CNI Newsletter
ISSN 1983-621X • Year 35 • Number 3 • July/September 2019

ECONOMIC REPORT

CNI
Brazilian National Confederation of Industry
THE FUTURE OF INDUSTRY

Economy recovering gradually

New growth cycle crucially depends on the investment rate

The fact that the Brazilian economy is recovering is undeniable; however, there is no consensus on the intensity and extent of this recovery. The latest activity data shows growth in the third quarter: industry's production and turnover have been modest, while retail sales have been growing more vigorously. CNI estimates a 0.9% GDP increase in 2019, with industrial GDP rising by 0.4% and investment by 2.5% because of this gradual improvement in activity throughout the year.

The macroeconomic scenario remains positive and will likely pave the way for a higher growth rate than the one seen so far. Inflation remains very low and expectations point to an annual rate below the target center, allowing for further cuts in the Selic rate. External accounts also remain favorable, despite the intensification of trade disputes in the international scenario.

Fiscal accounts have been evolving positively, but not at the required rate to prevent a primary deficit for the sixth year in a row. The "spending cap" and some other measures designed to curb spending have been playing a major role in the fiscal realm, but with limited scope. For the fiscal imbalances that led to the recession seen in recent years to be fully eliminated, compulsory spending must be appropriately disciplined, which requires a profound reform in the country's budgetary and administrative framework.

The second half of the year started positively, with the pension reform almost consolidated in the National Congress. However, growth prospects have not yet changed substantially.

Two basic factors explain this lower-than-expected growth. The first one is an increasing feeling that the process of passing indispensable reforms

(continued on the next page)

Brazilian economy in the third quarter of 2019

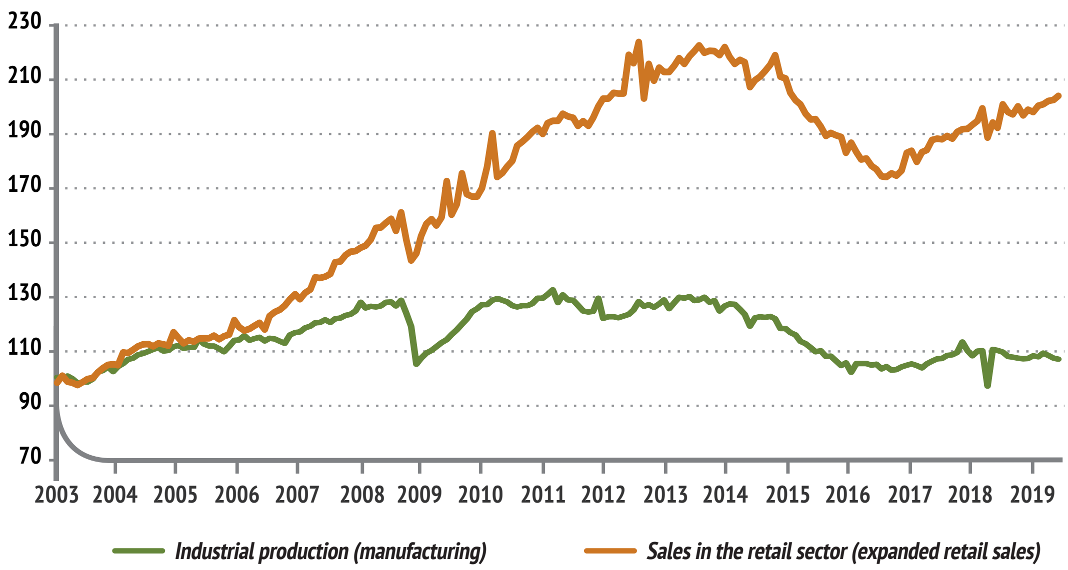
to ensure economic growth will be slower and more complex than initially realized.

The second factor that explains the weak growth seen so far is that little progress has been made on the so-called Brazil Cost reduction agenda. Without progress in this agenda, Brazilian companies still face difficulties to compete with their foreign competitors. This aspect has been affecting manufactured products more deeply.

Because of this lack of competitiveness, **industrial production has not been keeping up with the growth rate of domestic demand**, as reflected in the performance of retail trade, due to gradual improvements in the labor market and increases in total payroll.

Industry has not been keeping pace with the growth rate of retail trade

Manufacturing industry production and expanded retail sales
Fixed base index (2003 average = 100); seasonally adjusted



Source: IBGE
Prepared by: CNI

The competitiveness problems faced by manufacturing industry are bigger and different from those experienced in other productive sectors. Manufacturing faces direct competition from foreign products not affected by the same difficulties experienced by Brazilian producers: inefficient taxation, high interest rates, logistical shortcomings, high energy costs, unskilled labor, etc.

Urgent measures are required to change this situation, including structural reforms and actions to improve the business environment. A "confidence shock" and changes in the daily operations of companies must be brought about to improve their propensity to invest in the economy and, consequently, to generate more growth.

Excessive gradualism will not change the pace of investment substantially. Less robust reforms - or reforms excessively spaced apart in time - will only yield incremental gains in competitiveness without changing the behavioral inertia of economic agents, preserving a still hostile environment for companies.

In short, **the Brazilian economy is still stuck in slow gear and has not been gaining speed as expected.** Economic agents are still nurturing favorable expectations, meaning that there is potential for reaction in the short and medium term. Nevertheless, this capacity depends on the effective implementation of structural reforms – such as the pension and tax reforms required to ensure long-term fiscal balance – and on improvements in the business environment.

These are crucial changes for leveraging investment and productivity. By the way, productivity is the most important factor for long-term growth. Therefore, increasing productivity must be seen as Brazil's main challenge. For a long time, our productivity has been increasing at a slower pace than in other emerging countries, limiting our growth potential.

Economic Report
ISSN 1983-621X • Year 35 • Number 3 • July/September 2019

ECONOMIC ACTIVITY

Industrial activity has not been keeping up with demand growth

Industry continues to grow at a slower-than-expected pace

In July, we projected that second-quarter GDP would be frustrating in terms of economic growth. Preliminary activity data – especially data for industrial activity – suggested modest growth. June data had consolidated lower expectations for that quarter and contaminated expectations for the following quarter.

However, the official result from the National Accounts/IBGE for the second quarter was surprising, especially with regard to industrial activity. Second-quarter GDP in 2019 increased by 0.4% over the previous quarter, more than offsetting the 0.1% drop recorded in the first quarter. Industry grew in turn by 0.7% in the quarter, reversing the 0.5% drop seen in the previous quarter.

With regard to industry, July data were once again negative, but in August industrial production, capacity utilization, and hours worked in production increased, allowing for a reduction in excess inventories.

On the other hand, retail trade has continued to show the growth trend observed since May, especially the expanded retail trade sector (which includes, apart from retail trade, building materials and the vehicle and auto parts segment).

Thus, while positive signs of recovery for industry continue to be interspersed with negative data, a more robust growth trend has been observed for services and retail trade. That is, no homogeneous progress has been recorded for the different sectors of the economy, or even between the different activities of each sector. Domestic demand has been reacting and resuming an upward path, but only services and especially retail trade have been actually growing; industrial activity has not been keeping pace with this growth. This difference means that progress in overcoming the stagnation after the end of the crisis remains slow, without any significant momentum.

Better results are expected in the fourth quarter, but not without risks. Despite the positive effect of the release of FGTS funds on household consumption, its effect on industrial activity and investment will likely remain limited. In addition, the scenario abroad will remain challenging, especially for industry.

In this scenario, we are still projecting that GDP will grow by 0.9% and that industry will grow by only 0.4%. This means that 2019 will be another weak year from the point of view of resuming economic growth. Doubts remain as to whether industry will enter 2020 on the rise – albeit moderately – or still close to stagnation.

ANOTHER YEAR OF WEAK INDUSTRIAL GROWTH

Industry is yet to show signs of recovery and continues to be marked by the same low activity as in 2018. From May onwards, the setback in industry is mainly due to the low activity levels recorded for manufacturing industry. Industrial production (as measured by the PIMPF/IBGE survey) fell in May, June and July and grew by 0.8% in August. Considering manufacturing industry separately, these decreases were sharper in May-July and growth in August amounted to only 0.2%. The mining and quarrying industry grew in turn significantly in all of those months. The upturn recorded for the mining and quarrying industry was due both to the resuming of iron ore extraction after the collapse of a dam in Brumadinho and of oil extraction.

The low activity levels recorded for manufacturing industry is widespread across all industrial sectors. Although the overall result for industry was positive in August, production levels in 64% of all industrial sectors were still on the decline. This result reinforces the fact that industrial activity has been weak and reduces the possibility that the result in August will be indicative of the beginning of a stronger recovery process.

This difficulty is partly explained by a more challenging scenario abroad for exports. Exports of manufactured products declined by 10% between January and August 2019 as compared to the previous year. In August alone, this decline hit the mark of 29%.

This difficulty cannot be attributed to the fact that no recovery has been recorded in domestic demand. However, part of this new demand has not been leading to increased industrial production, as inventories remain high, above the levels planned by industry, even after partial adjustments made in August.

In addition, this new demand is being partly met by imports. CNI's Import Penetration Ratio, which measures the share of imports in meeting domestic consumption, closed 2018 close to its historical peak after increasing for two years in a row. In 2019, the process continues: even though the imported volume fell by 0.1% in the year to August, industrial production decreased by 1.7% on the same comparison basis.

The volume of imported intermediate goods, which are used as inputs for industry, increased by 6.1% in relation to July. This fact, in a scenario of virtual stagnation in domestic production, suggests that domestic inputs are being replaced by imported ones.

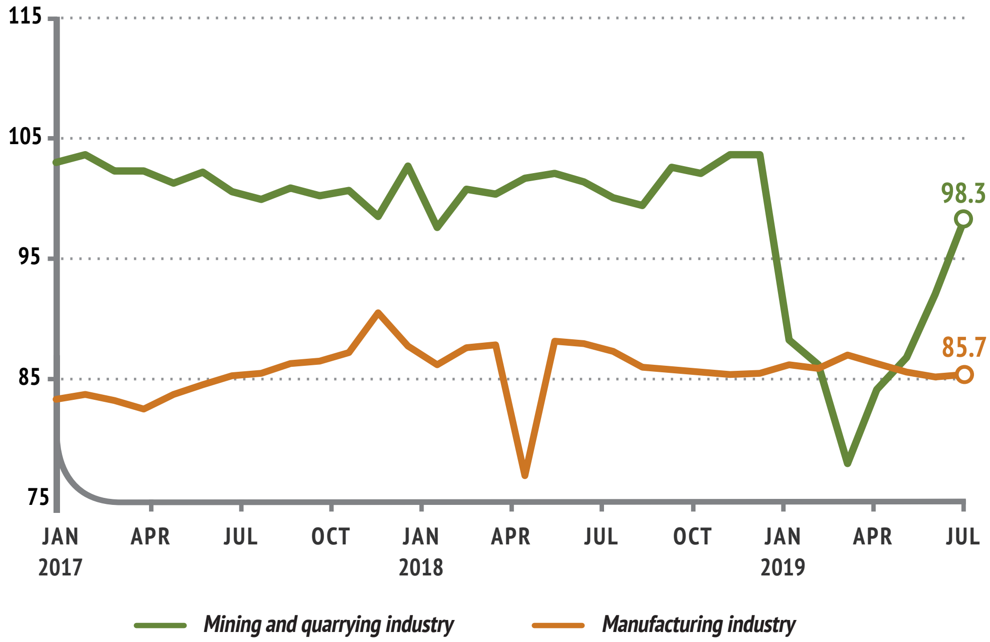
For the second half of 2019, we are projecting modest growth (0.4%) for manufacturing industry. We expect to continue to see a gradual increase in demand, but without changes in how industry has been reacting to this increase its response will remain limited.

However, not even this modest result is certain. There is a risk of an even more difficult scenario abroad, particularly of increased economic problems in Argentina, which will affect exports and possibly reduce the growth pace of manufacturing industry.

The mining and quarrying industry will likely continue to recover. Nevertheless, its activity level is expected to decline by 3% by the end of 2019.

Manufacturing industry is near stagnation while mining industry is on recovery

Industrial Production - Mining and quarrying industry
Index Number - 2002 Base = 100, seasonally adjusted



Source: PIM-PF/IBGE

The positive performance of the construction industry was one of the reasons for the positive result recorded for industry in the second quarter of 2019. Quarterly construction growth was the highest since the first quarter of 2014. In relation to the same quarter in the previous year, the sector grew by 2%, the first positive variation after twenty consecutive quarters on the decline on this comparison basis. The activity indexes for the sector, as calculated by the Construction Industry Survey (CNI), have been improving gradually since the beginning of the year.

This improved performance is explained by the construction of buildings, an area in which signs of recovery have been recorded. Infrastructure still represents the biggest challenge for the sector. Without fiscal space, public investment remains quite depressed. We are projecting that construction industry will grow by 0.6% in 2019. It will be the first time the sector will record growth after five years on the decline.

The Electricity and gas, water supply, sewage and others shrank by 0.7% second quarter of 2019 in relation to the previous quarter, but in the year to date it grew by 3.6%. This led us to revise our growth projections for 2019 downward from 3.5% to 3.0%.

MISMATCH BETWEEN INDUSTRY AND RETAIL TRADE

In July, while the industrial production index fell by 4.2% as compared to July 2018 (PIM-PF/IBGE), the volume of services (PMS/IBGE) increased by 1.2%, while sales in the expanded retail trade sector grew by 6.1%.

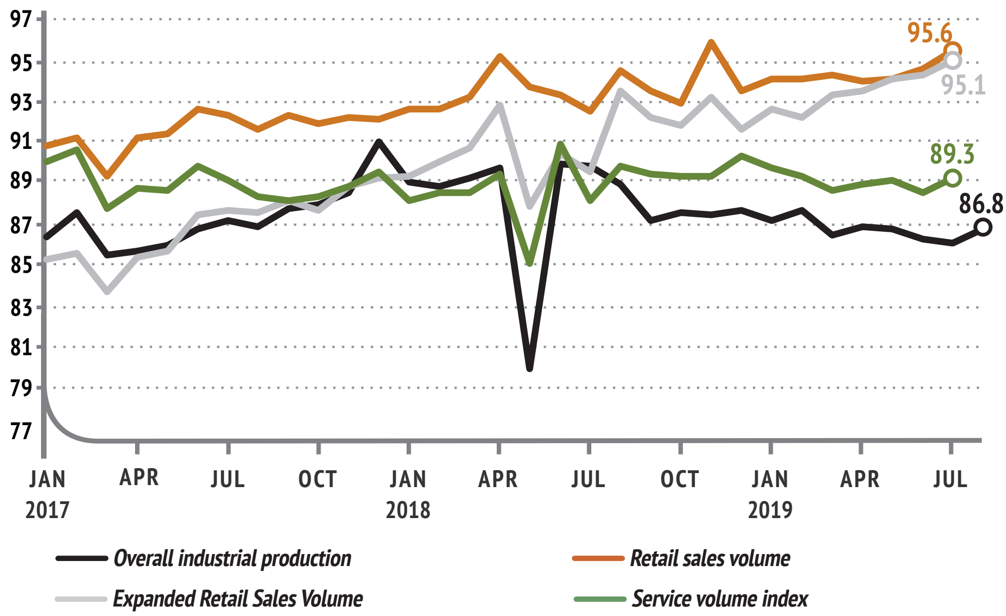
This is a sign that domestic demand is improving. Several factors explain this greater willingness to consume: (a) improved consumer confidence, which was already relatively high; (b) inflation under control; (c) gradual improvements in the labor market; (d) historically low interest rates; and (e) increased lending.

Unfortunately, as can be seen, there is a mismatch between industry and services. Demand growth can be felt in the service industry, especially in retail sales, but not in industrial activity (at least not as strongly) for the reasons already mentioned above: excess inventories, import penetration, and low external demand.

The third quarter will likely be characterized by a new difference between, on the one hand, the growth rates recorded for household consumption and for services and, on the other, for industrial

Increased demand can be felt more strongly in sales and not as much in industrial activity

Industrial production, retail sales volume, expanded retail sales volume and volume of services
Index Number - 2002 Base = 100, seasonally adjusted



Source: Monthly Industrial Survey - Physical Production (PIM-PF/IBGE), Monthly Retail Trade Survey (PMC/IBGE) and Monthly Survey of Services (PMS/IBGE) activity. We continue to project a growth rate of 1.1% for the service industry in 2019. Despite the more modest growth rate recorded for services focused on production, in particular on transportation, services for households and retail trade will grow at more robust rates.

INVESTMENT WILL REMAIN LOW IN 2019

Once again, household consumption will be the main driver of GDP growth in 2019. We are projecting that household consumption will grow by 1.5%, less than in 2018 (1.9%) and slightly more than in 2017 (1.4%).

Investment, as measured by Gross Fixed Capital Formation (GFCF), is still low. The fact that capacity utilization remains at historically low levels prevents investment from rising more intensely, especially because prospects for improved demand are still moderate. In addition, difficulties faced by the construction industry, as already mentioned above, especially with regard to the infrastructure sector, have not been overcome. CNI's forecast is that investment will increase by 2.5% in 2019.

As for exports, the crisis in Argentina has been limiting sales of manufactured goods. In the international scenario, the impacts of trade tensions continue to be felt. Export volumes have been decreasing month by month and there are uncertainties about the extent of monetary easing in several economies. As a result, we are projecting that exports of goods and services will increase by 1.5%.

Import volumes will likely increase in relation to 2018, but their growth rates are also becoming increasingly lower. We are projecting that imports of goods and services will increase by 3.5%.

Estimates for GDP and its components in 2019

Projected percentage change

	GDP COMPONENTS	Percentage change (%)
Demand side	Household consumption	1.5
	Government consumption	-0.2
	Gross fixed capital formation	2.5
	Exports	1.5
	(-) Imports	3.5
Supply side	Agriculture/livestock	1.0
	Industry	0.4
	Mining and quarrying	-3.0
	Manufacturing	0.4
	Construction	0.6
	Electricity and gas, water supply, sewage and others	3.0
	Services	1.1
GDP		0.9

Projected by: CNI

Economic Report
ISSN 1983-621X • Year 35 • Number 3 • July/September 2019

EMPLOYMENT AND INCOME

Increased informal employment supports real growth in total payroll

Unemployment rate will still remain high

In 2019, the job recovery rate remains moderate and driven mainly by rising informal employment. A low investment rate and the little progress made on economic activity in the year explain this weak performance.

As a result, and considering the sharper increase in the workforce, the unemployment rate continues to decrease at a slow pace, a behavior that will likely persist until the end of this year.

Real total payroll growth has in turn slowed down in the year-on-year comparison (current moving quarter against the same moving quarter in the previous year). This cooling-off was caused by the decrease observed in average real earnings on the same basis of comparison.

As real income is likely to increase very modestly in 2019 (by less than 0.5%), total payroll will essentially grow as a result of an increased occupation rate. CNI expects total payroll to increase by 2.5% in 2019, against 3.4% in 2018.

The average unemployment rate is in turn likely to remain at 11.9% in 2019, 0.4 percentage points lower than the rate recorded in 2018 (12.3%).

INCREASED INFORMAL EMPLOYMENT IS THE MAIN FACTOR LEADING TO IMPROVED JOB FIGURES

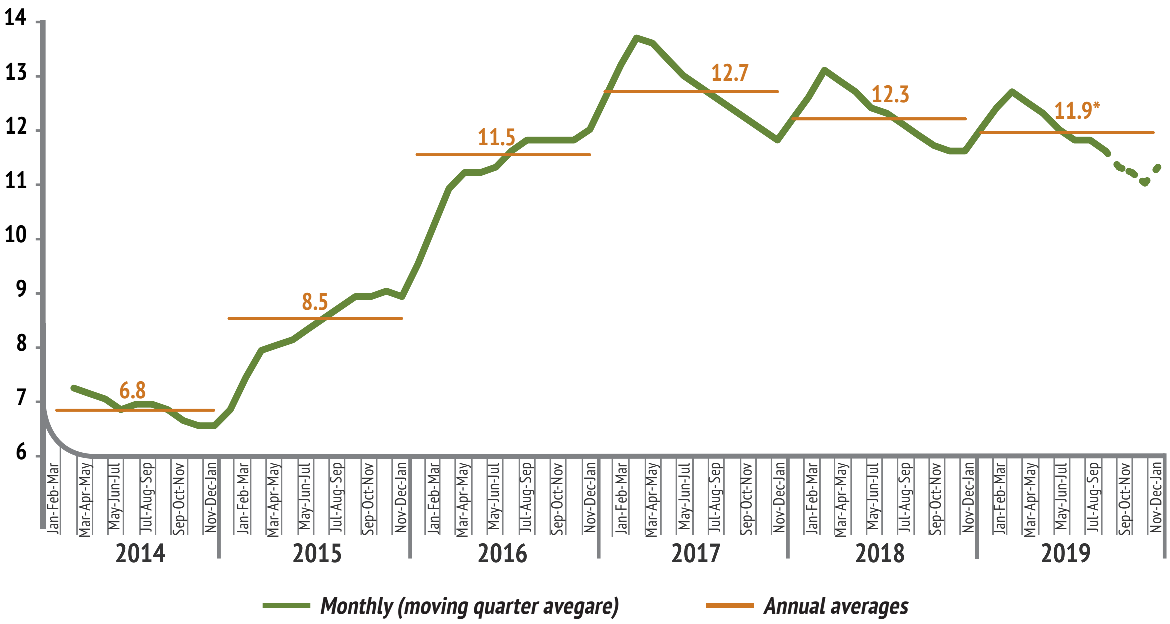
The unemployment rate as measured by IBGE's Monthly Continuous National Household Sample Survey remained stable at 11.8% of the workforce between July and August in the statistics for the moving quarter.

The rate has been on the decline since the beginning of the year, but the indicator is still very high, as almost 12.5 million economically active people are unemployed.

The unemployment rate has been falling slowly because, despite a reduction in the number of unemployed people in the year, the workforce has been growing at a faster pace than in 2018.

Unemployment rate will remain high

Monthly unemployment rate (moving average) and average annual unemployment rate
As a percentage of the labor force (%)



Source: Monthly Continuous National Household Sample Survey/IBGE
**CNI projection*

The unemployment rate will likely remain on a downward path in the coming months due to the gradual recovery of the economy and temporary hiring to meet year-end demand.

However, the pace of economic activity growth will not be robust enough to ensure a substantial reduction in the indicator this year. As a result, the average unemployment rate will likely remain high and hit the mark of 11.9% of the labor force, 0.4 p.p. below the 12.3% rate recorded in 2018.

FORMAL EMPLOYMENT ON THE RISE, EXCEPT IN THE RETAIL TRADE SECTOR

Brazil created 593,000 formal jobs between January and August, according to the General Register of Employed and Unemployed Persons (CAGED). This result is lower than the one recorded between January and August 2018, when 607,000 jobs were created.

The overall result for the first eight months of the year is positive for almost all sectors of the economy, except for the retail trade sector, which experienced a net loss of 59,000 jobs in the year.

The industrial sector created 202,000 jobs in the year up to August, mainly in the construction industry (97,000 jobs) and in the manufacturing industry (94,000 jobs). The mining and quarrying industry and Public Utility Industrial Services (SIUP, in the Brazilian acronym) created 5,500 and 5,300 net jobs, respectively.

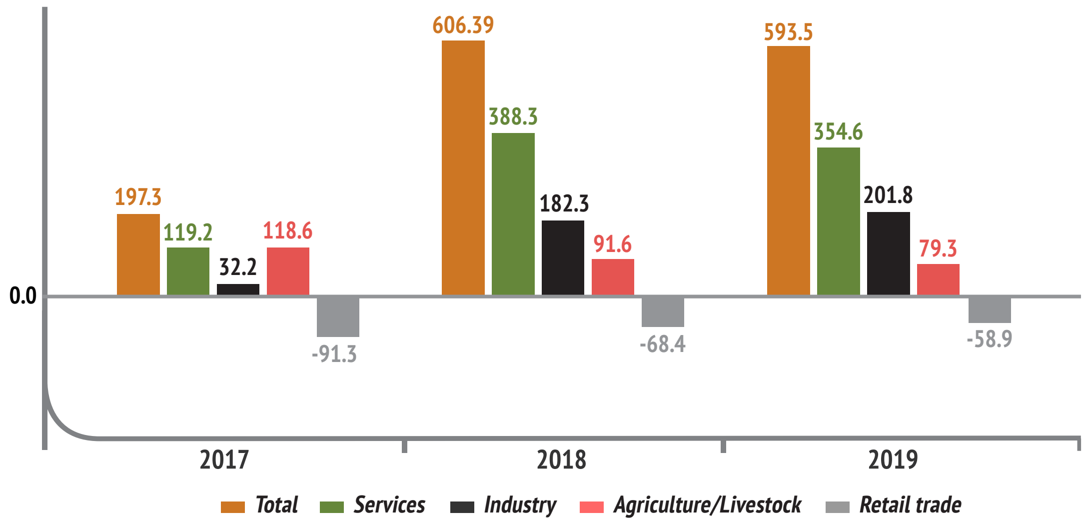
As a result, the net balance of formal jobs in the 12-month period up to August totaled 528,000 formal jobs, against 398,000 in the 12 months up to August 2018.

Given the moderate growth rate of the Brazilian economy, formal employment rate is not likely to grow more significantly this year.

Net formal employment growth as measured by CAGED is likely to follow the same seasonal trend, rising up to October and cooling off between November and December as a result of lay-offs of temporary workers.

Economy creates 593,000 net jobs in the year

*Net balance of formal jobs**
In thousands (between January and August 2019)



Source: CAGED/Ministry of Economy
**Considers information provided beyond deadline*

IMPROVED OCCUPATION RATE SUPPORTS GROWTH IN REAL TOTAL PAYROLL

The growth rate of real total payroll has cooled off in recent months due to the behavior of real average income, which has been falling for four months in a row in the year-on-year comparison.

According to data from IBGE's Monthly Continuous National Household Sample Survey, real income grew by 0.2% from January to August in relation to the same period in 2018. Between 2018 and 2017, it grew by 1.8% on the same comparison basis.

Total payroll grew in turn by 2.4% from January to August 2019 as compared to the same period in 2018. Between 2017 and 2018, it grew by 3.4% on the same comparison basis.

The fact that the employment rate increased mainly as a result of informal jobs explains in part the modest growth seen in average real income in 2019, as informal jobs usually pay less on average than formal ones.

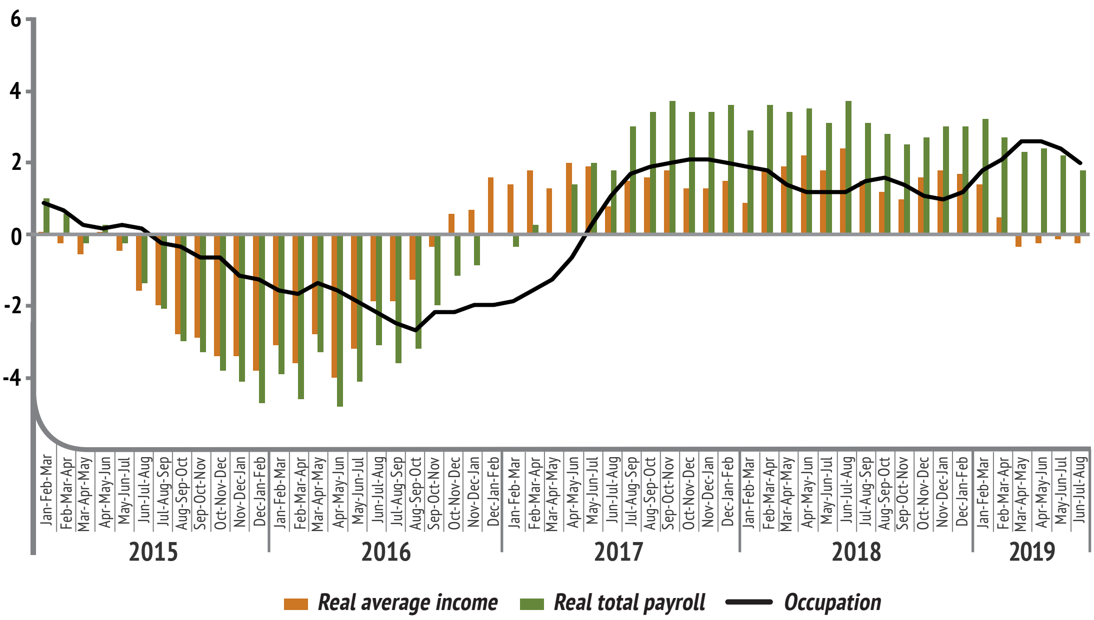
While on the one hand the increase in the employment rate based on informal jobs puts negative pressure on real income, on the other this increase in informal occupation has been supporting the growth observed in real total payroll over the year.

This scenario is likely to persist in the coming months. Real average income will likely increase by 0.4% in 2019, well below the 1.6% growth recorded in 2018. Thus, and considering that the job market will likely perform similarly to how it did in 2018, real total payroll is likely to increase by 2.1% in 2019, against 3.1% in 2018.

Increased labor market dynamism requires measures to boost investment and economic activity, such as actions to improve the business environment and reduce the cost of capital. The new cycle of cuts in the Selic rate is a major catalyst for creating this more favorable environment (see the section Inflation, Interest Rates and Credit). But other measures designed to improve the credit market and boost business confidence are essential for unlocking the economy and, consequently, promoting a significant increase in new jobs.

Informal employment supports growth in total payroll

Real average income, Real total payroll and Occupation
Variation as compared to the same moving quarter the year before (%)



Source: Continuous National Household Sample Survey/IBGE

INFLATION, INTEREST RATES AND CREDIT

Inflation below the target center allows for further cuts in the Selic rate

IPCA index likely to close the year at 3.5%

The behavior of the Extended National Consumer Price Index (IPCA) was favorable in 2019, as it fluctuated within the limits set by the Monetary Policy Committee (Copom).

In August, the dynamics of the inflation rate was even more positive, with a negative variation of 0.35%. As a result, the index stood at 2.95% in the 12-month period to August, well below the inflation target center of 4.25% set for 2019.

As this very benign scenario is likely to continue, there will be room for further reductions in the Selic rate, which according to our estimates will close 2019 at 5% a year.

INFLATION EVOLVING FAVORABLY

The group of government-regulated prices is the one that put the most pressure on inflation in 2019. Despite a downturn in the prices of this group in relation to 2018, they increased by 4.4% in the year to August, the highest variation recorded among the four main groups making up the IPCA index. In the 12-month period to August, the group recorded a 3.9% increase against 11.2% over the same period in 2018.

Food prices are the ones that increased the most in 2019, as a result of a strong seasonality experienced by the group early in the year. Over the last four months, however, negative variations were recorded. Year-to-date, food prices rose by 3.09%. In the 12-month period to August, food prices increased by 4.8%, against only 1.4% over the same period in 2018.

Service prices also showed an upward trend in 2019, but less sharply. Increases in tuition fees, eating out and airline tickets put pressure on service prices, which rose by 2.73% in the year to August. In the last 12 months, inflation in the group hit the mark of 4.4%, against 3.3% in the 12-month period to August 2018.

Inflation is likely to continue to perform well for the remainder of the year, even though it is expected to rise slightly, especially that of government-regulated prices.

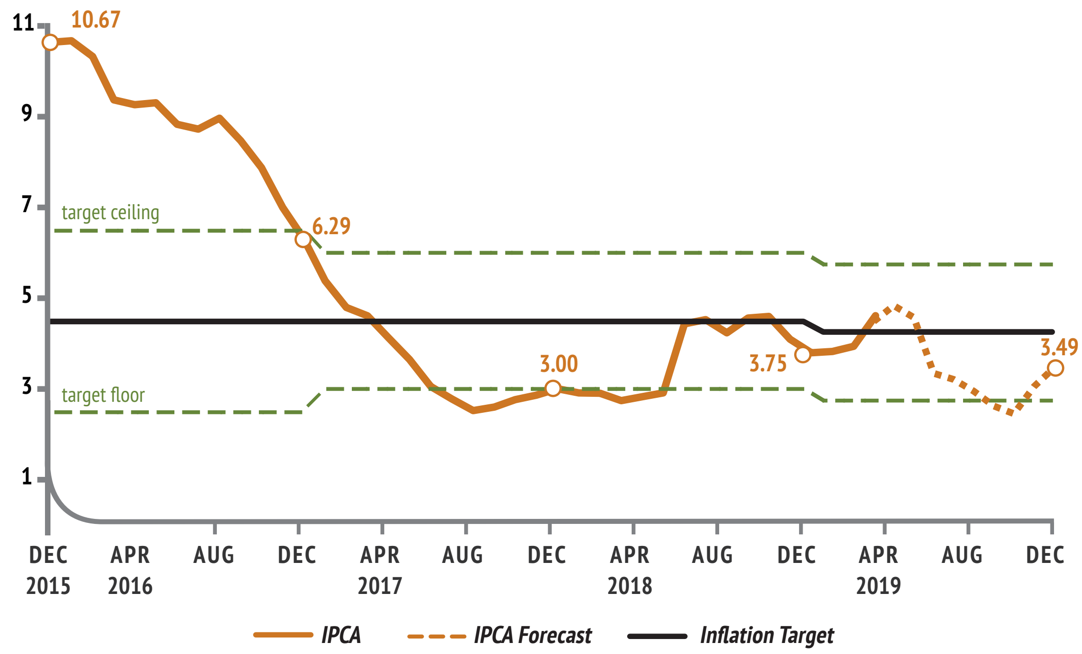
In the case of food prices, positive crop projections will likely ensure the same more favorable performance observed in recent months. Despite a rising exchange rate – with an impact on the prices of imported products such as wheat – and a lower availability of public credit – which is a major source of funds for the agriculture/livestock sector – weather conditions are much more favorable than last year.

Services are likely to continue to be influenced by the low dynamism of the labor market and by the current dynamics of inflation itself, reducing the inertial component in the composition of its adjustments.

Therefore, and considering the prospects for the labor market until the end of the year (see the section Employment and Income), we estimate that the IPCA index will likely close 2019 at 3.49%.

Inflation likely to close 2019 below the target center

Consumer Price Index - IPCA
12-month figure (%)



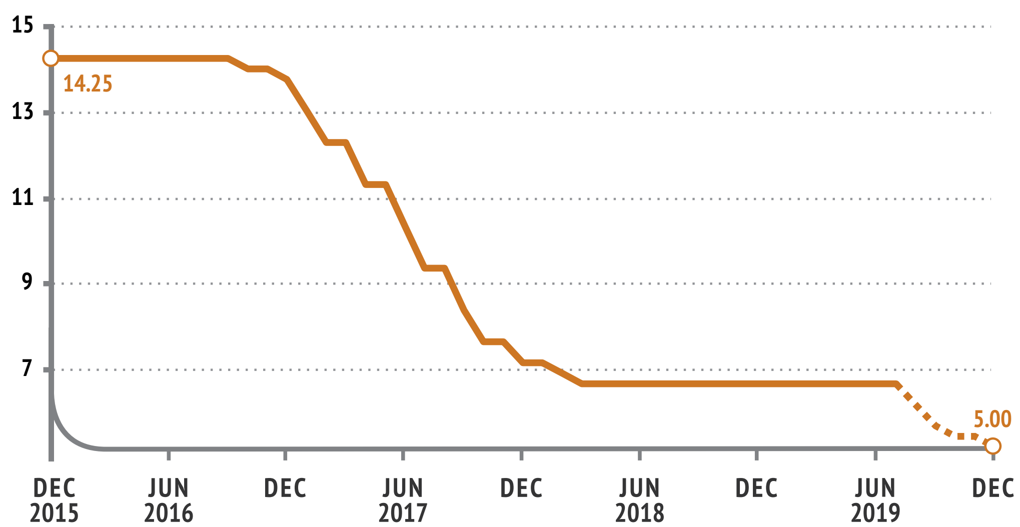
Source: IBGE and Central Bank of Brazil
CNI Forecast

MONETARY POLICY LIKELY TO BE EASED UNTIL DECEMBER

The Central Bank initiated a new cycle of cuts in the Selic rate at the Monetary Policy Committee (Copom) meeting held in late July. That decision was based on the positive behavior of product and service prices, on the moderate pace of economic activity, and on a still high unemployment rate. The cuts are also based on positive developments in the policy agenda and in measures designed to ensure macroeconomic stability, especially in the fiscal area, such as in the Pension Reform, which ensures favorable prospects for future inflation behavior.

With a new monetary easing cycle, the Selic rate will likely drop to 5.00% p.a. in 2019

Basic interest rate
End-of-period rate (% p.a.)



Source: Central Bank of Brazil

The prospect of continued cuts in domestic interest rates also follows a trend observed worldwide, with reductions in basic interest rates in emerging countries. The United States announced a cut in the Selic interest rate at its last meeting in September. This measure was intended to reduce the impacts of the slowdown in world economic activity on the US economy.

CNI expects the Selic rate to be further reduced before this year is over. We expect to see two further 0.25 percentage point reductions in the Selic rate at the next meetings of the Monetary Authority in October and December, as a result of which it will likely close the year at 5.00% p.a.

With the Selic rate at 5.50% p.a. currently and based on inflation expectations of 3.35% for the next 12 months according to BACEN's FOCUS survey, the real interest rate (ex-ante concept, which considers future inflation) stood at 2.5% p.a. in September.

BALANCE OF THE CORPORATE LOAN PORTFOLIO CONTINUES TO DECLINE IN 2019

Total credit stock, which declined over the past three years, took an upturn once again in 2019 in the year-on-year comparison. The indicator rose by 1.9% in August in real terms in relation to August 2018.

It should be mentioned that this improvement in total stocks is due to the balance of the loan portfolio of individuals. In August, that balance rose by 7.2%.

On the other hand, the balance of the corporate loan portfolio has not yet shown signs of recovery and has been on the decline since September 2015.

In August, the balance for companies decreased by 4.5% as compared to August 2018.

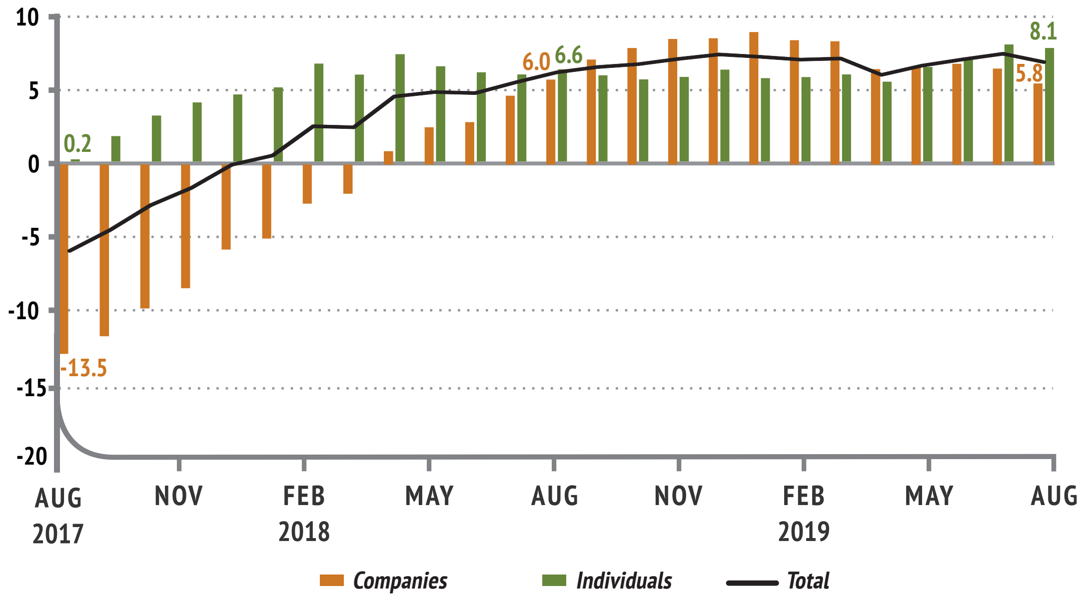
Lending in turn continues to increase year-on-year. In the comparison between the year up to August 2019 and the same period up to August 2018, total lending increased by 7.1% in real terms against 6.3% in 2018 on the same basis of comparison.

For companies, it grew by 5.8% (against 6.0% in 2018), while for individuals it increased by 8.1% (against 6.6% in 2018).

However, it is noteworthy that the growth in lending slowed down throughout the year, especially for companies.

Lending remains on the rise in 2019

Lending, in real terms
12-month variation



Source: Central Bank of Brazil

FISCAL POLICY

Federal Government likely to exceed the primary result target

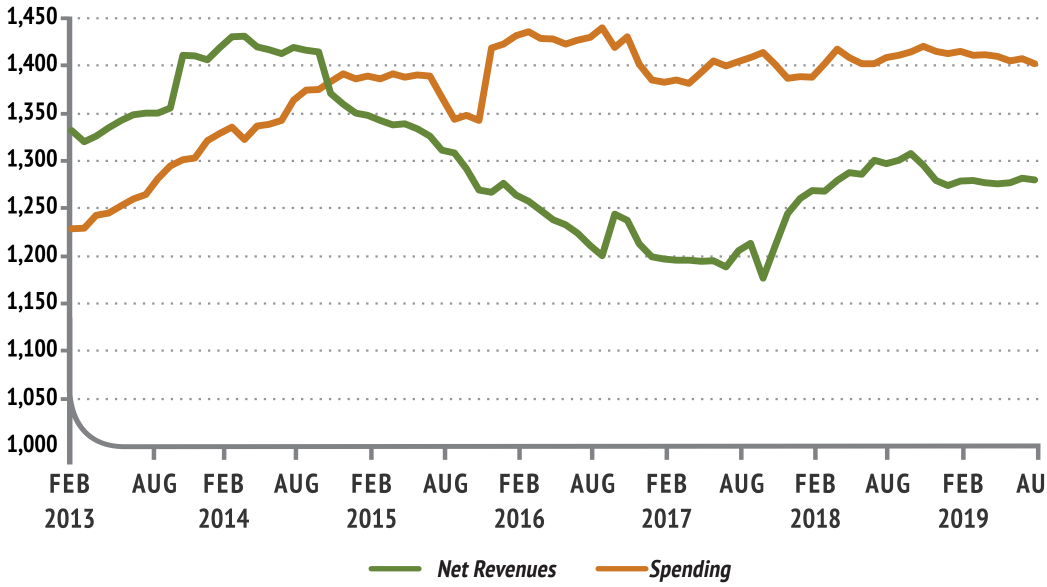
Meeting fiscal targets does not prevent further increases in public debt

The Federal Government will likely exceed its primary result target for 2019. The effects of keeping non-compulsory spending under control and of legislative changes on some mandatory expenses in previous years will outweigh the pressures from spending on pensions and personnel. However, despite the efforts being made to keep spending under control, the Federal Government's primary deficit is likely to be slightly higher than in 2018.

This small increase in the Federal Government's primary deficit will likely be offset by a higher primary surplus of states and municipalities. As a result, the public sector primary deficit is expected to close 2019 at R$114.9 billion (1.60% of GDP as estimated by CNI), close to the level recorded in 2018. Nevertheless, the nominal deficit is likely to be higher than required to prevent further increases in public sector debt, which will likely hit the mark of 78.4% in 2019.

12-month Federal Government spending decreased by 0.9% in real terms between December 2018 and August 2019

Evolution of federal government primary spending and net revenues
12-month figure (R$ billion in August 2019)



Source: National Treasury Secretariat/Ministry of Economy
Prepared by: CNI

FEDERAL GOVERNMENT SPENDING UNDER CONTROL

Federal Government spending fell by 1.3% in real terms (IPCA deflator) between January and August 2019 in relation to the same period in 2018. This drop was caused by reductions in spending on fixed costs and investments. Conversely, spending on pensions and personnel pushed expenditures up, albeit less intensely.

Spending on fixed costs and investment decreased by 7.4% in real terms from January to August 2019 as compared to the same months in 2018. Within this group, spending under Federal Government control (non-compulsory spending) was the one that decreased most, by 17.2% in real terms. Among these expenditures, a 18.0% drop in investments deserves special mention.

In the case of compulsory spending on fixed costs, a real reduction of 4.2% was recorded between January and August 2019 as compared to the same period in 2018. In this case, decreases in spending on compensation for payroll tax relief, wage bonuses, and unemployment insurance and subsidies deserve special mention. All of them reflect amendments to the respective laws made in previous years.

Pension spending put pressure on government spending, as it increased by 2.5% in real terms from January to August 2019 in relation to the same period in 2018. This increase may be explained by the increase in the number of pensions, by the indexation of these pensions, and by higher spending resulting from court rulings and court-ordered debt payments. Another expenditure item that put pressure on federal public spending was that of spending on personnel, which increased by 0.7% in real terms on the same comparison basis. This increase can be mainly explained by wage increases approved for several categories of civil servants in January 2019.

The Federal Government net revenue in turn reversed the decrease observed until May and increased by 0.1% in real terms over the period from January to August 2019 in relation to the same period in 2018.

Revenues managed by the Internal Revenue Service had a major bearing on the positive result observed so far, as they increased by 1.1% in real terms between January and August 2019 as compared to the same period in 2018. This increase was mainly due to the more intense economic activity recorded over that period and to an atypical revenue from corporate income tax. Net revenues did not increase more solely due to the negative impacts of lower revenues from debt installment payments to the Federal Government (under the REFIS program) and from the PIS (Social Integration Program contribution)/ COFINS (Contribution to Social Security Financing on fuel).

Social security revenues also increased by 2.6% in real terms from January to August 2019 against the same period in 2018. This increase was largely due to the growth recorded in total payroll.

Revenues not managed by the Internal Revenue Service declined by 4.0% on the same basis of comparison. This decrease is explained by a reduction in revenues from concessions and permits resulting from the fact that the sharing of oil revenues in August 2018 was not repeated in 2019.

SPENDING AND REVENUES OF STATES AND MUNICIPALITIES ON THE RISE

Unlike what has been observed for the Federal Government, the spending of state and local governments has been on the rise. Based on available data on state and municipal revenues and on the behavior of the primary result of states and municipalities, CNI estimates that regional government spending increased by 1.1% in real terms over the period from January to August 2019 against the same period in 2018.

On the revenue side, available data show a real increase of 1.9% on the same basis of comparison. Revenues from the ICMS (turnover tax), which is the main source of revenue for regional governments, increased by 2.0% in real terms from January to August 2019 as compared to the same period in 2018. Electricity- and retail trade-related tax revenues were the ones that increased the most over that period.

Transfers from the Federal Administration also contributed to the positive results recorded for the revenues of regional governments, as they increased by 3.7% in real terms from January to August 2019 in relation to the same period in 2018. This growth can be explained by increases in revenues from the income tax, a tax shared by the Federal Government, and in revenues from financial compensation for exploration of mineral resources.

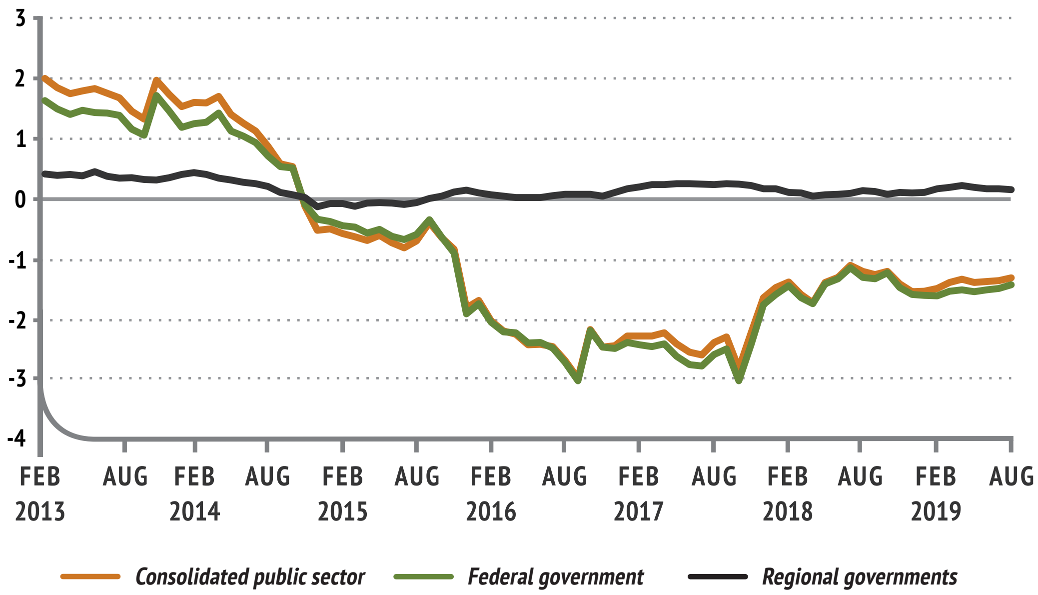
PUBLIC DEFICIT IS NOT FALLING ENOUGH TO PREVENT RISING DEBT

A lower Federal Government deficit and a higher surplus of regional governments led to a decline in the consolidated public sector primary deficit in 2019 in relation to 2018. The public sector recorded a deficit of R$95.5 billion (1.36% of GDP) over the last 12 months to August 2019. In December 2018, the result was negative by R$108.3 billion (1.59% of GDP).

This fall in the primary deficit and in interest spending led the 12-month nominal deficit to decrease from 7.14% of GDP in December 2018 to 6.32% in August 2019. However, this decrease was not sufficient to stabilize the Gross Debt-to-GDP ratio, which increased from 77.2% in December 2018 to 79.9% in August 2019.

12-month public sector primary deficit decreased by 0.23 percentage points of GDP from December 2018 to August 2019

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



Source: Central Bank of Brazil
Prepared by: CNI

PRIMARY DEFICIT IN 2019 LIKELY TO BE SLIGHTLY HIGHER THAN IN THE PREVIOUS YEAR

The primary deficit of the federal government will likely be higher than that observed up until August and close 2019 at a slightly higher level than that seen in 2018. This is because, by the end of this year, the real decline in Federal Government spending will likely turn into small growth. This reversal in spending will not be fully offset by a higher net revenue growth pace. The primary surplus of regional governments is in turn likely to close 2019 at a similar level to that observed until August and above the level recorded in 2018.

Federal Government net revenue is expected to increase by 0.5% in real terms in 2019 as compared to 2018. The expected improvement in relation to the result observed until August (real growth of 0.1%) will likely be brought about by the rise in revenues managed by the Internal Revenue Service, which are likely to close 2019 with real growth of 1.5% in relation to 2018. In addition to the effect of real GDP growth expected in the second half of the year, revenues managed by the Internal Revenue Service may no longer be negatively impacted by the reduction in the PIS/COFINS contribution, which was effective in the first half of 2019 but not in the same period in 2018.

Federal Government net revenue growth will not be higher due to a 4.2% decrease in revenues not managed by the Internal Revenue Service and also to a slowdown in the pace of increase in social security revenues.

Federal Government spending is in turn likely to close 2019 with a real growth of 0.2% in relation to 2018. This result may be explained by a more intense growth pace of spending on pensions and personnel until the end of the year. In the case of social security spending, its 3.4% increase is mainly due to disbursements related to the 13th salary (Christmas bonus) and to a real raise in the minimum wage at the beginning of the year. The pace of increase in spending on personnel is in turn likely to become more intense and rise to 1.9%, due to the effects of wage increases granted to civil servants on the thirteenth salary.

Moving in the opposite direction, spending on fixed costs and investment will likely record a real decrease of 4.9% in 2019. This recent release of R$12.5 billion for non-compulsory expenditures is the only factor that prevented this decrease from being sharper.

The Federal Government and its state-owned companies are therefore likely to close 2019 with a primary deficit of R$123.5 billion (1.72% of GDP as estimated by CNI). This result will make it possible for the R$142.5 billion target set for 2019 to be achieved by a fair margin. However, the result will still be higher than the R$112.7 billion primary deficit (1.65% of GDP) observed in 2018.

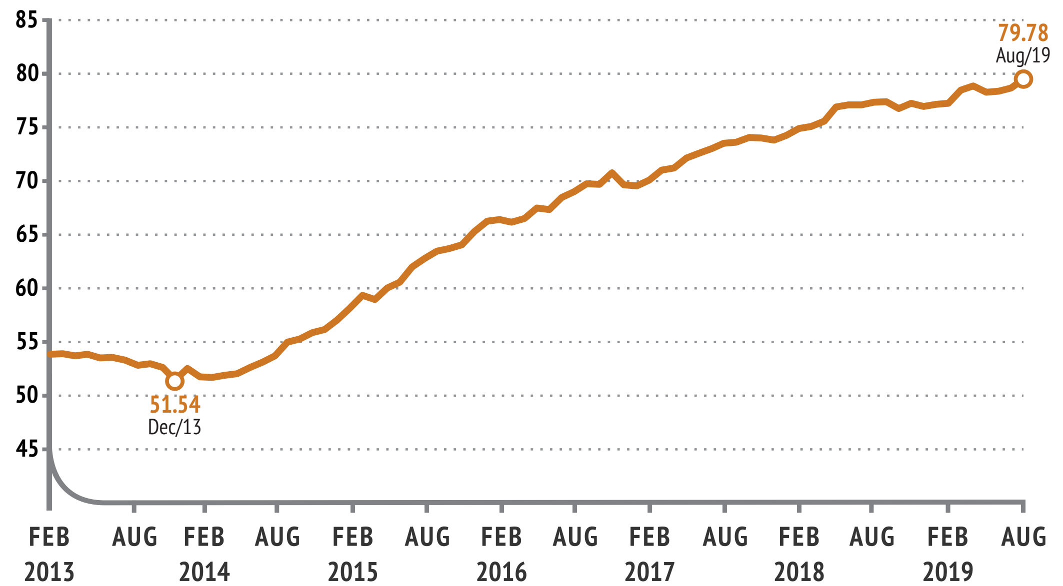
With regard to regional governments, the pace of revenue growth seen at the beginning of the year is likely to slow down, mainly due to the effect of a less intense increase in financial compensation for exploration of mineral resources on transfers from the Federal Administration. As the pace of spending growth is also expected to slow down by the end of 2019, the primary surplus of states and municipalities is likely to remain at around R$8.5 billion (0.12% of GDP as estimated by CNI), below the target of R$10.5 billion set for the year.

As a result, the consolidated public sector primary surplus is expected to record a deficit of R$114.9 billion (1.60% of GDP as estimated by CNI) in 2019. This result exceeds the target set for 2019 (R$132 billion) by about R$17 billion and is close to the 1.59% of GDP deficit observed in 2018.

Keeping the primary deficit at this level and reducing nominal interest spending by 0.7 percentage points of GDP will likely lead to a reduction in the nominal deficit from 7.14% of GDP in 2018 to 6.43% in 2019. Despite this reduction, the nominal deficit is still higher than required to stabilize the gross debt-to-GDP ratio, which may rise from 77.2% in 2018 to 78.4% in 2019. This increase is likely to be recorded despite the return by the BNDES of more than R$100 billion to the National Treasury.

Gross debt-to-GDP ratio rose by 2.6 percentage points from December 2018 to August 2019

Trajectory of the Public Sector's Gross Debt
As a percentage (%) of GDP



Source: Central Bank of Brazil

FOREIGN TRADE SECTOR

Scenario abroad and low growth have a negative impact on the trade balance

Exchange rate remains volatile at a higher level

Brazil's foreign accounts are beginning to show signs of deterioration as a result of an unfavorable scenario abroad and of a weak performance of the domestic economy.

In the third quarter of the year, the exchange rate became more volatile and depreciated further. The main external factors influencing this shift, trade conflicts and the recession in Argentina are conjunctural factors. However, domestic factors, such as the adoption of an accommodative monetary policy and low growth, are more structural in nature. Domestic interest rates declining at a faster pace contributed to reducing demand for the Brazilian currency in relation to the US dollar, which seems to be a longer-term trend.

Global trade flows, which have been compromised by trade conflicts, are also having negative effects on the Brazilian trade balance. The recession in Argentina is an additional factor leading to a reduction in exports of manufactured goods.

Finally, direct investment remains high enough to cover the current account deficit, showing that external accounts are still robust.

EXCHANGE RATE DEVALUATION AND VOLATILITY ON THE RISE IN THE THIRD QUARTER

In the quarter from July to September, the exchange rate averaged USD1/R$ 3.96 and the average for the year is USD1/R$3.90. In September, the average exchange rate hit the mark of USD1/R$4.12 as a result of a 5.6% devaluation above the year's average, but the first days of October saw a downward trend, as the rate declined to USD1/R$4.08 (October 8).

Trajectory of the exchange rate has been less influenced by country risk

Daily exchange rate (Ptax closing rate) and the Brazil Risk (EMBI)*
In R$/USD and points

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

The so-called Country Risk (EMBI), which rose to 252 points in August, shows a downward trend in the series over the last twelve months. In the third quarter of the year, the average risk amounted to 232 points.

Until the second quarter, the country risk and exchange rate series behaved similarly, showing that the country risk had a major bearing on the exchange rate. The little convergence between the series observed recently suggests that the weight of domestic factors in speeding up the depreciation of the exchange rate has become less important.

Conjunctural factors, such as the US-China trade war and the crisis in Argentina, have contributed to the stronger depreciation of the Brazilian currency. But structural changes in domestic monetary policy have also been leading, at least in the medium term, to the devaluation of the Brazilian currency against the US dollar.

Interest rates falling at a faster pace in Brazil than in the US narrow the gap between the cost of capital and returns on capital invested in Brazil, leading foreign investors to seek better returns in other countries. Capital outflows reduce the supply of US dollars in the Brazilian economy, leading to a higher appreciation of the US dollar against the Brazilian currency.

In the domestic scenario, the prospect of approval of reforms such as the pension and tax reforms attracts investment, strengthening the domestic currency.

Given the above-mentioned external shocks and domestic uncertainties, the exchange rate is projected to close 2019 at UD1/R$4.02, with the year average at USD1/R$3.90.

UNFAVORABLE SCENARIO ABROAD JEOPARDIZES TRADE PERFORMANCE

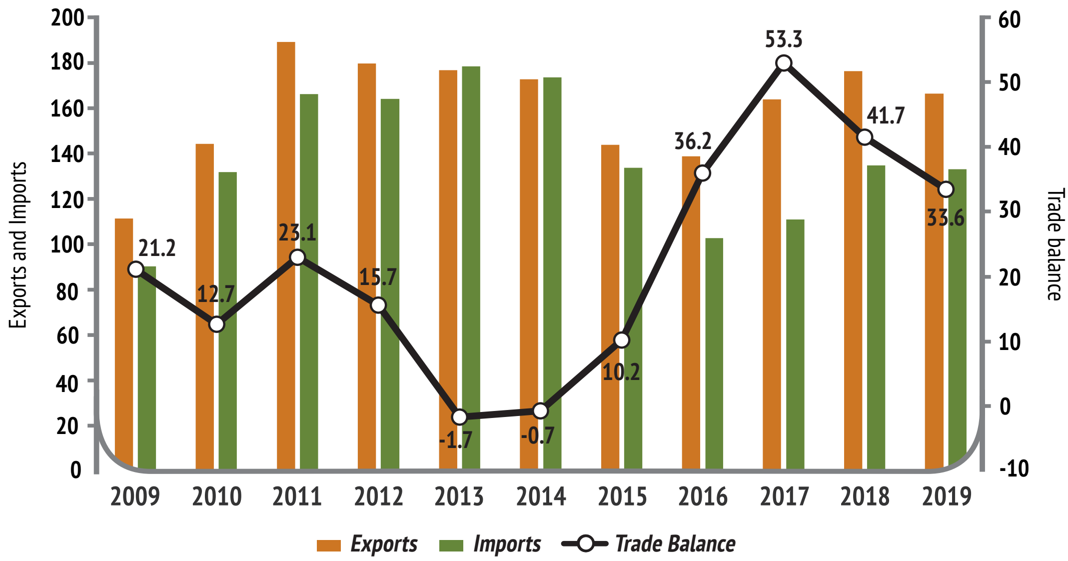
The trade balance has been on a downward trend since 2017. The trade surplus is lower than in 2018 both in the quarter-on-quarter and in the year-to-September comparison.

In the third quarter of the year, the trade balance recorded a surplus of USD7.5 billion, down by 36% as compared to the third quarter of 2018 (USD11.8 billion). In the year to September, the trade balance hit the mark of USD33.6 billion, down by 19.5% on the same comparison basis.

This lower surplus is due to a decline in the value of exports exceeding that observed in the value of imports, even though the quantity exported decreased less than the imported one. The import quantum index, which measures quantities, fell by 20.8 points between August and September, while the indicator for exports over the period declined by 6.3 points.

Stable trade surplus in the year to date

Exports, imports and trade balance in the year to June
In USD billion



Source: SECEX/MDIC
Prepared by: CNI.

Trade conflicts, uncertainties around Brexit, and the more aggressive exchange rate and monetary policies adopted by the United States and China are factors with a major bearing on exchange rates around the world. In the case of Brazil, the exchange rate volatility has been aggravated by the crisis in Argentina, which has also been undermining exports of manufactured goods.

Exports fell by 5.6% between January and September 2019 in relation to the same period in 2018. The balance in the third quarter is 9.3% lower than that recorded in the third quarter of 2018.

Exports in the year totaled USD167.2 billion in September. In the year up to August, the performance of all major economic categories was lower than in the same period in 2018, except for that of non-durable consumer goods, which remained stable. The sharpest decreases in the cumulative value of exports were those observed in the categories of capital goods and durable consumer goods, of 32% and 30%, respectively. The category of intermediate goods declined by 3.1% on the same comparison basis.

Between July and August, the export quantum index, which measures volume or quantity, declined for all economic categories, except for that of fuels. Year-to-date imports totaled USD133.6 billion in September. In the year to August, all major categories, except for that of intermediate goods, saw a decrease in value. The categories of durable consumer goods and capital goods were the ones that saw the sharpest declines, of 18.1% and 17%, respectively.

The import quantum index declined significantly, by 34.9 points, for fuel imported in August as compared to July. The volume of intermediate and non-durable consumer goods also decreased between July and August, by 24.4 and 8.2 points, respectively. That of durable consumer goods and capital goods increased by 7 and 0.5 points, respectively.

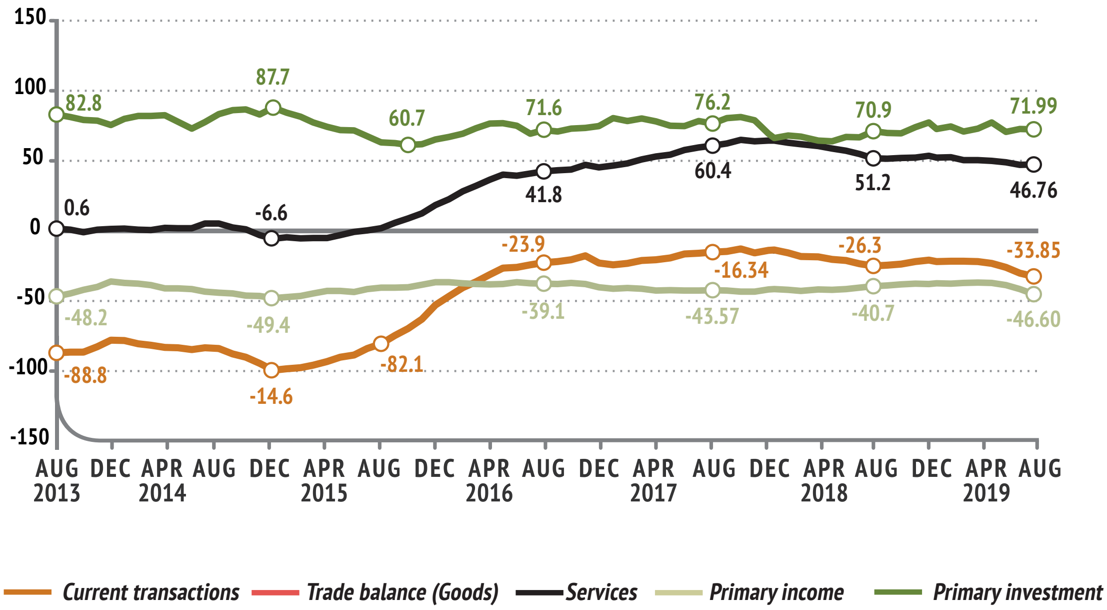
For 2019, CNI is projecting a trade balance of USD49.2 billion, with exports recording USD228.4 billion and imports USD179.2 billion.

PRIMARY INCOME ON THE DECLINE PUSHES CURRENT DEFICIT UP

The balance of payments is already reflecting the effects of the turbulence in the international scenario. While in previous quarters robust results were recorded for external accounts, a more clear deterioration has been detected in them in the current quarter.

Direct investment still higher than current account deficit

Balance of current transactions in 12 months
Direct investment in 12 months
In USD billion



Source: Central Bank of Brazil
Prepared by: CNI

The current account balance saw a deficit of USD4.3 billion in August. The deficit increased by 43.2% in relation to August 2018. In the last twelve months, the deficit in the current account amounted to USD33.85 billion, against USD26.3 billion over the same period in 2018.

This downturn in the current account balance is explained by the poor performance of the trade balance and, above all, by the significant drop recorded in primary income. Primary income covers foreign investors' demand for domestic currency assets, including both fixed-income and equity securities of companies located in Brazil. Over the period from June to August, primary income decreased by 21%, showing that demand for investments in domestic assets, which had remained relatively stable since 2015, took a downturn.

Direct investment continues in turn to perform well. In twelve months, the volume of investments amounted to USD72 billion in August, more than enough to make up for the current deficit.

It is noteworthy that direct investment falls under a different category than that of the investments referred to in connection with the primary income account. Direct investment covers investments by non-residents in resident companies with voting power of at least 10%, i.e. by foreign investors with the power to influence the decisions of resident companies.

By the end of the year, we expect the current account deficit to increase to USD28 billion, which represents approximately 1% of GDP as projected by CNI.

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2017	2018	2019 previous forecast (Economic Report 2st quarter 2019)	2019 current forecast
ECONOMIC ACTIVITY				
GDP (annual change)	1.1%	1.1%	0.9%	**0.9%**
Industrial GDP (variação anual)	-0.5%	0.6%	0.4%	**0.4%**
Household consumption (annual change)	1.4%	1.9%	1.5%	**1.5%**
Gross fixed capital formation (annual change)	-2.5%	4.1%	2.1%	**2.1%**
Unemployment rate (annual average - % of the labor force)	12.7%	12.3%	12.1%	**11.9%**
INFLATION				
Inflation (IPCA index - annual change)	2.9%	3.8%	3.9%	**3.5%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	9.92%	6.56%	6.15%	**6.04%**
(year's end)	7.00%	6.50%	5.25%	**5.00%**
Real interest rate *(ex-post - average annual rate and deflation: IPCA)*	6.20%	2.80%	2.30%	**2.40%**
PUBLIC ACCOUNTS				
Primary result (% of GDP)	-1.69%	-1.59%	-1.62%	**-1.60%**
Nominal result (% of GDP)	-7.80%	-7.14%	-7.08%	**-6.43%**
Public sector's gross debt (% of GDP)	74.07%	77.22%	79.20%	**78.80%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average for December)	3.29	3.88	3.75	**4.02**
(average for the year)	3.19	3.66	3.80	**3.90**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	217.7	240.0	238.0	**228.4**
Imports (US$ billion)	150.8	181.2	190.0	**179.2**
Trade balance (US$ billion)	67.0	58.7	48.0	**49.2**
Current account balance (US$ billion)	-7.2	-14.5	-17.0	**-28.0**

ECONOMIC REPORT | Quarterly publication of the National Confederation of Industry - CNI | www.cni.com.br | Industrial Development Board - DDI | Management and Economic Policy Unit - PEC | Executive manager: Flávio Castelo Branco | Fiscal and Tax Policy Unit | Manager: Mário Sérgio Carraro Telles | Team: Dea Guerra Fioravante, Fábio Bandeira Guerra, Isabel Mendes de Faria, Juliana Lucena do Nascimento, Marcelo Souza Azevedo; Débora Braga Reis de Sousa e João Pedro Fontoura (interns) | Editing Unit (DDI/GPC) | Coordinator: Carla Gadelha | Graphic Design: Simone Marcia Broch | Customer Service - Phone: +55 (61) 3317-9992 - email: sac@cni.com.br | This publication may be copied, provided that the source is cited. Document prepared on October 09, 2019.