Economic Watch

Brazil

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Economic Analysis

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Brazil: industrial production weakens and the government adopts measures to support the sector

The new industrial policy could impose an extra fiscal burden for the economy and create some upturn in industrial production, which could then put additional pressures on monetary policy

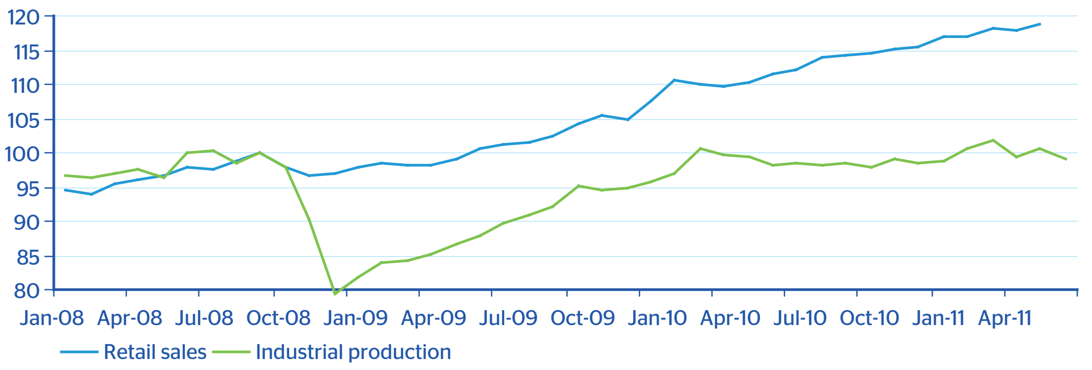
- **Industrial production dropped 1.6%m/m in June, significantly less than markets expected (a 0.4%m/m decline).** In yearly terms industrial production dropped from 2.7%y/y in May to 0.9%y/y in June.

- **The industrial growth in the second quarter of the year was equal to -0.7%q/q, in sharp contrast with the 2.0%q/q growth observed in the first quarter.** This reinforces the view that GDP growth will slow down in the second quarter of the year. It also suggests that our 0.9%q/q estimation for Q2 GDP could be somewhat optimist (GDP expanded by 1.3%q/q in q1).

- **The moderation of the industrial production is not only due to a general slowdown of the economy,** but it is also explained by competitiveness problems related to the appreciation of the exchange rate.

- **This view is supported by the comparison between industrial production and retail sales indicators.** While industrial production remains close to pre-crisis levels, retail sales are around 19% higher now than in September of 2008 (see graph below).

Chart 1
Retail sales and industrial production (Index: Sep/2008=100)



Source:IBGE

- **As a response to the weakness of the industrial sector,** the government announced this morning in Brazil a set of measures to support the sector ("Plano Brasil Maior").

- **Among the main measures announced today we highlight:** i) payroll tax cuts for labour-intensive sectors such as furniture, footwear, textile, and software industries; ii) tax incentives for exporters and investment expenditures; iii) adoption of new rules for government purchases to favour domestic industry ("Brazilian Buy Act"); iv) a more strict control of both irregular and "unfair" imports.
- **The implementation of this industrial policy should generate some revenue losses.** Although at this moment it is not clear the magnitude of these losses, they reinforce the perspectives that there is not much room for fiscal policy to provide extra support for countercyclical efforts. This could actually put extra pressures on monetary policy.
- **On top of that, the adoption of these measures could drive industrial production up and**, therefore, make the moderation of the economy more difficult. This could also to the pressures on monetary policy.
- **We, therefore, see the implementation of these measures as a suboptimal response to the problems of the productive sector** because they contribute to the deterioration of the policy mix (meaning tighter monetary policy and laxer fiscal policy) and, therefore, to the appreciation of the exchange rate.

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