CNI Newsletter
ISSN 1983-621X • Year 35 • Number 2 • April/June 2019

ECONOMIC REPORT

Brazilian National Confederation of Industry
THE FUTURE OF INDUSTRY

Economy needs stimuli to overcome stagnation

An economic agenda for the post-Pension Reform period is urgently necessary

The second half of the year began with positive developments,such as the approval of the Pension Reform by a large margin in a first vote at the lower house of Brazil's Congress, but also with the realization that economic activity is stagnant. This dual situation clearly suggests the country's priorities to focus on in the second half of the year: continuing to press for the reform agenda as a key requirement for laying the foundations for long-term growth while promoting short-term actions to rekindle demand. CNI's current forecast for GDP growth in 2019 has shrunk to 0.9%, in a scenario without more substantive changes in economic policy.

The results of the analysis of the first half of the year are quite indicative of the slump that marked economic activity during the period. Industrial activity has been sluggish, as captured by both production data calculated by the Brazilian Institute for Geography and Statistics (IBGE) and CNI surveys. The evolution of retail trade and services has been equally disappointing. As a result, job creation has been insufficient to reduce unemployment and increase the purchasing power of households.

GDP data for the second quarter are not yet available, but estimates point to near-zero growth, confirming a scenario of three straight quarters of economic stagnation. Consumption has been unresponsive, investment remains stagnant, and exports are experiencing difficulties. Therefore, private sources of demand remain too weak to rekindle the economy. Although the confidence of private agents is relatively high, endogenous forces of the economy have not been sufficient to boost productive activity.

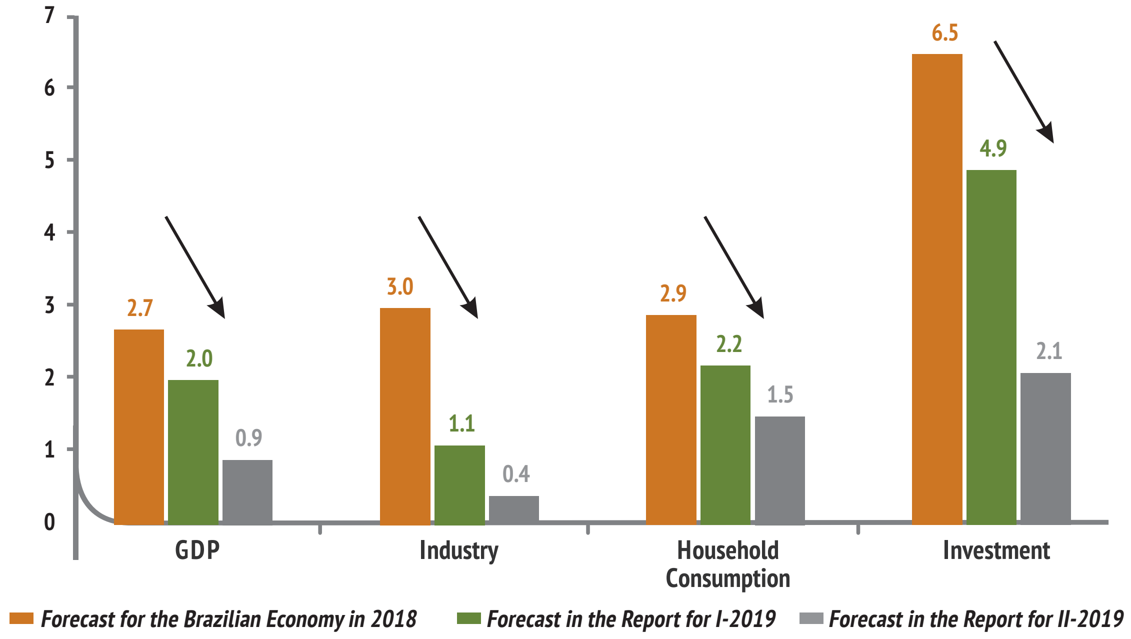
In this environment, it is imperative that government takes action to boost private demand in the short term. In a scenario of weak fiscal accounts,

(continued on the next page)

The Brazilian economy in the second quarter 2019

Successive frustrations with economic performance

Projections for GDP and its components in 2019
As a percentage (%)



Projected by: CNI

which is the main reason of the deep crisis Brazil has been facing since 2014, the natural path for addressing the situation is that of credit and monetary policy.

As the most obvious measure, the Central Bank should reduce the basic interest rate (Selic rate). There is no reason for the Selic rate to be kept at its current level of 6.5%, as has been the case since March 2018. Inflation is below the target center and inflation expectations have been kept low both by the absence of demand pressures and by high resource idleness, as well as by the appreciation of the exchange rate in the wake of favorable expectations resulting from the approval of the Pension Reform. In this scenario, postponing reductions in the Selic rate has a high cost in terms of economic activity, with effects on employment and on tax revenues.

It is also necessary to improve access to credit and release available funds not fully utilized. Clearing financing channels by setting up a guarantee system for small and medium-sized enterprises is an action that can be taken without resorting to fiscal resources. Reducing compulsory deposits, which are higher in Brazil than in other countries, is equally important.

Releasing funds from active FGTS (Warranty Fund for Severance Pay) accounts has the potential to leverage consumption, as confirmed by a similar experience in 2017. This can be achieved both by the direct effects of this measure on the purchase of goods by households and by its contribution to improving the financial situation of individuals. However, its effects are limited and depend on the amount of funds released immediately.

These are short-term actions that can leverage a response from private demand by creating opportunities for a response from investment not only to meet future economic expectations as structural reforms advance, but also as a requirement for reducing idle capacity.

The solution to resuming sustained growth does not lie in short-term topical measures. Nevertheless, economic policy cannot disregard the daily problems of companies and households. It is imperative that the economic agenda reconcile two priority areas. On the one hand, it must promote progress on structural issues - such as on the tax reform, on privatization, on improving the regulatory framework of the economy - to pave the way for increased supply in the medium and long term. On the other hand, it must contemplate actions designed to rekindle demand in the short term.

Success in this dual agenda will likely materialize as a lever for a new virtuous growth cycle.

ECONOMIC ACTIVITY

Economic growth is frustrated once again

Economy closes first half of 2019 nearly stagnant

The second quarter of 2019 was once again frustrating in terms of economic growth. Data available to date suggest stability or, at best, growth of 0.2% over the first quarter. In particular, preliminary data for June consolidate lower expectations for the quarter and contaminate expectations for the following quarter.

Regardless of the final figures for the past quarter, the results are disappointing, as the economy has been very close to stagnation since the end of the crisis.

The weak activity recorded in the first half of 2019 led us to revise our projections for the year downward. We are projecting a growth of only 0.9%, against our previous forecast of 2%. Therefore, we are now projecting another year of frustration with low economic growth: in late 2018, GDP growth projections for 2019 exceeded 2.5%.

INDUSTRY WILL LIKELY ONCE AGAIN GROW LESS THAN 1% THIS YEAR

A CNI's projection for industrial GDP growth in 2019 was once again revised downward from 1.1% to only 0.4%. The weak results recorded in the first quarter, coupled with the problems faced by the mining and quarrying industry, explain this downward revision. Today, it can be said that, technically, the mining and quarrying industry is facing a recession: the sector shrunk by 0.7% in the first quarter of 2019, after decreasing by 0.3% in the previous quarter.

Manufacturing GDP declined by 0.5% in the first quarter of 2019, after shrinking by 0.9% in the previous quarter. The second quarter had recorded numbers that are more positive in early April, but the result in May was negative. After growing by 1.2% in April, industrial production (PIM-PF/IBGE) declined by 0.5% in May; turnover (Industrial Indicators/CNI) increased in turn by 3.1% and then dropped by 2.2%. Preliminary data for June do not suggest that recovery is in progress in the month.

A number of factors have been hindering a faster recovery in industry, such as low demand. CNI's Industrial Survey shows that concern about low domestic demand has regained prominence among the main problems faced by industry, climbing to 2nd place in the ranking, behind only the high tax burden prevailing in the country (which usually ranks first). Weak external demand is also gaining importance in this same list of major problems.

This lack of demand has been generating excess inventories. The same survey shows that the industry has been accumulating excess inventories since February of this year.

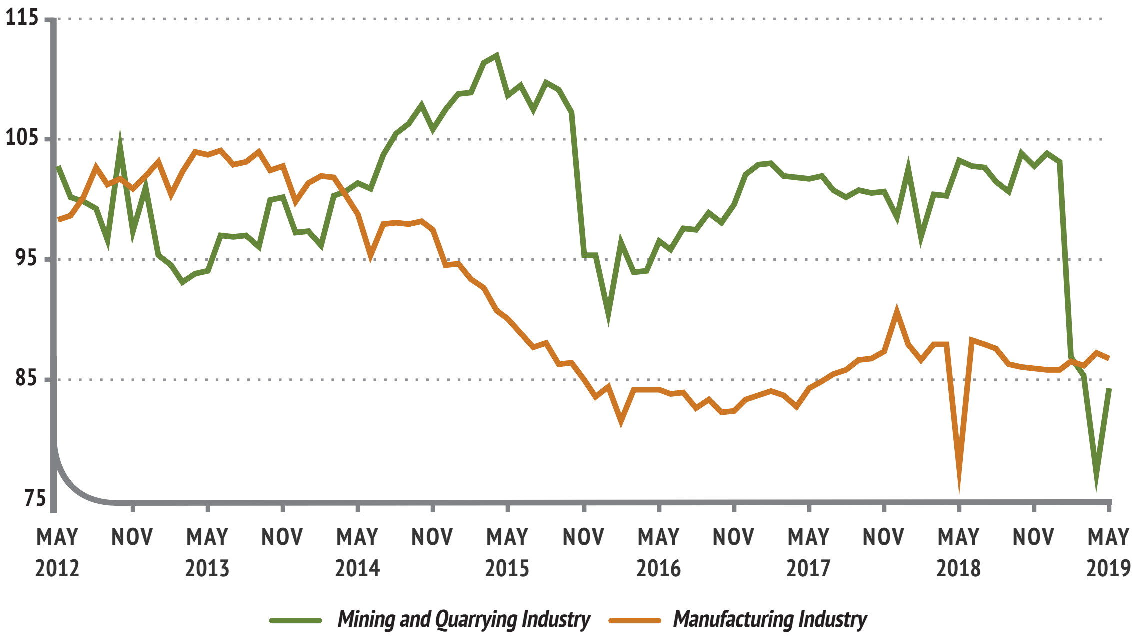
For the second quarter of 2019, we are projecting growth in manufacturing industry, despite the limitations imposed by the above-mentioned factors. The negative result recorded in the first quarter, coupled with our expectation of a marginally positive second quarter, had a strong carry-over effect on the growth forecast for the year. Despite the growth expected for the second half, CNI is projecting low growth for manufacturing industry in 2019: only 0.4%.

The mining and quarrying industry experienced in turn a decline of 6.3% in the first quarter of 2019, particularly as a result of the Brumadinho dam rupture. Its consequences, such as the interruption of other extractive activities, especially in Minas Gerais state, affect the result in the second quarter. The heavy rainfall recorded in Pará state also had a bearing on that result. Data for industrial production (PIM-PF/IBGE) show that it declined by 12%, considering the result recorded in the April-May quarter against the one observed in the first quarter of 2019. These impacts, which were more intense than previously anticipated, led us to revise the sector's performance downward once again, from a decrease of 0.2% to one of 2% in 2019.

The forecast for the construction industry was also revised downward from a growth of 0.3% in 2019 to stability. The first quarter saw a sharp drop of 2% in the sector's GDP in relation to the previous quarter, contaminating the result for the year. The industry will likely record better results throughout the year, offsetting the drop from the first quarter throughout 2019. Construction

Mining and quarrying industry on the decline and manufacturing industry nearly stagnant

Industrial Production - Manufacturing and Mining & Quarrying Industry
Index Number - 2002 Base = 100, seasonally adjusted



Source: PIM-PF/IBGE

and buildings sector, which has been showing some signs of recovery, will explain this improved performance.

Infrastructure remains the biggest challenge for industry. Without fiscal space, public investment remains rather depressed. Project concessions for the sector are being granted on a piecemeal basis and uncertainties about the "post-Pension Reform" agenda have been postponing the implementation of part of the projects.

Public Utility Industrial Services (SIUP) recorded growth in the first quarter of 2019, of 1.4% in relation to the previous quarter (3.3% growth over the past four quarters). This led us to revise our growth projection for 2019 upward from 2.4% to 3.5%.

GROWTH IN SERVICES LIMITED BY LOW ECONOMIC ACTIVITY

The growth expected for the service industry in 2019 was also revised downward from 2.2% to 1.1%. This revision can be mainly attributed to services focused on productive activity. The drop recorded in transportation services, in particular, is explained not only by weaker industrial activity, but also by a certain degree of verticalization resulting from uncertainties about the problem of freight pricing.

In addition, services focused on households and retail trade showed some moderation in the first half of 2019, following a clearer upward trend in 2018. The decrease observed in consumer confidence in early 2019 and weak job creation restricted possibilities for more positive developments.

Agriculture is the only GDP segment on the supply side for which there was no downward revision: our forecast of a growth of 1% in 2019 has been maintained. Still, this growth rate is weak.

INVESTMENT IN 2019 WILL REMAIN LOW

The performance of Gross Fixed Capital Formation will likely be weaker than in 2018. CNI's forecast for investment growth has been revised downward from 4.1% to 2.1%. It will be the second consecutive year with investment on the rise, but its growth is still not sufficient to reverse the decrease recorded in the previous four years: investment is projected to increase by 6.3% in the biennium, against a 29.4% decrease between 2014 and 2017.

The fact that idleness in manufacturing industry remains high discourages investment, as well as the above-mentioned difficulties faced by the construction industry, especially with regard to the infrastructure sector.

In addition, two other factors continue to restrict investment: disbursements by public banks, especially by Brazil's Development Bank (BNDES), have been declining since last year and the fiscal adjustment underway restricts government investment.

It is also noteworthy that, in part, the growth recorded in investment in 2019 - as in 2018 - is explained by a change in the REPETRO regime designed to grant special tax treatment to investments in oil and gas. This change generates merely accounting flows of "imports" of oil rigs that inflated investment in 2018 and are still affecting the result in 2019.

The forecast for household consumption growth has also been revised downward from 2.2% to 1.5%. Still, household consumption will once again be the main driver of GDP growth in 2019.

A number of factors led to this downward revision. The unemployment rate has been falling only modestly and this trend is likely to continue until the end of the year. In addition, consumers have resumed the more cautious stance that they had abandoned shortly after the election period, and fear of unemployment also increased in the first half of the year, putting an additional brake on consumption.

We maintain our forecast for government consumption at 0.2%, as government resumed a contractionary fiscal policy in 2019, leading to expectations of decreased spending (see the section Fiscal Sector). Therefore, government consumption remains limited by adjustment requirements.

With regard to imports, purchases related to record agricultural crops have led to a large increase in the volume of imports of intermediate goods. The impact of the REPETRO regime on imports of capital goods was also felt once again. Thus, we are projecting a 5.9% increase in imports of goods and services.

As for exports, the crisis in Argentina has been limiting sales of manufactured goods. On the other hand, the meat segment is experiencing a favorable period after the embargoes imposed last year were lifted. In the international scenario, high uncertainties still prevail about the tensions between the US and China, but the monetary easing in several economies will likely prevent a further reduction in world growth. As a result, we are projecting that exports of goods and services will increase slightly above 3.5%, as projected in the first quarter. Thus, the external contribution to GDP will likely be negative by 0.3 percentage points.

Estimate for GDP and its components in 2019

Projected percentage change

	GDP COMPONENTS	Percentage change (%)
Demand side	Household consumption	1.5
	Government consumption	-0.2
	Gross fixed capital formation	2.1
	Exports	3.5
	(-) Imports	5.9
Supply side	Agriculture/livestock	1.0
	Industry	0.4
	Mining and quarrying	-2.0
	Manufacturing	0.4
	Construction	0.0
	Public utility industrial services	3.5
	Services	1.1
PIB		**0.9**

Projected by: CNI

ISSN 1983-621X • Year 35 • Number 2 • April/June 2019

CNI

EMPLOYMENT AND INCOME

Labor market still on a modest recovery trend

Without investment, the unemployment rate will remain high

The labor market continues to recover slowly in 2019, reflecting the low dynamism of the Brazilian economy. The unemployment rate has been declining modestly and successive economic growth revisions (see the section Economic Activity) suggest that this behavior will continue in the second half of the year.

Real average income and total payroll growth slowed down in the first five months of the year compared to the same period last year, and employment growth was slightly lower on the same basis of comparison.

As a result, we expect the performance of employment and income indicators in 2019 to be similar to that recorded in 2018, well below initially foreseen for this year. CNI expects the average unemployment rate in 2019 to remain at 12.1%, only 0.2 percentage points lower than last year.

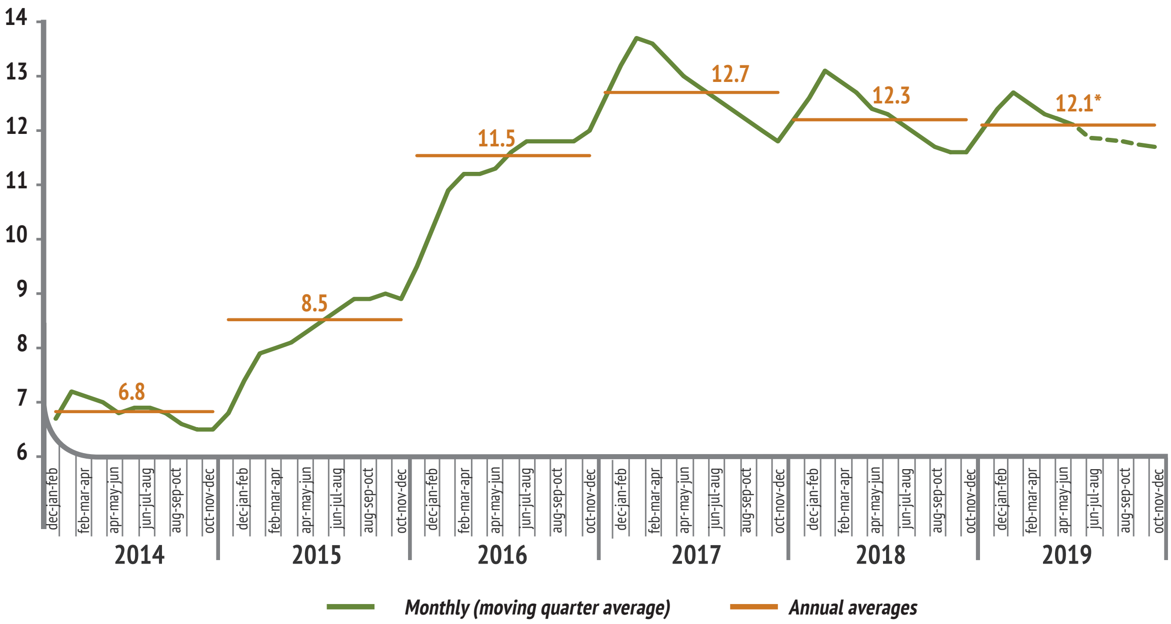
UNEMPLOYMENT RATE AT A LEVEL VERY SIMILAR TO THAT RECORDED IN 2018

The unemployment rate, as measured by the Continuous Pnad/IBGE survey, fell from 12.5% to 12.3% of the workforce between April and May in the measurement of the moving quarter. This is the second consecutive drop in the indicator, following the usual declining path observed from the second quarter of each year on due to seasonal effects. Despite this drop, unemployment remains quite high, affecting almost 13 million economically active people.

The unemployment rate will likely continue to decline until the end of the year, but at an insufficient pace to ensure a significant reduction in the indicator. Therefore, the average unemployment rate will likely remain at a high level and reach 12.1% of the workforce, just 0.2 percentage points below the 12.3% rate recorded in 2018.

Unemployment rate will remain high

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



Source: Continuous Pnad/IBGE survey
**Projected by CNI*

FORMAL JOBS IN RETAIL CONTINUE TO DECLINE

Brazil created 359,000 formal jobs in the year up to May, according to the General Registry of Employed and Unemployed Persons (CAGED). This result is similar to that observed over the same period in 2018, when 374,000 jobs were created.

The balance for the first five months was positive for almost all sectors of the economy, except for the retail industry, in which a net loss of 82,500 jobs was recorded in the year.

The industrial sector recorded a net creation of 125,800 jobs in the year up to May, mainly in the manufacturing industry (80,000 jobs) and in the construction industry (42,000 jobs). The mining and quarrying industry and Public-Utility Industrial Services (SIUP) saw a net creation of 2,800 and 1,200 jobs, respectively.

As a result, the net balance of formal jobs in the 12-month period up to May totaled 494,000 formal jobs, the same number of jobs recorded over the same period in 2018.

Despite a more favorable fiscal and monetary environment - resulting from the approval of the base text of the Pension Reform bill and from prospects of a reduction in the Selic rate - no significant improvement in the pace of formal employment growth is expected this year. Net formal employment growth, as measured by CAGED, will likely remain at about 500,000 jobs in 2019.

GROWTH RATE OF REAL INCOME AND TOTAL PAYROLL SLOW DOWN

The growth rates of real average earnings usually received by employed persons and total payroll slowed down in the first five months of 2019 in relation to the same period in 2018. Between January and May, real income increased by 0.8%, against 1,0% over the same period last year. Total payroll increased in turn by 2.6% against 2.9% in 2018 on the same basis of comparison, according to data from the Continuous Pnad/IBGE survey.

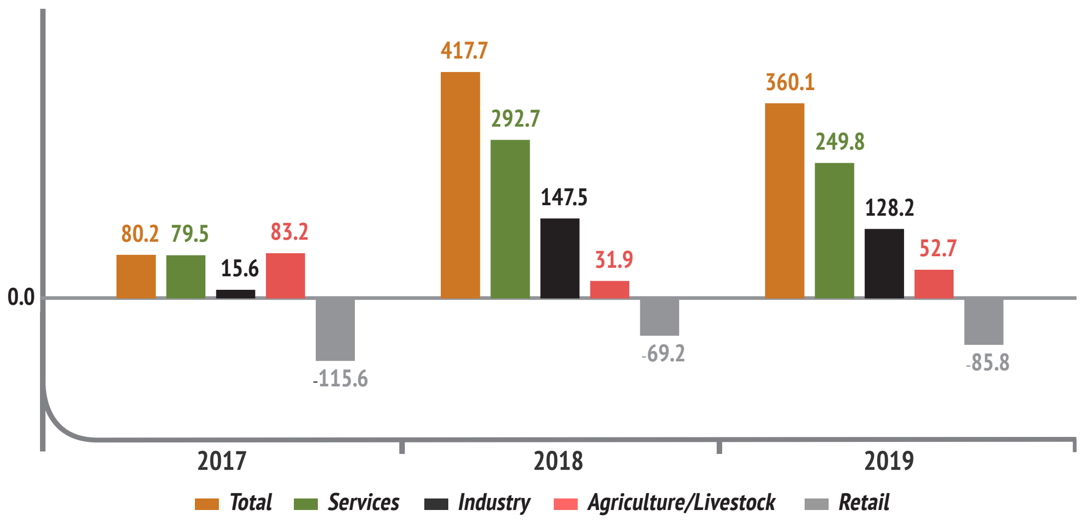
The rise in employment, particularly in employment without a formal contract and in underemployment due to insufficient working hours, explains part of the modest increase recorded for real average income, as wages for these occupations are usually lower.

In the coming months, real income will likely continue to grow at the same modest rate. In addition to an expected increase in informal employment, the high number of unemployed people coupled with weak demand for labor - due to weak economic activity - will continue to push wages down.

The indicator will likely close 2019 at an average rate very close to that observed in 2018, when it increased by 1.0%. Thus, and considering that occupational growth is likely to slow down compared to last year, real total payroll is expected to grow by 1.5% in 2019, against 2.0% in 2018.

Economy saw a net creation of 359,000 jobs in the year

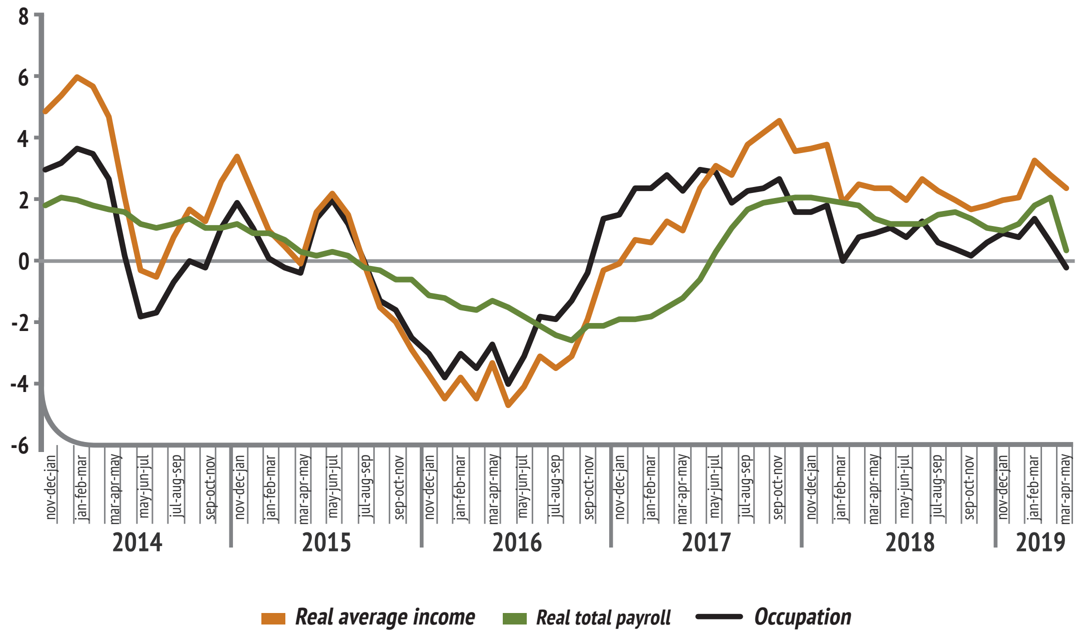
*Net balance of formal jobs**
Thousand jobs (from January to May 2019)



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

Lower real total payroll growth in 2019

Real Average Income, Real Total Payroll and Occupation
Variation as compared to the same mobile quarter the year before (%)



Source: Continuous Pnad/IBGE survey

EMPLOYMENT RECOVERY REQUIRES ECONOMIC RECOVERY

Recovering jobs is one of the main challenges facing Brazil today. There are almost 13 million economically active people without a job and a protracted recession has also reduced the willingness of Brazilians to look for a job. The number of discouraged workers increased from 1.5 million in 2014 to 4.9 million in 2019.

In addition, the long-term unemployment rate increased. The number of unemployed people who had been looking for a job for more than two years rose by 42.4% due to the crisis: from 17.4% in the first quarter of 2015 to 24.8% over the same period in 2019. This growth will end up shifting part of this group of unemployed people to the group of discouraged workers, since the longer they stay out of the labor market, the less likely they are to be reemployed.

The labor market is also experiencing a significant increase in employment without a formal contract and in the number of underemployed workers due to insufficient working hours. This dynamic is expected, as underemployment and informality become alternatives when the labor market deteriorates. However, the persistence of this scenario puts a negative pressure on real income and hinders consumption and production, since instability in employment creates insecurity not only for workers, but also for companies, due to the possibility of increased default risk.

To reverse this scenario, measures must be taken to stimulate economic activity, such as measures to improve the business environment and reduce the cost of capital. The cycle of reductions in the Selic rate that is expected to start at the next meeting of the Monetary Policy Committee (see the section Inflation, Interest Rates and Credit) will be an important catalyst in creating this more investment-friendly environment.

One-off actions, such as the likely release of funds from the Warranty Fund for Severance Pay (FGTS), may play an important role in rekindling the economy, since they improve the financial situation of households and stimulate domestic demand, creating opportunities for a response from private investment.

INFLATION, INTEREST RATES AND CREDIT

New cycle of reductions in the Selic rate is expected

Inflation below the target center makes it possible for the Selic rate to be reduced

In the first six months of 2019, the dynamic of the Broad National Consumer Price Index (IPCA) was positive within the limits set by the Monetary Policy Committee (Copom).

In the last two months, the dynamics of the inflation rate has been even more positive, with a 0.13% variation in May and one of only 0.01% in June. As a result, in the 12-month period to June, the rate stood at 3.75%, well below the inflation target center of 4.25% set for 2019.

In the first four months of 2019, the group that pushed inflation up the most was that of food products. Food prices spiked due to the strong seasonality of items such as tomatoes, potatoes, beans, and fruits at the beginning of the year. In the last two months, however, negative price variations were recorded for this group. In the year to date, food prices rose by 3.4%. In the last 12-month period to the end of June, they increased by 3.9%; and in the 12-month period to June 2018, they remained stable.

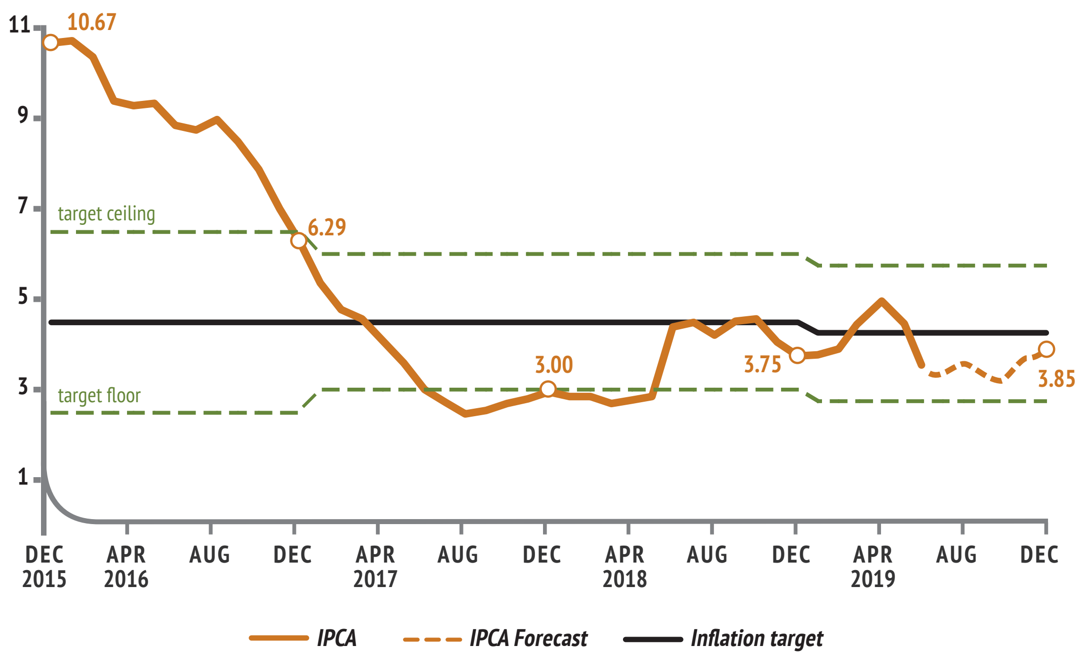
Service prices, in turn, tended upward in 2019. Increases in monthly payments at the beginning of the year and, more recently, the rise in restaurant prices and airfare tickets pushed prices in this group up, leading to a year-on-year increase of 1.8% until June. Over the last 12 months, the group's inflation hit the mark of 3.9%, against 3.1% in the 12 months to June 2018.

Government regulated prices were the ones that dropped the most among the four main groups considered for calculating the IPCA index. They rose by 3.6% in the year, influenced by the drop in fuel and electricity prices in June. In 12 months, prices in this group increased by 4.4%. In the 12-month period to June 2018, government regulated prices increased by 13.8% as a result of adjustments in gasoline and electricity prices, with the latter being charged at red flag level 2 during this period.

CNI expects the inflation rate to remain below the target in 2019 due to the high idleness in the

Inflation will likely close 2019 below the target center

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



Source: IBGE and Central Bank of Brazil
CNI Forecast

economy and to a still high unemployment rate, which have been repressing demand. Considering this scenario, a slight increase in current inflation is expected and, as a result, the IPCA index is likely to close the year at 3.85%.

MONETARY POLICY TO BE EASED BEFORE JULY IS OVER

The Central Bank of Brazil (BACEN) may initiate a new cycle of reductions in the Selic rate at the next meeting of the Monetary Policy Committee (Copom) in late July. This may be done for a number of factors: the positive behavior of product and service prices, as inflation is expected to remain below the target center this year and the next; successive revisions of economic growth forecasts, currently below 1%; and exchange rate appreciation resulting from favorable expectations about the approval of the base text of the Pension Reform bill.

The prospect of monetary easing is reinforced by the global movement toward reducing the Selic rate, especially in emerging countries, in anticipation of the expected cycle of US interest rate cuts. The monetary easing is intended to reduce the pace of global economic slowdown, which has been intensified by trade tensions.

There is room for a 0.5 percentage point cut in the Selic rate at the next Copom meeting in late July and a reassessment of risks may lead to further reductions by the end of the year.

CNI expects the Selic rate to be reduced by up to 1.25 p.p. over the next four meetings of the Monetary Authority and, as a result, the rate may close 2019 at 5.25% per year. If this happens, the basic interest rate will be reduced to a new historical level this year.

The new cycle of falling interest rates is also supported by an agenda of policies and measures designed to ensure macroeconomic stability, especially fiscal stability.

With the Selic rate at 6.50% per year currently and the inflation expected for the next 12 months at 3.5%, according to the FOCUS survey carried out by the Central Bank, the real interest rate (ex-ante concept, which considers future inflation) stood at 2.6% per year in June.

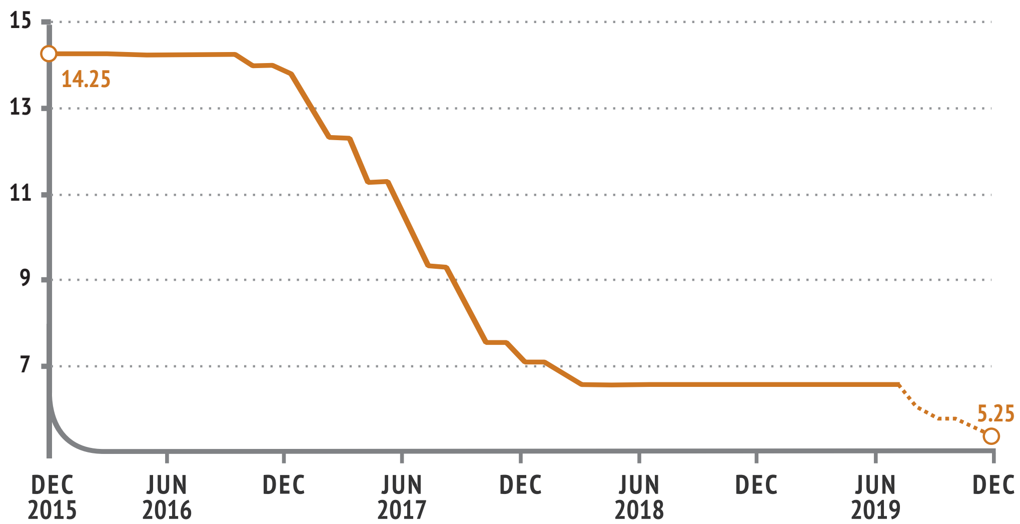
Although the basic interest rate is now at 6.5%, the bank spread - the difference between the interest rate agreed upon for loans and financing (application rate) and the rate financial institutions pay on deposits and borrowings - keeps the interest rates paid by borrowers among the highest in the world. The average interest rate on non-earmarked credit operations stood at 38.5% in May 2019 (19.5% for companies and 52.9% for individuals).

CREDIT MARKET IMPROVES MORE MODESTLY

Lending continues to grow in 2019 in relation to 2018. Comparing the 12-month period to May 2019 with the same period the year before, total lending increased in real terms by 6.8% against 4.9% in 2018 on the same basis of comparison.

Selic rate will likely reach a new all-time low in 2019

Selic rate
End-of-period rate (% per year)



Source: Central Bank of Brazil

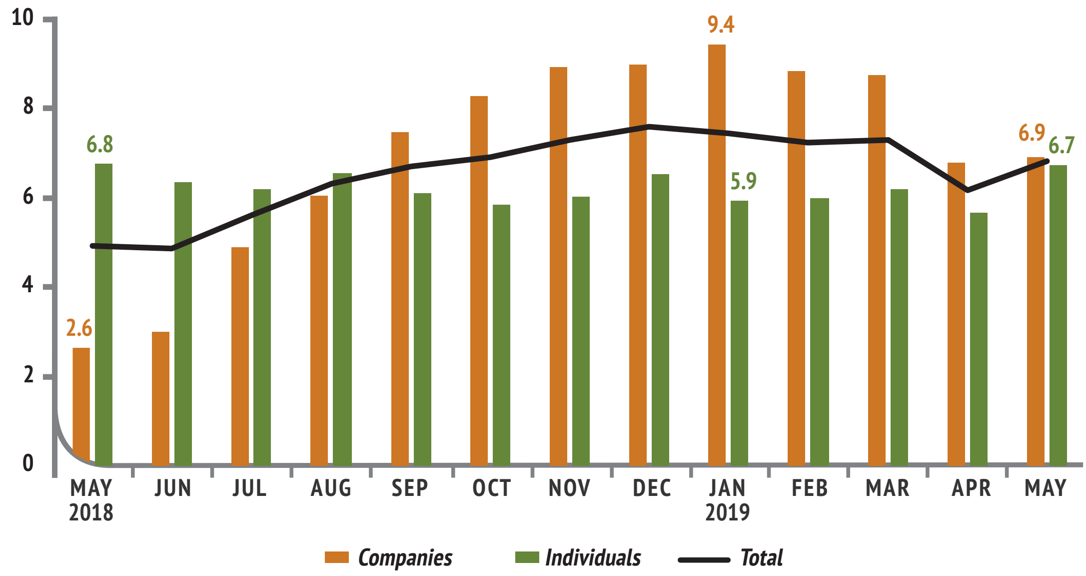
For companies, lending grew by 6.9% (against 2.6% in 2018), while for individuals it increased by 6.7%, the same growth rate observed in 2018. However, it is noteworthy that the lending growth rate has been slowing down over the year, especially for companies.

On the other hand, total credit stocks, which fell over the last three years, resumed an upward path in the year-on-year comparison, but their growth also slowed down over the year. In real terms, total credit stock increased by 0.6% in May in relation to the same month in 2018. In January, the indicator had increased by 1.3% on the same comparison basis.

Credit stocks increased in May due to the balance of the loan portfolio of individuals, which grew by 4.8%. The balance for companies, however, continues to drop at an increasingly sharp rate: by -4.4% in May in relation to the same period in 2018.

Lending still on the rise in 2019

Lending, in real terms
12-month variation



Source: Central Bank of Brazil

Investment growth depends on credit policy agenda

A more intense growth rate of economic activity and labor market recovery depend on the resumption of investment. This in turn depends on different actions and initiatives in the credit market designed, on the one hand, to reduce bank spreads and, on the other, to ensure greater access to credit by expanding credit guarantees.

In this regard, and considering the significant decrease in finance made available by development banks to productive activities, it is imperative that Brazil pursues an agenda designed to promote greater competition in the financial market.

Some actions have already been taken for this purpose. The implementation of the so-called Positive Register (Complementary Law 166/2019) and BACEN Communiqué No. 33.455/2019, which set the guidelines that will guide the proposal for regulating the Open Financial System in Brazil (Open Banking), are measures that can help reduce asymmetry in information and decrease delinquency provisioning costs, the most important variable in the composition of bank spreads, according to the Monetary Authority.

From the point of view of guarantees and legal certainty, setting up a National Credit Guarantee System, as already provided for in the General Law for MSEs (Complementary Law 123/2006), and expected amendments to laws regulating bankruptcy and judicial recovery are agendas that can mitigate short-term difficulties for accessing finance.

Combining these actions with a new cycle of reductions in the Selic rate may make it possible to promote more significant reductions in the final cost of credit in the medium term, unlocking the economy and enabling employment and income to begin to recover.

Economic Report
ISSN 1983-621X • Year 35 • Number 2 • April/June 2019

FISCAL POLICY

Federal Government primary spending on a downward path in real terms once again in 2019

Fiscal targets will be achieved handily, but public debt is likely to rise

The fiscal policy of the Federal Government will likely be contractionary once again in 2019. Federal primary spending is expected to decrease in real terms after its increase in 2018 was interrupted by two consecutive years of negative real variation. Thus, the federal government will likely achieve the primary result target and observe the ceiling imposed on public spending growth.

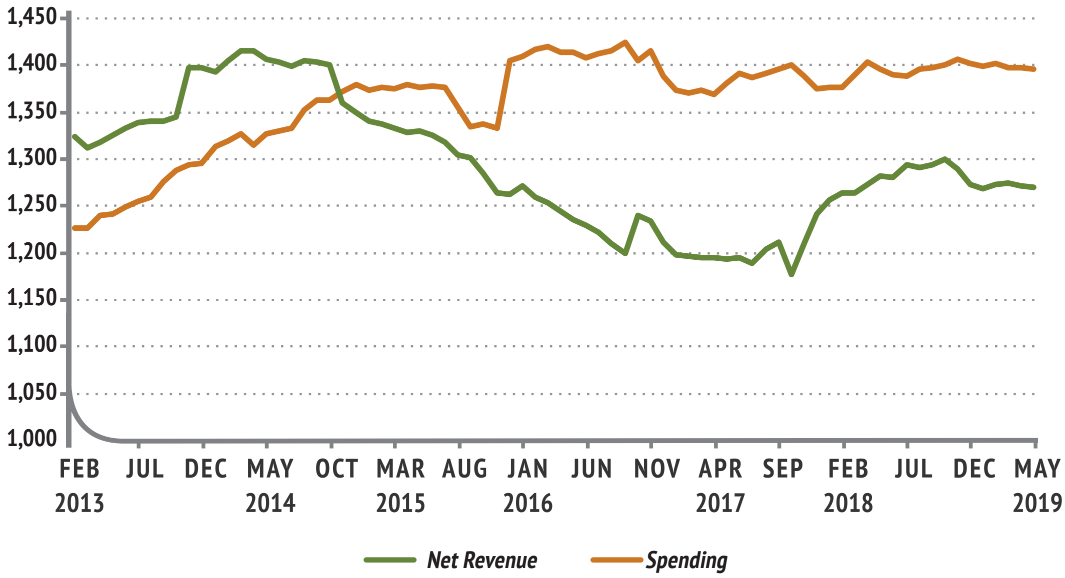
A significant increase in the primary surplus of states and municipalities will likely be recorded and, as a result, the public sector primary deficit will be lower than that observed in 2018. Still, the nominal deficit is likely to be higher than required to prevent public sector debt from rising again in 2019.

Keeping federal government spending under control is key for improving the fiscal situation in the short term, as the outlook for revenues is not positive. Apart from the slow pace of economic growth, two non-recurring factors that contributed to increase revenues in 2018 (debt installment payments to the federal tax authority and an increase in the PIS [Social Integration Program contribution]/Contribution to Social Security Financing [COFINS] on fuel) will have an opposite effect in 2019.

On the other hand, the revenues of regional governments will likely increase in real terms for the third year in a row. In addition to a real increase in revenues from their main tax, the ICMS (turnover)

12-month Federal Government spending decreased by 0.4% in real terms between December 2018 and May 2019

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



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

tax, regional governments will benefit from greater fund transfers from the federal government.

FEDERAL GOVERNMENT REVENUES AND SPENDING ON THE DECLINE

Federal government net revenues declined by 0.5% in real terms (IPCA deflator) from January to May 2019 in relation to the same period in 2018. In 2018, the net revenues of the federal government increased by 2.6% in real terms.

Revenues managed by the Internal Revenue Service (Receita Federal) put a lot of pressure on the net revenue result, which was 1.0% lower in the first five months of the year in relation to the same period the year before. This decrease was mainly due to a drop in revenues from debt installment payments and to a decrease in revenues from the PIS/Cofins on fuel contributions. In the latter case, the decline was caused by a reduction in taxation on diesel oil from June 2018, whose impacts were felt in the first months of 2019 but were absent in the same period last year.

Conversely, social security revenues increased by 2.6% in the first five months of 2019 compared to the same period in 2018. This increase was influenced by an increase in total payroll.

Revenues not managed by the Internal Revenue Service increased by 5.1% in real terms on the same basis of comparison. This increase was mainly brought about by higher revenues from concessions and permits, which were largely derived from a new contract for a hydroelectric power plant concession, and by an increase in the financial compensation for exploitation of natural resources resulting mainly from the devaluation of the Brazilian currency and atypical revenues in April due to changes in oil exploitation.

Spending in turn recorded a real decrease of 0.9% in the year up to May 2019 in relation to the same period in 2018. Despite an increase in spending on social security and personnel, declines in non-compulsory spending and other compulsory spending were sharper.

Social security spending had an impact on federal government spending and increased by 1.7% in real terms in the first five months of the year compared to the same period in 2018. This result can be explained by an increase in the number of beneficiaries and in the amount of pensions due to upward adjustments in January in the minimum wage and in pensions exceeding the minimum wage. Spending on personnel increased by 0.7% over the same period as a result of an increase in the wages of civil servants.

Non-compulsory spending decreased significantly between January and May 2019 in relation to the same period in 2018, declining by 15.8%. This spending declined in real terms for virtually all functions, but the decline in health and education spending was the sharpest.

Considering other compulsory expenses, other than spending on social security and personnel, there was a real reduction of 2.2%. In the case of other compulsory expenses over which the Federal Government has no control in terms of when they must be paid, reductions in the compensation for payroll tax relief and in subsidies and grants stand out. In the case of mandatory spending whose flow is controlled by the Federal Government, the sharpest reductions were recorded in health and education spending.

REVENUES AND SPENDING OF STATES AND MUNICIPALIES ON THE RISE

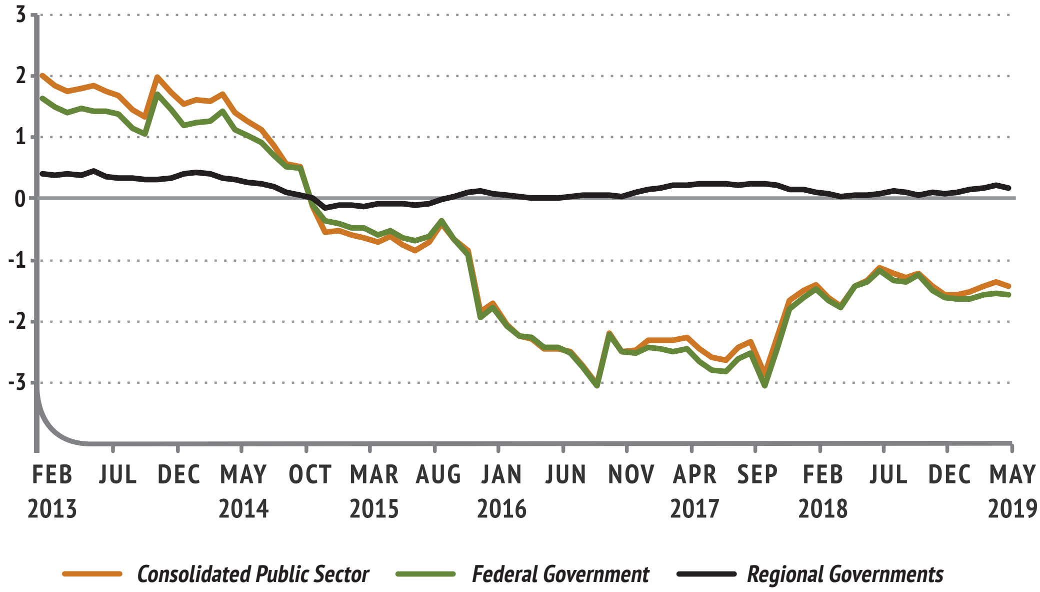
As opposed to the Federal Government, the revenues and spending of state and municipal governments are increasing. Based on the data available on the revenues of states and municipalities and on the behavior of their primary result, CNI estimates that the spending of regional governments increased by 1.2% in real terms in the year to April in relation to the same period in 2018.

Regarding revenues, the available data show a real increase of 3.6% on the same basis of comparison. Revenues from the ICMS tax, which is the main source of revenue for regional governments, increased by 2.5% in real terms mainly as a result of the performance of retail trade and of an increase in fuel prices. Revenues from other taxes increased by 3.2% on the same basis of comparison.

With regard to transfers from the federal administration, which constitute the second most important source of funds for states and municipalities, the real increase of 5.9% recorded in the first four months of 2019 in relation to the same period in 2018 can be explained by a rise in revenues from shared taxes (income tax and IPI tax) and from financial compensations for exploitation of natural resources.

12-month public sector primary deficit decreased by 0.15 percentage points of GDP in the first five months of 2019

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



Source: Central Bank of Brazil
Prepared by: CNI

LOWER PRIMARY AND NOMINAL DEFICITS HAVE NOT PREVENTED PUBLIC DEBT FROM INCREASING

A lower primary deficit of the federal government and a higher primary surplus of regional governments led to a drop in the primary deficit of the consolidated public sector in the first months of 2019 in relation to late 2018. The public sector recorded a primary deficit of R$100.4 billion (1.44% of GDP) in the last 12 months ending in May 2019. In December 2018, the negative result amounted to R$108.3 billion (1.59% of GDP).

As a result of this decline in the primary deficit and of stable spending on interest rates, the 12-month nominal deficit declined from 7.14% in December 2018 to 6.96% of GDP in May 2019. However, this reduction in the nominal deficit was not sufficient to stabilize the gross debt-to-GDP ratio, which increased from 77.2% in December 2018 to 78.7% in May 2019. It is noteworthy that this increase in the gross debt-to-GDP ratio could have been higher if the BNDES had not returned R$30 billion to the National Treasury in the first five months of 2019.

PRIMARY DEFICIT IN 2019 WILL LIKELY REMAIN AT THE SAME LEVEL RECORDED LAST YEAR

The federal primary deficit is expected to remain close to that seen in 2018, considering that the real decrease recorded in federal government spending in the second half of 2019 is likely to decline and net revenues are likely to improve slightly. The primary surplus of regional governments is in turn likely to close 2019 at a much higher level than that seen in 2018 due to the resumption by states of regular debt installment payments to the federal administration from July 2018. Thus, the primary deficit of the consolidated public sector is likely to close 2019 at a level close to the one observed in 2018.

The net revenue of the federal government is expected to decline by 0.3% in real terms in 2019 in relation to 2018. This improvement in relation to the result observed in the first five months of the year (real decrease of 0.5%) is likely due to an upturn in revenues managed by the Internal Revenue Service, which are expected to close 2019 with a real increase of 0.7% in relation to 2018. In addition to the effect of the real GDP growth expected to be seen in the second half of the year, it is likely that revenues managed by the Internal Revenue Service will no longer be negatively affected by the reduction in contributions from PIS/Cofins on diesel in the first half of 2019, which was not the case during the same period in 2018.

Net revenue growth will not be higher due to an expected contraction in revenues not managed by the Internal Revenue Service (-4.5%) and to the slowdown in the growth pace of social security revenues. As for revenues not managed by the Internal Revenue Service, the 5.1% growth observed in the first five months of 2019 will be reversed by the lower growth observed in revenues from financial compensation for exploration of mineral resources and concessions.

Federal government spending is in turn likely to close 2019 with a real decrease of 0.2% compared to 2018. This result will likely be due to a real decrease of 7.1% in spending on fixed costs and investment resulting from the financial programming of about R$32 billion in non-compulsory expenditures.

Conversely, spending on personnel and pensions is likely to record real growth in 2019. In the case of spending on personnel, the real increase of 4.9% is due to salary increases granted in January. In the case of spending on pensions, which is likely to close the year with a real increase of 2.8%, the pressure will come from an increase in pensions resulting from real increases in the minimum wage and in pensions exceeding the minimum wage. This pressure will be partially offset by the positive effects of measures designed to revise irregular pensions.

In this scenario, the federal government and its enterprises will likely close 2019 with a primary deficit of R$126.4 billion (1.76% of GDP as estimated by CNI). This result would be well below the target of R$142.5 billion set for 2019, but it would be higher than the primary deficit of R$112.7 billion (1.65% of GDP) observed in 2018.

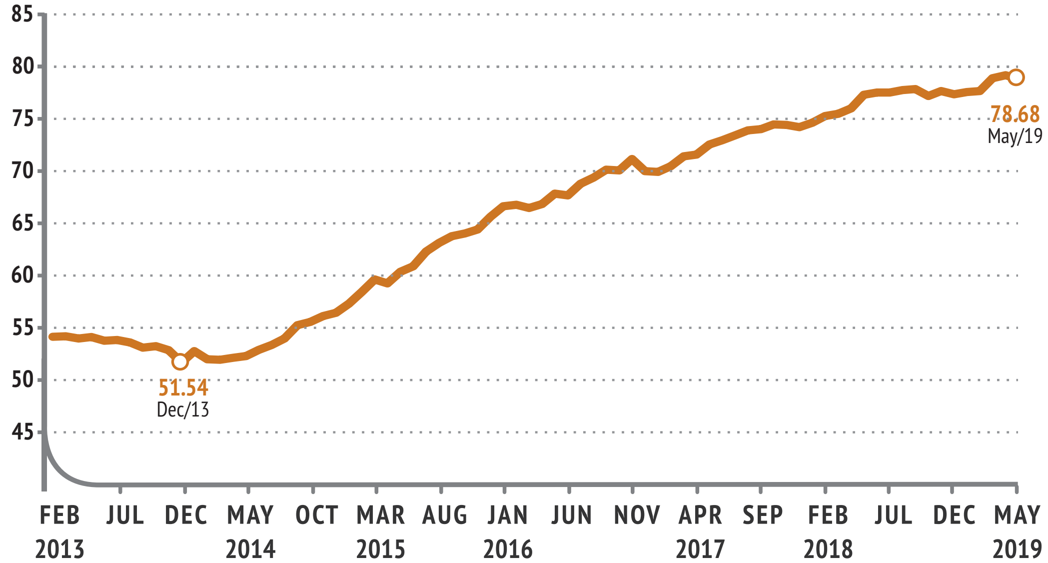
A reduction in the growth pace of revenues of regional governments observed in the early months of 2019 is likely mainly due to the less intense effect of financial compensations for exploitation of mineral resources on transfers received from the federal administration. Thus, the primary surplus of states and municipalities will likely fall slightly by the end of 2019 and hit the mark of R$10.5 billion in 2019 (0.15% of GDP as estimated by CNI).

As a result, the primary surplus of the consolidated public sector is expected to record a deficit of R$115.9 billion (1.62% of GDP as estimated by CNI) in 2019. This result would constitute a positive balance of R$16 billion in relation to the target of a deficit of R$132 billion set for 2019, but would be slightly higher than the 1.59% of GDP deficit observed in 2018.

This small increase in the primary deficit as a proportion of GDP will likely be offset by a reduction of 0.1 percentage point of GDP in nominal interest spending and lead to a slight decline in the nominal deficit from 7.14% of GDP in 2018 to 7.08% of GDP in 2019. This nominal deficit level is still higher than necessary to stabilize the gross debt-to-GDP ratio. Not even the return by the BNDES of over R$70 billion to the National Treasury will prevent the gross debt-to-GDP ratio from rising from 77.2% in 2018 to 79.2% in 2019.

Gross debt-to-GDP ratio increased by 1.5 percentage points in the first five months of 2019

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



Source: Central Bank of Brazil

Economic Report
ISSN 1983-621X • Year 35 • Number 2 • April/June 2019

FOREIGN TRADE SECTOR

Stable exchange rate and significant increase in direct investment

Domestic scenario contributes to a stable exchange rate and country risk

Brazil's foreign accounts continue to show stability, despite an unfavorable scenario abroad. Lower forecasts for world growth and trade conflicts make it difficult for Brazil to increase its trade flows.

In the foreign scenario, the crisis in Argentina continues to have a negative effect on exports of manufactured goods, which fell by 41.5% for that country in the first quarter of this year in relation to the same period last year. However, the trade surplus fell less than expected due to commodity exports.

The exchange rate and country risk (EMBI) took a downturn in mid-July, suggesting an improvement in the country's credibility and consequent strengthening of the real against the US dollar. The progress being made in passing the pension reform bill is the main domestic factor that contributed to the stability and appreciation of the national currency.

The current account deficit remains stable, with a slight drop in the twelve-month cumulative balance up to May of this year. However, direct investment over the same period reached its highest value in seven years, increasing the coverage margin of the current deficit.

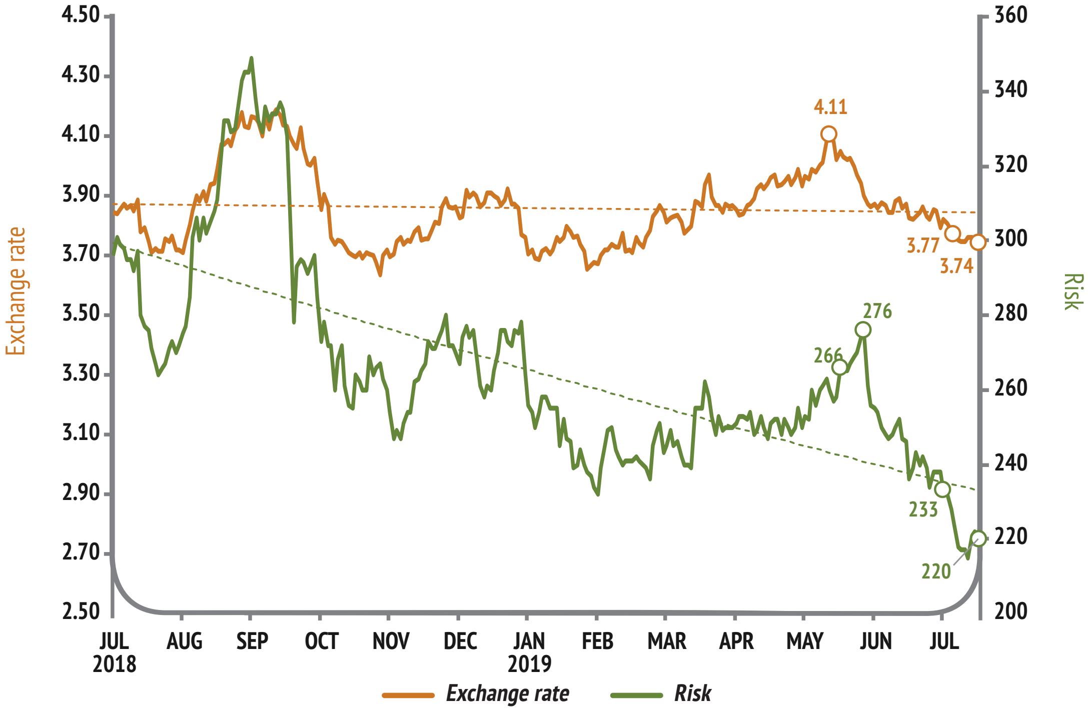
COUNTRY RISK AND EXCHANGE RATE APPRECIATION ON A DOWNWARD PATH IN JULY

The early second quarter of the year was marked by high exchange rate volatility and country risk (EMBI) variation, reaching R$4.11/USD1 and 276 points, respectively. As of June, both indicators showed more stability and a downward trend.

Brazil's country risk (EMBI) peaked in early June, but decreased by 56 points since then, reaching 220 points on July 19th. Over the last 12 months, the risk averaged 244 points, while in July the average was 226 points.

Stable Brazil risk influences exchange rate volatility

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



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

In July, the exchange rate averaged R$3.78/USD1 (up to July 19th), showing a 1.9% appreciation against the June average. The average exchange rate for the year is R$3.84/USD1 so far.

Foreign and domestic factors contributed to this less volatile scenario. In the foreign scenario, monetary easing measures adopted in several countries contributed to a slower deceleration of world growth and to the appreciation of the exchange rate. Commodity prices also stabilized, as well as the risk of emerging countries.

In the domestic scenario, the appreciation of the Brazilian currency was brought about by a decrease in uncertainties after the pension reform bill was approved in a first vote by the House of Representatives, even though doubts still linger about the progress being made on promoting other necessary structural adjustments for rekindling the Brazilian economy. If the political scenario is not favorable for implementing the post-pension reform agenda, the exchange rate will tend to fluctuate more intensely, reducing the predictability of Brazil's trade contracts and, consequently, having a negative effect on the trade balance.

We are projecting a slight appreciation of the Brazilian currency until the end of the year. As a result, the December 2019 average exchange rate would likely be R$3.75/USD1. The average exchange rate in 2019 would be about R$3.80/USD1, with the caveat that it might be lower if the economic reforms being proposed are actually approved.

TRADE BALANCE ON THE DECLINE IN THE FIRST HALF OF THE YEAR

In the year to date, the trade surplus amounted to R$28.5 billion, with exports at USD109.9 billion and imports at USD83.8 billion. The balance is 5% lower than that recorded over the same period in 2018. This decline is due to a 3.5% drop in exports, higher than the 0.04% decrease in imports, on the same basis of comparison.

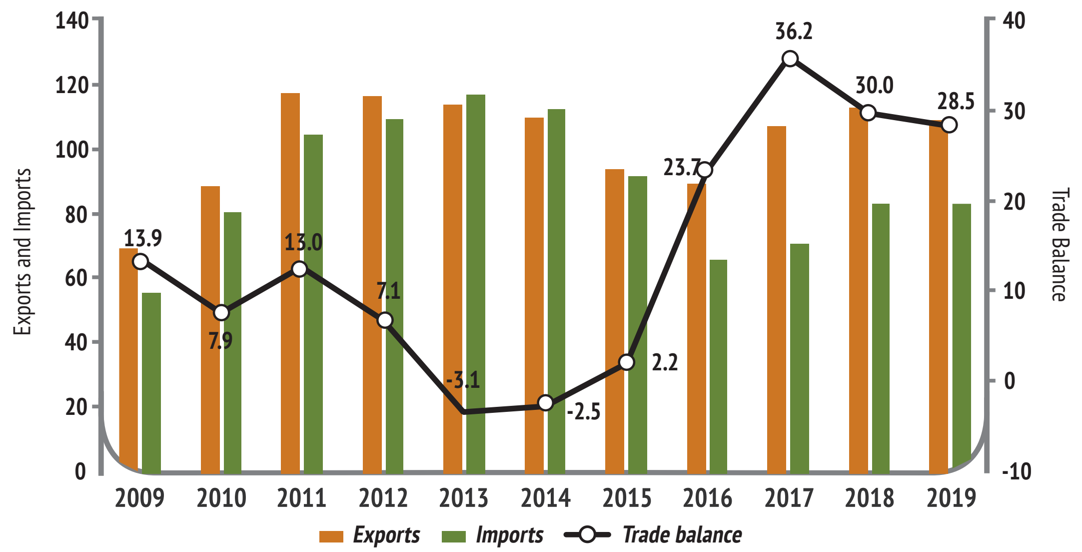
In the second quarter of this year, both imports and exports declined in relation to the second quarter of last year. Imports increased by 0.6% and exports decreased by 1.6%, resulting in a trade surplus 2.2% higher than that recorded over the same period in 2018. It should be noted that in the second quarter of last year the trade balance was affected by the truck drivers' strike.

Compared to the first six months of 2018, exports of capital goods declined by 19.1%, of intermediate goods by 3.8%, and of consumer goods by 6.2% in the year to June. Fuel exports increased in turn by 13.1%. According to the classification by aggregate factor, commodity exports increased by 3.3%, while those of manufactured and semi-manufactured products fell by 3.1% and 6.3%, respectively, on the same basis of comparison.

Exports continue to be affected by the crisis in Argentina, Brazil's third most important trading partner today. The Argentine crisis has been mainly affecting exports of manufactured goods. In the year to June, exports to Argentina decreased by

Trade surplus shows stability in the year to date

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



Source: SECEX/MDIC
Prepared by: CNI.

41.5% in relation to the first half of 2018. On the other hand, exports to the United States, mainly of manufactured and semi-manufactured goods, increased by 12.1%. The US is currently Brazil's second main trading partner, behind China only.

Imports recorded a 4.5% increase for capital goods and a 1.1% increase for intermediate goods in the year to June compared to the same period in 2018. For consumer goods and fuels and lubricants, imports fell by 7.1% and 1.7%, respectively. According to the classification by aggregate factor, the only group for which a decline in imports was recorded was that of manufactured goods, which decreased by 0.9% on the same comparison basis. Imports of basic and semi-manufactured products increased by 2.7% and 10.8%, respectively.

Currently, the international scenario does not seem to favor Brazil's trade balance. Factors such as the US-China trade war and the slowdown in world growth, coupled with the crisis in Argentina, do not leave much space for the trade surplus to rise. For 2019, CNI is projecting a cumulative trade balance of USD 48 billion, with exports recording USD 238 billion and imports USD190 billion.

TRADE DEFICIT UNDER CONTROL AND SIGNIFICANT INCREASE IN DIRECT INVESTMENT

Despite a slight worsening of its trade balance, Brazil's foreign accounts continue to show solid results due to the volume of direct investment, which has been more than sufficient to cover its current account deficit.

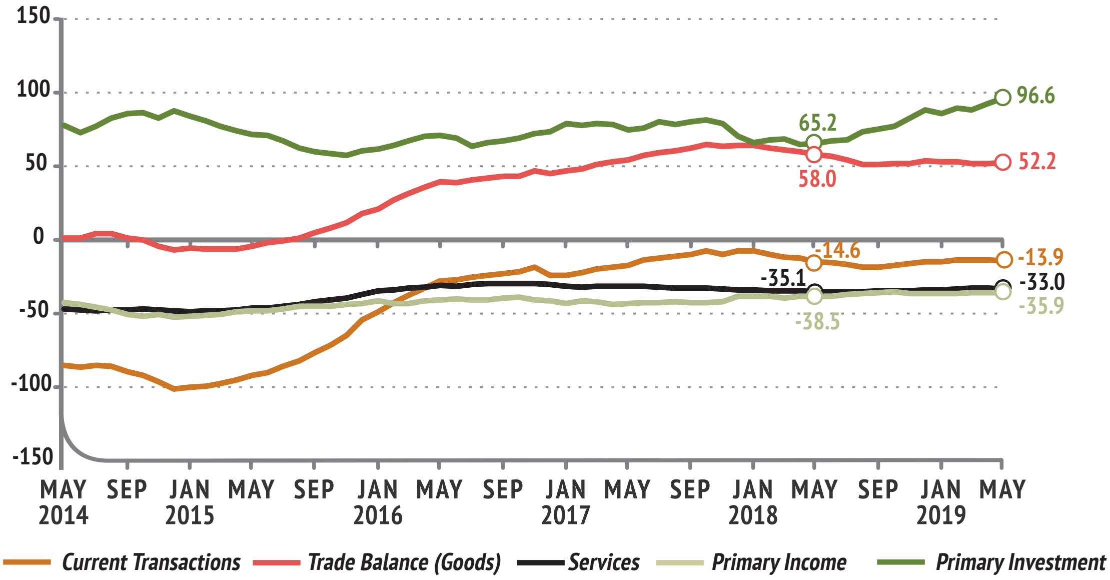
In the 12-month period to May, the current account deficit totaled USD13.9 billion, down by 4.8% from the USD14.6 billion deficit recorded over the same period last year. This improvement in the current account balance is due to a lower deficit in the service and primary income accounts compared to the 12-month period to May 2018.

Direct investment in twelve months to May totaled USD96.6 billion, the highest in 7 years. This figure represents an increase of 48.1% over the same period last year, equivalent to an additional USD31.4 billion.

By year's end, the deficit is likely to hit the mark of USD17 billion, about 0.9% of the GDP estimated by CNI. This deficit tends to increase due to a worse trade balance result caused by the slowdown in world growth and to an increase in imports with relative improvement of the economy in the second half.

Direct investment on the rise and stable current account deficit

Balance of current transactions and direct investment in 12 months to May
In USD billion



Source: Central Bank of Brazil
Prepared by: CNI

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2017	2018	2019 previous forecast (Economic Report 1st quarter 2019)	2019 current forecast
ECONOMIC ACTIVITY				
GDP (annual change)	1.1%	1.1%	2.0%	**0.9%**
Industrial GDP (variação anual)	-0.5%	0.6%	1.1%	**0.4%**
Household consumption (annual change)	1.4%	1.9%	2.2%	**1.5%**
Gross fixed capital formation (annual change)	-2.5%	4.1%	4.9%	**2.1%**
Unemployment rate (annual average - % of the labor force)	12.7%	12.3%	12.0%	**12.1%**
INFLATION				
Inflation (IPCA index - annual change)	2.9%	3.8%	4.2%	**3.9%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	9.92%	6.56%	6.42%	**6.15%**
(year’s end)	7.00%	6.50%	6.25%	**5.25%**
Real interest rate *(ex-post - average annual rate and deflation: IPCA)*	6.2%	2.8%	2.4%	**2.3%**
PUBLIC ACCOUNTS				
Primary result (% of GDP)	-1.69%	-1.59%	-1.39%	**-1.62%**
Nominal result (% of GDP)	-7.80%	-7.14%	-6.65%	**-7.08%**
Public sector’s gross debt (% of GDP)	74.07%	77.22%	78.20%	**79.20%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average for December)	3.29	3.88	3.82	**3.75**
(average for the year)	3.19	3.66	3.78	**3.80**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	217.7	240.0	240.0	**238.0**
Imports (US$ billion)	150.8	181.2	190.0	**195.0**
Trade balance (US$ billion)	67.0	58.7	45.0	**48.0**
Current account balance (US$ billion)	-7.2	-14.5	-25.0	**-17.0**

ECONOMIC REPORT | Quarterly publication of the National Confederation of Industry - CNI | www.cni.com.br | Industrial Development Board - DDI | Management and Economic Policy Unit - PEC | Executive manager: Flávio Castelo Branco | Fiscal and Tax Policy Unit | Manager: Mário Sérgio Carraro Telles | Team: Dea Guerra Fioravante, Fábio Bandeira Guerra, Isabel Mendes de Faria, Juliana Lucena do Nascimento, Marcelo Souza Azevedo; Débora Braga Reis de Sousa e João Pedro Fontoura (interns) | Editing Unit (DDI/GPC) | Coordinator: Carla Gadelha | Graphic Design: Carla Gadelha | Customer Service - Phone: +55 (61) 3317-9992 - email: sac@cni.com.br | This publication may be copied, provided that the source is cited. Document prepared on July 23, 2019.