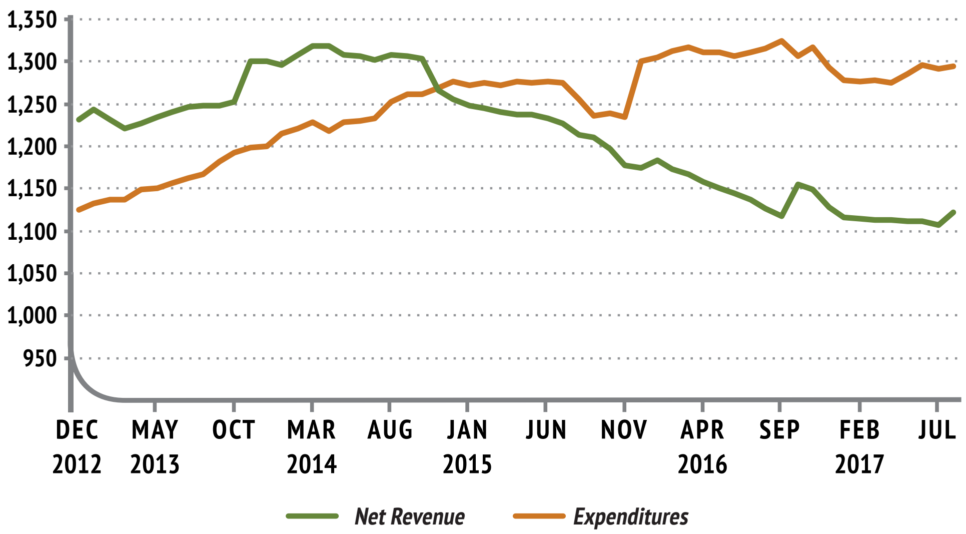
Fiscal policy is likely to be somewhat reversed in the second half of 2017. Public spending is likely to take an upturn once again after heavy restraints were imposed by federal and state governments in the first months of the year.

Late in the first half of the year, early court-ordered debt payments reversed a real drop in federal spending. This effect would be reversed in the second half of the year, but due to the lifting of budget spending restrictions after the primary deficit target was widened, federal public spending will likely close the year with a real increase. States and municipalities also increased their spending in response to a real growth in revenues.

The impact of this increased spending on public accounts will likely be offset by increased

Spending in the 12-month period to August 2017 was 1.6% higher than in the 12 months to April 2017, the month prior to the one in which early court-ordered debt payments began to be made

Evolution of expenditures and of the net revenue of the federal government
In 12 months (R$ billion from August 2017)



Source: National Treasury Secretariat / Ministry of Finance.
Prepared by: CNI

revenues. In this scenario, the primary deficit is likely to remain within the new fiscal target and to close 2017 slightly below the one recorded in 2016. Because interest spending in 2017 is also expected to be slightly lower than in 2016, the nominal result will be less negative. These results will not, however, be sufficient to prevent a further increase in the public sector debt.

EARLY PAYMENTS INCREASE FEDERAL SPENDING

Federal government primary spending increased by 0.3% in real terms (as deflated by the IPCA index) between January and August 2017 in relation to the same period the year before. Were it not for the decision to make early court-ordered debt payments, which in 2016 were concentrated in the last months of the year, spending would have decreased by 2.0% in real terms on the same comparison basis. Early payments in the first eight months of 2017 amounted to R$18 billion.

Therefore, excluding the effects of early court-ordered debt payments, it becomes clear that fiscal adjustment efforts were focused on the expenditure side. However, the rigidity of public spending in Brazil led to an undesirable composition of this adjustment that tends to undermine possibilities for medium and long-term economic growth.

Because compulsory spending, particularly with social security benefits, is subject to rules that increase it constantly, the adjustment must necessarily focus on non-mandatory spending, which has greater weight on investment.

Among compulsory expenditures, spending on personnel and pensions have increased sharply. Spending on personnel increased by 10.7% in real terms in the first eight months of 2017 compared to the same period in 2016. Although payroll increases automatically and there is little control over it, this growth level is due to wage increases granted to civil servants in the second half of 2016 and in January 2017 and to early court-ordered debt payments. However, even excluding the effect of court-ordered debt payments, spending on personnel would increase by 8.3% on the same basis of comparison.

Spending on pensions increased by 6.7% in real terms in the first eight months of 2017 compared to the same period in 2016. The reasons for this increase are the following ones: increase in the value of the benefits, increase in the number of beneficiaries, and early court-ordered debt payments. However, even without the effect of court-ordered debt payments, social security expenditures would have increased by 5.3% in real terms on the same comparison basis.

In an attempt to prevent a further deterioration in public accounts as a result of increased spending on personnel and pensions, the federal government compulsory expenditures reduced non-compulsory spending and even some compulsory expenditures, such as with salary bonuses, unemployment insurance, and subsidies.

In the case of non-compulsory spending, which declined by 14.6% between January and August 2017 in relation to the same months in 2016, costs were contained by reducing investments. Capital expenditures (excluding subsidies for the "My House, My Life" program) decreased by 33.3% in real terms on the same basis of comparison.

FEDERAL GOVERNMENT REVENUES SHOW SIGNS OF RECOVERY

Net federal government revenues decreased by 0.7% in real terms between January and August 2017 compared to the same period in 2016. However, revenues have been showing signs of recovery throughout the year. In the previous edition of this Economic Report, net revenues posted a real decrease of 3.3% in the first five months of 2017 compared to the same period in 2016.

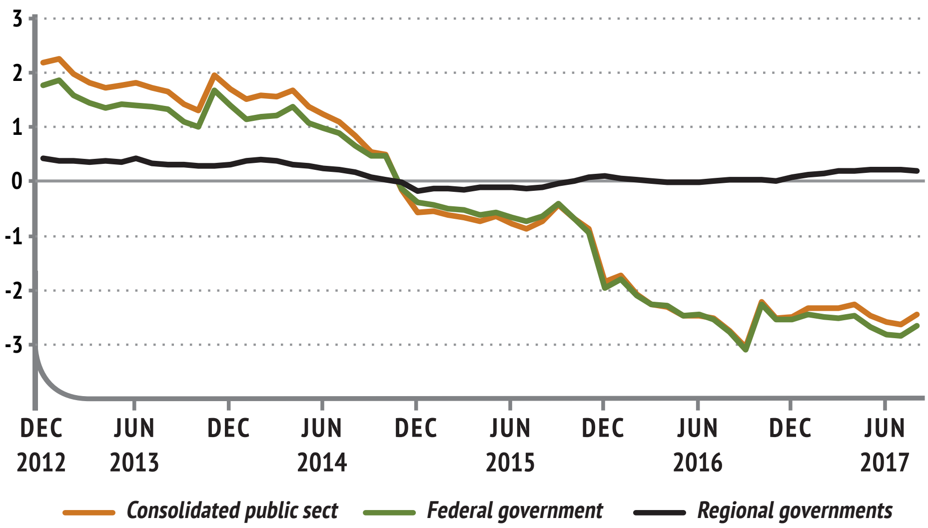
Among the three main components of federal government revenues, special mention should be made of a real increase of 1.2% in revenue managed by the Brazilian Internal Revenue Service in the first eight months of 2017 in relation to the same months in 2016. The increase in revenues managed by the Federal Revenue Service can be explained by specific factors such as programs for installment payment of tax debts and regularization of funds kept abroad and by conjunctural factors such as the effects of increased industrial production on the tax on industrialized products (IPI) and of total payroll on the income tax. Moreover, in the latter case, non-indexation of the income tax rate table led to an increase in taxation due to the total or partial indexation of wages to inflation.

Revenues not managed by the Internal Revenue Service also increased by 0.4% in real terms in the first eight months of 2017 compared to the same period in 2016. In addition to a significant increase in revenues from financial compensation for mineral exploration and dividends on the same comparison basis, the return of R$6 billion in court-ordered debt paid by the federal government that were not redeemed by their beneficiaries also contributed to this result.

The revenue of the social security system was the only revenue component to post a drop, as it recorded a real decrease of 0.3% between January and August 2017 in relation to the same period in 2016. Although it is still on the decline, the revenue of the social security system has also been showing signs of recovery throughout the year after declining by 2.5% between January and May

Regional primary surplus in 12 months increased by 0.3 percentage points of GDP between December 2016 and August 2017

Primary result of the consolidated public sector and by levels of government
As a proportion of GDP (%)



Source: Central Bank of Brazil.
Prepared by: CNI

2017. This recovery is due to an increase in real total payroll and it tends to become more intense as formal employment increases.

INCREASE IN REVENUES PAVES THE WAY FOR HIGHER SPENDING BY REGIONAL GOVERNMENTS

As recorded for the federal government, the revenues of states and municipalities also posted growth over the course of the year. Monthly data available indicates that the revenues of regional governments increased by 3.3% in real terms between January and July 2017 compared to the same period in 2016. In the year to April, revenues grew by 2.2% in real terms.

All three revenue groups for states and municipalities for which monthly data is available posted growth in the first seven months of 2017 compared to the same period in 2016. Revenues from the turnover tax (ICMS), which is the main source of revenue for regional governments, grew by 1.5% in real terms on the same basis of comparison. In addition, transfers from the federal administration and revenues from other taxes also posted real increases of 7.9% and 1.6%, respectively.

Based on this information on revenues and on the primary result of regional governments and their enterprises, CNI estimates that state and municipal spending increased by 2.3% in real terms in the first seven months of 2017 in relation to the same period in 2016. Until April 2017, such spending was down by 0.1%. However, the increase in revenues paved the way for reversing the drop in spending recorded over the past two years, which was due to restrictions imposed on states and municipalities by the Fiscal Responsibility Law and debt renegotiation agreements with the federal administration.

RELATIVELY STABLE FISCAL RESULTS IN THE FIRST EIGHT MONTHS OF 2017

Because the change in expenditure containment was accompanied by improved revenues, fiscal results recorded up to August 2017 have not changed significantly compared to late 2016. Over the last 12 months ended in August, the public sector posted a primary deficit of R$157.8 billion (2.44% of GDP), while in 2016 the primary deficit amounted to R$155.8 billion (2.49% of GDP).

It is worth noting that if the federal government had not made early court-ordered debt payments, the primary deficit in the 12-month period to August 2017 would have amounted to R$139.5 billion (2.16% of GDP).

In addition to a stable primary deficit, nominal interest expenditures also remained at about 6.5% of GDP both in the 12-month period ended in August 2017 and in the 12 months ending in December 2016. As a result, the 12-month nominal deficit remained at 8.98% in both periods being compared. Given the low nominal GDP growth, this nominal deficit level continued to push the public debt up. The gross debt-to-GDP ratio soared from 69.9% in December 2016 to 73.7% in August 2017.

WIDENING OF THE FISCAL TARGET MADE IT POSSIBLE FOR IT TO BE MET, BUT AT THE EXPENSE OF INCREASING THE PUBLIC DEBT

The federal government managed to approve a change in the primary deficit target from R$139 billion to R$159 billion in 2017. This change will make it possible for the target to be met despite the lifting of restrictions on expenditures earmarked in the budget that had been blocked, amounting to R$12.8 billion. Because regional governments will likely post a primary surplus and therefore exceed the fiscal target, the consolidated public sector is likely to record a primary deficit slightly below the target in 2017.

As compared to August, the lifting of restrictions on non-compulsory spending by the federal government is likely to push total spending up, which will likely close the year up by 1.3% in real terms. Cost and capital expenditures, which had dropped by 11.8% between January and August 2017 compared to the same period in 2016, will likely close the year with a real decrease of 8.4%.

Spending on personnel is likely to decrease in real terms from the current level of 10.7% to 6.5% due to the elimination of the effects of early court-ordered debt payments. Finally, social security expenditures will likely increase from 6.7% up to August to 6.9% at the end of the year. In this case, the elimination of the effect of early court-ordered debt payments will not be sufficient to make up for the effects, during the year, of increases in the value of the benefits and in the number of benefits paid.

The federal government net revenue is likely to continue to improve in the last months of the year. Thus, the net revenue will likely reverse the current decrease of 0.7% and close the year up by 1.8% compared to 2016. This reversal will likely be brought about by a higher increase in revenues not managed by the Federal Revenue Service and in social security revenues.

Revenues not managed by the Internal Revenue Service are likely to increase due to the revenue generated by concessions of hydroelectric power plants and oil exploration fields, which exceeded by R$4 billion the amount of R$12 billion estimated by the federal government. Social security revenues are in turn likely to close 2017 up by 0.6% in real terms due to the expected increase in real total payroll.

In this scenario, CNI estimates that the Federal Government and its enterprises will likely close the year with a primary deficit of R$159 billion (2.4% of GDP as estimated by CNI), below the new target of R$162 billion.

In the case of regional governments and their enterprises, expenditures are likely to continue to grow as a result of improved revenues. In addition, a fiscal recovery agreement signed between the federal administration and the state government of Rio de Janeiro will lift restrictions imposed on funds currently earmarked for debt repayment to cover primary expenses. On the other hand, revenues are likely to remain on an upward path, as the recovery of economic activity favors revenues from the turnover tax (ICMS). This effect will likely make up for the lower increase in transfers from the federal administration, which will not rely on as many extraordinary resources as in 2016, when they increased as a result of the regularization of funds kept abroad.

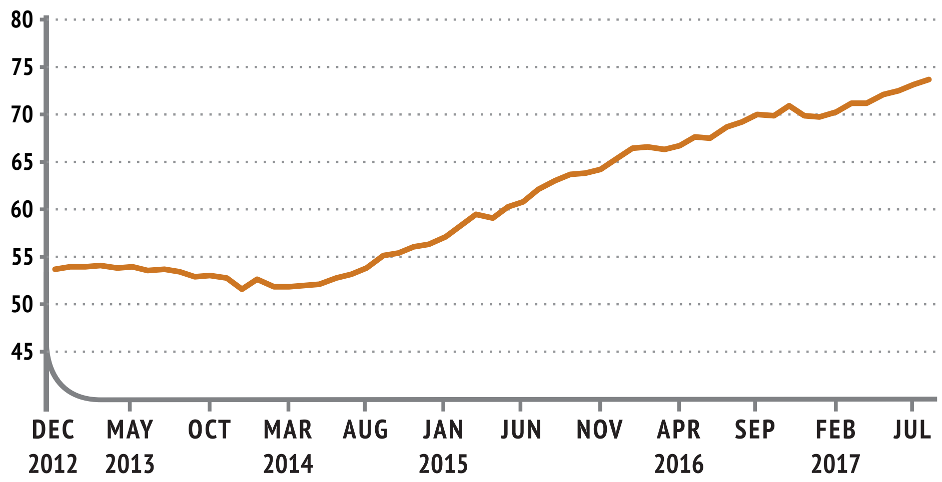
Therefore, regional governments will likely post a primary surplus of about R$2.5 billion (0.04% of GDP as estimated by CNI). As a result, the consolidated public sector will likely post a primary deficit of R$156.5 billion (2.35% of GDP) in 2017 and meet the target of R$163.1 billion set for the year.

If this result is confirmed, the primary deficit in 2017 will be lower than the one recorded in 2016 (2.49% of GDP). Due to the fall in the Selic rate and the slight exchange rate appreciation expected for the year, nominal interest spending is likely to decline from 6.49% of GDP in 2016 to 6.31% in 2017. Thus, the nominal deficit will likely fall from 8.89% of GDP in 2016 to 8.66% of GDP in 2017.

Albeit lower, this nominal result will not be sufficient to stabilize the gross debt-to-GDP ratio, which is projected to rise from 69.9% in December 2016 to 73.7% in December 2017. Were it not for the widening of the primary deficit target, that projection would be 0.3 percentage points lower than GDP. These projections already take into account the gross debt reducing effect of the return of R$50 billion from BNDES to the National Treasury.

The gross debt-to-GDP ratio increased by 3.8 percentage points between December 2016 and August 2017

Trajectory of the Public Sector Gross Debt in relation to GDP
As a proportion of GDP (%)



Source: Central Bank of Brazil

Economic Report
ISSN 1983-621X • Year 33 • Number 3 • July/September 2017

FOREIGN TRADE SECTOR

Record trade surplus ensures adjustment in foreign accounts

Exchange rate stabilizes in response to a favorable scenario abroad

The result of Brazilian foreign accounts was solid as the deficit in current transactions remains on a downward path and the amount of direct investments in the country is more than sufficient to cover that deficit. With the gradual recovery of domestic demand, we expect the deficit to resume an upward path at the end of the year. Nonetheless, the current account balance will remain at a comfortable level, closing 2017 at only US$15 billion, 0.7% of projected GDP.

A high trade surplus has contributed to reducing the deficit in current transactions throughout the year. The balance projected by CNI is US$64 billion by the end of 2017. Exports are expected to increase by 16.1% (US$215 billion) and imports by 9.8% (US$151 billion) compared to the previous year.

The exchange rate remained stable during the third quarter of 2017, mainly due to favorable international conditions, marked by abundant liquidity and consistent growth of the world economy.

The beginning of the third quarter was marked by an appreciation of the Brazilian real that brought the exchange rate back to the level observed in May. After that, the exchange rate remained fairly stable throughout the quarter. The average exchange rate (real/US dollar) in September was R$3.13/US$1, down by 0.5% from the previous month. As compared to the average recorded in December 2016, the Brazilian real has appreciated by 6.5%.

The fact that conditions abroad remain favorable for emerging countries, with an abundance of international funds, has contributed to push the Brazilian currency up. Developed countries at large have been posting growth and inflation rates consistent with low interest rates, favoring investment in risky assets.

A point deserving attention, which could reduce global liquidity, is the fact that the Federal Reserve (FED, the US central bank) might raise the benchmark interest rate once again this year, despite

Exchange rate back to the level recorded in May

Daily exchange rate (Ptax closing rate) in 2017*
In R$/US$

Source: Central Bank of Brazil
Prepared by: CNI
** The Ptax closing rate is the arithmetic average of bid and offer rates published in daily bulletins*

stable and low inflation data. However, if this occurs, this movement will be slow and is not likely to affect the availability of funds significantly until the end of the year.

Domestically, uncertainties remain high due to the evolution of the reform agenda and the possibility of new political events. However, the forces that have been keeping the exchange rate stable despite the political scenario are likely to prevail in the short term.

This scenario may change in the medium term due to the widening of primary result targets set for 2017 and 2018, which increases the difficulties faced by government to reverse the upward trajectory of public debt. As a result of these revisions, credit rating agencies may end up lowering the country's rating, leading to an outflow of funds and to devaluation of the Brazilian currency.

Considering that the scenario abroad is likely to remain favorable for emerging countries despite the above-mentioned risks, we are forecasting an exchange rate of about R$3.20/US$1 at the end of the year.

TRADE BALANCE KEEPS RISING STRONGLY

The Brazilian trade balance registered a surplus of US$53.3 billion in the year to September, up by 47.3% over the same period in 2016 (US$36.2 billion). Exports totaled US$164.6 billion, having grown at 18.7% in the daily average, while imports amounted to US$111.3 billion, up by 8.5% on the same basis of comparison.

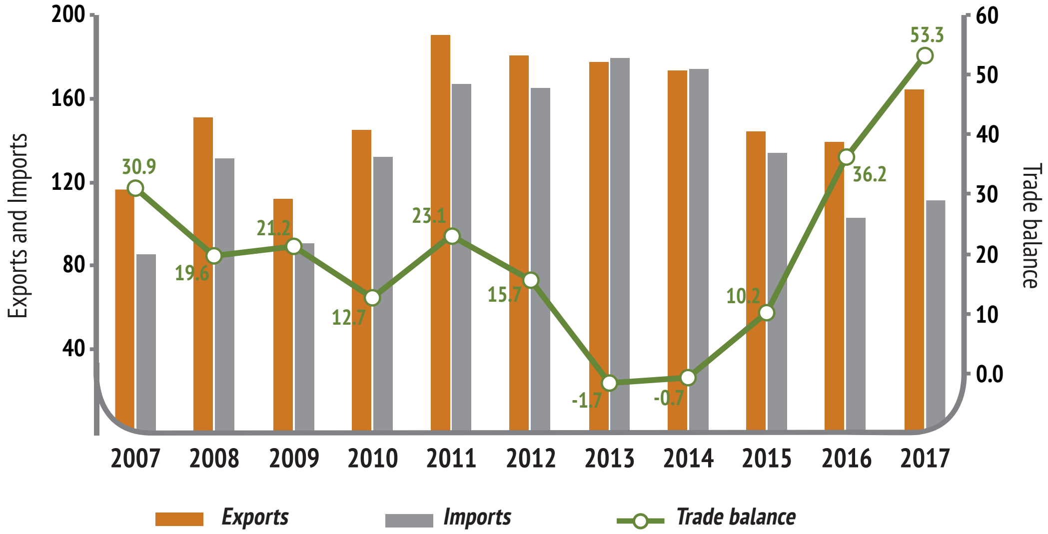
The increase in exports is mainly explained by basic products. In the classification of exports by aggregate factor, those of all products increased in the daily average in the year until the third quarter against the same period last year: basic products (26.9%), semimanufactured products (13.7%), and manufactured products (11.2%).

According to their classification by major economic categories, increases were recorded in the daily average of imports of fuels and lubricants (35.3%), of intermediate goods (11.4%), of durable consumer goods (6.4%), and of non-durable consumer goods (5.5%) in the year to September against the same period the year before. Only imports of capital goods decreased by 18.6% on the same comparison basis. It should be stressed that imports of capital goods increased in September for the second consecutive month in relation to the same month the year before, suggesting the beginning of a gradual recovery in investment.

In the evaluation of the price and quantum indices measured by FUNCEX, the second four months of the year were marked by an increase in both price and exported volume. In the year to August, the price index rose by 13.6% and the volume of exports increased by 4.3% compared to the same period last year, unlike what was observed in the first four months, when exports increased basically

Brazil shows good performance in the foreign trade sector in the third semester

Exports, imports and trade balance in the year to September
In US$ billion



Source: SECEX/MDIC.
Prepared by: CNI

due to prices. On the other hand, imports posted a 4.4% increase in the price index and a 2.8% increase in the imported volume index from January to August 2017 compared to the same period the year before.

With the gradual recovery of economic activity, we expect exports to remain at current levels until the end of the year and imports to increase at a slightly higher pace. As a result, the balance of the trade balance as estimated by CNI for 2017 will amount to US$64.0 billion, with exports growing by 16.1% (US$215 billion) and imports increasing by 9.8% (US$151 billion).

SOLID RESULT IN EXTERNAL ACCOUNTS

The upward trajectory of external accounts observed since the beginning of 2015 has continued throughout 2017. The deficit in current transactions amounted to US$13.5 billion (0.7% of GDP) in the 12-month period to August. Since December 2014, when the series' worst result was recorded, US$104.2 billion, the deficit fell by 87.1%.

Direct investment in Brazil amounted to US$82.5 billion in the 12-month period to August, equivalent to 4.2% of the 12-month GDP, more than enough to cover the current account deficit.

Between January and August 2017, the current account deficit amounted to US$3.0 billion, down by 77.0% over the same period in 2016 (US$13.1 billion). The main contribution came from the trade balance, which posted a surplus of US$46.3 billion against US$30.6 billion, up by 51.3% on the same comparison basis.

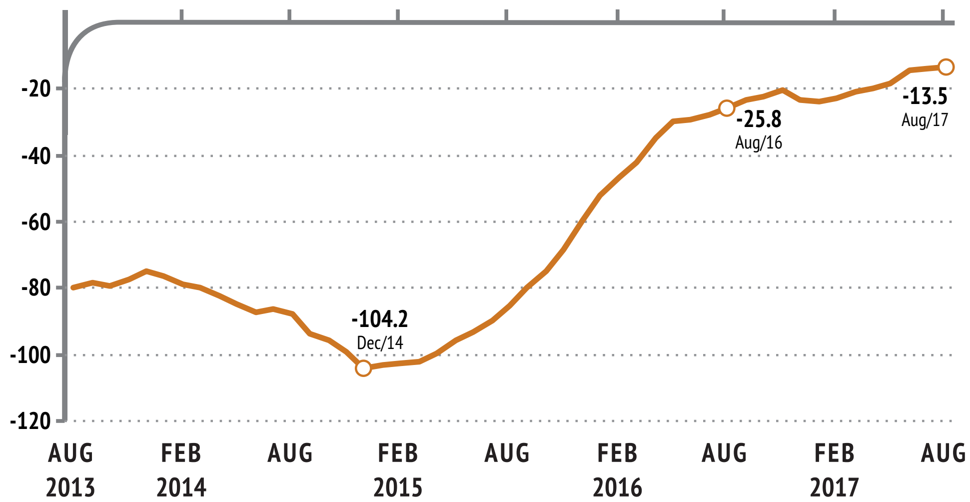
On the other hand, the deficit in the service and primary income accounts increased. The deficit in the service account rose from US$19.3 billion in the period between January and August 2016 to US$21.5 billion in the same period in 2017. Special mention should be made of a 77% increase in the deficit in international travel on the same basis of comparison.

The deficit in primary income increased from US$26.3 billion between January and August 2016 to US$29.2 billion during the same period in 2017. A decrease was recorded in the surplus in secondary income, old unilateral transfers, from US$1.9 billion to US$1.3 billion.

The high trade surplus has contributed to reducing the deficit in current transactions. For the rest of the year, we project smaller balances with an increase in the growth pace of imports due to the recovery of domestic demand. Therefore, the deficit in current transactions is likely to amount to US$15 billion in 2017, 0.7% of projected GDP, according to CNI.

Deficit in current transactions decreases

Balance in current transactions in the year to August
In billions US$



Source: Central Bank of Brazil

Economic Report
ISSN 1983-621X • Year 33 • Number 3 • July/September 2017

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2015	2016	2017 previous forecast (Economic Report - Jun/17)	2017 current projection
ECONOMIC ACTIVITY				
GDP (annual change)	-3.8%	-3.6%	0.3%	**0.7%**
Industrial GDP (annual change)	-6.3%	-3.8%	0.5%	**0.8%**
Household consumption (annual change)	-3.9%	-4.2%	0.1%	**0.8%**
Gross fixed capital formation (annual change)	-13.9%	-10.2%	-2.7%	**-4.0%**
Unemployment Rate (annual average - % of the labor force)	8.5%	11.5%	13.5%	**12.9%**
INFLATION				
Inflation (IPCA index - annual change)	10.7%	6.3%	3.6%	**3.1%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	13.47%	14.18%	10.45%	**10.15%**
(year's end)	14.25%	13.75%	8.50%	**7.00%**
Real interest rate (average annual rate and deflation: IPCA)	4.1%	5.0%	6.6%	**6.4%**
PUBLIC ACCOUNTS				
Nominal result (% of GDP)	-1.85%	-2.5%	-2.1%	**-2.35%**
Public sector primary result (% of GDP)	-10.2%	-9.0%	-8.8%	**-8.7%**
Net public debt (% of GDP)	65.45%	69.9%	74.3%	**73.7%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	3.87	3.35	3.30	**3.20**
(average in the year)	3.34	3.48	3.24	**3.18**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	191.1	185.2	205.0	**215.0**
Imports (US$ billion)	171.5	137.5	147.0	**151.0**
Trade balance (US$ billion)	19.7	47.7	58.0	**64.0**
Current account balance (US$ billion)	-59.4	-23.5	-23.0	**-15.0**

ECONOMIC REPORT| English version of "Informe Conjuntural Julho/Setembro de 2017" | Quarterly publication of the National Confederation of Industry - CNI | www.cni.org.br | Policy and Strategy Unit - DIRPE | Management and Economic Policy Unit - PEC | Executive manager: Diego Rosa Mambrin, Fabio Bandeira Guerra, Flávia Junqueira Ferraz, Isabel Mendes de Faria Marques, Marcelo Souza Azevedo e Mário Sérgio Carraro Telles | CNI Publishing Center | Graphic design supervision: Alisson Costa | Customer Service - Phone: (61) 3317-9992 - email: sac@cni.org.br Document prepared on October 9, 2017.