Economic Report
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ECONOMIC REPORT

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

Economy continues to show mixed signals of recovery

The pace of economic recovery depends on a long-term fiscal adjustment

The Brazilian economy is going through a transition. Following two years of a deep recession, there are signs of reversal in this scenario. Business confidence indicators are already on the positive side, although the statistics of the current situation have not confirmed that production has been actually resumed.

The fall in GDP in 2016 – by 3.1% as estimated by CNI – will be lower than previously estimated. In the coming quarters, GDP will reflect the end of recession and economic growth is expected to be resumed in the first quarter of 2017.

This relatively favorable scenario of cyclical recovery is based on several foundations. First, recession has already reached a point where endogenous forces of adjustment begin to show their effects in the production environment and in the competitiveness of enterprises. The positive response of the foreign trade sector, as evidenced by a robust trade surplus, resulted not only from a drop in imports, but also from an increase in export volumes. An adjustment can also be observed in the labor market, with a reduction in the unit cost of labor and improved productivity. Finally, another relevant aspect is the adjustment seen in stocks of finished products in companies, which are close to the desired level.

Second, major political uncertainties were removed when a new government took office on a permanent basis, radically changing the course of economic policy. Although the exact temporal dimension of the long-term fiscal adjustment has not been defined so far, the shift in approach has reversed expectations and has created a positive impact on the confidence of agents.

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The Brazilian economy in the third quarter 2016

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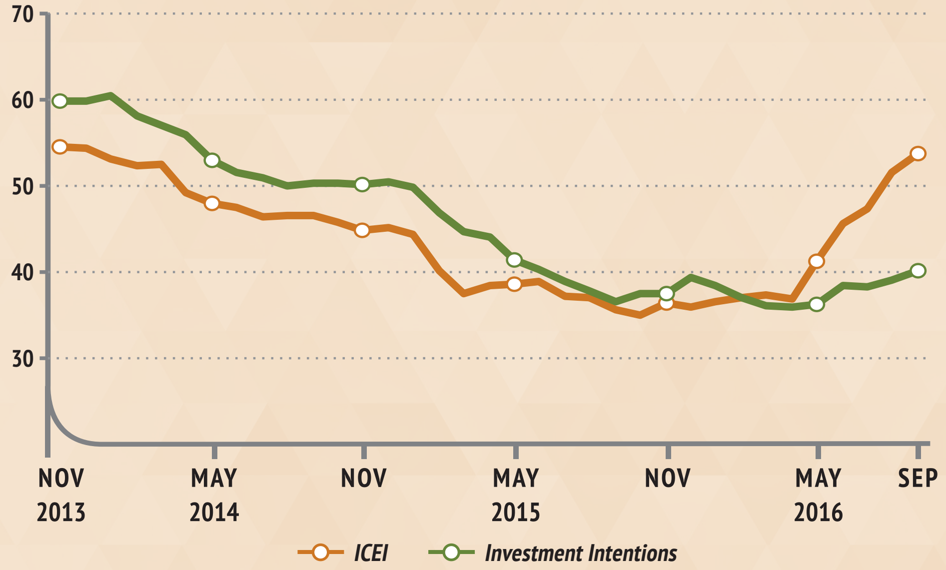
Investment intentions have not improved as much as confidence

*ICEI - Business Confidence * and Investment Intention Index*

Diffusion indexes (0-100 points)



Source: ICEI/CNI, Industrial Survey/CNI and Construction Industry Survey/CNI.
*The ICEI varies in the 0-100 interval. Figures above 50 points indicate lack of business confidence. The further below 50 points, the greater and more widespread the lack of confidence.

The expectation of recovery in demand conditions tends to have a direct bearing on the production level of enterprises, contributing to a gradual normalization of the level of capacity utilization. This process is likely to be seen within the next six months with the beginning of a cycle of interest rate reductions. Production and investment rates will naturally respond to this shift, albeit in a gradual way initially due to the high degree of idle capacity in the economy.

Risks related to the intensity of this recovery cycle are associated with a possible frustration with the economic adjustment process, especially regarding the fiscal issue, which is the main source of imbalance in the Brazilian economy. The two fiscal adjustment bills under discussion now – Constitutional Amendment Bill (PEC) 241, which imposes limits on public spending growth at federal level, and a social security reform bill – are critical elements. The fact that Constitutional Amendment Bill 241 was passed in the first round of voting is a positive sign.

Both bills are absolutely essential to reverse the severe fiscal imbalance experienced in recent years as a basic condition for economic stability and for ensuring a higher economic growth rate. Every political effort should be made to ensure the timely and substantive passage of these bills. Adjustments falling short of the necessary measures to reverse a rising social security deficit and excessive compromises in the mechanism for controlling spending growth may frustrate improved expectations. They can also lead to an environment of mistrust in relation to the dynamics of the Brazilian public debt, with serious consequences for economic stability.

The shift in the tax regime is essential for relaxing monetary and financial restrictions that limit the normal operation of the economy. The beginning of a sustained process of falling interest rates will be the first factor to boost domestic demand by improving the financial conditions of companies and consumers. However, a virtuous cycle of long-term growth will only be completed when private investment is fully resumed and changes in the business environment are actually implemented to promote the recovery of competitiveness in the Brazilian economy. Progress needs to be made on this agenda in the short term.

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ECONOMIC ACTIVITY

Data cannot ensure the resumption of economic growth

More positive expectations have not yet translated into increased activity

In the third quarter of 2016, the available data on economic activity do not confirm that recovery is under way. Recession has slowed down, but the shift toward a recovery trend has not been consolidated.

In the second quarter, two important changes in relation to the worst moment of the current recession could already be seen: improved confidence and adjusted stocks. These are key elements for recovery to begin. Increased activity would in turn reduce the idle capacity in the industrial park and, in time, stimulate increased employment and investment.

In the third quarter, stocks remained close to the level planned by enterprises and expectations continued to improve. The ICEI (Industrial Confidence Index) recorded a fifth consecutive increase in September and grew by 16.9 points over the period, getting close to the indicator's historical average. Over the past two months, the index exceeded 50 points, the dividing line between confidence and lack of it. According to CNI's Industrial Survey, demand expectations and export volumes were also positive during the entire third quarter.

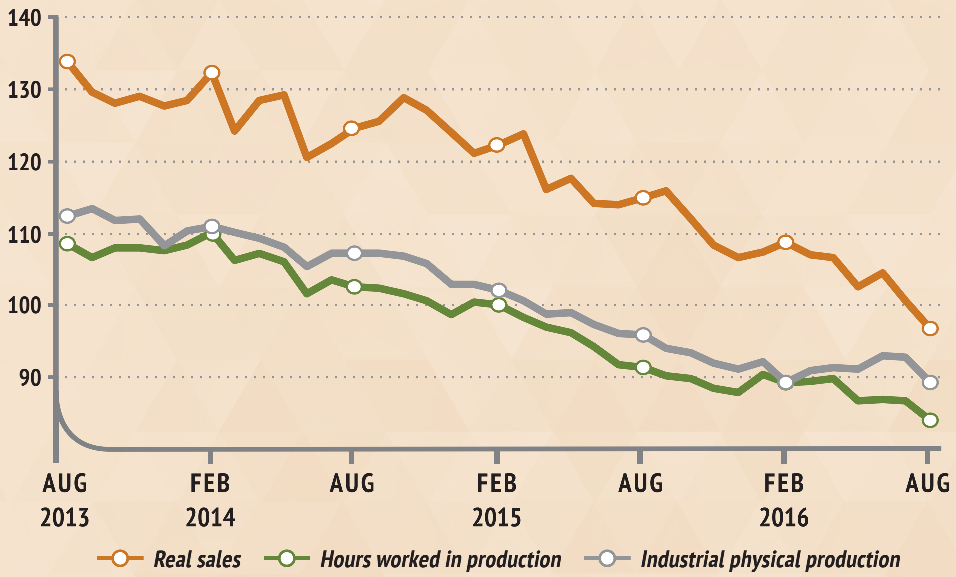
These positive expectations, however, have not translated into sustained output growth. Data for industrial activity continue to fluctuate. After increasing for five months, industrial output (PIM-PF/IBGE) dropped by 3.8% in August. Despite this result, production rose by 0.7% in the quarter ended in August as compared to the previous three-month period.

Working hours and sales (Industrial Indicators/CNI) remained on a downward trend during the quarter. In the comparison between the quarter ended in August 2016 and the previous three months, worked hours declined by 3.1% and sales dropped by 4.6%. Data from the Industrial Survey (CNI) show that idleness remains very high, as one-third of the industrial park is idle.

Indexes show no trend toward improved economic activity in the third quarter

Sales, hours worked in production, and physical production, seasonally adjusted

Fixed base index number: 2006 average = 100



Source: CNI and IBGE/PIM-PF

This scenario is explained by several factors. First, the exchange rate began to drop again, inhibiting exports, which played a key role in eliminating stocks.

In addition, when one analyzes confidence indices, two important facts stand out. Confidence indices rose mainly as a result of improved expectations and not of better business conditions. In the ICEI, the current conditions index (which reveals how entrepreneurs evaluate current business conditions), remains below 50 points, meaning that entrepreneurs cannot see any improvement in current conditions. Moreover, confidence has increased mostly as a result of a drop in negative markings for neutral results, not positive ones. In other words, entrepreneurs are ceasing to be pessimistic and to see a worsening in their business conditions, but they are still not seeing actual improvements in them and becoming optimistic.

Finally, in addition to the exchange rate and to the nature of the improvement recorded in confidence indices, the financial situation of companies also deserves special mention. A long period of excess inventory and high idleness, coupled with a scenario of difficult access to credit, has led to a rather uncertain environment in terms of financial conditions. This situation led entrepreneurs to become more cautious in deciding whether or not to increase production, as they were left with less room to absorb the costs of any further increase in stocks if their expectations are not confirmed.

To a greater or lesser extent, these two factors are also affecting other economic agents. Consumers also reported improved confidence levels in recent months, but no major improvement was recorded in purchases, especially in higher value purchases. Families are still worried about their level of indebtedness and, despite the recent improvement recorded in their expectations, they remain worried about the evolution of prices and employment in the future.

As a result, the volume of retail sales remains stable. As in the first quarter, stability is restricted to segments such as personal hygiene, drugstores and supermarkets. In other segments of higher value goods, such as Vehicles, Motorcycles and parts, Furniture and household appliances, and Office and IT material and equipment, sales continue to drop.

Trade is also restricting their orders to industry, for fear that demand may be weaker than initially planned in a scenario of greater financial constraints.

In summary, the data suggest that the worst moment of the crisis is behind us. However, the same data allows to predict that more rapid economic growth is unlikely in the short term.

Inflation will remain high until the end of the year, despite its more favorable dynamic, which will pave the way for the beginning of an expected cycle of interest rate cuts. Nevertheless, household consumption is still limited due to the credit crunch (see the section Inflation, Interest Rates and Credit) and to the drop in real total payroll (see the section Employment and Income). Because of this, trade and industry should be cautious before increasing their orders/production to avoid the risk of accumulating unwanted stocks. This dynamic will limit the increase in production that would be expected during the end-of-year period.

In the foreign trade sector, the stability of the exchange rate at a more appreciated level in relation to the beginning of the year limited the rate of increase of exports. Imports continue to record a sharp drop, which is explained by the decrease in income, economic activity, and investment (see the section Foreign Trade Sector).

*GDP estimate for 2016**

Percentage change in GDP components

	GDP COMPONENTS	Variation rate (%)
Demand	Household consumption	- 4.6
	Government consumption	-1.8
	Gross Fixed Capital Formation	-11.0
	Exports	6.0
	(-) Imports	-10.0
Supply	Agriculture/livestock	-0.5
	Industry	-3.7
	Mining and quarrying	-6.0
	Manufacturing	-5.0
	Construction	-3.0
	Public Utility Industrial Services	2.0
	Services	-2.9
	GDP	**-3.1**

*CNI Projection

In this scenario, CNI projects that GDP will drop by 3.1% in 2016 and that industrial GDP will decrease by 3.7%. The mining industry is expected to record a 6% reduction, while manufacturing and civil construction are likely to decline by 5% and 3%, respectively.

Household consumption will drop by 4.6%, contributing negatively by 2.9 percentage points to the 3.1% drop in GDP. Gross Fixed Capital Formation (GFCF) will decrease for the third year in a row: by 11% in 2016. A record idleness in industry and high interest rates explain this terrible result. The investment intentions index (Industrial Survey/CNI) shows low willingness of entrepreneurs to invest.

The contribution of the foreign trade sector to GDP will be positive by 2.2 percentage points in 2016. The volume of exports and goods and services will increase by 6% in 2016, while the volume of imports of goods and services will drop by 10%.

EMPLOYMENT AND INCOME

Labor market indicators post worst results in the historical series

Labor market is marked by double-digit unemployment rate and sharp decline in total payroll

The poor performance of the labor market indicators throughout 2016, as recorded by IBGE's Continuous Household Survey (PNAD Contínua survey/IBGE) and by the General Registry of Employed and Unemployed Persons of the Ministry of Labor (CAGED/MTE), has not come as a surprise.

The continued increases in the unemployment rate observed last year were expected to remain in place in 2016 amid a persistent recession. The prospects for an increase in real average earnings and total payroll were also bleak, not much because of inflation (as last year), but because of lower wage increases. Lower wage increases result from pressures caused by companies' need to adjust production costs, by a decline in economic activity, and by an increase in the labor force with the aim of restoring household income substantially.

The CAGED/MTE also shows continuous job losses throughout the year, with March seeing the worst result: 1.8 million jobs lost in 12 months. During the same period in 2015, the CAGED/MTE showed the creation of 34,700 jobs on the same comparison basis, while 2014 saw 1.2 million new jobs.

CNI is not expecting this scenario to reverse by the end of the year. Thus, the average unemployment rate would reach 11.5% in 2016, with the labor force and real total payroll dropping by around 4%.

UNEMPLOYMENT STILL TRENDING UPWARD

The unemployment rate, as measured by the PNAD Contínua survey/IBGE, amounted to 11.8% of the labor force in the quarter to August, representing a 3.1-percentage point increase from the same period in 2015, when it stood at 8.7%.

The indicator has been increasing since December 2014 (when it accounted for 6.5% of the labor force) and will likely double by December 2016 to 12.8%.

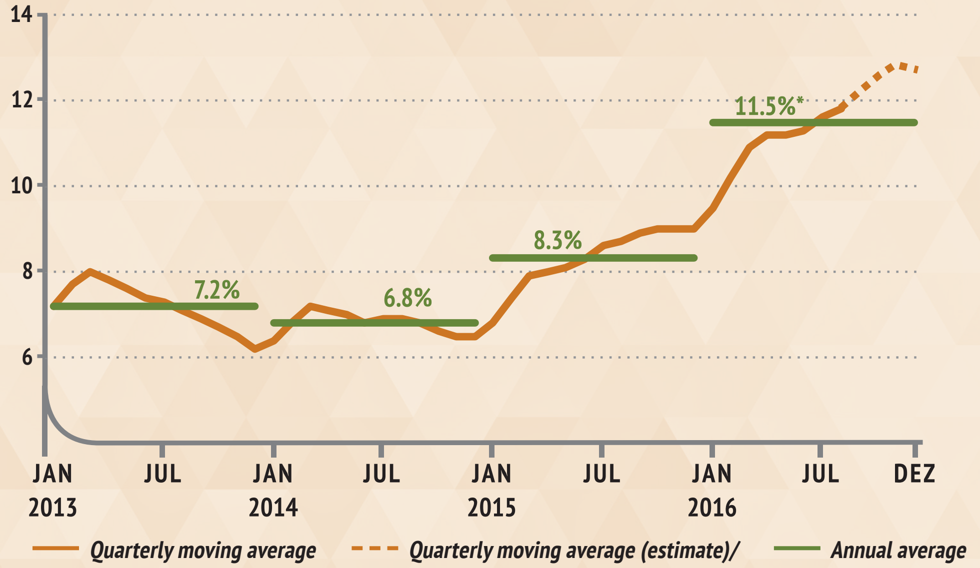
The trend in the unemployment rate will continue to be affected by both the decline in employment and the increase in the labor force. Jobs shrank by 2.2% in the quarter ended in August from the same period in 2015. The labor force, on the other hand, grew by 1.2% on the same comparison basis.

The decline in employment can still be explained by weak economic activity. While this situation

Average unemployment rate to reach 11.5% in 2016

Unemployment rate – moving quarter and annual average

As a percentage of the labor force (%)



Source: PNAD *Contínua* Survey/IBGE
* CNI's estimates

is expected to reverse, as indicated by economic confidence indices, hiring will only increase significantly when companies manage to reduce their high idle capacity rates.

The need to restore household purchasing power – due either to a decline in real income or a fall in employment – explains the behavior of the labor force, which will keep growing through the end of 2016.

As a result, the unemployment rate is not expected to improve in coming months, even considering the additional temporary workers who are traditionally hired to meet year-end demand.

INDUSTRY IS THE SECTOR WITH THE LARGEST NUMBER OF JOBS LOST

According to the CAGED/MTE, almost all economic sectors have experienced job losses in 2016. As in 2015, industry has been the hardest hit sector this year. Of the 646 thousand formal jobs lost in the economy in the year to August, more than half (337,300) was in the industrial sector. Trade and services come next, with 261,500 and 127,300 jobs lost, respectively. Agriculture/livestock was the only sector to record a positive net balance, meaning that it has created jobs in the year (75,000 jobs).

Among the industrial segments, the construction and manufacturing industries are the ones for which the greatest losses were observed: 178,200 and 143,900 jobs, respectively, in the first eight months of the year. The Mining and Quarrying and Public Utility Industrial Services (SIUP) sectors come next with 10,800 and 4,300 jobs lost, respectively, over the same period.

While the share of jobs destroyed has been falling since April, the Brazilian economy continues to lose an unprecedented number of jobs. In the 12 months to August, the economy lost 1.6 million formal jobs. During the same period in 2015, 902.2 thousand jobs were destroyed and, in 2014, Brazil had created 814,900 jobs on the same comparison basis.

TOTAL PAYROLL FALLS SHARPLY IN 2016

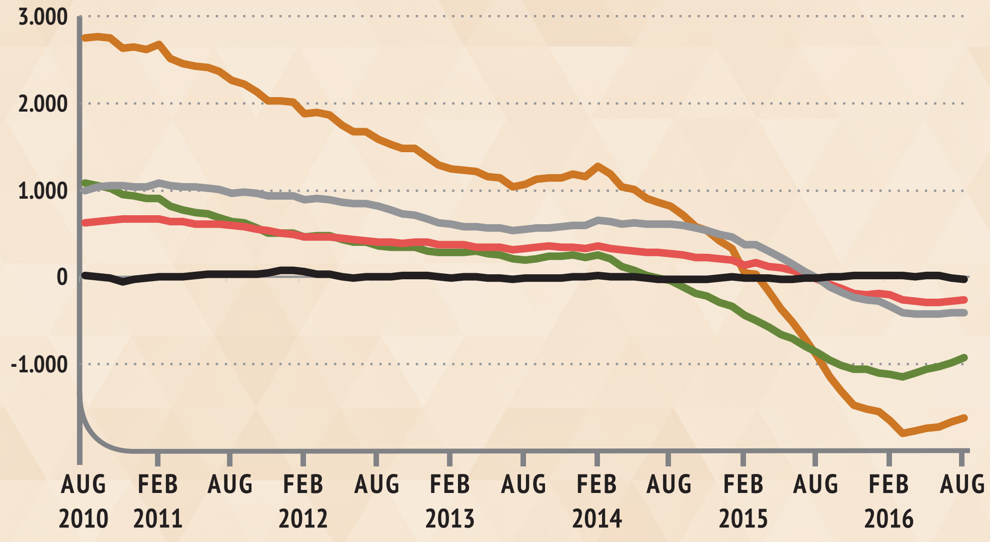
Despite the effects of the economic crisis, real average earnings of workers and total payroll posted growth in 2015. However, these two indicators will not increase in 2016 as they did in previous years.

This is mainly explained by tough wage increase negotiations – resulting from companies' need to adjust production costs in response to a slowdown in economic activity and an increase in the labor force – that are unable to recover the losses caused by the corrosive effects of inflation in 2015.

Record fall in employment in 2016

*Net balance of formal jobs**

In thousands (in the 12 months through August)



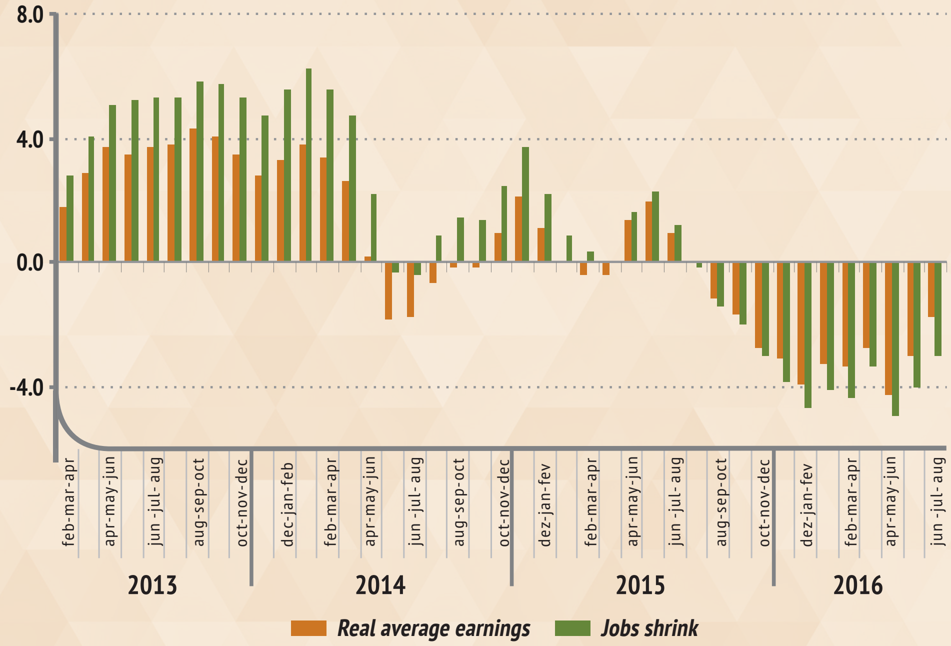
Source: CAGED/MTE

The reduction in real average earnings, coupled with the drop in employment, has led to significant declines in real total payroll in 2016 – of more than by 3% as compared to the same months in 2015. As this scenario is not projected to change, CNI expects total payroll to fall by around 4% in 2016, compared with a 0.5% growth in 2015.

Total payroll falls sharply as real average earnings and jobs shrink

Real average earnings and Real total payroll

Change from the same moving quarter in the previous year (%)



Source: PNAD *Contínua* Survey/IBGE

INFLATION, INTEREST RATES AND CREDIT

Inflation slows down at a slower pace than expected

Pressure from food prices prevented a sharper drop

Inflation has slowed down in 2016. The Expanded Consumer Price Index (IPCA), which closed 2015 at 10.7%, recorded a 12-month variation of 8.5% in September 2016. However, the speed of the slowdown in prices has been lower than expected. The main reason is the food group, whose prices were pressured by the El Niño climatic event. These effects, however, are expected to dissipate in the coming months, as observed in August and September, making it possible for inflation to drop further by the end of the year. CNI estimates that the Expanded Consumer Price Index (IPCA) will close the year with a cumulative rate of 7.1%.

Government-regulated prices continue to slow down. After increasing by 18.1% in 2015, the 12-month rate of the group in September was 7.9%. Electricity and gasoline, the items that pressured the IPCA up the most in 2015, accounted for the best behavior of the group in the year to September 2016. In one year, gasoline prices remained virtually stable and those of electricity dropped by 7.7%.

On the other hand, adjustments in the prices of pharmaceutical products, health insurance, and water supply and sewage mitigated the positive effects of the behavior of electricity and gasoline prices. Toward the end of the year, fuel prices are expected to drop due to the possible adoption by Petrobras of a pricing policy in line with the international market. Thus, the group is expected to close the year with an accumulated rate of 6.1%.

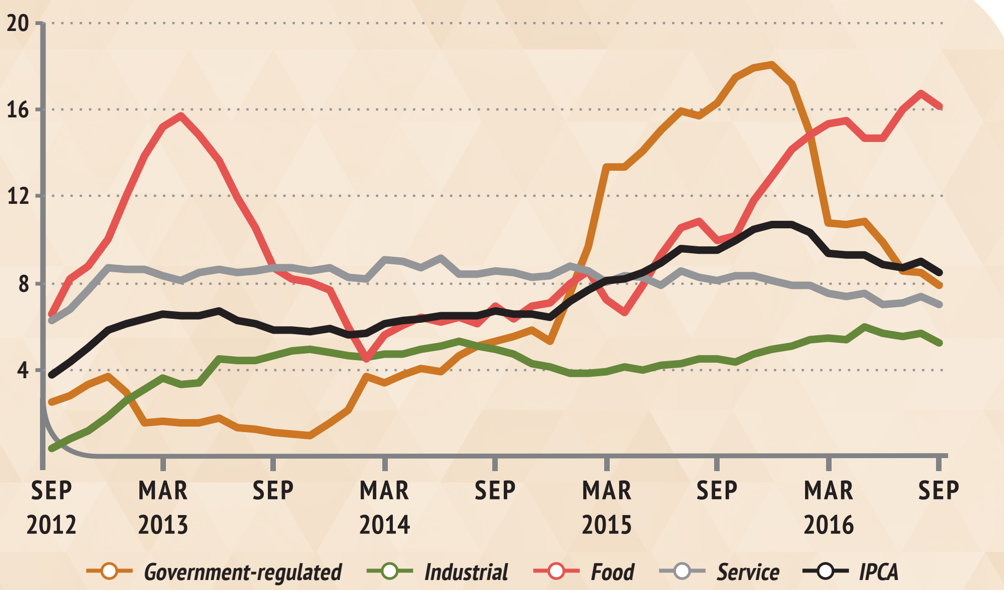
Food prices have been on the rise throughout 2016 and they belong to the group with the greatest impact on the overall index. The 12-month rate increased from 12.9% at the end of 2015 to 16.1% in September. The prices of products in this group rose mainly due to climatic phenomena that affected food supply, particularly the supply of in natura products. However, signs can be already perceived of a slowdown in the prices of this group in monthly price variations recorded in August and September. The 12-month rate, however, remains on the rise, but it is likely to decline as a result of the exclusion of the high monthly rates recorded in the fourth quarter of 2015. Thus, prices in this group are likely to close the year with an accumulated rate of 13.1%.

The group of industrial products is the one that pressures the overall index the least, even though their prices have risen during the year. Prices in

Government-regulated prices have slowed down at the beginning of the year

IPCA by groups

12-month figure (%)



Source: IBGE
Prepared by: CNI

this group closed 2015 with an accumulated variation of 4.9% and in September their rate rose to 5.2%. A 5.3% variation is expected in 2016.

Service prices have been slowing down, with the figure edging down from 8.1% in the 12 months to December 2015 to 7.0% in the 12 months to September 2016. The characteristic inertia observed in this group due to the indexation of its prices to past inflation and to the minimum wage prevents more significant downturns in its prices. In July and August, a decline in the 12-month rate that had been observed since December 2015 was interrupted. Thus, CNI estimates that prices in this group will continue to slow down, recording a cumulative rate of 6.2% in December.

INTEREST RATES ARE LIKELY TO DROP IN OCTOBER

The Central Bank of Brazil (BCB) has kept the nominal interest rate at 14.25% per annum since July 2015. The recent stance of monetary policy stems from two factors. First, from the slowdown in both the current inflation and in the one projected for the next 12-month period, which has been driving the real interest rate up, thus making monetary policy progressively more restrictive, with no changes in the nominal interest rate.

Second, from changes in the Bank's board made by the new government. The new Monetary Policy Committee has been issuing signals to economic agents that it will not be lenient with inflation. Clarity in relation to how monetary policy is conducted is essential for forming inflation expectations and for ensuring a more effective and less costly effect of monetary policy on price control.

The increase in the real interest rate combined with a still weak economic activity and with the effects of the deterioration in the labor market make it possible for a cycle of reductions in the Selic rate to begin in October. CNI predicts that the Selic rate will be reduced by 0.25 percentage points in each of the last two meetings of the Monetary Policy Committee to be held in 2016, closing the year at 13.75%.

CREDIT REMAINS ON A DOWNWARD PATH

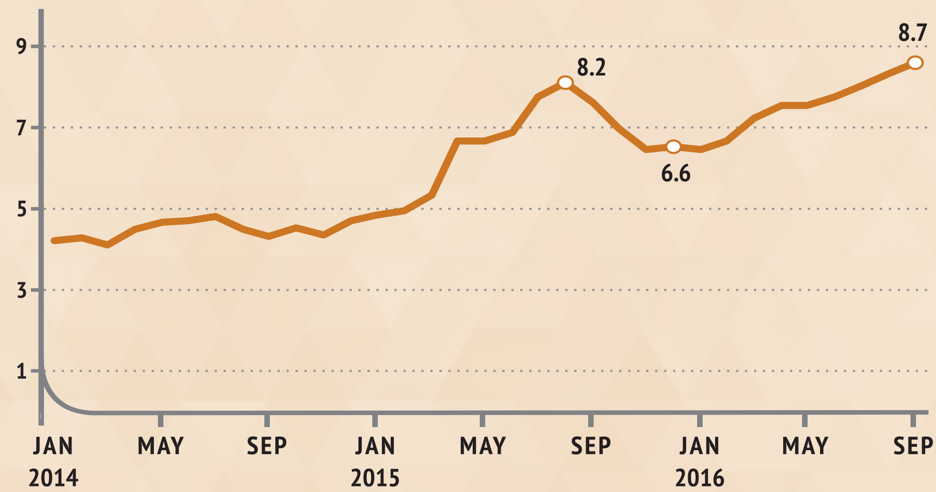
The credit balance continues to decline in real terms since the beginning of the year. According to data from the Central Bank, total balance declined by 5.0% in the average recorded in the last 12-month period ending in August 2016 as compared to the one recorded in the previous 12 months. On the same comparison basis, the average balance declined by 6.5% for corporations and by 3.2% for individuals.

Several factors have contributed to this downward trend of credit. On the supply side, the more selective behavior of banks due to the growth of bad debts in credit operations of the financial system has made it more difficult for economic agents to access credit. On the demand side, the decline in economic activity, the deterioration of the labor market, and the lack of confidence of entrepreneurs and consumers ended up intensifying the downturn in the credit market. The credit/GDP ratio decreased from 53.6% in August 2015 to 51.1% in August 2016.

Real interest rate

Nominal interest rate / Inflation expectation for the next 12 months, according to the Focus survey

Expectation for the year (%) on September 30, 2016



Source: Central Bank of Brazil

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FISCAL POLICY

Increased spending in the last months of the year reduces scope for achieving the target

2017 Budget Bill incorporates spending cap already

The growth rate of federal government spending is likely to accelerate significantly in the last four months of the year. This acceleration will be driven by the already hired increase in some expenses, such as pension and welfare benefits, and also by the effect of government decisions that will push other expenses up, such as a raise in the wages of civil servants and in the *Bolsa Família* grant. Therefore, regardless of meeting the fiscal target set for the primary deficit of R$ 170.5 billion in 2016, the scope for making up for the insufficient result of state and local governments will be reduced.

The increase in federal government spending expected for the next four months of the year are likely to revert the more moderate growth trend observed between June and August. However, while there are signs that austerity in fiscal policy will be relaxed in late 2016, the Annual Budget Bill (PLOA) for 2017 was drafted taking into account the public spending cap provided for in Constitutional Amendment Bill 241/2016.

FEDERAL GOVERNMENT SPENDING SLOWS DOWN IN THE QUARTER

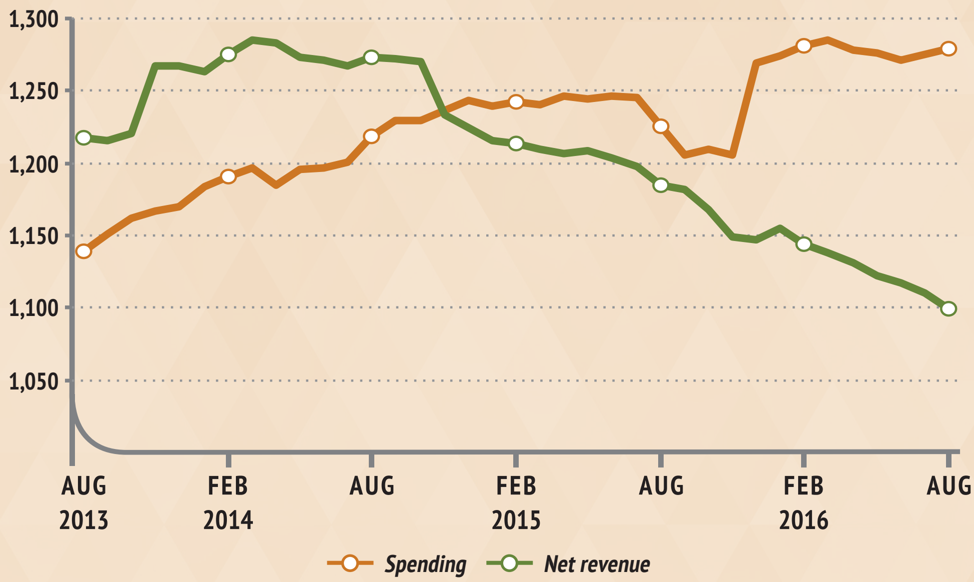
Federal government spending increased by 1.1% in real terms (IPCA deflator) during the first eight months of 2016 as compared to the same period the year before. This result shows that the growth rate of spending was lower in relation to that observed until May, when a 1.4% increase was recorded on the same comparison basis.

The slowdown in spending in the last three months can be mainly explained by the dilution of the effects of changes in the schedule of payments of wage bonuses and in how subsidies are accounted for following guidelines issued by the Brazilian Court of Audit (TCU) back in 2015. As a result, defrayal and capital spending, for which no variation had been recorded between January and May 2016 in relation to the same period in 2015, decreased by 2.7% in real terms when the period between January and August 2016 is considered.

The net federal government revenue recorded a real decrease of 14.5% between March 2014 and August 2016

Evolution of federal government revenues and primary spending

12-month R$ million in August 2016



Source: National Treasury
Prepared by: CNI

The real drop in net revenues amounted to 6.3% in the first eight months of 2016 as compared to the same period in 2015

Expenditures of the Workers' Support Fund (FAT) with salary bonuses and unemployment insurance, which recorded a real growth of 30.1% between January and May 2016, rose less intensely, by 17.6%, between January and August 2016. While both expenses grew due to the increase in the minimum wage, the significant increase observed in the first months of the year was mainly due to the change in the schedule of payments of wage bonuses, which transferred to the first quarter 2016 significant amounts due in 2015.

Spending on subsidies and grants, which grew by 106.9% in the first five months of 2016 in relation to the same months in 2015, began in turn to record a real growth of 24.2% when the months of January to August 2016 are considered. In this case, the increase is explained by the guidelines issued by the Brazilian Court of Audit eliminating the 24-month grace period for paying to the Brazilian Development Bank (BNDES) the equalization of interest rates for the Investment Support Program (PSI). As of 2016, payments will be semiannual, and this arrangement has already caused an impact in January and July.

On the other hand, some spending items put more pressure on the increased spending of the federal government in recent months. These include items that are affected by the raise in the minimum wage, such as social security and welfare benefits. In the case of social security, expenditures that had increased by 5.2% in real terms in the first five months of 2016 in relation to the same months the year before rose by 7.6% between January and August 2016. This rise is due to the nominal increase of 11.7% in all benefits, corresponding to the raise in the minimum wage or exceeding it, and also to the fact that this year the first payment of the thirteenth salary was made in the months of August and September, while in 2015 it was made in September and October.

The sub-item "other defrayal and capital expenditures," which falls under the category of non-compulsory expenditures of the Federal Government, decreased less after the last quarter. The real drop in this sub-item, which amounted to 9.4% in the first five months of 2016, rose to 8.8% between January and August as compared to the same period in 2015. While defrayal expenses declined by 3.9%, investment spending (GND-4 of SIAFI) dropped by 31.9%.

FEDERAL GOVERNMENT REVENUES DROP MORE SHARPLY

The real decline in federal government revenues was once again sharper in recent months. The real drop in net revenues amounted to 6.3% in the first eight months of 2016 as compared to the same period in 2015. Between January and May, the decrease in net revenues amounted to 5.0%.

The main factor explaining this further deterioration in the net revenue of the federal government was the decline in revenues managed by Brazil's Internal Revenue Service (RFB). In the first five months of 2016, they decreased by 7.0% in real terms in relation to the same months in 2015. This percentage increased to 8.0% in the period between January and August 2016. This behavior is mainly explained by the state of the economy, the first signs of recovery of which came from an increase in export volumes (which is not a relevant tax base), and by the fact that the extraordinary revenues recorded in 2015 as a result of installment debt payments were not repeated. It should be recalled that this drop was recorded despite the positive effects on revenues of increases in the rates of certain taxes, such as in those of the IPI (Tax on Industrialized Products), CIDE (Contribution for Intervention in the Economic Domain)-fuels, and PIS (Social Integration Program)/COFINS (Contribution to Social Security Financing).

On the other hand, improvements were recorded in the other two revenue components over the past three months. Revenues from social security taxes and contributions, excluding the compensation of the National Treasury for payroll tax reliefs, dropped by 5.4% in the first five months of 2016 in relation to the same months in 2015. This decline decreases to 4.9% when the months from January to August 2016 are considered. Revenues not managed by the RFB (concessions, dividends, financial compensation, etc.), which had risen by 0.3% in real terms in the first five months of 2016, recorded in turn an increase of 0.7% in the period from January to August 2016.

REGIONAL GOVERNMENTS CUT SPENDING MORE DEEPLY

Under strong pressure due to falling revenues, state and local governments are cutting their spending more deeply. Estimates based on revenue data available monthly and on the primary result of regional governments show a real decrease of 3.9% in expenses incurred between January and

July 2016 in relation to the same period in 2015. Considering only the period between January and May 2016, the real drop was lower, 2.3%.

While spending decreased more sharply, revenues improved slightly. Data already available show a real drop of 5.3% in the revenues of regional governments during the first seven months of 2016 as compared to the same period the year before. Considering only the first five months of 2016, the decline was higher, 5.5%. The effects of the downturn in economic activity continued to have a negative impact on VAT collection, which after decreasing by 3.9% between January and May 2016, dropped by 4.1% from January to July 2016. Transfers received from the federal government, which dropped from 12.3% to 10.0% in the two periods under analysis, contributed to the slight improvement recorded in state and local revenues.

FEDERAL GOVERNMENT FISCAL RESULT DETERIORATES SHARPLY

Despite the lower rate of increase in spending recorded in recent months, a sharp drop in revenue led to a significant deterioration in the federal government primary balance in recent months. In the 12-month period ending in August, the federal government primary deficit amounted to 2.82% of GDP, against 2.49% in May 2016. On the other hand, the sharper decrease in spending and the slight improvement in revenues led the 12-month primary surplus of state and local governments to rise from a deficit of R$ 1.5 billion (0.02% of GDP) in May 2016 to a surplus of R$ 2.6 billion (0.04% of GDP) in August 2016.

Despite the improved primary result of regional governments, a sharp deterioration in the federal government result prevailed, leading the 12-month consolidated public-sector primary deficit to increase from 2.52% of GDP in May 2016 to 2 77% in August 2016. Despite this increase in the primary deficit, the 12-month nominal deficit fell from 10.1% in May 2016 to 9.6% in August 2016. This improved nominal result was made possible by a decrease of 0.7 percentage points of GDP in interest spending between the two comparison periods. The main reason behind the reduction in interest spending between May and August 2016 were net gains of R$ 25.2 billion in foreign exchange transactions (swaps) due to the appreciation of the real against the dollar.

Despite its downward path, the nominal deficit is still well above the level required to at least stabilize the gross debt/GDP ratio. Thus, gross debt increased from 68.8% of GDP in May 2016 to 70.1% of GDP in August 2016.

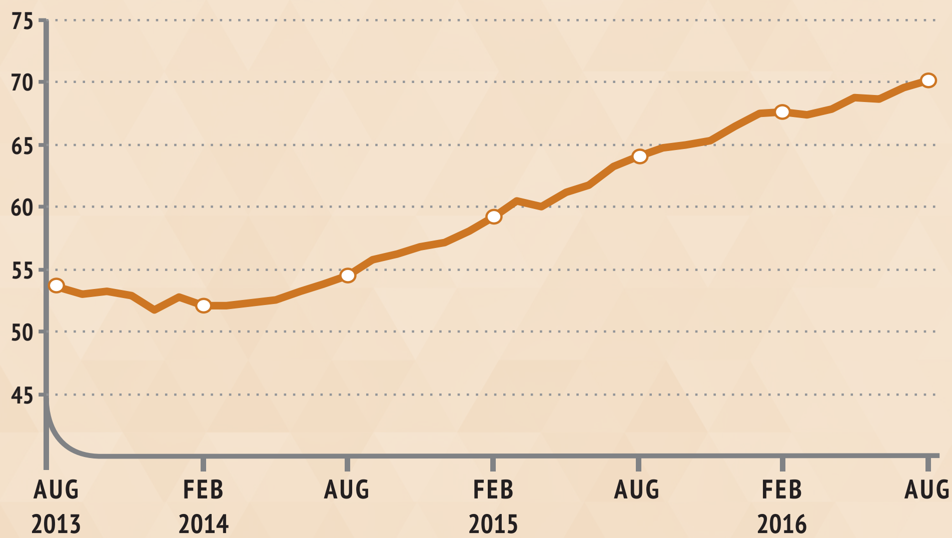
FEDERAL GOVERNMENT HAS LESS ROOM TO OFFSET THE RESULT OF REGIONAL GOVERNMENTS

If the expected acceleration in the growth rate of federal government spending until the end of 2016 is confirmed, it will still be possible to achieve the primary balance target, which contemplates a deficit of up to R$ 170.5 billion. However, the space available for the federal government to offset a likely primary result below the target of regional governments will be greatly reduced.

Gross debt/GDP ratio exceeded 70% of GDP in August 2016

Evolution of gross public sector debt

In relation to GDP (%)



Source: Central Bank of Brazil

The consolidated public sector primary surplus is expected to record a deficit of R$ 168.7 billion (-2.7% of GDP) in 2016

The main pressures for increased federal government spending in the last months of 2016 come from personnel, defrayal, and capital spending. In the case of spending with personnel, which decreased by 3.1% in real terms from January to August 2016, it is likely to close the year virtually unchanged in relation to 2015. This is due to wage increases granted to different categories of federal public servants that are expected to begin to have an impact on costs from September on.

Defrayal and capital spending will likely shift from a decrease of 2.7% in real terms observed until August 2016 to a real growth of 0.6% by December 2016 in relation to 2015. It should be recalled that these variations exclude from the expenditures recorded for 2015 a sum of R$ 55.6 billion paid in bonds that should have been settled in previous years to pay off loans resulting from the practice referred to as "fiscal backpedaling." Thus, federal government spending will likely close 2016 with real growth of 2.9%, higher than the 1.1% growth recorded from January to August 2016.

On the revenue side, a slight improvement is expected, as a result of which the 6.3% drop in revenues recorded between January and August 2016 will decrease to 6.2% at the end of the year in relation to 2015. The main reason for this improvement is the impact on revenues from the foreign exchange and tax regularization program, which is already projected to generate R$ 6.2 billion in revenues. The results can be even better, since the program will likely exceed that level of revenue. Considering the revenue made possible by that program, revenues managed by the RFB are likely to reduce the real decrease of 8.0% recorded between January and August 2016 to 6.9% between January and December 2016 in relation to 2015.

In such a scenario, the federal government is likely to record a primary deficit of R$ 169.7 billion (-2.72% of GDP, as estimated by CNI). This result represents a slight improvement over the deficit of 2.82% of GDP recorded in the 12-month period to August 2016, because in this case R$ 55.6 billion in "fiscal backpedaling" that were paid in December 2015 were accounted for.

If the primary deficit estimated by CNI is confirmed, the federal government would have a margin of only R$ 800 million to make up for the likely insufficient primary result of regional governments. It should be noticed that this margin may increase if the revenue generated by the foreign exchange and tax regularization program exceeds R$ 6.2 billion.

In the case of states and municipalities, despite a recent reversal in the 12-month primary balance from a deficit to a surplus, the R$ 6.5 billion surplus target is unlikely to be achieved. This may happen because judicial deposits incorporated as revenue by the states in the last months of 2015 will not be repeated. A primary surplus of R$ 1 billion is estimated for 2016.

Based on these estimates for the results of the federal government and regional governments, the consolidated public sector is likely to record a primary deficit of R$ 168.7 billion (-2.7% of GDP) in 2016. This result indicates a strong fiscal deterioration as compared to the deficit of 1.9% of GDP seen in 2015, even with the inclusion of the payment of R$ 55.6 billion to settle "fiscal backpedaling" loans.

Despite this increase in the primary deficit in relation to 2015, the nominal deficit is expected to drop from 10.4% of GDP in 2015 to 9.4% in 2016. This will be possible due to the decrease in interest spending from 8.5% of GDP in 2015 to 6.7% in 2016, as a result of gains from foreign exchange swap operations.

Despite this decline, the nominal deficit is likely to remain above the level required to stabilize the public sector debt to GDP ratio. CNI estimates that the gross debt/GDP ratio will rise from 66.5% of GDP in 2015 to 71.6% at the end of 2016.

BUDGET BILL FOR 2017 ADOPTS SPENDING CAP PROVIDED FOR IN CONSTITUTIONAL AMENDMENT BILL 241

Even before being actually passed, Constitutional Amendment Bill 241 was used as the basis for drafting the 2017 Budget Bill. With the exclusions provided for in the Constitutional Amendment Bill, such as, for example, those of spending on elections, spending in 2017 will grow according to the variation projected for the Expanded Consumer Price Index (IPCA) in 2016. As a result, total primary spending will likely increase by 7.7% in nominal terms. Given the expected nominal increase of 10.2% in net revenues, the Budget Bill projects a significant reduction in the federal government primary deficit in 2017, which would amount to R$ 139 billion (2.04% of GDP as contemplated in that bill).

However, some predictions for compulsory spending seem to be extremely optimistic. This are the case, for example, of spending on social assistance benefits, whose nominal growth has been estimated at only 4.3%, and of spending on wage bonuses and unemployment insurance, which would decrease by 4.1% in nominal terms. Because no laws have been passed yet to significantly change these and other expenses that have a high bearing on the composition of spending, the need to adopt measures to ensure a better regulation of public spending growth has become more pressing.

FOREIGN TRADE SECTOR

Exchange rate stabilizes at a new level in the third quarter

Trade surplus increases as domestic activity slows down

After falling for seven consecutive months, the monthly average Brazilian real-US dollar exchange rate recorded growth in September. In the month, the exchange rate averaged R$ 3.26 per US dollar, up by 1.5% from last month's average. Nevertheless, the exchange rate has still appreciated sharply in the year: by 15.9% as compared to the average rate recorded in January.

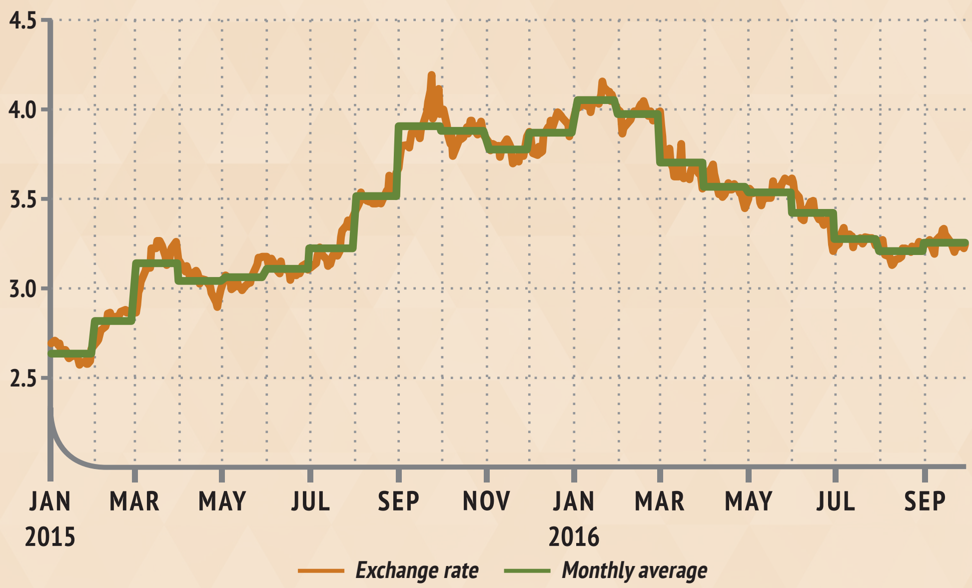
This appreciation trend in 2016 was not seen in the third quarter, which was characterized by a stable exchange rate. By comparing the monthly average of the first and last month of each quarter, one can see that the exchange rate depreciated by 1.5% in the third quarter. Meanwhile, the exchange rate had experienced much more significant changes in the first and second quarters of this year, when they appreciated by 8.6% and 4.0%, respectively.

This can be explained by both domestic and external forces. Brazil's Central Bank has reduced the stock of foreign exchange swaps and continues to show signs of a possible reduction in the Selic rate by the end of the year. The expected interest rate cut has halted the upward trend

Exchange rate remains stable in the quarter

Daily exchange rate (Ptax Closing Rate) and monthly average

In R$/US$



Source: Central Bank of Brazil

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that had been in place since the beginning of the year. Furthermore, a more stable political environment has also contributed to stabilize the exchange rate. In the foreign arena, despite a possible increase in the benchmark US interest rate later this year, it will likely be small and have no significant effects on the Brazilian currency.

CNI is not expecting to see major changes in the factors influencing the behavior of the exchange rate, meaning that it is projected to hold steady between R$ 3.20/US$ and R$ 3.30/US$ by December 2016. Under that scenario, the average exchange rate would amount to R$ 3.48 per US dollar in the year, representing a depreciation of 4.5% as compared to 2015's average.

It should also be stressed that the Special Foreign Currency and Tax Regularization Regime (RERCT) may trigger further exchange rate appreciations. Those who join the scheme are not required to repatriate their foreign earnings, but as more people and companies do that, there will be greater pressure for an appreciation of the Brazilian currency. By the end of September, the government will secure R$ 6.2 billion in revenue according to its report of income and expenses for the fourth quarter of 2016.

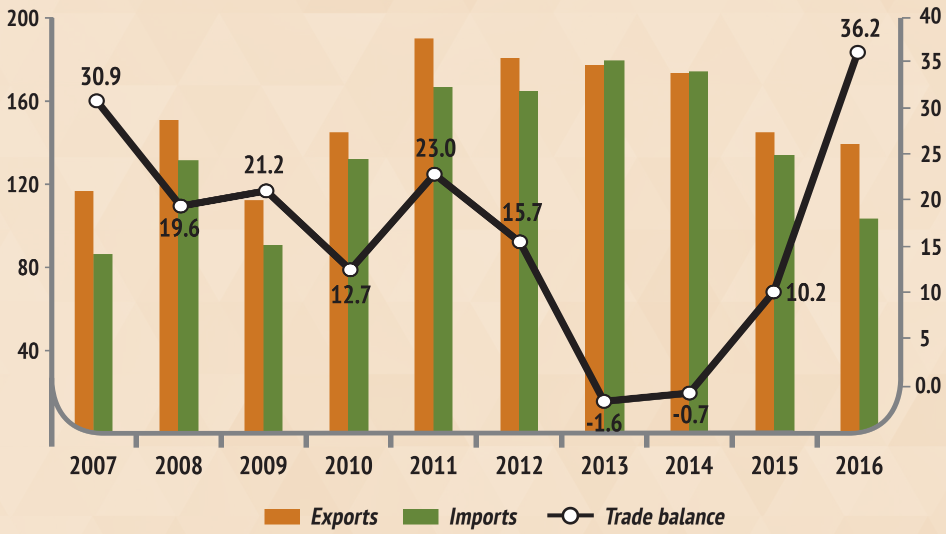
TRADE BALANCE STILL ON THE RISE

The Brazilian trade balance has posted record surpluses month after month throughout 2016. The trade surplus reached US$ 36.2 billion in the year to September, up from US$ 10.2 billion during the same period in 2015. The positive result is mainly attributed to a sharp decline in the value of imports, as exports are also down as compared to previous years.

Imports totaled US$ 103.1 billion in the January-September 2016 period, down by 23.1% from the corresponding period in 2015 – and the lowest level for the period since 2010. Both import prices and volumes are down: In the year to August, the import price index (measured by Funcex) dropped by 9.9% over the same period last year, while the quantum index (export volumes, also measured by Funcex) experienced a 16.4% decline on the same basis comparison.

Imports are down across all categories of use. The decline in household income, production and investments, coupled with the exchange rate appreciation, has contributed to this result. Special mention should be made of the decline in purchases of durable consumer goods, with a 45% drop in the value of imports, and in fuels, with a 43% decline.

Exports in turn hit the mark of US$ 139.3 billion from January to September 2016, down by 3.5% from the same period the year before. This is also the lowest level in six years. As opposed



Source: MDIC/SECEX

Trade surplus keeps increasing significantly

Exports, imports and trade balance in the year to September

In billion US dollars

to imports, exports have experienced an increase in shipped volumes – the decline in the value of exports was driven by falling prices. In the year to August, the quantum index is up by 9.1% as compared to the corresponding period in 2015, while the price index edged down by 12% on the same comparison basis.

The value of exports will likely keep falling through the end of the year. The difference between the growth of the Brazilian and global economies will decline gradually as economic activity in Brazil begins to show signs of recovery. The fact that the exchange rate remains at a more appreciated – albeit stable – level will also lead to a partial decline in exports, which are expected to total around US$ 190 billion by the end of 2016, slightly down from 2015's figure.

With regard to imports, production, consumption and investments are estimated to remain at a low level through the end of 2016, discouraging foreign purchases. The value of exports will thus keep falling significantly on a year-to-date basis. As a result, imports are estimated to fall by 19% in 2016, hitting the mark of US$ 140 billion. Under such a scenario, the trade balance would reach a surplus of US$ 50 billion in 2016, compared with a US$ 19.7 billion surplus in 2015.

EXTERNAL ADJUSTMENT REMAINS STRONG

The 12-month current account deficit is increasingly less negative: while the deficit totaled US$ 84.7 billion, or 4.24% of GDP, in August 2015, the figure fell to US$ 25.8 billion, or 1.46% of GDP, in the same month of 2016. The deficit has been trending downward since January 2015. Compared with December 2014, when the deficit posted its worst result in the series (US$ 104.2 billion), the figure is down by 75.2%. The decline in the deficit has been largely driven by a substantial trade surplus and by a reduction in services deficit as a result of less negative deficits in international travel and transportation.

The 12-month current account deficit will likely keep falling toward the end of 2016, reaching US$ 15 billion (0.8% of GDP in US dollars as estimated by CNI). The pronounced rise in the 12-month trade surplus in the last months of the year will be the main factor behind the further decline in the current account deficit.

Current account deficit still trending downward

12-month current account balance

In billion US dollars

Source: Central Bank of Brazil

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2014	2015	2016 previous forecast (07/07/16)	2016 current projection (14/10/16)
ECONOMIC ACTIVITY				
GDP (annual change)	0.1%	-3.8%	-3.5%	**-3.1%**
Industrial GDP (annual change)	-1.2%	-6.2%	-5.4%	**-3.7%**
Household consumption (annual change)	0.9%	-4.0%	-4.8%	**-4.6%**
Gross fixed capital formation (annual change)	-4.4%	-0.1%	-13.9%	**-11.0%**
Unemployment Rate (annual average - % of the labor force)	4.8%	8.3%	11.5%	**11.5%**
INFLATION				
Inflation (IPCA index - annual change)	6.4%	10.7%	7.3%	**7.1%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	10.96%	13.47%	14.18%	**14.18%**
(year's end)	11.75%	14.25%	13.75%	**13.75%**
Real interest rate (average annual rate and deflation: IPCA)	4.3%	4.2%	6.4%	**6.6%**
PUBLIC ACCOUNTS				
Nominal result (% of GDP)	-6.23%	-10.40%	-10.30%	**-9.40%**
Public sector primary result (% of GDP)	-0.59%	-1.88%	-2.62%	**-2.70%**
Net public debt (% of GDP)	57.2%	66.5%	73.4%	**71.6%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.64	3.87	3.30	**3.30**
(average in the year)	2.35	3.33	3.48	**3.48**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	225.1	191.1	192.0	**190.0**
Imports (US$ billion)	229.0	171.5	150.0	**140.0**
Trade balance (US$ billion)	-3.9	19.7	42.0	**50.0**
Current account balance (US$ billion)	-104.2	-58.9	1.0	**-15.0**

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