In 2012 the Brazilian economy is now expected to grow about 3% and inflation to decline to 5.2%, with the benchmark interest rate ending the year at 9%. Major risks to the outlook are European financial uncertainties and stagnation in domestic manufacturing.

At the end of 2011, Brazil's economic indicators confirmed a modest recovery, suggesting that the worst of the downturn was behind us. However, contrary to all the expectations, the outlook has clouded to some extent. A surprising drop in industrial production in January calls for downward revision of economic forecasts for 2012.

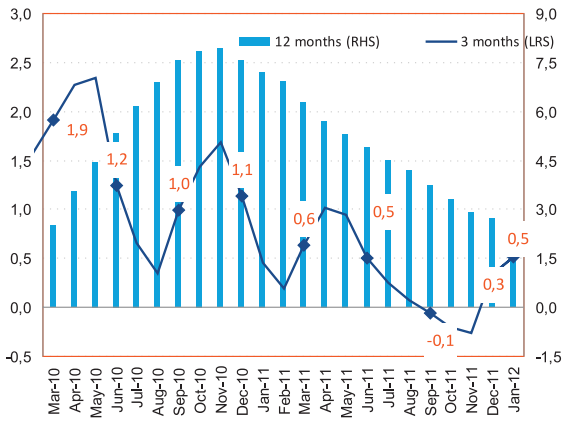
Nevertheless, we continue to predict a mild recovery and GDP growth of about 3%, but several factors are slowing the recovery. On the supply side, manufacturing is likely to stay feeble because its competitiveness has been undermined by exchange rate appreciation and slow productivity growth: the unit labor cost, measured by a basket of currencies, has risen by 122% over the past nine years. In agriculture crop yields are not likely to repeat last year's performance, and the service sector cannot be expected to grow quickly.

On the demand side, hopes are focused on household consumption, driven by credit availability and higher incomes, and on more robust growth in gross fixed capital formation. Household consumption, however, may be lower than hoped; it is constrained by indebtedness and the end of a durable goods purchasing cycle. And the recovery of gross fixed capital could cool because of the uncertainty about European finances.

Supporting this scenario, although IBRE's monthly economic activity indicator had been growing since November 2011, the cumulative 12-month rate fell from 2.7% in December to 2.5% in January. An intriguing aspect of the lukewarm current scenario of economic activity is the good performance of the labor market, where unemployment is low and stable.

IBRE Economic Activity Indicator, March 2010-January 2012

(Percent change over the previous quarter and 12-month moving average over the previous 12 months, seasonally adjusted)



Sources: IBGE and IMF; IBRE staff estimates.

Inflation is expected to decline from 6.5% in 2011 to 5.2% in 2012, mainly because moderation in food price increases should continue in the second quarter. However, inflation in services prices is preventing a greater reduction in the inflation rate.

Our scenario assumes that the central bank will continue its monetary easing policy, cutting the benchmark interest rate to 9.0% by year-end. But it appears that the trade-off between growth and inflation in Brazil has worsened: there will be lower growth, but inflation will remain high. Lessening this trade-off is a major challenge for policy makers.

Risks to the outlook

Recent restructuring of Greece's debt and aggressive expansion of bank liquidity in Europe by the European Central Bank may stave off a deeper crisis in Europe and for the time being has reduced the likelihood of a sharp slowdown of the world economy. Another downside risk to Brazil's growth is the stagnation of the manufacturing industry, despite the monetary and fiscal stimulus. Clearly, the structural problems of Brazilian industry cannot be resolved in the short term. Resumption of growth based on increased domestic demand without the necessary supply may further deepen imbalances in the economy, with negative effects on potential growth.

Brazil in step with world growth (% change)

