

Will Brazilian industry do better in 2012?

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A major contributor to the country's disappointing economic growth of only 2.7% of GDP in 2011, Brazilian industry is suffering from a combination of such factors as the global crisis, unfavorable exchange rates, and intensified competition from imports. After registering growth of 10.4% in 2010—an impressive recovery from the 5.5% drop in 2009—industrial GDP ended last year with growth of a mere 1.6%, casting doubts on its performance in 2012. Overall industrial output, which includes the important manufacturing segment, was virtually stagnant: growth was 0.3%, compared to 10.5% in 2011.

According to the February IBRE Economic Outlook, this year began with encouraging signs, despite a drop of 2.1% in industrial production in January compared to December in seasonally adjusted terms. The proportion of businesses with excess inventories fell from 8.5% in October to 5.1% in January, a level below the historical average of 5.6%. This suggests room for some recovery of economic activity ahead as industry rebuilds inventories. Likewise, according to the IBRE Industrial Sur-

vey, planned production has shown improvement recently. However, business expectations are clouded. For the next three months, expectations are neutral but over a longer horizon the predictions become explicitly pessimistic. In summary the IBRE Outlook says, "The result reflects an industry sensitive to the measures of monetary easing and fiscal stimulus announced at the end of last year, but with little drive to hire workers and invest."

Moderate recovery

The diagnosis agrees with the evaluation of two major representatives of the sector. Renato da Fonseca, executive manager, Research Unit, National Confederation of Industry (CNI), reports that CNI surveys show a tendency to maintain the pace of decline in industrial production in early 2012. "Capacity utilization has been below normal since December 2010, and there is no evidence that the adjustment in inventories is sufficient for a vigorous and immediate resumption of production. Still, one should remember that we are in a low period of industrial activity, which usually reaches its peak around October. There is room for recovery," says Fonseca, adding that the CNI predicts growth of 2.3% for industrial GDP in 2012, and about 3.0% for the economy.

Julio Gomes de Almeida, economist, Institute for Industrial Development Studies (IEDI), agrees that low inventories may have limited impact on growth and points out another limiting factor: "We should have a better year than 2011, but not much better because there remains a factor responsible for the low growth in recent years, which is the problem of industry's low competitiveness. Unless we have very relevant facts for 2012, I do not see how to overcome it immediately."

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The February IBRE Outlook shows that production in 2011 was strongly and negatively influenced by two major indicators of competitiveness: unit labor costs (ULC) defined as the ratio between the payroll in U.S. dollars and quantity produced, and the coefficient of import penetration, defined as imports and total domestic output. "Both have increased significantly, the first mainly due to increases in real wages and a decline in labor productivity," says IBRE Outlook coordinator Regis Bonelli. He explains that the ULC has increased 122% over the past nine years. For imports, the

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coefficient of penetration rose from 10.3% in 2003 to 20.4% in the third quarter of 2011.

"In a healthy economy, wage policy should accompany the increase in productivity, i.e., as workers become more productive, their wages increase. That happened in the first half of the decade. Now, wages are growing and productivity is not, but much of the movement can be credited to exchange rate appreciation, which increases the cost of labor measured in dollars," says CNI's Fonseca. IEDI's Almeida also does not hesitate to point out the exchange rate as the culprit causing lower industrial competitiveness in Brazil. He says, "An extraordinary and intense appreciation of our currency absolutely disrupts domestic industry. In my view, the competitive gap due to the appreciated exchange rate is about 50%, while productivity gains are only about 3% to 4%."

Fonseca admits that not all evils can be attributed to the exchange rate, and that productivity deserves attention: "Part of low productivity recently is related to the lack of skilled workers. The Brazilian economy grew and unemployment is very low, which means that companies have hired workers who are not adequately trained to perform their activities. It is a structural problem, which involves investment in education and innovation, but the macroeconomic environment prevailing until recently, with extremely high interest rates, discourages such action on the part of entrepreneurs."

The Brazil cost

Factors beyond industry's control also affect its competitiveness. Fonseca explains that "Logistics, for example, does not depend on the company but increases the cost of goods from factory to consumer. Brazil has also had one of the lowest industrial electricity costs among developed and developing countries, but today, because of taxes, it has one of the highest, second only to Italy." Almeida agrees: "An emerging country that wants to reach the standard of living of developed countries cannot have the most expensive taxation and cost of capital, energy, logistics, payroll taxes, and wages. Currently industry is paying for not only its own sins of not having better productivity, but also the sins of others. This makes it difficult to compete."

Both economists agree on the effects of increased import penetration on industrial production. "Why do retail sales grow more than industrial production?" Fonseca asks. "Because part of consumption is going to imports. And why is industry revenue growing more than production? Because inputs in the production are being replaced by imported inputs, i.e., the added value is falling. This means that we find it difficult to compete in both domestic and foreign markets." In the same vein, Almeida highlights the vulnerability of industry compared to other segments of the economy: "The agricultural sector in Brazil is very productive and has benefitted by highly favorable international prices, and the services sector in the majority of cases does not suffer from competition from imports."

For 2012, among the factors that may justify some optimism about the performance of Brazilian industry Almeida highlights the measures taken as part of the Great Brazil Plan, such as exemption from payroll taxes and investments in selected sectors, as well as the reduction in the basic interest rate, fewer requirements to obtain credit, and raising the minimum wage. "All this is not trivial, and should represent an increase in consumption of food and beverages, which employ many workers, have great weight in the industry as a whole, and are not as exposed to imports. [Industry] should grow more than in 2011," he says. Fonseca adds, "If I said that the government has not taken action, I'd be lying. But we must reinforce the sense of urgency, because we cannot miss the great opportunity to increase the country's competitiveness through structural reforms."

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