Economic Report
ISSN 1983-621X • Year 32 • Number 2 • April/June 2016

ECONOMIC REPORT

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

In the domain of expectations

Real economy still not rebounding solidly

The Brazilian economy is going through a transition. Leading indicators, which predict future economic activity, indicate recovery, as do confidence indices. The indicators gauging the real performance of Brazilian economy have fluctuated but are yet to indicate an economic upturn. According to our estimates, GDP will fall by 3.5% in 2016, with industrial GDP dropping by 5.4%.

It is almost certain that the recession is no longer worsening and that the economy has hit "rock bottom". The fluctuations seen in the indicators for production, sales and hours worked in industry and in retail sales often precede to some extent a rebound and provide clear signs that economic activity has not deteriorated further.

Domestic demand conditions, however, remain very depressed as a result of high unemployment rates and of the financial situation of households, with higher default rates and limited borrowing capacity. In this environment, not even a gradual recovery in consumer confidence could be expected to cause domestic consumption to react more significantly.

In the short term, expectations are also not positive on the investment side. Idleness in industry has hit a record high in recent times, business confidence remains in pessimistic territory, and financing costs and availability have not favored the development of new projects.

While the fiscal policy became expansionary during the first half of the year, it is unreasonable to expect a fiscal stimulus package to boost growth, considering the magnitude of the current fiscal imbalance. In fact, the extent of fiscal adjustment is at the root of the Brazilian crisis and there will be no sustained economic recovery if this issue is not addressed head-on.

Thus, economic recovery is likely to be driven by the foreign

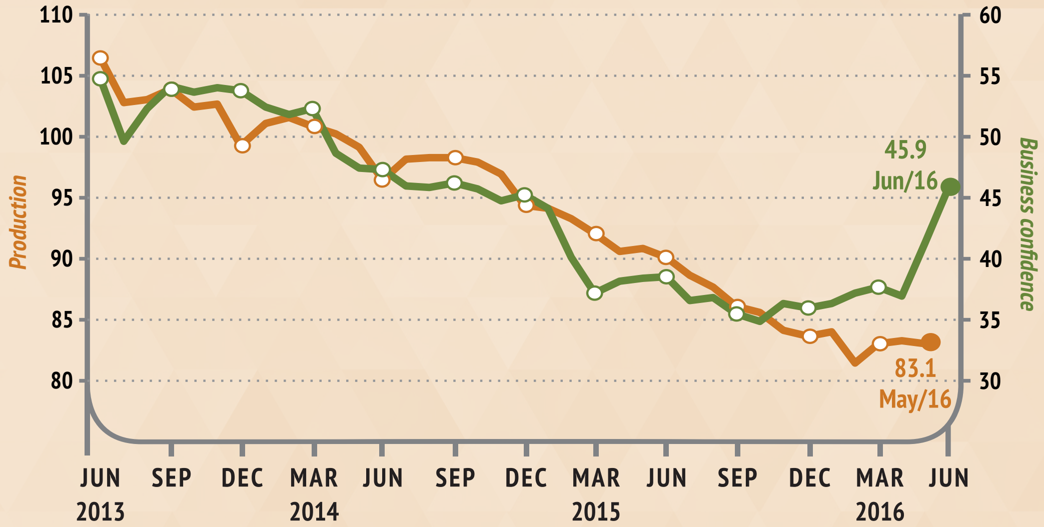
(continued on the next page)

The Brazilian economy in the second quarter 2016

Production still lagging behind expectations

Production and Business Confidence Index***

** Seasonally adjusted monthly fixed-base index (Base: average 2012 = 100)*
***Index (0-100 points)*



Source: IBGE and CNI

trade sector, with increased exports and import substitution with domestic production. This is in fact what has been happening. The change in the exchange rate level seen in the last two years, amid a fall in domestic demand, has stimulated this process.

The recent appreciation of the Brazilian currency (real) can pose a risk to the continuation of this process. In recent weeks alone, the real/US dollar exchange rate experienced a rapid and significant appreciation. Companies are frustrated with this trend, which could prevent them from making strategic decisions focused on greater worldwide market penetration or from resuming production to replace imports.

Recovery may be on the horizon for 2017. The change in the political scenario has paved the way for structural adjustments that require legislative and constitutional changes, such as a social security reform and the imposition of limits on public spending growth. A bill proposed by the federal administration has already been submitted to Congress and represents a breakthrough. However, its effects will only be felt in the medium term and depend on renewed growth – and new changes in the budget process will still be required for the proposal to become effective.

Activity recovery will be hampered by the financial situation of companies. The protracted crisis has exacerbated difficulties in accessing credit and has pushed up default rates in supply chains. This fragile situation – which according to CNI's surveys is more serious than that seen in the 2008 crisis – must be addressed so as not to undermine the responsiveness of companies when the fiscal and macroeconomic environment is rebalanced. This responsiveness may be negatively affected if no action is taken to mitigate operational and financial difficulties faced by companies.

In short, reversing expectations is a necessary but insufficient factor. It is also essential to provide the necessary conditions for expectations to materialize in the real economy, which requires focusing on a short-term agenda – an emergency action agenda – to make it possible for companies to resume a growth path.

ECONOMIC ACTIVITY

Have we hit rock bottom?

Recovery – when it comes – will be slow

In the first quarter of 2016, GDP recorded its fifth quarter-on-quarter fall at an average rate of 1.3% per quarter. The data released over the second quarter were inconsistent, with signs of stabilization followed by new negative results. For this reason, it is still unclear whether productive activity has hit "rock bottom" and, consequently, when activity will rebound and at what rate.

The Brazilian Central Bank's economic activity index (IBC-BR) shows signs that the worst is behind us. The seasonally adjusted index (i.e. adjusted for seasonal variations) held steady in April as compared to March, breaking a 15-month downward spiral during which it fell by 8.4%.

When considering industry, however, the positive results for the first quarter were not seen across all variables. In May, industrial production (Monthly Survey of Industry – Physical Production - PIM/PF-IBGE) held steady again after staying flat in April and growing in March. On the other hand, hours worked (CNI's Industrial Indicators survey) fell in May after experiencing growth in the previous month. Real sales (CNI's Industrial Indicators survey) posted growth in January and February, but have since trended downward. Comparing the quarter ended in May 2016 with the previous three months, production shows stability, while sales and hours worked have edged down by 2.5% and 1.0%, respectively.

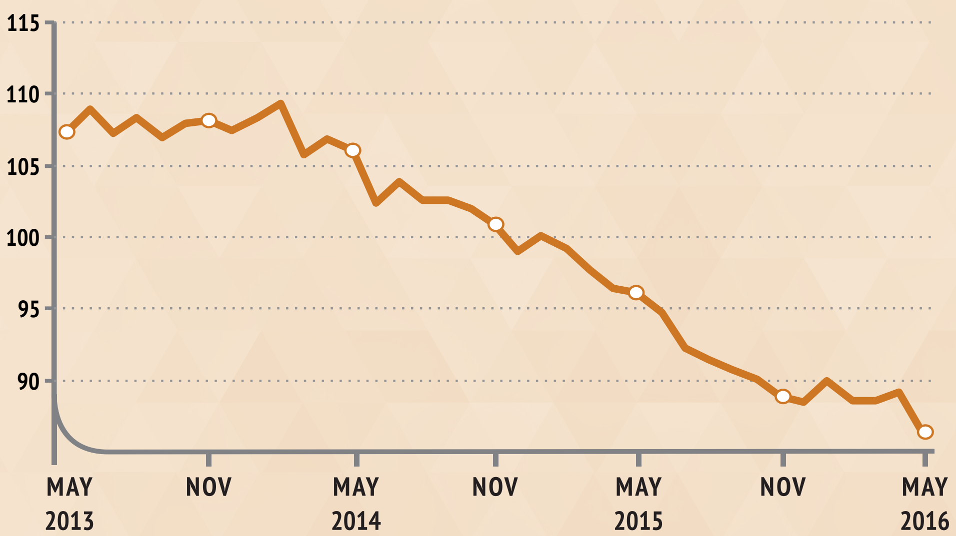
Data for retail sales (Monthly Survey of Trade/IBGE) show that sales have held relatively steady since the beginning of the year. However, this stability is restricted to segments such as Hypermarkets and Pharmacy. In credit-dependent segments with higher unit values, such as Motor vehicles, motorcycles and parts, Furniture and electrical appliances, and Office and computer equipment, sales remain on a downward trend.

As a result, both industrial activity and sales remain at significantly low levels. Comparing the average for the January-May 2016 period with the average for the same period in 2015, industrial production

Industrial activity keeps falling

Seasonally adjusted hours worked in production

** Fixed-base index number (Base: average 2012 = 100)*



Source: CNI

is down by 9.8%, hours worked in production fell by 10.1%, and sales experienced a 12.2% decline. Retail sales in turn fell by 6.9% in the first four months of 2016 from the corresponding period the year before.

The bright side is that the end of the first half of 2016 saw an improvement in expectations. The consumer confidence index (INEC/CNI) posted growth in May, but remains far below its historical average. The increase was based on the outlook for the coming months, as current assessments of financial conditions and indebtedness remain negative. In addition, default rates and fear of unemployment remain at a very high level.

Similarly, entrepreneurs' expectations have also improved. Data from CNI's Industrial Survey show that entrepreneurs are optimistic about both exports and demand over the next six months for the first time since February 2015. Business confidence (ICEI/CNI) in turn improved significantly in May and June, but has yet to reach the 50-point dividing line between confidence and lack of confidence. This result was influenced by entrepreneurs' negative assessment of current conditions of the Brazilian economy and of their own companies.

Therefore, the big question for the coming months is when the more positive expectations of consumers and entrepreneurs will translate into an actual improvement in economic activity – that is, if demand will recover in the second half and at what pace. We believe that, when it comes, recovery will be slow.

The fact that inflation has remained persistently above the target hinders a recovery in consumer confidence and a possible significant reduction in interest rates before the end of 2016. Household consumption is expected to remain depressed as a result of high interest rates, rising unemployment and falling disposable income – factors that will remain in place until the end of 2016. For the same reasons, demand for services will recover only moderately.

On the industry side, the deteriorating financial situation of companies leaves no room for bad decisions. While production may respond immediately to a recovery in demand as inventories remain at adjusted levels, this response will be gradual. The accumulation of unwanted inventories will further aggravate the situation of enterprises, meaning that entrepreneurs will have to be more cautious in resuming production.

On the foreign front, trade balance data show that export volumes of industrialized products exceeded double-digit growth throughout the first half of the year. Import data indicate an ongoing import substitution process or, perhaps more appropriately, a reversal of the pronounced increase in the share of imports in the Brazilian market (see Foreign Trade Sector section). This recent, more favorable trend, however, has not been enough to prevent industry from continuing on a downward spiral. Yet, the recent appreciation of the Brazilian currency may put an end to the import substitution process and reduce additional export gains.

Based on this scenario and under the assumption that interest rates will fall only in the last quarter of 2016 and in the absence of new political crises, CNI estimates that GDP will decline by 3.5% in 2016, with industrial GDP dropping by 5.4%.

Household consumption, the largest spending component of GDP (demand or expenditure side), is projected to fall again in 2016 by 4.8%. It will therefore make a negative contribution of 3.0 percentage points to the 3.5% decline in GDP.

GDP estimate for 2016

Percentage change in GDP components

	GDP COMPONENTS	Variation rate (%)
Demand	Household consumption	-4.8
	Government consumption	-2.0
	Gross Fixed Capital Formation	-13.9
	Exports	8.0
	(-) Imports	-10.0
Supply	Agriculture/livestock	0.5
	Industry	-5.4
	Mining and quarrying	-2.0
	Manufacturing industry	-6.3
	Construction industry	-6.8
	Industrial Public Utility Services	-1.0
	Services	-3.2
	GDP	**-3.5**

Gross Fixed Capital Formation (GFCF) is likely to decrease for the third consecutive year, down by 13.9% in 2016. This decline is explained by a record-high idle capacity and by high interest rates, which inhibit investment. The investment intention index (Industrial Survey/CNI) for June continues to show low investment intentions. In total, domestic demand is expected to shrink by almost 6% in 2016.

The volume of exports of goods and services is expected to increase by 8%, while that of imports will likely fall by 10%. It is worth stressing that exports have currently been the largest contributor to GDP growth, contributing 2.5 percentage points and confirming their position as the most dynamic sector in the economy.

On the supply side, special mention should be made of the 5.4% decline in industry, explained largely by a gloomy outlook for manufacturing industry, which is estimated to fall by 6.3% in 2016. The construction industry also shows a negative trend, with an expected drop of 6.8%. The mining and quarrying industry in turn is set to shrink by 2.0% in 2016.

EMPLOYMENT AND INCOME

Further deterioration in labor market indicators in 2016

First months of 2016 are marked by double-digit unemployment rates and a sharp decline in total payroll

The first five months of the year confirmed the deterioration in the labor market that CNI anticipated for 2016. Unemployment, which exceeded double-digit rates in the first two months, remains on an upward trend. Under this scenario, CNI expects the average annual rate to amount to 11.5% of the labor force.

Real average earnings and employment will likely keep falling through the end of the year. As a result, real total payroll would fall by almost 4% in 2016, down from a 0.5% increase in 2015, thus hindering a recovery in household consumption and economic activity.

UNEMPLOYMENT STILL TRENDING UPWARD

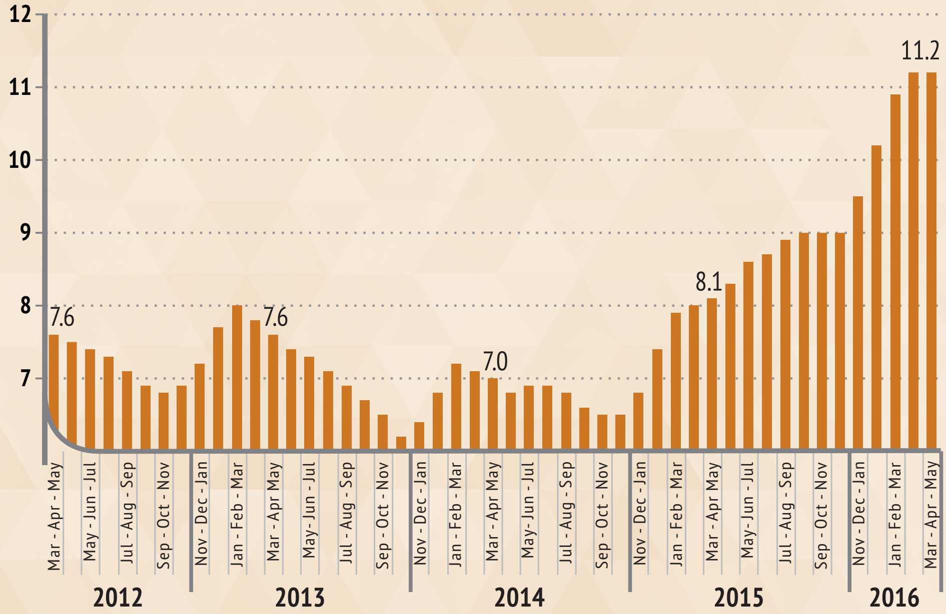
The unemployment rate usually begins to trend downward in the second quarter of each year on account of seasonal effects. In 2015, however, this behavior changed due to the economic crisis and its impact on the labor market. Since then, the unemployment rate has been on a steady upward trend – one never seen before in the historical series initiated in 2012. The indicator hit the mark of 11.2% of the labor force in the quarter ended in May, representing a 3.1-percentage point increase from the same period in 2015.

Unemployment is traditionally one of the last indicators to deteriorate during economic downturns and to rebound during upturns. This behavior can be partly explained by the fact that companies postpone layoff and hiring decisions as much as possible, primarily for two reasons: the high costs of laying off and hiring workers and the challenge of retaining skilled employees, which is time-consuming and requires additional training costs. Moreover, during economic upturns, companies begin to use all available resources (greater use of machinery and equipment and an increase in hours worked) in order to produce at full capacity, as part of the industrial park was previously underutilized due to reduced demand. Companies only begin to hire new staff when they become more confident that the economic recovery is sustainable and when their production capacity with current resources is reaching its limit.

Unemployment on an upward trend for 17 months straight

Unemployment rate

As a percentage of the labor force (%)



Source: Pnad Contínua Survey/IBGE

INCREASED UNEMPLOYMENT DRIVES DEFAULT RATES UP

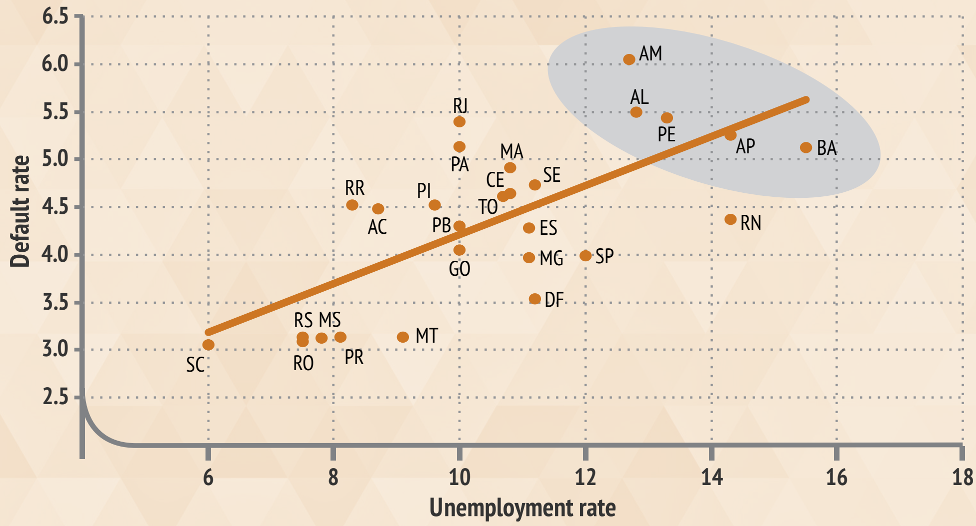
The lack of jobs has led to a decline in household consumption and a rise in default rates. As families adjust their budgets to the increased cost of living, household consumption fell for the fifth quarter in a row: down by 6.3% in the first quarter of 2016 (latest available data) as compared to the same period the year before.

The deterioration in the labor market has also impacted on default rates. Five out of the seven states with the highest default rates are among those that showed the largest unemployment rates in the quarter ended in March (latest data available for the regional/state-level profile of IBGE's survey), as shown in the chart below. These states are the following ones: Amazonas, Alagoas, Pernambuco, Amapá and Bahia.

Unemployment drives states' default rates up

Unemployment and default rates by Federation Unit

In %



Source: Pnad Contínua Survey/IBGE and Central Bank of Brazil
*Default: percentage of the loan portfolio in the National Financial System with at least one installment in arrears for more than 90 days.

The rise in household indebtedness [1], which edged up from 36.8% in April 2010 to 44.3% in April 2016, and the income-eroding effects of inflation have contributed to increasing default rates in the states most affected by unemployment.

BRAZIL LOSES 1.7 MILLION JOBS IN 12 MONTHS

The rise in the labor force has driven up the unemployment rate, but the decline in jobs has played a decisive role in bringing the rate to its current level. The labor force posted growth of 2.0% in the quarter ended in May from the same period in 2015. Meanwhile, jobs have been falling for nine months straight and experienced a 1.4% decline on the same comparison basis.

What is striking about the decline in employment is the volume and speed of job destruction seen in Brazil last year. According to data from the General Registry of Employed and Unemployed Persons of the Ministry of Labor (CAGED/MTE), the Brazilian economy lost 1.7 million formal jobs in the twelve-month period ending in May.

In 2015, industry was the sector that lost the largest number of jobs in Brazil. Trade has been the hardest hit sector in 2016, as it lost 225,200 formal jobs in the first five months of 2016. The second hardest-hit sector was industry, which cut 212,300 jobs. The services sector destroyed 59,600 jobs, while agriculture/livestock, the only sector that hired more workers than it laid off, created 43,700 jobs during the same period.

Among the industrial segments, manufacturing and construction were the hardest hit in the first five months of the year, as they lost 108,300 and 93,800 formal jobs, respectively. During the same period, the mining and quarrying and industrial utilities sectors cut 8,200 and 1,900 jobs, respectively.

REDUCTION IN TOTAL PAYROLL AFFECTS CONSUMPTION IN 2016

The beginning of 2016 was marked by a sharp reduction in real average earnings of workers. This decline was driven by a significant lag in the response of wages to changes in the unemployment rate due to the frequency of collective wage agreements.

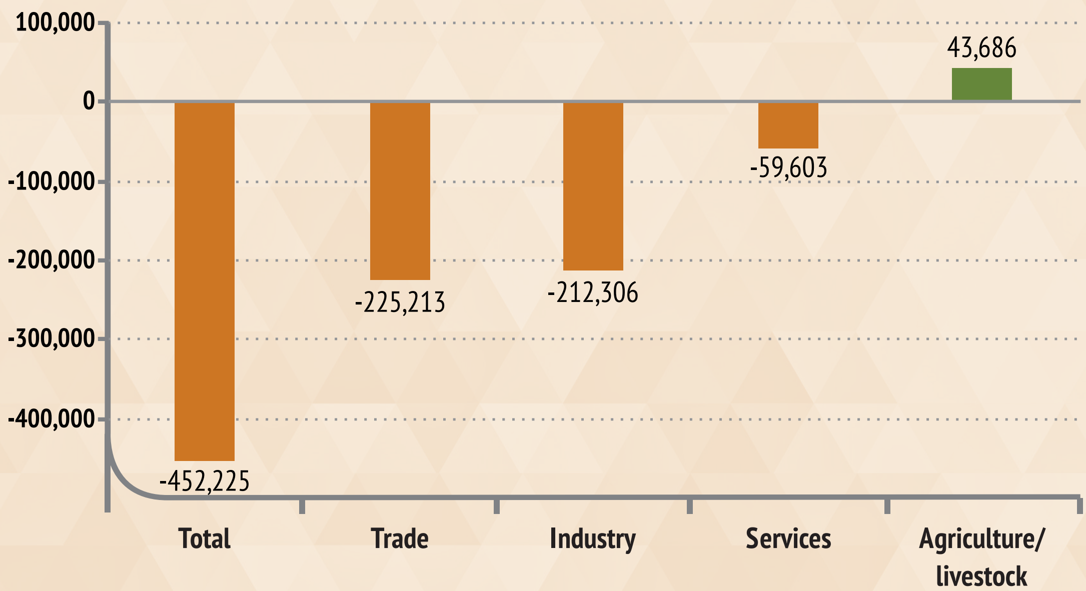
This is confirmed by the graph "Economic crisis hampers wage negotiations," which shows that wage negotiations were less successful in May 2016, with a real loss of 1.0%, compared to a real growth of 0.1% during the same month in 2015.

In sectors with the largest number of jobs lost as a result of the economic downturn, the need for cost adjustments resulted in lower wage increases. One of these sectors is industry, where average wage increases totaled 6.8% in May. Meanwhile,

Trade is the sector that has lost the largest number of jobs in 2016

*Net balance of formal jobs**

Accumulated figure from January to May 2016



Source: CAGED/MTE
* Includes information submitted after the deadline.

1 - Household indebtedness under the National Financial System (SFN) in relation to the income accumulated in the last twelve-month period.

the agriculture/livestock sector, which recorded a net creation of formal jobs, had an average wage increase of 10.1% – above the inflation rate.

Moreover, the reduction in employment, coupled with an increase in the labor force – so as to largely restore the income of families who lost their jobs – and the need to adjust business production costs amid an economic slowdown, has driven down wages in new employment contracts.

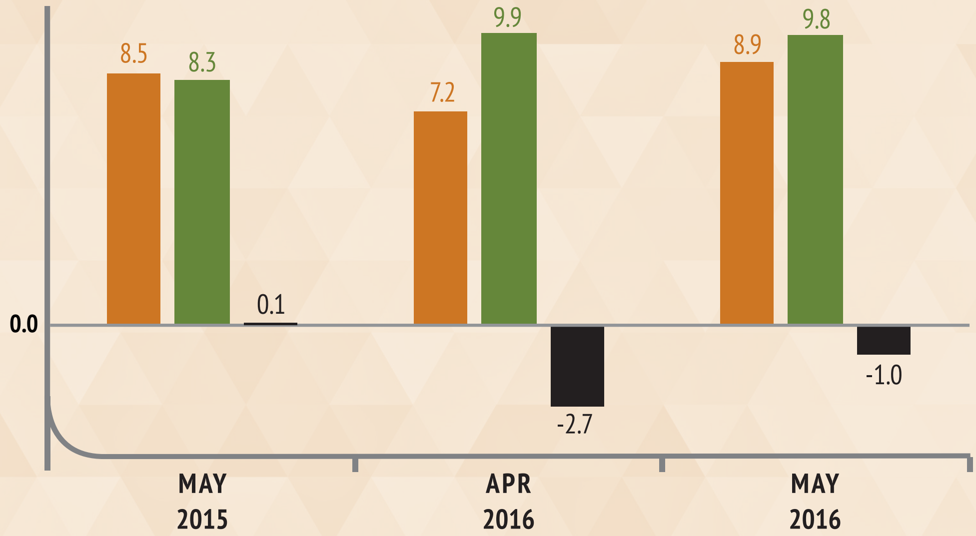
These factors have led to a significant decline in real average earnings and real total payroll in 2016. These indicators dropped by 2.7% and 3.3%, respectively, in the quarter ended in May from the corresponding period in 2015.

As total payroll is the main determinant of consumption, domestic demand is only expected to rebound significantly when the labor market shows signs of recovery.

Economic crisis hampers wage negotiations

Average wage increase, 12-month National Consumer Price Index (INPC), and real average wage growth

In %



Source: "Wageometer" developed by the Institute of Economic Research Foundation (FIPE)/University of São Paulo (USP)

INFLATION, INTEREST RATES AND CREDIT

Inflation slows down in the first half of the year

Trajectory influenced mainly by government-regulated prices

Inflation has shown signs of slowdown, though it still remains significantly above the target set by the National Monetary Council. The Extended National Consumer Price Index (IPCA), which closed 2015 at 10.7%, recorded a 12-month growth of 9.3% in May. The slowdown in the price index observed in the January-May period was influenced mainly by a smaller increase in regulated prices and particularly by a reduction in electricity rates. In addition, a scenario of weak economic activity and deteriorating labor market conditions has caused service prices to grow less significantly. On the other hand, food prices accelerated strongly and had the greatest impact on the index. In May, however, the food group showed signs of slowdown, suggesting a lower impact in coming months.

The group of regulated prices, which ended 2015 at 18.1%, posted a twelve-month increase of 10.9% in May. The slowdown in regulated prices is explained mainly by a 4.8% year-to-date decline in electricity tariffs as a result of the end of additional electricity charges. This effect was mitigated by an increase in pharmaceutical prices and urban bus fares, as well as by a rise in water and sewer charges after the end of a water consumption reduction program in São Paulo. In 2016, the group is expected to have less of an impact on the IPCA index than it did in 2015. This is mainly attributed to the conclusion of the realignment process of regulated prices. CNI is thus expecting the group's prices to grow by 7.1%.

The food group was the one that had the greatest impact on the overall index. The 12-month growth rate edged up from 12.9% at the end of 2015 to 14.7% in May 2016. This increase in the group was mainly due to climatic effects that affected food supply, particularly in natura food supply. However, the group's prices have shown signs of slowdown, with a consequent lower impact on the overall index. According to CNI's estimates, food prices will rise by 12.5% by the end of the year.

Prices of industrial products keep growing below inflation, even though they accelerated in the last twelve months – from 4.9% in December 2015 to 6.0% in May 2016. For the remainder of the year, however, the group's prices are projected to grow less significantly, mainly because the real will likely keep appreciating against the US dollar – a trend observed since February. This would reduce the pressure caused by the devaluation of the Brazilian currency in 2015. The group's growth rate would thus end the year at 5.5%.

Service prices have risen at a slower pace. The group's growth rate fell from 8.1% in the 12 months to December 2015 to 7.5% in the twelve-month period to May. It is unusual for the services sector to experience such a slowdown in short periods, as its prices are indexed to past inflation and to the minimum wage. However, the strong economic downturn and deterioration in labor market conditions have affected the dynamics of wages and employment, with wages increases often lagging behind the inflation accumulated in the period (see Employment and Income section). Lower-than-inflation increases reduce consumers' purchasing power and contribute to slowing down the group's prices. This trend is expected to continue, with the group ending 2016 with an accumulated growth rate of 6.4%.

Considering the behavior of the different groups analyzed, CNI estimates that the IPCA index will grow by 7.3% in 2016, down by 3.4 percentage points from 2015's figure.

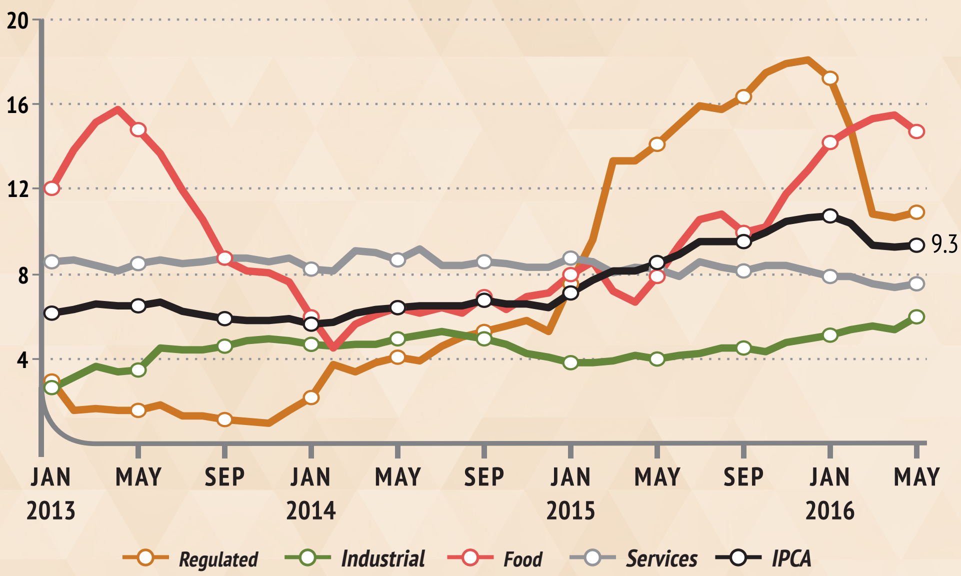
MONETARY POLICY BECOMES MORE RESTRICTIVE AS INFLATION FALLS

If the constant interest rate remains at current levels, the inflation slowdown will continue to push up the real interest rate, thus leading to a more restrictive monetary policy. Considering the ratio of nominal interest rate to expected inflation for the next 12 months included in the Central Bank's Focus survey, the real interest rate has been rising steadily since January 2016. Since then, the

Regulated prices slow down at the start of the year

IPCA index by groups

12-month figure (%)



Source: IBGE
Preparation: CNI

Economic Report
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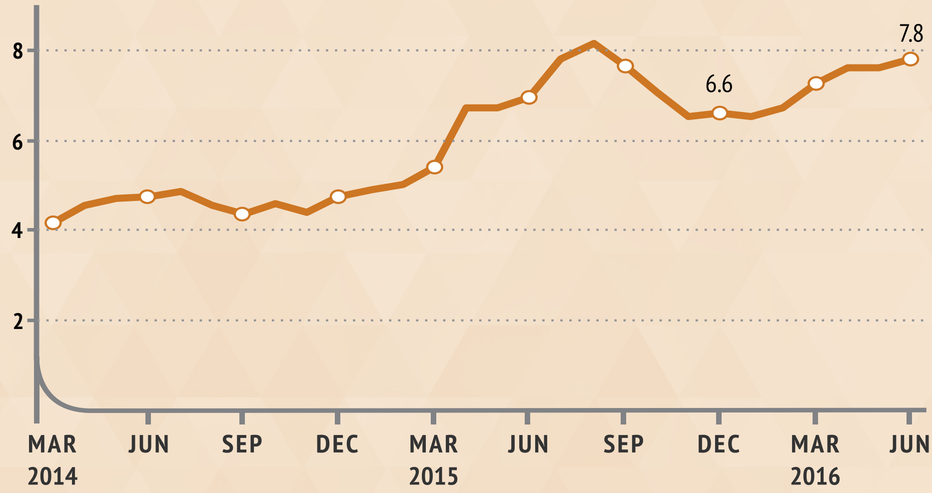
Real interest rate rises in the first half of the year

Nominal interest rate / Expected inflation for the next 12 months according to the Focus survey

In % per year



Source: Central Bank of Brazil

rate has increased by 1.3 percentage points and hit the mark of 7.8% per year in June.

The impact of higher real interest rates, coupled with the strong economic downturn and the lagged effects of monetary policy, pave the way for a downward cycle in interest rates over the coming months without negatively affecting current inflation or expectations.

However, for inflation to converge to the target in a quick and less costly way, fiscal measures must be taken to control public spending and ward off the risk of an unsustainable public debt trajectory (see Fiscal Policy section). The contribution of fiscal policy will intensify the downward trend in the Selic rate, helping the economy to get back on track.

Based on the current scenario, CNI estimates a 0.25-percentage point reduction in each of the last two Monetary Policy Committee meetings, which will be held in October and November 2016. Thus, the Selic would close the year at 13.75% per year.

CREDIT IS MORE RESTRICTED THAN IN THE 2008 CRISIS

Companies have never been so dissatisfied with their financial conditions and are facing unprecedented difficulties to access credit. According to data from CNI's Industrial and Construction Industry surveys, the indicators of satisfaction with financial conditions and of ease of access to credit indicate a more challenging environment for industry than the one it faced during the 2008 financial crisis.

Supply constraints, caused by a more selective credit policy of banks in response to rising default rates, have worsened the financial situation of firms and hampered economic recovery.

In addition, the deterioration in the credit environment is exacerbated by a reduction in demand for funding. This is explained by the slowdown in economic activity, by high household income-to-debt ratios and by rising unemployment rates, which have reduced consumer demand for credit. On the side of entrepreneurs, a scenario of high spare capacity in companies and weak activity has discouraged them from taking new loans.

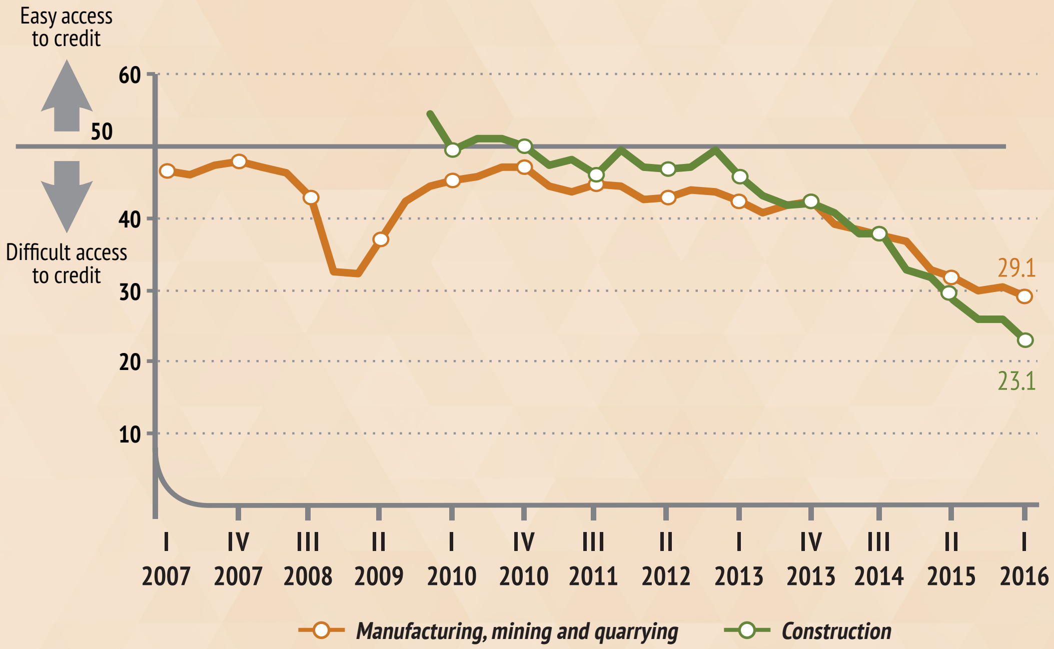
As a result, the credit balance fell in real terms at the beginning of the year. According to Central Bank data, the total balance dropped by 2.8% when comparing the average recorded in the last 12-month period ending in May with the average for the previous 12 months. On the same comparison basis, the average balance decreased by 3.6% for corporations and by 1.8% for individuals.

For the coming months, CNI estimates that if measures to stimulate the credit market are not taken, we will continue to see an adverse scenario, with a continued downward trend in the credit balance.

More restricted access to credit

Index of ease of access to credit

Diffusion index (0-100)



Source: CNI

* The index ranges from 0 to 100. Figures above 50 points indicate easier access to credit.

FISCAL POLICY

Federal government increases projected primary deficit for 2016

Proposal for limiting spending growth signals change in the medium term

Fiscal policy has once again taken an expansionary stance in 2016 – the same stance that characterized it in the years prior to 2015. Part of the expected increase in spending had already been anticipated, such as in the case of expenses impacted by minimum wage increases. Another part, however, will result from decisions that could be avoided by the interim government, such as bills providing for wage increases for civil servants. As a result of the increase in expenditures and the adoption of realistic projections for revenues, the federal government's primary surplus target has been increased to a R$ 170.5 billion deficit.

While actions taken in 2016 have focused on exposing the severe fiscal situation faced by the federal government, the following years signal an austere fiscal policy, with the imposition of significant limits on spending growth. These limits will also likely be extended to state governments under an agreement to refinance their debts with the federal government.

What is worrying, however, is the feasibility of applying such limits within the federal government, as the interim government has increased expenditures for the current and coming years (e.g. personnel expenses and spending on the *Bolsa Família* program).

FEDERAL GOVERNMENT SPENDING GROWS AGAIN IN 2016

Federal government spending grew by 1.4% in real terms (IPCA deflator) in the first five months of 2016 from the same period the year before. This increase contrasts with a 2.6% real decline observed in 2015 as compared to 2014, when R$ 55.6 billion paid in obligations that should have been settled in previous years are deducted, an operation referred to as "fiscal backpedaling" (delaying bank transfers to misrepresent balances).

The increase in spending in 2016 is mainly attributed to a rise in expenses impacted by minimum wage increases, to a review of the salary bonus payment schedule carried out in 2015, and to a new method of accounting for subsidies introduced by the Federal Court of Audit (TCU) at the end of 2015. The spending item exerting the greatest pressure on federal government expenditures is social security, which experienced a 5.2% increase in real terms in the first five months of 2016 as compared to the corresponding period last year. This increase is mainly due to a nominal increase of 11.7% in the minimum wage and to a similar increase approved for benefits exceeding the amount of the minimum wage.

The upward pressure on public spending triggered by the increase in the minimum wage has also reflected in funding and capital costs. While the item as a whole held steady in real terms in the first five months of 2016 from the same period in 2015, one can see a clear division within its sub-items.

Spending on welfare benefits and expenditures of the Workers' Assistance Fund (FAT) on salary bonuses and unemployment insurance grew by 4.3% and 30.1%, respectively, in real terms. In both cases, the increase in the minimum wage had a significant impact. The increase in FAT's expenditures is also impacted by a change in the salary bonus payment schedule and by a rising unemployment rate. Another sub-item of funding and capital expenses that experienced real growth is spending on subsidies and grants, which rose by 106.9% in the first five months of 2016 as compared to the same period in 2015. In this case, the increase is explained by a guideline issued by TCU putting an end to the 24-month grace period for making interest rate equalization payments to the Brazilian National Development Bank (BNDES) under the Investment Support Program (PSI). From 2016 on, payments will be semiannual, with January already seeing an impact.

On the other hand, the sub-item "other funding and capital expenses" experienced a real decline of 9.4% in the first five months of 2016 on a year-on-year basis. While funding expenditures fell by 4.2%, investment expenses (GND-4 of the SIAFI system) shrank by 33.2%. It is worth stressing that this decrease in investment follows a real decline of 34.3% in 2015. This behavior provides a clear picture of the problem caused by the extreme rigidity of the federal government's budget. In view of the need to rein in spending, there are few alternatives other than cutting investment.

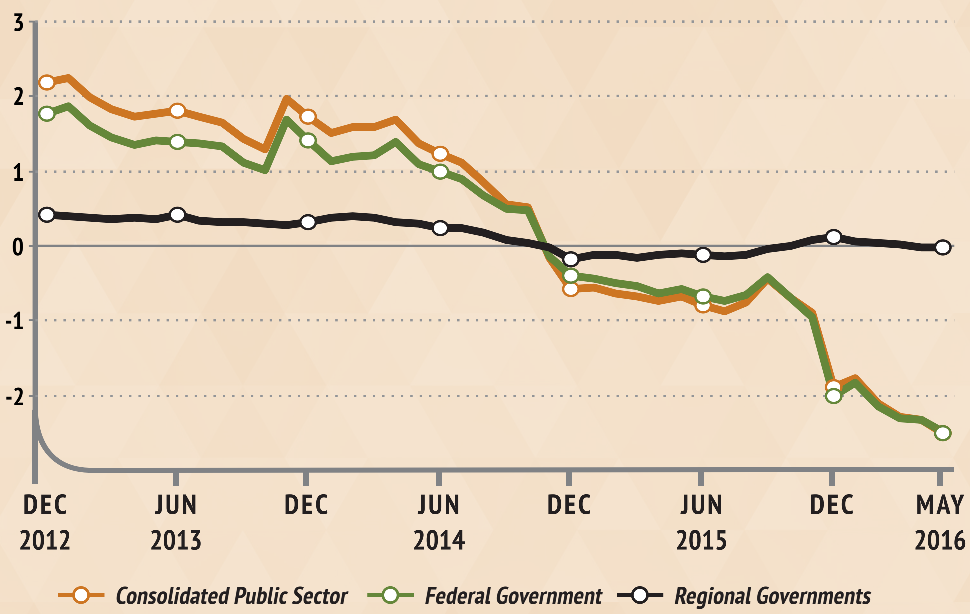
FEDERAL GOVERNMENT REVENUES DROP MORE SIGNIFICANTLY

Federal government revenues dropped even further in real terms in the second quarter of

12-month primary deficit advances by 0.5 percentage points of GDP in the first five months of 2016

Primary result of the Public Sector

12-month figure (% of GDP)



Source: Central Bank of Brazil

2016. Net revenues fell by 5.0% in the first five months of 2016 as compared to the same period in 2015. In the first quarter of 2016, net revenues had dropped by 2.9%.

Influenced by the economic downturn, revenues managed by the Brazilian Federal Revenue Service (RFB) experienced the sharpest decline (-7.0%). It should be stressed that this drop occurred despite the positive effects on tax revenues caused by increases in tax rates for taxes such as the IPI (Tax on Industrialized Products), *CIDE-Combustíveis* (Contribution for Intervention in the Economic Domain on Fuels), and PIS (Social Integration Program)/Cofins (Contribution to Social Security Financing). Another component of net revenues that contributed strongly to their reduction is social security tax revenues, which shrank by 6.6% in the first five months of 2016 from the same period the year before.

REGIONAL GOVERNMENTS EXPERIENCING A FALL IN REVENUES AND EXPENDITURES

Just like the federal government, state and municipal governments have experienced a significant decline in revenues. The available data show a real decline of 6.1% in revenues of regional governments in the first four months of 2016 as compared to the corresponding period in 2015. The effects of the economic downturn led to a 4.7% decline in revenues collected from the Tax on Circulation of Goods and Services (ICMS) and also reduced the volume of transfers from the Federal Government (-12.7%). These declines are partially offset by a real growth of 3.0% in other taxes and fees.

As opposed to what happens in the federal government, however, the decline in revenues has been accompanied by a decrease in expenditures. Based on revenue data available and on data for the primary result of regional governments, spending is estimated to have experienced a 3.4% real decline the first four months of 2016 on a year-over-year basis.

FISCAL RESULTS KEEP DETERIORATING

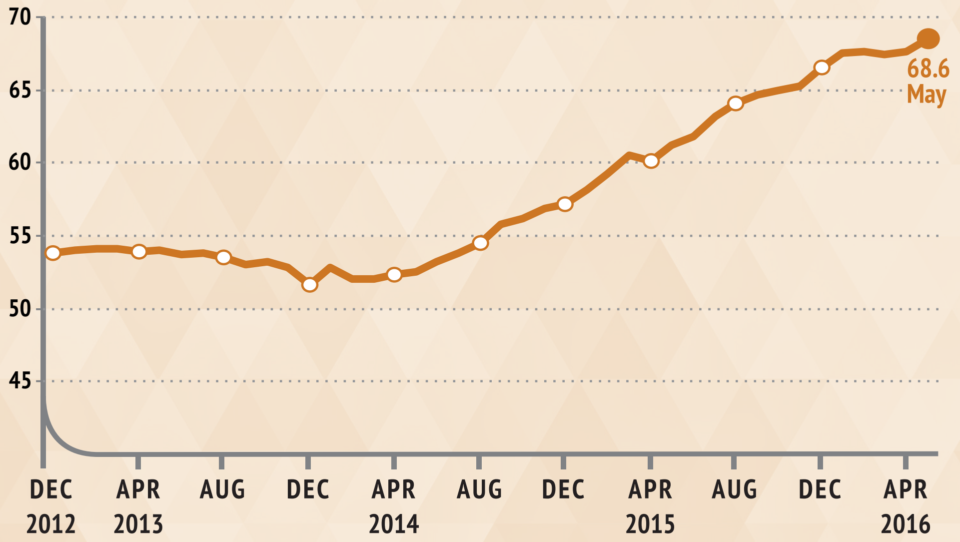
Rising expenses and a sharp decline in net revenues have caused the primary result of the federal government to deteriorate considerably as compared to the figure recorded at the end of 2015. In the 12-month period ending in May 2016, the federal government primary deficit hit the mark of 2.5% of GDP, compared to 2.0% in December 2015. In the case of regional governments, the decline in spending has been overshadowed by the effect of lower revenues, with the primary result moving from a surplus of R$ 7.1 billion (0.12% of GDP) in 2015 to a deficit of R$ 1.5 billion (-0.02% of GDP) in the 12 months ending in May 2016.

The deterioration in primary results of both the federal government and regional governments led to an increase in the primary deficit of the consolidated public sector, edging up from 1.9% of GDP in 2015 to 2.5% in the last 12 months ending in May 2016. Despite an increased primary deficit, the drop of 0.9 percentage points of GDP

Gross debt-to-GDP ratio grew by 2.1 in May 2016 from December 2015

Gross Public Sector Debt

As a percentage of GDP (%)



Source: Central Bank of Brazil

Gross debt-to-GDP ratio to rise from 66.5% of GDP in 2015 to 73.4% by the end of 2016

in interest expenses caused the 12-month nominal deficit to fall from 10.4% of GDP in December 2015 to 10.1% in May 2016. It is worth mentioning that the decline in interest expenses was driven by net gains of R$ 51.8 billion from foreign exchange transactions (swaps) in the first five months of the year.

Despite this decline, the nominal deficit remains at a high level – above the one required to at least stabilize the gross debt-to-GDP ratio. As a result, gross debt increased from 66.5% of GDP in December 2015 to 68.6% of GDP in May 2016.

PRIMARY RESULT EXPECTED TO DETERIORATE FURTHER

The new primary result target, which allows the federal government to post a deficit of up to R$ 170.5 billion, and the agreement to refinance states' debts with the federal government indicate a further deterioration in public finances in coming months. With respect to the federal government, the new target allowed for a financial programming of R$ 21.2 billion in discretionary spending to be canceled. On the side of state governments, previously repressed primary spending will begin to be unleashed as it finds its way into the budget as a result of non-payment of interest costs.

Under this new scenario, federal government spending would end 2016 with a real increase of 1.8%, up from the 1.4% growth rate observed from January to May. This increase in the growth rate of spending will likely be driven by social security and personnel expenditures. Social security spending is expected to end 2016 with a real increase of 7.4% as compared to 2015 due to increases in the minimum wage and in the number of beneficiaries, while personnel expenses, which dropped by 2.8% in real terms in the year to May, will likely close 2016 with a real decline of 0.3% in relation to 2015. This is explained by the wage increases that will be granted to different federal public servants in the second half of the year.

On the other hand, revenues are expected to drop more significantly and close 2016 with a real decline of 6.1%. The main reason behind this stronger decline in revenues is the expected behavior of revenues not managed by the Brazilian IRS. These revenues, which held steady in real terms between January and May 2016 from the same period in 2015, should end the year with a real decline of 13.0%. In the first months of the year, tax revenue was favored by R$ 11 billion received from hydroelectric power concessions. The amounts to be received by the end of the year will not be as significant. In addition, the receipt of dividends and royalties on oil production will likely keep falling sharply.

Social security revenues in turn are projected to keep falling at current rates. Meanwhile, revenues managed by the Brazilian IRS will probably decline at a lower rate due to a slower deterioration in economic activity and to the effects of tax increases occurred in 2015. These revenues are expected to fall by 4.5% in real terms in 2016.

The federal government would thus end 2016 with a R$ 158 billion deficit (-2.5% of GDP as estimated by CNI), leaving a US$ 12.5 billion margin for possibly compensating for the result of regional governments. However, the federal government might show a better result if it manages to collect significant revenues from the repatriation of undeclared funds held abroad – this is not included in the estimate above.

In states and municipalities, the primary result will likely keep deteriorating as the debt repayment agreement with the federal government will make room for primary expenditures and the volume of judicial deposits collected by states in 2015 will not be seen again this year. The primary deficit is expected to stand at R$ 6 billion in 2016, compared to a R$ 6.5 billion surplus target set by the federal government.

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$ 164 billion (-2.62% of GDP) in 2016. While this result would ensure that the new target is achieved, it would represent a significant deterioration from the deficit of 1.9% of GDP recorded in 2015, which included R$ 55.6 billion in "fiscal backpedaling."

The year-on-year increase in the primary deficit will probably be more than offset by the decline in interest expenses, which are projected to fall from 8.5% of GDP in 2015 to 7.7% in 2016. As a result, the nominal deficit would experience a slight decline, down from 10.4% of GDP in 2015 to 10.3% in 2016.

Despite this decline, the nominal deficit would remain at a high level and nominal GDP would grow at a slow pace, leading to a pronounced increase in gross public sector debt. CNI expects the gross debt-to-GDP ratio to rise from 66.5% of GDP in 2015 to 73.4% by the end of 2016.

IMPOSING LIMITS ON SPENDING GROWTH IS A POSITIVE PROPOSAL

In an attempt to stop the continuous and strong growth of spending, the interim government submitted a constitutional amendment bill (PEC) to Congress setting a cap on spending growth, which cannot be higher than the inflation rate recorded in the previous year. If this PEC is passed, this limit will also apply to education and health expenditures. Expenditure levels would thus not experience a real increase – or would only experience a slight real growth if inflation trends downward.

This proposal is positive and would have avoided the current fiscal crisis if it had been in place in recent years. Simulations carried out by CNI indicate that if the rule had been in force since 2010, after the fiscal policy was correctly used in a countercyclical manner in 2008 and 2009, the federal government spending in 2016 would be R$ 337 billion lower than the figure expected for this year. Thus, the federal government would record a primary surplus of R$ 180 billion (2.9% of GDP) in 2016, against a negative result of R$ 158 billion estimated by CNI (-2.5% of GDP).

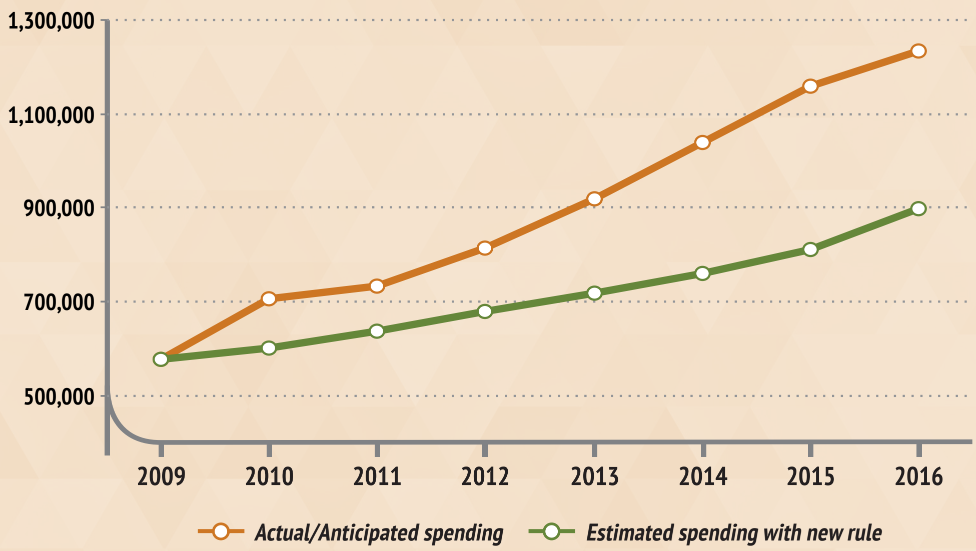
However, recent measures – as well as other previously implemented measures – have pushed up public spending, threatening the feasibility of imposing limits on spending growth. Considering CNI's projections for federal government spending and for the IPCA index in 2016, the new rule would make room for a nominal increase of about R$ 89 billion in federal government expenditures in 2017. As a result of previous and recent wage increases, personnel expenditures alone are expected to increase by R$ 25.2 billion in 2017, which, coupled with an estimated increase of R$ 64.6 billion in social security expenses (as the minimum wage will be adjusted for 2016 inflation and the amount of benefits will grow), would leave no room for an increase in spending.

This reinforces the need for additional measures to keep spending growth in check, such as reforming the social security system.

Spending would be R$ 337 billion lower than expected for 2016 if new rule was in place since 2010

Federal spending with and without new growth limits

In current R$ million



Source: CNI

FOREIGN TRADE SECTOR

Foreign trade accounts close to a balance

Brazilian currency on a strong appreciation trend

The real-US dollar exchange rate kept trending downward in the first half of 2016. The average exchange rate in January was R$ 4.05 per US dollar, the highest monthly average since the creation of the real. Since then, the Brazilian currency has appreciated for five consecutive months, reaching an average of R$ 3.42 per US dollar in June. This represents a 15.6% appreciation as compared to the average for January.

The uncertainties that beset the Brazilian political scene in 2015 have decreased with the impeachment process against President Dilma Rousseff, making room for a more stable exchange rate in the last three months. However, the real appreciated by 10.7% in June alone, reaching about R$ 3.20 per US dollar – an exchange rate not seen since the end of July last year.

The appreciation trend in the real is explained by several reasons, two of which are the trade surpluses achieved in the last 16 months and the recent rise in some commodity prices. More recently, a statement by the Central Bank that it will continue to pursue the inflation target for 2017 has postponed expectations of a decline in the Selic rate, contributing toward the appreciation of the Brazilian currency. In addition, less Central Bank intervention in the foreign exchange market has allowed for greater currency fluctuations.

It is worth stressing that the British referendum decision to leave the European Union reduced the probability of a new hike in US interest rates in the near future. Finally, the repatriation of funds held abroad may lead to further exchange rate depreciation, depending on the degree to which this repatriation process is successful (see Fiscal Policy section).

Therefore, the exchange rate evolution depends on a number of domestic and external factors. In the absence of major turbulences and assuming a moderate repatriation of funds, CNI expects the Brazilian currency to trade at R$ 3.30 per US dollar in December. The average exchange rate for 2016 is likely to stand at R$ 3.48 per US dollar, compared to R$ 3.33 per US dollar in 2015, representing a depreciation of 4.6%.

Exchange rate back to July 2015 levels

Daily exchange rate (Ptax Closing Rate) and monthly average

R$/US$

Source: Central Bank of Brazil

RECORD TRADE BALANCE

Brazil's external accounts improved strongly in the second quarter of 2016, closing the first half of the year with a trade surplus of US$ 23.6 billion, up from US$ 2.2 billion in the same period the year before. As in 2015, the positive trade balance is explained mainly by the fact that imports fell more than exports.

Imports totaled US$ 66.6 billion in the first half of 2016, down by 27.7% from 2015's figure. Both import prices and volumes are down: by 10.3% and 24.6%, respectively, in the January-May 2016 period as compared to the corresponding period in 2015.

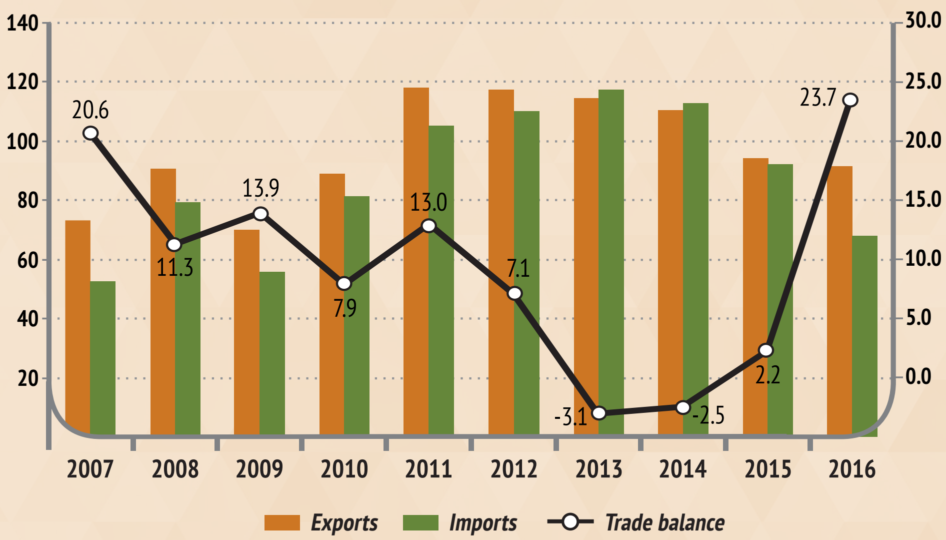
The value of imports is down across all categories of use. The drop in import volumes is due to the exchange rate and to the strong economic downturn, with impacts on investment, production and consumption.

Exports in turn hit the mark of US$ 90.2 billion in the first half of 2016, down by 4.3% from the same period the year before. The decline in the value of exports was driven by prices. In the year to May, the export price index (measured by Funcex) dropped by 16.1% from the same period last year, while the quantum index (export volumes, also measured by Funcex) increased by 17.1% on the same basis comparison.

Data for June show a different trend than that seen in recent months. The value of exports recorded a significant decline of 14.7% in June from the same year in 2015, while in March and April they had posted growth on the same comparison basis. It should be noted, however, that June 2015 saw remarkable export results: daily average exports amounted to US$ 934.7 million in that month, up by 22% from the daily average for 2015.

For the remainder of the year, we expect the recent trend in exports to lose momentum, with the exchange rate hovering around R$ 3.30 per US dollar. However, export volumes will keep growing and prices will keep falling. This is because although the exchange rate for exports is less favorable now than it was at the start of the year, the gap between the growth of Brazilian and world economies will remain large and commodity prices will regain some momentum. Exports are expected to total around US$ 192 billion by the end of 2016, slightly up from 2015's figure.

With respect to imports, the depreciation of the Brazilian currency and, mainly, the economic downturn will continue to have a major impact on foreign purchases. This will cause the value of imports to keep falling significantly throughout the year. Thus, imports are expected to fall by 12.5% in 2016, hitting the mark of US$ 150 billion.



Source: MDIC/SECEX

Trade balance reaches all-time high in the first half of the year

Exports, imports and trade balance up to June

In billion US dollars

Under such a scenario, the trade balance would reach a surplus of US$ 42 billion in 2016, up from US$ 19.7 billion in 2015.

CURRENT ACCOUNT BALANCE TO REACH EQUILIBRIUM BY THE END OF THE YEAR

The current account deficit hit the mark of US$ 29.5 billion in the 12 months to May, down by 69% from the same month in 2015 (US$ 95.2 billion). The result of both the trade balance and services has contributed to this improvement, as both of them have shown a positive trend.

The reduction in the current account deficit results from an increasingly positive trade balance, as the deficit in services has dropped at a slower pace and primary and secondary income has held steady.

The decline in the services deficit is more gradual, but this downtrend has been observed since early 2015. The main elements behind this decline have shown the same trend: deficits in travel, transportation and equipment rentals have been falling at an increasing rate.

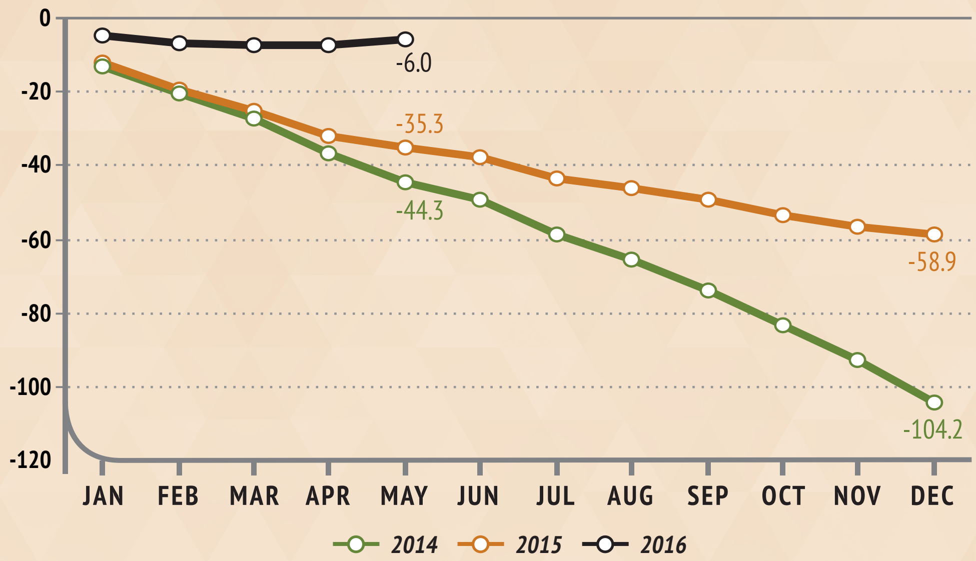
In the second quarter of 2016, these favorable results intensified the downward trend in the current account deficit initiated in 2015. With the surpluses achieved in April and May, the deficit reached US$ 6 billion in the year to June, well below the US$ 33.3 billion deficit recorded in the same period in 2015.

This deficit is expected to approach zero over the third quarter, possibly moving to a surplus at the end of the year. We expect a small surplus (less than US$ 1 billion) by the end of 2016. This would be the first current account surplus since 2007.

Current account deficit down by almost 70%

Current account balance

In billion US dollars



Source: Central Bank of Brazil

Economic Report
ISSN 1983-621X • Year 32 • Number 2 • April/June 2016

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2014	2015	2016 previous forecast (04/08/16)	2016 current projection (07/07/16)
ECONOMIC ACTIVITY				
GDP (annual change)	0.1%	-3.8%	-3.1%	**-3.5%**
Industrial GDP (annual change)	-1.2%	-6.2%	-5.0%	**-5.4%**
Household consumption (annual change)	0.9%	-4.0%	-4.4%	**-4.8%**
Gross fixed capital formation (annual change)	-4.4%	-0.1%	-13.5%	**-13.9%**
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%	7.1%	**7.3%**
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%	5.2%	**6.4%**
PUBLIC ACCOUNTS				
Nominal result (% of GDP)	-6.23%	-10.40%	-9.80%	**-10.30%**
Public sector primary result (% of GDP)	-0.59%	-1.88%	-1.73%	**-2.62%**
Net public debt (% of GDP)	57.2%	66.5%	72.9%	**73.4%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.64	3.87	4.00	**3.30**
(average in the year)	2.35	3.33	3.80	**3.48**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	225.1	191.1	192.0	**192.0**
Imports (US$ billion)	229.0	171.5	150.0	**150.0**
Trade balance (US$ billion)	-3.9	19.7	42.0	**42.0**
Current account balance (US$ billion)	-104.2	-58.9	-20.0	**1.0**

ECONOMIC REPORT| English version of "Informe Conjuntural Abril/Junho de 2016" | Quarterly publication of the National Confederation of Industry - CNI | www.cni.org.br | Policy and Strategy Unit - DIRPE | Management and Economic Policy Unit - PEC | Executive manager: Flávio Castelo Branco | Team: Flavia Junqueira Ferraz, Isabel Mendes de Faria, Marcelo Souza Azevedo and Mário Sérgio Telles Carraro | CNI Publishing Center | Graphic design supervision: Alisson Costa | Customer Service - Phone: (61) 3317-9992 - email: sac@cni.org.br This publication may be copied, provided that the source is cited. Document prepared on July 6, 2016