CNI Newsletter
ISSN 1983-621X • Year 31 • Number 3 • July/September 2015

ECONOMIC REPORT

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

Fiscal adjustment is crucial to bring the economy back on track

Instability and reduced confidence explain severity of recession

Economic uncertainties brought about by a sharp deterioration in public finances and difficulties to implement a fiscal adjustment have led to a deeper recession than previously expected for 2015. GDP will drop by 2.9%, the worst result since 1990, during the so-called Collor Plan. The unstable environment is further characterized by an annual inflation rate of around 10% and high volatility in currency and interest-rate markets.

Industry has been hit the hardest by the recession and will drop by an estimated 6.1%. The 7.1% rise in mining and quarrying, which is less affected by the domestic crisis, will help mitigate the sharp decline. Other industrial segments, however, will experience close to double-digit falls: manufacturing (-9.5%) and construction (-8.2%).

The services sector, which is usually less impacted by economic cycles, has proved to be very sensitive to current uncertainties and difficulties. The sector's GDP will drop by 2.0%, a very uncommon event in Brazil. The deteriorating economic situation of economic agents (with high household debt, rising interest and unemployment rates and falling real income due to inflation) and a pronounced loss of confidence have caused domestic demand to shrink. We expect household consumption to fall by 2.3% and investment to drop by an unprecedented 13.4%. As a result, domestic absorption – the domestic component of GDP – will contract by 4.4%. It is worth mentioning that the fall in GDP is being partly offset by the positive contribution of the foreign trade sector, led mainly by a decline in imports, which in turn results from the reduction in domestic absorption and from exchange rate adjustments.

Rebalancing public finances is the key to getting the Brazilian economy back on track. Without a credible fiscal adjustment that gives

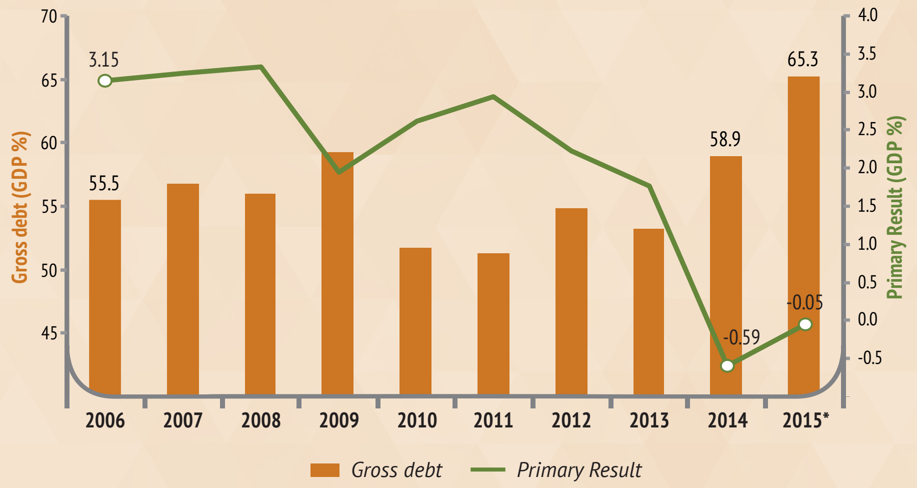
(continued)

The Brazilian economy in the third quarter 2015

Tax efforts to put gross debt back on a sustainable trajectory must be stepped up

Gross debt and primary result

As a share of GDP (%)



Source: Central Bank of Brazil
* CNI estimate

economic agents the perception of a sustainable public debt trajectory, it will not be possible to restore economic stability, which is crucial for boosting growth.

Fiscal adjustment has two dimensions: the federal government's 2016 budget and the long-run fiscal balance. First, it is essential to find a solution for next year's budget by generating a primary surplus with the aim of curbing the upward trend in the public sector debt.

A new primary public sector deficit is a threat that needs to be permanently addressed. The frequent revisions of the primary surplus target call into question the government's commitment to the sustainability of public finances.

Second, it is crucial to signal a change in the public debt trajectory, a key factor in maintaining Brazil's investment grade rating. This is an indispensable condition for Brazilian companies, as the downgrade of Brazil's sovereign debt rating has a direct impact on financing costs for businesses and consumers.

Implementing a long-term fiscal adjustment plan involves mainly a reduction in public spending, without resorting to new sources of taxation. Both society and the productive sector cannot afford any further increases in the tax burden, as it diverts resources from the private sector and raises production costs, thus reducing competitiveness and growth.

The spending cuts that have been made and announced so far are not enough to reverse the situation. It is necessary to go further and review mandatory spending requirements. Effective tools for reining in public expenditures must be implemented, eliminating automatic and mandatory mechanisms for increasing spending, such as those for binding expenses, for automatically indexing benefits to minimum wage and for setting minimum spending percentages regardless of the results and assessment of programs.

Reviewing social security and welfare expenditures is also essential. Their long-term trend is unsustainable and must be reversed to ensure their own sustainability and strengthen economic stability, as shown by international experience. Otherwise there will be upward pressures on taxes or public debt, both of which are infeasible.

Addressing fiscal issues is essential, but it alone will not bring back growth. The business and legal security environment must also be improved in order to regain confidence of economic agents and reverse future expectations. Both actions are crucial to bring back investment and resume growth.

Finally, Brazil's international integration strategy must also be redefined. The trend toward large agreements, such as the signing of the recent Trans-Pacific Partnership (TPP), creates further difficulties for Brazilian products in the international market and requires Brazil to adopt a bolder strategy in international negotiations.

Economic Report
ISSN 1983-621X • Year 31 • Number 3 • July/September 2015

CNI

Recession deepens and recovery remains uncertain

Industrial GDP to fall by 6.1% in 2015

The significant and widespread negative results of economic activity indicators during the first half of the year were already pointing to a marked contraction of Brazilian economy this year. After the release of actual and background data on industry and trade in the third quarter, the scenario became even more negative. We therefore conclude that the country's GDP will keep trending downward in the second half of the year, closing 2015 down by 2.9% – the worst performance since 1990.

The main reason to project a continued economic contraction in the third and fourth quarters of the year is the deterioration of the labor market, which will likely increase its negative effects on demand[1] in coming months, especially for services. This can be explained by two factors: the lagged effects of layoffs on consumption and expectations of continued job losses. With respect to industry, this trend of continued layoffs (over the next six months) has been frequently reported in CNI's Industrial Survey.

But there are some conditioning factors behind the current layoffs that go beyond a weakening consumption. Companies have also cut jobs because they are faced with uncertain future conditions, with no short-term prospects for improvement. As long as this environment persists, we will continue to see a low confidence among entrepreneurs, who will keep operating at a slower pace, postponing investments and laying off workers, thus hindering any kind of economic recovery.

INDUSTRY EXPERIENCES HIGHEST ACTIVITY CONTRACTION

Starting the analysis of GDP from the supply side, we can notice that industry has been the main driver of negative economic performance. Between January and August, industrial production fell by 6.9% in 2015 from the same period in 2014 (Monthly Industrial Survey - Physical Production-PIM-PF / IBGE).

The picture is even worse when we restrict the analysis to manufacturing industry. Production in this segment is also down by 8.8% in the first eight months of the year, with emphasis on capital goods, which experienced a 22.4% decline. Special mention should also be made of the widespread negative results across manufacturing sectors: all sectors covered by the survey (PIM-PF/IBGE) reported a reduced production in the period.

The drop in production is accompanied by a 6.6% fall in real sales in industry in the first eight months of 2015 over the same period the year before (Industrial Indicators/CNI).

The slowdown in industrial activity is also reflected in the performance of inventories. The indicator of actual-planned inventories for large enterprises edged up to 56.7 points in August, remaining away from the 50-point dividing line and indicating high levels of unwanted inventories in industry (Industrial Survey/CNI).

Companies have reduced the use of their production facilities in response to rising inventories and slowing demand. In August, average capacity utilization in manufacturing stood at 77.9% on a seasonally adjusted basis, hitting an all-time low since the historical series started in January 2003 (Industrial Indicators/CNI).

Issues such as unwanted inventories, an idle manufacturing park, reduced sales, and weak demand expectations have led to recurrent job losses in industry. Comparing the first eight months of this year with the corresponding period of 2014, one can see a 5.2% reduction in employment levels in manufacturing (Industrial Indicators/CNI).

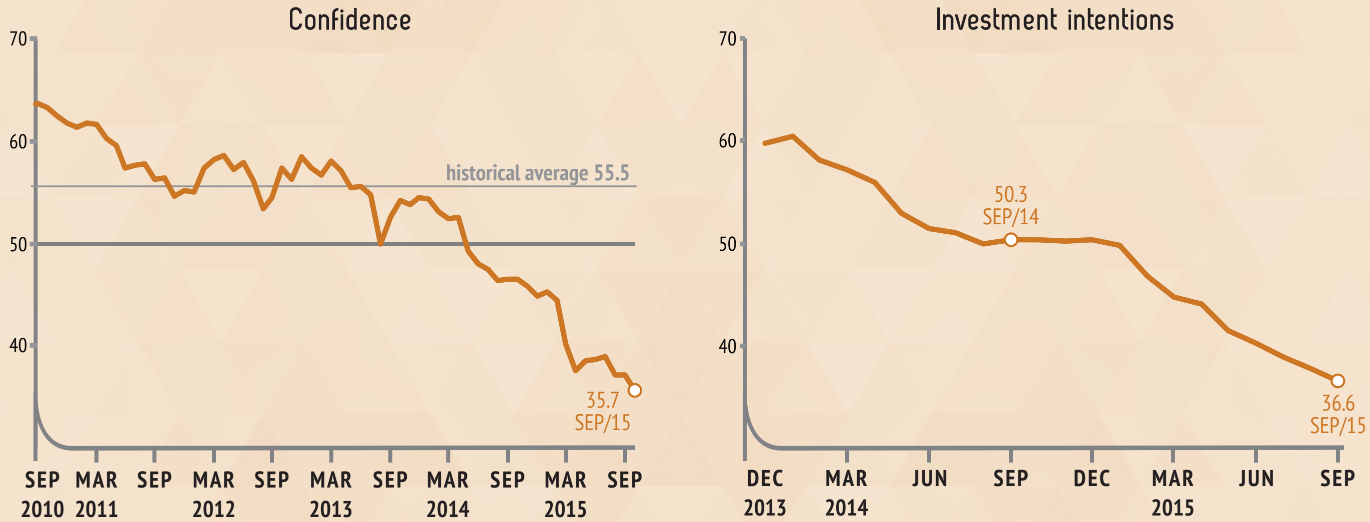
The reality in the construction industry is quite the same. According to data from CNI's Construction Survey, construction companies have

1 Already weakened by the impact of high interest rates on credit, by an increase in household debt-to-income ratios and indebtedness levels, and by public spending cuts.

Reducing uncertainties is critical for regaining confidence and resuming investment

Business Confidence Index (ICEI) and Investment Intentions Index

In points



Source: CNI.
Both indices refer to total industry (manufacturing, mining and quarrying, and construction).
The ICEI ranges from 0 to 100 points. Figures above 50 points indicate confident entrepreneurs.
The Investment Intentions Index ranges from 0 to 100 points. The higher the index, the more industry is likely to invest.

experienced successive declines in activity levels[2], reductions in new developments and services[3], low operating capacity levels[4], and lower number of employees[5]. These results are driven mainly by worsening mortgage credit conditions and by the temporary suspension of infrastructure projects due to the *Lava Jato* (Car Wash) operation.

Another industrial segment that has struggled in 2015 is the sector of Public Utility Industrial Services (SIUP, in its Brazilian acronym), which includes, among other activities, electricity production and distribution and water collection, treatment and distribution. As a result of the water and energy deficits experienced in the first months of the year and of the drop in residential and industrial electricity consumption – due both to an increase in rates and to a downturn in economic activity – we believe that the SIUP sector will fall in 2015, just as it did last year.

In contrast, the mining and quarrying industry has shown a positive performance over the year. The continued growth stems mainly from an increase in oil production. The results obtained up to August show a 7.7% increase in physical production in mining and quarrying (PIM-PF).

Under this environment, the Business Confidence Index (ICEI/CNI) continues to hover at low levels. In September, the index amounted to 35.7 points, the lowest level in the series started in 1999. This result indicates that the low confidence in industry is still strong and widespread.

As there are no prospects for this adverse scenario to be reversed in the short term, industrial entrepreneurs have been reluctant to invest. The Investment Intentions Index is down by 13.7 points between September 2014 and September 2015 (CNI).

Considering the overall picture of the industrial segments analyzed so far, we expect industrial GDP to fall by 6.1% in 2015, marking the second consecutive annual decline (-1.2% in 2014). This drop will be driven by a decline in manufacturing (-9.5%), in construction (-8.2%) and in SIUP (-6.9%) Mining and quarrying, on the other hand, is projected to rise by 7.1% in 2015.

The decline in industry, coupled with reduced household purchasing power, is expected to lead to a 2.0% contraction in the service sector this year. The last drop in this sector, which had been

2 Index of 36.2 according to CNI's Construction Industry Survey. Indices below 50 points suggest a month-over-month reduction in activity.
3 Index of 37.9 according to CNI's Construction Industry Survey. Indices below 50 points suggest an expected reduction in number of new developments and services over the next six months.
4 Index of 58% according to CNI's Construction Industry Survey. This is the lowest level in the series started in January 2012.
5 Index of 34.7 according to CNI's Construction Industry Survey. Indices below 50 points suggest a month-over-month reduction in number of employees.

recently leading economic growth, was over 20 years ago.

The results for the extended retail trade (which includes vehicle sales and construction materials) provide a clear picture of this scenario. Sales volumes in the January-July 2015 period were 6.5% lower than those recorded in the corresponding period the year before (Monthly Trade Sector Survey - PMC/IBGE).

Agriculture/livestock will probably be the only productive sector to experience growth in 2015. We forecast a growth rate of 2.3%, up slightly from 2014's figure (0.4%).

INVESTMENT RATE TO FALL BELOW 18%

On the demand side, investment (Gross Fixed Capital Formation - GFCF) is expected to fall again in 2015. The estimated decline of 13.4% is attributed mainly to a drop in manufacturing industry, a major consumer of machinery and equipment, and to a downturn in the construction industry, which accounts for over half of gross fixed capital formation in Brazil. As a result, investment rates (GFCF as a share of GDP) would fall from 19.7% in 2014 to 17.6% in 2015.

This decline in investment is explained by higher basic interest rates – reducing demand expectations and increasing opportunity costs of capital –, developments in the Lava Jato scandal, and an uncertain environment resulting from difficulties to approve some of the measures under the tax package being analyzed by Congress.

Estimativa do PIB para 2015

Variação percentual dos componentes do PIB

	GDP COMPONENTS	Rate of change (%)
Demand	Household consumption	-2.3
	Government consumption	-1.7
	GFCF	-13.4
	Exports	3.0
	(-) Imports	-8.4
Supply	Agriculture	2.3
	Industry	-6.1
	Mining and quarrying	7.1
	Manufacturing industry	-9.5
	Construction industry	-8.2
	SIUP*	-6.9
	Services	-2.0
	GDP	**-2.9**

* Public Utility Industrial Services (Serviços Industriais de Utilidade Pública, SIUP in Brazilian acronym)

Household consumption, which had been slowing down considerably since 2011, fell by 1.3% in the first half of the year. CNI expects this component to fall by 2.3% in 2015, an unprecedented result in recent decades. The downward trend can be explained by the continuation of a restrictive monetary policy, deteriorating labor market conditions, higher household debt-to-income ratios, stubbornly high inflation rates, difficulties to access credit, and the current fiscal tightening.

Given the current fiscal environment in Brazil, CNI projects a 1.7% drop in government consumption in 2015.

Due to the significant depreciation in the Brazilian currency, exports are likely to grow by 3.0% in 2015. This increase will not be higher because it takes time for the more favorable exchange rate to be reflected in companies' marketing strategies, as the export process is usually governed by long-term contractual relationships, thereby hindering immediate reintegration into the international market, especially in the case of manufactured products. Furthermore, the loss of competitiveness observed in recent years has steered the Brazilian industry away from different markets. This recovery can be slow and costly, especially as long as the exchange rate remains volatile, thus hindering the strategic planning of exporting companies (see the box "Exchange rate volatility hinders response of exporting industrial sector" in the Foreign Trade Sector section).

Imports, on the other hand, are expected to fall in 2015. As a result of a depreciated exchange rate – which raises the costs of inputs and final goods – the sharp slowdown in household consumption, and the decline in manufacturing industry, we estimate that imports are to experience an 8.3% drop this year.

Considering the increase in exports and, particularly, the decline in imports, the net contribution of the foreign trade sector to GDP growth is estimated at 1.5% in 2015. We therefore emphasize that the GDP estimate for this year would be even worse were it not for this external contribution: -4.4% instead of -2.9%.

Economic Report
ISSN 1983-621X • Year 31 • Number 3 • July/September 2015

Successive increases in unemployment rate

Unemployment rate in metropolitan areas to close the year at 8%

The metropolitan unemployment rate measured by the Monthly Employment Survey (PME/IBGE) rose to 7.6% of the labor force in August, representing a 2.6-percentage point increase as compared to the same period in 2014. This is the eighth consecutive increase in the indicator. The unemployment indicator measured by PNAD-Contínua (Pnad-C), a nationwide household survey, has also increased in recent months. In the three months to July, the unemployment rate amounted to 8.6% of the labor force, up by 1.7 percentage points from the corresponding period in 2014.

The unemployment rate evolution deserves special mention for two reasons. First, the decline typically observed in the indicator early in the second half of every year due to a typical increase in temporary jobs in the period was not seen in 2015. The rate has grown uninterruptedly since January and is not expected to reverse this uptrend in coming months. Second, the rate has increased at an accelerated rate. Between January and August, the indicator increased by 2.3 percentage points, compared to 0.2 percentage points during the same period in 2014.

ALMOST ONE MILLION JOBS LOST

The uptrend in unemployment is still being influenced by the decline in employment levels. According to data from the General Registry of Employed and Unemployed Persons (CAGED/MTE), the Brazilian economy lost 912,700 formal jobs in the 12 months ending in August.

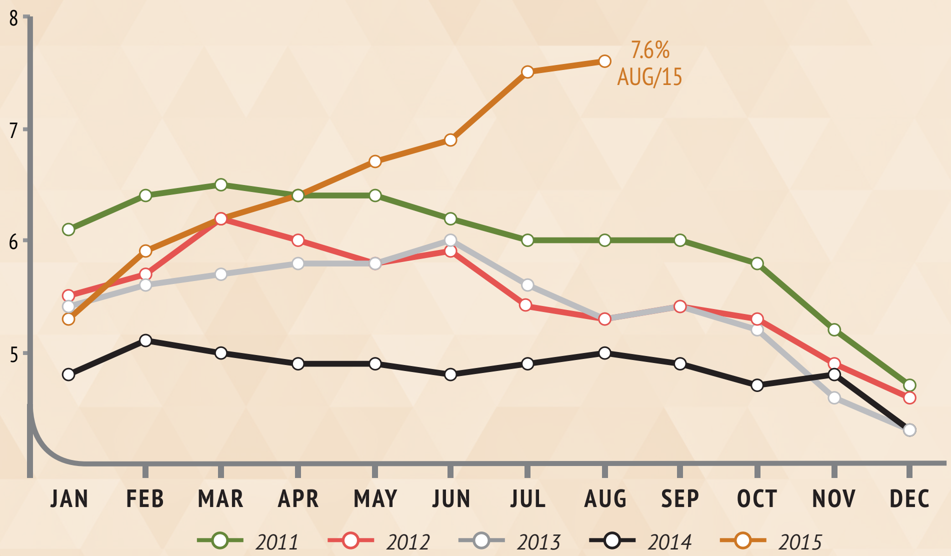
All economic sectors have been cutting jobs. Manufacturing and construction are the most affected sectors. In the 12 months to August, they lost 448,600 and 397,600 jobs, respectively.

In addition to lower employment levels (-1.8% in August on a year-on-year basis), the unemployment rate has also been pushed by a steady rise in the labor force. In August, the labor force increased by 0.9% from the same month in 2014. This can be explained by a reduction in workers'

Lower jobs and increased labor force push unemployment rate up

Unemployment rate

In % of the labor force

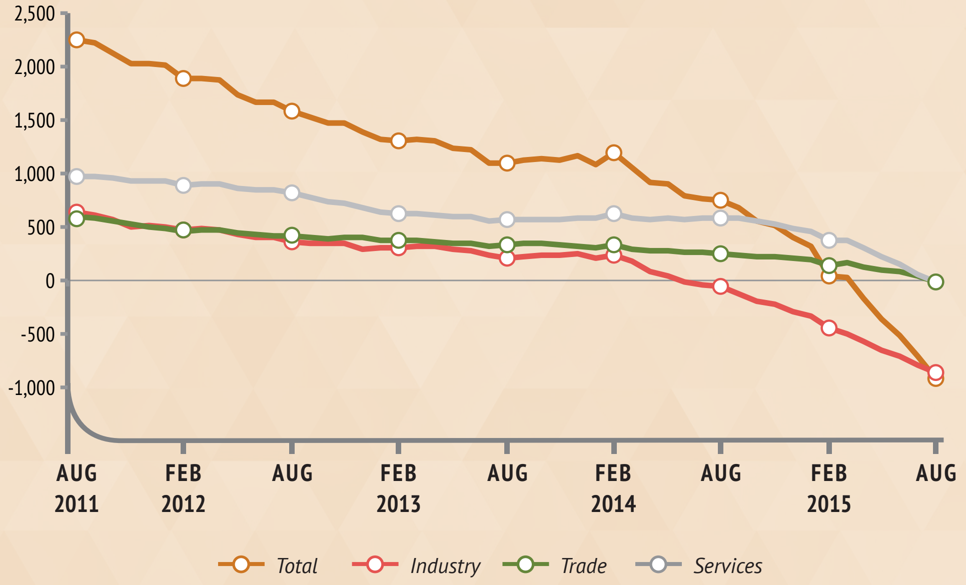


Source: PME / IBGE

Employment falls across all economic sectors

Net formal job creation

In thousands (in the 12 months to August)



Source: CAGED / MTE

purchasing power, forcing more people into the labor market to contribute to the household budget. This upward trend in the labor force is expected to remain in place until the end of the year. In such a scenario, CNI projects the average unemployment rate at 6.9% in 2015.

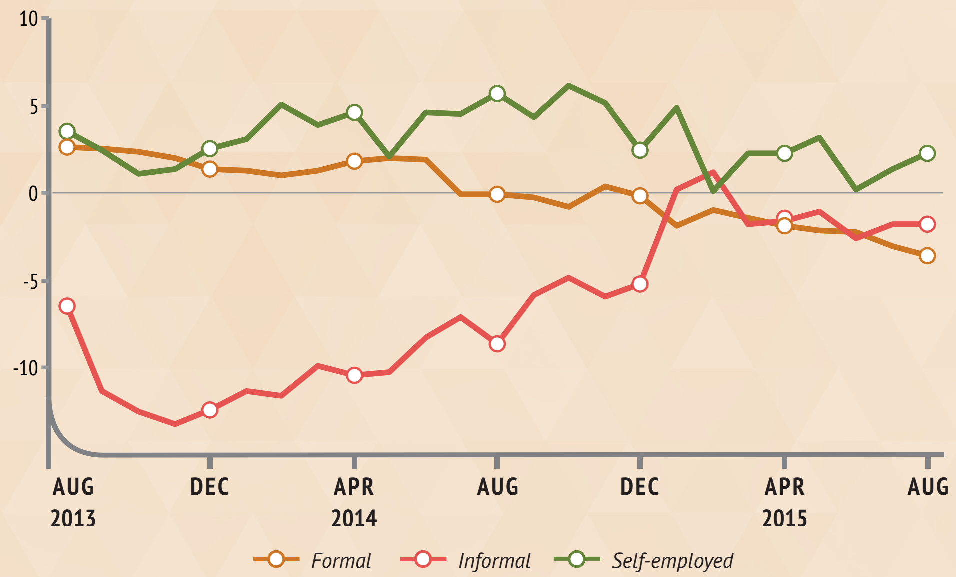
Special mention should also be made of the evolution of the employed population in different occupation categories.

Formal private sector jobs have declined across all months of the year as compared to the same period in 2014, including a 3.6% drop in August. This result has been offset by an increase in self-employed workers, which grew by 2.2% in August over the same period of 2014.

Contraction of formal employment confirms a deteriorating labor market in 2015

Occupation by category

Year-on-year change (%)



Source: Central Bank of Brazil

Meanwhile, the decline in formal employment has slowed down in 2015, with the indicator even recording small increases earlier this year as compared to the year before. Informal jobs edged down by 1.8% in August on a year-over-year basis. In 2014, the indicator had dropped by 8.6% on the same comparison basis.

This rise in the share of self-employed individuals is driven by the increase in layoffs, coupled with difficulties to find formal jobs. Given that the economic picture is not expected to change in coming months, this trend points to a possible structural change in the labor market.

REDUCED REAL TOTAL PAYROLL AFFECTS HOUSEHOLD CONSUMPTION NEGATIVELY

Real average earnings usually received by metropolitan workers have been trending downward since the beginning of 2015, falling by 3.5% in August over the same month a year ago. The indicator increased only once, in January (by 1.7% on the same comparison basis), influenced by a minimum wage increase. Still, it grew much less strongly than in the same month in 2014 (3.6%).

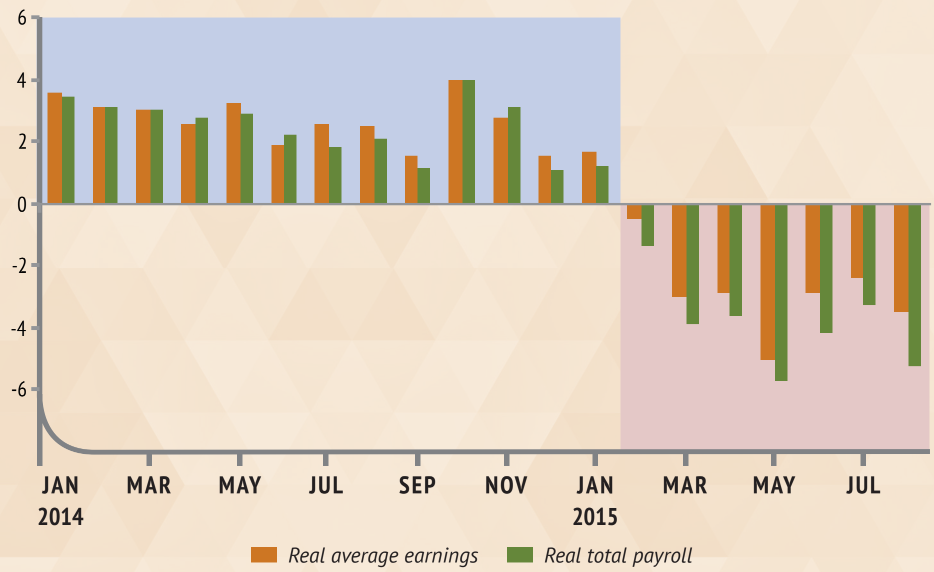
The decline in employment and real average earnings has significantly impacted on real total payroll in 2015. This indicator declined for the eight month in a row in August, decreasing by 5.2% over the same month in the previous year. As a result, household consumption, which had already been slowing in recent years, has been heavily impacted and will likely end the year with a decline of 2.3% (CNI's projection).

As this trend is not expected to reverse, real average earnings are estimated to fall by 2.5% in 2015, down from a 2.7% growth in 2014. Considering that the employed population is also likely to keep falling, CNI expects to see a 3.5% decline in total payroll in 2015.

Real average earnings and real total payroll keep plunging

Real average earnings and real total payroll

Year-on-year change (%)



Source: PME / IBGE

Economic Report
ISSN 1983-621X • Year 31 • Number 3 • July/September 2015

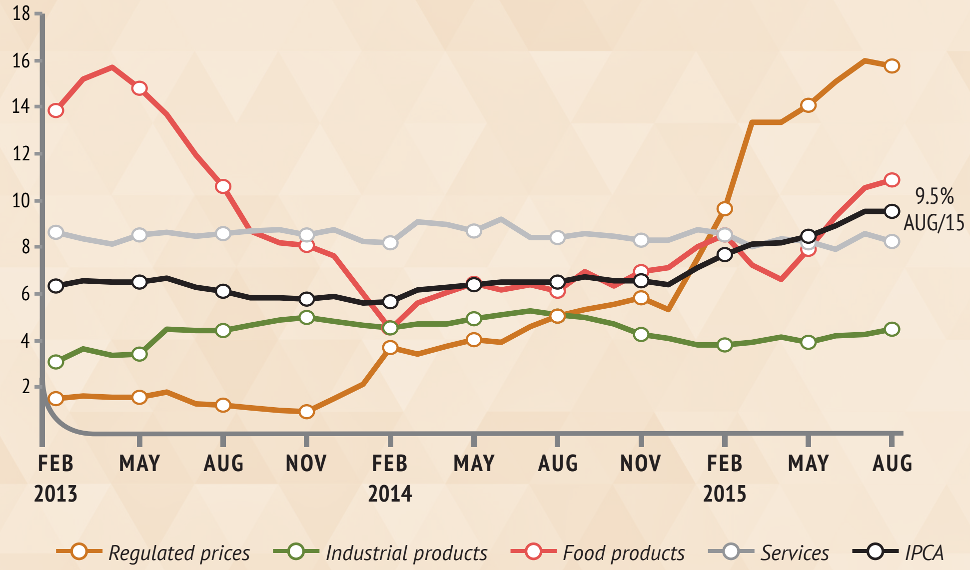
Inflation close to double digits

Interest rates to hold steady in spite of rising inflation

Inflation remains persistent

IPCA by groups

12-month figure (%)



Source: IBGE
Prepared by CNI

Inflation has been on the rise in 2015, reflecting relative price adjustments – upward adjustments in both regulated prices in relation to market prices and in domestic prices in relation to international prices. In August, the 12-month inflation rate reached 9.5%, up from 6.5% during the same period in 2014. However, when comparing the three months to August with the three-month period to May, we can see that the growth rate slowed down from 2.8% to 1.6%. This slowdown in prices can be attributed to a lower growth rate of regulated prices and food prices.

In the last 12 months to August, regulated prices increased by 15.8%. In the quarter ended in August, they grew by 2.6%, compared to a 5.4% growth in the quarter to May. The group's better performance has been mainly explained by more moderate adjustments in electricity prices and in the prices of pharmaceutical products. For the remainder of the year, the group's prices will be driven up because the 6% increase in gasoline prices and the 4% rise in diesel (announced by Petrobras in late September) will be passed on to consumers. While electricity prices are expected to increase modestly, the increase in fuel prices will exert an upward pressure on the group in coming months. CNI is therefore expecting regulated prices to grow by 16.7% in 2015.

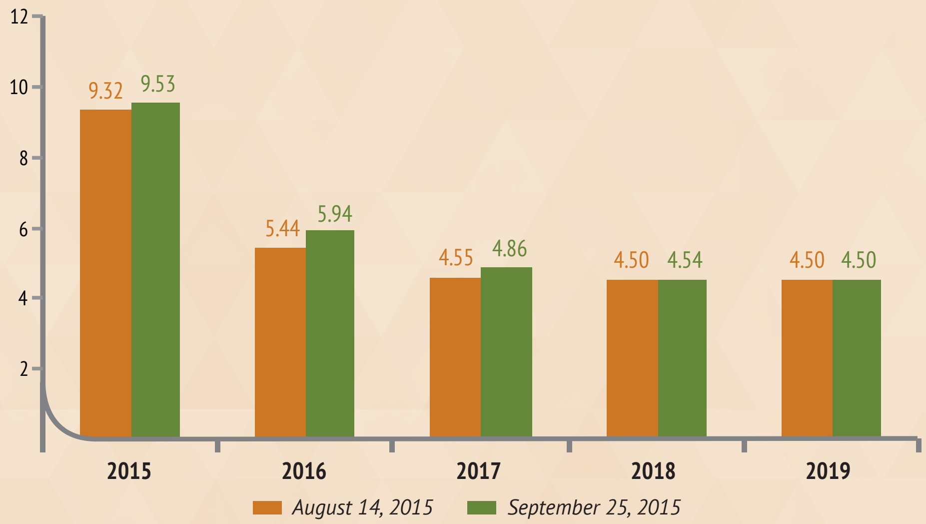
The food group also contributed to the slowdown in inflation in the quarter to August, when it went up by 1.0%, compared to a 3.8% growth in the quarter to May. In the 12 months to August, the growth rate amounted to 10.9%. This slowdown in food prices was driven by favorable seasonal factors during the period, which tend to ease food inflation, especially of natural food products. CNI estimates that the group's prices will post growth of 11.1% in 2015.

In the 12 months to August, industrial product prices edged up by 4.5%. They slowed down in the three months to August as compared to the three months to May, down to 1.1% from 1.5%. A weak economic activity coupled with a more pronounced drop in international prices of inputs have helped mitigate the effects of the exchange rate depreciation and of higher energy prices that have been passed on to consumers. The adverse

Higher inflation expectations for 2016, 2017 and 2018

Expected inflation according to Focus survey

Percentage points (%)



Source: Central Bank of Brazil

Economic scenario worsening affect inflation expectations

economic environment is expected to persist in the short term, thus exerting less pressure on the group's prices. For this reason, CNI estimates that industrial product prices will rise by 5.3% in 2015.

Services prices increased by 8.3% in the 12 months to August. In the quarter from June to August, these prices went up by 1.7%, down from a 1.5% increase in the three months to May.

Despite a weak economic activity and deteriorating labor market conditions, with impacts on real household income, service prices accelerated slightly in the quarter to August. This is mainly explained by their characteristic inertia, as they are directly affected by wage increases indexed to past inflation and increases in the minimum wage. This has made it possible for the increase in regulated prices, particularly in energy prices, to be passed through to services prices, albeit partially. CNI expects to see a moderate reduction in the growth rate of service prices in 2015. The group would thus close the year with an increase of 7.2%

Considering the behavior of the different groups analyzed, CNI expects the IPCA index to grow by 9.6% in 2015.

UNCERTAIN FISCAL POLICY THREATENS INFLATION CONTROL

The Central Bank decided to keep the Selic rate at 14.25% at its last meeting (held in early September), thus putting an end to the upward cycle started in October 2014, during which the rate was raised by 3.25 percentage points. At that time, the decision to interrupt the monetary tightening cycle was supported by the convergence of inflation expectations toward the targets set for coming years, by the impact of a weak economic activity and of fiscal adjustments in prices, and also by the lagged effects of higher interest rates on inflation.

Since then, the macroeconomic environment has been deteriorating, with ongoing fiscal uncertainties and a strong economic downturn and its impact on the labor market. This further worsening of the economic scenario, with consequences such as the loss of Brazil's investment grade rating by Standard and Poor's (S&P) and the significant devaluation of the Brazilian currency (real), has affected inflationary expectations. According to the latest Focus survey released on October 2, market analysts put inflation at 5.94% in 2016, up by 0.50 percentage points from the figure estimated in August this year. Likewise, inflation expectations for 2017 and 2018 have also increased by 0.31 and 0.04 percentage points, respectively.

While the changes are small, higher future inflation rates indicate a reversal of the downward trend seen in recent months. This signals a move away from medium-term expectations for the inflation target, making it difficult to keep inflation under control.

A deepening economic and political crisis has also impacted medium- and long-term interest rates. These rates were previously indicating a future reduction in the Selic rate as a result of a decline in medium-term inflation made possible by the recent contractionary monetary policy. Now, both medium- and long-term interest rates reflect the uncertainties brought about by a lack of certainty in fiscal policy and its effects on inflation. The consequence is a rise in market interest rates, further increasing government financing costs and undermining the already fragile fiscal situation.

In short, the current environment poses a threat to the benefits generated by the contractionary monetary policy adopted in recent months. We do not expect, however, Selic to increase further. A pronounced decline in activity will likely contribute significantly toward curbing price hikes. In addition, any further increases in the basic interest rate would have a strong impact on public debt costs. Thus, CNI estimates the Selic rate at 14.25% for the remainder of the year.

LOSS OF INVESTMENT GRADE LEADS TO DETERIORATING CREDIT CONDITIONS

Financial system credit operations have been growing at increasingly lower rates. According to Central Bank data, the real growth in the average balance in the last 12 months as compared to the average balance in the previous 12-month period decreased from 6.9% in August 2014 to 3.0% in August of this year. For individuals, the rate edged down from 8.7% to 4.3%, while the balance of loans granted to companies dropped from 5.4% to 1.9%.

Several factors have contributed to this continuous slowdown. These include an economic downturn and the lack of confidence among entrepreneurs and consumers, who end up postponing their consumption and investment decisions, thus reducing the demand for new loans. Furthermore, capital costs have increased as a result of the successive increases in the Selic rate and in the long-term interest rate (TJLP). Finally, banks have adopted a much more conservative and selective approach to lending, making it difficult for businesses and consumers to access credit.

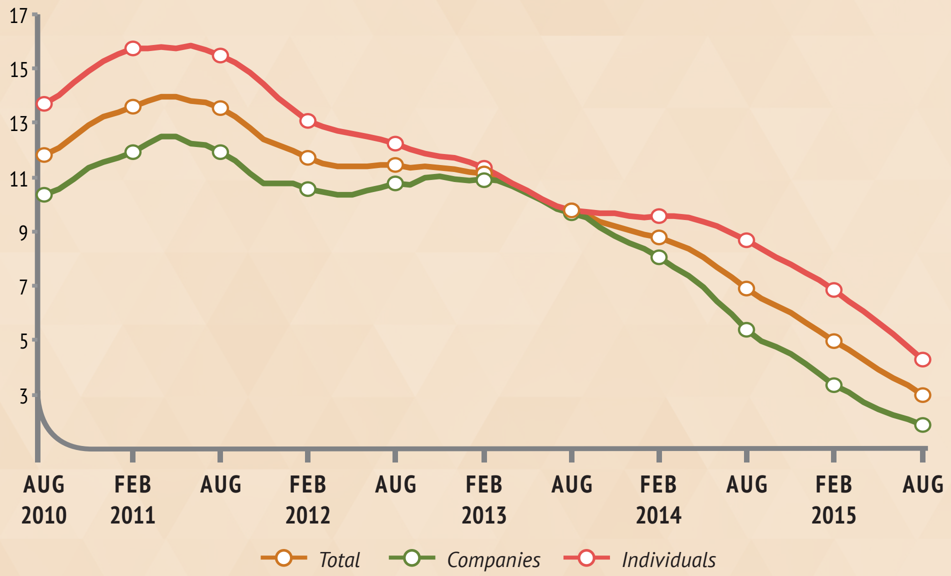
The current deteriorating credit environment will be compounded by the loss of Brazil's investment grade rating by S&P. The downgrade of Brazil's sovereign debt further restricts credit and increases the financing costs for businesses and consumers.

To put it simply, the loss of the country's investment grade rating and the continued negative economic scenario in the short term are expected to continue to slow down growth in the stock of credit in 2015.

Credit still slowing down

Balance of credit operations

Real variation in 12 months against the preceding 12 months (%), as deflated by the IPCA index



Source: Central Bank of Brazil

FISCAL POLICY

Lower revenues prevent primary surplus target from being achieved

Decline in spending by federal and regional governments is not enough

The real decline in public sector revenues will be the main reason preventing the primary surplus target from being achieved in 2015. Despite the reduction in expenditures, even the reduced goal will likely not be achieved due to the impact of the economic downturn on tax revenues. In addition, other factors have also hindered the achievement of the target: some expenses are growing due to the settlement of arrears from previous years and to advance revenue payments made in previous fiscal years (e.g. dividends).

FALLING FEDERAL SPENDING

A real decline of 2.1% (as deflated by the IPCA index) in federal government spending in the first eight months of 2015 as compared to the same period of 2014 provides a clear sign of the reversal of the expansionary fiscal policy. Most of this reduction in expenses was driven by non-mandatory expenditures, which experienced an 8.3% real decline on the same comparison basis. But even mandatory spending is down by 0.6% in real terms.

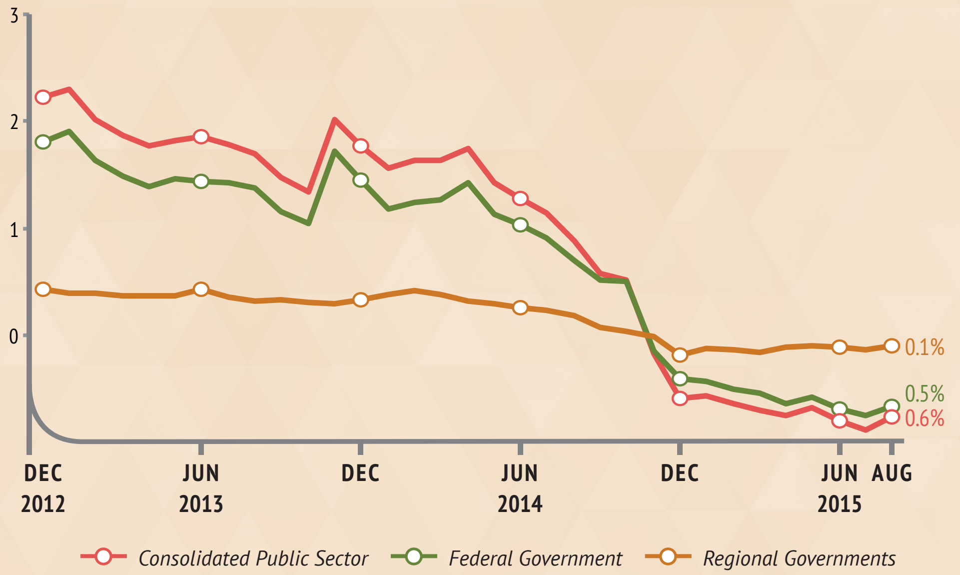
Among non-compulsory expenditures, the reduction was driven by investments (excluding subsidies granted to the My Home, My Life program), as they fell by 40.2% in the January-August 2015 over the corresponding period in 2014. Meanwhile, funding expenses, including subsidies for the My Home, My Life program and some mandatory spending items, held virtually steady in real terms, up by 0.1% on the same comparison basis.

The decline in mandatory expenditures in turn is explained by a real decrease of 1.6% in personnel expenses and of 14.3% in expenditures of the Workers' Assistance Fund (FAT, in its Brazilian acronym) on unemployment insurance and salary bonuses between January and August 2015 as compared to the same period in 2014. The real decline in personnel expenses is driven by a rise in inflation not offset by wage increases – and the same goes for average private sector earnings. As for the FAT's expenditures, the reduction was made possible by a review in the salary bonus payment schedule, with R$ 9.4 billion in spending carried over to the next year.

12-month primary deficit grows by 0.17 percentage points of GDP in 2015

Evolution of public sector primary result

12-month figure (% of GDP)



Source: Central Bank of Brazil.

On the other hand, some mandatory expenditure items continue to post real growth, undermining fiscal adjustment efforts. Social security expenses experienced a real increase of 0.9% in the first eight months of 2015 as compared to the corresponding period the year before. These expenditures are pushed up by real minimum wage increases and they would increase even more if a strike by officials from the National Institute of Social Security (INSS) had not reduced benefit payments in recent months.

Furthermore, special mention should be made of the 196.1% real increase in spending on subsidies and grants, which can be explained by the settlement of arrears from previous years. Spending on subsidies granted under the Investment Support Program (PSI) alone increased from R$ 117.2 million in the first eight months of 2014 to R$ 7.5 billion in the same period in 2015.

SHARP REDUCTION IN FEDERAL GOVERNMENT REVENUES

Not even the measures taken to increase federal tax revenue have been able to prevent the significant downturn in economic activity from intensifying the rate of decline in revenues in recent months. The federal government's net revenue fell by 4.8% in real terms in the first eight months of 2015 from the same period a year earlier. In the January-May 2015 period, the net revenue of the federal government posted a real decline of 3.0% on the same comparison basis.

Despite the increase observed in the rates of various taxes, tax revenues experienced a real drop of 4.2% in the first eight months of 2015 on a year-on-year basis. This decline was driven by lower economic activity and also by a 51.1% increase in tax refunds. Another decisive factor for the decline in federal revenue has been the fall in real wages, which in turn is the main reason behind the real decrease of 4.8% recorded in social security revenues after compensations from the National Treasury due to tax exemptions on payroll are excluded.

Finally, revenues not managed by the Brazilian IRS recorded a real decline of 13.2% in the first eight months of 2015 from the same period in 2014. This result is explained by a reduction in the receipt of dividends – partly because of advance payments made in previous years – and of financial compensation for oil exploitation activities due to lower oil prices.

STATES AND MUNICIPALITIES ALSO REDUCE THEIR SPENDING

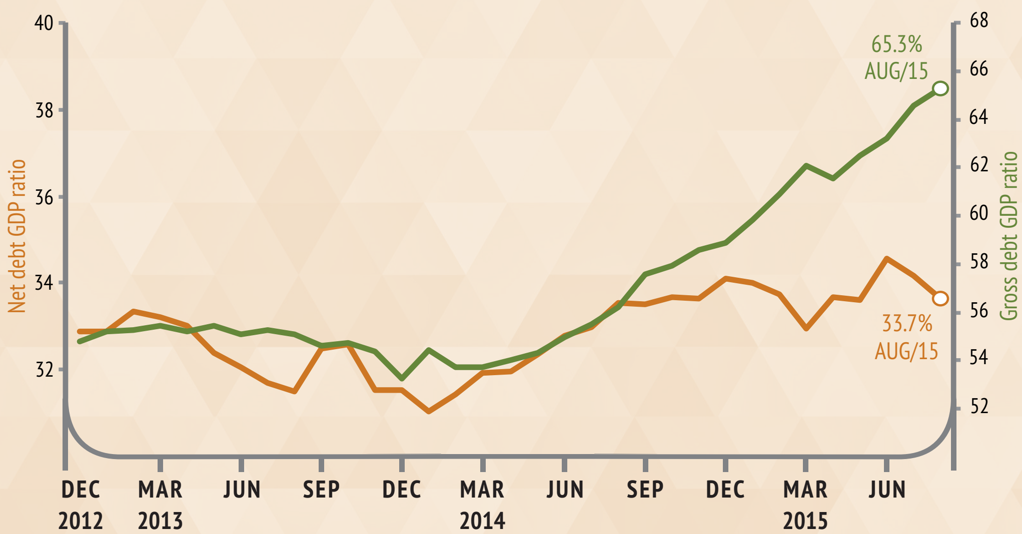
Regional governments have also reined in spending in response to declining revenues. The available data shows an estimated 3.6% real decline in spending by regional governments between January and July 2015 over the same months the year before.

As with the federal government, the slowdown in economic activity has negatively affected revenues of states and municipalities. In the first sev-

Gross debt-to-GDP ratio up by 6.4 percentage points as a result of higher nominal deficit

Evolution of public sector net and gross debt

As a share of GDP (%)



Source: Central Bank of Brazil.

The consolidated public sector would record a primary deficit of R$ 3 billion (0.05% of GDP) in 2015

en months of 2015, revenues of regional governments experienced a 2.5% drop in real terms as compared to the same period in 2014. The current economic conditions had a negative effect on the collection of ICMS (a Brazilian state value-added tax), which experienced a real decrease of 3.2%, as well as on transfers from the Union, which dropped by 3.6% in real terms.

NOMINAL DEFICIT EXCEEDS 9% OF GDP

However, the fiscal adjustment measures taken so far have been insufficient to prevent a deterioration of the primary result. In the 12 months to August, the consolidated public sector recorded a primary deficit of R$ 43.8 billion (0.76% of GDP). At the end of 2014, the primary deficit stood at R$ 32.5 billion (0.59% of GDP).

A higher primary deficit, coupled with an increase of 2.8 percentage points of GDP in interest spending, caused the 12-month nominal deficit to hit the mark of 9.2% of GDP in August 2015. The increase in interest expenses has been led by a rise in the Selic rate and by the Brazilian currency devaluation, which significantly increases the fiscal costs of foreign exchange swaps.

While on the one hand interest expenses have increased, on the other hand the exchange rate devaluation led the net debt-to-GDP ratio to fall from 34.1% to 33.7% of GDP between December 2014 and August 2015, despite the pronounced increase in the nominal deficit. The reason behind this decrease is that the exchange rate depreciation increases the value in domestic currency of foreign exchange reserves, which are subtracted from gross debt to calculate net debt. However, a higher nominal deficit has been reflected in the gross debt-to-GDP ratio, as it edged up from 58.9% of GDP in December 2014 to 65.3% of GDP in August 2015.

DESPITE REDUCTION, PRIMARY SURPLUS WILL NOT LIKELY BE ACHIEVED

In July, the federal government announced that the primary surplus target would be reduced from R$ 66.3 billion (1.1% of GDP) to R$ 8.7 billion (0.15% of GDP). Yet, this new target is not likely to be achieved. However, it is possible to estimate that fiscal results will improve from now until the end of 2015.

In the case of the federal government, the improvement should come from a further reduction in investment and operating expenses and from a lower rate of decline in net revenue. On the spending side, the additional financial programming of R$ 8.6 billion in non-compulsory expenditure items and the postponement of salary bonus expenditures will be the biggest reasons for the decline in operating and investment spending. Thus, CNI estimates that federal government spending will close 2015 down by 4.2%.

On the revenue side, the reduction in the rate of decline is expected to come from the continued effects of increases in the rates of several taxes and also from non-recurring revenues from programs like the Tax Litigation Reduction Program (PRORELIT), which creates more favorable conditions for companies to settle their tax debts. Meanwhile, the rate of decline in revenues not managed by the Brazilian IRS and in social security revenues is not likely to change significantly. CNI is therefore projecting that the federal government net revenue will fall by 2.9% in real terms in 2015.

In such a scenario, the federal government is set to record a primary deficit of R$ 5 billion (0.1% of GDP, as estimated by CNI). With respect to regional governments, the drop in spending and a rebound in ICMS collection, made possible by increases in energy and fuel prices, are expected to lead to a primary surplus of R$ 2.0 billion (0.2% of GDP). As a result, the consolidated public sector would record a primary deficit of R$ 3 billion (0.05% of GDP) in 2015.

Should this primary deficit forecast be confirmed, the nominal deficit would amount to 8.9% of GDP in 2015. The improvement in relation to the nominal deficit of 9.2% of GDP recorded in the 12 months to August can be explained by the reduction in the primary deficit. On the other hand, nominal interest expenditures, which currently stand at 8.45% of GDP, will likely grow to 8.8% of GDP by the end of the year as a result of the impact of the exchange rate depreciation on foreign exchange swap costs. A high nominal deficit and low nominal GDP growth will likely lead the net debt-to-GDP ratio to amount to 36.9% of GDP in December 2015. Gross debt in turn is estimated to remain at 65.3% of GDP, the same level observed in August 2015.

FOREIGN TRADE SECTOR

Real hits record devaluation against US dollar

Devaluation induces current account ajustment, but does not boost exports

In the third quarter of 2015, the Brazilian currency experienced a strong depreciation, thus speeding up the adjustment in the balance of payments. The trade balance in turn has recorded the largest surplus in three years. It is worth stressing, however, that the positive balance is due less to the exchange rate depreciation and more to the economic downturn. This becomes clear when one observes the pronounced decline in imports compared to a modest reduction in exports.

NEGATIVE EVENTS LEAD TO DEPRECIATION OF BRAZILIAN CURRENCY IN THE THIRD QUARTER

In the July-September period alone, the real depreciated by 27% against the US dollar. The exchange rate increased from R$ 3.11 per US dollar on July 1 to R$ 3.97 per US dollar on September 30, exceeding the mark of R$ 4.10 per US dollar on several occasions in late September. A string of bad events (national and international political and economic news) caused the exchange rate to depreciate in the last three months. Among these, special mention should be made of difficulties on the fiscal front, which culminated in the downgrade of Brazil's government bond rating by the Standard & Poor's agency.

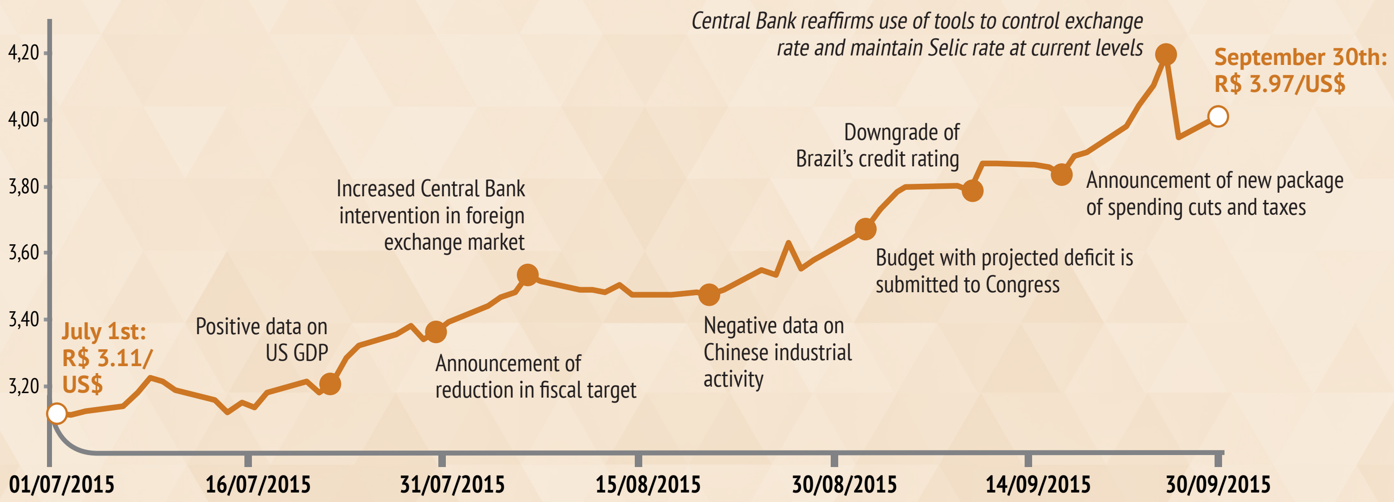
The figure below shows the exchange rate evolution and events that impacted it during the third quarter.

The downward pressure on the real does not reflect a lack of foreign exchange liquidity. The devaluation of the Brazilian currency is a result of current political and economic uncertainties and not of a shortage of foreign currency. The current account deficit recorded a significant drop during the same period and will likely close 2015 below the level of foreign direct investment (see more on this topic later in this section).

A string of negative events have led to a depreciation in the exchange rate in recent months

Daily exchange rate (Ptax Closing Rate)*

R$/US$



Source: Central Bank of Brazil
Prepared by: CNI
* The Ptax Closing Rate is the average of the buying and selling rates from the daily exchange rate bulletin.

The Central Bank has been intervening in the foreign exchange market via derivative operations such as foreign exchange swaps[6]. For some time, the Bank had been restricting its action to renewing these contracts, but it has started to issue new contracts again as a result of a more substantial devaluation of the Brazilian currency. These operations result in significant losses to the Central Bank when the real depreciates. According to preliminary data from the Central Bank, losses from foreign exchange swaps totaled US$ 84.7 billion in the year to August. Another operation that has been used is the so-called line auction (repurchase agreements)[7]. The total volume announced in September hit the mark of US$ 3.0 billion.

By the end of the year, the political environment is expected to remain turbulent and there will likely not be enough positive economic factors to reverse the exchange rate trend. It is actually the opposite: from an economic point of view, doubts will remain about the economies of China and the United States. Concerns over China come from its economic slowdown (which would affect Brazilian exports). As for the US, the concern is over a rise in the Country's benchmark interest rate, which would trigger capital outflow from the Brazilian market.

For this reasons, CNI expects to see high exchange rate volatility, with the figure sometimes exceeding the mark of R$ 4.00 per US dollar. We project that the average exchange rate for December will hit the mark of about R$ 4.00 per US dollar, reflecting a devaluation of over 50% as compared to the average for the same month the year before. The average exchange rate for 2015 would stand at R$ 3.37 per US dollar, compared to R$ 2.35/US$ in 2014.

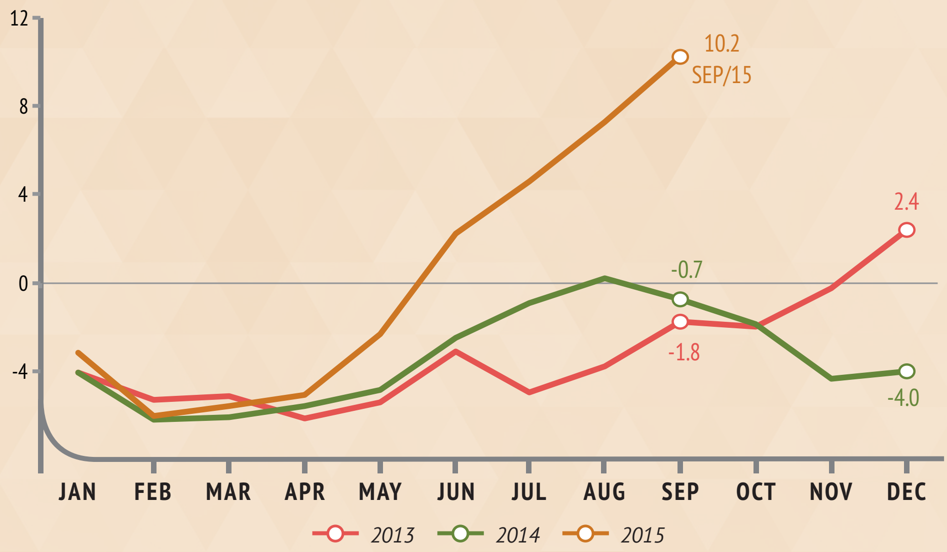
EXPORTS BARELY RESPOND TO NEW EXCHANGE RATE

The Brazilian trade balance continued to record positive results in the third quarter 2015. In the year to September, the surplus amounted to US$ 10.2 billion, compared to a US$ 0.7 million deficit in 2014. However, export and import values are lower than those observed in the same period of 2014. Unlike the two previous years, the balance is in surplus, with the rate of decline in imports (-22.6%) in the year to September exceeding that in exports (-16.3%) during the same period.

Primary surplus hits highest level in three years

Trade balance result in the year

In US$ billion



Source: Funcex

6 Through foreign exchange swap contracts, the Central Bank conducts an operation equivalent to sales of foreign currency on forward markets. The Central Bank offers time-bound US dollar sales contracts, but does not deliver the foreign currency. Upon expiration of these contracts, investors agree to pay an interest rate on the value of the contracts and receive an amount corresponding to the change in the US dollar exchange rate during the same period.

7 Line auctions involve selling US dollars in the spot market using Brazilian international reserves. In this case, however, the foreign currency must be returned to the Central Bank in the following months.

The devaluation of the real and a weak domestic activity are key factors behind the significant decline in imports and the reduction in oil prices. Imports experienced a widespread decline as compared to the same period (January-September) of 2014, affecting all use categories: capital goods (-17.1%), consumer goods (-15.5%), intermediate goods (-18.7%) and fuels (-45.9%). Import prices and volumes continue to trend downward.

Despite the positive impact of a depreciated domestic currency, exports edged down in the first nine months of the year. The reduction in commodity prices has contributed to this result. Compared to the January-September 2014 period, the value of exports of basic goods plunged by 21.9%, while that of semi-manufactured products fell by 7.9% and that of manufactured goods declined by 10.7%. Export volumes of both basic and semi-manufactured goods have increased. The reduction in export values has been driven by a decline in selling prices.

In the case of manufactured products, however, the positive impact of a depreciated domestic currency on exports has been hardly noticed. Both export volumes and prices are down. This result suggests that exports of manufactured goods do not depend solely on the exchange rate (see box “Exchange rate volatility hinders response of exporting industrial sector”).

The exchange rate will remain depreciated by the end of 2015. Despite this incentive, exporting firms will continue to respond slowly. In addition, export prices – especially commodity prices – will remain at a low level and will certainly lead to a drop in export values as compared to 2014. Under this scenario, CNI estimates that exports will total US$ 188 billion in 2015, down by 16% from 2014.

The exchange rate depreciation and, particularly, the sharp reduction in activity, investment and consumption will continue to drive further declines in imports by the end of 2015. We therefore estimate that imports will hit the mark of US$ 178 billion this year, a figure 22% lower than that recorded in 2014. In such a scenario, CNI estimates the trade surplus at US$ 10 billion.

This trend can be reversed in 2016 as a result of difficulties brought about by the ratification of the Trans-Pacific Partnership (TPP) between the United States, Japan and ten other countries. Brazilian products will lose competitiveness against products from those countries and companies will face additional difficulties to integrate into global value chains. Hence there will be trade diversion, especially in manufactured products. This will be a particular source of frustration for exporters with plans to increase their sales to the US, owing to the new exchange rate

Exchange rate volatility hinders response of exporting industrial sector

After a long period focusing mainly (and sometimes exclusively) on the domestic market, Brazilian industry has struggled to take advantage of a more favorable exchange rate and drive up exports.

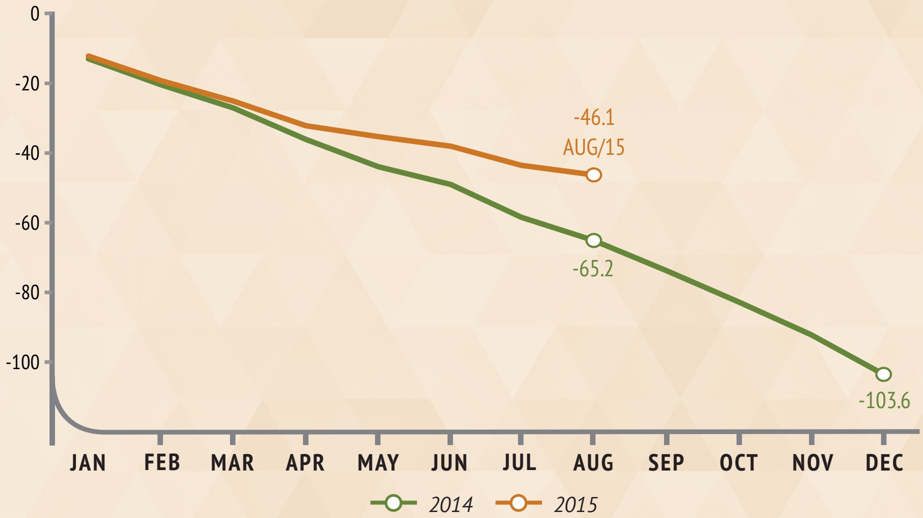
In many cases, it will be necessary to recreate distribution channels, adjust production processes and the relationship with suppliers, and win customers in a market that is much more competitive than in the past. Furthermore, the exchange rate volatility makes it difficult for companies to conduct any forward-looking analysis of export planning, pricing and investments required to boost exports.

As a result of the lack of a competitive cost structure and of a modern and stable trade policy, entrepreneurs cannot define a business strategy focused on increasing international integration and thus on stimulating foreign sales.

Difference between current account results is increasingly smaller

Current account result in the year

In US$ billion



Source: Central Bank of Brazil

level and to the more favorable growth outlook for the US. It should be stressed that the group accounted for 35% of total exports of Brazilian manufactured goods in 2014.

DEPRECIATION OF REAL LEADS TO ADJUSTMENT IN CURRENT ACCOUNT BALANCE

The current account deficit hit the mark of US$ 46.1 billion in the year to August, representing a 29.3% decline over the same period the year before. The rate of this decline has been increasing throughout 2015 due to the exchange rate depreciation and to the economic activity slowdown.

A more positive trade balance for 2015, coupled with a US$ 7.6-billion reduction in the income account deficit in the period, partly explains this positive trend. The deficit in services has also contributed, as it fell by US$ 4.3 billion in the year to August.

Special mention should be made of the US$ 3.3 billion reduction in spending on international travel during the same period.

The current account deficit has been almost entirely financed by direct investments. Foreign direct investment totaled US$ 42.2 billion in the year to August, down by 36% from the figure recorded in the same period of 2014.

CNI estimates that the current account deficit will keep falling by the end of the year and amount to US$ 69 billion, representing a 33% decline from 2014's level. The figure corresponds to 4.1% of GDP for the period (as projected by CNI), down from 4.4% of GDP in 2014.

Economic Report
ISSN 1983-621X • Year 31 • Number 3 • July/September 2015

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2013	2014	2015 previous forecast (07/09/2015)	2015 current projection (10/08/2015)
ECONOMIC ACTIVITY				
GDP (annual change)	2.7%	0.1%	-1.6%	**-2.9%**
Industrial GDP (annual change)	1.8%	-1.2%	-3.8%	**-6.1%**
Household consumption (annual change)	2.9%	0.9%	-1.2%	**-2.3%**
Gross fixed capital formation (annual change)	6.1%	-4.4%	-7.7%	**-13.4%**
Unemployment Rate (annual average - % of the labor force)	5.4%	4.8%	6.7%	**6.9%**
INFLATION				
Inflation (IPCA index - annual change)	5.9%	6.4%	8.9%	**9.6%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	8.29%	10.96%	13.47%	**13.47%**
(year's end)	10.00%	11.75%	14.25%	**14.25%**
Real interest rate (average annual rate and deflation: IPCA)	2.0%	4.3%	4.5%	**4.2%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	-3.05%	-6.23%	-6.45%	**-8.90%**
Public sector primary surplus (% of GDP)	1.77%	-0.59%	0.40%	**-0.05%**
Net public debt (% of GDP)	31.5%	34.1%	36.4%	**34.9%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.35	2.64	3.25	**4.00**
(average in the year)	2.15	2.35	3.10	**3.37**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	242.2	225.1	202.0	**188.0**
Imports (US$ billion)	239.0	229.0	197.0	**178.0**
Trade balance (US$ billion)	2.6	-4.0	5.0	**10.0**
Current account balance (US$ billion)	*	-104.8	-81.0	**-69.0**

*Data is not available because there is a change in methodological measurement of the Brazilian balance of payments developed by the Central Bank of Brazil.

ECONOMIC REPORT | 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: Flávio Castelo Branco | Team: Fábio Bandeira Guerra, Flávia Junqueira Ferraz, Isabel Mendes de Faria, Marcelo Souza Azevedo, Mário Sérgio Carraro Telles and Rafael da Silva Vasconcelos | CNI Publishing Center | Graphic design supervision: Alisson Costa | Customer Service - Phone: +55 (61) 3317-9992 - email: sac@cni.org.br. Document prepared on October 5, 2015.