Recovery still uncertain

Improvement of some indicators suggests that the recession may be bottoming out, but there are still many uncertainties about the likely speed of an economic recovery.

Chico Santos

THE ECONOMY IS MOVING, but slowly. That is how it seems in the Brazilian capital goods industry: production shows clear signs of improvement, but there is a huge pent-up demand for capital goods that will take a long time to get back to normal.

According to the government’s monthly industrial survey, in the first half of the year industrial production grew a cumulative 13.9% to June compared to the same period a year earlier—its performance for 2015 as a whole was dismal. André Macedo, manager of industry statistics for government agency IBGE, points out, however, that despite the welcome positive signs, production of capital goods in the first half of this year was still 41.3% below its historical peak in September 2013. He says, “Clearly there is a change in relation to the declining production trend that had been observed, especially in the case of capital goods.”
This has to do with an improvement in the mood of entrepreneurs regarding the future direction of the economy.”

Macedo cites numbers that justify caution: in the 12 months through June, production of capital goods, which tells how well investments are doing, had fallen a cumulative 26.9% over the previous 12 months, despite all the hope stimulated by the rising production since January. This is evidence that it would be unwise to bet on the view that has become common among analysts that the economy has reached the bottom and is now being driven by the more stable political situation.

Nevertheless, the positive IBGE capital goods production data, the National Development Bank’s financing for machinery, and IBRE’s economic surveys have brought about more cheerful expectations of recovery: the better performance of capital goods, especially production machinery and equipment, may indicate that the economy’s recovery is based on a sustainable upturn of investments, in contrast with the post-crisis recovery in 2008-09, which was driven by consumption—and which in the medium and long term had disastrous results.

**Caution for the moment**

IBRE’s technical manager of macroeconomic projections, Silvia Matos, is still advising caution, both about capital goods leading a general recovery and about the sustainability of the capital goods production recovery itself. When the situation is very bad, she notes, a slight improvement brings back optimism—even though the positive numbers for capital goods are well below comfortable levels achieved in the past.
“Clearly there is a change in relation to the declining production trend that had been observed, especially in the case of capital goods. This has to do with an improvement in the mood of entrepreneurs regarding the future direction of the economy.”

Andre Macedo

The Matos warning is aligned with recent assessments by representatives of the capital goods industry. The Brazilian Association of Machinery and Equipment (Abimaq) estimates that compared to May, in June net revenue increased by 4.2%, mostly due to domestic sales, which grew by 10.2%. However, compared to the same period last year, the data for the first half of 2016 suggest caution: total net revenue was 29.3% lower, sales-to-domestic market was 46.3% lower, and only exports went up, by just 1.1%.

Abimaq explained its skepticism: “The high idle capacity observed in the manufacturing industry makes uncertain the resumption of investment in the short term, even after the production peak in June 2016.” Indeed, data from the IBRE survey of industry are not encouraging: Despite its slight increase in recent months, in July the capacity utilization rate of the machinery and equipment industry was still only 66% and for the capital goods industry as a whole 67.4%, the durable goods industry 67%, and the entire manufacturing industry, 74.3%.

Brazil's capital goods production grew for six consecutive months through June 2016.

% change month-to-month, seasonally adjusted in 2015 and 2016

Source: IBGE.
Abimaq asserts that the June rise in domestic demand for capital goods was mainly met by imports of machinery and equipment, which almost doubled in value to US$2.32 billion—93.5% higher than in May. The association does not consider this reason for celebration. It attributes the more than 46% drop in domestic sales of machinery and equipment in the first six months of the year to double-digit interest rates (the central bank policy rate is 14.25%) that discourage investment. Moreover, this year’s appreciation of the exchange rate would have canceled out Brazilian industry competitiveness gains from devaluations in previous years, especially 2015. Abimaq also believes that those gains were not enough to restore industry profit margins, so that prices are below the cost of production inputs.

This analysis agrees with the assessment made by WEG, a leading Brazilian manufacturer of electrical machinery and equipment, in its balance sheet report for the second quarter 2016: compared to the first quarter net income fell by 9.7% to R$255 million, and net operating income declined by 3.4% to R$2.34 billion. In the report, Harry Schmelzer Jr., WEG president, said, “The business environment has continued difficult” and the focus of the corporation “remained in operational adjustments to preserve profit margins and returns, and increase generation of operating cash.”

“The situation is very bad, a slight improvement brings back optimism—even though the positive numbers for capital goods are well below comfortable levels achieved in the past.”

Silvia Matos

The Brazilian capital good industry is slowly coming out of the crisis.

(moving quarterly average index, seasonally adjusted, base 2012 = 100)

Sources: IBGE and IBRE.
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Schmelzer thinks expectations for the Brazilian economy “are not yet clear,” despite signs that the country is rising out of the economic cycle trough. As for foreign markets, which in the second quarter accounted for 59.9% of net WEG sales, he considers the environment not yet favorable to growth. From April to June, WEG’s foreign sales fell by 2.4% and domestic sales by 4.8%.

Though less skeptical than the businesspeople, IBRE’s Matos sees many question marks. She points out that although “exports have helped,” the credit essential for a healthy recovery is scarce. In June this year credit to the productive sector, which in 2012 and 2013 had been growing over 15% a month, increased by only 1%, mostly provided by government banks; so far in 2016 private bank credit has declined.

Matos points out that economic recovery itself could affect the exchange rate, which in turn could affect the incipient capital goods production recovery, noting “If the Brazilian economy improves, the exchange rate appreciates.” Exchange rate appreciation, which in part reflects an improved political environment, makes industrial products made in Brazil less competitive and imports cheaper, intensifying foreign competition in the domestic market.

Credit to the private sector plunges
% monthly growth, July 2015- June 2016

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<th>July 2015</th>
<th>August</th>
<th>September</th>
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<td>9.8</td>
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<tr>
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<td>10</td>
<td>5.4</td>
<td>7.7</td>
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Source: BNDES.
Because the world economy is weak, Matos says, competitiveness is even more essential for countries that wish to maintain their market share. In Brazil, the exchange rate has historically been a central factor in its competitiveness.

Matos points out that investment is driven by the growth outlook and the stability of the macroeconomic environment, adding that lack of credit, corporate debt, high idle capacity (especially in the durable goods and automotive sectors), and high interest rates are not favorable to growth. Moreover, “interest rates will only decline when the fiscal adjustment is clearer,” she says. And, inflation, especially food, has been more resistant than expected to the bitter medicine of high interest rates.

Matos concludes that “The patient has left the ICU, but is still sick.” She does not see economic growth of over 2% in 2017.

“The high idle capacity observed in the manufacturing industry makes uncertain the resumption of investment in the short term, even after the production peak in June 2016.”

Abimaq

Uncertain path
Aloisio Campelo Junior, IBRE’s superintendent for economic cycles, also sees a very foggy horizon where the recovery of the economy and the capital goods sector are concerned. “Investment fell by 18.5% in the fourth quarter of 2015 compared to the same period a year earlier,” he explains. He also notes that investments have been declining since the fourth quarter of 2013. “The biggest blow from the crisis was to durable goods, which was aggravated by the elimination of incentives to consumption,” Campelo said.

Although idle capacity remains high both in capital goods and the manufacturing industry generally, raising concerns about the sustainability of recovery,
Investment is driven by the growth outlook and the stability of the macroeconomic environment … lack of credit, corporate debt, high idle capacity (especially in the durable goods and automotive sectors), and high interest rates are not favorable to growth.

IBRE’s Survey of the Manufacturing Industry has been more positive: “Industry confidence has improved significantly. Between August 2015 and July 2016 the Industry Confidence Index has risen from 71.9 points to 90.5 in the machinery and equipment segment, 73.8 to 84.0 in capital goods, and 73.5 to 87.1 in manufacturing as a whole. In the same reporting period, the Current Situation Index jumped from 68.7 points to 89.1, 71.1 to 84.0, and 71.4 to 85.2.

Maintaining achievements
Exports were vital to the recent increase in Brazilian production of machinery and equipment and capital goods, according to the Foreign Trade Studies Center Foundation (Funcex). In July, exports of machinery and equipment grew 10.6% in volume, compared to the same month last year, and by a cumulative 18.9% in the first seven months of 2016.

Carlos Frederico Rocha, professor in the Industrial Economics Institute of the Federal University of Rio de Janeiro (UFRJ), believes the good performance of exports is the main factor in the growth of the Brazilian capital goods industry. “We have some capital goods companies that are active in the external market, especially in the segments in which we are more competitive, such as agriculture and energy,” he noted.

Rocha has two explanations for the rise in capital goods exports: a more competitive exchange rate and more competitive companies, with the latter having a more powerful effect. As the domestic marked for capital goods contracted, competitive companies went abroad in search of alternative markets. But access to foreign markets is not immediate and has a
high cost, so it will take time. Domestically, he said, the recovery of the capital goods industry generally follows improvement of the general level of economic activity rather than leading it.

Rocha does not consider exchange rate policy to be a way to boost competitiveness—in his opinion, competitiveness is essentially an issue of business strategy. Smaller companies need to understand the importance of maintaining both domestic and foreign markets, and invest in production capacity to support that. “You cannot fix this with government policies,” he says.

José Ronaldo Castro Souza Junior of the Institute of Applied Economic Research (IPEA) finds it natural that sectors that suffered most from the crisis, such as capital goods, are the first to recover: “Despite the large idle capacity, there is excess capital in many areas,” which would justify the investment recovery now being seen. He also argues that idle capacity does not necessarily mean that a company does not need to invest; the idle capacity may occur in an industrial park of low productivity that needs to be modernized to meet the challenges of competitiveness when demand recovers. In his opinion, companies need to begin to invest in the renewal of their machinery and

### Investment shows a timid recovery in 2016

(Base average 1995=100)

![Graph showing investment recovery](image-url)

**Sources:** Funcex, Pnad and IBGE.
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If exports are at the forefront of recovery for the capital goods sector, there are also signs of recovery in the domestic market, as is evidenced by applications for BNDES credit lines for the purchase of machinery and equipment for domestic production. Data into August show an upward trend, although the cumulative values of R$12.81 billion are still below the R$19.63 billion in 2015.

Except for agricultural machinery, BNDES disbursements for the capital goods sector are also somewhat positive but disbursements for capital goods excluding transport continue to show more negative growth than positive, though results were positive in June at 12% and in July at 1%. As for the agricultural sector, BNDES disbursements declined by 16% in June and 31% in July; however, this may be a seasonal phenomenon because in those months farmers are more occupied with financing the next crop than with renewing machinery.

The GDP seesaw
% change quarter-to-quarter

Sources: Funcex, Pnad and IBGE.