

March | 2014

Monthly Economic Outlook

Domestic activity set to remain moderate in 2014

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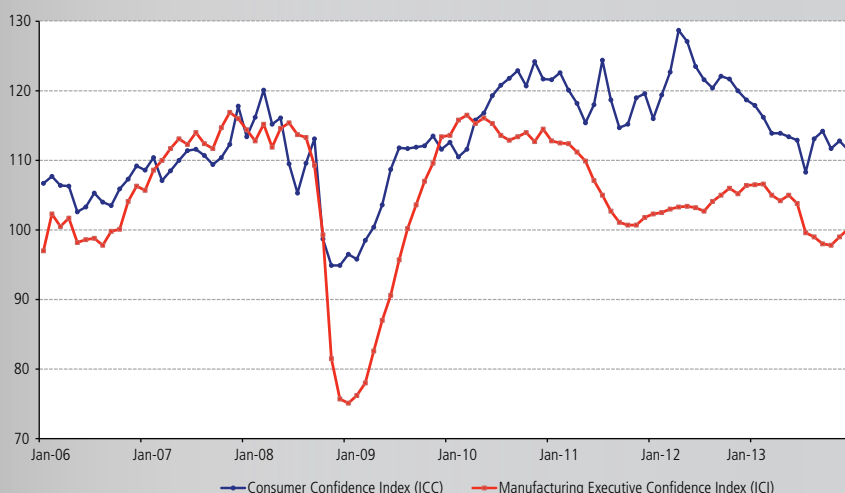
At the start of 2013, optimism regarding domestic economic performance in the year rebounded a little, after the surprising weakness seen in 2012. The consensus forecast for 2013 GDP growth was then in the range of 3.3%, which would have been a sharp improvement on 2012 growth (1%), while industrial production was expected to accelerate even more strongly, growing 3.5% in contrast with the 2.7% contraction seen in 2012. However, increasing global uncertainty alongside waning consumer and business confidence at home helped reduce this optimism, which gave way to a gradual downward revision of projections for domestic growth in 2013. Global market volatility was fueled by the possibility of a US fiscal crisis capable of interrupting the ongoing economic recovery and by expectations that the Fed

would soon begin withdrawing monetary stimulus. This increase in volatility contributed to a rise in long-term interest rates and risk premiums in Brazil.

Business and consumer confidence also trended down during the year (see first chart), deteriorating with particular acuteness in the aftermath of the wave of street protests that broke out across Brazil in June. In the industrial sector, the monetary tightening cycle and the resulting prospect of slower economic growth, combined with the deteriorating fiscal situation and the increasing likelihood of a sovereign downgrade for Brazil (potentially entailing the loss of investment grade), drove a decline in confidence from July on. Indeed, manufacturing executive confidence as measured by FGV's ICI index eventually reached the lowest level seen since 2009. It should be stressed that consumer confidence had already begun showing signs of deterioration in the first half in response to worsening inflation, despite the fact that labor market conditions remained favorable.

In this context consumer spending would naturally be expected to slow down, or investment and industrial production would presumably contract. Indeed, retail sales grew only 2.3% in annualized terms in first-half 2013, for the worst performance since the 2008 crisis (see chart below). They reaccelerated temporarily in the third quarter (13.1% p.a.), helped by lower domestic inflation. We estimate more moderate expansion in the fourth quarter, leading to 4.3% growth in the year, down from 8.4% in 2012. As for industry, after moderately better growth in second-half 2012 and

FGV: consumer and business confidence
Seasonally adjusted



Source: FGV. Chart: VWM.

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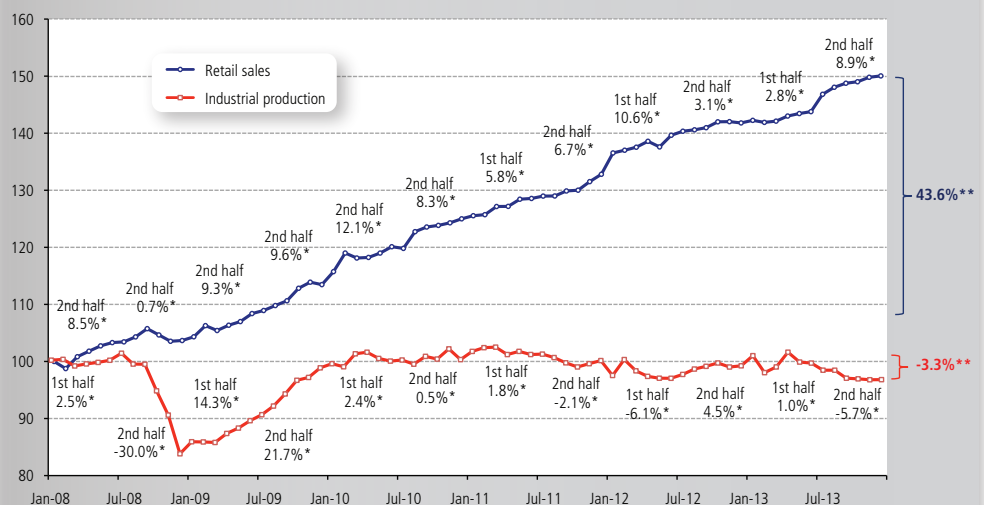
first-half 2013 (4.5% and 1% p.a.),¹ the sector is estimated to have contracted 5.7% in annualized terms in second-half 2013, for an overall annual performance below the level seen before the 2008 crisis. We estimate 1.1% growth in the year, recouping only part of the contraction seen in 2012. Not even the reduction in electricity costs for industry authorized by the government at the start of the year, alongside continuing tax breaks for specific segments (automotive, furniture and white goods) and local currency depreciation were sufficient to bolster the sector's performance significantly. An aspect of local currency depreciation worth noting is that in the short run the effect on production actually tends to be negative, given the adverse influence of exchange-rate shocks on business confidence, typically leading to a postponement of investment decisions. Although 2014 is an election year, the government's leeway to implement new measures to stimulate domestic demand will be limited by fiscal deterioration and

inflation dangerously approaching the upper limit of the target range set by the Central Bank (6.5%). Nevertheless, we do not anticipate a very different scenario from last year's. Despite a lower annual minimum wage hike and persistently high inflation, retail sales are set to rise at about the same pace, i.e. 4.3% or thereabouts (with statistical carryover to 2014 in the range of 2.9% thanks to the lower comparison base in early 2013). In addition, sales of furniture and appliances will again be boosted by the federal government's "Minha Casa Melhor" program of subsidized credit for home furnishing, and the FIFA World Cup may possibly have a positive impact. As for industrial production, in the absence of a long-term agenda to address such lingering structural problems as deficient infrastructure, logistical bottlenecks, a heavy tax burden and excessive bureaucracy, not to mention the dearth of skilled labor, the industrial sector appears set to continue recovering slowly and will probably not grow more than about 1% in 2014.

¹WMM calculates variations in industrial production using a different method for seasonal adjustment than the official methodology used by IBGE. Our seasonal adjustment method takes into consideration not just the Carnival and Easter holidays but also all other holidays in the Brazilian calendar that have a significant impact on industrial activity.

IBGE: retail sales vs. industrial production

Seasonally adjusted. Index (base 2013=100)



Source: IBGE. Chart: VAM
 * Annualized average monthly change in half. | **Total change compared with third-quarter 2008.
 NB. Industrial production time series seasonally adjusted by WMM. Values for Nov/13 and Dec/13 are projected by VAM.