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Brazil: Recession? (III)

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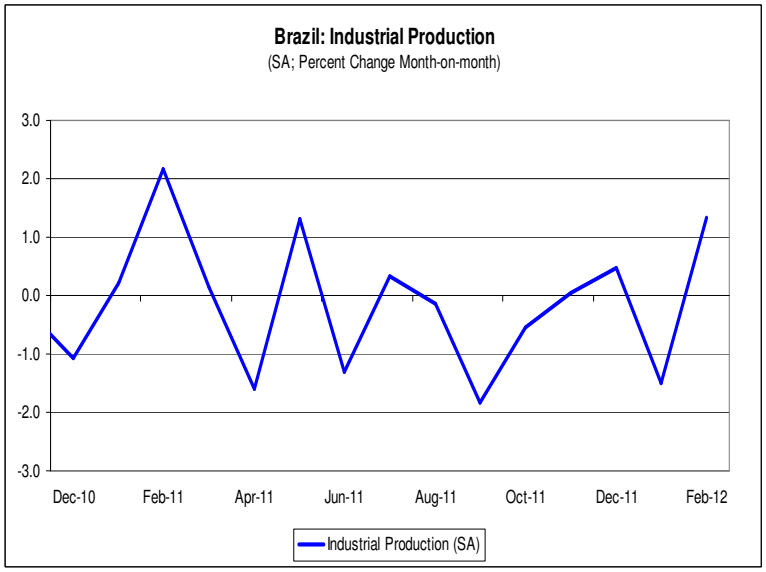
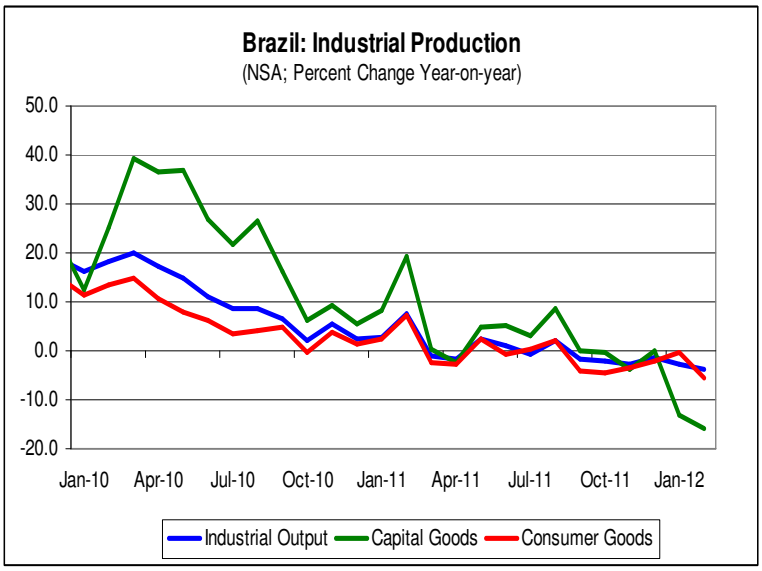
Brazil's industrial production data were, on balance, constructive and in line with other indicators pointing to a bottoming of the growth cycle at a relatively low rate. Seasonally-adjusted industrial production actually increased 1.3% month-on-month, the third positive result in the past four months (the exception was January, when industry retreated 1.5% month-on-month). The year-on-year calculation left industrial production 3.9% below its level of last year. But the comparison tends to overstate the weakness of the sector. The base year was extraordinarily strong, and there was a deficit of working days in February 2012, for which the series is not adjusted.

Nonetheless, it is clear that Brazilian industry faces strong headwinds, ranging from the real's appreciation to the recession in Europe, plus the impact of a very tight monetary policy, which the central bank is just unwinding.



As a response, the government announced a package of fiscal support measures worth up to 60 billion reais (roughly equivalent to 1.4% of 2011's GDP). Most of the package (45 billion reais) consists of additional funds for the state's development bank. The remainder consists of a number of tax cuts for sectors such as textiles, furniture, electronics, automobile and commercial vehicles, capital goods, information technology, hotels, call centers, airplanes and shipbuilding.



It should be noted that the program is both relatively limited in size and also supposed to be financed through still-not-specified tax increases. It is therefore a targeted, micro-oriented attempt to help a large section of Brazilian industry become more cost-competitive by reducing, among other things, labor taxes. This is an old goal by the industrial sector, finally achieved as the government's policymakers react to changing global conditions that make their 4.5% real GDP growth target hard to achieve.

Given how high some of the labor-related taxes have become, the direction of the changes is very supportive of employment and in fact equivalent to a

weakening of the real. Social security employer contribution rates, for example, were as high as 20% for some of the sectors involved; they have been reduced—*permanently*, according to the government—to low single-digits for a broad array of activities.

The program, in effect as of July 1st, should help strengthen the (likely) rebound of Brazil's economy during the second half of 2012 and into 2013, a recovery fundamentally induced by a still unfinished process of monetary easing. As regards the latter, rates will probably be cut at least 50 to 100 basis points further in the near-term. The introduction of fiscal stimulus is not (given the nature of the program, plus the ongoing deceleration of inflation) an obstacle for further rate reductions. There may be, however, less pressure from the industrial lobby for a weaker real—although it is highly unlikely that the central bank will tolerate any significant gains, and may even be inclined to hold the line near present levels.

The bottom line: on present trends, absent a major external shock, and given the rapid easing of monetary policy and the actions taken on the fiscal front thus far, Brazil's real GDP growth could actually be, on average, stronger this year than in 2011 (DE's estimate: 3.5%), possibly accelerating over 4% next year.

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