CNI Newsletter
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ECONOMIC REPORT

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

Economic recovery under threat

Political uncertainties may prevent economic growth from being resumed

The Brazilian economy has been showing signs of recovery after a major two-year recession. This initially moderate shift was mainly brought about by agriculture/livestock and the foreign sector of the economy. Its multiplier effects on the remaining segments of the economy are likely to be felt soon.

Data for the first months of the year support this assessment. If the current scenario continues, CNI expects to see a slight increase in this year's GDP (of only 0.3%), but with a gradual consolidation of this recovery trend in the second half of the year. The labor market is likely to show a lagged reaction, as is usual in these processes, with employment recovering slowly.

This expectation is based on economic reasons. Adjustments made by households, especially in relation to excessive debt, show that consumers are already reasonably prepared to respond positively to the beginning of a new period of resumed economic growth.

The sharp fall in inflation observed since the end of last year – the 12-month rate dropped from 9.3% in May 2016 to 3.6% in the same month in 2017 – contributes decisively to this possible scenario. The process of disinflation has paved the way for sharper decreases in the Selic rate, also contributing to expand horizons.

The effects of falling inflation are widespread. It increases the real income of consumers, at least of the large proportion of the population that remains employed, and makes it possible for households to resume consumption gradually. Improved financial conditions resulting from the decrease in the Selic rate and lower default rates reinforce this trend.

Adjustments in inventory levels, which are close to those planned by enterprises, suggest that initial increases in demand will likely lead to a gradual increase in production. Investment will respond in a second moment, as the level of use of installed

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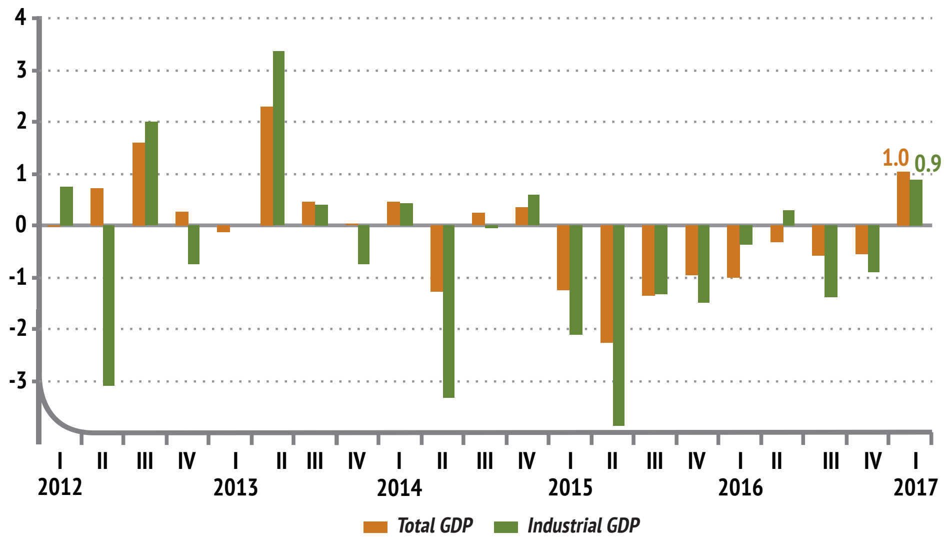
The Brazilian economy in the first quarter 2017

GDP resumes growth after decreasing for eight quarters in a row

Seasonally adjusted quarter-over-quarter variation
In %



Source: IBGE

capacity is still significantly below its maximum in industrial companies.

Factors that can undermine this virtuous process lie in the political realm, which can jeopardize the consolidation of the long-term adjustment in public accounts and hinder the reform agenda. Making progress on this agenda is key for consolidating a business-friendly environment and resulting stimulus for private investment with increased competitiveness for Brazilian products and greater productivity, the pillars of sustained growth.

The political turbulence gradually observed is already contaminating the economy. The confidence of agents (entrepreneur and consumers) was affected, halting the recovery trend, with possible impacts on their future decisions on consumption and investment. There are also signs that the Central Bank may slow down the pace of interest rate reductions due to this new scenario.

Minimizing the effects of that turbulence on the reform agenda is critical to keeping the economy on a growth path. The pace of labor reform can be a turning point. Its passage by the Senate shows that this agenda, albeit with some delay, continues to guide the country's strategy toward a more flexible economy and increased productivity.

Continuing to discuss the pension reform is critical. Achieving long-term fiscal balance crucially depends on the effective implementation of mechanisms to control public spending growth. The limitation imposed by the Constitutional Amendment Bill on a public spending ceiling is insufficient in itself because the State is not provided with effective mechanisms to reduce spending in relation to GDP. Reforming the social security system, which is the main factor generating the public deficit, is essential for this balance to be achieved.

Significant delays in promoting the reform agenda or even circumstances that could jeopardize it altogether will ultimately reduce the confidence of agents in the possibility that institutions will adjust themselves to competitiveness-related needs, with negative effects on potential long-term growth. If this actually happens, the forces currently pushing to reverse the economic downturn will not materialize, aborting the recovery cycle. Under these circumstances, the economy would remain stagnant.

CNI

ECONOMIC ACTIVITY

Positive early-year trend is yet to secure economic recovery

GDP to grow by only 0.3% in 2017

The 1.0% growth observed in the first quarter of 2017 broke an eight-quarter streak of declines in GDP. The following question is thus inevitable: is the Brazilian economy actually on a recovery path? The answer is not trivial, as signs are still timid and sometimes somewhat contradictory, both in comparisons between different months or indicators.

Monthly surveys, especially those related to trade and services, show a slight divergence from the National Account results, rendering it more difficult to make a prospective diagnosis of the Brazilian economy.

Another element that makes the economic outlook less clear is the political landscape, which is fraught with uncertainties. These deadlocks will likely not affect activity levels in the short term, but may somewhat hinder performance in the medium and long term.

The partial results for the year show that positive factors are in place for activity to get back on track, including a significant decline in inflation and interest rates, a slight upward trend in job creation, an increase in real average earnings, and an increase in lending to individuals. On the other hand, one can see a high idleness level in industry, low business and consumer confidence, high unemployment rates, and high household debt levels.

Furthermore, it is worth noting that some specific aspects observed early in the year will likely not be seen again over the next quarters, at least not with the same intensity, such as the pronounced increase in the agriculture and livestock sector and the effects of the methodological review of the Monthly Trade Survey (PMC/IBGE) and Monthly Service Survey (PMS/IBGE) series.

In this context, CNI expects GDP to grow by 0.3% in 2017. This is to say that this changing trend – end of downtrend and beginning of uptrend – is already taking place, but the return to a high growth path is yet to be consolidated.

INDUSTRY REACTS AND WILL RESUME GROWTH IN 2017

The supply-side analysis of GDP shows that the agriculture and livestock sector is the main responsible for the positive performance of Brazilian economy, as it posted growth of 13.4% in the first quarter of 2017 on a seasonally adjusted quarter-over-quarter basis. Climatic conditions have allowed for an increase in production yields, which is reflected in higher grain volumes.

In the January-May period, industrial production rose by 0.5% in 2017 as compared to the same period the year before. Specifically in manufacturing, however, production edged down by 0.3% on the same comparison basis. In addition, special mention should be made of the heterogeneous results among the manufacturing sectors: of the 25 sectors considered in the survey, 12 experienced an increase in production, while 13 recorded a decrease in this indicator during the same period (Monthly Industrial Survey - Physical Production - PIM-PF/IBGE).

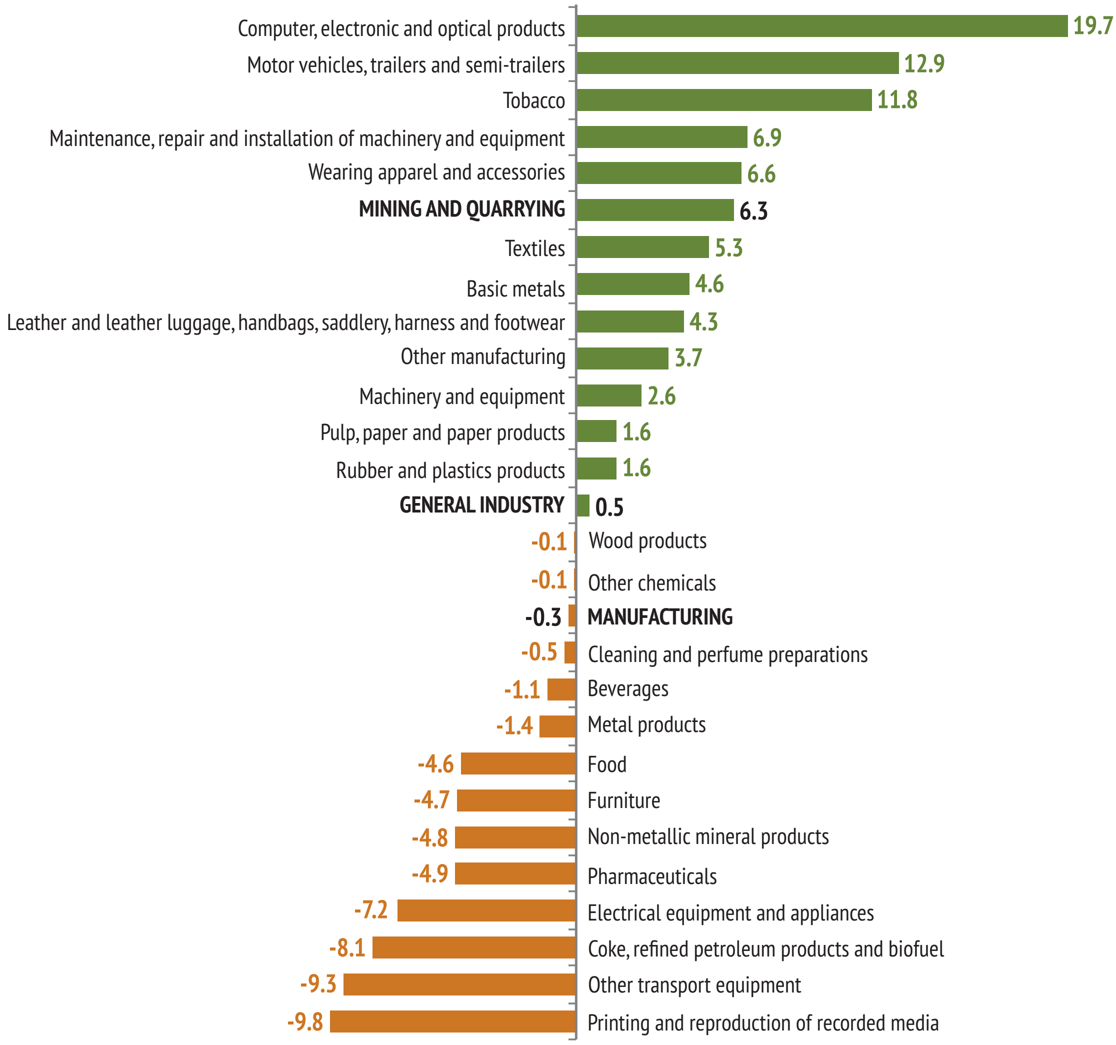
This decline in production in the manufacturing industry is accompanied by a 5.6% drop in real sales in the first five months of 2017 from the corresponding period last year (CNI Industrial Indicators).

On the other hand, the production of capital goods increased by 3.5% in the year to May (PIM-PF/IBGE), industrial inventories are adjusted to planned levels, and idleness timidly begins to decrease – although it remains at a high level (CNI Industrial Survey). These signs point to a slightly more favorable outlook for the manufacturing industry toward the end of the year.

The construction industry in turn remains on a negative trend. According to data from the Construction Industry Survey (CNI), construction companies have experienced successive decreases in activity levels and employee numbers, while operating capacity utilization remains at low

Mixed results among manufacturing sectors

Variation of industrial physical production - year to May 2017 as compared to the corresponding period of 2016
As a percentage



Source: IBGE

levels. In terms of expectations, the indicators are gradually reaching better levels, but are still negative.

This scenario is explained by the fact that the construction industry responds more slowly than the other industrial segments, as its activity is based on medium- and long-term projects and thus requires high confidence and high availability of resources both in its operations and procurement – requirements not currently met.

In the opposite direction, the mining and quarrying industry has performed very well this year. The sustained growth is driven mainly by the increase in production of metal ores and oil, boosted by higher international prices as compared to 2016. The results for the year to May 2017 show a 6.3% increase in the physical production in the mining quarrying industry (PIM-PF).

In this environment of mixed signals, the Business Confidence Index (ICEI/CNI) continues to fluctuate below its historical average (54.0 points), but well above 2016 levels. In June, the index hit the mark of 51.9 points. It is worth stressing that among the components making up the ICEI, the expectations indicators (54.9 points) are better evaluated than those of current conditions (46.0 points).

As confidence is yet to be fully regained, industrial entrepreneurs have been little inclined to invest, even though the Investment Intentions Index (CNI) has increased in 2017 to a level similar to that seen in early 2015 (46.5 points).

By taking stock of the industrial segments evaluated so far, we expect the industrial GDP to grow by 0.5% in 2017, marking the first positive annual result since 2013. The growth will be driven by an increase in mining and quarrying (8.0%), manufacturing (0.9%) and Public Utility Industrial Services - SIUP (1.9%). The construction industry in turn is expected to fall by 2.3% in 2017.

Despite the growth in industry, the services sector is expected to edge down by 0.4% this year, as it is still restricted by weak domestic demand. The results for the extended retail trade (which includes sales of vehicles and construction materials) provide a clear picture of this situation. Sales volumes from January to April this year were 1.8% lower than those recorded in the corresponding period of 2016 (PMC/IBGE).

The agriculture and livestock sector will likely be the fastest growing production sector in 2017 as a result of record grain harvests, particularly of soybeans and corn crops, which are harvested mainly in the first half of the year. We thus forecast a 9.0% increase in the sector. In other words, the agriculture and livestock sector will contribute almost 0.5 percentage points to GDP projected for this year. This is to say that without the extraordinary performance of the agriculture and livestock sector, GDP would decline by 0.1% in 2017 – given that even if this sector posted no growth, it would not affect the performance of other sectors.

Estimates for GDP and its components for 2017

Percentage change in GDP and its components

	GDP COMPONENTS	Percentage change (%)
Demand side	Household consumption	0.1
	Government consumption	1.0
	Gross fixed capital formation	-2.7
	Exports	7.0
	(-) Imports	3.0
Supply side	Agriculture/livestock	9.0
	Industry	0.5
	Mining and quarrying	8.0
	Manufacturing	0.9
	Construction	-2.3
	Public utility industrial services	1.9
	Services	-0.4
GDP		**0.3**

Prepared and estimated by: CNI

INVESTMENT RATE TO FALL TO BELOW 16%

On the demand side, investments (Gross Fixed Capital Formation - GFCF) are expected to fall again in 2017. The estimated 2.7% decline is associated with the contraction of the construction industry, which accounts for over half of the gross fixed capital formation in Brazil. As a result, the investment rate (GFCF as a percentage of GDP) is expected to fall from 16.4% in 2016 to 15.9% in 2017.

The decline in investment is also explained by an uncertain environment – brought about by the political turmoil and by difficulties to push major agendas in the National Congress – that undermines business confidence and hinders the implementation of public and private investment projects.

Household consumption is down by 0.1% in the first quarter of 2017. For 2017 as a whole, however, CNI forecasts growth of 0.1% in this indicator. The slight increase is attributed to the decline in both inflation and interest rates, a small reduction in the unemployment rate, and an increase in access to credit.

Despite the country's current fiscal situation, CNI projects a 1.0% increase in government consumption in 2017.

EXTERNAL COMPONENT TO CONTRIBUTE POSITIVELY

With the exchange rate hovering around US$ 3.30 per US dollar and commodity prices – particularly iron ore – standing above 2016 levels, exports will likely increase by 7.0% in 2017. This increase will be driven mainly by the results for the first half, with the second half of the year showing a slower pace of export growth.

Imports are also expected to rise in 2017 – particularly in the second half – but less so than exports. Albeit slow, the rebound in domestic activity has boosted imports of goods and services, particularly intermediate goods, which are mostly consumed by industry. We are thus projecting a 3.0% increase in imports this year.

Based on these projections, we estimate that the foreign trade sector will have a net contribution of 0.5 percentage points to GDP growth in 2017. Net domestic absorption in turn will contribute negatively by 0.2 percentage points.

EMPLOYMENT AND INCOME

Labor market shows first signs of rebound

First months of 2017 are marked by net job creation and higher real average earnings

The labor market showed the first signs of reaction after a long period of deterioration. The unemployment rate declined in the last two three-month periods; both real average earnings and total payroll edged up; and the General Registry of Employed Persons of the Ministry of Labor (CAGED/MTE) recorded the third positive net balance in the year.

However, activity needs to recover more strongly for the labor market to continue to deliver better results in a sustained fashion. This is because the indicators posted very negative results in the last years: double-digit unemployment rate, significant number of jobs lost, and decline in earnings and total payroll.

In addition, given that part of the labor force ended up being underutilized due to the decline in demand during the economic downturn, this production factor is still showing some level of idleness. Therefore, the existing labor force must first be used close to the limit before companies can begin to hire new staff more intensively.

ECONOMY RECORDS NET JOB CREATION ONCE AGAIN

Brazil created 49,800 jobs in May. This marked the second consecutive month, and the third time in the year, that more jobs were created than lost in the country.

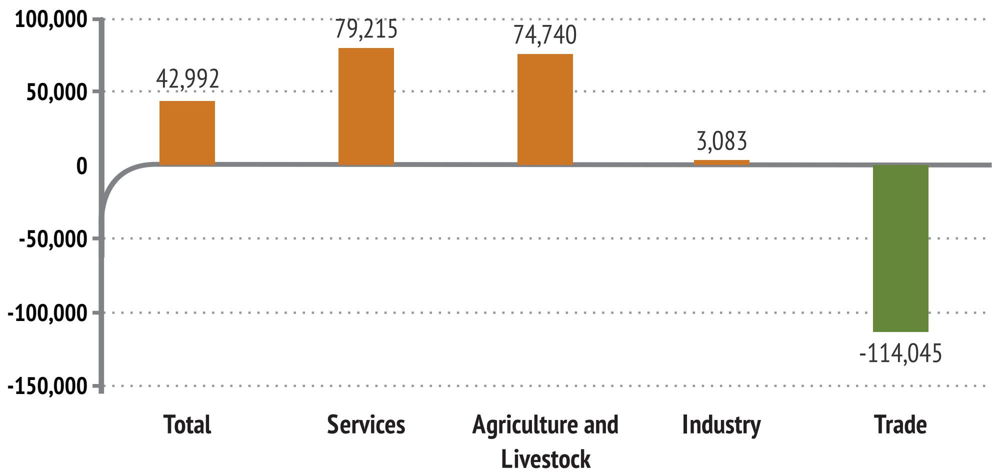
The result for the first five months was positive for almost all economic sectors – except for the trade sector, which posted a net loss of 114,000 jobs in the year.

The industrial sector recorded a net job growth, driven mainly by manufacturing (33,400 jobs added). The construction and mining and quarrying industries lost 31,200 and 1,400 jobs in the year respectively.

As a result, the net employment balance in the 12 months to May decreased by 52.7%, down from -1.74 million in 2016 to -825,000 in 2017.

Economy adds 43,000 net jobs in the year

Net balance of formal jobs by economic activity (in the January-May 2017 period)
In number of jobs



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

UNEMPLOYMENT RATE FALLS TO 13.3% OF LABOR FORCE

The unemployment rate fell from 13.6% of the labor force to 13.3% between April and May on a three-month basis. This marked the second consecutive decline in the indicator, resuming the downward trend that usually begins in the second quarter of each year – which had been interrupted by the economic crisis in 2014 – due to seasonal effects.

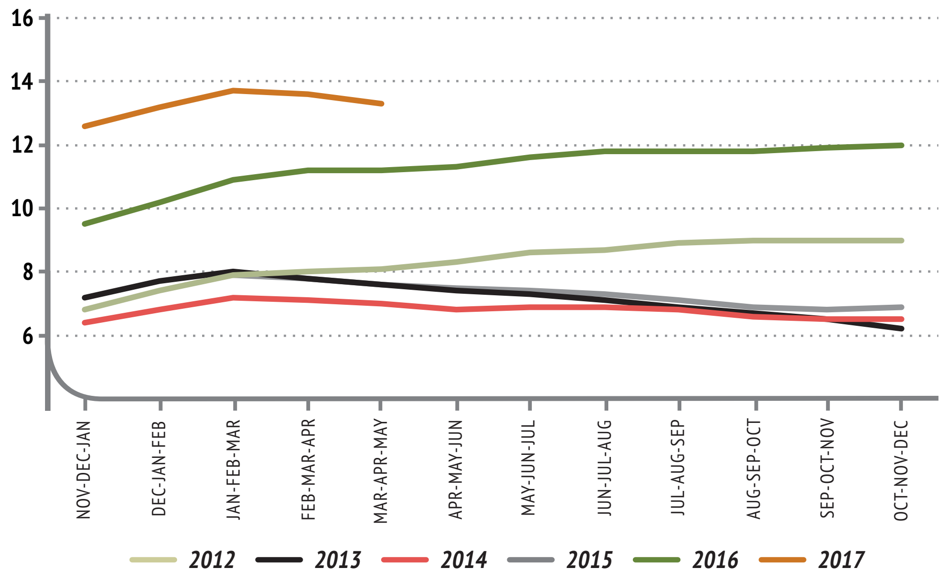
Despite this better result, unemployment – which affects more than 13.8 million Brazilians – is 2.1 percentage points higher than the figure observed in the same period in 2016, when it reached 11.2% of the labor force.

The change in the behavior of employment – i.e. creation of jobs – has been key to reversing the trajectory of the unemployment rate. The slowdown in the growth rate of the labor force has also contributed toward this trend: in the three-month period to May, the labor force grew by 1.1% from the same period the year before, compared to a 2.0% increase in 2016 on the same comparison basis.

Still, the unemployment rate remains at a high level and will likely close the year at 13.5%, up by 2.2 percentage points from the average for 2016, when it amounted to 11.3% of the labor force.

Unemployment rate falls again

Unemployment rate from 2012 to 2017 (quarterly moving average)
As a percentage of the labor force (%)



Source: Continuous PNAD survey/IBGE

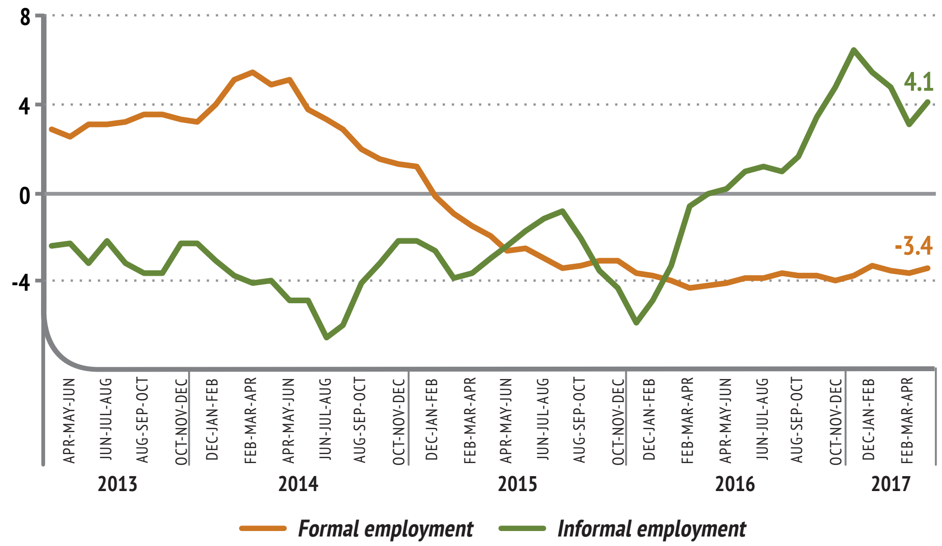
INFORMAL EMPLOYMENT GROWS STRONGLY IN 2017

Formal jobs have been shrinking since the beginning of 2015. In the three-month period to May, formal employment fell once again: down by 3.4% as compared to the corresponding period in 2016, representing the loss of 1.2 million jobs.

Informal employment, on the other hand, reversed its downward trend in mid-2016 and grew strongly in early 2017 in response to the labor market crisis. In the three-month period ended in May, the indicator edged up by 4.1% over the same quarter the year before.

Informal employment in the private sector increases

Formal and informal jobs in the private sector
Variation from the same three-month period in the previous year (%)



Source: Continuous PNAD survey/IBGE
**Excluding domestic workers*

LOWER INFLATION ALLOWS FOR BETTER WAGE NEGOTIATIONS

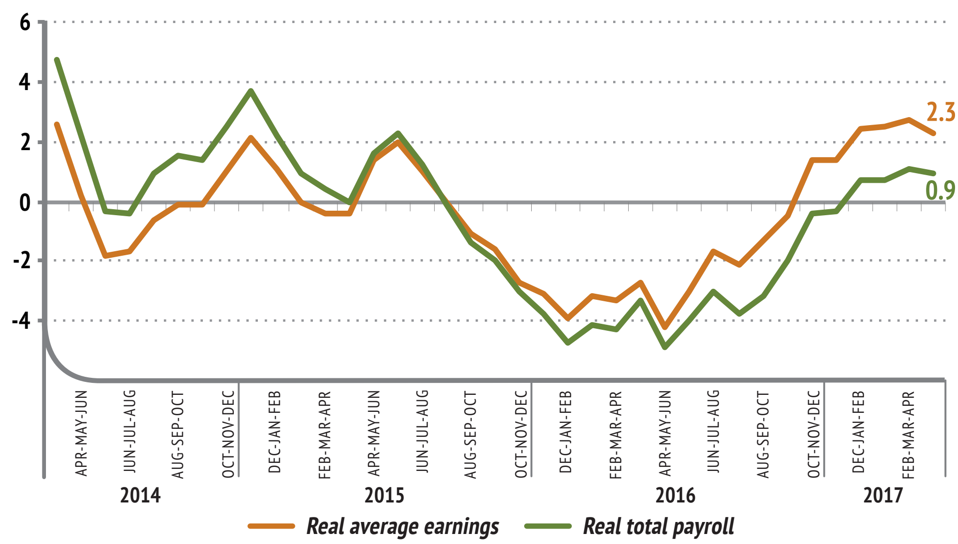
With inflation falling and economic activity giving its first signs of recovery, wages are once again being adjusted above the National Consumer Price Index (INPC) in 2017 after experiencing successive declines in 2016. As a result, real average earnings and total payroll increased again this year, which is expected to contribute toward the recovery of household consumption.

In the three-month period to May 2017, real earnings edged up by 2.3% compared to the corresponding period the year before. In 2016, earnings dropped by 2.7% on the same comparison basis.

The more significant increase in earnings had an impact on real total payroll, which rose by 0.9% in the three-month period to May. This marked the fourth increase in the indicator after a streak of 17 consecutive declines.

Real average earnings and real total payroll on the rise

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



Source: Continuous PNAD survey/IBGE

INFLATION, INTEREST RATES AND CREDIT

Disinflation process remains strong

Favorable scenario makes it possible to reduce the inflation target for 2019 and 2020

The slowdown in the inflation rate has surprised economic agents for its intensity. The National Extended Consumer Price Index (IPCA) posted a 3.6% variation in the 12 months to May, remaining below the target set by the National Monetary Council (CMN). Over the same period in 2016, inflation rose by 9.3%.

The unexpected performance of this indicator was mainly due a more favorable behavior of food prices, whose variations were well below the usual for the period, reflecting more favorable conditions of agricultural supply. Prices in this group decreased from 14.7% in the 12-month period to May 2016 to 1.1% over the same period in 2017.

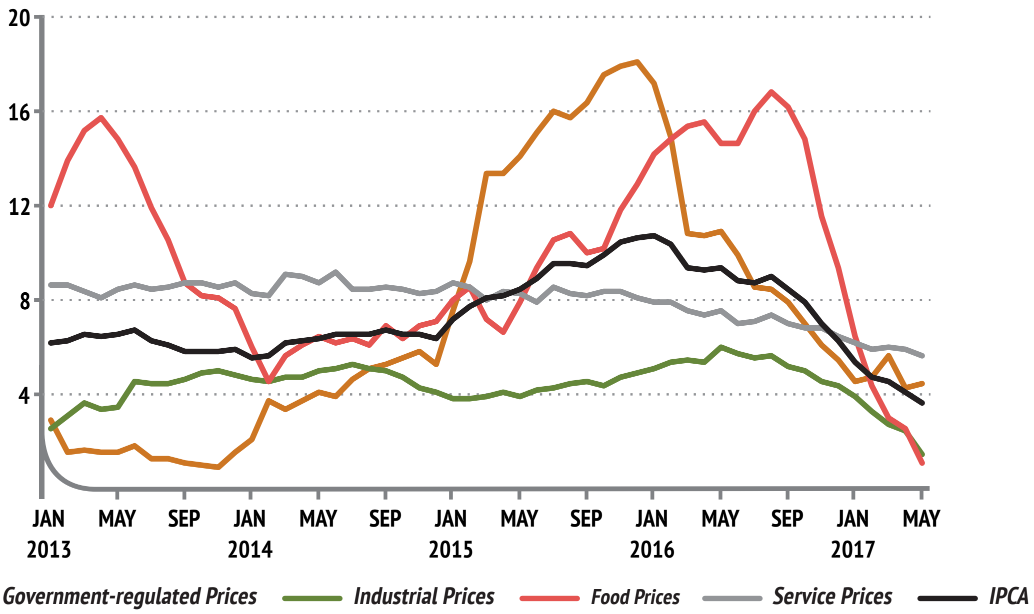
In addition, the strong economic recession and its impacts on demand have also influenced price formation and contributed to the widespread disinflation process observed in IPCA components. The diffusion index of Brazil's Central Bank, which measures the percentage of IPCA sub-items with a positive variation in a month, decreased from 63% in May 2016 to 52% in the same month in 2017. In recent periods of more persistent inflation, the diffusion index hit the mark of 78% at one point.

The disinflation process can be observed even in service prices, which are usually less responsive to monetary policy. The group of service prices, which usually has a strong inertia because it includes components indexed to the minimum wage and past inflation, recorded a significant slowdown. The 12-month rate dropped from 7.5% in May 2016 to 5.6% in May 2017.

For the remainder of the year, inflation will likely continue to show a favorable behavior. The IPCA index is expected to drop even further in the coming months as a result of the influence of seasonal factors related to the food group. For the last months of the year, a mild upturn in inflation is expected due to a reversal in the favorable impact of food prices on the total index. As a result,

Sharp downturn in the group of food prices

IPCA by groups - 12-month figures
In %



Source: IBGE
Prepared by: CNI

the IPCA index will likely close 2017 at 3.6% per year, 1.1 percentage points below the target set by the CMN.

RATE OF DECREASE IN THE SELIC RATE LIKELY TO SLOW DOWN

A slower growth pace of the IPCA index and successive downward revisions of inflation expectations made it possible for the pace of reductions in the Selic rate to be sped up in April. On that occasion, the basic interest rate was reduced by 1.0 p.p., to 11.25%.

However, the political turbulence and consequent increased uncertainties as to the approval of reforms led the Central Bank to adopt a more conservative stance at its June meeting. The Central Bank decided to keep the pace of interest rate reductions at 1.0 p.p. while signaling a less intense monetary easing for the next meeting in July.

The more cautious stance of the monetary authority takes into account the potential impact of increased uncertainties about the prospective inflation path. On the one hand, this high uncertainty can slow economic recovery down and have a disinflationary impact. On the other, it can pressure the exchange rate and push the structural interest rate up, driving inflation to a higher level.

For this reason, a gradual reduction in the Selic rate is expected pending a better assessment of the impact of increased uncertainties on price formation. As a result, the Selic rate is likely to close 2017 at 8.5% per year.

Redefining the Inflation Target

With the aim of reinforcing the commitment of the monetary authority to stabilizing the purchasing power of the Brazilian currency, the National Monetary Council reviewed the inflation target for 2019 and 2020.

The target, which today stands at 4.50% with a downward and upward tolerance of 1.50%, will be reduced to 4.25% in 2019 and to 4.00% in 2020, with the same tolerance interval in both years.

This change is important and signals a gradual convergence of the target toward international standards. Setting the target at lower levels contributes to controlling inflation more quickly and less costly, since it anchors expectations at lower levels.

However, for the desired results to be achieved it is above all necessary that the authorities remain committed to addressing the fiscal situation and to ensuring the transparency and credibility of the Central Bank. This is the only way for achieving the target without additional costs for the economy and society.

COST OF CREDIT DECREASES IN MAY

Successive decreases in the Selic rate have made it possible to reduce financing costs for companies and households, albeit modestly and far from ideal levels.

Interest rates on loans granted non-earmarked funds dropped for the third month in a row, from 53.4% in February to 46.8% in May. The drop was sharper for individuals, whose average financing costs decreased from 73.5% to 63.8% over the same period, while those borne by corporations rose from 28.7% to 25.9%.

Credit conditions, however, have been different for individuals and legal entities. Credit for individuals has already grown by 2.2% in real terms in the year to May as compared to the same period in 2016, while for legal entities it dropped by 14%.

The decrease in household indebtedness and increase in real income resulting from the sharp drop in inflation have made it possible for households to resume consumption gradually.

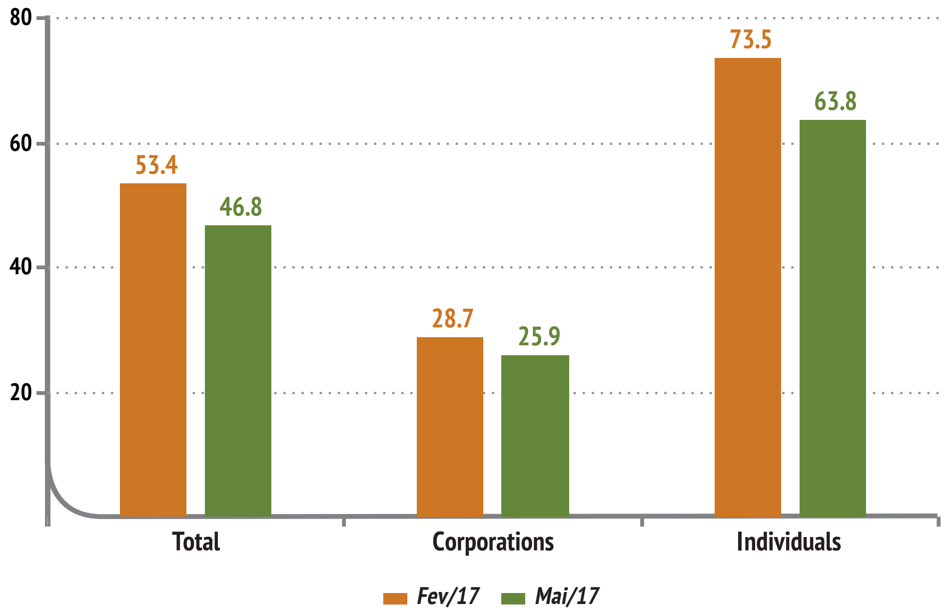
However, corporations are still highly indebted and with high idle capacity and this scenario has been inhibiting their demand for investment financing.

In addition, an increase in corporate defaults led banks to become more selective about granting credit.

A process of financial deleveraging of companies and households under way is expected to continue in the coming months. However, the pace of decline in balances is expected to be lower than the one recorded so far, incorporating the positive results of the expected further decreases in the Selic rate and the upturn, even if gradual, of the Brazilian economy.

Average cost of financing drops once again in May

Average interest rate on credit operations with non-earmarked resources
In % p.a.



Source: Central Bank of Brazil

FISCAL POLICY

Lower spending has not yet yielded better fiscal results

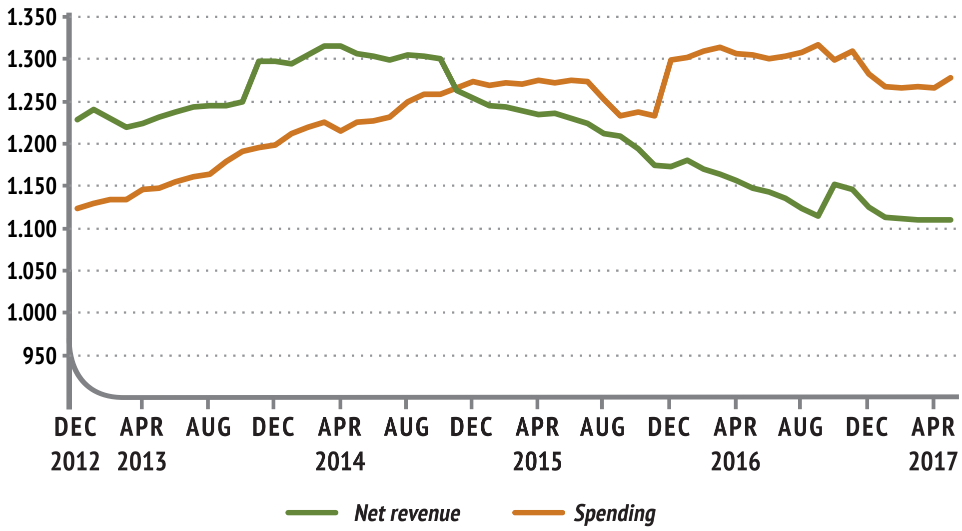
Reduced revenues at federal level make it difficult to improve public accounts

The first months of 2017 were marked by cuts in public sector spending both on the part of the federal administration and of state and municipal governments. Although the composition of the fiscal adjustment process - based on investment cuts - is not ideal from the point of view of economic growth in the medium and long term, this shift indicates an actual commitment to improving the fiscal situation. However, this improvement is not yet noticeable because revenues continue on a downward path, particularly at federal level.

This scenario of spending restrictions is likely to continue during the remainder of 2017, albeit not as intensely as in the first five months of the year. On the other hand, the performance of revenues will likely improve in the coming months reflecting on gradually less negative fiscal results. The expected increase in revenues and stability in spending are likely to lead to a reduction in the primary deficit - without interest - and in the nominal deficit - when interest is taken into account. Nevertheless, such results will still not be sufficient to prevent public sector debt from rising again.

Federal Government Net Revenue decreased by 15.7% in real terms between April 2014 and May 2017

Evolution of Federal Government spending and net revenue
12-month figures (R$ billion in May 2017)



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

INVESTMENT DECLINES BY NEARLY 50% IN THE FIRST FIVE MONTHS OF 2017

Primary spending of the Federal Government dropped by 1.1% in real terms (IPCA deflator) in the first five months of 2017 in relation to the same period the year before. This decrease would have been more pronounced were it not for a decision to move up the schedule of court-ordered debt payments to May, while in 2016 most of these payments were made in the last months of the year. As a result, court-ordered debt payments in the first five months of 2017 exceeded the amount paid over the same period in 2016 by R$9.5 billion. Without this effect, primary spending would have increased by 2.9% in real terms in the comparison between these two periods.

Despite the attempt at fiscal adjustment on the spending side, the composition of this adjustment is still far from ideal to promote economic growth in the medium and long term. This is because the cuts in spending are focused on non-compulsory spending, mainly on investments, while compulsory spending, such as with personnel and social security benefits, have been increasing significantly.

Spending with personnel is the one that increased the most in real terms among all the main components of Federal Government spending, as it increased by 11.8% from January to May 2017 in relation to the same period in 2016. This increase is explained by salary increases granted to federal civil servants in the second half of 2016 and in January 2017 and by the moving up of the schedule of court-ordered debt payments. However, even excluding the effect of court-ordered debt payments, spending with personnel expenses would have increased by 7.6% in the comparison between these two periods.

A real increase of 7.2% in social security spending also put a strong pressure on federal spending in the first five months of 2017 as compared to the same period in 2016. The higher social security spending is explained by an increase in the value of benefits and in the number of beneficiaries of the general social security system and by the moving up of court-ordered debt payments. However, even excluding the effect of those court-ordered debt payments, social security spending would still have increased by 5.1% in real terms in the comparison between these two periods.

Given the need to meet the primary deficit target, a higher spending with personnel and pensions must inevitably be offset by a reduction in non-compulsory expenditures. In this case, the decision was to reduce investment spending (excluding subsidies granted under the "My House, My Life" program), which decreased by 46.0% in real terms between January and May 2017 as compared to the same period in 2016.

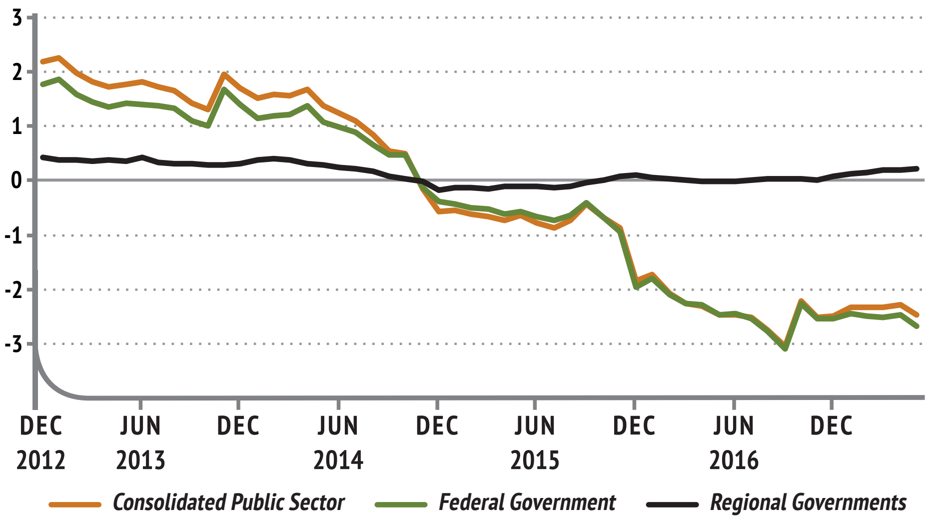
NET FEDERAL GOVERNMENT REVENUE STILL ON A DOWNWARD PATH

The net revenue of the Federal Government decreased by 3.3% in real terms between January and May 2017 in relation to the same months in 2016. While economic activity resumed growth in the first quarter of 2017, tax revenues have not responded significantly to this positive development due the weight of the foreign sector and of agriculture and livestock in this result, as these segments are subject to lower taxation.

Among the three main groups making up the Federal Government revenue, the least negative result was the one observed for revenues managed by Brazil's internal revenue service. This group recorded a real decrease of 0.6% in the first

No change in the twelve-month public sector primary deficit between December 2016 and May 2017

Primary result of the consolidated public sector and by levels of government
As a percentage of GDP



Source: Central Bank of Brazil
Prepared by: CNI

five months of 2017 in relation to the same period in 2016. This drop can be mainly explained by the negative effects of the economic slowdown in the domestic market on taxes levied on the production and sale of goods and services, such as on the IPI, PIS/Pasep and Cofins taxes and contributions.

On the other hand, revenues not managed by the internal revenue service, such as concessions, dividends, and financial compensation for mineral exploration had the worst result, as they recorded a real decrease of 6.2% in the first five months of 2017 as compared to the same period in 2016. This drop occurred because an R$11 billion financial input from the concession of hydroelectric power plants in 2016 was not repeated. Revenues with financial compensation for mineral exploration and dividends have in turn increased significantly in the first five months of the year.

Social security revenues posted a 2.5% decrease in real terms between January and May 2017 in relation to the same period in 2016. Albeit still negative, this result constitutes a positive development in relation to the 4.5% drop recorded in the first two months of 2017. This evolution is explained by the increase in total payroll resulting from nominal salary increases above the current inflation rate.

REGIONAL GOVERNMENTS: REVENUES ON THE RISE AND CONTROLLED SPENDING

Unlike the revenues of the Federal Government, those of regional governments are already on the rise in real terms. Monthly available data on the revenues of state and municipal governments shows that they increased by 2.2% in real terms between January and April 2017 as compared to the same period in 2016.

Revenues from the turnover tax (ICMS), the main source of revenue for regional governments, posted a real growth of 2.2% in the first four months of 2017 in relation to the same months in 2016. On the same comparison basis, transfers from the Federal Government and revenues from other taxes also increased, in real terms, by 7.3% and 0.4%, respectively.

Based on this information on the revenues and primary result of regional governments and their enterprises, CNI estimates that the spending of state and municipal governments decreased by 0.1% in real terms in the first four months of 2017 as compared to the same period in 2016.

NO IMPROVEMENTS IN FISCAL RESULTS SO FAR

Despite the containment of expenditures, as reflected in the real drop in the spending of the Federal Government and regional governments, the poor performance of the federal net revenue still prevented a significant improvement in fiscal results. Over the past 12 months to May, the public sector recorded a primary deficit of R$157.7 billion (2.47% of GDP). In late 2016, the primary deficit amounted to R$155.8 billion (2.49% of GDP).

However, it should be considered that the primary deficit would have decreased slightly if the schedule of court-ordered debt payments had not been moved up. Excluding the difference between payments made between January and May 2017 and over the same period in 2016, the primary deficit would have been one of R$148.2 billion (2.32% of GDP).

The relative stability of the primary deficit and the increase of 0.3 percentage points of GDP in nominal interest spending pushed the 12-month nominal deficit up from 8.98% in December 2016 to 9.22% of GDP in May 2017. As a result, and given the low nominal GDP growth, the Gross Debt-to-GDP ratio rose from 69.9% in December 2016 to 72.5% in May 2017.

REGIONAL GOVERNMENTS WILL LIKELY CONTRIBUTE TO ACHIEVING THE FISCAL TARGET IN 2017

The lifting of restrictions on non-compulsory expenditures in May and the poorer-than-expected performance of revenues affected the capacity of the Federal Government to achieve the fiscal target in 2017. On the other hand, regional governments will likely increase the primary surplus recorded in 2016 and exceed the fiscal target set for them for 2017. This combination is likely to make it possible for the consolidated public sector to achieve the fiscal target set for 2017.

As compared to the situation up to May, Federal Government spending will likely be pushed up, turning the observed real decrease of 1.1% into a slight increase of about 0.1%. Defrayal and capital costs will likely be the main source of this pressure on spending, as they are unlikely to continue to drop as strongly as recorded so far (16.0%). This group of expenses is expected to close 2017 with a real reduction of 10.4%, as spending with salary bonuses and subsidies begins to drop less intensely and spending with social security benefits begins to rise more sharply than observed until May.

The Federal Government's net revenue is in turn expected to shift from the real decrease of 3.3% recorded in the first five months of 2017 to a real increase of 1.0% from January to December. This reversal will likely be made possible by the better results expected for revenues not managed by the internal revenue service and social security revenues. In the case of unmanaged revenues, the increase in revenues from concessions largely explains the improvements recorded in their result. As for social security revenues, they are likely to increase in 2017 due to the expected increase in real total payroll.

In this scenario, CNI estimates that the Federal Government and its enterprises will close the year with a primary deficit of R$151.7 billion (2.27% of GDP as estimated by CNI). To achieve the R$142 billion target, the Federal Government will need to carry out additional financial programming and/or ensure revenues above the projected amount of R$9.7 billion. Non-projected revenues could be ensured through the passage of a bill allowing for redemption of court-ordered debt payments that were not withdrawn by their beneficiaries and/or through programs designed to settle tax and non-tax debts and regularize funds held abroad.

The expenditures of regional governments and their enterprises will likely increase to some extent after two consecutive years on the decline. Tax recovery agreements between the Federal Administration and some states may initially put some pressure on spending. This is because funds currently earmarked for debt payments to the Federal Administration will be released for covering primary expenditures.

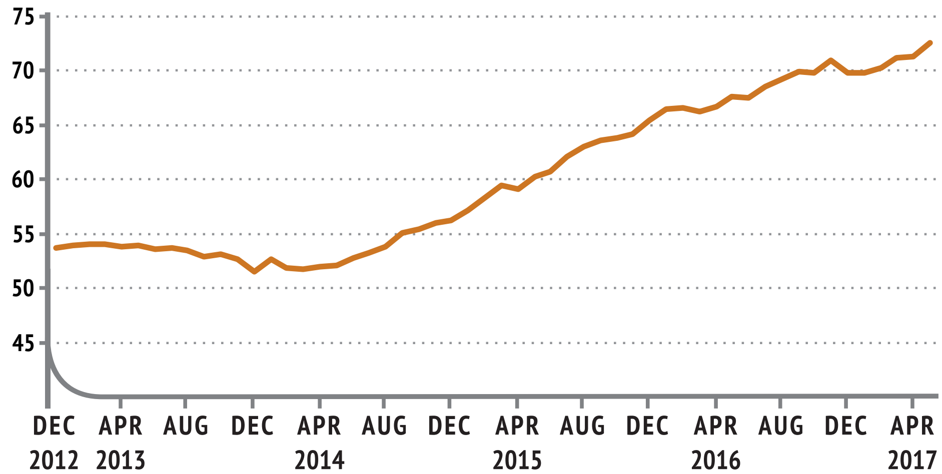
On the other hand, the behavior of revenues is not expected to change significantly, as revenues from the ICMS tax, which will rise as a result of improved economic activity, are likely to make up for the less favorable behavior of transfers received from the Federal Administration. The latter will not rely on the same volume of funds made available by the regularization of funds held abroad as in 2016. Regional governments will therefore likely record a primary surplus of about R$10 billion (0.15% of GDP as estimated by the CNI). As a result, the consolidated public sector is likely to record a primary deficit of R$141.7 billion (2.1% of GDP) in 2017 and achieve the R$143.1 billion target set for the year.

In such a scenario, the primary result in 2017 would be higher than the 2.49% of GDP deficit recorded in 2016. As nominal interest spending is likely to decline slightly as a proportion of GDP (6.7% of GDP in 2017), the nominal deficit is expected to drop from 9.2% of GDP in 2016 to 8.8% of GDP in 2017. The result will nevertheless not be sufficiently positive to stabilize the Gross Debt-to-GDP ratio, which is likely to rise to 74.3% in December 2017.

Gross Debt/GDP ratio increased by 2.7 percentage points between December 2016 and May 2017

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

As a percentage of GDP (%)



Source: Central Bank of Brazil

FOREIGN TRADE SECTOR

Comfortable current account position

Exports keep growing faster than imports

Data on balance of payments indicate lower vulnerability of external accounts, with the current account deficit declining steadily. This trend is explained by a significant increase in exports as a result of increased commodity prices and record-high harvests, as well as by a lower increase in imports.

We believe that the deficit will grow again toward the end of the year as domestic demand recovers gradually and commodity prices fall to lower levels, but it will still remain at comfortable levels. CNI predicts that the current account deficit will reach US$ 23 billion by the end of the year, amounting to only 1.1% of GDP projected for 2017.

The trade balance recorded a trade surplus of US$ 36.2 billion in the first half of the year. For 2017, CNI expects the trade balance to reach US$ 58.0 billion, with exports growing by 10.7% (US$ 205 billion) and imports rising by 6.9% (US$ 147 billion) as compared to 2016.

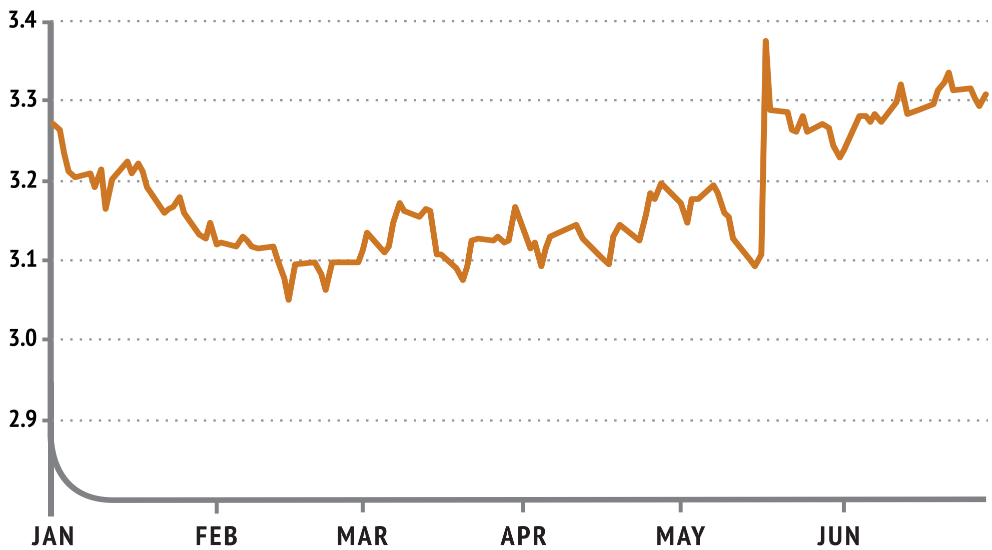
The beginning of the second quarter of 2017 was marked by relative exchange rate stability. Before the plea bargain signed by executives of the JBS group, the average exchange rate in Brazil in the quarter was R$ 3.14 per US dollar. However, on May 18, one day after the recordings were released, the real-US dollar exchange rate reached R$ 3.38 per US dollar, representing an increase of 8.6% over the previous day and marking the largest daily devaluation since January 1999.

After that, the exchange rate has appreciated moderately and stabilized at around R$ 3.25-3.30 per US dollar, basically as a result of favorable international conditions, as the domestic landscape is still marked by political instability and uncertainties about the progress of reforms. The average exchange rate stood at R$ 3.29 per US dollar in June, representing a depreciation of 4.7% as compared to the average in the year until the recordings were released.

In the international arena, the Federal Reserve raised its benchmark interest rate again by 0.25 percentage points to a range between 1% and 1.25%.

Uncertainties drive Brazilian currency down

Daily exchange rate (Ptax Closing Rate), in 2017*
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.*

In addition, the institution has indicated that it could make a further increase later this year. After the meeting, however, data for both inflation and GDP in the US fell short of market expectations, contributing to a further cautious increase in US interest rates.

As with the United States, other developed countries have been showing consistent economic growth with low interest rates. We therefore believe that the external environment will remain favorable for emerging countries like Brazil as a result of the high availability of resources.

Despite the favorable external scenario, political tensions in Brazil have cast doubts on the progress of reforms and fiscal adjustment, which could increase country risk and lead to the devaluation of the Brazilian currency. By taking stock of these factors, we expect the exchange rate to remain at current levels and reach about US$ 3.30 per US dollar in December 2017.

TRADE SURPLUS STILL ON THE RISE

Throughout the year, the Brazilian trade balance has posted record surpluses. In the January-June period, the accumulated trade balance amounted to US$ 36.2 billion, up from US$ 23.7 billion during the corresponding period in 2016. Exports totaled US$ 107.7 billion in the first half of the year, representing a 19.3% increase in average daily exports from the same period in 2016, while imports totaled US$ 71.5 billion and posted growth of 7.3% on the same comparison basis.

In the year to June 2017, exports edged up across all product classes as compared to the corresponding in 2016: basic goods (27.2%), semi-manufactured goods (17.5%) and manufactured goods (10.1%). Imports in turn recorded growth in fuels and lubricants (30.1%), intermediate goods (13.0%) and consumer goods (5.3%), while capital goods edged down by 27.6%.

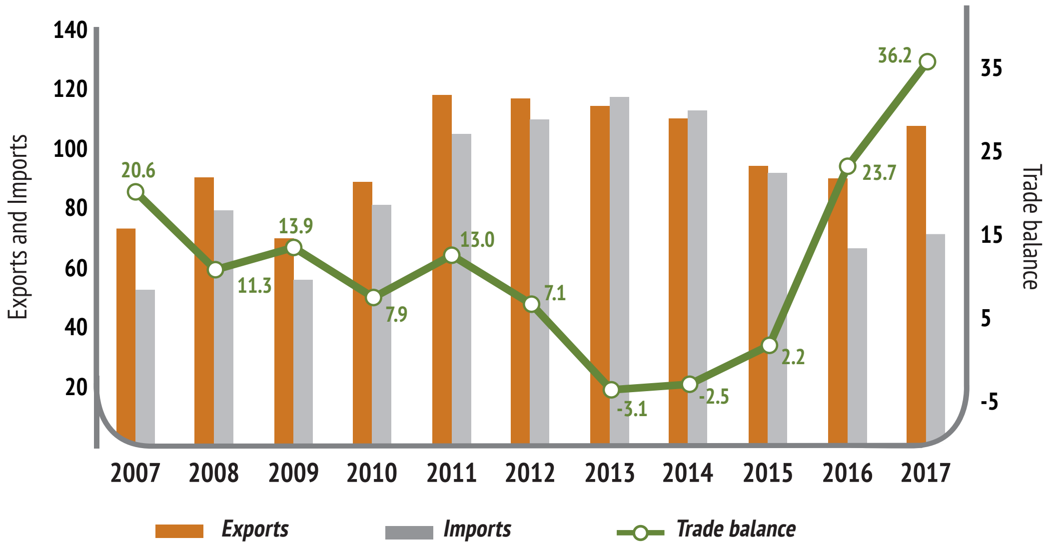
The increase in exports is explained mainly by prices, which grew by 19.7% in the year to May from the same period the year before, while the volume index posted growth of 0.1% on the same comparison basis, indicating little progress in new markets. Both indices are measured by FUNCEX.

Prices are up across all product classes: basic goods (29.8%), semi-manufactured goods (19.5%), and manufactured goods (7.9%). With respect to basic products, the increase in the price index is mainly attributed to two sectors: mining of metal ores and extraction of petroleum and natural gas, which grew respectively by 82.7% and 65.0% as compared to the first five months of 2016. However, the price indices are down from the levels observed in the first quarter of this year.

With regard to the quantum index of Brazilian exports, manufactured goods showed the best

Brazil shows good performance in the foreign trade sector in the first half of 2017

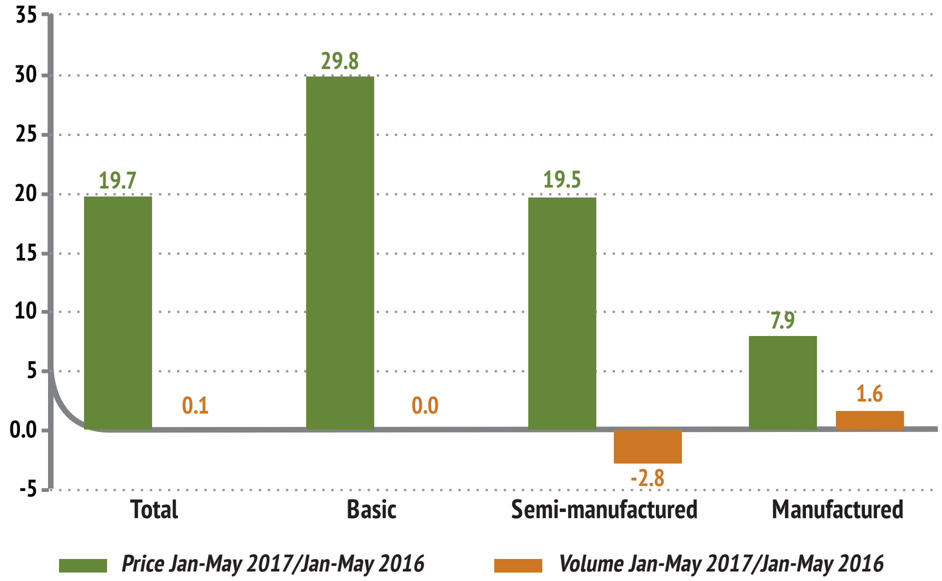
Exports, imports, and trade balance accumulated in the year to June 2017
In billion US$



Source: SECEX/MDIC
Prepared by: CNI

Higher prices push up exports

Change in prices and export volumes, by category of aggregated factor - average for January-May 2017/2016
As a percentage



Source: Funcex
Prepared by: CNI

performance, as they grew by 1.6% in the year to date as compared to the corresponding period in the previous year, with emphasis on shipments in the motor vehicle sector, which rose by 32.1% in the period. Meanwhile, basic products held steady and semi-manufactured goods declined by 2.8%.

With regard to the classification by large economic categories, a significant increase was observed in the volume of durable consumer goods (41.1%) and fuels (33.5%). Intermediate goods, non-durable goods and capital goods declined respectively by 2.8%, 4.9% and 9.2% in the year to May 2017 as compared to the same period the year before.

Imports in turn recorded an increase in both the price index (4.2%) and volume index (5.0%) in the year to May from the corresponding period of 2016. Nevertheless, the variation in prices, according to the classification by large economic categories, indicates that the increase is driven mainly by fuels (37.4%). Intermediate goods (1.6%) and durable consumer goods (0.9%) are also up, while capital goods and non-durable consumer goods fell respectively by 0.2% and 2.4%.

In the quantum index of imports, intermediate goods showed the best performance with a 13.1% growth, followed by non-durable consumer goods (5.3%) and durable goods (2.3%). Capital goods and fuels experienced a decline of 18.4% and 8.8%, respectively, in the year to May 2017 as compared to the corresponding period the year before.

Given that export prices have contributed strongly to the surpluses recorded in the trade balance so far, but have already begun to show signs of slowdown, we believe that exports will not continue to grow at the current rate in the second half of the year. In addition, we believe that imports will recover gradually as economic activity gets back on track. Therefore, according to CNI calculations, the trade balance will reach US$ 58.0 billion, with exports growing by 10.7% (US$ 205 billion) and imports rising by 6.9% (US$ 147 billion).

EXTERNAL ADJUSTMENT STILL IN PLACE

On a year-on-year basis, the current account deficit hit the mark of US$ 18.1 billion in May 2017. The figure is 38.6% lower than that registered in the same month last year (US$ 29.6 billion). The deficit has declined by 82.6% since December 2014, when it reached US$ 104.2 billion, the worst result in the series. At the same time, foreign direct investment in the country totaled US$ 80.7 billion, equivalent to 4.3% of GDP in 12 months, which is more than enough to cover the current account deficit.

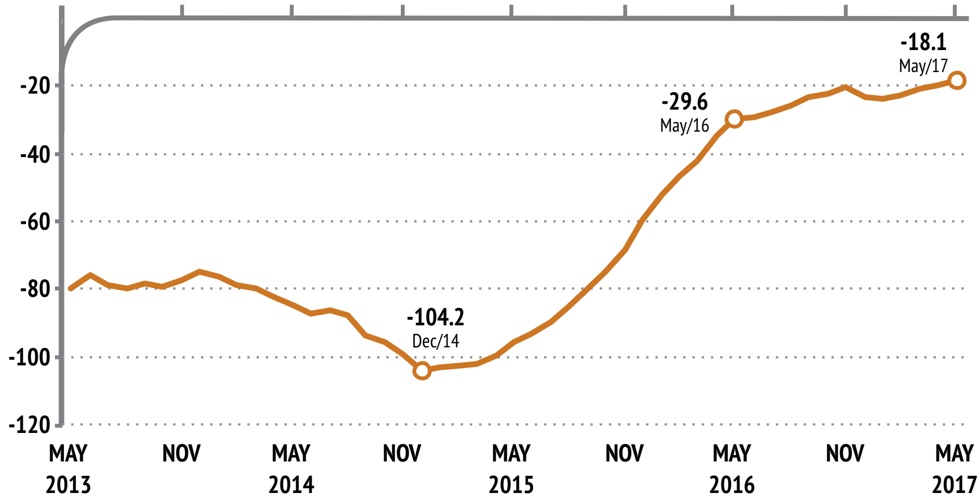
In the year to May, the current account deficit dropped significantly as compared to the same period in 2016, down from US$ 6.0 billion to US$ 600 million. This result is explained solely by a significant trade balance surplus, as there was an deficit increase in both the services and income accounts.

The trade surplus rose from US$ 18.6 billion to US$ 28.0 billion in the year to May as compared to the same period of 2016, while the service account deficit edged up from US$ 11.2 billion to US$ 12.4 billion and the income account deficit grew from US$ 13.4 billion to US$ 16.2 billion on the same comparison basis.

We expect the external accounts results to remain comfortable, contributing to maintaining some economic stability in spite of an unstable domestic environment. CNI predicts that the current account deficit will hit the mark of US$ 23 billion by the end of the year, amounting to only 1.1% of GDP for 2017 as projected by CNI.

Current account deficit falls

Current account balance in the year to May 2017
In billion US$



Source: Central Bank of Brazil

CNI

OUTLOOK FOR THE BRAZILIAN ECONOMY

	2015	2016	2017 previous forecast (Economic Report - Apr/17)	2017 current projection
ECONOMIC ACTIVITY				
GDP (annual change)	-3.8%	-3.6%	0.5%	**0.3%**
Industrial GDP (annual change)	-6.3%	-3.8%	1.3%	**0.5%**
Household consumption (annual change)	-3.9%	-4.2%	0.2%	**0.1%**
Gross fixed capital formation (annual change)	-13.9%	-10.2%	2.0%	**-2.7%**
Unemployment Rate (annual average - % of the labor force)	8.5%	11.5%	13.3%	**13.5%**
INFLATION				
Inflation (IPCA index - annual change)	10.7%	6.3%	4.2%	**3.6%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	13.58%	14.15%	10.35%	**10.45%**
(year's end)	14.25%	13.75%	8.50%	**8.50%**
Real interest rate (average annual rate and deflation: IPCA)	4.2%	5.0%	5.1%	**6.6%**
PUBLIC ACCOUNTS				
Nominal result (% of GDP)	-1.85%	-2.5%	-2.1%	**-2.1%**
Public sector primary result (% of GDP)	-10.2%	-9.2%	-8.2%	**-8.8%**
Net public debt (% of GDP)	65.5%	69.9%	73.5%	**74.3%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average in December)	3.87	3.35	3.25	**3.30**
(average in the year)	3.34	3.48	3.18	**3.24**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	191.1	185.2	195.0	**205.0**
Imports (US$ billion)	171.5	137.5	151.0	**147.0**
Trade balance (US$ billion)	19.7	47.7	44.0	**58.0**
Current account balance (US$ billion)	-59.4	-23.5	-26.0	**-23.0**

ECONOMIC REPORT | English version of "Informe Conjuntural Abril/Junho de 2017" | Quarterly publication of the National Confederation of Industry - CNI | www.cni.org.br | Policy and Strategy Unit - DIRPE | Management and Economic Policy Unit - PEC | Executive manager: Diego Rosa Mambrin, Fabio Bandeira Guerra, Flávia Junqueira Ferraz, Isabel Mendes de Faria Marques, Marcelo Souza Azevedo e Mário Sérgio Carraro Telles | CNI Publishing Center | Graphic design supervision: Alisson Costa | Customer Service - Phone: (61) 3317-9992 - email: sac@cni.org.br Document prepared on July 7, 2017.