Brazilian Economy

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Competitiveness is the key to growth

This year ended with relatively optimistic expectations. The macroeconomic environment – exchange and interest rates – is more favorable, and cost reduction measures – e.g. payroll exemptions and lower electricity rates – are likely to produce positive effects. Brazil will grow more in 2013.

In 2012, however, the slow economic growth observed in Brazil was once again frustrating. CNI estimates that GDP will grow by a modest 0.9%, one-third of the rate it had projected early this year.

Industry's performance is even more disappointing, with industrial GDP estimated to drop by 0.6% and manufacturing by 2.0%. As a result, industry's share in GDP will decrease even further in 2012.

This slowdown is not only a reflection of the effects of the world crisis. Emerging countries, including those in Latin America, will grow more than Brazil. Investment rates are generally higher in these countries than in ours, which partly explains the difference in performance.

Stagnation of productivity and high production costs are at the root of the problem. Low investment levels, quality of regulation, excessive red tape, and education quality are some of the reasons behind low productivity. With low productivity gains, any increase in costs translates into loss of competitiveness.

If Brazil is to grow at high rates again, the issue of competitiveness needs to be seriously addressed. This involves two dimensions: public and private. Government should focus its public policies on improving infrastructure, reducing systemic costs, and building an environment conducive to investment.

With lower costs and a favorable business environment, companies should invest in innovation and productivity.

Brazil has the tools to become a competitive economy. The challenge lies in implementing the transformation agenda as swiftly as possible. Experience shows that we need to double our efforts in implementing public policies, particularly because of bureaucratic remnants limiting or hindering the effectiveness of the mechanisms in place.

Brazil can grow at either a faster or slower pace: there are two possible scenarios for the near future. A high growth rate will depend on effective improvements in competitiveness, which means reducing costs and increasing productivity. Advances are required for Brazil to grow by 4% or more in a sustained fashion; without them, this figure would not exceed 3%. In the best-case scenario, industry will play a crucial role and drive growth. In the other one, we will continue to see a gradual decline in the sector's share in GDP.

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CNI

Overview 2012

Another low-growth year for the Brazilian economy

Everyone – government, entrepreneurs, and society – is frustrated over the fact that no changes were detected in the performance of the Brazilian economy in 2012. Even if no extraordinary performance was expected, the result estimated by CNI (0.9% of GDP growth) reveals that the Brazilian growth model, based only on consumption, is unsustainable.

This is not a new perception. Since late last year, CNI has drawn attention to the poor performance of the economy, particularly of industry, and to the need to boost investment to keep up with increasing household consumption.

Contraction in investment and industry

Difficulties to achieve a sustainable growth pace are becoming clearer and clearer. In spite of the continued adoption of strongly expansionary monetary and fiscal policies in 2012, the Brazilian economy has not managed to achieve reasonable growth, mainly due to low investment levels, which declined for five quarters in a row – until the third quarter of 2012. This is reflected in a frustrating industrial performance, with CNI expecting industrial GDP to drop by 0.6%.

An undesired stock accumulation, which led companies to experience idleness and cut investments, has further aggravated this scenario. Moreover, household consumption has been gradually and steadily directed at imported products and at the service sector. The variable that best reflects this behavior is the import penetration coefficient (CNI/ Funcex) – an indicator of the share of imported industrial goods in domestic consumption of these products –, which jumped by more than ten percentage points from 2003 to 2012.

The only industrial segments expected to record GDP growth in 2012 are the construction industry and public-utility industrial services: both of which by 2.0%.

As in 2010 and 2011, inflation remained at relatively high levels over the year – above the central target. This year, the upward pressure comes primarily from food products. The 12-month accumulated inflation for this group rose from 6.9% in January to 10.4% in October. In the opposite direction, inflation in industrial products fell from 3.2% to 1.0% during the same period.

Selic rate significantly down

From the standpoint of monetary policy, 2012 was marked by ten consecutive reductions in Selic (Brazilian basic interest rate). The shift toward an expansionary monetary policy, which began far back in the second half of 2011, continued throughout 2012, leading to a 5.25-percentage point drop between August 2011 and October 2012.

Due to the sharp drop in Selic, which ends the year at 7.25%, and to the forecast that the IPCA (Extended Consumer Price Index) is to close the year at 5.5%, the average real interest rate will stand at 3.1% in 2012.

In the foreign trade arena, special mention should be made of the depreciation in the exchange rate, which reached a new level in June 2012.

Overview 2012

As opposed to 2011, exchange rate fluctuations have also held steady. The factors behind this change were: a more stable international scenario, lower interest rates and, particularly, continued government intervention. On account of these factors, the real-US dollar exchange rate will close the year at a more depreciated level than last year, standing at about R$ 1.95/ US$, according to CNI's estimates.

Another striking difference from 2011 was observed in relation to exports. In 2012, we saw a sharp drop in sales not only of manufactured and semi-manufactured products, but also basic products, which reversed the uptrend seen in 2011 and are down by 7.3% in the year to October. Prices played a major role in this drop, falling by 4.3%. Export volumes, in turn, held steady as compared to the previous year.

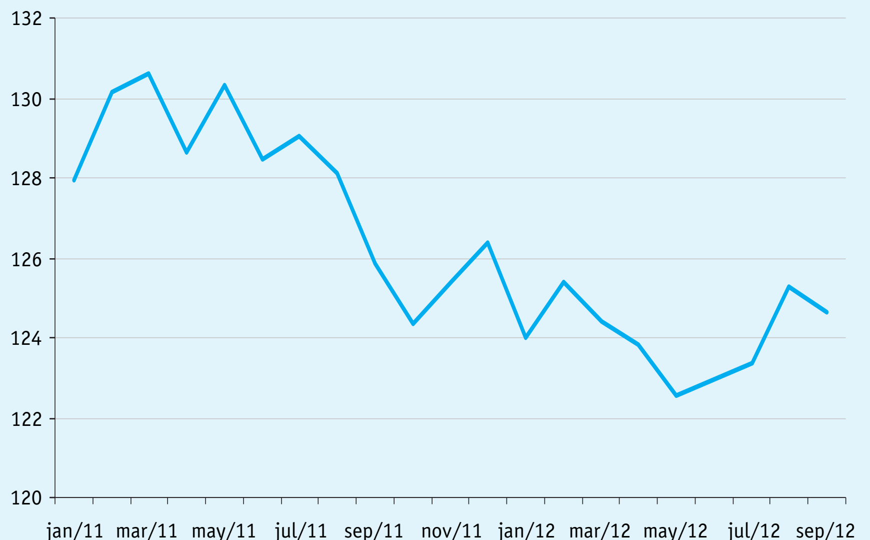
Imports also remained stable in relation to the 2011 results. The relevant variable was different in this case. Import volumes – which posted negative growth – largely accounted for the behavior of imports in 2012. Prices, in turn, remained virtually unchanged over the same period.

This composition led to a reduction in the trade balance surplus, which is expected to close the year at about US$ 19.7 billion (33.9% lower than in 2011).

Manufacturing production

2002 Index figure = 100 - seasonally-adjusted

Recovery in manufacturing in the second half not enough to reverse drop observed since 2011



Source: IBGE

Strongly expansionary fiscal policy

In 2012, the role of fiscal policy was quite different than that observed one year ago. In 2011, the fiscal policy played a major role in controlling inflation, which involved reducing costs and increasing revenues significantly. This year, the fiscal policy was highly expansionary, with the aim of countering the economic slowdown.

This countercyclical policy was put in place on account of the boom in federal spending growth – up by 6.4% between January and October 2012 – and of tax exemptions granted by the government. In contrast, this downturn in tax revenue coupled with lower GDP growth led to a marked drop in the growth rate of revenues, which rose by a modest 1.3% from January to October 2012.

This trend caused the primary surplus to decline: 2.25% of GDP in the 12 months ending in October, against 3.1% of GDP in December 2011. However, the nominal deficit will drop slightly, due mainly to lower interest costs. A reduced deficit coupled with exchange rate adjustments in domestic and foreign debt will result in the debt/GDP ratio falling from 36.4% in 2011 to 35.2% in 2012.

outlook for 2013

Economic upturn conditioned on industry recovery

In 2013, CNI is expecting to see a more positive economic activity performance than in 2012, with GDP estimated to grow by 4%. This improved performance, however, will only be achieved if the measures to boost competitiveness actually bring about positive results, particularly in industry, in the sense of increasing capacity utilization, enhancing industrial business confidence, and boosting investment levels in this segment.

While many of the barriers to economic growth in Brazil can be addressed domestically, it is worth noting that any worsening in the international scenario could change the recovery trend in the Brazilian economy in 2013.

In a more stable international scenario – without further deterioration of current difficulties faced by developed economies and with the measures adopted to boost domestic economy being effective – we will likely see lower production costs and enhanced competitiveness. CNI is thus expecting industrial GDP to grow by 4.1% in 2013.

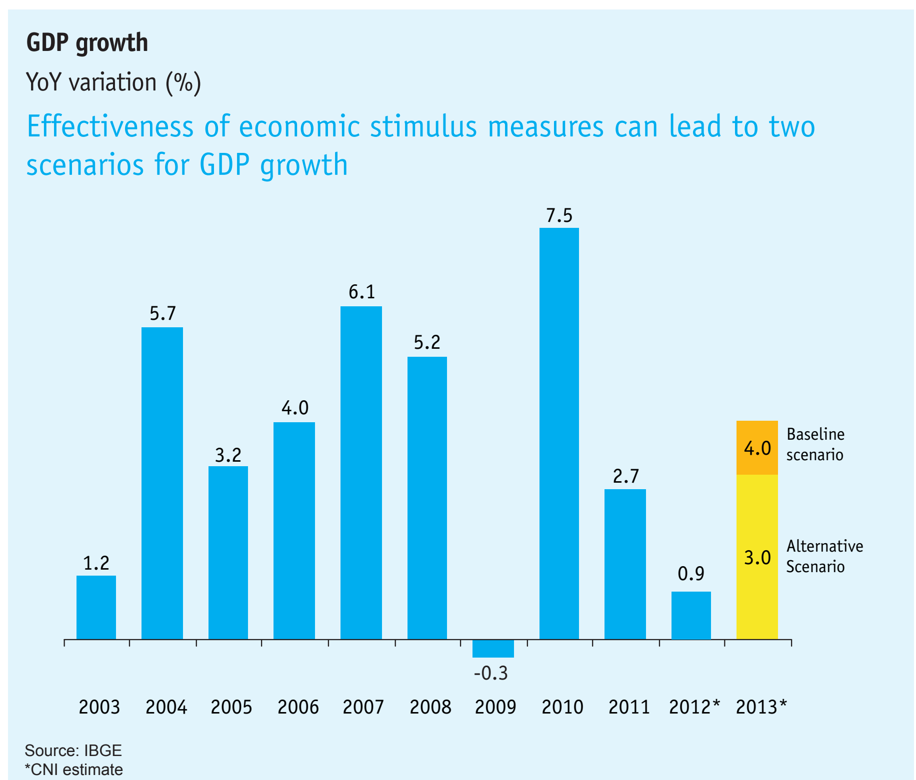
Apart from industry growing at this rate, investments will also experience a strong increase, up by about 7% in 2013. This is a fundamental aspect for the Brazilian economy to grow again in a sustained fashion.

Should this scenario materialize, household consumption is likely to grow by 3.8% in 2013, meaning that the upward trend observed in this GDP component in recent years will continue.

Economic recovery will lead to greater employment growth in 2013. Formal jobs are expected to keep growing more strongly than informal occupations. As a result, workers' average real earnings will remain on the rise next year.

With the increasing number of new jobs, CNI estimates that the unemployment rate will drop to 5.3% in 2013, hitting a new historic low.

If the above-mentioned measures to stimulate economy are not fully effective, industry will probably not be able to recover more significantly, growing by only 2.3% in 2013. In this alternative, less optimistic scenario, GDP would increase by 3% and



outlook for 2013

investments would rise by only 4%. It should be mentioned that little would change in terms of household consumption, even considering lower economic growth rates. The difference would lie only in the origin of purchased products, as a greater share of consumption demand would be met by imported products.

The inflation scenario will remain pretty much the same in 2013. CNI estimates that the slight upward pressure on prices will linger on throughout the year, with the 12-month IPCA standing above the mark of 5% and, in some periods, probably above 6%.

Four assumptions have been considered for the 2013 inflation forecast: recovery of economic activity, resumption of the IPI (Tax on Industrial Products) on vehicles, effects of lower electricity rates for individuals and corporations, and possible fuel price adjustments. Coupling the effects of each of these factors with the trend in food prices (down from current levels) and services (growth in late 2013), we expect to see the IPCA at 5.5% in 2013, the same figure estimated for 2012.

In addition, CNI believes that the Monetary Policy Committee (COPOM) will continue to apply the policy adopted in 2012, focused on keeping inflation within the upper target band. Under this scenario, the Selic rate is expected to hold steady at 7.25% per year in 2013. As a result, the average real interest rate will fall to 1.4% in the year.

International scenario still unfavorable

Due to the difficulties faced by developed economies to overcome the crisis, the international outlook for 2013 remains unfavorable.

CNI estimates that exports will grow by 5.6% (in value) in 2013, totaling US$ 258.3 billion. Imports, in turn, are expected to grow by 6.8% next year and hit the mark of US$ 240.2 billion, a trend in line with the upturn in the Brazilian economy as a whole.

The current account deficit is likely to increase in value owing to a lower trade balance. Likewise, a more dynamics domestic activity will add new momentum to the deficit in services. Foreign investments will remain high enough to cover the growing deficit. CNI is therefore estimating the current account at US$ 62.1 billion in 2013, equivalent to 2.60% of GDP.

As for the exchange rate, we are not expecting to see any change in the current policy adopted by the government. Throughout the year, the R$ 2.10/US$ "ceiling" will be probably "tested" by the market sometimes. Unless there are more abrupt changes in the international market, the exchange rate will probably remain close to this higher level for some time, but not permanently. As a result, CNI estimates an average exchange rate of about R$ 2.06/US$ in 2013.

Fiscal policy to remain expansionary

The fiscal policy will likely remain expansionary in 2013. The Draft Annual Budget Law (PLOA) provides for a significant increase in both mandatory and discretionary spending. Furthermore, the Federal Government is also expected to be less strict in the implementation of discretionary spending, using it in support of economic activity recovery.

Considering a possible financial programming of R$ 12.1 billion in 2013, CNI projects a real growth of 6.0% in Federal Government expenditures.

CNI is also expecting real revenues to increase by 6.0% as a result of the non-renewal of some tax cuts, the end of the effect of extraordinary revenues in 2011, and expectations of higher economic growth.

Based on these projections for spending and revenues, CNI estimates that the public primary surplus will amount to R$ 112.7 billion in 2013, or 2.3% of GDP.

SPECIAL TOPIC competitiveness gap

Why has the Brazilian industry performed so poorly?

The weak performance of the Brazilian industrial sector is neither momentary nor a mere effect of the international crisis affecting mainly developed countries. Lack of demand is also not the problem. Domestic demand in Brazil was little affected by the crisis. In the 2008-2011 period, household consumption rose by 16.3%; commerce GDP grew by 13.5%; and services GDP increased by 10.7%. Over the same period, manufacturing GDP rose by only 0.6%.

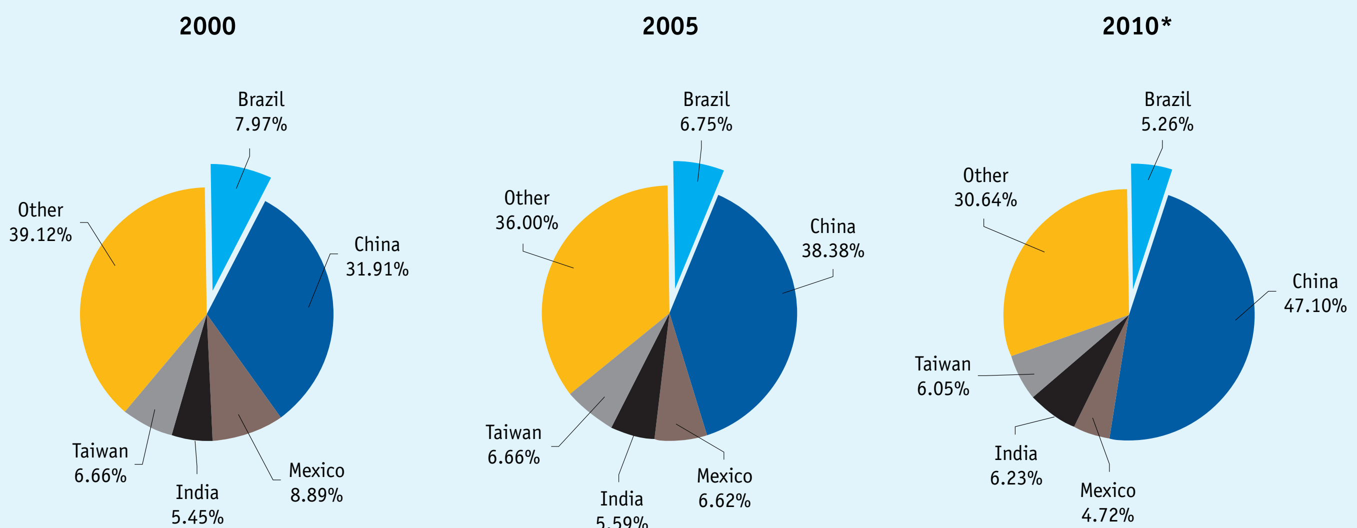
The process of loss of competitiveness is not recent; it has been unfolding for some time now as a result of a combination of factors. The international crisis has exacerbated the effects of loss of competitiveness owing to fiercer competition in global markets.

Domestic industry loses importance among emerging countries

In analyzing the evolution of Brazilian industry over the past decade, one can clearly see a process of loss of competitiveness and consequent decline in importance on the international scene. In 2000, according to the United Nations Industrial Development Organization (UNIDO), manufacturing production in Brazil accounted for 8% of the total production of developing countries. In 2010, this share dropped to close to 5%. In the opposite direction, China increased its share from 32% to 47%.

Brazilian exports of manufactured goods have also lost market share. From 2000 to 2010, Brazil's share in exports of manufactured products originating in developing countries dropped from 3.6% to 3.2%. Our industry has lost share

Share of Brazilian industry in the MVA (Manufacturing Value Added) of developing countries
In (%)
Industry lost market share over the past decade



Source: UNIDO
* estimated figures

in the domestic market, too. In 2000, only 11.8% of domestic consumption of manufactured products was met by imported goods. This percentage almost doubled in 2011, reaching 20.7% (CNI/FUNCEX data).

The sluggish trend in Brazilian industry is reflected in the country's comparative advantage structure. From the mid--1990s to the late 2000s, China not only became one of the leading manufacturing centers in the world, but also managed to redefine its comparative advantage structure from labor-intensive goods toward more elaborate products.

In the 1995-1997 period, labor-intensive manufactured products accounted for 52% of the export products that had ensured a clear comparative advantage to China. In 2007-2009, this percentage dropped to 30%, while the share of manufactured products from specialized suppliers (particularly capital goods) rose from 3% to 17% and of R&D-intensive manufactured goods from 10% to 33%.

During the same period, the only significant change in Brazil's comparative advantage structure was the increased share of mineral commodities. In terms of manufactured goods, few changes were observed and the country's comparative advantages remained concentrated on scale economy-intensive products such as steel products, metal products, plastic, chemicals, and rubber products.

Labor productivity has not evolved over the past decade

The productivity of industrial labor in Brazil remained virtually stagnated in the 2000s and is yet to show any signs of recovery. Manufacturing production grew at an average annual rate of 2.4% between 2000 and 2011, but this growth was almost entirely driven by an increase in the number of workers: industrial jobs grew at an average annual rate of 2.1% over the same period.

Why is the Brazilian industry losing competitiveness? Why are companies not increasing their productivity? There are several factors behind the poor industrial performance that must be addressed for industry to find its way back to growth.

Some factors are strictly related to enterprises. Low investment levels, particularly in innovation, are certainly one of the reasons. But why would companies stop investing if this is crucial for their survival? This is where an unfavorable economic and institutional environment, gaps in the country's infrastructure, and poor-quality education become major factors.

Education is the foundation of everything. Without education there is no innovation, and productivity gains become scarce. The poor quality of the education available in Brazil is one of the country's main shortcomings, as evinced by tests conducted under the Programme for International Student Assessment (PISA) organized by the OECD and by the low percentage of adults with a college degree.

The poor quality of education makes it difficult to obtain skilled labor, which impacts productivity in two different ways. The first direct impact is that of having no choice but hiring poorly skilled workers, resulting in an almost immediate drop in productivity. These new workers must first learn how to do their job, and here is where the second impact is felt.

Labor Productivity – Manufacturing Industry

Average annual growth rate (%)

	2000-2010
Taiwan	6.9
Czech Republic	6.0
South Korea	5.6
United States	5.2
Sweden	4.4
Finland	4.0
Singapore	3.4
United Kingdom	3.1
Japan	3.1
Norway	2.7
Denmark	2.6
Netherlands	2.6
France	2.1
Australia	2.0
Belgium	1.8
Germany	1.4
Spain	1.2
Canada	0.7
Brazil	0.6
Italy	-0.8

Source: BLS/US and CNI

SPECIAL TOPIC competitiveness gap

Given their poor education, workers – regardless of their schooling – have learning difficulties. This not only makes it difficult for companies to regain their lost productivity, but also hinders innovation, another source of increased productivity. Workers face difficulties to adapt to technological changes and lack creativity and logical thinking skills to devise more efficient production processes. The poor quality of education is a major hurdle to innovation.

Besides the poor quality of education, other problems include high costs and difficulties to access credit; a high tax load (which negatively affects investment); high transportation and energy costs; and high labor costs including taxes, ancillary obligations, excessive red tape, lack of incentives for improved efficiency, and high risk of legal uncertainty.

Another aspect deserving special mention is the negative impact of the appreciation of the real on competitiveness, a trend observed since the mid 2000s. Between 2001 and 2011, the unit labor cost – i.e. the labor cost to produce a unit of product in the Brazilian manufacturing industry, dropped by 12.7%, as measured in real. However, considering the cost in US dollars, a relevant measure for international comparisons, the growth was 94.5%.

The exchange rate evolution reversed the downward trend and is already above 2.00 R$/US$. Even if the current rate is sustained, the increase in the unit cost in dollars would be close to 60%. The exchange rate is a factor leading to lower competitiveness, but cannot be considered as the primary factor.

Brazilian business environment not stimulating investment

In short, Brazil is now an expensive country. Our business environment discourages investment, and Brazil is ranked among the worst countries for its impact on competitiveness. According to the World Bank, Brazil ranked 130th among 185 countries in terms of favorable business environment (Doing Business 2013). In a report prepared by the World Economic Forum, the Global Competitiveness Report 2011-2012, which considers 142 economies, Brazil ranked 53rd. According to the IMD World Competitiveness Yearbook 2012, Brazil ranked 46th out of 59 economies in terms of competitiveness.

The common conclusion is: Brazil is at a competitive disadvantage against other emerging countries. This disadvantage explains much of the gap between the growth rate of these countries and that of Brazil. It is therefore imperative for Brazil to take action to reduce systemic costs.

As a medium and long-term policy, Brazil needs to invest in improving the quality of education, promote the quality of basic education, encourage the professional education and training of engineers, and stimulate investments in innovation.

In developed countries, government support has proved crucial for investments in innovation. This is no different for developing economies such as Brazil. The country needs to expand its structure to support companies willing to innovate and build a regulatory environment conducive to innovation.

In the short run, the cost reduction policies in place need to be further strengthened. It is essential to take action to reduce the Brazil Cost. Such measures will certainly increase business competitiveness and bring about positive effects on business confidence and investing capacity. This is the only way for industry to resume growth in a sustained fashion.

economic activity

Increasing investment is crucial for higher GDP growth

The Brazilian economy is expected to grow by 0.9% in 2012, i.e. by one-third of the figure registered in 2011. Economic activity experienced two distinct moments over the year. In a first moment (first quarter), it stagnated, while in the second one, comprising the remaining three quarters of the year, signs of a gradual recovery were detected.

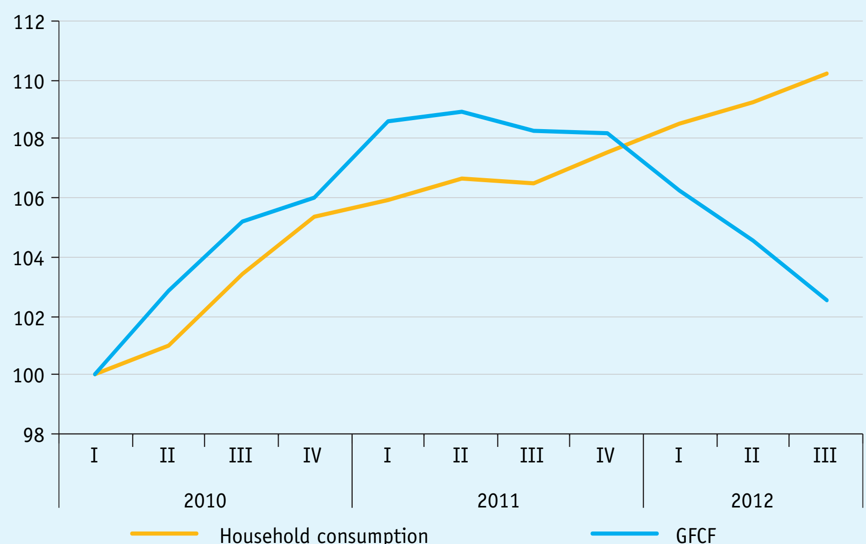
The economy is taking longer than expected to recover on a sustained basis despite a strong domestic demand in terms of household consumption. Investments, in turn, dropped for five quarters in a row (until the third quarter of 2012).

The problem is that household consumption demand has been increasingly met by foreign markets through imports and by the services sector, limiting its effect on industrial production growth.

A similar process was observed in the production sector, as companies increase their purchases of imported inputs to the detriment of those manufactured in Brazil, ultimately affecting the performance of the supply chain as a whole.

Household consumption and gross fixed capital formation (GFCF)
Index figure, base 1st quarter 2010 = 100 – seasonally-adjusted

Household consumption is up, but investment is down



Source: IBGE

The fact that demand has been met by increased imports can be confirmed by the rise observed in the import penetration coefficient (CNI/Funcex). This indicator, which measures the share of imported industrial goods in the domestic consumption of these products, soared from 12.1% in 2003 to 22.2% in 2012.

The increase in the import penetration coefficient is a direct result of competitiveness difficulties facing the Brazilian industry. Industry is faced with two challenges: marketing its products in the international market at competitive prices and coping with an increasing inflow of imported products to the domestic market.

Under this scenario, industrial GDP will fall by 0.6% in 2012. Physical manufacturing production (Monthly Survey of Industry - Physical Production/IBGE) dropped in four of the first six months of the year. From January to September 2012, it dropped by 3.6% from the same period in the previous year.

economic activity

Sixteen of the twenty-six manufacturing sectors experienced a slowdown in production between January and September 2012 from the corresponding period a year ago.

All use categories are down. Capital goods contracted by 12.4% (most investments continue to be made via imports of machinery and equipment), durable goods by 6.2%, and intermediate goods by 2.2%.

To achieve sustained growth, the increase in consumption must be accompanied by higher investment, but this has not been happening. Measures taken by the government, such as reducing the IPI in selected sectors like that of Automotive vehicles, were initially focused on stimulating consumption. Then, other measures were gradually taken to boost industrial competitiveness, but these will only become more effective in 2013.

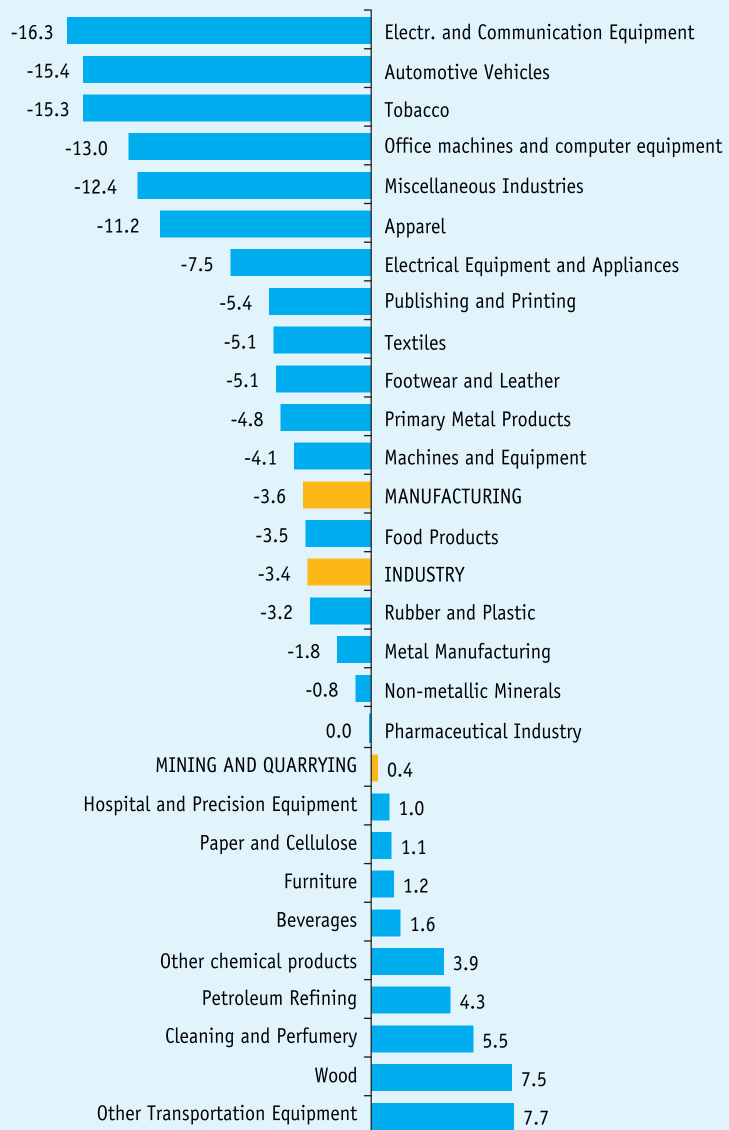
The challenges are not limited to the domestic market and industry is still facing major difficulties to export its products as a result of the deterioration observed in the international situation.

The inventories adjustment process in industry, which began in mid-2011, was slow. With excessive inventuries, industry has experienced idleness. The indicator for actual-usual capacity utilization (Industrial Survey - Manufacturing and Mining/CNI) has been below 50 points since December

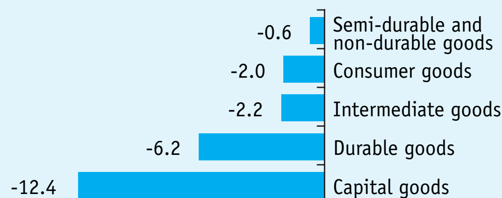
Manufacturing production by sectors and use category

Average (%) variation between January and September 2012 from the same period in the previous year

Manufacturing production down in most sectors



PRODUCTION BY USE CATEGORY



Source: IBGE

economic activity

2010, suggesting lower-than-usual capacity utilization for the month. With idle capacity, investment shrank. For investments to grow, capacity utilization needs to increase and return to usual levels.

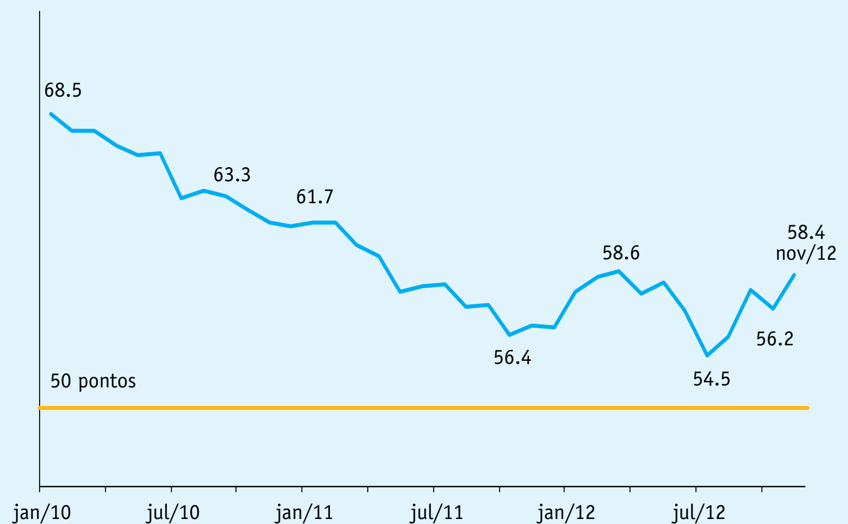
Recent data suggest that industry has managed to adjust its inventories. The indicator for actual-planned inventory levels (Industrial Survey - Manufacturing and Mining/CNI) remained close to the 50-point dividing line in September and October 2012 (figures above 50 points suggest inventories above planned levels, while those below 50 points suggest inventories below planned levels). Adjusting inventories is important to pave the way for manufacturing production to grow in a more continuous fashion over the next few months, strengthening the manufacturing activity recovery process.

Industrial recovery is not enough to avoid drop in the year

While manufacturing production decreased in the first half of the year, the sector managed to initiate a recovery process in June. The increase in manufacturing activity, however, was not continuous. In September, production dropped by 0.6% from the previous month, slowing down the pace of industrial recovery.

Business Confidence Index (ICEI)

Figures above 50 points suggest higher confidence



Source: CNI

GDP growth estimate for 2012

Percentage variation and GDP component's contribution

	GDP components	2012 Growth Rate (%)	2012 Contribution (p.p.)
Demand side	Household consumption	3.1	1.9
	Government consumption	2.8	0.6
	Gross fixed capital formation	-4.5	-0.9
	Exports	0.0	0.0
	(-) Imports	1.5	-0.2
Supply side	Agriculture/livestock	-1.6	-0.1
	Industry	-0.6	-0.2
	Mining and quarrying	-1.0	0.0
	Manufacturing	-2.0	-0.3
	Construction industry	2.0	0.1
	Public industrial services	2.0	0.1
	Services	1.8	1.2
	GDP	**0.9**	

Preparation: CNI

economic activity

The recovery in industry is well represented by the increase in the Business Confidence Index (ICEI) calculated by CNI, which shows a gradual recovery in the second half of 2012.

Notwithstanding the recovery in manufacturing in the year's second half, GDP for the sector will still probably post drop of 2.0% in 2012.

The only industrial segments that will likely grow are the construction industry, which is expected to grow at a rate of 2.0% in the year despite a slowdown in activity, and public-utility industrial services (2.0%).

Since an increasing share of household consumption is being met by services, this sector is estimated to grow by 1.8%, twice the GDP growth rate.

According to IBGE's National Accounts methodology, which also includes trade in services, the foreign trade sector will make a negative contribution to GDP growth of 0.2 percentage point. Exports are not likely to grow in the year, while imports may expand by 1.5%.

Outlook

Economy will grow more in 2013

CNI has projected two scenarios for 2013: a baseline scenario – which is more likely – and an alternative one. The difference between the two scenarios lies in the effectiveness of governmental measures designed to boost competitiveness and stimulate industry investments. Just as the reduction of electricity rates and payroll exemptions are important factors to increase the competitiveness of industry, the concessions of highways, railroads, ports and airports are also key for boosting investment.

The faster the different measures are implemented, the more business confidence will grow, ultimately leading to greater economic growth.

In the baseline scenario, CNI believes not only that the economy will close the year in acceleration, but also that the continuation of interest rates at historic lows levels and governmental measures to enhance industry competitiveness will provide a major impetus to the sector's, and to GDP, growth. CNI estimates a 4.0% increase in both GDP and manufacturing GDP for the next year.

The construction industry GDP is projected to grow by 5.0% – the highest growth rate on the supply side. This positive result is expected not only due to the concessions of highways, railroads, ports and airports, but also as a result of the intensification of construction projects for the World Cup and the Olympic Games.

Greater balance between consumption and investment

Economic growth will be sustained by a more balanced domestic demand in terms of consumption and investment. Since household consumption will continue to rise in 2013 (by an estimated 3.8%), the resumption of investments will be an important change in the composition of GDP growth. CNI projects that investments will grow by 7.0% next year.

With a more competitive industry, exports will grow by 5.0% and imports by 8.0% in 2013, as much of the investment will continue to be met by imports. The foreign trade sector will make a negative contribution to GDP growth of 0.4 percentage points.

The alternative scenario is less likely, but still relevant. It is based on a weaker recovery of investments (4.0% growth), which would lead to a 3.0% increase in GDP in 2013.

economic activity

In both scenarios, domestic demand will continue to go up, since the labor market will remain strong. Jobs – mainly formal jobs – will grow more strongly in 2013 than in 2012.

In a less optimistic scenario, governmental measures to improve industry competitiveness would have a low impact, which would cause the sector to grow at a rate of 2.3% (almost half the figure estimated in the baseline scenario), with manufacturing advancing by a mere 2.0%.

Greater GDP growth in 2013 will depend on increased industry competitiveness

Uncertainties on the international environment will continue in 2013. We are not expecting to see any breakdown in the euro or any country leaving the European Union, much less a worsening of the crisis as in 2008. However, industrialized countries will recover very slowly in coming years.

Under the two scenarios, services and agriculture will continue to grow more than industry (by 3.5% and 3.0%, respectively). The growth rate of the Brazilian economy in 2013 will depend on domestic measures. The difference between a more intense and a less strong growth rate will be determined by the effectiveness of governmental measures to boost investments and competitiveness. An increase in industry competitiveness and the recovery of investments will be crucial if the Brazilian economy is to resume growth on a sustained basis.

GDP growth estimate for 2013

Percentage variation and GDP component's contribution

		Baseline scenario		Alternative Scenario	
	GDP components	Growth Rate (%)	Contribution (p.p.)	Growth Rate (%)	Contribution (p.p.)
Demand side	Household consumption	3.8	2.3	3.5	2.2
	Government consumption	3.9	0.8	3.6	0.8
	Gross fixed capital formation	7.0	1.3	4.0	0.7
	Exports	5.0	0.6	1.0	0.1
	(-) Imports	8.0	-1.0	6.1	-0.8
Supply side	Agriculture/livestock	3.0	0.2	3.0	0.2
	Industry	4.1	1.1	2.3	0.6
	Mining and quarrying	3.1	0.1	1.5	0.1
	Manufacturing	4.0	0.6	2.0	0.3
	Construction industry	5.0	0.3	3.0	0.2
	Public industrial services	4.5	0.1	3.5	0.1
	Services	3.8	2.6	3.5	2.4
	GDP	**4.0**		**3.0**	

Preparation: CNI

employment and wage

Low employment growth in 2012

The employment growth has been slowing down since mid-2010 – when it recorded the highest growth rate in the last seven years.

Since then, jobs began to grow at a slower pace, increasing by only 2.0% in the six largest metropolitan Brazilian regions (Monthly Job Survey/IBGE) from January to October 2012 from the corresponding period the year before.

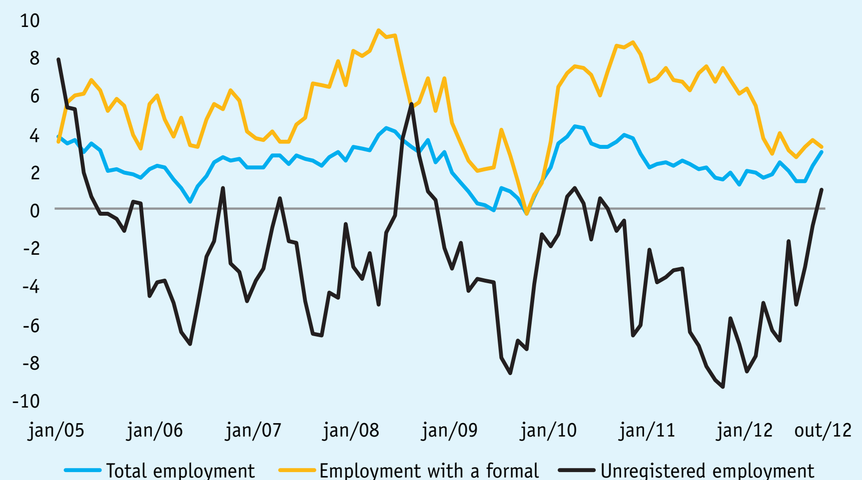
The continued drop in non registered jobs and the slowdown in the growth of registered employment explain the lower employment growth rates. Although it is growing at a slower pace, total employment will continue to grow above GDP in 2012.

The main reasons behind a strong domestic demand are not only an increase in jobs, but also in registered employment to the detriment of non registered ones. Registered jobs provide more financial security than non registered occupations for two basic reasons. New entrants in registered jobs have more access to the credit market, since they can confirm the source of their income. And those jobs also pay considerably higher wages than informal occupations.

Metropolitan employment

YoY variation

Employment slowing down its growth rate since the second quarter of 2010



Source: IBGE

Average real earnings of workers in registered jobs in the private sector, as measured by the PME, are 40.7% higher than those of employees holding non registered jobs.

Considering the formal labor market throughout Brazil, as measured by the General Registry of Employed and Unemployed Persons/MTE, 1.3 million jobs were created in the period from January to October 2012. With low GDP growth, the formal labor market continues to absorb a large number of workers.

Manufacturing labor market holds steady in 2012

The industrial labor market points to a complete loss of momentum, as a result of which employment is at the same level as in early 2011. It is worth noting that despite the 2.0% drop in manufacturing GDP in 2012 (CNI's estimate), the number of employees in the sector has held steady.

There are some possible explanations for this apparent disparity, such as

employment and wage

high dismissal costs and greater difficulties in finding skilled workers – in the case of an expected recovery of manufacturing activity. According to CNI's Industrial Survey - Manufacturing and Mining, the lack of skilled labor became more intense throughout 2012, despite the slow recovery of manufacturing activity. This problem will increase in importance as activity recovers.

The performance of manufacturing industry varied remarkably in the different activity sectors. Employment is up in half of the sectors considered by the CNI Industrial Indicators survey. Other transportation equipment and apparel were the sectors for which the sharpest increase in employment was registered in the period from January to September 2012 as compared to the same period last year: up by 4.0% and 2.8%, respectively. On the other extreme, the Wood and Electronic and communication materials sectors recorded drop of 4.1% and 3.9%, respectively.

It should be emphasized that employment will drop more than GDP in only five manufacturing sectors: Metal manufacturing, Wood, Electronic and communication materials, Leather and Footwear, and Textiles.

The labor market is yet to react in 2012, given its slow response to changes in activity. As a result, industrial jobs will likely hold steady in 2012. Jobs in manufacturing are only projected to grow steadily in 2013, when we expect to see an increase in manufacturing activity.

Outlook

More intense economic growth in 2013 will create more jobs

As in the other productive sectors, jobs in industry will grow in 2013, with registered jobs continuing to grow at a higher rate than non registered occupations. As a result, the average real earnings of workers will continue to rise.

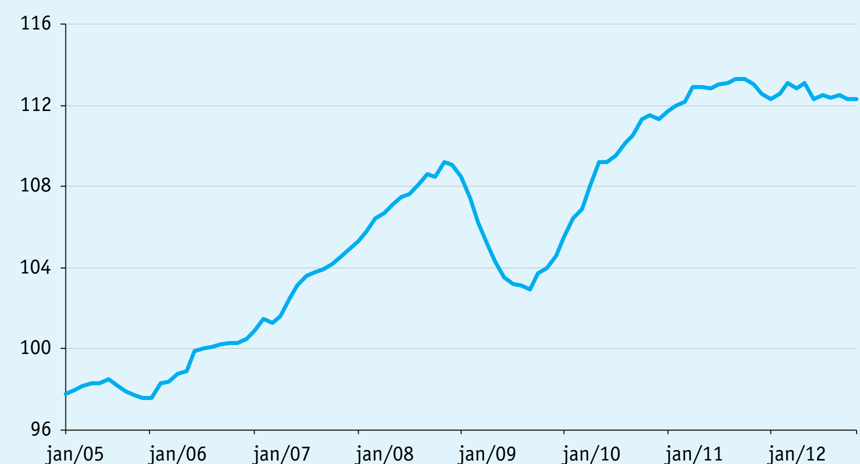
The labor force will keep growing at a slower pace than employment. Since the number of new entrants in the labor market looking for a job will be lower than the number of jobs created, the average unemployment rate will likely drop to 5.3% in 2013, a new record low.

The increase in employment, labor market formalization and average real earnings will sustain household consumption, which will post growth of 3.8% in 2013.

Job in manufacturing

2006 Index number = 100 - seasonally adjusted

Employment at the same level as in early 2011



Source: CNI

inflation, interest rate and credit

Inflation above central target for third consecutive year

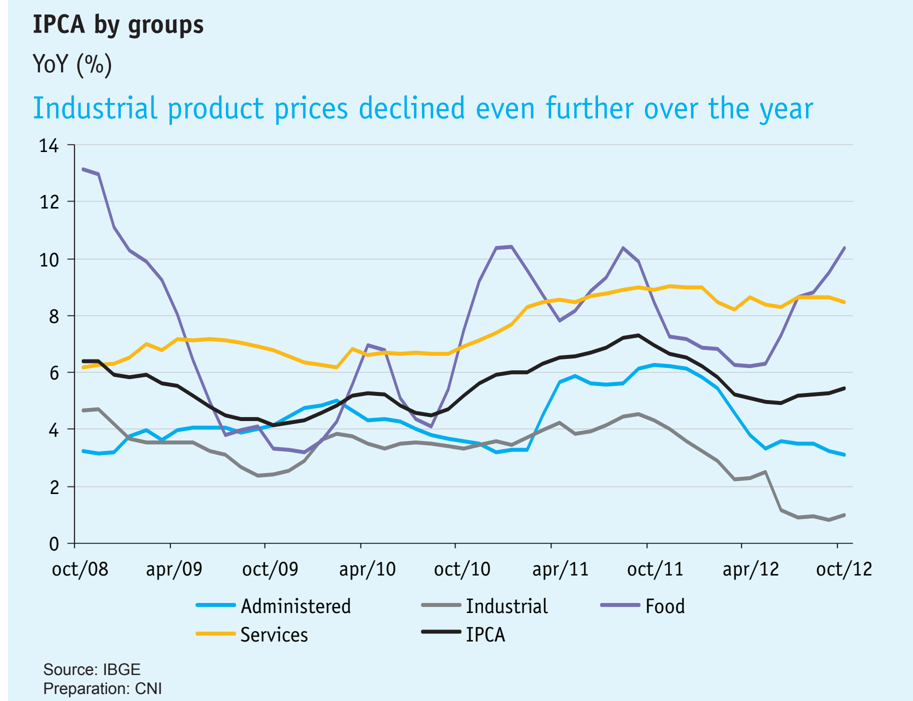
Inflation in 2012 remained at high levels, but below the 2011 figure. Annual inflation will stand at 5.5% in 2012. Last year, the IPCA (based on which the target is set) remained within the upper limit of the target at 6.5%, distant from the central target of 4.5%, and even amounting to 7.31% in September.

This performance is not homogeneous among the four major IPCA groups (food products, services, industrial and administered products). Food prices rose more rapidly over the year and the 12-month figure for service prices remained at a high level, both of which contributing to a high IPCA.

On the other hand, industrial products, the group that was already experiencing the lowest increases in prices, slowed down even further and administered prices are also trending downward, both offsetting the more significant increases in food and service prices. But this was not sufficient to put the IPCA close to the central target.

Once again, food prices played a major role in pushing the IPCA up over the year. The 12-month figure for the group rose from 6.9% in January to 10.4% in October, and this was the IPCA component for which the highest inflation was registered. As a comparison, the 12-month figure for the group stood at 8.5% in October 2011.

IPCA by groups
YoY (%)



Source: IBGE
Preparation: CNI

This upward pressure on food prices is not unique to Brazil. Agricultural commodity prices experienced a more marked increase in 2012, partly offsetting the drop observed in 2011. The IMF commodity index, which shows the evolution of food and beverage prices, rose by 8.7% over the 12-month period ended in October.

The group's inflation is expected to remain at a moderate level in the last two months of the year, dropping below double-digit figures. This moderation, however, will not suffice for food products to cease being the group with the highest annual inflation in the IPCA.

Industrial product prices continue to be the group exerting the lightest pressure on inflation. The 12-month figure for the group shrank from 3.2% in January (already below the central inflation target) to 1.0% in October.

This slowdown can be explained by two main factors. First, poor economic performance, particularly in the first half of the year, resulted in industry having a hard time to reduce its stocks. Second, there was a reduction in the

inflation, interest rate and credit

IPI on automotive vehicles (which led the group to drop by almost 1 p.p.). The fact that the IPI will only be resumed in January will make it possible for the group's inflation to stand at approximately 1% this year. Thus, the more modest evolution as compared to the other groups brings about positive effects for the general inflation index.

Inflation in services remained at a high level and experienced little volatility in the year. Due to the inertia in this group as a result of the price rate of many items being linked to the minimum wage and to the still-positive performance of domestic consumption, the group's prices are up by more than 8% in the year.

Albeit timid, however, there was actually a slowdown in 2012. In January, the 12-month figure for the group totaled 9.0%, dropping to 8.5% in October. This slow deceleration is expected to continue in the two remaining months, but standing above 8% in the year.

Administered prices reversed the trend observed in 2011. Last year, the 12-month figure for the group jumped to an average annual rate of 5.3%, compared to an average of 3.3% in the 2007-2010 period.

This increase in 2011 was strongly influenced by adjustments linked to price indices such as the General Price Index (IGP), which, unlike 2011, grew strongly in 2010. As a result, this trend was less pronounced in 2012. The 12-month figure for the group dropped from 5.8% in January to 3.1% in October. By the end of the year, this rate is expected to grow slightly, closing the year with an accumulated figure of 3.5%.

The balance of these effects will cause inflation to be lower in 2012 than in 2011 (when it remained above the upper band limit of 6.5%). The 12-month IPCA was above 5% in nearly every month of the year and the central target will once again not be achieved.

CNI is expecting to see the 12-month IPCA at 5.5% in December – one percentage point above the central target. Inflation this year was not higher only because of industrial product prices. As a comparison, if industrial product prices were to experience monthly increases equal to the average figure for previous years, the IPCA would close the year at about 6%.

Inflation target not affected by reductions in Selic

The slowdown in the inflation rate from 6.5% in 2011 to below the current level of 6% allowed for new increases in the basic interest rate (Selic) in 2012.

Copom believes that even though inflation is above the central target, there are no long-term risks of higher inflation. Furthermore, the Central Bank and the government seem to be committed to promoting price stability in a broader context and generating lower impact on economic activity.

As a result of these reductions, the Selic rate, which reached 12.50% per year in August 2011, stood at 7.25% (per year) in October – down by 5.25 p.p. in a period of little more than one year, totaling 10 consecutive cuts.

The main purpose of this reduction process was to diminish the negative effects of the ongoing international crisis on the domestic economy. As a result of the decline in manufacturing activity, the Brazilian government opted to provide more liquidity to the market by reducing credit funding costs.

Besides Selic, essentially a short-term interest rate, government also reduced Long-Term Interest Rates (TJLP) from 6% to 5.5 and the interest rate charged by the Brazilian Development Bank (BNDES) (mainly under the Investment Support Program – PSI, now with nominal rates from 2.5% per year).

The trend toward a more expansionary monetary policy seems to have come to an end. In the last meeting of the year (November 27 and 28), COPOM decided to maintain Selic at the current rate (7.25% per year), making it clear that it will remain at this level for an extended period.

Selic will thus close the year at 7.25% (per year). With CNI expecting inflation to stand at 5.5% in 2012, the average real interest rate in the year will amount to 3.1%.

inflation, interest rate and credit

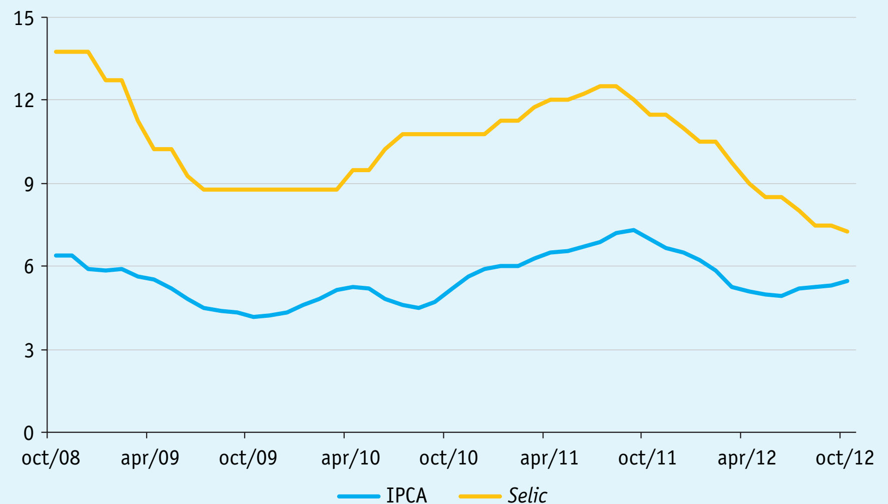
Lower interest rates not leveraging loans

A sluggish economic activity has also affected lending. In addition to the effects on private interest rates from the reduction in Selic, a number of measures were adopted to reduce lending costs in Brazil, mainly by increasing bank competition. Notwithstanding, loans with non-earmarked resources to individuals slowed down in the year and remained stable for corporations.

IPCA and Selic

IPCA (YoY) and annual Selic rate (%)

Selic rate down even with inflation above central target



Source: IBGE and Central Bank
Preparation: CNI

The average interest rate for individuals began 2012 at 45.1% (per year), close to the average observed last year. After the above-mentioned measures were taken, this rate hit the mark of 35.4% (per year) in October (latest data available). For corporations, the figure rose from 28.7% to 22.1% (per year) over the same period.

Part of this drop can be explained by the decline in bank spreads. In the January-October period, spreads on loans to individuals dropped from 34.9% (per year) to 27.8% (per year); for businesses, they dropped from 28.0% to 22.3% (per year) over the same period.

Despite this more favorable environment to borrow at lower interest rates, this drop has not led to an increase in lending.

The increase in loans with non-earmarked resources to individuals, which reached an impressive 22.1% in January 2011 (YoY), has since trended downward. This rate amounted to 11.2% in December last year, hitting the mark of 8.8% in October 2012. On the same comparison basis, the increase in lending to businesses held steady during this period (8.1% in December 2011 and in October 2012).

On the other hand, the continuation of BNEDS's Investment Support Program (for the purchase of machinery and equipment) has leveraged expenditures with funds from BNDES in recent months. Excluding the petroleum sector, which distorts the indicator due to Petrobras capitalization process in 2010, disbursements grew at a rate of 5.7% in September (YoY).

CNI are expecting to see a recovery in loans through the remainder of the year, as a result of the economy performing better in the second half than in the first one and of the lagged effects from the drop in the basic interest rate on the credit market.

inflation, interest rate and credit

Outlook

Better economic situation will keep pressuring inflation up in 2013

The inflation scenario will not change much in 2013. CNI estimates that prices will remain under pressure throughout the year, with the 12-month IPCA above 5% and even exceeding 6% in some periods.

This scenario is based on the recovery of economic activity, with economic growth exceeding the rates observed in 2011 and 2012 combined with expansionary monetary and fiscal policies.

Some points should be highlighted with regard to inflation. The prices of industrial goods are expected to put greater pressure on inflation in January, when the IPI will be resumed for cars. The IPCA index is expected to experience a direct impact of around 0.25 percentage points.

On the other hand, lower charges levied on electricity will lead to a drop in the IPCA index in the first months of the year, offsetting the rise in the IPI. The average reduction in electricity rates for individual consumers, estimated at 16%, will cause the IPCA to drop by about 0.5 percentage points.

The reduction in charges levied on legal entities is also expected to have deflationary impacts on the IPCA index, but measuring this effect is difficult. Lower electricity rates will contribute to reduce the costs of enterprises, but the amount of pass-through of these effects to prices will depend on market conditions and on how fast economic growth is resumed in Brazil.

Discussions are being held on the possible need to raise fuel prices. There is no date for such raise to be determined, but fuel prices are expected to increase by about 10% somewhere in 2013. Such a high raise will push the IPCA up by approximately 0.4 percentage points.

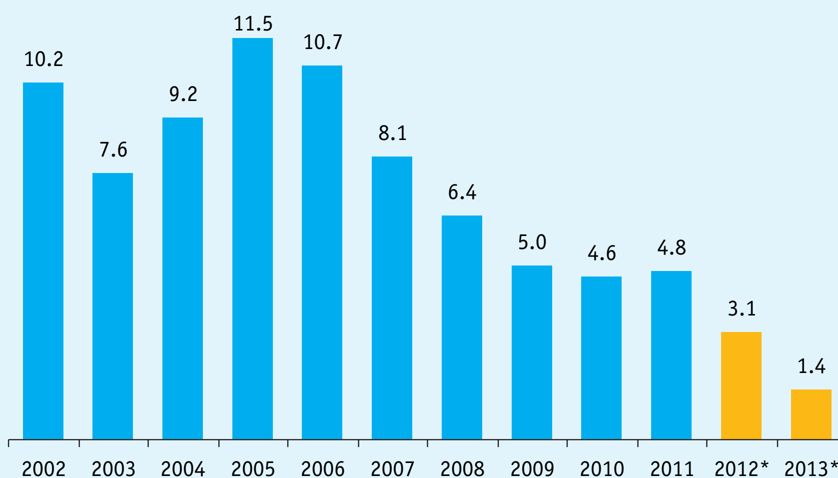
CNI's estimate for inflation in 2013 is based on four assumptions: recovery of economic activity, resumption of the IPI tax on cars, lower charges levied on electricity for natural and legal persons, and a possible increase in fuel prices. Food prices will not continue to rise at the same pace as now, but their pressure on the IPCA index will still be felt. Prices for services are only expected to rise again late in 2013. As a result, the IPCA will amount to 5.5% in 2013, the same percentage estimated for this year.

In this inflation scenario, CNI believes that the COPOM will continue to apply the same policy adopted in 2012: keeping inflation within the upper target band. Considering that the estimated inflation scenario contemplates this policy and that lower funding costs will be crucial for stimulating economic activity, CNI expects the Selic rate to remain stable at 7.25% per year in 2013. Thus, the average real interest rate will fall to 1.4% in the year.

Annual average real interest rate

Percentage per year (%)

Downward trend in the average real interest rate to continue in 2013



Source: IBGE and Central Bank
* CNI estimate

fiscal policy

Expansionary fiscal policy attempts to contain economic slowdown

Significant increases in public spending and a series of tax reductions characterized the strongly expansionary fiscal policy adopted in 2012. The Federal Administration resorted to these fiscal instruments, combined with an also expansionary monetary policy, in an attempt to curb economic slowdown. The increase observed in the spending of state and local governments, in turn, reflects the effects of electoral periods and an increase in credit operations authorized by the Federal Administration.

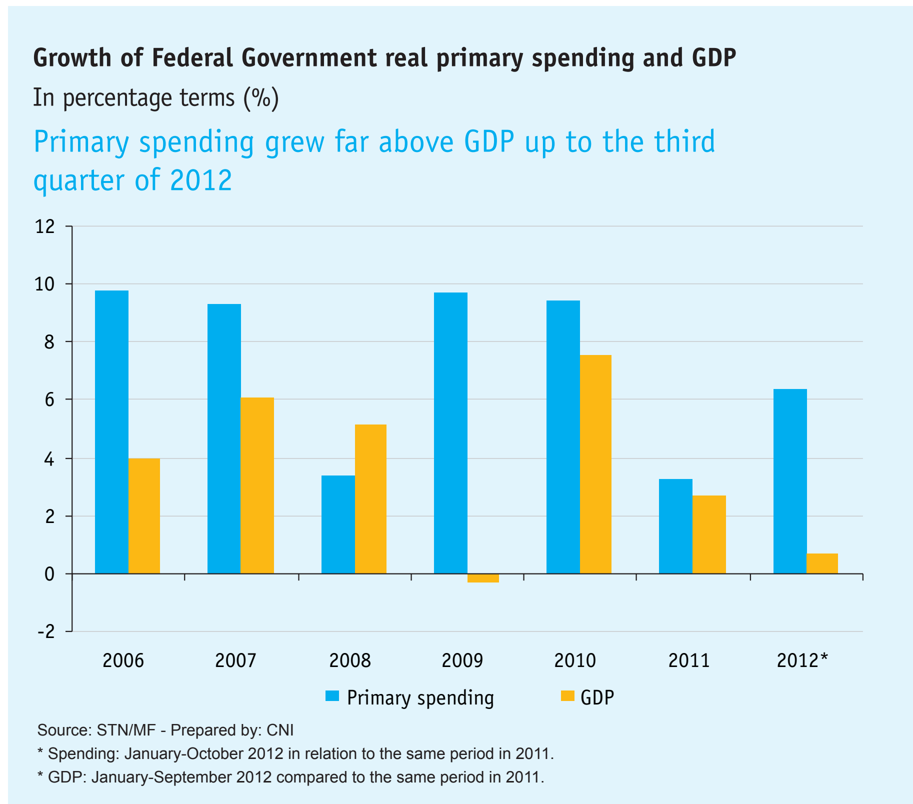
The countercyclical use of the fiscal policy is likely to lead to a marked decrease in the public sector primary surplus as compared to 2011. The Federal Government will still achieve an adjusted target, net of investment expenditures, but the primary surplus of states and municipalities is expected to fall far short of the target set by the Federal Administration.

There will be no major changes in the fiscal policy in 2013. The Federal Government must continue to spend more to support the economic recovery process seen in the last months of 2012. Only on the revenue side, one should not expect to see the same behavior observed in 2012.

Growth of Federal Government real primary spending and GDP

In percentage terms (%)

Primary spending grew far above GDP up to the third quarter of 2012



Source: STN/MF - Prepared by: CNI
* Spending: January-October 2012 in relation to the same period in 2011.
* GDP: January-September 2012 compared to the same period in 2011.

While, on the one hand, changes in the Social Security contribution base are certain to reduce taxation, on the other hand some tax cuts will no longer be applied.

The spending of states and municipalities will continue to grow at significant rates, but their primary outcome is expected to improve slightly as a result of a recovery of revenues, mainly in the form of transfers from the Federal Administration.

Growth of federal spending doubles for 2011

Federal primary spending increased, in real terms (IPCA deflator), by 6.4% between January and October 2012 as compared to the same period the year before. This spending growth pace is twice as high as that registered over the same period in 2011 in relation to the rate accumulated over January-October 2010.

fiscal policy

The countercyclical use of the fiscal policy becomes more evident in the strong nominal increase registered in discretionary spending,12.2% between January and October 2012 as compared to the same period in the previous year. While the increase in discretionary spending contributed strongly to pushing operating expenses up by 12.3%, it should be noted that there was a shift in investment in relation to 2011.

Federal Government investments (according to data provided by the Integrated Financial Management System - SIAFI) had a real increase of 11.6% in the first ten months of 2012 as compared to the same period the year before. In 2011, investments experienced a real decline of 12.0% due to cuts in spending by the Federal Administration as a means to fight inflation.

Pension benefits also played a major role in increasing federal spending, as they had a net increase of 7.4% between January and October 2012 in relation to the same period in 2011. The main reason for the increase observed in Social Security spending was a 14.1% raise in the nominal value of the minimum wage, approved in January 2012.

The pressure caused by rising operating expenses, investments and pension benefits led the Federal Government to restrict any increase in staff expenditure. Over the first ten months of 2012, these expenses dropped by 1.9% in real terms.

Slight growth in federal revenues

The net revenue of the Federal Government grew by 1.3% in real terms between January and October 2012 in relation to the same period in 2011. This increase is close to the GDP growth registered over this period. However, this is a different result than that observed in recent years, when this increase invariably exceeded the economy's growth rate - except in 2009.

This atypical behavior observed in 2012 can be explained by three factors. The first one is that the high flow of extraordinary revenues registered in June and July 2011 has not been repeated. These extraordinary revenues resulted from a waiver of legal claims against the collection of the Social Contribution on Net Income - CSLL (R$ 5.8 billion) and from payments of overdue debts in installments, made possible by Law 11.941/09 (R$ 14.4 billion).

The second factor refers to tax cuts approved by the Federal Government that led to a real decline in revenues from the Tax on Financial Operations (IOF) (-7.0%), from the Tax on Industrialized Products (IPI) not linked to imports (-15.8%) and from the excise tax on fuels (CIDE-combustíveis) (-66, 8%).

The third factor is the decline observed in the profitability of companies, which resulted in a real decrease of 4.0% in revenues from the Corporate Income Tax and from the CSLL contribution.

Spending of states and municipalities still on the rise

CNI estimates that the spending of states and municipalities increased by 5.7% in real terms between January and September 2012 as compared to the same period in 2011. This is the same behavior observed in 2011, when their spending grew by 5.9% relative to 2010. Such behavior is noteworthy, as the tax revenue of regional governments increased by only 2.8% in 2012, while in 2011 it was growing at a rate of 7.8%.

It should be noted that any increase in the spending of states and municipalities must be consistent with the behavior of revenues, as provided for in the Fiscal Responsibility Law and in debt refinancing agreements. The inconsistency between the spending and revenue of these governments in 2012 can be explained by a marked increase in credit operations for states authorized by the Ministry of Finance. In 2012, the amount of authorized credit has so far hit the mark of R$ 58.3 billion, against R$ 39.4 billion in 2011.

fiscal policy

Strong reduction in the primary surplus

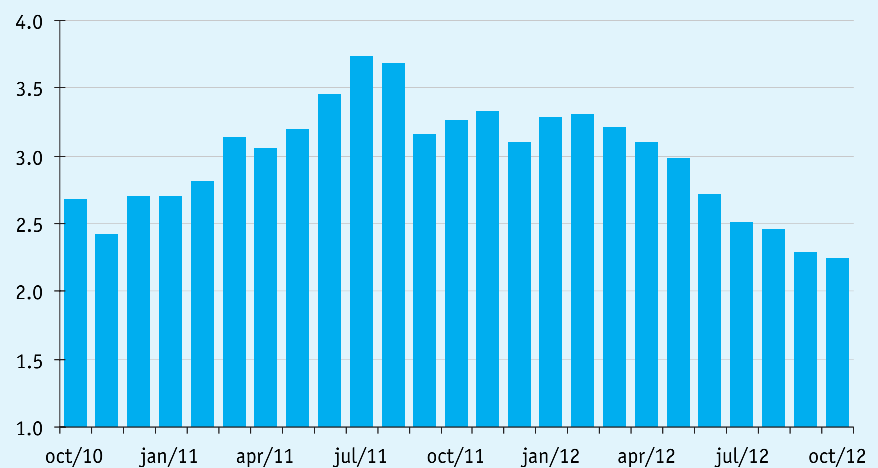
A sharp increase in spending coupled with slow revenue growth led the primary surplus to drop significantly throughout 2012. Over the 12-month period ending in October, the public sector primary surplus amounted to only R$ 98.4 billion (2.25% of GDP). For the Federal Government and its enterprises, the primary result was R$ 71.4 billion (1.6% of GDP) and for regional governments and their enterprises it amounted to R$ 26.5 billion (0.6% of GDP). In 2011, the public sector primary surplus was equivalent to 3.1% of GDP, with the federal government accounting for 2.25% of GDP and regional governments for 0.85% of GDP.

According to CNI's projections, the growth rate of government spending will become more intense and hit the mark of 7.7% in real terms by the end of 2012. This will be due to a more intense rise in staff expenditure, operating expenses and investment. With regard to staff expenditure, wage increases granted to some categories of workers in the second half of 2012 are expected to reverse the real drop observed until October and lead to a real growth of 0.5% by December. Operating expenses and investments are likely to follow the trend of acceleration in the growth pace observed in recent months, especially after the release of previously retained budget resources, in the amount of R$ 8.5 billion, in November.

Evolution of the public sector primary surplus

12-month accumulated (% of GDP)

Primary surplus fell by 0.8 percentage points of GDP between December 2011 and October 2012



Source: Central Bank

The growth rate of the Federal Government net revenue is expected to gather speed until the end of 2012 and close the year with a real growth of 4.2% over 2011. It is likely that the main reason for this acceleration is a strong increase in revenues from dividends and financial compensations, which led the Federal Government to increase its expected revenue by R$ 8.5 billion. We therefore estimate that the primary surplus of the Federal Administration and its enterprises will rise to R$ 74.3 billion (1.7% of GDP) in 2012, exceeding the R$ 71.4 billion target.

For regional governments, the spending rate is likely to rise more sharply until the end of the year. However, with regard to their revenues, a shift similar to the one observed for the Federal Government is not expected, as the more intense growth rate in federal revenues will be mostly brought about by revenues not shared with states and municipalities. As a result, the surplus of regional governments and their enterprises will continue to drop, closing next year at R$24.0 billion (0.5% of GDP), i.e. below the R$ 42.8 billion target. In this scenario, the public sector primary surplus is likely to amount to R$ 98.3 billion (2.2% of GDP, as estimated by CNI), against an adjusted target of R$ 114.2 billion.

Despite the expected sharp drop in the primary surplus, lower interest expenditure are likely to lead to a slight reduction in the nominal deficit. With the Selic rate at a historically low level, interest expenditure will likely drop from 5.7% in 2011 to 4.8% in 2012. Thus,

fiscal policy

the nominal deficit is expected to total 2.6% of GDP, the same level observed in 2011. Still, the rise in the nominal GDP and exchange rate adjustments for the domestic and foreign debt are likely to push the public sector net debt down from 36.4% in 2011 to 35.2% in 2012.

Outlook

Expansionary fiscal policy will continue to be applied in 2013

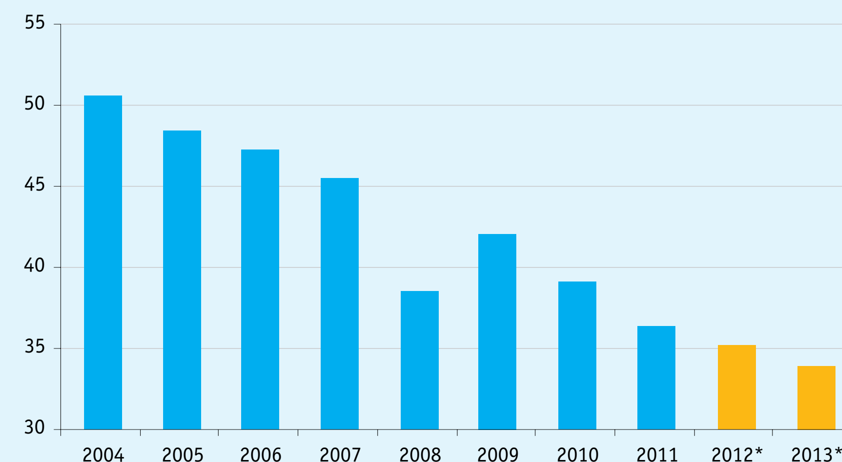
The expansionary character of the current fiscal policy will be preserved in 2013. The Draft Annual Budget Law (PLOA) contemplates a significant increase in both compulsory and discretionary spending. In addition, the Federal Government is not expected to seek to meet the full primary surplus target, i.e. without deducting R$ 25.0 billion in investment outlays. It may thus be less rigorous with its discretionary spending and use it in support of economic recovery.

The PLOA contemplates a real growth of 16.2% in discretionary spending in 2013 in relation to the budget appropriation authorized in November 2012. However, if the Federal Government meets only the adjusted primary surplus target, it will have to carry out a financial programming of R$ 12.1 billion. In this case, its discretionary spending will increase by 10.1% in real terms. Thus, CNI projects a real increase of 6.0% in 2013 over 2012.

Path of the public sector net debt relative to GDP

Relative to GDP (%)

Net Debt/GDP ratio is likely to drop by 1.4 percentage points in 2012, falling for three years in a row



Source: Central Bank

* CNI estimate

On the revenue side, CNI projects a real growth of 6.0%. The faster increase in revenue relative to 2012 might be brought about by the discontinuation of some tax cuts, greater economic growth, and the end of the base effect caused by the exceptional revenues registered in 2011. On the other hand, changes in the Social Security funding base and a lower increase in revenues from dividends, royalties, and financial compensations are factors that will prevent revenues from increasing even more in 2013.

Based on these projections for revenues and spending, CNI estimates that the Federal Government primary surplus will amount to R$ 83.1 billion (1.7% of GDP) in 2013, or to the unadjusted target. For states and municipalities, we estimate a primary surplus of R$ 29.6 billion (0.6% of GDP), lower than the target set for 2013, namely, R$ 47.8 billion. As a result, the public sector primary surplus will close 2013 at R$ 112.7 billion (2.3% of GDP), below the adjusted target of R$ 130.9 billion.

In this scenario, the nominal deficit is expected to drop to 2.2% of GDP, mainly due to a decrease of 0.4 percentage points of GDP in interest costs. Given a lower nominal deficit and a faster GDP growth, the Net Debt/GDP ratio is likely to decline once again, from 35.2% of GDP in 2012 to 33.9% of GDP in 2013.

foreign trade sector and exchange rate

Exchange rate at a new level in 2012

After four months of relative stability in the range of R$ 2.00/US$ - R$ 2.05/US$, the real depreciated once again in early November and fell to R$ 2.09/US$ in the second half of the month. Discouraging news from abroad had a negative impact on most emerging-country currencies, but the depreciation of the Brazilian real was more pronounced than that recorded in most of those countries.

Since April, the exchange rate has been used as a tool to enhance the competitiveness of productive sectors, so it is highly unlikely that it will appreciate to R$ 2.00/US$ or less in the short term. Moreover, the government doesn't seem to be willing to allow fluctuations above R$ 2.10/US$. Therefore, there are implicit indications of a managed exchange rate fluctuation.

There is not much room for any further depreciation of the real beyond the upper limit. The government fears the pass-through to prices and the inflation projected for 2013 is above the central target. Another tool for controlling inflation, i.e. increasing interest rates, is not an option right now, as the Government is concerned with preserving the pace of economic activity.

According to CNI's projections, the exchange rate will more often remain at a level of about R$ 2.10/US$ by the end of 2012. As a result, the average rate in December will be R$ 2.06/US$ and the annual average rate will be US$ 1.95/US$. Thus, the average exchange rate in 2012 will be more depreciated than in the previous year, when it amounted to R$ 1.67/US$.

Exports of industrial products on a downward path

Exports totaled US$ 202.3 billion in the 2012-accumulated result up to October, 4.6% below the figure recorded over the same period in 2011. All three product categories contributed to this fall: basic products (-7.3%), semi-manufactured products (-9.2%) and manufactured products (-2.0%).

A negative scenario abroad (high uncertainty in the European economy, slow recovery in the US and economic slowdown in China) has been affecting Brazilian exports in two ways. Commodity prices, especially of metal commodities, had a sharp decline due to the lower growth pace of the global economy. Moreover, demand for industrial products from our key partners is still depressed due to the poor performance of their economies or of their increased protectionism. As a result, commodity export prices and

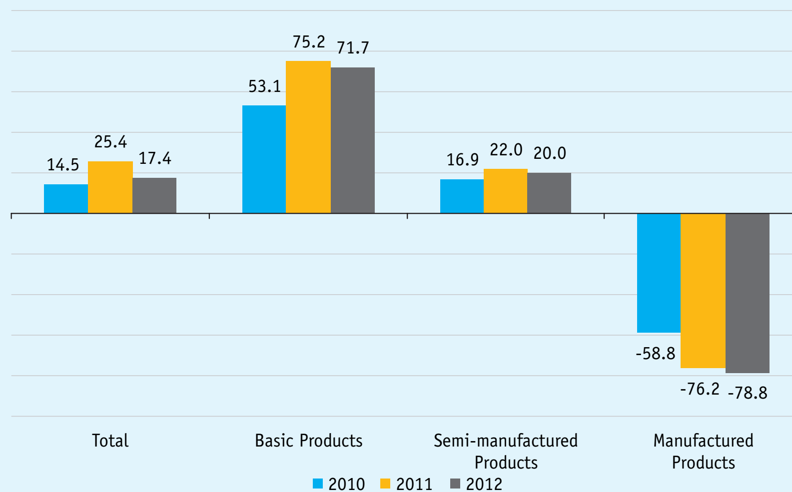
Evolution of the Real/US dollar exchange rate

PTAX closing rates (R$/US$)

After four months of relative stability, the real depreciated in November

Source: Central Bank

foreign trade sector and exchange rate



those of some by-products are down and Brazilian companies are facing difficulties to export industrial products.

The price indices and export volumes calculated by Funcex show that between the first ten months of 2012 and 2011 prices fell by 4.3%, while export volumes remained stable (growth of only 0.1%). The drop in export prices is explained by commodities and semi-manufactured goods, for which a negative growth of 8.0% and 5.8%, respectively, was recorded. A positive variation of 0.9% was observed for manufactured products. The drop in export volumes is explained by the sales of industrial products abroad: semi-manufactured products (-2.2%) and manufactured goods (-1.7%). The exported quantum of basic products increased by 2.1%.

The scenario abroad and its constraints are not likely to change abruptly in 2012, meaning that Brazilian exporting companies will face similar difficulties until the end of the year. Thus, CNI expects exports to total US$ 244.6 billion, 4.4% less than in 2011.

Imports of consumer goods continue to increase

Brazilian imports totaled US$ 184.9 billion between January and October of 2012, a figure very close to that observed in the same period last year (down by 0.9%). Imports of raw materials and intermediates and fuels reflect the weak performance of the Brazilian economy and dropped by 2.9% and 6.8% on the same comparison basis, respectively. Imports of consumer durables also decreased (-5.4%). Purchases of Brazilian consumer non-durables abroad, in turn, rose by 7.9% in the same comparison, while those of capital goods increased by 2.6%.

Import volumes experienced a negative growth of 1.4% in 2012 in the figure accumulated up till October, while import prices are stable, having increased by 0.6%.

Domestic demand is expected to continue to grow and the exchange rate level is likely to remain at the same level until the end of 2012. However, in late October, US$ 6.0 billion in imports of oil and oil by-imports by Petrobras remained unaccounted for. Part of that sum was accounted for in the third week of November (leading the trade balance in that week to record the worst weekly deficit in 15 years). Given that US$ 4.5 billion are still to be accounted for, imports are likely to increase over the next few weeks. Thus, CNI estimates that imports will total US$ 224.9 billion at the end of the year, a figure close to the one registered in 2011 (drop of 0.6% on this comparison basis).

As a result, the Brazilian trade surplus will total US$ 19.7 billion in 2012, against US$ 29.8 billion in 2011, meaning that it will drop by 33.9%.

foreign trade sector and exchange rate

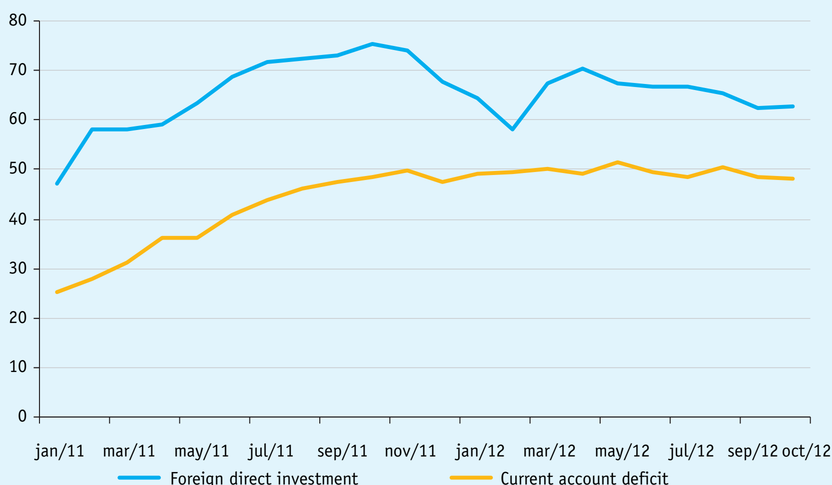
Current account deficit remains stable

The 12-month current account gap amounted to US$ 52.2 billion in October, almost the same figure recorded in 2011 (US$ 52.4 billion), accounting for 2.3% of GDP. A steady and strong inflow of foreign direct investment (FDI) widespread across sectors continues to fund this deficit. Over the last 12-month period ending in October, the accumulated net inflow of FDI amounted to US$ 66 billion, or 2.9% of GDP. The deficit is likely to remain stable until the end of the year, totaling US$ 54 billion.

Current account deficit and net foreign direct investment (FDI)

Accumulated in 12 months - in US$ billion

FDI finances current account gap



Source: Central Bank

OUTLOOK

Competitiveness is the key for stepping up exports of industrial products

The outlook for the foreign trade scenario in 2013 remains unfavorable. CNI projects that core economies will continue to have a hard time dealing with the crisis. In this scenario, China is likely to take further measures to stimulate domestic consumption and capital will tend to flow to emerging markets, in search of profitable projects. Demand for food remains high, but it is lower for mineral and energy commodities. The situation in Argentina, however, is unique. It is one of the main markets for Brazilian industrial products, but its economic performance will remain weak and it will continue to impose strong restrictions on imports.

In a more optimistic scenario for the global economy - resulting from improvements in the economic performance of China and the United States, for example - the outlook for Brazilian industrial products in foreign markets is more positive. However, improving the competitiveness of Brazilian industry will be crucial for achieving a more significant recovery in sales of industrial products.

With respect to the exchange rate, no changes are expected in 2013 in the policy adopted by the government to try and keep it at its current level, given the dual role it has been playing in the economy. Throughout the year, the “ceiling” of R$ 2.10/US$ might be “tested” by the market a few times more. Unless there are more abrupt changes in the international market, the exchange rate might rise above that level for some time and drop afterwards. Thus, CNI projects an average exchange rate of around R$ 2.06/US$ in 2013.

The baseline scenario for 2013 incorporates the positive impacts

foreign trade sector and exchange rate

and continuity of policies designed to boost the competitiveness of Brazilian industrial products; as a result, sales of industrial products abroad are likely to increase in both volume and price. However, the scenario abroad suggests that commodity exports will vary only slightly, as increases in volume will be offset by lower prices. In this case, exports would grow by 5.6% and hit the mark of US$ 258.3 billion.

Imports are likely to increase as a result of clear signs of a more intense economic activity than in 2012. Purchases of raw materials and fuels will grow once again year on year. In the wake of increased investment, purchases of capital goods will also increase.

At the same time, in a scenario of more effective government measures to boost competitiveness and investment in industry, the use of imported goods in production processes and the consumption of imported products will lose momentum. A higher exchange rate will prevent purchases of consumer goods beyond a certain level. All of these factors will play the role of partially restricting increases in imports, but will not prevent them from growing more than exports.

CNI projects a growth of 6.8%, which would lead imports to total US$ 240.2 billion. As a result, the trade surplus would amount to US$ 18.1 billion, with a larger share of manufactured products in total exports.

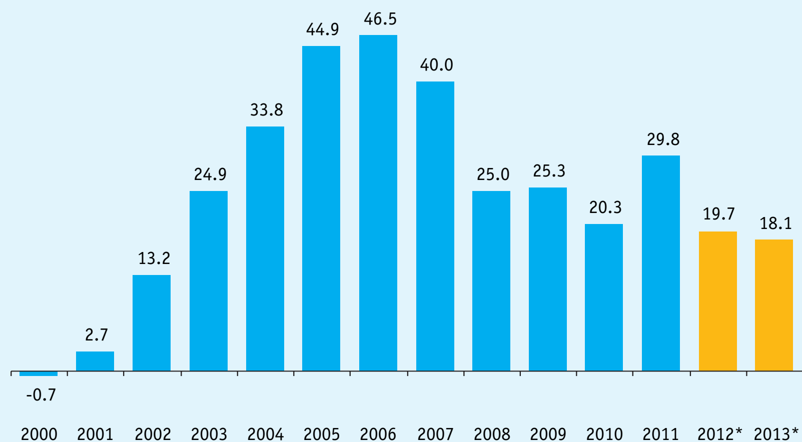
The current account deficit is expected to increase in value due to a lower trade surplus. Likewise, a more intense domestic activity will tend to further enhance the deficit in services. Also considering a foreign scenario in which developed economies continue to face difficulties to overcome the crisis, foreign investment will remain high enough to cover a growing deficit. We forecast a deficit of US$ 62.1 billion in 2013, equivalent to 2.60% of GDP.

If the measures to improve the industrial competitiveness of Brazilian products are less effective, exports of industrialized products, particularly of manufactured ones, would be lower and would grow only marginally as compared to 2012. On the other hand, while a lower economic activity would limit the growth of imports, the use of imported items in production processes and the penetration of imported products would remain high, leading imports to increase more than exports. Should this happen, the trade surplus would be lower, i.e. of about US$ 12 billion, more than 30% below our forecast in the baseline scenario.

Brazilian trade balance

US$ billion

Trade surplus in 2013 will be the lowest one in eleven years



* CNI Forecast
Source: Secex

BRAZILIAN ECONOMY OUTLOOK FOR 2012 - 2013

	2010	2011	2012 *estimate*	2013 *projection*
Economic activity				
GDP (annual variation)	7.5%	2.7%	**0.9%**	**4.0%**
Industrial GDP (annual variation)	10.4%	1.6%	**-0.6%**	**4.1%**
Household consumption (annual variation)	6.9%	4.1%	**3.1%**	**3.8%**
Gross fixed capital formation (annual variation)	21.3%	4.7%	**-4.5%**	**7.0%**
Unemployment rate (annual average - % of the labor force)	6.7%	6.0%	**5.5%**	**5.3%**
Inflation				
Inflation (IPCA - annual variation)	5.9%	6.5%	**5.5%**	**5.5%**
Interest rates				
Nominal interest rates				
(average rate in the year)	9.90%	11.76%	**8.63%**	**7.25%**
(end of year)	10.75%	11.00%	**7.25%**	**7.25%**
Real interest rate (average annual rate and defl: IPCA)	4.6%	4.8%	**3.1%**	**1.4%**
Public accounts				
Nominal public deficit (% of GDP)	2.55%	2.61%	**2.60%**	**2.20%**
Public primary surplus (% of GDP)	2.77%	3.11%	**2.20%**	**2.30%**
Net public debt (% of GDP)	40.2%	36.4%	**35.2%**	**33.9%**
Exchange rate				
Nominal exchange rate - R$/US$				
(average in December)	1.69	1.83	**2.06**	**2.07**
(average in the year)	1.76	1.67	**1.95**	**2.06**
Foreign trade sector				
Exports (US$ billion)	201.9	256.0	**244.6**	**258.3**
Imports (US$ billion)	181.6	226.2	**224.9**	**240.2**
Trade balance (US$ billion)	20.3	29.8	**19.7**	**18.1**
Current account balance (US$ billion)	-47.5	-52.9	**-54.0**	**-62.1**

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