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Fuel price policy: Who wins?

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The BRAZILIAN ECONOMY

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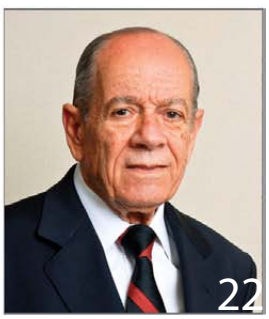
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THE BRAZILIAN ECONOMY









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Although Petrobras has the legal right to set prices, the government often assumes that prerogative, as it has recently. But although consumers and retailers may be pleased, a wider view of the economy reveals distortions that harm Petrobras and ethanol producers and will ultimately inhibit growth. Cláudio Accioli and Solange Monteiro consult experts to get a sense of how the fuel price issue will play out, and consult the CEO of Petrobras about what lies in the oil company's future.

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Despite tax reductions that have put more flex cars on the road, ethanol has still not been able to establish a solid position as a fuel because it costs more than gasoline—especially since the government lowered gas prices. Solange Monteiro analyzes the pressures on the industry and what might be done.

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Former Finance Minister Ernane Galvêas, now consultant to the National Commerce Confederation, explains to Cláudio Accioli how the "excessive burden" of government intervention in the economy has inhibited investments and thus economic growth. He also points out that because activities of the Central Bank and the Treasury contradict each other, "There are two monetary policies in Brazil."

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28 2013: What can go wrong? And what may go right?

Though economic indicators released early in 2013 shows signs of continuity with the end of last year, at least some of them were surprisingly positive. Growth in 2013 will be better and more robust than in 2012—but a growth rate of 4% is not yet on the radar.

ECONOMY

Job creation falls in January
According to the Labor Ministry General Register of Employed and Unemployed, only 28,900 new jobs were created in January, 75.7% fewer than the 118,895 jobs generated in January 2012. (February 22)

Current account deficit again widens
Brazil's monthly deficit widened to US$11 billion in January from US$8 billion in December, the central bank reported. The 12-month current account deficit also widened, to US$59 billion, 2.6% of GDP, from US$54 billion in December, 2.4% of GDP. The main problem was the trade balance, which recorded a deficit of US$4 billion compared with a surplus of US$2 billion in December. (February 22)

Sixth monthly fall in consumer confidence
In February the seasonally adjusted Consumer Confidence Index of the Getulio Vargas Foundation declined by 1.4% from the January figure, the sixth consecutive monthly fall. In the last three months, confidence has been heavily influenced by consumer dissatisfaction with the current situation, though expectations about the future of the economy remain positive. (February 26)

Industry confidence up slightly
The Industry Confidence Index increased by 0.1% in February compared to January, the Getulio Vargas Foundation stated. The finding reflected an increase of 1.4% in industry expectations for the future of the economy, which more than offset a decline of 1% in the industry assessment of the current situation. (February 28)

Brazilian economy grew 0.9% last year
The Brazilian economy grew only 0.9% in 2012 compared to 7% in 2011 and the worst performance since 2009. GDP amounted to R$4.4 trillion (US$2.2 trillion) in 2012. However, after falling for five consecutive quarters, investments rebounded in the last quarter, growing 0.5% compared to the previous quarter. (February 28)

Trade balance deficit of US$1.2 billion in February
Imports totaled US$16.8 billion, 8.8% more than in the same period of 2012, against US$15.6 billion in foreign sales, 8.9% less than last year, according to the Ministry for Development, Industry and Foreign Trade. In the first two months of the year, the trade deficit totaled US$5.3 billion as exports plunged and imports of oil and its derivatives went up. (March 1)

Stocks down, the real up
The Stock Exchange (Bovespa) recorded a fall of 3.91% in February —the worst monthly performance since May 2012—for a total loss of 5.79% in the first two months of 2013. Particularly hard-hit were electricity utilities and state-owned oil company Petrobras. The real ended the month at R$1.978 per U.S. dollar, appreciating 0.59% in February and 3.22% since December. (February 28)

Industrial production up in January
Industrial production rose 2.5% month-on-month in January, bringing year-on-year growth to 5.7%, according to government statistics agency IBGE. Leading the increase was capital goods, up 8.2% month-on-month largely due to a jump in transport equipment. However, production could head back down in February, judging from recent data on car production. (March 8)

Cheaper electricity holding back inflation
Official inflation as measured by the National Consumer Price Index was 0.60% in February, compared to 0.86% in January, according to IBGE. Through February, 12-month inflation was 6.31%, nearing the target ceiling of 6.5%. Lower electricity rates, which were 15.17% cheaper in February, are helping suppress inflation. (March 8)

JUDICIARY

Chief Justice's low opinion of judges
Chief Justice Barbosa recently told the press that Brazilian judges have a "conservative, pro-status quo, pro-impunity" mentality. He also believes that the independent public prosecutors in the Public Ministry are "with very few exceptions, rebels against the status quo." The Association of Brazilian Magistrates, the Association of Federal Judges of Brazil, and the National Association of Judges of the Labor Court issued a public statement characterizing Chief Justice's comments as "prejudiced, general, superficial, and especially disrespectful." Last year, the Supreme Court clashed with Congress and judges over decisions involving corrupt congressmen and government officials. (March 3)

INTERNATIONAL

Brazil/Russia to cooperate on agriculture and defense

Brazil and Russia have signed several agreements to increase trade and to advance cooperation in defense, energy, and agriculture, including Brazilian purchase of Russian anti-aircraft missile batteries on condition that Moscow agrees to transfer technology. The agreements are expected to expand trade from US$5.9 billion to US$10 billion in the next three years. Brazil is interested in buying medium-range surface-to-air Pantsir S1 combined missile and artillery batteries and Igla-S shoulder-held missiles, as well as learning to build the weapons itself. Brazilian officials said Medvedev's visit advanced talks to eliminate hurdles that are slowing Brazil's meat sales to Russia, its largest buyer. Other agriculture issues were related to Brazil's purchase of Russian wheat and the sale of its soy meal and pork to Russia. (February 22)



Photo: Antonio Cruz/Agencia Brasil.

Russian Prime Minister Dmitry Medvedev and Brazilian President Dilma Rousseff.

ECONOMIC POLICY

January primary budget surplus a record

Brazil posted a primary budget surplus of R$30 billion (US$15 billion) in January after a surplus of R$22 billion (US$11 billion) in December. The strong result was aligned with an increase in central government tax collections. Investors keep close watch on the primary budget surplus—the excess of revenue over expenditures before interest payments are taken into account—because it measures a country's ability to service its debt. Tax revenues jumped last month because many companies paid some taxes early, though it is not clear why, and it is too early to say what that portends for revenue performance as a whole in 2013. (February 26)

Rousseff veto of oil royalties bill overturned

On a vote of 54 senators to 9, Congress overturned President Rousseff's veto of a law that would have restructured the payment of royalties to states for oil exploration. The overthrow of President Rousseff's veto has raised concerns among investors and state governments about legal uncertainty for the next auction of oil exploration blocks in May, and may drive away potential investors. (March 7)



Photo: Marcello Casall Jr. /Agencia Brasil.

National Treasury Secretary Arno Augustin announces the budget balance for January 2013.

Central bank policy rate again unchanged

The decision to keep the policy rate at 7.25% was unanimous. However, the accompanying statement did not reference the bank's previous commitment to "stability of monetary conditions for a sufficiently prolonged period" as the optimal strategy to ensure that inflation converges to target, although it did emphasize the need to monitor macroeconomic developments up to the next policy meeting. This more data-driven approach increases the likelihood that monetary policy may soon begin to tighten. (March 7)

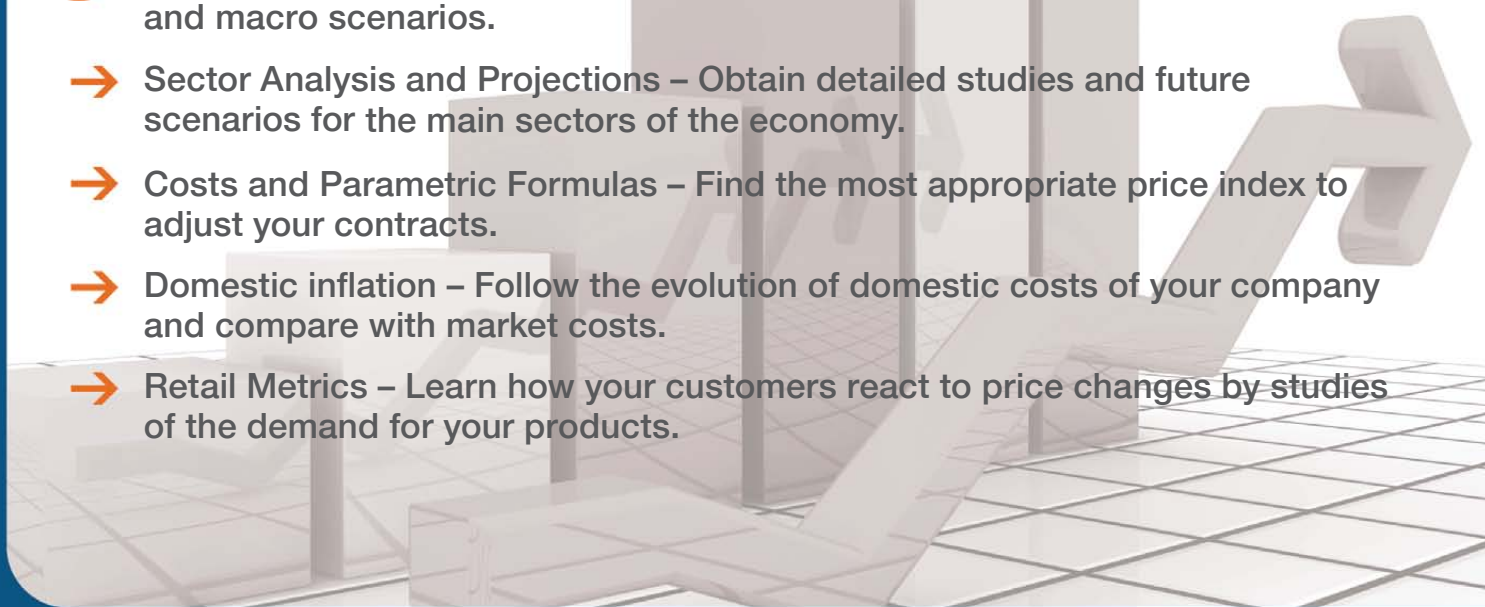
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April 2011

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- Research and Management of Reference Prices – Learn the average market price of a product and better assess your costs.
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Why investors shy away from Brazil

SOME PEOPLE LOVE SURPRISES. Investors are not among those people. They prefer predictability. They look for investments that give them some reassurance that they can earn a decent return. Domestic or foreign, they do not expect perfect predictability, but they do want to have some confidence that they're not throwing their money away. And it's not hard to see why in recent years they have not been particularly interested in investing in Brazil. Brazil's meager economic growth in the last few quarters can be directly attributed to a dearth of investment.

The reason investors no longer love Brazil is that they can have no idea what the government is going to do next to throw the economy off-balance. Who can? Even the administration doesn't seem to know. It surely must have been surprised by the results of some of its recent decisions.

For instance, last year the government decided to allow certain electricity concessions to expire several years early to reduce the rates charged to consumers. True, the concessionaires could choose not to let their contracts expire, but the decision (never thoroughly explained) was unnerving enough that utilities stocks tanked. With the same concern for consumers, and a lack of concern about and understanding of how business works, the administration took over Petrobras oil company's role in setting consumer fuel prices.

Today the value of Petrobras stock is barely half what it was a few years ago. That means the oil company doesn't have the operating income it needs to fund the infrastructure investments it needs without borrowing a great deal. (And, speaking of infrastructure, the government decision to ask private companies to invest in public infrastructure has not exactly been greeted with open arms by those companies.)

Then there was a decision to offer tax incentives to encourage Brazilians to buy flex-fuel cars. They did. Unfortunately, Brazil's ethanol producers were not able to achieve the volumes needed at prices that compete with gasoline—especially after gas price controls were introduced.

As former Minister of Finance Ernane Galvêas makes clear in the interview in this issue, "The government has frightened off entrepreneurs" with its unpredictability, which is heightened by its lack of transparency. It doesn't help that the central bank and the Treasury seem to have contrary ideas of what money policy should be. Should the goal be to control inflation? Or should it be to expand credit? The two choices lead in different directions. The administration has chosen both.

Investors aren't necessarily interested in what the administration says. They are looking at what it does. And that is not inspiring them to open their wallets.

There are plenty of things the government could do to promote growth and attract investment. It could, for instance, think ahead to the likely results before it makes a policy move. It could put together a task force to identify what can be done to reduce the Brazil cost—which has become such a common topic of conversation that it's no longer put in quotation marks. Or government leaders could just sit down together and map out a path to where they want the economy to go—and let us know what it is.

Investors aren't necessarily interested in what the administration says. They look at what it does. And that has not inspired them to open their wallets.

A new Tordesillas in Latin America?

João Augusto de Castro Neves, *Washington D.C.*

IN THE 15TH CENTURY AN imaginary line cut through Latin America. The Treaty of Tordesillas, signed in 1494, split the New World—as a matter of fact, the entire world—between the Spanish and Portuguese empires. In a way, the region has been divided ever since. Beyond the language difference, Spanish America broke into many nations while the Portuguese side remained united. Republics flourished on one side, a European-style monarchy endured on the other. In the last century or so, numerous attempts to gradually erase the line through integration projects have been hampered on both sides, either by suspicion or by hubris.

When it comes to trade relations, in the last decade the regional divide has been getting starker. Notwithstanding the bold rhetoric that usually surrounds the innumerable regional summits, integration is still relatively rare. Despite unarguable advances to diffuse regional rivalries, Mercosur, the Common Market of the South, is still beleaguered by constant trade disputes between member states. Unasur, the Union of South American Nations, is a union in name only. It has no real impact on trade flows. Other regional groupings, such as the Andean Community and the Bolivarian Alternative to the Americas (Alba), are either near extinction or never actually evolved from an embryonic stage.

In addition to the lack of institutional teeth in regional trade agreements and the plague of disputes from within, the currents of global trade are carrying the regional blocs in Latin America apart. While many countries in the region have signed free trade agreements (FTAs) with the world's major economies (the United States, the European Union, even China), Mercosur has signed only three FTAs outside the region: with Israel, Egypt, and the Palestinian Authority. Recent trade initiatives launched by the U.S., such as the U.S.-EU talks and the Trans-Pacific Partnership (TPP), may well exacerbate those trends as the U.S. draws the new Pacific Alliance (Mexico, Chile, Colombia and Peru) closer to its orbit.

As for Mercosur, part of the reason it lags behind when it comes to a more proactive trade agenda is the asymmetry of interests among its members. Four countries at different stages of economic development were recently joined by a fifth, Venezuela, with its interests mostly focused on oil and subject to the ideological whims of its leaders. Moreover, with Bolivia and Ecuador soon to join the South American bloc, its

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In addition to the lack of institutional teeth in regional trade agreements and the plague of disputes from within, the currents of global trade are carrying the regional blocs in Latin America apart.

external negotiating cohesiveness will certainly diminish dramatically. In this light, the soon-to-be-restored talks between Mercosur and the EU should be taken with a very large grain of salt.

But Brazil is also to blame. In the last decade, the lack of major trade deals signed by Brazil and Mercosur was overshadowed by high commodity prices and booming demand from China. While Brasília boasted record-high export numbers, the country's share in world trade was still relatively unchanged. Furthermore, targeted protectionism has been a key component of Brazil's policy response to an unfavorable economic environment. This not only sends a negative message to potential trade partners, it may also fuel demand for more protectionism from other Mercosur members. Not a very sound strategy for a country seeking to lead the region by example.

Is change possible? Can Mercosur move away from being a trade-protecting fortress to become a trade-promoting platform? Given the Brazilian government's current and growing concern with inflation, the announced intention to revise some of the recently implemented protectionist measures could slowly tilt trade policy to a more positive direction. In the longer term, as the global economic slowdown negatively impacts Brazil's export sector and trade surplus, the government will be pressed to take a larger view of its trade policy. Less favorable trade winds are already affecting Brazil's exports. The country's trade surplus in 2012 was 35% lower than the previous year (from US$30 billion to US$19 billion). Ultimately, Brazil could decide to either promote more trade liberalization within Mercosur, downgrade the bloc from a customs' union to a free trade zone, or leave the bloc altogether.

Until then, the dividing line in trade relations in Latin America will certainly become more visible, with one side being more open and revolving around the U.S. and the Pacific and the other, represented by Mercosur, stalled by protectionist measures.

Targeted protectionism has been a key component of Brazil's policy response to an unfavorable economic environment. This sends a negative message to potential trade partners.

Fuel price policy: Who wins?

Petrobras losses and stagnation in the ethanol market make it urgent to redefine fuel price policy.





Cláudio Accioli and Solange Monteiro,
Rio de Janeiro

INTERNATIONAL OIL PRICES are up, demand for oil products in Brazil is growing, but the main Brazilian oil company is suffering from lower production and profits. This is more than just a corporate problem. Two government activities make a potentially explosive mixture: an energy policy that sets actual fuel prices, and short-term policies to stimulate economic activity and control inflation.

Since 2002 Petrobras has had the legal right to set domestic prices for oil products. In practice, though, the government, still traumatized by past hyperinflation, has always restricted this prerogative in order to ease the weight of fuel on inflation. Until 2008 there was not much controversy about what the government was doing, but then came the global crisis. To avoid a sharp contraction of the Brazilian economy, the government encouraged the purchase of durable goods, especially cars, through more credit and a reduced tax on industrialized products (IPI). At the same time, it restricted prices of gasoline and diesel, an important input to agriculture, which in recent years has led the growth of the economy and Brazil's external trade surplus.

Two government activities make a potentially explosive mixture: an energy policy that sets actual fuel prices, and short-term policies to stimulate economic activity and control inflation.

PROBLEMS

Increased demand took producers of hydrated alcohol (ethanol) by surprise, just as productivity was falling. The shortage of ethanol and an inability to expand the supply of gasoline due to refining bottlenecks further aggravated demand for fossil fuel. After 2011, the country lost self-sufficiency in gasoline, and Petrobras had to import fuel, paying more than it could sell it for in Brazil. To make matters worse, there is no prospect that ethanol production will soon recover, since its economic problems were aggravated by the competition that arose from gasoline price controls, which turned away investors and led sugar cane producers to direct less production to ethanol.

"It's a vicious circle," says Marcelo Colomer, energy economics researcher at the Federal University of Rio de Janeiro (UFRJ). Colomer also points out that Petrobras has little investment capacity and is thus unattractive to investors, which tends to perpetuate the market distortions. "It is not clear whether the population really wins with the current strategy," he says. Experts agree that the country urgently needs a transparent pricing policy for fuels. "Currently, the government insists on episodic interventions that create domino distortions," says Maurício Canêdo, researcher at the Institute of Brazilian Economics (IBRE).

Alisio Vaz, president, Fuel Distributors Union (Sindicom), shares the concern: "For consumers and retailers, the market seems to be functioning, but on a wider view of the economy, there are distortions that harm Petrobras and ethanol producers." Vaz also notes that it is hard to project demand accurately without proper signaling of the relative prices of gasoline and ethanol, and clarity about the share of each in fueling flex-fuel cars. According to Sindicom, from 2009 through 2012 Brazil's gasoline consumption went up 57% and ethanol consumption dropped 41%.

"Any government intervention in the gasoline market interferes with the ethanol market because they are linked by consumption. This explains why the ethanol market has become disorganized, even though the government has not intervened in it directly," says IBRE's Canêdo. "The low price of gasoline may be a good buy for consumers but it says do not produce it to producers." It is no coincidence that Petrobras is the only private agent interested in investing in refining capacity in Brazil, and that the market for ethanol fuel has become unbalanced.



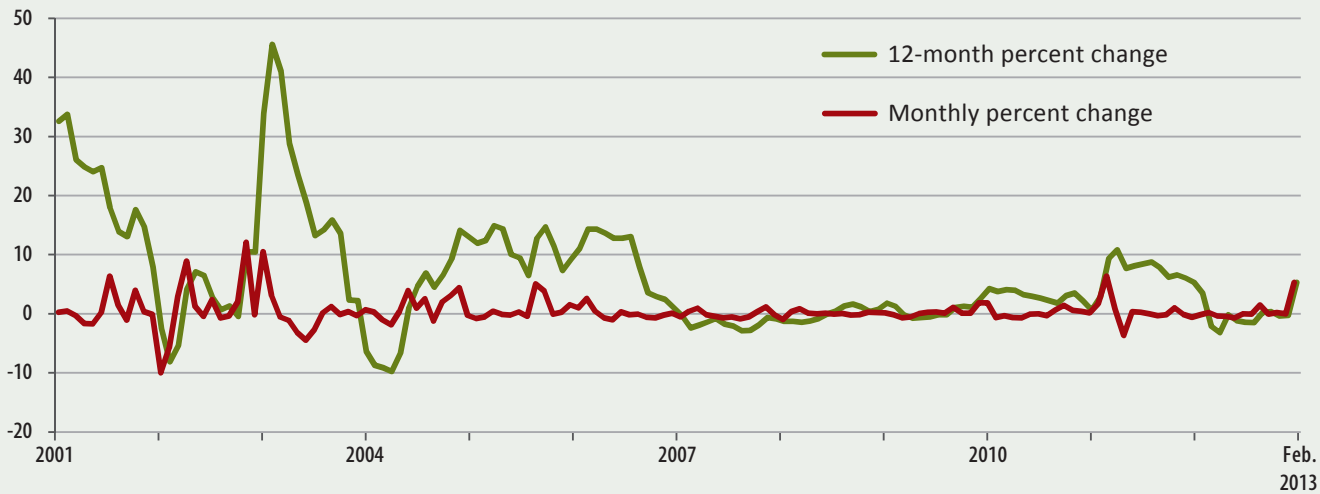
OLD HABIT

Using fuel prices as an instrument of economic policy is not new. Before the market was liberalized in the late 1990s, direct state intervention had a variety of different goals: keeping GDP growing after the first oil crisis (1973); bringing down demand to soften the second shock (1979); controlling inflation since 1985; and containing the public deficit after 1987. Former Finance Minister Ernane Galvêas (1980–85) explains, "In October 1973, a barrel of oil went from US$2 to US$10 [which] forced the government to redo the entire economic policy of import substitution and subsidies to industry," he says. To keep importing fuel , and to avoid suppressing economic growth, he adds, "The Ernesto Geisel administration opted to subsidize the balance of payments and borrow abroad to pay for it. In that period, the economy grew annually on average between 5% and 5.5%."

Galvêas recalls that "When the João Figueiredo administration took office, the price of oil shot up from US$10 to US$36. We had no resources, the country was in debt, and oil prices continued to rise. To curb imports, in the United States

Changes in gasoline prices in Brazil have virtually plateaued since 2007.

Gasoline prices, % changes



Source: Brazilian Institute of Economics (IBRE).

"Today, the government forces producers to sell gasoline and diesel below the international market price, generating cash-flow troubles for producers."

Adriano Pires

the Federal Reserve, led by Paul Volcker, significantly raised interest rates. This was a problem because high interest rates forced entrepreneurs to get rid of their inventory. In Brazil, exports plunged. We were hit by three shocks: oil, interest rates, and inventory adjustment. With the fall in exports, we had to reduce total imports almost by half. . . . It was the most difficult period in the economic history of Brazil."

That economic contraction did not affect Petrobras operations. Then the company was more focused on refining than on production; the profitability of gasoline, its most important product, far exceeded that of the other oil derivatives. "At the time, the government set prices for each fuel that were equal to or higher than the average of all prices of the refinery as a whole," said Adriano Pires, director, Brazilian Center for Infrastructure (CBIE). "Today, the government forces producers to sell gasoline and diesel below the international market price, generating cash-flow troubles for producers." He adds that currently gasoline and diesel together represent more than 60% of Petrobras revenues.

But the idea of fuel subsidies no longer fit into the new market opening scenario. "It was necessary to encourage Petrobras to compete with other companies, attract foreign investment, and encourage the construction of private refineries, export terminal, and pipelines in Brazil," says CBIE's Pires, noting that from 1998 to 2001, there was a transition phase in which the prices of all petroleum products were updated monthly, tracking the Persian Gulf oil price and the exchange rate. "It was pretty much the only time that Brazil followed the trends in the international market," he says.

NEW SCENARIO

Since 2002, the government, availing itself of the Petrobras refining monopoly, has had a policy of cushioning the effects of variation in international oil prices on domestic fuel prices. "Petrobras has operated taking into account the long-term evolution of prices, alternating between periods of gains and losses, keeping its cash flow balanced over time, and removing the perceived risk to shareholders," UFRJ's Colomer notes.

Until 2010, the oil price oscillations did not have much financial impact on Petrobras. Since then, however, the fuel market has become bipolar. On the demand side, the flex-fuel car fleet, growing thanks to tax incentives, has increased demand for fuels. On the supply side, fuel producers have not been able to respond to this growth in demand. Economic difficulties have affected investment and production of fuel ethanol, further swelling demand

for gasoline. The expected increase in fossil fuel production, however, was halted by Brazil's historic refining deficit. Colomer explains that "During the financial crisis of 2008, there were already some signs of trouble, but the alcohol sector managed to supply the market. In 2009, the downturn in economic activity reduced demand for fuels. However, with the beginnings of recovery in 2010 and a stronger economy in 2011, imports of gasoline increased significantly."

In this new scenario the gasoline trade balance moved from a surplus of US$1.8 billion in 2007 to a deficit of US$2.9 billion in 2012, and the diesel trade deficit widened from US$2.5 billion in 2011 to US$6.3 billion. "We have a structural problem with diesel, regardless of the international price; we have always imported this fuel. It is a peculiarity of our refining, which is not adapted to our demand profile and our transportation choices," Colomer believes.

Gradually, the policy of offsetting fuel prices has lost ground to a policy of mitigating the effect of the price changes on consumer price inflation. The difference between domestic gasoline and international fuel prices began to widen, directly undermining the Petrobras balance sheet. In 2012 the company reported a 14.15% decline in operating profit. The R$21.2 billion profit was the worst in eight years, down 36% from 2011.

INFLATION

According to Salomão Quadros, assistant superintendent, FGV Inflation, gasoline is one of the main items that influences the Consumer Price Index (IPCA), very close to household spending on electricity, medicines, and education. The last adjustment of 6.6% in refinery fuel prices reflected a 5% increase in retail prices, and about 0.19 percentage points in the IPCA. However, Quadros does not think the numbers justify government price controls: "These tricks are totally counterproductive. I am always in favor of a realistic approach. This type of micromanagement is also used to adjust the relative portion of anhydrous ethanol in gasoline. But it must be clear that if on one hand fuel is cheaper, on the other hand you are buying low-energy gasoline."

"The low price of gasoline may be a good buy for consumers but it says 'do not produce it' to producers."

Maurício Canêdo

Petrobras will have a difficult 2013. The recovery of the U.S. economy is likely to raise the price of oil above US$100 a barrel, which would widen the gap between international prices and Brazil's prices. That will also affect the company's cash flow, increasing its debt and risking the loss of its international investment grade rating. "The company operates with revenue far below potential. It is losing twice—by importing fuel at high prices and selling it domestically at lower prices," says Luiz Francisco Caetano, analyst at Planner brokerage. For 2014, the scenario is not

"If on one hand fuel is cheaper, on the other hand you are buying low-energy gasoline, a mixture of poor quality."

Salomão Quadros

very encouraging either, but the size and reputation of the company weigh in its favor, Caetano believes, so that Petrobras stock reacts quickly to any positive sign

With a management style that is far more pragmatic than her predecessor, Petrobras CEO Maria das Graças Foster has declared outright that the current fuel pricing policy is not sustainable, and that investment in refineries will resume only when Petrobras can afford it. The company projects that the current deficit of 300,000 barrels of gasoline and diesel a day will last at least until 2020, when new refining units come into operation. "Let's not forget that any investment in deep sea oil will require a payment of 30% from Petrobras," recalls the former minister Galvêas, crediting part of the problem to the new sharing contract model for oil exploration: "In the previous model, we attracted investments and technology, which allowed the first discoveries of deep sea oil. In the last five years, there has been no bid for new blocks, and oil production has stagnated at 2 million barrels a day. "

WHO PAYS THE BILL?

The private sector is not likely to invest in Petrobras projects, especially in refining. UFRJ's Colomer says, "There has to be at least a sign that the long-term trend of cash flow is positive"—rather than the current context of inflationary pressure and high taxes.

Pires of the CBIE identifies the issue as the fact that "there is no fuel price policy in Brazil." He believes the government's recent 5% increase in diesel prices, which made Petrobras shares rise, surprised the market—"and there is surprise only because there is no transparency," he says. Despite the adjustment, he estimates that the gasoline price is still 16% less than the international price and diesel is still 15% behind. Quadros agrees: "If the government is not letting the market set prices, and [is trying to] prevent transmission of the volatility of international prices to the economy, it is essential to set a clear rule." He calls attention to the fact that Petrobras regularly adjusts the prices of other petroleum products that have less weight on inflation, such as jet fuel.

The million-dollar question is: who pays the bill? The consumer? A new state fund? Petrobras? For Pires, the best alternative would be for the company to exercise its prerogative to set prices that it was given in 2002. An inferior alternative, he says, is for the government to recognize that Petrobras is losing money on the fuel it has to import and compensate the company. "It's still a bad choice, but better than the situation we have today," Pires says. IBRE's Canêdo adds that if the true costs were made explicit, "Brazilians will be able to evaluate whether it's appropriate to transfer billions of dollars a year to car owners."


Photo: Tânia Rêgo/Agencia Brasil

Maria das Graças Foster

Petrobras still committed to investment

The Brazilian Economy talks with Maria das Graças Foster, CEO of the state-owned oil company.

Solange Monteiro, Rio de Janeiro

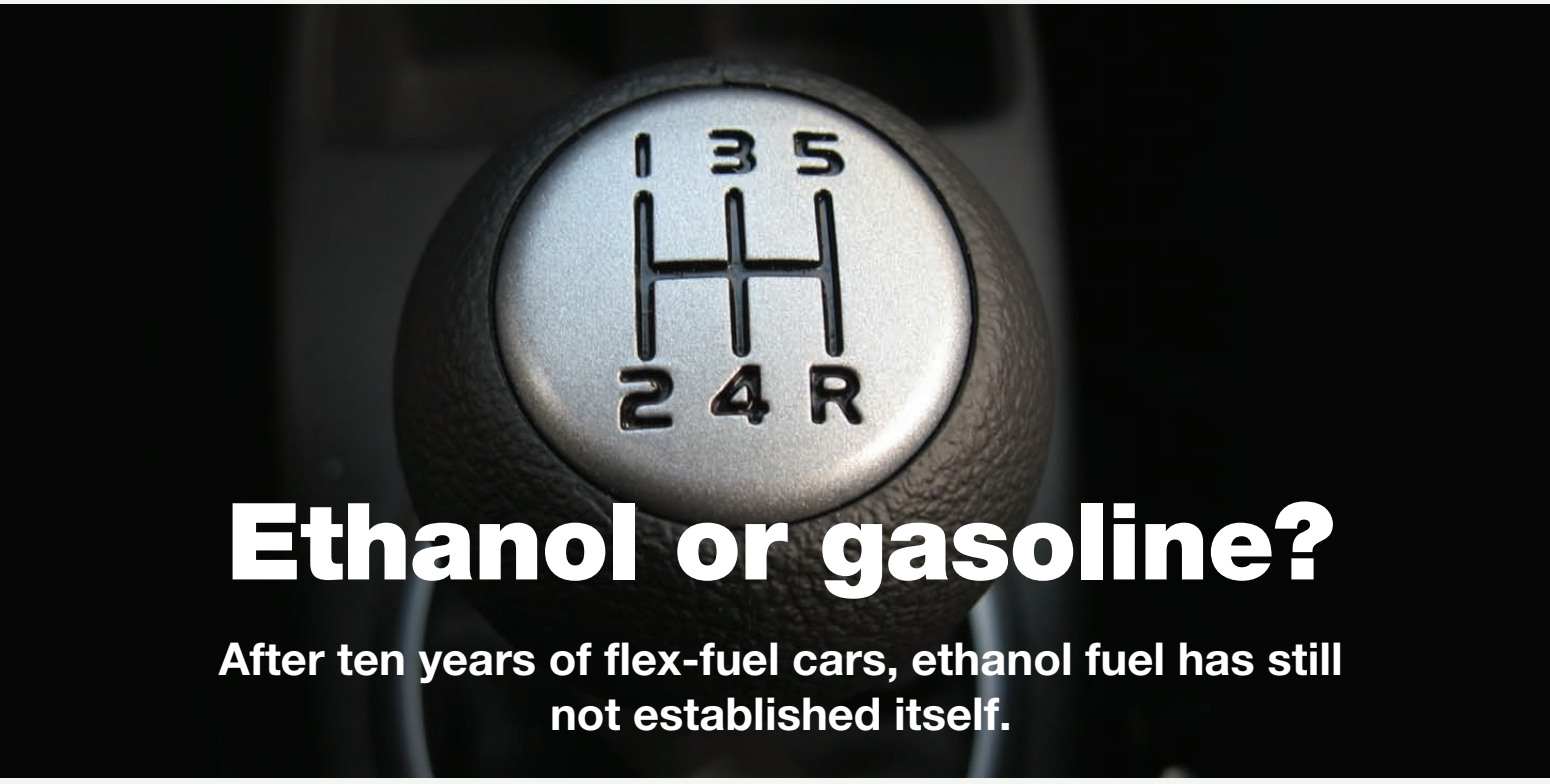
THE MARKET HAS SEEN a downturn in Petrobras investments, reflected in the significant drop in the company's results. How do you expect to keep attracting investors and prove that Petrobras is viable?

We are not pulling out of investment. On the contrary, investments have been increasing: In 2012, they were US$42 billion, 16% more than in 2011. The Petrobras Business Plan for 2013 provides US$49 billion for investment. With regard to resources for investment, the viability of the Petrobras Business and Management Plan for 2012–16 will be guaranteed by cash flow from operations, borrowing US$80 billion, and selling US$15 billion in assets. Equally important to the viability of our business are management programs established in 2012: the Program of Operating Cost Optimization (Procop), which will potentially save US$16 billion by 2016; the Program for Increasing the Operational Efficiency of the Campos Basin (Proef), which seeks to ensure the reliability of our supply of peak oil through interventions and maintenance of oil rigs and undersea systems; and the Program of Logistics Infrastructure Optimization (Infralog), which will ensure integrated management of logistics projects for reducing the costs of investments that may save US$1.6 billion by 2016.

Brazil's current fuel pricing policy has been blamed for discouraging development of the market for hydrous ethanol. As indirect control of fuel prices continues, what can be done to stimulate the domestic market for ethanol?

The recent adjustment of gas prices and increase of alcohol added to gas from 20% to 25% last May has created conditions for making ethanol more competitive. For 2013, the outlook is for a bigger and better harvest of sugarcane and therefore lower costs, which will help improve sector competitiveness. The projected increase in the volume of ethanol in the Brazilian market is about 26 billion liters (6.9 billion U.S. gallons). The government is also working on new measures, more structuring, to improve the environment for investment in the sector.

Since 2009, Petrobras has been investing in ethanol production and plans for growth and investment in the sector through three affiliates, Guarani, New Frontier, and Total. In 2013, ethanol production is expected to increase by 28%. The goal is to produce 1.1 billion liters (0.3 billion U.S. gallons) in 2013, a significant jump from the 0.2 billion liters in the previous harvest. Petrobras continues to focus on efficiency and reducing production costs. It also invests in technologies to increase productivity from second-generation ethanol produced from sugarcane bagasse, which would increase production from the same planting acreage by 40%.



Ethanol or gasoline?

After ten years of flex-fuel cars, ethanol fuel has still not established itself.

Solange Monteiro, *Rio de Janeiro*

WHEN THE FIRST FLEX CAR HIT the streets in March 2003, it was a real innovation that the driver could choose between gas and ethanol without having to change the car. Ten years later, however, although spurred by tax reductions considerably more flex cars have been sold in recent years, the large fleet has not been able to establish a solid position for ethanol as a fuel because it costs more than gasoline.

Government price controls on gasoline were a major factor in ethanol's fall from grace. Without a clear policy that defines the share of ethanol in the fuel market and maintenance of the relative price between ethanol and gas, the ethanol industry will not be able to invest in more sugarcane processing capacity, which could be exhausted in two years.

"If the rules of the game had not changed, Brazil would not be importing gasoline, investments would continue, and the sector would be producing a few billion more gallons of ethanol," says Antonio de Padua Rodrigues, technical director, Union of the Brazilian Sugarcane Industry (UNICA). Between 2004 and 2008, the sector attracted US$60 billion in investments. At that time, gasoline prices in Brazil and in the international market were somewhat equivalent and there were domestic taxes on importing and marketing oil and oil products. When it was created in 2001, the gas tax was US$0.25 a gallon, but starting in

2004 it was gradually reduced to US$0.14, and by June 2012 the tax on both gasoline and diesel oil had disappeared in order to offset the high fuel prices and tamp down inflation. "Now," says Rodrigues, "we need to know . . . which public policies will be adopted to ensure that the ethanol share is preserved. The policies must be defined so that an entrepreneur who invests R$ 1 billion in an ethanol plant will know that in 20 years the investment will be repaid."



Photo: Tadeu Fessel/Unica.

GOING BACKWARD

Plinio Nastari, president, Datagro Consulting, illustrates the fluctuation in the ethanol share of the fuel market: "In 1988, the share of ethanol in automobile fuel consumption was 57%; from 1988 to 1996, the share fell to 37%. From 1996 to 2010, it rose to 45%, mainly because of the flex car fleet. But in 2012 the average fell to 32%." He says other countries using ethanol have



Photo: Tadeu Fessel/Unica.

Flex-fuel cars account for 87% of all sales.

Sales of light commercial vehicles by type of fuel, in thousand units.

	Gasoline	Ethanol	Flex-fuel	Diesel
2002	1,283	56	-	64
2003*	1,152	36	48	55
2004	1,077	51	328	66
2005	697	32	812	77
2006	316	2	1,430	83
2007	246	0.1	2,003	92
2008	217	0.1	2,329	125
2009	222	0.1	2,652	135
2010	281	0.1	2,876	172
2011	377	0.1	2,848	200
2012	274	0.1	3,162	197

Source: National Association of Vehicle Manufacturers (Anfavea).
* Flex-fuel cars began to be produced in 2003.

not seen a decline. "In the United States, the goal is to reach an alcohol share of 20% in 2022, against the current 10%. In Europe, the goal is to increase alcohol share from the current 3.4% to 10%."

Today, because the price of ethanol is not competitive, its market is limited to the states of São Paulo, Goiás, and Mato Grosso, where state tax incentives make its pump price attractive. Unica's Rodrigues points out that the global financial crisis in 2008 affected the sector: "At that time, investments were maturing. The crisis hit the extremely indebted ethanol industry hard. To survive, companies had to reduce farming expenses, which meant less agricultural activity." In addition, adverse weather caused crop failures, and mechanized harvesting further reduced productivity. Exchange rate appreciation and price rises for the carbon steel used in ethanol plants also raised production costs. Nastari offers an illuminating comparison: "Ten years ago production cost US$0.17 cents a liter, today it's about US$0.50 cents."

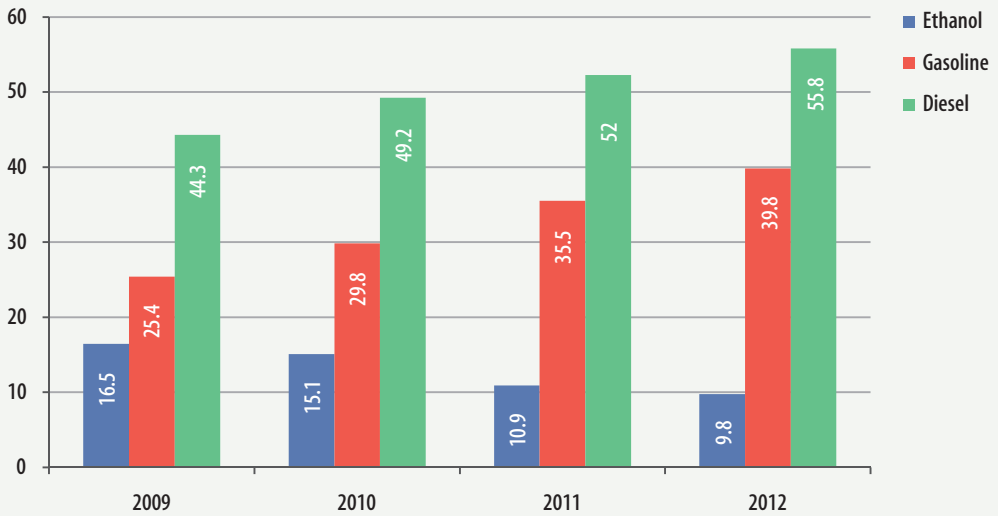
> **"If the rules of the game had not changed, Brazil would not be importing gasoline, investments would continue, and the sector would be producing a few billion more gallons of ethanol."**
>
> *Antonio de Padua Rodrigues*

Even with crop productivity gradually recovering and costs being reduced, the



Consumption of gasoline has increased by 26%, while ethanol has fallen by 40%.

Billions of liters



Sources: National Association of Distributors of Fuels and Lubricants (Sindicom) and National Petroleum Agency (ANP).

future of ethanol depends on the opportunity cost between ethanol and sugar, the price of which is set in the international market and can be hedged with contracts in the futures and commodities market.

Today, because the price of ethanol is not competitive, its market is limited to the states of São Paulo, Goiás and Mato Grosso, where state tax incentives make its pump price attractive.

PRICE CONTROLS

Mirian Bacchi, researcher and professor, School of Agriculture Luiz de Queiroz (Esalq-University of São Paulo), points out that alcohol has not escaped price controls. She explains that "The government issued a resolution late in 2011 that 90% of purchases of anhydrous ethanol by distributors should be through contracts, establishing the price of hydrous ethanol as a price indicator plus a value premium of 13% on average depending on quality." She adds that ethanol profitability is very dependent on gas pricing policy.

Bacchi is aware of the concerns about inflation that motivates fuel price controls but says that "both the state-owned oil company and the ethanol producers are being penalized," and stresses that "the fact that society is benefiting from low fuel prices and inflation may mean that in future there will be no growth." Government incentives to support innovation, including in the sugar cane sector, are important, Bacchi says, but innovation takes time. She argues that the only way to reduce costs is to eliminate the taxes on ethanol production now.

According to Rodrigues, "We will not solve anything relieving three or four cents now without knowing what will happen after tomorrow." Dialogue with federal government officials continues, and Rodrigues says, "There is full knowledge in the various ministries; everyone knows that you need a solution, but the government makes the decisions. [Meanwhile,] we are working to reduce costs, increase productivity, and invest in logistics and research to double or even triple the amount of ethanol produced per hectare." Yields are starting to exceed 78,000 metric tons per hectare, compared to the previous 70,000.

The issue is delicate, since not all producers in the sector can afford to wait through the medium term for policy changes. In recent years, of the 400 sugar cane mills in Brazil, 40 were closed and another 10 will soon stop producing. "We have to find a solution to stop the closure of production units," Rodrigues says. To achieve these objectives, he knows, the market for ethanol should be strengthened—and that depends on a good relationship with the consumers who decide how to fuel their cars.

"The government has frightened off entrepreneurs"



Ernane Galvêas

Former Finance Minister, now consultant to the National Commerce Confederation

Cláudio Accioli, Rio de Janeiro

Breach of contracts, disregard for grandfathered rights, legal uncertainty—former finance minister and former central bank governor Ernane Galvêas ascribes the decline of investments that has inhibited Brazil's economic growth to the "excessive burden" of government intervention in the economy. "The government has frightened off private entrepreneurs, both national and foreign," he says. Now economic advisor to the National Commerce Confederation (CNC) and a member of the Board of Getulio Vargas Foundation (FGV), Galvêas also criticizes what he sees as a contradiction: while the Central Bank is charged with containing credit to control inflation, the Treasury does the opposite, expanding the credit operations of state-owned financial institutions. "There are two monetary policies in Brazil."

***The Brazilian Economy*—Recent data for 2012 show that the Brazilian economy continues to struggle to grow. To what do you attribute this situation?**

Ernane Galvêas—The main cause of this worrying loss of drive in the Brazilian economy is the lack of productive investment. Without investment, there is no economic growth. For over 10 years, there has been great concern to redistribute income to reduce social inequalities. However, the government does not have enough money to invest in both social programs and the economy at the same time because it struggles with a permanent fiscal deficit . . . . The emphasis on social programs has led to a neglect of investment. Several quarters of falling investment have produced meager GDP growth. Although it is in crisis, the United States has been growing more than 2% a year; Brazil, which is not in crisis, is growing at less than half that. Recently, the government announced ambitious infrastructure projects of R$486 billion (US$243 billion), but I don't think it has the resources to get them done. Right now, Finance Minister Guido Mantega is doing a road show in New York to demonstrate to foreign investors that Brazil is a fertile field for investments in infrastructure. He will also contact the World Bank and the Inter-American Development Bank to

try to get funding for these projects. But … I have serious doubts that the advertised programs can really happen in 2013 and 2014.

Why is the private sector reluctant to invest in Brazil?

The government has frightened off private entrepreneurs, both national and foreign, with its excessive intervention in the economy. It has disregarded grandfathered rights, broken contracts, and created a climate of legal uncertainty by taking measures that changed transport and energy policy.

The first intervention was disastrous for the oil industry. The government adopted the sharing contract model for oil exploration, effectively making Petrobras responsible for all new oil exploration concessions, since Petrobras has mandatory participation of 30% in all future oil exploration projects. . . . As a result, for five years there have been no new oil well auctions in Brazil, and Petrobras is producing less than it did two years ago. The government has also been controlling Petrobras prices to contain inflation . . . . More or less the same thing has occurred with regard to electricity. By anticipating in 2013 expiration of concession contracts maturing in 2015 and 2017 in an attempt to reduce the rates charged to consumers, the government disrupted the entire system, causing a fall in the stock prices of the large power companies, as with Petrobras, which today are worth less than half what they were worth two or three years ago. The government is now announcing a series of programs that will affect Eletrobras Furnas and other companies, but investors are reluctant to accept the legal uncertainty that shapes the present scenario. Because dissatisfaction and uncertainty affect investments, they affect economic growth.

The main cause of the worrying loss of drive in the Brazilian economy is the lack of productive investment. Without investment, there is no economic growth.

Still, the Brazilian labor market continues buoyant, with very low unemployment. How would you explain this apparent paradox?

It is difficult to explain, especially since industry is not growing. We have the lowest unemployment rate in the history of the country, around 5.5%. … IBRE researchers have suggested that, because of a shortage of qualified professionals, companies are trying to hang on to their best workers and wait for a possible economic recovery rather than incurring the costs of rehiring and training them when there may be more competition for them. However, if you check the statistics, there is considerable volatility in labor markets. … There has been a huge movement between hiring and dismissals, sometimes millions of workers changing sides. The result has for now been a net increase in employment, but volatility is very high.

Is this oscillation also to be seen in commerce?

Commerce grew 9% last year and is expected to grow by about 7% to 7.5% this year . . . . There has been a structural change in the sector, represented by the growth of shopping centers and supermarkets in recent years. It is a new configuration as commerce moves from the streets to shopping malls and super or hypermarkets, which employ a lot of workers. The service sector has also shown significant development, especially production of goods related to technology, globalization, and transmission of scientific knowledge, which does not depend on government policies. Another sector growing fast is tourism—travel, air and land transport, hotels and inns.

Recently, the government announced ambitious infrastructure projects of R$486 billion (US$243 billion), but I don't think it has the resources to get them done.

What about the recovery of industry?

The share of Brazilian industry in GDP has declined for a number of reasons, including loss of a significant portion of the foreign market. … High interest rates, an appreciating exchange rate, a lack of credit, and poor infrastructure have done much to weaken industry. … Brazilian industry works with an advanced level of technology, similar to North American or European levels. But it has suffered from the economic constraints and, of course, intense international competition, especially from China. The Chinese have taken markets aggressively, at first catching everyone off guard. They took many markets from Brazil [and have] penetrated Brazil's domestic markets, selling textiles, footwear, toys, and manufactures of all kinds. Brazilian industry has really been squeezed, although today, I believe, it has stabilized.

In this scenario of low growth, is inflation over 6% a year worrying?

What is the nature of inflation in Brazil today? Is it driven by demand, supply, wages, government spending? Without a correct diagnosis, it is difficult to talk about measures to fight it . . . . I believe inflation will tend to remain above 6% because of the budget deficit and wage policy. Wages are being adjusted in real terms by more than inflation, and this is clearly itself inflationary. At the same time, we have an expansion of credit that is incompatible with a low inflation rate. Credit grew 19% in 2011 and 16% in 2012. With credit expanding at these rates, how can inflation be 4.5%? Add to this situation the Brazil cost, which not only weighs a lot but has risen, particularly in the transport sector. And there arises a curious contradiction: if there is inflation, we must fight it with fiscal policy but even more so with monetary policy. But what monetary policy? … There are two monetary policies in Brazil. The Central Bank is trying to contain credit to avoid creating demand

inflation. Meanwhile, the government, through the Treasury, does exactly the opposite, expanding the credit operations of state-owned banks and stimulating borrowing from abroad.

The government has frightened off private entrepreneurs, both national and foreign, with its excessive intervention in the economy.

As a former central bank governor, do you think the Central Bank should act more firmly to control inflation?

Of all Brazilian institutions, the Central Bank is best prepared to respond to changes in the economy. But the Central Bank is still government, and cannot deviate from the government's goals. Lowering the policy interest rate was a very important decision. But it was not a Central Bank decision. Until 2009, there was great resistance to reducing the policy interest rate . . .. Later, President Rousseff ordered lower interest rates . . . . Today, many economists are advocating a rise in interest rates to contain inflation [but that] would stir up inflationary expectations . . . .The policy interest rate is in the right place at 7.25%. The key to controlling inflation is to correct the fiscal deficit, the wage policy and that excessive expansion of credit.

What is the outlook for the international economy in 2013?

That is completely dependent on China. Its entry into the world market in 1990 boosted demand and prices of manufactured goods, raw materials, food, and fuel. … At first, it brought huge benefits for all emerging countries and oil producers. Now the picture has changed because China is itself a major producer of heavy equipment for industry, oil rigs, and ships as well as information technology and communications. The World Trade Organization and the Organization for Economic Cooperation and Development expect international trade to grow about 2% this year and next, [and] China accounts for most of the expansion. I have the impression that China will no longer be able to grow 10% or 11% a year, but 7% growth should be enough to sustain the volume of Brazil-China trade.

What about the United States and the Eurozone?

The United States is slowly recovering . . . . If it develops shale gas faster and becomes self-sufficient in fuel, we will witness the beginning of a revolution whose consequences we cannot yet assess. That could frustrate Brazil's plans to export to the U.S. the deep sea oil it produces.

The main problems for the Eurozone are the fiscal deficit, companies' lack of confidence to invest, and high unemployment. Average unemployment is about 16%, including France, Germany, Belgium, and Holland. In countries like Portugal, Spain, Greece, and Italy, it reaches 26%. It's a desperate situation: you need to invest, but

the government has no resources and the companies have no confidence; without investment, there are no jobs and no consumption. It can become chronic. Many people think that Europe's problem will take several years to resolve.

Because dissatisfaction and uncertainty affect investments, they affect economic growth.

Wages are being adjusted in real terms by more than inflation, and this is clearly itself inflationary.

Back in Brazil, do you believe that 2013 will be better than 2012?

A little better, mainly because of the expected expansion in agriculture, which does not employ a lot of workers but creates demand for tractors, trucks, fuel, etc. . . . Some of the government's infrastructure projects may take off, generating better growth prospects for 2013 and 2014. It is also good to remember that we are entering an election period, during which the government traditionally spends more on travel, advertising, and projects . . . . The economy will improve, but there won't be a growth explosion.

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Expectations continue to improve in Latin America generally as well as in Brazil.

Lia Valls Pereira

Center for International Trade Studies, IBRE

THE JANUARY 2013 ECONOMIC CLIMATE INDICATOR for Latin America (ICE-AL) continued the trajectory of improvement that started in October 2012. The month's indicator was 0.2 percentage points above the 10-year average for January. The improvement was caused by an increase in the Expectation Indicator (IE-AL) that more than offset a slight worsening of the Current Situation Indicator (ISA-AL).

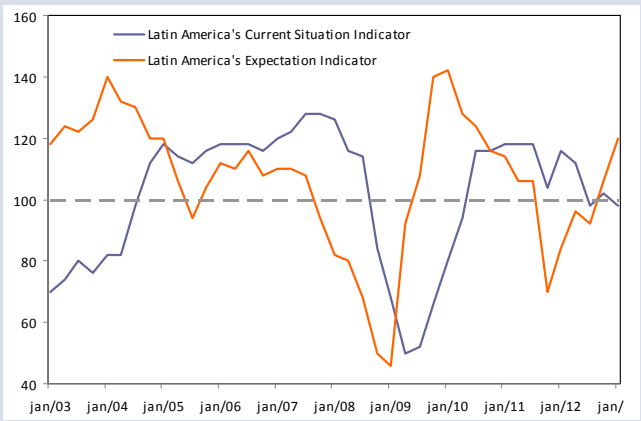
The Economic Climate Indicator improved in six Latin American countries; the change was particularly noteworthy for Paraguay, Peru, Chile, and Uruguay. In Paraguay, expectations went from an unfavorable to a favorable outlook. In Peru, both the current situation and the expectations indicators improved and the country's economic cycle moved from decline to boom. The same occurred in the indicators for Uruguay. In all these countries, exports of commodities have made major contributions—above 20%—to output growth; the prospect of an increase in 2013 in world trade and in Chinese production are helping to improve the business climate.

The Economic Climate Indicator fell in Bolivia, Brazil, Ecuador, and Venezuela, but the outlook for Bolivia and Brazil remained favorable. In Brazil, the already unfavorable assessment of the current situation indicator dropped a little. The worsening of the current situation outlook was associated with consumption, while the worsening of expectations was associated with a slight deterioration in the investment outlook. Because prospects for the trade balance are also deteriorating, Brazil's economic cycle is still in the recovery phase.

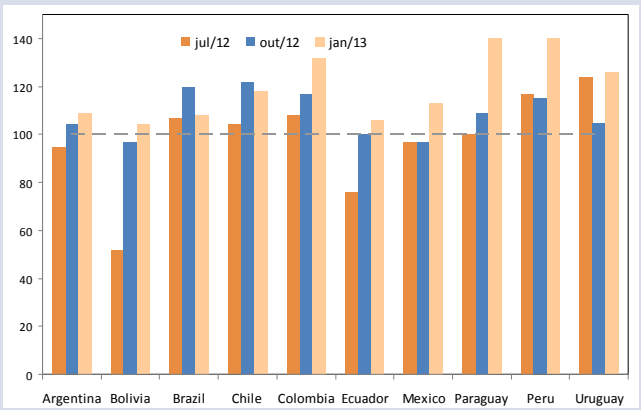
In Brazil, expectations at the beginning of 2013 are more favorable than they were a year ago. However, there has been a clear deterioration in how the present situation is assessed. It is possible that the results at the end of 2012, which confirmed how little the Brazilian economy had grown, led to a pessimistic assessment of the current situation as 2013 started. At the same time, expectations of a more favorable international outlook, a wave of new investment associated with major sport events (the World Cup, the Olympics), low interest rates, and a more competitive exchange rate may have led to a more optimistic outlook on the future. This suggests Brazil's economic performance should improve in coming months.

The Economic Climate Index is a quarterly survey conducted by the German Ifo Institute for Economic Research—Ifo World Economic Survey (WES)—and the Getulio Vargas Foundation The ECI is an average of the current situation and expectations for the next six months based on experts' answer to questions on key macroeconomic data (consumption, investment, inflation, trade balance, interest and exchange rates). The indicators are weighted by the share of trade of each country in the region. http://portalibre.fgv.br/main.jsp?lumChannelId=402880811D8E34B9011D92BBCC431F08

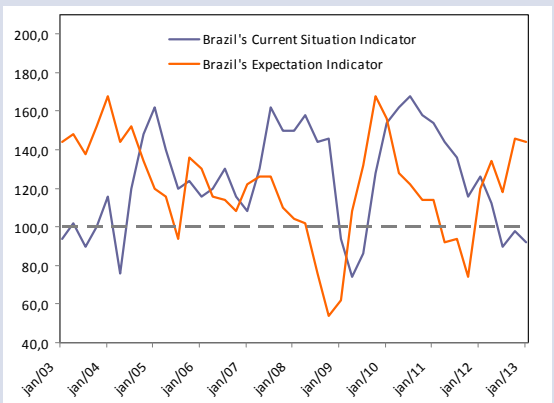
The Economic Climate Indicator for Latin America improved mainly because of better expectations.



The Economic Climate Indicator improved in six Latin American countries.



More favorable expectation suggests Brazil's economic performance should improve in the coming months.



Source: Ifo-FGV Latin American Survey.

2013: What can go wrong? What may go right?

IN 2012 ANNUAL GDP GROWTH WAS only 0.9%. The rate for the last quarter was just 0.6%. Yet at least some of the economic indicators released early this year surprised positively. Among the positive indicators were growth in industrial production in January, 2.5% month-on-month seasonally adjusted, and the continued low unemployment rate, 5.6% seasonally adjusted—the same as in December.

Among the negative indicators, inflation took the spotlight: the National Index of Consumer Prices rose 0.6% in February, far above what was expected. The rise came in spite of the lowered electricity rates and the postponement of adjustments to bus fares in Rio and São Paulo cities. Even inflation of the prices of manufactured products (excluding food)—a group in which tax cuts helped to reduce inflation in 2012—has started to pressure consumer prices, partly because the temporary tax cuts ended.

Growth in the first quarter will be good, but growth in the following quarters may not necessarily keep pace with it. Specific factors, such as the significant increase in production of trucks and buses, contributed to the growth in industry in January, but so far there is not enough information to support continuation of growth at this level. In addition, surveys by the government statistics agency, IBGE, show that the various sectors of the economy are still proceeding cautiously.

We have revised the GDP growth projection down to 2.7% from our forecast in December of 2.9%; that is short of most market forecasts. Undoubtedly, growth in 2013 will be better and more robust than in 2012, but a growth rate of 4% is not yet on the radar.

We are forecasting 2013 inflation at 5.9%, slightly higher than our December forecast of 5.7%. Even with the slowdown in food price inflation and with government-controlled prices, other items are expected to keep up the pressure, especially the rising prices of industrial goods and services inflation.

However, there is one major change in our outlook: We anticipate that the central bank will in the first half of the year begin a new cycle of monetary tightening and will raise its policy interest rate to 8.75% by the end of 2013. The deterioration in the inflation outlook, even with the economy gradually recovering, prompted the central bank to put inflation at the center of its concerns, it appears from the minutes of the March 6 monetary-policy meeting. A new tightening cycle will likely not have a significant effect on inflation this year but will be crucial to contain the spill—over of inflation expectations to the economy and prevent inflation from breaching its target ceiling of 6.5% in 2014. The downside is that higher interest rates will affect growth next year, and we may repeat 3% growth in 2014.

Brazil: IBRE baseline scenario, 2009-2013

	2009	2010	2011	2012	2013 March Proj.
Real GDP growth (% change)	-0.3	7.5	2.7	0.9	2.7
Inflation (% change)	4.3	5.9	6.5	5.6	5.9
Central Bank policy rate (end-period, %)	8.75	10.75	11.00	7.25	8.75
Exchange rate (average, Reais per U.S. dollar)	2.0	1.8	1.7	1.9	2.0
Budget primary surplus (% of GDP) [1]	2.1	1.9	3.2	2.3	1.5
External current account balance (% of GDP)	-1.5	-2.3	-2.1	-2.2	-2.7
Trade balance (US$ billions)	25	20	30	18	16
Export (US$ billions)	153	202	256	244	254
International reserves (US$ billion)	239	289	352	378	390

Source: Brazilian Institute of Geography and Statistics, Central Bank of Brazil, IBRE staff projections.
[1] Excludes interest payments on public debt.