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BRAZILIAN ECONOMY

Special edition of the Economic Report

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

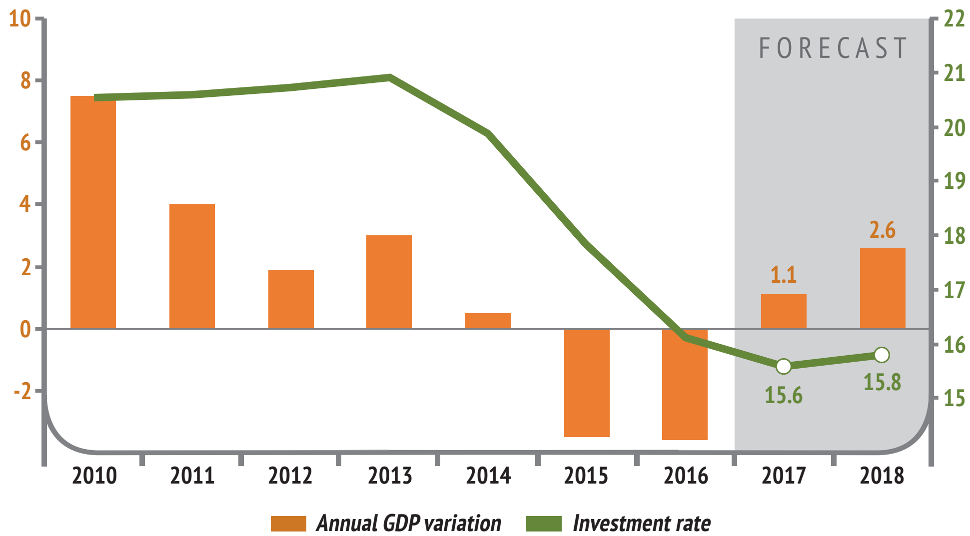
New growth cycle requires persistence in pushing for reforms

THE BRAZILIAN ECONOMY HAS EMERGED FROM THE DEEPEST RECESSION IN ITS HISTORY. Recent data on the Gross Domestic Product (GDP) clearly indicate recovery in domestic demand, especially in household consumption, which has been on the rise for three quarters in a row. In the third quarter of 2017, even investment - Gross Fixed Capital Formation (GFCF) - took an upturn after a long period of continuous decline.

Investment is key for the new growth cycle

Annual GDP variation and investment rate (Gross Fixed Capital Formation / Gross Domestic Product)

As percentages (%)



Source: National Accounts/IBGE.
Prepared and forecast by: CNI.

SECTIONS

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CNI

Cyclical recovery has limits, and creating conditions for private investment to be resumed is therefore crucial

IN 2017, THE ECONOMY WILL RESUME GROWTH AFTER DECLINING FOR TWO YEARS. CNI is projecting a rise of 1.1% in GDP. After three years, industrial GDP will also return to positive levels by posting a growth of 0.2% - manufacturing industry will grow by 1.7%, while the construction industry will decline by 5.0%. By rising by 1.3%, household consumption will be the main driver of growth on the demand side, while investment will still decrease by 2.1%, posting the fourth consecutive annual decline. As a result, the investment rate of the economy will remain low, accounting for only 15.6% of GDP.

THERE IS ROOM FOR GROWTH IN THE SHORT TERM WITHOUT A MAJOR INVESTMENT EFFORT. There is idleness both in capital and in labor to meet an increase in demand without pushing costs up, especially in the manufacturing industry. Even so, in certain segments, such as in those of durable consumer goods and capital goods, which are more sensitive to technological changes, investment may be required to upgrade products and processes. However, for the economy to continue to grow in the medium and long term, it is imperative to resume the investment cycle.

BRAZIL NEEDS TO LAY THE FOUNDATION FOR THIS NEW GROWTH CYCLE. Increased private investment must necessarily be the engine of sustained growth. Reactivating this engine requires deepening and continuing to promote the process of reforms designed to improve the business environment and productive competitiveness.

EFFORTS TO PROMOTE A VIRTUOUS GROWTH CYCLE SHOULD NOT BE BASED ON CONSUMPTION ALONE. Consumption should be the ultimate goal of society as a result of increased productivity and competitiveness in the economy; it should not be seen as the main lever of growth. This was the great misconception of the early years of this decade.

THE CURRENT RECOVERY OF THE ECONOMY HAS A CYCLICAL COMPONENT OF LIMITED DURATION. During the recession, families and households made adjustments, especially with regard to their level of debt, which was strongly leveraged in the early years of the decade. However, the sharp fall in inflation - especially of food prices - was a determining factor for the recovery of consumption, as it preserved the real income of individuals who kept their jobs. One-off factors, such as the release of FGTS (Employee Severance Indemnity Fund) funds, also contributed to consolidate the upturn in demand.

EXPORTS PLAYED A MAJOR ROLE IN RECOVERING DEMAND. During the recession period, there were changes in competitiveness conditions for companies, such as exchange rate stability and reduction of labor costs, as a result of which exports became a major element for recovering segments of industry.

DISINFLATION PROCESS SURPRISED FOR ITS INTENSITY. The annual inflation rate as measured by the IPCA (Expanded Consumer Price Index) is likely to remain at 2.9% in 2017, below the target floor. An exceptional agricultural harvest, which led to a reduction in food prices, has contributed decisively to this result. In addition, the maintenance of a tight monetary policy in a scenario of deep recession has made it possible to control inflation and to break inflation inertia in important segments, such as in that of services. However, the agricultural sector is not likely to contribute as strongly to such positive results in 2018 and the economy is also expected to become more heated as compared to this year. Therefore, stability must be anchored on solid foundations.

FALL IN INTEREST RATES FAVORS REACTIVATION OF THE ECONOMY. With the decline in inflation, the Selic rate was reduced to 7%, its lowest historical level, thus bringing real interest rates to close to 3%, considering inflation expectations for 2018. Keeping real interest at a low level is one of the challenges of macroeconomic policy. Consolidating expectations of a gradual but consistent adjustment in fiscal accounts is a necessary condition for macroeconomic equilibrium - growth with inflation within the target and public debt under control. Stability will be compromised if the recent trend toward a higher public debt/GDP ratio is not reversed. In the medium-term, this is undoubtedly the most relevant and most visible variable for international investors.

ADOPTION OF A "SPENDING CEILING" IS A NEW ELEMENT IN THE CURRENT SCENARIO. As total federal public spending growth was limited to inflation, passing the Pension Reform becomes even more urgent. Without such a reform, it will be virtually impossible for the federal budget to cover expenses other than social security benefits and payroll. Social programs and investment will be directly harmed.

FAVORABLE POSITION OF EXTERNAL ACCOUNTS HAS BEEN A FACTOR OF STABILITY. As opposed to other moments of the crisis, the difficulties being faced now were not caused by external constraints. Keeping high reserves and reducing the current account deficit were stabilizing elements for the foreign exchange market, favored by a scenario of ample international liquidity.

REVERTING EXPECTATIONS WAS A MAJOR POSITIVE DEVELOPMENT. In addition to the cyclical explanation, the expectations component - improved political scenario and its implications for adopting structural reforms - contributed to recovering confidence and reactivating the economy. Some advances that led to improved expectations deserve to be highlighted: amendments to the labor law, the infrastructure concession and privatization program, the new regulatory framework for the oil and gas industry, and changes in the governance rules for state-owned enterprises. Pushing this agenda forward is key for facing the challenge of competitiveness.

SCENARIOS AND RISKS: dominance of the electoral calendar

IN THE SHORT TERM, THE ECONOMY WILL CONTINUE TO GROW AT A MODERATE RATE, with gradual improvements in employment, increases in real income, low inflation, and interest rates at a low level. Endogenous forces will continue to generate the consumption demand required for GDP to grow by 2.6% in 2018. Growing more, and beyond 2018, will require additional efforts in connection with the modernization and competitiveness agenda.

UNCERTAINTIES ASSOCIATED WITH THE ELECTORAL CALENDAR WILL LIKELY GRADUALLY INFLUENCE DEVELOPMENTS IN THE MEDIUM TERM, possibly in the second half of 2018. The evolution of the electoral debate is likely to "contaminate" the economic environment, influencing the decisions of economic agents. Consolidating the victory of a candidate committed to carrying on with and deepening the above-mentioned reforms will likely intensify the recovery process and pave the way for a new growth cycle based on higher investment.

A SCENARIO DOMINATED BY POPULIST CANDIDATES WILL LEAD TO INSTABILITY. Insisting on a "past agenda" and criticizing the fiscal adjustment are likely to have a negative effect on the confidence of economic agents, potentially affecting the exchange rate market and the prices of assets, apart from jeopardizing investment and growth. Such a scenario will tend to reproduce the macroeconomic difficulties that prevailed during much of the current decade, promoting a situation of economic stagnation.

INTERNATIONAL SCENARIO: the challenge of competitiveness

Low productivity growth prevailed in the Brazilian economy in the early years of this century. This is a structural issue, especially for manufacturing industry, which has been hindering our competitiveness and economic growth. A recent study by CNI (Productivity in Industry, December 2017) shows that the adjustments made by companies to confront the recession crisis have already led to increased productivity in industry in 2015 and 2016.

That study also shows that our productivity gap in relation to our main trading partners is significant. As compared to 2000 data, Brazil's productivity decreased by 25% in relation to this group of countries, which largely explains Brazil's much more modest economic performance as compared to mature and developing economies during this decade, as shown in the Special Topic section of this document on "Ten Years After the Global Financial Crisis."

THE COMPETITIVENESS AGENDA

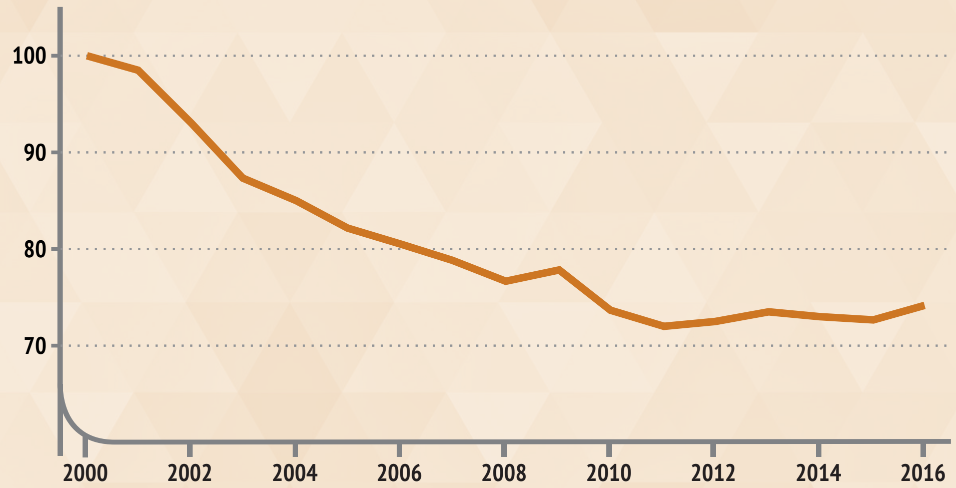
Setting a solid competitiveness and modernization agenda is fundamental for recovering the competitive capacity of Brazilian products and paving the way for a new growth cycle. Progress must be made not only in setting the macroeconomic agenda and in promoting fiscal adjustment, but also in setting an agenda of microeconomic reforms designed to remove both regulatory and red tape barriers that hinder the day-to-day operation of companies and have a negative impact on investment decisions. Measures must be taken to reduce capital costs and increase financing sources for the private sector, to lend efficiency and rationality to regulation and bureaucracy, and to define regulatory frameworks with clarity and legal certainty. These are low-complexity agendas that do not imply any fiscal cost and should be sped up.

The tax reform must be included in the country's agenda. After the progress made in the labor and pension reforms (based on the expectation that the latter will be passed by Congress in 2018), it is imperative to include measures to modernize the Brazilian tax structure in the priority agenda. The focus of this reform should be on promoting simplification and efficiency. The current system is burdensome for companies and generates high compliance costs and legal disputes due its complex and frequently changing rules. These costs affect the competitiveness of Brazilian products and generate legal uncertainty, with negative impacts on investment. In addition, our system makes it difficult for Brazilian companies to integrate into global value chains.

Reduced labor productivity jeopardizes Brazil's competitiveness

Actual relative labor productivity, manufacturing industry (2000-2016)*

Index, basis: 2000=100



Source: IBGE, INDEC, INEGI, FUNCEX, The Conference Board and CNI.
Prepared by: CNI.
* The indicator measures the evolution of labor productivity in Brazilian industry in relation to the average productivity of workers in the industries of Brazil's main trade partners.

SPECIAL TOPIC

Ten Years After the Global Financial Crisis

Brazil at the end of the growth line: the role of structural policies

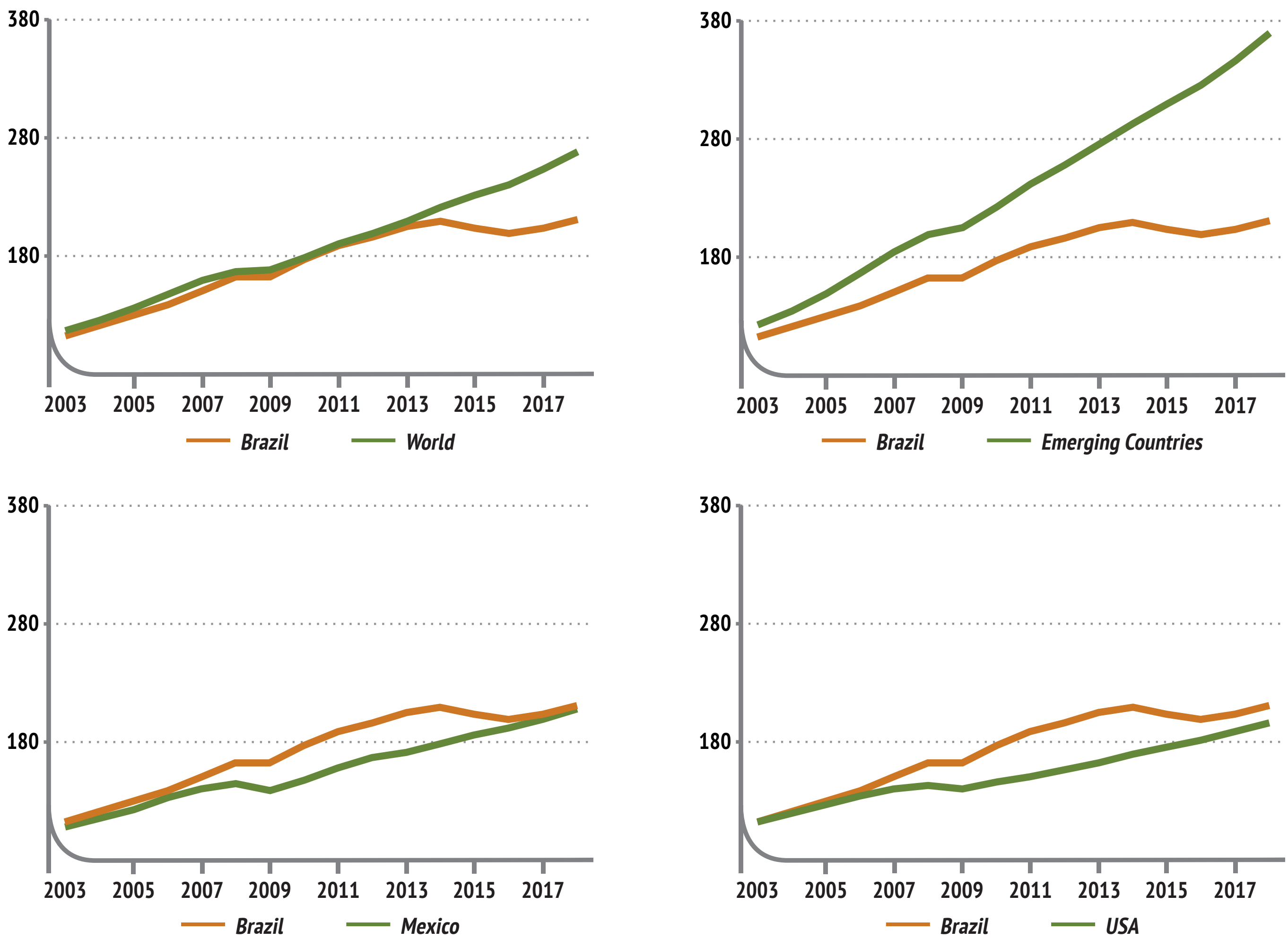
One decade after the outbreak of the US subprime mortgage crisis, which erupted in July 2007, the global economic scenario has become much more favorable today. Developed countries resumed growth consistently and emerging economies have been posting high growth rates - albeit at a lower level than before 2007. In Brazil, however, economic indicators fluctuated a lot in the post-crisis years, as the country went through a deep recession recently and is experiencing a new recovery process now.

Between 2010 and 2016, after the sharpest moment of the crisis, world GDP grew by 3.8% a year in average, according to data from the International Monetary Fund (IMF). During the same period, developed countries posted growth of 1.9% a year, while in developing countries the rate was 5.4% a year. Brazil's GDP grew more modestly, at an average annual rate of 1.4%, more slowly than that of mature economies even.

Brazil has been failing to keep pace with the growth of the world economy

GDP trajectory (in international dollars and purchasing power parity) - comparison between Brazil and selected countries and groups

Index, basis: 2000=100



Source: IMF.
Note: The data for 2017 are estimates and those for 2018 are projections, the reporting of both of which is the responsibility of the IMF.
Prepared by: CNI.

BRAZIL GREW LESS THAN THE WORLD AVERAGE AFTER THE CRISIS

If we focus on the most recent years, including with forecasts for 2017 and 2018, the scenario becomes even more adverse for Brazil. According to the IMF, the world economy is likely to post a growth of 3.5% a year between 2014 and 2018, while in rich and emerging countries rates of 2% and 4.6% a year are expected, respectively. On the other hand, Brazil will experience a negative average variation of 0.9% a year, as a result of which it was ranked 183rd among the 192 countries studied by the institution.

The size of our gap also becomes evident when we compare the growth curve of the Brazilian GDP with the curves recorded for Mexico, a country that has similarities with Brazil and was strongly hit by the crisis, and for the US, the country where the crisis began. Between 2010 and 2017, Mexico is likely to grow at an average rate of 3% a year, the U.S. at 2.1% a year and Brazil at only 1.3% a year.

THE FALSE POSITIVE

The curious fact is that in 2009 - the "eye of the hurricane" - Brazil's economy experienced a drop of 0.1%, while those of Mexico and the U.S. decreased much more sharply (by 4.7% and 2.8%, respectively). Also noteworthy is the fact that Brazil's economy grew more strongly in 2010, right at the beginning of the process of recovery of the world economy: Brazil (7.6%), Mexico (5.1%) and the U.S. (2.5%).

The initial signs seemed to suggest that Brazil would not be affected by the crisis. While most countries recorded a strong contraction of GDP in 2009 and slow recovery of economic growth, in 2010 Brazil proclaimed itself as an economy immune to international problems.

This armor, however, was fragile and momentary. While Brazil's economy recovered faster than others, it lacked fuel to continue to grow at high rates.

While Brazil's economy recovered faster than others, it lacked fuel to continue to grow at high rates

BET ON CONSUMPTION FAILED TO ENSURE SUSTAINABLE GROWTH

The explanation for this phenomenon is associated with the strategy adopted by the country to boost the economy at that time, as well as its duration. Brazil chose to boost consumption without stimulating productivity growth and taking appropriate measures to increase competitiveness.

For this purpose, the government at that time increased public spending and stimulated credit to households and businesses. Immediately after the crisis, the result was as expected: GDP grew driven by consumption.

However, the lack of competitiveness of the economy meant that growth was only possible with more public spending and more stimulus to credit, mostly subsidized by public banks. Keeping this strategy began to create imbalances and led Brazil to reduce its savings to keep investment at the level required to sustain economic growth, even if it was "artificial."

This was only feasible thanks to the exchange rate appreciation, which led to high deficits in the country's external accounts. Besides generating a deficit in the trade balance, increased consumption without a corresponding increase in supply also pressured prices. Consumption supplied by imports without leading to any significant increase in GDP suggested that the model was possibly close to exhaustion.

A few years after the crisis, more acute signs of economic disarray began to be perceived. The inflation rate fluctuated above the target ceiling, twin deficits (negative balance in external accounts and negative nominal result of public accounts) increased, investment was on the decline, and industry was unable to lead economic growth.

By the end of 2014, the inconsistency of this policy became obvious, as consumption was no longer sufficient not even to ensure a reasonable growth rate. Brazil's GDP grew by only 0.5%, with an inflation rate of 6.4% and interest rates close to 12%. The red siren rang, putting the country on maximum alert for possible economic turbulence.

The international economy ceased to be a determinant of these problems. The world had already left the 2007-09 crisis behind. The average global growth rate in 2014 was 3.6% and the rate recorded in emerging countries was 4.7%. Portugal and Greece, icons of the European crisis, had already started to grow again.

Brazil's mistake was to focus too much on the demand side and, on the other hand, to neglect the determinants of supply. In other words, not enough effort was made to reduce systemic costs and improve competitiveness

In 2015, it became even clearer that Brazil's negative results could be explained by domestic difficulties and not by external factors. Since then, the world continued to grow at a steady pace, while Brazil began to experience a recession and to suffer the effects of uncontrolled public accounts, high unemployment and inflation rates, and double-digit interest rates. In this scenario, the government reviewed its economic policy strategy and shifted to a contractionary monetary stance, in addition to adopting measures to reduce public spending.

It was only in 2017 that this situation began to change, albeit gradually and with uncertainties on the horizon. However, unlike what happened in the period following the international crisis of 2007-09, we are now almost alone in our efforts.

COMPETITIVENESS IS THE KEY TO ECONOMIC PROSPERITY

Brazil's mistake was to focus too much on the demand side and, on the other hand, to neglect the determinants of supply. In other words, not enough effort was directed to make progress in reducing systemic costs and improving competitiveness. This seems to have been exactly what led us to experience a different situation than that of successful countries after the international financial crisis.

When we evaluated economically relevant countries with the best performance in the post-crisis period (between 2010 and 2017), we identified different profiles, but with some common characteristics. The group of countries that grew at an average annual rate of 3%-6% includes Mexico, South Korea, Chile, Colombia, Thailand, Peru, and Singapore. To a greater or lesser extent, these countries have been making progress on the competitiveness agenda and in preserving macroeconomic stability.

The group of countries with a growth rate above 6% includes Malaysia, Indonesia, Paraguay, Ireland, Turkey, India, and China. Except for Ireland, all of them are considered developing countries. In addition, these are countries with a business environment in the process of being improved and reasonably sound macroeconomic fundamentals.

Data from the survey Doing Business carried out by the World Bank to measure the ease of doing business corroborate this analysis. In the comparison between the 2010 and 2018 surveys, Indonesia moved up 50 positions in the overall ranking, India 33, Paraguay 16, and China 11. Meanwhile, Brazil moved up only 4 positions (from 129th to 125th) among 183 countries in 2010 and 190 countries in 2018.

It should be mentioned, however, that some of the countries mentioned above moved down in the ranking. Peru, for example, moved down 2 positions. In any case, Brazil continues to rank poorly among its competitors. All countries with a positive performance in the post-crisis period are considerably ahead of Brazil in the ranking of Doing Business - Mexico (49th), Thailand (26th), Chile (55th), and Colombia (59th). Even Peru, which fell in the ranking, is 65 positions ahead of Brazil currently.

BRAZILIAN FOREIGN TRADE IS LOW AND BRAZIL LACKS MORE INVESTMENT

Two other striking characteristics of the countries listed in the above paragraphs also deserve special mention: their high rate of investment and share in international trade. Their investment rate, as calculated by the IMF, averaged 28% of GDP in the 2010-2016 period, while their degree of openness, as measured by the representativeness of their total trade - sum of exports and imports - amounted to 75% in relation to GDP, according to data from the World Trade Organization (WTO) and the IMF.

These results contrast with the reality in Brazil, whose average investment rate was 21% and total trade amounted to 19% (in relation to GDP) during the same analyzed period. Lack of investment and low foreign trade jeopardize the competitiveness of our economy; whether in the domestic market, competing with imported products; or in the foreign market, competing with major international exporters.

Finally, two important considerations should be made. First: despite Brazil's unfavorable trajectory, the progress made by the country this year must be recognized (disinflation, reduction of the Selic rate, moderate resumption of employment growth, increased consumption and industrial growth, and the recent resumption of investment). Reforms carried out to boost the country's competitiveness, particularly the labor reform, should also be highlighted.

Second consideration: despite its relatively positive situation currently, the world economy requires attention in the medium and long term due to risks associated with low private investment and low interest rates in developed countries. In addition, account must be taken of likely imminent geopolitical and economic changes that may occur as a result of the turbulent decision-making processes of the Trump administration and European countries, which are also under pressure from protectionist waves.

REFORMS SHOULD NOT BE POSTOPONED ANY LONGER

The economic future of Brazil is associated with the results of the next general elections. For Brazil to resume a path of solid and sustainable growth, its political leaders must be committed to addressing the country's structural problems, especially in the fiscal realm, for which purpose it is imperative to pass the pension reform, among other measures. The reformist impetus should be preserved. We need to get closer to the best global practices of production and competition, which is an objective that fundamentally depends on a more efficient tax system. Of course, all of this must be done without losing sight of the need to ensure macroeconomic stability.

OVERVIEW OF 2017

End of recession

The results recorded in 2017 suggest that the Brazilian economy has been recovering at a moderate pace, marking the end of the recession that hit the country in recent years. Consumption played a prominent role in this recent economic upturn. On the supply side, agriculture played a leading role, but industry also stands out for resuming growth after three consecutive years on the decline.

Following the positive performance of economic activity, the unemployment rate fell throughout the year, although it is still high. Addressing the tax issue remains crucial, despite some efforts made to curb non-mandatory spending. The pressure exerted by the continued growth of mandatory expenditures and constant easing of primary income targets prevented significant improvements in the fiscal framework. With regard to monetary policy, the results recorded in 2017 deserve to be celebrated: inflation will close the year slightly below the target floor and, as a result, the base interest rate (Selic rate) hit its lowest historical level.

GROWTH RESUMED. In 2017, GDP will rise by 1.1% in relation to 2016, according to CNI estimates, the first increase since 2014. Growth has been resumed based on consumption, which is expected to rise by 1.3%. Investment is in turn likely to fall for the fourth year in a row (-2.1%), despite the moderate growth recorded in the second half of the year. On the production side, agriculture deserves special mention as a result of an estimated increase of 11.1% brought about by a record harvest in the year. Albeit timid, the 0.2% increase recorded for industry, according to CNI calculations, will put an end to a four-year contraction cycle (see the section economic activity).

IMPROVEMENTS IN THE LABOR MARKET. The labor market recovered during 2017. According to the General Register of Employed and Unemployed Persons of the Ministry of Labor and Employment of Brazil (CAGED/MTE), more than 300,000 net jobs were created in the year to October. As a result, the unemployment rate, which had risen to 13.7% in the first quarter, will likely close 2017 at 12.8% in average according to CNI calculations. Another positive development was the increase recorded in average income in real terms (see the section Employment and Income).

STRONG DISINFLATION AND INTEREST RATES AT THEIR LOWEST HISTORICAL LEVEL. Inflation slowed down sharply throughout 2017. CNI estimates that the Expanded Consumer Price Index (IPCA) will hit the mark of 2.9% in the year, below the target floor set by the National Monetary Council (CMN). This disinflation process was brought about by a lower fluctuation in service prices and, mainly, by a downturn in food prices. The sharp recession experienced in recent years contributed to keeping prices down.

This improved price behavior and expectations of a lower inflation rate have intensified the cycle of falling interest rates. In its eight meetings held in 2017, the Central Bank reduced interest rates by 6.75 percentage points, reducing the Selic rate from 13.75% to 7% a year (see the section Inflation, Interest Rates and Credit).

EASING OF THE TARGET LEADS TO INCREASED SPENDING. The pressure exerted by constant increases in mandatory expenditures and the constant easing of primary result targets prevented significant changes in the fiscal framework, despite some efforts to curb non-mandatory spending. As a result, 2017 will close with a high primary deficit and increased spending. The new development this year is that tax revenues resumed growth in response to improved economic activity and increased taxation (see the section Fiscal Policy).

STABLE EXCHANGE RATE AND RECORD TRADE SURPLUS. The process of adjusting external accounts continued throughout 2017. In the 12-month period to October, the current account deficit fell to US$9.6 billion, equivalent to 0.48% of GDP. In the same period in 2016, the deficit was US$22.3 billion, or 1.25% of GDP.

The deficit in current transactions decreased mainly as a result of the trade surplus, which was the highest one in the historical series for the period from January to November. The US$62 billion trade surplus is the result of a 18.2% increase in exports and a 9.6% increase in imports in the comparison between January-November 2017 and the same period in 2016.

The real/US dollar exchange rate, which remained relatively stable for a good part of the year, will close 2017 at R$3.25/US$1 (see the section Foreign Trade Sector).

OUTLOOK FOR 2018

Uncertainties and promise of a new growth cycle

The year 2018 will likely mark the consolidation of a new cycle for the Brazilian economy, but there are still many uncertainties on the horizon, especially with regard to the political scenario and to the feasibility of the reform agenda.

In the short term, there is still idle capacity to allow for economic activity to grow without pushing the inflation rate up despite the low investment rate projected for next year. The inflation rate will likely remain within the target, allowing for interest rates to be kept at a historically low level.

The labor market will continue on its path of recovery, with net job creation. The fiscal issue will in turn continue to be a crucial problem to be addressed and a source of instability and uncertainty throughout the year. The external scenario will likely remain favorable.

THE NEXT STEP IN THE RECOVERY PROCESS. Economic activity as a whole will likely increase throughout 2018, leaving fluctuations behind and consolidating a clearer growth trajectory. In this scenario, we are estimating a 2.6% GDP growth in the coming year not only as result of consumption, but also of investment. On the supply side, growth will be more uniform than in 2017 with the positive contribution of industry, agriculture, and services.

Special mention should be made of the projected increase of 3% in the industrial GDP, a rate that exceeds GDP growth for the first time since 2011. This development is explained by the pace of recovery of domestic demand.

The service sector is also expected to grow significantly, by 2.2%. The agriculture/livestock sector is in turn likely to grow at a moderate rate in relation to the exceptionally high rate recorded in 2017 for this sector (see the section Economic Activity).

UNEMPLOYMENT DECLINING. The labor market tends to keep pace with economic activity and therefore net jobs are expected to continue to be created next year. As a result, CNI expects the average unemployment rate in 2018, as measured by the continuous National Household Sample Survey (PNAD), to decrease in relation to 2017, hitting the mark of 11.8% of the workforce. With inflation on a downward path, the real average income

In 2018, the primary result of the consolidated public sector is expected to be negative by R$153.1 billion (2.12% of GDP). In addition to being below the target set for the year, R$161.3 billion, this result would represent a decrease in relation to the deficit projected for 2017

of workers is likely to increase by 1.6% in 2018 according to CNI projections, while total earnings will likely increase by 2.8% (see the section Employment and Income).

SELIC RATE AT A NEW HISTORICAL FLOOR. In 2018, inflation will likely remain at low levels due to a still high idleness rate in the Brazilian economy and the breaking of inflation inertia in 2017. However, the IPCA will likely rise to 4.4%, slightly below the center of the inflation target of 4.5%. This behavior will be brought about by a restructuring of food prices and adjustments in government-regulated prices, caused mainly by an expected increase in electricity rates.

With the current inflation and expectations at low levels, a further reduction in the Selic rate is likely to be decided upon at the first meeting of the National Monetary Council in 2018, which is scheduled to be held in February, lowering the rate to 6.75% a year. CNI estimates that this level will be maintained throughout 2018.

For this rate to be kept at a low level in the long term with no impact on inflation the fiscal adjustment must be ensured and reforms must be implemented at a faster pace, particularly the pension reform. Otherwise, the Central Bank will be forced to reverse the downward path of interest rates recorded so far (see the section Inflation, Interest Rates and Credit).

ACHIEVING THE FISCAL TARGET DEPENDS ON THE APPROVAL OF NECESSARY MEASURES. The restrictions imposed on increases in the Federal Government primary spending by the New Fiscal Regime will require the passage of bills designed to curb mandatory spending, such as that of the pension reform, and the postponement of a wage increase for public servants. In any of those proposals is rejected, the federal government is likely to impose limits on non-mandatory expenditures. Even so, the inertia of mandatory expenditures will lead to a further real increase in federal spending in 2018. At the state and municipal levels, spending is likely to remain on an upward trend, with improvements in tax collection.

In 2018, the primary result of the consolidated public sector is expected to be negative by R$153.1 billion (2.12% of GDP). In addition to being below the target set for the year, R$161.3 billion, this result would represent a decrease in relation to the deficit projected for 2017.

However, the decrease in nominal interest spending will likely be the main factor leading to improved public accounts in 2018. The significant reduction in the Selic rate seen in 2017 and the likely relative stability of the exchange rate in 2018 will be reflected in a reduction in interest spending to 5.5% of GDP.

As a result, the nominal deficit will likely decrease to 7.6% of GDP in 2018. Even so, this level will not be sufficient to stabilize the gross debt-to-GDP ratio, which is expected to increase to 76.2% of GDP in 2018 (see the section Fiscal Policy).

TRADE SURPLUS LIKELY TO DECREASE THROUGHOUT 2018. The scenario abroad will probably remain favorable in 2018. We therefore expect the average exchange rate to remain at a level of about R$3.27/US$1, representing a moderate devaluation in relation to the average recorded in 2017 (R$3.19/US$1).

The trade surplus is expected to decline over the course of the year as the pace of import growth is likely to gain momentum in 2018 as a result of the recovery in domestic demand. Exports are also likely to grow, albeit to a lesser extent, since the base is very high and estimates suggest that global economic activity will continue to grow at its current pace. We are therefore projecting a trade balance of US$54 billion for next year: increase of 5.1% in exports, which would hit the mark of US$228 billion, and of 15.2% in imports, which would amount to US$174 billion.

We expect to see an increase in the current account to US$27 billion, 1.5% of the GDP projected by CNI for 2018, following the higher rate of growth of imports resulting from the recovery in domestic activity. Despite this growth, external accounts will remain comfortable, since the estimated deficit remains perfectly financeable through direct investment in the country (see the section Foreign Trade Sector).

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Industry continues to grow at a modest rate in 2017

Decline in the construction industry limits recovery of industrial GDP

Gross Domestic Product (GDP) will grow by 1.1% in 2017 following a 6.9% decrease after declining for two years in a row. Unlike what occurred in previous situations, the economy is recovering from the recent crisis gradually. As the months went by, it became increasingly clear that the recession had been left behind, but the fluctuations of a series of economic indicators reflected difficulties to consolidate economic recovery without widespread improvements among all sectors.

In the first quarter of 2017, GDP grew by 1.3% compared to the previous quarter (seasonally adjusted data). This growth was largely brought about by the exceptional result of the agricultural harvest, which influenced not only the data for agriculture, but also those for agroindustry. In the second quarter, GDP posted a growth of 0.7%, but doubts remained about the actual strength of demand, which could have had a one-off result due to consumption boost made possible by the release of funds from the Employee Severance Indemnity Fund (FGTS).

Despite the weaker growth recorded in the third quarter (0.1% in relation to the previous quarter), demand remained strong: household consumption rose by 1.2% even after the period of withdrawal of FGTS funds. In addition, gross fixed capital formation increased by 1.6% after 15 quarters with no positive results. We are projecting a more positive result for the fourth quarter, with a further increase in investment and household consumption and corresponding growth in industry and services.

INDUSTRY IS BEGINNING TO RECOVER

In 2017, industry will finally put an end to a three-year period of negative results, during which it shrank by 10.9%. This year, industry as a whole is expected to grow by only 0.2%. Even with this slight increase, industry's share of GDP will continue to decline, decreasing to 21% in 2017 from 26% in 2012.

Although industry as a whole posted modest results, the figures recorded for manufacturing industry were more consistent in 2017. In October, the production of manufacturing industry as measured by the PIM-PF/IBGE survey grew by 0.5% in the seasonally adjusted series. In the year to date, it grew by 1.5%.

CNI's Industrial Indicators survey shows a recovery in the turnover of manufacturing industry. Turnover has been on the rise since October 2016, but with a "saw-like" shape trajectory, that is, one often interrupted by setbacks, albeit less intense than subsequent growth cycles.

Industry has a long way to go to return to its pre-crisis levels

Industrial activity indicators (seasonally adjusted)

Variation in October 2017 in relation to the indicated period (recent maximum before the crisis)

REAL SALES
Drop of 22.1% in relation to August 2013

HOURS WORKED IN PRODUCTION
Drop of 23.5% in relation to March 2012

PRODUCTION
Drop of 19.1% in relation to June 2013

EMPLOYMENT
Drop of 17.6% in relation to February 2014

CAPACITY UTILIZATION
Drop of 5.8 percentage points in relation to June 2013

Source: Industrial Indicators/CNI and PIM-PF/IBGE
Prepared by: CNI

In this scenario, the result in the year to date is still 1.3% lower than that recorded in the same period in 2016, even though turnover increased by 1.9% in the last two months and rose by 11.9% in October in relation to the same month in 2016.

Also according to the CNI data, both employment and hours worked have not taken an upturn so far and are still below the level recorded in 2016 (3.2% and 2.6% below that level, respectively), very close to the lowest levels after the end of the recent recession.

While recovery in the manufacturing industry is incipient, it hasn't even begun in the construction industry. CNI's Construction Industry Survey has shown very negative figures for the sector throughout the year. Activity and employment levels indicate a decline, but at a slower pace than that observed in 2016.

Entrepreneurs are more confident

Albeit slow, the trend toward economic recovery has been improving expectations, especially among entrepreneurs. The Business Confidence Index (ICEI/CNI) showed a clear improvement trend in the second half of the year. In November, it remained above its historical average and posted its highest level since April 2013.

Confidence had been improving only as a result of a more favorable outlook. While the Expectations index rose to well above the 50-point line, the Current Conditions index (which measures the recent evolution of current business conditions) remained below 50 points, with modest increases. In recent months, confidence gained a new momentum based on assessments of business conditions. In November, the Current Conditions index rose by 1.1 percentage points in relation to October, reaching 51.5 points. This indicates that entrepreneurs are perceiving improvements in current business conditions, something that had not been seen since November 2012. The index is the highest one since April 2011 and is now 7.7 points above that recorded in November 2016.

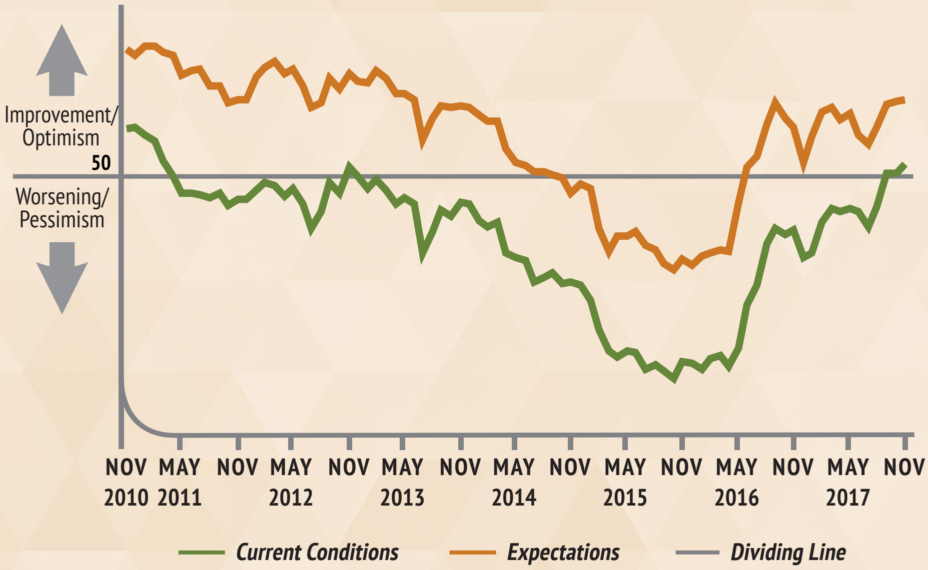
Consumer confidence, in turn, has not shown clear signs of improvements as that of entrepreneurs. The Consumer Confidence Index (INEC/CNI-Ibope) has alternated between positive and negative variations and, as result, remains relatively low. The INEC index in November 2017 is 2.1% lower than that recorded in November 2016 and 6.6% lower than its historical average.

Consumer expectations are favorable with respect to future employment and inflation developments (the indices are above their respective historical averages, suggesting optimism), while the indices for financial situation and debt are low due to the still high debt ratio and delicate financial situation of households. This situation has prevented confidence from rising despite the more favorable outlook.

Entrepreneurs perceive improvements in current business conditions

ICEI components (indices for Current Conditions and Expectations)

Diffusion index (0-100 points)



Source: Business Confidence Index (ICEI/CNI)

Note: The indices range from 0 to 100 points. Figures above 50 points indicate an improvement in business conditions or optimistic expectations.

The mining and quarrying industry is less influenced by the domestic conditions of demand, since the dynamics of this segment follows conditions prevailing in the international market. In October, production in this industrial segment (PIM/PF-IBGE) increased by 0.3%, meaning that it rose by 1.4% over the last two months. In the year to October, it increased by 6.2%.

Special mention should also be made of the long road ahead for industry to return to the levels recorded before the crisis erupted in 2014. Despite having declined in 2017, idleness in production is still high in all industrial segments. Use of Installed Capacity (UCI) in manufacturing industry in October remained at 77.7%, 3.7 percentage points below the average recorded in previous years (Industrial Indicators/CNI). Likewise, the actual-usual capacity utilization index (Industrial Survey/CNI) for the mining and quarrying industry stood at 44.9 points in October, below 50 points, the dividing line between below and above usual activity[1]. Similarly, the construction industry has also been operating far below usual levels. The actual-usual activity level index remained at 34.1 points in October[2].

Services will also post growth in 2017, after declining for two years. We are projecting a 0.3% increase by end of the year, a decrease of 5.3% in the past two years. The resumption of growth in services is highly concentrated in the trade sector, which is in turn influenced by household consumption. The trade sector has grown by 2% over the last four quarters, while the service sector increased by 0.2% on the same comparison basis.

CONSUMPTION LEVERS GROWTH

From the perspective of demand, economic growth in 2017 was mainly driven by increased household consumption. We are projecting a growth rate of 1.3%, which would constitute a contribution of 0.8 percentage points in relation to the 1.1% GDP growth estimated by CNI. Despite this year's growth, consumption is still lower than in 2012, given its decline of 7.4% between 2015 and 2016.

Although there is no doubt that the withdrawal of FGTS funds has played a major role in boosting consumption, a number of other structural factors support the continuation of this process in the second half of the year. The sharp reduction in inflation, especially the fall in food prices, increased consumers' purchasing power. Likewise, the fall in interest rates and the increased availability of credit to individuals also contributed to push consumption up. Mention should also be made of the impact of increased employment, which has increased total earnings.

GDP estimate for 2017

Projected variation (%)

	GDP COMPONENTS	Variation rate (%)
Demand side	Household consumption	1.3
	Government consumption	-0.6
	Gross formation of fixed capital	-2.1
	Exports	7.8
	(-) Imports	6.1
Supply side	Agriculture/livestock	11.1
	Industry	0.2
	Mining and quarrying industry	5.2
	Manufacturing industry	1.7
	Construction industry	-5.0
	Public utility industrial services	1.7
	Services	0.3
	GDP	**1.1**

Prepared and projected by: CNI

Government consumption continues to fall, in line with the fiscal adjustment under way (see the section Fiscal Policy). The drop recorded in 2017 is lower than that observed in 2016: -0.1% versus -0.6%.

Gross Fixed Capital Formation (GFCF), which measures investment in the country, will continue to decline in 2017. We expect to see a decline of 2.1% over the year. GFCF will therefore post four years of negative results, accumulating an impressive decline of 27.6%. It should be noted that GFCF showed signs of recovery in the last half of the year.

Investment was being limited by a number of factors: high idleness, the financial situation of weakened companies, low expectations, and high cost of capital. These negative factors have been showing signs of improvement: confidence is on

1 - The index ranges from 0 to 100 points and figures below 50 points indicate capacity utilization below usual. The smaller the figure, the greater the distance between actual and usual activity in a month.
2 - The index ranges from 0 to 100 points and figures below 50 points indicate activity level below usual. The smaller the figure, the greater the distance between actual and usual activity in a month.

the rise, the cost of capital is falling, and corporate finance is more balanced.

A high idle capacity makes it possible for the economy to grow in the short term with investment at a lower level. But for economic activity to grow at a faster pace without generating inflationary pressure, investment must be resumed. For this purpose, continuing to implement a reform agenda designed to create a favorable business environment and promote competitiveness is of paramount importance.

The year 2017 will be another year marked by a positive external contribution to GDP. Exports are likely to post a growth of 7.8%. During 2017, exports were boosted by a low demand and benefited from more favorable external market conditions marked by high price gains, especially for basic products. Imports are expected to rise by 6.1% and begin to grow at a faster pace at the end of the year in the wake of resumed economic activity (see the section Foreign Trade Sector).

OUTLOOK

MORE INTENSE RECOVERY IS LIKELY

If our expectations of a moderate increase in GDP in the last quarter of 2017 are confirmed, there will be a statistical carryover of 0.5% to 2018[3].

The widespread recovery of economic activity will likely become more intense throughout 2018 as variables for which no clear growth trend was detected take a clearer upturn over the coming year. As a result, the negative monthly results that were still frequent in 2017 will likely become rarer and gains will accumulate and generate a more robust positive result by the end of 2018. In this scenario, we estimate that GDP will grow by 2.6% not only as a result of consumption, but also of investment. On the supply side, growth will be more uniform than in 2017, with a positive contribution from agriculture, industry, and services.

CONSUMPTION AND INVESTMENT WILL GROW IN 2018

The factors that led household consumption to take an upturn in 2017 will still be present throughout 2018: stable inflation, unemployment on the decline, and greater availability of credit. We also expect consumer confidence to recover over the course of the year, providing a new impulse to demand growth. We are projecting a 2.8% increase in household consumption in 2018. The risk for this forecast lies in the political-electoral scenario, which may affect the trajectory of exchange rates and inflation.

Due to the need for fiscal adjustment, we are projecting stability in government consumption, even with rising economic activity.

We are estimating a 4.0% increase in GFCF in 2018, the first one in four years. Investment will likely benefit from confidence on the rise, more favorable financial conditions, more consistent signs of recovery in demand, and gradual reduction in idleness. The indicators for industry's investment intentions, both for the manufacturing and for the mining and quarrying industries (Industrial Survey/CNI), as well as for the construction industry (Construction Industry Survey/CNI), are already showing signs of greater propensity to invest at the end of 2017. The recovery of investment depends on the political scenario, which can have a strong impact on the confidence of economic agents, leading them to postpone - or, at worst, cancel - investments.

GDP estimate for 2018

Projected variation (%)

	GDP COMPONENTS	Variation rate (%)
Demand side	Household consumption	2.8
	Government consumption	0.0
	Gross formation of fixed capital	4.0
	Exports	5.0
	(-) Imports	7.0
Supply side	Agriculture/livestock	2.0
	Industry	3.0
	Mining and quarrying industry	2.5
	Manufacturing industry	3.5
	Construction industry	2.0
	Public utility industrial services	2.6
	Services	2.2
	GDP	**2.6**

Prepared and projected by: CNI

3 - If the quarterly GDP remains constant until the end of 2018, the annual GDP variation in that year would amount to 0.5%.

The external contribution to GDP will be negative in 2018, after three years of positive contributions. More intense economic activity will stimulate imports of consumer goods, inputs, and capital goods, which are likely to grow more than exports in 2018. We expect imports to grow by 7% and exports by 5%.

INDUSTRIAL GDP WILL LIKELY GROW MORE THAN GDP FOR THE FIRST TIME IN SEVEN YEARS

We expect industry to grow by 3%, above the GDP growth rate for the first time since 2011. The pace of recovery of demand will sustain a further expansion of the manufacturing and mining and quarrying industries.

The construction industry will also likely post a positive result, something that has not been seen since 2014. This projection takes into account a likely increase in real estate credit in a more favorable macroeconomic scenario, an increase in the disposable income of households, and the lagged effects of the fall in interest rates.

The service sector is also expected to grow significantly, by 2.2%. Differently from 2017, growth will not be restricted to trade, as the transportation sector and, above all, services provided to households will also grow. Agriculture will likely increase moderately, given the comparison with its exceptional performance in 2017.

EMPLOYMENT AND INCOME

Labor market reacts in 2017

Country resumes net job creation and real income gains

Brazil experienced a deep deterioration in employment and income indicators over the past two years as a result of the economic crisis that erupted in 2014. According to data from the Annual List of Social Information (RAIS/MTE), 3.5 million formal jobs were lost in the economy in 2015 and 2016, more than half of which (1.9 million) in industry. As a result of such loss of jobs, companies had virtually no idle labor in 2017. For this reason, this year the labor market responded to the increase in economic activity in an atypical way compared to other recessionary periods[4], generating 302,000 jobs in the year to October.

The average real income growth also surprised. The recovery of economy activity, associated with a strong disinflation process, made it possible for wages to be raised above the inflation rate. This recovery of purchasing power stimulated household consumption, the demand component that influenced the positive result recorded for GDP in 2017 the most (see the section Economic Activity).

CNI expects to see a more intense recovery of the Brazilian labor market in 2018, especially of the formal labor market. The more robust growth of economic activity will likely lead to more workers being hired than in 2017. As a result, the average unemployment rate will likely decrease to 11.8% of the workforce, 1 percentage point lower than the rate estimated for 2017.

BRAZIL RESUMES NET JOB CREATION

In 2017, almost all sectors of the economy responded positively to the resumption of economic activity, generating positive net job balances. The exception was the trade sector, where 41,600 net jobs were lost in the year to October, according to the General Register of Employed and Unemployed Persons of the Ministry of Labor and Employment (CAGED/MTE). This decline can be mainly explained by the retail trade in clothing and accessories, which has been recording the lowest net job balances in the trade sector since 2015.

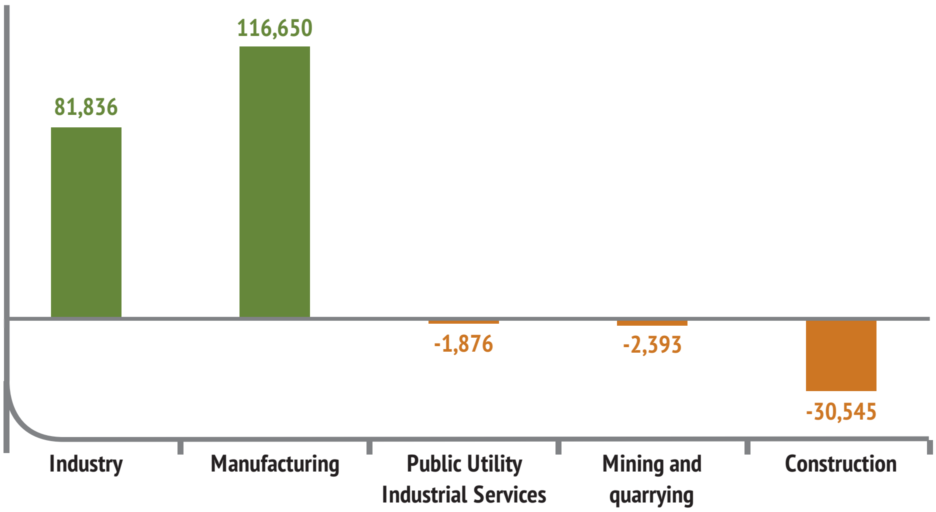
The greatest positive contribution to the CAGED result in 2017 came from the service sector, where 138.800 jobs were created in the year to October. Hospital care activities - the sector that generates more jobs in the service sector historically - was the one that influenced this result the most.

4 - Employment is traditionally one of the last indicators to deteriorate in periods of recession, as well as to react when activity recovers. This behavior can be partly explained by the fact that companies postpone as much as possible their decision to dismiss and hire employees. This is mainly due to two reasons: the high costs involved in dismissing and hiring employees and the need to retain skilled labor, whose training requires time and investment.

The resumption of economic activity makes an upturn in employment in the manufacturing industry possible

Net balance of formal jobs in industry and its segments

*In number of jobs (in the year to October)**



Source: CAGED/MTE
* Includes late responses

Agriculture/livestock, the activity that posted the second best result in terms of job creation, recovered positively in the year to October (105,100 jobs) and is expected to close 2017 with the highest net job creation recorded in the past five years. The greatest contributions to this result came from the Orange-Growing and Agricultural Support Activities sectors.

Industry in turn recorded the creation of 81,800 net jobs. Manufacturing industry was the only segment accounting for this result, as it created 116.600 jobs. Public Utility Industrial Services (SIUP), the mining and quarrying industry, and the construction industry lost jobs in the year to October, with a net loss of 1,900, 2,400 and 30,500 jobs, respectively.

UNEMPLOYED RATE ON THE DECLINE

In 2017, a period of 28 months with unemployment on a sharp upward trend came to an end. In March, when it reached a peak in the historical series (13.7%) initiated in 2012, the unemployment rate took a downturn and dropped to 12.2% of the workforce in the quarter ended in October, according to data from the National Household Sample Survey (Continuous PNAD/IBGE). CNI estimates that this indicator will continue to decline until December and is likely to close the year at an average rate of 12.8%.

The reactivation of economic activity played a major role in this downturn. However, some aspects of the behavior of the unemployment rate deserve further analysis.

First, employment took an upturn mainly in segments in which informal labor is prevalent. Among the additional 2.6 million people included in the employed population in relation to the quarter ended in March, 843,000 are self-employed, 798,000 are private sector employees without a formal contract, and 203,000 are domestic workers. The public sector, where labor is formal, generated 651,000 jobs. The number of employees in the private sector with a formal contract, on the other hand, fell by 103,000 during the same period.

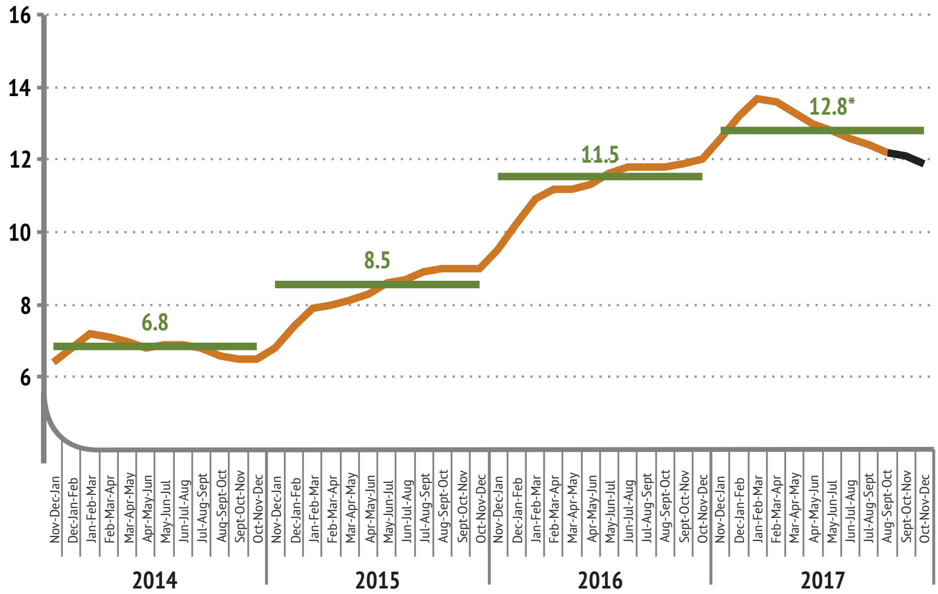
It should be emphasized that, overall, informal workers enjoy fewer benefits and earn less than formal ones. In addition, a significant number of these employees are in a situation of underemployment because of their low working hours, i.e. these are people who work less than 40 hours a week but would like to work for more hours.

In addition, a long period of employment on the decline led part of the unemployed population to stop looking for a job, increasing the number of "discouraged individuals" (people who were

Unemployment rate falls again in 2017

Unemployment rate (quarterly moving average) and average annual unemployment rate

As a percentage of the workforce (%)



Source: Continuous Monthly PNAD/IBGE *
CNI Forecast

not looking for a job in the reference week of the survey but would like to have one). In part, this discouragement can be explained by the perception of a fiercer competition for jobs due to the increase in the number of unemployed individuals and lower availability of jobs. In addition, the long duration of the economic crisis made it impossible for part of the unemployed population to bear the costs of looking for a job, such as transportation costs, the cost of eating out, documentation costs, among others.

The growth posted by informal labor and the replacement of unemployed by discouraged workers - also known as potential labor force - suggest that the improvements recorded in the labor market are somewhat fragile and that, therefore, a more robust recovery of economic activity is required.

The passage of the labor reform bill a was major achievement in 2017. The changes promoted by the Labor Reform are positive, as they make the labor market more flexible, dynamic, and efficient and can contribute to increased formalization. CNI's Special Survey, released in December, shows that the expectations of industrial entrepreneurs are that the reduction in legal uncertainty promoted by the Labor Reform will boost investment and employment.

GROWTH OF TOTAL EARNINGS SUSTAINS RECOVERY OF HOUSEHOLD CONSUMPTION

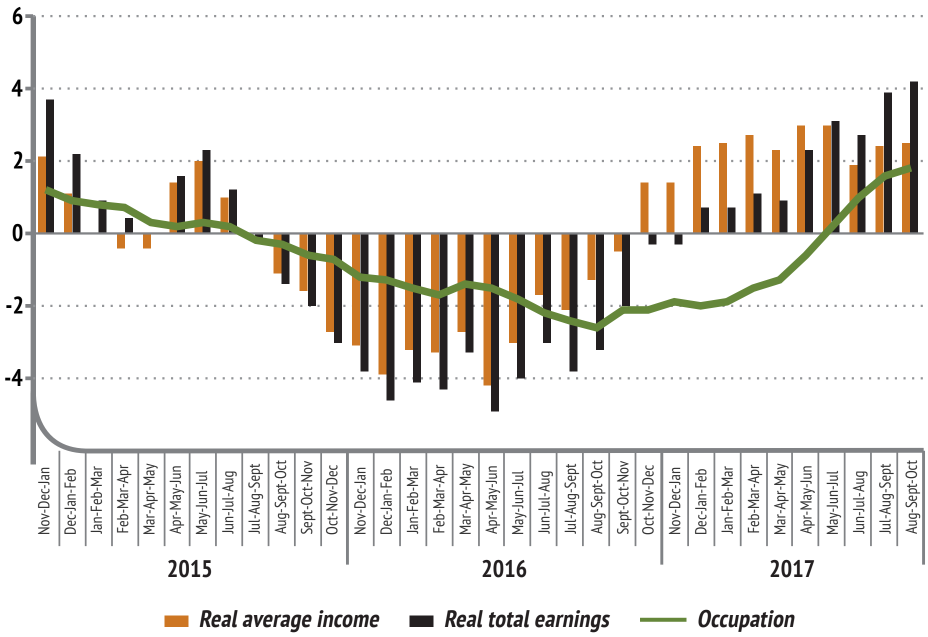
Like employment, the increase recorded in the average real income earned by workers surprised in 2017. The strong disinflation recorded throughout the year and the resumption of economic activity made it possible for wages to be increased above the National Consumer Price Index (INPC). In October, average wages rose by 1.3% in real terms in relation to inflation, against a loss of 1.1% over the same period in 2016, according to the Salariômetro (wage meter) measured by the Economic Research Institute Foundation of the University of São Paulo (FIPE/ USP).

The increase in employment as of the second half of the year led real total earnings to grow more robustly, contributing to the recovery of household consumption. In the moving quarter ended in October, total earnings grew by 4.2% in relation to the same quarter in the previous year against a 3.2% decline in 2016, on the same basis of comparison. CNI estimates that real total earnings will continue to increase in the last two months of the year and close 2017 with an average growth of 2.2%.

Total earnings resume growth in 2017

Average real income, total earnings and occupation

Variation as compared to the same moving quarter the year before (%)



Source: Continuous Monthly PNAD/IBGE

OUTLOOK

In 2018, CNI expects the labor market - especially the formal one - to recover more robustly due to the more intense economic growth expected for the year. The unemployment rate will likely remain on its usual upward path in the first quarter, when temporary year-end work contracts expire, and take a sharper downturn from the second quarter than the one observed in 2017. As a result, the average unemployment rate is likely to hit the mark of 11.8% of the workforce in 2018.

It should be emphasized that the sustainability of this recovery also depends on addressing structural issues such as the need to improve the business environment and boost competitiveness in the Brazilian economy.

Average real income will remain on the rise due to improved economic activity and measures to continue to keep inflation under control. Total earnings will likely grow more than real income due to a more intense job creation. As a result, CNI estimates that real average income will grow by 1.6% and that real total earnings will increase by 2.8% next year.

INFLATION, INTEREST RATES AND CREDIT

Inflation surprises positively in 2017

IPCA index is likely to close the year at 2.9%

The disinflation process observed throughout 2017 surprised economic agents for its intensity. The Expanded National Consumer Price Index (IPCA), which had closed 2016 at 6.3%, decreased to 2.8% in the 12 months to November. It will likely close 2017 at 2.9%, remaining slightly below the lower limit of the target set by the National Monetary Council (CMN).

The effects of a strong economic recession on demand, the stability of the exchange rate, and the commitment of the monetary authority to keep inflation under control influenced the dynamics of prices and the formation of expectations, all of which played a key role in promoting the widespread disinflation process recorded among the IPCA components. The diffusion index disseminated by the Central Bank of Brazil (BACEN), which measures the percentage of IPCA sub-items with a positive variation in a month, recorded an average of 52.1% between January and November 2017, against 64.1% in 2016.

It should be noted that the unexpected intensity of the fall in the indicator was mainly due to the favorable behavior of food prices resulting from record agricultural crops, which increased the supply of food and, consequently, pushed agricultural prices down. After rising by 11.6% in the 12 months to November 2016, the prices of agricultural products dropped by 5.3% over the same period in 2017.

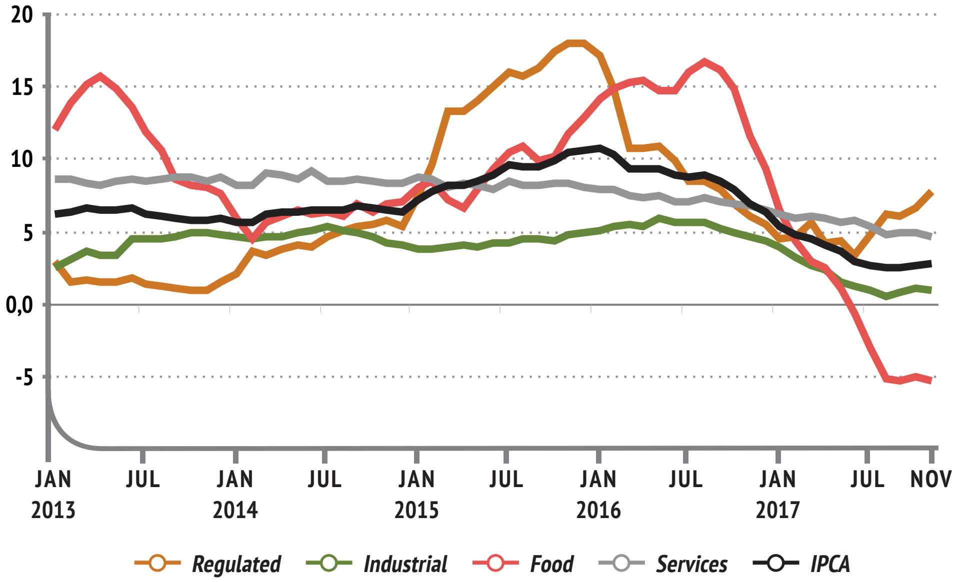
The services group, which is usually pressured by the strong inertia caused by the indexation of service prices to past inflation and the minimum wage, cooled off more intensely than usually. After rising by 6.8% in the 12 months to November 2016, service prices dropped to 4.6% over the same period of 2017.

The group of government-regulated prices was the one that pushed inflation up the most this year. The group posted a variation of 7.8% in the 12 months to November, a rate above the

Food deflation contributes to keeping inflation under control

IPCA by groups

12-month figure (%)



Source: IBGE
Prepared by: CNI

one observed in the total index, of 2.8%. This behavior was mainly due to strong adjustments in electricity, health insurance, and gasoline prices, which together accounted for 66% of the variation observed in this group.

The IPCA index is estimated to rise by 0.39% in December, bringing the inflation rate down to 2.9% in the year to date, the lowest annual rate since 1998.

SELIC RATE HITS HISTORICALLY LOW LEVEL IN 2017

The favorable behavior of inflation, which will likely close the year slightly below the lower limit of the target range, coupled with anchored inflation expectations for the coming years, made it possible for the monetary authority to adopt an expansionary policy in the second half of the year, leading the Selic rate down to a historical low. In its eight meetings held in 2017, the Central Bank reduced interest rates by 6.75 percentage points, bringing the Selic rate down from 13.75% to 7% a year.

FINANCIAL DELEVERAGING PROCESS CONTINUES

The process of financial deleveraging of the economy, which was initiated in 2016, continued in 2017. Total credit balance remained on a downward path in real terms, mainly due to a reduction in the stock of credit for corporations. Real credit balance for individuals declined less sharply and is already showing signs of stability in the comparison between 12 months to October 2017 and the same period in 2016.

During 2017, a decline in financing costs for households and companies was recorded due to successive decreases in the Selic rate and to lower credit default rates. Interest rates on loans granted with non-earmarked resources dropped from 54.2% a year in October 2016 to 43.6% a year in the same month in 2017. The decrease was sharper for individuals, whose average financing costs decreased from 74.3% to 59.5% a year during the same period, while for enterprises they dropped from 30.4% to 23.3% a year. Despite this decrease, real interest rates for borrowers remain at extremely high levels.

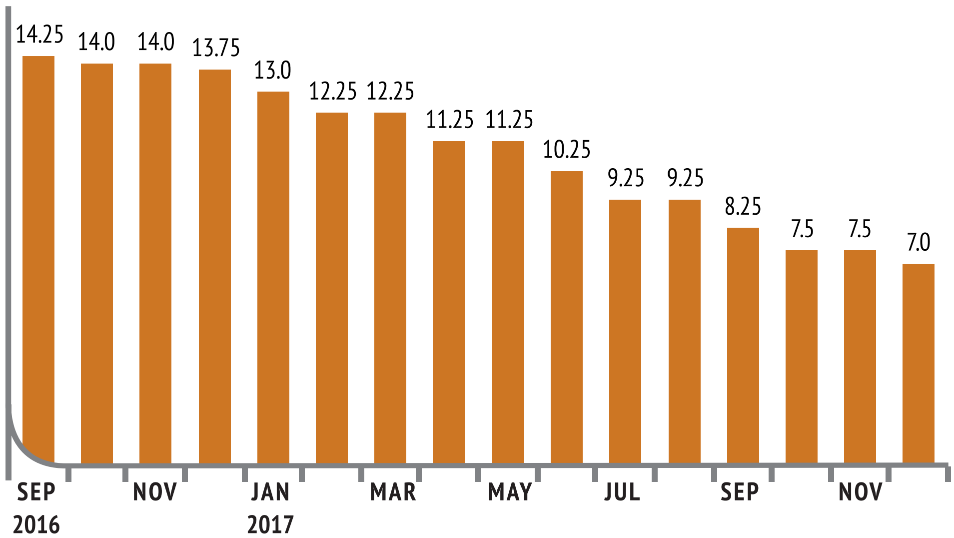
The decrease in financing costs, added to an increase in the disposable income of households, made it possible for households to resume consumption. Falling indebtedness, improvements in the labor market, and food deflation - an important component of the household consumption basket - accounted for the increase seen in the share of disposable income. This fact played a role in increasing the availability of credit to individuals, which rose by 4.4% in real terms in the comparison between the year to October and the same period in 2016. Credit to enterprises decreased by 4.7% in real terms on the same basis of comparison.

During the remainder of the year, total credit balance will likely continue on a downward path and the cost of financial operations is also expected to decrease.

Selic rate hits the mark of 7.0% a year.

Selic - Basic interest rate

Final rate in the period (% a year)

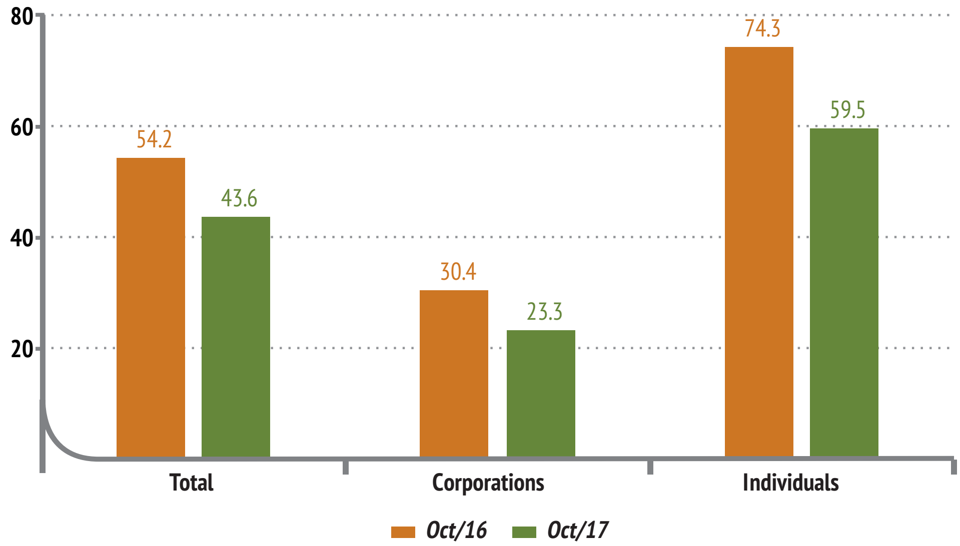


Source: Central Bank of Brazil

Lower credit costs for enterprises and households

Average interest rate for credit operations with non-earmarked resources - Total, Corporations and Individuals

Average rate (% a year)



Source: Central Bank of Brazil

OUTLOOK

SELIC RATE LIKELY TO HIT THE MARK OF 6.75% IN 2018

Inflation is likely to remain low in 2018 due to the still high idleness in the Brazilian economy, to a high unemployment rate, and to the breaking of inflation inertia in 2017. However, the IPCA index is likely to rise to 4.4%, slightly below the 4.5% inflation target set by the CMN. The restructuring of food prices and adjustments in government-regulated prices will cause this behavior, particularly by an expected increase in electricity rates. Low water levels in reservoirs coupled with a recovery in economic activity are likely increase the need to use thermoelectric plants, pushing electricity rates up.

A sharper-than-expected devaluation of the Brazilian currency in the event of an electoral result not in line with the continuity of the reforms and economic policy adopted today is an inflationary risk factor not contemplated in this CNI estimate. In such a scenario, the impact of an increase in the exchange rate on inflation would be stronger and could jeopardize the favorable result expected for 2018.

Keeping current inflation and its expectations at low levels will likely make it possible for the Selic rate to be further reduced in the first meeting of the CMN in 2018, which is scheduled to be held in February. According to an announcement made during the last meeting, held in December, the Selic rate will likely hit a new record low, of 6.75% a year. CNI estimates that this level will be maintained throughout 2018.

However, for this low rate to be maintained in the medium- and long-term without impacting inflation, the fiscal adjustment must be ensured and the reforms sped up, particularly the pension reform, otherwise the Central Bank will be forced to reverse the downward path of the Selic rate observed so far.

The historically low level of the basic interest rate and the economic growth expected for 2018 will contribute to a gradual recovery of credit for individuals and to an inflection in the granting of credit to corporations throughout the year.

FISCAL POLICY

Easing of the fiscal target leads to increased spending

Recovery of public sector revenues is not reflected in a decrease in the deficit

The Brazilian public sector will close 2017 with a high primary deficit, which will remain at practically the same level as the one recorded in the previous year, and with increased spending. What this means is that despite some attempts to contain non-mandatory expenditures, the pressure from continuous increases in compulsory spending and constant changes in primary result targets prevented a significant change in the fiscal framework. The new fact observed in 2017 was the resumption of revenue growth in response to improved economic activity and tax increases promoted by the federal government and state governments.

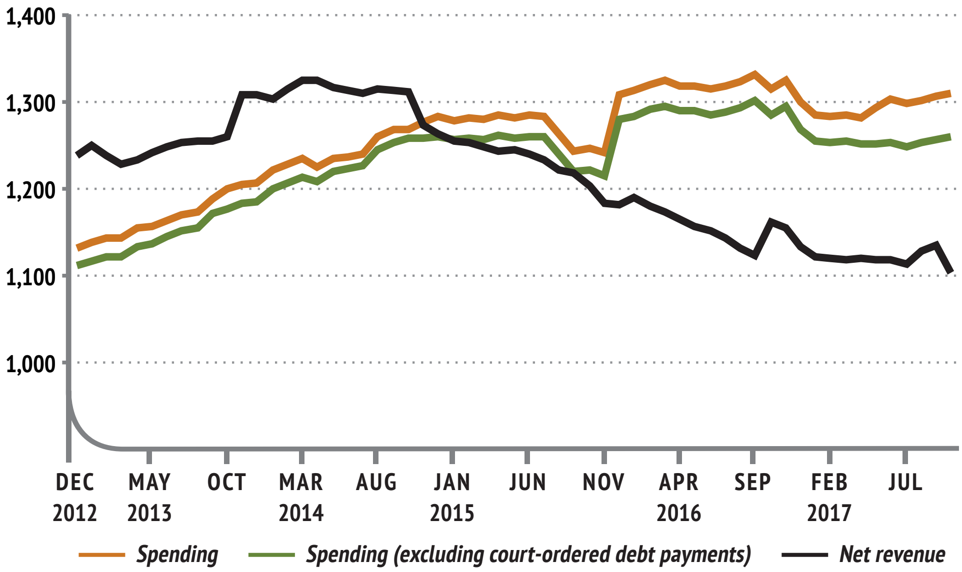
This scenario is not likely to change significantly in 2018. The restrictions on increased federal government primary spending imposed by the New Fiscal Regime require the passage of legislative proposals designed to curb mandatory spending, such as the pension reform and the postponement of wage increases for civil servants. If any of those bills is not passed, the federal government will likely impose limits on non-mandatory spending to comply with the primary target and meet the limits imposed on primary spending. However, the pressure from mandatory spending will still lead to a further real increase in federal spending. The expenditures of states and municipalities will likely continue to rise as observed in 2017.

Revenues are also likely to increase further as a result of the continued recovery of economic activity and the effects of increased taxation, despite a sharp reduction in non-recurring revenues. However, it is still very likely that the primary deficit will not be much lower than the one recorded in 2017, meaning that it will not be

Were it not for the frontloading of expenditures with court-ordered debt payments, federal government primary spending would have posted a real decrease

Evolution of the primary spending and net revenue of the Federal Government

In 12 months (R$ billion in October 2017)



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

sufficient to prevent a further increase in public-sector indebtedness.

MANDATORY SPENDING PUSHES FEDERAL GOVERNMENT EXPENDITURES UP

Federal government primary spending increased by 1.0% (IPCA deflator) in real terms between January and October 2017 in relation to the same period in the previous year. However, after deducting the effect of the frontloading of court-ordered debt payments in relation to 2016, spending decreased by 0.8% on the same basis of comparison. This result shows that the real decrease of 13.5% observed in non-compulsory spending, which has a lower weight on the composition of the public budget, exceeded the pressure exerted by compulsory spending, which rose by 2.7% and has a greater weight on the budget.

Considering the results not affected by the impact of the frontloading of court-ordered debt payments, spending with pensions, personnel, and benefits were the mandatory spending items that pushed overall spending up the most. Pension system expenses increased by 5.9% in the first ten months of 2017 in relation to the same period in 2016. This increase resulted from an increase in the value of pensions and in the number of pensioners. The same explanations apply to the 6.0% increase observed in spending on social security benefits.

Spending on personnel continued to pressure public accounts. The real increase of 7.8% in spending on public personnel was a result of wage increases granted in mid-2016, which had a direct impact on public accounts only in 2017, and of wage increases granted in January 2017. The decision to grant such wage increases as efforts are being made to promote fiscal adjustment compromised the achievement of the primary result targets set for 2016 and 2017, which had to be expanded and will need to be reviewed so as not to jeopardize public accounts in 2018 as well.

A real growth of 2.7% in mandatory spending in the first ten months of 2017 requires a sharp reduction in non-mandatory expenditures, especially in investment

The reduction seen in non-mandatory spending was concentrated in investment, which declined by 33.8% between January and October 2017 in relation to January-October 2016. Financing costs, including subsidies for the My Home, My Life (*Minha Casa Minha Vida*) program, posted a real decrease of 8.0% on the same basis of comparison.

Federal government net revenue showed a real decrease of 3.2% over the period between January and October 2017 in relation to the same period in 2016. However, this result is due to a reduction in non-recurring revenues in relation to those recorded over the same period in 2016. In 2016, net revenue from the program for the regularization of undeclared funds held abroad, known as repatriation, and revenues from concessions largely exceeded the main non-recurring revenues recorded in 2017, such as those generated by the reopening of repatriation, debt installment payment programs, concessions, and refund of judicial deposits.

The greatest impact of the non-repetition of the non-recurring revenues recorded in 2016 was felt on revenues managed by the Internal Revenue Service. In the first ten months of 2017, those revenues declined by 3.5% compared to the same period in 2016. Were it not for the decline in non-recurring revenues, collections by the Internal Revenue Service would have increased already as a result of the positive effects on tax revenues resulting from the resumption of economic activity and tax increases, such as of an increase in the rates of the Social Integration Program/Social Security Financing Contribution (PIS/Cofins) on fuels.

Revenues of the social security system are on the rise already. Between January and October 2017 these revenues posted a real increase of 0.7% compared to the same months in 2016. This increase would have amounted to 2.1% were it not for the effect - merely in accounting terms for public accounts - of a reduction in National Treasury compensations for exemptions on payroll taxes granted to some economic sectors. This expansion is due to the real growth of total earnings and, to a lesser extent, to the revenues generated by the debt installment payment programs.

Even revenues not managed by the Internal Revenue Service, in which the volume of concessions is still lower than that recorded in 2016, posted a real increase of 4.8% in the first ten months of 2017 in relation to the same period in 2016. This result was made possible by the increase in revenues from financial compensation for mineral exploration, dividends, and refund of judicial deposits.

SPENDING OF REGIONAL GOVERNMENTS INCREASES IN RESPONSE TO INCREASED REVENUES

After two years marked by strong expenditure restraints, the spending of states and municipalities is on the rise again. However, given a significant increase in revenues, this behavior did not have a negative impact on the primary surplus generated by them.

Based on available data on state and municipal revenues and on the behavior of their primary result, CNI estimates that the spending of regional governments increased by 3.4% in real terms between January and September 2017 in relation to the same period in 2016.

As for revenues, the available data indicate a real increase of 4.6% in the first nine months of 2017 against the same period in 2016. The revenue from the turnover tax (ICMS), which is the main source of revenue for regional governments, increased by 4.7% in real terms on the same basis of comparison. Tax revenues were favored by the resumption of economic growth and tax increases promoted by several state governments.

The economic upturn and its positive effects on the collection of federal taxes shared with states and municipalities and the increased financial compensation for mineral exploration led transfers from the Union to increase by 7.9% in real terms in the first nine months of 2017 against the same period in 2016. It is worth remembering, however, that this growth will lose momentum in the last months of the year, as the transfers resulting from the repatriation of undeclared funds held abroad will not be repeated.

PRIMARY DEFICIT REMAINS HIGH

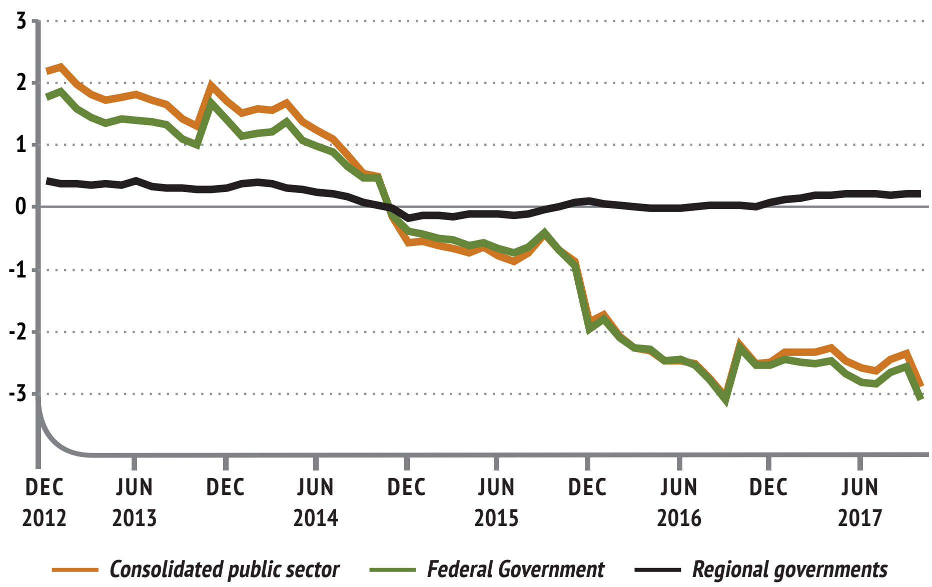
Over the past 12 months to October, the public sector posted a primary deficit of R$187.2 billion (2.88% of GDP). In December 2016, the deficit was equivalent to 2.49% of GDP. However, the frontloading of court-ordered debt payments by the Federal Government was the very main factor that accounted for the increase in the primary deficit of the consolidated public sector in 2017. Discounting the effects of that frontloading, the primary deficit in the 12 months to October would have been R$164.6 billion (2.53% of GDP).

Despite a reduction of 0.12 percentage points of GDP in nominal interest spending, explained by the strong reduction in the Selic rate, the increase in the primary deficit led the 12-month nominal deficit to rise from 8.98% of GDP in December 2016

The 12-month public sector primary deficit increased by 0.39 percentage points of GDP between December 2016 and October 2017

Primary result of the consolidated public sector and by levels of government

(% of GDP)

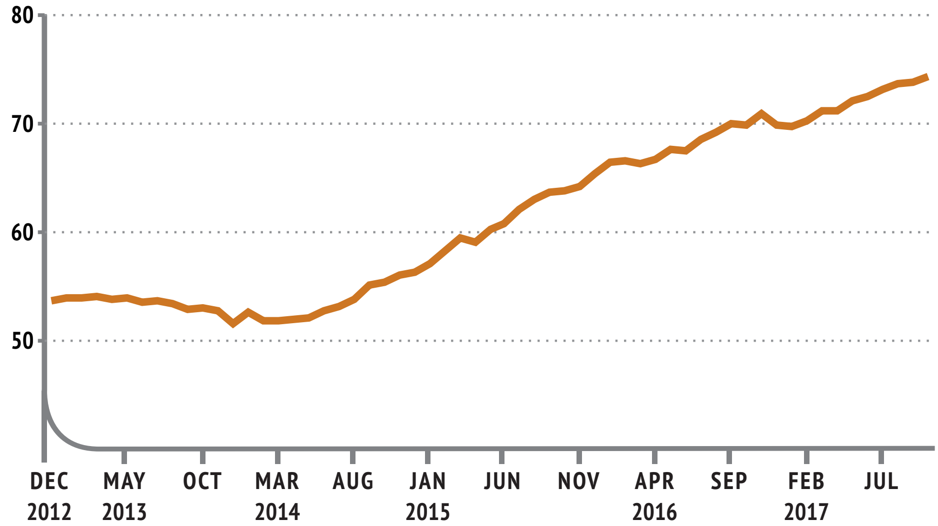


Source: Central Bank of Brazil
Prepared by: CNI

The Gross Debt/GDP ratio grew by 4.5 percentage points between December 2016 and October 2017

Trajectory of the Gross Debt of the Public Sector in relation to GDP

(% of GDP)



Source: Central Bank of Brazil

to 9.25% of GDP in October 2017. The rise in the nominal deficit and a low nominal GDP growth led the Gross Debt/GDP ratio to increase from 69.9% in December 2016 to 74.0% in October 2017.

PRIMARY RESULT IS LIKELY TO IMPROVE BY THE END OF 2017

The primary deficit of the Federal Government in the 12-month period to October will likely decrease in the last two months of 2017. Although spending will likely increase at a faster pace over that period, the expected upturn in net revenues will likely more than offset the behavior of expenditures. On the other hand, the primary surplus of regional governments is expected to decrease by the end of 2017. The net result will nevertheless be a lower primary deficit of the public sector in the last two months of the year.

Federal spending is turn expected to increase in real terms from 1.0%, as recorded in the period from January to October, to 1.7% in the year to December 2017. Non-mandatory spending will be the main factor leading to this more intense increase. The increase in the primary deficit target has led to the lifting of restrictions imposed on budget funds amounting to over R$20 billion, which is likely to significantly reduce the decline recorded in non-mandatory expenditures so far.

The net revenue of the Federal Government is in turn likely take an upturn and close the year with an increase of 2.4%, after decreasing by 3.2% in real terms until October. Proceeds from concessions in the areas of oil exploration, hydroelectric power plants, and airports are likely to be the main factors driving this shift. As a result, revenues not managed by the Internal Revenue Service are expected to close the year with a real increase of 25.6%. In addition, revenues managed by the Internal Revenue Service will likely continue to be favored by the resumption of economic activity and by the proceeds from the debt installment payment programs. The decline recorded until October, of 3.5%, is likely to take an upturn and close the year at 1.9%.

In this scenario, CNI estimates that the Federal Government and its state governments will likely close the year with a primary deficit of R$158.3 billion (2.37% of the GDP estimated by CNI). Albeit high, this result is within the R$162 billion limit set as the 2017 fiscal target.

In the case of regional governments and their state-owned companies, a slowdown in revenue growth is likely due to the non-repetition of the volume of funds transferred by the Federal Administration in 2016 as a result of the repatriation of undeclared funds held abroad. Because the behavior of expenditures is not likely to change significantly, the primary surplus of regional governments and their state-owned enterprises is expected to take a slight downturn and close 2017 at about R$7.0 billion (0.1% of the GDP estimated by the CNI).

CNI estimates the primary deficit of the Federal Government and its state-owned enterprises at R$156.1 billion (2.16% of the GDP estimated by CNI) in 2018, within the target of R$162.5 billion

As a result, the consolidated public sector will likely post a primary deficit of R$151.3 billion (2.27% of the GDP estimated by CNI) in 2017. Although this result is below the R$163.1 billion target set for 2017, it will be slightly lower than the R$155.8 billion deficit recorded in 2016.

The slight improvement in the primary result and the decline of 0.5 percentage points of GDP projected for spending on nominal interest rates by the end of 2017 will likely lead to a drop in the nominal deficit in 2017 compared to 2016. The nominal deficit is expected to fall from 8.98% of GDP in 2016 to 8.4% of GDP in 2017. Albeit on a declining path, this level is still not low enough to at least stabilize the Gross Debt/GDP ratio, which will likely rise from 69.9% in December 2016 to 74.0% in December 2017.

OUTLOOK

COMPLIANCE WITH FISCAL TARGETS SET FOR 2018 REQUIRES APPROVAL OF MEASURES OR CURBING OF NON-MANDATORY SPENDING

Complying with the primary deficit target and meeting the federal government's primary spending cap will depend on the passage of bills by Congress to curb mandatory spending and increase revenues. If those bills are not passed, the federal government will likely conduct a financial programming of non-mandatory expenditures.

On the spending side, our scenario considers the passage of the consensual bill on pension reform by February 2018 and the postponement of a new wage raise for civil servants. Thus, CNI estimates that federal spending will increase by 1.4% in real terms in 2018.

Increased pension spending will be the main factor leading to this rise in federal spending in 2018. Social security expenditures are expected to rise by 2.8% due to the effects of a pension raise resulting from an increase in the minimum wage and in the number of pensioners. If the wage raise for civil servants is postponed, spending on personnel is expected to increase by only 0.2% in 2018.

If the measures to curb spending are actually approved, there will be no need for the federal government to conduct a significant financial programming of non-mandatory expenditures. Thus, cost and capital expenditures are likely to decline slightly, by 0.1%. On the one hand, there would be an increase in spending on salary bonuses, unemployment insurance, and welfare benefits, which would be impacted by the increase in the minimum wage and in the number of pensioners. On the other hand, non-mandatory expenditures would decline from R$122 billion, as projected for 2017, to R$112.6 billion, as proposed in the 2018 budget.

CNI projects a real increase of 2.3% in the net revenue of the federal government in 2018 in relation to 2017. Among the components of net revenue, the highest growth is likely to be seen in revenues managed by the Internal Revenue Service, which are expected to increase by 4.1% in 2018 in relation to 2017. Tax collection will be favored by the real growth of 2.6% of GDP and tax increases that will only be fully effective in 2018, such as the increase in the rates of the Social Integration Program/Social Security Financing Contribution (PIS/Cofins) on fuels and in the Income Tax on closed-end investment funds (a bill yet to be passed).

The revenues of the social security system are also expected to rise by 4.1% in 2018 compared to 2017. In addition to the more intense growth rate of total earnings, these revenues will likely increase even more if a bill reinstating the social security contribution on the payroll for several economic sectors is passed.

Based on these projections for revenues and spending, CNI estimates that the primary deficit of the Federal Government and its state enterprises will amount to R$156.1 billion (2.16% of the GDP estimated by CNI) in 2018, within the R$162.5 billion target.

If measures to curb spending and increase taxation are not approved, the federal government will have to conduct a financial programming of R$18 billion earmarked for non-mandatory expenditures in the budget. This is a challenging figure, as it would reduce the available amount to R$94.6 billion, which is lower, in nominal terms, than the amount earmarked for such expenditures in 2017. However, there would be no other alternative, since we estimate that the expenditures projected for 2018, already considering that the above-mentioned measures will be approved, are only R$2.6 billion below the spending cap.

We are projecting a new primary surplus for states and municipalities in 2018, but one lower than that observed in 2017. A more intense recovery of economic activity in 2018 will have a positive effect on the collection of the ICMS tax and of federal taxes shared with states and municipalities. In addition, transfers will be favored by a further increase in compensation for exploitation of mineral resources. However, spending will also continue to rise due to increased revenues, the electoral calendar, and the debt renegotiation agreement with the state of Rio de Janeiro. CNI therefore estimates that states, municipalities, and their state-owned enterprises will a post a primary surplus of R$3.0 billion in 2018.

In such scenarios for the federal government and state governments, the primary result of the consolidated public sector in 2018 will likely be negative by R$153.1 billion (2.12% of the GDP estimated by CNI). Apart from falling short of the target set for 2018, which is R$161.3 billion, this result would represent a decrease in relation to the deficit of 2.27% of GDP estimated for 2017.

However, the main factor leading to improved public accounts in 2018 will likely be the reduction of spending on nominal interest rates. The significant decrease seen in the Selic rate in 2017 and the relative stability of the exchange rate expected for 2018 will be reflected in a reduction of spending on interest payments to 5.5% of GDP. As a result, the nominal deficit will likely decrease to 7.6% of GDP. However, this level will not yet be sufficient to stabilize the Gross Debt/GDP ratio, which is expected to rise again and hit the mark of 76.2% of GDP in 2018.

Therefore, the task of correcting the imbalance in public accounts will still unfinished at the end of 2018.

FOREIGN TRADE SECTOR

Record trade surplus ensures a reduction in the current account deficit

Exchange rate stabilizes with favorable scenario abroad

The year 2017 was marked by the continuation of the downward trend recorded for the current account deficit, suggesting that the Brazilian external accounts have become less vulnerable. In the 12-month period to October, the deficit in current transactions amounted to US$9.6 billion, against US$22.3 billion recorded for the same period in 2016. Since December 2014 - when the worst result of the series was recorded, a negative balance of US$104.2 billion - the 12-month deficit in current transactions decreased by 78.5%.

The trade balance contributed positively to this adjustment in two different ways. In 2015 and 2016, the contribution came from the economic recession faced by the country, marked by a sharp drop in imports that more than made up for a decline in exports. In 2017, the contribution had a new composition. Exports increased significantly, influenced by the excellent result recorded for commodities, while imports grew, reflecting the end of the recession and recovery of economic activity, albeit slowly and gradually.

With the gradual recovery of domestic demand, the deficit is likely to increase at the end of the year. However, the current account deficit will remain at a comfortable level, closing 2017 at only US$11 billion, 0.5% of the GDP projected by CNI. The trade balance expected by CNI is, in turn, US$66 billion, with exports rising by 17.1% to US$217 billion and imports increasing by 9.8% to US$151 billion against the previous year.

STABLE EXCHANGE RATE IN 2017

During the course of 2017, the exchange rate remained stable, varying from R$3.10/US$1 to R$3.30/US$ 1 in terms of the monthly average. This behavior can be mainly explained by favorable international conditions for emerging countries, marked by abundant liquidity and consistent growth of the world economy.

The scenario of stability is good for the planning of enterprises, as it allows for more accurate estimates for turnover and/or costs, for example. In addition, a more stable exchange rate facilitates

Exchange rates has been fluctuating below R$3.30/US$1 since May

Daily exchange rate (Ptax closing rate)*

In R$/US$

Source: Central Bank of Brazil
Prepared by: CNI
* The Ptax closing rate is the average of the buying and selling rates from the daily exchange rate bulletin.

the investment and production decisions of enterprises.

The average exchange rate in November was R$3.26/US$1, up by 2.1% compared to the previous month's average. In relation to the average recorded in December 2016, the Brazilian currency appreciated by 2.8%.

This scenario is not likely to change until the end of the year. We are projecting an average exchange rate of about R$3.25/US$1 in December, a depreciation of 3.0% in relation to the average recorded in December 2016. CNI estimates the average exchange rate in 2017 at R$3.19/US$1, against R$3.48/US$1 in 2016.

RECORD TRADE SURPLUS

The trade balance has been posting record positive balances throughout the year. In the year to November, the surplus amounted to US$62.0 billion, 43.2% higher than the one recorded in the same period in 2016, US$ 43.3 billion. This result was recorded with both exports and imports on the rise, unlike what was seen in 2015 and 2016, when a sharp drop in imports that more than offset the negative result recorded for exports mainly explained the positive trade balance. In the year to November, exports amounted to US$200.2 billion, an increase of 18.2% in terms of daily average compared to the same period in 2016, while imports grew by 9.6% to US$126.0 billion in relation to the same period the year before.

In the classification of exports by aggregate factor, the exports of all products increased in terms of daily average in the year to November against the same period last year: basic products (28.0%), semimanufactured products (13.8%), and manufactured products (9.0%). Among basic products, the exports of crude oil and iron ore stood out, posting an increase of 64.6% and 53.4%, respectively, on the same basis of comparison. Among manufactured products, the significant growth recorded for exports of fuel oils (75.4%), earthmoving machinery (60.0%), tractors (54.2%), and passenger cars (46.8%) deserves special mention.

In their classification by large economic categories, imports of fuels and lubricants, intermediate goods, and consumer goods increased by 41.2%, 10.7% and 7.5%, respectively, in terms of daily average in the year to November in relation to the same period last year, while purchases of capital goods decreased (13.5%).

According to the evaluation of indices calculated by FUNCEX, imports increased both in terms of prices and volume by 4.2% and 4.8%, respectively, in the comparison between the year to October and the same period last year. Intermediate goods increased by 2.6% in prices and by 8.5% in volume,

Exports increased more than imports in 2017

Exports, imports and trade balance in the year to November

In US$ billion

Source: SECEX/MDIC
Prepared by: CNI.

reflecting the better performance of the economy. On the same basis of comparison, imports of capital goods decreased by 1.1% in prices and by 14.6% in import volume.

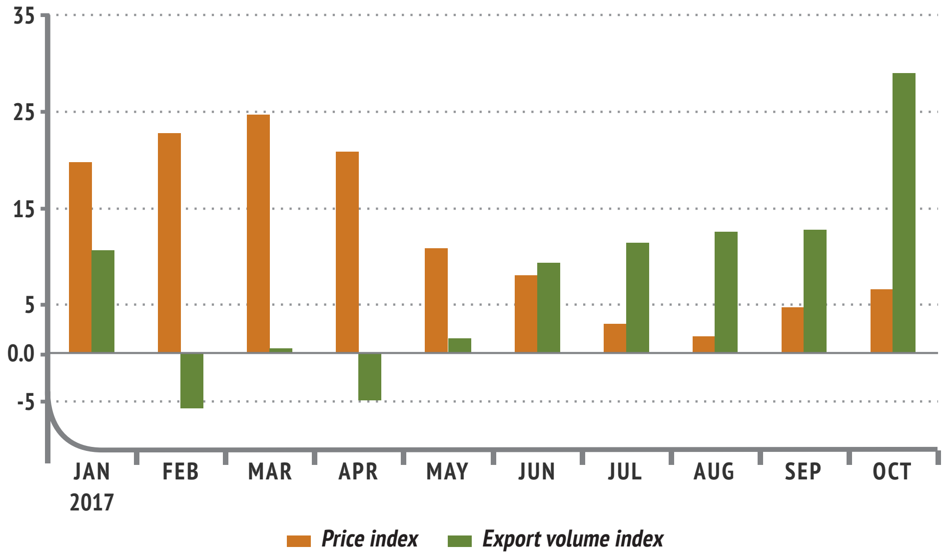
However, it should be noted that the volume of imports of capital goods increased in October for the third month in a row in relation to the same month last year, which may suggest the beginning of a gradual recovery of investment.

The increase in exports in 2017 is explained by both prices and volumes. Prices rose by 11.7% and volumes increased by 7.2% in the year to October against the same period last year. The behavior of those indices was not homogeneous throughout the year. Compared to 2016, exports grew fundamentally due to their prices early in the year in all large economic categories, especially in that of basic products, while the export volume has been growing consistently since June 2017.

Export volume shows recovery

Price indices (in US$) and export volume

Variation compared to the same month in 2016 (%)



Source: Funcex

CNI estimates that exports will total US$217 billion in 2017, up by 17.1% in relation to 2016. Imports are in turn likely to hit the mark of US$151 billion, up by 9.8% on the same basis of comparison. A trade balance of US$66 billion is therefore expected, representing an increase of 38.4% over 2016.

SOLID RESULT IN EXTERNAL ACCOUNTS

In 2017, the trend toward a lower deficit in current transactions continued, albeit less intensely. In the 12-month period to October 2017, the current account deficit hit the mark of US$9.6 billion, equivalent to 0.48% of GDP. This deficit was US$22.3 billion, or 1.25% of GDP, in the same period in 2016. Since December 2014, when the worst result of the series was recorded (a negative balance of US$104.2 billion), the deficit decreased by 90.7%.

This lower deficit can be mainly explained by the trade surplus, since negative variations were recorded for the other accounts in the comparison between the year to October and the same period in 2016: services (US$2.3 billion), primary income (US$3.1 billion), and secondary income (US$0.5 billion).

In the balance of services, the deficit rose throughout 2017, increasing to US$27.0 billion in the period from January to October from US$24.7 billion in the same period the year before. Special mention should be made of the deficit in international travel, which increased by US$4.2 billion on the same basis of comparison due to a higher average exchange rate than the one recorded in 2016 and to an increase in real income resulting from the downturn in the Brazilian inflation rate.

The primary income deficit increased due to both interest payments and remittances of profits and dividends, which grew by US$1.1 billion and US$2.0 billion, respectively, in the year to October 2017 against the same period in the previous year.

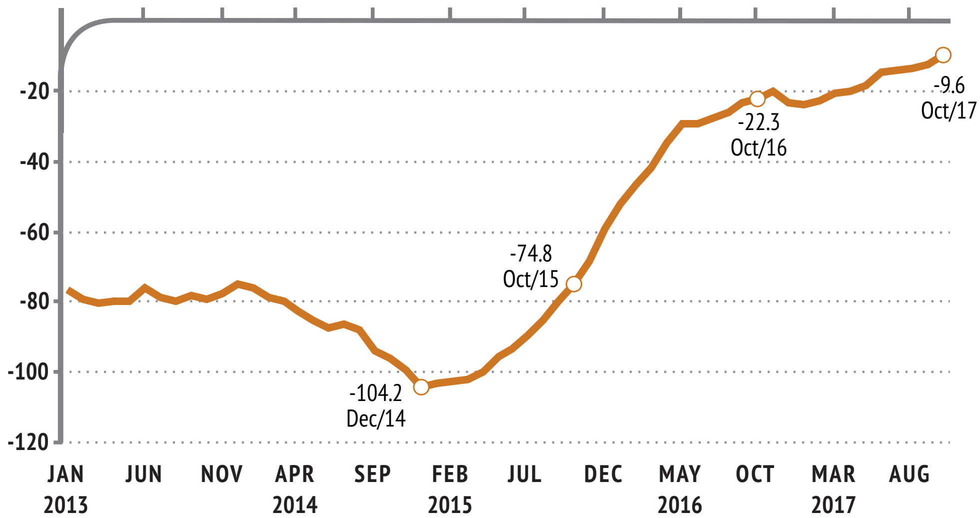
In the 12-month period to October 2017, Direct Investment in the Country (IDP, in the Brazilian acronym) amounted to US$83.3 billion, equivalent to 4.14% of GDP. That amount is more than sufficient to cover the current account deficit of US$9.6 billion, or 0.48% of GDP, recorded in the 12-month period to October. In the same period last year, that deficit amounted to US$74.5 billion, or 4.16% of GDP.

For the last two months of the year, we are projecting lower balances and a more intense growth rate for imports due to the recovery of domestic demand. The current account deficit is therefore likely to amount to US$11 billion in 2017, 0.5% of the GDP projected by CNI.

Lower deficit in current transactions

Current account balance in the year to October

In US$ billion



Source: Central Bank of Brazil

OUTLOOK

TRADE SURPLUS LIKELY TO DECLINE DURING THE COURSE OF 2018

The scenario abroad will likely remain favorable in 2018. We expect the average exchange rate to remain at a level of about R$3.27/US$1, moderately lower than the average recorded in 2017, which was R$3.19/US$1. It should be highlighted that the exchange rate will likely become more unstable over the next year due to a set of uncertainties related to the pace of required reforms, the upcoming presidential elections, and the monetary tightening in the US.

In the domestic scenario, the cyclical recovery of the economy is likely to continue. However, non-continuation of the reform agenda and of the commitment to carry out a fiscal adjustment could give rise to uncertainties. These uncertainties may increase in the medium term due to the upcoming presidential elections, which may lead to increased country risk and push the exchange rate up.

In the international scenario, the difference between the interest rates adopted in Brazil and in developed countries will likely continue to decline over the coming year and may lead to a weakening of the Brazilian currency. In the US, the gradual pace of rising interest rates is expected to continue in 2018. Even if the tax reform proposed by the Donald Trump administration is passed, its possible fiscal and inflationary effects will likely only be felt from October 2018, when the new US fiscal year begins.

The trade surplus is expected to decline over the coming year, as the growth pace of imports is likely to gain momentum in 2018 as a result of the recovery in domestic demand. Exports are also likely to increase, albeit to a lesser extent, since the base is very high and the current pace of global growth is expected to continue. In this scenario, we are projecting a trade balance of US$54 billion over the next year as a result of a combination of a 5.1% increase in exports, which would rise to US$228 billion, and a 15.2% increase in imports, which would rise to US$174 billion.

Regarding the external deficit, we are projecting an increase to US$ 27 billion, 1.2% of the GDP projected by CNI for 2018, in line with a more intense import growth rate, as a result of the recovery in domestic activity. External accounts will still remain comfortable, as it will be perfectly possible to fund the estimated deficit with direct investment in the country (which we expect to amount to US$80 billion). In addition, the greater absorption of external savings, with the increased current account deficit, will contribute to finance the expected increase in the investment rate of the economy.

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2015	2016	2017 (estimates)	2018 (estimates)
ECONOMIC ACTIVITY				
GDP (annual change)	-3.5%	-3.5%	1.1%	**2.6%**
Industrial GDP (annual change)	-5.8%	-4.0%	0.2%	**3.0%**
Household consumption (annual change)	-3.2%	-4.3%	1.3%	**2.8%**
Gross fixed capital formation (annual change)	-13.9%	-10.3%	-2.1%	**4.0%**
Unemployment Rate (annual average - % of the labor force)	8.5%	11.5%	12.8%	**11.8%**
INFLATION				
Inflation (IPCA index - annual change)	10.7%	6.3%	2.9%	**4.4%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	13.47%	14.18%	10.20%	**6.75%**
(year's end)	14.25%	13.75%	7.00%	**6.75%**
Real interest rate (average annual rate and deflation: IPCA)	4.1%	5.0%	6.5%	**2.9%**
PUBLIC ACCOUNTS				
Nominal public deficit (% of GDP)	-1.9%	-2.5%	-2.3%	**-2.1%**
Public sector primary surplus (% of GDP)	-10.2%	-9.0%	-8.4%	**-7.6%**
Net public debt (% of GDP)	65.5%	69.9%	74.0%	**76.2%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	3.87	3.35	3.25	**3.30**
(average in the year)	3.34	3.48	3.19	**3.27**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	191.1	185.2	217.0	**228.0**
Imports (US$ billion)	171.5	137.5	151.0	**174.0**
Trade balance (US$ billion)	19.7	47.7	66.0	**54.0**
Current account balance (US$ billion)	-59.4	-23.5	-11.0	**-27.0**

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