BRAZILIAN ECONOMY

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# Corrections in the path of the economy are required

Economic performance in 2013 was better than in the previous year. GDP will grow by 2.4%, more than the 1.0% rate recorded in 2012. GDP growth composition was also more favorable, as investment and industry expanded. In 2012, both of them had shrunk.

The economy's performance in 2014 will be similar to the one recorded this year, with GDP growing by 2.1% and investment increasing by 5.0%. Industry as a whole will grow by 2.0%, while manufacturing industry will expand by 2.5%.

A more depreciated exchange rate and measures to reduce costs (reduction in electricity rates and payroll tax exemptions) explain the sector's partial recovery. However, 2013 still didn't see any actual change in the economy's growth trajectory.

Difficulties to resume more vigorous growth rates remain. Business confidence has not yet returned to the levels registered in the past. Economic distortions that increase the costs of investment projects and discourage business decisions persist. Rising interest rates is an additional complicating factor in this scenario.

There is a mismatch between supply and demand in the economy. Even with slow GDP growth rates, inflationary pressures and rising public and current account deficits have been observed. Although they are not in a critical range, these high twin deficits have not materialized in higher investment and potential output, which is a precondition for sustaining robust and stable growth rates in the medium term.

There are clear signs that the potential output growth rate fell by an additional percentage point since 2008, dropping to less than 3% a year (see the special section of this Report). It is therefore necessary to promote an increase in both public and private domestic savings capacity to enhance the potential for expansion.

Corrections must be made in this path, and making choices for this purpose is crucial. The improvement observed in economic growth, which is only gradual, requires adjustments for strengthening the inducing role of investment. Using consumption as a growth lever has macroeconomic limitations, besides fiscal restrictions. Since the fiscal space has narrowed significantly in 2013, tax exemptions are likely to be focused on reducing production costs, to the detriment of those intended to boost consumption.

Certain risks must be anticipated, such as changes in US monetary policy, which will reduce the availability of funds to finance the external deficit. The effects of this change may result in a sharp depreciation of the domestic currency and inflation pressure. If these effects are not correctly offset by an appropriate fiscal policy, they will result in a combination of higher inflation and slower growth, possibly consolidating a low potential GDP growth rate.



CNI

overview 2013

# Difficulties to resume more vigorous growth rates in 2013 remain

The advances achieved in 2013 were insufficient to ensure more significant growth rates in the year. On one hand, recurrent demands were partially met, such as those for more investment and cost reductions (reduction in energy rates and payroll tax exemptions); on the other, monetary tightening measures, current account issues, and lower business confidence rates have prevented more significant progress in the economy.

## Expansion in investment and industry

Investment on the rise and the fact that growth in the industrial sector was resumed are positive developments observed in 2013. However, investment has increased primarily as a result of unusual events that will not occur again with the same intensity in 2014.

The hike observed in investment rates (Gross Fixed Capital Formation) – investments are expected to increase by 7.1% in 2013 – was basically driven by the transportation equipment category (up by 21.6% in relation to the average registered between January and October 2013 against the average seen over the same period last year), as a result of amendments in the law requiring diesel engines to lower sulfur emissions. Other groups that also contributed to higher production rates – albeit less intensely – were those of capital goods for serial industrial purposes (14.2%) and of agricultural capital goods (16.9%).

The emphasis on household consumption as a driver of economic growth has lost momentum. In fact, the consumption-driven growth model is already showing signs of exhaustion for the third year in a row: in 2010, household consumption grew by 6.9%; in 2013, CNI is forecasting a growth of only 2.1%. This slowdown was mainly caused by rising interest rates and a downturn in lending rates.

With regard to industry, the scenario is relatively more positive. The industrial sector, which shrank by 0.8% in 2012, is expected to grow in 2013. CNI's projections suggest that industry will grow by 1.4% and manufacturing by 2.3%, which are still modest rates. This low-growth scenario is due to old distortions – high investment costs, legal uncertainty, and infrastructure bottlenecks – and to aspects such as monetary tightening and inflationary pressure.

Inflation remained at high levels – above the target center – in 2013, as in 2011 and 2012, and is expected to close the year at 5.7%. Once again, food and service prices were the main source of inflation pressure. This pressure would have been higher if government-approved increases in public transportation fares had not been canceled (in some cases, they were even reduced) or if electricity rates had not been lowered. These factors reduced the impact of regulated prices on the IPCA (Expanded Consumer Price Index).

From the point of view of monetary policy, 2013 was marked by the resumption of the cycle of increases in the Selic rate, which closed the year at 10.00% p.a., up by 2.75 percentage points.

Despite the increase in Selic rate, the average rate in 2013 will be lower than in 2012. Inflation, in turn, behaved the other way around: the average rate in 2013 was higher than in 2012. As a result, the average real interest rate will fall from 3.1% in 2012 to 2.0% in 2013.

## Current account deficit increases in 2013

In 2013, exports were lower than in the previous year, totaling US$239.4 billion, 1.3% less than in 2012. Imports, on the other hand, increased by 7.0% in relation to 2012, totaling US$238.7 billion in

# overview 2013

the year. As a result, the trade balance surplus dropped from US$19.4 billion in 2012 to only US$740 million in 2013.

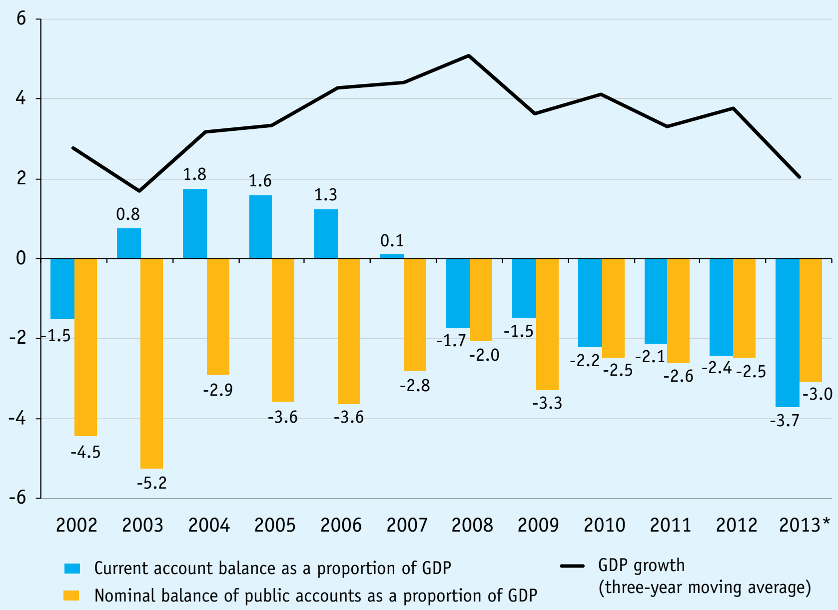
This result strongly affected the current account deficit, which is expected to rise to US$81.3 billion in 2013, the highest one in 12 years. At the same time, foreign direct investment (FDI) dropped by 11.2% in the year to October, increasing the need for external financing to more than 1% of GDP in October of this year.

The relative exchange rate stability recorded in 2012 was not repeated in 2013, especially in the second half of the year. Besides its volatility, there was a change in the exchange rate level, and it is more depreciated now. This latest devaluation was caused by deterioration in the current account deficit and the projected decrease in purchases of securities by the Federal Reserve.

**Current account balance and nominal public account balance**

In %

Deficits hinder economic growth




Source: IBGE and Central Bank * CNI estimate

As a result, the average annual real-dollar exchange rate will close the year at a more depreciated level than last year, i.e. at BRL2.16/US$ 1, as estimated by CNI, against BRL1.95/US$1 in 2012.

## Fiscal policy continues on a strong expansionary path

In 2013, the expansionary nature of fiscal policy was maintained with the aim of speeding up economic growth.

This approach was made possible by a marked increase in federal spending – 7.3% between January and October 2013 – and tax exemptions granted by the Federal Government.

The net revenues of the Federal Government, in turn, continued to increase at rates similar to those observed in the previous year – at 2.0% between January and October 2013, against 2.2% in 2012.

The gap between revenues and spending led fiscal indicators to deteriorate sharply in 2013. Thus, despite the expected increase in tax revenues until the end of the year, the primary balance of the consolidated public sector was negatively affected and is projected to amount to only BRL91.0 billion (1.9% of GDP), far from the BRL120.9 billion target set for the year.

As a result of the drop in the primary surplus and interest spending, which is expected to remain stable this year, a significant increase is projected for the nominal deficit: 3.0% of GDP, against 2.5% in 2012. Despite this higher nominal deficit, the expected increase in nominal GDP combined with exchange rate adjustments for the domestic and external debt is likely to bring the net debt/GDP ratio down from 35.2% in 2012 to 33.9% in 2013.

## outlook for 2014

# Slowdown in investment has been restricting growth

The performance of the Brazilian economy in 2014 will be similar to that observed in 2013. Despite the more favorable scenario observed this year in relation to 2012, there were only minor improvements and expectations for the coming year are only modest. GDP is expected to grow by 2.1% in 2014, slightly less than in 2013. However, this growth will be more homogeneous across sectors, with agriculture accounting for most of it (4.0%). Industry will not yet resume its leading position in this growth process in 2014.

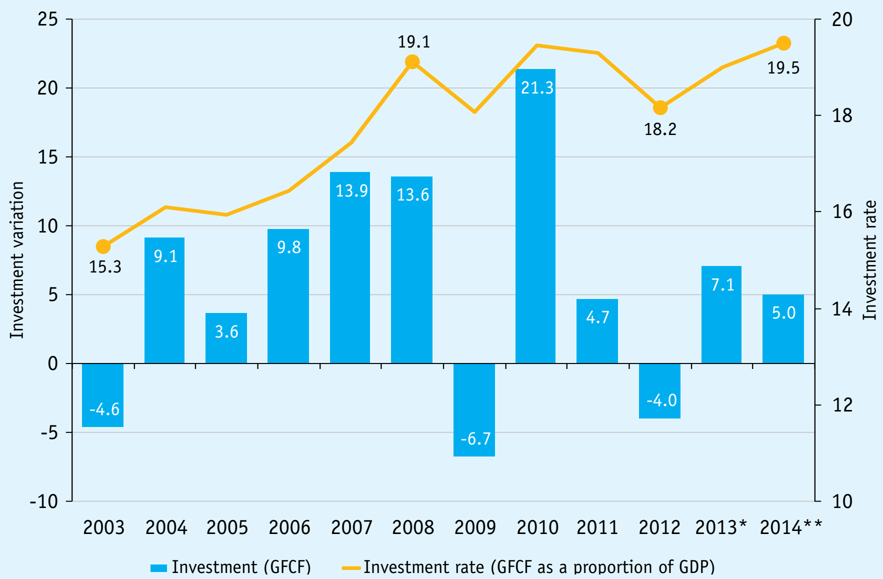
Industry's contribution to economic growth will still be modest, namely, of only 2.0%, with manufacturing expanding by 2.5%.

Factors preventing higher growth rates have been observed both abroad and domestically. Externally, deterioration risks have been associated with changes in US monetary policy. On the domestic side, the risks lie in the electoral calendar, which provides little space for bolder corrections in the path of economic policy, and in a projected slowdown in investment.

**GFCF and investment rate evolution**

In (%)

GFCF growth has not been sufficient to raise the investment rate to the desired level




Source: IBGE
*Estimated by CNI - ** Projected by CNI

## Modest investment growth

Brazil's lower GDP growth can be partly explained by a slowdown in investment, which is expected to grow by only 5.0% in 2014, less than in 2013. This lower growth rate has been mainly attributed, on one hand, to the policy of raising interest rates and to low business confidence levels. On the other hand, in 2014 we will not rely on the significant contribution of investments in transportation equipment that marked 2013. Advances observed in Brazil's infrastructure concession program, which constitute a positive aspect in the medium term, are expected to produce moderate impacts next year.

Household consumption, the engine of economic growth in recent years, is expected to continue to slow down. For 2014, we are projecting an increase of only 1.7%, lower than the one recorded in 2013. This lower growth is due to the effects of a tighter monetary policy with high interest rates and a slowdown in credit, but also to a lower raise in the minimum wage (as a result of the low GDP growth observed in 2012).

Imports are likely to increase less and exports of goods and services are expected to increase slightly. Thus, the contribution of net exports in 2014 will be less negative (-0.4 p.p.) than this year (-0.9 p.p.).

# outlook for 2014

## Less expansionary economic policy

High inflation hampers more robust growth. In 2014, inflation is expected to get closer to 6.0% than to the target center (4.5%) for the fourth year in a row. Different factors justify this expectation: the end of reducing effects on the prices of public services, a more devaluated exchange rate, and inertia in the prices of non-tradable goods, especially services. The impact of the cycle of increases in the Selic rate, which will moderate price increases in deregulated market segments, has been offsetting these effects.

In this scenario, the Extended Consumer Price Index (IPCA) will close 2014 at 6.0%, against 5.7% in 2013. Thus, the inflection in monetary policy seen in 2013 will not be reversed in 2014. CNI expects a new increase in the Selic rate in early 2014. With the Selic rate at a level in excess of 10% virtually throughout the year, the average real interest rate will rise to 4.4% p.a.

The prospects are that the fiscal policy will be less expansionary in 2014. Deteriorating fiscal fundamentals are expected to lead to a review of some tax exemptions. On the spending side, a lower increase in the minimum wage and the level of discretionary expenditures, which is already high, are likely to bring about moderate growth.

CNI estimates that the primary surplus of the consolidated public sector will hit the mark of BRL71.0 billion (1.4% of GDP) in 2014, below the target of BRL109.4 billion. As a result, the nominal deficit will rise to 3.7% of GDP due to both the drop in the primary surplus and to the increase in interest spending by 0.2 percentage point of GDP.

Despite the higher nominal deficit, the effect of the exchange rate devaluation on the domestic and foreign debt will lend stability to the net debt/GDP ratio, which is projected to close 2014 at 33.9% of GDP.

## External deficit will remain high

The exchange rate will devaluate further in 2014, favoring exports and restricting imports. This will occur even if the rating of Brazilian public bonds remains the same or there is no abrupt withdrawal of US monetary stimulus. CNI projects an exchange rate of about BRL2.45/US$1 at the end of 2014, with an annual average of BRL2.35/US$1.

Exports (in value) are expected to increase by 4% in 2014, totaling US$249 billion. Imports (in value), in turn, are expected to remain virtually stable, totaling US$240 billion. Thus, the trade balance will be positive in 2014, amounting to about US$9 billion.

The current account deficit will be lower in value, decreasing by 13.3% to US$72.2 billion in 2014, or 3.3% of GDP, but it will still be high, considering the possibility of reduced liquidity.

## Risks in the international arena

The outlook for the international scenario involves two distinct aspects. A gradual recovery from the crisis seems to consolidate itself, with positive effects on trade and growth potential for Brazilian exports.

On the financial side, the environment of abundant liquidity has come to an end. US monetary policy is expected to be normalized during 2014, with a gradual reduction in quantitative measures and higher market interest rates.

This will not be an abrupt change, but it will reduce the flow of funds to emerging economies. This new situation will entail smaller facility to finance current account deficits in emerging countries such as Brazil, with pressures on the exchange rate.

The greatest risks are associated with more abrupt actions of the Federal Reserve, if combined with a continued deterioration in fiscal fundamentals and in Brazil's balance of payments.

In this scenario, the likelihood of a downgrade of the Brazilian ranking by rating agencies would increase. The effects would be harmful for the stability of the exchange rate and inflation, requiring firmer domestic economic policy responses to reduce their impact on economic growth.

SPECIAL TOPIC

# Potential GDP: how can Brazil grow more?

There is a heated discussion around whether Brazil has the potential to grow or whether the current performance of the economy reflects growth with maximum use of its production factors.

In fact, the Brazilian economy has been slowing down in recent years. In the five pre-crisis years, from 2004 to 2008, Brazil's GDP grew at an average rate of 4.8%. As a comparison, this rate is higher than the world average growth (4.6%) and than that of advanced countries (2.4%). Emerging countries grew by 7.6% over that period on average.

In the five years following the onset of the crisis, from 2009 to 2013, average economic growth in Brazil dropped to 2.6% (CNI estimate). Albeit higher than the growth rate recorded in advanced economies (0.9% on average), this rate is less than half that registered in emerging countries (5.3%). It is noteworthy that global growth amounted to 2.9% over the same period (IMF estimate).

This slowdown provides clear evidence that apart from growing less than it could (or should), Brazil may be about to face a downward trend in its productive potential.

In search of empirical evidence for this discussion, the economic literature tends to estimate what would be potential GDP of the country. Potential GDP is the one in which growth does not cause distortions in the economy, such as inflation or unemployment above a level seen as "natural" or imbalances in the balance of payments.

With this information, one can check whether the current performance is above or below the one that would be expected in the absence of shocks in the economy and what was the actual trajectory of this potentially expected performance.

## What is behind potential GDP

The potential GDP of a country is basically explained by three main elements: capital stock, stock of labor, and Total Factor Productivity (TFP).

Capital stock is the total amount of machinery and facilities available for production. However, knowing this stock is not sufficient to determine the potential of capital, since the available machinery is not always fully utilized.

What is actually observed is that installed capacity is only fully used (mainly by industry) during emergency periods. Companies usually keep some idle capacity on standby to be able to respond to fluctuations in demand and due to the time of maturity of investment. Growth of the capital factor depends on the expansion of investment.

The labor factor indicates the potentially available labor for production. The growth of this factor depends on the population growth rate and on the percentage of the population available to work (the so-called Economically Active Population – EAP – or labor force).

As with capital, the stock of available workers still does not indicate the potential of the labor factor. This potential depends on the proportion of actually employed workers, i.e. on the occupation rate.

Total factor productivity (TFP) indicates the quantity produced with one unit of capital and one unit of labor. When productivity rises, it means that capital, labor or both are more productive, i.e. it means that more can be produced with the same amount of capital and labor.

From the point of view of capital, greater productivity depends on the production and absorption of new technologies. From the standpoint of labor, it depends on developing workers' skills through basic, technical and higher education and on better management.

# SPECIAL TOPIC

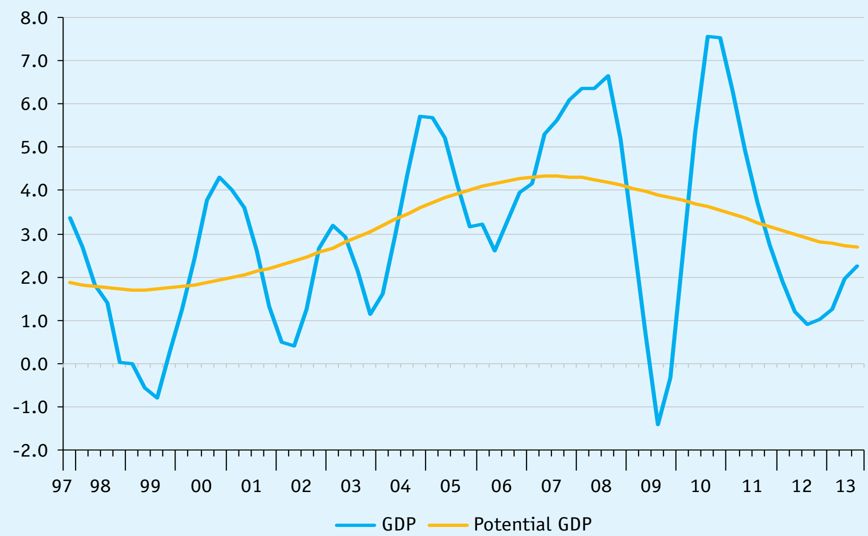
## An estimate of Brazil's potential GDP

Several methods allow for potential GDP to be estimated, such as statistical filters (the most common of which is the HP - Hodrick-Prescott filter) or estimates based on the production function. It is also possible to combine the two methodologies. In this study, the Hodrick-Prescott filter was applied, which is an alternative accepted in the international literature that provides results in tune with reality. For this purpose, quarterly data on the Brazilian GDP between the first quarter of 1996 and the third quarter of 2013 was used (latest data available).

**PIB e PIB potencial**

Últimos 4 trimestres contra os 4 trimestres anteriores (%)

PIB potencial desacelera desde 2008




Source: IBGE
Prepared and estimated by CNI

After this estimate, the variation rate of real and potential GDP was calculated based on the methodology used for calculating GDP variation (average in the last four quarters against the average in the four previous ones). Based on this estimate, one can see that the Brazilian economy experienced three distinct cycles during this period.

First, until the fourth quarter of 1999, the rate of potential GDP growth was below 2.0% p.a. and slowing down. In this cycle, the average growth rate of potential GDP dropped from 1.9% p.a. to 1.7% p.a. and real GDP was below its potential during most of the period.

The second cycle is the one characterized as the most prosperous, with a more intense potential GDP growth rate. Between the first quarter of 2000 and the first quarter of 2008, the growth rate of potential GDP more than doubled, from 1.8% p.a. to 4.3% p.a. During this cycle, real GDP was above potential GDP in most quarters.

In the third cycle, from the second quarter of 2008 onwards, a slowdown was observed. The strong growth rate of 4.3% p.a. observed in early 2008 was not sustained, and it fell to 2.7% p.a. in the third quarter of 2013.

In particular, three distinct periods were observed in this last cycle: between the first quarter of 2009 and the first quarter of 2010, during the worst period of the crisis, GDP remained substantially below its potential.

Between the second quarter of 2010 and the third quarter of 2011, the opposite was observed: GDP remained well above potential, suggesting a brief recovery in relation to the most negative period of the crisis. However, as of the fourth quarter of 2011, GDP once again dropped below potential and hasn't recovered since then.

## Determinants of potential GDP over recent years

Given the discrepancy between average growth rates in the two last periods discussed above – from the first quarter of 2000 to the first quarter of 2008 and from the second quarter of 2008 to the

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third quarter of 2013 – it is worthwhile making an effort to identify likely determinants of potential GDP in each of these intervals.

The average potential growth estimated between the first quarter of 2000 and the first quarter of 2008 is more intense than that estimated for the following cycle due to an increased absorption of productive capital and labor resources.

It was seen that the labor force grew and that there was a sharp reduction in the unemployment rate during that period. At the same time, a sharp increase in the investment rate was observed.

From 2004 to 2008, the EAP (IBGE) grew by 1.7% per year on average, more than during the 2008-2012 period (1.5% p.a.).

In addition to a greater labor supply, a sharper reduction in the unemployment rate was observed during that period (IBGE): -4.4 percentage points between 2003 and 2008 and -2.4 percentage points in the 2008-2012 period.

As for the investment rate (Gross Fixed Capital Formation as a proportion of GDP - IBGE), an increase of 2.3 percentage points between 2000 and 2008 (from 16.8% to 19.1%) was observed, contrasting with a drop of 1.0 p.p. in the most recent period - 2008-2012 (from 19.1% to 18.1%).

Capacity utilization in industry (CU - Industrial Indicators/CNI) rose in turn by 3.7 percentage points between 2000 and 2008 and dropped by 1.2 percentage points in the 2008-2012 period (comparison between annual averages).

Besides the labor and capital factors, productivity also partly explains the better performance observed between 2000 and 2008.

Estimates of Total Factor Productivity (TFP) presented by Souza Júnior (2013) show that TFP contributed 1.2 p.p. to potential GDP growth in the 2004 -2008 period. At a much slower rate, TFP contributed only 0.4 percentage points to potential GDP growth between 2009 and 2012.

Given these findings, it can be seen that the increase in the investment rate played a key role in allowing potential GDP to grow more intensely between 2000 and 2008 than between 2008 and 2013.

## How can potential GDP growth be leveraged?

There is some consensus that regardless of the estimate and of the methodologies used to calculate Brazil's potential GDP, its growth rate has slowed down in recent years. This performance is indicative of bottlenecks in the Brazilian economy, which manifest themselves in low productivity growth and in the loss of competitiveness of domestic products.

Leveraging potential GDP is not a trivial task. More investment is required to boost production capacity, for which purpose a higher domestic savings rate (both public and private) is necessary. Furthermore, investing in education and management is essential for us to have more efficient and productive workers.

Structural changes to lend greater productivity to capital and labor factors are also required. In this context, regulatory, tax, and infrastructure issues stand out. In such a scenario, there is only one alternative for the coming years: deepening reforms, increasing the investment rate, and improving education. This is the path for a more robust and sustainable growth to be resumed.

**Reference**

*Souza Júnior, J.R.C. Produto potencial: Onde estamos? Para onde vamos? In: Propostas para o Governo 2015/2018. Organized by: Fabio Giambiagi and Claudio Porto. Elsevier, 2013.*

economic activity

# Industry resumes growth in 2013

The Brazilian economy is expected to grow by 2.4% in 2013. This rate is higher than the one recorded in 2012, but lower than the rate observed in many emerging countries this year and in Brazil itself in the last decade – 3.6% a year on average.

Despite this poor performance, investment, which is essential for ensuring sustained growth, has been showing signs of improvement and is projected to increase by 7.1% in 2013. However, a significant portion of this growth resulted from exceptional events that are not likely to occur again with the same intensity next year – increased sales of trucks driven by an amendment to the law on greenhouse gas emission standards, for example.

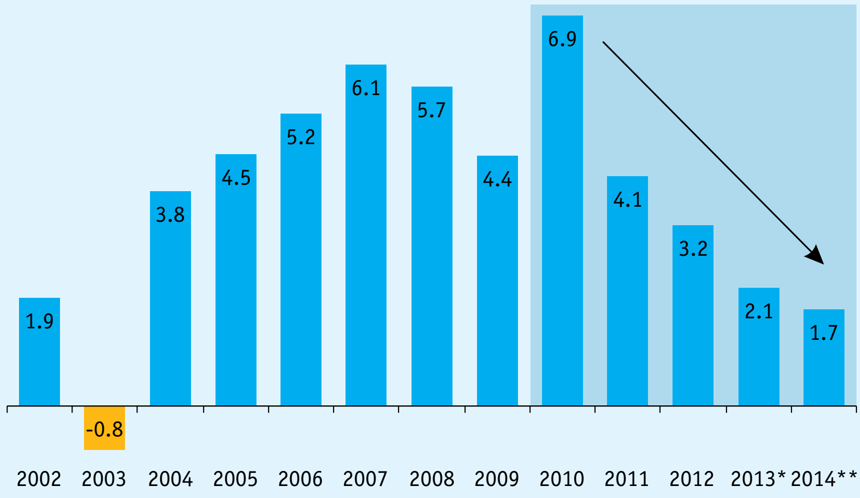
Still regarding investment, it should be mentioned that despite the significant growth observed in the year, the investment rate (Gross Fixed Capital Formation as a proportion of GDP) will close 2013 at about 19%, well below the average recorded in developing and emerging countries, estimated at 32.8% by the IMF.

On the supply side, agriculture had a particularly positive performance in 2013, as it grew by 7.5% in a comparison between the first three quarters of this year and the same period in 2012. Agriculture is expected to grow by 9.0% in 2013.

**Household consumption**

Annual variation (%)

Household consumption slows down in recent years




Source: IBGE
*CNI estimate **CNI projection

## Signs of slowdown in household consumption

CNI estimates that household consumption will grow by 2.1% in 2013. This lower growth rate is attributed, among other factors, to increases in the Selic rate and to a lower growth in lending. Thus, although household consumption continues to play a major role as a driver of the economy, it is not as robust as in recent years: 2012 (growth of 3.2%), 2011 (4.1%) and 2010 (6.9%).

## Industry seems to have recovered slightly, but it continues to face difficulties

After experiencing oscillations throughout the year, industry continues to face difficulties to resume continuous and vigorous growth. It should anyhow be mentioned that after posting negative growth last year, industrial activity resumed a growth path in 2013 – albeit less intensely.

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Comparing the average from January to October 2013 to the one recorded in the same period last year, it can be seen that industrial production in general grew by 1.5% and that manufacturing increased by 1.9% (PIM-PF/IBGE). This growth was still not sufficient to raise capacity utilization (CU) to the level observed in 2010, when industry grew significantly, and to reduce idleness in industry.

The modest growth observed in physical production is also reflected in hours worked in industry. Comparing the first 10 months of this year with the same period last year, one can see that this indicator increased by only 0.1% (Industrial Indicators/CNI).

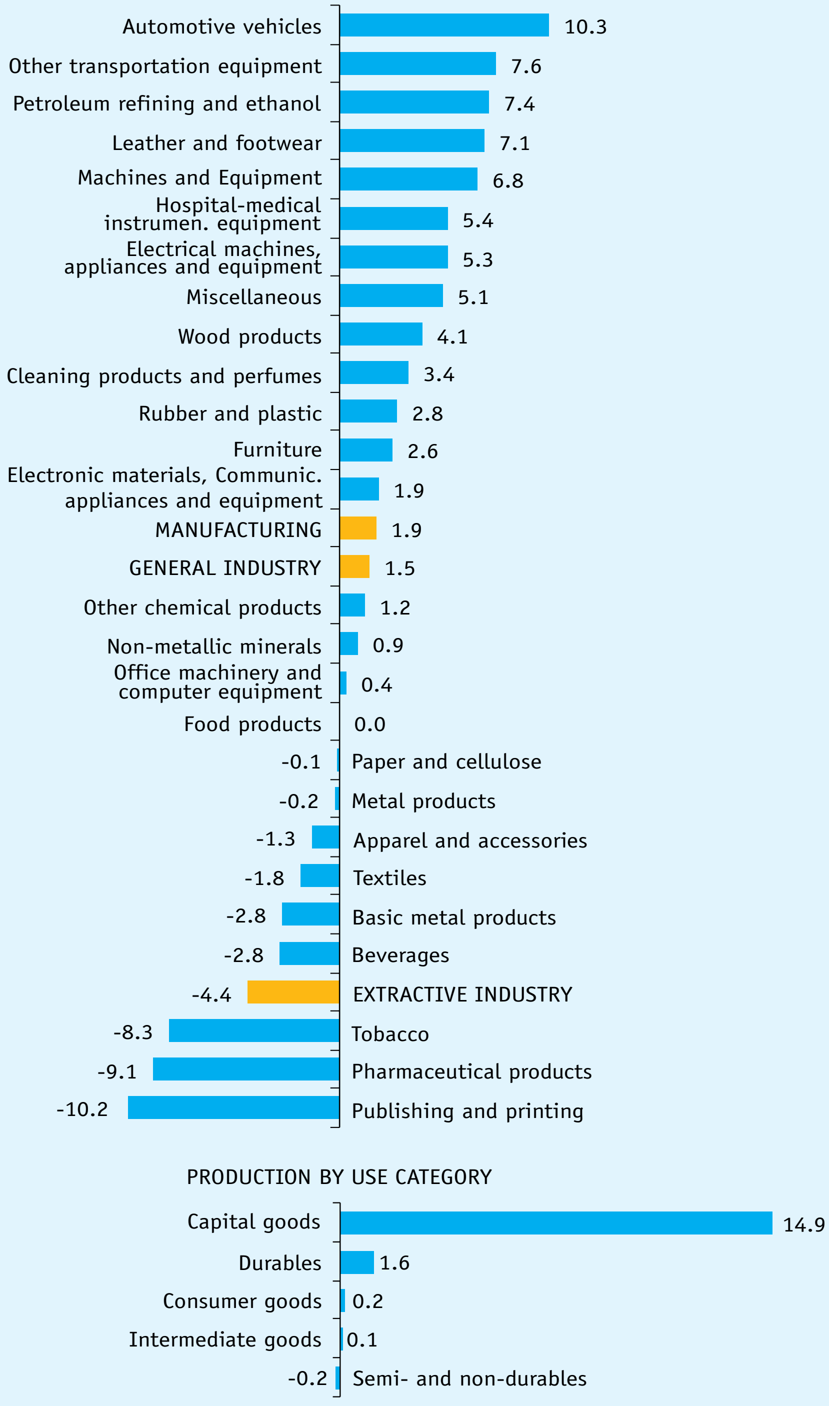
A sectoral evaluation indicates a rather heterogeneous behavior between different segments of manufacturing industry, reinforcing the interpretation of a slow recovery in industrial activity. Of the 26 sectors evaluated by IBGE, 9 had a negative growth in production and 17 experienced a positive growth – all in a comparison between the average recorded between January and October 2013 and the one observed during the same period in 2012.

If the same analysis is carried out by category of use, we see that capital good production increased by 14.9% (with transportation equipment accounting for most of this growth), consumer good production grew by 0.2% – with durables accounting for 1.6% and semi and non-durables for -0.2% – and intermediate good production increased by only 0.1%.

**Industrial production by sector and category of use**

Average from January to October 2013 as compared to the same period the year before (%)

## Despite their heterogeneous behavior, most sectors posted growth




Source: IBGE

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Industry had excess stocks for five consecutive months – between April and August 2013 – but the latest data (for September and October) shows that actual stocks were adjusted to planned levels (Industrial Survey/CNI). The balance of planned stocks is crucial for industry to expand capacity utilization and resume investment.

The overall picture of industry in 2013 is very similar to that observed in the last two years. This is so because the factors that limited its growth are still the same: high costs and, therefore, difficulties to compete with imported products. Between 1996 and 2012, the share of imports in consumption of intermediate and final industrial products rose from 12.5% to 22.0%, according to the import penetration coefficient. This trend continued in 2013 and in the third quarter that coefficient increased to 22.8% (CNI/FUNCEX Coefficient of Trade Liberalization survey).

With respect to the costs borne by industry, special mention should be made of an upward trend in labor costs, the weight of which in the direct production cost of manufacturing industry on average is of approximately 18% (estimated by CNI based on the PIA/IBGE). Between 2006 and 2012, average real wages in industry rose by 27.5%, while the productivity of industrial workers increased by 7.0% (CNI estimates based on IBGE data), a behavior that has compromised the competitiveness of domestic industry.

In this scenario, CNI estimates that industry will expand by 1.4% in 2013 and that the manufacturing industry will grow by 2.3%.

To reverse this situation, continuous efforts should be targeted to implementing an agenda designed to promote a better business environment and to reduce the so-called Brazil cost, including actions to improve the quality of formal education, to intensify professional training programs, to reduce the tax burden, to reduce the infrastructure deficit (transportation, energy and telecommunications), to eliminate red tape, and to modernize labor laws, among others.
Services are expected to grow by 2.3% in 2013, close to the GDP growth rate. This growth is partly explained by a continued increase in the share of consumption targeted to this sector.

According to IBGE's National Accounts methodology, which also includes trade in services, the contribution of the external sector to GDP will be negative by 0.9 percentage point.
Exports are likely to grow modestly (by 0.7%), while imports are expected to increase by more than 7.0%.

**GDP estimate for 2013**

Percent variation and contribution of GDP components

| | GDP components | 2013 Growth Rate (%) | 2013 Contribution (p.p.) |
|---|---|---|---|
| Demand side | Household consumption | 2.1 | 1.3 |
| | Government consumption | 1.7 | 0.4 |
| | Gross fixed capital formation | 7.1 | 1.3 |
| | Exports | 0.7 | 0.1 |
| | (-) Imports | 7.3 | -1.0 |
| Supply side | Agriculture/livestock | 9.0 | 0.5 |
| | Industry | 1.4 | 0.4 |
| | Mining and quarrying | -2.9 | -0.1 |
| | Manufacturing | 2.3 | 0.3 |
| | Construction industry | 1.9 | 0.1 |
| | Public industrial services | 2.5 | 0.1 |
| | Services | 2.3 | 1.6 |
| | **GDP at market prices** | **2.4** | |

Prepared by: CNI

# economic activity

**Business Confidence Index (ICEI)**
In points
Industry confidence oscillates at a low level in 2013


Source: CNI
The index ranges from 0 to 100. Figures above 50 indicate increased confidence.

## OUTLOOK

## Slow pace of the economy is likely to persist in 2014

The scenario projected for 2014 is not that different from the one seen in 2013. The Brazilian economy is likely to continue to face difficulties to grow at a faster pace, since most barriers to this acceleration lie in structural issues unlikely to be resolved in the short term.

In addition, some additional complicating factors are expected next year, such as the effects of the cycle of increases in the Selic rate on economic activity. CNI thus projects a 2.1% GDP growth in 2014, lower than the rate estimated for this year.

## Rising Selic rate is likely to reduce household consumption next year

Although the job market continues to expand, household consumption is likely to continue to slow down. CNI projects an increase of 1.7% in household consumption in 2014, lower than that expected in 2013. This limited growth can be partly explained by increases in the Selic rate, by a lower increase in the minimum wage (due to the low growth of GDP in 2012), and by a slowdown in credit (which can be felt already).

Government consumption, in turn, is likely to grow more in 2014 than estimated for 2013, as in election years governments tend to expand the amount of public services provided to the population, as well as to increase their spending on personnel. However, this expansion is not expected to be too high, given Brazil's current fiscal situation. For these reasons, CNI projects that government spending will increase by 2.1% in 2014.

Still on the demand side, investment is likely to grow by 5.0% in 2014, less than in 2013.

This lower pace is associated with end of exceptional events registered in 2013 (strong sales of trucks, as mentioned before), as well as with likely constraints that the cycle of increases in the Selic rate is expected to impose on investors in the coming months.

A higher Selic rate pushes demand down and the opportunity cost of capital up, making investment projects less attractive.

For investment to grow continuously and at significant rates, both government and private domestic savings rates must increase in Brazil. However, this change would require readjustments in the economic growth model, which is currently based on consumption.

As a result of a higher exchange rate in 2014, exports – as measured by IBGE's National Accounts methodology, which also includes trade in services – are expected to rise by 3.2%, above the estimate for 2013 (0.7%).

# economic activity

Imports are in turn likely to increase less than this year: by 5.5%, against 7.3% in 2013. This lower growth is explained by household consumption, which will expand at a lower rate than in 2013, and by the exchange rate depreciation.

The contribution of net exports is therefore expected to be less negative next year: -0.4 p.p., against -0.9 p.p. in 2013.

## Industry is likely to grow more in 2014

The difficulties faced by industry may be slightly mitigated by the likely devaluation of the domestic currency, which will make domestic goods more competitive than those produced by foreign competitors. Therefore, CNI expects industry to grow by 2.0%, more than estimated for 2013 (1.4%).

Despite the moderate improvement expected in industry performance next year, the current business confidence level in the sector suggests that this will not be achieved easily.

The Business Confidence Index (ICEI) is at 54.3 points (December). Despite the optimistic prospects suggested by that index (above the 50-point dividing line), it is well below the average recorded in 2010 (64.8 points), when industry grew by over 10%.

Services are expected to grow less in 2014 than in 2013, as household consumption continues on a downward path. CNI projects an increase of 2.0% in the service sector next year, against the 2.3% growth estimated for 2013.

It is likely that this lower growth rate will also be observed in agriculture next year. After expanding by 9.0% in 2013 (CNI estimate), agricultural activity is projected to increase by 4.0% in 2014.

**GDP estimate for 2014**

Percent variation and contribution of GDP components

| | | 2014 | |
|---|---|---|---|
| | GDP components | Growth rate (%) | Contribution (p.p.) |
| Demand side | Household consumption | 1.7 | 1.1 |
| | Government consumption | 2.1 | 0.4 |
| | GFFC | 5.0 | 1.0 |
| | Exports | 3.2 | 0.4 |
| | (-) imports | 5.5 | 0.8 |
| Ótica da oferta | Agriculture/livestock | 4.0 | 0.2 |
| | Industry | 2.0 | 0.5 |
| | Mining and quarrying | 1.0 | 0.0 |
| | Manufacturing | 2.5 | 0.3 |
| | Construction industry | 2.1 | 0.1 |
| | Public industrial services | 2.1 | 0.1 |
| | Service prices | 2.0 | 1.4 |
| | **GDP at market prices** | **2.1** | |

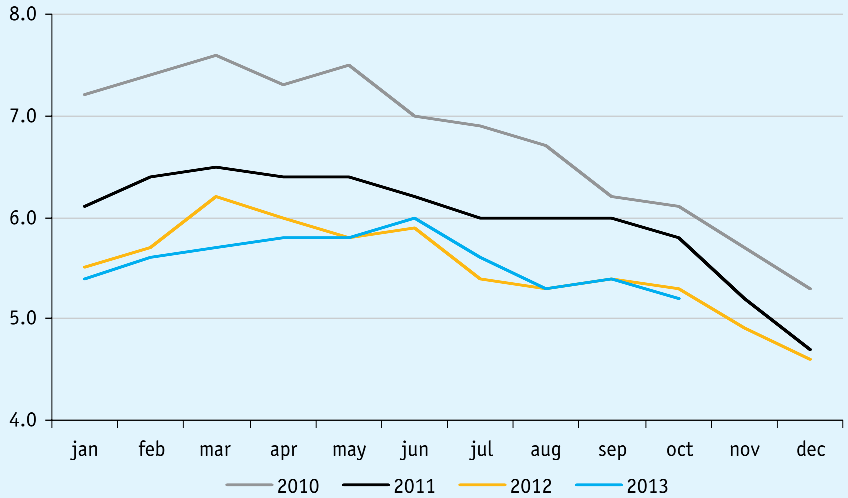
Prepared by: CNI

employment and income

# Productivity in check

The labor market is facing a paradox. On the one hand, the unemployment rate remained below 6% in virtually every month over the past two years. At the same time, Brazil has been growing at low rates and there are no signs of significant changes in this scenario, in which average wages increased more than industrial production, with a strong impact on industry's competitiveness. For this distortion to be eliminated, it is imperative to improve the skills of the workforce in Brazil, as indicated by the latest CNI Polls and Surveys.

**Unemployment rate**
In (%) of the labor force
Declining trend in the coming months is seasonal



Source: IBGE

## Unemployment at its lowest historic rate in 2013

The unemployment rate rose steadily in the first half of 2013. A downturn in the rate was seen in July, when it fell by 0.4 percentage points from the previous month, which continued until it hit the mark of 5.2% of the labor force in October.

Employment growth in the six-month period ending in October evolved at about the same rate as that of the labor force, restricting the scope for further declines in the unemployment rate. However, a slight decoupling of these indicators is expected toward the end of the year, given the seasonal effect of the year-end holidays on the number of temporary staff. Thus, CNI projects an average unemployment rate of 5.4% of the labor force in 2013, the lowest level in the time series.

Despite the evolution of the unemployment rate, spending on unemployment insurance continues on the rise. Between January and November, the federal government spent BRL26.4 billion in unemployment insurance payments, BRL2.6 billion more than in the same period last year.

This increase was partly attributed to the formalization of the labor market itself, and partly to a lower raise in the minimum wage, which has a direct bearing on the insurance amount.

## Continued increase in labor market formalization

Unregistered employment rates declined significantly in 2013. Informal employment was 12.6% lower in October than in the same period in 2012, accounting for 308,000 less jobs in the 12-month period to that date. This is the biggest drop in the time series.

On the other hand, registered employment, which had been losing momentum since the beginning of the year, took an upturn in August and recorded a growth of 3.6% between that month

# employment and income

and October in relation to the same period the year before. This shift led to the creation of 413,000 new formal jobs in the 12-month period ending in October.

As a result of the shift in the growth pace of formal and informal jobs, the labor market formalization index, as calculated by the sum of formal and statutory jobs in relation to total employment, hit the mark of 63.5% in October, 12.8 percentage points above the lowest indicator of the time series, recorded in December 2003.

## Increases in real income have not ensured greater consumption

Usual average real earnings (PME/IBGE) have resumed an upward path since August, reversing the downward trend recorded in the previous five months. This upturn can be partly explained by the increase in formal employment, which offers higher wages than other occupations.

This higher formalization rate and average earnings created a more favorable environment for consumption. However, the influence of a rising Selic rate, the forecast of a lower increase in the minimum wage in January, due to the low GDP growth recorded in 2012, and the slowdown in lending restrict the possibility of a more significant rise in consumption, which is expected to grow at a slower pace in 2014.

## Outlook

## Lower employment growth in 2014

Formal employment will continue to grow in 2014, albeit at a slower pace, pushing the average real income of workers up and keeping it at a high level. Considering that 2014 will be an atypical year because of the World Cup, informal employment is also expected to grow, but only seasonally.

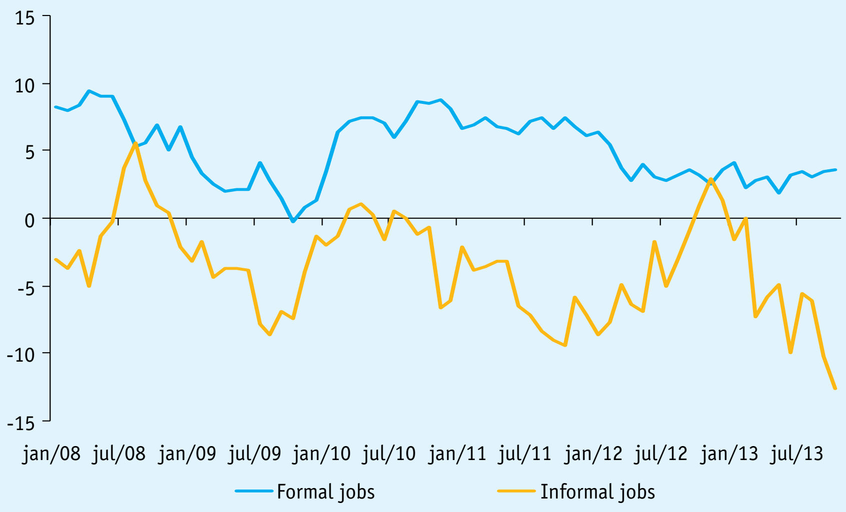
The labor force will continue to grow at par with the employment rate in the first half of 2014. These two rates are expected to follow slightly different paths in the second half of the year, as the number of employed and unemployed individuals looking for a job will increase at a faster pace than the number of jobs created. In this scenario, CNI projects an average unemployment rate of 5.6% of the labor force in 2014.

This slowdown in job growth, in the formalization of the labor market, and in real average income will lead to a reduction in household consumption, which will increase by only 1.7% in 2014.

**Employment by occupation category**

Variation (%) in relation to the same month in the previous year

Informal employment drops by 12.6% in October as compared to the same period in 2012




Source: IBGE

inflation, interest rates and credit

# Inflation remains at the same level as last year

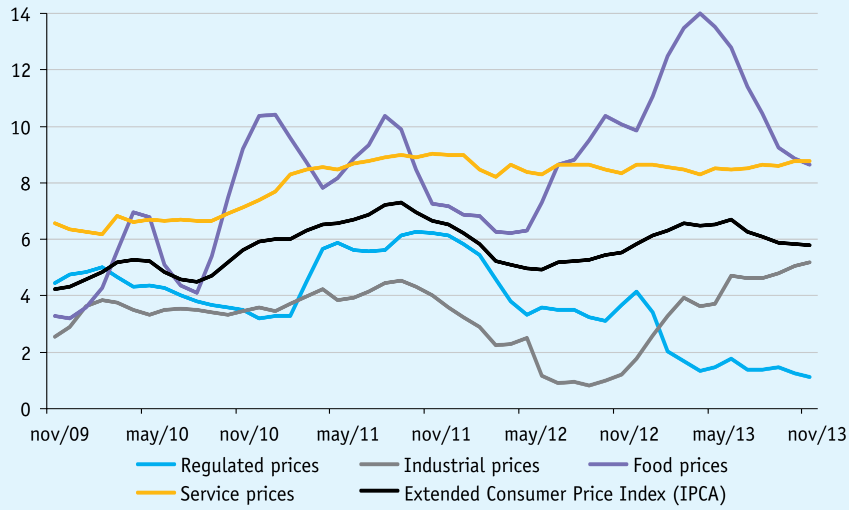
Inflation remained above the target throughout 2013. The IPCA index, which was used as the basis for the 4.5% inflation target, rose by 5.77% in the 12-month period to November, but it hit the mark of 6.70% in June. With only one month to the end of the year, there is no room for any major change in this scenario: the IPCA index is likely to close the year at 5.7%.

This situation required stronger measures via monetary policy, tax cuts, and control of regulated prices. On the monetary policy side, the cycle of increases in the Selic rate was resumed, as a result of which it rose by 2.75 percentage points (p.p.) in the year.

**IPCA index by groups**

Accumulated in 12 months (%)

Food prices drop to the level of service prices




Source: IBGE
Prepared by: CNI

With respect to taxation, selected tax exemptions were granted and others extended. In addition, some planned increases in the prices of public services were canceled. Because of this situation, increases in regulated prices in 12 months were much below their historical average, as opposed to what was observed in relation to other prices: those of industrial products rose at a faster pace during the year, food prices were marked by high volatility, and those of services continued to rise sharply.

Food prices pushed inflation up in 2013. Historically, food prices have been highly volatile due to their strong correlation with the evolution of international commodity prices.

They began the year putting pressure on the IPCA index. In the 12-month period to January, food prices had risen by 11.1%. If this were not enough, they took an upturn and hit the mark of 14.0% in April – the highest increase since July 2008. This situation was influenced by harvest-related problems that also affected international prices.

In May, however, the scenario improved as the harvest problems ceased and tax exemptions were applied to basic food products. As a result, food price hikes slowed down and dropped to 8.6% in November. However, food prices remained well above the IPCA level, contributing to the non-achievement of the center of the inflation target.

Projections for December suggest that food prices will close the year with an accumulated increase of 8.7%. The slowdown would be more pronounced were it not for the effect of the exchange rate depreciation observed in recent months, which put more pressure on these prices.

The usual inertia of service prices was once again observed in 2013. One of the factors contributing to this inertia is that service prices are directly affected by price adjustments based on past inflation and on the minimum wage. Another factor is that, because these prices are not tradable, foreign competition is minimal.

The 12-month accumulated figure for this group has remained at high levels since the beginning of the year, fluctuating between 8.5% and 8.8% (rate registered in November). An 8.5% increase has been estimated for December. Thus, the 12-month accumulated figure for service and food prices will be very similar, pushing the IPCA up.

The prices of industrial products in 2013 showed a reversal in relation to the scenario observed in 2012, which was marked by a slowdown. In January, the 12-month figure was 2.6%, while in November it rose to 5.2%. This hike can be explained by certain factors.

First, part of the IPI (tax on industrialized product) exemption for motor vehicles was restored, reducing the rate to 2%. In June, the effect of falling vehicle prices as a result of the exemption was reversed. The remainder of the tax rate would be gradually restored during the year, but this measure was postponed to 2014 to boost the sector and prevent further pressure on prices.

Second, the exchange rate devaluation observed in recent months led to a hike in the domestic price of imported goods, apart from pushing up the prices of products that use imported inputs. Thus, industrial product prices are estimated to close the year with an increase of 5.1%.

Regulated prices was the grup that exhibited the most atypical behavior in 2013. Their behavior was crucial for achieving the inflation target ceiling set for the year. The 12-month figure for this group rose from 3.4% in January to 1.1% in November. Selected tax exemptions and postponements of price increases ensured this slowdown, which was mainly caused by a reduction in electricity prices. A reduction of approximately 16% in electricity prices pushed the IPCA down by about 0.6 percentage points between January and March.

Another fact that contributed to this situation is that there was no increase in public transportation prices in large capital cities as a result of protests in the middle of the year. Hikes in urban bus, train and subway prices in June were more than reversed in July. In December, the 12-month price increase in this group is likely to remain at 1.1%.

With the backdrop of high inflation in food and service prices, rising inflation in the prices of industrial goods, and inflation in regulated prices below the historical average, CNI estimates that the IPCA index will close the year at 5.7%, close to level observed in 2011 and 2012 but above the central target for the fourth consecutive year.

## Selic rate back at double digits as a result of monetary tightening

A scenario of rising inflation in 2013 led the Monetary Policy Committee (Copom) to resume the cycle of increases in the Selic rate, which started the year at 7.25% p.a., the level recorded in October 2012. However, the Copom decided to resume the cycle of increases in the Selic rate back in April 2013, when the IPCA was approaching the target ceiling.

Its perception then was that it would be difficult to bring inflation down without a more effective policy and that tax exemptions would not be sufficient to offset the hikes in food and service prices.

That is why the Copom decided to raise the Selic rate to 7.50% p.a. in April. Despite the negative effects of monetary tightening on economic activity, the Committee approved further increases of 0.50 percentage points in each of its following meetings.

The pass-through of the exchange rate depreciation to inflation and the fact that prices continued to rise (especially food prices) led the Copom to continue to increase the Selic rate until the end of the year. As a result, it closed the year at 10.00% p.a., i.e. with an increase of 2.75 percentage points in 2013.

# inflation, interest rates and credit

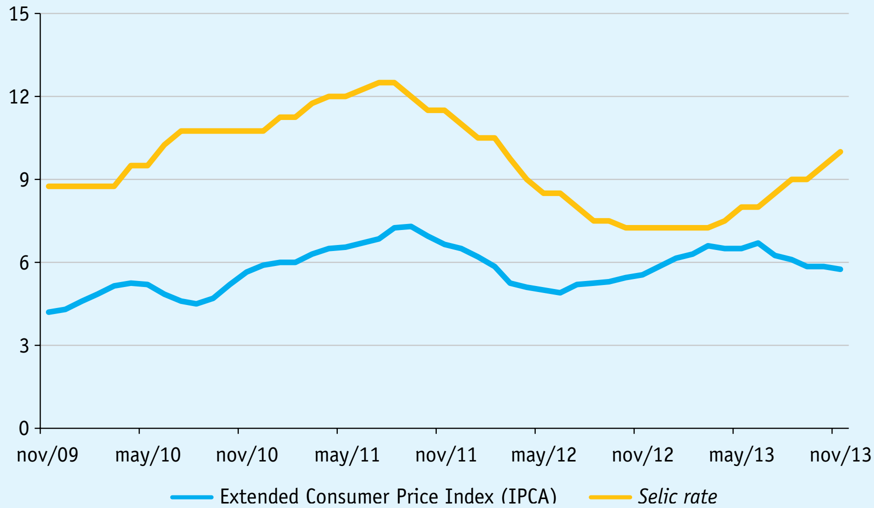
The effects of this rise on inflation, however, are still modest. Given the usual lag between increases in the Selic rate and demand, and consequently on price levels, it is likely that these effects will be more strongly felt from the beginning of 2014.

With the Selic rate at 10.00% and considering the 5.7% inflation projected by CNI for 2013, the average real interest rate will drop again this year from 3.1% in 2012 to 2.0% in 2013.

**Extended Consumer Price Index (IPCA) and the Selic rate**

12-month IPCA variation and annual Selic rate (%)

Selic on the rise again in 2013




Source: IBGE and Central Bank
Prepared by: CNI

## Hike in the Selic rate slows down lending

The credit market is one of the channels through which monetary policy is transmitted to the real economy. The rise in the interest rate on government bonds (Selic rate) increased the costs of credit and financing. This is most evident in loans with funds from the banks themselves, the so-called non-earmarked resources. Central Bank data confirms this trend. In October (latest data available), the average interest rate charged to companies hit the mark of 14.8% p.a. As a comparison, the rate was 13.5% per year in May. For natural persons, the rate was 26.1% in October, up from 24.0% in May.

This movement, coupled with low economic activity, pushed demand for credit down. One can in fact observe a slowdown in the evolution of credit balances during the year, both for individuals and legal entities.

A comparison of the credit balance for individuals in the last and previous 12 months shows a hike of 15.8% in October, down by 1.8 percentage points as compared to hike in January. In the same comparison, the balance of loans to companies rose by 15.4% in October, down by 1.5 p.p. on the same comparison basis. In the last two months of the year, the Selic rate is likely to continue to increase and credit expansion to remain on a downward path.

When analyzing only BNDES financings, one can clearly observe a divergence between the behavior of free and targeted resources. The interest rate on funding for investment is linked to the TJLP (long-term interest rate), which has dropped from 5.5% p.a. to 5.0% p.a. since January, following the decrease in the Selic rate in 2012.

The TJLP, however, has not increased again to keep pace with the recent increases in the Selic rate. Thus, the average interest rate on BNDES investment funding has remained relatively stable at around 6.6% since April. Moreover, the interest rate on working capital financing associated to investment, which follows market rates, fell from 7.9% p.a. in March to 9.9% p.a. in October.

## OUTLOOK

## Inflation will remain a problem in 2014

Inflation was the focus of attention in 2013. No change in this scenario is expected next year: inflation will remain closer to 6.0% than to the target center.

# inflation, interest rates and credit

Some factors justify this situation: the end of the reduction in electricity rates will push up the 12-month increase in regulated prices and a more depreciated exchange rate will have a more noticeable effect next year. The impact of the cycle of increases in the Selic rate has been offsetting this effect.

Food prices are likely to remain volatile at high levels during the year. They are not expected to rise as much in the first months of the year, but the 12-month increase is likely to be higher from the middle of the year as a result of end of the effect of tax exemptions on basic food items. The exchange rate devaluation has impact on this group as well; the balance of these effects will cause food prices to accumulate an increase of 8.9% in 2014.

Service prices tend to slow down during the year, but they will remain at a high level. The minimum wage increase will be lower than in 2013 (about 6.7%, against 9.0% in 2013), resulting in less pressure on service prices. Average inflation in 2013, which will be used to define adjustments to past inflation, will be roughly equal to that recorded in 2012, maintaining this component of inertia. The 12-month rate is thus expected to close 2014 at 7.8%, down from 8.5% in 2013.

Prices of industrial products tend to slow down during 2014. The increase in the Selic rate has a direct bearing on the behavior of industrial product prices by reducing demand and credit. The slowdown in these prices would be sharper were it not for the return of the Tax on Industrialized Products (IPI) on cars (scheduled for January) and the lagged effects of the exchange rate depreciation. But they will still close the year with an increase of 4.2%, slightly lower than the 5.1% hike recorded in 2013.

Regulated prices will show an inverse behavior to that observed in 2013. They are likely to rise more sharply due to the end of the effect of the reduction in electricity rates. A likely above-average increase in the prices of airline tickets due to the World Cup will also contribute to this scenario.

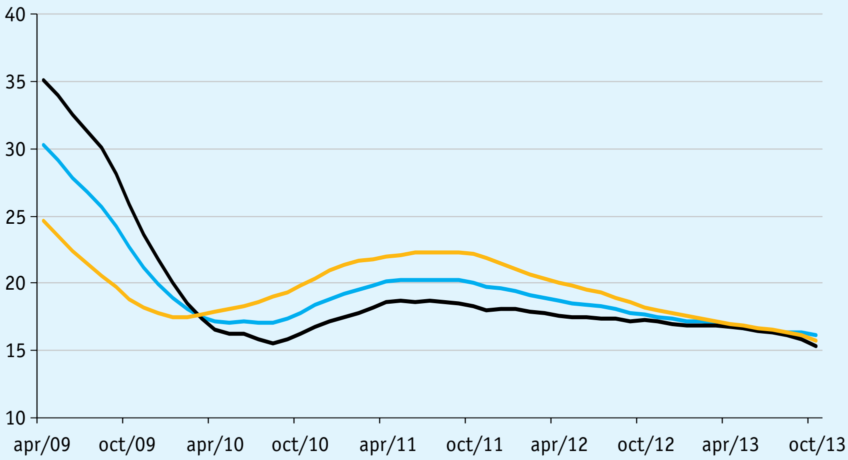
The electoral calendar is the only factor that will prevent sharper price hikes. Due to the proximity of elections and the holding of the World Cup, no increases in public transportation rates are expected, at least until the elections are held. As a result, the 12-month increase in regulated prices is likely to rise from 1.1% in 2013 to 3.4% in 2014. In this scenario, the Extended Consumer Price Index (IPCA) will close 2014 at 6.0%, against 5.7% in 2013. In such an environment, the cycle of increases in the Selic rate is not expected to end in 2013. CNI anticipates a new increase in the Selic rate in early 2014, leading the base interest rate to hit the mark of 10.50% and to remain at that level until the end of 2014.

Since the effects of monetary policy are lagged, the cycle would end at this rate, with the Copom keeping track of the IPCA evolution until the end of the year. As a result, the average real interest rate for the economy would rise to 4.4% p.a.

**Balance of credit operations**

Balance accumulated in 12 months against the previous 12 months (%)

Credit continued to slow down in 2013




Source: Central Bank
Prepared by: CNI

fiscal policy

# Expansionary nature of fiscal policy is intensified in 2013

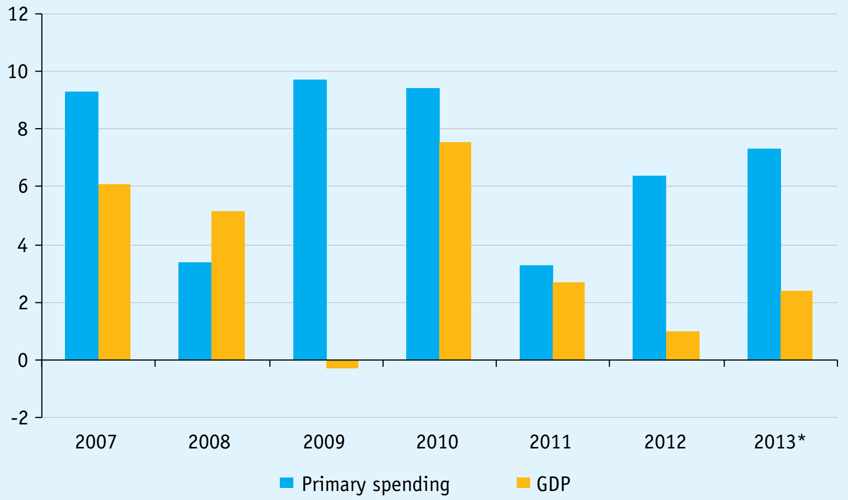
Higher spending and tax cuts for specific items will once again characterize fiscal policy in 2013. In the case of spending, it grew at a faster pace than that observed in 2012. The Federal Government made more intense use of fiscal tools as an attempt to boost economic growth, which was low. For states and municipalities, the increase in spending was determined by higher revenues and an increase in financing operations.

As a result, fiscal indicators continued to deteriorate, leading to a sharp decline in the public sector primary surplus as a particularly negative outcome. The Federal Government will only be able to achieve the target set with investment discount by using a high volume of extraordinary revenues. The result of states and municipalities will in turn be far from the target provided for in the Budget Guidelines Law of 2013.

Fiscal policy is likely to change in 2014 for the Federal Government, whose spending and revenues will be substantially lower than in 2013. The opposite is expected for states and municipalities, whose spending and revenues are likely to increase. Overall, a new drop in the primary surplus is likely.

**Real growth of primary spending of the Federal Government and GDP**
In percentages (%)

Spending increased by 5 percentage points above GDP in the first nine months of 2013




Source: STN/MF - Prepared by: CNI
* Spending: from January to October 2013 against the same period in 2012.
* GDP: from January to September 2013 against the same period in 2012.

## Federal Government spending on the rise

Federal Government primary spending took an upturn throughout the year and in relation to 2012. Compared to the same period the year before, spending rose by of 7.3% in real terms (IPCA deflator) between January and October 2013. This growth rate is higher than the 6.0% rate recorded between January and July 2013 and also than the 5.4% one observed in 2012. Despite a significant increase in several mandatory spending items, countercyclical use of fiscal policy became evident in the sharp increase recorded in discretionary spending, which grew by 10.7% between January and October 2013 against the same period in 2012.

Given the option for a countercyclical policy, the composition of the growth of discretionary spending was not the ideal one, as it favored current expenditures rather investment. Federal Government investments (GND-4) dropped by 0.3% in real terms in the first ten months of 2013 in relation to the same period in 2012.

# fiscal policy

Non-mandatory current expenditures increased in turn by 13.5% in real terms on the same comparison basis.

Among mandatory spending items, those related to social security, which are strongly influenced by increases in the minimum wage, were the ones that contributed most to their growth. Welfare benefits increased by 8.2% in real terms between January and October 2013 as compared to the same period in 2012. Pension benefits, in turn, grew by 6.4% and spending on salary bonuses and unemployment insurance rose by 6.7%.

## Revenues grow at the same pace of GDP

The net revenue of the Federal Government increased by 2.0% in real terms between January and October 2013 in relation to the same period in 2012. This expansion was close to the real GDP growth of 2.4% recorded in the first nine months of 2013 and also in 2012, when GDP grew by 2.2%.

As for the situation observed in 2012, despite a recovery in tax revenues, the performance of social security (NSS) revenues and of revenues not regulated by Brazil's IRS was the worst one. Tax revenues left behind a real decline of 0.2% in 2012 and had a real increase of 1.4% in the first ten months of 2013. This shift can be explained by a slight improvement in economic activity, as reflected on PIS/COFINS collection and by extraordinary revenues of BRL3.0 billion from corporate income tax (IRPJ) and the social contribution on net profit (CSLL).

Social security revenues, in turn, slowed down from a real growth of 6.4% in 2012 to one of 5.1% between January and October 2013. The lower increase in INSS revenues was due to an increase of almost BRL9.8 billion in payroll tax relief.

In relation to revenues not regulated by the Brazilian IRS, the real decline of 2.9% observed between January and October 2013 contrasts with the 2.5% increase recorded in 2012. Much of this decline can be explained by the dividends received by the Federal Government, which declined to 30.7% in the first ten months of 2013 after increasing by 33.2% in real terms in 2012.

## Spending of regional governments on the rise

CNI estimates that the spending of regional governments increased by 4.8% in real terms between January and September 2013 in relation to the same period in 2012. As observed for the Federal Government, the spending of these governments took an upturn after increasing by 2.6% in 2012.

This shift in the spending of states and municipalities can be explained by two factors: a more intense increase in revenues and in authorizations to contract loans. States and municipalities can only spend more if their revenues increase, due to the restrictions imposed by the Fiscal Responsibility Law and by debt refinancing agreements.

The revenues of regional governments, which in 2012 had a real growth of only 0.1%, recorded real growth of 3.8% in the first nine months of 2013 as compared to the same period in 2012. The expansion of Federal Government guarantees for contracting new credit operations explains the fact that spending increased more than revenues. Between April and August 2013 alone, the volume of guarantees increased by BRL40.0 billion.

The significant increase in spending caused the primary surplus to drop in 2013. In the 12-month period to October, the primary surplus of the public sector amounted to BRL67.9 billion (1.4% of GDP). Excluding withdrawals from the Sovereign Wealth Fund and the early payment of dividends in December 2012, the primary surplus would amount to BRL48.5 billion (1.0% of GDP). In 2012 this result was equivalent to 2.4% of GDP.

Given the decline in the primary surplus and the stability of interest spending at 4.9% of GDP, the 12-month nominal deficit increased from 2.5% in December 2012 to 3.45% of GDP in October 2013. This increase was not reflected in the Net Debt/GDP ratio, as it was offset by the effect of exchange rate adjustments applied to the domestic and foreign debt.

fiscal policy

Therefore, the Net Debt/GDP ratio remained stable, dropping from 35.2% in December 2012 to 35.1% in October 2013. As for the Gross Debt/GDP ratio, it rose slightly to 59.0% of GDP in October 2013 from 58.7% in December 2012.

## Better tax results are expected

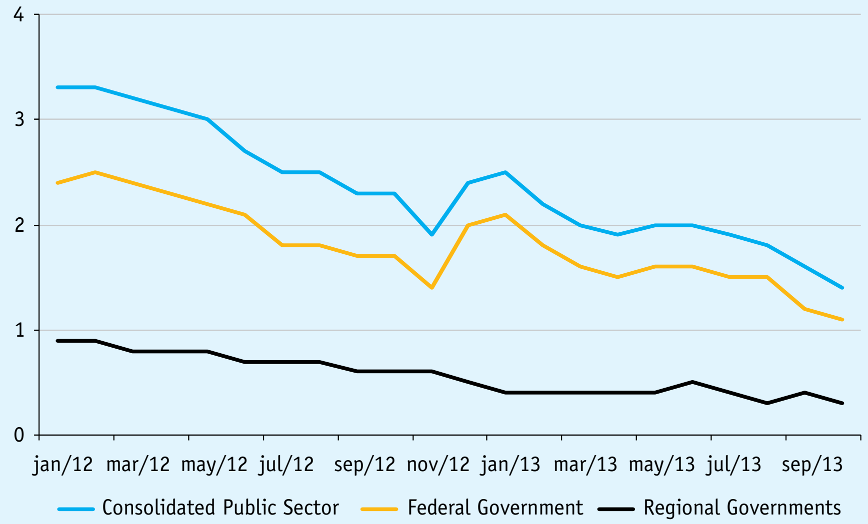
Better fiscal indicators are expected in the two last months of 2013, despite a projected increase in the spending rate by year's end. CNI projects federal spending to increase by 8.6% in real terms.

Therefore, improvements in the indicators will be brought about by a significant increase in federal revenues, which are likely to close 2013 with a real growth of 7.7% over 2012. Tax revenues, which improved throughout the year, are likely to be positively influenced by an extraordinary collection of BRL20.0 billion made possible by tax instalment payment plans. In addition, revenues not regulated by the Brazilian IRS are likely to be boosted by revenues from concessions, particularly by the BRL15.0 billion from the Libra oil field. Since we also considered a withdrawal of BRL3.1 billion from the Sovereign Wealth Fund, CNI estimates that the primary surplus of the Federal Government and its state enterprises will hit the mark of BRL78.0 billion (1.6% of the GDP estimated by CNI) in 2013. The result should therefore be higher than the BRL73.1 billion target.

**Evolution of the primary surplus of the public sector**

12-month (% of GDP)

Primary surplus declined by 1.0 percentage points of GDP between December 2012 and October 2013




Source: Central Bank

The spending of regional governments is expected to continue to exceed the revenue growth rate. As a result, the surplus of states and municipalities is likely to decrease slightly until the end of 2013 and to amount to about BRL13.0 billion (0.3% of GDP), far below the BRL47.8 billion target. Thus, the primary surplus of the consolidated public sector is expected to amount to BRL91.0 billion (1.9% of GDP), against a target of BRL120.9 billion.

In relation to 2012, the drop in the primary result and the fact that interest spending remained stable are likely to lead to a higher nominal deficit. Interest spending is expected to remain at around 4.9% of GDP as in 2012, since the increase in the Selic rate is likely to be offset by the currency devaluation in reverse exchange-rate swaps. Thus, a nominal deficit of 3.0% of GDP is expected, against 2.5% in 2012. Still, a higher nominal GDP and exchange rate adjustments for domestic and external debts are likely to lead the Net Debt/GDP ratio to drop from 35.2% in 2012 to 33.9% in 2013.

### OUTLOOK

## Primary surplus continues to drop

Unlike recent years, fiscal policy is not likely to be characterized by a marked increase in federal spending in 2014. Expenditures that are more affected by minimum wage adjustments are likely to be less pressured by the lower increase in the minimum wage due to GDP's

# fiscal policy

lower real growth of 1.0% in 2012. Thus, CNI estimates that social security spending will have a real increase of only 2.8%, against the expected 4.4% increase in 2013.

Current and capital expenditures will also suffer a lower impact from the minimum wage increase. This factor, coupled with the extremely high base observed in 2013, will keep the real growth in this component at only 1.0%, against the 14.5% increase that will likely be registered in 2013. In this projection, we believe that the Federal Government will only strive to achieve the adjusted primary surplus target, which will require the financial programming of only BRL2.0 billion in the discretionary spending contemplated in the 2014 Annual Budget Bill. The only expenditure item for which growth rate upturn is expected is that of spending with staff, which is likely to rise from 2.4% in 2013 to 3.4% in 2014. Thus, CNI projects a real growth of 2.2% in federal spending in 2014.

With respect to the net revenue of the Federal Government, CNI projects a real decline of 0.4%. Revenues not regulated by the IRS are likely to drop by 15.7% in real terms in 2014 in relation to 2013, as a result of a lower revenue from concessions. In addition, social security revenues are likely to rise by only 2.0% in 2014 due to a lower increase in total earnings and to the more pronounced impact of payroll tax exemptions. Finally, tax revenues are expected to increase by only 1.1% in real terms due to non-repetition of the high extraordinary revenues recorded in 2013. With these projections, CNI estimates that the Federal Government primary surplus will amount to BRL58.1 billion (1.15% of GDP) in 2014, in tune with the adjusted target.

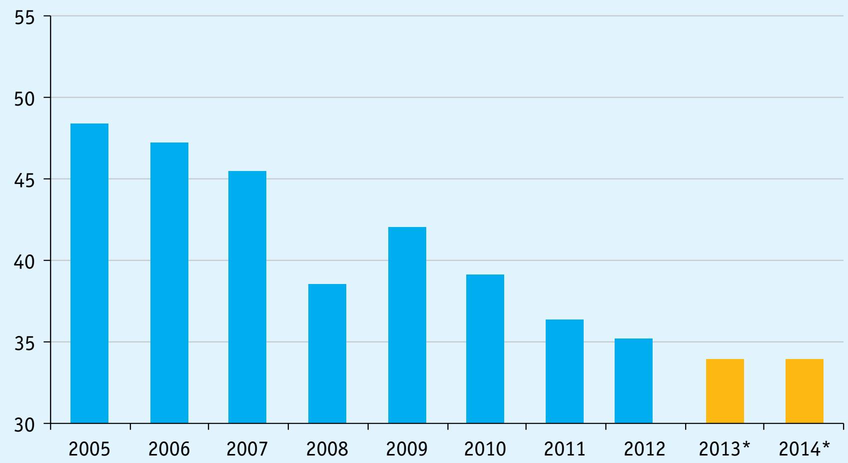
States and municipalities are likely to continue to increase their spending significantly. Apart from the continued effects of possible increases in indebtedness, state and local governments will suffer greater pressure due to their higher spending with staff resulting from the World Cup and from an election year. On the revenue side, we expect to see an increase in relation to 2013 due to a higher rate of transfers resulting from a likely higher increase in the tax revenue of the Federal Government. Thus, CNI estimates the primary surplus at BRL13.0 billion (0.25% of GDP) for regional governments, below the BRL51.3 billion target set for 2014. Thus, the primary balance of the consolidated public sector in 2014 has been estimated at BRL71.0 billion (1.4% of GDP), lower than the adjusted target of BRL109.4 billion.

In this scenario, the nominal deficit is likely to rise to 3.7% of GDP due to the drop in the primary surplus and to the 0.2 percentage point of GDP increase in interest spending. Despite a higher nominal deficit, the effects of the exchange rate devaluation on domestic and foreign debt adjustments will lend stability to the Net Debt/GDP ratio, which is expected to close 2014 at about 34.0% of GDP.

**Trajectory of Net Public Sector Debt in relation to GDP**

In relation to GDP (%)

Exchange rate adjustment is expected to reduce the Net Debt/GDP ratio in 2013




Source: Central Bank
* CNI estimate.

foreign trade sector and the exchange rate

# Current account deficit will be the highest one in 12 years

## Volatile exchange rate in the second half of the year

The exchange rate remained unstable during the second half of 2013. After a hike between February and August and a recovery in the two following months, the exchange rate took a downturn again, from BRL2.19/US$ in October to BRL2.36/US$1 in December (until the second week). It is noteworthy that the average monthly variation between June and December 2013 exceeded 3% a month.

The latest depreciation can be explained by an increase in the so-called Brazil risk, particularly in the last months of 2013. This pessimism stems from the response of international investors to worsening fiscal results and to a plunging current account deficit (which is relatively low but shows no signs of recovery).

The way the US has been conducting its monetary policy explains the higher volatility of the exchange rate. It is difficult to predict how strongly the US economy will recover for the policy of reducing monetary stimulus granted by the Fed to begin to be applied and how it will be reduced.

The exchange rate will remain at about BRL2.36/US$1 in December. As a result, the average rate in 2013 will be BRL2.16/US$1. Thus, the average exchange rate in 2013 will be more undervalued than in the previous year, when the average was US$1.95/US$1.

## Trade balance in 2013 will be the lowest one since 2000

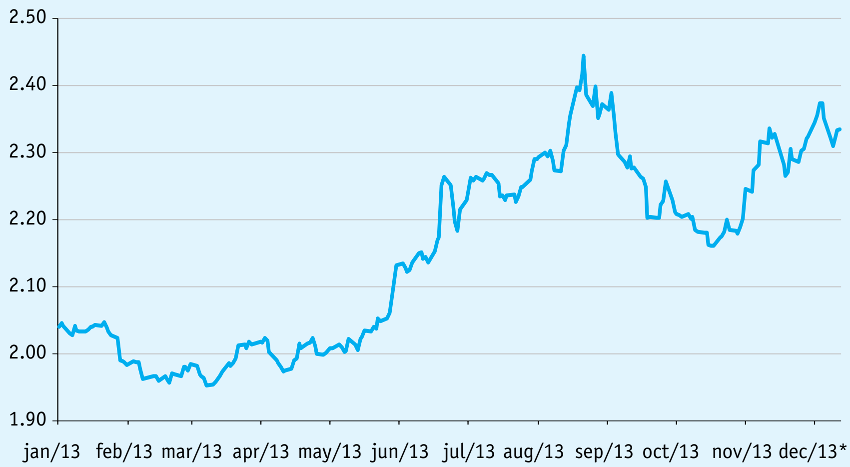
Exports totaled US$221.3 billion in 2013 to November, 1.1% below the figure recorded in the same period in 2012. Brazilian imports totaled US$221.4 billion over the same period, 7.2% higher in the same comparison. Thus, the trade balance recorded a deficit of US$89 million in the year to November, the worst result in 13 years. Over the same period in 2012, the trade balance recorded a surplus of US$17.1 billion.

CNI projects that exports will hit the mark of US$239.4 billion, 1.3% less than in 2012. Imports will in turn total US$238.7 billion, 7.0% more than in 2012. In this scenario, the trade balance

**BRL/USD exchange rate**

PTAX Closing quotations (BRL/USD)

Exchange rate alternating appreciation and depreciation in the second half of the year

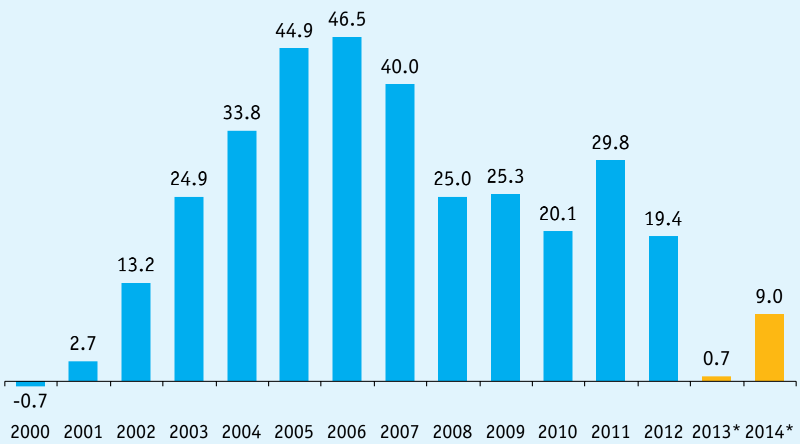



Source: Central Bank
* Up to 12/13/2013

# foreign trade sector and the exchange rate

**Brazilian trade balance**
In US$ billion

Trade balance in 2013 will be the lowest one since 2000




Source: Secex
* CNI projection

would be lower than US$1 billion (US$740 million), but a trade deficit at the end of 2013 has not been ruled out.

The decline in exports in 2013 was caused by a decrease in the exports of semi-manufactured and basic goods. A drop in the export prices of semi-manufactured goods (10.1% until October, according to FUNCEX) was the main factor that led to a decline of 8.7% in the export value of these products in the year to November. The prices of basic goods, in turn, decreased due to a sharp contraction in the sales of crude oil (US$ 6.8 billion, down by 38.1%). Removing crude oil from this comparison, exports of basic goods increase to 7.5%. Exports of manufactured goods grew by 0.6% in the year to November. It can be observed, however, that Petrobras oil rigs were the main item among manufactured goods in 2013, but they have no continuous export flow. Except for these rigs, whose exports totaled US$6.6 billion until November, exports of manufactured goods decreased by 5.6% in 2013.

Imports, in turn, increased in all categories of use between January and November 2013 compared to 2012. Purchases of fuels and lubricants increased by 13.8%, mainly on account of oil imports, which grew by 22.5%. Purchases of consumer goods expanded by 4.0%, driven by purchases of consumer nondurables,for which an increase of 9.3% was registered. In addition, imports of raw materials and intermediates increased by 6.9% and those of capital goods rose by 5.6%.

## Need for external financing continues to increase

In October 2013, the 12-month current account deficit totaled US$67.6 billion, 71% higher than the one recorded over the same period in 2012. The figure represents 3.6% of GDP, against 2.4% at the end of 2012. This deficit growth trend is expected to lose momentum by the end of the year, but it will still amount to US$81.3 billion, the highest figure in more than a decade. This amount represents 3.7% of GDP as estimated by CNI.

The increase in the deficit in the year to October is mostly (69%) due to a decline in the trade surplus over the same period. The deficit in services and revenues increased by 16%, from US$59.3 billion to US$68.6 billion, and contributed to push the current account deficit up. International travel expenditures increased by 15% and accounted for almost half the increase recorded in the service and income deficit recorded over the period.

During the same period, foreign direct investment (FDI) decreased by 11.2%. FDI hit the mark of US$49.1 billion in late October 2013, down from US$55.3 billion in the 12-month

# foreign trade sector and the exchange rate

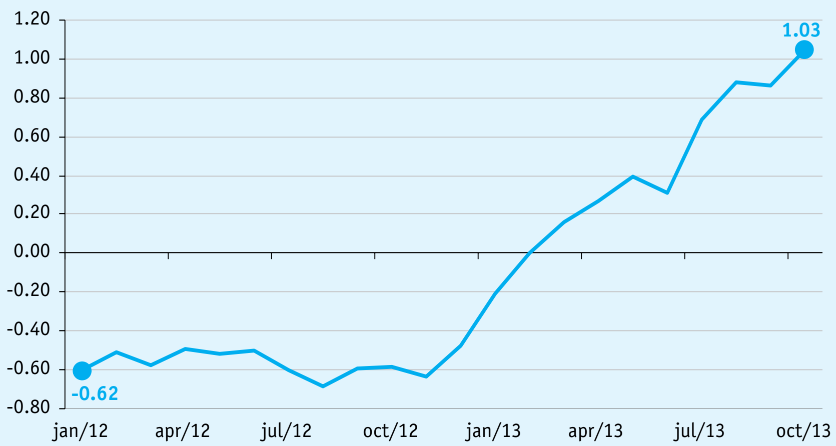
period to October 2012. Besides the difference in the amounts recorded in each period, a change in FDI composition can also be observed. In the 12-month period to October 2012, investment in equity capital accounted for 81% of FDI, while intercompany loans accounted for 19%. In 2013, equity participation fell to 66.7% of FDI and loans accounted for one third of it.

External financing needs (EFN), i.e. the difference between the current account balance and FDI, which had been negative until February of this year, took an upturn and increased rapidly since then. In January 2013, EFN was negative by 0.22% of GDP. In October 2013, it exceeded 1% of GDP.

**External financing needs**

To GDP in the previous 12 months (%)

External financing needs grew rapidly in 2013




Source: Central Bank

## Outlook

## The exchange rate will be more favorable to foreign accounts in 2014

The average exchange rate in 2014 will be more depreciated than in 2013, favoring exports and reducing imports. This will occur even if the rating of Brazilian securities remains the same or if the US withdraws its monetary stimulus smoothly. Otherwise, the exchange rate is likely to rise even further. This would provide a greater stimulus to generating a trade surplus, but because the Central Bank would have a hard time to curb volatility in such a scenario, the positive effects on foreign trade would be limited.

CNI expects the bond rating to remain at investment grade in 2014 (even if this rating is downgraded, there would be no downward bias) and the US to withdraw its monetary stimulus gradually as of mid-2014 (late in the first half or early in the second half of the year). Moreover, in relation to GDP in the previous 12 months (%), CNI believes that the Central Bank will continue to intervene in the exchange rate market actively to curb volatility.

The strengthening of the dollar has the potential to lead to a depreciation of the Brazilian Real and hence to pressure prices. Since inflation is close to the target ceiling, the Central Bank has little room to maneuver. In this scenario, the exchange rate is expected to rise to BRL2.45/US$1 in late 2014, recording an annual average of US$2.35/US$1.

The global economy will grow at a higher rate in 2014. The US economy will grow at a faster pace, bringing the unemployment rate down. The European economy is expected to grow (albeit marginally), overcoming the recession recorded in previous years. Emerging economies will expand more as a result of the increased activity in developed economies. China, in particular,

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will also benefit from reform plans launched by its government.

As opposed to the global economy, the Brazilian economy is likely to expand less in 2014 than in 2013. This will limit imports even more, and not only of consumer goods, but also of capital goods and inputs.

In addition, the deficit in the balance of trade of oil and its by-products, which pushed the trade balance down in 2013, will not be as negative in 2014. A more sluggish economy and, above all, a higher domestic oil production will contribute to reduce the deficit.

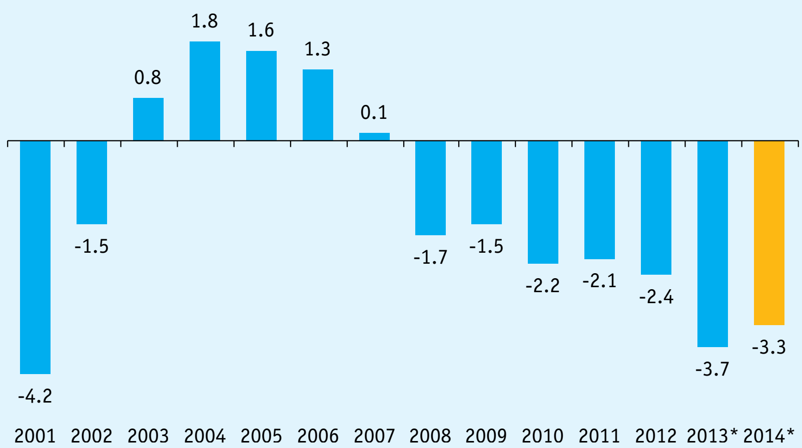
In this scenario, exports are expected to increase by 4% in 2014, totaling US$249 billion. It should be stressed that they could grow more, but the increase in exports of manufactured goods will be limited even in this more favorable scenario. The low competitiveness of Brazilian industry will reduce the possibility of more significant market gains. Commodities will experience a higher growth rate, mainly as a result of the increase in oil and iron ore production.

Meanwhile, imports are likely to remain virtually stable, totaling US$240 billion. The trade balance in 2014 will be positive, totaling about US$9 billion, but it will still be the lowest one since 2001 (excluding 2013).

The current account deficit will be lower in value: it will drop by 13.3%, hitting the mark of US$72.2 billion in 2014, equivalent to 3.3% of GDP. The higher deficit in services nullifies part of the increase in the trade balance. Spending on equipment rentals is likely to rise due to the increase in the number of rigs in operation, while transportation costs will also rise as a result of the increase in the export quantum. Revenues from international travel will not increase sharply, as observed in other countries that hosted the World Cup, while expenditures will drop, reflecting the exchange rate depreciation.

Foreign direct investment (FDI) will be lower in 2014 and will not be sufficient to cover the deficit for the second year in a row. Several factors are contributing to the reduction in FDI, among which the following ones stand out: the prospect of lower growth in the medium term (at the same time that the economies of developed countries are expected to grow at higher rates), the increasing likelihood of a downgrade in the country's rating, and a lower global liquidity.

**Current account deficit**
In relation to GDP (%)
Deficit is expected to remain above 3% of GDP in 2014




Source: Secex
* CNI forecast

# BRAZILIAN ECONOMY OUTLOOK FOR 2013 - 2014

| | 2011 | 2012 | 2013 *estimate* | 2014 *projection* |
|---|---|---|---|---|
| **Economic activity** | | | | |
| **GDP** (annual variation) | 2.7% | 1.0% | **2.4%** | **2.1%** |
| **Industrial GDP** (annual variation) | 1.6% | -0.8% | **1.4%** | **2.0%** |
| **Household consumption** (annual variation) | 4.1% | 3.2% | **2.1%** | **1.7%** |
| **Gross fixed capital formation** (annual variation) | 4.7% | -4.0% | **7.1%** | **5.0%** |
| **Unemployment rate** (annual average - % of the labor force) | 6.0% | 5.5% | **5.4%** | **5.6%** |
| **Inflation** | | | | |
| **Inflation** (IPCA - annual variation) | 6.5% | 5.8% | **5.7%** | **6.0%** |
| **Interest rates** | | | | |
| **Nominal interest rates** | | | | |
| (average rate in the year) | 11.76% | 8.63% | **8.29%** | **10.48%** |
| (end of year) | 11.00% | 7.25% | **10.00%** | **10.50%** |
| **Real interest rate** (average annual rate and defl: IPCA) | 4.8% | 3.1% | **2.0%** | **4.4%** |
| **Public accounts** | | | | |
| **Nominal public deficit** (% of GDP) | 2.61% | 2.47% | **3.00%** | **3.70%** |
| **Public primary surplus** (% of GDP) | 3.11% | 2.38% | **1.90%** | **1.40%** |
| **Net public debt** (% of GDP) | 36.4% | 35.2% | **33.9%** | **33.9%** |
| **Exchange rate** | | | | |
| **Nominal exchange rate - R$/US$** | | | | |
| (average in December) | 1.83 | 2.08 | **2.36** | **2.45** |
| (average in the year) | 1.67 | 1.95 | **2.16** | **2.35** |
| **Foreign trade sector** | | | | |
| **Exports** (US$ billion) | 256.0 | 242.6 | **239.4** | **249.0** |
| **Imports** (US$ billion) | 226.2 | 223.2 | **238.7** | **240.0** |
| **Trade balance** (US$ billion) | 29.8 | 19.4 | **0.7** | **9.0** |
| **Current account balance** (US$ billion) | -52.5 | -54.2 | **-81.3** | **-72.2** |

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