CNI Newsletter
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# ECONOMIC REPORT

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

# Electoral uncertainty hampers stronger recovery in 2018

## Stepping up productivity is a necessary condition for sustained growth

**The Brazilian economy continues to recover at a moderate pace,** despite a strong improvement in the macroeconomic environment as inflation continues below the target floor and the international environment remains benign. This situation allowed for the benchmark interest rate (Selic) to be reduced more significantly than anticipated by economic agents. The Selic rate hit its lowest level since it was instated in the 1990s, with the real interest rate (based on the ex-ante concept) falling below 3%.

**This environment should have led to an even stronger rebound in activity than what was observed.** However, production is growing at only a moderate pace and unemployment has been falling slowly. In the 2008 recession, when the international financial crisis burst, the recovery was much more intense than it has been now.

For illustrative purposes only, even with the GDP growing by 1% in 2017, **per capita income is still down by 8.2% from 2014 levels and industrial production in early 2018 is still 14% below its highest point registered in 2013.** This is to say that even if GDP grows by 2.6% as predicted by CNI, the losses caused by the recession will not yet be fully recovered in 2018.

**There are factors hindering the economy's ability to react.** These factors are not only reflected in the limited recovery of household consumption, but also on the supply side, as installed capital remains significantly idle and thus investments have been reacting weakly.

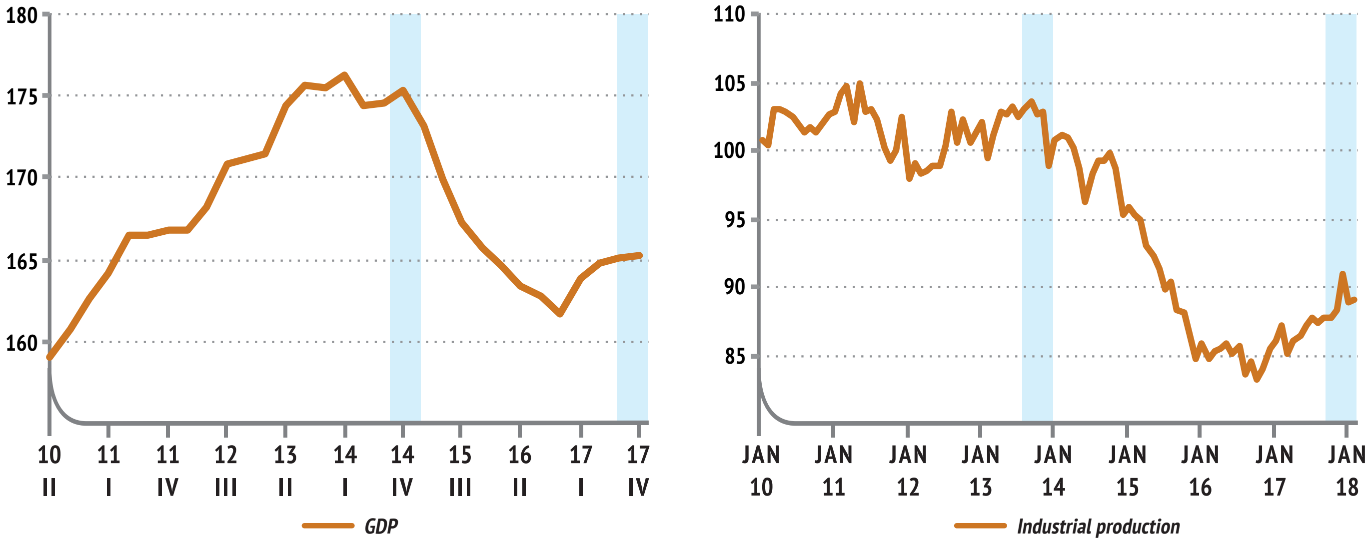
**At the root of these constraints is the unfinished process of public finance adjustment,** the main factor behind the recession in recent years. While the consolidated public sector deficit

*(continued on the next page)*

## The Brazilian economy in the first quarter 2018

## Recovery has not yet completely reversed losses from previous years

*Recent trend in GDP and industrial production*
*Indices: GDP (1995 average = 100) and seasonally adjusted industrial production (2012 average = 100)*




*Source: CNT/IBGE and PIM-PF/IBGE*

declined in 2017 both in nominal terms and as a percentage of GDP, the magnitude of this deficit is still significant and continues to lead to a continued increase in public debt, the most relevant indicator of long-term public sector solvency.

**Permanent adjustment measures on the spending side are thus absolutely indispensable.** The activity rebound leads to a recovery of tax revenues, which are necessary to bring down the public deficit but certainly insufficient to definitely bring the public accounts back into balance.

**The main reason behind the frustration over the adjustment process is the suspension of the social security reform.** The social security deficit is the single most important cause of the consolidated public deficit, meaning that balancing public accounts will be impracticable without significantly reforming the rules for granting social security benefits, including the establishment of a minimum age.

**Social security is the main but not the only element of concern over the continued increase in public spending.** Taking measures to keep personnel expenditures under control is equally indispensable. The Provisional Presidential Decree that postponed the increase in public service wages was suspended by the Supreme Federal Court (STF) and its discussion in the legislature came to a halt. In addition, other fiscal adjustment measures under discussion have also not progressed.

**General elections are on investors' radar.** The uncertain electoral scenario is a source of uncertainty about the continuation of the necessary adjustment that will fall on the shoulders of the elected government, as well as of the new legislature that will analyze the adjustment measures.

**A new cycle of sustained growth requires an increased investment rate in the economy** and, for this purpose, it is crucial to put in place the right conditions to stimulate growth and remove obstacles to projects for the purpose of leveraging the reaction of private investment. The focus should lie on improving the business environment and enhancing competitiveness by improving the governance system of policies that affect productive decisions.

**Brazil should be obsessed with enhancing productivity.** Our greatest challenge is to drive forward the process of income convergence with the world economy from which we have moved away. Long-term growth will only come with the continued increase in productivity so as to reduce (and eliminate) Brazil's productivity gap relative to other countries.

**Brazil's growth agenda is known and cannot take shortcuts:** fiscal balance, social security reform, tax reform, availability of long-term financing, reduction of red tape, efficient regulatory models, legal certainty, and greater effectiveness of public spending. The future implications for productivity, employment, income and living standards will be the fruits of this agenda.

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ECONOMIC ACTIVITY

# Recovery continues at gradual pace

## Unemployment and idle capacity remain at high level and hinder recovery

The latest data on the Brazilian economy are positive and show that 2018 will be a year of partial recovery from the losses caused by the crisis. However, the same data indicate that this positive performance is still weak, thus undermining more optimistic recovery projections, especially for the long term.

Some factors will support the positive performance of activity in the medium run, though it will keep advancing at the current pace. Household consumption will continue to be stimulated by the same factors as in 2017: low and stable inflation, falling unemployment, a record low interest rate, and gradually cheaper and available credit.

Albeit lower than the level seen in the last two years, idle capacity in the industrial park will still allows for the increasing demand to be met without short-term supply bottlenecks. This idleness, however, hinders the recovery of investments focused on increasing capacity. In addition, while the unemployment rate continues to trend downward, it remains above 12%. Household and business financial conditions have improved, but remain weak. Finally, consumer confidence remains at a level below its historical average.

The increase in GDP over the course of 2017 generated a carryover effect of 0.3% for this year. In other words, if GDP remains constant in 2018, standing at the same level as in 2017, a 0.3% growth would already be guaranteed for this year. As we expect the upward trend to continue throughout 2018, our forecast is that GDP will grow by 2.6%.

### BUSINESS CONFIDENCE REMAINS HIGH WHILE CONSUMER CONFIDENCE REMAINS LOW

Industrial confidence, as measured by the Business Confidence Index (ICEI/CNI), started the year on a positive note (+0.7 points between December and January) and has held virtually steady since then. The stability came after a long sequence of increases, which caused the index to stand above the 50-point mark (a benchmark between confidence and lack of confidence) and exceed its historical average.

By analyzing the components that make up the index, one can see that the improvement period was stimulated mainly by expectations. Entrepreneurs' assessment of current business conditions is increasingly positive, but the pace of improvement is much more modest – which corroborates the fact that the recovery from the crisis has more gradual. The indices measuring expectations and current conditions have held virtually steady in 2018.

*Latest industrial activity figures show a slowdown in activity*

*Industrial activity indicators (seasonally adjusted)*

*Change between January and February 2018*

**REAL SALES**
Up by 0.5%

**HOURS WORKED IN PRODUCTION**
Down by 0.5%

**PRODUCTION**
Up by 0.2%

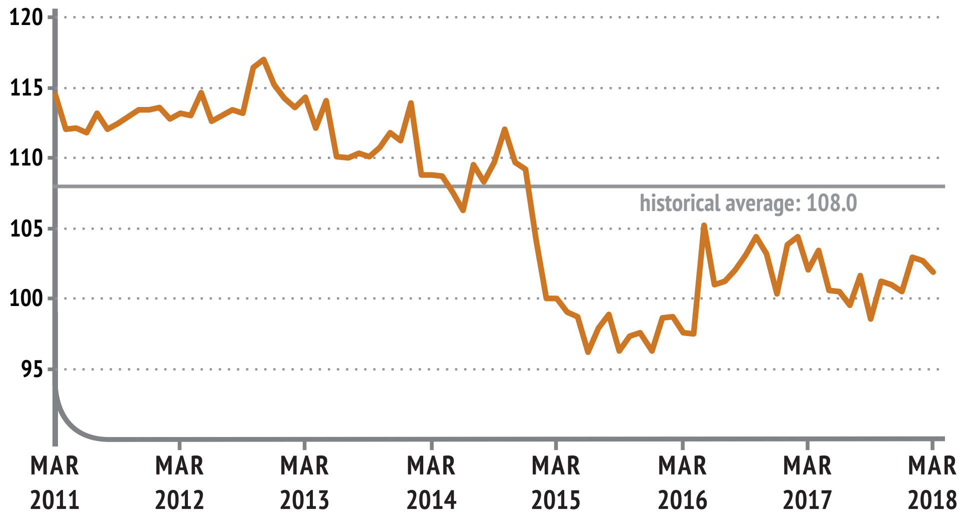
**EMPLOYMENT**
Up by 0.1%

**CAPACITY UTILIZATION**
Down by 0.1 percentage point

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

## *Consumer confidence remains low and is yet to boost consumption*

*Consumer Confidence Index (INEC)*
*Monthly fixed base index (Base: 2001 average = 100)*




*Source: CNI*

Consumer confidence in turn continues to hover at a level below the historical average for the index. The Consumer Confidence Index (INEC/CNI) dropped for the second consecutive month in March and is down by 5.6% from its historical average. Consumers are also particularly cautious about their financial situation and indebtedness levels.

Consumer confidence may improve throughout 2018, but will likely remain at a moderate level as consumers are dissatisfied with current conditions, especially when compared to the situation prior to the 2014-16 crisis.

### INDUSTRY TO GROW AFTER FOUR YEARS

CNI's Industrial Indicators survey shows a slight slowdown in the growth rate of industrial activity levels in February. While real sales grew by 0.5%, hours worked in production are down after growing for three months. In addition, the capacity utilization rate held virtually steady at 78%. Industrial production (Monthly Industrial Survey - Physical Production - PIM-PF/IBGE) declined by 2.2% in January and grew by a mere 0.2% in February.

On the other hand, the labor market data released by CNI's Industrial Indicators survey show that employment is still on a moderate recovery path. Industrial jobs grew by only 0.1% between January and February 2018 in the seasonally adjusted series, totaling five months of growth and a 1.3% increase during the period. Real average earnings and thus real total payroll also remain on the rise.

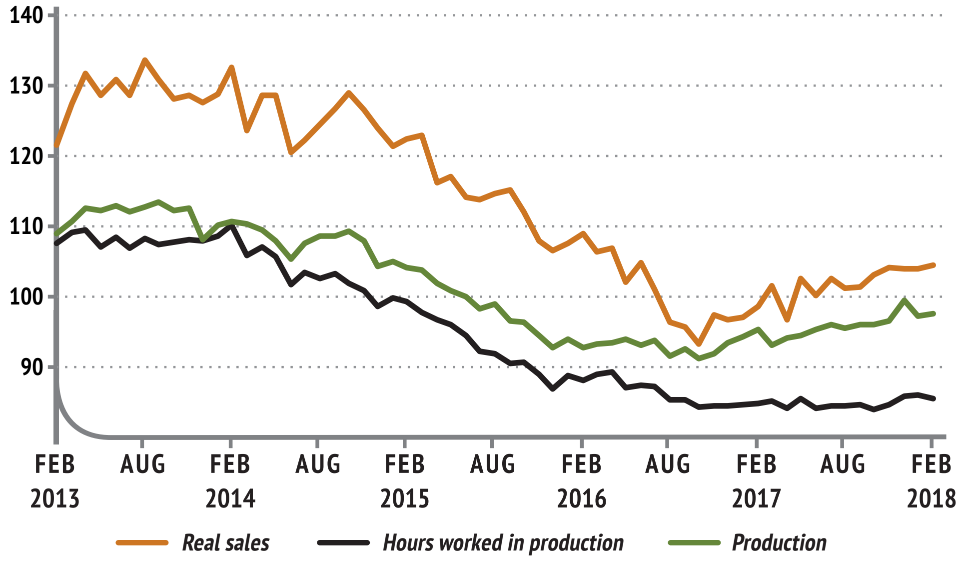
Despite the slowdown in the growth rate in February, we project that manufacturing will continue to recovery gradually throughout the remainder of 2018, with domestic demand rebounding and the external scenario remaining favorable. We expect manufacturing to grow by 3.5% by the end of 2018.

Data for the construction industry, particularly for the Civil Engineering sector, continue to be affected by the ongoing fiscal adjustment. However, there are signs of improvement in the housing sector, with real estate project launches increasing and contract cancellations falling. Activity data from CNI's Construction Industry Survey provide a clear picture of this situation: they are not yet in positive terrain, but are getting better and better.

Construction expectations in turn have been positive since the end of last year. Construction business confidence is improving, as pointed out by the ICEI-Construction Index (CNI), which exceeded not only the 50-point dividing line (between confidence and lack of confidence), but also its historical average. In addition, the March 2018 survey also shows that entrepreneurs have not noticed a deterioration in their current business conditions for the first time since February 2013. Under this scenario, we estimate that the construction industry will grow by 2% in 2018, which would mark the first growth after four years of decline.

## *Activity posts modest growth after dropping sharply*

*Real sales, hours worked, and production in manufacturing*
*Seasonally adjusted monthly fixed base indices (Base: 2006 average = 100)*




*Source: CNI and IBGE*

We also project a 2.5% increase in the mining and quarrying industry in 2018, down from a 4.3% growth in 2017, and a 2.6% increase in Public Utility Industrial Services (SIUP). In this scenario, we estimate that industry will rise by 3% in 2018. This will mark the first increase in industrial GDP since 2013 – when it grew by 2.2% – and the first time industrial GDP will grow more than total GDP since 2011 (when it rose by 0.1 percentage point above GDP growth).

## *GDP estimate for 2018*

*Percentage change in GDP and its components*

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

*Prepared and estimated by: CNI*

In 2018, agricultural crops will only fall behind last year's record result. Nevertheless, coffee crops and meat production are estimated to increase. Thus, we still expect to see a favorable environment for the agriculture/livestock sector, which is set to grow by 2.0% in 2018.

In 2017, the result for the services sector was highly dependent on trade growth. For 2018, considering the more positive industrial performance, we forecast that services linked to this segment, such as transportation and IT, among others, will also grow throughout the year. The rise in household consumption and the expected increase in labor formalization in 2018 will likely lead to an increase in household services. As a result, CNI estimates that the services sector will grow by 2.2% in 2018.

### INVESTMENT IS FINALLY RECOVERING

On the GDP demand side, the largest contributor to economic growth in 2018 is a new increase in household consumption. The withdrawal of FGTS (Employee Severance Indemnity Fund) funds played an important – if not key – role in boosting household consumption in 2017, particularly in the second and third quarters, when it grew by 1.2% and 1.1% respectively. The slowdown seen in the last quarter of the year (growth of only 0.1%) was an evening out of these high growth rates and also reflected the unwinding of those effects.

However, other factors that have been stimulating consumption are expected to trend positively and allow us to estimate that this increase will continue. Albeit still high, the unemployment rate is slowly dropping, while interest rates and inflation remain low and loans to individuals are recovering. For this reason, we estimate a 2.8% increase in household consumption, which would contribute 1.8 percentage points to the projected GDP growth of 2.6%.

In 2017, the Gross Fixed Capital formation (GFCF) – an indicator that measures the country's investment – dropped by 27.6% after posting negative results for four years. By the end of 2017, the increase in business confidence had already boosted investments, as reflected in CNI's Investment Intentions indices, particularly in the manufacturing industry. Although limited by high idle capacity levels and an expected moderate growth in demand, data from the IPEA indicator for GFCF have shown a rebound in investment in machinery and equipment. However, the result for the construction industry – still very negative in 2017 – has led to a decline in global investment.

In 2018, we expect to see not only continued investments in machinery and equipment but also the beginning of the rebound of the construction sector, mainly residential projects. As a result, we estimate that GFCF will rise by 4%.

After three years of positive contributions, the external contribution to GDP will be negative in 2018. The increase in domestic economic activity has already boosted imports of intermediate goods, driven by an increase in consumption of both industrial inputs and consumer and capital goods, which are expected to outgrow exports in 2018. According to our projections, imports will grow by 7% while exports will record a 5% growth, both based on IBGE's National Accounts concept.

## EMPLOYMENT AND INCOME

# Improvement in activity will boost jobs in 2018

### Modernization of labor laws should also contribute to the dynamization of the labor market

The labor market recovery that started in 2017 is expected to intensify in 2018, especially through the creation of more jobs. The positive outlook is driven by a greater expected increase in economic activity in the year, as well as by the improvement in the business environment brought about by the modernization of labor laws.

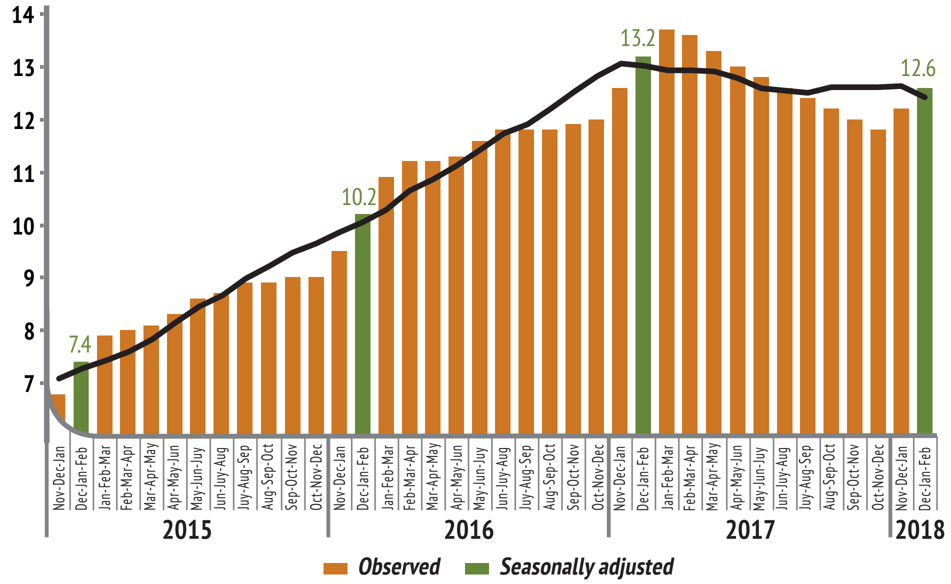
This outlook is corroborated by the increase in jobs in the first two months of the year as compared to the corresponding period a year ago. The behavior of real average earnings and total payroll also point in the same direction. The indicators started the year on the rise and accelerated this growth in the three months to February on the same basis of comparison, which can be mainly explained by the higher-than-expected decline in inflation in recent months.

The unemployment rate, on the other hand, posted growth in the first two months of the year. This increase was expected and reflected the typical seasonality for the period. The indicator usually accelerates in the first quarter, when temporary work contracts for the holiday season come to an end, and begins to slow down again in the second quarter. However, in the seasonally adjusted indicator calculated by CNI based on data from IBGE's PNAD survey, the unemployment rate fell by 0.2 percentage points in February from the previous quarter.

Despite the better outlook for the labor market, the unemployment rate will still remain at a very high level as compared to the period before the crisis that hit in 2014. The indicator's response will depend on the robustness and consistency of the recovery of activity and also on the time required for idle resources in the productive sector to even out. CNI predicts that the average unemployment rate will reach 11.8% in 2018, down by 0.9 percentage points from the figure recorded in 2017, when the indicator stood at 12.7% of the labor force.

## *Despite the decline expected for 2018, unemployment rate will remain at a high level*

*Unemployment rate, as a percentage of the labor force – three-month moving average*
*As a percentage (%)*




*Source: Monthly Continuous PNAD/IBGE*
*Prepared by: CNI*

### UNEMPLOYMENT RATE INCREASES IN THE FIRST TWO MONTHS OF THE YEAR

The year 2018 began with two successive increases in the unemployment rate, which caused the indicator to rise from 11.8% in December 2017 to 12.6% in February 2018.

The growth was led by a decline in employment (1,017 fewer jobs in February as compared to December 2017), given that the labor force also declined (-207,000) during the same period.

The increase in the unemployment rate reflected the typical behavior of the indicator in the first months of the year. This is due to the increase in economic activity between September and November of each year, when industry hires additional staff to meet the demands of the holiday season while commerce and services significantly increase temporary work contracts.

In contrast, between December and the first quarter of each year, these workers are dismissed. Climatic factors also influence seasonality, not only in the agriculture/livestock sector on account of the harvest season, but also in sectors such as the construction industry, which reduces its activities due to strong seasonal rainfall.

It is worth noting, however, that the seasonal adjustment of the historical series – started in 2012 – of IBGE's PNAD Continuous survey made by CNI shows a slight drop of 0.2 percentage points (within the margin of error) in the unemployment rate in February as compared to the previous quarter. In addition, the observed unemployment rate was 0.6 percentage points lower than the figure recorded in the same three-month period in 2017, when it reached 13.2% of the labor force.

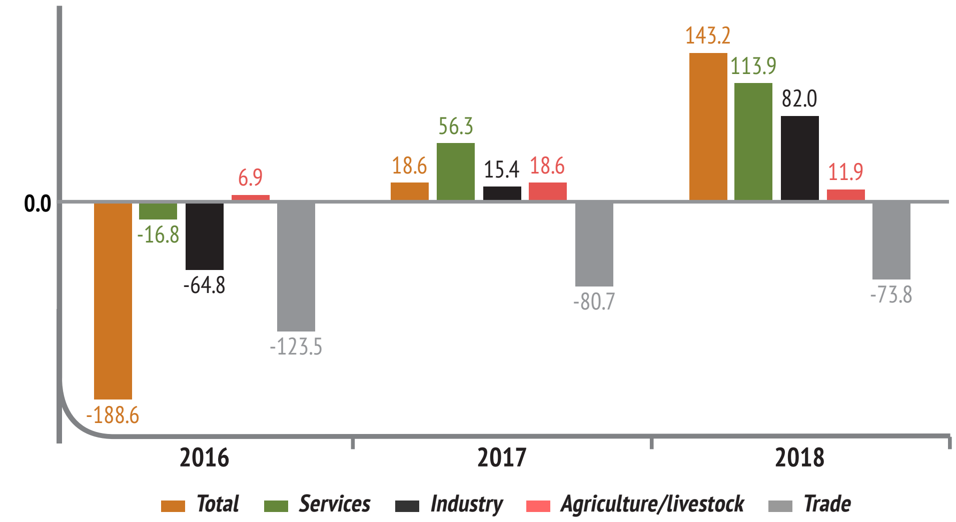
### DESPITE THE DECLINE EXPECTED FOR 2018, UNEMPLOYMENT RATE WILL REMAIN AT A HIGH LEVEL

In the formal labor market, as measured by the General Register of Employed Persons (CAGED/MTE), the net employment balance in the 12 months to February was 102,500 jobs, suggesting a recovery in job creation in the country, especially as compared to recent years. In the twelve months ending in February 2017, 1.1 million net jobs had been lost. And in 2016, this figure amounted to -1.7 million jobs.

Considering only the first two months of the year, 143,200 net jobs were created, driven mainly by the service and industry sectors, which generated 113,900 and 81,900 net jobs respectively. On the other hand, the trade sector lost 73,800 jobs during the same period.

## Formal employment shows signs of recovery in the first two months of the year

*Net balance of formal jobs - in the first two months of the year*
*In thousands*




*Source: CAGED/MTE*
** Includes information reported after the deadline*

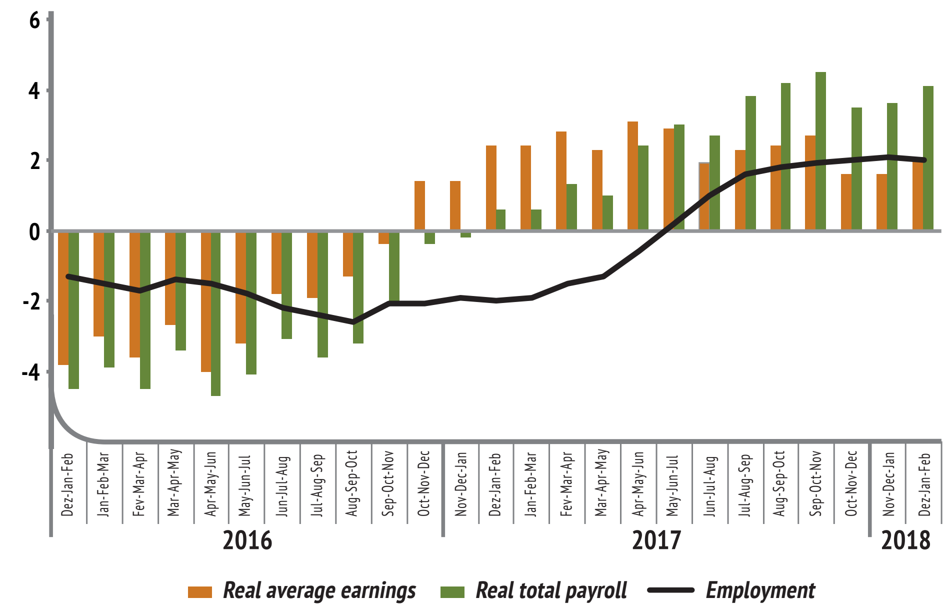
### EMPLOYMENT GROWTH TO BOOST TOTAL PAYROLL IN 2018

Total payroll began the year on a strong upward note. In the three-month period to February, the indicator edged up by 4.1% as compared to the corresponding period in 2017. This result is explained by the behavior of employment and real average earnings usually received by workers, which increased respectively by 2.0% and 2.1% on the same comparison basis.

For the coming months, total payroll is likely to continue to grow more strongly, mainly on account of an expected greater increase in jobs in the year. The stepped-up economic activity, coupled with the modernized labor laws that

## Increase in total payroll and lending will boost household consumption in 2018

*Real Average Earnings and Real Total Payroll - change over the same three-month period in the previous year*
*As a percentage (%)*




*Source: Monthly Continuous PNAD/IBGE*

took effect in November 2017, tends to lead to an increase in labor formalization, as it encourages the absorption of unemployed or informal workers, who will be able to legally take intermittent work or jobs with flexible working hours.

The upward trend in formal employment is a necessary condition to reverse the negative balance of 3.4 million formal jobs as compared to December 2014. This sharp decline in formal jobs has been offset more recently by the increase in informal employment, particularly self-employment, which already saw an increase of 1.4 million workers on the same comparison basis.

Real average earnings are also expected to grow, albeit to a lesser extent than in 2017, owing to the lower nominal wage increase and the effect of the slight increase in the expected inflation for 2018. Nonetheless, inflation control will continue to allow for wages to be adjusted above the National Consumer Price Index (INPC). According to the Wageometer (FIPE), 87.3% of wage negotiations in the first two months of the year led to higher-than-inflation increases. It should be noted that only two wage reduction agreements were made during this period.

Employment is also expected to grow more than in 2017. As a result, real total payroll will likely advance a little further and post growth of 2.8% in 2018, up from a growth rate of 2.4% in 2017.

The increase in total payroll and the rise in lending boosted by the cycle of falling interest rates (see the section Inflation, Interest Rates and Credit) are expected to further stimulate household consumption in 2018, a component that will once again make the greatest contribution to economic growth in the year (see the section Economic Activity).

## INFLATION, INTEREST RATES AND CREDIT

# Lower inflation makes room for new interest rate cut

### IPCA remains below the lower limit of the target

Inflation has behaved more positively than expected in early 2018. The Extended National Consumer Price Index (IPCA) reached 2.7% in the 12 months to March, remaining below the lower limit of the target set by the National Monetary Council (CMN), currently set at 3%. In the same month of 2017, inflation reached 4.6% on a 12-month basis.

The moderate pace of recovery in economic activity has not been enough to reduce the economy's high idle capacity, which has contributed to the positive trend in inflation. A favorable inflation inertia, coupled with a relatively stable exchange rate – despite recent fluctuations – and inflation expectations falling within the established targets, also favors the price trends observed early this year.

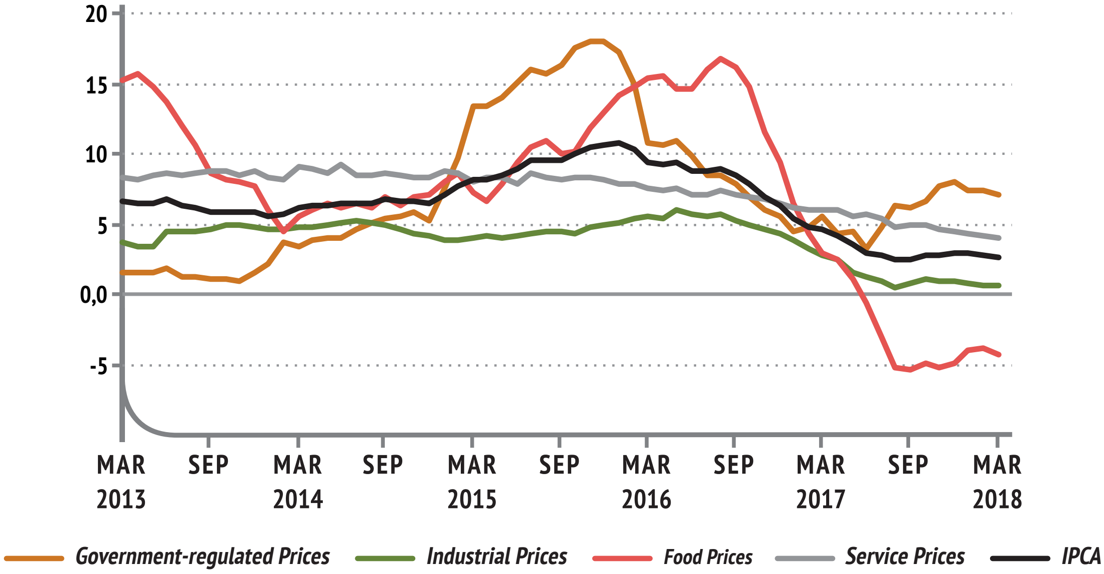
The positive trend in prices is widespread. The diffusion index calculated by the Central Bank of Brazil (BACEN), which measures the proportion of IPCA sub-items that posted positive changes in the month, reached 50.4% in March. It is worth noting that March's result is low and reflects the favorable price trends, as the diffusion index ranges from 60% to 70% during periods of high inflation.

The food group, the key driver behind the decline in inflation in 2017, has been recovering more gradually than expected. The group experienced a pronounced growth in January – in line with the seasonal pattern for the month – but reversed this increase in February and March. As a result, the group's prices dropped by 4.3% in the 12 months to March.

The services group, which is usually pressured by the strong inertia brought about by the indexation of prices to past inflation and to the minimum wage, continues to show a slowdown in prices. This process is determined by the still weak labor market and by the slow recovery of

### IPCA remains below the lower limit of the target

*IPCA by groups - 12-month rate*
*As a percentage (%)*




*Source: IBGE*
*Prepared by: CNI*

economic activity. The group's inflation reached 3.9% in the twelve-month period ending in March.

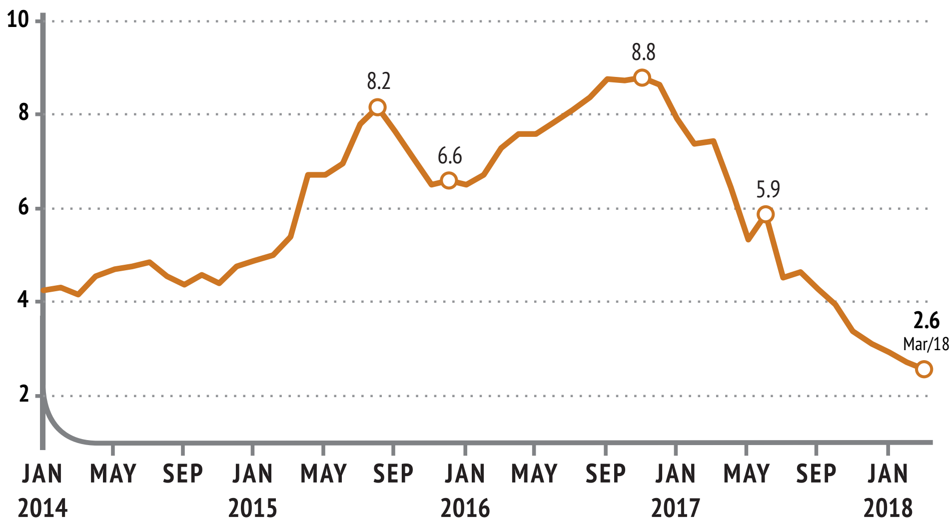
Inflation is expected to remain at a low level in 2018 on account of the still high idle capacity in the economy, a high unemployment rate, and the lower inflation inertia in 2017. However, the IPCA is expected to accelerate slightly to 3.7%, falling within the inflation target range set by the CMN, which ranges from 3.0% to 6.0%. This behavior will be led by a partial rebound in food prices and by a greater pressure from government-regulated prices, caused mainly by an increase in electricity tariffs.

## INTEREST RATE REACHES NEW RECORD LOW

The favorable behavior of inflation in the first quarter of the year and prospects of lower-than-target inflation in the year have allowed for the monetary easing process to continue, leading the

### Real interest rate stands below 3.0% per year

*Real interest rate (ex-ante)*
*As a percentage (%)*




*Source: IBGE and Central Bank of Brazil*
*Prepared by: CNI*

benchmark interest rate to hits its lowest point ever in the historical series.

The Selic rate, which started 2018 at 7.0%, reached 6.5% in March, following two cuts of 0.25 percentage points made at the February and March meetings. At the next meeting of the Monetary Policy Committee (Copom), the entity is expected to reduce the Selic rate by an additional 0.25 percentage points and put an end to the downward cycle, with the Selic rate remaining at 6.25% per year until the end of 2018.

With the Selic rate at 6.25% per year and inflation set to stand at about 3.8% over the next 12 months according to BACEN's FOCUS survey, the real interest rate (ex-ante concept, which considers future inflation) amounted to 2.6% per year in March, its lowest point since June 2013.

The extended cycle of falling interest rates aims to stimulate consumption and investment with the aim of accelerating economic recovery and improving the financial situation of companies and households after a two-year deep recession. However, if interest rates are to remain at a low level without inflationary pressures, it is crucial to adopt complementary policies and measures designed to ensure a permanent macroeconomic stability, particularly in the fiscal field, such as the social security reform.

## CREDIT MARKET SHOWS SIGNS OF RECOVERY

In keeping with the recovery of economic activity and the stimuli stemming from the cycle of falling interest rates, the credit market has shown signs of recovery.

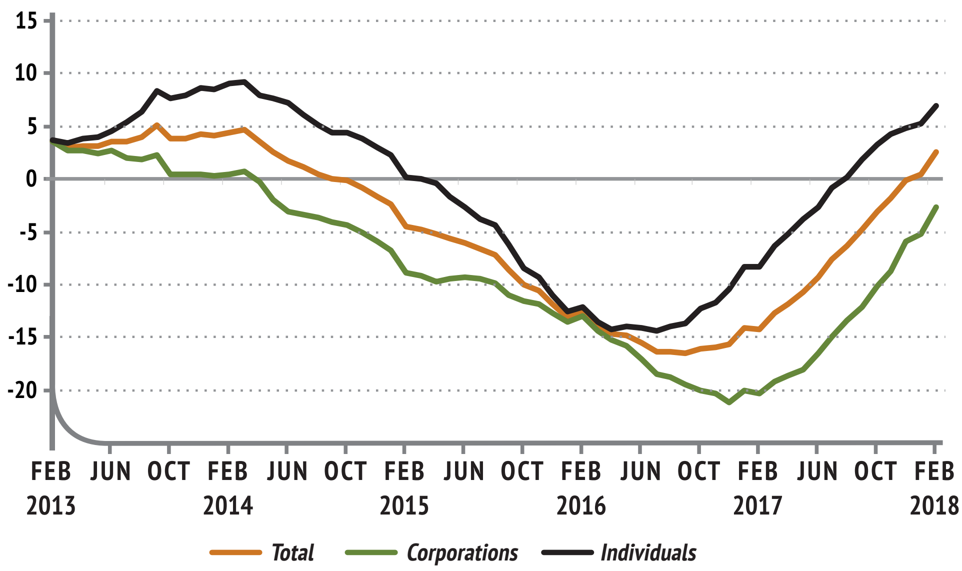
The real increase in lending in February reinforces the scenario of an improved credit market. In the 12 months to February 2018, total lending grew by 2.6% in real terms from the corresponding period in 2017. While loans to individuals grew by 7.0%, loans to corporations experienced a decline of 2.7% – a figure much more modest than the 20.0% decline observed in the 12 months ended in February 2017 over the same period of 2016.

On a year-on-year basis, total credit stock declined less sharply in real terms in February 2018, when it fell by 3.1%, compared to an 8.4% decline in the same month of 2017. The drop was influenced by a 9.3% reduction in the real stock of lending to corporations, as the real credit balance for individuals increased by 2.9%, both in real terms.

According to BACEN's Inflation Report for March 2018[1], the decline in credit stock for corporations is partly explained by the replacement of funds from the National Financial System (SFN) with funds raised in the capital and external markets.

### *Lending grows in February 2018*

*Lending, in real terms*
*12-month rate (%)*




*Source: Central Bank of Brazil*

1 - Box "Financing obtained through the capital market and the external sector and stock of corporate debt".

Companies with access to the capital market increased their indebtedness significantly in 2017 while reducing their outstanding balance with the SFN. Considering the total number of companies – both with and without access to the capital market – indebtedness levels experienced a decline last year.

This contrast highlights the importance of intensifying actions designed to foster the capital market as an alternative to bank financing. The increased access to credit and reduced credit cost boost investment and make firms more productive and competitive, thus contributing to sustained economic growth.

For the remainder of the year, the credit market is expected to continue to recover.

## FISCAL POLICY

# Primary deficit to remain below the target as revenues recover

### Despite efforts to keep spending under control in a similar way as in 2017, primary deficit is expected to grow in 2018

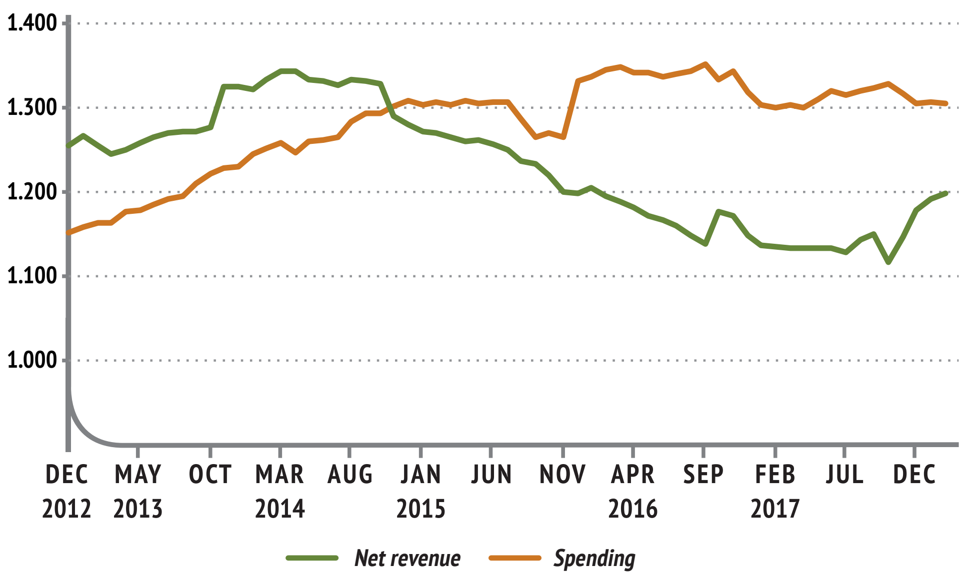
The behavior pattern of public accounts in the first months of 2018 was similar to that observed in 2017. At the federal level, the efforts to rein in spending seen in 2017 have not changed significantly and revenues continue to show positive results. Across all state and municipal governments, one can also see a strong increase in revenues, but with acceleration in the growth rate of expenditures.

Under this scenario, the downward trend in the public sector primary deficit started in late 2017 has remained in place in early 2018.

This scenario, however, is likely to change by the end of 2018. The federal government's expenditures are expected be driven up by the failure to pass legislative proposals designed to keep

*12-month figure for federal government's primary spending shows a real decrease of 3.4% between September 2016 and February 2018*

*Evolution of federal government's primary spending and net revenue*
*12-month figure (R$ billion in February 2018)*




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

them under control, including the social security reform and the postponement of public service wage increases. In addition, regional governments' spending is expected to continue on the upward trend that was resumed in 2017, albeit to a lesser degree than in early 2018.

On the revenue side, the continued recovery of economic activity and of the labor market is projected to lead to another real increase in revenues. However, the effects of the increase in taxation implemented in 2017 and the increase in non-recurring revenues are expected to lose momentum by the end of 2018. For this reason, the primary deficit is set to end 2018 within the target, but at a level above that seen in 2017 and, therefore, farther away from the surplus required to reverse the upward trend in public sector indebtedness.

## INCREASE IN REVENUES IMPROVES FEDERAL GOVERNMENT'S ACCOUNTS IN EARLY 2018

The federal government's net revenue posted real growth (IPCA deflator) of 11.1% in the first two months of 2018 on a year-on-year basis. While the recovery of economic activity explains part of this increase, its magnitude is related to non-recurring revenues from installment payments of debts with the Brazilian Internal Revenue Service and to the increase in the rates of the Social Integration Program (PIS)/Contribution to Social Security Financing (COFINS) taxes levied on fuels, which was not yet in force in the same period of 2017.

As a result, revenues managed by the Brazilian IRS grew by 12.0% in real terms in the first two months of 2018 over the same period in 2017. Revenues not managed by the Brazilian IRS were another component of net revenue for which a pronounced increase was registered in the first two months of 2018. In this case, the real increase of 15.4% is explained by the rise in financial compensation for the exploitation of natural resources, which has benefited from the rise in oil production and prices.

Finally, social security revenues increased by 3.5% in real terms in the January-February 2018 period as compared to the corresponding period of 2017. This increase was driven by the real growth of total payroll and, to a lesser extent, by revenues from debt installment payment programs.

On the spending side, the federal government has made the same efforts to keep expenditures under control as in 2017, when total primary spending experienced a 1.0% decrease in real terms. Expenditures posted real growth of 0.6% in the first two months of 2018 from the same period the year before. Much of this growth, however, was driven by compulsory spending.

Among mandatory expenditures, the greatest upward pressure on expenses was exerted by social security and personnel spending. Social security expenses grew by 3.8% in the first two months of 2018 as compared to the corresponding period in 2017. This result was driven by an increase in benefits – due to adjustments made in January – and by an increase in the number of beneficiaries.

The increase in personnel spending could have been lower if the Federal Supreme Court had not suspended the Provisional Presidential Decree that postponed the wage increase for public servants. With the decision, salaries were adjusted upward and personnel expenditures posted real growth of 1.6% in the first two months of 2018 on a year-on-year basis.

Non-compulsory expenditures in turn experienced a real increase of 2.5% in the first two months of 2018 as compared to the same months of 2017. Among these expenditures, special mention should be made of the fact that investments (capital spending minus subsidies for the My Home, My Life [Minha Casa Minha Vida] program) grew by only 0.9%, even after dropping by 28.5% in 2017.

## REGIONAL GOVERNMENTS' SPENDING CONTINUE TO TREND UPWARD AS REVENUES INCREASE

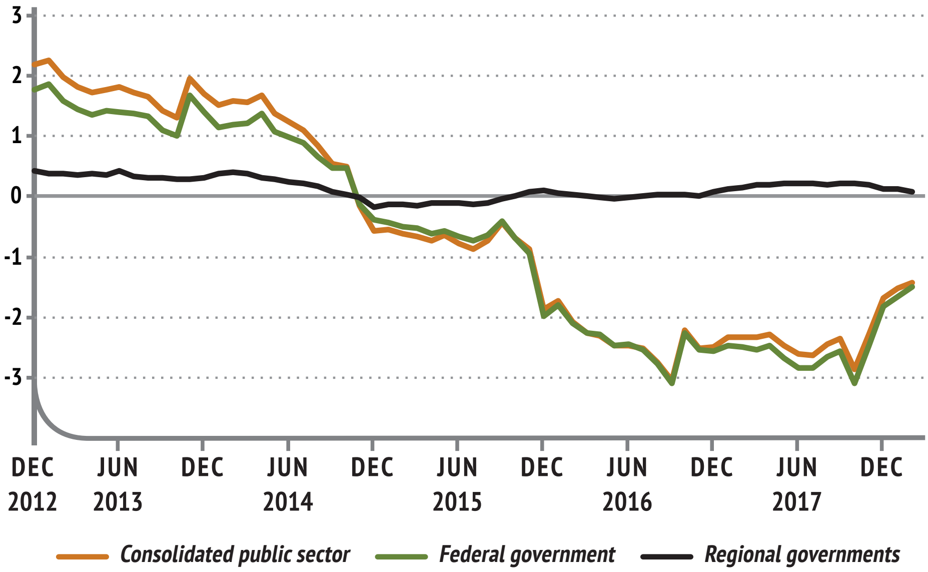
State and municipal governments, which recorded a real increase in spending again in 2017 after keeping costs under control for two years, continued this trend in early 2018. The revenue behavior has also not changed and these public entities experienced a strong increase in revenues.

Based on available data on state and municipal revenues and on the behavior of the primary result for all these public entities, CNI estimates that regional governments' spending grew by 7.9% in real terms in January 2018 as compared to the same month in the previous year.

As for revenues, the available data indicate a real increase of 6.0% in January 2018 over the same period in 2017. Revenues from the turnover tax (ICMS), which is the main source of revenue for regional governments, increased by 6.2% in real terms on the same comparison basis. Revenue from the ICMS tax has been favored by the recovery of

## 12-month figure for federal government's primary deficit fell by 1.59 percentage points of GDP between October 2017 and February 2018

*Primary result of the consolidated public sector and by levels of government*
*As a percentage of GDP (%)*




*Source: Central Bank of Brazil*
*Prepared by: CNI*

economic activity and by tax increases promoted by several state governments.

The second most important source of funds – transfers received from the federal government – was also favored by the economic recovery, which has a positive impact on the collection of federal taxes shared with states and municipalities. In addition, the rise in oil production and prices has led to an increase in transfers of financial compensation for the exploitation of natural resources. For this reason, transfers grew by 4.4% in real terms in the first two months of 2018 against the same period in 2017.

### PRIMARY DEFICIT DROPS IN THE FIRST TWO MONTHS OF 2018

The increase in revenues, both in the federal government and in regional governments, and the spending control measures taken by the federal government have led the public sector primary result to experience a significant improvement in recent months. The public sector posted a primary deficit of R$ 94.3 billion (1.43% of GDP) in the 12 months to February 2018. Thus, the downward trend started in the last quarter of 2017 – when the deficit totaled R$ 187.2 billion (2.87% of GDP) in October – remains in place.

Coupled with the reduction of 0.2 percentage points of GDP in nominal interest spending, the decline in the primary deficit led the 12-month nominal deficit to fall from 7.8% in December 2017 to 7.34% of GDP in February 2018. Yet, this nominal deficit was not enough to prevent the gross debt-to-GDP ratio from increasing from 74% in December 2017 to 75.1% in February 2018.

### UPWARD PRESSURE FROM COMPULSORY SPENDING WILL LIKELY CAUSE THE PRIMARY RESULT TO DETERIORATE BY THE END OF 2018

The decline in the federal government's primary deficit in recent months is expected to be partially reversed by the end of 2018. The pronounced growth in net revenue seen in the first two months of 2018 is projected to slow down throughout the year, while increases in compulsory spending will likely cause primary expenditures to grow more strongly. In addition, the primary surplus of regional governments is projected to decline by the end of 2018 on account of the continued increase in expenditures.

Federal spending in turn has grown by 0.6% in real terms so far this year and is expected to close 2018 with a real growth rate of 3.8%. Compulsory spending will be the main factor behind this acceleration in the growth rate. Personnel expenditures are expected to accelerate their growth rate from the current 1.6% to 2.9% by December. This is a result of the impact of salary adjustments made in

January 2018. In addition, spending on subsidies, salary bonuses and unemployment insurance is also expected to reverse the real decline observed in the year to February 2018 as compared to the same period in 2017.

With respect to the federal government's net revenue, the real increase of 11.1% observed until February is projected to slow down and close 2018 at 2.2%. The decline in the growth rate of revenues by the end of 2018 is explained by two main factors: first, the revenues collected from federal tax debt installment payment programs will not be repeated in coming months, and second, the increase in the rates of the PIS/Cofins taxes, which took effect in July 2017, will have a smaller impact. In addition, revenues not managed by the Brazilian IRS will likely not include the return to the public coffers of judicial deposits not withdrawn by beneficiaries occurred in 2017 and this forecast also does not include the R$ 12.2 billion that would come from the privatization of Eletrobras.

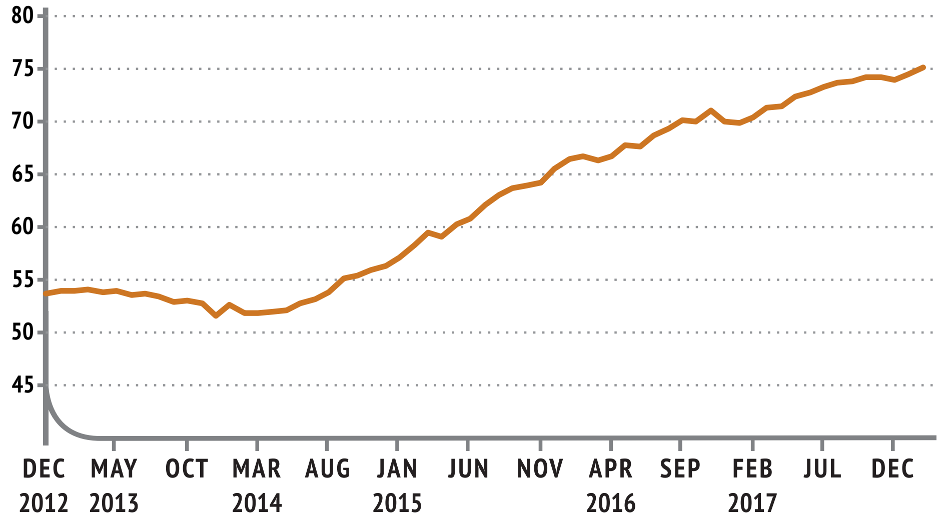
Under this scenario, CNI estimates that the federal government and its state-owned enterprises would close the year with a primary deficit of R$ 155.7 billion (2.23% of GDP as estimated by CNI). Although high, this result falls within the limit of R$ 162.5 billion set as the 2018 fiscal target. The figure, however, would be above the primary deficit of R$ 119.4 billion (1.82% of GDP) observed in 2017. Yet, the primary deficit could be lower if the federal government chooses not to use the entire limit of non-mandatory spending available, as it did in 2017.

In the case of regional governments and their state-owned enterprises, revenues are expected to continue to show positive results due to the continued recovery of economic activity. On the other hand, expenditures will also likely continue to post significant increases. One of the reasons for this is the increase in revenues, since the restrictions imposed by the Fiscal Responsibility Law and by the debt renegotiation agreements with the federal administration tend to link the increase in spending to the behavior of revenues. Another reason is the impact of the debt renegotiation agreement with the state of Rio de Janeiro, which could lead to an increase in primary spending in the state due to the non-necessity of using a percentage of revenue to pay interest to the federal government (the state of Rio Grande do Sul closed a similar agreement recently, but in this case, the impacts will not be felt as the state had no longer been paying interest to the federal government as per a court order). Thus, the primary surplus of these entities is expected to decline and close 2018 at about R$ 3.0 billion (0.04% of GDP as estimated by CNI).

As a result, the consolidated public sector would post a primary deficit of R$ 152.7 billion (2.19% of GDP as estimated by CNI) in 2018. While this

## *Gross debt-to-GDP ratio grew by 1.1 percentage points between December 2017 and February 2018*

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




*Source: Central Bank of Brazil*

result is below the target of R$ 161.3 billion set for 2018, it will be higher than the R$ 110.6 billion deficit recorded in 2017.

Notwithstanding the increase in the primary deficit in relation to 2017, the one percentage point decline of GDP expected in nominal interest spending will likely cause the nominal deficit to fall from 7.8% in 2017 to 7.2% of GDP in 2018. Yet, this nominal deficit would not be enough to at least stabilize the gross debt-to-GDP ratio. However, as the National Bank for Economic and Social Development (BNDES) must return R$ 130 billion to the National Treasury in order to comply with the Golden Rule (according to which public indebtedness cannot exceed the amount spent on capital expenditures), the gross debt-to-GDP ratio is set to close 2018 at 73.7%.

## FOREIGN TRADE SECTOR

# Current account deficit keeps falling

*Exports still growing at high rates*

The beginning of 2018 was marked by the continuation of the downward trend in the deficit in current transactions that started in 2015. In the 12 months to February, the current account deficit hit the mark of US$ 7.8 billion, down from US$ 22.8 during the same period in 2018.

In the year to March, the trade balance recorded a surplus of US$ 14.0 billion. This is the second highest result in the historical series, falling only below the figure observed last year (US$ 14.4 billion). Exports have increased significantly, particularly of manufactured goods. Imports have also grown at a faster pace, influenced by both the lower comparison basis and the resumption of domestic demand.

CNI estimates that the trade balance will reach US$ 58.0 billion by the end of 2018, with exports growing by 5.6% (to US$ 230 billion) and imports rising by 15.4% (US$ 151 billion). Regarding the current account balance, we expect the deficit to increase to US$ 25 billion, or 1.2% of GDP as estimated by CNI, by the end of the year.

### UNCERTAINTIES PUSH DOWN THE REAL

The depreciation trend in the Brazilian currency (real) started at the end of January 2018 has been driven by an uncertain environment. This trend was intensified in early April and the exchange rate against the US dollar exceeded the mark of R$ 3.40 per US$. This figure is close to the level observed in May 2017, after JBS group executives signed a plea agreement. In April 2018, the average exchange rate is up by 3.1% from the average for the first quarter.

At the domestic level, the uncertainties are linked to the electoral scenario, as the risk exists that the country will not approve the reforms required to balance public accounts in the medium and long run.

In the external scenario, the protectionist stance of the Trump administration, with higher tariffs on steel and aluminum imports, has contributed toward strengthening the US dollar. This measure has an impact on Brazil, both because the US is the main destination of Brazilian exports and because it leads to an increased competition for these products in the international market. However, Brazil was granted a temporary exemption until the end of April, which can be extended or even become definitive, as the country is not the focus of the new US trade policy and, since 2008, the trade balance has been recording a surplus in favor of the US.

Another factor that contributed toward the devaluation of the Brazilian currency is the decline in the interest rate differential between Brazil and the US. The Selic rate will remain at a low level throughout the year and the US interest rates are expected to rise, which could reduce global liquidity by the end of 2018.

We therefore estimate that the Brazilian real-US dollar exchange rate will hit the mark of R$ 3.40

## Brazilian currency depreciates further in early April

*Daily exchange rate (Ptax Closing Rate*)*
*In R$ per US$*


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

per US$ by the end of 2018, with increased volatility throughout the year.

However, risks exist that the real will depreciate even further. In the external environment, the increase in US protectionism poses a risk to international trade as a whole, which can be intensified by retaliations from the affected countries. A trade war that results in lower global growth, particularly in China, affects Brazil indirectly, not only because of the Chinese weight in Brazilian exports but also because of its influence on international commodity pricing. At the domestic level, additional uncertainties in the electoral scenario may lead to a further depreciation of the real.

### TRADE SURPLUS STILL ON THE RISE

The Brazilian trade balance recorded a surplus of US$ 14.0 billion in the first quarter of the year. This is the second highest result in the historical series, falling only below the figure observed last year (US$ 14.4 billion). The 3.1% year-on-year decline in the trade balance in the first quarter of 2018 is explained by the fact that imports grew more than exports, reflecting the recovery of Brazil's economic activity. Exports totaled US$ 54.4 billion, with the daily average growing by 11.3% in the first quarter of 2018 as compared to the same period in the previous year. Imports in turn reached US$ 40.4 billion, up by 15.8% on the same comparison basis.

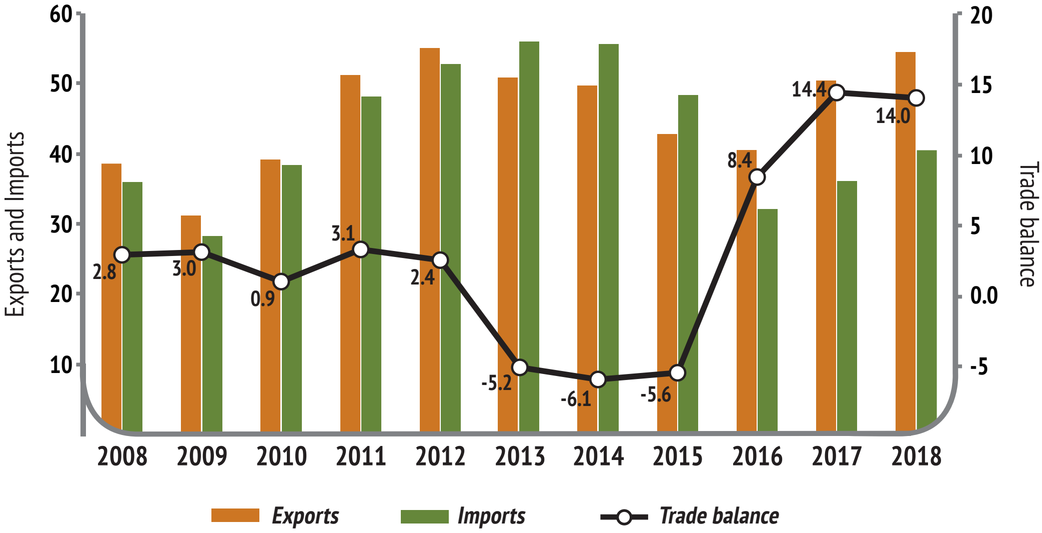
Imports increased across all major economic categories: fuels and lubricants (40.4%), consumer goods (18.8%), capital goods (18.2%) and intermediate goods (9.8%). Among the signs pointing to a recovery of economic activity are the 14% increase in purchases of manufactured industrial inputs, which account for almost 60% of all intermediate goods. In addition, another factor corroborating the economic improvement was the increase in imports of capital goods.

Albeit to a lesser extent than imports, exports continued to grow at significant rates in the first quarter of the year, driven mainly by the performance of exports of manufactured products. In the classification of exports by aggregate factor, the daily averages of all product groups increased in the first quarter as compared to the same period last year: manufactured goods (23.1%), semi-manufactured goods (6.5%), and basic goods (3.7%). Manufactured products posted a significant growth: cast iron tubes (145.1%), frozen orange juice (102.8%), earthmoving machinery (85.5%), and tractors (84.2%).

The indices calculated by FUNCEX using data available up to February show that the year-on-year increase in exports so far in 2018 is mainly explained by export volumes, which increased by 11.3%. Meanwhile, the Brazilian export price index increased by only 1.3% on the same basis of comparison.

*Imports outgrow exports in the first quarter of 2018*

*Exports, imports and trade balance in the year to March*
*In billion US$*




*Source: SECEX/MDIC*
*Prepared by: CNI*

On the import side, both volumes and prices are respectively up by 8.7% and 5.9% in the first two months of 2018 compared to the corresponding period a year ago.

We estimate that the trade surplus for 2018 will be lower than last year's, given the recovery of imports and the resumption of economic growth. CNI expects the trade balance to reach US$ 58.0 billion, with exports growing by 5.6% (US$ 230 billion) and imports rising by 15.4% (US$ 172 billion).

## CURRENT ACCOUNT DEFICIT CONTINUES TO TREND DOWNWARD

The downward trend in the current account deficit observed in the last three years remained in place in early 2018. The first two months of 2018 saw a deficit of US$ 4.0 billion, down by 33.3% as compared to the same period the year before (US$ 6.0 billion deficit). The greatest contribution came from the primary income account, which, on the same comparison basis, reduced its deficit from US$ 8.4 billion to US$ 6.1 billion, with emphasis on the 68.8% decline in the deficit in profits and dividends.

The current account deficit reached US$ 7.8 billion in the twelve-month period to February 2018, down by 66% in relation to the figure recorded in the 12 months to February 2017 (US$ 22.8 billion). This behavior is explained mainly by the positive trade balance performance and by the recent improvement in the profits and dividends account. Foreign direct investment in Brazil in turn edged down from US$ 83.6 billion to US$ 64.8 billion on the same basis of comparison. Despite this decline, the figure is more than enough to cover the current account deficit.

We estimate that the current account deficit will increase to US$ 25 billion by the end of 2018, corresponding to 1.2% of GDP as projected by CNI. This increase will likely be explained by an increased growth rate of imports driven by the recovery of domestic economic activity, but will not be enough to compromise the sustainability of external accounts.

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# OUTLOOK FOR THE BRAZILIAN ECONOMY

| | 2016 | 2017 | 2018 previous forecast (Brazilian Economy - December 2017) | 2018 current forecast |
|---|---|---|---|---|
| **ECONOMIC ACTIVITY** | | | | |
| **GDP** (annual change) | -3.5% | 1.0% | 2.6% | **2.6%** |
| **Industrial GDP** (annual change) | -4.0% | 0.0% | 3.0% | **3.0%** |
| **Household consumption** (annual change) | -4.3% | 1.0% | 2.8% | **2.8%** |
| **Gross fixed capital formation** (annual change) | -10.3% | -1.8% | 4.0% | **4.0%** |
| **Unemployment rate** (annual average - % of the labor force) | 11.5% | 12.7% | 11.8% | **11.8%** |
| **INFLATION** | | | | |
| **Inflation** (IPCA index - annual change) | 6.3% | 2.9% | 4.4% | **3.7%** |
| **INTEREST RATES** | | | | |
| **Nominal interest rate** | | | | |
| (average rate for the year) | 14.18% | 9.92% | 6.75% | **6.40%** |
| (year's end) | 13.75% | 7.00% | 6.75% | **6.25%** |
| **Real interest rate** *(ex-post - average annual rate and deflation: IPCA)* | 5.0% | 6.2% | 2.9% | **3.0%** |
| **PUBLIC ACCOUNTS** | | | | |
| **Primary result** (% of GDP) | -2.5% | -1.7% | -2.1% | **-2.2%** |
| **Nominal result** (% of GDP) | -9.0% | -7.8% | -7.6% | **-7.2%** |
| **Public sector's gross debt** (% of GDP) | 69.9% | 74.0% | 76.2% | **73.7%** |
| **EXCHANGE RATE** | | | | |
| **Nominal exchange rate - R$/US$** | | | | |
| (average for December) | 3.35 | 3.29 | 3.30 | **3.40** |
| (average for the year) | 3.48 | 3.19 | 3.27 | **3.35** |
| **FOREIGN TRADE SECTOR** | | | | |
| **Exports** (US$ billion) | 185.2 | 217.7 | 228.0 | **230.0** |
| **Imports** (US$ billion) | 137.5 | 150.7 | 174.0 | **172.0** |
| **Trade balance** (US$ billion) | 47.7 | 67.0 | 54.0 | **58.0** |
| **Current account balance** (US$ billion) | -23.5 | -9.8 | -27.0 | **-25.0** |

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