CNI Newsletter
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ECONOMIC REPORT

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

Economy is only expected to recover in 2016

Persistence in economic adjustment needs to be accompanied by pro-competitiveness actions

The Brazilian economy recorded a strong deterioration in the first half of 2015. High inflation and recession on the rise – which is already affecting others sectors of the economy and not only industry – are two factors that explain this situation. Among the immediate causes of this deterioration include imbalance in public accounts, which is much more serious than anticipated initially, and a process of correcting regulated prices.

Current difficulties are not only derived from the macroeconomic adjustment under way, even though it deepens recession. In fact, Brazil is currently faced with a perverse combination of conjectural and structural causes that hinder our performance.

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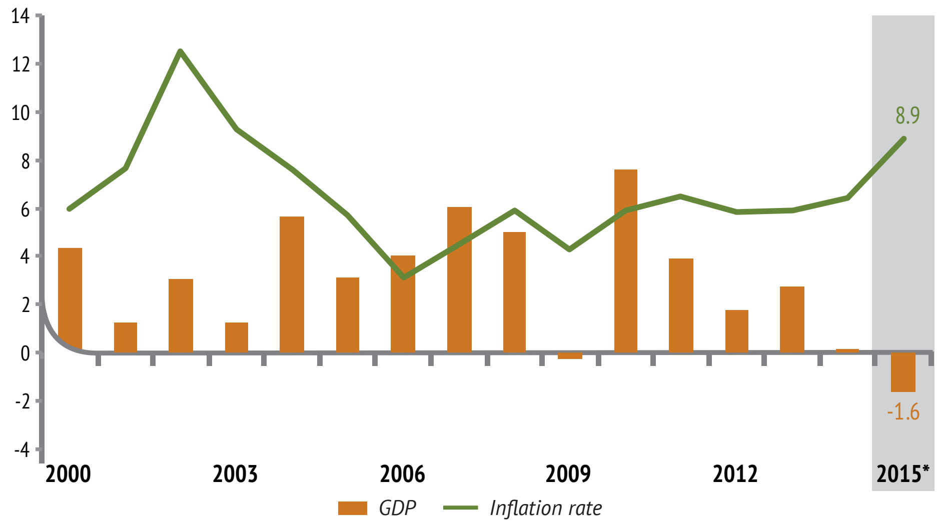
Sustained growth requires bringing inflation under control

Annual GDP variation and inflation rate

Percentage change (%)



Source: IBGE - * CNI Projection

Brazilian economy in the second quarter 2015

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The economic adjustment will continue to affect activity in the second half of the year. CNI estimates that inflation will remain at around 9% per year in 2015 and that GDP will decrease by 1.6%, with a drop of 6.4% in production of manufacturing industry and of 7.7% in investment. The foreign trade sector will provide a positive contribution of 0.9%, smoothing the decline in GDP mainly as a result of a decline in imports.

Factors contributing to the decline in GDP include a drop in household demand led by rising unemployment, the corrosive effect of inflation on income, financing restrictions resulting from rising interest rates, and limited additional debt capacity. The drop in investment is explained by the existence of idle capacity and also by major uncertainties and the high cost of capital. Problems in the oil and gas industry, the main leverage of investment in recent years, also prevent resumption of investment.

The worst situation is likely to be hit in the second half of the year and a gradual recovery is expected to begin in 2016. Exports and investment in infrastructure might be the exits of the current crisis. However, both have limited impact in the short term and depend on proper policy coordination to materialize. In such a context, advances in the pro-competitiveness agenda are crucial not only right now, but also to pave the way for the economy to resume growth in the future.

Improving the business environment – with improvements in regulatory frameworks and bureaucracy reduction – is part of this agenda. These are actions of low fiscal cost, although they require policy coordination and political commitment. Actions to rationalize the tax system, especially tax rates on value aggregated, which have a negative impact on competitiveness, are also expected to be part of this structuring effort.

Rebalancing public accounts is the foundation stone of all of these actions. Productive agents and consumers must be assured that growth in public expenditure will be actually contained. This is the only way to remove uncertainties as to the extent of the fiscal and monetary adjustment cycle.

This is a basic condition for restoring confidence in the economy and for the return of private consumption and investment decisions. If public expenditure is not contained, there will be pressures to increase taxes or debt. Both are unacceptable.

Unfortunately, recent actions have been sending worrying signs. Projects approved by the Brazilian Congress suggest that costs will continue to increase for enterprises and that public expenditure will remain on the rise. If not avoided, these initiatives will reduce our competitiveness and undermine possibilities for recovering sustainable growth path, keeping the economy stagnated for a longer period.

Rebalancing public accounts is the foundation stone of all of these actions

ECONOMIC ACTIVITY

Industry still far from a rebound

Weak consumption also leads to decline in services sector in 2015

The negative first-quarter GDP result, coupled with the statistics (on current situation and outlook) already available for most of the second quarter, suggests that Brazilian economy will experience a significant downturn in 2015. The fiscal and monetary adjustments required to restore the country's macroeconomic stability have been slightly accompanied by competitiveness-enhancing actions, thereby further deteriorating activity and possibly hindering economic recovery.

Given that efforts to offer greater predictability to economic agents are still under way (balancing public accounts and keeping inflation under control) and that the incentives for private investment will likely only have a significant impact as of 2016 (National Export Plan and Logistics Investment Program), we conclude that GDP will only begin to grow again moderately in the fourth quarter – still not characterizing a recovery – and close the year down by 1.6%.

On the supply side, industry is the main responsible for the negative performance of economic activity. In the January-May period, industrial production fell by 6.9% in 2015 as compared to the same period in 2014 (Monthly Industrial Survey - Physical Production - PIM-PF/IBGE).

Brazil's GDP to drop by 1.6% in 2015

The scenario is even worse when we restrict the analysis to manufacturing industry. Production in this segment is also down by 9.0% in the first five months of the year, with emphasis on capital goods, which experienced a 20.6% drop. Furthermore, the widespread negative results across the manufacturing sectors deserve special mention: all the 25 sectors covered by the survey reported a reduction in production between January and May 2015 (PIM-PF/IBGE).

The drop in production is accompanied by a 7.3% fall in real sales in industry in the first five months of 2015 over the same period the year before (Industrial Indicators/CNI).

The slowdown in industrial activity is also reflected in the performance of the inventory and capacity utilization indicators. The indicator of actual-planned inventories for large companies went up to 56.7 points in May, moving away from the 50-point dividing line and indicating an increase in unwanted inventories in industry (Industrial Survey - Manufacturing and mining /CNI).

Companies have reduced the use of their production facilities in response to rising inventories and slowing demand. In May, average capacity utilization in manufacturing stood at 80.1% on a seasonally adjusted basis, the lowest level since March 2009 (Industrial Indicators/CNI).

Unwanted inventories, an idle manufacturing park, reduced sales, and weak demand expectations have led to recurrent job losses in industry. Comparing the first five months of this year with the same period of 2014, one can see a 4.5% reduction in employment levels in manufacturing (Industrial Indicators/CNI).

The reality in the construction industry is quite the same. According to data from the CNI's Construction Industry Survey, construction firms have experienced successive declines in activity levels, reductions in new developments and services, low operation capacity levels, and lower number of employees.

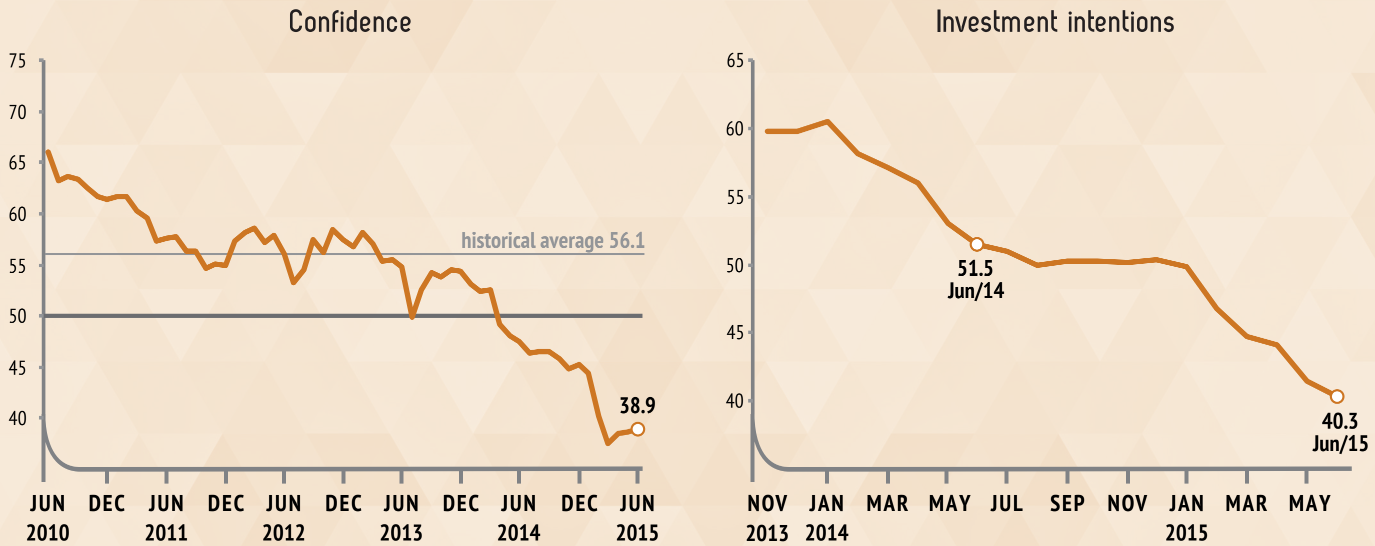
Another industrial segment that is expected to face difficulties in 2015 is the sector of Public Utility Industrial Services (SIUP, in its Brazilian acronym), which includes, among other activities, electricity production and distribution and water collection, treatment and distribution. As a result of the water and energy deficits experienced in the first months of the year and of the sharp hike in electricity prices, we believe that the SIUP sector will fall in 2015, just as it did last year.

In turn, the mining and quarrying industry is estimated to report a positive performance in this year, even though its expected growth rate will be lower than that observed in 2014. The maintenance of growth stems

Regaining confidence will be crucial for industry to invest and grow again

Business Confidence Index (ICEI) and Investment Intentions Index

In points



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

mainly from an increase in oil production. The results obtained up to May show a 9.9% increase in physical production in mining and quarrying (PIM-PF).

Under this environment, the Business Confidence Index (ICEI/CNI) continues to hover at low levels. In June, the index hit the mark of 38.9 points, down by 17.2 points from its historical average. This result indicates that the low confidence in industry is still strong and widespread.

With no prospects of a short-term reversal in this adverse scenario, industrial entrepreneurs have been reluctant to invest. The Investment Intentions Index (released by CNI this year) experienced an 11.2-point drop between June 2014 and June 2015.

Considering the overall scenario of the industrial subsectors analyzed so far, we expect industrial GDP to fall by 3.8% in 2015, marking the second consecutive annual decline. This drop will be driven by a decline in manufacturing (-6.4%), in construction (-5.2% drop) and in SIUP (-6.8%). Mining and quarrying, on the other hand, is estimated to post growth of 6.9% in 2015.

The decline in industry, coupled with reduced household purchasing power, is expected to lead to a 1.0% drop in the services sector this year. The last drop in this sector, which had been recently leading economic growth, was over 20 years ago.

GDP estimate for 2015

Percentage change in GDP components

	GDP COMPONENTS	Rate of change (%)
Demand	Household consumption	-1.2
	Government consumption	-0.6
	GFCF	-7.7
	Exports	1.8
	(-) Imports	-4.7
Supply	Agriculture	2.3
	Industry	-3.8
	Mining and quarrying	6.9
	Manufacturing industry	-6.4
	Construction industry	-5.2
	SIUP*	-6.8
	Services	-1.0
	GDP	**-1.6**

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

The retail trade results provide a clear picture of this scenario. Sales volumes in the January-April 2015 period were 6.1% lower than those recorded in the corresponding period a year ago (Monthly Trade Sector Survey - PMC/IBGE). Vehicle registration data released by Anfavea support this scenario, with the number of registered vehicles down by 20.7% in the first quarter of 2015 on a year-over-year basis.

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

On the demand side, household consumption, which had been slowing down considerably in recent years, is estimated to fall in 2015. CNI expects to see a 1.2% drop in this component. If confirmed, this will be the worst result since 2003. The downward trend can be explained by the continuation of a restrictive monetary policy, deteriorating labor market conditions, higher household debt-to-income ratios, stubbornly high inflation rates, difficulties to access credit, and the current fiscal tightening.

Investment (Gross Fixed Capital Formation - GFCF), a key component to accelerating sustainable growth, is expected to decline once again in 2015. The estimated decline of 7.7% will be driven mainly by a drop in manufacturing industry, a major consumer of machinery and equipment, and by a shrinking in the construction industry, which accounts for over half of gross fixed capital formation in Brazil. As a result, investment rates (gross fixed capital formation as a share of GDP) would fall from 19.7% in 2014 to 18.5% in 2015.

The most significant factors behind this decline in investment include higher basic interest (Selic) rate – reducing demand expectations and increasing opportunity costs of capital –, developments in the Petrobras scandal, and an uncertain environment resulting from difficulties to approve some of the measures under the tax package being analyzed by Congress.

Given the current fiscal environment in Brazil, CNI projects a 0.6% drop in government consumption in 2015.

Due to the significant depreciation in the Brazilian currency, particularly in the first quarter, exports are expected to grow by 1.8% in 2015. This increase will not be higher because it takes time for the more favorable exchange rate to be reflected in firms' marketing strategies, as the export process is usually governed by long-term contractual relationships, thereby hindering immediate reintegration into the international market, especially in the case of manufactured products. Furthermore, the loss of competitiveness observed in recent years has steered the Brazilian industry away from different markets, and this recovery can be slow and costly.

On the other hand, imports are expected to fall in 2015. As a result of a depreciated exchange rate, the sharp slowdown in household consumption, and the decline in production of manufacturing industry, we estimate that imports are to experience a 4.7% drop this year.

Considering the increase in exports and, particularly, the decline in imports, the net contribution of the external sector to GDP growth is estimated at 0.9% in 2015.

EMPLOYMENT AND INCOME

Labor market deteriorating in 2015

First months of 2015 are marked by rising unemployment rate, lower employment levels, and reduction of average earnings

The labor market deteriorated in the first five months of 2015. All surveys covering employment and income indicators point to a similar scenario: unemployment rate on the rise, decline in employment levels in almost all economic sectors, and lower real average earnings. And the labor market is expected to worsen further in coming months.

● **UNEMPLOYMENT RATE RISES AND MAY CLIMB BACK TO DOUBLE-DIGIT LEVELS.** The unemployment rate measured by the Monthly Employment Survey (PME/IBGE) rose to 6.7% of the labor force in May. This is the highest percentage for May in four years. As compared to May 2014, unemployment is up by 1.8 percentage points. On a seasonally adjusted basis, the rate rose from 6.0% in April to 6.3% in May.

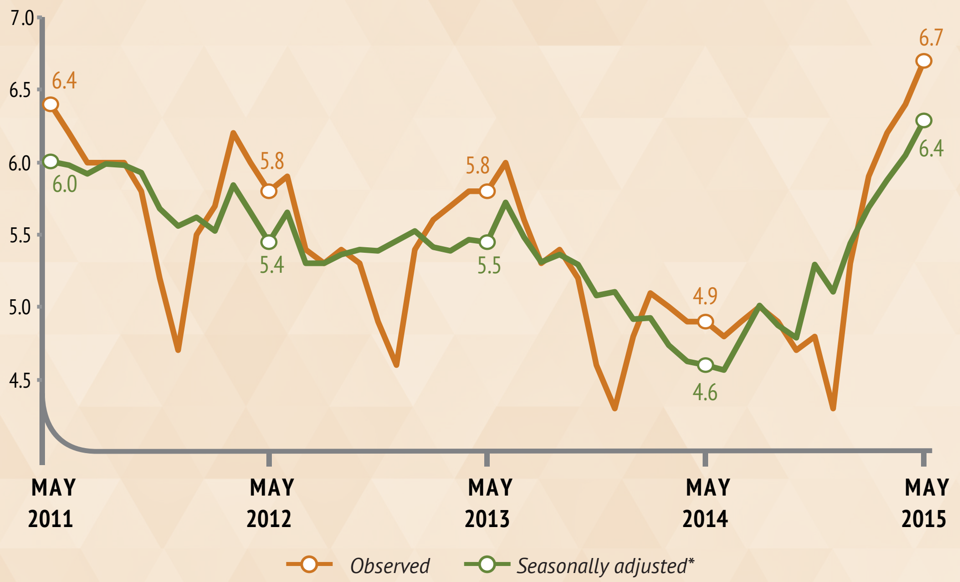
The unemployment indicator measured by the PNAD-Contínua (Pnad-C) Survey confirms the deterioration in the indicators of the Monthly Employment Survey (PME). In the three months to April, the unemployment rate amounted to 8.0% of the labor force, representing a 0.9-percentage point increase from the same period in 2014. This is the highest rate recorded for a February-April period since the series started in 2012. The unemployment rate measured by Pnad-C can be expected to reach double-digit levels by the end of the year.

The uptrend in unemployment is still explained by the continued decline in employment in 2015. According to data from the General Registry of Employed and Unemployed Persons (CAGED/MTE), the Brazilian economy lost 115,600 formal jobs in May alone. In the first five months of the year, 278,300 jobs were lost. This is the worst result for the period since 2002, when the series began to be conducted. In the last 12 months ended in May, the economy eliminated a total of 593,300 formal jobs.

Unemployment rate on the rise and at worst level in four years

Unemployment rate in metropolitan areas

In % of the labor force



Source: PME/IBGE   * Preparation: CNI

Industry continues to record the most significant decline in jobs. In the first five months of 2015 alone, the sector lost 215,700 formal jobs. In the last 12 months ending in May, a total of 687,500 jobs were cut. Considering only the manufacturing industry, 340,200 jobs were lost in the last 12-month period. Construction is another industry for which a sharp decline in number of employees was recorded: reduction of 334,000 jobs in the last 12 months.

In addition, the labor force continues to grow, pushing the unemployment rate further up. In May, the labor force increased by 1.2% on a year-on-year basis. In April and March, it grew by 0.9% and 0.3%, respectively, on the same comparison basis. In the year to May, the labor force increased by 0.5% as compared to the same period in 2014. The same comparison between 2014 and 2013 showed a 0.8% decline in the labor force.

The impact of weak economic activity and inflationary pressures will likely keep the labor force on its upward trajectory in 2015 as more people look for income alternatives to support their families.

In this scenario, we project that the average rate of metropolitan unemployment will stand at 6.7% of the labor force in 2015.

● **REAL AVERAGE EARNINGS AND REAL TOTAL PAYROLL FALL STRONGLY IN 2015.** Real average earnings usually received by metropolitan workers experienced a significant decline in the first months of 2015. The indicator fell by 5.0% in May as compared to the same period a year ago. This is the fourth consecutive monthly decline in the indicator. The last time the index fell so significantly was in February 2004, when it edged down by 4.8% from February 2003.

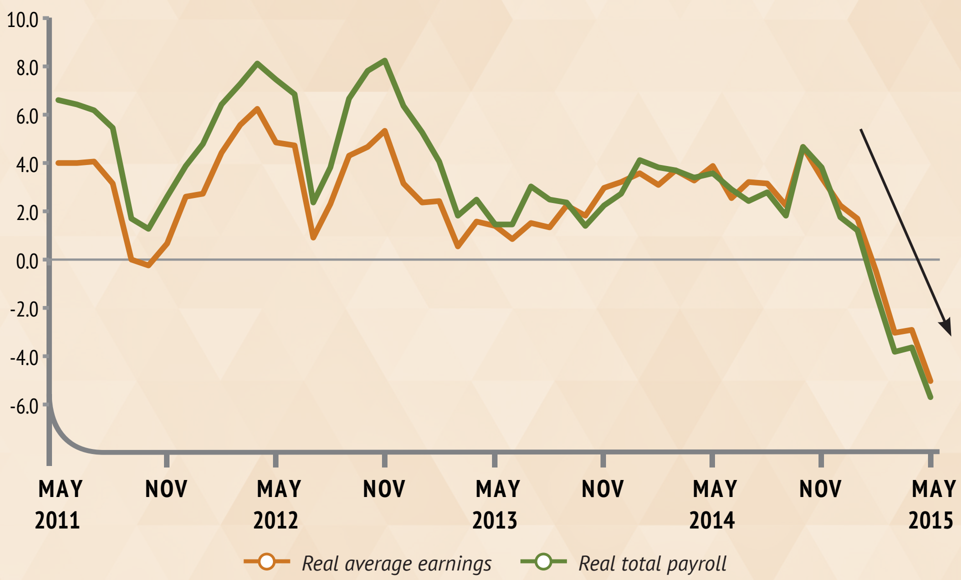
For 2015, real average earnings are expected to keep falling, driven both by inflationary pressures on workers' purchasing power and by the decline in employment due to low economic activity. This latter effect is enhanced by the more significant reduction in formal jobs, as this type of employment pays higher-than-average wages. Under this scenario, we expect to see a 2.5% drop in real average earnings in 2015, down from a 2.7% growth recorded in 2014.

The decline in jobs and real average earnings has a strong impact on real total payroll, which had been growing steadily since 2004. In May, the indicator dropped for the fourth month in a row, falling by 5.7% from the same month in 2014. CNI estimates that real total payroll will fall by 3.5% in 2015. This will be the worst annual result for the indicator in the historical series started in 2002.

Reduction in real average earnings and employment hinders growth of real total payroll in 2015

Real Average Earnings and Real Total Payroll

Year-on-year variation (%)



Source: IBGE

INFLATION, INTEREST RATE, AND CREDIT

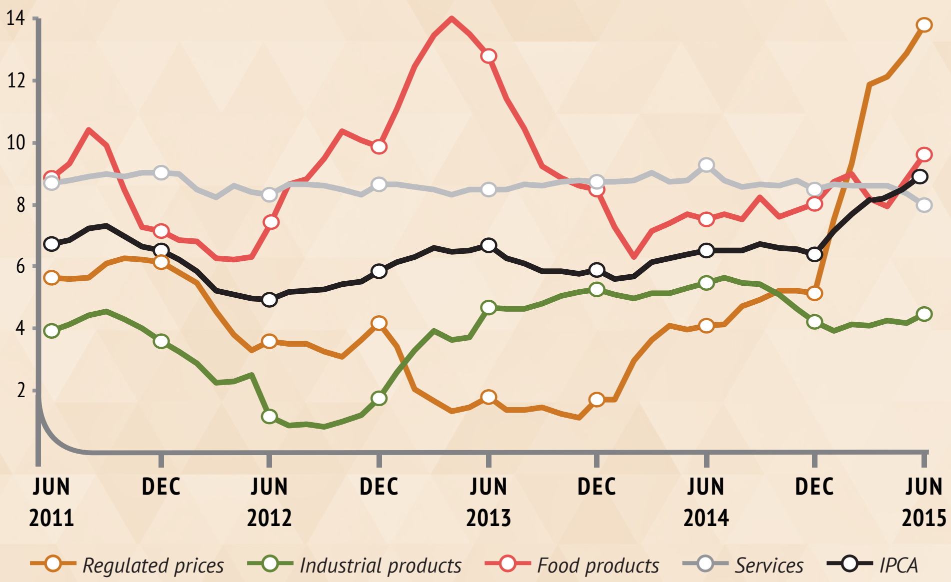
Inflation close to the upper limit of the range in the first half of the year

Relative price adjustments have been pushing inflation up in the first half of 2015

Regulated prices rise at a faster pace in the first half of the year

IPCA by groups

12-month figure (%)



Source: IBGE - Preparation: CNI

Inflation remained on the rise in the second quarter of 2015, albeit less intensely than in the first quarter. The Expanded Consumer Price Index (IPCA, in Brazilian acrynm) rose by 2.3% in the quarter to June after increasing by 3.8% until March. The 12-month index hit the mark of 8.9% in June, as compared to 6.5% over the same period in 2014.

The IPCA increased by 6.2% in the first half of the year, exceeding the target set by the Brazilian National Monetary Council (CMN). The sharper rise in inflation during this period was mainly caused by relative price adjustments – upward adjustments in both regulated prices in relation to market prices and in domestic prices in relation to international prices. Among the items included in the IPCA index, regulated prices and food and beverage prices were the ones that had the highest impact on prices early this year.

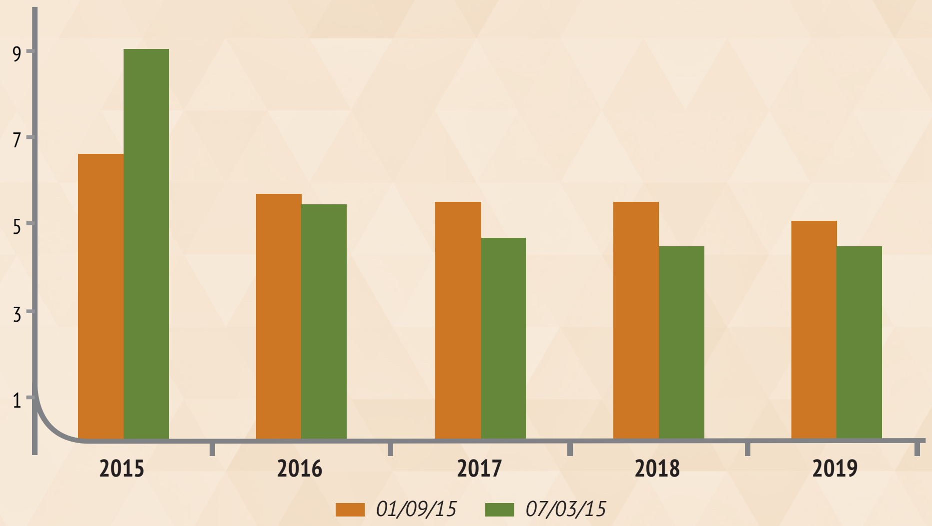
In the 12 month-period to June, regulated prices rose altogether by 13.8%, against 4.1% over the same period in the previous year. They have risen by 10.1% in the year so far. This significant increase in regulated prices in the first half of 2015 was mainly caused by an upward adjustment of 42.0% in energy prices, as well as by a 9.2% increase in gasoline prices and a 6.0% increase in the prices of pharmaceutical products. Moderate adjustments in electricity prices are expected in the second half of the year, reducing the pace of increases in regulated prices. The IPCA index might be pressured upward by a likely increase in gasoline prices, which is seen as a way of neutralizing the effects of the exchange rate depreciation and of an alignment of domestic prices with international prices. Still, these adjustments are likely to reduce the inflationary pressure seen in the first half of the year. Thus, CNI expects to see an increase of 13.3% in regulated prices in 2015.

Food and beverage prices accounted for the second highest impact on the overall index. In the 12 months ending in June, the rate amounted to 9.6%, higher than the 7.5% rate recorded in the same period in 2014. These prices rose by 6.6%

More favorable inflation expectations in the medium term

Inflation according to the Focus survey

Expectations for the year (%)



Source: Central Bank of Brazil.

see a moderate reduction in the growth rate of service prices in 2015. Thus, the group would close the year with an increase of 7.4%.

CNI expects the IPCA index to hit the mark of 9.1% in 2015, significantly above the upper limit defined in the inflation-targeting program.

New signals issued by the Brazilian Central Bank are having an effect on inflation expectations in the medium and long term

in the first half of 2015. Several factors contributed to this behavior of food prices, three of which deserve special mention. First, weather-related problems affected the supply of some agricultural products. Second, the exchange rate depreciation had an impact on prices, as it pushed the prices of imported inputs up and led domestic production to be mainly targeted to the international market. Finally, production costs increased as a result of higher water, fuel, and electricity prices. CNI estimates an increase of 10.9% in food and beverage prices in 2015.

The prices of industrial products rose by 4.5% in 12 months to June, against 5.5% in the same period in 2014, meaning that they increased less than the average general inflation rate. Altogether, they rose by 3.0% in the first six months of the year. The factors that contributed to this modest variation in the prices of industrial products include weak demand, which makes it difficult to pass the effects of the depreciation of Real and of the rise in energy prices through to consumer prices. This behavior is likely to continue in the remainder of 2015, as no major change is expected in the current adverse economic scenario. We thus project that the prices of industrial products will rise by 4.8% by year's end.

Service prices increased by 8.0% in the 12 months to June, compared to 9.3% in the same period in 2014. They have risen by 5.1% in the year so far. Despite a weak economic activity and labor market deterioration, with their impacts on real household income, service prices rose more modestly as compared to the previous year. This is mainly explained by their characteristic inertia, as they are directly affected by wage increases indexed to past inflation and increases in the minimum wage. This rigidity in service prices made it possibly for the increase in regulated prices, particularly in energy prices, to be partially passed through to them. Therefore, CNI expects to

● INFLATION IS LIKELY TO CONVERGE TO THE TARGET CENTER FROM 2016 ON. The Central Bank has decided to continue to increase interest rates in the second quarter of the year. It thus raised the basic interest rate to 13.75% – 0.5 percentage points (p.p.) at each of its meetings held in April and June. Since this cycle was initiated in October of last year, the basic interest rate went up by 2.75 percentage points.

Stronger inflationary pressures than had been initially projected clearly contributed to successive increases in the basic interest rate. However, this extension of the cycle of increases in interest rates even in a period of marked contraction of economic activity is intended to rescue the credibility of the Brazilian Central Bank, which was jeopardized in recent years. This is key for anchoring expectations and, consequently, for leading inflation to converge to the target center in 2016. To reaffirm the commitment of the monetary authority to control prices, the Brazilian National

Monetary Council reduced its tolerance to inflation in 2017, even though the inflation target was kept at 4.5%. The tolerance interval decreased from 2.0 p.p. to 1.5 percentage points, limiting the inflation fluctuation band to a range of 3.0-6.0 percent.

New signals issued by the Brazilian Central Bank are having an effect on inflation expectations in the medium and long term. According to the latest Focus survey, issued on July 3, market analysts are projecting an inflation rate of 5.45% in 2016, 0.25 percentage points lower than the one estimated in January of this year. The expectation of a lower inflation can be clearly observed in the projections for 2017, 2018 and 2019, as shown in the chart below. It is noteworthy that inflation projections have been lowered despite the expectations of a higher inflation rate in 2015, a result that was achieved thanks to the current monetary policy strategy.

The effects of contractionary monetary and fiscal policies, added to a scenario of weak economic activity and a deteriorating labor market, are likely to contribute to push prices down. As a result, we believe that the cycle of rising interest rates will come to an end in July, after a final increase of 0.5 p.p. that will raise the Selic rate to 14.25%.

- **FURTHER DETERIORATION IN THE CREDIT MARKET.** Credit continued to slow down in the first months of the year. According to data of the Brazilian Central Bank, the real growth in the average balance of credit in the last 12 months as compared to the average balance in the previous 12-month period decreased from 8.1% in May 2014 to 3.9% in May of this year (last available data). For individuals, the rate ranged from 9.4% to 5.6%, while the credit balance for firms dropped from 7.0% to 2.5%.

Different factors have been contributing to the slowdown in the credit market. First, successive increases in the basic interest rate and in the long-term interest rate (TJLP) have increased financing costs with both nonearmarked and earmarked resources. Second, the poor performance of economic activity and low confidence in the economy have led households and entrepreneurs to postpone their consumption and investment decisions.

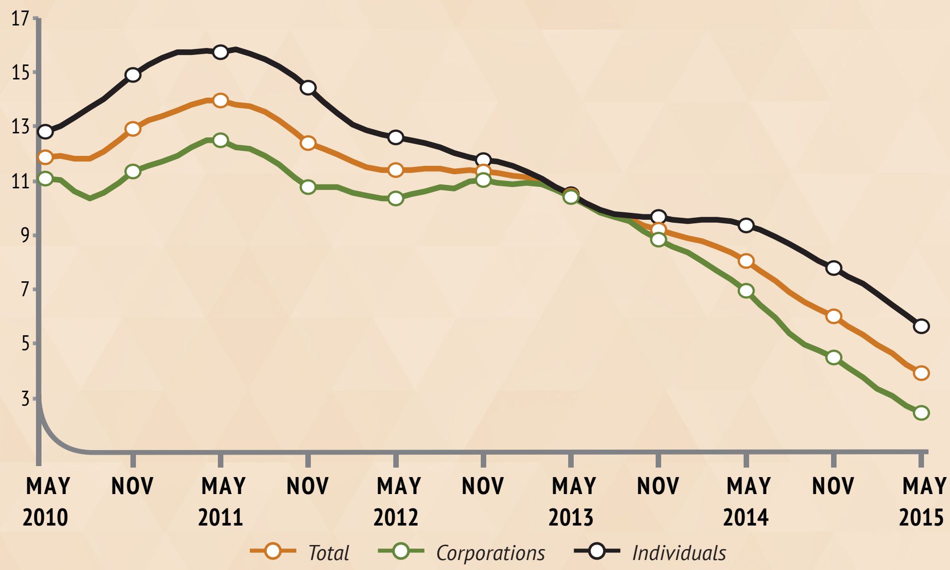
For earmarked credit, the government has signaled a reduction in disbursements by the Brazilian Development Bank (BNDES, in its Brazilian acronym). Data provided by the BNDES show that its disbursements decreased by 20.3% between January and May 2015 as compared to the same period in 2014. Besides contributing to pushing prices down, this slowdown in earmarked credit reduces subsidies granted through credit operations, thereby contributing to fiscal control. In addition, Caixa Economica Federal, the federal savings bank that grants most housing loans in Brazil, raised financing charges and reduced credit limits for used real estate funded with savings deposits. These measures are likely to continue to have an impact on the Brazilian credit market over the next six months, contributing to a further deterioration.

In short, the reduction in BNDES disbursements and the likelihood of a continued negative scenario for the economy in the short term are expected to continue to slow down growth in the stock of credit in 2015.

Credit remains on a downward path

Balance of credit operations

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



Source: Central Bank of Brazil.

FISCAL POLICY

Achievement of the primary deficit target becomes unlikely

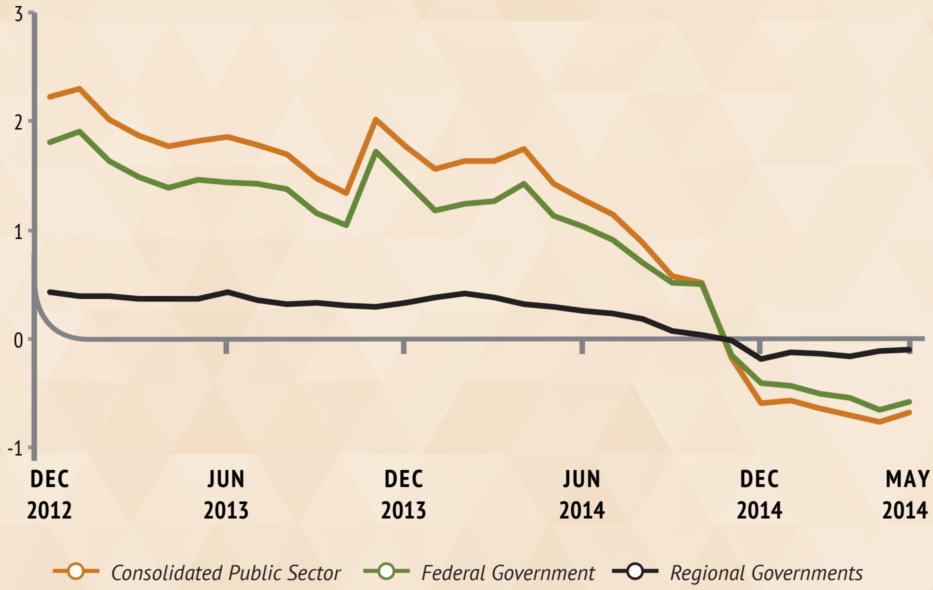
Fiscal adjustment actions had their effects reduced by Brazilian Congress and a sharp drop in economic activity has been impacting on tax revenues

Reversing the expansionist fiscal policy adopted in recent years will not be sufficient to ensure that the primary deficit target will be achieved in 2015. Part of the reduction in expenditure and the increase in revenues that the Federal Government of Brazil hopes to achieve through the measures it submitted to Brazilian Congress for approval will not materialize due to changes made in them by the legislature. In addition, the impact of the downturn in economic activity on tax revenues has been stronger than anticipated initially. Finally, significant increases have been observed in some expenses due to payments not made in previous years.

12-month primary deficit increased by R$ 6.0 billion in the first five months of 2015

Evolution of the Public Sector primary result

12-month figure (% of GDP)



Source: Central Bank of Brazil.

FEDERAL EXPENDITURE IS STABLE IN THE FIRST FIVE MONTHS OF 2015. Plans to reverse the fiscal expansion observed in recent years become evident when one analyzes the expenditure of the Brazilian Government in early 2015, either as a whole or in disaggregated terms. The primary expenditure of Federal Government increased by 0.2% in real terms (as deflated by the IPCA index) between January and May 2015 in relation to the same months last year. In 2014, real expenditure rose by 6.1% as compared to 2013.

The behavior of some mandatory expenditure items has been making it difficult to control total of public expenditure. Social security spending grew by 4.8% in real terms in the first five months of 2015 in relation to the same period in 2014. This growth was mainly due to a real minimum wage increase of 2.3%. This factor also explains much of the real increase of 6.8% in expenditure of social benefits and of 9.0% in expenditure on unemployment insurance and salary bonuses. In the latter case, however, the increase appears to be partly linked to the settlement of overdue payments from previous years. This explanation also applies to the 61.2% real increase recorded in spending on subsidies and transfers.

On the other hand, non-compulsory expenditures with investment or defrayal decreased by 8.3% in real terms in the first five months of 2015 as compared to the same period in 2014. This reduction in non-compulsory expenditures was made possible by a real decrease of 38.3% in investments of the Federal Government (excluding subsidies granted to the My Home, My Life program) and of 5.9% in operating expenses.

MASSIVE DOWNTURN OF ECONOMIC ACTIVITY MAKES IT DIFFICULT TO RECOVER FEDERAL REVENUES. Some measures designed to increase federal tax revenue are already in force and partly explain why revenues have not been dropping as intensely as observed in recent months. Net revenue of the Federal Government recorded a real decrease of 3.0% in the first five months of 2015 in relation to the same period last year. When applied to January and February 2015, the same comparison indicated a real drop of 4.3%.

However, the positive effects of fiscal adjustment actions on revenues are less clear due to the negative effects of real total payroll. Despite the increase observed in the rates of various taxes, tax revenues still experienced a real drop of 3.0% in the first five months of 2015 as compared to the same period last year. In addition to the decline in economic activity, a 90% increase in tax refunds also helps to explain this result. The decline in real total payroll is in turn the main factor explaining the real decrease of 3.1% recorded in social security revenues after compensations from the Brazilian National Treasury due to tax exemptions on payroll are excluded.

Revenues not managed by the Brazilian IRS experienced in turn a real decrease of 14.4% in the first five months of 2015 in relation to the same period in 2014. This result is explained by a reduction in the receipt of dividends and financial compensation for oil exploitation activities by the Federal Administration.

STATE AND MUNICIPALITIES REDUCE THEIR EXPENDITURES. The results in terms of expenditure cuts in states and municipalities are more significant than those recorded for the Federal Government. Based on the available data, it can be estimated that regional governments reduced their expenditure by 3.6% between January and April 2015 as compared to the same months last year.

The only reason why the primary result was not better is because the revenues of states and municipalities decreased. In the first four months of 2015, the revenues of regional governments recorded a real decrease of 2.3% in relation to the same period in 2014. The downturn in economic activity had a negative effect on the collection of tax rate on consumer and services (ICMS, in Brazilian acronym), which recorded a real decrease of 3.3% in real terms, as well as on transfers from the Union, which dropped by 2.9% in real terms.

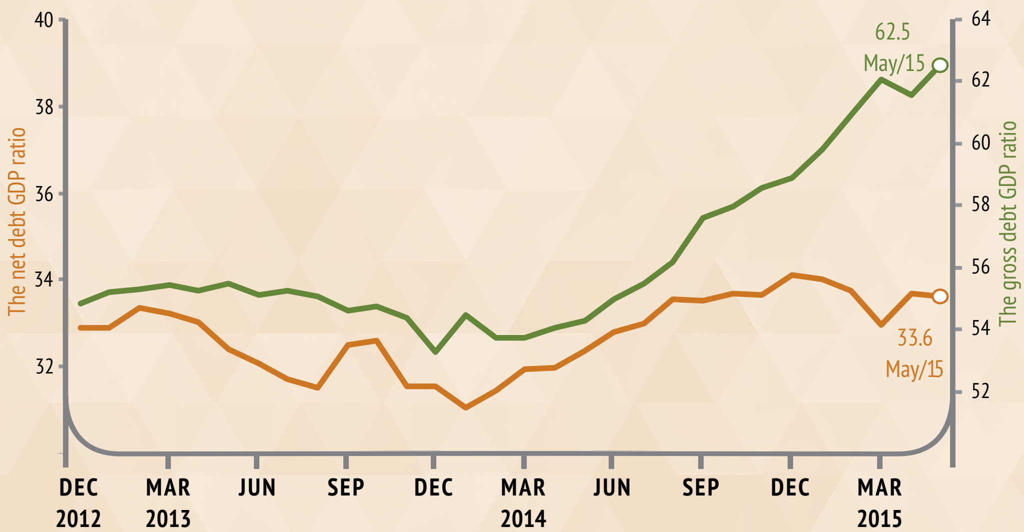
SIGNIFICANT INCREASE IN THE NOMINAL DEFICIT. Despite the adoption of a contractionary fiscal policy at the federal and regional levels, the primary result continued to deteriorate in early 2015 as a result of the drop in revenue. Over the past 12 months to May, the consolidated public sector recorded a primary deficit of R$ 38.5 billion (0.68% of GDP). In late 2014, the primary deficit amounted to R$ 32.5 billion (0.59% of GDP).

In addition to a higher primary deficit, an increase of 1.58 percentage points (p.p.) of GDP in interest expenditure led the 12-month nominal deficit to

Increase in the nominal deficit led to an increase of 3.86 percentage points in the gross debt/GDP ratio over the last five months

Evolution of the Public Sector Net Debt and Gross Debt

In relation to GDP (%)



Source: Central Bank of Brazil.

hit the mark of 7.9% of GDP in May 2015. Even with the nominal deficit at such level, the net debt/GDP ratio dropped from 34.1% to 33.6% of GDP between December 2014 and May 2015. This decrease was caused by the effects of the exchange rate depreciation on domestic and foreign debt. However, the gross debt/GDP ratio increased from 58.9% of GDP in December 2014 to 62.5% of GDP in May 2015. This occurred because public sector credit is not deducted from gross debt, whose value in the Brazilian currency increases as the exchange rate depreciates, as happens with the international reserves of the Brazilian Central Bank.

● **PRIMARY DEFICIT TARGET IS NOT LIKELY TO BE ACHIEVED.** The effects of fiscal adjustment actions will be more strongly felt in the coming months and, as a result, fiscal results are likely to improve significantly from now until the end of 2015. On the expenditure side, the financial programming of R$ 70.8 billion in non-compulsory expenditure items of the Federal Government and the approval of new rules for granting Unemployment Insurance are expected to lead to a faster drop in current and capital expenditure in the remainder of the year. In addition, the current pace of decline in personnel expenses in real terms is likely to continue and the growth pace of social security expenditure is expected to slow down. Thus, CNI estimates that Federal Government expenditure will close 2015 with a real decrease of 3.1%.

On the revenue side, increases in the rates of several taxes are likely to reverse the real drop in tax revenues recorded in the first five months of 2015, leading them to close the year at stable levels in real terms as compared to 2014. In addition, Federal Government projections for revenue not managed by the Brazilian IRS suggest that the pace of real decline will slow down by the end of the year. On the other hand, social security revenues continue to deteriorate as total payroll decreases more intensely in real terms. Thus, CNI estimates that the net revenue of the Federal Government will close 2015 with a real decrease of 0.6% as compared to 2014.

In such a scenario, the Federal Government is likely to record a primary deficit of R$ 10.5 billion (0.2% of GDP, as estimated by CNI). In the case of regional governments, the drop in expenditure and the higher revenues made possible by increases in energy and fuel prices and by a higher collection of ICMS are likely to at least make it possible for the primary deficit target of R$ 11.0 billion (0.2% of GDP) to be achieved. As a result, the consolidated public sector primary deficit is likely to amount to R$ 22.5 billion (0.4% of GDP) in 2015.

This result would fall short of the primary deficit target of R$ 66.3 billion set for 2015. To achieve this target, the Federal Government should conduct an additional financial programming of R$ 44.7 billion. However, such an amount seems unfeasible, since the programmable basis was reduced to R$ 122 billion after the first financial programming. An alternative would be to combine a smaller additional financial programming with the raising of extraordinary revenues, such as through the public offering of shares of Caixa Seguradora.

The financial programming of R$ 70.8 billion was in line with CNI's estimate announced in the first Economic Report of 2015 for achieving the primary deficit target. The need for an additional financial programming of R$ 44.7 billion can be explained by two factors. The first one is the deadline and the way that fiscal adjustment measures were approved in Congress, as a result of which the Federal Government lost R$ 16.0 billion in expenditure cuts and higher revenues in 2015. The second factor is the deterioration of economic activity, which is stronger than expected, and its impact on tax revenues.

Thus, if the projected consolidated public primary deficit of R$ 22.5 billion (0.4% of GDP) is confirmed, a nominal deficit of 6.45% in 2015 is likely. This estimate considers that nominal interest expenditure, which is currently estimated at 7.2% of GDP, is likely to decrease to 6.85% of GDP by the end of the year as a result of the impact of the exchange rate depreciation on foreign exchange swap costs. As a result of a high nominal deficit and low nominal GDP growth, the net debt/GDP ratio is expected to amount to 36.4% of GDP in December 2015.

The consolidated public sector primary deficit is likely to amount to R$ 22.5 billion (0.4% of GDP) in 2015

FOREIGN SECTOR

Foreign trade attenuates effects of reduced domestic demand

Depreciation of Brazilian currency affects trade balance positively

In the second quarter of 2015, the real appreciated slightly against the US dollar and became less volatile as compared to the first quarter. At the same time, the Brazilian trade balance began to show a surplus starting in March. However, this surplus was not led by the substantial increase in exports, but by a fall in imports. Furthermore, the current account deficit has continued to trend downward in 2015, adjacent to a backdrop of annual depreciation of the real and lower economic activity in Brazil.

● **BRAZILIAN CURRENCY DEPRECIATES LESS STRONGLY AND BECOMES LESS VOLATILE.** The real hit the mark of R$ 3.10 per US dollar at the end of June, accumulating a decline of 15.2% in the January-June period this year. In the second quarter, the real appreciated by 2.25%, when considering the average monthly exchange rate from April to June. In parallel with this appreciation, the real/dollar exchange rate was also less volatile in the second quarter as compared to the first quarter of 2015. The difference between the highest and lowest daily exchange rate in the second quarter was R$ 0.28 per US dollar, or 9.8% of the minimum quotation, while in the first quarter this figure stood at R$ 0.69 per US dollar or 26.9% of the minimum exchange rate. The implementation of some fiscal adjustment actions and the softening of political tensions may have reduced short-term uncertainties on the Brazilian economic policy. As a result, they have led to a reduction in the exchange rate volatility.

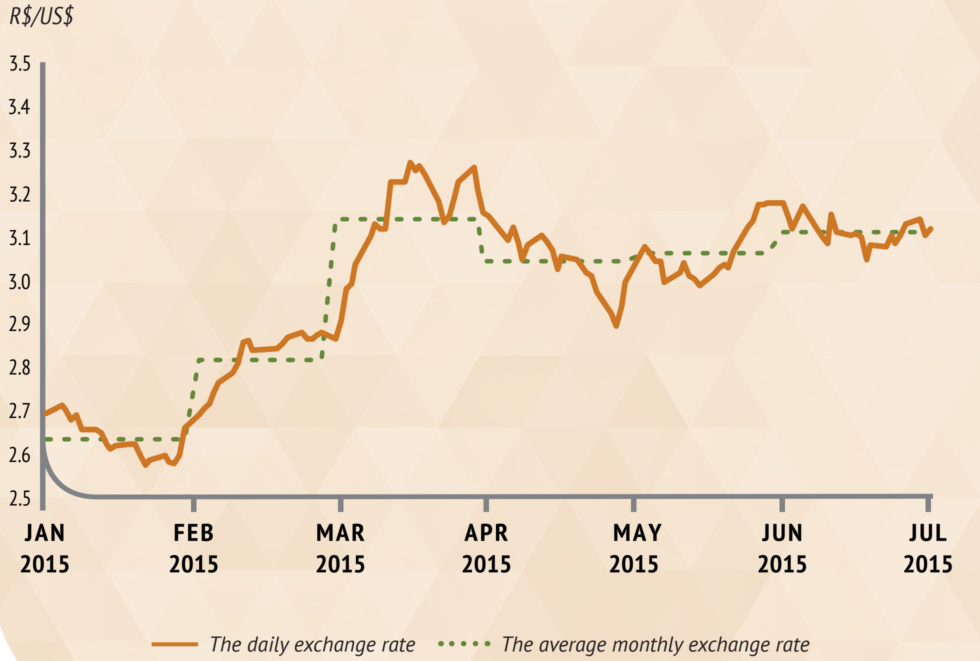
● **SHARP DECLINE IN IMPORTS SUSTAINS TRADE BALANCE.** In the year to June, the trade balance reached US$ 2.2 billion, way up from the US$ 2.4 billion deficit recorded during the same period in 2014. The significant reduction in imports explains the trade balance result in the first half of the year.

In the year to June, imports hit the mark of US $ 92.1 billion, down by 18.5% of value imported during the same period in the previous year. Comparing the first five months of 2015 with the corresponding period in 2014, the Funcex indices of import prices and volumes fell, respectively, by 10% and 9.9%.

All use categories experienced a drop in imports. In the January-May period this year, imports of fuels and lubricants dropped by 36.4% and those of durable consumer goods edged down by 21.3% from the same period of 2014. These categories have shown the worst results in terms of import value in the year. Imports of capital goods and durable consumer goods experienced the steepest decline in volume in the year to May: down by 19.1% and 20.1%, respectively.

Exchange rate becomes less volatile in the second quarter

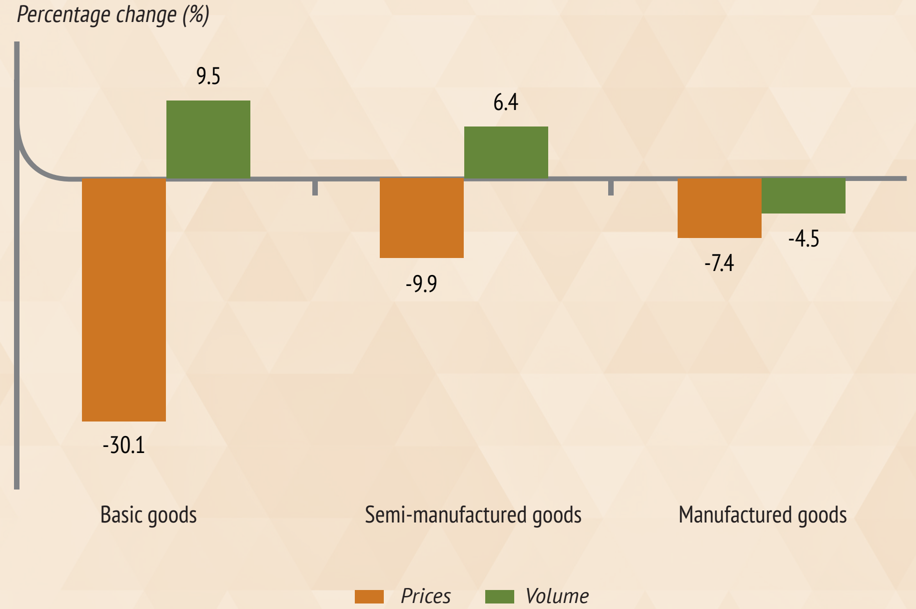
Exchange rate in 2015



Source: Central Bank of Brazil

Decline in export prices is not restricted to basic goods

Variations in export prices and volumes by product class between January-May 2014 and January-May 2015



Source: Funcex

The devaluation of Real, coupled with a strong slowdown in activity, investment and consumption, explains the strongly and generalized drop in imports

Given the specific use of these goods, such as machinery and equipment, the reduction in these imports is a reason for apprehension because it points to falling investment.

The devaluation of Real, coupled with a strong reduction in activity, investment and consumption, explains the strongly and generalized drop in imports. Since this scenario is not expected to change in the second half of the year, the downward trend will likely continue. For this reason, CNI estimates that imports will total US$ 197 billion in 2015.

Exports totaled US$ 94.3 billion in the year's first half, representing a 14% decline over the export value in the same period in 2014. The export price index calculated by Funcex shows a decrease of 19.7% from January to May 2015 over the corresponding period a year ago, while the export volume index increased by 3.6% during the same period.

The sharp decline in commodity prices was the main factor driving export prices down. However, the drop in prices is not restricted to basic goods. Comparing the first five months of 2015 with the same period in 2014, export prices of basic goods, semi-manufactured products, and manufactured goods edged down by 30.1%, 9.9% and 7.4%, respectively. On the same comparison basis, export volumes of basic and semi-manufactured goods increased by 9.5% and 6.4%, respectively, while those of manufactured goods fell by 4.5%.

In June, average daily exports dropped by 8.7% as compared to the same month in 2014, a less pronounced drop than that recorded in the year to May (16.2%). The fact that the US$ 690 million export of an oil rig in June was accounted for in the calculations contributed to this result. In addition, one can see that exports showed a positive performance in June, indicating a possible rebound driven by the exchange rate depreciation. This relative improvement in exports is expected to continue in the second half, but not to a greater extent. Considering all these factors, CNI estimates that exports will total US$ 202 billion in 2015. The trade balance will thus hit the mark of US$ 5 billion by the end of 2015.

● **CURRENT ACCOUNT DEFICIT KEEPS FALLING.** The current account deficit in 2015 reached US$ 35.8 billion in May, down by 20.3% from the same period the year before. This lower deficit results partly from the annual depreciation of the Brazilian currency and partly from a weak activity of the Brazilian economy. In addition, the improvement in the trade balance has also helped bring down the current account deficit.

The deficit on international travel reached US$ 5.7 billion, 25% lower than the level recorded in the same period of 2014. This decrease would be another consequence of the devaluation of the Brazilian currency in 2015, which increased costs for Brazilians travelling abroad and helped reduce the current account deficit.

The current account deficit was partly financed by direct investments. After the January drop, foreign direct investment grew again and hit the mark of US$ 25 billion in the year to May. This figure, however, is 35% lower than that observed in the same period in 2014.

CNI estimates that the current account deficit will keep falling by the end of the year and amount to US$ 81 billion, down by 23% from 2014's level.

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2013	2014	2015 previous forecast (04/14/2015)	2015 current projection (07/09/2015)
ECONOMIC ACTIVITY				
GDP (annual change)	2.7%	0.1%	-1.2%	**-1.6%**
Industrial GDP (annual change)	1.8%	-1.2%	-3.4%	**-3.8%**
Household consumption (annual change)	2.9%	0.9%	-0.6%	**-1.2%**
Gross fixed capital formation (annual change)	6.1%	-4.4%	-6.2%	**-7.7%**
Unemployment Rate (annual average - % of the labor force)	5.4%	4.8%	6.7%	**6.7%**
INFLATION				
Inflation (IPCA index - annual change)	5.9%	6.4%	8.1%	**9.1%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	8.29%	10.96%	13.12%	**13.47%**
(year's end)	10.00%	11.75%	13.50%	**14.25%**
Real interest rate (average annual rate and deflation: IPCA)	2.0%	4.3%	4.7%	**4.4%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	-3.05%	-6.23%	-4.97%	**-6.45%**
Public sector primary surplus (% of GDP)	1.77%	-0.59%	1.13%	**0.40%**
Net public debt (% of GDP)	31.5%	34.1%	35.7%	**36.4%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	2.35	2.64	3.10	**3.25**
(average in the year)	2.15	2.35	3.10	**3.10**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	242.2	225.1	208.0	**202.0**
Imports (US$ billion)	239.0	229.0	207.0	**197.0**
Trade balance (US$ billion)	2.6	-4.0	1.0	**5.0**
Current account balance (US$ billion)	*	-104.8	*	**-81.0**

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

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