CNI Newsletter
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ECONOMIC REPORT

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

Economy on hold pending the outcome of the electoral process

Fiscal adjustment is critical to pave the way for growth to be resumed

Economic recovery slowed down in the third quarter, despite a relative return to normalcy after the trucker drivers' strike in May. Uncertainties regarding the economic program to be adopted by the next federal administration, especially in relation to the indispensable fiscal adjustment, have stalled decisions on stepping up production, employment, and investment. As a result, CNI's forecast for GDP growth in 2018 fell to 1.3% from 2.6% at the beginning of the year.

In fact, the downturn in economic recovery could be felt even before the shutdown of road haulage services, despite a positive macroeconomic framework – marked by below-target inflation and basic interest rates at an all-time low. A weak response of the labor market, with a massive number of people still unable to find a job, and difficulties related to the cost and availability of financing prevented a more solid upturn in consumption despite this environment.

This situation was aggravated by economic uncertainties arising from the electoral process. Promoting fiscal adjustment to put public accounts on a track of fiscal responsibility is a must. However, discussions about raising taxation – including about ending certain tax exemptions – and the lack of a clear definition of the comprehensiveness and composition of this adjustment have increased uncertainties. The recipe for addressing the crisis is well known: rebalancing public accounts and creating a business environment that stimulates private investment, the engine of the future expansion cycle.

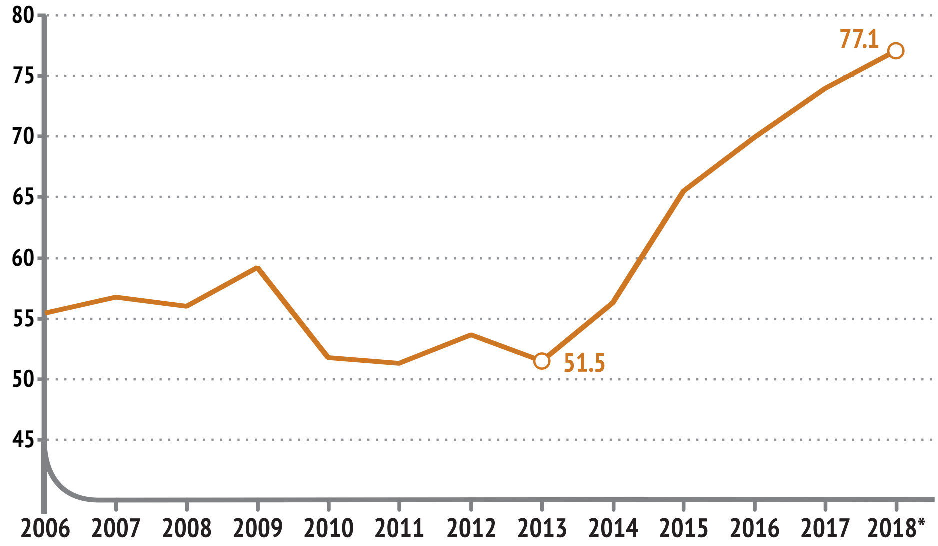
The State has no fiscal means to boost economic recovery as required. Only the return of private investment can stimulate the resumption of job creation

(continued on the next page)

The brazilian economy in the third quarter 2018

Adjusting public accounts is the main challenge to be faced by the next government

Public Sector Gross Debt
% of GDP



**2018 - CNI Estimate*
Source: Central Bank of Brazil (Bacen)

and promote income generation and consumption demand at the pace required to ensure a new cycle of sustained growth.

The path of fiscal activism, should voters opt for it, will result in destabilization and higher public indebtedness, as raising the tax burden is an unacceptable option for society. Therefore, adjusting spending is the only option left.

The October elections afford a unique opportunity for resuming growth paths that cannot be missed. However, this will not be an easy task, as the solution depends not only on the immediate results of the ballot box, but also on the concrete proposals of the new government. This means that an effective and credible adjustment effort must be made to restore the expectations and confidence of economic agents as a fundamental step toward resuming investment and, consequently, boosting economic recovery.

In addressing this challenge, it is important to keep in mind that there are no "shortcuts" or "creative solutions" to leverage demand through fiscal resources. Recent experience, and even that of a few decades ago, shows that a choice of this kind results in rapid reversal of ephemeral growth lacking solid foundations.

The misconception that public spending can grow without limits led primary spending to increase from 14.8 percent of GDP in 2000 to 19.5 percent in 2017. When spending outpaces revenues, fiscal balance, a fundamental pillar of long-term economic stability, is undermined by deficits. The year 2018 will be the fifth consecutive year of significant primary deficits that led to an increase of 25 percentage points in the public debt/GDP ratio. This scenario needs to be reversed.

A formal framework is in place to control spending: the cap imposed by Constitutional Amendment 95, known as the "spending cap." This cap is a mechanism designed to make it clear that the government is facing budget constraints and to make society aware of the need to make choices.

For the "cap" to be preserved, it needs solid pillars. These pillars are the basic reforms that discipline the growth of spending on personnel and of social security spending. Bills have been submitted to Congress to address these two issues. Progress in these discussions is therefore likely, leading to the passage of the Pension Reform and of bills dealing with the remuneration of public servants. Both are crucial for reducing the pace of expansion of primary spending.

It is a fact that the current environment of the world economy is less friendly than in the past, which imposes restrictions. This causes turbulence that can be particularly felt in the form of pressure on the exchange rate, leading to currency devaluation and great exchange rate volatility for emerging countries.

However, Brazil's situation in this regard is different. We have no external vulnerability and no liquidity crisis. Our current account deficit is low and our reserves are large and more than sufficient to ensure the flow of payments. What we are facing is a domestic crisis caused by fiscal disarray. The challenge before us is huge, but addressing it fundamentally depends on our own choices and is therefore within our reach.

Restoring confidence and credibility is critical for Brazil to get back on track and overcome the crisis. Obviously, fiscal adjustments do not materialize immediately and it takes a long time for its effects to be actually felt. However, structural adjustment measures in the right direction and with the appropriate intensity can ensure sufficient credibility to reverse expectations. In this case, their positive effects in terms of economic recovery can materialize within a shorter time horizon.

In short, if solid and credible adjustment mechanisms are adopted to eliminate the primary deficit within the term of office of the next president and to reverse the growth path of public debt, the economy may take an upturn as early as in 2019 at a rate close to 3%, leaving the recession and the crisis behind for good. This new environment of economic growth will make room for bolder actions to increase competitiveness – such as a reform on taxation on consumer spending and corporate income taxation – that will boost the pace of the new growth cycle. The alternative is that of economic stagnation as experienced now.

ECONOMIC ACTIVITY

Recovery jeopardized

Growth forecasts for industry in 2018 are revised downward once again

Four months after the truck drivers' strike at the end of May, it can be seen that the immediate decline in economy activity it caused was quickly reversed. However, its negative effects on the confidence of economic agents appear to be long-lasting, preventing a faster rate of economic recovery. Despite having increased in the aftermath of the strike, the confidence and expectations of entrepreneurs fell below the level of optimism recorded in the first quarter.

Second-quarter GDP data clearly revealed this slow pace of economic activity (of only 0.2% over the previous quarter), leading to a significant downward revision of the result recorded in the first quarter, from a 0.4% growth rate to one of only 0.1%.

In the domestic scenario, economic uncertainties stemming from political unpredictability have put the economy on hold. Consumer and business indebtedness remains high and decisions to expand production, employment, and investment are on hold, making it impossible for economic activity to recover more strongly and, in particular, for unemployment to decline more sharply (learn more in the section Employment and Income).

In the external scenario, there is also a second source of uncertainty for entrepreneurs. During most of the third quarter, the external market was turbulent, with the US dollar and oil prices on the rise, as well as increased risk aversion (learn more in the section Foreign Trade Sector). This scenario has shown some signs of stability in recent weeks, but a new round of turbulence cannot be ruled out yet.

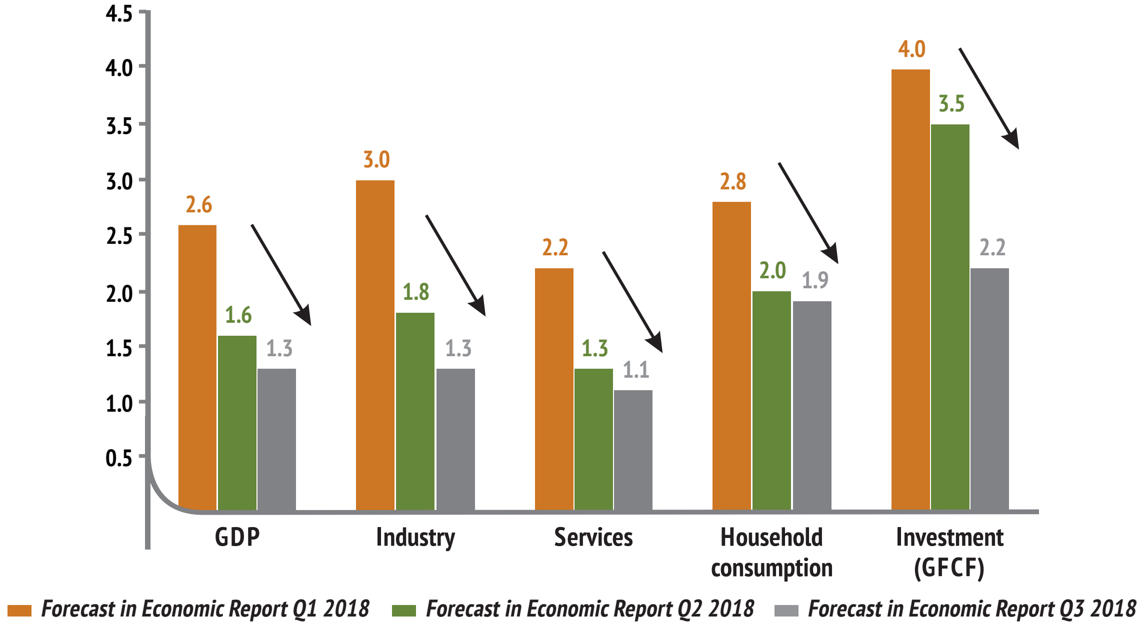
In this context, the pace of recovery in the second half of 2018 has been even slower, contradicting initial forecasts once again. As a result, we expect GDP to increase by only 1.3% in 2018, half the percentage projected by CNI early this year.

BUSINESS CONFIDENCE RECOVERS ONLY PARTIALLY

The Business Confidence Index (ICEI/CNI) stood at 52.8 points in November. Albeit above 50 points (indicating that entrepreneurs are confident), the index is 1.3 points below its historical average and 2.9 points below the one recorded in September 2017. After a sharp drop in June (-5.9 points), the index took an upturn in July and August (3.7 points over the two months), but it declined by 0.5 points in September.

Negative impact on economic activity

Forecasts for GDP and its components in 2018
In (%)



Estimated and prepared by: CNI

It should be noted that the Current Conditions Index – a component of the Business Confidence Index that reflects the entrepreneurs' assessment of current business conditions – began to fall below 50 points as of June, indicating a worsening in the current situation since then.

Consumer confidence has in turn improved in recent months. The National Consumer Confidence Index (INEC/CNI) rose by 7.7% in the third quarter. Still, consumer confidence remains relatively low, 1.7% below its historical average. In addition, the INEC index shows that consumer indebtedness remains high and that their financial situation continues to deteriorate. These factors have been holding back the recovery of demand, and consequently of the economy as a whole.

By the end of the year, the confidence of economic agents is likely to improve, especially that of consumers, which has shown signs of improvement, as they tend to place confidence in the beginning of a new government. As the economy continues to recover, confidence may rise to a sufficiently high level by the beginning of next year to boost consumption more strongly, even though the financial situation of families may limit this increase in consumption.

NO LASTING RECOVERY IN INDUSTRIAL ACTIVITY

Data provided by the report Industrial Indicators (CNI), which are already available for the third quarter, July and August, show that: use of installed capacity is still below that observed in April; hours worked in production have been oscillating with no defined trend; and that there is instability in the labor market – with stability in industrial employment only and falling incomes. Billing is the only variable showing a clearer recovery trend.

The Monthly Industrial Survey (PIM-PF/IBGE) points to a drop in production in the two-month period ended in August. In addition, the Industrial Survey (CNI) revealed a small undesired accumulation of inventories, a weak financial situation, and a decline in optimism on the part of entrepreneurs regarding the future of exports, production, and hiring.

The Construction Industry Survey (CNI) shows in turn that industry continues to face many difficulties in a scenario of declining economic activity and employment. Entrepreneurs operating in this sector are pessimistic.

GROWTH DECLINES IN LARGE ECONOMIC SECTORS

Without a clear recovery trend, industry continues to face difficulties pending the result of the elections. In this scenario, we have once again revised our industrial GDP forecast for 2018 downward. In the previous edition of this report, this forecast had been revised downward from 3% to 1.8%. We have now revised it to 1.3%.

The agricultural sector had already been severely affected by the truck drivers' strike and its consequences, such as by the setting of minimum freight prices. And due to the slower-than-expected recovery in household consumption and industrial production, agricultural GDP growth was revised downward from 1% to 0.5% in 2018.

The service sector has also been facing difficulties in the post-strike period. In the seasonally adjusted series (PMS/IBGE), the total volume of services decreased by 2.2% in July after declining in May (-3.4%) and increasing in the following month (4.8%). Thus, despite a recovery from the decline recorded in May, the total volume of services dropped to below the level observed in April (1% drop in this comparison).

Retail sales have been showing an even more unfavorable dynamic since May. Seasonally adjusted data from the Monthly Retail Trade Survey (PMC/IBGE) show that the volume of retail sales fell in July for the third month in a row (i.e. it has been falling since the strike in May), accumulating a drop of 2, 3%. Considering the expanded retail trade, which includes sales of vehicles and construction material, the result in June was positive (+2.5% in relation to May), but because the decline recorded in May was sharper (-5.1% in relation to the previous month), the accumulated decline between May and July hit the mark of 3.1%.

Some recovery in the service sector is expected over the next few months. However, the unfavorable result observed in the last few months requires a downward revision of the sector's growth. Therefore, CNI's forecast for service GDP growth in 2018 was revised downward from 1.3% to 1.1%.

CONSUMPTION AND INVESTMENT WILL ALSO GROW LESS

Consumption continues to grow slowly. Unemployment remains high and a significant part of its recent decline is due to an increase in informal employment, which contributes less to boosting consumption (learn more in the section Employment and Income).

Inflation will close the year closer to the target and forecasts for 2019 are becoming more optimistic. In particular, inflation in September 2018 was the highest in the month since 2015 (learn more in the section Inflation, Interest Rates and Credit). In addition, despite its more favorable dynamics, consumer confidence remains low. Even though expectations are more favorable, financial situation and indebtedness continue to be negatively assessed, with a stronger recovery of consumption. In this scenario, household consumption is likely to increase by 1.9% and not by 2.0% as indicated in the previous Report.

Our growth projection for Gross Fixed Capital Formation (GFCF) has also been revised downward. Both private and public investment are low. Several factors are leading entrepreneurs to postpone investments. Business confidence is still lower than before the truck drivers' strike; uncertainty remains high; use of installed capacity remains low; inventories are on the rise again; and the outlook for the construction industry is also pessimistic. The drop in the growth rate of GFCF can also be perceived in the Investment Intentions Index (Industrial Survey/CNI), which declined in six of the last seven months (between March and September 2018). As a result, we are projecting a 2.2% growth in GFCF.

Estimates for GDP and its components for 2018

Estimated percentage change

	GDP COMPONENTS	Percentage change (%)
Demand side	Household consumption	1.9
	Government consumption	0.0
	Gross fixed capital formation	2.2
	Exports	5.0
	(-) Imports	9.0
Supply side	Agriculture/livestock	0.5
	Industry	1.3
	Mining and quarrying	0.5
	Manufacturing	2.1
	Construction	-0.5
	Public utility industrial services	1.5
	Services	1.1
GDP		1.3

Projected by: CNI

Imports remain high, despite a devalued Brazilian currency. A change in the REPETRO regime is one of the factors that explain this phenomenon, as it has been generating significant accounting flows of "imports" of oil rigs. However, the recovery, albeit slow, of economic activity after years of decline has also been stimulating purchases.

The pace of exports, despite a more favorable exchange rate, is being restricted by a contraction in the sale of automobiles to Argentina. In addition, despite the recent lull, the external environment is challenging and uncertain, as trade disputes between the United States and China escalate and the US central bank's (FED) contractionary monetary policy push interest rates up.

CNI's projects that imports of goods and services will increase by 9%, while exports of goods and services will rise by 5% (both according to IBGE's National Accounts concept) by the end of the year. Thus, the external contribution to GDP will be negative by 0.4% in 2018, after positive contributions for three years in a row.

EMPLOYMENT AND INCOME

Gradual adjustment in the labor market

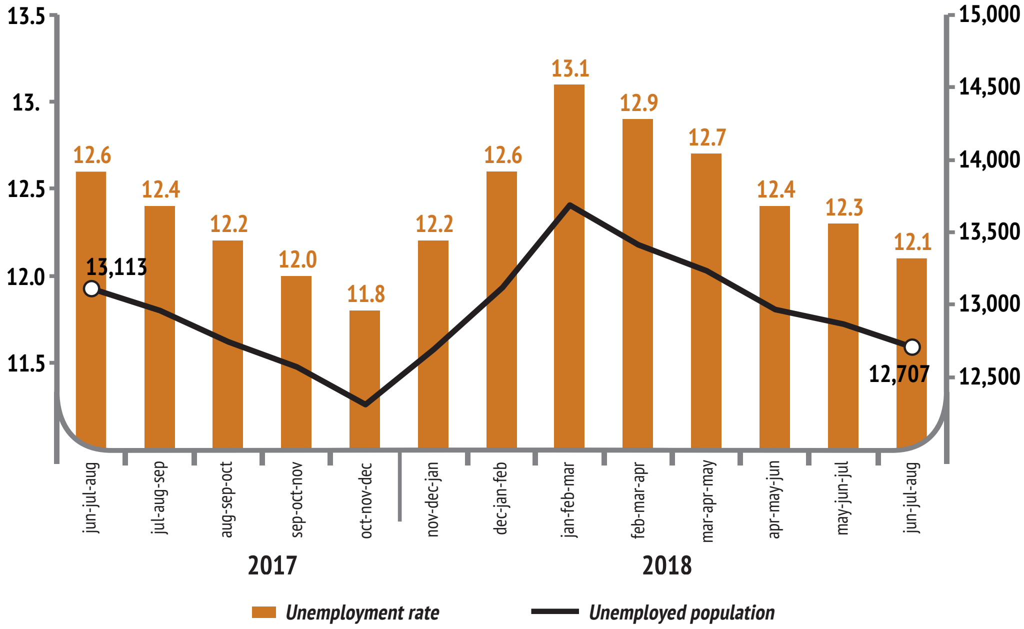
Low growth compromises more significant improvements in employment rates

In 2018, labor market indicators have been showing a moderate and gradual reaction. The unemployment rate, as published in the National Continuous Household Sampling Survey (Continuous PNAD/IBGE), accumulated a decrease of 1 percentage point (p.p.) from the January-March to the June-August moving quarters, very close to that observed in the same period in 2017 (1.1 p.p.).

Real average income showed more modest growth than seen in 2017 in the interannual comparison of the moving quarters. On the other hand, total payroll

Unemployment rate declines, but there are still 12.7 million people out of work

Unemployment rate (in percentage of the labor force) and Unemployed population (in thousand people)



Source: Monthly Continuous Pnad/IBGE

has been increasing more strongly as a result of the improved employment scenario in the year.

It should be noted, however, that a stronger recovery was expected in 2018, especially in formal employment. The labor law modernization process in 2017 was a major step in this direction, as it made possible to hire workers under more flexible rules, bringing labor relations more in line with the current economy and favoring job formalization.

However, despite this breakthrough, the environment required to ensure more robust improvements in employment rates failed to thrive. The low growth rate of economic activity and especially the lack of incentive for investment – a fundamental variable for creating new jobs – ended up playing a major role in undermining the dynamics of employment.

On the public sector side, this dynamics was affected by fiscal constraints. On the private sector side, it was affected to by the idle capacity of production factors, by low confidence on the part of enterprises, and by a still high cost of capital.

As a result, the average unemployment rate in 2018 is still high and will likely remain at 12.2% of the workforce, representing almost 13 million people without jobs.

UNEMPLOYMENT RATE DECLINES BUT IS STILL HIG

According to data from the Continuous Pnad Survey/ IBGE, the unemployment rate declined once again in the moving quarter ended in August, hitting the mark of 12.1% of the workforce. This was the fifth consecutive drop in the indicator in the year. As a result, the rate is 0.5 p.p. lower than in the same period in 2017, as a result of an increase of 1.1% in the employed population and of 0.6% in the labor force.

In the moving quarter ended in July, the unemployment rate fell by 0.2 p.p. However, in the seasonally adjusted series – prepared by CNI – the rate showed stability, remaining at 12.1% between the moving quarters ended in July and August.

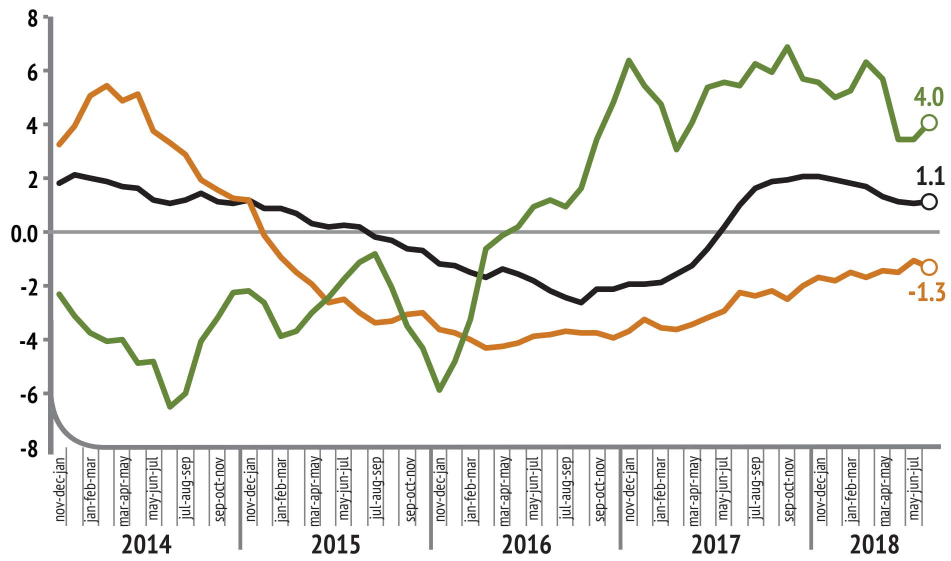
The slowdown in the unemployment rate – albeit small – is an important trend indicator, but attention must be paid to the behavior of its components.

The rate has fallen due to a growth in informal work, which usually offers lower paid employment and fewer guarantees. While employment in the private sector without a formal contract (excluding domestic workers) increased by 4.0% in the quarter ended in August compared to the same period in 2017, formal jobs in the private sector fell by 1.3% on the same basis of comparison.

Informal work continues to support improvements in the unemployment rate

Total employed workers, Employed workers in the private sector with a formal contract and Employed workers in the private sector without a formal contract

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



Source: Monthly Continuous Pnad/IBGE

Among domestic workers, 70.6% do not have a formal contract, representing 4.5 million workers, and among self-employed workers 80.5% do not have the CNPJ (income tax registration number for individuals), representing 23.3 million peopl.

The drop in the unemployment rate was also caused by an increase in the number of people who gave up looking for work, the so-called "discouraged unemployed workers": these workers totaled 4.8 million people in the quarter ended in July (Quarterly Continuous Pnad/IBGE), a record in the historic series initiated in 2012.

Taking into account the number of unemployed workers, the potential workforce – which includes discouraged unemployed workers – and underemployed workers due to insufficient hours worked, the number of underutilized workers in the economy rises to almost 30 million people.

This deterioration in employment has negative effects on the recovery of economic activity, as it weakens household consumption, which accounts for 63% of GDP.

CNI estimates that the average unemployment rate in 2018 will amount to 12.2% of the workforce, 0.5 p.p. below the level recorded in 2017, when the indicator reached 12.7%.

FORMAL EMPLOYMENT, AS MEASURED BY CAGED, MAY RECOVER IN 2018

The Ministry of Labor (MTE) recorded a net creation of 110,400 formal jobs in August, more than double the figure recorded in the same period in 2017 (49,400 jobs). In the two previous years, 2015 and 2016, the country had experienced a net loss of jobs in August.

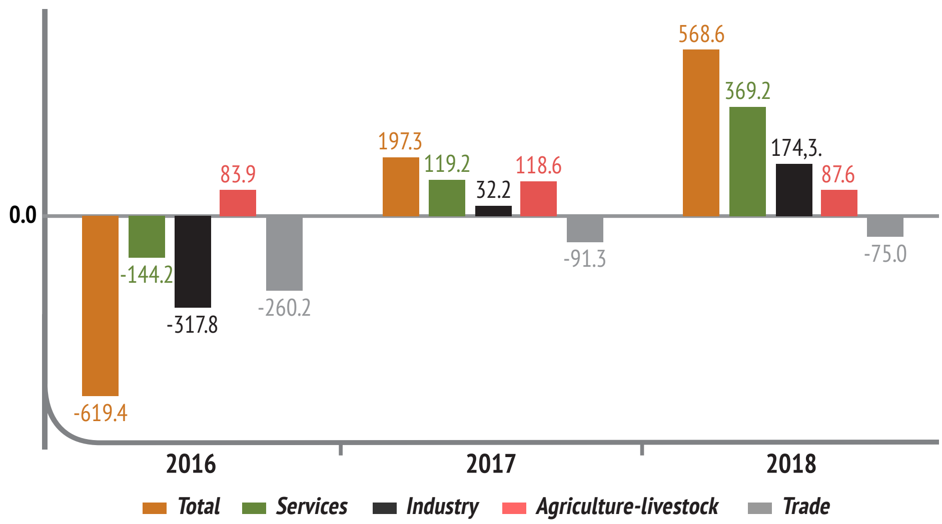
From January to August, the net balance of formal jobs hit the mark of 568,500. Net job creation was recorded in almost all sectors of the economy in the year. The only exception was that of the Retail trade sector, which lost 75,000 jobs over that period.

In 12 months, net job creation amounted to 357,000 positions and the Service sector stood out in this regard, as 290,000 new jobs were created in it over the period.

Brazil will likely be able to halt a three-year net decline in formal employment in 2018, when more than 3.5 million formal jobs were lost in the economy.

Formal employment likely to recover in 2018 after three years on the decline

*Net balance of formal jobs - in the year to August**
In thousands



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

DESPITE INCREASED TOTAL PAYROLL, FEAR OF UNEMPLOYMENT KEEPS CONSUMPTION DOWN

The increase in the number of employed persons in the economy in 2018 led to a more robust increase in real total payroll in the interannual comparison, as it increased by 7.2 billion – from 192.6 billion to 199.8 billion in the moving quarter to August, according to data of the Continuous Pnad/IBGE. This growth represented a variation of 2.6% in the indicator.

This growth resulted from the creation of 1 million jobs and from a 1.3% increase in the average real income usually received by workers on the same basis of comparison.

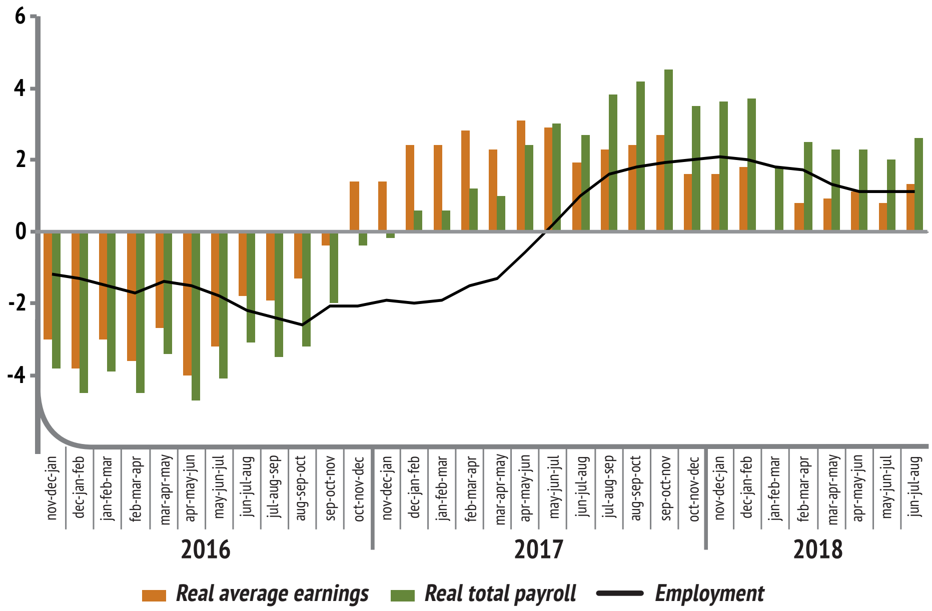
The increase in total payroll and the potential growth of the credit market – as a result of a reduction in the Selic rate – should have contributed to a more significant growth of household consumption this year and, consequently, to economic activity.

However, the high number of unemployed people, fear of unemployment , and still high financing costs due to the high banking spread in Brazil are repressing this effect. As a result, household consumption growth estimates were revised downward over the year and will likely close 2018 at 1.9% (learn more in the Economic Activity section).

CNI expects real total payroll to grow by 2.2% in 2018, 0.2 p.p. less than in 2017, when a 2.4% growth rate was recorded.

Real total payroll on the rise in 2018

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



Source: Monthly Continuous Pnad/IBGE

[1] The Fear of Unemployment Index (IMD/CNI) reached 65.7 points in September 2018. The index is at a high level, 16 points above the historical average of 49.7 points. The IMD index is a diffusion indicator ranging from 0 to 100. Values above 50 points indicate that individuals are very afraid of losing their job.

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Inflation rising at a faster pace than expected

Fuels push Broad Consumer Price Index (IPCA) up

The Extended National Consumer Price Index (IPCA/IBGE), which closed 2017 at the lowest level since 1998 (2.97%), took an upturn in 2018. Still, the inflation rate is likely to close the year below the 4.5% target set by the National Monetary Council (CMN) for the year.

In September, the IPCA recorded an increase of 0.51% – in the seasonally adjusted series – against a negative variation of 0.03% in August. This result was mainly driven by an increase in the group of government-regulated prices due to upward adjustments in fuel prices. Services and Food products also contributed to this rise in prices, given the increases in airfares and the influence of the US dollar on commodities.

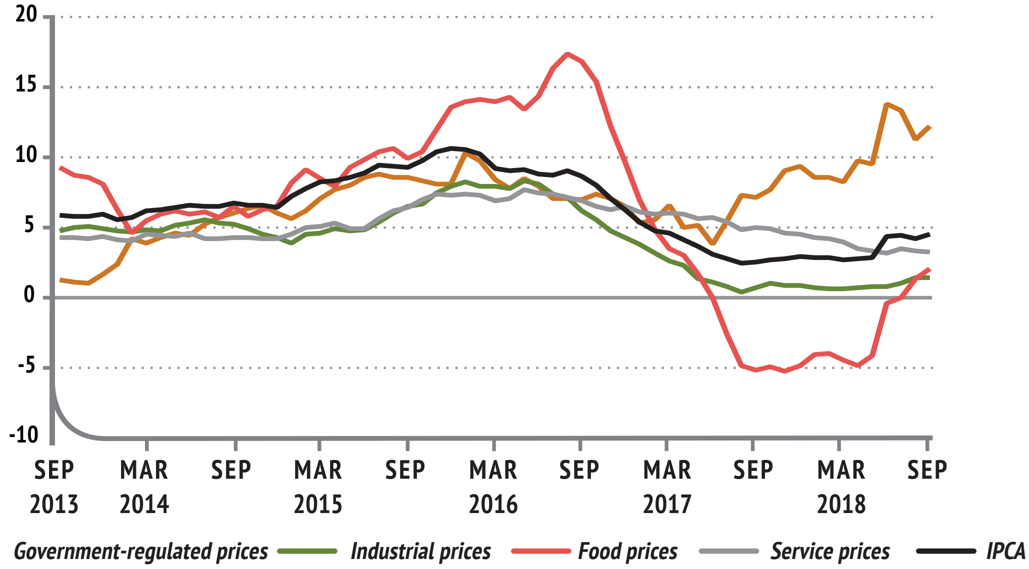
Except for the Wearing Apparel and Communication subgroups, all the remaining groups experienced a positive change in price levels from August to September. As a result, the diffusion index calculated by Central Bank of Brazil (BACEN), which measures the percentage of IPCA items with a positive variation in the month, rose from 51.7% in August to 62.1% in September, reflecting the most widespread rise in prices in the month.

Due to the faster rise in the IPCA index in June and September, which is atypical for these months, inflation increased by 4.53% in 12 months and as result it rose above the target center for the first time in the year.

Government-regulated prices continue to show the sharpest variations in the year in relation to 2017. In September, these prices had increased by 12.2% in 12 months, against 7.1% over the same period the year before. The main factors leading to this increase were the following ones: electricity – since June, the red-flag rate for electricity has been in force at level 2, which imposes an additional charge of R$0.05 per kwh consumed – and fuels, whose prices rose more strongly in September: gasoline (3.94%), ethanol (5.42%), and diesel oil (6.91%). It is worth remembering that the price of diesel oil was adjusted upward by 13% in late August.

Inflation is likely to close 2018 close to the target center

Seasonally adjusted IPCA by group – 12-month rate
As a percentage (%)



Source: IBGE
Prepared by: CNI

Food prices, which had been on a somewhat stable trajectory – with slight positive variations or even declines – rose very sharply in June in the aftermath of the truck drivers' strike. Even though most prices of items included in this group remained somewhat stable in subsequent months, they ended up rising by 2.1% in the 12-month period to September against 5.2% in 2017 on the same comparison basis.

Service prices have slowed down in 2018. Comparing the 12-month period to September 2017 to that to September 2018, the increase rate declined from 5.0% to 3.2%. The characteristic inertia of service prices resulting from their indexation to past inflation and the minimum wage partly explains their behavior.

Finally, industrial product prices are the ones that exert less pressure on the general price index, although they increased more sharply in 2018 in relation to 2017. Prices in this group rose by 1.4% in September, double the variation recorded over the same period last year (0.7%).

In the coming months, inflation is likely to return to a positive trajectory. As a result, the IPCA index will likely cool down and close 2018 at 4.38%, 0.12 percentage points (p.p.) below the target set by the National Monetary Council (CMN) for this year.

SELIC RELIC LIKELY TO REMAIN UNCHANGED UNTIL THE END OF 2018

The basic interest rate, the Selic rate, started the year at 7.0% and, after being reduced by 0.25 p.p. for two consecutive months, it hit the mark of 6.5% in March. At its last meeting on September 19, the Monetary Policy Committee (Copom) of Brazil's Central Bank (Bacen) kept the basic rate at 6.5% for the fourth time in a row. The rate will likely close the year at this level.

Some factors have contributed to this decision. First, economic indicators point to a continued, albeit slow recovery process after the impact of the slowdown caused by the truck drivers' strike late in May (learn more in the section Economic Activity).

Second, despite a more challenging international scenario for emerging countries and its effects on the exchange rate – marked by devaluation and greater volatility – the Brazilian economy is experiencing a more favorable situation due to the robustness of its balance of payments.

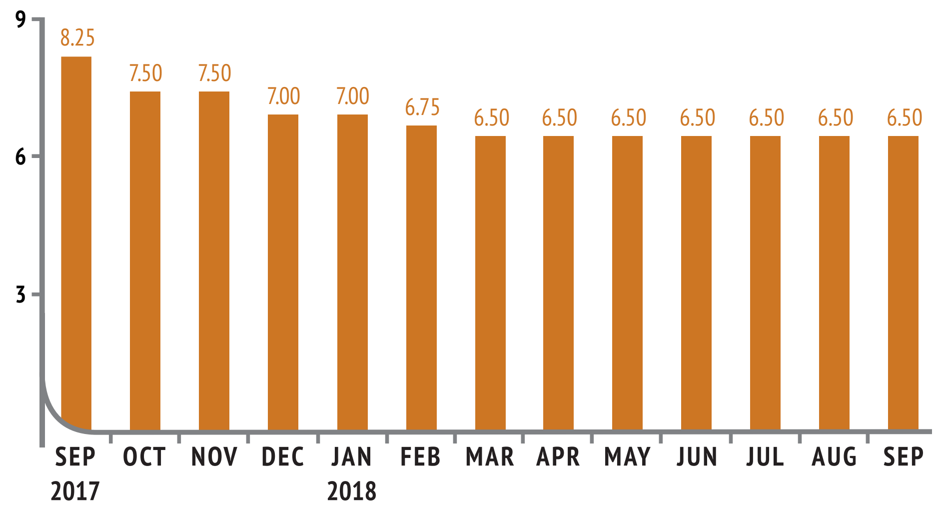
In addition, the exchange rate swings being experienced now are also associated with uncertainties about the presidential election, but in principle they do not constitute threats to the dynamics of inflation.

The Selic rate is therefore likely to close the year at 6.5%, even though an additional drop would be relevant to stimulate consumption and investment and, consequently, a more robust recovery in economic activity.

It should also be noted that, in the medium term, monetary policy will be determined not only by economic activity and price developments, but also

Monetary policy will remain unchanged until the end of the year

Basic interest rate - target set by Copom for the Selic rate
(%) per year



Source: Central Bank of Brazil

by whether necessary reforms – particularly the Pension Reform – are actually carried out and by the trajectory of public accounts toward fiscal balance.

RECOVERY IN THE CREDIT MARKET

The credit market remains on a recovery path. Total lending increased by 6.2% in real terms in the comparison between the 12-month period to August 2018 with the same period in 2017. On the same comparison basis between 2017 and 2016, total lending dropped by 6.3% altogether.

The increase in lending to individuals was slightly higher than to corporations, up by 6.6% and 5.8% respectively, on the same comparison basis. In relation to credit operations with non-earmarked funds, the performance of individual and corporate portfolios was also similar over the period, with variations of 7.4% and 8.4%, respectively.

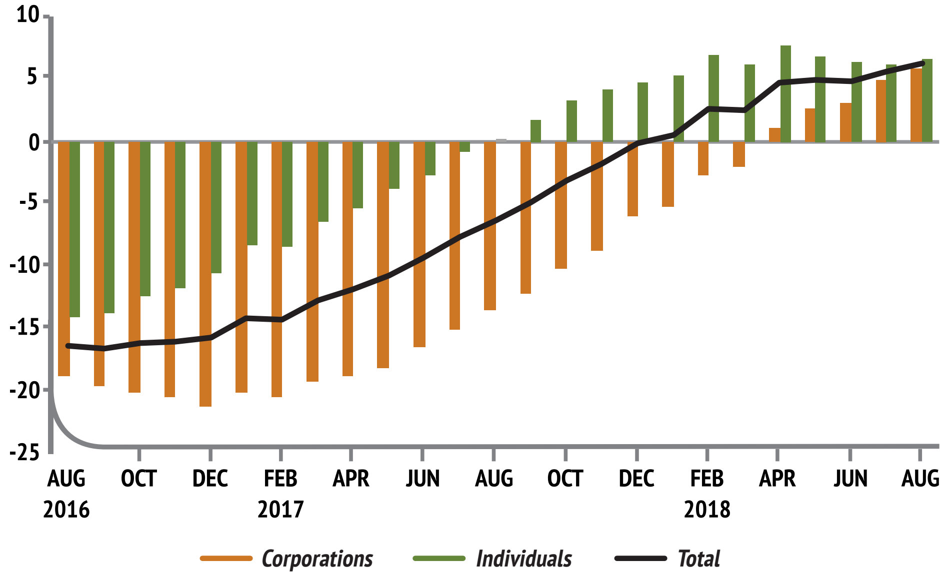
The total balance of credit operations of the National Financial System (SFN) continues to decline in real terms, but at decreasing rates. According to data from the Brazilian Central Bank, the average balance in the past 12 months varied by -2.6% in August 2018 in real terms in relation to the average balance in the previous 12 months, against -7.7% in August 2017. For individuals, lending increased by 2.8% in 2018, against a decline of 1.7% in 2017, while the credit balance for corporations recorded a variation of -8.3% against -13.2% on the same basis of comparison.

Despite the recovery trajectory, the current level of the basic interest rate – which is at a historical low – should have allowed a much more significant improvement in the credit market. However, on the supply side of credit, the requirements imposed by banks in terms of collateral and high spreads make it difficult for economic agents to access financing lines. On the demand side, a scenario of low business and consumer confidence, high unemployment rate, and weak recovery of economic activity ends up decreasing demand for finance.

These difficulties are reflected in the country's credit/GDP ratio, which in August was 46.7%. This result is well below the world average of 130% or that recorded in member countries of the Organization for Economic Cooperation and Development (OECD), 147%, according to World Bank data.

Lending remains on the rise in 2018

Lending, in real terms
12-month change



Source: Central Bank of Brazil

FISCAL POLICY

Revenue growth ensures below-target primary result

Increased compulsory expenditures poses challenges in terms of compliance with fiscal rules

The fiscal scenario in 2018 appears to have been consolidated and it shows that revenues on the rise will offset increased spending and ensure the achievement of the primary result target. Although the containment of spending observed in recent years was not continued in 2018, factors such as the resumption of economic growth, increased taxation, and extraordinary revenues led to a significant increase in the revenues of the federal government and of states and municipalities.

The pace of revenue growth seen until the third quarter is likely to slow down by the end of the year. Two factors that contributed to increased revenues (installment repayment of tax debts with federal tax authorities and increase in the PIS [Social Integration Program benefits)/Contribution to Social Security Financing [COFINS] on fuels) will lose intensity in the last quarter of the year. As the rate of increase in spending is not expected to change significantly, especially that of the federal government, the primary deficit will likely rise by the end of the year. Nevertheless, the public sector is likely to meet the primary target with ease and the federal government is also likely to close the year within the cap imposed on spending growth.

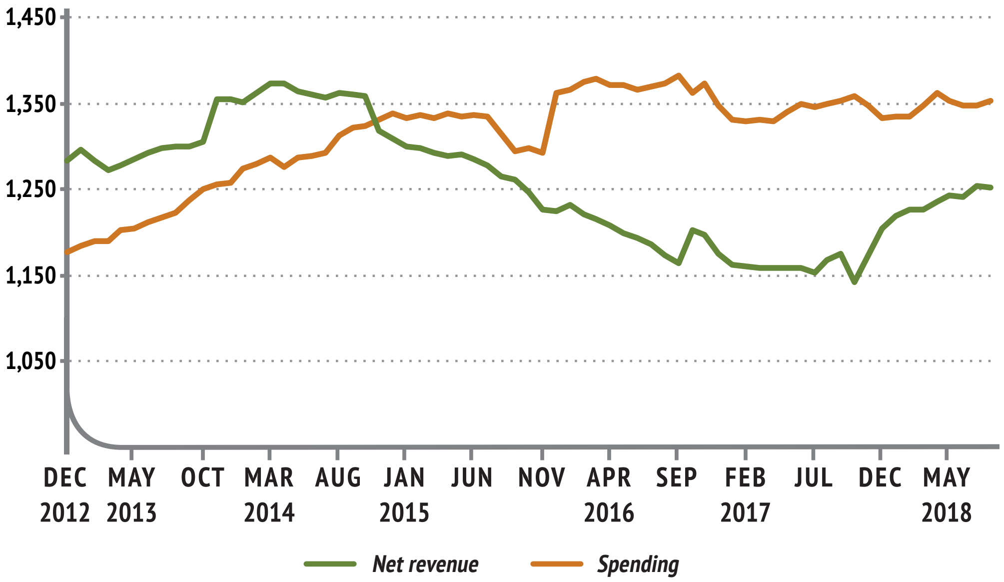
However, the fiscal situation remains worrying for the next few years, as the continued increase in compulsory spending will likely make it necessary to reduce non-compulsory spending once again, including investment. This is what the federal budget bill for 2019 shows. With the aim of ensuring the achievement of the primary result target and compliance with the cap on spending growth, the bill contemplates the lowest investments in recent years and a real decrease in non-compulsory spending.

FEDERAL GOVERNMENT REVENUES RISING SHAPLY

The federal government net revenue increased by 6.3% in real terms (IPCA deflator) between

Net revenue of the federal government in 12 months increased by 9.6% in real terms between October 2017 and August 2018

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



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

In the first eight months of 2018 in relation to the same period in 2017, federal government spending increased by 2.4%

January and August 2018 in relation to the same period in 2017. This result can be basically explained by three factors: resumption of economic activity, with positive impacts on revenues from PIS (Social Integration Program benefits)/Contribution to Social Security Financing (COFINS) contributions and from the Tax on Industrial Products (IPI); agreements for installment repayment of tax debts with the federal government (PERT and installment repayment of overdue debt) and increase in taxation via PIS/Cofins on fuels. These two latter factors will likely lose intensity by the end of the year, as their effects began to be felt, or became more intense, in the second half of 2017. Thus, the high comparison basis in the last months of 2017 is not likely to be repeated in 2018.

These factors mainly affected revenues managed by Brazil's Internal Revenue Service, which showed a real increase of 7.3% in the first eight months of 2018 against the same months in 2017. The second component that contributed most to the significant increase observed in net revenues was that of revenues not managed by the Internal Revenue Service, which increased by 16.3% between January and August 2018 in relation to the same period in 2017. In this case, such growth is explained by an increase in the financial compensation for exploiting natural resources in a positive scenario of increased oil production and oil prices on the rise, greater inflow of funds from concessions, and a larger volume of dividends received by the Federal Government.

The only component of net revenues that did not increase significantly was that of social security revenues, which recorded a real increase of 0.5% between January and August 2018 in relation to the same period in 2017. This increase was due to improvements in the labor market, which led to an increase in total payroll, and to payments collected via programs for installment repayment of debt. On the other hand, the compensation received for payroll tax exemptions decreased.

On the spending side, the federal government increased its expenditures once again after containing them for two years. In the first eight months of 2018, federal government spending increased by 2.4% in real terms in relation to the same period last year.

Both compulsory and non-compulsory spending increased in the first eight months of 2018 as compared to the same period in 2017. Among compulsory expenditures, spending on pensions increased by 2.1% as a result of indexation adjustments of pension benefits in January and of an increase in the number of beneficiaries.

In addition, spending on personnel increased by 1.1% in the first eight months of 2018 as compared to the same period in 2017. In addition to the payroll vegetative growth, spending on personnel is on the rise due to a decision of the Federal Supreme Court late in 2017 to suspend a Provisional Measure that postponed indexation adjustments for public servants.

Increases in spending on pensions and personnel exceeded the real decrease of 3.3% recorded for other compulsory expenditures on the same basis of comparison. This decrease is mainly due to the approval of legal measures that reduced spending with subsidies, unemployment insurance, and the Higher Education Student Financing Fund (FIES).

Even discretionary spending, which is controlled by the federal government, showed a real increase of 9.5% in the first eight months of 2018 in relation to the same months in 2017. This increase shows how difficult it is for the federal government to contain such spending as in 2017, when they decreased by 14% in real terms compared to 2016.

SPENDING OF STATES AND MUNICIPALITIES INCREASES SIGNIFICANTLY

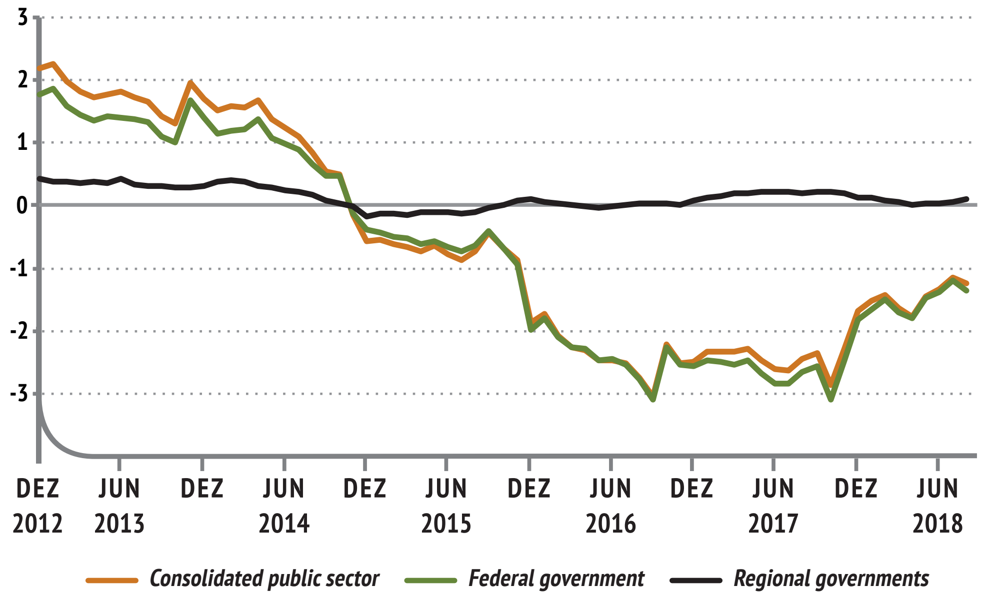
Spending of states and municipalities remains on the rise in 2018. After containing costs for two years, states and municipalities increased their spending in 2017 once again and its growth pace intensified now. As a result, spending began to grow at a faster pace than revenues, as reflected in a drop in the primary surplus of regional governments.

Based on available data on the revenues of states and municipalities and on their primary result, CNI estimates that regional governments' expenditures increased by 6.2% between January and July 2018 in relation to the same months in 2017.

Regarding revenues, available data show a real increase of 4.7% between January and July 2018 as compared to the same months in 2017. Revenues from the turnover tax (ICMS), which is the main source of revenue for regional governments, increased by 3.8% on the same basis of comparison.

12-month public sector primary deficit decreased by 1.62 percentage points of GDP between October 2017 and August 2018

Primary result of the consolidated public sector and by levels of government
Percentage (%) of GDP



Source: Central Bank of Brazil
Prepared by: CNI

The increase in revenues from the ICMS tax reflects the recovery of economic activity and tax increases promoted by several state governments.

Transfers from the federal government, the second main source of funds for states and municipalities, increased by 6.7% in the first seven months of 2018 in relation to the same period in 2017. In addition to the effects of resumed economic activity and debt repayment, which have a positive impact on revenues from federal taxes shared with states and municipalities, transfers have been on the rise due to increased oil production and higher oil prices, resulting in increased financial compensation for exploiting natural resources.

SIGNIFICANT IMPROVEMENT IN THE PRIMARY RESULT UNTIL AUGUST 2018

The increase in revenues of the federal government and regional governments outpaced the growth of consolidated public sector expenditures and made it possible for the public sector primary deficit to remain, in 2018, on the downward path first recorded in the last months of 2017. The public sector recorded a primary deficit of R$84.4 billion (1.25% of GDP) in the 12-month period to August 2018. The negative result was R$110.6 billion (1.69% of GDP) in December 2017 and it hit the mark of R$187.2 billion (2.87% of GDP) in October 2017.

The reduction in the primary deficit exceeded the increase of 0.09 percentage points of GDP in nominal interest spending and made it possible for the 12-month nominal deficit to drop from 7.8% in December 2017 to 7.45% of GDP in August 2018. Nevertheless, the nominal deficit is at a much higher level than necessary to stabilize the Gross Debt/GDP ratio, which increased from 74% in December 2017 to 77.3% in August 2018.

LOWER GROWTH IN REVENUES IN THE LAST MONTHS OF THE YEAR WILL LIKELY INCREASE THE PRIMARY DEFICIT

The growth recorded in federal government revenues will likely slow down in the final months of 2018. Because no significant changes are expected in the spending growth rate, the primary deficit will likely increase in relation to August. The primary surplus of regional governments is in turn expected to grow for the remainder of the year as a result of the end of a reduction approved for debt repayment installments paid by the states to the federal government from July 2018. Since the effect of an increase in the primary deficit of the federal government will likely exceed that of an improved result for regional governments, we are forecasting an increase in the primary deficit of the consolidated public sector in the coming months.

The Federal Government's net revenue will likely increase by 2.5% in 2018 in relation to 2017. The reduction in relation to the 6.3% growth observed up to August will likely be caused by the fact that the volume of revenues from debt repayment in installments to federal tax authorities observed in the last months of 2017 will not be repeated in the next few months of this year. In addition, the PIS/Cofins taxation on fuels is not expected to be increased at the same pace as in the first half of 2018, as in the second half of 2017 the increase was already in force, which increases the comparison basis. The growth rate of revenues not managed by the Internal Revenue Service is also likely to slow down by the end of 2018 due, among other factors, to the fact that court-ordered deposits not withdrawn by their beneficiaries will not be returned to the public treasury as in 2017.

Regarding federal government spending, it is likely to increase by 2.6% in 2018, slightly above the growth rate observed until August (2.4%). This small rise in the spending growth rate will likely be caused by spending on personnel and by cost and capital expenditures. Spending on personnel will continue to reflect salary increases granted in early 2018 and it is expected to close the year with a real growth of 2.0%. In the case of cost and capital expenditures, their faster growth to 3.7% may be partly explained by the diesel subsidies granted by the government. Social security spending will likely close the year with a real growth of 2.0%, close to that observed until August.

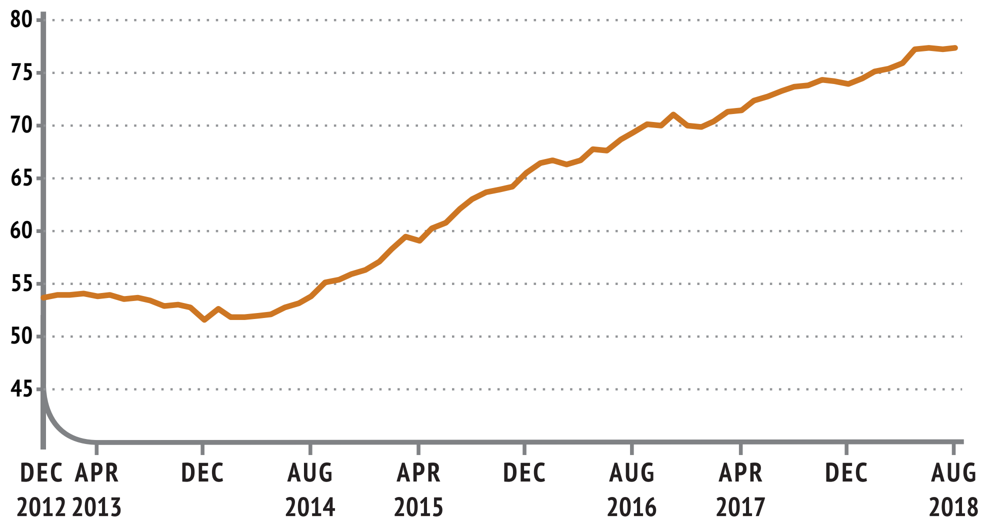
In this scenario, CNI estimates that the Federal Government and its state enterprises will close the year with a primary deficit of R$124.1 billion (1.81% of GDP as estimated by CNI). If it materializes, this result will be much lower than the target of R$162.5 billion set for 2018 and will be close to the primary deficit of R$119.4 billion (1.82% of GDP) observed in 2017.

The revenues of regional governments will likely continue to grow at the same pace. On the one hand, continued economic activity will keep revenues from the ICMS tax on the rise and, on the other, as oil prices and production will remain high, transfers from the Federal Government to regional governments will continue to grow.

However, primary spending will likely grow at a slower pace as a result of the resumption of debt repayment installments with no reduction since July 2018, as agreed upon between states and the Federal Government. Thus, the primary surplus of state governments will likely increase to R$11.0 billion in 2018 (0.16% of GDP as estimated by the CNI).

Gross debt-to-GDP ratio rose by 3.0 percentage points between December 2017 and August 2018

Trajectory of the Public Sector's Gross Debt
Percentage (%) of GDP



Source: Central Bank of Brazil

As a result, the consolidated public sector primary surplus is expected to record a deficit of R$113.1 billion (1.65% of GDP as estimated by CNI) in 2018. Besides the R$48.2 billion spared in relation to the deficit target of R$161.3 billion set for 2018, this result will be lower than the R$110.6 billion deficit (1.69% of GDP) recorded in 2017.

The drop in the primary deficit in relation to 2017 will likely exceed the increase of 0.2 percentage points in GDP projected for nominal interest spending. The nominal deficit is therefore expected to take a slight downturn, from 7.80% in 2017 to 7.58% of GDP in 2018. Albeit on the decline, the nominal deficit will still be at a much higher level than necessary to stabilize the Gross Debt/GDP ratio. Despite the return of R$130 billion to the National Treasury by the Brazilian Development Bank (BNDES) in compliance with the Golden Rule (according to with public indebtedness must not exceed the amount spent on capital expenditures), the Gross Debt/GDP ratio will likely close 2018 at 77.1%.

BUDGET FOR 2019 INDICATES REVERSION OF THE DOWARD TREND OF THE PRIMARY DEFICIT RECORDED OVER THE LAST TWO YEARS

The 2019 Annual Budget Bill (PLOA) points to stability in federal government primary spending, in line with the public spending growth cap. It is necessary, however, to draw attention to the composition of these expenditures. In order to accommodate the 5% real growth in compulsory spending, non-compulsory expenditures will be reduced by 6.5% in real terms. Therefore, budgeted investments amount to only R$27.4 billion, against R$31.1 billion in 2018 and R$33.1 billion in 2017.

Compulsory spending includes a real increase of 3.9% in spending on personnel and of 3.1% in spending on pensions. In the case of social security, the need for a reform designed to reduce the spending growth pace is well known.

However, the increase in spending on personnel during the fiscal adjustment years has not been much discussed. Between 2014 and 2018, spending on personnel increased by 8.7% in real terms altogether. With the real increase of 3.9% projected for 2019, growth over the period may hit the mark of 13.0%.

With the real increase of 1.3% projected for net revenues, the federal government will likely record a primary deficit of R$139 billion, within the target set for 2019. If confirmed, this result will reverse the downward trend of the primary deficit seen in 2017 and 2018 and put additional pressure on public debt growth.

FOREIGN TRADE SECTOR

External shocks and domestic uncertainties keep the Brazilian currency depreciated and volatile

Declining trade balance increases current account deficit

In the third quarter of the year, the Brazilian currency experienced its sharpest devaluation since the Real Plan was implemented. Throughout September, the exchange rate remained above four reals, hitting the mark of R$4.19/US$1 on the 14th. The continuous depreciation trend of the real took a downturn in late September and early October, but the exchange rate remains volatile.

The US dollar has strengthened against several currencies, mainly due to the rise in US interest rates, indicating that the Brazilian exchange rate devaluation is also being caused by external factors. Emerging countries, especially those with external payment problems, are the ones experiencing the sharpest currency devaluation and fluctuations.

Even though the devaluation of the real favors exports, the trade balance recorded a lower surplus than expected for the period due to an increase in imports exceeding exports by far. While imports grew by 29.4%, exports increased by 16.0% in the third quarter compared to the same period last year.

As a result of this deterioration in the trade balance, the current account deficit increased from US$3.1 billion in the 12-month period to August 2017 to US$4.7 billion in the same period this year.

DEPRECIATION OF THE REAL SLOWS DOWN

The US dollar exchange rate remained at high levels in the third quarter of the year. However, the devaluation trend of the real slowed down in recent weeks after the names of the candidates who will participate in the second ballot were announced. The so-called Brazil Risk (EMBI) influences the exchange rate movement, signaling that political and economic instabilities are priced in foreign currency debt securities, which in turn affect the exchange rate.

In the quarter from July to September, the average exchange rate rose to R$3.95/US$1, up by 10% compared to the average price recorded in the second quarter. During the month of September, the US dollar hit the mark of R$ 4.19/US$1, the highest value since the Real Plan was implemented. However, after the results of the first ballot were announced the real appreciated against the US dollar and the exchange rate fell by 6.6% in relation to the closing rate in September, standing at R$3.73/US$1 now (October 9, 2018). The real depreciated by 18.2% over the last twelve months.

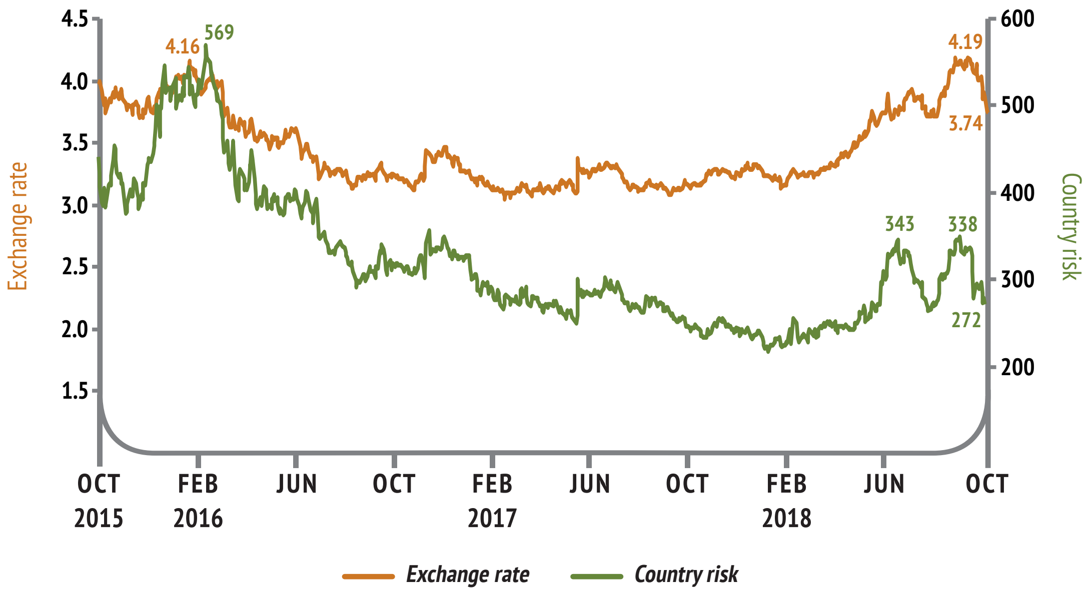
Domestically, political uncertainties and the frustration of lower-than-expected growth for the year also contributed to this movement in September, marked by high volatility in the real exchange rate against the US dollar. These oscillations have in turn made it difficult for economic agents to develop their plans and have turned economic forecasting into a challenging task.

Difficulties in approving structural reforms to address our fiscal problem have been reducing the credibility of investments, increasing Brazil's risk premium. Due to the possible high risk involved, investing in Brazilian debt securities has become less attractive, so it is necessary to increase the remuneration of these securities to preserve the level of capital invested. Brazil's risk premium rose to 349 points in early September, the highest figure since November 2016. In the last three months, the average was 306 points, an increase of 13% over the average recorded in the second quarter of the year.

External factors have strongly influenced the appreciation of the US dollar against several foreign currencies, especially against those of emerging countries. The contractionary monetary policy adopted by the US central bank (Fed) has contributed to the appreciation of the US dollar against other currencies. The

Increase in Brazil's risk premium influences devaluation of the real

Daily exchange rate (Ptax Closing Rate) and the Brazil's country risk (EMBI)*
In R$/US$ and points



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

US economy's growth of about 3% this year increases the possibility of the Fed continuing to raise interest rates: a further increase is expected by the end of this year and three increases in 2019, which will likely keep the US dollar at a high value.

In the face of external shocks and domestic uncertainties, the exchange rate projected for the end of 2018 is R$3.80/US$1, with the observation that it will likely be higher if the result of the elections does not signal the approval of structural economic reforms.

DECLINING TRADE SURPLUS

In the third quarter of the year, the trade balance accumulated a surplus of US$14.5 billion, 15% lower than the one recorded over the same period last year, of US$17 billion. In the year to September, the balance was positive by US$44.3 billion, down by 16.8% from the balance accumulated in 2017 on the same basis of comparison, US$53.3 billion.

This deterioration in the trade balance is explained by imports increasing at a faster pace than exports. The crisis in Argentina is one of the factors contributing to modest export growth. Argentina is one of Brazil's main trading partners, accounting for about 8% of Brazilian exports.

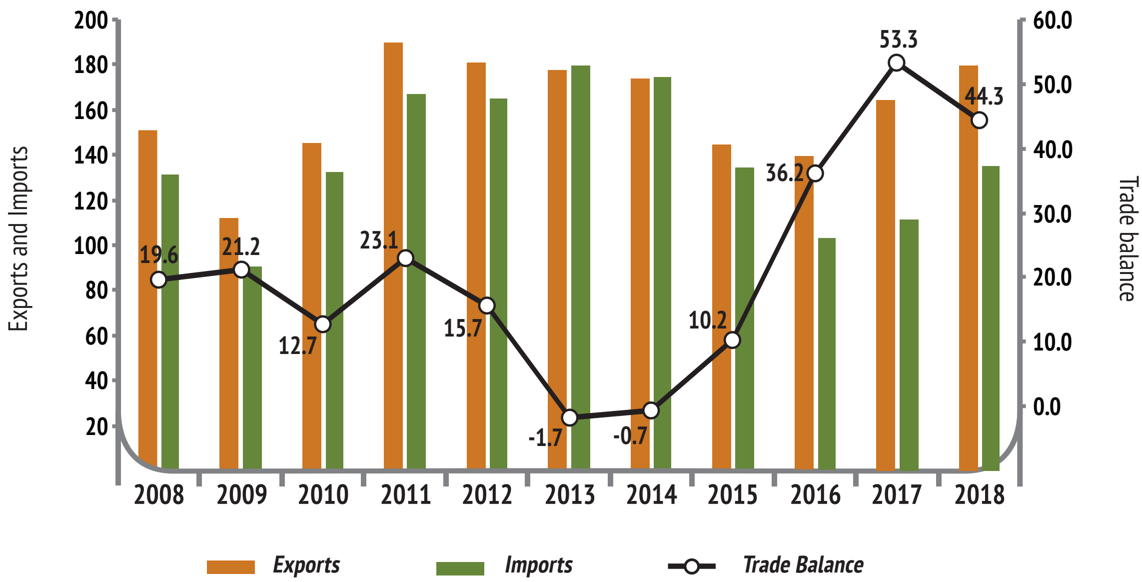
While imports grew by 29.4% in the third quarter compared to the same period last year, exports increased by only 16%, despite the favorable exchange rate for them. Exchange rate volatility reduces the predictability of trade contracts and tends to inhibit the positive impact of a depreciated exchange rate on exports. In the year to September, imports totaled US$135.3 billion, up by 22% in relation to the same period last year. Altogether, exports up to September amounted to US$179.7 billion, exceeding by 9.1% their total value until September 2017.

Imports increased in all major economic categories in the year to August in relation to the same period in 2017: consumer goods (17.2%), intermediate goods (13.4%), fuels (26.2%) and, in particular, capital goods, which had a significant increase of 95.8%. The increase in imports in general stems from the expectation of improved economic activity, but the significant increase in imports of capital goods was mainly due to imports of oil rigs under the REPETRO program (see the section Economic Activity).

On the same basis of comparison, exports of capital goods increased by 33.8%, of intermediate goods by 6.6%, and of fuels by 26.6%, while those of intermediate goods fell by 6.4%. By aggregate factor, no significant changes were recorded in exports of basic and manufactured products: they varied between 0.9% and -1.0%, while those of semimanufactured products decreased by 16.8% in relation to the 12-month period to August last year.

Trade surplus on the decline despite increased exports

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



Source: SECEX/MDIC
Prepared by: CNI

For 2018, we are projecting an even more pronounced drop in the trade surplus as a result of imports increasing more than exports, despite a more depreciated exchange rate. CNI projects that the overall annual trade balance will record a surplus of US$48 billion, with exports totaling US$228 billion and imports US$180 billion.

STABLE CURRENT ACCOUNT DEFICIT

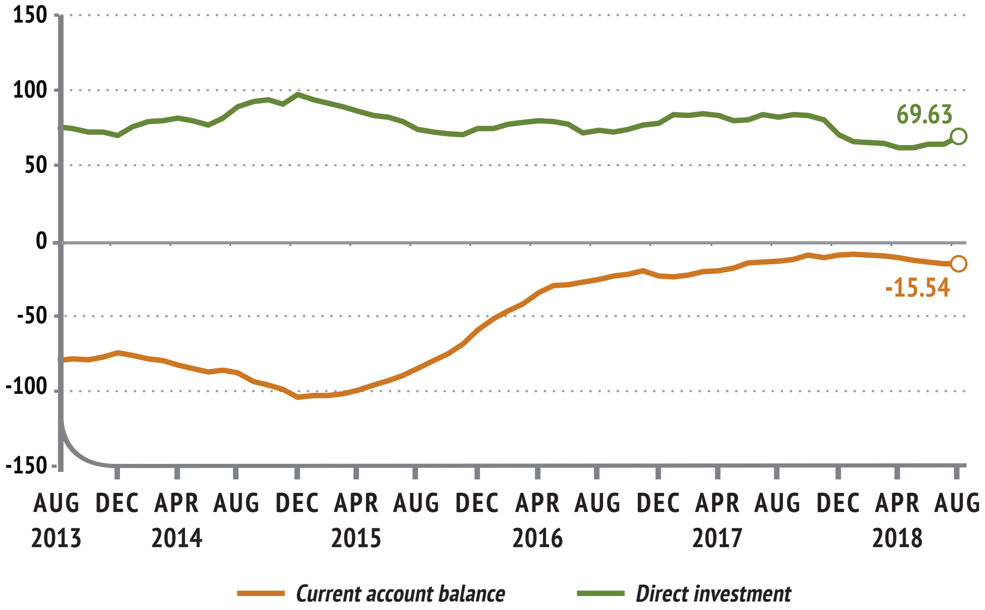
The current account balance showed a deficit of US$717 million in August. In the period from January to August this year, current account transactions accumulated a deficit of US$8.9 billion against US$3.2 billion in the same period last year. This higher deficit is justified by the deterioration in the trade balance and primary income, which fell by 25% and 22%, respectively, on the same basis of comparison. In twelve months, the current account deficit increased by 13.7%, from US$13.6 billion in August of last year to US$15.5 billion in August of this year.

Despite this drop in the balance, direct investment in 12 months amounted to US$69.6 billion, or more than four times the value of the current account deficit, showing that direct investment can finance the foreign account deficit. However, direct investment in Brazil fell by 15% in relation to last year: up to August, average monthly investments amounted to US$5.8 billion, against US$6.8 billion invested in 2017 on average.

By the end of the year, the current account deficit will likely amount to US$20 billion, accounting for 1.1% of GDP as projected by CNI. This amount is largely offset by the inflow of funds into the capital account.

Direct investment exceeds current account deficit

12-month current account balance
12-month direct investment
In billion US$



Source: Central Bank of Brazil
Prepared by: CNI

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OUTLOOK FOR THE BRAZILIAN ECONOMY

	2016	2017	2018 previous forecast (Brazilian Economy June/18)	2018 current forecast
ECONOMIC ACTIVITY				
GDP (annual change)	-3.5%	1.0%	1.6%	**1.3%**
Industrial GDP (variação anual)	-4.0%	0.0%	1.8%	**1.3%**
Household consumption (annual change)	-4.3%	1.0%	2.0%	**1.9%**
Gross fixed capital formation (annual change)	-10.3%	-1.8%	3.5%	**2.2%**
Unemployment rate (annual average - % of the labor force)	11.5%	12.7%	12.4%	**12.2%**
INFLATION				
Inflation (IPCA index - annual change)	6.3%	2.9%	4.2%	**4.4%**
INTEREST RATES				
Nominal interest rate				
(average rate for the year)	14.18%	9.92%	6.58%	**6.58%**
(year's end)	13.75%	7.00%	6.50%	**6.50%**
Real interest rate *(ex-post - average annual rate and deflation: IPCA)*	5.0%	6.2%	3.4%	**2.7%**
PUBLIC ACCOUNTS				
Primary result (% of GDP)	-2.5%	-1.7%	-2.0%	**-1.65%**
Nominal result (% of GDP)	-9.0%	-7.8%	-7.5%	**-7.6%**
Public sector's gross debt (% of GDP)	69.9%	74.0%	76.3%	**77.1%**
EXCHANGE RATE				
Nominal exchange rate - R$/US$				
(average for December)	3.35	3.29	3.80	**3.80**
(average for the year)	3.48	3.19	3.63	**3.70**
FOREIGN TRADE SECTOR				
Exports (US$ billion)	185.2	217.7	232.0	**228.0**
Imports (US$ billion)	137.5	150.7	170.0	**180.0**
Trade balance (US$ billion)	47.7	67.0	62.0	**48.0**
Current account balance (US$ billion)	-23.5	-9.8	-20.0	**-20.0**

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