

China opens its eyes to Brazil

Angelica Wiederhecker, Beijing, China

Brazil has been one of the biggest beneficiaries of the China boom of the last decade. At the start of the century China was not even one of Brazil's top 10 export markets, occupying 12th place. Yet in less than a decade, the country has overtaken the US to become Brazil's biggest commercial partner. Driven by China's ferocious appetite for commodities, Brazil entered its own cycle of expansion in recent years, and the importance of the Chinese market was underlined during the global financial crisis. The US and Europe suffered the sort of recession that had not been seen since the 1930s, yet the Brazilian economy continued to prosper, fuelled by China's huge program of infrastructure

spending, which led to record imports.

Yet the initial gains from Brazil's ties with China are wearing out. Instead, economic relations between the two countries are entering a new phase, one that presents both risks and opportunities. The bad news is that Brazil could be about to receive a new wave of exports from China that will compete not only in the domestic market with goods produced by Brazilian companies but also in other markets that are important for Brazil, especially the other countries in Latin America. The good news is that the long-awaited surge of Chinese investment is finally beginning. The crucial question is whether Brazil has the

capacity to take advantage of such investments.

New wave

The impressive expansion in the economy in the first half of 2010 — the fastest growth in at least 14 years, according to the Brazilian Institute of Geography and Statistics (IBGE) — has allowed Brazil to return to its pre-crisis growth. In 2009 Brazil suffered six months of recession and the economy shrank by 0.2%, but this year Brazil should grow by about 5%, making it an attractive alternative for companies worried about sluggish markets in the US and Europe, which the IMF forecasts will grow by just 3.1% and 1% this year.

As a result Chinese entrepreneurs are demonstrating increasing interest

in the region: “We consider emerging markets such as Brazil to be strategic, given that they have not been so severely affected by the crisis,” says Wu Zengqi, senior vice president at ZTE, the Chinese telecom equipment manufacturer. “Our strategy is to increase our investments in Latin America, especially in Brazil.”

ZTE is one of the biggest Chinese multinationals, with sales of US\$8.8 billion in 2009; it has had a presence in Brazil for about eight years. But it is not just the giants of corporate China that have their eye on the Brazilian

market. Many small and medium-sized companies, which in the past would not have seriously considered trying to do business on the other side of the world, are looking at the country as an important growth opportunity.

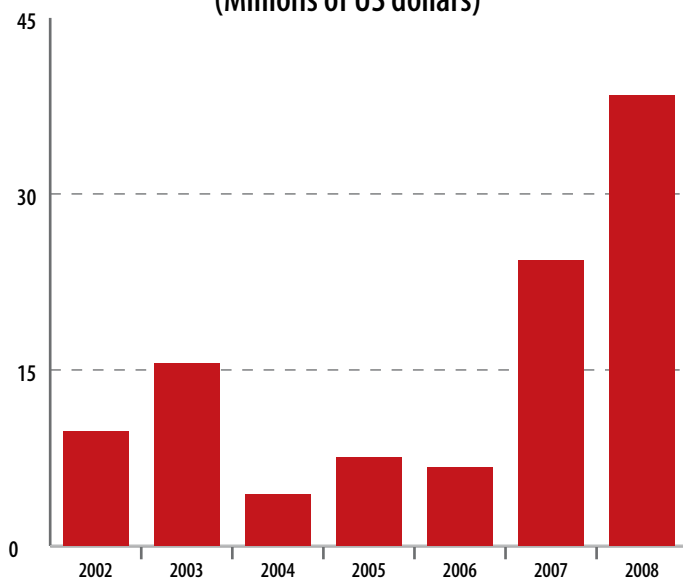
Sichuan Great Trading, which is based in Chengdu in south-west China, makes a broad range of hand tools, such as screwdrivers, saws, and hammers. After taking part in a commercial visit to Brazil last year, the company is planning to establish itself in this market. “It is only now that we are starting to take the Brazilian market

Chinese entrepreneurs are demonstrating increasing interest in the region, in particular in Brazil.

seriously,” says Qi Kejun, marketing director. Qi says that because Sichuan Trading is state-owned, it is usually more conservative in assessing new markets than a private company might be. In the past, it concentrated mostly on Europe and the US, but with the crisis the outlook changed. “We are very enthusiastic about the Brazilian market, which could be very promising for made-in-China products,” Qi says.

Shirley Woo, director of Guangdong Yulong, a medium-sized furniture company in the south of China, said there is growing interest in Latin America, especially Brazil. “It is a new market for the company, so we do not have much experience, but we see great potential,” she says.

China's direct investment in Brazil
(Millions of US dollars)



Source: Central Bank of Brazil.

The threat from Chinese exports is a factor throughout Latin America, where China is advancing rapidly in markets that are important for Brazil.

The company exports its own ready-made furniture for Brazilian clients but is also interested in doing contract manufacturing.

An analysis of Chinese exports shows how the crisis has led the country to accelerate geographic diversification of its exports, with emerging markets becoming increasingly important. Chinese trade figures for the first five months of 2010 show an 110% increase in exports to Brazil; Russia was in second place among major markets with a 92% increase. “The recovery in exports since the start of the year has been driven by the strong rebound in other developing economies,”

says Ha Jiming, economist at China International Capital Corporation, an investment bank.

The growing Chinese presence in developing economies is partly a reflection of the slow-growth forecast in advanced economies, but it is also a result of China’s exchange rate policy. Until last week the renminbi was pegged to the US dollar. When the currencies of several other emerging economies, such as Brazil, India, and South Korea, appreciated significantly against the dollar, the renminbi depreciated by about 14% against those currencies, boosting the competitiveness of Chinese goods and services. The World Bank notes that in the first five months of 2010, Chinese exports were 10% above the level in the same period in 2008, before the start of the crisis. That clearly indicates that Chinese companies have increased their share of exports, considering that globally imports are still below pre-crisis levels.

Chinese competition

The threat from Chinese exports is a factor throughout Latin America, where China is advancing rapidly

in markets that are important for Brazil. This is especially worrying for Brazilian manufactured goods, whose principal destination is South America. According to a study by Kevin Gallagher, professor of international relations at Boston University, 39% of all Brazilian exports are under threat from goods imported from China, but the competition is even more intense in the case of manufactured goods, with 91% under threat from lower-priced Chinese goods. In the case of hi-tech products, the share is an even higher 94%.

The brutal competition from Chinese goods is reflected in the relative positions of Brazil and China in the global market. China’s share in global exports of manufactured goods rose from 0.4% in 1985 to 11.5% in 2006, while Brazil’s fell from 1% to 0.8%. “China is increasingly winning the competition with exporters of manufactured goods from Latin America in the world and in regional markets, and the worst is yet to come,” said Gallagher, one of the authors of the book *The Dragon in the Room — China and the*

Future of Latin American Industrialization.

The increase in Chinese competition would not be so problematic if Brazilian companies were thriving in the Chinese market, but they have faced a range of challenges. Embraer, a Brazilian aircraft manufacturer and one of the rare examples of higher-value-added manufacturer establishing itself in China, could see its plans there curtailed. Embraer, which has had a joint venture with state-owned Avic II since 2003, currently assembles ERJ-145 jets with 50 seats, and all its orders will be delivered by 2011. The principal objective for the company now is to start producing a regional jet (in the E-190/195 family) with capacity for 120 passengers, for which it needs Chinese government authorization.

If it is not able to produce a plane suited to local demand, the company could close its activities in China. “We expect a conclusion of the negotiations and a decision on the part of Embraer about remaining [in China] in the coming months,” said a spokesman for the company, who observed that “the cultural differences between the

two countries have had a big impact on the business and the strong presence of the state and the tight regulation of the market are very different from the situation in Brazil.”

The showdown between Embraer and the Chinese government is part of a broader picture of the increasing difficulties of foreign companies operating in China. Beijing has been making growing demands in terms of transfers of technology and jobs in return for access to the Chinese market. “In the last 20 years, I have not seen the foreign business community in China so disillusioned,” says James McGregor, a former director of the American Chamber of Commerce in China.

Even with raw materials, the situation is becoming more complex. The Brazilian mining company, Vale do Rio Doce, has prospered in China, but it has also come up against obstacles. The negotiations over the benchmark price for iron ore have become a delicate subject, especially after executives from the Anglo-Australian group Rio Tinto received harsh prison sentences of up to 10 years

China’s share in global exports of manufactured goods rose from 0.4% in 1985 to 11.5% in 2006, while Brazil’s fell from 1% to 0.8%.

in March for taking bribes and stealing commercial secrets. The investigation and the punishment of the executives followed a complex series of events, starting when the Chinese group Chinalco was frustrated last year in its attempt to buy a stake in Rio Tinto, which infuriated the Chinese. In 2009, after prices dropped during the crisis, China also demanded a discount of 45% from the iron ore price the year before, but the company stuck to the 33% discount that it was offering the rest of the market.

As tensions in the sector have been growing, Vale has been reducing its shipments to China, although the country remains its biggest market in terms of revenue. Prices in the

China's growing interest in Brazil could also translate into significant investments, especially in natural resources.

Chinese market have fallen 10% since April, when the Chinese government adopted measures to contain speculation in the property sector; as a result, China accounted for 32% of Vale's sales in the first quarter, down from 45% last year, according to the consultancy CreditSights. José Carlos Martins, Vale's executive director for ferrous minerals, said recently in Shanghai that the company's dependence on China would be reduced this year because other markets were growing.

Investment

Although the new Chinese export offensive is a sign of tougher competition ahead for Brazilian goods, China's growing interest in Brazil could also

translate into significant investments, especially in natural resources. After years of high expectations in Brazil, Chinese investment in the local market is finally becoming a reality. Last December Wuhan Iron & Steel Group (WISCO) announced it would invest US\$400 million in the mining company MMX, owned by Eike Batista, in exchange for a 21.5% stake in the company. Among the projects that MMX could develop are a steel mill in the port of Açú in Rio de Janeiro state, which could cost US\$5 billion, and two mines in Minas Gerais state.

In early 2010 Sinopec, the second biggest company in the Chinese energy sector, completed the construction of an 856 mile pipeline in Brazil. The project, which runs through 72 Brazilian cities and has the capacity to transport 20 million cubic meters of natural gas a day, is one of the biggest Sinopec has built. In a separate deal, China Development Bank loaned Brazil's oil company, Petrobras, US\$10 billion, which will help fund a broad investment plan, including development of the pre-salt oil reserves,

considered the biggest find in the Americas in more than three decades.

Recently, the Chinese have also displayed interest in purchasing land in Brazil so that they could start cultivating soybeans. In April 2010 the daily Chongqing News in central China published a report that the Chongqing Grain Group, a state-owned company, was considering investing US\$300 million to buy land in Bahia. "This is an inflection point in the relationship between Brazil and China," says Tatiana Rosito, the economic counselor at the Brazilian Embassy in Beijing, referring to the Chinese investment wave.

The new competitive threat to Brazil from Chinese exports has reopened the old debate about whether the country will be able to take full advantage of its economic links with China. The concentration of Brazilian exports in commodities has suggested to some commentators that the relationship has a neocolonialist echo that could leave Brazil dependent on China's development. Nevertheless, the same comparative advantages can be used in Brazil's

interest. China has large amounts of capital and vast experience in infrastructure building, which could help Brazil sort out some of its deficiencies.

Brazil, however, has a lot to learn about how to attract direct investment from China. “Both countries need more chances for interaction,” says Sun Hongbo, a researcher at the Center for Latin American Studies of the Chinese Academy of Social Sciences, citing the lack of mutual knowledge as an obstacle to a closer economic relationship. Sun also says that it can be confusing for Chinese companies wanting to do business in Brazil when state governments and the federal government have different demands or positions about particular projects.

Many economists and government officials believe that if Brazil and the rest of Latin America are to survive this new Chinese offensive, they will need a more coherent industrial policy. Javier Santiso, an OECD economist, highlights the importance of diversifying exports and pushing



Sun Hongbo

forward with reforms, especially in infrastructure. An Economic Commission for Latin America and the Caribbean (ECLAC) report published in May makes similar arguments, pointing out that to truly benefit from the Chinese boom. Latin American countries need to broaden the range of their exports, particularly higher-value-added goods.

“China is rapidly building the technological capabilities needed for industrial development, whereas Latin American countries are not paying enough attention to innovation and industrial development,” says Kevin Gallagher. “Diversification and innovation should be at the core of the debate about economic policymaking in the region.”

To truly benefit from the Chinese boom, Latin American countries need to broaden the range of their exports, particularly higher-value-added goods.

From enemy of the Chinese state to thriving entrepreneur



Yin Mingshan is a legend in the Chinese business world. During Mao Zedong's regime, he was sent off to a labor camp as an "enemy of the state." Years of

hardship followed before he managed to cleanse his reputation and scrape together the funds to set up his own company, Lifan, an automaker based in the city of Chongqing in central China. Yin took advantage of the gaige kaifang ("reform and opening") period initiated by Deng Xiaoping to expand his business from what had been a small manufacturer of spare parts for motorcycles into the biggest Chinese exporter in that sector. In 2003 he decided to diversify into automobiles, just as the local market was taking off.

Yin is enthusiastic about the prospects for trade with Brazil, which was the company's biggest export market in 2008, before the global crisis slowed the world economy. He believes that "This year Brazil will go back to being our biggest market," and predicts that Lifan's sales to Brazil will surpass the US\$70 million achieved in 2008. In 2010 the company will attempt to expand its sales of cars as well as motorcycles. "Brazil is a very promising market, with a vast territory and a big domestic market," he says, "Some Chinese businessmen are foolish enough to ignore Brazil, but I am not that stupid."

The company currently has an auto assembly factory in Uruguay whose main markets are Brazil and Argentina. Uruguay was chosen as Lifan's first base in South America because it is part of Mercosur, which enables the company to sell cars to the other member countries without incurring import duties, and because of its relatively cheap labor. "We will probably set up a factory in or around Brazil," says Yin talking about his plans for manufacturing motorcycles in South America, although Argentina and Paraguay are also being considered. "Our decision will be made this year, or next year at the latest."

As trade ties with Brazil grow, he says, exports must be offset by imports so as to minimize currency risks. "Otherwise, we would be seriously affected by any volatility in the currency markets, exposing our business to a lot of turbulence," Yin says. One of his solutions is to increase imports from Brazil. On Lifan's shopping list are food products, iron ore, and steam engines in addition to the car engines it already imports: "We want to start with these purchases gradually, expanding our cooperation with Brazil." Yin believes ethanol is another promising prospect for bilateral trade, with a lot of room for technical collaboration, although this idea still awaits a green light from Beijing.

Yin considers the need to use the US dollar as the reference currency for their trade as the biggest hurdle to expanding the ties between Brazil and China. "If this problem is solved, our trade with Brazil would increase substantially," he says. "This is the single biggest obstacle to doing business with Brazil today."