Economic Report
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# ECONOMIC REPORT

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

## Economic crisis being overcome slowly

### Signs of slow economic upturn

The Brazilian economy has left the longest and most severe recession in its history behind, but the economic crisis has not been overcome and Brazil is yet to resume a growth path. Alternating positive and negative results were recorded in the first three months of the year, as is typical in transitions from recession to recovery. However, this transition has been longer than usual due to difficulties to adjust key indebtedness and competitiveness conditions to steer the economy back on track through its own forces. CNI forecasts that GDP will grow by only 0.5% in 2017.

This delay in resuming growth can be explained by the after-effects for economic agents of the imbalances that led to the recession, especially by the downturn in household consumption. The persistence of high unemployment without any sign of reversal and the efforts of households to reduce their debt levels have been inhibiting the recovery of household consumption. This has been happening despite the drop in inflation, which preserves the real earnings of those who remain employed.

The rise observed in consumer confidence, as measured by the INEC (Consumer Confidence Index) calculated by CNI, was not sufficient to support a consistent economic recovery, and the index dropped once again in March. Despite the higher level recorded by this index in early 2016, the indicator is 6.1% below its historical average. Recovering confidence is crucial for recovering consumption, the main item making up GDP on the spending side.

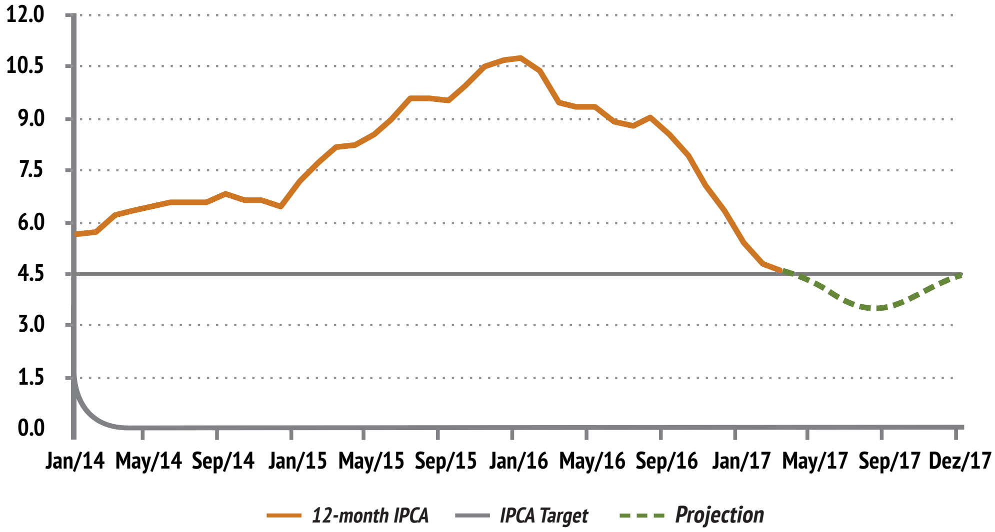
Without the contribution of consumption, the expected vectors for resuming growth – exports and private investment – remain weak and cannot sustain growth on their own. High idle capacity rates in industry, both in manufacturing and construction, have been inhibiting investment decisions in the sector. Investments in infrastructure have not materialized, in part due to a slower

*(continued on the next page)*

## The Brazilian economy in the first quarter 2017

*Inflation will fall below the target by mid-2017*

*Extended Consumer Price Index (IPCA)*
*12-month figure (%)*




*Source: Brazilian Institute for Geography and Statistics (IBGE)*
*Projected by: CNI*

than desired pace of concessions and in part due to the complex characteristics of the projects involved, many of which are still under preparation.

Exports have been a major factor in sustaining economic activity in some productive sectors. However, the performance of exports has been restricted by the appreciation trend and volatility of the Brazilian currency, which had a negative effect on the profitability of exports and have prevented a clearer definition of export strategies by companies. Structural barriers that reduce the competitiveness of Brazilian products – such as tax distortions and labor costs – have not been removed, and as a result the exchange rate remains a key element in determining the profitability of exports.

In this environment, a more intense drop in interest rates has the potential to become the driver of the country's economic upturn. A sharp drop in inflation – the newsletter Boletim Focus published by Brazil's Central Bank points to an inflation rate in 2017 slightly below the midpoint of the target – makes it possible to foresee a more pronounced downward trend for interest rates toward a "neutral rate," i.e. one that would not jeopardize price stability. The Central Bank could thus "move up" the expected cuts in interest rates to the coming months and adjust the Selic rate downward immediately. With firm and clear communications, this decision can be absorbed as an early adjustment in interest rate levels in response to the positive and unanticipated behavior of inflation.

This shift has multiple implications. On the one hand, it could be instrumental in speeding up financial recovery processes of economic agents and in bringing the credit market back to normal conditions, in addition to eliminating one of the exchange rate appreciation factors. On the other hand, it could reduce the pressure on public debt interest payments, improving their dynamics. The public and private sectors would be relieved from a restriction that has been preventing the economy from growing.

The protracted discussion on the social security reform can be an obstacle to this shift. Approving this robust reform is essential to make this virtuous scenario feasible. The approval of the reform would remove uncertainties about the long-term fiscal adjustment, paving the way for a monetary policy in tune with a new growth cycle.

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ECONOMIC ACTIVITY

# Economy will only grow more robustly in 2018

## Recovery has not yet been consolidated in the quarter

The latest economic data provide clear signs that the Brazilian economy is not yet back on track, but reinforce the perception that the worst of the economic crisis is behind us. These data also do not indicate that the difficulties faced by both entrepreneurs and families have been overcome. Idle capacity in the industrial park and unemployment remain at very high levels. Financial conditions of both companies and consumers also remain weak. All these factors have prevented the economy – which remains fragile – from recovering.

In this scenario, we will not see a robust recovery in 2017. As GDP fell in all quarters of 2016, the carryover effect was significant: -1.1%. In other words, for average GDP to remain constant as compared to 2016, activity will need to grow by 1.1% from the figure observed in the last quarter of 2016.

CNI estimates that quarterly GDP will decline in the first quarter of 2017, but at a lower rate than that registered in the fourth quarter of 2016, when it dropped by 0.9%. We expect the downward trend in GDP to come to a halt only in the second quarter (totaling nine consecutive quarters of decline, according to our forecasts), followed by more positive results in the second half of the year. According to our estimates, GDP will grow by only 0.5% in 2017.

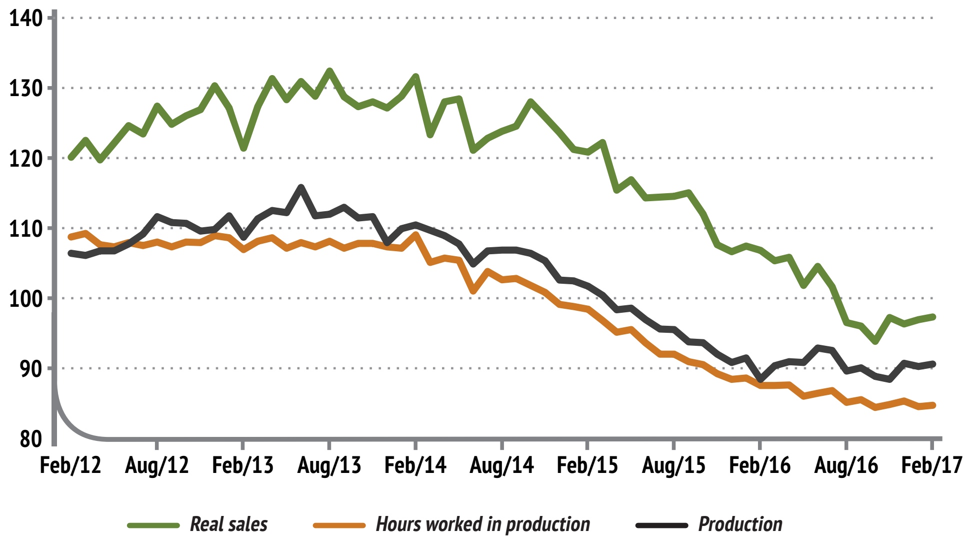
### INDUSTRIAL DATA DO NOT POINT TO ECONOMIC RECOVERY YET

Industrial confidence has improved again after a brief decline at the end of last year. In March, the Business Confidence Index (ICEI) hit the mark of 54 points – the highest level since January 2014. When analyzing the components of the index, however, one can see that entrepreneurs still have a negative perception of current business conditions (index below 50 points), while their expectations are increasingly positive (indices above the 50-point mark).

CNI's Industrial Indicators confirm that industry continues to face the same difficulties observed

### *Downtrend comes to a halt, but still no growth*

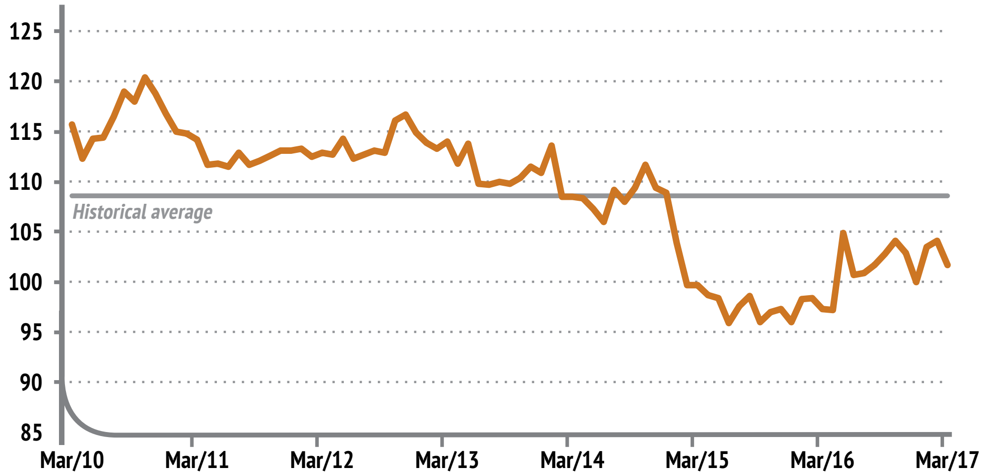
*Real sales, hours worked, and production in manufacturing*
*Seasonally adjusted monthly fixed base indices (Base: 2006 average = 100)*




*Source: CNI and IBGE*

## *Consumer confidence still not boosting consumption*

*Consumer Confidence Index (INEC)*
*Monthly fixed base index (Base: 2006 average = 100)*




*Source: CNI/IBOPE*

throughout 2016. In recent months, these indicators have shown monthly increases interspersed with declines or slowdowns. In February, real total payroll, real average earnings, and capacity utilization experienced a decline on a seasonally adjusted basis. On the other hand, the indicators of real sales, hours worked in production, and employment posted positive changes – among these, only sales are up for two consecutive months, accumulating a modest 1% growth over the period. Hours worked and employment in turn did not grow at a sufficient rate in February to reverse the previous month's decline. In the first two months of 2017, hours worked fell by 0.7%, while employment held virtually steady with a 0.1% drop.

Industrial production (Monthly Industrial Survey - Physical Production - PIM-PF/IBGE) has stayed almost stable in recent months, with the indicator edging up by 0.1% in February 2017 and accumulating growth of 0.3% in the first two months of 2017.

Data from the Construction Industry Survey show that the scenario remains quite challenging for this industrial segment. As with industry as a whole, one can see an improvement in construction entrepreneurs' expectations driven by some stimulus measures, including recent changes to the Minha Casa, Minha Vida (My House, My Life) program, and by a decline in interest rates. Lack of demand, however, is still the main problem faced by the construction industry, which will likely recover at a slower and weaker pace than the other industrial sectors.

For the next quarters of 2017, we expect industrial activity to recover gradually and accelerate its growth rate throughout the year. This improvement will be led by the continuation of the monetary easing cycle and the increase in exports as a result of a less adverse external scenario (see the Foreign trade sector section). We expect industrial GDP to grow by 1.3% by the end of 2017. This will mark the first increase in industrial GDP since 2014 and the first time industrial GDP will increase above total GDP since 2011 (when it grew 0.1 percentage point above that year's GDP growth).

### AGRICULTURE TO DRIVE GDP GROWTH

The agricultural sector will provide the greatest stimulus to GDP growth in 2017. Estimates from the Systematic Survey of Agricultural Production (LSPA/IBGE) point to a 21.8% increase in crops as compared to last year. This growth is expected to lead to a significant GDP growth in the agriculture/livestock sector. We expect to see an increase of 5.0%, thus contributing almost half of GDP growth for 2017 as estimated by CNI.

The services sector in turn has not shown positive results in 2017. According to data from the

Monthly Trade Survey (PMC/IBGE), retail sales volumes decreased by 0.7% in January from December, while nominal revenues edged down by 0.8% on the same comparison basis. Seasonally adjusted data from the Monthly Service Survey (PMS/IBGE) indicate that the services sector recorded a 2.2% decrease in services in January after a 0.7% drop in December.

We project that the services sector will hold steady in 2017. It may continue to post negative results in the first half of the year as industrial activity remains low and household income continues to fall, coupled with the fact that the labor market remains far more negative than in recent years. However, we expect the sector to resume growth in the second half of the year with an upturn in industrial activity and an adjustment – albeit slow – in the labor market (see the Employment and income section).

## *Estimates for GDP and its components for 2017*

*Estimated percentage change*

| | GDP COMPONENTS | Percentage change (%) |
|---|---|---|
| Demand | Household consumption | 0.2 |
| | Government consumption | 1.0 |
| | Gross fixed capital formation | 2.0 |
| | Exports | 3.0 |
| | (-) Imports | 4.5 |
| Supply | Agriculture/livestock | 5.0 |
| | Industry | 1.3 |
| | Mining and quarrying | 4.5 |
| | Manufacturing | 1.2 |
| | Construction | 0.7 |
| | Public utility industrial services | 1.9 |
| | Services | 0.0 |
| **GDP** | | **0.5** |

*Prepared and estimated by: CNI*

### CONSUMPTION AND INVESTMENT WILL NOT RECOVER QUICKLY

While consumer expectations have improved, they are still depressed and unable to give demand a major boost. The Consumer Confidence Index (INEC/CNI) edged down in March and is 6.1% short of its historical average. The INEC shows that consumers remain deeply concerned about unemployment and inflation – despite the decline in the Extended Consumer Price Index (IPCA) (see the Inflation, interest rate and credit section). Consumers are also cautious about their financial situation and indebtedness levels.

The possibility of withdrawing funds from FGTS (Guarantee Fund for Length of Service) accounts and the decline in interest rates will likely help keep household debt levels balanced. This rebalancing, coupled with the increase in real earnings because of falling inflation, is expected to lead to a gradual increase in household consumption throughout 2017. We expect household consumption to increase as compared to 2016, albeit by a small margin: up by 0.2%.

The high industrial idleness and, in particular, the difficult scenario facing the construction industry will continue to restrict investment. On the other hand, falling interest rates and increasingly optimistic expectations are likely to have a positive – albeit limited – impact in 2017, particularly toward the end of the year. As a result, we expect the gross fixed capital formation to grow by 2%.

Unlike recent years, the foreign sector will provide a negative contribution to GDP in 2017 after two years of positive contributions. Albeit slow, the rebound in domestic activity will boost imports of goods and services, which are projected to grow by 4% in 2017. Exports of goods and services in turn will post growth of 3.5%.

EMPLOYMENT AND INCOME

# Labor market continues to deteriorate

## Unemployment rate hits all-time high in historical series

The economic crisis of the past two years continues to affect the labor market, with unemployment skyrocketing and the other indicators deteriorating. The beginning of 2017 was marked by a significant rise in the unemployment rate, which reached 13.2% in February, up from 10.2% and 7.4% in the same month in 2016 and 2015, respectively. CNI estimates that the unemployment rate will remain at high levels throughout the year, reaching an annual average of 13.3%.

The increase in the labor force and a decline in the working population played a major role in driving up the unemployment rate. Along the same lines, the balance of jobs continues to fall on a twelve-month basis, but to a lesser extent than in 2016. A positive sign is that February saw a net creation of jobs.

With the decline in inflation and relatively successful wage negotiations, real earnings are now up on a year-on-year basis. On the other hand, the decline in the working population prevented total payroll from increasing during the same period. With prospects for moderate growth in the working population and in real earnings, total payroll will experience a slight increase in 2017.

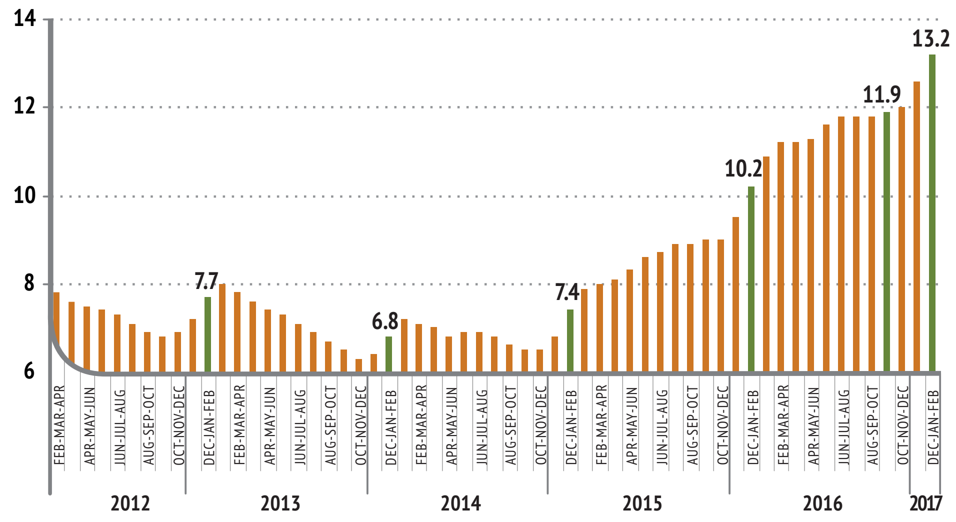
### UNEMPLOYMENT RATE REACHES 13.2% OF THE LABOR FORCE

The unemployment rate measured by the National Household Continuous Sample Survey (PNAD-C/IBGE) worsened significantly in February and reached 13.2% of the labor force, up from 11.9% in the three-month period to November. The month's figure represents an increase of 3.0 percentage points from the same period in 2016.

The increase in the unemployment rate in February is explained by two factors, namely, the 2.0% decline in the working population and the

### *Unemployment rate keeps trending upward*

*Unemployment rate*
*As a percentage of the labor force (%)*




*Source: Continuous PNAD/IBGE*

1.4% increase in the labor force (as compared to the same three-month period in 2016). This is to say that many people lost their jobs and joined the unemployed population at the same time that more people entered the labor market looking for a job, but failed to succeed.

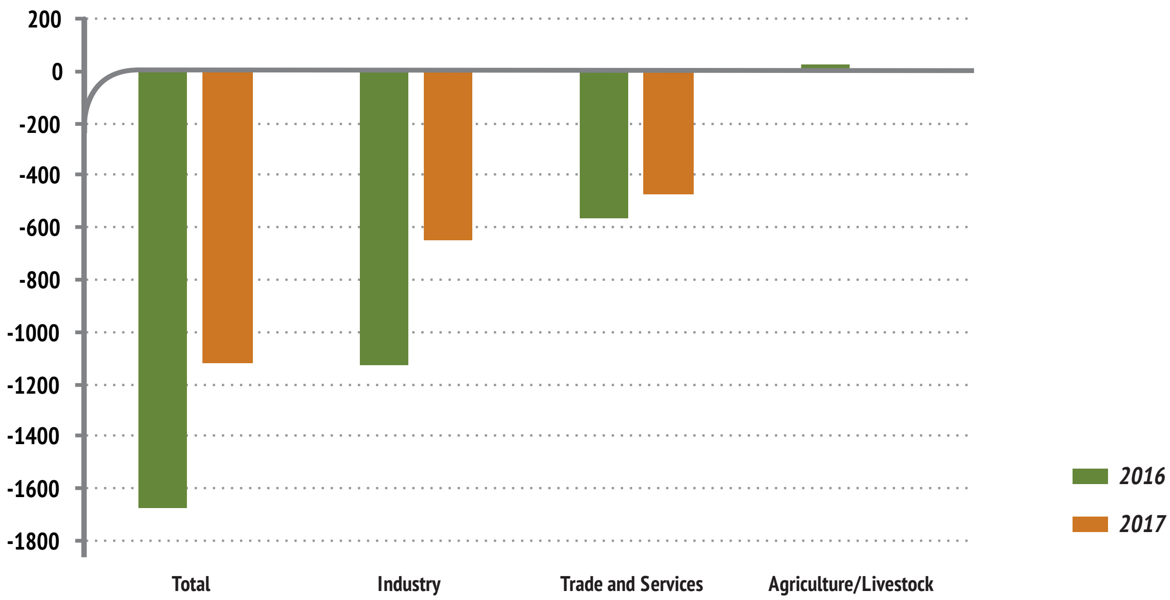
In line with the decline in the working population, the formal job market lost more than 1.1 million net jobs in the 12 months to February 2017, as measured by the General Registry of Employed Persons of the Ministry of Labor (CAGED/MTE). The industrial sector was the hardest hit during the period, with 640,000 jobs lost. Among the industrial sectors, the construction industry lost the highest number of jobs on the same comparison basis (-377,000).

One can see, however, that jobs have fallen at a slower rate in recent months. In the twelve months ending in February 2016, over 1.6 million jobs were lost. During that period, industry had cut more than 1.1 million jobs.

When considering only monthly job figures, 35,600 net jobs were created in February 2017, the first positive monthly result since April 2015.

## *Jobs fall at slower pace*

*Net balance of formal jobs**
*In thousands (in the 12 months to February)*




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

As employment takes some time to respond to changes in economic activity, the working population is also projected to begin to show signs of recovery in the second half of the year, driven by an expected economic upturn in the second quarter. However, the trend in the unemployment rate over the year will depend on the behavior of the labor force.

Due to the expected increase in the working population by the middle of the year – coupled with an estimated increase in real earnings (discussed below in this section) – a significant number of inactive people will likely begin to look for a job again, driving up the labor force. This would not only initially lead to an increase in the unemployment rate, but would also make it harder to bring down joblessness, which is likely to fall slowly and gradually toward the end of 2017. Until then, the unemployment rate is expected to keep trending upward and reach an annual average of 13.3%.

## AVERAGE EARNINGS AND TOTAL PAYROLL SHOW SIGNS OF IMPROVEMENT

Real average earnings, which edged down by 2.3% in 2016, have shown signs of improvement on a month-over-month basis since late last year. In the three-month period to February, real earnings grew by 1.0% as compared to the three months to November and by 1.5% as compared to the same three-month period in 2016.

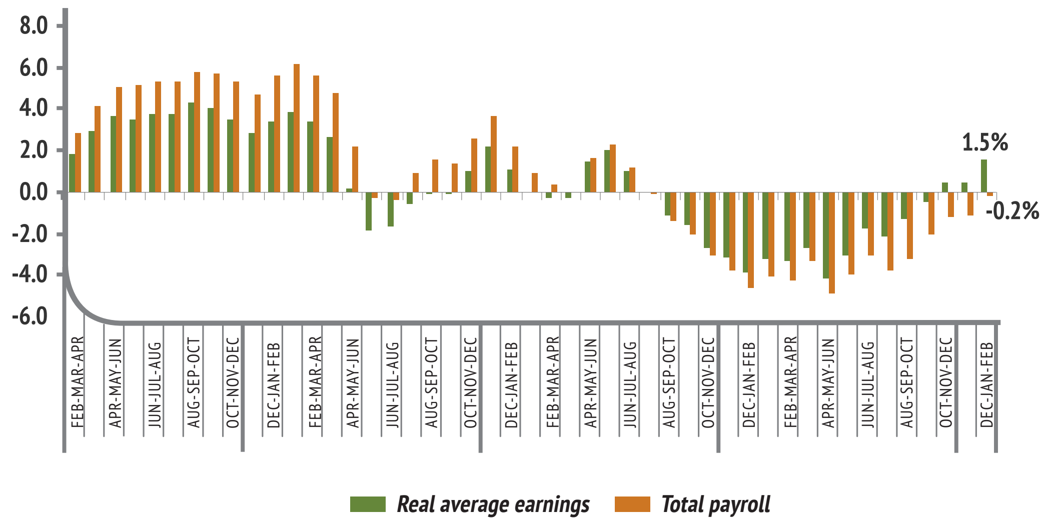
This increase in earnings is explained by two interrelated factors. The first is the significant and continued reduction in inflation observed last year (see the Inflation, interest rate and credit section). The second are wage negotiations, which, according to the Wage Meter developed by FIPE, have produced real median wage increases for the second consecutive month. In addition, the proportion of wage increases below the National Consumer Price Index (INPC) is the lowest since January 2015, while the proportion of wage increases below inflation keeps falling. It is also worth noting that the number of wage reduction agreements has been declining: only 27 such agreements were negotiated over the past four months and only two used the Unemployment Insurance Program (formerly Employment Protection Program).

As inflation forecasts for the coming months still point to a downward trend and real wage increases will likely be sustained, CNI expects average earnings to grow by 0.8% in 2017.

Total payroll, on the other hand, continues to trend downward both on a quarter-over-quarter and year-over-year basis, albeit less intensely. While real earnings are up in recent months, the decline in the working population has prevented total payroll from increasing. However, the expected increase in real earnings along with the projected rise in the working population during the second half of the year will cause total payroll to grow by about 0.6% in 2017.

### *Real average earnings and total payroll show signs of improvement*

*Real average earnings and real total payroll*
*Change from the same three-month period in the previous year (%)*




*Source: Continuous PNAD/IBGE*

INFLATION, INTEREST RATES AND CREDIT

# Inflation declines at a faster pace than expected

## Food prices made it possible for inflation to drop more sharply

The dynamics of inflation is more favorable than expected at the beginning of 2017. After closing 2016 with a cumulative rate of 6.3%, the 12-month cumulative rate of the Extended Consumer Price Index (IPCA) declined to 4.6% in March, slightly above the annual target set by the National Monetary Council.

The impact of the economic crisis on price formation has contributed to a widespread disinflation among the IPCA components. This dispersion can be observed in the diffusion index calculated by the Central Bank of Brazil, which measures the proportion of IPCA sub-items with a positive variation in the month. The index declined from 69.4% in March 2016 to 55.8% in the same month in 2017.

This surprising pace of decline is mainly explained by the positive supply shock brought about by agriculture. Record harvests pushed food prices down in the first quarter, which is an atypical behavior in such period. The food group decreased by 0.3% from January to March 2017, against an increase of 5.9% over the same period in 2016. In the 12 months to March, the rate dropped from 15.3% in 2016 to 3.0% in 2017.

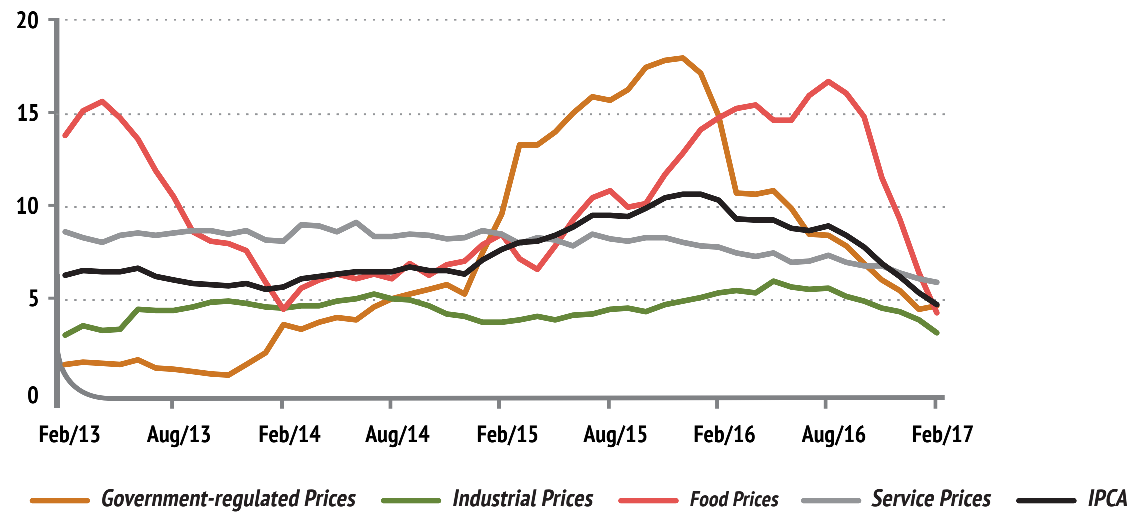
The fall in inflation can also be observed in the behavior of service prices, which are less sensitive to the contractionary monetary policy. This is due to the strong inertia caused by the indexation of service prices to past inflation and to the minimum wage. The group recorded a 1.5% increase between January and March 2017 and a 2.0% rise over the same period in 2016. The rate dropped from 7.5% to 6.0% in the 12-month period to March 2016 as compared to the same period in 2017.

The recent appreciation of the Real also contributed to the more favorable behavior of inflation by reducing the pressure on the prices of tradable goods. Between March 2016 and 2017, the exchange rate fell by 16%, contributing to slow down the rise recorded for this group from 9.8% in the 12 months to March 2016 to 3.8% over the same period in 2017.

The ongoing disinflation process is likely to continue during the rest of the year. The IPCA index will likely reach 3.3% in the middle of the year, influenced by the favorable impact of food prices on the total index that is usually observed in this period of the year. These effects are likely to dissipate in the second half of the year, leading

### *Food prices drop sharply*

*12-month IPCA by groups (%)*




*Source: IBGE - Prepared by CNI*

inflation to rise to 4.1% in December. The index will therefore close the year below the center of the target set under the Inflation Target Regime for the first time since 2009.

## INTEREST RATES LIKELY TO FALL MORE SHARPLY

The more favorable dynamics of inflation and the anchoring of inflation expectations played a key role in intensifying, in January 2017, the cycle of interest rate cuts initiated in October 2016 by the Central Bank of Brazil.

Estimates by market analysts published in the Central Bank's Focus survey on March 31 suggest inflation rates of 4.1% and 4.5% in 2017 and 2018, respectively, meaning that inflation will be brought back to the target center. The IPCA index is likely to remain slightly below 4.5% (see chart below) in the period between 2019 and 2021.

The fact that inflation is nearing the target in March of this year paves the way for new and more aggressive reductions in the Selic rate without jeopardizing inflation control in any way. CNI expects the monetary authority to cut the Selic rate by a further 1.0 p.p. at its next meeting in April and to continue to bring it down at the same pace at its meeting in May. At subsequent meetings, the pace of reductions will likely slow down gradually until it is interrupted in December, when the Selic rate will hit the mark of 8.5% a year.

Even sharper reductions in the Selic rate are necessary mainly due to their positive effects on

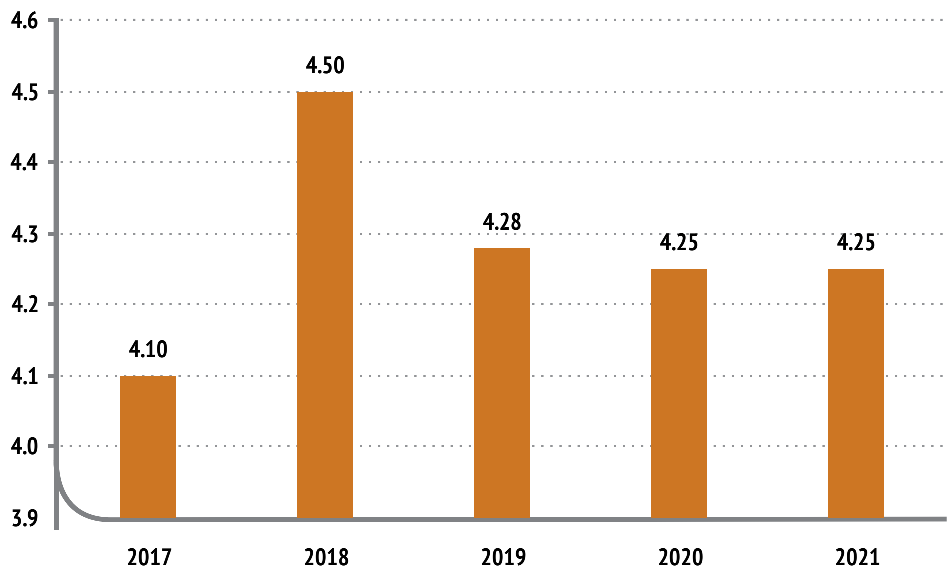
### "Neutral" interest rate

*The "neutral" or equilibrium interest rate is the one that makes it possible for Gross Domestic Product (GDP) to grow to its potential while not jeopardizing price stability. Therefore, for monetary policy to be contractionary, the effective interest rate must be above the equilibrium level, pushing aggregate demand and, consequently, inflation down. The opposite happens when monetary policy is expansionary and, therefore, the Selic rate is below the neutral rate.*

*Thus, for the basic interest rate to converge to rates consistent with international levels on a sustainable basis, it is absolutely necessary to implement structural reforms designed to reduce the "neutral" interest rate of the economy. This is the only way to keep the Selic rate at levels consistent with international rates sustainably without jeopardizing inflation control.*

### Anchored inflation expectations until 2021

*Expected inflation according to the Central Bank's Focus*
*Expectation for the year (%) on 03/24/2017*




*Source: Central Bank of Brazil*

economic recovery and on the financial situation of enterprises. However, additional cuts in the basic rate must to be accompanied by fiscal reforms such as the social security reform, so as not to put pressure on prices in the future and thus make it impossible to keep the rate at a low level.

## CREDIT CONTINUES ON A DOWNWARD PATH

Certain determinants of the credit market have shown some improvements in recent months. The first one is that average interest rates on loans have decreased because of a lower Selic rate in a scenario of stable default rates. The second one is that business and consumer confidence has improved – the latter to a lesser extent – both of which are essential for guiding decisions on allocating funds between savings and consumption/investment.

However, the improvement recorded in both indicators was not sufficient to reverse the downward trend of credit stocks. According to Central Bank data, the total actual credit balance dropped by 8.3% in the last 12-month period to February in relation to the average recorded in the previous 12 months. On the same comparison basis, the average actual balance for companies dropped by 12.3%, while that for individuals decreased by 4.0%.

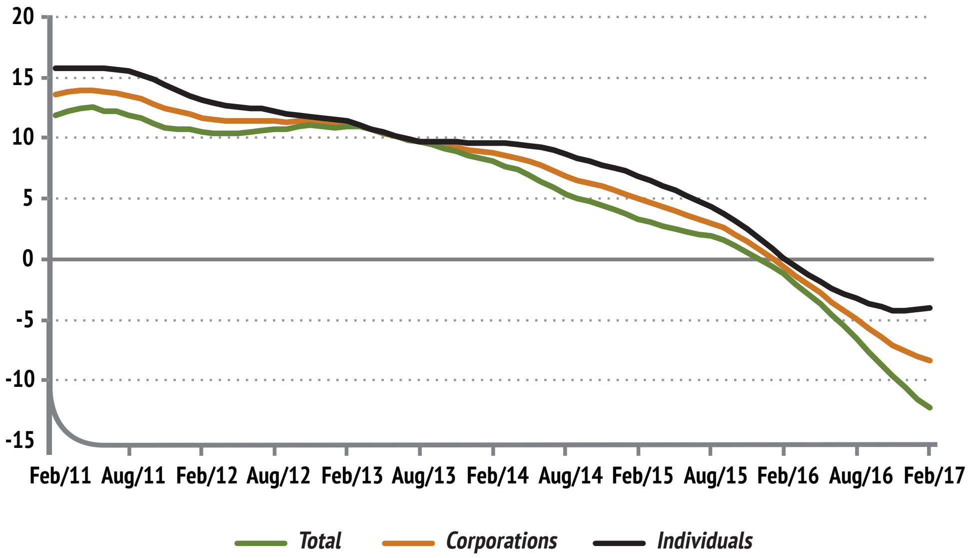
This behavior can be explained by several factors. For companies, high idleness in industry inhibits additional investments and the still high cost of finance often undermines the feasibility of investment projects.

On the consumer side, a weak labor market and a high household debt rate – which despite having dropped remains high as compared to its historical average – have been postponing consumption and, as a result, demand for credit by households.

In the coming months, the deleveraging process of businesses and households is expected to continue. However, the pace of decline in balances is likely to slow down due to the positive results of the expected additional cuts in the basic interest rate, to expectations of improvements in confidence and to the resumption, albeit gradual, of economic growth in Brazil.

### *Credit continues on a downward path*

*Balance of credit operations*
*Real variation in 12 months against the preceding 12-month period (%), as deflated by the IPCA index*




*Source: Central Bank of Brazil*

FISCAL POLICY

# Federal spending drops in early 2017

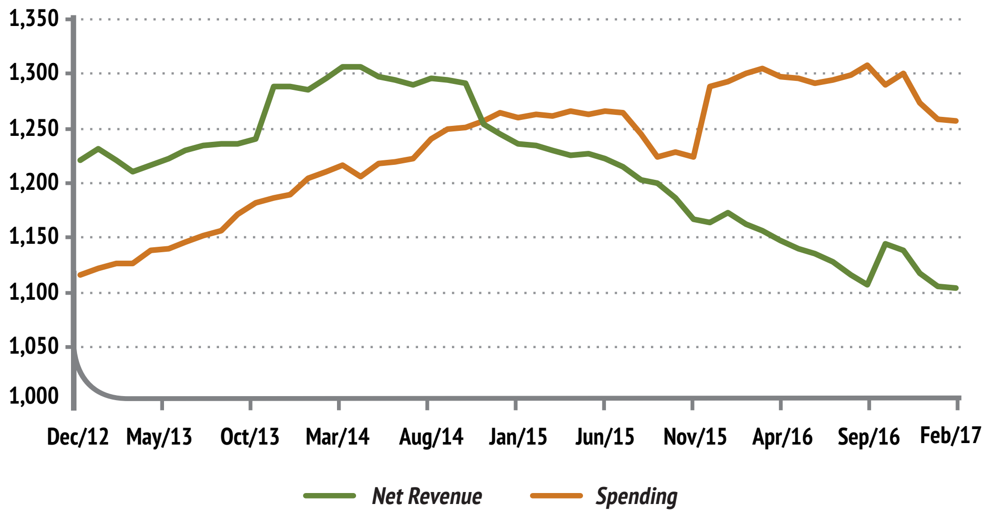
## Drop in investment and defrayal offsets wage increases and social security spending

Federal government spending decreased in the first two months of 2017 as compared to 2016. While on the one hand this decline shows a firm commitment to improving the fiscal situation, on the other its composition is far from what can be considered ideal for fiscal policy and for resuming economic growth in the medium term. Spending was reduced by cutting non-compulsory expenses sharply, particularly investment, which offset the rise in some compulsory expenses, particularly spending on personnel and social security benefits.

This scenario of lower expenditures despite increases in spending on personnel and social security is likely to remain unchanged until the end of 2017. On the revenue side, the decline observed in the first months of the year will likely be reversed. The slight real increase in net revenues and lower spending will likely lead to improvements in fiscal indicators, such as in the primary result – without interest – and in the nominal result – when interest is considered. However, these improvements will not be sufficient to prevent the public sector debt from rising again.

### *Federal government net revenue dropped by 15.5% since April 2014*

*Evolution of spending and federal government net revenue in 12 months (R$ billion in February17)*




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

### INVESTMENT DROPS BY MORE THAN 60% IN THE FIRST QUARTER OF 2017

Federal Government primary spending dropped by 7.9% in real terms between January and February 2017 in relation to the same period last year. The pressure from higher spending with personnel and social security benefits was more than offset by cuts in non-compulsory expenditures, both with defrayal and investment.

Spending with personnel was one of the main components of Federal Government spending for which the highest real increase was recorded, i.e. 7.0% in the first quarter of 2017 as compared to the same period in 2016. This increase is explained by wage increases granted to federal civil servants in the second half of 2016. Given the need to meet the fiscal target and limit spending growth as provided for in Constitutional Amendment 95, this higher spending with personnel will likely lead to a reduction in non-compulsory expenditures, including investment.

A real increase of 6.0% in social security spending also put pressure on federal spending in the first quarter of 2017. This expansion was due to a nominal increase of approximately 6.5% in the value of pensions and in the number of beneficiaries of the General Social Security Regime.

These increases in spending with personnel and social security benefits were offset by a reduction in non-compulsory expenditures, among which investment spending (SIAFI's GND-4) increased by 62.7% in real terms between January and February 2017 in relation to the same period in 2016. Defrayal, including subsidies allocated to the Minha Casa, Minha Vida (My House, My Life) program, decreased in turn by 25.8% in real terms on the same comparison basis.

## SMALL POSITIVE SIGN RECORDED FOR TAX REVENUES MANAGED BY BRAZIL'S INTERNAL REVENUE SERVICE

Federal Government net revenue recorded a real decline of 6.6% (IPCA deflator) between January and February 2017 as compared to the same period in 2016. Despite the sharp decrease recorded in early 2017, following the trend observed over the last three years, there are signs of improvements in some revenue components.

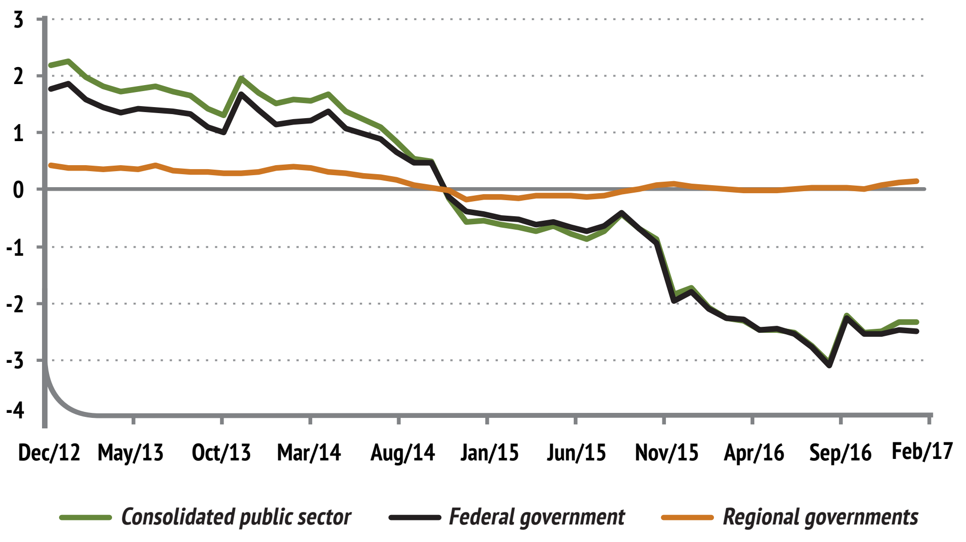
Among the three main groups making up the revenues of the Federal Government, the group managed by Brazil's Internal Revenue Service increased by 1.1% in real terms in the first quarter of 2017 in relation to the same period in 2016. This increase in the tax revenues managed by the Internal Revenue Service was mainly determined by a higher revenue from income tax and from the social contribution on net profits (CSLL). On the other hand, revenues from taxes on production and sale of goods and services, such as IPI, PIS/Pasep and COFINS, continued to fall.

Revenues not managed by the IRS experienced in turn a real decrease of 31.3% in the first two months of 2017 as compared to January and February 2016. This decrease was caused by the non-repetition of the entry of R$ 11 billion into Brazil in 2016 due to power plant concessions. The decline was therefore brought about by a one-off event and will likely be reversed in the next few months.

An area in which no positive signs have been recorded so far is that of social security revenues, which dropped by 4.5% in real terms between January and February 2017 in relation to the same period in 2016. In this case, the decrease can be explained by the continued decline in real wages caused by the reduction in the number of employed individuals.

### *Public sector primary deficit decreased by 0.15% of GDP in the first quarter of 2017*

*Primary result of the consolidated public sector and by levels of government in relation to GDP (%)*




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

### POSITIVE SIGNS FOR THE REVENUES OF REGIONAL GOVERNMENTS AS WELL

As recorded for some components of federal revenues, there were also positive signs for the revenues of regional governments in early 2017. Monthly data on the revenues of states and municipalities showed a real increase of 3.7% in January 2017 in relation to the same month in 2016.

The turnover tax (ICMS), the main source of revenue for local governments and one that was heavily impacted by the downturn in economic activity, increased by 4.1% real terms in January 2017 against the same month in 2016. On the same comparison basis, real increases were also recorded in transfers from the federal administration (2.8%) and in revenues from other taxes (3.9%).

Based on this information on revenues and on the behavior of the primary result of state governments and their enterprises, CNI estimates that the expenditures of regional governments had a real increase of 0.3% in January 2017 in relation to the same month in 2016.

### PRIMARY DEFICIT ON A DOWNWARD PATH IN THE FIRST MONTHS OF 2017

The sharp drop in federal government spending and the increase in the revenues of regional governments contributed to reduce the consolidated public-sector primary deficit in the first two months of 2017. Over the past 12 months to February, the public sector recorded a primary deficit of R$147.4 billion (2.34% of GDP). In December 2016, it amounted to R$ 155.8 billion (2.49% of GDP).

The reduction in the primary deficit and the 0.4-p.p. GDP drop in nominal interest expenses led the 12-month nominal deficit to decline from 8.98% in December 2016 to 8.47% of GDP in February 2017. Despite this decline, the nominal deficit is still at a higher level than necessary to stabilize the public sector debt level. The Gross Debt-to-GDP ratio thus rose from 69.9% in December 2016 to 70.6% in February 2017.

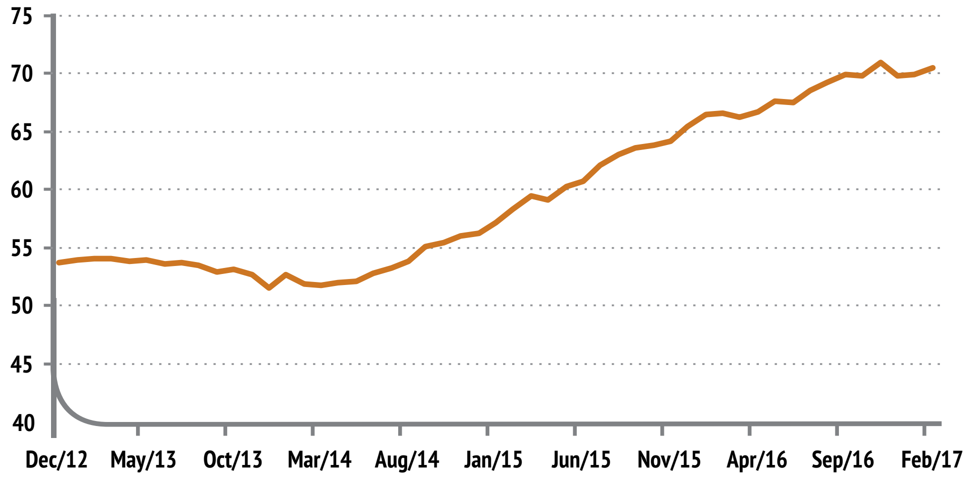
### FISCAL TARGET LIKELY TO BE MET IN 2017

The financial programming of costs and some additional sources of revenue will make it possible for the federal government to get closer to its primary surplus target for 2017. Because regional governments are likely to record a primary surplus once again and remain above the set target, expectations are that the consolidated public sector will meet its fiscal target in 2017.

In the case of the Federal Government, the financial programming of R$ 42.1 billion will likely lead to a decrease of 11.3% in spending with defrayal and capital. Thus, despite the anticipated real increases of 6.0% and 5.4% in spending with social security and personnel, respectively, total spending is likely to decline by 0.8% in 2017 in relation to 2016.

## *Gross Debt-to-GDP ratio increased by 0.7 percentage points in the first quarter of 2017*

*Paths of the gross public sector debt in relation to GDP*
*As a proportion of GDP (%)*




*Source: Central Bank of Brazil*

The net revenue of the Federal Government is in turn likely to recover from the drop recorded in the first two months of 2017 and close the year with a real growth of 0.4% in relation to 2016. This reversal will be made possible by gradual improvements in the results of revenues not managed by the IRS and of social security revenues. Revenues not managed by the IRS will contribute to a better result in the auction of power plants previously held by CEMIG (Energy Company of Minas Gerais State) and to ensuring higher dividends from mineral exploration and financial compensation for such exploration. Social security revenues will in turn be favored by the reversal in the real drop in total payroll until the end of the year.

In this scenario, CNI estimates that the Federal Government and its enterprises will likely close the year with a primary deficit of R$ 147 billion (2.2% of GDP, as estimated by CNI). To meet the R$ 142 billion target, the Federal Government would only need to carry out a financial reprogramming of R$ 5 billion, which is perfectly feasible if we consider that the reprogrammable balance after the first financial reprogramming still amounts to R$ 105 billion.

In the case of regional governments and their enterprises, additional revenues from the legal repatriation of funds kept abroad and from the resumption of economic growth until the end of 2017 will likely ensure a primary surplus at the same level of the one recorded in 2016, i.e. R$ 4 billion (0.1% of GDP, as estimated by CNI). Thus, the consolidated public sector will likely record a primary deficit of R$ 143 billion (2.1% of GDP) in 2017 and meet the target set for the year.

This primary result constitutes an improvement over the deficit of 2.49% of GDP recorded in 2016. In addition, we expect to see a drop of almost 0.5 percentage points of GDP in nominal interest expenses in 2017 in relation to the previous year as a result of the cuts in the Selic rate. These two factors are expected to ensure a reduction in the nominal deficit to 8.2% of GDP in 2017. However, this nominal deficit level will still be insufficient to stabilize the Gross Debt-to-GDP ratio, which will likely hit the mark of 73.5% in December 2017.

## FOREIGN TRADE SECTOR

# External adjustment continues to lead to an appreciated Brazilian currency

### Commodity prices boost exports

Balance of payments data indicate a continued improvement in the Brazilian external accounts. The adjustment process initiated in 2015 continued in place in the first two months of 2017. In the 12 months to February, the current account deficit hit the mark of US$ 22.8 billion. By the end of the year, however, we expect to see a deficit of US$ 26 billion, representing 1.3% of GDP for 2017 as projected by CNI.

The trade balance recorded a trade surplus of US$ 14.4 billion in the first quarter of the year, with exports totaling US$ 50.5 billion – mainly as a result of rising commodity prices – and imports reaching US$ 36.0 billion. We believe that both exports and imports will increase by the end of the year, with a positive trade balance of US$ 44.0 billion.

#### REAL APPRECIATES IN THE FIRST QUARTER

The first quarter of 2017 was marked by a decline in the Brazilian real/US dollar exchange rate. The average exchange rate in March was R$ 3.13 per US dollar, representing an appreciation of 6.7% as compared to the average for December 2016. However, the average exchange rate for March held somewhat steady as compared to the average for the previous month (R$ 3.10 per US dollar), with a 0.7% depreciation.

An improved economic outlook in Brazil and the commodity price rebound have led to an appreciation in the Brazilian currency in early 2017. However, possible risks to the fiscal agenda and a higher-than-expected hike in US interest rates could reverse this appreciation trend, which is still prone to volatility.

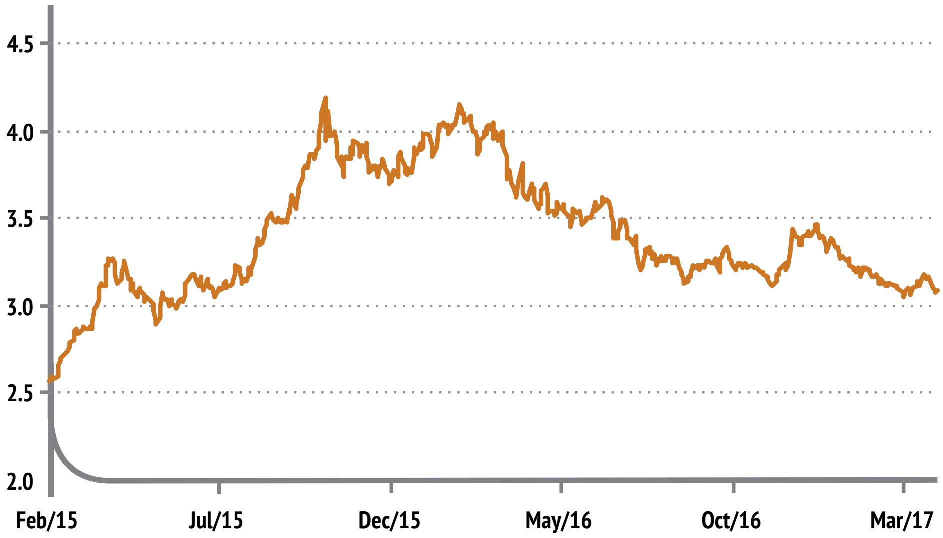
The pace of US interest rate hikes will depend on the pace of change in US economic policy to boost activity levels. Moreover, the evolution of inflation in Brazil makes it possible for deeper interest rate cuts than previously expected, which would make Brazil relatively less attractive to financial capital, even though the interest rate differential remains high. Thus, a reduced demand for Brazilian reals would lead to exchange rate depreciation.

At the domestic level, a satisfactory approval of the institutional reforms proposed by the government, particularly the welfare reform, and the Lava Jato (Car Wash) operation are sources of uncertainty that drive up Brazil's country risk and may cause the real to appreciate.

We believe that commodity prices will not remain at current levels and that the US interest rate normalization will have an impact on prices of emerging market assets. Thus, we estimate that the exchange rate appreciation seen in the first quarter will be partly reversed and that the Brazilian real/US dollar exchange rate will reach R$ 3.25 per US$ in December.

## *Exchange rate back to June 2015 levels*

*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.*

### TRADE SURPLUS STILL ON THE RISE

The first quarter of 2017 ended with a record trade surplus of US$ 14.4 billion, up by 71.9% from the same period in 2016 (US$ 8.4 billion). Exports totaled US$ 50.5 billion in the first quarter, representing a 20.4% increase in average daily exports as compared to the corresponding period in 2016. Imports in turn reached US$ 36.0 billion, edging up by 8.4% on the same comparison basis.

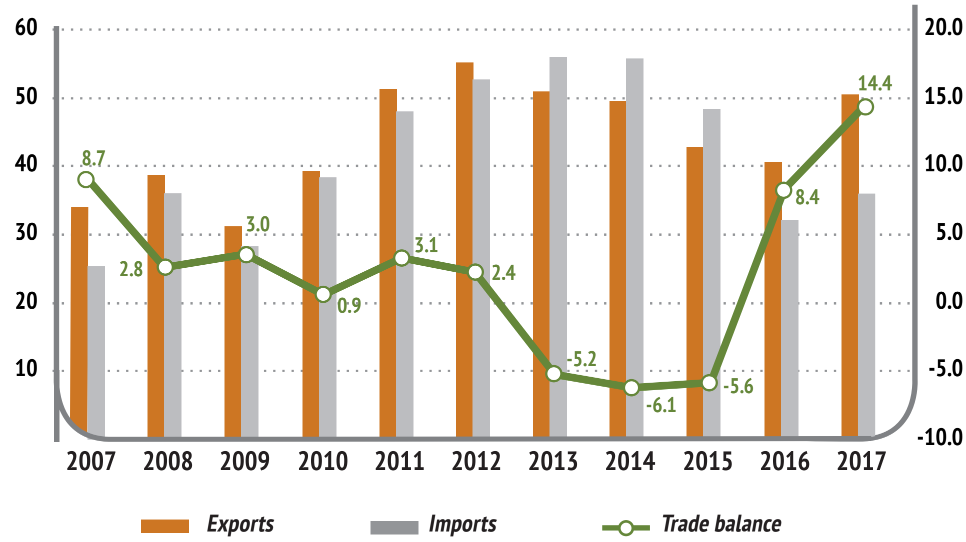
With regard to exports, all product groups posted growth in the first quarter over the same period last year: basic (34.7%), semi-manufactured (11.2%) and manufactured (8.1%) goods. The behavior of basic goods is explained primarily by rising commodity prices. Special mention should be made of the pronounced increase in the value of exports of crude oil (171.7%) and iron ore (147.7%) on the same comparison basis, with the latter raking first in the list of Brazilian exports.

In the year to March, average daily imports of fuels/lubricants (20.9%) and intermediate goods (16.2%) posted growth, while those of capital goods (-22.6%) and consumer goods (-0.6%) edged down as compared to the same period last year.

With respect to price and quantum indices, export volumes increased by 1.8% in the first quarter of 2017 from the corresponding period in 2016, while export prices recorded a 21.2% increase. Prices are up across all classes of products: basic

## Trade balance for the quarter hits record high

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



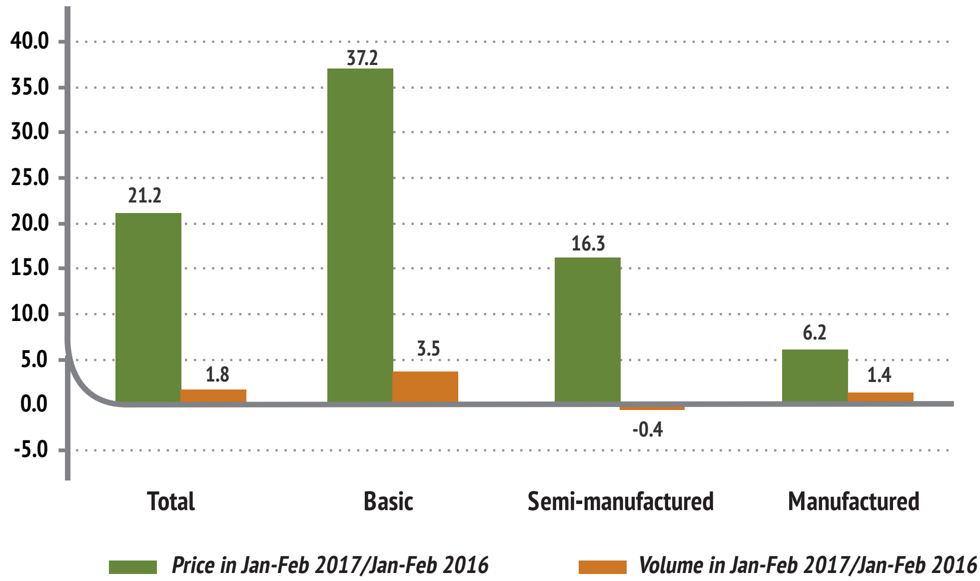

*Source: SECEX/MDIC*
*Prepared by: CNI*

(37.2%), semi-manufactured (8.1%), and manufactured (6.2%) goods. In the case of basic goods, special mention should be made of the 110.5% increase in the price index for the mining of metal ores sector and the 75.2% rise in the index for the extraction of crude petroleum and natural gas sector, both on the same comparison basis.

Imports rebounded in the first two months of the year as a result of an appreciated exchange rate and of a low comparison base, meaning that the upturn was driven primarily by volumes. The import quantum index grew by 11.4% in the first two months of 2017 as compared to the same period a year ago. The 25.1% increase in volumes

## Prices of basic goods stand out

*Change in prices and export volumes - average for January-February 2017/2016*
*As a percentage (%)*




*Source: FUNCEX*
*Prepared by: CNI*

of imported intermediate goods and the 25.3% decline in capital goods deserve special mention. The import price index in turn held virtually steady, up by 0.6%.

The surplus in 2016 was marked by a sharp decline in imports – as a result of the strong economic downturn faced by the country – that more than offset the negative export figures. For 2017, despite recent positive trends in export prices, we expect the trade surplus to be lower than last year's figure, given that imports will likely rebound as economic activity gets back on track. According to CNI estimates, the trade balance will reach US$ 44.0 billion, with exports growing by 5.3% (US$ 195 billion) and imports rising by 9.8% (US$ 151 billion).

## CURRENT ACCOUNT DEFICIT FALLS

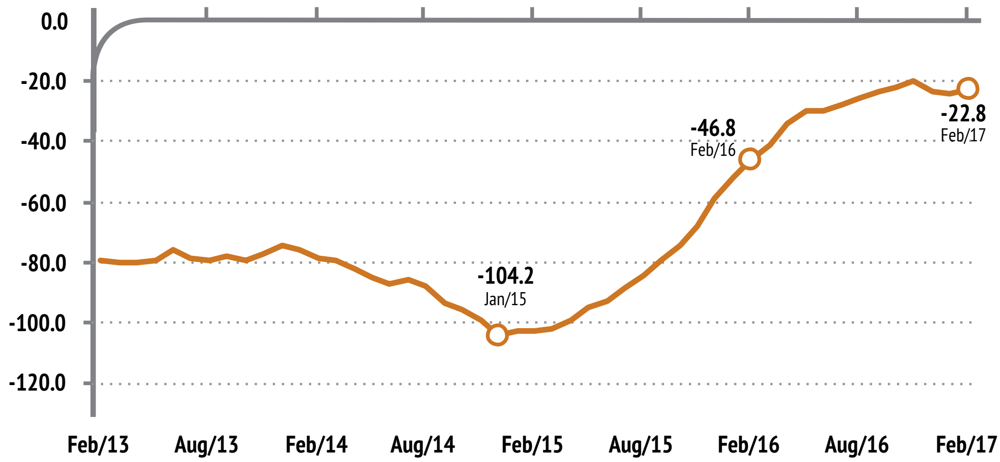
On a twelve-month basis, the current account deficit reached US$ 22.8 billion in February 2017, less than half the deficit accumulated in the 12 months to February 2016 (US$ 46.8 billion). Since December 2014, the deficit is down by 78.1%. In 12 months, foreign direct investment in the country hit the mark of US$ 84.4 billion, equivalent to 4.6% of GDP. This amount is more than enough to cover the current account deficit of US$ 22.8 billion – or 1.2% of GDP – observed in the 12 months ending in February.

The external adjustment process seen in the last two years remains in place at the beginning of 2017. The first two months of 2017 saw a deficit of US$ 6.0 billion, down by 10.6% as compared to the same period the year before (US$ 6.7 billion deficit). In the year to February, the main contribution came from the trade balance, which increased by US$ 3.4 billion over the corresponding period last year. The deficits in services and income accounts, however, grew respectively by US$ 1.5 billion and US$ 1.1 billion during the same period.

Considering the expected appreciation of the average exchange rate as domestic demand recovers gradually, we believe that the current account deficit will close 2017 at US$ 26 billion, down by 9.2% from 2016's level. This figure represents 1.3% of GDP for 2017 as projected by CNI.

### *External adjustment still in place*

*12-month current account balance*
*In billion US$*




*Source: Central Bank of Brazil*

CNI

# OUTLOOK FOR THE BRAZILIAN ECONOMY

| | 2015 | 2016 | 2017 previous forecast (Brazilian Economy) | 2017 current projection |
|---|---|---|---|---|
| **ECONOMIC ACTIVITY** | | | | |
| **GDP** (annual change) | -3.8% | -3.6% | 0.5% | **0.5%** |
| **Industrial GDP** (annual change) | -6.3% | -3.8% | 1.3% | **1.3%** |
| **Household consumption** (annual change) | -3.9% | -4.2% | 0.2% | **0.2%** |
| **Gross fixed capital formation** (annual change) | -13.9% | -10.2% | 2.3% | **2.0%** |
| **Unemployment Rate** (annual average - % of the labor force) | 8.5% | 11.5% | 12.4% | **13.3%** |
| **INFLATION** | | | | |
| **Inflation** (IPCA index - annual change) | 10.7% | 6.3% | 5.0% | **4.2%** |
| **INTEREST RATES** | | | | |
| **Nominal interest rate** | | | | |
| (average rate for the year) | 13.58% | 14.15% | 11.93% | **10.35%** |
| (year's end) | 14.25% | 13.75% | 10.75% | **8.50%** |
| **Real interest rate** (average annual rate and deflation: IPCA) | 4.2% | 5.0% | 6.5% | **5.1%** |
| **PUBLIC ACCOUNTS** | | | | |
| **Nominal result** (% of GDP) | -1.85% | -2.5% | -2.7% | **-2.1%** |
| **Public sector primary result** (% of GDP) | -10.2% | -9.0% | -9.5% | **-8.2%** |
| **Net public debt** (% of GDP) | 65.5% | 69.9% | 76.2% | **73.5%** |
| **EXCHANGE RATE** | | | | |
| **Nominal exchange rate - R$/US$** | | | | |
| (average in December) | 3.87 | 3.35 | 3.55 | **3.25** |
| (average in the year) | 3.34 | 3.48 | 3.48 | **3.18** |
| **FOREIGN TRADE SECTOR** | | | | |
| **Exports** (US$ billion) | 191.1 | 185.2 | 195.0 | **195.0** |
| **Imports** (US$ billion) | 171.5 | 137.5 | 151.0 | **151.0** |
| **Trade balance** (US$ billion) | 19.7 | 47.7 | 44.0 | **44.0** |
| **Current account balance** (US$ billion) | -59.4 | -23.5 | -26.0 | **-26.0** |

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