

Brazil's rising trade imbalance

Brazil's trade deficit has not been this high for 20 years. Does yet another policy need to be rethought?

Solange Monteiro, *Rio de Janeiro*

THE BRAZILIAN TRADE BALANCE DEFICIT in the first seven months of 2013 was US$5 billion, the highest recorded since 1993. It has deeply disappointed the expectations of analysts, who hoped for a recovery last July. The trade deficit will push up the external current account deficit, turning the spotlight on the less bright side of the Brazilian growth model in recent years—dependence on external financing to boost domestic consumption and on favorable prices for our exports at the expense of increasing competitiveness.

In addition to international reserves of over US$370 billion and a favorable external debt profile, today Brazil has solid fundamentals and is in a good position to adjust the balance of payments, which in June recorded a deficit of US$72 billion. However, any adjustment will directly impact incomes and credit. "In the situation we're in, either we produce more, more efficiently, or we consume less.

Clearly this will affect people directly," says Silvia Matos, coordinator of the IBRE Economic Outlook. "When the external outlook is favorable, we can have higher domestic absorption, because the world is financing us. But now the external outlook is deteriorating in a domestic context in which Brazil has many problems, among them high inflation, rising interest rates, low growth in investment, and no growth in the economy," Matos says.

Lia Valls Pereira, IBRE coordinator of external sector studies, emphasizes the importance of the trade balance in this context, commenting, "The prospect of a future without the trade surpluses of US$40 billion that financed deficits in services and income has made Brazil dependent on more volatile portfolio investments, which increases our external vulnerability."

Tatiana Prazeres, former Secretary of Foreign Trade of the Ministry of Development, Industry and Trade (MDIC), maintains that "The government holds to its original estimate: 2013 will be difficult, but we will continue to export at a high level, close to the levels of 2011 and 2012"—which would be the very optimistic range of US$10–19 billion. Prazeres noted that the trade balance deficit in the first half of 2013 reflected the delayed recording of various import operations made by the oil company Petrobras in 2012 and the drop in Petrobras production caused by scheduled shutdowns for oil rig maintenance. "We had a significant reduction in exports in the first six months, 48%, and a significant increase in import costs," she said. From January to July, the oil account deficit alone was US$15.4 billion.

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For Bráulio Borges, an economist with LCA Consulting, recovery of oil production will have a positive effect on the trade balance in 2014."Oil rigs will be working again with a larger production capacity. And six new oil rigs will start operating in the second half of the year," he says. But Pereira points out that there is a risk of lower U.S. demand for oil because of the increased supply of U.S. shale gas.

Though clearly relevant, oil has not been the only variable affecting trade. Expectations for exports of minerals and agricultural products depend on China, where the economy is slowing and domestic demand is rebalancing from infrastructure to consumption. Borges notes that "One would expect a change in the prices of commodities. Prices of metals will weaken . . . because Chinese investment in fixed capital will no longer be growing at 40% to 50% a year. On the other hand, Chinese consumption will

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Lower Chinese demand is the main channel for the contagion of slower global growth to reach Brazil. According to the International Monetary Fund, in the last three years global GDP grew only 3.1%. That lower global growth has helped bring about the worsening of Brazil's trade balance. Last year, internationally exports increased by less than 2% in volume and this year should approach just 3%. The historical average is about 7% a year.

If growth of the U.S. economy is confirmed at close to 3% in 2014, and global growth is close to 4%, how much would Brazil be able to benefit from the recovery?

INDUSTRY

Brazilian exporters of manufactured goods have hopes of maintaining an undervalued currency to guarantee gains in competitiveness. "The important thing here," Pereira says, "is that there is exchange rate stability. As long as the new

Warning sign: Brazil's trade balance has deteriorated significantly in the last 3 years.



* January-June for current account balance and January-July for trade balance.
Sources: Ministry of Development, Industry and Commerce, and central Bank of Brazil.

exchange rate level is unclear, exporters will feel insecure about the best time to sell, afraid to make losses."

"Many factors led to a worsening of the trade deficit in manufactures . . . and the exchange rate issue is one of them," Borges says. He explains that there was continuous appreciation starting in 2003 that reached R$1.60 to the U.S. dollar early in 2011. Only in mid-2012 did this scenario begin to change slightly. Stronger growth of the U.S. economy growth, he notes, will cause the dollar to appreciate. "This means that the trade deficit in manufactures should decline in coming years, or at least not continue deepening," Borges says, pointing out that a depreciated exchange rate will also reduce imports.

For a sector where competitiveness is a chronic problem, however, an exchange rate of R$2.25 to the dollar may not be enough to offset the Brazil cost. "It's a relief; it somewhat improves the trade balance," says José Augusto de Castro, chairman of the Brazilian Foreign Trade Association (AEB). "If we had decent infrastructure, a civilized tax system, normal interest rates, and less bureaucracy, an exchange rate of R$1.80 per dollar would be acceptable. But today we have to depend on [a much depreciated exchange rate], and ideally it should reach R$2.50."

For Castro, a lower exchange rate will not be enough to stimulate exports, or discourage imports, which are growing. A survey by the National Confederation of Industries (CNI) shows significant growth in the use of imported inputs in manufacturing—21% in the first half of 2013. Among sectors where there have been major increases are computers, electronic and optical goods, pharmaceutical chemicals and pharmaceuticals, textiles and clothing, and metal products. "It seems that R$2.25 is still not enough to cause a reversal of this situation," says Marcelo Azevedo, CNI economist.

"What generates economic development is trade flows, and we need to stimulate those by adding more value to exports."

José Augusto de Castro

For manufacturing exporters it will be crucial to rebuild market share in Europe as well as recover the dynamics in markets like Argentina, Brazil's third largest trading partner.

THE CURRENT ACCOUNT

Castro thinks, however, that increased sales of manufactures because of a depreciated exchange rate will only keep Brazil's exports around their historical 10% of GDP. With the outlook for the trade balance less auspicious, the government will be forced to check the uncontrolled growth of the current account deficit. According to IBRE staff, Brazil has sound fundamentals and an economic policy that make it possible to adjust the external balance without plunging the country into crisis. But this will require addressing the consumption-led growth that has been a government target in recent years.

CONTINUED UNCERTAINTIES IN BRAZIL-ARGENTINA TRADE

Solange Monteiro

FOR THE THIRD BIGGEST MARKET for Brazilian exports, Argentina, the medium-term economic outlook for foreign trade is unfavorable. "This year we still anticipate a dynamic second half, but next year the scenario promises to be more mixed, with some difficulty in finding foreign currency for foreign trade," says Enrique Dentice, coordinator of the Center for Economic Research at the University of San Martín, Buenos Aires.

The fiscal and currency crisis that has affected the Argentina since 2011 has significantly reduced the international reserves that support foreign trade. "Our economy is more open than Brazil, and production of both commodities and manufactures depends on imported inputs," Dentice says. He calculates that "for Argentina, a 30% growth in imports results in 1% GDP growth."

Because of the shortage of foreign currency, the government is releasing imported products and materials slowly, which is slowing down economic activity in Argentina. "This situation benefits some sectors like automotive or steel industries that have advantages in negotiating the purchase of foreign currency. However, it has a different effect on industries like textiles, which mainly supply the domestic market, which is protected by the government, and must pay high prices for foreign currency. That was the reason that Brazilian mining company Vale was forced to exit Argentina," Dentice points out, referring to the Rio Colorado potassium mining project that Vale abandoned last March. It was the largest foreign direct investment in Argentina—about US$6 billion, creating 2,700 jobs.

"Argentina's economy is not dependent just on Brazilian industrial goods . . . Today Brazil is also our major direct investor," Dentice says. The insecure business environment, however, has reduced the appetite of Brazilian corporations for investing in Argentina. In January, the Brazilian oil company Petrobras sold its stake in EDESUR, which distributes electricity. EDESUR has been running losses because of government controls on electricity rates. In April, Duratex closed its hydraulic products factory; and in June, Argentina President Cristina Kirchner canceled a rail contract with ALL Logistics.

The best hope for reversing Argentina's current situation is investment in the exploitation of its shale gas, ranked among the top five reserves in the world. The state-owned oil company YPF has an agreement with Chevron that provides for it spending US$1.2 billion in Vaca Muerta in the province of Neuquén. The government also intends to stimulate public investment in shale gas by issuing a Treasury bond with an interest rate of 4% a year and a tax amnesty for dollars reinvested in the country. "We will see what the response of economic agents is," says Dentice. He has pointed out that a similar instrument was launched in early July without much success. The Certificate of Deposit for Investment (Cedin) offers a 90-day tax amnesty, and the same rate of 4%.

By attracting dollars that are outside the formal foreign currency market, the government hopes to maintain its current level of international reserves and set a ceiling on the price of the dollar in the informal market, where this year the difference with the official exchange rate has been more than 100%. "In the first month, the new financial instrument had little effect," says Dentice. "Purchases have not yet reached US$8 million, and the initial expectation was at least US$4 billion." The government estimates that Argentines have US$200 billion deposited in offshore accounts or under their mattresses. "There is no lack of financial instruments to stimulate investment, but uncertainties abound," Dentice concludes.

In the short term, the alternative is to reduce consumption and investment. "Between the two, it is best to adjust consumption," Silvia Matos says. Depreciation of the exchange rate should reduce income, she notes, inhibiting domestic demand.

Sandra Manuelito, economic affairs officer of the UN Economic Commission for Latin America and the Caribbean (ECLAC), points out that for some years Brazil has stood out in the region for attracting foreign direct investment (FDI). "In the early 2000s FDI represented about 16% of GDP and is now closer to 20%," she says. However, a recent ECLAC study warns that in recent years FDI in Brazil and other Latin American countries has compromised the quality of economic growth. "The large FDI flows were concentrated in two sectors, domestic commerce and services, which cater to domestic consumption but contribute little to exports, and the production of commodities, which works against diversification of exports, generating vulnerability," Manuelito says. She argues that a solid exporting industrial base can generate export revenues to balance FDI-related external obligations, such as remittance of profits.

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AEB's Castro warns that much of the FDI coming into the country relates to mergers and acquisitions, not new business: "Currently FDI in Brazil purchases a company that is already established; there are no new investments." Luis Afonso Lima, president of the Brazilian Society for the Study of Transnational Corporations and Economic Globalization (SOBEET), confirms that "Today, less than 50% of FDI coming into the country is [invested in new industries]." SOBEET estimates that Brazil will be by 2015 the

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fifth preferred destination for FDI, even if some conditions—reduced purchasing power and tighter credit—suggest the possibility that the investments will be less profitable. "However, FDI will not completely bankroll the current account deficit as it did in the recent past. The deficit has grown because of structural and external factors, and investment is declining. Now, it's up to us to do our homework," he says.

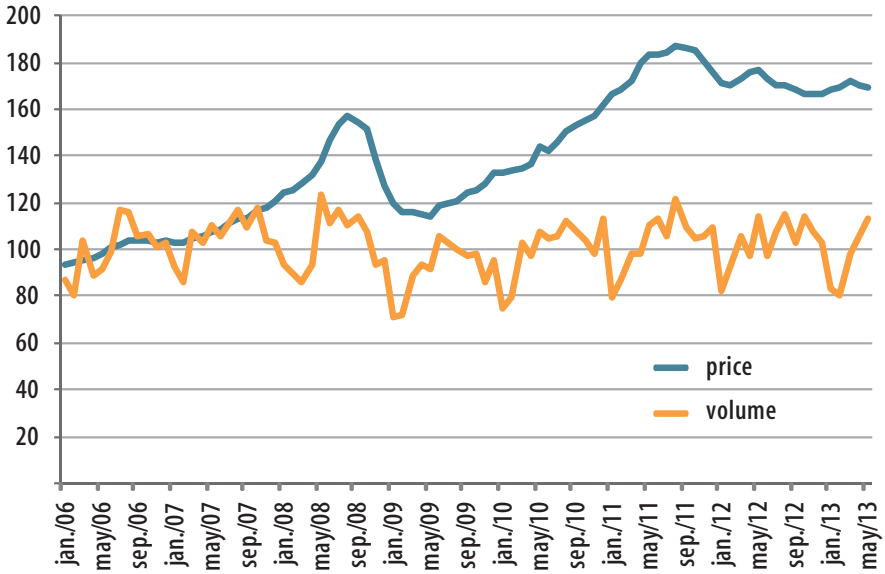
With little domestic savings to invest and no more large trade surpluses, Brazil will have to adjust. "Having a current account deficit is not necessarily bad," Matos says. She cites as an example Australia, which has had a deficit in its balance of payments of more than 4% of GDP since the 1980s. But its macroeconomic framework has enabled Australia to survive major international crises without major damage. "Australia has opted for a low level of industrialization and focused its activities in commodities and services, where it is competitive," says Matos. To do the same, Brazil would have to ensure a sound fiscal balance as well as opt for less industry. For Matos, a key step toward an external adjustment is the end of remedial policies to maintain a large industrial sector.

In contrast, AEB's Castro calls for major reforms that will ensure that Brazil's industry



Since mid-2011 prices of Brazilian exports have declined slashing significantly the trade surplus.

(price and volume indexes)



Sources: Funcex and MDCI.

is competitive. "The measures that we see, the temporary relief programs, are all cyclical, not structural. As long as Brazil does not make the necessary labor and tax reforms, there will be no gain in competitiveness," he says. "A trade balance surplus is always a consequence, not a cause. What generates economic development is trade flows, and we need to stimulate those by adding more value to exports," he adds.

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